

# Euro Area: Staff Concluding Statement of the 2021 Mission on Common Policies for Member Countries

December 6, 2021

*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.*

**Washington, DC:** *The forceful policies implemented in the euro area over the last year have supported household disposable incomes, maintained worker-job relationships, provided credit to the economy, and protected corporate sector balance sheets. Together with high vaccination levels, these policies have underpinned a strong economic rebound through higher private consumption and investment. Looking ahead, coordinating fiscal, monetary, and financial sector policy normalization in the face of uncertain pandemic dynamics and legacies will be a challenge. Policies should remain accommodative but become increasingly targeted, with a focus on mitigating potential rises in inequality and poverty. Fiscal policy space should be rebuilt once the expansion is firmly underway, but credible medium-term consolidation plans should be announced now. Recent inflation readings have surprised on the upside, but much of the increase still appears transitory, with large second-round effects unlikely. Hence, monetary policy should continue to support the recovery. Structural reforms and high-impact investment, including in climate-friendly infrastructure and digitalization, remain crucial to enhancing resilience and boosting potential growth.*

## Outlook and Risks

**The euro area economy is recovering rapidly, thanks to high vaccination levels and continued forceful policy support .** After falling by about 6½ percent in 2020, euro area output has rebounded strongly since the second quarter of 2021. While the flash Q3 GDP estimate came in slightly stronger than expected in our October 2021 *World Economic Outlook* baseline, the fourth quarter looks weaker given growing supply pressures, elevated energy prices, and, more recently, the reintroduction of mobility restrictions in several countries due to a new wave of infections. Taken together, these factors suggest the possibility of modest revisions in the January WEO Update to our current forecasts of 5.0 percent growth for 2021 and 4.3 percent for 2022. Beyond the headline numbers, the recovery is likely to be uneven across countries and sectors, potentially increasing inequality and disparities both across and within countries. Labor market slack is expected to continue declining, with hours worked increasing in line with activity and participation and employment rates slowly converging to pre-pandemic trends.

**Uncertainty remains high and is largely tied to the evolution and legacies of the pandemic .** On the downside, the ongoing wave of infections and renewed concerns about newer and more transmissible Covid-19 variants highlights the continuing risk that the pandemic poses to recovery, especially if it were to be accompanied by decreased vaccine effectiveness or incomplete vaccination coverage. The expiration of policy

support, a potential correction in real estate markets, or spillovers from a sharp slowdown in China could also create headwinds. On the upside, faster-than-expected adjustment to Covid-19 would boost activity, while a material unwinding of large excess savings could significantly increase consumption. Pandemic-induced acceleration of automation and digitalization could also boost productivity and potential growth.

**Underlying inflation in the euro area is projected to remain weak, despite the recent price increases** . The November flash estimates saw a further increase in headline and core inflation to historically high levels of around 5 and 2½ percent, respectively, largely reflecting base effects from last year's low energy prices and transitory factors, such as supply chain disruptions and the reversal of Germany's VAT cut. Under the baseline, inflation is projected to decline through 2022 as these factors dissipate, and to remain below the ECB's 2-percent target in the medium term. This is predicated on limited second-round effects from currently high inflation given the persistence of aggregate labor market slack. Indeed, negotiated nominal wages grew at about 1½ percent in 2021Q3 on a year-on-year basis. Inflation risks, however, are tilted to the upside as the transitory factors could persist for longer than expected. Upcoming wage negotiations, which are expected to be more frequent than in previous years after many contract renewals were put on hold during the pandemic, will need close monitoring.

## **Policies to Support the Recovery**

**Policy coordination remains key in the post-pandemic recovery phase** . Fiscal, monetary, and financial sector policies have worked well together to dampen the effect of the pandemic on the real economy. Going forward, the sequencing and speed of policy normalization should consider the interaction of these policies to continue supporting the recovery and limiting scarring.

**Fiscal policy should remain supportive but become increasingly targeted as the recovery continues** . The accommodative fiscal stance that appears to be embedded in euro area countries' 2022 budget plans is consistent with supporting the recovery and limiting scarring. However, stronger private consumption and labor markets imply less demand for broad lifelines such as job retention schemes, and support should therefore increasingly focus on the most affected sectors and households. Individual countries should carefully calibrate their fiscal positions to country-specific circumstances. Once the expansion phase is firmly in train, high-debt countries in particular will need to gradually rebuild fiscal buffers. While the timing of consolidation will depend on individual country circumstances, credible medium-term consolidation plans should be put forward now. In that context, improving the composition of spending can create space for needed public investments that would increase potential growth and accelerate the green and digital transitions while still bringing deficits down.

**The fiscal framework should be reformed to make it more efficient at preventing debt distress, while allowing adequate room for macroeconomic stabilization** . The application of the current fiscal rules would require unrealistically large—and counterproductive—adjustments by some high-debt countries. Deep consultation will be needed to find a political consensus on how to improve the rules. As this consensus may be difficult to achieve before the general escape clause is expected to be deactivated in 2023, a time-bound transitional arrangement would be desirable until the new rules become effective. A further strengthening of national fiscal councils, the European Fiscal Board, and national medium-term budget frameworks could play an important role in the new EU framework. A green investment fund at the EU level could be an efficient way to

finance investment to meet the EU's common climate goals, especially since the benefits of reducing carbon emissions are felt across national borders.

**The NGEU package will help speed up the recovery, facilitate resource reallocation, and promote progress on long-standing structural issues** . The package can help address the trend of increasing divergence among EU countries by supporting potential growth and cushioning the drag from greater spending restraint once consolidation starts, especially in high-debt countries. Following the approval of ambitious national resilience and recovery plans (RRPs), policymakers now have to navigate the tradeoff between disbursing funds rapidly and ensuring that supported investments and reforms are of high quality and in line with countries' implementation capacity. Funds will also need to adhere to the highest standards of transparency and accountability. Preliminary IMF staff analysis suggests that the implementation of the RRP could expand euro area value-added by about 1¼ percent by 2026 . RRP will also play a significant role in supporting the green and digital transitions.

**The key monetary policy challenge is to maintain clear and effective communication in the face of extraordinary uncertainty** . With underlying inflation dynamics expected to remain weak over the medium term under the baseline, the ECB should look through transitory inflation pressures and maintain a highly accommodative monetary policy stance. The ECB will need to clarify soon how monetary support will be maintained when the Pandemic Emergency Purchase Program and the third round of Targeted Longer-Term Refinancing Operations (TLTRO III) are phased out. Nevertheless, the ECB should also stand ready to scale down and then terminate asset purchases and TLTROs, followed by a gradual adjustment of policy rates, should high inflation prove to be more durable than expected.

**The conclusion of the ECB Monetary Policy Strategy Review is proving to be timely** . The formal adoption of a symmetric 2-percent inflation target has removed the ambiguity surrounding the previous target and provides more clarity on the ECB's approach to temporary inflation overshooting, like that under the current baseline. The strengthened link between monetary and financial analysis underscores a holistic approach to dealing with stretched asset prices. Climate-related measures, including enhanced monitoring, stress testing, and disclosures, will allow supervisors and banks to better account for climate-related risks. The scope for greener central bank policies—which could potentially help to reduce market failures associated with emissions externalities—requires careful analysis given considerations such as still-limited market depth for “green assets.” The proposed inclusion of owner-occupied housing costs into the HICP price index will help provide a more accurate reflection of consumer spending, and ways to improve the timeliness of construction and house price indices should be explored.

**The impact of the pandemic on the financial sector has so far been smaller than initially feared, but vigilance remains crucial** . The results of the July EBA stress-test indicate that European banks remain resilient even in an adverse macroeconomic scenario. Nevertheless, a rise in corporate sector insolvencies as public guarantee schemes are lifted, a more complete recognition of credit losses, and a possible correction in asset values (especially in real estate markets) could affect bank capital. Banks therefore need to maintain sizable buffers, with supervisors continuing to make sure that loss recognition is sufficiently forward-looking and provisioning levels are appropriate.

**A continued, gradual normalization of financial sector policies is appropriate** . Crisis-related prudential accommodations for banks should be normalized over time, in

accordance with pre-announced timelines. Some euro area national authorities need to tighten their macroprudential stance to support resilience in the face of stretched asset valuations, especially in real estate markets, and elevated household debt. Corporate sector policies should shift from broad liquidity support to targeted solvency support for intrinsically viable firms.

**The European Commission's recently announced banking package aims to support lending and contribute to the green transition, but could lead to some divergence with global standards**. The package appropriately enhances supervisory powers across national competent authorities and takes important steps to address Environmental, Social and Governance risks. However, it also widens the gap between EU capital regulations and Basel III standards, in particular as relates to the long phase-in period for the treatment of certain bank exposures. A timely and faithful implementation of internationally agreed bank capital standards would help underpin global financial stability.

**A renewed push for completion of the Banking Union is crucial**. Further improvements in bank supervision and resolution are essential to creating a truly single market for bank services in Europe, ultimately underpinned by common European deposit insurance. This would help European banks to efficiently respond to the structural challenges of low profitability and accelerating digitalization, while enhancing cross-border risk sharing. Further progress towards Capital Market Union also remains important to create a more balanced and efficient financial system in Europe. The single access point for corporate information should be pushed forward assertively, among other necessary steps.

## **Structural Policies**

**Ambitious policies are needed to support ongoing structural transformations, including the digital and green transitions**. Given the strength of the recovery, the focus of labor market policies should shift to facilitating labor reallocation. This includes expanded training to reskill and upskill workers, paired with a judicious use of hiring subsidies to pave the way for job creation given lingering uncertainty. Introduction of temporary and targeted wage-loss insurance can also incentivize workers to move to occupations and sectors that offer lower pay initially. Targeted policies, including via enhanced safety nets but with greater reliance on means-testing, will be needed to protect and support the vulnerable, who may find it difficult to transition into new jobs or enter the labor market.

**Implementation of structural reforms embedded in national RRPs should be a priority**. Proposed reforms in the national RRPs, including those related to the green and digital transitions, public administration, governance, pension sustainability, education, and healthcare, are crucial to boost euro area potential growth. Insolvency and bankruptcy frameworks should also be strengthened by addressing administrative constraints and establishing fast-track procedures for debt restructuring, while increasing labor and product market flexibility will help facilitate the needed reallocation.

**EU policies to address climate change will be critical to accelerate the green transition**. The ambitious Fit for 55 climate change mitigation agenda is welcome as it gives a more central role to carbon pricing while protecting the most vulnerable households. The design and phase-in of the proposed carbon border adjustment mechanism should be given careful consideration to ensure compatibility with WTO rules and other international commitments. Additional steps, such as using the Common

Agricultural Policy to reduce greenhouse gas emissions in the agricultural sector and tightening EU vehicle emissions standards, could also be considered. In the context of the current spike in energy prices, policy measures to protect the most vulnerable are appropriate. In crafting these measures, it will be important not to undermine efforts to attain the EU's green goals and strengthen the European energy market.

**EU engagement on global issues such as trade, taxation, and vaccine availability remains crucial** . The EU should continue its engagement with major trading partners to address underlying sources of global trade tensions and investment distortions. The recent agreement between the EU and U.S. on steel and aluminum tariffs is an important step toward a de-escalation of bilateral trade tensions. We look forward to a prompt resolution of outstanding technical issues to finalize the proposed global corporate minimum income tax. As one of the leading exporters of Covid-19 vaccines, the EU should continue its efforts to increase global vaccine production, which is critical to ending the pandemic.