INTERNATIONAL MONETARY FUND

IMF Country Report No. 25/174

EURO AREA POLICIES

2025 ANNUAL CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

July 2025

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2025 Annual Consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 7, 2025, consideration of the staff report that concluded the annual consultation.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 7, 2025, following discussions that ended on May 22, 2025, with the officials of EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2025.
- A **Statement by the Executive Director** for Germany and EURIMF President, on behalf of the euro area member states and the European community.

The document listed below will be separately released.

Financial System Stability Assessment

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

Copies of this report are available to the public from

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

International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2025 Consultation with Euro Area

FOR IMMEDIATE RELEASE

Washington, DC – July 11, 2025: On July 7, 2025, The Executive Board of the International Monetary Fund (IMF) concluded the 2025 discussions on common euro area policies with member countries.[1] This year, the consultation also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for the euro area.[2]

Growth in the euro area is likely to stay moderate over 2025-27. Trade tensions and elevated uncertainty are expected to weigh on activity, despite some boost from higher defense and infrastructure spending. In addition, the geopolitical situation in Europe is expected to dampen sentiment and weigh on investment and consumption, despite looser monetary policy and projected gains in real income. Headline inflation is projected to remain broadly at target from the second half of 2025, while core inflation will return to 2 percent in 2026.

Risks to growth are on the downside while they are two-sided for inflation. Trade policy uncertainty, potential tariff escalations, and ongoing geopolitical tensions may negatively impact demand and growth more than previously anticipated. These factors are expected to outweigh any positive effects of unanticipated fiscal easing, particularly if countries increase defense spending. Regarding inflation, lower-than-expected non-energy goods prices because of trade diversion, weaker-than-expected activity and wages, as well as the recent euro appreciation could result in inflation below the baseline. On the other hand, fiscal spending could turn out larger or more inflationary than in the baseline, while geopolitical tensions, supply chain disruptions, and tariff escalation could lead to higher import prices, and wage growth may not moderate as strongly as expected.

In an increasingly challenging global environment, a comprehensive policy strategy is needed for decisive EU-level actions to boost Europe's growth potential and financial resilience. This includes reforms to strengthen the EU single market, enhance energy security, and orient the EU budget to invest in common public goods. Ensuring debt sustainability and securing

---

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

[2] Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion.

financial and price stability are essential prerequisites for the successful implementation of these reforms.

The euro area FSAP found the banking system to be adequately capitalized and liquid overall, while some banks would dip into their buffers under stress. It identified financial stability risks stemming from interlinkages with non-bank financial institutions and called on the authorities to enhance data sharing, strengthen systemic risk monitoring, and conduct system-wide stress tests. While welcoming progress on several fronts, including the strengthening of banking supervision and introduction of the new Anti-Money Laundering Authority, fragmentation continues to hinder the development of more resilient, deeper, and integrated euro area-wide financial markets. The FSAP recommended fully implementing the international capital standard for banks (Basel III); strengthening the resources and prudential powers of the European authorities overseeing nonbank financial institutions; introducing a common deposit insurance system; making bail-in requirements more flexible; and strengthening arrangements for liquidity in resolution.

Executive Board Assessment[3]

Executive Directors welcomed the resilience of the euro area's economy, marked by record-low unemployment, declining inflation, and a stable financial system. Directors recognized that higher US tariffs, trade and geopolitical tensions, and elevated uncertainty are weighing on the euro area outlook and creating downside risks to growth, while risks to inflation remain two-sided. Some Directors also highlighted the impact of Russia's war in Ukraine. Directors encouraged the authorities to take decisive European Union level actions to place the economy on a stronger footing in a more complex global environment.

Directors emphasized the necessity of deepening the single market to stimulate investment and innovation. In this context, they welcomed the proposal for the adoption of a 28th corporate regime aimed at establishing a uniform set of regulations and legal standards to facilitate firms' expansion and innovation. Directors agreed that advancing the capital markets union is vital for channeling savings to innovative projects, while lowering barriers to cross-border bank mergers would allow for more efficient provision of banking services across the single market. Directors also agreed that the introduction of the digital euro could help deepen the integration of financial services.

Directors agreed that coordinated efforts at the EU level are essential for addressing shared challenges and helping member states manage fiscal tradeoffs, emphasizing the significant role the EU budget can play in this regard. They called for reforms to create a more streamlined budget that is responsive to changing needs and emphasized that strengthening

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

the financing framework through regular borrowing paired with resources to support debt service will allow for a more ambitious EU budget.

Directors encouraged the authorities to continue to advocate for a stable, rules-based global trading system. They further noted that deepening and diversifying global partnerships, while removing remaining internal trade barriers, can help strengthen supply chain resilience and capture efficiency gains from trade.

Directors agreed that for countries with high debt and limited fiscal space, significant fiscal adjustments are needed to mitigate fiscal risks. They also stressed the importance of implementing credible medium-term fiscal plans to address urgent and rising spending needs while ensuring fiscal sustainability. Directors generally agreed that the activation of the national escape clause of the EU fiscal rules should be limited to the initial phase of scaling up defense investment expenditures and not to finance recurring spending over an extended period. Directors concurred that non-defense net current expenditures should remain consistent with adopted medium-term fiscal plans and emphasized that it will be important to assess the impact of overall defense spending on debt sustainability on an ongoing basis.

Directors agreed that a monetary policy stance close to neutral is justified by close-to-target inflation and a mildly negative output gap. They concurred that increasingly communicating with greater emphasis on the forecast together with well-designed illustrative scenarios and sensitivity analysis around a baseline would become more important to help guide rate expectations.

Directors welcomed the findings of the FSAP and agreed with the assessment that the banking system is generally well-capitalized and maintains a healthy level of liquidity. However, banks' exposures to contingent liquidity risks have increased and require continued monitoring. Directors therefore encouraged policymakers to continue to analyze systemically important banks' counterparty credit risk and closely monitor vulnerabilities arising from the expanding nonbank financial intermediation sector including through the implementation of system-wide stress testing. They underscored the importance of facilitating better data sharing among EU and national authorities while continuing efforts to close existing data gaps. Directors also highlighted the importance of strengthening the euro area financial architecture by completing the banking union with the introduction of a common deposit insurance system. They agreed that establishing arrangements for the Single Resolution Fund to offer guarantees—ideally supported by an EU fiscal backstop—is critical for enhancing the provision of central bank liquidity during bank resolutions and will boost the resilience of the euro area-wide financial system.

Table 1. Euro Area: Main Economic Indicators, 2021–2030
(y/y percent change, unless otherwise specified)

					Projections 1/					
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Demand and Supply										
Real GDP	6.3	3.5	0.4	0.9	0.8	1.2	1.3	1.3	1.2	1.1
Private consumption	4.7	5.0	0.5	1.0	1.0	1.2	1.4	1.3	1.2	1.1
Public consumption	4.4	1.1	1.4	2.8	1.7	1.4	1.0	1.0	1.0	1.1
Gross fixed investment	3.8	2.0	1.7	-1.9	1.4	1.6	1.6	1.8	1.5	1.3
Final domestic demand	4.4	3.4	1.0	0.8	1.2	1.3	1.4	1.3	1.2	1.2
Stockbuilding 2/	0.7	0.5	-0.9	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
Domestic demand	5.1	3.8	0.1	0.5	1.3	1.3	1.4	1.3	1.2	1.2
Foreign balance 2/	1.4	-0.2	0.3	0.4	-0.4	-0.1	0.0	0.0	0.0	0.0
Exports 3/	11.4	7.3	-0.8	1.0	0.0	1.4	2.2	2.6	2.5	2.5
Imports 3/	9.0	8.3	-1.4	0.2	1.0	1.8	2.4	2.8	2.7	2.7
Resource Utilization										
Potential GDP	2.3	1.2	1.0	1.1	1.0	1.1	1.1	1.2	1.1	1.1
Output gap 4/	-1.6	0.6	0.1	-0.2	-0.4	-0.3	-0.1	0.0	0.1	0.1
Employment growth	1.6	2.4	1.4	1.0	0.3	0.2	0.2	0.1	0.1	0.0
Unemployment rate 5/	7.8	6.7	6.6	6.4	6.4	6.3	6.2	6.2	6.2	6.2
Prices										
GDP deflator	2.1	5.1	5.9	2.9	2.2	2.0	2.1	2.1	2.1	2.1
Consumer prices	2.6	8.4	5.4	2.4	2.1	1.9	2.0	2.0	2.0	2.0
Public Finance (percent of GDP)										
Overall fiscal balance	-5.1	-3.5	-3.6	-3.1	-3.2	-3.4	-3.5	-3.5	-3.6	-3.7
Primary balance	-3.8	-1.9	-2.1	-1.5	-1.5	-1.6	-1.5	-1.4	-1.3	-1.3
Structural balance 4/	-4.0	-3.6	-3.6	-3.1	-3.0	-3.3	-3.5	-3.7	-3.8	-3.8
Structural primary balance 4/	-2.7	-2.1	-2.2	-1.5	-1.3	-1.4	-1.5	-1.5	-1.5	-1.4
Gross public debt	93.9	89.5	87.4	87.7	88.7	89.7	90.4	91.1	91.9	92.9
External Sector (percent of GDP) 6/										
Current account balance	2.7	-0.1	1.7	2.8	2.3	2.1	2.1	2.0	2.1	2.1
Interest Rates (percent, end of period) 7/										
Euro short-term rate (€STR)	-0.6	1.9	3.9	2.9	2.2	...	...	...	...	...
10-year government benchmark bond yield	0.3	3.0	2.9	2.8	3.1	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.1	1.1	1.1	1.0	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	96.5	96.2	97.7	96.4	99.6	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.1	85.0	89.0	88.8	85.4	...	...	...	...	...

Sources: IMF staff estimates; and European Central Bank.
1/ Projections for 2025-30 are based on the aggregation of the latest projections by IMF country teams, unless otherwise indicated.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2025.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

June 20, 2025

STAFF REPORT FOR THE 2025 CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES

KEY ISSUES

Context. Despite recurring shocks, Europe's economy remains resilient with record-low unemployment, declining inflation, and a stable financial system. However, policymakers face mounting challenges, including trade tensions, rising demand for defense spending, and the need to ensure energy security, all while addressing long-standing productivity challenges, rapid aging, and weak medium-term growth.

Outlook. Euro area growth is likely to stay moderate over 2025-27. Higher tariffs, trade policy uncertainty, and geopolitical tensions weigh on activity especially in 2025, more than offsetting an anticipated lift from fiscal policy support and easing monetary policy. Headline inflation is projected to remain broadly at target from the second half of 2025, while core inflation is projected to return to 2 percent in 2026. Slow productivity growth and spending pressures—including related to aging, defense, and energy security—cloud the medium-term outlook. Risks of persistently elevated trade policy uncertainty, an escalation of tariffs, and the shifting geopolitical context further complicate economic prospects.

Policy priorities. As the global economic environment becomes more challenging and demographic change weighs on growth, Europe needs a comprehensive strategy to boost its own economic potential and resilience. National and EU-level reforms are critical and can reinforce each other. Deepening the single market is the EU's key lever to enhance investment and productivity. Directing EU public resources to support shared priorities, seeking further trade diversification through advancing new free trade agreements and strengthening existing trading relationships, and improving energy security can boost economic resilience and productivity. Completing the euro area financial architecture—by strengthening the euro area financial safety net and advancing the banking and capital markets unions—is essential for enhancing resilience against future shocks. Securing price stability remains a critical prerequisite to address these long-term challenges, while the EU fiscal rules should facilitate member states' efforts to manage spending pressures while ensuring sustainability.

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

Discussions took place in Brussels (Belgium), Frankfurt (Germany), and Luxembourg and virtually with the European Banking Authority, European Fiscal Board, European Securities and Markets Authority, and European Systemic Risk Board during May 7–22, 2025. Mission members include M. Nabar (head), L. Brandao, H. Lin, R. Beyer, F. Caselli, A. Dizioli, A. Fotiou, H. Tong, R. Varghese, J. Yoo (all EUR), joined by J. John, N. Arnold, F. Toscani, M. Busse, and J. Frie (all EUO), O. Exton (SPR), and FSAP mission chief M. Dobler (MCM). O. Celasun (EUR Front Office Reviewer) participated in key meetings with the ECB and the European Commission. The Executive Director, J. Stephan, and J. Guigue (both OED), R. Rüffer (ECB observer at the IMF) and M. Perretti (ECB advisor at the IMF), participated in the meetings. K. Cerrato, M. Maneely, K. Qin, and S. Wilson (all EUR) supported the mission from HQ.

CONTENTS

CONTEXT 4

RECENT DEVELOPMENTS 4

OUTLOOK AND RISKS 11

POLICY STRATEGY 17

STRENGTHENING EUROPEAN INTEGRATION IN A MORE CHALLENGING GLOBAL ENVIRONMENT 18

A. Strengthening the EU Single Market to Lift Investment, Innovation, and Productivity 18

B. Coping with a Challenging Global Policy Arena 23

MANAGING COMPLEX FISCAL TRADEOFFS TO ADDRESS RISING SPENDING NEEDS 25

A. Managing Spending and Fiscal Adjustment Needs under the Economic Governance Framework 25

B. Enhancing the EU Budget to Address Shared Challenges 28

SECURING PRICE STABILITY AMID POSSIBLE LARGE SHOCKS 31

IMPROVING SYSTEM-WIDE RISK MONITORING AND COMPLETING THE FINANCIAL ARCHITECTURE 35

CONTINGENCY POLICIES FOR ADVERSE SCENARIO 39

STAFF APPRAISAL 40

BOXES

1. A Case for a European Union 28th Regime _____ 20
2. Effectiveness of ECB Communications and Financial Conditions _____ 33

FIGURES

1. Real Sector Developments _____ 43
2. Inflation Developments _____ 44
3. Public Sector Accounts _____ 45
4. Financial Stability Risks _____ 46
5. External Sector Developments _____ 47

TABLES

1. Main Economic Indicators, 2021—2030 _____ 48
2. External Sector Assessment _____ 49
3. Risk Assessment Matrix _____ 50

ANNEXES

I. 2025 FSAP: Preliminary Recommendations _____ 55
II. Status of Key Recommendations from the 2018 FSAP _____ 58
III. Authorities' Response to Past Key Policy Recommendations _____ 65
IV. Data Issues _____ 67

CONTEXT

1. **Europe's economy has withstood difficult shocks well.** Although growth has been weighed down by heightened geopolitical tensions, energy price headwinds, and the lagged effects of a rapid tightening in monetary policy, unemployment is at record lows, inflation has declined significantly and is broadly at target (headline inflation is at target, but core remains slightly above 2 percent), and the financial system has remained resilient.

2. **Yet the economic model faces complex new challenges overlaid on long-standing ones.** European policymakers have to grapple with the economic and social consequences of higher US tariffs and increased public sector spending, including on defense, all while accelerating the push for energy security, maintaining price stability, striving to boost productivity, and, in many countries, ensuring fiscal sustainability amidst high debt and increasing spending pressures. Medium-term growth is expected to remain anemic—which puts Europe's prosperity in peril and complicates efforts to address long-term fiscal spending needs.

3. **Multi-faceted challenges require multi-pronged solutions.** In a more challenging global environment, Europe will need to harness its own strengths more effectively with decisive EU-level actions. Deepening the EU single market and integration within Europe more broadly can help enhance investment, innovation, and productivity. EU public resources should be effectively directed to supporting shared priorities—including through the multiannual financial framework (MFF)—which can help internalize positive cross-border externalities, leverage economies of scale, and avoid costly duplicative national efforts. Ensuring orderly, smooth, and growth-friendly consolidations depending on country-specific fiscal risks is critical to preserving fiscal sustainability and managing long-term spending pressures associated with aging and increased spending on security. Diversifying economic ties, expanding rule-based trade integration, and enhancing energy security through renewable energy development and electricity market integration can further bolster competitiveness and strengthen economic resilience. Safeguarding price stability continues to be the bedrock for addressing these longer-term challenges.

RECENT DEVELOPMENTS

4. **Higher tariffs, elevated trade policy uncertainty, and financial market volatility have had notable impacts on sentiment.** In March, the US increased tariffs on steel and aluminum, and automobiles and auto parts to 25 percent. On April 2, the US announced a global tariff of 10 percent on most goods and an additional 10 percent tariff on EU exports to the US, with exceptions for semiconductors, pharmaceuticals, copper, and lumber (for which tariffs remain unchanged, as of June 6) (Text Table 1). Around 70 percent of the EU exports to the US are currently affected. Following the announcement, European equity markets sold off, with the Stoxx 600 index dropping 14 percent in the week after the April 2 announcement due to a broad-based sell-off across multiple sectors. On April 9, the US announced a 90-days pause for the additional tariffs, reducing the increase in the effective tariff rate of EU exports to the US in 2025 from 13.9 percentage points to

8.3 percentage points and contributing to a full recovery of the Stoxx 600 index back to pre-April 2 levels by mid-May. Investor sentiment, which in April reached its lowest level since October 2023, had recovered only partially by May (measured by the Sentix investor confidence index).

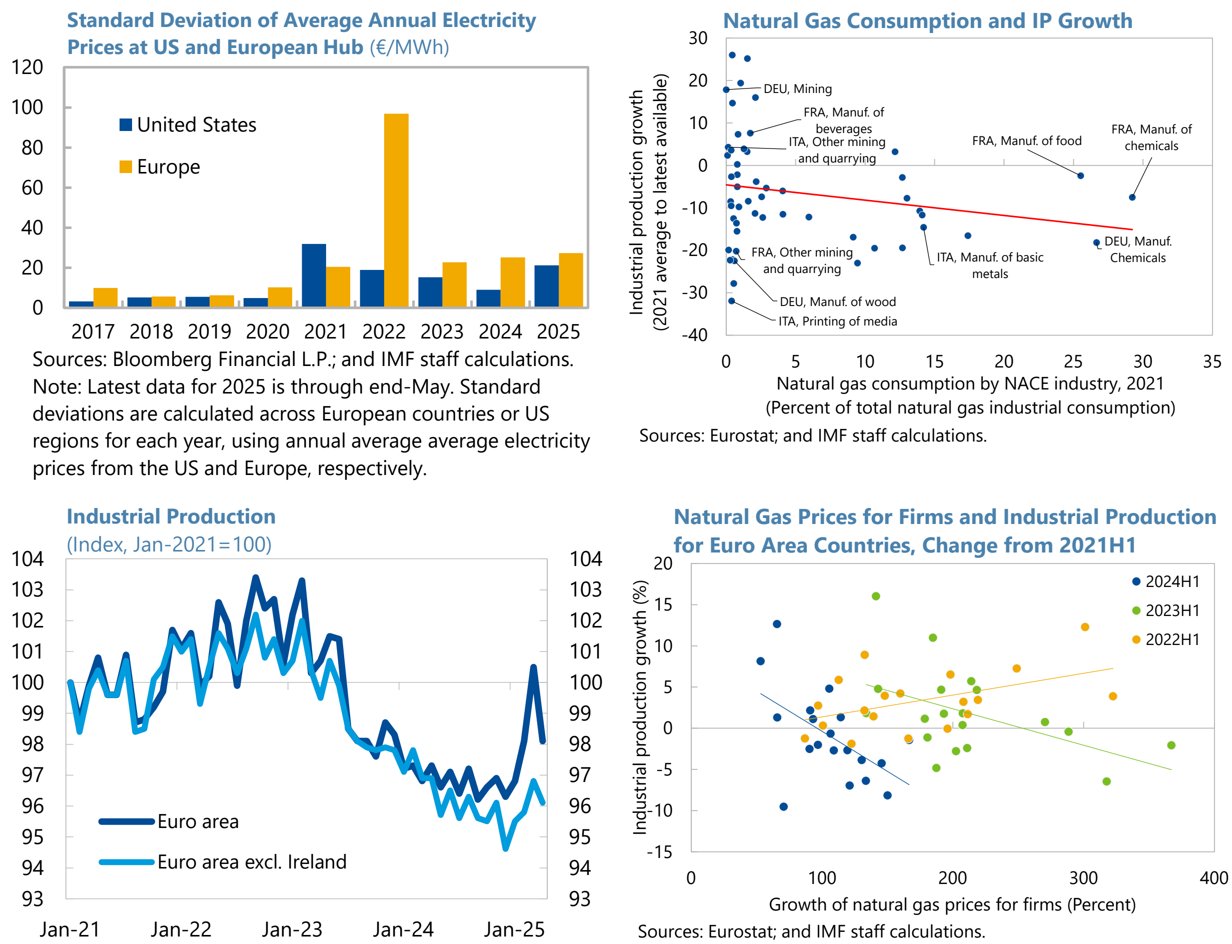
Text Table 1. Euro Area: Significant U.S.-EU Trade Measures

Date	Description
March 12, 2025	**Section 232 tariffs extended on steel and aluminum** The U.S. (i) increased existing aluminum tariffs from 10 to 25 percent and maintained steel tariffs at 25 percent, ii) removed previous product exemptions, iii) terminated agreements to exempt the EU and others, iv) extended application to derived steel and aluminum products.
March 26, 2025	**Section 232 tariffs of 25 percent on automobiles and auto parts.** 25 percent tariffs on autos effective from April 3, and auto parts effective from no later than May 3. Partial exemption for US content for preferential auto imports under U.S.-Mexico-Canada Agreement (USMCA), and temporary full exemption for auto parts under USMCA.
April 2 & 9, 2025	**Higher tariffs.** EU faces new tariff of 20 percent – effective from April 9. Exclusions from the duties on products covered by Section 232 tariffs (steel, aluminum, autos) and products enumerated in Annex II to the Executive order (copper, lumber, pharmaceuticals, semi-conductors, certain critical minerals, energy and energy products). The new tariffs only apply to the non-U.S. content, provided at least 20 percent of the value of the imported good is U.S. originating.
April 9, 2025	**Countermeasures in response to steel and aluminum tariffs.** EU member states approved measures on April 9, with the first wave of measures effective from April 15. On April 10, it was announced that these countermeasures (and any others under consideration) would be paused for 90 days.
April 10, 2025	**Temporary 90 day pause on higher tariffs announced on April 2nd.** For 90 days only the 10 percent additional tariff rate will apply (as well as section 232 tariffs).
April 11, 2025	**Exceptions for smartphones and other consumer electronics that contain semiconductors.** These products will not be subject to the tariffs associated with the April 2nd tariffs and subsequent April 10th modifications.
April 29, 2025	**Import adjustment offset for automotive manufacturers.** Automobile manufacturers may apply for offset equal to 3.75 percent of the Suggested Retail Price (MSRP) value of all automobiles assembled in the U.S. from April 2025 through April 2026 and equal to 2.5 percent for those assembled the year after.
May 30, 2025	**Higher tariffs on steel and aluminum.** From June 5, they increase from 25 percent to 50 percent.

5. The escalation of tariffs comes on the back of an extended period of high uncertainty, which has been weighing on activity. Both consumption and investment remained subdued for most of 2024 amid weak consumer and business confidence from elevated geopolitical tensions and policy uncertainties. On the other hand, net exports contributed positively, largely due to import compression under tight financing conditions (see Caselli and Dizioli, 2025). The heterogeneity in growth across euro area countries has increased, with contractions in large economies (France and Germany) and large expansions in tourism-oriented economies (Croatia and Portugal) at the end of the year. A different dynamic was observed in 2025Q1, with GDP growth surprising to the upside, reflecting mainly the front-loading of exports to the US (from Belgium, Germany, and Ireland). Some reversion is expected for the next quarters.

6. The underperformance of the industrial sector persists, as energy prices have remained high and volatile. Electricity price volatility over time and across electricity hubs in Europe still exceeds three times its pre-pandemic average and is significantly higher than in the US (Text Figure 1, panel a)[1] while the median wholesale electricity price across EU countries has doubled from the pre-pandemic level.[2] Weighed down in part by high energy prices, the underperformance of the manufacturing and energy-intensive industries persisted throughout 2024 (Text Figure 1, panel b), extending the decline in industrial production that began in early 2023 (Text Figure 1, panel c). The negative association between natural gas price growth and industrial production appears to be intensifying over time (Text Figure 1 panel d) suggesting that high energy prices might have permanent impacts on the industrial sector. Although industrial production rebounded in 25Q1 (at 1.5 percent versus -1.7 percent y/y in 24Q4), this reflects large front loading of exports to the US, which jumped 60 percent y/y in March.

Text Figure 1. Euro Area: Industrial Production and Energy Prices Developments



Sources: Bloomberg Financial L.P.; and IMF staff calculations. Note: Latest data for 2025 is through end-May. Standard deviations are calculated across European countries or US regions for each year, using annual average average electricity prices from the US and Europe, respectively.

Sources: Eurostat; and IMF staff calculations.

Sources: Eurostat; and Haver Analytics.

Sources: Eurostat; and IMF staff calculations.

---

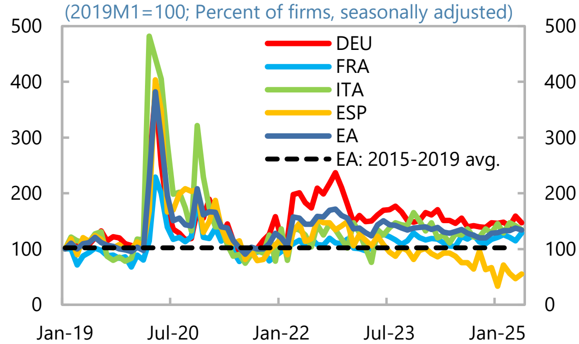
[1] IMF Staff Background Note on EU Energy Market Integration.

[2] Longarice et al. (2024) show that energy shocks can have a negative impact on corporate investment with financially constrained firms and firms in energy-intensive sectors reducing investment the most.

7. Despite overall subdued activity, labor markets have held up—albeit with some signs of cooling down. Labor market tightness—as seen in the vacancies-to-unemployment (V/U) ratio—continued to moderate but the pace varied across countries. While the V/U ratio is now below pre-pandemic levels in Germany, it has remained well above in Italy and Spain. Unemployment has been stable at historic lows (6.2 percent in April). Higher participation rates of women, older workers, foreign nationals, and workers with tertiary education bolstered employment, helping meet solid labor demand.[3] In most countries, firms not only continued retaining workers partly in anticipation of rehiring difficulties amid aging and concerns about skills shortages (Text Figure 2, panel a), but also increased hires to maintain labor input as hours worked continued to decline. Wage growth is moderating on average (Text Figure 2, panel b).

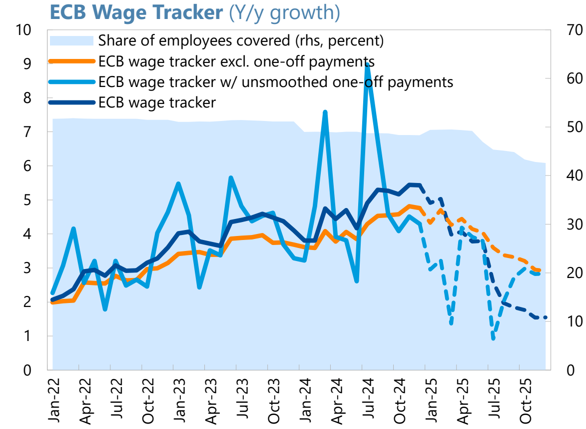
Text Figure 2. Euro Area: Labor Market

Labor Hoarding 1/
(2019M1=100; Percent of firms, seasonally adjusted)



Sources: European Commission; and IMF staff calculations.
1/ Measures the percentage of managers expecting their firm's output to decrease, but employment to remain stable or increase.

ECB Wage Tracker (Y/y growth)



Sources: ECB calculations based on data provided by the Deutsche Bundesbank, Bank of Greece, Banco de España, Banque de France, Banca d'Italia, Oesterreichische Nationalbank, the Dutch employers' association AWVN and Eurostat.
Notes: The solid lines correspond to the period for which there is information for both the wage tracker and the indicator of negotiated wages. Dashed lines denote the periods in which only the ECB wage tracker is available and thus represent forward-looking information.

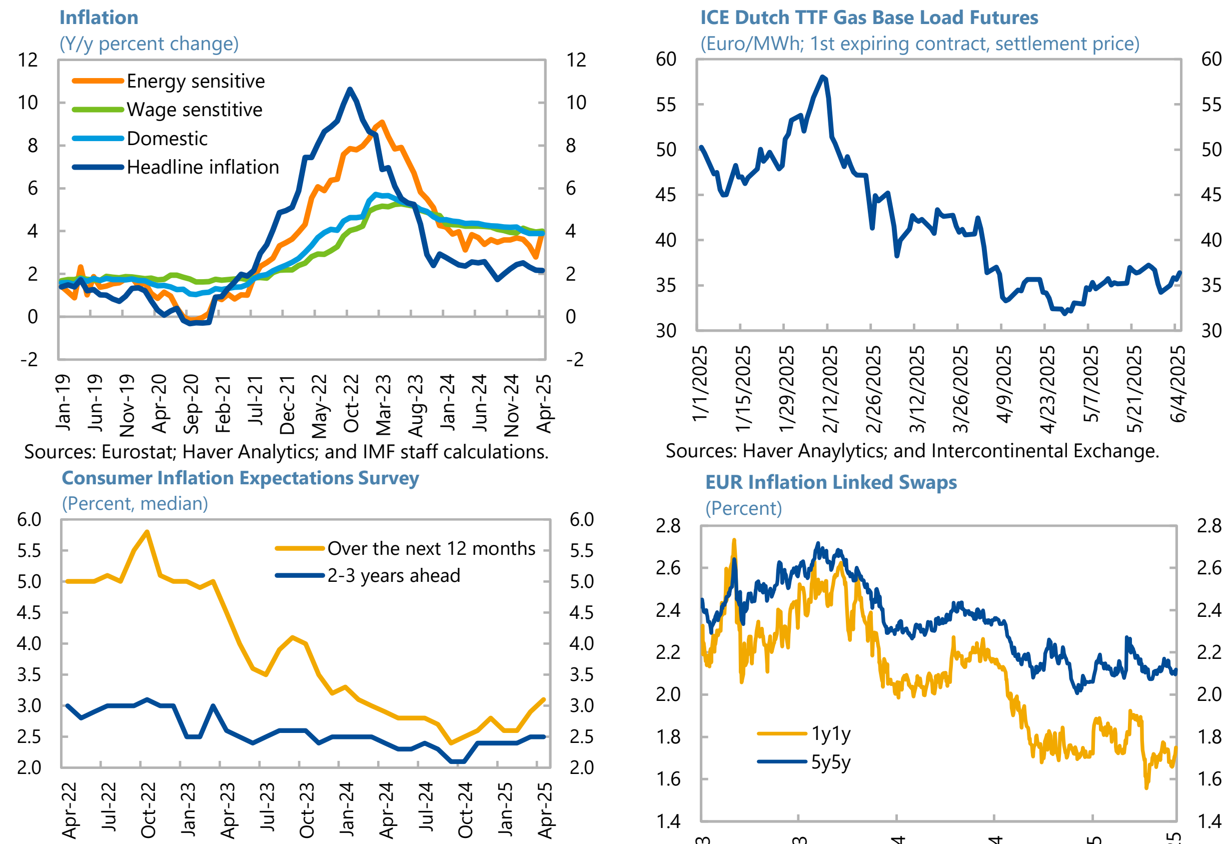
8. The disinflation process is on track despite volatile energy prices. Other than domestic inflation, which remains high (Text Figure 3, panel a), key components of core inflation trended down through 2024 and in early 2025 on the back of services inflation deceleration and weak non-energy goods inflation. After surging at the end of 2024 and early 2025, energy inflation retreated somewhat in the second quarter, supporting the downward trend in headline inflation, even though significant fluctuations in natural gas prices persist (Text Figure 3, panel b). Most measures of inflation expectations have remained anchored at the ECB's 2 percent target (Text Figure 3, panel c and d).[4]

[3] The recent migration wave has helped accommodate strong labor demand, with around two-thirds of jobs created between 2019 and 2023 filled by non-EU citizens, while unemployment of EU citizens has remained at historical lows. See also ECB (2024) for a discussion of socioeconomic characteristics of workers driving the labor force expansion.

[4] In the last two months, there has been a small divergence in inflation expectations, with professional forecasters firmly anchored around the target, financial markets pricing near term inflation expectations slightly below target and households' short-term inflation expectations in the ECB's Consumer Expectations Survey started rising again—

(continued)

Text Figure 3. Euro Area: Inflation Developments



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

Sources: Haver Anaylytics; and Intercontinental Exchange.

Sources: ECB; and Haver Analytics.
Note: Weighted estimates for inflation expectations over the next 12 months and the 12 month period 2-3 years from the survey month. The median is computed on the basis of a symmetric linear interpolation that accounts for rounding of responses.

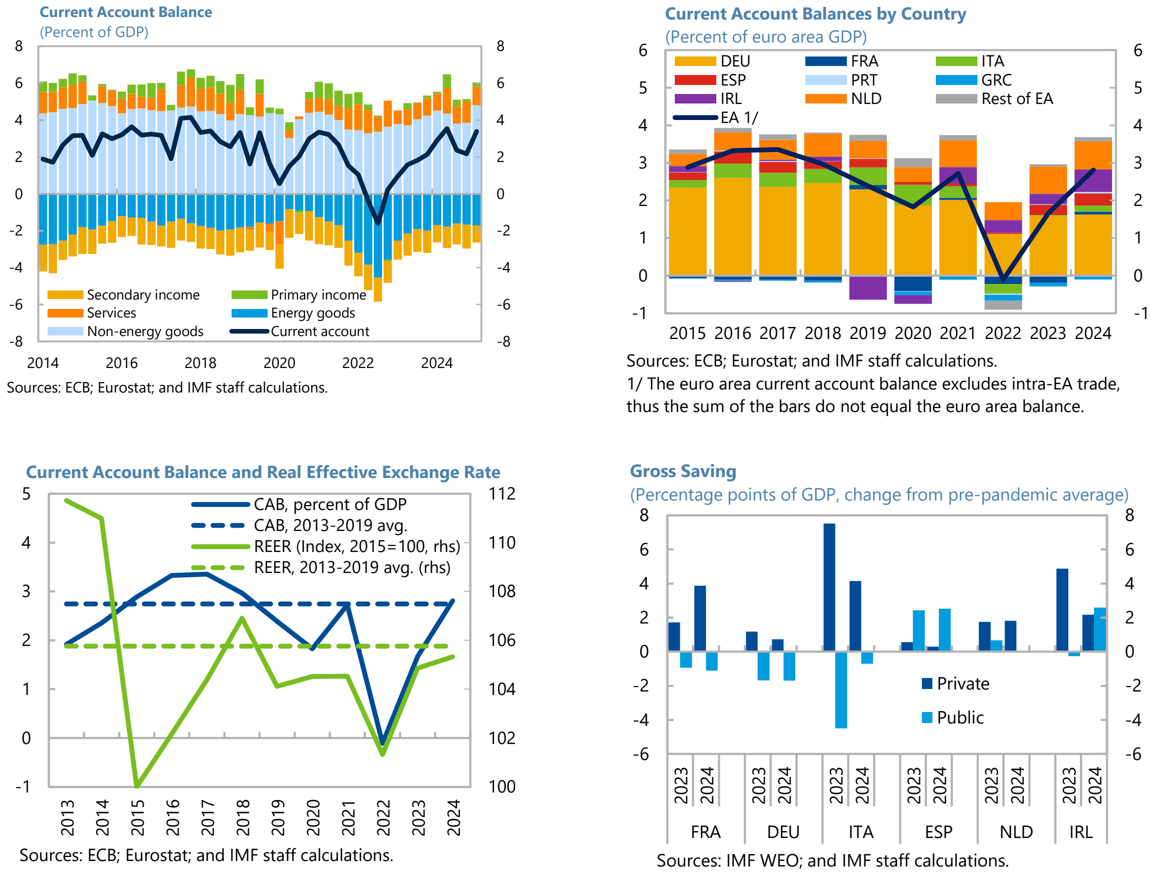
Source: Refinitiv Eikon.

9. **The current account surplus has risen back to its pre-pandemic average.** The surplus reached 2.8 percent of GDP in 2024, driven by declining energy imports and increasing non-energy goods exports (Text Figure 4, panel a and c). While long-standing creditor countries, notably Germany and the Netherlands, recorded large surpluses in 2024, about one-third of the widening of the CA balance was from Ireland, in part due to a large one-off IP-related services export in the MNE sector (Text Figure 4, panel b). Private savings stayed above pre-pandemic averages in most countries, more than offsetting the decline in public savings (Text Figure 4, panel d), while investment remained subdued. The real effective exchange rate was broadly stable in 2024, close to the pre-pandemic average (2013-2019). Staff assesses that the euro area's external position in 2024 was moderately stronger than the level implied by medium-term fundamentals and desirable policies (Table 2). Due to frontloading of trade amid tariff uncertainty and declining energy prices, the trade and current account surplus increased further in 2025Q1. Since the start of 2025, the euro has been

possibly reflecting increases in food prices to which consumers are particularly attentive to. However, there are no indications that this rise is persistent (Schnabel 2025, "Keeping a steady hand in an unsteady world" and Lane 2025, "Interview with Frankfurter Allgemeine Zeitung").

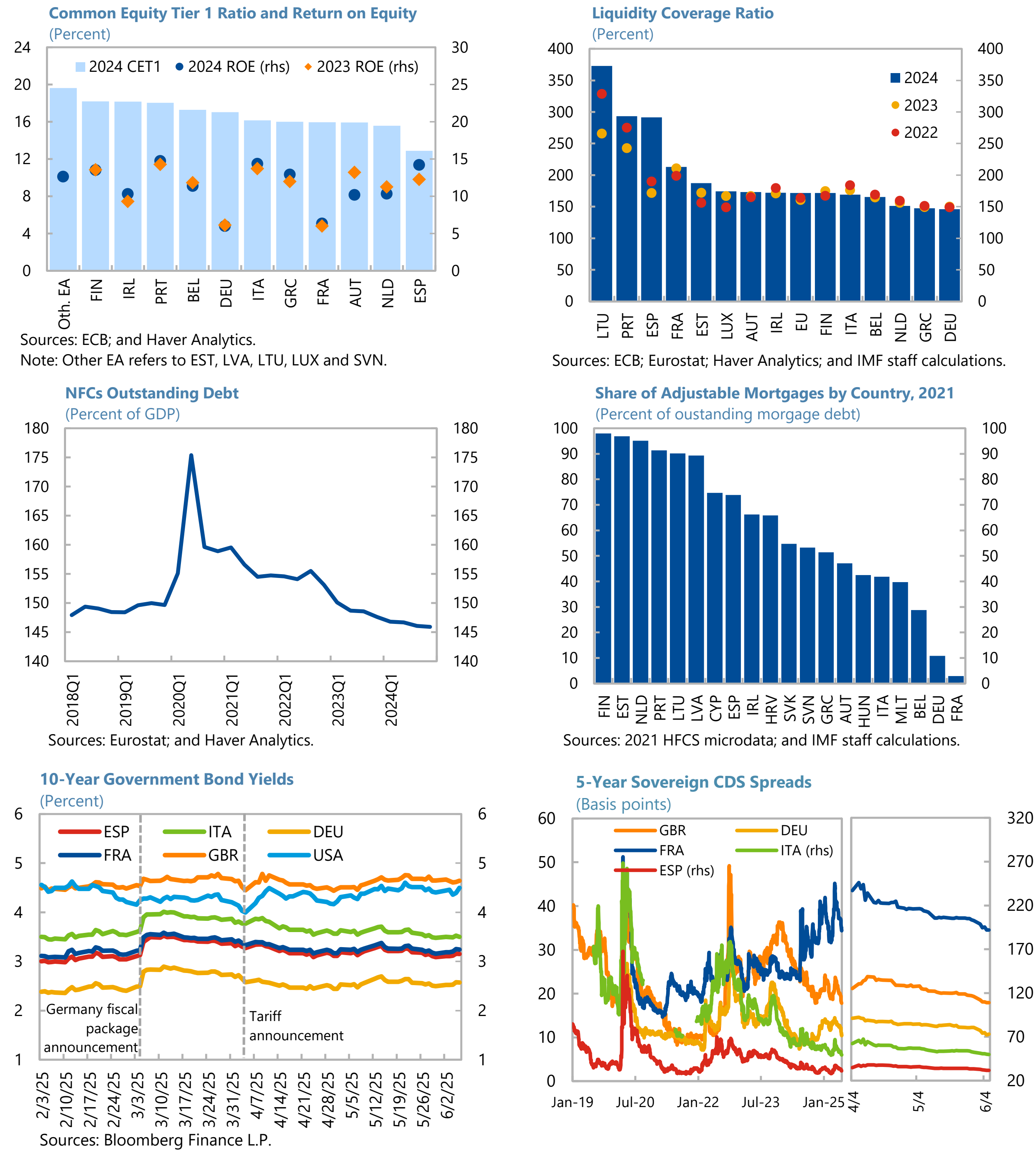
appreciating in nominal effective terms and against the US dollar—reversing the sharp depreciation at the end of 2024—and is now approaching levels last seen prior to Russia's invasion of Ukraine.

Text Figure 4. Euro Area: Current Account Developments



10. Balance sheets have remained healthy, buffering the financial system from shocks. Robust capital and liquidity positions in aggregate (Text Figure 5, panels a and b) and a diversified deposit base continued to underpin banks' resilience, with profitability still benefiting from wider net-interest margins over the last monetary policy tightening cycle. Credit to firms (at -1 percent y/y) and households (at -1.3 percent y/y) continued to contract in real terms in 2024Q4—but the pace has slowed. Credit standards tightened for firms during 2024Q4 and 2025Q1, driven by higher perceived risks and banks' lower risk tolerance despite monetary policy easing, but eased moderately for households (Figure 4, panel c). Amid weak manufacturing and geopolitical uncertainty, firms' credit demand remained subdued even as interest rates declined (Figure 4, panel d). Mortgage loan demand, on the other hand, increased strongly across key member states, driven by lower interest rates and improving housing markets. Business bankruptcies picked up from a low base, in part due to post-Covid normalization. Household vulnerabilities vary significantly across the EA due to heterogeneity in the share of adjustable-rate mortgages (Text Figure 5, panel d).

Text Figure 5. Euro Area: Financial Sector Developments



11. Interest rates have been volatile amid shifts in the German fiscal outlook and tariff announcements. While the change in the outlook for German fiscal policy led to a 30-basis-point increase in the 10-year bund yields, yield curve decompositions and muted sovereign CDS spreads suggest that financial markets did not see it as reflecting increased sovereign credit risk but instead a reassessment of the future path and increased uncertainty regarding future growth and inflation. Other EA sovereigns also experienced similar increases in borrowing costs, although with a slight narrowing of the spreads (Text Figure 5, panels e and f). However, after the April 2 US tariff announcement, 10-year bund yields declined by 25 basis points with flight to safety, offsetting the earlier rise and have held steady since (as of May 20th). In sum, following short-lived tightening and increase in volatility in the immediate aftermath of the tariff announcement, financial conditions are now close to levels prior to the Germany fiscal package announcement (Figure 4, panel a and b).

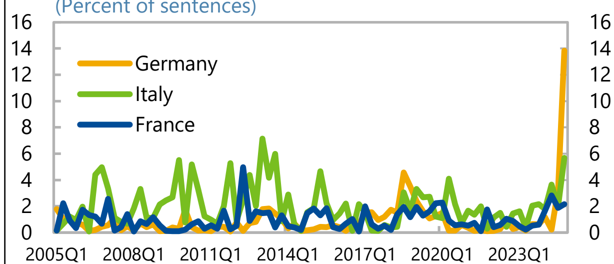
12. The public debt-to-GDP ratio increased slightly in 2024, reflecting still elevated deficits. The euro area aggregate fiscal deficit narrowed by 0.4 percentage point in 2024 and the structural primary balance (SPB) improved by 0.7 percentage point reflecting the unwinding of crisis support measures, including Italy's Superbonus incentives for housing improvements. The fiscal deficit, however, remained large in many economies. Excessive deficit procedures (EDPs) were launched against seven EU member states (Belgium, France, Hungary, Italy, Malta, Poland, and Slovakia) and remained open for Romania. Public debt inched up to 87.7 percent of GDP in 2024 (Table 1).

OUTLOOK AND RISKS

13. Higher US tariffs and elevated uncertainty are expected to weaken activity in 2025 and weigh on the pick-up in domestic demand in 2026 and 2027. Germany's fiscal package and higher defense spending in some countries are projected to only partially offset the negative external shock (Text Table 1).[5]

- Higher US tariffs constitute a direct adverse demand shock for EU exporters.[6] In addition, the geopolitical situation in Europe and elevated trade policy uncertainty—at a record-high level in several countries [7]—are projected to dampen sentiment and weigh on investment and consumption (Text Table 1), despite looser monetary policy and projected gains in real income.

Trade Policy Uncertainty
(Percent of sentences)



Sources: Albrizio, Buesa, Roth and Viani. Forthcoming. "Unraveling Uncertainty: Disentangling Trade Policy Risks from Broader Uncertainty." IMF Working Paper and IMF staff calculations.
Note: The units are measured as the total number of sentences including trade policy uncertainty over the total number of sentences in firms' earnings calls.

[5] The main elements of the reform include: (i) exemption of defense spending over 1 percent of GDP from the debt brake; (ii) a €500bn infrastructure fund (11.6 percent of 2024 GDP) to be spent over 12 years, with its borrowing exempt from the debt brake as long as infrastructure spending in the regular budget exceeds 10 percent of total spending; (iii) easing in the state-level net borrowing constraint from zero to 0.35 percent of GDP; and (iv) further unspecified debt-brake reforms by end-2025.

[6] In the baseline scenario (the April WEO 'reference point' forecast based on actions and announcements as of April 4), the effective US tariffs on the EU is 13.9 percentage points higher than in 2024 and is assumed to be permanent. No EU retaliation is assumed.

[7] Different trade exposures in general and to the US specifically can explain the divergence between the increase in trade policy uncertainty across countries.

- While high uncertainty is expected to persist through at least 2026, a slight decline in saving rates from their elevated levels and easing financial conditions should help lift domestic demand in 2026 and 2027. Germany's fiscal package is expected to directly boost euro area growth by 0.2 percentage point in 2026 and 0.1 in 2027 (Text Table 1).[8] For other euro area countries, the net effect of the German fiscal package is expected to be minimal as demand spillovers are counterbalanced by drags on activity from higher borrowing costs.

Text Table 1. Euro Area: GDP Growth Revisions
(April 2025 WEO versus January 2025 WEO)

	2025	2026
Tariff/trade	-0.1	-0.2
Uncertainty & financial conditions	-0.2	-0.2
Fiscal spending	0.1	0.2
Overall impact	**-0.2**	**-0.2**

Source: IMF staff estimates.

- Beyond 2027, growth is expected to remain modest, as weak productivity growth, subdued investment, and an aging population, limit potential growth.

14. Headline inflation is projected to remain broadly at target from the second half of 2025, while core inflation is expected to return to 2 percent in 2026. Under the April WEO projections, this is supported mostly by lower energy prices, but also by subdued activity, moderating nominal wage growth and firmly anchored inflation expectations. Because of the slow pass-through of moderating wage growth to services inflation, core inflation only returns sustainably to 2 percent in 2026. Germany's public spending is expected to have limited inflationary impact (less than 0.1 percent) at the euro area level.

15. The euro area current account surplus is projected to decline and stabilize at around 2 percent of GDP over the medium term as investment picks up. Higher public investment, driven by a scale-up of defense and infrastructure spending, as well as higher private investment supported by more accommodative financial conditions, are expected to boost imports. At the same time, trade tensions and slowing tourism growth (e.g. in Spain) are likely to weigh on exports of goods and services.

16. The monetary-fiscal policy mix is expected to turn broadly neutral in the near term. With a mildly negative output gap, headline inflation projected to remain broadly at target from the second half of 2025, and core inflation expected to return to 2 percent in 2026, barring additional shocks, the baseline assumes that the ECB will keep its deposit facility rate at 2 percent following its cut in June 2025—which is within the range of plausible short-to medium-run neutral rate estimates.[9] Fiscal policy is expected to be broadly neutral, with the euro area aggregate SPB improving marginally by 0.2 percentage point in 2025, partially offset by a likely positive impulse from the implementation of Recovery and Resilience Facility (RRF) (Table 1). However, this masks divergent fiscal outlooks across countries—Italy is expected to continue tightening its fiscal policy, albeit at a slower pace than in 2024; Germany is set to shift from tightening last year to a neutral stance this year; meanwhile, fiscal policy in France is expected to tighten as it implements significant

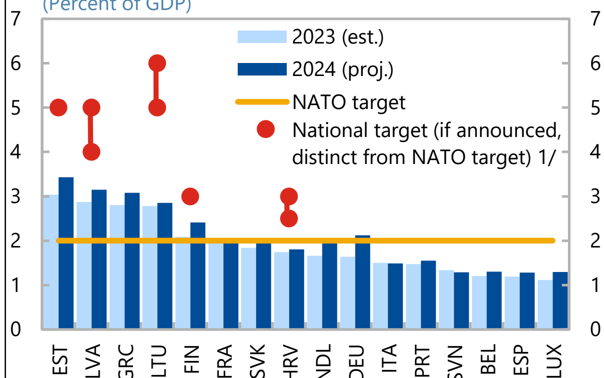
[8] In the baseline, fiscal multipliers of the spending increase in Germany are assumed to be around 0.7.

[9] See Beyer and Brandao-Marques (forthcoming 2025) and ECB 2025.

adjustments. Fiscal policy is expected to remain broadly neutral in 2026 at the aggregate level, with SPB marginally declining by 0.1 percentage point.

17. The medium-term fiscal outlook indicates rising debt at the aggregate level, although this largely reflects substantial shifts in Germany's fiscal policy. In Germany, higher spending on defense and planned infrastructure investments are expected to lead to moderate but continuous increases in both the deficit and debt. To date, most countries that have announced plans to increase defense spending have low to medium debt levels below 90 percent of GDP. Taking into account the budgetary impact of the plans that have been agreed upon by end-April and are sufficiently detailed, defense expenditures in the baseline at the euro area aggregate level are projected to rise from 1.6 percent of GDP in 2024 to 2.2 percent of GDP in 2030.[10] Mostly accounted for by Germany's projected fiscal easing, the euro area fiscal deficit is expected to widen from 3.1 percent of GDP in 2024 to 3.7 percent of GDP in 2030. The euro area aggregate general government debt is projected to rise over the medium term to reach 92.9 percent of GDP in 2030. Excluding Germany, the overall fiscal balance is projected to remain stable at around 3.4 percent of GDP over the medium term—little changed since last year. The euro area government debt excluding Germany is projected to rise modestly from 99 percent of GDP in 2024 to 102 percent of GDP in 2030—unchanged from what was envisaged in the 2024 Annual Consultation. While overall risks are mild, the plans to increase defense spending, particularly in countries with higher debt, could put upward pressure on sovereign risk premia.

Defense Spending, 2023-2024
(Percent of GDP)



Sources: NATO; and national authorities
1/ As of end-April 2025.

18. Risks around the baseline are on the downside for growth while two-sided for inflation. Although the April 9 announcement of a pause in US tariffs constitutes a small upside risk to the baseline, heightened trade policy uncertainty, an escalation of tariffs and the shifting geopolitical context could all further suppress confidence and drag growth below the baseline. An illustrative downside scenario in the April WEO indicates that euro area growth would be 1 and 0.75 percentage point below baseline in 2026 and 2027, respectively. On the upside, a larger fiscal easing on the back of a push to increase defense spending above recent levels could lift growth, especially in 2026 and beyond. Regarding inflation, possible trade diversion from other regions can lower non-energy goods import prices and weaker-than-expected activity could suppress employment and wage growth, lowering inflation faster than expected. These risks are countered by upside factors, such as the possibility of higher-than-expected wage growth, as well as

[10] For April 2025 WEO, assumed defense expenditures underlying fiscal projections were increased relative to January 2025 WEO in eight euro area countries where the plan was agreed and sufficient details are available. Fiscal multipliers for the projected increase in defense spending is expected to be modest given limited domestic capacity.

higher imported inflation due to the escalation of geopolitical and trade tensions. Fiscal spending (including on defense) might also turn out larger or more inflationary than in the baseline (Table 3).

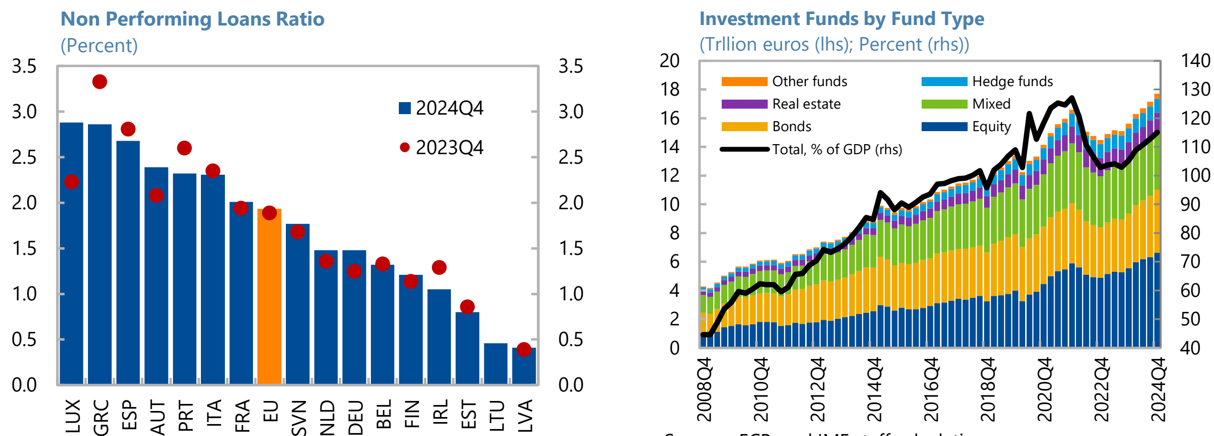
19. Financial conditions are likely to remain highly volatile. Financial stability risks from past monetary tightening appear to have further subsided. Yet market volatility related to trade tensions and banks' exposures to nonbank financial intermediaries (NBFIs) remain as significant sources of systemic risk. The negative demand shock due to higher US tariffs could hurt EU exporting firms' profit margins and worsen asset quality of exposed banks. Given heightened trade policy uncertainty and geopolitical tensions, banks' counterparty credit risks from leveraged, complex, and opaque NBFIs, primarily investment funds, could pose challenges (Text Figure 6, panel b). Stretched valuations and compressed risk premia remain vulnerable to an even sharper correction, as investors reassess the global growth and inflation outlook. This could trigger severe distress in investment funds through redemption shocks and spikes in margin and collateral calls, significantly affecting core funding markets as well as banks exposed to NBFIs.[11] The 2025 Financial Sector Assessment Program (FSAP) stress tests document how NBFIs could amplify risk propagation in the banking sector and system-wide spillovers from investment fund distress. Monitoring European banks' US dollar liquidity needs is important, given the recent spike in financial market volatility and their growing reliance on US repo funding, which could create rollover risks. Anticipated fiscal policy easing, if not anchored by debt sustainability objectives, could act as a transmitter of shocks, reducing the availability of credit to the real economy given banks' exposures to highly indebted sovereigns (Figure 5, panel f). As evidenced by a recent event which interrupted TARGET services for nearly a day (although without material impacts on funding markets and liquidity),[12] operational risks to financial market infrastructure (FMI) remain potent. In this context, the continued increase in digitalization and rising fintech penetration could also leave the financial system more prone to cybersecurity breaches.

20. A de-escalation of trade tensions with the US, possibly including a trade agreement, constitutes an upside risk to the outlook. The current baseline includes actions taken up to April 4 implying an increase in the effective US tariff rate on imports from the EU of 13.9 percentage points. A plausible upside scenario could entail a reduction in the effective tariff rate with the US to about half of the April 4 level, combined with a reversal of the increase in trade policy uncertainty since January by about 50 percent. In this upside scenario, financial conditions could return to levels similar to those prior to April 2 announcement. Based on these developments, model simulations suggest that GDP growth could improve by 0.1 percentage point in 2025 and 0.2 percentage point in 2026 relative to the baseline. Inflation would also be slightly higher than in the baseline, but it would still be broadly at target from the second half of 2025.

[11] On aggregate, NBFIs are net lenders to banks according to EBA estimates. Banks' asset holdings of NBFIs are about 9 percent of total assets while liability exposures are over 10 percent. Off-balance sheet exposures—undrawn loan commitments, financial guarantees, and other commitment—show that commitments to NBFIs represent 6.4 percent of banks' off-balance sheet items while those from NBFIs account for 9 percent. See, EC (2025), Summary Report, Targeted Consultation on the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation.

[12] Target 2 and Target2-Securities—systemic Eurosystem infrastructures for payments and securities settlement—failed for nearly a day on February 27, 2025.

Text Figure 6. Euro Area: Banks' Asset Quality and Investment Fund Sector



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

Sources: ECB; and IMF staff calculations.

***Authorities' Views*[13]**

21. The authorities broadly shared staff's views on the macroeconomic outlook. The euro area economy is expected to continue to grow at a moderate pace in 2025, with uncertainty and trade tensions weakening activity and delaying the expected cyclical recovery. The quarterly growth profile will be volatile because of trade frontloading ahead of tariffs. Trade policy uncertainty is already impacting investment decisions and there are initial signs that it is also weighing on consumer confidence. Financial conditions have tightened. Higher tariffs are expected to lower both imports and exports. The labor market continues to cool but remains tight. The EU economy is set to continue generating jobs but at a slightly lower pace. Long-term structural factors, including an aging population, higher levels of education, and a trend toward lower hours worked are contributing to further falling unemployment levels. Plans for increased fiscal spending in Germany could mildly boost growth in the longer term, but are not yet part of the baseline, and the impact is more uncertain depending on the type of spending, the degree of crowding-in of private investment, and the degree of import content. The authorities concurred that subdued productivity growth, along with population aging, is weighing on medium-term growth.

22. The disinflationary process continues as expected. The authorities noted that headline disinflation in recent months proceeded broadly in line with expectations to around the ECB's target, but this was helped by a moderation of energy inflation on account of lower oil and gas wholesale prices (2025Q1). Increasing agricultural commodity prices have been driving food inflation above expectations, but do not pose a major risk to disinflation. Although domestic inflation, driven by services, remains elevated, most measures of underlying inflation have moved closer to target. The authorities noted that wages have been somewhat higher than expected in late 2024, but overall evolved broadly in line with the European Commission's Autumn Forecast and

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

wage growth is set to decelerate significantly in the second half of 2025, further supporting the disinflation process. Meanwhile, a lower path for future commodity energy prices should also support disinflation. The authorities acknowledged that short-term inflation expectations of consumers, markets, and professional forecasters have temporarily diverged recently, while long-term measures remain anchored. Finally, the authorities concurred that the German fiscal package is likely to have limited inflationary effects.

23. The authorities saw risks to growth tilted to the downside and risks to inflation two-sided. They stressed that key downside risks to growth come from escalation of geopolitical tensions and trade policy uncertainty—with effects on confidence, including of households, and trade fragmentation. In addition, a resurgence of financial volatility may result in tighter financial conditions, with early signs of banks adopting a more cautious approach towards lending activities in turn impacting economic growth. These downside factors dominate upside risks to growth, which include stronger demand on the back of increased euro area-wide fiscal spending and stronger-than- expected decline in energy prices. On inflation, the authorities noted that upside risks include tariffs retaliation, supply chain disruption, wage persistence and increased fiscal spending, while downside risks arise from weaker economic activity, euro appreciation, potential diversion of Chinese exports, and lower energy prices.

24. The authorities assessed the euro area external position to be broadly in line with fundamentals. The authorities stressed that their assessment of the euro area external position remained qualitatively unchanged from the previous year, citing lower energy prices as a factor behind the rebound in the current account balance, which had also been accompanied by a slight strengthening of the real exchange rate of the euro. They also viewed the IMF staff assessment as based on a gap that could not be entirely attributed to domestic policy gaps but instead also reflected policy gaps originating in jurisdictions outside the euro area, in particular more expansionary fiscal policies than in the euro area.

25. The authorities agreed that financial stability risks have increased since early 2025. While noting that the financial sector has remained resilient in the face of a spike in interest rates following the announcement of fiscal reform in Germany and higher US tariffs, the authorities noted that risks from trade tensions, financial market volatility, and NBFIs including their interlinkages with banks remain pertinent amidst elevated uncertainty. They concurred that financial markets have ample capacity to absorb the projected increase in sovereign borrowing given the current country composition of announced fiscal easing measures. However, any further fiscal easing, especially in high debt countries, could lead to a reassessment of the absorption capacity by financial markets. Mentioning the growing share of households and foreign investors among holders of euro area sovereign bonds, the authorities also noted that the presence of hedge funds in euro area sovereign markets is increasing. The authorities further noted that while hedge funds active in euro area sovereign markets did not amplify volatility during the recent stress episode, they nonetheless recognized the potential for these funds to pose challenges for market functioning.

26. The authorities noted nascent signs of possible reversal in capital flows between the US and Europe in the aftermath of the tariff announcement, which could support sovereign

funding markets. However, they noted that it is too early to assess if this reflects a structural portfolio reallocation. While the authorities acknowledged the limited depth and liquidity of markets for EU safe assets, they noted that recent common EU issuances under NGEU and planned defense-related borrowing, as well as ongoing work on the Savings and Investments Union (SIU) represent important steps toward enhancing market capacity for EU safe assets. The authorities also noted that the more challenging business environment for corporates with trade exposures to the US is unlikely to pose systemic risks in a baseline scenario due to banks' robust capital and liquidity positions, and elevated profitability.

27. The authorities recognize significant uncertainty regarding the fiscal outlook, particularly related to the implementation of announced policies in Germany. They expect the fiscal stance in 2025 to be broadly neutral, with slightly contractionary national policies offset by the implementation of EU funds, particularly the Recovery and Resilience Facility (RRF). Expenditure composition is anticipated to shift as countries consolidate net current spending while aiming to increase or maintain public investments. Uncertainties remain regarding the implementation of the announced fiscal policy changes in Germany, particularly the pace and financing of increased expenditures. The EU's fiscal outlook excluding Germany remains stable but varies across member states. The Commission finds the near-term fiscal stance broadly appropriate in most countries, albeit with somewhat more gradual consolidation than staff recommendations in some countries. Countries with high deficit and debt levels, like Italy and France, are expected to undertake significant fiscal adjustments in line with the adopted Medium-term Fiscal Structural Plans (MTFSPs). The authorities do not foresee significant risks to the fiscal outlook from potential fiscal support measures in response to tariffs and related economic disruptions.

POLICY STRATEGY

28. In an increasingly challenging global environment, a comprehensive policy strategy is needed for decisive EU-level actions to boost Europe's growth potential and financial resilience. This includes reforms to strengthen the EU single market, enhance energy security, orient the EU budget to invest in common public goods, and upgrade the macroprudential and crisis management framework to combat new shocks. The goal is an economic model for Europe where robust private investment powers innovation and high value-added job creation. Such a model can deliver healthy domestic demand to reinforce diversified external economic ties while fostering strong productivity growth to generate resources for meeting long-term spending challenges. Accordingly, the strategy detailed below first discusses policies coordinated at the EU level to address common domestic and external challenges. Ensuring debt sustainability and securing financial and price stability are essential prerequisites for the successful implementation of these reforms. The conjuncture suggests a need for policy neutrality, but there are difficult fiscal trade-offs to be managed to address spending pressures, while monetary policy will have to be prepared to respond to unfolding events. Improving system-wide risk monitoring beyond banks and completing the financial architecture are key to preserving financial stability.

STRENGTHENING EUROPEAN INTEGRATION IN A MORE CHALLENGING GLOBAL ENVIRONMENT

A. Strengthening the EU Single Market to Lift Investment, Innovation, and Productivity

29. A more integrated EU single market can increase investment and innovation, ultimately lifting productivity and recalibrating the composition of domestic demand.[14] Interconnected intra-EU barriers in different areas—fragmented regulation, inefficient and fragmented financial intermediation, limited labor mobility, and a fragmented energy system—hamper productivity and growth in multiple ways. They slow down innovation and technology diffusion by impeding cross-border scale up of firms, limit market dynamism, and ultimately result in the misallocation of resources. Moreover, they create non-tariff barriers to intra-EU trade. Staff analysis estimates that these barriers are equivalent on average to a 44 percent tariff on goods and 110 percent on services (Adilbish and others, 2025). A strengthened single market with a streamlined regulatory environment, greater labor mobility and an integrated energy market, along with a well-functioning savings and investments union (SIU)—comprising capital markets union (CMU) and banking union (BU)—will help reduce these barriers, thereby fueling innovation and recalibrating the composition of domestic demand toward more private investment. The planned digital euro could increase the efficiency of cross-border retail payments and ultimately help facilitate greater cross-border economic activity within the EU.[15] Staff analysis (Arnold and others, 2025) suggests that a few actionable steps along these dimensions could jumpstart the process of deeper integration and already deliver a meaningful initial payoff by increasing the EU GDP level over 10 years by around 3 percent—a sizable improvement considering that the EU potential growth is projected to be just above 1 percent annually over this horizon—with about one fifth of the increase in the GDP level attributed to gains in total factor productivity and the rest explained by higher factor accumulation (increased capital stock and labor supply). Individual member states would benefit from this in the range of around 2 to 5 percent.[16]

30. Adopting a 28th corporate regime is critical for firms' scale up and innovation. Progress with harmonizing the EU company law and insolvency law frameworks has been modest and full

[14] For a detailed discussion see Arnold and others (2025).

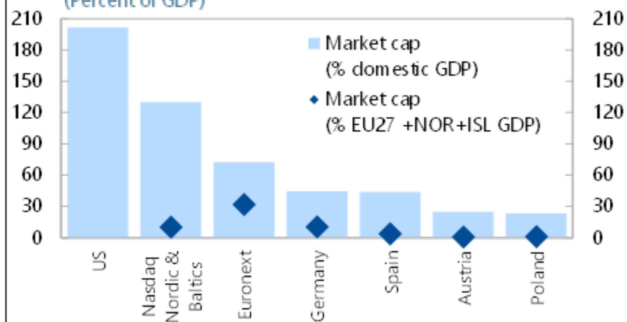
[15] An ECB (2022) study involving nine EU countries finds that while substantially falling throughout the 2010s, the private costs of payments (incurred by the relevant individual parties in the payment chain) ranged from 0.2 to 1.6 percent of GDP (mainly due to the cost of handling cash and of debit cards).

[16] Four types of reforms are modeled in the simulation: (i) adopting a high-quality insolvency regime uniformly for all firms across the EU, which lowers corporate risk premia and incentivize scale-up; (ii) increasing venture capital investment in the economy (which fosters an ecosystem for more firm creation and innovation leading to higher TFP), (iii) increasing labor mobility across the EU, which helps better balance demand and supply of labor and improve skill matching; and (iv) lowering the level and volatility of energy prices through energy market integration.

harmonization cannot be achieved in the near term.[17] In the meantime, a 28th regime—alternative to national regimes—that establishes uniform regulations and legal rules crucial for not only the formation and operation of firms, but also their dissolution, can provide a voluntary EU-wide legal framework to facilitate firms' expansion without requiring them to navigate divergent national regulations (see Box 1). This would help lower regulatory burdens and improve legal certainty for firms (which also matters for investors, including for cross-border investments) and, importantly, preserve precious resources for advancing on investment and innovation to strengthen competitiveness. Increased innovation and technology adoption could, in turn, facilitate productivity gains related to the spread of Generative Artificial Intelligence.[18]

31. As part of the push toward SIU, a well-functioning CMU requires a larger capital pool, more efficient allocation, and strengthened private risk sharing. Broadening the options of funding for risky projects that often lack tangible collateral required by banks will allow firms to invest, scale up and innovate, while also improving "exit" options (e.g., going public), yet the European stock markets are small and fragmented (text figure). The pool of long-term capital can be gradually expanded through introducing automatic enrolment in voluntary occupational pension schemes for employees, lowering the cost of retail investment, and enhancing financial literacy and attractiveness of investment products to retail investors.[19] A greater share of the assets of institutional investors can be channeled toward equities by implementing the Solvency II review aimed at facilitating equity investment by insurers, increasing institutional investor familiarity with venture capital (Arnold et al., 2024), and regular reviews to identify and address undue restrictions on equity and other risky investment by institutional investors. Additionally, improving capital allocation within the single market requires furthering regulatory and supervisory convergence (which would benefit from increasing the independence, powers, and budget of ESMA).[20] With more diversified EU-wide (or

Stock Market Capitalization, 2024
(Percent of GDP)



Sources: World Federation of Exchanges; Eurostat; and IMF staff calculations.
Note: Nasdaq includes exchanges in DNK, FIN, ISL, SWE, EST, LVA, LTU. Euronext includes exchanges in BEL, FRA, IRL, ITA, NLD, NOR, PRT. Domestic GDP defined as the sum of GDPs of countries with exchanges in the Nadaq or Euronext group.

---

[17] According to Gelter (2019), EU company law harmonization has been largely a top-down effort led by the Commission without any particular business or investment interest group pushing for harmonization. Scholars are divided about the magnitude of the impact. Enriques (2016) viewed the progress toward uniformity as modest, but noted positive impacts from a few top-down initiatives, for example, the Shareholder Right Directive (on member states companies' internal governance) and the Cross-Border Merger Directive (that made regulatory arbitrage easier, which in turn incentivized member states to harmonize).

[18] Misch and others (2025) find that the medium-term productivity gains for Europe as a whole are around 1 percent cumulatively over five years, larger than estimates by Acemoglu (2024) for the US.

[19] For instance, an ambitious review of the framework on the Pan-European Personal Pension Product (PEPP) could go a long way toward identifying actions to increase the attractiveness of private pension products for European retail investors (see Arnold and others, 2025).

[20] See Euro Area FSAP Technical Note on Capital Markets Union for further detail on the steps and careful sequencing needed for centralizing supervision if pursued in line with recent CMU proposals.

worldwide) equity portfolios, households will be able to smooth consumption through the business cycle, improving private risk sharing.

Box 1. European Union: A Case for a 28th Regime

Staff's proposed voluntary 28th regime aims to establish uniform regulations and legal rules crucial for not only the formation and operation of firms, but also their dissolution. Under this framework, the Business Code would standardize areas related to: a) corporate and securities law, b) accounting regulations, and, in particular, c) insolvency procedures.

- A uniform company law framework would significantly remove the extra burden (stemming from divergence of national regimes) on firms in their expansion across the EU.
- Accounting standards would be unified and applied uniformly across jurisdictions.
- Insolvency procedures would be subject to a single regime and applied uniformly and be dealt with by a specialized court/judge in the country of incorporation.
- A standardized investment procedure and a lightweight and standard investment contract—inspired by the French Bon de Souscription d'Actions par Accord d'Investissement Rapide (BSA Air) or the Simple Agreement for Future Equity (SAFE) available in the US—would allow investors to easily invest in small, young firms.

Regulatory burdens for firms incorporated in Europe are significant, with administrative costs estimated by the Eurostat to be around €150 billion annually. The necessity to navigate diverging corporate structures and legal practices across borders hampers firms' ability to scale up because of increased compliance costs and legal uncertainties—factors that are also significant for potential investors. In particular, for small and young firms, industry experts indicate that certain national corporate frameworks are inadequate for supporting venture capital investments essential for their growth (Biernat et al., 2024).

Following the announcements on a 28th regime (e.g. Competitiveness Compass, Startup and Scaleup Strategy, and Single Market strategy), the EC is launching a public consultation on a 28th regime. The consultation, seeking stakeholders' inputs, will likely cover a wide range of topics. At the same, the upcoming EU Innovation Act (expected in Q1 2026) and European Parliament's report (expected in December) will feed into the 28th regime discussions.

Possible significant benefits justify decisive efforts toward adopting and implementing such a regime in a timely manner, though the process will be challenging. The adoption of such an alternative regime alongside divergent national regimes is a complex process, requiring delicate negotiations and cost-benefit analyses. Moreover, the implementation of the regime will be difficult because this unified regime cannot be as exhaustive as national regimes, and there could be cases where national rules have to be used, thus lowering the effectiveness of the regime.

32. **Advancing the SIU also requires continued progress on the banking union (BU)—a critical complement to the CMU.** Lowering barriers to cross-border bank mergers and acquisitions would help augment bank finance, address long-standing concerns of structurally low profitability and high costs, and spur competition within the euro area's banking sector.[21] Completing the BU will make the banking sector—at the core of the European financial system—more resilient and efficient. This requires strengthening the euro area financial safety net (see para 67), including by introducing more flexibility in the resolution regime to allow a wider range of banks access to the Single

[21] See evidence on the positive effects of cross-border M&As on bank performance in Figueiras, I., S. Gardó, M. Grodzicki, B. Klaus. and L. Lebastard, 2021. "Bank mergers and acquisitions in the euro area: drivers and implications for bank performance." *ECB Financial Stability Review*, November 2021.

Resolution Fund, introducing a European Deposit Insurance Scheme (EDIS)—which will help reduce the interlocking vulnerabilities of national-level public finances and bank balance sheets (i.e. the sovereign-bank nexus), finalizing the ratification of the ESM Treaty to enable the ESM to act as a backstop for the Single Resolution Fund, and making further progress on access to liquidity in resolution (see para 66). The digital euro—as a secure, low-cost pan-euro area payment solution that is in its preparatory stage[22]—could help deepen the integration of financial services within the European market, complementing the SIU and the single market more broadly. Through streamlining and unifying both domestic and cross-border retail payments, it could help improve payment system efficiency and reduce transaction costs for users, especially households and small enterprises, and enhance competition in the retail payments system.

33. Improving intra-EU labor mobility can help alleviate local labor shortages and improve skill matching. Modernizing the EU-level professional qualification recognition can help better align the supply of skills with evolving labor market demand. Enhancing the transferability of pension rights and the coordination of social security systems will provide mobile workers with greater financial security, while introducing portable wage agreements and reducing restrictions on freelance employment will foster a more dynamic EU labor market. Addressing housing affordability and accessibility will help reduce the financial burden on mobile workers, in turn improving job reallocation.[23] Finally, policies that support healthy aging and effective migrant integration can help counter the adverse impact of aging on labor supply, alleviating labor shortages and ultimately fiscal pressures. [24,25]

34. Enhancing energy security through increasing the reliance on renewables in line with goals of the "Fit for 55" package and better integrating the EU electricity market can bolster competitiveness and strengthen resilience. While energy import dependency has declined—particularly from Russia, which the US has replaced as the most important fuel exporter to the EU—it remains high, especially for petroleum and natural gas (Text Figure 7). Faster adoption of renewables can further reduce fossil fuel dependence, lower emissions and costs, and boost competitiveness, while a more integrated electricity market will reduce price disparities and strengthen resilience (IMF 2025).[26] At the same time, addressing challenges such as intermittency and base load reliability may require complementary energy solutions. Achieving a fully integrated, single energy market requires member states to overcome obstacles to integration and develop a coordinated strategy (anchored in a Europe-wide perspective but tailored to country specifics; see Kammer 2025).

[22] See Cipollone (2025), Harnessing the digital future of payments: Europe's path to sovereignty and innovation.

[23] See, Höynck et al. (2025), Developments in the recent euro area house price cycle; and Elfayoumi et al. (2021), Affordable rental housing: Making it part of Europe's recovery.

[24] IMF, 2025, WEO Chapter 2 "The Rise of The Silver Economy: The Global Implications of Population Aging." April WEO 2025.

[25] See Caselli et al. (2024), Migration into the EU: Stocktaking of Recent Developments and Macroeconomic Implications.

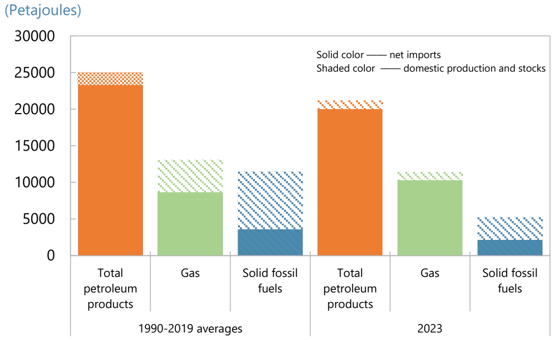
[26] Simulations that assume a market integration scenario under which cross-border electricity trade rises by 50 percent find that annual EU GDP could increase by around 0.1 percent by 2030 (IMF 2025).

35. EU-level reforms need to be complemented with equally ambitious national-level efforts, which would amplify their growth impact. Remaining structural domestic policy gaps relative to most growth-friendly regulatory settings highlight the scope for complementary policy action at the national level (Budina and others 2025). Successful implementation—by which countries aim to close 50 percent of their prioritized domestic policy gaps—would entail sizable gains in GDP level of around 5.7 percent for the EU in the medium term. Building human capital and improving the functioning of labor markets would not only raise labor force participation, but also (increasingly) boost productivity through improved allocation of workers and seize upon new technological opportunities. Given that further integration of the EU single market may adversely affect some firms and segments of the population within regions, addressing adjustment costs and the distributional impacts of reforms, through leveraging existing safety nets and providing temporary and targeted fiscal support where justified, will also be important.[27] Finally, enhancing the social acceptability of structural reforms through informed, inclusive, and trust-based approaches, including early active dialogue with stakeholders to clearly communicate on the societal benefits of the measures, will help maximize their impact.[28]

Text Figure 7. European Union: Energy Dependency and Imports

Energy Dependency by Fuel

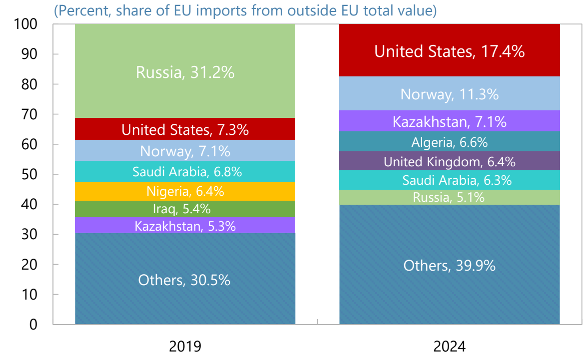
(Petajoules)



Sources: Eurostat and IMF staff calculations.

Energy Imports from Outside the EU in 2019 vs 2024

(Percent, share of EU imports from outside EU total value)



Sources: Eurostat; and IMF staff calculations.

Authorities' Views

36. The authorities agreed on the urgency to strengthen the EU single market to boost Europe's productivity growth and enhance resilience. They concurred with the assessment that regulatory barriers, subdued capital deepening, and slow adoption of new technologies contribute to constraining innovation and scale-up. They emphasized the importance of having a collective effort

[27] Lessons from the rollout of COVID-19 extraordinary support measures can help guide the design of targeted and temporary fiscal support, including in the selection of instruments that take due consideration of fiscal costs and burden sharing with the private sector. See Ebeke and others, 2021, "Solvency Support for Enterprises: Key Considerations and Preliminary Lessons from Europe Programs."

[28] See World Economic Outlook Chapter 3, October 2024, "Understanding the Social Acceptability of Structural Reforms" and Fiscal Monitor Chapter 2, April 2025, "Public Sentiment Matters: The Essence of Successful Energy Subsidies and Pension Reforms".

both at the EU and national level with initiatives that would deliver more harmonized insolvency regimes (possibly complemented with a 28th regime framework), enhanced labor mobility, and deeper EU capital markets. The authorities agreed that actionable priorities regarding the coordination of social security benefits, facilitating the recognition of professional qualifications, as well as expanding education programs (such as Erasmus+) are key for improving labor mobility. Finally, the authorities acknowledge the role of the single market in incentivizing private investment and boosting domestic demand.

37. The authorities concurred on the pressing need for advancing the SIU to mobilize private capital in supporting economic growth and investment across the EU. They emphasized that initiatives related to securitization, increasing financial literacy and supplementary pensions, facilitating public/private co-investments in risk capital and encouraging retail participation (through tax-advantaged accounts), and cross-border integration (with the review of PEPP Regulation, IORP II Directive and the implementation of the FASTER Directive, and by advancing the single market for banking), would facilitate greater cross-border investment, improve access to financing for businesses, and ultimately contribute to the overall resilience and competitiveness of the European economy. They broadly agreed on the need to enhance the supervisory powers of ESMA to foster a more resilient financial environment. The authorities acknowledged that the implementation of the digital euro could enhance the efficiency of payment systems, reinforce monetary sovereignty, and facilitate greater financial inclusion, thereby supporting the overall integration of the euro area financial markets. At the same time, they noted that despite all the adequate safeguards in the digital euro’s design, some banks are still concerned about potential reduction in deposits, costs, and how the digital euro fits in the payments structure. The authorities are actively engaging with banks to address these concerns.

38. EU authorities emphasized that energy security, competitiveness, and affordability remain top priorities. They underscored the need for a broad and sustained strategy focused on deployment of renewable energy, resolving key bottlenecks, particularly in permitting, and manufacturing of clean technologies. While a fully centralized and integrated approach is not envisaged, coordination tools such as the Projects of Common Interest (PCIs) under the TEN-E regulation play a crucial role in addressing cross-border infrastructure challenges. In addition, dedicated EU-level instruments play a role in facilitating coordination between the EU and Member States, helping to align national efforts with broader EU policy objectives. Implementation is primarily driven by member states, with EU-level coordination provided through the Governance of the Energy Union and Climate Action, European Semester and financial incentives via EU funds. Funding continues to be a key concern, with ongoing efforts to enhance access to financing, including through collaboration with the European Investment Bank.

B. Coping with a Challenging Global Policy Arena

39. An escalation of trade tensions challenges the EU. The EU, like other open economies well integrated into global supply chains, is vulnerable to the deteriorating outlook for trade. Extended tariffs and potential retaliatory measures are likely to curtail global trade and aggravate fragmentation, exacerbate inefficiencies, and discourage investment, ultimately undermining productivity and growth potential. The adverse effects of tariffs on countries imposing them are generally more pronounced when levied on intermediate and less substitutable goods and depend on the magnitude of retaliatory actions and the adaptability of trade policies with other trading partners. These effects would also depend on the extent of possible trade diversion from other regions.

40. The EU would benefit from its continued advocacy for a stable, rules-based global trading system, removing remaining internal trade barriers, and deepening and diversifying its trade agreements. The EU should continue its leading role in promoting multilateral and plurilateral integration and supporting a more open, stable, and transparent trading system through reforms at the World Trade Organization (WTO), including the full restoration of the dispute settlement system. In a more tariff prone world, the value of deepening integration within the EU and with its trading partners is increased. Further diversifying global partnerships—that is, advancing new free trade agreements and strengthening existing trading relationships, including with the UK (building on the May summit agreement), finalizing the agreement with Mercosur, and exploring closer ties with CPTPP —can help improve supply chain resilience and capture efficiency gains from trade.

41. Any new industrial policies should be limited to well-defined market failures and be coordinated at the EU level. The EU's desire to enhance resilience and competitiveness in response to global trade fragmentation and protectionism is understandable and, in designing measures, it is important to avoid creating new distortions that harm the European economy or provoke retaliation. Where state aid is justified based on market failures or positive externalities, it should be judicious, temporary, limited in scope, and coordinated at the EU level.[29] To this end, the calibration and implementation of the industrial policy framework outlined in the EU's Competitiveness Compass and Clean Industrial Deal, including exceptions for state aid, should avoid adding inefficiencies (through distorting trade and investment), leaning against structural transformation, or discriminating against foreign producers (e.g., the proposed introduction of European preference in public procurement for strategic sectors and low-carbon technologies). Amid plans for revising merger guidelines to better reflect innovation capacity and global competition, preserving contestable markets through product market reforms and broader efforts to strengthen the EU single market (see Section A) remains essential.

Authorities' Views

42. The authorities expressed a strong intention to deepen economic integration with trading partners while continuing to champion the rules-based international trading system. They emphasized the need to engage with trading partners to identify mutually beneficial solutions that can de-escalate trade tensions and enhance trade relations. The authorities reiterated that they are continuously monitoring potential trade diversion, and that the EU has the necessary tools to

[29] Hodge and others (2024) "Industrial policy in Europe: A single market perspective", IMF WP 24/249; and Brandao-Marques and Toprak (2024) "A bitter aftertaste: How state aid affects recipient firms and their competitors in Europe,", IMF WP/24/250.

take actions if necessary. They also highlighted the need to strengthen economic resilience through diversification and strategic safeguards, while reaffirming their commitment to a rules-based global trading system. Engagement has been intensified with a broad set of trading partners to deepen integration through both bilateral agreements (including Free Trade Agreements, and alternative forms such as Sustainable Partnership Agreements, Digital Agreements; and Clean Trade and Investment Partnerships) and plurilateral cooperation. The authorities continue to view the WTO as a critical institution for maintaining a rules-based multilateral trading system and continue to work toward reforms.

43. The authorities emphasized the importance of a coordinated industrial policy at the EU level and plan to update competition guidelines. Industrial policy will focus on enhancing competitiveness and strengthening strategic supply chains within the single market (e.g., chips and semiconductors, clean technologies). Changes to state aid rules introduced during the COVID-19 pandemic may become more permanent under the Clean Industry State Aid Framework, while safeguards will avoid subsidy races and ensure a level playing field. Adjustments to the EU's public procurement aim to enhance supply chain resilience while remaining consistent with WTO principles. The authorities have initiated a study of competition policy and innovation, and plan to modernize the guidelines to reflect significant changes in market realities, including from globalization and digitalization.

MANAGING COMPLEX FISCAL TRADEOFFS TO ADDRESS RISING SPENDING NEEDS

A. Managing Spending and Fiscal Adjustment Needs under the Economic Governance Framework

44. For countries with high debt and limited fiscal space, significant fiscal adjustments are needed to mitigate fiscal risks. Excluding Germany, staff's fiscal policy recommendations for euro area countries would see the SPB rise from -1.5 percent of GDP in 2024 to 1.4 percent of GDP in 2030 (a cumulative adjustment of 2.9 percent of GDP). Relative to what is assumed in the baseline projections, this requires additional SPB improvement of 1.9 percentage points of GDP (cumulative over 2024-2030). These adjustments should prioritize revenue and expenditure measures that minimize adverse impacts on labor supply and long-term growth. In Germany, fiscal space allows for a temporary rise in the deficit to accommodate higher spending on defense and public infrastructure, followed by a gradual fiscal adjustment.

45. Achieving the EU's goal to strengthen defense capabilities exacerbates member states' fiscal challenges. Many countries have announced plans to increase defense spending, although not yet sufficiently detailed to be included in the baseline. While the full budgetary impact is uncertain, additional defense spending would exert further fiscal pressure. A broad increase in defense spending at the scale referenced in the Commission's ReArm Europe Plan (up to 1.5 percent of GDP) would lead to a steep increase in debt levels if not coupled with adjustment efforts to counterbalance the increased defense spending.[30] Moreover, potential economic and trade disruptions from higher tariffs may lead to temporary fiscal support paired with policies to facilitate reallocation for affected households and businesses. These emerging pressures come on top of already significant long-term spending pressures related to interest costs, aging populations, climate transition and energy security—reaching about 3.9 percent of GDP annually for the euro area economies in 2050.[31]

46. Member states should transparently account for rising spending pressures within their fiscal frameworks and develop credible plans to ensure sustainability. Countries with high-debt levels may have little room to increase spending due to fiscal sustainability concerns and rising risk premia, requiring fiscal adjustment plans to offset any increases; for some, substantial and front-loaded adjustments could mitigate risks and bolster confidence. Low- and medium-debt countries have more room to borrow but nonetheless should articulate a credible plan to ensure debt sustainability. In all cases, new defense expenditures should be included in the regular budget for transparency, with robust oversight to ensure accountability and spending efficiency. The EU budget can reinforce national efforts to address shared priorities. In case severe economic and trade disruptions necessitate fiscal support, measures should be narrowly targeted to the most affected and be temporary. If disruptions are expected to be permanent, structural policies such as active labor market policies should take a key role in the transition.

47. The Commission proposed a coordinated activation of national escape clauses within the Economic Governance Framework adopted in 2024 to allow for increased defense spending.[32] Countries can decide whether they maintain their commitment to the planned consolidation paths or activate the escape clause, based on their defense spending plans and fiscal sustainability considerations. As of April 30, 16 member states (Belgium, Bulgaria, Croatia, Czechia, Denmark, Estonia, Finland, Germany, Greece, Hungary, Latvia, Lithuania, Poland, Portugal, Slovakia, and Slovenia) have decided to request the coordinated activation, while countries can still submit

---

[30] In an illustrative scenario with a permanent 1.5 percent of GDP increase in deficit-financed defense expenditures from 2028 in all euro area countries excluding Germany (where a substantial increase is already included in the baseline), the aggregate debt for this group is expected to rise to 107 percent of GDP in 2030 and 116 percent of GDP in 2035. Stabilizing the debt-to-GDP ratio in five years thereafter would require an annual SPB improvement of 0.4 percent point (a cumulative 2.1 percentage point of GDP) over the 2029-2033 period—larger than the 0.1 percent of GDP annual SPB improvement (cumulative 0.6 percentage point of GDP) over the same period that would keep the debt ratio stable without the increase. Despite the stronger efforts, the debt ratio would stabilize at a level over 4 percentage points of GDP higher than before the spending increase. Furthermore, many countries would need to undertake additional measures to put debt on a downward trajectory and create space to address other spending pressures.

[31] See Eble and others (2025).

[32] The framework entered its first implementation phase in 2025, with the adoption of the medium-term fiscal-structural plans (MTFSPs) for 22 member states (with two under the Council's consideration after positive assessments from the Commission, two under the Commission's review, and one not yet submitted, as of mid-May 2025). These plans outline member states' commitment to fiscal trajectories, framed by the ceiling on the net expenditure growth, along with plans for reforms and investments—aligned with the corrective path if a member state is under the excessive deficit procedure (EDP). For five countries (Finland, France, Italy, Romania, and Spain), the adjustment period is extended to seven years from four based on their reform and investment commitments. Annual Progress Reports are published for 24 member states.

requests at any time. Upon activation, member states may deviate from the committed fiscal path in their MTFSPs when specifically linked to increased defense expenditures since 2021—with the deviation from the agreed path in any given year capped at 1.5 percent of GDP.[33] The definition of eligible defense expenditure encompasses both investment and current expenditures, aligned with the classifications of defense in national accounts. This alignment would help ensure data consistency and facilitate monitoring, while strong guidance on data accuracy remains important.

48. It is essential that member states and the Commission assess the consequence of increased defense spending on debt sustainability, modify the adjustment path as necessary, and engineer a smooth exit from the escape clause. Avoiding unintended broader expenditure slippages while ensuring medium-term debt sustainability is crucial for preserving the framework's credibility. The use of the escape clause should be limited to the initial phase of scaling up defense investment expenditures and not for recurring spending over an extended period. While the escape clauses are in effect, as per the Commission's guidance, member states should ensure non-defense expenditure complies with the agreed net expenditure path. As member states' plans for increased defense expenditures evolve, their impact on debt sustainability and required adjustment needs should be assessed on an ongoing basis. If the adjustment needs required to ensure debt sustainability are significantly higher than commitments in the current MTFSPs, the Commission should provide guidance to facilitate a further gradual adjustment in other expenditures or discretionary revenues while the escape clause is still active to help avoid abrupt corrections as the countries exit from the escape clause. Member states and the Commission should use the rules to continue facilitating necessary dialogue on consolidation efforts aimed for sustained fiscal stability.

49. The implementation of the fiscal rules should ensure available fiscal space can be used to improve the longer-term outlook without compromising fiscal sustainability. Equally important is to ensure that the rules do not hinder countries with low fiscal risks from increasing spending to boost potential growth and enhance resilience. Reopening the fiscal rules at this stage may be premature. However, following the ramp-up in defense spending, if the rules require significant fiscal adjustment in countries with low fiscal risks—contradicting the risk-based spirit of the fiscal rules—a broader assessment of key parameters may be necessary. This could include raising the debt-to-GDP threshold beyond which the rules become binding to achieve an optimal balance between allowing these countries to fulfill spending objectives that can have favorable EU-wide spillovers and ensuring their debt remains sustainable.

[33] When assessing the deviation, the Commission will consider the increase in defense expenditures since 2021. If deviation is explained by this increase and is below 1.5 percent of GDP, no enforcement steps will be taken. Furthermore, the Commission has proposed that while the escape clause is active, the deficit resilience and debt sustainability safeguards (i.e., minimum annual adjustment requirements beyond the sustainability-based requirements) do not apply, and EDP may not be opened when the 3 percent of GDP deficit threshold is breached due to increased defense spending.

B. Enhancing the EU Budget to Address Shared Challenges

50. Coordinated efforts at the EU level and targeted investments are crucial to address shared challenges and help member states manage fiscal tradeoffs. Identifying existing investment gaps and areas where joint EU-level initiatives would deliver cost-effective solutions can provide a blueprint for priority actions. The EU budget, formally known as the multiannual financial framework (MFF), is an important policy lever in this regard, pooling and channeling resources to efficiently address common challenges and share risks.[34] The EU budget should focus more on European Public Goods (EPGs) for which EU level actions can generate efficiency gains over provisions at the national level, by leveraging economies of scale and positive cross-border externalities, as well as avoiding costly coordination failures. Focusing on areas with clear EU-level advantages, including spending on research and innovation to boost productivity and investing in energy security, clean energy transition and defense to enhance resilience, the EU budget can maximize value and generate net savings for member states. In the area of clean energy transition, for instance, better EU-level coordination and planning can lower investment costs by 7 percent.[35]

51. Strengthening the financing capacity and adaptability of the EU budget is key to maximize its impact.[36] The current modest size and limited allocations for new priorities (e.g., single market, innovation, defense) fall short of addressing the growing EU challenges that require centralized responses. Ongoing discussions on the next MFF covering 2028-34 offer an opportunity to revamp the EU's primary central fiscal instrument.[37] Bottom-up estimates of EU-level public investment needs for EPGs suggest that budget capacity would need to increase by at least 50 percent to avoid a shortfall, if funding for other programs including the Cohesion Policy and Common Agricultural Policy were to remain unchanged. To support initial investment scale-up without delay and distribute the fiscal burden effectively over time, the budget's financing framework should be enhanced with borrowing capacity, paired with progress toward expanding own resources to enhance the long-term sustainability of the budget. Further, reforms are needed to make the budget more streamlined, responsive to evolving needs, and more effective by incentivizing good performance in delivering national reforms and investments aligned with shared EU priorities. A performance-based approach that links financial support to outcomes can improve the effectiveness of EU spending.

[34] See, for example, Fuest and Pisani-Ferry (2019), Buti, Coloccia, and Messori (2023), Claeys and Steinbach (2024), Wyplosz (2024) for discussions on EPGs, and see Janse, Beetsma, Buti, Regling, and Thygesen (2025) and Demertzis, Pinkus, and Ruer (2024) for more discussions on the EU's role in strategic investment. See Arnold and others (2022) for discussions on a greater EU role in macroeconomic stabilization and provision of public goods.

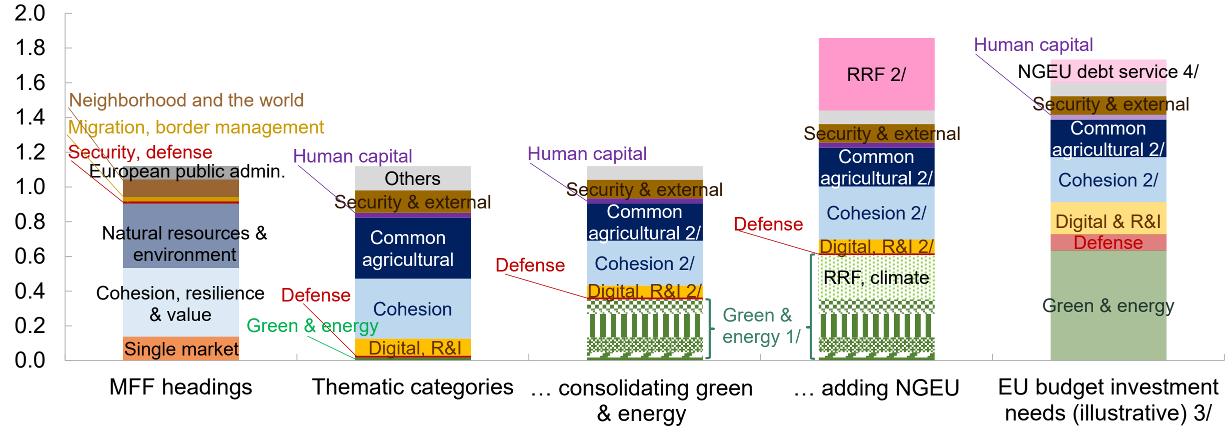
[35] See IMF, 2024, Euro area policies: 2024 annual consultation staff report.

[36] For a detailed discussion see Busse and others (2025).

[37] In February, the Commission outlined key challenges for the next MFF, underscoring the need for an ambitious overhaul of the budget in size and design, with a formal proposal for the next MFF for 2028-2034 expected in July.

Text Figure 8. Euro Area: The Current EU Budget and Potential Investment Needs

(Percent of GNI)



Sources: The European Commission, Darvas and McCaffrey (2024), Draghi (2024), Letta (2024), Nerlich and others (2024), IMF staff calculations.

Note: R&I = research and innovation. See Busse and others (forthcoming) for details.

1/ Incorporating the Commission's estimate on the EU budget spending based on the Climate Mainstreaming, consolidating climate-related expenditures in various programs. While fully recognized in the charts, many have argued that these estimates are likely overstated (Darvas and Sekut, 2025; Begg and others, 2025; European Court of Auditor, 2024).

2/ Excluding the portion counted for the Climate Mainstreaming.

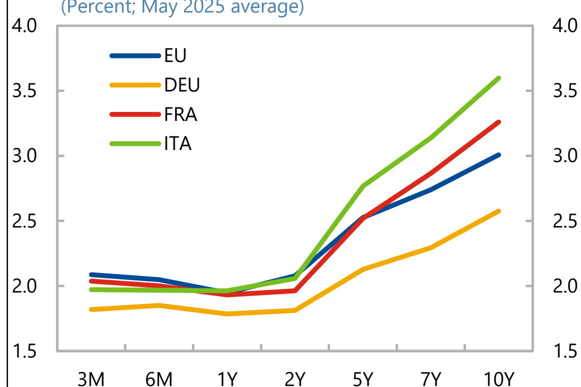
3/ The EU budget investment needs for the green transition and energy security are calculated based on the Commission's estimates on total investment needs to achieve the EU climate goals and the share of EU public sector investments (weighted by the sectoral investment needs) estimated by Nerlich and others (2024); Defense investment needs are based on the ambition announced by the Defense Commissioner, equivalent to about 30 percent of the total investment needs estimated by the Commission; Digital, R&I investment needs are based on the proposal by Draghi (2024). It assumes spending needs for other areas remain constant.

4/ 140-168 billion in total during the 2028-34 MFF, based on Darvas and McCaffrey (2024)

52. The EU can harness its collective financing capabilities to better support member states. In response to large shocks, the EU mobilized resources through joint borrowing (e.g., the European Financial Stability Facility, NGEU, and Support to mitigate Unemployment Risks in an Emergency), and it recently announced a new loan instrument for joint defense procurement, Security Action for Europe (SAFE).[38] These initiatives could potentially enhance risk sharing and reduce the overall financing costs, allowing member states to access capital at lower interest rates than they

Yield Curve Across EU Instruments

(Percent; May 2025 average)



Sources: Bloomberg Financial LP.; and IMF staff calculations.

[38] The Security Action for Europe (SAFE) is a joint borrowing instrument supported by the remaining headroom in the current EU budget, with a total envelope of €150 billion. Under SAFE, the European Commission will provide loans to assist member states in financing increased defense spending and facilitating joint procurement efforts. In addition to lower financing costs, by supporting joint procurement, it aims to mitigate the risks associated with rapid and uncoordinated increases in defense expenditures. Competitive tendering in joint procurements enhances cost-effectiveness, while independent reviews and the publication of summary contracts, with sensitive information removed, promote transparency.

might individually (text figure). While the EU has established a robust creditor network and market infrastructures through these experiences and held AAA credit ratings, EU bond yields are higher than German bond yields and bond yields of other supranational EU institutions, likely reflecting relatively low liquidity and uncertainty about the EU as a steady issuer. A stronger presence in bond markets could deepen the market and position EU bonds as genuine European safe assets. This would help the EU capitalize on the convenience yield (extra return investors are willing to forgo for holding a safe and liquid assets) and bolster the euro's status as an international reserve currency (ECB 2021 and 2025; Ando and others, 2023). Any further increases in joint borrowing, however, should be paired with concrete plans to establish new resources for debt service.

53. Greater absorption of EU funds, including via implementation of RRF national targets and milestones, can help member states manage difficult fiscal tradeoffs. With less than two years until the RRF concludes in August 2026, only 28 percent of targets and milestones for EU economies have been completed, and around 47 percent of allocated funds have been disbursed. Implementation delays may limit the facility's positive economic impact, with recent estimates suggesting an impact on GDP of 0.4-0.9 percent by 2026 and 0.8-1.2 percent by 2031 for the euro area, compared to the initial estimate of 1.5 percent by 2026 that was contingent on swift, full implementation (Bankowski and others, 2024). Prioritizing the improvement of absorptive capacity—including by building relevant expertise at sub-national levels of government—while upholding the highest standards is essential to realize the full potential of the RRP. The Commission should continue focusing on eliminating duplicative efforts, harmonizing requirements and providing technical assistance and capacity-building support through the EU budget.[39] This will ultimately strengthen member states' potential growth and generate resources to meet rising long-term spending needs.

Authorities' Views

54. The authorities view the national escape clause as a transitional mechanism that provides flexibility as member states prepare to sustainably incorporate higher defense expenditures. The Commission's recommendation to adopt the clause is informed by stylized assessments of the fiscal sustainability impact of the maximum allowed flexibilities (1.5 percent of GDP increase) in defense spending. Beyond these flexibilities, the authorities concurred on the necessity of closely monitoring non-defense net current expenditures and any excess defense expenditures against the adopted MTFSPs and assessing their impact on debt sustainability on an ongoing basis. In case of non-compliance, excessive deficit procedure (EDP) continues to apply. The authorities noted that countries with high debt and deficit levels have been more cautious about increasing expenditures and activating the national escape clause. The reformed Economic Governance Framework, anchored in country-specific fiscal risks, has been useful in centering fiscal policy decisions on sustainability. Given the prevailing macroeconomic and fiscal uncertainties, the authorities prioritize maintaining the rules and their key parameters.

[39] In June 2025, the Commission provided guidance to revise and streamline the plans for RRF disbursements and explore alternative measures to use the remaining allocation including transferring funds toward national contribution to EU programs.

55. The Commission agreed with staff on several elements of the proposed MFF reform. The authorities highlighted the EU budget's potential to cost-effectively deliver on shared priorities, improving allocative efficiency and generating fiscal savings for member states. To meet rising budget demands, the authorities seek greater own resources and consider proposing additional sources beyond their 2023 proposal. Furthermore, the Commission concurred on the importance of improving the EU budget flexibility to address new policy needs and to react to crises such as natural disasters. The new MFF proposal—expected to be published in July—will discuss the possibility of consolidating various programs supporting national, regional, and local reforms and investments under one umbrella to enhance efficiency and foster synergies. Similarly, it suggests integrating EU direct investment programs into a "European Competitiveness Fund" for streamlined, flexible financial support alongside the full investment journey of projects and companies, from research to manufacturing and deployment. While modernizing the budget structure, the Commission aims to continue relying on its traditional strengths, including by enhancing engagement with regional and local authorities and supporting basic research. The Commission agreed that the performance-based approach combining reforms and investments has proven effective, and wider adoption is seen as beneficial. The implementation of ReArm Europe plan continues as planned, including the agreement on the loan instrument for joint procurement under the Security Action for Europe (SAFE).

56. The Commission agreed that it is crucial to accelerate implementation and disbursements under the RRF, as full absorption is at risk at the current pace. They plan to provide guidance to expedite implementation, including revising plans to simplify milestones and targets, and focus support on measures likely to be implemented by August 2026, including via financial instruments. Given the current structure, the authorities see opportunities to streamline processes without compromising ambition or implementation quality. The Commission reaffirmed that the facility will end in 2026, and access to unused funds will be lost, urging member states to utilize funds in time.

SECURING PRICE STABILITY AMID POSSIBLE LARGE SHOCKS

57. Since headline inflation is broadly at target, core inflation is slightly above 2 percent, and the output gap is mildly negative, a monetary policy stance close to neutral is justified. A temporary dip in headline inflation below target, on the back of lower energy prices, while core inflation remains above 2 percent, would not warrant a major change in the expected policy path, unless inflation expectations de-anchor. Thus, barring further shocks that materially revise the inflation outlook, the ECB should keep the policy rate at 2 percent. While the neutral rate that neither restricts nor stimulates the economy can only be measured with great uncertainty, estimates can provide some anchor on the neutral stance and provide a starting point to apply judgement consistent with broader economic data. Updated estimates of the short-term neutral rate (Beyer and Brandao-Marques, 2025), along with insights from other data (including the ECB’s bank lending survey), indicate that the real neutral rate is in the range of 0-0.25 percent, consistent with a nominal policy rate of 2-2.25 percent and inflation expectations broadly at target.

58. In a more shock-prone world, the ECB should retain optionality to swiftly respond to evolving conditions. Inflation was above target for the last three years, resulting in a higher frequency of price adjustments and higher wage demands than in the past. Even though inflation expectations remain well anchored, following a period of high inflation the risk of second-round wage and price effects in response to temporary supply shocks could be higher than prior to the pandemic. A materialization of upside inflation risks could necessitate reversing recent policy easing. Equally, if growth weakens relative to the baseline and inflation projections and/or inflation expectations point to a high probability of persistent, under-target inflation, then lowering the policy rate below neutral would be justified. Higher tariffs on EU exports would represent an adverse demand shock, leading to lower inflation. In the case of EU retaliation, higher import prices would provide a partial offset. Overall, trade tensions seem to be negative on growth but ambiguous on inflation. The ECB should continue to closely monitor import prices developments to better understand the impact of tariffs on inflation and react swiftly to meaningful changes in the inflation outlook.

59. Going forward, as uncertainty subsides and inflation continues to come in close to or at target, communicating with greater emphasis on the forecast together with illustrative scenarios would become increasingly important to help guide rate expectations. ECB communications have helped steer financial conditions through a period of high uncertainty (Box 2). As the current high level of uncertainty subsides, and provided that forecast accuracy does not deteriorate, an increased forecast-centered approach would benefit transmission. In addition, well-designed illustrative scenarios and sensitivity analysis around a baseline can help policymakers to convey uncertainty about the future interest rate path (Dizioli 2025).

60. Quantitative tightening (QT) should remain gradual and predictable. The short-term policy rate is the primary instrument for implementing monetary policy, with QT operating in the background in a stable manner to reduce the ECB's footprint in the bond market. In December 2024, banks repaid the remaining amounts borrowed under the targeted longer-term refinancing operations, an important milestone in the balance sheet normalization process. So far QT has proceeded smoothly without affecting money market functioning and should continue. This is welcome as the transition into the ECB's new operational framework with a leaner balance sheet proceeds, but hedge funds' growing role as intermediaries in money markets warrants careful monitoring of the effects of QT.

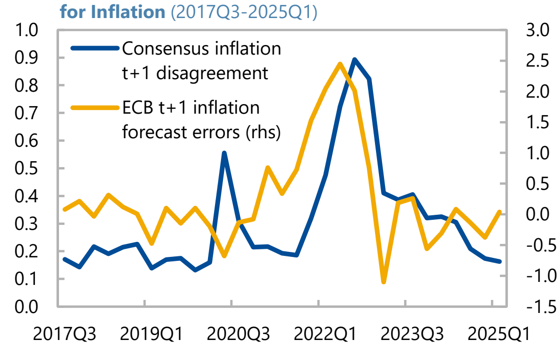
Box 2. Euro Area: Effectiveness of ECB Communications and Financial Conditions

Central bank communication is a powerful tool for steering financial conditions. Staff analysis shows that recent changes in ECB communications have significantly impacted markets' expectation of the rate path. With inflation now very close to target and forecast errors back to pre-pandemic levels, communicating with greater emphasis on the forecast will become more important. At the same time, given the high uncertainty around the outlook, retaining optionality to maneuver in the face of shocks will remain essential.

In 2022, the ECB announced that its monetary policy decisions would follow a data-dependent and meeting-by-meeting approach. Inflation spiked after the start of the war in Ukraine, and inflation forecast errors and "disagreement" among professional forecasters about the future path of inflation increased (Figure 1). At the time, the ECB introduced the data-dependence language implying that incoming real time data would inform the policy decision more than in normal times.[1] Another concept introduced to deal with heightened uncertainty was the meeting-by-meeting approach, which was aimed to convey that the Governing Council would maintain optionality and avoid committing to a predetermined policy path.

Figure 1. Forecast Errors Back to Normal

Consensus Disagreement vs. ECB Forecast Errors for Inflation (2017Q3-2025Q1)



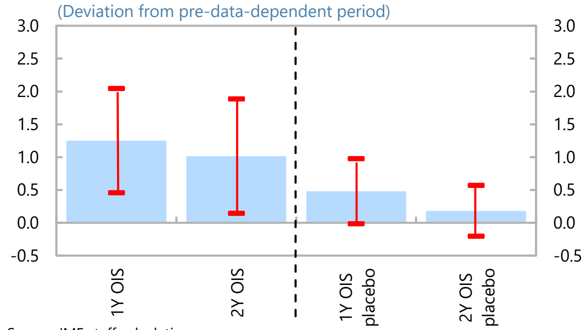
Sources: Consensus Economics Inc.; ECB; and IMF staff calculations.
Note: Consensus disagreement is the standard deviation of the 1-year ahead inflation forecast from Consensus Economics. The ECB forecast error is calculated as the ECB's forecast for the year-over-year inflation produced one quarter earlier minus the outturn.

Following the adoption of the data-dependence language, market sensitivity to data releases increased. Since the adoption of the data-dependence language in the monetary statement, market expectations for interest rates across various maturities became more responsive to data releases compared to the period preceding the announcement.[2,3] This result suggests that markets internalized the increasing importance of incoming data in affecting rates decisions (Figure 2).

The introduction of the meeting-by-meeting language seems to have been effective in buying optionality for the ECB. Following an extended phase in which future policy decisions relied on forward guidance, the Governing Council's adoption of the meeting-by-meeting language in April 2022 signaled the intention to retain the flexibility to quickly change its course of action if unexpected shocks were to occur. After the introduction of this language a greater sensitivity of the 2-year Overnight Index Swap (OIS) following Governing Council and inter-Governing Council speeches is observed (Figure 3), supporting the notion that the ECB effectively conveyed its intention not to pre-commit to a particular path.

Figure 2. Effect of Data-dependence on the Yield Curve

Impact of EA CPI Data Release Surprises on OIS at Different Maturities in the Data-Dependence Period (Deviation from pre-data-dependent period)



Source: IMF staff calculations.
Note: The chart reports the coefficient on the interaction term between the euro area CPI data release surprise and a dummy for the post-June 2022 period. This coincides with the introduction of the data-dependence language in the monetary policy statement. The model is estimated with a GARCH to account for excess volatility. The placebo estimates are based on an alternative treatment date 1-year prior to June 2022.

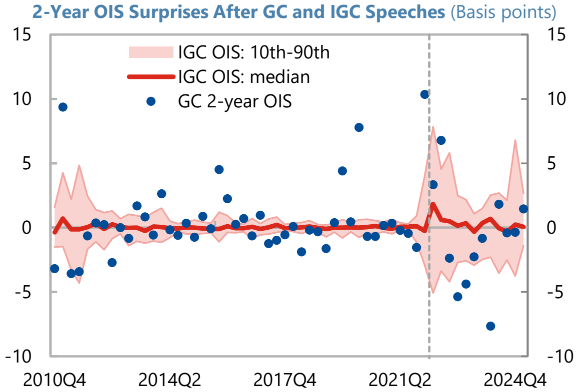
Subsequently, the introduction of forward-looking statements in late 2024 effectively steered financial conditions. In October 2024, with forecast accuracy having improved significantly and inflation approaching target, language referring to "a clear direction of travel" for the policy path was introduced, while maintaining optionality—via "meeting-by-meeting"—to determine the pace and size of rate cuts. The introduction of this language led markets to fully price in rate cuts several months in advance (Figure 4).

Box 2. Euro Area: Effectiveness of ECB Communications and Financial Conditions (Concluded)

Over this recent period of high inflation and uncertainty, different elements of the ECB communication were effective in steering financial conditions. Data-dependence led to an increased sensitivity of interest rate expectation to data releases, and meeting-by-meeting bought optionality on expectations of future policy path, while the "direction of travel is clear" guided policy expectations in the second half of 2024.

Figure 3. Effect of the Meeting-by-meeting Language Adoption on the 2-year OIS

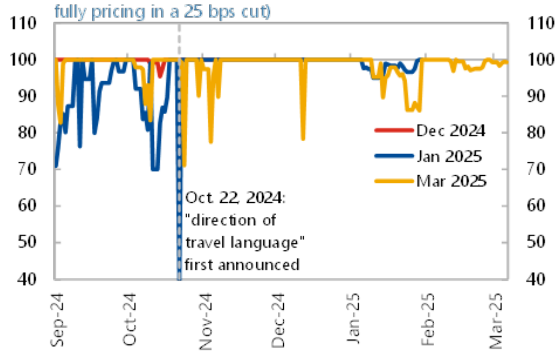
2-Year OIS Surprises After GC and IGC Speeches (Basis points)



Note: the figure plots the10th-90th percentile range for the 2-year OIS in a 90-minute window around the IGC speeches. The same metric is plotted for each GC meeting (blue dots). The vertical line corresponds to the introduction of the meeting-by-meeting language.

Figure 4. Effectiveness of the Direction of Travel on Probability of Future Rate Cuts

Market Probabilities of a Rate Cut Prior to the ECB GC Meetings (Percent; a value of 100 indicates the market is fully pricing in a 25 bps cut)



Source: Bloomberg Financial L.P.

---

[1] For a discussion of the meaning of "data-dependence", see Lane (2024), "The 2021-2022 inflation surges and monetary policy in the euro area." The June 2022 monetary policy statement added the language of data-dependence to the one of "optionality, gradualism, and flexibility" already introduced in April of the same year. Data-dependence meant that, given the high level of uncertainty, the principles of optionality, gradualism and flexibility should be informed by the information contained in the incoming data.

[2] This is also consistent with the evidence mentioned in Lagarde (2025), "A robust strategy for a new era."

[3] Estimates are based on a GARCH (1,1) model to account for heteroskedasticity in the data. The baseline model controls for inflation and interest rates in the US and in the euro area. The inflation release surprise is calculated using inflation expectations from the Bloomberg survey of professional forecasters. While the analysis relies on a high frequency identification approach in which the interest rate response is measured in a 120-minutes window to reduce omitted variables concerns related to confounding factors, other variables could have also impacted the interest rate response to data releases during this period (for example, non-linearities in markets inflation expectations). Placebo exercises with an alternative time treatment one year prior to the introduction of the data-dependence show a non-significant effect reinforcing the baseline result.

Authorities' Views

61. **Given the high degree of uncertainty, the ECB will maintain its meeting-by-meeting and data-dependent approach.** The ECB concurred that uncertainty is exceptionally high and therefore retains the optionality to adjust the monetary policy stance to sudden changes in the inflation outlook. The ECB reiterated the importance of accounting for risks and uncertainty surrounding the baseline for inflation and the economy. It also emphasized the importance of scenario analysis and sensitivity analysis—which for example was used extensively by the ECB during the pandemic—to make policy decisions more robust to changing circumstances. For instance, it has

been conducting various scenarios to simulate the impact of tariffs that indicate a negative effect on output, but an ambiguous impact on inflation, which also depends on the degree of retaliation and the net effect of tariffs on euro area financial conditions. In the current environment of substantial uncertainty and inflation close to target, the ECB de-emphasized the role of the neutral rate for future policy decisions. Finally, as part of its strategy review, the ECB is conducting an evaluation of its external communication.

62. The ECB reiterated that the primary tool for calibrating the monetary policy stance is the deposit facility rate, with quantitative tightening working in the background. The authorities have currently no intention of altering the pace of quantitative tightening, which is proceeding as planned. Any shock leading to a divergence of the inflation outlook from the ECB's target, including from changing trade tensions, would first be addressed by an adjustment of the deposit facility rate, with quantitative easing available as an additional tool in case the ECB assesses that there is insufficient room to adjust the monetary policy stance through the deposit facility rate. Temporary asset purchases could also be deployed if needed to support monetary policy transmission in the event of severe market dysfunction, using the instruments with a dedicated transmission objective. For instance, the Transmission Protection Instrument (TPI) continues to be available in case monetary policy transmission is threatened by unwarranted, disorderly market dynamics that are not due to country-specific fundamentals.

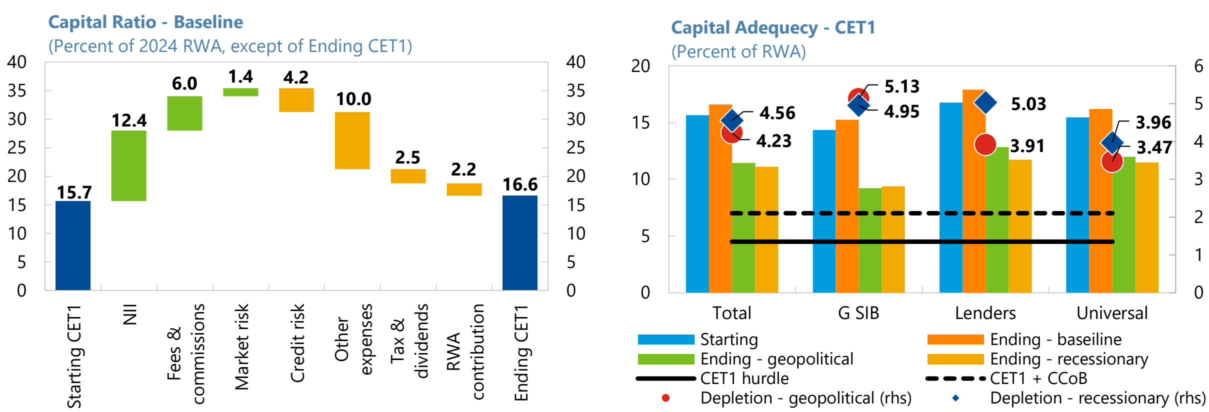
IMPROVING SYSTEM-WIDE RISK MONITORING AND COMPLETING THE FINANCIAL ARCHITECTURE

63. While the banking system generally appears adequately capitalized and liquid, stress tests point to vulnerabilities in some small banks. Bank profitability (Figure 4, panel e) and asset quality (Text Figure 6, panel a) continue to hold up even as activity remains subdued. The 2025 FSAP solvency stress tests indicate that euro area significant institutions (SIs) would be resilient to stress scenarios, including a geopolitical scenario featuring further escalation of geopolitical conflicts, commodity price volatility, and tariff shocks, and a recessionary scenario in which there is a demand-driven global slowdown amplified by sovereign distress.[40] A few small banks could breach their capital requirements (Pillar 2 capital ratios), with their capital shortfall accounting for 0.1 percent of total risk weighted assets. Cash flow stress tests suggest that SIs can withstand significant liquidity outflows under severe scenarios, however, banks' exposures to contingent liquidity risks have increased and require continued monitoring. However, the results from joint stress testing of solvency and liquidity risk for banks reveal the importance of monitoring of balance sheet items in relation to their sensitivity to market and liquidity shocks and adequately measuring counterparty credit risk, including from vulnerable NBFIs.

[40] See Euro Area FSAP Technical Note on Stress Testing the Banking Sector.

64. The authorities should closely monitor the vulnerabilities related to the NBFI sector and their interlinkages with banks. The interbank network analysis undertaken as part of the FSAP suggests that the risk of contagion through interbank exposures within the euro area is low. However, a severe scenario calibrated to reflect combined NBFI risks (i.e., banks' largest five NBFI counterparties default) and market risks (i.e., fair value shocks to high quality liquid assets) suggests that the risk of contagion through interbank exposures could be material. Moreover, an EA-wide investment funds' liquidity distress exercise[41] to quantify system-wide spillovers indicates that available liquidity is not sufficient to meet the total demand for liquidity in a two-day market shock scenario. Over a two-week stress horizon, the exercise also reveals significant knock-on effects in core funding markets as investment funds meet the liquidity demand mostly by selling assets which could amplify market volatility. Against this background, the ECB's plan to undertake a counterparty credit risk scenario analysis for banks is welcome. However, the authorities should further develop NBFI-oriented prudential tools (e.g., leverage limits and liquidity requirements) and accelerate plans for an EU system-wide stress test, including by overcoming data sharing hurdles across authorities, which currently limit the ability to undertake a complete system-wide analyses (e.g., the FSAP stress tests). The authorities should also take urgent efforts to align regulation of money market funds (MMFs), including strengthening liquidity buffers, with international standards.[42]

Text Figure 9. Euro Area: Projected Capital Ratios and Capital Depletion Across Scenarios



Source: IMF staff calculations.

Source: IMF staff calculations.

65. Policymakers should conserve or build releasable buffers on a country-by-country basis and ensure a full, timely and faithful implementation of Basel standards. Adequate capital and liquidity, including for banks' noncore activities, is crucial to ensure the resilience of the euro area financial system against adverse shocks. In relevant jurisdictions, this could be achieved through a move toward positive neutral rate countercyclical capital buffers. The adoption of the banking package—the Capital Requirements Regulation 3 (CRR 3) and the Capital Requirements Directive

[41] See the Euro Area FSAP Technical Note on Systemic Risk Analysis – NBFI.

[42] See the Euro Area FSAP Technical Note on Investment Funds, Regulation, Supervision, and Systemic Risk Monitoring for further details.

6 (CRD6)—is welcome, and it is expected to be transposed into national law by member states by January 2026. Delaying consistent implementation of internationally agreed bank regulatory standards across jurisdictions further complicates the global regulatory reform agenda. Continuing to coordinate with other systemic jurisdictions can help ensure a full, timely and faithful implementation of Basel standards and a level-playing field.

66. A key policy priority should be to improve system-wide risk monitoring of the financial sector beyond banks including closing data gaps arising from legal restrictions for sharing or timely access, as well as further harmonizing and strengthening prudential oversight (Annex I). Policymakers should continue efforts to improve data collection and data sharing among financial oversight agencies, and analysis (including for NBFIs and transaction-level data)—which is crucial for cross-sector and cross-border systemic risk monitoring and facilitating system-wide stress testing.[43] In tandem, further strengthening the macroprudential framework, including by allowing for early activation of the counter cyclical capital buffer, harmonizing buffers for other systemically important institutions, and streamlining governance arrangements for the activation of macroprudential measures would enhance the resilience of the euro area financial system.[44] Strengthening the resources and prudential powers of the supranational authorities with oversight of NBFIs, including providing ESMA with powers to top up liquidity and leverage requirements for substantially leveraged funds as well as to require cross-border reciprocation,[45] is critical given the growing interlinkages between banks and nonbanks as well as the nature of recent global events which demonstrated the potential for NBFIs to amplify liquidity risks.[46]

67. The 2025 FSAP also highlights the urgent need to complete the euro area financial architecture. Significant progress has been made on the minimum requirement for own funds and eligible liabilities (MREL), single resolution board (SRB) operational preparedness as well as the newly established Authority for Anti Money Laundering and Countering the Financing of Terrorism (AMLA). However, reforms to the crisis management framework remain incomplete. The FSAP reiterates key recommendations from the 2018 FSAP (Annex II), including to introduce more flexibility into the single resolution mechanism (SRM) and to introduce an EA-wide system of deposit insurance with pooled loss sharing and strong funding backstops. The absence of a common industry-funded European deposit insurance system restricts risk sharing and, thus, reinforces the need to raise the minimum funding targets for national deposit guarantee schemes to mitigate the risk of national schemes being unable to finance a deposit payout or resolution. It is crucial that the Commission, the Council, and the Parliament work together to find a solution that allows a greater use of national deposit guarantee funds for resolution and make bail-in requirements more flexible, helping the authorities respond in situations involving systemic risk. Arrangements for banks' access to liquidity

[43] See Appendix I, Recommendations on Enhancing Financial Stability Data Collection, Sharing and Transparency in the EA in the Financial System Stability Assessment (FSSA).

[44] Euro Area FSAP Technical Note on Macroprudential Policy.

[45] See Euro Area FSAP Technical Notes on Investment Funds and on Capital Markets Union for further detail on the steps and careful sequencing needed for centralizing supervision.

[46] FSB (2024), Peer Review of Switzerland, Review Report.

in resolution too remain inadequate.[47] The authorities should urgently put in place arrangements for the single resolution fund (SRF) to provide guarantees to enhance the provision of central bank liquidity in resolution, ideally with an EU fiscal backstop. The authorities should also further harmonize and ultimately centralize Emergency Liquidity Assistance (ELA) provision at the ECB.[48] While not pressing in the short-term, preparations for the provision of ELA to NBFIs that are subject to robust oversight, and enhanced monitoring and transparency to mitigate moral hazard concerns should be advanced, as NBFI activities are expected to grow further, especially given the objectives of the SIU.[49]

68. The authorities should further enhance operational resilience of the financial system to cybersecurity and FMI-related risks to advance digital transition. The FSAP recommends strengthening the resources and governance of the TARGET Services oversight team. Cyber risk expert capacity should be increased in FMI oversight and on-site inspections should be conducted regularly. While the implementation of Digital Operational Resilience Act (DORA) is welcome, it is critical to empower European Supervisory Authorities to impose penalties as part of corrective actions for non-compliant critical third-party providers (CTTPs). Strengthening TARGET Services oversight and supervision of CTTPs are crucial as the ECB moves ahead with its preparatory phase of retail and wholesale central bank digital currency initiatives, including the recent decision to settle transactions recorded on distributed ledger technology in central bank money.[50]

Authorities' Views

69. The authorities noted nascent signs of possible reversal in capital flows between the US and Europe in the aftermath of the tariff announcement, which could support sovereign funding markets. However, they noted that it is too early to assess if this reflects a structural portfolio reallocation. The authorities acknowledged the shallow depth and liquidity of markets for EU safe assets which might limit haven flows into euro-denominated assets during times of stress. The authorities also noted that the more challenging business environment for corporates with trade exposures to the US is unlikely to pose systemic risks at the current juncture due to banks' robust capital and liquidity positions, and elevated profitability.

---

[47] The resolution of a large EA bank, especially in a fast-burn liquidity crisis, would be quite likely to require more liquidity than the funds available through the SRF and the ESM "backstop" (once ratified). Guarantees by the SRF of central bank liquidity on top of the maximum possible extent of collateral protection, are critical to help plug this substantial gap in the EA crisis management framework. See, the Euro Area FSAP Technical Note on Financial Sector Safety Nets for further details.

[48] Currently, ELA is a national level operational tool, with national central banks within the Eurosystem responsible for providing liquidity support to solvent financial institutions facing temporary difficulties. The decision to grant ELA is taken in coordination with the ECB with ELA operations exceeding a threshold of €500 million requiring ECB approval. See here for details.

[49] ECB's past programs addressed liquidity stress through dealing directly with banks and purchasing marketable securities assessed as key to monetary transmission. See Euro Area FSAP Technical Note on Systemic Liquidity for further details.

[50] On February 20, 2025, the Governing Council of the ECB decided to expand its initiative to settle transactions recorded on distributed ledger technology in central bank money. See here, for further details.

70. The authorities assessed current levels of macroprudential buffers to be appropriate in most Member States and reiterated the need to conserve them at this juncture. However, the authorities acknowledged the importance of closely monitoring euro area banks' liquidity needs going forward as the Eurosystem normalizes its balance sheets lowering the excess liquidity available to banks. The authorities expect that, increasingly, as excess liquidity decreases, the Eurosystem's standard refinancing operations would become a part of banks' day-to-day liquidity management. The authorities also noted that, unlike some previous episodes of global risk aversion, euro area banks did not experience stress in dollar funding markets during recent bouts of financial market volatility. Yet, they emphasized the need to continue monitoring euro area banks' US dollar funding conditions given elevated uncertainty. The authorities agreed that risks of extreme market volatility, which could affect NBFIs, and in turn banks, could be non-linear in an environment characterized by heightened uncertainty and stretched valuations—requiring careful monitoring. The authorities reiterated their commitment to scenario analyses of counterparty credit risk to better assess bank-NBFI interlinkages and advance macroprudential policies for NBFIs. This requires addressing NBFI related data gaps and, more broadly, removing restrictions on data sharing among EU and national authorities, that constrain system-wide monitoring. They also emphasized the need to enhance the operational resilience of the financial sector, including to cybersecurity risks, amidst heightened geopolitical tensions, as well as via enhanced crisis management.

CONTINGENCY POLICIES FOR ADVERSE SCENARIO

71. Policies for an adverse global scenario. In the event that global risks (Table 3) and a downside scenario were to materialize characterized by further tariff escalation by trading partners and retaliation, increases in global policy uncertainty and tighter financial conditions (for example, the April WEO, Box 1.1, Scenario A), this would dampen growth, particularly in sectors exposed to trade, and inflation in the euro area. The authorities should allow automatic stabilizers to operate and consider targeted and time-bound support to vulnerable households and firms, paired with active labor market policies to facilitate reallocation. Countries with low fiscal risk have more fiscal space available for this support. However, where fiscal space is limited additional offsetting measures anchored in a well-defined and credible multi-year adjustment path should be identified to safeguard public finances. In such a scenario, further monetary easing and liquidity support by the ECB would help limit the adverse impact on activity, alleviate funding pressures, and reduce the risk of disorderly market conditions. In the event of disorderly market conditions and financial stability concerns that undermine monetary transmission, the ECB can consider adjusting the pace of QT or—depending on the severity of the downside—conducting asset purchases and targeted long-term credit operations. Moreover, the TPI remains a powerful tool to address market dynamics not warranted by fundamentals. Finally, if these adverse conditions were to materialize, the policy agenda discussed above, including deepening the EU single market and enhancing the EU budget for public goods investment would become even more urgent.

STAFF APPRAISAL

72. The euro area economy is expected to continue growing at a moderate pace while disinflation remains on track. Higher US tariffs, trade tensions, and elevated uncertainty are expected to weigh on activity—especially investment—in 2025-26, despite some support from higher defense and infrastructure spending. Headline inflation is projected to remain broadly at target from the second half of 2025, while core inflation will return to 2 percent in 2026. Risks to growth are on the downside, while risks to inflation are two sided.

73. Decisive EU-level actions are urgently needed to place the economy on a stronger footing in a more complex global environment. Identifying existing investment gaps and areas where joint EU-level initiatives would deliver cost-effective solutions can provide a blueprint for priority actions. Coordinated efforts at the EU level and targeted investments are critical to address shared challenges and help member states manage fiscal tradeoffs (such as in cross-border infrastructure, common defense needs, R&D incentives). Focusing on areas with clear EU-level advantages, the EU budget can create net positive value for member states by internalizing externalities, leveraging economies of scale, and minimizing duplication. To achieve this, an increase in the EU budget by at least 50 percent will be needed, if funding for other programs were to remain unchanged. Reforms are needed to make the budget more streamlined, responsive to evolving needs, and more effective by incentivizing good performance. Strengthening the financing framework through regular borrowing and focusing on strategic investments will bolster support for a more ambitious EU budget. A stronger presence in bond markets could deepen the market and position EU bonds as genuine European safe assets.

74. Steps to strengthen the single market are essential to increase investment and innovation, ultimately lifting productivity and resilience. Lowering barriers to firms' ability to scale up within the single market, at the EU and national level, in different areas—regulation, finance, labor, and energy—remains essential. A common 28th regime for laws governing not only the formation and operation of firms, but also their dissolution, can offer an alternative viable solution to support firms' scaling up and enhance the efficiency of cross-border capital allocation, ultimately fostering innovation. Advancing the capital markets union is vital to facilitate more efficient channeling of savings to early-stage, risky assets. Lowering barriers to cross-border bank mergers and acquisitions would help augment bank finance, address long-standing concerns of structurally low profitability and high costs, and spur competition within the euro area's banking sector. The introduction of the digital euro could help deepen the integration of financial services by streamlining and unifying cross-border retail payments, thereby improving payment system efficiency and reducing transaction costs. Improving intra-EU labor mobility can help alleviate local labor shortages and reduce skill mismatches while offering productive firms greater access to talent. Enhancing energy security through increased reliance on renewables and better integration of the EU electricity market can further bolster competitiveness and resilience. While deeper intra-Europe integration is the most promising response to the increasing geoeconomic fragmentation in the global economy, complementary structural reforms are also needed at the national level.

75. The EU would benefit from its continued advocacy for a stable, rules-based global trading system. Further diversifying global partnerships can help strengthen supply chain resilience and capture efficiency gains from trade.

76. For many European countries with high debt and limited fiscal space, significant fiscal adjustments are needed to mitigate fiscal risks. The needed fiscal adjustment creates a challenging tradeoff because, at the same time, Europe faces high and rising spending pressures that are crystallizing faster than previously anticipated. Countries should develop and implement credible medium-term fiscal plans that address urgent and rising spending needs while ensuring fiscal sustainability.

77. The use of the national escape clause of the EU fiscal rules should be limited to the initial phase of scaling up defense investment expenditures and not to finance recurring spending over an extended period. It is essential for member states and the Commission to assess the consequence of increased defense spending on debt sustainability, modify the adjustment path as necessary, and engineer a smooth exit from the escape clauses. While the escape clauses are in effect, member states should ensure non-defense expenditure complies with the agreed net expenditure path. Eventually, a broader reassessment of key parameters may be needed to achieve an optimal balance between allowing countries with low fiscal risks to fulfill spending objectives that can also have favorable EU-wide spillovers and ensuring debt remains sustainable.

78. A monetary policy stance close to neutral is justified by close-to-target inflation and a mildly negative output gap. Depending on whether incoming information materially affects the inflation outlook, the policy path may need to be adjusted. Going forward, as uncertainty subsides and inflation remains close to or at target, increasingly communicating with greater emphasis on the forecast together with well-designed illustrative scenarios and sensitivity analysis around a baseline would become more important to help guide rate expectations.

79. While the banking system generally appears adequately capitalized and liquid, the authorities should closely monitor the vulnerabilities from the growing NBFI sector. Although financial stability risks linked to past monetary tightening are easing, a deteriorating business environment for corporates, especially those with trade exposures to the US, could weigh on banks' otherwise healthy balance sheets. Moreover, new systemic risks have emerged, particularly from market volatility due to higher tariffs and banks' exposures to NBFIs. Authorities should stand ready to address potential liquidity stress, including by preparing a framework for the provision of emergency liquidity assistance to NBFIs, paired with closer oversight.

80. Facilitating better data sharing among EU and national authorities will improve risk monitoring, particularly to close gaps that hinder system-wide analyses. A key policy priority is to improve system-wide risk monitoring of the financial sector beyond banks, including by closing data gaps arising from legal restrictions for sharing or timely access by supervisors, which currently limit the ability to undertake complete system-wide analyses.

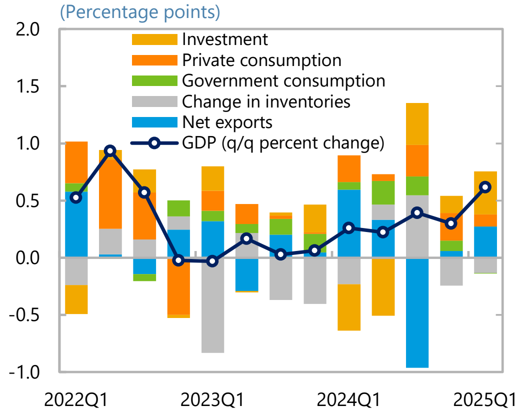
81. Fragmentation continues to hinder the full benefits of the banking union and the development of a more resilient, deeper and integrated EA-wide financial system. Further steps to strengthen the euro area financial architecture include completing the banking union with the introduction of a common deposit insurance system, allowing a greater use of national deposit guarantee funds for resolution and making bail-in requirements more flexible; putting in place arrangements for the Single Resolution Fund to provide guarantees to enhance the provision of central bank liquidity in resolution, ideally with an EU fiscal backstop; fully implementing the international capital standard for banks (Basel III); and strengthening the resources and prudential powers of the European authorities overseeing NBFIs, including empowering ESMA to top-up national measures for substantially leveraged investment funds and to enforce cross-border reciprocation.

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

Figure 1. Euro Area: Real Sector Developments

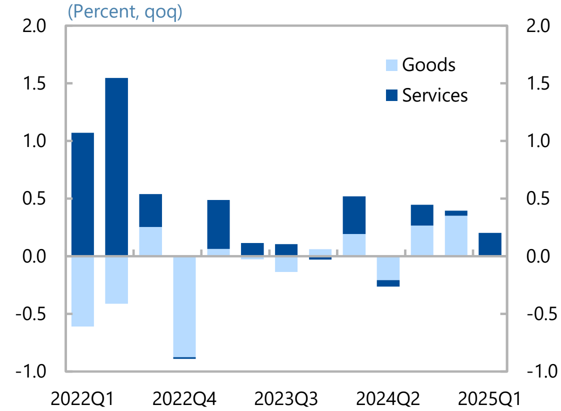
Euro area growth rebounded strongly in 25Q1 driven by export front-loading and investment, while consumption slowed down.

Contribution to Growth
(Percentage points)



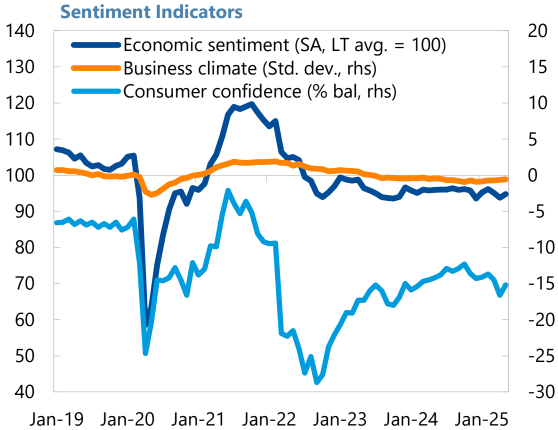
The moderation in consumption was driven by a large slowdown in goods consumption, even though services consumption rebounded.

Contribution to Private Consumption Growth 1/
(Percent, qoq)



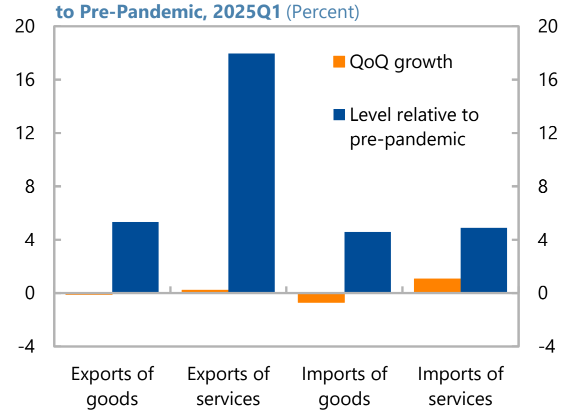
Consumer confidence remains much weaker than pre-pandemic levels.

Sentiment Indicators



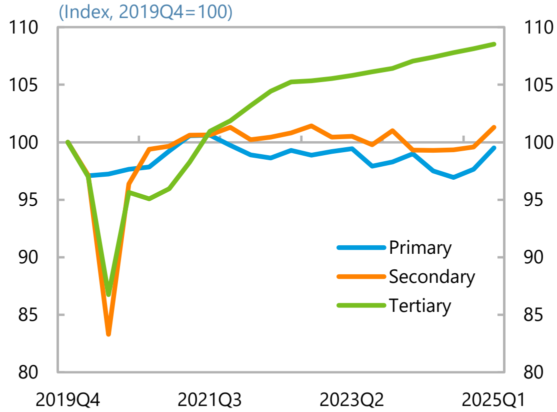
Trade growth is subdued compared to pre-pandemic, with the exception of services exports.

QoQ Real Export and Import Growth and Level Relative to Pre-Pandemic, 2025Q1 (Percent)



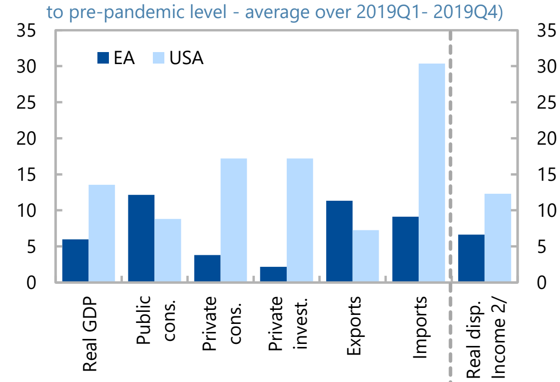
The divergence between manufacturing and services has been widening.

Level of Gross Value Added by Sector
(Index, 2019Q4=100)



Domestic demand has been much weaker than in the US, partially reflecting lower disposable incomes.

Level of GDP Components in 2025Q1 and Real Disposable Income in 2024Q4 (Percent change relative to pre-pandemic level - average over 2019Q1- 2019Q4)

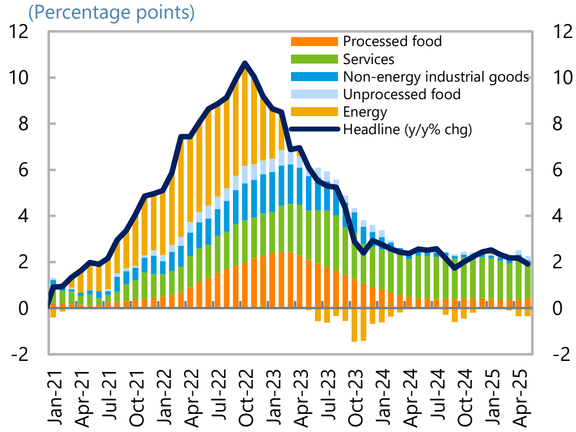


Sources: Bureau of Economic Analysis; European Commission; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Euro area is proxied by the sum of the countries which publish disaggregated quarterly consumption data.
2/ Disposable income is deflated using the personal consumption deflator.

Figure 2. Euro Area: Inflation Developments

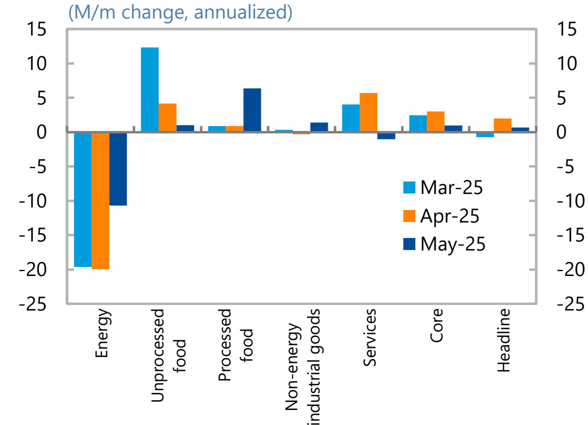
Annual euro area inflation fell to 1.9 percent, lower than consensus expectations (2 percent). Core inflation (excluding energy and unprocessed food) also fell somewhat to 2.4 percent.

Contributions to Headline Inflation, May 2025
(Percentage points)



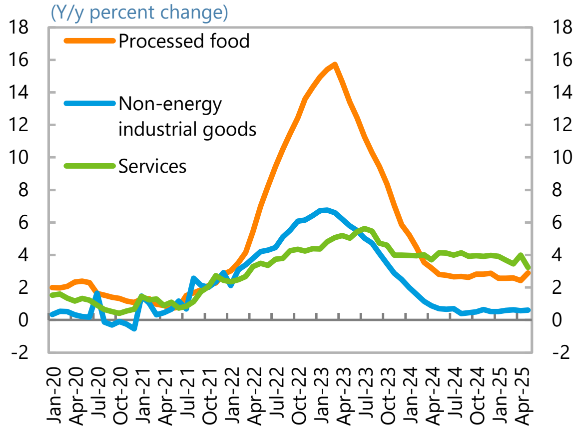
On a sequential basis, energy inflation was again somewhat negative. Different price dynamic across components with non-energy goods inflation going up to levels above pre-pandemic while services inflation surprising somewhat to the downside

Sequential Inflation
(M/m change, annualized)



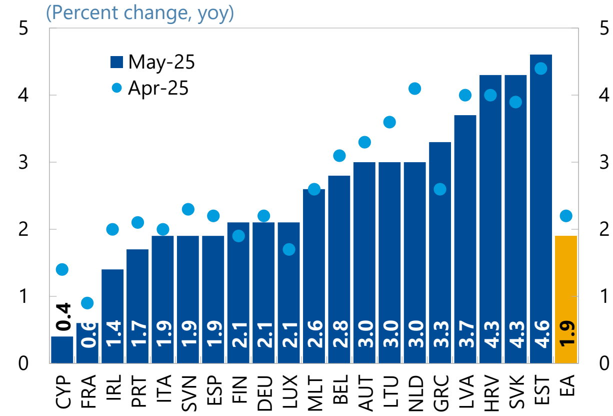
With the different timing for the Easter this year compared to last year, services inflation has been more volatile and dropped somewhat to 3.2 percent, the lowest level in 3 years.

Inflation, Core Components
(Y/y percent change)



France inflation remained an outlier slowing down further and printing at 0.6 percent. Netherlands and Belgium also showed large decelerations.

Dispersion in Headline Inflation Across Member States 1/
(Percent change, yoy)

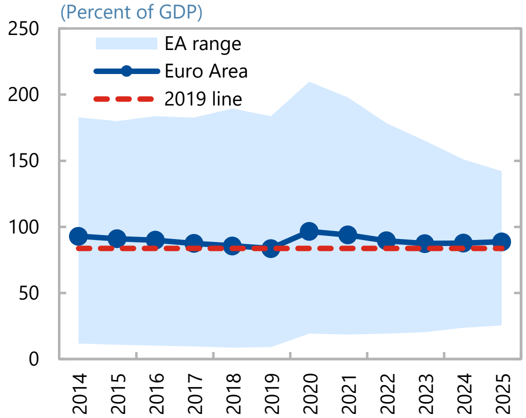


Sources: European Commission; Eurostat; Haver Analytics; IMF *World Economic Outlook*; and IMF staff calculations.
1/ Numbers inside the bars are the latest inflation rates.

Figure 3. Euro Area: Public Sector Accounts

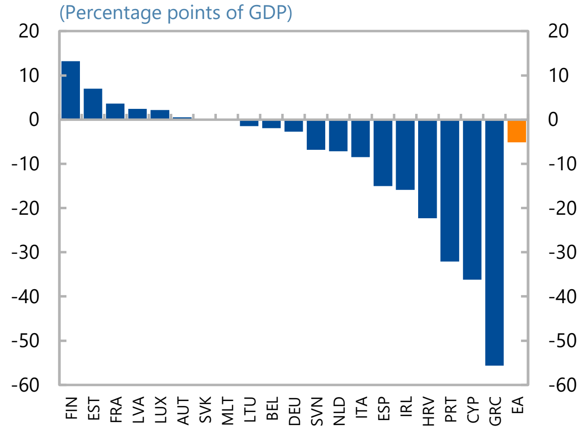
Public debt has fallen since the 2020 peak, although still higher than pre-pandemic levels

General Government Debt
(Percent of GDP)



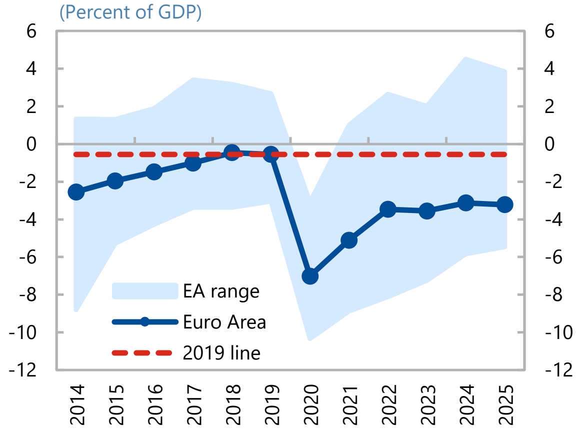
Most countries have reduced debt ratios mainly because of favorable debt dynamics.

Change in Public Debt between 2021 and 2025
(Percentage points of GDP)



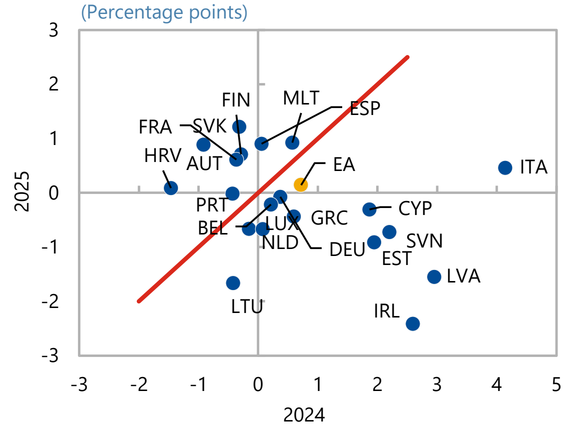
Deficit levels remain elevated.

Net Lending and Borrowing
(Percent of GDP)



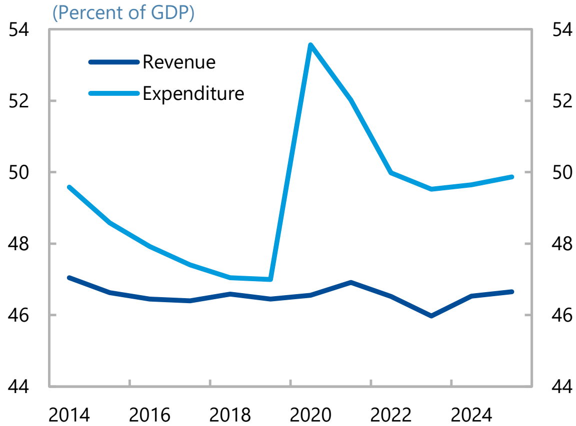
On aggregate, the euro area fiscal policy is expected to be broadly neutral in 2025, albeit with large cross-country differences.

Change in Cyclically Adjusted Primary Balance
(Percentage points)



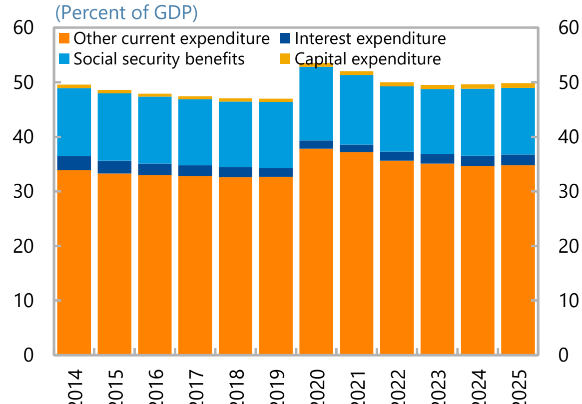
Despite large adjustments since 2021, government expenditures remain elevated, …

Revenue and Expenditure
(Percent of GDP)



… driven mainly by non-social security primary current spending.

Government Expenditure Decomposition
(Percent of GDP)

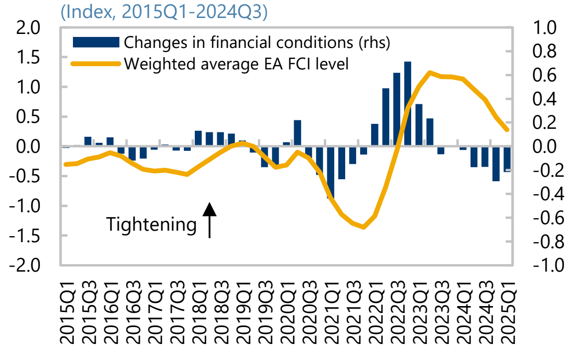


Sources: IMF *World Economic Outlook*; and IMF staff calculations.

Figure 4. Euro Area: Financial Stability Risks

Driven by monetary easing, financial conditions in the euro area have been broadly easing.

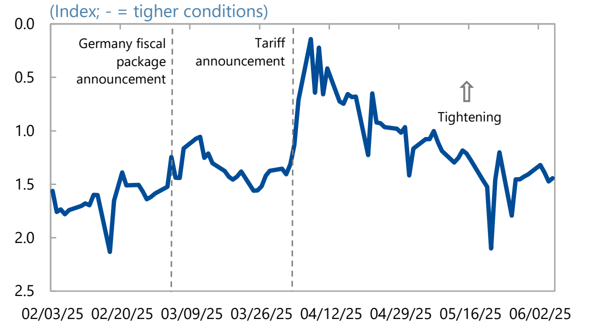
Financial Conditions
(Index, 2015Q1-2024Q3)



Source: Borraccia et al., 2023, IMF Working Papaer 23/209.
Note: Chart shows the liability-weighted average of the Euro area countries' Financial Condition Indexes. 2024Q4 and 2025Q1 are forecasts.

While financial conditions tightened and became more volatile in the immediate aftermath of the April 2 announcement, they have eased since and are now close to levels prior to the Germany fiscal package announcement.

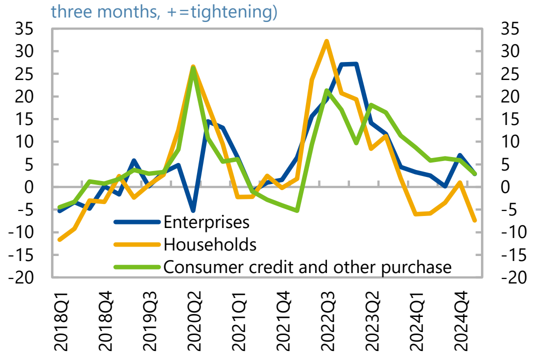
Financial Conditions Index
(Index; - = tigher conditions)



Source: Bloomberg Financial, L.P.
Note: All of the indicators included in the composite FCI index are normalized by subtracting the mean and dividing by the standard deviation for each series. The mean and standard deviation are calculated from observations during the pre-crisis period, which is defined as the period from 1999 to July 1, 2008. The FCI index is a Z-Score that indicates the number of standard deviations by which current financial conditions deviate from normal (pre-crisis) levels.

Credit standards have recently tightened for firms, yet it is unlikely to be binding …

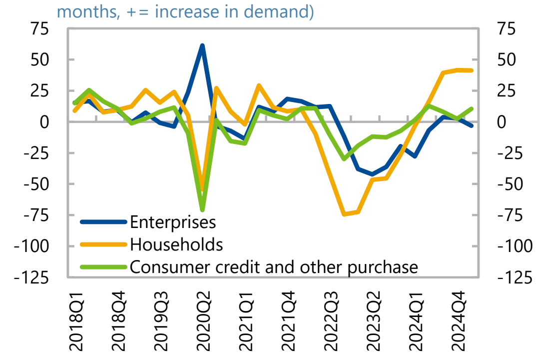
Changes in Credit Standards (Net percentages of banks reporting a tightening of credit standards over the past three months, +=tightening)



Source: ECB Bank Lending Survey.

… given firms' weak credit demand. Meanwhile, mortgage lending demand continued to increase strongly.

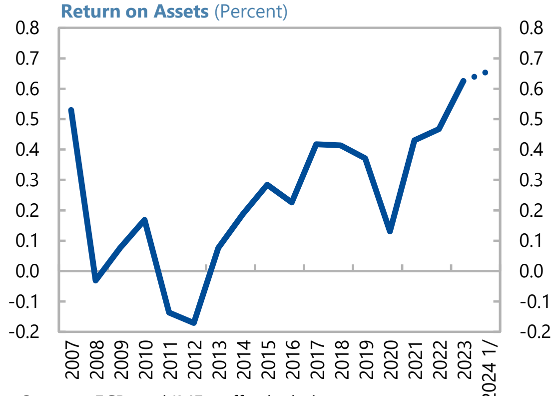
Changes in Credit Demand (Net percentages of banks reporting a tightening of credit demand over the past three months, += increase in demand)



Source: ECB Bank Lending Survey.

Banks maintained elevated profitability, which is expected to remain resilient despite monetary easing.

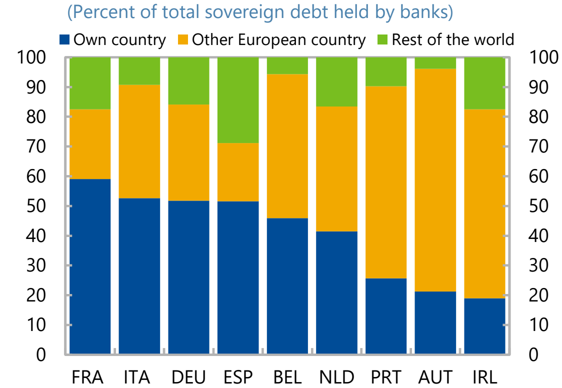
Return on Assets (Percent)



Sources: ECB; and IMF staff calculations.
1/ 2024 data is estimated.

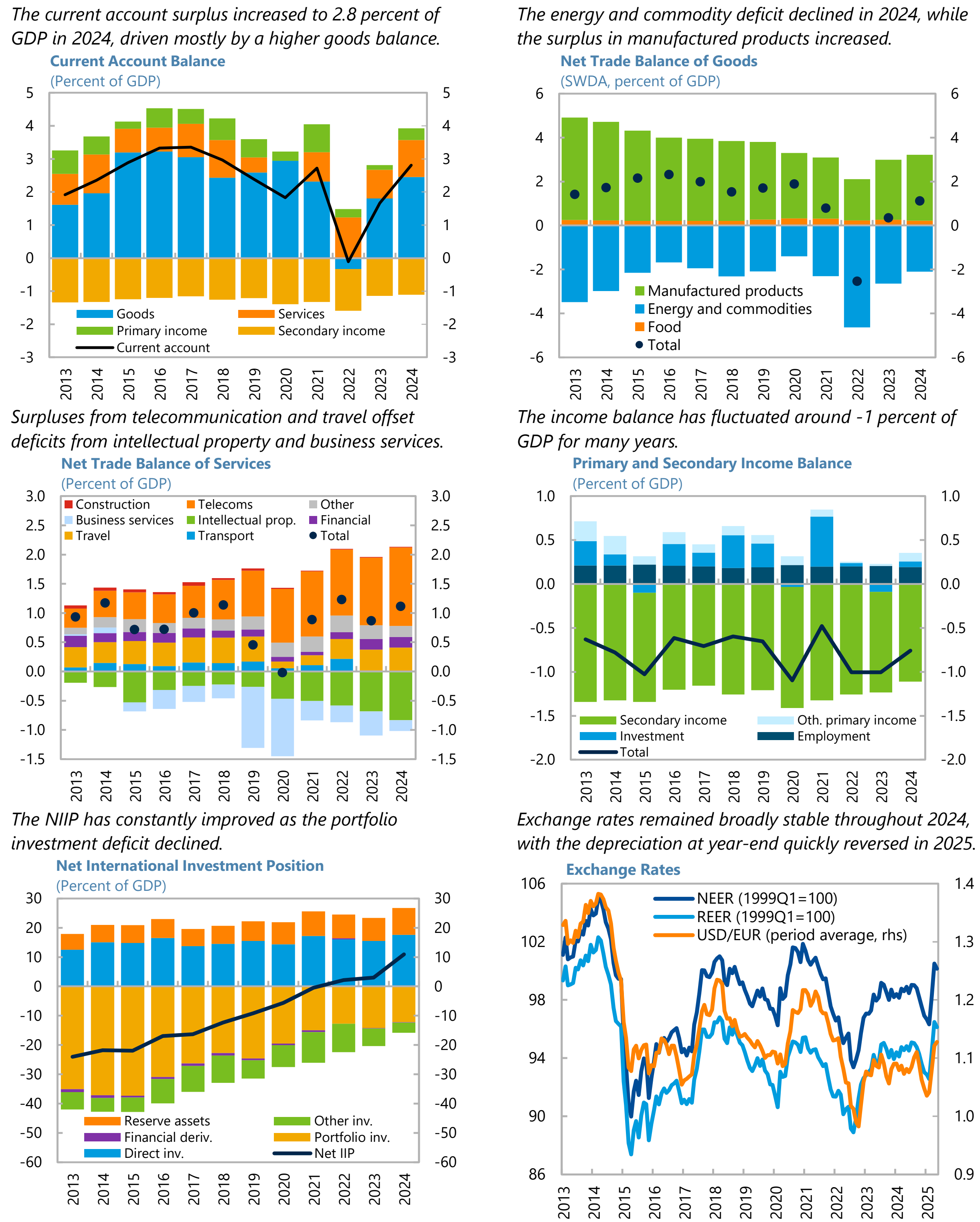
However, banks' exposures to highly indebted sovereigns could amplify shocks if fiscal headroom erodes.

Banks' Sovereign Exposure by Geography
(Percent of total sovereign debt held by banks)



Sources: European Central Bank and IMF staff calculations.

Figure 5. Euro Area: External Sector Developments



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

Table 1. Euro Area: Main Economic Indicators, 2021–2030[1/]
(Y/y percent change, unless otherwise specified)

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
				Est.	*Proj.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*
Demand and Supply										
Real GDP	6.3	3.5	0.4	0.9	0.8	1.2	1.3	1.3	1.2	1.1
Private consumption	4.7	5.0	0.5	1.0	1.0	1.2	1.4	1.3	1.2	1.1
Public consumption	4.4	1.1	1.4	2.8	1.7	1.4	1.0	1.0	1.0	1.1
Gross fixed investment	3.8	2.0	1.7	-1.9	1.4	1.6	1.6	1.8	1.5	1.3
Final domestic demand	4.4	3.4	1.0	0.8	1.2	1.3	1.4	1.3	1.2	1.2
Stockbuilding 2/	0.7	0.5	-0.9	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
Domestic demand	5.1	3.8	0.1	0.5	1.3	1.3	1.4	1.3	1.2	1.2
Foreign balance 2/	1.4	-0.2	0.3	0.4	-0.4	-0.1	0.0	0.0	0.0	0.0
Exports 3/	11.4	7.3	-0.8	1.0	0.0	1.4	2.2	2.6	2.5	2.5
Imports 3/	9.0	8.3	-1.4	0.2	1.0	1.8	2.4	2.8	2.7	2.7
Resource Utilization										
Potential GDP	2.3	1.2	1.0	1.1	1.0	1.1	1.1	1.2	1.1	1.1
Output gap 4/	-1.6	0.6	0.1	-0.2	-0.4	-0.3	-0.1	0.0	0.1	0.1
Employment growth	1.6	2.4	1.4	1.0	0.3	0.2	0.2	0.1	0.1	0.0
Unemployment rate 5/	7.8	6.7	6.6	6.4	6.4	6.3	6.2	6.2	6.2	6.2
Prices										
GDP deflator	2.1	5.1	5.9	2.9	2.2	2.0	2.1	2.1	2.1	2.1
Consumer prices	2.6	8.4	5.4	2.4	2.1	1.9	2.0	2.0	2.0	2.0
Public Finance (percent of GDP)										
Overall fiscal balance	-5.1	-3.5	-3.6	-3.1	-3.2	-3.4	-3.5	-3.5	-3.6	-3.7
Primary balance	-3.8	-1.9	-2.1	-1.5	-1.5	-1.6	-1.5	-1.4	-1.3	-1.3
Structural balance 4/	-4.0	-3.6	-3.6	-3.1	-3.0	-3.3	-3.5	-3.7	-3.8	-3.8
Structural primary balance 4/	-2.7	-2.1	-2.2	-1.5	-1.3	-1.4	-1.5	-1.5	-1.5	-1.4
Gross public debt	93.9	89.5	87.4	87.7	88.7	89.7	90.4	91.1	91.9	92.9
External Sector (percent of GDP) 6/										
Current account balance	2.7	-0.1	1.7	2.8	2.3	2.1	2.1	2.0	2.1	2.1
Interest Rates (percent, end of period) 7/										
Euro short-term rate (€STR)	-0.6	1.9	3.9	2.9	2.2	...	...	...	...	...
10-year government benchmark bond yield	0.3	3.0	2.9	2.8	3.1	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.1	1.1	1.1	1.0	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	96.5	96.2	97.7	96.4	99.6	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.1	85.0	89.0	88.8	85.4	...	...	...	...	...

Sources: IMF staff estimates; and European Central Bank.
1/ Projections for 2025-30 are based on aggregation of the latest projections by IMF country teams, unless otherwise indicated.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2025.

Table 2. Euro Area: External Sector Assessment

Overall Assessment: *The external position in 2024 was moderately stronger than the level implied by medium-term fundamentals and desirable policies.* The CA balance increased to 2.8 percent of GDP in 2024—up from 1.7 percent of GDP in 2023—driven mostly by lower energy imports (due to declining energy prices) and higher non-energy goods exports. While the euro area's CA surplus is projected to decline in the medium-term relative to 2024—as domestic demand is expected to strengthen—it is projected to remain around 2 percent of GDP, with sizable imbalances in some countries.

Potential Policy Responses: Policy responses should increase resilience by recalibrating the composition of domestic demand and reducing country-level imbalances where needed. Deepening the EU single market—by lowering firms' regulatory burdens, reducing administrative barriers, streamlining trade procedures, enhancing labor mobility, and better integrating financial services—will create a more productive and resilient domestic economy. As part of a deeper EU single market, completing the savings and investments union would strengthen public and private sector risk sharing and lift investment, supporting external stability especially of high-debt countries. Reforms to boost energy security, enhancing the EU budget for efficient public goods investment, and structural reforms to improve the business environment can lift investment and private domestic demand, compensating for the needed higher public saving in some countries. These measures will also support productivity, lift growth potential and mitigate headwinds from aging. Trade policies should seek to constructively resolve trade tensions, promote clarity and transparency, pursue pragmatic cooperation and deepen economic integration by pursuing free trade agreements at the regional, plurilateral or multilateral level. Industrial policies should be deployed cautiously, remain targeted to specific objectives where externalities or market failures prevent effective market solutions, be coordinated at the EU level and avoid favoring domestic producers over imports to minimize trade and investment distortions. As historical policy gaps at the national level are projected to persist, countries with external positions stronger than the norm should boost domestic demand and increase investment and countries with external positions weaker than the norm should increase public sector saving and implement reforms to enhance productivity. Germany's announced increase in defense and public investments and the recommended rotation from public to private spending in other countries, as well the policies outlined above, will boost investment and innovation, help lift productivity and enhance resilience by better aligning domestic demand with potential output.

Foreign Asset and Liability Position and Trajectory	**Background.** After falling to –20.5 percent of GDP in 2009, the NIIP of the euro area turned positive in 2022 and rose to 10.9 percent of GDP by the end of 2024. These increases mostly reflect accumulated CA surpluses. However, the robust increase of 7.9 percentage points of GDP compared to 2023 was attributable to both the current account surplus and valuation effects in the fourth quarter. Gross foreign assets were 260.4 percent of GDP and liabilities 249.4 percent of GDP, both higher than last year but lower than in 2021 (it declined in 2022 and 2023 due to higher interest rates and repricing). Net external assets (including those vis-a-vis other euro area member states) remain elevated in external creditor countries (e.g., Germany), whereas net external liabilities remain high in debtor countries (e.g., Portugal and Spain). Gross external debt declined by 1.1 percent of GDP, as an increase from general governments was more than offset by declines from Eurosystem, other MFIs, and other sectors. **Assessment.** Projections of continued CA surpluses over the medium term suggest that the NIIP-to-GDP ratio will rise further, at a moderate pace. While the region's overall NIIP financing vulnerabilities appear low, large net external debtor countries bear an elevated risk of a sudden stop of gross inflows.					
2024 (% GDP)	NIIP: 10.9		Gross Assets: 260.4	Debt Assets: 94.1	Gross Liab.: 249.4	Debt Liab.: 88.2
Current Account	**Background.** The current account balance for the euro area increased to 2.8 percent of GDP in 2024, up from 1.7 percent of GDP in 2023. This increase was driven by a significant improvement in the goods balance—mainly due to lower energy import prices—and a small increase in the services surplus (partly due to unusually high exports of intellectual property from Ireland). Following an initial post-reopening increase, the investment rate declined for two years in a row—from 10.1 percent in 2022 to 9.8 percent in 2023 and 9.2 percent in 2024—widening the saving-investment gap. The primary income surplus slightly increased to 0.4 percent of GDP, while the secondary income deficit remained stable at -1.3 percent of GDP. Large creditor countries, such as Germany and the Netherlands, maintained sizable surpluses, reflecting high corporate and household savings and weak investment. In the medium-term, the current account surplus is projected to decline (to around 2 percent of GDP). **Assessment.** The EBA model estimates a CA norm of 1.4 percent of GDP, against a cyclically adjusted CA of 2.9 percent of GDP. This implies a gap of 1.4 percent of GDP. Adjustments of -0.4 percent of GDP were made to the underlying CA to account for CA measurement issues in Ireland and the Netherlands. Considering these factors and uncertainties in the estimates, staff assesses the CA gap to be 1.0 percent of GDP in 2024, with a range of 0.2 to 1.8 percent of GDP (considering a standard error of 0.8).					
2024 (% GDP)	CA: 2.8	Cycl. Adj. CA: 2.9	EBA Norm: 1.4	EBA Gap: 1.4	Staff Adj.: -0.4	Staff Gap: 1.0
Real Exchange Rate	**Background.** In 2024, the CPI-based REER appreciated by 0.4 percent from 2023. The euro area CPI-based REER appreciated by 5.3 percent between 2015 and 2024 following a depreciation of nearly 20 percent in the post global financial crisis period. As of March 2025, the CPI-based REER was 0.2 percent below its 2024 average. **Assessment.** Consistent with the IMF staff CA gap, the IMF staff assesses the REER gap to be -3.1 percent in 2024, with a range of -0.7 to -5.5 percent, based on the estimated CA-REER elasticity of 0.33. As with the CA gap, the aggregate REER gap masks a large degree of heterogeneity in REER gaps across euro area member states. In contrast, the EBA REER index and level models suggest an overvaluation of 4.1 percent and 1.7 percent, respectively.					
Capital and Financial Accounts: Flows and Policy Measures	**Background.** The euro area experienced a balanced capital account and a financial account surplus of 3.2 percent of GDP in 2024 (up from 1.9 percent of GDP in 2023), driven mostly by a rebound of net direct investment that more than offset a decline in net other investment. Net portfolio investment and financial derivatives also contributed, albeit small. **Assessment.** Aggregate risks are limited, given the strength of its external position and the euro's status as a global reserve currency. However, large external financing needs of sovereigns and the banking sector cause some vulnerability to tighter global financial conditions and sustained market volatility.					
FX Intervention and Reserves Level	**Background.** The euro has the status of a global reserve currency. **Assessment.** Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.					

Table 3. Euro Area: Risk Assessment Matrix

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Global Risks			
Trade policy and investment shocks	**High** Higher trade barriers or sanctions reduce external trade, disrupt FDI and supply chains, and trigger further U.S. dollar appreciation, tighter financial conditions, and higher inflation.	**High** Weaker export growth, combined with higher uncertainty and weaker consumer and business confidence, weighs on the corporate sector and result in lower investment and a slower recovery in private consumption, ultimately undermining productivity and lowering potential output.	• Continue advocating for a stable, rules-based global trading system and pursuing constructive engagement. • Ensure consistency with WTO principles in the use of targeted instruments (e.g., safeguard procedures and anti-dumping, anti-subsidy, and anti-coercion measures). • Diversify global partnerships and advance new free trade agreements. • Deepen single market and avoid industrial policy that creates distortions or provokes retaliation.
Deepening Geoeconomic Fragmentation	**High** Persistent conflicts, inward-oriented policies, protectionism, weaker international cooperation, labor mobility curbs, and fracturing technological and payments systems lead to higher input costs, hinder green transition, and lower trade and potential growth.	**High** Trade barriers and supply disruptions lead to shortages in crucial inputs, higher inflation and production bottlenecks that reduce economic activity and decrease confidence.	• Diversify energy production and secure supply chains to avoid shortages of critical raw materials. • Diversify global partnerships and advance new free trade agreements. • Continue advocating for a stable, rules-based global trading system and pursuing de-escalation and constructive engagement. • Ensure consistency with WTO principles in the use of targeted instruments (e.g., safeguard procedures and anti-dumping, anti-subsidy, and anti-coercion measures).

Table 3. Euro Area: Risk Assessment Matrix (Continued)

Tighter financial conditions and systemic instability	**Medium** Higher-for-longer interest rates and term premia amid looser financial regulation, rising investments in cryptocurrencies, and higher trade barriers trigger asset repricing, market dislocations, weak bank and NBFI distress, and further U.S. dollar appreciation, which widens global imbalances and worsens debt affordability.	**Medium** Higher funding costs and a shift in risk sentiment lead to bond repricing and financial tightening, reducing credit growth. Insolvencies increase, resulting in deterioration of bank balance sheets and profitability. Rates staying high for longer will also lead to housing market corrections. Sovereign spreads increase, straining fiscal sustainability in high-debt countries.	• Enhance liquidity support to financial institutions and markets to avoid contagion and prevent liquidity shortages morph into insolvencies. • Ensure strong coordination between the ECB and the national authorities on financial stability risks. • Use countercyclical financial policy to support viable financial institutions.
Regional Conflict	**Medium** Intensification of conflicts (e.g., in the Middle East, Ukraine, Sahel, and East Africa) or terrorism disrupt trade in energy and food, tourism, supply chains, remittances, FDI and financial flows, payment systems, and increase refugee flows.	**Medium** Increased uncertainty weakens consumer and business confidence, reducing consumption and investment. Spikes in energy prices and supply disruption reduce competitiveness and the purchasing power of households.	• Accelerate the energy transition. • Provide targeted support to vulnerable households to mitigate the impact if risks materialize.
Commodity Price Volatility	**Medium** Supply and demand volatility (due to conflicts, trade restrictions, OPEC+ decisions, AE energy policies, or green transition) increases commodity price volatility, external and fiscal pressures, social discontent, and economic instability.	**Medium** Higher commodity import prices lead to higher energy prices that fuel inflationary pressures. Export competitiveness of European firms is adversely affected which in turn slows down activity. High energy prices have an adverse impact on households, leading to lower domestic demand.	• Maintain monetary policy flexibility. • Allow automatic stabilizers to operate and provide fiscal support to vulnerable households. • Safeguard energy security by accelerating the green transition and electricity market integration. • Provide targeted support to vulnerable households to mitigate the impact of higher energy prices.
Cyberthreats	**Medium** Cyberattacks on physical or digital infrastructure (including digital currency and crypto assets), technical failures, or misuse of AI technologies	**Medium** Depending on the country level of digitalization and exposure to digital infrastructure, cyberattacks disrupt the	• Advance crisis preparedness to cyberattacks. • Further strengthen coordination at the European/international level.

Table 3. Euro Area: Risk Assessment Matrix (Continued)

	trigger financial and economic instability.	financial system as well as the real economy.	• Strengthen the operational resilience of the financial system.
Climate Change	Medium Extreme climate events driven by rising temperatures cause loss of life, damage to infrastructure, supply disruptions, lower growth, and financial instability.	Medium Productivity declines or shortages lead to price increases. EU members may receive migrants from economies facing severe climate disruptions.	• Build fiscal space that can be used in response to large climate shocks. • Enhance the EU budget to invest efficiently to mitigate climate risks and flexibly respond to extreme climate events. • Accelerate green transition.
Global growth acceleration	Low Easing of conflicts, positive supply-side surprises (e.g., oil production shocks), productivity gains from AI, or structural reforms raise global demand and trade.	Medium Higher export growth, combined with stronger consumer and business confidence, supports the corporate sector and results in higher investment, lower unemployment, and a faster recovery in private consumption. Higher growth leads to an improvement in public debt sustainability in some high-debt countries.	• Allow automatic stabilizers to operate and accelerate fiscal consolidation to rebuild buffer. • Promote high quality public investment in infrastructure, and advance structural reforms. • Diversify global partnerships and advance new free trade agreements.
		Euro Area Domestic Risks	
Disorderly energy transition	Medium A disorderly shift to net-zero emissions (e.g., owing to shortages in critical metals) and climate policy uncertainty cause supply disruptions, stranded assets, market volatility, and subdued investment and growth.	Medium Higher energy prices lead to higher inflation and decreased real incomes. Increased climate policy uncertainty lowers investments in green technology.	• Provide temporary, targeted fiscal policy support to households and businesses severely affected by energy transition. • Promote public investment and accelerate structural reforms to improve energy efficiency and facilitate labor reallocation with active labor market policies.
Higher defense spending	Medium New NATO commitments or a lower-than-expected efficiency of additional defense spending could result in higher than	Medium Higher defense spending supports growth but raises concerns about public sector debt sustainability and raises interest rates.	• Limit the use of the national escape of the EU fiscal rules clause to the initial phase of scaling up defense investment expenditures.

Table 3. Euro Area: Risk Assessment Matrix (Continued)

	anticipated defense spending.		• Assess the consequence of increased defense spending on debt sustainability. • Closely monitor efficiency of additional defense spending.
Populism and Polarization	**Medium** Real income loss, spillovers from conflicts, dissatisfaction with migration, and worsening inequality ignite populism, polarization, and resistance to reforms.	**Medium** Delayed and suboptimal policies weaken confidence and raise uncertainty, lowering growth and leading to market repricing. Delayed fiscal adjustment weakens fiscal sustainability and increases sovereign risks.	• Increase growth and productivity, and ensure benefits are shared widely. • Ensure that increased defense spending and fiscal consolidation do not undermine targeted social spending or exacerbate inequality. • Provide temporary support to vulnerable households if needed.
Realization of Financial Sector Vulnerabilities	**Low** A shift in market perception undermines the ability to roll over and service debt, re-igniting financial fragmentation and adversely affecting the banking system. NBFIs could amplify risk propagation in the banking sector and system-wide spillovers from investment fund distress	**High** Higher funding costs and a shift in risk sentiment lead to bond repricing and financial tightening, reducing credit growth. Insolvencies increase, resulting in deterioration of bank balance sheets and profitability.	• Enhance liquidity support to financial institutions and markets to avoid contagion and prevent liquidity shortages morph into insolvencies. • Ensure strong coordination between the ECB and the national authorities on financial stability risks. • Use countercyclical financial policy to support viable financial institutions. • Rely on bank resolution systems to address unsound banks. • Enhance system-wide monitoring and improving data sharing.
Shifting sentiment on countries with high public debt	**Low** Policy slippages with weak growth outturns in some high-debt euro area countries, along with weak trust in the Governance Framework, could raise concerns over debt	**High** Sharp increases in funding costs strain high-debt countries' ability to service their debt resulting in adverse real-financial feedback loops and financial	• Activate EU support lines for high-debt countries under stress. • Make use of the transmission protection instrument (TPI) if higher spreads are not based

Table 3. Euro Area: Risk Assessment Matrix (Concluded)			
	sustainability in high debt countries.	fragmentation that weighs on economic activity and impairs monetary policy transmission.	on fundamentals. • Enhance liquidity support to financial institutions and markets with strong coordination between the ECB and the national authorities on financial stability risks.

Annex I. 2025 FSAP: Preliminary Recommendations

Recommendation	Authorities	Timing[1]
Systemic Risk Analysis		
Strengthen system-wide financial risk monitoring on a cross-country and cross-sectoral basis and conduct system-wide stress tests, including bank and nonbank sectors.	ECB, ESRB, ESMA	MT
Enhance data collection and powers for automatic and timely sharing of financial stability data including for nonbank financial institutions and transaction-level data.	EC	MT
Continue enhancing macroprudential stress tests that account for the interaction between bank solvency and liquidity risk, in particular through margin calls, business risk, and credit sensitive funding.	ECB	MT
Financial Sector Oversight—Micro- and Macroprudential		
Banking		
Reduce the Single Supervisory Mechanism (SSM)'s reliance on national legislative frameworks, improve governance of budgetary processes, further delegate decision-making, and ensure alignment of resources to current and expected future workload.	ECB	MT
Review capital requirements for EU internationally active banks and ensure that they are aligned with the Basel standards.	EC	MT
Make supervisory process more risk-focused, consider sovereign risk concentration when setting pillar 2 capital add-ons, and utilize the full panoply of corrective and sanctioning powers.	ECB	MT
Ensure that legislation explicitly allows for early activation of the CCyB buffer even in the absence of cyclical risks.	EC	ST
Ensure a consistent use and availability of releasable capital buffers, including through the use of recommendations or top-up powers.	ESRB, ECB	MT
Streamline the EU governance procedures for activating macroprudential measures.	EC	ST
Harmonize the methodology for the implementation of structural other systemically important institution (O-SII) buffers, while allowing some flexibility to reflect country specific issues.	ECB, EBA	MT
Insurance		
Provide stronger powers to the European Insurance and Occupational Pensions Authority (EIOPA) to address supervisory convergence on internal models and policyholder protection risks from cross-border insurance.	EC, EIOPA	ST
Implement a minimum harmonization framework for IGS across member states to protect policyholders.	EC, EIOPA	MT
Ensure EIOPA is adequately resourced for the significant new permanent tasks it has assumed through legislative reform.	EC, EIOPA	I

Recommendation	Authorities	Timing[1]
Investment Funds and SIU		
Reform the Money Market Fund (MMF) Regulation in line with international standards.	EC	ST
Introduce a single reporting mechanism for fund-level data and centralize data collection at ESMA.	EC, ESMA	MT
Introduce a more structured approach to stress testing (ESMA) and systemic risk monitoring and further develop system-wide stress testing.	ESAs, ESRB, ECB	MT
Introduce compulsory supervisory colleges and consolidated supervision for large cross-border asset management groups.	EC, ESMA	MT
Empower ESMA to top-up national measures (including leverage limits and liquidity requirements) for substantially leveraged investment funds and enforce cross-border reciprocation.	EC, ESMA	MT
Strengthen ESMA's institutional and governance arrangements for supervision—including amending ESMA's Regulation to provide it with: (i) a wider range of supervisory powers; and (ii) a sustainable funding framework—before expanding its direct, risk based supervisory mandate.	EC, ESMA	MT
Payments System		
Review and augment resources of the TARGET Services oversight team, apply forward-looking interventions to anticipate emerging risks and ensure TARGET Services addresses oversight findings on a timely basis.	ECB	I
Strengthen procedures to identify and address potential conflicts of interest between the ECB's role as operator and overseer of TARGET Services, including by separating functions into different directorates.	ECB	ST
Cybersecurity		
Strengthen FMI oversight by planning and executing on-site examinations of the cybersecurity control environment.	ECB	ST
Accelerate the development of cybersecurity risk supervision capacity in the context of Digital Operational Resilience Act (DORA) implementation.	EBA, ESMA, EIOPA	ST
AML/CFT		
Ensure AMLA, in close coordination with prudential and financial stability experts, adopts a holistic methodology to classify risk profiles and a harmonized AML/CFT supervisory methodology	EBA, EC, ECB, AMLA	MT
Foster stronger cooperation among NCAs, AMLA, and third-country supervisors, including through AML/CFT supervisory colleges.	AMLA, EBA	MT
AMLA should take an active role in harmonizing AML/CFT regulatory enforcement practices across the EA to ensure consistent compliance and reduce regulatory arbitrage.	AMLA	MT

Recommendation	Authorities	Timing[1]
Financial Safety Nets and Systemic Liquidity		
Introduce a financial stability exemption into the special resolution regime for access to the Single Resolution Fund (SRF).	EC	ST
Establish a European deposit insurance system, including loss sharing and strong funding backstops.	EC	MT
Put arrangements in place for the SRF to provide guarantees to support central bank lending to banks in resolution, ideally, if possible, with an EU fiscal backstop.	SRB, Eurosystem, EC	I
Maintain high priority of work on resolution execution, complete bridge bank handbooks and address third-country securities law issues in bail-in (including fallback options).	SRB	I
Further harmonize and ultimately centralize Emergency Liquidity Assistance (ELA) arrangements.	ECB	ST
Address the barriers to the provision of ELA to NBFIs, ensure appropriate liquidity monitoring of relevant institutions, and operational readiness.	Eurosystem	MT
Allow for the expansion of the counterparty framework for systemwide support to be used in times of stress.	ECB	MT

[1] I: immediately; ST: short term = less than 1 year; MT: medium term = 1–5 years.

Annex II. Status of Key Recommendations from the 2018 FSAP

Recommendation*	Timing**	Actions
Supervision		
Reduce the fragmentation of national legal frameworks for bank supervision (EU)	MT	**Status: Partially implemented.** The *Banking Package* (CRR 3 and CRD 6) includes measures designed to ensure more consistent supervision across the EU. CRD6 (i) harmonizes the provisions for the assessment of banks' directors and key function holders (fit-and-proper assessments); (ii) introduces a common set of rules for branches of third-country banking groups operating in Member States will replace heterogeneous national approaches and strengthen the single market; (iii) and further harmonizes national powers related to the acquisition of qualifying holdings, transfers of assets or liabilities, and mergers or divisions. However, the ECB continues to exercise supervisory powers granted under national legislation and apply different national laws which, despite some progress, remain unharmonized in several areas (e.g., licensing criteria and governance of credit institutions.
Revise legal provisions to close regulatory gaps with international standards (EU)	MT	**Status: Not implemented.** The deviation from Basel III capital standards identified in the 2014 Regulatory Consistency Assessment Program (RCAP) conducted by the Basel Committee have not been addressed (Danish compromise, limited scope of the Credit Valuation Adjustment capital charge, small and medium enterprise (SME) supporting factors), while new deviations have been introduced permanently or temporarily in CRR 3 (lower risk weights for equity exposures and specialised lending, lower input floors for exposures to regional governments and local authorities, transitional arrangements for exposures to real estate and unrated corporates, as well as for securitisation and counterparty credit risk, to allow banks to apply reduced risk weights for these exposures when determining risk-weighted assets under the standardised approach), making the output floor less binding during the transition period. The impact of these deviations from Basel is material, as shown in the EBA impact study and further detailed in the ECB confidential impact analysis.
Improve planning of supervisory resources (SSM)	ST	**Status: Partially implemented.** ECB Banking Supervision was reorganized in October 2020, to make the structure more agile and integrated. The reorganization brought the creation of one new business area (D-SSR) with a focus on strategy, risk analysis, and a second line of defense. The D-SSR/Strategic Planning Office is responsible for the set-up, implementation, and continuous improvement of the SSM planning process and its monitoring, as well as for the development of a comprehensive overview of activities and resources vis-à-vis priorities. It also conducts the organizational readiness exercise for implementing SSM priorities and proposes the allocation of the SSM resource pool. The resources used for the ECB's supervisory tasks are financed via supervisory fees borne by the supervised entities (banking groups or stand-alone entities). The ECB in its annual budget planning exercise applies a lean process to cost allocation and provides an early estimation of the supervisory fees using a number of assumptions, including the full consumption of the allocated budget, while the cost metric types applied are based on latest available information (year-end metrics of the previous

Recommendation*	Timing**	Actions
		year). Several actions have been taken to integrate and simplify SSM processes. As regards staffing the NCA leg of Joint Supervisory Teams, several improvements were introduced in the annual staffing process. As part of the supervisory planning process, several tools have been introduced to support the organization's readiness for the implementation of priorities, including capacity building on critical areas. However, the dependency on NCA staff is both a strength but also an additional vulnerability which affects the planning and delivery of supervisory tasks, with more than half the NCAs not being able to meet their staffing commitments to the SSM. in addition, the ECB banking supervision business lines' consultation on the budget proposed by the ECB budgetary function is pro forma and late stage.
Raise standards for handling of loan classification and provisioning (SSM)	ST	**Status: Implemented.** There were developments in supervisory expectations on loan loss provisioning through: (i) the publication of the Addendum for new Non-Performing Exposures (NPEs) as of April 1, 2018; (ii) the SREP recommendations for the stock of NPEs as of March 31, 2018; and (iii) a new automatic Pillar 1 backstop for NPEs from newly originated loans as part of the EU Banking Reform package approved in 2019. In addition, at the onset of COVID-19 pandemic, "dear CEO" letters were published communicating supervisory expectations among others on classification and provisioning aspects. This was followed by extensive assessment of compliance at an individual bank level, issuance of specific recommendations to banks, and follow-up by offsite supervisory teams to ensure any gaps to supervisory expectations are closed. Deep dives in the areas of forbearance, UTP and IFRS 9 implementation were conducted over the last two years and will continue going forward. Lastly, training on these topics was provided to Joint Supervisory Teams (JSTs) and dashboards for the monitoring of asset quality and provisioning were enhanced.
Improve coordination and information sharing regarding AML/CFT (ECB, national authorities)	ST	**Status: Implemented.** At the end of 2018, ECB/SSM set up an AML Coordination Function (ALMCO) with responsibilities to: (i) act as a central point of contact for SIs; (ii) set up a network for achieving consistent SSM-wide prudential approach; and (iii) act as an internal center of expertise on prudential issues. In January 2019, the ECB also signed an agreement for information exchange with nearly 50 national AML/CFTs authorities in Europe as mandated by the 5th review of the AML Directive. Following the ESA review, the EBA is playing a coordinating role on AML/CFT supervision issues across sectors and the EU. The ECB/SSM have taken steps to streamline the information exchange process with AML/CFT authorities and implemented the changes coming from the EBA regulatory framework (EBA cooperation Guidelines, EBA database on material weaknesses). Based on recent external assessments (ECA report, SSM review by the EC), the information exchange process works well overall. The ECB/SSM enhanced the way ML/TF risks are reflected in prudential supervision for the SREP (implementation of the SREP Guidelines), authorizations, and fit-and-proper assessments.
Transfer supervision of systemic investment firms and third country branches to the SSM (EU)	ST	**Status: Partially implemented.** The new Investment Firm Regulation and Directive—in force since June 2021—have introduced a multi-tiered regulatory regime for investment firms. They require that the largest and more systemic investment firms (above EUR 30 billion at solo- or group-level) and engaging in specific activities (dealing on own account or underwriting or placing financial instruments on a firm commitment basis)

Recommendation*	Timing**	Actions
		are authorized as credit institutions and, if the criteria for significance are met, fall under the direct supervision of the ECB. Although CRD 6 will improve the regulation and supervision of third-country branches, such branches will remain licensed and supervised by NCAs (outside the SSM) unless they are converted into subsidiaries and considered SIs. The process to require the establishment of subsidiaries is rather complicated and led by NCAs, without any possibility for the ECB to influence the outcome. There is also limited information available at the EU or EA level on the type and importance of activities of these branches, as well as on the risks taken and their booking models. It is also envisaged that CRD 6 will further enhance supervisory cooperation by including those TCBs with a larger EU footprint under EU supervisory colleges.
Ensure the availability of a full set of borrowers-based macroprudential instruments (EC, ESRB)	MT	**Status: Not implemented.** The ESRB has recommended the implementation of BBMs in its responses to the European Commission's public consultations. To the consultation on banking sector macroprudential policy review in 2022 the ESRB has proposed the introduction of a common minimum set of BBMs in EU legislation for residential real estate loans. In the non-banking review, the ESRB called for the introduction of activity-based regulation into EU law, enabling national authorities to set BBMs and apply them to all types of lenders. In the 2024 report on the macroprudential review, the Commission identified BBMs as one of the key areas for further work for enhancing the framework's ability to tackle risks stemming from real estate markets. BBMs differ across the EU because the measures, where they exist, are exclusively governed by national law.
Preparations for the U.K. Exit from the EU		
Accelerate discussions on action to ensure continuity of service and data access (ECB, ESAs, SSM)	I	**Status: Implemented.** Cliff edge effects from derecognition of U.K. CCPs were avoided. Cooperative arrangements between the Eurosystem/ECB, the Bank of England, and the relevant U.K. CCPs were adopted due to the United Kingdom's withdrawal from the EU. U.K. CCPs were (temporarily, until June 2025) recognized for the purposes of providing clearing services in the EU. The EC adopted a decision (January 2025) to extend equivalence for UK CCPs for a further three years until 30 June 2028. This decision aims to ensure EU financial stability in the short-term and provide clarity to EU financial market participants. In March 2019, the ECB and the BoE announced the activation of the currency swap arrangement for the possible provision of euro to U.K. banks and of GBP to euro area banks. ECB Banking Supervision cooperates and exchanges confidential supervisory information with the U.K. prudential authorities on the basis of the Memorandum of Understanding (MoU) concluded in 2019 for the period after Brexit.
NPL Resolution		
Prescribe rules for valuation of immovable loan collateral, including repossessed collateral. (EU).	MT	**Status: Implemented.** The 2017 EBA guidelines on PD and LGD estimation require some level of prudence for the purpose of LGD estimation, to reflect that the value of repossession does not always reflect accurately the market value of the asset. Banks are required to address this uncertainty by applying an appropriate haircut to the value of repossession.

Recommendation*	Timing**	Actions
		The *Banking Package,* contains requirements for determining the property value, a concept which is more prudent than the market value, and which should remove the divergence between jurisdictions using either market value or mortgage lending value. CRR 3 and EBA Guidelines on Loan origination and monitoring, NPL and FB, and SREP set out the requirements for banks' valuation of immovable and movable properties at origination, requiring banks to set out internal policies and procedures for the valuation of collateral; collateral valuation of immovable and movable properties pledged for nonperforming exposures , including the governance, procedures and controls in the collateral valuation; the frequency of the valuations; and the methodology for valuation of the collateral.
Set consistent NPL definitions and reporting standards (EC, EBA, SSM)	ST	**Status: Implemented.** Regulation (EU) No. 630/2019 amended Regulation (EU) No. 575/2013 and introduced a clear set of conditions for the classification of nonperforming exposures. EBA Guidelines on SREP, Loan Origination, Default, and NPLs set out requirements for the ongoing administration and monitoring of the various credit risk-bearing portfolios and banks' exposures, including identifying and managing problem credits and making adequate value adjustments and provisions. These guidelines set out: the definition of default; technical criteria for the identification of past-due borrowers; technical criteria for the identification of problem borrowers (e.g. unlikely-to-pay or UtP) and thus in default status; several possible triggers that banks could consider for classifying borrowers as UtP; and expectations with regard to the recognition of NPLs.
Establish minimum standards for insolvency and creditor rights regimes (EU)	MT	**Status: Partially implemented.** The 2019 Directive on Preventive Restructuring and Insolvency established minimum standards in certain areas, such as preventive restructuring mechanisms and debt discharge for entrepreneurs. In December 2022, the Commission proposed a Directive harmonizing certain aspects of insolvency law, which is still being negotiated. Critical issues, such as commencement standards for insolvency and the ranking of claims are outside the scope of the Directive.
Crisis Management and Financial Safety Nets		
Strengthen early action framework and advance resolution preparation (SRB, SSM, EC, NRAs)	I	**Status: Partially implemented.** Operational readiness at both the SSM and SRB has improved, with several initiatives to improve understanding of the practical steps needed to implement resolution completed or underway. There have been numerous incremental updates, including to the ECB's escalation procedures and the SSM-SRB MoU. The draft Crisis Management and Deposit Insurance (CMDI) legislation also includes reforms to the early intervention framework and the SRM's involvement earlier in potential resolution cases, but it remains subject to negotiations.
Quickly buildup MREL and iMREL, prioritizing large banks (SRB)	I	**Status: Implemented.** The SRB reports that all significant institutions met their MREL targets as of January 1, 2024, with a few cases where a longer transition period was granted accounting for all of the remaining MREL shortfall. All EU G-SIIs still comply with TLAC.
Ensure availability of liquidity in resolution (SRB, EC, Eurosystem)	ST	**Status: Not implemented.** The SRB has stated publicly that the SRF can contribute to liquidity provision to institutions in resolution, but it should not be deemed as the only solution considering its capacity in case of liquidity needs post resolution for large banks. In addition, one member

Recommendation*	Timing**	Actions
		state has not yet ratified the ESM treaty changes to implement the ESM backstop. Recent crisis cases in other jurisdictions have required larger amounts of liquidity than the combined size of the SRF and ESM backstop.
Designate and make operational the SRF backstop (such as the ESM) (EU, SRB, ESM)	ST	**Status: Not implemented.** The establishment of the backstop is legally embedded in the revised ESM Treaty, with entry into force still pending ratification by one signatory. The backstop will have the form of a revolving credit facility initially amounting to EUR 68 billion.
Establish an EDIS with a backstop (EU)	ST	**Status: Not implemented.** Eurogroup-mandated work on EDIS has been suspended since 2022. The SRB has stated publicly that during the next legislature, the Council should decide to re-start discussions on EDIS.
Ensure consistency of triggers for action such as resolution, liquidity assistance, and precautionary recapitalization (EC, ECB, SRB)	ST	**Status: Partially implemented.** In 2018, ECB Banking Supervision has adopted a new definition of solvency to be used in the context of: (i) precautionary recapitalization; (ii) state guarantees on newly issue liabilities; and (iii) state guarantees to back central bank liquidity facilities. The new methodology is based on a forward-looking assessment of compliance with Pillar 1 and Pillar 2 capital requirements. It ensures alignment with the FOLTF assessment (which is one of the three conditions for resolution). The proposed CMDI reform would broadly improve the alignment of triggers for crisis management tools, including precautionary recapitalization, preventive measures, and resolution.
Align state- aid loss-sharing requirements (in resolution) with the BRRD/SRMR, while introducing flexibility through a financial stability exemption (EU)	ST	**Status: Not implemented.** The Commission is carrying out an evaluation of its state-aid framework for banks, which was expected to be completed in the first quarter of 2024 but has not yet been published. The outcome of this evaluation is expected to inform a subsequent potential review of the state-aid framework for banks.
Further harmonize the creditor hierarchy in bank insolvency (EU)	MT	**Status: Not implemented.** The proposed CMDI reform includes further harmonization of creditor claims as regards the ranking of depositors in insolvency (all depositors ranking in a single tier), but not other issues (e.g., treatment of post-default interest).
Introduce an administrative liquidation tool for the SRB (EU)	ST	**Status: Not implemented.** The approach taken with the proposed CMDI review is to facilitate the application of the already harmonized resolution framework to small- and middle-sized banks.
Pare back state-aid oversight of the use of the SRF and deposit insurance funding on a least-cost basis (EC)	ST	**Status: Not implemented.** The Commission's CMDI proposal envisages a targeted simplification of the process to be followed by the Commission and the SRB in case of use of Fund or State aid in resolution while maintaining the assessment of compatibility of such aid with the single market.
Buttress SRB independence and powers (for example, by granting permanent observer status at the	I	**Status: Partially implemented.** The revised version of the SSM-SRB MoU signed in 2022 sets forth that "*the Supervisory Board will invite the Chair of the SRB to participate as an observer in its meetings for items relating to the tasks and responsibilities of the SRB.*" Other changes to the SRB's status and powers have not been pursued.

Recommendation*	Timing**	Actions
SSM Supervisory Board) (SSM, EC)		
Liquidity Management		
Articulate an explicit financial stability mandate for the ECB/Eurosystem (ECB)	MT	**Status: Not implemented.** The authorities consider that Article 127(5) of the Treaty of the Functioning of the European Union—*"The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system"*—and Article 25 of the ESCB Statute suffice. Following the latest Strategy Review, the ECB has taken steps to integrate financial stability analysis into the monetary policy-making process. These aim to preserve the focus on the primary objective to maintain price stability while taking into account any spillovers or interactions with financial stability matters.
Intensify "horizon scanning" involving supervisory and operational functions (ECB, SSM)	I	**Status: Partially Implemented.** The ECB had taken note of the recommendation regarding the "horizon scanning" arrangements to better detect emerging liquidity strains. Elements of horizon scanning are, however, already built into processes on the supervisory and monetary policy sides of the ECB. Additional elements will need to be considered in future work. With respect to the *euro area* CCPs' access to the Eurosystem facilities, there is ongoing work regarding the TARGET emergency credit facility, which covers, to the extent feasible, the possible harmonization of conditions across various credit facilities available to CCPs (with and without a banking license) as well as considering potential safeguards and enhancements of cooperation/information-exchanges (with relevant CCP supervisors).With respect to *non-euro area* CCPs, the internationally agreed "No Technical Obstacle" principles are considered to provide sufficient basis for possible establishment of arrangements between the ECB and non-euro area central banks.
Further harmonize and ultimately centralize ELA arrangements (ECB)	ST	**Status: not implemented.** The ECB regularly reviews the rules and procedures surrounding the provision of ELA, as laid down in the ELA agreement (driven by transparency considerations, the ELA agreement was first published in June 2017; the last ELA review was finalized in 2020: Q4). The ELA framework has evolved and expanded over the last years with more elements being covered by the ELA agreement to ensure that the provision of ELA by NCBs does not interfere with the Eurosystem monetary policy. Moreover, and with a view towards a consistent approach within the euro area, topics related to communication and disclosure, solvency definition, or provision of foreign currency are also being looked at in the context of regular ELA reviews. Centralizing ELA would have substantial benefits, and should be pursued as a key element of completing the BU
Manage the transition from crisis-related policy settings and develop the future operational framework to reflect regulatory and market developments (ECB)	MT	**Status: Implemented** The ECB implemented changes to its operational framework for steering short-term interest rates in October 2024. The major changes are a narrowing of the corridor (to 15 basis points) between the rates applied to the Main Refinancing Operation and the Deposit Facility, and the move to a demand driven approach where liquidity is provided on demand (weekly basis through the MRO) at a fixed rate. Also announced was the intention to construct a portfolio of long-term refinancing operations and securities with details to be announced at a later stage.

Recommendation*	Timing**	Actions
[1] The RTS specify (i) the criteria to evaluate the risks arising from potential changes in interest rates and (ii) the modelling and parametric assumptions and the supervisory shock scenarios complemented by an Implementing technical standard (ITS) on Pillar 3 disclosure of banks' exposure to IRRBB, which is applicable since June 2022. The GLs provide criteria for the identification, evaluation, management, and mitigation of IRRBB in banks' internal systems.		
* In this table, EU will refer to the Council of the EU, the European Parliament, and the European Commission. **I: Immediate, within 1 year; ST: short term, within 1 to 2 years; MT: medium term, within 2 to 5 years.		

Annex III. Authorities' Response to Past Key Policy Recommendations

2024 Consultation Recommendations	Authorities' Reponses
Monetary Policy	
The ECB can commence a gradual loosening of its monetary policy stance in June 2024 to reach a neutral stance by 2025Q3.	The monetary easing cycle started in June 2024 and the ECB has lowered its main policy rate from 4 percent to 2 percent in June. The gradual policy loosening was slightly faster than IMF staff predicted last year (about 25bps difference), which reflects the economy growing at a slower pace and inflation being slightly lower than staff estimated.
Fiscal Policy	
Fiscal policy should tighten in 2024. Quality consolidation measures are needed for 2025 and beyond.	Fiscal balance improved in 2024 reflecting the unwinding of crisis support measures, including Italy's Superbonus incentives for housing improvements. The medium-term fiscal adjustment commitments outlined in the Medium-Term Fiscal Structural Plans (MTFSPs) broadly align with staff's recommendations at the aggregate level. While the Plans include specific measures for fiscal adjustments in 2025, details of medium-term measures are yet to be specified.
Successful implementation of the new Economic Governance Framework (EGF) will require a clear guidance on operational aspects (from the Commission), as well as significant capacity and political support from the member states. Member states should focus on identifying and committing to high-quality measures within their Medium-Term Fiscal Structural Plans (MTFSPs) to meet the required fiscal adjustments	The EGF entered its initial implementation phase with the adoption of MTFSPs by 22 member states as of April 2025. In March, the Commission invited all member states to consider activating the national escape clause, allowing flexibility for increased defense expenditures under the framework—a move that introduces significant challenges to its implementation. As of end-April 2025, 16 member states have decided to request the activation.
Financial Sector Policies	
Financial stability risks associated with rapidly rising interest rates should be closely monitored. Expanding macroprudential tools that limit leverage and liquidity mismatches in the NBFI sector and improving cooperation (including with respect to data sharing) between national regulatory authorities would help reduce systemic risk.	Discussions and proposals are ongoing. Financial sector risks in the banking sector, interest-rate risk for banks is frequently monitored. While risks from NBFI sector remains a high priority issue, more progress is needed. The EC consultation on macroprudential tool for NBFIs is progressing with the EC publishing a summary report (May 2024) on the feedback provided by the private sector, national authorities, and EU institutions. Bridging data gaps for the NBFI sector while continuing to develop a macroprudential toolkit. The authorities are introducing a regulation amending existing regulations with regards to reporting requirements in the fields of financial services and investment support to facilitate better data sharing among ESAs, SRB, ECB, and AMLA, national and other Union authorities. This includes provisions for memoranda of understanding to enable efficient and

2024 Consultation Recommendations	Authorities' Reponses
	seamless data sharing as well as sharing of resources for the collection and processing of shared data.
Further strengthen the EU's financial architecture, including through the ESM treaty ratification, agreeing on a European deposit insurance scheme, and making progress toward the CMU.	Discussions are ongoing. The progress on the ESM treaty ratification and agreeing on a European deposit insurance scheme remains limited. The recent EC announcement identified key priority areas for progressing with the Savings and Investments Union and provided a timeline for implementation. A mid-term review of the overall progress is expected in 2027Q2.
Structural Reforms	
Actions to boost productivity are essential, including strengthening the single market. Labor market policies at both national and EU levels should aim to enhance productivity, address the challenges of structural change, and counter the effects of a shrinking workforce.	Discussions and proposals are ongoing, with high-level officials contributing reports and recommendations to the EU's plan for boosting productivity and strengthening the single market. The Competitiveness Compass (published in January 2025) stresses the urgent need for action to boost productivity, drawing on the Draghi and Letta reports. It calls for action in innovation, decarbonization and security, to be underpinned by five "enablers": (1) regulatory simplification, (2) lowering barriers to the single market, (3) financing competitiveness through the refocused EU budget and savings and investments union, (4) the EU's skilled workforce, and (5) better policy coordination. A Single Market Strategy was published in May aimed at reducing barriers to intra-EU trade and reaping the full potential of the single market.
Enhancing energy security and advancing climate goals. Policy must internalize the fiscal, efficiency, distributional, and cross-border effects of the EU's climate goals.	Reforms and proposals are ongoing on multiple fronts. On February 26, 2025, the European Commission published the Clean Industrial Deal, the Action Plan for Affordable Energy, and the Simplification Omnibus Packages.

Annex IV. Data Issues

Table 1. Euro Area: Data Adequacy Assessment Rating 1/

Please select your overall DAA rating from one of the circled buttons on the right.

Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
Questionnaire Results 2/	A	A	A	A	A	A	A
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	A	A	A	A	A		
Granularity 3/	A		A	A	A		
			A		A		
Consistency			A	A		A	
Frequency and Timeliness	A	A	A	A	A		

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

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

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

Changes since the last Article IV consultation. In November 2024, the European Council formally adopted amendments to Regulation (EU) No 691/2011, expanding the scope of European environmental economic accounts. This amendment introduced three new modules: ecosystem accounts, forest accounts, and environmental subsidies accounts.

The authorities are introducing a Regulation of the European Parliament and of the Council amending existing regulations (Regulations (EU) No 1092/2010, (EU) No 1093/2010, (EU) No 1094/2010, (EU) No 1095/2010, (EU) No 806/2014, (EU) No 2024/1620 and (EU) 2021/523) with regards to reporting requirements in the fields of financial services and investment support to facilitate better data sharing among ESAs, SRB, ECB, and AMLA, national and other Union authorities. This includes provisions for memoranda of understanding to enable efficient and seamless data sharing as well as sharing of resources for the collection and processing of shared data. The authorities are close to completing the final text of the regulation to be published in the Official Journal and expects to finalize within the next six months.

Corrective actions and capacity development priorities. None.

Use of data and/or estimates in Article IV consultations in lieu of official statistics available to staff. The staff report uses third-party indicators directly (e.g., Orbis, Bloomberg, Refinitiv) and indirectly through citing existing work.

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

Table 2. Euro Area: Data Standards Initiatives

By May 2025, 16 euro area countries had already adhered to SDDS Plus and 4 euro area countries adhered to SDDS.

Statement by Mr. Joerg Stephan, Executive Director for Germany
and Mr. Julien Guigue, Advisor to Executive Director
on behalf of the Euro Area Authorities
July 7, 2024

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

The authorities of the euro area Member States and the EU Institutions are grateful for the open and fruitful consultation with staff and their constructive policy advice. The authorities are in broad agreement about the need to strengthen fiscal sustainability, by implementing the revised EU fiscal rules, improve productivity, reducing labour market shortages and mismatches, promoting investment and reforms, and deepen the single market while seeking further trade diversification through advancing new free trade agreements and strengthening existing trading relationships.

The euro area is among the most open economies and is thus especially exposed to the risks of trade fragmentation. It has been particularly affected by the Russian war of aggression in Ukraine and the subsequent energy crisis. In a context where managing potential risks linked to external dependencies, including on fossil fuels, is key, reforms and investment are needed to accelerate the green transition, boost productivity, and reinvigorate growth. However, those geoeconomic challenges also serve as a reminder that our economy has solid economic fundamentals and institutional strengths, which are even more relevant in the context of high global uncertainty. In this context, it is noteworthy that there are some signs that markets are optimistic about Europe and trust in our system, as evidenced by the recent shifts in economic and financial market sentiment. The upcoming enlargement of the euro area is yet another sign of its vitality and attractiveness.

More specifically, we have the following comments on the two Staff Reports:

EURO AREA POLICIES (ANNUAL CONSULTATION)

Economic outlook and risks

The authorities broadly share the Fund's overall assessment of the euro area's macroeconomic outlook. The economy has withstood multiple shocks, but growth is projected to stay moderate. The forecast downgrade is largely due to the impact of increased tariffs and the heightened uncertainty caused by the recent abrupt changes in trade policies and the unpredictability of the tariffs' final configuration. Despite these challenges, the Commission spring forecast projects growth to rise to 1.4% in 2026, supported by continued consumption growth and an acceleration in exports and investment.

The authorities agree that risks to growth are tilted to the downside. Among the downside risks, an escalation of trade tensions would have ripple effects on the EU economy. Uncertainty about the inflation and employment outlook in the US and the corresponding policy stance could generate further shocks with adverse spillovers on global financial conditions and EU external demand. Still, heightened policy uncertainty can prove a catalyst for needed reforms at the national and European levels, including in relation to the Single Market and the Savings and Investment Union. Trade uncertainty could also settle at a lower level than currently expected. Planned increases in infrastructure and defence spending, notably in Germany, is expected to support economic activity, although this is not yet fully reflected in forecasts. Temporary flexibility is being provided within the SGP to facilitate higher defence spending while maintaining public finances on a sustainable medium-term trajectory - the associated spending may also stimulate economic activity, especially if focused on investment and innovation.

Inflation is currently at around the ECB's two percent medium-term target. Euro area headline inflation had followed a steady disinflation process and stood at 1.9% in May 2025. Core inflation – excluding energy and food – declined to 2.3% in May. Most indicators of underlying inflation suggest that inflation will stabilise sustainably at the 2% medium-term target. Domestic cost pressures continue to moderate mainly thanks to easing nominal wage growth, a process that should continue as pressures to recoup past real wage losses fade. The June 2025 Eurosystem staff projections saw inflation staying temporarily below 2% in 2026 – driven in part by a stronger euro and a decline in energy commodity prices – before returning to target in 2027. The outlook for euro area inflation is more uncertain than usual, with mainly geopolitical tensions and frictions in global trade responsible for both upside and downside risks.

The authorities assess the euro area external position to be broadly in line with fundamentals. The assessment of the euro area external position remained qualitatively unchanged from the previous year, with lower energy prices driving the rebound in the current account balance, which had also been accompanied by a slight strengthening of the real exchange rate of the euro. The strengthening of the euro area current account in 2024 cannot be entirely attributed to domestic policy gaps, as it also reflects temporary factors and policy gaps originating in jurisdictions outside the euro area. In the current uncertainty environment, drawing firm conclusions from single year developments is not advisable.

Macroeconomic policies

With inflation set to stabilise around the two per cent target on a sustained basis, monetary policy, at the current interest rate levels, is in a good position to navigate the uncertain circumstances. Especially in the current context of exceptional uncertainty, the ECB's Governing Council is not pre-committing to a particular rate path and will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance. Interest rate decisions will be based on the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. The normalisation of the Eurosystem's balance sheet initiated in late 2021 is proceeding at a measured and predictable pace, with the drawdown of the ECB's bond portfolios having been absorbed by the market smoothly. In its recently concluded monetary policy strategy assessment, the ECB confirmed the symmetric two per cent medium-term inflation target and that all monetary policy tools currently available to the Governing Council will remain in its toolkit.

The authorities broadly agree on the need for a gradual and sustained fiscal adjustment in many Member States, though fiscal situations and optimal fiscal policy strategies differ across countries. The euro area fiscal stance is projected to turn broadly neutral in 2025 and 2026, based on unchanged policies. The general government deficit is anticipated to rise to 3.3% of GDP by 2026. Eight euro area Member States recorded a deficit above 3% of GDP in 2024, and this number is expected to reduce to six euro area Member States by 2026. The debt ratio is expected to edge up to about 90% of GDP in 2026, with five Member States exceeding a 100% debt-to-GDP ratio. The impact of activating the National Escape Clause of the Stability and Growth Pact, providing flexibility for higher defence expenditure over 2025-2028, is not yet fully reflected in this forecast. At the same time, there is scope, through the 2026 budgets, to improve the differentiation of fiscal policies across euro area Member States in line with the country specific fiscal challenges and the corresponding fiscal structural plans. This would entail an overall slightly restrictive fiscal stance in the euro area in 2026, which however could be broadly offset by higher defence spending.

The authorities concur on the need to closely monitor risks to financial stability. Financial stability risks have increased in the past few quarters amid mounting geopolitical and policy uncertainties. Against this background, the Fund rightly highlights the context of high volatility and operational risks to the financial system, including financial market infrastructure, which are however challenges faced in all jurisdictions. While asset markets have recovered from a recent fall, intensifying trade tensions and fears for an economic slowdown could lead to further capital market volatility in asset markets. Liquidity and leverage fragilities in parts of the non-bank financial intermediation sector could amplify asset price corrections. Banks' capital and liquidity buffers are robust, but profitability and asset quality are likely to be adversely impacted by the economic impact of rising trade tensions. In addition, the uncertainty over the implementation of international standards by other jurisdictions increases the risk of regulatory and financial fragmentation.

Structural reforms

The authorities agree on the need to enhance the competitiveness and resilience of the euro area economy in the face of ongoing global transformations, noting that action is already underway. To this end, the European Commission has put forward the "Competitiveness Compass", a strategic framework to guide the work on strengthening EU competitiveness over the next five years. It builds on the findings and recommendations of the reports by Enrico Letta on the future of the EU Single Market and Mario Draghi on the future of European Competitiveness and provides a list of ambitious initiatives to be developed or finalized over the coming months. The three pillars of the Compass are closing the innovation gap; a joint roadmap for decarbonisation and competitiveness; and reducing excessive dependencies and increasing security. To complement these three pillars, the competitiveness compass also introduces five "horizontal enablers" of competitiveness: regulatory simplification, removing barriers in the Single Market, enabling more efficient financing for competitiveness, promoting skills and quality jobs, and ensuring better policy coordination at EU and national level. Several major proposals have already been presented over the past few months on a wide range of areas such as regulatory simplification, the Single Market, the Clean Industrial Deal, or the Savings and Investment Union, to name a few. The EU and its Member States will continue working collaboratively to deliver impactful structural reforms and investments, also in the context of the European Semester and RRF implementation. The proposal for the next EU long-term budget will consider streamlined, flexible financial support and strategic investment capacity and help leverage and de-risk private investments.

A successful implementation of climate policies to meet the 2030 emissions target is key and work on the post-2030 climate policy framework is ongoing. Regarding key new policies, a number of targeted simplifications have been introduced to facilitate effective implementation and reduce administrative burden. In the case of the upcoming Emissions Trading System for road transport and buildings (ETS 2), simplified monitoring, reporting and verification (MRV) requirements have been introduced for small emitters, and the system remains on track for implementation in 2027. For the Carbon Border Adjustment Mechanism (CBAM)—which aims to prevent carbon leakage by placing a carbon price on imports of selected goods from countries with less stringent climate policies—several administrative simplifications were adopted as part of the so-called "Omnibus Regulation", notably reducing the number of importers subject to detailed reporting obligations. Authorities have reported positive feedback from stakeholders on these changes. A comprehensive report expected by the end of 2025 will assess the functioning of CBAM governance and may consider a possible extension of its sectoral scope. The extension of the CO_2 emission compliance period for cars from 2025 to 2027 provides regulated flexibility for manufacturers, without altering the emission targets or overall policy ambition. Looking beyond 2030, a legal proposal for the 2040 EU climate target is expected shortly, with work progressing on the accompanying post-2030 climate policy framework. In parallel, the European Commission is developing a position and corresponding legal framework regarding the use of international carbon credits.

In response to increasing geoeconomic fragmentation, the European Union is implementing a strategy designed to continue to champion a rules-based, fair multilateral trading system, while avoiding a cycle of retaliatory measures. This strategy rests on several key pillars, including the preparation of cases before the World Trade Organization (WTO), when appropriate, with a view to resolving disputes while minimizing the risk of escalation and tit-for-tat policies. A further core component is the monitoring of trade diversion, particularly considering recent measures adopted by major trading partners that could lead to significant shifts in global trade flows, potentially harming European economies. This monitoring is conducted on a sector-specific basis to identify and mitigate potential spillover effects arising from trade tensions between third countries.

Developing the Savings and Investments Union (SIU) is essential for strengthening competitiveness and innovation and for achieving policy priorities. The SIU is a new political initiative by the European Commission that builds on the Capital Markets Union and Banking Union policy agendas. It aims to enhance financing for innovation, green efforts, digital transformation, defence, and infrastructure across the EU. The initiative focuses on increasing household wealth and business financing opportunities by better connecting savings to productive investments, boosting EU economic competitiveness. Supported by strong political momentum, the Commission plans to deliver several actions by 2025 and early 2026. On 17 June 2025, the Commission presented one of this year’s key initiatives: a proposal to review the regulatory framework for securitisation. The aim is to increase the amount of financing available to the real economy and enhance risk diversification within the single market and enhancing EU capital market supervision. Actions also aim to boost retail investor participation in capital markets, with recommendations on savings and investment accounts, measures for supplementary pensions and a financial literacy strategy. Other objectives include finalising negotiations on the 2022 proposal on insolvency; a 28th legal regime can also play an important role in removing fragmentation and fostering competitiveness. The Commission will publish in 2026 a report assessing the overall situation of the single market for banking, including the evaluation of the banking sector's competitiveness, and considering all banking union dimensions.

FINANCIAL SYSTEM STABILITY ASSESSMENT

The authorities agree with the IMF's overall assessment that the euro area financial system is resilient, as also reflected by the results of banking sector and system-wide stress-tests, which complements their own assessment of risks and vulnerabilities. The authorities also welcome the acknowledgement of significant progress made in implementing regulatory reforms.

The authorities appreciate the valuable discussions and relevant insights from the IMF, including concerning ongoing efforts aimed at developing a comprehensive financial system-wide perspective, taking into account the interlinkages between the banking sector and non-bank financial institutions, the impact on core markets, as well as pursuing further methodological refinements. They broadly support the IMF team's concerns with data gaps, data access, and data sharing, and they see merit in exploring further centralisation of data collection at EIOPA and ESMA, while noting the legal challenges for cross-border sharing at national level.

In terms of prudential oversight, the authorities welcome the IMF's acknowledgement of the considerable efforts undertaken to enhance the stability and resilience of the EU financial system, including the resilience of the EU banking sector, the soundness of the macroprudential framework and the recent reforms in the insurance sector and the new Anti-Money Laundering framework.

The authorities appreciate the IMF's positive assessment of the significant progress in the regulation and supervision of the euro area banking sector since the previous FSSA. The assessment of the compliance with the Basel Core Principles for effective banking supervision shows strong improvement and the IMF acknowledges that the Single Supervisory Mechanism (SSM) is a capable supervisor, supported by excellent risk analysis and a strong skill set. The authorities note that many of the IMF's recommendations aimed at enhancing the ECB's supervisory effectiveness and efficiency are fully in line with initiatives currently underway within the SSM.

The IMF did not fully consider in their Basel Core Principles (BCP) assessment the already adopted Capital Requirements Directive (CRD6), which will enter into force a few months after the publication of the FSSA report and will fully address some of the deviations highlighted by the IMF. As such, the BCP scoring understates the level of compliance for the period ahead.

The authorities also wish to point out that deviations from the Basel standards highlighted in the IMF's report could be considered balanced by the fact that the EU applies the Basel standards across all its banks, not just its globally systemically important ones, which helps strengthen banks' safety and soundness and financial stability and eliminates the potential for regulatory arbitrage between banks. In addition, the authorities note that many deviations are temporary, and they should be placed in the context of the overall EU regulatory framework for banks and of the delays in other jurisdictions as regards Basel III.

In the area of insurance, the authorities welcome the IMF's recognition of Solvency II as a well-functioning prudential framework that has helped enhance the resilience of the insurance sector. The authorities take note of the IMF's recommendations to strengthen EIOPA's supervisory powers and to provide it with adequate resources for its new responsibilities, while noting that any such changes would require careful consideration in the context of the existing supervisory framework in the EU. The IMF's recommendation to introduce minimum harmonisation for insurance guarantee schemes (IGS) is timely, as EU authorities are conducting their own analysis, following the adoption of the Insurance Recovery and Resolution Directive (IRRD). The authorities concur with the IMF's view that prudential objectives should be prioritised in the Solvency II review, giving due consideration to the enhanced risks and the need for a stable sector. However, they emphasise that this should not lead to an underestimation of the socio-economic role of insurers.

The authorities particularly welcome the recommendations that have the potential to support the SIU. The authorities share the IMF's assessment that there is considerable scope to further deepen capital markets in the euro area. The authorities are committed to creating truly integrated and deep capital markets and to further improving their supervision. They largely share the IMF's assessment that supervisory reforms should be carefully calibrated and sequenced, ensuring that ESMA's powers and resources are suitably aligned to its evolving responsibilities.

Regarding macroprudential policy, appropriate countercyclical capital buffers and adequate flexibility in using them in crisis periods should ensure resilience of credit flows at all times. Borrower-based measures commonly serve as structural backstops against risky loan origination, tackle risks stemming from the real estate sector and build financial sector resilience over time. The authorities will give careful consideration to recommendations to legally clarify the possibility to activate the countercyclical capital buffer (CCyB) early in the cycle, to streamline EU governance procedures for activating macroprudential measures, and to harmonise the methodology for implementing other systemically important institutions (O-SII) buffers while allowing some flexibility to reflect country specificities. EU authorities are exploring potential measures in this regard, as well as measures to further simplify and streamline procedures in the framework.

The authorities appreciate the IMF's positive reception of the Digital Operational Resilience Act (DORA) and see merit in the draft recommendation for the ESAs to accelerate development of cyber risk oversight capacity in the context of DORA implementation. However, the authorities have reservations on the IMF's view that it should be possible to fine Critical Third-Party ICT Service Providers' (CTTPs) non-compliance with requirements, since such a recommendation would require a fundamental change of DORA.

Regarding financial safety nets, the authorities concur with the IMF on the importance of completing the banking union and appreciate the acknowledgement of the significant progress made on resolution preparedness and build-up of the loss absorbing capacity in the euro area banks as well as on the operational preparedness of the Single Resolution Board (SRB).

The authorities agree on the need to further address the issue of liquidity in bank resolution with adequate safeguards. The authorities note that the draft recommendation to introduce a general financial stability exemption in the resolution framework would present significant political challenges in the short as well as in the medium term.

The authorities recognise the need to work towards addressing remaining gaps in the bank crisis management and deposit insurance framework. Nevertheless, the authorities would have appreciated a better recognition of the Crisis Management and Deposit Insurance (CMDI) reform, which was at that time under negotiation by the co-legislators to improve the framework and make it functional for all banks, including smaller and medium-sized banks.