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Which way out?

Developing crisis exit strategies

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Table of contents

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Editorial

Exit strategies: choosing the right way out

Dear Reader,

In our last edition, we noted signs of 'green shoots' in the economy. And, indeed, signs that the world economy is about to emerge from the crisis continue to appear. The latest indicators and forecasts are generally positive, albeit still fragile.

Swift and forceful policy intervention has been the key factor in preventing meltdown. Financial rescue policies helped restore the liquidity and capital of banks and provided guarantees to get the financial system functioning again. Central banks cut policy interest rates to unprecedented lows and gave financial institutions access to lender-of-last-resort facilities. The European Economic Recovery Plan (EERP) is providing strong fiscal support and the EU has provided balance-of payments assistance to Member States in Central and Eastern Europe.

But the European economy is not yet back on its feet – far from it. It is more like a patient in critical care whose situation has stabilised. We now need to design and put into practice a recovery regimen to return the patient to full health, while continuing to carefully monitor the patient's vital signs.

For the time being, that means sustaining the strong policy support. There must be no withdrawal of stimulus until a durable, self-sustaining recovery is under way. At the same time however, the discussion of how and when to wind down that support does need to begin.

Choosing the right exit strategies will determine Europe's long-term growth prospects, and preparing them now – while waiting for the appropriate moment to implement them – will not undermine short-term expansionary measures. On the contrary, being clear about the exit strategy will bolster the effectiveness of those measures, since economic actors are forward-looking. This is one of the key messages set out in DG ECFIN's recent report 'Economic crisis in Europe: causes, consequences and responses'.

In addition, it will be important to coordinate at EU level the discussions on potential exit strategies to ensure that effective competition and the proper functioning of the single market are maintained, and that public finances consolidation in line with the Stability and Growth Pact takes into account cross-country spillovers.

Government budgets already face a serious challenge from an ageing population. And the recent crisis-related expenditure has badly hurt balance sheets. In order to ensure long-term growth, therefore, Europe needs to couple fiscal strategies to reduce deficits and debt with structural reforms of labour markets and social protection systems.

At the same time, we need to treat the root cause of the current crisis. Fixing the financial system is the only way to return the real economy to full health, and it ultimately will require removing investors' uncertainty about the quality of banks' balance sheets. Removing toxic assets and underperforming loans from financial institutions' balance sheets is an essential step for re-establishing the viability of the EU banking sector. In cleaning up financial institutions' balance sheets, however, we must exercise care not to create distortions to the Single Market, just as a doctor is careful to avoid harmful side effects.

One effect of the crisis which is yet to be fully felt is the impact on the labour market. The EU unemployment rate is expected to continue increasing over 2009 and 2010 - but this rise in unemployment has been tempered by the measures taken by Member States via the EERP. Considerable budgets have been devoted to employment, and rightly so. As we move from stabilisation towards recovery, future employment growth will now need to be embedded in a comprehensive, coordinated strategy to ensure that unemployment does not become structural.

Global imbalances should also be addressed. Unbalanced demand, and the build-up of large and persistent external surpluses and deficits, created the environment in which the financial crisis could happen. The EU should act in unison through the G20 and the Bretton Woods institutions to reform the system of international economic governance.

Iceland's close encounter with collapse sharply underlines our interdependence in a globalised economy. In this issue we profile Iceland's economy and examine its sudden economic turmoil. The country's difficulties should serve as a warning but also show that a nation can recover, even from the brink of total collapse.

In finally exiting this crisis, coordination at EU level will be crucial, both to avoid harmful 'spill over' effects and to learn from one another. Rather than turning inward, we need to act together. Upholding the ideals of the European project – and putting them into practice – has never been more important.

Marco Buti
Director-General,
Economic and Financial Affairs DG

Getting back on track:

Strategies for smoothly exiting from support measures

The EU's response to the global downturn was immediate and forceful, and has included fiscal support amounting to 5% of GDP. But the process of repair and recovery remains incomplete. The EU must therefore maintain its strong policy response and avoid any premature withdrawal of stimulus, while at the same time beginning to design strategies for exiting from temporary support measures – when the time is right, and in a cooperative and coordinated way. This planning will help make the critical transition from crisis to self-sustaining recovery.

Following the unprecedented shock caused by the financial crisis which broke out in 2007, the EU economy now finds itself in the midst of the steepest downturn since the 1930s. Real GDP is projected to shrink by more than 4% in 2009, the sharpest contraction in the history of the Union.

The European Economic Recovery Plan

The EU's response to the downturn has been swift and decisive. The first priority was crisis control: to stabilise, restore and reform the banking sector. The second step, came in the form of the European Economic Recovery Plan, launched in December 2008 and designed to get the economy back on its feet. It consisted of a coordinated massive injection of purchasing power into the economy. The overall fiscal stimulus, including the effects of automatic stabilisers, amounts to 5% of GDP, including the effects of automatic stabilisers as well as the combined discretionary fiscal stimulus by Member States over 2009 and 2010. Of course, and as detailed in *Economic Crisis in Europe: Causes, Consequences and Responses*, the impact of the fiscal stimulus will vary from one country to another, depending upon each economy's characteristics (such as their openness or share of credit-constrained households) and the composition of the fiscal stimulus (i.e. share of resources devoted to strategic investment in line with the objectives of the Lisbon Strategy). There is no question, however, that it has had the desired effect.

Designing exit strategies

While clearly necessary, the bold fiscal stimulus comes at a cost. From a low in 2007, the EU's debt-to-GDP ratio is set to increase sharply as a result of crisis-induced revenue shortfalls and the budgetary support provided to the economy – the crisis-induced increase in debt in 2009 and over the four years 2009-12 are likely to be the highest ever experienced by EU economies in peacetime. In the absence of as-yet-unspecified adjustment measures, public debt in the euro area could reach 100% of GDP by 2014.

As soon as a recovery takes hold, and the risks of an economic relapse diminish sufficiently, fiscal policy will have to shift to consolidation. Most euro area Member States will be subject to excessive deficit procedures, which will provide recommendations on the adjustment path. While respecting obligations under the Treaty and the Stability and Growth Pact, a differentiated approach across countries will be needed, taking into account relevant factors such as the pace of recovery, fiscal positions and debt levels, as well as the projected costs of ageing, external imbalances and risks in the financial sector.

The design and implementation of credible and well-coordinated exit strategies will help put the EU back on the path of sustainable growth. Preparing exit strategies now will not undermine short-term expansionary measures. On the contrary, the very effectiveness of short-term expansionary measures depends upon clarity regarding the pace with which such measures will be withdrawn. Since financial markets, businesses and consumers are forward-looking, expectations are factored into decision making today. Businesses and consumers may increase saving and reduce investment and consumption because of uncertainty or the perceived need to insure against the risks of unsustainable public finances. Fiscal stimulus measures with a clear end date, therefore, typically have a stronger impact on spending or production. The precise timing of exit strategies will depend on the strength of the recovery, the exposure of Member States to the crisis and internal and external imbalances.

The threat to long-run growth

Some observers believe that potential GDP growth in the EU could fall to a permanently lower trajectory, the so-called 'L-shaped' recovery scenario. The crisis could erode growth potential due to several factors. First, protracted spells of unemployment in the workforce tend to lead to a permanent loss of valuable skills. Second, the stock of equipment and infrastructure will decrease and become obsolete due to lower investment. Third, innovation may be hampered as spending on research and development is one of the first outlays that businesses cut back on during a recession.

Member States have implemented a range of measures to provide temporary support to labour markets, boost investment in public infrastructure and support companies. To ensure that the recovery takes hold and to maintain the EU's growth potential in the long-run, however, the focus must increasingly shift from short-term demand management to supply-side structural measures. These measures should help spur adjustment and avoid locking resources into sectors or enterprises that are not viable in the long-run. As outlined in the European Economic Recovery Plan, government initiatives should support investment in infrastructure (whether public or private), the development of skills, greater labour mobility (geographical or across industries or occupations) and innovation (including the development of low-carbon technologies).

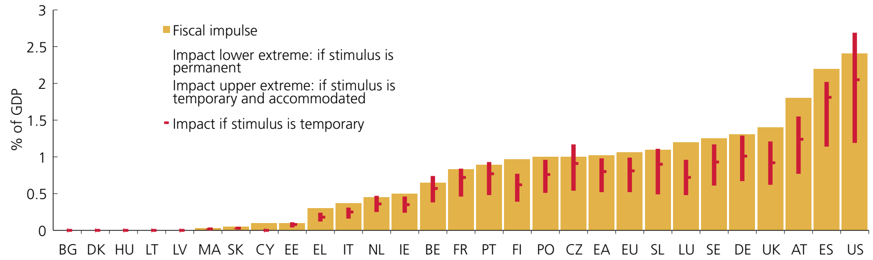
The importance of EU coordination

Close coordination will be beneficial. 'Vertical' coordination aims at ensuring that the withdrawal of measures is properly sequenced between the various strands of economic policy (fiscal, structural, financial), an important consideration as turning points may differ across policy areas. 'Horizontal' coordination will help Member States to avoid or manage cross-border economic spill-over effects, to benefit from shared learning and to leverage relationships with the outside world.

Moreover, within the euro area, close coordination will be particularly important because the financial crisis seems to be speeding up adjustment to external imbalances. Surplus countries have seen their net exports plummet while deficit countries have experienced a shake out in domestic demand. This adjustment process should not only be allowed to play out, it should be actively facilitated. There is a risk that fiscal and structural measures taken in support of economies over the medium-term will hinder rather than facilitate the necessary re-balancing in competitiveness. Measures that impede adjustment should be unwound with priority. Addressing the underlying causes of diminished competitiveness must be an integral part of any exit strategy.

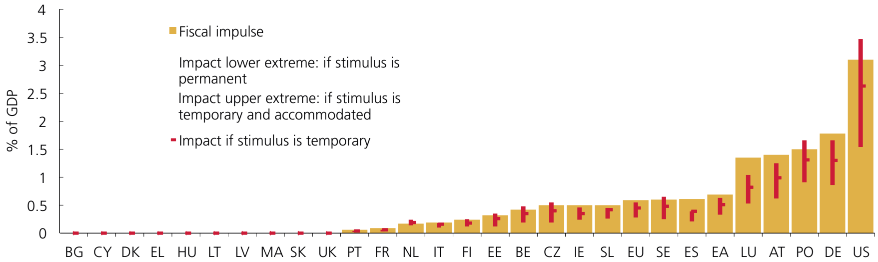
Government support for specific sectors will also need to be withdrawn. Failing to do so could impede the restructuring process or create harmful distortions to the integrity of the Internal Market. In the financial sector, government guarantees and holdings in financial institutions will need to be gradually unwound as the private sector gains strength, while carefully balancing financial stability with competitiveness considerations. A return to full viability in the financial industry will require significant re-structuring, however (see "Financial sector repair" article - p.8).

Fiscal stimulus in 2009



Source: European Commission.

Fiscal stimulus in 2010



Source: European Commission.

Exiting fiscal stimulus measures

With the exception of Germany, Poland, Austria and Luxembourg, most European countries will reduce the size of their fiscal impulse relative to GDP in 2010. The graphs also show that a fiscal stimulus that is temporary and accommodated by an easier monetary policy stance, which is more likely if monetary authorities consider the stimulus to be credibly temporary) has the highest impact. This is partly because well-defined exit strategies remove uncertainty about the future, with the result that economic actors are more likely to seize the opportunity to bring spending or production plans forward, rather than saving as an insurance against future risks).

Apart from orchestrating the orderly exit from short-term support measures, an exit strategy should also ensure that Europe maintains its place at the frontier of the low-carbon revolution by investing in renewable energies, low carbon technologies and green infrastructure.

Further information

• Economic Crisis in Europe: Causes, Consequences and Responses:
http://ec.europa.eu/economy_finance/thematic_articles/article15893_en.htm

• Annual Statement and Annual Report on the Euro Area 2009:
http://ec.europa.eu/economy_finance/thematic_articles/article15859_en.htm

Not over yet:

Softening the impact of the financial crisis on the labour market

The EU unemployment rate is expected to increase to above 10% in 2009, reversing the downward trend which started a decade ago. Nonetheless, there is some cause for hope. Member States have allocated considerable budgets and attention to addressing employment issues. Moreover, most of the measures implemented thus far seem to be temporary, targeted and timely. Such measures have helped lessen the impact of the crisis on unemployment. They now need to be embedded in a comprehensive, coordinated strategy to prevent the rise in unemployment from becoming structural.

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Employment has been identified as Europe's first priority. And indeed, a failure to address the employment issue could impact fiscal sustainability, long-term growth and social stability. Unfortunately, the employment outlook for Europe is gloomy. Initially, unemployment resulting from the crisis was concentrated in Spain and Ireland, but is now rising across all Member States. This is not surprising since the impact on employment is typically only felt 2 to 3 quarters after the beginning of a recession.

Although there are signs that the recession is bottoming out, unemployment is set to continue rising. Employment is expected to contract by about 2½% in both the EU and the euro area in 2009. As a result, the unemployment rate will increase to above 10% in the EU and close to 11% in the euro area. In general, European economies are likely to face a larger labour market adjustment than in previous downturns – though employment should recover more quickly than in the past. This is because recent reforms have increased labour market flexibility while making unemployment benefits less generous and tightening access to early retirement in most countries.

European principles for action

European principles for action are presented in "The EU's response to support the real economy during the economic crisis: An overview of Member States' recovery measures", from DG ECFIN's Occasional Papers series. Measures should aim at reducing the costs of adjustment and speeding up transitions from old to new jobs in order to avoid more permanent losses in employability.

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Protecting incomes of the most disadvantaged groups of the population is a priority and will itself stimulate aggregate demand given the high marginal propensity to consume of these income groups.

Policies should facilitate structural adjustment (improving unit labour costs), especially in euro area countries, to address divergences in external competitiveness.

Policies to address the crisis should not run counter to long-term reform strategies, notably the implementation of the flexicurity principles under the Lisbon strategy.

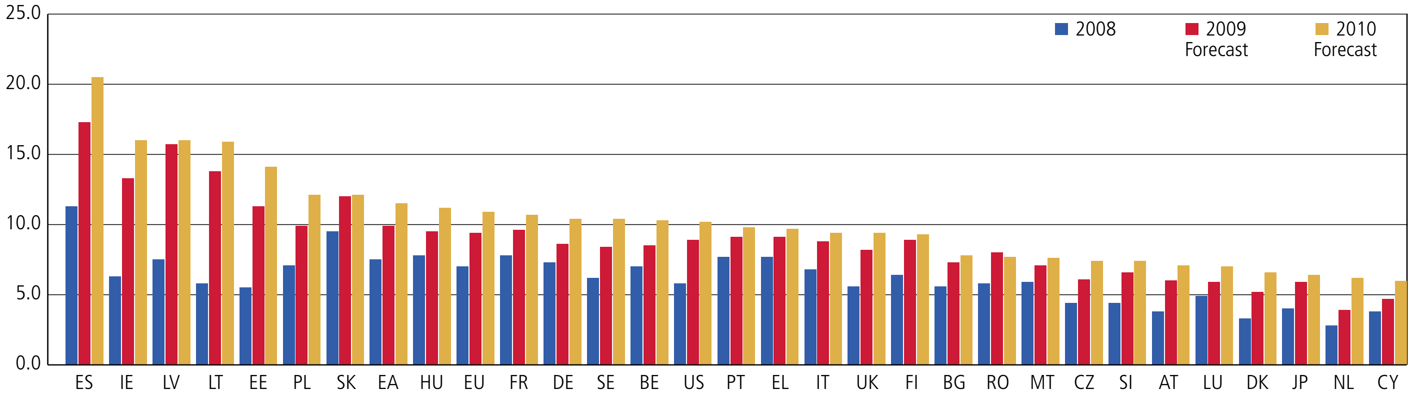
The good news

Despite the grim outlook, there is some cause for hope. Member States have put significant emphasis on employment in designing their recovery packages, and considerable budgets are being allocated to support employment: as much as 0.87% of GDP for measures aimed at raising household purchasing power and 0.14% for labour market measures. Moreover, job losses have been limited so far, particularly in the manufacturing sector, thanks largely to short-term measures to preserve existing jobs (such as short-time working, partial unemployment schemes or temporary lay-offs) while the cost of unemployment has been kept down by extending the duration and coverage of unemployment benefits and social safety nets.

An assessment of labour market measures

An assessment by DG ECFIN experts shows that measures undertaken so far within the framework of the European Economic Recovery Plan are promising. The experts published their findings in "The EU's response to support the real economy during the economic crisis: An overview of Member States' recovery measures," from the European Economy Occasional Papers series. They classified labour market and social protection measures in recovery programmes into nine broad types of action, and assessed them against a number or criteria including: timeliness, the degree of

Unemployment (percentage of civilian labour force)



Employment outlook: worsening.
Unemployment is set to increase enormously in 2009 and 2010 across Europe, reaching double digit levels in the hardest-hit countries.

Source: European Commission (2009 spring forecast, DG ECFIN).

Policy do's and don'ts

Policy do's and don'ts are presented in "The EU's response to support the real economy during the economic crisis: An overview of Member States' recovery measures", from DG ECFIN's Occasional Papers series. The do's and don'ts are based on the principles and on the evaluation of the effectiveness of policies in previous crises.

Do's and don'ts are based on the principles and on the evaluation of the effectiveness of policies in previous crises.

Do's:

- Keep people in employment by providing financial support for temporary flexible working-time arrangements, combined with measures supporting employability and helping people transition to new jobs. Measures need to be coordinated to avoid negative spill-overs in other Member States.
- Provide adequate income support for those most affected by the economic slowdown, while helping them not to lose contact with the labour market.
- Invest in re-training and the upgrading of skills.
- Consider measures such as lowering non-wage costs for low-skilled workers.
- Tackle youth unemployment and support school leavers.
- Reduce labour market segmentation by, e.g., better aligning employment protection for workers on temporary and permanent contracts.

Don'ts:

- Avoid indiscriminate support for jobs in declining industries or regions as this could reduce economic efficiency and delay needed re-structuring.
- Large direct job-creation schemes artificially inflate the public sector and are not sustainable in the long-run.
- Policies that pursue economic re-structuring by encouraging early retirement for workers in declining sectors will have negative effects on labour supply and, given demographic ageing, the long-term sustainability of public finances.

targeting, the time consistency of short-term support measures with long-term policy goals such as those in the Lisbon Strategy, and the possible need for coordination in light of cross-border spill-over effects.

Measures were also assessed in light of European principles for action and policy do's and don'ts (see box). Most measures were found to meet these criteria as well as to be temporary, targeted and timely. Nonetheless, potential negative impacts further down the line must be anticipated and kept in check, even if the immediate priority is containing labour shedding, and even if measures need to be stepped up further as unemployment continues to rise. Questions remain, for example, regarding thereversibility of some policies, such as large-scale public job creation schemes. In addition, some 10% of measures are likely to have permanent adverse effects on public finances, while very few measures aim at improving the efficiency of welfare systems. A further 25% of measures are likely to generate considerable spill-over effects. Policies that seek to cut labour costs by reducing social security contributions and subsidies for shorter working time, for example, could create cross-border distortions in the hiring and firing decisions of multi-national corporations.

"Because many firms have used working time reductions to maintain employment, we expect that a wave of re-structuring and redundancies is still to come," warns Giuseppe Carone, Head of Unit for Labour Market Reforms within DG ECFIN and one of the authors of the study.

Against this backdrop, and in view of the considerable policy variation across Member States and the danger of distortions in the internal market, there is a clear need for stronger EU-level co-ordination. ●

Financial sector repair:

The *sine qua non* for economic recovery

Complete recovery of the real economy depends on restoring the financial system to full health. The various policy measures implemented thus far have been highly effective in averting a complete meltdown of the financial system and in helping to restore normal market functioning. The final step requires restoring the viability of individual financial institutions. Moreover, care must be taken to ensure that a level playing field is maintained and distortions are not created between countries or banks.

Unlike most past contractions, the current downturn – the deepest in 50 years – is the direct result of problems in financial markets. Moreover, if the recession was triggered by the financial crisis then its resolution ultimately depends on fixing the financial sector. Failing to do so runs the risk of creating a negative feedback loop, as the crisis in finance affects the real economy, leading to further problems in finance.

The crisis in financial markets deepened substantially with the bankruptcy of Lehman Brothers in mid-September 2008. The US investment bank had previously been considered 'too big to fail' and had thus benefited from an implicit rescue guarantee. With the end of such implicit guarantees, banks stopped lending to each other, and money markets froze up.

A system-wide liquidity crisis

The largely unexpected breakdown of a systemically important global bank prompted a re-evaluation of the risks embedded in the financial system. Central banks took decisive action to calm money markets. The ECB lowered its borrowing costs by 50 basis points to 3.75 percent in October 2008, in a coordinated move with the Bank of England, the Sveriges Riksbank and various non-EU central banks. More reductions followed between October 2008 and the summer of 2009, leading to an overall reduction of the ECB benchmark policy rate by 325 basis points to 1 percent. Besides lowering borrowing costs, central banks have also stepped in as central providers of liquidity, thereby ensuring the availability of short-term bank funding on dysfunctional money markets.

Despite the decisive measures taken by central banks, several European financial institutions fell into difficulties, including *Bradford and Bingley*, the UK mortgage bank, and *Hypo Real Estate* of Germany. Moreover, the drying up of liquidity in the interbank market soon began to affect otherwise sound financial institutions. In short, the liquidity crisis had become systemic. Several Member States set up general schemes in order to support the financial sector and ensure financial stability. It became doubtful, however, whether existing rules on rescue and restructuring aid were sufficient to handle a systemic crisis that affected banks not normally considered 'companies in difficulties'. Additional measures would be required.

The European response

Meeting in October 2008, European leaders agreed to implement national rescue packages with a view to safeguarding the stability of the financial sector, restoring the normal functioning of wholesale credit markets and underpinning the supply of credit to the real economy. Such measures mainly took the form of recapitalisation, guarantees on bank debt issuance and relief for impaired assets. The Commission issued guidance on how Member States can take measures to support banks while avoiding excessive distortion of competition, in accordance with EU state aid rules Commission guidance on government measures to support the financial sector was provided in the for of three Communications (see box).

Member States have provided aid to financial institutions either through general schemes (creating a general authorisation framework) and/or through specific rescue operations targeting individual financial institutions. In some cases, general schemes have been adopted but have not been used in practice,

Commission guidance on government measures to support the financial sector

The '**Banking Communication**' adopted on 13 October 2008 provided a European framework to allow rescue operations in order to stop or prevent runs on financial institutions.

The '**Recapitalisation Communication**' of 5 December 2008 identified a set of standards and safeguards allowing Member States to recapitalise banks in order to ensure adequate levels of lending to the economy.

The '**Impaired Assets Communication**' of 25 February 2009 provides the framework for cleaning-up financial institutions' balance sheets by removing toxic assets and underperforming loans.

Rescue vs. Restructuring

Rescue aid is temporary assistance to keep a firm in financial difficulties afloat for the time needed to work out a restructuring and/or a liquidation plan. It must in principle be given in the form of loans or guarantees lasting no more than six months and it should be restricted to the minimum necessary to keep the firm in business during the rescue period.

Restructuring aid, on the other hand, is based on a feasible, coherent and far-reaching plan to restore a firm's long-term viability. It usually involves different elements such as the reorganisation and rationalisation of the firm's activities on a more efficient basis, the restructuring of those existing activities that can be made competitive again, diversification towards new and viable activities, financial restructuring (capital injections, debt reduction) and the adoption of measures to limit distortion of competition. Restructuring aid is not aimed at making good past losses without tackling the reasons for those losses. Repeated rescue or restructuring aid for the sole purpose of keeping firms artificially alive is not allowed.

Commission guidelines for restructuring aid

i) Aided banks must be made viable in the long-term without further state support;

ii) Aided banks and their owners must carry a fair burden of the restructuring costs;

iii) Measures must be taken to limit distortions of competition in the Single Market.

while still being deemed necessary by Member States to ensure rapid implementation if necessary and to reassure the financial markets by their mere existence. As of end September 2009, 25 schemes have been approved and, since April, 13 national schemes have been prolonged (UK, Sweden, Finland, France, Italy, Latvia, Germany, Austria, Netherlands, Slovenia, Denmark, Hungary and Greece). As of the end of September 2009, 8 Member States have not taken any measures.

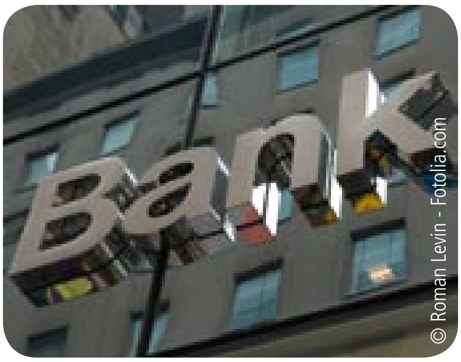
In aggregate figures, more than EUR 310 billion has been approved by the Commission for re-capitalisation of banks. Of this amount, almost EUR 200 billion has been injected. This amounts to about 2.7% and 1.7% of EU GDP respectively. More than EUR 2.900 billion has been approved by the Commission to guarantees on bank borrowing, of which about EUR 920 billion is reported to having been allocated. This amounts to about 25% and 8% of EU GDP respectively. In total, about 31% of EU GDP has been committed and 12.5% effectively engaged.

Avoiding distortions

While resolving the financial crisis is its top priority, the Commission has always advanced the view that resolution should not come at the expense of the Internal Market. Rules must be designed that ensure a level playing field between banks located in different Member States as well as between banks which receive public support and those which do not. Failing to do so could trigger harmful subsidy races, in which Member States compete to offer the most attractive rescue or restructuring packages. Furthermore, the crisis itself has raised questions regarding remuneration, accountability and governance. Limiting moral hazard, therefore, is an important concern.

In order to ensure a level playing field and set the stage for the eventual withdrawal of support, the Commission has adopted guidelines for assessing restructuring aid given by Member States to banks. The Commission approach is based on three fundamental principles: i) aided banks must be made viable in the long-term without further state support; ii) aided banks and their owners must carry a fair burden of the restructuring costs; and iii) measures must be taken to limit distortions of competition in the Single Market.

"We need to make banks viable again without state support and to re-invigorate competition in the Single Market," stated Competition Commissioner Neelie Kroes in announcing the guidelines.



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Effectiveness of the EU policy response

The various policy measures implemented thus far have been highly effective in averting a complete meltdown of the financial system and in restoring the normal functioning of markets. A full return to pre-crisis levels, however, is unlikely in the short- to medium-term for two reasons. First, risk perceptions prevailing before the crisis were relatively low, and it is unlikely that the situation will revert to pre-crisis conditions. Second, the economic outlook has deteriorated considerably, and softness in the real economy is certain to impact financial activity.

Despite these caveats, the financial picture has improved. As a result of the banking rescue packages implemented in the third quarter of 2008, the balance sheets of EU banks are now stronger. As noted in DG ECFIN's *Quarterly Report on the Euro Area*, banks' capital and reserves increased by more than 4% in the period from July 2008 to March 2009. Debt financing conditions have also improved on the back of public debt guarantees. Net issuance of debt is broadly back to pre-crisis levels. Similarly, interbank interest rate spreads have narrowed, falling 70% from their peak in October 2008. This signals a gradual decline in risk aversion and counterparty risk, as well as a tentative recovery in expectations concerning bank profitability. Despite this good news, bank lending to both businesses and households has decelerated, because of weakening demand for credit as well as tighter credit conditions and more costly financing.

Next steps

Although progress has been made, the task of re-establishing the viability of the EU banking sector is not yet completed. Banks are not yet able to properly perform their function as lenders to the real economy. They are still highly leveraged and concerns about the quality of their assets remain. Short- to medium-term prospects for economic growth depend on public support for bank restructuring, and restoring the viability of individual financial institutions. At the same time, proper sequencing and clarity regarding exit strategies is essential. "Rather than being about exact timing, the point of an exit strategy is to clarify the direction of future policy and the conditions for its implementation," says Sean Berrigan, Acting Director for Macrofinancial Stability at DG ECFIN. A clearer policy roadmap would reduce uncertainty and risk, and bring the crisis to an earlier resolution. ●

Further information

• DG ECFIN and the financial crisis:
http://ec.europa.eu/economy_finance/focuson/focuson13254_en.htm

• The European Commission and the financial crisis:
http://ec.europa.eu/financial-crisis/index_en.htm

No continent is an island:
Addressing global macroeconomic imbalances

The crisis shows that major economies of the world are highly interdependent. While not the direct cause of the banking crisis and subsequent recession, global macroeconomic imbalances were a contributing factor. A new framework for macro-financial surveillance must be built at the international level and the role of the IMF, the Financial Stability Board and other international organisations should be reinforced.

If nothing else, the unfolding of the financial crisis and global recession proves that the major economies of the world are now highly interdependent. While the global recession was triggered by a banking crisis, macroeconomic imbalances have exacerbated the situation. Moreover, a sustainable and balanced economic recovery will not be possible without addressing these long-term, structural imbalances.

"Global imbalances were always considered to be a risk that could end up in a financial crisis," observes Paul van den Noord, an economic adviser at DG ECFIN, "And the crisis did come– but not in the way we expected. So there is still a risk that global imbalances could unwind in a disorderly manner and produce another crisis or cause international economic stagnation."

Global imbalances

In the years prior to the onset of the financial crisis, the distribution of global demand was highly uneven. This unbalanced demand was reflected in the build-up of large and persistent external surpluses and deficits. Private saving in the United States, in particular, was too low and declining, while saving in other parts of the world was too high. Countries with too high saving typically relied on external demand to sustain export-led growth. An over-reliance on external demand left them excessively vulnerable to external shocks, however.

A likely consequence of the global recession and the financial crisis which triggered it is that private saving will rise in key deficit countries such as the United States. In addition, these countries will need to follow responsible medium-term fiscal policies in order to ensure a medium-term increase in public saving. In turn, surplus countries such as China will either need to boost domestic consumption and demand or face the prospect of lower growth rates. Past policies of competitive non-appreciation of exchange rates and export-led growth can no longer be pursued by individual members of the G20 without having negative consequences for the global economy as a whole. Absent these structural changes, growth in many countries will permanently slow, and global growth will falter. "Essentially, the developing world will have to replace the US as the engine for global demand growth," states van den Noord.

The role of the G20 and international institutions

As it brings together developing, emerging and developed countries that account for 85% of the world economy, the G20 is an important forum for discussing and resolving international economic issues. And, indeed, at the G20 Summit in Pittsburgh in September, world leaders designated the G20 as "the premier forum for our international economic co-operation" which will have important consequences for the international financial architecture. G20 leaders agreed to launch a new Framework for Strong, Sustainable and Balanced Growth. The basic idea is to develop a system of mutual assessments by G20 finance ministers and central bank governors of policy frameworks and their implications for more sustainable and balanced trajectories for the global economy. The IMF will assist this process by providing forward-looking analysis on the policies pursued by individual G20 countries.

In order to further enhance the legitimacy of the IMF, G20 leaders also agreed to give dynamic emerging market and developing economies a greater voice and representation consistent with their greater share in – and responsibility for – the world economy. Ultimately, to better anchor stability in the global system, a new framework for macro-financial surveillance must be built at the international level with a reinforced role for the IMF, the Financial Stability Board and other international organisations.

"At the G20, we are in the process of reforming the system of international economic and financial governance," says Antonio de Lecea, Director for International Economic and Financial Affairs, "in order to prevent financial and economic crises of the magnitude we've seen from ever happening again and to ensure that the world economy returns to, and stays on, a path of sustainable growth."

A stronger voice for the euro area:

The impact of the Lisbon Treaty on EMU

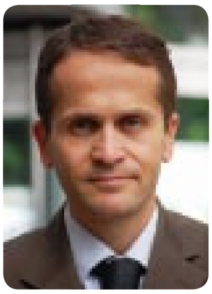
In a referendum held on 3 October, Irish voters approved the Lisbon Treaty by a margin of 67.1 to 32.9 per cent, representing a swing of more than 20 per cent from the outcome registered in June 2008, when an earlier version of the Treaty was rejected by 53.4 per cent. Brian Cowen, Ireland's prime minister, welcomed the results, saying: "Today the Irish people have spoken with a clear and resounding voice. It is a good day for Ireland and it is a good day for Europe." The referendum result greatly improves the chances that the institutional reforms set out in the Lisbon Treaty will come into effect next year. The treaty was signed by the Head of States and Governments in December 2007 and is intended to make the EU "more democratic, more transparent and more efficient". European Economy News interviewed Benjamin Angel, Head of Unit for the economic aspects of regulatory policy in DG ECFIN, to find out how Lisbon will impact EMU.

1. What impact will the Lisbon Treaty have on EMU?

The Reform Treaty will not revolutionise the functioning of the economic and monetary union, but it will bring some concrete, positive and useful improvements. It reinforces the euro area's visibility and its capacity to decide and act autonomously.

The Treaty extends the areas in which Member States not participating in the euro have no voting rights in the Council. This is now the case in all measures relating to the excessive deficit procedure as it applies to euro area Member States. The latter will also vote on a recommendation to the Council on whether a country applying to join the euro may do so.

The important role of the Eurogroup in the euro area's decision-making process is also recognised in a separate Protocol which is annexed to the Reform Treaty. The Protocol confirms the current practice of informal meetings of the euro area ministers in which the Commission participates and to which the ECB is invited. It specifies that the Eurogroup will elect a President for two and a half years. The Reform Treaty also introduces an article which explicitly gives the Council the possibility to adopt measures specific to the Member States of the euro area. The intention is to strengthen the coordination and surveillance of their budgetary policy.



Benjamin Angel, Head of Unit for the economic aspects of regulatory policy - DG ECFIN

2. Does the Reform Treaty change the role of the Commission?

The Reform Treaty strengthens the Commission's role as independent "referee" in relation to economic governance. In the context of multilateral surveillance, the Commission will have the possibility to issue direct warnings to Member States whose economic policies are either inconsistent with the broad economic policy guidelines or risk jeopardising the proper functioning of EMU. Moreover, the Commission will be able to directly address an opinion to the country concerned when it considers that an excessive deficit in a Member State exists or may occur.

3. How will the Reform Treaty facilitate the decision making process?

It will extend the scope of qualified majority voting to new areas (e.g., the appointment of the ECB executive board members) and will bring some improvements to the voting process. The Member State concerned will, for instance, no longer be allowed to vote on Council recommendations and decisions addressed to it (and could not therefore contribute to blocking them).

4. What else will change under the Reform Treaty?

The Reform Treaty will bring two symbolic improvements: the ECB will become an institution and the idea of establishing a *unified* representation of the euro area within the international financial institutions is for the first time clearly stated. ●

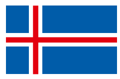
Yes campaigners celebrate the result of the EU Lisbon Treaty outside Dublin Castle on 3 October.

Back from the brink?

Iceland's road to recovery

Iceland's spectacular and sudden economic collapse was the result of macroeconomic imbalances which built-up over time. These were driven by a booming economy and aggressive expansion by Icelandic banks. Iceland's highly leveraged economy was vulnerable to adverse external shocks such as the global financial turmoil. Ultimately, the IMF had to step in to rescue it. The country has stabilised, and has several long-term advantages. Moreover, membership in the EU and adoption of the euro – if they proceed – could provide greater stability. Nonetheless, the future of this remote island nation remains uncertain.

Iceland (Ísland)



Currency: króna (ISK)

Population: 319 368

Real GDP growth rate: -11.6%

Unemployment rate: 5.7 %

Consumer price index: 14.3

General government balance (as % of GDP): -13.5%

Gross external debt (as % of GDP): 150%

Current account balance: -1.1%

Sources: European Commission (2009 spring forecast, DG ECFIN), IMF, Icelandic Ministry of Finance, United Nations World Statistics Pocketbook, Eurostat.

All data are forecast figures for 2009.

In October 2008, just days after the demise of Lehman Brothers, Iceland's entire banking system collapsed, and in the space of just a few days, most of it was taken into public ownership. The immediate cause of the collapse was a sudden loss of confidence by international financial markets. Investors stampeded to sell their stakes or short the Icelandic króna. Asset prices plummeted. The króna depreciated by more than 70% and Iceland's stock market fell by 80%. In response, the Icelandic government developed the programme of measures that is now supported by an IMF Stand-By Arrangement.

Despite these efforts, the crisis spread rapidly to the real economy. Domestic demand declined sharply in 2008 and is forecast to decline further due to very high interest rates and the collapse of private consumption. Incomes are under pressure and pensions are facing cuts. Moreover, unemployment increased within months to 4% in December 2008 and is expected to top 6% in 2010. Inflation peaked at over 18% in December 2008 and is expected to remain high in 2009 before easing towards the end of 2010. Monetary policy has been tight and interest rates shot up to 18% in the first half of 2009 before easing to around 12%.

How did it come to this?

"Iceland's sudden economic decline was several years in the making", explains Loukas Stemitsiotis, head of the unit in DG ECFIN dealing with the EFTA countries. A long, foreign-funded boom led to overstretched private sector balance sheets and a large share of foreign exchange-linked and inflation-indexed debt. Meanwhile, Iceland's banks relied on ample foreign funding to rapidly expand abroad. Banks' accumulated assets amounted to almost 900% of GDP by the end of 2007. Expenditures on interest and dividend payments on its growing foreign debt and investment flows put the small Nordic nation in an untenable position. Moreover, strong economic growth and the explosion in domestic demand led to a severe deterioration in net exports. As a result of this combination of factors, the Nordic nation's balance of payments deteriorated, and gross external indebtedness reached 650% of GDP by the end of 2008. The highly leveraged economy became vulnerable to adverse external shocks such as the global financial turmoil. With the precipitous fall of the króna at the end of 2008, Iceland could not bear the cost of servicing its mostly private sector debt and the banking sector collapsed.

People take to the streets of Reykjavik on 8 November 2008 to protest against the government's handling of the crisis.

Rescue and the agreement with the IMF

On November 19, 2008, the IMF Executive Board approved a two-year Stand-By Arrangement (SBA) with Iceland in the amount of SDR[1] 1.4 billion (US$ 2.1 billion). The remainder of Iceland's financing need is to be met by other official institutions. The Commission is considering proposing MFA assistance in the order of 100 million euros.

A major roadblock to EU and IMF assistance seemed to be removed when Iceland reached agreements with the UK and the Netherlands in June on the reimbursement of amounts owed to foreign savers with Icelandic accounts (specifically the "Icesave" accounts). The agreements were approved by Iceland's parliament after protracted negotiations and with two preconditions. The first stipulates that the state guarantee is valid only until the year 2024, even if the loan has not been fully repaid by that time. The second precondition

[1] Special Drawing Rights.

links repayment to economic growth. The bill also gives parliament a mandate to cancel the agreements if the Dutch and the British do not agree to the preconditions. Iceland will begin repaying £2.3 billion ($3.7 billion) to Britain and 1.3 billion euros ($1.7 billion) to the Netherlands from 2016, with payments spread over nine years. As the European Economy News goes to publication, the conditions set by the Icelandic Parliament still need to be agreed by the UK and the Netherlands. Conclusion of the deal would clear the way for release of $4.6 billion in promised bailout funds from the IMF and Nordic countries.

Banking sector restructuring

Another challenge on Iceland's road to economic recovery is banking sector restructuring. Iceland's government decided to separate nationalised banks into new and old banks. The new banks will take over domestic operations and will be privatised over time. The old banks will take over all external liabilities and assets and will be liquidated in due time. Most creditors are stuck in the bankrupt "old" banks, but they will receive any surplus value from the new banks, once the government is reimbursed, in the form of bonds or shares. The government also announced this summer that it would inject $2 billion of capital into the "new" domestic banks.

Outlook

The outlook for Iceland is unclear. On the positive side, Iceland's economy boasts several strengths. Public finances have been sound and the country has a fully funded pension system. The labour force is relatively young, with 64% of the population aged between 16 and 65, which makes Iceland the country with the youngest population in Europe. In addition, people typically only retire around the age of 70. The economy has also become more diversified. Aluminium exports, for example, now represent close to 9% of GDP, and capacity could be expanded.

Iceland has now moved into a period of macroeconomic adjustment that could ultimately return the country to economic health. GDP growth is expected to decline significantly to -11.6% in 2009 but bounce back in 2010. By the end of 2009 the private sector external debt burden could be significantly reduced after the bank restructuring, and gross external debt should be reduced to around 150% of GDP.

Inflation is expected to slow in 2009 and 2010. The current account deficit declined significantly in 2008 and will continue to do so in 2009 and remain low in 2010.

Despite these promising developments, however, several dark clouds loom on the horizon. First, the freeze on mortgage repayments is due to end in November. Payments on mortgages that are denominated in yen or Swiss francs will double, and króna mortgages face big increases in payments because they are tied to the consumer price index. Second, government spending is due to be cut by 20-30% later this year, and a wide range of taxes will be raised to try to eliminate the budget deficit by 2013. The Icesave debt alone could amount to 50% of the country's GDP. Third, capital controls are to be eased, but at the cost of maintaining high interest rates which stifle investment. In the worst case, the country could still default on its debt.

An EU escape?

On 16 July, Iceland's parliament voted by a slim margin of 33 to 28 to apply for membership in the EU. Membership – and adoption of the euro in particular – would provide more stability and a buffer against external macroeconomic shocks. It would have to be approved by a referendum, however, and recent opinion polls show that only 38% of Icelanders are in favour of EU membership, down from 52% last October. The main sticking point is the EU's common fisheries policy, which would give other EU members access to Iceland's fishing grounds.

While adopting the euro might be beneficial for a small, open European economy such as Iceland's, it would not solve the country's macroeconomic problems. The current macroeconomic situation requires significant adjustment measures, whether in euros or króna. Setting euro adoption as a medium-term target could, however, help anchor expectations and facilitate the macroeconomic adjustment and convergence process.

An end in sight?

The Iceland story is not over yet. Icelandic banks' balance sheets are still fragile and the króna is still vulnerable. Time will tell whether this remote island nation can emerge unscathed from its recent turmoil.

In brief

G20 becomes the premier international economic forum

Meeting in Pittsburgh on 24-25 September, world leaders designated the G20 as "the premier forum for our international economic co-operation." They also agreed to avoid the premature withdrawal of stimulus measures yet plan their exit strategies. The G20 leaders endorsed proposals previously agreed by G20 Ministers of Finance in London on 4-5 September, which included a global framework for bank capital rules, under which banks will face higher capital requirements, and proposed guidelines on banker pay.
http://www.g20.org/

Commission proposes to strengthen financial supervision in Europe

On 23 September, ahead of the G20 Pittsburgh summit, the Commission formally adopted a proposal to create a central system of financial market supervision. This will comprise two umbrella bodies, the European Systemic Risk Board (ESRB), an early-warning system in charge of assessing potential threats to financial stability, and the European System of Financial Supervisors (ESFS), a network of national supervisors working together with three new European Supervisory Authorities to safeguard the financial soundness of individual financial firms The two bodies were recommended by the de Larosière report last February.

Latest forecast sees recession ending but uncertainty high

The Commission's latest interim forecast, published by DG ECFIN on September 14, left GDP growth projections unchanged at -4% for 2009 in both the EU and the euro area, following a worse-than-expected outcome in the first half, but a more promising outlook for the second half of the year. The new figures are based on updated projections for France, Germany, Italy, the Netherlands, Poland, Spain and the United Kingdom, which together account for about 80% of the EU's GDP. "The situation has improved," said Commissioner Joaquín Almunia, "but the weak economy will continue to take its toll on jobs and public finances."

DG ECFIN's 6th Annual Research Conference: Crisis and reform

At DG ECFIN's 2009 research conference on 15 and 16 October an array of European and international speakers such as Willem Buiter (LSE), Allan Drazen (University of Maryland), Charles Goodhart (LSE), Axel Leijonhufvud (UCLA) and Marco Buti (DG ECFIN) sought insights into the interplay between political and economic issues in the reform process, the pros and cons of proposals for reforming financial systems in the light of lessons from the current crisis, and the challenges that the crisis is posing to classical economic thinking on market behaviour.

Quarterly Report on the Euro Area evaluates signs of recovery and impact of the crisis on trade

DG ECFIN's latest Quarterly Report on the Euro Area was released on 8 October. In addition to evaluating the incipient signs of recovery, it discusses the impact of the crisis on global current-account imbalances, proposes a novel econometric analysis of the interrelations between housing, credit constraints and consumption and presents a new methodology to estimate potential output in the euro area. A focus section looks into the impact of the crisis on trade.

IMF and World Bank annual meetings look at the impact of the recession on developing economies

The Annual Meetings of the World Bank Group and the International Monetary Fund bring together central bankers, ministers of finance and development, private sector executives, and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academics to discuss issues of global concern. This year's meetings, held in Istanbul on 6-7 October, focused on how developing countries are coping with the the crisis, and discussed how to help countries hit hard by downturns in capital flows, trade and tourism. Climate change and governance reform were also at the top of the agenda.
http://www.imf.org

Decision makers at Eurofi financial forum discuss future of finance

At the Eurofi financial forum, key decision makers from industry and government, including Commissioner Joaquín Almunia, Jacques de Larosière, Jean-Claude Trichet and many others, discussed initiatives for restoring confidence, preventing future crisis and improving the security and efficiency of financial services in Europe. The international symposium took place in Göteborg on 31 September-1 October ahead of the Eurogroup and the informal ECOFIN Council meetings. It was sponsored by DG ECFIN and organised in association with the Swedish EU Presidency.
http://www.eurofi.net/

Parliament gets new ECON committee members and a new crisis committee

Following the parliamentary elections in June, the EP's standing committee on economic and monetary affairs (ECON), got a makeover with new members and a new chair: Mrs. Sharon Bowles (UK) of the ALDE (liberal) political group.

In addition, a special committee on the crisis was, at the time of writing, expected to be given the go-ahead by Parliament at its 7-8 October mini-plenary. Chaired by Mr Wolf Klinz, a German MEP in the ALDE grouping, it is tasked with looking into the causes of the economic and financial crisis, and will be an important interlocutor for DG ECFIN.

Parliament's ECON committee exchanges views with the Swedish Minister of Finance

On 2 September 2009, Swedish Minister of Finance Anders Borg presented the Swedish Presidency's priorities in the area of Economic and Financial Affairs to the new ECON Committee. In the current economic and financial crisis, "defence line number one" is to improve the supervision of financial markets and to set up European infrastructure in this area, Borg said. He also stressed the need to ensure the long-term sustainability of public finances, and an active labour market policy. MEPs added that the Stability and Growth Pact should be implemented more strictly, prudently, and consistently, and that the EU should speak with one voice at the G20.

Further information

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

Looking ahead

For your diary

November 2009

Autumn economic forecast 3 November

DG ECFIN's next full economic forecast including data for all EU members as well as selected non-EU countries will be published in early November. This will be an important opportunity to gauge the effectiveness of measures to stimulate an economic recovery. The publication of the autumn 2009 economic forecast is to be adapted and extended in several dimensions: it will have a more streamlined, story-telling horizontal forecast chapter, new analytical, horizontal chapters, and a broadened Member-State section using the forecast to highlight each country's economic challenges.


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G20 Finance Ministers Meeting St Andrews, Scotland 7-8 November

G20 Finance Ministers will reconvene in Scotland. Representatives from the International Monetary Fund (IMF), the new Financial Stability Board (FSB) and the Financial Action Taskforce (FAT) will meet with the Financial Ministers.

Summit on the Global Agenda 2009 Dubai, UAE, 20-22 November

The World Economic Forum is forming Global Agenda Councils on the foremost topics in the global arena. For each of these topics, the Forum will convene the most innovative and relevant leaders to capture the best knowledge on each key issue and integrate it into global collaboration and decision-making processes.

Practical preparations for the euro

The Commission will publish the ninth progress report on 'practical preparations for the future enlargement of the euro area'. Many of the newer Member States have still to adopt the euro and join the euro area. In addition to the economic convergence criteria, many practical preparations need to be made for eventual euro adoption. These include legal matters, communication campaigns, and preparations by banks and businesses. To ensure a smooth adoption process, DG ECFIN regularly assesses the preparedness of candidate Member States to adopt the euro on a practical level.

December 2009

"France: weathering the crisis, preparing the future" A DG ECFIN seminar Brussels, 3 December

What reforms are needed to stimulate French growth, improve labour market conditions and boost competitiveness so that the economy can take full advantage of globalisation? To what extent will the French economy be able to benefit from the upcoming global recovery? To what extent will the long-term sustainability of public finances be compromised by the crisis? How can the different components of public spending be curbed to help budgetary consolidation? These and related issues will be discussed by European economists in a one-day seminar on France, hosted by DG ECFIN.

UN climate change conference Copenhagen, 7-18 December

A key issue to be discussed at the Copenhagen conference will be the financing of low-carbon development strategies in developing countries. In September, the Commission proposed a blueprint for scaling up international finance to help developing countries combat and cope with climate change. In October, the Ecofin Council and European Council will further scrutinise the plan, which envisages three sources for the necessary funds: domestic sources (public and – mainly – private investment), an expanded international carbon market, and international finance from public sources.

The fourth issue of the Quarterly Report on the Euro Area 22 December

The fourth issue in 2009 of the Quarterly Report on the Euro Area will focus on the sustainability of public finances in the euro area and on the changing structure of its banking sector.

January 2010

American Economic Association annual meeting Atlanta, Georgia, 3-5 January

The annual meeting of the American Economic Association will address a wide range of topics over multiple sessions and conference tracks. The keynote address will be delivered by Joseph Stiglitz, who will talk about the impact of the economic crisis on economic theory. ECFIN Research Director István P. Székely and Head of the Econometric Models Unit Werner Röger will, along with other ECFIN participants, speak on the subject of Fiscal and Monetary Policy in Emerging Market Economies During Crises on 4 January.
http://www.vanderbilt.edu/AEA/Annual_Meeting/index.htm


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World Economic Forum Annual Meeting 2010 Davos-Klosters, Switzerland, 27-31 January

The recent global economic and financial crisis reveals that significant opportunities remain to catalyse greater global cooperation in addressing current challenges and mitigating future risks. The World Economic Forum's 40th Annual Meeting in 2010 will address this opportunity and, in preparation, the Forum has launched the Global Redesign Initiative, an unprecedented global multi-stakeholder dialogue to help establish processes and structures of global cooperation in the 21st century.

Further information
• A list of the events organised by ECFIN is available at:
http://ec.europa.eu/economy_finance/events/index_en.htm

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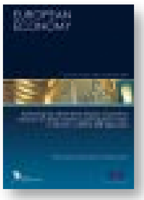
Recent research and analysis by DG ECFIN

European Economy Research Letter

The last issue of the year, scheduled to be published around the beginning of December, will feature reports on DG ECFIN's Annual Research Conference on the subject of 'Crisis and Reform', and the European Research Directors' meeting, hosted by the Commission, that preceded it. Other topics include the report on Economic crisis in Europe: causes, consequences and responses (published by DG ECFIN as European Economy 7/2009 on 14 September) and bond spreads.



Economic Papers

The European Economy Economic Papers provide economic research with an analytical focus that is relevant to the European Union. The research is conducted by staff of the DG, sometimes in cooperation with external researchers.

- Assessing the short-term impact of pension reforms on older workers' participation rates in the EU: a diff-in-diff approach
- The diffusion/adoption of innovation in the internal market
- Lessons for China from financial liberalization in Scandinavia
- Gauging by numbers: A first attempt to measure the quality of public finances in the EU
- The euro and prices: changeover-related inflation and price convergence in the euro area

Occasional Papers

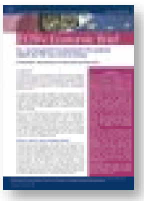
The European Economy Occasional Papers provide economic research with a policy focus that is relevant to the European Union. The research is conducted by staff of the DG, sometimes in cooperation with external researchers.

- An analysis of the efficiency of public spending and national policies in the area of R&D
- Economic performance and competition in services in the euro area: policy lessons in times of crisis
- 2009 Economic and Fiscal Programmes of potential candidate countries: EU Commission's assessments
- The EU's response to support the real economy during the economic crisis: an overview of Member States' recovery measures
- What drives inflation in the New EU Member States? Proceedings of the workshop held on 22 October 2008
- Impact of the current economic and financial crisis on potential output

Country Focus series

The Country Focus series covers topical economic issues affecting one or more Member States. This series is published online only.

- UK public finances and oil prices: tax bonanza from black gold?
- Estonia: Analysis of a Housing Boom
- External imbalances of the Greek economy: the role of fiscal and structural policies: The composition of government revenues, 2002-2008



Economic Briefs

Economic Briefs showcase new policy-related analysis and research by DG ECFIN staff on a variety of topics. This occasional series is published online only.

- At a turning point? Assessing the first positive signals for the euro-area economy
- The financial crisis and potential growth: Policy challenges for Europe
- Beyond the crisis: a changing economic landscape keynote speeches at the Brussels Economic Forum 2009

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

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