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Assessment and recommendations

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

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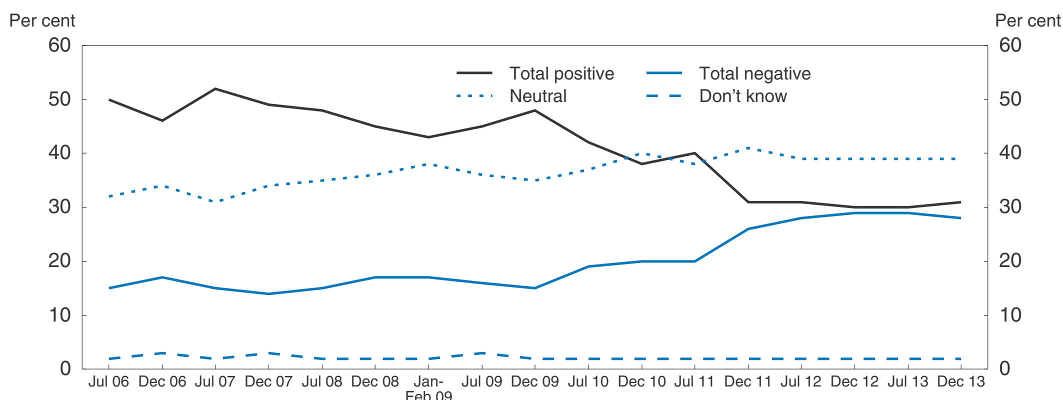
More than five years after the onset of the global economic and financial crisis, growth is beginning to pick up in euro area economies. Systemic risks have been reduced, large external and internal imbalances have receded, and most of the vulnerable countries are gradually regaining competitiveness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

Figure 1. **EuroBarometer**

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



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

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

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

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

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

Fostering economic recovery

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

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

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

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

Bank liquidity and solvency risk

Sovereign bond spreads[3]

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

Source: Datastream.

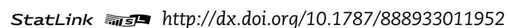
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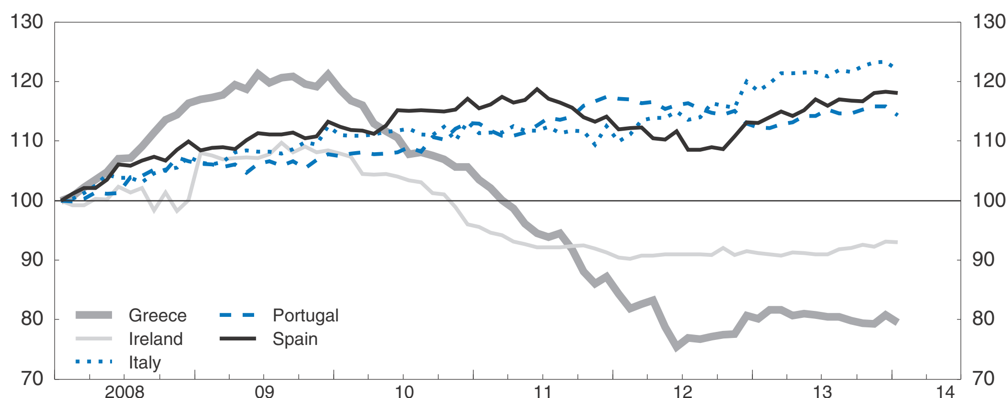
Figure 3. **Bank deposits[1] have bottomed out**

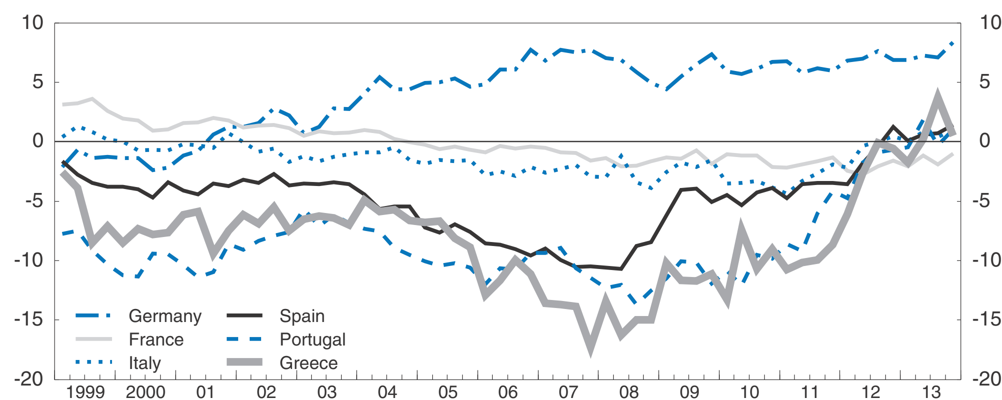
Index January 2008 = 100



1. Non-financial corporations and household deposits in monetary financial institutions (MFIs).
Source: European Central Bank.

Figure 4. **Current account balances**

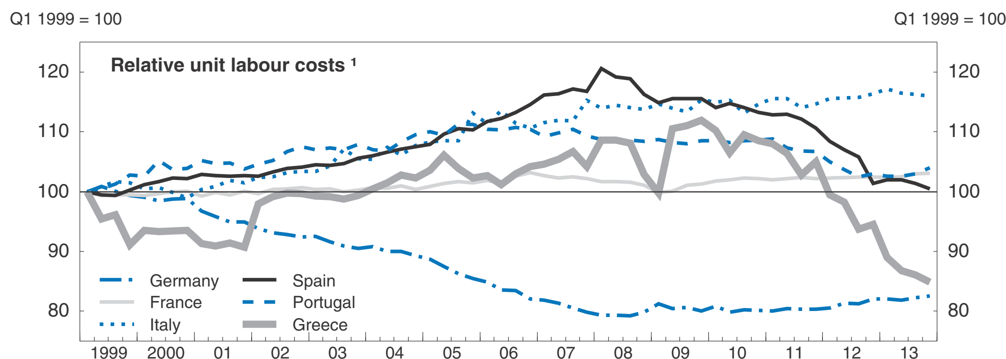
As a percentage of GDP

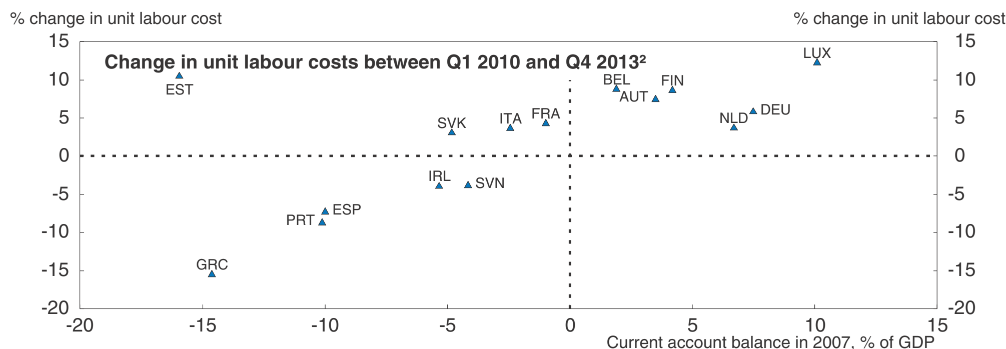


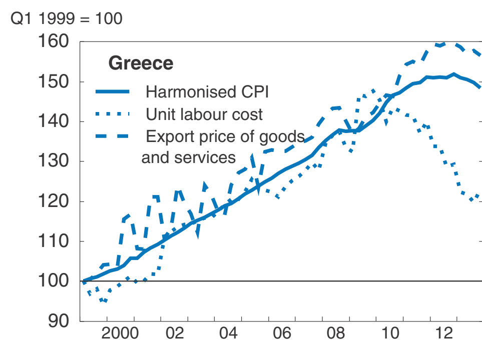
Source: OECD, *OECD Economic Outlook database.*

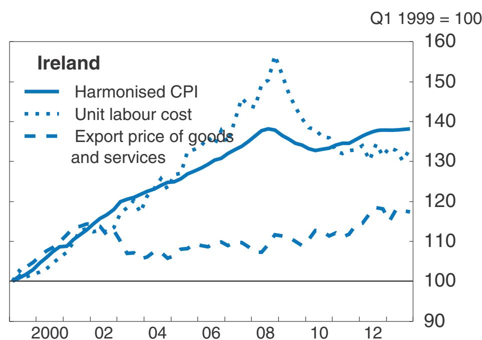
Net international investment positions (NIIPs) of vulnerable countries remain strongly negative, and reducing them will require many years of current account surpluses or large valuation changes. This inevitably slow pace of correction, in turn, might damp further reductions in sovereign risk premia,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

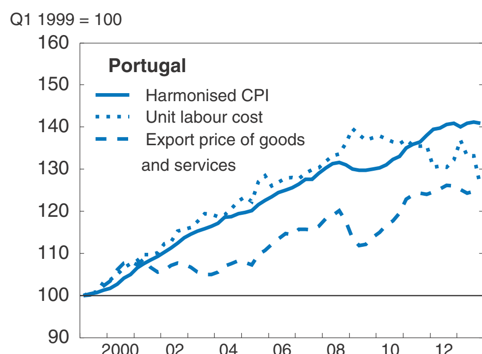
Figure 5. **Evolution of price competitiveness**

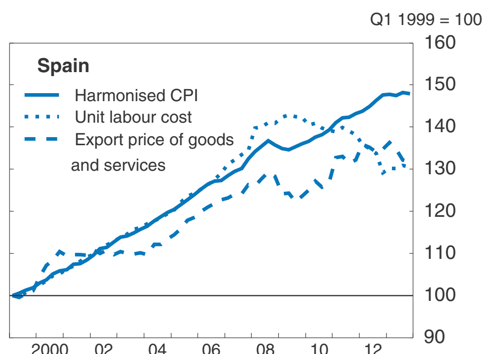












1. The figures shown correspond to unit labour costs of the whole economy relative to unit labour costs in the rest of the euro area.
2. Or latest available data.

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

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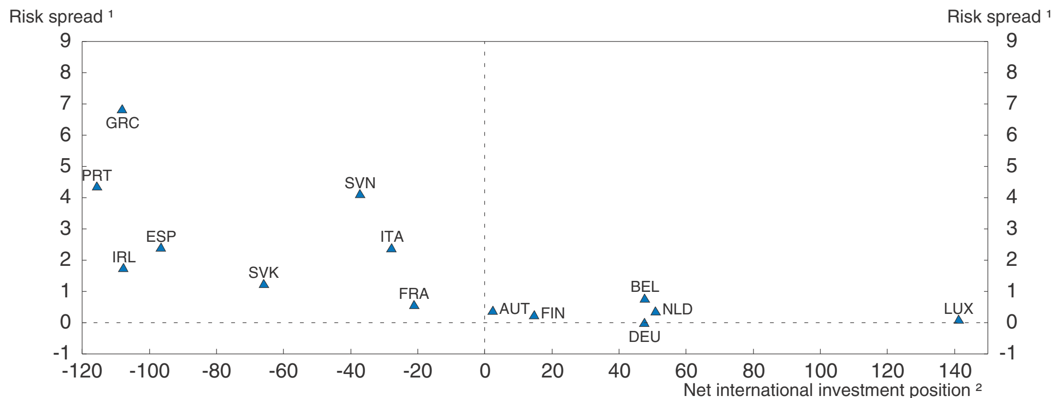
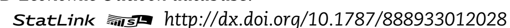
Figure 6. **Net international investment position and sovereign risk spread**

Q4 2013 or latest available data



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

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

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

Growth in the euro area remains weak and non-inclusive

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

Table 1. **Macroeconomic indicators and projections**

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

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

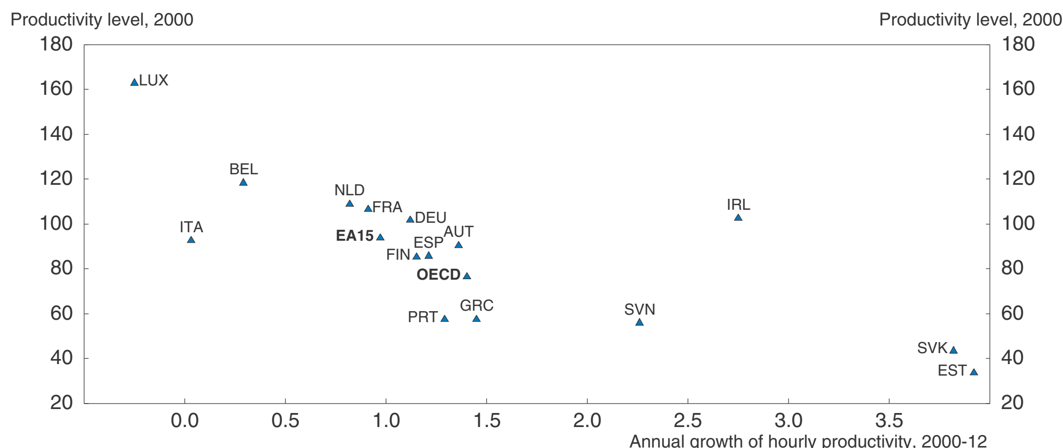
1. EA15 refers to the 15 countries in the euro area that are also members of the OECD.
2. Projections are taken from the *OECD Economic Outlook 94*.
3. Contribution to changes in real GDP.
4. Potential output and the output gap are taken from the *OECD Economic Outlook 94*.
5. As a percentage of potential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

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

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

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

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



Source: OECD, *Productivity database.*

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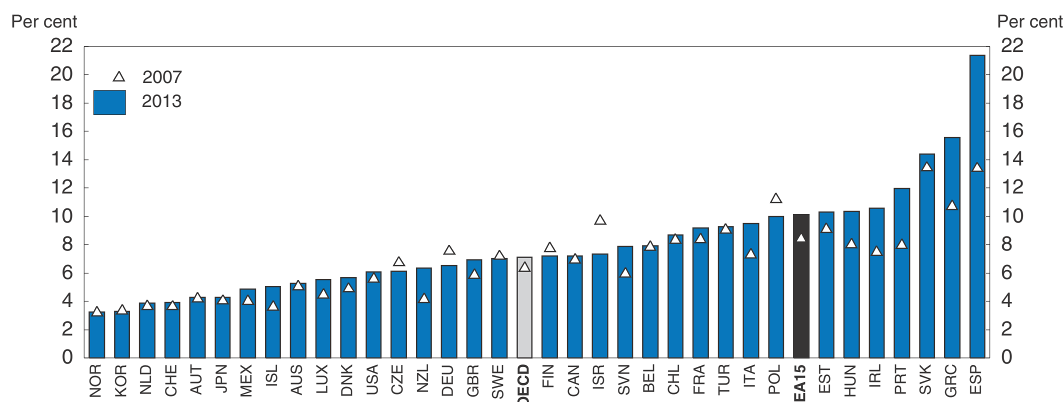
Figure 8. **Structural unemployment in the euro area is high and growing**

Non-accelerating inflation rate of unemployment



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

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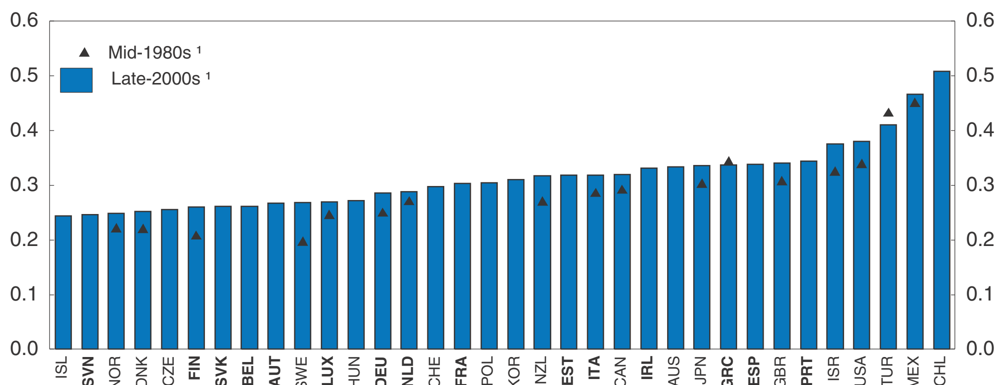
likely do little more than stabilise employment in the coming years (OECD, 2013a and b). Against the background of weak innovation, labour productivity growth may prove only moderate. Achieving the 60% target of government debt with such low growth prospects will require maintaining fiscal surpluses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

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

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

Gini coefficient of household disposable income, total population



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

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

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

Average growth rate, per cent

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

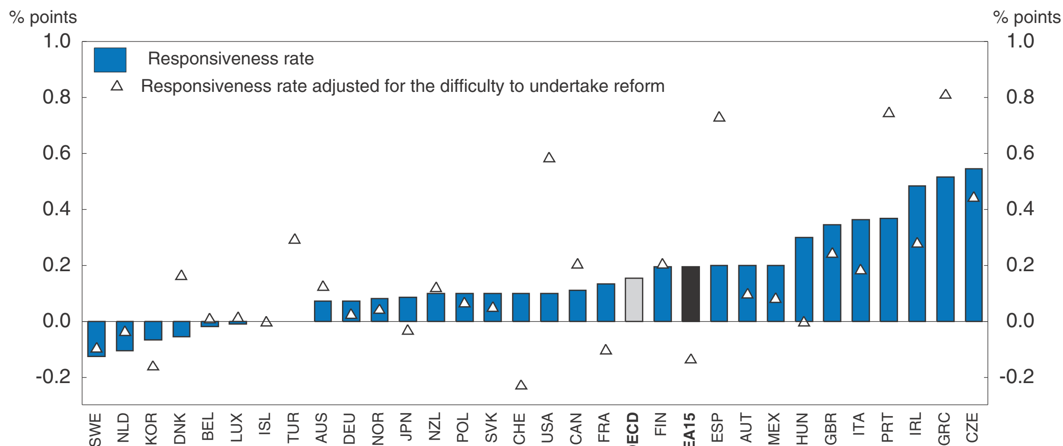
1. End of period.
2. Per cent of GDP.
3. Per cent of labour force.

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

Monetary policy has been highly accommodative

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

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



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

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

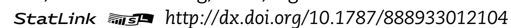
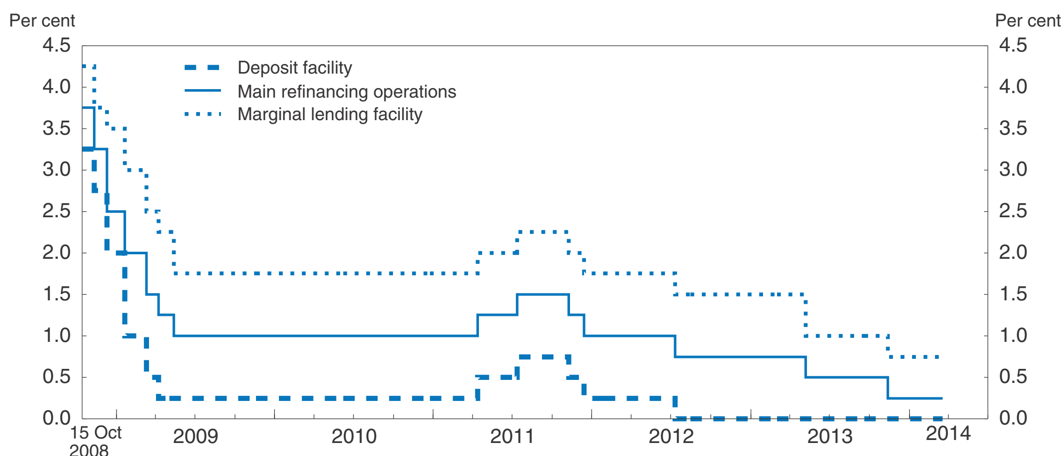
StatLink  http://dx.doi.org/10.1787/888933012104

Figure 11. **Key ECB interest rates**



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

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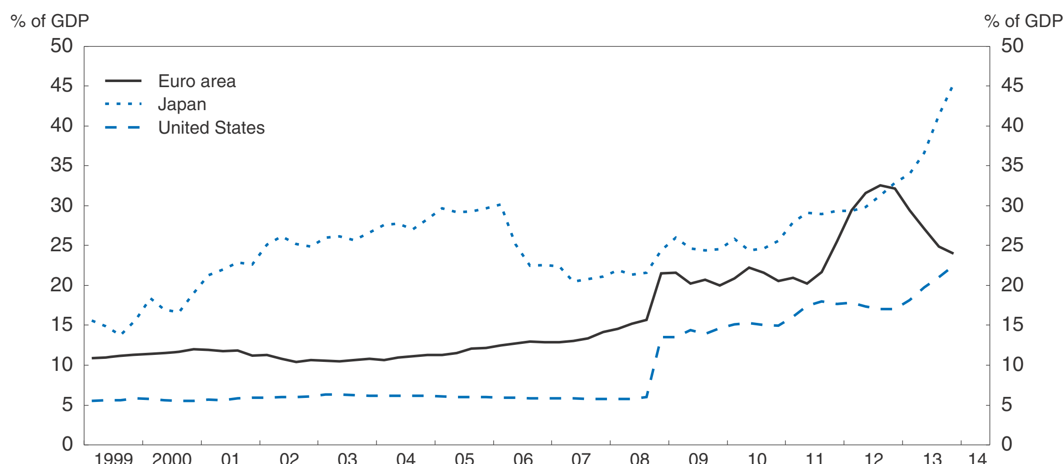
However, financial conditions remain fragmented, resulting in impaired transmission of policy. The more favourable conditions in private sector credit funding have not yet translated into improved bank lending conditions, reflecting weak economic activity, diverging perceptions of risk and weakness in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

Figure 12. **Total central bank liabilities**



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

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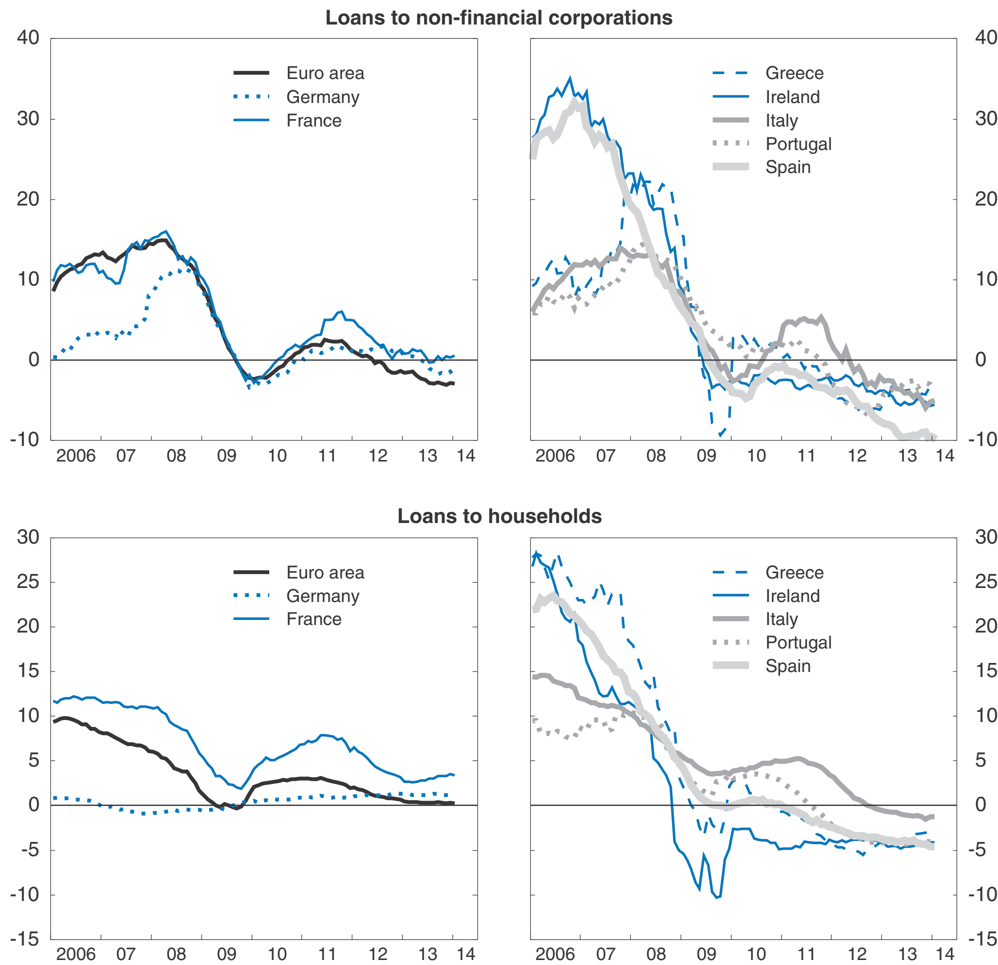
Euro area consumer price inflation has declined to 1¼ per cent on average in 2013, despite increases in indirect taxes, and remained low in early 2014. Euro area inflation rates substantially below the ECB's objective of below but close to 2% in the medium term make adjustment of relative prices across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

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

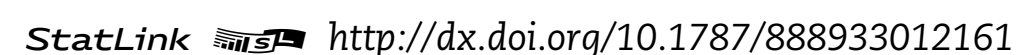
Figure 13. **Growth of bank credit to the private sector**

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



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

Source: European Central Bank and Banca d'Italia.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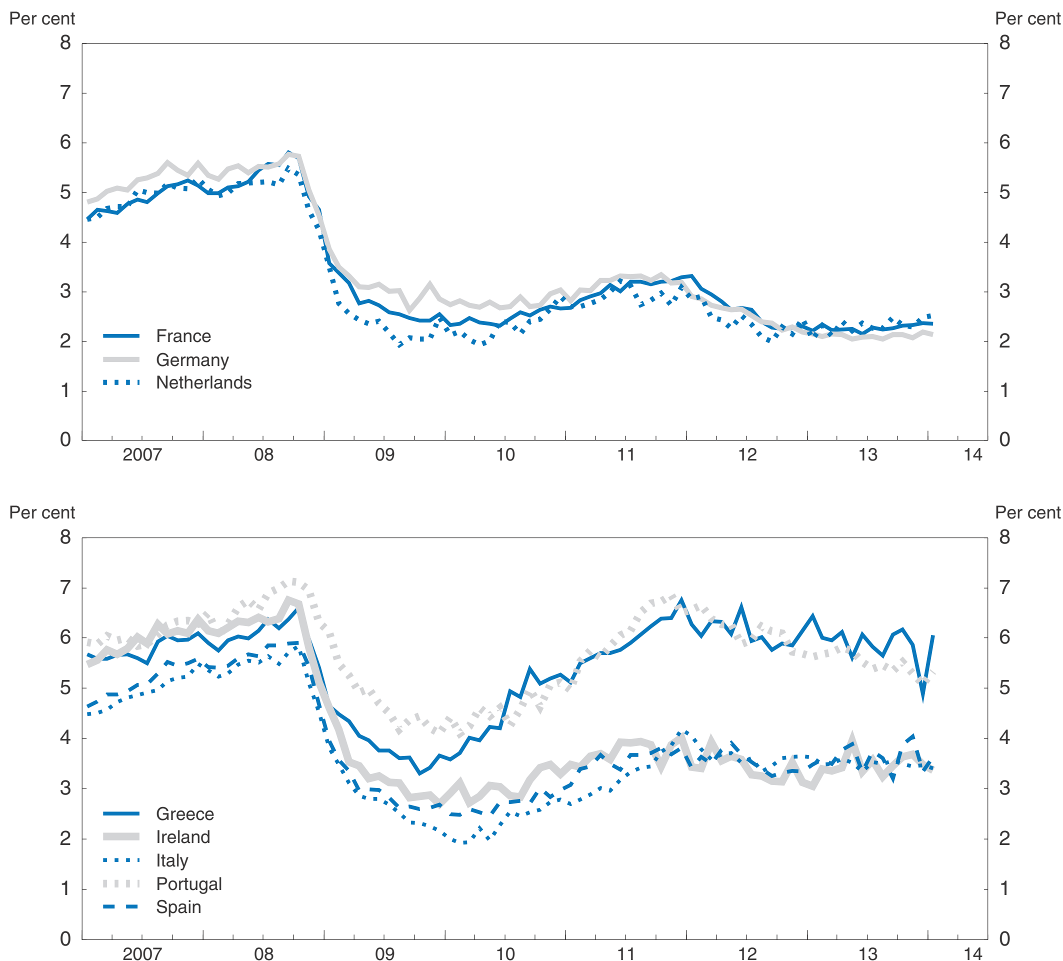
stimulus in line with the changing outlook for price stability, inflation expectations could rise. These issues reinforce the case for establishing a banking union, which would help to overcome financial market fragmentation.

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

Figure 14. **The cost of credit[1] in euro area countries**
Last observation: January 2014



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

Source: European Central Bank.

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Recommendations on monetary policy

Key recommendation

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

Further recommendation

- Continue with strong communication as monetary stimulus is withdrawn.

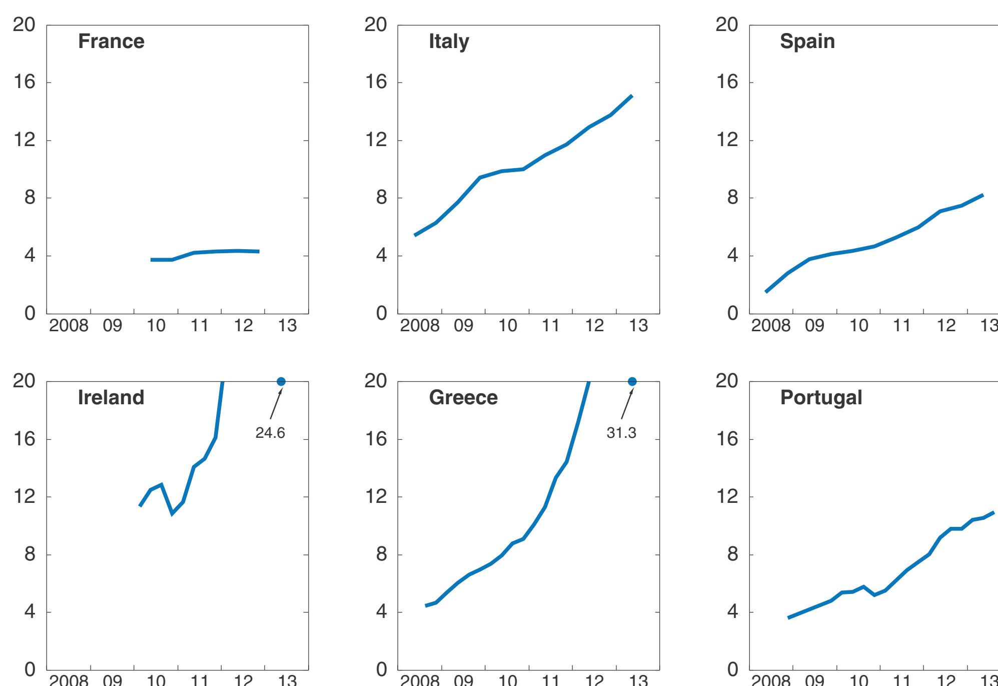
Stronger bank balance sheets are key to recovery

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

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

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

As a percentage of total gross loans



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

Source: IMF, *Financial Soundness Indicators database.*

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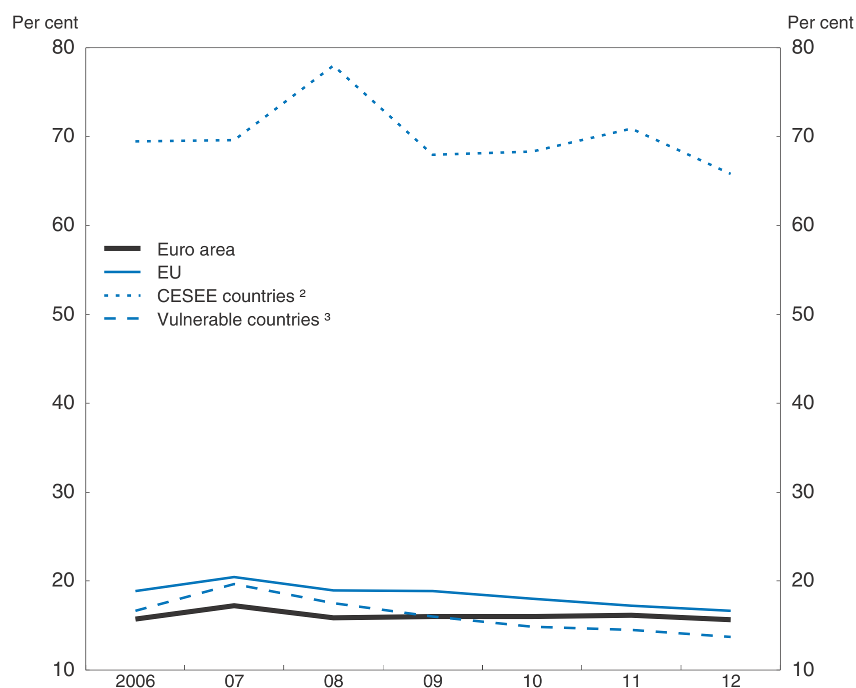
Low cross-border holdings of banks' equity capital diminish risk sharing. Even prior to the crisis, foreign equity capital holdings in banks in some vulnerable countries were comparatively low, and they have declined further. Bank penetration – defined as the share of total bank assets in a given country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

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

Per cent of total banking assets



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

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

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

Capitalisation of euro area banks

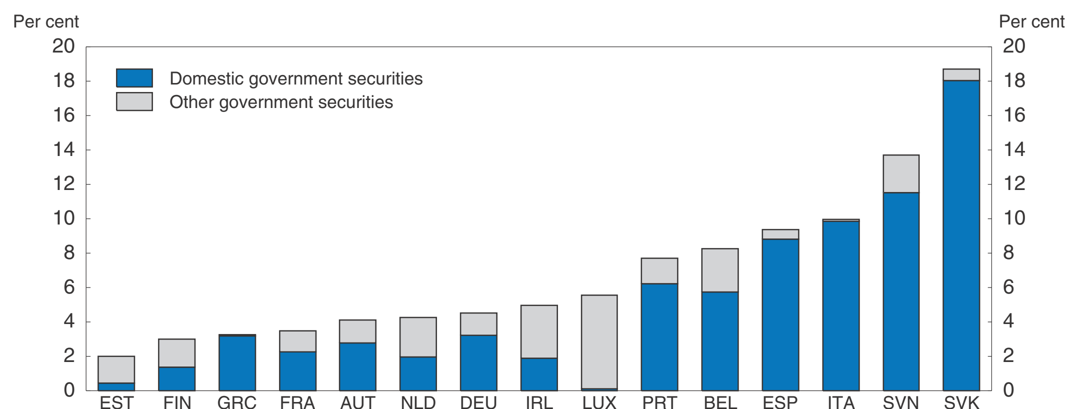
As agreed at the international level, the Basel III approach, and its transposition into EU law (Capital Requirements Directive IV and Capital Requirements Regulation, CRD IV/CRR), measures capital adequacy by risk-weighted indicators. The ongoing comprehensive assessment of banks' balance sheets aims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

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

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

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

As a percentage of total MFIs assets, January 2014



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

Source: European Central Bank.

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

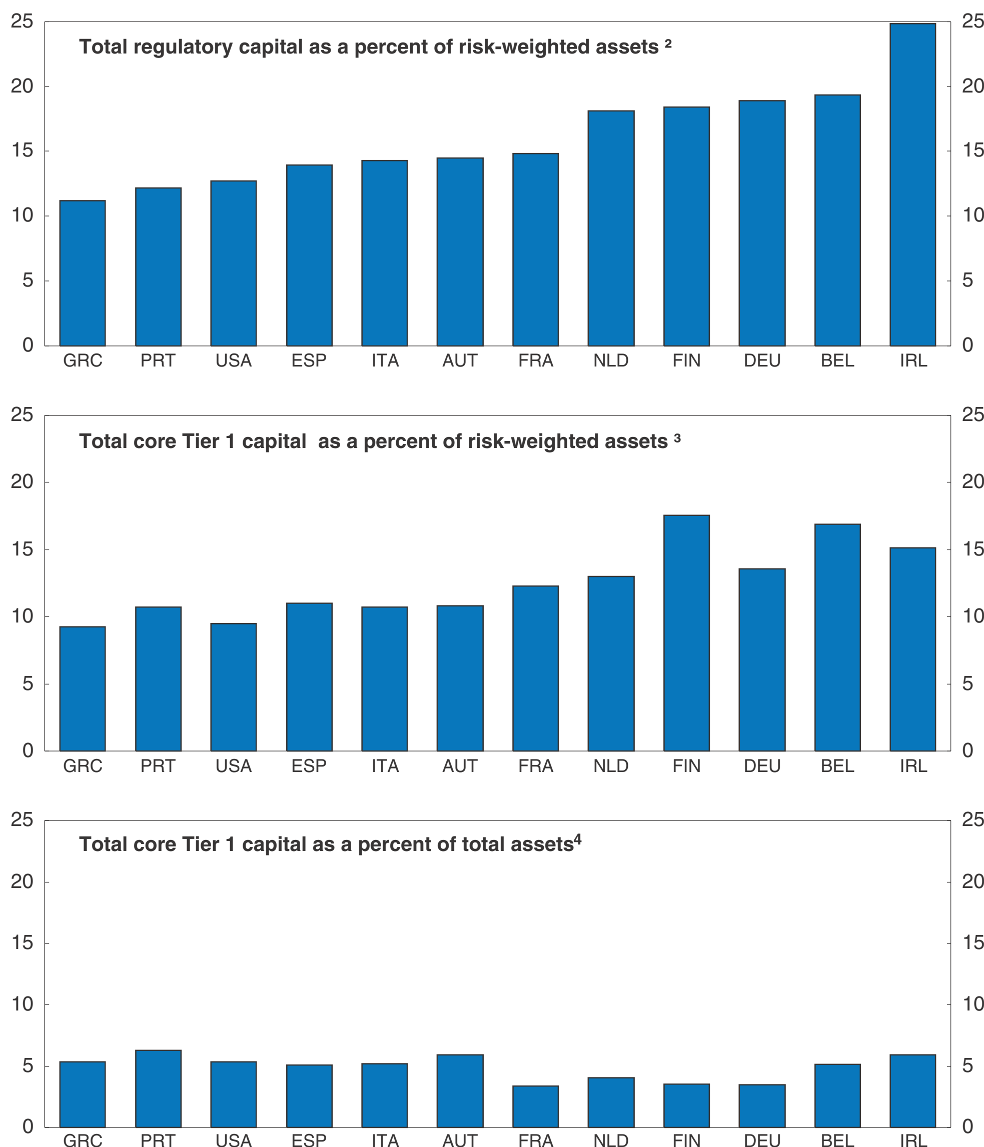
Against this background, attention has increasingly been paid to the leverage ratio (equity to non-weighted assets) as a supplementary measure to risk-weighted capital ratios in assessing banks' capital adequacy. Research suggests that a leverage ratio is a predictor of banks' distance to default (Blundell-Wignall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

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

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

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

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



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

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

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

Strengthening banks' balance sheets and completing the banking union

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendations on regulation of the banking sector

Key recommendations

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

Further recommendations

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

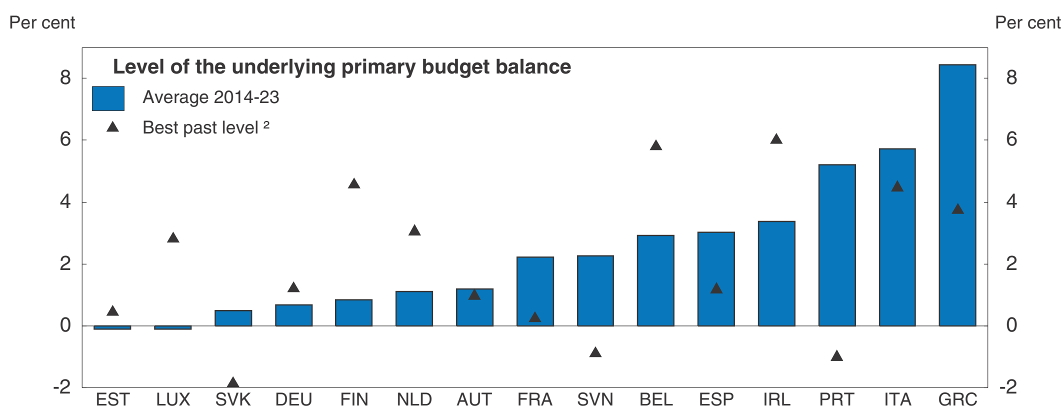
Remaining fiscal challenges

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

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

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

In per cent of potential GDP



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

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

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

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

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

The pace of consolidation is set to slow

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

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

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

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

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

A fiscal capacity to enhance incentives for structural reforms

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

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

Fiscal governance is being strengthened

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

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

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

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

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

Recommendations on fiscal consolidation

Key recommendations

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

Further recommendation

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

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