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OECD Economic Surveys: Euro Area 2021

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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.

The economic situation and policies of the Euro Area were reviewed by the Committee on 29 April 2021. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 9 June 2021.

The Secretariat's draft report was prepared for the Committee by Filippo Gori and Álvaro Pina under the supervision of Pierre Beynet. Statistical research assistance was provided by Paula Adamczyk, Mauricio Hitschfeld, Markus Schwabe and Patrizio Sicari and editorial assistance by Poeli Bojorquez, Jean-Rémi Bertrand, Emily Derry and Alexandra Guerrero.

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BASIC STATISTICS OF THE EURO AREA, 2020*

(Numbers in parentheses refer to the OECD average)**

LAND, PEOPLE AND ELECTORAL CYCLE				
Population (million)	341.2		Population density per km ² (2018)	147.6 (38.2)
Under 15 (%)	15.0	(17.8)	Life expectancy at birth (years, 2019)	80.8 (80.2)
Over 65 (%)	21.2	(17.4)	Men (2019)	78.0 (77.6)
International migrant stock (% of population, 2019)	14.2	(13.2)	Women (2019)	83.7 (82.9)
Latest 5-year average growth (%)	0.2	(0.6)		
ECONOMY				
Gross domestic product (GDP)			Headline inflation (y-o-y % change, Jul-2021)	2.16 (4.20)
In current prices (billion USD)	12 944.3		Key monetary policy rate (% , Aug-2021)	-0.50
In current prices (billion EUR)	11 344.9		Value added shares (% , 2019)	
Latest 5-year average real growth (%)	0.2	(0.7)	Agriculture, forestry and fishing	2.2 (2.6)
Per capita (thousand USD PPP)	47.0	(46.2)	Industry including construction	24.7 (25.7)
			Services	73.1 (71.7)
GENERAL GOVERNMENT				
Per cent of GDP				
Expenditure (OECD: 2019)	53.9	(40.6)	Gross financial debt (OECD: 2018)	121.3 (107.7)
Revenue (OECD: 2019)	46.7	(37.6)	Net financial debt (OECD: 2018)	75.3 (68.0)
EXTERNAL ACCOUNTS				
Exchange rate (EUR per USD)	0.88		Main exports (% of total merchandise exports)	
In per cent of GDP			Machinery and transport equipment	30.6
Exports of goods and services	45.2	(50.9)	Chemicals and related products, n.e.s.	18.5
Imports of goods and services	41.5	(47.3)	Manufactured goods	15.9
			Main imports (% of total merchandise imports)	
			Machinery and transport equipment	32.1
			Chemicals and related products, n.e.s.	16.9
			Manufactured goods	13.1
LABOUR MARKET, SKILLS AND INNOVATION				
Employment rate (aged 15 and over, %)	53.8	(55.1)	Unemployment rate, Labour Force Survey (aged 15 and over, %)	7.9 (7.1)
Men (OECD: 2019)	59.3	(65.6)	Youth (aged 15-24, %)	20.3 (15.0)
Women (OECD: 2019)	48.8	(49.9)	Long-term unemployed (1 year and over, %)	2.8 (1.3)
Participation rate (aged 15 and over, %)	59.4	(59.6)	Tertiary educational attainment (aged 25-64, %, 2019)	36.7 (38.0)
Average hours worked per year	1,536	(1,687)	Gross domestic expenditure on R&D (% of GDP, 2018)	1.7 (2.6)
ENVIRONMENT				
Renewables (% of total primary energy supply, 2019)	17.9	(10.8)	CO ₂ emissions from fuel combustion per capita (tonnes, 2019)	6.6 (8.3)
Exposure to air pollution (more than 10 µg/m ³ of PM 2.5, % of population, 2019)	63.0	(61.7)	Municipal waste per capita (tonnes, 2019)	0.5 (0.5)
SOCIETY				
Income inequality (Gini coefficient, latest available, OECD: latest available)	0.298	(0.318)	Education outcomes (PISA score, 2018)	
Relative poverty rate (% , 2018, OECD: 2017)	11.0	(11.7)	Reading	489 (485)
Median disposable household income (thousand USD PPP, 2018, OECD: 2017)	25.2	(24.2)	Mathematics	495 (487)
Public and private spending (% of GDP)			Science	491 (487)
Health care (2019)	8.6	(8.8)	Share of women in parliament (%)	33.0 (31.5)
Pensions (2017)	10.3	(8.6)	Net official development assistance (% of GNI, 2017)	0.3 (0.2)
Education (% of GNI, 2019)	4.5	(4.4)		

* The year is indicated in parenthesis if it deviates from the year in the main title of this table.

** Where the Euro Zone and OECD aggregates are not provided in the source database, a simple average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

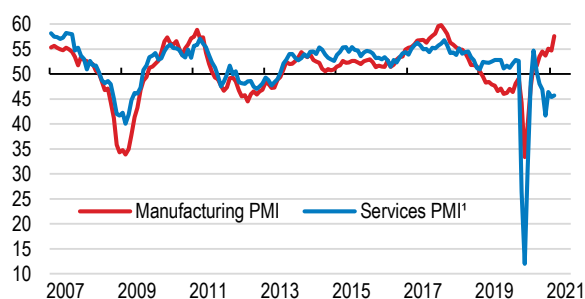
Executive summary

The euro area is facing unprecedented challenges

The euro area response to the crisis was strong and followed by a swift recovery, but risks remain.

In 2020, the COVID-19 pandemic led the euro area into its worst recession. Several waves of infections forced most euro area economies into repeated lockdowns, curbing economic activity, especially in the service sector (Figure 1). The policy reaction to the crisis was rapid and effective. On the monetary policy side, immediate ECB action helped to shore up bank lending and liquidity. On the fiscal policy side, the EU activated the general escape clause of the Stability and Growth Pact (SGP) – which allows temporary deviations from SGP budgetary targets – and, among other measures, it agreed on common tools to support national short-time work schemes, and set up an ambitious plan to promote economic recovery and accelerate the green and digital transitions (Next Generation EU).

Figure 1. Services were hit the most by the pandemic



Note: 1. Private service sector firms.

Source: IHS Markit.

StatLink  <https://doi.org/10.1787/888934276052>

The recovery is firming up, however, the pandemic could have persistent economic consequences and fiscal support should not be withdrawn prematurely (Table 1). In some sectors the pandemic may weaken demand durably and unemployment could remain high for longer. Moreover, disruptions to the education system may affect the human capital of future generations, negatively affecting future growth. Given these challenges, European policymaking should not be complacent when the health crisis will be over. Fiscal policy should keep supporting

affected sectors until the recovery is firmly established, avoiding premature consolidations. Moreover, a durable recovery will require the completion of an ambitious reform agenda, and would be supported by reforms to the economic architecture of the currency union.

Table 1. The recovery is firming up

	2020	2021	2022
Gross domestic product (GDP)	-6.7	4.3	4.4
Private consumption	-8.0	2.5	6.0
Government consumption	1.2	2.9	0.9
Gross fixed capital formation	-8.5	5.7	5.6
Unemployment rate (%)	7.9	8.2	7.9
Consumer price index	0.3	1.8	1.3

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

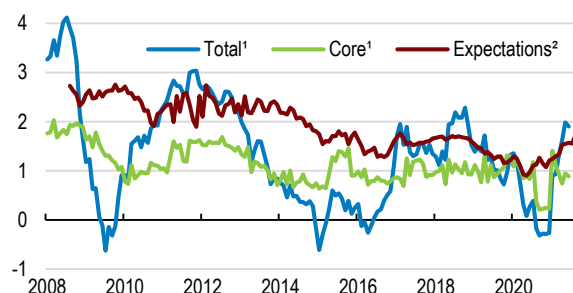
Monetary policy should remain accommodative following the revision of its framework

Monetary policy accommodation should continue until inflation robustly converges to the ECB target. The new framework will help the conduct of monetary policy.

The ECB policy support in the wake of the crisis has been prompt and forceful. Newly introduced monetary policy measures included a set of longer-term refinancing operations at very favourable conditions, easing conditions on the existing and new targeted longer-term refinancing operations (TLTROs), collateral easing measures and a large expansion of the central bank's asset purchases. Such measures succeeded in calming financial markets. However, even if picking up in 2021 (Figure 2), inflation over the medium-term is still off from the ECB objective. Against this background, monetary support is still required.

The ECB has completed a review of its monetary policy strategy. The review brought welcome changes, such as emphasised symmetry in the monetary policy objective, guidelines for improved ECB communication and an action plan for the incorporation of climate change considerations into the monetary policy framework. In the current context, vigilance should remain high against possible negative side effects of protracted easing measures, such as unsustainable asset price dynamics in financial and real estate markets.

Figure 2. Inflation has rebounded in 2021



Note: 1. Harmonised indices, excluding energy, food, alcohol and tobacco for core inflation. 2. Expected average annual inflation based on the forward rates calculated from 5-year and 10-year inflation swaps.

Source: Eurostat (2021), "Harmonised indices of consumer prices", Eurostat Database and Thomson Reuters (2021), Refinitiv Database.

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Europe needs to improve its fiscal governance

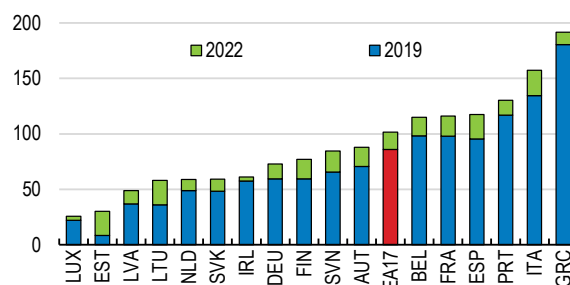
The evaluation of EU fiscal rules should aim at improving the fiscal framework. New crisis-related fiscal tools should be deployed quickly and their assessment should feed the debate on the completion of the monetary union.

The COVID-19 crisis poses new challenges to the current fiscal framework. At times, European fiscal rules did not prevent pro-cyclical fiscal policy, and the framework has become too complex. The COVID-19 crisis significantly worsened fiscal balances causing public debt to rise to new highs (Figure 3). While the existing framework has flexibility margins, strict compliance with it would require large consolidations efforts over the coming years, risking to derail the recovery. Against this background, the current set of fiscal rules should be evaluated with the aim to better ensure sustainable government finances, sufficient counter-cyclical and greater ownership. Fiscal prudence could be encouraged through strengthening the involvement of independent fiscal institutions, by enhancing medium term budgetary frameworks, and by considering positive incentives.

Common European, crisis-related fiscal instruments should be deployed fast. SURE and Next Generation EU represent a remarkable achievement. EU countries should focus on a prompt implementation of the recovery and

resilience plans to deliver structural reforms and investment based on sound cost-benefit analysis. At a later stage, the economic impact of SURE and Next Generation EU should be rigorously assessed as they could provide valuable inputs to the debate on the completion of the EMU architecture.

Figure 3. Debt to GDP will rise to new highs
Maastricht definition, as a percentage of GDP



Note: Data for 2022 are forecasts.

Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

StatLink  <https://doi.org/10.1787/888934276090>

Stronger cyclical convergence will support a balanced recovery

Resilient labour markets will help the economic rebound. Strengthening the single market for capital will reduce the risk of financial fragmentation.

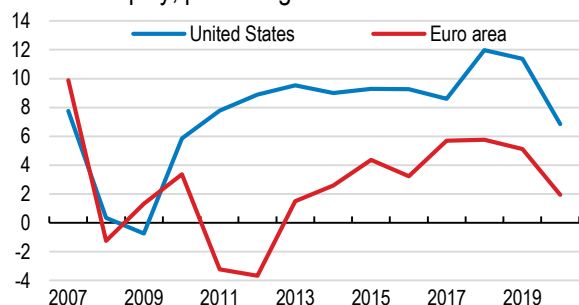
After the global financial crisis, large differences in business cycles across euro area countries emerged. These differences developed into diverging economic paths for hardest hit economies, threatening economic convergence and European cohesion. The COVID-19 pandemic again has affected euro area economies differently, raising the risk of economic divergence inside the currency union. This calls for policies to foster cyclical convergence, to ensure that no country will be left behind during the recovery.

More resilient labour markets increase the capacity of the economy to absorb shocks and accelerate the recovery. Job retention schemes (JRSs) have proven effective in preserving employment in the face of large economic shocks. To ensure a prompt recovery of labour markets, the phase out of JRSs should be paired with augmented job mobility policies. In this regard, active labour market policies and training

programmes should be extended to workers under JRSs.

Figure 4. Provisions for credit losses had a negative impact on bank profitability

Return on equity, percentage



Note: Euro area, changing composition.

Source: ECB (2020), ECB Statistical Data Warehouse (database); and Federal Deposit Insurance Corporation (FDIC).

StatLink  <https://doi.org/10.1787/888934276109>

Cross-border labour mobility can be effective in abating differences in domestic labour markets.

However, despite having increased over the last decade, labour mobility across euro area countries was still limited before the pandemic. An extension of automatic recognition of professional qualifications, and the complete implementation of the Electronic Exchange of Social Security Information could effectively support cross-border labour mobility.

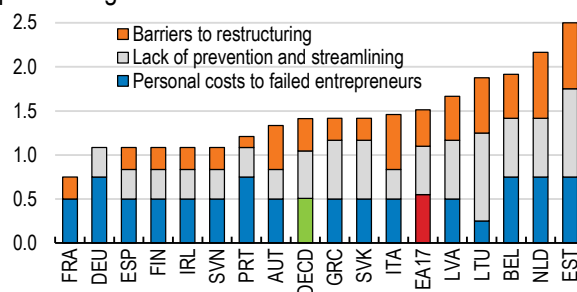
The European banking system is not yet fully integrated, contributing to financial fragmentation and economic divergence after the financial crisis. Deposits in euro area banks are vulnerable to shocks in individual countries, and discussions are ongoing in the High Level Working Group on a European Deposit Insurance Scheme (HLWG on EDIS). Completing the banking union would require to address all outstanding issues in a holistic manner and with the same level of ambition.

Financial authorities should strengthen the European framework to deal with NPLs. Bank profitability could be further weakened by a possible new wave of non-performing loans (Figure 4). Supporting banks dealing with NPLs will require approving ongoing reforms on foreclosing procedures and supporting the development of secondary markets. The establishment of a

network of Asset Management Companies (AMCs) should also be considered.

Figure 5. Insolvency regimes vary significantly across euro area countries

Indicator increasing in the extent to which the insolvency regime delays the initiation and resolution of proceedings¹



Note: 1. The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. 2. Euro area member countries that are also members of the OECD, excluding Luxembourg (16 countries). Source: Andrews, D., M. Adalet McGowan and V. Millot (2017), "Confronting the zombies: Policies for productivity revival", OECD Economic Policy Papers, No. 21, OECD Publishing, Paris.

StatLink  <https://doi.org/10.1787/888934276128>

Reducing the reliance of European financial markets on banks is a priority. Higher diversification in sources of funding for corporates would allow to increase the resilience of credit to firms during downturns, avoiding that possible bank distress could lead to financial fragmentation. Several aspects of the Capital Markets Union remain incomplete, most notably the development of securitisation and equity markets together with the convergence of national frameworks regarding financial market regulation, supervision, and insolvency proceedings (Figure 5).

Increasing fiscal integration is key to reduce divergence in business cycles and strengthen the stability of the euro area in case of shocks. A common fiscal capacity is one of the main tools for business cycle stabilisation and cyclical convergence in a currency union, and it remains a missing feature of the euro area. The establishment of a common fiscal capacity should be considered to complement the capacity of euro area member states to conduct counter-cyclical fiscal policy.

MAIN FINDINGS	KEY RECOMMENDATIONS
Keeping monetary policy accommodative	
Inflation had remained well below the ECB objective for a long time and risks are tilted to the downside beyond the short term.	Continue monetary policy accommodation until inflation robustly converges towards the ECB objective.
Improving European fiscal arrangements	
The European fiscal framework is particularly complex and in the past it did not prevent pro-cyclical fiscal policy in the euro area. After the crisis, the application of the current set of fiscal rules will be even more challenging.	Evaluate the fiscal framework with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership. Improve fiscal policy making by strengthening the involvement of independent fiscal institutions, enhancing medium term budgetary frameworks, and by considering positive incentives.
In response to the crisis the EU has recently adopted common fiscal tools in the form of Next Generation EU and the Support to mitigate Unemployment Risks in an Emergency (SURE). However, these measures are temporary and may not be renewed.	Swiftly implement national recovery and resilience plans to deliver structural reforms and investments based on sound cost-benefit analysis. Rigorously assess the economic impact of SURE and Next Generation EU as they could provide valuable inputs to the debate on the completion of the EMU.
One missing feature of the euro area is a common fiscal capacity which would help to reduce diverging business cycles.	Consider setting up a common fiscal stabilisation capacity, for example, through an unemployment benefits re-insurance scheme for the euro area.
Making labour markets more resilient to the economic cycle	
Countries that favour within-firm work flexibility in case of economic shocks and have a good training system for the unemployed often had smaller and shorter increases in unemployment.	Encourage member states to reinforce job retention schemes to be used in case of a temporary economic shock, together with training. To favour job reallocation in case of durable shock, encourage member states to enhance activation policies, including for workers under job retention scheme.
Cross-border labour mobility helps the functioning of the EU single market through better matching between workers and job offers across countries, and reducing persistent wedges in labour markets.	Extend cross-border recognition of professional qualifications. Complete the implementation of the Electronic Exchange of Social Security Information.
Improving the functioning and resilience of the common European financial market	
As a consequence of the COVID-19 crisis, Euro area banks are expected to face a new wave of non-performing loans (NPLs).	To facilitate the disposal of bank NPLs: i) approve ongoing reforms on foreclosing procedures; ii) improve data standardisation on secondary markets (for example via NPL standardised templates); iii) consider the establishment of a network of asset management companies (AMCs).
The European banking system is not yet fully integrated. Deposits in euro area banks are vulnerable to shocks in individual countries, and discussions are ongoing in the High Level Working Group on a European Deposit Insurance Scheme (HLWG on EDIS).	Complete the Banking Union by addressing all outstanding issues in a holistic manner and with the same level of ambition.

1 Key policy insights

The euro area is facing new and unprecedented challenges

After over a decade since the global financial crisis, the currency union is today facing a new challenge of different nature; in spring 2020 the COVID-19 pandemic forced most euro area countries to shut down part of their economies, precipitating the euro area into a recession of unprecedented nature and magnitude. Subsequent waves of infections plunged euro area economies into a new, albeit milder, contraction that further worsened the socio-economic consequences of the crisis. Over one year after the beginning of the pandemic, infections abated thanks to ambitious vaccination campaigns but the risk of another worsening of the sanitary conditions due to new virus variants still looms.

Euro area policymakers reacted fast and forcefully to the pandemic, building a multi-pronged policy response comprising monetary, financial and fiscal easing. On the monetary policy side, immediate ECB action has shored up bank lending and liquidity, and eased overall financing conditions. On the fiscal policy side, the EU activated the general escape clause of the Stability and Growth Pact to allow national fiscal policies to support the economy more freely, and, as regards support to firms it established a temporary framework for State aid measures. More financial support came from the EU: after agreeing on tools to deal with the most immediate consequences of the crisis (such as SURE, a fund to support short-time work schemes), European leaders approved Next Generation EU, an ambitious plan to support economic recovery, increase economic resilience, and strengthen long-term growth including by accelerating the green and digital transitions.

All such measures showed a resolute commitment by European policy makers to respond to the COVID-19 shock with all available means at their disposal. However, the pandemic may have longer-term effects on euro area economies and more action is needed: many sectors may continue to suffer from durable weakness in demand, causing unemployment to remain high for longer. Disruptions to the education system in many countries may have prolonged negative effects on the human capital of younger generations. All euro area countries are likely to be affected, but some more than others, because of the structure of their economy or due to particularly unfavourable dynamics during the health crisis. Facing these challenges, European policy makers should not feel complacent. The COVID-19 crisis has created a momentum for reforms to the architecture of the currency union as well as national structural reforms that should continue.

In a context of a large deterioration of fiscal balances in euro area countries, the complex set of EU fiscal rules should be reviewed to lead to its better functioning. The newly introduced temporary EU instruments for cross-country crisis fiscal support, representing an important achievement for the EU, need to be implemented quickly and effectively. A rigorous assessment of the economic impact of SURE and Next Generation EU should be conducted, as they could provide valuable inputs to the debate on the completion of the EMU architecture. Monetary policy, a crucial factor supporting the resilience of the currency union over the last decade, still needs to support the recovery. The monetary policy framework has recently been re-assessed against the structural shifts of the euro area economy.

As in the aftermath of the global financial crisis, the asymmetric economic impact of the COVID-19 pandemic has the potential to disconnect business cycles across euro area economies, with the risk of longer-run economic divergence. The Second Chapter of this survey looks into policies to support convergence in business cycles among euro area countries, as to ensure a balanced and broad-based recovery in the aftermath of the crisis. To this end the euro area should consider the possible establishment of a common fiscal stabilisation capacity. The euro area should also improve the functioning of the common market for capital and labour. This will require deepening the Capital Markets Union (CMU), the establishment of a truly pan-European banking system, and the implementation of a set of reforms – many of them at national level – that will make euro area labour markets more resilient to shocks.

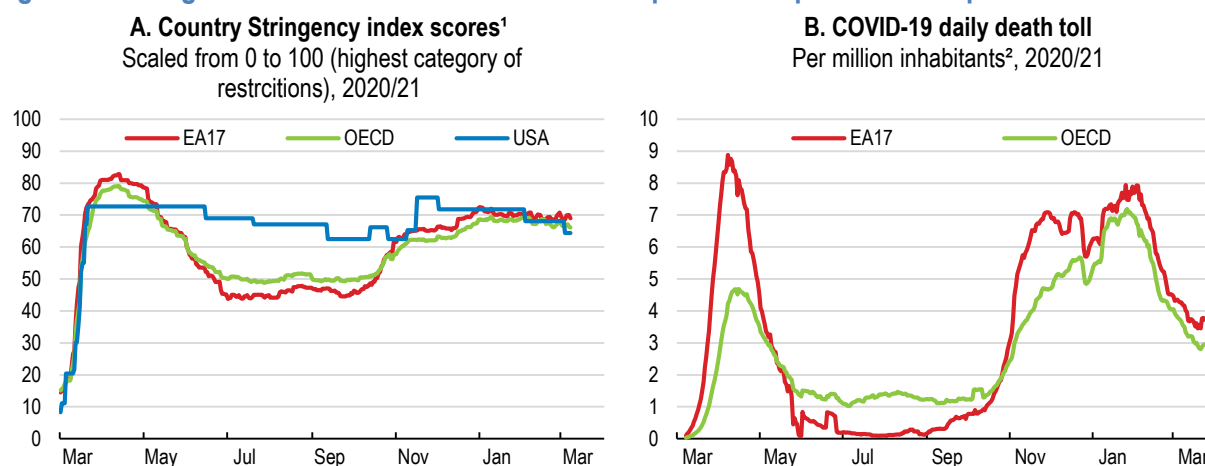
The key messages of the 2021 OECD Economic Survey on the euro area are:

- Monetary policy needs to remain accommodative until inflation has converged robustly towards the ECB objective. The new monetary policy framework represents a positive change in many directions, such as making the inflation objective more explicitly symmetrical and an action plan for incorporating climate change concerns in the framework.
- Fiscal policy should keep supporting the euro area economy until the recovery is firmly established, avoiding premature consolidations and EU crisis-related fiscal measures should be deployed swiftly. The European fiscal framework needs to be evaluated with the aim to better ensure sustainable government finances, sufficient counter-cyclical and greater ownership.
- The risk of divergence among euro area members following the COVID-19 crisis needs to be addressed by considering the establishment of a common fiscal capacity, completing the Banking Union, deepening the Capital Markets Union (CMU), and encouraging reforms of domestic labour markets.

The euro area is recovering from a recession of unprecedented nature and magnitude

Euro area countries have been among the first hit by the COVID-19 pandemic, suffering large economic damage. In spring 2020, when the first wave of infections struck, authorities took unprecedented measures to limit contagion, often imposing country-wide lockdowns with mandatory closure of large swathes of economic activity (Figure 1.1). Strict containment measures led to high output losses by international comparison in the first half of 2020 (Figure 1.2, Panel A). Following the end of lockdown measures, activity rebounded vigorously until mid-summer 2020. However, with the resurgence of the pandemic in the autumn, many countries have progressively re-imposed lockdowns, though often less strict than in the spring of 2020. This has induced a temporary reversal of the recovery. During the first months of 2021, a new wave of infections spread across the euro area, forcing countries to impose new containment measures and further delaying the recovery. An improvement in sanitary conditions, also due to enhanced vaccination campaigns, supported the gradual removal of containment measures in most euro area countries in the second quarter of 2021.

Figure 1.1. Tough containment measures reflected a pervasive spread of the epidemic



Note: 1. The stringency index score is an index averaged across eight closure and containment policy components and scaled from 0 (no restriction) to 100 (highest category of restrictions). The closure and containment policies include school closing, workplace closing, cancel of public events, restrictions on gatherings, close public transport, stay at home requirements, restrictions on internal movements and international travel control. 2. 7-day moving average.

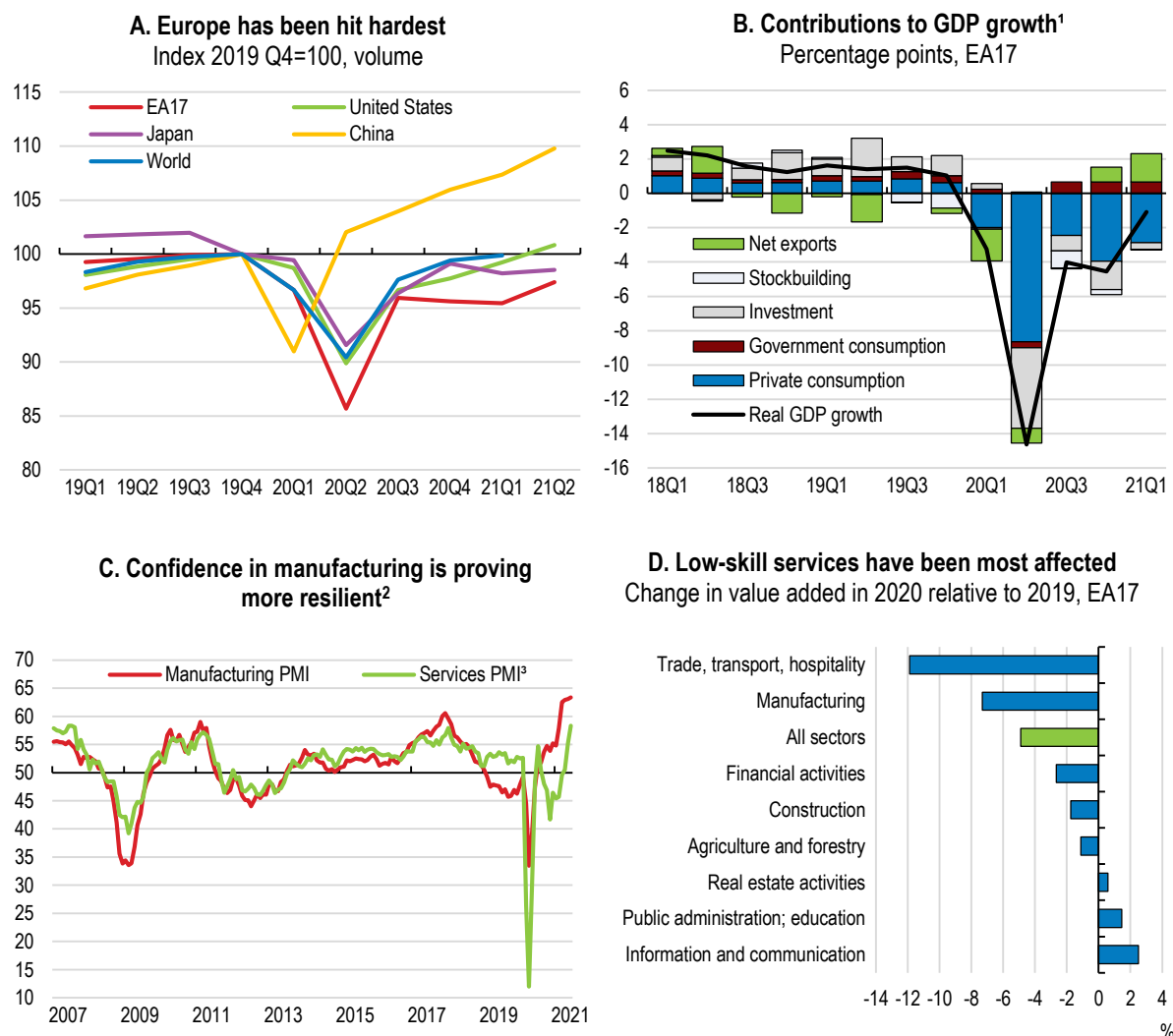
Source: OECD calculations based on the Oxford Covid-19 Government Response Tracker <https://covidtracker.bsg.ox.ac.uk/> and European Center for Disease Prevention and Control (ECDC) through Our World in Data.

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The COVID-19 pandemic hit particularly hard private consumption, on the back of restrictions to movement and access constraints to a wide variety of personal activities. Investment has also contracted sharply, mainly as a result of depressed demand and high uncertainty (Figure 1.2, Panel B).

Sectoral impacts have varied widely, with labour-intensive and low-skilled sectors often hit hardest. Services have been most affected, especially those relying on direct contact between providers and clients (Figure 1.2, Panel D). Tourism, also hit by travel restrictions, is a prime example, especially when dependent on international visitors. Activity in manufacturing and in construction was also severely hampered in spring 2020, but has proved more resilient to the following waves of the pandemic, with a post-spring recovery bringing these sectors close to pre-pandemic production levels (a rebound which was faster in construction and more gradual in manufacturing of capital goods) (Figure 1.2, Panel C). In contrast, sectors more amenable to social distancing or teleworking, like agriculture, finance or ICT services, have suffered less.

Figure 1.2. The large recession has been highly asymmetric across sectors



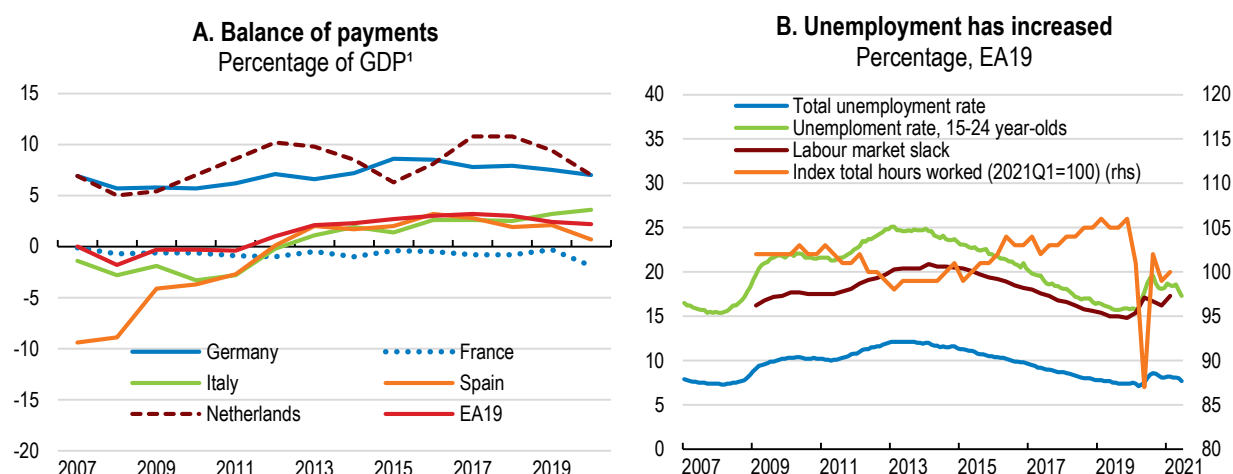
Note: 1. Contribution to GDP growth relative to the same quarter of the previous year. 2. An index reading above 50 indicates an overall increase in its value, relative to the previous monthly observation. 3. Private service sector firms.

Source: OECD (2021), OECD Macroeconomic Statistics (database); IHS Markit.

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The pandemic has also weighed on the labour market. Developments in activity were mirrored in total hours worked (Figure 1.3, Panel B). Widespread resort to short-time working has limited the rise in unemployment, but broader measures of labour market slack recorded somewhat stronger increases, notably due to more people available to work but not seeking it. Labour market worsening could have a negative persistent impact on young and female workers. Amidst large impacts of the pandemic on international trade, the current account balance of the euro area has decreased somewhat in 2020, partly reflecting lower tourism exports. Nonetheless, a large surplus remains, reflecting an asymmetric adjustment across countries over the past decade (Figure 1.3, Panel A) and mirroring investment weakness.

Figure 1.3. The current account surplus remains high, unemployment has started to decrease



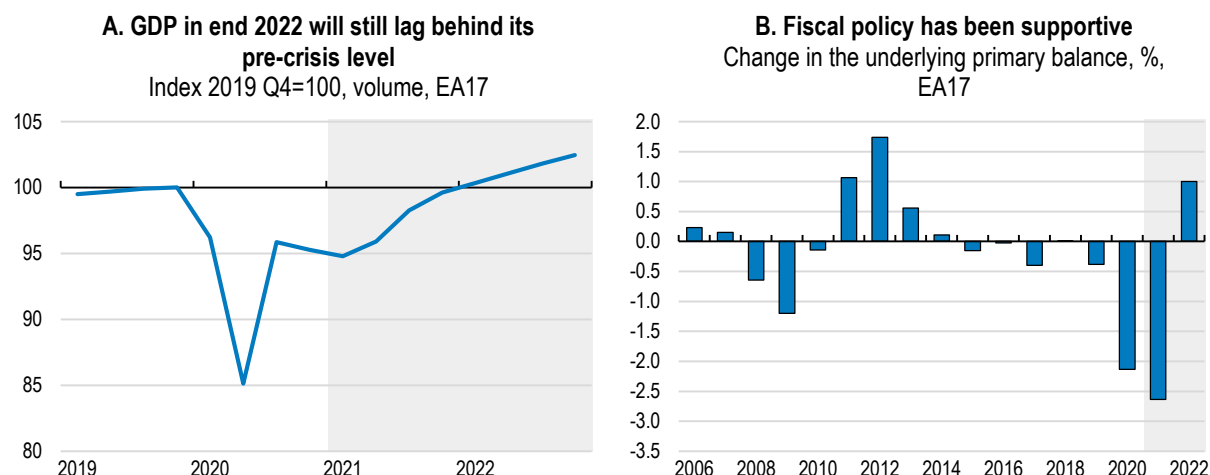
Note: 1. National-level current account balances include intra-EU net positions.

Source: Eurostat (2021), "Balance of payments statistics (BPM6)", Eurostat Database.

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The European policy response has been prompt and forceful by historical standards, comprising monetary and fiscal stimuli, capital relief programmes for banks, loan guarantee schemes by the European Investment Bank, and low-conditionality lending facilities to member states, among other measures (Box 1.1).

After a sharp contraction in 2020, and a delayed recovery in early 2021, GDP growth is expected to accelerate strongly in the second half of this year before moderating in 2022, but nonetheless remain robust (Table 1.1 and Figure 1.4). In the second half of 2021, private consumption is set to benefit from the lifting of containment measures and from sizeable pent-up demand. Activity will be further supported by considerable fiscal stimulus and vigorous export dynamism. In 2022, growth will continue to be spurred by exports and capital formation, the latter relying on a significant contribution from public investment. Nonetheless, household saving, albeit declining, is projected to remain higher than before the pandemic, and the recovery of private investment will be only moderate. At the end of 2022, unemployment is projected to return close to pre-pandemic levels. Continued fiscal support will keep Maastricht debt above 100% of GDP in the coming years.

Figure 1.4. The recovery will be robust

Note: Data refer to European Union member countries that are also members of the OECD (22 countries).

Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

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Risks to the economic outlook are multiple: longer term “scarring effects” could emerge, as a consequence of a worsening in labour market dynamics or if investment retrenches durably. An increase in non-performing exposures could scale back bank credit and an abrupt, sustained inflation revival could force an early exit from monetary support, possibly generating financial tightening. The emergence of new, vaccine-resistant virus variants could undermine the efforts to control the epidemics through the ongoing vaccination campaigns, and delay the phase out of containment measures. On the upside, a relaxation of vaccine production constraints and an acceleration in the deployment of ongoing vaccination campaigns, coupled with continuous testing, tracing and isolation strategies to circumscribe episodes of virus resurgence, could speed up the recovery in activity. Swift and efficient implementation of the European recovery plan could bolster investment and structural reforms, helping the euro area achieve stronger productivity growth (Table 1.2).

Box 1.1. The European monetary, financial and fiscal response to the COVID-19 crisis

- The ECB has expanded its asset purchase programme by an overall EUR 1970 billion (16.5% of the euro area 2019 GDP). This mainly consists of the EUR 1850 billion Pandemic Emergency Purchase Programme, with net purchases set to continue until it is judged that the COVID-19 crisis is over, but not before March 2022. In March 2020, the Governing Council stated that it would consider revising some self-imposed limits to the extent necessary to make its action proportionate to the risks.
- To preserve bank lending and liquidity, the ECB has launched new non-targeted longer-term refinancing operations, made borrowing conditions applied in targeted longer-term refinancing operations (TLTRO III) more favourable and eased collateral standards.
- Bank capital and liquidity ratios have been temporarily relaxed. Further temporary capital relief has come from changes to the Capital Requirements Regulation and from supervisory flexibility regarding the treatment of non-performing loans (NPLs).
- The Capital Markets Recovery Package has made targeted changes to capital market rules (Prospectus Regulation, MiFID II and securitisation rules), *inter alia* to make it easier for issuers to quickly raise capital and to facilitate the use of securitisation, including of NPLs, so as to enable banks to expand their lending.
- The EU activated the general escape clause of the Stability and Growth Pact (SGP), which allows for temporary deviations from SGP budgetary targets. According to the European Semester Spring Package 2021, the general escape clause will continue to be applied in 2022 and is expected to be deactivated as of 2023.
- Two Coronavirus Response Investment Initiatives (CRII and CRII+) have accelerated the implementation of cohesion policy, *inter alia* by reducing national co-financing and enlarging investment eligibility.
- Pandemic Crisis Support credit lines have been established within the framework of the European Stability Mechanism, with a benchmark 2% of national GDP (about EUR 240 billion in total) to finance with loans direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis. These loans will have a maximum average maturity of 10 years and favourable pricing modalities. So far no country has applied.
- A new European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) has been created. Endowed with EUR 100 billion, SURE comprises lending on favourable terms to member states to help them finance short-time work schemes and other measures to support workers and the self-employed.
- European Investment Bank guarantee schemes have been expanded. In particular, a EUR 25 billion European Guarantee Fund has been created to support up to EUR 200 billion of financing (debt and equity) for companies throughout the EU. At least 65% of the financing will go to SMEs.
- The Next Generation EU recovery plan will provide EUR 750 billion (about 5.5% of EU27 2019 GDP) of grants and loans to member states, funded by EU debt issuance.
- The EU also temporarily adjusted the State aid regime to enable member states to provide necessary support to businesses.

Table 1.1. Macroeconomic indicators and projectionsEuro area,¹ annual percentage change, volume (2015 prices)

	2018	2019	Projections		
			2020	2021	2022
Gross domestic product (GDP)	1.9	1.3	-6.7	4.3	4.4
Private consumption	1.5	1.3	-8.0	2.5	6.0
Government consumption	1.2	1.7	1.2	2.9	0.9
Gross fixed capital formation	3.2	5.7	-8.5	5.7	5.6
Final domestic demand	1.8	2.5	-6.1	3.3	4.7
Stockbuilding ²	0.1	-0.5	-0.3	0.0	0.0
Total domestic demand	1.8	1.9	-6.4	3.4	4.7
Exports of goods and services	3.5	2.5	-9.7	9.1	6.0
Imports of goods and services	3.6	3.8	-9.3	7.6	6.9
Net exports ²	0.1	-0.5	-0.5	1.0	-0.1
Other indicators (growth rates, unless specified)					
Potential GDP	1.1	1.1	0.9	0.8	0.8
Output gap ³	0.1	0.2	-7.3	-4.1	-0.7
Employment	1.3	1.2	-0.9	0.2	0.9
Unemployment rate	8.2	7.5	7.9	8.2	7.9
GDP deflator	1.4	1.7	1.6	0.9	1.3
Consumer price index (harmonised)	1.8	1.2	0.3	1.8	1.3
Core consumer prices (harmonised)	1.0	1.0	0.7	1.2	1.1
Household saving ratio, net ⁴	6.5	6.8	13.7	11.9	7.5
Current account balance ⁵	3.5	3.1	2.9	3.3	3.2
General government fiscal balance ⁵	-0.5	-0.6	-7.2	-7.2	-3.7
Underlying general government fiscal balance ³	-0.4	-0.6	-2.5	-5.1	-3.9
Underlying general government primary fiscal balance ³	1.2	0.8	-1.3	-3.9	-2.9
General government gross debt (Maastricht) ⁵	87.7	85.9	100.2	102.8	101.4
General government net debt ⁵	63.2	63.3	76.3	79.4	78.4
Three-month money market rate, average	-0.3	-0.4	-0.4	-0.5	-0.5
Ten-year government bond yield, average	1.1	0.4	0.0	0.0	0.0
Memorandum item					
Gross government debt ⁵	102.4	103.5	121.9	124.6	123.2

Note: 1. Euro area member countries that are also members of the OECD (17 countries). 2. Contribution to changes in real GDP. 3. As a percentage of potential GDP. 4. As a percentage of household disposable income. 5. As a percentage of GDP.

Source: OECD (2021), "OECD Economic Outlook No. 109", OECD Economic Outlook: *Statistics and Projections* (database).

Table 1.2. Events that could lead to major changes in the outlook

Event	Possible outcomes
New COVID-19 outbreaks linked to new vaccine-resistant virus variants.	Re-imposition of stricter confinement measures and heightened uncertainty, with major negative impacts on private consumption and investment. Increases in unemployment and bankruptcies.
A surge in NPLs, in a context of increased risk-aversion.	A significant worsening in bank balance sheets could compromise credit provision to the economy. Banks' increased need for public support could put additional pressure on public finances and lead to a steep increase in sovereign spreads.
Slow implementation of the EU recovery plan and premature withdrawal of fiscal support.	Persistently weak public investment would slow down the recovery. Sovereign debt tensions could re-emerge.
A broad vaccination coverage, coupled with continuous testing, tracing and isolation strategies.	Circumscribing episodes of virus resurgence can allow for a faster phase out of virus control measure, thereby supporting a quicker recovery in activity.

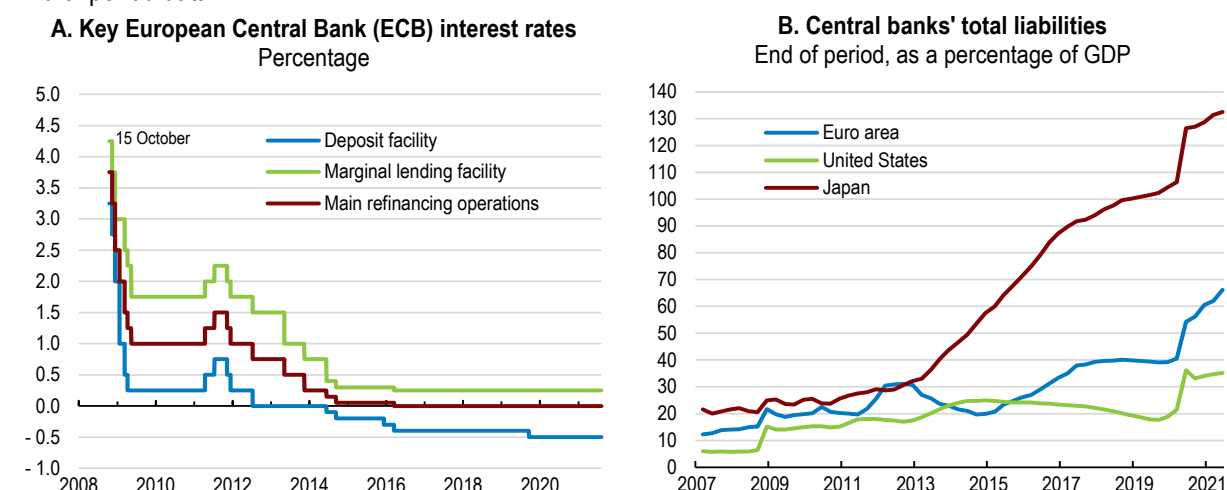
Maintaining monetary policy effectiveness after reviewing its framework

Monetary policy should remain accommodative

The ECB has acted forcefully in support of the economy from the outset of the COVID-19 crisis and its monetary policy stance has remained very accommodative since then. To preserve bank lending and liquidity, the ECB has announced a number of new monetary policy measures such as new additional longer-term refinancing operations (LTROs) offered at highly accommodative terms, as well non-targeted longer-term refinancing operations (called pandemic emergency longer-term refinancing operations, PELTROs), lowered twice the interest rate floor applied in targeted longer-term refinancing operations (TLTRO III), increased the total amount that counterparties are entitled to borrow in the TLTRO III, and eased collateral standards. Furthermore, the ECB has expanded the overall envelope of its asset purchase programme by an overall EUR 1970 billion, almost 17% of the euro area 2019 GDP (Figure 1.5). This mainly consists of the EUR 1850 billion Pandemic Emergency Purchase Programme (PEPP). The Governing Council has agreed to terminate with net asset purchases under the PEPP once it judges that the COVID-19 crisis phase is over, but in any case not before the end of March 2022.

Figure 1.5. The ECB policy rates are at a historical low, and central bank balance sheet liabilities grew considerably

End of period data



Source: ECB (2021), "Financial Market Data: Official Interest Rates", Statistical Data Warehouse, European Central Bank; Refinitiv (2021), Datastream Database and OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

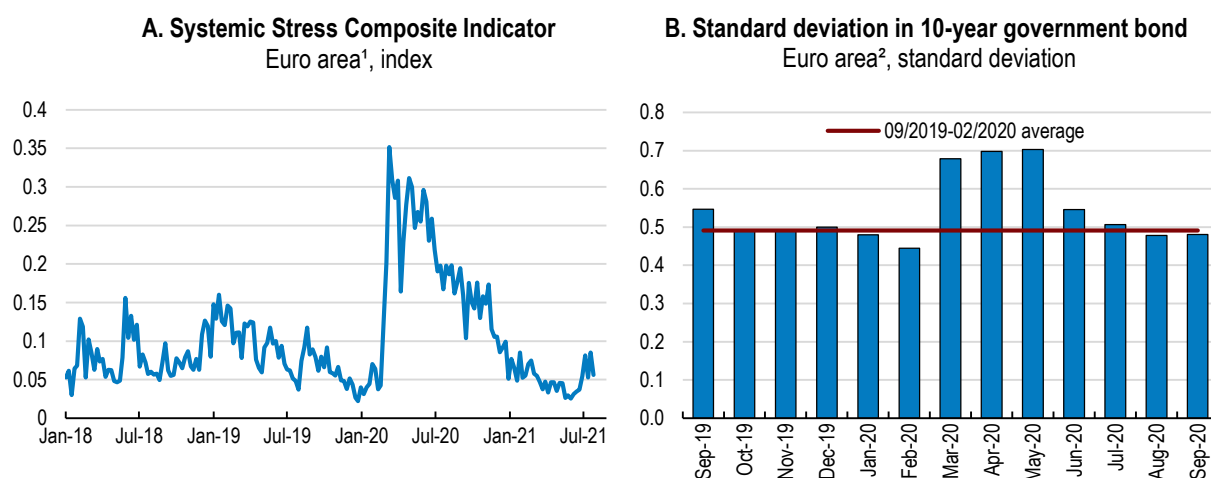
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The ECB also introduced new important features to its new asset purchase programme. A waiver of the eligibility requirements for securities issued by the Greek government was granted for purchases under PEPP, in a welcome commitment to provide support to every euro area member during the crisis. The ECB Governing Council also decided to expand the range of eligible assets under the corporate sector purchase programme (CSPP) to non-financial commercial paper, and to ease the collateral standards by adjusting risk parameters of the collateral framework. Finally, the ECB committed to conduct asset purchases in a flexible manner – thus allowing for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions. This accounts to a temporary relaxation of self-imposed limits in place for previous programmes. All those measures are welcome as they provided the necessary support with adequate flexibility and targeting.

As a result of the ECB actions, systemic stress in the euro area receded after the outbreak of the pandemic in March 2020 and financial conditions in the euro area eased considerably since then (Figure 1.6, Panel A). Moreover, financial fragmentation measured by the dispersion of sovereign bond yields ebbed substantially (Figure 1.6, Panel B).

Figure 1.6. The ECB response to the pandemic calmed financial markets

Euro area



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The capital relief and conservation measures released buffers of more than EUR 156 billion for euro area banks and helped maintain the flow of credit during the first half of 2020. However, recent bank lending surveys suggest that the approval criteria for loans to firms and households have tightened, reflecting intermediaries concerns about credit risk arising from the crisis. While some estimates suggest that euro area banks have excess capital to absorb credit losses linked to the COVID-19 crisis (IMF, 2020), a slower recovery could result in capital shortfalls in the banking sector, as protracted subdued economic activity would exacerbate pervasive liquidity or solvency problems for businesses. Premature withdrawal of support measures could also contribute to capital shortfalls.

The gradual unwinding of capital relief measures throughout the recovery will need to be carefully assessed against possible strains to the financial system. As acknowledged by the ECB, system-wide restraints on dividend payments and share buybacks should be lifted first, while reverting to

the usual supervisory practice of assessing the planned distribution of dividends on a bank-by-bank basis. Other supportive financial sector measures should be maintained until the recovery will consolidate, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit.

The inflation outlook is uncertain. While price dynamics deteriorated in 2020 (also on the back of the appreciation of the euro), euro area inflation spiked-up rapidly over the first months of 2021, driven up *inter alia* by rising energy and food prices and by the reversal of an earlier tax cut in Germany (Figure 1.7). However, core measures of inflation, such as the inflation rate stripped of food and energy items, still remain below the 2% objective, also on the account of still limited wage growth. These factors point to a temporary inflation adjustment or to a return to the higher, but still subdued, pre-pandemic inflation path. As a consequence, central forecasts still expect inflation to be below the ECB objective in 2022. While vigilance over possible rising price pressures should remain high – especially if wage driven – the recent inflation correction does not warrant a policy change by the ECB yet.

In this context, monetary policy accommodation should remain in place until inflation robustly converges toward the ECB objective. This calls for careful judgement on the part of the ECB in discerning between temporary and more long-lasting price shocks, and it could be consistent with allowing for a temporary period of inflation above 2 percent as acknowledged by the ECB. However, should underlying inflation durably exceed the 2% objective, the ECB could consider to start trimming its monetary stimuli, for example by reducing the pace of net purchases under the APP and terminating net purchases within the framework of the ongoing Pandemic Emergency Purchase Programme (PEPP) sometime before March 2022.

On the other hand, even if the risk of deflationary dynamics has significantly abated over the past quarters, the ECB should nonetheless stand ready to act with additional monetary policy easing measures in case of a weakening of the inflation rate. The economic outlook remains fraught with risks, notably due to the fast emergence of more contagious coronavirus variants that may hurt the recovery and constrain inflation. Further easing could come from a number of actions, including (i) an extension of the current asset purchase programmes; (ii) an adjustment of key parameters of long-term refinancing operations; and (iii) a strengthening of forward guidance.

A significant expansion of sovereign asset purchases in response to a possible deterioration of the inflation outlook would likely entail a longer suspension of self-imposed limits on the volume of purchasable assets. A first constraint that may become binding requires the country composition of the bond portfolio held by the Eurosystem to be the same of the NCBs' shares in the ECB capital (so-called "capital keys"). A second constraint, usually referred to as the "issuer limit", imposes that the bond portfolio held by the Eurosystem as a share of outstanding debt eligible for purchase for each country does not go beyond 33%. This limit has been subsequently lifted as regard to purchases under the PEPP. The last self-imposed limit, constraining purchases to 33% (or 25% in exceptional cases) of each individual issuance (the "issue share limit") is meant to reduce the risks that an outsized central bank held portfolio could hamper the functioning of national government bond markets and to impede the ECB from having blocking majority in case of restructuring in relation to collective action clauses. An outsized central bank held portfolio of government bonds can generate, for example, reduced trading volumes, decreased yields volatility, a deterioration of market liquidity, and lower turnover (Potter and Smets, 2019).

If needed, the ECB could envisage providing further easing through an adjustment of key parameters of the central bank longer-term refinancing operations, including the PELTRO and TLTRO III. The last PELTRO operation is currently planned for December 2021. Should the economic conditions warrant, new operations in 2022 should be considered. The interest rate currently applied on PELTRO operations is 25 basis points below the average rate applied in the

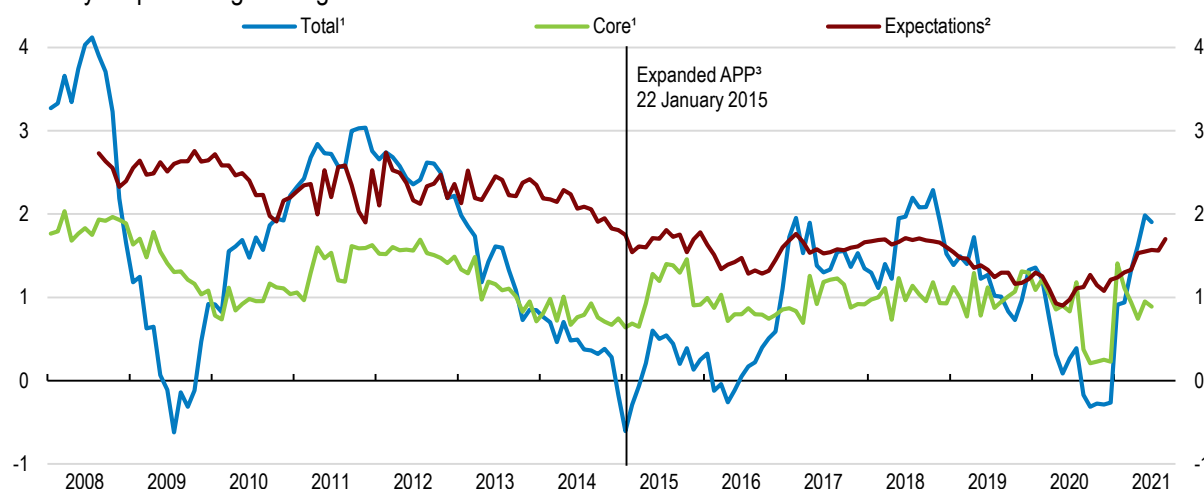
Eurosystème's main refinancing operations (currently 0%). Additional easing could be achieved by lowering the interest rate further. Similarly, a further reduction of the interest rate on TLTRO III operations (which at present can be as low as 50 basis point below the interest rate on the deposit facility, currently at -0.5%) could be envisaged, together with an extension of their tenor beyond the current 36 months (with early repayment options for borrowing banks). Finally, improving forward guidance, for example by making more explicit the link between new policy actions and some key indicators such as, for example, the inflation rate, could increase the predictability of future policy actions (OECD, 2018).

Possible negative side-effects should be kept in check

The balance of positive impacts and negative side effects of the ECB non-standard policy measures – notably the negative interest rate policy and the asset purchase programmes – has remained favourable so far, but negative side effects might become more severe if policies stay in place for a longer period, or following the implementation of further easing measures. This calls for vigilance in monitoring possible financial fragilities, as well as steadiness in the adoption of measures to soften potential side effects.

Figure 1.7. Inflation rebounded in 2021

Year-on-year percentage change



Note: 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 (2021), "Harmonised indices of consumer prices", Eurostat Database and Thomson Reuters (2021), Refinitiv Database.

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The negative interest rate policy adopted by the ECB in 2014 appeared to have been successful in providing incentives for banks to extend credit in the run up to the COVID-19 crisis. However, a negative interest rate environment also hurts intermediaries' sources of income, compressing bank net interest margins. There is some evidence that negative interest rates contributed – in addition to generally cost-heavy business structures – to the poor profit performance of euro area intermediaries with respect to pre-global financial crisis standards, and comparing with banks in other advanced economies (Figure 1.8, panel B; Altavilla et al, 2017; BIS, 2018; OECD, 2019; Brunnermeier, and Koby, 2016; Borio et al 2017; Stráský and Hwang, 2019).

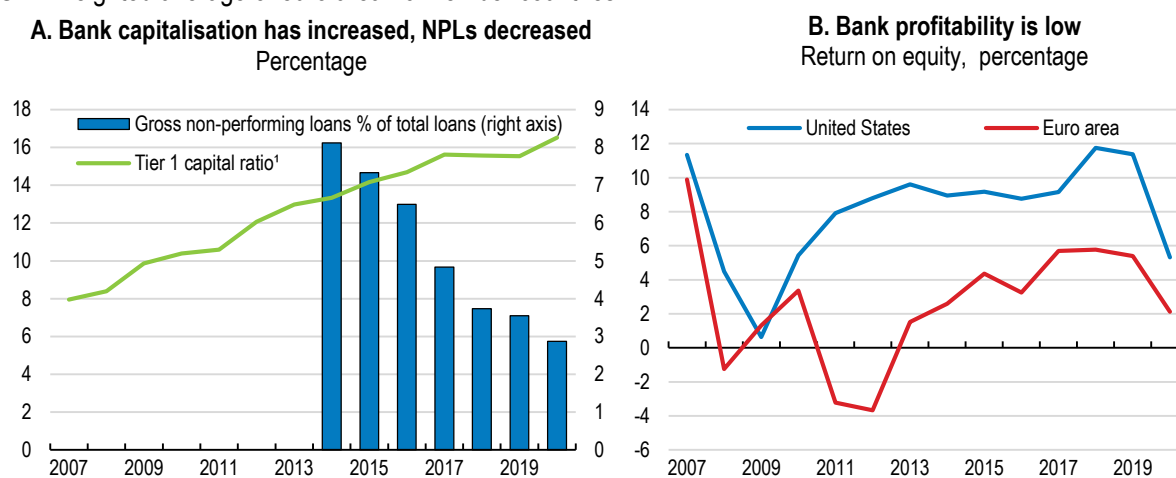
While non-performing loans remain for the moment limited, in the context of the expected rise in credit losses as a consequence of the COVID-19 crisis, euro area banks have already booked

large provisions for credit losses. Initial estimates for a worst case scenario suggested that up to EUR 1.4 trillion of NPLs could potentially arise as a consequence of the COVID-19 crisis, although the probability of this scenario seems to have reduced since 2020 (Enria, 2020). Ongoing stress tests carried out by the EBA and the ECB will likely provide more accurate figures over the coming months. Limited bank profitability represents a source of concern for the health of the banking system in the currency union, as a further deterioration of the quality of credit is more likely to erode bank capital if intermediaries' operating margins remain low.

In this context, measures to reduce the adverse impact of negative interest rates on bank income, like the two-tier system for excess reserve remuneration, are important. In a two-tier system, banks' profits are partially shielded from the consequences of negative interest rates, since part of banks' holdings of excess liquidity are exempt from the negative deposit facility rate. In the euro area, the introduction of the two-tier reserve system had also the positive effect of redistributing excess liquidity away from countries in which banks had excess liquidity, such as Belgium, Germany and the Netherlands, towards banks in countries with unused liquidity allowances, such as Italy (Cœuré, 2019a). The possibility of keeping a two-tier system for reserve remuneration should be considered even after monetary policy normalisation, due to its potential for reducing financial fragmentation in some segments of the money market.

Figure 1.8. Non-performing loans remain for now low, but banks are expecting credit losses

GDP-weighted average of euro area 19 member countries



Note: 1. Regulatory Tier 1 Capital to risk-weighted assets.

Source: IMF (2020), Financial Soundness Indicators (database), International Monetary Fund, Washington, D. C.

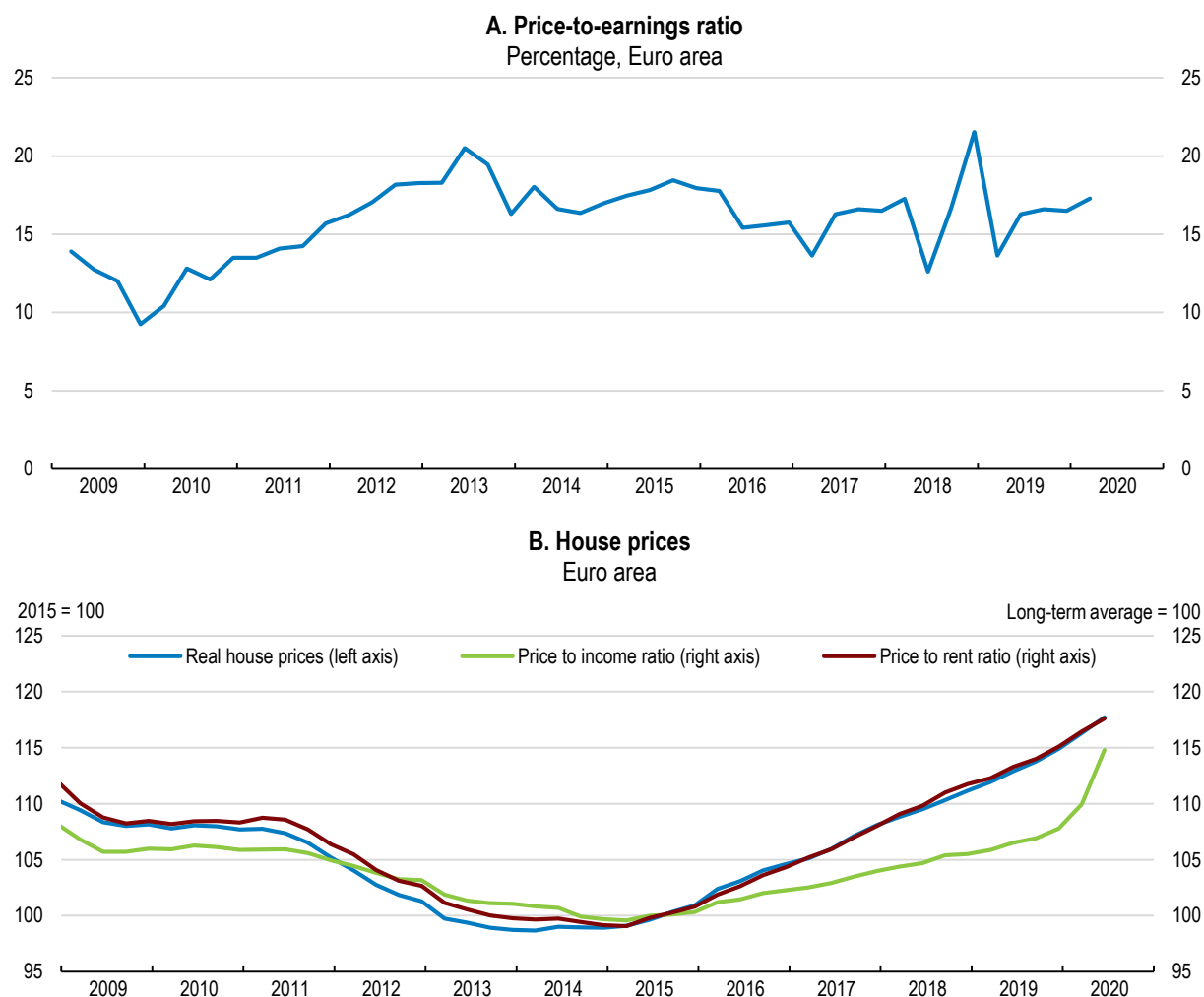
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Protracted central bank asset purchases and low borrowing costs can result in excessive risk-taking and unsustainable asset price dynamics. In 2020, bond and equity prices rebounded significantly from the minima of April, on the back of the ample liquidity available in financial markets and in apparent disconnect with, at the time, relatively sombre economic projections. So far, while it seems clear that price developments have been supported by a recovery in risk sentiment contingent on on-going policy support, no systemic overvaluation or disconnect from fundamentals appears evident. Yet, pockets of potential overvaluation may be present in particular market segments, such as the high-yield corporate bond market (ECB, 2020a). Dynamics in equity and bond markets, and their linkages with financial intermediaries and retail investors should be carefully monitored, as to avoid the risk that abrupt asset price reversal could put the financial system under stress. The possible consequences of large scale ECB sovereign bond holdings on

the functioning of some segments of the money and public debt markets should be monitored as well.

Real estate prices have been steadily increasing over the last five years, especially in some euro area countries, such as the Netherlands, Germany and France, on the back of historically high loan origination. This trend has continued since the beginning of the COVID-19 crisis, with house prices in the euro area rising by 5.8% in the first quarter of 2021, compared with the same quarter of 2020 (Figure 1.9). The COVID-19 crisis could in principle negatively affect the price of urban dwellings and commercial properties, especially in some regions that experienced fast growth over the past years. A decline in demand for properties in prime locations can come from reduced incomes of prospective buyers (the average price-to-income ratio for real estate properties has increased markedly in 2020), from a shift to more flexible work arrangements (such as teleworking) causing a drop in demand for urban dwellings, and from a decline in commercial rents, especially those linked to sectors particularly hit by the crisis (i.e. retail commerce, hotel and restaurants). These factors so far did not offset the positive effect of lower interest rates on the demand for housing. Should this happen in the future, there is a risk of a (possibly abrupt) reversal in real estate valuations that may generate financial strains for homeowners and financial intermediaries. To minimise the risk of house price imbalances developing further, macroprudential frameworks should be actively used in concerned markets. The ESRB has provided valuable inputs to euro area countries experiencing real estate-related vulnerabilities for stepping up adequate macroprudential measures (Table 1.3).

Figure 1.9. House prices have increased markedly in 2020



Note: Euro area member countries that are also members of the OECD (17 countries).

Source: Thomson Reuters, Refinitiv Database; OECD (2020), OECD Analytical House Price Indicators (database).

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Table 1.3. Monetary and macroprudential policy measures taken since the 2018 Survey

Main recommendations of the 2018 Survey	Action taken since 2018
Gradually normalising monetary policy	
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.	The ECB has expanded its asset purchase programme by an overall EUR 1970 billion (16.5% of the euro area 2019 GDP). This mainly consists of the EUR 1850 billion Pandemic Emergency Purchase Programme, with net purchases set to continue until it is judged that the COVID-19 crisis phase is over but not before March 2022. The Governing Council stated that to the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, it will consider revising them to the extent necessary to make its action proportionate to the risks.
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.	In December 2018, the Council and the European Parliament agreed to amend the Capital Requirements Regulation and Directive (CRR/CRD IV), as part of a broader overhaul of the EU's prudential and resolution rules for banks ("banking package"). The banking package includes a number of targeted improvements to the macroprudential provisions in CRR/CRD IV. Since 2018, the Commission approved several national measures implemented on the basis of Article 458 of the CRR (so called "national flexibility measures"), aimed to enhance the resilience of credit institutions to potential downward corrections in the residential real estate markets (in Belgium, Estonia and Finland) and to unsustainable developments in debt levels of large non-financial corporates to which the credit institutions are highly exposed (in France).
To better gauge commercial real estate price dynamics, systematically collect granular and harmonised data on commercial real estate.	In spring 2018 the ESS (European Statistical System) paved the way for working towards building up a data collection on commercial real estate indicators (CREI) which does not exist at European level yet. As a first step the TF CREI (Task Force Commercial Real Estate Indicators) was established and met regularly since autumn 2018. In March 2019, the Commission (Eurostat) received an ESRB Recommendation for establishing a common minimum framework for the physical CRE market within the ESRB Recommendation on closing real estate data gaps (ESRB/2016/14, as amended by ESRB/2019/03).

The review of the monetary policy framework

Following a review of its monetary policy framework launched in January 2020, the European Central Bank (ECB) has recently updated its monetary policy strategy (Box 1.2). The new monetary policy framework represents a step forward in many directions and it will improve the ECB capacity to conduct monetary policy effectively over the coming years. The revision of the monetary framework was long overdue since the central bank monetary policy strategy, which was set in 1998, was last reviewed in 2003. Throughout this time, the economy of the euro area went through some profound structural changes, including declining productivity and trend growth, ageing population, as well as the legacy of the financial crisis. The toolkit at the disposal of the central bank has increased too. As acknowledged by the ECB, in the context of a fast changing economy, the euro area would benefit from more regular in-depth reviews of the monetary policy framework as planned by the Bank of Canada and the Federal Reserve.

The main outcomes of the review can be grouped in three main areas: (i) a new quantitative formulation of the price stability objective; (ii) the stocktaking of the available toolkit to achieve this objective, including its communication strategy; and (iii) an analysis of other considerations relevant for the conduct of monetary policy, such as financial stability, employment and environmental sustainability.

Box 1.2. The new monetary policy strategy of the ECB

The main components of the new framework are:

- *A new definition for the price stability objective:* the new strategy adopts a symmetric 2% inflation objective, over the medium term. This will replace the previous formulation of the price stability objective, notably the aim of maintaining inflation rates for the euro area “below, but close to, two per cent”. The medium-term orientation remains.
- *A future change in the measurement of the price index:* The Harmonised Index of Consumer Prices (HICP) will remain the price measure to assess the price stability objective. However, the ECB recognises that the inclusion of the costs related to owner-occupied housing in the HICP would better represent the inflation rate that is relevant for households and it will initiate a multi-year project with Eurostat in order to ensure the full inclusion of owner-occupied housing in the HICP.
- *The incorporation of climate change considerations into the monetary policy framework:* The ECB is committed to including climate change considerations in monetary policy operations in the areas of disclosure, risk assessment, collateral framework and corporate sector asset purchases along a precise roadmap. To do so the ECB will expand its analytical capacity in macroeconomic modelling, statistics and monetary policy with regard to climate change.
- *Improved communication.* The ECB is committed to improving its communication with the aim of enhancing the information and its accessibility for various audiences. The monetary policy statement relative to the ECB’s monetary policy decisions has been streamlined and its clarity improved. Its structure has been adapted, with a focus on an integrated narrative motivating the policy decision. The ECB intends to make outreach events a structural feature of the Eurosystem’s interaction with the public. Such future events will have both a “listening” and an “explaining” dimension, to enable the public to understand the ECB’s monetary policy strategy and its implications.
- *The establishment of a regular review cycle for the monetary policy framework.* The next assessment is expected in 2025.

Additional elements of the review include: a stock-taking of new monetary policy instruments adopted by the central bank over the past decade and a recognition that they have become part of the ECB’s toolkit and the introduction of a proportionality assessment as an integral part of monetary policy decisions. This assessment includes an analysis of the benefits and the possible side effects of monetary policy measures.

Making the inflation objective symmetric

Under its mandate, the ECB is asked to achieve price stability. While this mandate is clearly stated in EU treaties, the operational definition of price stability is delegated to the ECB. The previous monetary policy framework defined price stability with a formulation comprising a year-on-year increase in the HICP for the euro area of below 2%. Also, in the pursuit of price stability the Governing Council aimed to maintain inflation rates below, but close to, 2% over the medium term. The new formulation of the quantitative inflation objective is defined as “a two per cent inflation target over the medium term”. This formulation is welcome: the new target is simple, clear and easy to communicate, and it is thus expected to contribute to a more solid anchoring of longer-term inflation expectations.

The new formulation of price stability also attempts to remove the asymmetry in the previous target, often perceived implying stronger corrections when the inflation rate is above than below 2%. At times, the ECB has been criticised for tightening too rapidly when inflation was above the Governing Council’s aim (the last instance being the hike in summer 2008 just before the peak of

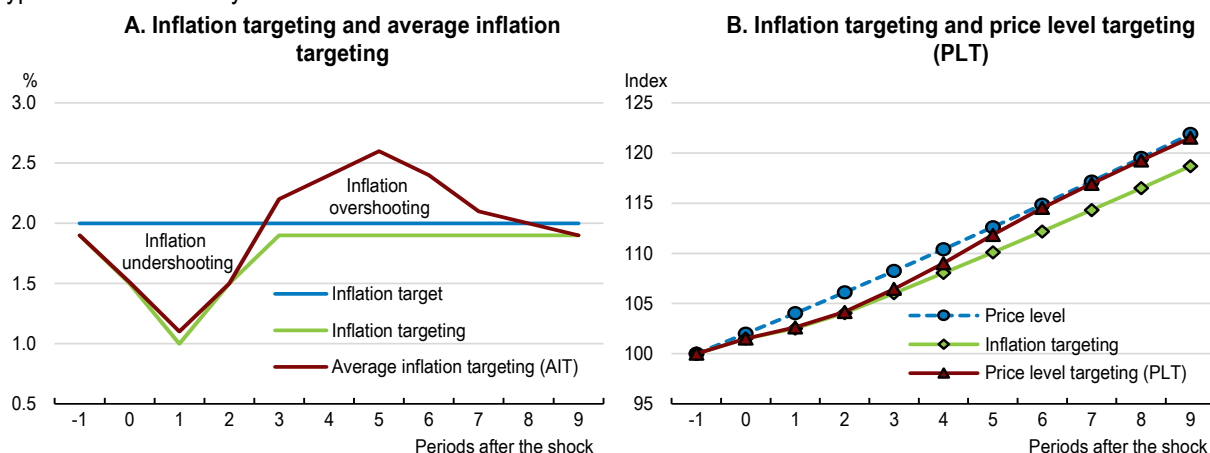
the global financial crisis), while loosening less rapidly when inflation was undershooting the aim. The removal of the wording “below 2%” from the definition of price stability enshrines symmetry more explicitly in the formulation of the price stability objective.

While the new formulation confirms the medium-term inflation objective relevant to monetary policy decisions, it does not explicitly detail how this objective is met. To smooth the reaction to inflation spikes, the ECB could have considered targeting its inflation objective on average over a certain period (Average Inflation Target, AIT). A variant of this framework has been recently adopted by the Federal Reserve Board (Box 1.3) and previously by the Reserve Bank of Australia. A central bank adopting an average inflation target chooses a period of time over which it measures inflation with the goal of meeting a numerical target on average. By including past inflation in the current assessment, this framework differs from a conventional inflation target; in an average inflation target framework past-periods of below-target inflation (so-called “bygones”) give rise to policies aimed at inflation overshooting (so called “makeup strategies”) as to achieve the target on average over the medium term (Figure 1.10).

An alternative framework such as the Price-Level Targeting (PLT), in which a central bank targets a specific level of a price index, could be a useful benchmark among makeup policies, but it also represents a more significant and perhaps undesirable departure from the flexible inflation-targeting framework compared with average inflation targeting. Both price-level targeting and average inflation targeting strategies imply promises of above- or below-target inflation in the future, possibly under quite different economic conditions, and rely on the commitment for makeup policies that aim temporarily at higher inflation after a period of too-low inflation. The benefits of a makeup strategy would therefore depend on the extent inflation expectations are forward-looking, and on whether households and firms believe that higher inflation will be delivered when the time comes. As a consequence, under these makeup strategies, credibility, commitment, and time consistency have an important role. Ultimately, although the new definition of price stability supports the ECB commitment to react equally against upward and downward deviations of inflation from the objective, it nonetheless falls short of identifying an explicit role for make-up strategies, which could play a role in stabilising inflation expectations around the target over the medium term. An assessment of the possible role of makeup strategies for the conduct of monetary policy in the euro area could be included in the next review of the monetary framework planned in 2025.

Figure 1.10. Average inflation targeting and price level targeting require periods of above-target inflation after inflation undershooting

Hypothetical inflation dynamics after a shock.



Source: OECD calculations.

StatLink  <https://doi.org/10.1787/888934276166>

The assessment of new non-standard instruments

The ECB has proved innovative in the use of new, non-standard instruments of monetary policy during the global financial crisis, and showed resolution in their extension in the wake of the COVID-19 pandemic. The review of the monetary policy framework assessed and took stock of the effectiveness of such new tools. However, the review did not discuss possible new ways to stimulate the economy, during times of persistently low inflation. A few options could be worth exploring in such circumstances (for a broader discussion, see Praet, 2016).

Box 1.3. The review of the monetary policy framework by the Federal Reserve

In early 2019, the Federal Open Market Committee (FOMC) of the Federal Reserve launched a comprehensive review of its monetary policy framework (MPF), comprising the strategies, tools, and communication practices employed by the central bank to achieve its mandate of maximum employment and price stability. The review, however, took the Federal Reserve's statutory mandate as given as well as the FOMC's previously articulated longer-run inflation objective of 2 percent.

The review process featured three key components: (i) a “Fed Listens” initiative providing outreach to and consultation with a broad range of people and groups across the country; (ii) a flagship research conference that brought policymakers together with academics and researchers; and (iii) a set of five ad-hoc discussions in consecutive FOMC meetings informed by analytical work by research staff across the Federal Reserve System.

In August 2020, the FOMC released one of the key products of the review, a consensus Statement on Longer-Run Goals and Monetary Policy Strategy that modify the way the FOMC articulates its actions for the first time since 2012. Main changes include:

- The adoption of a “flexible form” of average inflation targeting implying the achievement of an “inflation that averages 2% over time”. Flexibility with respect to a standard average inflation targeting (AIT) framework comes from the fact that decisions about appropriate monetary policy will continue to reflect a broad array of considerations and will not be dictated by any formula.
- The decision of assessing, for the purpose of monetary policy, ‘shortfalls’ rather than ‘deviations’ from full employment. This implies that improvements in the labour market, based on a set of indicators rather than estimated NAIRUs, would trigger a tightening only if they come with significant price pressures.
- The explicit identification of financial stability concerns as an important part of the Fed's mandate.

The FOMC stated the intention of conducting a regular review of its monetary policy strategy, tools, and communication practices roughly every five years.

A yield curve control would require the ECB to target some medium- or longer-term rate and pledge to buy as many bonds as needed to keep the rate from rising above its target. The experience of the Bank of Japan and the Reserve Bank of Australia suggests that, if pledged with enough credibility, yield curve control could allow the central bank to achieve the targeted yield curve configuration, potentially with a more limited amount of actual asset purchases with respect to a protracted APP. The implementation of a yield curve control framework would anyway be more complex in the euro area than in other jurisdictions, since the ECB would need to target 19 sovereign yield curves. Alternatively, the ECB could consider targeting the yield curve of the euro-denominated asset linked to Next Generation EU, or a risk-free yield curve, such as the overnight index swap curve, coupling it with a flexible use of the ECB's asset purchase programme. In any case, a yield curve control framework in the euro area is likely to have a different connotation with

respect to similar programs adopted in other advanced economies, as dynamics in long-term yields for euro area countries have been driven more often by differentials in credit risk premia, than in term spreads or inflation expectations.

New methods for monetary policy to support directly aggregate demand, and especially consumption, could also be considered. For example, via ad-hoc refinancing operations targeted to consumer-credit, as to link bank financing costs to the achievement of lending targets in specific segments of credit to consumers. Linking bank reserve remuneration to the same targets could strengthen the pass-through. Consumer credit targeted refinancing operations and yield curve control are potentially extreme (and controversial) ways in which a monetary authority could stimulate the economy, and a possible assessment of such tools should take into account a rigorous balance of risks.

Characterising new communication tools

The review of the monetary framework provided guidelines for an improved ECB communication strategy. The elements of the new communication strategy are primarily a new monetary policy statement, streamlined and focusing on an integrated narrative, and a set of outreach events that are to become a structural feature of the Eurosystem's interaction with the public. The new ECB communication strategy thus includes some important positive innovations that aim at extending communication to a wider audience beyond financial market participants and policy makers. This can increase the awareness of all citizens about the monetary policy process and decisions, a particularly important feature in countries where monetary policy decisions face regular criticism from the public.

Further options to improve communication could have included making the individual views of Board members public or even encourage ECB Board members to publish their expected policy rates paths (OECD, 2018). The experience of central banks in other jurisdictions (the Federal Reserve publishes “The Federal Open Market Committee” participants’ assessments of the appropriate future policy rate, in the form of the “dot plot” in the Summary of Economic Projections) shows that path guidance has been successful in coordinating disperse market views on future interest rates. Even in the European context, revealing diversity of views and expectations of monetary policy can enhance the transparency, accountability, and effectiveness of monetary policy by contributing to stabilise private sector expectations in line with the desired monetary policy stance. At the same time, to be effective, communication on diverse views needs to be systematic and coherent to avoid that disagreement give rise to noise and misunderstandings, in turn diluting policy signals. A move in that direction would require some changes in the operational practices of the ECB while consideration also needs to be given to shield Governing Council members from national pressures and preserve their independence.

Incorporating climate change in the framework

Monetary policy may need to take into account the impact of climate change on the economy. Climate change can affect macroeconomic conditions in a number of ways: recurrent major climate events (such as droughts) may affect headline price dynamics, among others through temporary spikes in agricultural prices. Global warming can permanently affect agriculture yields producing durable alterations in relative prices which may be more difficult for the central bank to look through (Figure 1.11). Policies taken by all actors, including governments, to combat climate change can also affect macroeconomic conditions and price dynamics.

Following the review of its monetary policy framework, the ECB has committed to an ambitious climate-related action plan to further include climate change considerations in its monetary policy framework. As a first step the ECB will enhance its analytical and macroeconomic modelling

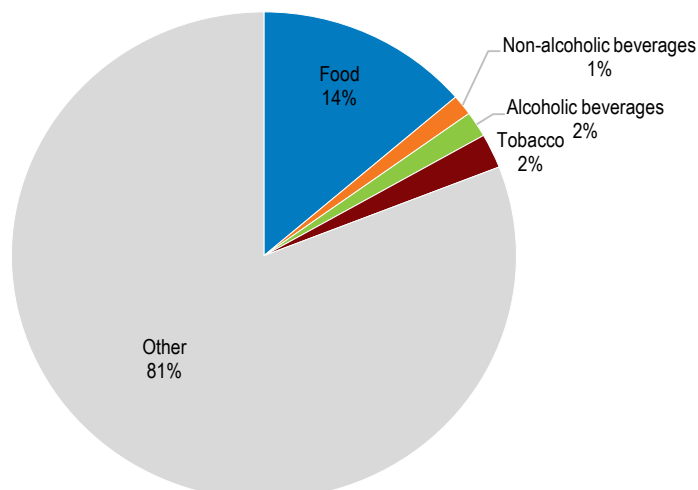
capacities and develop statistical indicators to foster the understanding of the macroeconomic impact of climate change and carbon transition policies. Second, the ECB will adapt the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework. More in detail, the ECB will introduce disclosure requirements for private sector assets as a new eligibility criterion or as a basis for a differentiated treatment for collateral and asset purchases and it will start conducting climate stress tests of the Eurosystem balance sheet in 2022 to assess its exposure to climate change. Finally, the ECB will consider relevant climate change risks when reviewing the valuation and risk control frameworks for assets mobilised as collateral by counterparties in its credit operations and will take relevant climate change risks into account in its due diligence procedures for its corporate sector asset purchases in its monetary policy portfolios. The action plan is supported by a detailed road map that should define targets for climate-related actions to be achieved by 2024.

The establishment of more standardised and broader climate-related disclosures from issuers of assets eligible as collateral for ECB's asset purchases and bank borrowers, can pave the way for a so-called "green" quantitative easing. This can be operationalised by introducing an explicit bias towards green assets in the APP framework, by rebalancing the existing portfolio by overweighting/underweighting least/high carbon-intensive companies, or by excluding bonds issued by carbon-intensive companies or sectors. The launch of long-term facilities designed to steer credit supply towards activities that contribute to the green transition ("green TLTROs") could also be considered.

However, the effectiveness of a green quantitative easing could be limited as some recent studies have found little evidence for green bond issuance being associated with a reduction in carbon emissions (Ehlers et al., 2020). This result may be due to the prevailing uncertainty around what qualifies as a green activity. Some research suggests that a more explicit bias toward green bonds in the ECB APP could reduce emissions only if green and non-green bonds are imperfect substitutes, as to prevent investors to exploit arbitrage between bonds issued by the green sector and bonds issued by the non-green sector (Ferrari and Nispi Landi, 2020). From an implementation standpoint then, a green QE would also require relevant regulation biasing investor preferences toward green bonds.

Figure 1.11. Agriculture-related products account for almost 20 percent of the euro area HICP

HICP main sub-components for the euro area, 2020.



Note: Food includes both processed and unprocessed food.

Source: Eurostat.

StatLink  <https://doi.org/10.1787/888934276185>

A green QE may entail some rethinking of the role of the central bank in the economy, and can deliver possibly unwanted side effects. Central banks are managed by officials, independent from political influence and are tasked with the control of a macroeconomic objective (inflation). Redefining the role of the monetary authority in order to target specific social or sectoral objectives may risk stretching central bank actions to domains traditionally reserved to elected officials (such as fiscal policy). This may risk conditioning the monetary policy action to that political process that the definition of such new objectives entails.

Moreover, from an economic standpoint, a policy based on subsidised credit may be not optimal for the development of the green economy. The experience of conducting industrial policy through subsidised credit, in jurisdictions where it took place, like China, has been linked with the rise of a number of fragilities in targeted sectors, such as overcapacity, excessive leverage, credit overreliance and low profitability. Green investment, due to the longer horizon of underlying projects, is instead likely to benefit more from an extension of equity financing.

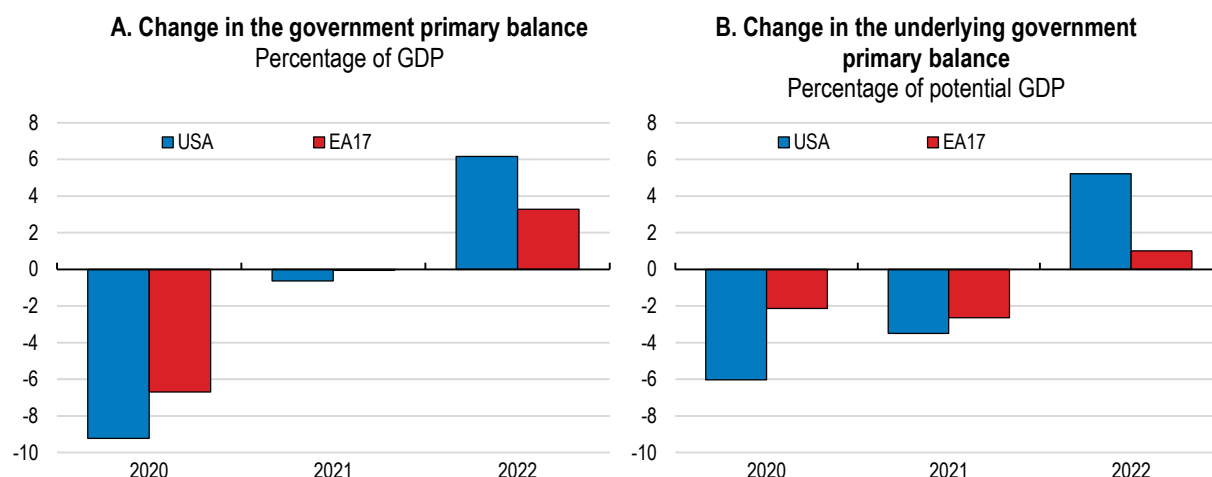
In light of the above, the inclusion of climate-related considerations in the conduct of monetary policy should ideally be limited to the tangible risks posed to the financial sector and the monetary transmission mechanism. The ECB should, on the other hand, resist the temptation of using monetary policy as a tool to finance directly the (needed) transition to a low-carbon economy. Against this background, a possible “green bias” in the conduct of monetary policy needs to be grounded on a rigorous, compelling and numerically quantifiable mapping of climate-related impacts on the assets possibly subject to this bias. The ECB showed a firm commitment to this end. Yet, such a precise quantification is very complex and has proved elusive so far, representing one of the main challenges to the ECB plan to include climate-related considerations in its monetary policy strategy.

The EU needs to evaluate its fiscal governance framework to improve its functioning

The COVID-19 crisis will have profound impacts on fiscal balances, but support is still needed

The fiscal response to the coronavirus pandemic has been robust. European governments have used the full flexibility embedded in the Stability and Growth Pact (SGP) to support their economies, also through the temporary adjustment of the State aid regime. The EU activated the general escape clause of the SGP, allowing for temporary deviations from the requirements of the SGP. A wide range of fiscal stimuli have been put in place, including measures aimed at expanding medical capacity, and schemes in support of workers and firms. Wage subsidies and short time-work schemes for employees have been strengthened in most EU countries – a welcome measure – and, in some cases, grants were offered for the self-employed. Businesses have benefited from certain tax measures, including the deferrals of some taxes and social security contributions. In the euro area as a whole, measures with a direct impact on the budget balance are estimated to account to a discretionary stimulus in 2020 of around 2 percentage points of GDP. This is large by historical standards, but smaller with respect to other advanced economies, such as the U.S. (Figure 1.12), although it should be noted that automatic stabilisers (estimated at around 4% of GDP in 2020) are much larger in the euro area than in the U.S., as is the magnitude of liquidity support measures, which are outside the deficit figures.

Figure 1.12. The fiscal response to the crisis was large



Source: OECD (2021), OECD Economic Outlook 109: Statistics and Projections (database).

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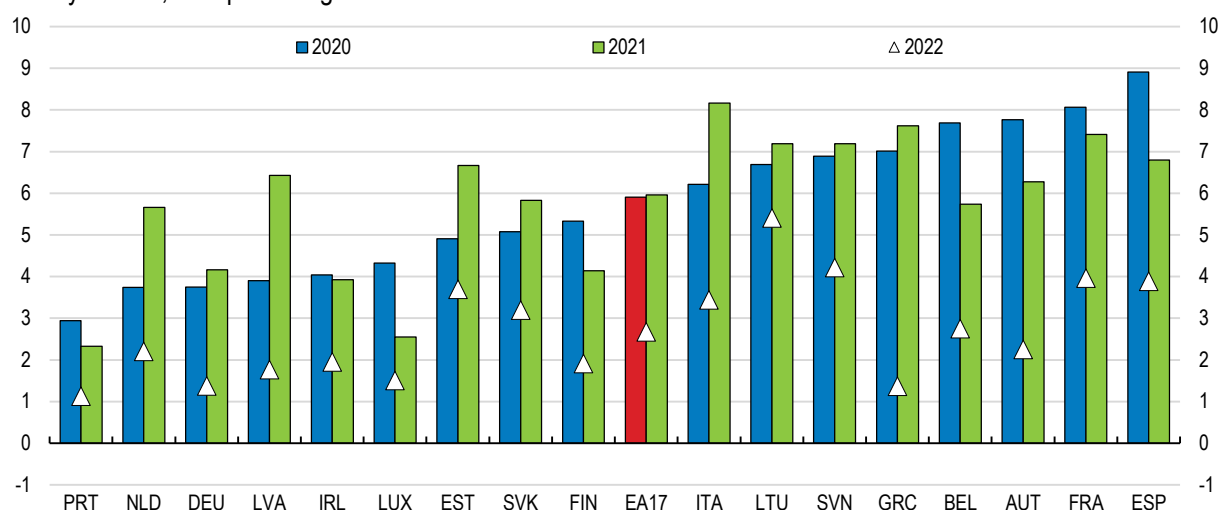
The impact on public finances of the economic downturn, combined with the fiscal packages put in place to counteract it, will be large (Figure 1.13 and Figure 1.14). For the euro area as a whole debt is expected to reach the all-time high of close to 103% of GDP in 2021. The possibility that a proportion of corporate sector guarantees will be called risks widening fiscal deficits further in the near future. Stable financing sources and historically low borrowing costs are likely to support debt sustainability over the short-term. However, a possible post-pandemic decline in potential output growth and heightened credit risk tensions – if they materialise – could put to test medium-term fiscal sustainability in some euro area countries.

Despite these challenges, it is important for fiscal policy to keep supporting the euro area economy until the recovery is firmly established. Fiscal policy support should be contingent on the state of the economy, with new policy measures implemented promptly and fully if required. The explicit commitment not to reduce fiscal support until the health crisis is over and the recovery is firmly underway in the euro area has supported economic confidence, increasing the predictability of the future fiscal stance and reducing the risk of a premature tightening - a policy mistake made in the aftermath of the global financial crisis.

During the recovery, fiscal support should be more targeted, and public investment will need to focus on productive projects. member states should focus on reforms that will promote private investment and will increase the productive capacity of the euro area. The implementation of Next Generation EU recovery package will need to be ambitious and efficient. General business lifelines should be gradually replaced with a support to firms with good post-pandemic viability prospects, while facilitating the exit of unviable companies. The identification of viable businesses is hard; in some cases, it could be guided by an analysis of pre-crisis average profitability or turnover ratios. In the case of small businesses, banks could be involved in the assessment. At the same time, the phasing out of job retention schemes should be paired with the scaling up of skilling and activation policies, so as to facilitate job reallocation. Once the recovery is firmly under way, euro area member states should address increased public debt levels by implementing sustainable medium-term fiscal strategies, with an emphasis on improving the quality of public finances.

Figure 1.13. Deficits will remain high in 2021

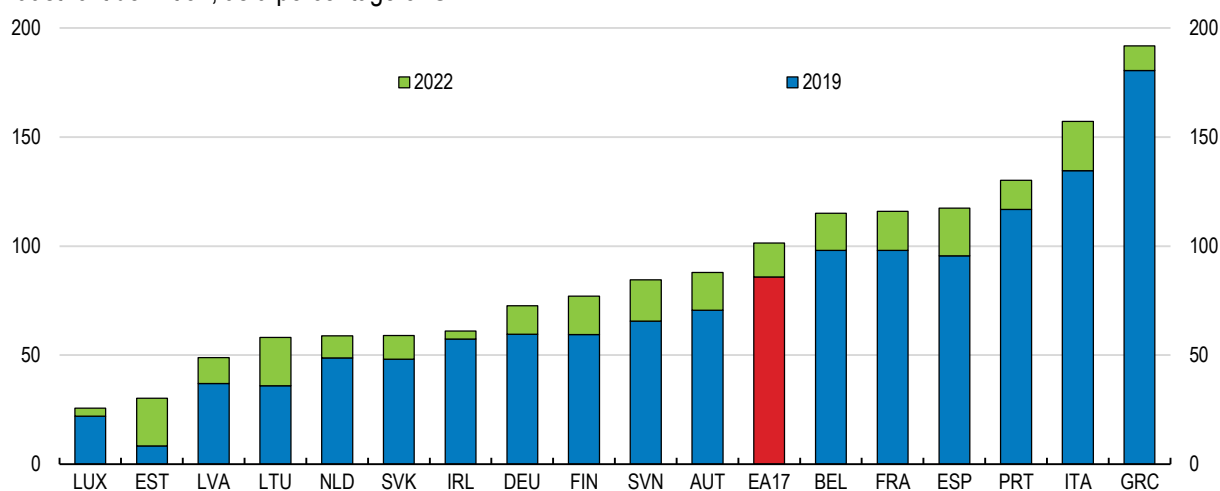
Primary deficits, as a percentage of GDP



Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

StatLink <https://doi.org/10.1787/888934276223>**Figure 1.14. Public debt increased substantially in 2020 and will remain high in the coming years**

Maastricht definition, as a percentage of GDP



Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

StatLink <https://doi.org/10.1787/888934276242>**Improving EU fiscal rules will make fiscal policies more effective***Reviewing fiscal benchmarks to ensure sustainability, reduce complexity and avoid pro-cyclicality*

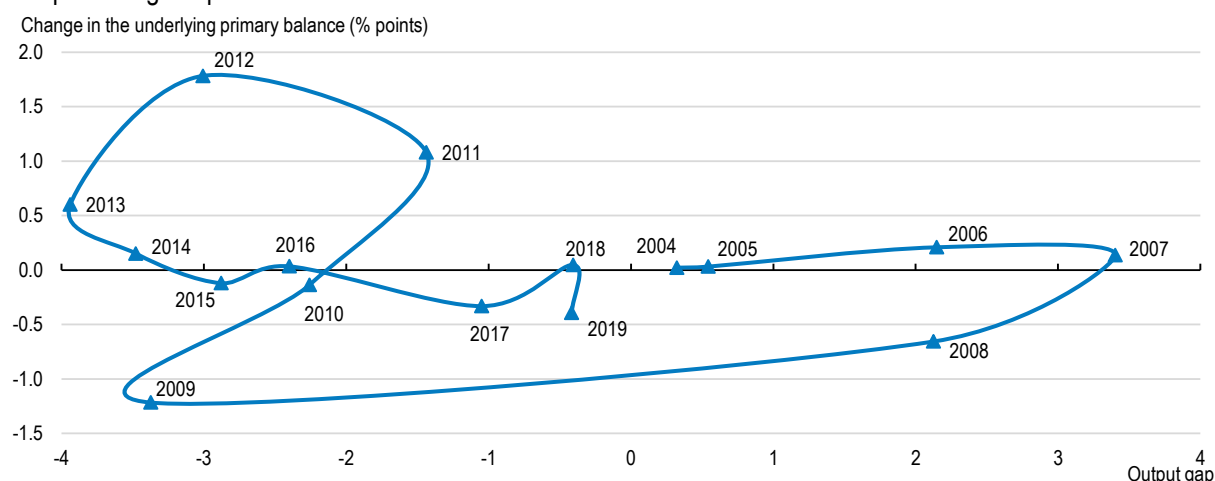
The European fiscal framework has shown some limitations in the past, and there are reasons to believe that its application could face new challenges after the current crisis. During and in the aftermath of the global financial crisis, European fiscal rules did not succeed in preventing pro-cyclical fiscal policies (Figure 1.15; and Figure 1.16). The experience with the Stability and Growth

Pact illustrates the difficulties arising when tackling both sustainability and cyclical issues in a strict rule-oriented framework. To avoid pro-cyclicality in fiscal policy, the preventive arm of the Stability and Growth Pact is based on a set of rules that targets country specific Medium-Term Budgetary Objectives (MTOs), which are cyclically adjusted balances net of one-off measures. The main issue of the cyclically adjusted fiscal balance is that different methods for its estimation can yield different results and that forecasts and outturns can be subject to large errors and significant revisions.

The Stability and Growth Pact evolved over two decades through successive layers of reforms, to make it better able to take economic conditions into account. As a result, the complexity of the framework has grown over time, on the back of a proliferation of different numerical targets, procedures, contingency provisions and compliance indicators (OECD, 2014; OECD, 2016). The process of monitoring of fiscal imbalances has become increasingly intricate and contentious, generating dissatisfaction among member states and weakening its capacity to ensure sustainable and predictable fiscal dynamics. Moreover, in the past, consolidation episodes often came to the detriment of public investment, and the European fiscal policy framework did not succeed in encouraging the build-up of sufficient fiscal buffers in good times (Figure 1.17; European Fiscal Board, 2019; Eyraud, et al. 2017).

Figure 1.15. The fiscal stance in the euro area has frequently been pro-cyclical or neutral, rarely counter-cyclical

As a percentage of potential GDP



Note: Euro area member countries that are also members of the OECD (16 countries).

Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database).

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Finally, the pandemic presents an additional challenge for the application of the current fiscal framework. The COVID-19 crisis led to a large deterioration in fiscal balances in the euro area and, in the coming years, compliance with the debt reduction rule would require large consolidation efforts to many euro area countries, with the risk of adversely affecting the recovery. As an example, a country with a debt to GDP ratio of 130% would be required – if this rule applies – to reduce its debt ratio by 3.5 percentage points on average each year. Under 3% nominal growth, this would roughly require a balanced budget, and thus a large consolidation effort, which may risk leading the country back into recession. Moreover, Europe faces large investment needs in the near future, which will need to be supported in part by public spending, and also by improving the quality of public finances; to meet environmental targets alone, the additional annual investment over the next decade has been estimated at around EUR 470 billion per year (3½% of EU GDP; European Commission, 2020).

Box 1.4. Numerical rules and their choice

Fiscal rules are generally assessed against their capacity to correct fiscal policy biases, thus ensuring sustainability and economic stabilisation (within the rule or through ad-hoc escape clauses), and on their capacity to perform this task efficiently, with operational simplicity and offering policy guidance, resilience, and ease of monitoring and enforcement (Kopits and Symansky, 1998). Against these benchmarks different fiscal rules fare differently, although all these criteria are unlikely to be simultaneously achievable by a single fiscal rule, and in practice, different fiscal rules entail different trade-offs (Lledo et al., 2018).

Overall balance rules impose a ceiling on the headline deficit, in nominal terms or in percent of GDP. Overall balance rules are simple, easy to communicate because they rely on well-known fiscal aggregates. Moreover, they tend to be effective in supporting debt sustainability, as the overall budget balance is closely linked to debt dynamics. However, they typically do not contain good economic stabilisation features, which can lead to a pro-cyclical fiscal stance (Lledo et al., 2018).

Cyclically-adjusted balance rules instead set limits on the overall balance, but correct for the effects of business cycle fluctuations on revenue and expenditure (Fedelino, et al., 2009). The aim of cyclically-adjusted balance rules is to offer better stabilisation properties than traditional nominal budget rules. However, monitoring and enforcing cyclically-adjusted balance rules can be challenging, due to the difficulty of estimating the output gap. Similar to cyclically-adjusted balance rules, structural balance rules adjust the overall balance beyond business cycle revenues and expenditures, by also correcting for one-offs. Their computation and monitoring tend to be more complicated than cyclically-adjusted balance rules (Bornhorst et al., 2011).

Over-the-cycle-rules target the same aggregate of budget balance rules, but in this case ceilings are imposed not annually but on average over the years, thus encompassing different stages of the business cycle (IMF, 2009). These type of rules tend to have strong stabilisation properties (Caceres and Ruiz-Arranz, 2010), but their greater flexibility tend to come to the detriment of higher complexity and a more arduous real time monitoring. This is because the peaks and troughs and the distance between them are unknown until the cycle is complete.

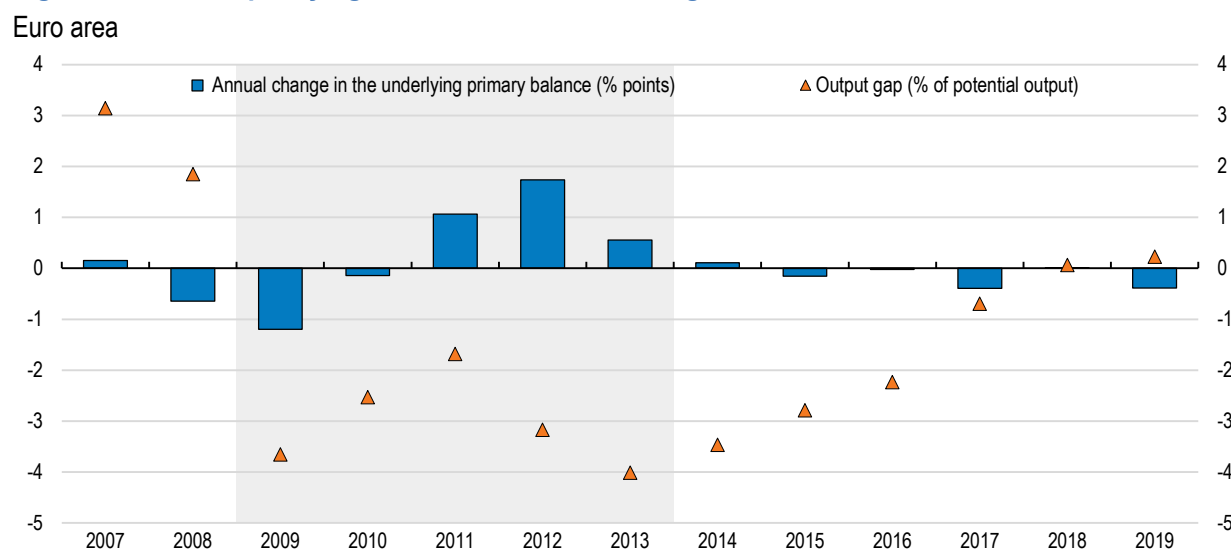
Expenditure rules set limits on a broad expenditure aggregate (e.g. total, primary, or current spending, sometimes excluding some items). These limits can apply to nominal or real expenditure and they are typically set in absolute terms or growth rates. In net expenditure rules, additional expenditures can be possible, if they are funded by discretionary revenue measures. Expenditure rules are generally easier to understand, monitor, and enforce than most other rules, because they target a part of the budget the government controls most directly (Lledo et al., 2018; Ayuso-i-Casals 2012; Manescu and Bova, 2020). Expenditure rules can support macroeconomic stabilisation, allowing automatic stabilisers, which are mostly on the revenue side, to operate in times of adverse shocks (Ayuso-i-Casals 2012). Even greater counter-cyclicality can be achieved by excluding cyclically sensitive expenditure items, such as unemployment benefits. On the other hand, expenditure rules tend to bias the composition of expenditure towards items which are politically harder to cut, and may thus induce lower levels of public investment (unless the latter is excluded from the rule, which in turn would increase complexity and might create incentives for creative accounting). Moreover, the calibration of the expenditure target may also rely on hard-to-measure variables and, to be effective, expenditure rules need to be linked to a long-term fiscal anchor, like the debt to GDP ratio.

Against this background, there is a need for the EU to evaluate its fiscal framework with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership.

Choosing a better numerical benchmark

Some of the issues affecting the current European fiscal framework – including excessive complexity – could be addressed by modifying the numerical benchmark underpinning the preventive arm of the Stability and Growth Pact. Different types of numerical rules with different characteristics can be considered for the task (Box 1.4). However, ultimately, the identification of the suitable numerical benchmark will require making a choice along possible trade-offs (for example between stabilisation and simplicity), and it will need to be guided by economic circumstances as well as country preferences (Lledo et al., 2018).

Figure 1.16. Fiscal policy tightened too soon after the global financial crisis



Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

StatLink  <https://doi.org/10.1787/888934276280>

Among possible alternatives, expenditure rules anchored to debt targets have been the object of extensive research and should be considered attentively for a reform of the European fiscal framework (Box 1.5; OECD, 2018; European Fiscal Board, 2018; IMF, 2020; Table 1.4). Expenditure rules have also a positive track record of successfully curbing the deficit bias in some European countries (Box 1.6). However, pure expenditure targeting does not correct a structural tendency toward excessive deficits, as curbs to the rate of growth of expenditure can still be consistent with a deterioration of the fiscal balance, if the government cut taxes. In practice, an expenditure rule should be characterised by a ceiling on the growth rate of expenditure net of discretionary revenue measures. In principle, expenditure rules should be as broad-based and simple as possible. The use of comprehensive aggregates reduces the risk that expenditure ceilings are circumvented by increasing the outlays excluded in the targeted aggregate.

Some country specificity is necessary

The fiscal position and fiscal needs of euro area countries are very diverse and there should not be expectation that a single rule could represent a good fit for all European countries. A country-specific adjustment could be enclosed in the general fiscal rule, while taking into account the need to ensure predictability, transparency and equal treatment across countries. This should reflect the need for different consolidation efforts across the block. For the specific quantification of the adjustment, the European Fiscal Board proposes an *ex-ante* country-differentiation of debt-reduction strategies, based on a set of key macroeconomic variables (i.e. the actual debt ratio, the

growth rate and borrowing interest rates), or a speed of adjustment based on a case-by-case basis, taking into account a comprehensive economic judgement (European Fiscal Board, 2020). These proposals could be considered.

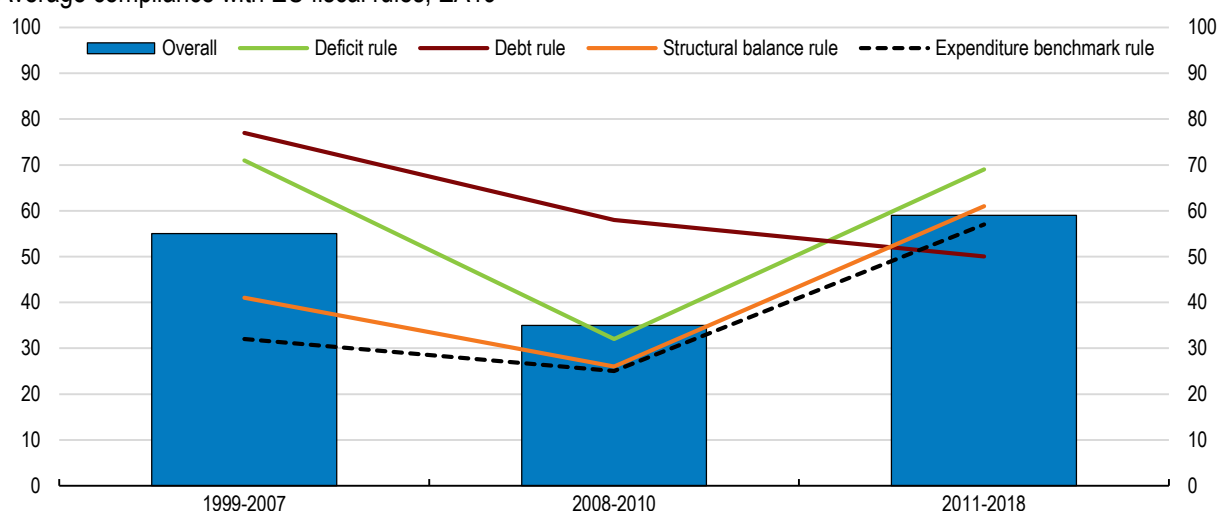
Box 1.5. Analytical assessment of expenditure rules

Theoretical models and simulations often provide only limited practical insight for the assessment of fiscal rules, owing to their often stylised framework and their heavy reliance on restrictive assumptions. For example, the vast majority of existing DSGE models consider debt sustainability as just one constraint that must be satisfied, and they neglect government commitment issues and time inconsistencies (Mbaye and Ture, 2018).

With these limitations in mind, the existing literature suggests that expenditure rules perform well in simulations and analytical exercises. Assessing the fiscal performance of euro area countries between 1999 and 2009, Hauptmeier et al., (2011) find that an expenditure rule over the 1999-2009 period in all EU countries would have implied lower primary expenditure ratios by 2-3 ½ pp in 2009. Ducoudré et al., (2018) simulated fiscal policy that would have resulted from the rule proposed by Bénassy-Quéré et al. (2018) for France between 1997 and 2017. Under most scenarios considered, the expenditure rule would have performed better in term of debt reduction and counter-cyclicalities than the actual policy adopted. Brück and Zwiener (2006) analyse the effectiveness of deficit and expenditure rules for business cycle stabilisation in Germany. Results show that in general the deficit benchmark of the Stability and Growth Pact leads to more limited cyclical stabilisation than an expenditure rule. Andrieu et al., (2015) compare the performance of the expenditure and structural balance rules if they had been implemented in Italy and France. In this scenario, public debt would have been significantly lower under expenditure rules.

Figure 1.17. Compliance with EU fiscal rules has been low

Average compliance with EU fiscal rules, EA19



Note: The overall compliance rate is the frequency of compliant cases across all rules, years and countries, as a percentage of all cases.

Source: European Fiscal Board (2019).

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Higher ownership and a holistic approach to fiscal sustainability could justify more ambitious reforms

The European fiscal framework has been so far mostly guided by debt sustainability concerns, and in particular by fears that a debt crisis in one country would place undue pressure on the common monetary policy or create financial instability across the euro area (Blanchard et al., 2020). Sustainability and financial stability concerns remain valid, and all the more so given the impact of the pandemic crisis on public debt and banks' balance sheets. Yet, debt sustainability should be assessed in a longer run perspective, while the current European fiscal setting tend to be primarily driven by shorter-term objectives.

To respond to those challenges, focus areas to consider for the European fiscal framework could include three key directions:

- Ensuring a higher ownership of rules at the political and citizens' level. Without such ownership, sustainability of public finances cannot be achieved durably, as the poor track record of compliance with the current European rules illustrates. To that aim, rules and their implementation should respond to citizens' needs and their perceptions of fairness within and between generations. However, the imposition of tight numerical targets in difficult times can undermine political and citizen ownership of national fiscal policies.
- Maintaining the capacity of fiscal policy to smooth the economic cycle. Many countries tend to refrain from fully using fiscal space when their economy goes into recession, while others do not build sufficient fiscal buffers when the economy is booming. This makes it more difficult to coordinate effectively fiscal stances in case of shock, putting an excessive burden on monetary policy.
- Preserving the capacity to invest for the future. This is key for growth, as public investment crowds-in much private investment in times of large changes, such as now with both digital and climate transformation at the horizon. In the long run, growth is the main factor underpinning sustainability.

Against this background, alternative and more ambitious reforms of the current fiscal framework could be considered. Countries could be given sufficient degrees of freedom to decide how best to adapt their national fiscal framework, while respecting principles set at European-level about fiscal sustainability and counter-cyclicalities. Rather than complex and over-prescriptive fiscal rules, the reform of the European fiscal framework could emphasise more qualitative guidelines to promote the triple objectives outlined above. Recent work by the European Fiscal Board on the country differentiation of debt reduction strategies, taking into account a comprehensive economic assessment (European Fiscal Board, 2020), provides a valuable starting point.

In such a setting, national fiscal frameworks and medium-term fiscal targets would still need to be monitored and endorsed at the EU level. The focus should be on the consistency of national arrangements with European principles of sustainability, counter-cyclicalities and quality of public finances. In addition to establishing new principles that countries should follow in national fiscal policies, the EU should also further characterise the scope and means of independent fiscal institutions, by providing new guidelines on the way they should operate. As national fiscal rules gain prominence, so should a stronger involvement of independent institutions (discussed in the next Section). The two objectives of setting high-level principles and ensuring adequate oversight by independent institutions should be put at the same level to effectively enhance public finances management.

Box 1.6. Expenditure rules in EU national fiscal frameworks: the Netherlands and Sweden

The Netherlands

The Netherlands has a budgetary framework built around multiannual expenditure ceilings. The fiscal process is articulated and begins before general elections. The independent fiscal council (Centraal Planbureau, CPB) provides medium-term macroeconomic projections and evaluates budgetary implications of political party programmes. A non-partisan national advisory group (Studiegroep Begrotingsruimte, SBR) then provides (nonbinding but influential) recommendations on budgetary policy. After the elections, the core of the framework relies on a coalition agreement among political parties. The coalition agreement defines expenditure ceilings in real terms for three main budgetary areas (central government, social security and health care), and sets benchmarks for the revenue side in terms of desired change in the tax base and tax rates. The trend-based principle of the rule implies that while revenues are allowed to fluctuate over the cycle, the expenditure ceilings need to be respected. If spending overruns forecasts, the ministries are required to propose corrective actions. Any additional tax relief needs to be compensated by tax hikes, or vice versa.

In terms of fiscal performance, the framework fared well. The introduction of the rule in 1994 was followed by a significant reduction in spending and debt ratios, until the 2008 crisis. The debt ratio almost halved between 1993 and 2007 to 42 percent of GDP, and spending also declined by 10 percentage points to 42 percent of GDP, even if the expenditure ceilings were breached in the early 2000s, and right before the global financial crisis (Vierke and Masselink, 2017). Following the global financial crisis and the Eurozone crisis, the debt ratio rose by over 25 percentage points of GDP between 2007 and 2014, in part due to financial sector interventions. Overall the success of the Dutch expenditure rule has been linked to the broad coverage of the expenditure ceilings, which has helped monitor and control a large part of the general government activity, the role of independent institutions (such as the CPB and SPR), and coalition agreements on the ceilings, which have enhanced political buy-in and adherence to the rules (Mbaye and Ture, 2018).

Sweden

The expenditure rule in the Swedish fiscal framework is set in nominal terms for the current and next three years and includes a budget buffer to deal with unforeseen cyclical expenditures. This expenditure rule is completed by a budget surplus target for the general government of 1/3 percent of GDP to be achieved on average over the business cycle. Compliance with the surplus target is monitored via several indicators, but there are no formal sanctions or correction mechanisms in place for past deviations. An independent fiscal council assesses ex-post whether public finances are sustainable in the long-term, and are consistent with the surplus target, the expenditure ceiling, and the cyclical position of the economy.

Overall, the Swedish expenditure rule has been successful in maintaining fiscal discipline while avoiding pro-cyclicality (Mbaye and Ture, 2018). Swedish debt went from being among the highest in Europe to one of the lowest from 1998 to 2019, decreasing from about 70% to around 40%. In the same period, in the EU the debt ratio increased from around 60% to 80%. The features contributing to the success of the Swedish fiscal rule include a broad coverage of rules beyond the central government; a well-designed expenditure rule consistent with an over-the-cycle surplus target that has allowed full operation of automatic stabilizers and flexibility for discretionary actions; independent fiscal institutions and broad political and public consensus toward fiscal discipline, which has cemented the respect of the rules even in the absence of formal enforcement mechanisms (Andersson and Jonung, 2019; Mbaye and Ture, 2018).

Improving fiscal responsibility with independent institutions, enhanced medium term budgetary frameworks and positive incentives

Fiscal rules can support stronger fiscal management, but cannot by themselves substitute for a political commitment to prudent fiscal policy. The underlying reasons for the deficit bias and procyclical policies are well known: policymakers tend to focus primarily on the consequences of their discretionary actions in the short term and pay insufficient attention to the medium and the long-term (Kumar and Ter-Minassian, 2007). There may also be political and distributive conflicts which entails the “common pool” problem (the basic tendency for any given political constituency or group to use the available resources for specific distributive purposes without regard to the overall budgetary position). The choice of a numerical benchmark – chosen at national or supranational level – still requires a strong institutional and procedural setting linked to the fiscal process, to support the commitment of authorities to respect fiscal targets. Strong procedural frameworks define the attributes and interactions of participants in the budget process, set deliverables and objectives, aiming to enhance transparency, accountability, and fiscal management. These frameworks typically require the government to commit to a monitorable fiscal policy strategy, usually for a multiyear period, and to report and publish fiscal outcomes and strategy changes on a routine basis.

Fiscal frameworks in Australia and New Zealand place great emphasis on procedures, and the experience of these countries suggests that strong procedure can be pivotal in determining prudent fiscal dynamics. This also requires the presence of independent fiscal institutions, and a context of widespread political commitment to fiscal sustainability. Such commitment in these countries is established to the extent imprudent fiscal decisions are typically sanctioned from a political standpoint, for example, with a reputational damage vis-à-vis elected assemblies or voters.

The possibility of achieving sustainable fiscal dynamics in a context of diverse national commitments to fiscal prudence could rely on strengthening provisions that discourage the misuse of fiscal discretion. The Council Directive 2011/85/EU on requirements for budgetary frameworks of the member states, as well as the Two-pack regulation (Regulation (EU) No 473/2013), introduced some important provisions to reinforce the budgetary surveillance, including via independent fiscal institutions, and national budgetary frameworks of euro area countries. However, improvements are still possible in two directions:

- Promoting accountability of domestic fiscal processes and improving national medium term-budgetary frameworks. The publication of the Stability and Convergence Programmes often does not encourage wider domestic debate on the medium-term direction of fiscal policy. Also plans presented in the Stability and Convergence Programmes are in many instances not executed as envisaged, suggesting a weak link between the annual budgets and these programmes. In general, Stability and Convergence Programmes rely on national medium term budget frameworks that differ quite significantly across countries in terms of political commitment, planning horizon, coverage and detail, formulation of targets and binding nature (Sherwood, 2015). To improve the capacity of national medium term budget frameworks to ensure transparency and prudent medium term fiscal management, reforms should encourage convergence toward best practices in medium term fiscal plans and enhance their visibility in national public debates, as well as their binding nature.
- Increasing the role of fiscal councils (FCs): Evidence suggests that FCs seem to reduce optimistic biases in budgetary forecasts and to improve their accuracy. FCs also appear to foster compliance with budget-balance and expenditure rules, in part through their influence on the accuracy of budget plans (Beetsma et al., 2018). The effectiveness of FCs ultimately rests on a government’s commitment to incorporate FCs into national fiscal processes, on their independence and on the formal mandate assigned to them. The Two-

pack Regulation 473/2013 introduced the requirement for establishing FCs, yet fiscal councils in the euro area differ in terms of the extent of their independence and most of them do not provide costing of fiscal measures in the short and medium term. FCs in Europe should be made, where needed, more independent and could be given the responsibility to produce or validate the costing of fiscal policy measures. This would require a significant upgrading of their current institutional and operational setting.

Finally, the European fiscal framework has over time become increasingly prescriptive, with the consequence that complying with it in full often entails removing national discretion in fiscal decisions, which caused compelling complaints about lack of ownership. To the extent that the use of formal and informal (like peer pressure) sanctions in a highly prescriptive setting proved in the past ineffective in improving EU members' political commitment to prudent fiscal policies, the current fiscal enforcement system based on negative incentives, should be paired with a set of positive incentives rewarding the achievement of more prudent fiscal targets. This could involve, for example, increased access to EU common investment funds, or to a possible future common stabilisation capacity. If such incentives are strong enough to offset those underpinning the deficit bias, they may support a stronger political commitment to more prudent fiscal policies even in less prescriptive frameworks.

Table 1.4. Reforming the European fiscal framework

Main recommendations of the 2018 Survey	Action taken since 2018
As the expansion continues, euro area countries should ensure their fiscal position improves, gradually reducing debt ratios.	In 2020, the economic situation worsened dramatically due to the effects of the Covid-19 pandemic, which required a resolute fiscal policy response. The necessary fiscal measures adopted by member states to deal with the crisis have been giving rise to much higher levels of public debt. The adoption of supporting fiscal measures was facilitated by the activation, already in March 2020, of the 'general escape clause' of the Stability and Growth Pact, which allows member states to temporarily depart from the normal fiscal requirements of the Pact, provided that this does not endanger fiscal sustainability in the medium term.
Eventually, countries should follow an expenditure objective that ensures a sustainable debt-to-GDP ratio.	The Commission has launched a public consultation on the economic governance framework to give an opportunity for stakeholders to provide their views on the functioning of surveillance so far and on possible ways to enhance the effectiveness of the framework in delivering on its key objectives.
The European Fiscal Board could assess the appropriate fiscal stance for each country consistent with the optimal stance at the euro area level.	The European Fiscal Board assesses the prospective fiscal stance appropriate for the euro area as a whole based on an economic judgment, and may advise the Commission on the appropriate national fiscal stances, within the rules of the Stability and Growth Pact. Council recommendations in the context of the European Semester, the assessment of the Stability and Convergence Programmes or EDP provide country-specific recommendations on the appropriate fiscal policy.

Making the best use of crisis-related common fiscal tools, and providing input for the future economic architecture of the EU

In support of EU countries harder hit by the pandemic, EU member states agreed on a number of new temporary financing measures that increased the capacity to deal with the crisis and to sustain the recovery. The measures adopted comprise some new tools of financial support – such as SURE – and a larger financing plan linked to the next long-term EU budget 2021-2027 (Next Generation EU). The financial support of the euro area also extends to the possibility of accessing lines of credit on favourable terms provided by the ESM under conditionality limited to the use of funds. Next Generation EU will have a significant size of about 5.5% of EU GDP in 2019 (EUR 750 billion), which is well designed to support the recovery in the coming years (Verwey and al., 2020).

The establishment of temporary tools entailing fiscal transfers in support of EU members more hit by the crisis represents a remarkable achievement in response to the crisis. In the current juncture, the EU should focus on the implementation of the recovery package, including the preparation of the recovery and resilience plans and the ratification of the own resources decision in national parliaments. As discussed in the Economic survey of the EU, an ambitious and efficient implementation of Next Generation EU is a key priority to ensure maximum effectiveness of the new instruments.

After the package will be fully operational, Europe's comprehensive economic policy response to the COVID-19 pandemic could provide a valuable input to the debate on what is needed to complete the EMU architecture, including the creation of possible new fiscal tools. In this context, if the EU budget were to be used in any euro area specific instrument, an appropriate mechanism should be put in place to financially protect non-euro area member states. New fiscal tools should be designed to address possible moral hazard issues that could arise by undermining the incentives to conduct sound economic policies at national level. Many proposals have been made in the past to provide euro area countries with a permanent fiscal capacity (for a review Benassy-Quéré and Weder di Mauro, 2020). Among these, several studies (Carnot et al., 2017; Claveres and Strasky, 2018) indicate that an unemployment reinsurance scheme could play a significant role in smoothing activity of euro area countries in case of large shocks. Simulations indicate that an unemployment reinsurance fund would need a borrowing capacity of about 2.5% of euro area GDP to function adequately.

Alternative options could also be explored. A European "Growth Fund", could take the form of a rainy day fund linked to the EU budget, and would support investment and structural reform in countries, should a large shock hit. While the purpose of this fund should be mainly to support investment in crisis-hit countries, as to avoid post-crisis divergence among member states, it could also be activated to bring forward spending benefitting sustainable growth or European public goods, such as the greening of the economy, through common debt backed by future EU or EA budget resources.

The European recovery package will support the international role of the euro

A more global euro would benefit the euro area economy

A wider international use of the euro can benefit the euro area economy in a number of ways. It can lower the cost of international transactions for European businesses, reducing the need for hedging against FX risk. This would be particularly beneficial for small businesses, which typically have limited access to financial hedging instruments. An increase in the use of the euro as denomination currency of financial securities can also benefit European savers and international investors, potentially improving their choice for investment products across the globe. European borrowers would benefit from a higher demand for euro-denominated debt securities and thus lower financing costs, an important aspect given the increased sovereign financing need over the coming years. Finally, trading with non-European partners in euro would reduce exchange rate pass-through, limiting the response of import prices (and thus inflation) to currency fluctuations.

However, while being the second global reserve currency after the US dollar (about 20% of all allocated reserves at the end of 2019 were in euro, exceeding the euro area share of global GDP), the relative share of euro-denominated foreign currency reserves decreased since the global financial crisis (Figure 1.18, Panel A). This is explained by a surge in international debt issuance in US dollar attributable to emerging market economies entities up to the COVID-19 crisis (Figure 1.18, Panel B and C). On the other hand, euro-denominated international debt remains

confined to developed and European countries (ECB, 2020b). Moreover, only about half of euro area exports and imports of goods and services are invoiced in euros (Figure 1.18, Panel D).

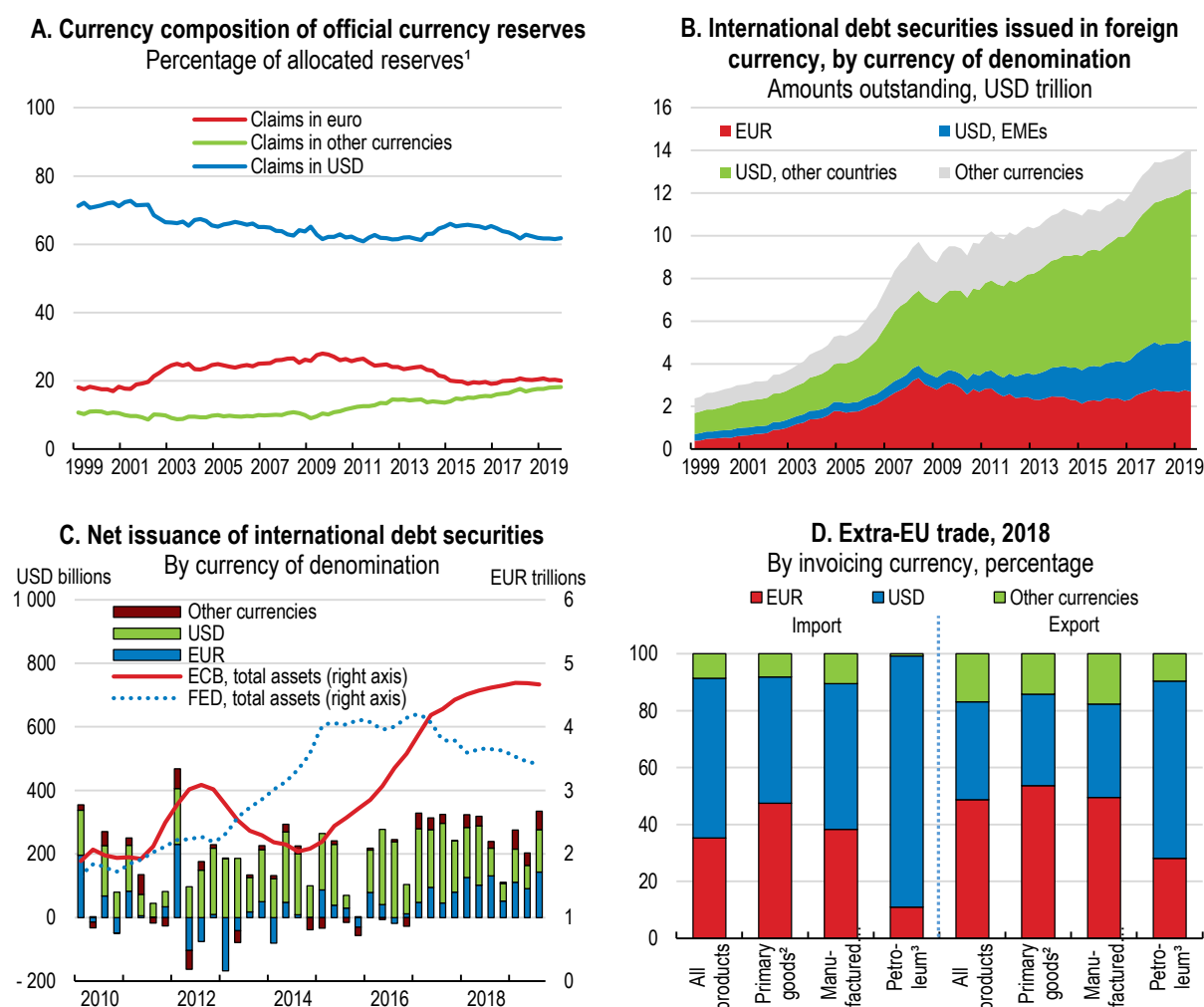
The role of the euro as a global reserve currency will be temporarily supported by a larger supply of euro-denominated EU assets linked to Next Generation EU. Other important preconditions to foster the international role of the euro over the coming years are a robust recovery and enhanced economic resilience, underpinned by a sound financial architecture as well as deep, liquid and well-functioning euro-denominated financial markets. Strengthening the economic and monetary union, completing the Banking Union and making progress towards a complete Capital Markets Union are all essential to progress towards a stronger international role of the euro.

A temporarily larger supply of euro denominated EU assets will contribute to support the euro as a global reserve currency

Debt in euro issued by the EU as an entity remains limited. In 2019 the outstanding stock of debt securities issued by the EU was about EUR 52 billion and about EUR 435 billion were issues by the EIB against over EUR 9 trillion of euro-denominated debt issued by euro area member states. This generates a largely fragmented market for euro-denominated bonds, characterised by different yield curves, diverse risk profile and heterogeneous depth. Supporting a more global use of the euro would require more uniform yield benchmarks, and more liquid markets for all maturities. US Treasuries perform those tasks, which allows the US dollar to provide stability and safety during times of global financial distress, an endeavour the literature has referred to as “exorbitant duty” (Gourinchas et al. 2010; Caballero et al. 2015).

In this context, new debt issuances at the EU level within the framework of Next Generation EU and SURE will provide an increase in supply of European asset and, through this, strengthen the international role of the euro, albeit on a temporary basis. The recovery-related EU borrowing is expected to dramatically reshape the markets of EU bonds by adding an additional 800 billion of euro of common European debt securities. EU bonds issued under the programmes established to fight the COVID-19 crisis will also offer large improvements to the functioning of European financial markets, by possibly creating a leading benchmark for capital markets in Europe, and increasing total supply of euro denominated safe assets (AA+/AA1 and above) by over a half by 2026, based on current outstanding amount.

Figure 1.18. The international role of the euro has decreased since the Global Financial crisis



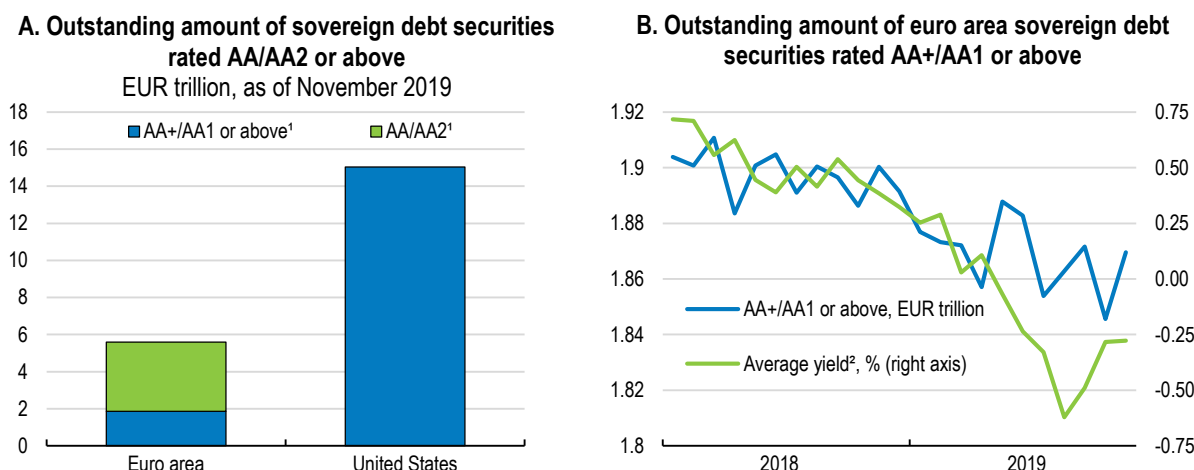
Note: 1. Reserves of gold are excluded from the total. 2. Excluding petroleum, petroleum products and related materials. 3. Petroleum, petroleum products and related materials.

Source: BIS international debt securities statistics. IMF International Financial Statistics database; Refinitiv; Eurostat.

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An increase in the supply of European assets in the euro area could also attenuate the downward pressure on yields (currently negative) on safe investments that has been weighting on European banks and other financial market intermediaries' margins for many years (Figure 1.19). However, for the possible establishment of a European safe asset, EU debt issuances cannot be *a priori* limited in time, as this would ultimately result in reduced liquidity.

Figure 1.19. The supply of euro safe assets has shrunk in the past



Note: 1. AA+/AA1 or above rated sovereign bonds includes securities issued by the following jurisdictions; Germany, Finland, Austria, Luxembourg and the Netherlands. AA+/AA1 or above rated sovereign bonds includes securities issued by the following jurisdictions; Germany, Finland, Austria, Luxembourg and the Netherlands. AA/AA2, a lower rating, includes France. 2. The average yield is computed as the weighted average of the yields for 10-year sovereign bonds of Germany, Finland, Austria, Luxembourg and the Netherlands. Weights are the relative share of outstanding bonds on the total for these countries.

Source: ECB (2020), Statistical Data Warehouse (database); Refinitiv, Datastream Database.

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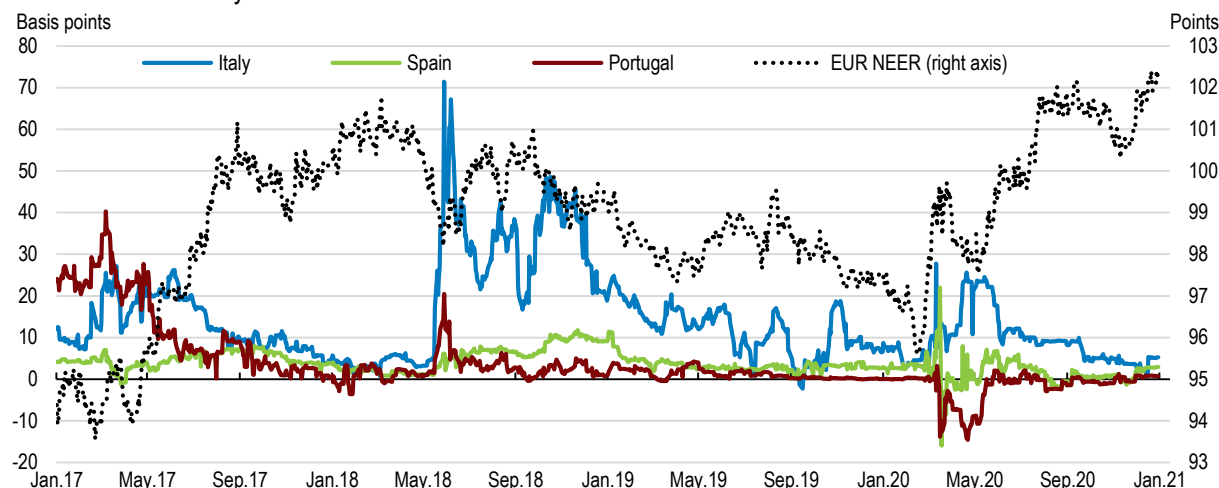
Enhancing the euro area architecture would increase confidence in the euro and its international use

A global currency needs the support of a stable and resilient economy together with liquid financial markets. The European institutional and economic framework is relatively stable, and the ECB's independence and commitment to price stability is a supportive factor. However, missing components in the economic architecture of the area underpin some aspects of fragility that may undermine investors' trust in the euro. The developments in the international stance of the euro in recent years can be partially attributed to the fragility that the euro area economic framework showed in the aftermath of the global financial crisis. This fragility reached a peak during the European sovereign debt crisis, when the rise in sovereign risk premia paired with a spike in re-denomination risk for sovereign assets in exposed countries. A rise in re-denomination risk underlined markets' anxiety with respect to the future of the currency union. Metrics of redenomination risk have declined significantly and remained low since the sovereign debt crisis (Figure 1.20).

Despite some progress in improving the euro area governance framework – including the creation of the Banking Union and the establishment of the ESM – the framework to help euro area members cope with economic shocks remains insufficient. Moreover, the absence of a common European deposit insurance renders euro area banks more vulnerable to domestic developments. European capital markets are still fragmented along national borders, due to various legal and institutional barriers. Against this background, reforms to the architecture of the currency union aimed at strengthening the resilience of the Eurozone to shocks and at delivering a genuine financial union are crucial for strengthening investors' confidence in the euro and for supporting its role in international markets. Ultimately, strengthening the role of the euro as a reserve currency would be achieved with the completion of much-needed reforms to improve the functioning of the euro area economic system.

Figure 1.20. Redenomination risk abated since the global financial crisis and has remained low

Difference between 5-years CDS ISDA2014 and ISDA2003



Note: The solid lines represent the difference between 5-years credit default swap (CDSs) based on International Swaps and Derivatives Association (ISDA) 2014 and 2003 credit event qualifications. Only CDS contracts based on ISDA 2014 incorporate an explicit reference to redenomination as a credit event, whereas the previous (2003) vintage does not. The difference between the two types of contract, for a same issuer, can be used as a proxy for currency redenomination risk. All currencies are expressed in units of currency per Euro.

Source: Refinitiv; and ECB database.

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Higher cyclical convergence would buttress the euro area

In the aftermath of the global financial crisis, large differences in business cycles across euro area countries developed into diverging economic paths for hardest hit economies. Today, the COVID-19 pandemic is affecting again differently euro area economies and there is a risk that such differences could exacerbate current diverging economic trajectories or create new ones. In this context, the Thematic Chapter of this survey focuses on policies to foster cyclical convergence in the currency union, as to ensure that no country will be left behind during the recovery.

Cyclical divergence in the euro area has deep roots, including heterogeneous economic structures of member states that enhance the likelihood of asymmetric shocks. However, a comparison with other currency unions of similar size (such as the United States), suggests that industrial polarisation alone cannot explain the relatively high divergence in economic cycles observable among euro area economies. Much of the cyclical divergence in the currency union is explainable by policy and institutional frameworks which are unique to the euro area.

Increasing fiscal integration is key to reduce cyclical divergence

Fiscal integration remains one of the most important missing features of the euro area (Table 1.5). Common fiscal tools would help business cycle stabilisation and cyclical convergence in the currency union. In the past, many proposals have been made to equip the euro area with a common fiscal capacity (for a review Benassy-Quéré and Weder di Mauro, 2020). Previous OECD surveys presented a European unemployment re-insurance scheme that would be complementary to other national schemes, providing short-term nondiscretionary transfers to euro area countries in need (OECD, 2018). Simulation results suggest that a euro area unemployment re-insurance scheme could have reduced the standard deviation of euro area GDP growth by 0.4% during the global

financial crisis (Claveres and Stráský, 2018). Against this background, the euro area should consider setting up a common fiscal stabilisation capacity through an unemployment re-insurance scheme.

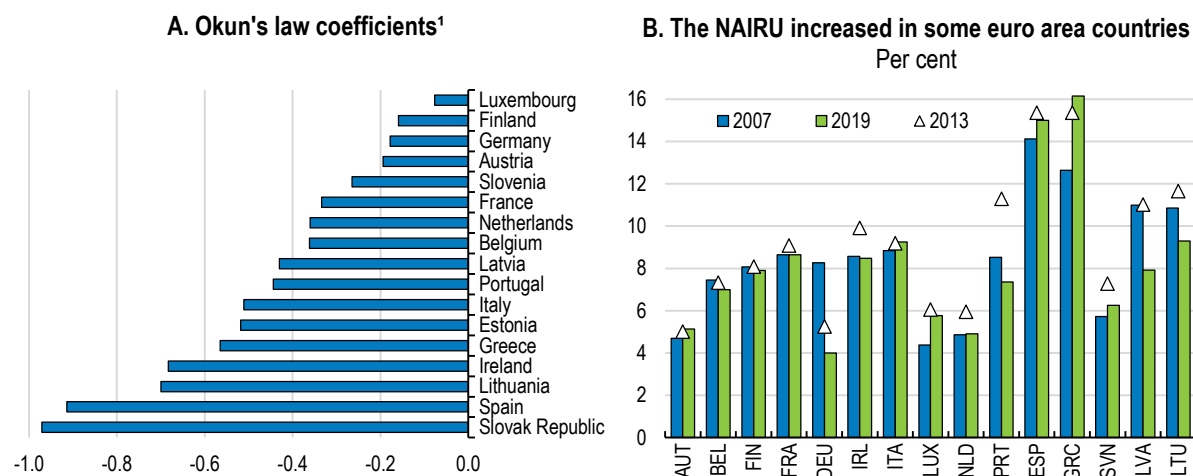
Table 1.5. Strengthening resilience through a common fiscal capacity

Main recommendations of the 2018 Survey	Action taken since 2018
Set up a common fiscal stabilisation capacity, for example through an unemployment benefits re-insurance scheme, and allow it to borrow in financial markets.	Since the pandemic outbreak, a number of new and temporary instruments for the Union and the euro area were agreed in a short space of time, which are contributing to macroeconomic stabilisation in the EU. This notably includes the Recovery and Resilience Facility (RRF), which will provide EUR 312.5 billion of grants and up to EUR 360 billion of loans to member states, with these funds oriented towards the economies worst affected by the economic fallout of the pandemic. Other instruments at the EU level have been supporting member states' stabilisation effort. For instance SURE contributes, via cheap loans, to a safety net for workers and the self-employed.
Make access to the common fiscal stabilisation capacity conditional on past compliance with fiscal rules.	The new instruments set-up at the EU level since the start of the pandemic have been supporting member states' stabilisation efforts. Their access is not conditional on past compliance with fiscal rules. Given the dramatic worsening of the economic situation, these instruments are needed, in particular for highly indebted EU member states which over the past have not always complied with the requirements of fiscal rules. Many of these countries have also been among the most severely affected by the pandemic.

More resilient labour markets would reduce dispersion in business cycles

Labour legislation and policies largely determine the way labour markets function, amplifying or dampening economic shocks and, consequently, affecting business cycle dynamics. In the euro area, labour markets are embedded in largely differing institutional frameworks that are defined at national level. This in the past resulted in a large variation in labour market responses to similar shocks (Figure 1.21). Cross-border labour migration can be effective in attenuating differences in domestic labour markets, but labour mobility across euro area countries is still limited and there is a risk that it will decrease further as a consequence of the COVID-19 pandemic.

Figure 1.21. Euro area labour markets respond differently to shocks



Note. 1. Coefficients resulting from the estimation of a gap version of the Okun' law specified as $(u - u^*) = \beta(y - y^*)$, where y^* and u^* represent the log of the natural level of output and the NAIRU, $y - y^*$ is the output gap for the total economy and $u - u^*$ cyclical unemployment. Estimation period from 1999 to 2018 on yearly frequency.

Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database).

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More resilient labour markets can reduce divergence in business cycles, increasing the capacity of euro area economies to absorb economic shocks and the speed of recovery. Labour market policies are mainly the responsibility of member states, but the EU can assist national authorities' effort with funding, by promoting best practices or offering policy guidance, in the framework of the European Semester.

In this regard euro area countries should step up their policy efforts to enhance the resilience of their labour markets along two lines. The first consists in assessing how to strengthen policies that preserve viable jobs during major downturns, such as job retention schemes (JRS). In the early stages of the COVID-19 crisis, many euro area governments have modified existing JRS to maximise take-up. The main challenge going forward is to strike the right balance between offering sufficient JRS to jobs at risk of being terminated, but likely to remain viable in the longer term, while favouring a quick and smooth job relocation to the others. In this context, labour mobility policies and training programmes should be extended to workers under JRS.

A second set of policies for a more resilient labour market is to ease workers transition to new jobs through skilling and activation. OECD evidence suggests that active labour market policies (ALMPs) decrease aggregate unemployment and have positive effects on the speed of re-employment for jobseekers. Among other areas of intervention, activation measures should be intensified by structurally increasing spending and effectiveness in euro area countries where they are currently underdeveloped or ineffective. During the current crisis, public employment services need to scale up their capacity significantly and should better focus on groups of people and economic sectors suffering more damage (such as hotels and restaurants and the transportation industry).

Finally, cross-border labour mobility can be effective in attenuating differences in domestic labour markets, reducing the likelihood of long-term unemployment and hence the risk of hysteresis following an economic shock. However labour mobility across euro area countries is limited and there is a risk that it will decrease further as a consequence of the COVID-19 pandemic, at least for some time. To support labour mobility over the longer-run, policy and institutional settings should ease the recognition of professional and academic qualifications across jurisdictions and complete the implementation of the Electronic Exchange of Social Security Information.

Table 1.6. Reducing financial fragmentation to increase private risk-sharing

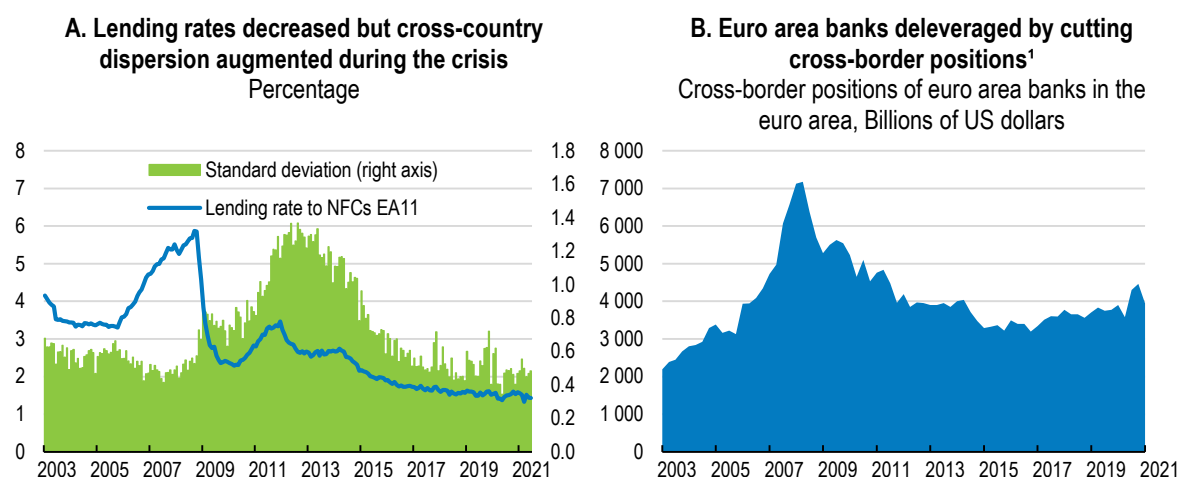
Main recommendations of the 2018 Survey	Action taken since 2018
Implement swiftly the ECOFIN action plan on NPLs; facilitate the creation of asset management companies.	The ECOFIN Action Plan to tackle NPLs in Europe is almost fully implemented. The Commission continues to work to achieve the remaining items. The EBA and ECB have also delivered most of the elements of the Action Plan within their remit. As part of its package of measures to address NPLs (March 2018), the Commission published a technical (non-binding) blueprint on how to set up national Asset Management Companies (AMCs). The non-binding blueprint guides member states on how they can set up national AMCs, should they find it useful, in full compliance with EU banking and State aid rules.
Building on progress in risk-reduction, develop a pre-funded common European deposit-insurance scheme with contributions based on risks taken by banks.	Discussions on the design of the hybrid model for EDIS are ongoing in the Council's Ad Hoc Working Party. All remaining issues on the common backstop have been closed. The ESM Treaty amendment, including the common backstop and

Main recommendations of the 2018 Survey	Action taken since 2018
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.	the amendment to the SRF Inter-governmental Agreement, were signed in January 2021 following the political agreement on the early introduction of the common backstop from end November 2020. member states are now in the ratification process which is expected to be completed by the end of 2021. In the context of the High-Level Working Group on EDIS, two possible measures have been under consideration: (i) a reform of the regulatory treatment of banks' sovereign exposures; and (ii) taking account of their sovereign bond portfolios in the determination of the risk based contributions to a future EDIS. Long-standing divergences of views remain on both.
Progress in harmonising insolvency proceedings through minimum European standards allowing simpler early restructuring, shortening effective time to discharge, and more efficient liquidation proceedings.	The Directive (EU) 1023/2019 on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures was adopted in 2019 and will have to be implemented by member states by July 2021 or, following a request for extension, by July 2022. The rules to be adopted in national law by transposition of this Directive will ensure that distressed but viable companies can avail themselves of restructuring with the aim of avoiding insolvency proceedings, and that bankrupt honest entrepreneurs can obtain a debt discharge after maximum three years.

A more effective single market for capital and stronger banks can reduce the risk of financial fragmentation

During the global financial crisis, the European single market for capital dissolved, and capital markets segmented along national lines, giving rise to different financial conditions across the euro area (Figure 1.22). In countries where the financial turmoil was stronger this resulted into a credit crunch that exacerbated the economic contraction and curbed the recovery. The past experience of fragmentation in euro area financial markets was characterised by three distinctive aspects: the presence of weak banks; fragile and unstable cross-border financial linkages and a widespread underdevelopment of market-based finance, which failed to substitute the cutback in bank credit.

Figure 1.22. Financial fragmentation was one of the reasons of diverging business cycles during the last crisis



Note: 1. Cross-border positions of euro area banks in the euro area.

Source: ECB statistical warehouse; and BIS international Banking Statistics.

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To ensure improved resilience in the common European financial market, European intermediaries need to be strengthened. In the current context, this requires supporting European banks dealing with a possible new wave of non-performing loans (NPLs). Regulators and financial authorities should strengthen the European framework to deal with NPLs framing it around three main pillars: designing better insolvency and loan foreclosure procedures, improving regulatory policies, and developing secondary markets for distressed assets (Table 1.6). To strengthen European banks it is also necessary to complete the banking union, by addressing all outstanding issues, in a holistic manner and with the same level of ambition.

Finally, reducing the reliance of European financial markets on banks is a priority to increase the resilience of credit provision to the real economy during downturns, avoiding that possible bank distress could develop in financial fragmentation. The COVID-19 crisis creates new urgency for the issue. Despite some notable efforts toward the development of a European Capital Markets Union (CMU), the constitution of a truly European capital market still needs to develop along a number of priorities, most notably the development of securitisation and equity markets. These two objectives could be achieved with convergence of national legal frameworks regarding financial market regulation, supervision, and insolvency proceedings.

Table 1.7. KPI Recommendations on macro-economic and financial policies

MAIN FINDINGS (specific to the KPI)	RECOMMENDATIONS (Key in bold)
Keeping monetary policy accommodative	
Inflation had remained well below the ECB objective for a long time and risks are tilted to the downside beyond the short term.	Continue monetary policy accommodation until inflation robustly converges toward the ECB objective.
Structural characteristics of the euro area economy pertinent to the conduct of monetary policy keeps evolving over time, while inflation has been undershooting the objective for a while. The ECB has recently reviewed its monetary framework and will do it again in 2025.	In its next strategic review, the ECB could consider moving towards average inflation targeting in case the inflation objective is not met.
Pandemic-related capital relief and conservation measures supported credit provision, but the prolongation of the economic turmoil will increase borrower bankruptcy risk.	Exit from pandemic-related financial measures should be gradual. Capital and liquidity buffers should be rebuilt gradually.
The ECB has proved innovative in the use of new, non-standard instruments of monetary policy during the global financial crisis and the COVID-19 epidemics, and showed resolution in loosening self-imposed limits when needed.	Take stock of the effectiveness of recently adopted new tools and the suspension of self-imposed limits to the asset purchase programme, prolonging them if needed.
Improving the European fiscal arrangement	
The European fiscal framework is particularly complex and in the past it did not prevent pro-cyclical fiscal policy in the euro area. The EU activated the general escape clause of the Stability and Growth Pact during the pandemic. After the crisis, the re-application of the current set of fiscal rules would be even more challenging.	Evaluate the fiscal framework with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership. Improve fiscal policy making by strengthening the involvement of independent fiscal institutions, enhancing medium term budgetary frameworks, and by considering positive incentives.
In response to the crisis the EU euro area has recently adopted common fiscal tools in the form of Next Generation EU and the Support to mitigate Unemployment Risks in an Emergency (SURE). However, these measures are temporary and may not be renewed.	Swiftly implement national recovery and resilience plans to deliver structural reforms and investments based on sound cost-benefit analysis. Rigorously assess the economic impact of SURE and Next Generation EU as they could provide a valuable input to the debate on the completion of the EMU architecture.
The complexity of the fiscal framework has grown overtime, on the back of a proliferation of different numerical targets, procedures, contingency provisions and compliance indicators. Expenditure rules anchored to a debt ratio target tend to be simpler and easier to control, while limiting the risks of pro-cyclical fiscal policies.	Among other options, consider adopting an expenditure rule anchored to a debt ratio target.
Augmenting the stance of the euro as a reserve currency	
The international stance of the euro as a reserve currency relies on the economic resilience of the euro area and on a stable supply of euro-denominated bonds.	Enhance the economic resilience of the euro area by completing the Banking and the Capital Markets Unions.

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2 Fostering cyclical convergence in the euro area

During the first decade of the currency union, business cycle fluctuations among euro area countries were relatively synchronised and similar in magnitude. This concordance disappeared during the 2008 financial turmoil and the following European sovereign debt crisis, a time when key flaws in the architecture of the euro area became apparent. The recovery helped reduce cross-country differences in unemployment and output gaps, but countries worst hit by the crisis took much longer to recover, and in some cases negative consequences of shocks became entrenched. The COVID-19 crisis could lead to a resurgence in euro area cyclical di-synchronisation, risking to exacerbate economic divergence among member states and putting to the test the macroeconomic stability of the currency union.

Diverging cyclical paths among euro area countries originate from differences in economic structures and domestic institutions. However, such differences are compounded by features in the economic policy architecture of the currency union – such as the lack of a common fiscal stabilisation tool – and by remaining frictions in the functioning of the common labour and financial markets. Reforms to the common euro area economic policy framework combined with those to improve labour and capital mobility across euro area members are needed to foster cyclical convergence in the currency union.

A high degree of business cycle synchronisation is crucial for the smooth functioning of a currency union, as it facilitates coordination in national fiscal frameworks, and the effective implementation of a common monetary policy. In the euro area, heterogeneous economic structures, imperfectly integrated labour and capital markets and some key architectural features – such as the absence of a common fiscal stabilisation capacity – contributed in the aftermath of the European sovereign debt crisis to the emergence of large differences in the magnitude and timing of business cycles. Such diverging cyclical dynamics are significant as they have the potential to develop into diverging medium-term economic trajectories through hysteresis effects, threatening economic convergence and European cohesion.

The possibility of a resurgence in cyclical divergence in the euro area is particularly severe in the current juncture, as euro area members are affected differently by the economic consequences of the COVID-19 crisis. In this context, there is a tangible risk that the current crisis could further undermine convergence, ultimately weakening the economic stability of the currency union as a whole.

Structural reforms involving the architecture of the euro area are needed to improve the functioning of the currency union and its ability to deal with large economic shocks affecting euro area economies differently, such as the ones stemming from the COVID-19 pandemic. Against this background, cross-border labour mobility should be preserved until the pandemic will be over and improved over the medium run. Remaining strings to the emergence of a frictionless common financial market should be eliminated to reduce the risk of financial fragmentation. Finally, a common fiscal capacity, for example in the form of an unemployment re-insurance scheme, would complement the capacity of euro area member states to conduct counter-cyclical fiscal policy. These reforms should be complemented by structural reforms taken at the national level to improve domestic economic resilience, so as to facilitate individual countries' adjustment to cyclical shocks.

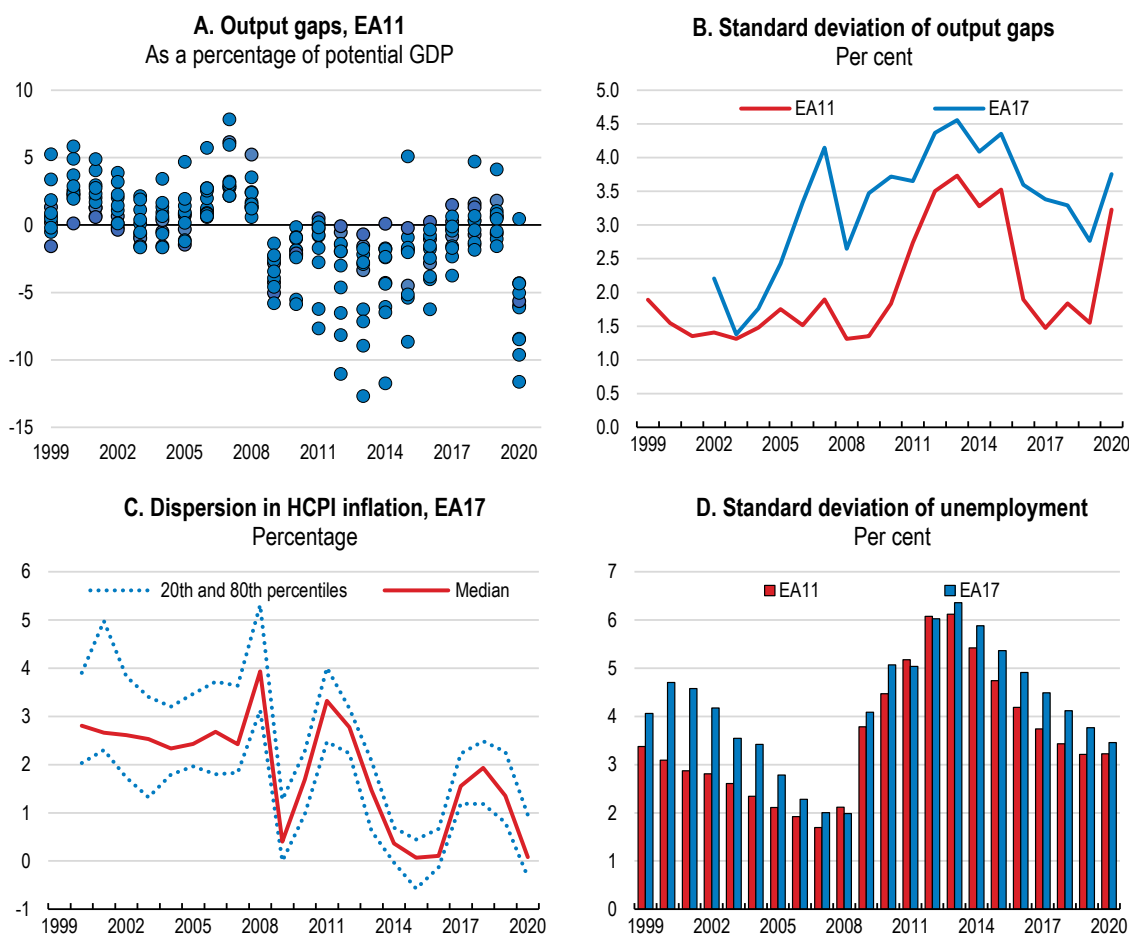
Euro area cyclical divergence has deep roots

The classical theory of optimum currency areas emphasises structural convergence, factor mobility and fiscal integration as preconditions for the smooth functioning of a monetary union (Mundell, 1961; Kenen, 1969; McKinnon, 1963). Structural convergence requires greater similarity in the economic structures of participating economies, so as to reduce possible asymmetric shocks that may be difficult to counteract with a unique monetary policy. Factor mobility is required as, in the presence of a country-specific shock, factor inputs must adjust if relative prices cannot. Fiscal integration requires a system of fiscal transfers between member states to support regions hit by stronger shocks during downturns.

The original architecture of the euro area lacked many of the characteristics of an optimal currency area. Yet, generally muted business cycle shocks until the global financial crisis concealed such structural deficiencies. During the first decade of the euro, business cycle fluctuations of member countries were relatively synchronised and of similar, mild magnitude. Over the same period, dispersion in unemployment and inflation rates gradually declined. This concordance in business cycles disappeared during the European sovereign debt crisis in 2011-12, at a time when output gaps and unemployment rates in euro area countries greatly diverged, as consequence of largely asymmetric real and financial shocks that brought afloat some crucial weaknesses in the economic functioning of the currency union (Figure 2.1).

Figure 2.1. Euro area business cycles diverged during the global financial crisis

Annual data



Note: EA11 include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. EA17 include all other euro area members that are also part of the OECD.

Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

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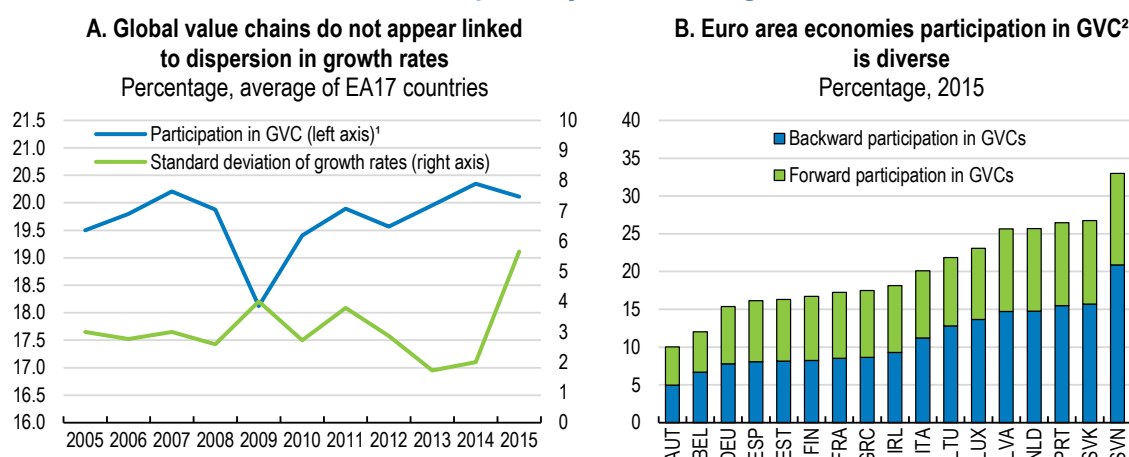
Different economic structures generate dispersion in business cycles

Sectoral composition influences the characteristics of an economy's business cycle, such as its length and amplitude, and it determines the vulnerability of a country to specific economic shocks. Symmetry of shocks across a currency union therefore depends on the degree of homogeneity of economic structures in its regions. The euro area comprises countries with different economic structures, which translates into relatively large differences in sectoral sources of aggregate business cycle fluctuations (Orlandi et al., 2004) and exposes euro area countries to a higher likelihood of idiosyncratic shocks.

In the years following the introduction of the currency union, in conjunction with the strengthening of the single market, the removal of trade and investment barriers led to spatial agglomeration of economic activities along the lines of national or regional competitive advantages (Fontagné and Freudenberg, 1999; Mongelli et al., 2016). Heightened competition and agglomeration economies favoured industry concentration, resulting in greater divergence in the productive structure of individual euro area economies (Figure 2.3, Panel A). The extension of the supply chains beyond local markets further increased specialisation in economic activities. In the euro area, trade flows of intermediate inputs has increased rapidly, almost doubling as a share of GDP between 1990 and the early 2000s, and stabilising at relatively

high levels thereafter (Gunnella et al., 2019). The development of stronger industrial linkages among euro area countries had the potential to increase cyclical convergence. Yet, over the last decade, stronger European cross-border value chains do not appear correlated with higher cyclical synchronisation of euro area economies (Figure 2.2, Panel A). This can be explained in light of the uneven development of cross-border industry networks, in terms of the overall extent, the geographical linkages and with respect to the position of single economies in global value chains (Figure 2.2, Panel B).

Figure 2.2. Global Value Chains did not improve cyclical convergence



Note: 1. Sum of forward and backward participation indexes. 2. GVC participation is the sum of the backward participation in GVCs (foreign value added share of gross exports, by value added origin country) and forward participation in GVCs (domestic value added in foreign exports as a share of gross exports, by foreign exporting country).

Source: OECD, Inter-Country Input-Output (ICIO) Database, 2018.

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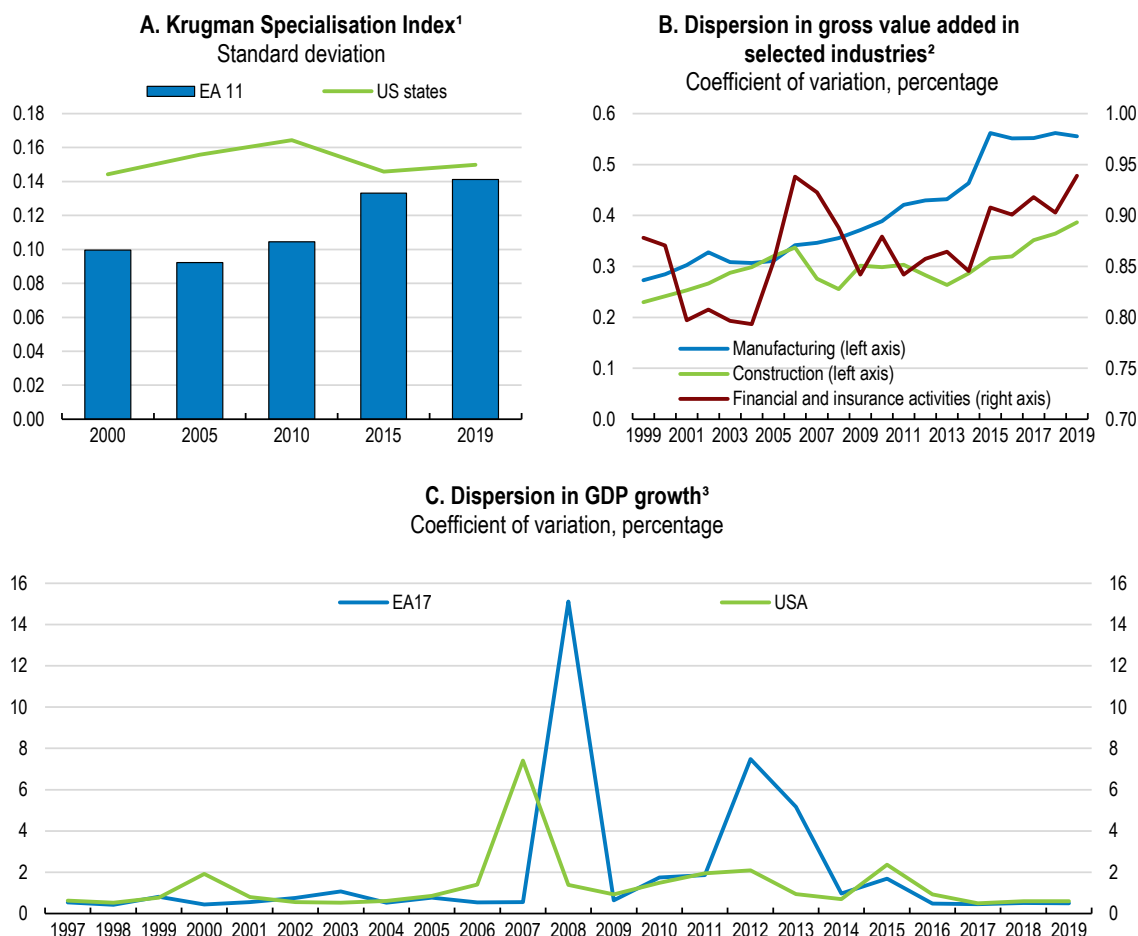
The significant heterogeneity in the cross-border industry linkages of euro area countries is linked to specificities that distinguish the economic structure of individual economies, including their different position with respect to the productivity frontier and their sectorial specialisation (Crosculo et al., 2016). For example, the car manufacturing supply chain extends between some core euro area countries (such as Germany, France, Italy and Spain) and most central Eastern European countries, but it has a limited footprint in northern European countries (including the Baltics) and in remaining Mediterranean economies (such as Portugal and Greece). Overall these differences support diverse income elasticity of trade, determining different responses of euro area countries to shocks in specific industries, and, as such, they have the potential of increasing business cycle divergence across the euro area.

Even considering the same sectoral value chain, some economies are located more upstream (with higher domestic value added embedded in third-country exports) compared to others. To the extent upstream industries further away from the final consumers are more exposed to demand shocks, while downstream industries are relatively more vulnerable to supply shocks higher up the value chain, such differences can explain the emergence of different economic responses even in case of shocks developing along the same sectoral value chain (Acemoglu et al., 2015; Carvalho, 2014; OECD, 2015).

The emergence of regional concentration, for example, in manufacturing and financial services, is reflected in higher cross-country dispersion in Gross Value Added (GVA) shares for key industries (Figure 2.3, Panel B). Divergence in manufacturing activities, traditionally having an important role in business cycle dynamics in the euro area (Orlandi et al., 2004), has been particularly strong; despite a general trend toward the service sector, Austria, Germany, Ireland and Finland managed to maintain a high industry share, while other countries (such as Belgium, the Netherlands, France, Spain, Greece, Portugal and Luxembourg) experienced considerable deindustrialisation. Stronger specialisation of euro area economies is also observable in rising dispersion in Krugman specialisation indexes computed for

individual euro area countries (Figure 2.3, Panel A). These indexes reflect the weight of a sector in the production structure of a particular country, relative to the weight of that sector in total EU production.

Figure 2.3. Differences in industrial structures among euro area members have been rising



Note: 1. The Krugman Specialisation Index (KSI) is a widely-used specialisation measure. It can be seen as a relative specialisation compared to one other country or to a reference group, in this case the EA11. The Index is defined as the absolute sum of the share of value added produced in a generic sector i by a country with respect to the same share in a reference country. The chart shows the standard deviation of for the Krugman specialisation index across EA11 countries (columns) and US states (line). 2. Gross value added by NACE activities, EA17. 3. Coefficient of variation for annual GDP growth across 50 US States and EA17 countries. EA17 include all other euro area members that are also part of the OECD.

Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database); Eurostat.

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If economic structures of euro area countries have been diverging since the introduction of the euro, from an industrial standpoint, euro area regions are still more homogenous than those of the United States – a currency union of similar size (Figure 2.3, Panel A). Despite a relatively milder industrial heterogeneity, cross-sectional dispersion in GDP growth among euro area members tend to be higher than the one measured across US states, peaking during downturns (Figure 2.3, Panel C). This suggests that industrial polarisation alone cannot explain the relatively high divergence in business cycles observable among euro area economies and that much of cyclical divergence in Europe need be explained by policy and institutional frameworks which are unique to the euro area, such as those pertaining to the functioning of the common labour and capital markets.

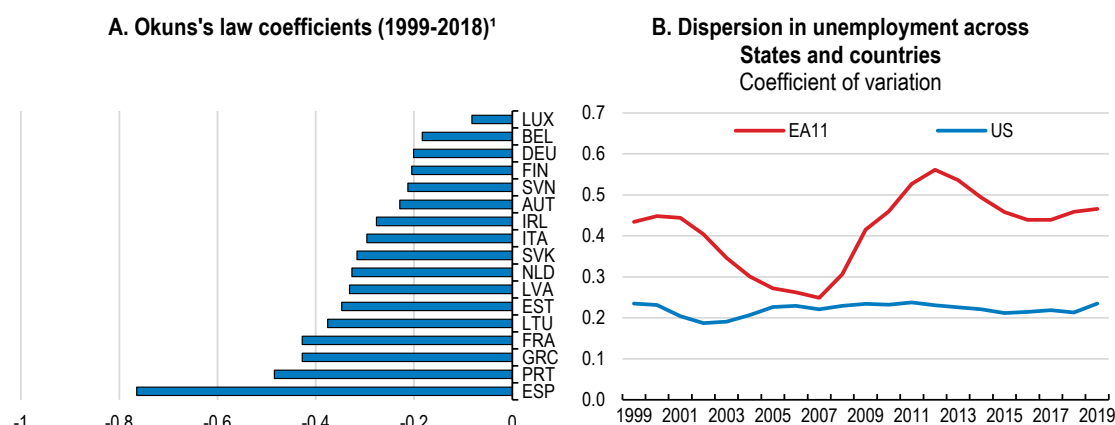
Limited labour mobility impedes labour market convergence

Labour legislation and policies determine the way labour markets function, amplifying or dampening economic shocks and, consequently, affecting business cycle dynamics. Social protection schemes, and wage setting mechanisms determine the interaction between unemployment, household consumption and output, partially driving output fluctuations during shocks. Stronger social protection systems, including unemployment benefits and short-time work programmes – such as those financed by SURE – are effective in smoothing employment and consumption fluctuations during economic downturns (OECD, 2018a; Hijzen and Venn, 2011; OECD, 2014). This reduces cyclical fluctuations, increasing the shock absorption capacity of an economy in a downturn.

In the euro area, different national labour market policies and institutions contribute to diverging economic responses even in the presence of similar economic shocks. In the EU, employment protection is not granted uniformly in all member states, with the exception of some common minimum requirements stemming from EU legislation and other international obligations. The Treaty on the Functioning of the European Union (TFEU), defines the role of the common EU legislation as limited to basic transnational standards of employment, such as basic individual labour rights, anti-discrimination, and rights to minimal job security. These treaty based provisions have been accompanied by a number of recent labour market legislations (e.g. the directive on transparent and predictable working conditions and the Commission proposal for a directive on minimum wages). Yet, EU competences do not explicitly include social protection, wage regulation, and the dismissal of workers, features that account for most of the labour market dynamics during downturns and subsequent recoveries. As a consequence, labour markets in the euro area are embedded in largely differing institutional frameworks and respond differently to shocks (Figur 2.4, Panel A and Panel B).

The coordination of EU employment policies through peer reviews, in which member states exchange best practice and discuss reform and policy priorities, has helped ensured a certain convergence of EU labour markets in recent decades, which should improve their resilience to economic shocks. Moreover, the European Semester helps national authorities to commit to their reform agenda in accordance with the priorities set by the Commission in the Annual Sustainable Growth Survey (ASGS). The country-specific recommendations provide tailored advice to individual member states on how to boost jobs, growth and investment, while maintaining sound public finances.

Figure 2.4. Labour markets in the euro area react differently to shocks



Note: 1. The Okun coefficients measure the impact of GDP changes on the unemployment rate. Estimates are based on the following country-specific equations estimated over the sample period 2000q1-2019q4: $U(q) = a + \beta_0 \Delta \log(GDP(q)) + \beta_1 \Delta \log(GDP(q-1)) + \beta_2 \Delta \log(GDP(q-2)) + e(q)$; where U is the unemployment rate in quarter q , GDP is the real GDP, β are the Okun coefficients and e is the error term. The bars show the sum of β_0 , β_1 , β_2 .

Source: OECD (2020a), "Flattening the unemployment curve? Policies to limit social hardship and promote a speedy labour market recovery"; OECD (2020), OECD Economic Outlook: Statistics and Projections (database).

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In the aftermath of the 2008 crisis, large differences in labour market dynamics contributed to diverging economic trajectories among euro area economies. In some countries, such as Greece, Spain, Portugal and the Baltics, unemployment grew extensively, partially on the account of different labour institution and policies, causing an increase of labour markets mismatch and a rise in long-term unemployment. In contrast, in Germany, unemployment almost halved between 2007 and 2019. Moreover, prolonged unemployment spells had “scarring effects” on workers, ultimately decreasing labour productivity and output potential. However, during the recovery following the global financial crisis, labour market convergence in the euro area increased substantially. In the current juncture, idiosyncratic labour market shocks risk to re-emerge following the COVID-19 crisis.

Cross-border labour mobility can contribute in attenuating differences in domestic labour markets, reducing the likelihood of long-term unemployment and hence the risk of hysteresis following an economic shock. However labour mobility across euro area countries, despite having improved over the years prior to the current crisis, still remains limited with respect to what can be observed in other currency areas (Box 2.1), and it faced large challenges during the pandemic.

Box 2.1. Mobility as an adjustment mechanism for labour markets in the EU and the U.S.

A high degree of labour mobility, is one of the defining characteristics of an optimum currency area (Mundell, 1961). Labour mobility facilitates macroeconomic adjustments by reducing differences in unemployment between regions of a currency union. Internal mobility reduces the unemployment costs of economic shocks supporting the rebalancing of diverging dynamics in local labour markets. Early research on the role of labour mobility on labour markets rebalancing emphasised the importance of labour mobility in this adjustment process, showing that local unemployment rates primarily adjust by workers moving to areas where there are more jobs, as opposed to local job creation (Blanchard and Katz, 1992).

In the U.S., interstate migration has decreased steadily since the 1980s, partially owing to demographic shifts and other social and economic factors such as, for example, higher home ownership and higher synchronisation of state business cycles (Blanchflower and Oswald, 2013), while in Europe labour mobility has been picking up, almost doubling since the introduction of the euro, bringing the two currency unions closer in this respect. However, despite the closing gap, the elasticity of labour mobility to economic shocks remains significantly lower in Europe than in the U.S.

In the aftermath of the global financial crisis, while mobility flows increased from countries with high unemployment to countries with low labour market slack (Arpaia et al., 2014), those flows were too small to significantly reduce unemployment in origin countries (Elsner and Zimmermann, 2013; Bräuninger and Majowski, 2011). Studies that have compared the response of labour mobility to unemployment in the two currency areas throughout the crisis, estimated labour in Europe to be about half as mobile as in the U.S. (Dao et al., 2017). Other research finds the average elasticity of population size to employment shocks is much lower in the euro area than in the US, with point estimates of 0.2 and 0.8, respectively (Basso et al., 2018). This means that, following a shock lowering employment by 10%, only 2% of the population would move from the affected euro area country versus 8% in US States. Labour mobility being a less important adjustment mechanism in response to country-specific labour demand shocks in the euro area, labour markets adjust by stronger and more persistent reactions of the employment and the participation rate (Beyer and Smets, 2015).

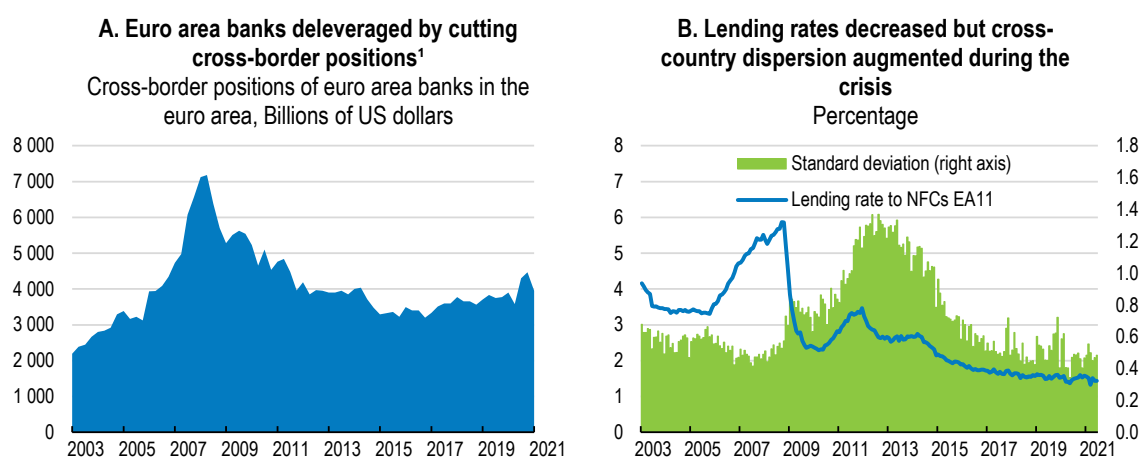
Financial markets fragmentation generated diverging economic cycles

The global financial crisis and the following European sovereign debt crisis represented a hard test of the functioning of the common European financial market. At the peak of the European sovereign debt crisis, mark-to-market impairments on sovereign bond portfolios exposed banks to rising credit risk and funding

costs. Declining policy interest rates were not enough to offset increasing risk premia in the most affected countries. Market-based finance, traditionally underdeveloped in most European economies, failed to substitute for bank-based credit, leaving borrowers with rising liquidity constraints and spiking funding costs. In countries where sovereign distress was higher, banks passed through rising borrowing costs to corporates, increasing the cost of new funding and debt rollover. Smaller borrowers were particularly affected (EIB, 2016).

When asymmetric financial distress arose across euro area economies, the European single market for capital dissolved and capital markets segmented along national lines, giving rise to different financial conditions (Figure 2.5, Panel A). In the aftermath of the sovereign debt crisis cross-border capital mobility failed to halt this mechanism. In fact, financial fragmentation was supported by a steady retrenchment of cross-border bank positions by euro area intermediaries (Figure 2.5, Panel A).

Figure 2.5. After the global financial crisis financial fragmentation increased, bank cross-border lending declined



Note: 1. Cross-border positions of euro area banks in the euro area.

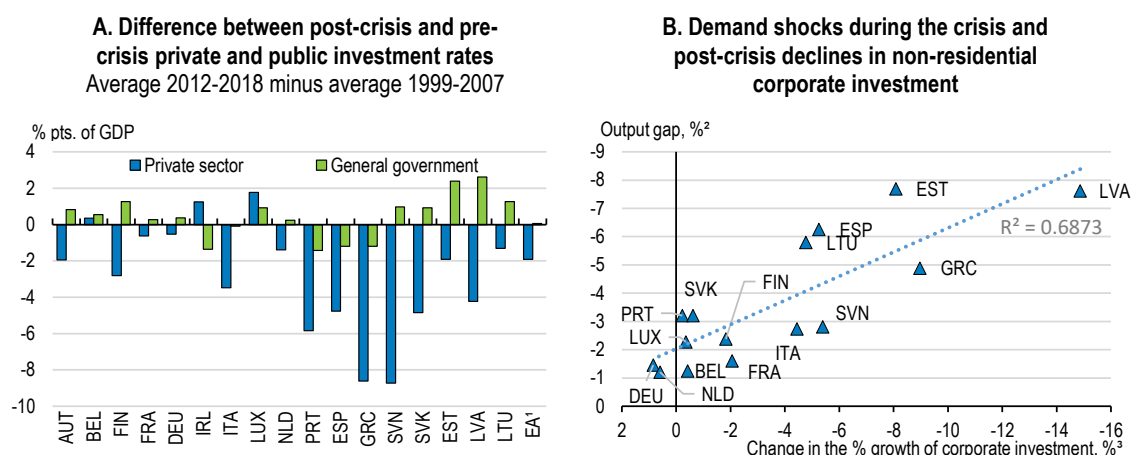
Source: ECB statistical warehouse; and BIS international Banking Statistics.

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In the aftermath of the global financial crisis, in countries where the financial turmoil was stronger, the rise of constraints for financing institutions contributed to a credit crunch that exacerbated the economic contraction and curbed the recovery. For some euro area economies, the credit crunch was severe enough to have large impacts on investment even after the crisis - especially for the private sector - and fuelling unsettling medium-term diverging economic paths (Figure 2.6). In the euro area, asymmetric financial frictions have a key role in determining diverging business cycle dynamics, and improving the integration and resilience of the common European financial market is a necessary condition to ensure business cycle convergence.

The past experience of fragmentation in euro area financial markets was supported by three distinctive aspects: the presence of weak banks; fragile and unstable cross-border financial linkages; and a widespread underdevelopment of market-based finance, which failed to compensate the fall in bank credit. Steps have been made since the global financial crisis to strengthen the resilience of euro area financial markets. Yet, more needs to be done: European intermediaries need to be strengthened, their cross-border linkages should improve further, and renewed efforts are necessary for the development of market-based finance to complement bank lending.

Figure 2.6. Corporate investment declined asymmetrically in the aftermath of the global financial crisis



Note: 1. Euro area member countries that are also members of the OECD (17 countries). 2. Average 2009-10, as a percentage of potential GDP. 3. Difference, in percentage points, between the average annual percentage growth rate of non-financial corporation's gross fixed capital formation, in constant prices, in the period between 2012 and 2017, and the same average annual percentage growth rate in the period between 1999 and 2006.

Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database), and updates.

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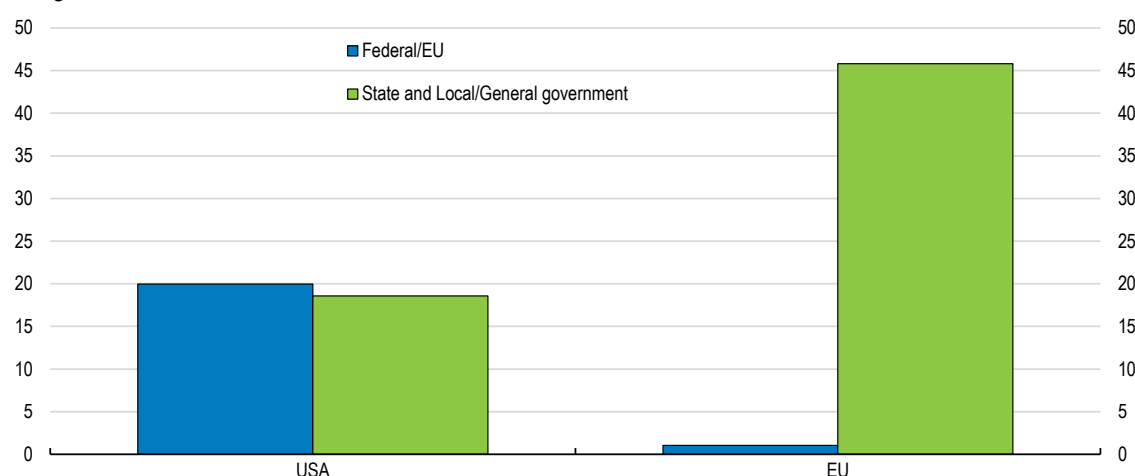
The absence of a common fiscal capacity amplifies diverging business cycles

A common fiscal capacity is one of the main tools for business cycle stabilisation and cyclical convergence in a currency union, and it remains a missing feature of the euro area. Existing studies suggest that common fiscal shock absorbers play an important role in economic stabilisation through risk-sharing in large economic regions such as the U.S. and Canada. It is estimated that US federal taxes and transfers offset between 20 to 30 cents of each dollar decline in regional income (Sala-i-Martin, 1996; Bayoumi and Masson, 1995). US corporate income taxes collected at the federal level are the single most efficient instrument of stabilisation against common shocks, while social security benefits and personal income taxes have a greater role in stabilising asymmetric shocks (Nikolov and Pasimeni, 2019).

Fiscal spending and fiscal stabilisation in the euro area is primarily entrusted to individual member states. Stabilisation in the event of large shocks for the currency area requires a high degree of coordination, which has so far proved difficult. The budget of the European Union, is small in comparison to the sum of the national budgets, accounting for roughly 1 percent of the EU's GDP. As a comparison, the US Federal budget amounts to around 20% of the US GDP, also reflecting broader responsibilities of the US Federal government comparing to the EU (Figure 2.7). Moreover, the EU budget performs mainly an allocative function that is not related to stabilisation needs, the EU having no fiscal instrument dedicated to offset heterogeneous cyclical shocks across its members. As a result, estimates show that the net redistributive and stabilisation impact of the EU budget is much lower than in the United States (Pasimeni and Riso, 2019).

Figure 2.7. Government expenditure by level of government

Percentage of GDP, 2018



Note: US state and Local/General government of EU countries.

Source: US Census; and Eurostat.

StatLink  <https://doi.org/10.1787/888934276812>

In the aftermath of the 2008 crisis, in the absence of any form of fiscal transfers and facing binding fiscal targets, countries experiencing fiscal distress, were forced into damaging pro-cyclical fiscal consolidations that exacerbated the slump in domestic demand and augmented economic divergence relative to other euro area members. In that setting, a common fiscal stabilisation function could have helped to prevent exacerbating the economic downturn. It could also have supported a more balanced policy mix.

Making labour markets more resilient to the economic cycle

More resilient labour markets can reduce divergence in business cycles, increasing the capacity of euro area economies to absorb economic shocks and speeding the recovery. Labour mobility represents an additional adjustment mechanism for the labour market, contributing to the reduction of cross-country wedges in labour market slack with temporary workforce reallocation. Labour market policies are mainly the responsibility of member states, but the EU can assist national authorities' effort with funding, by promoting best practices or offering policy guidance, in the framework of the European Semester. This multilateral surveillance framework for economic policy coordination has helped national authorities committing to their reform agenda in accordance with agreed EU priorities. Structural reforms are also needed at the European level to create a more unified euro area labour market.

European tools to support policies for resilient national labour markets

Policies and labour market frameworks that facilitate the absorption of labour market shocks can be grouped into two categories. The first aims at preserving viable jobs during downturns, the second fosters displaced workers transition to new jobs, notably by providing new skills and helping job search. Euro area countries should step up their policy efforts to enhance the resilience of their labour markets along these two lines.

Job retention schemes help reduce the impact of economic shocks on unemployment

The COVID-19 crisis has confirmed a lesson already learnt in the Global Financial Crisis that well-designed Job retention schemes (JRS) are effective in mitigating the unemployment costs of deep economic downturns (OECD, 2018b; Hijzen and Venn, 2011; OECD, 2020b). JRS can take the form of short-time

work (STW) or temporary layoff schemes that directly subsidise hours not worked, such as the German “Kurzarbeit”, the Italian “Cassa Integrazione Ordinaria” or the French “activité partielle”. They can also take the form of wage subsidy schemes that subsidise hours worked, or they top up the earnings of workers on reduced hours, such as the Dutch Emergency Bridging Measure.

In the early stages of the COVID-19 crisis, many governments have modified existing JRS to maximise take-up, for example by simplifying access, extending coverage to non-permanent workers, and raising generosity (OECD, 2020c). At the same time, the EU has provided some financial support to national job retention schemes through SURE. In the wake of the COVID-19 shock, these policies contributed to the relative resilience of labour markets in some euro area countries with respect to other jurisdictions. Against this background, it is important to encourage member states to reinforce job retention schemes to be used in case of temporary economic shocks. The main challenge going forward is to strike the right balance between offering sufficient JRS to jobs at risk of being terminated, but likely to remain viable in the longer term, while favouring a quick and smooth job relocation for the others (OECD, 2020c).

In this context, labour mobility policies and training programmes can be extended to workers still under JRS, for example by allowing workers on STW to register with the public Employment Services and benefit from their support (OECD, 2020c). OECD analysis shows that early interventions – including those before displacement takes place – can be very effective in promoting smooth job transitions (OECD, 2018b; OECD, 2020d). Moreover, training participation of workers on reduced hours could be promoted to improve workers viability of their current job or the prospect of finding a different job (OECD, 2020a). Several European countries encourage training during STW by providing financial incentives to firms or workers (e.g. France and Germany), while in a few others participation in training is a requirement for receiving JRS subsidies (e.g. the Netherlands).

Strong activation policies and balanced employment legislation improve labour market outcomes, including in the recovery phase

Employment protection legislation should strike the right balance between offering job security and providing enough incentives to job reallocation (OECD, 2020c). In some euro area countries, once the trough of the global financial crisis passed, labour market recoveries accelerated or were made more far-reaching by increasing employers’ incentives to hire, for example by reducing severance pay (notably in the Netherlands, Spain and Greece) or promoting more flexible wage setting schemes and reforming collective bargaining (such as in Belgium and Slovenia; OECD, 2019), and by reforms aimed at improving hiring dynamics – for example in Italy (Jobs Act) and France (the 2017 labour market reform package).

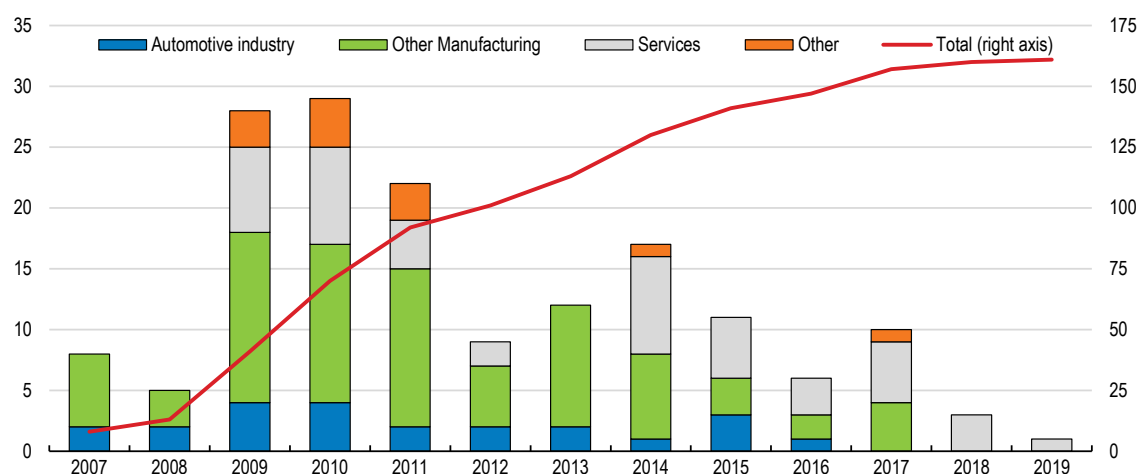
A fast recovery of the labour market requires a quick relocation of displaced workers. Evidence suggests that active labour market policies decrease aggregate unemployment and have positive effects on the speed of re-employment for jobseekers (Scarpetta, 1996; Boone and van Ours, 2004; Bassanini and Duval, 2006). Activation measures should be intensified by structurally increasing spending and effectiveness in euro area countries where they are currently underdeveloped or insufficiently effective, such as in Greece, Italy and Lithuania (OECD, 2019). During crisis times, public employment services need to scale up their capacity significantly and should better focus on groups of people and economic sectors suffering more damage (such as tourism and the transportation industry during the current crisis). In the current juncture, active support by employment services for job transitions, including reskilling, complemented by well-targeted hiring and transition incentives are the most effective ways of sustaining economic recovery.

The EU has a number of tools to support activation policies in euro area countries, such as the European Social Fund (ESF), the European Globalisation Adjustment Fund (EGF) and Next Generation EU. The ESF (called ESF+ for the programming period 2021-2027), is the main tool to promote employment and social cohesion in Europe and is targeted to job seekers, in particular to individuals with lower qualifications or who have lost skills, such as long-term unemployed. The EGF co-finances one-off, time-limited support

for active labour market policies targeted at workers who have lost their jobs during major restructuring events. Until 2020, this was only possible when these restructuring events occurred as a consequence of globalisation or a specific crisis (Figure 2.8). In the wake of the coronavirus pandemic the intervention criteria that determine whether a member state can apply for assistance from the Fund has been widened, as to help workers made redundant due to any restructuring.

Figure 2.8. The number of restructurings resulting in in European Globalisation Adjustment Fund interventions remains limited

Number of restructuring by sector and total



Source: European Commission.

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Although it is still early to assess its efficiency, the increase in resources linked to the EGF, the widening of the intervention criteria, and the removal of the evidence requirement justifying the reason of the dismissals are all welcome steps to increase the effectiveness and the timeliness of the instrument. To further improve the impact of the EGF in the aftermath of the crisis, European Authorities should consider revising the application procedures, to avoid lengthy approval processes by the Parliament and Council, which are currently necessary for each single project (OECD, 2018a). Political control on EGF disbursements, via the Parliament and Council, should be limited to the definition of high-level access requirements, and cannot involve the validation of each single project. In other words, once clear entitlement criteria have been established by the political authority, their verification should be left to the Commission.

Box 2.2. Lessons from two decades of labour mobility in the EU

Patterns of intra EU labour mobility have changed over the last decade

During the first decade of the euro, intra-EU labour mobility was driven mainly by income and wage differentials between the Eastern and Western member states. Between 2004 and 2007 the accession of 10 Central and Eastern European countries led to large east-west flows of workers. During this phase the pattern of cross-border mobility was affected by transitional restrictions on labour mobility imposed in many of the EU-15 countries, deviating workers to countries with more liberal mobility policies such as Denmark, Ireland, Sweden and the UK (Boeri and Brücker, 2005).

In the aftermath of the global financial crisis, the drivers of intra-EU mobility changed, and diverging labour market performance became a major factor driving cross-border labour flows, especially between euro area members (Rosini and Markiewicz, 2020). Between 2013 and 2017, Spain lost close to half a million inhabitants due to mobility while Germany and the UK, benefited from a net inflow of about 1.5 million of individuals. The increase in mobility flows within the euro area has been accompanied by an increase in mobile workers' education level. The percentage of intra-EMU mobile workers with tertiary education increased from 34% to 41% with respect to pre-crisis standards (Jauer et al., 2014).

Mobility has limited impact on native employment and wages

Potential negative impacts of mobility on employment and wages of natives, especially for low-skilled workers, have been source of public and policy concern. However, evidence from existing studies suggests that, in the short-term, intra-EU mobility does not have a negative impact on the employment outcomes of natives (Bonin, 2005; Devlin et al., 2014; Edo et al., 2018). Evidence on wage impacts is less conclusive, but generally points to small negative effects on wages concentrated on the bottom of the distribution. Impacts tend to be stronger for native workers in the unskilled service sector (Zorlu and Hartog, 2005; Dustmann et al., 2013; Nickell and Salaheen, 2015).

Cross-border labour flow can increase productivity and growth in receiving countries

The impact of mobility on productivity and growth is complex and intrinsically hard to measure. The empirical literature focusing on the EU mobility experience is sparse but generally suggesting positive effects. Looking at the UK experience, Ottaviano et al., (2015) finds that a 1% increase in mobile workers' concentration in local labour markets is associated with a 2-3% rise in labour productivity; Rolfe et al., (2013) find that mobile workers' concentration within specific industries was associated with slight increases in productivity, but the impact was small. At the aggregate level, Boubtane et al., (2015) find that mobility tends to boost productivity in euro area countries, with an estimated impact of 0.5% increase in productivity per a 1 percentage point in the mobile workers' share of the working age population.

Improving labour mobility

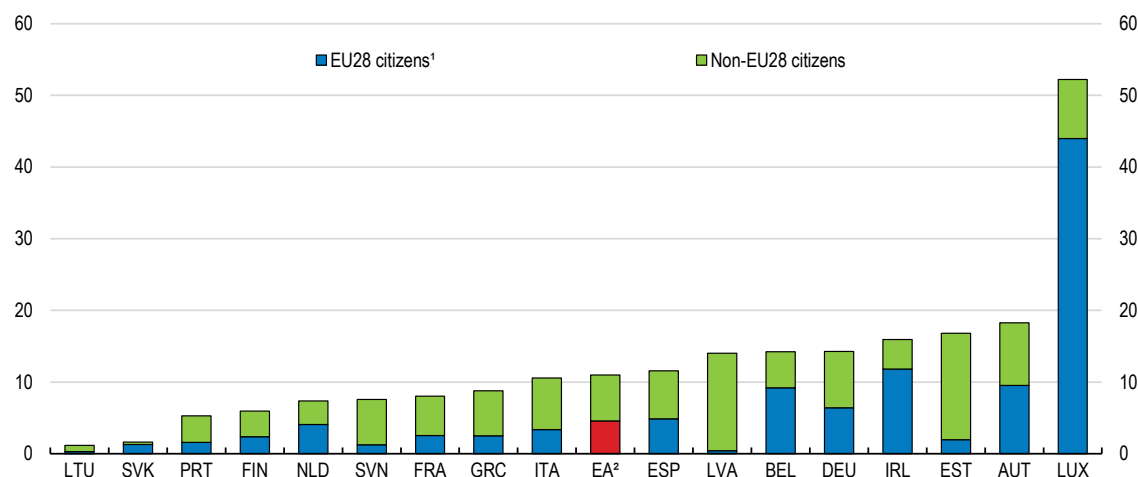
Cross-border labour mobility represents an important feature for the functioning of the EU single market and a key balancing tool for domestic labour markets experiencing excessive slack (or tightness) for prolonged periods. Despite often being a subject of controversy, evidence suggests that labour mobility does not reduce employment opportunities of natives, and it has the potential of delivering productivity gains in receiving countries (Box 2.2). Moreover, labour mobility policies – when also facilitating return mobility – may also help to reverse brain drain, where labour market developments allow (Box 2.3).

Movement of workers across euro area members has increased right before the pandemic, but at a slower pace than in previous years. In 2019, almost 18 million Europeans lived in another EU country, out of which 13 million of working age yet, the number of working-age EU-28 movers grew by only 1.2% in 2019,

substantially less than the 3.4% in 2018 (European Commission, 2021). Moreover, despite the stock of active movers has constantly increased from 2012 to 2019 (European Commission, 2021), cross-country flows of mobile workers are still too limited to significantly reduce unemployment in origin countries (Elsner and Zimmermann, 2013; Bräuninger and Majowski, 2011) and, in some euro area countries, third-country citizens outnumber EU nationals among working-age foreign residents (Figure 2.9).

Figure 2.9. In some euro area countries third-country citizens outnumber EU nationals among working-age foreign residents

20-64 year-olds, % of total population, 2018



Note: 1. Excluding nationals in reporting countries. 2. Euro area member countries that are also members of the OECD (17 countries).

Source: Eurostat (2020), "Population by age group, sex and citizenship", Eurostat Database.

StatLink  <https://doi.org/10.1787/888934276850>

Today, the necessity of supporting labour mobility within the EU is more stringent than ever. Restrictions to the freedom of movement within the Union, higher hurdle and financial costs linked to cross-border travel had a negative effect on intra-EU labour mobility over the last year (OECD, 2020d). During the spring 2020 peak of the COVID-19 pandemic, cross-border labour mobility has stopped, as a number of European governments closed their borders with neighbouring EU countries, cancelled international flights, or imposed border checks in an emergency attempt to stop the spread of infections. These measures were joined by domestic lockdowns, as most member states imposed restrictions on nonessential movements.

During the initial phase of the pandemic, the categories most affected by reduced cross-border mobility were seasonal and care workers. Yet, personal-care workers together, together with health professionals, have been on the frontline of the fight against the pandemic. In 2016, there were almost 350 000 health professionals in a member state other than their country of citizenship (European Commission, 2018). In addition, there are 257 000 personal care workers living in another EU Member State. Together, these three groups represent roughly 7% of all employed EU-28 movers (European Commission, 2018). Over one year after the beginning of the pandemic, some cross-country movement restrictions are still in place. As of September 2021, EU countries have restricted land border crossing to individuals presenting negative COVID-19 test results or being vaccinated against the COVID-19.

In case of the emergence of new vaccine resistant or more infectious virus variants causing a protracted pandemic, the challenge of maintaining adequate labour mobility in the EU would critically hinge on making cross-border transport safe (for travellers and destination countries) and affordable. In this respect and until the crisis is over, the EU should extend the coordinated approach to the restriction of free movement in response to the COVID-19 pandemic to some minimal rules for the screening and tracking of cross-

border travellers. The introduction of a COVID-19 vaccine passport has been a positive development to help improving the safety in cross-border travel.

The possibility of travelling affordably across euro area countries is a determinant of the decision of workers to relocate. This also relies on preserving capacity in cross-border transport services, chief among them the air transport industry. Air carriers have already cut a significant share of their cross-border and domestic flights, and there is the risk that they will not be able to quickly scale-up capacity again if the pandemic persists for long. In this respect, the possibility of utilising ad-hoc EU resources for the support of this industry, for example by financing job retention schemes via SURE, should be considered.

To support labour mobility beyond the pandemic, policy and institutional settings should ease the recognition of professional and academic qualifications across jurisdictions. Despite the 2013 Professional Qualifications Directive, qualification, training and other requirements to access regulated professions vary widely across countries, and the recognition of qualifications is often made on a case-by-case basis. Automatic cross-border recognition of professional qualifications is limited to a few health professions. Extending automatic cross-border recognition of professional qualifications to other professions could be explored. Other ways of further streamlining the national recognition procedures and improving access to regulated professions at the national level should also be considered.

Europe's linguistic and cultural diversities are another factor dampening cross-border labour flows. The Commission proposal for an enhanced Erasmus+ program, offering resources for learning and training abroad to young individuals, is welcome as it should help labour mobility eventually. Different social security systems can also limit social protection for migrant workers or distort mobility incentives. Improvements in the portability of pension rights as well as the extension of the exportability of unemployment benefits, making the country of last employment responsible for paying cross-border workers' benefits, may contribute to ease EU-movers' concerns about their social rights (OECD, 2018a). Finally, the complete implementation of the Electronic Exchange of Social Security Information (EESSI) system, a secured digital platform linking EU social security institutions at all territorial levels, could go a long way in coordinating social security institutions by enabling quicker and more efficient calculations of mobile workers' social security benefits. Other tools (e.g., the portability of accrued pension benefits or even a common pension mechanism) might also favour labour mobility.

Box 2.3. Labour mobility versus brain drain

Persistent net outflows of workers may deplete the human capital endowment in the country of origin, ultimately causing affected economies to suffer from declines in potential output and reducing their capacity to recover from shocks. The human capital loss of labour mobility is larger when mobile workers leaving the country have higher educational attainment (a situation often referred as “brain drain”). The concrete impact of such mobility on the involved economies is, however, difficult to assess (Bonin et al. 2020). In 2019, 34% of EU movers had a tertiary level of education. An estimated 1.8% of the population in the eastern member states that joined the EU in 2004 moved to the EU-15 between 2004 and 2009, rising to 4.1% for Bulgaria and Romania between 2007 and 2009 (Fic et al., 2011; European Commission, 2019) even if return mobility has increased in recent years and the COVID-19 pandemic appears to be linked to a significant reversal in brain drain.

The EU cohesion policy provides a support for regional development and for reducing disparities in the level of development among regions. Moreover, EU policies on labour mobility may counteract brain drain by supporting countries suffering sustained and prolonged losses of human capital due to mobility outflows. This could take place, for example, through the development of targeted mobility schemes, even in the context of the EURES – a platform that helps jobseekers to move abroad by finding a job in Europe – or *via* a fund supporting labour relocation of skilled workers to countries that underwent large and persistent net labour outflows. The exchange of good practices in the field, in the form of mutual learning and peer exchange, could also be envisaged, for instance through the ESF transnational cooperation platform and ESF+ transnational cooperation, once in place. Sending countries should prioritise policies aimed at fostering circular and return mobility, including through streamlined procedures for the validation of skills acquired abroad and the establishment of permanent links with diasporas.

Some EU countries supported initiatives to reverse brain drain. The success of these schemes, also depends on the overall national and regional development prospects. Greece launched “Rebrain Greece”, a program that offers workers between 28 and 40 years old a job with an attractive compensation if they return to Greece and “bring with them the knowhow gained abroad, innovations and fresh ideas.” The Greek government has committed to covering 70% of these salaries, with companies contributing the other 30%. Portugal’s Programa Regressar (“return programme”) has offered returnees who sign a full-time work contract in Portugal a cash incentive, a 50% income tax reduction for five years, and a cover for relocation costs. In Italy the “rientro dei cervelli” (“return of the brains”) programme was expanded in 2019. Italian nationals who relocate to Italy with a work contract and agree to stay there for at least two years can now get a 70% break on their income tax for up to 10 years. Provided non-discriminatory treatment between national and non-national EU citizens, the EU cohesion policy could consider targeted financial aids to national governments of countries that suffered brain drain for the financing of similar programmes. Indeed, for brain gain policies to be consistent with the fundamental principle of freedom of movement within the EU, they should be extended to attract educated citizens from all EU member states, instead of targeting only returning nationals.

Avoiding financial fragmentation during downturns

Completing the Banking Union is key to ensure improved resilience in European financial markets. The completion of the Banking Union should be approached in a holistic manner, covering all outstanding elements with the same level of ambition. Moreover, in the current juncture, European intermediaries need to be supported, in the face of a possible deterioration of credit quality in the aftermath of the pandemic. Reducing the reliance of European financial markets on banks is another priority to increase the resilience of credit provision to the real economy during downturns, avoiding that possible bank distress could develop in financial fragmentation. Despite some notable efforts toward the deepening of the Capital

Markets Union (CMU), the constitution of a truly European capital market still needs to develop along a number of priorities, most notably a stronger convergence in national frameworks, the development of securitisation and equity markets.

Increasing the resilience of European banks

A strong banking sector is at the core of smooth and balanced monetary policy transmission across euro area economies. This is a key determinant for cyclical convergence in a currency union. The levels of capitalisation and liquidity of euro area banks have increased significantly since the global financial crisis up to 2020 (Figure 2.10, Panel A). Yet, even before the COVID-19 pandemic, the European banking sector was challenged by low levels of profitability.

Looking ahead, European banks will face an increasingly challenging economic environment: after improvements in the quality of credit, the COVID-19 crisis could be accompanied by a significant rise in non-performing loans (NPLs). Initial estimates for a worst case scenario suggested that up to EUR 1.4 trillion of NPLs could potentially arise as a consequence of the COVID-19 crisis, although the probability of this scenario seems to have reduced since 2020 (Enria, 2020). Ongoing stress tests carried out by the EBA and the ECB will likely provide more accurate figures over the coming months. Credit losses are expected to be particularly large on exposures to sectors more hit by the crisis, such as recreation, transportation and, to a lesser extent, wholesale and retail trade (Mojon et al., 2021).

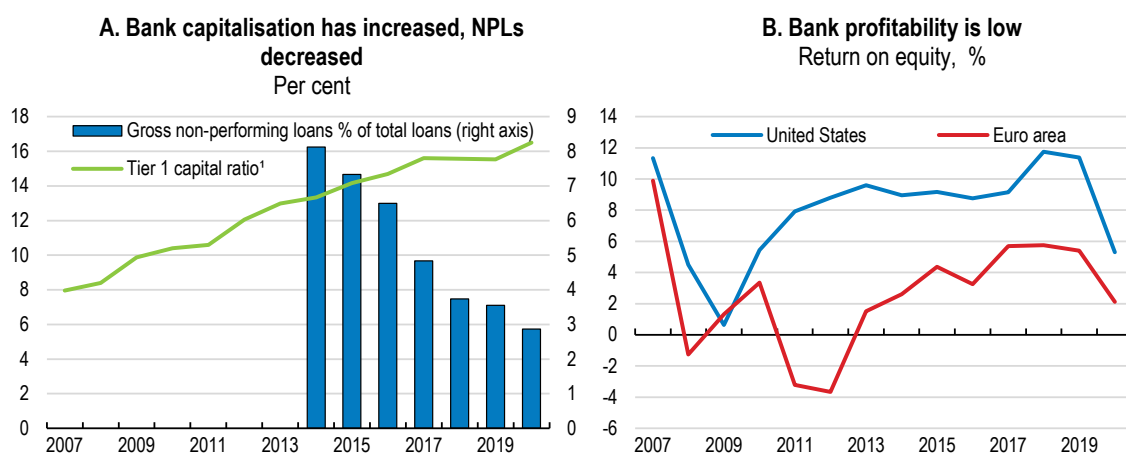
Euro area banks profitability has already deteriorated in 2020, on the account of expected credit losses booked since the beginning of the pandemic, in compliance with the newly introduced accounting standards for expected credit loss (Figure 2.10, Panel B). Given current low profit buffers, should a further deterioration of credit quality materialise – possibly in light of the prospected termination of debt moratorium policies – an increase of provisions for credit losses (PCLs) could dent banks' capital ratios. Moreover, over the medium term, the possible phase-out of the crisis support measures, may coincide with the re-emergence of heightened sovereign credit risk tensions, putting further pressure on banks in more exposed countries. Against this background, European financial policy should focus on supporting intermediaries' efforts to achieve higher operational efficiency, on reducing bank NPLs, and on setting up mechanisms to weaken bank-sovereign credit risk linkages.

Supporting European banks

Low bank profitability could be a primary source of concern for financial stability in the current economic turmoil, as low profit margins will limit banks' ability to preserve capital in the face of prospected credit losses. While preserving a sound competition environment, the EU policy framework should aim at helping banks reducing NPLs and at providing incentives to improve their profit margins, including via consolidation.

The expected increase in NPLs could be a main factor limiting the ability of European banks to generate profit and possibly to extend credit in the coming years. The best way to tackle non-performing loans is acting early and decisively. Regulators and financial authorities should strengthen the European framework to deal with NPLs, framing it around three main pillars: designing better insolvency and loan foreclosure procedures, improving regulatory policies, and developing secondary markets for distressed assets.

Figure 2.10. Euro area banks are more capitalised but struggling with low profitability



Note: Euro area changing composition, Tier 1 capital ratio and gross non-performing loans and advances % of total gross loans and advances, of all domestic banking groups and stand-alone banks. Last observation 2020Q3.

Source: ECB statistical warehouse; and Federal Reserve Bank of St. Louis.

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Reforms to loan foreclosing procedures should aim at cutting the length of procedures, at facilitating the transfer of collateral to the creditor and at expediting the sale and the valuation of collaterals. The proposed EU Directive on credit servicers, credit purchasers and the recovery of collateral (2018/63) contains some welcome provisions in this direction. The Directive proposal aims at accelerating extrajudicial collateral enforcement to reduce the costs for resolving NPLs, and at facilitating the outsourcing of the servicing of the loan to specialised credit servicers, and at facilitating the sale of nonperforming assets to specialised credit purchasers. A prompt and full adoption of the Directive proposal is necessary.

Some provisions in the EU securitisation framework limited the role that this financial practice can play in reducing NPLs in banks' balance sheets. The previous framework based on the Securitisation Regulation (EU) (Regulation (EU) 2017/2402) and the Capital Requirements Regulation (Regulation (EU) 575/2013) contained obstacles for banks to securitise non-performing exposures (NPEs), such as high capital charges on NPE securitisation positions that tended to overstate the actual risk embedded in the portfolio. The recently adopted amendments to the framework (Regulation (EU) 2021/557 and 2021/558) have removed these impediments and are therefore welcome.

The development of secondary markets for distressed debt is an important precondition to support bank efforts to dispose NPLs. Initiatives to improve data standardisation and infrastructure on secondary markets for NPLs (such the EBA standardised templates for the screening, financial due diligence and valuation during NPL transactions, and the Communication of the Commission Tackling non-performing loans in the aftermath of the COVID-19 pandemic) are welcome and can help reduce the wedge between the average NPL coverage ratio (in Europe about 45% in 2019, which means that on average NPE is valued 55 cents on euro book value) and the market price (around 20 cents on euro). This bid-ask divide - the gap between the price at which banks are willing to sell NPLs and the price at which buyers are willing to purchase them - is a major factor blocking the development of secondary markets for NPLs. Some concerns about the necessity of streamlining the EBA NPL template should be taken into consideration to improve its effectiveness.

To speed up the process of offloading NPLs from bank balance sheets, the establishment of Asset Management Companies (AMCs) dedicated to purchase NPLs should be considered. AMCs have often been used to manage distressed assets arising from systemic financial sector stress (Cerruti and Neyens, 2016) and have a proven track record in making significant contributions to the clean-up of banking sectors suffering from NPL problems in some circumstances (Fell et. al, 2017; OECD, 2018a). AMCs are

particularly suitable for the disposal of non performing exposures linked to loans of relatively large unit sizes, or linked to commercial real estate (due to relatively high collateral quality). This latter category is a likely source of NPLs for banks in the current juncture, which makes AMC's potentially suitable to deal with part of the NPLs arising during the pandemic.

The establishment of single European asset management company (EAMC) dealing with specific categories of NPLs could be one option to consider, as smaller euro area countries could face difficulties in setting up domestic AMC's, due to the fact that the establishment of such entities is complex and typically benefit from economies of scale. However, a EAMC, faces many hurdles, including the definition of its corporate governance, funding, the role of national governments, and to the presence of different insolvency and collateral enforcement frameworks across EU countries. Against this background, the establishment of national AMC's – possibly linked in a network – as encouraged by the European Commission's blueprint for national AMC's, could represent a more easily implementable option.

An AMC could be designed to purchase NPLs at market value against the issuance of bonds that could then be lodged by selling banks with the ECB as collateral for refinancing operations. The fund should ideally be backed by private investors including selling banks (as in the case of the Italian Recovery Fund, formally Atlante fund), to avoid conflict with the EU Bank Recovery and Resolution Directive that, under normal circumstances, allows the use of state aid to failing banks only if the bank is put in resolution, as a consequence. Selling intermediaries could be asked to invest in the fund proportionally to the stock of NPL that they plan to dispose via the AMC. Investing banks could therefore receive the difference between the average NPL coverage ratio (measuring the loan loss reserves set aside against the NPL accounted in bank balance-sheets) of sold NPEs and their market value in the form of shares of callable AMC capital. A private-sector backed AMC will not clash with state-aid rules even if purchasing NPLs above market prices, and it should be considered as a preferable option, in case of limited pockets of non-performing assets concentrated in few banks.

The possibility of a public participation in the capital of AMC's should be considered if needed in order to preserve financial stability (OECD, 2016). In normal times a government-backed AMC cannot buy NPLs above market prices without being considered as providing state aid and, as result, breaching the BRRD. However this option should be considered to remedy a serious disturbance in the economy, should a large and widespread deterioration of bank asset quality arise in the aftermath of the pandemic result in a threat to financial stability. This, together with other relevant conditions, could contribute to its qualification as a precautionary measure (as per art. 32(4)(d) of the BRRD and State aid measures). A public participation should also protect depositors and taxpayer's money and ensure a coherent burden sharing, as enshrined in BRRD.

Well-designed consolidation can help address the issue of overcapacity in retail banking by streamlining overlapping distribution networks, especially in fragmented markets. The risk stemming from too-large-to-fail financial institutions weakened support for consolidation in the banking industry in the aftermath of the global financial crisis. Yet, larger banks are now subject to capital surcharges that account for the increased systemic risk they entail for the economic system reflecting their systemic risk, requirements to absorb losses and recapitalise the bank without taxpayer support in resolution, and regimes for the recovery and resolution of large banks (FSB, 2021). Larger banks could also be better placed to meet business challenges and regulatory requirements in the industry. For example having easier access to the large Information and Communication Technology (ICT) investment necessary for cost-light banking models, and being better able to absorb the fixed cost linked to the issuance of TLAC instruments or those eligible under MREL (Minimum Requirement for own funds and Eligible Liabilities) (Klaus and Sotomayor, 2018).

Supervisory requirements should facilitate bank consolidation, while maintaining a safe banking sector. In particular, financial supervisors should consider that recognising the accounting gain — known as negative goodwill, or “badwill” — that can be generated when a bank buys a rival for less than the book value from a prudential prospective can create relatively strong incentives for bank mergers. The goodwill is the

difference between the purchase price and the net fair value of the assets minus the liabilities purchased in the acquisition. Banking regulation allows the goodwill to be included in the CET1 of a bank, but supervisors can, on a case-by-case basis, reduce the recognition under the prudential rules. Most European banks are currently trading below their book value, creating the potential for goodwill that can be used to boost capital ratios following aggregation. There is limited case, however, to support bank distribution of the windfall from the goodwill for example via dividends or share buybacks. The welcome ECB guidelines on the supervisory approach to consolidation in the banking sector published in January 2021 follow these principles.

Introducing a common deposit insurance scheme

A common European deposit insurance scheme (EDIS) would represent an important safeguard for the architecture of the European banking system in the wake of a possible re-emergence of asymmetric sovereign credit risk shocks, notably when monetary policy will start normalising. The pooling of deposit protection across the euro area in a common European deposit insurance scheme fuelled fears in some countries that a common fund could lead to excessive bank risk-taking behaviour (so-called moral hazard). To limit the risk of banks' cross-subsidisation and minimise moral hazard the insured banks should pay to the EDIS ex-ante insurance premia that should be based on a common methodology reflecting bank's riskiness and the systemic risk that they generate for the EU banking system (OECD, 2018b; European Commission, 2015; Carmassi et al., 2018; Acharya et al., 2010).

Proposed regulatory measures, such as "sovereign concentration charges", aim at discouraging banks to hold excessive amounts of domestic sovereign bonds since it could weaken the financial position of banks in case of a sovereign debt crisis (Véron, 2017). Credit risk spillovers between sovereigns and banks, were one of the aggravating factors of the 2011-2012 euro area sovereign debt crisis, although the strong commitment from the ECB to support monetary union helped abate the crisis and avoid its resurgence during the current pandemic crisis. However, a reduction of sovereign bonds held by domestic banks will in practice promote higher holdings of those bonds by foreign banks. In time of crisis, this may contribute to an increase in sovereign rollover risk, as the lending propensity of foreign investors tends to be more sensitive to credit risk reversals than that of domestic investors (BIS, 2018; Arslanalp and Tsuda, 2014; Ichiue and Shimizu, 2012; Gennaioli et al, 2018). To balance those conflicting risks, sovereign concentration charges could be limited to banks' mark-to-market portfolios, so as to exempt those longer-term investors that are a source of stability in sovereign debt markets. In any case, the possible introduction of sovereign concentration charges should be carefully assessed against the possible negative macroeconomic consequences they entail, in particular in times of crisis, and their possible phased-in only done very gradually.

Improving cross-border lending

Facilitating the operations of cross-border European banking groups could be an effective way to improve the resilience of the European banking sector. In addition to increased cross-border bank lending, it could also improve banking services to customers and contribute to addressing the fragmentation affecting European banks by promoting the establishment of more integrated groups. This should however not come at the detriment of national and European financial stability or depositor protection, and therefore be accompanied by appropriate safeguards, in particular in times of crisis.

The proposal to have cross-border capital waivers within the EU was not taken forward in the Capital Requirements Regulation II, because several member states feared it did not adequately address their concerns on national financial stability. This was a missed opportunity to reduce ring-fencing of European banking markets. National regulators can only choose to exempt subsidiaries of EU banking groups from some prudential ratios, such as liquidity requirements and large exposure limits, provided they are met at the group level. The Capital Requirements Regulation specifies that domestic supervisors can waive sub-

consolidated liquidity requirements for subsidiaries of parent bank entities within the Banking Union (so-called “cross-border waivers”).

In practice, national supervisors can decide not to apply such waivers if they consider that financial outflows may affect the liquidity position of local intermediary. In the 2019 EBA Risk Assessment Survey, 35% of the banks identified complexity and regulatory requirements as two of the main obstacles for cross-border consolidation, and 30% of the banks considering regulatory requirement as an obstacle refer to national waivers not being exercised (EBA, 2019). The ring-fencing of domestic markets, which aims to safeguard financial stability, can complicate cross-border banking operations, affecting cross-border bank lending and discouraging the establishment of more integrated European groups.

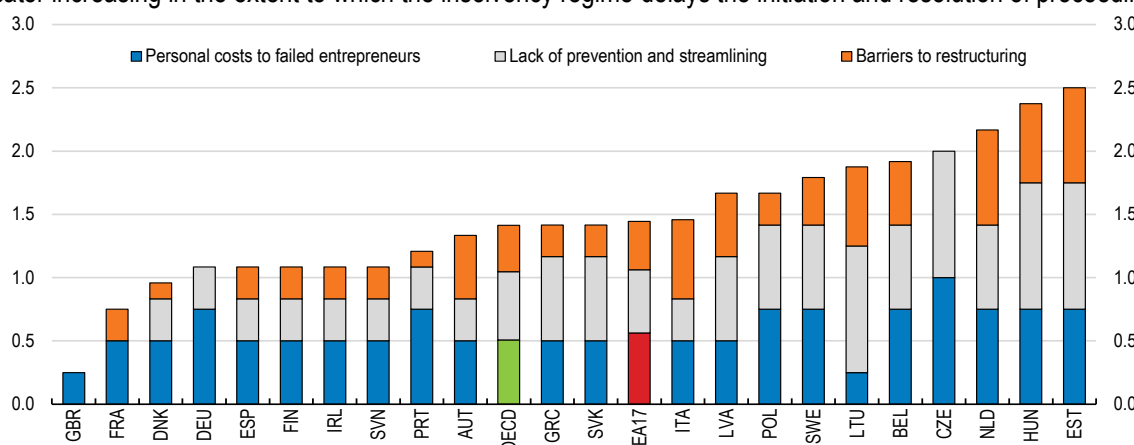
Further fostering convergence among national frameworks: insolvency regimes, regulation and oversight

Transparent and efficient insolvency frameworks are the backbone of cross-border capital market transactions and are necessary to improve cross border lending. In Europe, fragmentation in national insolvency regimes makes credit risk assessment difficult, including for NPLs’ valuation (Figure 2.11). The Commission has made welcome progress in facilitating debt recovery and harmonising insolvency proceedings across euro area members; the Recast Insolvency Regulation (Regulation (EU) No. 2015/848) provided valuable new rules regarding the law applicable to hybrid, pre-insolvency and secondary proceedings. Moreover, a new Directive (EU No. 2019/1023) entered into force in July 2019 with the objective of harmonising the laws and procedures of EU member states concerning preventive restructurings and the discharge of debt. These reforms are steps in the right direction, but further harmonisation efforts are necessary (OECD, 2018a; IMF, 2019; Deslandes et al., 2019).

Admittedly, a full harmonisation of national insolvency proceedings would be difficult to achieve, as insolvency regimes incorporate core specificities of national legal systems that cannot be easily levelled without reshaping a large part of national legal frameworks. Also, the EU has currently limited legislative competence in matters relating to many aspects that intertwine with bankruptcy law (such as corporate and labour laws). On the other hand, aiming at only a minimum harmonisation of the legal framework of restructuring may still be unsatisfactory, since the information costs of cross-border investments would still be significant.

Figure 2.11. Insolvency regimes vary significantly across European countries

Indicator increasing in the extent to which the insolvency regime delays the initiation and resolution of proceedings



Note: The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. Only countries for which data are available for the three sub-components in 2016 are included.

Source: Andrews, D., M. Adalet McGowan and V. Millot (2017), "Confronting the zombies: Policies for productivity revival", OECD Economic Policy Papers, No. 21, OECD Publishing, Paris.

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An alternative solution would be the introduction of a specific EU regime for corporate restructuring and insolvency to be applicable in specific cases. This pan-European insolvency regime could be envisaged as a parallel set of EU-wide regulations sitting alongside each of the national regimes and could include pan-European insolvency and bankruptcy rules that some companies could follow instead of their national laws. For example, their application could be imposed on larger companies issuing debt securities.

Ultimately, the creation of an EU regime for restructuring and insolvency would involve overcoming a number of hurdles, not least relating to the judicial treatment and national constitutional compatibility. This system could require the creation of specialised European bankruptcy Courts. These can be either full-fledged branches of European courts of first instance or spin-offs of national courts dedicated to the application of this regime. Non-legislative targeted approach could help to achieve further harmonisation. Easier access to information about national insolvency frameworks would be helpful for investors for example. Sharing best practices among member states and benchmarking exercises performed by the Commission may prove useful.

Bank insolvency regimes are also very different among the EU and could be further harmonised, benefiting the Banking Union and improving the predictability of insolvency outcomes through the Single Resolution Mechanism (Gelpern and Veron, 2019). The Bank Recovery and Resolution Directive (BRRD) currently does not fully substitute national bank insolvency proceedings, and it is only applicable where justified by public-interest considerations. Moreover, the insolvency process is seen by some as fairly cumbersome, potentially slow and permeated with political judgement that renders final outcomes hard to foresee – an undesirable characteristic for insolvency proceedings (IMF, 2018). In alternative, an EU administrative liquidation regime managed by resolution authorities could be considered, or a wider use of the harmonised resolution framework for banks that are failing or likely to fail.

For the European single market to function smoothly and efficiently, regulatory and supervisory practices between the competent authorities need to converge. A single supervisory mechanism is in place for the supervision of credit institutions, but not for financial markets. Against this background, the presence of gaps in the regulatory landscape can present a risk to the development of a real level playing field in the financial services industry and represent a cost for market participants willing to operate across borders. One of the reasons of such regulatory fragmentation is that much of European financial legislation is in the form of Directives that need to be transposed into domestic legal systems, a procedure that often entails the addition of national specificities. This results in cross-jurisdictional differences in regulations and supervisory practices. One possibility to increase the convergence of the oversight of capital markets and thereby speed up the deepening of the capital markets union, is to increase the supervisory role of the European Securities and Markets Authority (ESMA). The CCP Supervisory Committee (CCPSC), established under the European Market Infrastructure Regulation (EMIR) as a permanent internal committee of European Securities and Markets Authority (ESMA), has already started its work in the supervision of a limited number of activities in European financial markets, such as central clearing counterparts (CCPs). The supervisory role of ESMA could be gradually extended to other areas and financial market activities.

Strengthening market-based finance

Reducing the reliance of European financial markets on banks is a priority to increase the resilience of financing to the real economy during downturns, avoiding that possible bank distress could develop in financial fragmentation. For different reasons, the COVID-19 crisis and Brexit, create new urgency for the issue. The current crisis has the potential of heightening the risk of financial fragmentation in the euro area, while Brexit will result in a substantial structural change to the EU's financial architecture, calling for increased liquidity and integration in European financial markets. If the precise overall impact of Brexit on the EU's future financial architecture is difficult to predict at this stage (ECB, 2020), changes in euro area financial markets are likely to take place in a number of activities still underdeveloped in the currency union,

such as derivatives clearing, investment banking and securities and derivatives trading. Against this background, deepening the European Capital Markets Union (CMU) and the constitution of a truly pan-European capital market is key. The Commission has taken a number of steps in this direction, including measures in the CMU action plan. Yet progress is still needed - requiring substantial political backing by member states – in a number of areas. These include the development of equity markets and securitisation.

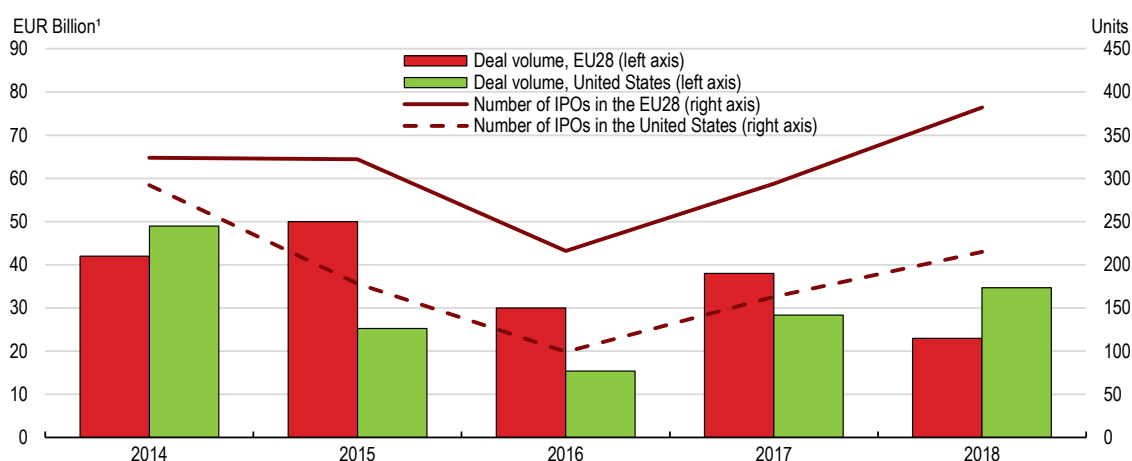
Developing equity financing

The development of equity markets is a priority for offering European firms a stable stream of funds as an alternative to debt finance, including via banks. The COVID-19 crisis has reinforced the importance that equity financing may have for firms, as stock market valuations recovered significantly after the initial shock linked to the pandemic, offering ample financing opportunities for listed companies willing to issue new shares. However, stock markets in Europe are sharply segmented along national lines, resulting in a wide dispersion of funding, limited liquidity, and overall insufficient mass. Along with an excessive fragmentation come higher costs for investors and limited depth. The proposal for the creation of a “consolidated tape” (CT) – an electronic system containing pre- and post-trade data (such as price and volumes) for equity instruments – is a welcome initiative, ensuring simpler access to and lowering the cost of market data. The European market CT will likely increase transparency and reduce overall transaction costs. However, its impact on pre-trade decision making for best execution (i.e. achieving the best possible result for customers when executing their orders via execution venues), especially in the corporate bond market often characterised by low liquidity, is less clear and it will crucially depend on the response of dealers and execution platforms.

The proposed establishment of a European single access point (ESAP) for companies’ financial and sustainable investment-related information – the first action in the Commission’s new action plan on the Capital Markets Union (CMU) – is a positive initiative to consolidate information on publicly traded companies, reducing fragmentation of information and search costs. The ESAP will particularly benefit the collection of comparable environmental, social and governance (ESG) data. However, non-financial reporting standards should be clearly identified prior to digitisation. This should include the ESG data relating to the Taxonomy Regulation and the Non-Financial Reporting Directive (NFRD), Sustainable Finance Disclosure Regulation (SFDR), and EU taxonomy.

Initial Public Offerings (IPOs) have been relatively buoyant in the EU (Figure 2.12). Yet, the market is still largely fragmented, and still relaying on non-EU players such as the London Stock Exchange (LSE) group accounting for about 40% of the total number of new share issuances (Constancio et al., 2019). The 2017 EU Regulation (EU 2017/1129) on prospectus regimes, aimed at simplifying and reducing costs for companies to access capital markets, introduced simplification and flexibility for all types of issuers. This regulation together with the introduction of “SME growth markets” – a new subcategory of multilateral trading facilities aimed at giving European SMEs much less onerous access to the public markets – and the recent Recovery Prospectus initiative, shortening prospectus requirements for share issuance in the wake of the COVID-19 crisis, are welcome developments. The Commission support for a SME IPO Fund is also positive. Public funding could act as an anchor investment to attract more private investors in high-growth, innovative SMEs at the stage of public listing.

Figure 2.12. The EU IPOs market has overtaken the one in the US in terms of deals, but volumes are declining



Note: EU-28 stock exchanges include, Athens, BME, Bucharest, Budapest, Bulgaria, CEESEG – Prague, CEESEG – Vienna, Deutsche Börse AG, Euronext (including Amsterdam, Brussels, Dublin, Paris, and Portugal), Ljubljana, LSE Group (including the London Stock Exchange and Borsa Italiana), Luxembourg, Malta, Nasdaq Nordics and Baltics (including Copenhagen, Helsinki, Iceland, Stockholm, Tallinn, Riga, and Vilnius), Warsaw, and Zagreb. US stock exchanges included are the Nasdaq-US and NYSE.

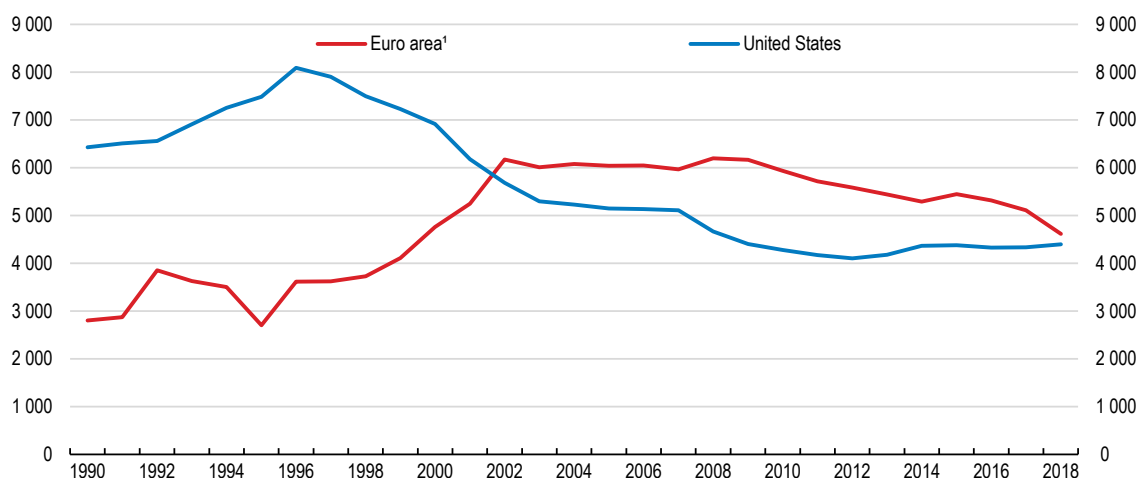
Source: Constancio, V., Lannoo, K., and Thomadakis, A. (2019). "Rebranding Capital Markets Union: A market finance action plan", CEPS-ECMI Task Force, June 2019.

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The challenge of developing equity finance in Europe is made more arduous by the current shrinking of public equity markets - where stock are bought and sold through publicly - in most advanced economies (Figure 2.13). This is due to a number of factors including a shift toward private equity, reduced liquidity, and cost imbalances between the cost of equity and the cost of debt (favouring the latter) (for an overview in Europe, Oxera Consulting, 2020). Against this background, European policy makers should put more efforts toward reducing the bias in favour of debt rather than equity created by corporate taxation rules (Figure 2.14). Most European corporate tax systems significantly favour debt over equity as a means of external financing, primarily through the deductibility of interest payments (ZEW, 2016; OECD, 2015). Moreover, dividends typically undergo double taxation, requiring corporates high dividend pay-outs to attract investors. Tax neutrality in corporate financing choices could be achieved by reducing the deductibility of interest payments. Most EU countries have already taken steps in this direction through the implementation of Action 4 of the OECD framework on BEPS (Base Erosion and Profit Shifting), that limits and links interest payments to profits earned.

Figure 2.13. The number of publicly listed companies declined in the euro area and in the U.S. over the last 20 years

Number of publicly listed companies



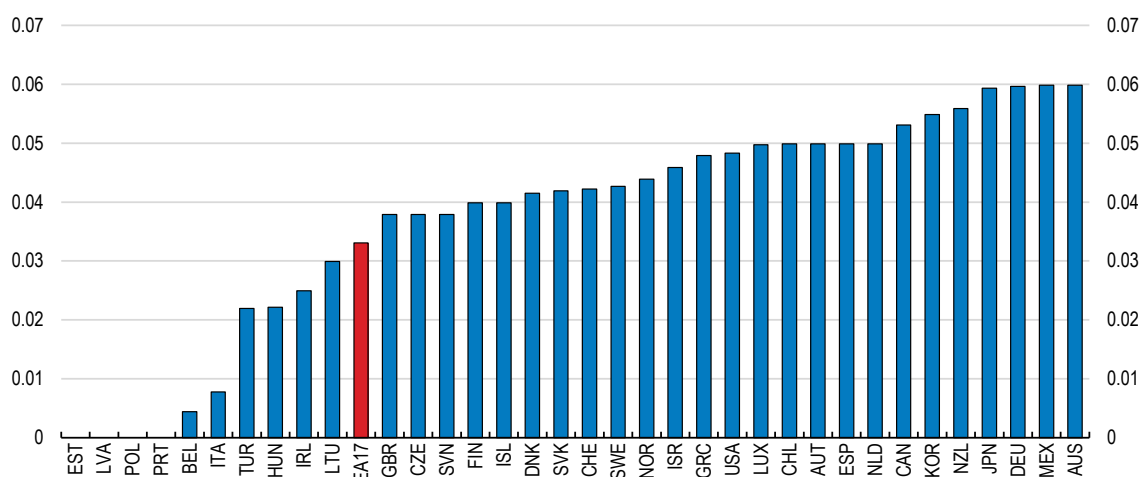
Note: Euro area member countries that are also members of the OECD, excluding Estonia, Finland, Lithuania and Slovenia for data limitations. Figures for Spain between 2004 and 2005 are interpolated.

Source: World Bank Development Indicators database.

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Figure 2.14. Corporate taxation favours debt over equity financing

Estimate of the debt-equity bias at the corporate level, percentage points, 2019



Source: OECD Corporate Tax Statistics.

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Alternatively, to avoid undesirable increases in the corporate effective average tax rate (EATR), an Allowance for Corporate Equity (ACE) should be considered (Box 2.4). The ACE has been in tax reform agendas since the 1980s, when its theoretical foundations were developed. Different models have been introduced during the past years by some euro area countries such as Austria, Belgium and Italy (Boadway and Bruce, 1984; Wenger, 1983; Klemm 2006). ACE can be interacted with adjustments to the capital income tax for individuals, to reduce dividend double taxation. The European Commission introduced ACE in the 2016 proposal for a common corporate tax base in the European Union (CCCTB).

Box 2.4. Allowance for corporate equity (ACE) in Europe

The characteristics and rationales of ACE schemes currently in place in euro area countries vary along a number of dimensions, including key factors such as the applied notional interest rate (approximating the return to debt); the equity base (covering the full amount of equity or only new equity – so-called “incremental” ACE schemes”); and the presence of anti-abuse provisions (preventing intra-firm cascading of multiple ACE deductions).

In Belgium the allowance for corporate equity allows all companies subject to corporate income tax to deduct a fictitious interest calculated on the basis of their shareholder’s equity (net assets) from their taxable income. Small firms receive an additional 0.5% risk premium on their notional rate. This was initially capped at 6.5% and is now limited to 3%. Since 2018, the deduction no longer applies to the full equity stock. It includes anti-avoidance provisions to prevent the cascading of the tax benefit. The rate is based on the return on a Belgian 10-year state bond. In Portugal, the ACE scheme foresees a notional return deductible up to EUR 2 million and capped at 25% of a firm’s EBITDA. It applies to capital increases for 5 years, provided capital is not reduced in that period. Prior to 2017, Portugal’s allowance for corporate equity was limited to small- and medium-sized enterprises (SMEs). In Italy the allowance for corporate equity allows all companies not involved in insolvencies procedures and keeping standard accounting books to deduct a fictitious interest calculated on the basis of their shareholder’s equity (net assets) from their taxable income. The deduction corresponds to the net increase in the “new equity” employed in the entity multiplied by a rate yearly determined annually (1.3% from 2019).

Source: Tax Policies in the European Union: 2020 Survey, European Commission staff work document SWD(2020) 14, January 2020, European Commission, Brussels.

Healthy equity markets require transparency to reduce information asymmetries between counterparts. This also relies on the availability of valuable market research. The requirement included in the MiFID II Directive to unbundle research costs from trading fees was aimed at increasing the transparency in the way equity market research was offered to investors, avoiding clients the burden of paying for unused research. If the Directive has clearly succeeded in increasing transparency in the procurement of market research for investors, some evidence suggests that it also might have had a negative impact on the overall availability of research, especially for small- and mid-cap firms, and that it produced a shrinking in market research infrastructure (CFA Institute, 2017). A decline in available market research should be considered as particularly worrisome for the future of equity markets, especially in the context of the ongoing shift toward passive investing strategies. The popularity of index mutual funds and exchange-traded funds (ETFs), which passively track existing stock indexes, has already grown substantially over recent years, also thanks to lower management fees that passive tracking allows, displacing higher-cost active investment styles.

Yet, there are reasons to believe that a non-discriminatory allocation of capital in equity markets may be suboptimal, damaging higher potential firms and promoting adverse selection effects. In fact, passive index tracking (as for the case of ETF and index funds) removes selective fund allocation, which is an important feature of efficient capital markets. There is a risk that reduced supply of market research can accelerate the drive toward passive investing, increasing sorting costs for investors in equity markets. In light of the above, the amendment the research of the unbundling rule contained in the MiFID II Directive to allow banks and financial firms to bundle research and execution costs when it comes to research on small and mid-cap issuers contained in the recent Capital Markets Recovery Package is a welcome decision. Whether this targeted amendment of the MiFID II will succeed in increasing the provision of market research will depend on the way the industry will react to the policy change. Looking ahead, the complete removal of the unbundling rule should be considered.

Increasing European cross-border equity capital mobility and holdings is an important objective of the CMU and a key factor to avoid fragmentation of domestic financial markets, notably in the euro area. Increased

cross-border equity flows and positions would allow for transnational private risk sharing and – no less important – would establish the ground for a wider pan-European ownership structure in European companies. This may represent an important driver for the development of a solid European corporate culture in larger EU firms to the benefit of the common market. In fact, the development of European companies is often hampered by an excessive national focus which blocks them from reaping the full potential of the Single Market. When they expand in other European markets, firms with strong single national ownership sometimes fail to develop an international corporate culture that is often key for succeeding cross-border. From this standpoint, the introduction of a European prospectus passporting, allowing issuers to offer or admit their securities to trading in any Member State without multiple approvals is a valuable provision.

Strengthening securitisation

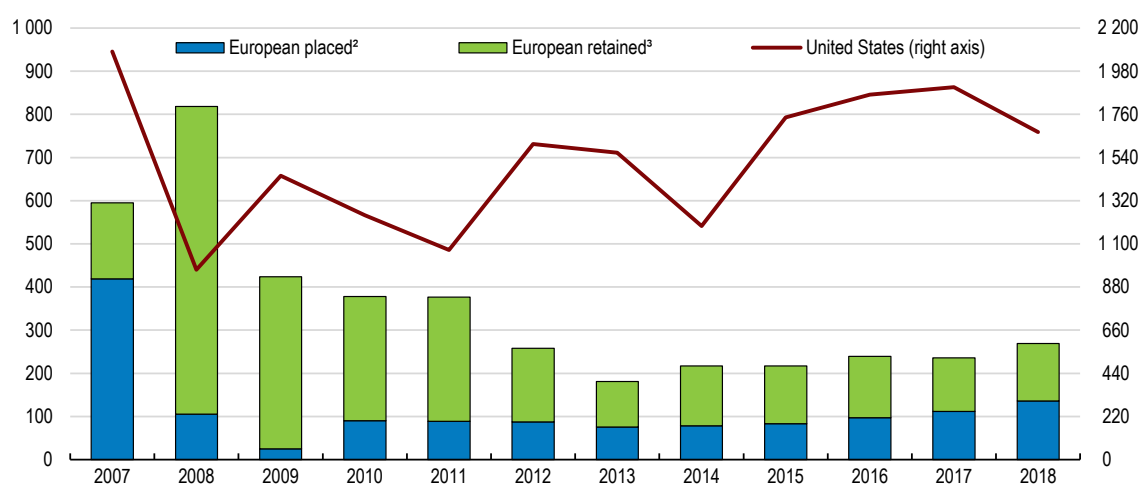
One way of increasing financing opportunities for firms and reducing the reliance on bank credit is to revive the European securitisation market. Securitisation can also support bank credit by freeing up capital for new lending and by helping banks disposing of NPLs. In 2018 securitisation issuance volumes in the EU were the highest recorded since 2013, at EUR 269 billion. Still this figure is far below pre-crisis levels (Figure 2.15). In contrast, the U.S. securitisation market is much larger and has almost recovered to pre-GFC levels, albeit with a different asset mix.

The EU approach to revive securitisation has been to develop some European basic rules for a safer securitisation. The Regulation (EU) 2017/2402, sets a number of provisions for Securitisation Special Entities (SSPEs) and provides criteria and common rules for so called simple, Standardised and Transparent Securitisation (STS) in the EU. These are positive development.

The development of covered bond-like structures backed by SME loans, such as the European Secured Notes (ESNs), can complement efforts to open up new financing sources for SMEs as an alternative to bank credit. The ESNs are dual recourse instruments (the investor has recourse against the issuer and the collateral), similar to covered bonds but arguably riskier, that can provide a useful additional source of funding, especially for small institutions that do not have access to the securitisation market or have difficulty issuing unsecured long-term debt. The function of ESNs as financing instruments for SMEs partially overlaps with the one obtainable with securitisation. However, ESNs do not relieve banks from credit obligations as in the case of securitisation, which links the quality of ESNs to the overall credit worthiness of the banking sector. Challenges with the development of the ESNs concern possible lack of market interest and the definition of the parameters of the product in the context of generally high and heterogeneous default rates for SME loans.

Figure 2.15. Securitisation in Europe has not recovered since the global financial crisis

European and US issuance¹, EUR billions



Note: 1. European volumes include transactions from all countries in the European continent, including, Iceland, Kazakhstan, Russia and Turkey. European volumes include CLOs and CDOs denominated in all European currencies. Volumes have been subject to periodical revision according to the available updated information. 2. Placed issuance refers to issuance sold to investors. 3. Retained issuance refers to securities retained by the originators. A high retention ratio may suggest lack of demand.

Source: Association for Financial Markets in Europe (2019), AFME 2019-Q2 Securitisation Data Report.

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Establishing a fiscal framework for cross-country business cycle stabilisation

A common fiscal capacity is one of the main tools for business cycle stabilisation and cyclical convergence in a currency union, and it remains a missing feature of the euro area. While the euro area is currently built on a model of limited fiscal integration, a common fiscal stabilisation capacity would provide resources to reduce divergence in business cycle fluctuations across its members, complementing the capacity of euro area member states to conduct counter-cyclical fiscal policy. The necessity for such a tool has increased in the wake of the COVID-19 crisis, which had a large and asymmetric economic impact across euro area economies. Building on the European responses to the pandemic crisis, a debate over the creation of a common euro area fiscal stabilisation capacity should be restarted.

The COVID-19 crisis created some momentum toward deeper fiscal integration in the EU. In support of countries more strongly hit by the epidemics, EU member states have agreed on a number of new financing measures that represented a significant step toward a stronger framework of cross-country fiscal support in response to the COVID-19 crisis. The measures adopted comprise some new temporary lending tools – such as the Support to mitigate Unemployment Risks in an Emergency (SURE) – and a larger recovery plan (Next Generation EU) linked to the next multiannual EU budget 2021-27. These measures can have an impact in reducing growth divergence in the aftermath of the current crisis. However, they are meant to be temporary only.

Many proposals have been made in the past to provide euro area countries with a permanent fiscal capacity (for a review Benassy-Quéré and Weder di Mauro, 2020). The previous OECD Survey (OECD, 2018a) proposed a European unemployment re-insurance scheme that would be complementary to other possible national schemes, providing short-term non-discretionary transfers. Unemployment is critically affected during business cycles and an unemployment insurance scheme works as an automatic stabiliser (Beblavý et al., 2015). Several studies indicate that an unemployment reinsurance scheme could play a significant role in smoothing activity of euro area countries in case of large shocks (Carnot et al., 2017; Claveres and Strasky, 2018; Arnold et al., 2018; Box 2.5). Simulations indicate that an unemployment

reinsurance fund would need a borrowing capacity of about 2.5% of euro area GDP to function adequately. Against this background, the euro area should consider equipping itself with a central stabilisation capacity, for example in the form of an unemployment reinsurance scheme.

Cross-country fiscal stabilisation is not only linked to the expenditure side. In currency unions, income taxes collected at a centralised level contribute to stabilisation against shocks (Nikolov and Pasimeni, 2019). Although controversial in some member states, increasing the taxation capacity of the EU may represent an alternative route for the establishment of cross-border fiscal stabilisation in the euro area under the condition that EU funds are spent in a way that supports fiscal stabilisation. As tax receipts tend to fluctuate with the economic cycle, countries in expansion can contribute more to the EU budget with respect to countries in recessions. To increase efficacy, a preference should be given to taxes showing larger tax revenue elasticity to cycle fluctuations. Increasing the tax capacity of the EU can also strengthen its ability to borrow in financial markets, allowing the EU to compensate for the loss of fiscal revenue in downturns, without cutting spending to avoid running a deficit.

In November 2020, EU institutions agreed on a roadmap towards the introduction of new own resources. As a first step, the digital levy, the carbon border adjustment mechanism and the Emissions Trading System own resource will be proposed with a view to their introduction in 2023. As a second step, a proposal of additional new own resources, which could include a Financial Transaction Tax and a financial contribution linked to the corporate sector or a new common corporate tax base, would be studied. The institutions furthermore agreed that the new own resources should be sufficient to cover an amount corresponding to the expected expenditure related to the repayment under Next Generation EU. The own resources arrangements should be guided by the overall objectives of simplicity, transparency and equity, including fair burden-sharing.

Finally, some revenue-based fiscal stabilisation can also be obtained by adjusting national GNI-based contributions to the EU budget on the basis of one or more indicators of the cyclical position of the contributing economy. Such contributions, for example, could be partially based on GNI growth in previous years.

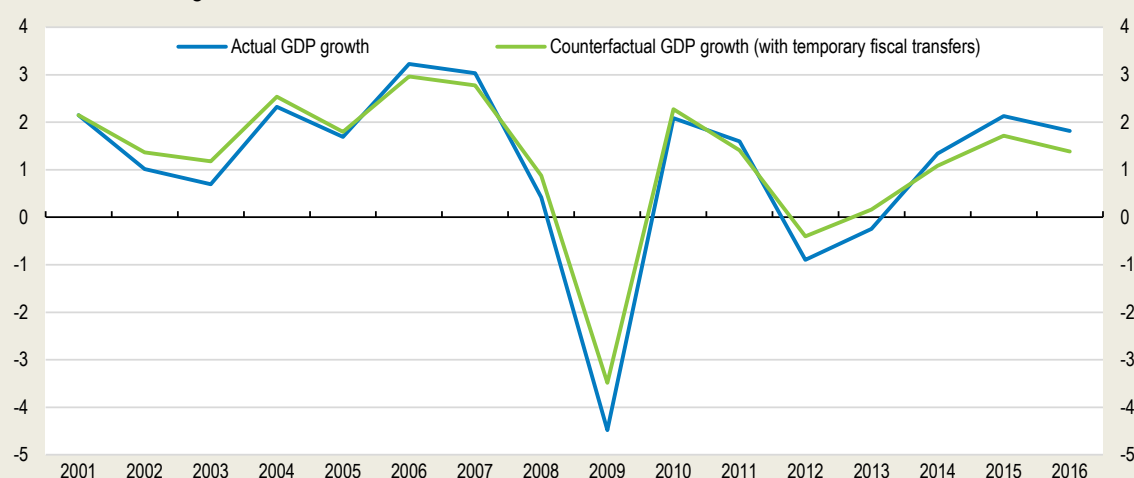
Box 2.5. The stabilisation effect of a common employment insurance scheme

Claveres and Stráský (2018) provide evidence of the macroeconomic stabilisation properties of a European unemployment re-insurance scheme. This scheme is designed to release payments on the basis of a rise in the unemployment rate in comparison to the previous year and to the 10-years moving average. As pay-outs 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. Moreover, the support is not maintained when the unemployment rate settles down at a higher level, thus not weakening incentives for the country to undertake structural reforms. This job retention schemes) and only in the form of transfers (SURE is based on loans).

Simulations suggest that a European unemployment re-insurance scheme could have reduced the standard deviation of euro area GDP growth by 0.4% during the financial crisis (Figure 2.16). In doing so, the scheme would have mobilised average annual contributions of participating countries of around 0.2% of their national GDP, over 2000-16 while avoiding permanent transfers. Also, most euro area countries would have benefited from the scheme at some point. These results are comparable to other studies in the literature with slightly modified assumptions regarding the conditions for payouts and contributions (Carnot et al., 2017; Beblavý et al., 2017).

Figure 2.16. Unemployment benefits re-insurance scheme help smoothing economic shocks

Euro area real GDP growth



Source: Claveres and Stráský (2018) based on OECD (2018), OECD Economic Outlook: Statistics and Projections (database).

StatLink  <https://doi.org/10.1787/888934276698>

FINDINGS (main in bold)	RECOMMENDATIONS (key in bold)
Establishing a framework for cross-country business cycle stabilisation	
One missing feature of the euro area is a common fiscal capacity which would help to reduce diverging business cycles.	Consider setting up a common fiscal stabilisation capacity, for example, through an unemployment benefits re-insurance scheme for the euro area.
Making labour markets more resilient to the economic cycle	
Countries that favour within-firm work flexibility in case of economic shocks and have a good training system for the unemployed often had smaller and shorter increases in unemployment.	Encourage member states to reinforce job retention schemes to be used in case of a temporary economic shock, together with training. To favour job reallocation in case of durable shock, encourage member states to enhance activation policies, including for workers under job retention scheme.
Cross-border labour mobility helps the functioning of the EU single market through better matching between workers and job offers across countries, and reducing persistent wedges in labour markets.	Extend cross-border recognition of professional qualifications. Complete the implementation of the Electronic Exchange of Social Security Information.
Persistent net outflows of high-skilled workers ("brain drain") may deplete the human capital endowment in the country or region of origin.	Promote the exchange of good practices to favour return mobility, for instance through the European Social Fund Plus (ESF+) including its transnational cooperation framework. In countries suffering brain drain, extend brain gain policies to attract EU skilled workers regardless of their nationality.
Improving the functioning and resilience of the common European financial market	
As a consequence of the COVID-19 crisis, euro area banks are expected to face a new wave of non-performing loans (NPLs).	To facilitate the disposal of bank NPLs: i) approve ongoing reforms on foreclosing procedures; ii) improve data standardisation on secondary markets (for example via NPL standardised templates); iii) consider the establishment of a network of asset management companies (AMCs).
The European banking system is not yet fully integrated. Deposits in euro area banks are vulnerable to shocks in individual countries, and discussions are ongoing in the High Level Working Group on a European deposit Insurance Scheme (HLWG on EDIS).	Complete the Banking Union by addressing all outstanding issues in a holistic manner.
Fragmentation in supervision and oversight, and inconsistencies among national insolvency frameworks are obstacles to the functioning of the single market for capital and for the completion of the Capital Markets Union.	Consider increasing in due time the supervisory role of the European Securities and Markets Authority (ESMA). Step up convergence in insolvency regimes or explore frameworks for a pan-European corporate insolvency regime.

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EURO AREA

The COVID-19 pandemic forced most euro area economies into repeated lockdowns in 2020 and early 2021 that lead the euro area into its deepest recession on record in 2020. The policy reaction to the crisis was large and rapid. It included, among others, significant monetary and fiscal stimuli, but also an ambitious European plan ("Next Generation EU") to promote economic recovery financed by joint borrowing. However, a durable recovery will require the completion of an ambitious reform agenda, including to the economic architecture of the currency union. This Survey has three main messages. Firstly, monetary and fiscal policy accommodation should continue as long as necessary for the recovery to take hold and inflation to return to the central bank objective. Secondly, the current review of the monetary strategy and the planned discussion of the European fiscal framework are key to buttress macro-economic policy in Europe. The European Central Bank should adjust its objectives and tools to new challenges while fiscal rules need to be evaluated with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership. Thirdly, the risk of divergence among euro area members following the COVID-19 crisis needs to be addressed by considering the establishment of a common fiscal capacity, completing the Banking Union, deepening the Capital Markets Union (CMU), and encouraging reforms of domestic labour markets.

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