Euro Area—IMF Staff Concluding Statement of the 2019 Article IV Mission

The euro area is at a challenging juncture. Growth is expected to firm-up later this year but there are significant risks to this outlook. Greater structural reforms efforts at the national level would enhance the region's resilience. In the event of a sharp downturn additional policy support will be needed. While there is some progress on euro area reforms, in many cases political consensus on the path forward is missing. The incoming European Parliament and European Commission should use the opportunity to forge a renewed consensus around strengthening the foundations of the monetary union.

Outlook and Risks

Euro area growth has slowed and inflation continues to disappoint. Growth decelerated sharply in the second half of 2018, due to a combination of slowing external demand and mostly temporary domestic factors. While headline inflation has fluctuated with energy prices, core inflation has remained troublingly low despite declining unemployment and a gradual pickup in wage growth.

Growth should firm up over the course of this year, but inflation will take longer to pick up. The growth projection is premised on continued robust domestic demand on the back of a tight labor market, a global recovery and continued monetary accommodation. Inflation, however, is forecast to reach the ECB's objective only gradually, reflecting subdued core inflation.

Little progress has been made on reducing imbalances. The euro area current account surplus has narrowed slightly, but it is still assessed by IMF staff to be moderately stronger than warranted by fundamentals. This is primarily driven by a few countries with sizable current account surpluses.

The central forecast is precarious, with three serious risks that could derail the upswing. First, prolonged global trade tensions could undermine external demand. Second, the risk of a no-deal Brexit remains high; while the financial sector has made progress in preparing for this eventuality, firms in other sectors—especially smaller firms—are less prepared. Third, high-debt countries' failure to rebuild fiscal buffers and implement structural reforms leaves them more vulnerable to shifts in market sentiment and the next downturn. These risks could materialize synchronously. Even without a major shock, the euro area could experience a prolonged period of anemic growth and inflation.

Monetary and Fiscal Policy

The persistent undershooting of the inflation objective calls for prolonged monetary accommodation, although this is not without risks. The ECB's stance is already accommodative, and the recent further extension of its forward guidance should support a sustained pickup in inflation. Keeping rates lower for longer is not without risks though. The heterogeneity in cyclical conditions across euro area countries implies that a prolonged period of further accommodation could contribute to the emergence of financial stability risks in countries with positive output gaps. Macroprudential policy tools should be actively deployed to help contain these risks. If the inflation outlook is downgraded further, even greater accommodation will be needed.

Better compliance with and enforcement of the fiscal rules is needed now. Despite robust growth in recent years, high-debt countries have not sufficiently consolidated, and in some cases have even

eased fiscal policy. Yet, these deviations have been met by lenient enforcement, weakening countries' incentives to respect the rules and making it hard for the EU institutions to credibly react to new violations.

Countries with limited fiscal space should prioritize debt sustainability, while those with ample space should use it to lift potential growth. Even with growth slowing in the baseline, high-debt countries should rebuild fiscal buffers in case the growth outlook worsens significantly, including through a more growth-friendly composition of fiscal policies. Countries with ample fiscal space should take advantage of low borrowing costs to invest in potential growth-enhancing areas, such as infrastructure, innovation and education.

Should growth deteriorate sharply, a more active fiscal policy response will be needed. If the euro area is tipped into a recession, the escape clause in the fiscal framework could be activated, allowing countries to use fiscal policy to support growth, while being appropriately differentiated according to national fiscal space, financing conditions, and the severity of the downturn. Fiscal policy should become more expansionary through temporary, high-quality measures in countries with fiscal space. Fiscal consolidation could be slowed down temporarily in countries where fiscal space is at risk, provided that their financing conditions remain amenable and debt sustainability is not jeopardized.

Structural Reforms

More demand will not fix deep-seated productivity and competitiveness problems in some countries; these require more decisive structural reforms. Product and labor market reforms are critical to closing productivity and competitiveness gaps between euro area countries. Such reforms would most benefit those countries with lower productivity levels. Critically, at a time when risks loom, reforms would make economies more resilient, lessening the depth and duration of downturns.

The new Commission should reinvigorate the push to fully implement the EU Services Directive. The single market for services lags far behind the EU's substantial accomplishment in creating a single market for goods. Better implementation of the EU Services Directive has the potential to boost productivity and cross-border trade in services. This can be done through focusing on the services sector in country-specific recommendations and stepping up enforcement of the Directive. The next EU budget also provides an opportunity to provide more financial and technical support for reforms.

The EU has been laudably proactive in safeguarding gains from international trade. Increasing economic prosperity through economic integration is one of the cornerstones of the EU. We welcome the EU's initiatives to reform the World Trade Organization to address its current weaknesses.

Financial Sector

Further strengthening the banking sector is also critical to making the euro area more resilient. While banks have boosted capital buffers and made progress on reducing nonperforming loans, low bank profitability remains a pervasive concern throughout much of the euro area. Supervisors should continue to assess banks' business models critically, pushing for greater revenue diversification and cost efficiency, including through cross-border mergers and acquisitions.

The authorities are making a determined effort to tackle the 2018 Financial Sector Assessment Program (FSAP) recommendations, although in some areas progress is slower than hoped. In

line with FSAP advice, the Single Supervisory Mechanism (SSM) is monitoring liquidity more closely and has begun using its early intervention powers to deal with problem banks. While the reviews of the bank supervision and resolution frameworks have been delayed until the next Commission, the SSM has begun developing an action plan to reduce legal fragmentation in supervision that will inform the review. The new Commission should use the reviews to reduce legal fragmentation and enhance the toolkits of the supervisory and resolution authorities, as recommended by the FSAP. Recent money laundering cases have highlighted the need to centralize anti-money laundering (AML), which is also fragmented along national lines. The SSM's new AML coordination function, which acts as a central point of contact and information exchange for systemic institutions, is welcome. Over the medium term, an EU-level AML body should be established, consistent with FSAP advice.

Euro Area Architecture

The euro area needs a truly borderless banking market but getting there will require more ambitious steps. The agreement on the European Stability Mechanism providing a backstop to the Single Resolution Fund is welcome, but the final design must allow for rapid deployment of the backstop in a crisis. Ring fencing of capital and liquidity at the national level impairs the development of the banking union yet reflects legitimate home–host tensions on burden-sharing when banks fail. Addressing this will require creating a common deposit insurance scheme with due attention to risk reduction. The next Commission should seek to reenergize this effort.

The new Commission should also push to develop the Capital Markets Union (CMU). Capital markets in Europe remain fragmented, impeding cross-border private sector risk sharing. Relatively technical actions would advance the CMU. For example, centralized reporting requirements for companies would improve transparency, while minimum standards on insolvency regimes and simplified procedures for reclaiming withholding taxes would reduce cross-border investments' costs.

The euro area also needs an additional macroeconomic stabilization instrument. As we proposed last year, a central fiscal capacity could enhance the region's resilience to shocks. However, reaching agreement on such an instrument is likely to take time. Though the details of the proposed euro area Budget Instrument for Convergence and Competitiveness have not been determined yet, it is an encouraging acknowledgment of the need for a euro area-level fiscal instrument.

A simplification of the fiscal rules would make them easier to communicate, monitor and enforce. We favor focusing on an expenditure growth rule anchored by a debt rule. Agreeing on how to revamp the fiscal rules will not be easy, but the next Commission should not shy away from it.

The next EU budget offers leaders and the incoming European Parliament a chance to demonstrate their ingenuity in addressing priority issues. Brexit will result in the loss of the U.K.'s net contribution to the EU budget for 2021–27. This could be tackled with a mix of new revenue sources and streamlining of some expenditures. The next budget should also be reoriented to better address critical priorities such as climate change, innovation, migration, and security.

Strengthening the architecture and addressing common challenges will require creative cooperation. And given the imminent risks facing the euro area, governments should do more to reduce imbalances and increase economic resilience at the national level.