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Assessment of the 2014 national reform programmes and stability programmes for the EURO AREA

Accompanying the document

Recommendation for a Council recommendation

on the implementation of the broad guidelines for the economic policies of the Member States whose currency is the euro

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EXECUTIVE SUMMARY

There are genuine signs that a lasting recovery is now taking place in euro area. Recovery, although fragile, is gradually gaining strength and spreading across the EU. Growth turned positive in a large majority of Member States over the course of last year and the outlook has improved even in the more vulnerable ones. Real GDP growth in the euro area is projected to advance with moderate momentum in 2014 before gaining further speed in 2015. Labour market conditions have started to improve and unemployment should continue to decline albeit very gradually in most Member States. The aggregate fiscal picture for the euro area has continued to improve as the large consolidation efforts implemented in difficult economic conditions in recent years are now bearing fruit.

However, high public and private debts and related deleveraging pressures in a subdued inflation environment, weak possibilities for productive investment under a recovering and fragmented financial system and unacceptably high levels of unemployment are a legacy of the crisis and create challenges for returning from fragile recovery to strong and sustainable growth and jobs. In meeting these challenges, the high level of interconnectivity and potentially large spillovers between euro area Member States continues to put a specific responsibility on them to take ambitious and coordinated action in those areas of particular importance for a well-functioning EMU.

Both euro area Member States and the EU institutions have made significant progress to implement the 2013 euro area recommendations. Member States, especially vulnerable ones, have continued with fiscal consolidation and structural reforms, while at EU level significant steps have been taken to deepen the EMU, notably in the area of Banking Union, and in the application of the strengthened economic and budgetary governance framework. However, the implementation of specific recommendations for individual euro area Member States and the euro area as a whole is incomplete and challenges remain. For the euro area Member States ambitious and coordinated action is needed in a number of areas;

- Structural reform policy; Rebalancing in the euro area is ongoing, but has been asymmetric and there has not been progress in adjustment of current account surpluses. Deleveraging in the private sector has still a long way to go in many euro area Member States. And levels of unemployment remain elevated, in some euro area Member States to unacceptably high levels. Given the high interconnectivity in the euro area, ambitious structural reform action remains needed to ensure the well-functioning of EMU, promote convergence and further mitigate risks for stability, future growth potential and social cohesion in the euro area taking the potentially large spillovers of such reforms into account. .

- Fiscal policy: thanks to the large efforts in the past years fiscal consolidation can proceed on a more gradual pace. However, continued effort is needed to decrease high debt levels and move towards Medium Term Objectives. Making the adjustment as growth-friendly as possible, which implies a more growth-friendly mix of spending and revenues and increased efficiency of spending, is essential. Euro area Member States have a specific responsibility in this regard in the light of ensuring an appropriate overall euro area policy

stance and the potentially large spillovers between euro area Member States related to the sustainability of public finances.

- Financial sector: access to finance, notably for SMEs remains challenging in many euro area Member States which risks undermining the economic recovery as well as the proper functioning of EMU. Risk of a funding gap for productive investment remains acute, against the backdrop of continuing deleveraging pressures and still significant market fragmentation which is hampering the proper functioning of EMU. Next to the creation of banking union, a number of initiatives related to financing the long term economy are needed. Further repairing banks' balance sheets and continuing the strengthening of equity buffers, where needed, will further contribute to repairing the credit channel.

1. INTRODUCTION

The euro area's economic recovery, which began in the second quarter of 2013, is expected to continue to spread across countries and gain strength while at the same time becoming more balanced across growth drivers. As is typical following deep financial crises, however, the recovery remains fragile. In this context, the nature of the challenges the euro area faces is changing. Just a few years ago, the main policy issues related to establishing budgetary credibility with rampant deficits and swiftly increasing public debt; stopping the negative feedback loops between sovereigns and the banking sector and fixing problems of the real economy which was characterised by unsustainable current-account deficits, worrying losses in competitiveness, increasing private debts, and high housing prices. Ambitious policy action both on EU and Member States' level has moved the euro area beyond this. The main challenges of the euro area now concern the lingering impact that deleveraging pressures in many countries have on medium-term growth and unacceptably high levels of unemployment and inequality; the sustainability of private and public debts in a context of competitive disinflation; the need to provide credit to viable investments in the vulnerable economies under a recovering financial system These should not be seen in isolation but as a complex system of interacting economic variables, underscoring the importance of a consistent and coordinated policy mix of the national and euro area level policies.

In the following section the specific policy agenda for the euro area in ensuring a well-functioning EMU is assessed with specific attention to the the issues of structural reform, fiscal policy and policies related to the financial sector.

2. ASSESSMENT OF EURO AREA CHALLENGES AND POLICY AGENDA

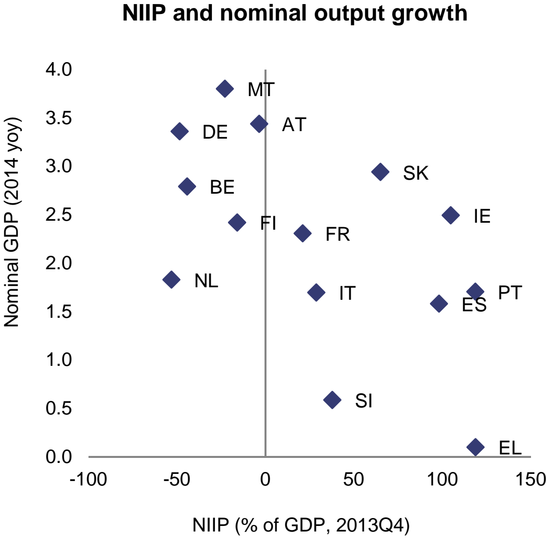
2.1. Structural reform policy

The rebalancing in the euro area is on-going and well advanced. Significant adjustment has taken place in the countries in the euro area periphery, which experienced high current account deficits prior to the start of the financial crisis. These vulnerable countries as a group actually recorded a surplus of around 1.3% of their GDP in 2013, which is expected to further increase to 2.0% in 2015. A large share of this adjustment is non-cyclical and as such will not dissipate once the overall economic situation improves. It has been driven by both structural declines in domestic demand and, to an increasing extent, by improved export performance. To the extent that the adjustment has been due to lower domestic demand linked to the reductions in potential output, it bears high economic and social costs. Given the high private and public indebtedness in these countries and the related drag on domestic demand, future growth will have to importantly rely on exports, which will help sustain sound external positions. In this respect, most of the vulnerable countries have made important progress towards recovering cost competitiveness loses that accumulated prior to the crisis.

The rebalancing process is far from complete as the debt legacy is still looming. Despite the adjustment in flows, the stocks of external debt are very high in most of the vulnerable countries. In this context, the dichotomy between these 'debtor' countries and their euro area 'creditors' has replaced the traditional one between 'deficit' and 'surplus' countries. The improvements in current accounts have not led to proportional reductions in NIIP-to-GDP ratios due to the dismal growth in nominal output and, in some cases, also sizeable negative valuation effects (to the extent that such valuation effects reflect the increase in the value of foreign liabilities, e.g., increased prices of domestic equity owned by foreigners, they can be a symptom of confidence of markets in the economies concerned). Figure 1 shows that indeed, the euro area countries with the highest levels of net external liabilities are those, where growth and/or inflation have been very low. This effectively impairs two of the main channels, which have historically proven to be key in dealing with debt overhangs. To reduce the very high levels of external indebtedness to more sustainable levels, the improved current account balances thus need to be sustained in the future and, in some case, further improvements might be required. While all of the vulnerable countries now record current account balances which are consistent with ensuring a stable path of their NIIP-to-GDP ratios, reasonably fast reductions in these ratios would require, in some cases, still higher trade and current account surpluses.

Moreover, the adjustment has been asymmetric and there has not been progress in adjustment of current account surpluses. As a result the euro area current account shifted to a surplus of around 2.2% in 2013, and is forecasted to increase slightly to 2.3% in 2014 and 2015 (see figure 2). The risks arising from such a surplus are the strain on domestic demand and therefore on the ability of the euro area to grow, but also the possibility of a euro appreciation. Through its effect on external demand and price and cost adjustment this could erode peripheral countries' efforts to regain competitiveness, while, through its effect on disposable income, also making disinflation more-broad based.

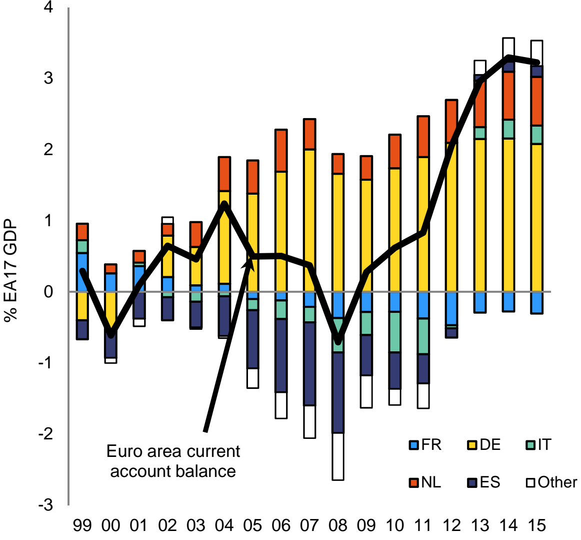
Figure 1: External indebtedness and nominal growth



Note: IT, LV, LU (2013Q3), MT (2013Q2), FR (2012Q4); NIIP multiplied by (-1)

Source: Eurostat, AMECO

Figure 2: Geographical decomposition of euro area current account balance



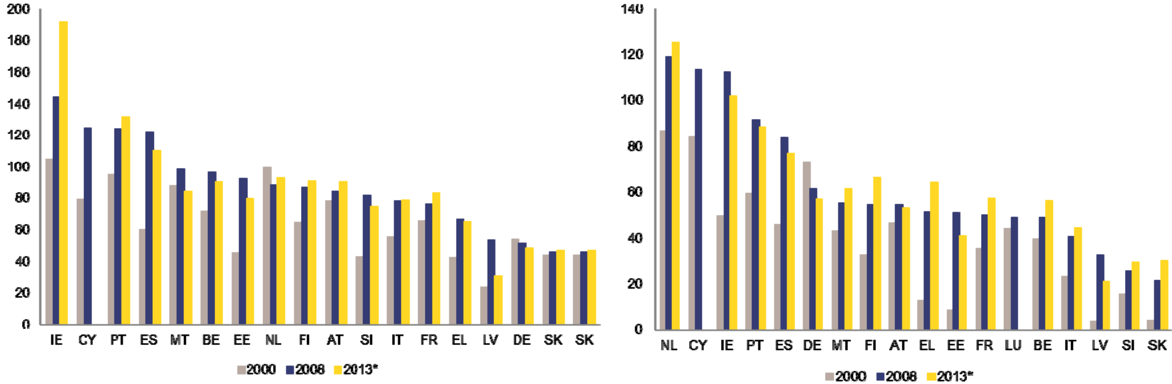
Source: Eurostat

The rising euro area current account surplus is a sign of weak aggregate domestic demand. As interest rates are close to the zero lower bound, monetary policy has limited to no scope for boosting demand. Similarly, fiscal policy appears equally constrained in most countries. Given also the limited scope for increasing domestic demand in the periphery countries, higher domestic demand on the part of the surplus countries is the only other way of closing the output gap of the euro area as a whole. In addition, the shortfall of domestic demand in the euro area as a whole tends to exert downward pressure on prices. The 'lowflation' environment – with inflation rate below the ECB's definition of price stability of below, but close to, 2 per cent – makes it much more challenging for the periphery countries to achieve the necessary adjustment in relative prices. In this respect, given nominal rigidities, a persistent very low inflation might also be a hurdle to the necessary adjustments in real wages, which has important consequences for employment and unemployment. A more symmetric adjustment in the euro area would make the overall adjustment smoother and less costly and also moderate the overall euro area surplus.

Deleveraging in the non-financial private sector has still a long way to go in many European countries. The high external debt in the vulnerable countries is a reflection of high indebtedness of domestic sectors, both private and public. At the current juncture, it is particularly the deleveraging pressures in the private sector, affecting households as well as businesses, that hold back consumption and investment. As figure 3 signals, debt levels are very high in a number of euro area countries and in a number of cases no reductions have been recorded since the onset of the crisis. Particularly, deleveraging in the corporate sector was very slow and firm indebtedness decreased only in a few countries. Even in cases where

some deleveraging has occurred, the size of the adjustment observed so far in the debt-to-GDP ratio is only a limited share of the pre-crisis increase, which would suggest that the reduction in outstanding stocks of private debt is still in early stages. Despite the subdued growth in new credit, the sluggish or even negative GDP growth was playing against the reduction in the indebtedness ratios.

Figure 3 Private sector indebtedness, NFCs (left) and Households (right), % of GDP



3. Source: Eurostat. Note: consolidated figures presented for NFCs. Debt includes loans and securities other than shares, excluding financial derivatives. LU excluded in the figure on NFC indebtedness.

Unemployment reached 12% in 2013, which reflects a 0.7 pps increase since 2012. Unemployment rates increased strongly in 1/3 of Eurozone Members States, including in a number of countries where rates were already very high. The speed of adjustment is still slow and the share of long-term unemployment has continued to rise, reaching 50% of total unemployment in 2013, enhancing the risk of unemployment becoming increasingly structural. Real unit labour costs have grown slower in countries with higher rates of unemployment, smoothening job losses while aiming to contain unemployment divergences between euro area countries. Nonetheless the risk persists that unemployment becomes less responsive to wage dynamicsThe process of reallocation of resources has started to take effect, as nominal wages in the non-tradable sector fell more significantly as compared to the tradable sectors, a development indicative of the conditions for labour to move away from the non-tradable towards the tradable sector. This reallocation and labour mobility in general is indeed key for a sustainable improvement of external positions in countries that have accumulated largely negative net investment positions over the past year.

The social situation in the euro area deteriorated throughout the crisis, and almost all social indicators worsened in 2012 (i.e. reflecting 2011 income), except for the share of people living in very low work intensity households. The situation has especially worsened further for the working age population, most directly hit by the deterioration of labour market conditions. The current levels are all above pre-crisis levels. The at-risk of poverty level stands at 17%, severe material deprivation at 7.6%, the level of people living in a very low work intensity households at 10.5%, the in-work poverty rate at 10.6%, and lastly, the poverty gap at 23.4%. Starting from 2010, those countries most severely hit by the crisis have seen their severe material deprivation rate increase steeply, while a number of Member States

have kept most of their poverty indicators stable. The potential effects of social developments on long-term growth and public debt sustainability are multiple[1]. In fact, poverty matters for productivity via the access to education and health services, while inequality has dynamic effects on growth through private debt accumulation and consumption growth. Additionally, higher poverty and unemployment rate can affect the 'reform fatigue', which can substantially disturb the recovery needed in the EA and, in turn impact on the sustainability of public finances in vulnerable countries.

In mitigating these challenges for the well-functioning of the euro area, ambitious implementation of structural reforms leading to a more flexible economy are key. Structural reforms cannot only contribute to a durable rebalancing process, but also attenuate the negative impact of households' deleveraging: stronger real wage adjustment leads to a smoother reaction of employment and, consequently, of real output, while a faster adjustment in prices allows for an also faster adjustment in the real interest rate towards the equilibrium level. Reforms are instrumental for restarting sustainable and inclusive growth and for stimulating employment, which in turn contributes to the sustainability of private and public debt, and protects welfare systems in times of fiscal consolidation.

Given the high interconnectivity between euro area Member States there are potentially large spillover effects related to the implementation of structural reforms. Trade and competitiveness are among the main channels through which spillovers are transmitted. Product, services and labour market reforms as well as certain tax reforms may affect employment and growth in the implementing Member State, and hence the demand for products and services from other Member States. Some reforms may produce spillovers through financial markets when reforms increase the Member State's ability to withstand external shocks and limit the risk of contagion of risk premiums in case of concerns with regard to debt sustainability. Furthermore, in areas where structural reform is needed in a most or all euro area countries, coordinated reform can help communicate the broader welfare effects of structural reform, while benchmarking, mutual learning and the exchange of best practices can provide additional benefits

Vulnerable Member States have recently pushed through impressive structural reforms. These achievements notwithstanding, further progress is needed to create investment opportunities that will help in shifting resources towards the production of tradable goods and services, raising external competitiveness and boosting productivity. **In member states in the core area, reform efforts have generally been less ambitious so far.** Appropriate reforms in core countries and a greater symmetry in the adjustment would thus be good for stimulating the domestic demand in the creditor countries, as well as in the whole euro area, and facilitate the efforts to restore competitiveness and to grow in the periphery. Policies that contribute to an increase in investment in particular are critical as they boost demand in the short term, and increase potential growth in the future. Here, product market reforms aimed at improving competition in non-tradable sectors would notably spur investment and facilitate the development of these sectors.

[1] Darvas, Z. and G. Wolff (2014), 'Europe's social problem and its implication for economic growth', Bruegel policy brief, issue 03.

In general, structural reform efforts on product market has been limited. There has been only very limited progress in the implementation the recommended measures in services, including reforms to remove unjustified restrictions to the access to and the exercise of professions, and to reduce barriers to entry in retail. Limited progress has been achieved in reforms of the business environment (e.g. red tape, contract enforcement, starting a business, support to SMEs, insolvency procedures, late payments). Some action has been taken to enhance the competition framework but further actions should be taken in some countries to strengthen the independence and effectiveness of the competition authority. Further reforms are also needed in the area of R&D and innovation and in network industries, especially in railway.

There is scope and a need in many Member States to improve the structure of taxation by shifting taxes away from labour and corporate income towards less-detrimental tax bases such as consumption, environment and recurrent property taxes. The composition of taxes in the euro area is too heavily geared towards taxation on labour. The tax wedge in the euro area is above 45%, which is much higher than in non-European OECD members (see table 1).

Table 1. Average tax wedge for a single person at 100% of average earnings, no child (%)

	2013	**Change 2013-2009**
Euro area	46.5	-0.2
OECD – Average	35.9	0.7
Australia	27.4	0.7
Canada	30.7	0.5
Japan	31.6	2.5
New Zealand	16.9	-1.2
Sweden	42.9	-0.3
United States	31.3	1.3
United Kingdom	31.5	-0.9

OECD (2010), "Taxing Wages: Comparative tables", OECD Tax Statistics (database). Average tax wedge Euro area calculated as the weighted average of the 15 Euro Area Member States that are member of the OECD.

The process of reallocation of resources should be facilitated by fluid labour markets both on Member State and euro area level. Reforms enhancing labour market adjustment have been implemented in a number of euro area countries in the past years, such as

introducing changes in the definition of fair dismissals or in the size of severance payments, but also reforms facilitating the exit flexibility by revising dismissal rules. Specific measures that increase the disincentive against temporary and atypical contracts have been introduced to reduce labour market segmentation, though the latter remains a significant labour market challenge for the future. The administrative burden or reallocation options in case of dismissal have also been reduced in several countries.

Reforms of unemployment benefit systems should support transitions back to work, primarily by adjusting the design of unemployment benefits over the unemployment spell and in some cases by strengthening job-search conditionalities. Incentive-friendly measures include reduction in the maximum level of benefits, adaptation of the design of benefits over the unemployment spell, cuts in benefit duration, and stricter eligibility criteria.

Several Member States have reinforced their system of ALMPs, in particular through more tailor-made job search assistance coupled with a tightening of requirements for the continued receipt of benefits. Next to activation measures, in their efforts to address poverty, some countries are also reforming their social assistance systems.

2.2. Fiscal Policy

The aggregate fiscal picture for the euro area has continued to improve: the large consolidation efforts implemented in difficult economic conditions in recent years are now bearing fruit, supported by improving economic conditions. In fact the nominal deficit in 2014 is expected to fall below the 3% of GDP in the euro area, for the first time since 2009, standing at 2.5%. Moreover, public debt is expected to finally stabilize in 2014, although at a high level of 96% of GDP in the euro area, ending a continuously growing trend in past years. With that, both the debt and deficit projections for the euro area are considerably more positive than for other major economies including the United States and Japan. The Commission Spring Economic Forecast shows that **the pace of fiscal consolidation in the euro area will be slower in 2014 than in previous year and is expected to be below ¼ pp of GDP.**

Fiscal achievements have to be acknowledged, but efforts towards sustainable budgetary positions should continue. Consolidation efforts have been large over the past few years and have managed to reduce deficits and halt the rise in debt. Also, the economic outlook has been ameliorating and improving the prospects for deficit and debt ratios. From a procedural point of view this has been visible in Member States correcting the excessive deficits in a sustainable manner and exiting the EDP. However, still many Member States have deficits above 3% reference value and debt levels above 60% and need to continue their efforts to reduce deficits and put debts on a steady declining path, in line with the debt reduction benchmark, introduced in the reformed SGP. Also, many Member States, which have corrected their excessive deficits have not reached sustainable budgetary positions as defined by the MTOs.

Mistakes of the pre-crisis years have to be avoided. One of the major innovations to the EU fiscal framework introduced by the Six-Pack was the strengthening of the preventive arm of the SGP. This has been based on the lesson drawn from the crisis that the weak compliance with the SGP preventive arm was one of the main reasons behind the deep fiscal deficits and the surge in debt during the crisis, but in fact already the diagnosis preceding the 2005 reform of the SGP indicated the non-compliance with the preventive arm as one of the main sources of the ensuing fiscal problems. To remedy the weaknesses, the Six-Pack has clarified the assessment of compliance with the MTO or the adjustment path towards it and introduced sanctions for euro area Member States in case of non-compliance. Also, to underpin the importance of structurally balanced budgets, Member States have signed the TSCG enforcing in the national legislation at constitutional or equivalent level the requirement of compliance with the MTO. It is therefore of utmost importance that Member States ensure full compliance with the preventive arm requirements. Improving economic conditions should be taken as an opportunity to press ahead on the adjustment path towards the MTO and to build fiscal buffers before cyclical factors turn again. From this point of view the structural consolidation effort of below ¼ pp of GDP in 2014 points to an overall insufficient response to the euro area's fiscal challenges. This is particularly the case taking into account that for the Member States still in EDP in 2014, the average structural effort recommended for 2014 in EDP recommendations equals 1% of GDP, while for the Member States in the preventive arm the SGP requires 0.5% of GDP structural adjustment towards the MTO as a benchmark and only four euro area countries have reached the MTO. This conclusion however should be qualified, as the structural balance may underestimate the underlying fiscal effort on grounds of a lower than normal response of revenue to economic growth and the current subdued growth of potential output in a medium term perspective.

Since the inception of the Europe 2020 Strategy, the Commission has consistently called on Member States to give priority to growth-enhancing policies when consolidating their public budgets. Important elements of a growth-enhancing fiscal policy are the differentiation of the fiscal consolidation effort, the long term sustainability (both assessed above), the composition and structure of revenue and expenditures and a sound fiscal framework.

The overall quality of expenditure results from the combination of two main aspects: (i) the composition of expenditures and in particular the weight of more growth-friendly spending items; and (ii) **the efficiency of expenditures**, i.e. how well public resources are translated into services to citizens and business.

In terms of targeting spending areas which should, in principle, positively affect growth, the expenditure categories commonly focussed upon are public investment, education and research and development (R&D). Latest trends in expenditure composition in the euro area since the onset of the economic and financial crisis highlight a generalised increase in the share of social protection accompanied by a reduction in several other functions, including education, as well as a widespread tendency to cut public investments, which is often viewed as an easy target for consolidation. For example, the average expenditure on capital formation in the euro stood at 2.1 % of GDP and 4.3% of total spending in 2013, down from 2.6% and 5.7% respectively in 2007 (see table 2).

Table 2. Public Investment (Gross Fixed Capital Formation) as % of GDP and total expenditure

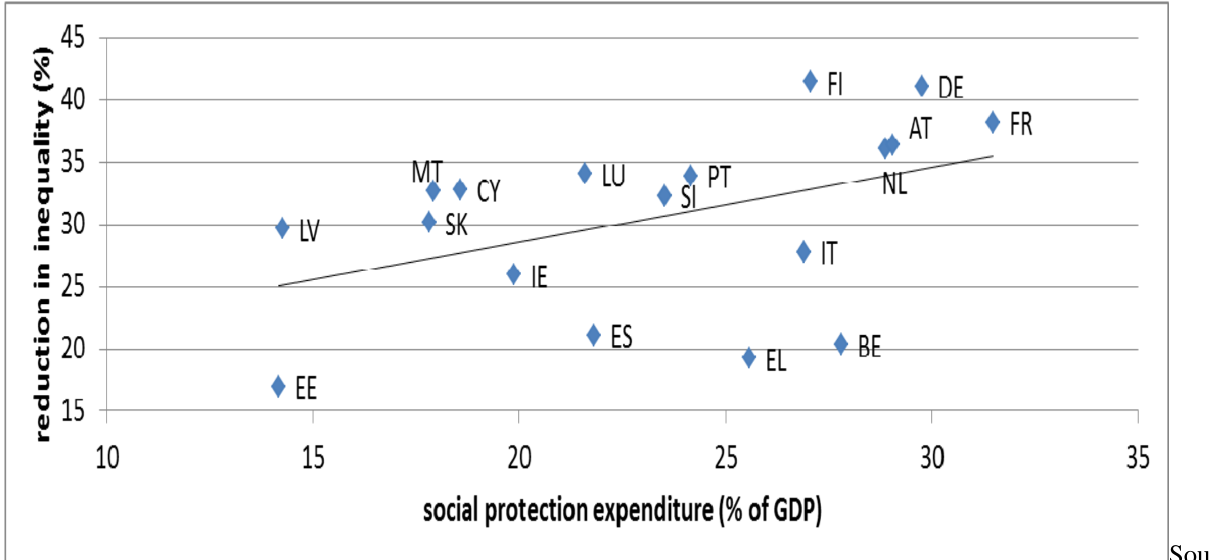
	GCFC (% of GDP)			GCFC (% of total expenditure)		
	2007	2014	chng	2007	2014	chng
BE	1.6	1.6	0.0	3.2	2.9	-0.3
DE	1.5	1.6	0.1	3.4	3.5	0.1
EE	5.1	4.0	-1.1	14.9	10.3	-4.5
IE	4.7	1.6	-3.1	12.7	3.9	-8.8
EL	3.4	2.6	-0.8	7.1	5.5	-1.6
ES	4.0	1.3	-2.7	10.3	3.0	-7.3
FR	3.3	3.0	-0.2	6.2	5.3	-0.8
IT	2.3	1.6	-0.7	4.9	3.3	-1.6
CY	3.0	2.3	-0.7	7.3	4.8	-2.4
LV	5.7	3.7	-2.0	15.8	10.5	-5.3
LU	3.3	3.1	-0.2	9.1	7.2	-1.9
MT	3.7	2.7	-1.0	8.8	6.2	-2.7
NL	3.3	3.3	0.0	7.3	6.6	-0.7
AT	1.1	1.0	-0.1	2.2	1.9	-0.3
PT	2.7	1.8	-0.9	6.1	3.8	-2.3
SI	4.2	4.2	0.0	10.0	8.4	-1.6
SK	1.9	1.9	0.0	5.5	5.0	-0.5
FI	2.4	2.9	0.4	5.1	4.8	-0.3
EA-18	2.6	2.0	-0.6	5.7	4.1	-1.5

Source: Commission services (Ameco)

As far as efficiency of expenditure is concerned there also remains ample scope for improvement in the euro area. This is illustrated in the domain of social expenditure. Figure 2 presents the correlation between the reduction of income inequality and social expenditure. Although, reducing inequality is not the only goal of social security expenditures, the figure

suggests that **it is possible to improve public finances without increasing the income inequality provided efficiency gains can be identified.**

Figure 1. Correlation between the reduction of market income inequality and social protection expenditure, 2000-11



Source: Eurostat and the Standardised World Income Inequality Database. Note: the reduction in market income inequality is the percent difference between the Gini coefficient after taxes and transfers and the Gini coefficient before taxes and transfers.

With regard to fiscal frameworks, across the euro area progress has been made in the past couple of years. This was spurred by the need to display and adhere to stricter fiscal discipline accompanied by more stringent requirements in European fiscal governance, illustrated for instance by the entry into force of the Directive on national budgetary frameworks[2] at the beginning of 2014 in the EU-28. This drive towards improved fiscal governance is particularly acute in the Euro area, where additional commitments have been made to support fiscal discipline. During 2013 the framework for the euro area became operational with the entry into force of Two-pack[3] (see above) and the "Fiscal Compact" [4], which fully applies for all Euro Area Member States.

2014 will be a critical year in terms of compliance with new requirements on fiscal frameworks. Subject to the combination of newly established legislative elements outlined above, Euro Area Member States need to ensure compliance with all legal provisions now fully in place as soon as possible; ongoing compliance assessment for the transposition of the Directive and Fiscal Compact are currently undertaken by the Commission. Major areas of attention for Euro Area Member States in the coming months should be to ensure the effective setup and functioning of fiscal rules, in particular structural budget balance rules, and their monitoring by independent fiscal institutions; as well as the full national integration of the

[2] Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, part of the "6-pack"

[3] Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

[4] The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)

new common budgetary timeline including Draft Budgetary Plans and Medium-Term Fiscal Plans, based on forecasts produced or endorsed independently.

2.3 Financial sector policy

Heterogeneity of lending conditions remains very high and contrasts with the reduced financial fragmentation in other market segments such as those for sovereign and corporate debt. Euro-area banks acknowledged in the ECB Bank Lending Survey that the dissipation of sovereign debt tensions contributed on average to an improvement in banks' funding conditions while the impact of the easing of the sovereign debt crisis on banks' credit standards remained muted. This suggests the banks are not yet translating the improved funding conditions into better lending conditions. Over the last couple of months, interest rates for loans to enterprises in core countries like Germany and France have stopped falling while they have declined slightly in the most fragile countries like Greece and Portugal. However, differences in lending rates for enterprises between countries like Italy or Spain and Germany have not yet started to narrow in earnest. Also, credit flows have remained subdued. The latest bank lending data confirms that the economic recovery we are seeing at the moment is essentially creditless. Credit flows to the private sector shrank over the last few months on the back of still very weak lending volumes to the non-financial corporate sector. Such credit constraints can put a brake on recovery, notably in vulnerable countries and add to disinflationary pressures.

The weakness of lending to the real economy is attributable to demand and supply side elements. On the supply side, the interplay of a protracted economic weakness with legacy balance sheet issues, amid continued corrections in residential and commercial property markets in some countries, affects credit risk. This results in worsening credit quality and increases in the Non-Performing Loan (NPL) ratios of euro area banks. Moreover, according to some market participants, asset quality problems are more acute than reported as banks exercise forbearance towards borrowers with low credit quality. This in turn can reduce banks' capacity to extend new loans to productive firms as the high proportion of NPLs and loans involving forbearance tie up capital and funding. The ongoing ECB asset quality review, followed by an EU-wide stress test, is expected to reveal any unrecognised losses in banks and further foster the completion of the necessary balance sheet repair. On the other hand, the ongoing private sector debt overhang and deleveraging, the weak economic environment and the poor economic prospects in the euro area weigh on borrowers' debt servicing capacity and credit demand. In some euro area countries, the slow progress on corporate sector restructuring further dampen the demand for new loans.

Despite the relatively difficult economic environment, euro area banks have continued to strengthen their capital positions. As a result, the Basel III Common Equity Tier 1 (CET1) ratios of euro area large banks are broadly comparable with those of their global peers. Also, many large banks that already report Basel III CET1 ratios reached or surpassed levels of 9% by September 2013. As a result, despite continued increases in loan-loss provisions, capital ratios in euro area banks remain stable overall and are even growing in many euro area Member States. Nonetheless coverage ratios remain relatively low in some countries as

increases in NPLs outpace the growth in provisions. The improvements in euro area banks' capital ratios were achieved through a combination of capital increases and reductions of risk-weighted assets. Given the uncertainty of financial market participants related to the calculations of risk-weighted assets, a simple leverage ratio is increasingly used as a complementary indicator to gauge the strength of the banking sector. On this metric, the progress of euro area banks is less pronounced.

Looking forward, financial fragmentation could be further reduced if progress can be made in addressing its underlying causes. In this respect, various policy initiatives are under way to tackle this issue and the fragility of the banking system. Banking Union initiatives remain critical points on the EU's policy agenda. The Banking Union will create a more robust financial sector in the euro area, making all banks safer in the first place by crisis prevention, while the centralisation of supervision under the auspices of the Single Supervisory Mechanism (SSM) will reduce the risks of supervisory capture. If banks do face solvency, liquidity or viability challenges, supervisors can intervene at an early stage to manage them and, if problems still cannot be adequately addressed, a framework will now be in place that allows for the orderly resolution of troubled institutions.

The ECB has made significant progress with taking over the responsibility for bank supervision in the euro area. In particular, the ECB is carrying out a comprehensive assessment of the largest banks in the euro area (128 credit institutions across 18 Member States, covering approximately 85% of total euro-area banks' assets) with the aim to finalise it prior to assuming its single-supervisor role in November 2014. This exercise involves a risk assessment for each bank and an asset quality review (AQR) followed by a stress test (ST), which will be held in all EU-28 Member States, performed in close coordination with the EBA. Work on the AQR is well underway. The methodology was published at the end of March and the AQR process is expected to be finalised in July. The stress tests preparations are also ongoing and the EBA has published the scenarios and methodology on 29 April. The EBA and the ECB have announced in coordination the key elements of the exercise, including the capital thresholds of 8% CET1 for the baseline and 5.5% CET1 for the adverse scenario. Unlike in past exercises, the supervisory decisions to address the outcomes of the stress tests and the implications for banks' results will not be coordinated by the EBA; rather, this task will be allocated to competent authorities including the ECB. A number of elements confirm the credibility of the stress test especially taking into account that the starting point is more credible and tougher given the preceding AQR. Further elements confirming this include (i) the extension of the horizon of the exercise from 2 to 3 years, (ii) better harmonised definitions for important parameters such as NPLs and (iii) a common approach for the treatment of sovereign bonds in the stress test without national discretion. In addition, the level of transparency introduced in the exercise and its comprehensiveness are reassuring for institutions and market participants. Moreover, the very favourable market conditions may also make it easier and cheaper for banks to raise capital or dispose in better conditions of assets that may be penalised during the exercise.

The Single Resolution Mechanism (SRM) has been approved by the co-legislators in April 2014. The SRM will apply to all banks in the Euro Area and other Member States that opt to participate. The decision-making procedures of the SRM have been carefully calibrated

so that it will be possible to decide on a resolution case over a week-end. The SRM is built around a strong Single Resolution Board and will involve permanent members as well as the Commission, the Council, the ECB and the national resolution authorities. In most cases, when a bank in the euro area or established in a Member State participating in the Banking Union needs to be resolved, the ECB will notify the case to the Board, the Commission, and the relevant national resolution authorities. In the Banking Union, the national resolution funds are pooled together gradually in the Single Resolution Fund to which all the banks in the banking union countries will contribute as from 2016 and which will amount to EUR 55 billion by 2024. However, The SRM Regulation does not establish yet a common backstop to the fund, which will be constructed over the coming years.

Access to finance for SMEs remains challenging in many Member States which risks undermining the economic recovery. At the same time, investment needs for transport, energy and broadband infrastructure networks are estimated at EUR 1 trillion over 2020. Risk of a funding gap in Europe remains acute, against the backdrop of continuing deleveraging pressures and still significant market fragmentation (see above). Next to the creation of banking union, a number of initiatives related to financing the long term economy have been taken or are planned.

There is a broad agreement on the need to diversify financing sources as Europe is characterised by a system dominated by bank intermediation. European capital markets are relatively underdeveloped and currently insufficient to fill the funding gap created by bank deleveraging. A number of bottlenecks exist for capital-market financing to take off. Incentives for institutional actors such as insurers to engage in long-term financing could be adjusted. SMEs access to capital markets is currently held back by asymmetries of information and the absence of a liquid securitisation market. To revive the securitisation market it would be crucial to “differentiate” between good and bad securitisation which should then allow improving the prudential framework for the good one. In the market for infrastructure financing, financial market participants have often pointed to the lack of transparency on project pipelines as an obstacle to more predictable financing, for example as concerns public-private partnerships (PPP). The enhanced availability of information on national infrastructure and investment plans and on projects promoted by national authorities could attract capital markets to projects in Europe. Finally, a number of cross-cutting factors related to corporate governance, accounting issues and taxation and legal issues are also holding back market financing. The Commission Communication on long-term financing adopted end March 2014 focuses on a concrete action plan with several actions to be undertaken already this year to address these issues.