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EURO AREA POLICIES

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

July 2018

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 16, 2018 consideration of the staff report that concluded the Article IV consultation with member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 16, 2018, following discussions that ended on May 24, 2018, with the officials at EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 27, 2018.
- A **Statement by the Executive Director** for Germany, on behalf of the euro area Member States and the European community.

The documents listed below have been or will be separately released.

Selected Issues
Financial System Stability Assessment

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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IMF Executive Board Concludes 2018 Article IV Consultation on Euro Area Policies

On July 16, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] on euro area policies with member countries. This year, the consultation also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for the euro area.[2]

The euro area expansion, while still vigorous, is slowing to a more moderate pace. The main engine remains domestic demand, underpinned by solid job creation. Growth is projected to remain above potential in 2018 and 2019, at 2.2 percent and 1.9 percent, respectively, before easing to an annual rate near 1½ percent. In the medium term, demographic changes, weak productivity growth, and crisis legacies will continue to exert drag. While headline inflation has exhibited some volatility lately, core inflation has remained subdued. Inflation is still expected to take a few years to durably converge to the European Central Bank (ECB)'s objective of below, but close to 2 percent.

An array of global and domestic risks hangs over the outlook. Trade tensions have risen with the recent U.S. imposition of tariffs on steel and aluminum imports. Policy inaction and political shocks at the national level are important domestic risks, especially with regard to rebuilding fiscal buffers in countries with high public debt and implementing structural reforms while growth remains strong. And the lack of progress in Brexit negotiations raises the risk of a disruptive exit.

The FSAP finds significant progress on the banking union. The size and quality of banks' buffers are higher than before, and nonperforming loans have declined, but low profitability remains a serious challenge for many banks. Banking supervision has undergone a step improvement with the creation of the Single Supervisory Mechanism, and the handling of bank resolution is better under the Single Resolution Mechanism, although the fragmentation of rules along national lines remain an issue. The FSAP lays out detailed recommendations for further improvement.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion.

Executive Board Assessment[3]

Executive Directors welcomed the continued broad-based economic expansion and strong job creation, underpinned by solid domestic demand and accommodative monetary policy, noting that this is the fruit of many years of sustained policy effort. Core inflation and wage growth remain subdued, however, despite a closing output gap and a recent energy price driven spike in headline inflation.

Directors cautioned that risks are skewed to the downside, stemming from domestic policy inactions and political shocks, as well as a less favorable external environment, underpinned by escalating trade tensions and Brexit-related uncertainties. Moreover, policy reversals could risk sending borrowing costs abruptly higher, derailing the ongoing expansion.

Directors agreed that monetary policy should remain supportive until inflation is convincingly converging to the ECB's objective. They welcomed the ECB's intention to keep interest rates low well beyond the end of net asset purchases this year. In this respect, clear communication remains essential to anchor interest rate expectations.

Directors agreed that decisive policy efforts should support external rebalancing and promote trade openness and the rules-based global trading system. With respect to staff's assessment that the euro area current account surplus is moderately stronger than warranted by fundamentals, they underlined that the policy remedies lie primarily at the national level.

Directors were concerned that national budgetary plans did not adequately address country specific challenges. High-debt countries should increase their fiscal adjustment efforts while conditions remain supportive. Directors generally also encouraged countries with ample fiscal space to pursue additional investment that will lift potential growth and contribute to necessary external rebalancing. Directors stressed the importance of better compliance with and enforcement of the fiscal rules, along with a plan to simplify the fiscal framework. They also called for internationally coordinated efforts to address new taxation challenges arising from globalization of corporate activities and digitalization.

Directors recognized that deep structural issues continued to impede medium-term growth prospects and hamper income convergence. They urged countries to step up structural reform efforts to boost productivity and employment, and supported initiatives to link EU financial support to reform implementation.

Directors welcomed the improvement in overall banking health, as documented in the FSAP review. They urged further efforts to strengthen the resilience of the system, in particular in terms of profitability, and encouraged vigilance against financial stability risks. They appreciated the strengthening of banking supervision under the Single Supervisory Mechanism, while noting remaining challenges. Directors encouraged ongoing supervisory and other actions to clean up legacy assets. They recognized that bank crisis preparedness and management have been

[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

upgraded, yet saw the need to address certain transitional and structural issues. They agreed on the importance of building up "bail-in-able" debt in banks, and gradually reducing financial intermediaries' exposures to home sovereign debt, both of which will help attenuate sovereign bank feedback loops. Further progress on building the capital markets union and enhancing the supervision of nonbanks were viewed as valuable in themselves, and all the more so in the context of Brexit.

Directors considered architectural reforms a necessary complement to national action. They urged swift progress on reducing the legal fragmentation across national lines, creating a credit line from the European Stability Mechanism to backstop the Single Resolution Fund, and establishing a common deposit insurance scheme. Most Directors saw merit in developing over time a central fiscal capacity to support macro stabilization, embedding strong safeguards against permanent transfers and moral hazard.