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

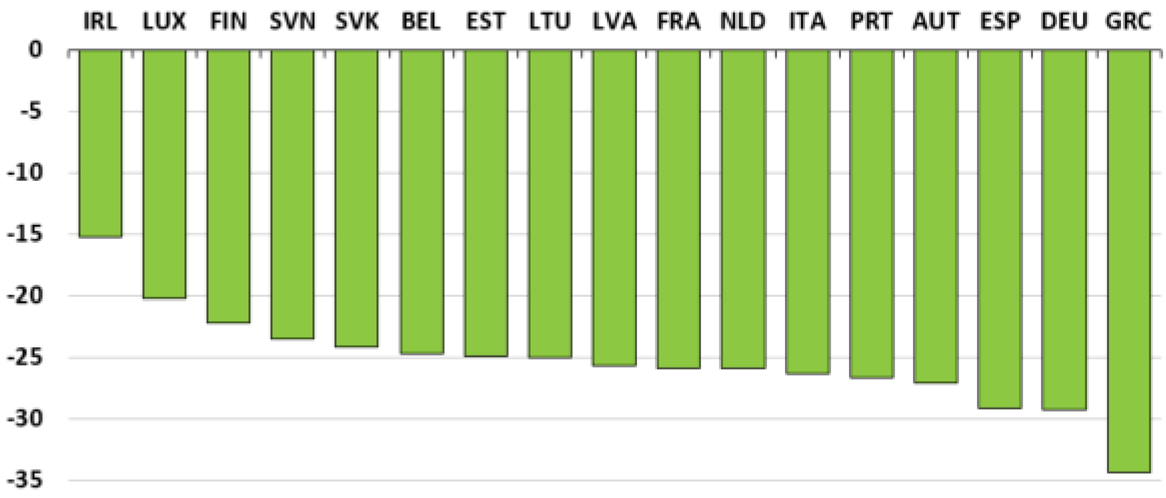
We are currently facing extraordinary challenges posed by the Covid-19 pandemic, due to which necessary health measures are shutting down part of our economies and precipitating a recession of unprecedented nature and magnitude.

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.

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.

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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

Euro area real GDP growth

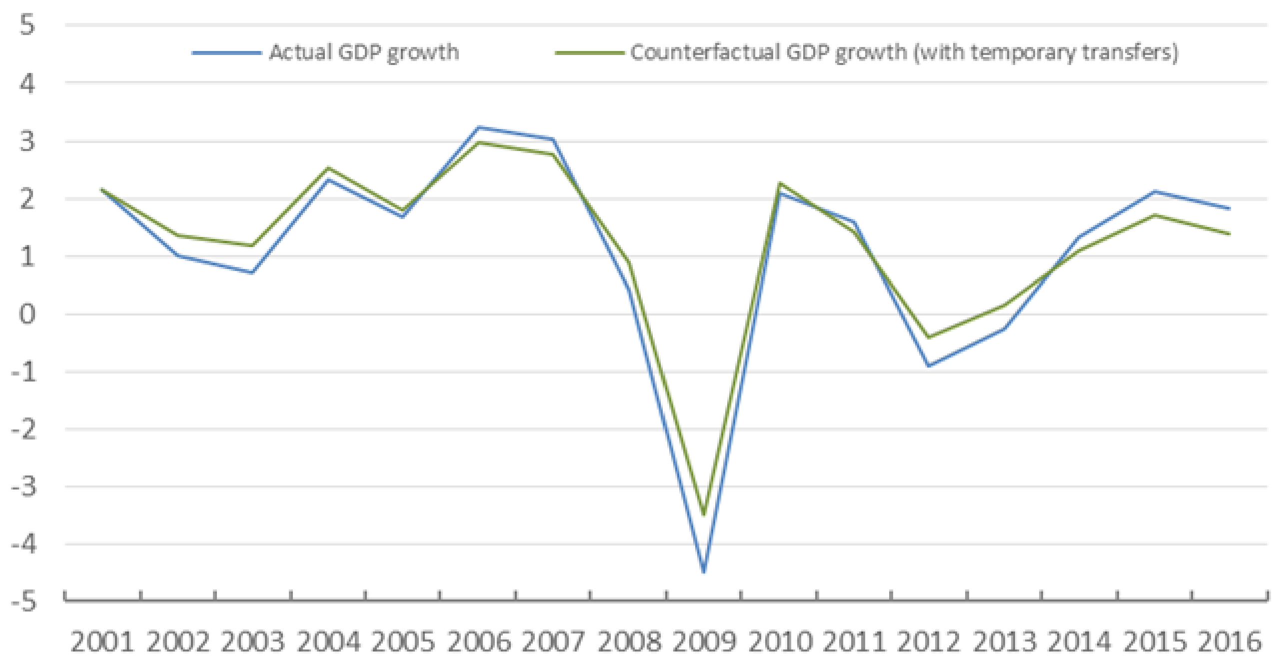
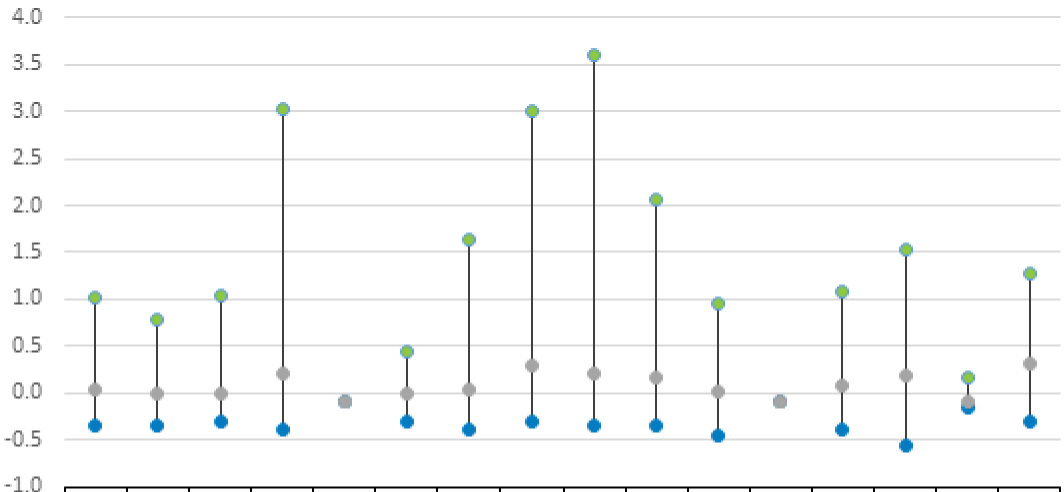


Figure 2. Pay-outs can be significant at times, but the average net transfers are close to zero

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

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.

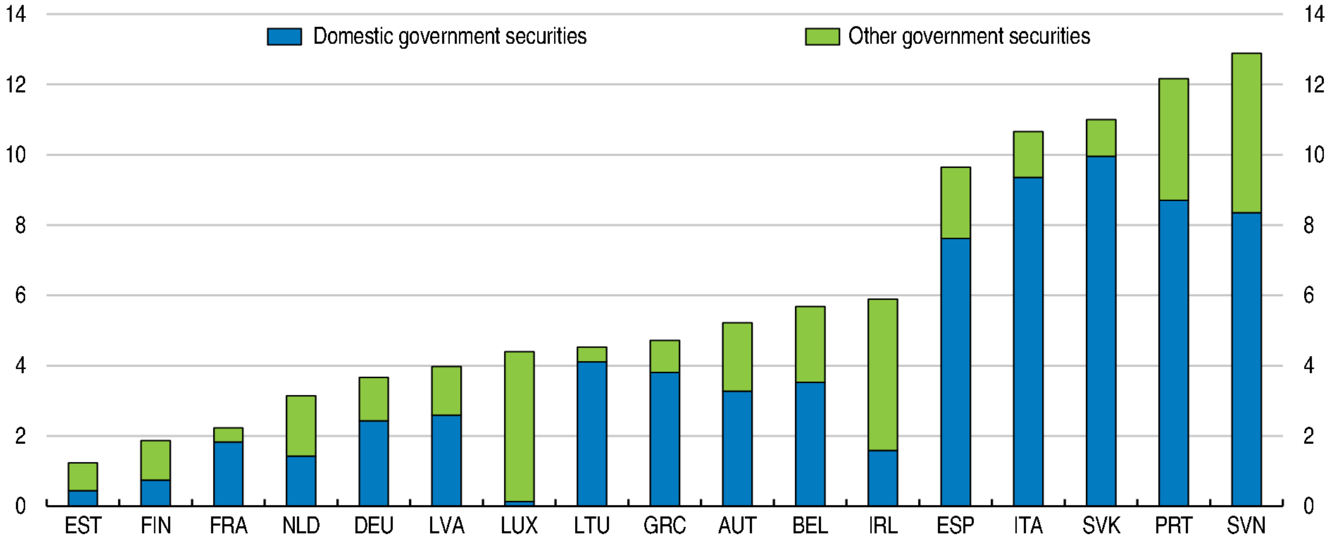
The euro area banks are now much better capitalised than before the financial crisis and benefit from stronger and unified supervisory standards. Even so, additional reforms to complete the banking union are necessary. The Single Resolution Mechanism that restructures failed banks while preventing wider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

StatLink 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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