Europe must act now to prepare the aftermath of the pandemic crisis

by Laurence Boone, OECD Chief Economist and Alvaro S. Pereira, Director, Economics Department Country Studies Branch, OECD

We are currently facing extraordinary challenges posed by the Covid-19 pandemic, due to which necessary health measures are shutting down part of our economies and precipitating a recession of unprecedented nature and magnitude.

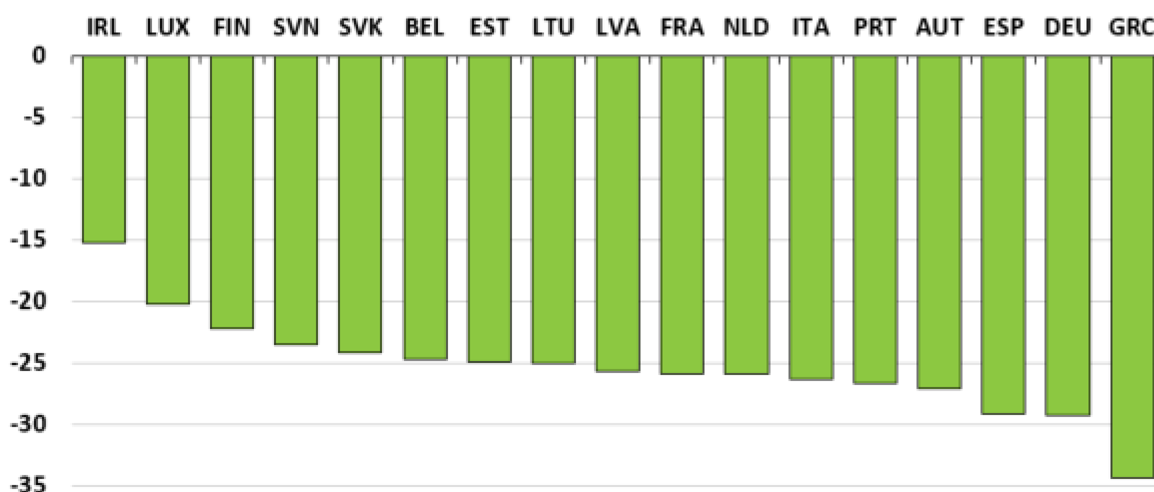
In the immediate response to the crisis, governments increased health spending, but also introduced large fiscal support (e.g. short-time working weeks, extended unemployment schemes, tax and social security deferments, new credit lines, among others, see **OECD Policy tracker**) in an attempt to mitigate the social and economic impact of the pandemic. In addition, in Europe, the ECB launched a large program of asset purchases and a set of other unprecedented measures, and the European Commission temporarily shut down budget rules and exceptionally lifted state aid rules.

Still, given the magnitude of the crisis that we are facing, these measures and packages, albeit important and unprecedented, will not be enough for most European countries to address a post-pandemic world where debt levels will be much higher and the job losses tremendous. According to **OECD estimates**, the widespread shutdowns needed to contain the spread of the coronavirus and save lives will cause an estimated initial direct output decline of around 25% in many

economies (Figure 1).This is equivalent to a contraction of about 2 percentage points of annual GDP per month of confinement. Thus, the 2020 output fall will far exceed that of 2009.

Figure 1 The potential initial impact of partial or complete shutdowns on activity in euro area countries[1]

In percent of GDP at constant prices[2]



1. Euro area countries that are also members of the OECD (17 countries).
2. The sectoral data are on an ISIC rev. 4 basis in all countries. The sectors included are manufacturing of transport equipment (ISIC V29-30), construction (VF), wholesale and retail trade (VG), air transport (V51), accommodation and food services (VI), real estate services excluding imputed rent (VL-V68A), professional service activities (VM), arts, entertainment and recreation (VR), and other service activities (VS). The latter two are grouped together as other personal services in the figure. Full shutdowns are assumed in transport manufacturing and other personal services; declines of one-half are assumed for output in construction and professional service activities; and declines of three-quarters are assumed in all the other output categories directly affected by shutdowns. Real estate services excluding imputed rent are assumed to be 40 per cent of total real estate services in countries in which separate data are not available.

Sources: OECD Annual National Accounts; OECD Trade in Value-Added database; and OECD calculations.

When the confinement is gradually withdrawn, European policymakers will have to do more to speed up the recovery and avoid massive unemployment and firm bankruptcies. The challenge will be significant: many euro area countries will have debt ratios above – and sometimes much above – 100% of GDP, and economic fundamentals will have been hurt. History shows that countries that invest in the recovery, rather than tighten too much too fast, not only accelerate the recovery, but are also able to bring debt down faster. Too rapid fiscal tightening in some countries in 2010/2011 weakened the euro area and left it with long-term scars, including an incomplete

restructuring of the banking and corporate sectors, higher structural unemployment, low investment and low inflation, and a failure to revive structural reforms agendas.

There is an important positive element in the current crisis: by committing to “do everything necessary within its mandate”, the ECB has responded forcefully and much faster than in the previous crisis, contributing to and buying precious time for policymakers to work out a sustainable response to this symmetric shock.

Europe is building up a multi-pronged response to the crisis and the ensuing recovery, but some debate remains regarding the financial instruments that must be used for this purpose. The EIB is proposing substantial support to firms, and the Commission is proposing to support the unemployed, which seems to have met consensus. But the bulk of Europe’s fiscal response to address the “war effort”-like recovery remains largely individual or national. Unlike in the recent financial crisis, this exogenous shock is shared across countries. The debate is made more complex by some perceptions that the uneven situation across countries is due to different levels of responsibility at the national level, especially regarding fiscal policy. It may be fair to say that much of the debt legacy prior to the crisis is indeed individual countries’ responsibility. But this is not the case for the health and economic efforts resulting from the Covid-19 pandemic. Both **the widespread pandemic and the close integration of EU countries argue for a financial response that should be large and shared** . Such a response should be clearly differentiated from the stock of debt prior to the Covid-19 crisis.

It is imperative to bridge the gap between the existing options in the debate for a forceful response. Two options

could provide the EU with the necessary fire power to address this crisis: a new financial instrument featuring joint issuance, and the European Stability Mechanism (ESM). We start with the latter.

The ESM was created by euro area members to mobilise funding and provide financial assistance to countries threatened by or experiencing severe financing problems. Its use involves a rigorous analysis of public debt sustainability and strict policy conditionality, because these difficulties were perceived as resulting from past policies having led to poor economic performance. Obviously, these criteria do not apply in the current crisis. In particular, the strong conditionality attached to financial assistance seems totally inadequate when the crisis arises from a pandemic or a natural disaster. Some are suggesting light conditionality. However, this approach may not be acceptable to those countries that believe that strict conditionality is an explicit requirement for accessing its resources. In addition, the 410 billion euros in unused lending capacity (3.4% of 2019 euro area GDP) seems modest when compared to the needs of the euro area as a whole. In addition, the ESM currently relies on short-term credit facilities having an initial maturity of one year, and renewable twice, each time for six months. Therefore, ESM credit lines provide only limited relief against medium-term rollover risks, which makes it more of a bridge facility to overcome temporary fiscal distress pending a medium to long-term solution.

For all these reasons, as it currently stands, the ESM is ill suited to provide widespread fiscal support to euro area countries to counteract the economic fallout of the pandemic. **If the ESM is to play a significant role in the challenges posed by the current crisis, its firepower will have to be substantially upgraded, the conditionality requirements will**

have to be significantly watered down and replaced by an allocation usage condition (namely, fund all pandemic-related spending).

An alternative is the creation of European financial instruments that mutualise a large part of the fiscal costs and financing of the crisis. More specifically, **the launch of one-off, ad-hoc European debt instruments should help finance fiscal needs at a relatively low cost for all euro area members and for the euro area as a whole**. This would have the advantage of not adding directly to the national debt numbers, provided such a feature is part of the original design. This approach demands that several conditions are met:

- Ensuring the one-off, temporary nature of the fund: the credibility of the one-off nature of the instrument would be enhanced by dedicating a targeted tax flow to its payment over a very long period, such as, for example, the model of the German solidarity tax after reunification. Long maturities should help ensure that repayments will be spread over generations and not hamper the recovery efforts.
- The spending would cover only Covid-related expenditures, to address health risks and the associated recovery from the exceptional shutdown. The instrument would be governed by the European Commission, and overseen by the European Parliamentt.
- The supra-national nature of the bonds would allow the ECB to purchase up to 50% of the issuance, while anchoring the fiscal commitment of euro area countries to the recovery .
- Such instrument would increase the fiscal space in countries more sensitive to borrowing costs and accelerate the recovery for all.

The crisis faced by Europe is extraordinary and requires extraordinary responses. It is also a unique opportunity for Europe, and in particular the EMU, to consolidate its economic and financial architecture, and to promote Europe as the engine of "shared prosperity". A significantly reinforced and revamped ESM or a new financial instrument based on joint issuance, as described above, would be possible vehicles to translate words into action. The ECB has bought European policymakers some precious time that they now have to use to devise a common approach.

Right here, right now: The quest for a more balanced policy mix

Laurence Boone, Chief Economist, OECD and **Marco Buti**, Director General, DG Economic and Financial Affairs, European Commission

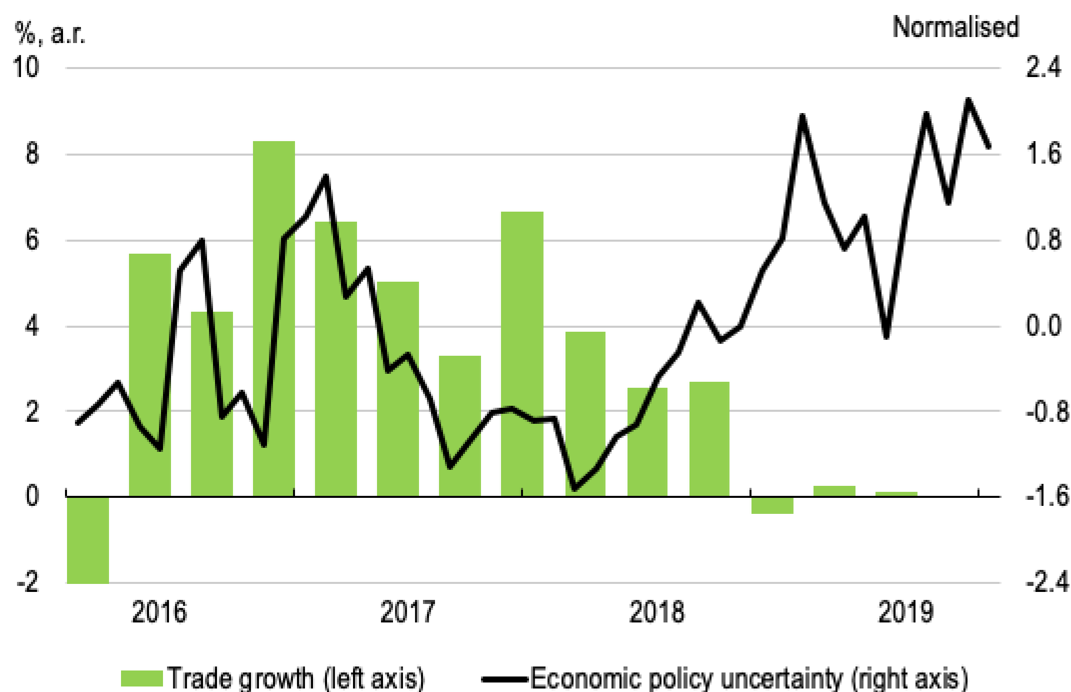
After years of solid growth, worldwide economic activity has slowed down sharply in 2019 while global trade has stalled. Policymakers have the difficult task of addressing the immediate policy challenges to support economic growth while also preparing our economies for the future. This column argues that while monetary policy is widely recognised as facing increasing constraints, fiscal policy and structural reforms need to play a stronger role. In particular, fiscal policy could become more supportive, notably in the euro area. Undertaking the right type of public investment now – in

infrastructure, education or to mitigate climate change – would both stimulate our economies and contribute to making them stronger and more sustainable.

Over the past few years, economies in the OECD and in particular in the EU had been growing at cruising speed, after having seemingly shrugged off the remains of the global financial crisis. The US is experiencing its longest bout of uninterrupted positive GDP growth on record. Similarly, despite lower growth performance, the EU has been growing for 25 quarters and its unemployment rate is now at its lowest since 2000.

Yet, worldwide growth has been decelerating sharply in 2019, dragged by a global trade and investment slump along with, in Europe and most notably in Germany, a steep drop in manufacturing activity. Recent indicators suggest that growth could weaken further (IMF 2019). Rising uncertainty has been driving this slowdown, as a result of increasing economic tensions between China and the US, geopolitical developments in the Middle East (with the associated risk of a sharp rise in oil prices), and the political deadlock over Brexit. The materialisation of these risks could put the world economy on a collision course. Even if they remain only looming threats, high and increasingly entrenched uncertainty is sufficient to put a brake on investment and growth.

Figure 1 Global trade growth and policy uncertainty



Note: Global uncertainty index normalised to 0 over the period

Source: www.policyuncertainty.com and OECD Economic Outlook database.

The impact of these tensions is exacerbated by a number of structural developments, in particular in Europe. The drop in potential growth, evident since the 2000s, has prompted concerns of 'secular stagnation' affecting the US and Europe. An important driver could be the slow diffusion of technologies: as Anzoategui et al (2019) argue, much of the slowdown in productivity after the recession can be attributed to lower technology adoption. In addition, demographic change is taking a toll on growth potential while the appetite for reforms has slowed.

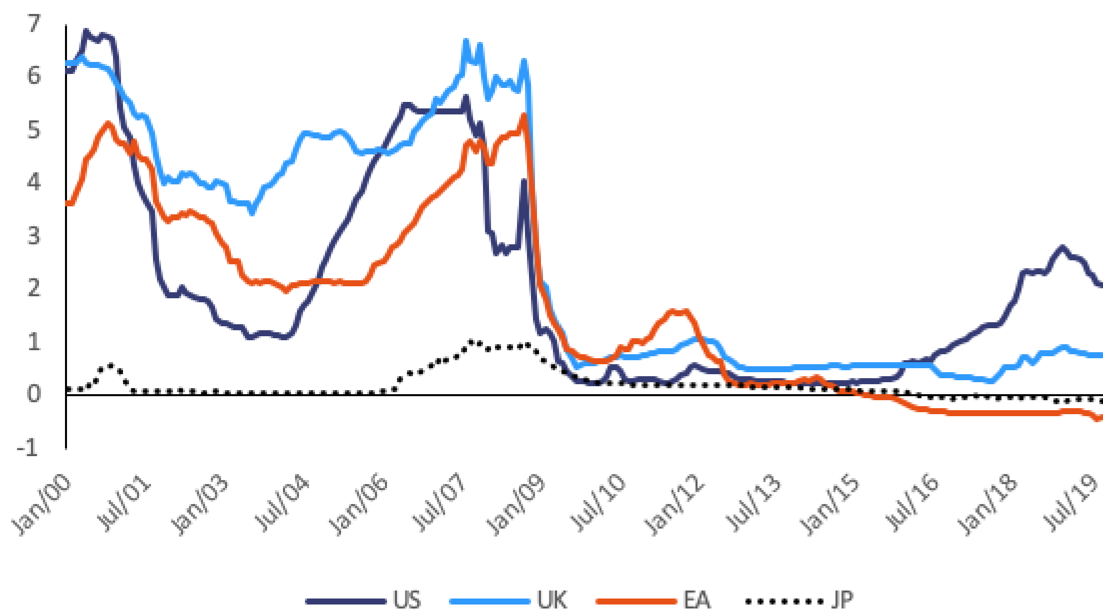
A better policy set-up is needed to lift economies back to growth

The conjunction of cyclical and structural impediments to

growth calls for a review of the customary economic policy response to a deteriorating economic climate. Current inflation and policy rates, which are expected to remain at their low levels, suggest that ever more accommodative monetary policy will not be enough to revive GDP growth. At the same time, nominal GDP growth rates being above interest rates paid on public debt for most countries, and set to remain there for long, increase the space for public investment.

Since the outset of the financial crisis, monetary policy has remained exceptionally accommodative, bringing interest rates close to zero (see Figure 2). In particular, the Fed continues to take expansionary measures, while the Bank of Japan maintains an extraordinary degree of monetary accommodation. Zooming in on the euro area, the ECB announced a fresh stimulus package in September as it cut the deposit rate further by 10 basis points and relaunched its quantitative easing (QE) programme, together with expanded forward guidance. However, monetary policy faces increasing constraints.

Figure 2 Three-month interbank interest rates (%)



Source: Bloomberg

The other policy instruments in the toolbox – both fiscal and structural – thus need to help. Together with the structural reforms needed to lift productivity durably, public investment could be put to use to halt the ongoing slowdown and prepare the ground for stronger and more sustainable economies. In fact, the same factors that constrain monetary policy are a bonanza for fiscal policy, which jointly with structural reforms can lift growth in a sustainable way.

Fiscal interventions are more powerful when inflationary pressures are low and monetary policy is likely to accommodate fiscal expansions as long as inflation remains below target. The euro area as a whole has fiscal room to manoeuvre, even though the situation differs markedly across countries. But while the slowdown is becoming entrenched, under current plans, fiscal levers are not being activated: on average in the euro area, the fiscal stance is expected to be broadly neutral in the next two years.

At the same time, the appetite for reforms with potential to lift growth and employment in the longer term – such as easing barriers to entrepreneurship, improving and expanding training, and supporting R&D and technology adoption – has waned, as shown by the implementation of the Going for Growth recommendations (OECD 2019a) or EU country-specific recommendations. Yet, such reforms are needed to reverse the slowdown in productivity that started even before the crisis but was exacerbated by the hysteresis effects of the Great Recession on investment and skills. Structural reforms are also needed to make growth more environmentally sustainable, by aligning policies and regulation with the goal of transition to a low-carbon economy (OECD 2015).

In addition, reforms are easier to implement when accompanied by a supportive policy mix, while in times of faltering demand, structural reforms alone may weigh on inflation and already weak demand (Eggertsson et al. 2014). In effect, reforms introduced when the economy is weak have a better chance of succeeding when undertaken together with supportive macroeconomic policies and renewed public investment, and when they put more weight on measures that also boost demand in the short term, such as strengthening job search assistance and training and improving the tax structure (Caldera Sanchez et al. 2016). Simulations on the euro area run by the OECD for its Economic Outlook illustrate how combining a temporary public investment push with productivity-enhancing reforms can help bring forward the long-term benefits of reforms (OECD 2019b,c).

There is a strong case for a more supportive fiscal policy in the euro area

In the euro area, the inadequacy of a policy mix relying exceedingly on the monetary policy pillar is becoming particularly obvious, as notably emphasised by the institution itself (Draghi 2019). Meanwhile, the 'reflationary' efforts conducted by the ECB are meeting increasing resistance both within and outside the institution.

Consequently, the usual arguments for relying mainly on automatic budgetary stabilisers and monetary policy when dealing with adverse shocks to the euro area may have to be reconsidered. In particular, modelling work done by the European Commission (In't Veld 2019) shows that when monetary policy is constrained by the zero-rate floor, fiscal stimulus has a stronger impact on growth in the short term and a more benign effect on the debt ratio in the long term.

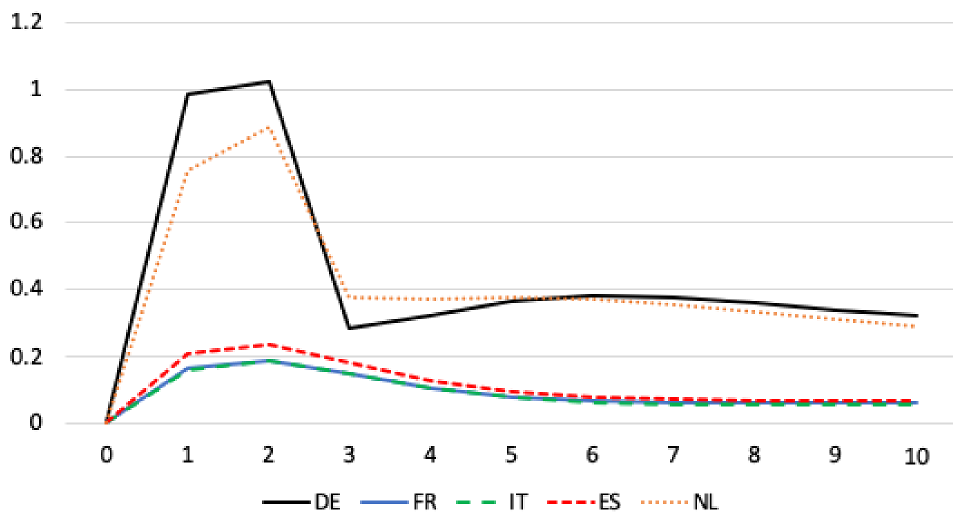
While the benefits of a more supportive fiscal policy already appear sizeable at the current juncture, depending on how events unfold, the failure to act could result in snowballing negative effects going much beyond those captured in the usual simulations. In particular, the lack of action may increase the risk of the economy moving to inferior equilibria where deteriorating expectations of growth, employment and price developments, as well as private sector balance sheet effects, may further add to the current downward spiral. In these circumstances, the costs of too little stimulus in a worsening economy are likely to outweigh the costs of too much stimulus should a more favourable scenario materialise. The large compounded downward risks call for a risk-based approach to fiscal policy, with more pre-emptive rather than reactive policy action.

In absence of a common euro area budget, the current situation offers an opportunity for a truly coordinated approach to a

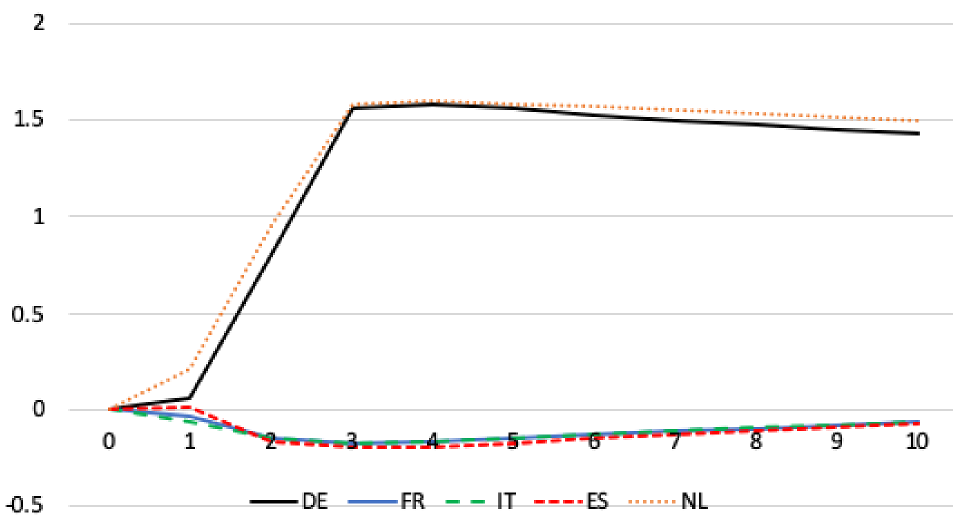
supportive but differentiated fiscal stance in the 2020 budget plans. A more active role for fiscal policy in the policy mix would require differentiation between Member States with fiscal space and Member States with high debt, taking into account the divergent sustainability challenges. Furthermore, it is also important to improve the quality and composition of public finances, in particular boosting investment to ease the climate transition, and step up structural reforms.

Figure 3 Effects of differentiated fiscal expansion: Germany and the Netherlands

a) GDP



b) Debt-GDP ratio



Note: GDP effects as percentage difference and debt-GDP ratios as percentage-point difference from baseline for a 1% of GDP increase in public investment for two years in DE and NL. Default assumptions for debt profile: r^g =0 (i^g=2, π=2, g=1.7).

Source: In't Veld (2019)

Illustrative simulations with the Commission's QUEST model suggest that an increase in public investment of 1% of GDP for two years in Member States with fiscal space, with monetary policy at the zero lower bound, leads to GDP increases of around 1% during that period in the concerned Member States and slightly less for more open economies (Figure 3). In the medium run, even after the stimulus has been removed, output

remains above the baseline due to productivity gains from higher investment. Spillovers to other euro area Member States are modest at around 0.1-0.2% of GDP. The resulting effects of a temporary fiscal stimulus on debt to GDP ratios are benign, thanks to higher growth. In the Member States with fiscal space, the debt-to-GDP ratio would increase around by 1½ percentage points in the short run, fading out in the long run. A more persistent expansion in public investment in surplus countries, which would correct past cutbacks, would give a bigger boost to the euro area economy, with larger spillovers to other countries and still a manageable increase in debt ratios compared to the baseline scenario (In't Veld 2016). Where interest rates are negative, as is presently the case for most countries, the debt dynamics are even more favourable.

High fiscal multipliers and benign effects on debt developments rely on the nature of the fiscal impulse. Investment spending, which supports the economy's productive capacity and is time-limited in nature, has a stronger impact. A differentiated investment stimulus in line with the spirit of the EU fiscal framework would be most effective.

Now is the time to invest in stronger and more sustainable economies for the future

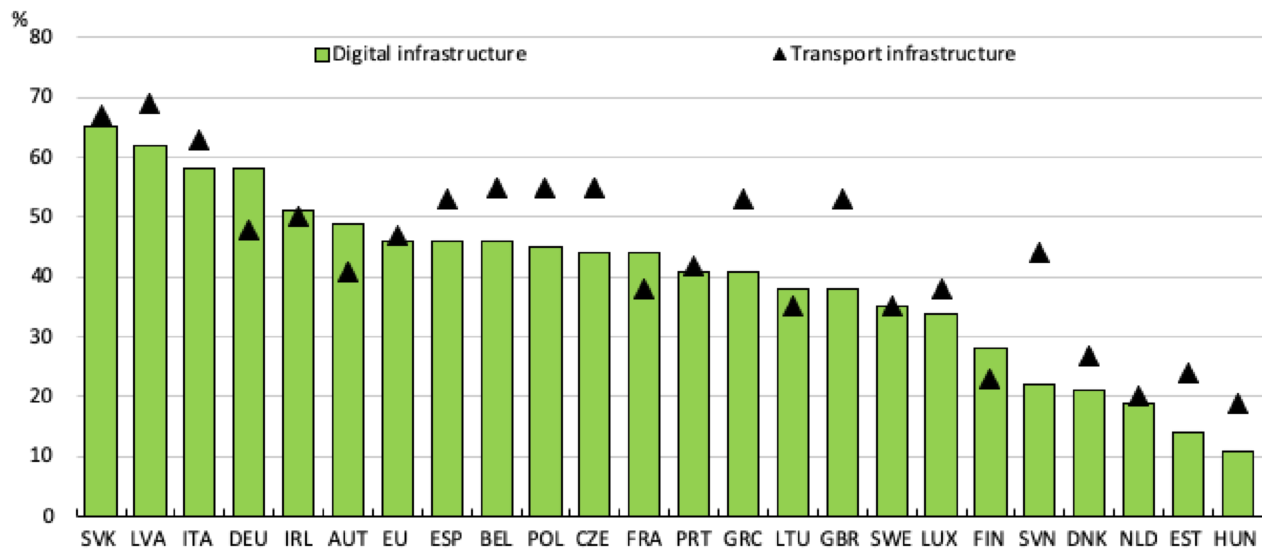
The case for a more active use of fiscal policy is not only rooted in the critical role it must play to drag weak economies out of the risk zone. The current situation also offers an opportunity not to be missed to address deep economic challenges and invest in the future. The low interest rates at which governments are borrowing, even at long maturities, mean that many of them can more easily undertake

investments to raise long-term growth, sustainability and wellbeing without putting strain on public finances.

In the aftermath of the global financial crisis, governments often resorted to cuts in public investment to achieve fiscal consolidation in a way deemed less painful than raising taxes or cutting social spending or the public sector wage bill. Throughout the post-crisis period, this shortfall in public investment has not been made up for. A decade of infrastructures that were not built or were not properly maintained has been taking its toll on productivity and growth potential. It risks turning into persistently missed chances to better connect people, firms and regions to opportunities.

Some countries, such as Germany, are in dire need of stronger investment. Across the EU, almost half of firms are held back in their investment decisions by the inadequacy of transport infrastructure, and the same number by the lack of access to digital infrastructure (Figure 4). High-speed networks are the backbone of a knowledge economy and a pre-condition for firms to innovate and thrive in the near future. Bridging the rural digital divide is also key to reduce regional disparities and improve social cohesion. Further investment in health, education and skills would also support a more durable and more inclusive growth.

Figure 4 Firms reporting that infrastructure is an obstacle to their investments (%)



Source: European Investment Bank Investment Survey, 2018.

At the same time, the need to invest in greening our economies is becoming ever more pressing, as delaying action will entail steeply rising costs of climate change mitigation (IPCC 2018). The growing scale and reach of climate-motivated demonstrations and civil disobedience actions in recent months have given a political urgency to the issue. The energy transition will require more investments – and different investments than under the current trajectory – to decarbonise entire sectors starting with energy, industry and transport. In the EU, President-elect van der Leyen has announced a “Green Deal” to accelerate the transition towards achieving carbon neutrality by 2050 (van der Leyen 2019). Such an initiative could mobilise public and private resources to lift innovation and investment in low-carbon technologies and build more sustainable economies.

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Do negative interest rates in the euro area hurt bank profitability?

Jan Stráský and Hyunjeong Hwang, OECD Economics Department

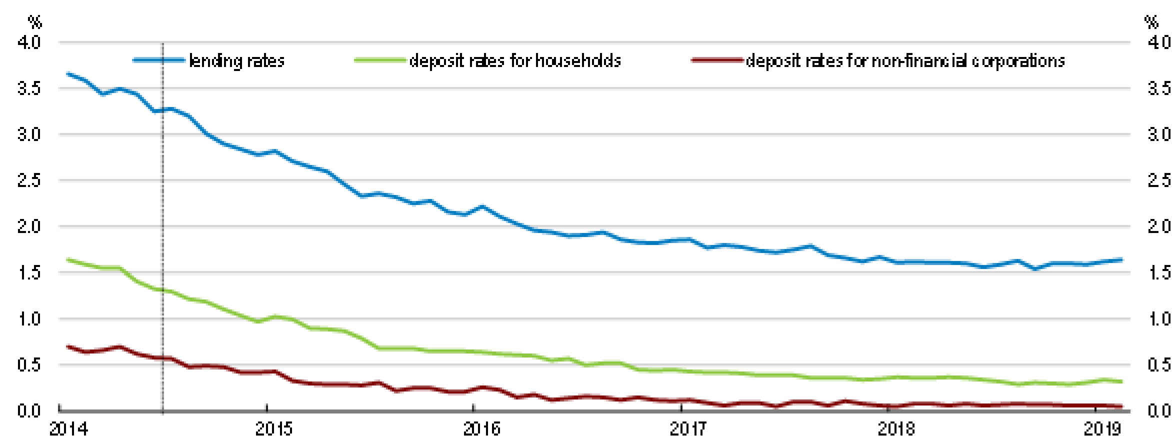
The recent decision of the European Central Bank (ECB) in September 2019 to lower the deposit rate from -0.4% to -0.5% triggered another round of criticisms in some countries about the negative impact of negative interest rates on banks' profits. This debate happened despite the fact that the ECB has introduced a two-tier system, which exempts part of the reserves held by the commercial banks from the negative deposit rate, highlighting the sensitivity of the issue. How damaging are actually negative interest rates to banks profits? We try to gauge this question in our recent paper Negative interest rates in the euro area: does it hurt banks?

The interaction between negative interest rates and banks' profit is complex

When policy interest rates turn negative, banks may protect their interest margins by not reducing lending rates in step with policy rates and by not reducing their deposit rates for corporate and individual depositors below zero, thus limiting depositors' incentive to switch to another bank or to cash. Indeed, the deposit rates in the euro area compressed by less than lending rates and remain well above zero (Figure 1). The

deteriorating profitability, in particular over prolonged periods, could lower banks’ ability to create capital from their profits and hence the ability to withstand risk and supply credit.

Figure 1. Lending rates and deposit rates of the euro area banks



Note: Lending rates mean MFI interest rates on new euro-denominated loans to non-financial corporations for loans between EUR 250,000 and EUR 1 million over three months and up to one year initial rate fixation. Deposit rates mean MFI interest rates on new euro-dominated deposits from euro area residents with an agreed maturity of up to one year. The vertical line denotes the time when the euro area policy rate turned negative.
Source: European Central Bank.

However, negative and declining policy interest rates bring additional loosening of monetary policy improving macroeconomic outlook and raising demand through revised consumers’ and investors’ plans. The resulting Increase in bank lending helps lift bank profitability. The overall effect is likely to differ from bank to bank, depending on their business model, their source of funding and other characteristics, such as the existing stock of non-performing loans and the state of demand for loans in bank’s home market. As monetary policy rates decline more and more below zero, monetary policy could eventually reach a “reversal rate” where negative effects on bank profitability outweigh improvements from accommodative monetary policy on macroeconomic outlook and increased bank lending (Brunnermaier and Koby, 2019).

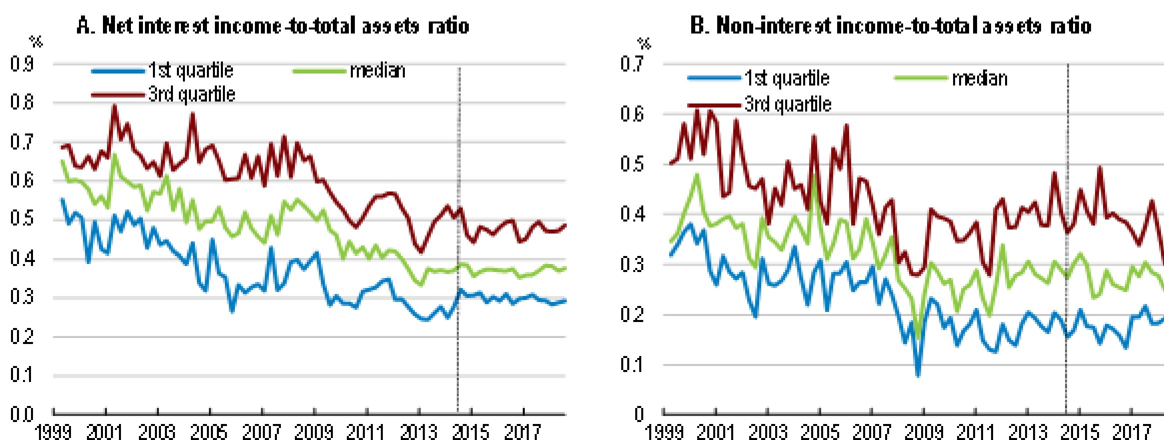
Estimated effects of negative rates on profitability do not

indicate a significant impact

Since the various effects of negative interest rates on bank profitability are going in opposite directions, the overall effect has to be determined empirically. To do so, we use quarterly data on bank groups directly supervised by the ECB extracted from quarterly accounts reported in Bloomberg. As the data cover the period from 1999 to 2018, our study contributes to the literature by analysing separately, for the first time to our knowledge, the period of negative interbank interest rates in the euro area that started in 2015.

While the banks seem able to preserve their net interest margins in the period of negative interest rates (Figure 2, panel A), the ability of the best performing banks to generate non-interest income seems to have deteriorated in comparison to other banks (Figure 2, panel B). However, since our data covers the period when negative interest rates were in place together with large-scale asset purchases, the econometric analysis combines the effects of all monetary policy measures.

Figure 2. Main components of bank profitability



Note: The vertical line denotes the time when the euro area policy rate turned negative.

Source: OECD calculations using Bloomberg data.

The econometric analysis confirms the effect of the interest rate level on bank profitability, suggesting that decreasing interest rates lead to decreasing bank profitability, and in some specifications also suggests an additional negative effect on profitability associated with the period of negative interest rates. However, the negative effects of bank profits are not robust and tend to disappear when we control for the link between policy interest rates and expected macroeconomic conditions, such as expected real GDP growth and CPI inflation. In line with some other studies, we also find weak evidence of possible negative effects from keeping rates low for an extended period of time. However, this finding is valid only for the rate of return on total assets and not for other measures of bank profitability, such as net interest income or the provisioning needs.

Although we do not find consistent evidence of negative effects on bank profitability from the negative interest rate policy, possible negative effects may be associated with keeping rates low for an extended period of time. Measures preserving profitability at the bank level, such as cost cutting and mobilisation of the sources of non-interest income seem a prudent policy in this context.

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Global growth is weakening: coordinating on fiscal and structural policies can revive euro area growth

by Laurence Boone, OECD Chief Economist

The
global expansion is continuing to lose steam, and faster than anticipated a few
months ago. Growth in Europe has been particularly disappointing, as trade
growth both within the EU and with external partners has stalled. Business and
consumer confidence has plummeted in advanced economies as trade tensions
persist, high levels of policy uncertainty in Europe linger, and the pace of China's
slowdown continues to raise concerns.

Global growth is projected to ease further from 3.6% in 2018 to 3.3% in 2019 and 3.4% in 2020 in our latest Interim Economic Outlook. It has been revised downwards in almost all G20 economies, with particularly large revisions in the euro

area in both 2019 and 2020, driven by weakness in Germany and Italy, but also in the UK, Canada and Turkey. And the manufacturing sector seems to take a hit across the G20 on the back of trade tensions.

OECD Interim Economic Outlook Projections

Year-on-year, %. Arrows indicate the direction of revisions since November 2018.

	2018	2019	2020		2018	2019	2020
World	3.6	3.3	3.4	G20	3.8	3.5	3.7
Australia	2.9	2.7	2.5	Argentina	-2.5	-1.5	2.3
Canada	1.8	1.5	2.0	Brazil	1.1	1.9	2.4
Euro area	1.8	1.0	1.2	China	6.6	6.2	6.0
Germany	1.4	0.7	1.1	India[1]	7.0	7.2	7.3
France	1.5	1.3	1.3	Indonesia	5.2	5.2	5.1
Italy	0.8	-0.2	0.5	Mexico	2.1	2.0	2.3
Japan	0.7	0.8	0.7	Russia	2.3	1.4	1.5
Korea	2.7	2.6	2.6	Saudi Arabia	2.0	2.1	2.0
United Kingdom	1.4	0.8	0.9	South Africa	0.8	1.7	2.0
United States	2.9	2.6	2.2	Turkey	2.9	-1.8	3.2

Note: Difference in percentage points based on rounded figures. Dark red for downward revisions of 0.6 percentage points and more. Dark green and dark orange for, respectively, upward and downward revisions of 0.3 percentage points and more but less than 0.6 percentage points. Light green and light orange for, respectively, upward and downward revisions of less than 0.3 percentage points. The European Union is a full member of the G20, but the G20 aggregate only includes countries that are also members in their own right.
1. Fiscal years starting in April.

Some
factors are supporting growth, including easier financial conditions, with
major central banks having signalled a pause in monetary policy normalisation.
Also labour markets remain resilient for now, and wage growth is slowly picking
up, supporting household incomes and spending. However, worryingly, downside
risks continue to build up and growth could be much weaker if these risks were
to materialise.

Three major sources of risks are our main concerns.

First,
the continued uncertainty about trade policies remains a significant drag to
global investment, jobs and, ultimately, living standards. Even if the United
States and China conclude a trade agreement soon, we cannot exclude that other
measures will be implemented later in 2019, or that new restrictions will be
put in place in specific trade-sensitive sectors, such as cars. If the US imposed
tariffs on European cars, this would hit the European economies particularly
hard. Motor vehicle exports represent around 10% of total EU merchandise
exports to the United States and there are significant supply-chain linkages
within Europe that would spread the impact widely across countries and firms.

Second,
there is considerable uncertainty about the extent of China's slowdown. The government has
put in place sizeable monetary and fiscal stimulus, including tax cuts and
infrastructure investment. However, the jury is still out regarding the effectiveness
of these fiscal measures. Meanwhile, corporate sector indebtedness is at very
high level, posing risks to financial stability.

China

has significantly contributed to global growth for the past two decades, so
that any sharper deceleration than expected would cascade to the rest of the
world. Countries in East Asia, commodity exporters and Japan would be
particularly hard hit by a sharp slowdown in Chinese demand growth. Reduced
demand in China would also affect global confidence adding significantly to
these costs, particularly in the advanced economies. Overall, taking direct trade
and confidence effects into account, our simulations suggest that a decline of
2 percentage points in the growth rate of demand in China for two years would
lower global GDP growth by over 0.5 percentage point in the first year already.

Third,
in Europe further weakness coming from China, Germany, Italy or the United
Kingdom could quickly spread to other European economies, given the importance
of trade linkages across the EU: EU countries trade more between themselves
than with the rest of the world, and very often goods or services are produced across
several countries. In the euro area, where most credit to firms is distributed
through banks, the weakness could be aggravated if sovereign yield increased,
raising banks funding costs and in turn reducing credit supply, dampening
investment and consumption, and ultimately jobs. Brexit is also an immediate

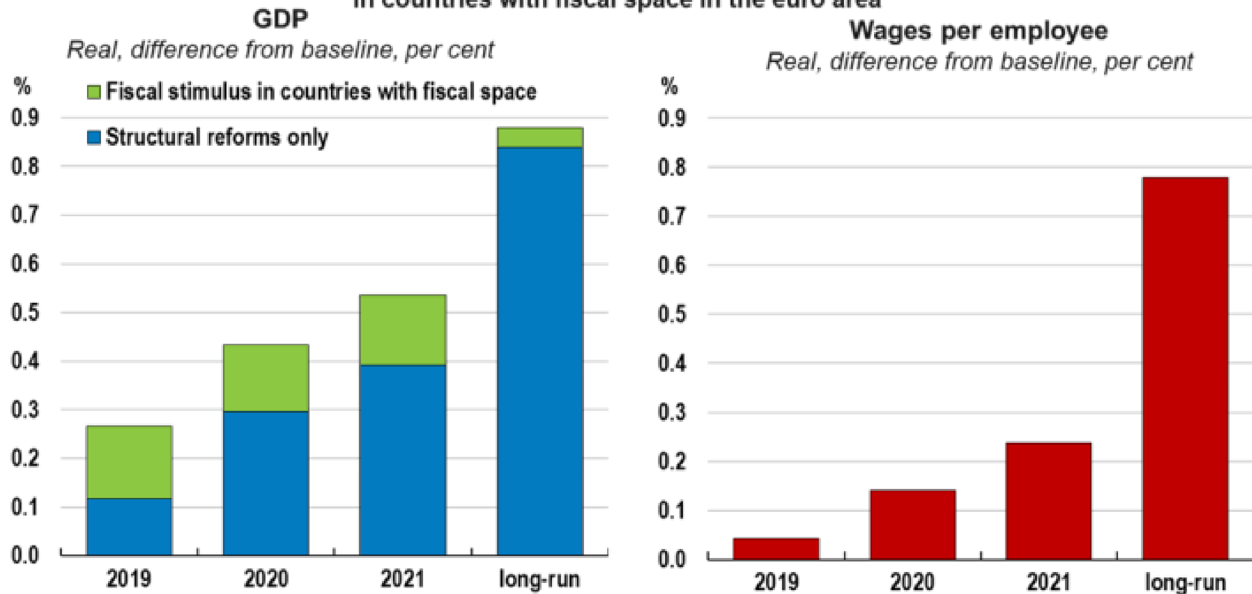
downside risk. We have already seen a clear dent in the growth rate of
investment in the UK since the Brexit referendum. And the costs of a no-deal
would be significant. According to our estimates, it could amount to 2% of GDP for
the United Kingdom by 2020 already.

One
final risk is that a sharper-than-expected slowdown in global growth could
trigger corporate bonds downgrades or even defaults. The outstanding stock of corporate
bonds at the end of 2018 was twice that in 2008 in real terms (at USD 13
trillion), the quality of outstanding debt has continued to decline, and there
are signs that corporate earnings growth has begun to slow. Significant bond
repayments are also due in emerging-market economies in the next three years,
especially in China.

In
this environment, governments must intensify multilateral dialogue on trade, and
in the euro area coordinate all levers of policy to avoid a sharper downturn.

Monetary policy normalisation has been on pause in the main advanced economies, and rightly so given rising uncertainty, weaker growth prospects and contained inflation. But monetary policy can and should not act alone.

Impact of structural reforms and a coordinated 3-year fiscal stimulus in countries with fiscal space in the euro area



Note: The level of technical progress is gradually raised by 1% by the fifth year in all countries, and countries with fiscal space also increase government investment by 0.5% of GDP for three years. Euro area monetary policy is assumed to be set in a way that takes into account the eventual long-run improvement in output. Countries with fiscal space here include Germany, the Netherlands, Austria, Finland, Ireland, Slovak Republic, Slovenia, Estonia, Latvia, and Lithuania.
Source: OECD calculations.

Taking advantage of accommodative monetary conditions, euro area governments should coordinate fiscal and structural policies to revive growth both in the short and medium term. A moderate fiscal stimulus in countries that have fiscal space, targeted at public investment, would lift growth during the time it takes for structural reforms to deliver their full effect. On the structural front, there is ample scope for reforms to encourage innovation and business dynamism in Europe by streamlining permits and licenses, improving the transparency of regulation and reducing barriers to entry in network industries, professional services and retail sector. The co-ordinated fiscal and structural policy action would also benefit workers and give a necessary boost to wages. But more importantly, the coordinated action could lift confidence in governments’ capacity to reap the full benefits of the euro area. Euro area governments would show, that by acting together they can lift growth and improve the lives of all.

This would demonstrate that Europe is stronger than its individual member states.

La Croissance est à son pic, la négociation d'un atterrissage en douceur s'annonce délicate

Laurence Boone, Chef économiste de l'OCDE

L'économie mondiale traverse des zones de turbulences. La croissance du PIB mondial est élevée, mais a probablement atteint son pic. Dans de nombreux pays, le chômage est bien en dessous de ses niveaux d'avant-crise, les tensions sur l'emploi augmentent et l'inflation demeure modérée. Mais les échanges et l'investissement marquent le pas, sur fond de hausse de certains droits de douane. De nombreuses économies émergentes sont confrontées à des sorties de capitaux et ont vu s'affaiblir leur monnaie. L'économie mondiale paraît prête pour un atterrissage en douceur, avec une croissance du PIB mondial qui devrait passer de 3.7 % en 2018 à 3.5 % en 2019-20. Mais les risques s'accumulent et les gouvernements et banques centrales devront naviguer prudemment pour préserver des rythmes de croissance du PIB certes plus modestes, mais durables.

Négocier un atterrissage en douceur a toujours été délicat,

mais l’exercice est particulièrement difficile aujourd’hui. Avec des banques centrales qui réduisent progressivement, et à juste titre, leurs injections de liquidités, les marchés ont commencé à revoir les prix des risques, la volatilité fait son retour, le prix de certains actifs baisse. Les flux de capitaux, qui ont contribué à l’expansion des économies de marché émergentes, s’inversent progressivement. Les tensions commerciales génèrent de l’incertitude et risquent de perturber les chaînes de valeur mondiales et l’investissement, plus spécialement dans les régions aux liens étroits avec les États-Unis et la Chine. Des incertitudes politiques et géopolitiques montent également en Europe et au Moyen-Orient.

Une accumulation de risques pourrait créer les conditions d’un atterrissage plus brutal que prévu. La recrudescence des tensions commerciales pourrait peser sur la croissance des échanges et du PIB, et générer encore plus d’incertitude pour l’investissement des entreprises. Le durcissement des conditions financières pourrait accélérer les sorties de capitaux en provenance des économies émergentes et faire reculer encore la demande. Un net ralentissement de l’activité en Chine frapperait non seulement les économies émergentes, mais aussi les économies avancées, si ce choc entraînait un repli des cours des actions et une augmentation des primes de risque dans le monde.

Les tensions politiques autres que commerciales augmentent aussi. Au Moyen-Orient et au Venezuela, les difficultés géopolitiques et politiques ont accru la volatilité des cours du pétrole. En Europe, les négociations autour du Brexit suscitent des inquiétudes. Dans certains pays de la zone euro, l’exposition des banques à la dette souveraine pourrait peser sur la croissance du crédit si les primes de risque devaient encore augmenter, ce qui ralentirait la consommation, l’investissement, la croissance et l’emploi.

Dans ce contexte, nous invitons instamment les responsables politiques à rétablir la confiance dans les institutions

internationales et dans le dialogue entre tous les pays. Notamment pour apporter une solution coopérative aux discussions sur les échanges commerciaux. L'adoption de mesures concrètes au niveau du G20 serait aussi un signal positif, démontrant que les pays peuvent agir de manière coordonnée et concertée si la croissance devait ralentir plus nettement que prévu.

La coopération est d'autant plus nécessaire que les marges de manœuvre de politique économique sont limitées. Dans certains pays, les taux sont très bas et la politique monétaire est encore très accommodante, alors que les ratios dette privée/PIB et dette publique/PIB se situent à des niveaux historiquement élevés. Le soutien budgétaire diminue, à juste titre, mais si la croissance devait ralentir plus brutalement, les pouvoirs publics devraient profiter de la faiblesse des taux d'intérêt pour s'engager dans une relance budgétaire coordonnée. Dans cette édition des *Perspectives économiques*, nous présentons des simulations qui montrent qu'une relance budgétaire coordonnée *au niveau mondial* serait un moyen efficace de réagir rapidement à un ralentissement plus marqué que prévu.

La fragilité de l'environnement rend d'autant plus important l'achèvement de l'Union monétaire européenne, comme suggéré dans la dernière *Étude économique de la zone euro* réalisée par l'OCDE. Il est urgent que l'Europe mène à son terme l'union bancaire. L'absence de progrès dans ce domaine n'incite pas les banques à réduire la part, toujours importante, d'obligations souveraines domestiques dans leur bilan, ce qui nourrit la perception du risque de redénomination. Progresser sur la mise en œuvre d'une capacité budgétaire commune aiderait aussi à accroître la confiance dans l'aptitude de la zone euro à réagir aux chocs, et à inscrire la croissance dans la durée.

Enfin, la reprise mondiale depuis la crise financière n'a pas produit d'améliorations tangibles du niveau de vie pour un

grand nombre de citoyens. Si la pauvreté absolue a fortement reculé dans un certain nombre d'économies émergentes, la crise a montré que les écarts de bien-être entre la partie de la population mobile et hautement qualifiée et la part, plus nombreuse, de personnes moins mobiles et souvent moins qualifiées, se sont creusés depuis plusieurs décennies dans de nombreuses économies avancées. Les écarts de revenu se perpétuent d'une génération à l'autre : trop souvent les perspectives d'avenir de chaque individu dépendent de l'endroit où il est né, où il a été scolarisé et où il a commencé à rechercher un emploi. Ces inégalités, l'absence de mobilité intergénérationnelle, menacent la croissance et alimentent le rejet de la mondialisation, qui a pourtant été vecteur de prospérité de nombreuses régions du monde.

Le ralentissement des gains de productivité dans de nombreuses économies bride la hausse des salaires réels mais même dans les entreprises très productives, la progression des salaires a été modeste. L'innovation technologique, qui tire vers le bas le prix relatif des investissements, renforce le pouvoir de marché des entreprises très productives. En même temps, la baisse du prix relatif des investissements peut entraîner une substitution du capital au travail, en particulier pour les emplois faiblement qualifiés et répétitifs, pour toutes les entreprises. Avec la diffusion du numérique, le fossé entre les emplois hautement qualifiés peu répétitifs et les emplois faiblement qualifiés répétitifs se creuse. Conjuguées à une redistribution moins poussée, ces tendances risquent d'aggraver les inégalités.

Les pouvoirs publics peuvent faire davantage pour favoriser l'augmentation de la productivité et des salaires. Renforcer la concurrence sur les marchés des produits permettrait de favoriser la croissance de nouvelles entreprises, d'encourager une diffusion plus large des nouvelles technologies, et de contribuer ainsi à une hausse des gains de productivité, mais aussi de mieux répercuter les gains de productivité sur les

salaires. Renforcer les compétences est également essentiel parce qu'une main-d'œuvre qualifiée est moins facile à remplacer par de nouvelles technologies. Des politiques actives du marché du travail et des politiques de formation axées sur les compétences sont aussi clés pour aider ceux qui courent le risque d'être exclus du marché du travail.

Certaines décisions des pouvoirs publics renforcent les vents contraires qui soufflent sur nos économies. Aujourd'hui plus que jamais, nous avons besoin de meilleures politiques, qui reposent sur la coopération, la confiance et l'ouverture, pour pouvoir créer des emplois, pérenniser la croissance et relever les niveaux de vie.

Éditorial extrait des Perspectives Économique de l'OCDE, Novembre 2018

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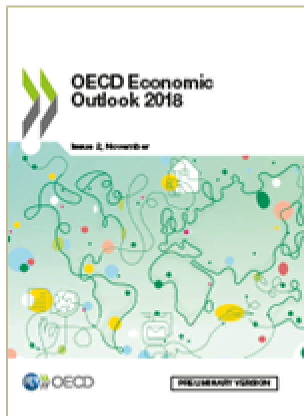
Growth has peaked: Challenges in engineering a soft landing

by Laurence Boone, OECD Chief Economist



The global economy is navigating rough seas. Global GDP growth is strong but has peaked. In many countries unemployment is well below pre-crisis levels, labour shortages are biting and inflation remains tepid. Yet, global trade and investment have been slowing on the back of increases in bilateral tariffs while many emerging market economies are experiencing capital outflows and a weakening of their currencies. The global economy looks set for a soft landing, with global GDP growth projected to slow from 3.7% in 2018 to 3.5% in 2019-20. However, downside risks abound and policy makers will have to steer their economies carefully towards sustainable, albeit slower, GDP growth.

Engineering soft landings has always been a delicate exercise and is especially challenging today. As central banks progressively, and appropriately, reduce their liquidity support, markets have started repricing risks as reflected by the return of volatility and the decline of some asset prices. Capital flows, which had fuelled the expansion of emerging market economies, have been reversing towards advanced economies and especially the United States. Trade tensions have heightened uncertainty for businesses and risk disrupting global value chains and investment, especially in regions tightly linked to the United States and China. Political and geopolitical uncertainty has increased in Europe and the Middle East.

An accumulation of risks could create the conditions for a harder-than-expected landing. First, further trade tensions would take a toll on trade and GDP growth, generating even more uncertainty for business plans and investment. Second, tightening financial conditions could accelerate capital outflows from emerging market economies and depress demand further. Third, a sharp slowdown in China would hit emerging market economies, but also advanced economies if the demand

shock in China triggered a significant decline in global equity prices and higher global risk premia.

Political tensions other than trade have also grown. In the Middle East and Venezuela, geopolitical and political challenges have translated into more volatile oil prices. In Europe, Brexit is an important source of political uncertainty. It is imperative that the European Union and the United Kingdom manage to strike a deal that maintains the closest possible relationship between the parties. In some euro area countries, the exposure of banks to their government debt could weigh on credit growth if risk premia were to increase further, with dampening effects on consumption, investment, GDP growth, and ultimately jobs.

Against this backdrop, we urge policymakers to restore confidence in international dialogue and institutions. This would help strengthen trade discussions in order to tackle critical new issues and to address concerns with the rules and processes of the existing trading system. Concrete action at the G20 level will send a positive signal and help demonstrate that countries can act in a coordinated and cooperative fashion should growth slow more sharply than envisaged.

It is all the more important to cooperate now that policymakers have limited margins for manoeuvre in case of an abrupt slowdown. In some countries, monetary policy is still very accommodative, while public and private debt-to-GDP ratios are historically high. Fiscal stimulus will be scaled back, which is appropriate. But in the event of a downturn, governments should leverage low interest rates to coordinate a fiscal stimulus. In this Economic Outlook, we report simulations showing that a coordinated fiscal stimulus at the global level would be an effective means of quickly responding to a sharper-than-expected global slowdown.

The fragile environment heightens the importance of completing European Monetary Union, as suggested in the latest OECD

Economic Survey of the Euro Area. It is urgent for Europe to complete the banking union. The lack of progress has led to higher domestic sovereign debt holdings by banks in some countries, magnifying hazards and maintaining the redenomination risk that undermines confidence. Progress towards establishing a common fiscal capacity would help maintain confidence in the ability of the euro area to react to shocks and sustain growth.

The global recovery since the financial crisis has not led to tangible improvements in the standards of living of many people. While absolute poverty has plummeted in a number of emerging market economies, the crisis exposed decades of widening well-being gaps between the higher-skilled mobile part of the population and a larger number of less mobile, often less-skilled people in many advanced economies. Income gaps pass from one generation to the next: one's future prospects are framed by where one is born, educated and starts looking for a job. These entrenched inequalities threaten growth, intergenerational mobility, and fuel discontent with the integrated global economy, which has brought prosperity across large parts of the world.

The general slowdown in productivity growth in many economies constrains real wage growth. But even in highly productive firms, wage growth has been more sluggish than expected, a result in part of technology driving down investment prices. This can prompt substitution of labour by capital, particularly for low-skilled, high-routine jobs. As digitalisation deepens, the divide between high-skill, low-routine jobs and low-skill, highroutine work risks widening. In addition, slower business dynamics preserve firms which are less productive and accordingly are less able to increase wages.Together with declining redistribution, this trend risks fuelling inequalities.

Governments can do more to foster higher productivity and wages. Strengthening product market competition would not only

favour wider diffusion of new technologies, thereby raising productivity growth, but also help transfer productivity gains to wages. Investment in skills can help workers seize the gains from technological progress as higher-skilled labour is less easily replaced by new technologies. Effective active labour market and skills training policies can help those at risk of being excluded from the labour market.

Certain policy decisions are exacerbating many of the headwinds faced by our economies. Better policies, built on greater trust and openness, are needed now more than ever in order to create jobs, sustain growth and raise living standards.

Editorial from the November 2018 edition of the Economic Outlook

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A sustainable European currency needs a common fiscal stabilisation instrument

Jan Stráský and Guillaume Claveres, OECD Economics Department, Euro Area/EU desk

The euro area sovereign debt crisis has exposed important

flaws in the design of the Economic and Monetary Union, especially when it comes to dealing with macroeconomic shocks. Compared to federal states, fiscal transfers at the euro area and EU level are virtually non-existent. Since labour mobility remains low, private risk sharing in the euro area mainly takes place through cross-border flows of capital and credit, which may not always be sufficient to deal with large negative shocks.

The lack of effective risk-sharing is particularly damaging in a monetary union, where countries cannot use independent monetary policy or exchange rate depreciation to support growth and employment and national fiscal policies in some countries may be unable, in the short run, to deal with country-specific shocks through national counter-cyclical policies. Moreover, monetary policy may become overburdened even when dealing with common shocks. During the financial crisis, contagion effects and negative feedback loops between sovereigns and banks threatened price stability and forced the ECB to reduce policy interest rates to below zero, coming probably close to an effective constraint for monetary policy. Even though the ECB put in place other unconventional measures, such as asset purchases, to ensure transmission of its policy, these measures are not without costs and limits.

The weak potential growth and inflation outlook for the euro area, as well as the global shifts in saving and investment preferences, also suggest that nominal interest rates may stay close to zero for a prolonged period of time and return close to zero more often in the future (Rachel and Smith, 2017).

In this situation, where the ECB monetary policy may remain constrained for some time and fiscal space limited in some countries, a common fiscal stabilisation instrument would improve the policy toolkit. Our recent paper, **Euro area unemployment insurance at the time of zero nominal interest rates** simulating a general equilibrium model of the euro area with imperfect risk-sharing mechanisms shows that a fiscal

capacity, in the form of a common unemployment benefit scheme, can significantly improve macroeconomic stabilisation when the monetary policy constraints become binding.

Building a common fiscal stabilisation instrument for the euro area is an important topic of the 2018 Economic Survey of the Euro Area. The concept of a common fiscal instrument goes back at least to the 1970s Marjolin's Report and the interest in the topic has been rekindled post-crisis by several concrete proposals, including the IMF's rainy-day fund (Arnold et al., 2018), the European Commission's investment protection scheme (European Commission, 2017) and several variants of unemployment insurance and re-insurance schemes (Beblavý and Lenaerts, 2017; Dullien et al., 2018). However, such schemes face significant resistance, due to the fears of permanent transfers towards some countries that would reduce incentives to carry out structural reforms. To overcome these criticisms, the scheme must avoid permanent transfers among countries, a condition made explicit in the Five President's Report.

Our companion paper, **Stabilising the euro area through an unemployment benefits re-insurance scheme,** discusses a novel design for a common fiscal stabilisation instrument, in the form of an unemployment benefits re-insurance scheme. As other recently proposed mechanisms (European Commission, 2017), the scheme is activated according only when unemployment increase and is above its long-term average, and involves a cap in payments, ensuring that pay-outs to individual countries are limited. These features, together with a mechanism charging higher contributions to countries that draw more frequently on the fund (experience rating), effectively prevent permanent transfers in the medium term.

Using counterfactual simulations of the proposed mechanism for individual euro area countries on annual data from 2000 to 2016, we show that the scheme would have delivered considerable stabilisation gains, both at the individual country level and euro area level (Figure 1). Macroeconomic

stabilisation would be timely in most cases and achieved at the cost of limited debt issuance (less than 2% of the euro area GDP) and average annual contributions not exceeding 0.17% of GDP (Figure 2). It would have also avoided permanent transfers among countries, as none of them would have been a major net contributor or receiver with respect to the scheme, and all countries would have benefited from the scheme at one point in time.

Figure 1. The scheme could deliver significant stabilisation for the euro area

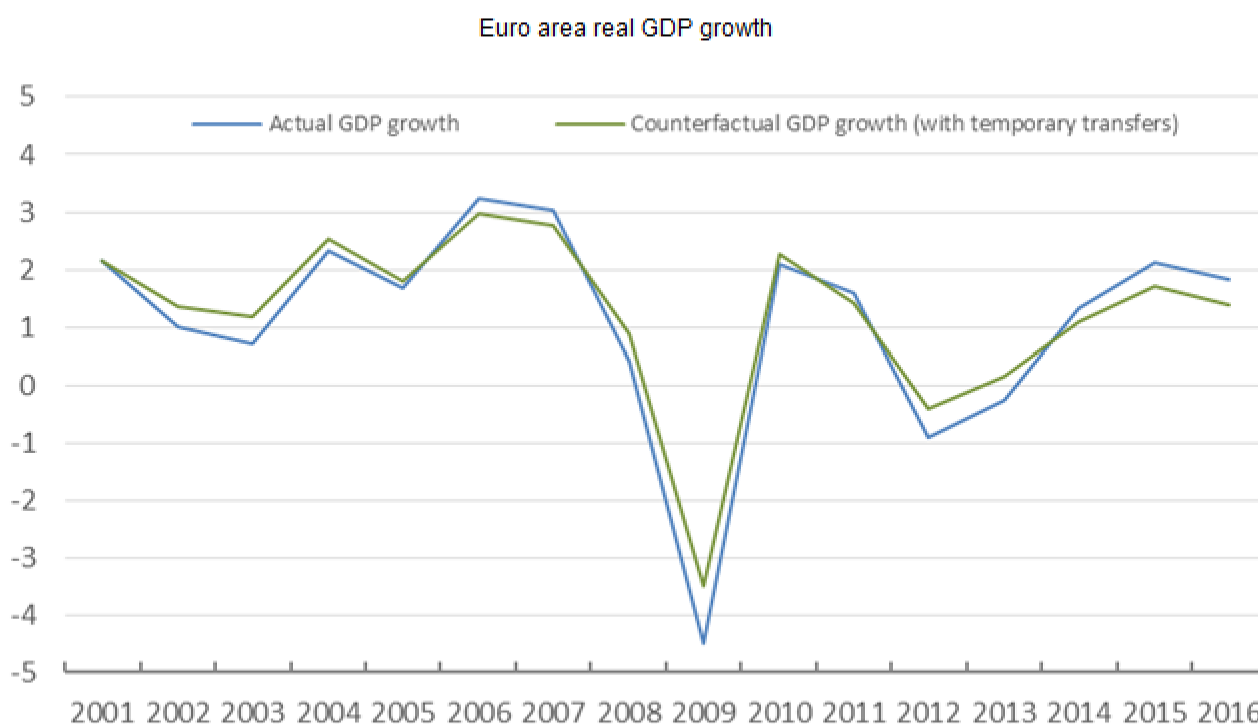
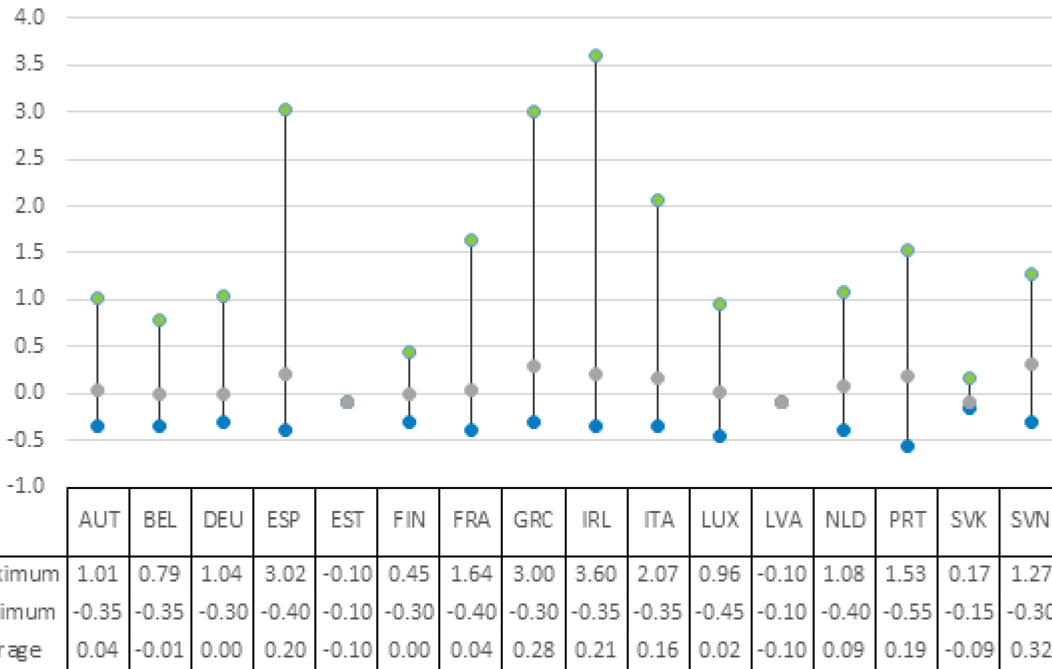


Figure 2. Pay-outs can be significant at times, but the average net transfers are close to zero

As a percentage of GDP



	AUT	BEL	DEU	ESP	EST	FIN	FRA	GRC	IRL	ITA	LUX	LVA	NLD	PRT	SVK	SVN
Maximum	1.01	0.79	1.04	3.02	-0.10	0.45	1.64	3.00	3.60	2.07	0.96	-0.10	1.08	1.53	0.17	1.27
Minimum	-0.35	-0.35	-0.30	-0.40	-0.10	-0.30	-0.40	-0.30	-0.35	-0.35	-0.45	-0.10	-0.40	-0.55	-0.15	-0.30
Average	0.04	-0.01	0.00	0.20	-0.10	0.00	0.04	0.28	0.21	0.16	0.02	-0.10	0.09	0.19	-0.09	0.32

Source: Claveres and Stráský (2018).

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European banking union in its final leg

by Jan Stráský and Guillaume Claveres, OECD Economics Department, Euro Area/European Union desk

After years of crisis, we are now experiencing an economic expansion in Europe. But further crises are certain to come, sooner or later, and improvements in the euro area's resilience to economic shocks will require further policy changes. Notably, it is important to allow that the cost of significant economic shocks is shared as widely and fairly as possible, both within private and public sectors, what we call for simplicity public and private risk-sharing. In this post, based on the 2018 Economic Survey of the Euro Area, we focus on potential for private risk sharing through the banking sector. The lack of risk sharing in this sector was a major cause of the euro area crisis during the great financial recession since governments became overly exposed to difficulties faced by their banking sectors. Better risk sharing would reduce the risk that a banking crisis triggers government insolvency, reinforcing the solidity of the euro area.

For better or for worse, banks remain at the core of the financial system in Europe. Diversification towards other sources of financing and better access to finance for small and medium enterprises are important goals, which in the longer-term will be substantially facilitated by completion of the capital markets union project. In parallel, the efforts to improve the functioning of the European banking system, including the conditions for creation of Pan-European banks, must continue.

The euro area banks are now much better capitalised than before the financial crisis and benefit from stronger and unified supervisory standards. Even so, additional reforms to complete the banking union are necessary. The Single Resolution Mechanism that restructures failed banks while preventing wider repercussions in the financial system needs an effective backstop to ensure its credibility. The backstop should be fiscally-neutral over the medium term, meaning that any pay out should be recouped from future banks'

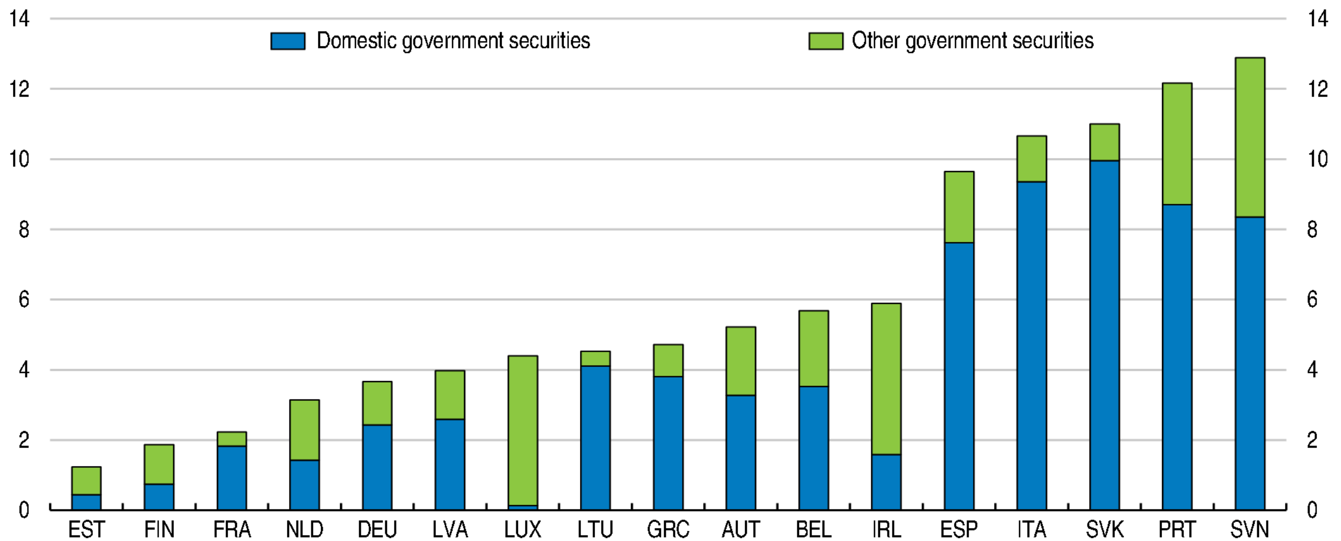
contributions. As the next step, euro area countries should put in place a pre-funded common European deposit insurance scheme. Such a tool would increase financial stability benefits for all participating countries by spreading the risks across a large and more diverse pool of financial institutions and reducing the likelihood that individual pay outs will overwhelm the system. It would also further improve monetary policy transmission in the euro area by making different forms of money more homogenous across euro area countries.

To limit the risk of some banks subsidising others, the insured banks should pay to the European deposit insurance scheme a variable insurance premium that would require risker banks – based, among other things, on the level of loss-absorbing capacity, stability and variety of funding sources, business model and management quality – to pay higher contributions. In addition, the risk premia should also be sensitive to the amount of systemic risk in the national banking system.

Risk reduction in the banking sector will eventually have to go beyond the reduction of still-elevated non-performing loans in some countries and prevention of the build-up of new non-performing loans. The recent gyrations in some European sovereign debt markets have shown that the potentially harmful links between banks and their own states that amplified the euro area crisis are still present. Large exposures of banks to the sovereign debt of their home country, linking the health of the banking sector to the health of public finances, continue to exist in many euro area countries and need to be addressed (Figure 1).

Figure 1. General governments securities[1] held by banks are mainly domestic

As a percentage of total MFIs assets, March 2018



1. Domestic government securities denote own-government securities other than shares held by monetary and financial institutions (excluding central banks). Other government securities refer to other Euro area government securities held by MFIs.

Source: ECB (2018), *Statistical Data Warehouse*, European Central Bank.

http://dx.doi.org/10.1787/888933741770

The reduction in banks' holdings of government bonds would make banks' financing costs dependent on their own riskiness, rather than geographical location, potentially reinforcing cross-border activity and banks' ability to exploit the economies of scale. Such change, which would need to be gradual, including long phase-in periods and involving only the newly issued debt, could be achieved by introducing an additional capital requirement increasing with concentrated sovereign bond holdings of banks (BCBS, 2017; Véron, 2017). Banks with higher holdings of sovereign debt would be required to hold additional capital as protection against associated risks. In order to give banks an alternative safe asset to invest in, potential changes should be considered in parallel with the introduction of a European safe asset. Although some existing proposals suggest the creation of synthetic safe assets, such instrument may be too sensitive to cyclical variation in investors' demand. Other ways of creating a European safe asset without risk mutualisation thus may be needed.

The Banking Union needs to be completed and the time to act is now. The three missing legs the Banking Union should stand on are the fiscal backstop to the Single Resolution Fund, the European deposit insurance scheme and the reduction of the harmful links between banks and their own states.

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Solving Non-Performing Loans in Europe to speed up the recovery

by Pierre Beynet, Head of Division, Country Studies Branch, OECD Economics Department

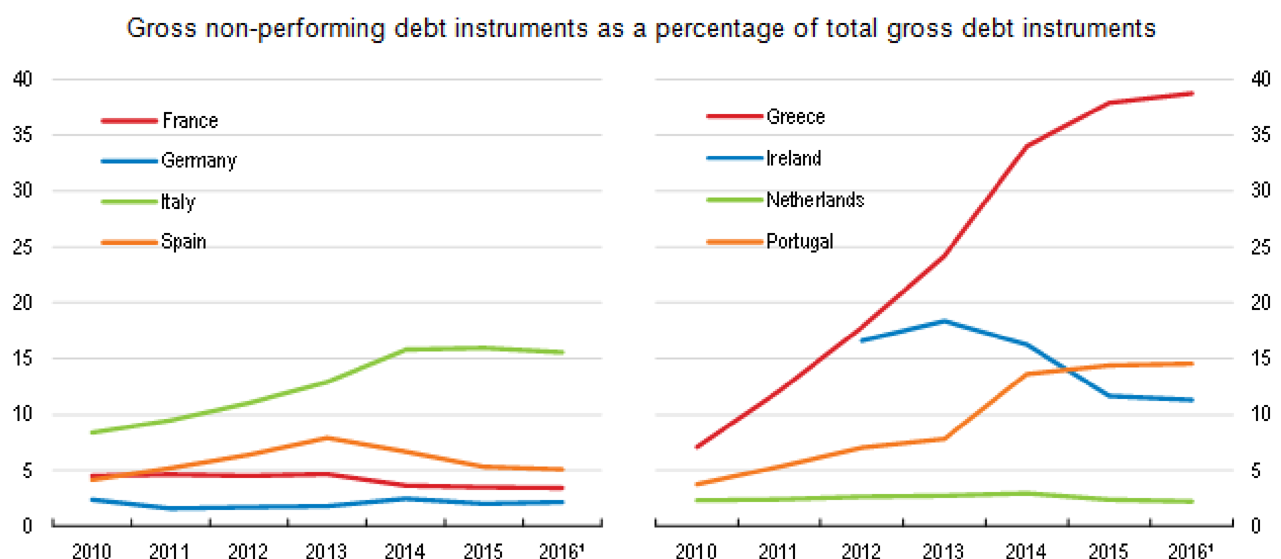
Almost 10 years after the outset of the financial crisis in summer 2008, European growth remains modest, constantly underperforming the OECD average. Several factors explain this disappointing performance. The pace of fiscal consolidation

was rapid in the countries most affected by the crisis while structural reforms were not sufficiently pursued in other countries. One key factor that may continue to cripple growth is the persistently high level of non-performing loans (NPLs or impaired assets) in several countries (Figure 1). Impaired assets are a legacy of the crisis, but also a cause of the weak recovery as they limit bank capital available to more productive and innovative firms (Aiyar et al., 2015; European Commission, 2017). The negative impact of impaired assets on bank credit may worsen from 2018 as the new accounting standards (IFRS9) and more forward-looking provisioning rules should lead to faster recognition of losses (Constâncio, 2017).

Given this context, it is urgent to pursue a more aggressive policy to resolve NPLs, preferably at the European level. This requires introducing more flexibility in EU rules, including state aid rules, which may otherwise block the most ambitious options to resolve NPLs, as discussed below and outlined in the last OECD economic survey on the euro area (OECD, 2016).

Figure 1. Non-performing loans

Gross non-performing debt instruments as a percentage of total gross debt instruments



1. Average of first three quarters.

Source: ECB (2016), "Monetary and financial statistics", *Statistical Data Warehouse*, European Central Bank.

To free-up maximum capital for new lending, banks need to sell NPLs at a sufficiently high price. This is tricky since

potential buyers not knowing the exact level of risk associated with NPLs are likely to offer the lowest possible price and banks may consider the offered price too low, ending up in no transaction. The longer NPLs stay on the books, the lower is the value obtained after removal from the bank, which could make transactions increasingly difficult overtime.

To facilitate transactions, setting up an asset management company (AMC) can be very effective. AMCs' expertise for valuing impaired assets allows banks, especially smaller ones, to get a better price. Establishing an AMC at the European level would maximize economies of scale and diversify asset recovery risks (OECD, 2016; Haben & Quagliariello, 2017; Constâncio, 2017). Since a European AMC could imply cross-country risk sharing, some financial sector conditionality could be imposed on countries benefiting from it, to make it acceptable to all Euro Area countries.

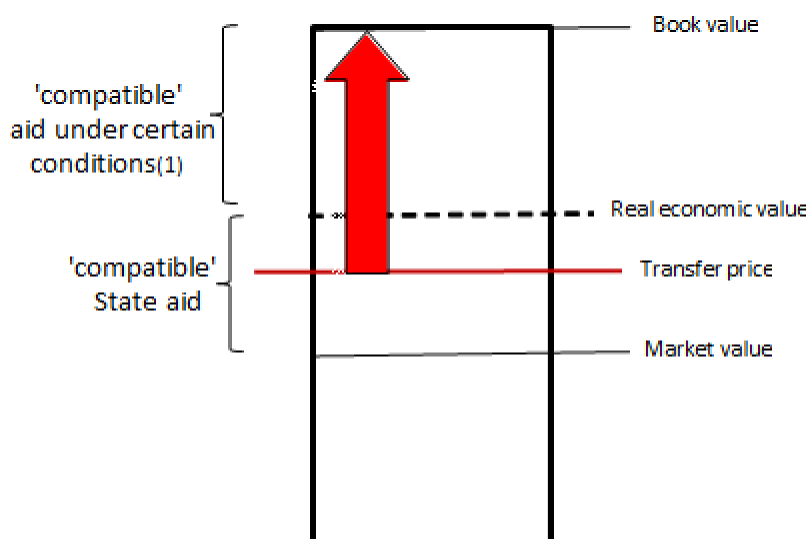
Another option would be to continue setting up AMCs at the national level. Public support (participation of the State in the capital of the AMC or guarantees granted) may be needed to allow AMCs to buy impaired assets at a sufficiently high price and to reduce risks faced by private investors participating in the capital of AMCs. However, European rules could hinder such public support. Under the new bank recovery and resolution directive (BRRD), selling assets to AMCs above market price is considered state aid, and it triggers the implementation of a restructuring plan for the bank, a "bail-in" of junior creditors (i.e. their financial participation in the recapitalization of the bank) and, since January 2016, possibly a bail-in of senior creditors as well.

Hence, the combined application of the BRRD and state aid rules creates a significant hurdle for governments to participate in the setting up of AMCs since it could result in sizeable fiscal costs in the event of public bail-out of the bank, in addition to bail-in of private creditors. It could also create huge political costs if private creditors who

participate in the bail-in end up being bank retail customers who were not aware of the risk when they purchased some financial products. It appears that several banks have misled their individual clients by selling such products as safe assets…

In this context, introducing flexibility in EU rules to solve NPLs without triggering bail-in and resolution procedures should be considered. A very high level of NPLs should be considered a serious economic disturbance and warrants a waiver of bail-in and resolution procedures. Alternatively, a more lenient definition of the price level triggering state aid – and hence resolution – could be used. Currently, the European Commission assumes state aid for any purchase of impaired assets by a state-supported AMC at a price above the estimated “market price” (Figure 2; Cas and Peresa, 2016). For example, when the market prices are uncertain and depressed by stressed conditions, resolution requirements could be applied only for prices above the “real economic value” or a level half way between the “market price” and the “real economic value”. Member states benefitting from this exceptional treatment could in return be required to make their insolvency regimes more efficient, facilitating a faster recovery of collaterals and enabling the AMCs to get a higher price for impaired assets.

Figure 2. Valuation of impaired assets and state aid rules



(1) These conditions include claw-back clauses, in-depth restructuring and/or liquidation.

Source: Cas and Peresa, 2016

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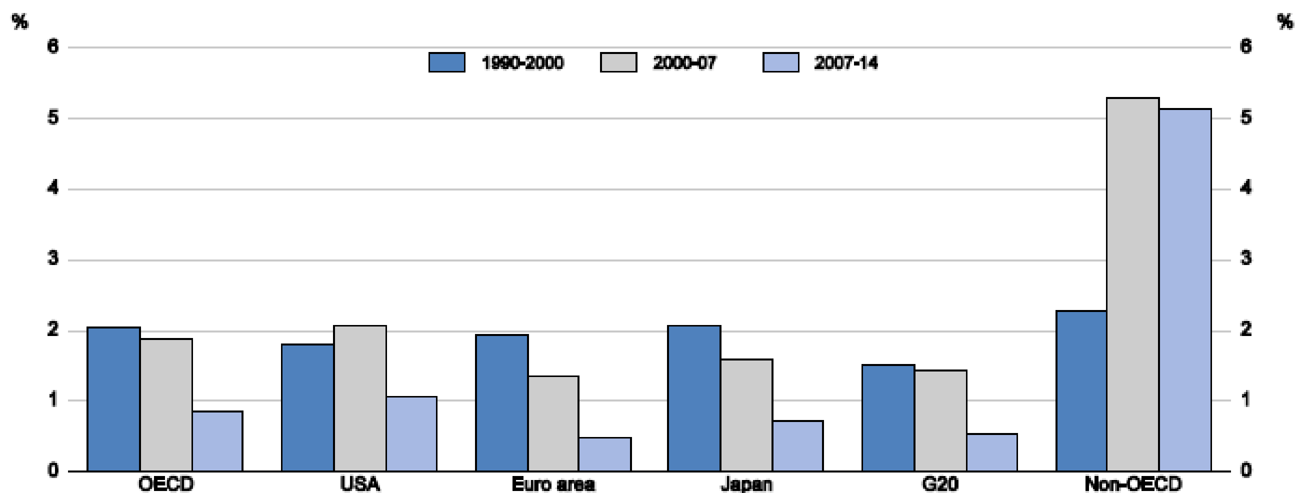
Structural reforms to revive growth in Europe: necessary but not sufficient

By Aida Caldera Sánchez, European Union Desk, and Nicolas Ruiz, Structural Surveillance Division, OECD Economics Department

After many years characterised by output losses or quasi-stagnation, steadier growth appears to be setting in across European economies. Recent data point to an upturn in growth, the euro-area unemployment rate has finally fallen below 10%, and private-sector confidence has strengthened. Yet, there is still a need to address the consequences of the crisis, as unemployment remains high, and sizable non-performing loans continue to be a constraint in some countries. Moreover, one challenge that basically all governments face is the sharp slowdown in productivity. Productivity – a central ingredient in the pursuit of growth and well-being – has been decelerating in most European economies. The slowdown has been particularly sharp since the crisis but was already noticeable before, suggesting that structural factors may lie behind the downward trend (Figure 1).

Figure 1. Annualised growth of labour productivity
Output per hour worked



Source: OECD calculations.

To address these challenges, structural reforms are necessary but not sufficient to restore robust growth in Europe. This is why the OECD advocates for a three-pronged approach (OECD, 2016a). First, existing exceptional monetary measures should continue in the euro area until inflation reaches target, albeit the scope to continue the stimulus or to move beyond existing plans is now very limited. Second, more active fiscal policy is needed to support aggregate demand and boost potential output. Third, these macro-policies should support an enhanced and efficient implementation of structural reforms.

Indeed, fiscal policy should take advantage of the increase in fiscal space provided by low interest rates to boost growth, equity, and productivity, including via enhanced hard and soft infrastructure investment and other tax, spending, and structural measures that support growth and potential output. Fiscal policy should do more to support growth, possibly by easing the application of the EU Stability and Growth Pact within existing rules, for example by making it easier to exclude net investment spending from fiscal rules (OECD, 2016a). Collective fiscal efforts would have greater impact than individual efforts. Combined with bold and coherent

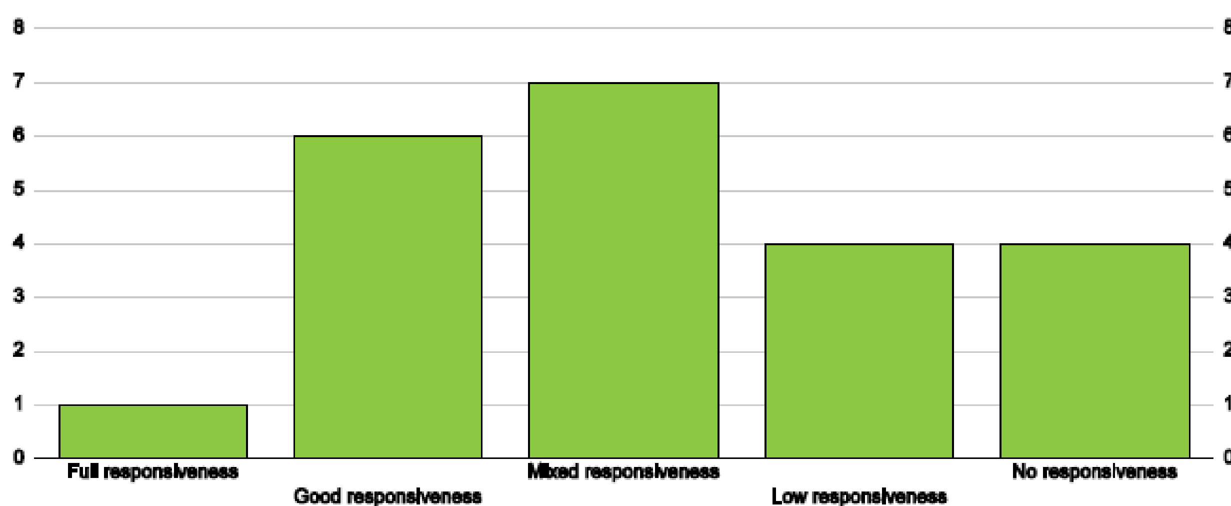
collective actions on structural reforms to strengthen Europe's economic fabric, the gains from fiscal action would be magnified. In short, the gains would be more than the sum of the parts.

On the structural reforms front what needs to be done? The EU **Single market** remains far from completed, and the 2016 OECD Economic Survey of the European Union (OECD, 2016b) makes recommendations to reinvigorate it:

- Capital markets are fragmented, and firms are over-dependent on bank financing. Improved securitisation, better collection and sharing of credit information on SMEs and harmonization of insolvency regimes would help expand and diversify sources of financing and help sustain the recovery.
- Labour mobilitywould profit from reduced administrative and regulatory barriers, such as faster recognition of professional qualifications and better portability of social and pension rights.
- Product market reforms would help to unlock investment. National regulations and technical specifications in network sectors, such as energy and transportation, should be harmonised further. Regulatory burdens could be alleviated by better impact assessment of legislative proposals and ex-post policy evaluation. Projects to improve trans-European transport and energy grids should be prioritised.

Structural reforms are needed but they also need to be designed coherently. A bigger bang for the buck will be ensured if reforms are implemented through articulated and coherent policy packages that maximise synergies across areas. A review of the evidence suggests that simultaneous reforms of labour and product markets are typically more growth enhancing than isolated reforms (Caldera Sánchez et al., 2016). Over the last two years, however, such reform packages have not been the norm. For example, reforms have been undertaken *either* in

the labour market *or* product markets, but very rarely in both (Figure 2). An example is Greece, where much of the adjustment has been borne by workers, while monopoly power and barriers to entry have remained in place in many sectors (OECD, 2016c). Better coordination of reforms across different areas would ease implementation and maximise the favourable growth and job impact of structural reforms.



Note: The horizontal axis shows the responsiveness rate in 2015-16 to OECD recommended reform packages that include a mix of recommended product market reforms (including FDI and trade) and labour market reforms. Full responsiveness refers to a value of 1, indicating that all recommendations have been undertaken. Good responsiveness refers to a responsiveness rate at or above 0.5 for both product and labour market reforms. Mixed responsiveness refers to a responsiveness rate above 0.5 for either product or labour market reforms. Low responsiveness refers to a responsiveness rate between 0.5 and 0 for both sets of reforms. Coverage is the number of OECD countries.

Source: OECD calculations.

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