Euro Area: IMF Staff Concluding Statement of the 2023 Mission on Common Policies for Member Countries

June 16, 2023

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 economy has shown remarkable resilience in the aftermath of Russia's invasion of Ukraine and the largest terms of trade shock in several decades, thanks to a strong policy response. However, economic activity has weakened and inflation—although gradually declining—remains elevated. Monetary policy must continue to tighten to bring inflation to target in a timely manner. Fiscal consolidation should also proceed to ease inflation pressures and rebuild fiscal space. A swift agreement on the reform of the EU economic and fiscal governance framework would support fiscal sustainability over the longer term. Recent bouts of financial market turbulence underscore the need to continually monitor vulnerabilities, further increase capital buffers, and complete the Union's financial architecture. Structural policies should focus on delivering the green transition and addressing structurally weak productivity growth.

Growth in the euro area is likely to pick up gradually following a significant weakening . The 2022 growth outturn exceeded the initial post-invasion projections, thanks to a swift policy response and a strong rebound in contact-intensive services. Activity nevertheless weakened considerably in the second half of the year and slipped into a mild technical recession in early 2023 as financial conditions tightened, real wages dropped, and consumer confidence plummeted following the spike in energy prices. Growth is expected to pick up modestly throughout 2023 and 2024, supported by a slow recovery in real incomes, a further easing of supply constraints, and firmer external demand, even as financial conditions continue to tighten. Looking towards the medium-term, output is likely to remain below pre-war trend for an extended period given the costs of adjusting to persistently higher energy prices.

Inflation has peaked, but the two percent target remains far off . While headline inflation has fallen sharply since 2022Q4 thanks to lower energy prices, core inflation has proven more persistent and has begun to decline only recently. This reflects in part the delayed transmission of lower commodity prices into consumer prices and firms' ability to protect or increase profits. Looking ahead, inflation is projected to continue to decline as tight financial conditions restrain demand and supply shocks dissipate further. The convergence to target is projected around mid-2025, assuming nominal wage growth remains moderate, firms

absorb part of the wage increase through lower profits, and import prices continue to decrease.

Uncertainty surrounding the outlook remains high, with risks to growth tilted to the downside and risks to inflation to the upside . A reemergence of financial turbulence, possibly caused by distress in global markets, could weigh on the economic recovery by leading to a sharp contraction in credit or increases in broader risk aversion. Weaker external demand would also negatively affect the bloc's growth prospects, particularly if it emanates from an abrupt slowdown in key trade partners--the United States or China. More persistent inflation than expected would require a tight policy stance for longer, weighing on domestic demand. In this regard, stronger-than-expected wage growth in the context of tight labor market conditions, especially if profit shares do not adjust, would push inflation up and potentially lead inflation expectations to de-anchor. In addition, renewed supply shocks, which could result from an escalation of the war in Ukraine and a related increase of commodity prices, or a further intensification of geoeconomic fragmentation, would raise inflation and hurt growth. On the upside, the economy could again prove more resilient than expected, especially amid a still large stock of excess savings.

Reducing Inflation while Preserving Financial Stability

With inflation persistently high, monetary policy should continue to tighten and maintain a tightening bias . Recent policy rate hikes have shifted market rates up and brought the monetary policy stance into contractionary territory. Going forward, the inflation outlook and the high uncertainty regarding inflation persistence suggest that a more restrictive stance than at present, maintained over sustained period, will be needed to keep inflation expectations anchored and return inflation to target in a timely manner. That said, a continued flexible and data-dependent approach to monetary policy decisions remains appropriate as it provides the flexibility to change course should incoming data indicate a need.

The Eurosystem should continue to trim its balance sheet gradually and cautiously, consistent with a learning-by-doing approach, with the policy rate serving as the primary policy tool . The ECB Governing Council's decision to reduce the Eurosystem's bond holdings in a predictable manner during the current monetary policy tightening cycle is welcome as it would reduce its footprint in financial markets. In the meantime, the tightening of the monetary policy stance should be achieved primarily through the key policy rates as their transmission to financial conditions and economic activity is better understood and their changes are easier to communicate. Moreover, building conventional monetary policy space would reduce the risk of hitting the effective lower bound in a possible downside scenario.

Economic conditions call for a tight fiscal policy stance. Tighter fiscal policy would help reduce inflation pressures, lessening the upward pressure on interest rates and reducing the risk of financial market disruptions. Smaller fiscal deficits are particularly critical in high debt and deficit countries, which need to rebuild fiscal space. In this context, it is important that revenue windfalls are saved, and energy support measures introduced over the past year are allowed to expire, to achieve a meaningful deficit reduction. Should energy prices rise significantly again, any new support measures should be targeted to the most vulnerable to assist the consolidation efforts and strengthen the incentives for energy conservation.

The euro area's banking system has proven resilient but tightening financial conditions could expose vulnerabilities . Overall, euro area banks have robust capital

and liquidity positions and have benefitted from higher profits as the return on their assets has risen faster than the cost of their liabilities, given sticky deposit rates. Looking ahead, rising funding costs because of upcoming repayments of the ECB's Targeted Longer Term Refinancing Operations and increased competition for deposits, and deteriorating credit quality could erode bank profits and potentially reduce capital. It is therefore advisable to increase the capital buffers of banks in jurisdictions where banks are experiencing temporarily high profits. Pockets of vulnerability related to the effects of higher interest rates on bank balance sheets and the impact of actions to shrink the ECB's balance sheet on liquidity conditions deserve close monitoring. Continued stress-testing and disclosures of bank credit, interest rate, and liquidity risks—ideally including less-significant institutions—would help assuage concerns about financial stability risks.

Vulnerabilities in the nonbank financial intermediation (NBFI) sector also require close monitoring and an upgraded macroprudential policy toolkit . Increased volatility in financial markets raised liquidity demands by some NBFI entities with large positions in financial derivatives. In addition, investment funds (including those investing in real estate) may be forced to reduce leverage as markets cool and financial conditions tighten. So far, deleveraging in the NBFI sector has been orderly, but a wider implementation of macroprudential tools that limit leverage and liquidity mismatches in the sector would help reduce systemic risk. Given the significant cross-border activities of the NBFI sector, close cooperation between national authorities regarding the prudential regulation of the sector is key. Finally, closing data gaps and improving data quality is essential to ensure effective oversight of this sector.

Recent financial turbulence underscores the need to further strengthen the EU's financial architecture . The Commission's proposal for a reform of the Crisis Management and Deposit Insurance (CMDI) framework, which would extend the EU's resolution powers to more banks and improve resolution funding arrangements, is a step in the right direction. However, more flexibility in the deployment of resolution funds would be welcome as it would help the authorities to handle bank failures nimbly and contain systemic risk. Fully ratifying the European Stability Mechanism treaty to create a backstop to the Single Resolution Fund and agreeing on a European deposit insurance scheme would pave the way for a deeper, more resilient Banking Union. Europe is a long way from having a single capital market, undermining investment, innovation, and dynamism. In this context, progress toward the Capital Markets Union would diversify financing options for firms, including for the green transition. Finally, a full implementation of Basel III is essential, as recent events outside Europe point to the danger of selective implementation of banking regulation.

Safeguarding Fiscal Sustainability

A swift agreement on the EU economic and fiscal governance reform is a priority given the medium-term fiscal challenges . Euro area public debt increased sharply in 2020 and is set to remain well above pre-pandemic projections over the forecast horizon. The European Commission's legislative proposal for economic governance reform would appropriately promote a differentiated, risk-based medium-term fiscal adjustment. Relying on net primary expenditure as the operational target simplifies the framework and allows countercyclical automatic stabilizers to operate. At the same time, cautious implementation of the framework would be critical. The possibility to extend adjustment periods in return for growth-enhancing reforms and investment is positive but relying on overly optimistic growth estimates must be avoided. In this context, an Independent European fiscal council could add credibility to the process. An EU-wide fiscal capacity for macroeconomic stabilization and provision of public goods would also strengthen the framework. It is vital that an

agreement is reached soon so the new framework can anchor fiscal policies in 2025 and beyond.

Delivering the Green Transition and Energy Security

Despite initial fears, the energy crisis is likely to be favorable for the green transition. European solidarity, diversification of supply, and greater than expected demand adjustment—both due to the adaptability of the private sector and a mild winter—have significantly reduced short-term energy security risks. High energy prices have also boosted energy efficiency, made renewable electricity production more cost-attractive, and accelerated green policy initiatives. Early estimates suggest that this led to a drop in EU carbon emissions in 2022 despite the increased use of coal for power generation. At the same time, EU countries remain far off from achieving their commendably ambitious emission reduction objectives, highlighting the importance of maintaining policy momentum.

The EU is showing global leadership on the use of price-based carbon reduction mechanisms. The EU Emissions Trading Scheme (ETS) reform that is soon to come to force is welcome as it will strengthen the EU's climate policy instruments, including by expanding the ETS-covered sectors, while supporting vulnerable households in the energy transition. Over the longer run, it would be important to align carbon prices across sectors to reduce potential distortions in emission reduction incentives. The widening of the scope of the Carbon Border Adjustment Mechanism (CBAM) to a broader set of goods will also support global emission reduction efforts by encouraging cleaner industrial production in non-EU countries. It will be critical to implement the CBAM in line with WTO rules and based on actual embodied carbon content of traded products rather than benchmarks.

The Green Deal Industrial Plan can support the green transition but has elements that should be implemented carefully. Measures aimed at streamlining regulatory and permitting processes, enhancing skills, and fostering green innovation are welcome as they will complement ongoing efforts to achieve climate neutrality. However, the relaxation of state-aid rules, which allows Member States to grant subsidies or tax incentives to match what is being offered by third countries could potentially lead to high fiscal costs, as well as economic inefficiencies and distortions, including to the EU Single Market. More broadly, such industrial policies and measures to enhance the resilience of EU's supply chains could potentially increase the risks of global fragmentation and undermine multilateral trade. Steps to engage with all major trade partners and finding a common WTO-consistent approach in areas such as tariffs and subsidies should remain a priority. Such an approach—underpinned by thorough analysis of the measures' climate and economic effects—would limit distortions to international trade and improve resource allocation and productivity.

An EU Climate Investment Fund could play a role in improving the provision of common public goods related to energy security and the green transition. Such a mechanism, potentially under an EU central fiscal capacity would help ensure the EU's emissions reduction goals are achieved efficiently, including by allocating funds to countries and sectors with the highest rate of return on carbon abatement and ensuring that projects with strong cross border spillovers get adopted. Moreover, an EU Climate Investment Fund can help ensure a level playing field for green investments given member countries' differing fiscal space and ability to provide support.

Boosting Productivity and Growth

Ambitious actions to boost productivity are needed to increase euro area growth . A faithful implementation of the national Recovery and Resilience Plans would boost growth by delivering much needed structural reforms and investments. Reforms should be implemented as planned, though greater flexibility on the timing of investments may be needed if countries have constraints on their capacity to utilize funds. Furthermore, given ongoing sectoral shifts, including due to the green and digital transitions, additional policy action to foster the reskilling and upskilling of the workforce, with a strong focus on digital skills, and continued improvement in labor market flexibility, would be helpful to facilitate a smooth reallocation of workers and boost economic dynamism. Policies to better integrate immigrants across the EU could help them deploy their human capital productively and alleviate some of the fiscal pressure caused by an aging European population. Finally, a renewed emphasis on R&D investment environment could bring Europe closer to the global innovation frontier.