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December 4, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Euro Area Policies**

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***Unless an objection from the member authorities of the Euro Area countries is received prior to the conclusion of the Board's consideration, the document will be published.**

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

December 3, 2020

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

KEY ISSUES

The COVID-19 pandemic has led to severe socio-economic dislocations and hardship. Supported by an unprecedented policy response and by the easing of lockdown measures as the infection rate moderated, the euro area economy initially recovered strongly from the pandemic's first wave. However, a large second wave and re-imposition of containment measures suggest much slower growth momentum in the near term. The outlook is for a subdued economic recovery and low inflation, with a significant permanent output loss relative to the pre-crisis trajectory. Uncertainty remains extremely high, mainly due to different pandemic scenarios, including regarding the availability and effectiveness of potential vaccines and therapies and behavioral changes. Output growth is expected to be much lower through 2021Q1 than projected in 2020 October *World Economic Outlook (WEO)* but may rebound beyond then in light of recent promising news on vaccine development.

The key policy challenge is to continue countering the pandemic while facilitating a robust and inclusive recovery, including by addressing the health crisis, containing economic scarring, supporting resource reallocation and transformation to greener and more digital economies, and limiting the crisis's impact on inequality and poverty. In a downside scenario, sizable further stimulus would be needed.

- Fiscal policy will need to continue providing broad-based support during the second wave. Once the pandemic wanes, however, policy will have to manage the transition from necessary lifelines to facilitating a durable recovery. Priorities include investing in climate change mitigation and digitalization, while addressing likely increases in inequality and poverty. The Next Generation EU recovery funds can help finance the investments needed to respond to climate change, though achieving the EU's emission reduction goals will require a broader set of measures. Importantly, a positive experience with Next Generation EU could help build political support for a permanent central fiscal capacity. Further policy support—including potentially at the EU level once current facilities were exhausted—would be required if the outlook deteriorates markedly. Over the medium term, fiscal policy will need to be adjusted to sustainably boost growth. Credible and carefully calibrated fiscal consolidation strategies will be needed in high-debt countries.

- Additional monetary policy stimulus is needed to support the recovery and facilitate a sustained increase in inflation. An expansion of asset purchase programs should be the first line of defense, but other options should also be considered. In a downside scenario, and if the inflation outlook is significantly downgraded or inflation expectations drift downwards, substantial additional accommodation will be needed via existing and new policy instruments. A clear, transparent, and well-communicated symmetric point inflation target would have significant benefits, and the ECB's upcoming monetary policy strategy review should therefore formally codify the Governing Council's recent emphasis on symmetry of their inflation aim into such a point target. In the context of an extended period of undershooting the medium-term inflation aim, a flexible average inflation target—like that adopted by the Federal Reserve—could also be explored.

- Supportive financial sector measures should be maintained until the recovery is well underway, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit. As nonperforming loans (NPLs) are likely to surge, especially when extraordinary support measures expire, swift balance sheet repair will be critical to support intermediation, including by adopting credible NPL reduction strategies and strengthening insolvency frameworks. Improving the EU's crisis resolution capabilities, completing the banking union, and further advancing the capital market union are also key to further increasing euro area resilience.

- Structural policies should focus on facilitating reallocation of resources to expanding firms and sectors, limiting scarring, and protecting the vulnerable. A combination of adjusting job retention schemes, strengthening social safety nets, promoting job search, enhancing training programs, and providing carefully targeted hiring subsidies will likely be necessary to achieve these multiple objectives. More broadly, to make sure people are not left behind, a more fundamental rethink of how to adapt labor market policies to respond to accelerating automation and to facilitate green and digital transformations may be needed. Public support to firms should be selective and ideally provided only to otherwise viable firms whose operations are impaired by health risks or social-distancing restrictions. To limit the cost to the taxpayer and incentivize the necessary reallocation, such support should be given on a temporary basis with appropriate private sector risk sharing and be gradually withdrawn as the recovery is firmly established. Globally, the EU should continue to be a strong proponent of a rules-based international trade regime.

Approved By
Alfred Kammer (EUR) and Jeromin Zettelmeyer (SPR)

Discussions took place by video conference during October 19–November 10, 2020. Mission members included P. Gerson (head), R. Balakrishnan, B. Barkbu, N. Klein, N. Arnold, A. Jobst, S. Mitra, H. Qu, A. Santos, T. McGregor, V. Nguyen, and D. Malacrino (all EUR), joined by A. Bhatia, N. Belhocine, C. Ebeke, J. Frie, and L. Rabier (all EUO). C. Erceg, Z. Jakab, and J. Linde (all MCM) also contributed to the discussions and report. Executive Director, M. Pösö, and his advisor, I. Valdés Fernández, and R. Rueffer, ECB observer at the IMF, participated the meetings. X. Shao, E. Cohn Bech, and C. Rubio supported the mission.

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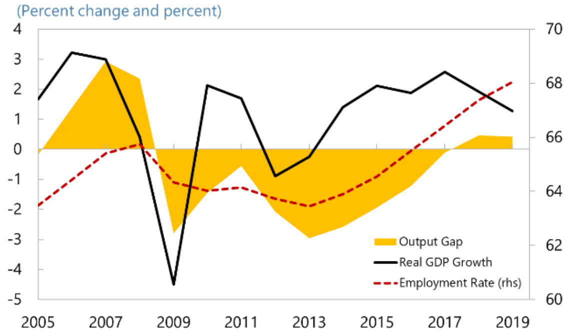
CONTEXT: PRE-COVID LANDSCAPE

1. Euro area resilience improved considerably before the pandemic hit, but some vulnerabilities remained. Banks reduced nonperforming loans (NPLs) and increased the size and quality of their capital buffers, allowing them to enter the COVID-19 crisis in better shape than on the eve of the Global Financial Crisis (GFC). However, fiscal policy space varied significantly across countries, with high-debt countries making limited or no progress in rebuilding fiscal buffers. While the architecture of the economic and monetary union was significantly strengthened after the GFC, progress on further increasing public and private cross-border risk sharing and completing the banking union stalled due to lack of political support.

2. Following a long expansion with sizable employment gains, the euro area entered the crisis with slower growth but still low inflation. Real GDP growth decelerated in 2018 and 2019 owing to weaker external demand and some temporary domestic factors. Despite the slowdown, the economy is estimated to have been operating around potential, with the employment rate reaching an all-time high. Notwithstanding the cyclical position and continued strong monetary policy accommodation, inflation persistently undershot the ECB's medium-term aim.

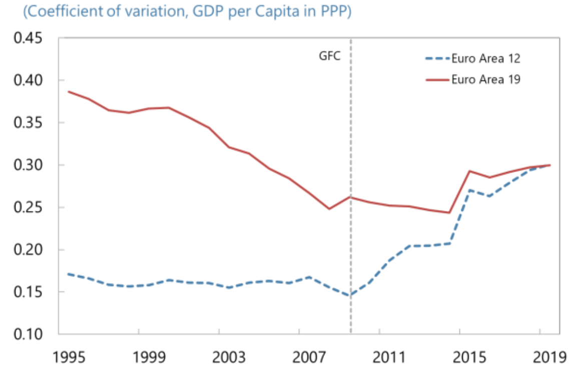
3. Deep structural issues continued to impede medium-term growth prospects and undermined income convergence and inclusiveness. Low investment and uneven implementation of structural reforms resulted in large productivity and competitiveness gaps, high structural unemployment, and lingering poverty in some countries. Low productivity growth in countries with lower initial GDP per capita also reversed income convergence and contributed to subdued potential growth in the euro area as a whole.

Euro Area: Real GDP Growth, Output Gap and Employment Rate 1/
(Percent change and percent)



Sources: IMF, World Economic Outlook; and Eurostat.
1/ Employment rate as percentage of working age population (15-64 years).

Convergence Across Euro Area 1/
(Coefficient of variation, GDP per Capita in PPP)

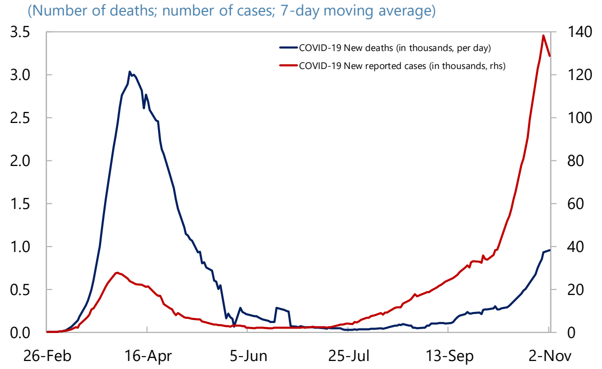


Sources: IMF, World Economic Outlook; and IMF staff calculations.
1/ Excludes Luxembourg.

THE INITIAL IMPACT OF THE PANDEMIC AND POLICY RESPONSE

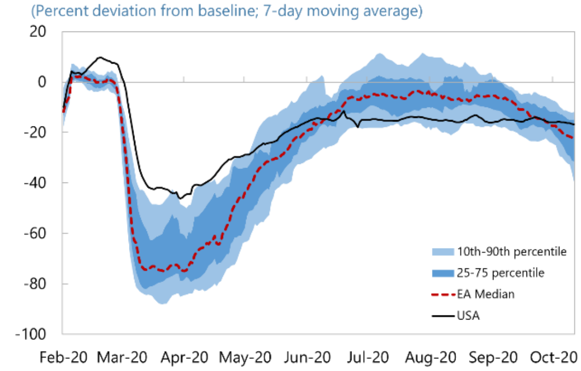
4. As a shock of unparalleled magnitude, the COVID-19 pandemic is leading to severe socio-economic dislocations and hardship. Since the first reported case in January, the pandemic has spread across the euro area with varying speed and intensity. The first wave, which resulted in catastrophic numbers of infections and deaths in some euro area countries, was successfully contained by unprecedented lockdown measures. More recently, however, as countries reopened, virus infections again increased exponentially. With new daily cases in the euro area exceeding the first wave's peak, policymakers were forced to reinstate local and nationwide lockdowns. Fortunately, mortality—although also increasing—has so far remained below the levels seen in April.

Euro Area: Reported COVID-19 Cases and Deaths
(Number of deaths; number of cases; 7-day moving average)



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

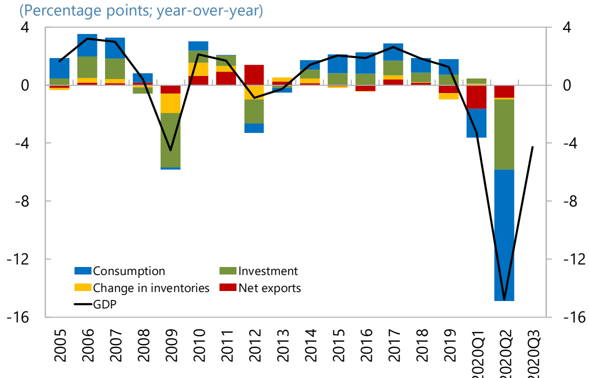
Euro Area: Retail and Recreation Mobility
(Percent deviation from baseline; 7-day moving average)



Sources: Google; and IMF staff calculations.

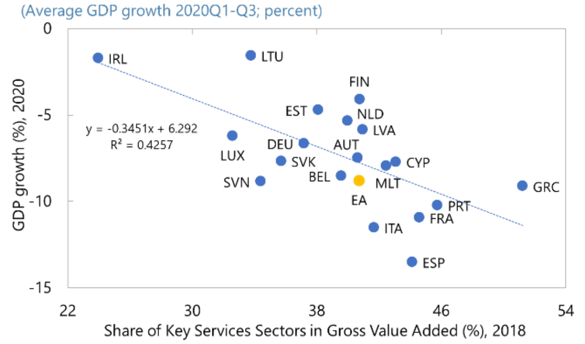
5. Economic activity fluctuated sharply in response to the pandemic's dynamics and the stringency of containment measures. Euro area real GDP plummeted by 3½ percent (q/q) in 2020Q1 as lockdowns started in late February, and by 12 percent (q/q) in 2020Q2 as mobility substantially dropped. The contraction was mainly driven by private consumption, as consumer confidence deteriorated, precautionary savings increased, and spending on nonessential goods and services fell significantly. The sizable decline in gross fixed capital formation and lower net exports—a reflection of the collapse of global trade—also dragged on growth. Flash estimates for 2020Q3 point to a record rebound of nearly 13 percent (q/q) in economic activity as containment measures were relaxed. Despite the strong recovery, output remains 4½ percent below its pre-pandemic level, with the crisis impact varying significantly across countries, partly reflecting differences in economic structure and lockdown stringencies.

Euro Area: Contribution to Growth
(Percentage points; year-over-year)



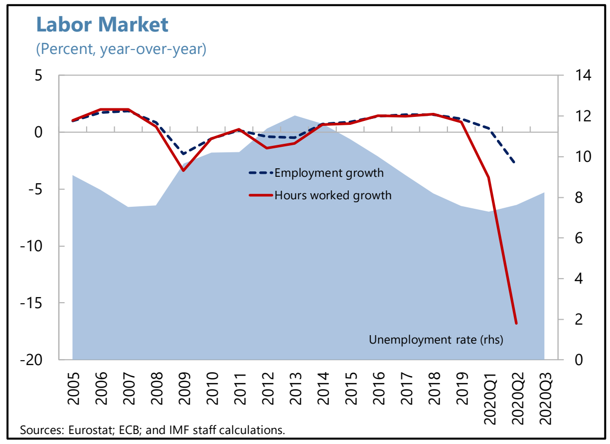
Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Share of Key Services Sectors and GDP Growth 1/
(Average GDP growth 2020Q1-Q3; percent)

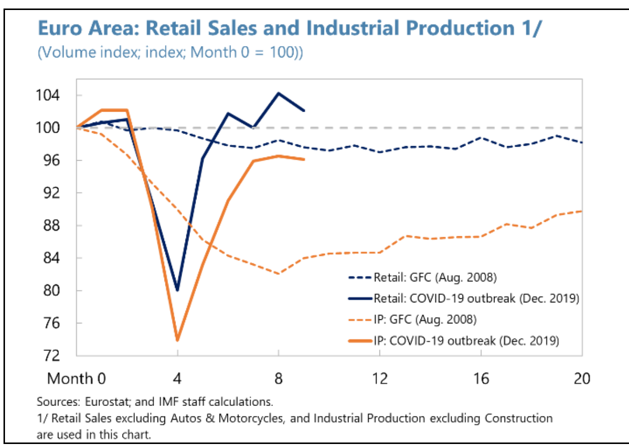


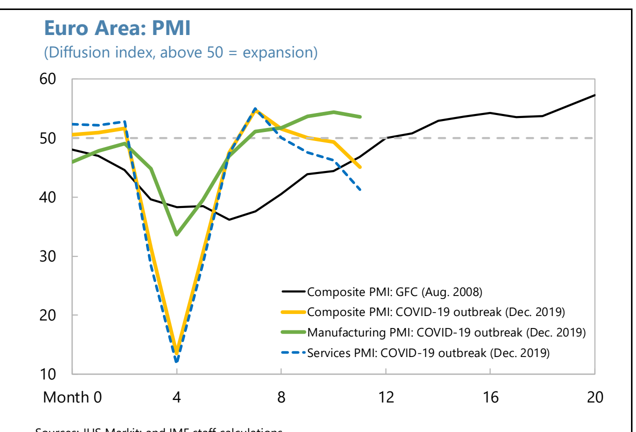
Sources: Haver Analytics; and IMF staff estimates.
1/ Retail; arts and recreation; public administration, education and social work; accommodation and food services; and real estate activities.

6. Despite the historic economic contraction, the unemployment rate has increased only modestly thanks to widespread use of job retention schemes. The extensive use of short-time work programs, which provide income support on reduced working hours while maintaining worker-employer ties, has been particularly effective in facilitating an unprecedented adjustment in hours worked without accompanying job destruction. Indeed, so far in 2020, the euro area unemployment rate has only increased by one percentage point to 8.4 percent (October, seasonally adjusted). By comparison, the U.S. unemployment rate has increased by about 3½ percentage points during the pandemic. The recent decline in the participation rate, which reflects labor market stress and the related exit of discouraged workers from the labor force, also dampened the increase in the euro area unemployment rate.



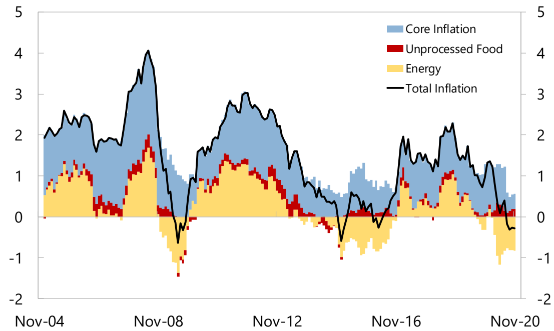
7. High-frequency indicators suggest that the economic recovery has lost momentum in 2020Q4. After several months of modest expansion, the composite PMI shifted into contractionary territory (November) as activity in services further deteriorated amid rising infections. Manufacturing continued to expand, however, albeit at a slower pace. While retail sales have rebounded to above pre-crisis levels, mobility indicators have shown a decline following the re-imposition of lockdowns. Economic sentiment indicators continue to be weak, with consumer confidence deteriorating in October and November.





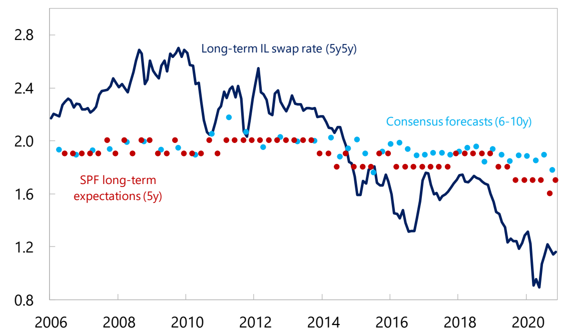
8. Inflation has fallen into negative territory for the first time since early 2016. The initial decline in headline inflation from 1.4 percent (y/y) in December 2019 to 0.1 percent in May mainly reflected a steep drop in energy prices. In recent months, headline inflation has descended into negative territory (-0.3 percent, November) as temporary factors such as Germany's temporary VAT cut came into play. The recent euro appreciation has also contributed to disinflation pressures. While remaining broadly stable at just above 1 percent in the first seven months of the year, core inflation (HICP excluding energy and unprocessed food) weakened sharply to a record low of 0.4 percent in recent months. Meanwhile, market-based long-term inflation expectations have partly recovered from the initial effects of the crisis but remain well below their historic averages.

Euro Area: Contribution to HICP Inflation
(Percent)



Sources: Haver Analytics; and IMF staff calculations.

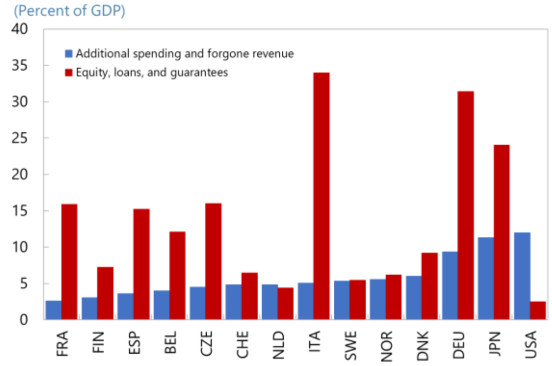
Euro Area: Inflation Expectations
(Percent)



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

9. **National fiscal policies have provided critical support for workers and firms, markedly dampening the socio-economic impact of the crisis**. Alongside large automatic stabilizers (worth about 5 percent of GDP), the discretionary fiscal response has been both rapid and sizable, with above-the-line measures worth over 5 percent of euro area GDP overall, ranging from 2.6 percent of GDP in France to 9.4 percent of GDP in Germany. Measures include increased health spending, expanded or new short-time work schemes, and temporary tax cuts and/or deferrals for workers and firms. Governments have also provided substantial financial support to firms and offered guarantees for bank lending to businesses. These commitments could exceed 20 percent of euro area GDP if all guarantees were called. There is little evidence so far that differences in countries' capacities to provide state aid to their firms have created an unlevel playing field. In particular, take-up rates of financial support for firms have been lower in countries that have announced some of the largest packages (e.g., Germany).

Fiscal Responses to COVID-19 Crisis
(Percent of GDP)



Sources: Database of Country Fiscal Measures in Response to Covid-19 Pandemic; and IMF staff calculations.

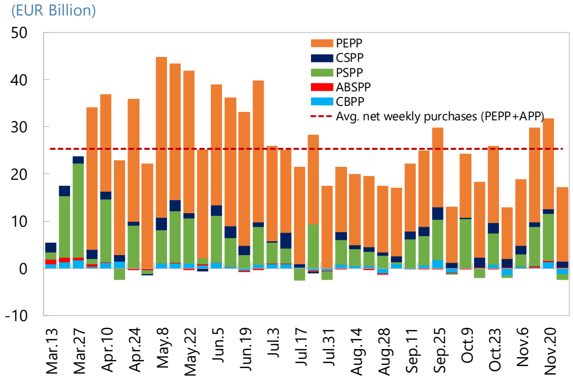
10. **National fiscal responses have been supported by a rapid and sizable EU response aimed at providing flexibility and financing to countries**. In March, the EU moved quickly to support countries by providing greater flexibility in their use of EU funds to combat the pandemic (Coronavirus Response Investment Initiative Plus), and by activating the escape clause in the fiscal rules and temporarily allowing state aid to firms. This was followed in May by a package of financing support worth over 4 percent of EU27 GDP (table). The EU has moved quickly to implement the package, already approving €87 billion in loans from the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) to support countries' short-time work schemes. Finally, in July, the European Council reached an historic agreement on the €750 billion Next Generation EU (NGEU) package. Once legislated, this will provide grants and loans to EU members over the next few years to help accelerate the recovery.

Available and Potential EU Support

11. The ECB has responded forcefully to ease financial conditions and safeguard monetary transmission. As the severity of the crisis became apparent, the ECB adopted a series of measures to support confidence and avoid an adverse feedback loop between the financial system and the real economy. This included topping up the asset purchase program (APP) by €120 billion in 2020 and introducing a new pandemic emergency purchase program (PEPP) with an initial envelope of €750 billion, almost half of which was deployed within the first three months. Given its extensive use, PEPP was later augmented to €1.35 trillion and its minimum expected horizon for net purchases was extended by half a year to mid-2021 (Table 2). PEPP's flexible design, which allows purchases of sovereign securities at shorter maturities and with lower credit quality, has helped stabilize markets and enabled a substantial easing in the monetary policy stance. The ECB has also relaxed collateral requirements and provided substantial liquidity to the financial sector through targeted and untargeted long-term financing operations (LTROs).[1] This, together with the sizable expansion of asset purchases, contributed to a sharp expansion of its balance sheet, on par with those of central banks of other large advanced economies.

ECB's Weekly Net Asset Purchases

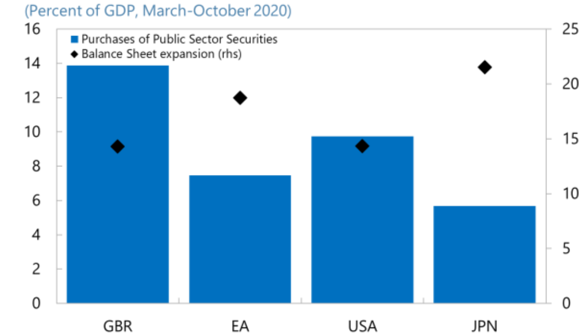
(EUR Billion)



Sources: European Central Bank; and IMF staff calculations.

Purchase of Public Sector Securities and Balance Sheet Expansion by Central Banks 1/

(Percent of GDP, March-October 2020)



Sources: National Central Banks; Haver Analytics; European Central Bank; and IMF staff calculations.
1/ Data refers to net purchases of public sector securities in Japan (March-October).

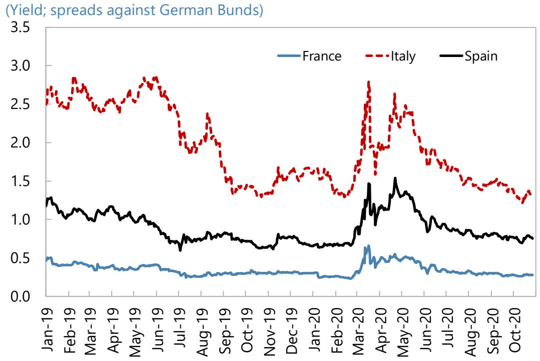
[1] Liquidity provision under the June targeted long-term refinancing operations (TLTRO) registered the highest amount to date, with 742 banks participating for a total of over €1.3 trillion, of which €548 billion was fresh liquidity. The strong demand for liquidity continued in the September allotment, although the net uptake was significantly lower at €158 billion.

12. The ECB Banking Supervision has also provided substantial capital and liquidity relief for banks to strengthen their capacity to absorb losses while continuing to lend. Banks were allowed to use up their capital conservation buffers and operate temporarily below the level of capital required under the Pillar 2 guidance and the liquidity coverage ratio. Prudential authorities also temporarily granted flexibility in the classification and provisioning of loans backed by public support measures. These temporary measures, which have been enhanced by the appropriate relaxation of countercyclical capital buffers, have provided substantial capital relief. Together with capital conservation measures, such as restrictions on dividend distribution and share buy backs, this has boosted bank lending.

13. Rising risk aversion has recently slowed the momentum generated by the unprecedented policy response. The onset of the crisis led to an increase in financial stress to levels not seen since the GFC. With the announcement of accommodative policy measures, market confidence gradually returned, and prices of risky assets mostly recovered from earlier losses. Supported by the strong policy response, spreads between the hardest-hit euro area countries and Germany also narrowed significantly. Corporate credit growth and net issuance of debt increased substantially in 2020H1 in the face of low revenue, higher liquidity needs, and favorable financing conditions. Consumer credit, however, generally stagnated, partly reflecting households' tendency to defer consumption. More recently, as governments tightened mobility restrictions in response to the second wave, market sentiment has deteriorated. Incipient tightening of credit conditions in 2020Q3 and early signs of slowing credit growth indicate that rising risk aversion has become more binding on banks' willingness to lend.

10-year Sovereign Bond Yield Spreads

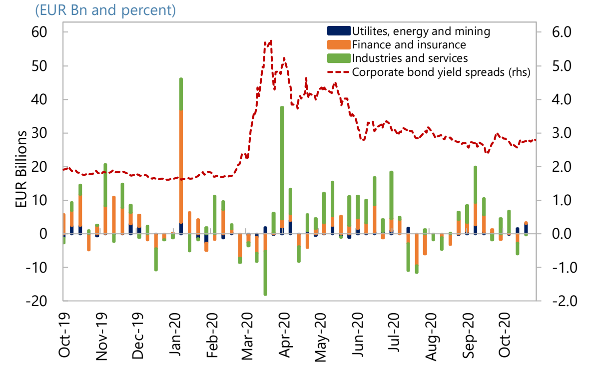
(Yield; spreads against German Bunds)



Sources: Bloomberg Finance L.P.

Weekly Net Bond Issuance and Corporate Bond Spreads

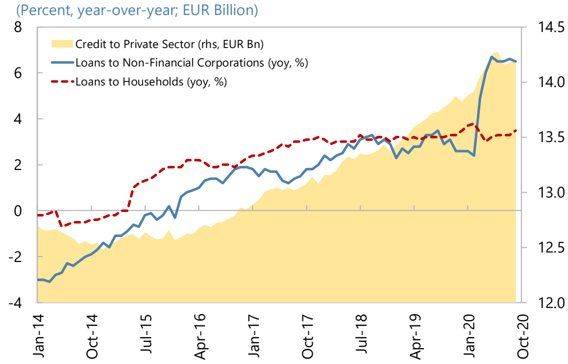
(EUR Bn and percent)



Sources: Bloomberg Finance L.P.; and Dealogic.

Lending to Non-Financial Corporations and Households

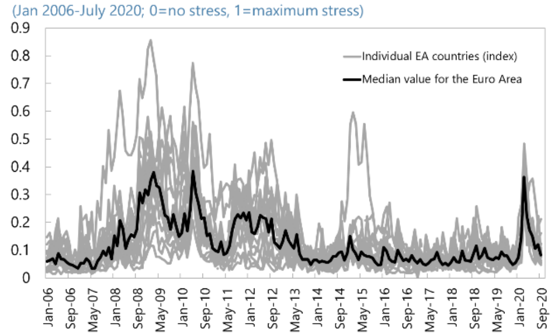
(Percent, year-over-year; EUR Billion)



Sources: European Central Bank.

Euro Area: Financial Stress Index 1/

(Jan 2006-July 2020; 0=no stress, 1=maximum stress)

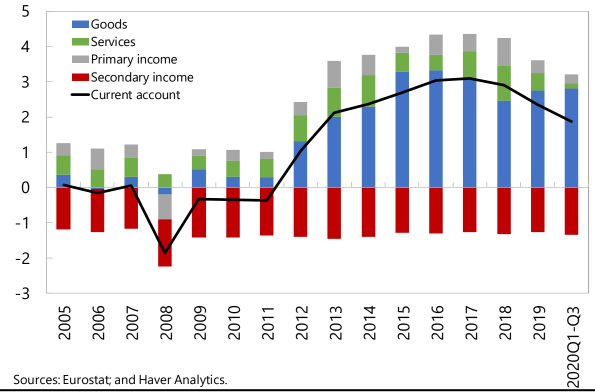


Sources: ECB; and IMF staff calculations.

1/ Each country's financial stress index captures stress in equity, bond, and foreign exchange markets. No available data for Estonia.

14. The current account surplus moderated in the first three quarters of the year as external demand for euro area services declined. The external position was moderately stronger than the level implied by medium-term fundamentals and desirable policies in 2019 (Table 3). The current account surplus moderated in 2019 to 2.3 percent of GDP from 2.9 percent in 2018 due to lower services and investment income, which more than offset a stronger goods balance. By 2020Q3, the current account narrowed further as services receipts collapsed, reflecting in part the decline in tourism, while the income balance fell slightly due to lower investment income net flows. Weakness in imports exceeded that in exports, translating into a slight improvement in the goods balance. The recent REER appreciation along with a strong fiscal stimulus may have contributed to a further moderation in the current account in 2020Q3. While highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis, these developments suggest a shift in the overall external position in 2020 to being broadly in line with medium-term fundamentals and desirable policies.[2]

Euro Area: Current Account Balance
(Seasonally adjusted; percent of GDP)



Sources: Eurostat; and Haver Analytics.

OUTLOOK AND RISKS

A. Recovery Contingent on Pandemic Dynamics with Rising Medium-Term Challenges

15. Compared to the October *WEO* projections (see text table and Table 1), staff now expects lower growth through 2021Q1 followed by a rebound of uncertain timing thereafter. As an effective vaccine or therapies/treatments are assumed not to be widely available until the summer of 2021, renewed outbreaks are expected to be accompanied by ramped-up testing and local lockdowns. Contact-intensive sectors, such as retail, accommodation and food services, are likely to suffer persistent negative demand shocks with social distancing embedded in their new business models, while long-term scarring due to higher bankruptcies and destruction of physical and human capital is likely to weigh on growth prospects in the near and medium term.

Near-term Outlook (2020–21)

16. Economic activity is likely to remain subdued and well below pre-crisis levels. Despite the better-than-expected 2020Q3 growth outturn, the euro area entered 2020Q4 with a large second wave of infections and new lockdowns, which will likely disrupt activity. Staff projects real GDP to fall by about 8 percent this year, as private domestic demand, which sharply contracted in the first half of 2020, will not fully recover. The economy is expected to partially bounce back in

[2] Complete analysis of the 2020 external position will be provided in the 2021 External Sector Report.

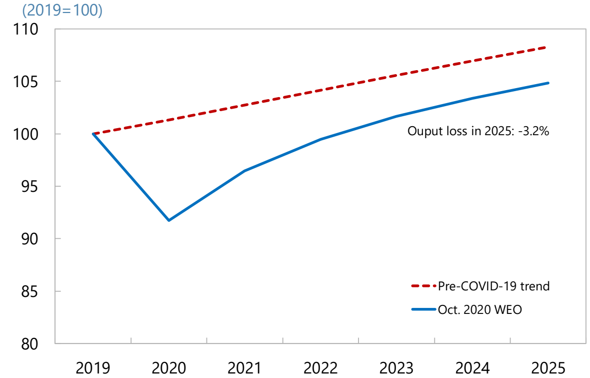
2021, with almost all demand components growing even as precautionary saving continues and private investment is muted given continuing elevated uncertainty. Sluggish global demand is projected to weigh on export-oriented economies, with both imports and exports recovering only slightly in 2021. At the end of 2021, real GDP is projected to remain below its end-2019 level.

17. Notwithstanding the waning of temporary supply-side effects, inflation is expected to remain subdued. The collapse in aggregate demand in 2020 is projected to exceed the fall in potential output, resulting in a sizable output gap and downward pressures on prices. Combined with a drag from negative energy price growth and other temporary factors (e.g., the German VAT cut), this will drive down average headline inflation to just above zero in 2020. Average core inflation is also projected to hit an historically low level of below one percent in 2020. In 2021, headline inflation is expected to recover gradually as some of the temporary disinflationary effects fade, but average core inflation is projected to remain broadly unchanged due to the high degree of inflation persistence in the euro area.

Medium-term Prospects

18. The gradual recovery will likely leave permanent output losses relative to the pre-crisis trajectory, with inflation remaining low. Sluggish growth in private consumption and investment from 2022 onward will drag on the recovery. The contribution of net exports to growth is projected to remain broadly neutral over the medium term, despite a modest recovery of exports. Reflecting long-term scarring effects on potential growth, output is expected to remain well below its pre-COVID trend throughout the medium term. Given a high degree of inflation persistence and a flat Phillips curve, inflation will only gradually pick up with the recovery, and is forecast to remain well below the ECB's medium-term aim throughout most of the projection horizon.

Euro Area: Output Loss
(2019=100)



Source: IMF, World Economic Outlook.

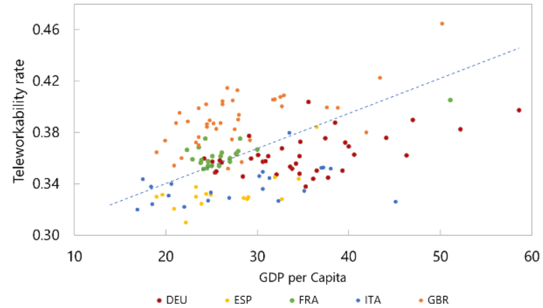
19. The pandemic is expected to exacerbate regional disparities and inequality in the euro area. Following the GFC, disparities across countries and across regions within the same country have sharply increased—mainly due to divergences in employment rates and productivity—reversing the pre-GFC downward trends. These patterns will likely be amplified by the current crisis as the pandemic and the lockdown measures are disproportionately affecting workers in nonessential sectors, who are more likely to be young and lack the liquidity buffers needed to weather the crisis. Moreover, the income gaps faced by poorer regions, which already confront formidable structural challenges, are likely to further increase given their higher share of non-teleworkable jobs (Box 1).

Box 1. The COVID-19 Crisis and Its Potential Impact on Regional Disparities and Inequality

The COVID-19 crisis has the potential to exacerbate disparities across geographic areas and across workers. With persistent social distancing and continued containment and mitigation measures, the impact on contact-intensive (e.g., tourism sector; transport) and "nonessential" sectors[1] is likely to be more severe, resulting in disproportionate effects on some regions and segments of the euro area population, despite the exceptional policy support deployed by the authorities.

European regions with lower GDP per capita and subdued economic performance prior to the pandemic appear to be more exposed to the effects of the crisis. These so-called *laggard* regions are characterized by a disproportionally higher share of contact-intensive sectors, large dependency on SMEs, lower productivity, and lower shares of employment in teleworkable occupations. These large structural differences could exacerbate existing regional disparities across regions as well as within and between countries.

GDP per Capita and Teleworkability Rate 1/
(2016; percent; EUR thousand)

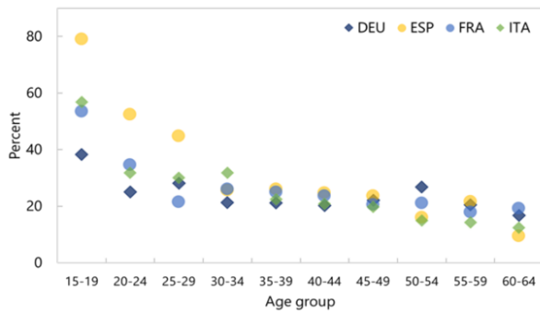


Sources: Eurostat; OECD - PIAAC Survey of Adult Skills; and Dingel and Neiman (2020).
1/ Each data point refers to a NUTS 2 region.

The pandemic also has the potential to exacerbate intergenerational inequities. At the household level, the young and poor appear to be hit doubly hard. First, young workers are more likely to be employed in nonessential and non-teleworkable sectors,[2] which were hit hardest by the containment measures. Second, younger workers are concentrated in the lower quintiles of both income and wealth distributions. This lack of buffers will undoubtedly hinder their ability to weather the crisis, especially if the recovery is delayed. These same households also experience more credit constraints. Women, especially those aged 25 or younger, experienced a larger employment loss than men, even though several indicators of employment risk suggest that they were not more vulnerable prior to the crisis.

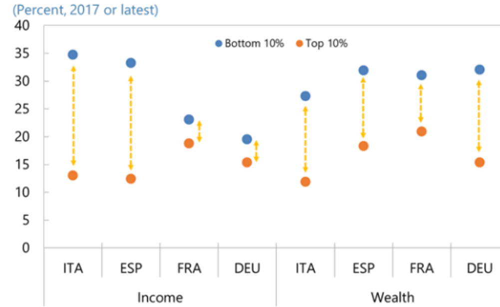
Disproportionality varies greatly across countries. Among the four largest economies in the euro area, the gap in the share of nonessential workers between the top 10 percent and the bottom 10 percent in the income distribution reaches almost 20 percentage points in Italy and Spain but less than 5 percentage points in Germany and France. The wealth gap is more homogenous across these four countries, with those in the bottom 10 percent of the wealth distribution more likely to work nonessential sectors.

Share of Workers in Non-essential Sectors by Age group
(In percent, 2017 or latest)



Sources: ECB HFCS, IMF Staff Calculations.

Share of Non-essential Workers by Household Income and Wealth Percentile
(Percent, 2017 or latest)



Sources: European Central Bank HFCS; and IMF staff calculations.

1/ The selection of nonessential sectors is largely based on the OECD's classification. Those include construction, wholesale and trade, accommodation and food services, real estate, arts and entertainment, certain manufacturing, and transportation.

2/ There is some overlap between nonessential and contact-intensive or non-teleworkable sectors. However, some contact-intensive sectors such as healthcare, food related, early and special education are considered essential.

Text Table. Euro Area: Main Economic Indicators, 2019–25
World Economic Outlook (October 2020), Percent

		Projections					
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth	1.3	-8.3	5.2	3.1	2.2	1.7	1.4
with contributions from (ppt):							
Private consumption	0.7	-5.0	2.9	1.7	1.0	0.8	0.7
Public consumption	0.4	0.4	0.2	0.1	0.2	0.2	0.2
Gross fixed investment	1.2	-2.6	1.6	1.1	0.7	0.5	0.4
Net exports	-0.5	-1.0	0.5	0.3	0.2	0.1	0.1
Current account (%GDP)	2.3	1.9	2.4	2.5	2.5	2.6	2.5
Unemployment rate	7.6	8.9	9.1	8.4	7.9	7.7	7.6
Potential GDP growth	1.3	-3.2	3.1	1.4	1.2	1.3	1.2
Output gap	0.2	-5.1	-3.2	-1.6	-0.6	-0.2	0.0
Inflation	1.2	0.4	0.9	1.2	1.4	1.6	1.7

Source: IMF, *World Economic Outlook*.

B. Substantial Known and Unknown Risks

20. Risks to the outlook are sizable and their impact depends materially on the policy response. Finding the right balance between measures to contain the pandemic and those aimed at supporting the recovery is extremely challenging given the extraordinary degree of epidemiological uncertainty. Yet the robustness of the recovery will depend critically on how effective policies are at mitigating the economic damage of containment measures in the near term while facilitating the necessary economic restructuring and reallocation of resources across sectors and regions over the medium term. Providing insufficient fiscal support, delays in implementing the NGEU recovery package, or withdrawing support too early would weaken the recovery.

21. Output growth is expected to be lower through 2020Q1 than projected in the October *WEO* but may rebound beyond then in light of recent promising news on vaccine development. The greatest risks remain further major resurgences of infections in the near term and delays in developing or distributing effective vaccines and therapies (Risk Assessment Matrix, Table 4). These would result in deeper scarring effects, a slower recovery, and a further output loss. Even if the virus is contained in euro area countries, a widespread outbreak in key trading partners would significantly lower external demand and undermine growth prospects. A longer and deeper-than-expected crisis would exacerbate scarring, and potentially lead to social discontent, especially if vulnerable groups are left behind.

- **Households**. Short-time Work Schemes (STWs), wage subsidies, and payroll tax relief have helped prevent a massive increase in unemployment. However, if the crisis drags on, more layoffs and a substantial increase in unemployment are inevitable. Absent policies to facilitate a rapid reallocation of workers, significant labor market hysteresis is likely, which could be a drag on productivity growth for years and may result in higher poverty rates and inequality in Europe. Household income losses could also result in sizable mortgage defaults, home foreclosures, and downward price pressures on residential properties.

- **Nonfinancial corporate sector**. With a prolonged crisis and support measures expiring, firms' liquidity problems could morph into credit defaults, while delays in insolvency proceedings and inefficient bankruptcy procedures in some countries will stifle the recovery (Box 2). Higher corporate debt also exposes firms to more market volatility and changes in financial conditions and could potentially result in adverse macro-financial feedback loops.
- **Banks**. The sharp deterioration in asset quality given rising bankruptcies, mortgage defaults, and falling property prices could result in sizable capital shortfalls and higher risk aversion, potentially impairing the lending channel with concomitant feedback effects. While banks are likely to benefit from favorable funding conditions, structurally low profitability combined with a slow recovery and adverse market conditions will constrain their ability to rebuild capital buffers or raise fresh capital, markedly reducing their resilience to future shocks.

22. The crisis has exacerbated fiscal vulnerabilities. Debt levels have risen considerably in all euro area countries and are expected to remain above or close to 2019 levels for the foreseeable future in most countries. While helping to mitigate the immediate pandemic impact, the provision of government loan guarantees and other liquidity support has created potentially sizable contingent liabilities—averaging around 20 percent of GDP in euro area countries with government debt already above 100 percent of GDP. The current favorable financing conditions are helping governments finance large deficits and rollover needs this year and next. However, countries' budget plans were drafted without accounting for a major second wave, suggesting deficits in 2021 will be higher than forecast in October, further eroding fiscal space. Larger increases in public debt will leave currently highly indebted sovereigns even more vulnerable. Any unexpected change in market perceptions could threaten the ability of high-debt countries to roll over and service public debt. Moreover, if a prolonged crisis were to undermine the solvency of the banking sector, this could lead to pressure on sovereigns to bail out their banks, which for some countries could precipitate a spike in sovereign borrowing costs.

23. Brexit and trade tensions remain significant risks to the recovery. Gaps on key issues remain between the U.K. and EU27 in defining their future relationship. Moreover, the U.K.'s proposed unilateral modification of the Withdrawal Agreement has raised strong opposition from the EU and is perceived to have increased the likelihood of a no-deal Brexit, which could lead to sharp disruptions in trade and adversely affect output when the transition period expires at the end of 2020.[3] While a waiver arrangement grants EU-based financial institutions access to the U.K. market infrastructure for clearing and settlement services until mid-2022, there is still no agreement on regulatory equivalence. The latter requires trading of certain liquid derivatives to occur within the EU or jurisdictions that have been granted equivalence, and places any U.K.-based activities of EU financial institutions under the U.K. supervision. Trade tensions with the United States pose additional risks. Even if they abate, tensions with China could grow in the coming years, particularly as the EU seeks to use trade and investment policies to address any industrial subsidies that it thinks distort the single market.

[3] While conditional on specific assumptions regarding financial conditions, border disruptions and immigration policies, staff's analysis suggests that a no-deal Brexit (default to WTO rules) would result in an EU output loss (relative to the baseline) of 0.5 percent within three years and 0.3 percent over the longer term.

Box 2. Corporate Sector Vulnerability in the Euro Area: The Role of Policies[1]

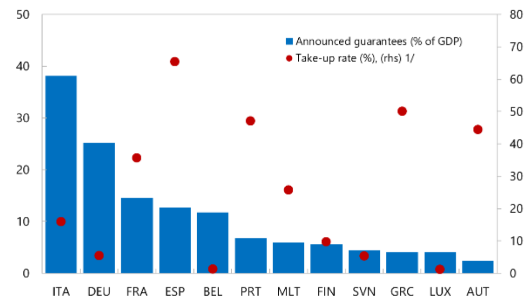
Firms are weathering an unprecedented shock well so far. Rating downgrades have increased, and defaults have risen, though so far to a much smaller degree in Europe than during the global financial crisis. This reflects exceptional and effective policy support aimed at cushioning the impact of the liquidity shock.

The intensity of policy support, choice of instruments, and take-ups of schemes vary remarkably across countries. Some governments focused on reducing firms' costs (through wage subsidies, debt moratoria or tax deferrals); others provided liquidity through grants or equity injections; and most countries tried to ensure continued credit supply through bank loan guarantees, which represent more than half of the total policy support in the euro area. The size of the programs and their take-up vary, reflecting different crisis impacts, existing safety nets, and available policy space (Figure 1).

The shock is projected to increase liquidity and solvency gaps. Based on a sample of nearly 2 million companies in 13 euro area countries, staff simulations—based on the October 2020 *WEO* projections and announced government policies—show that the size of the firms' remaining liquidity and equity gaps after policy support could reach 4.7 and 2.4 percent of GDP, respectively, after accounting for announced policies (Figures 2 and 3).[2] The share of illiquid and insolvent firms could rise by 5 and 8 percentage points to 21 and 19 percent, respectively. However, the increase would have been significantly higher in the absence of policy support.

Liquidity risks may prove easier to address than solvency ones. Loan guarantees, debt moratoria, and short-term work schemes could help bring the liquidity gaps closer to pre-crisis levels, but solvency gaps would remain large, in part due to the COVID-related surge in leverage. The bulk of the liquidity and solvency gaps would mostly originate from SMEs, which appear particularly vulnerable to an early withdrawal of key programs. The sectors the most at risk include food and accommodation, construction, and trade (Figure 4).

Figure 1. Euro Area: Loan Guarantee Schemes in Select Countries (Percent of GDP; percent)



Sources: National authorities; and IMF staff calculations based on latest data.
1/ Disbursed guarantees in percent of the announced envelope.

Figure 2. Euro Area: Reduction of Liquidity Gap by the Policies and Size of Remaining Gap
(Percent of GDP; simple averages)

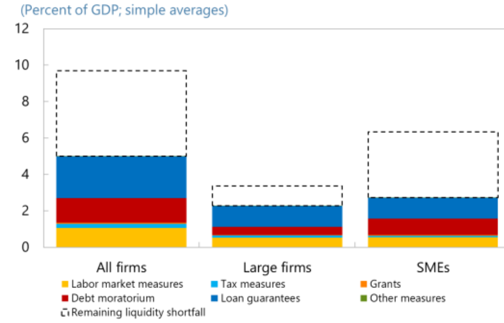


Figure 3. Euro Area: Reduction of Solvency Gap by the Policies and Size of Remaining Gap
(Percent of GDP; simple averages)

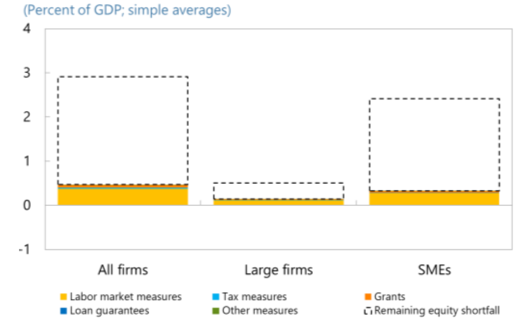
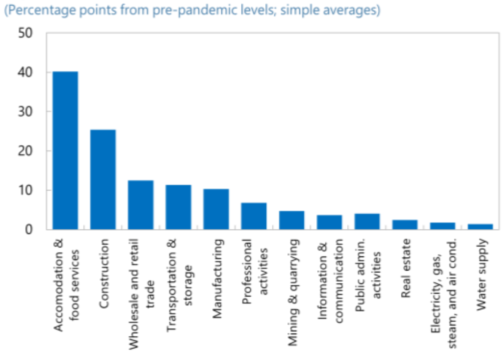


Figure 4. Euro Area: Increase in the Share of Insolvent Firms
(Percentage points from pre-pandemic levels; simple averages)



1/ Source: "Corporate Liquidity and Solvency in Europe During the COVID-19 Pandemic: The Role of Policies", Chapter 3 of the October 2020 Regional Economic Outlook for Europe.
2/ Liquidity and equity gaps emerge when cash holdings and equity turn negative, respectively. Pre-COVID liquidity and equity gaps reflect the elevated leverage and narrow scope for equity financing faced by SMEs, which only deleveraged partially after the GFC and have limited recourse to nonbank financing.

24. Early access to effective and widely available vaccines and therapies and/or a faster-than-expected adjustment to the virus are key upside risks. Rapid confirmation of the recent promising news on vaccine developments would likely instill confidence and result in faster-than-expected re-openings. Alternatively, a quick adjustment of businesses and consumers to the "new normal" would limit the scarring and the adverse impact on productivity, even if effective vaccines and therapies/treatments are not immediately available.

***Authorities' Views*[4]**

25. The authorities broadly agreed that the pandemic remains the main source of uncertainty for the outlook, with the second wave weighing on economic activity in the near term. They noted that the second wave has disrupted growth momentum and—while stressing the high uncertainty—expected a pickup in economic activity only next year when containment measures are assumed to be gradually lifted. The authorities concurred that the recovery is likely to remain incomplete until the end of 2022 and to vary widely across countries. Regarding inflation, the authorities expected downward pressures to prevail as weak demand and labor market slack more than offset the upward pressures caused by supply side disruptions. They expected inflation to remain in negative territory until early 2021 before gradually increasing as the effects of temporary factors wane and the base effects of lower energy prices diminish. The authorities did not see a high risk of deflationary pressures. They expressed some concern about the duration of temporary disinflationary factors and the impact of renewed lockdowns on demand.

26. The authorities saw important downside risks to the outlook, but also emphasized that upside risks have come to the fore. A prolonged health crisis was viewed as the key risk, due to its potential scarring effects. Possible bank-sovereign-corporate feedback loops, which could be amplified by a premature withdrawal of policy support, could also hamper the recovery. However, medical breakthroughs that would allow for a faster return to a more normal economic situation, and an ambitious and swift implementation of the NGEU/RRF funds could significantly boost the economic recovery. A trade agreement between the EU and the U.K. was also seen as an upside risk, and Brexit-related financial stability risks appeared contained as banks, insurers, and asset managers seemed well prepared to transition to a separate regulatory regime for their U.K. operations in the absence of regulatory equivalence.

27. The authorities concurred with the IMF's 2019 external sector assessment and stressed the difficulty in making an assessment during a pandemic year. Noting the high degree of heterogeneity across euro area countries' external positions, the authorities agreed that the aggregated euro area current account balance was moderately stronger than the level implied by medium-term fundamentals and desirable policies in 2019. For 2020, the authorities emphasized the high degree of uncertainty about the pandemic's impact on medium-term fundamentals, which complicates the external sector assessment. They indicated, however, that the recent REER appreciation—likely due to the forceful policy measures—implies that it is likely to be close to, or even moderately above, its equilibrium.

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

POLICIES: BALANCING SUPPORT FOR THE RECOVERY WITH FURTHER PANDEMIC MANAGEMENT

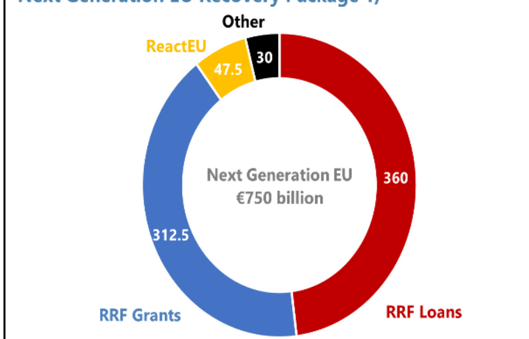
The policy challenges involved in continuing to counter the pandemic and facilitate a durable recovery are formidable. They include tackling the evolving health crisis, containing scarring, supporting resource reallocation and a transformation to more green and digital economies, and limiting the effects of the crisis on inequality and vulnerable segments of society. Importantly, policies should be flexible enough to quickly respond to the economic and social impact of changes in epidemiological conditions. In a downside scenario, further stimulus would be needed. While monetary policy has a role to play, further fiscal and other EU-level support would also be critical.

A. Fiscal Policy: Sustainably Supporting the Recovery

EU Fiscal Policy

28. The historic NGEU recovery package could provide a meaningful boost to euro area growth, especially in some of the countries hardest hit by the pandemic. The NGEU recovery package entails the European Commission borrowing €750 billion to be used to finance €390 billion in grants and €360 billion in loans to members. The main component is the Recovery and Resilience Facility (RRF), which will disburse all the loans and the bulk of the grants (€312.5 billion). The remainder of the grants will be used to top up other programs in the 2021–27 EU budget. While many of the details of the NGEU package remain to be clarified—including how the debt incurred by the European Commission will be repaid—estimates suggest Southern and Eastern EU countries will benefit most from the grants (Box 3).

Next Generation EU Recovery Package 1/



Sources: European Council (2020); and IMF staff estimates.
1/ RRF is Recovery and Resilience Facility. "Other" includes the Just Transition Fund, Rural Development, Invest EU, Horizon Europe, and RescEU.

29. The growth impact of the grants will depend largely on the additionality and quality of the spending. To the extent that grants finance already planned spending or that spending quality is low, the impact will be diminished. While plans for NGEU-financed spending for most countries remain relatively uncertain, the October WEO forecasts made an effort to incorporate the spending's growth impact based on reasonable country-specific assumptions. These forecasts estimate the EU27 real GDP level will be about ¾ percentage point higher in 2023 than it would be without the NGEU grants. Model simulations suggest that the output impact could be twice as large if a sizable share of the grants were used to finance additional high-quality investments. While the recovery fund does not create the permanent central fiscal stabilization capacity that Fund staff has long argued for, a positive experience with it could help build political support for the future introduction of such a capacity.[5]

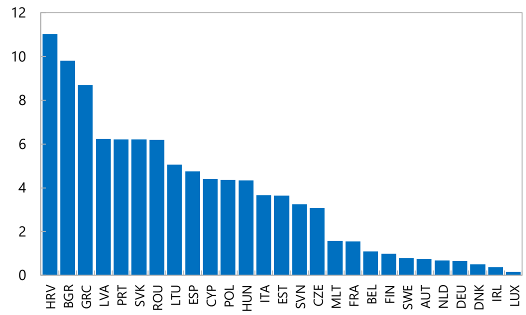
[5] See Allard and others (2013) and Arnold and others (2018).

Box 3. The Recovery and Resilience Facility: Allocation and Economic Impact

The Recovery and Resilience Facility (RRF) is the main element of the EU recovery plan. It is expected to finance countries' public spending in line with EU priorities of growth, employment, resilience, and green and digital transitions, as stated in the "country-specific recommendations." The Council agreement, which must be formally approved by European and national parliaments before entering into force, foresees repayment of the borrowing either with new EU revenues (a recycled plastic packaging waste tax, a carbon border adjustment tax, a digital levy, an emissions trading scheme, or a financial transactions tax), or by additional country contributions, over 2028–58.

Eastern and Southern countries would be the largest beneficiaries of the grants, as a share of their GDP. Over the entire period, a country's allocation will be proportional to its population size and inversely proportional to its per capita income level (i.e., richer countries get less). During 2021–22, the allocation of 70 percent of the funds will also consider the unemployment rate in 2015–19. In 2023, however, the allocation for 30 percent of the funds will reflect the economic impact of the crisis instead. Under these assumptions, Eastern and Southern countries would be the largest recipients of grants, with Croatia, Bulgaria, and Greece estimated to receive between 8½ and 11 percent of their 2019 GDP. Italy and Spain, two large countries hard hit by the pandemic, would receive 3.7 and 4.8 percent of GDP, respectively.

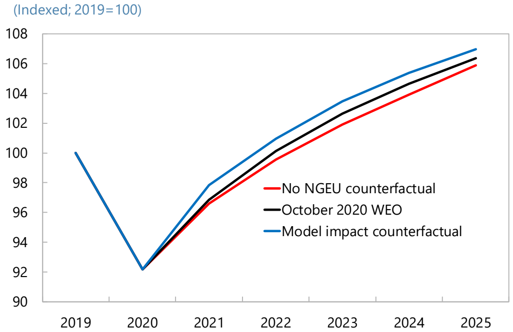
Recovery and Resilience Facility Grants
(Percent of 2019 GDP)



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

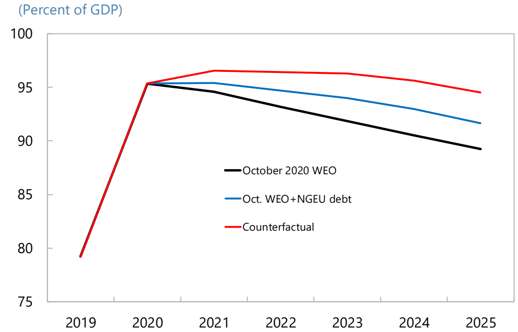
RRF grants have the potential to increase EU27 real GDP by over 1½ percent in 2023 relative to a counterfactual without the grants. The economic impact is simulated using the IMF's EUROMOD model (Andrle and others, 2015). The simulation assumes two thirds of grants translate into additional public spending, with one third financing already-planned spending, spread over 2021–24. It also assumes monetary policy remains accommodative over the simulation horizon. The results are used to construct a counterfactual scenario without the RRF grants. In the counterfactual scenario, EU27 real GDP is estimated to be 1½ percentage points lower than in the model simulations—or ¾ of a percentage point lower than the October 2020 *WEO* projections that already incorporate some impact of the grants—by 2023. The aggregate of EU27 national government debt ratios is forecast to decline starting in 2021 (black line). If the debt issued by the EU to finance the NGEU grants is included, the aggregate ratio only starts to decline in 2022 and falls by less (blue line). Notably, the debt ratio is higher in the counterfactual, reflecting the denominator effect of lower GDP and correspondingly lower tax revenues more than offsetting the lower public spending.

EU27: Real GDP Level
(Indexed; 2019=100)



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

EU27: General Government Debt
(Percent of GDP)



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

The simulations are illustrative. The assumption on the additionality of spending financed by grants may prove to be optimistic. Other factors, such as the amount of slack in the economy, the composition and quality of public spending, the level of uncertainty, and the timing of the spending, can also affect the impact. On the upside, the simulations do not account for structural reforms linked to the grants, which, if ambitiously implemented, could boost output further.

30. NGEU funds should be used to accelerate Europe's green and digital transformations. In the near term, using NGEU funds for investments aimed at addressing climate change and increasing digitalization would boost growth by supporting aggregate demand (see October 2020 WEO Chapter 3). Over the medium term, such investments could deliver substantial productivity improvements, especially in countries where productivity growth has lagged. To this end, the European Council agreed that 30 percent of the combined EU budget and NGEU package, or up to €555 billion over 2021–27, should support sustainable development measures, including mitigating climate change. Moreover, the RRF would allocate at least 37 percent of its spending envelope to climate change and 20 percent to digitalization, though countries should aim to exceed these targets given the potential of such investments to raise productivity.

31. However, achieving the EU's emission reduction goals will require combining public investment, more robust carbon pricing, and more ambitious implementation than currently envisaged (Annex I). The Green Deal has raised the EU's ambition in tackling climate change and is the signature policy initiative of the current European Commission. It seeks to reduce EU carbon emissions by 55 percent by 2030 and reach net carbon neutrality by 2050, though many details remain to be determined. One essential measure for achieving this would be expanding the Emissions Trading System (ETS) to other sectors and setting a sufficiently binding carbon price floor for the ETS. This will need to be complemented by nonprice policies at the EU and national levels, including regulatory measures (e.g., tighter vehicle emission standards, binding targets for efficiency improvements in buildings) and fiscal support (e.g., feebates incentivizing the purchase of low emission vehicles, means-tested low-interest loans/grants for renovations, making Common Agricultural Policy payments "greener"). In combination, such measures should catalyze sizable investment by the private sector and lead to economic and health benefits for decades to come. It is critical however that transfers be used to protect lower-income households and countries that are more affected by a rising carbon price. A carbon border adjustment mechanism (CBA) may also be needed to help address "emissions leakages" (i.e., production in greenhouse gas-intensive industries moving abroad to avoid paying higher carbon prices and then exporting output to the EU).

National Fiscal Policies

32. Countries draft budgetary plans suggest fiscal policies will remain supportive next year. The draft budgetary plans published in mid-October likely do not fully reflect the fiscal support needed next year given the pandemic's resurgence. However, they already envisioned a slightly expansionary aggregate fiscal impulse, abstracting from the planned expiration of temporary pandemic-related measures. Of course, such temporary measures may need to be extended next year. Much of the October forecast for the improvement in the headline fiscal balance is the result of automatic stabilizers unwinding as growth improves. If 2021 growth is lower than projected in October, then deficits will be larger and debt levels higher.

33. With the resurgence in the pandemic, national fiscal policies will need to provide more broad-based support for longer than initially envisioned. The immediate priority is to contain the pandemic in a coordinated manner, including by ensuring that national health care systems can cope and secure adequate resources for testing, contact tracing, personal protective equipment, and medical supplies. Continued fiscal support should be provided to households affected by the crisis and to firms that will be viable after the pandemic abates, including through short-time work schemes, liquidity and equity support for firms, and temporary tax cuts or tax payment deferrals. This will entail a more supportive aggregate fiscal impulse than forecast in the 2020 October *WEO*. Once the recovery gains a solid footing, it will be important to adopt new fiscal measures to facilitate the reallocation of labor and capital and allow the Schumpeterian creative destruction process to take place (e.g., targeted hiring subsidies, wage-loss insurance schemes, and enhanced training and job search programs). Such a process is necessary following any recession, although the specific needs associated with this pandemic are unclear at this stage. These will likely depend on the efficacy and timing of vaccines and therapies, as well as behavioral changes. The pace at which governments withdraw support to hard-hit sectors should also be state contingent, in that they should halt or reverse reductions in fiscal support if economic indicators weaken. To ensure a robust recovery, fiscal policy will also need to support aggregate demand more generally through productive public investment.

34. Countries should not withdraw fiscal support too quickly, although pressure to do so will be understandably higher on high-debt countries. Full use of EU financing (e.g., SURE, ESM Pandemic Crisis Support (PCS), NGEU grants and loans) and continued ECB monetary policy accommodation will be important in ensuring that high-debt countries can sustainably maintain the needed fiscal support during the recovery. Even in countries with substantial fiscal space, there is a risk of a premature tightening that seeks to quickly reverse the rise in debt precipitated by the crisis. In current circumstances, the costs of tightening too soon outweigh those of maintaining slightly higher debt levels for a few more years.

35. Countries should use stimulus measures to tackle critical challenges like climate change and digitalization. In the near term, countries should focus a significant share of stimulus resources on public investment, particularly for climate change mitigation and adaptation. Over the medium term, carbon taxes could be raised in nearly all countries and the revenues generated could finance public investment, R&D, and targeted transfers to ameliorate the growth and distributional effects of the rising carbon price. Incentives could also be provided for investments delivering high-speed internet access in rural and underserved areas. Education spending and job training programs could prioritize building skills needed in the digital and green economy.

36. Over the medium term, changes to the composition of fiscal policy will be important to sustainably boost inclusive growth and reduce fiscal vulnerabilities. Ensuring the composition of fiscal policy is made more growth friendly and inclusive—on both the spending and tax sides—could help boost medium-term potential growth rates in most euro area countries, while ameliorating the impact of the pandemic on inequality and poverty. For example, ensuring the withdrawal of means-tested benefits as income rises is not regressive and reducing labor tax wedges for low-income and marginally attached workers can help reduce inequality. Fiscal reforms would complement ambitious structural reforms that boost growth, which is a critical factor in reducing debt ratios. Even then, some countries' debt ratios will rise to very risky levels in the wake of the pandemic, and they will eventually need to embark on a gradual but steady path of fiscal adjustment to restore space to respond to future shocks.

37. Even greater fiscal support will be needed if the outlook materially deteriorates further. In a downside scenario, fiscal support for workers and firms would need to be extended for longer, increasing the cumulative fiscal impact, while contingent liabilities from existing guarantees could be realized. Countries with fiscal space should be able to bear this burden, particularly in the context of accommodative monetary policy. However, for countries with already high debt levels, providing the necessary fiscal support and realizing sizable contingent liabilities could lead to an adverse market reaction, with potential adverse knock-on effects on banks whose sovereign debt exposures have increased significantly since the onset of the crisis. If facilities such as the ESM's PCS and the RRF loans were to be exhausted, further EU financing support could be needed in the event of a severe downturn. In a prolonged crisis, differences in fiscal space may also materially impact the extent of state aid provided in different countries, undermining the level-playing field of the Single Market and increasing economic divergence among countries.

EU Fiscal Rules

38. Activation of the escape clause was warranted and should be extended until the recovery is firmly established. The escape clause suspends the requirements of the fiscal rules with respect to structural fiscal adjustment toward countries' medium-term objectives, providing countries with adequate flexibility to respond to the crisis. But it does not suspend the requirement to open excessive deficit procedures (EDPs) for countries that breach the deficit criterion. All euro area countries will have deficits in excess of 3 percent of GDP this year, and most will exceed that threshold next year, suggesting they could be subject to the EDP. The Commission may find itself in the position of recommending opening EDPs for most euro area countries. There is also a risk that if the rules come into force again in 2022, it could precipitate a shift toward fiscal adjustment sooner than is warranted by economic developments.

39. This could therefore be an opportune time to reform the fiscal rules. Though undoubtedly politically difficult, a fundamental reform of the EU fiscal rules would be desirable. Any reform should simplify the rules and make them easier to communicate and enforce. While the Commission's fiscal rule review that started in early 2020 was delayed by the crisis, it will hopefully conclude in 2021. European leaders should task the review with the ambitious goal of proposing a fundamental reform and simplification of the rules.

Authorities' Views

40. The European Commission largely agreed with staff's fiscal advice. Countries need to continue to provide well targeted and temporary fiscal support for their economies given resurging virus cases and lockdowns but should avoid either creating permanent entitlements, which may affect fiscal sustainability in the medium term, or withdrawing fiscal support too early or too quickly, which would hamper the recovery. Favorable financing conditions supported by a positive perception of the NGEU and by monetary policy easing measures contribute to reduce the risk of an early withdrawal. Reforms and investments financed by the EU under the NGEU will also support the recovery going forward. However, the Commission underlined that it was important that NGEU grants be well spent on productive investments and programs, coupled with structural reforms, in order to ensure a robust recovery and promote integration. The Commission also did not see a need for additional EU financing support at this stage, while efforts continue to improve absorption of the funding. They argued that if downside risks materialize, the untapped financing already available was sufficiently sizable.

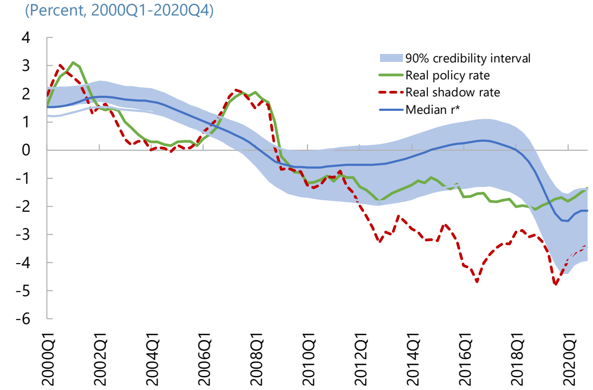
41. Staff-advocated policies to address climate change are in line with those envisioned by the Commission. They recognized further policy measures, including extending the ETS and greater carbon pricing, would be needed to meet their emission reduction goals. They are currently looking at a carbon border adjustment mechanism to address emission leakages, which may be necessary to achieve their ambitious goals.

42. The decision on when to return to the normal application of the fiscal rules will depend on economic uncertainty being resolved, while the political appetite for reforming the rules may be low. The general escape clause will remain active in 2021 and the fiscal guidance for 2022 will be presented and discussed next Spring. The Commission confirmed it would simultaneously re-assess the economic situation, recalling that the high degree of uncertainty on the economic and budgetary situation prevented opening excessive deficit procedures so far. Pandemic dynamics and the extent of uncertainty over the outlook at that point will factor heavily in those decisions. They noted that with the escape clause still active, fiscal adjustment may not be required initially for countries even after the eventual launch of EDPs. The Commission was open to the argument made by staff and the European Fiscal Board that it would be a good time to rethink economic governance before the escape clause is lifted. However, given how potentially contentious a possible reform could be in light of the prevailing divide over governance and enforcement, they thought prospects were dim for reaching an agreement on a comprehensive reform soon.

B. Monetary Policy: Maintaining Accommodative Policy Stance While Being Attentive to Deflationary and Fragmentation Risks

43. The monetary policy response to the pandemic has been appropriately bold, but given the second wave further support is needed. The ECB has successfully countered a tightening in financial conditions and maintained an accommodative monetary policy stance as evidenced by an estimated shadow rate that is well below the median estimate of the natural rate.[6] Going forward, with the recovery disrupted by the second wave and output projected to remain below potential over the medium term, further monetary policy

Euro Area: Estimated Natural Interest Rate
(Percent, 2000Q1-2020Q4)



Sources: IMF staff calculations. Estimate for 2020Q4 is based on projections assuming the same rates as Q3.

[6] The shadow rate measures the implied interest rate in the face of a lower bound and is estimated using the Krippner methodology (2015). The natural rate follows the Laubach-Williams (2015) model.

accommodation will be needed to counteract the pandemic's disinflationary impact and lift inflation expectations. In this regard, the ECB Governing Council's commitment to recalibrate its instruments once the December round of Eurosystem staff macroeconomic projections is available is welcome.

44. An expansion of asset purchases should remain the main tool to offset further disinflationary pressures, but effective communication is critical. PEPP can be further expanded, both in size and duration, to counter possible market fragmentation and the larger medium-term inflation gaps that could emerge.[7] An extended period of asset purchases may face some implementation challenges, however, as evidenced by the recent German Constitutional Court ruling on aspects of the ECB's public sector purchase program. In assessing issues related to the PSPP, the Court stressed the centrality of the ECB's self-imposed safeguards for price formation—including the capital key and minimum standards of credit quality. This underscores the need for effective communication about proportionality assessments that consider the full range of possible effects arising from asset purchases, the rationale for any capital key deviations and expected convergence back to the key, and the planned exit from asset purchases and reinvestment strategies.

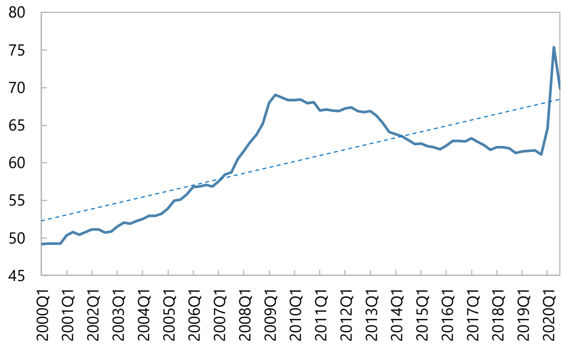
45. Interest rates can be reduced, but the impact of new cuts would likely be limited. The ECB reduced the deposit rate by 10 bps to -0.5 percent in September 2019—the first policy rate cut since 2016. While additional rate cuts seem technically feasible—as most likely the reversal rate has yet to be reached—they may have a limited effect on bank lending in the face of higher credit risk and potentially lower profitability. Adjusting the tiering multiplier and continuing to provide targeted and untargeted LTROs with effective funding costs below the deposit rate could reduce the adverse effects on the lending channel. These measures would need to be backed by forceful forward guidance on the path of the policy rate and the asset purchase programs, including the reinvestment of principal from maturing securities.

46. The benefits of an accommodative monetary policy stance continue to outweigh possible adverse side effects, although close monitoring is needed. Prolonged periods of unconventional monetary policy (UMP) can fuel financial stability risks, including by inflating asset prices and increasing risk taking by banks. Indeed, financial stability risks—while not excessive—were building up in some areas prior to the crisis, requiring continued close monitoring and proactive use of macroprudential tools to address segments of risk. Moreover, despite concerns about the pernicious effects of UMP on the distribution of income and wealth, evidence suggests that these effects were negligible in the pre-crisis period, and UMP could in fact help reduce inequality in the post-crisis era by supporting sizable employment gains, which normally have greater impact on lower income groups.[8] Lastly, even if UMP did trigger undesirable side effects, these could nevertheless be an acceptable price to pay to avoid an extended period of very low growth that could result from a failure to forcefully address the impact of the crisis now.

[7] PEPP's high degree of flexibility regarding the maturities and credit quality of its secondary market sovereign bond purchases also helps alleviate potential pressures in primary markets and prevent loss of market access.

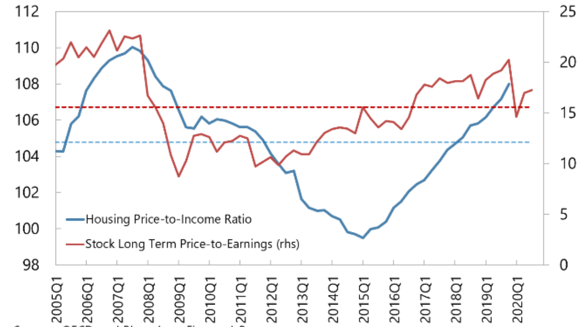
[8] Lenza and Slacalek, 2018.

Euro Area: Total Credit Outstanding
(2000Q1-2020Q3, Percent of GDP)



Sources: European Central Bank; and Eurostat.

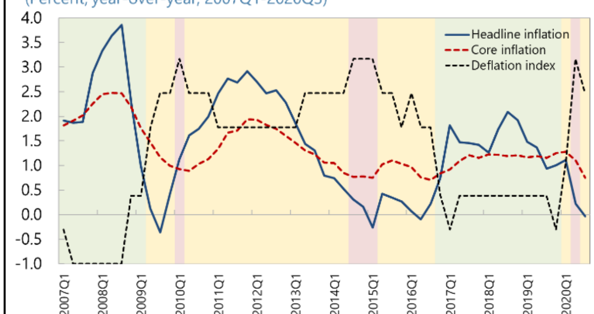
Euro Area: Housing Price-to-Income and Stock P/E Ratios 1/
(2015=100, 2005Q1-2020Q3, Dashed lines refer to period average)



Sources: OECD; and Bloomberg Finance L.P.
1/ Period average refers to 2005Q1 - 2019Q4, prior to the pandemic crisis. Long-term price to earnings ratio is the ratio of price to 10 year average real earnings per share (EPS) adjusted with CPI.

47. **Substantial additional monetary policy accommodation via existing and new policy tools would be needed if the inflation outlook were to be materially downgraded**. The risk of prolonged low inflation or even deflation is nonnegligible, especially if downside risks materialize. Even under the October *WEO* projections, the euro area deflation index shows a moderate probability of headline inflation remaining in negative territory for several quarters.[9] To prevent the risk of prolonged deflation or sharp deterioration in the inflation outlook in a downside scenario, the ECB would need to further ramp up support, including by considering new policy tools.[10]

Euro Area: Deflation Risk Index 1/
(Percent; year-over-year; 2007Q1-2020Q3)



Sources: IMF, World Economic Outlook; Haver Analytics; and IMF staff calculations.
1/ The analysis uses an estimated Deflation Risk index to delimit different regimes. Shaded areas are defined as: green (low) = index below 0.3; yellow (moderate) = index between 0.3 and 0.49; and pink (high)= index equal or above 0.5. The calculation is based on the methodology in IMF Task Force Paper (2003).

48. **Direct support to the nonfinancial corporate sector could be envisaged should monetary policy transmission become impaired**. As banks are likely to deleverage and reduce risk taking in an adverse scenario, the ECB could fully or partly finance a Special Purpose Vehicle (SPV) to deliver temporary bridge financing to viable firms facing COVID-related liquidity shortages, and/or purchase loans originated by eligible lenders (learning from recent experience with the Main Street Lending Program in the United States).[11] All these facilities need to include appropriate screening procedures and thresholds to avoid lending to so-called "zombie firms." Expanding the range of eligible assets under the PEPP by including high-yield corporate bonds, "fallen angels", or equity exchange traded funds (ETFs) could also be considered to provide greater support to the nonfinancial sector and tackle possible stresses in different market segments. However, as the Bank

[9] The aggregation method for the deflation index may not, however, capture the changing relationship between indicators for slack and inflation in the recent years.

[10] Introducing yield curve control (YCC) is likely to face considerable legal and operational complexities given the implicit commitment to buying unlimited amounts of sovereign paper and the need to target the yield curves of 19 member states or the euro swaps curve.

[11] The European Investment Bank (EIB) could also take the lead in setting up, financing, and managing the SPV, potentially allowing the option of providing credit protection on pools of bank loans to SMEs.

of Japan experience shows, the latter may generate losses while the former could have limited effectiveness given European firms' heavy reliance on bank financing.

ECB Strategy Review

49. Given a persistent inflation undershoot, long-term structural trends, and the pandemic shock, the ECB's planned review of the monetary policy framework is timely. The review is scheduled to be concluded by mid-2021—with the aim of assessing monetary policy objectives and instruments, studying inflation measurement, and analyzing long-term issues such as digitalization, climate change, and automation. As in Japan and the United States, with declining neutral rates, inflation has undershot the medium-term objective for an extended period. Given this, the strategy review will analyze the merits of moving away from the current "below, but close to, 2 percent" aim and the extent to which the ECB needs to react to large and persistent deviations from its aim, while also examining other objectives such as financial stability and employment.

50. Preliminary analysis suggests that a clear and well communicated symmetric point inflation target would be desirable. Staff's analysis clearly illustrates that a symmetric point target formulation outperforms an asymmetric inflation objective in an environment marked by a secular decline in real interest rates and a weak sensitivity of inflation to economic activity (Annex II). This suggests that the ECB's recent emphasis on their aim being symmetric has been appropriate and should be clearly codified and articulated around a specific point inflation target. Adopting a lower inflation target or an inflation range would be undesirable as it would carry higher deflation risks. Regarding makeup rules, the analysis suggests that especially after an extended period of undershooting the medium-term aim, allowing inflation to overshoot the target for some time (i.e., adopting a flexible average inflation targeting regime) could be beneficial to better anchor inflation expectations closer to the target. But the long-term benefits of such a regime remain uncertain, given that it can generate higher output volatility (e.g., when average inflation is above target because of cost-push rather than demand shocks) and because of its potential implications for financial stability risks. A continued medium-term orientation would allow the ECB to consider broader objectives such as employment and financial stability within its price stability mandate.

Authorities' Views

51. The ECB broadly agreed that a highly accommodative monetary policy stance is necessary in light of the second wave of COVID-19. The ECB stands ready to assess incoming information in the context of its new macroeconomic projections in December and recalibrate its toolkit, as appropriate, to safeguard favorable financial conditions and ensure a return of inflation to its aim. In the meantime, it will continue to use the PEPP flexibly across asset classes, time, and jurisdictions to ensure a proportionate response to the current risks and secure a smooth transmission of monetary policy and an appropriate accommodative monetary stance.

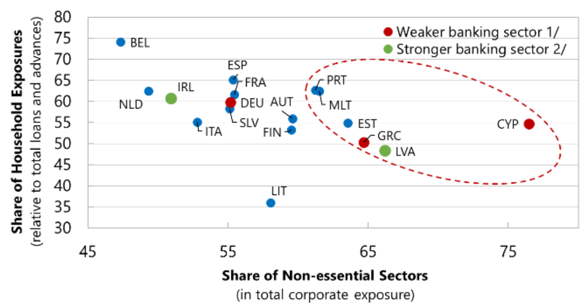
52. Financial stability risks from the negative interest rate environment appear limited. The ECB noted that macroprudential policies are the first line of defense against any build-up of financial vulnerabilities but stressed that there are no signs of excessive risk taking or stretched valuations in the housing market at this stage. Policy innovations, such as tiering reserves and the TLTRO, along with higher credit growth, have mitigated the impact of negative rates on bank profitability.

53. The ECB considers the strategy review as an important step to reflect on its monetary policy tools and aims. The ECB has taken note of the outcome of other central banks' strategy reviews but emphasized that its strategy review is guided by the specific mandate of the ECB, as stated in the Treaty on the Functioning of the European Union, and the characteristics of the single market. The ECB pointed to the importance of a clearly codified symmetric aim for anchoring inflation expectations to its medium-term inflation aim, and stressed that, in practice, there has already been a commitment to symmetry by the Governing Council, as highlighted in past press statements.

C. Financial Sector Policies: Safeguarding Financial Stability and Supporting Lending

54. Pandemic-related capital relief and conservation measures helped maintain the flow of credit. During the first lockdown and subsequent reopening, banks were able to slowly absorb rising impairments without a significant change in their capital ratios given continued borrower-support and effective capital conservation measures. Moreover, the release of capital buffers of more than €156 billion expanded banks' lending headroom. After accounting for potential loan losses based on the October *WEO* projections (Box 4), which would consume more than three-quarters of current surplus capital, banks' capacity for net lending would still amount to about €0.4 and €0.9 trillion to households and nonfinancial corporates, respectively (equivalent to 5 and 11 percent of the current stock of loans).

Euro Area: Exposure to Households and Corporates in Non-essential Sectors
(Percent)



Sources: EBA; and IMF staff calculations.
1/ Lower system-wide profitability and capital adequacy (CET1<16.5% and RoA<0.2%); 2/ Higher system-wide profitability and capital adequacy CET1>18.0%, RoA>0.6%

55. As borrower support measures expire and default risk increases further, however, banks have started to tighten lending conditions, especially in countries with legacy NPLs. Regulatory flexibility and credit guarantees have cushioned the immediate impact of potential impairments but have not altered the underlying deterioration of credit risk. According to the ECB's latest Bank Lending Survey, banks have raised their underwriting standards as the impact of higher risk perceptions and balance sheet constraints have outweighed that of lower funding costs. While bank capitalization is appropriately high, a broader deterioration of asset quality is likely to adversely affect banks' already low profitability, especially given significant credit exposures to commercial lending in vulnerable sectors. Indeed, banks in vulnerable countries have increased their loan loss provisions on precautionary grounds, and already report a net tightening impact of higher NPL ratios as the effect of the initial pandemic-related containment measures on borrowers is becoming increasingly apparent.

Box 4. Impact of COVID-19 on Bank Capital in Europe

The COVID-19 crisis has intensified the profitability challenges of many euro area banks, with potentially adverse implications for their lending capacity next year. Prior to the crisis, most banks' business models were already under pressure due to compressed net interest margins and inefficient cost structures amid legacy assets from the last crisis. The pandemic has amplified these pre-existing conditions as banks are likely to: (1) raise provisions for higher loan losses and lower collateral expected from the economic shock; (2) write off a rising share of nonperforming loans due to corporate insolvencies; and (3) face lower income from nonlending activities. Over 60 percent of banks' corporate exposures are to nonessential sectors, especially to real estate and trade (and to a lesser extent, construction and transport; table). In addition, more than half of bank lending is to households, especially via mortgages, which are increasingly affected by the distributional impact of adverse aggregate income and employment effects. These exposures have already adversely impacted banks' profit and capital positions and will continue to do so as the crisis evolves.

Loans to Non-essential Sub-sectors 1/

(Percent of Tier 1 capital)

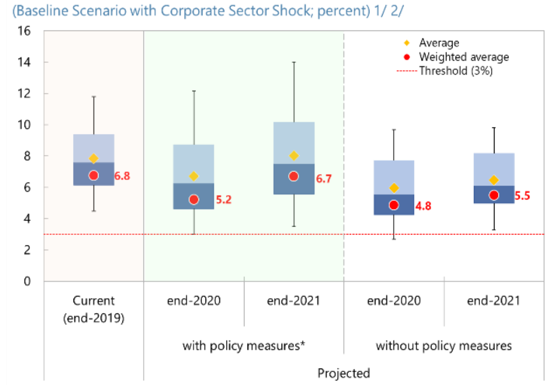
	Construction	Wholesale & Retail Trade	Transport & Storage	Accommodation & Food Services	Real Estate Activities	Arts & Entertainm	Other Services
AT	29	56	18	16	116	2	4
BE	26	40	15	4	41	3	4
CY	39	59	17	46	44	2	3
DE	10	42	28	4	177	2	11
EE	14	59	24	4	86	3	7
ES	29	70	24	18	48	3	24
FI	20	30	30	4	167	3	10
FR	18	53	25	9	90	2	28
GR	40	91	51	40	29	6	10
IE	6	25	13	21	60	4	8
IT	47	77	24	16	66	3	28
LU	9	3	2	3	22	0	5
LV	12	33	33	14	72	1	5
MT	16	24	10	12	32	4	1
NL	15	68	33	7	88	2	21
PT	34	41	19	18	38	3	19
SI	16	52	39	6	11	1	4
EA SSM	22	47	23	15	90	3	11

Source: EBA Transparency Exercise; IMF staff calculations.
1/ Cells ≥100 (50) are colored red (orange).

Staff's analysis suggests that euro area banks are likely to remain broadly resilient under the October *WEO* projections thanks to a wide range of mutually reinforcing financial policy measures, but a significant decline in capital could constrain their lending capacity next year.[1] Public bank-level data from statutory filings as of end-2019 is combined with information from the 2020 EBA Transparency Exercise to project bank profits, the scale of potential corporate defaults in each sector on bank capital, and their interaction with borrower support measures until end-2021.[2] Under the October *WEO* projected path for growth and unemployment, the aggregate capital-to-asset ratio would almost fully recover by end-2021, after an initial drop. However, two banks remain below the indicative threshold of 3 percent, even after considering the effect of debt moratoria and credit guarantees (chart), which provide a substantial cushion of about 1.2 percentage points. Under an illustrative downside scenario (with GDP growth -0.9 and -2.7 percent below the baseline in 2020 and 2021, respectively), the capital-to-asset ratio declines by an additional 0.2 percentage point in 2020 and barely improves in 2021—even with the current policy measures in place (with six banks falling below the threshold).[3] These results are consistent with the ECB's recent COVID-19 Vulnerability Analysis (July 2020), which found that banks remain stable under baseline conditions but that under a severe scenario, several banks would need to take action to maintain compliance with their minimum capital requirements.

Euro Area Banks-Stress Test of the Capital-to-Asset Ratio

(Baseline Scenario with Corporate Sector Shock; percent) 1/ 2/



Sources: EBA; ECB; ESRB; FitchConnect; and IMF staff estimates.
1/ The blue shaded area of the boxplots shows the inter-quartile range (25th-75th percentiles), with whiskers at the 5th and 95th percentiles. */ Debt repayment relief (moratoria) and credit guarantees (without excluding cash and reserves from assets as temporary adjustment to the leverage ratio until mid-2021). 2/ WEO October 2020 baseline forecast for GDP growth and unemployment plus single-factor shock of expected firm bankruptcies (of which about 15 percent occur in 2020 on average). The analysis examines the change of the capital-to-asset ratio (as proxy for the leverage ratio) of 90 large euro area banks through the decline in profitability (net interest income and provisions) and the change in net lending (after accounting for write-offs). The crisis-specific factors influencing the results are: (1) extraordinary write-offs of exposures to illiquid and insolvent non-financial corporates, (2) lower provisions for guaranteed loans to solvent firms (and a limited increase of provisions for eligible loans for the duration of moratoria), and (3) the decline in interest income due to debt moratoria.

1/ Based on IMF (forthcoming), "The Impact of COVID-19 on European Banks," EUR Departmental Paper.
2/ Based on IMF, 2020, "Corporate Liquidity and Solvency in Europe During the COVID-19 Pandemic: The Role of Policies," Chapter 3, Regional Economic Outlook (October).
3/ The adverse scenario is based on Chapter 1 of the IMF's World Economic Outlook (October 2020).

56. A slower recovery could result in sizable capital shortfalls in the banking sector. Subdued economic activity due to delayed reopening would exacerbate pervasive liquidity problems and increase debt overhang, especially in vulnerable sectors. This would result in potentially much larger bank credit losses. In turn, banks' diminishing capacity to lend would likely weigh on financing for consumption and investment at the time when it would be needed most. Rising fiscal vulnerabilities in countries that are most affected by crisis could strengthen the sovereign-bank nexus, raising the cost of borrowing and limiting credit availability.[12] Some banks might be able to raise new capital at manageable costs, while others would need their viability carefully assessed, ideally in the context of the ECB's bank capital planning review. The ECB should prepare a system-wide stress test to secure full flexibility for potential public financial support without burden sharing to banks that are vulnerable under a downside scenario (Box 4).

57. Unwinding capital relief measures during the recovery period will require a careful balancing act. Supportive financial sector measures, including restrictions to dividend payouts and share buybacks, should be maintained until the recovery is well underway, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit. Borrower support, mainly aimed at staving off liquidity shortfalls, would need to remain available until the recovery is underway. However, eligibility criteria should be tightened over time to better target illiquid but solvent firms and the most vulnerable households. Moratoria should be targeted and extended only if needed to prevent widespread insolvencies and without distorting classification and provisioning requirements of banks.

58. Swift balance sheet repair will be critical to maintain confidence and support intermediation, especially in a downside scenario. As the recovery takes hold, prudential standards should be normalized—and clearly communicated—to incentivize the timely recognition of problem assets. Supervisors should enhance their monitoring and ensure that banks' have the capacity to resolve NPLs with credible reduction strategies. Uncertainty over the crisis' impact requires such strategies to cover a longer time horizon than usual. Banks that face capital shortfalls should present plans to restore their capital. Insolvency regimes should be strengthened to address high numbers of cases, and the capacity of court systems should be supplemented by an intensive use of out-of-court restructuring (Annex III). Swiftly implementing the European Restructuring and Insolvency Directive and reaching an agreement on extra-judicial collateral enforcement would increase the efficiency of national systems.

59. Asset management companies (AMCs) could support these efforts but would likely face significant political and operational challenges. The European Commission's blueprint for national AMCs provides a roadmap for their establishment, yet the large expected deterioration in credit quality might make them unattractive in countries with fiscal space at risk. A pan-European AMC could potentially overcome the funding limitations in fiscally constrained countries, while also helping to further deepen the distressed debt market and reduce the pricing gap for bad loans.

[12] Recent regulatory measures, such as lower capital requirements for the credit and market risk of government debt securities, have significantly reduced the extent to which higher sovereign risk can affect bank solvency.

Nevertheless, different insolvency and collateral enforcement frameworks across EU countries and hurdles related to asset purchases, funding, and the potential for mutualization of losses would make agreement on a pan-European AMC unlikely. A network of nationally established AMCs, however, relying on common NPL data templates, transaction platforms, and valuation methodologies could be more politically acceptable and still facilitate cross-country transactions.

60. Addressing structurally low profitability in the banking system could help facilitate "self-healing" once the recovery gains traction. In addition to current cost pressures from rising impairments and provisioning requirements, cost structures weigh on returns on equity (RoE). An increasing number of banks are now reporting earnings below their cost of capital. While many banks have started investing in digital technologies to reduce structural margin and cost pressures, this adds to short-term expenses. Supervisors will need to intensify assessments of business model sustainability. Absent bold actions to cut operating costs, RoE is likely to remain subdued over the medium term, especially given the prolonged scarring effects of the crisis. Increased consolidation through mergers and acquisitions could improve banks' efficiency and profitability.

61. The pandemic underscores the need to rapidly close existing gaps in the crisis management framework. As recommended by the 2018 FSAP, several reforms would significantly strengthen the EU's crisis resolution capacities. These include: (i) greater harmonization and centralization of emergency liquidity arrangements; (ii) making the powers of the Single Resolution Board more usable for smaller banks and in systemic crises (including introducing a systemic exemption to burden-sharing rules; adjusting interpretation of the "public interest test;" and introducing an EU level administrative bank liquidation tool to address situations in which banks may fail the public interest test but still be too large for national insolvency proceedings);[13] and (iii) providing an operational financial backstop for the Single Resolution Fund (SRF) by finalizing the European Stability Mechanism (ESM) treaty reform.[14]

62. The specter of potential fragmentation calls for advancing financial sector architecture reforms to support the recovery and strengthen resilience:

- *Banking Union*. The emerging consensus on the design of the European Deposit Insurance Scheme (EDIS) offers an opportunity for removing remaining obstacles. The interim report (June 2019) of the High-Level Working Group proposes concrete steps towards implementing the European Deposit Insurance Scheme (EDIS. The current proposal centers on a hybrid model, relying on the existing national deposit guarantee schemes, which are reinsured by a central fund. The implementation of the EDIS co-insurance would allow risk-sharing to evolve in parallel to risk reduction and should be implemented swiftly.

[13] Banks are resolved by the Single Resolution Board if liquidation is not warranted because they provide a critical function or liquidation could threaten financial stability ("public interest test").

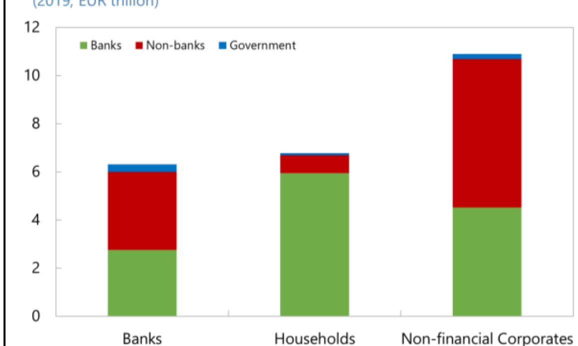
[14] On November 30, the Eurogroup agreed to proceed with the ESM reform and introduce a common backstop for the SRF by early 2022, pending ratification of the amended ESM treaty by member state parliaments.

- *Capital Markets Union (CMU)*. The new 2020 CMU action plan published by the European Commission in September has identified several steps needed to "reboot" the EU's push for greater capital market integration. These include fostering access to comparable company data through a single pan-European portal, facilitating company listings, developing adequate pension products, centralizing supervisory power in some areas, and ensuring converging outcomes in national insolvency proceedings. These are in line with previous staff recommendations, which further urged a data-driven upgrade of insolvency proceedings following minimum EU-level standards. Fast implementation of these recommendations would ease access to market-based finance and lessen firms' reliance on bank borrowing, hence increasing private risk sharing and strengthening the resilience to shocks.

- *Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT)*. To ensure harmonized and consistent AML/CFT oversight, the European Commission has laid out plans to establish a single AML/CFT rule book and expressed support for a single supervisor. Full transposition by member States of the 5th AML Directive's provisions on central bank account mechanisms and publicly available beneficial ownership registers with high-quality data should further strengthen the region's AML/CFT safeguards.

63. Prudential measures should be strengthened to address vulnerabilities in nonbank financial institutions. Nonbank financial institutions provide sizable funding to firms and banks, and yet many of them fall outside the prudential perimeter of macroprudential surveillance. A rising share of illiquid asset holdings make investment funds, especially those exposed to real estate and alternative assets, more vulnerable to redemption pressures as risk sentiment changes. Moreover, supervisory fragmentation prevents timely identification of liquidity risks and proper activation of liquidity management tools. While current liquidity risks remain limited, some long-term institutional investors have become more active in repo markets to leverage their returns, which raises their susceptibility to adverse financial conditions. In the absence of a comprehensive safety net for nonbank financial institutions, these risks should be carefully monitored, including those that emanate from increased exposure to lower-grade corporate debt and real estate. As recommended in the 2018 FSAP, borrower-based tools could be legislated where they are currently unavailable and national macroprudential supervisors should have the authority to use these tools for all financial institutions. Efforts should continue to reduce data gaps in the measurement of the OFI sector. For investment funds, ESMA should be given more authority to bring about supervisory convergence on liquidity management tools, and greater coordination across national supervisors on the use of leverage restrictions.

Euro Area: Sources of Total Borrowing 1/
(2019; EUR trillion)



Sources: Haver Analytics; and IMF staff calculations.
1/ Excludes equity.

Authorities' Views

64. While the crisis impact on the banking sector has remained limited so far, the authorities are concerned that a new round of lockdowns could adversely affect credit

conditions. The authorities shared staff's view that banks remain resilient based on October *WEO* projections given continued borrower-support and effective capital-conservation. However, they noted that possibly deteriorating asset quality and persistent profitability challenges could weigh on their lending capacity, especially if capital buffers are not sufficiently used. The ECB is proactively assessing banks' forward-looking profitability projections, cost-reduction efforts, and the broader viability of their business models. To provide incentives for greater consolidation, the ECB has recently issued guidance on its supervisory approach to banks' consolidation plans.

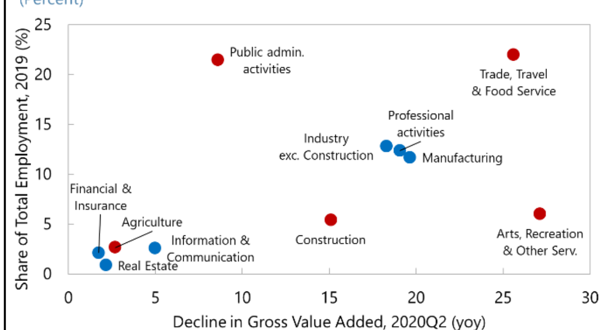
65. The authorities saw rising downside risks to financial stability amid a deteriorating outlook and shared staff's assessment that bank balance sheet repair will be needed. The ECB noted that the sluggish recovery could result in potentially larger bank credit losses and has intensified supervision. It agreed that supportive financial sector measures should become more targeted and expectations on the applicability of capital requirements should be clearly communicated. The ECB argued that the premature phase-out of supportive fiscal measures could create potential "cliff effects" from provisioning gaps and amplify de-leveraging pressures on weaker banks, especially those most exposed to vulnerable sectors. However, the phase-out of the flexibility in loan classification was deemed necessary to restore asset quality transparency as some banks might be forced to raise new capital. To prevent a renewed build-up of NPLs, the authorities are working with member states on a comprehensive strategy that includes reforming insolvency and debt recovery frameworks and further developing markets for distressed assets. They underscored the importance of facilitating cross-border NPL transactions and widening the investor base through greater data standardization and transparency, and developing NPL transaction platforms. This could also involve creating a network of national AMCs or a pan-European institution. With regards to Minimum Requirement for Own Funds and Eligible Liabilities (MREL), the Single Resolution Board (SRB) has provided relief to the sector through the gradual buildup of the MREL capacity.

66. The authorities noted that the crisis has generated political momentum for advancing financial sector architecture and crisis management reforms. The Commission recognizes that resolution powers could be improved for certain less significant banks and will reflect on the available toolbox for the resolution of medium-sized banks. At the same time, the SRB highlighted its intention to apply the resolution powers within its remit to address bank failures, including for medium-sized banks, and highlighted the importance of transfer tools for the resolution of such banks. Regarding the completion of the Banking Union, discussions resumed on a hybrid model for EDIS and its interaction with the crisis management and depositor protection frameworks in the context of the announced legislative package for 2021Q4. A political agreement on ESM reform and early introduction of the common backstop to the SRF was expected on the basis of an assessment on the progress in risk reduction. Further work remains on liquidity in resolution where, notwithstanding the lack of progress concerning a central EU resolution liquidity facility, the SRB is advancing with its approaches and requirements to ensure funding in resolution from private sources. However, it is premature to consider a systemic risk exemption to burden sharing (along the lines of the current Temporary State Aid Framework). Regarding new measures to advance the CMU, the authorities noted that political consensus has been reached for most of the key elements, but progress on some of the more ambitious reforms, such as improving insolvency regimes or centralizing supervisory power, would take time and require intensive preparation. Finally, the ECB has set up a new coordination function to exchange information with AML/CFT supervisors more systematically and to address the prudential implications of AML/CFT risks. They stressed their support for creating a single oversight body for AML/CFT, but recommended setting up separate institution given the ECB's mandate only covers the prudential supervision of credit institutions.

67. The authorities were mindful of emerging risks from the non-bank sector and the need to develop a macroprudential framework. Cognizant of the greater role of non-bank lenders and some vulnerabilities in the investment fund industry, they stressed that some member states have passed legislation to broaden the toolkit available in their jurisdictions. They also indicated that, together with the national competent authorities, they have been carefully monitoring investment funds with significant exposures to less liquid assets while seeking greater coordination on liquidity management tools.

D. Structural Policies: Facilitating Resource Allocation and Boosting Productivity

Euro Area: Sectoral Distribution of the Pandemic Impact 1/
(Percent)



Sources: Eurostat; and IMF staff calculations.
1/ Red dots indicate most contact-intensive sectors based on IMF staff calculations using Koren and Peto (2020) methodology and data from Eurostat and OECD.

68. The crisis is likely to have persistent effects on many countries' economic structures. The severity of the pandemic, its duration, and its sectoral impact remain highly uncertain. Yet social distancing and behavioral changes are likely to persist for some time, reducing the demand in contact-intensive sectors and constraining their operations. The potential reallocative and distributional consequences could have significant implications for labor and product markets, especially given that contact-intensive sectors in some countries account for a large share of economic activity and employment.

69. The scale of the COVID-19 shock and uncertainty about its persistence argue for carefully expanding solvency support. As demand firmly recovers, policies would need to gradually transition from general lifelines for businesses to supporting firms with good post-pandemic viability prospects, while facilitating the exit of unviable companies.[15] Implementing such triage is inherently difficult, however, given the uncertainty surrounding the post-pandemic landscape, likely justifying erring on the side of caution at this point and preserving some firms that will ultimately prove to be unviable. To tackle this challenge, government support should be selective and provided to firms with solid pre-crisis average profitability or turnover ratios whose operations have been impaired by health risks or social distancing restrictions. To limit the cost to the taxpayer and incentivize necessary reallocation, support should be targeted and temporary, with

[15] See October 2020 Fiscal Monitor, Chapter 1.

existing shareholders bearing much of the burden.[16] For systemic firms that provide critical services or whose bankruptcies could trigger large spillovers, public support should be subject to strict conditions to guard against distorting competition. At the European level, a solvency support instrument could play a critical role in maintaining the integrity of the Single Market given countries' differing capacities to inject equity into struggling firms. The expected high pressure on courts, which will require well-functioning corporate bankruptcy frameworks and expedited out-of-court restructurings, also highlights the need to streamline procedures and strengthen judicial capacity.

70. Labor policies should remain agile to ease adjustment and support the recovery, and a more fundamental redesign may be warranted given ongoing structural transformation. An unprecedented expansion of job retention schemes successfully prevented massive job losses and an immediate surge in unemployment (Box 5). Nevertheless, as the restrictions on economic activities are gradually lifted, job protection will need to be gradually phased out and complemented by policies to support workers and facilitate reallocation towards expanding firms and sectors. Specifically, mean-tested social assistance programs should be strengthened to ease passage into work while maintaining sufficient support. Job retention schemes will need to be adjusted, including by introducing clear phasing-out mechanisms, and promoting training to reskill and upskill. Strengthening incentives for job search that encourage workers to register for employment services, and reducing hiring costs for viable firms (e.g., by providing carefully targeted hiring subsidies) would also play an important role in promoting labor mobility. More generally, the pandemic will likely accelerate the trend towards automation in the context of the appropriate push for green and digital transformations. To make sure people are not left behind as demand switches across sectors, a more fundamental rethink may be needed on how to adapt labor market policies to respond to such shifts.

71. Mitigating the adverse distributional effects of the pandemic should be a key policy focus. The pandemic is likely to disproportionately affect poorer regions with preexisting structural impediments and exacerbate inequality along different dimensions (Box 1). Hence, targeted policies will be needed to safeguard vulnerable regions, with special attention given to the young and disadvantaged groups to prevent rising inequality. The intensity of the required support would undoubtedly depend on existing policy firepower, yet priority should be given to strengthening social safety nets (e.g., for workers on temporary contracts and the self-employed) and reforms that focus on retraining and reskilling. Supporting the adaptability to social distancing and teleworking—including via higher investment in digitalization to accelerate the roll out of broadband in rural areas and expand digital public services—should also help. Carefully calibrated place-based policies may be appropriate, especially for infrastructure but even potentially for social safety nets depending on the extent of their existing coverage. In this regard, staff analysis suggests that spatially targeting means-tested programs can reduce income inequality without increasing fiscal costs.[17]

[16] Government support should include conditions such as caps on executive compensation and bans on dividend distributions and share buybacks, and could be in exchange for equity participation.

[17] See October 2019 *WEO* Chapter 2, Box 2.4.

Box 5. Short-time Work Programs During the Pandemic Crisis

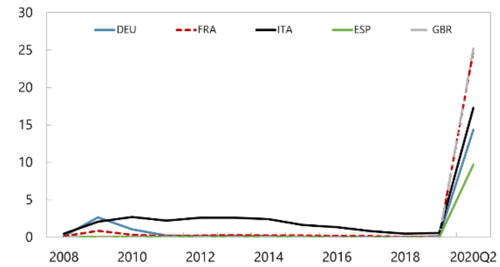
Job retention schemes were utilized at unprecedented levels during the initial phase of the crisis. Many countries expanded existing short-time work programs (STWs), including by simplifying access, extending coverage, and raising generosity, or introduced new programs (e.g., the U.K.). Wage subsidy programs were also used in some countries. These schemes, which support the income of workers on reduced working hours while maintaining worker-employer ties, allow firms to quickly return to their normal operations once economic activity recovers.

These schemes successfully prevented an immediate unemployment surge. Despite the much larger decline of output in 2020H1 compared to the global financial crisis, unemployment rates barely budged in the large euro area economies and the U.K., while take-up of the STW programs surged. Indeed, the sharp reduction in overall hours worked in these economies during 2020Q2 was mostly driven by a reduction in hours per worker and not by extensive job losses.

The usage of STW schemes varies substantially across sectors, partly reflecting the impact of the crisis on sector activity. The incidence of STW schemes,[1] which measures the sector's take-up of the programs relative to its size, is generally higher in sectors that were most affected by the crisis. Specifically, since the beginning of the year, the STW incidence was higher in contact-intensive sectors in most countries, especially the wholesale, transportation and accommodation and food sector. However, some sectors, such as construction in France and Italy, and manufacturing in Germany and Italy, do appear overrepresented in the allocation of STW schemes funds given the decline they faced in sectoral value added.

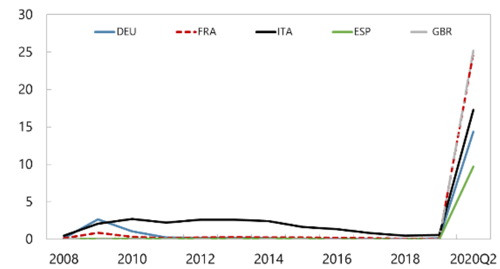
Long-lasting usage of broad-based STW programs could hamper resource reallocation and delay the recovery. While STW schemes are a successful tool in preventing large adjustments in labor markets during a downturn, they may impose a sizable fiscal cost if continued untargeted, and could risk supporting unviable jobs in sectors in decline, slowing down the recovery ([WEO 2010](WEO 2010)). Unwinding their use as the recovery begins would require a delicate balancing act, especially given the uncertainties about future pandemic dynamics.

Short-Time Work Take-Up 1/
(Percent of employment)



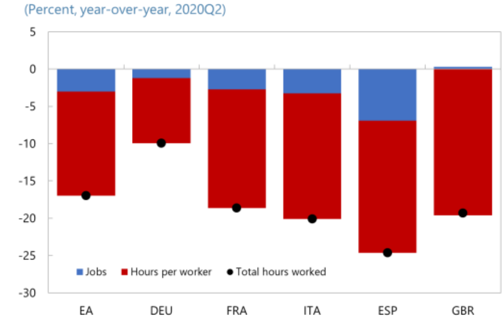
Sources: Eurostat; national authorities; and IMF staff calculations.
1/ STW take-up rates are calculated as the share of people effectively in the STWs in total employment, except for Italy where it is the ratio of authorized hours under the CIG over total working hours. Annual figures are presented, except for 2020Q2 where end-quarter data are used.

Short-Time Work Take-Up 1/
(Percent of employment)



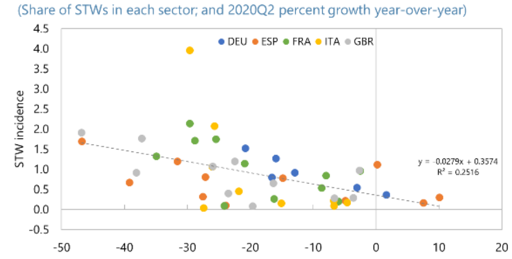
Sources: Eurostat; national authorities; and IMF staff calculations.
1/ STW take-up rates are calculated as the share of people effectively in the STWs in total employment, except for Italy where it is the ratio of authorized hours under the CIG over total working hours. Annual figures are presented, except for 2020Q2 where end-quarter data are used.

Working Hours Growth Decomposition
(Percent, year-over-year, 2020Q2)



Sources: Eurostat; and IMF staff calculations.

STW Schemes Incidence and Value Added Growth 1/
(Share of STWs in each sector; and 2020Q2 percent growth year-over-year)



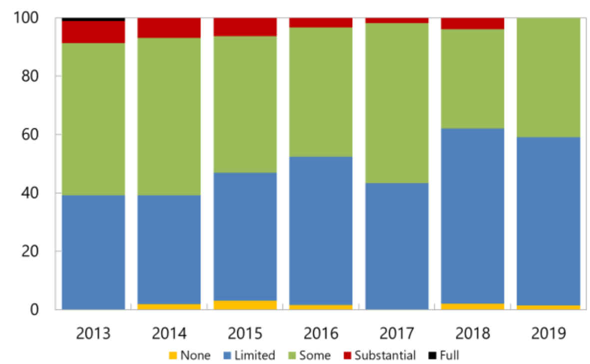
Sources: Eurostat; NFO (DEU), INPS (ITA), Ministry of Labor (FRA and ESP), Revenue and Costume Dept. (UK).
1/ STWs measures vary by country. Germany: effective number of workers in Kurzabeit as of April 2020. Spain: number of cases resolved and reported by the labor ministry as of May 2020. France: estimate of the number of employees effectively in partial activity in April 2020 from the Acemo Survey. Italy: total authorized STWs hours in 2020. UK: workers furloughed per day by sector.

1/ The incidence of STW schemes is measured by the sector's share of STW programs to the sector's share of employment. A ratio higher than one indicates an overrepresentation of the sector in the allocation of STW programs.

72. In order to secure a strong, sustainable, and inclusive recovery, EU funds should be used to incentivize reforms that address long-standing structural impediments. Structural reform implementation has waned in recent years, as shown by diminishing compliance with EU country-specific recommendations (CSRs). EU recovery funds should be used to rekindle reform momentum—especially in countries where productivity growth has lagged. Reforms are also needed to enable smooth green and digital transformations that are critical to securing a sustained recovery. In particular, advancing reforms to facilitate the entry of viable and innovative firms while allowing for the exit of unviable ones—including via improved insolvency regimes—would hasten the reallocation of resources to expanding sectors and productive firms.[18] While deepening the Single Market for services at the EU level would help raise productivity.[19]

73. Safeguarding the economic gains from trade liberalization is critical in an environment of elevated uncertainty and depressed global trade. Staff supports the authorities' continued efforts in upholding and modernizing the multilateral rule-based global trading system, including by operationalizing the multi-party interim appeal arrangement as a stop-gap solution to the blockage of the World Trade Organization (WTO) Appellate Body. Joint efforts from the EU and its global trading partners will be crucial to the success of needed WTO reforms.[20] The EU has also taken actions aimed at complying with the WTO ruling in the Airbus case, and has expressed a commitment to a negotiated settlement in the long-running Airbus and Boeing disputes dispute with the U.S. Any EU CBA mechanism needs to be carefully designed to avoid discrimination against foreign producers and products, which could lead to retaliation by trading partners and destabilize both global trade and climate policy. The recent launch of a major trade policy review in response to the new global challenges and lessons learned from the pandemic is welcome.

CSR Compliance of EA Countries
(Percent)



Sources: European Commission's Country Reports.

74. The recent proposal to address foreign industrial subsidies is well-calibrated, but the EU should also continue to work toward a global solution. The EU has a strong framework, including state-aid rules, to prevent distortionary subsides by EU countries. However, the framework does not capture subsides by third countries, and EU efforts to address this gap at the global level have not gained sufficient support. In response to EU leaders' request, the EC White Paper proposes a new framework to address distortionary subsidies in the single market by third countries. While the proposal needs to be guarded against the potential capture by interventionist or protectionist

[18] See Aiyar and others, 2019.

[19] See Ebeke, Frie, and Rabier, 2019.

[20] The free trade agreements with Singapore and Vietnam—the EU's two largest trade partners in Southeast Asia—entered into force recently. An agreement in principle on trade with Mercosur was reached in June 2019. Trade negotiations are ongoing with Australia, Chile, Indonesia, New Zealand, and Tunisia.

interests within the EU, it could shape the search for global solutions to the issue, which are critical to reducing tensions and promoting a more open trading environment.

Authorities' Views

75. The authorities saw a continuing need for general lifelines to workers and companies, given the protracted nature of the crisis and a high degree of uncertainty. Acknowledging that job retention schemes could impede the needed reallocation of resources, the authorities viewed them as important for employment stabilization given the elevated pandemic-related uncertainty and high hiring and firing costs in Europe. However, they noted that reallocation may be needed at some point and highlighted the need to reskill workers through training programs once containment measures are lifted. For companies, the authorities agreed that liquidity needs could potentially morph into solvency shortfalls, including for some companies that were profitable before the pandemic. They argued for maintaining broad support in the near term given the difficulty in achieving effective targeting under elevated uncertainty and the significant policy implementation hurdles. But they recognized that policy recalibration will eventually be needed to minimize the risks of keeping insolvent companies operating. In this regard, the authorities argued that some programs at the national and EU-levels were equipped with private sector risk-sharing mechanisms, which helped passively target support to viable firms. The authorities also highlighted that the common set of tools and the conditions attached under EU state aid rules helped mitigate the risk of distorting competition in the Single Market from national support measures, and that the EU-level instruments would help balance support among the member states with differing degrees of fiscal firepower.

76. The authorities agreed that actions are needed to tackle the impact of the pandemic on inequality and poverty. They concurred that the crisis is likely to disproportionally affect young and disadvantaged groups and noted that recent policy support at both the national and EU levels had helped alleviate the negative impact of the crisis on inequality. They also stressed that EU structural funds, together with the additional resources from the NGEU, could also help address inequality across regions.

77. The authorities emphasized the need to advance reforms at the national level to support the recovery and transition, and the RRF is expected to play an important role. They saw several aspects of the RRF having a substantial, positive impact on growth and convergence: its green and digital focus; its skew towards countries hardest-hit by the pandemic; and the expectation that it will provide an impetus for member states to implement reforms in line with the past CSRs.

78. The authorities remain committed towards free trade and a rules-based global trading system. They stressed their intention to continue working with trading partners to advance needed WTO reforms. They also reiterated the importance of complying with WTO rules for resolving trade disputes and introducing instruments for climate change mitigation. The proposed rules for governing foreign subsidies are seen as a mechanism to ensure a level playing field in the Single Market, which will help garner public support for globalization. Finally, the authorities noted that the ongoing trade policy review, which is centered on the overarching goal of achieving strategic autonomy while preserving an open EU, aims at identifying strategic priorities for EU trade policy for the coming decade.

STAFF APPRAISAL

79. The COVID-19 pandemic is leading to severe socio-economic dislocations and hardship despite an unprecedented policy response. Euro area real GDP suffered an historic decline in 2020H1. A forceful ECB monetary policy response and unprecedented fiscal stimulus, along with financial sector and other measures at both national and EU levels, offset some of the impact of the crisis and supported a strong rebound in economic activity in 2020Q3. However, the ongoing second wave of the virus will delay the recovery as the rising infections and re-imposition of lockdowns have damaged confidence and lowered mobility. Thus, the better-than-expected 2020Q3 growth outturn looks certain to be followed by weaker activity in 2020Q4, and—barring a sudden change in pandemic dynamics—weak growth in 2021Q1, as well.

80. Uncertainty over the near and medium-term outlook remains extremely high. Risks are dominated by pandemic dynamics. They remain clearly to the downside through early 2021 given the ongoing second wave, but the recent promising news on vaccine development provides a significant upside further out, as rapid and widespread delivery of safe and effective vaccines would likely instill confidence and spur a faster recovery. A prolonged health crisis and a slower recovery, however, would mean more scarring and divergence, with financial conditions tightening and private and public vulnerabilities increasing further. The ongoing negotiations regarding the UK's future relationship with the EU27 and a potential escalation of trade tensions add to the uncertainty.

81. The 2019 external position was assessed as moderately stronger than the level implied by fundamentals and desired policies, but the current account surplus has narrowed considerably since then. On a preliminary basis and subject to a high degree of uncertainty, this may suggest a shift in the overall external position in 2020 to being broadly in line with medium-term fundamentals and desirable policies.

82. The historic NGEU recovery package sends a strong signal of European solidarity and could provide a meaningful boost to euro area growth if it is implemented effectively. The NGEU should be finalized and operationalized as soon as possible given that further delays would damage euro area recovery prospects. The effectiveness of the NGEU will depend critically on the quality, efficiency and additionality of the national government spending it will finance. Moreover, linking the provision of funds to progress on implementing the EU's country-specific reform recommendations should help ensure that the NGEU serves as a catalyst rather than a substitute for structural reform efforts that are crucial for strong and durable growth. Importantly, a positive experience with the recovery fund could help build political support for a permanent central fiscal capacity. The NGEU's emphasis on green and digital transitions is also welcome, though a more ambitious implementation of robust carbon pricing and public investment policies than currently envisaged will likely be needed to meet EU emission reduction goals.

83. With the resurgence of the pandemic, national fiscal policies should continue to provide the first line of defense. National authorities should resist pressures for a premature withdrawal of fiscal support, as this would risk derailing any incipient recovery. However, as a recovery gradually takes hold and the pandemic abates, governments should focus on facilitating reallocation of labor and capital towards sectors and businesses that will likely be viable post-pandemic, as well as on sustainably boosting inclusive growth and reducing fiscal vulnerabilities. Should the outlook materially deteriorate further, additional fiscal stimulus would be needed. If existing untapped EU-level facilities are exhausted, further centralized support may also be needed. The escape clause from EU fiscal rules should remain activated until the recovery is on a firm footing, and the rules themselves fundamentally reformed to address well-known shortcomings and reflect the post-pandemic landscape.

84. The monetary policy response has been appropriately bold, but further support is needed to counter disinflation risks. In this respect, the ECB Governing Council's commitment to recalibrate its policy instruments in its next meeting, once the December round of the Eurosystem staff macroeconomic projections are available, is welcome. Asset purchases should remain a go-to instrument, but other options, including a policy rate cut and further relaxation of the terms of the targeted and untargeted LTROs should also be considered. A marked deterioration in the inflation outlook would require substantial further accommodation where new policy instruments—for example, providing direct support to nonfinancial corporates—could be considered.

85. The ECB's recent emphasis on its aim being symmetric should be clearly codified and articulated around a specific point inflation target during its ongoing strategy review. A clear and well-communicated symmetric point inflation target has significant benefits compared with an asymmetric target. Adopting a lower inflation target or an inflation range would be undesirable as it would carry higher deflation risks. A flexible average inflation target could also be explored to better anchor inflation expectations given the prolonged inflation undershoot. A continued medium-term orientation would still allow the ECB to consider broader objectives such as employment and financial stability within its price stability mandate.

86. Recent financial sector measures have supported credit growth and prevented widespread insolvencies but unwinding them will require a careful balancing act. Capital relief and conservation measures, including restrictions on bank dividend payouts and share buybacks, should be maintained until the recovery is well underway, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit. Borrower support would need to remain available if the recovery stalls but should become more targeted over time and extended only if needed to prevent widespread insolvencies and without distorting loan classification and provisioning requirements. The next system-wide stress test could be used to identify capital shortfalls in a downside scenario, helping secure potentially needed support via precautionary recapitalizations.

87. Swift balance sheet repair will be critical to maintaining confidence and supporting intermediation, especially in a downside scenario. As bank asset quality is set to deteriorate, supervisors should ensure that banks have credible medium-term strategies for NPL reduction.

Insolvency regimes should be strengthened to address the potentially high number of cases, and the capacity of court systems should be supplemented by intensive use of out-of-court restructuring. While likely requiring flexibility with state aid and banking rules, national AMCs could help deepen distressed debt markets, especially if linked in a network.

88. Advancing financial sector architecture reforms and swiftly closing crisis management gaps are critical to supporting the recovery and strengthening resilience. Urgent tasks include completing the banking union, further advancing the capital markets union, finalizing the ESM treaty reform (following the recent Eurogroup agreement), strengthening the SRB's powers, and ensuring greater harmonization and centralization of emergency liquidity arrangements. The Commission's plans to establish a single AML/CFT rule book are welcome. The prudential measures toolbox should be strengthened to address vulnerabilities in nonbank financial institutions.

89. Structural policies should remain agile in easing adjustment and supporting the recovery. Job retention schemes have been invaluable in protecting jobs and livelihoods since the outbreak of the pandemic. As the recovery takes hold, these schemes will need to be phased out and complemented by measures to facilitate the movement of workers to viable firms, including by strengthening social safety nets, promoting job search, enhancing training programs, and providing targeted hiring subsidies. In addition, policies will need to transition from general lifelines for businesses to supporting firms with good post-pandemic viability prospects. At the EU level, a solvency support instrument could play a role in maintaining the integrity of the Single Market given countries' differing fiscal capacities to help struggling firms, especially in a downside scenario.

90. Mitigating the pandemic's pernicious impact on regional disparities, inequality, and poverty should be a key policy priority. The pandemic is disproportionately affecting poorer regions with pre-existing structural impediments and is exacerbating inequality along different dimensions. Targeted policies will be needed to safeguard vulnerable regions, with special attention given to the young and disadvantaged groups to prevent rising inequality. Carefully calibrated place-based policies may also be appropriate.

91. Safeguarding the economic gains from trade liberalization is critical in an environment of elevated uncertainty and depressed global trade. Efforts to uphold and modernize the multilateral rules-based global trading system are welcome. The recent proposal to address foreign industrial subsidies is well-calibrated, but the EU should also continue to work toward global solutions to the issue, which are critical for a more open trading environment. Lastly, any EU carbon border adjustment mechanism needs to be carefully designed to avoid discrimination against foreign producers and products and possible retaliation by trading partners.

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

Table 1. Euro Area: Main Economic Indicators

	2017	2018	2019	Projections 1/ 2020	2021	2022	2023	2024	2025
Demand and Supply									
Real GDP	2.6	1.9	1.3	-8.3	5.2	3.1	2.2	1.7	1.4
Private consumption	1.8	1.5	1.3	-9.2	5.5	3.2	1.9	1.5	1.3
Public consumption	1.1	1.2	1.9	2.2	0.9	0.3	1.2	1.1	1.1
Gross fixed investment	3.8	3.2	5.8	-12.0	7.6	5.0	3.4	2.4	1.7
Final domestic demand	2.1	1.8	2.4	-7.4	4.9	2.9	2.1	1.6	1.3
Stockbuilding 2/	0.2	0.1	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0
Domestic demand	2.3	1.9	1.9	-7.5	4.8	2.9	2.1	1.6	1.3
Foreign balance 2/	0.4	0.1	-0.5	-1.0	0.5	0.3	0.2	0.1	0.1
Exports 3/	5.5	3.6	2.5	-12.9	8.3	5.8	4.3	3.6	3.3
Imports 3/	5.2	3.7	3.9	-11.6	7.8	5.7	4.2	3.6	3.3
Resource Utilization									
Potential GDP	1.5	1.3	1.3	-3.2	3.1	1.4	1.2	1.3	1.2
Output gap	-0.4	0.2	0.2	-5.1	-3.2	-1.6	-0.6	-0.2	0.0
Employment	1.6	1.6	1.2	-1.7	0.6	1.1	0.6	0.4	0.2
Unemployment rate 4/	9.1	8.2	7.6	8.9	9.1	8.4	7.9	7.7	7.6
Prices									
GDP deflator	1.1	1.4	1.7	1.6	1.2	1.3	1.4	1.6	1.8
Consumer prices	1.5	1.8	1.2	0.4	0.9	1.2	1.4	1.6	1.7
Public Finance 5/									
General government balance	-0.9	-0.5	-0.6	-10.1	-5.0	-2.7	-2.1	-1.8	-1.8
General government structural balance	-0.6	-0.5	-0.6	-5.3	-3.1	-1.8	-1.8	-1.7	-1.8
General government gross debt	87.7	85.8	84.0	101.1	100.0	98.4	97.0	95.6	94.3
External Sector 5/, 6/									
Current account balance	3.1	2.9	2.3	1.9	2.4	2.5	2.5	2.6	2.5
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	0.0	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.18	1.14	1.11	1.18	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	113.9	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.2	86.8	85.4	89.3	...	...	...	...	...

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

1/ Projections are based on aggregation of *WEO* Oct 2020 projections submitted by IMF country teams.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2020.

Table 2. Euro Area: Key Monetary and Financial Measures

Key Monetary Policy Measures	
March	Additional asset purchases of €120 billion until end-2020 under the existing program (APP).
March	Introduction of a pandemic emergency purchase program (PEPP) with an envelope of €750 billion until end-2020 with a minimum maturity of 70 days and flexible allocation across time, assets, and countries.
March	The range of eligible assets under the corporate sector purchase program (CSPP) were extended to nonfinancial commercial paper, making all commercial papers of sufficient credit quality eligible for purchase under CSPP.
March	Introduction of additional full-allotment auctions under the current liquidity facility (LTROs) at 25 bps below the deposit rate until next TLTRO auction in June; the terms of all TLTRO-III auctions (including past auctions) more favorable (up to 50 bps below the deposit rate).
March	Relaxation of collateral standards for Eurosystem refinancing operations (MROs, LTROs, TLTROs). Borrowing rates for TLTRO-III were lowered to between -25 and -75 bps and later further reduced to between -50 and -100 bps below the average MRO depending on the banks' lending performance. Borrowing allowances were raised.
March	The U.S. dollar liquidity swap line arrangement with the U.S. Federal Reserve (and other major central banks) was reactivated. The frequency of the 7-day USD operations was reduced to three times per week in June, and then once per week in September.
April	Relaxation of collateral standards by (i) widening the scope of the Additional Credit Claims (ACC) framework to include public sector-guaranteed loans to SMEs, self-employed individuals, and households; (ii) adopting a general reduction of collateral valuation haircuts (-20 percent) together with a temporary reduction of the same amount (until the end of the PEPP); and (iii) accepting Greek sovereign debt instruments as collateral in Eurosystem credit operation.
April	Grandfathering (until September 2021) of the eligibility of marketable assets and issuers' collateral that were investment grade on April 7, 2020 in case their rating falls below the current minimum credit quality requirement.
April	Introduction of a new liquidity facility, called pandemic emergency longer-term refinancing operations (PELTROs), which is offered monthly at 25 bps below the average MRO and matures in a staggered sequence between July and September 2021.
June	The PEPP envelope was increased to €1,350 billion in June and purchases were extended to June 2021 with reinvestment until at least end-2022.
June	Establishment of a Eurosystem repo facility for central banks (EUREP) to provide precautionary euro repo lines to non-euro central banks.
Key Financial Policy Measures	
March	ECB Banking Supervision allowed significant institutions to operate temporarily below the Pillar 2 Guidance (P2G), the capital conservation buffer, and the liquidity coverage ratio (LCR). New rules on the composition of capital to meet Pillar 2 Requirement (P2R) were front-loaded to release additional capital.
March	ECB Banking Supervision provided temporary flexibility in the classification requirements and expectations on loss provisioning for loans that are covered by public guarantees and crisis-related public moratoria.
March	ECB Banking Supervision asked banks not to pay dividends or buy back shares aimed at remunerating shareholders at least until October 1, 2020. This was later extended to January 1, 2021.
April	ECB Banking Supervision provided temporary capital relief for market risk by adjusting the prudential floor to banks' current minimum capital requirement. A lower qualitative multiplier aims to smooth the procyclical impact of market volatility on traded exposures.
April	The European Commission proposed a "banking package," which provides targeted and exceptional legislative changes to the capital requirements regulation (CRR 2), including greater flexibility in the application of the EU's accounting and prudential rules (a two-year extension of the current transitional arrangements for the IFRS9 implementation of provisioning standards, a more favorable treatments for SME and infrastructure lending, and a delayed recognition of valuation losses from some sovereign exposures). The package was adopted by the European Parliament and the European Council in June.
July	The European Commission proposed a Capital Markets Recovery Package with targeted adjustments to capital market rules to encourage investment, allow for the rapid re-capitalization of companies, and increase banks' financing capacity.
July	ECB Banking Supervision committed to allowing banks to operate below the P2G and the combined buffer requirement until at least end-2022, and below the minimum LCR until at least end-2021.
September	ECB Banking Supervision allowed banks under direct supervision to exclude cash holdings and central bank reserves from the calculation of their leverage ratio until end-June 2021.

Table 3. Euro Area: External Sector Assessment

<table>
<tr><td colspan="7">Overall Assessment: The external position in 2019 was moderately stronger than the level implied by medium-term fundamentals and desirable policies. The impact of the pandemic on the CA balance is highly uncertain amid the collapse in global trade and investment income. This year, the current account is projected to narrow to 1.9 percent of GDP, following a sizable decline in services exports during the first three quarters of the year. On a preliminary basis, these developments suggest a shift in the overall external position in 2020 to being broadly in line with medium-term fundamentals and desired policies. However, this assessment is highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis.[1] In the medium term, the CA surplus is projected to slightly increase relative to the 2019 levels, although the range of uncertainty around this is very high given the nature of this crisis. Imbalances that existed prior to the COVID-19 outbreak could remain sizable at the national level.
Potential Policy Responses: Short-term policies should focus on containing the COVID-19 outbreak and its economic consequences and provide relief to households and firms to reduce scarring from the crisis. The recent COVID-crisis initiatives both at the national EU-levels will support these efforts and potentially help reduce imbalances. While medium-term outcomes are subject to significant uncertainty, monetary policy should remain accommodative until inflation has durably converged to the ECB's medium-term price stability objective. If imbalances in policy gaps that existed prior to COVID-19 were to persist at the national level, then countries with excess CA surpluses should continue to strengthen investment and potential growth, whereas those with weak external positions should undertake reforms to raise productivity and enhance competitiveness as the acute phase of the pandemic recedes. Area-wide initiatives to make the currency union more resilient (e.g., banking and capital markets union and fiscal capacity for macroeconomic stabilization) could further reinvigorate investment and, hence, reduce the aggregate CA surplus.</td></tr>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="6">Background. The NIIP of the euro area had fallen to about –23 percent of GDP by the end of 2009, but has since recovered, reaching about -0.5 percent by the end of 2019. The rise was driven by stronger CA balances and modest nominal GDP growth. The increase in the NIIP during 2019 reflects primarily transactions and exchange rate changes, especially the net increase in "other investment" assets. Gross foreign positions were about 247 percent of GDP for assets and 247½ percent of GDP for liabilities in 2019. However, net external assets reached elevated levels in large net external creditors (e.g., Germany and the Netherlands), whereas net external liabilities remained high in some countries, including Portugal and Spain.
Assessment. Projections of continued CA surpluses over the medium term suggest that the NIIP-to-GDP ratio will rise further, at a moderate pace, and the euro area is expected to soon become a net external creditor. The region's overall NIIP financing vulnerabilities appear low. Despite rising CA balances over the medium term, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows.</td></tr>
<tr><td>2019 (% GDP)</td><td>NIIP: –0.5</td><td>Gross Assets: 246.9</td><td>Debt Assets: 95.1</td><td>Gross Liab.: 247.4</td><td colspan="2">Debt Liab.: 95.7</td></tr>
<tr><td>Current Account</td><td colspan="6">Background. The CA balance for the euro area stood at 2.3 percent in 2019, lower than in 2018, following a steady increase from close to zero in 2011. A stronger goods balance was more than offset by weaknesses in services and investment income balances. Some large creditor countries, such as Germany and the Netherlands, continued to have sizable surpluses, reflecting strong corporate and household saving and weak investment. The CA surplus declined through the first three quarters of 2020 mainly due to both lower services balance and net investment income. The goods balance slightly improved due to relatively weaker imports compared to exports.
Assessment. The EBA model estimates a CA norm of 1 percent of GDP, against a cyclically adjusted CA of 2.4 percent of GDP. This implies a gap of 1.4 percent of GDP. IMF staff analysis indicates a higher CA norm than estimated by the EBA model, consistent with the assessed external positions of euro area member countries. The higher CA norm considers policy commitments to reduce the large net external liability positions in some countries (e.g., Portugal and Spain) and uncertainty about the demographic outlook and the impact of recent large-scale immigration (e.g., Germany). In addition, adjustments to the underlying CA for measurement issues were undertaken in Ireland and the Netherlands. Considering these factors and uncertainties in the estimates, the IMF staff assesses the CA gap to be 1.3 percent for 2019, with a range of 0.5 to 2.1 percent of GDP.</td></tr>
<tr><td>2019 (% GDP)</td><td>Actual CA: 2.3</td><td>Cycl. Adj. CA: 2.4</td><td>EBA CA Norm: 1</td><td>EBA CA Gap: 1.4</td><td>Staff Adj.: –0.1</td><td>Staff CA Gap: 1.3</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="6">Background. The CPI-based REER depreciated by 3.1 percent in 2019, reversing the appreciation in 2018. This reflected a nominal depreciation of 1.5 percent in 2019, which was reinforced by weaker euro area inflation relative to its trading partners. The ULC-based REER depreciated by 2.3 percent. Other published REERs based on extra-euro-area trading partners depreciated by 1.6 percent on average. The REER continued to depreciate until February 2020, before reversing course in March and sharply appreciating through September by about 6½ percent from end-2019.
Assessment. The EBA REER index model suggests an overvaluation of 4.2 percent, and the EBA REER-level model implies an undervaluation of 0.7 percent. The REER gap derived from the IMF staff's CA gap assessment, with an estimated elasticity of 0.35, implies that the real exchange rate was undervalued by 3.6 percent in 2019.[2] Given the high uncertainty around these estimates, the staff-assessed REER gap range is –5.9 to 0, with a midpoint of –3.0.[3]
As with the CA, the aggregate REER gap masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 11 percent in Germany to overvaluations of 0 to 9 percent in several small to mid-sized euro area member states. The large differences in REER gaps within the euro area highlight the continued need for net external debtor countries to improve their external competitiveness and for net external creditor countries to boost domestic demand.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="6">Background. Mirroring the 2019 CA surplus, the euro area experienced net capital outflows, driven largely by transactions in other investment outflows as banks reduced external liabilities. In the first three quarters of 2020, the euro area experienced lower net capital outflows, with smaller net inflows of other investments and higher net portfolio investment in domestic securities.
Assessment. Gross external indebtedness of euro area residents decreased by 1.3 percent of GDP as higher external long-term sovereign debt was more than offset by lower other investment liabilities of banks and interoffice FDI debt.</td></tr>
<tr><td>FX Intervention and Reserves Level</td><td colspan="6">Background. The euro has the status of a global reserve currency.
Assessment. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td colspan="7">[1] A complete analysis will be provided in the 2021 External Sector Report (ESR). The 2019 CA was revised down from 2.7 percent of GDP (published in the 2020 ESR) to 2.3 percent of GDP in November 2020. The revision was mainly due to adjustments to intra-EA statistical discrepancies and, therefore, does not change the assessment in the 2020 ESR.
[2] The export and import elasticities are taken as the average of estimates from Consultative Group on Exchange Rate Issues (CGER)-inspired export and import equations using various types of REERs relevant for the euro area (with an ADL (2,2,2) model on quarterly data 2000–19). The trade balance elasticity is calculated using the share of exports and imports for extra-EA trade in GDP.
[3] The REER gap range derived from the CA gap range (0.5 to 2.1 percent) is –1.3 to –5.9 percent (with an elasticity of 0.35). The range of –5.9 to 0 is determined by putting more weight on the current account gap method and less on the two REER models.</td></tr>
</table>

Table 4. Euro Area: Risk Assessment Matrix [1]

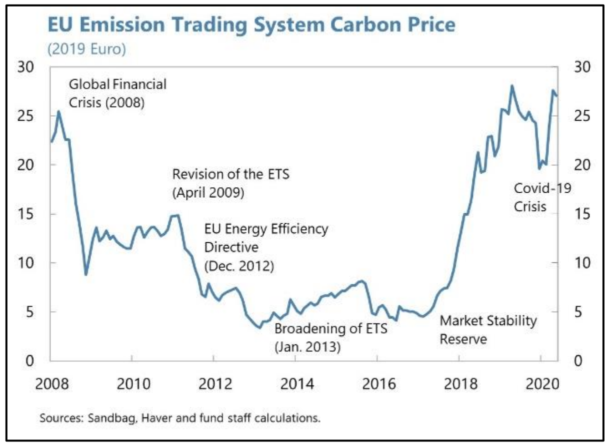
Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Unexpected (downside) shift in the Covid-19 pandemic	**High** The disease proves harder to eradicate (e.g., due to difficulties in finding and distributing a vaccine). There is a large resurgence of cases and mortality, requiring more containment efforts and impacting economic activity directly and through persistent behavioral changes. Monetary and fiscal policy response is insufficient amid dwindling policy space and concerns about debt sustainability. Financial markets reassess real economy risks leading to a repricing of risk assets, unmasking of debt-related vulnerabilities, and weakening banks and nonbank financial intermediaries–forcing them to reduce credit (further weighing on growth).	**High** The recovery is delayed with scarring effects, unmasking vulnerabilities in the private sector. More layoffs lead to a considerable increase in unemployment and labor market hysteresis, which will weigh on productivity growth. Firms' liquidity problems translate into insolvencies while highly leveraged corporates may experience significant stress, leading to higher credit spreads, potential downgrades, inability to refinance debt, and defaults. Banks' asset quality continues to deteriorate, resulting in widespread capital shortfalls, thus impairing the lending channel with further adverse implications to growth.	• Develop comprehensive strategies for containment to lower the risk of infection and mortality. Provide further support to the healthcare sector. • Further support the recovery by alleviating any tightening of funding conditions, preventing liquidity problems from becoming massive defaults and bankruptcies. Provide direct support to households and firms, especially SMEs. • Maintain an accommodative monetary stance by expanding the existing tools and exploring additional policy options. Develop NPL strategies to quickly repair private sector balance sheet. • Boost the EU policy response and address pre-existing structural issues at the national level to support the recovery.
Widespread social discontent and political instability	**High** Social tensions erupt as the pandemic and inadequate policy response cause economic hardship (including unemployment, higher incidence of poverty, and shortages and higher prices of essentials) and exacerbate preexisting socioeconomic inequities. Economic activity is disrupted. Growing political polarization and instability weaken policymaking and confidence, especially for decisions at the European level.	**High** Social tensions cause economic disruptions and erode trusts in policy makers. The resulting political instability complicates reaching political consensus on policies to address the pandemic. Public protests may also lead to an increased COVID-19 infection rate.	• Policies need to target the vulnerable population by ensuring adequate access to healthcare and social assistance including unemployment benefits. • Active labor market policies should be used to facilitate reallocation of workers toward expanding sectors and limit labor market hysteresis.
Accelerating de-globalization	**High** Geopolitical competition and fraying consensus about the benefits of globalization lead to further fragmentation. Reshoring and less trade reduce potential growth.	**High** Additional tariff and nontariff barriers imposed by trading partners or within the European Union reduce the trade flows, confidence effects, and growth. Disruptions in trade of vaccines or medical supplies due to national protectionist policies.	• Work with partner countries (through both bilateral channels and the WTO) to address the policies that distort trade flows and investment decisions. • Strengthen collaboration within the EU on medical supplies.

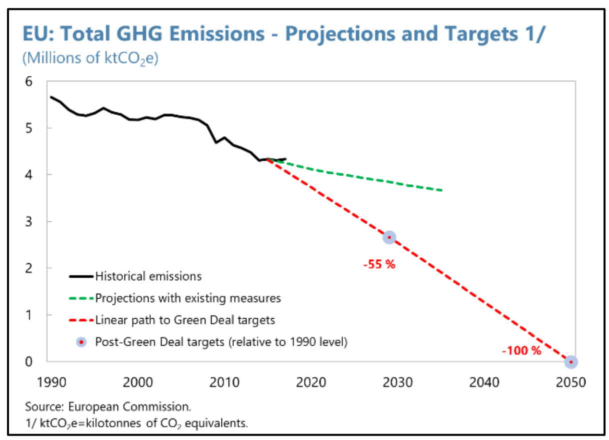
1/ The Risk Assessment Matrix shows events that could materially alter the baseline path. (The scenario most likely to materialize in the view of the staff.) The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. ("Low" is meant to indicate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

Table 4. Euro Area: Risk Assessment Matrix (concluded)			
Sources of Risk	**Likelihood of Risk** (High, Medium, Low)	**Expected Impact of Risk** (High, Medium, Low)	**Policy Responses**
Disorderly Brexit	**High** Failure to reach an agreement on the future relationship would lead to a no-deal Brexit, in which the U.K. and the EU will start trading under WTO terms in January 2021.	**High** Significant disruptions, including border delays and a sudden increase in tariff and nontariff costs, and long-term efficiency losses, especially for countries with closer links to the U.K. It may also lead to financial market disruptions as EU-based financial institutions would need to operate in the U.K. under new rules in absence of regulatory equivalence.	• Contingency planning and collaboration between U.K. and EU authorities to reduce any cliff-edge effects and disruptions.
A shift in market sentiment	**Medium** An abrupt adjustment in risk asset prices could interact—and amplified by—pre-existing vulnerabilities, and lead to a substantial tightening of financial conditions with adverse real-financial feedback loops.	**High** Sharp increases in funding costs further strain leveraged corporates and households, and result in sizable insolvencies and a rapid deterioration of bank balance sheets and profitability with adverse effects on the credit channel. High-debt countries may face potential downgrades, further undermining their ability to service their debt.	• Maintain an accommodative monetary stance by expanding the existing tools and exploring additional policy options. • EU financing support could be expanded both in size and scope to restore confidence. • High debt countries should announce credible medium-term consolidation plans.

Annex I. Climate Change Policies in the EU[1]

The EU is a global leader in climate change mitigation and has made important progress in reducing emissions, with total emissions currently about ¼ below their 1990 level. But achieving a 55 percent reduction in 2030 emissions below 1990 levels and net zero emissions by 2050, will require much stronger policy action. Robust EU-wide carbon pricing will need to be complemented by additional national and sector-specific non-price measures. Boosting "green" investments in the near-term, while gradually increasing the carbon price over time, would accelerate a job-rich recovery and ameliorate the transition costs.





1. **The two main planks of EU climate policy are the Emissions Trading System (ETS) and the Effort Sharing Regulation (ESR)**. The ETS—a cap-and-trade system—covers emissions by large companies in energy, industry, and aviation, which account for about 45 percent of total EU greenhouse gas (GHG) emissions. The other 55 percent falls under the ESR, which defines national emission reduction targets for non-ETS sectors (excluding land use, land use change, and forestry and fisheries), which countries meet through a combination of carbon pricing and non-price measures. A cap-and-trade system has the benefit of ensuring a given level of abatement, and, by providing a price on emissions, it encourages emissions reductions. However, the current ETS faces several important challenges. First, its sectoral coverage is limited, with transport and buildings—the two most important sectors not covered by the ETS—accounting for about 35 percent of emissions.[2] Second, a significant, but over time decreasing, amount of free emission allowances reduces the effectiveness of the price signal and revenues from the ETS.[3] Third, the ETS has generally generated a low and volatile price for carbon emissions, undermining incentives for green investments. However, the carbon price has

[1] Prepared by Nathaniel Arnold and Andreas Jobst, drawing on two recent EUR Departmental Papers (EU Climate Mitigation Policy and Sectoral Policies for Climate Change Mitigation in the EU).

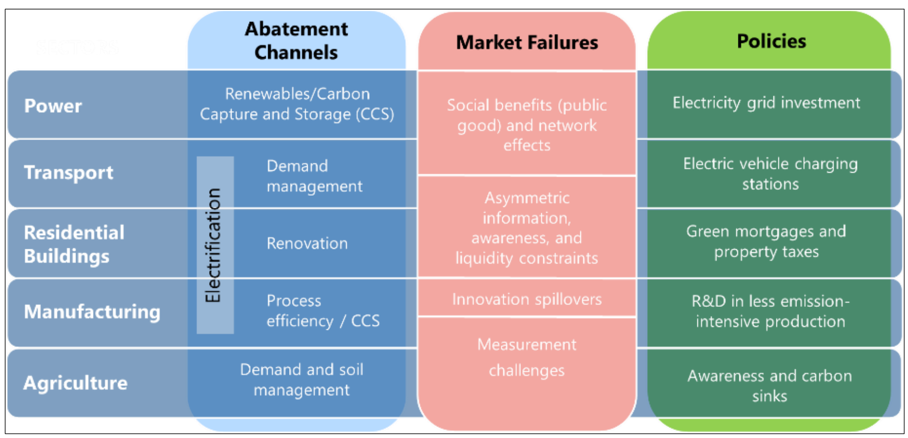
[2] Note that only intra-EEA air transport is included in the current ETS, and for buildings, the 2012 Energy Efficiency Directive (EED) and the 2010 Energy Performance of Buildings Directive (EPBD) form the main EU legislation.

[3] Note that free emission allowances were necessary for reaching agreement on the creation of ETS given the significant competitiveness concerns, with limited coverage as a design choice to primarily target the largest emitters. In 2013, the free allowances for energy producers were eliminated, and the free allowances for manufacturing were reduced based on strict benchmarks.

increased since the introduction of a market stability reserve (MSR) in January 2019, which addressed the surplus of allowances and improved the system's resilience to major shocks.

2. The EU Green Deal seeks to achieve net GHG emissions by 2050. This implies at least a 55 percent reduction (relative to 1990 levels) in net emissions by 2030 as an intermediate target following the recent State of the Union speech by the President of the European Commission on September 16, 2020 and the Commission's Communication "Stepping up Europe's 2030 Climate Ambition". The Commission aims to mobilize €1 trillion in public and private investments over the next decade to help achieve this target. Key funding sources include the EU budget and the Next Generation EU package, guarantees to the European Investment Bank and other development banks (through the InvestEU program), national co-financing, and ETS revenues. The €1 trillion also includes a Just Transmission Mechanism (€143 billion), which will help regions most affected by the transition to a carbon neutral economy to invest in and shift workers to less carbon intensive sectors. In addition, the RRF of the Next Generation EU package requires member states to allocate at least 37 percent of its spending envelope to addressing climate change. The EU is also considering introducing a carbon border adjustment (CBA) mechanism for certain sectors, which will enhance the acceptability of stricter measures by ensuring that imported products are subject to the same carbon price. The combined impact of these measures will be essential to achieving the desired emissions reductions, while mitigating competitiveness and emissions leakages effects from a rising carbon price.

3. A well-designed package of mutually reinforcing policies is needed to achieve the EU's emission reduction goals. Staff analysis suggests that more comprehensive and predictable carbon pricing should be the centerpiece of climate policies. A uniform EU carbon tax would be the simplest solution to incentivize the transition to a net zero GHG economy, but the idea has faced significant political and legal hurdles in the past. A similar outcome could also be achieved by expanding the ETS to other major emitting sectors and setting a carbon price floor for the ETS. Moreover, a CBA mechanism could help address "emissions leakages" (i.e. production in GHG-intensive industries moving abroad to avoid paying higher carbon prices then exporting to the EU), especially in manufacturing, but its implementation presents practical challenges.[4] In addition, other fiscal instruments or regulatory measures may have an important, and sometimes preferable, role to play, depending on country circumstances and preferences.



[4] There is also a large leakage potential for agricultural products; however, agricultural emissions are currently outside the ETS, and, thus, any leakage concern would need to be addressed via alternative mechanisms.

4. More extensive carbon pricing would need to be complemented by non-price policies to de-carbonize some sectors to steer investment towards sustainable activities in sectors outside the ETS. Non-price policies could help address political and financial constraints, measurement challenges, and incomplete markets, especially in sectors where carbon pricing is difficult to implement, and the pace of emission reduction has been slow:

- *Transport and Manufacturing.* Beyond including the transport sector in the ETS, fuel taxes and road usage charges may need to be raised to reflect externalities from congestion and air pollution.[5] This could be complemented by tighter emissions standards for vehicles and incentives for clean vehicles, such as differentiated road usage charges and "feebates," which combine higher taxes on emission-intensive vehicles and subsidies for low-emission ones. Regulation (e.g., the EU's 2019 CO_2 emission performance standards for new passenger cars and vans)[6] and accelerated investment depreciation, along with feebates could incentivize manufacturers to invest in cutting emissions with currently available technologies.

- *Residential buildings*. New construction will take too long to improve the energy efficiency of the existing EU housing stock consistent with the required trajectory of emission reduction.[7] However, the scale and pace of renovation is held back by several market failures (e.g., liquidity constraints, cost-benefit mismatches between owners and renters, and limited information on potential energy cost savings from renovation). Harmonizing energy efficiency ratings, such as energy performance certificates, would enhance their commercial relevance and support the introduction of binding targets for energy efficiency improvements to accelerate the renovation rate. Designing energy-dependent property taxes and options for "on-bill financing" of efficiency investments could help overcome owner-renter cost-benefit mismatches.

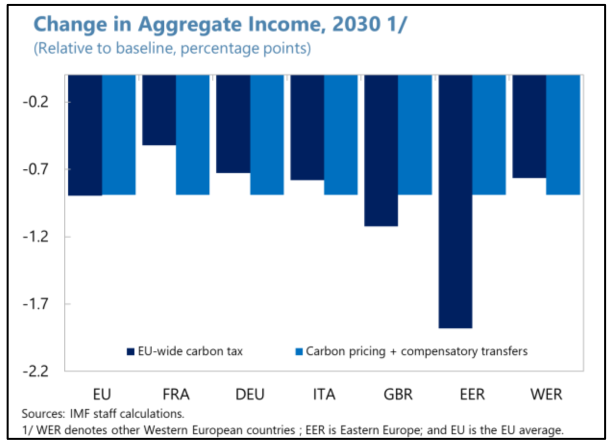
- *Agriculture.* Better soil management and reduced livestock emissions are the main abatement channels, while there is significant potential for carbon sequestration. Many farmers depend in part on financial support from the EU's Common Agricultural Policy (CAP). The 2021-27 EU planning period offers an opportunity to improve CAP's incentives, such as broadening the scope of the "green payments" mechanism to encourage livestock emissions reductions and introducing payments for carbon sequestration, which would build on recent proposals to allocate more payments to land use that benefits biodiversity and for environmental-related measures. This can be complemented by demand measures aimed at shifting consumer choices away from emission-intensive products, such as dairy and beef. Policies could include removing preferential VAT rates and introducing GHG emissions footprint labels on food, which is consistent with the EU's Farm to Fork Strategy to make food systems fair, healthy and environmentally-friendly.

[5] Greater emissions efficiency in transport would also require a higher use of more sustainable transport modes and greater multimodality.

[6] The new regulation introduces new targets that apply from 2025 and 2015; it also contains an incentive mechanism for zero- and low-emissions vehicles.

[7] The European Commission has published in October its Renovation Wave Strategy aimed at improving the energy performance of buildings. By strengthening standards and regulations while also providing access to well-targeted funding, the strategy intends to at least double renovation rates in the next ten years.

5. More broadly, across all sectors, public investment and financial support will be vital and could be funded by carbon pricing revenues. For example, governments can direct capital spending towards network infrastructure, such as power grids for cleaner energy and greater electrification, as well as electric vehicle charging stations and low emission public transportation.[8] They could also help promote early-stage technologies, such as hydrogen generation and carbon capture and storage, and new forms of energy storage. Another key policy lever would be targeted financial support for efficiency improvements in buildings and the electrification of heating systems via government subsidies and means-tested grants for poor households, which could complement market-based mechanisms like "energy efficiency mortgages." Given low borrowing costs currently, it would be beneficial to make such investments now, even before sufficient revenues from carbon pricing become available. However, if carbon prices increase too rapidly, revenues to fund green investment risk being lower than expected.



6. Revenues from carbon pricing should also be used to reduce the impact on vulnerable and heavily affected groups and to increase the political acceptability of higher carbon prices. Revenues could be used to mitigate the adverse effects on aggregate income by cutting labor and other distortionary taxes, and to increase transfers to groups negatively impacted by the direct effect of higher carbon prices. Indeed, simulations suggest that in wealthier EU countries transfers of around 0.5 percent of GDP would be sufficient to compensate poorer households for a €100-per-ton carbon price increase. Transfers would probably need to be higher in poorer EU countries, where lower-income households spend a larger income share on energy. Even without transfers, the economic and health benefits from lower pollution, better air quality, and avoided environmental damages, are likely to exceed the cost of higher carbon prices.

7. To ensure the costs of mitigation policies are shared equally, transfers between EU countries would be needed. Central and Eastern European countries typically have higher emissions per unit of output, so would see a greater tax burden increase from higher carbon prices.[9] Simulations suggest that Central and Eastern European countries could experience income losses (in percent terms) 2–3 times higher than Western European countries if carbon prices rose enough to achieve a 50 percent reduction in EU emissions by 2030. At the same time, they are also more likely to benefit from air quality improvements. Transfers between EU countries could equalize the income impact of mitigation policies without raising the overall EU income cost and with very modest additional costs for Western European countries. The general EU budget can play a significant role in this regard, but, in particular, these transfers could be implemented inter alia via the Just Transition Mechanism.

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[8] This would also include improving the interconnectivity of the energy infrastructure for renewable energy sources and ensuring sufficient storage capacity to accommodate renewables' intermittency in electricity production.

[9] These estimates are not accounting for the domestic revenue gains from higher carbon pricing (which offsets much of the burden of higher energy prices).

8. EU countries' recovery and resilience plans (RRPs) provide an opportunity to accelerate the shift to a greener, more sustainable, and fairer economy. The ambitious targets of the Green Deal are an expression of the EU's credibility on climate policy while demonstrating to other countries the benefits of shifting to a low-carbon economic model. The European Council has committed to spending 30 percent of available resources under the multiannual financial framework and the Next Generation EU package on climate action, and each member state will have to allocate at least 37 percent of their expenditure under the RRPs to climate.[10] To complement EU-level support, national fiscal stimulus measures could be directed towards climate-friendly investments (including green infrastructure and R&D). This can be combined with subsidies and guarantees to encourage demand for and incentivize private sector investments in low-carbon technologies. The implementation of non-financial disclosure standards consistent with the forthcoming EU Taxonomy on Sustainable Activities would help crowd in private investment.[11] Making such disclosures mandatory for corporations and financial institutions would be a key step towards better measuring climate change-related risks. Frontloading investments to reduce emissions, while progressively increasing the price of carbon over time, could accelerate the recovery and help ameliorate the transition costs from higher carbon prices.

[10] The EU's higher climate expenditure targets are expected to generate €285 billion for investment in climate-friendly projects.

[11] The EU's current review of the Non-Financial Reporting Directive aims to establish an EU-wide reporting standard for the disclosure of environmental, social and governance (ESG) impact of companies to better inform investors about the sustainability of their investments and, second, to give effect to the EU Taxonomy on Sustainable Activities.

Annex II. Monetary Policy Strategies for the European Central Bank[1]

This Appendix uses a model in the spirit of Smets and Wouters (2003, 2007). It features real frictions such as habit formation, investment specific adjustment costs, variable capacity utilization and time varying markups in price and wage setting. It also features nominal frictions so that firms and labor unions who cannot re-optimize their prices and wages index them to past inflation and productivity levels.

The model departs from Smets and Wouters in two important ways. First, given considerable recent evidence of declining potential output growth and very low equilibrium real interest rates, an environment with modest steady state output growth of 1.2 percent and a low steady state equilibrium real interest rate of 0.65 percent is considered. Second, following the recent work of Gabaix (2019), the model allows for departures from rationality in how households form expectations. In addition to improving the model's empirical fit, this framework helps mitigate the "forward guidance puzzle" (see Del Negro et al., 2015), which would make it unsuitable to analyze long lasting and recurrent zero/effective lower bound episodes.[2]

A. Advantages with a Symmetric Target

1. To characterize a symmetric target preference, we assume that the ECB follows the estimated policy rule and reacts symmetrically (i.e., equally) to inflation, output growth and the output gap when inflation is above or below 2 percent. For an asymmetric policy stance, the updated 2003 Governing Council monetary policy strategy of "inflation rates below, but close to, 2 percent over the medium term" is modeled by assuming that the ECB reacts more vigorously to increased inflationary pressures when projected inflation one year ahead exceeds 2 percent.[3] While ECB has since 2015 taken steps toward a symmetric interpretation of their target, this has not been codified in a subsequent strategy review.

Table 1. Unconditional Distribution for Symmetric and Asymmetric Policy Regimes

	Inflation					Output Gap			Nominal Policy Rate		
Regime	Mean	Std	P(pi<0)	P(pi>2)	P(pi>3)	Mean	Std	Mean ($y^{gap}<-5^{th}$)	Mean	Std	P(r<=0)
Symmetric target	1.99	0.93	1.95	45.98	12.21	-0.03	2.08	-4.21	2.58	1.89	9.38
Asymmetric target	1.69	0.85	2.56	32.05	3.92	-1.58	2.55	-5.78	3.38	2.38	6.85

2. As can be seen from Table 1, a fully symmetric rule and deployment of unconventional monetary policy tools as needed results in a simulated average inflation rate very close to the

[1] Prepared by Christopher Erceg, Zoltan Jakab, and Jesper Linde and drawing on Erceg, Jakab and Linde (2020).

[2] Specifically, we estimate a behavioral parameter for households equal to 0.95, whereas Gabaix (2019) uses 0.85 in his benchmark model. The term "forward guidance puzzle" refers to how standard New Keynesian models—which assume that households and firms form expectations rationally—imply that central bank guidance about *future* interest rate setting tends to exert (implausibly) large effects on output and inflation *today*.

[3] For further details on the modelling of the asymmetric policy rule, see Erceg et al. (2020).

assumed steady state of 2 percent. The mean output gap is also very close to zero. For the asymmetric rule, we obtain an average inflation well below 2 percent (1¾ percent), and the mean output gap is below -1 percent, implying that the economy operates notably below potential on average. The only favorable aspect of the asymmetric policy rule is that it generates slightly lower inflation volatility, reflecting that the probability of inflation exceeding 2 percent is notably lower under the asymmetric rule.

3. The large average output cost of the asymmetric policy response largely reflects an important role for cost-push shocks (price and wage markup) and a low sensitivity of inflation to aggregative demand (i.e., flat Phillips curve) in the estimated model. To be concrete, the policymaker's preference for offsetting a positive cost-push (to keep inflation from rising much above 2 percent) requires engineering a sharp output contraction given the low sensitivity of inflation to resource slack. Since inflation impulses above 2 percent are recurrent in the simulations, the asymmetric policy rule will cause output to be below zero on average. While it is assumed in these simulations that the sensitivity of inflation to the output gap is state independent (i.e., the same regardless of the economy is operating above or below its potential), allowing the sensitivity to be more (less) sensitive to demand when output is above (below) potential does not change this conclusion. Admittedly, allowing for a kink in the Philips curve provides some support that an asymmetric target formulation can be helpful to ensure that inflation remains below 2 percent on average, but quantitatively the impact on average inflation is small (average inflation falls from about 2.1 to 1.8 percent) whereas the associated adverse effect on average output is very large (-1.8 percent).

4. To facilitate a simple comparison between the regimes, we assume throughout all the simulations so far that the zero lower bound (ZLB) was a binding constraint in these simulations. However, if an effective lower bound constraint were imposed, a symmetric target regime would be even more advantageous. This reflects that the asymmetric regime is associated with lower inflation and output gaps on average, making it more likely that the economy will be pushed into a recession in which the ZLB binds in response to adverse shocks.

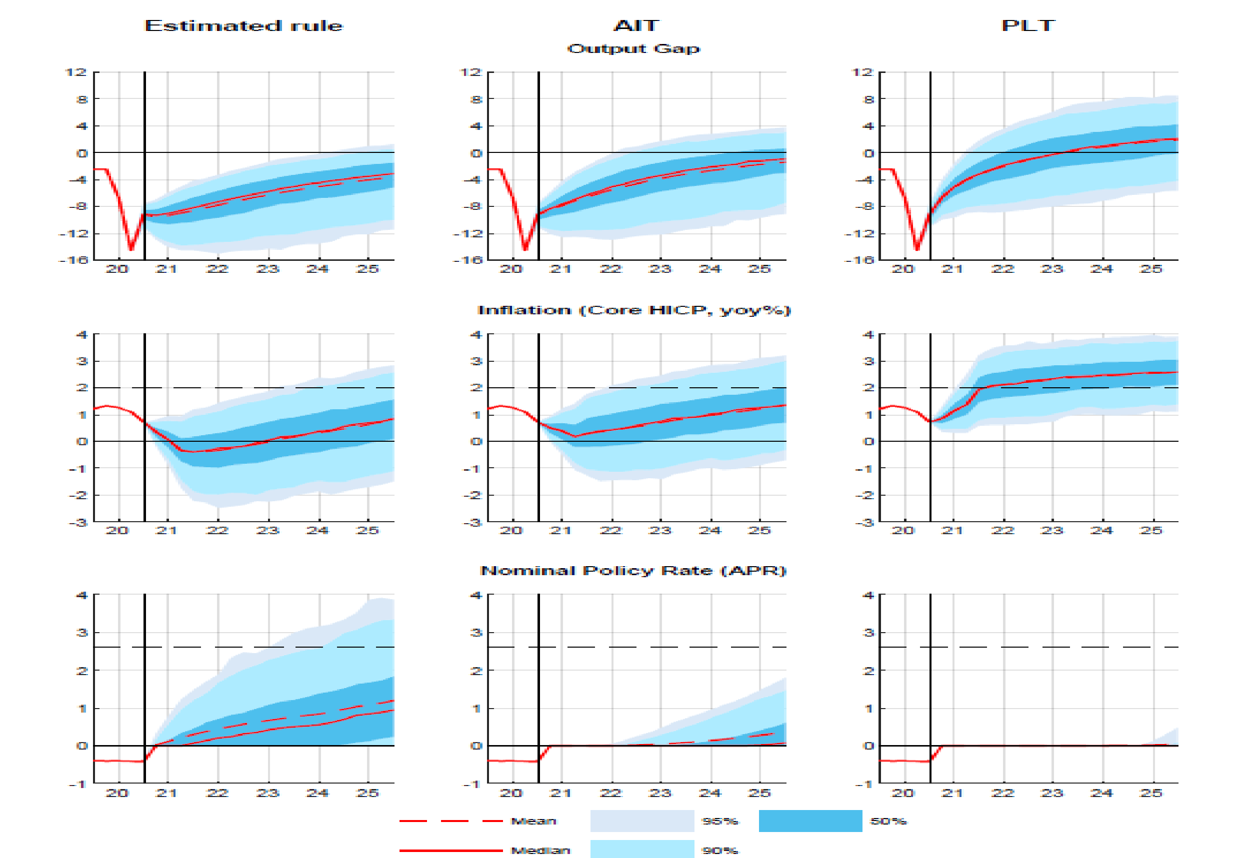
B. Alternative Monetary Policy Strategies at the Zero Lower Bound

- The merits of alternative monetary policy frameworks in the form of average inflation targeting (AIT henceforth; Nessen and Vestin, 2005) and price level targeting (PLT henceforth; Vestin, 2006) are studied in this section. Importantly, both AIT and PLT allows the inflation rate to overshoot the central banks inflation target on the transition path back to steady state in a situation where inflation is, and has been, below target for a protracted period. This is currently the case in the euro area.

- The AIT rule assumes that the ECB adopts a five-year window, i.e., it considers an average inflation rate during the past five years in the policy rule as opposed to current inflation only. The PLT rule assumes the central bank replaces the inflation term in the rule with the price level gap, where the price level gap equals the actual price level minus the target price level (which is simply a linear trend with a slope of 2 percent at an annualized rate).

- Figure 1 shows the impact on forecast distributions under alternative fully credible monetary regimes, using the latest IMF WEO projections as an initial condition for 2020Q2, assuming no unconventional monetary policy (UMP) tools are deployed and a hard ZLB constraint. The first column shows results for the estimated historical rule.[4] The second and third columns report results for AIT and PLT rules. AIT and even more so PLT rules are associated with noticeable improvements in the outlook. In a nutshell, if fully credible and well communicated to financial markets and households, these alternative monetary policy frameworks allow the central bank to provide more stimulus today and in the future given the current situation. Effectively, in the current state, these alternative policy rules provide the central bank with a means to endogenize and communicate forward guidance of future policy rates which overtime will contribute to a stronger recovery in the economy.

Figure 1. Predictive Conditional Densities Under Alternative Monetary Policy Regimes Without UMP



5. However, Table 2 shows that adopting these alternative rules on a permanent basis may not be desirable. In particular, when looking at unconditional simulations (i.e., not conditioned on the current low inflation high output gap environment) AIT and PLT trigger notably higher output gap volatility. This is especially true for the PLT rule, which also generates deeper recessions.

[4] The projections in Figure 1 are using a pure endogenous model conditional on a ZLB for the policy rate and assuming that no UMP tools are deployed. As such, the projections, especially those associated with the estimated historical rule, are notably more pessimistic than official IMF staff projections.

Intuitively, committing to reverse a runup in inflation—due say to a markup shock—entails a sharp and persistent tightening, with costly implications for output relative to allowing "bygones be bygones."[5] The implication that AIT and especially PLT can yield benefits in a deep recession but are less attractive as a permanent framework suggests potentially important credibility problems. This finding holds up under both rational and behavioral expectations formation in our estimated model, and even when we allow these alternative frameworks to be asymmetric and only applied when the policy rate is at its effective lower bound and the central bank deploys UMP tools.

6. Table 2 also report results for a regime with a lower (symmetric) inflation target equal to 1.5 percent, showing that a lower target causes deflation risks to increase notably and output to operate further below potential on average. Since the steady state real rate may be even lower than what we use (0.65 percent), a lower inflation target and asymmetric target formulation may be even more costly than suggested by our simulations. Finally, the effects of a "target band" for inflation are also studied. This is where monetary policy is much less responsive to economic activity and inflation developments when inflation is between 1.5 and 2.5 percent. Such a band will trigger larger fluctuations in inflation and the output gap relative to a point-target regime, although inflation will be close to 2 percent on average over a longer time period.[6]

Table 2. Unconditional Distribution Under Alternative Monetary Policy Regimes

	Inflation					Output gap			Nominal policy rate		
Regime	Mean	Std	P(pi<0)	P(pi>2)	P(pi>3)	Mean	Std	Mean (y^{gap}<-5th)	Mean	Std	P(r<=0)
Symmetric ZLB	1.96	0.95	2.62	44.80	11.74	-0.23	2.31	-5.46	2.71	1.71	5.38
Lower Target, ZLB	1.44	0.96	8.19	24.72	4.30	-0.37	2.45	-6.08	2.30	1.64	8.48
AIT, ZLB	1.98	0.86	1.34	45.28	10.49	-0.11	2.45	-5.16	2.67	1.55	4.17
PLT, ZLB	2.00	0.62	0.07	46.21	4.71	-0.22	3.99	-9.10	2.81	2.30	15.50

7. In Figure 2, we report the corresponding distributions under the assumption that the ECB deploy unconventional monetary policy tools.[7] Deployment of UMP tools are associated with a noticeable improvement in the outlook under the estimated rule, both in terms of the modal outlook and by lowering deflation risk and downside risk to economic activity. For the AIT and PLT regimes in the second and third columns, the improvement in the outlook is also notable, especially for the AIT regime. State-contingent large-scale asset purchases play an important role for reducing downside risk and improving the modal projections.[8]

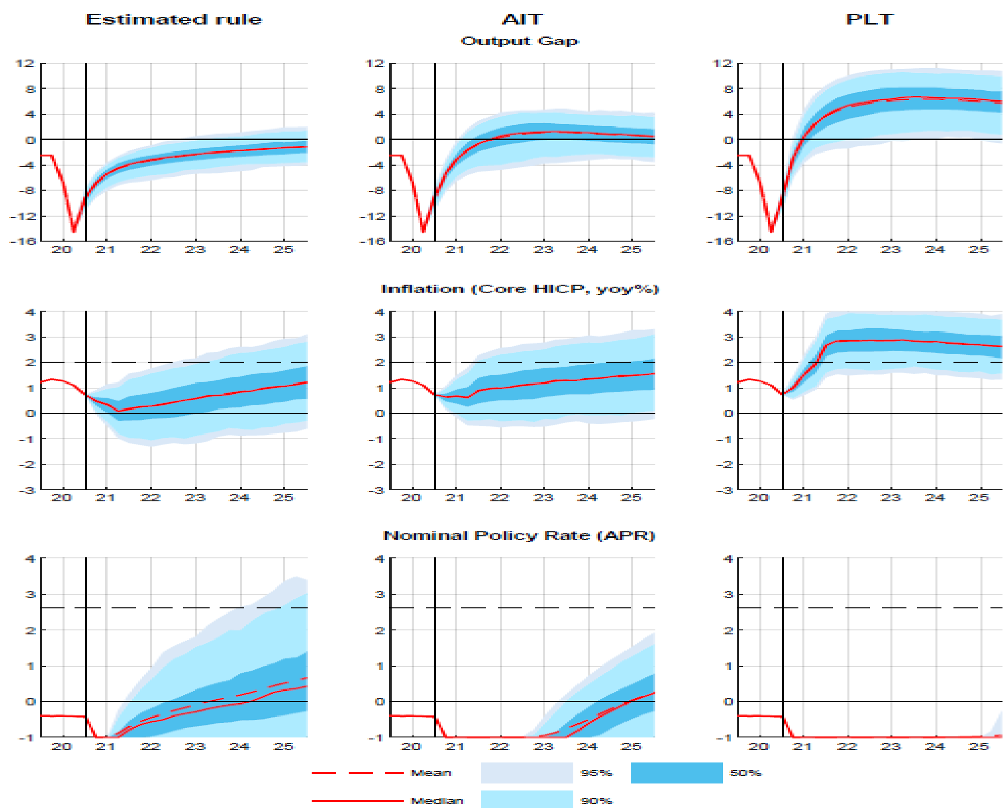
[5] Of course, the ultimate ranking of these alternative strategies depends on how much weight is given to inflation versus output in the policy maker's loss function

[6] Specifically, the standard deviation of inflation increases from around 1 in the first row in Table 2 to about 1¼ and the unconditional deflation risk increases from around 2.5 to 19 percent.

[7] We allow for three different UMP tools: a) negative interest rate policy (i.e. allowing the policy rate to be cut to -1); b) forward guidance (lower for longer interest rate policy based on a shadow rate concept including no response to output growth in the interest rate rule); and c) asset purchases to lower the term-premium and corporate spreads.

[8] The results suggest that the unconditional volatilities are very similar under UMP and ZLB.

Figure 2. Predictive Conditional Densities Under Alternative Monetary Policy Regimes With UMP



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Annex III. An NPL Strategy for Europe to Deal with the COVID-19 Fallout[1]

A comprehensive strategy with a phased approach should be put in place to deal efficiently and swiftly with the expected rise in defaults and insolvencies. Policymakers have implemented wide-ranging measures to alleviate cash-flow pressures, helping contain the liquidity shock and avoid widespread insolvencies.[2] Experience shows that vigorous supervisory actions to repair balance sheets are critical to maintain confidence and support intermediation (Ari et al. 2020, Aiyar et al. 2015). Policies should now pivot to new priorities during the reopening phase and in the subsequent full-recovery phase.

A. Policies for the Reopening Phase

1. During this phase, supervisory and insolvency actions that were put on hold should resume as the groundwork for structural improvements is laid out. Policy support should remain in place for the recovery to take hold although some measures can be tightened. Meanwhile, prudential standards for loan classification and provisioning should be maintained. The focus of policymakers should gradually shift from liquidity to solvency challenges in the following three areas:

- **Supervisory and prudential measures**. Continue to encourage banks to use capital and liquidity buffers to cushion the impact of NPLs and support credit extension;[3] provide further supervisory guidance on how banks should classify and provision restructured loans if necessary in view of potential new official measures to support borrowers;[4] and continue to encourage banks to restructure loans to help borrowers manage the impact of the pandemic on their business and minimize their own losses.

- **Debt enforcement and insolvency measures**. Extend moratoria only if necessary to prevent widespread insolvencies, with a recourse to more targeted and timebound ones; facilitate restructuring to reduce the debt burden or adjust repayment schedules; concentrate the limited legal and financial resources on sectors and companies with better prospects for recovery using transparent triaging criteria (see DeLong et al., 2020). Some EU countries could also benefit from financial assistance in setting up specialized courts and training insolvency professionals via the structural funds.

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[1] Prepared by Nazim Belhocine and André Oliveira Santos.

[2] See October 2020 Global Financial Stability Report and Fiscal Monitor.

[3] On March 12, the ECB issued a statement allowing banks to fully use their capital (and liquidity) buffers, benefiting from relief in the composition of capital for Pillar 2 requirements.

[4] On March 20, the ECB introduced supervisory flexibility regarding the classification of debtors as "unlikely to pay" on public guarantees and on March 25, EBA published temporary guidance on the definition of default, forbearance and the application of IFRS 9 in the context of moratoria in response to COVID-19, which was subsequently phased out at end-September.

- **Groundwork for structural improvements**. Put in place efficient out-of-court workouts with separate tracks for corporates, SMEs and households, and fast-track court procedures to support debt restructuring, which prove to be more efficient and less costly than court-led procedures.[5] These solutions can avoid overloading the court system and can be either supported by the state, for instance through a dedicated restructuring agency, or handled by the private sector. In this regard, a timely implementation of the EU Directive (2019/1023) on Restructuring and Insolvency will offer countries a better toolbox to deal with enterprise distress, with less intensive use of judicial resources. During this phase, it would also be important to put in place the building blocks for robust debt enforcement systems and efficient corporate insolvency regimes, where necessary (see Section B.2).

B. Policies for the Recovery Phase

2. Once the recovery is on a firm footing, policymakers should make full use of their prudential and resolution tools as they embark on structural improvements. Again, efforts should be comprehensive and based on the three pillars of: 1) supervisory and prudential measures; 2) insolvency reforms; and 3) the development of institutions to deal with NPLs.

Supervisory and Prudential Measures

3. Supervisors should forcefully implement prudential rules and address legacy issues quickly. Measures should include: 1) requiring banks to gradually rebuild capital and liquidity buffers; 2) following up closely with banks to swiftly recognize loan losses while encouraging robust provisioning, write-offs, and income recognition; 3) improving NPL reporting standards, with a more consistent and comparable NPL reporting by banks so that NPLs are reported transparently and that banks' NPL management performance is disclosed; 4) asking banks to develop credible action plans to reduce NPLs within a specific timeframe and encouraging them to adopt comprehensive NPL management strategies, that determine rules and work practices for NPL resolution[6]; 5) ensuring an adequate and conservative approach to collateral valuation—which in Europe is typically in the form of real estate— reflecting various constraints in valuing, accessing, and disposing of collateral; 6) adopting minimum valuation rules and guidance for immovable property used as loan collateral; and 7) dealing expeditiously with weak banks that experience significant credit losses while requiring banks to present credible plans to restore their capital.

Debt Enforcement and Insolvency Measures

4. Policymakers should address the private debt overhang and strengthen their regular debt resolution tools. Measures should aim to restructure debt of firms facing structural challenges from the COVID-19 pandemic if business models' adjustments can restore viability. Nonviable firms which cannot be saved through restructuring should be resolved and their orderly exit facilitated. Nonetheless, weak insolvency and debt enforcement regimes in some EU jurisdictions remain a major obstacle for viable but distressed debtors and creditors to achieve meaningful restructuring

[5] As adopted in Spain (2013) and Greece (2017), and Portugal (2018).

[6] Following the requirements and expectations outlined in the ECB Guidance to banks on non-performing loans and the Addendum to the Guidance.

(Bhatia et al., 2019). Moreover, corporate insolvency frameworks differ significantly in terms of their legal tools and institutional framework (Aiyar et al., 2015). More generally, corporate insolvency and debt enforcement frameworks remain almost entirely under EU national members states' purview.

5. Deficiencies in several national insolvency frameworks could be addressed by developing and setting common and higher standards at the European level (Bhatia et al., 2019, de Almeida et al., 2017). The Directive on Restructuring and Insolvency left many controversial issues unaddressed and it will be important for the EC to monitor and support member countries in the implementation of the Directive in order to ensure a proper transposition into national laws. There are three broad avenues for action:

- **Data collection**. Both the EU Justice Scoreboard and reporting requirements under the new Directive on Restructuring and Insolvency can be used by the EC to collect information on debt enforcement and corporate insolvency cases to more systematically assess effectiveness and identify gaps (European Commission 2019, Garrido et al, 2019). This information could be used to set minimum standards for several core features of insolvency processes.

- **Core principles**. Important features of insolvency processes warrant improvements such as triggers for insolvency proceedings, the effects of a stay, and rules on set-off (between the insolvent business and creditors), to name a few (de Almeida et al., 2019). In debt enforcement, a better mechanism for the enforcement of immovable collateral would be welcome; current enforcement processes are ineffective and prone to delays in some countries (European Council, 2017).

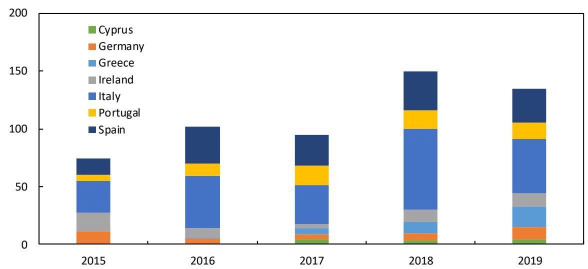
- **Monitoring progress**. Systematic monitoring of countries' progress in observing these core standards could be instituted at the EU level. The EC should follow up on the ongoing benchmarking exercise for debt enforcement and insolvency systems (Council of the European Union, 2017).

Deepening the Markets for Distressed Assets and Establishing AMCs

6. European distressed debt markets have deepened in recent years. A larger number of NPL deals and diverse underlying portfolios have attracted a large variety of investors (Deloitte, 2019). Global distressed debt investors have contributed to deeper NPL secondary markets by not only acquiring loan portfolios but also improving the market infrastructure with their captive servicers and third-party loan servicing platforms. Important distressed debt investors have also emerged from the consolidation of debt purchasing, collection agencies, and commercial loan servicers. However, European distressed markets remain concentrated, with some investors acquiring large volumes of NPLs. Anecdotal evidence suggests that these investors have not been impaired by the crisis yet, but it will be important to monitor their financial performance. They expect a deterioration in the credit quality of their distressed debt portfolios when mitigating measures are lifted, which could reduce their risk appetite or capacity to acquire new NPLs.

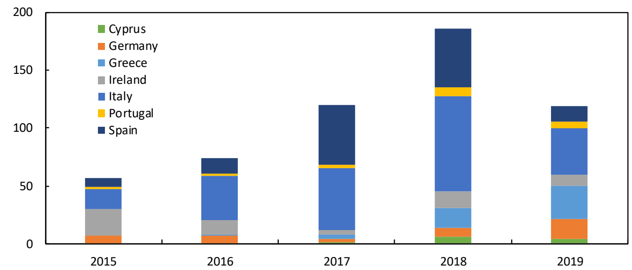
7. Further work to standardize data on NPLs could reduce information asymmetries. One of the impediments to NPL sales is information asymmetries between buyers and sellers and disparities in quality of data, which increases transaction costs and impairs price discovery. Simplification and widespread use of the EBA pre-trade data template would enhance the quality and comparability of NPL data, improve transparency, and could reduce the bid-ask pricing gap sales.

Number of Nonperforming Loan Deals in Selected EU Countries



Source: Deloitte

Nonperforming Loan Deals in Selected EU Countries
(€ billion)



Source: Deloitte

8. **Efforts to foster NPL securitizations can help further deepen distressed debt markets**. Except in Italy and recently in Greece, NPL securitizations have not been widely used by banks. The recent measures proposed in the Capital Markets Recovery Package (European Commission, 2020) include amendments to the securitization framework to address the disincentives for NPL securitizations. Moreover, new public guarantee schemes for NPL securitizations—akin to the Italian GACS and Greek HAPS—would further complement the EC's package.7 To encourage countries to create such public guarantee schemes, especially those with limited fiscal space, the EIB could expand its counter-guarantees to public guarantee schemes for NPL securitizations.

9. **National AMCs could help deepen distressed debt markets**. Key advantages of AMCs include (Aiyar et al., 2015): (i) economies of scale; (ii) greater bargaining power; (iii) increasing specialization; (iv) better valuation, credit discipline, and price discovery. While banks have the advantage of access to Eurosystem refinancing to help fund their NPL portfolios, AMCs can be exempted from the regulatory framework, enabling them to hold NPL portfolios with lower capital consumption. Notwithstanding, AMCs could also entail drawbacks related to: (i) the large liabilities associated with the asset transfers to AMCs; (ii) weakening debt recovery and risk management in the banks; (iv) a deterioration of payment discipline; (v) political pressure; and (vi) a dependence on government resources or guarantees (see Ingves, Seeling, and He, 2004).

10. **Flexibility with state aid and banking rules might be needed to allow for temporary government support to banks through AMCs without the bail-in of investors**. The Impaired Asset Communication (European Commission, 2009) defines the prices at which NPLs can be transferred to AMCs with and without state aid. Together with the Restructuring and the Banking Communications (European Commission 2009, 2013) and the Bank Recovery and Resolution Directive (the European Parliament and the Council of the EU, 2014), the rules have effectively limited the scope of national AMCs to: (i) bank resolutions, with national AMCs as asset separation

[7] Under public guarantee schemes, banks can offload their NPLs at transfer prices into special purpose vehicles (SPVs) for their sale to markets. Banks can then acquire public guarantees for the investment-grade rated senior tranches of the securitization. No State aid is involved as long as the fees paid by the banks for the public guarantees cover expected costs. Recent public guarantee schemes for NPL securitizations include the Italian *Garanzia Cartolarizzazione Sofferenze* (GACS) and the Greek Hercules Asset Protection Scheme (HAPS), which were set up in 2016 and 2019, respectively.

tools (ASTs); (ii) insolvency proceedings under national laws, with national AMCs facilitating the exit of non-viable banks; and (iii) precautionary recapitalizations. The more recent AMC Blueprint (European Commission, 2018) provides a roadmap to establish national AMCs that are consistent with the banking and state aid rules. To address problems stemming from the crisis without requiring the bail-in of investors, the temporary state-aid framework has incorporated flexibility for extraordinary public support to banks—including through AMCs—which could be extended beyond end-2020.

11. The appropriate capital structure could help mitigate the moral hazard associated with NPL sales to AMCs at higher prices than their market value. The Blueprint favors a capital structure based on senior guaranteed securities being exchanged for impaired assets. To address moral hazard, it recommends that banks should hold equity stakes in AMCs on a qualified mandatory basis. Total equity would need to be sufficient to cover the AMCs' initial losses from booking NPLs at a lower fair value than the transfer price (or the real economic value) and to provide them with a buffer against unexpected losses from loan workouts. However, materially addressing moral hazard would require banks to acquire enough of an equity stake to prevent taxpayers being called upon to bail out AMCs. Moreover, this would also prevent national AMCs from being consolidated in the fiscal accounts. Equity-linked instruments such as with-profit participation notes could also be explored to mitigate moral hazard and incentivize banks to share both losses and profits in AMCs.

12. A pan-European AMC could further support efforts to reduce NPLs but is likely to face significant political and operational challenges. The large expected deterioration in credit quality could make national AMCs unattractive in countries with limited fiscal space. A pan-European AMC could potentially overcome funding limitations in fiscally constrained countries. However, it might entail greater complexity as the transferred distressed portfolios would involve large firms and commercial real estate—the most fit assets for AMCs—in countries with different legal, insolvency, and collateral enforcement frameworks. Moreover, if the crisis results in large heterogeneous portfolios of retail and SME NPLs, the pan-European AMC would not be the most adequate NPL resolution tool. Finally, political challenges related to its funding and the potential for mutualization of losses might also limit its scope. Instead, a network of nationally established AMCs, however, relying on common NPL data templates, transaction platforms, and valuation methodologies could be politically acceptable, while facilitating cross-country transactions.

Annex IV. Statistical Issues

European statistics are developed, produced, and disseminated within their respective spheres of competence by the European Statistical System (ESS) and the European System of Central Banks (ESCB). The ESS, composed of Eurostat and the national statistical institutes (NSIs), and the ESCB, composed of the European Central Bank (ECB) and the national central banks (NCBs), operate under separate legal frameworks and cooperate closely.[1]

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

- Eurostat published a number of guidance and methodological notes.[2]
- On April 15, 2020, the ECB released communication to reporting agents on the collection of statistical information in the context of COVID-19 and a regulation on the extension of certain reporting deadlines.[3]
- Furthermore, the ESS and ESCB developed a joint template to identify the impact of COVID-19 related government policy measures on government revenue, expenditure and debt. Eurostat is developing guidance on the statistical treatment of these measures. The GFS data provided by countries is being closely monitored in order to ensure sound and comparable statistical treatments. A specific COVID-19 related metadata collection is under way.
- On July 22, 2019, the ECB Governing Council decided on a third series of targeted longer-term refinancing operations (TLTRO III), which were accompanied by additional data collection measures from the banking sector.

2. The transition to the latest international statistical standards is complete; minor enhancements are still expected. With regard to data availability, all temporary derogations from the European System of National and Regional Accounts (ESA) 2010 data transmission requirements expired on January 1, 2020. All member states should ensure full and timely data transmissions at the legal deadlines in 2020. Eurostat will continue to follow up the progress and prepare an overall analysis of the implementation of the derogations in 2021.

3. Despite the pandemic, Eurostat and the ECB continued working on the 20 recommendations of the second phase of the G20 Data Gaps Initiative (DGI-2), as members of the Inter-Agency Group on Economic and Financial Statistics.

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

[2] https://ec.europa.eu/eurostat/data/metadata/covid-19-support-for-statisticians

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0533

4. Eurostat and the ECB jointly support the Special Data Dissemination Standard Plus (SDDS Plus), the third and highest tier of the IMF's Data Standards Initiatives. By September 2020, 13 euro area countries (and 18 EU member states overall) had already adhered to the SDDS Plus.

5. Eurostat and the ECB continued their efforts to ensure the quality of statistics underlying the Macroeconomic Imbalance Procedure (MIP). The ESS–ESCB quality assessment report on statistics underlying the Macroeconomic Imbalances Procedure has been streamlined. The implementation of the Memorandum of Understanding on the quality assurance of statistics underlying the MIP[4] progressed with: (i) the publication of the lessons learnt from MIP visits;[5] and (ii) visits to Malta (April 2019), Ireland (November 2019) and France (January 2020).

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

- Climate change.
  - The ESCB Statistics Committee (STC) has launched an *Expert Group on the Climate-Change and Statistics* in a response to an increasing role of climate-related aspects in a number of central banking activities. The group will address the various data demands and their analytical objectives. It will also elaborate on the extensive measurement challenges and priorities regarding indicators and statistics related to climate-change.
  - A Task Force on the statistical treatment of sustainable finance and climate-related risks was established under the sponsorship of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).
- National accounts.
  - *Streamlining the flash releases of key national accounts (NA) indicators.* Following the introduction of the preliminary (T+30) GDP flash estimates for the EU and the euro area in April 2016, and of the European employment flash estimates in November 2018, Eurostat and NSIs continued to work on advancing the first releases of these indicators. Starting from July 2020, national GDP estimates were included in the preliminary flash GDP as more countries advanced their publication.
  - The regular reporting on the *quality of ESA 2010 data* transmitted by EU member states to Eurostat continued. Eurostat's assessment report on 2018 data transmissions provided a detailed analysis of national data revision practices. The report on 2019 data transmissions will elaborate on the coordinated benchmark revisions carried out by 18 countries.

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

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

  - To fully exploit the data available under ESA 2010 Transmission Program, Eurostat and some EU member states will aim to extend the production and the publication of data. Under the new phase of the *Growth and Productivity Accounts project*, a task force with NSIs will assess proposals for publication of additional indicators for labor, capital and multifactor productivity for all EU member states. In May 2020, Eurostat and some member states started a project on regional investment for the general government sector. Finally, a new task force on fixed assets and estimation of consumption of fixed capital under ESA 2010 will kick off in autumn 2020.

  - *EU inter-country supply, use and input-output tables*. Following the release of April 2018, the project will compile EU inter-country input-output tables for 2010-2018 by April 2021 in current prices, followed by annual regular production.

  - A "Handbook on the compilation of *statistics on sea and air transport in national accounts and balance of payments*" was published in July 2020.

  - The OECD-Eurostat TF on land and other non-financial assets concluded its final report on *Intellectual Property Products*.

- Concerning Commercial Real Estate indicators, Eurostat and the ECB continued to work with member states to close data gaps.

- Further progress has been made in Government Finance Statistics (GFS) to enhance fiscal surveillance. Annual and quarterly GFS time series are available for all countries and data mapped to the GFSM 2014 are regularly provided to the IMF. The provision of quarterly data to the IMF was expanded in late 2019. European GFS are consistent with the data supplied under the Excessive Deficit Procedure, which undergoes strong verification. Progress in data availability was made on Classification of the Functions of Government (COFOG) data, as well as on more detailed annual non-financial data, financial instruments and breakdowns of government debt. Eurostat publishes data on contingent liabilities and non-performing loans of the government.

- As part of the implementation of the medium-term strategy for financial accounts, the ESCB is planning improvements in the availability of data for the non-bank financial sector, to better capture the effects of globalization, and on households' financial portfolios.

- External statistics.[6]

  - Since 7 April 2020, the quarterly data published by the ECB for all reference period from 2016-Q1 onwards show full consistency between euro area balance of payments and the "rest of the world" sector of the euro area accounts.

  - Since 1 July 2020, the ECB's effective exchange rates (EERs) of the euro and harmonized competitiveness indicators (HCIs) of euro area member states, as well as the underlying trade weights, include trade in services to provide a more complete picture of price and cost

[6] A joint ECB, Irving Fisher Committee and Banco de Portugal conference 'Bridging measurement challenges and analytical needs of external statistics: evolution or revolution?' was held in Lisbon on February 17–18, 2020.

competitiveness. Moreover, the largest trading partner group (EER-38) was enlarged by four countries (now referred to as EER-42).

  - The ESS and the ESCB have also continued their efforts to reduce asymmetries, particularly intra EU asymmetries on foreign direct investment (FDI). Quarterly "Asymmetry Resolution meetings" have taken place since the beginning of 2019 between those countries responsible for major bilateral EU FDI asymmetries.

- Modernization of intra-EU trade in goods statistics. To reduce the reporting burden while maintaining quality in international trade in goods statistics, the exchange of micro-data on intra-EU exports between the EU member states will start in 2022. A project 'Modernization of the System of Compiling Intra-EU trade in Goods Statistics' has focused on the technical preparation of the micro-data exchange and paving the way for an efficient use of the data.

- Monetary and financial statistics.

  - The ECB conducted public consultations on amendments to the ECB regulations on (i) monetary financial institution balance sheet statistics (February 10–March 13, 2020) and (ii) payments statistics (February 27–May 7, 2020).

  - A regulation on payments statistics in under development. Information on innovative payment services and channels, payment schemes, and fraudulent payment transactions will help the ECB to perform its catalyst and oversight roles in the areas of retail payments and payment systems more effectively.

- Registers. More than 130,000 multinational enterprise (MNE) groups active in the EU are now part of the EuroGroups Register (EGR)—the central European register for MNE groups managed by Eurostat. The number of active entities maintained in the ESCB's Register of Institutions and Affiliates Data (RIAD) has recently reached 10 million. A new ECB guideline established the obligations of national competent authorities (NCAs) with respect to the recording, maintenance and quality management of reference data in RIAD for supervisory tasks.[7]

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

- Euro short-term rate (€STR).

  - The ECB published the €STR for the first time on October 2, 2019, according to the provisions laid down in the ECB Guideline ECB/2019/19[8] on €STR (July 10, 2019).

  - The ECB periodically publishes summary information on errors larger than 0.1 basis point that were detected after the standard publication and did not meet the republication criteria.

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020O0497

[8] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019O0019&from=DE

The implementation of this transparency policy started on February 28, 2020 with reference to Q4 2019.

- The external auditor to assess €STR compliance with IOSCO principles has been selected; the assessment will be published in Autumn 2020.

- The ECB conducted a public consultation on the publication of compounded €STR rates between July 14 and September 11, 2020.

- Money Market Statistical Reporting (MMSR). The amended regulation was adopted on September 30, 2019, to strengthen the legal basis for the early morning quality assurance process for the €STR.

- Securities holdings statistics. The data compilation has been adapted to support the ECB's Pandemic Emergency Purchase Programme (PEPP), and its timeliness improved.

- Analytical credit datasets (AnaCredit Project). The 2nd edition of the AnaCredit Reporting Manual was published in May 2019. A new set of Q&As were published due to the COVID-19 crisis.[9]

8. The ECB, Eurostat and the OECD actively cooperate on statistics and research concerning the joint distribution of income, consumptions and wealth (ICW) as well as linking macro and micro data on household wealth.[10] In July 2020, the ECB Expert Group Linking Macro and Micro Data published its final report.[11] The ESCB Statistics Committee established the Expert Group on Distributional Financial Accounts as its successor, to develop distributional results on household wealth which are consistent with the national accounts by 2022.

9. Technical work by Eurostat is also ongoing towards modernizing and harmonizing public sector accounting in the context of the European Public Sector Accounting Standards (EPSAS). In June 2019, Eurostat published a staff working document summarizing recent developments.[12] Subsequent technical work has focused on drafting screening reports assessing the consistency of individual International Public Sector Accounting Standards (IPSASs) with the draft EPSAS Conceptual Framework.

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[9] https://www.ecb.europa.eu/stats/money_credit_banking/anacredit/questions/html/ecb.anaq.200515.0024.en.html

[10] 3rd wave of the Household Finance and Consumption Survey (HFCS) - upon request, the micro data of the survey is available to external researchers.

[11] https://www.ecb.europa.eu/pub/pdf/scpsps/ecb.sps37~433920127f.en.pdf

[12] https://ec.europa.eu/eurostat/documents/9101903/9823491/EPSAS_Progress_Report_2019.pdf

PRESS RELEASE

PR[20/XX]

Appendix I. Draft Press Release

IMF Executive Board Concludes 2020 Article IV Consultation on Euro Area Policies

FOR IMMEDIATE RELEASE

Washington, DC – [December 18, 2020]: On December 18, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] on euro area policies with member countries.

The COVID-19 pandemic is leading to severe socio-economic dislocations and hardship. Euro area real GDP plummeted in the first half of the year, though the unprecedented policy responses at the national and EU levels helped cushion the impact of the crisis—including by limiting large increases in unemployment and insolvencies—and supported a strong rebound in the third quarter. Going forward, the recent second wave and necessary measures to contain it are expected to weigh on economic activity in the near term. Unless pandemic dynamics change significantly in the coming months, economic activity is set to recover more gradually than forecast in the October 2020 *World Economic Outlook*. Inflation, which has descended into negative territory in recent months, is expected to only gradually pickup and remain below the ECB's medium-term aim throughout most of the forecast horizon.

The outlook is subject to extreme uncertainty. Risks remain to the downside through early 2021, but the recent promising news on vaccine development provide a significant upside further out. While rapid and widespread delivery of safe and effective vaccines would likely spur a faster recovery, a prolonged health crisis and slower recovery would lead to tighter financial conditions. This would depress investment and increase private and public sector vulnerabilities. Significant labor market hysteresis would also be likely, increasing inequality and poverty. Taken together, these "scarring" effects would weigh on the growth potential of the euro area. The ongoing negotiations regarding the U.K.'s future relationship with the EU27 and a potential escalation of trade tensions add to the uncertainty.

Executive Board Assessment[2]

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

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

Table 1. Euro Area: Main Economic Indicators, 2017–25

				Projections 1/					
	2017	2018	2019	2020	2021	2022	2023	2024	2025
Demand and Supply									
Real GDP	2.6	1.9	1.3	-8.3	5.2	3.1	2.2	1.7	1.4
Private consumption	1.8	1.5	1.3	-9.2	5.5	3.2	1.9	1.5	1.3
Public consumption	1.1	1.2	1.9	2.2	0.9	0.3	1.2	1.1	1.1
Gross fixed investment	3.8	3.2	5.8	-12.0	7.6	5.0	3.4	2.4	1.7
Final domestic demand	2.1	1.8	2.4	-7.4	4.9	2.9	2.1	1.6	1.3
Stockbuilding 2/	0.2	0.1	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0
Domestic demand	2.3	1.9	1.9	-7.5	4.8	2.9	2.1	1.6	1.3
Foreign balance 2/	0.4	0.1	-0.5	-1.0	0.5	0.3	0.2	0.1	0.1
Exports 3/	5.5	3.6	2.5	-12.9	8.3	5.8	4.3	3.6	3.3
Imports 3/	5.2	3.7	3.9	-11.6	7.8	5.7	4.2	3.6	3.3
Resource Utilization									
Potential GDP	1.5	1.3	1.3	-3.2	3.1	1.4	1.2	1.3	1.2
Output gap	-0.4	0.2	0.2	-5.1	-3.2	-1.6	-0.6	-0.2	0.0
Employment	1.6	1.6	1.2	-1.7	0.6	1.1	0.6	0.4	0.2
Unemployment rate 4/	9.1	8.2	7.6	8.9	9.1	8.4	7.9	7.7	7.6
Prices									
GDP deflator	1.1	1.4	1.7	1.6	1.2	1.3	1.4	1.6	1.8
Consumer prices	1.5	1.8	1.2	0.4	0.9	1.2	1.4	1.6	1.7
Public Finance 5/									
General government balance	-0.9	-0.5	-0.6	-10.1	-5.0	-2.7	-2.1	-1.8	-1.8
General government structural balance	-0.6	-0.5	-0.6	-5.3	-3.1	-1.8	-1.8	-1.7	-1.8
General government gross debt	87.7	85.8	84.0	101.1	100.0	98.4	97.0	95.6	94.3
External Sector 5/, 6/									
Current account balance	3.1	2.9	2.3	1.9	2.4	2.5	2.5	2.6	2.5
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	0.0	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.18	1.14	1.11	1.18	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	113.9	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.2	86.8	85.4	89.3	...	...	...	...	...

Sources: IMF, *World Economic Outlook,* Global Data Source; Reuters Group; and Eurostat.
1/ Projections are based on aggregation of *WEO* Oct 2020 projections submitted by IMF country teams.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2020.