is the euro zone crisis over?

The euro zone has emerged from recession, borrowing costs have fallen and the risk of euro area collapse has diminished since mid-2012. However, major causes for concern persist. The economic recovery remains fragile, the currency bloc's politicians are showing a lack of urgency and political uncertainty is rising following the high-profile success of various populist Eurosceptic forces in recent European elections.

Two years ago, with the euro zone apparently on the brink of collapse and borrowing costs soaring in the bloc's highly-indebted countries, the president of the European Central Bank (ECB), Mario Draghi, made what proved to be two decisive interventions. He pledged to do "whatever it takes" to protect the euro and announced a new unlimited bond-buying programme (known as outright monetary transactions). In the period since, yields on government bonds have plunged in vulnerable countries such as Spain and Italy as investors have returned to the euro zone sovereign bond markets.

However, this increased demand for government bonds in the euro area is not fully warranted by the extent of economic recovery. Taken as a whole, the euro area moved out of recession in mid-2013. But the recovery has been sluggish. A prolonged period of economic stagnation - coupled with sustained low inflation - would make it more difficult for highly indebted households, banks and governments to reduce their debt burdens.

The euro area's economic outlook remains fragile. Unemployment is high and persistent; governments continue to focus on budget savings; and banks remain reluctant to lend. Against this backdrop, in early June the ECB announced a series of measures aimed at boosting price stability and bolstering the economic recovery, including cuts to the main interest rates and the provision of cheap funding to banks.

On the positive side, some of the short-term pain that the euro zone's weaker economies have endured is likely to deliver lasting benefits. Structural reforms and austerity measures that have been passed across the euro area should support private-sector activity in the medium term. The average cost of labour per unit of output has fallen significantly in the likes of Greece, Portugal and Spain. This has boosted companies' competitiveness and external trade balances in the vulnerable countries. Regulatory reform has improved the business environment, for example, by increasing labour-market flexibility, boosting investment incentives and opening closed professions. But the political and socio-economic costs of these reforms remain a source of concern. In particular, youth unemployment has reached crisis proportions and risks producing a "lost generation" of individuals with little work experience and limited employability. This is not just a personal tragedy, but also threatens to undermine long-term growth prospects.

A political backlash against austerity and "Europe" in general contributed to high-profile election victories for several Eurosceptic parties at the European Parliament elections in late May 2014, notably in France and Greece (as well as in countries that are not in the euro area such as Denmark and the UK). This in turn could

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boost these parties' agendas in the run-up to national elections - a snap election in Greece is possible in 2014-15, and voters in Spain and Portugal will go to the polls in late 2015. These contests could result in fragmented national parliaments and unstable governments that could further slow (or even reverse) the economic reform process. That said, growing opposition to mainstream parties is not a uniform trend across the euro zone. For example, Italy has recently seen stronger political stability, underscored by a landslide victory at the European election by the centre-left party of the new Prime Minister, Matteo Renzi.

Meanwhile, the health of banks remains fragile. This year the ECB will be undertaking an asset quality review and stress tests for the banking sector. If the exercise reveals significant capital shortfalls, bank lending in the euro area could deteriorate further.

Finally, some of the sense of security that followed decisive ECB rhetoric two years ago has proved to be false. In particular, the currency bloc's politicians are showing a lack of urgency as they struggle to put the euro area on a more sustainable institutional footing. Progress on banking union has been slow; only a few months ago politicians finally reached agreements on key planks of the banking union, notably a single banking resolution mechanism, but whether European leaders will muster the political will to establish a more robust banking union remains in doubt. Without a viable banking union, financial instability and debt crises are likely to return to the euro zone in the medium to long term.

View the thoughts from keynote speakers at PARC's recent meeting – *Europe in or out? The Implications for UK Companies and their Stakeholders* – here.

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