



## Euro Area: IMF Staff Concluding Statement of the 2017 Article IV Mission

June 15, 2017

*The recovery has gained momentum, with a virtuous circle of private consumption and job creation. This provides an excellent opportunity to push forward with architectural reforms to deepen the Economic and Monetary Union (EMU). At the same time, structural reforms at the country level are needed to spur productivity growth, reduce competitiveness gaps, and help revive income convergence across the union. High-debt countries should use the remaining window of monetary accommodation to rebuild policy buffers. Countries already operating at capacity should support the healing process, including by accepting above 2 percent inflation for a prolonged period and by fostering more demand at home.*

**The euro area recovery is strengthening and becoming more broad-based.** The dispersion of growth rates across countries is now at its lowest since the introduction of the euro. Progress is homegrown, driven by domestic demand and supported by a revival of credit—the payoff from years of balance sheet repair, accommodative policies, and institution building. Inflation and inflation expectations, however, remain subdued, with core inflation at undesirably low levels.

**The strength of the recovery and favorable political environment present an opportunity to deepen integration.** There should be a renewed commitment to completing the banking union, advancing the capital markets union and creating a common fiscal capacity. These projects would have wide-ranging benefits for member states, while increasing the resilience of the monetary union.

**Despite the firm cyclical recovery, the euro area faces deep-rooted structural weaknesses and imbalances.** Real income convergence among the 12 original adopters of the euro has stalled, bringing into question the promise of higher incomes through integration. At the same time, competitiveness gaps between euro area countries widened in the years after euro adoption and remain wide, despite painful post-crisis adjustments that, in some of the hardest hit countries, unavoidably centered on labor shedding. Narrowing these competitiveness gaps now requires faster productivity growth—in excess of nominal wage growth—in the lagging countries.

**Some high-debt countries may face rising sovereign spreads when monetary policy accommodation is reduced.** Ambitious policy plans matched by strong implementation are needed to avoid higher financing costs. More broadly, all countries face uncertainties around global trade, Brexit, and geopolitics, and policy buffers are depleted. While the cyclical recovery has been impressively resilient to shocks thus far, continued stability calls for more progress in resolving crisis legacies.

### **Implement structural reforms to raise productivity and foster convergence**

**Countries should take advantage of the breathing space afforded by the recovery to press forward on structural reforms.** Well-designed reforms can help raise productivity growth without painful job cuts. Faster productivity growth in the lagging countries will facilitate convergence and reduce relative unit labor costs, thereby narrowing competitiveness gaps. The main responsibility for implementing both product and labor market reforms lies at the national level.

**Mechanisms to incentivize structural reforms should be enhanced .** Weak implementation of reform recommendations in most countries, including those under specific monitoring due to imbalances, suggests the Macroeconomic Imbalance Procedure is not being used effectively. Stricter enforcement can be combined with incentives in the form of targeted support from European structural and investment funds and outcome-based benchmarking of reforms. Countries with fiscal space could use it to support and amplify the effects of structural reforms. Countries without fiscal space should sequence reforms carefully, prioritizing reforms which involve few near-term costs and help build fiscal space.

**National efforts should be complemented by measures to strengthen the single market.** Greater integration of markets in energy, transport and digital services would boost productivity. Efforts to advance ambitious free trade agreements should be vigorously pursued.

### **Use fiscal space where available, comply with the rules, and build a central fiscal capacity**

**Fiscal policy should be tailored to country-specific circumstances.** Fiscal space is unevenly distributed, and is lacking where output gaps are largest. Countries with fiscal space such as Germany and the Netherlands, should use it for initiatives that lift potential growth; this would also help with external rebalancing. High-debt countries with little or no fiscal space, most notably Italy and Portugal, but also France, should consolidate gradually in a growth-friendly manner to rebuild buffers, taking advantage of the recovery and the remaining window of accommodative monetary policy. All in all, our fiscal recommendations would result in a neutral fiscal stance at the level of the union for 2018, which is appropriate in light of the recovery.

**Bridging the gap between national fiscal space and national fiscal need calls for the establishment of a central fiscal capacity.** Such a mechanism would permit a more accommodative overall fiscal stance without jeopardizing national fiscal sustainability in a downturn, while supporting fiscal discipline in good times. To avoid moral hazard and help build consensus, access to central support should be conditional on compliance with the fiscal rules. The recent record of compliance with the Stability and Growth Pact (SGP) has not been encouraging,

and its credibility is not well served by increasingly discretionary enforcement. Consideration should be given to simplifying and strengthening the rules, e.g., by focusing on a single fiscal anchor and a single operational target and by making enforcement more automatic.

### **Maintain monetary accommodation until the inflation objective is safely met**

**Monetary policy should remain accommodative until there is a sustained shift in the inflation path.** Subdued wage growth and underlying inflation suggest there is a long way to go before headline inflation durably meets the ECB's objective. The ECB has rightly committed to keep policy rates low for an extended period, well past the horizon of net asset purchases. No changes to this forward guidance should be made until there is strong backing from the performance of actual inflation or a firm assessment that the inflation outlook has improved decisively. Countries with closed output gaps will need to accept above 2 percent inflation for a prolonged period.

**The euro area's real effective exchange rate and current account in 2016 were broadly consistent with medium-term fundamentals.** But there were large misalignments at the national level in some cases. Faster wage inflation and stronger domestic demand in Germany and the Netherlands and other net external creditors would help reduce their large current account surpluses. In parallel, net external debtors such as Italy and Spain need to undertake further reforms—in both labor and product markets—to keep productivity growth above wage increases.

### **Keep striving for a clean, efficient, and single euro area financial system**

**Building a unified banking system requires completing the banking union.** Supervisors should work to reduce ring-fencing of capital and liquidity. A common deposit insurance scheme with a common fiscal backstop would facilitate greater cross-border activity, and represent significant progress towards a true banking union.

**Progress on reducing non-performing loan (NPL) stocks has been slow in some countries, but recent supervisory actions are encouraging.** Although asset quality problems are concentrated in a few national jurisdictions, they cast a long shadow, posing an “EU-relevant” challenge. The ECB's supervisory guidance on NPLs should be applied in a proportionate way to all euro area credit institutions, followed by strict supervisory monitoring. Enhanced supervision should be complemented with continued harmonization and modernization of national corporate and household insolvency frameworks as well as the development of distressed debt markets. A blueprint from the Commission on national asset management companies to purchase banks' impaired assets would provide greater clarity and certainty to countries and investors over compliance with the state aid rules and the Bank Recovery and Resolution Directive (BRRD).

**Low bank profitability requires concerted action, including resolution where necessary.** Banks need to restructure and consolidate, discontinuing unprofitable business lines, developing new sources of noninterest income, and rationalizing staffing levels and branch networks. Although some large banks, faced with market pressure, have raised capital and improved profitability recently, structural weaknesses continue to depress profits in many medium- and small-sized banks. There have been few bank resolutions or closures, suggesting a reluctance by national authorities to

apply the BRRD fully and a lack of coordination between the several euro area-level institutions involved. Delays prolong uncertainty, however, and stand in the way of much needed industry consolidation.

**Brexit creates challenges, but also provides an opportunity to advance the capital markets union (CMU).** Investor sentiment could be weighed down by Brexit-related uncertainties, and—over the medium-term—supply chains distributed between the UK and continental Europe could face disruptions. The migration of multifaceted financial activities from London to the mainland may result in some loss of economies of scale, and some—likely modest— impact on transaction costs. Supervisory resources and capacities should be strengthened concordantly. This would give a fillip to the CMU, thereby promoting non-bank sources of funding and increasing private risk-sharing. As one EU member state leaves, others will need to pull closer together.

### **A call to action**

**In sum, even as past policy efforts bear fruit, much remains to be done—at both the national and collective levels.** Monetary policy must remain accommodative. Some countries need more spending to lift potential growth, while others need to consolidate to rebuild buffers. All countries need structural reforms. And, not least, the strengthening recovery makes this an excellent time to push for ambitious architectural reforms to deepen the union.