International Monetary Fund

IMF Executive Board Concludes 2016 Article IV Consultation on Euro Area Policies

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On July 6, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Euro Area.

The recovery has strengthened recently. Lower oil prices, a broadly neutral fiscal stance, and accommodative monetary policy are supporting domestic demand. However, inflation and inflation expectations remain very low, below the European Central Bank (ECB) medium-term price stability objective. Euro area GDP growth is expected to decelerate from 1.6 percent this year to 1.4 percent in 2017, mainly due to the negative impact of the U.K. referendum outcome. Helped by gradually rising energy prices, headline inflation is expected to increase from 0.2 percent this year to 1.1 percent next year.

At the same time, downside risks have grown. Externally, a further global slowdown could spill over and derail the domestic demand-led recovery. Domestically, the risks are largely political. Further spillovers from the U.K. post-referendum situation, the refugee surge, or a heightening of security concerns could contribute to greater uncertainty, hurting growth and hindering progress on policies and reforms. Other risks include banking and financial sector weaknesses in some countries. Moreover, prolonged low growth and inflation themselves make the euro area increasingly vulnerable to shocks. Policy buffers to counter these risks are low.

Medium-term prospects are mediocre, with crisis legacies of high unemployment, elevated public and private debt, and deep-rooted structural weaknesses weighing on the outlook and productivity growth. As a result, growth five-years ahead is expected to be about 1.5 percent, with headline inflation reaching only 1.7 percent.

Comprehensive and more balanced policies taken collectively are needed to respond to these risks, helping to boost growth, rebuild buffers, and strengthen integration. Structural reforms to improve productivity and reduce macroeconomic imbalances need to be incentivized. Given limited fiscal space at the national level, an expansion of centralized fiscal support is needed, but should be accompanied by a stronger governance framework to ensure that members comply with the fiscal and structural rules. These measures would complement the current stance of monetary policy, providing a more balanced policy mix.

Executive Board Assessment[2]

The euro area recovery continues, supported by still low oil prices, a neutral fiscal stance, and accommodative monetary policy. Directors cautioned, however, that inflation and inflation expectations remain stubbornly low, raising adjustment challenges for debtors, and that crisis legacies of high unemployment and debt, alongside structural weaknesses and low productivity, continue to weigh on the medium-term outlook. They stressed that risks are increasingly to the downside and that policy buffers are limited. External demand could weaken, while political risks have risen significantly, particularly related to uncertainty regarding the outcome of the referendum in the U.K. and its new economic relationship with the European Union. Directors encouraged a smooth and predictable transition to reduce uncertainty. In addition, an intensification of the refugee surge could prompt additional border controls and hinder free movement within the single market.

Against this challenging backdrop, Directors urged strong collective actions to boost growth and strengthen the union, and cautioned that the cyclical recovery should not lead to complacency. Policies should prioritize structural reforms, enhancing investment and fiscal governance, maintaining supportive monetary policies, completing the banking union, and repairing balance sheets. Directors warned that without decisive actions, the euro area will remain vulnerable to instability and repeated crises of confidence.

To raise potential growth and narrow imbalances, Directors stressed the importance of structural reforms such as reduced barriers to entry in retail and professional sectors, improved public administration, lower labor tax wedges, and reduced labor market duality. They encouraged use of outcome-based benchmarks to incentivize reforms and stronger enforcement of the Macroeconomic Imbalance Procedure.

Directors encouraged the authorities to pursue a more balanced policy mix through growth-friendly fiscal rebalancing, use of fiscal space where available, and an expansion of centralized investment schemes or funds for common projects. Countries without space should stick to consolidation plans and use interest savings to rebuild buffers. Directors noted that access to any new central fiscal support could be conditional on implementation of structural reforms and compliance with fiscal rules, which could be further encouraged by strengthening and simplifying the fiscal framework.

Directors concurred that monetary policy is appropriately accommodative, and that recent measures should help ease financial conditions. They viewed negative interest rates as having contributed to lower bank funding costs, higher asset values, and more bank lending. While most Directors considered that further rate cuts could entail diminishing returns by squeezing banks' net interest margins, a few Directors argued for a more holistic assessment that reflected possible valuation gains and improved asset quality. Nevertheless, Directors agreed that if the inflation outlook deteriorates, further easing, primarily through expanded asset purchases, would be warranted.

Directors urged faster balance sheet repair as part of a broader strategy to foster consolidation in the banking sector. They encouraged strong action by the ECB to set targets for banks to reduce impaired assets. This should be complemented by strengthening and harmonizing insolvency and foreclosure frameworks, and promoting distressed debt markets. Where appropriate, asset management companies could be used to kick-start markets, and in systemic cases, State aid rules could be applied flexibly.

Directors considered common deposit insurance and a common fiscal backstop as essential to completing the banking union. Deposit insurance should be accompanied by measures to reduce banking sector risks, and any changes to the prudential treatment of banks' sovereign assets should be consistent with global standards. Directors urged further progress on capital markets union to diversify financing sources and enhance private risk sharing.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] 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 summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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