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Report on the
EURO AREA

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CONTENTS

EXECUTIVE SUMMARY

The euro area is continuing its ongoing recovery and for the first time since 2007, all its economies are expected to grow again this year. While determined policy action and the fall in crude oil prices should support growth, the economic recovery is being restrained by long-standing weak growth trends, as well as by legacies of the recent economic and financial crisis: including ongoing external rebalancing; high public and private debt and related deleveraging pressures; high levels of unemployment and low confidence; together with a persistent weakness in investment. Further determined policy efforts are necessary to help overcome these weaknesses permanently.

The recent crisis has demonstrated that the cross-border transmission of shocks can be rapid and powerful within the euro area. Close links across the euro area economies imply that macroeconomic policies can have significant spillovers through trade and financial channels and in terms of the implications of national policy choices for the rest of the euro area. While the crisis has drawn attention to the negative type of spillovers and feedback loops, there is equal potential to create positive dynamic, trigger virtuous cycles and strengthen synergies by fostering coordinated and coherent policy choices across the Member States. The economies of the euro area are at different stages in the adjustment process and the challenges faced by the most crisis-affected euro area Member States limit their ability to contribute to growth in the euro area. The extent of imbalances prior to the crisis, the position in the business cycle and the fiscal space available vary significantly across Member States. The policy stance at the euro area level should promote growth, while at the same time ensuring that the progress made in rebalancing is not jeopardised. In many euro area economies, the process of deleveraging is far from complete. Whether and how reforms are now implemented will determine the euro area's growth potential in the medium to long term

Significant measures have already been taken over the last year, with the launch of the Commission's Investment Plan, the European Central Bank's monetary policy decisions and the large steps taken towards Banking Union.

The Eurogroup has been taking an increasingly active role in devising coordinated policy responses, fostering common understanding of policy challenges and strengthening trust among the main euro area stakeholders. However, the implementation of specific recommendations for individual euro area Member States and the euro area as a whole is not yet complete. Challenges remain in the following interrelated areas:

- The **implementation of ambitious structural reforms** - that boost competitiveness and growth potential - is not yet sufficient in the euro area. External rebalancing is ongoing, but progress has been asymmetric and there has not been an adjustment of large current account surpluses. Labour markets are showing signs of improvement, but levels of unemployment remain elevated and rising long-term unemployment risks becoming entrenched, further worsening poverty rates. In this context, ambitious structural reforms have the potential to facilitate the necessary economic adjustment within the euro area and to boost growth in the countries that implement them. If carried out jointly across Member States, they offer benefits to the euro area as a whole through positive spillover effects. But the correction of accumulated imbalances will still take time. Some of the short term impact of structural reforms on economic activity may be negative when monetary policy is constrained at the zero lower bound (i.e. when interest rates are close to zero and cannot be reduced much further). However, the reforms can be tailored to minimise any short term negative effects. The idea that delaying structural reforms into the foreseeable future would improve economic conditions at the zero bound is therefore not supported.

- **Coordination of fiscal policies** remains sub-optimal. The aggregate fiscal picture in the euro area has improved considerably since the crisis began and the aggregate fiscal stance is broadly neutral, which could be considered as an acceptable balance between ensuring sustainability and stabilising the business cycle. However, there are large differences among Member States, which do not always reflect the size of fiscal challenges and their obligations under the Stability and Growth Pact (SGP). While some countries fall short of their SGP obligations, others still have room for manoeuvre under the SGP rules. Improved coordination would support growth in the euro area as a whole if those Member States which do not have fiscal space would make efforts to regain it, and those Member States that do have fiscal space use the opportunity to encourage domestic demand, with a particular emphasis on investment. Potentially large and beneficial spillover effects on growth could be generated through more coordinated action. Using the flexibility of the SGP rules will support Member States in implementing their investment plans and structural reforms. Fiscal strategies are not yet sufficiently growth-friendly. On the revenue side, tax systems are not yet efficient enough and taxes on labour are too high, in spite of recent improvements encouraged by increased coordination within the Eurogroup. On the expenditure side, public investment backed by sound cost-benefit analysis and other public expenditure with strong and positive growth effects is too low. Spending reviews have emphasised the need for efficiency gains in public administration.
- **Financial market conditions** in the euro area have been improving, but lending to the private sector remains weak and financial market fragmentation remains too high. The launch of the EU Investment Plan, alongside the ECB's expanded asset purchase programme, still awaits accompanying action in the broader financial sector to boost credit provision. The single rulebook is not yet consistently applied across euro area banks. The process of diversifying funding sources towards more market-based financing has not yet gained pace. Better integrated and more efficient capital markets would mobilise further funding for investment, make the European economy less dependent on banks and make its financial structures more balanced and more stable.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK FOR THE EURO AREA

The euro area is continuing its ongoing recovery and for the first time since 2007, all its economies are expected to grow again this year. However, the recovery remains sluggish. While the fall in oil prices and supportive policies are expected to support growth, weak investment, a slowdown in growth among the euro area's major trading partners and a deteriorating geopolitical situation weighs on the short-term outlook. Very low inflation, fuelled by slack in the economy and falling energy and food prices, increases the challenges of debt reduction and relative price adjustment, while heterogeneity in debt levels and competitiveness persists. Regional and cyclical divergences have been exacerbated in the euro area as both the economic and financial challenges faced by Member States, along with the speed at which national authorities have tackled them, has varied. A moderate recovery is nevertheless expected in 2015 and 2016, but risks to the economic outlook continue to be tilted to the downside.

The persistently low growth is in part a direct legacy of the economic adjustment which followed the global financial and economic crisis and affects the short term economic outlook. Confidence has been weakened and deleveraging pressures remain in both the private and the public sector. Internal and external adjustment is taking place, but is highly asymmetric across countries. Potential growth has fallen through a contraction in capital formation and high unemployment rates, with an increase in structural unemployment. The persistently low growth is also related to a number of medium term challenges which were apparent already before the crisis, such as low total factor productivity and demographic ageing. Growth prospects are also limited by a weak investment environment and high unemployment. In addition, structural rigidities persist within national labour and product markets, which slow down monetary policy transmission and prevent the rapid adjustment of the real economy in the face of negative economic shocks. Financial market fragmentation along national borders has diminished, but has not yet returned to pre-crisis levels.

While many of the problems currently faced by the euro area are also faced by other advanced economies, weaknesses in the setup of Economic and Monetary Union (EMU) contributed to the depth of the crisis in the euro area. There has been growing awareness of the need to address deficiencies in EMU governance and strengthen its architecture to make it robust and resilient. The complex system of interacting economic variables and the high interdependence between Member States in a monetary union underscores the importance of a consistent and coordinated approach at both national and euro area levels. This has been emphasised by the recent crisis, which demonstrated that the cross-border transmission of shocks can be rapid and large, and that common shocks can have very asymmetric effects on growth across countries, due to the persistent and large differences in economic and institutional structures at Member State level. The unique EMU set-up underscores the need for a cooperative approach to achieve a more coordinated private and public adjustment to support domestic demand in the short term and to stimulate structural change to increase growth potential in the longer term. The euro area is more than a simple sum of its parts. The crisis-induced shocks and uncoordinated policy responses during the crisis spilled over national borders and created existential risks for the entire euro area. In the same way, close coordination of policy measures across Member States can create positive synergies, trigger virtuous feedback loops between policies and spur positive spillovers across Member States.

The recommendations addressed to the euro area in the context of the European Semester have already proven their value in fostering stronger policy coordination in the euro area. The increased ownership of the euro area recommendations by the Eurogroup has facilitated progress on a number of important policy areas over the last year. As a result, the review of the draft budgetary plans has led to firm commitments taken by Member States to adjust their fiscal policies. The Eurogroup has thoroughly discussed reform plans and fostered common understanding on important issues such as the potential benefits of structural reforms, including those to address high taxes on labour, and the effects of asymmetric economic adjustment within EMU. This has helped to find common understanding on current policy challenges, pinpoint best practices and helped to better coordinate policy responses into directions favourable to growth.

Sustaining and strengthening this recovery requires continued and determined policy efforts. Structural, fiscal, financial and monetary policies, combined in an integrated, growth-friendly approach, would tackle persistent low growth, acting both on the demand and supply sides of our economies. The key challenges for the euro area are to:

(i) support a balanced adjustment in the private and public sectors,
(ii) increase the economy’s growth potential in the medium to long term, and
(iii) complete the EMU architecture.

A vital role will need to be played by investment. Broad policy solutions are also needed to close the output gap and increase potential output to secure Europe’s long-term future, also in light of the EU's ageing population.

Short term challenges: The assessment of 2015 draft budgetary plans points to scope for better coordination of differentiated fiscal responses by the euro area Member States. Member States which do not have fiscal space need to work to regain it, while countries with more fiscal space should use the opportunity to encourage domestic demand, and in particular to promote investment. This would support growth and help to tap positive spillover effects in the euro area. The investment plan will help improve growth-friendliness of fiscal policy and prioritise productive investment opportunities. Monetary policy actions will also play an important role in supporting confidence and growth through the standard and non-standard monetary policy measures that have been announced. However, their effectiveness will also depend on the reform actions in the other policy domains – fiscal and structural – on the level of ambition in their design and determined implementation.

Medium-term challenges: Well-designed and properly implemented structural reforms in the labour, product and financial markets are still not being implemented quickly and forcefully enough. The correction of accumulated imbalances will still take time, however. While some of the short-term impact of structural reforms on economic activity when monetary policy is constrained at the zero lower bound (i.e. when interest rates are close to zero and cannot fall much further) may be negative, these effects are likely to be small and depend on the measure adopted. Measures can be tailored to minimise any short-term negative effects. Therefore, the idea that delaying structural reforms would improve economic conditions at the current juncture is not supported[1]. Moreover, when a number of countries implement these reforms in parallel, so as to tap positive spillover effects, the benefits effects can be magnified. An important part of these beneficial effects will come from removing regulatory bottlenecks to investment, making progress in areas such as services, energy, telecoms and the digital economy, improving general conditions for business, implementing labour market reforms, improving access to long-term financing and completing the Banking Union to address financial fragmentation and ensure financial stability.

In the long term, the challenge is to address the weaknesses in the EMU's architecture.

2. STRUCTURAL ISSUES

2.1. Structural reform policy

The 2014 Country Specific Recommendations for the euro area called for the implementation of structural reforms in the euro area - to encourage growth, convergence and adjustment of internal and external imbalances**.** The need to monitor, assess and stimulate progress in delivering reform commitments was emphasised, in particular for euro area Member States experiencing excessive imbalances and requiring decisive policy action and with a view to limiting undesirable spillovers to the euro area as a whole. The recommendation called for appropriate policies in countries with large current-account surpluses, in order to contribute to beneficial spillovers. Finally, the recommendations also proposed regular thematic discussions on structural reforms in the labour and product markets with potentially large spillovers, with a focus on reducing the high tax wedge on labour and reforming services markets.

Overall, some progress has been made on implementing structural reforms in 2014 (see annex table). However, overall, the pace of implementation of structural reform in the euro area as a whole has not increased during 2014.

External rebalancing in the euro area is progressing. Current account adjustments in a number of countries in the euro area have moved from very high deficits before the crisis to balanced or surplus positions. A large share of this adjustment is non-cyclical and is not expected to dissipate once the overall economic situation improves[2]. An important consequence of these achievements is that the euro area as a whole has an increasingly positive current account. It increased from a deficit of 0.8% of GDP during 2008 to a surplus of 2.0% of GDP in 2013 and 3.2% in 2014 (see Figure 1). Adjustment in debtor countries has driven much of the rebalancing at the euro area level, with creditor countries not adjusting their surplus positions. Current account surpluses are not as risky as large deficits, but require monitoring and possible policy action, since they signal the possibility of subdued domestic growth and economic resources which have not been allocated efficiently.

The debt legacy still dampens activity. Despite the adjustment in flows, external liability stocks remain high, particularly in some countries (see Figure 2). For a number of countries,

[1] See 'Structural reform at the zero lower bound', Quarterly report on the euro area, Vol.13, Issue 3, 2014.
[2] See the *Quarterly Report on the Euro Area*, Volume 13, No 4, European Commission.

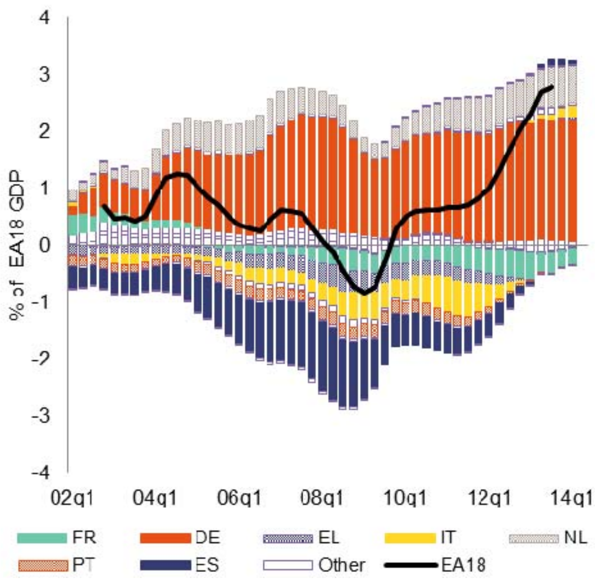
net foreign liabilities (NIIP) were close to or above annual output in 2013. Few have recorded a recent improvement. A dominant share of net foreign liabilities in adjustment programme countries is composed of debt, presenting sustainability risks. To reduce the high levels of external indebtedness to more sustainable levels, the improved current account balances need to be sustained in the future and, in some case, further improvements might be required through still higher trade and current account surpluses.

Some factors are currently complicating the adjustment process. Ongoing efforts to regain competitiveness and balance external positions are made more arduous due to lower-than-expected inflation and growth in the presence of downward price and wage rigidities. This environment implies a transfer of resources from debtors to creditors. The very low levels of inflation, while helping to support consumption, make the adjustment in relative prices within the euro area more difficult. While an important challenge for debtor countries is to avoid reform fatigue and continue to implement reforms and policies to consolidate their position, adjustment in creditor countries could generate positive spillovers for the rest of the euro area. The current euro depreciation, the fall in oil prices and non-standard monetary policy measures are expected to support rebalancing in particular in debtor countries. This is due to their generally higher export price elasticities, higher energy intensity and given their generally higher bond spreads and relatively blocked bank lending channels. Internationally, the euro area must be seen to credibly follow appropriate policies to promote economic adjustment.

Deleveraging by firms and households is under way. The reduction in outstanding stocks of private debt is still at an early stage[3]. The high external debt in some euro area countries is a reflection of the high indebtedness of both private and public sectors. In particular, deleveraging pressures in the private sector, affecting households as well as businesses hold back private consumption and investment. Such pressures have partly receded from the pre-crisis level. Negative credit flows have so far been the main driver of the reduction of debt/GDP ratios, leading to significant knock-on effects on economic activity. Sluggish or even negative GDP growth has played against the reduction in the indebtedness ratios.

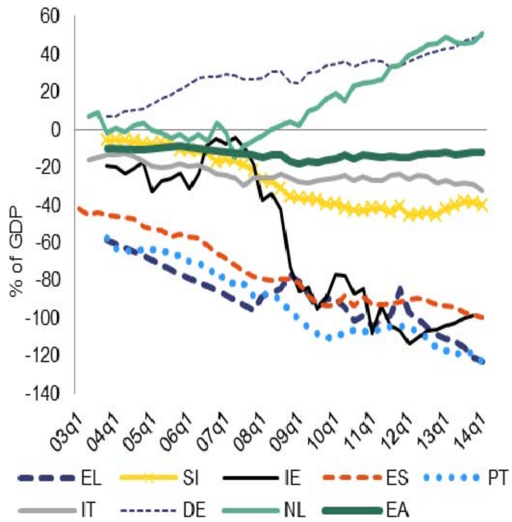
[3] See 'Private Sector Deleveraging, where do we stand', *Quarterly Report on the Euro Area*, Volume 13, No 3, European Commission.

Figure 1: Contributions to euro area current account balance (% of euro area GDP)



Source: European Commission. Note: The euro area current account is calculated as a sum of the individual current accounts of the Member States and is a four quarter moving sum.

Figure 2: Net international investment position for highly indebted countries (% of GDP), 2013



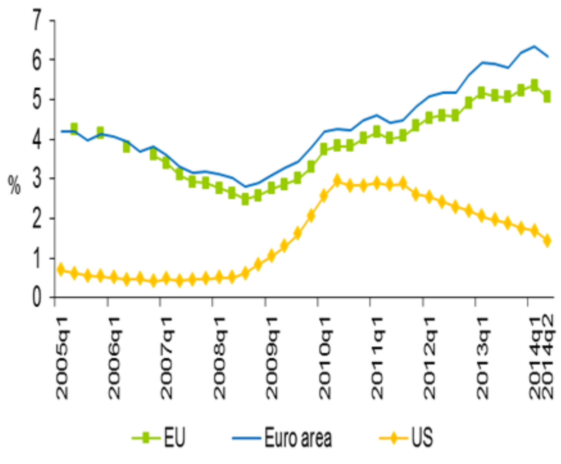
Source: European Commission.

Remaining deleveraging needs are still high in several economies. Private sector deleveraging needs are in excess of 30% of GDP in a number of countries, including some that have already seen a significant reduction in private indebtedness. Due to weaknesses in credit market conditions and private balance sheets requiring a higher pace for this adjustment, active deleveraging can be expected to continue.

Cyclical divergences are high among euro area Member States. Cyclical differences are to some extent inevitable in a monetary union (reflecting different economic structures, institutions and resilience, as well as adjustment to economic shocks). However they present a concern if excessive and persistent over time. The large cyclical divergences currently observed in the euro area can mainly be explained by large heterogeneity in Member States' economic structures, inadequate national economic policies, insufficient cross-border integration and shortcomings in EMU architecture, including inadequate risk sharing via financial and capital markets. It also shows that adjustment to shocks, notably those of a financial nature, remain slow in the euro area, particularly when fiscal policy is constrained and in the absence of a fully-fledged banking union.

Labour markets are improving, although unemployment rates still remain high. In 2014, for the first time since the beginning of the crisis, a small convergence in labour market conditions was observed, with unemployment decreasing also in those euro-area Member States that had recorded the highest increases in unemployment following the sovereign debt crisis. The unemployment rate remained broadly stable in countries with low levels of unemployment. A lack of overall labour market improvement was recorded in some of the countries with unemployment rates above 10% and the differences in unemployment rates among countries reached 20 percentage points. With long-term unemployment reaching close to 50% of total unemployment in 2014 (see Figure 3) and youth unemployment remaining high, the risk remains that some of the high rates of unemployment could become structural. The process of reallocation of resources away from the non-tradable sector towards the tradable sector continued in the adjustment programme countries, supported by more moderate wage developments in the non-tradable sectors. Tailor made policies are needed in addition to relative wages adjustment, to promote a faster reallocation of resources across sectors and help address long term unemployment. Important skill mismatches obstruct better labour market conditions in a number of Member States with a specific need to pursue policies addressing the low-skilled labour force. Measures encouraging life-long learning are not sufficient to tackle the challenge of an ageing work-force and labour mobility.

Figure 3: Long-term unemployment (for one year or more) in the EU, the euro area and the US (% of total labour force)



Source: European Commission and U.S. Bureau of Labor Statistics.

The social situation in the euro area has not significantly improved, following the post-crisis deterioration. The most recent data available shows that overall at-risk of poverty and severe material deprivation rates started to decrease on a year-on-year basis in 2013, to 16.7% and 7.4% respectively. However, the share of people living in very low work intensity households and the in-work poverty rate increased slightly to 10.9% and 11.5%, largely driven by trends in the countries most hit by the crisis. The poverty gap also continued to increase to 24.0% in 2013, due to continued negative developments in euro-area countries facing steep adjustments. Those countries most severely hit by the crisis have continued to see their poverty and severe material deprivation rates increase steeply and a number of Member

States have seen their national income levels fall. The possible effects of social developments on long-term growth and public debt sustainability are multiple[4]. Poverty can negatively affect productivity via poor access to education and health services, while inequality can have negative effects on growth through higher private debt accumulation and lower consumption growth. The high rates of youth unemployment and the increase in long term unemployment have negative long run social and economic implications. Long term unemployment is one of the factors most closely linked to poverty in Europe.[5]

Large rigidities remain in the regulations of labour and product markets of euro area countries, hampering the Single Market. Such rigidities may inhibit Member's States ability to adjustment to economic shocks, hindering the smooth functioning of EMU.

Potential growth fell in nearly all euro area countries between 2007 and 2013. The fall was sharpest in the most economically vulnerable euro area Member States and in the Baltic States. Hence Member States with income levels below the euro area average have seen their potential growth fall most. In some of these countries, a rise in unemployment was aggravated by adverse developments in working age population and participation rates. This fall in labour input was the main factor behind the fall in potential growth. The contribution of capital and total-factor productivity to potential growth was also reduced in all Member States between 2007 and 2013.

A renewed commitment to structural reforms to boost competitiveness and growth potential is needed. In the run-up to the introduction of the euro, there was a belief that the common currency itself would work as an incentive for reform as the exchange rate would no longer be available to improve competitiveness. This did not materialise and the record on structural reforms has been far from satisfactory. Since the crisis, ambitious structural reforms have been undertaken in a number of euro area countries, particularly the programme countries. These have continued in 2014, contributing to ongoing adjustment. However, reform progress across the euro area Member States remains well below the levels set by the individual Country Specific Recommendations. In addition, their effective implementation has sometimes stalled, and there is a risk of reforms back-sliding as soon as acute financing needs subside and economic conditions improve. The implementation of appropriate reforms in all euro area countries would help to stimulate domestic demand and facilitate the efforts to restore competitiveness and growth in the euro area. Furthermore, model simulations show that implementing structural reforms in multiple countries of the euro area simultaneously would lead to larger output gains than if countries act alone (see Box 1).

The utilisation of labour and capital in the euro area is too low. Well-designed reforms, through their effects on growth, productivity and employment, can lessen the negative impact of the necessary financial deleveraging in the private sector and help prevent harmful macroeconomic imbalances and damage to the overall social situation. Policies that help increase investment in particular are critical. An increase in investment in the large euro area

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[4] Darvas, Z. and G. Wolff, 'Europe's social problem and its implication for economic growth', *Bruegel Policy Brief*, Issue 03, 2014.Cingano, F. (2014), “Trends in Income Inequality and its Impact on Economic Growth”, OECD Social, Employment and Migration Working Papers, No. 163, OECD Publishing. .

[5] See "Poverty development in the EU after the crisis", M. Duiella and A. Turrini (2014), *ECFIN Economic Brief*, Issue 31, May 2014.

countries would generate positive spillovers for the rest of the euro area[6]. In this context, the Commission's Investment Plan for Europe was launched in November 2014. It is based on three mutually reinforcing strands. 1), the mobilisation of at least EUR 315 billion in additional investment over the next three years via specific risk-financing instruments, maximising the impact of public resources and unlocking private investment. 2), targeted initiatives to make sure that this extra investment meets the needs of the real economy. 3), measures to provide greater regulatory predictability and to remove barriers to investment, making Europe more attractive for investment. Simultaneous action in all three areas is essential to restore confidence and reduce the uncertainty impeding investment.

Stepping up the implementation of reform is essential for the euro area. The lack of exchange rate flexibility as an adjustment mechanism implies that other economic variables have to adjust to absorb shocks or to allow the economy to adapt. Furthermore, in many euro area countries, the higher share of the non-tradable sectors in employment and value added than at the beginning of the 2000s makes it more difficult for these economies to adapt to competitiveness pressure This can have adverse effects on the competitiveness of the whole economy.[7] Therefore, the functioning of the labour and product markets needs to be improved to allow for sufficient flexibility and to avoid translating imbalances or shocks into long-term unemployment.

The potential gains from structural reforms can be significant. Reforms typically take time to deliver their full effects. There are signs that reforms underway are showing early signs of success.

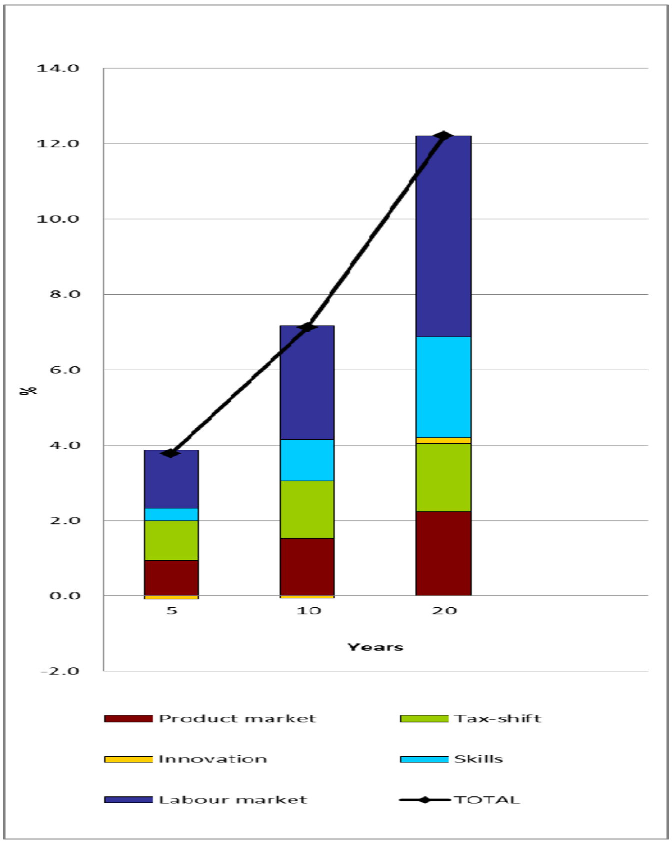
Box 1 sets out comparable economy-wide estimates of the impact of reforms using QUEST simulations.

[6] See 'Cross-border spillovers in the euro area' *Quarterly report on the euro area*, Volume 13, No. 4, December 2014.

[7] In some countries, a shift in structure towards tradables has started to take place: the share of value added in tradables increased in 7 euro area countries, while it barely changes over the period 2008-2013 in once country and decreased in the other euro area countries.

Box 1: The potential growth impact of structural reforms in the euro area

Figure 7: GDP effects by reform areas after 5, 10, and 20 years



Source: Varga and in ’t Veld (2014), % difference from baseline.

The euro area could reap significant benefits from structural reforms. Output could be 7% higher after 10 years, with higher employment and improved fiscal positions, according to a model-based analysis using the QUEST model of the European Commission. This benchmarking methodology is based on structural indicators in areas such as market competition and regulation, labour market and skills, tax structure and R&D, and applies a distance-to-frontier approach to quantify the potential for reform by assuming a gradual and partial closure of the gap from the average of the three best EU performers (see Varga and in’t Veld, 2014 for detailed explanation).[8] In order to avoid setting unrealistic and/or unattainable targets, the scenarios involve only half of the gaps being gradually closed.

Figure 7 shows the GDP effects for the reform areas in the euro area, assuming all Member States undertake similar reform measures in these areas. In the short run labour market reforms (increased participation, active labour market policies, and benefit reforms), tax reforms (shifting taxation towards indirect taxes) and product market reforms (higher competition in services sector and lower entry costs) have the largest effects. Skill-enhancing and R&D promoting policies have a major impact on GDP in the very long run, and account for more than one third of the long-term GDP effects. (See Varga and in ’t Veld, 2014).

[8] Varga and in ’t Veld, 'The potential growth impact of structural reforms in the EU. A benchmarking exercise', *European Economy Economic Papers*, 2014, pp.541.

Structural reforms in one country can have positive spill-overs into other countries. These may include: i) trade-spillovers from reforms that boost demand. For example, market liberalisation efforts by an exporting country may help to increase productivity in an importing country via better quality intermediate inputs; ii) reforms that make investment more attractive, in particular FDI, can help to channel investment flows; iii) reforms improving labour mobility and resource allocation in individual countries may also help to promote it at the euro area level; iv) by boosting confidence, structural reforms can also have a positive effect on the euro area. Coordinated reform efforts can help communicate the broader welfare effects of structural reform.

A number of structural challenges are more pressing, also in view of the potential benefits for the euro area as a whole, which can be reaped from their speedy implementation. In products markets, progress in areas such as services, energy, telecoms and the digital economy has the potential to create positive growth spillovers across Member States and together with improving general conditions for business (e.g. administrative simplification) would create new opportunities for investment, job creation and growth. Reforms aimed at improving competition in non-tradable sectors would support adjustment, spur investment and facilitate the development of these sectors. In the labour market field, reform helps to reallocate resources towards the most dynamic sectors and support adjustment and competitiveness. Reducing the high tax burden on labour remains important (see also Section 2.2 below). Given the increasing incidence of long-term unemployment, enhancing both active and passive labour market policies to improve skills performance and prevent further losses of human capital and labour market marginalisation would be beneficial.

2.2. Fiscal policy

The 2014 Country Specific Recommendations for the euro area called for coordination of the fiscal policies of the euro area Member States within the Eurogroup. This included in particular an assessment of draft budgetary plans to ensure a coherent and growth-friendly fiscal stance across the euro area. The recommendation pointed to the need to improve the quality and sustainability of public finances by prioritising investment at national and EU levels. Finally, emphasis was placed on the need to ensure that national fiscal frameworks, including national fiscal councils were strong.

The aggregate fiscal picture for the euro area continued to improve in 2014. Some progress was made on the coordination of fiscal policies. The fiscal outlook for the euro area as a whole improved and the aggregate fiscal stance seems appropriate. After falling below 3% of GDP in 2013 for the first time since 2008, the nominal deficit in the euro area is expected to fall to 2.6% of GDP in 2014 and 2.2% of GDP in 2015 according to the 2015 Winter Economic Forecast. The aggregate debt ratio is however expected to remain virtually unchanged in 2015 from around 94.3% of GDP in 2014 before starting to fall to 94% of GDP in 2016 (see Figure 8). For many countries the debt ratio will still continue to increase beyond 2015.

There is still some way to go to reach sustainable budgetary positions. Following a halt in consolidation efforts in 2014, euro area Member States on aggregate do not plan to resume fiscal consolidation in 2015. This is suggested by the different measures of structural budgetary adjustment - both the discretionary fiscal effort[9] and the change in structural balance show no adjustment in 2015 (see Figure 8). Following several years of sizeable fiscal effort and in the current context of low growth and low inflation, a broadly neutral aggregate fiscal stance appears broadly appropriate. The absence of fiscal tightening at the euro area aggregate level reflects in part the need to secure an appropriate balance between sustainability requirements and cyclical stabilisation concerns.

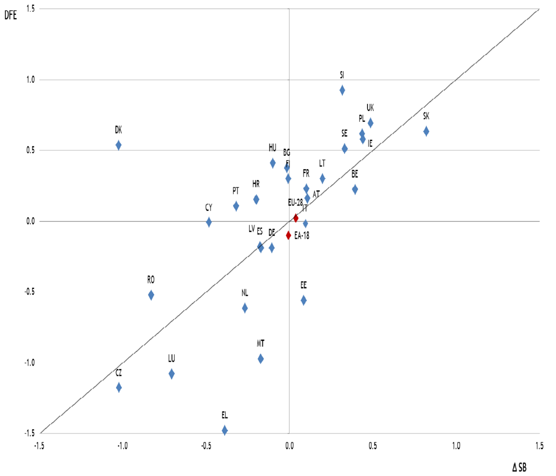
Coordination of fiscal policies remains sub-optimal. Large differences between countries remain, creating risks for the euro area as a whole (see Figure 9). Member States with more fiscal space now have the opportunity to take measures to encourage domestic demand, with a specific emphasis on investment. Fiscal buffers have not yet been restored, while sustainability concerns and high and increasing debt ratios remain to be addressed decisively in countries where these are present. Without further efforts to restore their buffers, Member States and the euro area as a whole remain vulnerable to adverse economic shocks. One of the key policy challenges facing the euro area is to reduce government debt by pursuing differentiated, growth-friendly fiscal policies while boosting the growth potential of the euro area[10]. Attention is increasingly being focused on sub-optimal coordination of fiscal policies within the EU rules-based framework. Those Member States which do not have fiscal space should work to regain it, and those Member States with fiscal space should use the opportunity to encourage domestic demand, with a particular emphasis on investment. Simulations considering the effects of a temporary two-year increase in government investment in countries with fiscal space of 1 % of GDP and identify a persistent positive effect on growth, with a multiplier of between 0.8 and 1. Import leakage lead to relatively high spillovers to other euro area countries, boosting GDP by between 0.2 and 0.3 %[11].

[9] The Discretionary Fiscal Effort consists of a "bottom-up" approach on the revenue side and an essentially top-down approach on the expenditure side (see also '*Public Finances in EMU* '– 2014, European Commission).

[10] See for example Goujard, A. 'Cross Country Spillovers from fiscal consolidations' OCED Economics Department Working Papers, No.1099, 2013 and In't Veld, J. 'Fiscal consolidations and spillovers in the euro area periphery and core', *European Economic Papers*, no.506.

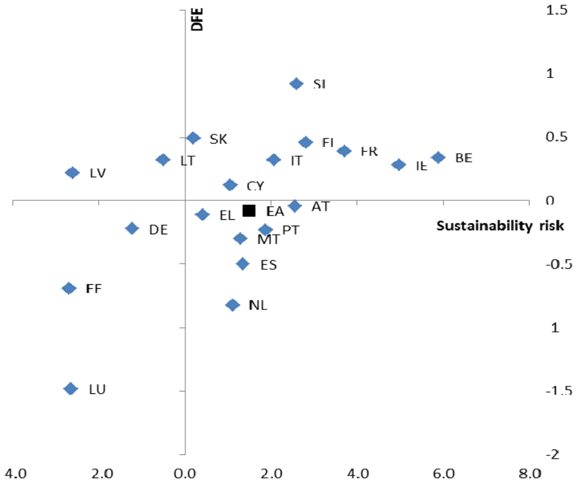
[11] See 'Cross-border spillovers in the euro area' *Quarterly report on the euro area*, Volume 13, No. 4, December 2014.

Figure 8: The discretionary fiscal effort and the change in the Structural Balance in 2015 (% of GDP)



Source: European Commission.

Figure 9: The degree of sustainability risk and the projected discretionary fiscal effort in 2015.



Source: 2015 Winter Forecast, European Commission. Notes: The degree of sustainability risk is measured by the S1 indicator, indicating (in percentage points of potential GDP) by how much the structural balance needs to change by 2020 compared to its 2014 level for the debt-to-GDP ratio to reach 60% in 2030. The fiscal effort is measured by the projected Discretionary Fiscal Effort in 2015.

Member States are required to ensure full compliance with the Stability and Growth Pact. Given that eight[12] of the euro area Member States remained in Excessive Deficit Procedure in 2014 and that only two of the Member States in the preventive arm are expected to be at or above their medium-term objectives in 2014-15, the lack of structural adjustment appears to point to a shortfall with respect to the requirements of the Stability and Growth Pact for the euro area as a whole[13]. The EU fiscal framework encourages a differentiated and growth friendly fiscal consolidation. The Stability and Growth Pact allows Member States to pursue differentiated fiscal strategies that take account of their individual circumstances. Countries that are facing larger fiscal challenges are required to implement larger consolidation efforts. The medium-term objectives represent the sound fiscal positions, which

[12] France, Ireland, Malta, Portugal, Slovenia, Spain, Greece and Cyprus

[13] The aggregate structural adjustment can only be viewed as illustrative in this respect, as it fails to capture the important differences across Member States vis-à-vis the requirements of the Stability and Growth Pact, which are the subject of the Commission's country-specific assessments. In addition, any conclusion on the overall consolidation effort based on the change in structural balance should be qualified, as the structural balance may not always give an accurate picture of the underlying fiscal effort due, for example, to an unusual response of revenue to economic growth.

take into account the need to create buffers against excessive deficits and ensure debt sustainability.

Flexibility in the Stability and Growth Pact makes it possible to preserve growth in the short term. In particular, for the increasing number of Member States in the preventive arm, fiscal effort can be adapted to the economic situation and take into account the implementation of substantial structural reforms. The Investment Plan for Europe will help increase potential growth by encouraging greater productive investment. In particular, in conducting assessments under the Stability and Growth Pact, the Commission will take a favourable position towards any capital contributions to the European Fund for Strategic Investments.

The quality of public finance has not improved sufficiently. The overall quality of expenditure results from the combination of two main factors: (i) the composition of expenditures and in particular the share of more growth-friendly spending items; and (ii) the efficiency of expenditures, i.e. how well public resources are translated into services to citizens and business. There is considerable space for the composition of fiscal strategies to be designed in a more growth friendly manner. While this is the case for all EU Member States, euro area Member States have a particular interest in ensuring that national budgets are used as an efficient adjustment mechanism. On the revenue side, the quality of public finances could be ensured through, for example, tackling tax fraud and inequality.

Box 2: Follow-up to the euro area recommendations – the tax burden on labour

For the great majority of euro area Member States the tax burden on labour is relatively high (around 40% or more of total labour costs). This negatively impacts labour market performance and economic activity. A crucial policy option is a shift away from labour taxes to more growth-friendly sources of revenue such as consumption, recurrent property and environmental taxes. These are underused in some countries. Shifting the tax burden away from labour stimulates labour supply and demand and contributes to firms' profitability, which in turn helps improve the return on capital and the incentives to invest.

Figure 10: **The tax burden on labour in the euro area and its composition (%), 2013**

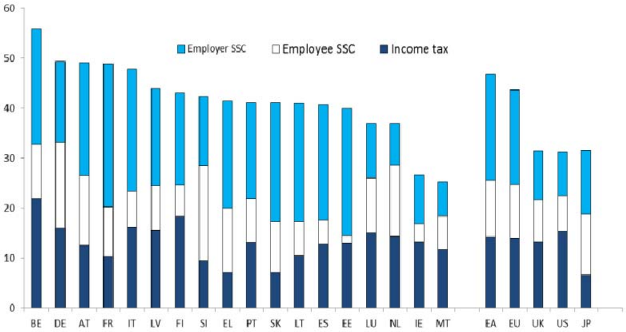


Figure 11: the development of the tax burden on low-wage labour in the euro area

Source: OECD and European Commission. Note: The measure shown – also called tax wedge – corresponds to the proportion of the cost of labour attributed to income tax and social security contributions (in %). The tax wedge is shown for a single worker with no children at the average wage in 2013 (Figure 10) and at 67% of the average wage (Figure 11). Recent data for Cyprus are not available.

During the crisis, efforts to reduce high taxation on labour faded and several Member States raised labour taxes to contribute to consolidation. The Council issued recommendations to individual Member States to address the high tax burden on labour and a recommendation to the euro area to discuss the issue given that the challenge is shared by many of its members and the potentially large spillovers involved, via demand and competitiveness effects.

The Eurogroup gave immediate follow-up to the recommendation by organising a number of thematic discussions. Open debate led to an agreement on common principles related to the design and the financing of labour tax reforms, as well as a firm commitment by Ministers to take work forward.

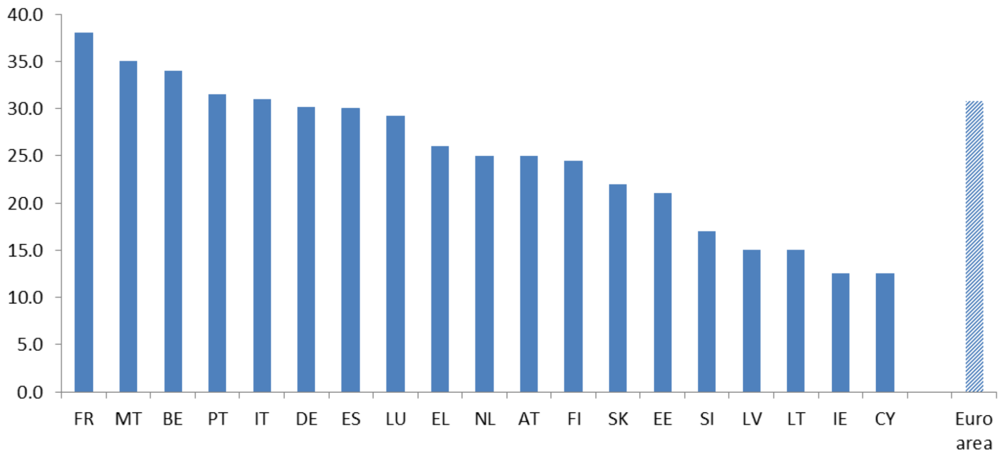
Inital stock-taking of implementation shows that the Eurogroup discussions have had an important impact on euro area Member States' awareness of the benefits of addressing high taxes on labour. Very few measures are being taken that increase the tax wedge while many Member States are planning or implementing measures to reduce the tax wedge. The common principles agreed in the Eurogroup are also well considered with Member States, for example, often targetting labour tax cuts specifically at lower income categories. There is also a need to avoid an over-complication for tax payers and the tax administration, to consider the broader labour market picture and to ensure political and societal support.

While the challenge and required policy direction is on the whole clear, it is important to continue to monitor implementation. Continued involvement of the Eurogroup could help ensure that the issue remains at the top of the policy agenda.

The Commission has consistently called for priority to be given to the composition of fiscal policies that boost growth. On the revenue side, this means ensuring an efficient and growth-friendly tax system. Particularly detrimental to growth are labour taxes (see Box 2). Shifts away from labour taxes to more growth-friendly taxes such as consumption, recurrent property and environmental have been taking place but these reforms remain relatively modest compared to the challenge. The average top corporate income tax rate in the euro area is not particularly high compared to other developed economies but rates differ significantly between Member States as illustrated in Figure 12. Differences in rates and bases can encourage tax competition. Differences may also create profit shifting possibilities, contributing to base erosion.

The composition of expenditure is not making significant progress towards being more growth-friendly. Details on recent trends in expenditure show an increase in some items that are considered to be less growth friendly, which may, however, reflect the activation of social safety nets to help mitigate the negative social effects of the crisis. At the same time, spending on more growth-friendly items like education or public investment has stabilised or in some cases fallen.

Figure 12: The tax burden on corporate income (%), 2014



Source: European Commission. Note: the euro area average is GDP-weighted. The measure shown is the non-targeted top statutory tax rate on corporate income ; existing permanent or temporary surcharges and local taxes are included. For details see European Commission, '*Tax reforms in EU Member States*', 2014.

Efficiency of expenditure in the euro area can be significantly improved. The quality of public spending can greatly benefit from a more systematic use of spending reviews as an integral part of the budgetary process, as a means to notably identify potential (least detrimental to growth) savings, reorient resources towards growth-inducing spending areas and achieve efficiency gains in the public sector, according to country-specific needs and priorities. Well-designed and thoroughly-implemented spending reviews lead to a 'smarter' expenditure allocation across national policy priorities which not only contribute to the attainment of fiscal targets but can also free up fiscal space for new or increased growth-enhancing spending or tax reductions[14]. While expenditure cuts are particularly advisable in countries with comparatively large public sectors, there may also be scope for some tax adjustment in countries with lower expenditure.

Robust and transparent national fiscal frameworks provide the foundations for responsible and sustainable fiscal policies in the euro area. 2014 brought the full entry into force of the legal requirements aiming to strengthen euro area Member States' national fiscal frameworks: the Directive[15] on budgetary frameworks, the Regulation[16] on enhanced budgetary monitoring and the Fiscal Compact[17], which fully applies for all euro area Member States. This legislation provided the opportunity for euro area Member States to review their domestic fiscal governance arrangements and proceed to significant reforms, sometimes amounting to a complete overhaul of fiscal rules, procedures and institutions. Reforms have touched all the main building blocks of national fiscal frameworks:

[14] See Vandierendonck, C., 'Public spending reviews: design, conduct, implementation', *European Economy Economic Papers* No, 525, July 2014

[15] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

[16] Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

[17] The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

- The number and strength of fiscal rules has been on the rise, with balanced-budget rules in structural terms becoming the central feature of reinforced fiscal frameworks in almost all euro area countries. While the latter are designed to target the medium-term objective or more ambitious fiscal objectives, the formulation of escape clauses and the constraining force of the correction mechanism in case of deviations may leave some room for slippages and the credibility of these new rules is still to be tested in the real public finance environment.
- The scope, quality and transparency of annual budgeting and medium-term fiscal planning have been upgraded. Moreover, these processes are being gradually aligned with the common milestones set out in the Two-pack.
- Independent institutions have been set up (or reinforced) with a mandate to monitor public finances, in particular fiscal rules in force, and to produce or endorse macroeconomic forecasts used for fiscal planning. However, such bodies are not yet in place in a few euro area countries and, more broadly, it is still early to judge the effective performance of these newly-established watchdogs and their impact on domestic fiscal policy.

Euro area Member States that are attempting to reap the full benefits of the "new generation" of national fiscal frameworks in the conduct of fiscal policy are facing two challenges:

i) Completing the design and adoption of outstanding reforms meant to transpose into national settings the requirements arising from the new EU fiscal governance set-up (noting that compliance with the relevant legal provisions is subject to ongoing checks by the European Commission);

ii) Ensuring the effective functioning of newly-established or upgraded fiscal frameworks so that they can play in full the envisaged role in pursuing a sound and sustainable fiscal policy in line with both domestic policy imperatives and EU Treaty budgetary commitments. This includes *inter alia* the full operationalisation of independent fiscal institutions and making the most of their accruing expertise for a more effective management of national public finances.

2.3. Financial sector policy

The 2014 Country Specific Recommendations for the euro area called for measures to ensure the resilience of the banking system. This included in particular by taking the necessary action in the follow up to the ECB's Comprehensive Assessment, by implementing the Banking Union regulations and by taking forward the further work foreseen in the Single Resolution Mechanism (SRM) transition period. The recommendations stressed the need to reduce financial fragmentation, stimulate private sector investment and increase the flow of credit to the economy via actions to improve access to credit by small and medium-sized enterprises (SMEs), deepening of capital markets and restarting the securitisation market. The recent crisis was characterised by large negative financial market spillovers - across sovereign bond markets and between sovereign and private risk. The analysis of bilateral spillover effects of sovereign credit risk in the euro area shows considerable heterogeneity across countries, with the economic adjustment program countries both being a source of spillovers themselves and also being vulnerable to stress from other Member States. The crisis partly reversed the financial integration trend which had been catalysed by monetary union, unleashing powerful fragmentation forces. The establishment, inter alia, of a Banking Union and implementation of the single rule book will help to break the link between sovereigns and banks. When combined with improved resilience of the banks, it is expected that more sustainable cross-border banking flows should grow in time.

Overall, substantial progress has been made in meeting these recommendations. More specifically, also with regard to the remaining financial sector policy challenges in the euro area:

Financial market conditions in the euro area have improved, but markets remain fragmented. In line with the evolution in ECB policy rates, euro area short-term money-market rates declined to near-zero levels. Similarly, euro-area government bond yields and spreads trended lower, supported in particular by (i) the impact of monetary policy measures, including the ECB's commitment to the outright monetary transactions (OMT) programme and large scale quantitative easing, (ii) a decline in long-term inflation expectations, (iii) a perceived reduction in credit risk in economically vulnerable Member States, (iv) strengthened frameworks for economic and fiscal governance, and (v) enhanced financial regulation and supervision. Euro area sovereign bond markets withstood temporary bouts of volatility linked to adverse geopolitical developments. In some market segments, financial fragmentation was partially reversed since mid-2013 but remains high by historical standards. Bank lending surveys continue to indicate differences in lending conditions across the euro area, to some degree driven by firm specific factors and trends in non-performing loans.

Despite improvements in funding costs, bank lending to the private sector remains weak. There is no conclusive evidence of a general funding gap in the euro area economy, with low levels of demand an important factor in explaining the limited expansion in credit. However, some frictions in financing flows are visible, in particular for longer-term infrastructure projects and for SMEs operating in the most economically vulnerable economies. Any constraints unduly restricting access to credit still need to be removed, so that funding gaps do not emerge and constrain economic growth once credit demand picks up.

To address low inflation, the ECB has adopted a number of standard and non-standard monetary policy measures. Inflation reached 0.4% on average in the euro area in 2014, well below the ECB's medium-term inflation objective. To support the firm anchoring of medium-term inflation expectations ECB policy rates were lowered to their effective lower bound. The interest rate for the main refinancing operations (MROs) was reduced to 0.05% in September 2014, while the interest rate on the deposit facility was set at -0.20%. In July 2013, forward guidance was introduced to influence more directly the term structure of interest rates. The ECB re-affirmed that key policy rates would remain low for an extended period, in line with the subdued outlook for inflation. Targeted long-term refinancing operations (TLTROs) were introduced to provide term funding of up to four years at a very low fixed interest rate. The ECB also took further non-standard measures, intervening directly in the markets for asset-backed securities (ABS) and covered bonds markets.

In January 2015, the ECB decided on a large scale quantitative easing programme. It announced that it planned to expand its asset purchase programme beyond asset-backed securities (ABS) and covered bonds to include euro-denominated, marketable, and investment grade bonds, issued by euro-area sovereigns and European institutions. Under this expanded purchase programme (EAPP), the combined monthly purchases by the Eurosystem of public and private sector securities will amount to EUR 60 billion until end-September 2016, and until a sustained adjustment in the path of inflation consistent with inflation rates of below, but close to, 2% over the medium term is reached. In addition, the ECB decided to change the pricing of the targeted long-term refinancing operations. The interest rate applicable to future targeted long-term refinancing operations will be equal to the rate on the Eurosystem's main refinancing operations prevailing at the time when each targeted long-term refinancing operations is conducted, thereby removing the 10 basis point spread over the main refinancing operations rate that applied to the first two targeted long-term refinancing operations. Markets reacted positively to the expanded purchase programme, which is expected to be large enough to have impact on wider macroeconomic developments in the euro area and induce the re-anchoring of medium to long term inflation expectations in line with the ECB's price stability objective of inflation rates below, but close to, 2%. This should in turn facilitate the deleveraging process throughout the euro area and support credit demand and investment. The effectiveness of this determined policy action by the ECB depends also on the determination and appropriateness of reform actions also in the other policy domains – including fiscal and structural.

Strong monetary stimulus is considered essential to help combat economic weaknesses and preserve price stability in the medium term, but these efforts are not yet accompanied by complementary actions in other fields, including in the financial sector. The results of the ECB Comprehensive Assessment and the EU-wide stress test coordinated by the European Banking Authority confirm a significant improvement in the capitalisation of European banks over the past 6 years. In the period from 2008 to 2013, capital in excess of EUR 200 billion was raised by the 130 banking groups participating in the ECB Comprehensive Assessment. Since January 2014 and before the completion of the CA in October 2014, a further EUR 57 billion was raised. This reflects significant bank recapitalisation efforts, driven by the new regulatory framework (the EU Capital Requirements Regulation & Directive), supervisory demands and market expectations. The ECB Comprehensive Assessment found a remaining capital shortfall of EUR 25 billion at 25 banks. Twelve of the 25 banks have already covered this shortfall by increasing their capital by a total of EUR 15 billion in 2014. Banks with shortfalls have prepared capital plans and have up to nine months to cover the capital shortfall. European banks are now much better placed to withstand financial shocks than before the crisis. This should reassure investors about the quality of EU banks' balance sheets and help to restore confidence, allowing banks to do their core function – lending to the real economy.

However, challenges remain and the adjustment of banks' balance sheets and governance structures is not yet complete. Considerable progress has been made to repair the financial sector in Europe, leading to stronger bank balance sheets and a better access to credit. In 2014, and for the first time in 7 years, euro area banks reported an easing of credit standards on loans to enterprises. The ECB's Bank Lending Survey suggests that conditions for credit growth in the euro area are gradually improving, but it remains to be seen whether these positive trends translate into net credit creation, since redemptions still outpace new lending in many countries. Bank lending will remain the main financing source for European businesses for some time, and banks have yet to restore their full lending capacity. To this end, further banking sector reforms are to be expected. Euro-area banks have still to move towards compliance with higher capital requirements under the capital requirements regulation and directive (CRD IV/CRR), which will have their full effect in 2019. In addition, banks will need to enhance their risk management, strengthen their governance structures and tackle profitability challenges. The business models of European banks can be made even more resilient to negative shocks, for example by enhancing the stability of bank funding sources. Moreover, banks' balance sheets remain under pressure from high levels of non-performing loans. In cases where firms' debt levels are not sustainable but their business models are deemed viable, actions to address non-performing loans include debt restructuring, better insolvency regimes or especially dedicated tools such as debt/equity swaps. Such instruments may be complemented by steps to ensure a better alignment between the tax treatment on debt and equity financing. The counterpart of addressing non-performing loans on bank balance sheets would be a necessary deleveraging in the private non-financial sector, in turn easing the post-crisis debt-overhang and helping to support economic activity.

Progress continues in the implementation of the Banking Union. The ECB Single Supervisory Mechanism (SSM) became operational as of 4 November 2014 and is now responsible for direct supervision of the most significant euro-area banks.

A consistent implementation of the Single Resolution Mechanism Regulation (SRMR) will complete the Banking Union architecture. In this respect, the establishment of the Single Resolution Board (SRB) is progressing. Permanent members of the SRB are expected to take up their duties in the coming months. The administrative and operational establishment of the Single Resolution Board is also on track, with the elaboration of bank resolution plans due to start this year.

Work progresses to establish a common backstop for the Single Resolution Fund (SRF) during the transition period, when national resolution resources of countries participating in the Single Resolution Mechanism will be gradually mutualised. In December 2014, Member States agreed on a statement ensuring equivalent treatment for the SRF between euro area Member States, backed by the European Stability Mechanism (ESM), and non-euro area Member States deciding to join the Banking Union.

Developing a more resilient financial system goes hand in hand with developing of alternative, diverse and resilient market-based financing channels. This becomes particularly important in light of Europe's high dependence on bank funding and as traditional bank funding channels are squeezed by deleveraging demands and business model adjustments to meet forthcoming regulatory changes. Compared to other economies, the euro area stands out as acutely bank-based. As to market financing, to the extent it has developed, it is heavily geared to debt financing, with equity financing playing a minor role. Research suggests that more diversification towards market-based funding can bring economic gains. Additional positive effects would come via greater financial stability as market-based financial structures are associated with lower systemic risk and higher economic growth in times of market tensions than bank-based models.

In order to diversify sources of external finance for companies and thereby contribute to economic growth, the European Commission is committed to delivering a capital Markets Union (CMU).

Commitments	**Summary assessment**
2014 Country specific recommendations (CSRs) for the euro area	
CSR1 Promote and monitor, in close cooperation with the Commission, the implementation of structural reforms in those areas most relevant for the smooth functioning of the euro area in order to foster growth and convergence and adjustment of internal and external imbalances. Assess and stimulate progress in delivering on reform commitments in euro area Member States experiencing excessive imbalances and in reform implementation in the euro area Member States with imbalances requiring decisive action, to limit negative spillovers to the rest of the euro area. Foster appropriate policies in countries with large current account surpluses to contribute to positive spillovers. Regularly hold thematic discussions on structural reforms in the labour and product markets with potentially large spillovers, focussing on reducing the high tax wedge on labour and reforming services markets.	The euro area has made some progress in addressing CSR 1: • Progress in delivering reform commitments has notably 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 country's 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 assessment of the implementation of country specific reform commitments in the individual Member States suggests that around [50]% of recommendations have seen at least some progress in the euro area as a whole. • The Eurogroup has held a number of discussions related to fostering appropriate policies in countries with large current account surpluses, e.g. in the context of the DBP assessment. • The Eurogroup has held two thematic discussions in July and September on reducing the high tax wedge on labour and one will take place in March on reforming services markets.
CSR2 Coordinate fiscal policies of the euro area Member States, in close cooperation with the Commission, in particular when assessing draft budgetary plans to ensure a coherent and growth-friendly fiscal stance across the euro area. Improve the quality and sustainability of public finances by prioritising material and immaterial investment at national and EU levels. Ensure that national fiscal frameworks, including national fiscal councils, are strong.	The euro area has made some progress in addressing CSR 2: • Some progress has been made on the coordination of fiscal policies, to the extent that fiscal outlook for the euro area as a whole has improved and the aggregate fiscal stance seems appropriate. However, the coordination of the fiscal policies remains sub-optimal. Discussion has taken place in the context of the DBP assessment. • The Commission has published on 13 January a communication on the best use of the existing flexibility in the Stability and Growth Pact, including by facilitating investment. • Limited progress has been made on improving the quality and sustainability of public finances, which is a topic for upcoming thematic peer reviews in the EPC. • Discussion has taken place at technical level and

	at the Eurogroup and ECOFIN on the issue of promoting investment, including prioritising material and immaterial investment at national and EU levels. • Technical discussions have taken place on national fiscal frameworks, including national fiscal councils.
CSR3 Ensure the resilience of the banking system, in particular by taking the necessary action in the follow up of the asset quality review and the stress tests, and by implementing the Banking Union regulations and taking forward the further work foreseen in the SRM transition period. Stimulate private sector investment and increase the flow of credit to the economy via actions to improve access to credit by SMEs, deepening of capital markets, restarting the securitisation market, based on the proposals and the calendar in the Commission Communication on long-term financing of the European economy.	The euro area has made substantial progress in addressing CSR 3: There has been substantial progress in steps to ensure the resilience of the banking system: • The ECB Comprehensive Assessment (CA), including the EBA coordinated EU-wide stress test, was successfully concluded in October 2014 and confirmed a significant improvement in the capitalisation of European banks over the last years. The follow up to the CA is underway. Banks with remaining shortfalls have prepared capital plans and have up to nine months to cover them. • With regard to implementing Banking Union, the SSM officially took over its supervisory tasks on 4 November 2014. One of its main priorities is to ensure a level playing field across European significant banks, not only in terms of their supervision, but also in terms of consistent application of the single rulebook. • Steps towards the operational establishment of the Single Resolution Board (SRB) are also on track. Permanent members of the SRB are expected to take up their duties in the coming months, with the elaboration of bank resolution plans due to start this year. • The rules for the risk-adjusted calculation of the contributions of banks to the resolution funds under the Bank Recovery and Resolution Directive (BRRD) have been agreed. There has been some progress in stimulating private sector investment and increase the flow of credit to the economy, by various measures: • In the context of public actions aimed to stimulate private investment directly, European Commission's Investment Plan was launched in November 2014. It will provide for better integration and diversification of European funding markets and act as a catalyst for private sector investment. • The Regulation on European Long-term Investment Funds (ELTIF) will provide a common EU regulatory framework and pass-porting rights for funds specialising in long term investments, for example in infrastructure

	projects or SMEs. The ELTIFs should be operational by mid-2015. • The European Commission has announced to work towards a capital markets union (CMU) to achieve a greater market size and depth and develop a true single market in financial services. • One of the Commission's near-term priorities is the development of a sustainable EU securitisation market. In this context, the Commission is developing an approach that introduces more risk sensitivity into the framework. The adoption of "high-quality" criteria in October within the Commissions' Delegated Acts on Solvency II (for insurer capital rules) and LCR (for bank liquidity rules) represents a first step in this direction. Additional public and private initiatives are needed to develop sound, deep and liquid securitisation markets in the EU.
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 reviews foreseen for end 2014.	The euro area has made some progress in addressing CSR 4: • The Commission presented the Communication on the review of the Six- and Two-Pack legislation as a basis for discussion with the European Parliament and the Council. On that basis, the Commission will reflect whether adaptations to the legislation itself, or to its implementation in practice, are necessary. • The Commission has announced in the AGS a number of steps to improve the application of the economic governance system already in the 2015 European Semester. • With regard to the broader topic of deepening Economic and Monetary Union, the Euro summit of October invited the President of the European Commission with the Presidents of the ECB, European Council and Eurogroup to prepare further steps to strengthen economic governance. The December European Council called for informal discussion at the February European Council and report to the June European Council.