Euro Area: Staff Concluding Statement of the 2016 Article IV Mission

June 16, 2016

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The euro area is at a critical juncture. *Growing political divisions and Euroscepticism have weakened prospects for collective action, leaving the euro area increasingly vulnerable to a number of risks at a time when there is little policy space. Boosting growth and strengthening the union requires a more balanced policy mix combining structural reforms, fiscal support from centralized initiatives, and continued adjustment in countries with high debt levels. Member states must abide by the rules to make the monetary union function, but at the same time, more centralized demand support and risk sharing are needed to make membership more attractive. Speedier bank balance sheet repair would spur credit growth and facilitate corporate restructuring. IMF staff suggest a four-pillar approach: create better incentives for structural reforms; strengthen the fiscal framework while expanding centralized fiscal support; continue with accommodative monetary policy; and accelerate bank balance sheet repair while completing the banking union.*

The euro area recovery has strengthened over the last two quarters. Domestic demand has been the main driver, supported by low oil prices, improving employment, a slightly expansionary fiscal stance, and an accommodative monetary policy. Inflation and inflation expectations, however, are still stubbornly low.

But this strong cyclical recovery should not lead to complacency. The medium term outlook is still weak. Crisis legacies, such as high non-performing loans (NPLs) in some banking systems, elevated levels of public and private debt, and still high unemployment, hold back potential growth and perpetuate imbalances. Productivity remains below pre-crisis levels and faces greater pressures from adverse demographics. Despite stabilizing oil prices, inflation is expected to remain below the European Central Bank (ECB) price stability objective for several years, reflecting the slow pace at which the output gap closes. Without more decisive actions to strengthen growth in the baseline, high unemployment and debt burdens are likely to persist, leaving the euro area vulnerable to the risk of stagnation.

External imbalances also persist at the national level as the overall current account continues to rise. The euro area's external position in 2015 remained broadly consistent with the level implied by medium-term fundamentals. However, progress in external rebalancing remains slow; the current accounts of debtor countries have improved due to competitiveness gains, but the surpluses of some large creditor countries continue to grow. Further adjustment is needed by large surplus countries to strengthen domestic demand and debtor countries to raise productivity and competitiveness.

Against this weak backdrop, political risks have increased markedly. The lack of a collective response to the refugee surge has vividly exposed political fault lines. If border

controls persist, or refugee inflows pick up again, these divisions could deepen, jeopardizing free movement within the single market. A "leave" vote in the U.K. referendum, or even a close result in favor of remaining, could exacerbate these tensions, contributing to further Euroscepticism and uncertainty. And if global trade were to slow, this could disrupt the momentum from domestic demand. Policy buffers to meet these risks are much lower than before the global financial crisis.

Strong collective actions are needed to allay Euroscepticism and renew faith in the monetary union. Without more decisive actions to boost growth and strengthen integration, the euro area may be subject to instability and repeated crises of confidence. Structural reforms to improve productivity and reduce macroeconomic imbalances need to be incentivized. And centralized fiscal support has to be accompanied by a stronger governance framework to ensure that members comply with the rules. These measures would be mutually reinforcing and would complement the accommodative monetary stance and provide a more balanced policy mix.

Create better incentives for structural reforms.

Structural reforms are central to reduce macroeconomic imbalances and raise potential growth, especially in the face of demographic headwinds. Without progress on structural reforms, high debt countries will continue to experience low trend growth and face greater challenges in staying on a sustainable path. At the national level, the priority should be on labor market liberalization and product market reforms in the professional and retail sectors. At the regional level, reforms to facilitate a single market in services, capital, energy, and digital commerce are needed. There should be more robust enforcement of the Macroeconomic Imbalance Procedure (MIP), including opening the Excessive Imbalance Procedure (EIP) against repeat offenders.

But structural reforms should be incentivized through a better governance framework. Country specific recommendations under the European Semester should be linked to outcome-based benchmarks that are concrete, measurable, and clearly linked to the ultimate reform objective. Benchmarking would reduce the scope for excessive discretion in enforcement. In addition to the labor tax wedge, agreed by the Eurogroup, other benchmarks could include indices of regulatory barriers in professional services, the number of licenses needed to engage in retail trade, employment protection in work contracts, the number of days to enforce a contract, and public sector value added per employee. Progress towards meeting common benchmarks could be made a precondition for accessing new centrally-financed initiatives, which can help offset upfront net costs of structural reforms.

Strengthen the fiscal framework while expanding centralized fiscal support.

Fiscal support is necessary to balance the policy mix but fiscal space is limited and unevenly distributed among member states. All countries should pursue growth-friendly fiscal rebalancing, while those with fiscal space should use it. Countries facing high levels of public debt should use the interest windfall from Quantitative Easing (QE) to repay debt.

Since fiscal space is concentrated in countries with small or no output gaps, there is a strong case for expanding centralized fiscal support. The European Fund for Strategic Investments could be enlarged, or new centralized public investment funds established for common projects such as energy transmission, refugee settlement, and climate adaptation and mitigation. Over the longer term, a stabilization capacity at the center, such as a euro area treasury, would help make the euro area more resilient.

But generating political support for greater centralized support will require stronger enforcement of fiscal rules. It is unfortunate that some countries with high debt burdens have spent their interest savings under QE and slowed the pace of adjustment, while

compliance with and enforcement of the Stability and Growth Pact (SGP) have been weak, undermining credibility in the framework. To restore trust and fiscal discipline, stricter enforcement is needed for countries that violate SGP rules. At the same time, simplifying the fiscal framework of the SGP, by focusing on a single fiscal anchor and single operational target, would enhance its effectiveness. A country's eligibility for centrally-financed investment should be made conditional on SGP compliance and implementation of structural reform recommendations. The European Fiscal Board, charged with assessing compliance with the SGP will need to be fully independent to command credibility.

Continue with accommodative monetary policy.

Monetary policy is appropriately accommodative. The new measures announced in March—scaled-up monthly purchases, extending purchases to corporate bonds, and the Targeted Long-Term Refinancing Operations II—should further ease financial conditions and expand credit supply. Negative interest rates have helped lower bank funding costs, improve asset quality, and ease lending standards. But substantial further rate cuts may squeeze banks' net interest margins, especially in countries more dependent on deposit funding and where large variable-rate mortgage portfolios are prevalent. Negative deposit rates also disproportionately raise the costs for banking systems with excess reserves.

If the inflation outlook deteriorates or fails to converge to the anticipated adjustment path, further easing would be warranted. This should come primarily from expanding the scope of asset purchases.

Accelerate bank balance sheet repair and complete the banking union.

Bank profitability has been persistently weak. The low return on bank equity makes it difficult for banks to raise new capital, and suggests consolidation is needed for the industry to thrive. Some banks are engaging in the process of de-risking by reducing the size of their correspondent bank networks, which could have spillovers elsewhere. This reflects both the tighter regulatory requirements and a more challenging economic environment, particularly for large global banks.

Bank balance sheet repair should be accelerated. There has been a modest reduction in the stock of NPLs, but write-off rates remain too low. The ECB's NPL taskforce should pursue more aggressively targets for reducing the stock of impaired assets. This should be accompanied by insolvency reforms and efforts to facilitate distressed debt markets, including through publicly-supported asset management companies where appropriate. Supervisors should also push for consolidation and rationalization of business lines.

A common deposit insurance scheme with a common fiscal backstop is essential to complete the banking union. We strongly support the rapid implementation of the EC's European Deposit Insurance Scheme (EDIS) proposal. Common deposit insurance would help expand the flow of cross- border liquidity and promote pan-European banking.

The EDIS timeline could be accompanied by various measures to reduce banking sector risks, such as faster reductions in NPLs, reducing national discretions in bank supervision, harmonizing insolvency regimes, and faster progress towards a Capital Markets Union. We also support European efforts to develop a more risk-sensitive prudential treatment of banks' sovereign exposures, which should be phased in gradually and closely coordinated with the international review being undertaken in the Basel Committee.