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Executive summary

- Monetary and financial policies to support the recovery
- Restoring credit growth
- Making public policy more supportive of inclusive growth
Monetary and financial policies to support the recovery

Growth has picked up gradually over the past two years, supported by very accommodative monetary policy. The effect of fiscal policy on domestic demand has turned broadly neutral. But unemployment is still very high in many euro area countries, investment has been sluggish and credit remains weak. Inflation is well below target and market-based measures of inflation expectations have been drifting down. Tackling these interconnected problems requires resolute and co-ordinated action by euro area countries to support aggregate demand and strengthen the financial sector to unlock credit growth.

Restoring credit growth

Important building blocks of banking union are now in place. But collective action is needed to complete banking union by further harmonising bank regulation, reinforcing deposit insurance at the national and European levels, and creating a common fiscal backstop to the Single Resolution Fund. The dependence between national banks and their governments still poses a serious risk in the event of renewed turbulence.

Making public policy more supportive of inclusive growth

In the wake of the global financial crisis, governments provided fiscal support and public debt rose sharply. Subsequent fiscal consolidation often resulted in deep cuts to public investment and increases in labour taxes, which weigh on future growth potential. Addressing these problems requires applying the flexibility embedded in the Stability and Growth Pact to support growth when appropriate, upgrading national budgetary frameworks and supporting private investment, including in the context of the Investment Plan for Europe.
### MAIN FINDINGS

#### Monetary and fiscal policies

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<th>KEY RECOMMENDATIONS</th>
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<tr>
<td>Inflation remains well under the target of below, but close to, 2%. Inflation expectations are drifting down.</td>
<td>Commit to keep monetary policy accommodative until inflation is clearly rising to near the target.</td>
</tr>
<tr>
<td>Aggregate demand is still weak and unemployment remains very high.</td>
<td>Countries with fiscal space should use budgetary support to raise growth.</td>
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<tr>
<td>In high-debt, low-growth countries, the strict application of the debt reduction rule of the Stability and Growth Pact can require very large fiscal adjustments.</td>
<td>Ensure that the application of the debt reduction rule of the Stability and Growth Pact does not threaten the recovery.</td>
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#### Financial policies

<table>
<thead>
<tr>
<th>MAIN FINDINGS</th>
<th>KEY RECOMMENDATIONS</th>
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<tbody>
<tr>
<td>Non-performing loans (NPLs) are still very high in some countries, which hampers credit growth.</td>
<td>When NPLs create a serious economic disturbance, speed up and facilitate the resolution of NPLs by not triggering bail-in procedures within the existing rules.</td>
</tr>
<tr>
<td>National fiscal positions are vulnerable to national banking crises.</td>
<td>Consider establishing asset management companies where needed, and possibly at the European level.</td>
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<td></td>
<td>Take supervisory measures to encourage banks to resolve NPLs, which might include raising capital surcharges for long-standing NPLs.</td>
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<td></td>
<td>Reinforce national deposit insurance schemes and implement a European Deposit Insurance Scheme, in tandem with continued risk reduction in the banking sector.</td>
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<td></td>
<td>To reduce links between national governments and their banks, create a common fiscal backstop to the Single Resolution Fund.</td>
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<tr>
<td>Banking regulation remains fragmented along national borders, which is an obstacle to a level playing field.</td>
<td>Further harmonise banking regulation in Europe.</td>
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### Making public finances more growth-friendly

<table>
<thead>
<tr>
<th>MAIN FINDINGS</th>
<th>KEY RECOMMENDATIONS</th>
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<tbody>
<tr>
<td>Investment in Europe remains weak.</td>
<td>As intended in the Investment Plan for Europe, the European Investment Bank should finance higher-risk projects that would not otherwise be carried out.</td>
</tr>
<tr>
<td>The composition of public spending and revenue has become less growth-friendly.</td>
<td>Countries should increase targeted public support to investment while enhancing the framework conditions for private investment.</td>
</tr>
<tr>
<td>Reforms to national budgetary frameworks have not been sufficient.</td>
<td>Allow longer initial deadlines for correcting excessive deficits if countries implement major structural reforms in spending and tax policies which enhance potential growth and long-term sustainability.</td>
</tr>
<tr>
<td></td>
<td>Adopt national expenditure rules and conduct spending reviews linked to budget preparation.</td>
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<td></td>
<td>Ensure that national independent fiscal institutions have resources to fulfil their mandate.</td>
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Assessment and recommendations

- Challenges facing Europe
- Fostering recovery and rebalancing
- Keeping monetary policy accommodative
- Improving monetary transmission by resolving non-performing loans
- Completing banking union
- Making public finances more growth and equity-friendly
Challenges facing Europe

Europe has made important progress in harnessing and reinforcing its policies and institutions to recover from a double-dip recession and improve crisis management. Very supportive monetary policy has helped growth to pick up gradually over the past two years (Figure 1, Panel A), and contributed to reduce tensions in sovereign debt markets (Figure 1, Panel B). The effect of fiscal policy on demand has turned broadly neutral. Important building blocks of banking union, on both supervision and resolution fronts, have come into operation, improving the resilience of the European financial system. Confidence in the European project has recovered from its lows in 2013, although it is still well below what it was before the crisis (Figure 2).

However, many legacies of the crisis are still unresolved, and major new problems have emerged. Unemployment is still high in many countries, and there is a wide dispersion across the euro area (Figure 3). Despite the somewhat stronger economy, inflation is close to zero, well below the European Central Bank (ECB) target of just under 2%. Unlike in the United States, investment is still far below 2007 levels, especially in those countries hit hardest by the crisis (Figure 4), mainly due to weak demand but also to high non-performing loans and, in many countries, high corporate indebtedness, which hamper credit (OECD, 2015a). Political tensions have flared up recently due to large inflows of refugees, and have put strains on border-free travel within the Schengen zone. The reintroduction of border controls in some Schengen zone countries is a setback for European integration.

Figure 1. GDP growth and long-term interest rate spreads

A. Real GDP growth in the euro area

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<tbody>
<tr>
<td>Real GDP growth (Percentage)</td>
<td>-5.5</td>
<td>-4.5</td>
<td>-3.5</td>
<td>-2.5</td>
<td>-1.5</td>
<td>-0.5</td>
<td>0.5</td>
<td>1.5</td>
<td>2.5</td>
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B. Long-term interest rate spreads

<table>
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<tbody>
<tr>
<td>Greece</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>Ireland</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>30</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>Italy</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>30</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>Portugal</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>30</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>Spain</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>30</td>
<td>25</td>
<td>20</td>
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</tbody>
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1. Euro area member countries that are also members of the OECD (15 countries).
2. Ten-year government bond spreads relative to the German rate.

StaLink: http://dx.doi.org/10.1787/88893366926
These challenges weigh on economic performance and, more broadly, on the quality of life of European citizens. Well-being in the euro area often displays large disparities across countries (Figure 5). These tend to be most acute in income, labour market outcomes and subjective well-being, all of which were deeply affected by the crisis. Furthermore, some countries often find themselves among the best or the worst performers in most dimensions of well-being (Figure 5). Improving well-being requires
stronger and more even growth and job creation across the euro area, but also reforms in specific policy areas, such as education and health, where the composition and efficiency of public spending plays a crucial role.
Building a better future calls for stronger collective action on several fronts. Despite recent progress, banking union remains incomplete, which hampers monetary policy transmission and capital market integration, and the resulting mutual dependence of national governments and national banks poses vulnerabilities during a crisis. Joint action is also needed to protect external borders and share the financial burden of the refugee inflow. Public investment remains depressed, due to strong and lopsided fiscal consolidations in the recent past, which have fallen heavily on capital spending, and insufficient consideration of cross-country spillovers. Business investment is further hampered by the high levels of corporate debt overhang, by remaining weaknesses in some national banking systems and by scant progress in goods and services markets integration after the crisis, not least through the persistence of high regulatory heterogeneity.

In this context, the 2016 OECD Economic Survey of the euro area mainly focusses on fiscal and financial challenges, and the 2016 OECD Economic Survey of the European Union on structural reform priorities to complete the Single Market. The main messages of the euro area Survey are:

- To deal with the problems they face, member states need to harness European institutions to develop and implement collective and co-operative solutions.
- The euro area economy is gradually recovering, but investment remains weak and the wide disparity in economic performance and well-being is still a major concern.
- Collectively strengthening aggregate demand and financial sector performance will be critical to ensuring that growth picks up and unemployment continues to decline.

**Fostering recovery and rebalancing**

Growth has gathered pace since mid-2014, supported by successive rounds of monetary expansion (Figure 6). The sharp fall in global oil prices has raised household incomes and fiscal policy is no longer weighing on domestic demand. Exports grew robustly for several quarters, reflecting the euro depreciation and stronger activity in major markets, such as the United Kingdom and the United States. More recently, a stronger euro and the slowdown in emerging markets have made export growth decelerate markedly. Business investment has disappointed, largely due to weak growth expectations and, in some countries, credit constraints.

Economic performance has been uneven from country to country. The sovereign debt crisis and the associated large fiscal and macroeconomic adjustment efforts by the countries hit hardest (e.g. Greece, Ireland, Italy, Portugal and Spain) led to very divergent output and unemployment developments across the euro area. This divergence has been modestly reversed over the past two years, with some of those countries recording above-average growth. Despite narrowing interest rate differentials and significant reductions in lending rates, credit and investment in most of those countries have remained hampered by high non-performing loans and corporate debt (Figure 7), and incomplete capital market integration. The exceptions have been Ireland, where large multinationals do not depend on domestic banks for financing, and Spain, which has made significant progress in cleaning up banks’ balance sheets.

External positions are rebalancing, but the process has been asymmetric and incomplete, and has left the euro area as a whole with a large external surplus. Germany and the Netherlands have further increased their already significant surpluses. The countries hit hardest by the global financial and euro area crises have all eliminated
significant current account deficits, although, in spite of structural improvement, this also reflects still weak domestic demand and, therefore, imports (Figure 8). The same countries also improved cost competitiveness (Figure 9), in the context of substantial output losses. Apart from Greece and Italy, export performance has improved as a result. However, a number of these countries continue to display poor net international investment positions, and improving them will require sustained GDP growth and current account surpluses in the medium and long run. Stronger wage and internal demand growth in surplus countries will ease further rebalancing and make it more symmetric, not least by reversing the persistent decline in their relative unit labour costs (Figure 9).

Labour market developments have also varied markedly across countries. As euro area unemployment started to increase in 2008, so did its dispersion across countries, which has only fallen slightly recently (Figure 3). Moreover, especially in the countries hit hardest by the crisis, estimates of structural unemployment have risen (Ollivaud and Turner, 2014)
and the labour force has fallen as workers have become discouraged and, in some countries, have emigrated in search of better job opportunities (OECD, 2015b). Conversely, Germany has benefited from lower unemployment and an increased labour force. Unsurprisingly, poverty has tended to increase more in those countries with large hikes in joblessness (Figure 10). Furthermore, recent consolidation efforts in the countries most affected by the crisis have sometimes included deep cuts to unemployment benefits (see Chapter 1), which have likely worsened distributional impacts.
Gross domestic product (GDP) growth for the euro area as a whole is projected to accelerate modestly to close to 2% (Table 1). Activity will continue to be supported by sustained monetary stimulus, a broadly neutral fiscal stance and lower oil prices. However, high private indebtedness will remain a drag on consumption and investment in many countries, and falling demand from emerging economies will weigh on exports. Unemployment will decline only gradually, and the stark differences across countries will persist. Inflation is projected to edge up to about 1% by 2017 as the effects of cheaper energy wane and cyclical slack gradually decreases.

A stronger-than-projected slowdown in China and other emerging market economies would weaken demand in the euro area through several channels. Impacts through trade linkages alone would likely be small (about 0.1% of GDP per percentage point fall in Chinese
domestic demand), as even the whole of Asia accounts for only 12% of euro area goods exports. However, repercussions on euro area GDP could increase by a factor of three if the demand slowdown in China led to adjustments in global financial markets, such as higher risk premia (OECD, 2015c). Through cheaper commodities and pressures for euro appreciation, a slowdown would also make it more difficult to steer euro area inflation towards 2%. While tail risks of financial stress have receded, the outcome of the upcoming referendum in the United Kingdom could have important implications for economic performance in both the United Kingdom and the rest of Europe (Kierzenkowski et al., 2016). The refugee crisis is already straining the Schengen agreement and might even affect the free flow of goods and, especially, labour in Europe. This could to some extent reduce the benefits of the single market and shake confidence in the European Union more generally. There is considerable uncertainty regarding the inflation projection, and a more long-lasting period of low inflation, or even falling prices, cannot be ruled out. This could make debt burdens more difficult to manage and, for the countries hit hardest by the crisis, further competitiveness gains harder to achieve, delaying the recovery.

On the other hand, more rapid progress in fiscal and structural reforms would boost growth relative to the projection. Of particular importance are collective fiscal action within the Stability and Growth Pact rules to boost investment and growth, the banking union and further progress on the single market. A resolution of the refugee crisis would bolster confidence in the EU institutional framework and thereby improve growth prospects. Recent and potential future policy moves by the ECB may prove more effective in raising inflation towards its target than assumed. Similarly, cheap oil may have a stronger-than-expected impact on demand.

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1. The poverty rate is the share of persons with disposable income (equivalised for family size) below 60% of national median disposable income.
2. Euro area 19 countries.

Source: Eurostat (2016), “Income distribution and monetary poverty” and “Unemployment and employment (LFS)”, Eurostat Database. [Link](http://dx.doi.org/10.1787/88893366993)
Keeping monetary policy accommodative

Following the outset of the financial crisis in September 2008 and the ensuing long period of low growth, the European Central Bank (ECB) successively cut its policy rates – except during a short period in 2011 – to their lowest levels since it started operating: the deposit rate has been negative since mid-2014 (Figure 11, Panel A). However, if assessed through the evolution of the real short-term market interest rate, monetary policy became less accommodative in 2013-14 (Figure 11, Panel B). This is explained by the fall in inflation since late 2011 (see below).

The use of unconventional monetary tools diminished in 2013 and 2014, as most commercial banks started reimbursing the loans they took under the long-term refinancing operations (LTROs). As a result, the Eurosystem balance sheet shrank significantly from 30% of GDP end-2012 to about 20% end-2014 (Figure 12). Persistent undershooting of

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Table 1. Macroeconomic indicators and projections
Euro area,\(^1\) annual percentage change, volume (2011 prices)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product (GDP)</td>
<td>-0.3</td>
<td>1.0</td>
<td>1.6</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Private consumption</td>
<td>-0.6</td>
<td>0.8</td>
<td>1.6</td>
<td>1.8</td>
<td>1.7</td>
</tr>
<tr>
<td>Government consumption</td>
<td>0.2</td>
<td>0.8</td>
<td>1.3</td>
<td>1.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>-2.5</td>
<td>1.4</td>
<td>2.6</td>
<td>3.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Final domestic demand</td>
<td>-0.8</td>
<td>0.9</td>
<td>1.8</td>
<td>2.1</td>
<td>1.9</td>
</tr>
<tr>
<td>Stockbuilding(^2)</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Total domestic demand</td>
<td>-0.7</td>
<td>1.0</td>
<td>1.7</td>
<td>2.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>2.2</td>
<td>4.1</td>
<td>5.2</td>
<td>3.0</td>
<td>4.1</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>1.3</td>
<td>4.5</td>
<td>6.0</td>
<td>4.4</td>
<td>4.6</td>
</tr>
<tr>
<td>Net exports(^2)</td>
<td>0.4</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.4</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

Other indicators (growth rates, unless specified)

- Potential GDP: 0.6, 0.7, 0.8, 0.9, 1.0
- Output gap\(^3\): -3.2, -2.9, -2.2, -1.5, -0.7
- Employment: -0.6, 0.6, 1.0
- Unemployment rate: 11.9, 11.5, 10.8, 10.2, 9.8
- GDP deflator: 1.3, 0.8, 1.2, 0.9, 1.1
- Consumer price index (harmonised): 1.3, 0.4, 0.0, 0.2, 1.2
- Core consumer prices (harmonised): 1.1, 0.8, 0.8, 0.9, 1.1
- Household saving ratio, net\(^4\): 6.3, 6.4, 6.4, 6.7, 6.6
- Current account balance\(^5\): 2.9, 3.1, 3.8, 3.8, 3.6
- General government fiscal balance\(^6\): -3.0, -2.6, -2.1, -1.8, -1.4
- Underlying general government fiscal balance\(^3\): -1.0, -0.8, -0.8, -1.0, -1.0
- Underlying general government primary fiscal balance\(^3\): 1.3, 1.4, 1.3, 0.9, 0.7
- General government gross debt (Maastricht)\(^5\): 93.7, 94.7, 93.3, 92.4, 91.3
- General government net debt\(^5\): 66.1, 72.5, 72.0, 72.0, 71.5
- Three-month money market rate, average: 0.2, 0.2, 0.0, -0.2, -0.3
- Ten-year government bond yield, average: 2.9, 2.0, 1.1, 0.9, 0.8

Memorandum item

- Gross government debt\(^5\): 105.2, 112.1, 110.5, 109.6, 108.5

1. Euro area member countries that are also members of the OECD (15 countries).
2. Contribution to changes in real GDP.
3. As a percentage of potential GDP.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

inflation led the Governing Council to reinvigorate the use of unconventional tools as of mid-2014, and most recently in March 2016. Measures have included a combination of conventional monetary policy easing, taking the deposit rate increasingly to negative territory, credit easing in the form of a series of targeted long-term refinancing operations (TLTROs), and quantitative easing through an asset purchase programme (APP) that initially comprised asset-backed securities and covered bonds and increased in scope to include sovereign bonds (from March 2015) and non-bank corporate bonds (from June 2016).
The asset purchase programme consists of purchasing various eligible assets, both private (asset-backed securities, covered bonds and non-financial corporate bonds) and public (such as government, agencies and European institutions bonds, under the so-called public sector purchase programme), at an original pace of EUR 60 billion per month, making it an effective quantitative easing (QE) programme. The initial intention was to carry out purchases at least till September 2016, but on 3 December 2015 the Governing Council extended it to March 2017 or beyond, if necessary, and increased the pool of eligible assets, notably by including regional and local government debt. The size of monthly purchases was increased to EUR 80 billion in March 2016 and the pool of eligible assets was widened further to investment grade bonds issued by non-bank firms. The balance sheet of the ECB is expected to reach close to 40% of euro area GDP by March 2017 (Figure 12).

The effectiveness and timing of quantitative easing policies has been highly debated (IMF, 2013). However, since the announcement of the programme to the end of the first quarter of 2015, the valuation of European stock exchanges increased by about 20% and the euro effective exchange rate depreciated by about 10% (Figure 13). In addition, the asset purchase programme has helped spreads of sovereign bonds in peripheral countries to remain low (despite some renewed financial market stress around Greece in 2015), which is facilitating the recovery in those countries. Based on a macroeconomic model simulation (NiGEM), a 10% depreciation of the euro could increase inflation by ¾ percentage point and growth by about 1¼ percentage points in the following year. Using the same model, the impact of an increase in stock prices of 20% would be more moderate, about ½ percentage point on activity and none on inflation.

Despite quantitative easing, inflation (total and core) and swaps-based inflation expectations are now well below the inflation target of the ECB (Figure 14). Temporary factors, such as the significant drop in oil prices and cheaper imports, notably from China,

![Figure 13. Financial indicators](http://dx.doi.org/10.1787/888933367029)
help explain this low inflation rate, but only to a certain extent. For example, the steep fall in the price of Brent by almost USD 40 per barrel in 2015 would have reduced headline inflation by only about ¼ percentage point in 2015, based on a NiGEM simulation.

The transmission of monetary policy has improved and interest rates of corporate loans have been converging in the past two years. However, for loans of smaller size, which matter more for small and medium-sized enterprises (SMEs), rates remain 1 or 2 percentage points higher in some countries (Figure 15, Panels A and B). While part of this differential reflects differences in macroeconomic risk among euro area countries, this could also indicate that firms with similar risk profile, and especially SMEs, tend to suffer from higher lending costs depending on the country in which they are located. This could be explained by the still fragile situation of many banks in some countries, which are plagued with high levels of non-performing loans (NPLs, see below). Banks with high levels of NPLs tend to lend less as they are less profitable, have weaker capital buffers and higher funding costs (Aiyar et al., 2015). As a result, credit is still falling, though more slowly, in most of those countries (Figure 15, Panel C). In a well-functioning single market, the impact of weak domestic banks or high sovereign risk premia should be minimal as creditworthy firms should be able to get financing from other banks or channels (Coeuré, 2015).

With inflation still low, inflation expectations falling and slack still large, monetary policy needs to remain firmly committed to an expansionary stance. Based on current OECD projections, inflation is set to remain below the ECB target until end-2017. In this context, the ECB should explicitly commit to keep monetary policy accommodative (i.e. not increase interest rates or shrink its balance sheet) and treat risks to the achievement of its inflation target symmetrically. In fact, explicitly accepting that inflation could go beyond 2% over the next two years without triggering a tightening of monetary policy could make monetary policy more effective at influencing expectations, which is crucial when interest rates are at the zero lower bound (Ambler, 2009). Nor would it necessarily reduce credibility.
The ECB should ease further if inflation remains below target for longer than expected, for instance in the event of negative economic shocks. The ECB could envisage additional rate cuts, notably the deposit rate as it is the most important policy rate in an environment of excess liquidity, although it would be necessary to carefully assess whether the risks of lowering bank profitability are still of second order compared to the need to sustain the recovery (Coeuré, 2014). Expanding the use of TLTRO is a key tool to reduce impairment in......
the transmission of monetary policy and to enhance the provision of credit. The impact of the APP could be strengthened further by increasing again the monthly purchases, which may require a new extension of eligible assets.

Macroeconomic imbalances linked to the very expansionary monetary stance seem so far limited. There is no indication at this stage of asset price bubbles at the euro area level, notably in the housing sector (Figure 16). Nevertheless, macro-prudential tools should be strengthened to avoid the reappearance of bubbles, which could also apply to EU countries outside the euro area as they could face high capital flows resulting from quantitative easing policies (Rey, 2015). In the housing sector, for example, lower loan-to-value or loan-to-income criteria could be imposed.

Improving monetary transmission by resolving non-performing loans

On the banking sector side, a more aggressive policy to resolve the high level of non-performing loans (NPLs) in several countries would improve banks’ financial situation, facilitating monetary policy transmission and, hence, credit expansion. NPLs are still very high in several countries (Figure 17). Comparing the level of NPLs is difficult, despite the introduction by the European Banking Authority (EBA) in October 2013 of a harmonised definition, as it has mainly applied to the larger banks so far (Aiyar et al., 2015). Swift resolution of NPLs, before the value of impaired loans or their collaterals becomes too low, is a key element needed to reallocate credit more productively to other firms. This is also a financial stability issue as banks in many euro area countries would suffer significant capital losses if the value of their collateral were to fall substantially (Figure 18).

To that end, banks should be encouraged to provision more on a case-by-case basis. Since current International Financial Reporting Standards (IFRS) do not require “dynamic” provisioning (i.e. using a forward-looking model of expected losses) before 2018, the regulator could consider other options, such as imposing capital surcharges. Such additional capital requirements could be triggered once NPLs have passed a certain period,
for example through higher risk weights. Still another way to encourage provisioning could be to impose a progressive reduction of the value of loan collateral past a certain duration: this was applied by the Bank of Spain for NPLs more than two years old.
In parallel to increasing the costs for banks to keep NPLs, policies should also create instruments for banks to recover the highest possible value from their impaired loans. One avenue is to improve insolvency procedures. In particular, they should be made faster in many euro area countries, for example by using out-of-court procedures: fast resolution is key to preserve the value of collateral, especially for firms whose collateral tends to depreciate rapidly through obsolescence. In some countries, legal procedures for banks to access collateral are unduly long.

Setting up an asset management company (AMC) can be a very efficient tool to resolve NPLs: such companies bring better knowledge to value impaired assets, which allows banks, especially smaller ones, to get a better price. A company set at the European level would maximise economies of scale and diversify asset recovery risks. At the same time, potential cross-country risk sharing could be compensated by some financial sector conditionality applied to countries benefiting from the European AMC. An alternative option would be to continue setting up AMCs at the national level. However, public capital may be needed to facilitate private sector participation. Under the new bank recovery and resolution directive (BRRD), selling assets to the AMC above market price (which is considered state aid) triggers a bail-in of junior creditors, the implementation of a restructuring plan for the bank, and, since January 2016, possibly a bail-in of senior creditors as well. Some of these senior bonds have been sold by banks to retail customers, which creates a significant hurdle for governments in some countries to move in that direction. Given the systemic and financial stability considerations in countries where the NPL problem encompasses large swathes of the banking sector, bank-level resolution considerations should not dominate, even if banks having structural viability problems should be restructured.

To facilitate the creation of AMCs, measures to treat NPLs on bank balance sheets within the existing rules without triggering bail-in and resolution procedures should be examined, including possible initiatives at the European level. A very high level of NPLs should be considered a serious economic disturbance and warrant such a waiver to bail-in and resolution procedures within the existing rules. Alternatively, a more lenient approach in the definition of the price level triggering state aid – and hence resolution – could be applied. Both approaches would have to be weighed carefully against moral hazard effects and the possible exacerbation of the sovereign-bank nexus. Currently, the European Commission considers that there is state aid – hence triggering resolution – for any purchase of the NPL by a state-supported AMC at a price above the estimated “market price” of the NPL. Alternatively, when market prices are uncertain and depressed by stressed conditions, resolution requirements could be applicable only for prices above a level half way between the “market price” and the “real economic value” (the latter being the ceiling above which purchases of NPLs by a state-supported AMC are prohibited). Member states benefitting from this exceptional treatment could in return be required to make their insolvency regimes more efficient, which would facilitate a faster recovery of collaterals and thus enable the AMCs to get a higher price for impaired assets.

Completing banking union

Despite recent progress, banking union is still unfinished business. Additional, mutually-reinforcing steps in the areas of supervision, resolution and deposit insurance are required. By curbing the still large potential for negative feedback loops between banks and their sovereigns, completing the banking union would considerably ease crisis
management. Together with steps to create a Capital Markets Union, it would also foster capital markets integration, with benefits for monetary policy transmission, private risk-sharing and rebalancing across the euro area. Furthermore, many of these channels, together with decreased uncertainty brought about by a more complete Economic and Monetary Union, would spur investment and demand in Europe.

The Single Supervisory Mechanism (SSM), comprising the ECB and the competent national authorities, came into operation in November 2014. The ECB directly supervises about 130 large banks, which account for over 80% of euro area banking assets, and oversees the supervisory activities of the competent national authorities on other banks. However, the regulatory framework remains fragmented by numerous options and discretions in the way national supervisors or legislators implement the EU banking law, which inter alia creates obstacles to harmonised supervision and cross-border banking consolidation in Europe. Recent harmonisation work by the ECB is expected to tackle about 120 options and discretions in the supervisory remit through an ECB regulation plus guidance to supervisory teams for decisions on a case-by-case basis (ECB, 2015). A level playing field, however, also depends on national legislation, both in banking law and in related matters, such as insolvency regimes.

Beyond harmonisation, the EU banking law treatment of sovereign exposures, now generally zero-risk weighted and exempted from large exposure limits, is under review. However, to avoid disruptions to sovereign debt markets and government financing, changes in regulation in this area should follow a co-ordinated approach at global level and require careful consideration of transition arrangements (ESRB, 2015).

The Single Resolution Mechanism became fully operational in January 2016, as planned, with a resolution authority (the Single Resolution Board), a harmonised framework for resolution tools (the Bank Recovery and Resolution Directive) and dedicated financial resources (the Single Resolution Fund). Bailing in shareholders and creditors by at least 8% of total liabilities (including own funds) is in general a pre-condition for access to the Single Resolution Fund. Over an eight-year transition period, this Fund will be built up with risk-adjusted contributions from banks, and its national compartments will be gradually mutualised. By end-2023, it should reach 1% of covered deposits in participating member states (an estimated EUR 55 billion). During the transition period, national credit lines will back up national compartments.

Further progress at both national and European levels is needed on deposit insurance. The 2014 Deposit Guarantee Schemes Directive further harmonised coverage, sped up pay-out to depositors and strengthened funding requirements for national schemes, which are in general to be built-up to a minimum 0.8% of insured deposits by 2024. However, due to different starting points, transposition delays (most countries missed the July 2015 deadline) and remaining options and discretions, actual funding levels still vary widely. While desirable in its own right, reinforcing national insurance schemes through full implementation of the 2014 directive would also help to pave the way for mutualised area-wide insurance by decreasing moral hazard concerns.

Even when fully built-up, national deposit guarantee schemes will remain vulnerable to large national shocks, an issue that mutualisation would mitigate. A recent European Commission proposal for a European Deposit Insurance Scheme, to be phased in over 2017-24, is a welcome step (European Commission, 2015a, 2015b). Overall costs for banks would not change, as contributions to the European Deposit Insurance Scheme would gradually replace those to national schemes, and the funding target of 0.8% of
covered deposits by 2024 would also remain unchanged. Moreover, bank contributions would better reflect risk, since they would be calculated relative to all other participating banks, rather than in relation to individual national banking systems. Equally welcome is the pre-condition of further harmonisation of national schemes, in aspects like target levels of funding and determination of risk-adjusted bank contributions.

To complete the banking union, it is necessary to introduce a European fiscal backstop to the Single Resolution Fund and to the European Deposit Insurance Scheme, once it is implemented. Layers of defence have been put in place in recent years, such as higher capital requirements, enhanced supervision and bail-in provisions. Yet the Single Resolution Fund, small even when fully built-up, could be insufficient to cope with a large banking crisis (CEPS, 2014). The direct bank recapitalisation instrument of the European Stability Mechanism, operational since December 2014 and designed as a last-resort tool after Single Resolution Fund intervention, provides only a partial solution. Amounts dedicated to this instrument are also limited (EUR 60 billion) and eligibility criteria are restrictive (Juncker et al., 2015), as they require national co-financing and could include general economic policy conditionality. A common backstop could be implemented through a credit line from the European Stability Mechanism to the Single Resolution Fund, and would be fiscally neutral in the medium term as banks would reimburse any public funds used through ex post contributions to the Single Resolution Fund. By breaking the banks-sovereign nexus at national level, a European fiscal backstop would also ease acceptance of tighter supervisory harmonisation (Schoenmaker and Wolff, 2015).

Making public finances more growth and equity-friendly

The crisis has taken a heavy toll on public finances, calling for reforms at European and national level

Public finances matter for growth and equity through multiple channels. Ensuring debt sustainability and smoothing cyclical fluctuations tend to support growth in mutually reinforcing ways. High levels of debt can hamper the ability to stabilise the economy (Fall and Fournier, 2015). In turn, deep recessions can harm long-term growth and thus compound sustainability challenges through hysteresis effects. By increasing long-term unemployment, these effects will also likely worsen inequality.

Certain changes in the composition of expenditure or revenue can significantly enhance growth (IMF, 2015a). Examples include a greater prioritisation of public investment or education, or a shift of taxation from labour to consumption and property (Johansson et al., 2008; Cournède et al., 2013). More qualitative fiscal-structural reforms, such as base-broadening in taxation to fund tax rate decreases or greater efficiency in spending, would also be growth-friendly. At the same time, some compositional changes may harm equity, but others, such as those favouring education and childcare spending, enhance it.

Sustainability, cyclicality, composition and efficiency are hence interconnected dimensions of the overall quality of public finances. However, several of these dimensions have deteriorated since the global financial crisis. The increase in public debt was substantial (Figure 19), largely due to the recession and to specific events, such as banking sector rescues (Eyraud and Wu, 2015). High debt can weaken fiscal sustainability including by triggering shifts in market sentiment, which could make debt financing more difficult. Further, although without firm conclusions on the direction of causality (e.g. Panizza and Presbitero, 2014), high debt levels tend to be associated with lower GDP growth. Concerns about high and rising debt, together with market pressure in some instances, led to sharp
fiscal consolidation in the euro area as a whole, especially in 2011 and 2012, and to a lesser extent 2013 (Figure 20). Consolidation partly reflected earlier commitments in the context of the 2008-09 co-ordinated fiscal stimulus package. Although estimates of the importance of spillovers vary across studies, fiscal consolidation in one country can have a sizeable negative growth impact on others, especially in bad times (Goujard, 2013; Carnot and Castro, 2015). As a result, the simultaneous fiscal adjustment across the euro area, including in core countries, is considered to have made the recession deeper and longer (Baldwin et al., 2015). This likely aggravated the debt-GDP ratio as growth was weaker.
Furthermore, shifts in budget composition have generally hurt medium-term growth prospects, especially in the countries carrying out the largest fiscal adjustments. Spending restraint has fallen heavily on public investment (Figure 21). Several countries, especially those hit hardest by the crisis, also cut social protection expenditures on family and children, although this spending tends to be growth and equity-friendly. Developments in revenue composition have been less harmful, but still a matter of concern. Social contributions have tended to account for a modest share of the adjustment, which is welcome, but personal income taxes have increased significantly in many countries. These increases can potentially make income distribution less unequal but tend to penalise employment and growth. Worryingly, labour tax wedges in euro area countries, already high in international comparison, have tended to rise further, and those on low incomes have sometimes risen the most (Figure 21). A recent stock-taking of reforms shows that many euro area countries are planning or implementing labour tax reductions, though measures could be more ambitious (European Commission, 2015c).

These developments in government revenue and spending have gone hand in hand with only a modest degree of implementation of fiscal-structural reforms that improve the composition or efficiency of public finances. Action in response to country-specific recommendations addressed to countries by the European institutions has on average been relatively low, and below-average in fiscal-structural policy areas (Deroose and Griesse, 2014). For instance, there has been limited progress in reducing taxes on labour and broadening tax bases. On the spending side, reforms to strengthen public administration governance and to improve cost-effectiveness and performance in key domains, such as education and health, have also tended to display below-average implementation.

While most policy levers to improve the quality of public finances remain at the national level, European and national policies can be mutually reinforcing in two key areas: fiscal governance and public investment. Fiscal governance matters for virtually all dimensions of the quality of public finances. Especially since the crisis, numerical fiscal rules have striven to reconcile sustainability and stabilisation (Schaechter et al., 2012). Other desirable features of fiscal governance, such as a multi-year budget horizon and independent fiscal institutions, can enhance the effectiveness of numerical rules and yield benefits for the composition and efficiency of public finances. For instance, better budget institutions tend to lead to more growth-friendly fiscal consolidation (IMF, 2014; Gonçalves and Pina, 2016). Multi-year budget frameworks, as encouraged by recent Stability and Growth Pact (SGP) reforms, help optimise public investment (IMF, 2015b), which is one of the fiscal tools with the strongest impacts on growth. Collective action to increase public capital formation and leverage private investment is critical to overcome persistent investment weakness in Europe and spur growth both in the short and the medium run. Especially in the latter horizon, the Investment Plan for Europe, in articulation with national resources and with other instruments at EU level, such as regional policy funds, may play an important role.

Reforming European fiscal governance to promote collective and inclusive growth

Fiscal policy remains a key competency at the national level. At the same time, national budgets are also subject to the requirements of the Stability and Growth Pact (SGP). The SGP has a dual structure, with a corrective arm and a preventive arm. The first, also called the Excessive Deficit Procedure (EDP), is based on ceilings for the nominal deficit and debt as a
Figure 21. Post-crisis fiscal consolidation episodes: Composition and labour tax wedge developments

A. Expenditure cuts
Change in the underlying primary balance, % points of potential GDP

B. Revenue increases
Change in the underlying primary balance, % points of potential GDP

C. Change in the labour tax wedge
For a single person with no children at different earning levels, percentage points

1. A fiscal consolidation episode is a period of consecutive years where the underlying primary balance is improving. A deterioration of this balance in an intermediate year is admissible, provided the balance improves in the sum of any two adjacent years. Episodes considered in the chart are those starting in 2009 or later. Due to data limitations on the composition of consolidation, the final year considered is 2013, though for some countries consolidation efforts have continued afterwards.

2. On both revenue and expenditure sides, increases or decreases in cyclically-adjusted budget items do not always relate to discretionary policy measures. For instance, tax elasticities can fluctuate for reasons not captured by the corrections performed for the economic cycle and for one-offs.

3. Income tax plus employee and employer contributions less cash benefits as a percentage of labour costs.

ratio to GDP (3% and 60%, respectively). The preventive arm is based on the so-called medium-term objective (MTO), which provides a medium-term target for the structural budget balance of each country.

Some 2011-13 reforms make better allowance for the fiscal and economic situation of the EU member states. At the same time, SGP rules have become complex due to the proliferation of different numerical targets, procedures, contingency provisions and compliance indicators across the two arms (OECD, 2014a; Eyraud and Wu, 2015). The SGP has nonetheless remained primarily focussed on individual national policies, with scope for further consideration of their aggregate area-wide impacts. Furthermore, despite strengthened enforcement provisions of the preventive arm, those of the EDP remain more visible, often making policymakers focus on the 3% of GDP deficit threshold, risking procyclical policy responses. With Treaty changes unlikely in the coming years (Juncker et al., 2015; European Commission, 2015d), the short-term challenge is to ensure a sound application of the current SGP rules. In particular, degrees of freedom afforded by the rules should be used by countries with fiscal space to contribute to a more supportive joint euro area fiscal stance.

The preventive arm contains some welcome flexibility in the structural balance trajectory towards the MTO. The required annual fiscal adjustment depends on cyclical conditions (for instance, with no required adjustment in case of negative GDP growth). In some cases, there can be temporary deviations from the MTO or the consolidation plan towards it to accommodate the short-term fiscal costs of major structural reforms, including certain kinds of investment. Rule enforcement allows for some margins of tolerance, since a deviation from the MTO or the path towards it is regarded as significant only if it reaches at least 0.5% of GDP in one year, or 0.25% on average in two consecutive years. Further, countries may be allowed to temporarily deviate from the adjustment path towards the MTO in periods of severe area-wide economic downturn, a provision unused so far.

As cyclical conditions improve and more countries leave the EDP, the need for fiscal adjustment under the preventive arm will increase. In this context, rules should be strictly enforced to help avoid a return to fiscal slippages in good times, as occurred before the global financial crisis (Eyraud and Wu, 2015; Carnot and Castro, 2015). In bad times, national fiscal policies should take account of cross-country spillovers (Goujard, 2013) and, within SGP rules, contribute to supporting euro area aggregate demand. In the current weak recovery, countries should use the flexibility afforded by preventive arm rules to temporarily slow down or halt consolidation efforts and, if room for manoeuvre under the SGP exists, adopt a temporary fiscal expansion. Public investment on trans-European networks should rank high among the priorities for using fiscal space. The recently announced European Fiscal Board may help to inform the debate on the appropriate area-wide fiscal stance and how it should translate into national fiscal stances.

In the corrective arm, large adjustments induced by the debt reduction benchmark should be avoided. The benchmark requires that the excess of the debt ratio over 60% of GDP be reduced at an average 1/20th per year (with some transitional provisions). For highly indebted countries, these fiscal adjustments can be very large. Italy, for instance, would have needed a cumulative structural effort of around 3 per cent of GDP over 2013-15 (European Commission, 2015e). In the cases it has examined so far (Belgium and Italy), the Commission took account of expected compliance with preventive arm requirements and
expected implementation of ambitious structural reforms, as well as of unfavourable economic conditions (especially low inflation), and decided not to open an EDP (European Commission, 2015e, 2015f). A similar approach should be taken in forthcoming cases, as other highly indebted countries leave the EDP and become subject to the debt reduction benchmark. In a future SGP revision, the appropriate speed of adjustment towards the 60% of GDP debt threshold should be reviewed (see below).

It is also important to strengthen incentives for reform, including of national budget frameworks. The corrective arm requires an annual adjustment of at least 0.5% of GDP regardless of cyclical developments, which may imply a procyclical stance, and a deadline for eliminating the excessive deficit. Longer deadlines are the main provisions for flexibility. Largely due to the recession, only five euro area countries achieved compliance with the initial deadline in EDPs that started in 2009/10, and five others were granted two or more deadline extensions. Building on recent steps (European Commission, 2015g), the Commission could make greater use of longer initial deadlines (or deadline extensions, conditional on a satisfactory track record of fiscal adjustment) to provide incentives for fiscal-structural reforms. Greater emphasis should also be given to the quality of national budgetary frameworks (an aspect already contemplated in current legislation) when taking EDP steps.

Over the medium term, SGP rules should be improved along two main dimensions. First, to reduce complexity and asymmetries in enforcement, the preventive and corrective arms could be more closely aligned and possibly merged, giving rise to a single set of targets, procedures and indicators. Second, the current multiplicity of numerical rules could be replaced by a single fiscal anchor underpinned by a single operational rule (Andrle et al., 2015). The natural anchor is the public debt-to-GDP ratio in each country, given its direct link to fiscal sustainability. These reforms would imply very substantial legislative changes, including to the Treaty. The spring 2017 White Paper envisaged in the Five Presidents’ Report (Juncker et al., 2015) offers an opportunity to start preparatory work.

Reinforcing national budgetary frameworks

Budget frameworks at national level play a key role in improving the quality of public finances and the procedures and institutions involved in preparing, approving and executing budgets are highly country-specific. The SGP reform of 2011-13 required stronger national fiscal frameworks, including numerical fiscal rules, independent fiscal institutions and improved budget reporting and transparency. Important strides have been made in some areas, such as the coverage and timeliness of budget statistics and the creation of independent fiscal institutions. However, overall budget reform activity since late 2011, as assessed by the OECD, has been generally modest (Figure 22). Apart from the transposition of the MTO into national law, the adoption of national-level numerical rules, such as expenditure rules with a broad coverage, has been limited (Schaechter et al., 2012; Bova et al., 2015). In most countries, more micro-level reforms enabling systematic expenditure prioritisation or the efficient use of performance information in budgeting have also had low implementation.

Adopting national expenditure rules and regularly conducting spending reviews would upgrade budget frameworks in mutually reinforcing ways. Expenditure rules offer a good balance between sustainability and stabilisation objectives, as automatic stabilisers are largely on the revenue side, and tend to perform well on other counts, such as simplicity and ease of communication (Andrle et al., 2015). In turn, through systematic
scrutiny of baseline expenditure, spending reviews can improve prioritisation and help achieve efficiency gains (Robinson, 2014). Rule-based aggregate expenditure ceilings provide a medium-term anchor to the determination of annual spending allocations, and thus facilitate reforms to increase the efficiency of public spending at sectoral or programme level. When integrated into the regular process of budget preparation, spending reviews support adherence to aggregate spending ceilings. Monitoring of rule compliance, as well as of spending reviews’ follow-up recommendations and respective impacts, should be entrusted to an independent fiscal institution.

Besides monitoring compliance with fiscal rules and preparing or endorsing macroeconomic forecasts, according to SGP requirements, the remit of national independent fiscal institutions could be usefully extended to estimating the costs of proposed policies, a common task among such institutions outside the European Union (Debrun and Kinda, 2014). This would contribute to a more informed public debate on spending and tax policies, potentially leading to a better design of such policies. Independent fiscal institutions should also be provided with the resources and conditions for a credible fulfilment of their mandate. Staff needs would generally increase if institutions were tasked with cost estimates, as this requires sector and programme-specific expertise. Safeguards on institutions’ budgets, such as multiannual funding commitments, are often lacking, but would enhance the independence of those bodies (OECD, 2014b). Less than half of EU independent fiscal institutions have full access to non-public budgetary information (European Commission, 2014). Finally, relations between the new advisory European Fiscal Board and national independent fiscal institutions should be organised in a mutually-reinforcing way, as planned, thus avoiding to undermine the scope of action and credibility of the latter.
Leveraging the impact of EU investment policies

Both European and national policy levers play a key role in ensuring enough and efficient spending on public investment. EU budget funds for investment and other growth-enhancing expenditure, such as on education and active labour market programmes, stand at 0.5% of EU GDP. This amount is arguably too low if account is taken of the potential for generating economies of scale and positive externalities, for example from research and development or infrastructure. However, even these limited resources can have a leveraged impact on the composition and efficiency of public finances if deployed in a way to crowd in national public funds and private investment, and foster greater investment productivity. At national level, better co-ordination of investment across levels of government and upgraded administrative capacity would increase investment efficiency.

The structure of EU budget expenditure should be made more growth-friendly. Funds aimed at investment and growth account for close to half of the total (Figure 23, “Smart and inclusive growth”). Most of these resources fund European regional policy and are geographically allocated. In contrast, “Competitiveness for growth and jobs” programmes are directly managed at European level with no country-specific allocations. They include, among others, the research and innovation Horizon 2020 and the Connecting Europe Facility (targeted at the development of trans-European networks in transport, energy and digital services). Also, in the context of the Investment Plan for Europe, the European Fund for Strategic Investments supports projects across the EU with no geographic pre-allocation. In the short term, it is essential to preserve investment and growth allocations in the face of pressures on other fronts, such as the refugee crisis. In the longer term, post-2020 financial frameworks should continue to increase resources for growth-enhancing expenditure, funded by either reallocation of expenditure or an increase in the overall EU budget size.

Figure 23. European Union budget: Structure of expenditure
As a percentage of total commitments appropriations for 2014-20

1. CAP: Common Agricultural Policy.
It is important to ensure additionality in EU regional policy (i.e. that EU funding adds to, rather than replaces, national public spending) and that funds are spent efficiently. Monitoring and enforcement mechanisms for additionality have been reinforced only gradually, and remain weak: possible sanctions appear late in the process (not before 2022 for the 2014-20 period) and are relatively light. Furthermore, especially for euro area countries, the levels of gross fixed capital formation required for compliance with additionality look often unambitious, implying an increase in the share of European structural and investment funds (and thus a decrease in that of national funds) in total public investment (Figure 24). Current rules for additionality should be credibly enforced, starting with the 2018 mid-term verification, where increasing required investment levels could be considered. In future programming periods, more ambitious levels should likewise be envisaged, and possible sanctions brought to an earlier stage.

Figure 24. **European structural and investment funds as a share of public investment**¹

![Image of Figure 24](http://dx.doi.org/10.1787/888933367118)

1. Allocations for the European Regional Development Fund, European Social Fund and Cohesion Fund as a share of government gross fixed capital formation.

2. Share of European structural and investment fund (ESIF) allocations in public investment if the latter equals the agreed reference levels for additionality verification. The fact that part of ESIF allocations will not fund gross fixed capital formation but rather other spending items (e.g. certain transfers) helps explain why shares can exceed 100%. In Italy and Slovenia the national-wide additionality targets depicted are merely indicative, as additionality will be verified at a regional level.


To support institutional quality and investment efficiency, conditionality requirements in EU regional policy have been generally reinforced in the 2014-20 period. Numerous ex ante conditionality requirements need to be met before the disbursement of funds, either of a general nature (such as compliance with public procurement rules) or of a thematic one (such as the existence of national strategies in specific sectors). In addition, macroeconomic conditionality aims to reinforce consistency between European structural and investment funding and key elements of EU economic governance. For instance, to better address country-specific recommendations, the Commission may request countries...
to reprogramme structural and investment funds, which could improve their alignment with relevant structural reforms. As in the case of ex ante conditionalities, preserving national ownership of reforms and other requirements will nonetheless be key.

In other cases, however, macroeconomic conditionality may be counterproductive. For example, the Commission must propose a suspension of structural funds when the Council assesses that no effective action has been taken to correct an excessive deficit. Though modulated in the light of economic and social conditions, suspended amounts will be at least in the range of 0.25 to 0.5% of GDP (or 25% to 50% of annual structural and investment funding if lower). This suspension will be lifted and re-budgeted as soon as the member state has adopted the necessary corrective action. Nevertheless, under fiscal stress, these sanctions would likely worsen the composition of public expenditure by intensifying downward pressures on public investment and other growth-enhancing items, and should therefore in most cases be avoided.

Announced in November 2014, the Investment Plan for Europe aims to generate at least EUR 315 billion (2.2% of 2015 EU GDP) of additional investment over three years, mainly from private sources and with a focus on strategic sectors, including infrastructure, innovation and SMEs. The Plan's funding pillar (the European Fund for Strategic Investments, EFSI) allows the European Investment Bank (EIB) Group to finance projects that would not have been supported otherwise. The EFSI is endowed with a risk-absorbing capacity of EUR 21 billion: EUR 5 billion from EIB resources, and an EU guarantee of EUR 16 billion. This guarantee will be backed up by EU budget resources mainly reallocated from other growth-enhancing programmes (Horizon 2020 and the Connecting Europe Facility). Alternative reallocations, drawing on less growth-friendly expenditure, would have been preferable. Similarly, it is important to ensure that the amounts committed by several countries to provide co-financing to investments represent additional public support, rather than investment reallocation. EFSI-supported investment has so far provided negligible stimulus to activity, but it may have a positive medium-term impact: project approvals are proceeding in line with the target, with those approved by mid-May 2016 expected to trigger total investment of about EUR 100 billion in the coming years. The Plan also comprises a second pillar for technical assistance (through the European Investment Advisory Hub) and project promotion, and a third pillar for structural reforms to create an investment-friendly environment, which are discussed in the 2016 OECD Economic Survey of the European Union. A case in point, essential to unlock investment, is the reduction of regulatory heterogeneity across Europe.

Given limited public resources, the medium-term success of the Plan will hinge on its ability to leverage private investment, for which the EIB Group’s lending behaviour and the quality of the projects presented will be key. The EUR 315 billion investment target presupposes a multiplier of 15: the EFSI guarantee should enable three times as much EIB Group funding, which will be used to finance an average 20% of the value of investment projects (the remainder coming from additional investors, with a large role played by the private sector). This requires selecting projects which are attractive for additional co-funding and (to avoid crowding-out) which would not otherwise be carried out. Crowding in private investment on the scale envisaged also requires that the EIB Group depart from its usual very prudent lending practices, characterised by a choice of low-risk projects and negligible levels of non-performing loans (Claeys, 2015). This implies accepting projects with higher risk than in the past, and financing on average a lower share of each (one-fifth, rather than the traditional one-third to one-half).
Improving public investment governance

At national level, stepping up efforts to co-ordinate investment among tiers of government is essential. Across the OECD, sub-national governments account for about 60% of total public investment, highlighting the need for vertical and horizontal co-ordination mechanisms (OECD, 2013). However, effective co-ordination is difficult: in a recent survey on infrastructure investment, more than three quarters of EU sub-national governments reported co-ordination challenges (OECD and Committee of Regions, 2015). Potential tools to foster co-ordination include bringing together different jurisdictions in dialogue fora with actual involvement in decision-making, co-financing and conditionality mechanisms, and the promotion of collaboration between sub-national governments through the removal of legal and regulatory barriers, possibly coupled with financial incentives. Better co-ordination among sub-national governments will also enhance their ability to promote sound investment projects under the Investment Plan for Europe.

Public administration capacity is also essential for efficient investment, but is often inadequate, especially at sub-national level. There is wide variation in the perceived quality of sub-national governments across the European Union, as well as within some countries (Charron et al., 2012). Capacity challenges have been identified at various stages of the investment cycle, including long-term strategic planning, the ability to involve the private sector (for instance through public-private partnerships) and public procurement (OECD, 2013). Aware of these weaknesses, EU regional policy has included the enhancement of administrative capacity among its ex ante conditionalities for the 2014-20 period, with an accompanying increase in financial support for this purpose. A recent proposal for a Structural Reform Support Programme (European Commission, 2015h) will also support capacity building, namely through technical assistance. At the same time, the European Investment Advisory Hub has the potential to provide expertise to national authorities and co-ordinate the already existing technical assistance activities. National authorities should prioritise actions to preserve and develop administrative capacity at different levels of government in response to the main gaps detected. In times of fiscal restraint, these considerations should inform the design of fiscal consolidation.

Bibliography


ANNEX

Progress in structural reform
ANNEX. PROGRESS IN STRUCTURAL REFORM

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<th>Main recommendations</th>
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<td>Keep the current expansionary monetary policy stance over an extended period, subject</td>
<td>Monetary policy has become more supportive since mid-2014, through policy rate cuts (which have taken the deposit rate increasingly to negative territory), a series of targeted long-term refinancing operations and expanded asset purchases.</td>
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<td>to the outlook for price developments over the medium term.</td>
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A. Monetary policy

- Ensure that the ongoing comprehensive assessment of banks – which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test – leads to a consistent overall evaluation of banks' balance sheets.
- Adopt a single resolution mechanism with predictable and swift decision-making that is politically accountable, and ensure that it is operative soon after the Single Supervisory Mechanism is in place. The agreement needs to ensure the effectiveness of the mechanism and its ability to quickly take decisions in emergency situations.
- Ensure legal certainty and equal treatment in the bail-in of bank creditors across states to avoid complicating resolution processes and a potential negative impact on bank funding. Ensure minimisation of national discretion in setting resolution conditions.
- For the national resolution funds to be set up under the Bank Recovery and Resolution Directive, ensure that burden-sharing arrangements for banks with cross-border activities are available. For the Single Resolution Fund, establish strong arrangements to ensure cross-border resolution financing as long as the resources of the national compartments of the Fund are not yet fully pooled. Move over time to full pooling of the Fund resources. Prefund the Resolution Fund or temporarily bridge funding gaps that might occur in the transition phase via a fiscal backstop and recuperate the finances needed by risk-based contributions from the banking sector.
- Complement the Resolution Fund by a common fiscal backstop that is fiscally neutral over the medium term and recoups ex post any bridge financing via contributions from the financial sector.
- Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets. Any decision would need to be taken in a co-ordinated manner at the international level. Diversify in the long run the banks' exposure to the debt of a single sovereign. Assess the merits of leverage ratios, as a supplementary measure to risk-weighted ratios, for gauging the strength of bank balance sheets.
- The 2014 comprehensive assessment of banks' balance sheets improved information on the health of the financial sector and led, in a number of cases, to bank recapitalisations, paving the way for the coming into operation of the Single Supervisory Mechanism.
- The Single Resolution Mechanism became fully operational in January 2016. Its ability to take decisions in emergency situations has not been tested yet.
- The Bank Recovery and Resolution Directive was adopted (May 2014) and has been transposed by most countries. However, transposition has had some delays and has resulted in substantial heterogeneity across countries in resolution settings.
- Preparatory work on different policy options for reforming the regulatory treatment of sovereign exposures has continued. No decisions have been taken yet.

B. Banking regulation and banking union

- Continue fiscal consolidation, respecting the requirements of the Stability and Growth Pact, as planned and allow the automatic stabilisers to operate fully.
- Design fiscal consolidation to favour inclusive growth and employment.
- Ensure effective implementation of the strengthened EU and Fiscal Compact rules in national fiscal frameworks, including medium-term budgeting, identification of future spending and revenue pressures and risks, independent fiscal councils and effective mechanisms to correct deviations from fiscal targets.
- In most cases, fiscal consolidation strategies have not favoured growth, equity and employment. Public investment has not recovered from previous cuts. Though some countries reduced social contributions in 2015, this has only reversed a small part of previous increases in labour taxation.
- More countries have set up independent fiscal institutions and transposed the medium-term objective and the adjustment path towards it into national law. The coverage and timeliness of budget statistics have improved. Less progress has been made in adopting national expenditure rules and regularly conducting spending reviews.