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Economic storms

Weathering the credit crunch

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Editorial

Marco Buti

Welcome to this edition of *European Economy News* and a Happy New Year to all our readers. Unfortunately, the current financial crisis will make 2009 a time of uncertainty as the EU Member States battle with the consequences of the 'credit crunch' in financial markets which are feeding through into the real economy of jobs, spending power and daily life.

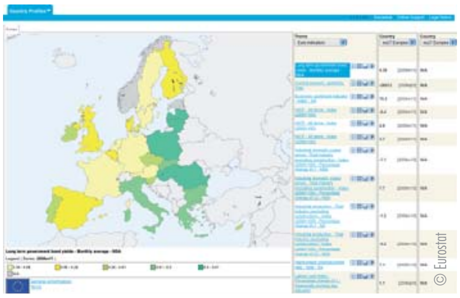
Articles in this issue describe how the crisis developed, the policy responses, and the recovery plan proposed by the European Commission in October 2008, fleshed out in detail on 26 November, and adopted by the European Council on 12 December. The recovery plan provides a coherent framework for a coordinated response worth 1.5% of GDP and EUR 200 billion. While proposing much-needed immediate action to shore up Europe's struggling economies, it is based on the understanding that short-term measures should not damage the long-term sustainability of public finances. The Stability and Growth Pact provides all the flexibility needed for the measures proposed under the recovery plan to be implemented and thus remains the cornerstone of the EU's budgetary framework. Furthermore, as a 'tool kit' rather than a prescriptive list, the recovery plan allows Member States the flexibility to take those measures most appropriate to their particular situations and financial positions in a coordinated manner. As well as these macroeconomic considerations it presents a raft of possible measures aimed directly at the real economy, for example by bringing forward Structural Fund spending to support employment, and investing more in infrastructure and human capital.

In the midst of these gloomy economic conditions the new year brings two noteworthy events: 1 January 2009 marked both the euro area's 10th anniversary and its third expansion in as many years with Slovakia becoming the sixteenth member. These milestones come as a reminder of what EMU has achieved and the euro's continued appeal beyond its borders – not least because of its protective effect in just such difficult times as we are now experiencing.

Marco Buti

Director-General, Economic and Financial Affairs DG

What's new



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Statistics at a glance

For those who despair at long tables and spreadsheets of EU statistical data, Eurostat has provided a welcome upgrade – a new Country Profile interface. Rather than searching through columns and rows, the reader can now find statistical information presented in an easy-to-read map format. The interface maps statistical data for the EU Member States for a range of thematic groups of indicators, for example, agriculture, demographics, education and, of course, economy and finance. More limited data on candidate and EFTA countries is included. The new Country Profile Interface can be consulted in the 'country profiles' section on the Eurostat website.

A one-stop shop for the financial crisis

DG ECFIN has created an on-line collection of Communications, press releases, press packs and documents relevant to the ongoing economic crisis. Arranged chronologically, the collection is focused on international and EU-level policy responses to the developing crisis and the actions proposed by the EU institutions. It forms a useful resource for the informed general public, economists and the press on the concerted measures taken by national governments, the ECB and the European Commission to restore confidence and sustainability to financial markets. The link to the on-line collection, 'the financial market crisis: facts and policies', can be found on the DG ECFIN website.

Appointment of new Director-General for ECFIN

On 4 December, Marco Buti was appointed Director-General of DG ECFIN. A trained economist with degrees from Florence and Oxford, Mr Buti – an Italian national – has spent much of his career within the DG, most recently as Deputy Director-General and Director responsible for the economies of the Member States. He has been visiting professor at the Université Libre de Bruxelles, the University of Florence and at the European University Institute, and has published extensively on EMU, macroeconomic policies, welfare state reforms, and unemployment in Europe.

'Major opportunities in demographic change'

Speaking at the 2nd Demography Forum, on better societies for families and older people, Commissioner Joaquín Almunia described ageing as one of the greatest forces that will reshape economies and societies in the 21st century. On current policies the impact of ageing will halve the average economic growth rate, he said, leading to falling employment levels and increased pressures on public spending on pensions and healthcare. This means that substantial modernisation of economic and social models is called for which should change the way we perceive the process of growing old as well as ensuring the sustainability of public finances today. "But I am optimistic," he concluded. "We can prepare for demographic change even in today's difficult economic climate." See the Commissioner's website for the full speech.

President Barroso and Commissioner Almunia

"Powerful, systematic and also pragmatic"

This is how Commission President José Manuel Barroso described the European Economic Recovery Plan – proposed by the Commission on 26 November 2008. He also underlined that exceptional times call for exceptional measures. The plan realises the particular strength of the EU, its ability to help partners work together while avoiding one-size-fits-all solutions, he said. Pointing to the different 'macroeconomic starting positions' in the Member States, he stressed the need for flexibility, "everyone is suffering from this crisis and everyone needs treatment. But not everyone needs the same kind of treatment." The plan calls for an EU-wide fiscal stimulus amounting to €200 billion that involves relieving short-term pain while taking longer-term measures to cure problems at source. The press speech and the Communication can be found on President Barroso's webpage.

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Darkening horizons

The Commission's autumn economic forecasts predict growth coming close to a standstill in the EU and the euro area in 2008-2010. And while the financial crisis is buffeting EU economies, the situation is being aggravated by housing-market corrections and fading external demand. The situation remains precarious, say the forecasters. In the real economy this means that job creation, which lifted employment by 6 million in 2007-2008, will increase only marginally over the forecast period. And unemployment is expected to rise by 1% from its lowest level in more than a decade. "We need coordinated action at the EU level to support the economy similar to what we have done for the financial sector," said Commissioner Joaquín Almunia, calling for a joint approach to boost investment and sustain employment. DG ECFIN's economic forecasts for the EU and the Member States can be found in the 'EU economic situation' section of the DG ECFIN website.

'Protracted recession' warns OECD

"In normal times, monetary rather than fiscal policy would be the instrument of choice for macroeconomic stabilisation – but these are not normal times," said the OECD Chief Economist Klaus Schmidt-Hebbel at the press launch of the latest economic outlook from the OECD. With most OECD economies in, or on the verge of, a protracted recession of a magnitude not seen since the 1980s, Schmidt-Hebbel warned governments to be ready to modify their stabilisation efforts in the light of events. "The global scale of the

financial crisis underscores more than before the necessity for international cooperation to avoid measures that distort competition of effectively shift the problem to other countries". The latest Economic Outlook can be downloaded from the OECD website.

Nicolas Sarkozy, French President, President of the European Council

Stimulating measures

The European Council meeting under the French Presidency on 11-12 December supported the need for a strong economic stimulus in response to the financial crisis and approved the Commission's recovery plan. The current crisis is a global crisis which demands a coordinated international response said EU leaders, who asked the Council and the Commission to bring forward proposals to facilitate a coordinated economic recovery in preparation for the next G20 summit in April 2009. The Council also supported measures for jobs and businesses in the real economy, such as EIB support to SMEs. The Council conclusions can be found on the French Presidency website.
www.ue2008.fr

A climate of ambition

On 11-12 December EU leaders agreed on an ambitious energy/climate package – the "20-20-20" plan to reduce greenhouse gas emissions by 20%, increase the proportion of renewable energies to 20 % and make energy savings of 20% – by 2020. The package covers an emissions trading scheme, a fair distribution of effort between countries, promotion of renewable energies and CO_2 capture and storage in the period from 2013 to 2020. In addition, the European Council agreed on some derogations for the new Member States and industries judged to be particularly at risk. On this basis, the legislative package was subsequently finalised by the Parliament. For more information see the Commission's 'climate action' website.
www.ec.europa.eu/climateaction

Ten years of EMU: more needs to be done says EP

MEPs set out their views on how economic and monetary union could be developed in the years to come in a new report adopted on 18 November 2008. The report stresses the need to stick to the SGP while fully using the permitted flexibility during the downturn. It also endorses the independence of the ECB and a single seat for the EU in international institutions such as the G8. The report insists on strict adherence to the terms of the Maastricht criteria and an even-handed approach for future enlargements of the euro area. MEPs also propose the 'Europeanisation' of EU financial supervision and financial market transparency to avoid future crises. The report can be accessed via the press service page on the European Parliament website.
www.europarl.europa.eu

End-of-year report: the QREA

The December issue of the Quarterly Report on the Euro Area reviews recent economic developments with a special emphasis on the impact of the financial turmoil. It assesses the magnitude of the associated rises in households' and corporations' financing, analyses the possible impact of changes in bank loan supply on real activity, and discusses the impact of financing constraints on business investment. The report also provides an analysis of fiscal windfalls. Its focus section presents the LAF (Lisbon methodology working group (LIME) assessment framework) methodology that helps to determine reform priorities in the context of the Lisbon Agenda.

Quality of public finances workshop

On 28 November, a workshop was organised by ECFIN on the links between fiscal policy and long-term economic growth. It discussed how a better quality of public finances can help Europe's economies cope with the dual challenge of ageing populations and globalisation. Specific policy responses advocated included growth-supportive, non-distortionary tax systems, sound fiscal governance, and efficient and effective public spending and investment. The papers presented at the workshop will be published in DG ECFIN's Occasional Paper series.

Country seminar on Hungary

On 3 December, DG ECFIN organised a seminar in Brussels on 'Hungary's Economic Policy Challenges: From Crisis Management to Sustainability'. Hungary is now at an important and critical juncture in economic policy-making. With disappointing GDP growth and one of the EU's highest budget deficits, despite significant adjustment and reform efforts, Hungary has been hit hard by the financial crisis. As well as looking at contributory factors and responses to the crisis, the seminar focused more particularly on medium- and long-term developments and challenges – notably, how to raise Hungary's growth potential.

Further information
The latest news and press releases from DG ECFIN are available at:
http://ec.europa.eu/economy_finance/index_en.htm

From crisis to recovery: the tools for the job

As the financial crisis infects the economy at large, the EU has unveiled its economic action plan to give the European economy a much-needed boost. This is the latest in a series of robust coordinated measures to stave off a deepening recession and to turn crisis into opportunity with key reforms of the European and global financial sectors.

© Yury Porozhdenko

It is said that a day is a long time in politics – in financial markets, it can seem like an eternity. Certainly, the global financial system has witnessed quite a few of those days in recent months. And what started off euphemistically – and optimistically – being referred to as a "credit crunch" soon developed into a full-scale financial crisis which is now slowly spreading its tentacles into the wider, or so-called 'real', economy.

Although trouble had been brewing for some time, and certain economists had been warning of difficulties ahead for the last few years, the generally accepted starting point of the current woes was the US bank liquidity crisis which began in the summer of 2007 due to a large number of defaults on so-called sub-prime mortgages – a once-obscure term that has now become a household name. Pretty soon, this credit crunch in the United States was beginning to cause concern around the world.

Some large European banks were exposed to the sub-prime crisis in the United States, putting a squeeze on liquidity in Europe, too. As a number of financial institutions on both sides of the Atlantic began to falter – the first sign of trouble being the nationalisation of the Northern Rock bank in the UK in February 2008 – this led to jitters on stock markets around the world. Given how closely intertwined and integrated global financial markets have become, when America sneezed, the whole world eventually caught a cold. "The EU is an important part of the global system and so we were bound to suffer sooner or later," explains Sean Berrigan, head of the Financial Sector Analysis Unit at DG ECFIN.

Summer of uncertainty

By the summer of 2008, things were beginning to look much more precarious. On the verge of collapse, America's two main mortgage guarantors, the colourfully named Fannie Mae and Freddie Mac, were placed under government conservatorship in September. The following week came the spectacular and shocking bankruptcy of Lehman Brothers, one of the USA's biggest investment banks. "Lehman Brothers completed the uncertainty because it had previously been viewed as a bank that was too big to fail," notes Berrigan. "This really shook market confidence badly." In the immediate aftermath, stock exchanges around the world took a battering.

By the end of September, the contagion had reached Europe, with the British mortgage lender Bradford & Bingley, the Benelux banking group Fortis, and Glitnir, Iceland's third largest lender, the first to drift into dire straits. Again, stock markets in Europe and the United States fell dramatically, with the Dow Jones suffering its steepest drop in history on 29 September, following the rejection of a bail-out plan by the House of Representatives. Ever since, markets have been fluctuating wildly.

Rising to the extraordinary challenge

With potential meltdown looming and the United States in deadlock over how to proceed, individual Member States and the EU rapidly and decisively roused into action, setting the pace and tone for the global response, which focused on injecting capital and confidence back into the markets. "From the outset, Europe has taken decisive action to manage this crisis," remarked Economic and Monetary Affairs Commissioner Joaquín Almunia, speaking at the 2nd Brussels International Economic Forum on 11 November 2008. "Governments, the Commission and the European Central Bank (ECB) have been working closely together to contain the turmoil, protect savings and maintain a flow for credit for businesses and households."

The first step involved boosting the liquidity of financial markets. Ever since the sub-prime crisis broke out, the ECB had been injecting a stream of capital into the markets – including tens of billions of euros in money-market auctions – and adjusting interest rates to calm investors and optimise conditions. With several European banks teetering on the edge, efforts were stepped up.

At the end of September, several rescue plans were launched to save a number of leading financial institutions through partial nationalisation and other measures. Belgium, the Netherlands and Luxembourg saved Fortis bank with an €11.2 billion investment; Iceland nationalised Glitnir, and France, Belgium and Luxembourg pumped €9 billion into Dexia bank. In early October, the British government announced that it would make GBP25 billion (€30 billion) in preference share capital available to a number of banks and financial institutions, while the Icelandic government took control of Landsbanki.

"If Europe acts decisively to implement this recovery plan, we can get back on a path of sustainable growth and pay back short-term government borrowing."

Commission President José Manuel Barroso

Commissioner Almunia delivers a speech on 'the financial market crisis – causes and counter measures' at the Bavarian Representation to the EU

Unprecedented coordination

Pretty soon, the word 'billion' was starting to lose its lustre and 'trillion' was entering the general lexicon at an alarming rate. But the disheartening speed of the emerging crisis was somewhat matched by the heartening level of the coordinated response to stave it off – here, the Commission, including DG ECFIN, played an important behind-the-scenes role. "The Commission has helped to monitor the situation, design responses and mediate between Member States," notes Berrigan.

In early October, in an audacious bid to avert a possible fear-induced banking collapse through the mass migration of depositors, EU leaders agreed to guarantee deposits of up to €50 000, while several Member States went a step further, pushing the figure up to €100 000. On 2 December the ECOFIN Council decided to apply this guarantee from 1 July 2008, subject to approval by the European Parliament.

On 16 October, all 27 Member States agreed an ambitious rescue package, worth up to €1 trillion, to shore up the beleaguered banking sector. "The October agreement… was an unprecedented act of coordination, allowing us to synchronise national responses within a common European framework," emphasised Joaquín Almunia.

Turning crisis into recovery

By the end of October, the Commission had hammered out a framework for recovery entitled 'From financial crisis to recovery'. "The EU should build on this success [in dealing with the financial crisis so far] and decide to tackle the next stages of the crisis in a united, coordinated manner, turning these challenges into opportunities; adding selected short-term measures to the Lisbon Strategy for growth and jobs," the Communication urged.

The proposal set out a three-pronged approach: redesigning the EU's financial market architecture, dealing with the fall-out from the financial crisis on the real economy, and putting the EU at the forefront of the global response to the financial crisis. Regarding the financial crisis, it recommends the rapid and consistent implementation of national bank-rescue plans and decisive measures to limit the spread of the crisis between Member States.

An example of this 'containment' policy was the €6.5 billion the EU pledged in financial assistance to troubled Hungary.

The document also calls for the restructuring of the European banking sector in order to avoid similar crises in the future. It points out that Member States, in collaboration with the Commission, need to redefine the European financial sector's regulatory and supervisory model, particularly for the large cross-border financial institutions. Currently, oversight bodies are national and this has severe limitations when dealing with cross-border organisations.

Kick-starting a stalling economy

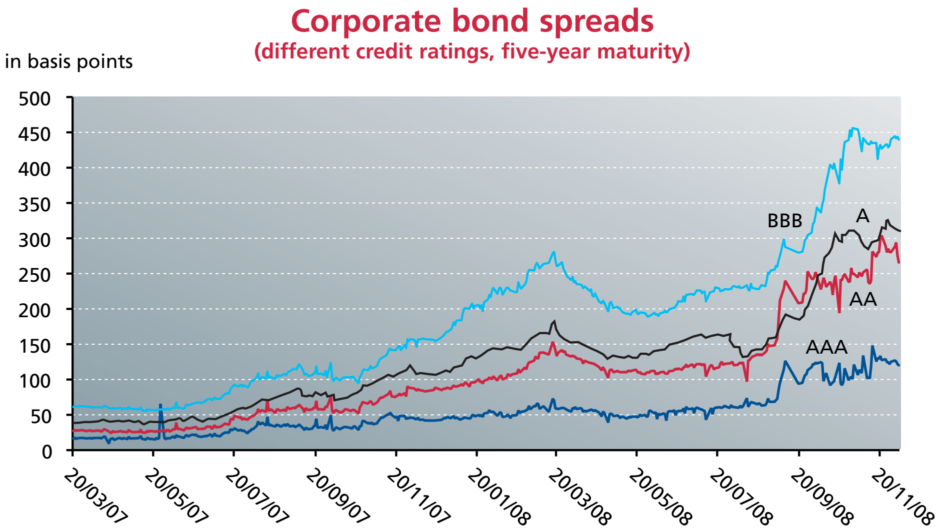
The woes in financial markets have gradually spread to infect the broader economy, reflected in, among other things, steeply rising financing costs and tightening lending conditions (see chart). "The financial crisis has now leaked into the real economy," observes Sean Berrigan. DG ECFIN's autumn economic forecast, which was released on 3 November 2008, revised earlier expectations downwards.

It projected 1.4% (1.2% for the euro area) economic growth for the EU in 2008, half what it was in 2007. This is set to drop even more sharply in 2009 to 0.2% (0.1% for the euro area), before recovering gradually to 1.1% in 2010 (0.9% for the euro area). As a result, employment is set to increase only marginally in 2009-2010, after the 6 million new jobs created in 2007-2008. Meanwhile, unemployment is expected to rise by about 1%, having reached its lowest level in a decade. "We are in danger of the weakening economic outlook feeding back into financial markets, thereby triggering a vicious cycle. The EU wants to prevent this through targeted measures," says Berrigan.

In its framework for recovery, the Commission outlined an action plan for jump-starting the faltering EU economy. It recommended that Member States raise their investment in research, innovation and education; promote more 'flexicurity' (job flexibility with social security provisions) as a means of protecting people rather than specific jobs; free up businesses, especially SMEs, to build markets at home and internationally; and enhance European competitiveness by continuing to green the economy.

"We must grasp this opportunity to drive forward a restructuring of global governance…"

Commissioner Joaquín Almunia



Source: Commission services

However, the document warned against an abandonment of budgetary constraints. "The Stability and Growth Pact provides the right policy framework, balancing short-term stabilisation needs and long-term structural reform requirements, notably supporting the adjustment process," the Communication elaborates. "Implementation of the Pact should ensure that any deterioration of public finances is accompanied by structural reform measures adequate to the situation."

Smart investment in the future

On 26 November 2008, the Commission fleshed out these priorities in a comprehensive €200-billion economic recovery plan which complements the financial markets. Representing 1.5% of the Union's combined GDP, the plan will mostly be funded (€170 billion) and run at the national level, with EU coordination and supervisory support. "Exceptional times call for exceptional measures. The jobs and well-being of our citizens are at stake," Commission President José Manuel Barroso said at the launch. Acknowledging that the coordinated fiscal expansion would likely lead some Member States to breach the 3% of GDP Maastricht deficit threshold, the Commission stressed that the Stability and Growth Pact would be applied to ensure that the correction of excessive deficits takes place in line with the recovery of the economy. As Commissioner Almunia put it at the press conference, "The Stability and Growth Pact stays. It's certainly not put in parentheses, as I've read somewhere. If a deficit is above 3% we will start the excessive deficit procedure, unless it exceeds the reference value by a few decimals only, is caused by exceptional circumstances and is temporary".

In order to ensure that Member States can customise their plans to suit their needs and learn from one another, the Commission has assembled an EU 'toolbox' which national governments can utilise. Tools in the box include greater support for the unemployed and the poorest households; the funding of large infrastructure projects such as energy networks and broadband internet; temporary VAT cuts across the whole economy, similar to those decided by the UK; and the reduction of taxes on labour. EU leaders approved the package at their summit in Brussels on 11 and 12 December 2008.

To have the maximum sustainable impact, the recovery plan needs not only to spark a recovery but also to help achieve the EU's longer-term socio-economic and environmental goals – this is what the Commission's proposal refers to as 'smart investment'. "If Europe acts decisively to implement this recovery plan, we can get back on a path of sustainable growth and pay back short-term government borrowing," President Barroso explained. "If we do not act now, we risk a vicious recessionary cycle of falling purchasing power and tax revenues, rising unemployment and ever wider budget deficits."

New dawn for the global economy

Another remarkable aspect of the current crisis is the extent to which the major economies of the world, both developed and emerging, have coordinated their responses and approaches. In addition to the close transatlantic collaboration, which might be expected given the alignment of the US and EU economies, there has also been close coordination between the so-called G20, a group of the world's top 20 economies. At its meeting in mid-November in Washington, the assembled leaders even agreed to work to resume the stalled Doha Round of world trade negotiations. The G20 is next due to assemble in London in April 2009 to review progress and further coordinate their actions.

Despite the gloom and doom that currently prevails, the turmoil can be constructively channelled to reform the global financial and trading systems so as to make them more efficient, equitable, sustainable and suitable for the times. Both Britain's Gordon Brown and France's Nicolas Sarkozy have called for a 'new Bretton Woods', evoking the need for an overhaul as radical as that undertaken following World War II.

"We must grasp this opportunity to drive forward a restructuring of global governance – including the Bretton Woods institutions – so that they reflect the geopolitical realities of the 21st century," said Commissioner Almunia at the International Economic Forum. From the Commission's point of view, global financial institutions – such as the International Monetary Fund (IMF), the World Bank and the Financial Stability Forum – should be made more equitable and Europe needs to consider consolidating its position within them.

Further information

'Financial crisis' on the DG ECFIN website:

http://ec.europa.eu/economy_finance/focuson/focuson13254_en.htm

The financial crisis of today: a rerun of the past?

The deep financial crisis of today has created an interest in the financial catastrophes of yesterday. Lars Jonung, Research Adviser at DG ECFIN, asks: is the present crisis a rerun of those of the past?

Lars Jonung

To answer, it is instructive to compare major recent crises with that of today. As demonstrated in the table, several financial crises have hit the world economy since the early 1990s. Of course, there are large differences across the countries shown in terms of size, political system, standards of living, etc. Still, all of them display roughly identical patterns of boom and bust as presented in a stylised manner in the figure below.

In short, the story is the following: the boom usually starts with financial deregulation and financial innovations combined with expansionary monetary and fiscal policies. The boom is driven by a rapid rise in credit and by low rates of interest. The rise in bank lending is channelled into asset markets, notably real estate and stocks. As real estate increases in price, the higher market value is used as collateral for new loans. The lending boom becomes a self-fulfilling process.

The general mood is one of optimism and risk-taking. Policy-makers, bankers and the public are not able to perceive the rising risks created in a financially vulnerable economy during the boom. Developments in the financial sector interact with the real economy. Consumption and investment, in particular in housing, rise rapidly. The whole economy is booming, that is, growing faster than the trend rate.

Eventually, the boom turns into a bust. Negative news changes the outlook from optimism to pessimism. Credit starts to contract. Interest rates rise sharply. The value of real estate and stocks falls. Wealth losses lead to lower consumption and investment and increase in private savings. Investment plummets, most rapidly within the construction sector. Unemployment soars. Tax revenues fall and public spending increases. The government budget deficit increases dramatically. The economy slides into a deep recession. At this stage, governments are usually forced to support the financial system with capital injections into banks and other measures to 'save' the financial system.

The above account describes the stylised boom-bust pattern of the 1990s. Yet the similarities with the recent crisis as it has developed in the US are striking. In the US, financial liberalisation and financial innovations fuelled the credit boom in the past ten years as they did in the crisis countries in the 1990s. Similarly, the expansion of lending originated in the housing sector, closely connected to the rise of sub-prime loans.

The high degree of financial innovations in the US made the country the centre of the recent financial storm by creating an extremely leveraged financial system. Structured products, sophisticated derivatives and a high degree of complex and opaque securitisation raised the extent of total US leverage. The outcome was excessive credit growth, excessive leverage and excessive funding that eventually turned into insolvency and panic when house prices stopped rising and the underlying model of refinancing broke down in 2006-2007. The boom turned into a bust in the summer of 2007, with a contraction of credit. Then it spread rapidly to the rest of the world.

As in the crises of the 1990s, the financial system was severely hit. Financial institutions in the US have been faltering on the brink of bankruptcy. The US government has been forced to step in with subsidies, financial support, outright ownership, etc. at enormous cost to the taxpayers. As in the 1990s, the budget deficit and public debt have soared in the US to unprecedented levels. Monetary policy in the US is now in an extremely expansionary phase as the authorities try to brake the economy's slide into deep recession.

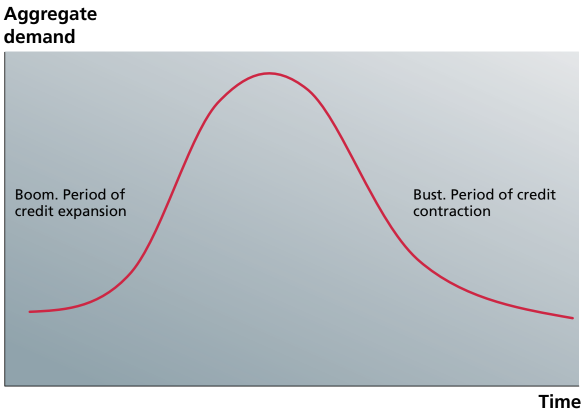
Of course, there are significant differences between the present crisis and those of the 1990s. The current one, originating in the US, has turned into a global recession because the US economy is the biggest in the world. The crises of 1990s remained local or regional as they took place in smaller countries. In the 1990s, crisis-hit countries could rely upon the rest of the world to provide demand for exports. This is not the case today, which makes the present crisis more threatening. In addition, the deep globalisation of finance and trade has caused the crisis to spread faster and further than in the past.

Although financial crises are not exactly the same, the boom-bust pattern of the 1990s is repeating itself to a surprising extent in the United States at present, and the figure captures the basic crisis dynamics of today as well as yesterday. ■

Major financial crises, 1992-2008

Country	Year
Finland, Sweden, UK	Autumn 1992
The ERM crisis	July 1993
Mexico	December 1995
Asia (Thailand, Indonesia, South Korea)	Summer 1997
Russia	August 1998
Brazil	January 1999
Turkey	May 2001
Argentina	December 2001
USA	August 2007
The world economy	2008

The boom-bust pattern. A stylised view



Source: Commission services

Slovakia's historic achievement

On the occasion of Slovakia's entry to the euro area,* European Economy News *invited Ján Počiatek, Minister of Finance of the Slovak Republic, to contribute his view on the achievement.

Slovakia's adoption of the single European currency on 1 January 2009 cannot be described as anything but an immense historic achievement for the entire country and all of its people. The exceptional nature of this achievement renders any modesty inappropriate. Our country has actually come to the end of a difficult path strewn with extremely tough obstacles, and the journey has been crowned with resounding success. The credit goes not only to the government, the central bank and European institutions – a major part of this achievement can be attributed to the thousands of people who were tasked with preparing dozens of institutions, public or private, for the euro changeover.

As Minister of Finance of the Slovak government, I am immensely proud of the fact that I had the opportunity to take part in this process and attend the key negotiations in Brussels where we heard the long-awaited and well-deserved verdict – Slovakia being given the 'go-ahead' to join the euro area.

These days, the euro is by far the hottest issue in my country – people are growing accustomed, step by step, to new banknotes and coins, and to new amounts on pricetags and payroll slips which are figures 30 times lower than those they have been familiar with for years. It is still too early to say that Slovaks already identify with the euro and have adapted to it. However, I am convinced that in a few weeks' time, or in a few months at most, I will be able to confidently make such a statement – as did my counterparts in the 15 countries which to date have been using the euro with great success.

However, under this celebratory headline I also wish to strike a serious note. On various occasions at home I reiterated many times – and wish to stress the same again now – that the euro changeover is not the ultimate goal for the Slovak government, not a finishing line that would reduce the need to keep pursuing a responsible economic policy. Quite the contrary – for us, the euro is a vehicle, or a key, which will allow our economy to advance as fast as possible even amidst the current severe global crisis. We are very well aware of our responsibility. Once our independent national monetary policy ceases to exist, our role will be clear – albeit not at all simple: through the application of a prudent and very flexible economic policy we need to make sure that our country will not be, even slightly, affected by the fact that we have abandoned our national monetary instruments. And we must ensure that our economy preserves its healthy development and best performance even after joining the monetary union. In my opinion, Slovakia's results achieved over the past few years clearly attest to the fact that this task and goal are by no means beyond our reach.

Ján Počiatek

The euro: a vehicle for economic growth in Slovakia

To conclude, I would like to avail myself, through this magazine, of the opportunity to thank all our foreign partners who supported us in the accession process – not only the European Commission and the European Central Bank, but also the individual countries of the euro area, their governments and their individual central banks. We are pleased to have joined the euro club, and we are already doing our best to contribute considerably. ■

ECFIN documentary: 10th anniversary of the euro

1 January 2009 marked 10 years since the euro was launched. The single currency has confounded critics and doomsayers to become one of the greatest success stories of European integration. To celebrate this achievement DG ECFIN has produced a 26-minute video documentary on the story of the euro, from its beginnings as a vision in the minds of a few committed Europeans to its existence as an everyday reality for millions of people.

The film draws extensively on archive footage as well as specially conducted interviews with key players in the euro's launch and management including Jacques Delors, Valéry Giscard d'Estaing, Theodor Waigel, Philippe Maystadt and Jean-Claude Trichet, to name but a few.

The first of the documentary's four sections – which can be viewed all together or as stand-alone modules – looks back at the the stages which led to the launch of EMU, starting with the devaluation of the dollar in 1971 and the ensuing period of instability which led to the launch of the EMS in the late 1970s. Valéry Giscard d'Estaing, Jacques Delors, former Belgian Finance Minister Philippe Maystadt and others describe how they conceived and implemented first a new common monetary system to help protect Europe from destabilising currency fluctuations, and then – at Maastricht in 1992 – a step-by-step plan to create a single currency.

The second module describes how the physical introduction of the euro in 2002 was planned and executed. From the choice of the name and design of the symbol – now as well known as the $, £ or ¥ – to the massive logistical operation involved in printing notes and minting coins, putting the new money into circulation and withdrawing the old, and ensuring that all members of society, including the most vulnerable, were properly prepared for the change.

The third module examines the euro's benefits for EU citizens and impact on companies. Ordinary people interviewed on the street for the documentary refer to the most obvious benefit, namely the way the euro has made it easier and cheaper to travel or do business across borders. Other benefits are greater price transparency, lower inflation, reduced interest rates, the creation of new markets, facilitation of intra-European investment, confidence in a stable currency, stimulation of growth, job creation, and so on. But in addition, as Commissioner Joaquín Almunia points out in an interview in the film, the euro acts as a shield and shock absorber in a crisis – a major advantage in today's difficult economic circumstances.

Finally, the fourth module looks at the prospects for the euro as a reference currency in the world. The euro area has already expanded from 11 to 16 members, with Slovakia the most recent addition. The sheer size of the euro area gives its members a weight on the international stage they would not otherwise have.

The documentary has been produced in 11 languages, and will be streamed on the web, (parts) hosted on EbS, EU Tube and other platforms, and distributed on DVD, and made available to TV stations across Europe. A three-minute trailer is also available.

This reflects a new departure for DG ECFIN's communication policy, which is now branching out into audiovisual media. A new multimedia section of the DG's website gathers photo and video material from the first 10 years of the euro. In addition, a number of short video clips on the euro and EMU are now in production for distribution via EUTube – and these will be available by around Easter 2009.

Further information

The documentary can be seen on the multimedia section of DG ECFIN's EMU@10 website:
http://ec.europa.eu/economy_finance/emu10/library_en.htm

The EU's Nordics: responsive to changing circumstances

The EU's three Nordic Member States – Denmark, Finland and Sweden – are examples of modern welfare states that have managed to balance high tax rates with competitive economies and strong fiscal discipline. All three have higher GDP per capita levels than the EU and the euro area's average, and have achieved higher growth and employment rates than many other Member States over the past decade.

The EU's three Nordic states have a tradition of economic reform and adjustment to changing circumstances, as seen by the deregulation of their markets and the relatively low level of red tape, and it is this that has allowed the three countries to remain competitive in the global market place – more so than other EU Member States.

But how far can these three economies serve as models for other EU members? Will their mix of fiscal and monetary polices survive intact under the twin stresses of globalisation and ageing populations? And how are the three adjusting to the current global financial crisis?

These are some of the questions to be discussed at an upcoming DG ECFIN seminar, 'The Nordics in the EU: Fiscal Similarities and Monetary Differences', which will be held on 13 February in Brussels. Georg M. Busch, head of the DG ECFIN unit that keeps track of the three economies, says that while Denmark, Finland and Sweden cannot be considered as blueprints for other Member States to follow, there are lessons to be learned from their economic approaches.

Little Mermaid, Copenhagen

The Nordics' different approaches to monetary policy demonstrate the wide range currently possible within the EU. Finland is a founding member of the euro area, where a common monetary policy is established through the European Central Bank. Denmark, in contrast, exercises its right under the EU Treaty to opt out of adopting the euro, like the UK. Unlike the UK, however, the country has chosen to peg its currency to the euro through the Exchange Rate Mechanism (ERM II) – a precondition for joining the single currency area. Under ERM II, the Danish krone's rate is fixed against the euro and can only fluctuate within a plus or minus 2.25% range. In practice, however, monetary policy has ensured that the rate has stayed within a much narrower range. Finally, Sweden's krona is a freely floating currency under an inflation-targeting regime.

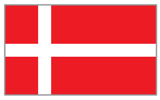
High in the rankings

Under these monetary systems the three Member States have all developed modern welfare states with large public sectors and generous public support schemes funded by high tax revenues. Denmark had the highest tax-to-GDP ratio of all EU Member States in 2007, at 49.5%, while Sweden came in second at 49% and Finland had the seventh highest rate at 42.8%, after Belgium, France, Austria and Italy.

Yet these three Member States have managed to combine this high-tax welfare system with open economies that have demonstrated solid economic and fiscal performance over the past decade. All three are characterised by good governance, sound public finances, and low levels of public indebtedness.

These positive qualities outweigh their high tax rates and labour costs in the annual competitiveness rankings of the World Economic Forum, which groups the Nordics among the world's most competitive economies. This year it ranked Denmark as the third most competitive country in the world, behind the USA and Switzerland. Sweden was ranked in fourth place, and Finland in sixth. Meanwhile, Transparency International ranked Denmark as the least corrupt country in the world in its 2008 global index, a position the country shared with New Zealand and Sweden. Finland was ranked in fifth place, behind Singapore.

Denmark



Currency: Danish krone
Population: 5.5 million
GDP per capita in purchasing power standards (EU-27=100): 121.8 (2007)
Real GDP growth rate: 1.6% (2007)
Public sector deficit (as a % of GDP): 4.5% (2007)
General government debt (as a % of GDP): 26.2% (2007)
Source: *European Commission*

Denmark's strategies during the 1980s and 1990s

Of the three, Denmark was considered the most open economy during the 1970s and 1980s. The country pegged the krone to the ECU in 1982 in a period when the country was marked by economic crisis, weighed down by high unemployment, inflation, interest rates and budget and current account deficits. In combination with fiscal consolidation, the fixed exchange rate led to a significant decrease in inflation and interest rates. The current account deficit was eliminated by 1990 and turned into a surplus of 3% of GDP in 1993.

The real GDP growth rate declined in 1993, due to a currency crisis that started in the previous year. During this period the European Monetary

Sweden

Currency: Swedish krona
Population: 9 million
GDP per capita in purchasing power standards (EU-27=100): 125.8 (2007)
Real GDP growth rate: 2.7% (2007)
Public sector deficit (as a % of GDP): 3.6% (2007)
General government debt (as a % of GDP): 40.4% (2007)
Source: *European Commission*

System's exchange limits for the krone were increased to a range within plus or minus 15% compared with the central rate. Denmark adhered to ERM II, when that system replaced the EMS in 1999, and the range was again decreased to plus or minus 2.25%. However, the krone has in fact stayed within a much narrower range of between +0.1% and -0.5%.

In the past decade the country has underperformed the euro-area's GDP growth rate in every year except for the 2004-2006 period, and only outperformed the EU as a whole for two of those years. In 2007, GDP growth was 1.6%, compared to the 2.9% average for the EU and 2.6% in the euro area, but GDP per capita was 22% higher than the EU average. Inflation was 1.7%, compared to the 2.3% average in the EU and 2.1% in the euro area.

Yet Denmark has been more successful than Sweden and Finland – and most EU Member States – in lowering the unemployment rate. In 2007, Denmark's unemployment rate was 3.8%, with only the Netherlands achieving a lower rate in the EU. The average unemployment rate in the euro area was 7.4%, and 7.1% in the EU.

Finland's and Sweden's adjustments to economic crises

Meanwhile, Finland and Sweden acted as economic twins during the 1980s, when both countries implemented financial deregulation, moves that were partially responsible for a boom in 1988-1989. The boom ended with a real interest rate shock that caused a banking and currency crisis and a deep downturn in the real economy in 1991-93.

Narrow street of Stockholm's Old Town

The economic crisis deeply impacted the two economies, which both experienced a significant loss in output, employment and industrial production. In Finland, the crisis was particularly harsh due to a meltdown of the financial sector, and the collapse of the Soviet Union, its major export market.

Finland's real GDP contracted by about 12% in the early 1990s, while Sweden's economy experienced a 4% contraction. Both countries saw their budget surpluses turn into deficits that peaked in 1993. Over three years, unemployment rose from about 2-3% in the two countries to reach 16% in Finland and 9% in Sweden. The two countries were forced to float their currencies in late 1992. Previously, both had linked their exchange rates to a basket of currencies before pegging them to the ecu in 1990.

Finland and Sweden experienced an economic turnaround in 1993 and since then have had a robust economic performance, led by strong export growth. Finland joined the EU in 1995 and ERM II in 1996 and adopted the euro at its launch in 1999. The country's real GDP growth has outperformed the EU's average, and that of the euro area, in every year from 1999, partly thanks to its openness and the emergence of the Nokia cluster. Growth has ranged from a peak of 5% in 2000 to a low of 1.6% in 2002. In 2007, real GDP growth was 4.5%. GDP per capita was 16% above the EU average. Inflation was 1.6%. Unemployment levels fell year on year to reach 6.9% in 2007. Finland has not recovered as quickly as the other two from the huge losses in employment during the recession years of the early 1990s, and has since had a higher level of structural unemployment than the other two Member States.

Like Finland, Sweden joined the EU in 1995. Unlike Finland, however, Sweden chose not to adopt the euro at its launch. However, it made its central bank independent in 1999 and gave it a mandate to maintain price stability. Having implemented a major tax reform in 1991 that lowered tax rates and broadened the tax base, it also reformed its pension system in the late 1990s, putting it on a more sustainable footing.

As in Finland, investment in information and communications technologies played an important role in the ensuing economic rebound, along with efforts to boost labour productivity in the high-tech sector. In almost every year of the past decade, Sweden's economy has outperformed the EU and euro-area average. Sweden achieved a real GDP growth rate of 2.7% in 2007, when inflation was 1.7%. GDP per capita was about 26% above the EU average. Unemployment was 6.1%.

Labour policies

One of the differences between the three countries relates to labour market flexibility – though throughout the last three decades all three countries have kept to a policy of working towards full employment as a goal.

Denmark has been particularly successful with what has been termed 'flexicurity'. Under this policy, Denmark allows companies a wide degree of flexibility in hiring and firing employees while providing income security for workers. Finland and Sweden's policies include elements from the flexicurity principles, but do not entirely follow the Danish model.

Notable differences relate to the wage formation arrangements in the three countries. In Denmark, minimum wages are mainly negotiated centrally while actual wages are set at a local level. Finland has a tradition of social partners negotiating centralised wage agreements, although the most recent wage-setting round was shifted to sector level. In Sweden, wages are usually negotiated by sector, which set wages under collective agreements, while government maintains the responsibility for helping the unemployed back into work.

Global crisis and reforms to the welfare state

These models of welfare and employment are being tested by the current global financial crisis and the growing stresses caused by increasing globalisation and population ageing. The three are directly exposed to the current crisis but in different ways.

Overall, Denmark is relatively more exposed to the housing market crisis, while Sweden and Finland are more reliant on their export industries, which have been hit by the drop in demand in the global market.

Helsinki cathedral

Finland is expected to do better, according to the European Commission's autumn economic forecast, given that its financial sector is relatively well shielded from the direct impacts of the global crisis.

To maintain long-term competitiveness in the face of globalisation – which puts pressure on their high-tax policies – and a reduction in the labour supply due to population ageing, all three countries are refining their welfare state policies by mixing tax cuts or freezes with reductions in government expenditures. They are attempting to improve competition in certain sectors and to adjust their labour markets to meet the challenges identified in the EU's Lisbon Strategy for growth and jobs.

In particular, Denmark is examining ways to reduce the cost and enhance the quality of labour through education and training. It is also providing better incentives to work in a bid to increase labour participation rates.

Finland has been building up budgetary surpluses to prepare for the effects of population ageing, and public pension schemes have built up large assets. In its national reform programme, the country is targeting structural unemployment, in particular by attempting to increase employment among low-skilled workers and the young. In response to the current global crisis, the government has also approved a package of income tax cuts – amounting to 0.9% of GDP – most of which will occur in 2009.

Meanwhile, in Sweden, the long-term budgetary impact of ageing is expected to be lower than the EU average. Pension expenditures are projected to remain relatively stable as a share of GDP over the long term due to reforms to the system adopted in 1998. In a move to improve the incentives to work, the government reduced income taxes in 2007 and 2008. More cuts are scheduled in 2009. Nevertheless, the unemployment rate is forecast to rise to about 7.5% in 2010 as companies cut jobs in response to weaker demand.

Finland

Currency: euro
Population: 5.2 million
GDP per capita in purchasing power standards (EU-27=100): 116.4 (2007)
Real GDP growth rate: 4.5% (2007)
Public sector deficit (as a % of GDP): 5.3% (2007)
General government debt (as a % of GDP): 35.1% (2007)
Source: *European Commission*

Variation within the EU

The performance of the EU's three Nordic members indicates the diversity of economic approaches that can coexist within the EU economy, notably in terms of monetary policy. But what Denmark, Finland and Sweden have in common is a useful capacity and readiness to adjust their economic models and embrace globalisation and new technologies. They have been more successful than others in reconciling economic efficiency with social equality. Yet, as globalisation and demographic change impact their public finances and labour markets, the question remains as to whether the traditions of openness and reform willingness will be adequate to preserve their welfare state policies. The Nordics have so far managed to remain competitive but continuous adjustment of their welfare models will be necessary in view of the twin challenges.

Another factor to consider is whether the current crisis will make the adoption of the euro more attractive to Denmark and Sweden. While the global financial crisis is putting stress on their economic models, their fiscal discipline leaves them better prepared to weather the downturn than many other EU members.

Further information
More information can be found on DG ECFIN's website:
http://ec.europa.eu/economy_finance/eu_economic_situation/eu_economic_situation8652_en.htm

Looking ahead

For your diary

13 February 2009, DG ECFIN workshop

The Nordics in the EU: fiscal similarities and monetary differences

This one-day workshop will discuss the economies of the EU's Nordic members: Denmark, Finland and Sweden. Among the topics are the lessons these countries' open economies, higher taxation, and higher social welfare regimes may have for other EU members. How their economies, with their different exchange rate regimes, are responding to the current economic downturn will also be covered by speakers and participants.

2 March 2009, A conference in Prague

EU Enlargement – Five Years After

On 1 May 2009, five years will have elapsed since the 2004 enlargement of the EU. This conference, organised in Prague by the Czech Presidency in co-operation with the European Commission, will discuss benefits, costs and challenges associated with enlargement. In the morning session, high-profile speakers will draw the political lessons. In the afternoon, parallel sessions zoom in on three specific aspects related to enlargement: (1) macro-financial stability, (2) the functioning of the internal market, and (3) labour migration. Further information will be available on the Czech Presidency's website: **www.eu2009.cz**

Vltava River, Prague

25 March 2009, DG ECFIN seminar

Economic policy challenges in the Baltics: rebalancing in an uncertain environment

This whole-day, cross-country seminar will discuss the current challenges to economic policy-making and possible responses in the three Baltic economies of Estonia, Latvia and Lithuania. It will comprise sessions on: assessing the recent boom and its aftermath; competitiveness developments and external account sustainability; raising the growth potential, including the role of public finances; and a panel discussion on challenges and prospects in the light of the current crisis.

Baltic Sea

Spring 2009, DG ECFIN seminar

Country seminar on France

The seminar will review the economic and budgetary situation in France as well as reform initiatives. Participants will discuss strategies to take advantage of globalisation, to raise potential growth, and to achieve sustainable fiscal consolidation. There will be two sessions – on growth/employment and public finances – and a panel on the challenges facing France.

8 May 2009, DG ECFIN conference in Brussels

Conference on ageing

In coming decades, ageing will lead to unprecedented changes in the size and age structure of the populations of all EU Member States. For some years, the European Commission has been working closely with EU Member States through the Economic Policy Committee to develop more comparable projections on the impact of demographic change on public finances. In May 2009, the ECOFIN Council is expected to endorse a new set of age-related expenditure projections for all 27 Member States up to 2060. In this context, DG ECFIN is organising a major conference to bring together senior academics and policy-makers to debate the policy challenges posed by ageing, and the required policy responses.

25-26 May 2009, ECB conference in Frankfurt

Retail payments: integration and innovation

Organised jointly with the Netherlands Central Bank (DNB), this conference aims to improve understanding of retail payment economics – particularly in light of the creation of the Single European Payments Area. It will help identify possible developments and dynamics that will shape the future retail payments landscape as it becomes increasingly integrated and consolidated. Participants will include economists and researchers from academia, central banks and financial institutions.
More information: **www.ecb.int/events**

14-15 May 2009, The Brussels Economic Forum

Organised by DG ECFIN, the annual Brussels Economic Forum (BEF) brings together a wide audience including economists and policy-makers to discuss topical matters in European economics. The 2009 BEF will cover the latest developments in the financial crisis and Europe's adjustment to it as well as reviewing the European economy five years after the 2004 enlargement.

Further information
http://ec.europa.eu/economy_finance/events/

Commission agenda

January 2009

DG ECFIN will publish an (early) interim economic forecast, which is exceptionally extended to cover more variables and all Member States in view of the rapid changes to the economic outlook.

January 2009

As part of its annual Lisbon package, the Commission will issue individual reports for each Member State in January, including proposals for short-term actions based on the European Economic Recovery Plan. They are intended to achieve the plan's aims of protecting people and preventing the crisis from deflecting attention from the EU's longer-term interests and the need to invest in its future. To this end, they will make a close connection between the fiscal stimulus and actions in the four priority areas of the Lisbon Strategy (people, business, infrastructure and energy, research and innovation).

March 2009

The Commission will publish its first Quarterly Report on the Euro Area for 2009. This will be a special issue devoted to competitiveness surveillance within the euro area.

March 2009

The Commission will publish a major report on five years of EU enlargement. It will be presented at a conference in Prague and will cover the impact of the 2004 enlargement on the EU as a whole as well as on the new entrants themselves, including economic performance, growth and trade patterns as well as issues concerning labour movements and the Lisbon Process.

March/April 2009

DG ECFIN will sponsor a conference evaluating the euro changeover process in Slovakia, which will have adopted the single currency on 1 January 2009. These conferences are an opportunity to collect and disseminate 'euro changeover' good practices of use to other euro-area candidate countries. The conference will be accompanied by a Communication in April 2009 on the euro changeover in Slovakia.

2nd quarter 2009

DG ECFIN will publish the annual 'Public Finances in EMU' report for 2009. The report will analyse the implications of the financial crisis for fiscal policy and the role of fiscal policy in facilitating the correction of external imbalances.

May 2009

DG ECFIN will publish the spring economic forecast for the EU and the euro area. This, together with the autumn forecast, usually comprises the major economic forecast for the EU and provides the basis for policy decisions. Forecasts for individual Member States are included.

June 2009

The Commission will publish the ninth progress report on preparations for the introduction of the euro. This report covers the economic developments in the euro-area candidate countries and the state of their preparations on the economic, monetary, legal and administrative aspects needed to adopt the single currency.

Editorial information

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Recent research and analysis by DG ECFIN

European Economy Research Letter

The Directorate for Economic and Financial Affairs publishes a regular web-based newsletter on the research activities of its staff – the *European Economy Research Letter*. Topics from the most recent edition include the 2008 ECFIN annual research conference on 'boosting growth and productivity in an open Europe'; the EU-US total factor productivity gap; public finances and economic growth; food prices in EU neighbour countries; and ECFIN's new MICREF database on microeconomic reforms. The *European Economy Research Letter* is available free of charge by e-mail subscription on the DG ECFIN website. **http://ec.europa.eu/economy_finance/publications**

To mark the tenth anniversary of the launch of Economic and Monetary Union, DG ECFIN economists and external academic contributors are producing research publications on aspects of the first decade of EMU and the euro. These publications are part of an EMU@10 umbrella project embracing a wide range of research activities. The publications can be downloaded via a dedicated website hosted by DG ECFIN, which provides information and resources on EMU for economists and non-specialists. The website can be found at: **http://ec.europa.eu/economy_finance/emu10**

Some titles from the EMU@10 series are:

- Global impact of a shift in foreign reserves to euro
- Fiscal policy, inter-country adjustment and the real inflation rate within Europe
- Implications of EMU for global macroeconomic and financial stability

Research publications

DG ECFIN also publishes frequently on economic research relevant to the European Union which is conducted by staff of the DG. These publications appear as part of the *European Economy* series.

The main *European Economy* series includes major reports and communications to the Council from DG ECFIN on behalf of the European Commission. *Economic Papers* and *Occasional Papers* cover the analytical and policy work done by the staff of DG ECFIN, sometimes in co-operation with external researchers. The *Country Focus* series covers topical economic issues affecting one or more Member State.

Economic Papers

Recent publications include:

- Economic impact of migration flows following the 2004 EU enlargement process – A model based analysis
- Costs and benefits of running an international currency
- The role of the euro in Sub-Saharan Africa and the CFA franc zone
- Adjustment capacity of labour markets of the Western Balkan countries

Occasional Papers

Recent publications include:

- The LIME assessment framework (LAF): A methodological tool to compare, in the context of the Lisbon Strategy, the performance of EU Member States in terms of GDP and in terms of 20 policy areas affecting growth
- 2008 Fiscal notifications of candidate countries: overview and assessment
- European Neighbourhood Policy: Economic review of EU neighbour countries

Country Focus series

Recent publications include:

- The Czech labour market: room for further improvement
- Germany: revisiting the budget rule
- The UK housing market: anatomy of a house price boom
- Cyprus: immigration, wage indexation and the adjustment in EMU
- Ireland's housing market: bubble trouble?

All research publications can be downloaded free of charge from the DG ECFIN website: **http://ec.europa.eu/economy_finance/publications_en.htm**

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