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Report on the Euro Area

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

on the economic policy of the euro area

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REPORT ON THE EURO AREA

CONTENTS

Executive summary

The economic recovery continues at a moderate pace in the euro area. Real GDP is expected to grow by 1.6% in 2015, gradually picking up to 1.9% in 2017, and the output gap is expected to progressively close. All euro area countries except Greece are forecast to record positive growth rates and almost all will see growth above 1% in 2016 and 2017, with differences across Member States. However, downside risks to the outlook have widened due to the downward revision of the growth forecast for the world economy, in particular for emerging economies. The continued deleveraging in the private sector remains a constraint on growth.

A coordinated approach to macroeconomic policies remains warranted. As argued also in the 2016 Annual Growth Survey, in view also of the high interconnections among the economies in EMU sustaining and strengthening this recovery requires continued and determined policy efforts. Structural, fiscal, financial and monetary policies, combined in an integrated, growth-friendly approach, will help to provide the most support to the recovery, to make the euro area more resilient to adverse shocks and to enhance positive cross-border spillovers through trade, financial and institutional linkages. Moreover, as confidence effects have also proven to be an important transmission mechanism, a coordinated approach in tackling macroeconomic imbalances and legacies of the crisis will support the recovery by continuing to build trust in our economic system and monetary union.

Challenges remain in the following interrelated areas:

- **Unlocking growth potential and tackling high unemployment.** Unlocking growth potential in the euro area would help to remove growth bottlenecks and contribute to support confidence in the sustainability of high levels of debt. Given the linkages between sectors, reforming the services sector, including by completing the single market, and removing barriers to investment, would play an important role in tackling this challenge. Moreover, high levels of unemployment and the persistence of long-term unemployment have a negative impact on GDP growth via lower employment and lower productivity and are closely linked to the increase in poverty observed after the crisis. Reforms can help to establish modern and flexible labour markets and social security that facilitate faster transitions back into employment. Also more progress in reducing the high tax wedge on labour can contribute to foster job creation.
- **External and internal rebalancing within the euro area.** The high current account surplus in the euro area is largely the result of weak domestic demand and reflects an inappropriate savings-investment balance. It also reflects an asymmetric adjustment whereby large external deficits have been largely corrected, while large surpluses continue to accumulate in Member States without significant deleveraging needs. The asymmetric adjustment has weighed on recovery at the euro area aggregate level and there is the risk that the slow growth becomes protracted. Such risk should be addressed through a better combination of, on the one hand, structural reforms that raise productivity, foster competitiveness and facilitate active deleveraging in high-debt countries, and on the other hand, policies that boost investment and foster a more efficient use of excessive savings in high surplus countries.
- **Private debt overhang and investment weakness.** Euro area countries whose capacity to sustain demand is constrained by debt overhang and a high level of non-performing loans face the challenge of having to implement growth enhancing reforms while ensuring at the same time an orderly deleveraging in the private sector to address the stocks of non-viable debt and reallocate capital more efficiently. In some euro area countries that have been

heavily hit by the crisis, investment has fallen sharply and is still being hampered by debt overhang, despite some recent recovery in private investment. These countries also face limited access to credit and limited fiscal space.

- **Ensuring an appropriate fiscal stance for the euro area as a whole.** Responsible national fiscal policies that ensure debt sustainability and the effectiveness of fiscal stabilisers, in full respect of the common fiscal rules, are essential for the proper functioning of the monetary union. At the same time, it is important to ensure an appropriate fiscal stance for the euro area as a whole, as complementary to national fiscal stances, to ensure the stabilisation of cyclical positions at times of large shocks. This is particularly needed when monetary policy is constrained by the zero-lower bound in interest rates. The assessment of the euro area fiscal stance has to be carried out against the twin objectives of long-term sustainability of public finances and short-term macroeconomic stabilisation. This implies that the required fiscal adjustment is differentiated across Member States, in order to reflect country-specific challenges in terms of reducing public debt and stabilisation of the cyclical position, while taking into account the spillovers across euro area countries. Effective national fiscal frameworks are key to achieving the appropriate aggregate fiscal stance. Efforts are still necessary to improve the composition of public expenditure and revenues.
- **The adjustment of the banking sector.** Banks and sovereigns in the euro area are still significantly interlinked. Banks' limited capital and provision buffers, the limited legal capacity to facilitate the resolution of non-performing loans (NPLs) and small transaction volumes in secondary markets for NPLs constitute further obstacles to making bank business models more resilient to shocks. Remaining challenges include how to ease the debt-servicing burden on the private sector and how to ensure the adoption of new and more harmonised approaches to business failure and insolvency.
- **Completion of banking union and deepening of capital markets.** The banking union continues to progress. However, the Bank Recovery and Resolution Directive (BRRD) remains to be fully transposed in order to ensure that the EU resolution framework is properly in place. The bridge financing arrangements for the SRF, to ensure its operational readiness from January 2016, and a common backstop for the SRF during the transition period are not yet fully in place. Finally, the creation of a common European deposit insurance, in parallel to further measures to reduce risk in the banking sector, will complete the Banking Union alongside single bank supervision and the single bank resolution mechanism. A series of review clauses included in the legislation establishing the macro-prudential framework, and its piecemeal construction, call for a revision to ensure that the framework is effective. The diversification of corporate funding channels, the deepening of European capital markets and the removal of impediments to cross-border investment, e.g. those related to inconsistent insolvency regimes, are challenges that the full implementation of the Capital Market Union should help to address.
- **Completion of the EMU architecture.** This includes the timely implementation of stage 1 initiatives as laid out in the Five Presidents Report and the Commission Communication of 21 October. In particular, to ensure that the national Competitiveness Boards are operational by end-2016 and that progress is made towards a more unified representation of the euro area in international fora. At the same time, a broad consultation process will be launched in 2016 to consult and engage on completing EMU in Stage 2. The outcome of this consultation and the work of the expert group should contribute to shaping the more fundamental steps ahead, contributing to the Commission's White Paper in Spring 2017 and leading to a stronger legislative and institutional framework for EMU.

1. Structural reform policy and rebalancing

1.1. Structural reforms

Sustainable convergence requires a broad set of structural policies, at both the macroeconomic and microeconomic levels. In a monetary union, it is particularly important that economies can adjust effectively to asymmetric shocks. Rigidities remaining, for example in the regulations of labour and product markets, inhibit Member's States adjustment capacity, hindering the smooth functioning of EMU. Supporting a balanced adjustment in the private and public sectors helps the euro area economies to sustain growth and create more jobs.

Reforms aiming at opening up sheltered sectors and completing the single market are particularly relevant for the adjustment capacity of the euro area. Given the linkages between services and other sectors and in a context of increased fragmentation of production processes, improvements in services' performance can generate substantial gains that disseminate to the rest of the economy and can have a significant impact on the performance of the tradable sector. Well-functioning services can also play a specific role in the euro area countries, as they can contribute to the rebalancing process and facilitate resource reallocation. Several indicators show signs of underperformance in the services sectors. For instance, in some cases, wage growth outperformed productivity growth and some sectors show relatively high average mark-ups. Such trends have negative implications for competitiveness and lead to welfare losses for consumers[1]. At the heart of it could be the high regulatory barriers that remain in the services sectors as well as large heterogeneity across euro area countries, hampering the well-functioning of the Single Market. Despite the importance of services, the pace of national reforms in the area of services slowed considerably over the last years[2].

Investment in the euro area is hampered by a variety of barriers, both regulatory and non-regulatory, which also differ in terms of their restrictiveness, complexity or predictability. Most frequent barriers to investment notably include product and labour markets distortions, unfavourable business environment, public-administration inefficiencies as well as barriers to access to finance both for SMEs and for long-term projects such as infrastructure. Euro area countries have been unevenly affected by the crisis and are characterised by different investment needs. Removing barriers to investment in the euro area is needed not only to help in boosting growth potential, but also to lift demand and contribute to the rebalancing within the EMU.

Labour markets continue to gradually improve, benefitting from strengthened economic activity and reform efforts undertaken in recent years. While employment growth was stronger in 2014 than what could be expected in the light of the modest recovery, it seems to have slowed down in the first half of 2015. Overall, as the draft Joint Employment Report[3] shows, the employment rate has increased by 1.8 percentage point in the euro area since the lowest level observed in 2013, but at 68.9% it is still 1.6 percentage points lower than the peak reached in mid-2008 (corresponding to some 5 million people).

Unemployment, including youth unemployment, continues the modest but steady decrease that had started in 2013. Over the year up to September 2015 it fell or remained stable in most Member States, with the highest decreases being recorded in the countries that had been the most severely hit by the crisis. But differences among euro area countries are still at historical heights. After having increased from 2008 to 2013, long-term unemployment in the euro area has broadly stabilised at a very

[1] See Quarterly Report on the Euro Area (QREA), Vol.14, No.2 (2015).
[2] National services reforms in 2012-2014 are not expected to yield more than 0.1% EU GDP growth against a 1.8% estimated potential from a more ambitious implementation of the Services Directive. This means that the EA and the EU are missing significant economic potential that could be achieved through more ambitious national services reforms. See Report on "Single market strategy and competitiveness in the EU and its member states, 2015" accompanying the Communication (2015) 550 "Upgrading the Single Market: more opportunities for people and business".
[3] 2016 Draft Joint Employment Report - COM(2015) 700.

high level of close to 50% of total unemployment and 6% of the labour force. High levels of unemployment and the persistence of long-term unemployment have a negative impact on GDP growth via lower employment and lower productivity. Long-term unemployment also leads to a loss of skills and is found to be one of the factors most closely linked to the increase in poverty after the crisis. At the same time, large and persisting cross-country disparities in the labour market adjustment capacity and social performance pose a challenge to the smooth functioning of the euro area. There is notably a risk of important market inefficiencies in terms of matching of unemployed people with vacant posts and that unemployment becomes entrenched with possible spill-over effects.

Euro area countries that have implemented labour market reforms have performed relatively well. Those that have not, or done so later, have faced particularly great challenges, and generally negative labour market impacts. In order to significantly improve labour market outcomes in the euro area it is key to strike the right balance between 1) flexible and reliable contractual arrangements; 2) comprehensive lifelong learning strategies; 3) effective active labour market policies; and 4) modern social security systems providing adequate income support during employment transitions.

Tax systems should become more growth-friendly and supportive of job creation. High labour taxes increase labour costs to employers and reduce net take-home pay of employees, negatively impacting both labour demand and labour supply. Shifting taxes away from labour can contribute to increasing employment and activity rates in the euro area by increasing incentives to hire and to look for, and take up, work. Targeted labour tax reductions, rather than across-the-board cuts, can specifically contribute to increased inclusion of groups at the margin of the labour market, such as low-income earners and the long-term unemployed while limiting revenue losses.

Although some countries have reduced the tax burden on labour in recent years, particularly for low income earners, the overall level remains high. Over the past few years, some Member States implemented measures to reduce labour taxes, focussing in particular on low-income earners. However, these measures were often relatively minor. The GDP-weighted euro area average tax wedge on labour for low income earners (i.e. for a single person earning 50% of the average wage) showed a relevant drop in the period 2010-2014 while the tax wedge on labour for a single person earning the average wage rose slightly with increases in 12 out of 19 Member States. Overall the tax burden on labour in many euro area Member States remains very high.

The most recent data shows that the overall at risk-of-poverty rate has slightly deteriorated to 17.1% in 2014[4]. Severe material deprivation stands at 7.3% of the total population[5]. Growth in real gross disposable household income in the euro area has slowly accelerated in the year to the second quarter of 2015 mainly due to an increase in income from work but also to a rise in social benefits. Despite this progress, financial distress is still well above the levels seen in the previous decade.

Adequate, well-designed and sustainable benefits and income support systems can support (re)employment. Unemployment benefit and minimum income schemes linked to activation allow those out of work to invest in job search and training, maintain the incentive to work for those able to do so while decreasing the pressure to find other subsistence means at any price - for instance through undeclared work. Broad reforms in education and training systems continue to be pursued, raising their quality, job market relevance and inclusiveness and allowing learners to engage in more flexible, individual pathways, will be key. This requires a close cooperation between Public Employment Services, education and training systems, and social partners.

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[4] The at-risk-of-poverty rate is the share of people with an equivalised disposable income (after social transfer) below the at-risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income after social transfers.

[5] Material deprivation measures the percentage of the population that cannot afford at least three of the following nine items: (i) to pay their rent, mortgage or utility bills; (ii) to keep their home adequately warm; (iii) to face unexpected expenses; (iv) to eat meat or proteins regularly; (v) to go on holiday; (vi) a television set; (vii) a washing machine; (viii) a car; (ix) a telephone. Severe material deprivation rate is defined as the enforced inability to pay for at least four of these items.

1.2. Rebalancing

External rebalancing in the euro area is progressing, although with some asymmetry. The euro area currently has one of the world's largest current account surpluses in value terms, with approximately EUR 390bn, or 3.7% of GDP, expected in 2015. The high current account surplus in the euro area reflects an inappropriate savings-investment balance, which is linked to weak domestic demand (see Figure 1). It also reflects an asymmetric adjustment whereby external deficits have been largely corrected in vulnerable Member States while surpluses continue to accumulate in some countries. The bulk of the surplus is accounted for by Germany and the Netherlands, whose contribution represents 2.5 and 0.7 percentage points respectively, and by Italy (0.4% percentage point). Former deficit countries are in general also recording balanced or surplus positions which are needed in order to ensure the sustainability of their external positions. As argued in the Alert Mechanism Report 2016, the fall in oil prices observed since mid-last year, as well as the recent developments in the euro exchange rate have contributed to the widening in current account surpluses in the euro area.

Government budget deficits are being reduced and deleveraging is ongoing in others sectors of the economy. Simultaneous deleveraging processes reinforce each other, contributing to low inflation and a marked widening of the euro area current account surplus. The growing gap between the actual current account surplus and the level implied by fundamental characteristics (e.g. ageing profile, levels of income per capita) for some of the high surpluses countries point to an overall lack of domestic demand in these countries. Looking forward, policies put in place at the EU level (e.g. the ECB's Public Sector Purchase Programme and the Investment Plan launched by the Commission) are meant to support credit and investment, even though the effect on the real economy might take some time to materialise.

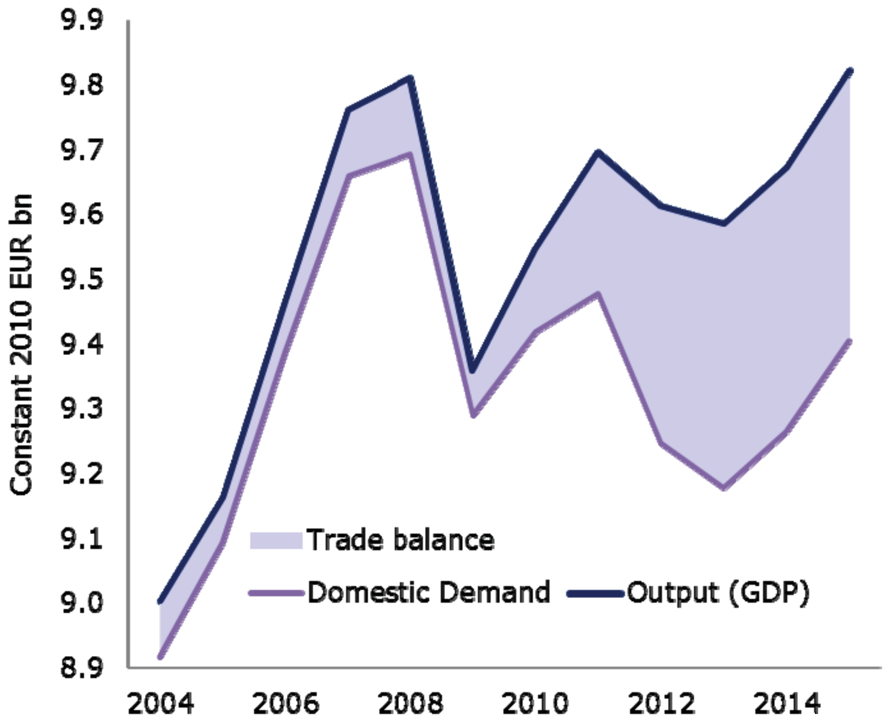

Figure 1: Euro area trade surplus: the difference between GDP and domestic demand
Source: European Commission

The adjustment in external flows continues to reduce external indebtedness. Since the correction of the large current account deficits in the euro area over the past few years, the net international investment positions (NIIPs) expressed as a percentage of GDP have not significantly improved in former deficit countries, as a result of an unfavourable contribution of nominal growth and valuation effects. In the majority of the economies with highly negative positions, higher current account surpluses than those currently observed would be needed in order to reduce their net external liabilities in a timely fashion. Consolidating improvements in export competitiveness remains therefore essential, as well as policies aimed at attracting FDI.

Private sector debt remains high in most Member States with a reduction in the debt-to-GDP ratios mainly resulting from negative credit flows. According to Eurostat data, in 2014, debt stocks in consolidated terms represented 59.7% and 79.5% of euro area GDP for households and non-financial corporations, while they amounted to 63.1% and 81.9% of GDP respectively in 2009. These aggregate figures mask a wide range of levels across Member States. In 2014, household and corporate debt ranged from around 20% and 30% of GDP in Lithuania, to nearly 130% and 220% of GDP in Cyprus. Since debt levels peaked, progress in deleveraging has been mixed, with reductions of indebtedness mostly observed in the corporate sector. The latest developments show a very uneven deleveraging picture across countries and sectors. Both the euro area and the United States experienced a surge in corporate indebtedness in the years preceding the global financial crisis and in its early stages. The ratio of debt to gross value added by non-financial corporations (NFCs) rose by about 40 pp between 2005 and 2009. Although both regions saw similar steep rises in corporate debt in the pre-crisis years, balance sheet adjustment since the crisis has been significantly slower in the euro area than in the United States. The more rapid adjustment in the United States can be explained by a stronger cyclical recovery, more supportive profitability developments and reduced dividend payment ratios. In the euro area, profitability has been hindered by a combination of lower flexibility in the labour markets and slow wage adjustment[6].

Looking forward, further adjustment, although to varying degrees, is likely in a number of Member States. This places constraints on the economy and on credit demand as the weight of existing debt held by households or corporates may affect new investment decisions and slow the recovery in consumption. In this context, dealing with still elevated levels of non-performing loans and following common principles in well-working insolvency frameworks constitute a key element of a successful and growth-friendly deleveraging process.

[6] See Quarterly Report on the Euro Area (QREA), Vol.13, No.1 (2014).

2. Fiscal policy

The euro area headline deficit is expected to decrease further on the back of continued albeit moderate economic recovery. The decrease in the aggregate euro area headline deficit is planned to continue through 2017 down from 2% of GDP in 2015. The number of euro area countries under an excessive deficit procedure has decreased to 7 in 2015 from 17[7] in 2011 and debt levels should slightly decrease after peaking at 94.5% of GDP in 2014. The euro area's debt-to-GDP ratio is forecast to gradually fall to 91.3% in 2017 according to Commission 2015 Autumn Forecast. The improvement on the fiscal side reflects mostly past effort and the moderate recovery. The structural fiscal position is set to remain broadly unchanged as from 2015, which suggests a broadly neutral fiscal stance in the euro area in 2016. While debt stabilization is welcome, the level of government debt remains high and, when coupled with high private indebtedness, can make an economy more vulnerable to adverse shocks and can act as a drag on growth (see Figure 2).

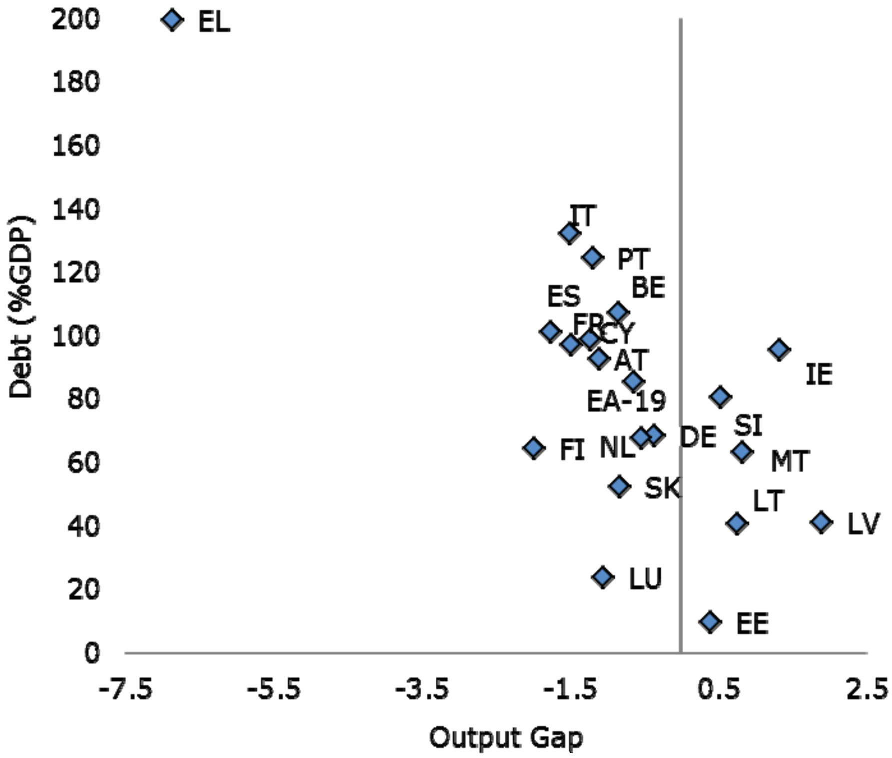

Figure 2: Sustainability and stabilisation; debt levels and the output gap forecast for 2016

Source: Autumn 2015 European Economic Forecast, European Commission.

[7] Including Latvia and Lithuania, which were not in the euro area at that time yet.

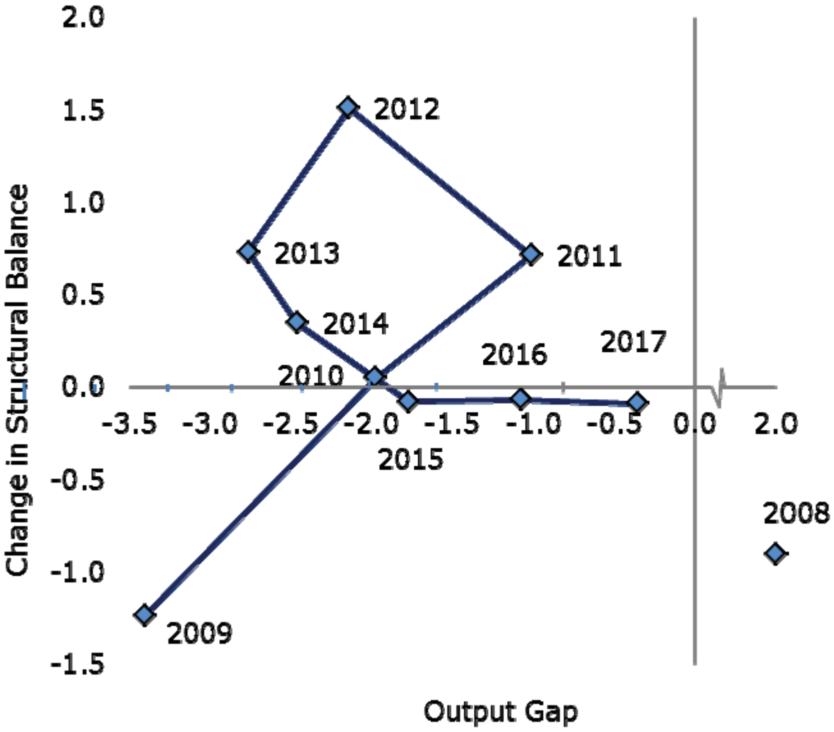

Figure 3: The fiscal stance; structural adjustment and the output gap.

Note: A positive change in the structural balance reflects a tightening of the fiscal stance.
Source: Autumn 2015 European Economic Forecast, European Commission.

A reinforcement of the coordination of fiscal policies within the currency union is needed to ensure an appropriate fiscal stance for the euro area as a whole, within the obligations under the Stability and Growth Pact. The large spillovers from fiscal policy decisions in the euro area and the current constraints on the single monetary policy related to the low level of interest rates call for strengthened attention to the aggregate fiscal stance at the euro area level. The Two-Pack acknowledged the necessity for enhanced coordination of fiscal policies and introduced the legal requirement for the Commission to assess and for the Eurogroup to discuss the overall budgetary situation and prospects in the euro area on the basis of the draft budgetary plans (DBPs). These discussions have proved useful in providing a unifying context for the analysis of the DBPs and have been a valuable tool of coordination of fiscal policies in the euro area. As the process of DBPs assessment takes place once a year, there is a case to consider making the discussions of euro area aggregate stance more frequent, outside the DBP assessment process and repeat them, for instance, in time for the preparation and the assessment of the stability programmes. A discussion on the aggregate euro area fiscal stance could again provide a valuable background for the assessment of fiscal plans of euro area Member States.

The euro area fiscal stance needs to be assessed against the twin objectives of long-term sustainability of public finances and short-term macroeconomic stabilisation. The former requires that public debt is put and maintained on a sustainable path, while the latter aims at bringing output growth in line with its potential, i.e. ensuring that the output gap closes at an appropriate pace in the short to medium term.

The moderate pace of the recovery, coupled with widening downside risks and elevated debt levels point to challenges for fiscal policy going forward. The Commission 2015 Autumn Forecast projects the aggregate fiscal stance to be broadly neutral for both 2015 and 2016. The change in the structural balance is expected to be close to zero for both 2015 and 2016, following substantial adjustment in the period 2011-2013. In view of the growth pattern and the downside risks to it, the broadly neutral aggregate fiscal stance appears appropriate, despite elevated debt levels, (see Figure 3). For 2017, the Commission Forecast projects the continuation of the moderate recovery and the gradual closing of the output gap. Public finances should be consolidated in periods of growth to benefit from favourable circumstances to reduce debt levels and to avoid the need for pro-cyclical consolidations in subsequent slowdowns. However, recent developments suggest that some of the downside risks identified in Commission 2015 Spring Forecast have materialised and the downside risk to the current outlook have widened.

Compliance with the Stability and Growth Pact is instrumental to ensure building up fiscal buffers and reduce debt levels. The SGP foresees taking into account country-specific circumstances in defining the adjustment path. The required fiscal adjustment will need to be differentiated across Member States, in order to reflect the country-specific challenges in terms of sustainability needs, and not least ensure the stabilisation of the cyclical position. Thus, the insufficient differentiation of planned efforts across euro area countries is a point of concern. In its Opinions on the Draft Budgetary Plans the Commission provided further orientation for the conduct of fiscal policy and the implementation in the respective budgetary processes for 2016[8].

Effective national fiscal frameworks are key to achieving an appropriate fiscal stance. Robust fiscal rules and multi-annual budget planning support counter-cyclical fiscal policies and long-term sustainability. Independent fiscal institutions help contain the deficit bias and promote transparency of fiscal policy, whereas transparent budgeting allows identifying feasible options to pursue growth-enhancing policies. To fully tap into this potential and based on EU fiscal governance requirements[9], euro area Member States have introduced an ambitious raft of reforms aiming to enhance the quality and strength of their fiscal frameworks. Looking forward, Member States are expected to ensure the effective functioning of the newly-established or upgraded fiscal frameworks, so that they can support in earnest the conduct of a responsible fiscal policy domestically, in line with SGP obligations. They could also underpin efforts to pursue an appropriate fiscal stance for the euro area as a whole.

Growth-friendly expenditure plans, increasing the efficiency of spending and prioritising public investment can support the recovery. In a context where tax ratios remain high, cutting expenditures and improving the quality of public finances and of public spending are key. Even if the planned reduction in the expenditure ratio by 0.6 percentage points in 2016 is mostly due to cyclical conditions, this goes in the right direction. It is also positive that, in the aggregate, euro area countries plan cuts for next year and 2017 in relatively less productive expenditure items such as the public sector wage bill and government purchases of goods and services. During the crisis years, the quality of public expenditures in the EU has suffered from a drop in public investment. While the plans would be favourable to medium-term growth prospects, more growth-friendly choices can be considered, in particular by maintaining or increasing public investment amid the important efforts of expenditure reduction. Two expenditure items are particularly relevant when discussing long-term sustainability of government finances: pension and health expenditures.

There has been considerable progress towards reforming pension systems, in recent years. A majority of Member States have adopted sustainability-enhancing reforms so as to better withstand the fiscal impact of future demographic changes. Pension policy also needs to ensure the adequacy of pensions, so as to provide for a decent level of income after retirement. Given the trend increases in life expectancy, a dynamic view on the age at which people can retire needs to be established. This includes linking retirement ages to life expectancy more systematically, as a number of Member States have done in recent years. A review of excessive early exit possibilities from the labour market is necessary.

A large share of expenditure on health systems in the euro area is borne by public means, which raises the issue of long-term sustainability of health systems and public finances at large. At the

[8] http://europa.eu/rapid/press-release_MEMO-15-6068_en.htm
[9] The six-pack's Directive on requirements for budgetary frameworks, the two-pack's regulation on enhanced monitoring of budgetary plans and the Fiscal Compact

same time, preserving and restoring good health of the population supports economic prosperity through improving labour market participation and labour productivity, and will therefore be crucial in the context of an ageing society. A challenge is therefore to balance the need to provide universal health care, meet an increasing demand related to an ageing population, as well as growing patient expectations due to technological development in the coming decades with the need to ensure the financial sustainability of the health care and long-term care systems. This highlights the need to assess their performance carefully.

A well-designed tax system can contribute to sustainable public finances, boost economic growth and employment, and improve social fairness. As mentioned in the previous section, a particular concern in this regard is the very high tax burden on labour. Shifting the tax burden away from labour to more "growth-friendly" tax bases (e.g. consumption, property and environmental taxes) can boost employment. Simplifying tax systems and addressing tax fraud and tax avoidance are essential to make tax systems more efficient and fairer.

3. Financial sector policy

Financial market conditions remain overall favourable in the euro area, against the background of an accommodative monetary policy stance. ECB monetary policy, including most recently the expanded asset purchase programme, continued to stabilise financial markets. Interest rates have continued to decline and have thereby fostered confidence. Moreover, bank funding costs have been systematically declining. This has further strengthened the access of companies and households to credit and lowered lending rates (see Figure 4). However, the still weak economic fundamentals and high leverage in the private sector continue to weigh on demand for bank lending and thereby economic growth.

Further important policy measures have been taken to reinforce the supervisory framework of the European banking sector. This is another important factor supporting investor confidence in financial markets. The ECB Single Supervisory Mechanism (SSM) is now fully responsible for direct supervision of the most significant euro-area banks and undertook the 2015 SREP exercise using a common methodology for all. The SSM has also launched a project to harmonise the exercise of options and national discretions (ONDs) by Member States in the Capital Requirement Regulation (CRR) and the Capital Requirements Directive (CRD). In line with the SSM Regulation, the Commission is carrying out the first SSM review on the functioning of the SSM with a view to publishing the report in 2016.

Efforts are being made to strengthen the macro-prudential framework. This framework is meant to ensure that financial stability risks are addressed in the most appropriate way at a national level, in line with divergent economic cycles and country-specific economic structures. A series of review clauses included in the legislation establishing this framework, and the fact that the framework has been constructed in a piecemeal manner, call for a revision to ensure that the framework is effective. The review is aimed to address potential inconsistencies among the policy tools on which it relies, to streamline the tools and the activation mechanisms related to their use, and clarify the role of the SSM and ESRB. Whilst focusing on the banking sector, the review of the macro-prudential framework should also reflect an assessment of the risks emanating from the more opaque and less regulated, non-bank parts of the financial system.

The establishment of the Single Resolution Board (SRB) is progressing and the elaboration of bank resolution plans for the euro area countries remains on track. As of January 2016, following the ratification of the Intergovernmental Agreement of the Single Resolution Fund (SRF) by the participating Member States by 30 November 2015, the SRB and the SRF will become fully operational and have all resolution powers, including bail-in. In this respect, infringement proceedings by the Commission are ongoing to ensure that all Member States transpose the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Schemes Directive (DGSD) as soon as possible, and that the EU resolution and depositors' protection framework is properly in place. It remains important that an appropriate bridge financing is in place by 1 January 2016. Work progresses to establish bridge financing arrangements for the SRF and to ensure its operational readiness from

January 2016. A common backstop for the SRF, which would be used as a last resort and would be fiscally neutral over the medium term, during the transition period still remains to be established. As a follow up of the Five Presidents' Report of June 2015 the Commission will make a proposal regarding a European deposit insurance scheme in the euro area, thereby aiming at establishing the third leg of the Banking Union, and will in parallel set out measures to further reduce risks and ensure a level playing field in the banking sector and limit the bank-sovereign loop. The recent crisis and the significant negative spillovers which were transmitted through financial channels have emphasised the importance of completing banking union for the euro area.

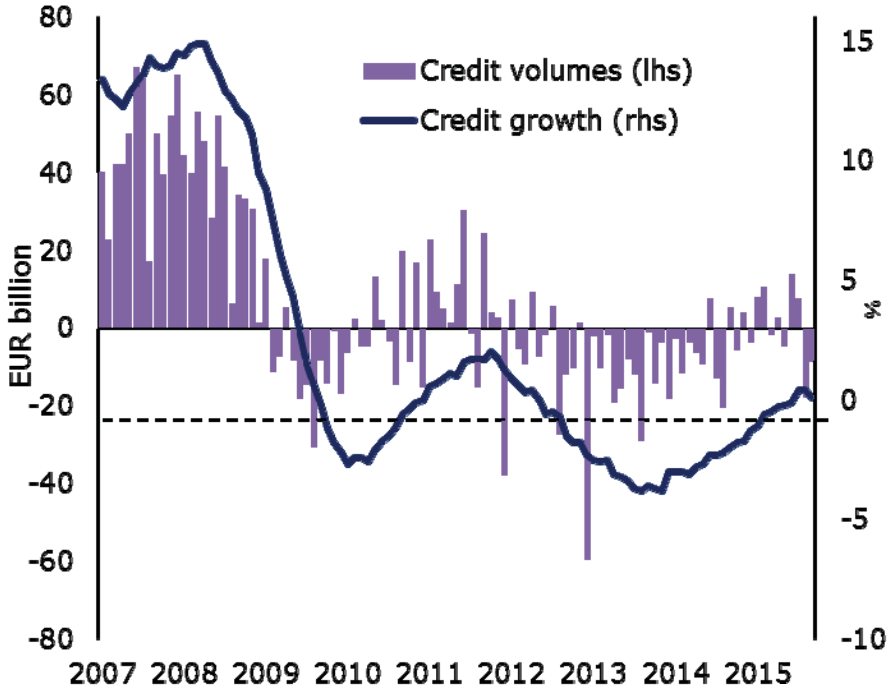

Figure 4: Credit to Non-Financial Corporations in the euro area.
Source: ECB

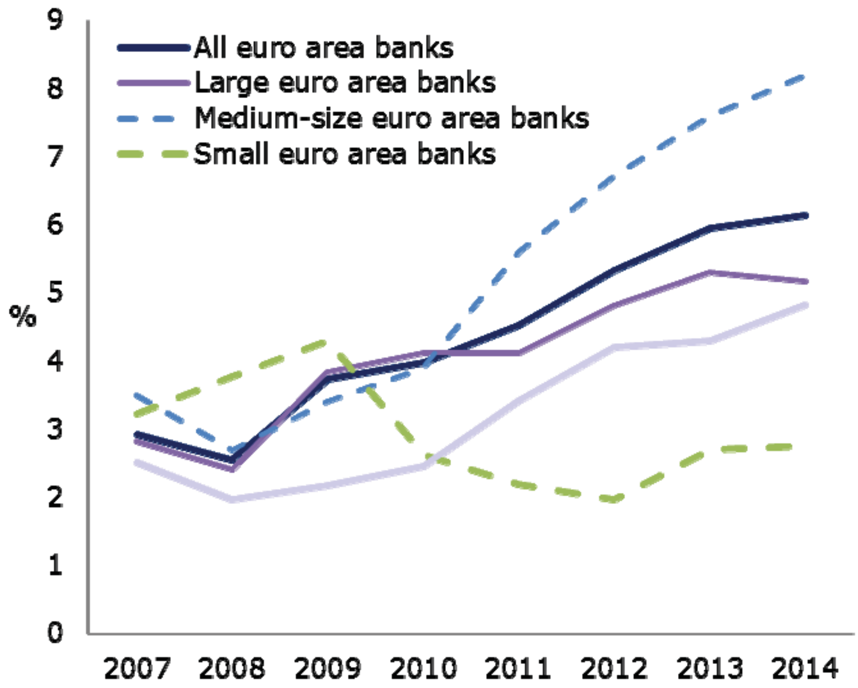

Figure 5: Gross non-performing loans, as a % of total debt instruments
Source: European Central Bank

Still, challenges remain and the adjustment of the banking sector is not yet complete. Banks and sovereigns in the euro area are still significantly interlinked, and bank business models can be made even more resilient to shocks, for example by enhancing the stability and diversification of bank funding sources. Moreover, some banks' balance sheets remain under pressure from high levels of non-performing loans (NPLs), hampering lending activity (see Figure 5). Historically, debt overhangs were corrected by a combination of inflation and economic growth, but these mechanisms are currently very weak in the environment of low growth and low inflation. Banks' limited capital and provision buffers, the limited legal capacity to facilitate the resolution of NPLs and small transaction volumes in secondary markets for NPLs constitute further obstacles. Against these challenges, work has started on identifying possible bank-level or system-wide approaches to handle distressed loans. Remaining challenges include how best to ease the debt-servicing burden on the private sector, for example via debt-equity swaps, in order to facilitate new credit demand.

In parallel to strengthening the banking sector, efforts continue to diversify corporate funding channels and deepen European capital markets. Following the adoption by the Commission of the Capital Markets Union Action Plan on 30 September, its gradual implementation is progressing, focusing on priority actions for 2016 and preparatory work for longer-term initiatives. Progress is made by the co-legislators on the adoption of the proposal for simple, transparent and standardised securitisation. The Commission will present a legislative proposal for revising the Prospectus Directive to simplify prospectus requirements and facilitate access to public capital markets by the end of the year. The Commission is also preparing a Green Paper on retail financial services and insurance, a report on crowd-funding for Q1 2016 and a consultation on the main barriers to the cross-border distribution of investment funds in Q2 2016. Furthermore, preparatory work is underway for actions around personal pensions, SME information systems, corporate bond market liquidity and post-trading. The Commission has also started to engage with Member States in a dialogue on remaining national barriers to the free movement of capital. Insolvency frameworks continue to vary significantly by Member State and the 2014 Commission Recommendation, which includes a series of common principles for national insolvency procedures for businesses, remains to be implemented. As regards the impediments to cross-border investing related to insolvency regimes, preparatory work has started and consultations are gearing up towards a legislative proposal for principles-based minimum harmonisation of business insolvency including both the issues addressed in Recommendation C(2014)1500 on a new approach to business failure and insolvency and further issues emerged from the CMU consultation.

4. Economic Governance

Work is ongoing to complete the EMU architecture. The architecture has been significantly strengthened to enhance economic governance and to achieve financial stability. Nevertheless, the EMU's resilience needs to be further reinforced and EMU completed. The Five Presidents' report[10] maps the way ahead to complete EMU, in two stages. In a first stage, which started on 1 July 2015, action will build on existing instruments and make the best possible use of existing Treaties. In a second stage, more fundamental reforms will be undertaken, moving to a medium- to long-term vision for the euro area. In October 2015, the Commission published a package of measures towards the deepening of EMU in stage 1. Overall, translating the Five Presidents' report into action requires a shared sense of ownership and of purpose among all euro area Member States and EU institutions.

The Commission has recommended setting up national Competitiveness Boards. These should be operational by end 2016 and should track performance and policies in the field of competitiveness. In fulfilling this task, these independent Boards should take into account euro area and EU objectives. Through this channel, the Boards will help to improve the coordination of economic policies. The scope of competitiveness aspects to be monitored should reflect a comprehensive notion of competitiveness, including price and non-price developments. Competitiveness in the euro area requires strong attention to longer-term drivers such as productivity and innovation but also to the capacity to avoid lasting misalignments in costs and prices vis-à-vis trading partners, which in turn requires sufficient adjustment capacity in labour and product markets. It is important that these Boards have the capacity to conduct high-quality analysis and on this basis formulate public advice on the appropriate policies. Their advice should help inspire domestic ownership and ensure that national, euro area and EU objectives are taken into account in national policies[11].

The independent European Fiscal Board (EFB) will complement the fiscal framework of the euro area, including by giving advice on the fiscal stance. Recently established by Commission Decision[12] and expected to become operational in the first half of 2016, the EFB will be instrumental in advising on the implementation of the EU fiscal framework and informing future policy discussions about the appropriateness of the fiscal stance. Its mandate specifically provides for an economic judgement on the appropriate fiscal stance for the euro area that is consistent with the SGP rules. Moreover, the EFB will also assess ex-post how the EU fiscal framework has been implemented and may also make suggestions for the future evolution of the EU fiscal framework. In carrying out its mission, the EFB will cooperate closely with national fiscal councils across the EU so as to benefit from their expertise in fiscal matters and their country-specific knowledge.

Work is underway to increase the effectiveness of the euro area voice in international financial institutions. The progress that the euro area has achieved on further internal integration is now to be reflected also in steps towards a unified external economic representation. This should allow the euro area to play a more active role in international financial institutions and to shape more effectively its future role in the global financial architecture. The Commission has recently proposed a roadmap for the steps ahead and a Council Decision to progressively establish unified representation of the euro area in the International Monetary Fund. This emphasises the need to strengthen coordination among the euro area Member States via a regular consultation framework, to update the coordination

[10] 'Completing Europe's Economic and Monetary Union' by Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz.

[11] http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/recommendation-ncbs_en.pdf

[12] Commission Decision of 21 October 2015 establishing an independent advisory European Fiscal Board - C(2015) 8000 final.

infrastructure and existing coordination arrangements in IMF matters in Brussels, and to enhance coordination in Washington alongside an improved accountability towards the Council and European Parliament. Later steps include improving the representation of the euro area through a rearrangement of constituencies at the IMF and moving towards a unified representation for the euro area in a single seat by 2025.

Preparation of the more fundamental reforms towards completion of EMU in stage 2 has been initiated. First and foremost, a broad debate on the measures required in stage 2 of completing EMU is commencing, including through consultation with the European Parliament, national Parliaments and stakeholders. This debate aims to flesh out the more fundamental reforms in stage 2. The outcome of this consultation and the work of the expert group should contribute to the Commission's White Paper in Spring 2017 and leading to a stronger legislative and institutional framework for EMU.

Summary assessment	
2015 Country specific recommendations (CSRs) for the euro area	
CSR1 Use peer pressure to promote structural reforms that facilitate the correction of large internal and external debts and support investment. Regularly assess the delivery of reforms in those Member States which require specific monitoring within the framework of the Macroeconomic Imbalances Procedure. Continue the regular thematic assessment of structural reforms. By spring 2016, take decisions on the follow-up to the coordination exercise on reducing the high tax wedge on labour and on reforming services markets.	The euro area has made limited progress in addressing CSR 1: • Progress in delivering reform commitments has been promoted at the euro area level, via i.a. technical discussions in Economic Policy Committee and Economic and Financial Committee and political discussion in Eurogroup and ECOFIN. Programme countries' reform progress, as well as discussion on reform progress in member states with excessive imbalances or imbalances requiring decisive action, has also taken place. • The Eurogroup has held thematic discussions on reducing the high tax wedge on labour, inter alia agreeing on a benchmarking exercise, as well as on reforming services markets.
CSR2 Coordinate fiscal policies to ensure that the aggregate euro area fiscal stance is in line with sustainability risks and cyclical conditions. This is without prejudice to the fulfilment of the requirements of the Stability and Growth Pact. By spring 2016, hold thematic discussions on improvements in the quality and sustainability of public finances, focussing in particular on the prioritisation of tangible and intangible investment at national and EU levels, and on making tax systems more growth friendly. Monitor the effective functioning of the recently strengthened national fiscal frameworks.	The euro area has made some progress in addressing CSR 2: • Assessments of the euro area fiscal stance have been carried by the Eurogroup, notably by reviewing the implementation of the Two-pack and discussing the implications of the Commission services' autumn 2013 and 2015 forecast for fiscal surveillance. • The Eurogroup has held thematic discussions on fiscal frameworks. • In the EMU Package on 21 October 2015, the Commission published its decision to set up an European Fiscal Board to act as an independent advisory body. Its mandate will include to evaluate how fiscal governance framework was implemented, to advise on the euro area fiscal stance and to cooperate with the national fiscal councils. • Some progress has been made on the coordination of fiscal policies, in particular in the context of the assessment of the draft budgetary plans, to the extent that fiscal outlook for the euro area as a whole has improved and the aggregate fiscal stance seems appropriate. However, the distribution of the fiscal stance remains sub-optimal.
CSR3 Ensure the timely finalisation of the follow up of the Comprehensive Assessment carried out by the European Central Bank, implementation of Directive 2014/59/EU of the European Parliament and of the Council (Bank Recovery	The euro area has made substantial progress in addressing CSR 3: • The ECB Single Supervisory Mechanism (SSM) became fully operational and responsible for direct supervision of the most significant euro-area banks. The asset quality review (the

and Resolution Directive), completion of the ratification of the Intergovernmental Agreement on the Single Resolution Fund and make the Fund fully operational as from January 2016. Promote measures to deepen market- based finance, to improve access to finance for SMEs and to develop alternative sources of finance. Encourage further reforms of national insolvency frameworks.	comprehensive assessment) of 130 banks was completed and the SSM started work towards further harmonisation of bank supervisory and regulatory treatment across the euro area. • The establishment of the Single Resolution Board (SRB) and of the Single Resolution Fund (SRF) advanced according to plans in 2015. Work also progressed towards agreeing bridge financing arrangements for the SRF and towards the establishment of a common backstop for the SRF during the transition period. • On 30 September 2015 the Commission launched the Capital Markets Union (CMU) Action Plan, aiming at boosting business funding and investment financing by building a single market for capital across the EU. This initiative will enable the development of alternative sources of finance complementary to bank-financing and to break down barriers blocking cross-border investments in the EU. CMU should be particularly beneficial to SMEs and start-ups. Preparatory work has started and consultations are gearing up towards a legislative proposal for principles-based minimum harmonisation of business insolvency.
CSR4 Take forward work on deepening Economic and Monetary Union, and contribute to the improvement of the economic surveillance framework in the context of the report on the next steps on better economic governance in the euro area, prepared by the President of the European Commission, Jean-Claude Juncker, in close cooperation with the President of the European Council, Donald Tusk, the President of the European Parliament, Martin Schulz, the President of the European Central Bank, Mario Draghi, and the President of the Eurogroup, Jeroen Dijsselbloem, and its follow-up.	The euro area has made some progress in addressing CSR 4: • On 21 October 2015 the Commission adopted a package of measures to further strengthen and deepen the Economic and Monetary Union. It followed up on the Five Presidents' Report published in June, which was based on a wide consultation with the Member States. • The package proposals included measures to revamp the EU Semester, in particular by strengthening its euro area dimension, it presented proposals for an improved toolbox of economic governance, including a recommendations to establish national Competitiveness Boards and a proposal for a more consistent external representation of the euro area.