2014 Article IV Consultation with the Euro Area
Concluding Statement of the IMF Mission

1. **The euro area recovery is taking hold.** Real activity has expanded for four consecutive quarters. An incipient revival in domestic demand is adding to the impetus from net exports. Financial market sentiment has improved dramatically, particularly after the recent ECB measures. Sovereign and corporate yields are now at historic lows in many countries, and lower funding costs have helped banks raise more capital.

2. **Strong policy actions have boosted investor confidence and laid the foundations for recovery.** At the national level, governments have made progress in repairing sovereign and bank balance sheets and pursuing structural reforms to restore competitiveness. At the area-wide level, policy makers have demonstrated collective commitment to the EMU, for example, through progress on building a banking union. And the ECB has taken a wide range of measures to support demand and address fragmentation. The ECB's Comprehensive Balance Sheet Assessment to be completed later this year is encouraging recapitalization and helping boost confidence in the banking system.

3. **But the recovery is neither robust nor sufficiently strong.**

- *Activity and investment have yet to reach pre-crisis levels*. The recovery of private investment has been weaker than in most previous recessions and financial crises. In the first quarter of 2014, growth was weaker than expected and unevenly distributed across countries.

- *Balance sheets are still impaired and debt levels elevated*. Public debt levels remain high. Weakness in banks' balance sheets inhibits the flow of credit and corporate and household debt overhangs impede demand.

- *Inflation is worryingly low, including in the core countries*. By keeping real interest rates and real debt burdens elevated, very low inflation stifles demand and growth. It also makes difficult the adjustment in relative prices and real wages that must occur for sustainable growth to take hold.

- *Unemployment, especially among the youth, is unacceptably high.* The average rate for the euro area is around 12 percent. Youth unemployment is even more elevated, averaging close to 25 percent. High unemployment erodes skills and human capital, inflicting permanent damage on the capacity of economies to grow.

4. **Much higher growth is needed to bring down unemployment and debt**. With the benign market environment, now is the time to implement reforms to increase growth. Policy efforts should focus on three areas: (1) demand support; (2) balance sheet repair and completion of the banking union; and (3) the advancement of structural reforms.

Providing more demand support

5. **The ECB's recent actions signal its determination to address low, below-target inflation and fulfill its mandate**. Collectively, the wide range of measures should lead to a substantial expansion of liquidity. The provision of targeted term funding for banks should encourage credit growth in stressed economies.

6. **The ECB's willingness to do more, if necessary, is reassuring.** If inflation remains stubbornly low, the ECB should consider a large-scale asset purchase program, primarily of sovereign assets according to the ECB's capital key. This would boost confidence, improve corporate and household balance sheets, and stimulate bank lending. Overall, it holds the potential to have a significant impact on demand and inflation.

7. **After several years of consolidation, the overall fiscal stance for the euro area is close to neutral**. This strikes the right balance between demand support and debt reduction. But large negative growth surprises should not trigger additional consolidation efforts.

Mending balance sheets and completing the banking union

8. **Progress on the ECB's Comprehensive Assessment has been encouraging**. Banks have already raised substantial capital in anticipation of the results of the Asset Quality Review (AQR) and associated stress tests. The ambitious timetable for recapitalization of banks should be feasible given markedly improved market conditions. The ECB should continue to urge banks to be proactive in raising capital.

9. **There has been substantial progress towards a more complete banking union.** The transition to a single supervisor—the Single Supervisory Mechanism (SSM)—will facilitate cross-border liquidity provision, thereby reducing fragmentation. Single Resolution Mechanism (SRM) decision-making procedures have been simplified. And, the timetable for mutualization of the Single Resolution Fund (SRF) has been shortened.

10. **Work needs to continue to establish a common backstop to sever effectively sovereign-bank links**. The current planned backstop may prove insufficient to break decisively bank-sovereign links. While the proposal for ESM direct recapitalization is a step in the right direction, as currently envisaged, the thresholds for such support are too high. Overall, centralized resolution resources may not be sufficient to handle stress in large banks.

11. **Working out the corporate debt overhang would help spur investment**. Many countries have taken steps to reform their insolvency regimes. These efforts need to continue, together with progress on harmonizing national insolvency frameworks. Measures should also be taken to facilitate out-of-court settlements, reduce impediments to debt restructuring, and introduce guidance on resolution procedures in line with international best practices.

Advancing structural reforms

12. **More structural reforms will be necessary to revive investment, employment, and productivity, as well as to reduce imbalances.**

- To this end, national reforms to improve *labor market functioning* and increase *competition in product and service sectors* need to progress further. These would be helped by efforts at the euro area level to implement the Services Directive, negotiate free trade agreements, and further integrate *energy markets* to mitigate possible disruptions in global commodity markets due to geopolitical events.

- Further policy efforts in both creditor and debtor economies are necessary to ensure that *intra-euro area imbalances* do not re-emerge as the recovery takes hold. In particular, higher infrastructure investment in creditor economies and further strides in improving competitiveness in debtor economies would be needed.

13. **A comprehensive strategy to tackle youth unemployment requires measures to boost growth and remove country-specific structural impediments.** Specifically, reducing the tax wedge could lower hiring costs. Bringing minimum wages more in line with average labor costs would avoid pricing the youth out of the labor market. And better-targeted work-related training programs would help align skills with job opportunities.

14. **Capital market development should be encouraged to support investment and growth**. Encouraging capital market financing alternatives—such as greater securitization for corporate funding—would help ensure lending to viable small firms and reduce the reliance on banks for credit. For instance, reducing regulatory capital charges for high-quality securitization structures would free up banks capital for further lending.

15. **Over the medium term, ideas that simplify and strengthen the fiscal governance framework should be explored.**

- Successive reforms of the SGP have introduced many positive elements. However, the system has become excessively complicated with multiple objectives and targets. Compliance with fiscal targets has been poor, reflecting in part weak enforcement mechanisms. And there is a worry that the framework discourages public investment.

- There are no easy solutions to these problems. Nevertheless, consideration should be given to a simpler framework with a single objective and an economically sound operational lever. For example, debt reduction could be the ultimate fiscal objective and the structural balance as the single operational target. The credibility of the rules would also be enhanced by much stronger enforcement mechanisms.

- Boosting the ability of the center to fund public infrastructure projects—such as cross-border investments in transportation, communications, and energy networks—would help lay the foundations for sustained growth. , while keeping countries within the bounds of the fiscal framework.

16. **In sum, concerted policy efforts are needed to strengthen the recovery.** Continued demand support is vital to address low inflation. The favorable market environment also provides a window of opportunity to make further progress on repairing balance sheets and advancing structural reforms. Together, these will create the conditions for higher growth, job creation, and a durable recovery.