Euro area in recovery but medium-term outlook weak

Collective action needed for further integration; muddling through carries heavy risks

Priorities: more EU fiscal support, reforms to raise growth potential, a common deposit insurance, improve bank balance sheets

Recovery in the euro area has strengthened, but the medium-term outlook remains weak and is endangered by a lack of collective action to address common challenges. Members must rebuild faith in the monetary union, says the IMF in its latest review of the currency union.

“The euro area is at a critical juncture. The progress made during the acute phase of the crisis and the recovery should not lead to complacency about the underlying challenges. Policymakers should seize this moment to reverse the rising tide of Euroscepticism and strengthen the monetary union by acting together. Muddling through is increasingly untenable,” said Mahmood Pradhan, mission chief for the euro area.

The fragile recovery that started in the euro area in 2014 has strengthened on account of consumer spending as more people find jobs, lower oil prices, a neutral fiscal stance, and accommodative monetary policy. However, medium-term growth prospects remain less bright. “Inflation remains too low, and weak investment, still high unemployment, and the aging of the population will continue to hurt productivity, raising the risk of stagnation,” said Pradhan.
Political risks rising

The subdued economic outlook is exacerbated by rising political risk in the euro area and the European Union (EU). Growing Euroscepticism has led to stark political divisions, which hinder a collective will to take crucial decisions for a stronger union—to deal with the refugee surge or address security concerns, for example. The recent United Kingdom referendum is likely to lead to persistent uncertainty regarding its new status vis-à-vis the EU. A slowdown in global growth could also undermine the recovery and raise the likelihood of stagnation.

Restore faith in the monetary union

Unless collective problems are resolved, the euro area is likely to suffer repeated bouts of economic and political instability leading to crises of confidence and economic setbacks. The EU should redouble efforts to ensure the benefits of economic integration and thus rebuild flagging faith in the monetary union. Countries should rapidly integrate refugees into their labor markets, while the block should reform its common border and asylum policy to protect social cohesion and preserve the single market.

Help business and employment

To counter the risk of stagnation, the report calls for a big push on structural reforms to improve the business climate and employment as incomplete reforms hold back investment and lower growth potential. Easier access to the professional and retail service sectors, more efficient public administrations, and stronger insolvency regimes encourage investment and bolster the impact of labor market reforms. A fully functional single market in services, energy, transport, digital commerce, and free trade agreements can open up markets and enhance productivity by allowing firms to scale up.

Shrinking the cost of hiring workers and expanding cost effective active labor market policies can draw more workers into the workforce. The recovery is an opportune time to commit to reducing excessive protection for workers on regular contracts and overly generous financial disincentives for entering the labor market as these distortions keep unemployment too high for too long.

To ensure that policymakers take action, the reform agenda should be based on benchmarks related to reform outcomes that are directly under the control of policymakers as this will improve transparency and accountability. The report also emphasizes the need to even-handedly enforce the EU’s economic governance rules, which sets the reform agenda for member states in a broad range of policy areas.

Strengthen fiscal policy and expand centralized support

Laden with high public debt, most euro area countries can ill afford to provide the fiscal support that is necessary to boost demand. These countries should change the composition of fiscal policy in a manner that supports growth and use the interest savings generated by easy monetary conditions to pay down their debt and rebuild buffers. Countries that have more budgetary space should use it to boost investment and support reforms.

In countries where demand is still low and which lack fiscal room, the EU could help with new or additional funds to support common investment projects such as in energy transmission and refugee settlement. Over the longer run, the EU should have the capacity to stabilize economic cycles.

But to garner political support and overcome moral hazard, such centralized support requires stronger enforcement of the fiscal rules of the zone. Access should therefore be conditional on compliance and the implementation of structural reforms. In the medium-term, the fiscal framework should be simplified as it has become too complex following successive reforms.

Accommodative monetary policy should continue

The European Central Bank’s supportive monetary policy of bond purchases and negative interest rates has helped ease financial conditions and the supply of credit. But if inflation stays stubbornly low or dips further, additional monetary easing will be necessary, mainly through larger asset purchases.

Clean up bank balance sheets and complete the banking union

Banking sector profits have remained subdued, making it difficult to raise new capital. Bank supervisors should encourage the consolidation of the banking system.

Banks need to off-load bad loans at a faster pace in order to restore financial health and further expand credit.
Ambitious targets for shedding bad assets are therefore necessary, as is less national discretion in banking supervision. Improved bankruptcy frameworks and a market for distressed debt could aid this process.

A common deposit insurance scheme with a common fiscal backstop is essential to completing the banking union. This will promote the flow of liquidity and promote pan-European banking. The European Deposit Insurance Scheme should be put in place rapidly, accompanied by measures to reduce banking sector risks. Faster progress toward a Capital Markets Union can help reduce overreliance on bank funding for capital and foster private sector risk sharing.