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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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Basic Statistics of Euro Area, 2017

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	340.7		Population density per km²	123.5	(37.2)
Under 15 (%)	15.2	(17.9)	Life expectancy (years, 2016)[c]	82.0	(80.5)
Over 65 (%)	19.5	(17.0)	Men	79.3	(77.9)
Foreign-born (%)	12.6		Women	84.6	(83.1)
Latest 5-year average growth (%)	0.2	(0.6)			
ECONOMY					
Gross domestic product (GDP)			Value added shares (%, 2016)		
In current prices (billion USD)	12,590		Primary sector	1.6	(2.5)
In current prices (billion EUR)	11,169		Industry including construction	25.1	(26.7)
Latest 5-year average real growth (%)	1.5	(2.1)	Services	73.4	(70.8)
Per capita (000 USD PPP)	42.9	(42.2)			
GENERAL GOVERNMENT[d]					
Per cent of GDP					
Expenditure	47.1	(40.6)	Gross financial debt	86.7	
Revenue	46.2	(37.7)			
EXTERNAL ACCOUNTS					
Exchange rate (EUR per USD)	0.887		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.762		Machinery and transport equipment	42.1	
In per cent of GDP			Other manufactured goods	23.9	
Exports of goods and services (including intra EA)	47.3	(58.0)	Chemicals and related products, n.e.s.	17.6	
Imports of goods and services (including intra EA)	42.9	(53.3)	Main imports (% of total merchandise imports)		
Current account balance	3.5	(0.4)	Machinery and transport equipment	34.5	
Net international investment position	-1.3		Other manufactured goods	25.8	
			Mineral fuels, lubricants and related materials	15.1	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate for 15-64 year-olds (%)	66.5	(67.7)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	9.1	(5.8)
Men	71.6	(75.4)	Youth (age 15-24, %)	18.8	(11.9)
Women	61.3	(60.1)	Long-term unemployed (1 year and over, %)	4.4	(1.7)
Participation rate for 15-64 year-olds (%)	73.1	(71.1)	Tertiary educational attainment 25-64 year-olds (%)[d]	30.3	(35.7)
Average hours worked per year (2016)[b]	1 696	(1 763)	Gross domestic expenditure on R&D (% of GDP, 2016)	2.1	(2.3)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2016)[d]	3.5	(4.1)	CO_2 emissions from fuel combustion per capita (tonnes, 2015)	7.2	(9.2)
Renewables (%)	12.8	(9.6)	Municipal waste per capita (tonnes, 2016)	0.5	(0.5)
Exposure to air pollution (more than 10 g/m3 of PM2.5, % of population, 2015)	73.0	(75.2)			
SOCIETY					
Income inequality (Gini coefficient, 2016)[d]	0.307	(0.311)	Education outcomes (PISA score, 2015)		
At risk of poverty rate (%, 2016)[d]	10.8		Reading	489	(493)
Public and private spending (% of GDP)			Mathematics	490	(490)
Health care, current expenditure (2016)[c]	8.6	(9.0)	Science	491	(493)
Pensions (2013)[c]	9.9	(9.1)	Share of women in parliament (%, April 2018)	32.4	(29.7)
Education (primary, secondary, post sec. non tertiary, 2014)	3.4	(3.7)	Net official development assistance (% of GNI)	0.33	(0.40)

Better life index : www.oecdbetterlifeindex.org

Note: Average of euro area 19 countries unless otherwise indicated.

a. Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

b. Average of the euro area member countries that are also members of the OECD (15 countries).

c. Latest available year for the OECD average.

Source: Calculations based on data extracted from the databases of the following organisations: Eurostat, OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

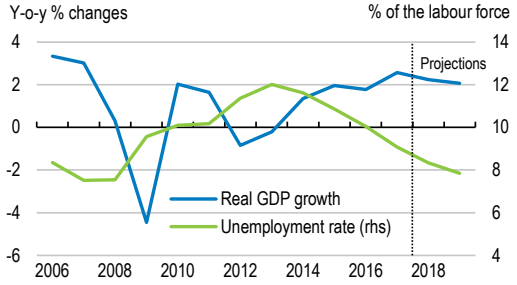
Executive summary

- *The economy is expanding supported by accommodative macroeconomic policies*
- *Better risk sharing is needed for a resilient and sustainable monetary union*

The euro area is expanding…

The euro area economy is growing robustly. The euro area economy has expanded since 2014 (Figure A), helped by very accommodative monetary policy, mildly expansionary fiscal policy and a recovering global economy. GDP growth is projected to slow somewhat, but to remain strong by the standards of recent years.

Figure A. The economy is expanding



Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database) and updates.

StatLink http://dx.doi.org/10.1787/888933740991

…but should fix its remaining fragilities

Ensuring the sustainability of the monetary union in the future requires further reforms. Improved economic conditions are also reflected in increasing citizens' support for the common currency. However, further reforms in the architecture of the monetary union are needed to enhance its resilience to downturns and ensure its long-term sustainability. In particular progress with banking union including risk reduction and sharing should be made rapidly. A fiscal stabilisation tool for the euro area would help to absorb country-specific and common euro area shocks and complement member states fiscal policies. Finally, reforms aimed at creating a genuine capital markets union should continue.

Monetary policy should stay accommodative

While remaining accommodative for now, monetary policy will have to gradually normalise. Monetary policy has strongly supported the recovery. Yet, headline inflation remains well below target and monetary policy should be firmly committed to remaining accommodative as long as needed to put inflation back on track. At the same time, the ECB should prepare for a gradual normalisation as inflation is expected to progressively return to objective. To avoid the risk of unintended market disruptions during the normalisation process, the ECB could reinforce its forward guidance on expected policy rate paths and commit to reduce its balance sheet only after the first interest rate hike and then only gradually. To minimise possible side effects of accommodative monetary policy, especially in countries that are experiencing strong expansion, macroprudential tools should be used to shield the financial system from overexposure to systemic risks, for example credit financed housing price bubbles, while other policies should also help avoid building up significant imbalances. To facilitate the use of macroprudential policy instruments, better collection of granular and harmonised data, in particular on commercial real estate, would be helpful.

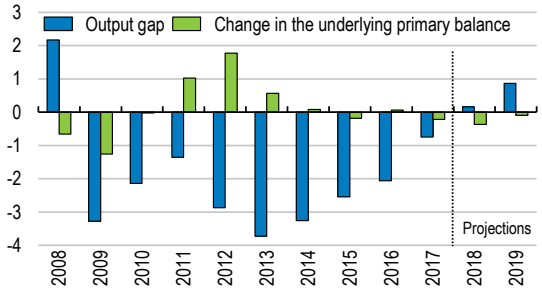
Resolving non-performing loans would boost credit and investment. Rapid resolution of remaining non-performing loans is key to facilitate new bank lending in former crisis countries and better transmission of monetary policy across the euro area. Policies to address non-performing loans are multifaceted and include better supervision to prevent build-ups in the future, the development of secondary markets for distressed assets, better aligned insolvency and debt recovery frameworks and further restructuring of the banking system. The EU Council Action Plan (2017) and the package of concrete measures on NPLs proposed by the European Commission (2018) are welcome and should be implemented swiftly. In particular, the creation of national asset management companies could be facilitated and help banking systems struggling with high levels of NPLs to work-out certain types of impaired assets.

The recovery should be used to improve fiscal positions

The European fiscal framework must ensure fiscal positions improve in good times. In some cases in the past, good times were not used to improve fiscal positions sufficiently and the crisis led to significant increases in public debt ratios. The expected broadly neutral fiscal stance in 2018 is appropriate, but as countries' economy expands and output gaps close, the countries with high

debt ratios should ensure that debt-to GDP ratios fall significantly by improving fiscal positions further (Figure B). This requires among others raising national awareness, notably through a more active role of fiscal councils, that fiscal consolidation is desirable in good times, together with implementing sound economic policies. In addition developing also stronger incentives by revising some aspects of the current European fiscal framework, as recently proposed by the European Fiscal Board, is needed.

Figure B. The euro area fiscal policy stance is set to remain broadly neutral



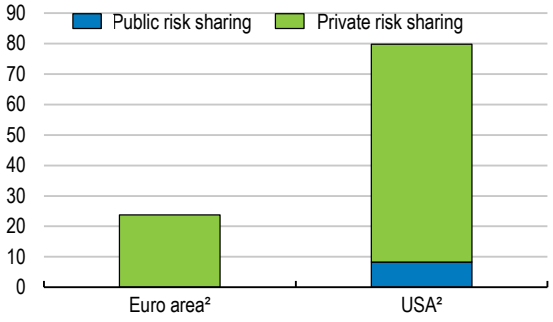
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).
StatLink http://dx.doi.org/10.1787/888933741010

While adjusting the current framework is an interesting avenue to ensure improved fiscal balances in good times, it is likely to make the European fiscal framework – which already includes multiple numerical targets, procedures and contingency provisions – even more complex. Simplifying the rules, while keeping necessary flexibility to take into account the overall assessment of the economic situation, would make them more operational. Eventually countries should consider following an expenditure objective that ensures a sustainable debt ratio.

Better risk sharing is needed for a resilient and sustainable monetary union

Risk sharing is important in a monetary union. As monetary policy should only react to area-wide shocks and may, from time to time, be constrained by an effective lower bound for its policy rates, other policy tools need to be available to deal with large or asymmetric shocks. In the euro area incomplete banking union and fragmented capital markets prevent higher levels of private risk sharing through broader range of savings and investment opportunities; public risk sharing through fiscal transfers currently is virtually non-existent (Figure C).

Figure C. Cross-border risk sharing in the euro area is low



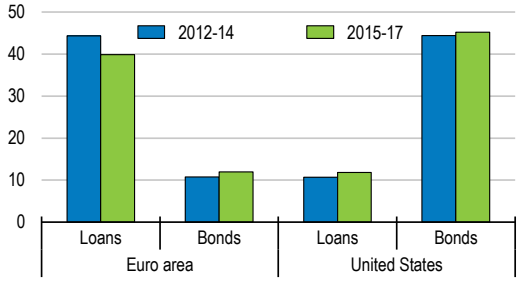
1. Public risk sharing refers to cross-border fiscal redistribution, whereas private risk sharing refers to the smoothing effect of cross-border factor income (capital and labour) and credit markets.
2. See figure 22 for details.

Source: European Commission (2016), "Cross-Border Risk Sharing after Asymmetric Shocks: Evidence from the Euro Area and the United States", Quarterly Report on the Euro Area 15(2), Brussels.
StatLink http://dx.doi.org/10.1787/888933741029

Banking reforms must address the potentially harmful link between banks and their sovereigns. Banking union remains unfinished business. Since financial intermediation in the euro area remains predominantly bank-based (Figure D), progress in this area is key to achieve greater private risk sharing. The resolution fund needs to be backstopped by rapidly available financial resources to ensure its credibility in the event of another large systemic shock, a role that could possibly be played, in a fiscally-neutral way, by the European Monetary Fund, as recently proposed by the European Commission. Building on progress in risk reduction, a rapid agreement on a common deposit insurance scheme is necessary to complete the banking union. To further loosen the potentially harmful link between banks and sovereigns, introducing charges that rise with the degree of concentration of sovereign debt in banks' portfolios and other policies could incentivise banks to diversify their holdings of sovereign debt (Figure E). A combination of policies, including a gradual introduction of higher capital charges on excessively high debt holdings of one country and the introduction of a European safe asset, is needed and should be considered in parallel.

Figure D. Financial intermediation is mainly bank-based

Outstanding loans and bonds of non-financial corporations as % of GDP, period average



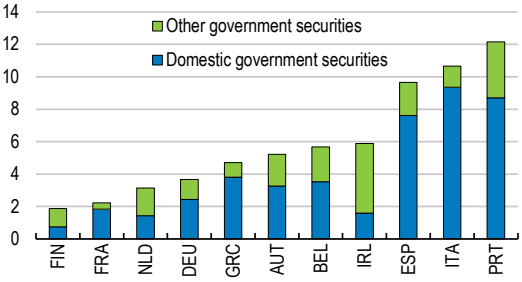
Source: Eurostat, European Central Bank, US Bureau of Economic Analysis, Board of Governors of the Federal Reserve System, and Securities Industry and Financial Markets Association.

StatLink http://dx.doi.org/10.1787/888933741048

Public risk sharing would help to counter large negative shocks. Private risk sharing that gives households and firms access to a wide range of investment and borrowing opportunities is likely to provide the bulk of risk sharing also in the euro area. However, private risk sharing may not always be sufficient in the aftermath of large negative shocks and has even declined in periods of crisis. The Five Presidents' Report therefore correctly calls for the creation of a fiscal shock-absorption capacity at the euro area level to complement national fiscal policies and the European Commission has made an interesting proposal in May 2018.

Figure E. Home bias in banks' sovereign debt holdings is high

Holdings of euro area general government securities[1] in % of total assets, March 2018



1. Domestic government securities denote own-government securities other than shares held by monetary and financial institutions (excluding central banks). Other government securities refer to other euro area government securities held by MFIs.

Source: ECB (2018), *Statistical Data Warehouse*, European Central Bank.

StatLink http://dx.doi.org/10.1787/888933741067

A fiscal stabilization function would be a vehicle for public risk sharing. One avenue to implementing such fiscal stabilisation function is a euro area unemployment benefit re-insurance scheme that would be activated in case of large negative shocks. While financed by all euro area countries, financing costs would over time be raised for countries that repeatedly draw on the fund. This would mitigate the risk of permanent transfers and provide a fiscal incentive to each country to pursue its own stabilisation policies. It would also be an instrument that, by reducing the negative impact of downturns, could help to increase citizens' trust in the euro project. To strengthen countries' fiscal incentives further, the access to the stabilization capacity should be conditional on compliance with fiscal rules prior to the shock.

More integrated capital markets can facilitate private risk sharing. Better integration of euro area capital markets would lead to more diversified sources of financing and more substantial cross-border investment. Progress on harmonising insolvency regimes would remove an important barrier to cross-border financial intermediation, by reducing legal uncertainty and facilitating the efficient restructuring of companies and resolution of non-performing loans. In addition to removing the bias towards debt financing over equity, the tax preference for debt over equity should be addressed in the context of the Common Consolidated Corporate Tax Base proposal. Fast-paced financial innovation in the non-banking financial sector and the departure of the United Kingdom from the EU also provide a rationale for further convergence of supervisory regimes.

MAIN FINDINGS	KEY RECOMMENDATIONS
Gradually normalising monetary policy	
Inflation remains well under the target of below, but close to, 2%. However, with inflation expected to return progressively to target, the forward guidance of ECB points to a very gradual normalisation of its monetary stance.	Keep committing to accommodative monetary policy until headline inflation is durably back to the objective, but gradually reduce support. Commit not to reduce the ECB balance sheet before the first interest rate hike to minimise the risks of unintended market moves. Consider strengthening forward guidance on the policy rates' paths.
Commercial and housing real estate prices are increasing strongly in some locations, which could eventually lead to financial stability concerns in case of housing price bubbles.	To limit side effects of accommodative monetary policy on housing and other sectors, encourage policy measures to support financial stability, such as lower loan-to-value (or loan-to-income) criteria for lending or add-on capital requirements. To better gauge commercial real estate price dynamics, systematically collect granular and harmonised data on commercial real estate.
Reforming the European fiscal framework	
In the past, fiscal policy in many euro area countries has not been tight enough in good times, reducing fiscal space to support the economy in bad times as public debt is very high in several countries.	As the expansion continues, euro area countries should ensure their fiscal position improves, gradually reducing debt ratios.
The fiscal framework lacks ownership by being too complex, relying too much on non-observable concepts (such as the structural fiscal balance).	Eventually, countries should follow an expenditure objective that ensures a sustainable debt-to-GDP ratio.
Fiscal rules do not take sufficiently into account the adequate fiscal stance for the euro area as a whole.	The European Fiscal Board could assess the appropriate fiscal stance for each country consistent with the optimal stance at the euro area level.
Reducing financial fragmentation to increase private risk-sharing	
Non-performing loans (NPLs) are still very high in some countries, hampering credit growth and investment. A comprehensive approach is necessary, in particular the further development of a secondary market. Asset management companies can be a useful tool for the resolution of NPLs.	Implement swiftly the ECOFIN action plan on NPLs; facilitate the creation of asset management companies.
Bank financing remains fragmented along national borders. Differences in bank financing costs reflect the strength of their home government fiscal position, and the links between banks and their sovereigns.	Building on progress in risk-reduction, develop a pre-funded common European deposit-insurance scheme with contributions based on risks taken by banks. To ensure smooth resolution of banks, use the European Stability Mechanism as a fiscally-neutral backstop for the Single Resolution Fund that can be deployed rapidly. Favour diversification of banks' exposure to sovereign bonds including by considering sovereign concentration charges in parallel to the introduction of a European safe asset.
Differences and weaknesses in national insolvency regimes impact bank lending, make it harder for investors to assess credit risk and complicate the resolution of non-performing loans.	Progress in harmonising insolvency proceedings through minimum European standards allowing simpler early restructuring, shortening effective time to discharge, and more efficient liquidation proceedings.
Strengthening resilience through a common fiscal capacity	
Private risk sharing may not be sufficient in the presence of large negative shocks and cross-border spillovers from fiscal and other policies.	Set up a common fiscal stabilisation capacity, for example through an unemployment benefits re-insurance scheme, and allow it to borrow in financial markets.
Permanent transfers between countries could weaken support for the fiscal stabilisation scheme.	Make access to the common fiscal stabilisation capacity conditional on past compliance with fiscal rules.

Key Policy Insights

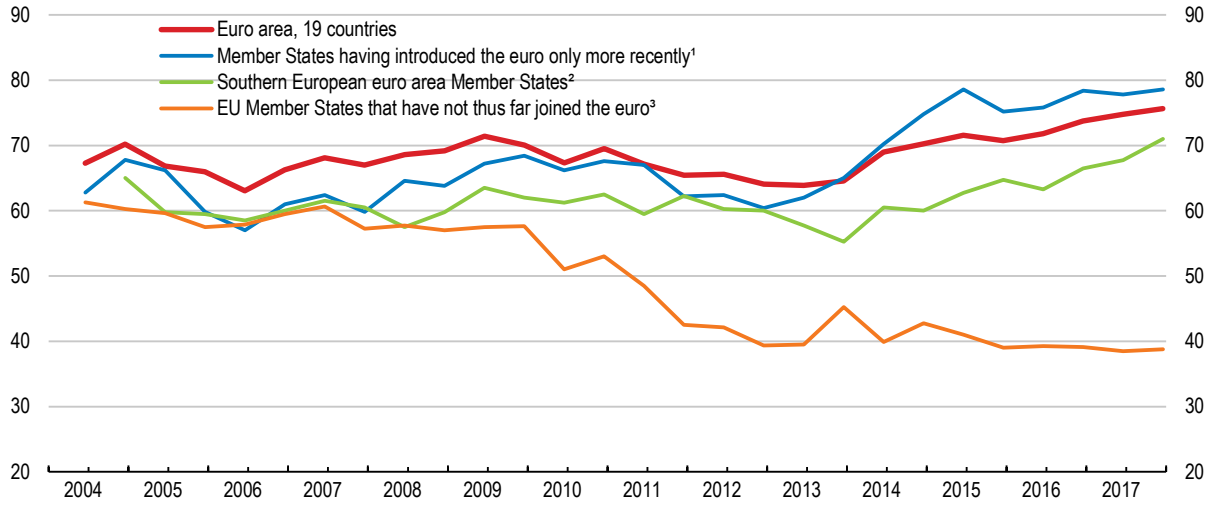
- *Recent macroeconomic developments and short-term prospects*
- *Resolving non-performing loans to facilitate financial transmission further*
- *Improving the European fiscal framework*
- *Policies to strengthen euro area resilience*

Challenges facing the euro area

After years of crisis, a positive economic momentum has taken place in the euro area over the last couple of years, helped by very accommodative monetary policy, mildly expansionary fiscal policy, successful structural reforms, and a recovering global economy. Growth has continued at a dynamic pace in 2017, broadening across sectors and countries and lowering unemployment. The improved economic conditions are reflected in growing popular confidence towards the monetary union. After decreasing in the aftermath of the financial crisis, support for the common currency has rebounded to new all-time highs in the euro area, while remaining stable in countries that have not yet adopted the single currency (Figure 1). The Economic and Monetary Union enjoys broad support in all euro area countries and a majority of EU citizens in all but two countries – Greece and the United Kingdom – is optimistic about the future of the EU (European Commission, 2017a).

Figure 1. Support for the euro in countries that adopted the single currency is increasing

Per cent of population in favour of a European economic and monetary union with one single currency



1. Unweighted average of Estonia, Latvia, Lithuania, Slovak Republic and Slovenia.
2. Unweighted average of Greece, Italy, Spain and Portugal.
3. Unweighted average of Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Denmark and Sweden.

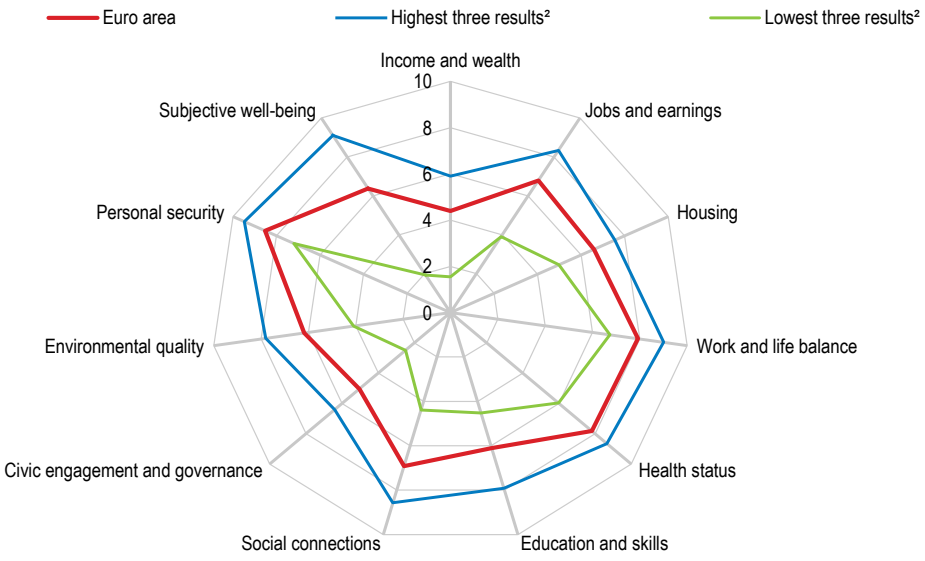
Source: European Commission, Standard Eurobarometer Surveys.

StatLink http://dx.doi.org/10.1787/888933741086

However, the legacies of the crisis are casting a long shadow, weighing on the well-being of euro area citizens. The largest disparity across countries is recorded in subjective well-being, income and wealth and labour market outcomes, dimensions that have deteriorated during the crisis (Figure 2). In some countries, the crisis led to widening income inequalities and a sense of deepening divisions, underscoring the importance of policies promoting inclusiveness and equality. Improving well-being requires not only the continuation of economic growth and further job creation, but also policies embodying reliability and fairness that are crucial for restoring trust in public institutions (OECD, 2017a).

Figure 2. Disparity in some well-being outcomes remains high

Euro area[1], 2017



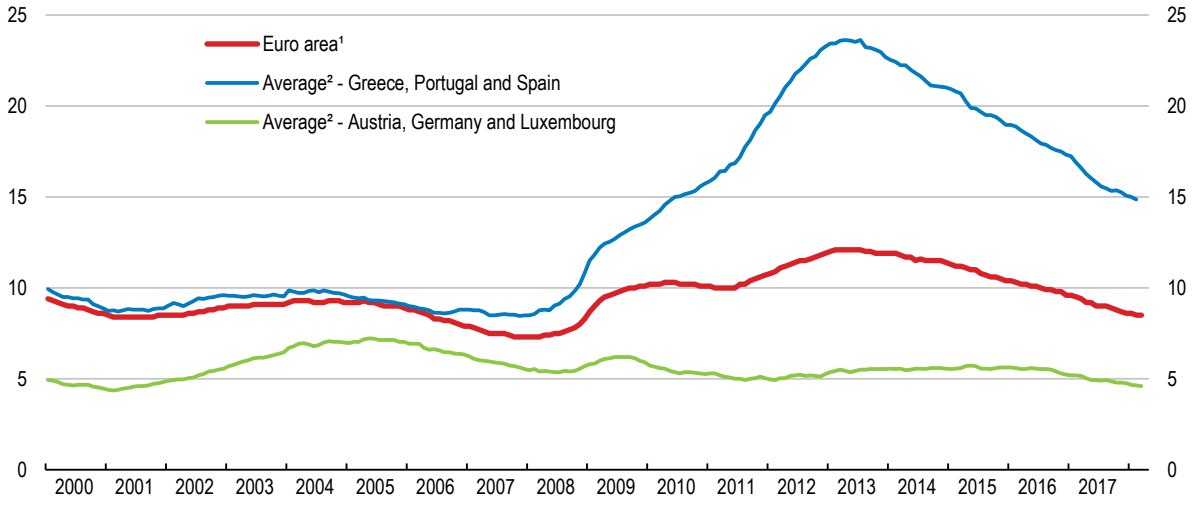
1. Euro area member countries that are also members of the OECD (16 countries). Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 according to the following formula: ([indicator value – worst value]/[best value – worst value]) x 10.
2. Calculated as a simple average of the highest and lowest performers of the euro area cross-country distribution.
Source: OECD Better Life Index, www.oecdbetterlifeindex.org.

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Unemployment has been falling in recent years, but it remains elevated in some countries (Figure 3). Broader measures of labour market slack indicate a persistent vulnerability and a threat to the well-being of workers: many would like to work more or remain only marginally attached to the labour market (Figure 4). Despite the ongoing expansion and accommodative monetary policy stance, nominal wage growth did not pick up meaningfully and higher headline inflation in 2017 meant limited real wage gains. In addition, the overall average improvement in real disposable incomes was not inclusive: more rapid growth of top incomes and weak improvements at the bottom meant that the overall income inequality did not decrease (OECD, 2017b). Investment is picking up in many euro area countries, but the accumulated weak performance, especially in countries hit the most by the crisis, keeps the aggregate investment in the euro area below the 2007 level and according to the most recent OECD projections, investment will not recover its pre-crisis level before 2019. This weakness of investment reduces future growth potential and contributes to the euro area's current account surpluses.

Figure 3. Unemployment is still high in many countries

As a percentage of the labour force



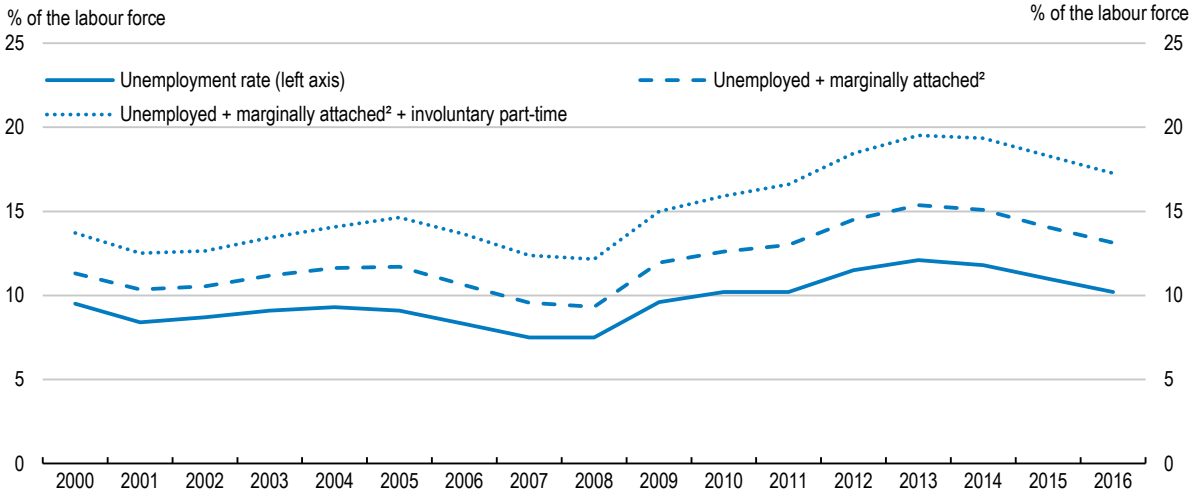
1. Euro area 19 countries.
2. Unweighted average.

Source: Eurostat (2018), "Employment and unemployment (LFS)", *Eurostat database*.

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Figure 4. Broad measures of labour market slack point to a persistent vulnerability of workers

Euro area[1], 15-64 year-olds



1. Euro area member countries that are also OECD members, excluding Slovenia, for which data on marginally attached workers are not available.
2. Persons neither employed, nor actively looking for work, but willing to work and available for taking a job during the survey reference week. Additionally, when this applies, they have looked for work during the past 12 months.

Source: OECD (2018), *OECD Employment Statistics* (database); and *OECD Economic Outlook: Statistics and Projections* (database).

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Fiscal policy in many countries remains excessively pro-cyclical and insufficiently co-ordinated at the euro area level. The European fiscal framework needs to be reformed, in order to incentivise the improvement of fiscal positions in good times and reinforce a convergence towards a sustainable debt level, as discussed below.

Important institutional reforms on the banking and capital markets unions, and their application in both supervision and resolution, continued to improve the resilience of the euro area financial system. However, the potentially disruptive link between banks and their sovereigns persists, limiting cross-border financial flows and the transformation of private savings into investment, and posing economic stability risks. Further measures balancing risk reduction and risk sharing as reinforcing elements are needed, compatible with gradual withdrawal of unconventional monetary policy measures and further normalisation of policy interest rates.

The favourable situation of firming economic expansion should be used to address the remaining shortcomings in the design and functioning of the Economic and Monetary Union (EMU), notably along the lines of the Five Presidents' Report (Juncker et al., 2015) and the Reflection paper on the deepening of the EMU (European Commission, 2017b). Against this background the main messages of the 2018 OECD Economic Survey on the euro area are:

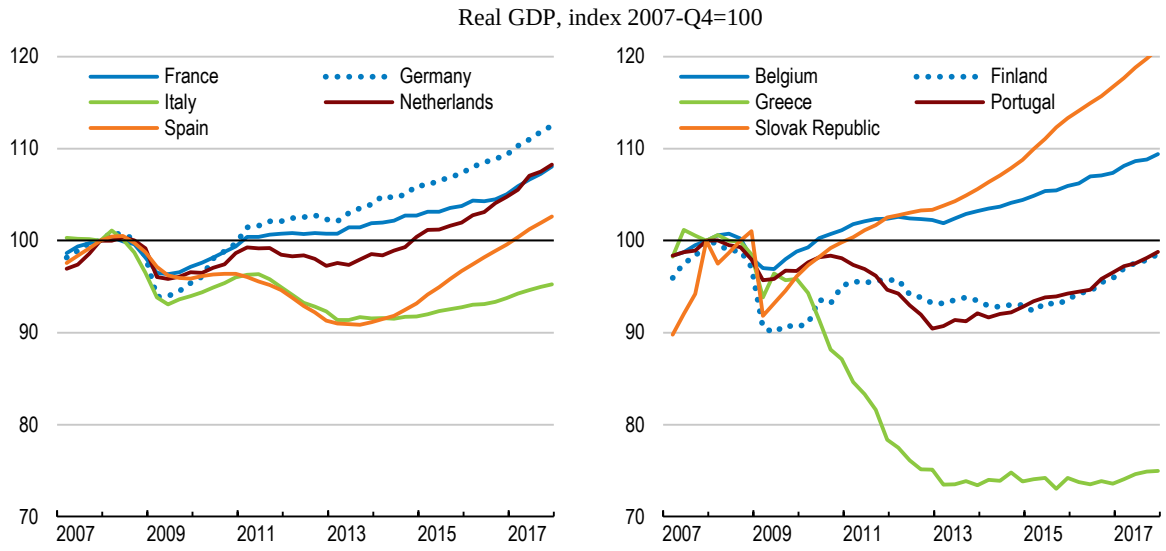
- With inflation still well below target, monetary policy should remain accommodative, but will have to gradually normalise as the expansion continues and inflation pressures increase. The process of normalisation could be smoothed by strengthened forward guidance.
- Likewise, as the expansion continues, governments should ensure that their fiscal positions improve significantly to allow a gradual reduction of high debt to GDP ratios, which would reduce the risk of pro-cyclical fiscal stances in bad times.
- Strengthening the resilience of the euro area and protecting its citizens in case of significant economic shocks requires an ambitious reform through the creation of a common fiscal stabilisation function, which could take the form of an unemployment benefit re-insurance scheme.
- Market mechanisms should also play a role in improving the resilience of the euro area by enhancing private cross-border financial flows through resolute progress in the capital market union and a stronger banking system by achieving the banking union.

The upswing continues

The euro area economy is growing at a fast pace (Figure 5), with growth broadening across sectors and countries, supported mostly by domestic demand (Figure 6, Panel A). Improving labour markets and very favourable financing conditions continue to boost incomes and, helped also by higher consumer confidence (Figure 6, Panel B), private consumption, despite lacklustre real wage growth. Investment is becoming more supportive of the recovery and has expanded at a dynamic pace in most countries (Figure 6, Panel C). Private investment growth is sustained by positive business sentiment, rising profits and easy financial conditions. Public investment, on the other hand, remains subdued (Figure 7). Exports have continued to strengthen on the back of an improved economic outlook in Europe and the rebound in world trade. Business and consumer confidence indicators remain high, pointing to healthy growth ahead and in

some sectors and countries firms are starting to face equipment and capacity constraints (Figure 6, Panel D).

Figure 5. The upturn continues and is broad-based



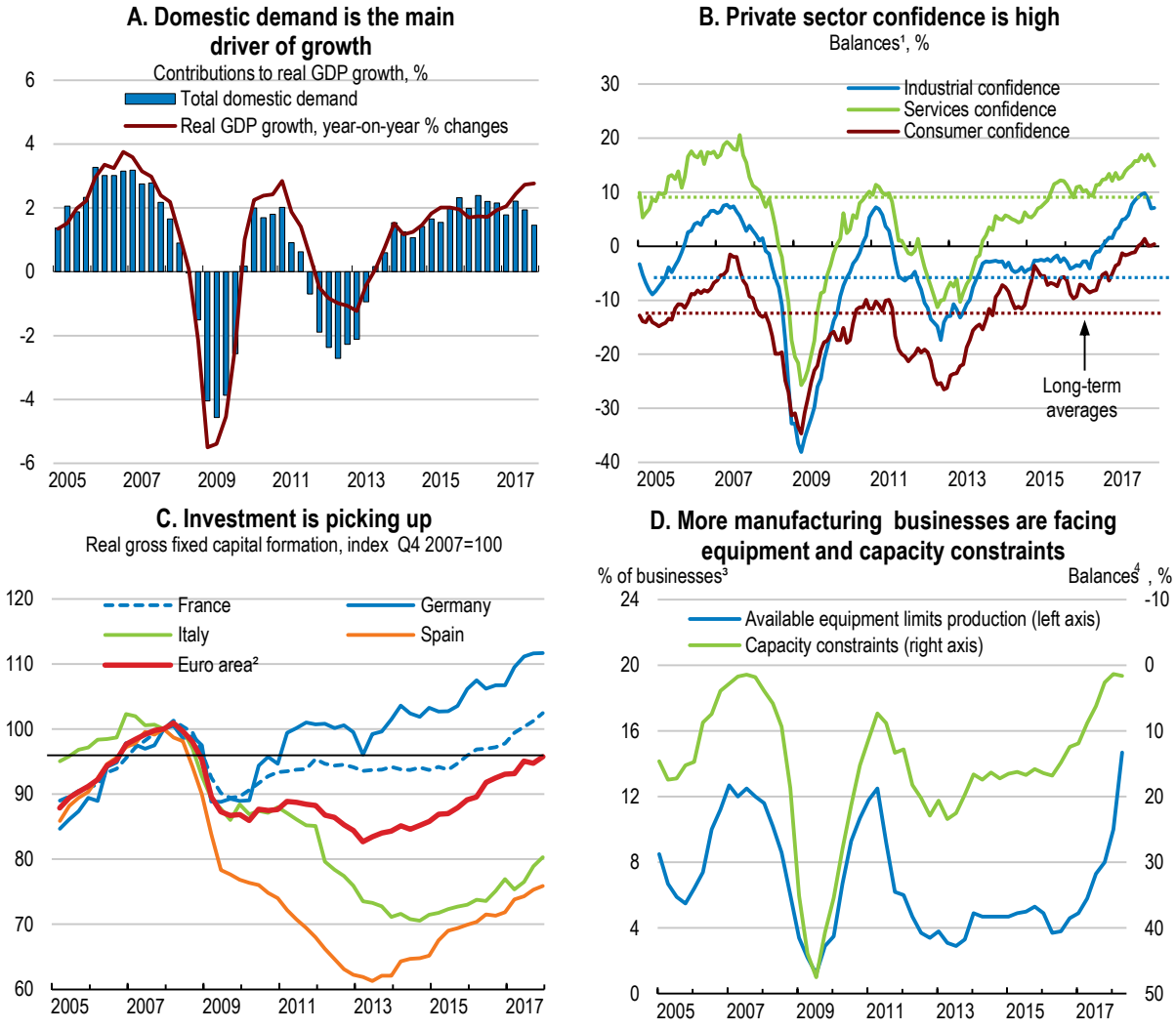
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Labour market conditions continue to improve. Employment and labour force participation rates in many countries are now above the levels prior to the crisis (Figure 8), helped by reforms that have raised activation, enhanced job creation, boosted flexibility and lowered barriers to female labour force participation. The unemployment rate keeps declining and the euro area average unemployment rate was 8.5% in April, although significant differences in unemployment rates remain across countries (Figure 9, Panel A); and most euro area countries have yet to regain their pre-crisis unemployment levels.

Improving labour market conditions have not translated into wage pressures: wage growth in the euro area has been picking up only slightly (Figure 9, Panel B). A number of factors weigh on wage growth including still significant labour market slack in some countries and weak productivity growth in past years. The shares of involuntary part-time work and discouraged workers in the labour force are still elevated and declining only slowly (OECD, 2017c), suggesting that labour market slack is probably bigger than what the unemployment rate indicates. Wage growth may have also been held down in recent years by an increasing share of part-time jobs, rising female labour force participation and growing employment in low-wage service sectors (OECD, 2018; Broadbent, 2015; Daly and Hobijn, 2017).

Figure 6. The broad-based recovery should support investment in the euro area



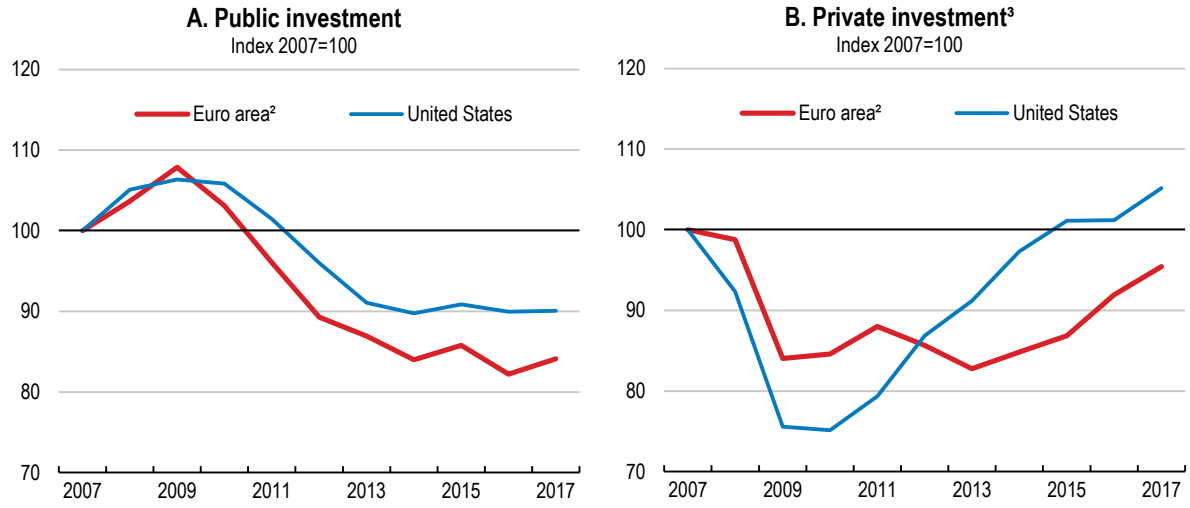
1. Difference between the percentages of respondents giving positive and negative replies.
2. Euro area member countries that are also members of the OECD (16 countries).
3. Percentage of businesses answering that their business is limited by shortage of space and/or equipment.
4. Difference between the percentages of respondents assessing that their current production capacity is more than sufficient and the percentage share of those assessing the latter as not sufficient, inverted axis.

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database); European Commission (2018), *Business and Consumer Surveys* (database), Brussels.

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Figure 7. Private investment is recovering, while public investment remains subdued

Volume[1]



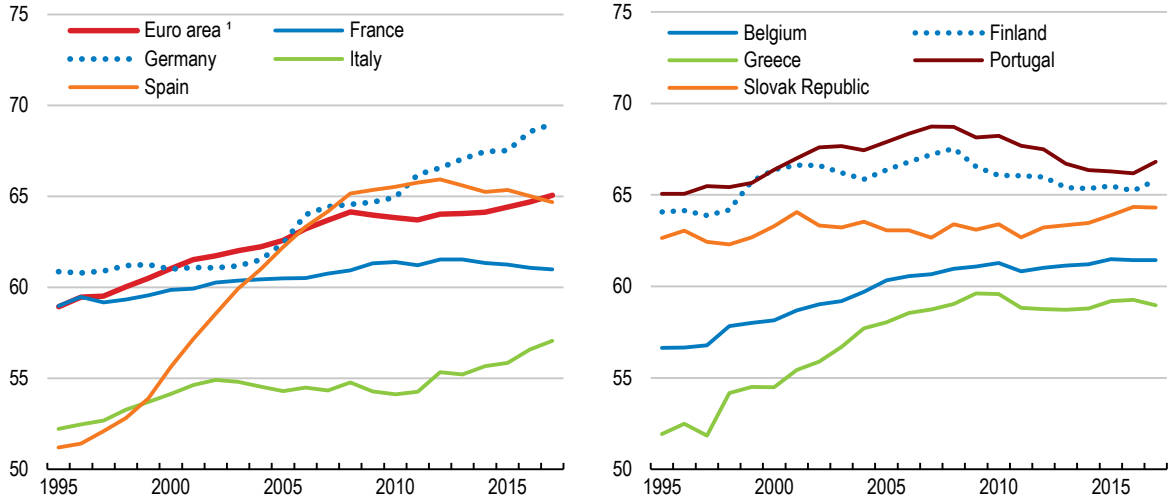
1. Deflated by the GDP deflator.
2. Euro area member countries that are also members of the OECD (16 countries).
3. Private investment is obtained as gross fixed capital formation of the total economy minus government fixed capital formation (appropriation account).

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Figure 8. Participation rates have risen in many countries

Labour force as a percentage of the population aged 15-74

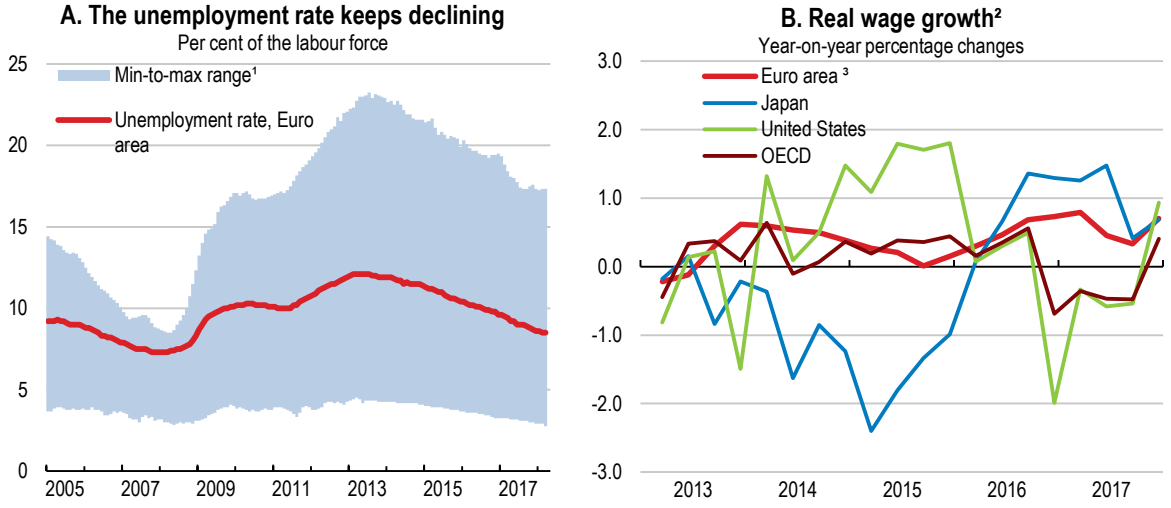


1. Unweighted average across euro area member countries that are also members of the OECD (16 countries) and Lithuania.

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Figure 9. The labour market is tightening but wage pressures remain limited



1. Measures, for each single monthly observation, the range between the minimum and the maximum unemployment rate registered across the 19 euro area Member States.
2. Real wages are measured as labour compensation per employee deflated by the GDP deflator.
3. Euro area member countries that are also members of the OECD (16 countries).

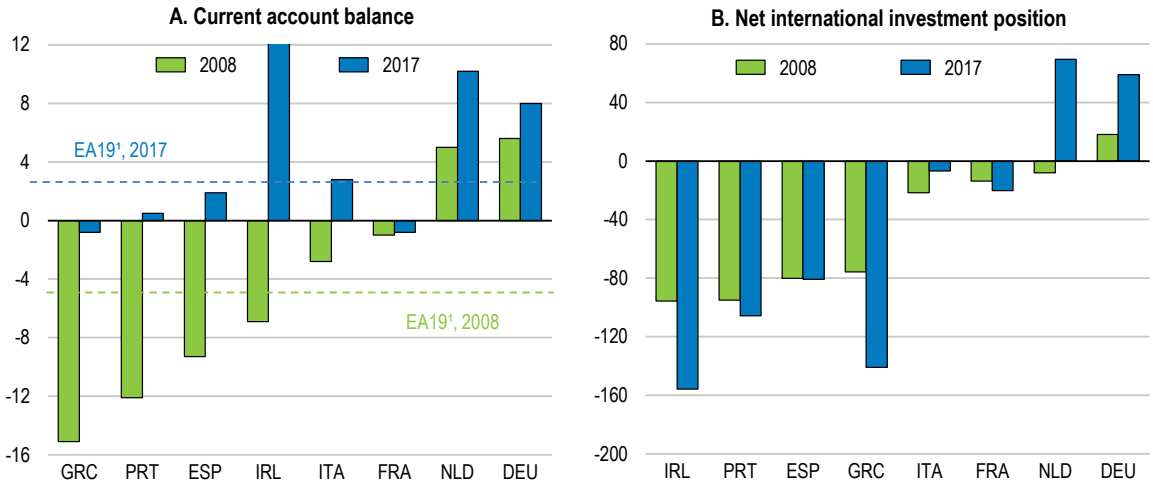
Source: Eurostat (2018), "Employment and unemployment (LFS)", *Eurostat Database*; OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Imbalances within the euro area have declined asymmetrically since the financial crisis, with adjustments mainly taking place in countries with larger net external liabilities. Net external debtor countries that had persistent and large current account deficits before the crisis, such as Portugal and Spain, have seen significant current account and some net foreign asset adjustments (Figure 10) reflecting more moderated domestic demand and in some cases a more competitive economy. However, additional reforms are needed to facilitate the return of the net international investment position to more sustainable level in some countries. At the same time, elevated external surpluses have persisted in Germany and the Netherlands, despite the strengthened euro. Elevated external surpluses have led the euro area average current account surplus to reach 3.8% of GDP in 2017, with significant projected current account surpluses also in 2018 and 2019. Reforms to remove barriers to entry in services, higher spending in public infrastructure and more dynamic wages, would help reduce the large current account surplus in Germany, while higher public spending in R&D would reduce the current account surplus in the Netherlands.

Figure 10. The Euro area current account surplus remains high, despite a mild reduction

As a percentage of GDP



1. Unweighted average.

Source: Eurostat (2018), "Balance of payments statistics and international investment positions (BPM6)", *Eurostat Database*.

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GDP growth is projected to average slightly above 2% per annum in the region in 2018-19 supported by accommodative macroeconomic policies and a cyclical recovery in the world economy (Table 1). While all euro economies are showing positive growth rates, they are at varying points in their cycles (Table 2). Rising employment should boost incomes and support private consumption, as wages are expected to rise faster than in the past. High business confidence, increasing corporate profitability and encouraging global demand should keep supporting investment. Despite tepid export growth, a large area-wide current account surplus will remain, with a projected continuation of significant current account surpluses in Germany and the Netherlands. Inflation will gradually strengthen in an environment with higher oil prices, disappearing slack and higher wage growth.

Table 1. Macroeconomic indicators and projections

Euro Area, [1] annual percentage change, volume (2015 prices)

				Projections	
	2015	2016	2017	2018	2019
Gross domestic product (GDP)	**1.9**	**1.8**	**2.5**	**2.2**	**2.1**
Private consumption	1.7	1.9	1.7	1.4	1.5
Government consumption	1.3	1.8	1.2	1.3	1.3
Gross fixed capital formation	3.0	4.5	3.2	4.2	4.1
Final domestic demand	1.9	2.4	1.9	2.0	2.0
Stockbuilding[2]	0.0	-0.1	0.0	0.0	0.0
Total domestic demand	1.9	2.3	2.0	2.0	2.0
Exports of goods and services	6.2	3.3	5.4	4.7	4.4
Imports of goods and services	6.5	4.8	4.5	4.5	4.6
Net exports[2]	0.1	-0.5	0.6	0.3	0.1
Other indicators (growth rates, unless specified)					
Potential GDP	1.2	1.2	1.2	1.3	1.4
Output gap[3]	-2.5	-2.1	-0.7	0.2	0.9
Employment	1.1	1.7	1.5	1.4	1.1
Unemployment rate	10.9	10.0	9.1	8.3	7.8
GDP deflator	1.4	0.8	1.1	1.5	1.8
Consumer price index (harmonised)	0.0	0.2	1.5	1.6	1.8
Core consumer prices (harmonised)	0.8	0.8	1.0	1.2	1.7
Household saving ratio, net[4]	6.0	5.8	6.0	5.3	5.2
Current account balance[5]	3.7	3.6	3.8	4.0	3.9
General government fiscal balance[5]	-2.0	-1.5	-0.9	-0.6	-0.4
Underlying general government fiscal balance[3]	-0.4	-0.2	-0.4	-0.6	-0.6
Underlying general government primary fiscal balance[3]	1.5	1.6	1.3	1.0	0.9
General government gross debt (Maastricht)[5]	92.4	91.4	88.9	87.0	84.9
General government net debt[5]	70.9	70.4	66.0	65.1	63.0
Three-month money market rate, average	0.0	-0.3	-0.3	-0.3	-0.2
Ten-year government bond yield, average	1.1	0.8	1.0	1.1	1.3
Memorandum item					
Gross government debt[5]	109.7	109.0	104.5	103.2	101.1

1. Euro area member countries that are also members of the OECD (16 countries).
2. Contribution to charges in real GDP.
3. As a percentage of potential GDP.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD (2018), "OECD Economic Outlook No. 103", *OECD Economic Outlook: Statistics and Projections* (database).

Table 2. Projected real GDP growth rates in the euro area

Year-on-year percentage changes

Year	2018	2019	Year	2018	2019
Member states:					
Austria	2.7	2.0	Latvia	4.1	3.6
Belgium	1.7	1.7	Lithuania	3.3	2.9
Estonia	3.7	3.2	Luxembourg	3.6	3.8
Finland	2.9	2.5	Netherlands	3.3	2.9
France	1.9	1.9	Portugal	2.2	2.2
Germany	2.1	2.1	Slovak Republic	4.0	4.5
Greece	2.0	2.3	Slovenia	5.0	3.9
Ireland	4.0	2.9	Spain	2.8	2.4
Italy	1.4	1.1			
Aggregates:					
Euro Area	2.2	2.1	OECD	2.6	2.5

Note: Euro area member countries that are also members of the OECD (16 countries).
Source: OECD (2018), "OECD Economic Outlook No. 103", *OECD Economic Outlook: Statistics and Projections* (database).

Policy uncertainty remains high and could increase further. Brexit is not considered a major macro-economic risk for the euro area; nonetheless, countries with the closest trade links to the United Kingdom could be severely impacted if the United Kingdom left the European Union without any trade agreement. An increase in trade protectionist measures or a sudden tightening of global financial conditions would negatively affect global demand and Europe's trade and investment. A too rapid tightening of monetary policy, especially if compounded by a steep appreciation of the euro, could weigh on the recovery in euro-area countries with high unemployment and negative output gaps. High debt countries may have difficulties coping with higher borrowing costs if monetary accommodation is rapidly reduced. On the upside, the cyclical recovery in world trade and on-going momentum in the global economy could lead to stronger than expected growth. Rapid progress in the capital market and banking unions could lead to higher cross-country financing and growth. The euro area economic prospects are also subject to medium-term risks, which are difficult to quantify in terms of risks to the projections (Table 3).

Table 3. Risks about the euro area's growth prospects

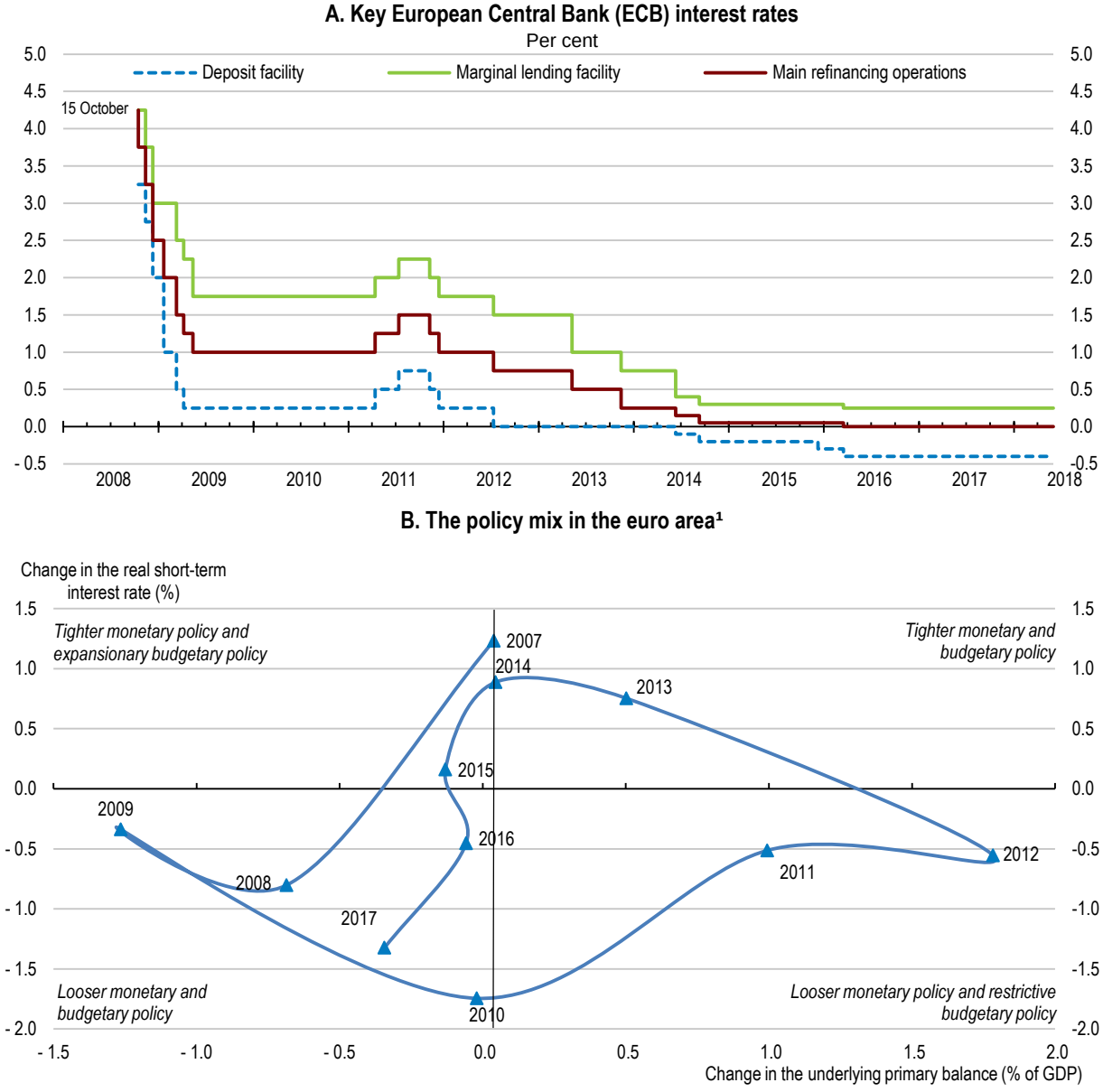
Uncertainty	Possible outcome
Rising protectionism in trade and investment	Many euro area countries are dependent on unimpeded trade and investment flows. An increase in trade protectionism would negatively affect confidence, investment and jobs, and harm longer-term growth prospects.
Sovereign debt market stress	A negative political event, such as a rise of populist parties in some euro area countries, coupled with the unfinished euro area architecture could lead to a sharp increase of redenomination risk and the loss of market access for some euro area sovereigns.
Ambitious and comprehensive reform of the euro area	An ambitious and comprehensive deal to solve fragilities of the euro area, combined with needed structural reforms at the national level, could significantly raise investors' confidence and boost growth.

Normalising monetary policy without disrupting the recovery

Monetary policy has been very supportive of the euro area recovery. The European Central Bank (ECB) policy rates have remained at their historical low since early 2016 (Figure 11, panel A). If assessed through the evolution of the real short-term market

interest rate, monetary policy has become even more expansionary in 2017 as inflation started picking-up (Figure 11, panel B). This has made the overall policy-mix very supportive in 2017, especially as fiscal policy became looser in many countries (Figure 11, panel B).

Figure 11. ECB policy rates and macroeconomic policy stance have become more supportive



1. In the absence of a consensus on the level of the natural interest rate, changes in real interest rates are used as a (rough) proxy of changes in the monetary stance.

Source: ECB (2018), "Financial Market Data: Official Interest Rates", *Statistical Data Warehouse*, European Central Bank; OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

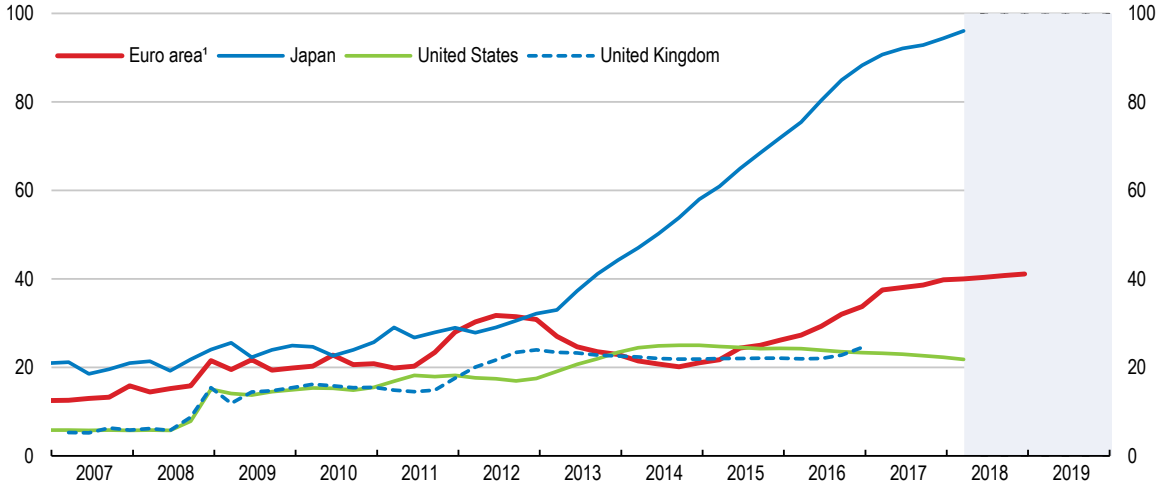
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Going forward, monetary policy is expected to remain very accommodative even if net asset purchases were to stop after September 2018 – the current ECB commitment until when net asset purchases will continue. Analysis from the ECB indicates that the size of the central bank's balance sheet matters more than the flow of asset purchases in reducing long term interest rates (Andrade et al., 2016; De Santis and Holm-Hadulla, 2017) and the balance sheet of the ECB will reach the sizeable amount of 40% of GDP by end-September 2018 (Figure 12). The progressive reduction of the monthly pace of the asset purchases (from 80 billion euros in 2016 to 30 billion euros from January 2018) and its end may, however, lead to some increases in peripheral economies sovereign spreads, although the impact of asset purchases on spreads has been very small so far (Hatzius et al., 2017).

Concerns that loose monetary policy for too long could have side-effects, such as reduced bank profitability or asset price bubbles, have not materialised yet. Regarding bank profitability, the positive impact on growth of low or even negative interest rate is expected to more than offset the negative impact of the flattening of the yield curve on bank profitability (Draghi, 2017; Altavilla et al., 2017). On average, indicators show that bank profitability in the euro area has recovered since the crisis (Figure 13, panel A). Preliminary OECD work on bank level data from directly supervised euro area banks shows limited support for an additional negative effect of negative interest rates on profitability, which has mainly affected smaller banks (Stráský and Hwang, 2018).

Figure 12. The stock of central banks' total liabilities is large

End of period data, as a percentage of GDP



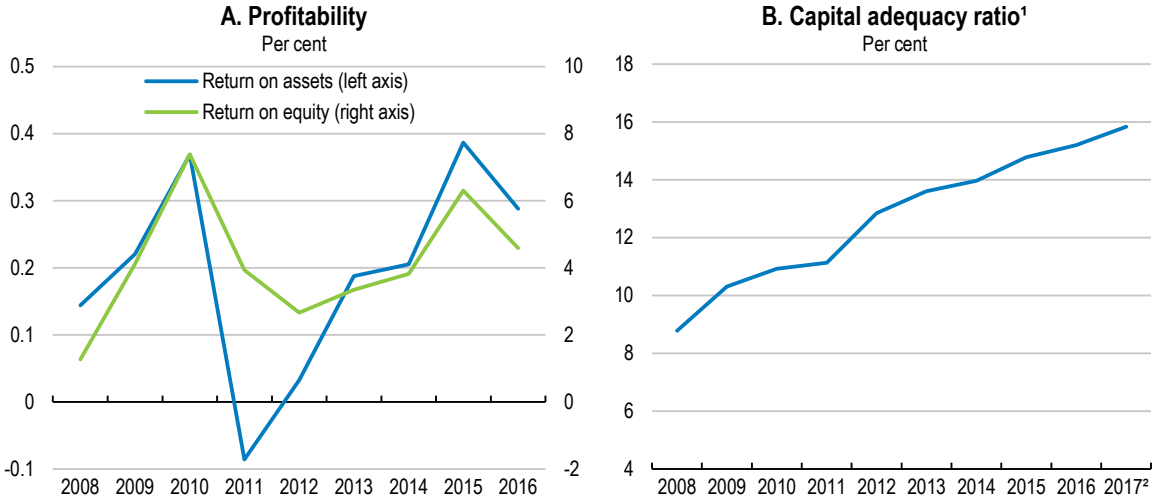
1. Estimate for 2018 second quarter onwards based on monthly increases of EUR 30 billion.

Source: Thomson Reuters (2018), *Datastream Database* and OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Figure 13. Average conditions in the euro area banking system have improved

GDP-weighted average of euro area 19 member countries



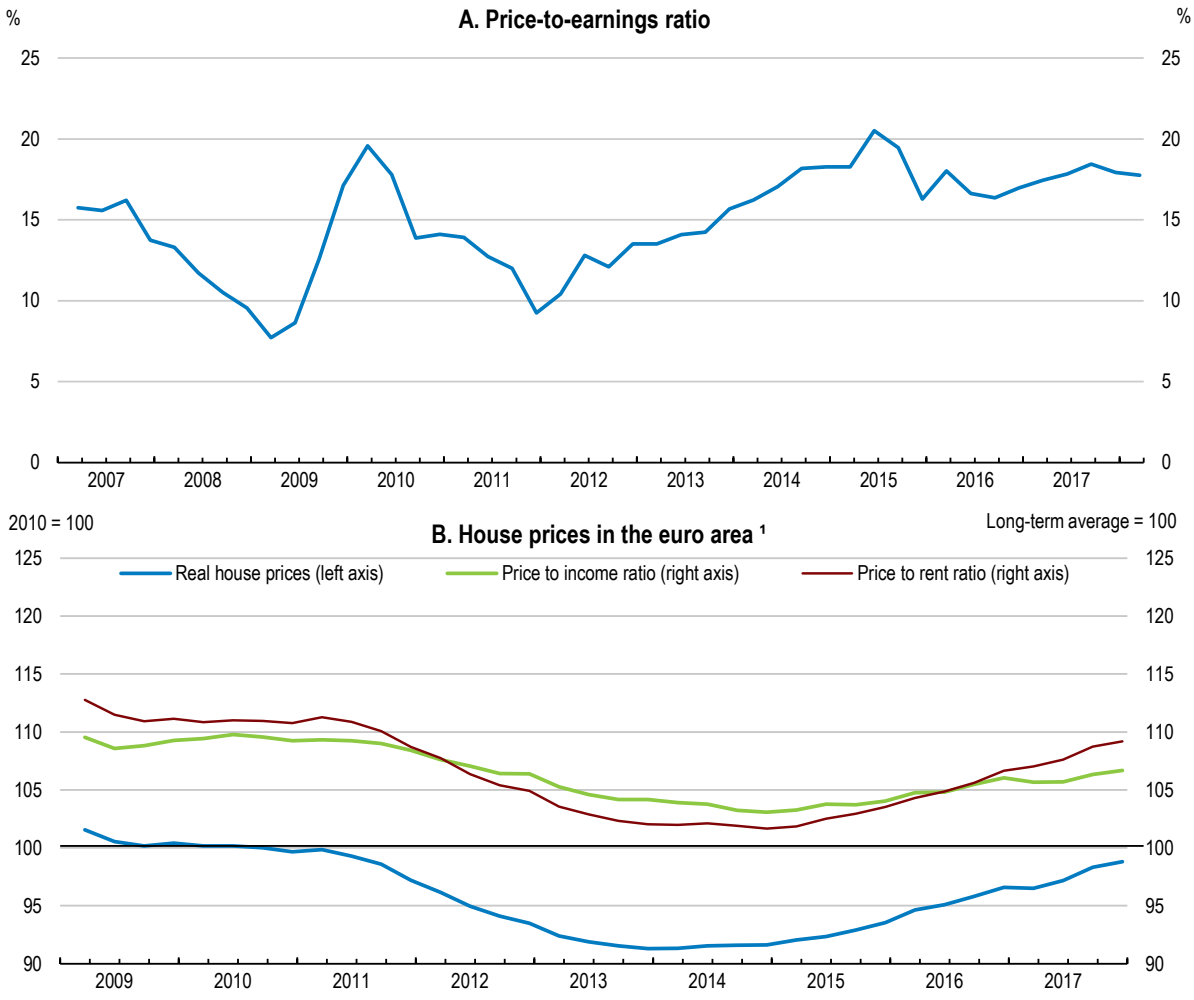
1. Regulatory Tier 1 Capital to risk-weighted assets.
2. Averages of available quarterly data in 2017 are used for Belgium, France and Italy.

Source: IMF (2018), *Financial Soundness Indicators* (database), International Monetary Fund, Washington, D.C.

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Regarding asset prices, real house prices are rising but on aggregate are still well below their peak of 2007, and probably closer to fundamentals; this is perhaps less true of share prices (Figure 14). Putting in place stronger macro-prudential tools could, however, be useful to avoid the reappearance of imbalances in some countries, especially in the housing sector. For example, lower loan-to-value or loan-to-income criteria or add-on capital requirements could be imposed when deemed necessary. Specific attention should also be paid to commercial real estate. Commercial real estate prices can be a lead indicator of emerging imbalances in the housing sector as a whole and some countries seem to experience very dynamic price growth of commercial real estate. However, systematic collection and harmonised data on commercial real estate are lacking, and progress in this direction would be welcome (ESRB, 2016).

Figure 14. Asset prices have increased



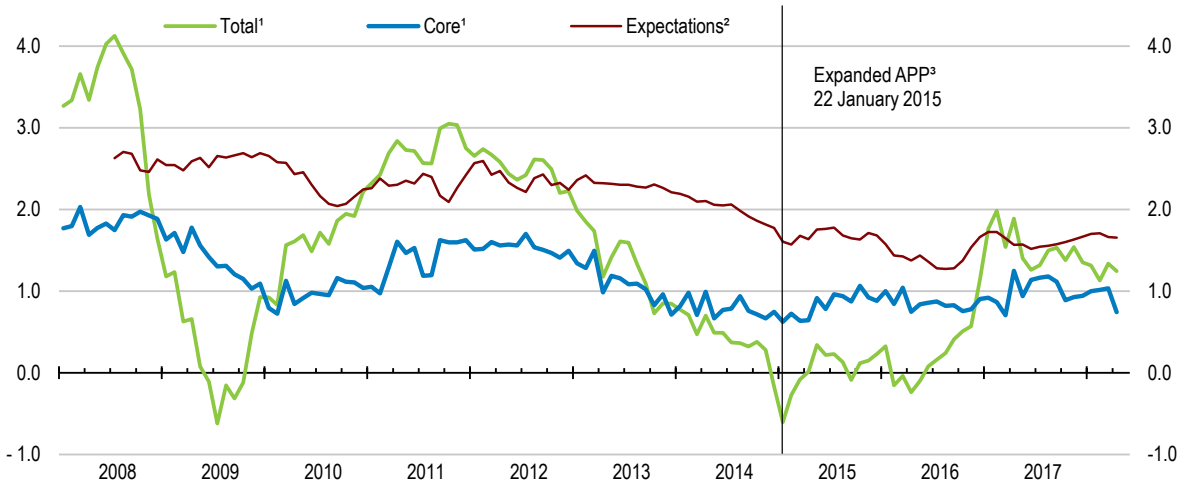
1. Euro area member countries that are also members of the OECD (16 countries).
Source: Thomson Reuters (2018), *Datastream Database*; OECD (2018), *OECD Analytical House Price Indicators* (database).

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The impact on inflation of looser monetary policy has not fully materialised so far. Headline inflation has increased from 0% in early 2016 to 1.2% in April, which is still well below the inflation target of the ECB of below, but close, to 2%; core inflation, at 0.7%, and swaps-based inflation expectations, at 1.7%, remain moderate (Figure 15). The ECB estimates that recent data show weak inflationary risks (Praet, 2018a). Wage growth, one of the main drivers of inflation, is moderate. This could indicate more slack in the economy than output gap measurement – the strong development of involuntary part-time work being one indicator – as discussed earlier.

Figure 15. Inflation remains below target

Year-on-year percentage change



1. Harmonised indices of consumer prices; core inflation excludes energy, food, alcohol and tobacco.
2. Expected average annual inflation based on the difference between 5-year and 10-year inflation swaps.
3. European Central Bank announcement of an expanded Asset Purchase Programme (APP).

Source: Eurostat (2018), "Harmonised indices of consumer prices", *Eurostat Database* and Thomson Reuters (2018), *Datastream Database*.

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In this context of below target inflation, but rapidly reducing economic slack, monetary policy needs to remain accommodative as long as needed to put inflation durably back to target while at the same time preparing for an exit strategy. This needs to be carefully communicated to avoid any negative market surprises. This is what the ECB is aiming at, notably through its "forward guidance" (Mersch, 2017). On monetary stance, the ECB has emphasised that monetary policy will remain accommodative as long as needed to secure a sustained return of inflation to levels close to 2% (Praet, 2018b). This commitment should be maintained.

On the exit strategy, the ECB has emphasised that interest rates will remain at their current level "well past" the end of the expansion of its balance sheet (Draghi, 2017; Coeuré, 2018). Its communication has fostered the market consensus that the ECB exit strategy could follow a path similar to that of the U.S. Federal Reserve, with a gradual decrease of net asset purchases to zero at the beginning, then a progressive increase in policy rates and only ultimately a reduction in the size of the balance sheet. Conversely, some argue that reducing the balance sheet first would give more room to manoeuvre to central banks to ease again their monetary stance in case of a negative economic shock. However, reducing the size of the balance sheet before raising interest rates could trigger less predictable changes in market interest rates than a gradual increase in policy rates. On balance, the sequencing of increasing interest rates first seems appropriate to reduce uncertainty and facilitate the exit strategy.

The forward guidance could, however, be strengthened to avoid a misunderstanding by markets of the timing of the exit, which could put at risk the return of inflation to the ECB

target. While most inflation forecasters do not expect headline inflation to return to target before end-2019, markets anticipate the first interest hike to happen in early 2019. This is not necessarily inconsistent with the current forward guidance (even after the first hike, monetary policy would still be accommodative), but there is a risk that market expectations of an earlier hike lead to rapidly tightening financial conditions, notably through further appreciation of the exchange rate, which could make it more difficult for the ECB to meet its inflation target. To limit this risk, the ECB could strengthen its forward guidance on the policy rates' paths. This could be done by releasing forecasts on interest rates to help drive market expectations, as done by some other central banks, although the institutional setting of the Eurosystem would make it much more difficult to manage. Another option, since the conduct of ECB monetary policy is data-contingent, could be to be more explicit on some level(s) of data, such as inflation, that would be considered to eventually trigger a first interest rate hike.

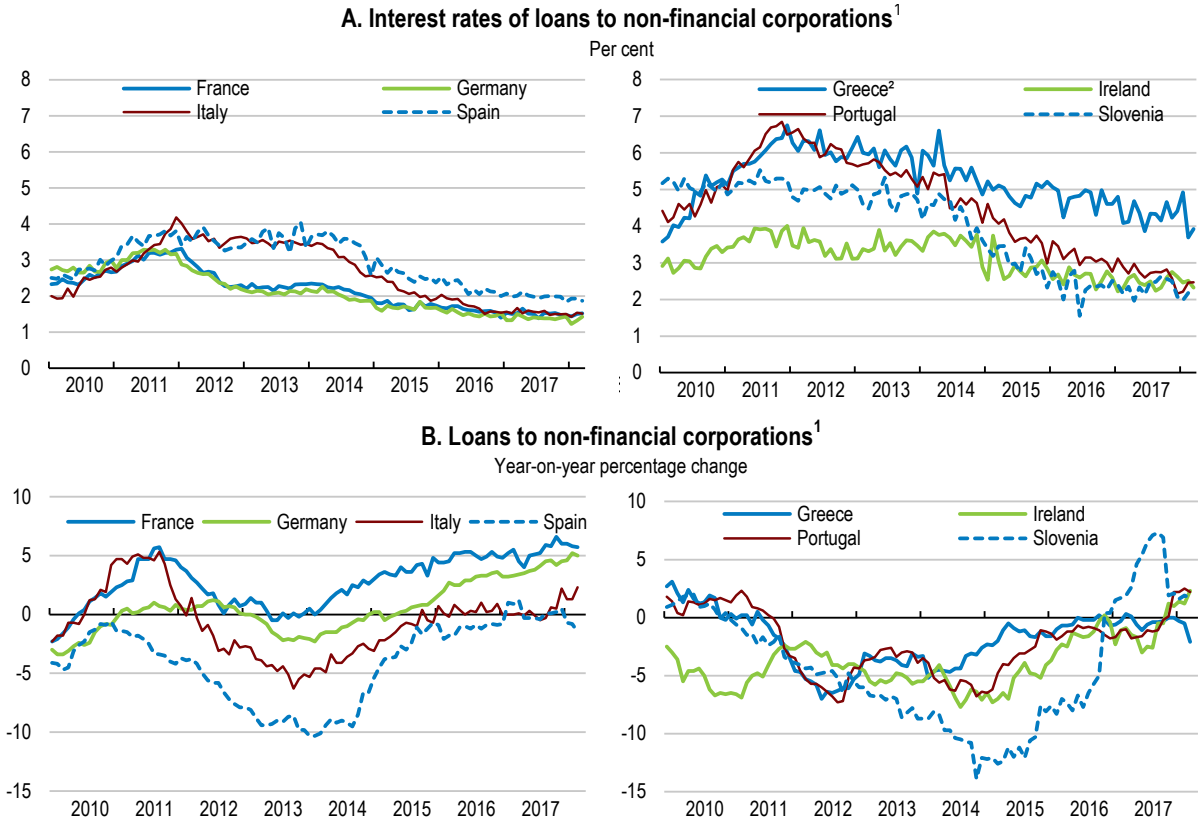
Another avenue to strengthen forward guidance is to clarify further how the ECB balance sheet will be managed once net asset purchases stop and before it starts to reduce the balance sheet progressively. Firstly, the ECB could clarify whether the size of its balance sheet would not be reduced before the first hike in interest rates. This would imply that the ECB will reinvest all maturing bonds. Secondly, since the commitment to reinvest all bonds could be constrained by the scarcity of sovereign bonds the ECB can buy in some countries (based on the eligibility criteria set by the ECB, such as the share of new issuances), the ECB could also assess whether not following capital keys in the country repartition of such reinvestments would help limit the risk of an increase in spreads in more vulnerable countries and facilitate monetary policy transmission.

Resolving non-performing loans to facilitate financial transmission further

The transmission of monetary policy has significantly improved among euro area countries. The increase in TARGET 2 imbalances since 2015 has been driven by the implementation of the asset purchase programme, not an increase in financial fragmentation as was the case when the financial crisis initially unfolded (Eisenschmidt et al., 2017). Interest rates of loans to firms have significantly converged since 2011. While interest rates remain about 1% higher in formerly financially-stressed countries, this probably reflects market valuations of higher macro-economic risks rather than market fragmentation (Figure 16, panel A).

Credit is still falling or is almost flat in some formerly financially-stressed countries (Figure 16, panel B), despite support through the ECB or even the Juncker plan – which can take the form of bank credit to firms in some countries. There is some anecdotal evidence that firms continue to suffer from credit rationing those countries. This could be explained by the fragile situation of banks that are still plagued with high levels of non-performing loans.

Figure 16. Financial fragmentation has been reduced



1. New business loans with an initial rate fixation period of less than one year. Loans other than revolving loans and overdrafts, convenience and extended credit card debt; loans adjusted for credit and securitisation in Panel B.
2. Loans of up to 1 year.

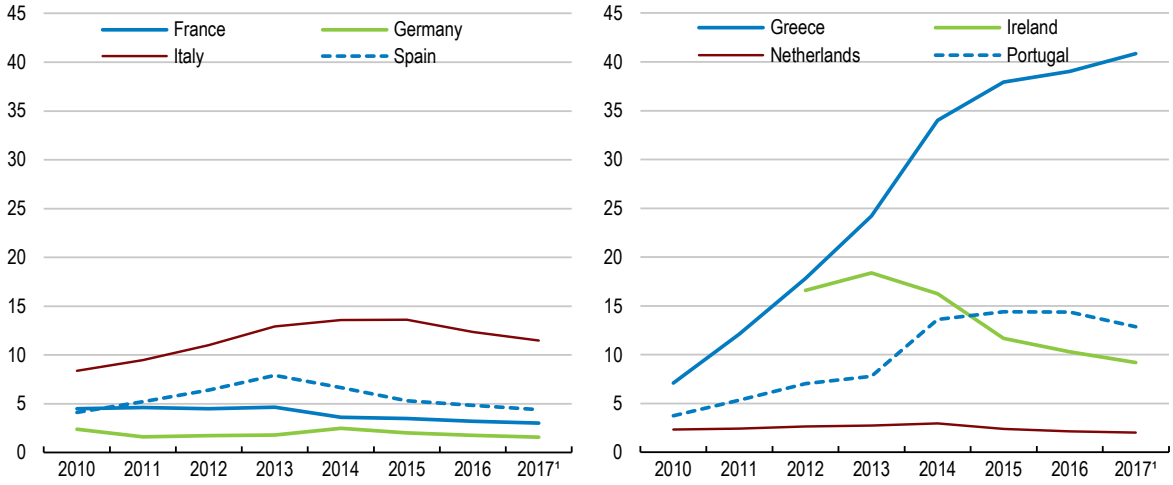
Source: ECB (2018), "MFI interest rate statistics", *Statistical Data Warehouse*, European Central Bank.

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On the banking sector side, a more rapid resolution of the high level of non-performing loans (NPLs) in several countries would be key to facilitate credit development and monetary policy transmission. Even if declining (with the exception of Greece), NPLs are still high in some formerly crisis countries; in Italy, the level is now higher than in Ireland (Figure 17). Comparing the level of NPLs is not always easy, though, despite the introduction by the European Banking Authority (EBA) in October 2013 of a harmonised definition since it mainly applies to the larger banks and some countries continue to publish their own definition. Efforts to ensure that banks use exclusively the harmonised definition of NPLs in their financial statements need to continue. The European Commission recently proposed to introduce a common definition of non-performing exposures, which is welcome (European Commission, 2018a). The regulator should also encourage higher provisioning when needed; the ECB guidance on supervisory expectations for prudent level of provisions for new NPLs is welcome in that respect (ECB, 2018), as well as the proposed regulation by the European Commission of common minimum coverage levels for newly originated loans becoming non-performing (European Commission, 2018a).

Figure 17. Non-performing loans have declined

Gross non-performing debt instruments as a percentage of total gross debt instruments



1. Average of first three quarters.

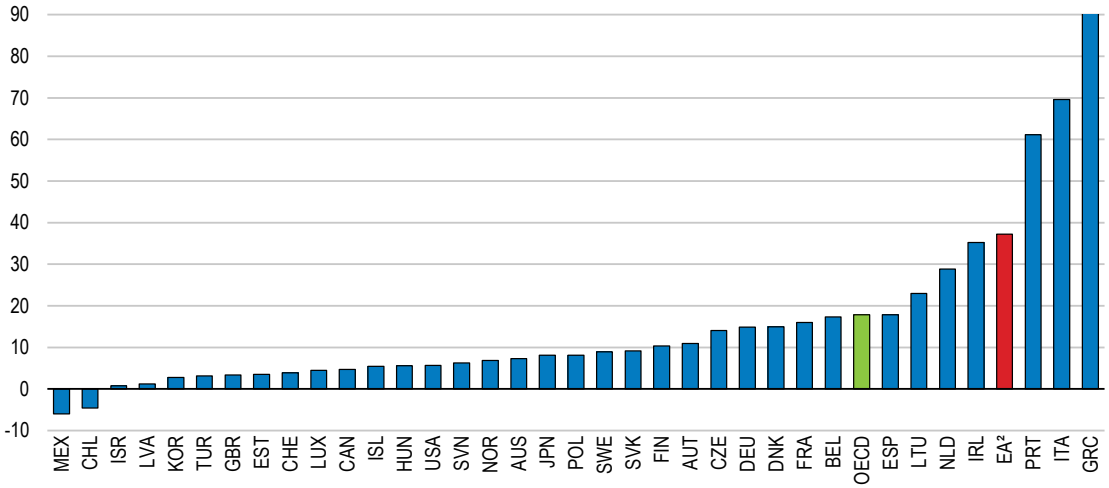
Source: ECB (2018), "Monetary and financial statistics", *Statistical Data Warehouse*, European Central Bank.

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An acceleration of NPL resolution is key to expanding bank lending. Even if on average the capital adequacy ratio has almost doubled since 2008 (Figure 13, panel B), high NPLs are still a key financial stability issue. In an extreme scenario where all NPLs were to be written off, assuming that the value of their collateral turns to zero, banks in many euro area countries would suffer significant capital losses (Figure 18). The Council set out an Action plan to tackle NPLs in July 2017, with four main areas of action: (i) developing a secondary market for distressed assets, (ii) reforming insolvency and debt recovery frameworks, (iii) enhancing supervision and (iv) restructuring of the banking system. Accompanying measures have been proposed in March 2018, notably on ways to reduce the current stock of NPLs and how to prevent the future build-up of NPLs (European Commission, 2018a). Those measures are welcome, but need to be implemented swiftly. Also, some further steps could be taken. For example, the 2016 OECD Survey of the Euro Area made recommendations on ways to develop a secondary market of impaired assets, notably through the creation of asset management companies, and when NPLs create serious economic disturbance, facilitating the resolution of NPLs by not triggering bail-in procedures within the existing rules (Table 4). Those recommendations are still valid. The European Commission Blueprint on asset management companies (European Commission, 2018c) considers that state aid should not be a default option, which is welcome. The previous OECD Economic Survey on the Euro Area analysed ways to provide more flexibility, such as revisiting the price level triggering state aid or the definition of exceptional circumstances that could allow granting a waiver to resolution rules, which are still worth considering (OECD, 2016). The benefits a European asset management company could bring, such as potential economies of scale and a diversification of asset recovery risks, could be assessed (OECD, 2016). Progress in the way the insolvency framework addresses companies facing financial stress is also key and the section below on the Capital Market Union analyses some policy recommendations on that area.

Figure 18. Non-performing loans net of provisions are high in some countries

As a percentage of capital, Q4 2017[1]



1. Data is end of period. 2014 for Korea; 2016 for Germany and Switzerland; Q2 2017 for France, Italy and Norway; Q3 2017 for Belgium, Japan and the United Kingdom. Aggregates are unweighted averages of the latest data available and OECD covers 33 countries. The precise definition and consolidation basis of non-performing loans may vary across countries.
2. Euro area 19 countries.

Source: IMF (2018), *Financial Soundness Indicators* (database), International Monetary Fund, Washington, D.C.

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Table 4. Past OECD recommendations on resolving non-performing loans

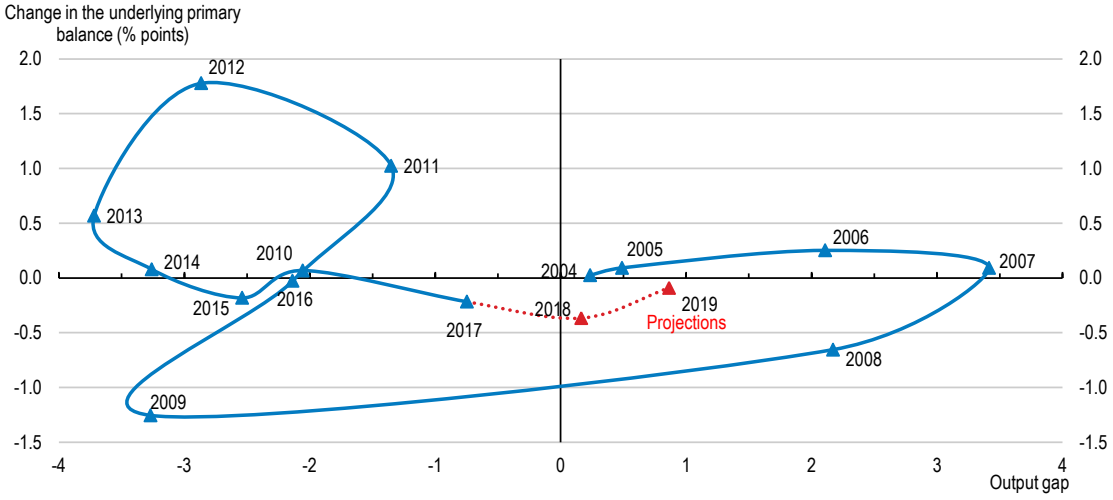
Recommendations in 2016 Economic Survey	Actions taken since 2016
When NPLs create a serious economic disturbance, speed up and facilitate the resolution of NPLs by not triggering bail-in procedures within the existing rules.	The existing framework under the Bank Recovery and Resolution Directive implies full bail-in under ordinary resolution. Under liquidation with state-aid there is bail-in up to subordinated debt.
Consider establishing asset management companies where needed, and possibly at the European level.	Several member countries have established AMCs. A non-binding blueprint for national Asset Management Companies (AMCs) providing recommendations based on best practices is being prepared by the Commission and other institutions (ECB, EBA and SRB).
Take supervisory measures to encourage banks to resolve NPLs, which might include raising capital surcharges for long-standing NPLs	The Commission consulted EU banks on the introduction of common binding minimum levels of provisions and deductions from own funds needed to cover losses on new non-performing loans. The ECB published guidance on non-performing loans calling for banks to adopt ambitious and credible strategies for tackling NPLs. In addition, an addendum by the ECB provides quantitative guidance on supervisory expectations regarding timely provisioning practices for new NPLs.

Improving the European fiscal framework

Ensuring counter-cyclical fiscal policies in good times

The euro area fiscal stance has loosened and become slightly expansionary in 2017, which was appropriate since there was still slack in the euro area in 2017 based on OECD estimates (Figure 19). Going forward, OECD projections show the fiscal stance slowly returning to a neutral position by 2019, as slack progressively disappears (Figure 19). The European Fiscal Board considers a neutral fiscal stance appropriate for 2018 (EFB 2017a).

Figure 19. The fiscal stance in the euro area is set to become broadly neutral

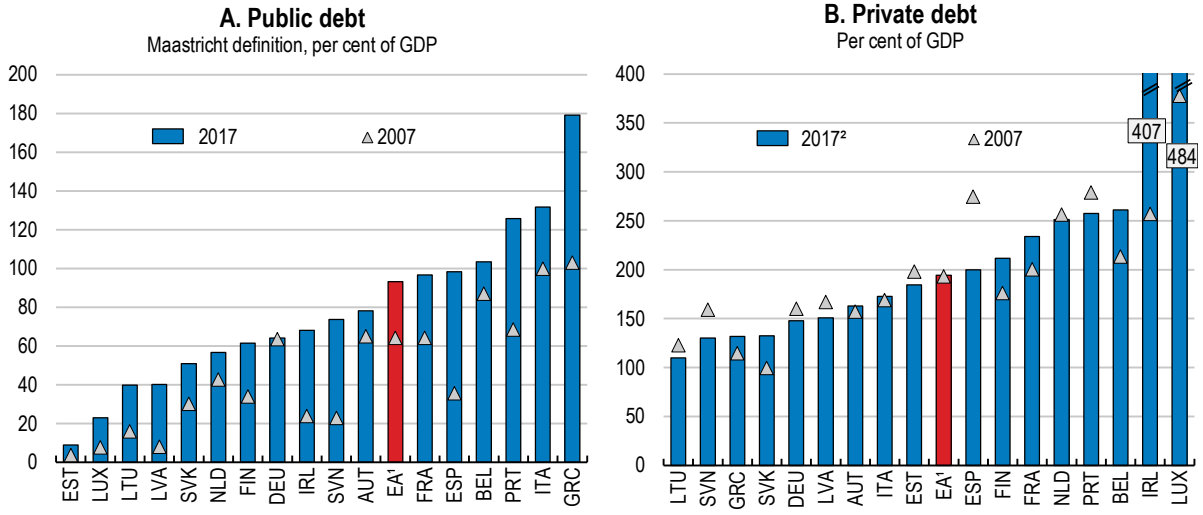


Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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If the euro area economy strengthens as projected or even further, leading to a significantly positive output gap, room will appear for governments to improve fiscal positions significantly and reduce debt ratios. In the past, fiscal policy in the euro area as a whole (and for most countries individually) has been excessively contractionary in bad times and insufficiently counter-cyclical in good times (Figure 19). It is critical the euro area does not repeat this mistake. Public debt levels are much higher now than in 2007, which would limit the available fiscal space when the next crisis hits (Figure 20).

Figure 20. Public debt has increased since the crisis, but private debt did not



1. Euro area member countries that are also members of the OECD (16 countries) and Lithuania; weighted average.
2. Or latest available year; 2016 for the euro area.

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* and *OECD Financial Indicators* (databases).

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Ensuring that fiscal policy at the national level is counter-cyclical is also a pre-condition for establishing an effective common stabilisation function. Against the favourable economic situation, member states should improve their fiscal position and not spend windfall revenues, especially in countries where there are fiscal sustainability issues (e.g. a high level of public debt or contingent liabilities).

Raising national awareness that fiscal consolidation is desirable in good times would pave a political way forward so that governments and their citizens are not tempted to spend windfall revenues immediately. This is a role national fiscal councils could play more actively, as long as they are properly staffed and financed, and communicate effectively to a wider audience which is not always the case. In parallel, the European Fiscal Board could support such activities. For example, the European Fiscal Board noted that the euro area fiscal stance in 2016 was broadly appropriate, but that the geographical composition was not optimal: some countries with fiscal space were not using it fully while others would have needed to implement some fiscal expansion to support demand (EFB 2017a). In its Annual Report, the European Fiscal Board warns about similar risks. The Board could go one step further by providing an assessment on the appropriate fiscal stance for each country consistent with the appropriate stance at the European level.

Incentives to tighten fiscal policy in good times are also needed, for example through a better implementation of the Stability and Growth Pact (SGP). In that vein, the EFB proposed in 2017 that countries under the corrective arm of the SGP (i.e. countries in excessive deficit procedure) would see their nominal fiscal deficit target brought forward in case of better economic conditions (EFB, 2017b). For countries under the preventive arm (i.e. countries outside the excessive deficit procedure), the EFB suggests a revised and faster convergence path towards the medium term objective (MTO), which is defined in structural terms, in case of past deviations from the required path.

The EFB ideas on adjusting the rules to make them less pro-cyclical in good times are valuable and worth exploring, although they face two difficulties. For countries still under the corrective arm, it would be politically difficult to request that they reach their nominal deficit target faster, even if growth is above potential, because spending needs remain high after several years of underinvestment and in view of rising inequality during the recession. For countries that are under the preventive arm, meeting the MTO objectives earlier would add more complexity to the rules without necessarily being a very effective instrument. The MTO concept has proved too complicated to be used by politicians to explain their policy choices. It is also a very imperfect instrument as uncertainties regarding the level of the output gap make it difficult to be used effectively in a fiscal rule. It is striking there are still significant revisions of the output gap several years after the publication of the first estimates (and lack of consensus among experts), weakening its relevance to assess consolidation efforts. In addition, sanctions have proved not to be an effective tool and can backfire politically, reducing goodwill for fiscal adjustment.

To avoid these difficulties, two options could be contemplated. Firstly, positive incentives are lacking and incentives could take the form of rewards rather than sanctions (Eyraud et al., 2017). The Commission has proposed recently to provide budgetary incentives for countries achieving agreed structural reforms (European Commission, 2017c). A similar idea could be explored regarding fiscal efforts.

Secondly, rules could be simplified. Current rules are complex and it is difficult to assess the adequate fiscal stance based on the numerous fiscal indicators produced at the European level (EFB, 2017b). Simplifying the rules could be achieved by adopting an expenditure objective ensuring a sustainable debt-to-GDP ratio, as suggested in the

previous euro area Survey or other studies (OECD, 2016; Eyraud and Wu, 2015; Claeys, 2017). To foster fiscal sustainability, the expenditure path should be set in a way that achieves a public debt-to-GDP ratio converging towards sustainable levels in the medium-term. For example, the framework could be similar to the Swiss debt brake rule, which includes a notional account to compensate for past deviations, but with no link with a structural balance target (Debrun, 2008). This would lead to the end of the current debt rule, which implies a rapid fiscal consolidation for countries with high debt ratio, which could be too rapid, notably in time of crisis (OECD, 2016; Table 5).

Ultimately, to simplify the Stability and Growth Pact the preventive and corrective arms could be merged so there is a single set of targets, procedures and indicators (Pina, 2016). Sanctions whose threat has been ineffective could be abandoned. Rather, it could be explored that countries that wish to deviate from their fiscal targets could be requested to finance their additional financing needs through GDP-linked bonds. The issuance cost of such bonds would likely entail a premium, introducing a market mechanism to encourage member states to meet their fiscal targets if the premium to issue GDP-linked bonds is considered too high. At the same time, this instrument could bring substantial benefits in terms of stabilising debt-GDP dynamics, especially with the current high ratio of public debt prevailing in some euro area economies, which would reduce restructuring risks (Blanchard et al., 2016; Benford et al., 2016; Carnot, 2017; Fournier and Lehr, 2018). However, such benefits should not be overestimated, as the issuance of such bonds could lack interested investors because of several practical difficulties, such as potential significant revisions of GDP or a fragmentation of debt markets, although there could be ways to overcome such difficulties eventually (Shiller et al., 2018). Another key challenge for the issuance of GDP-linked bonds is the "first-mover" issue, since similar bonds have been issued in the past by countries in crisis, creating a negative stigma. Linking deviations from the rules to the issuance of such bonds would help solve this issue while at the same time providing more flexibility to countries. Another challenge would be to assess deviations to rules that require or not the issuance of GDP-linked bonds. This role could be given to an independent institution, such as national fiscal councils.

Table 5. Past OECD recommendations on monetary and fiscal policies

Recommendations in 2016 Economic Survey	Actions taken since 2016
Commit to keep monetary policy accommodative until inflation is clearly rising to near the target.	Monetary policy has been very accommodative to secure a sustained convergence of inflation towards the inflation target. The continued monetary policy support is provided by the asset purchase programme, the reinvestment of maturing assets, and by the forward guidance on interest rates.
Countries with fiscal space should use budgetary support to raise growth.	The aggregate euro area fiscal stance is projected to stay broadly neutral over 2016-2018. Fiscal policy in some large countries with fiscal space is projected to turn expansionary, while other countries are expected to keep their fiscal stance unchanged.
Ensure that the application of the debt reduction rule of the Stability and Growth Pact does not threaten the recovery.	The implementation of structural reforms and adherence to the adjustment path towards the medium term objective are considered relevant factors in assessing progress in debt reduction.

Policies to strengthen euro area resilience

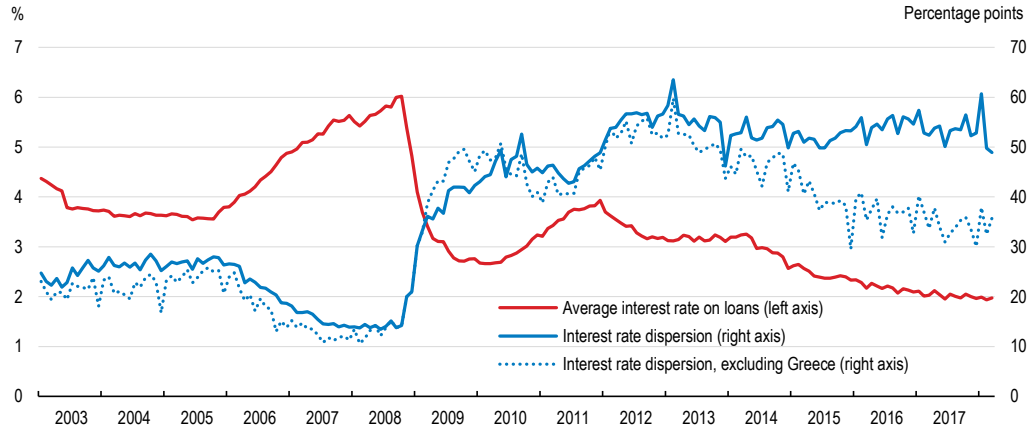
The euro area sovereign debt crisis exposed two important gaps in the architecture of European Monetary Union. First, monetary policy alone is not always sufficient to

smooth area-wide shocks, despite the use of unconventional instruments such as the asset purchase programme and negative interest rates, thus requiring the support of fiscal policy. However, national fiscal policies remained overly pro-cyclical in many countries and did not internalise spillovers. Second, the negative feedback loops linking weak banks and governments with weak public finances reinforced the potential of country-specific shocks to become systemic.

Risk-sharing channels, both private and public, are important in a monetary union, but remain relatively limited in the euro area. Private risk sharing through the financial system allows households and firms to smooth consumption and investment when they are affected by a recession, either by investing in more diversified capital market portfolios or by borrowing from wider sources of credit. Since the euro area financial markets remain fragmented along national lines (Figure 21) and financial intermediation is primarily bank based, the level of private risk sharing compared to federations like the United States, Canada or Germany tends to be lower and biased toward credit, rather than capital flows (Allard et al., 2013 and Figure 22). Moreover, as private risk sharing tends to be less effective in downturns (Furceri and Zdzienicka, 2015), it may not be sufficient to smooth out severe shocks.

Figure 21. Financing costs are declining, but the cross-country dispersion remains elevated

Average interest rates of MFIs' loans to non-financial corporations in the euro area[1], all loan amounts[2]



1. Average interest rates on MFIs' loans to NFCs in the euro area, as well as their cross-country dispersion, are computed based on a sample of 15 euro area countries (changing composition) for which data are available over the entire reference period. Dispersion is measured as the range of variation, in percentage points.
2. All amounts of new business loans other than revolving loans and overdrafts, convenience and extended credit card debt, except for Greece, where data refer to all new loans.
Source: ECB (2018), "MFI interest rate statistics", *Statistical Data Warehouse*, European Central Bank.

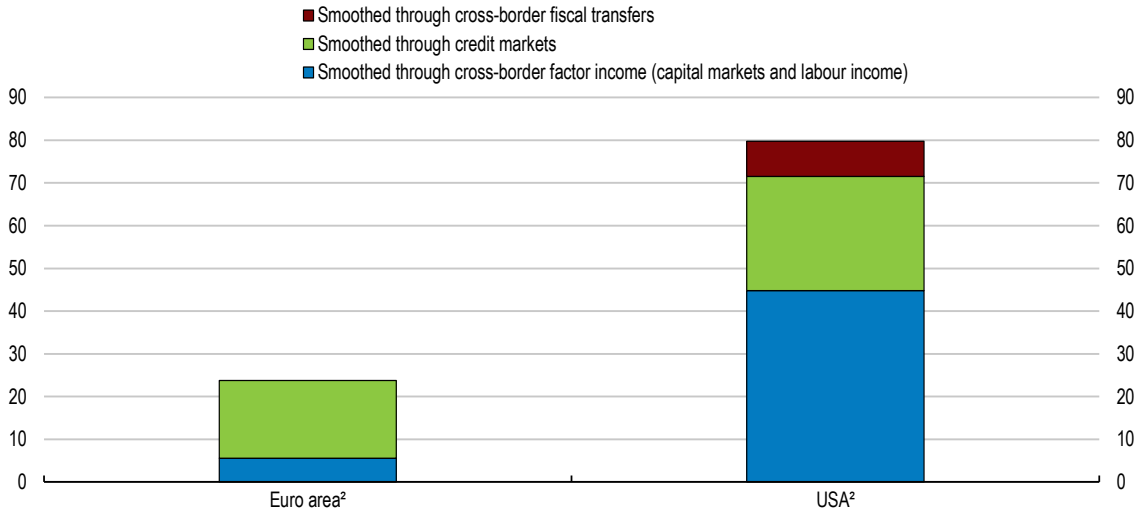
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Public risk sharing typically occurs through fiscal transfers that in some federations represent up to 50% of total spending. However, available tools are much weaker in the euro area and the EU. EU expenditures are only 2% of member states' spending (1% of EU GNI), and none of them is specifically designed for macroeconomic stabilisation. Moreover, private risk sharing may not be sufficient when banks or investors see more the risks than the benefits in investing in other countries and prefer to restrict their activities to their national market (Farhi and Werning, 2012). Empirical evidence confirms that the degree of risk sharing, defined as the share of GDP shocks that are smoothed through various channels, in Europe is lower than in the United States and

appears to have deteriorated in the wake of the financial crisis (Afonso and Furceri, 2008; Milano and Reichlin, 2017). One explanation is the dominant role of banks in channelling financing and the preference of European banks to restrict their activity to domestic markets for various reasons, notably the lack of a true banking union.

Figure 22. Cross-border risk sharing in the euro area is limited

Extent by which an asymmetric shock to GDP is smoothed by cross-border risk-sharing[1], %



1. Following Asdrubali et al. (1996), the degree of co-movement between GDP, income (before and after tax) and consumption after an asymmetric shock for a given US state or EA country is estimated with a 2-step generalised least square method. It measures the relative strength of cross-border risk-sharing channels through net factor income (cross-border property or commuter worker income streams for example), fiscal transfers and credit markets.
2. For the US, yearly data covers 50 states from 1964 to a rolling end date between 1999 and 2015. For the EA, the figure reports results for a sample of the euro area countries, due to partial data availability. The time period spans from 1999 to 2015 (quarterly). The use of different reference periods for the US and the EA does not affect comparability as the zones' risk-sharing estimations are found to vary little over time.
Source: European Commission (2016), "Cross-Border Risk Sharing after Asymmetric Shocks: Evidence from the Euro Area and the United States", Quarterly Report on the Euro Area 15(2), Brussels.

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The rest of this section discusses policies to enhance private and public risk sharing in the euro area, focusing, respectively, on measures for severing the negative feedback loop between banks and their sovereigns and creating an aggregate fiscal stance at the euro area level. After discussing policies to complete the banking union, such as a range of risk reduction measures, a fiscally-neutral backstop for the Single Resolution Fund and a common deposit insurance scheme, it turns to the tools for diversifying banks' sovereign exposures and policies enhancing capital market financing, including stronger convergence of national insolvency regimes. Finally, it assesses possible avenues for improving public risk sharing against large negative shocks, in particular a fiscal stabilisation capacity in the form of a European unemployment benefit re-insurance scheme.

Severing the link between banks and their sovereigns by completing the Banking Union

The banking union remains uncompleted (Box 1). The so-called "first pillar" of the banking union, focussing on supervision, is operational through the Single Supervisory

Mechanism (SSM). The SSM should provide uniform implementation of supervisory standards across the banking union. The "second pillar" of the banking union focuses on how to resolve failed banks without triggering a negative feedback loop, by using the Single Resolution Mechanism (SRM). This is the part that needs more progress for the banking union to be achieved. The "bail-in" component of the SRM has not been tested yet on a large scale and a fiscally-neutral backstop to the SRM is still missing, as explained below.

Box 1. Overview of the recent reforms to strengthen the euro area architecture

Many steps to fill the gaps revealed by the global financial crisis and the euro area sovereign debt crisis have already been taken and provided lasting solutions to the weaknesses in the euro area architecture. The euro area sovereign debt crisis was exacerbated by the absence of a lender of last resort. Although the ECB readily assumed the role of a lender of last resort vis-à-vis the banking sector, it could not, for fears of monetary financing and implicit transfer of resources, play the same role for euro area sovereigns. Instead, the European Stability Mechanism was created in 2012 as a lender of last resort for solvent euro area governments. In the same year, the Outright Monetary Transactions programme that allows the ECB to conduct potentially unlimited purchases in secondary sovereign bond markets conditional on an ESM macroeconomic adjustment programme or a precautionary credit line put in place an effective protection against purely speculative sovereign debt crises. In addition, banking union was created to ensure consistent application of rules, both relating to supervision (Single Supervisory Mechanism in 2014) and resolution (Single Resolution Board in 2016), and break the reinforcing links between national banking sectors national banking sectors and their sovereigns.

The euro area banks are now much better capitalised than before the financial crisis and benefit from strengthened supervisory standards. The reinforced euro area architecture has been put to test in the course of 2017 by resolving and/or liquidating one Spanish and several Italian banks. The system in general delivered solutions to the individual banks' problems, while contributing to the financial stability. However, some assessments also point out the inconsistency of the current framework, in which resolution falls under EU law (the Bank Restructuring and Resolution Directive), while liquidation is left to the diverse national insolvency regimes (Merler, 2018). This situation could be remedied by further harmonisation of insolvency laws or an introduction of an EU-wide insolvency regime for banks.

The purpose of the Single Resolution Fund is to ensure the efficient application of resolution tools and provide financing, while ensuring a uniform resolution practice. However, in case the fund is empty or not sufficiently filled, the Single Resolution Fund requires a fiscal backstop to ensure successful resolution. The backstop is designed to be fiscally neutral over the medium term and any pay-out will be recouped from future banks' contributions. As the backstop has already been agreed by member countries in 2013, the recent Commission's proposal to locate the backstop within the European Monetary Fund is welcome.

At the same time, the Commission proposed to establish a European Monetary Fund as an entity in EU law by taking over the assets and liabilities of the European Stability Mechanism and involving it more directly in the management of financial assistance programmes (European Commission, 2017d). The design includes features of several

recent proposals, such as stronger involvement in assistance, while leaving aside others, such as an active role in a sovereign debt restructuring mechanism (Sapir and Schoenmaker, 2017). The Commission also proposes that, in order to accelerate the decision making process, the deployment of the fiscal backstop should be decided by the Managing Director.

The purpose of the European deposit insurance scheme is to provide a stronger guarantee of deposits. At present, deposit insurance is provided by national deposit guarantee schemes that remain vulnerable to large national or euro area shocks. An European scheme would provide uniform confidence in the deposit safety, bring diversification benefits and, by improving cross-border substitutability of deposits, enhance monetary policy transmission (Praet, 2017). The differences in banks' funding costs would reflect primarily banks' riskiness, rather than geographical location, hence contributing to the severance of the doom loop between national banks and sovereigns.

The pooling of deposit protection across the euro area in a common European deposit insurance scheme is controversial, though: some countries fear that a common fund could lead to risky behaviour from banks (so-called moral hazard). To limit the risk of banks' cross-subsidisation and minimise moral hazard, in particular the tendency of banks to take on excessive risks, the insured banks should pay to European Deposit Insurance Scheme (EDIS) ex-ante risk-based contributions that should be based on a common methodology reflecting bank's riskiness and other resilience metrics, like liquidity. The risk premia should also be sensitive to the amount of systemic risk in the banking system (Acharya et al., 2010).

The Commission has recently outlined a possible way forward on the European Deposit Insurance Scheme regulation (European Commission, 2015), notably suggesting that the progress from re-insurance to co-insurance could be made conditional on sufficient progress in reducing banks' non-performing loans and illiquid, difficult to value instruments, so-called Level 3 assets (European Commission, 2017e; Table 6).

Reducing the home bias in sovereign debt holdings of banks

Completion of the banking union requires both increased risk sharing at the euro area level and effective risk reduction measures that can lead to more diversified banks' portfolios and strengthened market discipline. In addition to recent welcome proposals by the Commission aimed at reducing the amount of non-performing loans and tightening the provisioning rules for them discussed above, further progress is needed in reducing the home bias in sovereign debt exposures of banks (Figure 23).

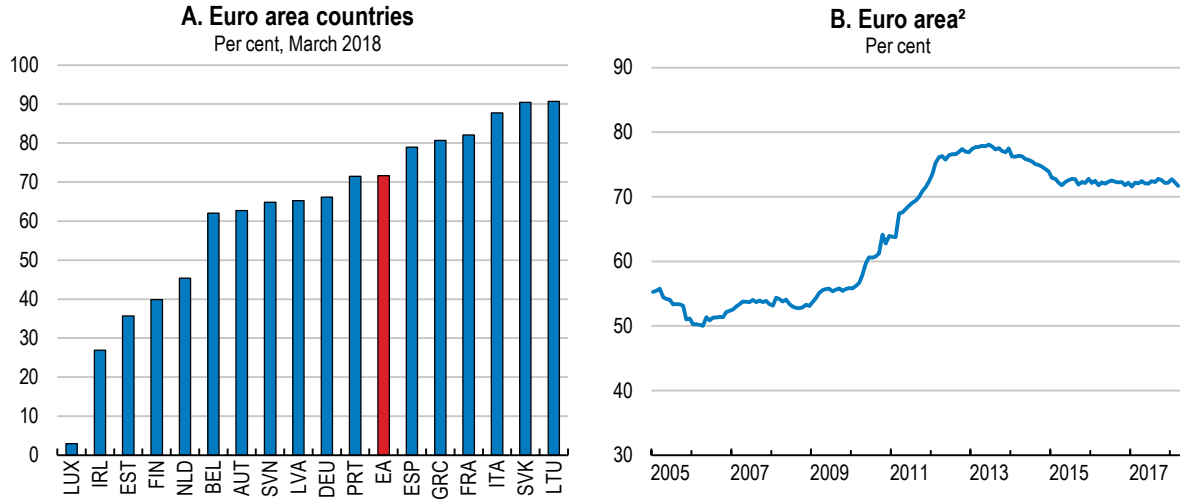
Large exposures of banks to the governments of countries, in which they are located, usually through sovereign bonds, reinforce the negative feedback loop between banks and their sovereigns. At the moment, the regulatory treatment of sovereign debt exposures includes both zero capital requirements for sovereign exposures to EU countries and the exclusion of zero-weighted sovereigns from the application of large exposure limits. The banks that do not have to allocate capital against their holdings of sovereign bonds of EU countries, while being allowed to invest into such assets beyond the usual limit of 25% of own capital, are thus encouraged to pile up sovereign bonds on their balance sheets.

Recent reform proposals tend to focus on increasing the credit risk weight on sovereign debt above zero, on introducing exposure limits or on alternative ways to address concentration risk, such as risk weights that increase based on banks' sovereign exposures relative to its capital (Andritzky et al., 2016; Véron, 2017). The leverage ratio introduced

by the Basel III regulations from 2019 onwards already implies a non-zero capital requirement for sovereign exposures, but it is considered too small.

Figure 23. Home bias in banks' holdings of government bonds is still high

MFIs, excluding the European System of Central Banks[1]



1. Home bias is measured as the share of domestic sovereign bonds in banks' portfolios of sovereign bonds issued by euro area countries.
2. Changing composition.

Source: OECD calculations based on ECB (2018), "Balance Sheet Items statistics", *Statistical Data Warehouse*, European Central Bank.

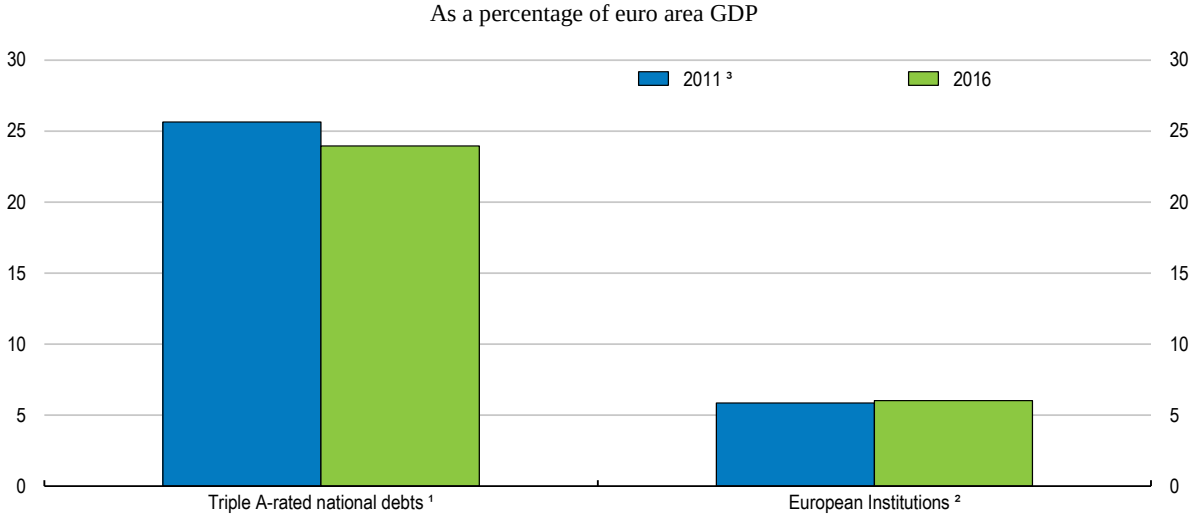
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Simple exposure limits may be preferable to credit risk weights, but the best solution may be the introduction of sovereign concentration charges that target concentration risk beyond certain concentration levels using non-zero risk weights. In principle, simple exposure limits have the advantage of not imposing additional capital requirements on banks and being difficult to avoid, thus directly promoting the diversification of banks' portfolios, but they may lead to strong adjustments when they become binding, even though, the existing parts of the European risk sharing mechanism, in particular the Outright Monetary Transactions programme, have reduced the probability of purely speculative sovereign debt stress and lowered the costs of relatively strict exposure limits (Frisell, 2016). Sovereign concentration charges, as proposed by Véron (2017), would involve increasing (using six brackets) marginal capital surcharges for sovereign exposures exceeding 33% of eligible capital and incentivise banks to diversify their sovereign exposures. Using euro area banking data from 2015, such a measure is estimated to result in aggregate capital surcharges of less than 1.5 percentage points across the euro area (Véron, 2017). Similar, but less stringent parameters for sovereign concentration charges have been proposed by the Basel Committee (BCBS, 2017). To ensure a smooth transition, the new regulation could involve extensive consultation with market participants, a sufficient phase-in period and an exemption from concentration charges for outstanding debt at the time of adoption.

In order to reinforce the diversification efforts and contain risks to financial stability, banks need to be provided with alternative investment instruments with a euro area dimension. One possibility might be synthetic safe bonds created by securitisation of the euro area sovereign debt (Pagano, 2016). As synthetic bonds produce "safety" by a

combination of diversification and seniority, they do not require a mutual guarantee that could lead to risk mutualisation and permanent fiscal transfers. Such synthetic safe bonds could become a new source of high-quality collateral for cross-border financial transactions and help revive the supply of euro area safe assets that has decreased in the aftermath of the financial crisis (Figure 24 and Caballero et al., 2017). The Commission's resolve to provide an enabling framework for private market participants to issue and trade such instruments, labelled Sovereign Bond-Backed Securities (SBBS), and the feasibility study issued by the European Systemic Risk Board's high-level task force are thus welcome (European Commission, 2017e).

Figure 24. Safe asset supply has declined



1. Sovereign debt securities issued by the governments of Germany, Luxembourg and the Netherlands.
2. Triple A-rated securities issued by the European Investment Bank (EIB), as well as those issued by EU authorities through the European Stability Mechanism (ESM), the European Financial Stabilisation Mechanism (EFSM), the Balance of Payment facility and the Macro-Financial Assistance Programs.
3. 2013 for European institutions.

Source: Brunnermeier, M. K., Langfield, S., Pagano, M., Reis, R., Van Nieuwerburgh, S., & Vayanos, D. (2017). ESBies: Safety in the tranches. Economic Policy, 32(90), 175-219; OECD calculations based on public information released by European Institutions.

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There are currently several proposals to create such synthetic assets, differing in the details of their design and the amount of synthetic safe asset created. The European Safe Bonds, or ESBies, are probably the most detailed proposal for creating such a safe asset backed by a pooled portfolio of euro area sovereign bonds (Brunnermeier et al., 2016). As the scheme rests on first pooling the sovereign debt and then tranching it into two tranches, a senior one and a junior one, it does involve diversification benefits that are missing from proposals that involve pooling only the senior tranches of national bonds. However, several issues remain unclear, partly owing to the novelty of the scheme and the lack of empirical data, in particular on past sovereign debt restructurings in Europe.

The global financial crisis has shown that financial securitisation can only relocate, not eliminate, financial risks. In that light, the weak point of the synthetic safe asset proposals, such as ESBies, is the demand for the junior tranche. If the demand for the junior tranche becomes dysfunctional in the time of market stress, it may not be possible

to continue the purchases of sovereign bonds for securitisation and the SBBS scheme could collapse, a risk that can be reduced by carefully considering the issuance amount of the SBBS and hence the supply of the junior instrument to be placed. In order to reduce the risk that public support will be provided in time of stress, private sector provision of SBBS should be encouraged (Corsetti et al., 2016).

Other ways of creating a euro area safe asset without risk mutualisation could be considered. Instruments, such as E-bonds issued by a senior intermediary that borrows at large scale in the market and then lends on to national governments (Monti, 2010) or debt issued by a euro area budget authority (Ubide, 2015), could improve the supply of safe assets, while not involving an explicit government guarantee. However, their possible drawbacks include reduced liquidity of national bond markets and redistribution of issuance costs across euro area members, which could increase the average cost of borrowing for some countries (Leandro and Zettelmeyer, 2018). Further analytical work on safe asset alternatives may be needed before deciding on the way forward.

Table 6. Past OECD recommendations on financial policies

Recommendations in 2016 Economic Survey	Actions taken since 2016
Reinforce national deposit insurance schemes and implement a European Deposit Insurance Scheme, in tandem with continued risk reduction in the banking sector.	In its Communication on completing the Banking Union, the Commission suggested that transition to co-insurance phase of a European Deposit Insurance Scheme (EDIS), could be made conditional on sufficient progress in reducing banks' non-performing loans and Level 3 assets.
To reduce links between national governments and their banks, create a common fiscal backstop to the Single Resolution Fund.	The creation of a backstop for the Single Resolution Fund was agreed by Member States in 2013, as a complement to the Single Resolution Mechanism Regulation. The Commission proposed a regulation establishing a European Monetary Fund, which should provide a fiscally-neutral backstop to the Single Resolution Fund.
Further harmonise banking regulation in Europe.	The Single Rule Book was strengthened by further implementing and delegated acts and European Banking Authority guidelines, for example on internal governance. Further harmonisation of supervisory practices was achieved as the number of options and national discretions available in the EU banking legislation decreased.

Enhancing public risk sharing through a common fiscal stabilisation capacity

Private risk-sharing channels and fiscal measures at the country level may not be sufficient in smoothing out large economic shocks at the country or area-wide level, even if sufficient fiscal buffers are built up in good times. A common fiscal stabilisation tool could provide additional public risk sharing for country-specific shocks since they cannot be smoothed by monetary policy, which focuses on the euro area as a whole. Even for euro area-wide shocks, a common fiscal stabilisation function would be useful since the support from monetary policy could reach its limits.

In periods of constrained monetary policy, co-ordinated fiscal support could become an important part of the policy mix and empirical evidence indeed suggests that in recessions temporary increases in government spending are associated with higher positive effect on output (Auerbach and Gorodnichenko, 2011). Hence, a common fiscal stabilisation capacity would complement the European fiscal rules framework aimed at ensuring the sustainability of national budgets, by providing an appropriate aggregate euro area fiscal stance (Carnot, 2017). Some have proposed that in order to reinforce the interaction of the fiscal capacity and the fiscal rules, access to the stabilisation capacity may be conditional

on past compliance with the fiscal rules and European Semester's country specific recommendations (EFB, 2017b).

A common fiscal capacity can take different forms, but recently discussed options focus on an unemployment benefit re-insurance scheme, a rainy day fund or an investment protection scheme, providing support in terms of both loans and grants (European Commission, 2017f). The proposed schemes follow pre-defined formulas, enhancing credibility and predictability of the schemes. The fiscal capacity should be allowed to borrow, either from the ESM or on the financial markets, in order to cover occasional deficits.

Existing studies suggest that to be effective in the euro area, the fiscal stabilisation function would need on average net payments of about 1% of GDP. If a rainy day fund were to be created with countries contributing at all times, contributions between 1.5% and 2.5% of GDP would improve the smoothing of income shocks from the current 40% to 80% (Allard et al., 2013). However, other studies find that significant macroeconomic stabilisation can already be achieved with contributions above 0.5% of GDP (Beblavý et al., 2017; Carnot et al., 2017).

A euro area-wide unemployment benefit re-insurance scheme could be a promising version of the fiscal stabilisation function for both political and economic reasons. From a political perspective, it would only be used against extreme negative events, making it easier to avoid permanent transfers, and so have a greater chance to be accepted by countries that fear such transfers and moral hazard. From an economic perspective, such a scheme would have significant potential to smooth activity because of the high multiplier effects associated with unemployment benefits (Beblavý et al., 2015).

The scheme would be financed by contributions from euro area countries and would provide pay-outs to national unemployment schemes in times of extreme negative shocks, according to a transparent, semi-automatic trigger and following a pre-defined pay-out formula. Counterfactual simulations using euro area data conducted in parallel to this Survey suggest that national contributions would be modest, amounting to 0.17% of GDP, and the scheme would reduce the standard deviation of GDP growth by 0.36% in the recent financial crisis (Box 2 and Claveres and Stráský, 2018). Moreover, deep declines in GDP in countries worst hit by the crisis would be mitigated by the scheme's pay outs.

While triggers based on the output gap tend to perform badly, mainly because of the problems with the real-time estimation, unemployment rate triggers are preferable, given its close correspondence to the cyclical position, harmonised measurement and negligible revisions (Carnot et al., 2017 and Figure 25). A system of experience rating, charging higher contributions to countries drawing often from the fund, could work towards preventing cases where some countries are continuously net recipients. The scheme should be allowed to borrow in financial markets to finance occasional deficits when pay-outs exceed contributions. Counterfactual simulations using euro area data suggest that the debt issuance would stay below 2% of the euro area GDP (Claveres and Stráský, 2018).

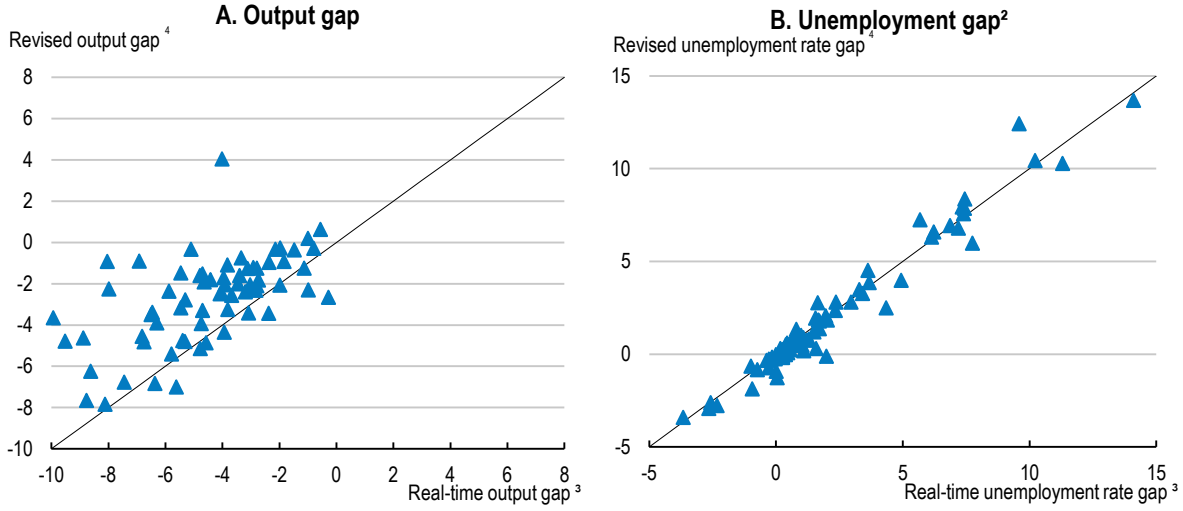
At the current juncture, an unemployment re-insurance scheme, with limited pay- outs in periods of large negative shocks, appears preferable to a genuine European unemployment insurance scheme that would fully mutualise the national unemployment resources and provide continuous pay-outs. First, the re-insurance scheme, insuring national agencies only up to a pre-defined transfer amount, can function with less

harmonisation across countries of their unemployment schemes in terms of duration, eligibility and replacement ratios than a genuine insurance scheme (Dolls et al., 2014). Second, the re-insurance scheme would be limited to periods of extreme negative shocks, thus limiting the time, in which individual countries receive support, and reducing the associated moral hazard.

In order to prevent permanent transfers between countries in the long-run, moral hazard issues need to be convincingly addressed. A scheme limited to times of extreme negative shocks helps reduce moral hazard: a double condition trigger limits pay-outs to countries with high, but unchanging unemployment and it improves incentives for a country to reduce high unemployment. In order to limit potential losses from missing repayment, the access to the scheme should be limited to countries in compliance with EU fiscal rules and with sustainable public debt.

Figure 25. Output gap measures are revised more than unemployment gap measures

Euro area countries[1], annual data from 2009 to 2013



1. Euro area members that are also members of the OECD, excluding Latvia (15 countries).
2. Measured as the percentage-point difference between the unemployment rate in year t and the average annual unemployment rate of the previous 10 years.
3. Rolling annual observations taken from previous vintages of the OECD Economic Outlook database (Nrs. 85, 87, 91 and 93).
4. Annual measures taken from the latest version of the OECD Economic Outlook database (No. 103), for the period between 2009 and 2013.

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Box 2. Macroeconomic stabilisation properties of a euro area unemployment benefits re-insurance scheme

In Claveres and Stráský (2018) we use counterfactual simulations to assess the macroeconomic stabilisation properties of an unemployment benefits re-insurance scheme for the euro area. Payments from the unemployment benefits re-insurance scheme are conditional on increases in the unemployment rate, both in comparison to the previous year and to the 10-years moving average (so-called double condition trigger). This double condition for payouts serves to limit moral hazard it two ways. First, since payouts only take place in the presence of large shocks, small fluctuations in the unemployment rate that likely reflect differences in national labour market institutions are

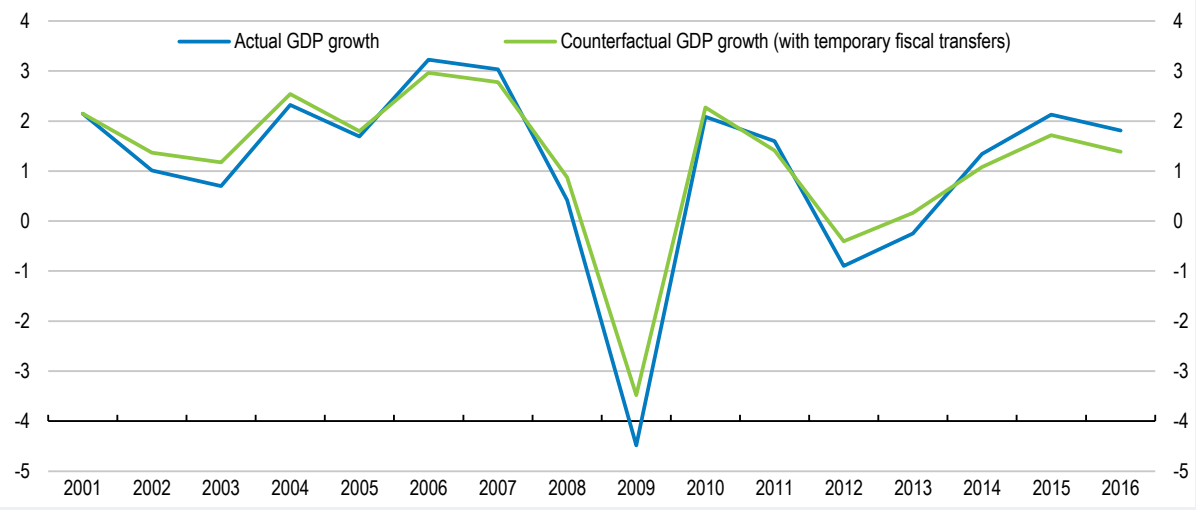
not taken into account. Second, the support is not maintained when the unemployment rate settles down at a higher level, thus providing incentives for the country to undertake structural reforms.

Once triggered, the payouts are proportional to the change in the unemployment rate, so that for 1 percentage point increase in the unemployment rate the country receives payout of 1% of GDP. The participating countries finance the scheme through two types of contributions: (i) automatic payments amounting to 0.1% of GDP by all countries each time the fund's balance drops below -0.5% of euro area GDP (so-called start-stop contributions) and (ii) an additional charge of 0.05% of GDP for every time the support scheme has been activated in the past 10 years (so-called experience rating). While the former ensures the fund stays broadly in balance most of the time, the slow-memory mechanism prevents permanent transfers by requiring higher contributions from countries that repeatedly draw on the fund.

The results suggest that a European unemployment benefits re-insurance scheme could have reduced the standard deviation of euro area GDP growth by 0.36% in the financial crisis, from 2009 to 2013 (Figure 26). In doing so, the scheme would have mobilised average annual contributions of participating countries of around 0.17% of their national GDP, over 2000-2016 while avoiding permanent transfers, as required by the Five Presidents' Report. Our results are comparable to other studies in the literature with slightly modified assumptions regarding the conditions for payouts and contributions (Carnot at al., 2017; Beblavý et al., 2017).

Figure 26. Unemployment benefits re-insurance scheme could help macroeconomic stabilisation

Euro area real GDP growth



Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database) and authors calculations.

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Enhancing private risk sharing by deepening the Capital Markets Union

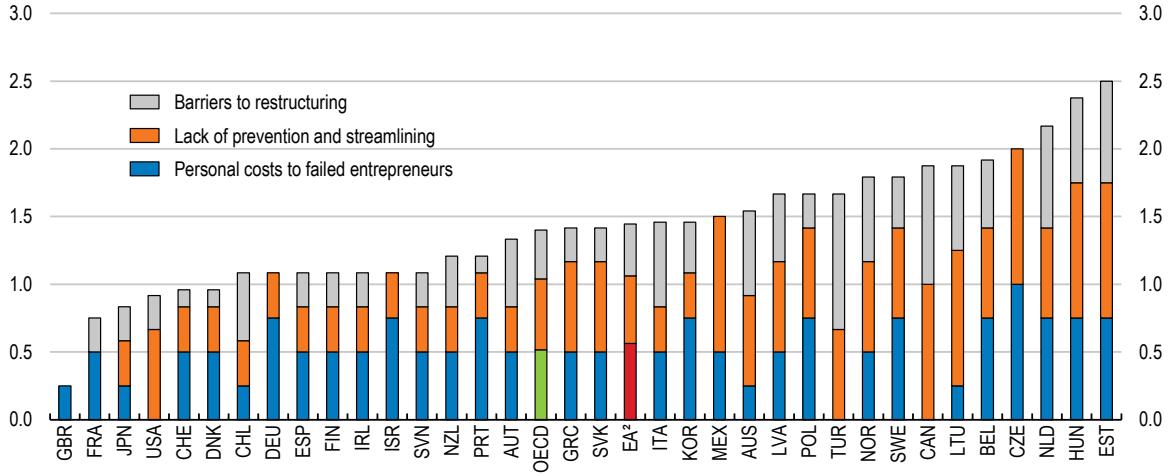
The Capital Markets Union aims at diversifying sources of financing and creating more integrated financial markets by multiple actions, such as improved securitisation rules, institutional and retail investment and preventive restructuring and second chance for entrepreneurs. Non-harmonised insolvency regimes can be a barrier to cross-border investment, creating legal uncertainty and complicating efficient restructuring of viable companies and resolution of non-performing exposures. In addition, some argue, the disparities in national insolvency laws complicate resolution of non-performing loans and

allow for circumvention of the bail-in rules of the Bank Restructuring and Resolution Directive through the application of heterogeneous national insolvency and liquidation rules to banks (Bénassy-Quéré et al., 2018 and Box 1).

Cross-border insolvency proceedings take on average three years and twice as many resources as domestic insolvencies, and considerable differences across countries remain (European Commission, 2017g and Figure 27). The Commission has made welcome progress in facilitating debt recovery in cross-border insolvencies. The revised rules avoiding secondary proceedings entered into force in June 2017 and group insolvency proceedings will be introduced by 2019. In addition, steps are being made to harmonise the insolvency proceedings. The Commission's 2016 proposal to set common principles on early restructuring and a second chance for honest entrepreneurs is a step in the right direction and should be adopted. As regards debt enforcement, in March 2018 the Commission proposed a common mechanism of out-of-court value recovery from secured loans.

Figure 27. Insolvency regimes differ considerably across countries

Index scale of 0 to 3, from most to least efficient insolvency regimes[1], 2016



1. A higher value corresponds to an insolvency regime that is most likely to delay the initiation of insolvency proceedings and/or increase their length.
2. Euro area member countries that are also members of the OECD, excluding Luxembourg, plus Lithuania; unweighted average.

Source: OECD calculations based on the OECD questionnaire on insolvency regimes; Adalet McGowan, M., D. Andrews and V. Millot (2017), "Insolvency Regimes, Zombie Firms and Capital Reallocation", OECD Economics Department Working Papers, No. 1399, OECD Publishing, Paris; Adalet McGowan, M., D. Andrews and V. Millot (2017), "Insolvency Regimes, Technology Diffusion and Productivity Growth: Evidence from Firms in OECD Countries", OECD Economics Department Working Papers, No. 1425, OECD Publishing, Paris.

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Regulatory harmonisation in other areas, including investment funds, covered bonds and transactions in claims, could facilitate development of cross-border financial markets. Recent proposals by the Commission for more harmonised rules on distribution of investment funds, cross-border transactions in claims and regulatory treatment of covered bonds, which represent important source of bank financing in some European countries, are thus welcome (European Commission, 2018).

Reforms enhancing capital markets integration extend beyond the current Capital Markets Union agenda and should include eliminating the debt bias that exists in many corporate tax systems and a more converging supervision of capital markets. The tax preference for debt over equity that exists in many countries and that contributes to create vulnerabilities in the financial and non-financial sector should be addressed as part of the Common Consolidated Corporate Tax Base proposal. The aim should be to place equity financing on the same footing as debt financing, making debt more expensive and/or equity cheaper compared to the current situation. To prevent windfall gains for existing owners, more neutral tax treatment should apply only to newly issued debt and equity-financed investment. Removing the debt bias could give a real boost to a capital market, including the development of equity markets for SMEs (Nassr and Wehinger, 2016).

In addition, greater convergence of capital markets supervisory regimes would enhance cross-border capital flows by removing undue differences in regulatory practices and improving consistent enforcement. One possibility would be that the European Securities Markets Agency could become a direct supervisor over certain segments of national capital markets with major cross-border activities, ensuring a level playing field in a higher number of areas than is currently the case. Such a development would be especially important when some of the UK-based financial activities relocate to several euro area financial centres and the previously unified regulatory framework (of the UK) is replaced by multiple frameworks of new host countries (Bénassy-Quéré et al., 2018).

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Annex. Progress in structural reform

This annex reviews action taken on recommendations from previous Surveys since the June 2016 Euro Area Economic Survey.

Main recommendations	Action taken since the previous *Survey* (2016)
A. Monetary and fiscal policies	
Commit to keep monetary policy accommodative until inflation is clearly rising to near the target.	Monetary policy has been very accommodative to secure a sustained convergence of inflation towards the inflation target. The continued monetary policy support is provided by the asset purchase programme, the reinvestment of maturing assets, and by the forward guidance on interest rates.
Countries with fiscal space should use budgetary support to raise growth.	The aggregate euro area fiscal stance is projected to stay broadly neutral over 2016-2018. Fiscal policy in some large countries with fiscal space is projected to turn expansionary, while other countries are expected to keep their fiscal stance unchanged.
Ensure that the application of the debt reduction rule of the Stability and Growth Pact does not threaten the recovery.	The implementation of structural reforms and adherence to the adjustment path towards the medium term objective are considered relevant factors in assessing progress in debt reduction.
B. Financial policies	
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.	The existing framework under the Bank Recovery and Resolution Directive implies full bail-in under ordinary resolution. Under liquidation with state-aid there is bail-in up to subordinated debt.
Consider establishing asset management companies where needed, and possibly at the European level.	Several member countries have established AMCs. A non-binding blueprint for national Asset Management Companies (AMCs) providing recommendations based on best practices is being prepared by the Commission and other institutions (ECB, EBA and SRB).
Take supervisory measures to encourage banks to resolve NPLs, which might include raising capital surcharges for long-standing NPLs.	The Commission consulted EU banks on the introduction of common binding minimum levels of provisions and deductions from own funds needed to cover losses on new non-performing loans. The ECB published guidance on non-performing loans calling for banks to adopt ambitious and credible strategies for tackling NPLs. In addition, an addendum by the ECB provides quantitative guidance on supervisory expectations regarding timely provisioning practices for new NPLs.
Reinforce national deposit insurance schemes and implement a European Deposit Insurance Scheme, in tandem with continued risk reduction in the banking sector.	In its Communication on completing the Banking Union, the Commission suggested that transition to co-insurance phase of a European Deposit Insurance Scheme (EDIS), could be made conditional on sufficient progress in reducing banks' non-performing loans and Level 3 assets.
To reduce links between national governments and their banks, create a common fiscal backstop to the Single Resolution Fund.	The creation of a backstop for the Single Resolution Fund was agreed by Member States in 2013, as a complement to the Single Resolution Mechanism Regulation. The Commission proposed a regulation establishing a European Monetary Fund, which should provide a fiscally-neutral backstop to the Single Resolution Fund.
Further harmonise banking regulation in Europe.	The Single Rule Book was strengthened by further implementing and delegated acts and European Banking Authority guidelines, for example on internal governance. Further harmonisation of supervisory practices was achieved as the number of options and national discretions available in the EU banking legislation decreased.
C. Making public finances more growth-friendly	
As intended in the Investment Plan for Europe, the European Investment Bank should finance higher-risk projects that would not otherwise be carried out.	The extension of the European Fund for Strategic Investments, including more precise definition of additionality of projects, was adopted by the European Parliament and the Council in 2017. Under new conditions, projects need to address sub-optimal investment situations and market gaps as part of the eligibility criteria. Specific elements giving a strong indication of additionality include investment in innovation and physical or other infrastructure projects linking or extending the link between two or more Member States.

Countries should increase targeted public support to investment while enhancing the framework conditions for private investment.	In the Country Specific Recommendations the Commission encourages countries to improve national investment performance by accelerating structural reforms and tackling regulatory and administrative barriers and lengthy approval procedures.
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.	Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and the Communication on the best use of flexibility within the existing rules of the SGP indicate relevant factors when considering a multiannual path for the correction of the excessive deficit.
Adopt national expenditure rules and conduct spending reviews linked to budget preparation.	Although most of the euro area countries use spending reviews, the link with budget making only exists in a minority of euro area countries, where expenditures are regularly reviewed as part of the budget process.
Ensure that national independent fiscal institutions have resources to fulfil their mandate.	About half of national independent fiscal institutions still find their budgets inadequate and the draft directive on strengthening fiscal responsibility from December 2017 calls for Member States to provide stable own resources for effective fulfilment of the IFIs' mandates.

Thematic chapter

Chapter 1.
Stabilisation policies to strengthen Euro Area resilience

The euro area sovereign debt crisis highlighted important weaknesses in the euro area design. Fiscal policy did not build sufficient buffers before the crisis, which forced some countries to tighten fiscal policy too rapidly during the downturn to restore market confidence in sovereign borrowing. Despite this, sovereign stress remained high, weakening further the banking sectors highly exposed to government bonds, which in return reduced further market confidence in fiscal sustainability in case of banks' bailout. As a result, monetary policy was the main public instrument to support the activity, but its effectiveness was reduced by the fragmentation of financial markets along national lines as the crisis deepened.

In order to durably sever the links between banks and their sovereigns, euro area countries agreed on a banking union. The creation of a common supervisor was a very important step in that direction. However, further progress is needed in reducing and sharing risks, creating a common deposit guarantee scheme and the application of existing rules to ensure sufficient risk sharing can take place in case of crisis. At the same time, incentives need to be put in place for banks to progressively move away from a too high exposure to domestic sovereign bonds. A step in that direction could be the introduction of euro area safe asset, which would pool sovereign issuance from various countries, in parallel with gradual introduction of capital surcharges on sovereign exposures. Such progress may not be sufficient, however, for national fiscal policies and monetary policy to smooth a major crisis. The introduction of common fiscal stabilisation capacity is necessary to buttress the euro area in case of a deep recession, both at the country level and euro area level. Finally, policies aiming at further cross-border integration of capital markets should reinforce private risk sharing, reducing the burden on macro policies.

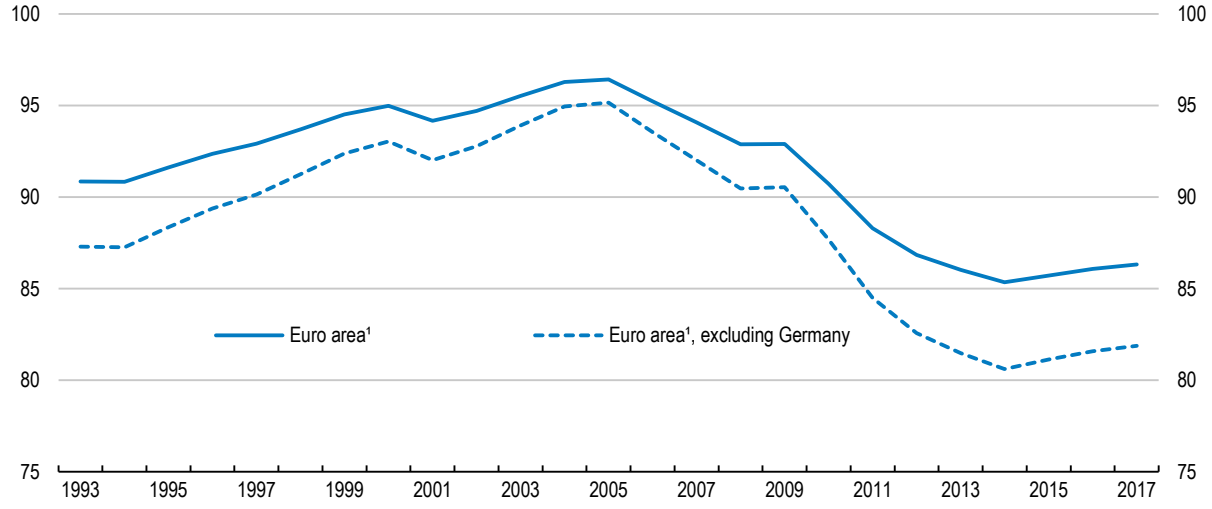
The capacity of the euro area to withstand negative shocks remains limited

The crisis has exposed important gaps in the euro area architecture

In the first years of its existence, the euro seems to have contributed to economic convergence in the euro area. With the benefit of hindsight, it seems possible that at least some of the convergence gains were due to only a moderation of country-specific shocks, alongside the build-up of unsustainable imbalances and mispricing of sovereign risk. As a result, the economic convergence achieved early in the euro's existence has been reversed since the crisis and the recent economic recovery has prevented further deterioration (Figure 1.1).

Figure 1.1. Euro area convergence has reversed since the crisis

Euro area real GDP as a fraction of German GDP, PPP-adjusted, per capita, population weighted

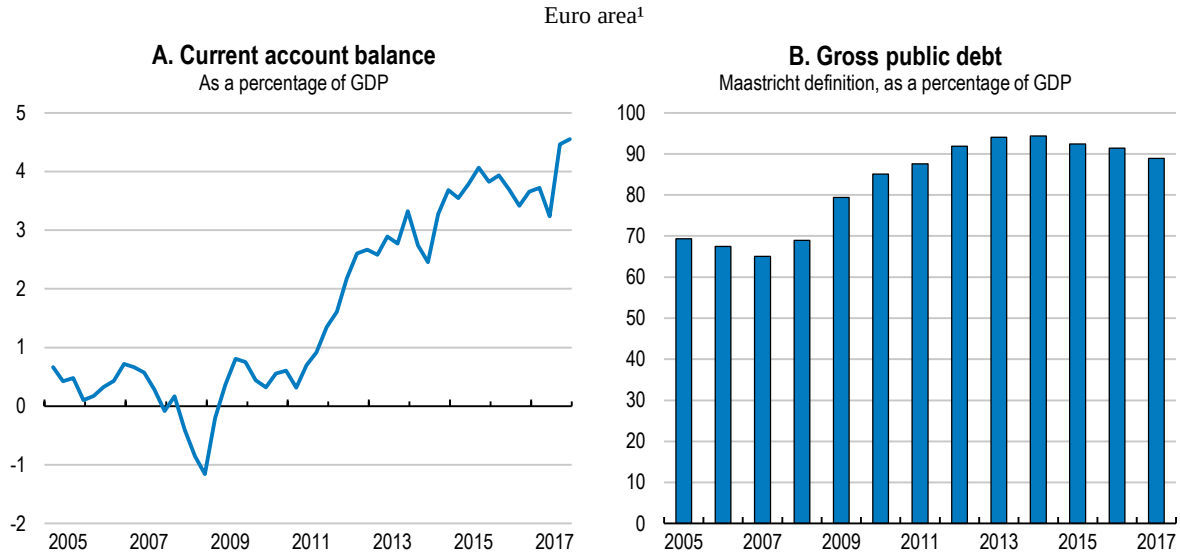


1. Changing composition.
Source: The Conference Board (2018), Total Economy Database.

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The euro area sovereign debt crisis was characterised by a sudden stop in cross-border lending, as investors adjusted financing flows to banks and governments in many countries, sharply reversing intra-euro area capital flows that gradually built up prior to the crisis. Slowing growth then lead to big budget deficits and rapidly increasing public debt ratios, in particular in countries where governments assumed some of their banks' debt (Figure 1.2). Moreover, euro area sovereigns facing financing difficulties did not have access to the lender of last resort, as national central banks could not create money to lend to sovereigns and the European Central Bank was explicitly forbidden to do so (Baldwin et al., 2015). Without the stabilising role of the lender of last resort, risk premia on government borrowing increased sharply, reinforcing budget deficits and future borrowing needs.

Figure 1.2. The crisis triggered a readjustment in external balance and public debt



1. Euro area member countries that are also members of the OECD (16 countries).
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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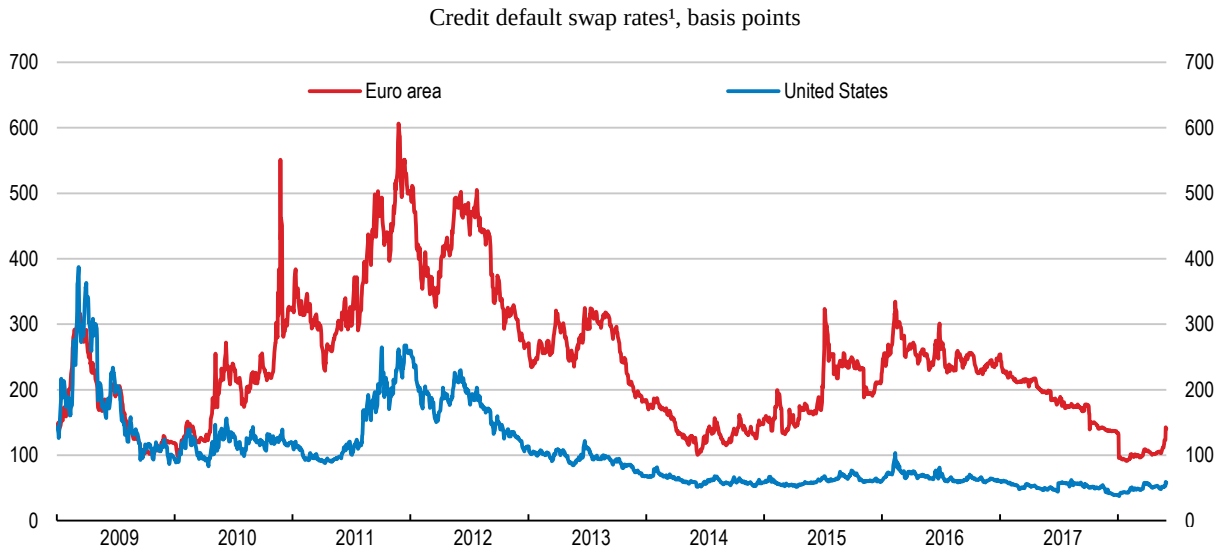
The close links between banks and sovereigns amplified the crisis. Many euro area banks were weakly capitalised when crisis started, due to excessive lending, mainly to the housing sector. Declining valuations of bank assets reinforced capital shortfalls and led to sharp increases in bank solvency and liquidity risk measures (Figure 1.3). Since the banks, in many cases, were not able to obtain new capital in the market, their recapitalisation needs exacerbated the deteriorating fiscal situation of their sovereigns. On the other hand, euro area banks were important buyers of sovereign bonds and concerns about their ability to continue to do so reinforced the concerns about the solvency of the sovereigns. The doom loop between banks and their sovereigns gradually weakened in the aftermath of the euro area sovereign debt crisis, following the announcement of the Outright Monetary Transactions programme and agreements on the banking union and the fiscal compact (Figure 1.4).

Even though the acute phase of the crisis subsided and the situation has normalised, the underlying causes of the crisis, including the policy failures that allowed the build-up of imbalances, were not fully addressed. In pre-crisis times, the windfall from declining interest rates and debt payments was not saved and higher revenues during boom years were wrongly considered permanent (Allard et al., 2013). When crisis started, national fiscal policies in many countries were forced to tighten rapidly during the downturn to restore market confidence in sovereign borrowing (Figure 1.5).

There is a risk that the current cyclical upswing will be incorrectly interpreted as an improvement in resilience, at the crucial juncture when further reforms are needed to ensure long-term sustainability of the euro area. After a decade of lacklustre performance, the euro area economy is expanding again and the economic outcomes across the euro area are getting more aligned again (Figure 1.6). This window of opportunity should be used to reduce the high levels of public debt and for further reforms, in particular further

reducing and sharing risks, completing the banking union and correcting the remaining macroeconomic imbalances.

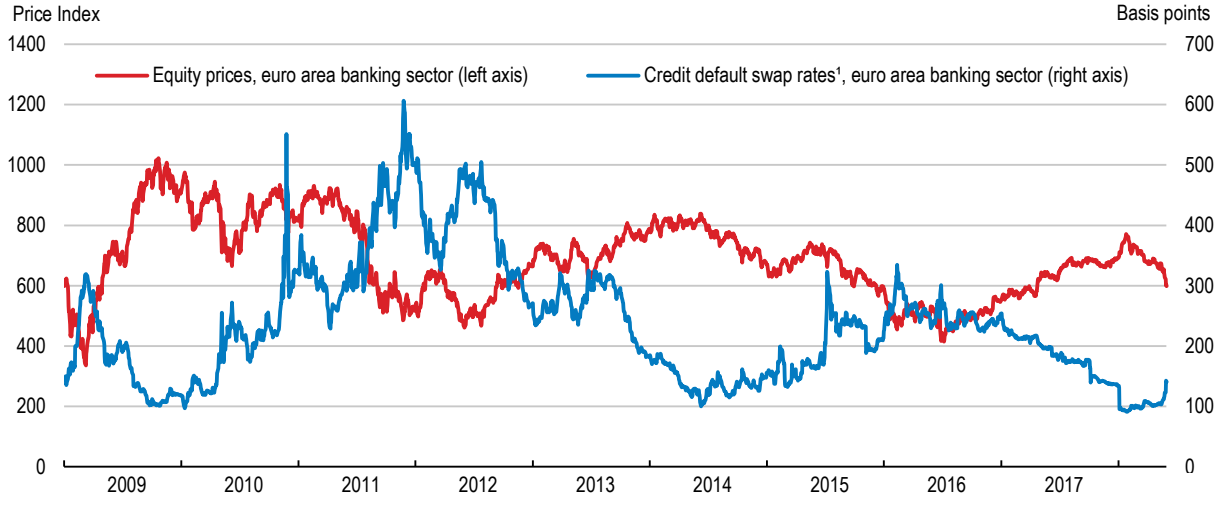
Figure 1.3. Bank solvency risk increased strongly in the crisis



1. Banking-sector five-year credit default swap rates.
Source: Thomson Reuters (2018), *Datastream Database*.

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Figure 1.4. The potentially harmful link between banks and sovereigns gradually weakened in the aftermath of the financial crisis

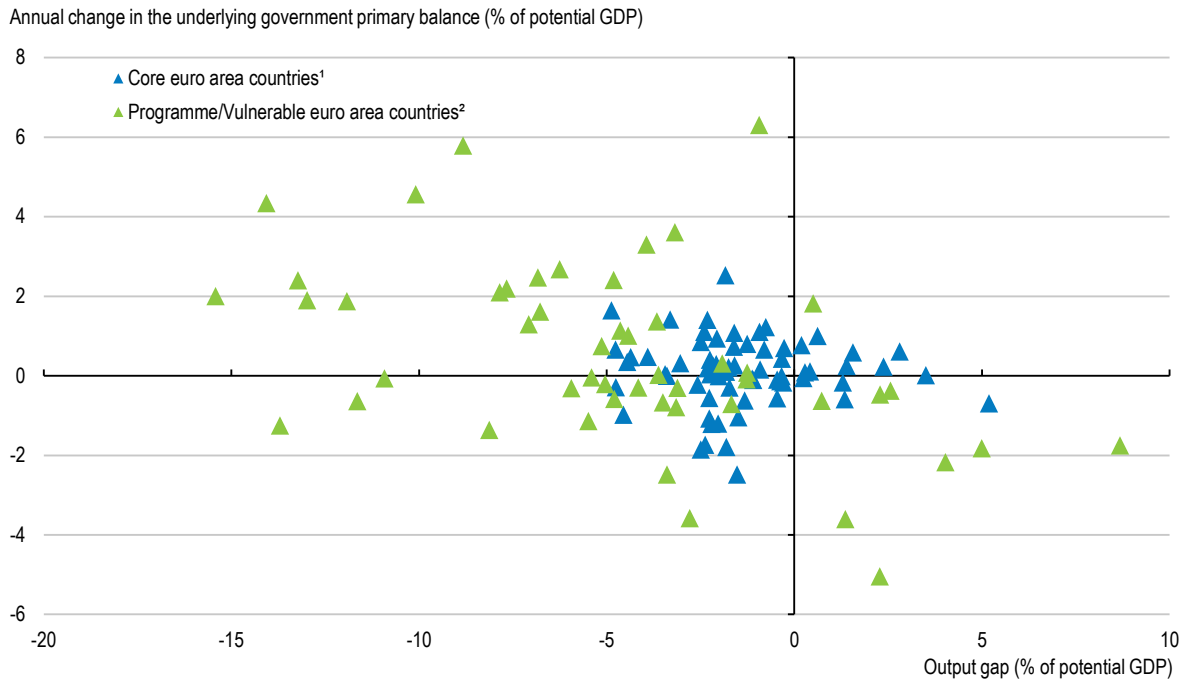


1. Banking-sector five-year credit default swap rates.
Source: Thomson Reuters (2018), *Datastream Database*.

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Figure 1.5. After the crisis, fiscal policy was not very supportive

Annual data, 2008-2017

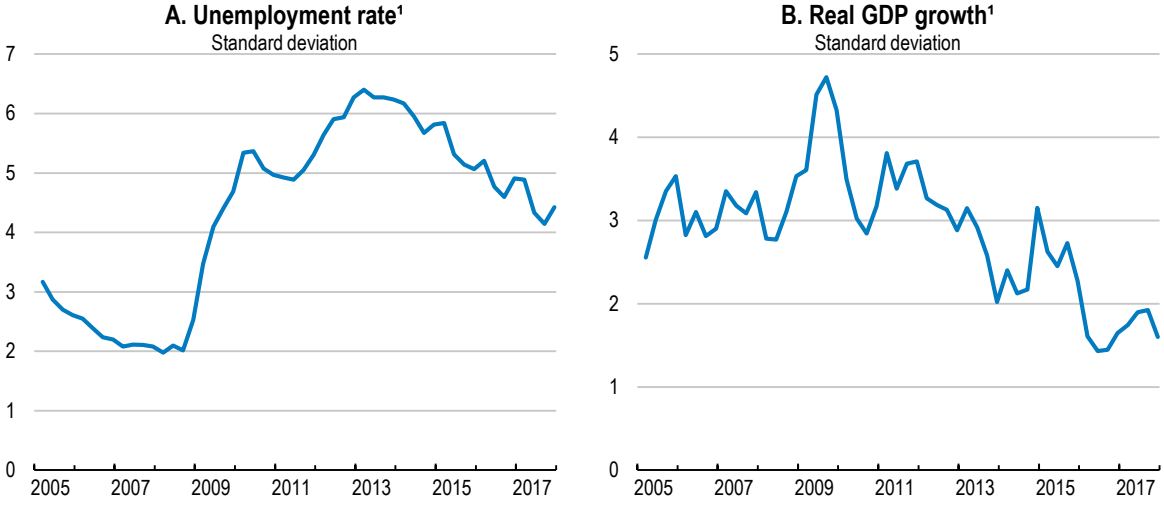


1. Core euro area countries include Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.
2. Vulnerable euro area countries include Greece, Ireland, Italy, Portugal and Spain.

Source: OECD (2018), OECD Economic Outlook: Statistics and Projections (database).

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Figure 1.6. Dispersion of economic performance in the euro area is decreasing again



1. Dispersion is measured as the standard deviation of quarterly unemployment and real GDP growth rates across all EA19 countries.

Source: Eurostat (2018), "GDP and main components" and "LFS series - detailed quarterly survey results", Eurostat Database; OECD (2018), OECD Economic Outlook: Statistics and Projections (database).

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Risk sharing channels in the euro area are insufficient

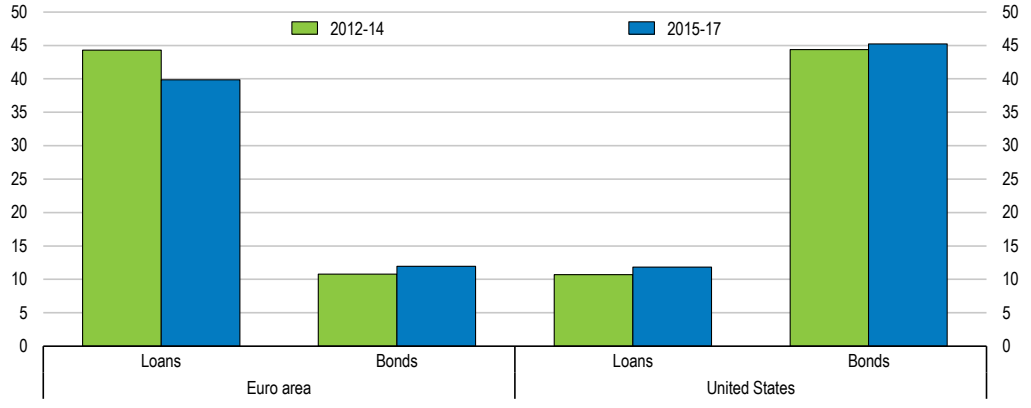
In case of a significant country-specific negative shock, the euro area countries cannot use independent monetary policy or exchange rate depreciation to support growth and employment. They can rely on national fiscal policy, but its effectiveness will, as in any open economy, be limited by trade leakages within the European Union, and will not be supported by labour mobility, which is relatively low. Since labour mobility remains low, private risk sharing in Europe usually takes place through cross-border flows of capital and credit. International capital flows lead to more geographically diversified portfolios that are less correlated with domestic income, while cross-border credit flows facilitate consumption smoothing in the aftermath of a country-specific shock.

Despite recent progress with the banking and capital markets unions, financial intermediation in Europe is primarily bank based (Figure 1.7) and financial markets remain fragmented along national lines (Figure 1.8). As a result of the bank-bias and cross-border fragmentation, the level of private risk-sharing compared to federations like the United States, Canada or Germany tends to be considerably lower and biased towards credit, rather than capital flows (Allard et al., 2013). Although high pre-crisis levels of cross-border financial integration were partly driven by unsustainable business models and mispricing of risks, the sharp drop in interbank loans at the end of 2008 suggests that, at least in the absence of a functioning banking union, risk sharing through the bank lending channel may break down in period of crisis, exactly when needed the most (Furceri and Zdzienicka, 2015).

Public risk sharing usually takes place through fiscal transfers, such as a centralised unemployment scheme or various equalisation payments. Such channels are virtually non-existent at the euro area and the EU level. Federal states typically allocate significant resources at the federal level, with regional spending just below 50% (and some 75% in Canada). In comparison, the EU budget represents some 2% of member states' total expenditure and none of its tools is meant specifically for macroeconomic stabilisation. Similarly, the European Stability Mechanism's (ESM) lending capacity of EUR 500 billion, which represents about 10% of the euro area's countries combined budgets, is designed to prevent fiscal transfers between countries.

Figure 1.7. Financial intermediation is mainly bank based

Outstanding loans[1] and bonds of non-financial corporations as a percentage of GDP, period average

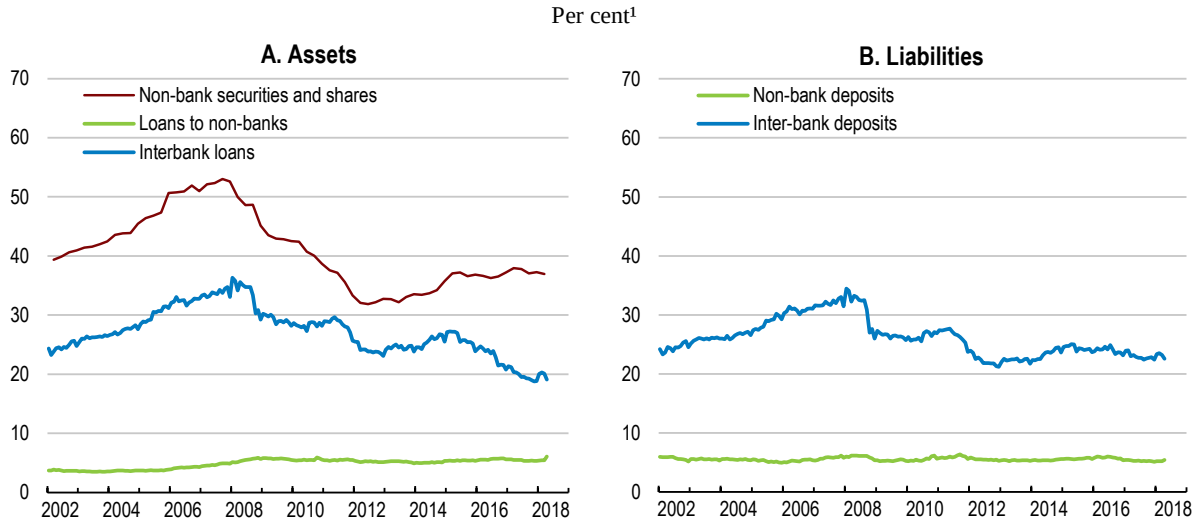


1. Loans of monetary and financial institutions.

Source: Eurostat, European Central Bank, US Bureau of Economic Analysis, Board of Governors of the Federal Reserve System, and Securities Industry and Financial Markets Association.

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Figure 1.8. Cross-border positions of euro area monetary financial institutions remain limited



1. Cross-border activity as a percentage of the total provision of financial services in the euro area.
Source: ECB (2018), "MFI balance sheets: Monetary statistics", *Statistical Data Warehouse*, European Central Bank.

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The empirical studies of the risk sharing channels in federal systems show important heterogeneity among countries. For the United States, Asdrubali et al. (1996) find that between 1963 and 1990 some 75% of the shocks to per capita state gross product were smoothed, mainly through capital and credit markets. In European OECD countries, less than a half of the GDP shocks between 1966 and 1990 were smoothed, roughly one half by fiscal transfers and another half by private savings (Sørensen and Yosha, 1998). Further studies of European Union countries confirmed that only 30% to 40% of GDP shocks are smoothed, mainly by social benefits (Afonso and Furceri, 2008). If anything, risk sharing in the euro area seems to have deteriorated in the aftermath of the financial crisis when more than 70% of shocks remained unsmoothed (Milano and Reichlin, 2017). On the other hand, to the extent to which they alleviated the debt burden through delayed repayment and interest rate reductions, the financial assistance instruments introduced during the European sovereign debt crisis increased the euro area's risk sharing capacity (Cimadomo et al., 2017).

Public risk sharing channels, such as a common fiscal stabilisation function, will remain essential, though, as private risk sharing will not be sufficient to accommodate major adverse shocks. Firstly, a symmetric negative shock cannot be smoothed, and may even be amplified, by private risk sharing alone, while monetary and national fiscal policies may be constrained, requiring further support from a common stabilisation tool. Secondly, private risk sharing may not be sufficient when agents fail to internalise the social benefits from private risk sharing and public institutions may need to reassure markets by providing a minimum level of shock absorption (Farhi and Werning, 2012).

Many measures have already been taken, but progress on remaining issues is needed

Many steps to fill the gaps revealed by the crisis have already been taken. Since the euro area sovereign debt crisis has been exacerbated by the absence of a lender of last resort, the euro area countries agreed in 2012 to create the European Stabilisation Mechanism as a lender of last resort for solvent sovereigns that had temporarily lost market access, provided they accepted a macroeconomic stabilisation programme (Box 1.1). In addition, the banking union was created to ensure consistent application of rules, both regarding to supervision (Single Supervision Mechanism, 2014) and resolution (Single Resolution Mechanism, 2016), and to break the doom loop between national banking sectors and their sovereigns by ensuring that shareholders and creditors of banks contribute through the application of the bail-in rules to any potential losses.

Box 1.1. The European Stability Mechanism in the crisis

The European Stability Mechanism (ESM) offers support to euro area countries with financing difficulties, when necessary to safeguard the financial stability of the euro area. In doing so, the ESM uses three main instruments: (i) lending to governments as part of a macroeconomic adjustment programme, (ii) precautionary financial assistance in the form of credit lines to countries meeting certain conditions, and (iii) lending for bank recapitalisation. Since its inception, the ESM has provided loans conditional on a macroeconomic adjustment programme to Cyprus[1,2] and Greece, while Ireland, Greece and Portugal benefited from similar facilities by its precursor, the European Financial Stability Facility. In addition, the ESM provided a loan to Spain targeted at recapitalisation of its banks. At the moment, Greece is the only country still in an ESM programme (planned to end in August 2018), but a first step to regain market access has been made in 2017 when Greece successfully issued its first government bond since 2014.

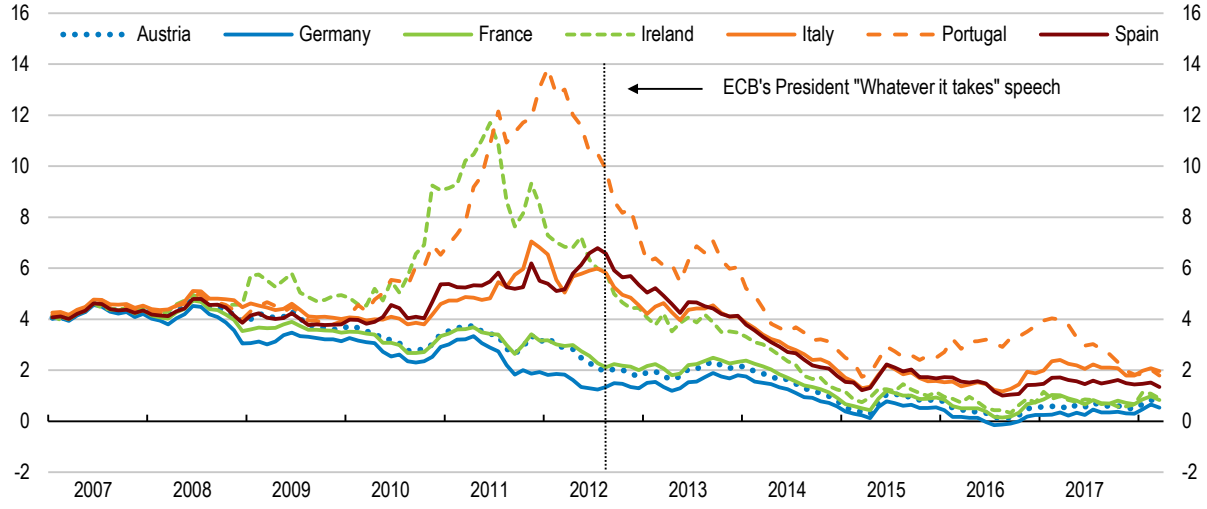
The ESM has an authorised capital of 704 billion euro, of which 80 billion has been paid in by euro area governments, while the rest can be called by the ESM Board of Governors. Based on its high paid-in capital and preferred creditor status (after the International Monetary Fund and excluding the Spanish banking sector programme), the ESM enjoys high credit rating and is able to raise money from investors at very favourable rates. The resources are, in turn, used to finance the ESM assistance programmes at costs that are lower than what the programme countries would be charged in the market, resulting in considerable budget savings for participating countries. Although these financing rates fluctuate according to market conditions and include fees to cover the ESM's operating costs, the savings generated for programme countries in 2016 alone ranged from 0.2% of GDP in Spain to 5.6% of GDP in Greece.

[1]Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

[2]Note by all the European Union Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

The Outright Monetary Transactions programme provided for potentially unlimited ECB intervention in the sovereign debt market in support of solvent governments facing temporary liquidity problems. It was put in place in July 2012 with the view of improving the euro area monetary policy transmission and limiting the redenomination risks. It is conditional on country's participation in a European Stability Mechanism's macroeconomic adjustment programme or a precautionary credit line. There was a positive confidence impact on both nominal and real bond yields from the announcement of the scheme and the ECB was able to stabilise sovereign debt markets, particularly in Italy and Spain where pressures were increasing at the time, without triggering the programme (Figure 1.9).

Figure 1.9. 10-year government bond nominal yields in Italy and Spain declined after the ECB action



Source: OECD (2018), *Key Short-Term Indicators* (database).

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Despite the progress made since the euro area debt crisis, important elements of the banking union, such as further risk reduction and a common deposit insurance scheme and the fiscally-neutral backstop to the resolution fund, are still missing. Since private risk sharing may not be sufficient to deal with large negative shocks, public risk sharing channels should be strengthened to provide a common stabilisation tool. Risk sharing through capital markets is under-developed in the euro area and should be developed further.

The rest of the chapter looks at the policy instruments for euro area reform in the order of importance (Table 1.1). We start from the most pressing concern, which is the completion of the banking union needed to reduce the negative loop between banks and sovereigns, such as further risk reduction and risk sharing, and a common deposit insurance scheme. The chapter then discusses possibilities for enhancing public risk sharing, namely an introduction of a fiscal stabilisation capacity. Finally, long-term policies for reinforcing private risk sharing through the creation of a genuine capital markets union are discussed.

Table 1.1. Overview of the euro area reform instruments

Instrument	Goal	Time (years)	Technical obstacles	Political obstacles
Fiscal backstop to the Single Resolution Fund	Sufficient capacity in resolution, improved credibility	1	None, provided that fiscally neutral	Reduction of fiscal revenues
Deposit insurance scheme	Uniform protection of depositors across euro area	2	Re-insurance or full insurance	Fear of permanent transfers, moral hazard
Reform of regulatory treatment of sovereign exposures	Diversification of banks' balance sheets	2	Parameters for capital surcharges; transition period	Possible financial instability
A European safe asset	New asset facilitating diversification of banks' balance sheets; expanding the supply of safe assets; benchmark for European markets	2	For synthetic bonds: Scaling up potential; pro-cyclicality of demand (especially the junior tranche)	Interaction with national bond markets; Possible redistribution across countries; Possible financial instability
Common fiscal stabilisation capacity	Re-insurance against large macroeconomic shocks	5	Difficult parameterisation of the scheme;	Fear of permanent transfers
Procedures for sovereign debt restructuring	Strengthen market discipline; provide more certainty in sovereign debt restructuring	5	Reducing uncertainty while avoiding automatic triggers	Insolvency often not clear
Develop a genuine Capital Markets Union	Deepening and cross-border integration of capital markets	10	Harmonisation of supervisory, regulatory, tax, insolvency and legal practices	Diverse national regimes

Severing the doom loop by completing the Banking Union

Durably severing the doom loop between banks and their sovereigns would allow banks to engage in more cross-border financial intermediation, while reducing the fiscal resources governments may have to spend to stabilise banks in the case of crisis, thus making it easier for governments to pursue counter-cyclical fiscal policy. Further steps are needed with regard to risk reduction, including the build-up of liabilities eligible for bail-in, the reduction and prevention of non-performing loans and improvements in the efficiency of the insolvency regimes.

Despite ongoing progress, the Banking Union is still not reality. While the Single Supervisory Mechanism is fully operational and provides uniform implementation of banking supervision across the euro area, the Single Resolution Mechanism that should provide orderly resolution of failed banks remains incomplete. The "bail-in" component is yet to be tested on a large scale, and the other components of the Banking Union are still missing. In particular, sufficiently financed resolution and deposit insurance funds need to be put in place to ensure credibility of the system. To ensure that the banking union is ready to deal with any eventuality and to strengthen its credibility, swift progress is needed on two missing components, a fiscally-neutral backstop to the already existing Single Resolution Fund and a common deposit insurance scheme.

Unifying the protection of bank deposits

The Banking Union was created to ensure common standards in banking regulation, supervision and resolution, thus ending the doom loop between national banking sectors and their sovereigns. While a single supervisory mechanism has been put in place and

progress has been made in establishing a single resolution mechanism, bank deposits continue to be covered by national deposit schemes with varying available resources, vulnerable to large national shocks. A common deposit guarantee scheme providing a uniform level of confidence in the safety of deposits across the euro area would increase the financial stability benefit for all participating countries, both by spreading risks across a larger pool of financial institutions and by reducing the likelihood that individual pay-outs will overwhelm the system (ECB, 2016a). While bank funding costs would still vary across the euro area, the differences would reflect differences in bank's risk profile, but not its geographical location (Schoenmaker and Wolff, 2015). Finally, a common deposit guarantee scheme would improve the monetary policy transmission in the euro area by making different forms of money, in this particular case the insured deposits, more homogeneous across euro area countries (Praet, 2017).

However, the link between banks and sovereigns can only be fully severed when banks are no longer backstopped by national government and the national deposit insurance, but at the Banking Union level. As the credibility of a national deposit guarantee scheme is influenced by the fiscal strength of the sovereign, countries with a weaker fiscal position may be viewed as unable to support a national insurance scheme in the face of a systemic financial crisis or a large asymmetric shock. Even in normal times, risk-averse depositors may decide to move their deposits to banks guaranteed by fiscally stronger countries, possibly triggering bank runs.

As with implicit government guarantees, a deposit insurance scheme might lead to moral hazard and banks may take on excessive risks (Schich, 2008). To limit the risk of banks' cross-subsidisation and minimise moral hazard, the insured banks would pay to the European Deposit Insurance Scheme (EDIS) an ex ante risk-based premium (Gros and Schoenmaker, 2014). These risk-based contributions should be based on a common methodology requiring riskier banks - based, among other things, on the level of loss-absorbing capacity, stability and variety of funding sources, business model and management - to pay higher contributions, reflecting their risk profile and other resilience metrics (European Commission, 2015; Allen et al., 2015). The risk premia should also be sensitive to the amount of systemic risk in the banking system (Acharya et al., 2010). To achieve efficiency gains, the administration of EDIS, including decisions on risk-adjusted contributions and management of pay-outs, could be given to the Single Resolution Board, as proposed by the European Commission (European Commission, 2015). This would improve cost efficiency, minimise inter-agency conflicts and allow for swift decision making in the crisis (Allen et al., 2011). Such an arrangement is in place in the United States and Japan where the Federal Deposit Insurance Corporation and the Deposit Insurance Corporation of Japan, respectively, combine deposit insurance and resolution powers. Although efficiency gains from jointly running both the resolution fund and the deposit insurance fund are possible, since the administration and investment of both funds require similar know-how and expertise, resources should be clearly earmarked for their respective purposes to avoid the risk that funds for deposit protection are used up in resolution (ECB, 2016b).

The Banking Union can only be completed and thrive if measures for risk reduction and risk sharing go hand in hand. For example, non-performing loans remain elevated in some euro area countries and need to be reduced, prior to further risk sharing. The Commission's proposals regarding the management of existing non-performing loans, including national asset management companies and other measures to develop secondary markets, and the provisioning rules proposed by the Commission and the ECB to prevent the build-up of new non-performing loans are thus welcome. In addition to recent

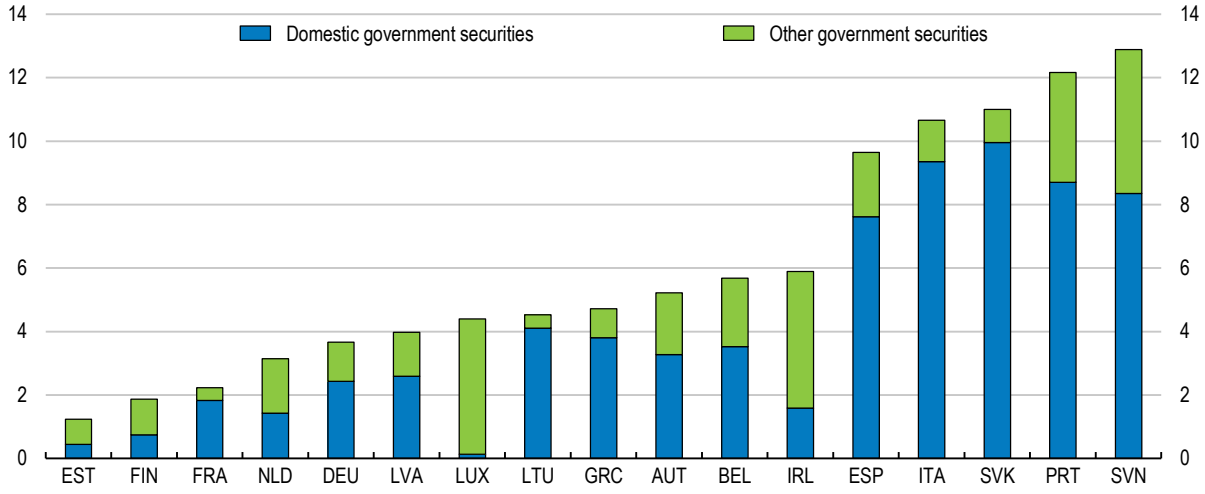
welcome proposals by the Commission aimed at reducing the amount of non-performing loans, further progress is needed in reducing the home bias in sovereign debt exposures of banks.

Diversifying the sovereign debt exposures of banks

Large exposures of banks to the sovereign debt of their home country continue to exist in many euro area countries (Figure 1.10). Such exposures link the health of the banking sector to the health of public finances, thus reiterating the potentially destructing link between banks and their sovereigns. To some extent, the link between banks buying substantial amounts of domestic debt may even stabilise sovereign debt markets: under more strict regulation, the effects of panic selling and the flights to safety observed during the crisis could have been more pronounced (Lanotte et al., 2016). However, the experience of the euro area sovereign debt crisis in 2011 and 2012 suggests that the destabilising impact of the "doom loop" exceeds any short-term stabilising effect of domestic banks' buying of their own sovereign debt.

Figure 1.10. General government securities held by banks are mainly domestic

As a percentage of total MFIs assets[1], March 2018



1. Domestic government securities denote own-government securities other than shares held by monetary and financial institutions (excluding central banks). Other government securities refer to other Euro area government securities held by MFIs.
Source: ECB (2018), *Statistical Data Warehouse*, European Central Bank.

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In most cases, the existing treatment of sovereign exposures is more favourable than other asset classes (BCBS, 2017). The preferential regulatory treatment of sovereign debt exposures comes from favourable treatment of credit risk in the banking book. Provided that assets are held to maturity, certain sovereign exposures may attract zero capital requirements and lower reductions in collateral value (haircuts) when used in collateralised operations, such as repurchase agreements. In addition, zero-risk-weighted sovereign bonds are excluded from the large exposure limit (ESRB, 2015 and Box 1.2).

Box 1.2. Current regulatory treatment of sovereign exposures in the euro area

The existing regulatory treatment of sovereign exposures of banks has recently been reviewed by the Basel Committee on Banking Supervision (BCBS). Although, at this stage, the Committee has not reached a consensus to make any changes to the treatment of sovereign exposures, the review report concluded that the existing rules could potentially exacerbate the negative aspects of the sovereign-bank nexus and that the existing treatment of sovereign exposures is more favourable than other asset classes. Most notably, all countries participating in the BCBS are currently applying a national discretion that allows a zero risk weight for sovereign exposures denominated and funded in domestic currency, regardless of their inherent risk (BCBS, 2017). In addition, sovereign exposures are currently exempted from the large exposures framework and no limits or haircuts are applied to domestic sovereign exposures that are considered high-quality liquid assets for purposes of liquidity regulation.

The Basel framework allows two possible approaches to risk weighting, the standardised approach, in which risk weights are assigned using external ratings, mostly by credit rating agencies, and the internal ratings-based approach relying on internal models of banks approved by regulators. Credit risk treatment under the standardised approach allows for the national discretion for sovereign exposures denominated and funded in domestic currency, while banks using the internal ratings-based approach are exempted from the 0.03% floor on the probability of default for sovereign exposures.

In EU law, Basel III standards are implemented by the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV). Article 114 of the CRR that applies to banks using the standardised approach contains the national discretion for exposures to sovereign bonds denominated and funded in the domestic currency. However, such treatment seems to ignore the fact that in the euro area the fiscal authority does not have influence on the common monetary authority and the EU Treaty explicitly prohibits monetary financing, which prevents the central bank from fulfilling the sovereign's commitment to an unlimited amount (Lenarčič et al., 2016). In addition, Articles 148 and 150 allow the national competent authorities to extend this discretion also to major banks that are using the internal rating-based approach (the so-called permanent partial use of the standardised approach). These provisions of the Capital Requirements Regulation appear to go beyond the Basel principles governing the use of the standardised approach and were criticised by the Basel Committee as materially non-compliant with Basel III (BCBS, 2014; Véron, 2017). However, in some EU countries, such as Sweden and Belgium, national regulators introduced more stringent treatment of the banks' sovereign exposures. They require banks to assess their sovereign exposures by the internal ratings-based models (Enria, Farkas and Overby, 2016) or impose additional capital buffers available under the Pillar 2 supervisory assessment.

Suggestions for reforming the regulatory treatment of sovereign bonds tend to focus on one or more of three broad possibilities: increasing the zero risk weight on sovereign exposures, gradually introducing large national exposure limits currently not applied to banks' sovereign bond holdings, and introducing an additional capital requirement for concentration risk. Risk-adjusted large exposure limits for sovereign exposures combined

with capital requirements based on non-zero risk weights for sovereigns were recently proposed by the German Council of Economic Experts (Andritzky et al. 2016a), while capital surcharges for sovereign concentration risk were recently suggested in a study commissioned by the European Parliament (Véron, 2017).

The first option of non-zero risk weights on sovereign exposures may seem a solution since government debt is never risk-free. However, the implementation of such measure is not straightforward and may further fragment the European financial market. First, potential risk weights must be based on some assessment of sovereign risk. Relying on the assessment of credit rating agencies would go against the trend of reducing reliance on external ratings, which have tended to be backward-looking, pro-cyclical and imperfect indicators of actual default (IMF, 2010; Kiff et al. 2012). That said, some empirical evidence suggests swifter adjustment of European ratings to changed fundamentals since 2010 (Brůha et al., 2017). Alternatively, risk weights could be based on broader indicators, such as debt-to-GDP ratio or the Maastricht criteria more generally (Gros, 2013), but this would weaken the close connection between the credit rating and sovereign credit risk. Finally, the leverage ratio introduced by Basel 3 from 2019 already implies a universal risk weight and hence a non-zero regulatory capital requirement also for sovereign exposures, but it is considered too small by some (Dombret, 2017).

The second option of exposure limits has the advantage of not imposing automatically additional capital requirement and diversification of banks' portfolios; however, it could amplify pro-cyclical behaviour and generate cliff effects by forcing banks to precipitously sell their sovereign bond holdings. If linked to sovereign credit risk, and thus beyond pure concentration risk, exposure limits could force banks to sell their sovereign bond holdings quickly following a sovereign rating downgrade. To dampen this effect, exposure limits could be linked to long-term averages of sovereign risk measures and bank capital, thus smoothing any required portfolio adjustments. Even if not linked to sovereign risk, exposure limits could act as co-ordinating device for speculative attacks and limit banks' ability to absorb shocks by purchasing sovereign debt in the event of, possibly self-fulfilling, sovereign stress (Visco, 2016). However, the existence of a European risk sharing mechanism, such as the Outright Monetary Transactions, should reduce the probability of purely speculative sovereign debt crises and strengthen the disciplining role of relatively strict exposure limits (Frisell, 2016).

Finally, the third option of sovereign concentration charges imposes an additional capital requirement increasing with concentrated sovereign bond holding. The recent proposal by Véron combines zero capital requirements for sovereign exposures below 33% of Tier 1 capital with gradually increasing capital charges for higher holdings of sovereign debt (Véron, 2017). For exposures to a single sovereign exceeding 33% of Tier 1 capital, six sovereign exposure brackets would be associated with increasing marginal concentration charges. Simulations using mid-2016 data for euro area banks, excluding outlier banks and assuming no portfolio adjustments, suggest that such gradual concentration charges would imply an additional Tier 1 capital ratio requirement of less than 1.5 percentage points, which banks should be able to meet by subscribing new capital in the markets. Similar, but less stringent parameters for sovereign concentration charges have been proposed by the Basel Committee (BCBS, 2017).

However, the induced portfolio adjustment flows associated with this regulatory reform may be considerable and, according to some estimates, may reduce demand for sovereign bonds or lead to market tensions. To ensure smooth transition, extensive consultations

with market participants, a long phase-in periods and grandfathering (i.e. exemption from concentration charges) of all outstanding debt, should be considered.

Given the complexity, the regulatory treatment of sovereign exposures would best be reformed at the global level and when such a consensus is reached in the Basel Committee, European banks should adopt it. If it is not possible to do so, the euro area countries should reconsider the provisions of the Capital Requirements Regulation for the "permanent partial use" of the standardised approach (Box 1.2).

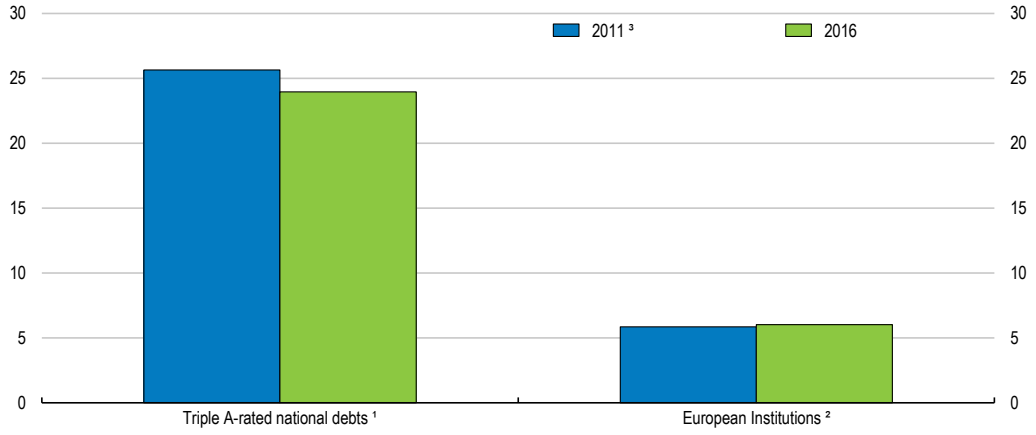
Creating a European safe asset

A euro area safe asset would provide banks with an alternative investment instrument to domestic sovereign bonds, thus helping to ensure financial stability during the transition period when banks diversify their sovereign exposures. Since the uncertainty related to the implementation of the reform of sovereign debt exposures of banks is high, it seems advisable to complement concentration charges by other measures (Pagano, 2016). One way to create safe asset is a synthetic safe asset that represents exposure to a basket of sovereign debt of different countries and should be attractive for banks that need to hold low risk euro denominated assets for liquidity and regulatory purposes. The new asset would offer even higher protection than a diversified portfolio of sovereign bonds, as it would be senior to the other tranches (Bénassy-Quéré et al., 2018).

There was a reduction in the amount of safe assets since the financial crisis, as many safe assets, often securitised and produced by the private sector, lost their safe asset status (Figure 1.11). Financial engineering, such as the pooling of risks among quasi-safe sovereigns to create a larger share of safe debt from existing public assets, could add another layer of supply of safe assets, provided that pooled assets are sufficiently uncorrelated in the face of common shocks (Caballero et al., 2017).

Figure 1.11. Safe asset supply has declined

As a percentage of euro area GDP



1. Sovereign debt securities issued by the governments of Germany, Luxembourg and the Netherlands.
2. Triple A-rated securities issued by the European Investment Bank (EIB), as well as those issued by EU authorities through the European Stability Mechanism (ESM), the European Financial Stabilisation Mechanism (EFSM), the Balance of Payment facility and the Macro-Financial Assistance Programs.
3. 2013 for European institutions.

Source: Brunnermeier, M. K., Langfield, S., Pagano, M., Reis, R., Van Nieuwerburgh, S., & Vayanos, D. (2017). ESBies: Safety in the tranches. Economic Policy, 32(90), 175-219; OECD calculations based on public information released by European Institutions.

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In the past, there have been several proposals for creating a euro area safe asset. Many early proposals, such as the blue and red bonds (Delpla and von Weizsäcker, 2010) or Eurobills (Philippon and Hellwig, 2014), envisaged debt mutualisation to enhance the safety of these assets, but would also increase the potential for redistribution. More recent proposals tend to avoid debt mutualisation, since some member states are reluctant to do it. Several proposals focus on designing a synthetic asset based on the securitisation of euro area sovereign debt, such as the Sovereign Bond-Backed Security (SBBS) recently proposed by the ESRB high-level task force (Brunnermeier et al., 2017; ESRB, 2018). In addition, the Commission proposed a regulation providing an enabling framework for the development of SBBS (European Commission, 2018a).

Sovereign bond backed securities (SBBS) are synthetic financial product backed by a pooled portfolio of euro area sovereign bonds bought by a public or private entity in either primary or secondary debt markets. Losses on the security are first borne by holders of the junior tranche. Only if losses exceed the part of the portfolio securitised into junior bonds (the subordination level), the senior tranche also suffers a loss. With prudently selected subordination level, senior SBBS can be considered safe, as events leading to a loss on the senior tranche are unlikely. ESRB (2018) tentatively suggests a tranching ratio of 70% (senior tranche) to 20% (mezzanine tranche) to 10% (junior tranche) – although a more conservative ratio may be more appropriate, given the empirically high correlation between sovereign bonds and the subdued market reaction to ESBies – and purchasing of sovereign bonds up to 1.5 trillion euro, roughly in accordance with the ECB's capital key. The fact that a significant part of the national sovereign debt would still be traded and be priced by private investors, other than the SBBS issuer, is crucial for retaining the market discipline in the pricing of SBBS (Demary and Matthes, 2017).

The weakest point of the various SBBS proposals is the allocation of the junior tranche. The financial crisis has amply demonstrated that the securitisation techniques only relocate financial risks, but do not eliminate them. If the market for the junior SBBS tranche broke down in the period of market stress, the agency could not go on buying national sovereign bonds and the SBBS concept would collapse.

Other ways of creating a euro area safe asset without risk mutualisation could be considered. Instruments, such as E-bonds issued by a senior intermediary that borrows at large scale in the market and then lends on to national governments (Monti, 2010) or debt issued by a euro area budget authority (Ubide, 2015), could improve the supply of safe assets while not involving an explicit government guarantee. However, their possible drawbacks include reduced liquidity of national bond markets and redistribution of issuance costs across euro area countries, which could increase the average cost of borrowing for some countries (Leandro and Zettelmeyer, 2018). Further analytical work on safe asset alternatives may be needed before deciding on the way forward.

Enhancing common macroeconomic tools to deal with significant adverse shocks

The existing euro area policies and institutions complemented by those recommended so far in this Chapter would make all euro area sovereign bonds safer. Firstly, the Outright Monetary Transactions programme has already made sovereign bonds practically immune to liquidity crises. Secondly, the completed banking union, including European Deposit Insurance Scheme and further measures to reduce and share risks, together with efficient diversification of sovereign debt exposures of banks would come a long way to severing the "doom loop" between banks and their sovereign.

However, in case of a significant adverse macro-economic shock, common monetary policy and national fiscal policies may not be enough to smooth activity. A fiscal stabilisation capacity could provide additional risk sharing against large asymmetric and area-wide shocks. Of course, there would still be the risk of sovereign default – and a possible sovereign debt restructuring mechanism should aim at reducing the uncertainty and transaction costs associated with precisely such an event, but the probability of default would be much lower than in the unreformed system. This section is looking at those issues.

Introducing a common fiscal stabilisation capacity

A fiscal stabilisation function at the euro area level would provide resources to deal with country-specific shocks that cannot be managed at the national level alone because of lack of fiscal space or high marginal borrowing costs. Through enhanced resilience and financial stability, future interventions by the European Stabilisation Mechanism would be less likely, thus saving the pooled financial resources. However, an even more important justification for a common fiscal stabilisation capacity is to deal with common shocks.

Common, area-wide shocks would normally, as far as they have implications for price stability, be stabilised by monetary policy. However, in periods when monetary policy is constrained by the zero lower bound, coordinated fiscal support may be an important part of the policy mix, especially since national fiscal policies could also be constrained by high spreads. Indeed, empirical studies and theoretical models both suggest that fiscal policy measures that stimulate aggregate demand, such as a temporary increase in government spending, are associated with higher multipliers in recession and at the zero lower bound (Auerbach and Gorodnichenko, 2011; Eggertsson, 2011).

Monetary policy is likely to remain constrained in the near and medium terms. Weak potential growth, implying a low neutral interest rate, and the weak outlook in the euro area for inflation suggest that nominal interest rates may stay close to zero for a prolonged period of time. Large shifts in saving and investment preferences also mean that monetary policy may be more frequently constrained by the zero lower bound (Rachel and Smith, 2017). Unconventional monetary policy may provide some additional accommodation, but its effectiveness may be limited and have undesirable distributional consequences (Orphanides, 2017).

The idea of complementing the monetary union in Europe with some form of fiscal federalism can be traced back to the MacDougall Report suggesting a community budget of 2-2.5% of GDP and other measures, including a common unemployment fund going "a small part of the way towards creating a situation, in which monetary union could be sustained" (MacDougall et al. 1977, p.13). More recently, the Five Presidents' Report highlighted the key characteristics for such a scheme: it should not lead to permanent transfers between countries, it should not undermine the incentives for sound fiscal policy-making at the national level, it should be consistent with the existing EU fiscal framework and it should not be an instrument for crisis management (Juncker et al., 2015).

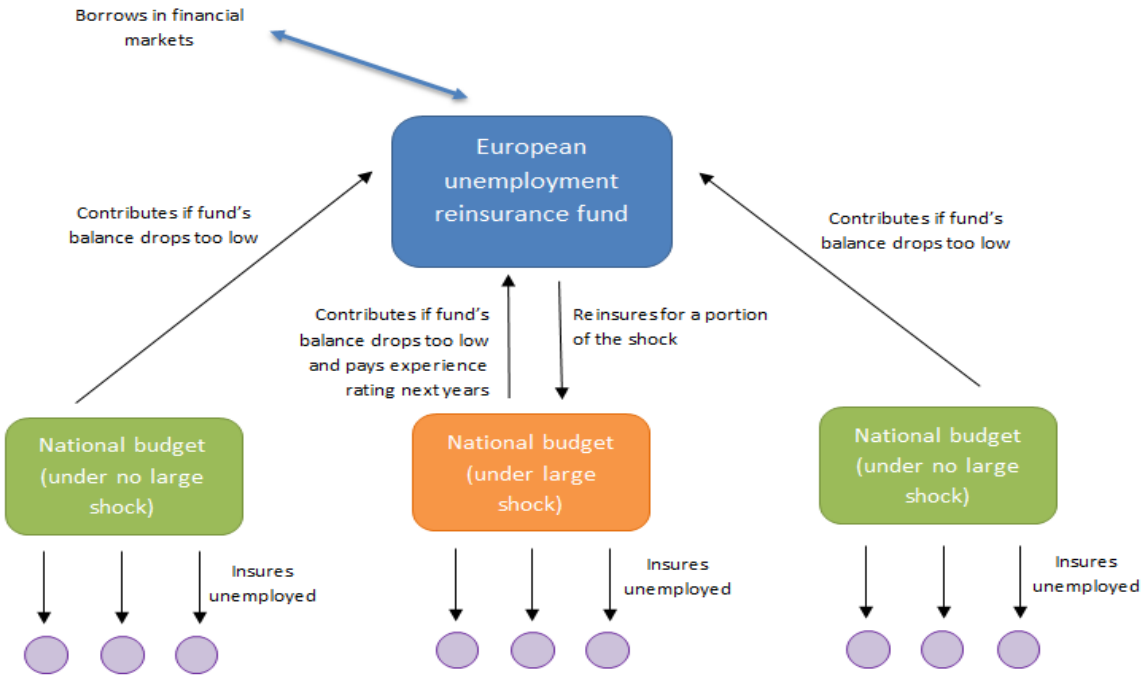
Following up on this issue, the European Commission has recently proposed a suite of new budgetary instruments for the euro area stabilisation (European Commission, 2017c). The proposal contains a stabilisation function in one of three forms: an investment protection scheme, a rainy day fund or an unemployment benefit re-insurance scheme. The stabilisation function would in all cases contain both loans and grants, for stronger

and more immediate macroeconomic effects. The preferred option of the European Commission seems to be a scheme that protects investment against large country-specific shocks. Such fiscal stabilisation capacity would use pooled resources accumulated in good times through countries' contributions to stabilise member countries hit by adverse shocks, based on an automatic trigger.

The fiscal stabilisation function could also be provided, with weaker impact, through short-term European Stabilisation Mechanism loans. Such loans would be repaid in the course of an economic cycle, conditional on lighter criteria than regular programmes and could be used to stabilise public investment or reward structural reforms (Strauch, 2018). However, such strengthening of the preventive capacity would require changes in the European Stabilisation Mechanism's mandate that would make it more like the European Investment Bank, an independent EU body with its own capital, for which the ESM Treaty would need to change.

From the macroeconomic stabilisation point of view, the precise form of the fiscal stabilisation function does not seem to matter much, as money is fungible. In this Chapter, as one part of the fiscal stabilisation package, we propose a European unemployment benefits re-insurance scheme that would be complementary to other possible schemes providing short-term nondiscretionary transfers (Berger et al., 2018). Unemployment is a key aspect of business cycles and unemployment insurance is therefore a natural and powerful automatic stabiliser (Beblavý et al., 2015). In practice, the scheme would cover only a portion of large negative shocks, based on small contributions from all member states (in times when the balance of the fund is close to zero) combined with gradually increasing contributions from countries that have benefited from its support (Figure 1.12).

Figure 1.12. European unemployment fund would reinsure the existing national schemes



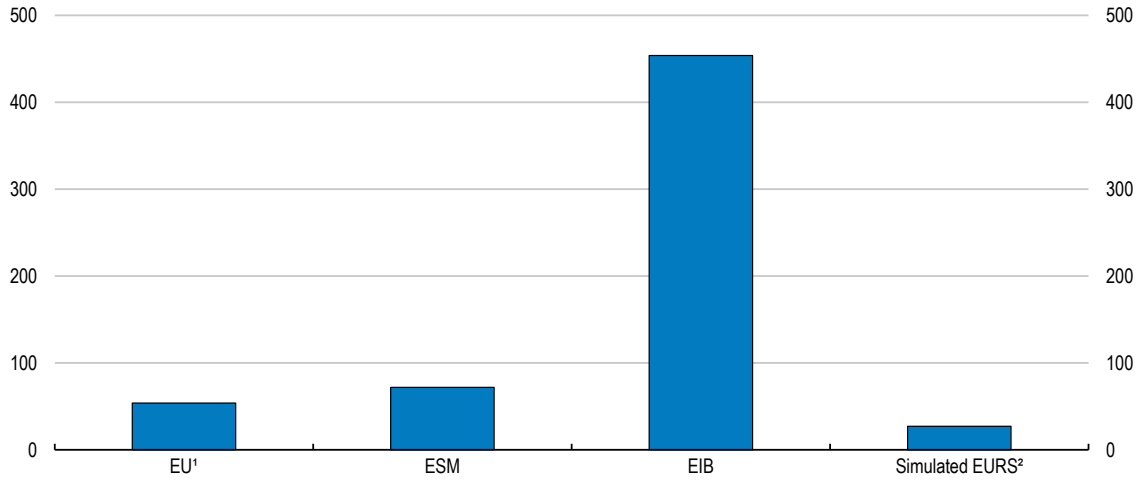
Source: Claveres and Stráský (2018).

The capacity should be activated when unemployment rate is both increasing and above the long-term average. Pay-outs from the scheme would be proportional to the unemployment increase, reflecting the pressure on public finances. Such a set-up would cease support when the unemployment rate stops increasing. Since countries with stable unemployment would stop receiving pay-outs, incentives for countries to reform their labour markets and lower structural unemployment would be preserved. To ensure that permanent transfers are avoided in the long-run, a slow-moving memory mechanism would be applied to link increases in net contributions to the scheme with the number of times a country has drawn on the scheme. Since the scheme would only re-insure national agencies up to a pre-defined transfer amount that would have to be broadly repaid, euro area countries would remain free to decide the details of their national unemployment benefit systems.

The scheme should be able to borrow in financial markets, under conditions similar to the European Stability Mechanism, so as to finance occasional deficits when accumulated contributions do not suffice to cover the pay-outs. Preliminary simulation results suggest that the debt issuance during the financial crisis would stay below 2% of the euro area GDP, not enough to materially increase the supply of debt by European super-national institutions (Claveres and Stráský, 2018; Figure 1.13).

Figure 1.13. Outstanding debt of European Institutions is low

EUR billions, end-of-year 2015 stocks



1. EU includes the European Financial Stability Mechanism, Balance of Payment Facility and Macro-Financial Assistance Programs.
Source: European Systemic Risk Board (2017) and Claveres and Stráský (2018).

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The macroeconomic stabilisation outcomes of the proposed unemployment re-insurance scheme with a double condition trigger and experience rating from a stylised macroeconomic model simulated using historical data from 2000 to 2016 suggest that such a scheme could prevent permanent transfers between countries, while contributing positively to euro area macroeconomic stabilisation (Box 1.3). For an average annual contribution of 0.17% of GDP, the scheme would have reduced the average standard deviation of GDP growth from 2009 to 2013 by 0.36% and the euro area GDP in 2009

would have been 1.05% higher. Such results are in line with results from similar studies. An IMF study identified that contributions between 1.5% and 2.5% of GDP would be needed to smooth income shocks in the euro area effectively (Allard et al., 2013).

Box 1.3. Counterfactual simulations of the euro area unemployment re-insurance scheme for 2000-2016

Trigger: The reinsurance activates according to a double-condition trigger when the unemployment rate is increasing from the previous year and above its 10-year average.

Payment: Upon its activation, the scheme reinsures the national agency with an amount equivalent to 1% of GDP times the change in the unemployment rate. This means that a country experiencing a 1% hike in unemployment (with current rate above the 10-year average) would receive transfer amounting to 1% of its GDP. Hence payment is proportionated to the unemployment hike. Cumulative net balances towards the fund are capped at 5% of GDP.

Financing: Every country contributes the equivalent of 0.1% of GDP each year if the fund's balance falls below -0.5% of total GDP the previous year. In addition, countries pay a premium due to experience rating if applicable. The fund is assumed to be able to borrow in financial markets.

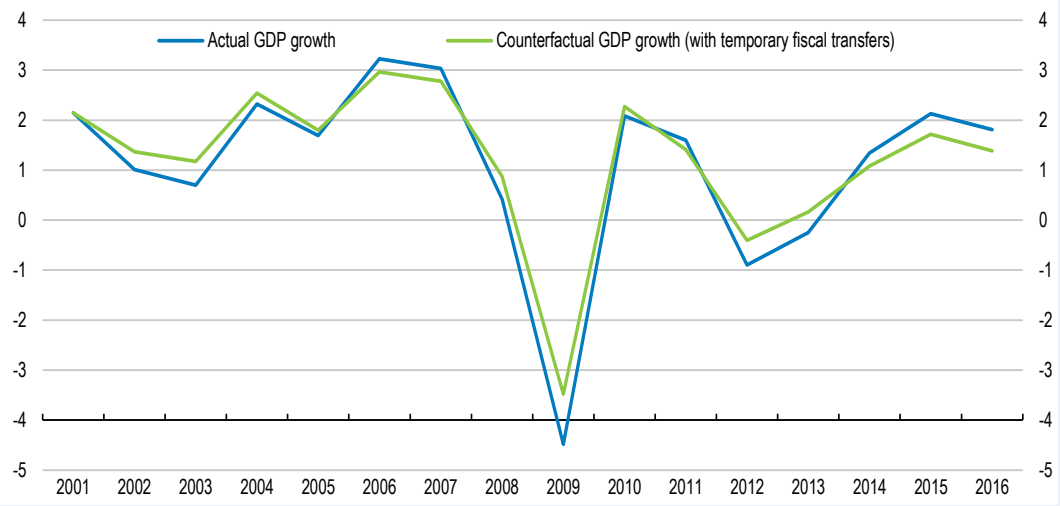
Experience rating: For each time the trigger was activated over the past 10 years, an additional contribution is paid amounting to 0.05% of GDP. Hence, at maximum if the fund activated 10 times the premium amounts to 0.1% of GDP for a total of 0.6% if there is an annual contribution.

Multiplier: Deciding on a multiplier to assess the stabilisation impact of the scheme is not trivial and subject to an extensive literature. Following Beblavý et al. (2015), we choose the conservative estimate of 1.5.

Based on these design features, we run a counterfactual analysis for European countries from 2000 to 2016, based on data availability. The scheme would have been activated in about one third of country-years and mobilized an average annual contribution from countries of 0.17% of GDP. In terms of stabilisation, it would have reduced the average standard deviation of GDP growth from 2009 to 2013 by 0.36%. The euro area GDP would have been 1.05% higher in 2009 (Figure 1.14). The fund's balance would have fluctuated between -0.7 and 0% of the euro area's GDP from 2000 to 2008, before decreasing due to the financial crisis in 2008. At the lowest, it would have settled at -1.97% of total GDP at the peak of the sovereign debt crisis in 2013 before increasing to -1.16% in 2017 (Figure 1.15).

Figure 1.14. Macroeconomic stabilisation properties of the simulated EURS

Euro area real GDP growth

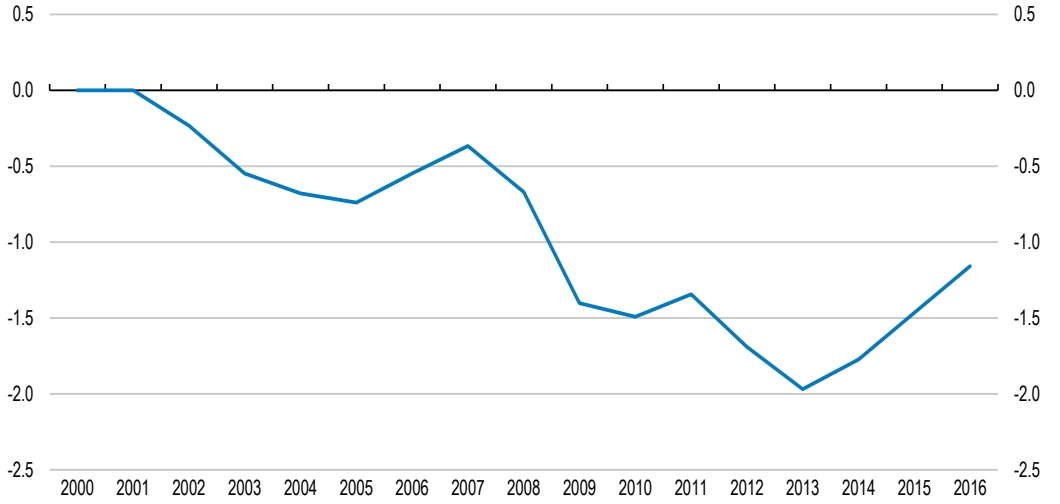


Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database) and authors' calculations.

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Figure 1.15. Cumulated balance of the simulated EURS

As a percentage of euro area GDP[1]



1. Based on the parameterisation discussed above and the annual GDP data from the *OECD Economic Outlook: Statistics and Projections* (database), May.

Source: Claveres and Stráský (2018).

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The annual net balances would have ranged from -0.55% (Portugal in 2014) to 3.6% of GDP (Ireland in 2009). Countries would have been alternatively contributors or recipients to the fund, avoiding permanent transfers (Table 1.2), expect for Estonia and Latvia which only join the scheme in later years. Germany and Austria would have received transfers from 2002 to 2005 and then have contributed in net terms

until the end of the period due to experience rating. France, Italy, Ireland or Spain would not have triggered the reinsurance until the 2008 crisis, and would have made payments due to the start-stop mechanism to keep it afloat, while Portugal would have switched between being a net recipient and net contributor frequently during the period. The trigger would have activated the fund in most countries in 2008-2009, and again in 2013.

Table 1.2. Transfers to and from the unemployment benefit re-insurance scheme

As % of GDP	AUT	BEL	DEU	ESP	EST	FIN	FRA	GRC	IRL	ITA	LUX	LVA	NLD	PRT	SVK	SVN
2000	0.0	0.0		0.0		0.0	0.0		0.0	0.0	0.0		0.0	0.0		
2001	0.0	0.0		0.0		0.0	0.0		0.0	0.0	0.0		0.0	0.0		
2002	0.3	0.0	0.8	0.0		0.0	0.0		0.0	0.0	0.3		0.0	0.0		
2003	0.3	0.0	1.0	0.0		0.0	0.0		0.0	0.0	0.8		0.0	1.3		
2004	1.0	-0.1	0.4	-0.10		-0.1	-0.1		-0.1	-0.1	0.2		0.7	0.2		
2005	-0.1	0.0	0.4	-0.1		-0.1	-0.1		-0.1	-0.1	0.2		0.0	0.7		
2006	-0.3	-0.2	-0.3	-0.1		-0.1	-0.1	-0.1	-0.1	-0.1	-0.2		-0.2	-0.2		
2007	-0.3	-0.2	-0.3	-0.1		-0.1	-0.1	-0.1	-0.1	-0.1	-0.4		-0.2	0.0		
2008	-0.2	-0.1	-0.2	3.0		0.0	0.0	0.0	1.7	0.0	-0.3		-0.1	-0.3		
2009	0.9	0.8	-0.3	2.3		-0.1	1.6	-0.1	3.6	-0.1	1.0		1.0	1.5		
2010	-0.4	0.2	-0.3	0.0		0.0	0.0	3.0	0.1	0.5	-0.1		0.4	1.0	-0.1	1.3
2011	-0.4	-0.3	-0.3	0.0	-0.1	-0.2	-0.2	2.2	0.1	-0.1	-0.5		-0.3	0.8	-0.1	0.8
2012	0.0	-0.3	-0.3	-0.2	-0.1	-0.2	0.4	-0.2	-0.3	2.1	0.0		0.6	-0.2	-0.1	0.5
2013	0.1	0.7	-0.3	-0.1	-0.1	0.3	0.3	-0.3	-0.4	1.2	0.3		1.0	-0.1	0.2	1.0
2014	-0.1	-0.2	-0.2	-0.4	-0.1	0.3	-0.3	-0.3	-0.4	0.2	-0.2	-0.1	-0.2	-0.6	-0.2	-0.3
2015	-0.2	-0.4	-0.2	-0.4	-0.1	0.5	-0.3	-0.3	-0.4	-0.4	-0.5	-0.1	-0.4	-0.5	-0.2	-0.3
2016	-0.1	-0.3	-0.1	-0.4	-0.1	-0.3	-0.4	-0.3	-0.4	-0.4	-0.4	-0.1	-0.4	-0.5	-0.2	-0.3

Note: Negative values are contributions to the funds and positives values are payments from it.

Improving market discipline through better procedures for sovereign debt restructuring

Public risk sharing using fiscal instruments, such as the unemployment benefit re-insurance scheme, provides coverage against adverse shocks. To minimise moral hazard and the risk of permanent transfers, access to the unemployment benefit re-insurance scheme should be conditional on past compliance with the European fiscal framework.

The euro area sovereign debt crisis and the Greek sovereign debt restructuring have amply demonstrated that sovereign debt is not zero risk. In fact, the sovereign default risk is likely to be higher in the euro area since the ECB is prohibited to finance government debt (De Grauwe and Ji, 2013). In case of sovereign bankruptcy and to reduce the burden for the sovereign, the European Stability Mechanism could be given a bigger role in making the settlement with private creditors more predictable and transparent. Such framework would not contain any automatic triggers, such as extension of maturities, but rather improvements in the existing framework, such as the reform of existing Collective Action Clauses to prevent lengthy negotiations with holdout investors (Regling, 2018).

To address the problem with creditors who refuse to participate in debt restructuring and hold out with the view of receiving payment in full, the treaty establishing the European Stability Mechanism already requires euro area countries to include standardised collective action clauses (CACs) in all new debt instruments. However, under these euro-

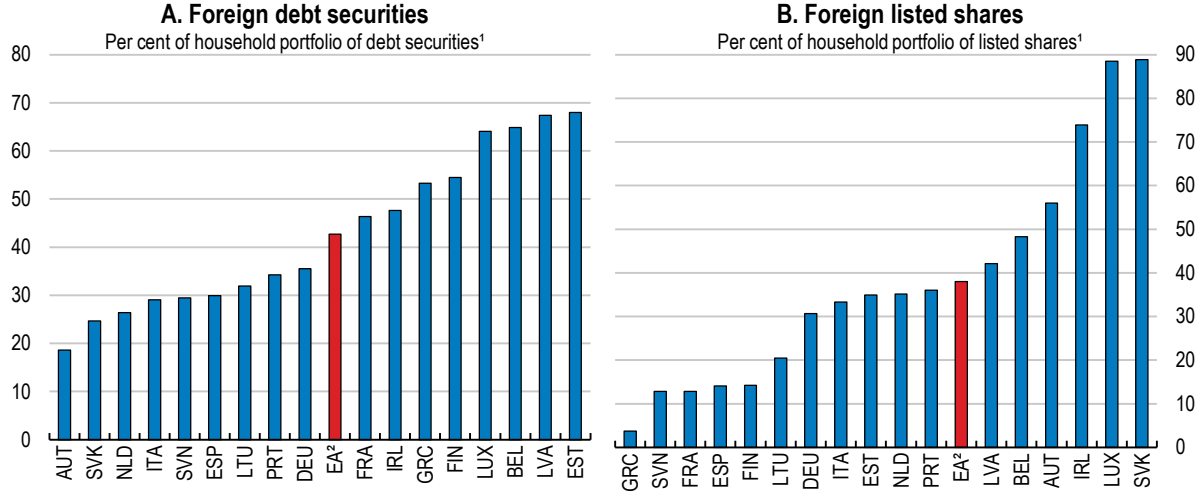
area CACs holdout creditors can still block the full restructuring of individual bonds, as the CACs rely both on aggregate and series-by-series voting. In other words, the aggregation feature may not be sufficient – and it is indeed weaker than the mechanism applied in the 2012 Greek debt restructuring where all domestic law bonds were subject to a single vote (Gelpern at al., 2015). Stronger aggregation rule allowing for a single vote across all debt instruments affected by a restructuring (the so-called "one-limb" voting) could considerably streamline the process, as it would make it much harder for potential holdouts to acquire a stake that could block a restructuring (IMF, 2014; Zettelmeyer, 2017). Other measures addressing the weaknesses of the one-limb voting would include a provision ensuring that all creditors are offered identical restructuring terms (Andritzky et al., 2016b).

Reinforcing private risk sharing through the Capital Markets Union

Completed banking union with cross-border banks would improve monetary policy transmission and remove the need for fiscal backstop at the national level. However, private risk sharing through the banking system should be reinforced by continuing integration of capital markets, further reducing the reliance on bank financing and the need for complementary public sector risk sharing. The creation of a genuine Capital Markets Union involves harmonisation of supervisory, regulatory, tax and legal practices, which are policy areas where member countries retain important competences and where progress in the past has been slow. Although the process of building the Capital Markets Union is likely to stretch over many years, because financial ecosystem can only change slowly, its potential benefits are substantial and should be pursued with determination. At the current juncture, the home bias that we have encountered in sovereign bond holdings of banks is also present in households' holdings of debt securities and listed shares in many euro area countries (Figure 1.16).

Figure 1.16. Financial assets held by households are mainly domestic

Q4 2017



1. Households and non-profit institutions serving households.
2. Euro area member countries that are also members of the OECD (16 countries)

Source: ECB (2018), "Quarterly Sector Accounts", *Statistical Data Warehouse*, European Central Bank.

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Well-designed banking and capital market policies could be mutually reinforcing. Progress in completing the banking union will enhance and reinforce the functioning of the Capital Markets Union (CMU). On the other hand, progress in capital markets integration and deepening will help the euro area economy to become less reliant on bank financing, while allowing banks to exploit the cross-border economics of scale (Constâncio, 2017).

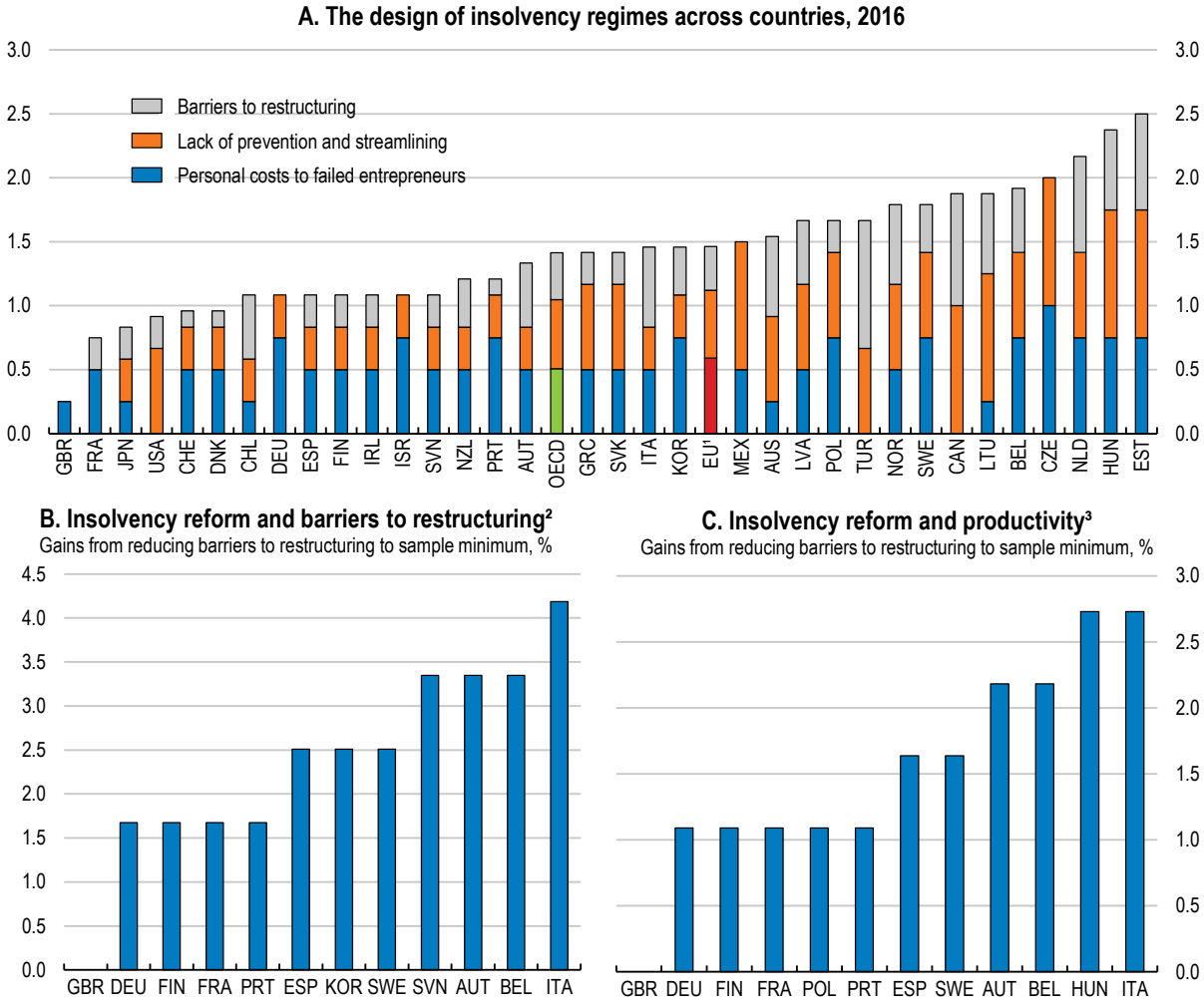
Differences in national insolvency regimes can create an important barrier to cross-country investment and legal uncertainty, complicating credit risk assessment by investors, resolution of non-performing loans and an efficient restructuring of viable companies. Cross-border proceedings are particularly costly taking three years on average and being twice as expensive as domestic insolvency proceedings (European Commission, 2016). New OECD indicators show significant differences across Europe in the design of insolvency regimes (Figure 1.17, Panel A) and the accompanying analytical work suggests that lack of well-designed insolvency regimes may hinder aggregate productivity growth by delaying the liquidation or restructuring of weak firms (Andrews et al., 2017). Reforms to insolvency regimes can reduce the share of capital sunk in weak firms, spur the reallocation of capital to more productive firms and facilitate technological diffusion (Figure 1.17, Panel B and C). In countries with weak banks and ill-functioning insolvency frameworks, which entail impediments to corporate restructuring and reduce recovery rates for creditors, efforts to address non-performing loans should be accompanied with insolvency regime reform.

The Commission proposed in December 2016 a directive to further harmonise insolvency proceedings, setting out common principles on early restructuring, so as to allow viable firms to be revitalised rather than liquidated, introducing measures to reduce the length of insolvency procedures and rules for entrepreneurs to benefit from a second chance. These are steps in the right direction. OECD work suggests that a brief time to discharge, allowing creditors to initiate restructuring and having early warning mechanisms are the most important dimensions of insolvency regimes with respect to the effects of reforms on productivity.

In addition, new rules to facilitate debt recovery in cross-border insolvency proceedings entered into force in June 2017. The rules aim at resolving the conflicts of jurisdiction in cross-border insolvency proceedings and ensuring the recognition of insolvency-related judgments across the EU. Thanks to the new regulation, the proceedings opened by courts in an EU country other than the one where the company's registered office is based (so-called secondary proceedings) will be avoidable, easing the restructuring of companies in a cross-border context. The regulation also introduces the group insolvency proceedings and the EU-wide interconnection of electronic national insolvency registers by June 2019.

Regulatory harmonisation in other areas could also facilitate development of cross-border financial markets. Better aligned national regulatory treatment would facilitate cross-border distribution of investment funds and provide more investment opportunities for savers. Similarly, clearer rules for cross-border transaction in claims, such as collateralisation or factoring, would provide legal certainty and unlock additional sources of financing. Recent proposals by the Commission for more harmonised rules on distribution of investment funds, cross-border transactions in claims and regulatory treatment of covered bonds, which represent important source of bank financing in some European countries, are thus welcome (European Commission, 2018b).

Figure 1.17. Insolvency regimes vary considerably across countries



1. Simple average across the 22 countries for which data are available.
2. Potential gains to productivity-enhancing capital reallocation – the elasticity of capital growth to past firm productivity – associated with lowering the level of barriers to restructuring; percentage difference between industries with high and low exposure to insolvency regimes.
3. Potential gains to within-firm productivity growth associated with lowering the level of barriers to restructuring to sample minimum level; percentage difference between industries with high and low turnover.

Source: OECD calculations based on the OECD questionnaire on insolvency regimes; Adalet McGowan, M., D. Andrews and V. Millot (2017), "Insolvency Regimes, Zombie Firms and Capital Reallocation", OECD Economics Department Working Papers, No. 1399, OECD Publishing, Paris; Adalet McGowan, M., D. Andrews and V. Millot (2017), "Insolvency Regimes, Technology Diffusion and Productivity Growth: Evidence from Firms in OECD Countries", OECD Economics Department Working Papers, No. 1425, OECD Publishing, Paris.

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Taxation rues should be adjusted to remove the tax disadvantage given to equity financing relative to debt financing. A bias in favour of debt financing may lead to higher leverage, increasing bankruptcy risks and distorting allocation across firms and industries (Sorbe et al., 2017). In some countries, taxation rules also reinforce the preference of savings allocation in low-risk, short-maturity instruments. The Commission's plans in the

2015 Action Plan on Corporate Taxation aimed at reducing the bias in the corporate tax treatment of debt and equity should be implemented, be it through carefully designed allowance for corporate equity schemes or limitations on the deduction of interest payments (OECD, 2016).

Empirical evidence suggests that the current regime of national implementation and enforcement of harmonised EU regulations leads to varying experiences of regulation and many market participants resort to country-specific legal advice in each country (Véron and Wolff, 2016). With Britain's departure from the EU approaching, relocation to financial centres in several euro area countries could result in more diverse market supervision and possibly higher cost of funding for EU firms and households.

Further efforts are needed to ensure consistent application and enforcement of European financial legislation. To this end, as recently suggested by the Commission, the European Securities Markets Agency (ESMA) could be made the direct supervisor over certain segments of national capital markets, including market entry and more central role in coordinating market abuse investigations (European Commission, 2017b). ESMA and the other European Supervisory Agencies (ESAs) could also set EU-wide priorities for supervision that would serve as a basis for the national supervisors when they draw up their respective work programmes. These proposals are welcome as they will help ensure compliance and integrate European capital markets.

At present, the ESMA has direct supervisory authority over limited market segments, namely credit rating agencies and trade repositories, and its mandate is not sufficient to foster supervisory convergence and integration of European capital markets. To ensure consistent application of the European rules, ESMA could be given direct supervisory powers in areas where national approaches tend to differ, such as the cross-border delegation decisions and supervision and resolution of central counterparties that serve international clients and hence have systemic character. In order to ensure independence and in line with international best practices, ESMA's funding should not be dependent on political negotiations about the EU budget, as is the case in the moment, but rely fully on a small levy paid by the regulated private firms to be more independent (Véron and Schoenmaker, 2017).

Box 1.4. Recommendations on efficient stabilisation policies to strengthen euro area resilience

Reducing financial fragmentation to increase private risk-sharing

Key recommendations

- Building on progress in risk-reduction, develop a pre-funded common European deposit insurance scheme with contributions based on risks taken by banks.
- To ensure smooth resolution of banks, use the European Stability Mechanism as a fiscally-neutral backstop for the Single Resolution Fund that can be deployed rapidly.
- Favour diversification of banks' exposure to sovereign bonds including by considering sovereign concentration charges in parallel to the introduction of a European safe asset.
- Progress in harmonising insolvency proceedings through minimum European standards allowing simpler early restructuring, shortening effective time to discharge and more efficient liquidation proceedings.

Additional recommendations

- To ensure uniform implementation and enforcement of EU capital market regulations, empower European Securities and Markets Authority to act as an effective regulator.

Strengthening resilience through a common fiscal capacity

Key recommendations

- Set up a common fiscal stabilisation capacity, for example through an unemployment benefits re-insurance scheme, and allow it to borrow in financial markets.
- Make access to the common fiscal stabilisation capacity conditional on past compliance with fiscal rules.

Additional recommendations

- Introduce more certainty into negotiated sovereign debt restructuring by reforming the European collective action clauses.

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