The eurozone: what’s next?

The current recovery in the eurozone is an opportunity to lay the foundations for a more resilient euro area, Poul Thomsen asserts

I will take the opportunity to share with you our view on some of the key issues facing the eurozone at this time. The economic news from the eurozone is very encouraging. Quarterly growth has been positive for the last 17 quarters. Like others, we have underestimated the strength of the recovery, and will soon again revise up our projection for 2017. In June, we projected growth to reach 1.9 percent, but this is now clearly too low. The ECB recently raised its projection for 2017 to 2.2 percent. I would expect our own estimate, which will be finalized shortly, to be close to that.

Important for the robustness of the recovery, investment is now playing a stronger role. Real investment, excluding construction, has surpassed its pre-crisis level. But most encouraging is the fact that the recovery is broad-based. All euro area countries are growing above trend and unemployment is declining. Looking at our measure for the dispersion of growth rates across member states, this is the most evenly distributed recovery for more than two decades.

European policymakers deserve much credit for this sustained upswing. You will obviously not have forgotten that it is not so long ago that a severe economic crisis raised existential questions about the viability of the eurozone—about its architecture and about the determination of policymakers to do what is needed. The ECB's very proactive accommodating policies above all, but also the creation of firewalls and the building of the banking union, among other architectural improvements, have been key to the recovery in confidence that is underlying the broader recovery.

Looking forward, let me make my main point upfront: the current recovery is an important opportunity to strengthen the resilience and growth potential of the currency union. Specifically, the main task facing policymakers at this juncture is to gradually rebuild fiscal buffers and push ahead with structural reforms—mainly at the national level—to improve productivity and raise potential output.

The challenge will be to avoid yielding to complacency—and not to waste the recovery. While policymakers have shown their resolve during the difficult times to do what is needed, complacency during good times has unfortunately also been a recurrent feature of European policy making in the past.

Let me be very explicit: the eurozone's ability to prevent major procyclical tightening when the next shock hits will critically depend on whether the right policy choices are made during the ongoing recovery. To understand the ur-

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gency, remember that there are seven countries in the eurozone, among them several large ones, with public debt near or above hundred percent of GDP, suggesting that policy buffers to deal with significant future shocks are very limited. And with structural unemployment still high in many countries, there is clearly a risk that future adverse shocks could cause significant political and social tensions unless policymakers take steps now to increase their future room for maneuver.

So what are the priorities?

Let me start with monetary policy. As mentioned, our estimates suggest that the output gap for the euro area as a whole is closing fast. Unemployment is down to 9 percent, of which we estimate only one percentage point to be cyclical. However, despite the improvements in labor markets, wage pressures are weak, and core inflation is inching up only very slowly. Our own projections suggest that inflation in the euro area would reach 1.9% only by 2021.

This clearly suggests that the ECB needs to maintain an accommodative policy stance for the foreseeable future. Its unconventional measures have been critical to averting deflation risks and getting the recovery going. At some stage, the ECB will have to slowly begin unwinding these measures, but this does not mean that it would have to stop its accommodative stance anytime soon.

One concern in this regard is premature pressures on the ECB to begin the normalization of monetary policy. In particular, for the ECB to reach its medium-term inflation objective of close to 2 percent for the eurozone as a whole, it is inevitable that countries with the strongest cyclical position at this juncture accept that their inflation rate will have to rise above this objective for some time.

From the perspective of investors, I would take comfort from the fact that the ECB has been clear about its resolve to maintain the accommodating stance as long as necessary.

Let me turn next to fiscal policy. Fiscal policies in euro area countries have had to strike a delicate balancing act in recent years. On the one hand, they had to restore confidence that fiscal policy would bring about a decline in public debt, which had shot up during the crisis. On the other hand, fiscal adjustment had to be sufficiently gradual to avoid choking the nascent recovery.

In this context, Europe's fiscal governance framework, complex and imperfect as it is, has provided an important anchor. Budget deficits have come down significantly since the crisis. That said, progress on fiscal consolidation has slowed in several countries where debt remains very high despite accelerating growth. Given the strength of the recovery and the interest savings from accommodative monetary policy, there is a concern that the countries with the least fiscal space are not using this window of opportunity sufficiently for rebuilding their fiscal buffers, leaving them vulnerable to potentially difficult adjustments when economic conditions deteriorate.

So, what are we advising?

First, with growth recovering quite strongly and output gaps narrowing fast, now is the time to rebuild fiscal space and place public debt on a firm downward trajectory. Gradual fiscal consolidation would help ensure that, when the next adverse shock hits, the eurozone is on a stronger footing and has the necessary buffers.

Second, we still see significant scope for rebalancing fiscal policy to become more growth friendly, including in countries that have some way to go in terms of fiscal consolidation. Making public spending more efficient and growth-oriented, while making the tax system more supportive of job creation and productivity growth, would further strengthen the recovery and raise the medium-term growth potential.

Let me next turn to the need for structural reforms to boost productivity in individual member states. The metrics developed by the Commission to monitor changes in this area show almost universally that there has been only very limited progress in recent years. This is the one area where the news is still not good enough. I shall not go in to what precisely is needed to raise productivity as this differs considerably from member state to member state, and the problems are generally well understood by policymakers.

In this regard, we welcome proposals to improve the eurozone's fiscal governance framework in a way that would incentivize support for productivity boosting reforms at the national level. But the main challenge remains the ability of policy makers to overcome fierce and entrenched resistance from vested interests at the national level.

To illustrate the importance of overcoming such resistance, consider the following discouraging picture of the development in GDP per capita for the original twelve eurozone members: before they adopted the euro, there was steady convergence, as countries with lower GDP per capita were growing faster than those with a higher GDP per capita. This is what you would want to see. But from around the time of euro adoption, convergence stopped. And since the crisis, we have actually seen divergence. That is, the countries with lower per capita GDP have fallen further behind.

The persistent productivity gaps is the root cause of the high structural unemployment and the particularly high youth unemployment in a number of countries. In the long-run, this is obviously politically unsustainable. Reforms to boost productivity remains the overarching challenge facing eurozone policy makers.

Finally, let me turn to the question about changes to the eurozone architecture. Polls show that support for the euro in member countries is at the highest level in more than a decade. Moreover, many national policymakers are more supportive of further integration, as exemplified by the recent speech by French President Emmanuel Macron and the encouraging dialogue between Germany and France.

To some extent, this is a reaction to Brexit and other external developments that are seen as a challenge to the integrity of the European Union, and not least the eurozone. As we have seen in the past, the sense of crisis has often catalyzed political support for further integration in Europe. Whatever the reason, the renewed impetus for reforms is very good news, coming only a few years after the eurozone was in the grip of widespread existential angst.

A few remarks about the priorities for architectural reforms. First, while much progress has been made already, there is still some way to go to complete the banking union. To create a truly integrated banking market, the Single Supervisory Mechanism and the Single Resolution Mechanism need to be accompanied by a common deposit insurance and a common fiscal backstop. But we also recognize that increased risk sharing must go hand-in-hand with risk reduction and a solution to legacy problems, including through an uncompromising approach to resolving problem banks. Closely related is the issue of advancing capital markets union. I think that these issues are well understood.

Let me also briefly comment on two architectural issues that have received much attention recently—the question of the creation of a eurozone budget and a European Monetary Fund.

We have argued for a number of years that a Central Fiscal Capacity would help improve the euro area's ability to offset shocks by alleviating fiscal space constraints in downturns and building buffers in good times. This could potentially be an element of an eventual common euro area budget if member states decide to move in this direction.

Similarly, there is a case to be made for a 'European Monetary Fund' in order to strengthen crisis prevention and crisis management. One critical issue is of course the role of such a fund relative to the existing European institutions. This is for European policymakers to decide. Ultimately, the success of a European Monetary Fund will critically depend on its ability to overcome some of the problems that have marred the fiscal governance framework in the past, not least its ability to demonstrate that it is robust to undue political interference. From the IMF's perspective, we have a long history of working cooperatively with regional financial institutions, including with the ESM.

The boldness and ambitions of such architectural reforms will undoubtedly be tempered by the concerns that prevail among some member states about moral hazard problems, that is concern about potential disincentives to pursue the necessary policies at the national if policies are not subject to national budget constraints.

Thus, the defining feature of the eurozone, and also the root cause of many of the problems we have seen during the last decade, is the fact that it is not a political union, which inevitably means that progress will remain gradual and evolutionary, involving difficult political compromises. The reforms might end up underwhelming those of you who compare European decision-making to what you are used to in much more homogenous political unions. But I would caution against setting the bar too high and about mistaking a slow incremental approach for a lack of a basic commitment to continued integration. I certainly think that there is now a climate in Europe where we stand a better chance of making meaningful progress than what we have seen for a very long time.

This being said, and here I am coming back to my central message, I want to reiterate that it is crucial that national policy makers do not defer critical measures during good times in the expectation that the changes to the architecture will significantly mitigate the next adverse shock. Whatever these changes will be, they will not be on a scale to alter the basic fact that for the foreseeable future the ability of individual member countries to weather shocks will continue to depend overwhelmingly on policies at the national level. Again: for countries with relatively limited fiscal space and modest potential growth, the ability to avoid a major pro-cyclical tightening in the face of a major adverse shock will depend on the buffers they build during the current recovery phase, both through fiscal adjustment and structural reforms.

In conclusion, the outlook for the eurozone has improved significantly. This is an opportunity to lay the foundations—both at the national and central level—for a more resilient eurozone. While the challenges ahead are still formidable, we have good reasons for being much more optimistic about the future. ■

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Based on a speech at the Financial Times Investment Management Summit, London, September 28, 2017