

2013 Article IV Consultation with the Euro Area
Concluding Statement of IMF Mission
July 8, 2013

Policy actions over the past year have addressed important tail risks and stabilized financial markets. But growth remains weak and unemployment is at a record high. Concerted policy actions to restore financial sector health and complete the banking union are essential to reverse financial fragmentation along national borders and support the recovery. While these efforts proceed, continued demand support in the near term and deeper structural reforms throughout the euro area remain instrumental to raise growth and create jobs.

1. **Important actions at both the national and euro-wide levels have tackled the immediate threats to the single currency evident at this time last year.** The ECB's Outright Monetary Transactions framework helped address severe market distortions and improve the efficiency of monetary policy. The completion of the ESM firewall, the extension of official loan maturities to program countries, the improvement in the policy coordination framework, and the agreements on Greece and Cyprus have also been instrumental in combating the crisis. And national governments have made progress in restoring the health of public finances and implementing structural reforms. Together, these actions have helped tackle dangerous tail risks for EMU and led to positive spillovers outside the euro area.
2. **Nevertheless, the centrifugal forces across the euro area remain serious and are pulling down growth everywhere.** Financial markets are still fragmented along national borders and the cost of borrowing for the private sector is high in the periphery, particularly for smaller enterprises. Ailing banks continue to hold back the flow of credit. In the face of high private debt and continued uncertainty, households and firms are postponing spending—previously, this was mainly a problem of the periphery but uncertainty over the adequacy and timing of the policy response is now making itself felt in falling demand in the core as well. Needed fiscal consolidation is also weighing on growth. And with unemployment, especially among the youth—at record levels, there is a risk of long-term damage to potential growth and to political support for reforms, including for further progress on EMU architecture.
3. **In this setting, reviving growth and employment is imperative.** This requires actions on multiple fronts—repairing banks' balance sheets, making further progress on banking union, supporting demand, and advancing structural reforms. These actions would be mutually reinforcing: measures to improve credit conditions in the periphery would boost investment and job creation in new productive sectors, which in turn would help restore competitiveness and raise growth in these economies. A piecemeal approach, on the other hand, could further undermine confidence and leave the euro area vulnerable to renewed stress.

Task #1: repair bank balance sheets to revive credit

4. **Stronger bank balance sheets are essential for economic recovery.** Faced with high funding costs, weak banks are unable to recognize losses. This perpetuates uncertainty about the quality of their assets, hinders fresh private capital injections, and ultimately restrains credit. To reverse these dynamics, bank losses need to be fully recognized, frail but viable banks recapitalized, and non-viable banks closed or restructured.

5. **A credible assessment of bank balance sheets is necessary to lift confidence in the euro area financial system.** A comprehensive, forward-looking *asset quality review* should quantify any capital shortfalls, but with a clear plan on how to meet potential capital requirements. A *credible backstop* is also essential to prevent pre-emptive deleveraging. Where private capital is insufficient, support from the public sector will be needed if fiscal space is available. In some cases, the ESM will need to be the effective backstop. It is therefore essential that the framework for direct ESM recapitalization be finalized by the time the asset quality review is conducted. Equally important, the involvement of an *independent third party* would ensure the transparency and credibility of the exercise.

Task #2: move to full banking union to reverse fragmentation

6. **Full banking union is necessary to reduce financial fragmentation.** This would introduce a systematic approach to supervision and incentives for early intervention in frail banks; halt ring fencing at the national level, and weaken bank-sovereign links.

7. **This calls for expediting the reforms in train.** The recent agreement by the European Council on the Bank Recovery and Resolution Directive (BRRD) helpfully lays out the pecking order in the event of bank intervention. The next steps on the agenda include: adopting the enabling legislation for the Single Supervisory Mechanism, reaching final agreement by the European Parliament on the BRRD, and making progress on the Deposit Guarantee Scheme Directive.

8. **A strong single resolution mechanism is critical to ensure timely and least-cost resolution of banks.** The goal should be a centralized authority with power to trigger resolution and make decisions on burden sharing. By contrast, compromise solutions that leave resolution at the national level while supervision is centralized carry significant risks, including of perpetuating bank-sovereign links and potential conflict between national supervisors in cross-border resolution.

9. **More support from the ECB could also help reduce fragmentation.** While monetary policy alone cannot address underlying weaknesses in bank balance sheets, it can provide additional funding to avert a further contraction in credit until the more comprehensive actions to restore banking system health take hold. The ECB could build on existing instruments—such as a new LTRO of longer tenor coupled with a review of current collateral policies, particularly on loans to small and medium-sized enterprises (SME)—or undertake a targeted LTRO specifically linked to new SME lending. Consideration could also be given to direct purchase of specific private assets, when efforts to expand the securitized asset market are more advanced.

Task #3: provide sufficient near-term support

10. **Given weak growth and subdued inflation, more monetary easing will likely be necessary to support demand.** Further policy rate cuts, including negative deposit rates, would support demand across the euro area and address deflationary pressures. The ECB can also provide more explicit forward guidance to anchor interest rate expectations. This may now be even more necessary because of market uncertainty about the exit from unconventional monetary policies in the United States.

11. **The recent extension for some countries to meet deficit targets will moderate the downdraft from fiscal consolidation on growth but more flexibility may be needed.** Current targets could still prove ambitious if growth disappoints. Further flexibility may be necessary in some cases, especially if that space is used to implement deeper structural reforms or to recapitalize viable banks. However, given the still-high debt levels, fiscal adjustment efforts should be anchored by a credible medium-term fiscal framework.

Task #4: implement structural reforms to lift growth and foster rebalancing

12. **The unfinished agenda here is large—but also promising.**

- *For the euro area as a whole*, a targeted implementation of the Services Directive would remove barriers to protected professions, promote cross-border competition, and, ultimately, raise productivity and incomes. A new round of free trade agreements could provide a much-needed push to improve services productivity. In addition, further support for credit and investment could be achieved through EIB facilities. The securitization schemes proposed by the European Commission and the European Investment Bank could also underpin SME lending and capital market development.
- *At the national level*, labor market rigidities should be tackled to raise participation, address duality—which disproportionately hurts younger workers—and, where necessary, promote more flexible bargaining arrangements. At the same time, lowering regulatory barriers to entry and exit of firms and tackling vested interests in the product markets throughout the euro area would support competitiveness, as it would deliver a shift of resources to export sectors. Progress here would also raise purchasing power and support rebalancing. In surplus countries, many of the reforms aimed at increasing productivity in the non-tradable sector could improve incomes and lead to higher external demand, including for deficit countries.

13. **The challenge to boost growth and create jobs calls for concerted policy action at the pan-European and national levels.** The benefits of a comprehensive reform effort—tackling financial fragmentation and structural weaknesses—could be significant over the medium term, and have positive spillovers. They would raise the level of euro area and global output, respectively, by about 3 percent and 1 percent within five years.