International Monetary Fund

Concluding Statement of the IMF Mission on Euro-Area Policies

(In the Context of the 2009 Article IV Consultation Discussions with Euro-Area Countries)

June 8, 2009

1. To secure recovery and a return to self-sustaining growth, policymakers need to take further decisive action, especially in the financial sector. The euro area is mired in recession, with tentative signs of improvement yet to germinate into a recovery. The policy arsenal being used to address the crisis is broad, ranging from the provision of substantial public resources for interventions in the financial system, to monetary easing and discretionary fiscal stimulus. A key missing element is a proactive strategy to deal with a weakened financial system, involving a review of capital needs to manage the recession, a cleansing of the financial system of its impaired assets, and a restructuring of weakened institutions. The momentum to reform Europe’s financial stability arrangements triggered by the crisis should be seized without delay, and extended to efforts to deliver fiscal sustainability and to structural reforms, with the latter crucial to shore up flagging growth potential. More effective coordination of policy actions across areas and borders, including support for neighboring emerging economies, will be highly beneficial to help restore confidence in the region’s economy.

Outlook: uncertain recovery

2. Following a very sharp contraction of economic activity, signs of improvement have emerged. The euro area has been hard hit by the collapse in trade on the heels of the global financial turmoil, exacerbated by a correction of home-grown imbalances in some countries. Twin feedback loops have been operating: one across borders owing to the tight financial and trade integration of the region, and another between the financial sector and the real economy, with the recession now adding to the financial sector’s woes. Bank lending remains subdued and financing conditions relatively tight, but corporate access to capital markets has improved. Survey indicators have been recovering and the fall in indicators of economic activity slowing. In sum, the decline in activity should moderate through the remainder of 2009 and give way to a modest recovery starting in the first half of 2010.

3. The recovery is likely to be slow and its shape and timing highly uncertain. Ongoing deleveraging, corporate restructuring, and rising unemployment will weigh on domestic demand. The adjustment of global imbalances and the relatively strong real exchange rate will limit support from the external side. Yet, low inventory levels, some pent-up demand, and further declines in the cost of credit could support an earlier rebound in economic activity. However, the euro-area’s remaining rigidities in labor and product markets, weak private balance sheets in some countries,

and the larger role of the public sector are likely to constitute a drag on growth potential in the medium term. Negative tail risks stem from the financial sector as well as from concerns about fiscal solvency and adverse cross-border spillovers.

4. The euro area is facing strong disinflationary pressures. Mainly due to the sharp fall of commodity prices, but also as a result of the significant weakening in economic activity, headline inflation has declined to very low levels and is likely to turn negative around mid-2009. It is expected to rebound thereafter, but stay below the ECB's definition of price stability for some time. The risk of deflation, though not unimportant, is small because of supportive macroeconomic policies, nominal rigidities, and the recent upticks in commodity prices. Importantly, inflation expectations have so far remained well anchored. Nonetheless, the recent euro appreciation and the large and widening output gaps will depress pricing power. In such an environment, further adverse feedback loops between the financial and the real sector could trigger a protracted deflation.

Financial sector: restoring normal functioning

5. The financial sector holds a key to the shape and the robustness of the recovery. The unprecedented actions undertaken by policymakers have helped stabilize the banking system. Yet stresses persist, conditions for access to bank lending are tight, funding costs remain high, and some segments of the financial markets are functioning poorly. Moreover, sizeable losses lie ahead as the recession unfolds. As a result, the financial sector is hamstrung in fulfilling its vital intermediation role.

6. A resolute and coordinated clean up of the banking system is now essential to restore confidence in the financial system. Europe can hardly afford a piecemeal approach which perpetuates uncertainty, leaves private investors sidelined, and allows government involvement in the sector to weigh on overall efficiency. The financial positions of banks need to undergo a comprehensive review to assess capital needs and viability. In addition to identifying impairments, a forward-looking assessment should evaluate the impact of the ongoing recession on capital. Most importantly, this review needs to result in follow-up action comprising disclosure, recapitalization, and, where needed, restructuring or resolution of financial institutions. Minimization of fiscal costs, safeguards against moral hazard, and transparency of the process are indispensable for the political legitimacy of these actions. In the process, the previously agreed ECOFIN crisis management principles need to be adhered to and full home-host coordination ensured, including with respect to emerging economies in the region. While national supervisors have to be in the driving seat, EU institutions should step up to harmonize the parameters of this exercise—in particular the macroeconomic environment, the definition of capital, and the valuation methodologies—to avoid cross-border distortions; ensure its completion in a synchronized and timely manner; and prevent an inefficient and disorderly exit from government interventions.

7. Establishing or improving resolution regimes for financial institutions is vital. In the present circumstances, policymakers in many EU countries face an unappealing choice when dealing with unviable financial institutions: disorderly bankruptcy or costly and recurring taxpayer bailouts. Instead, the resolution toolkit should be expanded—if necessary through a review of existing legal frameworks—to allow national authorities to take control of financial institutions at an early stage and implement resolution action as needed. To avoid hold-ups, the effect of such action must not

depend on the prior consent of shareholders or creditors, but should instead be subject to ex post judicial review.

8. The crisis-reinforced momentum to overhaul the EU's financial stability arrangements should be fully seized. The Commission's proposals for implementing the recommendations of the de Larosière group should be executed on an ambitious time table. It will be essential to secure adequate resources and independence, balanced with accountability, for the new structures, and an unrestricted information flow between supervisors and central banks within these structures. Central banks will have to play a strong leadership role in the European Systemic Risk Council, which will need a broad mandate to provide early warnings of a build-up of systemic risk and recommend corrective action. As proposed by the Commission, the European System of Financial Supervisors should have sufficiently binding powers and an efficient rule-making mechanism to establish and maintain a single rulebook. Establishment of supervisory colleges for cross-border groups with the participation of EU authorities will be helpful to foster trust and ensure dialogue among supervisory authorities. In parallel to these reforms, the EU needs to build on its ongoing crisis management roadmap to decisively address crisis resolution and burden sharing issues over the medium term, and in this context provide a sound basis for maintaining the single passport.

Monetary policy: preserving price stability

9. From its onset, the ECB has displayed an impressive response to the financial crisis. The ECB pioneered liquidity support to the financial system through far-reaching unconventional measures, rightly focusing on the banking system, given its dominant role for the euro area, and more recently also extending support to the market for covered bonds. While it could have reduced interest rates faster initially, the ECB has since cut policy rates to their lowest level ever. As a result of its broad collateral policy and its unlimited allotment at the policy rate, including at longer maturities, the ECB's balance sheet has expanded considerably. These operations have significantly narrowed the liquidity premium in money markets and helped anchor inflation expectations in positive territory.

10. The supportive monetary stance now needs to be sustained. Monetary policy should focus on keeping interest rates low by continuing to provide unlimited term funding at fixed rates and at longer maturities as long as disinflationary pressures continue. If downside risks were to intensify, a more forceful signal to keep interest rates low would be necessary. To deal with contingencies, all unconventional options, including active credit easing, will need to remain under consideration. The benefits of further cuts in the policy rate need to be judged against their possible adverse effects on the functioning of money markets, but it would be useful to explore any margin for further reductions as soon as possible. In its approach, the ECB has taken care to ensure a safe exit, thus underpinning overall confidence.

Fiscal policy: ensuring sustainability

11. Anchoring fiscal policy over the medium term is now more essential than ever before. Fiscal policy is burdened with the uneasy task of having to provide significant public resources to shore up the financial sector and cushion the downturn, while addressing solvency and sustainability concerns. How can it navigate these treacherous waters?

- With ongoing stress in financial markets and a slow recovery ahead, continued fiscal support for economic activity into 2010 will be essential. Given the large automatic stabilizers in the euro area, the discretionary measures currently adopted seem broadly appropriate, with further stimulus to be set aside for contingencies.

- To boost effectiveness and to avoid distortions in the single market, more ex-ante coordination of fiscal measures would be beneficial. Discretionary fiscal efforts need to be tailored to country circumstances, with more action by countries with better starting positions in terms of debt and deficits, more robust financial systems, and more credible consolidation frameworks. In the context of the ongoing mid-term review, some fine tuning of budgetary policies along these lines would be helpful.

- To address solvency concerns, short-term actions need to be embedded in credible medium-term consolidation programs, supported by the application of the Stability and Growth Pact, with pre-announced fiscal adjustments to be implemented as soon as the recovery takes hold. To ensure the longer-term health of public finances, national fiscal institutions should foster ownership of consolidation goals and pay more attention to the starting level of debt and the prospective cost of aging, as proposed by the Commission. At the same time, surveillance over progress toward these medium-term objectives will have to be intensified at EU and national levels.

Structural issues: boosting recovery potential

12. Intensified structural reforms are vital to ensure that the post-crisis recovery is built on a solid foundation. The financial crisis has curbed potential growth, jeopardized fiscal consolidation and triggered an unprecedented decline in trade. Reforms under the Lisbon agenda have been paying off, but it remains essential to reinvigorate structural reforms to avoid a protracted period of subdued growth. Thus, measures taken to support shorter working hours and raise social benefits—while important to shore up incomes and keep the labor force attached to the labor market—should have built-in reversibility. With economic restructuring ahead, a heightened focus on training, education, and job-matching will be essential. And implementing the services directive, revamping the Lisbon agenda, and facilitating an ambitious and early conclusion of the Doha round will contribute to the foundations of a solid recovery.