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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 19 February 2014. 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 21 March 2014.

The Secretariat's draft report was prepared for the Committee by Eckhard Wurzel and Jean-Marc Fournier under the supervision of Piritta Sorsa. Research assistance was provided by Isabelle Duong, Annamaria Tuske, Valery Dugain, Tomasz Berg and Satoshi Serizawa.

The previous Survey *of the euro area was issued in March 2012.*

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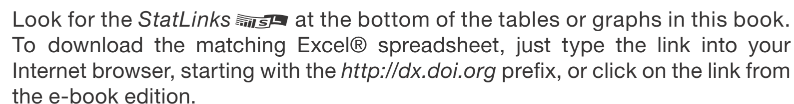
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BASIC STATISTICS OF THE EURO AREA,[a] 2012

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

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	331.8		Population density per km²	127.0	(34.6)
Under 15 (%)	15.4	(18.4)	Life expectancy (years, 2009)	81.0	(79.6)
Over 65 (%)	18.7	(15.3)	Males	78.0	(76.7)
Foreign-born (%, 2011)	11.4		Females	83.7	(82.4)
Latest 5-year average growth (%)	0.3	(0.7)	Last general election	127.0	(34.6)
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	12 184.7		Primary	1.7	(2.5)
In current prices (billion EUR)	9 483.7		Industry including construction	25.0	(27.3)
Latest 5-year average real growth (%)	-0.3	(0.6)	Services	73.3	(69.8)
Per capita, PPP (thousand USD)	28.8	(37.0)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure[c]	49.9	-43.0	Gross financial debt	90.6	
Revenue[c]	46.3	(36.9)			
EXTERNAL ACCOUNTS					
Exchange rate (EUR per USD)	0.778		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.989		Machinery and transport equipment	41.1	
In per cent of GDP			Other manufactured goods	23.7	
Exports of goods and services	45.8	(53.8)	Chemicals and related products, n.e.s.	16.5	
Imports of goods and services	43.2	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	1.3	(-0.5)	Machinery and transport equipment	27.9	
Net international investment position	-13.3		Mineral fuels, lubricants and related materials	26.5	
			Other manufactured goods	22.6	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (%) for 15-64 year olds	63.8	(65.0)	Unemployment rate (%)	11.4	(7.9)
Males	69.5	(73.1)	Youth (%)	23.1	(16.2)
Females	58.2	(57.0)	Long-term unemployed (%)	5.3	(2.7)
Participation rate (%) for 15-64 year olds	72.0	(70.9)	Tertiary educational attainment 25-64 year-olds (%)[c]	27.0	(31.5)
Average worked hours per year[d]	1 654	(1 765)	Gross domestic expenditure on R&D (% of GDP)	2.1	(2.4)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2011)	3.5	(4.3)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	7.2	(9.9)
Renewables (%, 2011)	10.3	(8.1)	Municipal waste per capita (tonnes, 2011)[e]	0.5	(0.5)
Fine particulate matter concentration (urban, PM_{10}, µg/m³, 2010)	19.4	(20.1)			
SOCIETY					
Income inequality (Gini coefficient)[f]	0.304	(0.305)	Education outcomes (PISA score)		
Relative poverty rate (%)[f]	23.4	(22.3)	Reading	494	(496)
Public and private spending (% of GDP)			Mathematics	495	(494)
Health care (2011)	8.5	(9.5)	Science	502	(501)
Pensions (2011)	13.2	(8.7)	Share of women in parliament (%, January 2014)	30.2	(26.5)
Education (2010)	5.7	(4.0)	Net official development assistance (% of GNI)	0.3	(0.4)

Better life index: *www.oecdbetterlifeindex.org*

a) Average of euro area 17 countries, unless otherwise indicated.
b) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.
c) 2011 for the OECD.
d) Average of the euro area 15 countries also members of the OECD.
e) 2010 for the OECD.
f) 2009 for the OECD.

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

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Executive summary

- *Main findings*
- *Key recommendations*

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Main findings

Ensuring a sustained recovery. The euro area economies, including those most heavily hit by the crisis, appear to be turning the corner after many years of low and uneven growth. Confidence has improved and progress been made in reducing fiscal and current account imbalances and improving competitiveness in many vulnerable countries. Structural reforms have also strongly progressed in these countries. However, economic activity remains uneven and fragile. Unemployment rates stand at double-digits in several countries, and in most are more than twice as high for the young. Inequalities have widened. Weak private sector balance sheets and impressive fiscal consolidation, necessitated by high sovereign debt, still bear on demand. The impact of supportive monetary policy is weakened by financial fragmentation, with inflation rates having fallen to around 1%. Persistent very low policy interest rates are supporting economic activity; if maintained for a long period, this could feed asset price booms in some countries and could delay the cleaning up of bank balance sheets.

Towards a banking union. The crisis left Europe with high non-performing loans, fragmented capital markets and a negative feedback loop between sovereigns and banks. Substantial public funds have been spent to save failing banks in some countries, while private creditors have taken fewer losses, potentially contributing to excessive risk taking and moral hazard. Strengthening growth and restoring credit flows depend on cleaning up bank balance sheets, based on credible stress tests and asset valuations, and on firmly establishing institutions that foster unbiased risk assessment in financial markets.

To improve the functioning of the credit system, break the bank-sovereign nexus and reduce systemic financial market risks, Europe is creating a banking union with common supervision and resolution mechanisms and a single rule book. Through the establishment of the Single Supervisory Mechanism (SSM), the European Central Bank will directly supervise large and cross-border banks (and indirectly all other banks), starting in autumn 2014. European banks are undergoing a Comprehensive Assessment in 2014, which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test. Progress on these elements has been substantial. Other elements of the banking union, notably a single resolution mechanism, are still work in progress.

Fiscal governance is being strengthened. The largest part of the fiscal consolidation required to reduce debt-to-GDP ratios to prudent levels has already been achieved. Therefore, although further effort is needed, this factor is likely to weigh less on growth going forward. To increase the credibility of fiscal targets, increase national ownership, and improve monitoring, several EU-level agreements have been implemented to reinforce fiscal and economic governance and co-ordination. The new governance elements include the expenditure and the debt rule, *ex ante* opinions of draft budgets and the requirement to make significant progress towards medium-term budgetary objectives (MTO). However, the multiplicity of these rules makes the new fiscal framework complex, reinforcing the need to foster "ownership" in the consolidation process. Also, real time estimates of the required structural balances and potential output are associated with considerable uncertainty, suggesting caution in interpreting fiscal policy estimates.

Implementation of consolidation policies is being supported by national fiscal councils and medium-term fiscal frameworks. Almost all euro area countries within the OECD reported in mid-2013 to have both in place. However, there appears to be considerable variation with respect to the mandate of the fiscal councils and some of the fiscal frameworks might require adjustment once experience is gained.

Key recommendations

Ensuring a sustained recovery

- Keep the current expansionary monetary policy stance over an extended period, subject to the outlook for price developments over the medium term.

Towards a banking union

- Ensure that the ongoing comprehensive assessment of banks – which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test – leads to a consistent overall evaluation of banks' balance sheets.
- Adopt a single resolution mechanism with predictable and swift decision-making that is politically accountable, and ensure that it is operative soon after the SSM is in place. The agreement needs to ensure the effectiveness of the mechanism and its ability to quickly take decisions in emergency situations.
- Ensure legal certainty and equal treatment in the bail-in of bank creditors across states to avoid complicating resolution processes and a potential negative impact on bank funding. Ensure minimisation of national discretion in setting resolution conditions.
- For the national resolution funds to be set up under the Bank Recovery and Resolution Directive, ensure that burden-sharing arrangements for banks with cross-border activities are available. For the Single Resolution Fund, establish strong arrangements to ensure cross-border resolution financing as long as the resources of the national compartments of the Fund are not yet fully pooled. Move over time to full pooling of the Fund resources. Prefund the Resolution Fund or temporarily bridge funding gaps that might occur in the transition phase via a fiscal backstop and recuperate the finances needed by risk-based contributions from the banking sector.
- Complement the Resolution Fund by a common fiscal backstop that is fiscally neutral over the medium term and recoups *ex post* any bridge financing via contributions from the financial sector.
- Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets. Any decision would need to be taken in a co-ordinated manner at the international level. Diversify in the long run the banks' exposure to the debt of a single sovereign. Assess the merits of leverage ratios, as a supplementary measure to risk-weighted ratios, for gauging the strength of bank balance sheets.

Fiscal governance is being strengthened

- Continue fiscal consolidation, respecting the requirements of the Stability and Growth Pact, as planned and allow the automatic stabilisers to operate fully.
- Design fiscal consolidation to favour inclusive growth and employment.
- Ensure effective implementation of the strengthened EU and Fiscal Compact rules in national fiscal frameworks, including medium-term budgeting, identification of future spending and revenue pressures and risks, independent fiscal councils and effective mechanisms to correct deviations from fiscal targets.

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Assessment and recommendations

- *Fostering economic recovery*
- *Strengthening banks' balance sheets and completing the banking union*
- *Remaining fiscal challenges*

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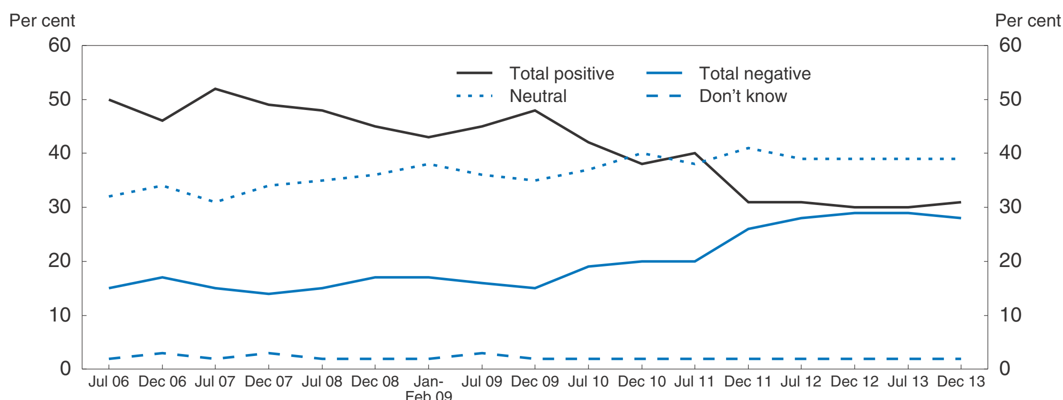
More than five years after the onset of the global economic and financial crisis, growth is beginning to pick up in euro area economies. Systemic risks have been reduced, large external and internal imbalances have receded, and most of the vulnerable countries are gradually regaining competitiveness via wage adjustment and significant structural reforms. Still, low confidence, weak private sector balance sheets and fiscal consolidation, necessitated by the high debt levels, weigh on demand. Unemployment rates stand at double-digits in several countries, and in most countries are more than twice as high for the young. Inflation is very low in many countries, and deflation risks have risen. The impact of supportive monetary policy on demand is weakened by financial fragmentation. Credit is restrained by weak bank balance sheets, high exposure to sovereign debt and, in the vulnerable countries, high interest rates driven by high perceived risks. These factors have been undermining confidence in the European project (Figure 1).

Figure 1. **EuroBarometer**

Replies to question QA11 on the image of the EU[1]



1. "In general, does the EU conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?"

Source: EC (2013), "Public Opinion in the European Union", First Results, *Standard EuroBarometer*, No. 80, Autumn, *http://ec.europa.eu/public_opinion/index_en.htm.*

StatLink http://dx.doi.org/10.1787/888933011933

The challenge for policy is to reinforce the recovery, get people back to work and create a basis for sustainable growth. While the largest part of the required fiscal consolidation has been achieved, in most euro area countries strong fiscal positions will need to be maintained for many years to bring debt down. Priority should be given to repairing financial sector balance sheets and recapitalising banks, where needed, in order to restore credit growth and support demand. Fragmentation can be reduced and confidence boosted by further progressing towards banking union in Europe. Expansionary monetary policy will need to support demand for some time. At the same time, higher priority needs

to be given to structural reforms to boost more even adjustment and rebalancing, competitiveness, and the growth potential. This could be facilitated by continued reinforcement and implementation of EU wide fiscal and structural governance.

The 2014 *OECD Economic Survey of the Euro Area* and the 2014 *OECD Economic Survey of the European Union* discuss these challenges from different perspectives: the former mainly focusses on financial sector reform and fiscal and monetary policies, and the latter on structural reform surveillance at the EU level.

Fostering economic recovery

The euro area exited from recession in the second quarter 2013, following six quarters of declining GDP. Confidence has improved against the backdrop of the Outright Monetary Transactions (OMT) programme, progress in fiscal consolidation, structural reforms and external rebalancing and steps forward in reforming European banking supervision. In vulnerable countries, both long-term government bond spreads against Germany and credit default swaps have declined from their peak levels in summer 2012 (Figure 2), and bank deposits have stopped falling or have picked up again (Figure 3). However, sizable differences remain, especially on the labour market, which usually lags behind recovery: the unemployment rate in Germany is at a record low of about 5%, but exceeds 25% in Spain and Greece. In the vast majority of countries, unemployment among the young is at least twice the overall rate. Risks of deflation or a protracted period of very low inflation remain as the large degree of economic slack has put persistent downward pressure on inflation, which is well below the ECB's quantitative definition of price stability (HICP inflation just below 2%).

Current account imbalances in the euro area have narrowed as, in some countries, the collapse in domestic demand has compressed imports and as better competitiveness has, in some countries, boosted exports (Figures 4 and 5). While business and housing cycles account for about 2 points of GDP of the current account adjustment in deficit countries in 2012 (Ollivaud and Schwellnus, 2013), these countries have undergone significant structural adjustment, suggesting that their current account positions will not return to pre-crisis levels. The current account improvements in vulnerable countries are likely to have contributed to the fall in credit risk premia since the second half of 2012, as external funding needs have fallen. Unit labour costs in these countries have come down substantially, with the notable exception of Italy, but prices have adjusted less than wages, in part reflecting slow product market reforms, which has limited the effect of declining unit labour costs on price competitiveness (Figure 5). Much less rebalancing has occurred in economies with high surpluses, suggesting inefficient levels of saving and investment. A stronger contribution of their domestic demand to growth would smooth overall adjustment in the euro area.

Structural reforms, in part by boosting growth, can put the rebalancing process on a more sustainable footing (e.g. OECD, 2011; OECD, 2012). Labour market reforms can help to better align wages to productivity (e.g. reforms of wage-setting frameworks). In deficit countries, structural reforms focusing on strengthening productivity and price and non-price competitiveness, and easing regulations would boost exports. In addition, removing policy distortions that encourage consumption would increase household saving. In surplus countries, measures to create more favourable conditions for investment and regulatory reform in service sectors could boost domestic demand and smooth the overall adjustment in the euro area.

Figure 2. **Banking and government risk measures**

Bank liquidity and solvency risk

Basis points

Credit default swap rate,[1] Euro area
Credit default swap rate,[1] United States
Money market spreads,[2] Euro area
Money market spreads,[2] United States

Sovereign bond spreads[3]

Per cent

France
Ireland
Italy
Portugal
Spain
Greece

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.

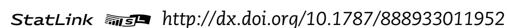
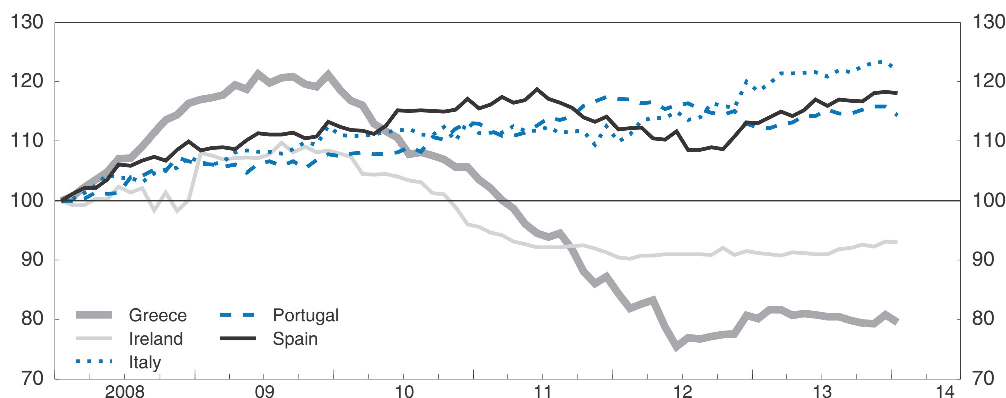

StatLink http://dx.doi.org/10.1787/888933011952

Figure 3. **Bank deposits[1] have bottomed out**

Index January 2008 = 100



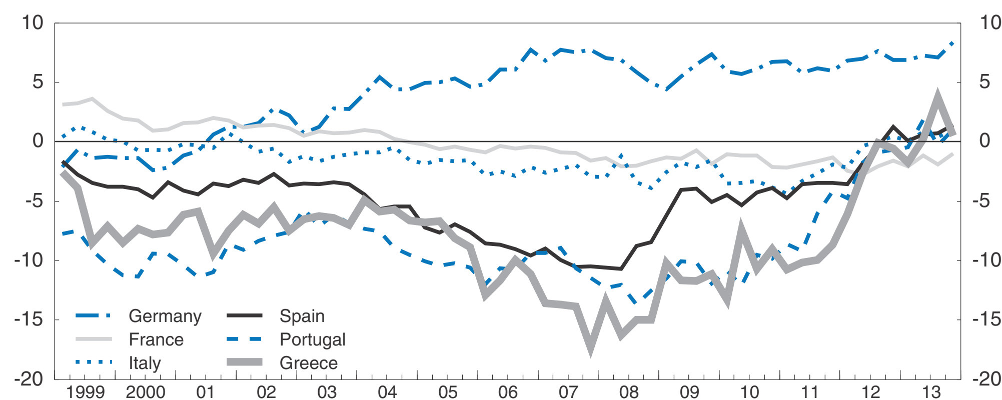
1. Non-financial corporations and household deposits in monetary financial institutions (MFIs).

Source: European Central Bank.

http://dx.doi.org/10.1787/888933011971

Figure 4. **Current account balances**

As a percentage of GDP



Source: OECD, *OECD Economic Outlook database.*

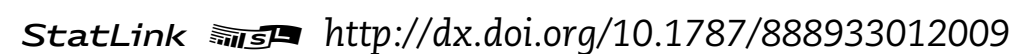
http://dx.doi.org/10.1787/888933011990

Net international investment positions (NIIPs) of vulnerable countries remain strongly negative, and reducing them will require many years of current account surpluses or large valuation changes. This inevitably slow pace of correction, in turn, might damp further reductions in sovereign risk premia, which appear to be positively correlated with European countries' NIIPs (Figure 6), especially so for euro area countries with both high external and high government debt (Turner and Spinelli, 2013). This points to the need to implement structural reforms to improve competitiveness and current account balances, and to restore fiscal sustainability.

Figure 5. **Evolution of price competitiveness**

1. The figures shown correspond to unit labour costs of the whole economy relative to unit labour costs in the rest of the euro area.
2. Or latest available data.

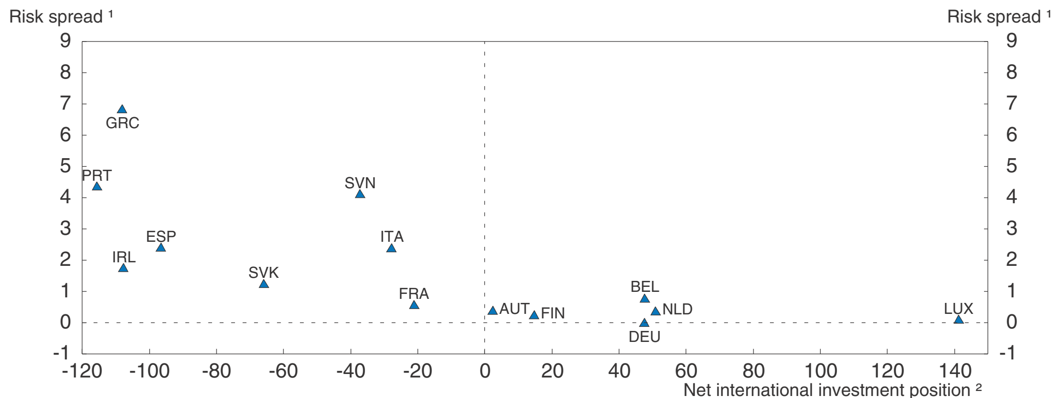
Source: OECD, *OECD Economic Outlook database* and OECD calculations.



http://dx.doi.org/10.1787/888933012009

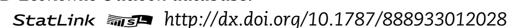
Figure 6. **Net international investment position and sovereign risk spread**

Q4 2013 or latest available data



1. Ten-year government bonds over Germany.
2. As a percentage of GDP.

Source: IMF, *Balance of Payments Statistics database*; OECD, *OECD Economic Outlook database*.


StatLink http://dx.doi.org/10.1787/888933012028

Economic growth is projected to rise in 2014 and 2015 as confidence improves further, financial market fragmentation declines and fiscal consolidation eases (Table 1). The pace will remain moderate, however, as tight credit conditions will bear on economic activity for some time, especially in the vulnerable countries. High unemployment and weak income growth are holding back private consumption and investment. Unemployment is projected to stabilise in 2014, starting to decline only in 2015. Inflation might change little in 2014, given the large slack, edging up somewhat in 2015. The current account surpluses of Italy, Portugal and Spain are projected to rise further over the next two years.

The risks to these projections have become more balanced but are still on the downside. Downside risks include the uncertain political situation, social tensions and still challenging public finances in many countries which mean that financial market turbulence could flare up again. The vulnerabilities in this respect would be increased by: insufficient progress in establishing institutions and rules to ensure that European banks function effectively; failure to achieve adequate asset quality reviews and stress tests in 2014 and, then, to clean up bank balance sheets; and insufficient progress on structural reforms in both debtor and creditor countries. Deflation risks may intensify if activity continues to be weak. External risks include a still sharper slowdown in emerging market economies, and a tightening of the US monetary stance (the prospect of which already upset markets in May 2013). The upside risk, that the recovery could be stronger than envisaged, could occur if further bold structural reforms are implemented. This could underpin positive feedbacks between confidence, economic growth – in particular investment – and the ability of the banking sector to extend loans.

Growth in the euro area remains weak and non-inclusive

Seen from a longer-term perspective, growth and productivity performance in the euro area has been disappointing, despite the potential gains from a unified European market. Since 2000, total labour productivity per worker grew, in trend, by 0.6% a year, as against 1.2% in the OECD on average. Differences within the euro area are also large (Figure 7). In countries with high productivity levels, unlocking new sources of productivity growth is

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2009 prices), EA15[1]

	2011	2012	2013	Projections[2]	
				2014	2015
GDP	**1.6**	**-0.6**	**-0.4**	**1.0**	**1.6**
Private consumption	0.3	-1.4	-0.6	0.6	1.2
Government consumption	-0.1	-0.6	0.2	0.3	0.3
Gross fixed capital formation	1.7	-3.8	-2.7	1.5	3.2
Final domestic demand	0.5	-1.7	-0.9	0.7	1.3
Stockbuilding[3]	0.3	-0.5	-0.1	0.1	0.0
Total domestic demand	0.8	-2.2	-0.9	0.8	1.3
Exports of goods and services	6.7	2.7	1.4	3.6	4.8
Imports of goods and services	4.6	-0.8	0.2	3.2	4.5
Net exports[3]	0.9	1.5	0.5	0.3	0.3
Other indicators (growth rates, unless specified)					
Potential GDP[4]	0.9	0.8	0.8	1.0	1.2
Output gap[4, 5]	-1.3	-2.7	-3.8	-3.8	-3.4
Employment	0.3	-0.7	-0.7	0.0	0.5
Unemployment rate	10.0	11.2	12.1	12.1	11.8
GDP deflator	1.2	1.3	1.4	1.0	1.1
Consumer price index	2.7	2.5	1.3	1.2	1.2
Core consumer prices	1.4	1.5	1.1	1.1	1.2
Household saving ratio, net[6]	7.9	7.6	7.7	7.9	7.8
Current account balance[7]	0.7	1.9	2.8	2.6	2.8
General government financial balance[7]	-4.1	-3.7	-2.8	-2.5	-1.8
Underlying government primary balance[5]	-0.9	0.4	1.3	1.9	2.4
Gross government debt (Maastricht)[6]	88.1	92.7	95.0	95.9	95.6
General government net debt[7]	58.8	65.7	67.9	69.4	69.4
Three-month money market rate, average	1.4	0.6	0.2	0.1	0.3
Ten-year government bond yield, average	4.2	3.7	2.9	3.2	3.5
Memorandum items:					
Gross government debt[7]	93.9	104.1	105.9	107.1	106.8

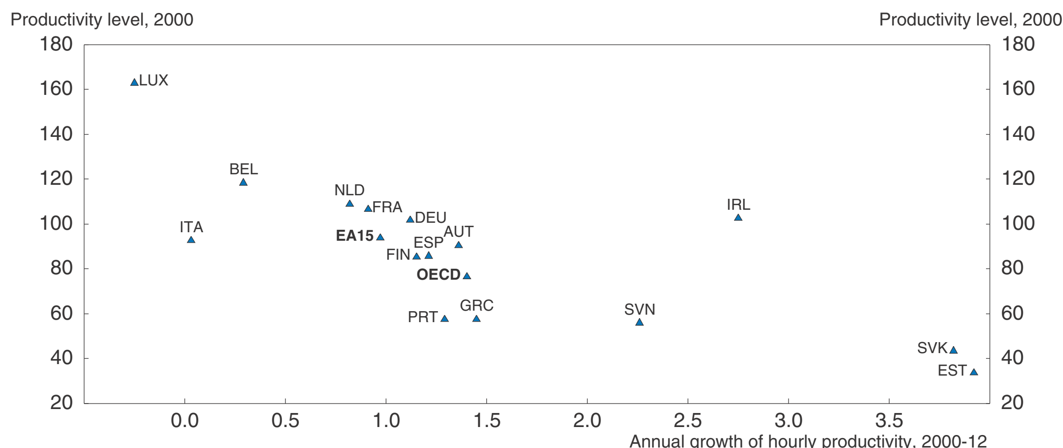
1. EA15 refers to the 15 countries in the euro area that are also members of the OECD.
2. Projections are taken from the *OECD Economic Outlook 94*.
3. Contribution to changes in real GDP.
4. Potential output and the output gap are taken from the *OECD Economic Outlook 94*.
5. As a percentage of potential GDP.
6. As a percentage of household disposable income.
7. As a percentage of GDP.

Source: OECD, *OECD Economic Outlook 94 database*.

getting harder. Southern European countries that were lagging behind in 2000 have failed to catch up. The recession has also set back euro area economies. The structural unemployment rate rose by about 1½ percentage points in the euro area between 2007 and 2013 (Figure 8). Also, growth has failed to reduce income inequalities in the euro area since the 1990s. Much of this reflects inequality within countries (Figure 9), but the situation has been worsened recently by falling incomes in some low-income countries (Bonesmo Fredriksen, 2012). All these factors have contributed to weakening support for the euro area as citizens perceive fewer benefits from it.

If structural reforms do not proceed further, growth is expected to remain modest over the longer term (Table 2). Because of ageing, employment growth, which had been roughly 1% per year before the crisis, will fall towards zero. Migration flows and regular increases in the effective retirement age, as countries complete substantial pension reforms, will most

Figure 7. **Low and uneven productivity growth**



Source: OECD, *Productivity database.*

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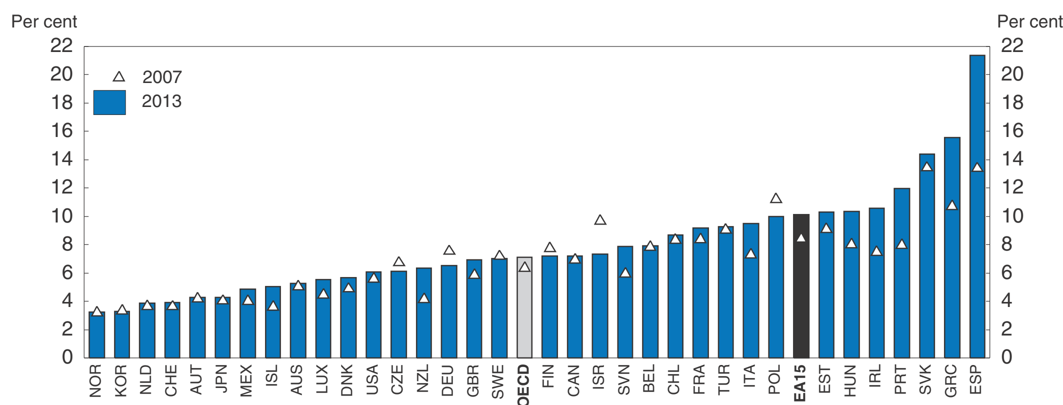
Figure 8. **Structural unemployment in the euro area is high and growing**

Non-accelerating inflation rate of unemployment



Source: OECD, *OECD Economic Outlook 94 database.*

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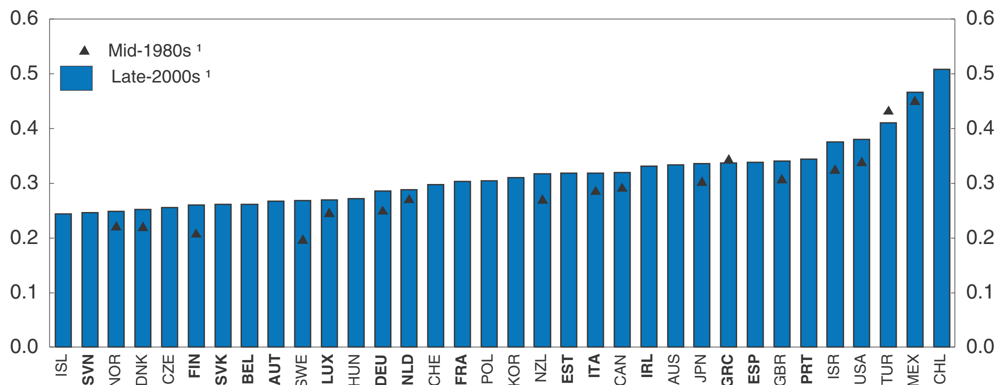
likely do little more than stabilise employment in the coming years (OECD, 2013a and b). Against the background of weak innovation, labour productivity growth may prove only moderate. Achieving the 60% target of government debt with such low growth prospects will require maintaining fiscal surpluses for an extended period of time, which will be a major policy challenge.

Risks to the long-term growth scenario may be mostly on the downside. Financial disruptions are still likely unless fragilities within the euro area are permanently fixed. Over time, the structure of European economies will be challenged by the rising Asian economies and other emerging markets, technological change, and environmental problems. Flexibility to adapt to change will be fundamental in facing these challenges, but so far Europe has been slow to tackle structural rigidities with bold policies at the national or the EU level (Figure 10). This would also help to boost competitiveness and improve structural current account balances.

Figure 9. **Inequality is increasing in some euro area countries**

Gini coefficient of household disposable income, total population



1. The reference year differs across countries. For mid-1980s, it refers to 1985 or nearest available year. As for late 2000s, it refers to 2010 or 2009.

Source: OECD, *Income Distribution database*, via *www.oecd.org/social/inequality.htm*.

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Table 2. **Long-term growth scenario for the euro area**

Average growth rate, per cent

	2018-30	2031-60
Real GDP	2.1	1.3
Real potential GDP	2.0	1.3
Investment rate[1, 2]	19.7	13.7
Labour efficiency	1.4	1.4
Potential employment	0.2	-0.2
Non accelerating inflation rate of unemployment[1, 3]	8.7	8.2
General government net lending[1, 2]	-0.1	-0.7
Cyclically-adjusted general government net lending[1, 2]	-0.1	-0.7
General government debt[1, 2]	60.6	59.7
Current balance[1, 2]	-1.5	2.0

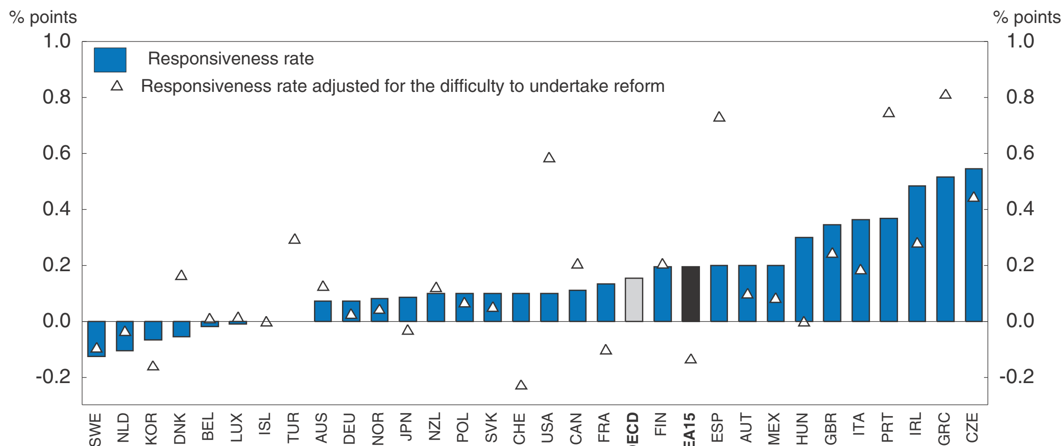
1. End of period.
2. Per cent of GDP.
3. Per cent of labour force.

Source: OECD, *OECD Economic Outlook 93 Long-Term database*.

Monetary policy has been highly accommodative

The ECB has used both conventional and unconventional tools to maintain price stability over the medium term, and to support demand and bank funding in the face of large economic slack, fiscal consolidation and impaired monetary transmission channels. Policy rates are at record low levels, and the ECB has offered unlimited liquidity allotment in fixed rate tenders, including Long-Term Refinancing Operations (LTRO) (Figure 11). As a result, the Eurosystem's balance sheet has expanded unprecedentedly relative to GDP, as in the United States and Japan (Figure 12). More recently, the Eurosystem balance sheet has shrunk somewhat as return of bank deposits and lower refinancing risks have allowed banks in vulnerable countries to repay prior to LTRO expiry a sizeable part of their holdings.

Figure 10. **Change in responsiveness to *Going for Growth* recommendations from 2009-10 to 2011-12**[1]



1. OECD and euro area aggregates do not include Chile, Estonia, Israel and Slovenia. The reform responsiveness rate indicator is based on a scoring system in which recommendations set in the previous edition of *Going for Growth* take a value of 1 if "significant" action is taken and 0 if not. The "adjusted" responsiveness rate weighs responsiveness on each individual priority according to the difficulty of undertaking the relevant reform, as measured by the inverse of average responsiveness to priorities in this area in non-crisis circumstances across the OECD or the BRIICS.

Source: OECD (2013), *Economic Policy Reforms 2013: Going for Growth*, OECD Publishing, Paris, Figure 1.2.

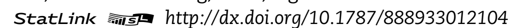


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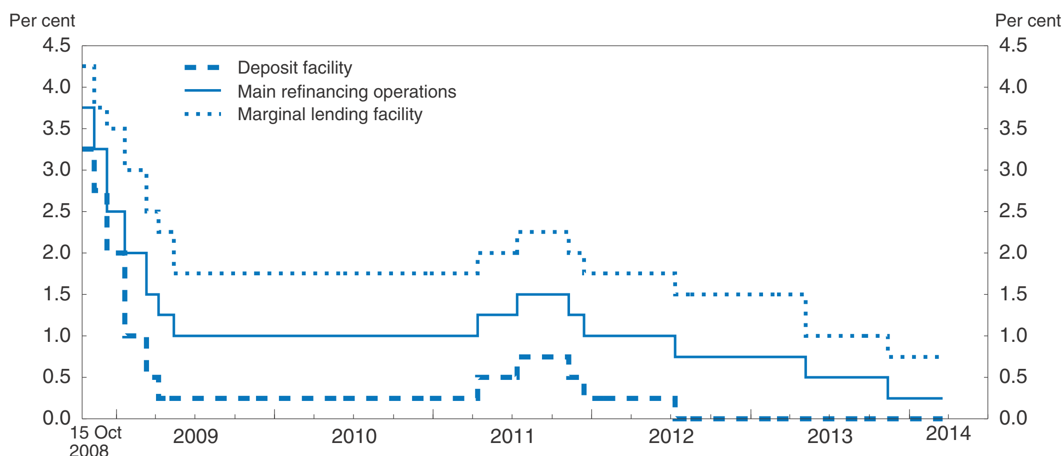
Figure 11. **Key ECB interest rates**

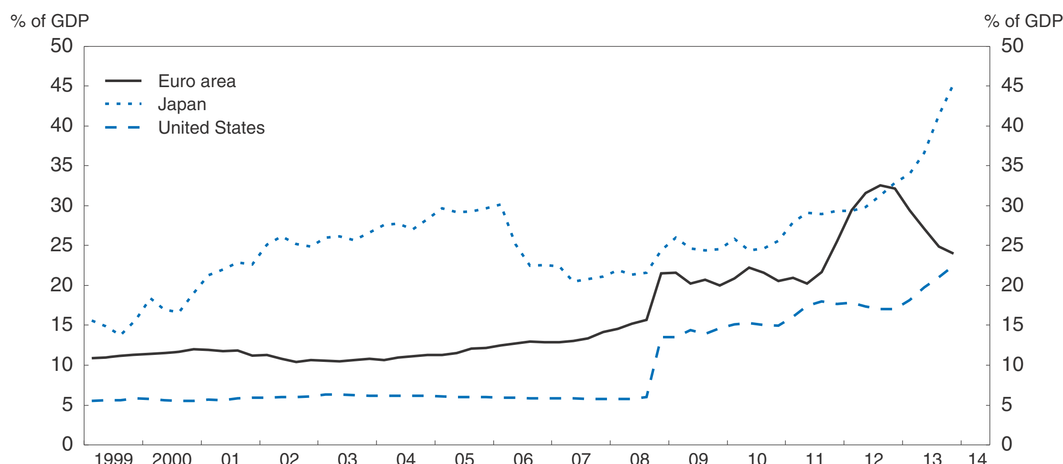


Source: ECB (2014), *Monthly Bulletin*, March, Table 1.2.

http://dx.doi.org/10.1787/888933012123

However, financial conditions remain fragmented, resulting in impaired transmission of policy. The more favourable conditions in private sector credit funding have not yet translated into improved bank lending conditions, reflecting weak economic activity, diverging perceptions of risk and weakness in banks' balance sheets (ECB, 2013). Loans to non-financial corporations and to private households are still falling or are stagnating in the euro area overall, with marked declines in most vulnerable countries (Figure 13). Similarly, the cost of credit is significantly higher in vulnerable countries than elsewhere, hitting Small and Medium Enterprises (SME) in particular (IMF, 2013) (Figure 14).

Figure 12. **Total central bank liabilities**



Source: Datastream and OECD, *OECD Economic Outlook database*.

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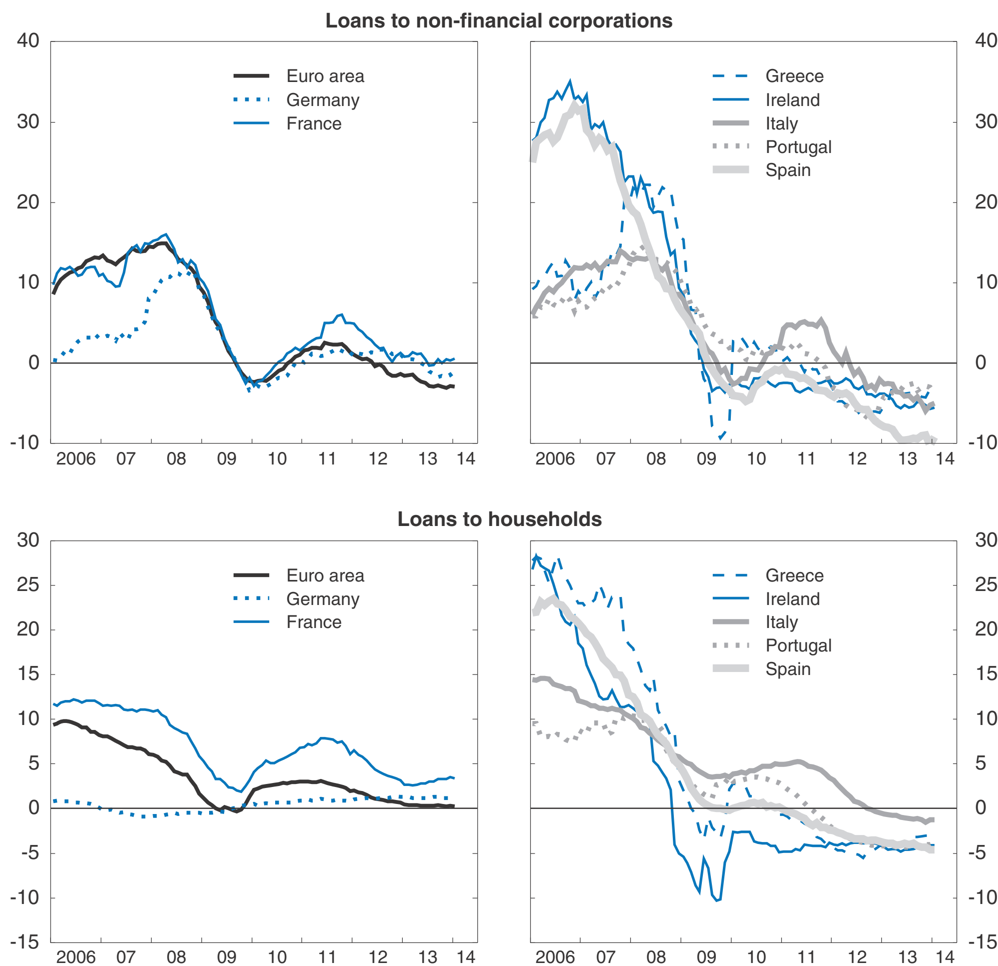
Euro area consumer price inflation has declined to 1¼ per cent on average in 2013, despite increases in indirect taxes, and remained low in early 2014. Euro area inflation rates substantially below the ECB's objective of below but close to 2% in the medium term make adjustment of relative prices across economies more difficult without significant price reductions in some countries. Nonetheless, inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with the ECB's definition of price stability. Inflation is projected to increase only gradually, as economic slack is projected to narrow only slowly. The ECB's monetary policy stance will therefore have to remain accommodative for an extended period of time, as the ECB has indicated in its forward guidance based on the overall subdued outlook for inflation extending into the medium term. The ECB's announcement to continue its fixed rate tender procedures with full allotment for as long as necessary but at least until mid-2015 should ensure that enough liquidity is available once the 3-year LTROs expire in late 2014 and early 2015. Separately, the European Investment Bank has set up a special programme to support small and medium enterprises (SME). However, if substantial uncertainties were to re-emerge, or if deflationary risks intensify, additional non-conventional measures should be considered.

The benefits of these policies need to be weighed against potentially severe unintended negative consequences of maintaining a highly expansionary stance over a long period. This can delay the needed rebalancing of the economy by shifting risk to the balance sheet of the central bank, masking private sector balance sheet weaknesses and undermining incentives to deal with impaired assets. It can also encourage excessive risk-taking, resulting in asset price bubbles and financial system instability (Borio and Zhu, 2012; Hahm et al., 2012). Near-zero interest rates are, over time, likely to lead to poor allocation of capital (Rawdanowicz et al., 2013). To at least some extent, micro- and macro-prudential bank supervision can play a role in reducing this risk. Liquidity injections by the ECB have also partly been associated with an increase in the banks' exposure to government debt (EBA, 2013a), a situation that could lead to instability if the risks associated with either public debt or the banks were to shift. Looking further ahead, if the perception arises that the central bank might hesitate to withdraw

Figure 13. **Growth of bank credit to the private sector**

Loans by monetary financial institutions (MFIs),[1] year-on-year percentage change



1. Total loans within the euro area, except for Italy where loans are domestic. From 2010 onwards, loans are adjusted for sales and securitisation.

Source: European Central Bank and Banca d'Italia.

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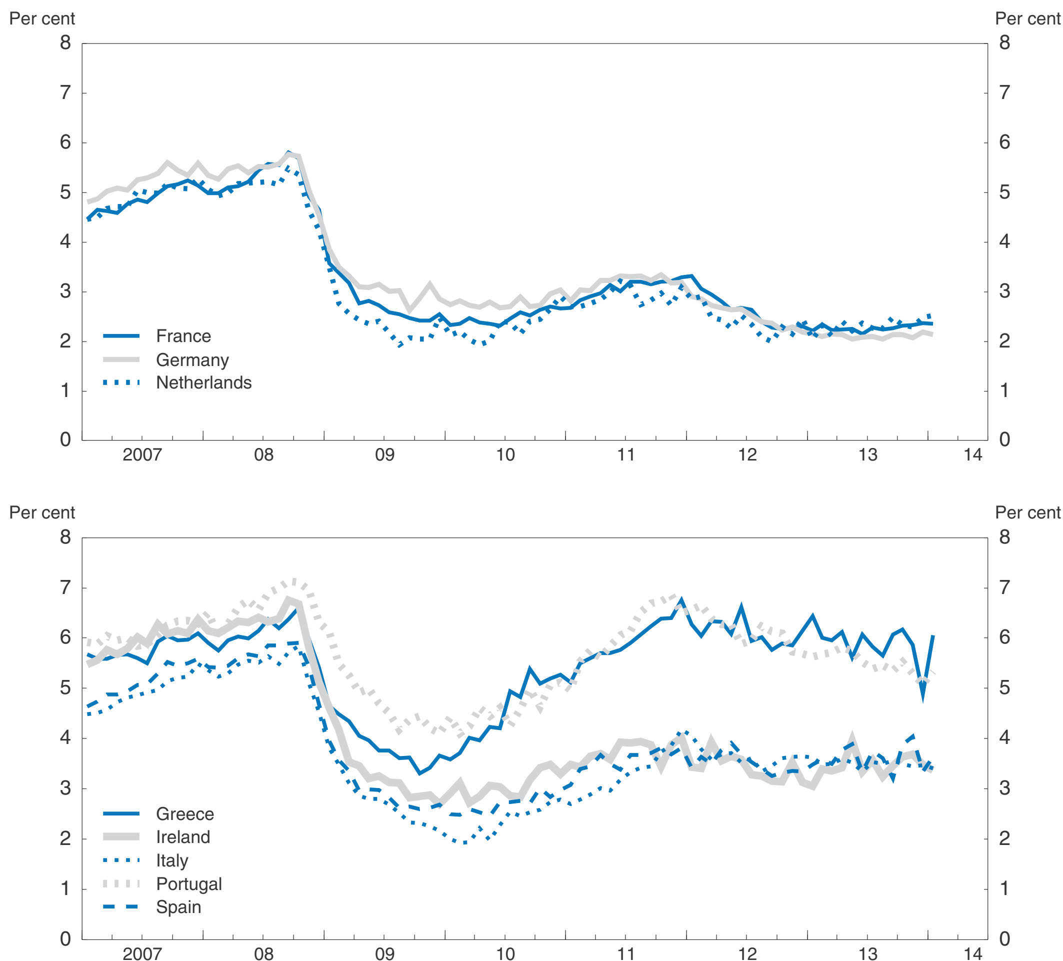
stimulus in line with the changing outlook for price stability, inflation expectations could rise. These issues reinforce the case for establishing a banking union, which would help to overcome financial market fragmentation.

As the recovery advances, deflation risks disappear and transmission channels for monetary policy resume functioning, monetary policy will have to gradually become less expansionary. The exit from the very expansionary monetary policy stance should be guided solely by the ECB's primary objective to maintain price stability over the medium term. Strong communication and avoidance of abrupt action will be key to prevent unsettling financial and exchange markets, as recent experience with the Fed's announcement of tapering in the United States indicates.

Figure 14. **The cost of credit[1] in euro area countries**

Last observation: January 2014



1. The cost of credit is defined as interest rates on new loans to non-financial corporations (all maturities) with the exception of Greece where it refers to new loans with maturity of up to one year.

Source: European Central Bank.

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Recommendations on monetary policy

Key recommendation

- Keep the current expansionary monetary policy stance over an extended period, subject to the outlook for price developments over the medium term.

Further recommendation

- Continue with strong communication as monetary stimulus is withdrawn.

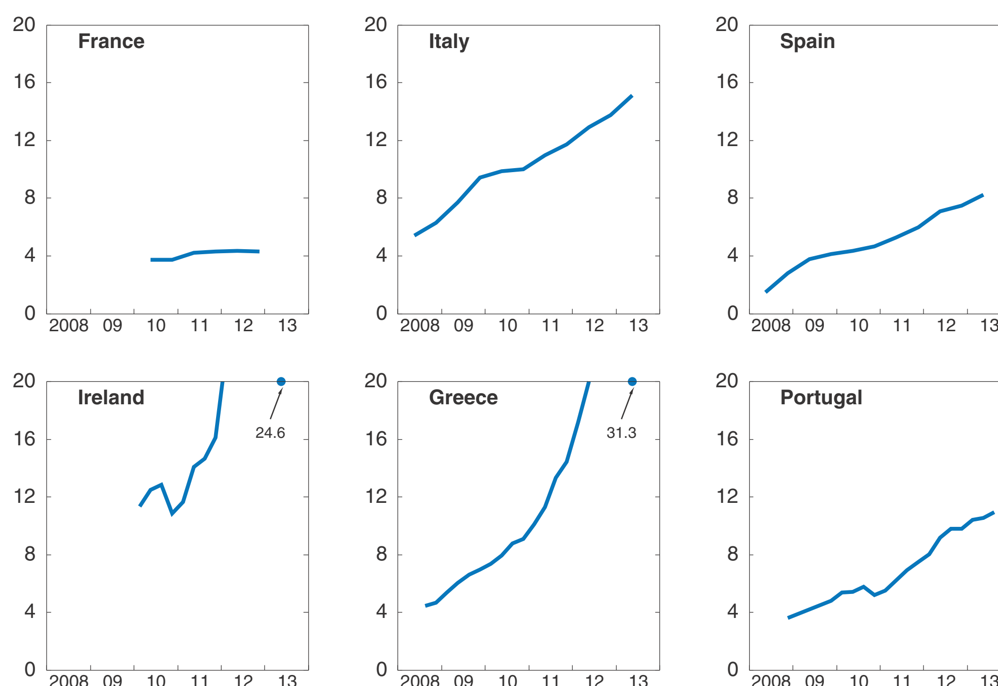
Stronger bank balance sheets are key to recovery

Healthy bank balance sheets are crucial to support the economic upswing and long-term growth. This is particularly important in the EU, where reliance on bank credit by enterprises, and in particular small- and medium-sized ones, is large compared, for example, to the United States. A relatively large share of non-performing loans in several banks, further capitalisation needs, and a decline in inter-bank equity holdings across-borders affecting banks in vulnerable countries indicate remaining weaknesses in the banking sector. Banks' large holdings of government paper may have crowded out private credit. These factors, which are also sources of risk, restrain the banks' capacity to lend.

Across the euro area, a substantial part of total bank assets is made up of non-performing loans (NPLs). While cross-country comparison of the level of NPLs is difficult, due to different definitions applied in different countries, available information indicates that the share of NPLs is particularly high in countries under stress. In most of the vulnerable countries, Italy included, NPLs are still rising owing to weak growth and, in some countries, falling house prices (Figure 15). In part, their share in total assets is increasing because total lending is contracting. Improving macroeconomic conditions could therefore raise loan recovery rates. The ongoing Comprehensive assessment of banks' balance sheets by the ECB reviews, among other objectives, the quality of banking assets and identify banks' non-performing loans, which could be higher than those reported.

Figure 15. **Banks' non-performing loans**[1]

As a percentage of total gross loans



1. Cross-country comparisons of non-performing loans are complicated by differences in definition.

Source: IMF, *Financial Soundness Indicators database.*

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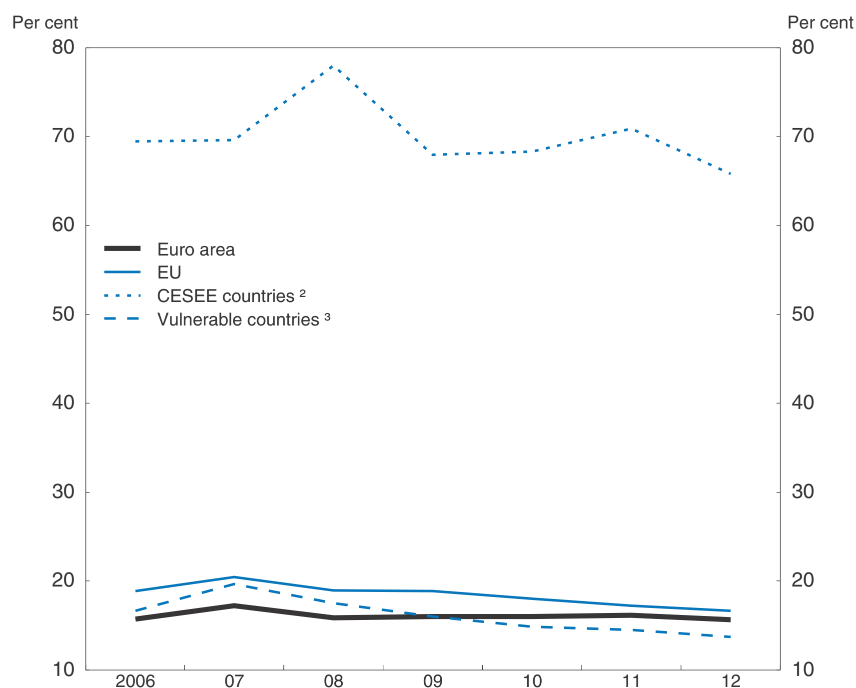
Low cross-border holdings of banks' equity capital diminish risk sharing. Even prior to the crisis, foreign equity capital holdings in banks in some vulnerable countries were comparatively low, and they have declined further. Bank penetration – defined as the share of total bank assets in a given country that belongs to branches or subsidiaries of banks that are based in another country – declined in a few countries. In Ireland, bank penetration has dropped by more than 10 percentage points since the onset of the crisis. Declines in Greece, Portugal and Spain have been smaller. Bank penetration remained unchanged in the euro area overall (Figure 16). Part of this cross-border fragmentation is regulatory-driven, as some supervisors appear to demand that assets and liabilities need to be matched locally (Schoenmaker and Peek, 2013).

Figure 16. **Cross-border bank penetration in Europe**[1]

Per cent of total banking assets



1. Cross-border bank penetration via branches and subsidiaries from EU countries. Penetration is measured by the share of total bank assets in a given country that belongs to branches or subsidiaries of banks that are located in another country. The average figures for each zone are asset weighted.
2. Central, Eastern and South Eastern European countries include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and the Slovak Republic.
3. Vulnerable countries include Greece, Ireland, Italy, Portugal and Spain.

Source: Schoenmaker, D. and T. Peek (2013), "The State of the Banking Sector in Europe", *OECD Economics Department Working Papers*, No. 1102, OECD Publishing, Paris.

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Capitalisation of euro area banks

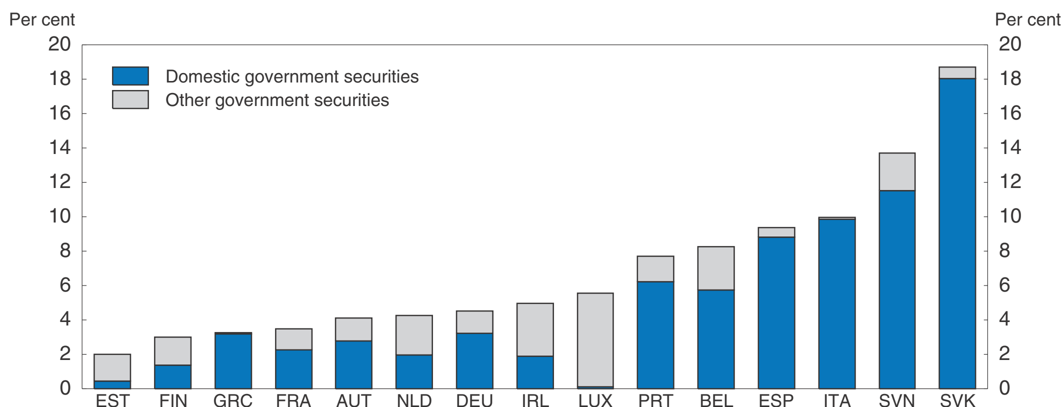
As agreed at the international level, the Basel III approach, and its transposition into EU law (Capital Requirements Directive IV and Capital Requirements Regulation, CRD IV/CRR), measures capital adequacy by risk-weighted indicators. The ongoing comprehensive assessment of banks' balance sheets aims to provide a clear understanding of the capital position of euro area banks relative to a CRD IV/CRR requirement of 8% of common equity Tier 1 capital, as a ratio to risk-weighted assets. The European Banking Authority (EBA) notes

that the capital position of European banks has considerably improved in the first half of 2013 as banks have raised capital and reduced their risk-weighted assets in anticipation of the comprehensive assessment (EBA, 2013b). Between January 2007 and September 2013, aggregate capital of euro area banks increased by EUR 710 billion, which includes large contributions by the public sector for bank recapitalisation.

However, some observers have expressed concerns that capital ratios on a risk-weighted basis may underestimate capital adequacy. For example, banks are allowed to use internal models to determine risk weights. These are meant to be elaborated as a more sophisticated measure of the underlying risk of assets, but have been found to vary among banks facing similar risks (Le Leslé and Avramova, 2012). The Bank for International Settlement (2013) notes a higher-than-expected range of variation in risk weights across banks, part of which is attributable to bankers' incentives to favour optimistic views on risk. The World Banks' Report on Bank Regulation and Supervision found that, among countries that had a financial crisis, 95% allowed banks to calculate their capital requirement using their own internal rating models. By contrast, among the countries not hit by a financial crisis, only half allowed such use of internal rating models (Čihák et al., 2012). Also, sovereign bonds, which account for a large share of banks' assets, carry a zero-risk weight (Figure 17). While sovereign debt holding in itself does not necessarily undermine banks' health, as this depends on many factors, the zero-risk weight may encourage undue asset concentration. This said, a high share of banks' holdings of general government securities may reflect to some extent the structure of the national banking sector. Some empirical research indicates that risk-weighted capital ratios have not been good predictors of market measures of risk (Blundell-Wignall and Atkinson, 2012; Blundell-Wignall and Roulet, 2013; Das and Sy 2012; Haldane, 2012). To some extent this might reflect Goodhart's law which states that when a measure becomes a target, its quality declines.

Figure 17. **Banks' holdings of general government securities**[1]

As a percentage of total MFIs assets, January 2014



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

Source: European Central Bank.

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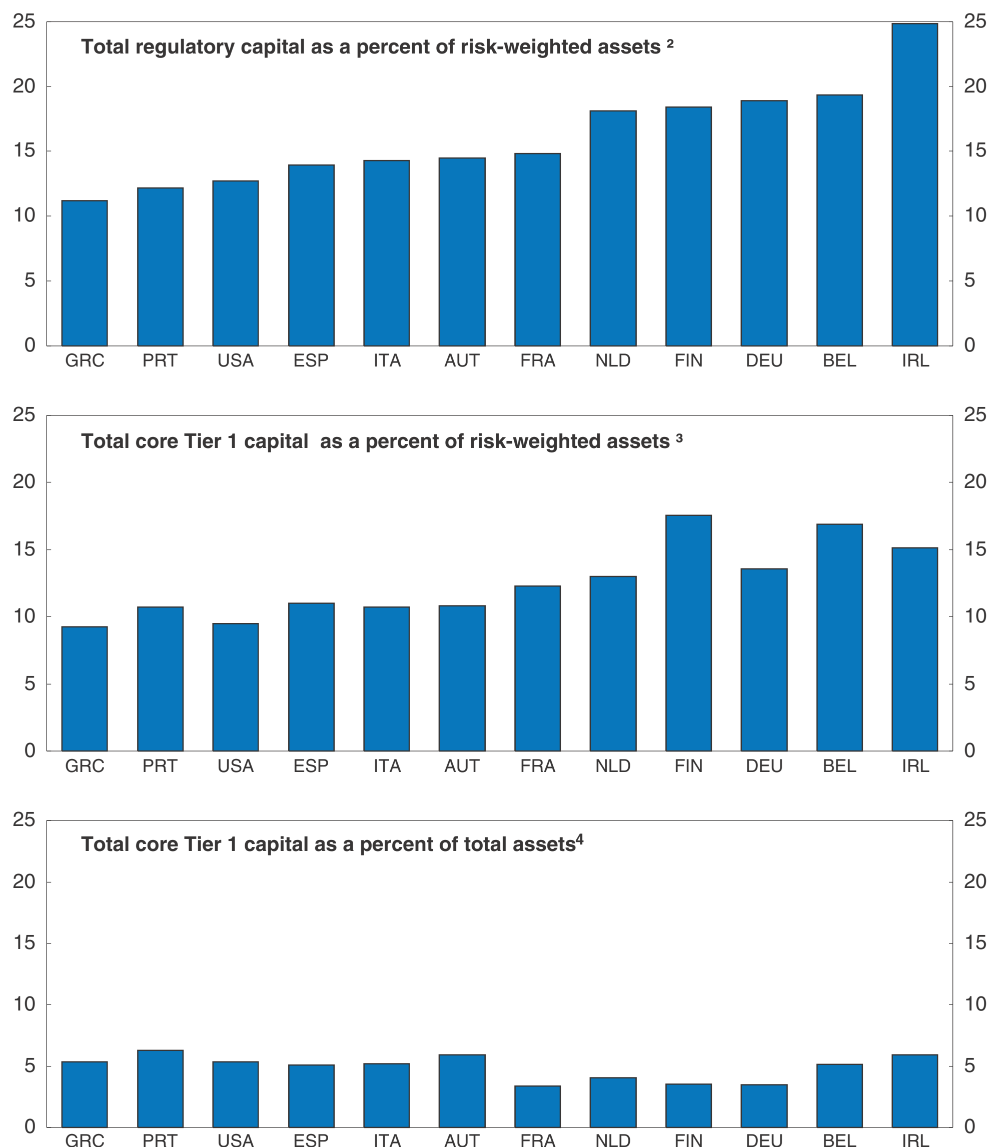
Against this background, attention has increasingly been paid to the leverage ratio (equity to non-weighted assets) as a supplementary measure to risk-weighted capital ratios in assessing banks' capital adequacy. Research suggests that a leverage ratio is a predictor of banks' distance to default (Blundell-Wignall and Atkinson, 2012; Blundell-Wignall and Roulet, 2013). Demirgüç-Kunt et al. (2012) find that the relationship between banks' capital position and stock performance is stronger when capital is measured as a leverage ratio. However, as a stand-alone measure the leverage ratio might punish low-risk business models and encourage banks to take on higher risks, because in itself this would not affect capital needs (Lautenschläger, 2013). This motivates the reference in Basel III to the leverage ratio as a supplement to risk-weighted capital ratios. For reference, Figure 18 shows some capital and leverage ratios, aggregated by country. These are not all computed on a consistent basis, and so should not be compared across charts. Indeed, there is no clear agreement on how to best compute such ratios. Research by the OECD Secretariat suggests that a leverage ratio in which derivatives are not netted on the asset side is the best predictor of distance to default (Blundell-Wignall and Roulet, 2013).

There are also different views about an appropriate level of the leverage ratio. The EU Capital Requirements Directive (CRD IV) requires supervisors to monitor the risk of excessive leverage and the Capital Requirements Regulation lays down disclosure requirements for a Tier 1 leverage ratio, starting on 1 January 2015. The Basel Committee is to use a 3% indicative Tier 1 leverage ratio during the monitoring period until 1 January 2017. A minimum 5% accounting-based leverage ratio is used as a benchmark for well-capitalised banks by the US Federal Deposit Insurance Corporation, while a ratio of 5% for the eight largest banking groups and 6% for subsidiaries has recently been proposed as a regulatory minimum in the United States.

That said, differences in accounting standards notably for derivatives and Securities Financing Transactions (SFTs) make this ratio not fully comparable with European standards. High leverage ratios have been suggested as a means to force shareholders to absorb losses instead of taxpayers. Admati and Hellwig (2013) suggest leverage ratios in the range of 20% to 30%, and Calomiris (2013) has proposed 10%.

Going forward, the methodology for asset risk weighting should be improved and made more transparent. In the euro area, a common supervisor, the Single Supervisory Mechanism (SSM), should contribute to this development via, *inter alia*, peer reviews. Available evidence suggests that there is a case for including a leverage ratio in the regulatory tool box. The merits of leverage ratios in gauging the strength of bank balance sheets should therefore be further explored. Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets and in a co-ordinated manner at international level. The emphasis on monitoring concentration risk in the CRD IV is therefore welcome. Basel rules now foresee limiting bank exposure to a single counterparty to a quarter of the eligible capital, but exposures to sovereigns are exempt, a situation which should be monitored closely and reviewed in due course.

Figure 18. **Capital ratios and leverage ratios**[1]



1. Averages, weighted by individual banks' total assets.
2. Total regulatory capital is defined under the latest regulatory guidelines at period-end. For European banks, this excludes transitional capital adjustments when available. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
3. Total core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
4. Based on quarterly data as of December 2013; where these are not available the most recent available data are taken, extending back to December 2012. The leverage ratio relates banks' core Tier 1 capital to total assets, in book values. Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Data for total assets are adjusted to reflect the International Financial Reporting Standard (IFRS).

Source: SNL Financials, Bloomberg, Datastream and OECD calculations.

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Strengthening banks' balance sheets and completing the banking union

In contrast to the United States in 2008 and the Nordic countries in the early 1990s, euro area bank balance sheets were not rapidly cleaned up after the onset of the crisis, despite substantial public aid to many banks (EC, 2012a). Stress tests were not sufficiently credible and there was forbearance by some national supervisors (Schich and Kim, 2013). Weak bank balance sheets are potentially sustaining doomed companies and impeding reallocation of credit to new activities. They also deter inter-bank funding and the provision of private sector capital to banks, both by domestic lenders and via cross-border capital flows.

The heads of state and governments in the euro area have agreed to establish a banking union. Elements of this banking union comprise a common rule book for banking supervision, bank resolution and deposit guarantee schemes (addressed in the CRD IV/CRR; Bank Recovery and Resolution Directive, BRRD; and Deposits Guarantee Schemes Directive, DGSD); a Single Supervisory Mechanism for banks (SSM); a Single Resolution Mechanism (SRM), backed by a Single Resolution Fund. Moreover, a common backstop is to be developed which is planned to be fully operational at the latest after ten years. There has been significant progress in setting up a regulatory framework along these lines, although important issues still need to be resolved.

In October 2013, the EU regulation creating the SSM was adopted. The ECB will take on supervisory responsibility for the banking sector in the euro area and in those EU states outside the euro area that will join the SSM. The ECB is scheduled to take on the responsibility for the direct supervision of roughly 130 large banks as of November 2014 and indirect responsibility for the other banks, which will be directly supervised by national supervisors. Also, the ECB will have the right to call, any time, for direct supervision of any bank or banks, and to provide guidelines to national supervisors.

The new supervisory regime will be preceded by a comprehensive assessment of banks' balance sheets in 2014, including a supervisory risk assessment, an asset quality review (AQR) and a stress test. This process is to ensure that banks will be assessed on the basis of a common methodology, for instance on non-performing loans, and to end the uncertainty surrounding the different approaches taken by national supervisors. Although the exercise may uncover capitalisation needs that may restrain credit growth in the short run, it can be positive for lending to the extent it increases confidence in the financial sector and the economy at large. It is thus indispensable that the reviews and tests are conducted in a way that provides a sound basis for strengthening the banking system. Uncertainty about the resolution regime and resolution funding must not give rise to uncertainties about the state of the banking system, with potentially serious economic repercussions. The co-ordinated strategy, put forward by the Ecofin Council in mid-November 2013 – regarding appropriate arrangements for effective resolution and resolution funding in the countries concerned – should be fully put in place swiftly.

Recently, the European Parliament and the Council reached agreement on rules for bank recovery and resolution (Bank Recovery and Resolution Directive, BRRD) (Council of the European Union, 2013a). The BRRD introduces resolution tools involving private bank investors and the banking sector as a whole in covering bank losses, but without jeopardising financial market stability (Council of the European Union, 2013b). Bail-in of bank investors is ordered from shareholders to senior creditors. Depositors will, however, be granted preferential status, with the national deposit guarantee scheme covering any

amount that would have had to be contributed by insured depositors. The banks are also required to hold a certain share of their total liabilities in terms of instruments that are eligible for bail-in. Bail-in would be supplemented, if needed and if sufficient market funding is not available, by resolution financing. To ensure that resolution tools can be applied effectively, the BRRD requires states to set up *ex ante* financed resolution funds. The BRRD requires bail-in of at least 8% of total liabilities before limited use of the resolution fund is allowed to absorb losses or provide equity.

National deposit guarantee schemes can also contribute to the resolution funding, with an agreement reached that requires each state to build up a deposit guarantee fund of 0.8% of insured deposits, financed by levies on the banking sector. Current funding levels for some deposit insurance schemes might not be large enough to easily absorb the effect of widespread bank failures or the failure of one or more of the largest banks (Schich and Kim, 2010).

Following agreement on the single rulebook for resolution, the European Parliament and Council also reached a political agreement on the establishment of a Single Resolution Mechanism, including a Single Resolution Authority and a Single Resolution Fund at the European level. In accordance with this agreement, the Single Resolution Fund (SRF) will be comprised of national compartments, whose resources will eventually be pooled. This Fund is to be built up over eight years to 1% of insured deposits via contributions by the banking sector that are meant to also capture the riskiness of the banks' activities. The funds raised at national level under the BRRD at its inception would be transferred into the Single Resolution Fund for participating member states. The plan is to pool 40% and another 20% of the resources of the national compartments within the first and the second years of the existence of the SRF, with full pooling achieved after eight years.

A pecking order of resolution funding that involves bank investors as much as possible without endangering financial market stability, while protecting insured depositors, is appropriate. It transfers risk from tax payers to equity and unsecured bondholders, reducing the cost of resolution and the implicit subsidy that banks, in particular large or interconnected ones, are otherwise enjoying. In a similar vein, basing the banks' contributions to the Resolution Fund on the institutes' risk characteristics can complement macro-prudential policies. Much will depend on whether the rules that govern the banks' contributions will be adequate to capture the risks of the banks' business.

The BRRD's bail-in provisions are scheduled to take effect in January 2016. Pending the entry into force of the BRRD for bank resolution, the bail-in regime will be subject to revised State Aid Rules, which have been in effect since August 2013. However, while the BRRD foresees the bail-in of senior bank creditors, the State Aid Rules are confined to the mandatory bail-in of junior creditors. The application of EU State Aid Rules is to ensure legal certainty and equal treatment in the bail-in of bank creditors across EU member states, thereby avoiding a potential negative impact on bank funding.

The agreement between the European Parliament and the Council on the BRRD allows national "precautionary" bank recapitalisation of solvent banks out of public sector funds under strict conditions. In the case of non-viable banks, national resolution authorities maintain some discretion in exempting creditors from bail-in when taking a resolution action on a case-by-case basis, with the Commission having the right to object. However, uniform bail-in rules across jurisdictions would better allow risk assessment of financial investors across countries. In order to eliminate the perception that bank debt might be

covered by implicit government guarantees, it should be strictly observed that deviations from the bail-in principle are only admissible in situations where without such deviations serious damage to financial market stability is to be expected. This principle of systemic risk exception is also applied in the United States, where its activation is subject to high hurdles for approval (Mishkin, 2006).

Not all funding arrangements are clear yet. National resolution funds (in accordance with the BRRD) require burden-sharing arrangements across borders for banks with cross-border activities. As long as a fully mutualised resolution fund does not exist and national compartments remain at the centre of the Single Resolution Fund, strong arrangements need to be established to ensure cross-border resolution financing. In the short run, care would need to be taken that the Single Resolution Fund is either fully funded immediately or any funding gap that might occur in the transition phase is temporarily bridged via a fiscal backstop. The political agreement foresees establishing a system that will enable the SRF to borrow, which would serve this purpose. Over the next eight years, pre-funding could be wound down or the backstop would be less used as banks' contributions to the Resolution Fund accumulate.

The political agreement between the Council and the European Parliament in March 2014 on the Single Resolution Mechanism attributes the main authority to trigger a resolution process to the ECB supervisor. The agreement foresees that draft resolution schemes are adopted by the Commission, with involvement by the Council only at the Commission's request. The legislation is planned to be finalised before the end of the legislature of the European Parliament in spring 2014.

The further legislative process should ensure that the decision-taking body is politically accountable, which is important as resolution decisions can have far-reaching consequences for property rights and public finances. At the same time, it is essential to ensure that the resolution can proceed in a predictable and swift way. It needs to be ensured that a bank can be resolved in an orderly fashion over, for example, a weekend. In particular, political pressure from member states needs to be avoided.

An adequate fiscal backstop needs to be available if recapitalisation and resolution costs exceed the financing that is available from the various sources including the Single Resolution Fund (1% of insured deposits once fully endowed). A backstop for the Resolution Fund should be fiscally neutral over the medium term and any losses should be recouped from the financial sector *ex post*.

Separately, EUR 60 billion of the resources of the European Stability Mechanism (ESM), which is mandated to safeguard financial stability in Europe by providing financial assistance to euro area member states, have been earmarked for direct bank recapitalisation. The ESM is supposed to obtain the right to directly recapitalise banks, but only subject to conditionality that has not yet been agreed upon. These uncertainties regarding the status of the ESM should be solved urgently.

Further harmonisation in key aspects affecting capital markets would be required for banking union to work effectively in the long run. Revisions to the Deposit Guarantee Schemes Directive foresee further harmonisation of the level of coverage of deposits and faster pay-out of insurance for all EU member states. Adoption of these revisions is likely to occur in early 2014 and would be welcome as it would foster more efficient risk assessment of capital markets by reducing incentives for capital to float to schemes offering higher security. Risks that activity moves into shadow banking need to be

monitored and addressed if necessary. Also, countries may need to review bankruptcy procedures to ensure efficient asset disposal of non-performing debtors. The ability of banks to effectively seize collateral if assets are non-performing is very different across member states, particularly with respect to housing (European Parliament, 2010; EC, 2012b). This has significant implications for how quickly a bank can reach a result for a non-performing loan, which in turn can significantly affect its ability to attract liquidity and capital. In times of financial crisis, when non-performing loans make up a significant section of a bank's balance sheet, the adverse consequences can be very large.

Recommendations on regulation of the banking sector

Key recommendations

- Ensure that the ongoing comprehensive assessment of banks – which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test – leads to a consistent overall evaluation of banks' balance sheets.
- Adopt a single resolution mechanism with predictable and swift decision-making that is politically accountable, and ensure that it is operative soon after the SSM is in place. The agreement needs to ensure the effectiveness of the mechanism and its ability to quickly take decisions in emergency situations.
- Ensure legal certainty and equal treatment in the bail-in of bank creditors across states to avoid complicating resolution processes and a potential negative impact on bank funding. Ensure minimisation of national discretion in setting resolution conditions.
- For the national resolution funds to be set up under the Bank Recovery and Resolution Directive, ensure that burden-sharing arrangements for banks with cross-border activities are available. For the Single Resolution Fund, establish strong arrangements to ensure cross-border resolution financing as long as the resources of the national compartments of the Fund are not yet fully pooled. Move over time to full pooling of the Fund resources. Prefund the Resolution Fund or temporarily bridge funding gaps that might occur in the transition phase via a fiscal backstop and recuperate the finances needed by risk-based contributions from the banking sector.
- Complement the Resolution Fund by a common fiscal backstop that is fiscally neutral over the medium term and recoups *ex post* any bridge financing via contributions from the financial sector.
- Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets. Any decision would need to be taken in a co-ordinated manner at the international level. Diversify in the long run the banks' exposure to the debt of a single sovereign. Assess the merits of leverage ratios, as a supplementary measure to risk-weighted ratios, for gauging the strength of bank balance sheets.

Further recommendations

- Clarify the conditions under which the European Stability Mechanism (ESM) will have the right to directly recapitalise banks.
- Foster efficiency of procedures to deal with bankruptcy at national level.

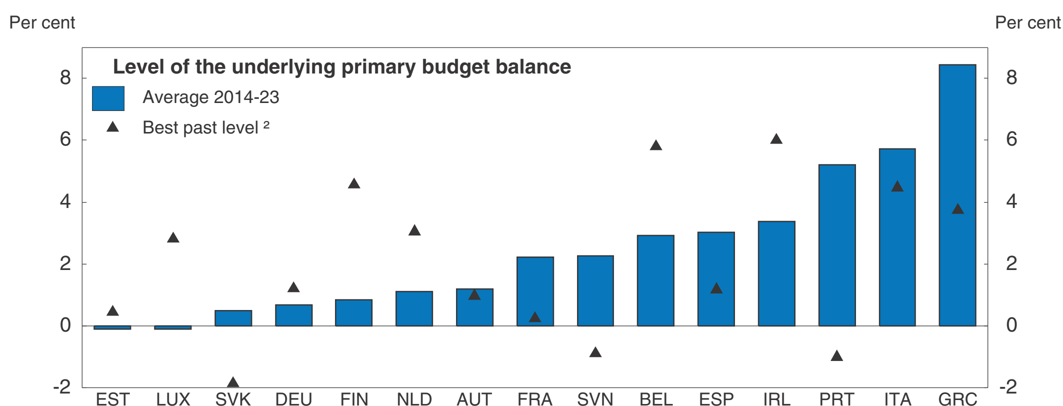
Remaining fiscal challenges

For the first time since the outburst of the crisis, debt-to-GDP ratios are about to stabilise in most euro area countries thanks to substantial consolidation efforts in the last two or three years. Debt levels are nevertheless still much too high, and remain in many euro area countries above the 60% of GDP reference value set in the Treaty on the Functioning of the European Union (TFEU). The estimates under the stylised assumptions of the OECD's long-term scenario suggest that the cumulative fiscal consolidation that will be achieved by 2014 will account for the largest part of the total consolidation required in the euro area to reach the 60% debt target by 2030 (OECD, 2013a). However, several states still have to advance much further with consolidation in order to stabilise debt at 60% of GDP. The task is now to take the necessary further steps in strengthening government budgets further.

Moreover, for government debt to be reduced to reasonable levels – undercutting 60% of GDP as enshrined in the EU Stability and Growth Pact – strong budgetary positions will need to be maintained for many years to come. To illustrate, a stylised consolidation scenario to reduce government debt over the medium term, taken from the *OECD Economic Outlook* No. 94, suggests the order of magnitude of these fiscal positions (Barnes et al., 2012; Johansson et al., 2013). Notably, for many countries the primary surplus will have to stay well above previous historical records (Figure 19). Clearly, the surpluses that will be needed will depend on medium-term growth and interest rate outcomes; higher growth, for example, would reduce the needed surplus.

Figure 19. **Primary budget estimates in a stylised scenario for reducing public debt over the medium term**[1]

In per cent of potential GDP



1. Fiscal assumptions: i) Fiscal projections for 2014 and 2015 are taken from the *OECD Economic Outlook 94*. Thereafter: ii) If the deficit exceeds 3% of GDP, the structural budget balance in the following year is reduced by ½ per cent of potential GDP. iii) If the debt/GDP ratio exceeds 60%, the excess over 60% is reduced by 1/20 annually, averaged over three years, using the Commission guidelines. Over a transition period of three years after the closure of an EDP, the underlying balance is reduced at a constant rate of maximal ¾ per cent of GDP per year. iv) Countries are assumed to move towards their current MTO by reducing the structural balance by ½ per cent of potential GDP per year.
2. Best past level refers to the average largest level of the underlying primary balance in any five-year period between 1990 and 2009 (subject to data availability).

Source: OECD, *OECD Economic Outlook 94 database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933012275

Such persistent fiscal discipline would be reinforced by strong fiscal rules at both the national and the European levels. The strengthened EU fiscal governance framework is therefore welcome. Under this framework, the budgetary policies of euro area countries are subject to four rules:

- The Excessive Deficit Procedure (EDP) stipulates that the headline fiscal deficit shall not exceed 3% of GDP and the debt ratio should decrease at a sufficient pace if it is above 60%. Since the 2011 Pact reform, an EDP can also be opened based on the debt criterion.
- The country-specific Medium-Term Objective (MTO) provides the principal medium-term anchor. The MTO is expressed in terms of the structural budget balance and set in a way that aims to ensure respect of the 3% deficit limit in a normal cyclical downturn and public finance sustainability or progress towards sustainability. The maximum level of the structural balance fulfilling these conditions is calculated by the Commission based on a commonly agreed methodology. There are limits of 1 or 0.5% of GDP (with the exact amount depending on the level of government debt and long-term sustainability of public finances). Subject to the limit, EU member states choose their MTOs and present them in Stability and Convergence Programmes. The MTOs are to be reached by reducing structural deficits by 0.5% of GDP annually as a benchmark.
- The debt convergence rule requires that the gap between actual debt and the 60% of GDP is to be reduced by 1/20 annually, averaged over three years. For countries that were in EDP in November 2011 (i.e. at the time of the introduction of the debt reduction rule) the rule will fully apply after a transition phase of three years after correcting the excessive deficit. In the transition period, a modified debt convergence rule applies.
- The Six Pack stipulates that evaluation of progress towards and respect of the MTO is subject to general government expenditures (net of spending financed via discretionary revenue increases, interest payment, cyclical component of unemployment and EU matching payments) growing less than a medium-term rate of potential GDP growth until the MTO is attained.

The pace of consolidation is set to slow

With a neutral fiscal stance in Germany, and with Italy, France and Spain planning to slow the pace of consolidation efforts in 2014 and 2015 relative to 2013, area-wide consolidation (the improvement in the underlying primary balance) is expected to be ½ percentage point of potential GDP in both 2014 and 2015 (Table 1 above). Greece and Portugal are likewise projected to gradually reduce their strong frontloaded budget consolidation efforts, and only Ireland will keep to the consolidation pace set over the past few years. A number of countries were assessed to have taken effective action in response to Council recommendations to correct the excessive deficits, and after the adoption of the recommendations suffered unexpected adverse macroeconomic events with unfavourable consequences for government finances. For these countries, the Council has extended the period over which nominal deficit targets are to be met.

Given the progress already achieved and the still weak economy, a slowdown in the pace of fiscal adjustment is appropriate and consistent with consolidation requirements if fiscal plans are implemented. Automatic stabilisers should be allowed to operate fully around the slower structural consolidation paths in case growth disappoints. Commitments under the Stability and Growth Pact would need to be met and governments should avoid reducing fiscal adjustment efforts relative to the commitments they have made in the event of

positive growth surprises or reduced financial market pressure. Consolidation efforts should be differentiated according to country situations, in view of the sustainability challenges and the economic situation stressed above.

The composition of fiscal consolidation can and should be adjusted to support inclusive growth and employment-enhancing structural reform (Cournède et al., 2013; Rawdanowicz et al., 2013). In particular, raising the effective retirement age would not harm growth much in the short term and would augment potential output growth in the long run. However, it would produce budgetary savings only gradually. Preserving or increasing funds for active labour market policies can help getting people back into work. Reforms of the education and health care systems should also rank high on the policy agenda in that they can produce large consolidation gains without compromising equity or service quality. Such gains might take several years to fully materialise, however, and would require meticulous programme planning and implementation to be effective. Cuts in government wages and employment can quickly yield budgetary effects, but should be linked to efficiency-enhancing public sector reform to avoid a deterioration in public services.

On the revenue side, cutting certain tax expenditures can increase both equity and economic growth and should be given high priority. Many tax expenditures have been introduced without serious welfare considerations, although there are exceptions like income tax credits and payroll tax rebates for low-wage workers. The value of many other tax reliefs, including tax breaks for health and child care, education, owner-occupied housing and various saving schemes, often benefit higher tax brackets and might be costly in achieving certain policy targets and distortionary for growth. Cutting such tax expenditures can thus benefit budgets, equity and long-term growth. At the same time, shifting the tax burden from taxing income (direct taxes) to taxing consumption (indirect taxes), property or the environment could promote growth.

A fiscal capacity to enhance incentives for structural reforms

The blueprint on deep and genuine European Monetary Union (EMU), which the European Commission presented in November 2012, pointed to potential benefits of a euro area fiscal capacity that could be used to counter cyclical shocks or to provide incentives for reforms in the member states. In December 2012, the European Council discussed the issue of possible contractual arrangements and associated financial support to reforming countries to raise incentives for structural reform. The European Council in December 2013 stated that partnerships based on a system of mutually agreed contractual arrangements and associated solidarity mechanisms would contribute to facilitate and support sound policies before countries face severe economic difficulties. Accordingly, the Commission has proposed options for a new “Convergence and Competitiveness Instrument” (CCI) (European Commission, 2012c and 2013). Governments would agree with the Commission and the Council on a contractual arrangement setting out details and time lines for the implementation of structural reform measures that are considered to be key for the stability of economic and monetary union and the creation of growth and employment, in line with European Semester country-specific recommendations. The options would include the possibility of financial support to the reforming country, where deemed appropriate, to mitigate short-term cost of reform or account for positive spillover effects to the euro area overall where justified.

On the other hand, the CCI could backfire if countries respond by refusing to carry out reforms unless subsidies are forthcoming or undo reforms to receive funds later. These and other issues point to significant implementation issues. Assessing the short-term costs of reform projects would be difficult, especially as the Commission might not have full information regarding the true costs. Other channels of financial support might therefore be preferable. Likewise, assessing the value of spillover effects would be difficult. As the financial support is to be conditional on carrying out specific reforms, a mechanism for ensuring that reforms are implemented or, if necessary, sanctioning non-implementation would be needed. Finally, a set-up whereby the instrument would generate financial flows to high-income countries might be difficult to justify politically. These issues will need to be assessed carefully in the European Council which will return to the topic in the October 2014 meeting.

Fiscal governance is being strengthened

The failure by a number of EU countries to meet the fiscal targets set under EU rules in the run-up to the crisis reduced the credibility of common fiscal rules and contributed to rising government debt, feeding concerns about debt sustainability. In response, several agreements have been concluded, notably the regulations contained in the "Six Pack" and the "Two Pack", designed to reinforce fiscal and economic governance by amending surveillance procedures, sharpening sanction mechanisms and setting intermediate fiscal and economic targets and adjustment procedures. Policies are co-ordinated and subject to surveillance by the EU Commission and the Council, and also addressed within the annual cycle of the "European Semester". For these mechanisms to work properly it is essential to further develop national fiscal governing frameworks.

The Fiscal Compact requires contracting parties (which include all euro area member states) to ensure structurally balanced public finances and to have mechanisms in place that oblige the government to correct deviations from the MTO and the adjustment path thereto. Euro area countries have put in place different mechanisms. One is a debt brake system, which takes stock of accumulated deviations that must be offset over time, including by over-achieving the MTOs (e.g. Austria and Germany). Another approach is to explicitly link the identification of a significant deviation by the EU Commission to the national budget process (e.g. Ireland and the Netherlands). Yet another approach is a provision specifying a time path to bring the structural deficit to fiscal targets, with the targets unspecified *a priori*. However, not all of the correction rules adopted so far might be sufficiently binding to secure convergence with the MTO. For example, *a priori* unspecified fiscal targets that are to be reached by corrective action might be subject to sequential revisions.

Almost all euro area countries within the OECD reported in mid-2013 to have a medium-term expenditure framework (MTEF) in place, with the notable exception of Belgium and Luxembourg (OECD, 2013b). The need for contingent planning underlines the importance of having in place a transparent medium-term budgeting framework at the national level that is able to identify long-term spending and revenue pressures and risks. In line with the provisions of EU legislation, the reporting framework should include a broad concept of fiscal accounts: ageing and health related spending and revenues; contingent liabilities, including government guarantees, non-performing loans, and liabilities stemming from the operation of public corporations; obligations arising from public-private partnerships; and information on the participation of the general

government in the capital of private and public enterprises. By reducing planning uncertainty, medium-term budgeting can also contribute to reducing governments' funding costs.

The Fiscal Compact and the Two Pack require countries to base their draft budgets on independent macroeconomic forecasts and to have independent Fiscal Councils (FCs) that monitor compliance with the fiscal rules. There is some evidence indicating a positive impact of FCs on fiscal discipline (Calmfors, 2012; Nerlich and Reuter, 2013). By now, almost all euro area countries have established an FC, either within an already existing administrative institution or as a stand-alone entity. The factual independence of Fiscal Councils depends on parameters such as the Fiscal Council's ability to set up a work programme, multi-annual funding commitments, and full transparency in the FC's work and operations (see the *OECD Principles for Independent Institutions* [OECD, 2013c]). There appears to be a considerable heterogeneity among euro area countries with respect to the coverage of the FCs' mandate. Moreover, the potential of the FCs is unlikely to be fully exploited yet. For example, none of the euro area countries within the OECD reported in mid-2013 the monitoring of the MTEF by an independent fiscal institution (OECD, 2013b).

Recommendations on fiscal consolidation

Key recommendations

- Continue fiscal consolidation, respecting the requirements of the Stability and Growth Pact, as planned and allow the automatic stabilisers to operate fully.
- Design fiscal consolidation to favour inclusive growth and employment.
- Ensure effective implementation of the strengthened EU and Fiscal Compact rules in national fiscal frameworks, including medium-term budgeting, identification of future spending and revenue pressures and risks, independent fiscal councils and effective mechanisms to correct deviations from fiscal targets.

Further recommendation

- Ensure that the uncertainty surrounding real-time estimates of structural balances and potential growth rates are taken into account in assessing fiscal positions.

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Thematic chapter

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Chapter 1

Making the euro area function better – the banking union and fiscal framework

A weak and fragmented financial sector is a risk for recovery and sustained growth in Europe. Bank capitalisation has improved, but high and rising non-performing loans and fragmented capital markets are weighing on credit growth. Heterogeneous supervision has fostered some forbearance at national levels, while reduced fiscal space limits scope for bank resolution and restructuring. As an outcome of the ongoing ECB's comprehensive assessment of banks' balance sheets, banks should be recapitalised or resolved if needed, according to the quantitative results. To reduce systemic risks and enhance financial integration the banking union with common supervision, resolution and rule books needs to be put in place soon. Supervisory rules should also be considered to better reflect risk and sovereign exposures.

Several agreements have been concluded to reinforce fiscal and economic governance by amending surveillance procedures, sharpening sanction mechanisms and setting intermediate fiscal and economic targets and adjustment procedures. For these mechanisms to work properly it is essential to further develop national fiscal frameworks. This should include the introduction of comprehensive medium-term budgeting that is able to identify future spending and revenue pressures and risks, independent fiscal councils with a broad mandate to evaluate fiscal policies, and effective mechanisms to correct deviations from fiscal targets.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Towards a banking union

Weaknesses in the financial sector, including heterogeneous supervision and prudential regulation, the mispricing of risks and high exposure to sovereign risk, were a main contributor to the euro area crisis. Asset booms concomitant with rising public and private liabilities masked vulnerabilities in many countries, which were not spotted by supervisors. This also created strong adverse links between the banks, the real economy and sovereigns. Financial fragmentation occurred from the crisis as risk perceptions rose, reflected in diverging interest rates, capital was pulled back from the most vulnerable countries and weaknesses in banks' balance sheets were gradually revealed. The close links with the highly indebted sovereigns, slumping economic activity and weak bank balance sheets created a toxic mix making the recovery more difficult. Action in restoring financial health in the area overall has been delayed as many tools for financial sector regulation have remained national. The need to create a banking union became urgent not just to exit the crisis but to establish a solid basis for future financial integration in Europe. Meanwhile, many banks have undergone significant recapitalisation and restructuring.

The heads of state and governments in the euro area have agreed to establish a banking union. Elements of this banking union comprise a common rule book for banking supervision (CRD IV/CRR), bank resolution and deposit guarantee schemes (Bank Recovery and Resolution Directive, BRRD; and Deposits Guarantee Schemes Directive, DGSD); a Single Supervisory Mechanism for banks (SSM); a Single Resolution Mechanism (SRM), backed by a Single Resolution Fund (SRF). Moreover, a common backstop is to be developed which is planned to be fully operational at the latest after ten years. There has been significant progress in setting up a regulatory framework along these lines, although important issues still need to be resolved. It is of high importance that these gaps are closed soon for the banking union to operate effectively. Work is also needed to enhance macro- and micro-prudential tools: The Commission is mandated to submit a review of the tools under the Capital Requirements Directive and Regulation (CRD IV/CRR), possibly together with a legislative proposal.

The Comprehensive Assessment of banks' balance sheets in 2014 will be critical for restabilising the health of the banking system, which is needed to contribute to confidence and credit to support economic growth. This is particularly important in an environment of accommodative monetary policy with near-zero policy interest rates, high liquidity provision by central banks and scarce equity capital. The opportunity cost for banks of rolling over doubtful loans is low when compared with the alternative option of recognising them and having to take capital-depleting provisions and write-offs. Evidence from other countries suggests that a prolonged phase of low interest-rates risks weaken capital allocation. For example, there is evidence for Japan that during the prolonged phase of low interest rates, weakening industries received a disproportionate share of loans from banks reaching for yield (BIS, 2010; Caballero et al., 2008; Watanabe, 2010). As the elements of the banking union are unlikely to be in place in 2014 upon the stress tests, it is important to ensure that banks will be recapitalised or resolved if necessary without undue forbearance.

Common bank supervision has been set on track

The Single Supervisory Mechanism (SSM) is scheduled to enter into force in November 2014, following the evaluation of the banks' balance sheets. The European Central Bank (ECB) will act as the common supervisory authority for the banking sector in the euro area and in those EU states outside the euro area that will join the SSM. The ECB is scheduled to take on the responsibility for the direct supervision of roughly 130 large banks as of November 2014 and indirect responsibility for the other banks, which will be directly supervised by national supervisors. ECB-supervised banks need to meet one of the following criteria: they are one of the 3 largest banks in the country or their balance sheets exceed EUR 30 billion or 20% of the country's GDP (unless assets are below EUR 5 billion). They also comprise banks for which public assistance by the European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM) has been requested or received. The ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating state and its cross-border assets or liabilities represent a significant part of its total assets or liabilities. Notwithstanding these criteria, the three most significant credit institutions in each of the participating states are required to be under the direct supervision of the ECB. This setting will likely cover more than 85% of bank assets in the euro area. To ensure consistent application of high supervisory standards, the ECB can assume direct supervision of less significant banks not automatically covered by the SSM. Moreover, the ECB exercises oversight over the functioning of the supervisory system and is responsible for the effective and efficient functioning of the SSM.

EU states outside the euro area can opt into the common supervisory system, which would mean that their banks would be covered by the future resolution mechanism as well. Participating states obtain a vote in the supervisory body but not in the ECB Governing Council. However, a mediation mechanism is foreseen in case of disagreement. EU states outside the euro area can leave the single supervisory mechanism in case of disagreement with a decision of the supervisory body, without being bound by the decision. Renewed opt-in into the system would be possible after a three-year period. EU states outside the euro area might have an incentive to join the system if capital markets perceived common regulation with high and consistent standards a sign of quality, helping SSM-regulated banks to attract capital at better conditions. Indeed, experience during the crisis suggests that attracting capital on grounds of weak bank supervision might not pay, as capital outflows or even sudden stops might follow. Nonetheless, incentives to opt out remain if domestic regulators were to count on regulatory arbitrage giving domestic banks an edge over foreign competitors or if disagreement with the rulings of the SSM were significant.

The literature on supervisory arrangements has generally not concluded in favour of a specific model of assigning supervisory functions to either the Central Bank or a separate supervisory body, but points to local circumstances (Abrams and Taylor, 2000; Carmichael and Pomerleano, 2002; Hall, 2003; Čihák and Podpiera, 2008). A number of central banks within the OECD area act as bank supervisors or have supervisory functions. Assigning the supervisory functions to the ECB can be motivated by the expertise of the European System of Central Banks in financial market monitoring and an attempt to borrow reputation from the ECB and to reduce the risk of supervisory capture. It has also been motivated by legal considerations, as establishment of a new independent body would have required a change in the European Treaty. On the other hand, Masciandaro et al. (2011) use empirical evidence

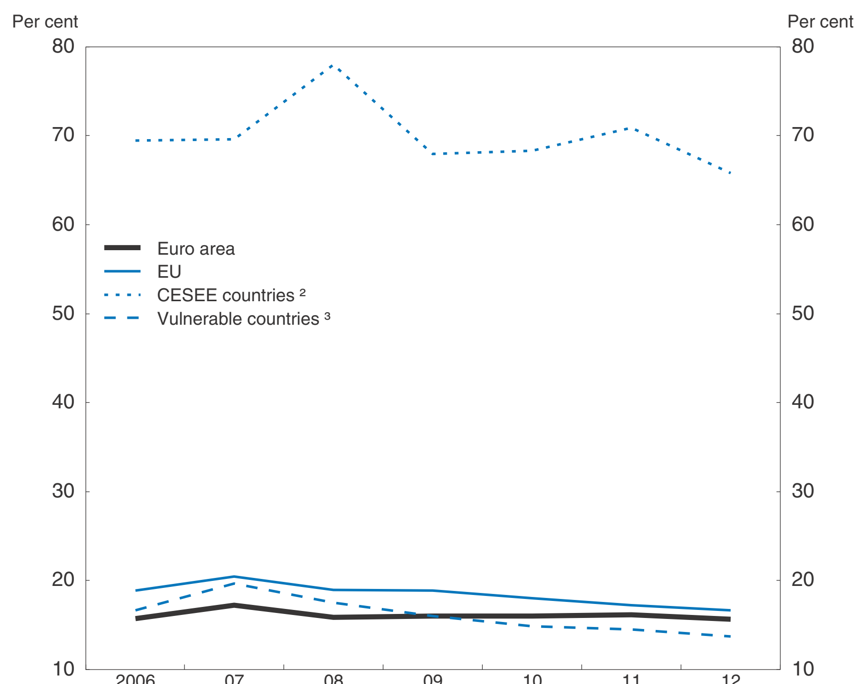
from the crisis to make a case for keeping macro- and micro-prudential supervision institutionally separate to allow for more checks and balances in order to reduce the probability of supervisory failure.

Potential conflicts of interest between regulatory and monetary policy tasks of the ECB might be a shortcoming of the new institutional setting. To avoid any possible interference with the ECB's primary monetary policy mandate, the new supervisory functions will be separated from the ECB's monetary policy functions. Nonetheless, at the executive level the ECB Governing Council, which is the single top decision body responsible for all policy matters, will also make decisions on supervisory issues, although at meetings other than those in which monetary policy decisions are taken. Decisions to be considered are draft decisions, which are deemed to be adopted if the Governing Council does not object during a certain period of time. Disagreement between the Governing Council and the ECB's Supervisory Board would trigger a mediation process that could slow down supervisory decisions and introduce uncertainty about supervisory policies.

It is desirable that EU countries outside the euro area participate in the common supervisory mechanism, given the high integration of banking across European countries within and outside the euro area (Figure 1.1). In particular, large banks are highly interconnected. The SSM Regulation offers the possibility to EU states that are not

Figure 1.1. **Cross-border bank penetration in Europe**[1]

Per cent of total banking assets



1. Cross-border bank penetration via branches and subsidiaries from EU countries. Penetration is measured by the share of total bank assets in a given country that belongs to branches or subsidiaries of banks that are located in another country. The average figures for each zone are asset-weighted.
2. Central, Eastern and South Eastern European countries include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and the Slovak Republic.
3. Vulnerable countries include Greece, Ireland, Italy, Portugal and Spain.

Source: Schoenmaker, D. and T. Peek (2013), "The State of the Banking Sector in Europe", *OECD Economics Department Working Papers*, No. 1102, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933012218

members of the euro area to join the SSM by establishing a close co-operation between their competent authorities and the ECB. This should reduce the likelihood of regulatory arbitrage between countries within and outside the euro area. However, at the same time, participating countries outside the euro area have various options to opt out of the SSM, reflecting the fact that they are not represented in the ECB Governing Council.

It is thus welcome that the SSM regulation requires the Commission to prepare recurring reports – at a frequency of three years, starting in December 2014 – that evaluate the appropriateness of government arrangements within the SSM. This concerns, in particular, the effectiveness of the separation between supervisory and monetary policy functions as well as presenting options for the further development of the SSM. Building on this exercise, after some years of experience an assessment should be made whether the common supervisory body should be separated from the ECB and made an independent institution.

Issues also arise with respect to the sharing of responsibilities between the ECB and national supervisors. From an operational point of view, it is necessary to incorporate national supervisory authorities into the supervisory mechanism, not least because it would be difficult to build up sufficient supervisory capacity for all banks at the ECB within a very short time period. Moreover, the supervision of regional banks by national supervisory authorities appears reasonable as these banks have simpler business models than large banks. Even so, care will need to be taken that the division of supervisory competencies between different banks does not lead to some persistence in the heterogeneity of regulatory standards. Experience with the crisis in a number of countries has demonstrated that smaller and regional banks can become systemic if exposed to common positively correlated risks (like real estate markets). Also, the limitations of splitting responsibilities along banks is apparent in view of legally independent credit institutions that are inter-connected within banking groups (see Ayadi et al., 2010 for a bank group description). Depending on their size, different banks within such systems, such as savings banks in Germany and co-operative banks in several countries, will be supervised by different supervisors, even if they are connected via mutual risk-sharing mechanisms.

Overall, there is a non-negligible risk that the separation of supervisory competencies between different authorities will reduce the transparency and efficiency of supervision. Operational complexity of comprehensive direct supervision might be dealt with via delegating certain functions to national supervisory authorities, while keeping full responsibility at the level of the Single Supervisor. In a similar vein, care will also need to be taken that there is a clear and transparent separation of responsibilities between the Single Supervisor (the ECB) and the European Banking Authority (EBA), the latter being mostly responsible for the single rule book. This is all the more necessary as the EBA has the right to address recommendations to the national supervisory authorities for breach of the Union law and, in case of non-compliance with the latter, to make decisions that are binding for the credit institutions.

Moreover, effectiveness of the SSM also requires efficient judicial systems on the national level. For example, the SSM regulation foresees that the ECB can apply sanctions and administrative penalties and can ask the national competent authorities to apply additional sanctions. But the enforcement of sanctions, which might be challenged legally by the banks concerned, could be impaired if the judicial system is lacking the expertise for prosecuting potentially complex finance matters.

Strengthening the European resolution framework

It is indispensable to complement the SSM with a single resolution mechanism, including a single resolution fund and a common fiscal backstop, for bank resolution to be applied consistently and in a timely way if it becomes necessary. International experience with banking crises shows that policies of regulatory forbearance, often introduced to buy time, lengthen the period of weakness and increase the overall economic and budgetary cost of crises (see Box 1.1).

In March 2014 the Council and the European Parliament agreed on the Single Resolution Mechanism, which attributes the main authority to trigger a resolution process to the ECB supervisor. The agreement foresees that draft resolution schemes are adopted by the Commission, with involvement by the Council only at the Commission's request. The legislation is planned to be finalised before the end of the legislature of the European Parliament in spring 2014. The further legislative process should ensure that the decision-taking body is politically accountable, which is important as resolution decisions can have far-reaching consequences for property rights and public finances. At the same time, it is essential to ensure that the resolution can proceed in a predictable and swift way. It needs to be ensured that a bank can be resolved in an orderly fashion over, for example, a weekend. In particular, political pressure from member states needs to be avoided.

Bail-in rules for resolution funding have been established

Recently, the European Parliament and the Council reached agreement on rules for bank recovery and resolution (Bank Recovery and Resolution Directive, BRRD) (Council of the European Union, 2013a). The BRRD introduces a set of harmonised resolution powers and tools involving private bank investors and the banking sector as a whole in covering bank losses, but without jeopardising financial market stability (Council of the European Union, 2013b). Under the BRRD, the bail-in of liabilities will take place according to a specific ranking of claims starting from shareholders to depositors. Depositors will, however, be granted preferential status, with the national deposit guarantee scheme covering any amounts that would have had to be contributed by insured depositors; this has the effect of safeguarding insured depositors for reasons of financial stability. The BRRD will furthermore require that banks hold a certain share of their total liabilities in the form of instruments that are eligible for bail-in. Bail-in would be supplemented, if needed and if sufficient market funding is not available, by resolution financing. To ensure that resolution tools can be applied effectively, the BRRD requires states to set up *ex ante* financed resolution funds. The BRRD requires bail-in of at least 8% of total liabilities before limited use of the resolution fund is allowed to absorb losses or provide equity.

National deposit insurance schemes can also contribute to resolution funding, with an agreement reached that requires each state to build up a deposit insurance fund of 0.8% of guaranteed deposits, financed by levies on the banking sector. Current funding levels for some deposit insurance schemes might not be large enough to easily absorb the effect of widespread bank failures or the failure of one or more of the largest banks (Schich and Kim, 2010).

A pecking order of resolution funding that involves bank investors as much as possible without endangering financial market stability, while protecting insured depositors, is appropriate. It transfers risk from tax payers to equity and unsecured bondholders, reducing the cost of resolution and the implicit subsidy that banks, in particular large or interconnected ones, are otherwise enjoying. In a similar vein, basing the banks'

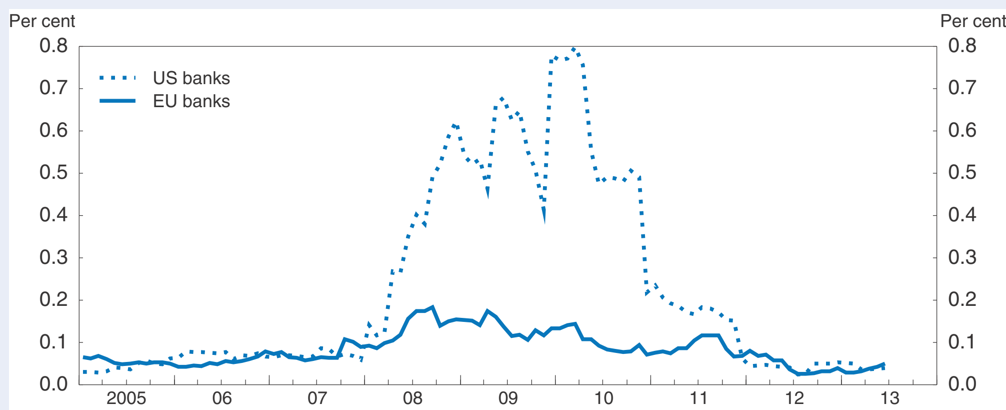
Box 1.1. **Recognition of non-performing loans and bank restructuring matter: Some international experience**

There is strong international evidence that the speed of dealing with banks' balance sheet problems following financial crises can have an important impact on economic performance. Swift recognition of non-performing loans and, where needed, bank recapitalisation and restructuring can significantly contribute to regaining economic strength.

In the United States, early and strong recapitalisation, mainly through equity issues, helped banks to resume providing credit to the economy. In Europe, the EBA conducted several stress tests, but these tests were less stringent on their implications and banks were granted more time to achieve the required capital ratios, which could be met either by strengthening capital or deleveraging. European banks have issued far less equity than banks in the United States (Figure 1.2). In the United States, banks raised more equity within a much more concentrated time period to stabilise the banking system than in the EU.

Figure 1.2. **Bank equity issuances in the EU and the United States**

Annualised data,[1] per cent of total assets



1. The monthly issuance is a rolling average which in turn is annualised.

Source: Schoenmaker, D. and T. Peek (2013), "The State of the Banking Sector in Europe", *OECD Economics Department Working Papers*, No. 1102, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933012294

Korte (2013) finds for Europe that stricter resolution has a positive impact on firm growth, with more profitable firms and firms relying predominantly on bank finance benefitting most. In Sweden, prompt public intervention and cleaning of banks' balance sheets laid the foundations for a solid economic recovery following the 1990-93 banking crisis and recession (see for instance Borio et al., 2010).

Peek and Rosengren (2005) show that Japan's "lost decade" was reinforced by troubled banks that were not resolved effectively, but instead misallocated credit by expanding lending to weaker, not healthier, firms and hence created artificially surviving, underperforming "zombie" firms. Caballero et al. (2008) show that the existence of such "zombie" firms had a depressing effect on "non-zombies" and hence decreased overall economic performance.

In Chile, the swift resolution of banks that had been taken over by the government during banking crisis, accompanied by an active process to liquidate bad loans along with bankruptcy reform, was followed by rapid growth. By contrast, in Mexico, where failing banks were kept under government ownership for about a decade, the provision by government-owned banks of credit below market interest rates to selected firms was accompanied by GDP per capita contracting over the 1982-95 period (Bergoeing et al., 2007; Brock, 2009; Córdoba and Kehoe, 2009).

contributions to the Resolution Fund on the institutes' risk characteristics can contribute to macro-prudential policies. Much will depend on whether the rules that govern the banks' contributions will be adequate to capture the risks of the banks' business.

The agreement allows national "precautionary" bank recapitalisation of solvent banks out of public sector funds in exceptional circumstances under strict conditions. In the case of banks that are in resolution, national resolution authorities maintain some discretion in exempting creditors from bail-in when taking a resolution action on a case-by-case basis, with the Commission having the right to object. However, uniform bail-in rules across jurisdictions would better allow risk assessment of financial investors across countries. In order to eliminate the perception that bank debt might be covered by implicit government guarantees, it should be strictly observed that deviations from the bail-in principle are only admissible in situations where without such deviations serious damage to financial market stability is to be expected. This principle of systemic risk exception is also applied in the United States, where its activation is subject to high hurdles of approval (Mishkin, 2006).

There is empirical evidence that banks tend to take on more risks if they perceive weak resolution and bail-in requirements (Ignatowski and Korte, 2013). At the same time, national regulators might have an incentive to be lenient to raise the attractiveness of banking in their country, giving rise to regulatory arbitrage. Moreover, regulators might try to reduce resolution costs, in particular when large banks or a large number of banks are failing ("too many to fail") (Kane, 1989; Kroszner and Strahan, 1996; Brown and Dinc, 2009). This evidence supports the case in favour of a strong common resolution framework, including a resolution fund that is *ex ante* funded by bank contributions.

Between October 2008 and 2012, the European Commission approved a total of EUR 5.1 trillion (40% of EU GDP) in state aid to rescue banks, of which some 13% of GDP was used until autumn 2011 (Table 1.1). About 10 to 15% of banks are under the state aid rules undergoing forced restructuring. Private sector recapitalisation after the 2011 EU wide stress tests conducted by the European Banking Authority has been about EUR 200 billion (IMF, 2013a).

Table 1.1. **State aid to the financial sector in the EU, 2008-12**

	Used amounts 1.10.2008-1.10.2011		Approved amounts 1.10.2008-1.10.2012	
	EUR billion	% of GDP	EUR billion	% of GDP
Recapitalisation	322.1	2.5	777.3	6.2
Guarantees	1 084.8	8.6	3 646.8	28.9
Asset relief	119.9	0.9	445.8	3.5
Liquidity support	89.0	0.7	216.27	1.7
Total	**1 615.9**	**12.8**	**5 086.0**	**40.3**

Source: European Commission (2012), "Report on State Aid Granted by the EU Member States – Autumn 2012 Update", SEC(2012) 443 final, Brussels; European Commission (2012), "Commission Staff Working Paper – Autumn 2012 Update", COM(2012) 778 final, Brussels.

However, in contrast to the practice in the United States, bank creditors in euro area countries rarely incur losses, with little change observed during the present crisis, despite some amendments in national regulatory regimes (Schich and Kim, 2013). While shareholders of euro area banks have been diluted or even wiped out during bank failure resolution cases, subordinated debt has only been affected in some cases and holders of

unsecured bank debt other than subordinated bonds have typically been exempted from loss-sharing. Correspondingly, empirical research indicates that until recently market perceptions of implicit government guarantees to bail out bank creditors, and thus the potential for distorted incentives in the allocation of capital, remain significant (Schich and Kim, 2013). Noticeable declines in perceived implicit government guarantees were found if legal changes towards improved resolution regimes were followed by bank-failure resolution cases involving losses of at least some bank debt holders. As long as implicit guarantees are perceived to exist, so, too, does the potential for distorted incentives with potentially severe adverse consequences for resource allocation and the pricing of risks, posing a threat to financial stability and reducing growth (Box 1.1 above). This reinforces the need to confine deviations from the bail-in principle to cases where otherwise serious damage to financial market stability were to be expected.

The BRRD's bail-in provisions are scheduled to take effect in January 2016. Pending the entry into force of the BRRD, the bail-in regime will be subject to revised State Aid Rules, which have been in effect since August 2013. However, while the BRRD foresees the bail-in of senior creditors, the State Aid Rules are confined to the mandatory bail-in of junior creditors. The application of EU State Aid Rules is to ensure legal certainty and equal treatment in the bail-in of bank creditors across EU member states, thereby avoiding a potential negative impact on bank funding. As the application of the rules for the bail-in of senior creditors outside cases involving state aid will be in the discretion of the national authorities until the BRRD becomes binding in January 2016, care needs to be taken to safeguard equal treatment in the bail-in of bank creditors across states. Short-term uncertainty about national bail-in conditions might have negative effects on bank funding. The larger the uncertainty of the regulatory framework, the greater systemic risks are in the banking sector.

The European Parliament and the Council also reached a political agreement on a single resolution fund at European level. In accordance with the agreement, the Single Resolution Fund (SRF) will be comprised of national compartments, whose resources will eventually be pooled. This fund is to be built up over eight years to 1% of insured deposits via contributions by the banking sector that are meant to also capture the riskiness of the banks' activities. The funds raised at national level under the BRRD at its inception would be transferred into the Single Resolution Fund for participating member states. The plan is to pool 40% and another 20% of the resources of the national compartments within the first and the second years of the existence of the SRF, with full pooling achieved after eight years.

Not all funding arrangements are clear yet. National resolution funds (in accordance with the BRRD) require burden-sharing arrangements across borders for banks with cross-border activities. As long as a fully mutualised resolution fund does not exist and national compartments remain at the centre of the Single Resolution Fund, strong arrangements need to be established to ensure cross-border resolution financing. In the short run, care would need to be taken that the Single Resolution Fund is either fully funded immediately or any funding gap that might occur in the transition phase is temporarily bridged via a fiscal backstop. The political agreement between the Council and the European Parliament foresees establishing a system that will enable the SRF to borrow, which would serve this purpose. Over the next eight years, pre-funding could be wound down or the backstop would be less used as banks' contributions to the Resolution Fund accumulate.

Establishing a fiscal backstop

Adequate fiscal backstops need to be available if recapitalisation and resolution costs exceed the financing that is available from the various sources including the Single Resolution Fund (1% of insured deposits once fully endowed). In the Swedish banking crisis of the 1990s, banks took losses equivalent to 17% of lending over 1990-93 (Englund, 1999). For the sake of illustration, applying such a loss rate to the pre-crisis stock of loans to households and non-financial corporations would mean write-offs equivalent to almost 20% of GDP in many large OECD economies (Bouis et al., 2013). Gross fiscal resolution costs associated with earlier systemic banking crises have been estimated to average 10% of GDP (IMF, 2013a).

In the present crisis, remaining resolution costs in Europe are likely to be much smaller, as much has been done already by public funds and the EBA recapitalisation, as discussed above. Substantial capital injections into failing banks have already occurred, and banks have reduced their exposures. However, depending on bail-in conditions, the funding by the single resolution fund and deposit guarantee schemes might not suffice to cover the resolution costs in a systemic banking crisis, and a common fiscal backstop might become necessary.

Funds for a common fiscal backstop are potentially available from the ESM, which has a funding capacity of EUR 500 billion. However, for the time being, ESM financial assistance is confined to governments seeking aid and subject to mutual agreement on specific conditions that would have to be fulfilled (for example a macroeconomic adjustment programme), depending on the financial assistance instrument used.

Separately, up to now, direct bank recapitalisation via the ESM has not been possible. The European Council confirmed in November 2013 an earlier agreement to create a direct bank recapitalisation instrument within the ESM, for which EUR 60 billion would be reserved (European Council ECOFIN, 2013). The agreement foresees that the amount could be revised upward if necessary. Creation of this instrument has been conditioned on the establishment of the Single Supervisory Mechanism. Financial assistance by the instrument, upon the request of an ESM member, could only be made available if supported banks are viable, funding is indispensable to safeguard the financial stability of the euro area, private sector sources for bank resolution are not sufficiently available, and the country is unable to provide financial assistance itself without very adverse effects on its own fiscal sustainability. Moreover, there is agreement that the requesting country should contribute a certain share to the total financial burden, with the size of the contribution depending on whether or not the benefitting banks have sufficient equity to reach the legal minimum common equity Tier 1 (CET1) capital ratio of 4.5% according to the CRD IV/CRR, under a prudent stress test (Eurogroup, 2013).

Further harmonisation in key aspects affecting capital markets would be required for banking union to work effectively in the long run. Revisions to the Deposit Guarantee Schemes Directive foresee further harmonisation of the level of coverage of deposits and faster pay-out of insurance for all EU member states. Adoption of these revisions is likely to occur in early 2014 and would be welcome as it would foster more efficient risk assessment of capital markets by reducing incentives for capital to float to schemes offering higher security. Risks that activity moves into shadow banking need to be monitored and addressed if necessary. Also, countries may need to review bankruptcy procedures to ensure efficient asset disposal of non-performing debtors. The ability of

banks to effectively seize collateral if assets are non-performing is very different across member states, particularly with respect to housing (European Parliament, 2010; EC, 2012b). This has significant implications for how quickly a bank can reach a result for a non-performing loan, which in turn can significantly affect its ability to attract liquidity and capital. In times of financial crisis, when non-performing loans make up a significant section of a bank's balance sheet, the adverse consequences can be very large.

Ensuring adequate bank capitalisation

The EU Capital Requirements Directive IV and Capital Requirements Regulation (CRD IV/CRR), which came into force on 1 January 2014, are designed to implement the Basel III agreement on capital requirements in the EU (EU, 2013). They create a single rule book for banks with common definitions on risk weights and non-performing loans (Box 1.2), and mark significant progress towards improving the equity capital endowment of banks, including macro-prudential capital buffers. Indeed, the EBA's monitoring of bank capitalisation shows that the capital endowment of European banks has strengthened considerably since the EBA evaluation of capital positions in 2011/12.

Several studies point to the crucial importance of adequate bank capitalisation to avoid banking crises and support economic recovery after downswings. In particular, based on the World Bank's 2011-12 Bank Regulation and Supervision Survey (BRSS), Čihák et al.

Box 1.2. **Capital requirements according to the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD IV)**

The Capital Requirements Regulation and Capital Requirements Directive IV CRR/CRD IV, agreed in April 2013 between the European Council, the European Commission and the European Parliament, implement the Basel III agreement on capital requirements in the EU. Institutions are required to apply the new rules from the 1 January 2014, with full implementation to be achieved by 1 January 2019.

Main capital requirement ratios

Within the overall capital requirement (which remains unchanged at 8% of risk-weighted assets), the Tier 1 capital ratio is gradually raised to 6% of risk-weighted assets (from 4% at present). Of the core capital, the share that has to be of the highest quality – common equity Tier 1 (CET1) which excludes preferred shares – gradually increases from 2% to 4.5 %.

Capital conservation buffer

Banks are required to set up a capital conservation buffer of CET1 capital equal to 2.5% of risk-weighted assets on top of the CET1 capital requirement, bringing the total CET1 equity ratio to 7%. Constraints on discretionary distributions such as dividend and bonus payments will be imposed should a bank fall into the buffer range.

Countercyclical capital buffer

A time-varying countercyclical capital buffer is introduced which can be set between 0 and 2.5% of risk-weighted assets. Macro-prudential authorities are asked to monitor on a quarterly basis a range of economic and financial variables based on which they should decide on the countercyclical buffer rate. The decision should be guided by the objective to protect the banking system against potential losses when excessive credit growth is associated with a build-up of system-wide risk, thereby supporting the sustainable provision of credit to the economy.

Box 1.2. Capital requirements according to the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD IV) *(cont.)*

Capital buffer for global systemically important institutions (G-SII buffer)

Global systemically important institutions (G-SIIs) are from 1 January 2016 onwards subject to supplementary requirements of CET1 capital surcharges ranging between 1% to 3.5% of risk-weighted assets, to account for their potential negative impacts on the international financial system, due to their size, interconnectedness, complexity, substitutability of services or financial infrastructure and cross-border activity. CRD IV provides that the European Banking Authority (EBA) shall develop draft regulatory standards, based on the definition of the Financial Stability Board (FSB), to specify the methodology for identifying G-SIIs as well as the methodology for the definition of at least five sub-categories and the allocation of G-SIIs in these categories (to be submitted to the EC before 30 June 2014).

Other systemically important institutions buffer (O-SII buffer)

Other systemically important institutions (O-SIIs) are likewise from 1 January 2016 onwards subject to capital surcharges (capped at 2%), given their impact on the domestic financial system and economy in the event of a failure or impairment. CRD IV stipulates that to identify O-SIIs, systemic importance is to be judged by "at least any of" these four criteria: i) size; ii) importance for the economy of the EU or the relevant member states; iii) significance of cross-border activities; and iv) interconnectedness of the institution or group within the financial system. CRD IV calls on the EBA, in consultation with the European Systemic Risk Board (ESRB), to publish by 1 January 2015 guidelines on the application of the criteria, taking into account relevant international frameworks as well as European and national specificities. Unlike the regulatory standards for the G-SII buffer, such guidelines will not be legally binding (instead authorities have to "comply-or-explain").

Systemic risk buffer (SRB)

The Systemic risk buffer (SRB) is a macro-prudential instrument which EU member states may implement in their national law. It aims to address systemic risks of a "long-term, non-cyclical" nature or macro-prudential risks otherwise not covered by the CRR. The SRB implies additional CET1 capital on all or a subset of exposures. Unlike the SII buffers, there are no specific criteria that define the level of the buffer *ex ante*. CRD IV only requires that the application of the buffer does not entail disproportionate adverse effects on the whole or parts of the financial system of other member states or the EU. There is no maximum limit for the SRB level, but notification to the Commission, the ESRB and the EBA, and the approval procedure where needed, depend on the level of the SRB rate (i.e. below 3 %, from 3 % to 5 %, above 5 %) and the scope of application (whether exposures in other member states and/or third countries are affected).

Leverage ratio

The EU Capital Requirements Directive (CRD) requires supervisors to monitor the risk of excessive leverage, and the Capital Requirement Regulation (CRR) requires banks to disclose, from January 2015 onwards, a Tier 1 leverage ratio whose composition complies with Basel regulation. The judgment on whether or not the leverage ratio of a particular institution is adequate will be left to its supervisor. During an observation period, data on the implications of the ratio will be gathered, and a report by the European Commission by the end of 2016 May include, if considered appropriate, a legislative proposal on the introduction of an appropriate number of levels of the leverage ratio that institutions following different business models would be required to meet as of 2018.

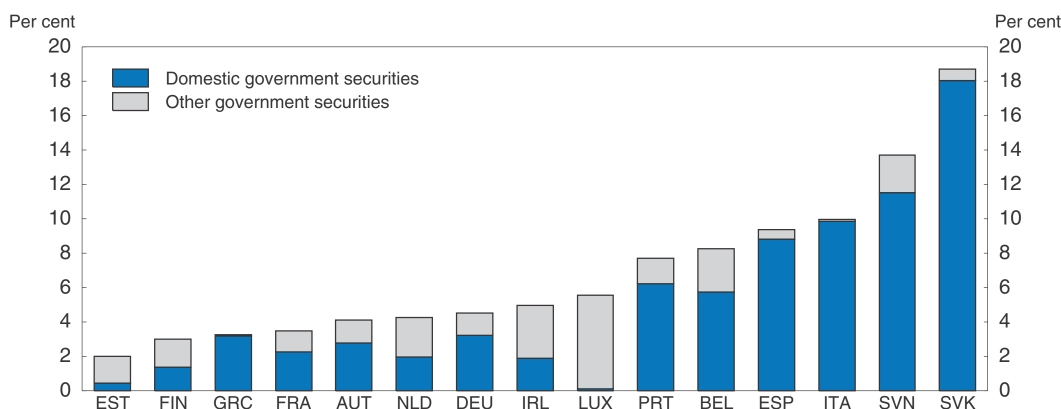
(2012) found that vulnerable countries during the recent crisis tended to allow for less stringent definitions of capital, had more discretion in how banks calculated capital requirements, and exhibited lower actual capital ratios than the rest of the world. At the same time, while 80% and 100% of crisis countries allowed, respectively, Tier 3 and Tier 2 capital (which is less reliable than Tier 1 in meeting market risks) in regulatory capital, only 28% and 85% among non-crisis countries did so. Crisis countries were also more likely to allow hybrid debt instruments to be part of Tier 1 capital.

The ongoing comprehensive assessment of banks' balance sheets aims to provide a clear understanding of the capital position of euro area banks relative to a CRD IV/CRR requirement of 8% of common equity Tier 1 capital, as a ratio to risk-weighted assets. The European Banking Authority (EBA) notes that the capital position of European banks has considerably improved in the first half of 2013 as banks have raised capital and reduced their risk-weighted assets in anticipation of the comprehensive assessment (EBA, 2013). Between January 2007 and September 2013, aggregate capital of euro area banks increased by EUR 710 billion, which includes large contributions by the public sector for bank recapitalisation.

However, some observers have expressed concerns that capital ratios on a risk-weighted basis may underestimate capital adequacy. For example, banks are allowed to use internal models to determine risk weights. These are meant to be elaborated as a more sophisticated measure of the underlying risk of assets, but have been found to vary among banks facing similar risks (Le Leslé and Avramova, 2012). The Bank for International Settlement (2013) notes a higher than expected range of variation in risk weights across banks, part of which is attributable to bankers' incentives to favour optimistic views on risk. The World Banks' Report on Bank Regulation and Supervision found that, among countries that had a financial crisis, 95% allowed banks to calculate their capital requirement using their own internal rating models. By contrast, among the countries not hit by a financial crisis, only half allowed such use of internal rating models (Čihák et al., 2012). Also, sovereign bonds, which account for a large share of banks' assets, carry a zero-risk weight (Figure 1.3). While sovereign debt holding in itself does not necessarily undermine banks' health, as this depends on many

Figure 1.3. **Banks' holdings of general government securities**[1]

As a percentage of total MFIs assets, January 2014



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

Source: European Central Bank.

StatLink http://dx.doi.org/10.1787/888933012237

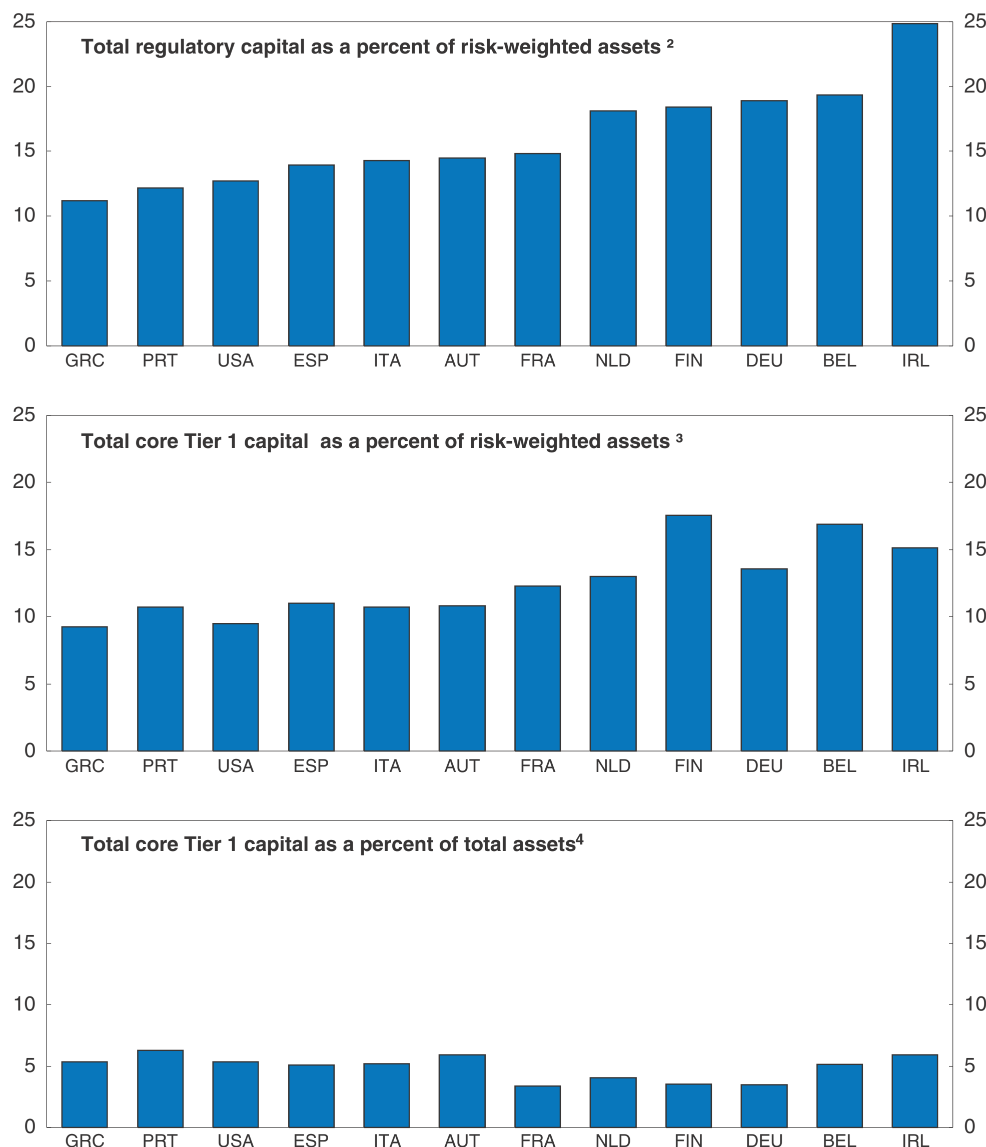
factors, the zero-risk weight may encourage undue asset concentration. This said, a high share of banks' holdings of general government securities may reflect to some extent the structure of the national banking sector. Some empirical research indicates that risk-weighted capital ratios have not been good predictors of market measures of risk (Blundell-Wignall and Atkinson, 2012; Blundell-Wignall and Roulet, 2013; Das and Sy, 2012; Haldane, 2012). To some extent this might reflect Goodhart's law which states that when a measure becomes a target, its quality declines.

Against this background, attention has increasingly been paid to the leverage ratio (equity to non-weighted assets) as a supplementary measure to risk-weighted capital ratios in assessing banks' capital adequacy. Research suggests that a leverage ratio is a predictor of banks' distance to default (Blundell-Wignall and Atkinson, 2012; Blundell-Wignall and Roulet, 2013). Demirgüç-Kunt et al. (2012) find that the relationship between banks' capital position and stock performance is stronger when capital is measured as a leverage ratio. However, as a stand-alone measure the leverage ratio might punish low-risk business models and encourage banks to take on higher risks, because in itself this would not affect capital needs (Lautenschläger, 2013). This motivates the reference in Basel III to the leverage ratio only as a supplement to risk-weighted capital ratios. For reference, Figure 1.4 shows some capital and leverage ratios, aggregated by country. These are not all computed on a consistent basis, and so should not be compared across charts. Indeed, there is no clear agreement on how to best compute such ratios. Research by the OECD Secretariat suggests that a leverage ratio in which derivatives are not netted on the asset side is the best predictor of distance to default (Blundell-Wignall and Roulet, 2013).

There are also different views about an appropriate level of the leverage ratio. The EU Capital Requirements Directive IV (CRD IV) requires supervisors to monitor the risk of excessive leverage and the Capital Requirements Regulation (CRR) lays down disclosure requirements for a non-binding Tier 1 leverage ratio, starting on 1 January 2015. The Basel Committee is to use a 3% indicative Tier 1 leverage ratio during the monitoring period until 1 January 2017. A minimum 5% accounting-based leverage ratio is used as a benchmark for well-capitalised banks by the US Federal Deposit Insurance Corporation, although differences in accounting standards makes this ratio not fully compatible with Europe due to the treatment of derivatives. While a ratio of 5% for the eight largest banking groups and 6% for subsidiaries has recently been proposed as a regulatory minimum in the United States. That said, differences in accounting standards notably for derivatives and Securities Financing Transactions (SFTs) make this ratio not fully comparable with European standards. High leverage ratios have been suggested as a means to force shareholders to absorb losses instead of taxpayers. Admati and Hellwig (2013) suggest leverage ratios possibly in the range of 20% to 30%. Calomiris (2013) is proposing 10%.

Going forward, the methodology for asset-risk weighting should be improved and made more transparent. In the euro area, a common supervisor, the Single Supervisory Mechanism, should contribute to this development via, *inter alia*, peer reviews. Available evidence suggests that there is a case for including a leverage ratio in the regulatory tool box. The merits of leverage ratios in gauging the strength of bank balance sheets should therefore be further explored. Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets and in a co-ordinated manner at international level. The emphasis on monitoring concentration risk

Figure 1.4. **Capital ratios and leverage ratios**[1]



1. Averages, weighted by individual banks' total assets.
2. Total regulatory capital is defined under the latest regulatory guidelines at period-end. For European banks, this excludes transitional capital adjustments when available. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
3. Total core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
4. Based on quarterly data as of December 2013; where these are not available the most recent available data are taken, extending back to December 2012. The leverage ratio relates banks' core Tier 1 capital to total assets, in book values. Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Data for total assets are adjusted to reflect the International Financial Reporting Standard (IFRS).

Source: SNL Financials, Bloomberg, Datastream and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933012256

in the CRD IV is therefore welcome. Basel rules now foresee limiting bank exposure to a single counter-party to a quarter of the eligible capital, but exposures to sovereigns are exempt, a situation which should be monitored closely and reviewed in due course.

The nature and degree of required bank capitalisation can also significantly affect other aspects of bank regulation. For example, the BRRD proposal foresees that inter-bank credit will be exempted from the bail-in obligations for the lending banks. This provision is motivated out of fear that interbank-credit linkages could raise systemic risk. However, such exemption would provide incentives to boost interbank credit, introducing a distortion into the allocation of capital that itself can make the banking system more vulnerable to shock transmission. Consideration should be given to reduce contagion risks by raising capital requirements for interbank credit rather than exempting it from bail-in.

Separation from deposit banking of risky proprietary trading activities and asset positions, which is a potential policy tool by national legislators, can help limiting incentives for excessive risk-taking. It allows activities which generate the largest systemic risks to be separated from those which need to be preserved in a banking crisis, notably deposit-taking and lending (Liikanen et al., 2012). This makes resolution of a failing bank easier and helps remove cross-subsidisation of investment banking from the implicit guarantees of being a part of an insured deposit bank with access to central bank lending (Blundell-Wignall and Atkinson, 2011). Notwithstanding the use of derivatives to hedge risks, a large share of banks' derivative business appears to serve the purposes of tax and regulatory arbitrage, for example to change the risk weights applied to primary assets in the bank balance sheet (OECD, 2011), while at the same time raising default risk (Blundell-Wignall and Roulet, 2013). This suggests that derivatives could be an important element for a separation rule (Blundell-Wignall et al., 2013).

Main recommendations on regulation of the banking sector

- Evaluate after a transition period whether the allocation of the single supervisory authority at the ECB is appropriate.
- Ensure that the ongoing comprehensive assessment of banks – which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test – leads to a consistent overall evaluation of banks' balance sheets.
- Adopt a single resolution mechanism with predictable and swift decision-making that is politically accountable, and ensure that it is operative soon after the SSM is in place. The agreement needs to ensure the effectiveness of the mechanism and its ability to quickly take decisions in emergency situations.
- Ensure legal certainty and equal treatment in the bail-in of bank creditors across states to avoid complicating resolution processes and a potential negative impact on bank funding. Ensure minimisation of national discretion in setting resolution conditions.
- For the national resolution funds to be set up under the Bank Recovery and Resolution Directive, ensure that burden-sharing arrangements for banks with cross-border activities are available. For the Single Resolution Fund, establish strong arrangements to ensure cross-border resolution financing as long as the resources of the national compartments of the Fund are not yet fully pooled. Move over time to full pooling of the Fund resources. Prefund the Resolution Fund or temporarily bridge funding gaps that might occur in the transition phase via a fiscal backstop and recuperate the finances needed by risk-based contributions from the banking sector.
- Complement the Resolution Fund by a common fiscal backstop that is fiscally neutral over the medium term and recoups, *ex post*, any bridge financing via contributions from the financial sector.

Main recommendations on regulation of the banking sector *(cont.)*

- Possible changes in the treatment of sovereign bonds, notably the gradual phasing out in the long run of the zero-risk weighting, should be assessed with a specific attention to possible impacts on the stability of financial markets. Any decision would need to be taken in a co-ordinated manner at the international level. Diversify in the long run the banks' exposure to the debt of a single sovereign. Assess the merits of leverage ratios, as a supplementary measure to risk-weighted ratios, for gauging the strength of bank balance sheets.
- Clarify the conditions under which the European Stability Mechanism (ESM) will have the right to directly recapitalise banks.
- Foster efficiency of procedures to deal with bankruptcy at national level.

Improving fiscal governance

The failure of some EU countries to meet the fiscal targets set under EU rules in the run-up to the crisis reduced the credibility of common fiscal rules and contributed to increasing government debt build-up, feeding concerns about debt sustainability. In response, several multilateral agreements have been concluded, notably the regulations contained in the "Six Pack" and the "Two Pack", designed to reinforce fiscal and economic governance by amending surveillance procedures, sharpening sanction mechanisms and setting intermediate fiscal and economic targets and adjustment procedures. Policies are co-ordinated and subject to surveillance by the Commission and the Council within the annual cycle of the "European Semester". The Treaty on Stability, Co-ordination and Governance requests from euro area countries (as well as the other contracting parties) to enshrine the rules of the Fiscal Compact in a binding and permanent way into national legislation, preferably constitutional, or, otherwise, national budgetary processes.

New fiscal rules govern consolidation

Within the strengthened fiscal governance framework, budgetary policies of euro area countries are subject to four sets of rules:

- Provisions under the Excessive Deficit Procedure (EDP) stipulate that the headline fiscal deficit shall not exceed the 3% of GDP reference headline deficit ceiling enshrined in the Treaty and the Stability and Growth Pact (SGP). Countries exceeding the threshold are subjected to an adjustment path with clear targets and deadlines for the correction of the excessive deficit.
- The debt convergence rule, introduced by the Six Pack requires that the gap between actual debt and the 60% debt/GDP level referenced in the SGP needs to be reduced by 1/20 annually, averaged over three years. The required debt reduction is calculated using the commonly agreed method. For countries that were in the EDP in November 2011 (i.e. at the time of the debt rule came into force), the rule will start applying after a transition phase of 3 years after the year of correcting the excessive deficit, which aims at reducing the deficit to conform to the debt reduction rule. During the transition phase, to ensure that the path of deficit chosen by the member state is sustained while allowing some room of manoeuvre, two conditions should be met simultaneously: the annual structural

adjustment should not deviate by more than ¼ per cent from the linear structural adjustment ensuring consistency with the debt benchmark and, at any time during the transition period, the annual structural adjustment should not exceed ¾ per cent of GDP.

- For countries under the preventive arm of the Pact, convergence towards the country-specific Medium-term Objective (MTO) is meant to provide the principal anchor for sound government finances in the medium term. The MTO is expressed in structural terms and set in a way so as to ensure respect of the 3% deficit limit in a normal cyclical downturn and to ensure public finance sustainability or progress towards sustainability. The maximum level of the structural balance fulfilling the above conditions is calculated by the Commission based on a commonly agreed methodology. Additionally, there are limits of 1 or 0.5% of GDP (with the amount depending on the level of government debt and long-term sustainability of public finances). The country-specific MTOs are defined by each EU member state, and a convergence path towards it is presented in the context of the Stability and Convergence Programmes update presented in spring each year. Present MTOs have been part of the 2013 Stability and Convergence Programmes. Additionally, the Fiscal Compact invited the Commission to propose a calendar of convergence to the MTO. The Commission proposed such a calendar in spring 2013, which has been included in the 2013 Country Specific Recommendations, sometimes at a higher level than required. The MTOs are to be reached by reducing structural deficits by 0.5 percentage points of GDP annually as a benchmark.
- The Six Pack stipulates that evaluation of progress towards and respect of the MTO should make use of an expenditure benchmark. The expenditure rule requires general government expenditures net of discretionary revenue measures to grow below a medium-term rate of potential GDP until the MTO is attained. Expenditures exclude interest payments, unemployment benefits and expenditure on EU programmes fully matched by EU fund revenue payments.

The multiplicity of benchmarks can improve the recognition of country-specific developments but makes the new EU fiscal framework complex. There are four reference quantities: the headline budget deficit, the structural budget balance, the debt-to-GDP ratio and an expenditure measure. These quantities are also subject to periodic revisions, with the structural deficit target and the convergence speed towards the headline deficit subject to resetting in the context of EDP deadline extensions.

The multiplicity of benchmarks implies that the fiscal rules that actually bind can vary over time. This is illustrated in Table 1.2, which shows the rules that would be binding over the next 10 years – excluding the expenditure rule – under a stylised set of assumptions about medium-term growth and interest rates, taken from the *OECD Economic Outlook*, No. 94 (see Barnes et al., 2012; Johansson et al., 2013). For the short-term up to 2015, the growth and fiscal projections of the autumn 2013 *OECD Economic Outlook* (OECD, 2013a) are employed, which incorporate current budget and medium-term plans. After 2015, a country's short-term interest rate is assumed to normalise towards a neutral rate that depends on the country's or area's potential growth rate and inflation target, as well as the country's external debt and fiscal positions. Output gaps are assumed to close within five years.

The required amount of fiscal consolidation is computed for the various fiscal rules, assuming that countries strictly follow the minimum requirement of the most stringent rule in terms of the level of the underlying budget balance. This may be too mechanistic an assumption given the past experience of over- or under-performance. The most restrictive

Table 1.2. **Binding fiscal rules in a stylised medium-term consolidation scenario**[1]

	Current deadline for EDP corrections	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Austria	2013	..	..	..	..	..	debt	=	=	=	=	=	=	=
Belgium	2013	3%	3%	..	..	..	=	=	=	=	=	=	=	=
Estonia	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Finland[2]	..	..	..	..	..	..	debt	=	debt	debt	debt	debt	debt	debt
France	2015	3%	3%	3%	3%	..	trans	=	=	=	=	=	=	=
Germany	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Greece	2016	3%	3%	..	..	..	trans	debt	debt	=	=	=	=	=
Ireland	2015	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=	=
Italy	..	3%	..	..	..	..	debt	debt	=	=	=	=	=	=
Luxembourg	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Netherlands	2014	3%	3%	3%	3%	..	trans	trans	=	=	=	=	=	=
Portugal	2015	3%	3%	3%	3%	3%	3%	trans	trans	trans	debt	debt	=	=
Slovak Republic	2013	3%	3%	..	..	..	->MTO	->MTO	=	=	=	=	=	=
Slovenia	2015	3%	3%	3%	3%	..	trans	trans	=	=	=	=	=	=
Spain	2016	3%	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=

1. "3%" is the 3% deficit ceiling rule under the current EDP. "trans." is the transition rule. "debt" is the debt convergence rule. "->MTO" stands for the transition to MTO. "=" denotes that the MTO is reached and maintained. Calculations start in 2016, following the end of the short-term projection horizon. ".." denotes that the 3% deficit limit is met. Fiscal assumptions: i) Fiscal projections for 2014 and 2015 are taken from the *OECD Economic Outlook*, No. 94. Thereafter: ii) If the deficit exceeds 3% of GDP, the structural budget balance in the following year is reduced by ½ per cent of potential GDP; iii) If the debt/GDP ratio exceeds 60%, the excess over 60% is reduced at an average rate of 1/20 over three years, using the Commission guidelines. Over a transition period of three years after the closure of an EDP, the underlying balance is reduced at a constant rate of maximal ¾ per cent of GDP per year. iv) Countries are assumed to move towards their current MTO by reducing the structural balance by ½ per cent of potential GDP per year.

Source: OECD, *OECD Economic Outlook 94 database* and OECD calculations.

rule (i.e. the one requiring the largest fiscal consolidation) is considered to be binding in the respective year and the overall amount of fiscal consolidation required over the medium term is then computed from the resulting "most restrictive" path. Due to differences in output gap estimates, automatic stabilisers and fiscal one-offs, the assessment may differ from that of the Commission.

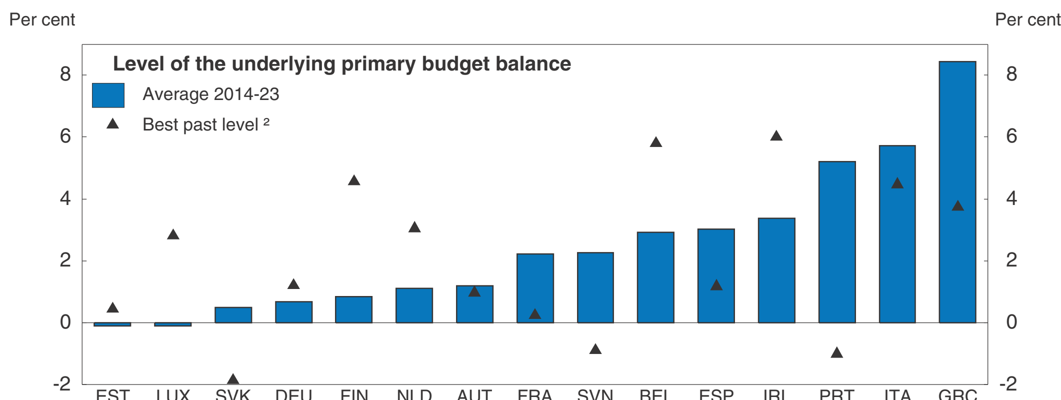
Given the large consolidation that has already been achieved and is projected by the OECD until 2016, in this scenario underlying balances will be at the MTOs or approaching them in half of the countries in 2016 and in most countries by 2018. For the remaining countries, the debt rule and its transition variant will govern adjustment, but in most cases only over short periods. The dominance of the MTOs over most of the adjustment period, despite high debt levels, is the result of the MTOs implying primary surpluses, which are large enough to make the debt-to-GDP ratio fall at a more than sufficient pace, given the GDP growth and interest rates assumptions.

Despite progress consolidation needs to remain high on the policy agenda

The estimates under the stylised assumptions of the OECD's long-term scenario suggest that the cumulative fiscal consolidation that will be achieved by 2014 will account for the largest part of the total consolidation required in the euro area to reach the 60% debt target by 2030 (OECD, 2013a). However, several states still have to advance much further with consolidation in order to stabilise debt at 60% of GDP. Moreover, strong budgetary positions will need to be maintained for many years to come. The stylised medium-term consolidation scenario, taken from the *OECD Economic Outlook 94*, suggests the order of magnitude of these fiscal positions (Barnes et al., 2012; Johansson et al., 2013). Notably, for

Figure 1.5. **Primary budget estimates in a stylised scenario for reducing public debt over the medium term**[1]

In per cent of potential GDP



1. Fiscal assumptions: i) Fiscal projections for 2014 and 2015 are taken from the *OECD Economic Outlook 94*. Thereafter: ii) If the deficit exceeds 3% of GDP, the structural budget balance in the following year is reduced by ½ per cent of potential GDP. iii) If the debt/GDP ratio exceeds 60%, the excess over 60% is reduced by 1/20 annually, averaged over three years, using the Commission guidelines. Over a transition period of three years after the closure of an EDP, the underlying balance is reduced at a constant rate of maximal ¾ per cent of GDP per year. iv) Countries are assumed to move towards their current MTO by reducing the structural balance by ½ per cent of potential GDP per year.
2. Best past level refers to the average largest level of the underlying primary balance in any five-year period between 1990 and 2009 (subject to data availability).

Source: OECD, *OECD Economic Outlook 94 database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933012275

many countries the primary surplus will have to stay well above previous historical records (Figure 1.5). Clearly, the surpluses that will be needed will depend on medium-term growth and interest rate outcomes; higher growth, for example, would reduce the needed surplus.

Proper application of the fiscal framework is key to credible consolidation

The challenge to maintain budgetary surpluses for many years underlines the importance of proper implementation of the EU fiscal rules. At the same time, experience suggests that successful application requires a certain degree of built-in flexibility in reaching fiscal targets, together with correction mechanisms if targets are missed. Rules that are too rigid may be perceived politically too costly to be followed (Guichard et al., 2007), undermining fiscal discipline or inducing fiscal gimmickry (Koen and van den Noord, 2005). Well-functioning fiscal frameworks require implementation of further procedures such as medium-term budget frameworks and long-term fiscal projections (Schick, 2003).

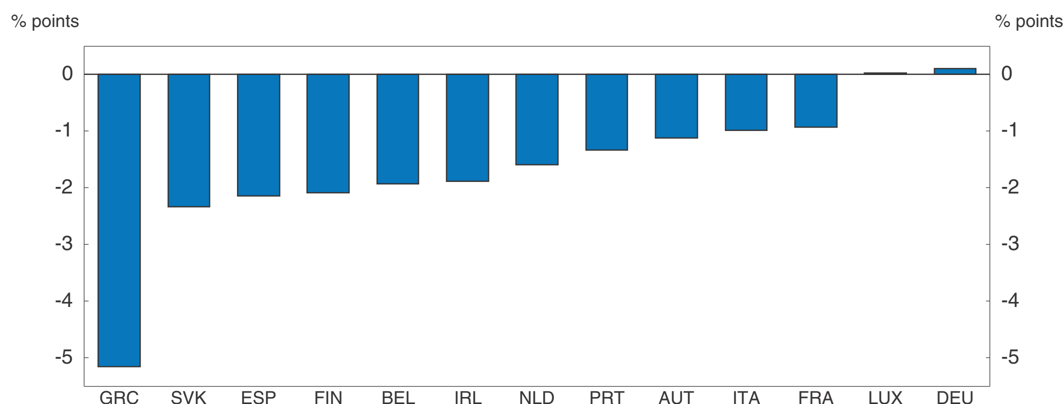
The MTO is the core fiscal anchor of the Stability and Growth Pact, designed to ensure sound fiscal positions that ensure robustness with respect to economic shocks. It is therefore of primary importance to ensure that the fiscal surveillance process at EU level and the national provisions are conducive to reaching and maintaining the MTO. In the Excessive Deficit Procedure – which is of particular relevance in the current economic environment (Table 1.1 above) – the EU Council issues recommendations to correct the excessive deficit within a specified time frame. There is built-in flexibility in this process in that cyclical conditions and other factors, such as debt sustainability, are taken into consideration. In the course of the crisis, in several country cases the Council extended the period over which nominal deficit targets are to be met to avoid undue fiscal retrenchment. In particular, in June 2013 the period was extended for six euro area states which were

assessed to have taken effective action in response to Council recommendations to correct the excessive deficits, but which after the adoption of the recommendations suffered unexpected adverse macroeconomic events with unfavorable consequences for government finances. For these countries the Council has extended the period over which nominal deficit targets are to be met. The revised paths contained less demanding structural efforts and thus slowed the scheduled consolidation in structural terms.

The risk of pro-cyclical fiscal adjustment is reduced by the MTOs being defined in cyclically-adjusted terms and convergence to the MTO in terms of changes in cyclically-adjusted balances. However, structural balances are difficult to estimate as they are subject to significant uncertainty about the size of the output gaps they are based on, which are unobservable variables to be estimated, and the sensitivity of government budgets to the output gap. Measures of output gaps can be subject to large *ex post* revisions. Moreover, revenue elasticities with respect to the output gap capture cyclical factors in revenues only to a limited extent. In particular, cyclical revenue buoyancy related to asset price and housing booms are often estimated as structural, as experienced in the run-up to the crisis, leading to flawed conclusions about underlying fiscal positions (Price and Dang, 2011). *Ex post* revisions to structural balance estimates can therefore be considerable and have been mostly one-sided over the past ten years, implying that the health of underlying fiscal positions has been significantly overstated in real time (see e.g. Kamps et al., 2013). For example, for the year 2009, the average absolute revision in structural balances, as estimated by the OECD, for all euro area countries between autumn 2010 and autumn 2013 totals 1.7 percentage points (Figure 1.6).

Figure 1.6. **Cyclically-adjusted balances in 2009: Revisions in OECD estimates**[1]

Percentage points of potential GDP



1. Difference in the structural balance for the year 2009, as it was estimated in the *OECD Economic Outlook 87* (published in June 2010) and the actual data as reported in *OECD Economic Outlook 94* (published in December 2013).

Source: OECD, *OECD Economic Outlook databases*, No. 87 and 94.

StatLink http://dx.doi.org/10.1787/888933012313

The expenditure rule, by setting a medium-term potential GDP growth rate as an upper limit for expenditure, net of spending financed by discretionary revenue measures, can help to keep government finances on track. It can prevent unsustainable revenue growth from financing an unsustainable expansion in spending, as was observed prior to the crisis. The limitation is that estimates of potential growth rates can be subject to considerable uncertainty as well, and are likely to be biased upwards in periods where economic bubbles are building up.

For example, *ex post*, after the onset of the crisis, potential GDP estimates have generally been revised downward (Furceri and Mourougane, 2012; OECD, 2013a). In order to alleviate this uncertainty, the expenditure rule is based on a ten-year average potential growth rate (including both realised data and forecasts). Thus, revisions in potential output and estimated structural balances would need to be taken into consideration in the evaluation of fiscal positions and structural efforts by the EU Commission. At the national level, procedures are needed that deal with such revisions in budgeting.

The debt convergence rule ("debt benchmark") generally implies that fiscal adjustment is front loaded. Front loading can contribute to faster recovery of market confidence and lower government debt servicing costs. Moreover, output gains associated with fiscal consolidation can be the larger in present value terms the earlier significant fiscal adjustment takes place (OECD, 2012). However, frontloading, as implied by the numerical debt benchmark, might not be appropriate in recessions or when unemployment is high, as is the case now in almost all euro area countries (Fioramanti and Vicarelli, 2011; Creel et al., 2012). Currently, this feature of the debt convergence rule is not relevant because fiscal adjustment is mostly driven by the need to comply with the deficit criterion and the convergence to MTOs. This could change, however, if the economic upswing is not sustained. Thus, if needed, the impact of the cycle on debt dynamics should be taken into consideration in the debt rule.

Moreover, the transition to MTOs and the numerical benchmark of the debt convergence rule are subject to escape clauses that allow for deviations from targets in cases of severe economic downturns. Care will need to be taken that such escape clauses do not incur risks to debt sustainability and, if applied, will be subject to the same standards across countries as a perception of arbitrariness would undermine the credibility of the fiscal framework.

Steering government finances towards sound positions

Fiscal surveillance within the framework of the European Semester should provide early warning signals if government finances are at risk to deviate from fiscal targets. Beyond the European Semester, one important innovation coming from the Two Pack is that governments submit their draft budgetary plans to the EU Commission, which responds with an assessment on whether the plans are in line with the governments' obligation under the Stability and Growth Pact (SGP) and can request a government to modify and resubmit its draft budgetary plan in case of serious non-compliance. This assessment, in turn, should be taken into account in the national budget processes. While the assessments in the autumn 2013 did not find any draft budgetary plan in serious noncompliance with the country's obligations, for five countries (Finland, Italy, Luxembourg, Malta, and Spain), the draft budgetary plans were found to pose a risk of non-compliance. In particular, for these five countries the Commission identified budgetary risks related to the insufficient fiscal effort compared to the EDP recommendations, risk of non-compliance with the debt convergence benchmark, and risk of significant deviations from the medium-term objective (MTO) or the adjustment path towards it. The newly gained tools of the Two Pack should be applied effectively to ensure timely compliance with the SGP. This includes addressing "an autonomous recommendation" by the Commission to the countries concerned in case of the risk of non-compliance with the EDP recommendations.

For euro area member states in the preventive arm, in case of a significant deviation from the MTO or the adjustment path towards it, the Commission can address an early warning and the Council can impose sanctions under reverse qualified majority voting if

inaction persists (under which a sanction is adopted unless a qualified majority of member states votes against it) (see the 2012 *OECD Economic Survey of the Euro Area*). The possibility to apply sanctions already at an early stage, within the preventive arm of the Stability and Growth Pact, can potentially aid early fiscal adjustment. The previous design had the weakness that sanctions could only be applied when it was essentially too late for a country to avoid a undesirable fiscal outcome and when it was likely to be facing considerable difficulties that a sanction would only exacerbate. Also, a reverse majority voting is in place for the opening of and subsequent steps in an excessive deficit procedure. Thus, sanctions become more automatic, increasing the pressure in favour of fiscal adjustment if the credibility of this instrument is established.

The Fiscal Compact requires contracting parties (all states in the euro area are contracting parties) to ensure structurally-balanced public finances and to have correction mechanisms in place designed to correct deviations from the MTO and the adjustment path thereto. Euro area countries have adopted different approaches to achieve this objective. One is a debt brake system with a control account that takes stock of accumulated deviations that must be offset over time, including by over-achieving the MTOs (e.g. Austria and Germany). Another approach is to explicitly link the identification of a significant deviation by the Commission to the national budget process (e.g. Ireland and the Netherlands). Yet another approach is a provision specifying a time path to bring back the structural deficit to fiscal targets, with the numerical path unspecified *a priori*.

Empirical work suggests that fiscal rules are likely to have the largest potential for countries with poor past stability culture (Heinemann et al., 2013). In practice, the effectiveness of fiscal rules is linked to various budget procedures and practices (see e.g. Schick, 2003: Sutherland et al., 2005). However, not all of the correction rules adopted so far might be sufficiently binding to secure convergence with the MTO. Also, since estimates of structural balances are generally based on national methodologies, the EU and national assessments about the existence of significant deviations might differ. The multiplicity of fiscal rules makes the new fiscal framework complex, reinforcing the need to foster ownership in the consolidation process.

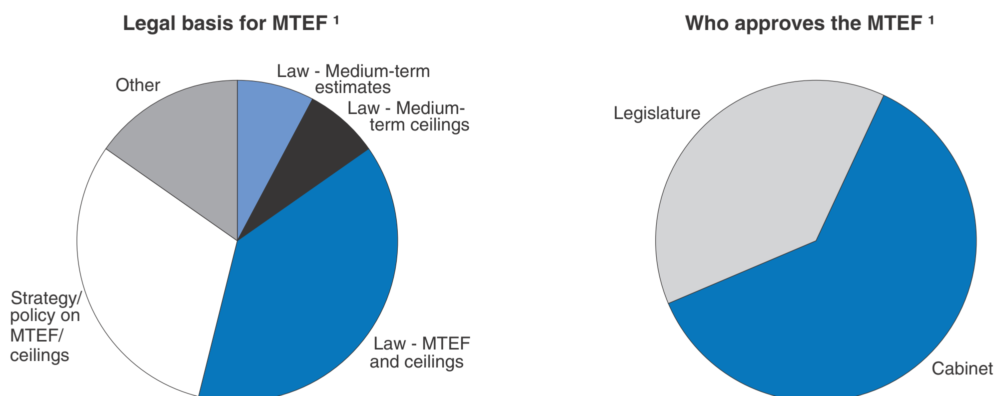
Medium-term fiscal frameworks and fiscal councils facilitate compliance

The need for contingent planning underlines the importance of having in place a transparent medium-term budgeting framework at the national level that is able to identify long-term spending and revenue pressures and risks. In line with the provisions of EU legislation framework should include a broad concept of fiscal accounts, covering *inter alia*: ageing and health related spending and revenues; contingent liabilities, including government guarantees, non-performing loans, and liabilities stemming from the operation of public corporations; obligations arising from public-private partnerships; and information on the participation of the general government in the capital of private and public enterprises. By reducing planning uncertainty, medium-term budgeting can also contribute to reducing governments' funding costs.

Almost all euro area countries within the OECD reported in mid-2013 to have a medium-term expenditure framework (MTEF) in place, with the notable exception of Belgium and Luxembourg (OECD, 2013b). More than half of the euro area countries have enshrined the MTEF in law and most of the rest have established the framework in a policy or strategy decided by the government or through other arrangements (Figure 1.7, left panel). In more than a third of the countries the MTEF is approved in parliament (Figure 1.7,

Figure 1.7. **Features of medium-term expenditure frameworks in the euro area**

In per cent of total responses



1. MTEF = Medium-term expenditure framework.

Source: OECD (2013), "Strengthening Budget Institutions in OECD Countries – Results of the 2012 OECD Budget Practices and Procedures Survey", *Hand-out 1*, Working Party of Senior Budget Officials of the Public Management Committee, 9th Annual Meeting on Performance and Results, Berlin, 7-8 November.

StatLink http://dx.doi.org/10.1787/888933012332

right panel). Moreover, 80% of the countries' mandatory expenditures are included in the MTEF. Comprehensive coverage of expenditure supports a broad budget discussion including the mandatory spending which might otherwise fall outside of consideration with the focus instead falling on discretionary spending.

The Fiscal Compact and the Two Pack require euro area member states to base their draft budgets and medium-term fiscal planning on independent macroeconomic forecasts and to have independent Fiscal Councils (FCs) that monitor compliance with the fiscal rules. There is some evidence indicating a positive impact of FCs on fiscal discipline (Calmfors, 2012; Nerlich and Reuter, 2012). Indeed, FCs can act as a cross check that constraining rules are not unduly stretched and give advice on how to return to fiscal targets in case of deviations. Moreover, given the partial loss in sovereignty on budgetary policies in the euro area, national Fiscal Councils could be significant in fostering "ownership" in consolidation policies.

By now, almost all euro area countries have established an FC, either within an already existing administrative institution or as a stand-alone entity, the latter mostly having been established since 2009. The factual independence of Fiscal Councils cannot be concluded from their allocation in either of these two categories, but depends on other parameters as well, such as the Fiscal Council's ability to set up a work programme, multi-annual funding commitments, and full transparency in the FC's work and operations (see the *OECD Principles for Independent Institutions*; OECD, 2013c). Moreover, there appears to be a considerable heterogeneity among euro area countries with respect to the coverage of the FCs' mandate and the choice whether to have one or two FCs for carrying out the policy tasks stemming from the Two Pack and the Fiscal Compact. For example, in Germany the Stability Council co-ordinates fiscal policy between the federal government and the federal states (Stabilitätsrat, 2013). In the Netherlands, the Council of State is also involved in economic assessment (The Council of State, 2013). In case personnel with fiscal expertise is lacking in smaller countries, inviting international experts into the councils might be a solution.

None of the euro area countries within the OECD reported in mid-2013 the monitoring of the MTEF by an independent fiscal institution (OECD, 2013a). It appears too early for a comprehensive assessment of the FC's performance in supporting the new European fiscal framework.

The risk assessment and monitoring potential of capital markets should be utilised as one of the tools to strengthen budgetary discipline. There is evidence that credible budgetary rules and institutions can reduce borrowing costs. For euro area countries, the strength of the enforcement mechanism was found to be of significant importance for reducing sovereign bond spreads relative to Germany (Iara and Wolff, 2011). Research for Switzerland indicates that strong fiscal rules and a credible no-bailout regime significantly contribute to lower risk premium for Cantonal debt (Feld et al., 2013). Government bond yields in the United States have been shown to be lower for states with more restrictive fiscal rules (Eichengreen and Bayoumi, 1994; Poterba and Rueben, 1999; Johnson and Kritz, 2005). In Canada and the United States, where central government control of sub-central fiscal positions is weak, almost all federal states have adopted balanced budget rules on their own to help reduce funding costs.

Main recommendations on fiscal governance

- Ensure effective implementation of the strengthened EU and Fiscal Compact rules in national fiscal frameworks, including medium-term budgeting, identification of future spending and revenue pressures and risks, independent fiscal councils and effective mechanisms to correct deviations from fiscal targets.
- Ensure that the uncertainty surrounding real-time estimates of structural balances and potential growth rates are taken into account in assessing fiscal positions.

Extending the area's "fiscal capacity"?

Once the banking union is fully established, the necessary regulatory and fiscal instruments should be in place to prevent banking crises from turning systemic across the euro area and the EU. On the funding side, the key components are the Single Bank Resolution Funds (SRF), and a common fiscal backstop offering conditional aid to governments that are facing temporary liquidity problems. Banking union, if properly set up, would help avoid area-wide recessions in income and employment not only *ex post*, once banks are failing, but also *ex ante*, via better functioning of capital markets. The Macroeconomic Imbalances Procedure, which aims at identifying and correcting macroeconomic imbalances in the European Union should also contribute to reducing the risk of sudden and deep economic downturns (see the 2012 *OECD Economic Survey of the Euro Area*).

Setting up a further area-wide fiscal capacity that is dedicated to counter idiosyncratic shocks across the euro area, is sometimes considered a significant element of deeper economic integration. The European Commission, in the 2012 Blue Print on further integration of the euro area, has pointed to the potential benefits of a common fiscal capacity designed to counter temporary idiosyncratic shocks in the euro area (European Commission, 2012; see also Van Rompuy, 2012). This proposal does not aim at permanent income redistribution across countries. Such a capacity has also been motivated by national monetary policies being no longer available for country-specific counter-cyclical policies (Wolff, 2012; IMF, 2013b).

The main fiscal stabilisation instruments that have been proposed are: i) common ("rainy day") funds to finance counter-cyclical transfers that average out over the cycle (e.g. Allard et al., 2013); ii) a larger EU or euro area budget associated with common spending and revenue competencies that could act as automatic or discretionary stabilisers (e.g. Allard et al., 2013; Trésor-Éco, 2013); and iii) a common unemployment insurance system (e.g. Allard et al., 2013; Wolff, 2012).

Empirical research indicates that asymmetric shocks still exist in the euro area (Seymen, 2012). Smoothing these shocks can potentially improve welfare for the area overall. However, business cycles in the euro area are highly correlated, with the correlation coefficients, measuring the annual pair-wise correlation since the beginning of the 1990s of output gaps and changes in output gaps, averaging 69% and 78%, respectively. This raises the issue whether the benefits of smoothing business cycles across countries that share a common currency outweigh the risks of inefficiencies that can be associated with cross-border transfer schemes.

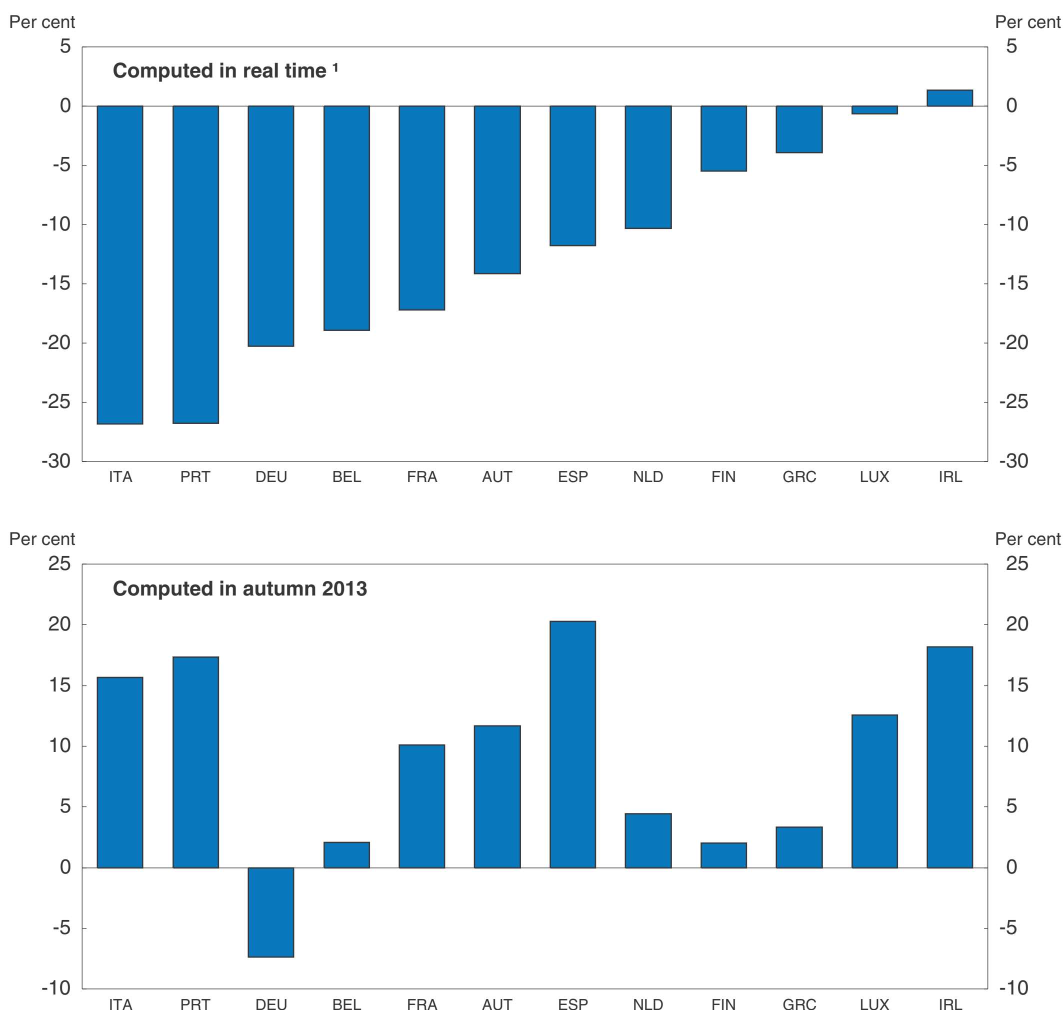
Table 1.3. **Cross-country business cycle correlations in the euro area**

	AUT	BEL	DEU	ESP	EST	FIN	FRA	GRC	IRL	ITA	LUX	NLD	PRT	SVK	SVN
Correlations of changes in output gaps															
AUT	1.0	0.9	0.9	0.9	0.9	1.0	1.0	0.3	0.8	1.0	0.9	0.9	0.7	0.9	0.9
BEL	0.9	1.0	0.9	0.9	0.8	1.0	0.9	0.3	0.7	1.0	0.9	0.9	0.8	0.9	0.9
DEU	0.9	0.9	1.0	0.8	0.8	1.0	0.9	0.1	0.7	0.9	0.9	0.9	0.7	0.8	0.8
ESP	0.9	0.9	0.8	1.0	0.8	0.9	0.9	0.6	0.8	0.9	0.9	0.9	0.7	1.0	1.0
EST	0.9	0.8	0.8	0.8	1.0	0.9	0.9	0.2	0.9	0.9	0.9	0.7	0.5	0.7	0.8
FIN	1.0	1.0	1.0	0.9	0.9	1.0	1.0	0.3	0.8	1.0	0.9	0.9	0.8	0.9	0.9
FRA	1.0	0.9	0.9	0.9	0.9	1.0	1.0	0.3	0.8	1.0	0.9	0.9	0.7	0.8	0.9
GRC	0.3	0.3	0.1	0.6	0.2	0.3	0.3	1.0	0.3	0.3	0.4	0.4	0.4	0.5	0.5
IRL	0.8	0.7	0.7	0.8	0.9	0.8	0.8	0.3	1.0	0.8	0.9	0.6	0.4	0.7	0.7
ITA	1.0	1.0	0.9	0.9	0.9	1.0	1.0	0.3	0.8	1.0	0.9	0.9	0.8	0.9	0.9
LUX	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.4	0.9	0.9	1.0	0.8	0.8	0.8	0.8
NLD	0.9	0.9	0.9	0.9	0.7	0.9	0.9	0.4	0.6	0.9	0.8	1.0	0.8	0.9	0.9
PRT	0.7	0.8	0.7	0.7	0.5	0.8	0.7	0.4	0.4	0.8	0.8	0.8	1.0	0.8	0.8
SVK	0.9	0.9	0.8	1.0	0.7	0.9	0.8	0.5	0.7	0.9	0.8	0.9	0.8	1.0	1.0
SVN	0.9	0.9	0.8	1.0	0.8	0.9	0.9	0.5	0.7	0.9	0.8	0.9	0.8	1.0	1.0
Correlations of output gaps															
AUT	1.0	0.9	0.7	0.9	0.8	0.9	0.9	0.7	0.8	0.9	1.0	0.9	0.8	0.5	0.9
BEL	0.9	1.0	0.7	0.7	0.8	1.0	0.8	0.7	0.6	0.8	0.8	0.9	0.6	0.7	0.9
DEU	0.7	0.7	1.0	0.3	0.7	0.8	0.5	0.1	0.3	0.5	0.5	0.6	0.3	0.5	0.6
ESP	0.9	0.7	0.3	1.0	0.6	0.7	0.9	0.9	0.9	1.0	0.9	0.7	0.9	0.2	0.7
EST	0.8	0.8	0.7	0.6	1.0	0.9	0.8	0.5	0.6	0.7	0.8	0.5	0.3	0.5	0.7
FIN	0.9	1.0	0.8	0.7	0.9	1.0	0.8	0.6	0.6	0.8	0.9	0.9	0.5	0.7	0.9
FRA	0.9	0.8	0.5	0.9	0.8	0.8	1.0	0.8	0.9	1.0	1.0	0.8	0.8	0.3	0.7
GRC	0.7	0.7	0.1	0.9	0.5	0.6	0.8	1.0	0.7	0.8	0.8	0.7	0.7	0.4	0.8
IRL	0.8	0.6	0.3	0.9	0.6	0.6	0.9	0.7	1.0	0.9	0.9	0.5	0.9	-0.1	0.5
ITA	0.9	0.8	0.5	1.0	0.7	0.8	1.0	0.8	0.9	1.0	1.0	0.7	0.9	0.2	0.7
LUX	1.0	0.8	0.5	0.9	0.8	0.9	1.0	0.8	0.9	1.0	1.0	0.8	0.8	0.3	0.8
NLD	0.9	0.9	0.6	0.7	0.5	0.9	0.8	0.7	0.5	0.7	0.8	1.0	0.7	0.6	0.9
PRT	0.8	0.6	0.3	0.9	0.3	0.5	0.8	0.7	0.9	0.9	0.8	0.7	1.0	0.0	0.5
SVK	0.5	0.7	0.5	0.2	0.5	0.7	0.3	0.4	-0.1	0.2	0.3	0.6	0.0	1.0	0.8
SVN	0.9	0.9	0.6	0.7	0.7	0.9	0.7	0.8	0.5	0.7	0.8	0.9	0.5	0.8	1.0

Note: Annual correlations, 1995-2013. Fourth quarter GDP, and for a few countries third quarter GDP, are OECD estimates.
Source: OECD, *OECD Economic Outlook 94 database* and OECD calculations.

Transfer schemes, such as payments from rainy day funds, based on measures of countries' cyclical positions, such as output gaps, would face difficult challenges. First, it is difficult to differentiate *a priori* between temporary and permanent economic shocks. Between 1995 and 2007, the last year prior to the crisis, cumulated output gaps, as estimated in the November 2013 *OECD Economic Outlook* (OECD, 2013a), were markedly different from zero for almost all euro area countries in the OECD (Figure 1.8, upper panel). Thus, transfers based on relative output gaps could lead to a permanent redistribution rather than a temporary one as desired for stabilisation purposes.

Figure 1.8. **Cumulated output gaps 1995-2007**



1. For each year, the real-time output gap is the estimate contained in the spring edition of the *OECD Economic Outlook* for the same year. Output gaps computed in autumn 2013 correspond to the estimates of the *OECD Economic Outlook 94*.

Source: OECD, *OECD Economic Outlook databases*, No. 55 to 94.

StatLink http://dx.doi.org/10.1787/888933012351

Second, output gaps are subject to considerable revisions over time, even abstracting from the effect of the recent crisis, complicating transfer policies. The size and direction of redistribution across countries based on "real time" output gaps can be very different from those that would be implied if up-to-date information, available at a later stage, had been available (Figure 1.8, lower panel).

Creating a larger common budget, funded by direct tax payments from each state, could aid in counter-cyclical stabilisation as tax revenues fluctuate with relative cyclical positions, and potentially via transfers to European countries that are insensitive to the cycle or counter-cyclical. Empirical work for federal states indicates that the impact of the central budget on local or inter-state income smoothing is relatively small although not negligible. Hepp and von Hagen (2013) estimate for post-reunification Germany that the government sector contributed around 10% to interstate consumption smoothing between 1995-2006. Studies for other countries show an impact on smoothing household income and consumption of between 15% and 25%. (Goodhart and Smith, 1993; Bayomi and Mason, 1995; Decressin, 2002; Obstfeld and Peri, 1998). These studies also show that the largest part of inter-regional income smoothing is achieved via capital markets.

OECD research indicates that intergovernmental transfers tend to be pro-cyclical in general, and in more than half of OECD countries they even tend to destabilise sub-central budgets (Blöchliger and Égert, 2013). Many grants are matching sub-central spending, thus tending to exacerbate sub-central spending fluctuations. Equalisation transfers, designed to redistribute tax revenues among states with different revenue-raising capacities or expenditure needs, work across jurisdictions but not over time and, rather than ease fluctuations in regional economic activity, they exacerbate them (see also Boadway and Hayashi, 2003 for Canada; Hepp and von Hagen, 2013 for Germany). Model calculations for the EU find that a union-wide fiscal equalisation system would (by definition) redistribute revenues from high- to low-income countries, but that its stabilisation properties would, at best, be neutral and probably pro-cyclical (Bargain et al., 2013; Dolls et al., 2013). In these models, the shock reduces the taxing capacity of the countries negatively affected by it, but it also reduces the taxing capacity of the union as a whole. Therefore, the sum of money available for fiscal equalisation declines and countries which benefited initially may even lose transfers.

Transfer spending to sub-central entities in OECD countries is often determined as a share of central government tax revenue, which itself tends to fluctuate with the cycle. Ensuring counter-cyclicality on the spending side of a euro area budget with own tax revenues would require that expenditures are smoothed by allowing the budget to run deficits, financed by issuing debt that is uncertain to be redeemed over the cycle through budgetary surpluses. The risk is that this would shift issues of fiscal sustainability to the euro area level. In any case, significant shifts of taxing and spending powers to the euro area level would require agreement about what spending and revenue items would be better allocated at the level of the euro area than at the level of the states.

Finally, a common unemployment insurance system, with funding provided from the centre, might have higher cross-border smoothing properties, with income smoothing via fluctuations in benefits and contributions. There would be a risk, however, that the scheme would subsidise inefficient institutions and labour market policies, since policies and institutions influence unemployment dynamics and its resilience to shocks. This would also be true if common insurance funding were confined to short-term unemployment,

since inflow into and outflow from unemployment depend not only on the business cycle but also on structural policy settings. Thus, a common insurance system would call for potentially far-reaching harmonisation across countries in favour of efficient labour market and even product market regulations. However, further progress in structural reform could make common elements of unemployment insurance an option, which could also help to foster labour mobility within the single market.

A fiscal capacity to support structural reform

The blueprint on deep and genuine EMU, which the European Commission presented in November 2012, pointed to potential benefits of a euro area fiscal capacity that could be used to provide incentives for reforms in the member states. In December 2012, the European Council discussed the issue of possible contractual arrangements and associated financial support to reforming countries to raise incentives for structural reform. The European Council in December 2013 stated that partnerships based on a system of mutually agreed contractual arrangements and associated solidarity mechanisms would contribute to facilitate and support sound policies before countries face severe economic difficulties. Accordingly, the Commission has proposed options for a new "Convergence and Competitiveness Instrument" (CCI) (European Commission, 2012b and 2013). Governments would agree with the Commission and the Council on a contractual arrangement setting out details and time lines for the implementation of structural reform measures that are considered to be key for the stability of economic and monetary union and the creation of growth and employment, in line with European Semester country-specific recommendations. The options would include the possibility of financial support to the reforming country, where deemed appropriate, to mitigate short-term cost of reform or account for positive spillover effects to the euro area overall where justified.

On the other hand, the CCI could backfire if countries respond by refusing to carry out reforms unless subsidies are forthcoming, or if already implemented reforms are backtracked to received funds later. These and other questions point to significant implementation issues. Assessing the costs of reform projects would in any case be difficult and subject to asymmetric information between member countries and the Commission as the former have better knowledge about true project costs. This would be particularly true if receiving governments used the grants to compensate pressure groups for a loss in their rents associated with reform. Assessing the monetary value of externalities emanating from reform would also be difficult, at least within a manageable assessment process. Also, it might be difficult to enshrine the *quid pro quo* in a contract, like for example the requirement that reform measures qualifying for aid must not be unwound within a certain time period. As the financial support is to be conditional on carrying out specific reforms, a mechanism for ensuring that reforms are implemented or, if necessary, sanctioning non-implementation would be needed. Moreover, a set-up whereby the instrument would generate financial flows to high-income countries might be difficult to justify politically. There is also a risk that creating a supplementary layer of contractual commitments would make the system of macroeconomic governance more complex, which could make it more difficult to ensure "national ownership" in the reform process (Rubio, 2013).

Ongoing amendments in EU cohesion policies should be explored before the introduction of new instruments is evoked (see the *OECD Economic Survey of the European Union*). These amendments seek to ensure that EU funding is better targeted to attain the Europe 2020 goals for growth and employment. To encourage better targeting, "Partnership Agreements" are agreed between the Commission and EU member states. They specify countries' economic objectives (out of a menu of 11, reflecting "Europe 2020" priorities), targets to be reached by the end of the programme period, performance indicators and milestones, and governments' commitments for action. Certain conditions have to be met prior to the disbursement of funds (e.g. the proper functioning of public procurement systems), and 6% of funding is conditional upon performance, to be evaluated in a mid-term review.

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Glossary

AQR	Asset Quality Review
BRRD	Bank Recovery and Resolution Directive
BRSS	Bank Regulation and Supervision Survey
CCI	Convergence and Competitiveness Instrument
CET1	Common Equity Tier 1
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGSD	Deposits Guarantee Schemes Directive
DR	Debt (convergence) Rule
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFSF	European Financial Stabilisation Facility
EMU	European Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FC	Fiscal Councils
FSB	Financial Stability Board
GNI	Gross National Income
G-SII	Global Systematically Important Institutions
HICP	Harmonised Index of Consumer Prices
LTRO	Long-Term Refinancing Operations
MTO	Medium Term (budgetary) objective
MTEF	Medium Term Expenditure Framework
NIIP	Net International Investment Positions
NPL	Non-Performing Loans
OMT	Outright Monetary Transactions
O-SII	Other Systematically Important Institutions
PISA	Program for International Student Assessment
SFT	Security Financing Transactions
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SRB	Systemic Risk Buffers
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty of the Functioning of the European Union

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