EUROPE AT A CROSSROADS
Policy Priorities and Prospects for the EU

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IMF Offices in Europe
(OVERARCHING) DEBATE: IS THE EUROZONE Viable?

Symptoms:
• Brexit... and other exits?
• The refugee crisis and the end of Shengen

Deep Faultlines:

• Inadequate EMU architecture:
  “The current halfway house—a single currency without the minimal institutions required of a common currency area—has not worked and is not likely to do so” (J. Stiglitz)

• Democratic deficit:
  “The crisis of EMU will drag on, and cannot be resolved without confronting either the supranational ambitions of the EU or the democratic nature of sovereign national governments” (M. King)
An Unhelpful Context
(No Debate)

Mediocre Medium-Term Prospects and Rising Risks
EURO AREA RECOVERY CONTINUES, LED BY DOMESTIC DEMAND…

Contribution to Growth
(Percentage point)

Source: Eurostat.
...SUPPORTED BY FISCAL & MONETARY POLICIES

**Euro Area: Structural Balance Fiscal Impulse**
(Percent of potential GDP)


**Euro Area: Corporate Lending Conditions**
(Percent)

Source: Haver Analytics.
BUT WEAK MEDIUM-TERM GROWTH & INFLATION OUTLOOK...

**Euro Area: Real GDP Over Various Cycles**
(Index: business cycle peak Q = 100)

**Various Inflation Measures**
(Percent, y-o-y)

Sources: ECB; WEO and IMF staff calculations.

Sources: Bloomberg, L.P.; and Haver Analytics.
DUE TO CRISIS LEGACIES OF STILL HIGH UNEMPLOYMENT...

Sources: Haver and IMF staff calculations. Note: */ after adjusting for changes in labor force participation.

Unemployment Rate since the Financial Crisis
(Percent) *

Number of Years to Reduce Unemployment to 2001-07 Levels
(Percent)

Sources: WEO; and IMF staff calculations. Note: Okun’s coefficient based on Ball and others (2014) is 0.3, 0.5, 0.9, and 0.3 for Italy, Portugal, Spain respectively.
WEIGHING ON INVESTMENT, ESPECIALLY FOR SMEs

Euro Area: NFC Leverage
(Debt to Assets; in percent)

Euro area: Contribution to Investment Growth
(Percent)

Source: Banque de France, BACH database.


RISING RISKS (DEBATE): WHAT POTENTIAL SPILLOVERS FROM BREXIT TO EURO AREA?3

Euro Area: Main Economic Indicators, 2016-18

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
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<tr>
<td><strong>Staff report</strong></td>
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<td>Real GDP (percent)</td>
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<td>Inflation (percent)</td>
<td>0.3</td>
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<td>Real GDP (percent)</td>
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</table>

Source: IMF staff estimates.

European Country Export to UK, 2014

Sources: Office of National Statistics; Haver Analytics; WEO; IMF staff calculations.

3 “Macroeconomic Implications of the United Kingdom Leaving the European Union,” 2016 IMF United Kingdom Selected Issues Paper
BREXIT COULD HAVE A LARGE NEGATIVE EFFECT ON EURO AREA GROWTH

Source: European Commission.
RISING RISKS (DEBATE): GROWTH EFFECTS OF MIGRATION INFLOWS POSITIVE, BUT UNEVEN

Impact of Refugee Inflows
(Deviation from baseline scenario)

Sources: IMF staff estimates.
DEBATE: THE EFFECTIVENESS OF MACROECONOMIC POLICIES GIVEN THE WEAK EUROPEAN OUTLOOK
Fiscal policy:
Does it support the recovery? (Should it be more expansionary?)
(Where) is there fiscal space?

Monetary policy:
Is more accommodation needed?
Have the limits of QE/NIRP been reached?
STRENGTHEN FISCAL FRAMEWORK AND EXPAND CENTRALIZED SUPPORT

Euro Area: Debt-stabilizing Primary Gap in 2016
(Percentage points of GDP)

General Government Debt
(Percent of GDP)

Sources: IMF WEO; and IMF staff calculations.

5 “Options for A Central Fiscal Capacity in the Euro Area,” 2016 IMF Euro Area Selected Issues Paper
LOW LONG-TERM RATES HINDERING MONETARY POLICY ACCOMMODATION?

A. 10-year yield: major economies

Sources: Turner et al. (2016).
MAINTAIN MONETARY ACCOMMODATION TO BOOST INFLATION…

Annual Loan Growth Required to Maintain Net Interest Margin, end-2015
(Y/y percent change) *

Scope of Available Assets after Completion of Current Asset Purchase Program (APP) as of end-March, 2016 (EUR billion)

Sources: Bloomberg L.P., EBA Transparency Exercise (2015), ECB, SNL, and IMF staff calculations. Note: */ assumes that new lending is fully funded using TLTRO I funds at a weighted average borrowing rate of -20bps. **/ based on the historical pass-through of policy rates and the elasticity of net interest margins to changes in term premia between Jan. 2010 and Feb. 2016; total mortgage and corporate loans at end-2015 to EA residents; scenario assumes an increase of monthly asset purchases (until Sept. 2017) by the ECB and a deposit rate cut of 10bps (as per ECB decision on March 10).

6 “Negative Interest Rate Policy (NIRP): Implications for Monetary Transmission and Bank Profitability” 2016 IMF Euro Area Selected Issues Paper
DEBATE: ARE STRUCTURAL REFORMS THE POLICY OF LAST RESORT?
PERISISTANT PRODUCTIVITY AND COMPETITIVENESS DIFFERENTIALS

Service Sector Productivity: US and Euro Area
(Index 2007 = 100)

ULC-based REER vis-a-vis Germany
(Index, 1999Q1=100)

Source: Haver Analytics.
INCENTIVIZE GROWTH-FRIENDLY STRUCTURAL REFORMS

Euro Area: Labor Market Reform and Outcomes
(Bubble’s size indicates the level of labor market rigidity in 2013)

Sources: OECD and IMF staff calculations.

Euro Area: Product Market Reform and Outcomes
(Bubble’s size indicates the level of product market rigidity in 2013)

Sources: OECD and IMF staff calculations.

DEBATE: IS A WEAK FINANCIAL SECTOR AN IMPEDIMENT TO GROWTH IN THE EURO AREA? (OR: WHAT FINANCIAL SECTOR POLICIES ARE NEEDED?)

PRIORITIES AND DELAYS

• Are banks sufficiently capitalized to withstand a financial shock?

• Can banks play their role in financing the real economy?

• Will enough progress be made on the Banking Union to reduce financial fragmentation and improve capital allocation?
SLOW PROGRESS IN DELEVERAGING...

Total Debt-to-GDP
(Percent of GDP)

Nonperforming Loans and Write-offs

Source: Haver Analytics. Note: NPISHs = non-profit institutions serving households. EA financial corporate debt is non-consolidated.

...AND REPAIR BANK BALANCE SHEETS AND COMPLETE BANKING UNION

Euro Area: Time to Reduce Stock of Nonperforming Loans to Pre-Crisis Levels
(Percent of total loans/years) *

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<tr>
<td>BEL</td>
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<td>4.5</td>
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</tbody>
</table>

Sources: EBA, ECB, national authorities, and IMF staff calculations. Note: */ As of end-Q2 2015 (for IRL and ITA, end-2014); assumes future loan growth in line with nominal GDP and non-performance of new loans at pre-crisis default rates.

Return on Bank Assets
(Percent)

Source: ECB.

7 “A Strategy for Resolving Europe’s Problem Loans” and “Tackling Small and Medium-Size Enterprise Loans in Europe,” IMF Staff Discussion Notes 15/19 and 15/04, 2015
...AND COMPLETE THE BANKING UNION

• **EU-wide common deposit insurance scheme** while mitigating banking sector risks

• **Risk reduction to accompany risk sharing:**
  - **Capital:** harmonize and strengthen the definition of capital
  - **Recovery and resolution:** clearly communicate differences in creditor hierarchies or establish common hierarchy
  - **Sovereign exposures:** make prudential treatment more risk sensitive

• **SRF and EDIS need a common fiscal backstop:** to minimize the chances that bank-sovereign risk links reemerge
DEBATE: POLICIES VS. INSTITUTIONAL CHANGE
COLLECTIVE, COMPREHENSIVE ACTION NEEDED TO BOLSTER GROWTH AND STRENGTHEN THE UNION

- Create better incentives for growth-friendly structural reforms
- Strengthen fiscal framework while expanding centralized fiscal support
- Accelerate balance sheet repair and complete the banking union
- Continue monetary policy accommodation

Comprehensive, more balance mix
“THE WHOLE IS GREATER THAN THE SUM OF ITS PARTS…”

Euro Area: GDP Growth Simulations
(Percent)

Euro Area: Inflation Simulations
(Percent)

Sources: IMF, World Economic Outlook (April 2016); and IMF staff calculations.

Sources: IMF, World Economic Outlook (April 2016); and IMF staff calculations.

DEBATE: WHAT ECONOMIC GOVERNANCE FRAMEWORK FOR THE EUROZONE?

Risks from the weak enforcement of common rules

- Some observers have criticized Commission for not enforcing EU governance framework (e.g., the recent cases of Spain and Portugal)

Are the rules themselves in need to be changed?

- Others have criticized EU fiscal rules themselves (need to change the rules?)
ECONOMIC POLICY COORDINATION IS WEAK

European Semester reform implementation index, 2011-2015

Sources: Darvas and Leandro (2016).
…IN THE CONTEXT OF UNBALANCED REGIONAL REBALANCING

Current Account Composition
(Percent of euro area GDP) *

- Intra-EA trade adjustment
- Germany
- Other EA Creditor
- Spain and Italy
- EA Debtor Program
- Other EA Debtor
- EA current account WEO

Net Foreign Asset Position
(Percent of GDP)

- Germany
- France
- Italy
- Spain
- Portugal
- Greece

Sources: World Economic Outlook; and IMF staff calculations.
Note: */ Figures for 2016 are calculated based on data available in the year-to-date and WEO projections for the remainder of the year.

Source: IMF, BOP Statistics.
DEBATE: WHAT ECONOMIC GOVERNANCE FRAMEWORK FOR THE EUROZONE?

• **Strengthen economic and structural reform governance:**
  - Open Excessive Imbalance Procedure (EIP) against repeat offenders
  - Set outcome-based euro area-wide benchmarks
  - Exploit reform incentives under the SGP
  - Improve coordination and ownership (e.g. national competitiveness boards)

• **Improve fiscal governance:**
  - Upgrade the fiscal framework: (1) simplify rules—single fiscal anchor (debt-to-GDP) and single operational target (expenditure growth); (2) Independent European Fiscal Board
  - Further fiscal integration over medium term: conditional on stronger compliance with fiscal rules and progress on structural reforms
  - Promote investment and rebuild buffers
  - Expand central investment schemes (EFSI)
DEBATE: POLITICAL ECONOMY CHALLENGES

• What are the key medium-term risks?
• How will governments handle rising anti-EU sentiment?
• What forms could EU disintegration take?
RISKS TO THE OUTLOOK HAVE INCREASED…

Tail risks:

1. Further exits by member states

2. Governments ignore EU rules with impunity

3. Capture of governments by nationalist parties
Thank you