OECD Economic Surveys

Euro Area

September 2021

OVERVIEW

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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 Alvaro 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 Jean-Rémi Bertrand, Emily Derry and Alexandra Guerrero. The previous Survey of the Euro Area was issued in June 2018. Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at http://www.oecd.org/eco/surveys.
### BASIC STATISTICS OF THE EURO AREA, 2020*

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

#### LAND, PEOPLE AND ELECTORAL CYCLE

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
<th>OECD Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2019)</td>
<td>341.0</td>
<td>147.6</td>
</tr>
<tr>
<td>Under 15 (%, 2019)</td>
<td>15.0 (17.9)</td>
<td>80.8 (80.2)</td>
</tr>
<tr>
<td>Over 65 (%, 2019)</td>
<td>20.9 (17.1)</td>
<td>78.0 (77.6)</td>
</tr>
<tr>
<td>International migrant stock (% of population, 2019)</td>
<td>14.2 (13.2)</td>
<td>83.7 (82.9)</td>
</tr>
<tr>
<td>Latest 5-year average growth (%)</td>
<td>0.2 (0.6)</td>
<td></td>
</tr>
</tbody>
</table>

#### ECONOMY

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
<th>OECD Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population density per km² (2016)</td>
<td>147.6</td>
<td>(38.1)</td>
</tr>
<tr>
<td>Life expectancy at birth (years, 2019)</td>
<td>80.8</td>
<td>(80.2)</td>
</tr>
<tr>
<td>Men (2019)</td>
<td>78.0</td>
<td>(77.6)</td>
</tr>
<tr>
<td>Women (2019)</td>
<td>83.7</td>
<td>(82.9)</td>
</tr>
<tr>
<td>Latest 5-year average real growth (%)</td>
<td>0.2 (0.6)</td>
<td></td>
</tr>
<tr>
<td>Gross domestic product (GDP)</td>
<td>12,904.3</td>
<td>1.9 (3.8)</td>
</tr>
<tr>
<td>In current prices (billion USD)</td>
<td>11,309.8</td>
<td>-0.5</td>
</tr>
<tr>
<td>In current prices (billion EUR)</td>
<td>11,309.8</td>
<td></td>
</tr>
<tr>
<td>Per capita (thousand USD PPP, 2019)</td>
<td>49.4 (47.6)</td>
<td>24.9 (26.6)</td>
</tr>
<tr>
<td>Services</td>
<td>72.9</td>
<td>(70.8)</td>
</tr>
<tr>
<td>latest 5-year average growth (%)</td>
<td>0.2 (0.6)</td>
<td></td>
</tr>
<tr>
<td>Headline inflation (y-o-y % change, Jun-2021, OECD: May-2021)</td>
<td>1.9</td>
<td>(3.8)</td>
</tr>
<tr>
<td>Deposit facility rate (% Jun-2021)</td>
<td>-0.5</td>
<td></td>
</tr>
<tr>
<td>Value added shares (%, 2019)</td>
<td>0.2 (0.6)</td>
<td></td>
</tr>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>2.2</td>
<td>(2.7)</td>
</tr>
<tr>
<td>Industry including construction</td>
<td>24.9</td>
<td>(26.6)</td>
</tr>
<tr>
<td>Latest 5-year average real growth (%)</td>
<td>0.2 (0.6)</td>
<td></td>
</tr>
<tr>
<td>Main exports (% of total merchandise exports)</td>
<td>30.6</td>
<td></td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>30.6</td>
<td></td>
</tr>
<tr>
<td>Chemicals and related products, n.e.s.</td>
<td>15.9</td>
<td></td>
</tr>
<tr>
<td>Manufactured goods</td>
<td>15.9</td>
<td></td>
</tr>
<tr>
<td>Main imports (% of total merchandise imports)</td>
<td>32.1</td>
<td></td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>32.1</td>
<td></td>
</tr>
<tr>
<td>Chemicals and related products, n.e.s.</td>
<td>16.9</td>
<td></td>
</tr>
<tr>
<td>Manufactured goods</td>
<td>16.9</td>
<td></td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>45.2 (50.8)</td>
<td></td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>41.2 (46.9)</td>
<td></td>
</tr>
<tr>
<td>Per capita (thousand USD PPP, 2019)</td>
<td>49.4 (47.6)</td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>72.9</td>
<td>(70.8)</td>
</tr>
<tr>
<td>Gross domestic expenditure on R&amp;D (% of GDP, 2018)</td>
<td>1.7 (2.6)</td>
<td></td>
</tr>
<tr>
<td>Average hours worked per year</td>
<td>1,536 (1,687)</td>
<td></td>
</tr>
<tr>
<td>CO2 emissions from fuel combustion per capita (tonnes, 2019)</td>
<td>6.6</td>
<td>(8.3)</td>
</tr>
<tr>
<td>Renewable (% of total primary energy supply, 2019)</td>
<td>17.9 (10.8)</td>
<td></td>
</tr>
<tr>
<td>Municipal waste per capita (tonnes, 2019)</td>
<td>63.0 (61.7)</td>
<td></td>
</tr>
<tr>
<td>Education outcomes (PISA score, 2018)</td>
<td>489 (487)</td>
<td></td>
</tr>
<tr>
<td>Science</td>
<td>489 (487)</td>
<td></td>
</tr>
<tr>
<td>Mathematics</td>
<td>495 (499)</td>
<td></td>
</tr>
<tr>
<td>Education (Gini coefficient, latest available)</td>
<td>0.298 (0.318)</td>
<td></td>
</tr>
<tr>
<td>Income inequality (Gini coefficient, latest available)</td>
<td>0.298 (0.318)</td>
<td></td>
</tr>
<tr>
<td>Relative poverty rate (%, 2018, OECD: 2017)</td>
<td>11.0 (11.7)</td>
<td>489 (487)</td>
</tr>
<tr>
<td>Median disposable household income (thousand USD PPP, 2018, OECD: 2017)</td>
<td>3.2 (17.8)</td>
<td>495 (499)</td>
</tr>
<tr>
<td>Public and private spending (% of GDP)</td>
<td>10.3 (8.6)</td>
<td>489 (487)</td>
</tr>
<tr>
<td>Health care (2019)</td>
<td>8.5 (8.5)</td>
<td>33.0 (31.4)</td>
</tr>
<tr>
<td>Share of women in parliament (%)</td>
<td>489 (487)</td>
<td></td>
</tr>
<tr>
<td>Education (Gini of GNI, 2019)</td>
<td>4.5</td>
<td>(4.4)</td>
</tr>
<tr>
<td>Net official development assistance (% of GNI, 2017)</td>
<td>0.3</td>
<td>(0.2)</td>
</tr>
</tbody>
</table>

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

** Where the OECD and euro area aggregate is 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.

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

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>
<thead>
<tr>
<th>Table 1. The recovery is firming up</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Gross domestic product (GDP)</td>
</tr>
<tr>
<td>Private consumption</td>
</tr>
<tr>
<td>Government consumption</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
</tr>
<tr>
<td>Consumer price index</td>
</tr>
</tbody>
</table>


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.
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 consolidation 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-cyclicality 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.

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.

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.

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

#### 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-cyclicity 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 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 of 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-cyclicality 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

<table>
<thead>
<tr>
<th>A. Country Stringency index scores¹</th>
<th>B. COVID-19 daily death toll</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scaled from 0 to 100 (highest category of restrictions), 2020/21</td>
<td>Per million inhabitants², 2020/21</td>
</tr>
<tr>
<td>EA17</td>
<td>OECD</td>
</tr>
<tr>
<td><img src="image1.png" alt="Graph showing stringency index scores" /></td>
<td><img src="image2.png" alt="Graph showing COVID-19 daily death toll" /></td>
</tr>
</tbody>
</table>

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.

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

A. Europe has been hit hardest
Index 2019 Q4=100, volume

B. Contributions to GDP growth¹
Percentage points, EA17

C. Confidence in manufacturing is proving more resilient²
Manufacturing PMI, Services PMI³

D. Low-skill services have been most affected
Change in value added in 2020 relative to 2019, EA17

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.
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**

<table>
<thead>
<tr>
<th>A. Balance of payments</th>
<th>B. Unemployment has increased</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of GDP¹</td>
<td>Percentage, EA19</td>
</tr>
</tbody>
</table>

Note: 1. National-level current account balances include intra-EU net positions.
Source: Eurostat (2021), "Balance of payments statistics (BPM6)", Eurostat Database.

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

A. GDP in end 2022 will still lag behind its pre-crisis level
   Index 2019 Q4=100, volume, EA17

B. Fiscal policy has been supportive
   Change in the underlying primary balance, %, EA17

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

Risks to the economic outlook are multiple: longer term “scarring effects” could emerge, as a consequence of bankruptcies, 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 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 projections
| Euro area,¹ annual percentage change, volume (2015 prices) |
|---------------------------------|----------------|----------------|----------------|----------------|----------------|
|                                  | 2018 | 2019 | 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  |
| Stockbuilding²                   | 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 exports²                     | 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 gap³                      | 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, net⁴     | 6.5  | 6.8  | 13.7 | 11.9 | 7.5  |
| Current account balance⁵         | 3.5  | 3.1  | 2.9  | 3.3  | 3.2  |
| General government fiscal balance³| -0.5 | -0.6 | -7.2 | -7.2 | -3.7 |
| Underlying general government fiscal balance³| -0.4 | -0.6 | -2.5 | -5.1 | -3.9 |
| Underlying general government primary fiscal balance³| 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 debt⁶     | 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 debt⁵          | 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.

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

<table>
<thead>
<tr>
<th>Event</th>
<th>Possible outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>New COVID-19 outbreaks linked to new vaccine-resistant virus variants.</td>
<td>Re-imposition of stricter confinement measures and heightened uncertainty, with major negative impacts on private consumption and investment. Increases in unemployment and bankruptcies.</td>
</tr>
<tr>
<td>A surge in NPLs, in a context of increased risk-aversion.</td>
<td>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.</td>
</tr>
<tr>
<td>Slow implementation of the EU recovery plan and premature withdrawal of fiscal support.</td>
<td>Persistently weak public investment would slow down the recovery. Sovereign debt tensions could re-emerge.</td>
</tr>
<tr>
<td>A broad vaccination coverage, coupled with continuous testing, tracing and isolation strategies.</td>
<td>Circumscribing episodes of virus resurgence can allow for a faster phase out of virus control measure, thereby supporting a quicker recovery in activity.</td>
</tr>
</tbody>
</table>

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

A. Key European Central Bank (ECB) interest rates

- Deposit facility
- Marginal lending facility
- Main refinancing operations

B. Central banks’ total liabilities

- Euro area
- United States
- Japan

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**

![Graph A: Systemic Stress Composite Indicator](image)

**Euro area¹, index**

![Graph B: Standard deviation in 10-year government bond](image)

**Euro area², standard deviation**

Note: 1. EA19 member countries. CISS stands for Composite Indicator of Systemic Stress (0=No Stress, 1=High Stress). It aggregates stress symptoms across money, bond, equity and foreign exchange markets and is computed from time-varying correlations among individual asset returns. 2. Euro area members that area also part of the OECD excluding Estonia.

Source: ECB Statistical Data Warehouse; and OECD calculations.

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 \textit{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 largely 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 rise to be, largely 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\% 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 after 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 Eurosystem’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.

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 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

<table>
<thead>
<tr>
<th>A. Bank capitalisation has increased, NPLs decreased</th>
<th>B. Bank profitability is low</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage</strong></td>
<td><strong>Return on equity, percentage</strong></td>
</tr>
<tr>
<td><strong>Gross non-performing loans % of total loans (right axis)</strong></td>
<td>United States</td>
</tr>
<tr>
<td><strong>Tier 1 capital ratio¹</strong></td>
<td></td>
</tr>
</tbody>
</table>

Note: 1. Regulatory Tier 1 Capital to risk-weighted assets.
Source: IMF (2020), Financial Soundness Indicators (database), International Monetary Fund, Washington, D.C.

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

A. Price-to-earnings ratio
Percentage, Euro area

B. House prices
Euro area

Note: Euro area member countries that are also members of the OECD (17 countries).
### Table 1.3. Monetary and macroprudential policy measures taken since the 2018 Survey

<table>
<thead>
<tr>
<th>Main recommendations of the 2018 Survey</th>
<th>Action taken since 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gradually normalising monetary policy</td>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
<td></td>
</tr>
<tr>
<td>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.</td>
<td>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).</td>
</tr>
<tr>
<td>To better gauge commercial real estate price dynamics, systematically collect granular and harmonised data on commercial real estate.</td>
<td>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).</td>
</tr>
</tbody>
</table>

### 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 makeup 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.
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.

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 temporarily 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

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.
Improving EU fiscal rules will make fiscal policies more effective

Reviewing fiscal benchmarks to ensure sustainability, reduce complexity and avoid procyclicality

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 cyclicity issues in a strict rule-oriented framework. To avoid procyclicality 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

Change in the underlying primary balance (% points)

-1.5 -1.0 -0.5 0.0 0.5 1.0 1.5 2.0
-4 -3 -2 -1 0 1 2 3 4
Output gap


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

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

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; Benassy-Quéré and al., 2018, 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-cyclicality 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. Andrle 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).

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-cyclicality. 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-cyclicality 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 pro-cyclical 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

<table>
<thead>
<tr>
<th>Main recommendations of the 2018 Survey</th>
<th>Action taken since 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>As the expansion continues, euro area countries should ensure their fiscal position improves, gradually reducing debt ratios.</td>
<td>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.</td>
</tr>
<tr>
<td>Eventually, countries should follow an expenditure objective that ensures a sustainable debt-to-GDP ratio.</td>
<td>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.</td>
</tr>
<tr>
<td>The European Fiscal Board could assess the appropriate fiscal stance for each country consistent with the optimal stance at the euro area level.</td>
<td>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.</td>
</tr>
</tbody>
</table>

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 (M. 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; Arnold et al., 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 issued 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

A. Currency composition of official currency reserves

Percentage of allocated reserves

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.

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

A. Outstanding amount of sovereign debt securities rated AA+/AA1 or above

EUR trillion, as of November 2019

<table>
<thead>
<tr>
<th>Year</th>
<th>Euro area</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>1.8</td>
<td></td>
</tr>
</tbody>
</table>

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.

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 re-denomination 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

![Graph showing the difference between 5-years credit default swap (CDS) 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.]

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

<table>
<thead>
<tr>
<th>Main recommendations of the 2018 Survey</th>
<th>Action taken since 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Set up a common fiscal stabilisation capacity, for example through an unemployment benefits re-insurance scheme, and allow it to borrow in financial markets.</td>
<td>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.</td>
</tr>
<tr>
<td>Make access to the common fiscal stabilisation capacity conditional on past compliance with fiscal rules.</td>
<td>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.</td>
</tr>
</tbody>
</table>

**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**

<table>
<thead>
<tr>
<th>A. Okun’s law coefficients¹</th>
<th>B. The NAIRU increased in some euro area countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>Per cent</td>
</tr>
<tr>
<td>Finland</td>
<td>16</td>
</tr>
<tr>
<td>Germany</td>
<td>14</td>
</tr>
<tr>
<td>Austria</td>
<td>12</td>
</tr>
<tr>
<td>Slovenia</td>
<td>10</td>
</tr>
<tr>
<td>France</td>
<td>8</td>
</tr>
<tr>
<td>Netherlands</td>
<td>8</td>
</tr>
<tr>
<td>Belgium</td>
<td>6</td>
</tr>
<tr>
<td>Latvia</td>
<td>6</td>
</tr>
<tr>
<td>Portugal</td>
<td>6</td>
</tr>
<tr>
<td>Italy</td>
<td>5</td>
</tr>
<tr>
<td>Estonia</td>
<td>4</td>
</tr>
<tr>
<td>Greece</td>
<td>4</td>
</tr>
<tr>
<td>Ireland</td>
<td>4</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4</td>
</tr>
<tr>
<td>Slovakia</td>
<td>4</td>
</tr>
<tr>
<td>Spain</td>
<td>4</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>2</td>
</tr>
</tbody>
</table>

Note. 1. Coefficients resulting from the estimation of a gap version of the Okun’ law specified as $(u - u^*) = β(y - y^*)$, 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.

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

<table>
<thead>
<tr>
<th>Main recommendations of the 2018 Survey</th>
<th>Action taken since 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implement swiftly the ECOFIN action plan on NPLs; facilitate the creation of asset management companies.</td>
<td>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.</td>
</tr>
<tr>
<td>Building on progress in risk-reduction, develop a pre-funded common European deposit-insurance scheme with contributions based on risks taken by banks. To ensure smooth resolution of banks, use the European Stability Mechanism as a fiscally-neutral backstop for the Single Resolution Fund that can be deployed rapidly.</td>
<td>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 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.</td>
</tr>
<tr>
<td>Favour diversification of banks’ exposure to sovereign bonds including by considering sovereign concentration charges in parallel to the introduction of a European safe asset.</td>
<td></td>
</tr>
<tr>
<td>Progress in harmonising insolvency proceedings through minimum European standards allowing simpler early restructuring, shortening effective time to discharge, and more efficient liquidation proceedings.</td>
<td>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.</td>
</tr>
</tbody>
</table>

**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

A. Lending rates decreased but cross-country dispersion augmented during the crisis

B. Euro area banks deleveraged by cutting cross-border positions

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

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

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

<table>
<thead>
<tr>
<th>MAIN FINDINGS (specific to the KPI)</th>
<th>RECOMMENDATIONS (Key in bold)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Keeping monetary policy accommodative</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation had remained well below the ECB objective for a long time and risks are tilted to the downside beyond the short term.</td>
<td>Continue monetary policy accommodation until inflation robustly converges toward the ECB objective.</td>
</tr>
<tr>
<td>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.</td>
<td>In its next strategic review, the ECB could consider moving towards average inflation targeting in case the inflation objective is not met.</td>
</tr>
<tr>
<td>Pandemic-related capital relief and conservation measures supported credit provision, but the prolongation of the economic turmoil will increase borrower bankruptcy risk.</td>
<td>Exit from pandemic-related financial measures should be gradual. Capital and liquidity buffers should be rebuilt gradually.</td>
</tr>
<tr>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td><strong>Improving the European fiscal arrangement</strong></td>
<td></td>
</tr>
<tr>
<td>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.</td>
<td>Evaluate the fiscal framework with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership.</td>
</tr>
<tr>
<td>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.</td>
<td>Improve fiscal policy making by strengthening the involvement of independent fiscal institutions, enhancing medium term budgetary frameworks, and by considering positive incentives.</td>
</tr>
<tr>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td>Among other options, consider adopting an expenditure rule anchored to a debt ratio target.</td>
<td></td>
</tr>
<tr>
<td><strong>Augmenting the stance of the euro as a reserve currency</strong></td>
<td></td>
</tr>
<tr>
<td>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.</td>
<td>Enhance the economic resilience of the euro area by completing the Banking and the Capital Markets Unions.</td>
</tr>
</tbody>
</table>
References


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