Executive summary

- *Main findings*
- *Key recommendations*

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Main findings

Ensuring a sustained recovery. The euro area economies, including those most heavily hit by the crisis, appear to be turning the corner after many years of low and uneven growth. Confidence has improved and progress been made in reducing fiscal and current account imbalances and improving competitiveness in many vulnerable countries. Structural reforms have also strongly progressed in these countries. However, economic activity remains uneven and fragile. Unemployment rates stand at double-digits in several countries, and in most are more than twice as high for the young. Inequalities have widened. Weak private sector balance sheets and impressive fiscal consolidation, necessitated by high sovereign debt, still bear on demand. The impact of supportive monetary policy is weakened by financial fragmentation, with inflation rates having fallen to around 1%. Persistent very low policy interest rates are supporting economic activity; if maintained for a long period, this could feed asset price booms in some countries and could delay the cleaning up of bank balance sheets.

Towards a banking union. The crisis left Europe with high non-performing loans, fragmented capital markets and a negative feedback loop between sovereigns and banks. Substantial public funds have been spent to save failing banks in some countries, while private creditors have taken fewer losses, potentially contributing to excessive risk taking and moral hazard. Strengthening growth and restoring credit flows depend on cleaning up bank balance sheets, based on credible stress tests and asset valuations, and on firmly establishing institutions that foster unbiased risk assessment in financial markets.

To improve the functioning of the credit system, break the bank-sovereign nexus and reduce systemic financial market risks, Europe is creating a banking union with common supervision and resolution mechanisms and a single rule book. Through the establishment of the Single Supervisory Mechanism (SSM), the European Central Bank will directly supervise large and cross-border banks (and indirectly all other banks), starting in autumn 2014. European banks are undergoing a Comprehensive Assessment in 2014, which consists of three complementary elements: a supervisory risk assessment, an asset quality review and a stress test. Progress on these elements has been substantial. Other elements of the banking union, notably a single resolution mechanism, are still work in progress.

Fiscal governance is being strengthened. The largest part of the fiscal consolidation required to reduce debt-to-GDP ratios to prudent levels has already been achieved. Therefore, although further effort is needed, this factor is likely to weigh less on growth going forward. To increase the credibility of fiscal targets, increase national ownership, and improve monitoring, several EU-level agreements have been implemented to reinforce fiscal and economic governance and co-ordination. The new governance elements include the expenditure and the debt rule, *ex ante* opinions of draft budgets and the requirement to make significant progress towards medium-term budgetary objectives (MTO). However, the multiplicity of these rules makes the new fiscal framework complex, reinforcing the need to foster "ownership" in the consolidation process. Also, real time estimates of the required structural balances and potential output are associated with considerable uncertainty, suggesting caution in interpreting fiscal policy estimates.

Implementation of consolidation policies is being supported by national fiscal councils and medium-term fiscal frameworks. Almost all euro area countries within the OECD reported in mid-2013 to have both in place. However, there appears to be considerable variation with respect to the mandate of the fiscal councils and some of the fiscal frameworks might require adjustment once experience is gained.

Key recommendations

Ensuring a sustained recovery

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

Towards a banking union

- 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.

Fiscal governance is being strengthened

- 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.

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