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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 14 February 2012. 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 7 March 2012.

This Survey *of the euro area has been prepared back-to-back with the* Survey *of the European Union, which was discussed and approved on the same days as this document. The* Surveys *are being released together.*

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes, Charlotte Moeser and Jon Pareliussen under the supervision of Piritta Sorsa. Research assistance was provided by Isabelle Duong.

The previous Survey *of the euro area was issued in December 2010.*

BASIC STATISTICS OF THE EURO AREA, 2010

	Euro area[1]	United States	Japan
LAND AND PEOPLE			
Area (thousand km^2)	2 703	9 832	378
Population (million)	324.2	309.1	127.5
Number of inhabitants per km^2	120	31	337
Population growth (2000-10, annual average % rate)	0.5	0.9	0.1
Labour force (million)	158.1	153.9	65.9
Unemployment rate (%)	9.9	9.6	5.1
ACTIVITY			
GDP (billion EUR, current prices and exchange rates)	9 138	10 958	4 122
Per capita GDP (current PPS)	26 917	36 255	26 023
In per cent of GDP:			
Gross fixed capital formation	19.1	15.4	20.5
Exports of goods and services	22.7[2]	12.7	15.2
Imports of goods and services	22.1[2]	16.2	14.1
PUBLIC FINANCE (per cent of GDP)			
General government: Revenue	44.7	31.7	32.6
Expenditure	51.0	42.5	40.4
Balance	–6.3	–10.7	–7.8
Gross public debt (end-year)	92.9	94.2	200.0
EXCHANGE RATE (national currency per euro)			
Average 2011		1.3920	111.0
February 2012		1.3224	103.8

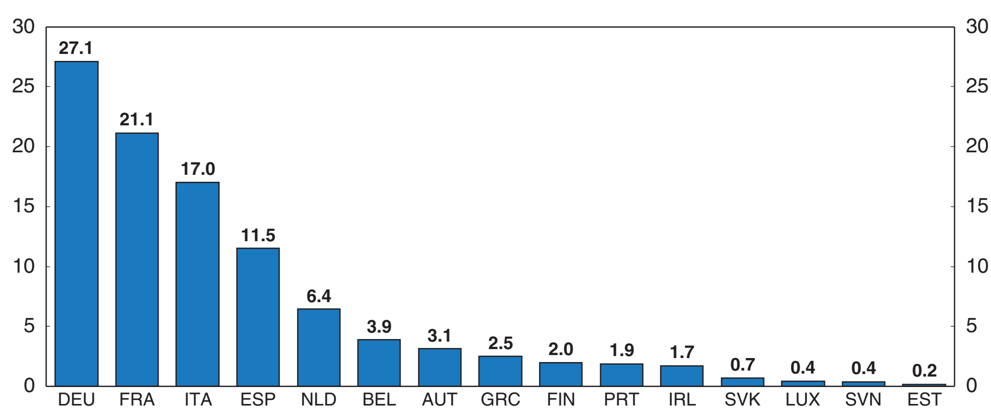
EURO AREA – EXTERNAL TRADE IN GOODS (main partners, % of total flows)

	Exports	Imports
Denmark, Sweden, United Kingdom	17.8	13.3
Other European Union member countries	13.8	11.8
Other Europe	11.1	9.7
OECD America	14.5	11.2
OECD Asia/Pacific	5.2	6.2
Non-OECD dynamic Asia[3] and China	11.2	19.4

1. OECD euro area (unless otherwise stated).
2. All euro area countries.
3. Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore and Thailand.

SHARE IN EURO AREA GDP

Current market prices



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Executive summary

The euro area is experiencing a crisis related to sovereign debt in several countries. *The crisis has its origins in the build-up of excessive financial, fiscal and economic imbalances in the euro area and the global credit cycle. The resolution of these imbalances has so far been incomplete, leading to a renewed bout of instability beginning in mid-2011. There is a risk that fiscal consolidation and potential bank deleveraging may restrict economic activity before the benefits of healthier public finances and reforms to boost growth materialise. High risk-spreads and self-fulfilling expectations could lead to unsustainable debt dynamics. There is a risk of global spillovers from these developments. This calls for both short-term action and long-term reforms.*

Decisive action is needed to stabilise vulnerable euro area sovereign debt markets. *Fiscal consolidation, economic governance reforms and financial assistance by the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Facility (EFSF), as well as the future ESM (European Stability Mechanism) and IMF support, are major steps forward, even if confidence has not yet fully been restored. Euro area stability funds should be expanded further, subject to conditionality, to provide credible support. For Greece, which is an exceptional case and had an unsustainable debt burden, debt should be restructured in a voluntary way. Bank balance sheets need to be rebuilt, while avoiding excessive deleveraging.*

Fiscal consolidation is necessary with monetary policy continuing to maintain price stability. *Domestic demand is weak, especially in countries with severe financial and fiscal crises, and there are large downside risks. With inflationary pressures expected to remain moderate in an environment of weaker growth in the euro area and globally, the ECB has eased monetary policy by reducing short-term interest rates and has expanded the balance sheet to provide liquidity to banks and thereby support the monetary transmission mechanism. A wider set of non-standard measures could be needed if the transmission process becomes further impaired. The public finances in most countries face difficulties. The automatic stabilisers should in principle be allowed to work around the structural adjustment path, consistent with fiscal commitments. For countries with some fiscal space, the pace of planned consolidation could be eased if the state of the economy worsens subject to long-term sustainability considerations. Countries under financial assistance programmes should stick to headline targets as agreed in the programme, while countries facing close market scrutiny should continue to meet the agreed budgetary targets and stand ready to pursue further consolidation measures if needed. Achieving prudent debt-to-GDP ratios will take many years of tight fiscal policy and would be facilitated by stronger growth.*

Ambitious structural reforms are needed to boost growth, improve debt sustainability and rebalance the economy. *These should tackle weaknesses in product market regulation, labour market institutions, tax systems, and strengthen the Single Market. While the full gains take time to materialise, many reforms would boost activity even in the short run. Structural measures would help address the causes of excessive imbalances in both surplus and deficit countries, including regulations that discourage investment and wage-setting mechanisms that weaken competitiveness. In particular, structural reforms have an important role to play in resolving excessive imbalances in countries having* *accumulated high levels of indebtedness and experiencing significant losses in competitiveness. Structural reforms would help to ease high debt burdens, restore competitiveness and attract foreign capital. In countries with low potential growth and weak domestic demand, structural reforms especially in the service sectors could boost investment and domestic activity.*

EU structural, fiscal and financial governance have been strengthened, but these measures now need to be implemented and there are some areas where reforms should go further. *Economic co-ordination and fiscal governance have been upgraded, notably around the EU Semester, the new Macroeconomic Imbalance Procedure and reforms to the Stability and Growth Pact. Further proposals are under consideration. Effective implementation of the new regime will be essential for its success. The Council retains discretion in enforcing fiscal discipline, although many decisions will now be taken by reverse qualified majority, making it harder to form blocking majorities. National fiscal institutions are being strengthened and could play an important role in improving fiscal performance. A wide range of reforms to financial oversight have been made, including the creation of EU micro- and macroprudential bodies. Additional reforms should tackle excessively close risk exposures between domestic banks and governments, which encourage moral hazard and add to risks of financial instability. The weak financial crisis management arrangements should be improved by strengthening bank supervision, backed by common financing relying as much as possible on private sector funds.*

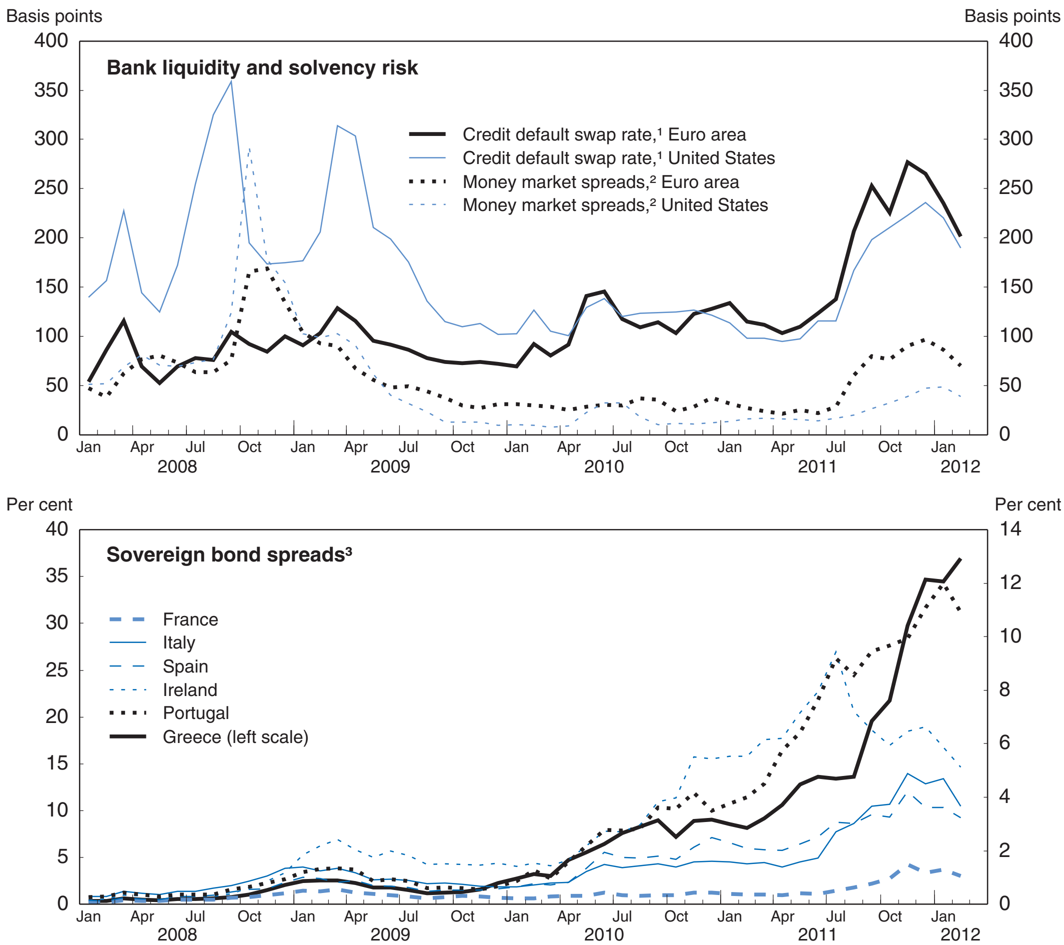
Assessment and recommendations

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

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

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

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



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

Source: Datastream.

StatLink http://dx.doi.org/10.1787/888932589601

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

Financial conditions have improved since December 2011 following policy actions by the European Central Bank (ECB), particularly the three-year long-term refinancing operation, although market conditions remain far from normal. The recent ECB non-standard measures support the transmission of monetary policy and are temporary. They build on earlier measures to support monetary transmission, including continued extensive liquidity support under fixed-rate full allotment tenders and additional steps taken in the summer of 2011 to reintroduce longer-term refinancing operations, the launching of a new Covered Bond Programme (CBPP2) of EUR 40 billion (0.4% of GDP), and making large additional purchases under the Securities Market Programme. New policy measures in December 2011 halved the minimum reserve requirement for banks, introduced two three-year long-term operations and changed the criteria for eligibility for certain asset-backed securities and for the use of credit claims as collateral in Eurosystem operations. In February 2012, the ECB approved some national central banks to apply temporary specific national eligibility criteria for collateral eligibility in eurosystem operations. As a result of these measures and demand under existing operations, the eurosystem's balance sheet has expanded sharply and the size of long-term operations exceeds its 2009 peak, while use of the deposit facility has jumped to close to twice its 2009 peak to EUR 450 billion (4.5% of GDP). This has contributed to lowering interbank rates to levels at the short end at or below the trough in 2009, as well as a lowering of sovereign spreads.

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

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

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

Table 1. **Selected economic indicators**

Percentage annual change

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

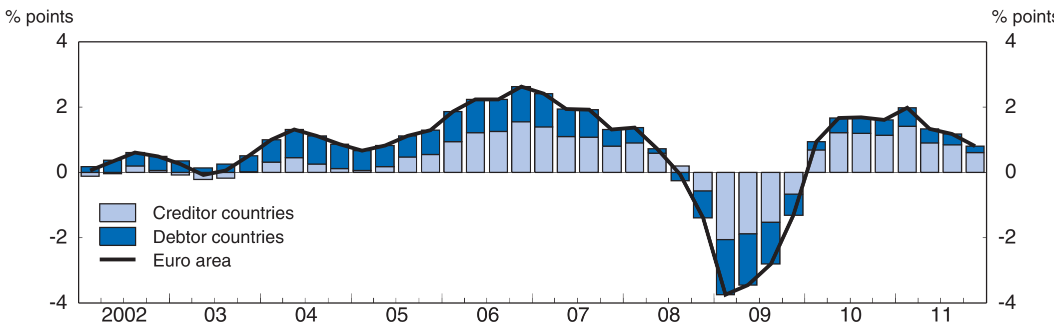
1. These projections are based on *OECD Economic Outlook*, No. 90.
2. Contribution to GDP growth.
3. Excluding energy, food, drink and tobacco.

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

Unresolved imbalances across euro area countries have delayed the resolution of the sovereign debt crisis and weakened growth prospects (Chapter 1). While current account imbalances have narrowed since 2007, countries that ran large current account deficits in the run-up to the crisis are experiencing financial and fiscal crises, and very weak private demand. Improvements in competitiveness have so far been modest and visible in only very few countries, notably Ireland. There has been some improvement in exports in countries that borrowed heavily during the credit boom, but too little to offset weak domestic demand. In surplus countries, saving has declined modestly but not enough to sustain aggregate demand in the euro area at its trend level. In countries with persistently low growth such as Italy, there is a need to return to a stronger growth path and improve competitiveness. Fiscal consolidation is now underway in all countries. On top of domestic factors, the impact of the sovereign debt crisis on confidence may contribute to the continued high saving in surplus countries. Any recovery in the euro area will remain fragile so long as the imbalances are unresolved (Figure 2).

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

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



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

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

StatLink http://dx.doi.org/10.1787/888932589620

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

Unemployment rose to 10.3% of the labour force in November 2011 and is likely to rise further as demand weakens. The unemployment rate stands at almost 23% in Spain, 19% in Greece, 14% in Ireland, 14% in the Slovak Republic and 13% in Portugal. The share of long-term unemployment in the euro area has risen to 45% with younger, older and less educated workers particularly hard hit. By contrast, the unemployment rate in Germany has been declining to reach low rates by recent historical standards. Compared with previous downturns, the impact of the 2008 recession on unemployment in the euro area as a whole has nevertheless been moderate relative to the fall in output, while the participation rate has held up. The increase in unemployment has been much less than in the United States. While this divergence remains to be fully explained, flexible work arrangements, the fruit of past labour market reforms, and short-time working schemes in a number of countries appear to have played a role. However, it is likely that these mechanisms will be less effective at cushioning the employment effects of the current downturn as firms might not view the renewed downturn as being as temporary as before, and because governments and firms may be less able than in 2008 to support these arrangements. Further labour market reforms would help in some cases to facilitate wage adjustments, to increase hiring incentives and crucially to reduce the likelihood that short-term unemployment becomes entrenched and that vulnerable workers lose their attachment to the labour market (Chapter 2). As set out in the *Economic Survey of the European Union*, removing obstacles to labour mobility across countries would help match workers to existing employment opportunities. Ultimately, a return to strong and sustainable growth is needed to bring unemployment down.

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

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

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

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

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

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

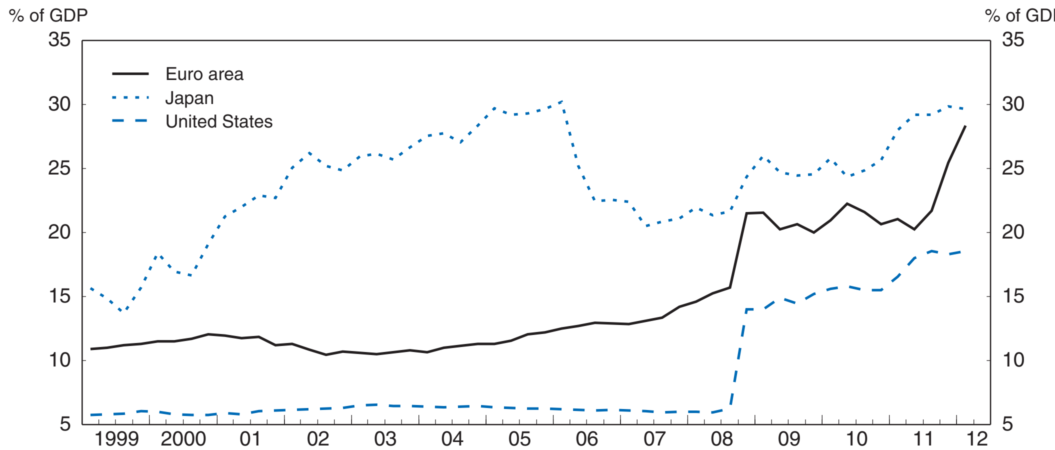
Box 1. **Main recommendations on resolution of the euro sovereign debt crisis**

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

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

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

Figure 3. **Total central bank liabilities**



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

StatLink http://dx.doi.org/10.1787/888932589639

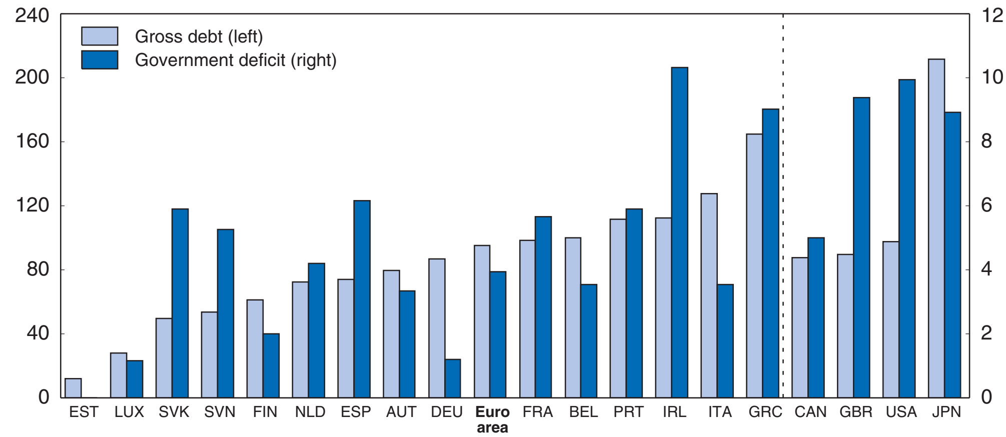
In the absence of significant changes in the medium-term inflation outlook, the monetary policy stance could remain accommodative to support overall demand through maintaining price stability, given the dampening effects on euro area aggregate activity of the sovereign debt crisis, private sector adjustment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

The public finances need to be strengthened

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

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

As a percentage of GDP, 2011



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

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

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

Fiscal consolidation is likely to have a downward effect on euro area domestic demand in the short term, although there could be some offsetting gains in terms of market or consumer confidence. While pro-cyclical policies should in general be avoided, there is little alternative for countries with no or vulnerable market access. In the current situation of fragile market confidence, ensuring fiscal sustainability is a key element underpinning economic stabilisation. Restoring credibility in the short run should create more fiscal space further ahead and facilitate normal access to financial markets. Furthermore, for some countries, fiscal consolidation is part of a deeper adjustment of public spending to a sustainable level: deficits are not being fully closed immediately but this process cannot be completely avoided. Even with relatively high estimates of fiscal multipliers and the elasticity of the budget balance to GDP, it is unlikely that consolidation of the budget balance would be self-defeating. To the extent that the causes of the current crisis are due to concerns about fiscal sustainability, addressing the fiscal challenges will help to put the economy on a more sustainable path. To maximise the impact of consolidation on medium-term sustainability, it should be used to introduce growth-friendly measures, including improvements to tax systems and more efficient public spending.

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

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

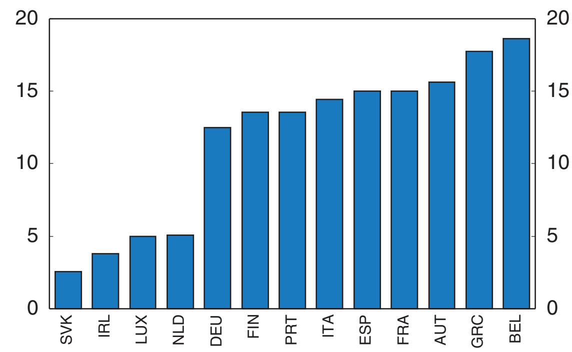
An ambitious package of structural reforms is needed to boost growth and rebalance the euro area

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

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

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

Ten-year horizon; levels, in per cent



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

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

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

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

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

Priorities in bold are part of the OECD Strategic Response

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

1. These reform priorities were set in 2010 and reported in the 2011 edition of *Going for Growth.*

Source: OECD (2011), *Going for Growth*, OECD Publishing, Paris.

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

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

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

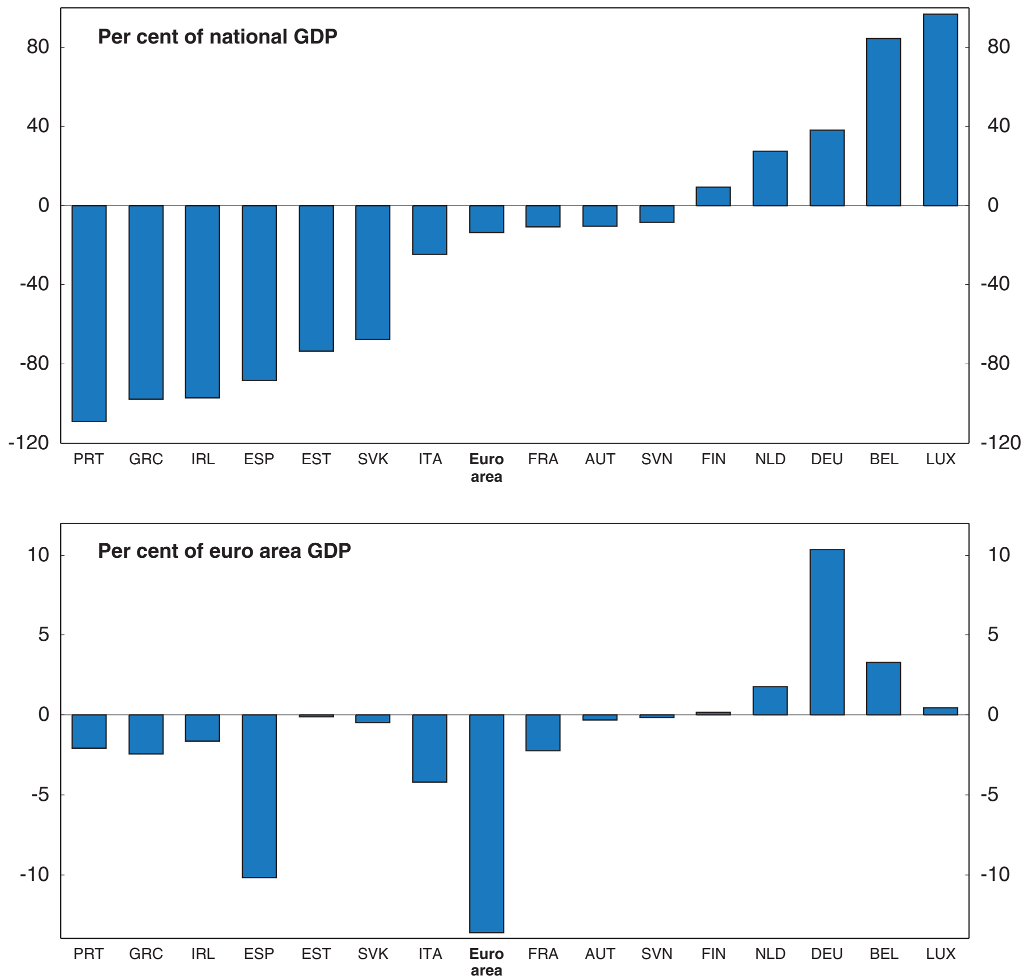
Stronger EU fiscal, financial and structural governance is needed to create stability

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

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

Figure 6. **Net foreign asset position**

In 2010



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

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

Strong fiscal institutions are needed to support the consolidation process and ensure that the inadequate budgetary discipline of the past is not repeated. At the EU level, the so-called "six-pack" of legislative measures also upgrades the Stability and Growth Pact, while a number of additional significant changes are being undertaken for the euro area, in particular the draft Regulation for enhanced monitoring of budgetary policies, the draft Regulation for enhanced surveillance for Member States with financial difficulties ("two-pack") and a new Treaty between euro area countries, which includes the "fiscal compact" (Chapter 1). Measures legislated in 2011 as part of the "six-pack" for strengthened euro area fiscal governance include a new system of earlier and more widely applicable sanctions to be activated on the basis of enhanced voting procedures, new benchmarks for expenditure and debt developments, much stronger requirements for statistical reporting and the obligation to strengthen national fiscal institutions. The new Treaty calls for a balanced budget requirement in structural terms in constitutional or equivalent national legislation. In addition, new legislative proposals from the Commission (the "two-pack") would require macroeconomic forecasts for the national budget to be made or endorsed by a body with functional independence from government and introduce a monitoring of draft budgetary plans to be presented in autumn. Recent reforms are a substantial improvement on the previous design of the Stability and Growth Pact. Effective implementation must now be achieved.

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

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

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

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

Financial governance is key to preventing future imbalances

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

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

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

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

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OECD Economic Surveys: Euro Area

Chapter 1

A sustainable euro area

The euro area sovereign debt crisis has its origins in the build-up of excessive economic, fiscal and financial imbalances in the euro area during the upswing of the credit cycle. Some euro area countries are experiencing severe financial and fiscal crises, as banking inflows have reversed and economic weakness has undermined the public finances. Resolving the underlying imbalances requires a range of policy responses across the euro area, notably structural reforms to bring savings and investment more closely into balance and a shift in relative prices across countries.

In the near term, events have exposed the need for a funding mechanism to deal with sovereign liquidity crises within the currency union. The euro area authorities have responded with the creation of the European Financial Stability Fund (EFSF) and the future European Stability Mechanism (ESM). The ECB has played a key role in ensuring that the banking system across the euro area has had appropriate access to liquidity.

The experience of the past decade underlined the need for a new cross-cutting approach to the governance of the euro area to avoid future imbalances and as the counterpart for the new crisis management arrangements. Economic, fiscal and financial governance and oversight have been strengthened significantly. However, implementation of the new framework will be key and further measures are needed in some areas, notably in creating a European system of financial crisis management and weakening the close link between banks and their domestic sovereigns.

The euro area is experiencing an economic, fiscal and financial crisis related to sovereign debt in several countries. Many of the origins of the crisis are in the build-up of excessive imbalances in euro area countries during the upswing of the credit cycle, as set out in the previous *Economic Survey* (OECD, 2010). Structural weaknesses contributed to these imbalances and the misallocation of capital. The imbalances led to heavy levels of private debt and a serious deterioration in the public finances in countries that undertook excessive borrowing, in part fuelled by inflows of capital from other parts of the euro area channelled through the banking system. These imbalances have led to boom-bust cycles and crises in countries with higher external debts, but also increased banking sector vulnerability in creditor countries. A severe adjustment process is underway in high debt countries and a number have become heavily reliant on official finance to support their banking systems and manage the economic and fiscal adjustment process. The rebalancing of the euro area in economic, fiscal and financial terms, including through structural reforms, is essential to restoring stability in the euro area and avoiding the risk of global spillovers.

The first section sets out the severe adjustment process in highly-indebted countries and continued vulnerabilities related to high debts, as well as the role of the necessary rebalancing of the euro area economy. The second section looks at immediate crisis resolution needs, as well as the institutions necessary to ensuring funding for countries with impaired access to market funding. The third section considers measures to strengthen economic and financial governance, which are necessary both to avoid moral hazard created by the potential availability of official financing but also to ensure that economic, fiscal and financial performance in the future is better than in the past and helps to avoid future imbalances.

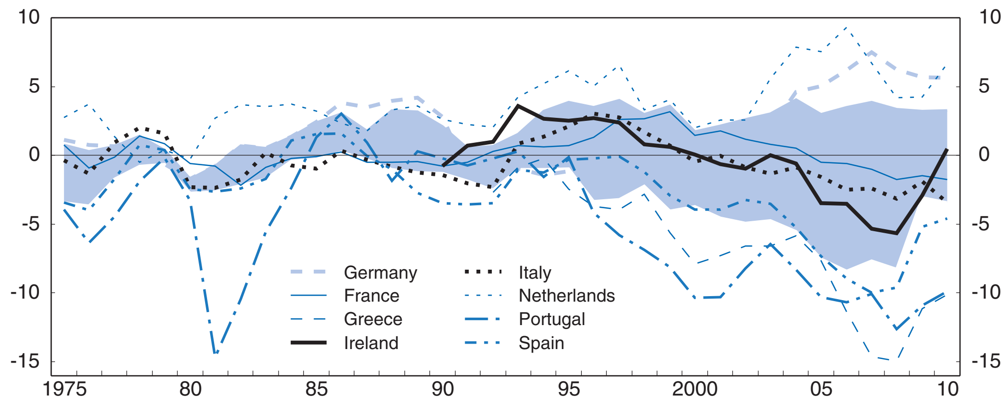
Rebalancing the euro area economy

Some countries are experiencing a severe crisis

The sovereign debt crisis in the euro area is part of the wider adjustment of large and persistent economic, financial and fiscal imbalances that built up during the upswing (OECD, 2010). Some of these imbalances, both surpluses and deficits, were larger than can be explained by economic fundamentals (Barnes *et al.*, 2010a). The excess imbalances resulted from a wide range of country specific shocks and insufficient macroeconomic and financial stabilisation. Destabilising movements in real interest rates contributed to diverging borrowing and saving patterns, fuelling credit booms and a weakening of competitiveness in some deficit countries. In some countries, weak growth and high public debt created internal imbalances, even in the absence of current account imbalances. Inadequate risk-pricing and weaknesses in financial regulation contributed to risk-taking in both deficit and surplus countries, leading to a misallocation of capital as unsustainable investment boomed in some countries. Weak structural policy settings contributed to excessive saving in some countries, the misallocation of capital and loss of competitiveness in others, and a lack of sustainable growth. Current account balances have narrowed substantially in deficit economies since the crisis began, while more limited reductions took place in surplus countries. Nevertheless, current account dispersion remains large by pre-EMU norms (Figure 1.1). As in historical episodes, the unwinding of imbalances through economic, financial and fiscal retrenchment is proving an unstable, costly and prolonged process.

Figure 1.1. **Current account balances**[1]

As a percentage of national GDP



1. The shaded area indicates the range between the 25th and 75th percentiles.

Source: OECD, *OECD Economic Outlook Database*.

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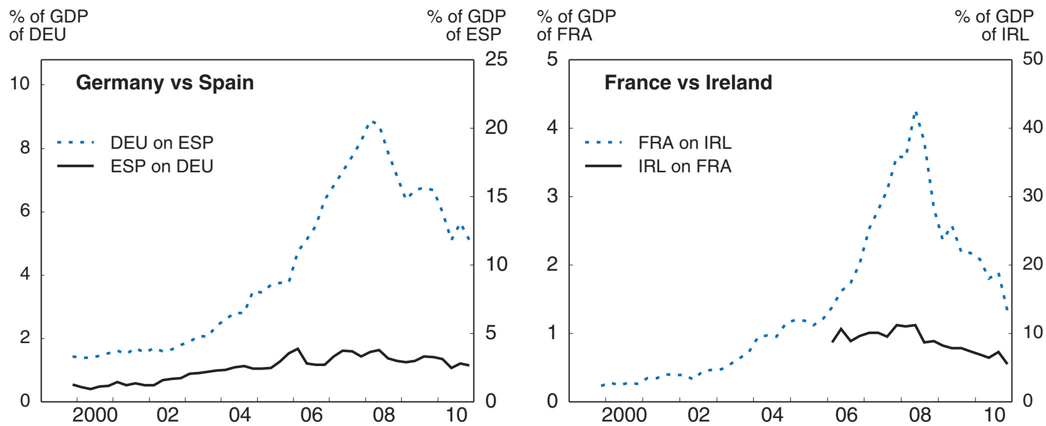
Some highly-indebted countries are experiencing financial crises

Financial adjustment in economies with large external debts has been severe. During the upswing, banks played a key role in channelling funds from economies with large surpluses to deficit countries, leading to the accumulation of considerable risks for borrowers and lenders (Barnes *et al.*, 2010b). The growing weight of debt in some countries was beginning to force a reduction in credit demand and house prices, even before the international financial crisis. However, as risk aversion increased, the risks of lending to more vulnerable economies were sharply reassessed. The tensions in international financial markets, notably for interbank lending, had a strong effect on banking systems that had relied heavily on outside finance, both in terms of their perceived solvency and liquidity. While idiosyncratic factors in terms of countries and institutions play a role, there have been very large reductions in bank lending from some countries to deficit economies (Figure 1.2). These developments are likely to be alleviated by the supply of funding that has been provided to these banking systems from the ECB through its monetary operations and non-standard measures, including longer term operations.

Financial adjustment has been amplified by domestic financial accelerator effects (Bernanke and Gilchrist, 1995). Given that domestic banks are typically very heavily exposed to their domestic economies, there is a powerful feedback mechanism between domestic weaknesses in credit quality and the overall availability of credit. On the one hand, the reduced value of collateral has sparked the *balance sheet channel*, reducing the creditworthiness of domestic borrowers: house prices have fallen in real terms since the crisis began by more than one-third in Ireland, almost one-quarter in Spain and close to one-fifth in Greece. On the other hand, large losses for domestic banks and their reduced

Figure 1.2. **Bilateral consolidated banking claims**

Claims of country X on country Y as a share of GDP of both countries in 2007



Source: BIS, *Consolidated Banking Statistics Database* and OECD, *OECD Economic Outlook Database*.

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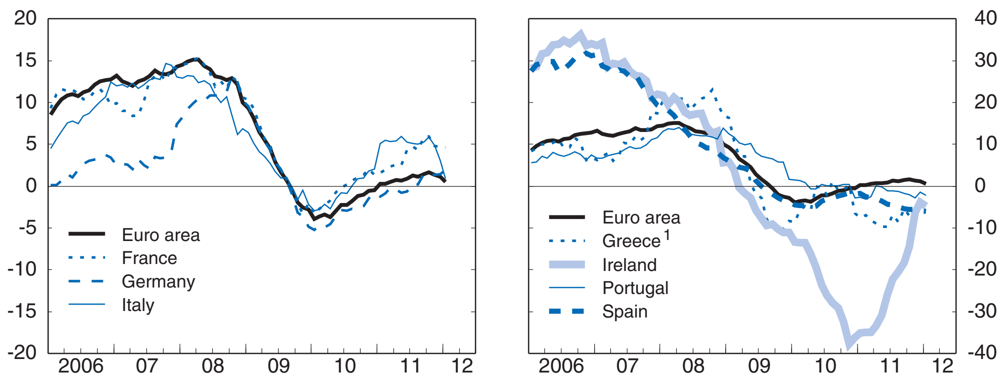
access to international finance have led credit availability to be reduced through the *bank lending channel*. The pressure on domestic banks can be seen through high costs of funding in the interbank market and extensive recourse in relation to their size to ECB monetary operations from institutions resident in countries such as Greece, Ireland, Italy, Portugal and Spain.

While credit demand plays a role in explaining weak new lending, credit supply effects are also exerting an important effect on loan dynamics. The results from the ECB Bank Lending Survey (for countries where it is published) show stronger tightening of standards in countries with large external debts than the euro area average, although these effects could reflect both the worsening outlook for lending as well as constraints on banks' ability to lend. Interest rate spreads on new mortgage loans are well above pre-crisis levels in Greece and have risen sharply in Portugal and Spain since 2010, while loan spreads have risen to very high levels for non-financial corporations in Greece and Portugal. Greece and, to a lesser extent, Ireland have experienced substantial reductions in the volume of deposits in domestic banks. While this may to some extent be the counterpart of deleveraging by the banking system, the withdrawal of deposits may itself be a factor forcing banks to reduce the size of their balance sheets, most forcibly in the case of Greece. There has been intense competition for deposits in some countries, notably Spain (OECD, 2011b).

Tight credit availability has contributed to a sharp reduction in credit and liquidity in some highly indebted countries. While the M3 broad monetary aggregate has increased moderately for the euro area as a whole since the crisis, it has contracted in Greece, Ireland, Portugal and Spain. Loan growth to households and non-financial corporations has been weaker in these economies than the euro area average: there have been falls in the stock of lending to households and to non-financial corporations in Greece, Ireland, Portugal and Spain (Figure 1.3). The reduced availability of credit could constrain spending substantially in some economies, contributing to weak demand in the short run and pointing to a protracted economic downturn. In the longer term, difficulties accessing financing for investment may reduce the ability of economies to recover and achieve sustainable growth. At the same time, some deleveraging is necessary in these countries to correct the previously built imbalances and bring debt to more sustainable levels.

Figure 1.3. **Growth of MFI loans to non-financial corporations**

Year-on-year percentage change



1. Adjusted for a break in series in June 2010 due to the inclusion of non-traded corporate bonds and exclusion of loans to sole proprietors from this date.

Source: Datastream.

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Excessive imbalances contributed to weak public finances

The intense financial crisis in some countries has contributed substantially to the marked weakening of the public finances and is leading to necessary but pro-cyclical fiscal consolidation. The sharp economic slowdown since 2007 has reduced cyclical revenues especially strongly in countries that had experienced strong credit cycles. Furthermore, the credit booms had created substantial revenue buoyancy as housing transactions, strong housing investment and high profits boosted revenues beyond those associated with a typical economic cycle. Between 2007 and 2009, government revenues fell by 15% in Spain and 20% in Ireland even after discretionary revenue raising measures. Losses in the banking system due to excessive risk-taking and credit growth have resulted in large costs to the tax payer and a substantial increase in government liabilities, both in terms of a weaker net asset position and in supporting the banking system by providing off-balance sheet guarantees (Table 1.1). The debt-to-GDP ratio has risen by around 30 percentage points in Spain compared with the pre-crisis level and by almost 90 percentage points in Ireland. Rapid and pro-cyclical fiscal consolidation has been required to deal with high debt levels or large deficits. Furthermore, concerns about the sustainability of the public finances contributed to rising sovereign risk premia and further market malfunctioning. Some further consolidation measures were put in place in the face of market pressure but these failed to restore confidence in Ireland and Portugal, which turned to official EU-IMF financing under "Troika" programmes as Greece had done earlier.

A rebalancing of demand and activity is required across the euro area

There has been some cyclical narrowing of current account imbalances, particularly as weak consumption and investment in deficit countries have reduced import demand. The economic adjustment in deficit economies has been driven by the contraction in domestic absorption resulting from private and public sector balance sheet rebuilding (Figure 1.4). By contrast, in surplus countries, domestic demand has been stronger and absorption has increased modestly since 2008 in most cases. However, this improvement may not be sustainable and current account balances may again widen as recovery starts. Permanent rebalancing requires, for deficit countries, an improvement in the competitiveness of their

Table 1.1. **Direct fiscal impact of financial rescues**

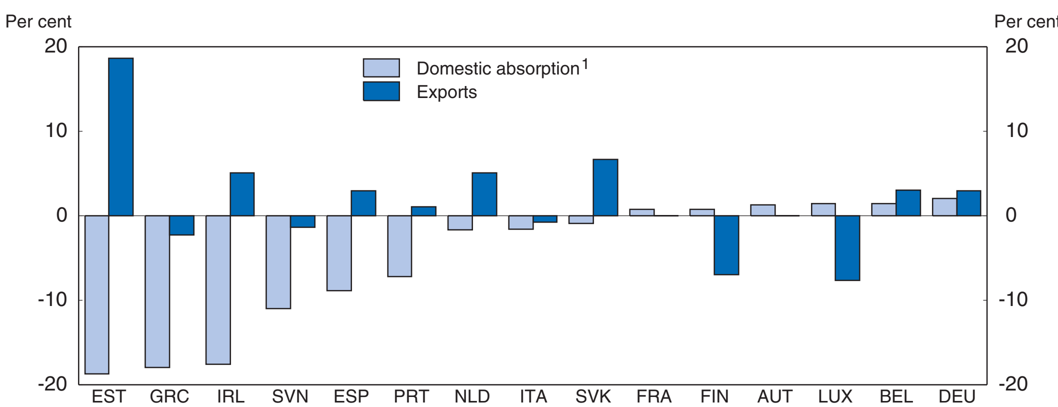
Per cent of GDP

	Net revenue/cost for general government	General government assets	General government liabilities	Contingent liabilities
	2008-10	2010	2010	2010
Austria	–0.5	2.0	2.6	7.8
Belgium	0.1	5.3	5.9	15.8
Estonia	0.0	0.0	0.0	0.0
Finland	0.0	0.0	0.0	0.0
France	0.1	0.1	0.0	4.7
Germany	–1.6	10.9	12.5	3.6
Greece	0.2	1.7	1.7	25.4
Ireland	–22.9	2.1	23.0	106.4
Italy	0.0	0.3	0.3	0.0
Luxembourg	–0.1	6.3	6.2	3.3
Netherlands	–0.6	8.5	9.0	6.8
Portugal	–1.3	3.6	3.6	3.1
Slovak Republic	0.0	0.0	0.0	0.0
Slovenia	0.1	0.0	0.0	6.2
Spain	0.1	2.3	2.5	5.7
Euro area (15)	**–0.9**	**4.3**	**5.1**	**6.5**
EU27	**–0.8**	**4.2**	**5.1**	**8.6**

Note: Gross costs over the period in some cases exceed net revenue costs as the result of gains or asset sales, while the assets and liabilities have also evolved through the crisis.
Source: Eurostat.

Figure 1.4. **Post-crisis changes in demand**

Change between 2008 and 2011



1. Defined as the sum of (public and private) consumption and investment.
Source: OECD, *OECD Economic Outlook 90 Database*.

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goods or a sustainable increase in the level of demand from other countries, either to crowd in export demand or further dampen import demand through substitution of domestic for foreign products. Some deficit countries, notably Ireland and Spain, have managed to improve export performance, although the gains are similar to those of Germany, a large surplus country. In the near term, such stronger export performance would have the additional benefit of helping to support demand. This permanent rebalancing requires changes in the situation of euro area countries with large excessive surpluses, as well as within the wider global economy. While domestic demand in the large surplus economies picked up over recent years, this recovery was relatively muted and it has been curtailed by the sovereign debt crisis. Overall, saving remains high in surplus countries due to the private sector and as fiscal consolidation begins to reduce government borrowing. High private saving, despite low real interest rates, is likely in part to reflect weak confidence and uncertainty related to the euro area as a whole.

The limited underlying rebalancing in part reflects the small reduction so far in the relative prices of deficit countries, with the exception of Ireland. Achieving nominal reductions in prices is difficult, particularly where product market competition is low and labour market institutions hinder downwards wage adjustment. While competitiveness has improved in terms of unit labour costs, this has often reflected productivity gains that are likely to be the counterpart of high cyclical unemployment. Changes in demand and relative prices in countries with excessive surplus could also contribute to sustainable rebalancing. While consumer price inflation over recent years has not been weaker in countries with deficits than in those with surpluses, this in part reflects increases in indirect taxes. Excluding these increases, inflation in Greece, Portugal and Spain has been below the euro area average, albeit by relatively small amounts. Inflation in the countries with the largest surpluses, Germany and the Netherlands, has been close to the euro area average.

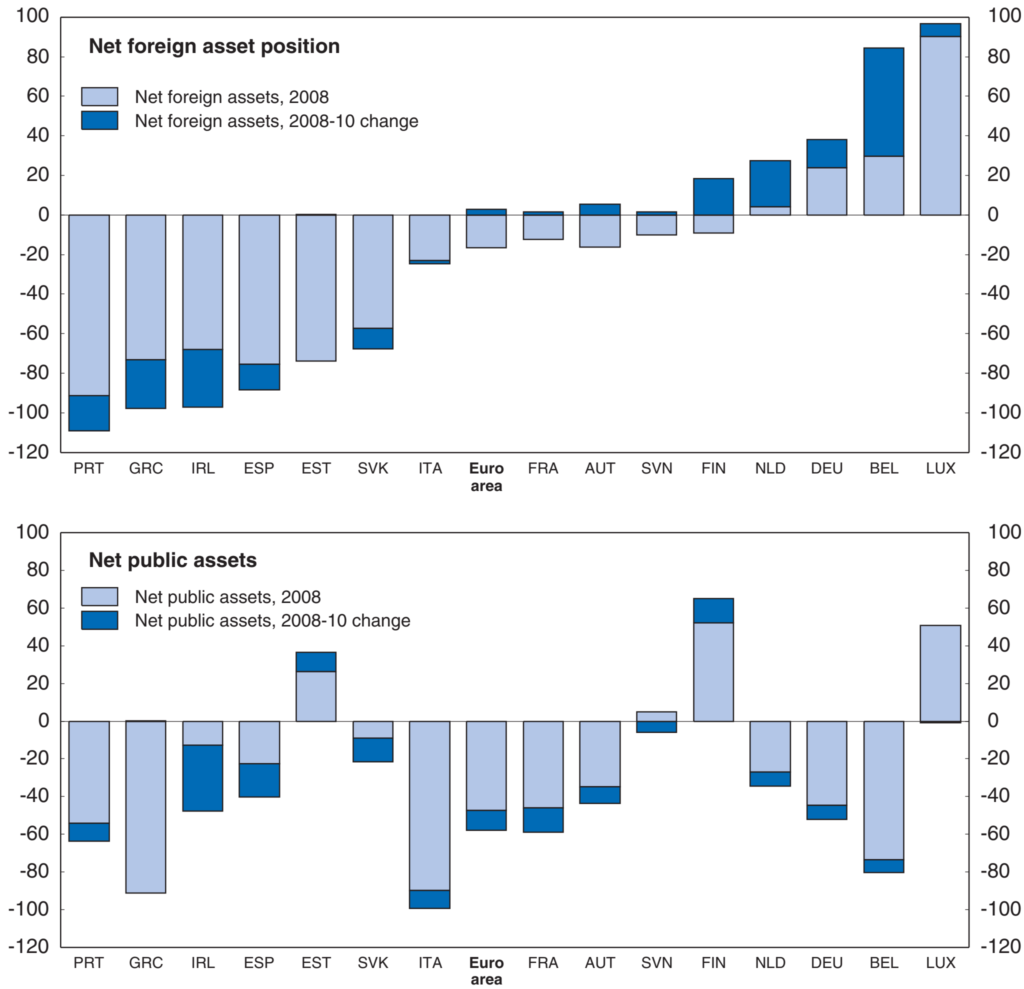
Risks to stability from imbalances remain

A key source of vulnerability in some euro area economies remains the high level of net external debt, which has increased since 2008 (Figure 1.5). The net foreign asset position as a share of GDP is far larger in Estonia, Greece, Ireland, Portugal, the Slovak Republic and Spain than the post-war norm for OECD countries and current levels in most OECD countries. While some of this is accounted for by net inward stocks of foreign direct investment or has been used to fund productive investment, much is likely to have been used to fund consumption or loss-making property investments. While the composition of national balance sheets differs widely (OECD, 2010), government debt now accounts for a large share of total exposures either because of past weakness in the fiscal position or the fiscal costs of deep banking crises. The high level of debt is likely to weigh on domestic demand for some time to come, depending on the combination of private sector balance sheet rebuilding, fiscal consolidation, and on policies addressing the weaknesses in the financial sector. This complicates the rebalancing of the economy through regaining competitiveness, as falls in nominal prices would tend to raise the debt burden in real terms (Fisher, 1933). While the possibility of a deflationary debt spiral in the sense of unanchored inflation expectations and ineffective monetary policy does not exist for individual countries in the monetary union, a rising real burden of debt can be a serious additional risk. The rising level of mortgage arrears in Ireland underlines the risks around the adjustment process in terms of high unemployment and deflation feeding back into financial sector and government risks (OECD, 2011c).

The high levels of external indebtedness raise questions about underlying sustainability. For the net foreign asset ratio to remain constant as a share of GDP, the trade balance must be equal to the net rate of return on net financial assets minus the growth rate of nominal GDP (in the absence of value changes and statistical discrepancies). In a number of countries with net external debts, the net rate of income paid out exceeds the likely growth rate over the coming years by some margin and the trade balance is too small to improve the net foreign asset position: this includes Greece, Portugal and Spain, which have large current account

Figure 1.5. **Net foreign asset position and net public assets**

As a percentage of GDP



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

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imbalances. While the composition of overall balance sheets and income streams is complicated and varies across countries, this points to risks that the net investment position is likely to deteriorate further and there will ultimately be a need for much larger adjustments.

The vulnerable position of countries with high debt poses risks to other euro area countries and globally. While there are some effects through the trade channel, financial linkages are likely to play the role in terms of contagion. Banks outside the most indebted countries are heavily exposed to risks emanating from those countries (Table 1.2). The main risks are to the private sector, through a combination of exposures to banks and non-financial corporations, but there are also exposures to sovereign debt. While the exposures are not huge relative to the size of creditor economies, they are substantial relative to the size of bank capital (Blundell-Wignall and Slovik, 2011). In addition, exposures are not evenly distributed across institutions, which can magnify the impact. Most importantly, contagion through risk premia for governments and financial institutions can be very significant, as shown by the unfolding of the sovereign debt crisis.

Table 1.2. **Cross-border banking exposures**

Per cent of creditor GDP, June 2011

Exposures to		Exposures held by						
				Of which:				
Country	Sector	Non-European banks	European banks	France	Germany	Italy	Spain	United Kingdom
Greece	Public sector	0.0	0.2	0.4	0.3	0.1	0.0	0.1
	Other	0.2	0.6	1.9	0.4	0.2	0.1	0.6
Ireland	Public sector	0.0	0.1	0.1	0.1	0.0	0.0	0.2
	Other	0.5	2.8	2.0	3.9	1.2	0.8	7.7
Italy	Public sector	0.2	1.3	3.7	1.3	0.0	0.7	0.7
	Other	1.2	4.6	14.1	4.8	0.0	3.0	3.5
Portugal	Public sector	0.0	0.2	0.2	0.2	0.0	0.5	0.1
	Other	0.2	1.2	0.9	1.2	0.3	6.7	1.1
Spain	Public sector	0.1	0.5	1.1	0.8	0.3	0.0	0.3
	Other	0.3	3.1	4.2	4.0	1.0	0.0	3.8
Other EU27	Public sector	1.7	5.7	6.3	3.0	3.9	4.1	6.7
	Other	17.0	51.9	58.4	47.7	42.5	49.8	48.3
Other countries	Public sector	5.0	11.3	10.2	3.7	2.5	16.8	32.9
	Other	31.4	65.8	70.3	52.4	18.4	54.0	145.2

Source: BIS (2011), *Consolidated Banking Statistics Database*, on-line extraction (December) and OECD, *OECD Economic Outlook Database*.

Structural reforms are the foundation of sustainable rebalancing

The sustainability of the external position of highly indebted economies would be improved by an ambitious programme of structural reforms aimed at achieving a higher income path. As explored in depth in Chapter 2, there would be significant gains in terms of GDP from undertaking such reforms. For surplus countries, such reforms could also stimulate investment and support stronger domestic demand. For countries experiencing severe adjustment from large current account deficits, increasing competition in product markets and removing restrictive labour market settings would help to boost competitiveness. There would be an advantage if competitiveness could be improved through higher equilibrium productivity, although wage and price reductions are also necessary. Stronger overall growth would make it easier for all countries to support the burden of accumulated debt and ease the adjustment process. While there is often a concern that reforms could have negative short-run impacts, many reforms would have substantial positive effects in the short run and could help to strengthen the confidence in the sustainability of all countries' external and fiscal positions. In the long run, achieving sound structural policy settings would help to avoid the recurrence of excessive imbalances.

Near-term crisis management measures are needed to avoid a very abrupt adjustment and contagion

In the near term, there is a need to ensure that capital continues to flow so that the rebalancing can be achieved without a costly "sudden stop" in the availability of financing, which would require abrupt correction of fiscal imbalances and limit options to support financial intermediation. Borrowing by the state has in effect substituted for external borrowing by other sectors, notably the banks: government borrowing now more than accounts for the entire external deficit in Greece and Spain and represents a high share in

Portugal. This is well above the share prior to the crisis, even in Greece where the underlying fiscal imbalances were the most serious. Furthermore, the governments in Greece, Ireland and Portugal lost market access, while interest rates on government debt in other countries, notably Italy and Spain, are at uncomfortable levels.

The pressures on governments' access to market finance may be especially high in the context of a monetary union without a fiscal union. The size of imbalances themselves and the more limited range of channels of adjustment may more easily call into question a government's position. In terms of liquidity crises, the lack of clear back-stopping mechanisms may lead to fragility. This in part reflects the absence of a national central bank (de Grauwe, 2011). In addition, there is potentially a high level of substitutability between different issuers of euro area government debt, given that the currency is the same. Together with the low liquidity of some sovereign debt markets, the ability to borrow of some countries is highly sensitive to information about their situation.

Loans from other euro area countries and funding from the ECB have avoided a "sudden stop"

The challenge of providing finance to countries that have had difficulties accessing private markets has been met in a number of ways:

- IMF standby facilities have been used by Greece, Ireland and Portugal. Bilateral loans have been used to finance the Greek Loan and bilateral loans from other EU countries have contributed to the assistance for Ireland.
- European financial assistance has been provided to Ireland and Portugal via the European Financial Stabilisation Mechanism (EFSM), a mechanism backed by the EU budget, and European Financial Stability Facility (EFSF), both set up in 2010. The EFSF is committed to providing funds for the second assistance package to Greece.
- Private sector involvement (PSI) has been agreed for Greece, which would involve a write-down of the face value of outstanding bonds in the context of an exchange.
- The ECB has supported the functioning of the transmission mechanism. In particular, the ECB has helped to alleviate the funding stress on banks, especially in countries most affected by the crisis. In this context, it has intervened in markets through the Covered Bond and Securities Market Programmes, where market malfunctioning had the potential to disrupt the transmission of monetary policy. National central banks in Greece and Ireland have provided Emergency Liquidity Assistance (ELA) on a persistent and substantial basis.

Overall, financing from all official sources, both in terms of government financing and provision of liquidity to the banking system, has been very large relative to GDP in Greece, Ireland and Portugal. Official financing in the form of loans has more than covered the current account deficit in Greece, and Portugal. Much of the financing has flowed abroad in interest and debt repayments to foreign holders of bank and sovereign debt. The Eurosystem has provided very substantial support in the course of its operations to alleviate funding stress in these countries and also to Italy and Spain. Taken together, all these measures have allowed sovereigns and banks facing varying degrees of difficulties in accessing market finance to continue to meet their financial obligations.

There are a number of design issues that the EFSF and EU support mechanisms have had to face, many of which have been resolved for the future European Stability Mechanism (ESM). This should allow the ESM to mobilise the maximum amount of funds rapidly and use them effectively, subject to appropriate conditions:

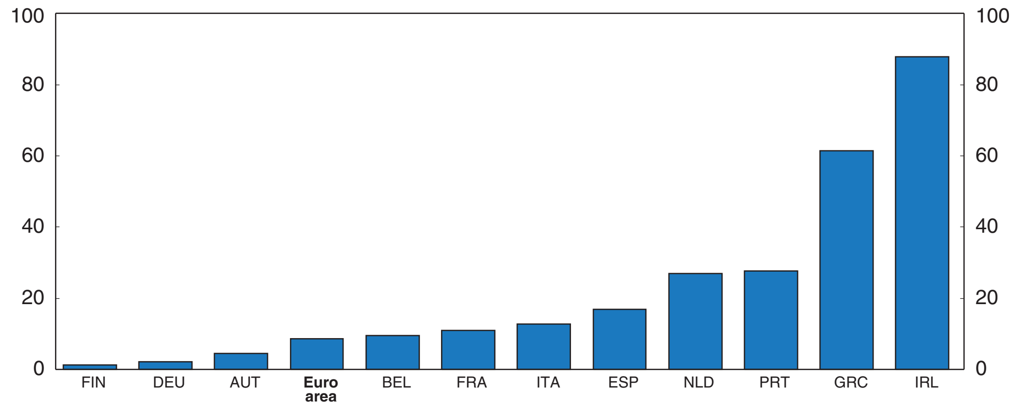
- In terms of ***financing***, the basic EFSF model is to borrow funds in the market from the private sector based on several but not joint guarantees from euro area countries, made in proportion to the ECB capital key. In its initial form, EFSF lending was over-collateralised to ensure greater protection for investors and to support its credit rating. The degree of over-collateralisation was reduced in July 2011, which increased the effective size of the fund to EUR 440 billion (around 4.5% of euro area GDP). As a way of maximizing the EFSF available resources, it was announced in autumn 2011 that the EFSF would be able to use two approaches to enhance the amount of loanable funds without increasing guarantees: it can either provide first-loss insurance for primary bonds issued by countries requesting financial support, or create one or more co-investment funds (CIFs) that would pool both private and public funds. The terms and conditions for these approaches have been set out and agreement on a prospectus reached. There has been no need to date to call upon these arrangements; as such, these structures remain untested. The European Stability Mechanism will be more robust as it is based on paid-in and callable capital rather than guarantees. Both guarantees and paid-in capital have implications for the fiscal position of countries providing support, notably paid-in capital which carries an upfront spending cost. Any increase in the size of the firewall would need to be balanced against fiscal and moral hazard considerations. The size of overall financing through the EFSF has, taken together with other mechanisms, not fully restored confidence in euro area sovereign debt markets. The size of the ESM's loanable funds remains similar to the EFSF at EUR 500 billion with a maximum joint lending capacity of the same size. The European firewalls should be expanded further and made more credible to restore confidence. Euro area governments have agreed that the adequacy of this cumulative capacity of EUR 500 billion will be reassessed in March 2012, prior to the ESM's expected entry into force.
- Effective but not excessive ***conditionality*** is needed to ensure that governments pursue policies consistent with improving their creditworthiness and regaining market access. The availability of financial assistance mechanisms, such as the EFSF, may create a greater risk of moral hazard. Furthermore, weak governments may simply and irrationally fail to implement the right policies. For these reasons, it has been appropriate that conditionality has been required of borrower countries. One risk is that euro area countries may be less willing to discipline each other effectively due to a wide range of economic and political ties, or because they cannot credibly commit to withdrawing funding. The involvement of the IMF may provide an additional safeguard. While conditionality is necessary, the conditions imposed should not be so severe as to undermine the solvency of the country receiving help. In terms of the credibility of the back-stop arrangement, it is important to avoid excessive "stigma" in seeking help, where it is genuinely needed, and for support to be realistic in terms of its political and social impact. In all cases where official finance has been sought, great reluctance has been shown to enter the programmes. The initial pricing conditions of the EFSF, a spread of 300 basis points over the cost of funding, created a tension with improving the debt sustainability of borrower countries. This has been lowered almost to eliminate the spread, along with the need to maintain a cash buffer.

- The ***decision-making*** of the EFSF requires approval of all its directors, one from each euro area country nominated by finance ministries. Parliamentary approval by the respective members is in principle required for advancing EFSF lending because of the EFSF's guarantee structure. This requirement makes approval a drawn-out process and creates the risk that a single country could block the approval of necessary support, undermining the credibility of the EFSF as a backstop. The ESM is allowed to make disbursements based upon approval by its Board of Governors, because of the mechanism's capital structure, so disbursements do not require parliamentary approval. The ESM, furthermore, has an emergency voting procedure, which can be invoked by a joint decision of the European Commission and the ECB that financial stability is at risk more broadly, under which it can agree upon disbursements not by unanimity but by an 85% qualified majority. Both these changes, relative to the EFSF, should contribute to the speed and credibility of the provision of ESM assistance.
- The ***scope*** of EFSF support was originally limited to providing stand-by loans. It was widened in July 2011 to include purchases of bonds in the primary and secondary markets, precautionary credit lines and loans to governments to support their financial systems. The ESM has the same set of instruments, although this could be extended by agreement by its Board of Governors. While the flexibility that comes with a range of instruments is useful, it is important to articulate clearly how they will be used.
- For countries that are insolvent, it is inappropriate to provide support without debt restructuring to ensure that long-term sustainability is likely to be achieved. The ESM, unlike the EFSF, would contain an explicit mechanism for assessing the solvency of a country before providing finance. Given the self-fulfilling nature of debt sustainability at different interest rates, this should be based on some reasonable assumption of normal interest rates in the euro area. For countries that were not deemed solvent, the ESM would require voluntary ***private sector involvement*** in line with "IMF practices". The explicit possibility of private sector involvement, however, can increase market perceptions of risk, as occurred when spreads rose for a number of countries during the debate on these issues in the autumn of 2010 and as private sector participation for Greece was advanced in 2011.
- The ***creditor status*** of official financing can be important both for the protection of official creditors and the claims of private lenders. EFSF debt ranks *pari passu* with all other obligations. ESM debt will have preferred creditor status in a similar fashion to that of the IMF, while accepting preferred creditor status of the IMF over the ESM. It is essential for the functioning of market discipline that private sector creditors should in principle bear some of the burden of any required reduction in the size of debt. This reduces the potential moral hazard for sovereigns by reducing the moral hazard for lenders.

The ECB has played a major role in providing liquidity to distressed banking systems and intervening in securities markets (Figure 1.6). These measures have been appropriate for maintaining the monetary policy transmission mechanism in the euro area, a pre-condition for ensuring price stability. While the risks to the Eurosystem balance sheet remain small, these actions have implied some underlying transfer of risks between euro area countries through the sharing of risks in the Eurosystem. The risk management of the ECB relies on its assessment of the quality of collateral and of the financial soundness of its counterpart. In terms of its capital position, the ECB has the right to call more capital from the national central banks. Emergency liquidity assistance (ELA), which is undertaken

Figure 1.6. **Central bank liquidity to national banking systems**

As a percentage of national GDP, end-January 2012[1]



1. End-December 2011 for France, Germany, Greece, the Netherlands and Spain.

Source: ECB and respective national central banks.

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by national central banks and which is subject to prior approval by the ECB's Governing Council in case it may interfere with single monetary policy, has been used on a substantial and on-going basis in some euro area countries to support the banking system. While not formally a risk to the Eurosystem balance sheet, this does have an impact on the position of some of its members. The ECB has no explicit power to impose conditionality on a country benefiting heavily from support. In dealing with problems in vulnerable countries, it is therefore important that other policy actors, including support mechanisms backed by euro area governments, are available and used appropriately so that there is not undue pressure on monetary transmission in those economies.

Strengthening euro area economic, fiscal and financial governance

The crisis and the underlying build-up of imbalances pointed to the need for a new and cross-cutting approach to economic and financial management in the euro area, as argued in the previous *Economic Survey of the Euro Area* (OECD, 2010). The experience of the monetary union, particularly developments in the run-up and during the crisis, underline the need to use other policy instruments in the absence of domestic monetary policy to achieve economic stabilisation and the necessity of having strong structural policies in place. The crisis has also demonstrated how weak economic, fiscal or financial policies in some countries can create risks to other countries in the euro area. Economic, fiscal and financial governance need to be strengthened both at the euro area level and through stronger national institutions. There are close interlinkages between the fiscal and financial governance issues. In addition, reforms are needed to economic and financial structures to address the underlying pressures than can lead to excessive imbalances. In the context of the current crisis in the euro area, these measures would in part help to resolve the crisis directly and also indirectly through restoring confidence to the euro area sovereign debt market. Substantial progress has been made in terms of economic and financial governance but effective implementation is now needed and some further measures remain necessary.

The EU and euro economic governance framework have been strengthened in a number of ways. The new EU Semester draws together economic, fiscal and structural surveillance in an annual cycle and leads to country-specific recommendations with precise timelines. Furthermore, there have been a number of cross-cutting political commitments among euro area countries to stronger co-ordination, including through the notification to the Council of proposed national measures that could have an impact on the overall functioning of the euro area. The so-called "six-pack" of legislative measures, a package of five regulations and one directive, forms the basic structure of reinforced economic co-ordination in terms of imbalances and fiscal policy, addressing both the strengthening of the EU policy framework and the improvement of domestic fiscal governance instruments (EC, 2011f-k). At the same time, greater emphasis on requiring measures to reinforce governance at national level is a key change compared to the previous EU fiscal framework. In addition, the Euro Plus Pact contains political commitments to a number of measures. The European Commission has made proposals for two additional regulations, dealing with strengthening economic and budgetary surveillance for countries with major risks of financial instability and with enhanced monitoring of budgetary policies and correction of excessive deficit procedures, as well as a discussion paper on a common euro area bond (EC, 2011c; EC, 2011n). A new intergovernmental Treaty between euro area countries and some other EU countries on "Stability, Co-ordination and Governance in the Economic and Monetary Union" was agreed in January 2012, which includes the "fiscal compact". The key provision is that national law of binding force and permanent character should require the budgetary position in structural terms to be balanced or in surplus. For euro area countries, the existence of adequate legal arrangements is subject to financial sanctions to be applied by the European Court of Justice.

Economic governance has been strengthened, but implementation risks remain

A new surveillance and enforcement procedure has been in force with the "six-pack" since December 2011. This includes procedures with the aim of preventing and correcting macroeconomic imbalances. This is based on continuous surveillance by the Commission based on a wide set of indicators with agreed indicative thresholds, complemented with broader economic analysis. The analysis of the European Systemic Risk Board (ESRB) is taken into account in the overall assessment. There are three steps to the Macroeconomic Imbalance Procedure:

- An ***alert mechanism*** by which the Commission can identify countries where there are potentially harmful imbalances based on the scoreboard and its own analysis. This is followed by in-depth examination of these imbalances and their drivers.
- ***Preventive action*** in the form of a recommendation from the Council to the country, based on a proposition from the Commission and informing the European Parliament and the Eurogroup.
- The ***Excessive Imbalance Procedure*** where imbalances are deemed "excessive". The core of this is that the Council may request a country to submit a corrective action plan. The Council may assess non-compliance, either if insufficient corrective plan is submitted or insufficient action is taken, based on a proposition from the Commission and voting with a reverse qualified majority. An interest-bearing deposit of 0.1% of GDP would be imposed where corrective action is not taken, transformed into a fine if two successive assessments of non-compliance are made.

The new procedure addresses an important issue but, wide-ranging surveillance mechanisms have existed for a long time, including the Broad Economic Policy Guidelines. However, these tools were effectively not used in the past. The design of the reformed framework may be more effective for a number of reasons. *Firstly,* the procedures related to imbalances are more clearly defined and should give rise to much more systematic surveillance and analysis than previously. *Secondly,* the scoreboard introduces more explicit criteria and has numerical thresholds that are likely to create a presumption of action at the trigger points, even if the consideration of additional indicators and the in-depth review necessary to identify excessive imbalances with significant spillover effects will then be taken into account. *Thirdly,* there is a procedure for dealing with excessive imbalances and non-compliance is assessed by the Council with a reversed qualified majority. *Fourthly,* there is the new possibility to impose sanctions, although the fine of 0.1% of GDP is likely to have a largely symbolic impact. *Fifthly,* there is greater involvement of other institutions such as the Eurogroup, European Parliament and the ESRB, which should raise the political profile of these issues and encourage policy action across a range of areas. In addition, the experience of the crisis is likely to make countries more aware of the risks posed by excessive imbalances, leading to greater political will to make effective use of this mechanism.

The imbalances procedure, however, will continue to rely heavily on the use of judgement exercised politically. There is a significant risk therefore that enforcement could be weak, making only limited progress compared with the past. This problem is exacerbated by the complex and poorly understood economic relationships underlying imbalances. The Commission will have to play a more courageous role than in the past: it will be important to act early where excessive imbalances are identified if it is to build a reputation for effective enforcement. The reverse majority voting may help given that it is more difficult to form a blocking majority against the Commission's propositions than to avoid finding majority support because countries would need to vote against the proposal rather than simply abstain. However, there is no guarantee that the Commission's propositions would be passed under this procedure. This procedure applies only to the assessment of non-compliance and also for the applications of sanctions. The large number of countries potentially subject to surveillance and corrective measures could reduce their support for enforcing discipline, given the high probability of falling under the procedure themselves. Determined implementation of the new procedure by the Council will be therefore crucial.

While applying both to surpluses and deficits, the current account thresholds in the scoreboard are 4% of GDP for deficits and 6% for surpluses, while the criteria regarding nominal unit labour costs, the net international investment position and the change in the export share only apply on the side associated with deficits (EC, 2011l). The imbalances problem cannot by definition be solved entirely on one side. While there needs to be differentiation across different situations and other factors taken into account in the overall assessment, which should be clearly justified, it is unclear that all the asymmetries in the scoreboard are warranted.

Given the limits of discretionary policy instruments to deal with imbalances, appropriate structural policies are essential to avoiding excessive imbalances (OECD, 2010; Chapter 2). The build-up to the crisis offers many examples of structural policies contributing to imbalances, such as restrictive product regulations depressing investment, inefficient housing support encouraging wasteful housing investment and labour market institutions that failed to maintain wages in line with productivity. A substantial range of reforms has been undertaken during the crisis that will help to remove these weaknesses in the longer term, such as reductions in severance pay in Spain, reforms to housing taxation in Ireland and removing restrictive product market barriers in Greece. However, further efforts will be required across euro area countries to ensure that economic structures are well aligned with the discipline of being in the monetary union. This should include effective implementation of the Single Market, as discussed in the *Economic Survey of the European Union*.

Stronger fiscal governance is envisaged at European and national levels

Weak fiscal policy settings contributed to imbalances during the upswing and poor fiscal performance has been a problem itself in euro area countries. As with many other OECD countries, government indebtedness has been on a rising trend since the 1970s: the debt-to-GDP ratio was almost 90% in 2011 on a Maastricht basis, around 30 percentage points higher than in the two previous decades. This is the result of a pattern of failing to run sufficiently large budget balances in economic good times, indeed there were consistent deficits over this period in most countries.

Fiscal institutions need to be more effective than in the past at both national and EU level to respond to new fiscal challenges, as well as to ensure that the inadequate fiscal discipline of the past ends. The necessary fiscal consolidation of the coming years is more likely to occur if there are sound institutions to support it and to give credibility to the necessary budgetary commitments. In addition, new mechanisms to provide liquidity support to euro area countries may increase moral hazard unless robust safeguards are put in place. While it is unclear that the expectation of "bail outs" undermined fiscal discipline in most euro area countries in the past, this risk may be stronger when explicit support mechanisms are in place, although this is tempered by conditionality. The main difficulties have been the combination of weak national and EU fiscal institutions, and ineffective market discipline during the period when funding costs were almost identical for all euro area countries, despite marked differences in underlying risks. At the EU level, there was a lack of effective enforcement of the rules, with for example no country being fined and widespread failure to meet Medium-Term Objectives (MTOs). Furthermore, the rules did not address the underlying fragility of the public finances in Ireland and Spain during the upswing, which fully complied with the rules just before facing major fiscal crises (OECD, 2010). In addition, there were significant weaknesses in national fiscal institutions in many countries.

Substantial changes have been made in euro area fiscal governance but implementation remains subject to Council discretion

A major reform effort has been made through the "six pack", Euro Plus Pact and other political commitments to strengthen the fiscal framework for euro area countries. The "fiscal compact" of the new "Treaty on Stability, Coordination and Governance in the EMU" makes some further changes. The main pillars of the strengthened fiscal institutions are (see Box 1.1 for details of reforms to the Stability and Growth Pact (SGP)):

- A wider range of sanctions for non-compliance, including earlier sanctions in the form of deposits rather than fines and new explicit sanctions under the "preventive" arm of the SGP.
- Clearer decision-making procedures and the application of reverse majority voting to a number of Council decisions. There is a benchmark rule for reducing debt, where it is above 60% of GDP.

Box 1.1. **Key reforms to Stability and Growth Pact**

Faster and clearer implementation of the excessive deficit procedure

- A numerical **benchmark** for reducing the debt-to-GDP ratio when it is above 60% of GDP: on average over three years, the debt ratio must fall by an amount approximately one-twentieth of the gap with the 60% ceiling taking into account the effect of the cycle. For three years following the correction of excessive deficits at the time of the entry into force of the new rule, the benchmark does not apply in full, but sufficient progress towards compliance is necessary.
- The previous definition of "**exceptional**" circumstances as a major "unusual event outside the control" of the government is augmented by a "severe economic downturn for the euro area or the Union as a whole".
- There is a stronger economic assessment of compliance, including implicit liabilities, up-front costs of pension reforms, excessive macroeconomic imbalances and potential growth.
- Corrective action can be requested within **three months**, compared with the standard deadline of up to six months, if an urgent need for action is identified.

Clearer requirements under the preventive arm

- The country-specific **medium-term budgetary objectives** (MTOs) for the cyclically-adjusted budget balance (net of one-offs) remain in place. "Windfall revenues" and the impact of structural reforms are taken into account.
- The **benchmark** for "significant" deviation from MTOs is set at 0.5% of GDP in one year or 0.25% in two, while compliance with an expenditure benchmark, windfall revenues, up-front costs of pension reforms and events outside a country's control should also be taken into account. For countries with debt above 60% of GDP or "pronounced sustainability risks", an improvement of *more* than the existing 0.5% benchmark improvement in the balance will be considered.
- The **procedure** for determining non-compliance is expected to take six months at the most. The Commission should formally report its recommendations to the Council. If a Commission recommendation is not taken up by the Council, the recommendation is subject to approval on a reverse *simple* majority votes.
- Assessment of the progress towards MTOs will include the **path of expenditure net of revenue measures**, which will be expected to grow below a medium-term rate of potential GDP until MTO is achieved. Expenditure excludes interest, unemployment benefits and EU matching payments.

Effective enforcement of budgetary discipline for euro area countries

- An ***interest bearing deposit*** of up to 0.2% of GDP, where a country fails to take action on response of a Council recommendation to correct "significant deviation" from the medium-term budgetary objectives (MTOs). The Council's decision is subject to reverse qualified-majority voting (RQMV), although it can amend the proposal by QMV.
- A ***non-interest bearing deposit*** of up to 0.2% of GDP can be required, where the Council identifies an excessive deficit and a country is already subject to an interest bearing deposit or non-compliance is "particularly serious" with legal budgetary obligations of the SGP.
- A ***fine*** of up to 0.2% of GDP if the Council, acting under Article 126(8) TFEU, decides that a country has not taken effective action to correct its excessive deficit Outstanding non-interest bearing deposits will be converted to a fine. The fine under Article 126(11) of the Treaty remains available.
- The Commission will have the power to investigate where there are "serious indications" of possible ***manipulation of statistics***, which may be sanctioned with a fine of up to 0.2% of GDP.

- A balanced budget in structural terms in national legislation at a high level, preferably constitutional. Under the new Treaty, this law would need to be of binding character and have permanent force. This closely mirrors the MTO but in a national rather than EU framework.
- Requirements for stronger statistical standards in terms of independence, coverage, timeliness and accuracy, together with stronger budgetary surveillance by the Commission.
- At national level, a multi-year numerical fiscal rule and macroeconomic forecasts to be made by a body with functional independence from the government. In addition, there are requirements in other areas such as budgeting and statistical reporting.

These reforms are a substantial improvement on the previous design. The wider and earlier applications of sanctions should increase the credibility of enforcement. The earlier design had the weakness that sanctions could generally only be applied when it was essentially too late for a country to avoid a bad outcome and when it was likely to be facing considerable difficulties that a fine would only exacerbate. The new procedures are clearer and comprehensive. This includes the requirement to reduce debt according to a numerical benchmark, which addresses the problem that some high debt countries made very little progress in this regard prior to the crisis. The amount and quality of information on which countries are assessed are considerably strengthened, reducing the deficiencies that could lead to significant revisions similar to those in Greece. National statistical offices will be required to be independent in the sense of having robust and autonomous recruitment and dismissal procedures, stable budget allocations and pre-established dates for publication of key releases. These bodies will be subject to EU guidance. In addition, there will be stronger surveillance by the Commission and the Council of budgetary situations and a more intrusive regime is proposed for countries emerging from programmes or deemed to be vulnerable (EC, 2011m; EC, 2011n). The information provided in the annual *Stability Programmes* will be more harmonised and detailed, including the requirement for national forecasts to be based on a most likely or more prudent scenario. Differences with Commission forecasts will need to be explained.

The improvements in design, however, are set within a similar overall approach to the pre-crisis regime. A key problem in the past has been weak enforcement by the Council. Under the new legislation, the Council retains a range of discretion. While the legislation says that the advice of the Commission should be followed “as a rule” or the Council should explain its position publicly, this lacks substantive legal meaning. Some political commitments have also been made. However, in a legal sense, there remain a wide range of margins of discretion. The enormous complexity of the rules and what they mean for fiscal policy may hinder their effective implementation and the amount of buy in. The reverse majority voting procedure is applied in a number of situations related to requiring deposits/fines, but does not apply across all stages of the procedures although its use would be widened under the new Treaty. While for given voting behaviour switching the majorities in this way could be decisive in terms of the application of sanctions, countries may change their voting behaviour in view of the new structure of incentives if they wish to enforce a lower standard than that recommended by the Commission. The current crisis may shift preferences towards greater discipline by underlining the costs of bad policies in other countries, but this could be offset by resistance as many countries will face tight restrictions for a long time. The enforcement of the rules has been strengthened as the Commissioner for Economic and Financial Affairs has been granted greater independence from the college of

Commissioners when making recommendations to the Council in this area. This could help the Commission to take a more independent line and make it harder for countries to exert political pressure to avoid the Commission making tough recommendations.

The new fiscal rules include two new numerical standards. The first is the benchmark 1/20th reduction of the excess of the debt-to-GDP ratio over 60%, calculated as an average over three years. This will make it easier to assess when countries are making enough progress towards reducing debt when it is at high levels. The formula lacks a clear economic rationale. It implies large adjustment in the short run when debt is at levels well above 100% of GDP and then only modest reductions while debt is approaching the 60% ceiling. The rule is asymptotic so it never even reaches the 60% level, even though this level is intended to be a ceiling rather than a target. Furthermore, the 1/20th benchmark is unlikely to bind very often in an economic sense for two reasons: *firstly*, consolidating enough to achieve it and then taking no further action means that the rule ceases to bind; and *secondly*, the MTOs are in most cases stricter in terms of the required budget balance. However, it could make a difference in procedural terms as it is part of the Corrective arm of the SGP, by contrast with the MTO which is in the Preventive Arm and subject to different procedures. The second new numerical standard refers to constraining spending to grow in line with trend growth (see Box 1.1). While this was initially proposed as an expenditure rule in its own right, it was downgraded to a factor to be taken into consideration in assessing compliance with the MTOs. The benchmark is well designed as it allows the automatic stabilisers to operate and tackles the temptation to spend revenues gain in good times. Countries undertaking successful fiscal adjustment have often combined budget balance and expenditure rules (IMF, 2009).

MTO targets and structural balance rules could be very demanding for high debt countries

The Medium-Term Objectives (MTOs) play a central role in the new EU fiscal governance framework. In the near term, countries emerging from EDPs with 3% deficits are likely to have large structural deficits and additional consolidation will therefore be required to comply with the MTOs. Simulations, based on 2011 *Stability Programme Updates* and the OECD *Medium-Term Baseline*, suggest that the consolidation phase under minimum MTO requirements would be very prolonged (Barnes *et al.*, forthcoming). However, the current MTOs also imply a very rapid rate of reduction in the debt-to-GDP ratio. This is because, for countries with high debt levels, an overall budget balance close to zero implies a very large primary balance and fast paying down of debt. The simulations imply a reduction in the debt-to-GDP ratio, typically averaging 1.5 to 2 percentage points of GDP per year from 2012 to 2020.

Requirements under the MTO for the structural budget balance, which are country-specific but has to be a least –1.0% of GDP, imply a rapid reduction in the debt-to-GDP ratio in many countries by historical standards. Standards specified in terms of the overall budget position imply a very large primary balance when interest payments are high. There is a risk that the required fiscal policy will be considered too demanding economically and politically. While it is important to reduce current levels of debt to a more prudent level, the process needs to be balanced appropriately against demand management and other economic and social objectives, as well as structural reforms to boost growth potential. The pressures to run tighter policies could be increased if the country-specific MTOs are revised in 2012 based on the existing formula: although this has never been published, applying the coefficient on high debts implied by past MTOs

(Biraschi *et al.*, 2010) suggests that required balances under the MTOs would be further *increased* relative to past norms, unless pension reforms substantially offset the impact of higher debts. There are two further risks with the design of the MTOs. *Firstly,* the implied steady-state debt-to-GDP ratio from a balanced budget will tend to be extremely low, close to 0 and far below 60% of GDP. This could partly be offset by allowing the country-specific MTO of a low debt country to be less demanding, but the MTO budget balance is bounded at –1% of GDP for euro area countries. *Secondly,* the structural balance targeted by the MTO is based on a common methodology that has proved unreliable in the past for some countries. This creates the risk that, taken at face value, country-specific MTOs are either too strict or too lax relative to the basic objective.

Table 1.3. **Scenarios for fiscal developments under EU rules**

Per cent of GDP

	Debt-to-GDP ratio				Primary balance	Structural balance	MTO
	2011	Peak	2025	Difference from 2011	Average 2011 to 2025		
Austria	74.0	75.5	47.2	28.3	*1.8*	–0.7	0
Belgium	96.7		59.4	37.3	*3.0*	–0.5	0.5
Finland	58.6	60.7	28.7	32.1	*1.8*	0.6	0.5
France	84.5	86.9	53.0	33.8	*1.9*	–1.0	0
Germany	83.2		59.2	24.0	*1.9*	–0.7	–0.5
Greece	149.2	151.8	83.6	68.3	*5.5*	–0.9	0
Ireland	112.6	118.9	62.0	56.9	*2.3*	–1.4	0
Italy	120.5		73.3	47.2	*4.4*	–0.3	0
Netherlands	65.8	66.9	46.6	20.3	*1.4*	–0.8	–0.5
Portugal	100.9	105.2	52.5	52.8	*3.2*	–0.4	0
Spain	67.9	69.2	35.3	33.9	*1.1*	–0.3	0

Source: Barnes, S. *et al.*, forthcoming.

The requirement to have national legislation mandating a balanced budget in structural terms is made in the revised Stability and Growth Pact, a number of subsequent political commitments and the "fiscal compact" Treaty. In a substantive sense, this effectively duplicates the MTOs by constraining budget balances and is constrained by the same lower bound. There is a further proposed requirement to have a mechanism to achieve "automatic correction" when this commitment is not met, but it is unclear what this implies beyond the existing obligation at the EU level to take corrective action to meet the MTOs. But if the economic objective of the MTOs and these additional requirements are the same, the basic difference is the enforcement rule, the MTO being part of the EU SGP and the proposed balanced budget requirement being in domestic law, which should make application of the rules more robust than applying EU law only, as well as ensuring consistency between EU and national rules. Like the MTOs, structural balance budget requirements are likely to be very demanding in the near term for highly-indebted countries and raise the same questions about the measurement of the structural balance.

National fiscal institutions are key to a lasting improvement in fiscal performance

A well-designed upgrading of national institutions is the key to improving fiscal performance because policy still remains largely at national level in terms of the instruments, decision-making and accountability. Furthermore, a strong political and social commitment to sound fiscal policy is likely to be the best guarantee of good policies being pursued, which again can be part of the national political compact. The EU directive on national budgetary frameworks aims to put in place minimum requirements for national institutions (EC, 2011k), alongside obligations under other parts of the "six-pack" to improve statistical standards. Additional measures proposed by the Commission for the euro area would require independent fiscal councils to monitor compliance with the national fiscal rules in terms of the structural budget balance, and official macroeconomic forecasts to be carried out or endorsed by institutions with functional autonomy. However, to carry legitimacy and foster ownership, there is a limit to how far stronger national fiscal institutions can be imposed from above. Six euro area countries have taken measures to strengthen budgetary institutions, including in some cases through independent national fiscal councils drawing on a wide range of models (Table 1.4). It will be important that the independence of Councils is respected across the political spectrum and that they are adequately resourced to fulfil their mandates (Hagemann, 2010).

Table 1.4. **Recent measures to strengthen national budgetary institutions**

Austria	A medium-term expenditure framework has been put in place with legally binding expenditure ceilings covering the majority of general government spending. There are sanction mechanisms for sub-national governments not complying with annual deficit targets under the Domestic Stability Pact.
Ireland	The Irish Fiscal Advisory Council was established in July 2011. The Fiscal Responsibility Bill, to be enacted in 2012, will establish multi-year fiscal rules.
Greece	A Parliamentary Budget Office was created in 2010 with the task of evaluating official forecasts, supervising budgetary implementation, performing long-term projections and working on the oversight of the public accounts. Improvements to the budgeting framework were also made including top-down budgeting, limiting borrowing capacity of some public entities, holding large reserves, mechanisms to control spending and publication of more regular data.
Portugal	An independent Council for Public Finances has been established. A new multi-annual framework with a budget balance rule has been put in place for the general government, requiring the MTOs to be achieved and applying from 2015 onwards.
Spain	Stronger rules in the form of a legal limit on public spending growth to trend GDP growth for central government and large municipalities have been introduced. Regional governments have committed to adopting similar rules. A requirement to limit public deficits and debt has been introduced in the constitution: specific structural deficit limits applying to each level of government from 2020 will be fixed by law.
Slovak Republic	An independent Council for Fiscal Responsibility has been established. A new constitutional law on fiscal responsibility was passed in 2011, imposing a constitutional limit on the debt-to-GDP ratio at 60%, falling to 50% over time.

Despite recent progress, financial governance and oversight need to be strengthened

The euro area financial system took excessive risks during the build-up of imbalances in the euro area and the global credit boom. Stronger financial regulation and supervision than in the past are necessary to avoid the build-up and propagation of imbalances, notably through the banking sector. In addition, the structure of European banking with a mixture of strong integration at the wholesale level and segmentation at the retail level creates inherent instabilities (Barnes *et al.*, 2010b), which would be reduced by greater integration of the banking sector across countries within a robust framework of oversight (see *Economic Survey of the European Union*).

Financial regulation is being overhauled

The EU has undertaken major reforms to financial regulation and banking since the crisis, in the context of the international initiatives to strengthen oversight. The Basel III accord is currently being translated into EU law through a revision of the Capital Requirements Directive (CRD IV/CRR) in the form of a directive and a regulation. The 2011 EU Stress Tests and the EU recapitalisation plan, co-ordinated by EBA, in practice represent a partial, if not complete, adjustment towards the higher Basel III capital standards in terms of the quality and quantity of capital, ahead of the international requirement. The EU legislative proposals (EC, 2011d; 2011e) follow the approach required by Basel III but deviate from the Basel III agreement in some key areas, such as the definition of common equity tier-1 capital and the treatment of significant investments in insurers. Despite the systemic risk create by excessive leverage, discussions are on-going on a leverage ratio. The new EU framework will implement the minimum regulatory capital requirements of 4.5% of core tier-1 capital to risk-weighted assets and put in place a core tier-1 Capital Conservation buffer of 2.5% above that level, which will need to be maintained for dividends and discretionary bonuses to be paid out. There have also been regulatory changes on a wide range of other fronts, including strengthening deposit insurance, where a draft directive is currently under legislative discussion. There has been some progress in developing crisis management policies, pending the adoption of an EU framework for bank recovery and resolution. This is expected to include resolution financing mechanisms.

An important innovation is that the revised CRD (CRD IV/CRR) will take the form of a regulation, which is immediately enforceable as law in all EU countries simultaneously, as well as a directive requiring elements to be transposed into national law. This "maximum harmonisation" approach will increase harmonisation and makes the next step in the direction of a Single Rule Book for some EU requirements belonging to the Pillar 1 of the Basel regime. Under proposals being considered, some national discretion would remain, principally where there are national financial stability issues. However, the degree to which the CRD IV allows national policymakers to tighten the regulatory requirements from macroprudential reasons in order to mitigate systemic risk is still being discussed. The regulation allows national authorities to maintain or introduce national provisions where uniform rules are not in place. The overall approach would contribute to a more consistent approach across EU countries and avoid some distortions related to regulatory arbitrage.

Regulatory and supervisory changes should make the euro area more robust to disruptive cross-border banking flows and risk taking. From a supervisory perspective, the European Banking Authority (EBA) has been established and should lead to more consistent oversight across countries and better functioning of supervisory colleges for cross-border institutions. The revised CRD would enhance the powers of the EBA by allowing it to set some binding technical standards. From a macroprudential perspective, the European Systemic Risk Board (ESRB) is in a position to take a system-wide perspective and brings together all the relevant bodies. It is too early to make a comprehensive assessment of the performance of the new framework, much of which is still being put in place at a practical level. However, the EBA has been more effective than its predecessor in ensuring the robustness of the EU Stress Tests. The ESRB started its operation in a difficult year when the euro area has been facing a major financial crisis. Its public statements on the crisis have been strongly worded but specific detail has been limited.

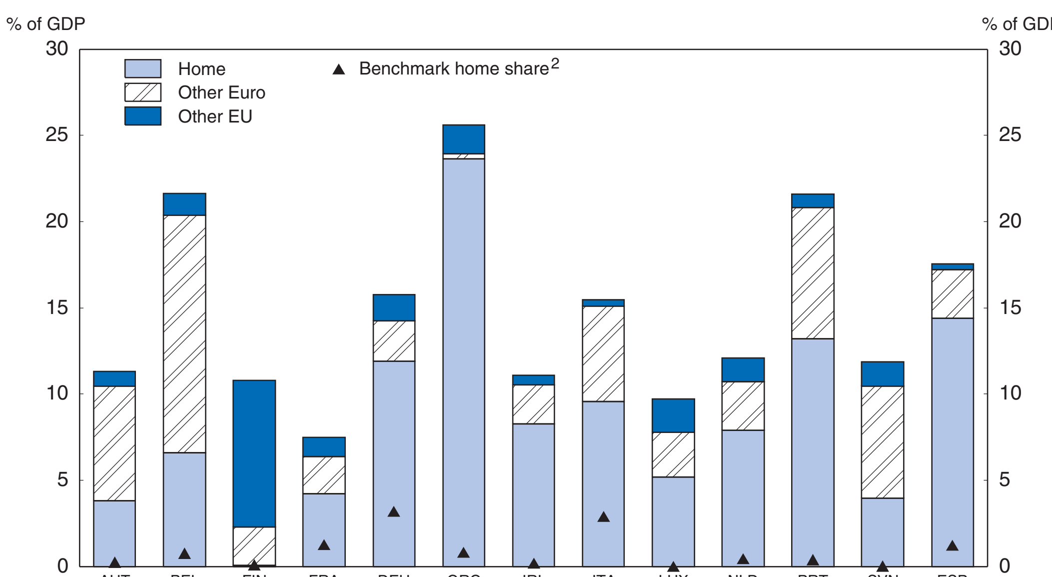
The lack of counter-cyclical instruments and the failure to apply counter-cyclical regulatory requirements were a key factor in the credit cycle (Barnes *et al.*, 2010b). In addition, national supervisors were often reluctant to take action against domestic bubbles because foreign banks lending through branches or cross-border institutions would not be affected. This argument also increased the leverage of domestic banks in responding to supervisors. The Counter-Cyclical Capital Buffer included in Basel III is therefore a key instrument that could contribute to stability also within the euro, particularly as real interest rates might play a destabilising role at national level in some countries and there is high capital mobility. This instrument has the advantage of being quasi-automatic and being applied by jurisdictional reciprocity so that any potential lender, domestic or foreign, is covered. In the EU, CRD IV will provide details on implementing this approach and how the ESRB would provide guidance.

The close relationship between banks and governments remains risky and creates poor incentives

The close links between domestic banks and their governments is a serious problem. Despite the possibilities of risk diversification offered by the single currency and the EU capital market, banks in most countries hold a disproportionate share of their holdings of EU sovereign debt in the bonds of their home country (Figure 1.7). This lack of risk diversification has caused problems during the crisis in terms of both solvency risks and liquidity, which has been impaired as falls in the value of domestic government debt have undermined collateral. Furthermore, banks have had to rely during the crisis on support from the state in the form of guarantees and participation in bank recapitalisation. From the perspective of governments, supporting the banking system in times of crisis is a very large implicit liability that has been substantially realised. For small countries with relatively large banking systems that took excessive risks, these costs were potentially huge and represented a serious risk to sovereign solvency, most notably in Ireland. Weak government finances can also compromise the ability of the state to support banks in times of crisis, creating the risk of bank runs. Although exceptional, this interaction was clearly seen in the case of Greece, where weakness of government finances and high exposures of the domestic banks to their

Figure 1.7. **Bank holdings of sovereign debt**

September 2011[1]



1. Due to the unavailability of Greek home country sovereign debt exposure in the 2011 Stress Test, all data for Greece refer to the 2010 EU Wide Stress Testing Exercise.
2. The benchmark home share is the implied holding of domestic sovereign debt if exposures were proportional to the share of domestic debt in total EU debt.

Source: European Banking Authority, *2010 and 2011 EU Wide Stress Testing Exercise* and OECD, *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932589829

own government's debt have contributed to serious financial tensions. At the same time, the home bias in sovereign debt portfolios implies that public debt issuance may have benefited from lenient lending practices from domestic banks. This could have contributed to the failure of market discipline and price signals during the pre-crisis period. These relationships provide a significant obstacle to maintaining fiscal discipline and sound policy in the euro area because the threat of allowing a government with a poor fiscal record to default lacks credibility for so long as this would imply significant stress, costs and contagion through the bank exposures to sovereign debt.

Separating the banking system from domestic sovereign risks should be a key part of reforms to financial oversight. In terms of overall exposures to sovereign debt, the zero-risk weighting for sovereign debt in regulatory capital requirements does not accurately reflect risks. Furthermore, sovereigns are excluded from the Large Exposures Directive. There is a risk that reforms to the liquidity regime under Basel III could strengthen and perhaps distort the incentives to hold sovereign debt. This warrants careful monitoring. In terms of avoiding excessive exposure to the domestic government, supervisors should systematically take into account concentration risk for exposures to one issuer (including a government) or one economy. Sovereign debt could also be subjected to the Large Exposures Directive, which limits large risk concentrations. A more integrated and liquid EU bond market would help. In many euro area countries, domestic banks are heavily represented among primary dealers and their activities, and the role of foreign institutions is relatively limited. Reducing incentives to hold sovereign debt and ensuring an appropriate diversification of risk has the advantage of being a robust strategy: while these should reduce the likelihood of a crisis occurring, the resolution of crises would be facilitated if the government and the banks were not exposed so heavily to each other. Given the unsettled state of euro area bond markets, the composition of bank balance sheets and low liquidity in some markets, these essential reforms need to be considered carefully and implemented gradually within an international framework.

A common euro area crisis management backstop is needed, implying major changes in supervision

More fundamental reforms of the euro area financial system would improve its stability. In particular, there are some inherent weaknesses in a system based on national banking supervision and crisis management mechanisms. Countries whose banks take very large risks relative to the size of the economy or whose fiscal position is in very poor shape may not be able to support their banking system. The EFSF and the future ESM are able to lend to countries for the purpose of bank recapitalisation. This is an important instrument that weakens the link between financial sector problems and the sovereign fiscal position. Conditionality targeted at the financial sector will be maintained under the guise of the existing EU state-aid framework. Crisis prevention may be hindered by a lack of co-ordination between national supervisors. This can become a vital problem during crisis management: the different incentives of national regulators can lead to failures to provide adequate solutions in a timely way. This problem undermines the credibility of the EU Stress Tests. National authorities have incentives to understate the relative weakness of the situation in their country, particularly if there is limited room for manoeuvre in terms of dealing with problems that are identified. This may partly explain why the Stress Tests in the United States were viewed as more credible by markets. It is also related to the exclusion of sovereign debt shocks from the July 2011 Stress Test, which ignored one of the main market concerns.

A common system of crisis management and resolution for euro area countries, relying as much as possible on private sector funds, could bring benefits in this respect. This would further help to decouple governments from their national banking systems. This system would most likely need a single supervisor at European level, particularly for large complex cross-border institutions, to avoid potential moral hazard at the level of national supervisors with access to common financing arrangements. Conversely, countries are only likely to accept a single system of supervision, which could have other advantages in terms of consistency and consistency of supervision as discussed in the *Economic Survey of the European Union*, if appropriate common backstop arrangements are in place. The possible gains of a more integrated supervisor would need to be balanced against ensuring that there is appropriate knowledge of local conditions and markets. The ultimate goal of supervision should be to reduce the likelihood of institutions failing. If such events occur, there should be effective crisis resolution tools. In addition, there should be either *ex ante* or *ex post* private sector-funded instruments to provide support. This could include the use of bail-in instruments. However, a fiscal backstop cannot be excluded in case of extremely severe events. The EU is expected to issue during 2012 a proposal that will establish an EU framework for bank recovery and resolution. While the current priority should be to resolve remaining weaknesses in the banking system, consideration should be given to a more integrated system of supervision and resolution for large cross-border institutions coupled with the necessary common financing of crisis management, relying as far as possible on private sector funds, notably when existing arrangements are reviewed in 2013.

Deeper economic, fiscal and financial integration could in the long-run increase euro area stability

The build-up of economic, fiscal and financial imbalances and the resulting crisis raise deep questions about the construction of the monetary union. In particular, can monetary union be sustained and successful without much deeper integration between its members? Reform measures undertaken over the past three years have contributed towards making the existing architecture more stable. This has involved undertaking or committing to structural reforms, strengthening of national and EU fiscal institutions, and upgrading of financial oversight. In addition, the creation of the EFSF and the ESM fills a gap in the original design by creating mechanisms to provide liquidity support to countries, subject to conditionality, if markets do not provide finance at reasonable rates. As argued above, the main remaining area where instruments are missing is in terms of completing the upgrading of financial supervision and a European crisis management regime based heavily on private financing arrangements. The main priority now should be making this existing architecture of monetary union work.

However, there is an argument that further integration would provide a more stable euro area. The main issue is whether greater fiscal union should be pursued. This has three dimensions: more centralised control of the public finances, common debt issuance, and a mechanism to provide transfers *ex ante* or *ex post*. There have been a number of proposals that incorporate some or all of these elements. A number of proposals have been made for various types of "euro bond", either backed by joint or several liabilities, including the Commission's *Green Paper* on euro bonds (EC, 2011c). Where the bonds would be guaranteed separately (that is, where each country's liability is capped at a share of the common pool rather than jointly for the whole issuance), a "euro bond" would essentially not change the overall riskiness of borrowing by euro area countries and there would be no net gain in terms of credit risk: risk spreads would tend to be lower for high risk countries but higher than in the past for the safest borrowers. However, there could be some modest net gains from the higher liquidity of the larger bond issue. Any "euro bond" would have to overcome problems of moral hazard given that each country would only pay a share of higher yields as borrowing rises. A number of proposals suggest a limit on overall issuance of the common bond by each country. However, it could be difficult to make such a limit, such as 60% of GDP, credible. Furthermore, by segmenting the risks in this way, it may be very hard to issue debt outside these limits, effectively capping overall lending at a given level. Given the experience with euro area governance to date, a much greater change in fiscal governance than currently envisaged would be necessary to make such a system work and for markets to find it credible.

Greater revenue-raising powers, well in excess of the very small "own funds" that the European Union currently has, are likely to be central to successful deepening of integration. This would follow the pattern of other fiscal unions, which have developed through increasing revenue raising powers at the federal level. The need for additional revenue raising powers arises for two reasons. *Firstly,* a common bond that would not be backed by a clear revenue stream would be a very different construction from conventional sovereign debt, given that it would not have a clear revenue source in the form of revenue raising powers to back it. As the experience of the EFSF appears to indicate, it could be difficult for a bond based on an agreement between countries to attain the same credibility as a sovereign signature. This would make it more costly to raise funds in this way. *Secondly,* binding constraints on national fiscal policy would most likely need some kind of offset in the form of potential transfers from where the discipline was being imposed. It is particularly important to avoid a situation where individual countries were pursuing pro-cyclical policies with no automatic stabilisation from the federal level.

Box 1.2. **Summary recommendations on stability in the euro area**

While immediate policy action is needed to stabilise the sovereign debt crisis, this can only create space for necessary medium-term adjustments and the strengthening of the architecture of the euro area. These reforms themselves can contribute to an improvement in market confidence and exit from the crisis.

Economic governance

- Establish the European Stability Mechanism as a permanent crisis mechanism with robust capital and governance structures as planned by July 2012. Stand ready to increase the capacity of euro area "firewall" to provide a credible level of support.
- Implement the "six-pack" of legislative measures to strengthen both the EU and the national fiscal frameworks and address macroeconomic imbalances. The Council should only use its discretion where it is genuinely warranted. The economic advice of the Commission should be made under the responsibility of the relevant Commissioner and political interference should be reduced.
- Use the reappraisal of the MTOs in 2012 to reconsider their role in the light of much greater need than in the past to reduce debt-to-GDP ratios. Adequate progress towards reducing the debt-to-GDP ratio, both through the budget balance and growth, should be the main guide to the appropriateness of policy.

Box 1.2. **Summary recommendations on stability in the euro area** *(cont.)*

- Continue to upgrade national fiscal institutions, including but not limited to implementation of the EU directive. Independent national fiscal councils should be set up in all euro area countries.
- The risks of excessive imbalances should be assessed symmetrically.

Financial governance

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

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Chapter 2

Structural reforms to create balanced growth and resolve imbalances

Structural reforms are needed to restore sustainable and balanced growth in the euro area. Medium-term growth prospects in the absence of reform are weak and there are downside risks to future labour productivity growth. An ambitious programme of structural reforms could transform this outlook and raise medium-term growth substantially, improve the sustainability of public and private debt, and create jobs and boost incomes. Achieving these gains would require measures across a broad range of areas including product market regulations, labour market institutions, social benefits and tax systems.

Some reforms would have positive effects on growth even in the short run, even though the full long-run benefits of reforms are likely to take time to materialise. There is a risk that some reforms could have a negative immediate impact, but this is often over-stated. Reform packages should be designed to achieve the best trade-off between short- and long-run effects, as well as take into account political economy considerations. Good communication and credible commitments, in addition to a well-functioning financial system, can boost the short-run growth benefits.

Weaknesses in structural policy settings contributed to the build-up of euro area imbalances, for instance through restrictive product market regulations that held back investment or wage-setting institutions that allowed pay to get out of line with productivity or generated weak growth. Reforms would help to resolve and avoid imbalances by tackling their underlying causes. In surplus economies, structural reforms especially in the service sectors could facilitate investment and domestic activity. In countries with high levels debt and large imbalances, reforms should be focused on raising productivity to improve debt sustainability, avoiding structural unemployment, attracting foreign capital and facilitating wage and price adjustment to regain competitiveness. These reforms should create favourable conditions for the development of new activities, particularly in export-oriented sectors.

Structural reforms are essential to restoring sustainable growth in the euro area. Long-term growth is likely to be dismal in the absence of policy measures to remove obstacles to higher labour productivity and employment. Raising long-term growth would help to improve the sustainability of private and public sector debts, and higher incomes would reduce the debt burden. Many of the benefits of structural reforms are likely to take time to be fully realised but some reforms would boost growth even in the short run. In addition, credible commitments to undertaking reforms could help to improve near-term economic stability by improving confidence, especially in financial markets, and bringing forward consumption and investment. Structural problems contributed during the upswing to imbalances both in surplus and deficit economies. Reforms are required to ensure that the structure of national economies is well-adapted to the pressures of monetary union and to avoid excessive imbalances in the future. Structural reforms, especially in services markets in surplus countries, can contribute to boost investment and enhance the domestic sources of growth on a sustainable basis. Furthermore, taking these measures now would help to resolve existing imbalances by improving the sustainability of external debts, facilitating the reallocation of resources across sectors, helping to avoid long-term unemployment, attracting foreign capital, improving price signals and facilitating wage and price adjustment. At the EU level, the main structural policy instrument to boost growth is further deepening of the Single Market in goods and services, as well as enhancing capital and labour mobility, as set out in the *Economic Survey of the European Union*.

The first section sets out the challenge to raise and sustain long-term growth, and how an ambitious programme reforms would contribute to raising growth, improving debt dynamics and supporting a fairer society. The second section considers the short-run impact of reforms. While the full gains from reforms typically come only slowly, there can be positive effects in the short run. The third section shows how weak structural policy settings have contributed to economic, financial and fiscal imbalances. Structural measures should also play a key role in resolving the existing imbalances, particularly in improving the sustainability and competitiveness of the countries with large external debts. The chapter focuses exclusively on the role of structural policies in boosting growth and dealing with imbalances. However, reforms would also play an important role in raising living standards, improving social outcomes and dealing with rising inequality, and in contributing to greater macroeconomic resilience in the face of exogenous shocks (Duval *et al.*, 2007).

Boosting growth and raising real incomes across the board

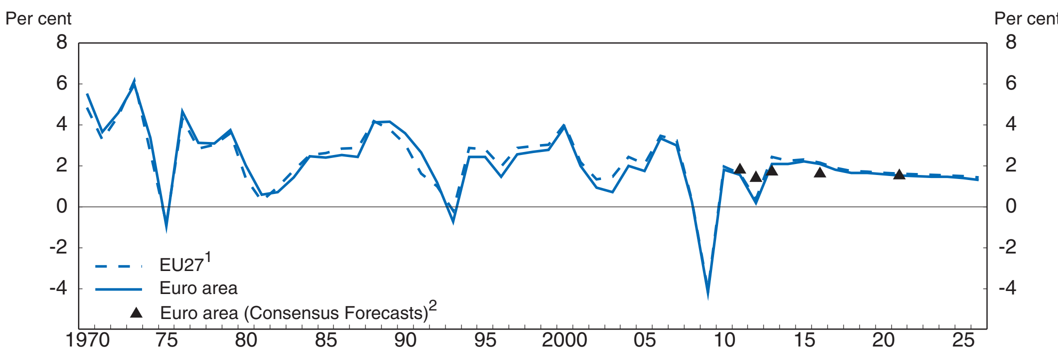
Underlying growth of output and productivity is likely to slow under current policies

Trend GDP growth is expected to slow over the medium term compared with earlier decades, in the absence of major reforms. The current OECD *medium-term baseline* scenario is for income growth in the euro area to slow to an annual rate of around 1.4% by 2025

(Figure 2.1). This is materially below the average pace of growth of 1.7% over the period 1990 to 2010: this implies a shortfall of around 3.5 percentage points in the expansion of the economy per decade relative to the norm of the past twenty years. There is wide agreement that growth prospects are weak. The long-term Consensus forecast for the euro area from August 2011 shows average growth from 2019 to 2023 of 1.6% at an annual rate. The EU benchmark projections from the Commission and the Ageing Working Group paint a similar picture (EC, 2009): growth for the euro area is projected to slow to around 1.5% over the period 2021 to 2040 with growth in the European Union only marginally stronger.

Figure 2.1. **Trend GDP is expected to slow**

Annual growth rate



1. EU27 refers to the 21 countries that are OECD members.
2. For the 2014-18 and 2019-23 periods, forecasts shown at mid-period.

Source: Consensus Economics (2011), *Consensus Forecasts*, August; OECD, *OECD Economic Outlook 90 Database* and *Medium-Term Baseline 90 Database*.

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The main driver of this projected sluggish output growth is contraction of the working-age population, against the background of weak projected labour productivity growth. The number of people of working age (those aged from 15 to 64) is expected to begin to fall in the next few years. This trend is set to accelerate even after allowing for some net inward migration (see Chapter 2 of the *Economic Survey of the European Union*). Net migration trends are notoriously difficult to predict and the extent to which migration trends will respond to the ageing population in Europe, as well as the policy response, is hard to gauge so these elements remain particularly uncertain. In addition, population ageing and other pressures may induce a postponement of retirement and a lengthening of the working age, which would tend to attenuate the impact of the demographic forces. However, adjustment to the ageing of the population along any of these margins is unlikely fully to compensate for the fall in the working-age population.

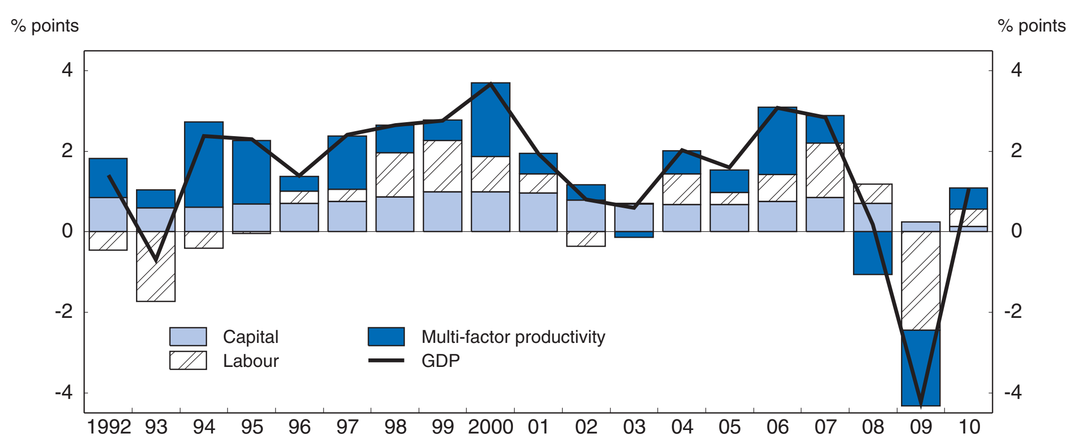
Long-term scenarios project labour productivity growth to be slow compared with post-war norms, but at around the rate of the past two decades. The OECD *medium-term baseline* scenario is for labour productivity growth in the euro area of around 1.6% in 2025, close to its average from 1990 to 2010, and similar to official EU long-term forecasts (EC, 2009). Labour productivity growth is inherently difficult to predict as both capital deepening and multifactor productivity are hard to forecast accurately. Long-term projections typically assume that labour productivity growth will either stay close to its recent pace or is driven by a process of catch-up towards the technological frontier.

However, this assumption may be too optimistic given evidence that the pace of productivity growth in Europe has been slowing over time (Timmer *et al.*, 2011) and that catch-up with the frontier has been weak in Europe over recent decades. If the deceleration or lack of convergence continues, labour productivity growth would be weaker than the long-run forecasts imply.

The potential drivers of future labour productivity growth in the absence of a shift in policy do not appear promising. Growth was relatively modest compared with past norms during the upswing from 2002 to 2007, despite the favourable conditions created by the international credit cycle (Figure 2.2). The growth rate of labour utilisation was fairly weak, in part as the scope from gains from rising female participation moderated. In addition, growth of labour productivity and capital inputs were weaker and less consistent than in the past. In terms of capital deepening, the share of investment in GDP has been falling over time. Although this partly reflects an international trend fall in the relative price of investment goods and the rising importance of investment in intangibles, the growth rate of capital services has slowed during the past decade (Figure 2.3). This slowdown has occurred despite historically low real interest rates and unsustainably easy financing conditions, as well as a rising profit share. The contribution of ICT capital services to growth was lower than its level during the late 1980s and well below peaks during the "dotcom" bubble, while other capital services also contributed only modestly to growth. In terms of the outlook for multifactor productivity growth, a key constraint is the low level of research and development (R&D) expenditure in Europe: as a share of GDP, it is lower than in the United States and around half the rate in Japan. Sectoral analysis based on the *OECD STAN Database* suggests that the contribution of manufacturing, transport and communications to productivity growth has remained strong since 1995, but that distribution, business services and finance have contributed little to gains in labour productivity.

There are substantial uncertainties about the drivers of future growth and new factors need to be taken into account. *Firstly,* the crisis has led to sharp falls in output. Evidence from past crises in OECD countries suggests that growth tends to recover eventually but there is a permanent effect on the level of output (Haugh *et al.*, 2009), although the deep and lasting crisis in Japan does appear to have affected growth in a more permanent way.

Figure 2.2. **Growth drivers in the euro area**[1]



1. Euro area comprising only Austria, Finland, France, Germany, Ireland, Italy, the Netherlands and Spain.

Source: OECD, *Multi-factor Productivity Database* and *OECD Economic Outlook Database.*

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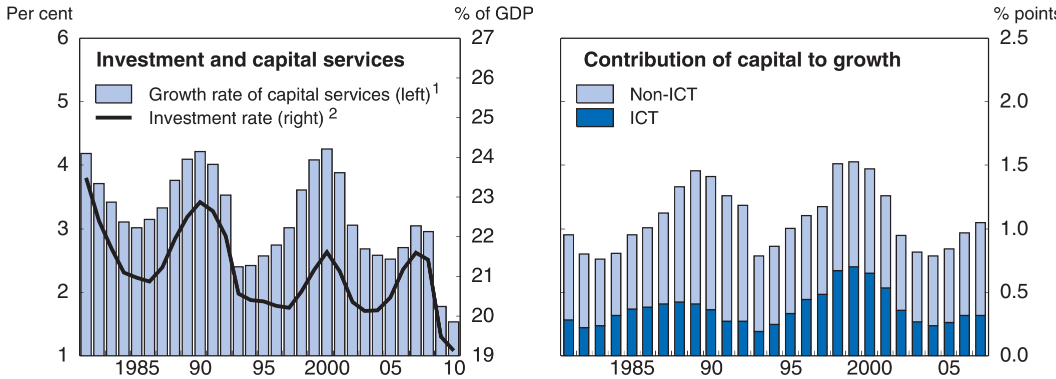
Figure 2.3. **Capital accumulation**



1. Change in real volume of capital services.
2. Nominal investment over nominal GDP.

Source: Groningen Growth and Development Centre, *EU KLEMS Database*, November 2009 release, March 2011 update; OECD, *OECD Economic Outlook 90 Database*.

StatLink http://dx.doi.org/10.1787/888932589886

EU policymakers have considered stylised scenarios of a "lost decade" following the crisis or even a "permanent shock" with structural unemployment remaining one percentage point higher than in the baseline and a fall in labour productivity growth of 0.25 percentage points (EC, 2009). *Secondly,* population ageing and globalisation could have profound impacts on potential growth and trigger a range of responses in the economy and policy settings. *Thirdly,* past observed gains in performance partly reflect the benefits of reforms that have already been undertaken (Barnes *et al.*, 2010): a "no change" policy scenario could generate weaker economic performance than observed in the past.

An ambitious programme of structural reforms would transform the outlook

A wide range of reforms are needed across euro area countries

An ambitious set of structural reform measures could transform the weak growth outlook that Europe currently faces. Economic performance in the European Union and euro area countries is generally well below the best performers in the OECD in terms of GDP per capita (OECD, 2011a). There are low rates of labour utilisation in many countries, while labour productivity often lags well behind the frontier of the best performing countries. This weak performance suggests that there is a large potential for euro area countries to raise living standards by tackling the obstacles to sub-standard performance, particularly weak policy settings that hold back the efficient working of the economy.

The required reforms include: changes to the labour market including unemployment benefits, activation policies, employment protection legislation, wage setting mechanisms; reforms to reduce the regulatory burden and boost competition in product markets; tax reform; encouraging well-regulated, competitive and open capital markets; measures targeted at boosting innovation; and education reforms. Country-specific structural reforms priorities for the euro area are set out in Table 2.1, based on the OECD *Going for Growth* assessment (OECD, 2011a) covering a broad range of areas. The OECD Strategic Response has identified some reforms as especially important from a macroeconomic perspective and to resolve the crisis, which are given in bold in the table. At the EU level, increasing economic integration through the Single Market is the main structural reform priority to boost growth, as argued in the *Economic Survey of the European Union*.

Table 2.1. **Going for Growth priorities for euro area countries**

Priorities in bold are part of the OECD Strategic Response

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

1. These reform priorities were set in 2010 and reported in the 2011 edition of *Going for Growth*.

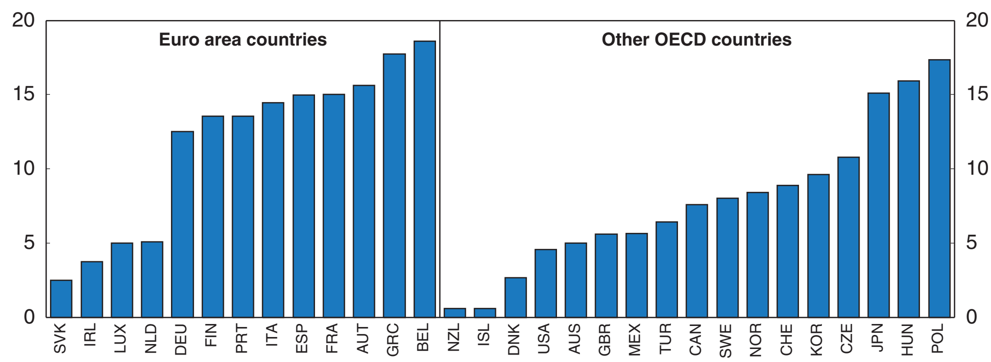
Source: OECD (2011), *Going for Growth*, OECD Publishing, Paris.

Reform measures would boost medium-term growth substantially

An illustrative assessment of the impact on potential GDP over a 10-year horizon of a set of structural reforms, based on a framework bringing together OECD empirical estimates of the impact of policies on performance, suggests large gains (Bouis and Duval, 2011). These policy measures include those set out in Table 2.1. This scenario implies that within this modelling framework a gradual alignment of product market regulations to best practice in a broad range of non-manufacturing sectors could boost aggregate labour productivity by over 5% across most of continental Europe. Labour market reforms would give a further boost to productivity. Under this framework, employment rates could be raised by several percentage points through bringing unemployment benefit systems, activation policies, labour taxes and pension systems closer to OECD best practices. There would be large gains from unemployment insurance reforms and shifting of taxes away from labour, notably in Belgium, Portugal and France. In the model, the potential overall gains from a full set of policy reforms depend heavily on the initial policy settings and potential long-run gains are modest in countries such as Ireland, the Netherlands and the Slovak Republic. However, the implied overall gain in potential GDP from the reforms combined over a 10-year period exceeds 10% of GDP in most euro area countries (Figure 2.4).

Figure 2.4. **Potential gains from broad reform package**[1]

Ten-year horizon; levels, in per cent



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

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

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The sheer scale of the potential gains implied by the illustrative assessment used above may appear counterintuitive, given how much of a sustained increase in growth rates from current norms they would imply. There is obviously great uncertainty around these scenarios, which could imply smaller or larger effects than those stated and different patterns of impacts across policies and countries than shown. Furthermore, this simple framework assumes reduced-form elasticities based on OECD empirical studies that are the same across countries and relies on heavily-stylised assumptions about the functioning of the economy. One reason why this assessment could understate all the potential gains from reforms is that it only considers an incomplete range of types of reforms. Furthermore, the underlying model does not allow for additional gains from the interaction of different reforms. For instance, the benefits of a less regulated, more dynamic product market will be larger if labour markets are more flexible, while a more competitive labour market will help adjustment in product markets. On the other hand, some of the estimated effects of past reforms on which the model is based may in fact already capture other positive factors or may be overstated. One of the reasons why the size of potential gains may appear counterintuitive is that ambitious reforms of the scale required to reap such gains have never been carried out in a comprehensive way in a short period of time in OECD countries: past reform programmes may not provide a good guide to the scale of what could be achieved and could differ significantly from those suggested by the illustrative assessment.

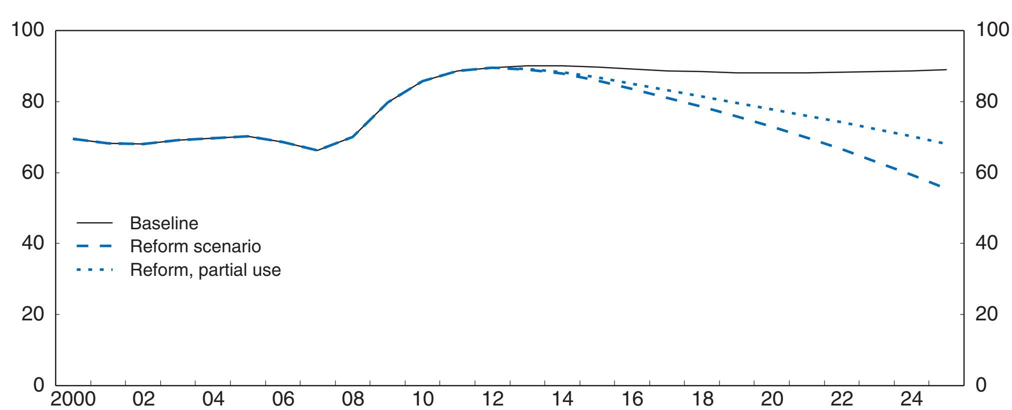
Raising medium-term growth would help improve debt dynamics

Ambitious structural reforms should be part of a strategy to grow out of current high debt levels by raising growth rates and incomes, thereby improving the sustainability of government and private debt in the euro area and reducing the debt burden: the gross government debt-to-GDP ratio in the euro area is likely to peak under current projections at over 90% of GDP, and there are high levels of private sector household and corporate indebtedness in many countries. Higher growth would also make it easier to deal with social challenges, both by increasing overall resources and because reforms would help to tackle some of the underlying causes of exclusion and joblessness. Over the coming years, the ageing population will lead to high and rising dependency ratios. Governments in most countries face large implicit liabilities related to inadequately funded pension commitments, which a larger revenue base would make a lesser burden. Higher growth brought about by reforms would increase the level of debt that can be sustained relative to current income and improve debt dynamics, while a shift up in the level of income would reduce the ratio of debts to income. However, the additional fiscal space created by an unanticipated shift upwards in the growth path could in principle be constrained by higher steady-state interest rates as the marginal productivity of capital shifts up as the result of the economy becoming more productive. In so far as interest rates did not adjust immediately and are in some way determined at the global level, such interest rate responses could however be limited. Furthermore, the improvement in debt dynamics could lower risk spreads and thereby have the positive effect of reducing financing costs.

A simple stylised scenario suggests that there would be large gains from reforms that boosted growth so that the level of GDP would be about 10% higher than in the baseline in 2025: if there were no effect on interest rates and all additional revenues associated with higher growth were used to pay down debt, the Maastricht debt-to-GDP ratio for the euro area would be around 25 percentage points lower than in the baseline by 2025 due to a large denominator and accumulated larger primary surpluses (Figure 2.5). As a "partial use" scenario (under which half of the additional revenues are spent) shows, locking in

Figure 2.5. **Euro area debt-to-GDP ratio under stylised reform scenarios**[1]

As a percentage of GDP, Maastricht criteria



1. The baseline scenario is based on the OECD medium-term baseline. Other assumptions are given in the text.

Source: OECD calculations.

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some gains from reforms in earlier years into the primary balance improves the debt dynamics in later years and so there is a strong gain from front-loaded reforms that translate into a stronger primary budget balance.

It takes time for the full gains to be achieved, but many reforms can boost activity in the near term

Some reforms lead quickly to positive effects on growth

It is likely to take time for the full long-run benefits of most reforms to materialise. However, some reforms have substantial positive effects on growth even in the short run, creating a "double dividend". There is a risk that some reforms could have a negative immediate impact, which is a common motivation from a political economy perspective for not carrying out reforms as politicians may fear being punished for short-run losses and being out of office before long-term gains are realised. However, it is impossible to generalise across the various types of reforms and the wider economic circumstances can affect the outcome of reforms.

Economic theory suggests a number of microeconomic frictions that may slow the effects of reforms and even lead to some short-run costs. *Firstly,* there are time lags in economic agents finding out about reforms and adjusting their behaviour in response. Entrepreneurs and workers need time to learn the new institutional and economic environment. *Secondly,* as adjustment costs are likely to be convex (greater adjustment is more costly), it is more efficient to implement only gradually changes in response to reforms. *Thirdly,* if there is a fixed sunk cost of adjustment, there may be an incentive for individual firms to wait to respond to structural changes, while at the aggregate level these individual changes can lead to a wide range of dynamic responses. *Fourthly,* some of the required adjustment in the economy is to stocks, such as physical capital, and so it will take time for flows, such as investment, to get the economy into the new steady-state. In terms of the labour market, economic theory suggests that workers are "matched" to jobs through a process that takes time for all workers and firms to find their place and so reforms may not achieve their objective immediately (Mortensen and Pissarides, 1994).

For many reforms, notably education policy, the short-term effects are likely to take a long time to work through the economy. Nevertheless, there are likely to be positive effects in the short run from some of the main types of reforms that are required (Bouis *et al*., 2012):

- Reforms to ***unemployment benefits*** and ***activation policies***, aimed at improving work incentives, are likely to boost employment rates relatively quickly and reduce unemployment, because they increase the cost of being unemployed and improve matching without any significant offsetting impact from layoffs. Reductions in the generosity of unemployment benefits would tend to dampen real incomes and reduce overall demand, which is a constraint during recessions, but work incentives can be improved by linking benefits to duration rather than reducing the overall level of support.
- ***Job protection reforms*** can have ambiguous near-term effects as a short-run increase in layoffs can be expected where legal constraints are released, while the employment gain from better conditions for making new hires may arise only slowly. ***Two-tier reforms,*** that facilitate temporary contracts without changing mainstream conditions, may yield quicker gains in employment but at the cost of negative long-run impacts on the stability of the labour market and human capital accumulation. Well-designed labour market reforms may help the reallocation of labour from declining to expanding sectors.

- ***Product market reforms*** can have ambiguous short-run effects. Inefficient firms may lose out as they are exposed to competition, which may even lead to their disappearance. On the other hand, there will be new opportunities in the more competitive market and new entrants may need to invest and create new jobs. Gains may be particularly strong in industries where regulatory barriers mean that there is pent-up demand and a need to scale up.

Tax reform would boost growth in the medium term, particularly through switching away from capital and labour income taxes towards consumption taxes and recurrent taxation of housing. In the current macroeconomic context, there is a need for substantial and sustained fiscal consolidation (Chapter 1). Some of this will need to occur through raising taxes, but the impact on long-run growth can be minimised if consolidation is used as an opportunity to improve the efficiency of the tax structure through broadening the base and increasing the reliance on the least harmful taxes from a growth perspective. The required consolidation will have a dampening effect on demand in the short run. However, there is unlikely to be a strong negative demand effect from long-term growth enhancing improvements in the tax structure through switching towards consumption and recurrent property taxes. While increasing VAT is sometimes perceived to have a disproportionate effect on low income households whose consumption is most closely linked to real incomes, the greatest absolute cost is to high income, high spending households who are likely to be more able to smooth their consumption (Arnold *et al.*, 2011). By contrast, reducing or at least maintaining income tax for low income households or introducing targeted transfers can be a priority in terms of minimising the short-run effect on demand.

Structural reforms on the large scale required would create an economic shock of macroeconomic proportions. Indeed, this is the objective of undertaking reforms to improve debt sustainability and contribute to rebalancing. How and at what speed the economy adjusts to the impulse from the reform at microeconomic level depends on the shock, the structure of the economy and any macroeconomic policy response. Theory suggests that the speed of wage and price adjustment is crucial to how rapidly the overall adjustment takes place and the effect on demand, output and employment. The rate of adjustment depends in part on the strength of competitive forces and labour market institutions. More flexible product markets will tend to improve the functioning of the labour market through speeding the pace of adjustment (Bassanini and Duval, 2006). Price adjustment is generally regarded as moderate in euro area countries and slower than in the United States (Altissimo *et al.*, 2006), in part because of the exact structural rigidities that create opportunities for reforms. Paradoxically, countries with more rigid economies have more to gain from reforms in the long run but face potentially larger short-run costs to achieve the necessary reforms. This argues for reforms to speed labour market and price adjustment to be a key priority.

In terms of the short-run macroeconomic impact, a key issue is the extent to which reforms change mark-ups in the goods and services sectors and bargaining power in the labour market (Blanchard and Giavazzi, 2003). A package that initially focuses on reducing mark-ups would tend to increase real incomes of workers, which could offset the effect of labour reforms in lowering bargaining power. For euro area countries, a further important factor is high openness to trade and capital flows: the unweighted median share of exports in GDP is around 50%. The openness implies that some of the negative demand and financing pressures of shocks are absorbed externally, while the impact on the terms of trade plays an important role in the adjustment mechanism.

Structural reforms are more likely to have a positive effect if expectations of future gains in growth feed back into current demand through consumption and investment. This depends on three channels. *Firstly,* financial markets must function effectively for future income gains to be capitalised, to fund the necessary investments to adapt the economy, and to permit income smoothing both in anticipation of future gains and to offset any temporary losses in income. *Secondly,* precautionary saving, particularly in view of short-run job losses, could dampen consumption following reforms. Workers are likely to be concerned about losing valuable existing job matches (Davis and Harrigan, 2011). These effects are reduced by greater certainty about the gains from reform, effective income insurance in the near term and a labour market that ensures that people find jobs quickly again. *Thirdly,* people will only respond to reforms if the measures have credibility and they believe that the measures will be properly implemented. Good communication is required for the opportunities offered by the new regime to be taken up quickly. For example, the drawn-out and piecemeal implementation of key structural reforms in Greece and poor communication are likely to have contributed to declining output and continued political tensions (OECD, 2011c).

The policy response to shocks stemming from structural reforms further conditions the short-run aggregate impact: more powerful automatic stabilisers or prompt discretionary fiscal action would in principle dampen any negative effects on demand, while effective and timely monetary policy reaction can help to stabilise prices and keep the economy close to potential. In the current circumstances in most euro area countries, fiscal and monetary policy may only have a limited role in being able to offset any dampening effect on demand. In a monetary union, the scope for monetary policy response to unco-ordinated reforms, that may be large in one economy but small relative to the euro area as a whole, is limited. In addition, movement in the nominal exchange rate cannot accommodate required adjustments in the terms of trade.

Some of the short-run growth gains from reforms could be substantial

The short-run macroeconomic impact of reforms can be ambiguous from a theoretical perspective and so quantitative and empirical evidence is needed. The standard approach to modelling the quantitative impact, based on large calibrated macroeconomic models, is to assume that their immediate effect is to reduce price-cost mark-ups in the product market or to reduce the bargaining power of workers or increase labour supply and thereby lower wages (see for example, Everaert and Schule, 2008; Gomes *et al.*, 2011). While the long-run supply potential of the economy increases, the short-run impact on demand is muted due to nominal and real rigidities. The temporary positive supply shock from the reform opens up a negative gap between demand and potential output, which can be attenuated by expansionary policies. There may be an ambiguous effect on demand from labour reforms to the extent that the positive impact on household incomes from stronger labour demand is counterbalanced by lower real wages.

In an open economy and monetary union setting, an important mechanism is how price and cost reductions following from reforms feed through the trade channel into demand (Gomes *et al.*, 2011). On the one hand, lower costs increase competitiveness and crowd in external demand. However, if these gains are concentrated in goods in which the country is highly specialised and an important supplier in world markets, the terms of trade will deteriorate as the world supply of goods from the country which has reformed increases. Furthermore, calibrated models tend to suggest that these effects on the supply side are dominated by larger effects in terms of stronger demand as agents anticipate future income gains through investment and higher consumption. These can be accommodated through a weakening of the current account balance. In the context of monetary union, demand may slow as anticipated falls in prices increase the real interest rate for a given euro area nominal interest rate, thereby braking the rise in demand (Vogel, 2011). Overall, these calibrated models tend to suggest that under the assumptions used, the effects of reforms are gradual but positive in the short run. The scenarios are, however, limited to a small set of structural reforms, namely product and labour market reforms of a type that reduce price and wage mark-ups and translate into higher equilibrium levels of output and employment. More detailed analysis of possible reforms could provide more nuanced results.

Assessing the impact of structural reforms on output and employment requires a differentiated perspective adequately to capture their first-round and second-round effects. Contrary to the mark-up shocks analysed in the modelling exercises above, there may actually be little or no supply effect at first. Indeed, the immediate supply-side effect could actually be negative rather than positive if workers are displaced or incumbent firms are forced out of business and their installed capital becomes redundant and is scrapped. One approach to capture these effects is to use a model that captures the turnover of firms and of workers in the labour market following a shock (Bouis *et al.*, 2012). The stylised and indicative results from a calibrated model of reforms for a small open economy, assuming that policy parameters are reformed from the euro area average to their average OECD level, imply that (Figure 2.6):

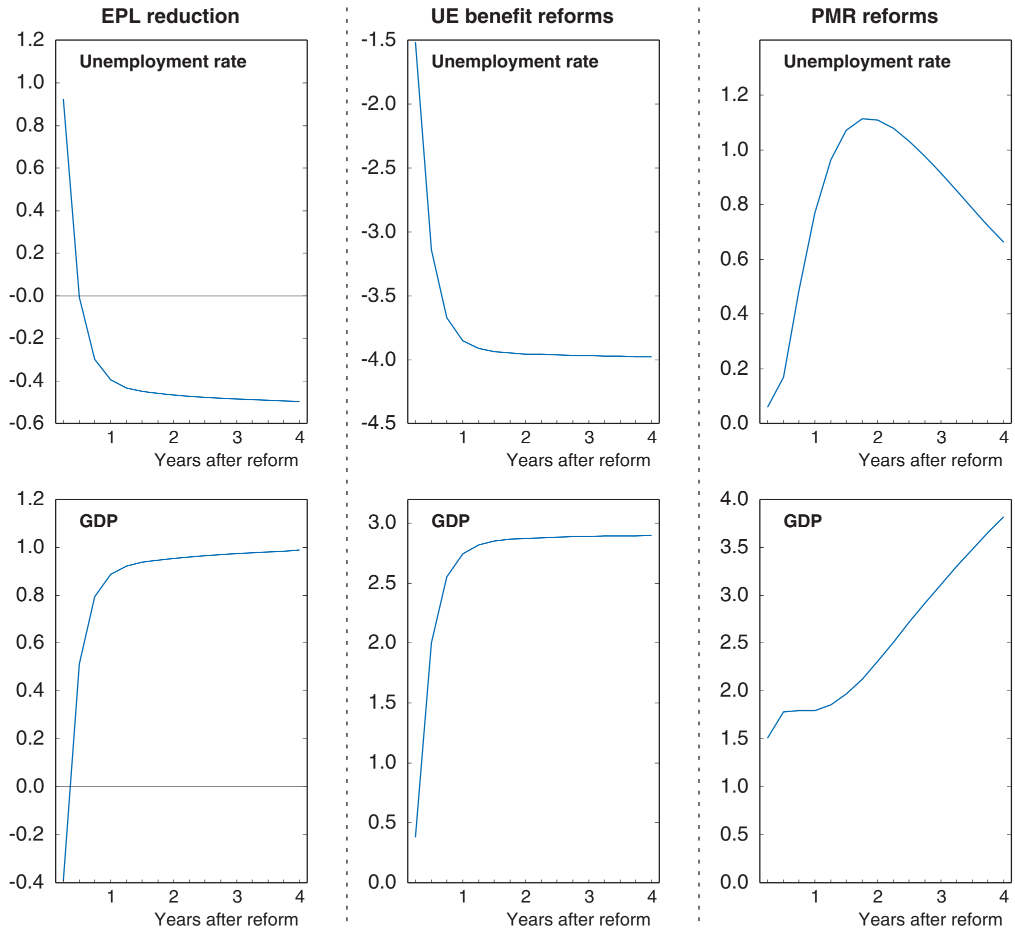
- A reduction in ***unemployment replacement rates*** leads to job creation but does not increase job destruction, so there is a rapid fall in unemployment which boosts demand.
- ***Job protection reforms*** increase unemployment in the short run and reduce GDP as the destruction of jobs is immediate but new jobs are only created gradually. The impact on GDP is partly attenuated by positive effects from higher anticipated long-run income. While sizeable output gains are made within a couple of years, real wages remain permanently lower.
- ***Product market reforms*** have large positive short-run impacts as new firms undertake investment to enter newly-opened markets. There is no initial effect on unemployment as job destruction at old firms is just compensated by job creation for new entrants, although the overall direction of the effect can be sensitive to the strength of pull of these opposing forces. Despite sizeable short-run gains, it takes time to realise the full benefits in terms of GDP.

Past experience suggests that reforms can boost employment in the short run, but much depends on the state of the economy

There have been very few rigorous empirical studies of the short-run impact of structural reforms either in specific economies or across countries. However, an analysis of the past experience of OECD countries suggests that reforms tend to raise employment rates even in the short run, although the benefits generally become apparent only after a couple of years. This analysis is based on the average impulse response in terms of employment following different types of structural reforms over the period 1985 to 2007 (Bouis *et al.*, 2012). Employment may provide a more accurate picture of the impact of the reforms than GDP, particularly for the labour market. In addition, the predictions of theory

Figure 2.6. **Simulated short-run effects of structural reforms**[1]

Deviation from the baseline, in percentage points



1. For more details on the model and assumptions, see *Source*.

Source: Cacciatore, M. *et al.* (2012), "Short-term Pain or Gain? A DSGE Model-based Analysis of the Short-term Effects of Structural Reforms in Labour and Product Markets", *OECD Economics Department Working Papers*, OECD Publishing, Paris, forthcoming.

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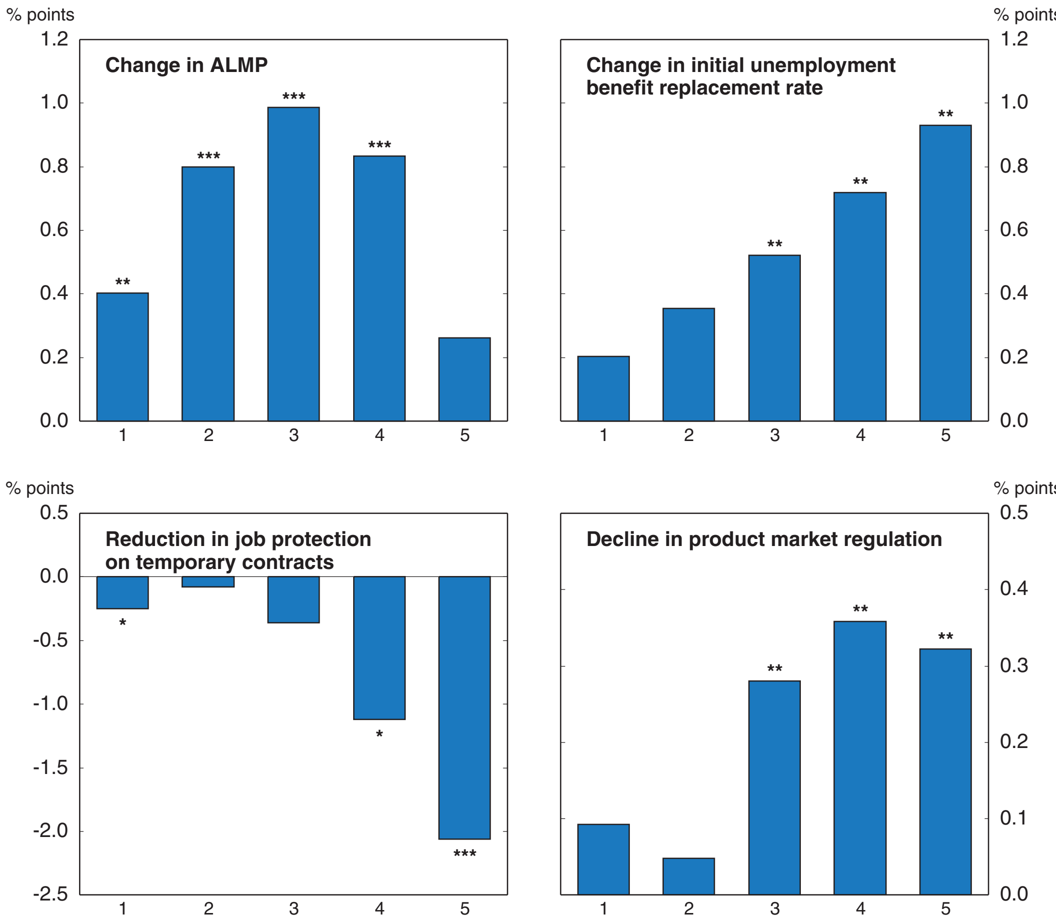
in terms of employment are more robust than on GDP. The analysis of past experience suggests that increasing active labour market policies yields relatively rapid results in terms of higher employment, although these ultimately do not last (Figure 2.7). Reducing the initial unemployment replacement rate does not have clear positive effects in the first two years, but there are significant positive gains in the following years. Reductions in overall job protection appear to lower unemployment for marginal workers (Bouis *et al.*, 2012). However, reducing protection on temporary contracts yields no short-run gains and reduces employment significantly in the medium term.

The effects of reforms on short-run demand appear to be less positive and are more likely to be negative when carried out where there is a large margin of excess capacity in the economy (Bouis *et al.*, 2012). This may be a significant concern in the current economic climate. For example, a reduction in the initial unemployment benefit replacement rate that would normally lead to near-term gains in employment (see Figure 2.7) would actually

Figure 2.7. **Impact of structural reforms**[1]

Years after the shock



1. The simulation is based on the median-sized reform observed of the estimation sample. ***, ** and * denote statistical significance at the 1%, 5% and 10% levels, respectively.

Source: Bouis, R. *et al.* (2012), "The Short-Term Effects of Structural Reforms: An Empirical Analysis", *OECD Economics Department Working Papers*, OECD Publishing, Paris, forthcoming.

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imply a small reduction in employment if carried out against the background of a negative output gap of 4%. Additional work incentives may yield few immediate gains where there is widespread joblessness, so that the negative impact from lower incomes for the unemployed dominates in this case. Equally, the costs of easing employment protection in the short run are likely to be higher when there is little appetite to hire but there are strong cyclical pressures to shed labour.

The design of reform packages should recognise that understanding and experience of the short-run impact of structural reforms is relatively limited. One limitation is that reforms, particularly the most radical measures, often take place during severe downturns so it can be difficult to identify the impact of the reform against the background of the economic weakness that would otherwise have prevailed. This arises from the political economy problem that it can be hard to agree reforms in good times, so reforms tend to occur in crises. Furthermore, there have been very few examples in OECD countries of major reform packages on the scale necessary to yield large long-term gains. The wide-ranging reforms undertaken in New Zealand from 1984 to 1996 stand out in their breadth and the radical measures taken. Overall, these measures led to greater macroeconomic stability, a sound fiscal position, productivity gains in a number of sectors, and rapid employment growth in the post-reform period. However, while it is difficult to isolate the impact of structural reforms from macroeconomic stabilisation policies, New Zealand also experienced a relatively sharp slowdown in activity and a rapid rise in unemployment in the late 1980s (Dalziel, 2002). Germany undertook a number of major reforms during the past decade, notably the so-called "Hartz" reforms of the labour market and a major pension reform. These contributed to impressive resilience during the financial crisis in terms of employment and put Germany on a more sustainable path for providing future retirement incomes. However, the growth of domestic demand during the decade over which the reforms took place was very low. While this can be attributed to a range of factors, including fiscal consolidation and recovery from a construction boom, increased labour market uncertainty stemming from the reforms and the creation of a dual labour market may also have depressed aggregate demand. Pension reform appears to have had a significant effect on increasing saving and lowering consumption (OECD, 2010b).

Reform packages should be well designed and prioritise measures that boost short-run growth

Reforms are more likely to boost growth in the short run if the package is well designed. Policy measures should be designed and prioritised to give the best overall trade-off between short-run effects and their ultimate impact. It could be desirable to prioritise reforms in sectors where there are the largest gains: either because the sector itself, for example, is labour intensive and so offers the prospect of strong employment gains if supply expands, or in sectors such as the production of intermediate goods or distribution, where reform would offer large gains to other sectors. For reform measures where the risk of negative short-run effects is the greatest, a delayed or gradual approach may be warranted to balance short- and long-run effects. Clear commitment and communication of existing and future reforms can help to reduce precautionary saving due to uncertainty, while increasing the chances that investment and consumption will rise in anticipation of the future benefits of the reform measures. This could also lower risk spreads in countries such as Italy and Spain to the extent that it is perceived as leading to higher incomes and making the debt burden more sustainable. Reforms that reduce prices may help to support real incomes across a wide proportion of households (Blanchard and Giavazzi, 2003). Political economy considerations are critical to successful implementation of necessary reforms and should be taken into account in their design (Tompson, 2009). This includes clear communication, building support and ensuring that the reforms are fair and perceived to be so.

Short-run gains can be maximised with supporting policies. It is important that financial markets are well-functioning so that the potential gains associated with the reforms rapidly find their way into domestic demand. Furthermore, the social and distributional impact of reforms needs to be reflected in their design. In particular, the short-run costs will be higher if a large share of any immediate costs is borne by those least able to carry it or if uncertainty about employment prospects leads to high precautionary saving. Policies need to be in place to provide effective unemployment insurance and to reduce the risk that people who lose their jobs will end up being excluded from the labour market. Other policy measures may help achieve this, such as well-designed active labour market policies providing retraining and ensuring that unemployment benefits are linked to effective activation policies with appropriate conditionality. More widely, ensuring that product and labour markets are competitive and able to adjust rapidly should be a priority to the extent that the conditions speed up reaping the benefits of reform.

Structural reforms are needed to rebalance the euro area economy

Structural problems contributed to the build-up of imbalances

Weak structural policy settings led to weak or unbalanced growth in many euro area countries during the run-up to the crisis, which contributed to excessive saving and borrowing. This spilled over between countries through the financial system to other euro area countries. Some of the structural problems directly led to housing and credit booms, such as tax distortions favouring owner-occupied housing or poorly functioning financial systems. For some surplus countries, overly tight regulations, in particular in the services sector, contributed to mismatch between high domestic savings and weak domestic investment. For instance, barriers to entry and competition in the domestically-focussed services sector contributed to low investment in Germany and to the orientation of activity towards the export sector (OECD, 2010b). For many countries with large deficits, regulatory barriers and a lack of competition in the domestic services sector harmed price competitiveness and led to low productivity growth, making rising debts harder to sustain (OECD, 2010a). Inefficient product markets and poorly-designed tax systems further contributed to funds being channelled into the housing market rather than productive investments. In countries such as Greece, Portugal and Spain, poor labour market institutions added to wage and price pressures. Structural problems in overheating economies were self-reinforcing, as the strong growth of the economy weakened the political economy conditions for undertaking reforms. Reforms to deal with these underlying problems would contribute to avoiding imbalances in the future. As discussed in Chapter 1, stronger surveillance at the EU and euro area level could help to ensure that this happens but the main onus is on national governments to ensure that their economies are well adapted to the pressures of monetary union and have well-functioning markets.

Structural reforms would help to rebalance the euro area in the medium term

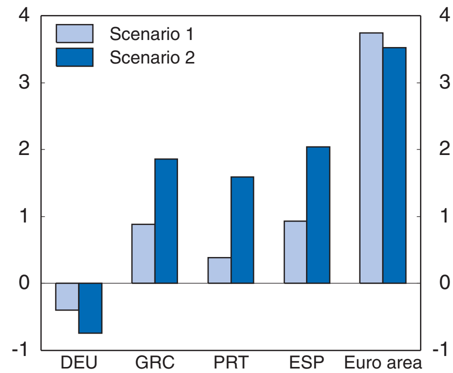
A package of growth-enhancing structural reforms would contribute at the same time to changing savings and investment incentives, leading to a rebalancing of the euro area economy. These effects can be difficult to evaluate with precision given the many channels involved, including through productivity growth, shifts in permanent income and the uncertainty that can be created. Based on cross-country analysis of 30 OECD countries over a long time period, structural reforms of the type set out in Table 2.1 would reduce current account imbalances over the medium term in a number of countries (Kerdrain *et al.*, 2010). Alongside fiscal consolidation, this would contribute to lower overall imbalances in the euro area (Figure 2.8). These results, however, are likely to be a lower bound given that the empirical framework does not fully reflect the range of effects that could be achieved through reform measures.

Well-designed and quantified structural reforms programmes would help crisis countries to recover

There is an acute economic, fiscal and financial crisis in countries that became heavily dependent on foreign borrowing during the upswing of the credit cycle, notably Greece,

Figure 2.8. **Changes in saving-investment gaps in a reform scenario**[1]

Total percentage point deviation from no-change scenario, after 10 years



1. Scenario 1 features fiscal adjustment while Scenario 2 features fiscal adjustment and structural reforms.

Source: Kerdrain, C. *et al.* (2011), "Current Accounts Imbalances: Can Structural Reforms Help to Reduce Them?", in *OECD Journal: Economic Studies*, Vol. 2011, OECD Publishing, Paris.

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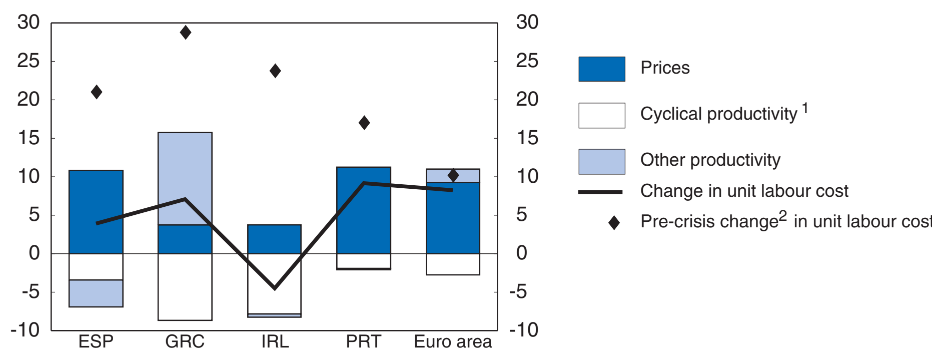
Ireland, Portugal and Spain (Chapter 1). Low growth in Italy combined with high public debt and a contagion effect has led to some similar pressures. With the withdrawal of foreign market funding, a sharp correction to economic, financial and the consequent fiscal imbalances has been required. Structural reforms are central to raising growth and income levels, so that high levels of accumulated debt are more sustainable and the debt burden becomes more manageable. Competitiveness needs to be improved to re-orient activity towards export sectors, requiring higher productivity and relaxation of obstacles to wage and price adjustment. At the same time, short-run demand and supply-side benefits of reforms are needed to help economies in deep recession return to growth.

There is an urgent need to improve competitiveness to crowd in demand through improved export performance and contribute towards the medium-term rebalancing of demand from domestic absorption to exporting. While unit labour costs rose far more than the euro area average in these countries during the pre-crisis period, adjustment has so far only partly reversed this misalignment. The need for downward wage adjustment and restraint is especially important in monetary union given that the nominal exchange rate cannot depreciate to induce the higher demand. This requires the relaxation of obstacles to price adjustment and price signals, including wage indexation, high minimum wages and collective agreements that lead to outcomes out of line with productivity. In Greece, 2010 reforms allow firm-specific collective agreements that opt out from sectoral deals and new arbitration measures are in place with a view to bolstering competitiveness. In Ireland, the hourly minimum wage was cut by EUR 1 in 2010 and it has been frozen in Portugal and Spain with large reductions planned in Greece for 2012, building on earlier reductions for younger workers. Substantial labour market reforms in Spain in 2011 included provisions to make it easier for firms to opt out of collective agreements (Wölfl and Mora-Sanguinetti, 2011). Further product market reforms that increase competitive pressures, which tend to make prices more responsive in the long run, would further facilitate the necessary price adjustment.

Given the high level of indebtedness of these countries and the scale of accumulated weaknesses in competitiveness, there is a risk that restoring competitiveness entirely through downward adjustment of nominal prices would slow the recovery process by raising the real burden of debt (Fisher, 1933). It is desirable, where possible, to seek to improve labour costs through strong improvements in productivity. However, to the extent this is not feasible, in countries facing severe crises, the process of rebalancing may also require downwards nominal wage adjustment. In such cases, it is essential that wage setting is sufficiently flexible to avoid prolonged and unnecessary unemployment. Ireland and Spain have already managed to achieve sharp improvements in labour productivity that would other things equal aid the restoring of competitiveness, while Greece and Portugal have made little progress so far. However, much of this improvement in productivity appears to reflect the large fall in resource utilisation in the economy (Figure 2.9), raising *de facto* capital intensity and leaving relatively unproductive workers from sectors such as construction unemployed. The need for reforms to raise productivity in an underlying sense, at a high level of labour utilisation, therefore remains alongside relative price adjustment.

Figure 2.9. **Unit labour cost developments**

Contributions to change between 2008 and 2011, in percentage points



1. Cyclical productivity identified assuming an elasticity of 1.25 to the measured output gap, in line with the cross-country experience from 2008 to 2011.
2. Change over the period 2002-07.

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

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Beyond improving competitiveness, there is an underlying need to reallocate resources away from sectors that grew too large during the boom years towards export-oriented activities that became squeezed by over-heating domestic demand (OECD, 2010a). The share of industry and manufacturing in GDP declined sharply during the boom years, while construction and services expanded (Table 2.2). Furthermore, buoyant revenues from the booming economy led to an unsustainable increase in public spending. Construction and, to a lesser extent, services output have already receded – perhaps to below long-run levels – but many of the workers and resources in these sectors are now unemployed.

Table 2.2. **Reallocation of resources during the boom**

Average share of GDP (excluding financial services) in Greece, Ireland, Portugal and Spain

	2002	2007
Industry	27.2	23.3
Construction	9.8	11.4
Services	31.6	33.8
Public administration	26.4	28.7

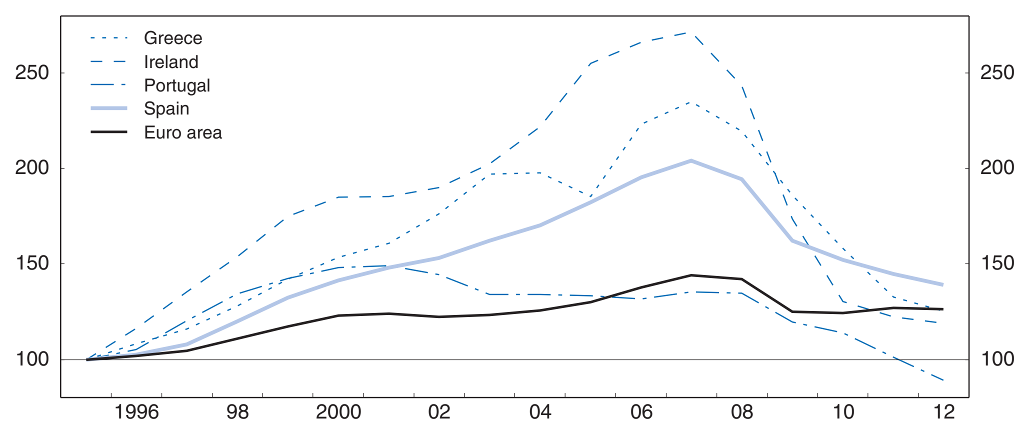
Source: Eurostat.

Activity in these sectors is unlikely to return to recent heights. There is thus a high risk of structural unemployment, particularly for workers with low or very specific skills that were heavily employed in these sectors (OECD, 2010c).

New activities need to be developed in these economies. This could be stimulated by reforms to product market regulations that make it easier to set up new businesses, allowing new opportunities to be taken. This should include strengthening the framework and institutional conditions for innovation, which would help to develop export-oriented activities and boost competitiveness. Reforms that enhance the reallocation of labour may also contribute to improve productivity growth by shifting resources from declining to expanding sectors. With the necessary reforms to stimulate competition and innovation, employment and activity could thus be put on a stronger path. At the same time, there could be an immediate gain in terms of investment. However, it is critical for all these effects that finance is available. As argued in Chapter 1, this is a serious problem in some countries. Restoring the flow of financing and the effective operation of capital markets and banking systems in countries undergoing adjustment is therefore critical. Furthermore, foreign direct investment (FDI) could be a very effective mechanism, both for raising productivity through spillovers (Lesher and Miroudot, 2008), notably via innovation linkages, and as a conduit for foreign financing as FDI is effectively collateralised lending and a way of realising the value of domestic assets for countries facing severe finance constraints. Investment has fallen to a low level in these economies (Figure 2.10) and there is an urgent need to restore capital formation in productive activities.

Figure 2.10. **Investment volumes**

Index 1995 = 100



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

StatLink http://dx.doi.org/10.1787/888932590019

Economic and financial conditions in countries experiencing severe adjustment warrant some caution in the approach to structural reforms: there are large output gaps and financial markets are functioning poorly. Labour market policies aimed at avoiding increases in structural unemployment – such as activation and retraining to help people move away from sectors that grew too large – should be given a high priority. Reforms that are likely to lead to large inflows into unemployment should be introduced cautiously and phased in as the recovery gets underway and the availability of new jobs increases.

Structural reform measures are part of the conditionality in the Troika programmes for Greece, Ireland and Portugal. This recognises the contribution that structural reforms can make to the overall strategy for restoring the public finances in the countries and rebalancing the economies, largely through improved competition in the services market and network industries and by easing wage adjustment. The packages include a very large number of reform measures for Greece and Portugal (Table 2.3). Many of the measures in these areas aim to achieve compliance with existing EU directives. The planned and already completed labour market reforms are substantial, particularly in the case of reducing severance payments, limiting the extension of collective agreements and improving work incentive under unemployment benefits. Wider use of indicator-based analysis could help to identify the main priorities. Well-organised and transparent communication could also help to build support for the package (Tompson, 2009). High macroeconomic slack and credit supply warrant careful monitoring of the short-run impact of reforms as part of the overall adjustment packages.

Table 2.3. **Structural reforms in economic adjustment programmes**

Policy area	Greece	Ireland	Portugal
Labour market	2		4
Public procurement	2		
PMR	8		2
Professional services	8	2	1
Other services	6	1	2
Network industries	7		8
Competition	2	1	
Recognition of qualifications	1		1
Innovation	2		
Planning	1		1
Revenue mix			1
Housing			3
Total	**39**	**4**	**23**

Note: Compiled based on programme documents. Excludes fiscal and financial measures. Measures involving commissioning reports, analysis and so forth are excluded.

Is there a case for co-ordination of structural reforms?

The strengthening of EU and euro area governance has included some measures aimed at improving the co-ordination of economic policies, including structural policies (Chapter 1). There are a number of reasons why co-ordination of structural reforms could boost their effect on short-run growth, while helping to ensure that imbalances are resolved. To the extent that reforms have short-term dampening effects on economic activity, there would be a case for an offsetting easing of monetary conditions. Within the euro area, only a co-ordinated and ambitious package of reforms would be sufficient to warrant a reaction in the stance of euro area monetary policy and so a co-ordinated approach could reduce the costs of doing reforms for all countries. These considerations are sometimes given as a reason for the slow pace of reforms in the euro area since monetary union. In principle, rebalancing of the euro area economy may be more effective in co-operative setting. There may be political economy or peer pressure arguments for countries to commit to reform packages together, although as noted in the *Economic Survey of the European Union*, the track record of EU co-ordination in this regard is not good.

In practice, there are major limits to how much policy co-ordination can achieve. Most of the reforms needed to boost long-term growth prospects require changes in national institutions and regulation. As economic structures and policy needs vary widely across countries, it can be hard to define a common approach. *Firstly,* negative short-run macroeconomic impacts of reforms are likely to be relatively limited so that there is little need for offsetting monetary policy support. *Secondly,* the economic spillovers between countries are likely to be small in most cases given that trade in goods and services to other euro area countries typically only accounts for a fraction of GDP, the effect will typically be widely spread across countries, and there are numerous other ways in which these shocks can be accommodated such as through changes in margins. While reforms have a first-order effect on the domestic economy, the effect on other economies will be of second-order and generally unlikely to be large. A country seeking to rebalance activity towards exports through structural reforms that improved competitiveness is likely to be able to improve its position without material impacts on other economies, except if the home country is either particularly large or trade integration is very high with the partner country. *Thirdly,* given the high level of uncertainty about the impact of particular policies, it is likely to be impossible in a credible and reliable way to "manage" a co-ordinated process of reforms across countries and for monetary policy to be able to react *ex ante* to a reform package rather than assessing the results *ex post* as the measures impact the economy. At the EU level, reforms to complete the Single Market should be the key priority as argued in the *Economic Survey of the European Union*.

The most important potential contribution to achieving the best short-run macroeconomic effects of structural reforms from co-ordinated action at the euro area level may be to ensure that the necessary capital is available for all economies to take advantage of the new opportunities created by the reforms. This requires good oversight of private capital flows and ensuring that the banking system and capital markets are functioning well for all euro area countries. In addition, adequate access to funding for national governments needs to be ensured so that necessary public investments can be undertaken and domestic demand can be supported in the near term.

Box 2.1. **Summary recommendations on structural reforms to boost and rebalance growth**

An ambitious programme of reforms is needed to boost near- and long-term growth, improve public and private debt sustainability, and resolve and avoid excessive imbalances:

- Undertake a substantial and ambitious programme of reforms to product market regulation, labour markets institutions and tax systems to boost growth. This should include effective implementation of the Single Market (see *Economic Survey of the European Union*), alongside measures at national level.
- Communicate clearly the package of reforms, including credible commitments to future measures to minimise uncertainty and encourage strong demand effects in terms of investment and higher consumption.
- Undertake reforms in both surplus and deficit countries with excessive imbalances aimed at enhancing growth and the adjustment capacities of the economy to address underlying causes of excessive imbalances and facilitate rebalancing. Structural reforms, in labour, product and services markets, can boost investment thus contributing to rebalancing through enhancement of their potential growth.

Box 2.1. **Summary recommendations on structural reforms to boost and rebalance growth** *(cont.)*

- In countries having built up excessive internal and external levels of debt and experienced large competitiveness losses, focus structural reforms on raising productivity, reducing structural unemployment, facilitating wage and price adjustment and attracting foreign capital. These reforms would encourage investment in new activities and export-oriented sectors.
- Under economic adjustment programmes, design reforms to maximise the positive impact on demand, and take into account large output gaps, tight financial conditions and a high level of existing economic dislocation.

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Glossary

CBPP2	Covered Bond Programme
CIF	Co-Investment Fund
CRD	Capital Requirement Directive
EBA	European Banking Authority
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFC	Economic and Financial Council
EFSF	European Financial Stabilisation Facility
EFSM	European Financial Stabilisation Mechanism
ELA	Emergency Liquidity Assistance
ESAs	European Supervisory Agencies
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ICT	Information, Communication and Technology
IMF	International Monetary Fund
MIP	Macroeconomic Imbalance Procedure
MTOs	Medium-Term Objectives
PPS	Purchasing Power Standards
PSI	Private Sector Involvement
QMV	Qualified Majority Voting
R&D	Research and Development
RQMV	Reverse Qualified-Majority Voting
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
VAT	Value Added Tax

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