June 7, 2010

Concluding Statement of the IMF Mission on Euro-Area Policies

(In the Context of the 2010 Article IV Consultation Discussions with Euro-Area Countries)

1. **Policymakers need to take decisive action to complete the project of monetary union.** The current euro area crisis results from fiscally unsustainable policies in some countries, delayed repair of the financial system, insufficient progress in establishing the discipline and flexibility needed for a smooth functioning of the monetary union, and deficient governance of the euro area. Consequently, divergences in economic performance have been allowed to fester, building up imbalances and leading to the recent dramatic wake-up call from markets. The immediate crisis response has been bold, demonstrating the euro-area's capability to act together when pushed. In this context, it will be imperative to quickly secure the operation of the European Financial Stability Facility. But crisis management is not an alternative to the corrective policy actions and fundamental reforms needed to reinforce the foundation of the European Monetary Union (EMU).

2. **What should be done?** Immediate action is needed to:

- Establish fiscal sustainability, with the pace of consolidation differentiated to take into account financial market pressures and the state of the recovery.
- Spur growth, including crucially by implementing a set of priority, country-specific structural reforms throughout the euro area.
- Accelerate the restructuring of the financial system.
- Strengthen economic governance of EMU. As recognized by the Commission and the President's task force, the focus should be on enforcing budgetary discipline, helped by fundamental legislative reform, and on addressing macroeconomic imbalances.
- Complete the EU's financial stability architecture by extending welcome progress in establishing more harmonized regulation and supervision of the EU financial system to the area of crisis management and resolution.

Near-Term Growth Outlook

3. **Already prior to the recent sovereign jitters, growth in the euro area was expected to be moderate and uneven, marked by high and persistent unemployment and subdued investment.** Despite very supportive fiscal, financial and monetary policies, which stabilized demand, growth remains weak in the euro area and diverging across member states. While policies and institutions limited the rise in unemployment on average, its counterpart was a significant decline in productivity across all sectors in the euro area. Hence, new job creation will be limited during the upswing. Lending constraints are weighing on demand of a significant number of households and small and medium-sized enterprises. Robust global demand and the weaker euro, now close to fundamentals, are helping the export sector, but rigidities, especially in labor and financial markets in some countries, are limiting the necessary restructuring in the aftermath of the global crisis and hampering the efficient reallocation of labor and capital.

4. **Key downside risks emanate from concerns about fiscal sustainability and possible adverse feedback between the financial sector and public finances.** Delayed or half-hearted fiscal consolidation in countries facing high spreads could trigger a further loss of financial market confidence in the fiscal sustainability of some member states, a spike in risk premiums and a sharp depreciation of the euro. While the recently established crisis management framework should limit abrupt movements, lack of sustained fiscal and structural policy adjustment would further sap business and consumer confidence, possibly undoing the impetus stemming from the global recovery and even adversely affecting the global economy. While overall bank performance and capital measures have improved substantially, weaknesses in parts of the banking system remain, amid concerns about the sustainability of the profit rebound and still highly leveraged private sector balance sheets in some countries.

Overcoming the crisis

5. **Policies need to move urgently from crisis management to fundamental reforms.** National authorities must now quickly implement a distinct set of policies for each member state to underpin fiscal sustainability, as several are doing, and boost sustainable growth. Governments should explicitly commit to specific policy actions, coordinated in a euro area context. Policy action is not only necessary in member countries suffering from market tensions or competitiveness problems, but throughout the euro area to generate confidence, display cohesion, and improve overall investment and growth prospects.

6. **Credible fiscal adjustment must be at the core of the response, emphasizing the need for early implementation of measures backing the fiscal targets.** Countries facing market pressures have no choice but to adjust forcefully and to prepare contingency plans to avoid any slippage jeopardizing the achievement of deficit targets. For all countries, additional efforts must be made to turn around unfavorable debt dynamics over the medium term. Comprehensive entitlement reforms should be a key ingredient of many consolidation programs, with an emphasis on large medium and long-term gains, such as from increases in the effective retirement age and healthcare reform. Attention should also be paid to the quality and the composition of adjustment to maximize support for growth and to measures to protect vulnerable groups during the reform and adjustment process.

7. **Fiscal actions will need to balance these considerations with the feeble state of the recovery.** Overall, the area-wide fiscal stance is correctly set to remain broadly neutral in 2010 as countries with manageable debt dynamics continue to provide adequate stimulus to nurture the recovery. Nonetheless, fiscal consolidation is inevitable, and will need to start in all countries in 2011 at the latest. Its pace should be differentiated across member states. Countries should stand ready to adjust their fiscal plans depending on the state of the financial system and the degree to which fiscal actions help bolster confidence.

8. **The longstanding problem of anemic growth in the euro area must now be addressed—higher growth is not only important for its own sake, but essential to help secure fiscal sustainability and strengthen the cohesion of the euro area.** Priority reforms have been clearly identified in the context of the Lisbon strategy, but the tools to bring about the needed coordinated implementation have been lacking. The case for these changes could hardly be more pressing. Key reforms include: making the labor market more effective, removing disincentives to work embedded in various public policies, enhancing wage bargaining flexibility, and further liberalizing services sectors. Other measures should target tax compliance, licensing restrictions, non-tariff trade barriers, and foreign ownership and investment restrictions. Distortions to competition in the banking sector should be removed, including by phasing out public ownership stakes. A renewed commitment to liberalize trade and avoid disguised forms of protectionism would be welcome.

9. **The stability of the euro area banking system needs to be secured.** Banks overly reliant on enhanced credit or government support should be forced to raise additional capital, clean up their balance sheets and establish a viable business model, or face restructuring or resolution. Supervisors should ensure that their actions do not unduly curb the availability of credit, especially to sound small business borrowers and households. Blanket financial support measures may need to be reinstated or remain in place for longer than envisaged, though care must be taken that they do not put off the urgency to restructure.

10. **More generally, financial sector reform remains a key priority and must be coordinated, both within Europe and globally**. This pertains to new capital and liquidity requirements, surcharges on systemic institutions, as well as targeted macro-prudential measures that address rapid credit growth and liquidity mismatches. For the euro area, a robust calibration in all areas is required to increase the banking system's resilience to any future shocks.

Monetary policy

11. **The ECB rightly took strong action to prevent the sharp tightening of credit conditions in some member states from undermining its monetary stance.** The Securities Markets Program (SMP) has reduced the extreme volatility in sovereign debt markets that was infecting other credit and financial markets and hampering the transmission of the supportive monetary policy stance. The establishment of this program should however not detract from the need for unwavering implementation of measures that underpin fiscal sustainability, especially where markets are most concerned. Once systemic liquidity conditions return to normal, the ECB can resume its gradual exit from its non-standard policy support to avoid distorting market mechanisms and reducing incentives for weak banks to restructure.

12. **With risks to price stability remote, the monetary policy rate can remain low**. Underlying inflation is expected to stay low for the next two years: wage growth is set to remain subdued in response to high unemployment and squeezed profit margins. Volatile commodity prices and indirect tax changes will be reflected in short-term inflation developments but do not pose risks in such an environment. Reflecting the ECB's excellent track record, long-term inflation expectations remain well anchored, keeping risks to price stability at bay. Protracted low rates do raise the risk of distortions that need to be monitored and addressed with macro-prudential tools.

Reforming economic and financial governance

13. **The euro area fiscal framework needs to be substantially strengthened to deliver the collective fiscal responsibility required for a well-functioning monetary union.** The Stability and Growth Pact did not encourage member states to take advantage of good times to build sufficient buffers and to bring down debt to prudent levels. This reflects fundamental weaknesses in prevention and enforcement that urgently need to be addressed. Ideally, one should aim at delegating to the center the capacity to enact binding deficit targets on member states based on sound economic judgment about individual countries' debt sustainability and cyclical positions, as well as area-wide needs. However, such a reform will require building consensus around Treaty changes, which will take time.

14. **The Commission's proposals to improve fiscal governance are welcome, but more ambitious changes are needed to foster compliance with the rules.** The Commission's calls for a stronger focus on medium-term debt sustainability in the excessive deficit procedure, and the early peer review of budgets and reform plans are particularly apposite. However, member states should also face stronger incentives to comply with common rules. One avenue is through greater national ownership, by adopting rules-based fiscal frameworks with a strong legal basis and effective enforcement at the national level. It would be essential to anchor national rules in the key objective of the SGP, namely a balanced budget in structural terms, and possibly more ambitious debt reduction. Meanwhile, other avenues could be explored to strengthen the cohesion of the euro area while reinforcing budgetary discipline, including through more use of central budgetary resources or access to common bond issuance linked to compliance with the SGP.

15. **Surveillance over external imbalances and structural weaknesses should also be improved.** In this respect, the Commission's May 12 Communication foresees a welcome upgrading of the peer review of competitiveness developments and underlying structural challenges by the Eurogroup. To assist this process, Europe 2020 should focus on policies that enhance market flexibility and facilitate competitiveness adjustments within EMU. The Eurogroup should systematically assess and communicate the benefits of reforms, especially in the areas of wage policies, tax measures impacting on labor costs, and actions aimed at removing major market rigidities. When non-compliance leads to significant cross-country spillovers in EMU, the Commission should address a policy warning to the Member States concerned, followed by a public statement by the Council. Cohesion policy should play a larger role in providing incentives for the correction of the underlying causes of intra-euro area imbalances.

16. **The European Systemic Risk Board (ESRB) and European Supervisory Authorities (ESAs) need to be established without delay.** Reaching an expeditious compromise between the Council and Parliament will be essential. The ESRB should be given a mandate to declare emergencies and recommend coordinated crisis management actions across all sectors, as well as to guide the calibration of preventive macro-prudential measures across the EU. The European Banking Authority should have a strong role both in supervisory colleges and in crisis management groups for individual cross-border institutions.

17. **Stronger and harmonized early intervention and resolution capabilities remain essential.** European legislation should urgently establish a core set of resolution tools and remove legal constraints on their effective use, thereby raising the scope for coordination in the resolution of cross-border institutions. A risk-based levy on the banking system, as currently proposed by the Commission, would help establish financial stability funds, which will also require a fiscal backstop. Such funds can be used to reduce systemic risks, by aiding the resolution of systemic institutions and enabling early action to force the sale of bad assets, including those arising from cross-border exposures. A European Resolution Fund and Resolution Authority can further strengthen financial stability, in particular where individual countries are fiscally constrained, but need to be linked to a strong role for the European Banking Authority in the supervision of individual institutions.