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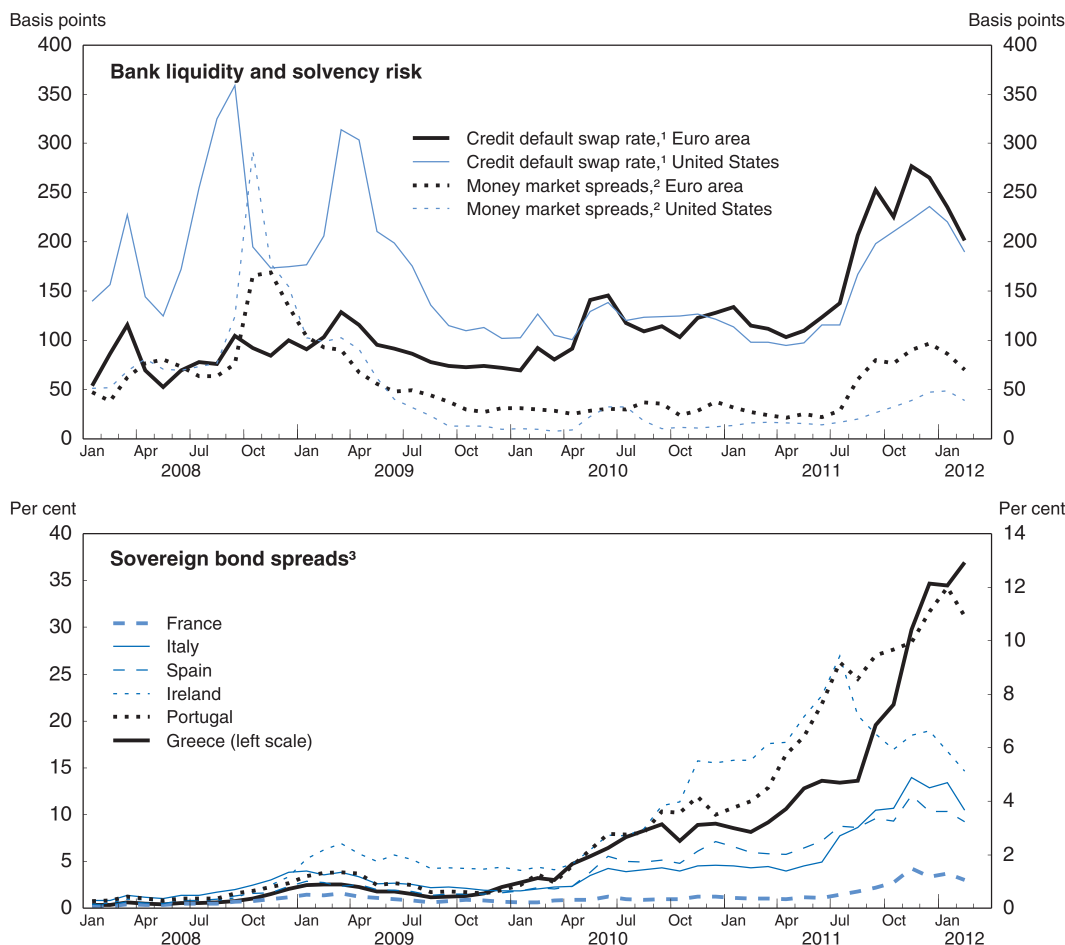
Assessment and recommendations

The euro area is experiencing a crisis related to financial, fiscal and economic stress in several countries. Excessive imbalances built up during the upswing and during the crisis led to a renewed bout of financial instability starting in mid-2011 and a slump in demand. The weakening position of some private and government balance sheets undermined bank portfolios and confidence. Some euro area countries are experiencing a liquidity and confidence crisis. The close relationships between national governments and banking systems create strong feedback effects between fiscal sustainability and financial stability, aggravating the impact on financial conditions and reducing fiscal policy space. Output has weakened and growth is anticipated to remain below trend for some time as the result of the loss of confidence, tighter financial conditions and underlying retrenchment. There are large downside risks to the financial system and activity, depending on how the crisis is resolved. The capacity for additional monetary stimulus, fiscal support of demand and measures to support the banking system is much more limited than in 2008. Debt-to-GDP ratios are high in most euro area countries and market confidence in euro area sovereign debt is fragile. This limits the ability of fiscal policy to support activity and the financial system. At the same time, the effect of recent ECB measures is still unfolding and inflation expectations remain well-anchored.

The euro area sovereign debt crisis threatens the financial system and growth

The financial crisis intensified in the summer of 2011 as the sovereign debt crisis worsened in a number of euro area countries, with markets questioning the ability of some euro area governments to finance public borrowing, and as global equity markets plummeted. The growing loss of confidence in euro area sovereign debt had knock-on effects on the funding and solvency position of banks, which are heavily reliant on sovereign bonds as collateral, have large exposures to sovereign risks, and are reliant on an explicit or implicit safety net from governments. The weaker position of banks in turn fed back into the credibility of governments, as the likelihood of their having to support domestic banks increased. This feedback mechanism contributed to a deterioration in interbank lending conditions and higher risk premia during the second half of 2011 (Figure 1). As the crisis intensified, the price of credit default swaps for European banks rose and bank share prices fell substantially, both in absolute terms and relative to other sectors. A number of major banks announced deleveraging plans under pressure from markets and regulators. These developments contributed to a reduction in the availability of credit to the real economy: the January 2012 ECB Bank Lending Survey points to a further tightening in bank lending standards for households and the non-financial corporate sectors, although there is considerable heterogeneity across euro area countries and banks have also reported weaker loan demand. Equity prices for financial companies have fallen to around 20% lower than at

Figure 1. **Banking and government risk measures**



1. Banking-sector five-year credit default swap rates.
2. Spread between three-month interbank rates (Euribor in the euro area, Libor in the United States) and overnight swap rates.
3. Ten-year sovereign bond yield relative to German yield.

Source: Datastream.

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the start of 2011 and much of the recovery since March 2009 has been unwound. The deterioration in financial conditions came against the background of relatively high levels of indebtedness in some parts of the euro area and weaknesses in the banking system in terms of bad loans, insufficient capital and weak funding bases. In some countries that experienced relatively strong credit booms during the upswing, the banking sector has been affected in a severe and adverse manner (Chapter 1). This led to substantial spillovers to banks in other countries with risk exposures.

Financial conditions have improved since December 2011 following policy actions by the European Central Bank (ECB), particularly the three-year long-term refinancing operation, although market conditions remain far from normal. The recent ECB non-standard measures support the transmission of monetary policy and are temporary. They build on earlier measures to support monetary transmission, including continued extensive liquidity support under fixed-rate full allotment tenders and additional steps taken in the summer of 2011 to reintroduce longer-term refinancing operations, the

launching of a new Covered Bond Programme (CBPP2) of EUR 40 billion (0.4% of GDP), and making large additional purchases under the Securities Market Programme. New policy measures in December 2011 halved the minimum reserve requirement for banks, introduced two three-year long-term operations and changed the criteria for eligibility for certain asset-backed securities and for the use of credit claims as collateral in Eurosystem operations. In February 2012, the ECB approved some national central banks to apply temporary specific national eligibility criteria for collateral eligibility in eurosystem operations. As a result of these measures and demand under existing operations, the eurosystem's balance sheet has expanded sharply and the size of long-term operations exceeds its 2009 peak, while use of the deposit facility has jumped to close to twice its 2009 peak to EUR 450 billion (4.5% of GDP). This has contributed to lowering interbank rates to levels at the short end at or below the trough in 2009, as well as a lowering of sovereign spreads.

The outlook for financial conditions in the euro area depends heavily on developments in the banking system. A further round of EU-wide stress tests was undertaken in July 2011, which was more robust and transparent than previous exercises. In the autumn of 2011, the EU recapitalisation exercise recommended national supervisors to require banks to achieve on a precautionary basis a temporary capital buffer of a core Tier-1 capital ratio of 9% by 30 June 2012, exceeding the standards set out in the stress test and also taking into account all sovereign exposures at prevailing market prices as of September 2011. Governments could be required to provide new capital and bank guarantees if needed and may have recourse to the financial assistance from the European Financial Stability Facility (EFSF) if they require additional funds. These recapitalisation instruments, which will also be included in the European Stability Mechanism (ESM), weaken the link between financial sector financing problems and sovereign financing problems. There is a potential risk that the recapitalisation requirements could lead to excessive deleveraging, hampering lending into the real economy if banks were eventually to face difficulties to obtain market funds and do not use as intended retained earnings to increase capital. However, the European Banking Authority (EBA) has issued guidelines with a view to avoiding "excessive" deleveraging in the context of the recapitalisation exercise and limiting assets reductions to certain operations. In addition, national supervisory authorities are required to ensure that recapitalisation plans are not achieved through excessive deleveraging, and that only sales of selected assets and already planned changes to internal models are allowed to reduce assets. A reduction of credit to cover the estimated capital shortfall would not be allowed. The EBA first review of capital plans in February 2012 suggested that, if feasible, banks' plans would have a negligible first-round impact on the volume of lending to the real economy. Direct capital measures accounted for 96% of the planned measures to close the initial shortfall. A better capitalised and more resilient banking sector will be in a better position to channel credit towards the real economy. Close oversight and the existence of credible public support, where necessary and with appropriate conditions, will be essential to avoiding adverse consequences for the supply of credit and economic activity. At the same time, the measures taken by the ECB to provide liquidity to the banking sector at longer maturities should contribute to limiting the risks of a further tightening of financing conditions.

The emerging recession is driven by tightening financial conditions and weak confidence

Growth has stalled and the euro area has entered a projected mild recession with the economy contracting around the end of 2011 and expected to grow only very slowly in 2012 (Table 1). Deteriorating confidence and financial market conditions, alongside fiscal consolidation, have weakened domestic demand, while slowing activity in other developed and developing countries has reduced export demand. The slowdown is smaller and less dramatic than the international financial crisis in late 2008, particularly in terms of trade developments. The post-financial crisis recovery was short-lived and, while erratic, sluggish overall. Private consumption and investment had briefly shown signs of recovery in the early part of 2011 and demand had continued to be supported by government borrowing. Nevertheless, euro area GDP in volume terms was almost 2% below its peak of early 2008 even before the current downturn. While the effect of recent ECB measures is still unfolding, the outlook for growth is unusually uncertain and depends critically on the resolution of the sovereign debt crisis. While effective policy action to resolve the crisis could lead to a stronger than anticipated and earlier recovery in confidence and investment, there are large downside risks as the lack of effective policy action would open the way to a severe recession (OECD, 2011a).

Table 1. **Selected economic indicators**

Percentage annual change

	2007	2008	2009	2010	Projections[1]		
					2011	2012	2013
Real gross domestic product (GDP)	3.0	0.3	–4.2	1.8	1.6	0.2	1.4
Private consumption	1.6	0.3	–1.1	0.8	0.4	0.1	0.9
Government consumption	2.2	2.3	2.6	0.5	0.0	–0.3	–0.2
Gross fixed investment	4.7	–1.3	–12.1	–0.6	2.1	–0.4	2.3
Inventories[2]	0.3	–0.1	–0.9	0.6	0.3	–0.2	0.0
Net exports[2]	0.3	0.0	–0.6	0.8	0.7	0.4	0.6
Headline inflation (harmonised CPI)	2.1	3.3	0.3	1.6	2.6	1.6	1.2
Core inflation[3]	1.9	1.8	1.4	1.0	1.4	1.5	1.3
Short-term interest rate	4.3	4.6	1.2	0.8	1.4	1.0	0.6
Employment	1.8	0.9	–1.8	–0.5	0.2	–0.3	0.2
Unemployment rate (% of labour force)	7.4	7.5	9.4	9.9	9.9	10.3	10.3
Current account balance (% of GDP)	0.2	–0.7	0.0	0.2	0.1	0.6	1.0
Government balance (% of GDP)	–0.7	–2.1	–6.4	–6.3	–4.0	–2.9	–1.9
Government debt (Maastricht def., % of GDP)	66.3	70.2	79.9	85.7	88.3	90.6	91.0

1. These projections are based on *OECD Economic Outlook*, No. 90.
2. Contribution to GDP growth.
3. Excluding energy, food, drink and tobacco.

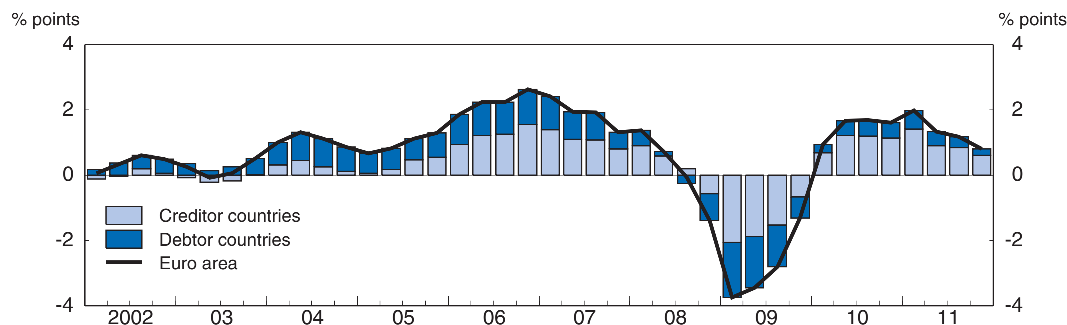
Source: OECD, *OECD Economic Outlook 90 Database*.

Unresolved imbalances across euro area countries have delayed the resolution of the sovereign debt crisis and weakened growth prospects (Chapter 1). While current account imbalances have narrowed since 2007, countries that ran large current account deficits in the run-up to the crisis are experiencing financial and fiscal crises, and very weak private demand. Improvements in competitiveness have so far been modest and visible in only very few countries, notably Ireland. There has been some improvement in exports in countries that borrowed heavily during the credit boom, but too little to offset weak

domestic demand. In surplus countries, saving has declined modestly but not enough to sustain aggregate demand in the euro area at its trend level. In countries with persistently low growth such as Italy, there is a need to return to a stronger growth path and improve competitiveness. Fiscal consolidation is now underway in all countries. On top of domestic factors, the impact of the sovereign debt crisis on confidence may contribute to the continued high saving in surplus countries. Any recovery in the euro area will remain fragile so long as the imbalances are unresolved (Figure 2).

Figure 2. **Growth by creditor and debtor countries**[1]

Contributions to year-on-year percentage change of the euro area GDP



1. The creditor and debtor countries are defined by their net foreign asset position as a share of GDP in 2010. "Debtor countries", which represent 60% of the euro area GDP, are Austria, Estonia, France, Greece, Ireland, Italy, Portugal, the Slovak Republic, Slovenia and Spain, and "creditor countries" are Belgium, Finland, Germany, Luxembourg and the Netherlands.

Source: IMF, *International Financial Statistics* and OECD, *OECD Economic Outlook Database*.

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Underlying domestic price pressures remain weak, given sluggish demand and considerable excess capacity. Movements in overall consumer prices in recent years have largely been driven by energy and food price developments, which have contributed to the high volatility of inflation. Monthly year-on-year headline inflation rates have ranged from –0.6% to 3% over the past three years. Despite these pressures, inflation over the past five years has averaged only 2.0%, broadly in line with the ECB's definition of price stability. Although commodity price increases have fed through the price chain, second-round effects on wages appear to have been very limited and inflation expectations, measured by surveys and market prices, seem well anchored. Over the past two years, fiscal consolidation, leading to higher VAT rates and administered prices, has had a significant impact on consumer prices. This is likely to continue as budgetary consolidation is pursued. Underlying inflation excluding energy, food, indirect taxes and administered prices has remained below 1% since June 2010. Consumer price inflation in countries with large current account deficits has not been significantly below the euro area average in overall terms, although there have been small improvements in their price competitiveness once indirect tax increases are excluded.

Unemployment rose to 10.3% of the labour force in November 2011 and is likely to rise further as demand weakens. The unemployment rate stands at almost 23% in Spain, 19% in Greece, 14% in Ireland, 14% in the Slovak Republic and 13% in Portugal. The share of long-term unemployment in the euro area has risen to 45% with younger, older and less educated workers particularly hard hit. By contrast, the unemployment rate in Germany has been declining to reach low rates by recent historical standards. Compared with previous downturns, the impact of the 2008 recession on unemployment in the euro area

as a whole has nevertheless been moderate relative to the fall in output, while the participation rate has held up. The increase in unemployment has been much less than in the United States. While this divergence remains to be fully explained, flexible work arrangements, the fruit of past labour market reforms, and short-time working schemes in a number of countries appear to have played a role. However, it is likely that these mechanisms will be less effective at cushioning the employment effects of the current downturn as firms might not view the renewed downturn as being as temporary as before, and because governments and firms may be less able than in 2008 to support these arrangements. Further labour market reforms would help in some cases to facilitate wage adjustments, to increase hiring incentives and crucially to reduce the likelihood that short-term unemployment becomes entrenched and that vulnerable workers lose their attachment to the labour market (Chapter 2). As set out in the *Economic Survey of the European Union*, removing obstacles to labour mobility across countries would help match workers to existing employment opportunities. Ultimately, a return to strong and sustainable growth is needed to bring unemployment down.

The crisis must be resolved by restoring confidence and dealing with the underlying causes

The sovereign debt crisis needs to be resolved through strengthening the public finances and bank balance sheets, and rebalancing of the euro area economy. However, while fiscal consolidation can contribute to enhancing confidence, there is a risk that large fiscal consolidation and, if this were to occur, excessive bank deleveraging hampering lending into the real economy may have a negative short-term effect on demand before the positive impact of healthier public finances and reforms to boost growth materialises. Short-term measures are therefore required to ensure the stabilisation of sovereign debt markets in the near term, creating space for essential longer-term measures to work. This requires that all solvent countries have continued access to finance to meet their debt obligations, fund government spending and provide public support to the banking sector if needed (Chapter 1). Resolving the crisis in the euro area is necessary to avoid the risk of global spillovers through financial markets and trade linkages.

Immediate action is required to ensure sufficient and large-scale availability of a firewall to stop the dynamics of runs against solvent sovereigns. The European Union together with the IMF has provided unprecedented financial assistance to Greece, Ireland and Portugal. The Greek Loan Facility has provided support to Greece as part of its first assistance package and the EFSF will contribute to the second assistance package. The EFSF and EFSM (European Financial Stabilisation Mechanism) are currently providing support to Ireland and Portugal. Official euro area support to vulnerable countries can be provided through direct funding (loans), precautionary credit lines, primary and secondary market purchases, and loans for the purpose of financial sector recapitalisation. There is a common objective to put the European Stability Mechanism (ESM) in place as a permanent mechanism as of July 2012. Euro area countries stand ready to provide paid-in capital of EUR 80 billion, giving the ESM lending capacity of up to EUR 500 billion (5% of euro area GDP). At present, the joint lending capacity of the EFSF and ESM has been limited to EUR 500 billion, although this will be reviewed in March 2012. Meanwhile, there is a plan to leverage existing EFSF funding, either through the issuance of Partial Protection Certificates or setting up of a Co-Investment Fund (CIF) with the EFSF providing some credit enhancement. There is also an agreement between euro area countries to provide at least an extra EUR 150 billion through bilateral loans to the

IMF to increase its lending capacity, which could be used to support euro area countries among others. So far, these measures have failed to restore full confidence in euro area sovereign debt markets. The governance structure of the EFSF, which requires all euro area countries to approve granting of support, subject to their parliamentary procedures, creates a drawn-out and uncertain process with regard to the provision of crisis assistance. By contrast, ESM decision-making provides greater certainty that assistance will be provided in a timely way: its Board of Governors can decide to grant stability support by mutual agreement and there is an emergency voting procedure – requiring only 85% of votes – that can be used in the event that the European Commission and the ECB conclude that failure to grant financial assistance would threaten the economic and financial stability of the euro area as a whole. In addition, the ESM's capital structure – which consists of the paid-in capital base – would allow the mechanism to provide some financial assistance without having to raise the funds beforehand in the markets.

The European firewalls should be expanded further and made more credible to restore confidence. To ease market tensions, the funds should be available on a scale sufficient to withstand possible future requests for financial assistance. These possible needs could include estimated refinancing needs of vulnerable euro area countries of over EUR 1 trillion over the coming two years and contributions to the recapitalisation of euro area banks (Blundell-Wignall, 2012). Although it is unclear that funds on this scale would ever need to be drawn down, the availability of credible firewalls may enhance confidence. Ultimately, the scale and form of funds needed will depend on how confidence returns, as well as economic and financial developments. Funds based on paid-in capital, as under the ESM, are likely to have stronger effects on confidence than existing guarantees under the EFSF. At the same time, increasing the firewalls must be balanced against the impact it has on the public finances of the countries providing fiscal support to the arrangements. The credibility of the euro area crisis management would be enhanced if the exceptional situation in Greece were swiftly and decisively resolved by bringing the debt-to-GDP ratio to a sustainable level. This includes voluntary debt restructuring and putting in place on-going financing, which are part of measures agreed by the Eurogroup in February 2012. As set out below, the necessary package of measures to tame the crisis needs to include credible fiscal consolidation, repair of the banking system, a rebalancing of activity across euro area countries and structural reforms to boost and rebalance growth, with monetary policy focused on maintaining price stability in the medium term.

How the current crisis is resolved will set important precedents for the future functioning of the monetary union, while resolution of current problems partly depends on appropriate long-term structures being put in place. A permanent and credible liquidity support mechanism for sovereigns, as the future ESM, is necessary. Although this could potentially increase the risk of moral hazard, the ESM will impose conditionality in a similar way to that applied during the crisis, which significantly mitigates this risk. In this context, a strengthening of economic, fiscal and financial governance was necessary. Progress has been made in recent legislation and political commitments, including the "fiscal compact". So long as the fiscal architecture of the euro area remains based on a model of national governments holding the policy instruments and issuing their own debt, market financing will continue to play the main role. To encourage market discipline, it is important that the ESM includes provisions for private sector involvement according to IMF practices for countries where debt is judged to be unsustainable, even if the current situation of Greece is exceptional (Chapter 1).

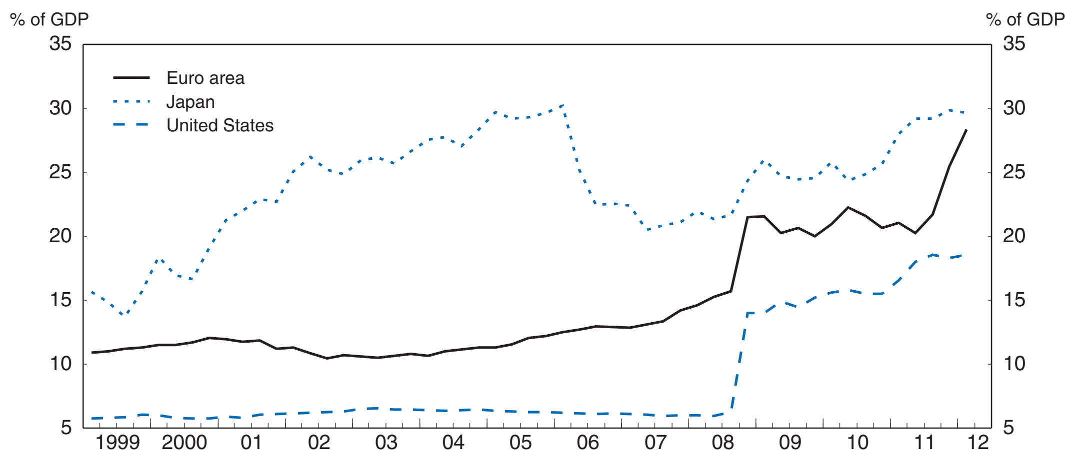
Box 1. **Main recommendations on resolution of the euro sovereign debt crisis**

- Resolve the crisis in Greece rapidly and in a structured way, including through a voluntary restructuring of its debt, recapitalisation of banks and a viable programme of official support.
- Stand ready to increase the capacity of the euro area "firewall" to provide a credible level of support.
- The euro area banking sector should be recapitalised as currently planned, if necessary drawing on public funds, and excessive deleveraging hampering lending to the real economy should be avoided.
- Establish the European Stability Mechanism as a permanent crisis mechanism with robust capital and governance structures as planned by July 2012.

Monetary policy should continue to support nominal demand through maintaining price stability while the public finances are repaired

A key difference with the 2009 slowdown is the much more limited space for policy stimulus: the ECB main refinancing rate in October 2008 was 4.25% and the euro area general government deficit in 2007 was just 0.7 % of GDP. Before the intensification of the sovereign debt crisis in the summer of 2011, monetary policy was already highly supportive of activity, although policy conditions were tightened somewhat in the first half of 2011 with an increase in the policy rate of 50 basis points. Non-standard policy measures had begun to be wound down. As the crisis deepened during 2011, there was a rapid shift towards providing greater support to the monetary transmission mechanism. This was achieved through the continued use of full allotment tenders at a fixed interest rate, allowing banks to access as much liquidity as they need against collateral at the main refinancing rate. In addition, there was a clear commitment to maintain full allotment in all operations until at least mid-2012. Longer operations were put in place. The dollar swap line with the Federal Reserve was renewed at lower costs and co-ordinated swaps lines were put in place between the major central banks. Demand for longer-term operations was less than in 2008-09 but the balance sheet of the Eurosystem expanded significantly. In November 2011, the main refinancing rate was cut to 1.25%, almost the same level as at the height of the international market crisis, but market interest rates did not fall as low as previously observed and this was followed by a further 25 basis points reduction in policy rates in December. A sizeable package was announced in early December to support monetary transmission: the minimum required reserve ratio was lowered from 2% to 1%, two three-year long-term operations with an option to repay after one-year were announced, collateral standards for asset-backed securities were changed and national central banks were authorised to expand the use of credit claims (performing bank loans) as collateral. These measures contributed to a significant reduction in market interest rates, with one-year rates well below the trough during the 2008-09 period at around 40 basis points, and a large expansion of the balance sheet of the Eurosystem beyond previous peaks (Figure 3). The nominal broad effective exchange rate has depreciated by around 5% since late 2011, having fluctuated within a narrow range around its long-run average over the two previous years.

Figure 3. **Total central bank liabilities**



Source: Datastream and OECD, *OECD Economic Outlook 90 Database.*

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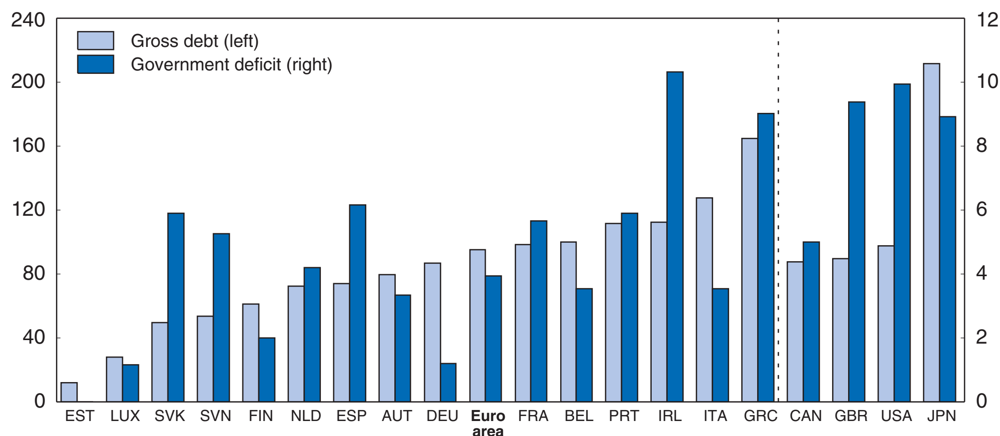
In the absence of significant changes in the medium-term inflation outlook, the monetary policy stance could remain accommodative to support overall demand through maintaining price stability, given the dampening effects on euro area aggregate activity of the sovereign debt crisis, private sector adjustment and fiscal consolidation going on in euro area countries. Unlike other major central banks, the ECB has not undertaken explicit quantitative easing measures. In the euro area, non-standard measures have already been used to support the effective transmission process. If the crisis were to re-intensify, these may need to be widened to support the monetary transmission mechanism and maintain price stability. Commitments to maintaining low interest rates for a long period could also be considered, although communication implications would need to be assessed. Such policies must balance the need to retain solidly-anchored inflation expectations and maintain flexibility to ensure medium-term price stability against the risk that excessive liquidity may eventually generate inflation or asset-price bubbles.

The public finances need to be strengthened

The public finances in most euro area countries are in poor shape and a prolonged process of fiscal consolidation and debt reduction will be required (Figure 4). The euro area debt-to-GDP ratio on a Maastricht basis is likely to peak at around 90% of GDP in the next couple of years, based on policies set out in *Stability Programmes* (OECD, 2011a). This follows a steady upwards trend since the 1970s and compares with the previous peak of 74% of GDP in 1996. Under current consolidation plans, the debt-to-GDP ratio would peak earlier and at a somewhat lower level than in other major advanced economies, partly reflecting the relatively advanced state of consolidation plans in the euro area. Nevertheless, indebtedness will be high by post-war OECD norms, though comparable to that of other major advanced economies today. Weak future growth and inflation prospects imply that bringing debt down to prudent levels will take many years of fiscal restraint. The debt-to-GDP ratio is well over 100% in a number of euro area countries and above the 80% level, which is widely regarded as having an impact on growth, in most euro area economies. While primary surpluses will need to be larger and sustained for longer than in past OECD experience to bring debt down, there will be increasing pressures on public

Figure 4. **Public gross debt and deficits**

As a percentage of GDP, 2011



Source: OECD, *OECD Economic Outlook 90 Database.*

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spending from ageing. However, several countries have introduced pension reforms, which have significantly decreased the expected increase in public pension expenditure. Ageing pressures will begin to have a strong impact on the budgetary outlook during the coming years, while debt levels will remain high.

The general government balance in 2011 for the euro area is a deficit of 4% of GDP. Most of the budget deficit is estimated to be structural. Fiscal consolidation is planned to continue in all euro area countries in 2012 and current consolidation plans imply that the deficit would narrow to 2% of GDP in 2013 and continue to fall thereafter, despite the headwinds in the near term from the weakness of economic activity. For countries such as Greece, Ireland, Portugal and Spain, the need to restore creditworthiness and close very large deficits is requiring strong pro-cyclical fiscal tightening. This will contribute to the rebalancing of external positions, where previous levels of domestic absorption were unsustainably high. While in a better position regarding the level of its deficit, Italy also needs to strengthen creditworthiness. In general, the automatic stabilisers should be allowed to work around the structural adjustment path in euro area countries, consistent with fiscal commitments. For countries with some fiscal space such as Finland, Germany and the Netherlands, the pace of planned consolidation could be eased temporarily if the state of the economy worsens subject to long-term sustainability and maintaining the credibility of fiscal frameworks. Countries under financial assistance programmes should stick to targets as agreed in the programme. Similarly, countries facing close market scrutiny should continue to meet the agreed budgetary targets and may need to undertake further measures. Achieving prudent debt-to-GDP ratios will take many years of tight fiscal policy and would be facilitated by stronger growth. Setting out more detailed medium-term plans and upgrading fiscal institutions would further help to restore confidence in some countries.

Fiscal consolidation is likely to have a downward effect on euro area domestic demand in the short term, although there could be some offsetting gains in terms of market or consumer confidence. While pro-cyclical policies should in general be avoided, there is little alternative for countries with no or vulnerable market access. In the current situation of fragile market confidence, ensuring fiscal sustainability is a key element underpinning economic stabilisation. Restoring credibility in the short run should create more fiscal

space further ahead and facilitate normal access to financial markets. Furthermore, for some countries, fiscal consolidation is part of a deeper adjustment of public spending to a sustainable level: deficits are not being fully closed immediately but this process cannot be completely avoided. Even with relatively high estimates of fiscal multipliers and the elasticity of the budget balance to GDP, it is unlikely that consolidation of the budget balance would be self-defeating. To the extent that the causes of the current crisis are due to concerns about fiscal sustainability, addressing the fiscal challenges will help to put the economy on a more sustainable path. To maximise the impact of consolidation on medium-term sustainability, it should be used to introduce growth-friendly measures, including improvements to tax systems and more efficient public spending.

Box 2. **Main recommendations on macroeconomic policy**

- In case of further declines in inflationary pressure, reduce monetary policy rates further to the extent possible. Additional non-standard measures may be needed if there is further impairment of the monetary transmission mechanism.
- Continue fiscal consolidation, allowing the automatic stabilisers to operate around current consolidation plans except in programme countries, where headline targets should be met, and countries under close market scrutiny, which should continue to meet the agreed budgetary targets. For countries with some fiscal space, the pace of planned consolidation could be eased if the state of the economy worsens subject to long-term sustainability.

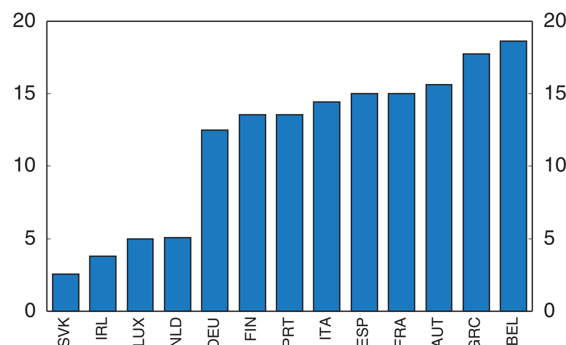
An ambitious package of structural reforms is needed to boost growth and rebalance the euro area

A sustainable improvement in growth is essential to strengthening public finances and reducing the burden of private debts, as well as raising living standards (Chapter 2). Long-term growth projections for the euro area in the absence of reform are dismal and subject to downside risks given past poor performance, a trend decline in investment rates and low innovation. An ambitious package of structural reforms, however, could transform the outlook and generate large gains in productivity and boost growth significantly (Figure 5; Bouis and Duval, 2011). The scale of reforms required to lift the euro area out of the crisis is large and bold decisions must be taken. At the European level, measures to make the Single Market work effectively, as discussed in the *Economic Survey of the European Union*, would contribute substantially to achieving the necessary economic transformation. A number of significant reforms are currently under way in euro area countries.

Country-specific structural reforms priorities for the euro area are set out in Table 2, based on the OECD *Going for Growth* assessment (OECD, 2011b). In broad terms, implementation of reforms in all these areas to align policy settings to the best performing OECD countries would be necessary to achieve most of the potential gains from the broad reform package illustrated in Figure 5. The OECD *Strategic Response* has identified some reforms as most important from a macroeconomic perspective and their contribution to resolving the crisis, which are given in bold in the table.

Figure 5. **Potential gains from broad reform package**[1]

Ten-year horizon; levels, in per cent



1. Estimated cumulative GDP impact from reforms specified in Bouis and Duval (2011).

Source: Bouis, R. and R. Duval (2011), "Raising the Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond", *OECD Economics Department Working Papers*, No. 835, Figure 15, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932589677

A credible and ambitious programme of structural reforms could also yield short-run increases in activity (Chapter 2). While the full gains from reforms are typically slow to materialise as it takes time for the economy to adjust, some types of reform can lead to more immediate gains. For example, more effective systems of unemployment support and job-search assistance can help to counter the risk that short-term unemployment becomes entrenched. Furthermore, the anticipation of future gains in the new growth-friendly policy environment can have an immediate positive effect through higher household and business confidence, more investment to exploit new opportunities and a reduction in risk premia in the wake of the improved long-term sustainability of existing debts. A credible commitment to future reform measures may help to achieve these effects, even if policies are implemented more gradually. Legislating measures up front, specifying clear implementations schedules and achieving broad political consensus would all help. Conversely, some reforms would have negative effects on demand in the short run, although these appear often to be overstated. The risk of short-run negative effects are likely to be larger when there is already a high level of excess capacity in the economy and when the financial intermediation needed to reap some of the gains from reforms is impaired. Reform packages, including economic adjustment programmes, should therefore be carefully designed to yield the best balance between short- and long-term gains and it is essential to repair the financial system to support positive outcomes.

Structural reforms are essential to rebalancing the euro area economy: structural weaknesses were a key driver of the excessive imbalances of the past decade in both surplus and deficit countries. These included tax systems that encouraged housing investment and bubbles, and wage-bargaining systems that allowed wages to get out of line with productivity. Dealing with the underlying causes of too much or too little saving would help to achieve sustainable rebalancing. Structural reforms have an important role to play in resolving the crises in countries, which built up excessive internal and external levels of debt and have experienced large competitiveness losses, by improving the sustainability of external debts, facilitating the reallocation of resources across sectors, helping to avoid long-term unemployment, attracting foreign capital, and easing and

Table 2. **Going for Growth priorities for euro area countries**

Priorities in bold are part of the OECD Strategic Response

Policy areas	Current policy priorities[1]
Product market regulations	
Strengthen competition in network industries	**Austria**, Belgium, European Union, **Ireland**, Slovak Republic, Slovenia
Reform/simplify product market regulations	Belgium, Spain, Luxembourg, Portugal
Reduce barriers to competition in the services sector	**Austria**, Belgium, **Germany**, **Ireland**, **Luxembourg** (priority at EU level)
Reduce barriers to foreign ownership/investment/trade	
Reduce regulatory barriers to competition	Austria, **France**, **Greece**, **Italy**, Spain
Strengthen private-sector participation in economic activity	Greece, **Italy**, Portugal, Slovenia
Reform planning regulations	Luxembourg
Labour market regulations	
Reform (disability) benefit schemes	Austria, Luxembourg, the **Netherlands**
Reform the unemployment insurance scheme	Belgium, Finland, the Netherlands, Portugal
Reduce restrictions on labour mobility	European Union, Slovak Republic
Reduce/moderate the minimum cost of labour	France, Greece
Reduce/ease job protection	Germany, France, **Italy**, **Spain**, Luxembourg, the Netherlands, **Portugal**, **Slovenia**
Reform the wage bargaining system	**Belgium**, **Spain**, Italy, **Slovenia**
Strengthen policies to support female labour force participation	Ireland, Slovak Republic
Improve incentives for (formal) labour force participation	Ireland
Taxation	
Reform/strengthen the structure of taxation	**Austria**, **Germany**, **Greece**, Italy, **Portugal**
Reduce implicit taxes on continued work at older ages	**Belgium, Finland**, France, Greece, Spain, Luxembourg, **Slovenia**
Reduce the (average) tax wedge on labour income	Austria, Belgium, Finland, **France**, **Germany**, Greece, Italy, the **Netherlands**
Shift toward indirect taxes	Austria, Belgium, Italy
Reduce impediment to full-time female participation	Germany
Human capital	
Improve educational efficiency/outcomes/achievement	Austria, Slovak Republic
Strengthen primary education	Greece
Strengthen secondary education	**Spain**, Greece, Italy, Portugal
Reform tertiary education	Austria, Germany, France, Finland, Italy, Portugal, Slovenia
Financial regulation	
Improve/streamline financial regulation	Spain (**priority at EU level**)
Other areas	
Reduce producer support to agriculture	(Priority at EU level)
Improve public sector efficiency	Finland, Portugal
Strengthen R&D and innovation incentives	Ireland, Slovak Republic
Improve the quality/provision of infrastructure	Ireland

1. These reform priorities were set in 2010 and reported in the 2011 edition of *Going for Growth*.
Source: OECD (2011), *Going for Growth*, OECD Publishing, Paris.

stimulating wage and price adjustment. These needs are largely acknowledged in the requirements under the economic adjustment programmes in Greece, Ireland and Portugal. This process must be carefully managed given large excess capacity and weak financial conditions in these economies. Structural reforms, especially in service markets, can facilitate investment in surplus countries thus contributing to rebalancing through enhancement of potential growth.

Box 3. **Main recommendations on structural reforms to boost and rebalance growth**

- Undertake a substantial and ambitious programme of reforms to product market regulation, labour market institutions and tax systems to boost growth. This should include effective implementation of the Single Market (see *Economic Survey of the European Union*), alongside measures at national level.
- Communicate clearly the package of reforms, including credible commitments to future measures to minimise uncertainty and encourage strong demand effects in terms of investment and higher consumption.
- Undertake reforms in both surplus and deficit countries with excessive imbalances aimed at enhancing growth and the adjustment capacities of the economy to address underlying causes of excessive imbalances and facilitate rebalancing. Structural reforms, in labour, product and services markets, can boost investment thus contributing to rebalancing through enhancement of their potential growth.
- In countries having built up excessive internal and external levels of debt and experienced large competitiveness losses, focus structural reforms on raising productivity, reducing structural unemployment, facilitating wage and price adjustment and attracting foreign capital. These reforms would encourage investment in new activities and export-oriented sectors.
- Under economic adjustment programmes, design reforms to maximise the positive impacts on demand, and take into account large output gaps, tight financial conditions and a high level of existing economic dislocation.

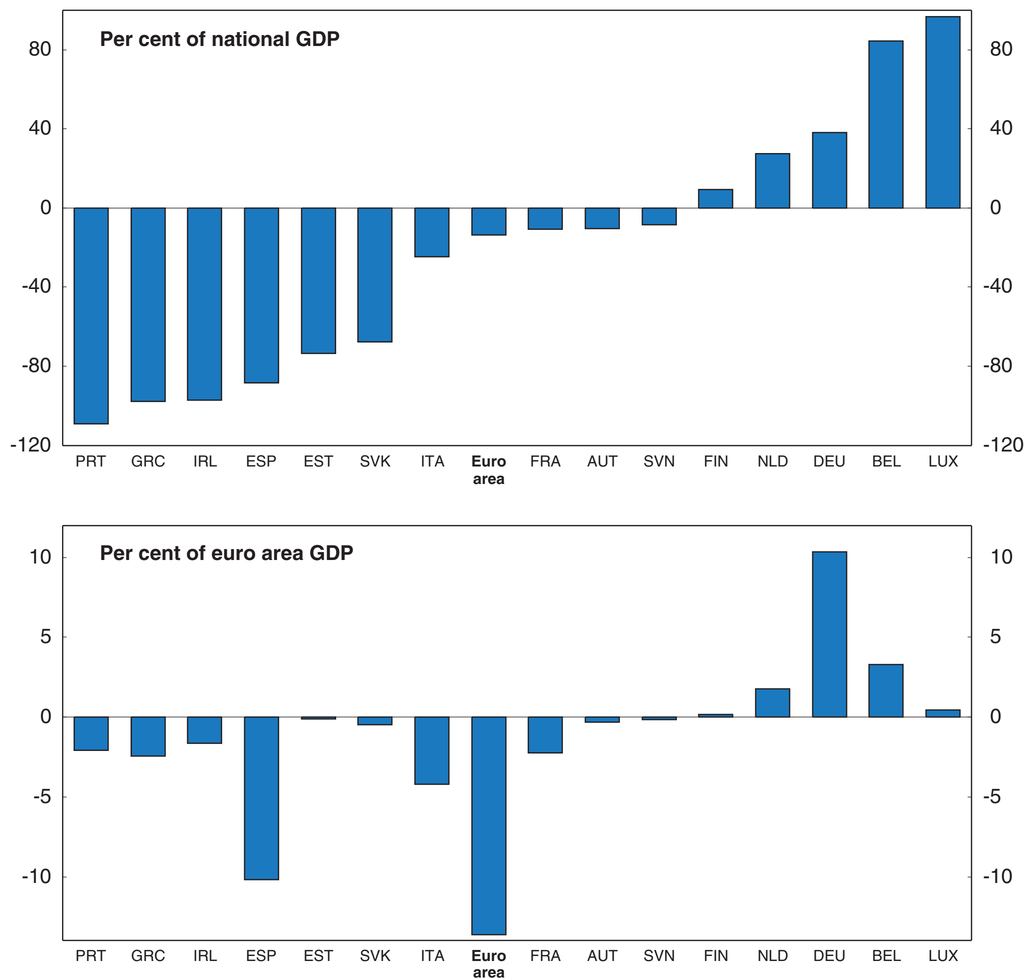
Stronger EU fiscal, financial and structural governance is needed to create stability

The experience of the euro area over the past decade underlined the need for a new and cross-cutting approach to the economic and financial management to ensure sustainable growth and avoid excessive imbalances in the future (OECD, 2010). These led to the accumulation of large net foreign assets and liabilities (Figure 6). Significant progress has been made since the crisis to strengthen macroeconomic, financial and fiscal management, both at euro area and national level (Chapter 1). These policy measures should contribute to resolving the current crisis, both directly and through improving the credibility of the institutional framework. The EU Semester draws many of these initiatives together in terms of wide-ranging annual surveillance in an annual cycle. Effective implementation of the measures put in place, notably on economic governance, fiscal surveillance and financial regulation, will be crucial in the coming years. Further measures are also required, both in terms of the institutional framework and addressing underlying structural weaknesses to make the existing architecture – a monetary union without a fiscal union – work. This approach could deliver a more stable euro area economy than in the past. There is a case to work towards much deeper economic, financial and fiscal integration of euro area countries, including much stronger governance, but this would require careful consideration of the fundamental changes required to make it work.

Given recent experience of the functioning of the monetary union, there is a clear need for more effective policies at national level to avoid excess imbalances. The new Macroeconomic Imbalances Procedure (MIP), introduced by the so-called “six-pack”, and the related surveillance in the context of the EU Semester provide a new framework for the

Figure 6. **Net foreign asset position**

In 2010



Source: IMF, *International Financial Statistics* and OECD, *OECD Economic Outlook Database*.

euro area. This procedure can lead to financial sanctions for countries that fail to take required policy action in the face of excess imbalances. However, given that enforcement will be key, it is vital that the Commission and the Council take an active approach to enforcing the new framework. In addition, the strongest safeguard against imbalances is tackling their underlying structural causes (Chapter 2): important reforms have been undertaken in some countries, but much still needs to be done.

Strong fiscal institutions are needed to support the consolidation process and ensure that the inadequate budgetary discipline of the past is not repeated. At the EU level, the so-called "six-pack" of legislative measures also upgrades the Stability and Growth Pact, while a number of additional significant changes are being undertaken for the euro area, in particular the draft Regulation for enhanced monitoring of budgetary policies, the draft Regulation for enhanced surveillance for Member States with financial difficulties ("two-pack") and a new Treaty between euro area countries, which includes the "fiscal compact" (Chapter 1). Measures legislated in 2011 as part of the "six-pack" for strengthened

euro area fiscal governance include a new system of earlier and more widely applicable sanctions to be activated on the basis of enhanced voting procedures, new benchmarks for expenditure and debt developments, much stronger requirements for statistical reporting and the obligation to strengthen national fiscal institutions. The new Treaty calls for a balanced budget requirement in structural terms in constitutional or equivalent national legislation. In addition, new legislative proposals from the Commission (the "two-pack") would require macroeconomic forecasts for the national budget to be made or endorsed by a body with functional independence from government and introduce a monitoring of draft budgetary plans to be presented in autumn. Recent reforms are a substantial improvement on the previous design of the Stability and Growth Pact. Effective implementation must now be achieved.

However, there remain similarities in the basic approach to the previous fiscal governance regime. In the enforcement of the Stability and Growth Pact, the Council retains a margin of discretion around all decisions, albeit in many cases now constrained by reverse qualified majority voting. While the experience of the crisis may have increased the determination to impose necessary discipline on other countries, the difficult situations of many countries for the foreseeable future may make it harder for the Council to pass appropriate restrictions. Once fiscal positions have been stabilised and deficits are below 3% of GDP, the commitment to the Medium-Term Budgetary Objectives (MTOs) and structural budget balance requirements in national legal frameworks will generally be the most binding constraint in terms of the fiscal balance in the EU fiscal governance framework. The effective implementation of the reforms and strong political commitment to them will be essential for progress to be made. Where debt levels are high, requirements under the MTOs and the new Treaty to maintain structural positions close to balance are likely to imply large primary balances and rapid reductions in the debt-to-GDP ratio. In the longer term, such requirements if implemented literally could imply very low steady-state debt levels. The 2012 revision of the MTOs will need to strike a careful balance between ensuring a sufficient pace of debt reduction and avoiding excessively rapid reductions in debt that are not credible.

Poor and incoherent communication and weak decision-making have made the resolution of the crisis more difficult than necessary. Procedures have improved considerably since the crisis began, for example through much more regular and close co-operation through the Economic and Financial Committee of the ECOFIN Council (EFC). One problem has been the large number of policy actors with no clear hierarchy: the President of the European Council, the President of the European Commission and the specialist Commissioner, the chairman of the Eurogroup, the country presiding the European Union, and heads of state and finance ministers of euro area countries. The decision to create a recognised leader for the euro area, who will in the first instance be the President of the European Council, could help, although it does not fully resolve the problem of multiple actors. Euro summits will be held formally at least twice a year. The Eurogroup, although playing a key role, remains an informal body. At the working level, the creation of a permanent Brussels-based head of the EFC will help co-ordination. However, there remains potential for conflict, slow decision-making and incoherent communication in this structure.

Box 4. **Main recommendations on economic governance**

- Implement the "six pack" of legislative measures to strengthen both the EU and national fiscal frameworks and to address macroeconomic imbalances. The Council should only use its discretion where it is genuinely warranted. The economic advice of the Commission should be made under the responsibility of the relevant Commissioner and political interference should be reduced.
- Use the reappraisal of the MTOs in 2012 to reconsider their role in the light of the much greater need than in the past to reduce debt-to-GDP ratios. Adequate progress towards reducing the debt-to-GDP ratio, both through the budget balance and growth, should be the main guide to the appropriateness of policy.
- Set out more credible and detailed medium-term budgetary plans. Continue to upgrade national fiscal institutions, including but not limited to implementation of the EU directive. Independent fiscal councils should be set up in all euro area countries.

Financial governance is key to preventing future imbalances

During the upswing, the euro area financial system took excessive risks and banks fuelled large imbalances within the euro area. Major reforms to financial and banking oversight have been undertaken since the crisis across a wide range of policy areas. Microprudential and macroprudential policy were not effective in the run-up to the crisis in mitigating risks to the stability of the overall financial system. Financial oversight overlooked high levels of risk arising from common exposures, interconnectedness between key institutions and the increasing international locus of financial firms. The on-going major upgrading of financial oversight and regulation in the EU, as part of international efforts, is therefore welcome. In terms of regulation, the Basel III Accord is currently being translated into EU law through the revised Capital Requirements Directive and a new regulation (CRD IV/CRR). From a macroprudential perspective, the Countercyclical Capital Buffer – which would be calibrated at national level – is especially important for individual euro area countries given the risks of destabilising real interest rates in individual countries within a monetary union and high capital mobility. This instrument, based on a numerical threshold rather than full discretion, could both increase the costs of engaging in excessive bank lending and create a capital cushion in good times that could be used in bad times. A strong advantage of this instrument is its international reciprocity as it applies to any potential lender into an economy and not just banks that happen to be domestically-regulated. The close interrelationship between domestic banks and their governments is a serious problem, creating poor incentives on both sides and leading to financial stability risks. Regulatory and supervisory treatment of sovereign risk needs to be stepped up to provide banks with appropriate incentives to manage and diversify sovereign risks to solvency and funding. This should include, eventually and in a global context, reassessing its zero risk-weighting, which does not accurately reflect its characteristics and leads to excessively low capital holdings, and ensuring that portfolios are adequately diversified in terms of credit risk and collateral for funding purposes. However, any possible alternative treatment has to be carefully assessed and the cost and benefits in terms of financial stability would need to be weighed and a level playing field ensured, both within the Single Market and globally.

There are some inherent weaknesses in a system of euro area financial oversight based on national supervision and crisis management. This structure creates unnecessary risks with cross-border financial flows (OECD, 2010), as well as acting as an obstacle to market integration as argued in the *Economic Survey of the European Union*. Since the crisis, the creation of the European Supervisory Agencies (ESAs) and requirements for colleges of national supervisors for all large cross-border institutions, alongside the setting up of the European Systemic Risk Board (ESRB) to provide a macroprudential oversight at EU level, has considerably strengthened the institutional setting for cross-border financial oversight, although it is too early to evaluate the effectiveness of this new regime in terms of crisis prevention. However, the crisis management framework remains weak. There is a risk that some euro area countries may not have the means to tackle a crisis of their large domestic banking systems, while strong crisis resolution can be very challenging to achieve where there are diverging interests between national authorities of home and host banks and co-ordination is difficult. Recent experience has shown the negative consequences of unco-ordinated bail-outs and the need to try to avoid such consequences in the future. Furthermore, banking sectors operating along national lines make the smooth implementation of the single monetary policy more challenging. Euro area financial crisis management arrangements should be improved. This could include a common system of crisis management and resolution backed by appropriate financing, relying as much as possible on private sector funds. The use of a bail-in instrument could also mitigate the impact of bank failures for both home and host authorities. Given the potential risks of moral hazard created by the existence of a common pool of funds, such a development would call for a more integrated and effective EU, or at least euro area, system of bank recovery, resolution and supervision. For large cross-border institutions, this could contribute to achieving more consistent and effective supervision of activities across banking groups and across countries, although any such system would need to be balanced against ensuring that there is appropriate knowledge of local conditions. While the current priority should be to resolve remaining weaknesses in the banking system, consideration should be given to the design of supervisory arrangements for large cross-border institutions and more integrated crisis management, relying as far as possible on private sector funds, notably when existing EU supervisory arrangements are reviewed in 2014.

Box 5. **Main recommendations on financial governance**

- Continue the on-going upgrading of EU financial regulations, including the implementation of Basel III. This should include counter-cyclical capital buffers based on national credit growth.
- Euro area financial crisis management arrangements should be improved, especially for large banking institutions with cross-border reach. Consideration should be given in the coming years to a more integrated system of bank supervision and crisis management and resolution, coupled with common financing relying as much as possible on private sector funds.
- Over time and in an international context, overhaul the treatment of sovereign risk in bank supervision to reassess the zero risk-weighting and to ensure that banks hold appropriately diversified portfolios. Liquidity regulations should ensure that there is no inappropriate bias towards sovereign assets and that collateral is well-diversified.

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