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Fostering cyclical convergence in the Euro Area

Filippo Gori

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FOSTERING CYCLICAL CONVERGENCE IN THE EURO AREA

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By Filippo Gori

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Abstract/Résumé

Fostering cyclical convergence in the euro area

During the first decade of the currency union, business cycle fluctuations among Euro Area countries were relatively synchronised and similar in magnitude. This concordance disappeared during the 2008 financial turmoil and the following European sovereign debt crisis, a time when key flaws in the architecture of the euro area became apparent. The recovery helped reduce cross-country differences in unemployment and output gaps, but countries worst hit by the crisis took much longer to recover, and in some cases negative consequences of shocks became entrenched. The COVID-19 crisis could lead to a resurgence in euro area cyclical di-synchronisation, risking to exacerbate economic divergence among member states and putting to the test the macroeconomic stability of the currency union. Diverging cyclical paths among euro area countries originate from differences in economic structures and domestic institutions. However, such differences are compounded by features in the economic policy architecture of the currency union – such as the lack of a common fiscal stabilisation tool – and by remaining frictions in the functioning of the common labour and financial markets. Reforms to the common euro area economic policy framework combined with those to improve labour and capital mobility across euro area members are needed to foster cyclical convergence in the currency union.

This Working Paper relates to the 2021 OECD Economic Survey of The Euro Area which was finalised in June 2021.

http://www.oecd.org/economy/euro-area-and-european-union-economic-snapshot/

JEL codes: E61, F42, E62, E32, H87

Keywords: financial integration, labour market reforms, macroeconomic stabilisation, European deposit insurance, Capital markets union, Banking Union

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Favoriser la convergence cyclique dans la zone euro

Au cours de la première décennie de l'union monétaire, les fluctuations conjoncturelles dans les pays de la zone euro étaient relativement synchrones et d'ampleur similaire. Cette coïncidence a disparu au cours des turbulences financières de 2008 et de la crise de la dette souveraine dans la zone euro qui s'est ensuivie, période pendant laquelle les principales faiblesses de l'architecture de la zone euro sont apparues au grand jour. La reprise a aidé à réduire les disparités entre les pays concernant le chômage et les écarts de production, mais les pays les plus durement touchés par la crise ont mis beaucoup plus de temps à se redresser et, dans certains cas, les conséquences négatives de ces chocs sont devenues endémiques. La crise liée au COVID-19 pourrait entraîner une résurgence de la désynchronisation conjoncturelle au sein de la zone euro, risquant d'exacerber les divergences économiques entre les États membres et mettant à l'épreuve la stabilité macroéconomique de l'union monétaire. La divergence des trajectoires conjoncturelles dans les pays de la zone euro trouve son origine dans la diversité de leurs structures économiques et de leurs institutions. Cela étant, ces différences sont amplifiées par les particularités de l'architecture de la politique économique de l'union monétaire – telles que l'absence d'un mécanisme commun de stabilisation budgétaire – et par les frictions persistantes affectant le fonctionnement du marché du travail et du marché financier communs. Il est indispensable de réformer le cadre de la politique économique commune de la zone euro tout en engageant des réformes pour améliorer la mobilité de la main-d'œuvre et des capitaux entre les membres de la zone euro afin de favoriser la convergence conjoncturelle au sein de l'union monétaire.

Ce Document de travail se rapporte à l'Etude économique de l'OCDE de Zone Europe 2021 qui a été finalisée en juin 2021.

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Mots clés : intégration financière, réformes du marché du travail, stabilisation macroéconomique, assurance-dépôts européenne, Union des marchés de capitaux, Union bancaire.

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Fostering cyclical convergence in the euro area

By Filippo Gori [1]

A high degree of business cycle synchronisation is crucial for the smooth functioning of a currency union, as it facilitates coordination in national fiscal frameworks, and the effective implementation of a common monetary policy. In the euro area, heterogeneous economic structures, imperfectly integrated labour and capital markets and some key architectural features – such as the absence of a common fiscal stabilisation capacity – contributed, in the aftermath of the European sovereign debt crisis, to the emergence of large differences in the magnitude and timing of business cycles. Such diverging cyclical dynamics are significant as they have the potential to develop into diverging medium-term economic trajectories through hysteresis effects, threatening economic convergence and European cohesion.

The possibility of a resurgence in cyclical divergence in the euro area is particularly severe in the current juncture, as euro area members are affected differently by the economic consequences of the COVID-19 crisis. In this context, there is a tangible risk that the current crisis could further undermine convergence, ultimately weakening the economic stability of the currency union as a whole.

Structural reforms involving the architecture of the euro area are needed to improve the functioning of the currency union and its ability to deal with large economic shocks affecting euro area economies differently, such as the ones stemming from the COVID-19 pandemic. Against this background, cross-border labour mobility should be preserved until the pandemic will be over and improved over the medium run. Remaining strings to the emergence of a frictionless common financial market should be eliminated to reduce the risk of financial fragmentation. Finally, a common fiscal capacity, for example in the form of an unemployment re-insurance scheme, would complement the capacity of euro area member states to conduct counter-cyclical fiscal policy. These reforms should be complemented by structural reforms taken at the national level to improve domestic economic resilience, so as to facilitate individual countries' adjustment to cyclical shocks.

Euro area cyclical divergence has deep roots

The classical theory of optimum currency areas emphasises structural convergence, factor mobility and fiscal integration as preconditions for the smooth functioning of a monetary union (Mundell, 1961; Kenen, 1969; McKinnon, 1963). Structural convergence requires greater similarity in the

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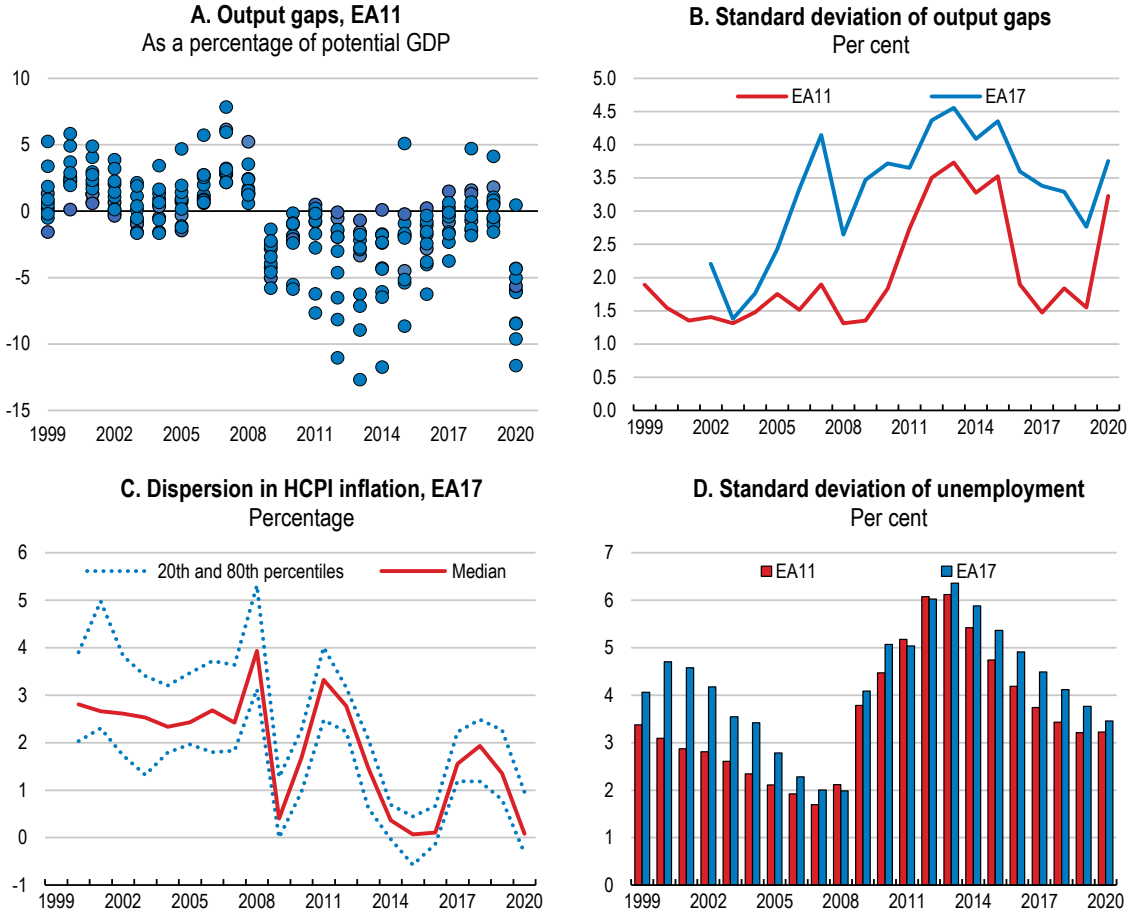
economic structures of participating economies, so as to reduce possible asymmetric shocks that may be difficult to counteract with a unique monetary policy. Factor mobility is required as, in the presence of a country-specific shock, factor inputs must adjust if relative prices cannot. Fiscal integration requires a system of fiscal transfers between member states to support regions hit by stronger shocks during downturns.

The original architecture of the euro area lacked many of the characteristics of an optimal currency area. Yet, generally muted business cycle shocks until the global financial crisis concealed such structural deficiencies. During the first decade of the euro, business cycle fluctuations of member countries were relatively synchronised and of similar, mild magnitude. Over the same period, dispersion in unemployment and inflation rates gradually declined. This concordance in business cycles disappeared during the European sovereign debt crisis in 2011-12, at a time when output gaps and unemployment rates in euro area countries greatly diverged, as consequence of largely asymmetric real and financial shocks that brought afloat some crucial weaknesses in the economic functioning of the currency union (Figure 1).

Figure 1. Euro area business cycles diverged during the global financial crisis

Annual data



Note: EA11 include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. EA17 include all other euro area members that are also part of the OECD.

Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

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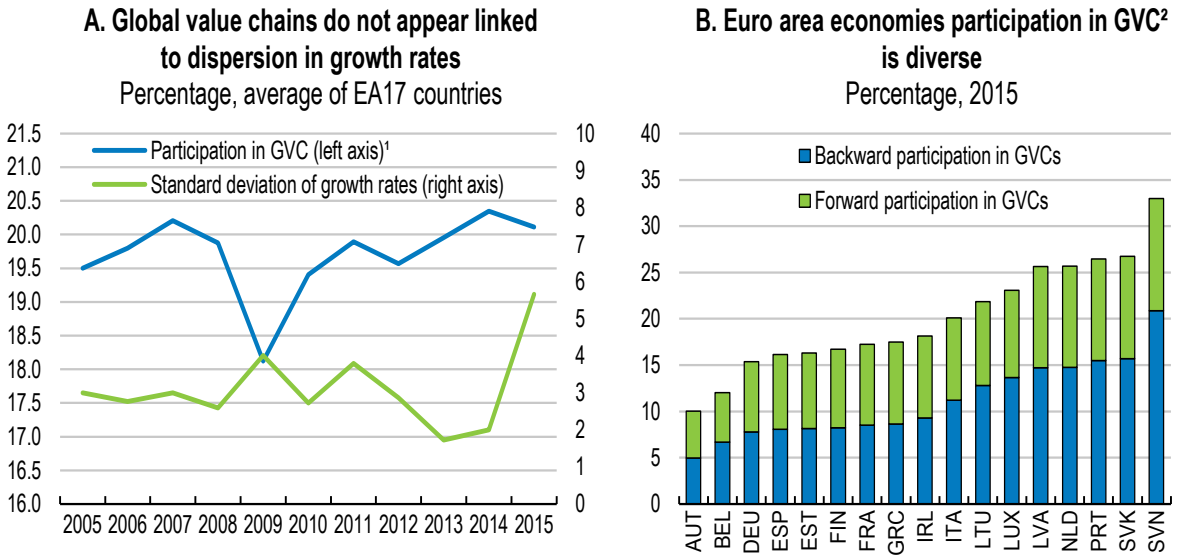
Different economic structures generate dispersion in business cycles

Sectoral composition influences the characteristics of an economy's business cycle, such as its length and amplitude, and it determines the vulnerability of a country to specific economic shocks. Symmetry of shocks across a currency union therefore depends on the degree of homogeneity of economic structures in its regions. The euro area comprises countries with different economic structures, which translates into relatively large differences in sectoral sources of aggregate business cycle fluctuations (Orlandi et al., 2004) and exposes euro area countries to a higher likelihood of idiosyncratic shocks.

In the years following the introduction of the currency union, in conjunction with the strengthening of the single market, the removal of trade and investment barriers led to spatial agglomeration of economic activities along the lines of national or regional competitive advantages (Fontagné and Freudenberg, 1999; Mongelli et. al, 2016). Heightened competition and agglomeration economies favoured industry concentration, resulting in greater divergence in the productive structure of individual euro area economies (Figure 3, Panel A). The extension of the supply chains beyond local markets further increased specialisation in economic activities. In the euro area, trade flows of intermediate inputs has increased rapidly, almost doubling as a share of GDP between 1990 and the early 2000s, and stabilising at relatively high levels thereafter (Gunnella et al., 2019). The development of stronger industrial linkages among euro area countries had the potential to increase cyclical convergence. Yet, over the last decade, stronger European cross-border value chains do not appear correlated with higher cyclical synchronisation of euro area economies (Figure.2, Panel A). This can be explained in light of the uneven development of cross-border industry networks, in terms of the overall extent, the geographical linkages and with respect to the position of single economies in global value chains (Figure 2, Panel B).

Figure 2. Global Value Chains did not improve cyclical convergence



Note: 1. Sum of forward and backward participation indexes. 2. GVC participation is the sum of the backward participation in GVCs (foreign value-added share of gross exports, by value added origin country) and forward participation in GVCs (domestic value added in foreign exports as a share of gross exports, by foreign exporting country).
Source: OECD, Inter-Country Input-Output (ICIO) Database, 2018.

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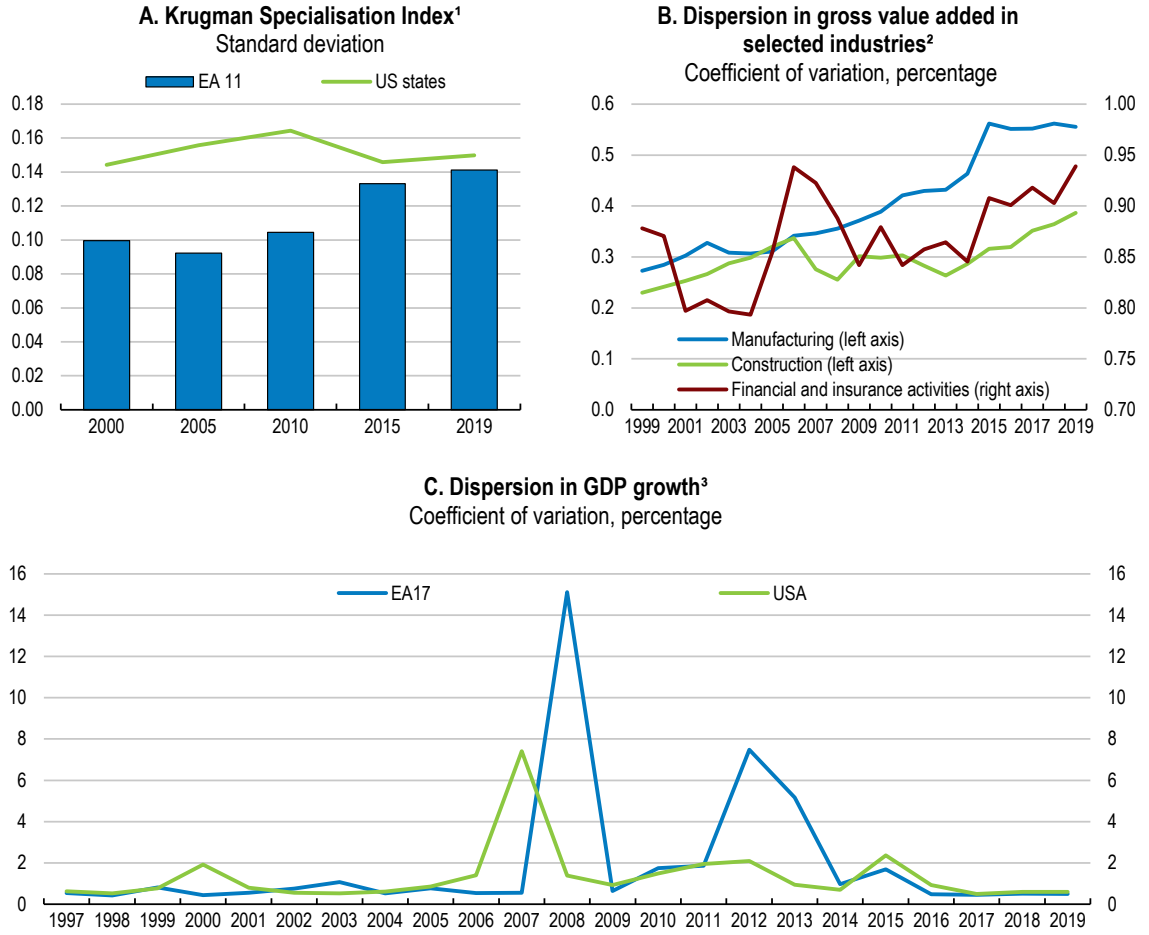
The significant heterogeneity in the cross-border industry linkages of euro area countries is linked to specificities that distinguish the economic structure of individual economies, including their different position with respect to the productivity frontier and their sectorial specialisation (Crosculo et al., 2016). For example, the car manufacturing supply chain extends between some core euro area countries (such as Germany, France, Italy and Spain) and most central Eastern European countries, but it has a limited footprint in northern European countries (including the Baltics) and in remaining Mediterranean economies (such as Portugal and Greece). Overall, these differences support diverse income elasticity of trade, determining different responses of euro area countries to shocks in specific industries, and, as such, they have the potential of increasing business cycle divergence across the euro area.

Even considering the same sectoral value chain, some economies are located more upstream (with higher domestic value added embedded in third-country exports) compared to others. To the extent upstream industries further away from the final consumers are more exposed to demand shocks, while downstream industries are relatively more vulnerable to supply shocks higher up the value chain, such differences can explain the emergence of different economic responses even in case of shocks developing along the same sectoral value chain (Acemoglu et al., 2015; Carvalho, 2014; OECD, 2015).

The emergence of regional concentration, for example, in manufacturing and financial services, is reflected in higher cross-country dispersion in Gross Value Added (GVA) shares for key industries (Figure 3, Panel B). Divergence in manufacturing activities, traditionally having an important role in business cycle dynamics in the euro area (Orlandi et al., 2004), has been particularly strong; despite a general trend toward the service sector, Austria, Germany, Ireland and Finland managed to maintain a high industry share, while other countries (such as Belgium, the Netherlands, France, Spain, Greece, Portugal and Luxembourg) experienced considerable deindustrialisation. Stronger specialisation of euro area economies is also observable in rising dispersion in Krugman specialisation indexes computed for individual euro area countries (Figure 3, Panel A). These indexes reflect the weight of a sector in the production structure of a particular country, relative to the weight of that sector in total EU production.

Figure 3. Differences in industrial structures among euro area members have been rising



Note: 1. The Krugman Specialisation Index (KSI) is a widely used specialisation measure. It can be seen as a relative specialisation compared to one other country or to a reference group, in this case the EA11. The Index is defined as the absolute sum of the share of value added produced in a generic sector i by a country with respect to the same share in a reference country. The chart show the standard deviation of for the Krugman specialisation index across EA11 countries (columns) and US states (line). 2. Gross value added by NACE activities, EA17. 3. Coefficient of variation for annual GDP growth across 50 US States and EA17 countries. EA17 include all other euro area members that are also part of the OECD.
Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database); Eurostat.

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If economic structures of euro area countries have been diverging since the introduction of the euro, from an industrial standpoint, euro area regions are still more homogenous than those of the United States – a currency union of similar size (Figure 3, Panel A). Despite a relatively milder industrial heterogeneity, cross-sectional dispersion in GDP growth among euro area members tend to be higher than the one measured across US states, peaking during downturns (Figure 3, Panel C). This suggests that industrial polarisation alone cannot explain the relatively high divergence in business cycles observable among euro area economies and that much of cyclical divergence in Europe need be explained by policy and institutional frameworks which are unique to the euro area, such as those pertaining to the functioning of the common labour and capital markets.

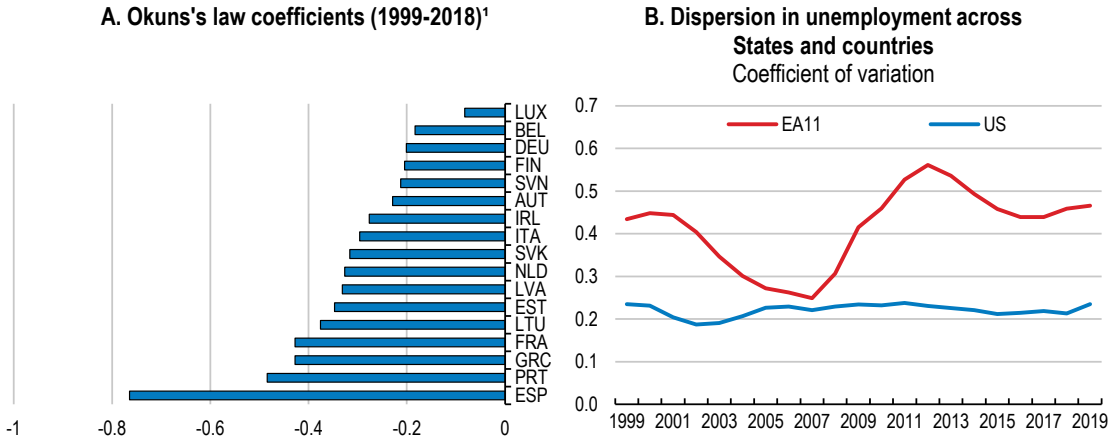
Limited labour mobility impedes labour market convergence

Labour legislation and policies determine the way labour markets function, amplifying or dampening economic shocks and, consequently, affecting business cycle dynamics. Social protection schemes, and wage setting mechanisms determine the interaction between unemployment, household consumption and output, partially driving output fluctuations during shocks. Stronger social protection systems, including unemployment benefits and short-time work programmes – such as those financed by SURE – are effective in smoothing employment and consumption fluctuations during economic downturns (OECD, 2018a; Hijzen and Venn, 2011; OECD. 2014). This reduces cyclical fluctuations, increasing the shock absorption capacity of an economy in a downturn.

In the euro area, different national labour market policies and institutions contribute to diverging economic responses even in the presence of similar economic shocks. In the EU, employment protection is not granted uniformly in all member states, with the exception of some common minimum requirements stemming from EU legislation and other international obligations. The Treaty on the Functioning of the European Union (TFEU), defines the role of the common EU legislation as limited to basic transnational standards of employment, such as basic individual labour rights, anti-discrimination, and rights to minimal job security. These treaty-based provisions have been accompanied by a number of recent labour market legislations (e.g. the directive on transparent and predictable working conditions and the Commission proposal for a directive on minimum wages). Yet, EU competences do not explicitly include social protection, wage regulation, and the dismissal of workers, features that account for most of the labour market dynamics during downturns and subsequent recoveries. As a consequence, labour markets in the euro area are embedded in largely differing institutional frameworks and respond differently to shocks (Figure 2.4, Panel A and Panel B).

The coordination of EU employment policies through peer reviews, in which member states exchange best practice and discuss reform and policy priorities, has helped ensured a certain convergence of EU labour markets in recent decades, which should improve their resilience to economic shocks. Moreover, the European Semester helps national authorities to commit to their reform agenda in accordance with the priorities set by the Commission in the Annual Sustainable Growth Survey (ASGS). The country-specific recommendations provide tailored advice to individual member states on how to boost jobs, growth and investment, while maintaining sound public finances.

Figure 4. Labour markets in the euro area react differently to shocks



Note: 1. The Okun coefficients measure the impact of GDP changes on the unemployment rate. Estimates are based on the following country-specific equations estimated over the sample period 2000q1-2019q4: U(q)=a + ß0 Δ log (GDP(q)) +ß1 Δ log (GDP(q-1))+ß2 Δ log (GDP(q-2)) + e(q); where U is the unemployment rate in quarter q, GDP is the real GDP, ß are the Okun coefficients and e is the error term. The bars show the sum of ß0, ß1, ß2.

Source: OECD (2020a), "Flattening the unemployment curve? Policies to limit social hardship and promote a speedy labour market recovery"; OECD (2020), OECD Economic Outlook: Statistics and Projections (database).

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In the aftermath of the 2008 crisis, large differences in labour market dynamics contributed to diverging economic trajectories among euro area economies. In some countries, such as Greece, Spain, Portugal and the Baltics, unemployment grew extensively, partially on the account of different labour institution and policies, causing an increase of labour markets mismatch and a rise in long-term unemployment. In contrast, in Germany, unemployment almost halved between 2007 and 2019. Moreover, prolonged unemployment spells had "scarring effects" on workers, ultimately decreasing labour productivity and output potential. However, during the recovery following the global financial crisis, labour market convergence in the euro area increased substantially. In the current juncture, idiosyncratic labour market shocks risk to re-emerge following the COVID-19 crisis.

Cross-border labour mobility can contribute to attenuating differences in domestic labour markets, reducing the likelihood of long-term unemployment and hence the risk of hysteresis following an economic shock. However, labour mobility across euro area countries, despite having improved over the years prior to the current crisis, remains limited with respect to what can be observed in other currency areas (Box 1), and it faced large challenges during the pandemic.

Box 1. Mobility as an adjustment mechanism for labour markets in the EU and the U.S.

A high degree of labour mobility is one of the defining characteristics of an optimum currency area (Mundell, 1961). Labour mobility facilitates macroeconomic adjustments by reducing differences in unemployment between regions of a currency union. Internal mobility reduces the unemployment costs of economic shocks supporting the rebalancing of diverging dynamics in local labour markets. Early research on the role of labour mobility on labour markets rebalancing emphasised the importance of labour mobility in this adjustment process, showing that local unemployment rates primarily adjust by workers moving to areas where there are more jobs, as opposed to local job creation (Blanchard and Katz, 1992).

In the U.S., interstate migration has decreased steadily since the 1980s, partially owning to demographic shifts and other social and economic factors such as, for example, higher home ownership and higher synchronisation of state business cycles (Blanchflower and Oswald, 2013), while in Europe labour mobility has been picking up, almost doubling since the introduction of the euro, bringing the two currency unions closer in this respect. However, despite the closing gap, the elasticity of labour mobility to economic shocks remains significantly lower in Europe than in the U.S.

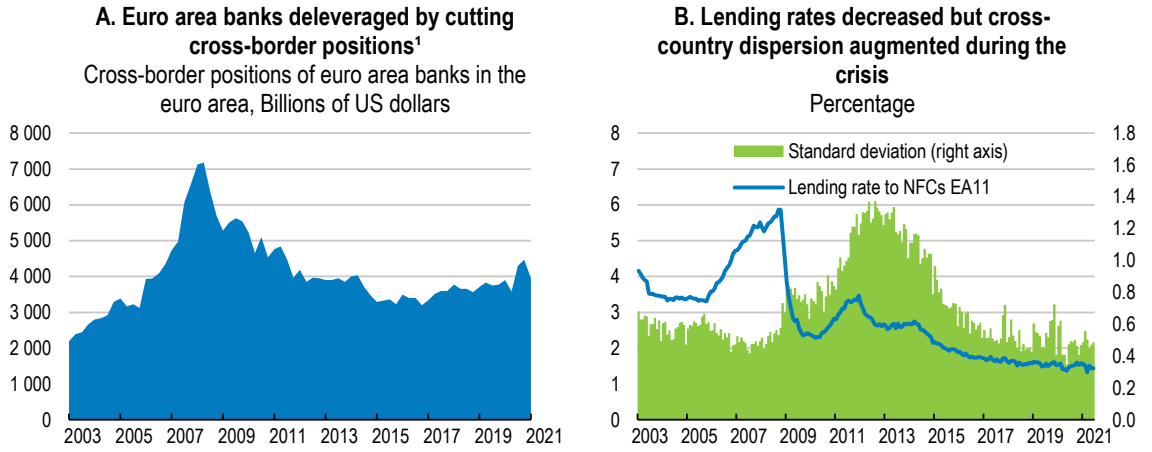
In the aftermath of the global financial crisis, while mobility flows increased from countries with high unemployment to countries with low labour market slack (Arpaia et al., 2014), those flows were too small to significantly reduce unemployment in origin countries (Elsner and Zimmermann, 2013; Bräuninger and Majowski, 2011). Studies that have compared the response of labour mobility to unemployment in the two currency areas throughout the crisis, estimated labour in Europe to be about half as mobile as in the U.S. (Dao et al., 2017). Other research finds the average elasticity of population size to employment shocks is much lower in the euro area than in the US, with point estimates of 0.2 and 0.8, respectively (Basso et al., 2018). This means that, following a shock lowering employment by 10%, only 2% of the population would move from the affected euro area country versus 8% in US States. Labour mobility being a less important adjustment mechanism in response to country-specific labour demand shocks in the euro area, labour markets adjust by stronger and more persistent reactions of the employment and the participation rate (Beyer and Smets, 2015).

Financial markets fragmentation generated diverging economic cycles

The global financial crisis and the following European sovereign debt crisis represented a hard test of the functioning of the common European financial market. At the peak of the European sovereign debt crisis, mark-to-market impairments on sovereign bond portfolios exposed banks to rising credit risk and funding costs. Declining policy interest rates were not enough to offset increasing risk premia in the most affected countries. Market-based finance, traditionally underdeveloped in most European economies, failed to substitute for bank-based credit, leaving borrowers with rising liquidity constraints and spiking funding costs. In countries where sovereign distress was higher, banks passed through rising borrowing costs to corporates, increasing the cost of new funding and debt rollover. Smaller borrowers were particularly affected (EIB, 2016).

When asymmetric financial distress arose across euro area economies, the European single market for capital dissolved and capital markets segmented along national lines, giving rise to different financial conditions (Figure 5, Panel A). In the aftermath of the sovereign debt crisis cross-border capital mobility failed to halt this mechanism. In fact, financial fragmentation was supported by a steady retrenchment of cross-border bank positions by euro area intermediaries (Figure 5, Panel A).

Figure 5. After the global financial crisis financial fragmentation increased, bank cross-border lending declined



Note: 1. Cross-border positions of euro area banks in the euro area.
Source: ECB statistical warehouse; and BIS international Banking Statistics.

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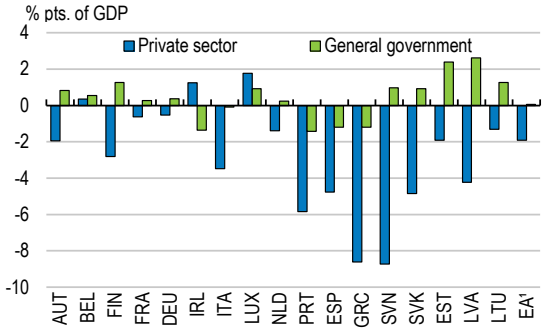
In the aftermath of the global financial crisis, in countries where the financial turmoil was stronger, the rise of constraints for financing institutions contributed to a credit crunch that exacerbated the economic contraction and curbed the recovery. For some euro area economies, the credit crunch was severe enough to have large impacts on investment even after the crisis - especially for the private sector - and fuelling unsettling medium-term diverging economic paths (Figure 6). In the euro area, asymmetric financial frictions have a key role in determining diverging business cycle dynamics and improving the integration and resilience of the common European financial market is a necessary condition to ensure business cycle convergence.

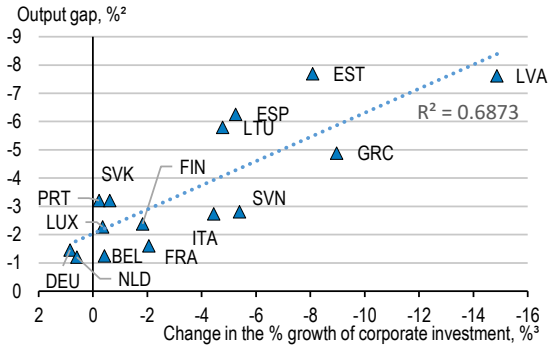
The experience of fragmentation in euro area financial markets was supported by three distinctive aspects: the presence of weak banks; fragile and unstable cross-border financial linkages; and a widespread underdevelopment of market-based finance, which failed to compensate the fall in bank credit. Steps have been made since the global financial crisis to strengthen the resilience of euro area financial markets. Yet, more needs to be done: European intermediaries need to be strengthened, their cross-border linkages should improve further, and renewed efforts are necessary for the development of market-based finance to complement bank lending.

Figure 6. Corporate investment declined asymmetrically in the aftermath of the global financial crisis

A. Difference between post-crisis and pre-crisis private and public investment rates
Average 2012-2018 minus average 1999-2007



B. Demand shocks during the crisis and post-crisis declines in non-residential corporate investment



Note: 1. Euro area member countries that are also members of the OECD (17 countries). 2. Average 2009-10, as a percentage of potential GDP. 3. Difference, in percentage points, between the average annual percentage growth rate of non-financial corporation's gross fixed capital formation, in constant prices, in the period between 2012 and 2017, and the same average annual percentage growth rate in the period between 1999 and 2006.
Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database), and updates.

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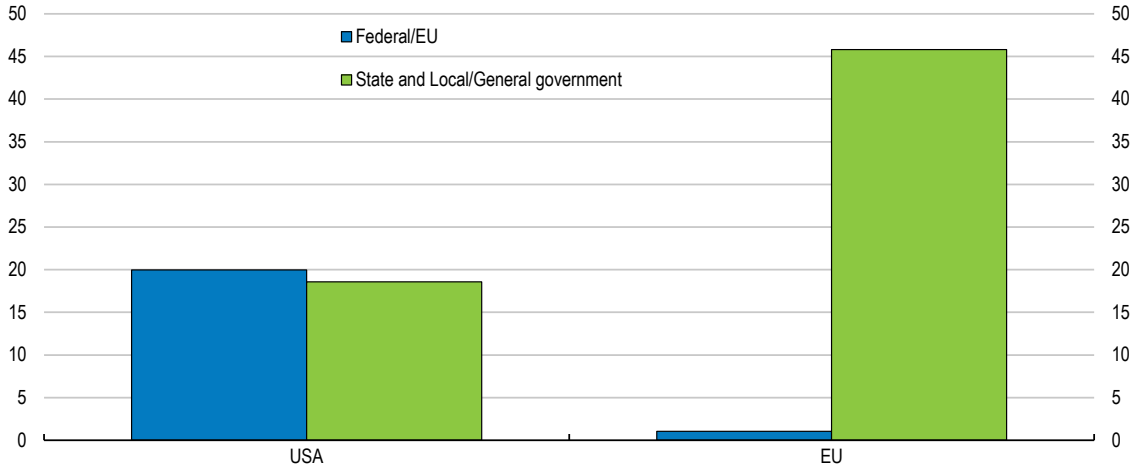
The absence of a common fiscal capacity amplifies diverging business cycles

A common fiscal capacity is one of the main tools for business cycle stabilisation and cyclical convergence in a currency union, and it remains a missing feature of the euro area. Existing studies suggest that common fiscal shock absorbers play an important role in economic stabilisation through risk-sharing in large economic regions such as the U.S. and Canada. It is estimated that US federal taxes and transfers offset between 20 to 30 cents of each dollar decline in regional income (Sala-i-Martin, 1996; Bayoumi and Masson, 1995). US corporate income taxes collected at the federal level are the single most efficient instrument of stabilisation against common shocks, while social security benefits and personal income taxes have a greater role in stabilising asymmetric shocks (Nikolov and Pasimeni, 2019).

Fiscal spending and fiscal stabilisation in the euro area is primarily entrusted to individual member states. Stabilisation in the event of large shocks for the currency area requires a high degree of coordination, which has so far proved difficult. The budget of the European Union is small in comparison to the sum of the national budgets, accounting for roughly 1 percent of the EU's GDP. As a comparison, the US Federal budget amounts to around 20% of the US GDP, also reflecting broader responsibilities of the US Federal government comparing to the EU (Figure 7). Moreover, the EU budget performs mainly an allocative function that is not related to stabilisation needs, the EU having no fiscal instrument dedicated to offset heterogeneous cyclical shocks across its members. As a result, estimates show that the net redistributive and stabilisation impact of the EU budged is much lower than in the United States (Pasimeni and Riso, 2019).

Figure 7. Government expenditure by level of government

Percentage of GDP, 2018



Note: US state and Local/General government of EU countries.
Source: US Census; and Eurostat.

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In the aftermath of the 2008 crisis, in the absence of any form of fiscal transfers and facing binding fiscal targets, countries experiencing fiscal distress, were forced into damaging pro-cyclical fiscal consolidations that exacerbated the slump in domestic demand and augmented economic divergence relative to other euro area members. In that setting, a common fiscal stabilisation function could have helped to prevent exacerbating the economic downturn. It could also have supported a more balanced policy mix.

Making labour markets more resilient to the economic cycle

More resilient labour markets can reduce divergence in business cycles, increasing the capacity of euro area economies to absorb economic shocks and speeding the recovery. Labour mobility represents an additional adjustment mechanism for the labour market, contributing to the reduction of cross-country wedges in labour market slack with temporary workforce reallocation. Labour market policies are mainly the responsibility of member states, but the EU can assist national authorities' effort with funding, by promoting best practices or offering policy guidance, in the framework of the European Semester. This multilateral surveillance framework for economic policy coordination has helped national authorities committing to their reform agenda in accordance with agreed EU priorities. Structural reforms are also needed at the European level to create a more unified euro area labour market.

European tools to support policies for resilient national labour markets

Policies and labour market frameworks that facilitate the absorption of labour market shocks can be grouped into two categories. The first aims at preserving viable jobs during downturns, the second fosters displaced workers transition to new jobs, notably by providing new skills and helping job search. Euro area countries should step up their policy efforts to enhance the resilience of their labour markets along these two lines.

Job retention schemes help reduce the impact of economic shocks on unemployment

The COVID-19 crisis has confirmed a lesson already learnt in the Global Financial Crisis that well-designed Job retention schemes (JRS) are effective in mitigating the unemployment costs of deep economic downturns (OECD, 2018b; Hijzen and Venn, 2011; OECD, 2020b). JRS can take the form of short-time work (STW) or temporary layoff schemes that directly subsidise hours not worked, such as the German "Kurzarbeit", the Italian "Cassa Integrazione Ordinaria" or the French "activité partielle". They can also take the form of wage subsidy schemes that subsidise hours worked, or they top up the earnings of workers on reduced hours, such as the Dutch Emergency Bridging Measure.

In the early stages of the COVID-19 crisis, many governments have modified existing JRS to maximise take-up, for example by simplifying access, extending coverage to non-permanent workers, and raising generosity (OECD, 2020c). At the same time, the EU has provided some financial support to national job retention schemes through SURE. In the wake of the COVID-19 shock, these policies contributed to the relative resilience of labour markets in some euro area countries with respect to other jurisdictions. Against this background, It is important to encourage member states to reinforce job retention schemes to be used in case of temporary economic shocks. The main challenge going forward is to strike the right balance between offering sufficient JRS to jobs at risk of being terminated, but likely to remain viable in the longer term, while favouring a quick and smooth job relocation for the others (OECD, 2020c).

In this context, labour mobility policies and training programmes can be extended to workers still under JRS, for example by allowing workers on STW to register with the public Employment Services and benefit from their support (OECD, 2020c). OECD analysis shows that early interventions – including those before displacement takes place – can be very effective in promoting smooth job transitions (OECD, 2018b; OECD, 2020d). Moreover, training participation of workers on reduced hours could be promoted to improve workers viability of their current job or the prospect of finding a different job (OECD, 2020a). Several European countries encourage training during STW by providing financial incentives to firms or workers (e.g., France and Germany), while in a few others participation in training is a requirement for receiving JRS subsidies (e.g., the Netherlands).

Strong activation policies and balanced employment legislation improve labour market outcomes, including in the recovery phase

Employment protection legislation should strike the right balance between offering job security and providing enough incentives to job reallocation (OECD, 2020c). In some euro area countries, once the trough of the global financial crisis passed, labour market recoveries accelerated or were made more far-reaching by increasing employers' incentives to hire, for example by reducing severance pay (notably in the Netherlands, Spain and Greece) or promoting more flexible wage setting schemes and reforming collective bargaining (such as in Belgium and Slovenia; OECD, 2019), and by reforms aimed at improving hiring dynamics – for example in Italy (Jobs Act) and France (the 2017 labour market reform package).

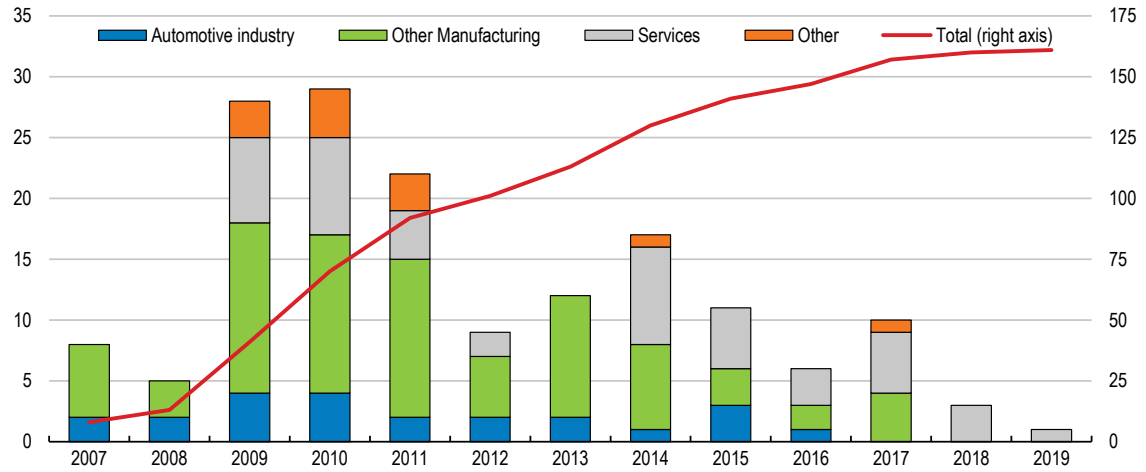
A fast recovery of the labour market requires a quick relocation of displaced workers. Evidence suggests that active labour market policies decrease aggregate unemployment and have positive effects on the speed of re-employment for jobseekers (Scarpetta, 1996; Boone and van Ours, 2004; Bassanini and Duval, 2006). Activation measures should be intensified by structurally increasing spending and effectiveness in euro area countries where they are currently underdeveloped or insufficiently effective, such as in Greece, Italy and Lithuania (OECD, 2019). During crisis times, public employment services need to scale up their capacity significantly and

should better focus on groups of people and economic sectors suffering more damage (such as tourism and the transportation industry during the current crisis). In the current juncture, active support by employment services for job transitions, including reskilling, complemented by well-targeted hiring and transition incentives are the most effective ways of sustaining economic recovery.

The EU has several tools to support activation policies in euro area countries, such as the European Social Fund (ESF), the European Globalisation Adjustment Fund (EGF) and Next Generation EU. The ESF (called ESF+ for the programming period 2021-2027), is the main tool to promote employment and social cohesion in Europe and is targeted to job seekers, in particular to individuals with lower qualifications or who have lost skills, such as long-term unemployed. The EGF co-finances one-off, time-limited support for active labour market policies targeted at workers who have lost their jobs during major restructuring events. Until 2020, this was only possible when these restructuring events occurred as a consequence of globalisation or a specific crisis (Figure 8). In the wake of the coronavirus pandemic the intervention criteria that determine whether a member state can apply for assistance from the Fund has been widened, as to help workers made redundant due to any restructuring.

Figure 8. The number of restructurings resulting in in European Globalisation Adjustment Fund interventions remains limited

Number of restructuring by sector and total



Source: European Commission.

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Although it is still early to assess its efficiency, the increase in resources linked to the EGF, the widening of the intervention criteria, and the removal of the evidence requirement justifying the reason of the dismissals are all welcome steps to increase the effectiveness and the timeliness of the instrument. To further improve the impact of the EGF in the aftermath of the crisis, European Authorities should consider revising the application procedures, to avoid lengthy approval processes by the Parliament and Council, which are currently necessary for each single project (OECD, 2018a). Political control on EGF disbursements, via the Parliament and Council, should be limited to the definition of high-level access requirements, and cannot involve the validation of each single project. In other words, once clear entitlement criteria have been established by the political authority, their verification should be left to the Commission.

Box 2. Lessons from two decades of labour mobility in the EU

Patterns of intra EU labour mobility have changed over the last decade

During the first decade of the euro, intra-EU labour mobility was driven mainly by income and wage differentials between the Eastern and Western member states. Between 2004 and 2007 the accession of 10 Central and Eastern European countries led to large east-west flows of workers. During this phase the pattern of cross-border mobility was affected by transitional restrictions on labour mobility imposed in many of the EU-15 countries, deviating workers to countries with more liberal mobility policies such as Denmark, Ireland, Sweden and the UK (Boeri and Brücker, 2005).

In the aftermath of the global financial crisis, the drivers of intra-EU mobility changed, and diverging labour market performance became a major factor driving cross-border labour flows, especially between euro area members (Rosini and Markiewicz, 2020). Between 2013 and 2017, Spain lost close to half a million inhabitants due to mobility while Germany and the UK, benefited from a net inflow of about 1.5 million of individuals. The increase in mobility flows within the euro area has been accompanied by an increase in mobile workers' education level. The percentage of intra-EMU mobile workers with tertiary education increased from 34% to 41% with respect to pre-crisis standards (Jauer et al., 2014).

Mobility has limited impact on native employment and wages

Potential negative impacts of mobility on employment and wages of natives, especially for low-skilled workers, have been source of public and policy concern. However, evidence from existing studies suggests that, in the short-term, intra-EU mobility does not have a negative impact on the employment outcomes of natives (Bonin, 2005; Devlin et al., 2014; Edo et al., 2018). Evidence on wage impacts is less conclusive, but generally points to small negative effects on wages concentrated on the bottom of the distribution. Impacts tend to be stronger for native workers in the unskilled service sector (Zorlu and Hartog, 2005; Dustmann et al., 2013; Nickell and Salaheen, 2015).

Cross-border labour flow can increase productivity and growth in receiving countries

The impact of mobility on productivity and growth is complex and intrinsically hard to measure. The empirical literature focusing on the EU mobility experience is sparse but generally suggesting positive effects. Looking at the UK experience, Ottaviano et al., (2015) finds that a 1% increase in mobile workers' concentration in local labour markets is associated with a 2-3% rise in labour productivity; Rolfe et al., (2013) find that mobile workers' concentration within specific industries was associated with slight increases in productivity, but the impact was small. At the aggregate level, Boubtane et al., (2015) find that mobility tends to boost productivity in euro area countries, with an estimated impact of 0.5% increase in productivity per a 1 percentage point in the mobile workers' share of the working age population.

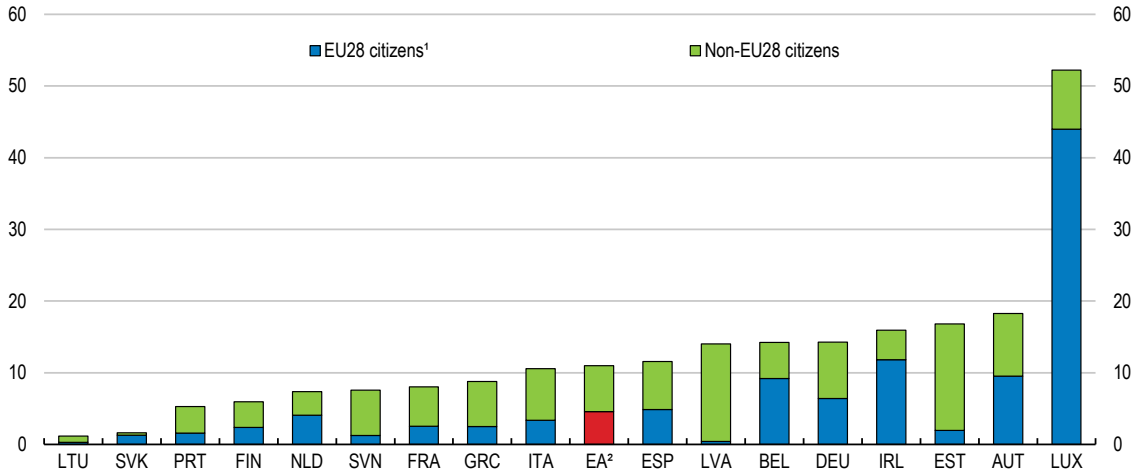
Improving labour mobility

Cross-border labour mobility represents an important feature for the functioning of the EU single market and a key balancing tool for domestic labour markets experiencing excessive slack (or tightness) for prolonged periods. Despite often being a subject of controversy, evidence suggests that labour mobility does not reduce employment opportunities of natives, and it has the potential of delivering productivity gains in receiving countries (Box 2). Moreover, labour mobility policies – when also facilitating return mobility – may also help to reverse brain drain, where labour market developments allow (Box 3).

Movement of workers across euro area members has increased right before the pandemic, but at a slower pace than in previous years. In 2019, almost 18 million Europeans lived in another EU country, out of which 13 million of working age yet, the number of working-age EU-28 movers grew by only 1.2% in 2019, substantially less than the 3.4% in 2018 (European Commission, 2021). Moreover, despite the stock of active movers has constantly increased from 2012 to 2019 (European Commission, 2021), cross-country flows of mobile workers are still too limited to significantly reduce unemployment in origin countries (Elsner and Zimmermann, 2013; Bräuninger and Majowski, 2011) and, in some euro area countries, third-country citizens outnumber EU nationals among working-age foreign residents (Figure 9).

Figure 9. In some euro area countries third-country citizens outnumber EU nationals among working-age foreign residents

20-64 year-olds, % of total population, 2018



Note: 1. Excluding nationals in reporting countries. 2. Euro area member countries that are also members of the OECD (17 countries).
Source: Eurostat (2020), "Population by age group, sex and citizenship", Eurostat Database.

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Today, the necessity of supporting labour mobility within the EU is more stringent than ever. Restrictions to the freedom of movement within the Union, higher hurdle and financial costs linked to cross-border travel had a negative effect on intra-EU labour mobility over the last year (OECD, 2020d). During the spring 2020 peak of the COVID-19 pandemic, cross-border labour mobility has stopped, as a number of European governments closed their borders with neighbouring EU countries, cancelled international flights, or imposed border checks in an emergency attempt to stop the spread of infections. These measures were joined by domestic lockdowns, as most member states imposed restrictions on nonessential movements.

During the initial phase of the pandemic, the categories most affected by reduced cross-border mobility were seasonal and care workers. Yet, personal-care workers together, together with health professionals, have been on the frontline of the fight against the pandemic. In 2016, there were almost 350 000 health professionals in a member state other than their country of citizenship (European Commission, 2018). In addition, there are 257 000 personal care workers living in another EU Member State. Together, these three groups represent roughly 7% of all employed EU-28 movers (European Commission, 2018). Over one year after the beginning of the pandemic, some cross-country movement restrictions are still in place. As of September 2021, EU countries have restricted land border crossing to individuals presenting negative COVID-19 test results or being vaccinated against the COVID-19.

In case of the emergence of new vaccine resistant or more infectious virus variants causing a protracted pandemic, the challenge of maintaining adequate labour mobility in the EU would critically hinge on making cross-border transport safe (for travellers and destination countries) and affordable. In this respect and until the crisis is over, the EU should extend the coordinated approach to the restriction of free movement in response to the COVID-19 pandemic to some minimal rules for the screening and tracking of cross-border travellers. The introduction of a COVID-19 vaccine passport has been a positive development to help improving the safety in cross-border travel.

The possibility of travelling affordably across euro area countries is a determinant of the decision of workers to relocate. This also relies on preserving capacity in cross-border transport services, chief among them the air transport industry. Air carriers have already cut a significant share of their cross-border and domestic flights, and there is the risk that they will not be able to quickly scale-up capacity again if the pandemic persists for long. In this respect, the possibility of utilising ad-hoc EU resources for the support of this industry, for example by financing job retention schemes via SURE, should be considered.

To support labour mobility beyond the pandemic, policy and institutional settings should ease the recognition of professional and academic qualifications across jurisdictions. Despite the 2013 Professional Qualifications Directive, qualification, training and other requirements to access regulated professions vary widely across countries, and the recognition of qualifications is often made on a case-by-case basis. Automatic cross-border recognition of professional qualifications is limited to a few health professions. Extending automatic cross-border recognition of professional qualifications to other professions could be explored. Other ways of further streamlining the national recognition procedures and improving access to regulated professions at the national level should also be considered.

Europe's linguistic and cultural diversities are another factor dampening cross-border labour flows. The Commission proposal for an enhanced Erasmus+ program, offering resources for learning and training abroad to young individuals, is welcome as it should help labour mobility eventually. Different social security systems can also limit social protection for migrant workers or distort mobility incentives. Improvements in the portability of pension rights as well as the extension of the exportability of unemployment benefits, making the country of last employment responsible for paying cross-border workers' benefits, may contribute to ease EU-movers' concerns about their social rights (OECD, 2018a). Finally, the complete implementation of the Electronic Exchange of Social Security Information (EESSI) system, a secured digital platform linking EU social security institutions at all territorial levels, could go a long way in coordinating social security institutions by enabling quicker and more efficient calculations of mobile workers' social security benefits. Other tools (e.g., the portability of accrued pension benefits or even a common pension mechanism) might also favour labour mobility.

Box 3. Labour mobility versus brain drain

Persistent net outflows of workers may deplete the human capital endowment in the country of origin, ultimately causing affected economies to suffer from declines in potential output and reducing their capacity to recover from shocks. The human capital loss of labour mobility is larger when mobile workers leaving the country have higher educational attainment (a situation often referred as "brain drain"). The concrete impact of such mobility on the involved economies is, however, difficult to assess (Bonin et al. 2020). In 2019, 34% of EU movers had a tertiary level of education. An estimated 1.8% of the population in the eastern member states that joined the EU in 2004 moved to the EU-15 between 2004 and 2009, rising to 4.1% for Bulgaria and Romania between 2007 and 2009 (Fic et al., 2011; European Commission, 2019) even if return mobility has increased in recent years and the COVID-19 pandemic appears to be linked to a significant reversal in brain drain.

The EU cohesion policy provides a support for regional development and for reducing disparities in the level of development among regions. Moreover, EU policies on labour mobility may counteract brain drain by supporting countries suffering sustained and prolonged losses of human capital due to mobility outflows. This could take place, for example, through the development of targeted mobility schemes, even in the context of the EURES – a platform that helps jobseekers to move abroad by finding a job in Europe – or *via* a fund supporting labour relocation of skilled workers to countries that underwent large and persistent net labour outflows. The exchange of good practices in the field, in the form of mutual learning and peer exchange, could also be envisaged, for instance through the ESF transnational cooperation platform and ESF+ transnational cooperation, once in place. Sending countries should prioritise policies aimed at fostering circular and return mobility, including through streamlined procedures for the validation of skills acquired abroad and the establishment of permanent links with diasporas.

Some EU countries supported initiatives to reverse brain drain. The success of these schemes also depends on the overall national and regional development prospects. Greece launched "Rebrain Greece", a program that offers workers between 28 and 40 years old a job with an attractive compensation if they return to Greece and "bring with them the knowhow gained abroad, innovations and fresh ideas." The Greek government has committed to covering 70% of these salaries, with companies contributing the other 30%. Portugal's Programa Regressar ("return programme") has offered returnees who sign a full-time work contract in Portugal a cash incentive, a 50% income tax reduction for five years, and a cover for relocation costs. In Italy the "rientro dei cervelli" ("return of the brains") programme was expanded in 2019. Italian nationals who relocate to Italy with a work contract and agree to stay there for at least two years can now get a 70% break on their income tax for up to 10 years. Provided non-discriminatory treatment between national and non-national EU citizens, the EU cohesion policy could consider targeted financial aids to national governments of countries that suffered brain drain for the financing of similar programmes. Indeed, for brain gain policies to be consistent with the fundamental principle of freedom of movement within the EU, they should be extended to attract educated citizens from all EU member states, instead of targeting only returning nationals.

Avoiding financial fragmentation during downturns

Completing the Banking Union is key to ensure improved resilience in European financial markets. The completion of the Banking Union should be approached in a holistic manner, covering all outstanding elements with the same level of ambition. Moreover, in the current juncture, European intermediaries need to be supported, in the face of a possible deterioration of credit quality in the aftermath of the pandemic. Reducing the reliance of European financial markets on banks is another priority to increase the resilience of credit provision to the real economy during downturns, avoiding that possible bank distress could develop in financial fragmentation. Despite some notable

efforts toward the deepening of the Capital Markets Union (CMU), the constitution of a truly European capital market still needs to develop along a number of priorities, most notably a stronger convergence in national frameworks, the development of securitisation and equity markets.

Increasing the resilience of European banks

A strong banking sector is at the core of smooth and balanced monetary policy transmission across euro area economies. This is a key determinant for cyclical convergence in a currency union. The levels of capitalisation and liquidity of euro area banks have increased significantly since the global financial crisis up to 2020 (Figure 10, Panel A). Yet, even before the COVID-19 pandemic, the European banking sector was challenged by low levels of profitability.

Looking ahead, European banks will face an increasingly challenging economic environment: after improvements in the quality of credit, the COVID-19 crisis could be accompanied by a significant rise in non-performing loans (NPLs). Initial estimates for a worst-case scenario suggested that up to EUR 1.4 trillion of NPLs could potentially arise as a consequence of the COVID-19 crisis, although the probability of this scenario seems to have reduced since 2020 (Enria, 2020). Ongoing stress tests carried out by the EBA and the ECB will likely provide more accurate figures over the coming months. Credit losses are expected to be particularly large on exposures to sectors more hit by the crisis, such as recreation, transportation and, to a lesser extent, wholesale and retail trade (Mojon et al., 2021).

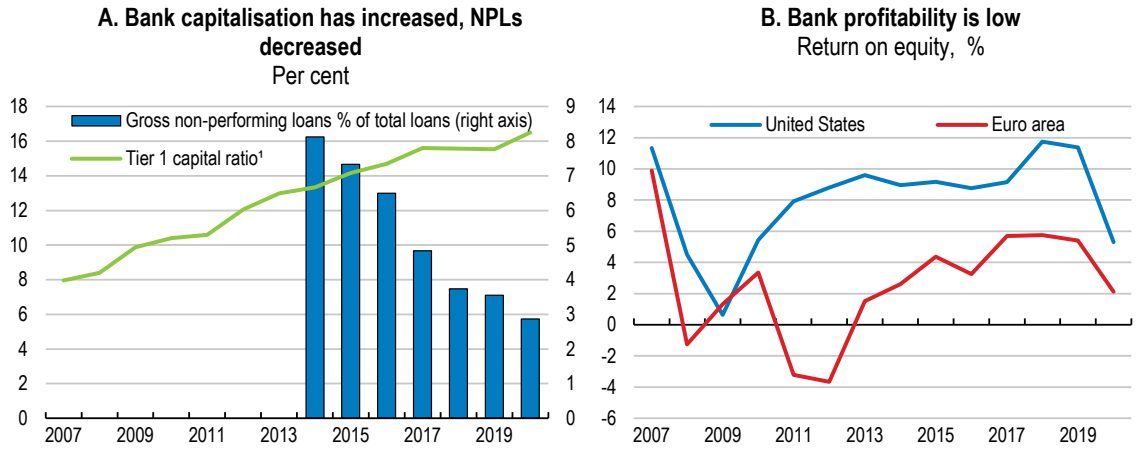
Euro area banks profitability has already deteriorated in 2020, on the account of expected credit losses booked since the beginning of the pandemic, in compliance with the newly introduced accounting standards for expected credit loss (Figure 10, Panel B). Given current low profit buffers, should a further deterioration of credit quality materialise – possibly considering the prospected termination of debt moratorium policies – an increase of provisions for credit losses (PCLs) could dent banks' capital ratios. Moreover, over the medium term, the possible phase-out of the crisis support measures, may coincide with the re-emergence of heightened sovereign credit risk tensions, putting further pressure on banks in more exposed countries. Against this background, European financial policy should focus on supporting intermediaries' efforts to achieve higher operational efficiency, on reducing bank NPLs, and on setting up mechanisms to weaken bank-sovereign credit risk linkages.

Supporting European banks

Low bank profitability could be a primary source of concern for financial stability in the current economic turmoil, as low profit margins will limit banks' ability to preserve capital in the face of prospected credit losses. While preserving a sound competition environment, the EU policy framework should aim at helping banks reducing NPLs and at providing incentives to improve their profit margins, including via consolidation.

The expected increase in NPLs could be a main factor limiting the ability of European banks to generate profit and possibly to extend credit in the coming years. The best way to tackle non-performing loans is acting early and decisively. Regulators and financial authorities should strengthen the European framework to deal with NPLs, framing it around three main pillars: designing better insolvency and loan foreclosure procedures, improving regulatory policies, and developing secondary markets for distressed assets.

Figure 10. Euro area banks are more capitalised but struggling with low profitability



Note: Euro area changing composition, Tier 1 capital ratio and gross non-performing loans and advances % of total gross loans and advances, of all domestic banking groups and stand-alone banks. Last observation 2020Q3.
Source: ECB statistical warehouse; and Federal Reserve Bank of St. Louis.

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Reforms to loan foreclosing procedures should aim at cutting the length of procedures, at facilitating the transfer of collateral to the creditor and at expediting the sale and the valuation of collaterals. The proposed EU Directive on credit servicers, credit purchasers and the recovery of collateral (2018/63) contains some welcome provisions in this direction. The Directive proposal aims at accelerating extrajudicial collateral enforcement to reduce the costs for resolving NPLs, and at facilitating the outsourcing of the servicing of the loan to specialised credit servicers, and at facilitating the sale of nonperforming assets to specialised credit purchasers. A prompt and full adoption of the Directive proposal is necessary.

Some provisions in the EU securitisation framework limited the role that this financial practice can play in reducing NPLs in banks' balance sheets. The previous framework based on the Securitisation Regulation (EU) (Regulation (EU) 2017/2402) and the Capital Requirements Regulation (Regulation (EU) 575/2013) contained obstacles for banks to securitise non-performing exposures (NPEs), such as high capital charges on NPE securitisation positions that tended to overstate the actual risk embedded in the portfolio. The recently adopted amendments to the framework (Regulation (EU) 2021/557 and 2021/558) have removed these impediments and are therefore welcome.

The development of secondary markets for distressed debt is an important precondition to support bank efforts to dispose NPLs. Initiatives to improve data standardisation and infrastructure on secondary markets for NPLs (such the EBA standardised templates for the screening, financial due diligence and valuation during NPL transactions, and the Communication of the Commission Tackling non-performing loans in the aftermath of the COVID-19 pandemic) are welcome and can help reduce the wedge between the average NPL coverage ratio (in Europe about 45% in 2019, which means that on average NPE is valued 55 cents on euro book value) and the market price (around 20 cents on euro). This bid-ask divide - the gap between the price at which banks are willing to sell NPLs and the price at which buyers are willing to purchase them - is a major factor blocking the development of secondary markets for NPLs. Some concerns about the necessity of streamlining the EBA NPL template should be taken into consideration to improve its effectiveness.

To speed up the process of offloading NPLs from bank balance sheets, the establishment of Asset Management Companies (AMCs) dedicated to purchase NPLs should be considered. AMCs have often been used to manage distressed assets arising from systemic financial sector stress (Cerruti and Neyens, 2016) and have a proven track record in making significant contributions to the clean-up of banking sectors suffering from NPL problems in some circumstances (Fell et. al, 2017; OECD, 2018a). AMCs are particularly suitable for the disposal of non-performing exposures linked to loans of relatively large unit sizes, or linked to commercial real estate (due to relatively high collateral quality). This latter category is a likely source of NPLs for banks in the current juncture, which makes AMCs potentially suitable to deal with part of the NPLs arising during the pandemic.

The establishment of single European asset management company (EAMC) dealing with specific categories of NPLs could be one option to consider, as smaller euro area countries could face difficulties in setting up domestic AMCs, since the establishment of such entities is complex and typically benefit from economies of scale. However, a EAMC, faces many hurdles, including the definition of its corporate governance, funding, the role of national governments, and to the presence of different insolvency and collateral enforcement frameworks across EU countries. Against this background, the establishment of national AMCs – possibly linked in a network – as encouraged by the European Commission's blueprint for national AMCs, could represent a more easily implementable option.

An AMC could be designed to purchase NPLs at market value against the issuance of bonds that could then be lodged by selling banks with the ECB as collateral for refinancing operations. The fund should ideally be backed by private investors including selling banks (as in the case of the Italian Recovery Fund, formally Atlante fund), to avoid conflict with the EU Bank Recovery and Resolution Directive that, under normal circumstances, allows the use of state aid to failing banks only if the bank is put in resolution, as a consequence. Selling intermediaries could be asked to invest in the fund proportionally to the stock of NPL that they plan to dispose via the AMC. Investing banks could therefore receive the difference between the average NPL coverage ratio (measuring the loan loss reserves set aside against the NPL accounted in bank balance-sheets) of sold NPEs and their market value in the form of shares of callable AMC capital. A private-sector backed AMC will not clash with state-aid rules even if purchasing NPLs above market prices, and it should be considered as a preferable option, in case of limited pockets of non-performing assets concentrated in few banks.

The possibility of a public participation in the capital of AMCs should be considered if needed in order to preserve financial stability (OECD, 2016). In normal times a government-backed AMC cannot buy NPLs above market prices without being considered as providing state aid and, as result, breaching the BRRD. However, this option should be considered to remedy a serious disturbance in the economy, should a large and widespread deterioration of bank asset quality arise in the aftermath of the pandemic result in a threat to financial stability. This, together with other relevant conditions, could contribute to its qualification as a precautionary measure (as per art. 32(4)(d) of the BRRD and State aid measures). A public participation should also protect depositors and taxpayer's money and ensure a coherent burden sharing, as enshrined in BRRD.

Well-designed consolidation can help address the issue of overcapacity in retail banking by streamlining overlapping distribution networks, especially in fragmented markets. The risk stemming from too-large-to-fail financial institutions weakened support for consolidation in the banking industry in the aftermath of the global financial crisis. Yet, larger banks are now subject to capital surcharges that account for the increased systemic risk they entail for the economic system reflecting their systemic risk, requirements to absorb losses and recapitalise the bank without taxpayer support in resolution, and regimes for the recovery and resolution of large banks (FSB, 2021). Larger banks could also be better placed to meet business challenges and regulatory requirements in the industry. For example, having easier access to the large Information and

Communication Technology (ICT) investment necessary for cost-light banking models, and being better able to absorb the fixed cost linked to the issuance of TLAC instruments or those eligible under MREL (Minimum Requirement for own funds and Eligible Liabilities) (Klaus and Sotomayor, 2018).

Supervisory requirements should facilitate bank consolidation, while maintaining a safe banking sector. In particular, financial supervisors should consider that recognising the accounting gain — known as negative goodwill, or "badwill" — that can be generated when a bank buys a rival for less than the book value from a prudential perspective can create relatively strong incentives for bank mergers. The goodwill is the difference between the purchase price and the net fair value of the assets minus the liabilities purchased in the acquisition. Banking regulation allows the badwill to be included in the CET1 of a bank, but supervisors can, on a case-by-case basis, reduce the recognition under the prudential rules. Most European banks are currently trading below their book value, creating the potential for badwill that can be used to boost capital ratios following aggregation. There is limited case, however, to support bank distribution of the windfall from the badwill for example via dividends or share buybacks. The welcome ECB guidelines on the supervisory approach to consolidation in the banking sector published in January 2021 follow these principles.

Introducing a common deposit insurance scheme

A common European deposit insurance scheme (EDIS) would represent an important safeguard for the architecture of the European banking system in the wake of a possible re-emergence of asymmetric sovereign credit risk shocks, notably when monetary policy will start normalising. The pooling of deposit protection across the euro area in a common European deposit insurance scheme fuelled fears in some countries that a common fund could lead to excessive bank risk-taking behaviour (so-called moral hazard). To limit the risk of banks' cross-subsidisation and minimise moral hazard the insured banks should pay to the EDIS ex-ante insurance premia that should be based on a common methodology reflecting bank's riskiness and the systemic risk that they generate for the EU banking system (OECD, 2018b; European Commission, 2015; Carmassi et. al., 2018; Acharya et al., 2010).

Proposed regulatory measures, such as "sovereign concentration charges", aim at discouraging banks to hold excessive amounts of domestic sovereign bonds since it could weaken the financial position of banks in case of a sovereign debt crisis (Véron, 2017). Credit risk spillovers between sovereigns and banks, were one of the aggravating factors of the 2011-2012 euro area sovereign debt crisis, although the strong commitment from the ECB to support monetary union helped abate the crisis and avoid its resurgence during the current pandemic crisis. However, a reduction of sovereign bonds held by domestic banks will in practice promote higher holdings of those bonds by foreign banks. In time of crisis, this may contribute to an increase in sovereign rollover risk, as the lending propensity of foreign investors tends to be more sensitive to credit risk reversals than that of domestic investors (BIS, 2018; Arslanalp and Tsuda, 2014; Ichiue and Shimizu, 2012; Gennaioli et al, 2018). To balance those conflicting risks, sovereign concentration charges could be limited to banks' mark-to-market portfolios, so as to exempt those longer-term investors that are a source of stability in sovereign debt markets. In any case, the possible introduction of sovereign concentration charges should be carefully assessed against the possible negative macroeconomic consequences they entail, in particular in times of crisis, and their possible phased-in only done very gradually.

Improving cross-border lending

Facilitating the operations of cross-border European banking groups could be an effective way to improve the resilience of the European banking sector. In addition to increased cross-border bank lending, it could also improve banking services to customers and contribute to addressing the fragmentation affecting European banks by promoting the establishment of more integrated groups. This should however not come at the detriment of national and European financial stability or depositor protection, and therefore be accompanied by appropriate safeguards, in particular in times of crisis.

The proposal to have cross-border capital waivers within the EU was not taken forward in the Capital Requirements Regulation II, because several member states feared it did not adequately address their concerns on national financial stability. This was a missed opportunity to reduce ring-fencing of European banking markets. National regulators can only choose to exempt subsidiaries of EU banking groups from some prudential ratios, such as liquidity requirements and large exposure limits, provided they are met at the group level. The Capital Requirements Regulation specifies that domestic supervisors can waive sub-consolidated liquidity requirements for subsidiaries of parent bank entities within the Banking Union (so-called “cross-border waivers”).

In practice, national supervisors can decide not to apply such waivers if they consider that financial outflows may affect the liquidity position of local intermediary. In the 2019 EBA Risk Assessment Survey, 35% of the banks identified complexity and regulatory requirements as two of the main obstacles for cross-border consolidation, and 30% of the banks considering regulatory requirement as an obstacle refer to national waivers not being exercised (EBA, 2019). The ring-fencing of domestic markets, which aims to safeguard financial stability, can complicate cross-border banking operations, affecting cross-border bank lending and discouraging the establishment of more integrated European groups.

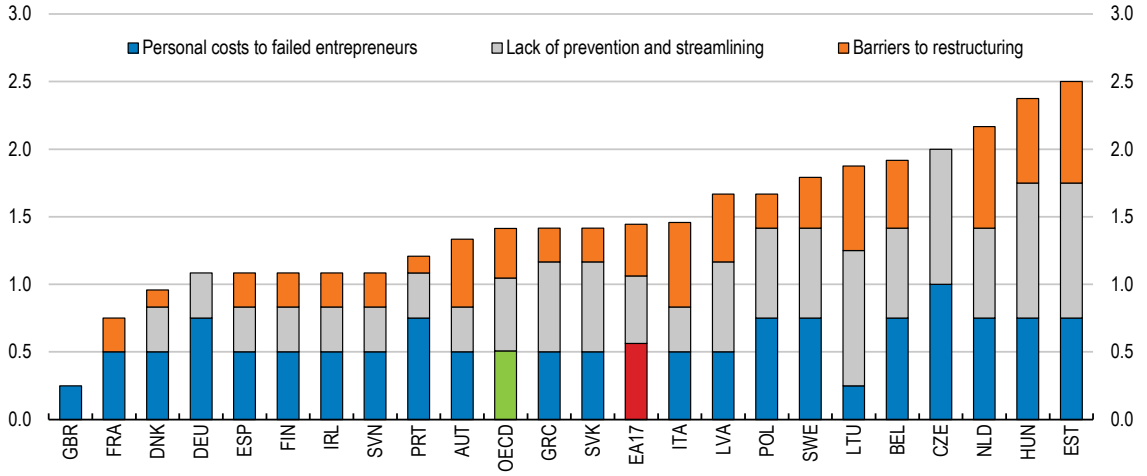
Further fostering convergence among national frameworks: insolvency regimes, regulation and oversight

Transparent and efficient insolvency frameworks are the backbone of cross-border capital market transactions and are necessary to improve cross border lending. In Europe, fragmentation in national insolvency regimes makes credit risk assessment difficult, including for NPLs’ valuation (Figure 11). The Commission has made welcome progress in facilitating debt recovery and harmonising insolvency proceedings across euro area members; the Recast Insolvency Regulation (Regulation (EU) No. 2015/848) provided valuable new rules regarding the law applicable to hybrid, pre-insolvency and secondary proceedings. Moreover, a new Directive (EU No. 2019/1023) entered into force in July 2019 with the objective of harmonising the laws and procedures of EU member states concerning preventive restructurings and the discharge of debt. These reforms are steps in the right direction, but further harmonisation efforts are necessary (OECD, 2018a; IMF, 2019; Deslandes et al., 2019).

Admittedly, a full harmonisation of national insolvency proceedings would be difficult to achieve, as insolvency regimes incorporate core specificities of national legal systems that cannot be easily levelled without reshaping a large part of national legal frameworks. Also, the EU has currently limited legislative competence in matters relating to many aspects that intertwine with bankruptcy law (such as corporate and labour laws). On the other hand, aiming at only a minimum harmonisation of the legal framework of restructuring may still be unsatisfactory, since the information costs of cross-border investments would still be significant.

Figure 11. Insolvency regimes vary significantly across European countries

Indicator increasing in the extent to which the insolvency regime delays the initiation and resolution of proceedings



Note: The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. Only countries for which data are available for the three sub-components in 2016 are included.
Source: Andrews, D., M. Adalet McGowan and V. Millot (2017), "Confronting the zombies: Policies for productivity revival", OECD Economic Policy Papers, No. 21, OECD Publishing, Paris.

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An alternative solution would be the introduction of a specific EU regime for corporate restructuring and insolvency to be applicable in specific cases. This pan-European insolvency regime could be envisaged as a parallel set of EU-wide regulations sitting alongside each of the national regimes and could include pan-European insolvency and bankruptcy rules that some companies could follow instead of their national laws. For example, their application could be imposed on larger companies issuing debt securities.

Ultimately, the creation of an EU regime for restructuring and insolvency would involve overcoming a number of hurdles, not least relating to the judicial treatment and national constitutional compatibility. This system could require the creation of specialised European bankruptcy Courts. These can be either full-fledged branches of European courts of first instance or spin-offs of national courts dedicated to the application of this regime. Non-legislative targeted approach could help to achieve further harmonisation. Easier access to information about national insolvency frameworks would be helpful for investors for example. Sharing best practices among member states and benchmarking exercises performed by the Commission may prove useful.

Bank insolvency regimes are also very different among the EU and could be further harmonised, benefiting the Banking Union and improving the predictability of insolvency outcomes through the Single Resolution Mechanism (Gelpern and Veron, 2019). The Bank Recovery and Resolution Directive (BRRD) currently does not fully substitute national bank insolvency proceedings, and it is only applicable where justified by public-interest considerations. Moreover, the insolvency process is seen by some as fairly cumbersome, potentially slow and permeated with political judgement that renders final outcomes hard to foresee – an undesirable characteristic for insolvency proceedings (IMF, 2018). In alternative, an EU administrative liquidation regime managed by resolution authorities could be considered, or a wider use of the harmonised resolution framework for banks that are failing or likely to fail.

For the European single market to function smoothly and efficiently, regulatory and supervisory practices between the competent authorities need to converge. A single supervisory mechanism

is in place for the supervision of credit institutions, but not for financial markets. Against this background, the presence of gaps in the regulatory landscape can present a risk to the development of a real level playing field in the financial services industry and represent a cost for market participants willing to operate across borders. One of the reasons of such regulatory fragmentation is that much of European financial legislation is in the form of Directives that need to be transposed into domestic legal systems, a procedure that often entails the addition of national specificities. This results in cross-jurisdictional differences in regulations and supervisory practices. One possibility to increase the convergence of the oversight of capital markets and thereby speed up the deepening of the capital markets union, is to increase the supervisory role of the European Securities and Markets Authority (ESMA). The CCP Supervisory Committee (CCPSC), established under the European Market Infrastructure Regulation (EMIR) as a permanent internal committee of European Securities and Markets Authority (ESMA), has already started its work in the supervision of a limited number of activities in European financial markets, such as central clearing counterparts (CCPs). The supervisory role of ESMA could be gradually extended to other areas and financial market activities.

Strengthening market-based finance

Reducing the reliance of European financial markets on banks is a priority to increase the resilience of financing to the real economy during downturns, avoiding that possible bank distress could develop in financial fragmentation. For different reasons, the COVID-19 crisis and Brexit, create new urgency for the issue. The current crisis has the potential of heightening the risk of financial fragmentation in the euro area, while Brexit will result in a substantial structural change to the EU's financial architecture, calling for increased liquidity and integration in European financial markets. If the precise overall impact of Brexit on the EU's future financial architecture is difficult to predict at this stage (ECB, 2020), changes in euro area financial markets are likely to take place in a number of activities still underdeveloped in the currency union, such as derivatives clearing, investment banking and securities and derivatives trading. Against this background, deepening the European Capital Markets Union (CMU) and the constitution of a truly pan-European capital market is key. The Commission has taken a number of steps in this direction, including measures in the CMU action plan. Yet progress is still needed - requiring substantial political backing by member states – in a number of areas. These include the development of equity markets and securitisation.

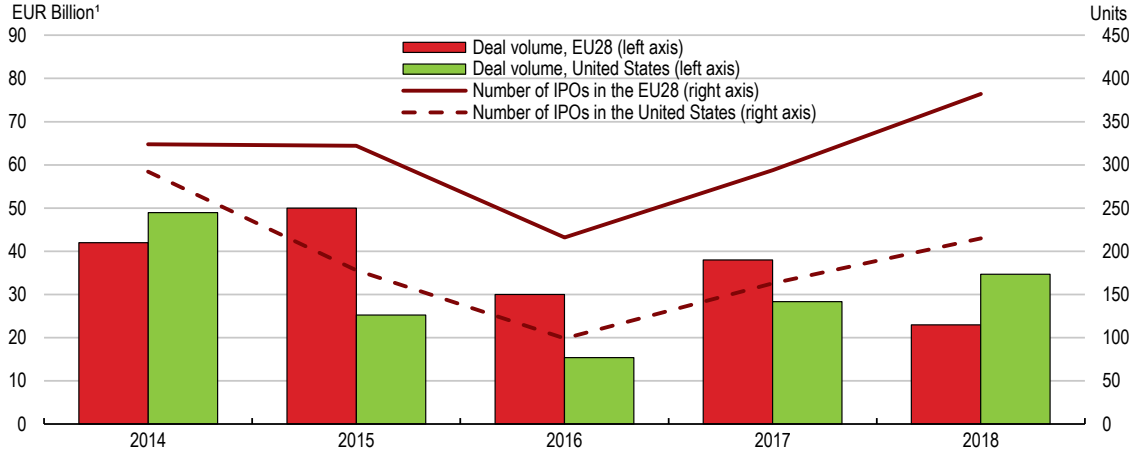
Developing equity financing

The development of equity markets is a priority for offering European firms a stable stream of funds as an alternative to debt finance, including via banks. The COVID-19 crisis has reinforced the importance that equity financing may have for firms, as stock market valuations recovered significantly after the initial shock linked to the pandemic, offering ample financing opportunities for listed companies willing to issue new shares. However, stock markets in Europe are sharply segmented along national lines, resulting in a wide dispersion of funding, limited liquidity, and overall insufficient mass. Along with an excessive fragmentation come higher costs for investors and limited depth. The proposal for the creation of a "consolidated tape" (CT) – an electronic system containing pre- and post-trade data (such as price and volumes) for equity instruments – is a welcome initiative, ensuring simpler access to and lowering the cost of market data. The European market CT will likely increase transparency and reduce overall transaction costs. However, its impact on pre-trade decision making for best execution (i.e., achieving the best possible result for customers when executing their orders via execution venues), especially in the corporate bond market often characterised by low liquidity, is less clear and it will crucially depend on the response of dealers and execution platforms.

The proposed establishment of a European single access point (ESAP) for companies' financial and sustainable investment-related information – the first action in the Commission's new action plan on the Capital Markets Union (CMU) – is a positive initiative to consolidate information on publicly traded companies, reducing fragmentation of information and search costs. The ESAP will particularly benefit the collection of comparable environmental, social and governance (ESG) data. However, non-financial reporting standards should be clearly identified prior to digitisation. This should include the ESG data relating to the Taxonomy Regulation and the Non-Financial Reporting Directive (NFRD), Sustainable Finance Disclosure Regulation (SFDR), and EU taxonomy.

Initial Public Offerings (IPOs) have been relatively buoyant in the EU (Figure 12). Yet, the market is still largely fragmented, and still relaying on non-EU players such as the London Stock Exchange (LSE) group accounting for about 40% of the total number of new share issuances (Constancio et al., 2019). The 2017 EU Regulation (EU 2017/1129) on prospectus regimes, aimed at simplifying and reducing costs for companies to access capital markets, introduced simplification and flexibility for all types of issuers. This regulation together with the introduction of "SME growth markets" – a new subcategory of multilateral trading facilities aimed at giving European SMEs much less onerous access to the public markets – and the recent Recovery Prospectus initiative, shortening prospectus requirements for share issuance in the wake of the COVID-19 crisis, are welcome developments. The Commission support for a SME IPO Fund is also positive. Public funding could act as an anchor investment to attract more private investors in high-growth, innovative SMEs at the stage of public listing.

Figure 12. The EU IPOs market has overtaken the one in the US in terms of deals, but volumes are declining



Note: EU-28 stock exchanges include, Athens, BME, Bucharest, Budapest, Bulgaria, CEESEG – Prague, CEESEG – Vienna, Deutsche Börse AG, Euronext (including Amsterdam, Brussels, Dublin, Paris, and Portugal), Ljubljana, LSE Group (including the London Stock Exchange and Borsa Italiana), Luxembourg, Malta, Nasdaq Nordics and Baltics (including Copenhagen, Helsinki, Iceland, Stockholm, Tallinn, Riga, and Vilnius), Warsaw, and Zagreb. US stock exchanges included are the Nasdaq-US and NYSE.
Source: Constancio, V., Lannoo, K., and Thomadakis, A. (2019). "Rebranding Capital Markets Union: A market finance action plan", CEPS-ECMI Task Force, June 2019.

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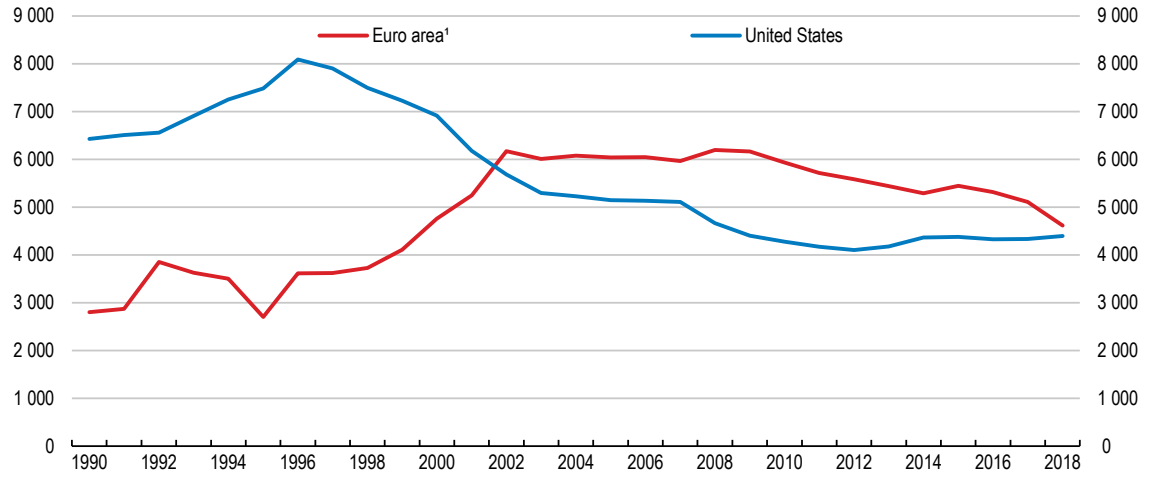
The challenge of developing equity finance in Europe is made more arduous by the current shrinking of public equity markets - where stocks are bought and sold through publicly - in most advanced economies (Figure 13). This is due to a number of factors including a shift toward private equity, reduced liquidity, and cost imbalances between the cost of equity and the cost of debt (favouring the latter) (for an overview in Europe, Oxera Consulting, 2020). Against this background, European policy makers should put more efforts toward reducing the bias in favour of debt rather than equity created by corporate taxation rules (Figure 14). Most European corporate tax systems

significantly favour debt over equity as a means of external financing, primarily through the deductibility of interest payments (ZEW, 2016; OECD, 2015). Moreover, dividends typically undergo double taxation, requiring corporates high dividend pay-outs to attract investors. Tax neutrality in corporate financing choices could be achieved by reducing the deductibility of interest payments. Most EU countries have already taken steps in this direction through the implementation of Action 4 of the OECD framework on BEPS (Base Erosion and Profit Shifting), that limits and links interest payments to profits earned.

Figure 13. The number of publicly listed companies declined in the euro area and in the U.S. over the last 20 years

Number of publicly listed companies



Note: Euro area member countries that area also members of the OECD, excluding Estonia, Finland, Lithuania and Slovenia for data limitations. Figures for Spain between 2004 and 2005 are interpolated.
Source: World Bank Development Indicators database.

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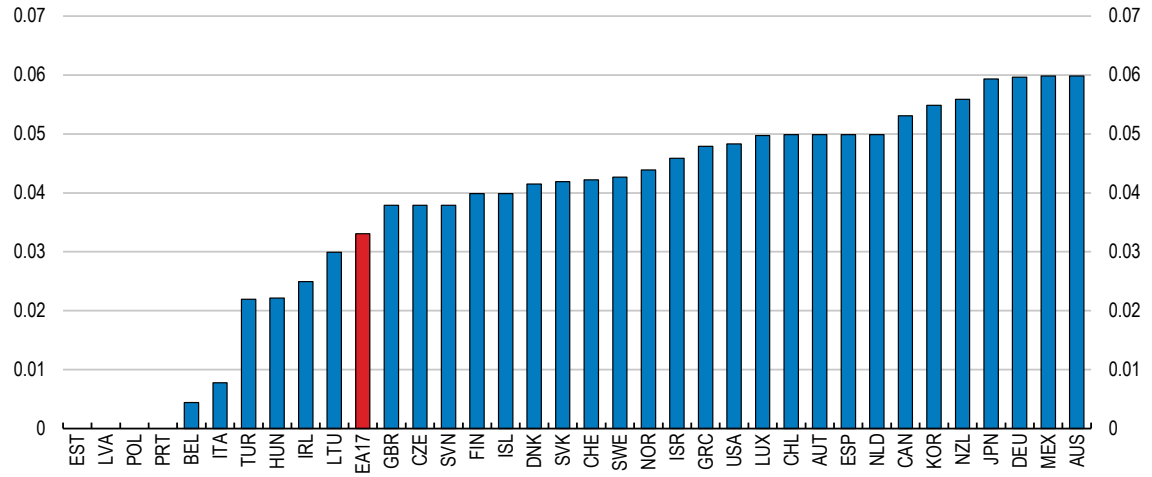
Figure 14. Corporate taxation favours debt over equity financing

Estimate of the debt-equity bias at the corporate level, percentage points, 2019



Source: OECD Corporate Tax Statistics.

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Alternatively, to avoid undesirable increases in the corporate effective average tax rate (EATR), an Allowance for Corporate Equity (ACE) should be considered (Box 4). The ACE has been in tax reform agendas since the 1980s, when its theoretical foundations were developed. Different models have been introduced during the past years by some euro area countries such as Austria, Belgium and Italy (Boadway and Bruce, 1984; Wenger, 1983; Klemm 2006). ACE can be interacted with adjustments to the capital income tax for individuals, to reduce dividend double taxation. The European Commission introduced ACE in the 2016 proposal for a common corporate tax base in the European Union (CCCTB).

Box 4. Allowance for corporate equity (ACE) in Europe

The characteristics and rationales of ACE schemes currently in place in euro area countries vary along a number of dimensions, including key factors such as the applied notional interest rate (approximating the return to debt); the equity base (covering the full amount of equity or only new equity – so-called "incremental' ACE schemes"); and the presence of anti-abuse provisions (preventing intra-firm cascading of multiple ACE deductions).

In Belgium the allowance for corporate equity allows all companies subject to corporate income tax to deduct a fictitious interest calculated on the basis of their shareholder's equity (net assets) from their taxable income. Small firms receive an additional 0.5% risk premium on their notional rate. This was initially capped at 6.5% and is now limited to 3%. Since 2018, the deduction no longer applies to the full equity stock. It includes anti-avoidance provisions to prevent the cascading of the tax benefit. The rate is based on the return on a Belgian 10-year state bond. In Portugal, the ACE scheme foresees a notional return deductible up to EUR 2 million and capped at 25% of a firm's EBITDA. It applies to capital increases for 5 years, provided capital is not reduced in that period. Prior to 2017, Portugal's allowance for corporate equity was limited to small- and medium-sized enterprises (SMEs). In Italy the allowance for corporate equity allows all companies not involved in insolvencies procedures and keeping standard accounting books to deduct a fictitious interest calculated on the basis of their shareholder's equity (net assets) from their taxable income. The deduction corresponds to the net increase in the "new equity" employed in the entity multiplied by a rate yearly determined annually (1.3% from 2019).

Source: Tax Policies in the European Union: 2020 Survey, European Commission staff work document SWD(2020) 14, January 2020, European Commission, Brussels.

Healthy equity markets require transparency to reduce information asymmetries between counterparts. This also relies on the availability of valuable market research. The requirement included in the MiFID II Directive to unbundle research costs from trading fees was aimed at increasing the transparency in the way equity market research was offered to investors, avoiding clients the burden of paying for unused research. If the Directive has clearly succeeded in increasing transparency in the procurement of market research for investors, some evidence suggests that it also might have had a negative impact on the overall availability of research, especially for small- and mid-cap firms, and that it produced a shrinking in market research infrastructure (CFA Institute, 2017). A decline in available market research should be considered as particularly worrisome for the future of equity markets, especially in the context of the ongoing shift toward passive investing strategies. The popularity of index mutual funds and exchange-traded funds (ETFs), which passively track existing stock indexes, has already grown substantially over recent years, also thanks to lower management fees that passive tracking allows, displacing higher-cost active investment styles.

Yet, there are reasons to believe that a non-discriminatory allocation of capital in equity markets may be suboptimal, damaging higher potential firms and promoting adverse selection effects. In fact, passive index tracking (as for the case of ETF and index funds) removes selective fund

allocation, which is an important feature of efficient capital markets. There is a risk that reduced supply of market research can accelerate the drive toward passive investing, increasing sorting costs for investors in equity markets. Considering the above, the amendment the research of the unbundling rule contained in the MiFID II Directive to allow banks and financial firms to bundle research and execution costs when it comes to research on small and mid-cap issuers contained in the recent Capital Markets Recovery Package is a welcome decision. Whether this targeted amendment of the MiFID II will succeed in increasing the provision of market research will depend on the way the industry will react to the policy change. Looking ahead, the complete removal of the unbundling rule should be considered.

Increasing European cross-border equity capital mobility and holdings is an important objective of the CMU and a key factor to avoid fragmentation of domestic financial markets, notably in the euro area. Increased cross-border equity flows and positions would allow for transnational private risk sharing and – no less important – would establish the ground for a wider pan-European ownership structure in European companies. This may represent an important driver for the development of a solid European corporate culture in larger EU firms to the benefit of the common market. In fact, the development of European companies is often hampered by an excessive national focus which blocks them from reaping the full potential of the Single Market. When they expand in other European markets, firms with strong single national ownership sometimes fail to develop an international corporate culture that is often key for succeeding cross-border. From this standpoint, the introduction of a European prospectus passporting, allowing issuers to offer or admit their securities to trading in any Member State without multiple approvals is a valuable provision.

Strengthening securitisation

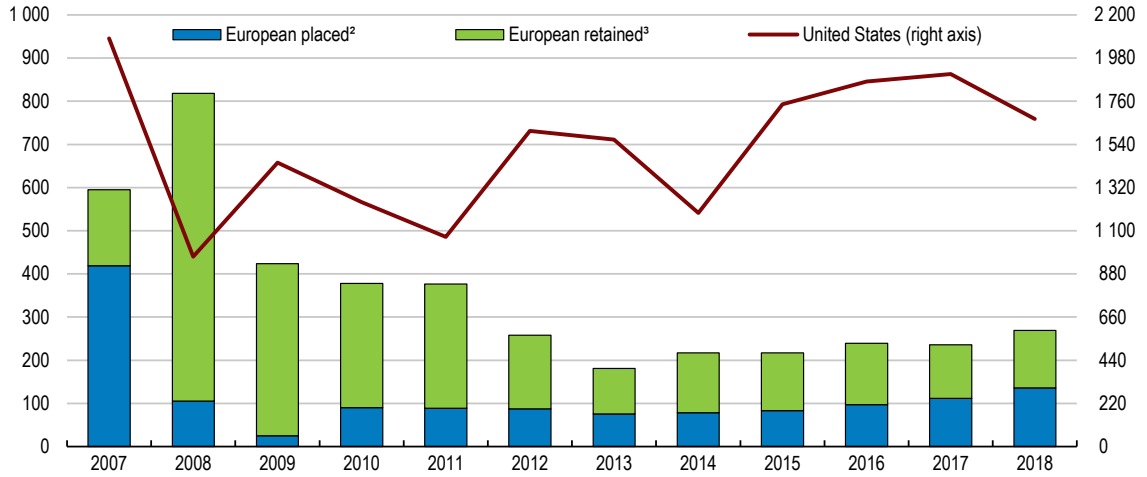
One way of increasing financing opportunities for firms and reducing the reliance on bank credit is to revive the European securitisation market. Securitisation can also support bank credit by freeing up capital for new lending and by helping banks disposing of NPLs. In 2018 securitisation issuance volumes in the EU were the highest recorded since 2013, at EUR 269 billion. Still this figure is far below pre-crisis levels (Figure 15). In contrast, the U.S. securitisation market is much larger and has almost recovered to pre-GFC levels, albeit with a different asset mix.

The EU approach to revive securitisation has been to develop some European basic rules for a safer securitisation. The Regulation (EU) 2017/2402, sets a number of provisions for Securitisation Special Entities (SSPEs) and provides criteria and common rules for so called simple, Standardised and Transparent Securitisation (STS) in the EU. These are positive development.

The development of covered bond-like structures backed by SME loans, such as the European Secured Notes (ESNs), can complement efforts to open up new financing sources for SMEs as an alternative to bank credit. The ESNs are dual recourse instruments (the investor has recourse against the issuer and the collateral), similar to covered bonds but arguably riskier, that can provide a useful additional source of funding, especially for small institutions that do not have access to the securitisation market or have difficulty issuing unsecured long-term debt. The function of ESNs as financing instruments for SMEs partially overlaps with the one obtainable with securitisation. However, ESNs do not relieve banks from credit obligations as in the case of securitisation, which links the quality of ESNs to the overall credit worthiness of the banking sector. Challenges with the development of the ESNs concern possible lack of market interest and the definition of the parameters of the product in the context of generally high and heterogeneous default rates for SME loans.

Figure 15. Securitisation in Europe has not recovered since the global financial crisis

European and US issuance[1], EUR billions



Note: 1. European volumes include transactions from all countries in the European continent, including, Iceland, Kazakhstan, Russia and Turkey. European volumes include CLOs and CDOs denominated in all European currencies. Volumes have been subject to periodical revision according to the available updated information. 2. Placed issuance refers to issuance sold to investors. 3. Retained issuance refers to securities retained by the originators. A high retention ratio may suggest lack of demand.
Source: Association for Financial Markets in Europe (2019), AFME 2019-Q2 Securitisation Data Report.

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Establishing a fiscal framework for cross-country business cycle stabilisation

A common fiscal capacity is one of the main tools for business cycle stabilisation and cyclical convergence in a currency union, and it remains a missing feature of the euro area. While the euro area is currently built on a model of limited fiscal integration, a common fiscal stabilisation capacity would provide resources to reduce divergence in business cycle fluctuations across its members, complementing the capacity of euro area member states to conduct counter-cyclical fiscal policy. The necessity for such a tool has increased in the wake of the COVID-19 crisis, which had a large and asymmetric economic impact across euro area economies. Building on the European responses to the pandemic crisis, a debate over the creation of a common euro area fiscal stabilisation capacity should be restarted.

The COVID-19 crisis created some momentum toward deeper fiscal integration in the EU. In support of countries more strongly hit by the epidemics, EU member states have agreed on a number of new financing measures that represented a significant step toward a stronger framework of cross-country fiscal support in response to the COVID-19 crisis. The measures adopted comprise some new temporary lending tools – such as the Support to mitigate Unemployment Risks in an Emergency (SURE) – and a larger recovery plan (Next Generation EU) linked to the next multiannual EU budget 2021-27. These measures can have an impact in reducing growth divergence in the aftermath of the current crisis. However, they are meant to be temporary only.

Many proposals have been made in the past to provide euro area countries with a permanent fiscal capacity (for a review Benassy-Quéré and Weder di Mauro, 2020). The previous OECD Survey (OECD, 2018a) proposed a European unemployment re-insurance scheme that would be complementary to other possible national schemes, providing short-term non-discretionary transfers. Unemployment is critically affected during business cycles and an unemployment insurance scheme works as an automatic stabiliser (Beblavý et al., 2015). Several studies indicate

that an unemployment reinsurance scheme could play a significant role in smoothing activity of euro area countries in case of large shocks (Carnot et al., 2017; Claveres and Strasky, 2018; Arnold et al., 2018; Box 5). Simulations indicate that an unemployment reinsurance fund would need a borrowing capacity of about 2.5% of euro area GDP to function adequately. Against this background, the euro area should consider equipping itself with a central stabilisation capacity, for example in the form of an unemployment reinsurance scheme.

Cross-country fiscal stabilisation is not only linked to the expenditure side. In currency unions, income taxes collected at a centralised level contribute to stabilisation against shocks (Nikolov and Pasimeni, 2019). Although controversial in some member states, increasing the taxation capacity of the EU may represent an alternative route for the establishment of cross-border fiscal stabilisation in the euro area under the condition that EU funds are spent in a way that supports fiscal stabilisation. As tax receipts tend to fluctuate with the economic cycle, countries in expansion can contribute more to the EU budget with respect to countries in recessions. To increase efficacy, a preference should be given to taxes showing larger tax revenue elasticity to cycle fluctuations. Increasing the tax capacity of the EU can also strengthen its ability to borrow in financial markets, allowing the EU to compensate for the loss of fiscal revenue in downturns, without cutting spending to avoid running a deficit.

In November 2020, EU institutions agreed on a roadmap towards the introduction of new own resources. As a first step, the digital levy, the carbon border adjustment mechanism and the Emissions Trading System own resource will be proposed with a view to their introduction in 2023. As a second step, a proposal of additional new own resources, which could include a Financial Transaction Tax and a financial contribution linked to the corporate sector or a new common corporate tax base, would be studied. The institutions furthermore agreed that the new own resources should be sufficient to cover an amount corresponding to the expected expenditure related to the repayment under Next Generation EU. The own resources arrangements should be guided by the overall objectives of simplicity, transparency and equity, including fair burden-sharing.

Finally, some revenue-based fiscal stabilisation can also be obtained by adjusting national GNI-based contributions to the EU budget on the basis of one or more indicators of the cyclical position of the contributing economy. Such contributions, for example, could be partially based on GNI growth in previous years.

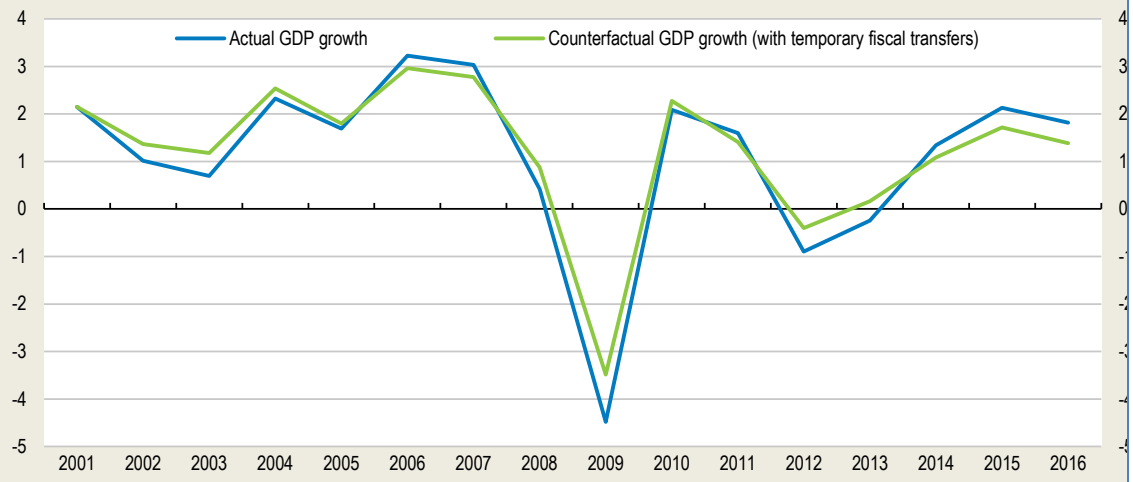
Box 5. The stabilisation effect of a common employment insurance scheme

Claveres and Stráský (2018) provide evidence of the macroeconomic stabilisation properties of a European unemployment re-insurance scheme. This scheme is designed to release payments on the basis of a rise in the unemployment rate in comparison to the previous year and to the 10-years moving average. As pay-outs only take place in the presence of large shocks, small fluctuations in the unemployment rate that likely reflect differences in national labour market institutions are not taken into account. Moreover, the support is not maintained when the unemployment rate settles down at a higher level, thus not weakening incentives for the country to undertake structural reforms. This job retention schemes) and only in the form of transfers (SURE is based on loans).

Simulations suggest that a European unemployment re-insurance scheme could have reduced the standard deviation of euro area GDP growth by 0.4% during the financial crisis (Figure 16). In doing so, the scheme would have mobilised average annual contributions of participating countries of around 0.2% of their national GDP, over 2000-16 while avoiding permanent transfers. Also, most euro area countries would have benefited from the scheme at some point. These results are comparable to other studies in the literature with slightly modified assumptions regarding the conditions for payouts and contributions (Carnot at al., 2017; Beblavý et al., 2017).

Figure 16. Unemployment benefits re-insurance scheme help smoothing economic shocks

Euro area real GDP growth



Source: Claveres and Stráský (2018) based on OECD (2018), OECD Economic Outlook: Statistics and Projections (database).

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FINDINGS (main in bold)	RECOMMENDATIONS (key in bold)
Establishing a framework for cross-country business cycle stabilisation	
One missing feature of the euro area is a common fiscal capacity which would help to reduce diverging business cycles.	**Consider setting up a common fiscal stabilisation capacity, for example, through an unemployment benefits re-insurance scheme for the euro area.**
Making labour markets more resilient to the economic cycle	
Countries that favour within-firm work flexibility in case of economic shocks and have a good training system for the unemployed often had smaller and shorter increases in unemployment.	**Encourage member states to reinforce job retention schemes to be used in case of a temporary economic shock, together with training.** **To favour job reallocation in case of durable shock, encourage member states to enhance activation policies, including for workers under job retention scheme.**
Cross-border labour mobility helps the functioning of the EU single market through better matching between workers and job offers across countries, and reducing persistent wedges in labour markets.	**Extend cross-border recognition of professional qualifications. Complete the implementation of the Electronic Exchange of Social Security Information.**
Persistent net outflows of high-skilled workers ("brain drain") may deplete the human capital endowment in the country or region of origin.	Promote the exchange of good practices to favour return mobility, for instance through the European Social Fund Plus (ESF+) including its transnational cooperation framework. In countries suffering brain drain, extend brain gain policies to attract EU skilled workers regardless of their nationality.
Improving the functioning and resilience of the common European financial market	
As a consequence of the COVID-19 crisis, euro area banks are expected to face a new wave of non-performing loans (NPLs).	**To facilitate the disposal of bank NPLs:** **i) approve ongoing reforms on foreclosing procedures;** **ii) improve data standardisation on secondary markets (for example *via* NPL standardised templates);** **iii) consider the establishment of a network of asset management companies (AMCs).**
The European banking system is not yet fully integrated. Deposits in euro area banks are vulnerable to shocks in individual countries, and discussions are ongoing in the High Level Working Group on a European deposit Insurance Scheme (HLWG on EDIS).	**Complete the Banking Union by addressing all outstanding issues in a holistic manner.**
Fragmentation in supervision and oversight, and inconsistencies among national insolvency frameworks are obstacles to the functioning of the single market for capital and for the completion of the Capital Markets Union.	Consider increasing in due time the supervisory role of the European Securities and Markets Authority (ESMA). Step up convergence in insolvency regimes or explore frameworks for a pan-European corporate insolvency regime.

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