



## Euro Area: Staff Concluding Statement of the 2018 Article IV Mission

June 21, 2018

*The euro area expansion, while still vigorous, is slowing to a more moderate pace. But global and domestic risks are rising, including escalating trade tensions, policy complacency among member states, and political shocks. Rebuilding fiscal buffers and addressing structural issues to improve resilience and build support for euro area reforms is now even more urgent. At the same time, completing the banking union and advancing the capital markets union is necessary to foster greater private sector risk sharing. And adding a central fiscal capacity would strengthen the currency union's ability to cope with shocks. Architecture reforms should go hand-in-hand with further efforts to reduce both fiscal and financial sector risks.*

**Euro area growth appears to be leveling off from the very high levels of late last year.** Growth is projected to remain above potential in 2018 and the output gap is expected to close. However, underlying inflation remains subdued. And despite declining unemployment, wage growth has remained muted.

**An array of risks overshadows the outlook.** Trade tensions have risen with the recent U.S. imposition of tariffs on steel and aluminum imports, and further escalation looms as a major risk. Time is running out on the Brexit negotiations with the lack of progress raising the risk of a disruptive exit that would weigh on confidence and investment. Policy complacency is the biggest domestic risk, particularly the lack of effort in many countries with high public debt on rebuilding fiscal buffers and implementing structural reforms. Recent policy uncertainty in Italy has highlighted these concerns, while causing a marked increase in volatility and tighter financial conditions, with attendant spillover risks.

### **ECB Should Stay Committed to Low for Long**

**We agree with the decision by the European Central Bank (ECB) to keep interest rates low well beyond the end of net asset purchases this year.** The still-slow convergence of inflation to the ECB's objective underscores the wisdom of its "patient, persistent, and prudent" approach. At present there do not appear to be any generalized financial stability risks; the pockets of risk that are emerging should be handled using macroprudential policies.

**Forward guidance on interest rates will become even more important as net asset purchases are wound down.** The episodes of volatility over the past year are a reminder of financial markets' sensitivity to any perceived changes in the direction of policy. To avoid any destabilizing surprises, normalization will need to be well communicated and gradual.

**The reinvestment of maturing assets on its balance sheet provides the ECB another monetary policy lever and should be calibrated flexibly, while remaining anchored to the capital key.** Highly rated euro-denominated debt securities, such as German bunds, are likely to become increasingly scarce, unlike in the U.S. The ECB could use its reinvestments flexibly to adapt to market demand for sovereign assets, while remaining anchored by the capital key.

### **Reinvigorate Fiscal and Structural Reforms to Improve Resilience and Build Trust**

**In the fifth year of economic expansion, there is no excuse for not rebuilding fiscal buffers.** Many countries with high public debt are making little to no fiscal consolidation effort, relying on cyclical revenue improvements to reduce headline deficits. With much reduced slack, the case for a flexible interpretation of the fiscal framework is becoming even weaker. The EU institutions should be enforcing the rules more strictly to strengthen credibility and restore trust between countries.

**The structural reform agenda needs to be tackled urgently—primarily at the national level—to shore-up resilience and build support for further deepening of the monetary union.** Reforms to the euro area architecture cannot fix deep structural problems such as low productivity and lack of competitiveness in some countries. Instead, renewed efforts are needed to boost productivity through labor and product market reforms.

**The IMF's latest external sector assessment finds the euro area current account surplus to be moderately stronger than warranted by fundamentals.** The policy remedies lie primarily at the national level. Countries with ample fiscal space and excessive current account surpluses, particularly Germany and the Netherlands, should boost potential growth through investments in infrastructure, education, and innovation. Policymakers in these countries could also express support for higher wage growth in their public communications. At the euro area level, completing the banking union and the capital markets union will help support investment and help reduce the external imbalance.

### **Reduce Financial Sector Risks and Fragmentation**

**The IMF's Financial Sector Assessment Program finds that the banking union has achieved a great deal.** The supervision of large banks is unequivocally better under the Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism (SRM) represents a significant improvement. Most large euro area banks have significantly improved the size and quality of their capital buffers and nonperforming loans (NPLs) have declined from very elevated levels. The ECB's new provisioning guidelines, together with the Commission's recent policy package on NPLs, should help strengthen provisioning practices and facilitate development of a pan-European secondary market for NPLs.

**But there are still significant gaps in supervision and resolution.** Supervision by the SSM is still impeded by differences in national laws and a host of national discretions that should be eliminated over time. The review of the Bank Recovery and Resolution Directive

(BRRD) provides a timely opportunity to refine the resolution regime. To this end, supervisors should also push to expedite the build-up of “bail in-able” liabilities for large banks. Aligning loss-sharing rules under different conditions , and introducing an administrative measure to facilitate liquidation of failing institutions under the SRM would help avoid situations in which creditors are better-off under liquidation than under resolution.

**Further progress is also needed on reducing risks in the banking sector.** Low profitability is a chronic problem for many banks despite favorable economic conditions, and some banks remain vulnerable to a turn in market conditions. While falling overall, NPLs are still far too high in a few countries and need to be tackled more aggressively. Bank-sovereign links also remain tight, with many banks still holding sizable amounts of debt issued by their home governments. Regulatory reforms and supervisory actions to tackle these vulnerabilities should be vigorously pursued, with due regard to transition costs and potential financial stability risks.

### **Strengthen the Architecture to Build a Deeper Union**

**Euro area architectural reforms need to combine increased risk sharing with risk reduction in both the public and private spheres.** Being in a monetary union implies more reliance on fiscal policies for macroeconomic stabilization. Greater fiscal risk sharing across the union would help ameliorate part of this burden, although it would not be a substitute for countries building their own buffers. More private sector risk sharing through financial markets to smooth economic fluctuations would help and could be enhanced by completing the banking and capital markets union. But, if efforts are not made to reduce risks, then the support for risk sharing may be limited in some countries.

**A central fiscal capacity would support economic stabilization and facilitate a better mix between fiscal and monetary policy.** Fund staff recently illustrated a mechanism for greater risk sharing: a “rainy day” fund which would link access to compliance with the fiscal rules, and avoid permanent transfers through caps on usage and contributions. The Commission’s proposal for a small investment stabilization function would be a step in the right direction.

**Ring fencing of capital and liquidity remains a major impediment to a single banking market, yet it persists because the costs of bank failure remain largely a national burden.** Creating a backstop to the Single Resolution Fund (SRF) in the form of a credit line from the European Stability Mechanism (ESM) would be a strongly positive first step. And to complete the banking union agreement is also needed on a plan toward common deposit insurance. These measures should proceed together with a further strengthening of the risk reduction agenda that is already underway.

**A true capital markets union would be a natural complement to the banking union, and Brexit adds urgency to the endeavor.** The vision is for equity capital raised in one jurisdiction to be available to support investment made in another, for deposits raised in one country to be able to fund loans made in another, and for firms to issue debt and equity into common euro area financial markets. Progress on the Capital Markets Union Action Plan has been commendable, but more is needed, especially as some capital markets activity migrates to the continent in response to Brexit. As this occurs, it is critical that regulatory and supervisory capacities are strengthened accordingly, with every effort made to seek close cross-border cooperation, including with the United Kingdom.

## **Act While Conditions Still Permit**

**Visible progress is needed at both the national and the euro area levels.** For now, growth is strong, and financial conditions are accommodative. But conditions will change—this much is assured—leaving no room for complacency.