A sustainable European currency needs a common fiscal stabilisation instrument

Category: Euro Area,European Union,fiscal policy,Uncategorized
written by oecdecoscope | August 3, 2018

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

Euro area real GDP growth

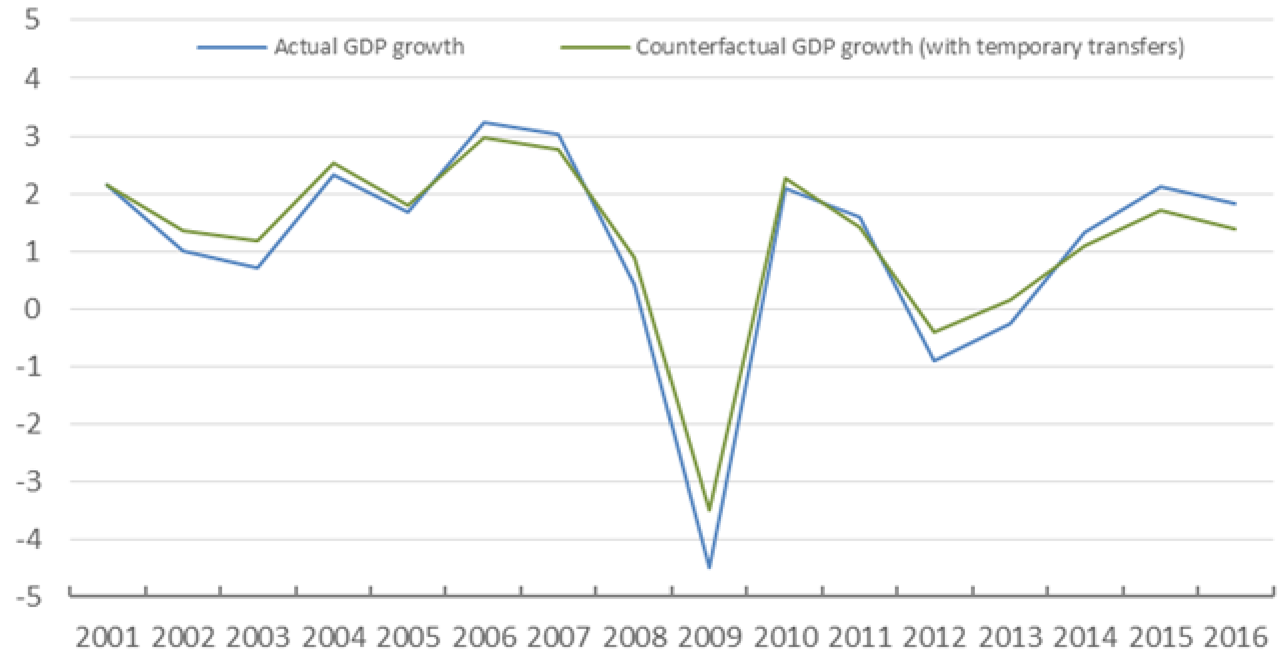
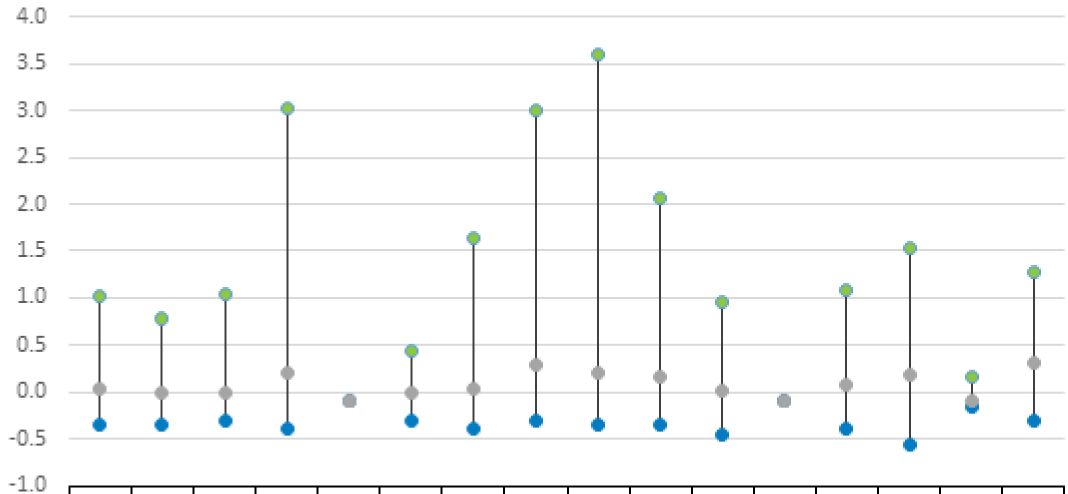


Figure 2. Pay-outs can be significant at times, but the average net transfers are close to zero

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

Category: Euro Area,European Union,Uncategorized
written by oecdecoscope | August 3, 2018

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.

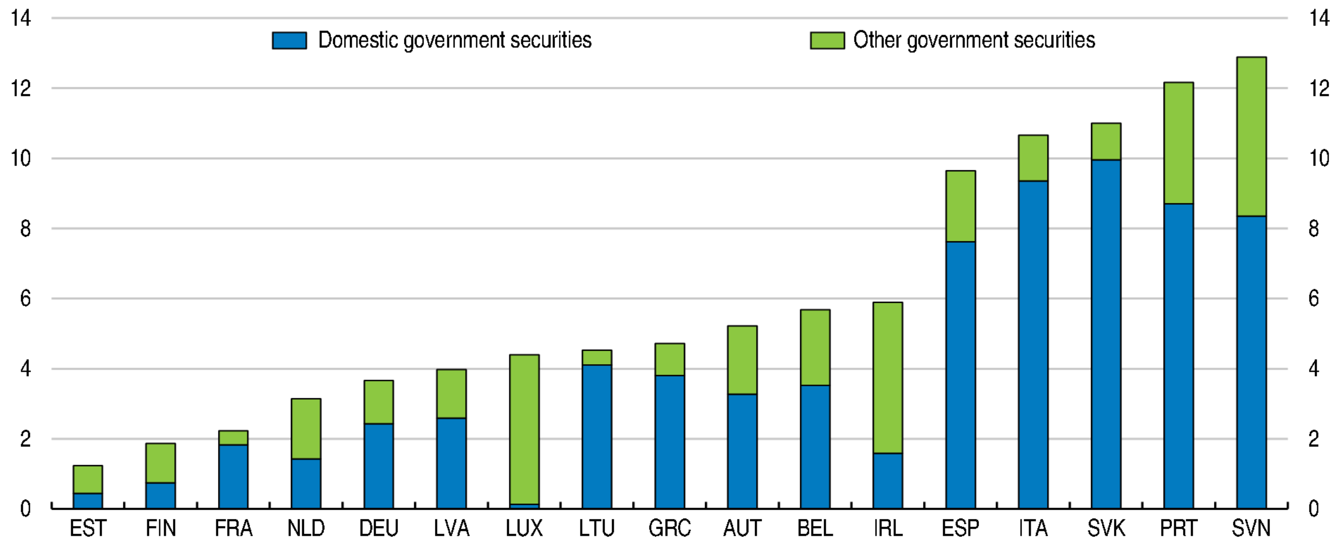
The euro area banks are now much better capitalised than before the financial crisis and benefit from stronger and unified supervisory standards. Even so, additional reforms to complete the banking union are necessary. The Single Resolution Mechanism that restructures failed banks while preventing wider 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.

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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

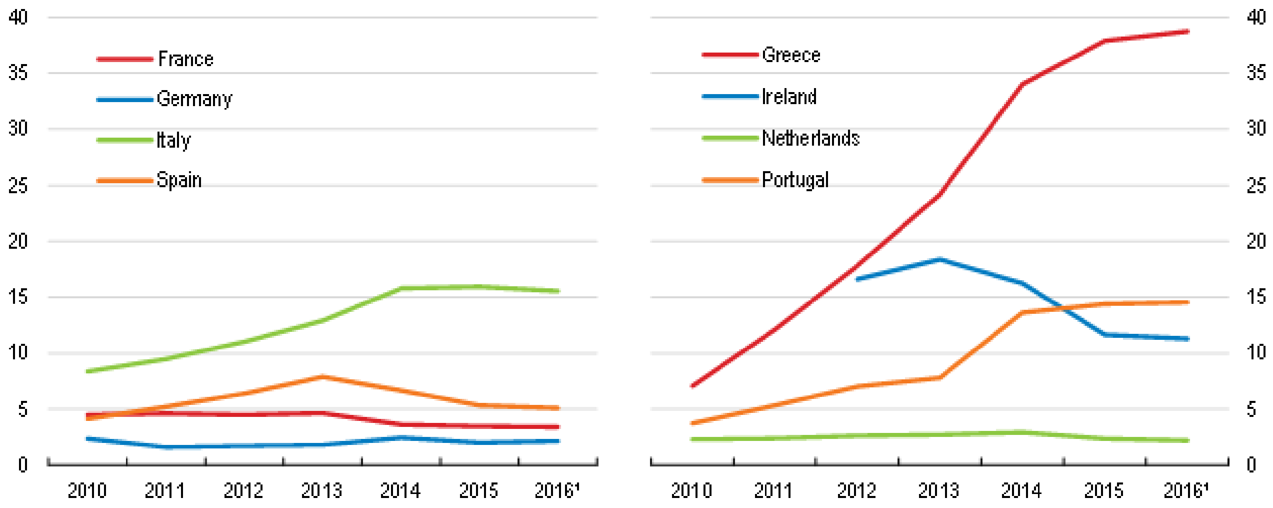
Category: Euro Area,Uncategorized
written by oecdecoscope | August 3, 2018
by Pierre Beynet, Head of Division, Country Studies Branch, OECD Economics Department

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.

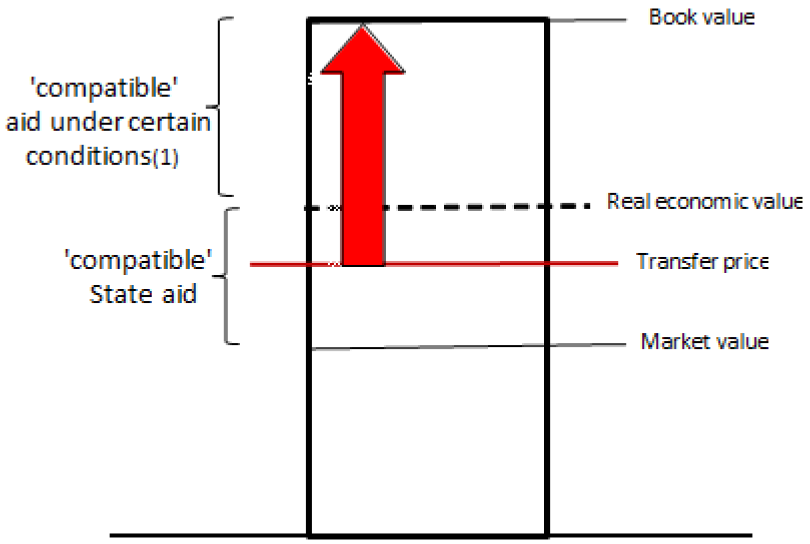
To facilitate transactions, setting up an asset management company (AMC) can be very effective. AMCs' expertise for valuing impaired assets allows banks, especially smaller ones, to get a better price. Establishing an AMC at the European level would maximize economies of scale and diversify asset recovery 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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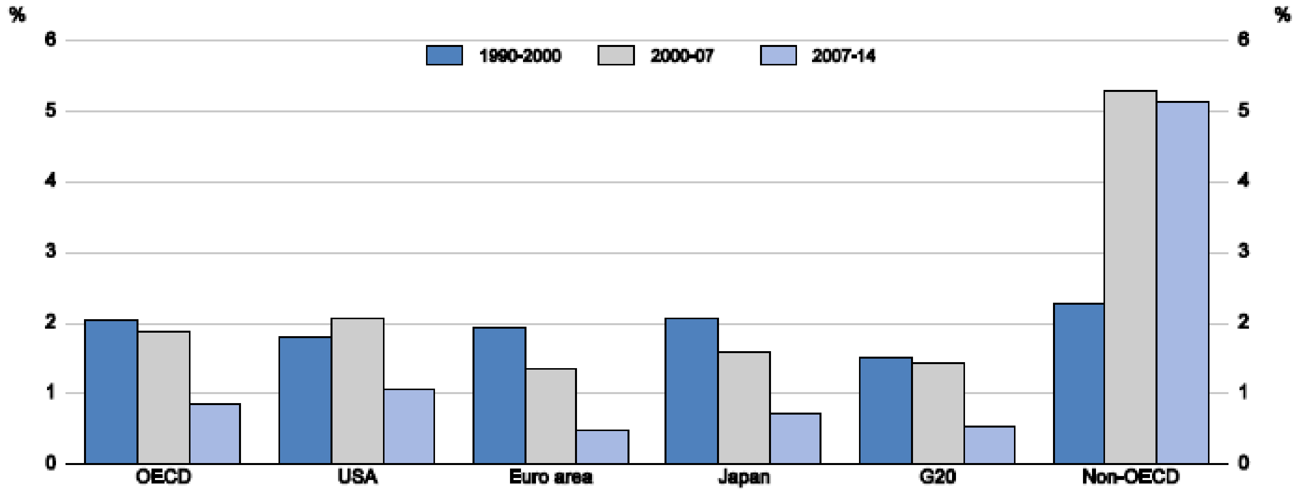
Structural reforms to revive growth in Europe: necessary but not sufficient

Category: Euro Area,Productivity,Structural reform,Uncategorized
written by oecdecoscope | August 3, 2018

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.

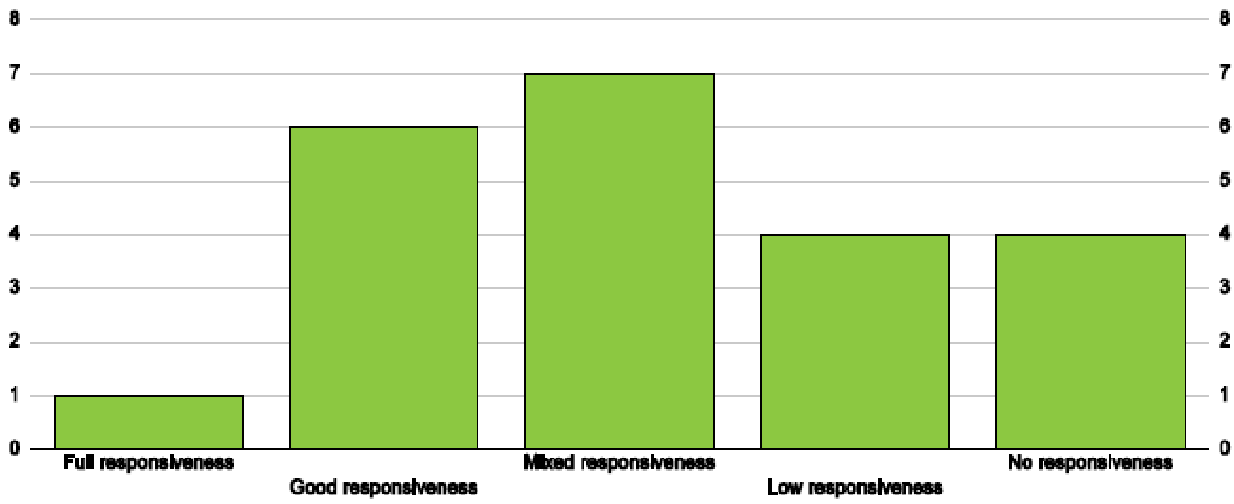
Indeed, fiscal policy should take advantage of the increase in fiscal space provided by low interest rates to boost growth, equity, and productivity, including via enhanced hard and soft infrastructure investment and other tax, spending, and structural measures that support growth and potential output. 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.

Figure 2. Implementation of reform packages is uneven



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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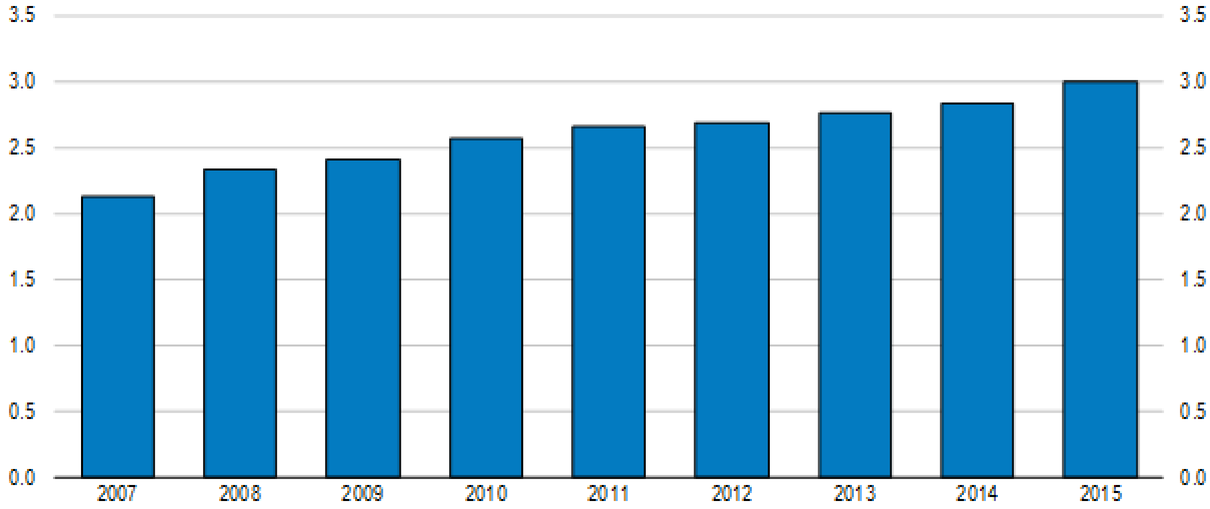
Labour mobility in the European Union: a need for more recognition of foreign qualifications

Category: Euro Area,Labour markets,Uncategorized
written by oecdecoscope | August 3, 2018
by Jan Stráský, Economist, OECD Economics Department

Labour market mobility in the European Union is increasing (Figure 1), but it remains too low to provide sufficient adjustment in the face of diverging labour market developments. This situation reflects non-policy factors, such as linguistic and cultural differences, but also policy barriers. In particular, difficulties in the recognition of professional qualifications are still a major hurdle.

Figure 1. Share of migrant population within the European Union

Population that are citizens of another EU28 country, as a percentage of total population



Source: Eurostat (2015), "Population on 1 January by five year age group, sex and citizenship", *Eurostat Database*.

Improvements in foreign language proficiency take time and require long-term policies. Publicly funded language courses aimed at cross-border workers are a useful tool, and should be provided. Even more important is to improve foreign language proficiency at an earlier stage, for example by considerably expanding the Erasmus student exchange programme that currently benefits only about 5% of European graduates.

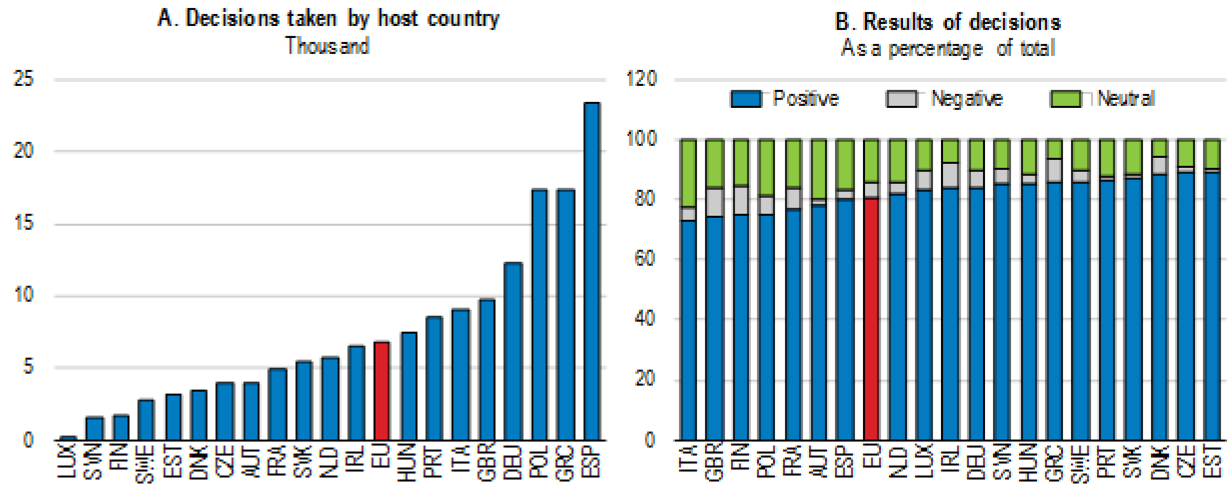
Policy barriers to labour mobility in the EU have been reduced by a broader use of electronic procedures, such as the European Professional Card and the planned electronic passports for services. However, more is needed. The European Professional Card needs to be extended to other qualifications, such as engineers. Countries should be restricted in their ability to invoke “public interest” to discriminate against foreign suppliers of regulated professional services. Regulatory barriers arising from diverging legal form and other organisational requirements should be addressed. Most reforms in services between 2012 and 2014 took place in countries under financial assistance, while other countries did not act on their recommendations.

The differences in regulation across the EU remain high and affect also the number of recognitions of professional qualifications. Some countries have awarded a large number of recognitions, while others did not, despite being parties to the same mutual recognition directives (Figure 2, panel A). Moreover, countries with the lowest barriers to entry into professions may face the highest barriers to providing services abroad. For instance, when engineering is not a regulated profession, the barriers to entry are low for nationals and foreigners alike. Countries that regulate engineering through licensing, however, often create insurmountable obstacles to engineers from unregulated countries.

Although in the EU as a whole only some 5% of applications for recognition of qualifications eventually get rejected, there are considerable differences in rejection rates across the member states (Figure 2, panel B). Slow and overly heterogeneous procedures can still constitute a barrier to labour mobility, even if decisions are eventually positive. The EU should monitor improvements and best practice and develop further the possibility of partial recognition instead of rejection, complemented by shortened additional education. Bolder changes to the existing process would involve extending the scope of automatic recognition to other professions and making wider use of the European framework for comparison of national qualifications.

Figure 2. Recognition of professional qualifications

By country where the qualification was obtained, 2010-15[1]



1. Within European Union applications only. The European Union aggregate is an unweighted average of data for the 28 member countries.

Source : European Commission (2016), *Regulated Professions Database*, http://ec.europa.eu/growth/tools-databases/regprof (accessed on 11 May).

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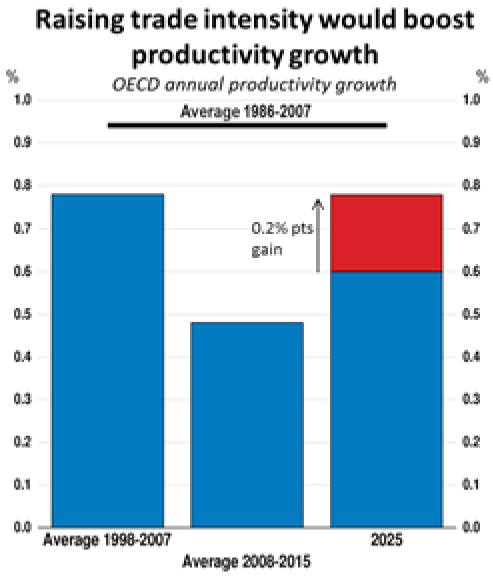
Global growth warning: weak trade, financial distortions

Category: Economic outlook,Euro Area,finance,trade,Uncategorized
written by oecdecoscope | August 3, 2018
By Catherine L. Mann, OECD Chief Economist

The global economy remains in a low-growth trap. In our latest *Interim Economic Outlook* global GDP growth is set to remain flat around 3% in 2016 and improve modestly to 3.2% in 2017. This is slightly lower than the June *Economic Outlook* forecast due to weaker conditions in advanced economies, including the effects of Brexit, offset by a gradual improvement in major emerging market commodity producers. More significantly, this string of feeble global growth rates is well-below historical norms.

The prolonged weakness in the world economy generates a self-reinforcing low-growth trap: depressed trade, investment, productivity, and wages in the current weak global environment, in turn lead to an additional downward revision in growth expectations and even more subdued demand. Poor growth outcomes combined with high inequality and stagnant incomes are also further complicating the political environment and increasing challenges facing policymakers.

Weak global trade is a particular concern. World trade was growing exceptionally slowly after the financial crisis, and has collapsed in 2015 and 2016. This weak trade growth is both a symptom of and exacerbates the weak global environment. As I have written separately, trade matters for productivity, living standards and inclusive growth. Returning to robust trade growth requires policy action to deepen global integration, but even more importantly to share the benefits, as detailed in our new paper examining the trade slowdown and policies to boost trade.



Note: The left-hand-side structural real time global value chain indicator is adjusted for the economic cycle and changes in commodity prices. The right-hand-side presents a scenario in which the world and OECD trade intensity (exports plus imports as a share of GDP) increases by 1.3 percentage points per annum (the average from 1986-2007) from 2017. The effect of this increase on OECD total factor productivity growth is shown. For further detail see OECD Economic Policy Paper "Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What Can Policy Do About It?".

Source: OECD Economic Outlook databases, OECD STAN Bilateral Trade database; Égert and Gal (2016); and OECD calculations.

Significant distortions in financial markets create vulnerabilities, made particularly stark against the poor performance of the real economy. Short- and long-term interest rates have fallen further in recent months to very low and – in many cases – negative levels. Around USD 14 trillion of government bonds, more than 35% of OECD government debt, is currently trading at negative yields, reflecting, among other factors, expectations for persistently low growth and expected monetary policy.

Low and negative interest rates underpin widespread and substantial increases in asset prices, both internationally and across asset classes. Equity prices remain high and have continued to increase in some economies despite weak profit developments and reduced long-term growth expectations. House prices are also rising rapidly in many economies. Credit spreads have tightened this year even as overall credit quality for corporate bonds has declined.

These financial distortions raise risks. In particular, a reassessment in financial markets of the path of interest rates could result in substantial re-pricing of assets and heightened financial volatility. As it is, sustained negative and low interest rates challenge financial institutions' business models and sustainability, demonstrated by the underperformance of bank shares relative to the overall market. Low interest rates also pose significant challenges for pension funds and asset managers, with implications for savers and retirement incomes.

Monetary policy is overburdened with associated risks. Hence, central bank policymakers need to calibrate both costs and benefits of increasing unconventional support.

On the other hand, fiscal space has been created by the low interest rates. In many advanced economies, interest rates have fallen by more than GDP growth, thereby raising the sustainable debt level. Low interest rates have reduced interest expenses. Hence, fiscal policy should take advantage of this fiscal space by increasing quality investment to boost human capital, physical infrastructure and equality. Canada, China, Japan and the US have recently announced fiscal expansion and the UK has signalled an easing in the budgetary stance. Euro area fiscal policy also should do more to support growth, such as easing the application of the EU Stability and Growth Pact and excluding net investment spending from fiscal rules.

Structural reform momentum needs to be intensified, rather than continue to slow. At the Hangzhou Summit earlier this month, G20 countries were only around half-way to their target of 2% additional G20 GDP by 2018 due to sluggish progress on implementation. Worryingly, despite concerns about weak trade, the share of trade policy commitments fell to 6% from 14% two years ago. Reforms to boost trade are a key lever to boost growth and need to be supported by complementary policies that ensure the gains from globalisation are widely shared among citizens.

The more balanced policy mix, making greater use of fiscal, structural and trade policies, would put the global economy on a stronger and more sustainable and inclusive growth path. Improved expectations of higher future growth from more fully deployed fiscal and structural policies would help to ease the burden on monetary policy and facilitate an eventual normalisation of interest rates.

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Fiscal policy in the euro area: in the current juncture, don’t apply sanctions

Category: Euro Area,fiscal policy,Portugal,Spain,Uncategorized
written by oecdecoscope | August 3, 2018

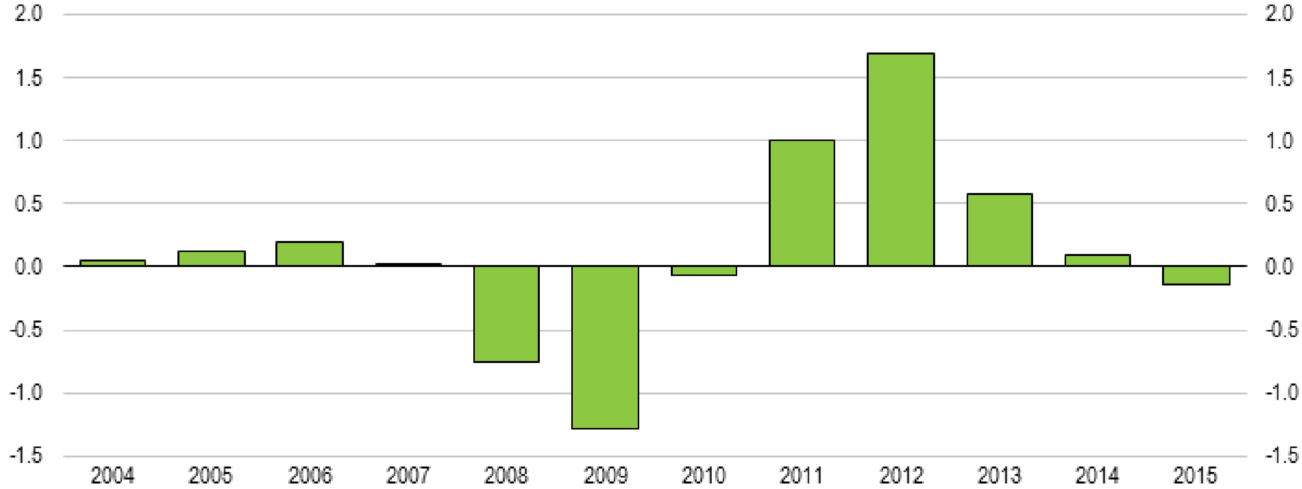
By Alvaro Pina, Head of European Union and Euro Area Desk, Country Studies Branch, OECD Economics Department

Tomorrow the European Commission will assess again the fiscal situation of Portugal and Spain, and decide whether to recommend to the Council that the Excessive Deficit Procedure be stepped up for those countries, exposing them to various sanctions. This momentous decision can have major consequences for the countries concerned, but also wider implications. It sets a landmark in the application of the Stability and Growth Pact rules, and therefore begs the question of how best those rules should be applied, especially in the current juncture of weak growth in Europe. In turn, this question hinges on what fiscal policies should do to support the recovery more. The recent OECD Survey of the Euro Area provides analysis on what should be done.

Growth has picked up gradually over the past two years, but demand is still weak and unemployment remains very high in several countries, including Portugal and Spain. In the euro area as a whole, support to the recovery has essentially come from monetary policy, with little or no fiscal help. After three years (2011-13) of strong and widespread fiscal consolidation, fiscal policy has turned broadly neutral (Figure 1), but it needs to go further in supporting demand as monetary policy alone cannot do everything. Budget support should mainly come from countries with fiscal space. Those without, like Portugal and Spain, should nonetheless avoid a return to austerity.

Figure 1. Euro area fiscal stance[1]

Change in the underlying balance as a share of potential GDP, percentage points



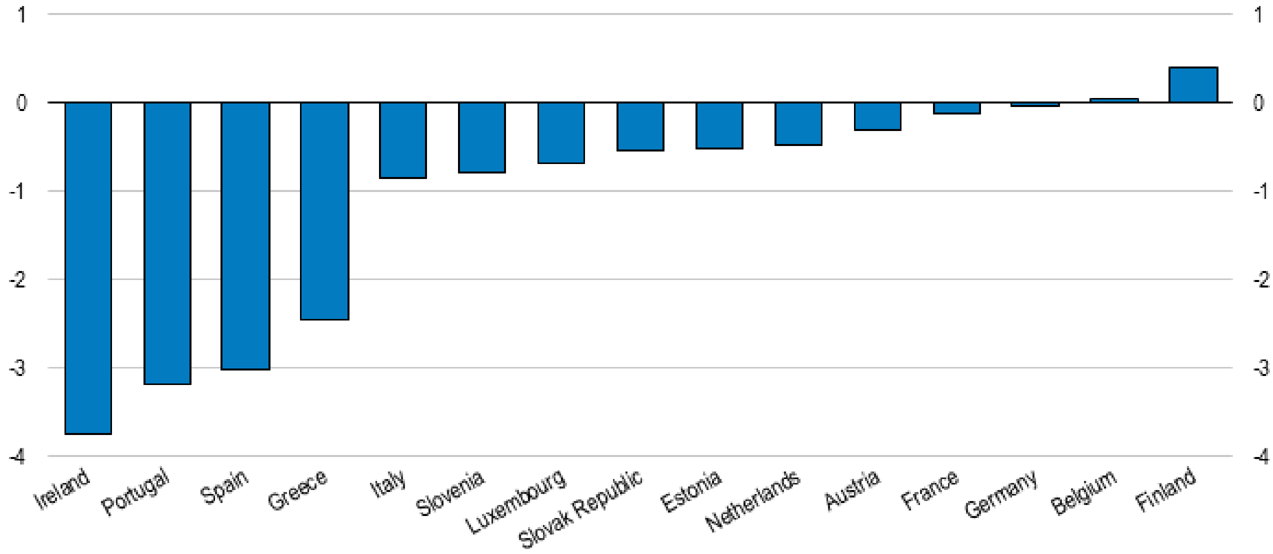
1. Euro area member countries that are also members of the OECD (15 countries).

Source: OECD (2016), "OECD Economic Outlook No. 99", *OECD Economic Outlook: Statistics and Projections* (database), June.

To maximise growth impacts and make them lasting, budget support should be targeted. Post-crisis consolidation often led to increases in labour taxes and large reductions in public investment (Figure 2), making public finances less growth-friendly. Policy levers to improve the composition and efficiency of public spending and taxes remain largely at national level, and progress on this front across the euro area has been insufficient. But European sanctions could make matters worse. For instance, they would likely imply a suspension (even if only temporary) of structural funds to the countries concerned, putting further downward pressure on public investment.

Figure 2. Change in public investment over recent fiscal consolidation episodes[1]

Percentage points of potential GDP



1. Consolidation episodes considered are those starting in 2009 or later.

Source: See Figure 21 of OECD (2016), *OECD Economic Surveys: Euro Area 2016* for futher details and source information.

In the current juncture, sanctions would be an economic mistake. In the absence of temporary fiscal expansion by countries with enough space, sanctions will somewhat tilt the euro area fiscal stance towards austerity, the opposite of what is needed. Further, they risk inducing further cuts to investment, thus hampering potential growth. Not to mention rekindling political tensions and animosities, again the opposite of what is needed. In a word: don’t.

See also:

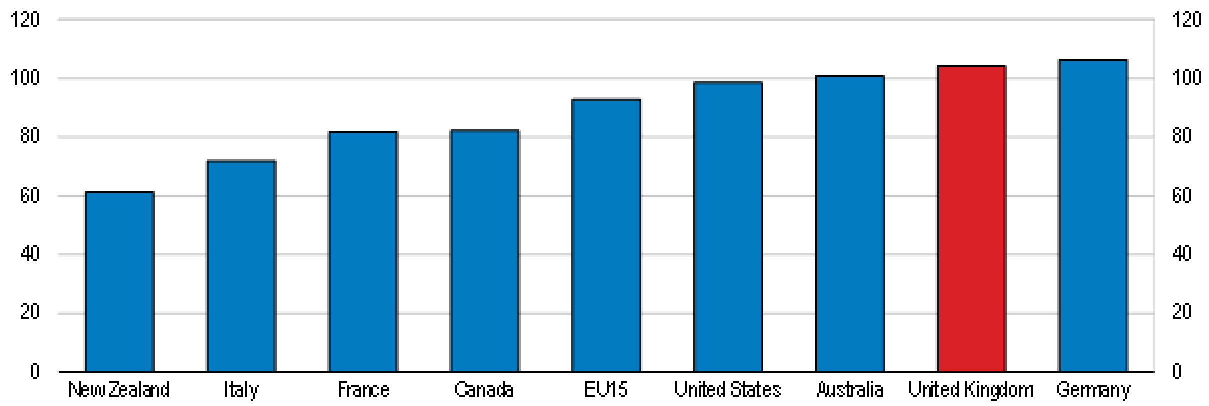
OECD (2016), OECD Economic Surveys: Euro Area 2016, OECD Publishing, Paris.

The UK's heart is wobbling but there are good reasons to Remain in the Union

Category: Euro Area,Uncategorized,United Kingdom
written by oecdecoscope | August 3, 2018
By Rafal Kierzenkowski and Nigel Pain, OECD Economics Department

Membership of the European Union contributes to the economic prosperity of the United Kingdom. Real GDP per capita has doubled since the United Kingdom joined the European Union in 1973, to almost 40.000 pounds now. The United Kingdom has outperformed other English-speaking countries that are not EU members over time, but also most other longstanding EU members (EU15) (Figure 1). EU membership has played an important role in this, reinforcing the gains from sound domestic policy settings. Membership expands the markets available to UK businesses, enhances the wellbeing of its citizens and strengthens the influence of the United Kingdom in the global economy.

Figure 1. Since EU membership in 1973, UK living standards have risen more than in peers
Real GDP[1] per capita, percentage change between 1973 and 2015



1. In constant purchasing power parities.
Source: OECD (2016), *OECD National Accounts Statistics* (database), June.

The United Kingdom is a trading nation, with nearly 45% of its exports destined for the EU market and 3 million of its jobs associated with trade with the European Union. Development of the EU single market has benefitted UK exporters, and there is more to come as the European Union undertakes new initiatives to reduce remaining internal barriers to services, benefitting the large UK services sector. Membership has also helped to develop UK trade relationships beyond the EU market. The United Kingdom gains from a large network of EU trade treaties with 53 non-member countries. Another 67 new free trade agreements are being negotiated, including with the United States, India and Japan. Collectively, the EU economies account for 12.5% of global trade, enhancing the bargaining power and influence of the United Kingdom, which accounts for only 2% of world trade. This ensures that new trade deals favourable for the UK economy can be struck.

EU membership has also added to the attractiveness of the United Kingdom as a location for foreign companies and investors. Access to the EU Single Market is a key consideration for many of these investors. The United Kingdom receives far more foreign direct investment than other EU member states, gaining over one-fifth of all new investments in the European Union over the past decade. These investments originate from not only from the United States and Japan, but half of them also from other EU countries. Such investment boosts UK exports and ensures strong integration with value chains in Europe and beyond, for instance in the car sector. Foreign-owned firms support jobs, with around 3.5 million people employed in foreign multinationals in the United Kingdom in 2012. They also support productivity and wages by undertaking a substantial share of research and development and other capital investments, and by introducing cutting edge managerial practices. These in turn diffuse to other UK companies.

The UK economy benefits from one of the lowest regulatory burdens in the major economies, both on businesses and labour markets, suggesting that EU membership is not a significant constraint to growth and job creation. Indeed, the UK employment rate is now at almost 75%, a record high. Further reforms are possible of course, but the remaining obstacles are largely home grown, for instance in the post and road sectors. Greater regulatory convergence in the rest of the EU, championed by the UK, would also generate positive spillovers to the UK economy.

The survey of the British Chamber of Commerce released in May shows that businesses of all sizes continue to support EU membership, even those where the burden of regulations is often the most challenging. The Small Business Act for Europe, launched in 2008, is the EU’s key policy initiative to support SMEs. The UK government has implemented the vast majority of its recommendations to reduce administrative burdens, improve access to finance and strengthen the innovative potential of small businesses. Access to bank finance has been an important constraint for UK SMEs. EU financing programmes for SMEs are channelled indirectly through different government levels and financial intermediaries. The EU also introduced legislation to shorten payment delays, a key challenge for many SMEs.

A major policy challenge facing the UK is to upgrade infrastructure to lift productivity and to make society more inclusive. The European Investment Bank, the EU bank, is helping to support this. Between 2011 and 2015, the Bank provided over 20 billion pounds of support to the UK economy, with 50% on transport, water and telecommunications, 30% on energy, and 10% on education and health. Projects it supports include one of the largest UK infrastructure investments to raise transport capacity in London, Crossrail, the development of the port of Liverpool, the construction of energy-efficient social housing in the UK, the roll-out of more than 7 million smart meters in homes across Great Britain, and the expansion of research and teaching facilities at Oxford University.

EU competition and single market policies benefit UK consumers by raising their protection and their rights. There are EU rules on passenger rights in air travel. Last year, UK residents made over 65 million visits abroad and many benefited from EU initiatives to reduce international mobile roaming charges in Europe. Indeed, these will be eliminated from mid-2017. The EU also plans to end unjustified geo-blocking, enhancing the benefits of online commerce. The creation of the digital single market would yield further gains.

After 43 years of EU membership, the sizeable doubts that have emerged about staying in the EU suggest that the UK may be prone to a mid-life crisis. Yet there is strong evidence that EU membership has magnified the underlying strengths of the UK economy and that it can deliver more benefits in the future. Acting together, as part of the EU, makes the UK stronger than standing alone to confront global challenges, such as climate change and profit shifting.

See also: Blog: The Economic Consequences of Brexit: A Taxing Decision

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