



INTERNATIONAL MONETARY FUND

# EUROPE AT A CROSSROADS

Policy Priorities and Prospects for the EU

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# (OVERARCHING) DEBATE: IS THE EUROZONE VIABLE?

## Symptoms:

- Brexit... and other exits?
- The refugee crisis and the end of Shengen

## Deep Faultlines:

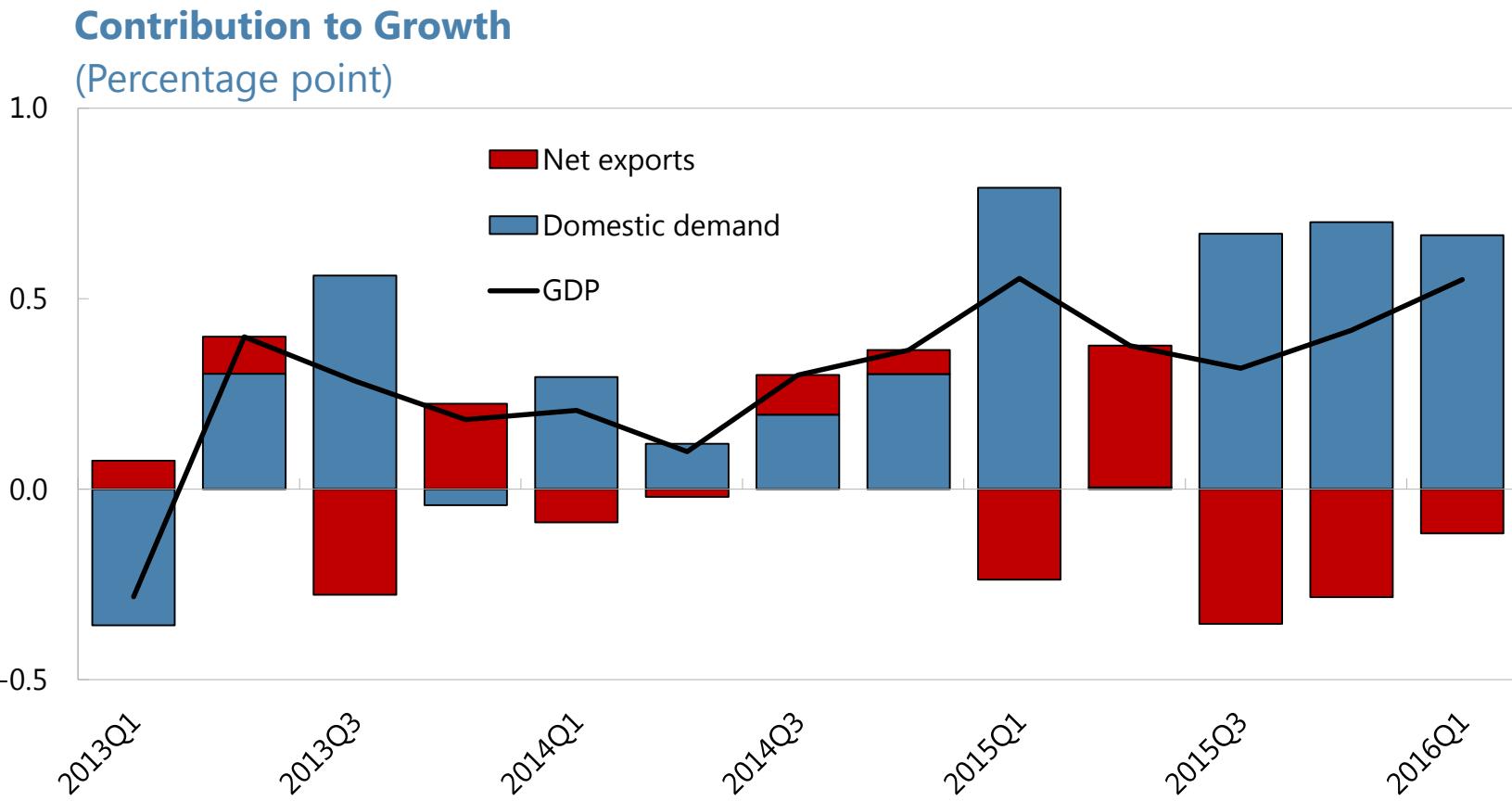
- **Inadequate EMU architecture:**  
“The current halfway house—a single currency without the minimal institutions required of a common currency area—has not worked and is not likely to do so” (J. Stiglitz)
- **Democratic deficit:**  
“The crisis of EMU will drag on, and cannot be resolved without confronting either the supranational ambitions of the EU or the democratic nature of sovereign national governments” (M. King)

A faint, grayscale world map is visible in the background of the slide, showing the outlines of continents.

**An Unhelpful Context  
(No Debate)**

**Mediocre Medium-Term  
Prospects and Rising Risks**

# EURO AREA RECOVERY CONTINUES, LED BY DOMESTIC DEMAND...

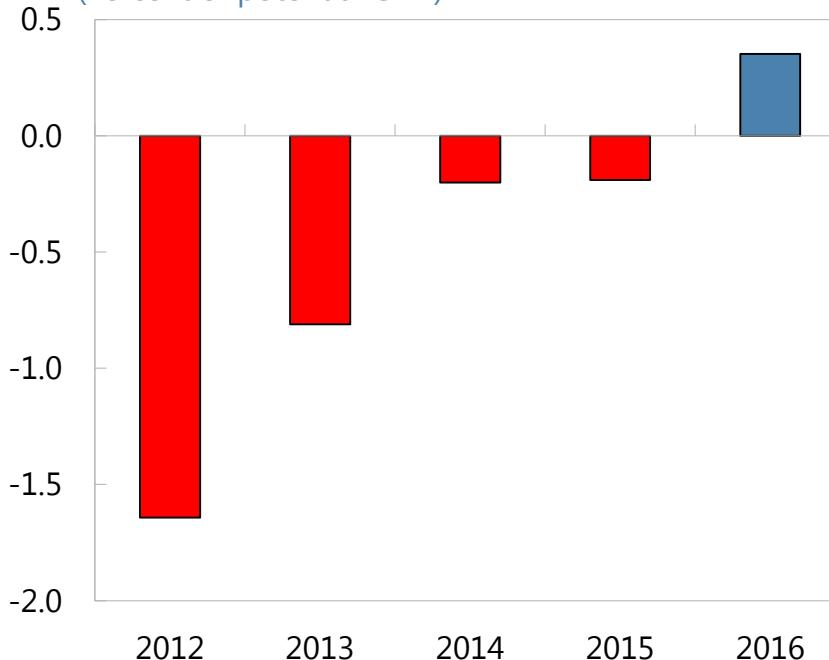


Source: Eurostat.

# ...SUPPORTED BY FISCAL & MONETARY POLICIES

**Euro Area: Structural Balance Fiscal Impulse**

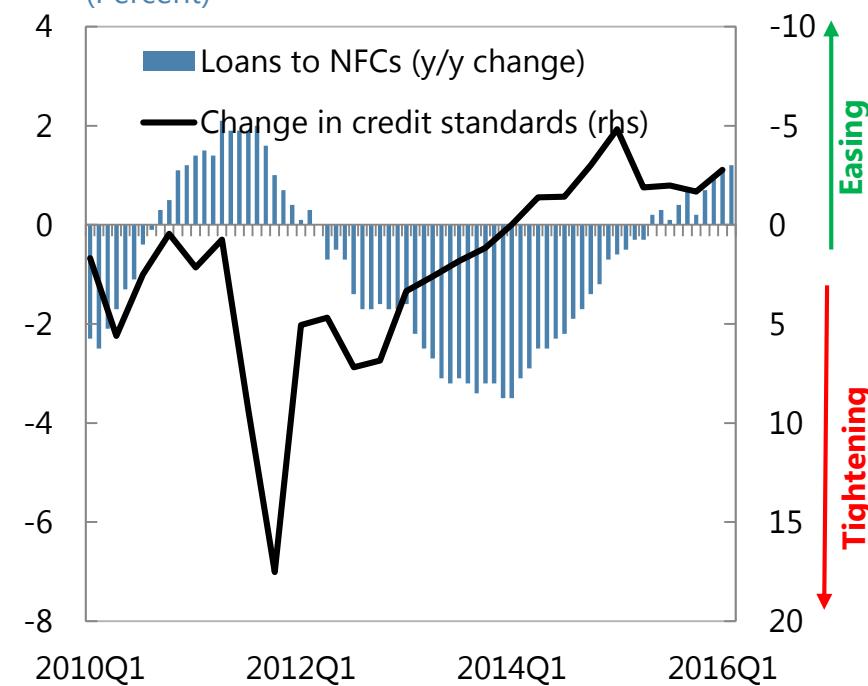
(Percent of potential GDP)



Source: IMF, World Economic Outlook (April 2016).

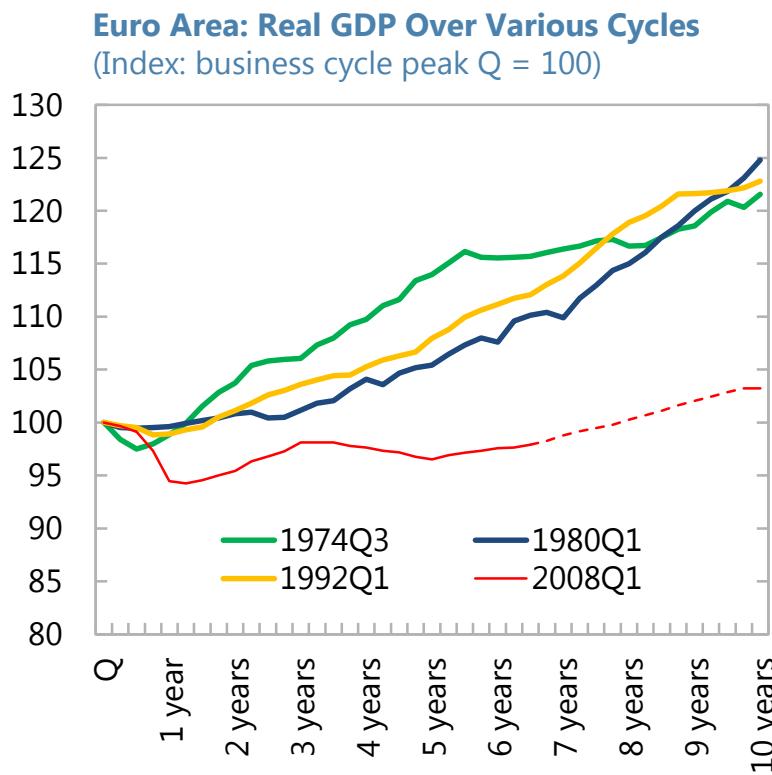
**Euro Area: Corporate Lending Conditions**

(Percent)

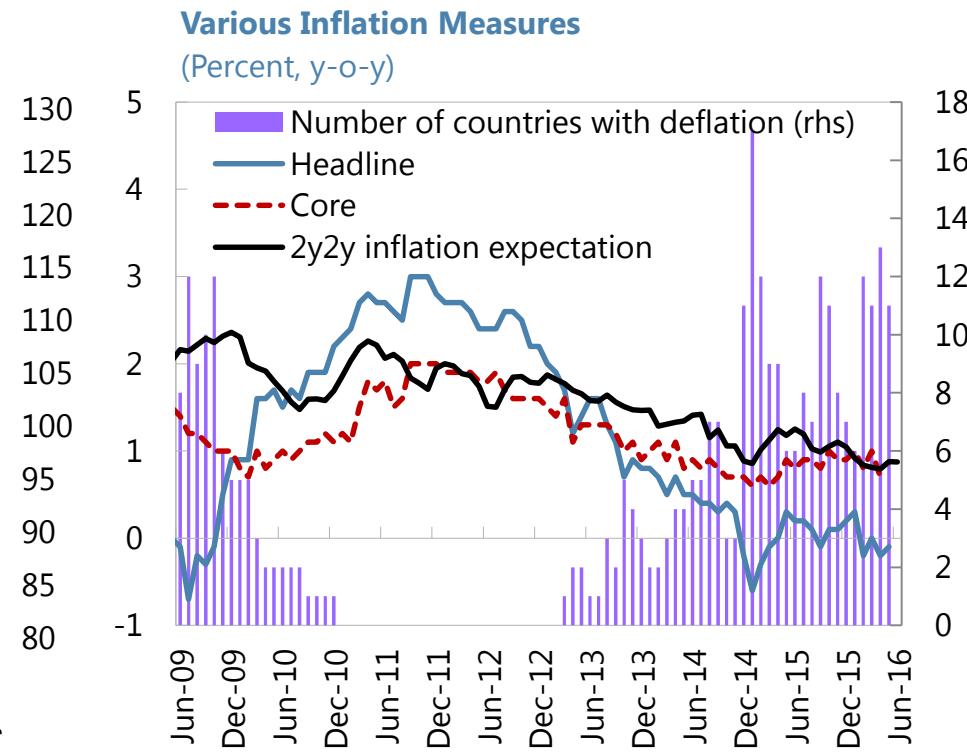


Source: Haver Analytics.

# BUT WEAK MEDIUM-TERM GROWTH & INFLATION OUTLOOK...

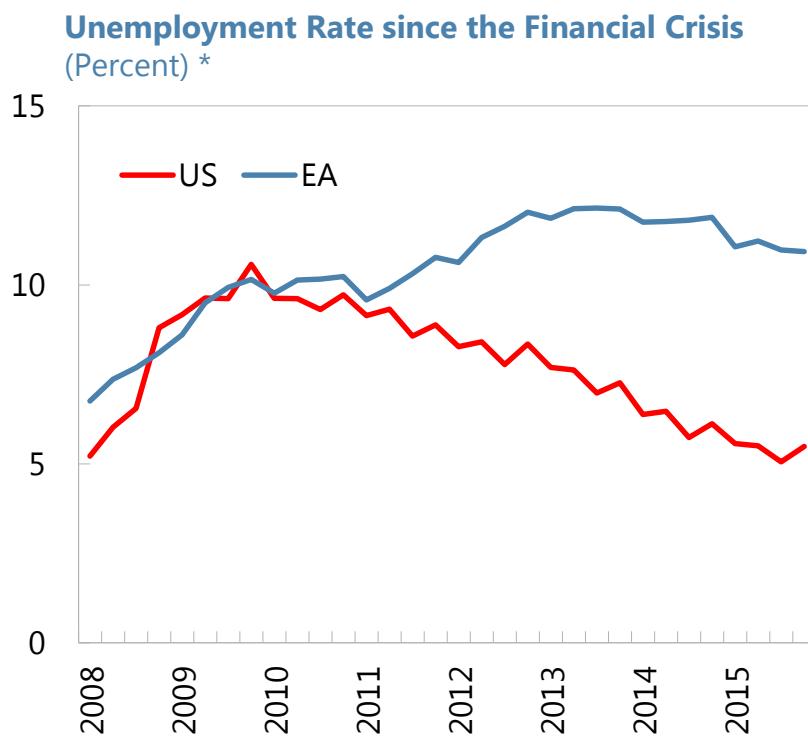


Sources: ECB; WEO and IMF staff calculations.

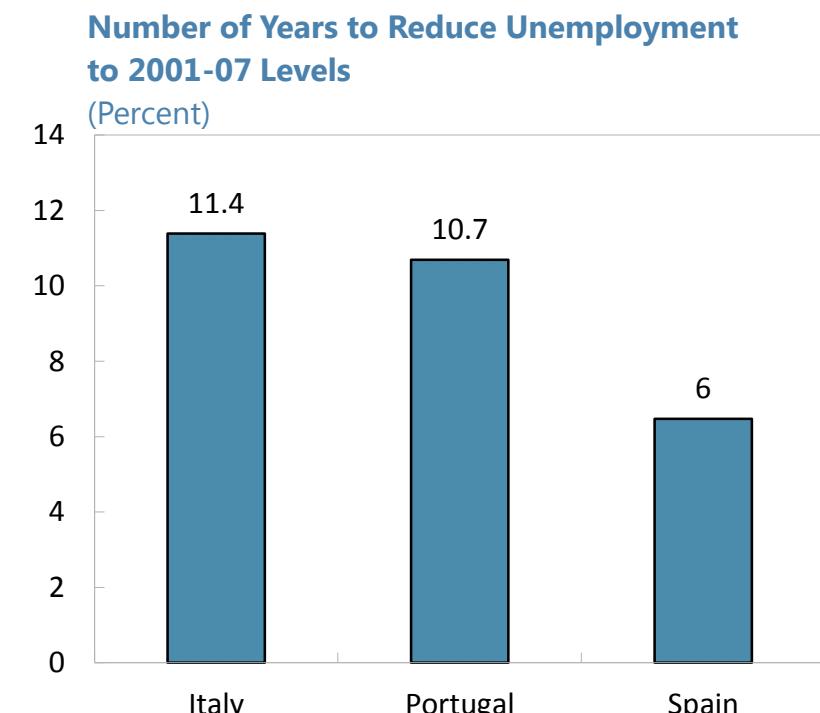


Sources: Bloomberg, L.P.; and Haver Analytics.

# DUE TO CRISIS LEGACIES OF STILL HIGH UNEMPLOYMENT...



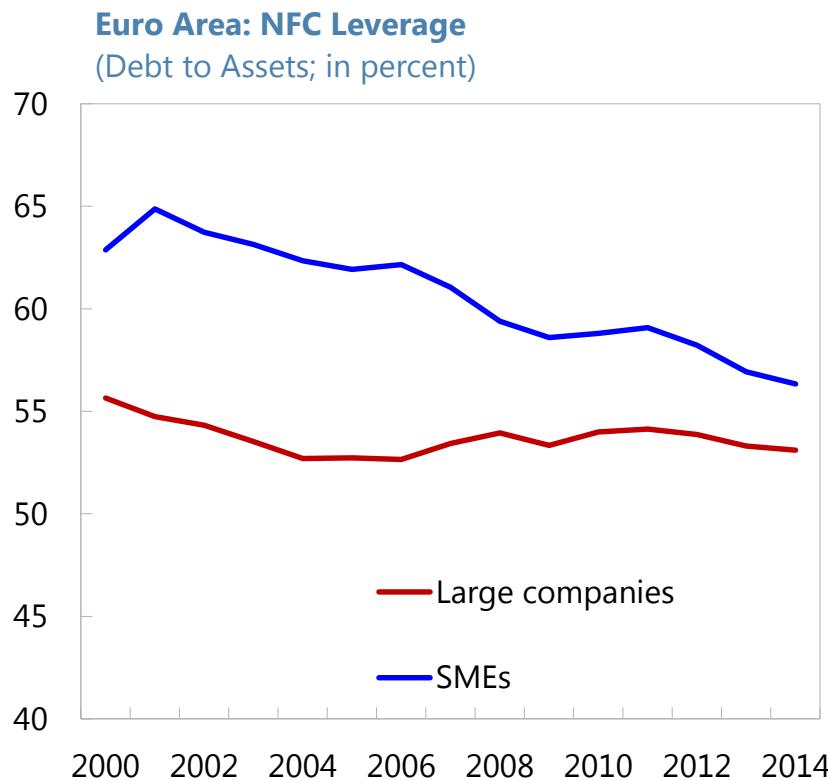
Sources: Haver and IMF staff calculations. Note: \*/ after adjusting for changes in labor force participation.



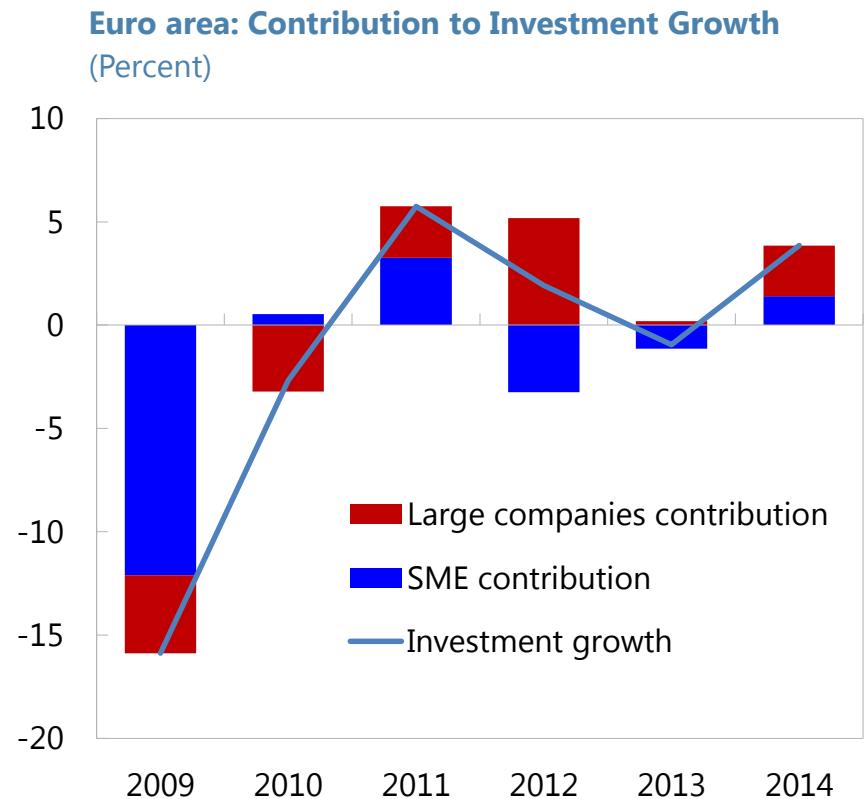
Sources: WEO; and IMF staff calculations.

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<sup>2</sup>



Source: Banque de France, BACH database.

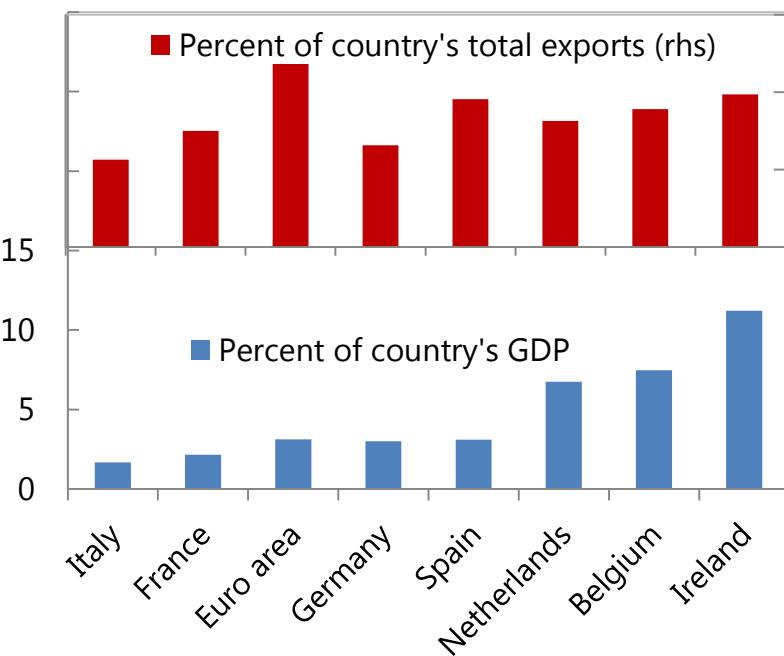


Sources: Banque de France, BACH database; and KfW SME Panel 2009-2015.

<sup>2</sup> "Investment, Firm Size, and the Corporate Debt Burden: A Firm-Level Analysis of the Euro Area," IMF 2016 Euro Area Selected Issues Paper

# RISING RISKS (DEBATE): WHAT POTENTIAL SPILLOVERS FROM BREXIT TO EURO AREA?<sup>3</sup>

European Country Export to UK, 2014



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

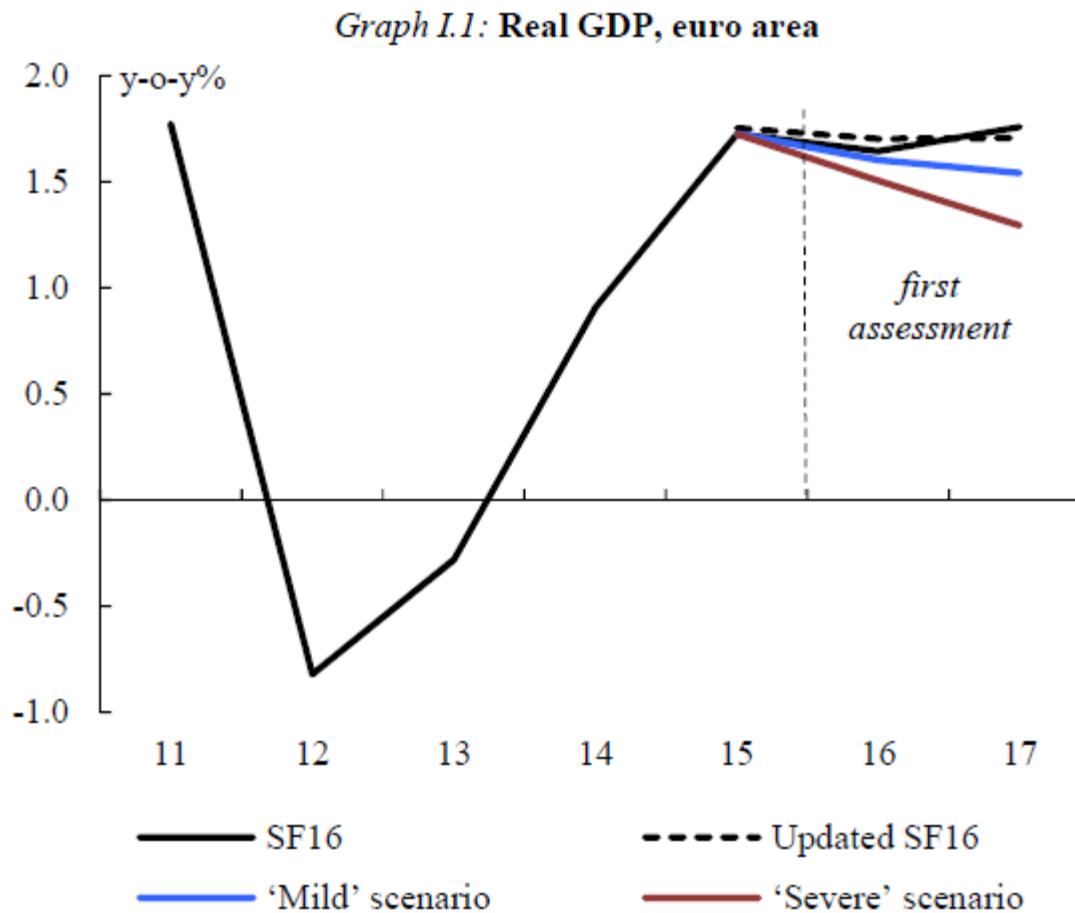
Euro Area: Main Economic Indicators, 2016-18

	2016	2017	2018
<b>Staff report</b>			
Real GDP (percent)	1.7	1.7	1.7
Inflation (percent)	0.3	1.2	1.4
<b>Preliminary forecast update</b>			
Real GDP (percent)	1.6	1.4	1.6
Inflation (percent)	0.2	1.1	1.2

Source: IMF staff estimates.

<sup>3</sup> "Macroeconomic Implications of the United Kingdom Leaving the European Union," 2016 IMF United Kingdom Selected Issues Paper

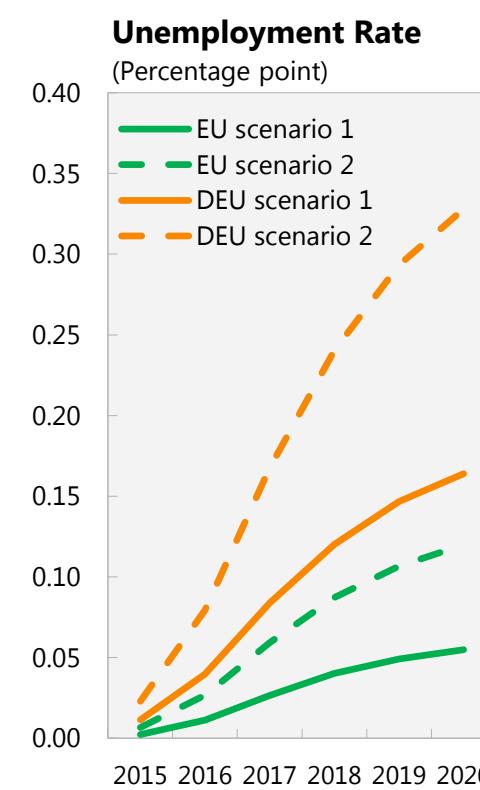
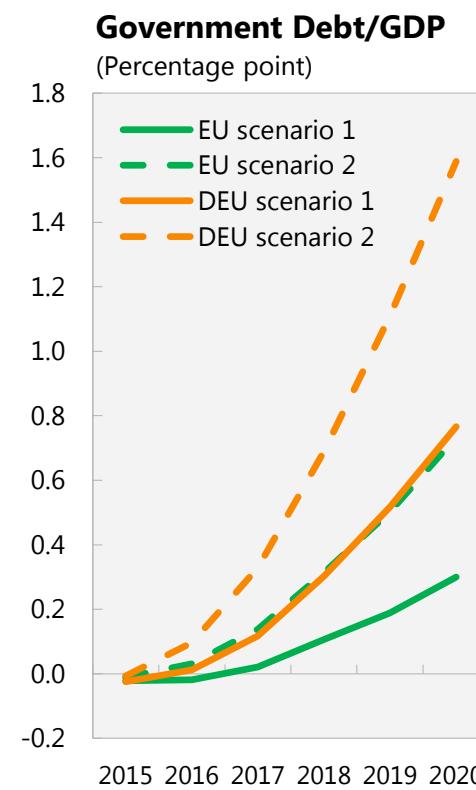
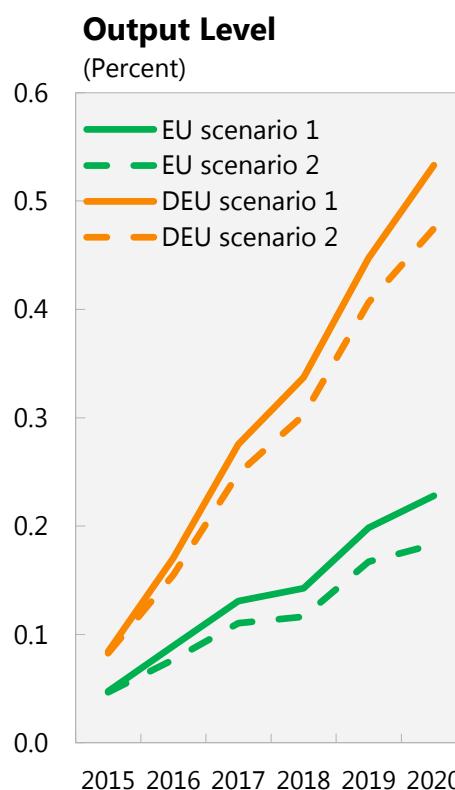
# BREXIT COULD HAVE A LARGE NEGATIVE EFFECT ON EURO AREA GROWTH



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?

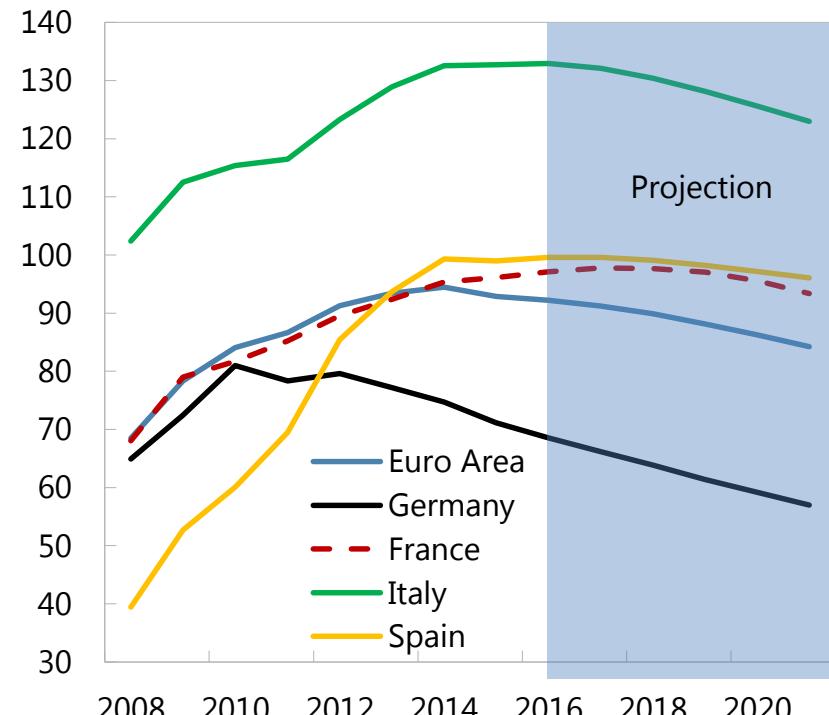
# STRENGTHEN FISCAL FRAMEWORK AND EXPAND CENTRALIZED SUPPORT<sup>5</sup>

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



Sources: IMF WEO; and IMF staff calculations.

**General Government Debt**  
(Percent of GDP)

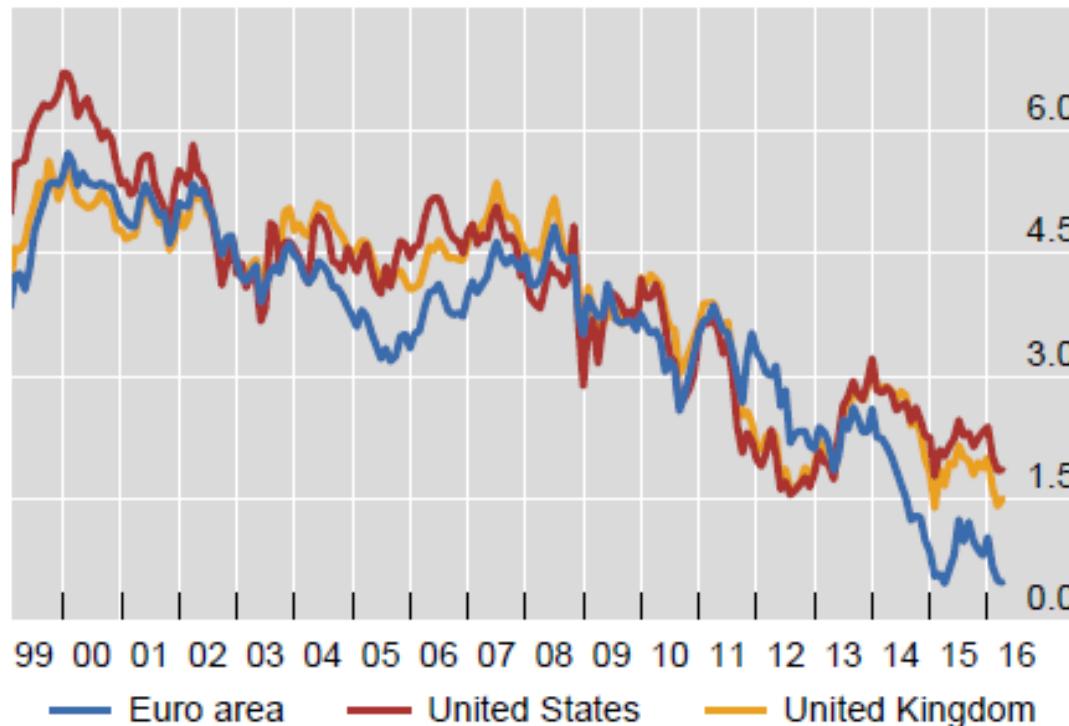


Sources: IMF WEO; and IMF staff calculations.

<sup>5</sup> "Options for A Central Fiscal Capacity in the Euro Area," 2016 IMF Euro Area Selected Issues Paper

# LOW LONG-TERM RATES HINDERING MONETARY POLICY ACCOMODATION?

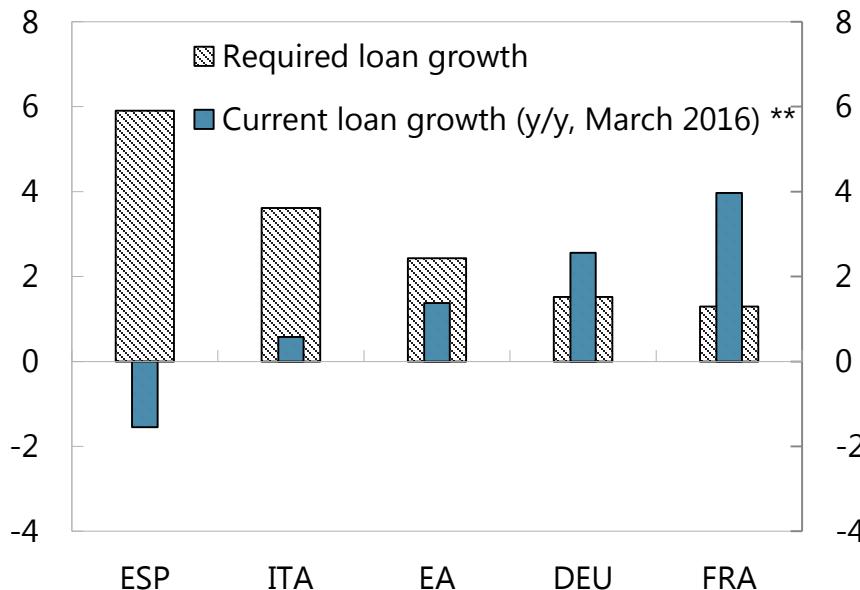
A. 10-year yield: major economies



Sources: Turner et al. (2016).

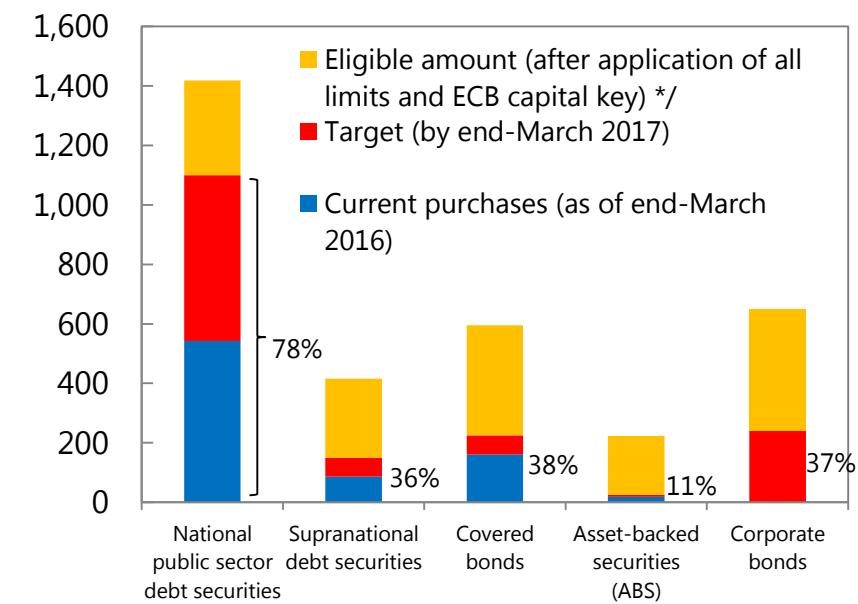
# MAINTAIN MONETARY ACCOMMODATION TO BOOST INFLATION...<sup>6</sup>

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



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).

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



Source: Bloomberg L.P., Dealogic, ECB, and IMF staff calculations. Note: \*/ The values are reported in nominal terms and take into account existing and planned purchases until March 2017 as well as issuer/issue limits (incl. SMP), and exclude government debt securities outside the eligible maturity range of between 2 and 30 years and securities trading below the deposit rate (as cap on the eligible market for each asset class); the amount is also reduced by further by the allocation of purchased based on the pro-rated ECB capital key (without Greece and Cyprus); \*\*/ includes sub-national and agency debt securities. For all securities, only the non-encumbered market was considered.

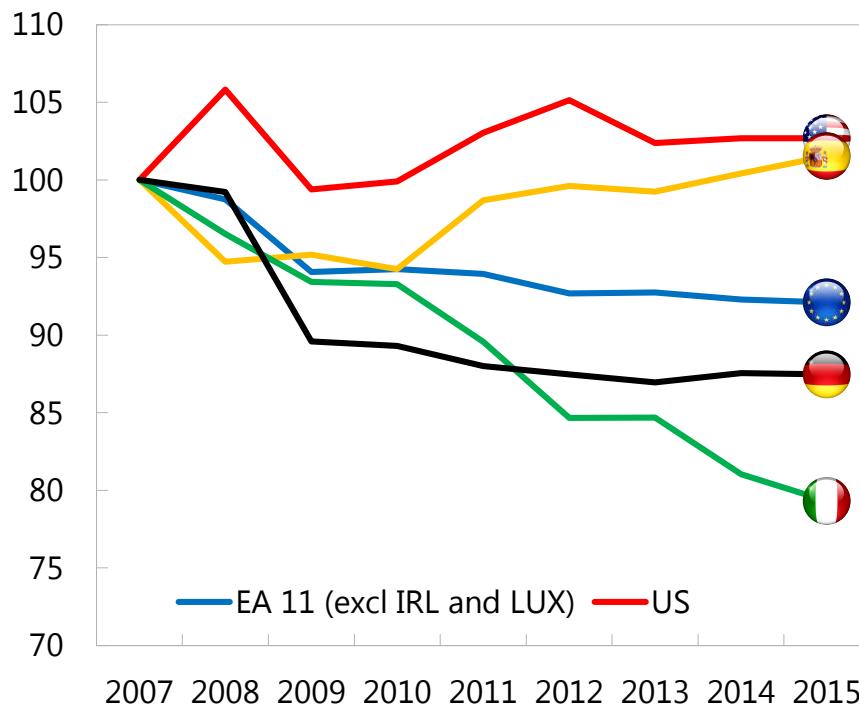
<sup>6</sup> "Negative Interest Rate Policy (NIRP): Implications for Monetary Transmission and Bank Profitability" 2016 IMF Euro Area Selected Issues Paper

# DEBATE: ARE STRUCTURAL REFORMS THE POLICY OF LAST RESORT?

# PERISTANT PRODUCTIVITY AND COMPETITIVENESS DIFFERENTIALS

Service Sector Productivity,: US and Euro Area

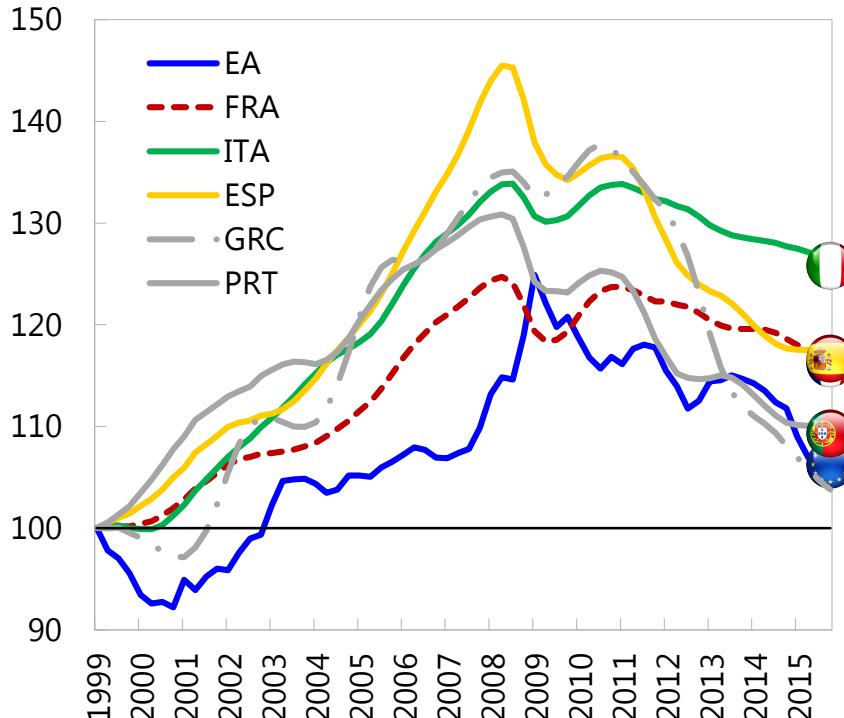
(Index 2007 = 100)



Source: Haver Analytics.

ULC-based REER vis-a-vis Germany

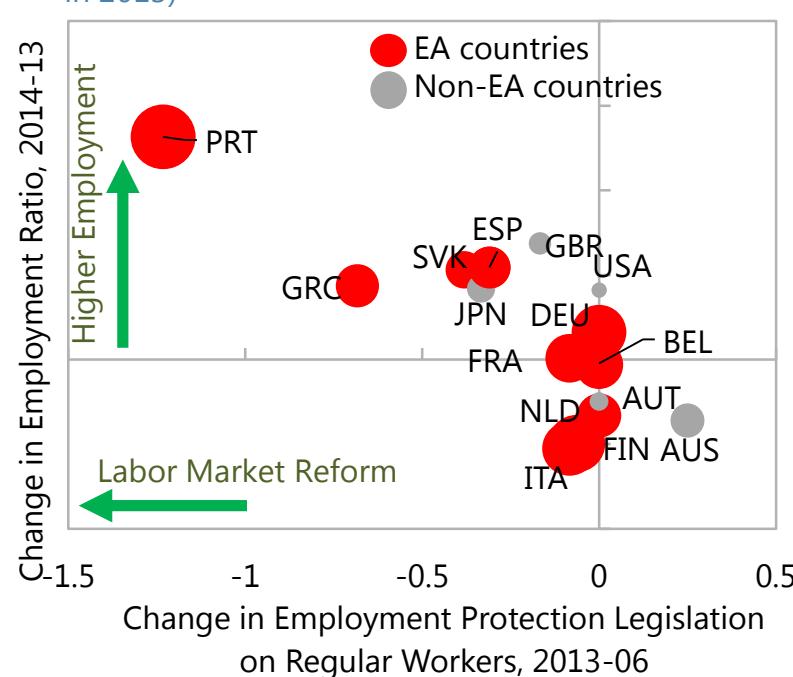
(Index, 1999Q1=100)



Source: Haver Analytics.

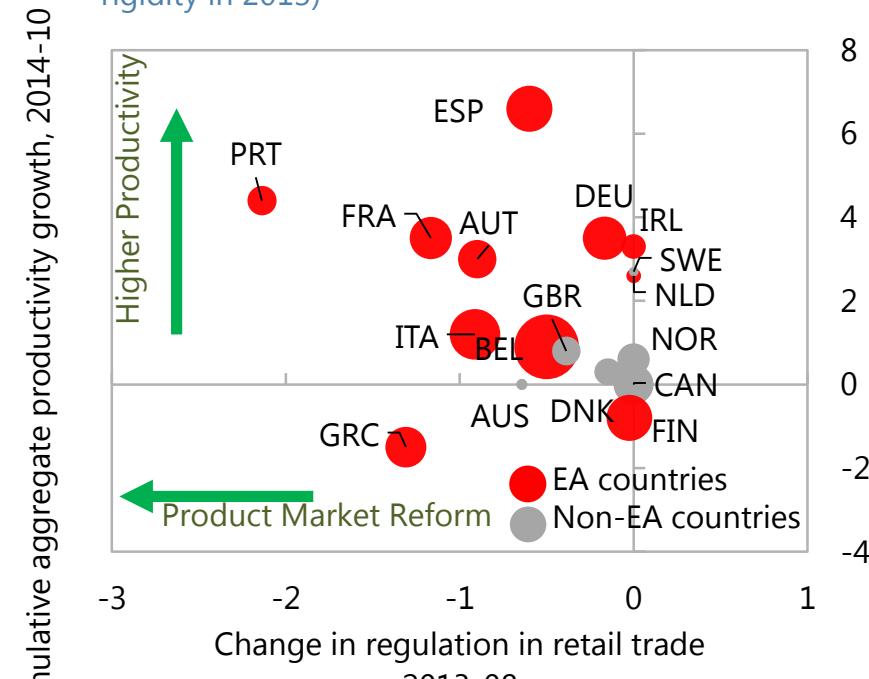
# INCENTIVIZE GROWTH-FRIENDLY STRUCTURAL REFORMS <sup>4</sup>

**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.

<sup>4</sup> "Building a Better Union: Incentivizing Structural Reforms in the Euro Area," IMF Working Paper 15/201, September 2015

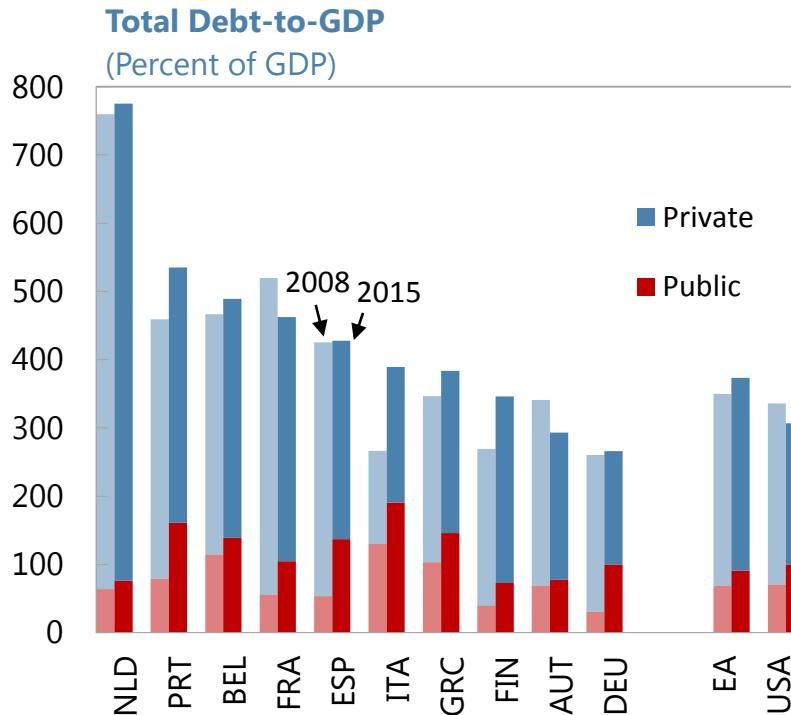
# DEBATE: IS A WEAK FINANCIAL SECTOR AN IMPEDIMENT TO GROWTH IN THE EURO AREA? (OR: WHAT FINANCIAL SECTOR POLICIES ARE NEEDED?)

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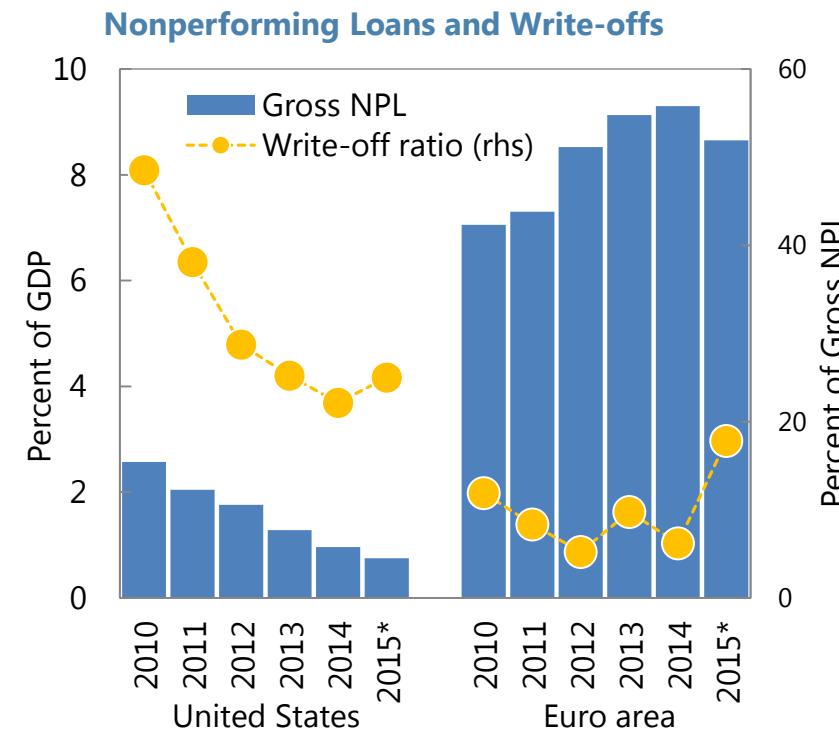
## PRIORITIES AND DELAYS

- 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...



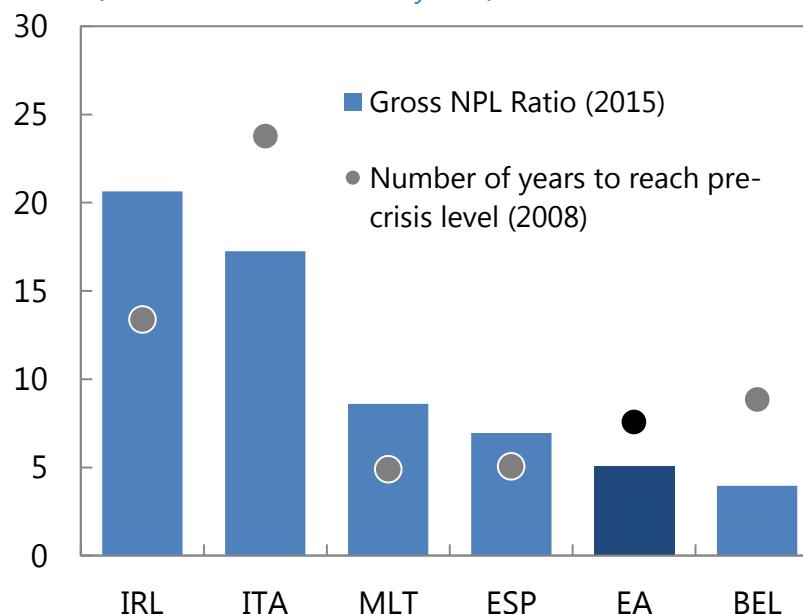
Source: Haver Analytics. Note: NPISHs = non-profit institutions serving households. EA financial corporate debt is non-consolidated.



Sources: Bloomberg, ECB, EBA Transparency Exercise (2015), U.S. Federal Reserve, IMF WEO, and IMF staff calculations. Note: \*/ as of end-Sept. 2015 for the United States and end-June 2015 for the Euro Area.

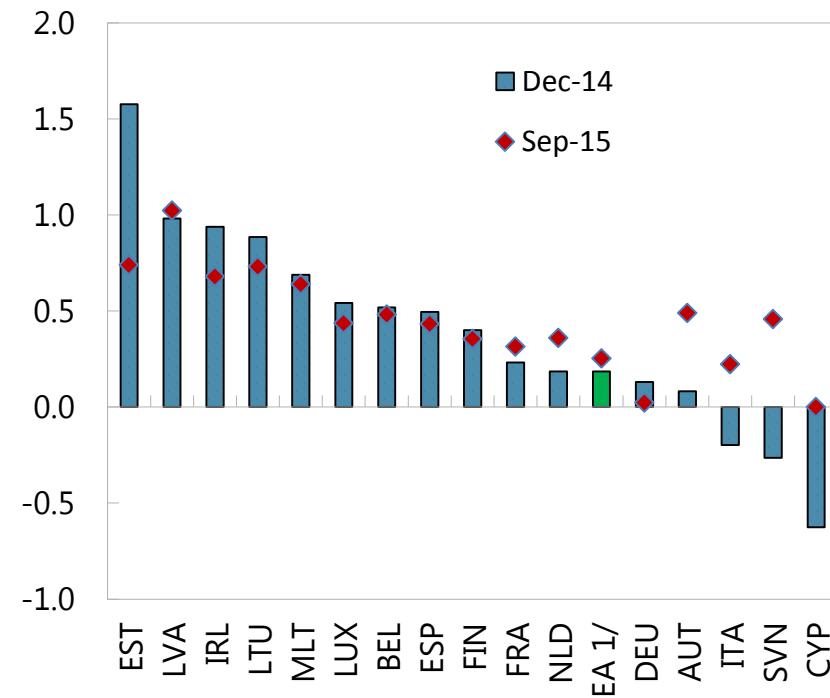
# ...AND REPAIR BANK BALANCE SHEETS AND COMPLETE BANKING UNION<sup>7</sup>

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



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.

<sup>7</sup> "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**

**Comprehensive, more  
balance mix**

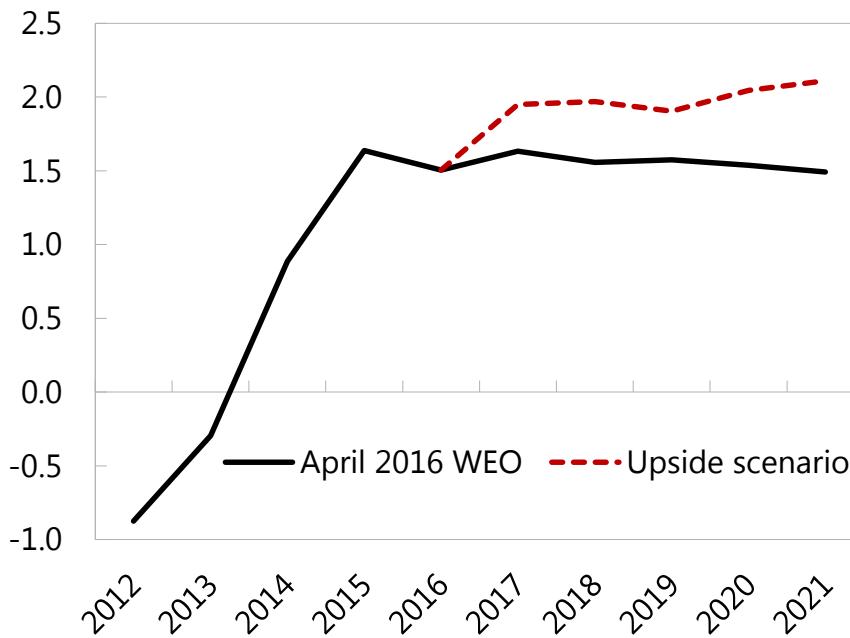
Accelerate **balance sheet repair** and complete the **banking union**

Continue **monetary policy accommodation**

# “THE WHOLE IS GREATER THAN THE SUM OF ITS PARTS...” 8

## Euro Area: GDP Growth Simulations

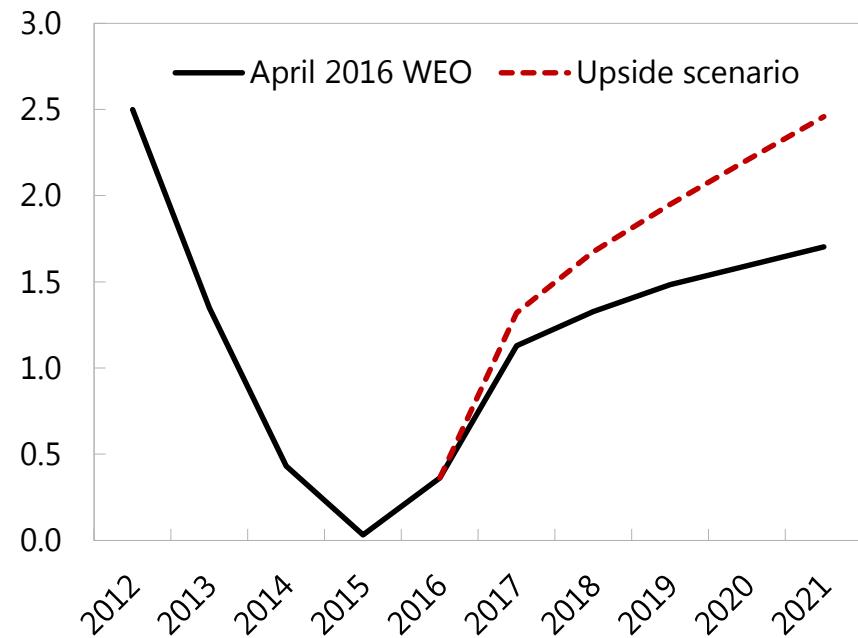
(Percent)



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

## Euro Area: Inflation Simulations

(Percent)



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

<sup>8</sup> “Comprehensive, Integrated Policies to Boost Euro Area Growth,” 2016 IMF Euro Area Selected Issues Paper

# DEBATE: WHAT ECONOMIC GOVERNANCE FRAMEWORK FOR THE EUROZONE?

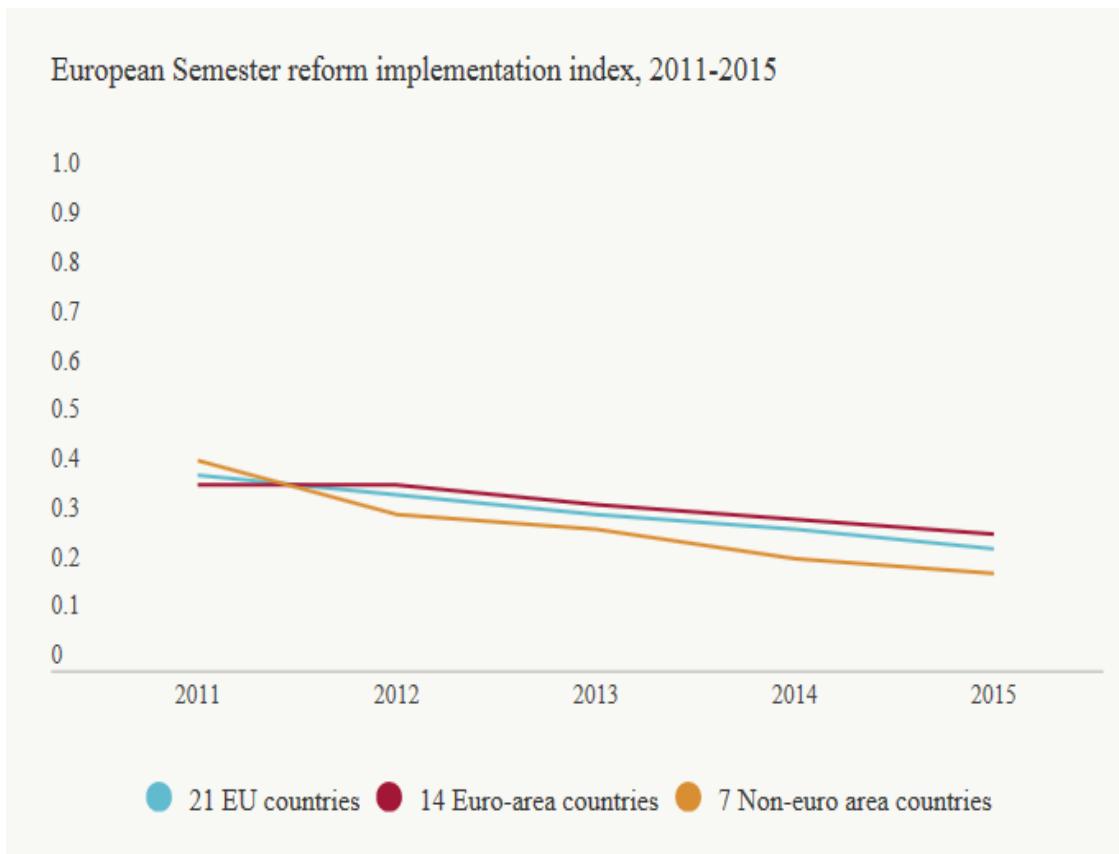
## Risks from the weak enforcement of common rules

- 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

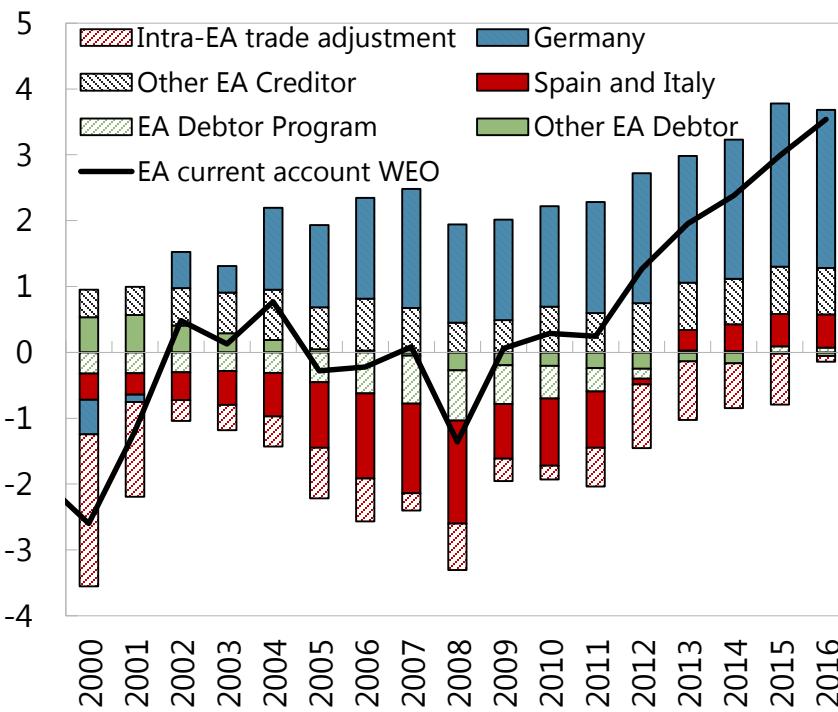


Sources: Darvas and Leandro (2016).

# ...IN THE CONTEXT OF UNBALANCED REGIONAL REBALANCING

## Current Account Composition

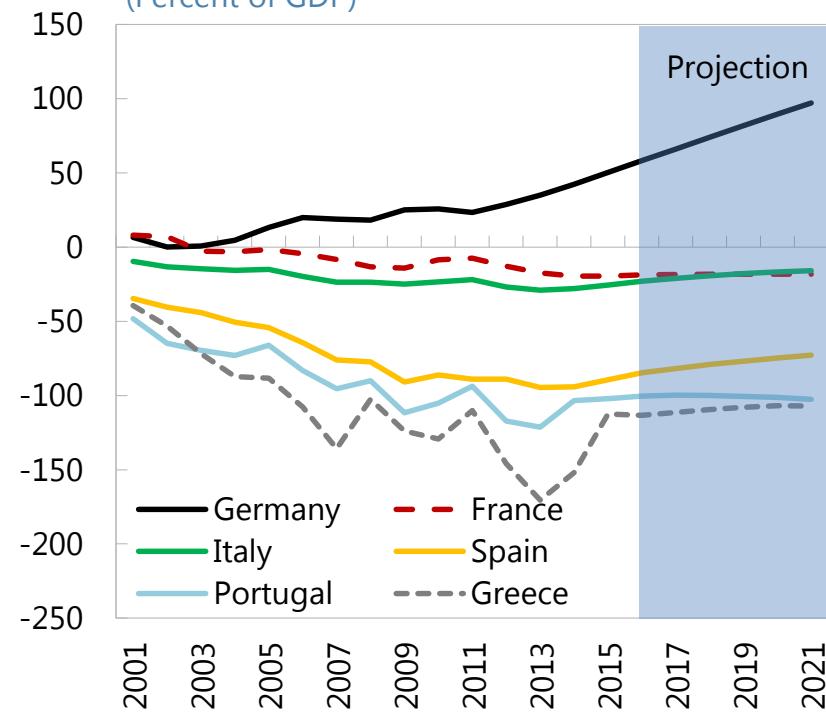
(Percent of euro area GDP) \*



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.

## Net Foreign Asset Position

(Percent of GDP)



Source: IMF, BOP Statistics.

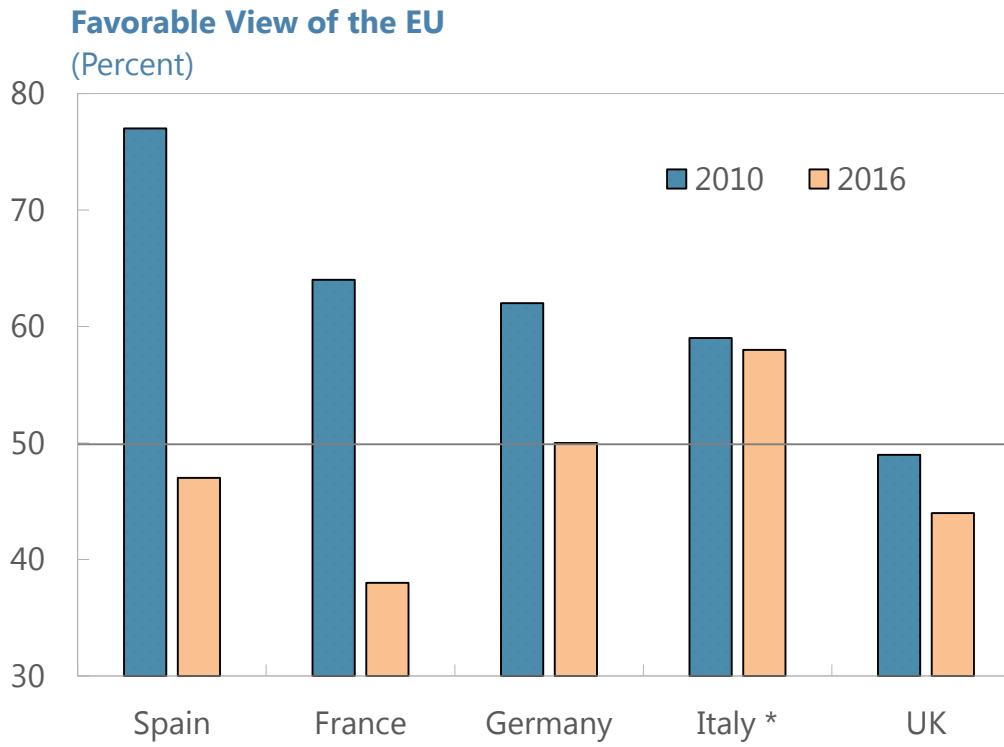
# DEBATE: WHAT ECONOMIC GOVERNANCE FRAMEWORK FOR THE EUROZONE?

- **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**



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A faint, light-gray world map serves as the background for the entire slide, showing the outlines of all major continents.

Thank you