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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/66-1

9:30 a.m., July 16, 2018

1. Euro Area—Policies

Documents: SM/18/171 and Correction 1, and Correction 2; and Correction 3; and Supplement 1; SM/18/175; and Correction 1; and Correction 2; SM/18/180; and Correction 1

Staff: Aiyar, EUR; Pradhan, EUR, Hardy, MCM; Bredenkamp, SPR

Length: 1 hour, 25 minutes

Executive Board Attendance

C. Lagarde, Chairman

Executive Directors	Alternate Executive Directors
M. Mkwezalamba (AE)	
D. Sembene (AF)	
A. Armas (AG)	
	C. Barron (AP)
A. Tombini (BR)	
Z. Jin (CC)	
C. Hurtado (CE)	
N. Horsman (CO)	
	C. Just (EC)
	A. Castets (FF)
S. Meyer (GR)	
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
M. Kaizuka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
A. De Lannoy (NE)	
T. Ostros (NO)	
	A. Tolstikov (RU), Temporary
H. Alogeel (SA)	
J. Agung (ST)	
M. Panek (SZ)	
	V. White (UK)
M. Claver-Carone (US)	

H. Al-Atrash, Acting Secretary
P. Cirillo, Summing Up Officer
L. Briamonte, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: Kenneth Henry Kang, K. Kang. Communications Department: Andreas Adriano, Marjorie Henriquez, Rhoda Lethea Weeks-Brown. European Department: Shekhar Shankar Aiyar, Nathaniel Gunn Arnold, N. Arnold, B. Barkbu, Bergljot Bjornson Barkbu, Ashok Vir Bhatia, A. Bhatia, Enrica Detragiache, Daniel Oliver Garcia Macia, Annette Kibuuka Kyobe, Julie Ann Kozack, J. Kozack, Li Lin, Srobona Mitra, S. Mitra,

Laura Papi, Anne Charlotte Paret Onorato, Mahomud Abdulrasul Pradhan, M. Pradhan, H. Qu, Haonan Qu, Andrea Schaechter, Xiaobo Shao, Jesse Brooks Siminitz, Poul Mathias Thomsen, A. Weber, Anke Weber. Fiscal Affairs Department: Hatice Elif Ture, H. Ture. Independent Evaluation Office: Charles V.A. Collyns, Jianping Zhou. Legal Department: Wolfgang Patrick Bergthaler, W. Bergthaler, Maike Berit Luedersen, David Ian McDonnell, Jonathan Talusan Pampolina. Middle East and Central Asia Department: Allison Mary Holland, Boaz Nandwa, B. Nandwa. Monetary and Capital Markets Department: Tobias Christof Adrian, Atilla Arda, Martin Cihak, M. Cihak, U. Das, Udaibir Saran Das, Selim Ali Elekdag, Jennifer Eileen Elliott, J. Elliott, Daniel C. Hardy, Dermot James Monaghan, James H. Morsink, J. Morsink, Fabio Massimo Natalucci, Laura Maria Valderrama-Ferrando, Frouke Wilhelmina Wendt, F. Wendt, F. Xavier Dezouzart Drummond Melo, Fabiana Xavier Dezouzart Drummond Melo. Office of Budget and Planning: Daniel Alan Citrin. Strategy, Policy, and Review Department: H. Bredenkamp, Hugh W. Bredenkamp, Erik Jerker Goran Lundback. Executive Director: H. de Villeroché (FF), D. Mahlinza (AE), A. Mozhin (RU). Senior Advisors to Executive Directors: M. Choueiri (MI), N. Jost (NE), W. Kuhles (GR), T. Sitima-wina (AE). Advisors to Executive Directors: A. Arevalo Arroyo (CE), X. Cai (CC), D. Fadhel (MI), J. Garang (AE), J. Hanson (NE), G. Nadali (MD), A. Park (AP), B. Parkanyi (NE), D. Vogel (AG), K. Hennings (BR).

1. EURO AREA—POLICIES

Mr. Meyer submitted the following statement:

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

The authorities of the euro-area Member States and the EU Institutions are grateful for the open and fruitful consultations with staff and for their constructive policy advice. The authorities are in broad agreement with the findings and recommendations in the Article IV staff report and Financial System Stability Assessment. We welcome the acknowledgement of the progress achieved in institutional and risk-reduction reforms, while agreeing that risks have heightened recently in some areas and the work is far from done.

Let me refer to these two reports in turn:

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

Economic Outlook

The authorities concur with the staff's assessment that economic growth remains strong, broad based and job friendly, even though underlying inflation has been subdued. Steady job creation underpins the robustness of the recovery while wage growth remained below 2 percent for most of the last six years. As highlighted by staff, the euro area is still reaping the fruits of wide ranging policy efforts but most recent readings suggest that the recovery has passed its peak. Our real GDP growth projections for 2018 and 2019 are in fact very much aligned.

We agree with staff that downside risks have heightened significantly since last year. Yet, we believe that staff's assessment of the likelihood and impact of those risks does not take sufficiently into account the euro area's achievements and commitment to reforms and sound policies.

As regards Brexit, the authorities agree that the uncertainty surrounding the final outcome of the negotiations represents a downside risk. Addressing this would require negotiations to progress faster, and it should be understood that it is not possible to maintain all the current benefits while leaving the EU regulatory, supervisory, enforcement and judiciary framework. We agree that Brexit will have a negative macroeconomic impact for both the EU and the UK, albeit disproportionately larger for the latter and for some Member States. At the same time, we must caution against the estimates produced by staff, as these are highly speculative and suffer from important modeling limitations.

Our assessments of medium-term growth prospects are very much aligned. Potential growth is expected to ease amidst demographic changes, weak productivity growth and crisis legacies, including ongoing private sector deleveraging in some countries. This calls for responsible and growth-friendly fiscal policies, rebuilding buffers, prioritizing investment, and improving the quality of public expenditure and revenues. Stepping up the implementation of structural reforms will also be important to enhance productivity and reduce vulnerabilities.

Monetary Policy and Inflation Outlook

With longer-term inflation expectations well anchored, the underlying strength of the euro area economy and the continuing ample degree of monetary accommodation provide grounds for confidence that the sustained convergence of inflation towards ECB's inflation aim will continue in the period ahead, and will be maintained even after the gradual winding-down of the net asset purchases. Underlying inflation has been increasing from earlier lows. However, the further build-up of domestic price pressures and headline inflation that we foresee over the medium term is still conditional on the support of a sizeable amount of monetary policy stimulus. This support will continue to be provided by the net asset purchases until the year end, by the large stock of acquired assets and the associated reinvestments, and by the enhanced forward guidance on the key ECB interest rates.

Fiscal Policies

The authorities agree with staff's assessment that the distribution of national fiscal policies differs from recommendations. Member States with high public debts need to increase their efforts to improve the sustainability of their public finances, while continuing to strengthen economic growth potential, taking advantage of the still robust growth while financing conditions are favorable. Conversely, Member States with stronger fiscal positions and external surpluses could prioritize investments to boost potential growth, as advised by staff, while preserving long term sustainability.

Consistent application of the fiscal rules continues to be warranted and, with negative output gaps finally closed according to most estimates, there may no longer be the same need – ceteris paribus – to use the flexibility provided by the fiscal rules, as done in 2018 to support the incipient recovery. We do not find sufficient recognition in the staff report that our public finances compare very favorably to those of other major jurisdictions, in aggregate, which can be partly attributed to the fiscal framework in place.

External Sector Policies

The authorities take note of staff's assessment of the euro area's external position, which is in line with the European Commission's. While much progress has been achieved among net debtor countries in correcting their external imbalances, large current account surpluses remain in some creditor countries. We agree that policy levers affecting the current account are mainly at the national level and that countries need to take steps in this regard. The main drivers are levels of savings relative to investment in the non-financial corporate and household sectors, although government balances also play a role, as highlighted in the report. The underlying determinants of savings and investment in the non-financial corporate and household sectors should be further analyzed to support more tailored policy advice. Further integrating financial markets and the broader EU single market, in the context of deepening of the Economic and Monetary Union, will also help to reduce imbalances among Member States.

Paragraph 43 in the staff report singles out external surpluses as potentially fueling protectionism in deficit countries. Within the current context of growing trade tensions, there is a risk that this over-simplified message could be misused to validate irrational policies.

The EU is unambiguously committed to free and fair trade and to international cooperation based on common rules. We underline the importance of preserving and deepening the rules-based multilateral trading system. The EU is committed towards its modernization and calls on all partners to contribute to this goal. At the same time, we firmly reject measures taken on spurious grounds for protectionist purposes. The EU will respond to all actions of a clear protectionist nature in full respect of WTO rules.

Deepening of the Economic and Monetary Union (EMU)

The authorities take note of the staff assessment of financial architecture and EMU deepening reforms. The Euro Summit agreed in June to progress towards completion of the banking union, to strengthen the European Stability Mechanism (ESM) and to discuss all other relevant items. Following the agreement on 25 May, the adoption of a package of measures aimed at reducing risk in the banking industry is expected before the end of the year. The ESM will provide the common backstop to the Single Resolution Fund (SRF) and will be strengthened. Differences of views remain on the issue of a common fiscal capacity. Discussions will continue on the European Commission proposal and on other recent ideas for a common fiscal capacity to support investment, convergence and stabilization.

Continuing our efforts on completing the banking union, advancing the capital markets union and developing meaningful forms of private and public risk sharing, will help build collective resilience to future shocks, as also emphasized by staff. The Euro Summit will come back to these issues in December 2018, including on the basis of terms of reference for the common backstop, a terms sheet for the further development of the ESM. Work should also start on a roadmap for beginning political negotiations on the European Deposit Insurance Scheme (EDIS), while adhering to all elements of the 2016 Council roadmap.

This concludes my statement on the staff report for the 2018 Article IV consultation. I will now turn onto my statement on the Financial System Stability Assessment:

FINANCIAL SYSTEM STABILITY ASSESSMENT (FSSA)

In terms of financial sector oversight, the authorities welcome and broadly concur with staff’s analysis and recommendations. The emphasis placed on anti-money laundering and cybersecurity is welcome. In the area of banking, some of the recommendations of the report are already covered in existing Union legislation. However, authorities do not concur with the statements referring to mandatory relocation of central counterparties (CCP). The European Commission’s proposal does not refer to relocation, but rather to the ability to provide clearing services within the EU. Furthermore, the CCP supervision proposal aims to strengthen the EU regime for third countries in general and is not solely driven by Brexit.

Authorities welcome the recognition of the importance of the Capital Markets Union project. Further progress has been made recently through a significant number of legislation and non-legislative initiatives, which are not covered in the FSSA. While the authorities agree with the main messages on macro-prudential supervision, developing new instruments for the non-banking sector is at a preliminary stage as several Union pieces of legislation are still spreading their effects.

Authorities broadly concur with the main messages in the field of crisis management and bank resolution, such as the criticality of sufficient MREL for an effective resolution, and welcome the acknowledgement of the progress made in completing the crisis management infrastructure. Authorities wish to point out that while the recommendation to proceed quickly with the build-up of external and internal MREL is welcome and shared, it should also take into account the diversity of banking groups and recognize the merit of transitional periods. Authorities are nevertheless urging all banks to build up the needed MREL buffers without delay in order to allow for a credible implementation of the resolution plans. Authorities furthermore welcome staff's recommendation to establish the ESM as a common backstop for the SRF.

Authorities note that a Treaty change to grant to the Single Resolution Board (SRB) the status of an "institution" may not be feasible in the short term and the SRB is already an independent agency in line with the Key Attributes. Moreover, the endorsement of resolution schemes by the European Commission does not delay resolution decisions, as the timeframe imposed by the law is just 24 hours and the EU institutions have taken all necessary arrangements to comply with this deadline. As regards the recommendation for an administrative liquidation tool for the SRB, its legal and operational feasibility is doubtful. Authorities disagree with the FSSA recommending a financial stability exemption that would allow the departure from the 8 percent bail-in requirements for accessing the Single Resolution Fund (SRF) and public funds. The aim of the SRF has never been to replace the bail-in tool, but to ensure efficient application of the resolution tools.

On State aid, the authorities point out that its control derives directly from the EU Treaties. Hence, the EU's co-legislators have acknowledged the role of State aid control in the EU's bank resolution framework, which is to ensure a level playing field between banks in- and outside the Banking Union. Whenever aid is needed, both in- and outside resolution, State aid control applies and ensures that the beneficiary bank is restructured or liquidated. Deposit insurance scheme (DIS) interventions beyond reimbursing depositors may fall under State aid control. Moreover, State aid rules require burden sharing and restructuring or market exit, thereby protecting the DIS. Finally, the application of State aid control is already fully transparent.

Regarding the withdrawal of the United Kingdom from the EU, potential financial stability risks are being monitored, including by a joint technical group between the ECB and the Bank of England. Each firm should take the necessary steps to ensure that it can continue to provide services to its clients. The financial services sector is accustomed to working in a cross-border environment, involving multiple jurisdictions.

The authorities welcome the comprehensive assessment undertaken by staff of the banking supervision methods and practices carried out by the ECB in close coordination with NCAs in the SSM. The authorities appreciate that staff recognize the increased level of supervisory intensity and intrusiveness, and the definition of clear supervisory methodologies and processes. The authorities concur with staff that the supervisory powers for relevant cross-border investment firms which carry out bank-like activities in the euro area needs to be addressed. On the EU prudential framework, the authorities welcome the recognition of the progress achieved, while they also agree that there are still important areas which are yet to be harmonized at EU level.

However, the authorities disagree with the assessment of BCP24 on Liquidity Risk as it severely misrepresents the intrusiveness, intensiveness, timeliness and efficiency of the ECB current supervisory practices and downplays its capacity and readiness to act when significant institutions' controls are not up to its standards and expectations. The ECB takes supervisory actions well ahead of the actual manifestation of any liquidity constraints, in order to ensure that in case an outright liquidity crisis eventually occurs all relevant stakeholders are sufficiently informed and the necessary decisions can be timely made.

The authorities generally agree with the general finding of an overall increase in banks' resilience, as concluded from their solvency and liquidity analyses of the largest euro area banks, and with the main findings of the liquidity stress-testing, albeit identified scenario specific liquidity shortfalls or vulnerabilities may often be attributed to very extreme or non-pragmatic scenario assumptions. Euro area banks have been consistently increasing their liquidity buffers as a response to regulatory changes, which appear to be one of the main drivers of the ample system-wide liquidity.

With regard to structural euro area bank profitability, the authorities broadly share staff's assessment of its main drivers and that improving macro conditions is not sufficient to fully address this problem. While banks have made some progress in improving efficiency and tackling NPLs, high NPL stocks continue to adversely affect performance. The authorities highlight that the pace of NPL reduction is partly dependent on banks' capital position and their ability to raise capital, and that the pace of NPL stock reduction has been accelerating since 2017. Profitability levels of euro area banks have been recovering significantly in the last years. Fragmented banking structures, cost inefficiency and little income diversification, continue to drag on the long-term profitability prospects of European banks.

Related to systemic liquidity management, the authorities take note of staff's recommendation regarding the 'horizon scanning' arrangements to better detect emerging liquidity strains. These will need to be carefully considered in light of the already existing arrangements, also to avoid overlaps in the responsibilities of the two functions.

Mr. Alogeel and Mr. Rouai submitted the following statement:

We thank staff for the well-written set of reports, including an excellent FSAP, and Mr. Meyer for his very helpful buff statement. Growth in the euro area remains strong, driven by domestic demand and supported by accommodative monetary policy, and the dispersion of growth rates is narrowing among countries. Nonetheless, and as pointed out by staff, productivity gaps across countries remain a fundamental threat to euro-area cohesion, as progress towards convergence of per capita incomes remains limited. In addition, the region continues to face important domestic and global risks, including those stemming from policy complacency, increased trade tensions, and possible lack of progress in Brexit negotiations. Against this background, we broadly agree with the thrust of the staff appraisal and support the main recommendation of advancing risk reduction and risk sharing in the euro area. We also support staff recommendations to strengthen the implementation of structural reforms to lift productivity and complete the architectural reforms of the euro area to improve resilience to future shocks. We will focus our comments on the following issues.

Monetary accommodation has been helpful is supporting the recovery and improving confidence, and we agree with staff that this stance should be maintained until inflation is convincingly converging towards the ECB's inflation objective of below, but close to 2 percent. Clear communication about future policy actions also remains important to anchor interest rate expectations and avoid risks to financial stability.

On fiscal policy, we note that the traction of the Fund policy advice seems to be limited both at the regional and bilateral surveillance as summarized by staff in ¶24 that "the distribution of national impulses differs diametrically from that advised by staff: the countries with ample fiscal space and excessive external surpluses consistently run tighter-than-advised fiscal policies, while most of the high-debt countries postpone adjustment—or even contemplate fiscal expansion.”. This leads staff to conclude in ¶27 that “regrettably, national budgetary plans are doing too little or go in the wrong direction.”

Staff notes that the enforcement by the responsible EU institutions of the fiscal rules has been too lenient. This finding is consistent with the recent European Court of Auditors’ report[1] which concludes that “The European Commission has applied fiscal rules with excessive flexibility, making them ineffective in reducing debt in highly indebted states… and has extensively used discretionary powers to reduce the adjustment requirements”. In its response to the ECA’s report, the European Commission indicated, among other, that “While the Stability and Growth Pact (SGP) frames the conduct of fiscal policy for Member States under the preventive arm, it is important to reiterate that budgetary policy is ultimately within the competence of Member States.” This suggests that the traction of the Fund’s policy advice is limited both in regional and bilateral surveillance.

Staff reiterates the recommendation for better compliance with and enforcement of the fiscal rules, but notes in ¶28 “that in contrast to previous years, the EU’s country-specific recommendations (CSRs) for 2018 did not specify the required fiscal effort that would be consistent with the SGP; moreover, the Commission intends to use a “margin of discretion” in its 2018 compliance assessments, hurting the credibility of the SGP.”

In view of the above, are there specific reasons related to the institutional framework of the euro area that limit the traction of Fund’s policy advice since there is currently no proposal to reform the fiscal rules? Or, was there a genuine need for flexibility in the implementation of the fiscal rules in the aftermath of the global financial crisis? Staff elaboration would be welcome.

We welcome the FSAP for the euro area, including the first detailed assessment of the Basel Core Principles, and commend staff and outside experts for an excellent and comprehensive work. We are comforted by the finding that the resilience of large euro area banks has improved.

[1] Is the main objective of the preventive arm of the SGP delivered?

While we broadly support staff recommendation, we would appreciate staff elaborations on the following issues:

It is not clear to us why the timing of the recommendations on NPL resolution are backloaded (medium-term, within 2 to 5 years). This seems to be inconsistent with the urgency to address legacy issues, in particular double-digit NPL ratios, and with staff's own assessment in Box 1 of the FSSA that "the authorities should consider extending their NPL action plan to address legacy issues quickly…"

The FSAP refers to important data gaps that could hinder comprehensive monitoring and appraisal of risks. Could staff elaborate on any action plan to address these gaps?

We appreciate the Note on Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision. We note, at the outset, that staff was not able to assess Principle 29 on "Abuses of financial services", including money laundering and the financing of terrorism, since the ECB is not responsible for all aspects of banking supervision. We therefore agree with staff suggestion to establish a European-level institution responsible for AML/CFT supervision.

When looking at the summary compliance with the Basel core principles, we have mixed views. On the one hand, we recognize the recent establishment of the SSM (2014). On the other hand, however, we are surprised by number of principles assessed to be "materially non-compliant"[2]. Out of the 28 principles assessed, 6 are materially non-compliant and cover important supervision areas like "capital adequacy", "transactions with related parties", and "liquidity risk". Could staff clarify why only one principle out of the six, judged to be "materially non-compliant" was referred to in the staff report?

Finally, we encourage staff to ensure consistency between the RAM in the staff report and the one in the FSSA as the likelihood of some risk (Retreat from cross border integration) is assessed differently. We would have also preferred more outward spillover analysis in the staff report in view of the importance of the euro area in the global economy.

[2] A rating of "materially non-compliant" applies in the case of severe shortcomings when, despite the existence of formal rules and procedures, there is evidence that supervision has not been effective, practical implementation is weak, and that the shortcomings are sufficient to raise doubts about the authorities' ability to achieve compliance.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for the comprehensive reports and Mr. Meyer for his helpful buff statement. Economic activity in the euro area remains strong, broad-based, and job friendly, driven by higher domestic demand and supported by continued accommodative monetary policy. Nonetheless, underlying inflation and wage growth remain subdued, while downside risks have increased since last year. Trade tensions have risen with the recent U.S. imposition of tariffs on steel and aluminum imports. The lack of effort in countries with high public debt to rebuild fiscal buffers and implement structural reforms could weigh on the recovery, while the lack of progress in Brexit negotiations raises the risk of a disruptive exit that would weigh on confidence and investment. Against this background, discussions appropriately focused on rebuilding thin policy buffers, addressing deep structural challenges, and rebalancing externally. We commend the euro area's efforts to preserve trade openness and the commitment of its members to the rules-based global trading system.

Staff's work in the Selected Issues Paper on the long-term impact of Brexit in the EU is welcome. Using two different, complementary approaches, the paper finds that, although there is significant cross-country heterogeneity, Brexit would have negative effects on the EU-27, given the depth and the complexity of the EU-U.K. integration, with larger output and employment losses associated with a 'hard' Brexit. The authorities consider that the negative impact of Brexit would mostly affect the U.K., and that these estimates are highly speculative and suffer from important modeling limitations. Can staff comment on the impact of Brexit on the EU budget and the potential size of financial market activity to migrate to EU-27?

Against the background of positive output gaps and tightening labor markets, the continued large degree of monetary accommodation provides grounds for confidence that the convergence of inflation towards the ECB's target will continue in the period ahead. In this connection, the ECB's commitment to maintain an accommodative stance by continuing the net asset purchases until the year-end and keeping policy rates low through mid-2019 and beyond, if needed, is important. We concur with staff on the need for clear forward guidance as quantitative easing is wound down, and a clear communication policy.

Fiscal policy is expected to be modestly expansionary in 2018, but staff note that the distribution of national fiscal impulses differs diametrically from what they advised. The countries with ample fiscal space and excessive external surpluses consistently run tighter-than-advised fiscal policies, while most of the high-debt countries postpone adjustment—or even contemplate fiscal expansion—as growth stays firm. We concur with staff that high-debt countries must rebuild buffers by accelerating their fiscal efforts while conditions remain supportive. At the same time, the large net external creditor countries with ample fiscal space and large current account surpluses should increase public investment in infrastructure, education, and innovation, as needed. We welcome the agreement between the authorities and staff on the need for tighter SGP compliance and enforcement, including by simplifying the rules, which would help rebuild buffers and ensure debt sustainability as output gaps close. We appreciate the European Commission's view that the available flexibility under the SGP had allowed it to strike a good balance between macroeconomic stabilization and debt sustainability.

Productivity gaps across countries have impeded the adjustment process in the euro area and contributed to delaying income convergence among countries. This highlights the need for countries to press ahead with structural reforms to improve productivity and create job opportunities. We concur with staff that product and labor market reforms should be energized to improve resilience, boost potential growth, and close competitiveness gaps. We welcome staff's recommendation to improve incentives by linking EU financial and technical support to structural reform implementation, and would appreciate hearing from staff about the authorities' reaction to this proposal.

We welcome the discussion on the euro area architectural reforms and agree that they would help build collective resilience to future shocks. Agreement at last June's Euro Summit to progress towards completion of the banking union and to strengthen the European Stability Mechanism (ESM) is encouraging. The expected adoption of a package of measures aimed at reducing risk in the banking industry before the year-end is a step in the right direction. We agree with staff that future steps should focus on lower legal fragmentation across national lines, an improved resolution framework, and a shared financial safety net complete with common deposit insurance and a backstop to the Single Resolution Fund (SRF). Efforts should also focus on building consensus for meaningful public risk sharing, an area where Mr. Meyer notes remaining differences of view on a common fiscal capacity.

The FSAP finds that the resilience of large euro area banks has improved overall. Capital buffers are sizable in aggregate relative to immediate threats, although some banks are vulnerable to credit, market, or liquidity risks. The banking system as a whole has ample liquidity, particularly given the ECB support. At a structural level, low profitability remains a chronic problem in banks across all business models, calling for sustained supervisory pressure. Banking supervision has improved markedly with the creation of the Single Supervisory Mechanism, and the handling of bank resolution also improved under the Single Resolution Mechanism, although the fragmentation of rules along national lines remains an issue.

As many banks still have double-digit NPL ratios and low provisioning coverage by international standards, we concur with staff that legacy asset clean-up should be accelerated. We see merit in the FSAP suggestion that common definitions of NPL, minimum standards for insolvency and creditor rights, and rules for valuation of collateral would accelerate resolution of NPLs. With regards to the bank crisis preparedness and management framework, we concur with the FSAP advice that a critical transitional challenge, the buildup of bail-in-able financing (MREL), be expedited, prioritizing large banks. Given the important home bias in financial intermediaries' sovereign exposures, staff's proposals to reduce the bias, ranging from concentration limits to sovereign risk weights to risk-based premia for common deposit insurance, deserve consideration.

Mr. Tombini and Mr. Cheong submitted the following statement:

We thank staff for the reports. We also thank Mr. Meyer for his statement in his capacity as President of EURIMF. We welcome the broad-based growth across the euro area, the improvement in the labor market, and the gradual convergence of inflation towards the European Central Bank's (ECB) objective. However, it is somewhat disappointing that, according to staff, the euro area's growth performance may have already reached its cyclical peak. We agree with staff that risks are tilted to the downside, with the challenges of navigating Brexit, trade tensions and tighter global financial conditions adding to the uncertainty. The Fund's overarching message over the last year—that countries should use the favorable environment to enact meaningful economic reforms—remains relevant for the region.

With inflationary expectations still not fully entrenched, the ECB accommodative monetary policy stance remains appropriate. In general, the ECB has crossed the era of unconventional monetary policy in a commendable manner and the unwinding of its quantitative easing operations has transitioned smoothly. We take note that staff cautions against raising interest rates too soon, but are comforted by the ECB's assurances that monetary policy decisions will remain data dependent and well communicated.

The differences in fiscal positions highlight the diverse economic circumstances across euro area members. We agree with staff that fiscal imbalances should be adjusted, and note their concerns that not enough is being done to implement such adjustments, notwithstanding the Stability and Growth Pact (SGP). As such, we welcome the agreement between the European Commission (EC) and staff on the need to tighten enforcement and simplify the fiscal rules. Meanwhile, the initiatives to address tax avoidance, and base erosion and profit shifting across the European Union are welcome. Conceptually, the central fiscal capacity (CFC) as proposed by staff can help provide counter-cyclical buffers and ensure adherence to fiscal rules. However, risk sharing and moral hazard concerns can be difficult to overcome. Nevertheless, the authorities' version of the CFC is some progress in this regard.

Structural reforms can assist in closing productivity gaps across the euro area, while also helping to address internal and external imbalances. However, we take note that progress in implementing key reforms has been somewhat slow, particularly for some high debt countries. Meanwhile, although the euro area's external position was assessed as moderately stronger than implied by fundamentals and desirable policies, there are significant divergences within the group. Correcting imbalances rests at the national level, and in many instances, involves product and labor market reforms. We welcome the euro area authorities' commitment to a free and rules-based trade system.

Among other issues, the Financial Sector Assessment Program (FSAP) highlighted the continued need to strengthen banks' balance sheets and restore profitability. While the number of large problem banks has fallen and capital buffers are large in aggregate, non-performing loans (NPLs) are still high in many banks, and stress tests show that vulnerabilities to market and credit risks remain significant. We broadly support the FSAP recommendations geared towards improving NPL resolution, and believe that the recent proposals by the EC and ECB are positive steps in this regard. Significant focus has been rightly placed on the banking sector, but regulatory improvements have also been taking place in the non-bank sector. Like staff, we encourage the authorities to continue to closely monitor developments in this segment.

Completing the banking union will require broad based political support. While further harmonization of regulations at the regional and national levels can aid in this regard, the establishment of a shared financial safety net remains a major sticking point. Meanwhile, the capital markets union (CMU) has gained traction and support, with the authorities noting that remaining hurdles are at the technical rather than political level. Although the CMU was conceptualized to complement the banking union, we wonder whether the former can be completed before the latter is finalized. Staff's views are welcomed.

Mr. Armas, Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the clear and comprehensive reports and Mr. Meyer for his helpful buff statement.

The euro area's situation and outlook bring about mixed feelings. The implementation of critical structural changes and more dynamism of economic activity are welcome, though increasing risks have the potential of seriously impairing the achievements attained since the crisis.

On the one hand, we observe all that the area and its authorities have accomplished to leave the crisis behind and to create and/or reinforce critical institutions and instruments that improve the area's economic and financial architecture. This willingness and cohesion allowed to preserve the euro area, one of the most important transformations in the global economy over the past century. The growth rate in 2017 was at its highest since the crisis -a somewhat similar expansion is expected this year- and job creation exhibits positive outcomes and prospects. Beyond the progress made so far, clearly there is no room for complacency. After all the above-referred developments, could the staff elaborate on how inequality has been impacted? We observe that there is a disagreement between the authorities and the staff regarding Brexit's macroeconomic impact. Could staff explain about where are the main uncertainties on that estimation?

On the other hand, risks appear to have become more substantial for the area. Nationalism and Euroscepticism have kept gaining traction. The departure of the United Kingdom from the EU remains a difficult and uncertain process and, as underscored in Box 1 of the staff report, there will no winners from Brexit. Uncertainties also come from other key countries of the area. Policy complacency has increased and rising protectionism could seriously affect the euro-zone. In this regard, we welcome Mr. Meyer's remarks about the EU unambiguous commitment to free and fair trade and to international cooperation based on common rules.

One of the most important difficulties to design and implement policies is the high economic dispersion among countries. Text figure 1 clearly depicts differences regarding current account (some countries with excessive CA surplus, according to the staff report) and public gross debt (many countries with public debt-to-GDP ratios above 90 percent). Then, the report exhibits important differences on real GDP growth and substantial ones on non-performing loans ratios, unemployment rates, sovereign bond yields, etc. Could this dispersion exacerbate Euroscepticism? In any case, it seems critical to continue efforts to improve the euro area's architecture and lay the basis for lifting productivity and create employment. In this regard, the staff makes thoughtful and timely recommendations on banking union, capital markets union, and fiscal institutional reforms. From the political point of view, how likely is the materialization of these recommendations? Product and labor market reforms should be energized. On the other hand, we encourage staff to further assess the drivers of savings and investment in the non-financial corporate and household sectors.

Considering the prevailing fragilities, the need to address economic dispersion among the countries in the area, and inflation developments so far, we agree with the staff that keeping policy rates at low levels is vital, but data-dependent. The staff presents an interesting analysis in Box 2 of the report on the euro area inflation dynamics, highlighting the strong backward-looking element of the inflation process. This is an area in which we would welcome further research on the factors behind this backward-looking element.

Staff poses clear arguments on the need for better compliance with and enforcement of the fiscal rules. This will reinforce the credibility of the area and in the medium term will reduce dispersions. While staff underlines that "as output gaps close, the case for a flexible interpretation of the fiscal rules is becoming ever weaker", we would like to note that there is considerable uncertainty around estimates of economic slack in the euro area. This said, in the absence of a meaningful central fiscal capacity, it is essential that countries with ample fiscal space and current account surpluses commit to increase public investment and provide incentives for higher private investment at home while preserving long run sustainability. This is necessary to maintain adequate growth in the area as a whole and ease the political tensions arising in high debt countries.

We are encouraged by the staff's judgement in the Financial System Stability Assessment that the short-term macrofinancial outlook is broadly favorable and the analysis of the improvements achieved in regulation and supervision of the financial system. We also welcome the efforts and progress made on reducing NPL levels, although clearly, much remains to be done in this area as Mr. Meyer rightly points out. The fact that a fifth of significant institutions remain vulnerable, measured by their prices to book and NPL ratio, constitutes a matter of concern, which merits the FSAP's main recommendations. The authorities should continue monitoring the housing sector; since staff judges that residential real estate appears overvalued in a few countries while in a recent release from Eurostat indicates that prices continue raising fast. We are pleased to read that the authorities agree with the staff's recommendations on crisis management and bank resolution. We note that there is a disagreement between the authorities and the staff on the assessment of BCP 24 on Liquidity risk. Could staff provide an explanation about this different point of view?

With these comments, we wish the Euro Area and its people every success in their future endeavors.

Ms. Barron and Ms. Park submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Meyer for his informative buff statement. While a strong expansion is currently underway in the euro area, the outlook for medium term growth is more subdued, and downside risks to the outlook are elevated. In this context, we agree with the focus on growth-friendly fiscal policies and strengthening fiscal frameworks. The increased resilience of euro area banks is welcome, and we support further efforts to address legacy vulnerabilities and strengthen financial sector oversight, crisis management and financial sector safety nets.

Euro Area Policies

Growth-friendly changes in the composition of fiscal policy should be prioritized. While this is particularly relevant for countries with ample fiscal space, room should always be made for high quality investment in physical and human capital. We agree that greater investment in infrastructure, education and research and development would be desirable to boost potential growth and incentivize private investment. To the extent that this also contributes to external rebalancing, this is welcome, though where external imbalances are driven by savings in the non-financial corporate and household sectors, further research may be needed to support more tailored policy advice.

Fiscal rules need to be enforceable and to be enforced. We note that neither the European Commission or the IMF has significant traction on fiscal policy recommendations; national fiscal stances are in many cases quite different to recommendations. To what extent has this divergence tended to be planned or unplanned in recent years – for example, due to revenue surprises? While temporary flexibility in fiscal rules has allowed fiscal policy to support the upswing, stronger enforcement is now needed in a context where policies that might be optimal for individual member countries might be suboptimal for the region as whole. Simplifying the rules to focus on a single operational target and a single fiscal anchor, as recommended, will strengthen the credibility of fiscal policy in the euro area. We also agree that a well-designed central fiscal capacity is desirable to enhance the macroeconomic stabilization capacity of the euro area and enable greater risk sharing.

Further progress with structural reforms is needed to lift productivity, and we agree with the priority areas identified. It is striking that structural unemployment is assessed to be close to 8 percent, and we agree that measures to address high youth unemployment, as outlined in the useful selected issues paper, are a priority.

The detailed analysis of the macroeconomic impact of Brexit is welcome, and reinforces the costs from a retreat from free and open trade. The selected issues paper highlights that higher barriers to trade, capital flows and movement of people following Brexit imposes considerable economic costs on both sides.

Monetary policy settings should remain supportive, with continued monitoring of emerging risks to financial stability. We caution against automatic recourse to macroprudential tools in the absence of rapid credit growth or evidence of a significant deterioration in credit standards. Understanding the nature of the macro-financial risks will assist in determining the appropriate policy response. Tax and zoning policies that expand the supply of land or encourage construction could have a more lasting impact on property prices.

Finally, we reiterate our call for this discussion of euro area policies to come before the detailed discussions of larger euro area economies. This would provide an upfront assessment of union-level policy considerations and ensure a sound and consistent basis for consideration of member states' policies.

Financial System Stability Assessment

Increased resilience of euro area banks and progress in enhancing financial sector oversight is welcome, though further efforts are needed to address legacy vulnerabilities and strengthen supervision. This includes strong supervisory pressure on banks to address structural issues including overbanking and unviable business models and to accelerate the restructuring and disposal of non-performing loans. We welcome staff's assessment that the supervision of banks has improved under the Single Supervisory Mechanism, and support further progress in harmonizing the prudential framework across countries to avoid regulatory arbitrage. The potential for disruption to supervision associated with uncertainty about access to resources should be addressed. We note the disagreement between staff and authorities on a few specific aspects of the BCP assessment; our view is that these assessments should focus on demonstrated outcomes, and avoid an assumption that these are best delivered by specific institutional arrangements.

Considerable progress has been made in enhancing crisis management and safety nets, and the completion of this work remains a priority. This should involve both efforts to enhance the operational and financial capacity and strengthening of key elements of the architecture.

Finally, as raised by the UK Chair in the discussion of Brazil's Article IV staff report and FSSA, we support further discussion on the Board's engagement with the FSAP process. We note that several of the FSAP technical notes were made available to the Board as late as yesterday, giving the Board more than 10 separate documents as background for this meeting. The FSAP process involves significant commitment of resources by the Fund and by the authorities for the financial system under review, but Article IV issues tend to dominate the Board's discussions when the two reports are considered together. We look forward to discussing this as part of the 2019 FSAP review.

Mr. Agung and Mr. Pham submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Meyer for his informative buff statement.

The Euro area is enjoying strong economic growth, supported primarily by monetary accommodation. The regional outlook remains positive with growth driven by strong domestic demand, including investment, and export performance. The recovery is complemented by steady job creation and an upward trend of wages and core inflation. However, downside risks to the economic outlook have clearly increased, including escalating trade tensions, policy complacency, and political shocks in member states. In this context, we agree with the authorities and the staff that rebuilding fiscal buffers and addressing structural issues to improve resilience and provide support for Euro area reforms is now quite urgent. At the same time, efforts in completing the banking union and advancing the capital market union are also needed to foster greater private sector risk sharing. These measures should be accompanied by further steps to reduce both fiscal and financial sector risks. We broadly concur with the staff's assessment and policy advices and offer the following points for emphasis.

We agree with the authorities that monetary accommodation should be maintained for an extended period, given subdued core inflation. As stated in the buff statement, the ECB's commitment to keep interest rates low through mid-2019 is appropriate given slow progress toward a self-sustaining convergence of inflation to the ECB's medium-term objective. To minimize surprises to the market, we encourage the authorities to set forward guidance on interest rates and supplemented the normalization stance with a clear communication exercise. We appreciate the staff's assessment on the macroeconomic impacts of Brexit on the EU and Euro area economy as highlighted in Box 1 of the staff report. Could staff provide further elaboration on the potential fiscal risks related to Brexit?

Stronger fiscal discipline, especially at the national level, is needed to help rebuild fiscal buffers. We agree with the staff's assessment that high-debt countries should focus on rebuilding fiscal buffers while the surplus countries with ample fiscal space should continue to boost potential growth through investments in infrastructure, education, and innovation. However, as in the recent Board discussion on Germany's Article IV report, we continue to stress that fiscal policy needs to strike the right balance between supporting higher growth potential and building fiscal buffers of the country given looming downside risks and demographic challenges. In addition, as mentioned in the report, some countries with high public debt are making very little or even no fiscal consolidation effort and instead relying on cyclical revenue improvements to reduce headline deficits. Therefore, we urge the authorities to enforce the fiscal rules more strictly to strengthen the credibility of the fiscal framework. As a union, a central fiscal capacity would help support economic stabilization and facilitate a better mix between fiscal and monetary policy which would link access to compliance with the fiscal rules.

To improve resilience and provide necessary support for further deepening of the union, the structural reform agenda needs to be implemented as soon as possible. We understand from the report that structural weaknesses of the Euro area, including low productivity and lack of competitiveness in some member states, could not be addressed by the reforms to current architecture. Instead, they will require renewed efforts to boost productivity through labor and product market reforms. Given the increased external risks and structural challenges, we encourage the authorities to swiftly implement, in a manner appropriate for the country context, policies to boost growth potential, including encouraging higher labor force participation, deepening human capital and removing bottlenecks in infrastructure. This would also help the economy become more resilient to adverse financial market conditions and weaker global trade.

We note from the Fund's FSAP report that most large euro area banks have significantly improved the size and quality of their capital buffers and NPLs have declined. The ECB's new provisioning guidelines and recent policy package on NPLs as stated in Box 5 of the staff report are welcome steps to help strengthen provisioning practices and facilitate the development of a secondary market for distressed debt in Euro area. However, the FSAP finds that gaps in supervision and bank resolution as well as low profitability of many banks may adversely affect the overall financial stability of the banking sector. Therefore, we encourage the authorities to vigorously pursue regulatory reforms and supervisory actions to address these vulnerabilities. Given that continued monetary accommodation is weighing on banks' net interest margins, we think operational cost reductions are important in the near-term to improve profitability and hence resilience. Staff's comments are welcome. In the case of the Euro area, given its size and complexity, we would have seen value in having separate discussions of the annual surveillance report and the FSAP/FSSA.

Ms. Horsman and Mr. Hart submitted the following statement:

We thank staff for their comprehensive reports and Mr. Meyer for his buff statement. We broadly agree with staff's assessment, and welcome the indications that euro area authorities share most of the analysis and recommendations. We offer the following comments for consideration.

The euro area is at an important juncture. Growth is robust and broad-based, while financial sector resilience is gradually improving. But the recovery is expected to wane just as downside risks are on the rise. In that context, decisive action to address well-known structural weaknesses is urgently required. We welcome the progress that has been highlighted in the report, but underscore a clear need for more policy action in the fiscal, financial, and structural reforms space, as well as at the euro area architecture level.

In our view, more effort is needed to address persistent intra-euro area imbalances. These imbalances undermine potential growth and pose a risk to the political support for difficult but necessary architectural reforms. There needs to be a collective effort to address excessive policy imbalances on the part of surplus and deficit countries, whereas, so far, the bulk of the adjustment has come from the latter. We think the overall macroeconomic consequences of an internal rebalancing (e.g., on the size of the euro area output gap and implications for monetary policy) are worthy of further investigation.

From a fiscal perspective, we are discouraged to note that members' fiscal policy stances are largely the inverse of both staff's recommendations and what is required to support sustainable rebalancing. Members with high debt and deficits need to rebuild buffers and reduce vulnerabilities. Surplus countries should take more decisive steps to support private investment, including through investments in human and physical capital. We note staff's conclusion that the European Commission has been overly flexible in applying its fiscal rules, and we agree that simpler rules could contribute to greater traction and compliance. On tax issues, we agree with staff that interim and partial solutions are distortionary. Comprehensive, internationally- coordinated solutions should be found to the taxation challenges posed by an increasingly digitalized global economy.

We agree with the Fund's assessment that a supportive monetary stance should be maintained until inflation is sustainably converging to the ECB's target. We share the view that inflation is likely to remain weak for some time following the closing of the output gap, and thus support staff's advice for patience and prudence with regards to future rate hikes, as well as clear communication.

Financial sector resilience-building continues to make progress, yet concerted action is needed to finish the job. Legacy issues, including high NPLs and low profitability, exert a drag on the euro area banking sector, albeit heterogeneously. The FSAP's findings underscore the importance for policymakers to redouble their efforts to clean up legacy bad loans. Authorities should also encourage banks to increase the build-up of "bail in-able" debt in the largest banks while conditions are more favorable. More generally, the FSAP identifies a large number of areas where reforms are needed—including to address the fragmentation of national laws, the oversight of liquidity, and credit risk—and we encourage the European authorities to give all of the FSAP recommendations due consideration.

We share staff's view that intra-euro area productivity gaps are a threat to regional cohesion. A combination of low estimated potential growth and rapid technological change in the job market underscores the necessity of structural reforms to facilitate convergence and an increase in living standards. The need for product and service reforms should be a high priority, but staff rightly emphasize the need to shield the most vulnerable from the negative impact of such reforms. Youth unemployment also remains a challenge for most members, and we agree with the suite of reforms suggested in the report and useful selected issues paper.

In addition to actions at the member level, accelerating euro area architectural reforms—including the banking and capital markets union—is needed to allow for deeper economic and financial integration. This would support sustainable growth, resilience, and the unwinding of regional imbalances that remain an important source of fragility. More generally, we welcome the Fund's contributions to the architecture discussions—even where there is disagreement on specific proposals.

We welcome staff's detailed analysis on the potential spillovers from Brexit on other European members states, recognizing the inherent uncertainties in such estimates. We share the view that there will be no winners from Brexit, although the degree of exposure varies widely across euro members. We encourage all parties to expedite negotiations towards a mutually-acceptable outcome, with due consideration for the importance of the UK-Irish border.

Finally, we commend the euro area members' clear commitment to free trade, international cooperation, and a rules-based global trading system. We support their commitment to discussing ways to modernize the trading system, and strongly agree that trade protectionist measures are highly counter-productive in that regard.

Mr. Claver-Carone and Ms. Svenstrup submitted the following statement:

Despite signs that growth has peaked, the euro area's broad-based cyclical expansion remains sound, driven by wide ranging policy efforts and accommodative monetary policy. Member countries should use this window of opportunity to further advance structural and macroeconomic reforms to raise long-term growth potential and rebuild buffers. The recent EU Summit was a missed opportunity to advance euro area architecture reforms needed to strengthen the euro area's growth prospects and resilience to future shocks. We urge member countries to take action on this front, including completion of the capital markets and banking union and development of a central fiscal capacity.

We generally agree with staff's conclusions and policy recommendations, particularly with the need for euro area countries to use fiscal space more effectively to support growth and investment. We also thank staff for the FSAP for the euro area and agree with many of their recommendations, although we would have preferred for the technical notes to be released earlier to allow more time for review and consultation with our authorities.

Fiscal Policy

Staff repeat their sensible call for differentiated fiscal strategies among euro area members: countries with ample fiscal space and excessive external surpluses, such as Germany and the Netherlands, should reduce tax burdens, boost public investment and promote structural reforms, whereas countries with high debt-to-GDP levels, such as Italy and Portugal, should rebuild buffers and enact growth-enhancing structural reforms. We deeply regret that member states have failed to heed staff's advice. Indeed, as underscored in Figure 22, countries with fiscal space are running much tighter budgets than staff recommend, while high-debt countries are largely postponing further fiscal adjustment or backtracking on reforms.

Monitoring and implementation of the SGP have become increasingly complex over time, and its design has proven to be counterproductive to fiscal rebalancing. We thus agree on the need to streamline rules and move away from the structural balance as the key indicator. Reform efforts must simplify while balancing the need to enforce rules with flexibility that encourages countries to fully utilize available fiscal space and avoid pro-cyclical fiscal tightening in downturns. Moreover, we repeat our call for member countries to develop a central fiscal capacity to further strengthen the euro area's macroeconomic stabilization function and balance the fiscal sustainability focus of the SGP, while safeguarding against moral hazard.

Monetary Policy

Regarding staff's assessment that the ECB should maintain its monetary stance, we urge the ECB to remain flexible if downside risks materialize and continue to clearly communicate its intentions to ensure a smooth and gradual process. We note that staff's forecasts for euro area inflation are higher than market-based inflation expectations. Could staff discuss the main drivers of the different forecasts?

External Sector

Staff assess the euro area's external position in 2017 to be moderately stronger than implied by medium-term fundamentals. Meanwhile, the euro area's aggregate fiscal stance is expected to be modestly expansionary this year. Do staff view this fiscal impulse to be sufficient to address external imbalances and support growth?

Sizable external imbalances remain at the national level, and the persistently large surpluses of some member countries are increasingly diverging from levels consistent with medium-term fundamentals. We strongly urge surplus countries to use fiscal space to finance reforms that will enhance potential growth, raise the returns to private investment, and lift current wages. We also encourage member countries to redouble efforts to address deep-seeded structural challenges and narrow competitiveness gaps, particularly while economic circumstances remain favorable. To this end, we agree with staff's recommendations that countries undertake product market reforms such as reducing the regulatory burden on firms and removing barriers to entry in service markets; labor market reforms such as shifting taxes away from labor and encouraging apprenticeship programs; and governance reforms such as enhancing public administration capacity in countries where this is weak.

Financial Sector

The health of large euro area banks has generally improved, as most are reporting improvements in capital levels and quality, as well as some efficiency gains. However, the persistence of double-digit NPL ratios, the low interest rate environment, and unviable business models continue to suppress bank profitability across the euro area. Further, as staff's stress tests highlight, there is considerable heterogeneity in banks' ability to manage various shocks. In this context, we welcome staff's focus on weak banks and addressing the high stock of NPLs. Moreover, we support staff's call for swifter progress on the banking union to reduce credit risk correlations between euro area governments and their national banking systems. Completion of the capital markets union action plan is also critical to promote diversification of intermediation beyond banks and to foster private risk sharing.

The adoption of BRRD and the SRMR provide a strong foundation to deal with problem banks, but more work remains to complete and unify the resolution regime. For example, we support staff's recommendation for a credible banking sector liquidity backstop that can be accessed in a timely manner and for a euro area deposit insurance. Staff indirectly refer to the Banco Popular resolution – this case should have been given more emphasis as it provides specific evidence of the need for greater coordination between national and EU authorities, and better access to financial resources. Likewise, the bailouts of three Italian banks last year illustrates the importance of aligning the loss sharing requirements under state aid rules with those in the BRRD.

We welcome staff's view that relocation of CCPs and associated markets is not necessary for financial stability and would be detrimental to the real economy. However, the recommendation that ESMA be given "direct supervisory powers over euro clearing in CCPs outside the EU" is acutely problematic. The purpose of supervisory coordination and cooperation – and the key to risk management – is access to data and information. Supervisory cooperation and sharing of information is the best way to manage risks, and the United States fully supports recommendations and efforts to this end. Linking supervision to the denomination of traded contracts invites conflicts of law and will likely result in legal uncertainty and market confusion.

Finally, we notice that the FSAP team included 22 staff members, as well as external experts. How would the implementation of the new streamlining rules, which limit FSAP teams to six FTE, impact the scope of coverage of an FSAP of this magnitude? Specifically, what would be omitted from the report?

Brexit

We welcome staff's detailed discussion on the impact of Brexit in the staff report. The Selected Issues Paper, in particular, provided a useful analysis of the trade, investment, financial, supply chain, and migration linkages between the UK and the EU/euro area. The results are not surprising – euro area output and employment will be materially impacted under most scenarios, with a few countries affected more severely due to stronger linkages to the UK. Noting that the authorities' views on this topic were not represented, could staff discuss how their assessment compares to the methodology and results of any impact analysis the ECB or EC have done? We appreciate Mr. Meyer's assurance that the authorities are closely monitoring potential financial stability risks associated with Brexit, including at a joint technical group between the ECB and the Bank of England.

However, we thought that the FSAP could have better addressed associated financial stability risks that could result from financial market fragmentation and the loss of access by and to UK-located markets and institutions. For example, could staff discuss their views on the need for a public solution to the issue of contract continuity? Both EU and UK authorities have expressed divergent views and there is potential risk to financial stability, as outlined in the recent Bank of England Financial Stability Report. Similarly, a discussion of the EU's equivalency regime for third countries and implications for continued access to markets and mobility would be useful. New regulatory regimes in the EU, including MiFID II and EMIR, may have significant and negative consequences for cross-border investment and capital formation. Staff comments would be welcome.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the comprehensive reports and Mr. Meyer for his informative buff statement.

After recovering from the crisis, the Euro region has performed well supported by easy monetary conditions and rising domestic demand. Unemployment has declined and inflation remains subdued and is likely to converge to the ECB objective slowly due to backward looking expectations, the labor market drag led by population ageing despite increasing wages and rising oil prices. Going forward, staff expects the output gap to close in 2018 and turn positive in 2019 on sustained growth momentum.

In contrast, the medium-term growth prospects look somewhat weaker due to the demographic transition, weak productivity, ongoing private sector deleveraging and Brexit. Downside risks from policy inactions and reversal of reforms including financial dislocations due to political shocks, ascending protectionism and the normalization of US monetary policy including Brexit could weigh significantly on the economic outlook. On the other hand, improving global economic prospects backed with commitment to sound economic policies could potentially spur an upward growth surprise.

The Euro area's fiscal position shows widely varying degrees of national fiscal capacities. Staff advises that while highly indebted member states like Italy, Portugal and Spain need to build buffers and ensure debt sustainability through strict compliance with SGP rules, those with ample fiscal space such as Germany and Netherlands should increase expenditures on productive investments to induce positive spinoffs for growth. We are encouraged to note that staff advice has been seconded by the authorities. To establish durable fiscal sustainability the European Commission has recently flagged the need for compliance with and enforcement of SGP rules, which we consider highly relevant from the point of view of improving long-term sustainability of public finances. In this context, could staff comment on the contrasting views expressed in the report by the authorities' and the EFB regarding the flexibility of SGP rules.

We support the proposal about establishing a centralized fiscal capacity for macroeconomic stabilization as a fiscal backstop although its acceptance hinges on consensus among member states on the mechanism of sharing fiscal resources. For CFC, the relative merits of the authorities' proposed borrowing-lending framework based on EU budgetary contributions including interest subsidies drawn from seigniorage income from member states and the staff suggested contribution-transfer may have to be assessed judiciously to prevent permanent transfers. The proposals mooted by the EC on limiting corporate tax arbitrage are welcome and should be evolved in line with international framework for income taxation as advised by staff.

The aggregate external surplus in the Euro area is moderately stronger than that suggested by medium-term fundamentals. Could staff elaborate more substantially what might explain the accumulation of surpluses by the private sector?

The overall resilience of the financial system has strengthened with improved solvency and liquidity metrics of large euro area banks, although some remain financially vulnerable due to high NPLs. Banks need to improve profitability and strengthen their business models while cleaning up legacy assets. In this regard, expediting NPL restructuring and disposal within strict timelines and building up provisions including implementing stringent valuation rules for immovable collateral are important. The FSAP stress tests indicate that both credit and market risks are significant sources of instability in the banking sector. Could staff inform about the authorities' views on

FSAP's risk assessment and willingness to take adequate measures to mitigate these risks? Moreover, building external and internal MREL buffers to bolster loss absorbing capacity in line with the provisions of the Single Resolution Board (SRB) would enhance resilience. We support recommendations by the FSAP on the framework for locally tailored macroprudential policies aimed at mitigating sectoral overheating risks and the enhancement in the transparency of ESRB warnings and ECB decisions. At the Euro area level, reducing fragmentation of national laws would serve to establish a single banking union with shared/common resolution and deposit insurance safety nets. We support FSAP advise on central EU level supervision of all aspects of AML to enable convergence of rules. We note that the capital market union has progressed with key legislative and non-legislative measures. What are the prospects of success of a more comprehensive capital market union in future?

Structural reforms in product and labor markets can improve productivity in members states. Reduction in regulatory burdens, eliminating barriers to entry and encouragement to innovations and technology diffusion as part of product market reforms are useful. On the other hand, ALMPs and assurance for quality education and vocational training can enhance labor efficiency. We are concerned that product market reforms in several member states have slowed and impose a drag on economic progress. We welcome the European Commission proposal on direct financial support for national reforms efforts and consider it an important incentive for structural reforms.

We wish the authorities the very best and success in future endeavors.

Mr. Panek and Mr. Trabinski submitted the following statement:

We thank staff for a set of very good reports, and Mr. Meyer for his well-written buff statement. The euro area's (EA) economic growth remains solid and broad-based, driven by strong domestic demand and increasing employment. However, downside risks related to i) the impact of Brexit, ii) political uncertainty, iii) potential trade restrictions, iv) the tightening of global financial conditions, and v) country-specific vulnerabilities pose significant challenges for coherent policy implementation. These risks could negatively affect debt sustainability, borrowing costs, and economic growth, and thus threaten the EA's outlook. Also, various indicators suggest that growth may already have peaked. We broadly share the thrust of staff appraisal and offer some comments for emphasis:

Fiscal policy should reflect country-specific conditions and comply with the Stability and Growth Pact (SGP). Given the large debt stock and the unevenly distributed fiscal space across EA members, we see merit in a country-tailored approach in which highly indebted countries should focus on debt reduction, while those with fiscal space could use it for growth-enhancing measures. Compliance with the SGP fiscal rules should be better enforced with a limited role for discretion – in particular in the high-debt countries in order to i) rebuild buffers, ii) ensure debt sustainability, and iii) maintain confidence in the fiscal framework. We welcome the European Commission's (EC) readiness to improve the credibility of the SGP and to consider recommendations of the European Fiscal Board.

A comprehensive set of structural reforms aimed at closing productivity gaps would help ensure EA cohesion and medium-term growth performance. Although the EA economies have recently made some progress in reforming their labor and product markets as well as their tax systems, compliance with the Fund's country-specific recommendations remains mixed and uneven. Some fiscally constrained countries are lagging behind in productivity, which ultimately endanger EA cohesion. Therefore, we see merit in staff's proposal for a budget-neutral approach, focusing on i) product and labor market reforms – in particular to address youth unemployment -- and ii) improving efficiency of governance and institutions. Given that current favorable conditions may worsen rapidly, we encourage the authorities to step up reform efforts. In this regard, we welcome the EC's new incentive tool for reform delivery that honors national reform efforts with direct financial support.

The accommodative monetary stance should be sustained. We agree with staff that monetary policy should remain supportive until inflation convincingly converges to target. Labor market slack is still ample and the output gap has not yet been closed. A less accommodative stance in the medium-term would be appropriate if i) economic expansion continues, ii) core inflation gradually rises beyond its established range of the last four years and iii) financial conditions stay favorable.

We note significant improvements in restoring the financial sector resilience, yet more has to be done to reduce existing vulnerabilities. We note that the health of banks directly supervised by the SSM continues to improve, despite credit and liquidity risks in some institutions. However, bank profitability remain low as impaired assets continue to weigh on earnings, and the system is overbanked. We therefore concur with staff that enforcement of the sector's balance sheet restructuring is needed. In this context, the recent policy proposals by the EC and the ECB on NPLs are timely and they are an important further component on the background of the regulatory framework.

Since the report does not elaborate on the implications of the protracted period of low interest rates on pension funds and insurance companies, we would appreciate staff's assessment of the risks stemming from low interest rates for these sectors.

Progress has been achieved in implementing architectural reforms. We encourage the authorities to complete the banking union, and to include adjustments recommended in the FSAP as well as to advance with the capital market union. Such steps should substantially enhance the EA's resilience to shocks. With regard to strengthening the crisis management framework, well-thought out governance arrangements are necessary to ensure independent decisions. Finally, given the complexity and potential inefficiencies of the supervisory framework for the central clearing counterparties, we encourage the European authorities to clearly assign supervisory responsibilities between the national authorities and European Securities and Markets Authority.

Mr. Kaizuka and Mr. Minoura submitted the following statement:

We thank staff for the comprehensive reports and Mr. Meyer for the informative BUFF statement. We welcome that growth in the euro area remains strong, supported by both domestic demand and net exports. However, gaps among member states in income, employment, productivity, and external balances have been persistent. It is indispensable for the euro area economy, namely the Economic and Monetary Union (EMU), to build the architecture which helps adjusting imbalances caused by such gaps in an orderly manner. In this regard, we concur with the staff that the current expansion provides a good opportunity to build resilience, lift growth potential, and strengthen the EMU. We encourage the EMU and member countries to pursue continued and effective structural reforms so as to ensure sustainable growth in the euro area. As we agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We share the concern that divergence of fiscal conditions persists across member countries and the distribution of national impulses differs diametrically from that advised by staff. We urge high-debt countries to ramp up their efforts to proceed fiscal consolidation and build buffers while conditions remain supportive. In this regard, as the compliance with and enforcement of the Stability and Growth Pact (SGP) have been weak, we agree with the staff that better compliance with the rules is essential to ensure the credibility of the fiscal framework and to building consensus on further fiscal integration. Regarding the staff's proposal of simplifying the rules, we appreciate staff's more detailed elaboration on the proposal and granular evaluation for it.

At the same time, we share the staff's view that countries with substantial fiscal space should use it to boost potential growth. As output gaps become closed, countries with substantial fiscal space should use it for efficient and effective expenditures to help advancing necessary structural reforms, while maintaining fiscal discipline and paying attention to long-term adjustment needs stemming from aging population. Stimulating investment and consumption through structural reforms is also important to address both intra-union and external imbalances.

Regarding corporate tax, the European Commission has proposed the Common Consolidated Corporate Tax Base (CCCTB) and a digital sales tax. We welcome staff's comment on fiscal and growth impacts of these measures to the euro area. We share the staff's view that an internationally coordinated comprehensive solution should be found to the taxation challenges posed by an increasingly digitalized global economy. At the same time, tax reforms should be consistent with international rules and discussions at the OECD and the WTO.

We welcome the staff's timely and useful proposal and analysis on a Central Fiscal Capacity (CFC) as a macroeconomic stabilization framework. A CFC is expected to work as a countercyclical buffer to smooth country-specific shock and cushion common shocks, under the situation that the monetary policy is not based on each member's development and fiscal space is limited in some countries. In this regard, we welcome staff's proposal that includes mechanisms such as a cap on cumulative net transfers and "usage premium" to encourage member countries to build their own buffers and address concerns about moral hazard and permanent transfer. We encourage staff's further analyses on macroeconomic stabilization frameworks including pros and cons for alternative frameworks, to refine mechanism and facilitate deeper discussion among member countries in the euro area.

Monetary Policy

As wage growth has remained subdued and inflation has remained below the ECB's "below, but close to, 2 percent" objective, together with the backward-looking inflation process, we agree with the staff that monetary policy needs to stay accommodative until inflation is convincingly converging to objective. Meanwhile, while we can see large divergence of wage growth across member countries, it is difficult for the ECB to deal with it by monetary policy. In this light, we would welcome staff's comment on appropriate response of member countries to deal with the divergence. We also share the staff's view that the importance of forward guidance will grow even stronger as quantitative easing is wound down.

At the same time, it is essential to pay close attention to spillover effects of the U.S. fiscal expansion on long-term interest rates. We share the concern that sharp real estate price appreciation or corporate debt accumulation are emerging in some countries. In this light, how do staff see potential impacts of these risks on macroeconomy and financial system?

Financial Sector Policy

While we positively take note that the health of banks directly supervised by the SSM continues to improve, we agree with staff's appraisal that the authorities should energize banks' NPL restructuring and disposal efforts with demanding timelines for provisioning and charge-off and stricter valuation rules for immovable collateral, as many banks still have double-digit NPL ratios and low provisioning coverage by international standards. As banks' profitability remains far below pre-crisis level, aggressive reductions in NPLs are also important to improve their profitability. In this regard, we take note of the staff's view that profitability reflects deep structural issues, including overbanking and unviable business models in some cases, and would welcome staff's comments on what policy responses would be considered to address these problems.

Potential housing market overvaluation in some areas coupled with a recent pick-up in household indebtedness, as well as risks in nonbank financial intermediaries, warrant careful and continued monitoring.

Trade Policy

We welcome the authorities' commitment to free trade and the rules-based system. As staff rightly pointed out, the authorities should maintain free trade and the rules-based global trading system, reduce trade barriers and, whenever possible, resolve disagreements through the WTO. At the same time, it is preferable to mitigate possible adverse side effects by strengthening safety nets and providing vocational training.

In this light, the EU and Japan confirmed the finalization of negotiations on the Economic Partnership Agreement (EPA) which covers wider areas than the FTA and constitutes the foundations for deeper and broader cooperation in December 2017, and the EPA is expected to be signed in Tokyo on July 17. Against rising trade tensions and protectionism, we believe it significant that one of the largest developed economic zones in the world with approximately 28 percent of the world GDP and 37 percent of the world trade volumes was newly established. As a champion of free trade, Japan, together with the EU, will contribute to ensure economic order based on free and fair rules.

We also appreciate staff's analysis on macroeconomic impacts of Brexit, including Box 1. However, given the recent conflict of opinions in the UK administration, a high degree of uncertainties remains in Brexit negotiations. We encourage staff's close monitoring on progress in negotiations and provide timely information update and continued analysis on macroeconomic impact of Brexit on the EU and global economy.

Structural Policy

Existence of productivity gaps across countries have led to stalling convergence of per capita incomes, high structural unemployment in some countries and external imbalances, and remain a fundamental threat to euro area cohesion. We agree with staff' view that the authorities should grasp the opportunity afforded by strong growth to progress structural reforms to boost potential growth and close competitiveness gaps.

In this regard, it is essential to improve business environment through product market reforms such as reducing the regulatory burden on firms, removing barriers to entry in service markets, and taking steps to encourage innovation and technology diffusion. Furthermore, against pressures from population aging, we encourage staff to provide tailored advices to member countries including labor market, education and training reforms to lower structural unemployment and increase labor force participation, as well as migration policies, based on each country's situation. Enhancing public administrative capacity, procurement frameworks, and the effectiveness of justice systems are also important to raise potential growth.

Further efforts of high debt countries with current account deficits to enhance productivity through labor market and product market reforms are expected to contribute to addressing intra-union imbalances. However, we take note with concern that structural reform delivery has been uneven.

Therefore, such structural reforms should be more effectively induced at the EU level. In this regard, the European Commission's proposal of a new reform delivery tool to bring direct financial support to national reform efforts is considered to assist structural reforms of member countries. We would appreciate it if staff could elaborate more on the proposal and share evaluation for it.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for their informative Article IV report, Selected Issues papers, and FSSA report, and Mr. Meyer for his helpful buff statement.

The near-term economic outlook for the euro area (EA) remains broadly positive. The resilience to shocks has increased, supported by reforms which reinforced the area-wide institutions, and by multi-year efforts to strengthen the balance sheets. Economic expansion is broad-based and will carry forward, also its' pace is slowing down closer to the potential. The overall unemployment rate has declined to the lowest level since early 2009. Financial system conditions are strengthening with credit beginning to grow again.

Notwithstanding positive developments, the future remains clouded by the unfavorable demographics, slow productivity growth and uneven implementation of structural reforms agenda across member countries. Rising protectionism, uncertainty related to Brexit and political trends in some key countries present serious and growing downside risks. Therefore, relatively benign current economic conditions should be used to strengthen the EA fundamentals and continued reform implementation. While many challenges require policy responses at the national level, reinforcing the EA institutions and mechanisms remains critically important to increase resilience to future shocks.

The accommodative monetary policy stance played an important role in improving financial and credit conditions in the EA, supporting portfolio rebalancing, lending activity and reduction in lending rates. We agree with staff that taking into account subdued inflation and backward-looking inflation expectations, it would be premature to increase policy rates until inflation becomes more entrenched. Hence, the ECB should continue net asset purchases at least until the end-2018, and provide the enhanced forward guidance on the key interest rates.

Fiscal policies of the EA members are far from optimal. It is disturbing that high-debt countries have delayed necessary fiscal adjustments or even contemplate fiscal expansion. At the same time, countries with strong fiscal positions are implementing tighter that advised fiscal policies. Moreover, this tendency may carry on in the future, as envisaged by the fiscal plans of the major EA countries. How can the EU institutions, responsible for enforcement of the fiscal rules, encourage national authorities to implement more appropriate fiscal policies?

Staff assess the euro area external position as moderately stronger than implied by medium-term fundamentals and desired policy settings. This is mostly the consequence of developments in the large net creditor countries with excessive current account surpluses. We understand that the main drivers of these surpluses are households' and private sector's decisions on savings and investments, with fiscal balances playing only a minor role.

Financial system resilience and conditions continue to improve but credit and market risks remain significant. NPLs are declining slowly and remain concentrated in a few countries, while many banks still have double-digit NPL ratios. Further efforts are needed to restructure or dispose NPLs and increase provisioning and we welcome recent European Commission and ECB guidance in this regard. The build-up of MREL is critical for strengthening banks' crisis preparedness and transition for the operational single resolution mechanism. It is also important to encourage gradual reduction of home bias in bank's sovereign exposures. To diversify sovereign exposure, the development of various kind of the euro area safe assets could be explored.

We welcome the FSAP conclusion that banking supervision in the EA has significantly improved following the creation of the Single Supervisory Mechanism. At the same time, the creation of the full-fledged banking union remains work in progress, as other necessary elements, including the Single Resolution Mechanism and the European Deposit Insurance Scheme remain in the various stages of development. We note steady but slow progress in this area and encourage the EA authorities to speed up the development of necessary legal and institutional infrastructure.

Rise of protectionist and inward-looking policies present major risk to global growth and prosperity. In this regard, we welcome the EU commitment to free and fair trade and international cooperation.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

Underpinned by sound policies and strong institutions, the euro area is experiencing its fifth consecutive year of economic recovery. Despite recent deceleration, growth in 2018 remains robust and broad-based; inflation is slowly rising as output gaps are closing, but is not yet expected to reach the ECB's target; and the unemployment rate has dropped to its lowest level in a decade, although high youth and female unemployment continues to be an issue. With wide divergences across countries, the fiscal deficit is narrowing; the current account surplus is wider than implied by fundamentals; and the debt-to-GDP ratio is declining, even though it remains above 90 percent in almost half of euro area countries. The health of banks directly supervised by the SSM continues to improve, but important vulnerabilities persist. While growth is expected to continue above potential in the near term, the medium-term prospects are clouded by crisis legacies, weak productivity, demographic changes, and more recently by growing global trade frictions. We concur with the thrust of staff appraisal and, given mounting downside risks to the outlook, encourage the authorities to take advantage of the recovery to rebuild policy buffers, address external imbalances, strengthen financial sector resilience, and advance growth-enhancing structural reforms.

Monetary policy should remain accommodative until inflation has durably converged to the ECB's target. While positive output gaps and tightening labor markets will eventually lift inflation, this is expected to take time given the strong backward-looking element in the euro area inflation process and the possible rise in potential with actual output. We welcome the ECB's commitment to keeping policy rates low and data-dependent and maintaining a large balance sheet for an extended period by rolling over maturing debt. In either case, future policy actions should be gradual and clearly communicated.

Fiscal policy should aim at rebuilding buffers in high-debt countries to ensure debt sustainability and at increasing priority spending in large net creditor countries to lift growth potential and to contribute to the necessary external rebalancing. Simplifying the fiscal rules to focus on a single fiscal anchor and operational target will help improve SGP compliance and enforcement, which could be further strengthened by ensuring strong funding, autonomy, and voice for national fiscal councils and the European Fiscal Board. We welcome the draft EU multiannual budget for 2021-27 that envisages significant savings and efficiency gains by streamlining existing expenditures to fund new priority areas and by mobilizing revenues through modernization and diversification of current sources, and look forward to its finalization in due course. On corporate tax issues, we note the divergence of views between staff and the European Commission (EC) on the recommendation for a digital sales tax, and appreciate staff elaboration, including on the expected timeline for its adoption as well as its likely implication for a more permanent yet elusive internationally coordinated comprehensive solution.

The resilience of large banks has improved. Capital buffers are sizeable relative to immediate threats; liquidity is ample against a backdrop of ECB support; and supervision has strengthened following the creation of the SSM. However, stress tests conducted under the first FSAP exercise for the euro area suggest some banks are vulnerable to credit and market risks. Profitability remains a serious challenge, reflecting low interest rates, overbanking, unviable business models, and still-high NPLs. Continued progress is needed to clean up legacy assets, reduce widespread home bias in banks' sovereign exposures, and build up bail in-able debt in the largest banks. We note many banks with high NPLs largely rely on disposals rather than loan restructurings, and wonder what steps are being taken at the national or euro area levels to bolster banks' workout capacity. Staff comments are appreciated. Regulation and supervision should be strengthened by closer interagency coordination and data sharing, closing data gaps in commercial real estate and shadow banking, and applying well-targeted macroprudential tools to address localized financial stability risks, including housing market overvaluation and elevated household indebtedness.

Reforming product and labor markets, enhancing governance and institutions, and further liberalizing trade are essential to increase competitiveness, lift productivity, and raise potential output. Efforts should continue to advance the EU single market strategy, implement well-designed active labor market policies and better align wages with productivity, and enhance public administrative capacity and the effectiveness of justice systems. The EC's new reform delivery tool appropriately aims to cushion short-term costs and build country ownership, and closely links EU financial support to reform implementation. We welcome the EU authorities' commitment to a free, fair, and rules-based multilateral trading system, as reiterated by Mr. Meyer in his helpful buff statement, and underscore the need to ensure that the gains from trade are more widely shared. Could staff elaborate on the gaps in WTO rules that leave important nonmarket distortions unaddressed?

Architectural reforms to complete the banking union, advance the capital markets union, and create a central fiscal capacity (CFC) should proceed more vigorously with a view to reducing and sharing risks and building collective resilience to future shocks. The single banking market requires reduced legal fragmentation across national lines, a shared financial safety net, and improved resolution and crisis management frameworks. We agree that Brexit has increased the urgency of capital markets union, and welcome the joint technical group between ECB and the Bank of England to look into financial services risk management through Brexit. Could staff provide an update on the likely impact of recent political developments on Brexit negotiations? The establishment of a full-fledged CFC has been delayed, with several countries seeking a longer track record of fiscal discipline before considering greater risk sharing. We note the pros and cons of the authorities' borrowing-lending scheme versus staff proposed contribution-transfer scheme, and agree that a well-designed CFC should incorporate strong safeguards against permanent transfers and moral hazard.

Ms. White and Miss Chen submitted the following statement:

We thank staff for an informative set of reports including a comprehensive financial system stability assessment (FSSA), and Mr. Meyer for his insightful buff statement on behalf of the Eurozone member states.

Outlook

We broadly agree with staff's assessment of economic developments and the medium-term outlook. While the balance of risks does seem to be skewed to the downside at the moment and growth may have passed it peak we welcome that it is likely to remain above trend throughout 2018 and, given the significant uncertainty, could even surprise positively.

Fiscal Policies

We endorse staff's call for Euro Area countries with high debt loads to reduce risk and rebuild fiscal buffers while growth is supportive. The recent guidance from the ECB that asset purchases will come to a close by the end of the year and the first rate rises penciled in for mid-2019 reinforces the urgency of this advice.

Structural Policies

We broadly agree with staff's suggestions for growth-enhancing structural reforms and welcome the additional work on youth unemployment in the Selected Issues papers. However, while we agree that gains in productivity will need to be reinforced by structural measures if they are to be sustainable we would query staff's assertion that "much of the improvement [in competitiveness] was cyclically driven". Rather we consider that wage restraint in the periphery, in part linked to the implementation of structural reforms, brought nominal wage growth more in line with productivity development and that part of the adjustment took place through a reallocation of resources towards the more productive export sectors. Staff views would be welcome.

Output Gap

We take note that staff projects the Euro Area's output gap will close in 2018; however, we believe there is currently still a material degree of slack in the area. Supply-side constraints may have played a part in the recent deceleration of growth, given survey evidence of labour shortages and above-average capacity utilisation, and bottlenecks in the capital goods producing sector may have weighed on firms' ability to expand capacity. But we judge that these effects are likely to prove temporary. In addition, a rapidly closing output gap appears at odds with the Fund's relatively weak inflation forecast. We wonder if staff are perhaps placing too much weight on persistence as an explanation of subdued trend inflation, and if they underplay the role of structural reform. Staff comments would be welcome.

FSSA

We broadly concur with the report's assessment that while the resilience of large Euro Area banks has improved important vulnerabilities remain while tighter financial conditions, weaker growth and geopolitical uncertainties all pose risks to financial stability.

Clearly there are also risks to the financial sector from Brexit and staff recommend that authorities on both sides take urgent steps to avoid disruptions. Mr. Meyer rightly notes the establishment of the joint ECB and Bank of England technical group co-chaired by Governors Draghi and Carney as one way in which the potential financial stability risks are being assessed. In addition to the work of the technical group and for completeness we would note that building on robust implementation of prudential standards in the UK, the Bank of England has taken various actions to guard against disruptions including:

Ensuring the UK banking system could continue to lend to UK households and business even in the event of a disorderly, cliff-edge Brexit through a sufficiently severe 2017 banking stress test encompassing a wide range of UK macroeconomic outcomes that could be associated with Brexit.

Identifying the most important risks from a cliff-edge Brexit to the provision of financial services, and outlining the necessary steps to address them, including a commitment from the UK Government to legislate, if necessary, to put in place a temporary permissions regime to enable EU-based financial companies to continue to provide financial services to UK end users.

On the banking sector, banks' capital ratios have improved over the last few years, NPLs have fallen (although still high in some countries) and funding has become more stable. However, low profitability continues to be a structural problem. Despite recent improvements, Euro Area banks' ROEs remain well below estimates of the cost of equity. For most of the post-crisis period, this reflected high non-performing loans, but that effect has largely faded now. We would attribute most of the continued shortfall in profitability to cost inefficiencies and overbanking in some countries. There is some evidence that higher capital requirements and the new resolution regime have succeeded in fostering expectations of bail-ins instead of bail-outs. While this should reduce moral hazard and improve financial stability, it also pushes down on bank profitability by reducing the indirect subsidy that arises through lower bank funding costs. Staff views on these possible alternative causes of low profitability would be welcome.

We agree with staff's assessment that "the potential forced relocation of a globally systemically important CCP to the EU should be viewed with great hesitation and as a last resort" and we note Mr. Meyer's comments here accordingly. We echo staff's view that strong regulatory cooperation and information sharing amongst authorities complemented by the application of comparable rules is the preferred solution to maintain the efficient functioning of multi-currency central-clearing.

Finally, the Euro Area credit cycle is still in a recovery phase and for now there are only pockets of overvaluation. Nevertheless, the risks associated with high debt levels in some member states against the backdrop of an incomplete institutional framework could prove to have an amplifying effect on any vulnerabilities.

Mr. Sembene and Mr. Bah submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Meyer for his insightful buff statement on the Article IV and FSAP consultations with the euro area.

The implementation of a wide range of sound policies has helped the euro area to weather the financial crisis and reconnect with growth. Powered by domestic demand, the economies of all euro area members have grown in 2017. The overall unemployment rate has declined to its lowest level for the past decade although youth unemployment remains a challenge in many countries. Inflation is converging toward the ECB objective—albeit slowly.

While these developments are encouraging, a number of risks continue to weigh on medium-term prospects, including the uncertainty associated with Brexit and the rise of protectionism and oil prices. In this context, we agree that the present conditions offer a good opportunity for member countries and regional institutions to speed-up their reform efforts with a view to strengthening the recovery and resilience and lifting growth potential. In this regard, rebuilding fiscal buffers, improving productivity, addressing external imbalances and sustaining trade openness will be critical.

On monetary policy, we take note of the ECB’s commitment to keep its policy rates at their current levels at least until mid-2019. We concur on the need to keep the stance of monetary policy accommodative until inflation converges assuredly to the ECB’s objective. Indeed, raising rates prematurely could potentially sparkle negative demand spillovers and market turbulences. Going forward, ensuring smooth normalization of monetary policy will entail the implementation of a clear communication strategy to guide interest rate expectations.

We welcome the first Financial Sector Assessment Program (FSAP) exercise for the euro area. Encouragingly, the resilience of large banks in the region has improved although some institutions face vulnerabilities associated with credit and market or liquidity risks. We also note that the creation of the Single Supervisory Mechanism with an operational independence and effectiveness has helped improve significantly the banking supervision. Notwithstanding this progress, continued efforts are required to address the NPLs issues as many banks have double-digit NPL ratios. The authorities are encouraged to ensure effective coordination of prudential supervision with an oversight of anti-money laundering structures. We also see merit in establishing a banking union to support the monetary union with further efforts focused on improving the resolution framework and a shared financial safety net.

The euro area has made good progress on structural reforms to increase productivity. This progress needs to be strengthened to lift potential growth and address productivity gaps across countries. Increased focus should be put on reforms related to product and labor markets, governance and institutions. In this regard, reducing the regulatory burden on firms, removing barriers to entry service markets and encouraging innovation and technology diffusion will be helpful. To address the high youth unemployment, we see merit in encouraging apprenticeship programs and implementing policy measures needed to increase labor force participation. We encourage further steps to strengthen public administration capacity and ensure the effectiveness of institutions including justice systems. Staff comments on the proposal to link EU financial support to reform implementation would be welcome.

We note that the euro area's external position in 2017 was stronger than implied by medium-term fundamentals. Given the need to further strengthen potential growth, we share the view that net creditor countries should use their ample fiscal space to finance well-targeted reforms and investments. As for the net debtor countries, they are invited to pursue their efforts to address external imbalances. We are encouraged by the EU strong commitment to free trade and the rules-based global trading system.

Mr. Mkwezalamba and Ms. Gasasira-Manzi submitted the following statement:

We thank staff for their informative set of reports and Mr. Meyer for his insightful buff statement. The euro area's growth remains strong, supported by domestic demand, including investment, and solid job creation. In addition, wide ranging policy efforts continue to support growth. Consumption is expected to remain firm, monetary policy conditions supportive, and the aggregate output gap is expected to close in 2018 and turn positive in 2019. However, medium term growth prospects will continue to be affected by demographic changes, weak productivity, and crisis legacies. Risks to growth are skewed firmly to the downside, with policy inaction and political shocks on the domestic side and rising protectionism a major global concern. In addition, geopolitical risks and socio-economic disruptions remain a high probability. We broadly agree with staff's assessment, and make the following comments.

We appreciate staff's assessment on the impact of Brexit and note that both the EU and the United Kingdom will be negatively impacted. However, given the uncertainty that exists regarding the slow progress of the negotiations, we agree that progress be made towards timely completion of the negotiations.

We welcome the authorities' commitment to free trade and to the rules-based system. Like staff, we caution against escalation of trade disagreements and urge partners to work together to reduce trade barriers and resolve disputes within the World Trade Organization (WTO). Further, whereas there has been some progress to correct external imbalances, particularly in deficit countries, large current account surpluses remain in some creditor countries. In this regard, we support the call for further fiscal policy actions, particularly reforms to support private investment for creditor countries and improved competitiveness in debtor countries to support the rebalancing.

We note that fiscal policy actions have been mixed since the 2017 Article IV Consultation. Some countries with fiscal space and external surpluses continue to tighten their fiscal stance, while there is limited adjustment in high debt countries, despite closing output gaps and robust growth. Faster consolidation efforts, with the aim to reduce debt and build buffers in high debt countries, should be prioritized as increased growth-friendly public investment is encouraged in countries with surpluses. In addition, better compliance with the fiscal rules and their strict enforcement should support credibility of the fiscal framework as well as strengthen fiscal sustainability.

The monetary policy stance is still accommodative, although inflation remains subdued. Higher oil prices, positive output gaps, and tightening labor markets are expected to lift inflation. However, convergence towards the European Central Bank's (ECB's) medium-term objective will only happen gradually. In this context, we agree with staff that raising interest rates prematurely could have adverse effects on the euro area and the rest of the world through spillover effects. Hence, we are of the view that monetary accommodation remains appropriate, and enhanced forward guidance would help ensure a smooth normalization process.

Strengthened supervision and monitoring in the financial sector is essential to support the improved performance of banks. We note that credit is beginning to grow, and bank profits and capital ratios are improving. Further, non-performing loan (NPL) ratios are coming down, albeit with a large dispersion across countries, with some countries still experiencing double-digit NPL ratios and low provisioning. In this regard, we welcome the new risk reduction measures proposed by the European Commission (EC) and the ECB, and encourage strong supervisory follow up. In addition, strengthening the oversight of the growing nonbank financial sector and macroprudential policy, to support financial stability, is warranted.

Structural reforms remain important to increase investment, productivity, and competitiveness. Addressing structural inefficiencies in the labor and product markets is key to lifting productivity levels and promoting income convergence. While some progress has been made towards the energy union project and the European Union's (EU) digital single market initiative, overall national implementation of the 2015 EU single market strategy remains slow. We welcome staff elaboration on the main reasons for the slow progress in the structural reform agenda and the extent to which linking EU financial support to reform implementation could help accelerate progress.

Mr. Jin and Mr. Fan submitted the following statement:

We thank staff for the well-written reports and Mr. Meyer for the informative buff statement. We agree with the thrust of the staff's analysis and would limit our comments to the following.

Supported by solid domestic demand and steady job creation, the growth in the euro area remains strong, broad-based, and job friendly. However, the complacency on fiscal adjustment and structural reform, the political shock at the national level, and rising protectionism around the world, have casted a shadow over the sustainable growth momentum in the euro area. We see a strong need for the euro area, particularly the high-debt countries, to continue promoting structural reform in order to raise growth potential. We fully support the staff's proposal to stay committed to free trade and the rules-based global trading system, and to work together constructively to reduce trade barriers and resolve disagreements through the WTO. We commend the authorities' unambiguous commitment on this issue.

Under the context of subdued wage and inflation growth, we agree with staff that the decision for monetary policy normalization needs patience, persistence, and prudence. While we agree that the current policy rate at extraordinarily low levels might still be friendly to aggregate demand, we note that the profits in the bank and insurance sectors is still under pressure, and the hunt for yield has already pushed financial institutions toward riskier assets. It is noteworthy that the monetary policy in the euro area in recent years has effectively favored countries in stress, which might have been over expansionary for countries with solid economic performance. Generally speaking, the improvement in profit might make corporates more resilient under the shock of rate raise. We welcome staff's discussion on the profit of corporates in the euro area and their capability in absorbing the shock of rate raise. We noticed in paragraph 13 that the looser U.S. fiscal stance could affect the exchange rate independently. Looser U.S. fiscal stance supported by increasing supply of U.S. Treasuries might push up interest rate, and thus strengthen US dollars. Meanwhile, the increase of debt might weaken the fundamental of US dollars and thus result in depreciation in the future. We welcome staff's elaboration on the ultimate impact of looser U.S. fiscal stance on the Euro.

We noticed that the euro area's external position in 2017 was moderately stronger than implied by medium-term fundamentals and desired policy settings, and most euro area countries are now running current account surpluses, with some countries surpluses remaining high for years. Even after cyclically adjusted, the current account in the euro area was 3.4 percent of GDP in 2017, which might be significant for euro area.

Efforts are needed to further promote architectural reforms to facilitate economic integration in the euro area. We commend the current progress in the three pillars of the Euro Area Architecture, and see merit for a broader policy consensus. We encourage member states to eliminate legal fragmentation across national borders, strengthen the resolution framework, and establish a common deposit insurance scheme. We emphasize the importance of strengthening the financial market infrastructure, especially under the uncertainties of the Brexit. We believe that with the development of fiscal cooperation within the euro area, the monetary policy decision could be conducted in a more unbiased manner and thus further mitigate financial and economic risks. We welcome staff to assess a scale for the progress of the 3 pillars respectively, from 0 to 10, for example, and give us a score on where we are at the current juncture.

The Chairman made the following statement:

For this meeting, we have a combination of the typical euro area Article IV consultation with a selected issues paper, and a Financial Sector Assessment Program (FSAP).

That work was done prior to two developments which did not necessarily require an additional paper, as we discussed earlier with the team. First, in the first quarter of 2018, there was an indication of a slowdown that was particularly reflected in the purchasing managers' index (PMI) numbers.

While we eventually considered doing an update, clearly, the second quarter's latest numbers confirmed the assessment made by the team in relation to softening, but certainly not a hard softening, of the activity in the euro area.

The second development that took place was the European Council meeting, at which we were hoping for a more in-depth consideration of some of the issues on which we have written consistently since 2015, which has to do with the architecture of the euro area and the strengthening of the European Union's architecture. While the expectations were high, the results were relatively low, because the European Council was completely overwhelmed by the issue of the moment that had to do with migration and the best way to address it on a coherent, cohesive basis.

It is a bit disappointing. However, there was clearly a deferral and a tasking of the teams in order to work and to deepen this architecture in relation to the banking union, and various other matters strengthening the architecture, although not on the central fiscal consolidation, which is the area where we are a bit disappointed. But where the European Stability Mechanism (ESM) was identified as requiring a hardening and a more comprehensive ability to deal with banks' resolution eventually as a backstop and with having to support members of the euro area in case of difficulty. That is the second development, which is partly deferred until December, when their next summit will be tasked with focusing on those issues.

My final point is that since these documents were released and circulated, there has been further work in relation to Brexit: a publication of the white paper, further discussions, probably a deepening of the analysis of the work in relation to the transfer of contracts once the exit takes place and during the transition period, with various positions being clarified and legal issues identified better ,with a continuation of contract possibly considered as well. The leadership of Mr. Draghi and Mr. Carney as co-chairs of that particular committee to address those issues is expected. Those are the three areas that have evolved over the course of the last few days, but together with the staff, we agreed that it did not require an additional paper but would be addressed in the course of questions and points.

Mr. Meyer made the following statement:

I thank the staff for their comprehensive, insightful, and frank reports. I also thank Directors for their thoughtful statements.

Why do I take the floor first? I have issued the buff statement in my capacity as the euro area president and on behalf of my euro area colleagues. Let me highlight some aspects going beyond the main messages in the buff statement.

First, on the current situation and prospects for the euro area, I would like to start with the good news. The euro area made great progress in the last few years, both in terms of economic indicators and with regard to the institutional setup. To corroborate this statement, I would highlight that all countries in the region are growing. The growth composition is healthy, with private consumption and investment being the main drivers. Countries that had large current account deficits managed to reduce these deficits and even move to solidly balanced current accounts.

Growth in the euro area is expected to remain strong despite some signs in early 2018 that it might have peaked. The unemployment rate—and that is important—is expected to continue to be reduced substantially.

On the institutional front, euro area and EU partners made huge progress in the last few years. With the creation of the ESM, we have strengthened our crisis management framework; we have created a banking union, achieving considerable risk reduction already; and we have strengthened our fiscal frameworks in several steps. At the same time, our authorities fully agree with the staff that risks have heightened recently and that the work is far from being done. The strong expansion gives us some precious time to further increase resilience and to raise potential growth. Risks linked to trade tensions and Brexit also point to the downside.

Making progress in the euro area often takes time, as 19 member states are involved, with sometimes very different views. Compromises have to be found. In this regard, the staff's input is highly appreciated in indicating possible ways forward.

In addition, it is important to highlight that differences in members states' cyclical positions, economic structure, and their policy space most often require a differentiated approach based on national policy action.

A good example for the differentiated approach is external balances. Current account balances, while having converged to some extent, still differ significantly within the euro area, with large surpluses in some countries raising concerns. The staff note, however, that although government policies play a role, savings decisions by the private sector are the main driver of these external imbalances. Hence, as many colleagues also underlined in their statements, to devise effective and tailored policies, the underlying determinants of savings and investment in the non-financial, corporate, and household sectors are central and should be analyzed further.

Moving on to fiscal policies, the staff finds similar dispersion among euro area members and mentioned some design elements and enforcement issues of fiscal rules as a possible culprit. This is true to a large extent. Member states with high public debt need to increase their efforts to improve the sustainability of their public finances, while continuing to strengthen their growth potential. Conversely, member states with stronger fiscal positions and external surpluses need to prioritize investments to boost potential growth, while preserving long-term sustainability.

However, I would emphasize that 2018 might be the first year in the history of the euro area when no member country has an excessive government deficit. This shows that, while flaws remain, the combination of the EU and national frameworks do have a guiding force over fiscal policy decisions.

On European Monetary Union (EMU) deepening, the discussion is ongoing about how to further improve these institutions. As part of the intentions to further improve the EU's architecture, the Euro Summit - that the Chairman referred to - agreed in June to progress toward completing the banking union and to strengthen the ESM. Measures aimed at reducing risk in the banking sector are also expected before the end of the year.

The Chairman expressed some disappointment, and one Director described this summit as a lost opportunity. I would disagree. It is a reflection of how the euro area or the EU is working: step by step to find solutions that are, in the end, acceptable to all members.

This brings me to my last point, the Financial System Stability Assessment (FSSA). The euro area is a globally systemic region. Therefore, it is vitally important that its financial stability is safeguarded. We welcome the staff's acknowledgement of the significant improvements made in the financial architecture of Europe and the euro area, in particular. The new crisis management and bank resolution framework has been applied to real cases and is fully operational. Of course, there is still room for improvement, and the staff's assessment is welcome in this regard.

At the same time, the authorities felt that certain features were not fully appreciated by the staff. For instance, continuing to apply state aid rules in the bank resolution framework—something that the staff has criticized—is important to ensure a level playing field between the ins and outs of the banking union. Also, supervisory practices of the European Central Bank (ECB) with regard to liquidity risks were misrepresented by staff in the assessment. However, we do share the staff's recommendation for banks to quickly build up bail-inable assets, taking into account the diversity of banks and transitional periods. Similarly, NPLs need to be reduced further, notwithstanding the accelerated reduction since 2017.

Mr. Tombini made the following statement:

As noted by Mr. Meyer in his comprehensive buff statement, the benefits of the wide-ranging reforms implemented over the past few years are being felt broadly across the euro area. Driven by strong demand, the staff has made the point that growth has become more broad-based and job-friendly. However, with increasing uncertainties on many fronts, there is the continued need for careful coordination of policy actions to resolve remaining issues, such as high levels of public debt and NPLs in some countries.

The ECB's monetary policy has played an important role in supporting the euro area's recovery. With some measures of inflation, expectations are still below the ECB objective, and there is still space for monetary policy to remain accommodative, and the bank has signaled as such to the markets. More broadly, I agree with the authorities that a future path of monetary policy should be data-dependent.

Much has been said about the varying public debt dynamics across the euro area and the differences in national budgetary plans versus the actions that are most needed. In this regard, I welcome the staff's recommendation on the need to simplify the fiscal rules by focusing on a single operational target and on a single fiscal anchor.

Important progress has been made toward strengthening the euro area institutional frameworks over the past few years, as has been noted by Mr. Meyer and the Chairman. The regional supervisory framework has been improved, and the NPL reduction strategies are progressing, albeit slower than some would like. While critical elements for the completion of the banking union will require support at the political level, the capital market union is gaining traction.

The staff has mentioned the proposal put forward by the High-Level Task Force on Safe Assets for the European Systemic Risk Board for the euro area, and the authorities also highlighted the potential benefits of such assets. However, the tone of the report expressed some reservations about whether there will be market appetite for this instrument. This is a question that I posed before. I wanted the staff to develop its views on this safe asset initiative, which would be a constructive one.

Mr. Alkhareif made the following statement:

We appreciate the informative introductory remarks. We thank the staff for a well-written set of reports, including an excellent FSAP, and Mr. Meyer for his helpful buff statement. We would like to emphasize two points that we have made in our gray statement.

First, like Ms. Horsman and Mr. Claver-Carone, we are disappointed by the limited traction of staff advice on fiscal policy. The euro area plays an important role in the global economy, and we look forward to the forthcoming Comprehensive Surveillance Review (CSR) for additional analysis and guidance on how to improve the traction of the Fund's policy advice.

Second, while we commend the authorities for the progress achieved in recent years in addressing many legacies of the euro area crisis, we are surprised by the weaknesses identified by the FSAP team, including data gaps and non-compliance with Basel Core Principles in important areas, like capital adequacy and liquidity risks. We take this opportunity to support the suggestion made by Ms. Barron to consider during the next FSAP review having sequenced rather than a simultaneous Board discussion of the FSSA and the Article IV consultation.

Mr. Just made the following statement:

We thank both mission teams for their dedication and well-argued and reasoned reports. Our authorities expressed their appreciation for the candid discussions in the staff's constructive and well-meaning engagement. We associate ourselves with Mr. Meyer's buff statement and opening oral remarks.

I would like to make a few more general reflections. Despite the continuing positive growth outlook, the tone of this year's Article IV report is more somber. Concrete progress on deepening the euro area's architecture has not progressed as hoped.

Deepening will not advance significantly if there is only limited political support in member countries to strengthen the union as a whole. At this juncture, this partial equilibrium may persist for some time. Thus, we reiterate our call for prudence in order to strengthen the fiscal and financial foundations and structural reforms in all 19 euro area members to support the common roof.

A strengthened, more resilient euro area common house could also be found more attractive to those EU member states that are expected to eventually join the euro area. Their voices also have to be listened to, probably more attentively than has been the case.

Turning to the FSSA, it was clearly worth the organization and logistical tour de force as, together with the supporting documentation, it offers a rich and comprehensive analysis of the development of the financial architecture and the stability of the financial system in the euro area. For example, we see the staff's AML/CFT recommendation as critical to address the collective action problem. We have some reservations about some of the recommendations, but those could be addressed either in the future FSAP or the FSAPs of euro area members.

The level of analysis, as well as the direction of many recommendations, are heavily skewed to the center. The ECB Single Supervisory Mechanism (SSM) focus is logical and necessary but may not reflect sufficiently well the complete SSM framework when national competent authorities play a critical role for day-to-day supervision.

While the staff did some work on outreach to poor national competent authorities (NCAs) for the Basel Core Principle (BCP) assessment, a possible future euro area FSAP should find a way to include all 19 NCAs in the BCP, but also in other areas with significant national contributions in order to get a more complete and accurate picture of how supervision is actually accomplished in the hub-and-spoke model. This time, it may have yielded a more nuanced assessment on whether there is an overall lack of sufficient controls over the supervisory powers by the ECB.

This conclusion is not fully shared by the NCAs from our constituency. Ms. Barron and Ms. Park rightly note that the focus should be on demonstrated outcomes, without the presumption that these are best delivered by specific institutional arrangements.

Building on this, we would see an important role for the Fund to assess whether the processes and the extensive reporting requirements established by the ECB SSM for NCAs are efficient or whether there is a risk of distracting attention from actual supervision.

We were also a bit surprised by the staff's firm recommendation to centralize emergency liquidity assistance (ELA) with a short-term priority. The current ELA rules and procedures already entail a significant degree of centralization but at the same time reflect the legal framework where central banks assume the costs and risks and are accountable to their national parliaments in case of a loss.

We highly value both reports and the analytical rigor and the pointed recommendations, which are important contributions, not least to our internal European debates. We trust that the euro area FSAP will be required reading for national euro area, as well as EU mission teams, in order to move toward more consistent policy advice across the union. We are also confident that the euro area FSAP will result in efficiency gains and savings for both national authorities and the Fund in national FSAPs.

This chair usually points to the exclusion of Central and Eastern European member states in staff reports on the region. In this report, we take issue with putting the emphasis on small euro area member states; for example, as the main ring fences on bank liquidity. Given that ring-fencing is at most second-best and may reduce the efficiency of the single market, a generic reference to member states would appear to be a more accurate description of the status quo.

Finally, non-euro area member states could be featured more systematically in the otherwise informative figures and tables, as those are expected to join banking union and might do so even prior to adopting the euro.

Mr. de Villeroché made the following statement:

I associate myself with the remarks made by Mr. Meyer.

I will start by saying that to preserve growth and the achievements of the euro area and the European Union, we concur that convergence is a key point and it is deeply necessary. Convergence should be sought by all parties. It means an acceleration of structural reforms for countries that need to raise productivity and increase their competitiveness. It means active policies for large external creditor countries with fiscal space to support investment and domestic demand. It also means a consistent fiscal policy, complete with a reduction of debt for highly indebted countries and the use of fiscal space, when it exists. We will talk about this question of rebalancing more deeply this afternoon, so I will not develop it too much.

I would like to draw attention on the deepening of the European integration as a critical point. We face euro skepticism, and I agree that the European discussions can be lengthy and bumpy. However, I would like to underline what is happening and not what is missing.

The Meseberg Declaration between the French and the German heads of state was a significant milestone. It restated the commitment of our two countries for a deeper integration of the EMU. Among the engagements that were taken, I would like to underline the attachment to open markets, multilateralism, trade, and two initiatives to foster convergence: First, a proposal to establish a euro area budget to promote competitiveness, convergence, and stabilization in the euro area; and second, the consideration of a European Unemployment Stabilization Fund, for which we expect concrete proposals by December 18.

We also had the commitment to complete the banking union; notably, by the entry into force of a backstop to the Single Resolution Fund. That is a result of the European Council in June, which should be seen as a step forward as well.

Going forward, we can only agree with the staff's calls to strengthen the European architecture, and we would like to have staff's assessments of the recent proposals by European leaders.

I would also like to hear from staff about the convergence and more coordination of economic policies, including in the tax field, where there is room for more harmonization. I believe the Fund is well placed to provide useful analysis and advice on the question of coordination of policies in the euro area more generally.

I have raised my next remark many times. We need to start the discussion of the euro area Article IV before large euro area members' reports. I encourage the Chairman to have bilateral meetings to try to fix this. It has been done for two years now by the European Semester, and the Fund is lagging behind in discussing Article IV reports.

Mr. Kaizuka made the following statement:

I thank the staff for the comprehensive report and the Chairman for the opening statement. I thank Mr. Meyer for his informative buff statement and equally informative oral statement.

We welcome that the euro area economy has continuously marked strong growth, but at the same time, we noticed that there are still gaps in income, the unemployment rate, productivity, and the external balances in the area. For future sustainable growth, it is essential to construct a mechanism to adjust these internal imbalances while the current strong economic conditions are favorable.

Both member countries and the EU institutions should continuously engage in the necessary informal process. In this regard, we take positive note of the staff's proposal on the central fiscal capacity. It is expected to work as a countercyclical buffer and to smooth out the country-specific shocks. It is necessary to prevent any moral hazard and also incentivize member countries to build up their own policy buffers.

We encourage the staff to continue its analytical work to refine the mechanisms, taking into consideration the pros and cons. At the same time, we urge the staff to make efforts to enhance accurate measurements of economic slack in the euro area, although we understand it is a challenging job.

Let me turn to three specific points. First, on Brexit, we agree with Mr. Meyer's buff statement which states that the staff's estimates are highly speculative and suffer from important model limitations. We asked the staff to continuously monitor ongoing negotiations and to gather objective data and economic implications and periodically report back to the Board.

Second, on tax, on the corporate income tax, there are interesting developments and proposals in the EU, such as a Common Consolidated Corporate Tax Base (CCCTB), and a sales tax on digital transactions. On the CCCTB, which suggests formulary apportionment, we understand it is unique to the EU situation and would not be easily applicable outside the EU. In this regard, we look forward to our discussion on the corporate tax in February next year.

On the taxation on the digital economy, we understand that the OECD discussions and negotiations are going on under the inclusive framework and hope that consensus will emerge before the 2020 deadline and that all the participant countries will make their own tax policies consistent with those emerging consensuses.

Lastly, on trade and investment, I am encouraged by the buff statement, which notes that the EU is committed to the rules-based multilateral trading system. In this regard, I emphasize that tomorrow, we will sign the Japan-EU economic partnership agreement, which includes the free trade agreement. This could be a big milestone not only for Japan-EU economic relations and their respective economies, but more importantly, also for the rules-based multilateral system. We are fully committed to working with the EU to preserve the merit of this particular multilateral system.

Mr. De Lannoy made the following statement:

We welcome today's discussion and broadly concur with the report, which addresses a broad range of issues. We associate ourselves with Mr. Meyer's statement, so I will focus on a few issues in addition to our common buff statements, and Mr. Meyer's intervention.

Overall, we agree with the staff's assessment on the current economic outlook for the euro area. We welcome the staff's emphasis on the importance of efforts at the national level. The current favorable business cycle and low interest rates provide the opportunity to bring down debt levels. Efforts to reform labor and product markets and reduce high levels of NPLs in the banking sector will increase long-term potential growth and resilience and improve convergence between member states. When it comes to the external sector, we do not share the staff's recommendations that countries with a current account surplus need to increase spending. This would have a procyclical effect and not address the source of the savings surplus. We look forward to discussing this matter in more depth in the context of the External Sector Report (ESR).

Regarding the discussion on the central fiscal capacity, we do not believe it is the ultimate instrument of shock absorption. We believe that we should focus our attention on strengthening other channels of shock absorption first, including increasing fiscal resilience within member states. Similarly, the completion of the capital markets and banking union, which are both underway, offer the opportunity to further enhance risk sharing. In this context, the ESM is also a powerful tool to assist in case of adverse shocks.

Turning to the financial sector, the FSSA and the technical notes cover an impressive range of topics. Overall, we concur with the staff that continued efforts are necessary to reduce legacy risks in banks, and we support the staff's call for a reduction of intermediaries' exposures on sovereign debts. We also fully agree with the staff's recommendation to speed up the buildup of internal and external loss data, which is critical for a credible implementation of resolution plans, notably, when it comes to cross-border resolution. In this sense, we also welcome that the staff acknowledges the arguments favoring the centralized buffers of capital and liquidity, which is in line with earlier assessments in national FSAPs.

In this context, we were surprised by the staff's use of the word "ring-fencing," as it gives the wrong impression of the regulatory environment and supervisory practice in this context.

Finally, we regret that the FSSA does not devote more attention to the issue of conglomerate supervision. Systemic bank insurance groups supervised by the ECB are an important feature inter alia in the Belgian financial landscape. Supervision of financial conglomerates raises specific questions with regard to capital adequacy, contagion, and complexity. We were wondering whether the staff could clarify why supervision of financial conglomerates, including an assessment of core principles on conglomerates, was not included in the euro area FSAP.

To conclude, I thank staff for their hard and extensive work on these complex matters and the Chairman for her efforts and engagement with the Eurogroup.

Mr. Claver-Carone made the following statement:

We thank the staff for a well-written report, for the FSAP, and for their answers to our technical questions. The euro area's cyclical recovery has created an opportunity for member countries to raise their long-term growth potential and strengthen the resilience of the euro area to future shocks. In this context, we urge all countries, particularly high debt ones, to implement needed structural reforms to lift productivity and create job opportunities.

We strongly agree with the staff's longstanding recommendation for differentiated fiscal strategies among euro area members. We also note the staff's response that the small expansionary aggregate fiscal impulse will do relatively little to reduce the euro area's external imbalance.

I would like to stress two points. We once again strongly reiterate our call for large creditor countries, such as Germany and the Netherlands, to utilize their available fiscal space to reduce tax burdens, boost public investment, incentivize private investment, and encourage faster wage growth.

Meanwhile, countries with high debt-to-GDP levels, such as Italy and Portugal, should focus on rebuilding their buffers. These are necessary not just to correct imbalances, which clearly we feel strongly about, but also to promote greater equity and consistency within the monetary union itself. We also strongly urge member countries to advance and complete architecture reforms, including the capital markets and banking union and the central fiscal capacity. We hope that member countries will take up these issues again at the December Euro Summit.

We greatly appreciated the level of detail provided in the FSAP, and we included our views in our gray statement. However, we wanted to emphasize that we would not favor the adoption of a new framework for supervising central counterparties (CCPs) in Europe, as the existing global deference framework for regulatory harmonization is working well. I wanted to ask the staff to clarify the recommendation in the FSSA that a global deference framework be put in place. Does that imply a change to the current system?

More broadly, we continue to believe that the FSAP is an important surveillance tool, which this comprehensive report clearly highlights. We look forward to discussing how to strengthen this tool and improve its efficiency in its upcoming review.

Mr. Ostros made the following statement:

I thank both mission teams for their excellent work. They are good reports and interesting reads. They will be useful. I associate myself with the buff statement sent out by Mr. Meyer as well as his intervention.

I broadly agree with the economic assessment and outlook. I appreciate the staff's effort to provide estimates of the long-term impact of some of the uncertainties facing the euro area; for example, Brexit and trade tensions. These are difficult things to do and are subject to modeling limitations, but it is very important. I would encourage the staff to continue to do that. We had an important discussion on Friday about trying to estimate the effects of trade wars and tariff issues.

On the institutional architecture of the EU and the euro area, it is in much better shape today than it was at the start of the previous crisis in 2008. This is the result of a determined architecture building that takes time because of many parties involved, but it deserves credit. That being said, the architecture needs completion. The focus should be on what has already been started. The report could perhaps have been clearer in outlining the short-term versus the long-term priorities.

Regarding the central fiscal capacity, I am not fully convinced that this is the right step to take at this juncture. A stronger EMU requires, first and foremost, decisive actions at the national level and full compliance of the common rules. It starts by implementing structural reforms and respecting the Stability and Growth Pact (SGP) and to build fiscal buffers.

The report is very clear on the need for better compliance with and enforcement of the fiscal rules, and I fully support the staff on that.

On the FSSA, the staff is clearly outlining the continued challenges of legacy NPLs, as well as the need for some banks to transition to viable business models. I also welcome the emphasis on Anti-Money Laundering (AML) and cybersecurity from a regional perspective, an area where the national authorities are also strengthening their oversight and enforcement.

Completing the banking union is essential. Progress should be made on developing the capital markets union to foster cross-border private risk sharing. With this, I believe we are on the creditors' side when it comes to timely use.

Mr. Psalidopoulos made the following statement:

I thank the staff for the extensive reports. We associate ourselves with Mr. Meyer's remarks and his buff statement. I will add a few comments for emphasis.

The staff rightly acknowledges the progress achieved in reforming the euro area's institutional architecture. Progress has been notable also in reducing risks. Indeed, domestic tail risks have been reduced, such as those in the Italian banking system, which accounts for the bulk of the declining NPLs, as correctly evidenced in the report. It is our hope that such developments will facilitate progress in terms of risk sharing. This chair has always favored progress in both risk reduction and risk sharing.

More generally, we appreciate the Fund's advice on the necessary reforms to make the euro area more robust and resilient to future shocks, and we encourage further analysis and studies. We agree that ambitious policy goals should be pursued. In particular, the completion of the banking union with the European deposit insurance scheme remains a key priority, as is the establishment of a central fiscal capacity.

Regarding the latter, as we observed at the time of the informal briefing on the subject, the functioning of a stabilizing mechanism should be anchored to objective indicators, such as unemployment, outside the control of any government. If done differently, it would have destabilizing effects. We see economic analysis going in that direction—for example, the staff discussion note (SDN) on the central fiscal stabilization capacity, and more recently, a working paper by the ECB, where transfers from the euro area export-based stabilization capacity are linked to changes in world market conditions in the various export sectors.

In the banking area, we agree with the staff that the current resolution and crisis management framework has been strengthened but faces significant transitional and structural challenges. Thus, we welcome the staff's proposals in paragraph 60 to 63; notably, the financial stability exemption.

On a more general level, we believe that in dealing with banking crises, concerns about potential distortions of competition and state aid rules should be thought of as second-order when compared with the risks to financial stability. This is notably true for small local banks, where distortions of competition are eminently theoretical.

Finally, as we noted during the discussion on the World Economic Outlook (WEO) update past Friday, we believe that the views on Italy are overall gloomy. The Italian Economic Minister has confirmed his commitment to debt reduction, which will be reflected in the forthcoming budget law and medium-term plan, and let us await the facts.

Mr. Hurtado made the following statement:

We have only two related points. The first one is on fiscal policy. This chair would like to express its concern that the distribution of national fiscal impulses, as the staff calls them, differs importantly from the Fund's advice. Countries with ample fiscal space and excessive external surpluses are consistently running tighter-than-advised fiscal policies. This is not new, and this chair has expressed this view before. The same goes for high-debt countries, with public debt ratios expected to remain above 90 percent of GDP in almost half of the euro area countries next year. These countries could use the cycle to rebuild buffers.

The second point regards the external sector. We continue to see a need for rebalancing in some countries with large current account surpluses. Imbalances are generally good; but at least in the case of monetary unions, they may cause externalities to other members of the union. Net creditors could take action to raise private investment, encourage wage increases, and use ample fiscal space. There are efforts that go in the right direction, but more needs to be done.

Mr. Agung made the following statement:

I thank the staff for the excellent report, and I also thank Mr. Meyer for the informative buff statement.

We welcome the broad-based growth in the euro region, which remains sound, supported by a wide range of policy efforts and supportive monetary conditions. The member states should take this opportunity to advance the necessary structural and fiscal reforms and rebuild buffers. In particular, the current strong growth environment should be optimized by the authorities to more decisively rebuild fiscal buffers and reduce high debt.

The EU-agreed fiscal rule must, therefore, be complied with and applied fully and consistently across member states and over time. This is indispensable for trust in the common currency and for progress toward completing the EMU.

Finally, further progress is also needed on reducing risks in the banking sector. Low profitability is a legacy problem for many banks, even in favorable economic conditions. Some banks remain vulnerable to adverse changes in market conditions. The FSAP report shows that NPLs are still high in a few countries and need to be addressed more aggressively.

Regulatory reform and supervisory action to tackle this vulnerability should be vigorously pursued. In this regard, I want to suggest that in the case of the euro area, given its size, complexity, and ongoing architectural reforms, we would have seen value in having a separate discussion on the Article IV and FSAP.

Ms. White made the following statement:

I thank the staff for the clear and informative reports and Mr. Meyer for his buff statement and helpful introduction.

We issued a gray statement, in which we broadly agreed with the staff's analysis, and we appreciate the answers that the staff provided to the questions we posed. We also appreciate the brief update from the Chairman on the developments since the reports were circulated, including the publication of the U.K. Government's white paper in the last weeks.

On that point, I note that the staff report's main source of data for the non-tariff barriers, the Cross Whitehall briefing paper, was provisional and incomplete internal work. We look forward to the staff incorporating the newly published white paper in their future work.

Second, I have a more general point on the FSSA, which is very much in line with the point made by Mr. Claver-Carone. As this chair has noted many times in the past, the analysis the staff provides in FSSAs as both a standalone document and as a complement to Article IV reports is invaluable. The Fund's unique role in providing objective, in-depth, and comprehensive analyses is critical. This particular FSSA posed unique challenges, given the euro area's supervisory model and the number of authorities involved. The staff are to be commended for their efforts here. We hope that any learnings from this exercise in terms of process and results will be incorporated in the upcoming FSAP review.

Third, reflecting on Mr. Kaizuka's points about the need for ongoing monitoring of the economic implications of Brexit and the limitations of the model, we fully expect the staff will be on top of this and wondered whether they could share any plans for future channels, such as the link between trade and total factor productivity (TFP), such as knowledge delivery and innovation.

Mr. Gokarn made the following statement:

We join others in thanking the staff for an excellent set of reports and Mr. Meyer for his buff statement and opening remarks, and the Chairman for her opening remarks.

I have two sets of points. One relates to the second selected issues paper. The Chairman mentioned the first selected issues paper on Brexit, but the second one is equally important. It highlights the fact that this region has had a persistent problem with youth unemployment. Despite an overall decline in unemployment, youth unemployment seems to remain very sticky and sluggish. It is an important effort, following up on the paper that was done a few months ago, trying to understand what causes youth unemployment, why is it so persistent in some countries, and what governments can do to address it. This is a larger question that many of our countries deal with, and we would appreciate this work stream being expanded beyond the confines of the euro area, understanding that there are data limitations that will impede it.

I want to focus on the situation in Europe. A number of causal factors have been identified in the selected issues paper. In terms of recommendations, what is confidence based on evidence that some of the initiatives that have been talked about in the paper will address the problem? In particular, I am speaking of the reference to the use of regional resources to incentivize labor market reform or other kinds of structural reforms that will help this problem. This bears a deeper analysis, and we would like to hear about the staff's thinking and possible solutions to this problem.

The second issue relates to a point that Mr. Alogeel and Mr. Rouai raised in their gray statement about Basel Core Principles. Despite an overall positive assessment of the stability of the financial system, the report points out that for 6 out of 28 Core Principles the system was materially non-compliant, but this was not given much attention in the report. The question is: Is this a transitional situation? Is the system converging toward this compliance? Also, in terms of aggregation from individual countries to the region, is there some disconnect? Are country systems, compliant, whereas, when the staff aggregates the region, it does not meet the mark on these issues?

Mr. Armas made the following statement:

I thank the staff for the excellent report for both the Article IV and the FSSA. We issued a gray statement, so I want to emphasize one point from our statement and also provide our reaction to one of the questions that we asked in our gray statement, which is question No. 6.

In terms of emphasis, we welcome the willingness of the authorities to preserve the euro area during this hard period when the euro area was facing a serious challenge, because we consider the euro area to be one of the most important transformations in the global economy over the past century.

We welcome the growth rate in 2017 as it was at the highest since the crisis. We welcome the improved job creation. We also appreciate what Mr. Meyer emphasized, the fact that for the first year, every country has accomplished the fiscal deficit.

Beyond that progress, clearly, there is no room for complacency. We asked a question about how inequality has been impacted, and the answer that we received concerns us. It was mentioned that youth unemployment remains above 20 percent in several countries. Job creation for young adults has been much lower than the overall rate. In that regard, we encourage the authorities to continue with the structural reforms to achieve inclusive economic growth because that is key for the long-run sustainability of the euro area as a whole.

The Deputy Director of the European Department (Mr. Pradhan), in response to questions and comments from Executive Directors, made the following statement:[3]

I will start with Mr. Tombini's question on the tone of the report, on this idea of safe assets that is being proposed by the European Systemic Risk Board (ESRB).

The ESRB's proposal has been around for about five years and is put out now in a much-refined form from earlier incarnations of that report. The key in that proposal is that there is no mutualization and all that is required is some enabling legislation. I will explain what that enabling legislation is.

At present, for investors or banks, when they hold sovereign debt, government bonds, they do not incur a risk weight. But if they hold a securitized asset, something that has a sovereign bond inside it but is a tranched asset, then they incur a capital charge. To make it a level playing field, that capital charge on a high-quality, securitized asset, which comprises income streams from AAA-rated bonds, should be set at zero, which would make it a level playing field with sovereign bonds.

At this point, there is not enough support in the EU to make that legislative change, to make it a level playing field. Our view is that the way this asset is proposed, its success depends entirely on the market demand for this asset. We are not against this safe asset coming into being if the market has a demand for it. We have been supportive of the legislative change that

[3] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

would make a level playing field, but there has not been appetite for it. There are many other technical aspects of this proposal that I will not go into now, but I want to assure the Board that we are not against the proposal, itself.

I will address two general questions. I will start with Mr. Kaizuka's point, which Mr. Meyer also mentioned, although he did not pose it as a question. Mr. Ostros and Ms. White also raised this. It is about our work on Brexit and the modeling of it. We feel reasonably comfortable that we have looked at many different studies of this type done by the OECD, by other academic researchers, and we have presented this work at the European Commission, at the ECB. These institutions have not published their own estimates, but they have not questioned our estimates or our modeling techniques. We are always willing to subject our modeling techniques to scrutiny. We are publishing it, so it will be widely available.

We have done our best. When Directors say that we suffer from modeling limitations, we would like to hear from them and their authorities what these modeling limitations are, because that would help us. That would help us improve our work.

Let me turn to Mr. de Villeroché and Mr. Kaizuka, who both raised the issue of corporate taxation. The staff is working on a Board paper to discuss various aspects of international taxation, together with our experts in the Fiscal Affairs Department (FAD). They are actually in the lead on this. The staff report does mention some progress. The Anti-Tax-Avoidance Directive, which will come into force in 2019, should significantly reduce tax avoidance. There is another measure on the way, the comprehensive CCCBs. It is still being discussed, and if adopted, would be a major simplification. In the area of digital taxation, the Fund's position is that international coordination would be both useful and necessary. It may not be an area where one region or one bloc—however complicated the EU might be—can go and make progress on its own, because this is a difficult area. I am saying this, knowing that our FAD experts are working on this, and we will follow this up.

In response to Mr. Gokarn's question on traction and the central fiscal capacity. Mr. Ostros and Mr. De Lannoy noted—in line with Mr. Meyer's comments—that progress on architecture takes time. On the central fiscal capacity, at this point, there is not consensus or strong support among all member countries. This will take time. But there is, as Mr. de Villeroché pointed out, the German and French agreement on the euro area budget. Things are moving gradually in that direction. It will take time. We will continue to argue the case for a central fiscal capacity because, in addition to idiosyncratic shock, we also believe that it would lead to a more optimal policy mix of monetary and fiscal policy in the area. But there are many hurdles, many safeguards and moral hazards. People want to avoid permanent transfers and we will continue to work on a better design.

The staff representative from the European Department (Mr. Aiyar), in response to questions and comments from Executive Directors, made the following statement:

It is absolutely right that the youth unemployment points to an important structural impediment in the euro area. In response to what can be done about it, our study finds that the labor tax wedge is an important determinant of high youth unemployment, so fixing the labor tax wedge is one element. Another element would be targeting education to young people in areas that improve competitiveness. A third would be product market reforms which make entry and exit of businesses easier, reform of insolvency regimes. Anything that makes it easier to establish a business, run a business, and close a business could potentially help with the problem of youth unemployment.

Finally, a Director asked whether the CFC proposal in itself could help with youth unemployment. My answer to that would be, probably in the future. At this point, it is already a legacy problem, and what the CFC does is help with unemployment in a cyclical manner. In the next crisis, if it prevents unemployment from rising as far as it would in the absence of the CFC, and thereby obviates the hysteresis that would occur in the absence of the CFC, then to that extent it would help dampen future youth unemployment.

The staff representative from the Monetary and Capital Markets Department (Mr. Hardy), in response to questions and comments from Executive Directors, made the following statement:

I thank Directors for their interesting and thought-provoking gray statements. As a general point, it is worth bearing in mind that this FSAP was focused on what are distinctly euro area issues, rather than on broader European Union issues. Thus, analyses and recommendations concentrate on the resilience of the large banks, how they are supervised, the management of the banking crises in the euro area, and systemic liquidity management. This economy in resource use, which I expect the Board supports, implies that relatively less attention was paid to certain EU-level matters, except insofar as they were highly pertinent to the euro area. Examples of such lower-intensity matters include the regulation of insurers, AML, and the capital markets union.

For example, regarding the oversight of conglomerates, I would like to point out that the BCP assessment does look at consolidated supervision; but also, conglomerates were addressed in the recent Belgian FSAP. They may be followed up in national FSAPs later for countries in which they are particularly important—likewise, the issue of data gaps relating to so-called other financial institutions. We note that in the FSAP, but we have also already addressed this in the recent FSAPs for Luxembourg, the Netherlands, and Ireland. We noted that the authorities in those countries have actually been active and effective in trying to fill those gaps.

We noted that this is a complicated set of policies, and there are areas where the opinions of reasonable people may differ, or at least differ in emphasis. One such area, which came up in a number of gray statements, relates to the oversight of liquidity risk and how it is managed. The FSAP gives full credit to the authorities for the increasing comprehensiveness of their approach and their alertness in addressing strains that arise from time to time. But we have seen in the global financial crisis and in recent cases of bank interventions, including in the euro area, that the reduced availability of liquidity and spikes in funding costs are the proximate determinants of bank failure, so it is worth doing a good job in this area.

On the specific point of the Basel Core Principles 24, in observance of it, a careful assessment of compliance with the essential and additional criteria was undertaken, based on the procedures and practices that were obtained at the time, and a number of deviations from the Basel standards were documented. These shortfalls relate mostly to the requirements placed on banks and not to the ECB's monitoring of liquidity risks. If Directors would like to see documentation, it can be found in the Report on the Observance of Standards and Codes (ROSC), paragraph 45, page 73 of the FSSA. No one item was critical; but in our opinion, and consistent with the assessments made for other FSAPs, together, they amounted to a material shortfall relative to that exacting standard.

Similar issues applied to the other standards, where full compliance was obtained. The authorities chose to be assessed relative to the essential additional criteria and a very tough standard. These standards have evolved over time, so they are not fully comparable to the past FSAPs.

If one looks at the recent country materials, one will see similar issues arising, some perhaps a bit better, some a bit worse. One of the challenges for the SSM is that it needs to apply the supervision using rather fragmented legal frameworks in many areas.

Something similar relates to ELA, where elements of harmonization are there, and we have acknowledged this very much. But national central banks do differ in their operations, in the criteria they use for evaluating collateral. There is a tension between harmonized supervision and more decentralized ELA. Therefore, the FSAP talks about further harmonization over perhaps the next few years and then more integration thereafter.

Similarly, on crisis preparedness and management, the staff came to the conclusion that, despite impressive progress, fragmentation in laws and procedures remains significant and is a crucial impediment to reducing risk and creating a true banking union. Indeed, improving how the system deals with weak banks is essential to smooth structural change in the sector and to eventually restoring profitability. We do not see these things as separate elements; they are very much part of a whole. The FSAP recommendations on financial stability exemption, an administrative liquidation tool, and also paring back the processes for state aid rule oversight of EA-level resolution actions are designed to help reinforce a credible, time-consistent system for dealing with problem cases that supports the banking union. The recommendations are based on our analysis and are very much in line with the international "Key Attributes" in this area.

On financial market infrastructure and specifically, the internationally important central counterparties (CCPs), we believe that there is less disagreement on this complex topic than meets the eye. The objective should be to maintain or even enhance a system that yields the benefits of centralizing transactions in CCPs—in terms of efficiency, market liquidity, and reduced counterparty risk—while ensuring consistently strong oversight and the ability to deal with contingencies that may arise. We see the solution in the application of rules in keeping with the internationally agreed Principles for Financial Market Infrastructures, strong cooperation and information sharing among authorities, a role for central banks of issue on liquidity questions, and safeguards to ensure that all authorities are doing their part. To this end, it seems entirely reasonable that the EU regime be aligned with that of others regarding deference to the home authorities of a third-country CCP, wherein most home authorities do retain some form of direct supervisory authority. We believe a global system of symmetric deference, open communication, and cooperation is the way to go.

We look forward to following up on the FSAP through our ongoing dialogue with the European authorities. Also, the euro area FSAP will inform the upcoming national FSAPs and will make them more efficient and more focused on particular national concerns. We are also planning various forms of outreach to market participants, academics, and other stakeholders.

We would emphasize that this is a collaborative venture with authorities and with Executive Directors, as reflected in Mr. Meyer's constructive and helpful buff statement. We have been communicative throughout. We enjoyed working with authorities' staff and various agencies on these matters.

Mr. Meyer made the following concluding statement:

I thank Directors for an interesting discussion and the staff for their useful explanations. Our euro area authorities will appreciate the encouragement and the numerous thoughtful suggestions for further improvement.

I will make two comments on substance. On the Basel Core Principles, as Mr. Hardy also explained, our authorities chose to be assessed against the high standards. Considering that we created a number of new institutions, to a certain extent, it is understandable that there are still some weaknesses. We will work hard to further improve them, and this also means the improvement of the interplay between the national and the euro area level.

On the issue of inclusive growth raised by Mr. Armas, our authorities could not agree more, that this is front and center. The question then is—and this is the debate that is ongoing—what to do at the national level versus the euro area level.

I will now thank the staff teams. The two teams are so big that I could not possibly mention all of them. I will just thank the euro area team, headed by Mr. Pradhan and Mr. Aiyar, aided by Ms. Barkbu and Mr. Bathia; and on the side of the Monetary and Capital Markets Department, I thank the head of the team, Mr. Hardy, along with Ms. Elliot and Mr. Elekdag, and all this under the supervision of Mr. Morsink. I thank the staff for the constructive engagement. It is greatly appreciated on our side.

Let me finish with a quote from Robert Schuman, one of the founding fathers of the EU, as a way to respond to some of the worries expressed today regarding the further evolution of the EU: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the continued broad-based economic expansion and strong job creation, underpinned by solid domestic demand and accommodative monetary policy, noting that this is the fruit of many years of sustained policy effort. Core inflation and wage growth remain subdued, however, despite a closing output gap and a recent energy-price driven spike in headline inflation.

Directors cautioned that risks are skewed to the downside, stemming from domestic policy inactions and political shocks, as well as a less favorable external environment, underpinned by escalating trade tensions and Brexit-related uncertainties. Moreover, policy reversals could risk sending borrowing costs abruptly higher, derailing the ongoing expansion.

Directors agreed that monetary policy should remain supportive until inflation is convincingly converging to the ECB's objective. They welcomed the ECB's intention to keep interest rates low well beyond the end of net asset purchases this year. In this respect, clear communication remains essential to anchor interest rate expectations.

Directors agreed that decisive policy efforts should support external rebalancing and promote trade openness and the rules-based global trading system. With respect to staff's assessment that the euro area current account surplus is moderately stronger than warranted by fundamentals, they underlined that the policy remedies lie primarily at the national level.

Directors were concerned that national budgetary plans did not adequately address country-specific challenges. High-debt countries should increase their fiscal adjustment efforts while conditions remain supportive. Directors generally also encouraged countries with ample fiscal space to pursue additional investment that will lift potential growth and contribute to necessary external rebalancing. Directors stressed the importance of better compliance with and enforcement of the fiscal rules, along with a plan to simplify the fiscal framework. They also called for internationally-coordinated efforts to address new taxation challenges arising from globalization of corporate activities and digitalization.

Directors recognized that deep structural issues continued to impede medium-term growth prospects and hamper income convergence. They urged countries to step up structural reform efforts to boost productivity and employment, and supported initiatives to link EU financial support to reform implementation.

Directors welcomed the improvement in overall banking health, as documented in the Financial Sector Assessment Program review. They urged further efforts to strengthen the resilience of the system, in particular in terms of profitability, and encouraged vigilance against financial stability risks. They appreciated the strengthening of banking supervision under the Single Supervisory Mechanism, while noting remaining challenges. Directors encouraged on-going supervisory and other actions to clean up legacy assets. They recognized that bank crisis preparedness and management have been upgraded, yet saw the need to address certain transitional and structural issues. They agreed on the importance of building up “bail-in-able” debt in banks, and gradually reducing financial intermediaries’ exposures to home sovereign debt, both of which will help attenuate sovereign-bank feedback loops. Further progress on building the capital markets union and enhancing the supervision of nonbanks were viewed as valuable in themselves, and all the more so in the context of Brexit.

Directors considered architectural reforms a necessary complement to national action. They urged swift progress on reducing the legal fragmentation across national lines, creating a credit line from the ESM to backstop the Single Resolution Fund, and establishing a common deposit insurance scheme. Most Directors saw merit in developing over time a central fiscal capacity to support macro stabilization, embedding strong safeguards against permanent transfers and moral hazard.

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.

APPROVAL: March 3, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Economic Outlook and Risks

1. ***Can staff comment on the impact of Brexit on the EU budget and the potential size of financial market activity to migrate to EU-27?***

- Brexit will open a gap in the EU budget due to the loss of the United Kingdom's net contribution of around €10 billion a year from 2021 (after the transition period). The European Commission's draft EU budget for 2021–27 proposes to close this gap, while also funding additional spending on priority areas such as migration and R&D, through both expenditure savings and revenue mobilization. The draft EU budget envisages rationalization of common agricultural and cohesion funds, and modernization and diversification of current revenue sources.

- Regarding the migration of financial activities, we do not have quantitative estimates to share at this time. However, as shown in Box 7 of the Staff Report, almost one-third of certain types of EU-27 financial services—such as syndicated loans and advisory services—and a significant share of EU insurance and derivative business are currently centered in London. All these services currently enjoy EU cross border passporting. After Brexit, banking and insurance services will lose cross border passporting benefits, and EU derivatives business from London could only continue if U.K. trading venues were recognized by the EU. Therefore, we expect a migration of EU-centric banking and insurance services from London to the EU-27 after Brexit. In fact, many firms (e.g., Barclays, Citi, and Merrill Lynch) have already announced plans to establish branches or subsidiaries in the EU-27.

2. ***We observe that there is a disagreement between the authorities and the staff regarding Brexit's macroeconomic impact. Could staff explain about where are the main uncertainties on that estimation?***

- Quantifying counterfactual outcomes is difficult. Staff has relied on various methods and datasets to provide a range of possible long-term economic effects of various Brexit scenarios on the EU-27. The estimated impacts fall within the range of estimates in the recent Brexit literature. To the best of our knowledge, no other study has yet examined the economic consequences of Brexit in such depth. Our work took into account various economic channels (beyond trade) through which Brexit can affect EU-27 countries as well as detailed country-specific sectoral ties with the

United Kingdom. As a result, we were able to provide robust estimates of potential output and employment losses for the EU-27 aggregate and by country.

- Despite these efforts, two sources of uncertainty remain (and are extensively discussed in ¶17 of the SIP). First, there is uncertainty regarding the outcome of ongoing negotiations between the EU-27 and the United Kingdom and the paper clearly acknowledges the impossibility of predicting the exact final outcome. Second, there is statistical uncertainty around the precision of the Brexit impact, even if we were to get the scenario right. Our paper goes further than the current literature on Brexit by providing robust confidence interval bands.

3. *Could staff provide an update on the likely impact of recent political developments on Brexit negotiations?*

- With 260 days until the United Kingdom's formal exit from the EU, the clock is ticking to finalize both the withdrawal agreement and the joint political declaration on the future relationship between the EU-27 and the United Kingdom. The EU-27 via its chief Brexit negotiator has welcomed the United Kingdom's post-Brexit White Paper, which will be analyzed by the EU-27 in light of the EU Council's negotiating guidelines. EU-27 concerns include preserving the integrity of the Single Market and its four freedoms (full mobility of goods, services, people, and capital) and permanently avoiding a hard border between Northern Ireland and the Republic of Ireland. Uncertainty therefore remains as to whether a workable solution can be reached ahead of time. Upcoming negotiation rounds, which start next week, will take some time.

4. *Noting that the authorities' views on this topic [Brexit] were not represented, could staff discuss how their assessment compares to the methodology and results of any impact analysis the ECB or EC have done?*

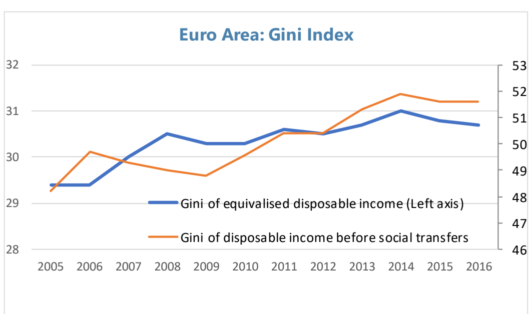
- Staff is not aware of any empirical study on the impact of Brexit on the EU-27 published by the European Commission or the European Central Bank. Staff has therefore benchmarked its results against those available in the academic literature and from the OECD. Staff results fall well within the range of estimates in these various studies

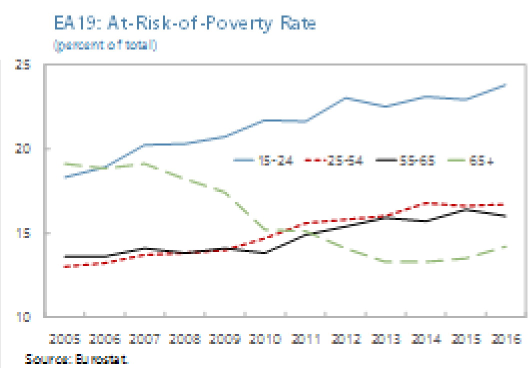
5. *We appreciate the staff's assessment on the macroeconomic impacts of Brexit on the EU and Euro area economy as highlighted in Box 1 of the staff report. Could staff provide further elaboration on the potential fiscal risks related to Brexit?*

- Brexit poses a potential fiscal risk indirectly through its adverse macroeconomic impact on the EU and the euro area. Lower nominal and potential output growth, as well as higher unemployment in the event of a "hard Brexit" scenario, would negatively affect public finances especially in countries with deeper economic ties to the United Kingdom, such as Belgium, Ireland, and the Netherlands. The European Commission's proposal for the 2021-27 EU budget already takes into account the loss of the U.K. net contribution, although how precisely the shortfall is met in the final EU budget remains to be negotiated among EU-27 countries.

6. ***This willingness and cohesion allowed to preserve the euro area, one of the most important transformations in the global economy over the past century. The growth rate in 2017 was at its highest since the crisis -a somewhat similar expansion is expected this year- and job creation exhibits positive outcomes and prospects. Beyond the progress made so far, clearly there is no room for complacency. After all the above-referred developments, could the staff elaborate on how inequality has been impacted?***

- The economic recovery in the euro area is strong, broad-based, and job friendly. The Gini index for the euro area overall increased during the global financial crisis, but has started to show signs of reversal as the economic recovery has progressed.
- However, youth unemployment remains above 20 percent in several countries, and job creation for young adults has been much slower than the overall rate. As flagged in the SIP, the share of young people at risk of poverty continues to rise in the euro area.





7. ***Text figure 1 clearly depicts differences regarding current account (some countries with excessive CA surplus, according to the staff report) and public gross debt (many countries with public debt-to-GDP ratios above 90 percent). Then, the report exhibits important differences on real GDP growth and substantial ones on non-performing loans ratios, unemployment rates, sovereign bond yields, etc. Could this dispersion exacerbate Euroscepticism?***

- The euro area is enjoying a recovery with all countries growing, and the dispersion of growth rates is at its narrowest since the launch of the single currency. This is no small achievement.

- However, staff views that insufficient policy buffers and deep structural challenges create fragility and stifle opportunity. The resulting threat to euro area cohesion requires determined responses, especially at the national level. Risk reduction needs to include rebuilding fiscal buffers, improving productivity, addressing external imbalances while maintaining trade openness, and enhancing resilience in banking and finance. In addition, architectural reforms are a necessary complement to national action. The priorities are completing the banking union; advancing the capital markets union; and creating a central fiscal capacity. All these efforts need to bring together risk sharing and risk reduction

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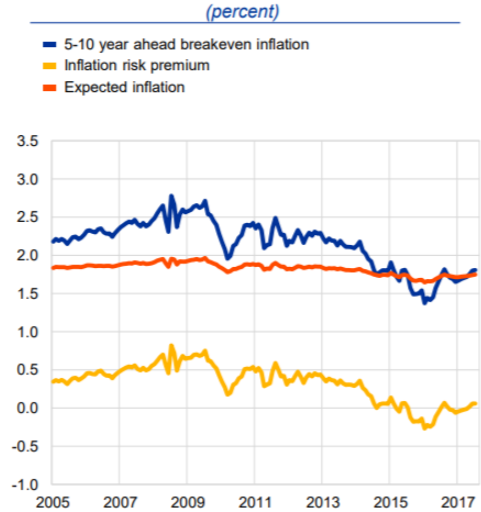
8. ***We welcome staff's elaboration on the ultimate impact of looser U.S. fiscal stance on the Euro.***

- On balance, we think that the U.S. fiscal expansion would put some downward pressure on the euro. Besides pushing up the longer-term rates through increasing the supply of government debt, the procyclical loosening also generates higher inflation, possibly prompting the Federal reserve to hike more rapidly and hence a stronger dollar. In addition, some fiscal measures aim to bring overseas corporate profits back to the U.S., which could contribute to dollar appreciation. We agree that the resulting deterioration of the fiscal position and the widening current account deficit could weaken the fundamentals of the US dollar. Nonetheless, the customary safe-haven status of the dollar affords some protection against significant depreciations that might associated with fiscal deteriorations.

Monetary Policy

5-10 year decomposition of breakeven inflation rates for the euro area
(percent)



Source: Thomson Reuters and ECB staff calculations.
Notes: The decomposition is based on an affine term structure model and fitted to the euro area zero-coupon inflation linked swap curve. The estimation method follows Joslin, Singleton and Zhu (2011). For details please see Camba-Mendez, G. and T. Werner (2017). Last observation is for December 2017.

9. ***We note that staff's forecasts for euro area inflation are higher than market-based inflation expectations. Could staff discuss the main drivers of the different forecasts?***

- The lower market-based inflation expectations (as shown in staff report figure 10), compared with forecasts by IMF staff (and also those by ECB staff and professional forecasters), likely reflect the currently negative inflation risk premium, as investors are less concerned about upside inflation risks. This matters because market-based inflation expectations, derived from yields of inflation-linked swaps, reflect both 1) market participants' expectations of future inflation and 2) the inflation risk premium. An ECB publication (in January 2018) shows that the inflation risk premium has fallen and turned slightly negative in recent years, while the expected medium-term inflation rate has been close to ECB's objective. In staff's projection, inflation will converge gradually to the ECB's objective.

10. ***Meanwhile, while we can see large divergence of wage growth across member countries, it is difficult for the ECB to deal with it by monetary policy. In this light, we would welcome staff's comment on appropriate response of member countries to deal with the divergence.***

- The divergence of wage growth across euro area countries reflects differences in productivity growth, unemployment rates, and inflation rates. Staff have shown in past consultations that structural reforms could benefit countries with lower productivity levels to a larger extent, helping to close competitiveness gaps and contribute to a healthy rebalancing within the euro area. At the same time, stronger wage increases in countries such as Germany will increase wage differentials, but also contribute to needed rebalancing.

11. ***We wonder if staff are perhaps placing too much weight on persistence as an explanation of subdued trend inflation, and if they underplay the role of structural reform. Staff comments would be welcome.***

- There is a wide range of uncertainty around estimates of slack and output gaps, and low inflation may suggest there is still unmeasured labor market slack. The unemployment rate, for example, does not capture the underutilization of labor due to discouraged workers or involuntary part-time work. This is why we have studied the inflation process in detail. And we find that the persistence in the inflation process remains the key driver for low inflation, regardless of which slack measure we used in the modeling (e.g., the unemployment rate, different measures of the output gap and a broader measure of slack).
- Staff's baseline assessment remains that the remaining unemployment is mostly structural now, considering how long this recovery has been going and how unemployment has fallen. The persistence in the inflation process delays the adjustment of inflation to labor market developments, which we consider a key reason for the fact that inflation has been rising slowly despite the closing output gaps. It is possible that structural reforms have kept wage growth and inflation low, particularly in countries where reform efforts have been strong. Product market reforms can boost potential output and labor market reforms can increase labor supply, hence are "disinflationary" in a favorable sense. However, given weak reform progress in recent years, we do not see structural reforms as a major driver of current low underlying inflation in the euro area.

Fiscal policy

12. ***Regarding the staff's proposal of simplifying the rules, we appreciate staff's more detailed elaboration on the proposal and granular evaluation for it.***

- Staff published a proposal to strengthen and simplify the SGP rules in 2015, see SDN/15/09 on Reforming Fiscal Governance in the European Union. The proposal consists in moving to a single fiscal anchor (e.g., the gross debt as a share of GDP) and a single operational target (e.g., an expenditure growth rule tied to the potential growth rate), with a debt correction mechanism linking the expenditure growth rule to the anchor. This simplified framework should be complemented by greater automaticity in enforcement, more credible sanctions, and more enhanced monitoring, including by national fiscal councils, to incentivize compliance and reinforce fiscal sustainability.

13. ***In view of the above, are there specific reasons related to the institutional framework of the euro area that limit the traction of Fund's policy advice since there is currently no proposal to reform the fiscal rules? Or, was there a genuine need for flexibility in the implementation of the fiscal rules in the aftermath of the global financial crisis?***

- As noted above, staff proposed how the rules could be simplified in a SDN in 2015. While the Commission has broadly agreed with our proposal to simplify the rules, there is no political consensus currently for a big overhaul of the rules. Moreover, some of the reforms would require EU Treaty change, which makes it very difficult to do.
- During and immediately after the global financial crisis there was arguably a need for flexibility in the application of the fiscal rules, which staff has supported by calling for flexibility related to public investment and structural reforms. However, the balance of risks for countries with high debt levels argues for stronger consolidation efforts consistent with a less lenient interpretation of the fiscal rules, particularly in the past few years when we have seen strong growth and rapidly closing output gaps.

14. ***We note that neither the European Commission or the IMF has significant traction on fiscal policy recommendations; national fiscal stances are in many cases quite different to recommendations. To what extent has this divergence tended to be planned or unplanned in recent years – for example, due to revenue surprises?***

- Better than expected growth, revenue surprises, and interest expense windfalls have certainly impacted the headline fiscal balance outturns in recent years. However, for some countries much of the divergence between IMF advice and their fiscal stances, when measured by the change in the structural primary balance, have been planned.

For example, in recent years, even as headline fiscal balances have improved on the back of stronger growth and lower interest expense, structural primary balances have deteriorated in several high debt countries—such as Italy, Portugal and Spain—contrary to IMF advice for gradual consolidation. At the same time, countries with ample fiscal space have not invested as much in human and physical capital as the IMF has recommended.

15. ***Could staff comment on the contrasting views expressed in the report by the authorities' and the EFB regarding the flexibility of SGP rules?***

- The European Fiscal Board, in its annual assessment of the application of the SGP rules, found that both conventional and new degrees of flexibility were used in 2016. The EFB argued that such greater flexibility, and the consideration of the economic rationale, such as stabilization, had come at the price of complexity and more discretion. The European Commission considered that the flexibility had allowed countries to appropriately balance stabilization and sustainability objectives. Both parties, however, concurred with staff that, given robust growth and closing output gaps, high-debt countries should now focus on rebuilding buffers.

16. ***How can the EU institutions, responsible for enforcement of the fiscal rules, encourage national authorities to implement more appropriate fiscal policies?***

- Implementing sound fiscal policies is ultimately a member state's responsibility. However, better enforcement is needed to strengthen the credibility of the common fiscal rules. Moreover, simplifying the fiscal rules would make monitoring of the rules more transparent and communication easier, which could improve incentives for compliance. Financial incentives, such as making support from a central fiscal capacity conditional on compliance with the rules, could also help build political buy-in. Finally, enhanced monitoring and communication by national fiscal councils and the European Fiscal Board, could also encourage sound fiscal policies by raising the reputational costs of imprudent fiscal policies.

17. ***Regarding corporate tax, the European Commission has proposed the Common Consolidated Corporate Tax Base (CCCTB) and a digital sales tax. We welcome staff's comment on fiscal and growth impacts of these measures to the euro area.***

- These are proposals that remain to be fleshed out, so we don't have a full assessment of the fiscal and growth impact yet. That said, preliminary assessment of revenue impact could be as follows:
- The proposal for the CCCTB envisages a firm's EU-wide profit to be allocated between members states based on factors such as sales, employment (payroll and/or number of employees), and assets in each country. It is expected that the

cross-country revenue allocation would be highly sensitive to the adopted apportionment factors and their weights, which could have significant redistributive effects.

- Regarding the digital sales tax, at a tax rate of 3 percent, preliminary estimates suggest it could raise about €5 billion (0.03 percent of EU GDP)—a rather marginal increase in revenue but from a distortionary instrument.

18. ***On corporate tax issues, we note the divergence of views between staff and the European Commission (EC) on the recommendation for a digital sales tax, and appreciate staff elaboration, including on the expected timeline for its adoption as well as its likely implication for a more permanent yet elusive internationally coordinated comprehensive solution.***

- The proposed digital services tax by the Commission has the risk to be highly distortive. It applies tax irrespective of the level of profit; can lead to international double taxation; and might not achieve its goal of taxing profits, as the tax may ultimately be shifted onto local consumers. Staff favors a harmonized international solution, and the OECD has reported recently that the Base Erosion and Profit Shifting (BEPS) Inclusive Framework members are working on a consensus-based solution by 2020.
- Currently, there is no common position on a digital sales tax among EU or OECD/Inclusive Framework member states. While some states favor a permanent and internationally coordinated solution, others consider a temporary solution, such as a digital sales tax, as needed to address current revenue losses. Spain, for instance, has proposed recently a digital services tax, aligned with the Commission's proposal, to be effective before end-2018. With EU decisions on taxation requiring unanimity, however, there is no certainty as to whether and when the digital sales tax proposal will be approved at the EU level. It is similarly unclear what implications this might have for a more permanent internationally coordinated solution, but it has clearly focused more attention on the issue.

Structural reforms

19. ***We welcome staff's recommendation to improve incentives by linking EU financial and technical support to structural reform implementation, and would appreciate hearing from staff about the authorities' reaction to this proposal.***

20. ***We encourage further steps to strengthen public administration capacity and ensure the effectiveness of institutions including justice systems. Staff comments on the proposal to link EU financial support to reform implementation would be welcome.***

21. ***We welcome staff elaboration on the main reasons for the slow progress in the structural reform agenda and the extent to which linking EU financial support to reform implementation could help accelerate progress.***

- The slow progress in implementing structural reforms reflects a number of factors, including political opposition, concerns about distributive and short-term economic effects of reforms, and financial and capacity constraints.
- The recommendation to link EU financial and technical support to reform implementation has been part of our advice over the past years. It would help alleviate financial and capacity constraints and cushion distributive and short-term economic effects of reforms.
- In this respect, the European Commission has recently proposed, in the context of the 2021–27 EU budget, a reform support program to provide financial and technical support to EU countries pursuing structural reforms. This includes a reform delivery tool (€22 billion) which will provide financial support for implementing key reforms such as those identified in the EU country-specific recommendations, and a technical support instrument (€0.84 billion) to help countries design and implement reforms and improve their administrative capacity.

22. ***While we agree that gains in productivity will need to be reinforced by structural measures if they are to be sustainable we would query staff's assertion that "much of the improvement [in competitiveness] was cyclically driven". Rather we consider that wage restraint in the periphery, in part linked to the implementation of structural reforms, brought nominal wage growth more in line with productivity development and that part of the adjustment took place through a reallocation of resources towards the more productive export sectors. Staff views would be welcome.***

- We share the Executive Director's view that wage restraint and structural reform efforts have helped deficits countries to regain competitiveness after the crises. However, as shown in the staff report, productivity gaps remain, suggesting that more needs to be done in this regard. Moreover, high unemployment and depressed demand post crises led to low wage growth and inflation in deficit countries, which played an important role in containing labor cost. Our concern is that, as the economies recover and wage growth revives in these countries, the competitiveness gaps have not been addressed. This is consistent with the observation that improvements in unit labor cost stalled during the recent years of economic recovery for several member countries including France, Greece, Italy, Portugal, and Spain. Staff have shown in past consultations that structural reforms could benefit countries with lower productivity levels to a larger extent, which will be the key in closing the competitiveness gaps and ensuring a sustainable rebalancing within the euro area.

External Sector

23. ***Staff assess the euro area's external position in 2017 to be moderately stronger than implied by medium-term fundamentals. Meanwhile, the euro area's aggregate fiscal stance is expected to be modestly expansionary this year. Do staff view this fiscal impulse to be sufficient to address external imbalances and support growth?***

- The small expansionary fiscal impulse at the aggregate level—i.e., the sum of the 19 national impulses—will do relatively little to reduce the euro area current account surplus, as is reflected in our projections. Hence more is needed, especially from the countries with large external surpluses, including using fiscal space to finance well-targeted reforms and investments. Such actions would enhance potential growth and raise returns to private investment at home. At the same time, it is it important for high-debt countries to take advantage of the current favorable economic backdrop to rebuild fiscal buffers, even if these necessary actions will tend to reduce the aggregate fiscal impulse.

24. ***The aggregate external surplus in the Euro area is moderately stronger than that suggested by medium-term fundamentals. Could staff elaborate more substantially what might explain the accumulation of surpluses by the private sector?***

- As discussed in the staff report, Netherlands and Germany are the main two euro area countries that have excessive private savings relative to private investment. In the case of the Netherlands, the high CA surplus largely reflects the high corporate savings and liquidity of Netherlands-based multinationals, partly due to some favorable tax treatment for corporate income. In the case of Germany, rising corporate savings, alongside fiscal consolidation, are the main factors behind the rise in Germany's external surplus. Household savings have remained high, but stable. Several factors may explain the rise in NFC saving, including corporate tax reforms in 2000 and 2008 which reduced incentives for debt financing, precautionary savings motives following a period of tight financial conditions during the GFC, or a need to build up cash buffers to finance R&D spending. The decline in interest rates may also have reduced pressure to pay out dividends at the same rate as in the past.

25. ***We welcome the EU authorities' commitment to a free, fair, and rules-based multilateral trading system, as reiterated by Mr. Meyer in his helpful buff statement, and underscore the need to ensure that the gains from trade are more widely shared. Could staff elaborate on the gaps in WTO rules that leave important nonmarket distortions unaddressed?***

- The question refers to the authorities' views rather than staff's position. The authorities consider that important non-market distortions, such as industrial subsidies and unfair transfer of technology, remain unaddressed in the WTO rules and are actively engaging trading partners in this respect.

- Most recently, the EU and China announced the formation of a joint working group on WTO reform, focused on subsidy issues. The EU is also part of a group of countries that has circulated a rough proposal to tighten WTO rules relating to credit subsidies to state-owned enterprises. In addition, the EU has held discussions with trading partners on the enforcement of WTO subsidy notification requirements; extending WTO provisions on subsidies, and tightening WTO subsidy rules. Work also continues toward new export credit guidelines under the International Working Group on Export Credits (IWG), in which China and other EMs participate, along with the current participants of the OECD Export Credit Arrangement. Beyond subsidies, the EU, Japan, and U.S. have discussed cooperating on other areas in which reform is needed to address gaps in the rules-based trading system such as those pertaining to technology transfer policies and practices and foreign investment screening practices.

Euro Area Architecture

26. ***The staff makes thoughtful and timely recommendations on banking union, capital markets union, and fiscal institutional reforms. From the political point of view, how likely is the materialization of these recommendations?***

- For a brief moment, there had been signs that Brexit and broader geopolitical challenges might inject new energy into European efforts to advance the eurozone architecture more forcefully. At the Euro Summit in June, leaders agreed to progress towards completion of the banking union, to strengthen the European Stability Mechanism (ESM) and to discuss all other relevant items. Differences of views remain on the issue of a common fiscal capacity. While staff was hoping for more progress at the June Euro Summit, it takes note that the Euro Summit will come back to these issues in December 2018.
- **Banking union.** Leaders agreed that the ESM will provide the backstop to the SRF, and that the ESM will be strengthened, with details to be fleshed out by December 2018. The agreed statement vaguely refers to a common deposit insurance scheme, calling for a roadmap for political negotiations conditional on sufficient risk reduction.
- **Capital markets union**. This issue appears less politically controversial contentious in that it hinges more on overcoming—sometimes complex—technical challenges. The ongoing discussion is therefore largely not concerned with this issue. Staff does not expect CMU to be one of the areas where there will be a significant acceleration in the coming months relative to the already-agreed timetables.

- **Fiscal institutional reforms.** No decision was taken on a euro area budget at the June Summit, despite its prominence in the Franco-German Meseberg declaration adopted a few days earlier. Regarding staff's proposed central fiscal stabilization capacity, staff is aware that such a facility has little political support at this juncture. Staff had always stressed that it viewed such steps toward deeper fiscal integration as more of a medium-term endeavor.

27. ***We believe that with the development of fiscal cooperation within the euro area, the monetary policy decision could be conducted in a more unbiased manner and thus further mitigate financial and economic risks. We welcome staff to assess a scale for the progress of the 3 pillars respectively, from 0 to 10, for example, and give us a score on where we are at the current juncture.***

- While staff will not assign individual scores, below is a summary of progress so far. Despite significant achievements, some critical pieces of the architecture are still missing.
- **Banking Union.** Remarkable progress has been made in setting up the key pillars of the banking union, including in the areas of banking supervision and resolution, as also noted by the FSAP. However, a truly borderless single banking market will require a shared financial safety net and progress in reducing the divergence across national laws that results in fragmentation. Staff welcomes the recent agreement at the Euro Summit in June to progress towards completion of the banking union. Leaders agreed that the ESM will provide the backstop to the SRF, and that the ESM will be strengthened, with details to be fleshed out by December 2018. The agreed statement refers to a common deposit insurance scheme, calling for a roadmap for political negotiations conditional on sufficient risk reduction.
- **Capital markets union.** Last year's mid-point review found that more than half of the Capital Market Union Action Plan's individual items had been implemented. A new EU Prospectus Regulation, to take effect in 2019, enhances cross border comparability of firms' financial statements, with the European Securities and Markets Authority (ESMA) planning to set up an EU-wide online prospectus database. The European Venture Capital Funds Regulation supports financing for start-ups. Agreement in principle by the European Parliament and the EU Council on a standard for simple, transparent, and standardized securitization could help SMEs tap market financing. However, some important elements of the plan, such as insolvency law standards are still pending.
- **Fiscal institutional reforms**. The euro area currently relies too heavily on monetary policy to stabilize the economy when hit by a shock. Recently, some countries have supported a stabilization function to help maintain investment in the event of large asymmetric shocks. Agreement on such a stabilization function, while being an important step forward, would likely fall well short of the full-blown countercyclical facility that many believe is critical for the euro area and that staff has long

advocated. A concrete proposal for such a central fiscal capacity (CFC) for macroeconomic stabilization was laid out in a recent staff discussion note.

28. ***The capital markets union (CMU) has gained traction and support, with the authorities noting that remaining hurdles are at the technical rather than political level. Although the CMU was conceptualized to complement the banking union, we wonder whether the former can be completed before the latter is finalized. Staff's views are welcomed.***

- The CMU and the banking union are very much mutually complementary, aimed at facilitating borderless banking and capital markets—"finance without frontiers" to spur private cross-border risk sharing. The CMU is a multi-faceted, multi-year project aimed at improving investor choices and expanding funding opportunities for firms, helping them to diversify away from a bank based system. There are a number of elements in the CMU Action Plan that would support the banking union. For example, minimum standards for national insolvency laws would achieve a common framework for corporate and bank liquidations, and simple and transparent securitizations regulation would help banks and investment firms take advantage of lower capital requirements for securitized assets. Equally, there are multiple pending action items toward completion of the banking union, including steps to reduce national fragmentation in regulation, supervision, and resolution, to introduce a common backstop to the Single Resolution Fund, and to phase in common deposit insurance. These are not a hindrance to pressing forward on the CMU per se, although in practice much capital markets activity tends to be arranged or underwritten by banks. For these and other reasons, staff would argue that the two projects should proceed in parallel.

29. ***We note that the capital market union has progressed with key legislative and non-legislative measures. What are the prospects of success of a more comprehensive capital market union in future?***

- As noted, much progress has been made in implementing the CMU action plan. Further success of the CMU will depend on sustaining momentum to tackle complex challenges, including further harmonizing the legal and regulatory framework including on credit rights regimes and insolvency laws, and efforts to develop an investor base interested in more innovative, cross-border instruments.

Financial Sector and FSAP

NPLs

30. ***It is not clear to us why the timing of the recommendations on NPL resolution are backloaded (medium-term, within 2 to 5 years). This seems to be inconsistent with the urgency to address legacy issues, in particular double-digit NPL ratios, and with staff's own assessment in Box 1 of the FSSA that "the authorities should consider extending their NPL action plan to address legacy issues quickly.***

One of the three main NPL resolution recommendations is short-term, consistent with a realistic timeline to fully implement the reform. The other two recommendations are structural in nature, and will thus necessarily involve significant analysis, public consultation and a transition to full implementation, and will necessarily take more than 2 years. The other four recommendations contained in the Box 1 could be implemented effectively in a shorter timeframe.

31. ***We note many banks with high NPLs largely rely on disposals rather than loan restructurings, and wonder what steps are being taken at the national or euro area levels to bolster banks' workout capacity. Staff comments are appreciated.***

- The ECB/SSM NPL guidance issued in March 2017 includes requiring substantial improvements in banks operational capacity including changes in governance structure, NPL monitoring and reporting, and deployment of specialist collections and workout capabilities. Banks are expected to have detailed collection and workout targets for key performance indicators (e.g. cash collected, case response times, cases closes, caseload per employee, etc.). Efforts are on-going: in July the ECB announced further steps to ensure that banks adequately provision legacy NPLs. This more intrusive oversight has led to substantial improvements in workout capacity in most banks, including through outsourcing to specialist firms. But this operational transformation takes time due to the labor-intensive nature of the work and the need for re-training, and thus there is still scope to significantly improve capacity in many banks.

Bank Profitability

32. ***As banks' profitability remains far below pre-crisis level, aggressive reductions in NPLs are also important to improve their profitability. In this regard, we take note of the staff's view that profitability reflects deep structural issues, including overbanking and unviable business models in some cases, and would welcome staff's comments on what policy responses would be considered to address these problems.***

33. ***Given that continued monetary accommodation is weighing on banks' net interest margins, we think operational cost reductions are important in the near-term to improve profitability and hence resilience. Staff's comments are welcome.***

- Despite recent improvements, bank profitability remains a concern for numerous euro area banks. Analysis based on 109 major euro area banks over 2007–16 suggests that higher growth would raise profits, but that a large share of banks with the weakest profitability would continue to struggle even with a cyclical recovery. Furthermore, the analysis indicates that higher short-term interest rates and a steeper yield curve generally do not appear to raise bank profitability. Operational cost reductions would improve profitability for most banks, but those in the least profitable bucket would benefit most from NPL resolution. In sum, taking advantage of the current upswing to address NPLs stocks, enhance efficiency, and revamp business models (as appropriate depending on bank-specific circumstances) would contribute to durably improving medium-term bank profitability prospects. For further details, please see the Euro Area Policies FSAP Systemic Risk Analysis Technical Note.

34. ***There is some evidence that higher capital requirements and the new resolution regime have succeeded in fostering expectations of bail-ins instead of bail-outs. While this should reduce moral hazard and improve financial stability, it also pushes down on bank profitability by reducing the indirect subsidy that arises through lower bank funding costs. Staff views on these possible alternative causes of low profitability would be welcome.***

- The "Too-Important-To-Fail" (TITF) implicit subsidy is relevant for the largest of banks, typically G-SIBs, whereas weak bank profitability is generally more pervasive across numerous euro area banks. Therefore, although the expectation of greater future bail-ins may have raised funding costs for the largest of banks, this is less likely to be one of the main determinants putting downward pressure on the profitability of most euro area banks. Indeed, empirical analysis of 109 major euro area banks (of which at most 8 are considered G-SIBs) indicates that real GDP growth and the NPL ratio are the most reliable predictors of profitability. For further details, please see the Euro Area Policies FSAP Systemic Risk Analysis Technical Note. Moreover, saver banks with less cyclical risks should also have a lower cost of capital. These are very interesting propositions and could be further investigated empirically.

Financial Stability Risks

35. ***Since the report does not elaborate on the implications of the protracted period of low interest rates on pension funds and insurance companies, we would appreciate staff's assessment of the risks stemming from low interest rates for these sectors.***

- Protracted low interest rates have hurt the profitability of the insurance sector, but there is no euro area-wide concern as yet. The concern was most acute for firms that offered guarantee rate products, concentrated in some euro area countries. However, we see an adjustment by these insurers and improved market conditions. Long-term interest rates and the slope of the euro yield curve increased in 2017. There is evidence that affected insurers have also made a downward adjustment in guaranteed rates that has helped them adapt to the low rate environment. The Technical Note on Insurance, Investment Firm and Macroprudential Oversight presents empirical evidence from the investment spread (that is, the investment yield minus the guaranteed interest rates): on aggregate, EA insurers' investment spread has been positive over the last years.

36. ***We welcome staff's discussion on the profit of corporates in the euro area and their capability in absorbing the shock of rate raise.***

- The FSAP stress tests found a positive relationship between the slope of the yield curve and corporate defaults. On average, every 100 basis point steepening in the sovereign yield curve increases the probability of default (PD) of corporates by ½ a percentage point, that is EA-wide average PDs would increase from 2.4 percent to about 3 percent. As a comparison, PDs increased by 2 percentage points during 2008Q4 right after the Lehman crisis. The sensitivity of PDs to the slope of the yield curve varies with countries and economic sectors. In addition, corporate credit risk deteriorates with a widening of spreads in bond markets (relative to the Bund) and money markets (relative to the Treasury bill rate). These econometric results are documented in the Annex of the Technical Note on Stress Testing.

37. ***It is essential to pay close attention to spillover effects of the U.S. fiscal expansion on long-term interest rates. We share the concern that sharp real estate price appreciation or corporate debt accumulation are emerging in some countries. In this light, how do staff see potential impacts of these risks on macroeconomy and financial system?***

- At the current juncture, staff sees no generalized financial stability concerns. Overall bank credit growth is still trailing nominal GDP growth in the euro area. Moreover, recent Eurostat data shows that residential house prices increased by 4.5 percent in 2018Q1 over the year, and the mortgage credit growth increased at a modest pace of 3.1 percent. Historical cross-country evidence suggests that risks of a generalized boom is low.
- However, based on a range of indicators—household leverage, housing affordability and corporate sector debt—to assess household and corporate sector vulnerabilities, staff finds that there are some localized pockets of excesses. For instance, there are some euro area countries that experience potential housing market overvaluation coupled with a recent pick-up in household indebtedness. And, in a few countries,

corporate debt relative to GDP is also rising fast. But, importantly, these cases are the exception, not the rule.

- Policymakers undoubtedly need to remain vigilant about potential financial sector risks and continue to expand the toolkit. In some cases, they need to move now to counteract isolated pockets of vulnerability.
- A few countries—Austria, Belgium, Finland, Luxembourg and the Netherlands—were already alerted by the European Systemic Risk Board in November 2016 about potential overvaluation in their housing markets and about rising household indebtedness. In response, most of these countries have tightened prudential or borrower-based tools.
- While macroprudential policy is an area where remarkable progress has been made in just a few years, there is room for improvement, as the FSAP notes. The EU macro prudential framework would benefit from some simplification. Procedures to activate macro prudential instruments are complex, involving many authorities at different levels. Moreover, some euro area countries have not yet legislated borrower-based tools, which are best suited to address specific risks for all institutions—domestic banks, foreign branches, nonbank financial institutions—so that the possibility of leakage is low. These are Belgium, Greece, Italy, Portugal and Spain. Ideally, all countries should legislate borrower-based tools with harmonized definitions. Moreover, macro prudential authorities should be able to tighten these tools for all lending institutions, and they should be applicable to both households and corporates.
- Such improvements to the framework would further limit spillover risks from pockets of excesses. Besides macroprudential policies, IMF bilateral surveillance has also shown the importance of a range of other policies—like tax policy, housing finance, and restrictions on land supply—that have a strong bearing on the underlying issues that macro prudential policies typically seek to address.

38. ***The FSAP refers to important data gaps that could hinder comprehensive monitoring and appraisal of risks. Could staff elaborate on any action plan to address these gaps?***

- European initiatives are ongoing to close various data gaps:

- *Other Financial institutions (OFIs):* Recall that OFIs roughly correspond to nonbank, non-insurance financial institutions. Despite a sizeable euro area OFI gap, several euro area countries (e.g., Belgium, Ireland, Netherlands) have appreciably reduced the size of their OFI residuals. Furthermore, enhancements to statistical frameworks are underway and include undertaking new surveys, extending granular data reporting requirements (e.g., Ireland and the Netherlands), and examining a full range of existing supervisory and statistical data sources to reconcile measures of various non-bank sectors (e.g., Belgium, Germany, Luxembourg). For further details, please see the last chapter in the Euro Area Policies FSAP Systemic Risk Analysis Technical Note, the 2017 ESRB Shadow Banking Monitor, and relevant country FSAPs.

- *Commercial real estate (CRE) prices*: The ECB has started collecting experimental data on CRE prices. So far, only a few countries are covered, in part because commercial real estate data is much harder to obtain and aggregate than that on residential real estate. We hope that the coverage increases rapidly.
- *Legal entity identifiers (LEIs):* The new MIFID II requires all entities to have LEI for accessing trading venues, so hopefully the LEI gap would eventually close.
- *Loan-by-loan data (AnaCredit):* From the end of 2018, the ECB will collect loan-by-loan information on banks' credit exposures to all legal entities (including SMEs) in the Euro Area (AnaCredit database). The database will work as a single data source for credit risk from which all relevant information (on performing and non-performing loans) can be extracted; in the long term this could contribute to streamlining aggregate reporting requirements, reducing the reporting burden on banks.
- *Harmonization of supervisory reporting, versatility, reduced reporting burden on banks (BIRD and IReF):* The European System of Central Banks (ESCB) has launched two initiatives - the Banks' Integrated Reporting Dictionary (BIRD) and the Integrated Reporting Framework (IReF) – currently focused mainly on ESCB statistical requirements, but that could lead, in the longer term, to the creation of a single, common, ultra-granular data source for users' multiple information needs.

39. ***Could staff inform about the authorities' views on FSAP's risk assessment and willingness to take adequate measures to mitigate these risks?***

- As noted in Mr. Meyer's BUFF, the authorities' own assessment of risks is broadly in line with that of the FSAP, and the authorities were broadly in support of recommendations made in the FSAP, many of which conform to the existing work program in the EC and ECB. We would refer to the Mr. Meyer's BUFF which sets out areas of disagreement.

Brexit Related Issues

40. ***We thought that the FSAP could have better addressed associated financial stability risks that could result from financial market fragmentation and the loss of access by and to UK-located markets and institutions. For example, could staff discuss their views on the need for a public solution to the issue of contract continuity?***

- Contract continuity, both in the financial sector and in other areas, is an issue that requires close scrutiny to ensure minimal disruptions as the UK exits the EU in March 2019. Yet, contract continuity is a complex challenge as many aspects remain in national law. We urge financial institutions to make preparations to ensure contract continuity beyond March 2019, as emphasized both by the European Banking Authority and the Bank of England. At the same time, the U.K. and European authorities should cooperate closely at a high level to prevent cliff-edge risks. We look forward to the recommendations of the taskforce chaired by President Draghi and Governor Carney, which is assessing potential financial stability risks related to Brexit. We would also caution that given the challenges of resetting complex interrelationships in the financial sector may require additional time and that there may be a role for extending deadlines once an agreement has been reached.

41. ***New regulatory regimes in the EU, including MiFID II and EMIR, may have significant and negative consequences for cross-border investment and capital formation. Staff comments would be welcome.***

- Staff welcome the continued strengthening of the regulatory framework for markets in the EU through enhancements in MiFID and EMIR. The articulation of an equivalence framework under these directives is important in ensuring uniform treatment of third country institutions across member states. As set out in the FSSA, staff considered the proposed strengthening of oversight of third country CCPs under the new EMIR and concluded that the systemic importance of a CCP located in a third country warrants enhanced oversight. This is line with the practices of other large jurisdictions. We note that since publication in 2017, the EMIR standards have been under discussion and further developed. We look forward to a new published version.

Basel Core Principles

42. ***When looking at the summary compliance with the Basel core principles, we have mixed views. On the one hand, we recognize the recent establishment of the SSM (2014). On the other hand, however, we are surprised by number of principles assessed to be "materially non-compliant". Out of the 28 principles assessed, 6 are materially non-compliant and cover important supervision areas like "capital adequacy," "transactions with related parties", and "liquidity risk". Could staff clarify why only one principle out of the six, judged to be "materially non-compliant" was referred to in the staff report.***

- The FSAP found banking supervision has been strengthened under the SSM, which is reflected in the FSSA findings. Many of the deficiencies noted in the Basel Core Principles Assessment relate to gaps and weaknesses in the regulatory framework and implementation due in large part to the reliance on national laws and gaps in relation to international standards. This is a well noted concern in the FSSA. Also, it is worth noting that the authorities chose to be assessed and rated against both the essential criteria and the additional criteria of the BCP, the highest standards of supervision and regulation. Details of the particular grades can be found in the Detailed Assessment Report.

43. ***We note that there is a disagreement between the authorities and the staff on the assessment of BCP 24 on Liquidity risk. Could staff provide an explanation about this different point of view?***

- The assessment of BCP 24 was a result of cumulative shortcomings across a number of areas, measured against the essential and additional criteria of the Basel Core Principles and based on the rules and practices at the time of the assessment. Some refinements to the liquidity framework were not yet implemented at the time of the FSAP, although in the SSM work plan. Finally, staff disagree with the authorities regarding the lack of accurate and comprehensive knowledge about the exact amount of emergency liquidity assistance (ELA) and available eligible collateral: staff deem this also to be a serious impediment to an effective supervisory monitoring of a bank with a rapidly deteriorating financial situation, while authorities, in their comments, considered it of 'limited impact'.

Other

44. ***We notice that the FSAP team included 22 staff members, as well as external experts. How would the implementation of the new streamlining rules, which limit FSAP teams to six FTE, impact the scope of coverage of an FSAP of this magnitude? Specifically, what would be omitted from the report?***

- The euro area FSAP was a complex undertaking involving a relatively large team. Note that a number of staff members were non-travelling and supporting from HQ. The streamlining of FSAPs of course may impact how staffing of individual FSAPs unfolds. However, we note that it will be possible with Management permission to expand the envelope for particularly complex FSAPs, of which the euro area may be one of a few.