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EURO AREA POLICIES

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2021 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

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 2021 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 February 4, 2022 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 February 4, 2022, following discussions that ended on November 5, 2021, 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 December 21, 2021.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for the Nordic-Baltic Constituency, on behalf of the euro area member states and the European community.

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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International Monetary Fund
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PRESS RELEASE

PR22/28

IMF Executive Board Concludes 2021 Discussions on Common Euro Area Policies with Member Countries

FOR IMMEDIATE RELEASE

Washington, DC – **February 7, 2022**: The Executive Board of the International Monetary Fund (IMF) concluded the 2021 discussions on common euro area policies with member countries.[1]

The euro area economy is recovering rapidly. After falling by about 6½ percent in 2020, euro area output has rebounded strongly since the second quarter of 2021 thanks to high vaccination levels, strong policy support, and increasing consumer and business adaptation to the pandemic, with real GDP having reached its pre-crisis level by the end of last year. Inflation accelerated in 2021, largely reflecting base effects from last year's low energy prices and transitory factors. Looking ahead, supply chain disruptions, elevated energy prices, and the resurgence of Covid-19 cases—including those related to the Omicron variant—are likely to pose near-term headwinds to growth. However, these factors are expected to dissipate over the course of 2022, and the robust recovery is set to continue on account of a strong labor market, the normalization of the households' savings rate, and the impulse provided by the Next Generation EU Plan. Upside inflation risks have increased. However, with temporary factors dissipating, inflation is projected to decline through 2022 and to remain below the ECB's 2-percent target in the medium term.

Uncertainty remains high and is largely tied to the evolution of the pandemic. As elsewhere, the ongoing wave of infections and renewed concerns about newer and more transmissible Covid-19 variants highlight the continuing risk that the pandemic poses to the recovery, especially if it were to be accompanied by decreased vaccine effectiveness or incomplete vaccination coverage. The ongoing phasing-out of policy support, a potential correction in real estate markets, or spillovers from a sharp slowdown outside Europe could also create headwinds. Conversely, faster-than-expected adjustment to Covid-19 would boost activity, while a material unwinding of large household savings could significantly increase consumption, and an effective implementation of the envisaged reforms and investments could also raise medium-term growth prospects. Rising geopolitical tensions pose a new downside risk to growth and an upside risk to inflation, although the precise impact will depend on how events and related policy responses unfold in the coming weeks.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. Staff hold separate annual discussions with the regional institutions responsible for common policies for the countries in four currency unions—the Euro-Area, the Eastern Caribbean Currency Union, the Central African Economic and Monetary Union, and the West African Economic and Monetary Union. For each of the currency unions, staff teams visit the regional institutions responsible for common policies in the currency union, collect economic and financial information, and discuss with officials the currency union's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis of discussion by the IMF Executive Board. Both staff's discussions with the regional institutions and the Board discussion of the annual staff report subsequently are considered an integral part of the Article IV consultation with each member.

Executive Board Assessment[2]

Directors commended the authorities' forceful economic policies, which, together with high vaccination levels and better adaptation to Covid-19, helped the euro area economy recover rapidly. Directors agreed that strong growth is set to continue, but also noted that uncertainty remains high and risks to the outlook remain dominated by pandemic dynamics and legacies.

Directors emphasized that fiscal policy should remain supportive, and, as the recovery takes hold, become increasingly targeted to support the vulnerable and limit scarring. They welcomed the approval of national Resilience and Recovery Plans and urged their rapid and high-quality implementation. Directors noted the debate on reforming the EU fiscal framework and agreed that a time-bound transitional arrangement could be desirable until the new rules become effective. They acknowledged that an expenditure growth rule with a debt anchor could be an attractive option for the new framework, and that an EU-level climate investment fund could complement the fiscal rules by creating scope for financing essential climate investments and realizing the potential for positive cross-border spillovers from carbon-mitigation efforts.

Directors observed that, despite rising near-term price pressures, inflation is expected to remain below target over the medium term. They generally concurred with the ECB's recent decision to maintain an accommodative monetary policy stance until its medium-term inflation target is met, while retaining flexibility to adjust course should elevated underlying inflation prove to be more durable than currently projected. Directors welcomed the conclusions of the ECB's strategy review, including an ambitious climate-related action plan.

Directors observed that, while the financial system appears resilient, bank supervisors need to ensure timely loss recognition and appropriate provisioning. They agreed that housing markets conditions warrant a more effective use of macroprudential policies in jurisdictions where real estate risks are higher. Continued progress on European financial architecture reforms and a faithful implementation of internationally agreed bank capital standards would help underpin global financial resilience and stability. Directors saw merit in establishing a single AML/CFT rulebook and making progress towards the harmonization of AML/CFT supervision.

Directors agreed that ambitious structural policies and sizable investments will be needed to increase euro area potential growth and support the digital and green transitions. In this context, they observed that the Next Generation EU provides a unique opportunity to make progress on these priorities. Labor market policies should focus on facilitating reallocation, including through programs for reskilling and upskilling of workers, and temporary and targeted subsidies. Improving the coverage of social safety nets by relying on progressivity and means-testing would help mitigate the impact on the vulnerable of structural economic shifts. Directors welcomed the EU's climate change mitigation agenda, together with the authorities' assurances that the design of any carbon border adjustment mechanism would be compatible with WTO rules.

Directors underscored that the emergence of the Omicron variant illustrated the criticality of continued EU efforts to ensure equitable global access to Covid-19 vaccines.

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[2] 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.

Euro Area: Main Economic Indicators

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Projections 1/					
Demand and Supply										
Real GDP	2.6	1.8	1.6	-6.4	5.2	3.9	2.5	1.7	1.6	1.4
Private consumption	1.8	1.5	1.3	-7.9	3.5	5.2	3.1	1.7	1.7	1.6
Public consumption	1.1	1.1	1.8	1.3	3.7	0.1	0.9	1.1	1.1	1.0
Gross fixed investment	3.9	3.1	6.7	-7.0	4.6	4.1	3.2	2.4	1.9	1.8
Final domestic demand	2.1	1.7	2.6	-5.8	3.8	3.8	2.6	1.7	1.6	1.5
Stockbuilding 2/	0.2	0.1	-0.1	-0.5	0.3	-0.1	0.0	0.0	0.0	0.0
Domestic demand	2.3	1.8	2.5	-6.2	4.0	3.7	2.6	1.7	1.6	1.5
Foreign balance 2/	0.4	0.1	-0.8	-0.3	1.3	0.4	0.0	0.1	0.0	0.0
Exports 3/	5.6	3.6	2.7	-9.1	9.9	6.2	4.6	3.8	3.4	3.2
Imports 3/	5.2	3.8	4.7	-9.1	7.7	5.9	5.0	4.0	3.7	3.5
Resource Utilization										
Potential GDP	1.5	1.4	1.4	-2.0	3.3	2.0	1.9	1.6	1.5	1.4
Output gap	-0.6	-0.1	0.1	-4.3	-2.6	-0.7	-0.1	0.0	0.1	0.1
Employment	1.6	1.6	1.3	-1.5	0.8	1.2	0.6	0.3	0.2	0.1
Unemployment rate 4/	9.1	8.2	7.6	7.9	7.8	7.5	7.3	7.2	7.1	7.0
Prices										
GDP deflator	1.1	1.5	1.7	1.6	1.7	2.3	1.8	1.8	1.8	1.8
Consumer prices	1.5	1.8	1.2	0.3	2.6	3.0	1.7	1.8	1.8	1.8
Public Finance (percent of GDP)										
Overall fiscal balance	-0.9	-0.4	-0.6	-7.2	-6.3	-3.8	-2.4	-1.9	-1.6	-1.5
Primary balance	0.8	1.2	0.8	-5.9	-5.1	-2.7	-1.4	-0.9	-0.7	-0.6
Structural balance	-0.5	-0.3	-0.5	-4.6	-4.7	-3.3	-2.3	-1.9	-1.7	-1.6
Structural primary balance	1.3	1.3	0.9	-3.3	-3.5	-2.2	-1.3	-1.0	-0.7	-0.7
Gross public debt	87.5	85.5	83.6	97.3	97.4	95.1	93.5	92.4	91.1	89.9
External Sector 5/, 6/										
Current account balance	3.2	2.9	2.3	1.9	2.9	2.8	3.0	2.9	2.8	2.8
Interest Rates (end of period) 4/, 7/										
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	-0.6	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	-0.1	0.3	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.18	1.14	1.11	1.22	1.13	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	114.6	111.0	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.3	85.5	84.0	87.3	82.0	...	...	...	...	...

Sources: IMF, *World Economic Outlook,* Global Data Source; Reuters Group; and Eurostat.
1/ Projections are based on aggregation of January 2022 *WEO* projections submitted by IMF country teams.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2021.

EURO AREA POLICIES

December 21, 2021

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES

KEY ISSUES

Following a deep recession in 2020 and further contraction in 2021Q1, the euro area economy recovered rapidly in the second and third quarters thanks to high vaccination levels, increasing household and business adaptability to the virus, and continued forceful policy support. Looking ahead, while supply chain disruptions, elevated energy prices, and resurgences of Covid-19 cases—including those related to the Omicron variant—are likely to pose near-term headwinds to growth, the recovery is set to continue in 2022 as the impact of the pandemic on economic activity continues to weaken over time and supply-side constraints ease. Medium-term output losses relative to pre-crisis trends will vary significantly across countries and sectors as will the extent of labor market scarring. Price pressures are building up as production bottlenecks are set to persist for a while. However, inflation—despite increasing significantly in recent months due to transitory factors—is projected to moderate during 2022 and remain below the ECB's inflation target over the medium term. Uncertainty surrounding the outlook remains high and largely related to pandemic dynamics and legacies, including induced behavioral and preference changes.

The key policy challenge is to sustain the recovery in the face of still elevated uncertainty surrounding pandemic dynamics and legacies. This will necessitate policy agility to adjust course as needed, with a focus on containing economic scarring—including by facilitating a smooth reallocation of resources towards growing firms and industries—and protecting the vulnerable. Addressing longstanding structural gaps and investing in climate-friendly infrastructure and digitalization will be needed to enhance resilience and lift potential growth. Given the diversity of conditions across the euro area, part of the challenge will be allowing for sufficient flexibility in policies across countries while maintaining the strictures of euro area policy rules.

Key Policy Recommendations

- Under staff's baseline, monetary policy will need to remain highly accommodative for an extended period to durably lift inflation to the ECB's new symmetric inflation target of 2 percent, potentially calling for additional asset purchases in 2023 and beyond. In this scenario, the ECB should ensure that its self-imposed limits on asset purchases do not unduly constrain monetary policy operations. Risks of large second-round effects from currently elevated headline inflation appear limited for now, but given the uncharted territory of this pandemic, the ECB should stand ready—and is well equipped—to scale down unconventional measures and adjust policy rates early if evidence of inflation durably overshooting its target materializes. The ECB's Governing Council decided in December to end net purchases under the Pandemic Emergency Purchase Program in March 2022 while overall gradually reducing asset purchases in 2022. They underscored flexibility to adjust course as needed given the heightened uncertainty, which is appropriate.

- Fiscal policy should remain supportive to sustain the recovery and limit scarring, but the focus can now begin shifting toward more targeted interventions, especially as strengthening consumption and labor markets imply less demand for more broad-based assistance. Once the expansion phase is firmly in train, high-debt countries in particular will need to steadily rebuild fiscal buffers. Credible fiscal consolidation strategies should be put forward now. Spending from Next Generation EU grants can alleviate the impact of national fiscal consolidation on growth, while better targeted transfers can help reallocate resources. The current EU fiscal framework should be reformed to make it more efficient and better at preventing debt distress, while allowing for macroeconomic stabilization during downturns. A common fund would help meet the EU's climate investment needs. To allow time for deep consultation across EU countries, a transitional arrangement might be needed to avoid the unrealistic adjustments that would be mandated under the current rules given high public debt.

- Structural polices should facilitate pandemic-induced reallocation of labor and capital while protecting the vulnerable. Job retention schemes should continue to be gradually phased out as activity firms. Training to reskill and upskill workers along with temporary and targeted use of hiring subsidies and wage loss insurance would pave the way for job creation, given lingering uncertainty among potential employers. Improving the coverage of social safety nets in a progressive and means-tested manner would help mitigate the pandemic's impact on the vulnerable. More broadly, difficulties in managing structural transformations indicated a fundamental rethink of labor policies was called for even before the pandemic, and this need has only become more urgent. Recovery and Resilience Plans should support better coordination of national and EU-level policies, help achieve EU green objectives, and boost resilience and growth.

- Financial sector policies require a fine balancing act to allow an unwinding of support measures while ensuring the flow of credit to the economy. As the recovery proceeds, prudential standards can be normalized gradually, in accordance with pre-announced timelines. Supervisors should continue their efforts to achieve timely bank loss recognition and appropriate provisioning. Some euro area national authorities need to tighten their macroprudential stances to ensure resilience in the face of stretched asset valuations, especially in real estate markets. Efforts to address administrative constraints and establish fast-track procedures for debt restructuring would strengthen insolvency and bankruptcy frameworks. A renewed effort to advance architecture reforms, including by completing the banking and capital market unions, is essential to strengthening the euro area financial system's efficiency and resilience.

- On the vaccine and trade front, the EU should continue efforts to ensure global equitable access to Covid-19 vaccines, while engaging with major partners to strengthen the multinational trading system and address underlying sources of global trade tensions and investment distortions.

Approved By
Alfred Kammer (EUR) and Jeromin Zettelmeyer (SPR)

Discussions took place by video conference during October 20–November 5, 2021. Mission members included P. Gerson (head), R. Balakrishnan, B. Barkbu, N. Klein, T. McGregor, V. Nguyen, L. Ratnovski, A. Santos, A. Shahmoradi, N. Suphaphiphat, and F. Toscani (all EUR), joined by A. Bhatia, N. Arnold, N. Belhocine, J. Frie, and L. Rabier (all EUO). Executive Director, M. Pösö, and his advisor, I. Valdés Fernández, and R. Rüffer, ECB observer at the IMF, participated the meetings. S. Domit (EUR), A. Hodge (WHD), Z. Jakab, J. Linde (both MCM), N. O'Hanlon, and Z. Zahn (both STA) contributed to the report. M. Maneely, E. Cohn Bech, and C. Rubio (all EUR) supported the mission.

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