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Annual Report on the Euro Area – 2009

EUROPEAN ECONOMY 6/2009

ABBREVIATIONS

Member States

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EA-16	European Union, Member States having adopted the single currency (BE, DE, EL, SI, SK, ES, FR, IE, IT, CY, LU, MT, NL, AT, PT and FI)
EU-10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EU-15	European Union, 15 Member States before 1 May 2004 (BE, DK, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI, SE and UK)
EU-25	European Union, 25 Member States before 1 January 2007
EU-27	European Union, 27 Member States

ABBREVIATIONS

Other abbreviations

AIFM	Alternative Investment Fund Managers
CDO	Collateral Debt Obligation
CFCI	Composite Financing Cost Indicator
CRD	Capital Requirements Directive
EA	Euro Area
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	European Council of Economics and Finance Ministers
EDP	Excessive Deficit Procedure
EERP	European Economic Recovery Plan
EESC	European Economic and Social Committee
EGF	European Globalisation Fund
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESA	European Supervisory Authority
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESI	Economic Sentiment Indicator
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ESRC	European Systemic Risk Council
Eurostat	Statistical Office of the European Communities
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
SCP	Stability and Convergence Programme
MDB	Multilateral Development Bank
MiFID	Market in Financial Instruments Directive
MTO	Medium-term Budgetary Objective
NAB	New Arrangements to Borrow
NFA	Net Foreign Assets
PBoC	The People's Bank of China
PPP	Public-Private Partnership
QPF	Quality of Public Finances
R&D	Research and Development
REER	Real Effective Exchange Rate
SDR	Special Drawing Rights
TARP	Troubled Asset Relief Program
TEN-T	Trans-European Network Programme
ULC	Unit Labour Costs
VAT	Value Added Tax

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Part I

Annual Statement on the Euro Area – 2009

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN CENTRAL BANK
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http://ec.europa.eu/economy_finance/thematic_articles/article15859_en.htm

1. THE EURO AREA ECONOMY IN 2009

In the wake of the shockwaves of the worst crisis since the 30s, signs of economic stabilisation are emerging. Throughout the world, important policy interventions have succeeded in achieving a degree of stability in the financial system. Financial conditions have improved over the summer, with several financial indicators returning to pre-crisis levels. Business and consumer confidence indicators also have improved in recent months. World trade has stabilised, and there are indications that the destocking cycle is bottoming out. The relative resilience of consumption has proved to be a stabilising factor during the recession, as disinflation and relief measures included in fiscal stimulus packages have supported household incomes.

According to the latest interim forecast published by the Commission services in September 2009, growth in the euro area is set to fall by 4% in 2009, unchanged from the Spring 2009 forecast. The stronger than expected contraction in activity in the first quarter was compensated for by a faster than projected stabilisation in the second quarter, especially in Germany and France.

However, the strength and resilience of the recovery has yet to be fully tested. While banks are in the process of strengthening their solvency ratios, helped by the accommodative stance of monetary policy and rescue packages, the stabilisation in financial markets has yet to yield concrete outcomes for credit distribution to the economy, which has decelerated considerably throughout the first half of 2009. Deteriorating employment prospects are another source of uncertainty and concern. On the positive side, the considerable amount of policy-induced stimulus that is still in the pipeline should not be overlooked. Overall, the sustainability of the recovery is yet to be tested.

The euro has acted as a valuable shield in the crisis. The euro has efficiently shielded the euro area from the exchange rate and interest rate turbulence that had proved so damaging for Member States in episodes of financial market stress in the past. It has also played a valuable role as an anchor of sound macroeconomic policies for Member States actively pursuing the adoption of the euro, or whose currencies are linked to the euro. Finally, the capability of the euro area to act swiftly in co-ordination with other central banks has contributed to the stability of the entire international monetary system.

The financial crisis has increased the attractiveness of the euro for non-euro area Member States. In particular, two potential benefits of euro membership have come to the forefront: first, it would eliminate the risk of sudden and disruptive exchange rate movements; and, second, it would grant domestic institutions access to euro central bank liquidity. At the same time, however, the crisis has shown that the euro does not solve all economic challenges - in particular challenges related to internal and external imbalances, as demonstrated by the fact that some euro area countries with imbalances have been hard hit. This experience confirms the rationale for achieving a high level of sustainable convergence prior to euro adoption, as required by the Treaty. Euro-candidate countries should equip their respective economies for life in the euro by means of policies to strengthen fiscal discipline, prevent macro-financial imbalances, and foster productivity, competitiveness and ultimately their adjustment capacity within EMU.

But the crisis is amplifying some challenges in the euro area. The crisis is weighing on the sustainability of public finances and potential growth. Furthermore, while the adjustment induced by the crisis is helping to reduce some imbalances within the euro area, there is a risk that divergences in competitiveness positions will increase again if policy action is not appropriately co-ordinated.

As a consequence of the steep fall in revenues, fiscal stimulus measures under the European Economic Recovery Plan (EERP) and the operation of automatic stabilisers, government balances have deteriorated sharply. Thanks to effective policy action since autumn 2008, coordinated in the context of the EERP, a financial meltdown and a generalised loss of confidence has been avoided. Fiscal policymaking has been successfully targeted to the need and urgency of pulling the economy out of the recession. Discretionary fiscal stimulus and unfettered automatic stabilisers have provided a cushion to economic activity and contributed to the recent signs of improvement, but have led to a substantial deterioration in government accounts. Rising budget deficits and low or negative growth, as well as the support being given to the banking sector, are feeding into significantly higher public debt levels. The average euro area budget deficit is now expected to increase from 2% of GDP in 2008 to over 5% of GDP in 2009. On the basis of current plans and projections, the euro area deficit will further increase to 6½% of GDP in 2010, while public debt could reach 84% of GDP by 2010, i.e. an increase of 18 percentage points from 2007. In 2009, with the possible exceptions of Cyprus and Luxembourg, almost all euro area Member States will post budget deficit ratios above the 3%-of-GDP threshold, with some countries exceeding the benchmark by a large margin. In the first half of 2009 and on the initiative of the Commission, the Council opened Excessive Deficit Procedures (EDPs) for Greece, Ireland, France, Malta and Spain on the basis of a breach of the reference value in 2008 (2007 for EL)[1]. The Commission proposes today that the Council open EDPs for countries which are expected to breach the reference value in 2009. The flexible application of the Excessive Deficit Procedure permitted under the Pact provides important support and direction for Member States in these difficult circumstances. As a result, budgetary consolidation paths recommended under the EDPs have been largely set in a medium-term perspective and, depending on circumstances of individual countries, longer deadlines have been recommended for correction of the excessive deficits.

The crisis may accelerate downward pressures on trend growth. The Commission had projected that potential GDP growth in the euro area would fall in the long run due to the ageing population. A number of crisis-related factors may amplify this phenomenon. First, unemployment, if protracted, would entail a prolonged, perhaps permanent, loss of valuable skills. Second, the stock of equipment and infrastructure will decrease and may become obsolete due to lower investment and sectoral change. Third, innovation may well be hampered as research and development spending are usually among the first outlays that businesses cut during a recession. Higher risk premia may make the financing of R&D more expensive in the future. The loss in potential growth is expected to be higher in countries experiencing deep recessions.

The reduction of divergences within the euro area in the immediate aftermath of the crisis is welcome. In the immediate wake of the financial crisis, growth took a dive in all euro area countries, but to differentiated extent. The Commission services interim forecast shows that growth trajectories are beginning to fan out within the euro area. For example, growth in 2009 has been revised upwards for Germany and France, while Italy and Spain recorded downward revisions. As for divergences in current accounts, the ongoing housing market correction and its impact on domestic demand is likely to go some way towards reducing disparities, a welcome step towards more balanced growth patterns. However, the convergence is moderate and is not consistent among the euro area Member States.

2. IMBALANCES ACCUMULATED IN THE PAST RENDERED SOME EURO AREA MEMBER STATES MORE VULNERABLE WHEN CRISIS STRUCK

The crisis shone a spotlight on some pre-crisis imbalances. At a global level, the speed and intensity of the contagion from the Lehman Brothers bankruptcy came as a surprise. The collapse in demand and GDP in some euro area Member States has been just as deep as in other, potentially more exposed, economies. While the global, interconnected nature of the banking and financial system largely accounts for the contagion, the difficulties experienced by some Member States have underscored a number of vulnerabilities within the euro area itself.

Accumulated intra-euro area imbalances exposed some economies, more than others, to shocks. Benign macroeconomic conditions characterised by strong macroeconomic growth, low rates of inflation, compressed interest rates and low levels of financial market volatility led economic agents to greatly

[1] All the relevant documents regarding the EDP procedure are available at: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2

underestimate some of the risks inherent in the financial system at the global level and facilitated the expansion of credit worldwide. In some euro area Member States, the same benign economic environment also allowed the financing of fast growth at the expense of the accumulation of large current account deficits (primarily EL, ES, PT and CY, but also IE, MT, SI, SK), while other Member States ran ever-higher current account surpluses (DE, LU, AT, NL, FI). Within the euro area, the dispersion of current account balances between these two groups had steadily increased since the mid-1990s and reached an all-time high just before the crisis. From a balanced position in 1999, surpluses steadily accumulated and reached 7.7% of GDP in 2007, while aggregated deficits rose from 3.5% of GDP in 1999 to 9.7% in 2007.

In countries in deficit, the divergence trend reflected the build-up of domestic imbalances. They materialised through excessive domestic demand pressures, a surge in house prices and a bloated construction sector. This was especially patent in Ireland, Spain and Greece, which consistently recorded higher growth and inflation than the rest of the euro area during the decade. High current account deficits – and associated foreign capital inflows – are warranted in a catching-up scenario insofar as they enable an economy to increase its capital stock and prepare the ground for sustainable medium-term growth prospects. However, capital has not always been channelled to its most productive uses in deficit countries. As a result, a significant share of the labour force was attracted to high cyclical sectors, such as construction, which now requires substantial adjustment.

Conversely, countries in surplus capitalised on their traditional strengths, with a growth model centred on their already-competitive export sector. In these countries the engine of domestic demand never really kicked in to take over the export engine. The impact of the crisis revealed the vulnerability of this growth model to fluctuations in global demand, with implications for growth in the euro area as a whole.

Another source of imbalances lay in the rapid growth of the financial sector. Ireland has been a textbook case, as the share of the financial sector in total value-added made up 10.6% in 2007, compared with only 5% on average in the euro area. Following the crisis, ballooning impaired assets weakened the banking sector and put public authorities, acting as the lender of last resort, under pressure.

Such imbalances explain why the crisis has hit some Member States harder than others. Since the large external liabilities increased exposure to financial shocks, deficit countries suffered from reduced risk-appetite on financial markets. The adjustment of bloated construction sectors has also weighed heavily on growth and employment from the very beginning of the crisis. In parallel, countries in surplus were hit almost immediately by the fall in global demand and saw growth drop sharply. Countries with larger banking sectors are at risk of incurring significant fiscal liabilities. Overall, Member States pursuing unbalanced growth models have suffered particularly severe economic contractions.

The impact of the crisis demonstrates the need for action. While these imbalances and their associated risks had been identified for several years, their resolution has been long overdue as policymakers in Member States largely ignored these imbalances in good economic times. They should not be ignored any longer.

3. UNFINISHED BUSINESS ALSO HAMPERED THE EURO AREA'S CAPACITY TO RESPOND TO THE CRISIS

Deeper financial integration in the euro area was not matched by a parallel strengthening of supervisory arrangements. Existing supervisory arrangements failed to promote a common supervisory culture, to apprehend the systemic linkages between financial markets and the real economy and to provide a resilient framework for a speedy and co-ordinated response when the crisis started. Initial responses were disjointed and largely shaped by domestic considerations. For instance, initiatives on deposit guarantee schemes and the emergency de-consolidation of a large cross-border financial institution paid testimony to the absence of workable crisis management procedures. The first Eurogroup summit at the level of Heads of State and Government, held in Paris in October 2008, helped to catalyse the EU response.

The Commission has acted effectively to fill this gap. It provided a common framework for the implementation of national banking rescue plans, in line with state aid rules, benefitting also from ECB support. Since then, following the conclusions of the Larosière Group, the Commission has presented its formal legal proposals for new European financial supervision architecture. The proposals aim to strengthen the prudential oversight of both individual financial institutions and the financial system as a whole. In parallel, the EU is at the forefront of the regulatory reform of financial markets, shaping the initiatives and commitments of the G20.

While the fiscal house was mostly in order when the crisis struck, some Member States had limited room to respond to the crisis. After several years of broadly successful fiscal consolidation in line with the recommendations of the Stability and Growth Pact, most Member States in the euro area were in a much better position to weather the crisis than they were before. Fiscal consolidation was unfinished business in some euro area countries, however, despite the good economic times. Public debt levels remained high in Greece, Italy and Belgium, while fiscal consolidation was slow and indecisive in France, Greece and Portugal. In other countries, public finances became dependant on fiscal revenues either from the financial sector or the real estate boom whose slump added to the deterioration of public finances and greatly diminished the fiscal room for manoeuvre available to counteract the effects of the crisis. Consequently, several Member States had to limit or withhold their contribution to the joint fiscal stimulus as laid out in the European Economic Recovery Plan. If consolidation had been achieved, the euro area's fiscal response could have been even more decisive.

Globally, euro area governments did their fair share in the concerted global effort to sustain demand within the EU-wide coordinating framework of the European Economic Recovery Plan (EERP). They have deployed a broad range of sizable fiscal and structural policy measures. The overall fiscal support amounts to about 4.6% of euro area GDP (about 5% for the EU as a whole); it includes the effects from automatic stabilisers and the combined discretionary fiscal stimulus of Member States over 2009 and 2010 in the magnitude of 1.8% of euro area GDP. Of the 590 national measures reported by euro area Member States, 22% are geared towards boosting the purchasing power of households, including the most vulnerable; 25% buttress investment; 32% provide sectoral or company support; and 21% are earmarked to improve the functioning of labour markets. According to the Commission's June 2009 assessment, most measures are timely and well-targeted, in line with the EERP principles. However, doubts about the reversibility of certain measures are a cause for concern as they may make expansionary policies less effective.

The aggregate impact of the euro area economic policy response could have been faster and perhaps stronger if co-ordination had started earlier and been more comprehensive. While co-ordination matters for the EU as a whole, it is particularly important for euro area Member States given their close economic and financial inter-linkages and the fact that they share a common currency and a single monetary policy. Overall, the established mechanism of policy co-ordination within the euro area did not work well in the crisis. Working on this evidence, the Eurogroup committed itself to improving the co-ordination of the implementation of national recovery measures in order to avoid unintended negative spill over effects and to fully implement the surveillance framework defined by the Stability and Growth Pact. More than ever, the euro area should exert leadership in these testing times.

4. THE WAY FORWARD: ENSURING EFFICIENT INTERNAL ADJUSTMENT AND SUSTAINABLE GROWTH IN A CHALLENGING ENVIRONMENT

The crisis has clearly demonstrated the urgency for euro area Member States to make rapid progress on the EMU@10 reform agenda: broadening and deepening macroeconomic surveillance. A well-functioning EMU is a major asset for the EU as a whole. In its EMU@10 communication[2] in May 2008, the Commission proposed a three-pillar agenda to improve the functioning of EMU in the face of a rapidly changing global environment, ageing populations and rising concerns about energy and climate change. The domestic agenda called for macroeconomic surveillance in EMU to be broadened beyond fiscal policy to include macro-financial stability aspects and competitiveness trends, as defined in the context of the Lisbon Strategy for Growth and Jobs, and to ensure better integration of structural reform in overall policy co-ordination within EMU. It also called for the deepening of fiscal policy co-ordination and increased surveillance. The external agenda of EMU@10 argued that the euro area should play a more important role in global economic governance. The crisis highlighted the need to forcefully implement this reform agenda.

Broader macroeconomic surveillance is urgently needed to spur a co-ordinated policy response to the competitiveness challenge. Resolute and urgent policy actions need to be taken as structural divergences have the potential to undermine the cohesiveness of the euro area. Despite repeated warnings, imbalances within the euro area were not treated at a time when economic conditions were favourable. Now, the crisis is forcing an adjustment of current account balances the hard way, through a collapse in domestic demand and sharply rising unemployment. This is most notably - but not exclusively - the case in countries in deficit, such as Spain and Ireland. Moreover, the rebalancing of competitiveness trends risks being more protracted in view of: (i) the global nature of the crisis, which impairs an export-led strategy; (ii) lower potential growth, which limits the room available to rebalance accumulated wage and cost divergences; (iii) and the fact that, as the recovery firms up, countries experiencing weak growth may face higher real interest rates than the rest of the euro area. In an effort to broaden macroeconomic surveillance, the Eurogroup agreed in 2008 to regularly review intra-euro-area competitiveness trends and to encourage Member States to take action to adjust. Addressing the underlying causes of harmful competitiveness developments in the euro area is a matter of common concern and must be an integral part of the area's exit strategy.

The broadening of surveillance should also incorporate financial market developments in earnest. Over-indebtedness in the private sector led to unsustainable economic trends. Such financial imbalances should be detected and dealt with at an early stage. The EMU@10 communication stressed that 'while market integration, particularly in financial services, is beneficial overall for EMU, it can also, if not accompanied by appropriate policies, amplify divergences among the participating countries'. The crisis demonstrates how fast financial shocks can hit the real economy and how strong feedback loops are. In addition to the broadening of macroeconomic surveillance to intra-area competitiveness developments, the early detection of asset price booms appears essential to avert costly corrections of fiscal and external imbalances at a later stage.

Surveillance should be deepened to ensure sustainable public finances. In the wake of the crisis, the combination of low growth and accelerating debt risks putting public finances in a precarious situation, just when the impact of ageing is starting to set in. If policies are unchanged, public debt in the euro area is projected to reach 100% of GDP in 2014. As part of a deeper fiscal co-ordination in the euro area, a firm commitment is needed for a fiscal strategy that can appropriately balance stabilisation and sustainability considerations in line with the Stability and Growth Pact. With a view to ensuring a consistent set of fiscal policies for the euro area, the euro area Finance Ministers agreed in June 2009 on terms of reference to provide orientations towards the formulation of government budgets for 2010 (Mid-

[2] 'EMU@10: success and challenges after 10 years of Economic and Monetary Union' Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank - COM(2008) 238, 7.5.2008.

Term Budgetary Review). Notably, they decided that as soon as the recovery takes hold, and the risks of an economic relapse diminish further, the balance of fiscal policies should shift to consolidation. Also, they agreed that the pace of fiscal consolidation should be differentiated across countries, taking into account not only the pace of the recovery, fiscal positions and debt levels, but also the projected cost of ageing, external imbalances and risks in the financial sector.

Consolidation should also enhance the quality of public finances and stem the debt increase while contributing to long-term growth, by consolidating non-productive expenditures and strengthening incentives for raising the productive capacity of the economy. In addition, domestic fiscal frameworks need to be strengthened and made more conducive to effective consolidation in good times. Overall, a lesson from the crisis is that macroeconomic surveillance should consider sustainability as a cornerstone for elaborating economic strategies.

Co-ordination across policies and Member States should be enhanced to permit judicious exit strategies. Credible and well-coordinated exit strategies are particularly relevant for the euro area to ensure sustainable growth and avoid that potential growth trajectories fan out when the economy gains strength again. Co-ordination should essentially take the form of common understandings on the appropriate timing, pace and sequencing of normalisation of policy settings. Eventual withdrawal of fiscal stimulus and business support measures, accompanied by the formulation of credible fiscal consolidation and structural reform plans, would improve the outlook for price stability and hence facilitate the conduct of monetary policy. Rapid progress on financial repair would be essential to ensure that the banking system does not act as a drag on the recovery and the price stability objective of monetary policy does not enter into conflict with the financial stability objective. Differentiated policy responses will need to be incorporated in national exit strategies so as to achieve the best global output. In line with the Council recommendations to the euro area in the context of the Lisbon strategy, progress is needed on the implementation of reforms that enhance potential growth and facilitate adjustment to shocks.

Lessons learned for governance. The crisis underscored the need to reinforce the framework for euro area surveillance and governance. In its 2008 EMU@10 communication, the Commission had already underlined the need for euro area Member States to show clearer political will and leadership to turn common understanding into concerted policy action, calling for true ownership of the Eurogroup by Member States as a policy body for frank discussion and determined action. The Lisbon Treaty provides the necessary platform for the further improvement of economic governance of the euro area. Highlighting the need to develop ever-closer co-ordination of economic policies within the euro area, a new Protocol attached to the Lisbon Treaty gives formal recognition to the Eurogroup and its President. The Lisbon Treaty also strengthens the role of the Commission in the surveillance of the functioning of EMU.

United, the euro area can influence the global agenda. The emergence of the G20 as the forum of choice for the promotion of global economic and financial governance reform raises the stakes for the euro area. In the wake of the crisis, the global economy faces the difficult challenge of managing the transition towards a more balanced and sustainable pattern of growth across the world's major economies. To this end, the enhanced role of global surveillance under the aegis of the IMF is warranted. In this context, the euro area should be considered as a single economic entity, which will continue to grow in importance as new members progressively join. For the euro area to speak with a strong voice at the global level, the EU external representation, particularly within the IMF, needs to be strengthened. Now is the moment, while discussions on quota and representation reform are gaining momentum. This is why the Commission's stance as conveyed in the EMU@10 one year ago is today more relevant than ever.

Part II

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INTRODUCTION

This 2009 issue of the Annual Report on the Euro Area explores in depth the global financial and economic crisis that sprang up in the second half of 2008 and rocked the euro-area economy. The roots of the crisis lay in the gradual building-up of macroeconomic imbalances over the past decade. In a context of ample liquidity combined with insufficient supervisory oversight, loose lending policies laid the groundwork for the emergence of a housing bubble in the US and other advanced economies. Its extent and duration was prolonged by massive flows of capital from emerging market economies with large external surpluses, notably China. Risk became mispriced and leverage increased for all sectors of the economy, be they households, companies or financial institutions throughout the world. Domestic and global imbalances fed each other until breaking point.

Financial markets were at the epicentre of the crisis. From June 2007 onwards, interbank interest rates had been tightening considerably. Increasing insolvencies in US subprime lending shattered trust in sophisticated structured products. Financial institutions became saddled with illiquid holdings in their portfolio and were increasingly reluctant to lend to each other. The funding of several institutions with risky business models became compromised. Northern Rock, Bear Stearns, Freddy Mac, monoline insurers, and AIG made the headlines in quick succession, while generalised losses began percolating into balance sheets through regular quarterly reporting of financial institutions.

On 15 September 2008, the investment bank Lehman Brothers filed for protection in the largest US bankruptcy case in history. The Lehman bankruptcy saw the collapse of a financial institution deemed 'too big to fail'. In the aftermath, interbank markets essentially froze, and banks became almost completely reliant on central bank support for short-term financing. The European Union and the euro area were not spared, with some large financial conglomerates on the verge of default. In October 2008, exceptional measures in the EU, spearheaded by euro-area governments, prevented a collapse of the banking system. Still, confidence was at an all-time low.

The real economy bore the brunt of the financial crisis during the fourth quarter of 2008. Business surveys, closely followed by hard indicators, such as industrial production and external trade, tumbled to historic lows all around the world. The spectre of a negative feedback loop between banks and the real economy seemed to materialise. It implied that an additional wave of loan losses from companies and households hit by the global recession had the potential to aggravate the already-stretched situation of banks' balance sheets.

Although the euro area was not at the origin of the current crisis, it has been hit hard too. First, euro-area banks had purchased asset classes that eventually became subject to impairment. Second, the episode of acute financial stress in the euro area in September and October markedly affected consumer confidence. Third, euro-area exporters, and especially those of investment goods, suffered from the sharp slowdown in world markets. This explains why there are few differences between countries most directly affected by the financial crisis and the euro area as regards current growth prospects. A severe contraction in GDP is projected for 2009, with forecasts pointing to a subdued recovery in 2010.

Although the economic and financial shock was of unprecedented scope, policymakers learnt from the mistakes of the post-1929 period. They quickly introduced measures on an unprecedented scale to prevent the recession from morphing into a protracted depression and to lay the groundwork for economic recovery.

This Annual Report on the euro area encompasses all key aspects of the ongoing economic and financial crisis. Chapter 1 describes how the crisis struck and how the economic situation suddenly changed. Chapter 2 explains the economic policy response in the euro area to the crisis, with particular emphasis laid on the European Economic Recovery Plan (EERP). Chapter 3 reviews the reaction of major non-EU economic powers and the emergence of the G-20 as the critical forum in global economic governance. Chapter 4 reflects on euro-area economic governance in a period of crisis. The overall aim of this report is to shed light on the complex interconnections that sent the world economy into recession and how it affected the euro area. The accompanying Annual Statement on the Euro Area contains ensuing policy considerations.

1. MACROECONOMIC DEVELOPMENTS

1. ***After almost three years of robust growth, economic activity in the euro area weakened in the course of 2008, before entering in the last quarter its worst recession in decades.*** The downturn was characterised by an extraordinarily rapid and large fall in world trade and industrial output as well as business and consumer confidence, amid a rapidly escalating financial crisis. The euro area was not spared. This first chapter provides an assessment of the macroeconomic developments that impacted on the euro area during 2008 and the economic outlook. Section 1.1 sets the scene, describing the economic situation in 2008 and prospects for 2009 and 2010. Section 1.2 takes stock of monetary and financial developments, while fiscal developments are covered in Section 1.3. Labour market developments in the euro area are outlined in Section 1.4. Finally, Section 1.5 analyses competitiveness developments within the euro area.

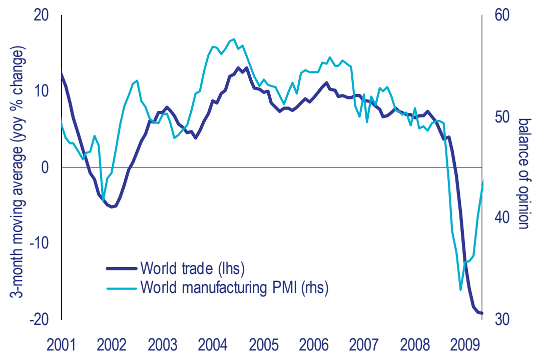
1.1. ECONOMIC SITUATION AND PROSPECTS

2. ***A series of adverse events put a brake on economic activity in the first half of 2008.*** During the first half of 2008 economic activity in the euro area weakened gradually, reflecting an external environment characterised by soaring commodity prices and a deceleration in world growth and trade (following vibrant expansion in 2007), as well as the first repercussions of the financial turmoil. In the second quarter of 2008, output contracted in the euro area for the first time since the early 1990s (-0.3% quarter-on-quarter), in contrast to the robust performance in the first quarter (0.7%).

3. ***Financial distress materialised in September 2008 and sent the global economy into a tailspin.*** The financial market turmoil, which originated in the US subprime mortgage market in the summer of 2007, intensified sharply in September 2008. The main contagion channels to the real economy were severe deteriorations in financing conditions and confidence effects. Disruptions in money markets led banks to tighten lending conditions. As a result, access to trade finance and insurance was curtailed. Pervasive risk-aversion shattered confidence and led to a reversal of international capital flows away from emerging markets.

4. ***The impact of the financial crisis fed almost instantly into the real economy.*** During the fourth quarter of 2008, survey indicators of global economic activity dropped steeply. The OECD leading indicator fell to its lowest level since the mid-1970s. This was mirrored by a precipitous decline in world trade, which dropped by some 6% in the last quarter of 2008, a rate not registered since World War II (Graph 1.1). Industrial production was severely affected as well, with double-digit contractions both in the main industrialised regions and in many emerging-market economies.

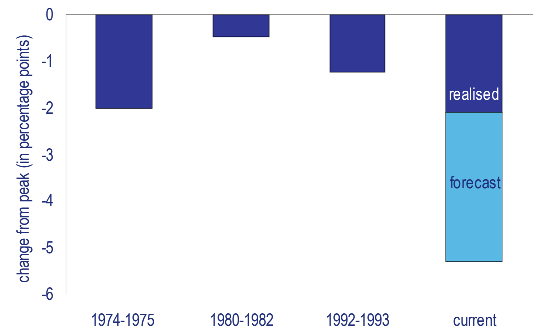
Graph 1.1: World trade and manufacturing Purchasing Managers Index (PMI)



Note: Data for world manufacturing PMI cover the period January 2001 to May 2009
Source: CPB Netherlands Bureau of Economic Policy Analysis, EcoWin, Bloomberg.

5. ***With the external environment deteriorating significantly, economic activity in the euro area fell into recession in the second half of 2008.*** In the third quarter of 2008 GDP contracted for the second consecutive quarter, falling by 0.4% quarter-on-quarter. However, the full impact of the financial crisis began to be felt in the final quarter of 2008, when GDP dropped by as much as 1.8 %. This drop was the steepest in quarterly terms since the beginning of Economic and Monetary Union (EMU). For 2008 as a whole, GDP expanded by just 0.7% in the euro area, a marked deceleration from the previous year (+2.7%). The carryover for 2009 GDP growth as computed at the end of 2008 was strongly negative (almost 1½ percentage points). Overall, the current recession outstrips by a wide margin past recessions in the euro area (Graphs 1.2 and 1.3).

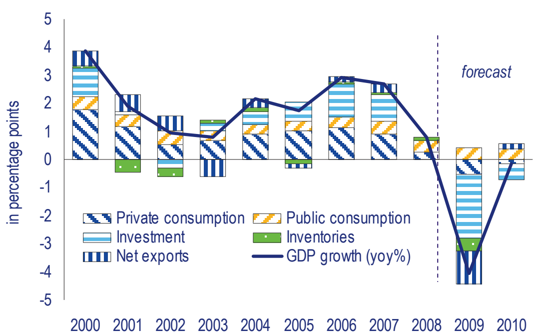
Graph 1.2: **GDP losses across recessions, euro area**



Note: Data on past recessions exclude Slovenia and Slovakia.
Source: Commission services.

6. ***Euro-area exports were hard hit by the global slowdown.*** They fell by more than 7% in the fourth quarter of 2008 (-8% for goods only), the sharpest quarterly contraction ever (data since 1970). With the pace of contraction in exports exceeding that of imports, the contribution of net exports to real GDP became increasingly negative in the second half of 2008, reaching almost a full percentage point in the fourth quarter. The unexpected shock to exports contributed to sizeable involuntary inventory accumulation and translated almost instantly into a steep decline in industrial production (Table 1.1).

Graph 1.3: **Contribution to GDP growth, euro area**



Source: Commission services.

7. ***The ongoing deceleration in construction investment was amplified by the sudden fall in business investment.*** Construction investment decelerated throughout 2008 in response to moderating and, in some cases, falling house prices (see Box 1.1). This was amplified by the slump in business investment in the fourth quarter. The slump in business investment was the response of firms to missing demand and decreasing profits. Capacity utilisation of equipment in place fell to 70.5% in April 2009. It was the lowest rate since the beginning of EU business surveys in 1990. In addition, banks' tighter lending standards have reduced the availability of capital.

8. ***Private consumption growth also turned negative, but only mildly so, in the fourth quarter of 2008.*** Consumption was subdued in the first three quarters of 2008, before falling by 0.4% in the fourth quarter. While nominal compensation remained relatively robust in 2008 (+3.3% year-on-year), the sharp rise in inflation in the first half of the year (peaking at 4% in the euro area in July 2008) depressed real incomes. The subsequent sharp fall in commodity prices led to a reversal of inflation dynamics and allowed households to recover some purchasing power during the summer. However, this was eventually offset by the deterioration in labour market conditions in the latter part of the year. Moreover, households' assessment of their personal financial situation deteriorated during 2008 and in early 2009, mirroring the poor return on investment in financial markets.

Table 1.1: **Industrial production in the euro area (year-on-year change)**

	August 2008	May 2009
Euro area	**-1.9**	**-17.0**
Germany	1.5	-17.9
France	-1.9	-13.8
Spain	-8.4	-20.5
Italy	-3.1	-19.8

Source: Commission services.

9. ***Activity contracted further during the first quarter of 2009.*** GDP dropped by 2.5% quarter-on-quarter, the worst rate of GDP contraction in the post-war era. The contraction was broad-based across euro-area countries. Investment was again one of the main sources of weakness in activity. Gross fixed capital formation fell by 4.1% quarter-on-quarter, subtracting almost one percentage point from GDP growth. Businesses cut their inventories significantly, which reduced growth further by a full percentage point. By comparison, the contraction in private consumption was limited to 0.5% quarter-on-quarter, as both the decline in inflation and measures taken by Member States supported the purchasing power of households.

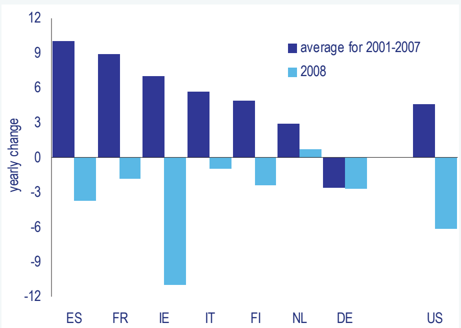
Box 1.1: The housing correction in the euro area

The housing cycle has turned and most euro-area Member States are experiencing price decreases in real estate. The ongoing correction follows nearly a decade of buoyant housing markets in which, driven by low interest rates and –in some cases– dynamic demographics, several EU countries posted double-digit rates of house price increases in real terms for several years in a row. Among the largest countries, France and Spain were in that position from the turn of the century, while Ireland stood out among the smaller countries.

While real house price growth was still positive in the first half of 2008, in the second half it turned negative in most euro-area Member States. In Ireland, real prices declined by about 11% on a year in 2008. This compares with an average annual increase of about 7% between 2001 and 2007. A marked reversal in the dynamics of house prices could be seen also in Spain, Finland and France. Germany is an outlier, given that real house prices remained on a downward trend for most of the last decade.

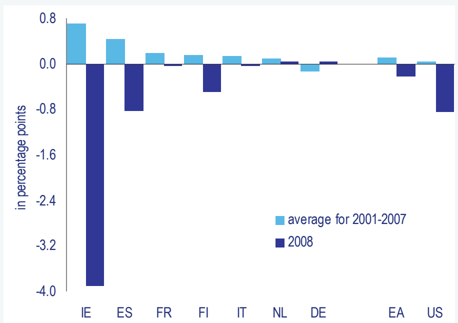
In terms of the contribution of housing investment to GDP growth, the correction appears to be particularly strong in the countries where the downturn in house prices has been most marked in 2008. In Ireland, housing investment subtracted as much as 2.1 percentage points from GDP growth in the first half of 2008, against an annual positive contribution of 0.5 percentage point on average between 2001 and 2007. Substantial contractions in housing investment in 2008 were also observed in Spain and Finland. In the euro area as a whole, housing investment subtracted 0.23 percentage point from GDP growth in 2008.

Graph A: Real house prices, selected countries



Source: Commission services.

Graph B: Contribution of housing investment to GDP growth, selected countries



Source: Commission services.

The extent of the correction in house prices will depend, inter alia, on the degree to which house prices are considered to be overvalued. This requires an estimate of an equilibrium house price level, on the basis of its fundamental determinants. Typically such estimates vary depending on the estimation technique used, as well as on the sample, data sources and time period considered. The IMF estimates the average overvaluation by the end of 2008 at about 20-30% in Ireland and the UK, and about 10-20% in Spain, France, Italy and the Netherlands (IMF, World Economic Outlook, 2008). However, the extent of the correction will also depend on the economic environment, the health of the domestic banking system, and economic policy responses. Poor growth prospects and the tightening of credit conditions create a difficult environment for housing developments in 2009 and 2010. Based on developments in 18 countries over a 35-year period, an OECD Study[1] suggests that the average housing cycle lasts about 10 years. During the expansion phase (lasting about six years) real house prices increase on average by around 45%. In the subsequent phase of contraction (lasting around five years), prices correct by about 25%.

(Continued on the next page)

Box (continued)

A more recent study[2] shows that in the aftermath of more severe crises real house price declines average 35% and stretch out over six years. Given that the magnitude of the housing boom in the last years exceeded by far what had been observed in past cycles, the ongoing corrections might be more severe and protracted than before.

[1] Girouard, N., Kennedy M., van den Noord P. and André C., (2006): 'Recent house price developments: the role of fundamentals', OECD Working Paper No. 475, 2006.

[2] Reinhart, M., and Rogoff K. (2008): 'The Aftermath of Financial Crises' American Economic Association meetings in San Francisco, January 3, 2009.

10. ***The Commission services' spring 2009 economic forecast points to the recession continuing through 2009, before growth stabilises next year.*** The GDP forecast for the euro area has been revised downward to 4% for 2009. The downturn affects all Member States to varying degrees (depending on their trade openness, exposure to the financial crisis and domestic housing-market developments). It also has an adverse impact on nearly all demand components, with the exception of government consumption and public investment. The latter will contribute positively to growth in 2009-2010, reflecting in part the budgetary stimuli within the framework of the European Economic Recovery Plan (see Chapter 2). In contrast, exports and investment should undergo a marked contraction this year, in line with the slump in global demand. While private consumption is expected to hold up relatively well, deteriorating labour market conditions and moderating wage growth are likely to dampen real disposable income, though lower inflation in 2009 should have some offsetting effect. However, as external demand improves and measures taken to support the financial system and boost aggregate demand gain momentum, the fall in GDP should level off towards the end of 2009, with modest growth resuming in the course of 2010. For 2010 as a whole, GDP is forecast to broadly stabilise at 0.1%.

11. ***Signs of stabilisation emerged in spring 2009.*** The Commission services' Economic Sentiment Indicator (ESI) for the euro area picked up in April (for the first time since May 2007) and continued to improve in May and June, although it remained well below its historical average. Between the first and the second quarter of 2009, all components of the ESI improved, except in the construction sector. The improvement in the ESI was also broad based across euro-area countries, with the trough being reached by most countries in March or a month earlier. Conversely, the quarterly manufacturing survey, carried out in April 2009, indicates a further fall in capacity utilisation since the last survey in January: it stands at 70.5% in the euro area – the lowest since 1990. According to the six-monthly industrial investment survey which was carried out in March and April, managers in most Member States expect real investment to drop by 20% in the euro area in 2009. All in all, difficult financial conditions and weak confidence are set to continue to weigh on economic activity, but are likely to be gradually offset by the impact of expansionary macroeconomic policies.

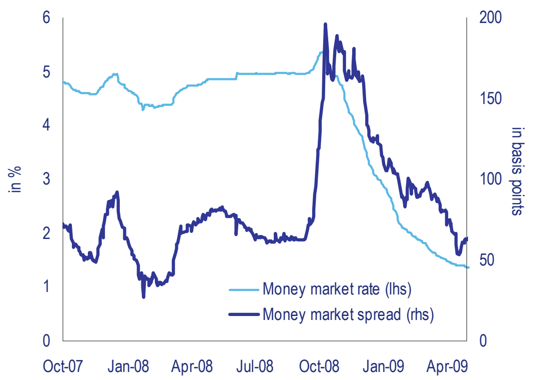
12. ***The growth outlook for the euro-area economy is, however, characterised by exceptional uncertainty.*** While the ambitious policy actions taken by governments and central banks since last autumn have prevented a systemic financial meltdown, financial markets and institutions remain under stress. The world economic situation continues to be exceptionally uncertain. Risks to the forecast are sizeable and remain somewhat skewed to the downside for 2009, but appear more balanced for 2010. Of particular concern is the possibility that the negative feedback loop, from the deteriorating real economy to the still-fragile financial sector, may intensify (e.g. via rising impaired loans or cross-border contagion effects). This may reinforce the deleveraging process, pushing the projected recovery in the real economy even further into the future. There may also be a risk of abrupt exchange-rate movements or the possibility that trade-distorting protectionist measures might be

put in place. On the other hand, policy measures may be more effective than anticipated in restoring stability and confidence in financial markets, thereby supporting economic activity.

1.2. MONETARY AND FINANCIAL DEVELOPMENTS

13. ***The crisis in financial markets deepened substantially during 2008.*** The bankruptcy of the US investment bank Lehman Brothers in mid-September 2008 prompted a re-evaluation of risks embedded in the financial system (Box 1.2). The global financial system became extremely fragile, reflecting the dislocation of several key credit markets, notably the markets for interbank lending. This derived from the fall in investor confidence, amid pervasive uncertainty about the strength of banks' balance sheets. The combination of this uncertainty and increased risk aversion led to a generalised portfolio reallocation towards safe assets in the second half of 2008.

Graph 1.4: **Euro-area money market rates (1 Oct 2007 to 30 June 2009)**



Note: The money market rate is the 3-month Euribor. The money market spread is the difference between the 3-month Euribor and the 3-month Overnight Interest Swap rate.
Source: EcoWin.

14. ***Interbank markets were characterised by severe liquidity shortages as banks hoarded cash, driving up interbank rates***. Spreads on euro-area interbank markets, which had already been elevated since the start of the financial market turbulence in summer 2007, remained abnormally high throughout 2008 (Graph 1.4). The three-month interbank spread, measured as the difference between unsecured money market rates and risk-free interest rates with similar maturity, peaked at 196 basis points in mid-October 2008. With the interest rate cuts starting in October, interbank money market rates fell perceptibly. By June 2009, the gap between unsecured and collateralised short-term interest rates had decreased substantially to less than 50 basis points, although it still remained higher than prior to the financial crisis. Despite some stabilisation, investor confidence has not fully recovered, given the uncertainties about valuation, counterparty risks and the evolution of the deleveraging process.

15. ***Long-term interest rates fell in response to the escalation of the crisis***. The German 10-year Bund yield increased between January and July 2008 by around half a percentage point to 4.66%, amidst growing inflation expectations and still robust economic indicators. The Bund then fell sharply to 2.90% in mid-January 2009, its lowest level since the introduction of the euro. Revisions in respect of growth and inflation as well as interest rate cuts weighed on yields. In the following months, government bond yields increased to 3.72% at the beginning of June owing to improvement in economic sentiment and increasing supply of government debt. Renewed uncertainties related to the strength of the recovery triggered a limited easing of interest rates (3.40% at the end of June 2009).

16. ***Spreads for government bonds within the euro area widened***. The spreads of government bond yields compared to the German Bund benchmark, which were low in the years before 2007, increased steadily throughout 2008 (Graph 1.5). At the beginning of 2008, spreads on 10-year government bond yields stood at 17 basis points for Ireland and 29 basis points for Greece. The widening became significantly more pronounced in the fourth quarter of 2008. In early 2009, spreads peaked at 282 basis points in the case of Ireland and 302 basis points for Greece. The sharp rise in spreads reflected inter alia higher perceptions of credit risk against the backdrop of expectations of higher future borrowing needs, as well as the general increase in liquidity premia. Since then, spreads have narrowed markedly, but remain elevated by historical standards.

Box 1.2: **The crash of the US Investment Bank Lehman Brothers**

On 15 September 2008, Lehman Brothers Holding Inc. was filing for bankruptcy. The listing of USD 639 billion in assets made it the largest bankruptcy in U.S. history. Its failure marked a watershed in the global financial crisis.

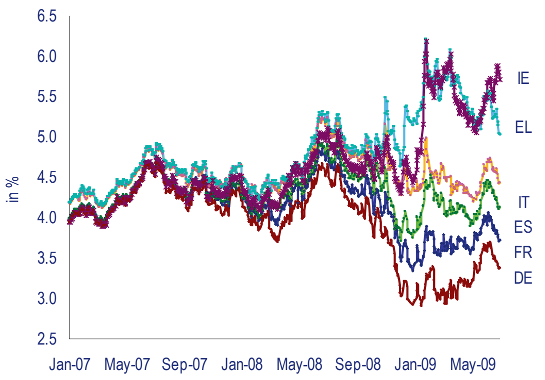
Founded in 1850, Lehman had developed into the fourth-largest US global investment bank and a global workforce of about 25,000. Until the nineties, the Glass-Steagall Act of 1933 separated commercial banks from investment banks. The Gramm-Leach-Bliley Act of 1999 paved the way for Lehman like other investment banks to expand its business into more complex –and riskier– segments of financial markets. At the peak of the US housing market in 2007, Lehman had emerged as the biggest underwriter of mortgage-backed securities. With over USD 600 billion in assets but less than USD 20 billion of common shareholder equity, Lehman had the highest gross leverage ratio of all US investment banks, except for Bear Stearns. As the housing market deteriorated, Lehman incurred very substantial losses on its holdings of sub-prime and other lower-rated mortgage tranches, which it had retained in the process of securitisation. Market analysts began to highlight Lehman's high leverage ratio. Even more than other financial institutions, Lehman's share price came under heavy selling pressure, with its share price declining from about USD 50 at the beginning of 2008 to about USD 9 at the end of August. On 12 September, Lehman's share price fell by a further 42 percent, when a rating agency warned of a possible downgrade of the bank's credit rating. On 13 September, the US authorities renewed calls for a private-sector solution to Lehman's financial difficulties, but reiterated their reluctance to use government funds to bail out the bank. On 14 September, Barclays and Bank of America withdrew from negotiations to buy Lehman. By 15 September, Lehman filed for Chapter 11 bankruptcy protection.

The fall of Lehman led to a global reappraisal of risk in financial markets. The market had been previously counting on the 'too-big-to-fail' presumption. In other terms, very large financial entities could be considered systemic in the eyes of public authorities. They were supposed to get some form of support at the eleventh hour that would save them. When Lehman failed, the event sent shockwaves within the financial system. Counterparty risk became a reality. On 15 September, the Dow Jones Industrial Average was down by 4.42%. In the credit default swaps (CDS) market, the cost of insuring corporate debt against the risk of default rose sharply. Further reflecting an increase in risk aversion, prices of ten-year US government bonds had their biggest rally in 20 years, pushing yields lower by about 20 basis points to about 3.5%. Central banks took stabilising measures on interbank markets. On 15 September, the US Fed increased its emergency lending programme for investment banks to USD 200 billion and announced a further relaxation in the types of collateral that financial institutions can use to obtain loans. Meanwhile, the ECB, the Bank of England and the Swiss National Bank all announced measures to ease liquidity strains in their respective interbank markets.

As part of the bankruptcy proceedings, it took some time to value Lehman assets and unwind its trading positions with the relevant counterparties, especially those related to derivatives. About 900,000 derivatives contracts involving the bank had to be terminated since the bankruptcy filings. As a consequence to the Lehman case, regulators looked at ways to better protect investors from counterparty risk, possibly through recourse to central counterparty clearinghouses.

17. ***The slope of the euro-area yield curve steepened, as the sharp drop in short-term interest rates dominated the more moderate decline at longer maturities***. The slope in the euro-area yield curve, measured as the difference between the three-month Euribor and the ten-year German Bund yield, increased by almost 400 basis points between mid-October 2008 and June 2009 (Graph 1.6). The steepening of the yield curve reflected the lowering of interest rates by the ECB since October 2008. It also signalled market expectations of positive economic activity and inflation for the future.

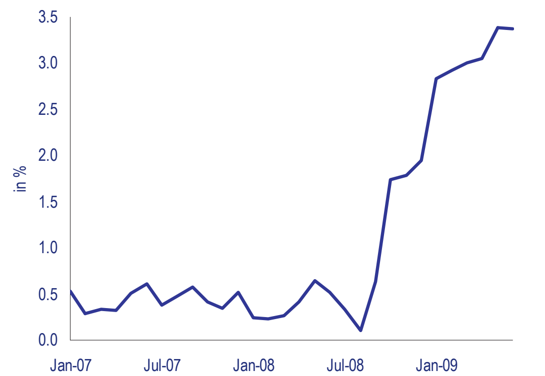
Graph 1.5: **10-year government bond yields, euro area (1 Jan 2007 to 30 June 2009)**



Source: Source: EcoWin.

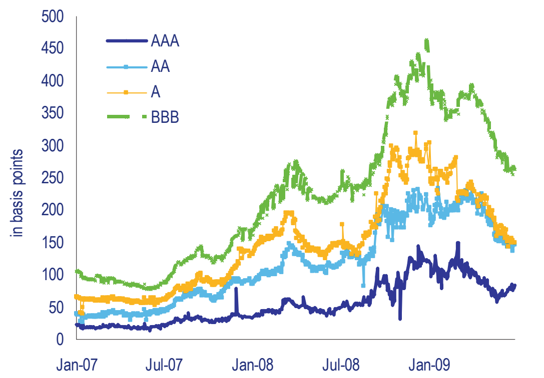
18. ***Spreads of corporate bond yields also increased during the financial crisis***. Gloomier economic expectations and increasing risk discrimination caused markets for corporate bonds to dry up in 2008. Credit markets reacted with significant increases in corporate bond spreads (Graph 1.7). The spread on ten-year bonds issued by BBB-rated enterprises stood at 462 basis points at the end of 2008, more than 300 basis points higher than at the beginning of the year. Since then, default expectations for the corporate sector have receded notably, but concerns over credit quality remained. At the end of the review period, long-term bonds by BBB-rated companies were yielding 5.9%. By contrast, interest rates for the best-rated companies declined over 2008, even though the risk premium visibly increased also for these issuers.

Graph 1.6: **Euro-area yield curve slope (Jan 2007 to June 2009)**



Note: Spread between the 10 years and the 3 months spot rates.
Source: ECB

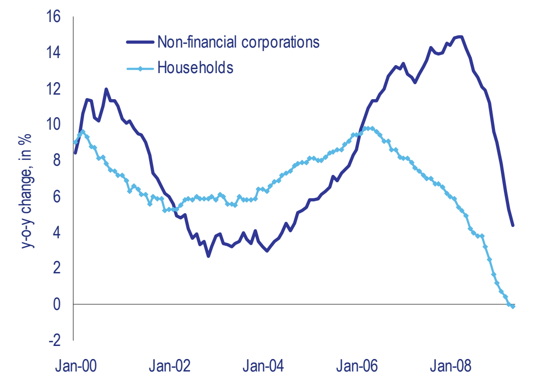
Graph 1.7: **Corporate bond spreads per rating, euro area (1 Jan 2007 to 30 June 2009)**



Source: EcoWin.

19. ***Credit growth decelerated sharply after September 2008.*** Up to the third quarter of 2008, the growth rate of credit remained strong, in particular to non-financial corporations (Graph 1.8).

Graph 1.8: **Monetary Financial Institutions lending in the euro area (January 2000 to May 2009)**



Source: EcoWin.

A significant turnaround took place in the fourth quarter of 2008. The annual growth rate for loans to the private sector decelerated to 1.5% in June 2009, down from 11.1% in December 2007. The slowdown was mainly influenced by demand factors such as the moderation of economic activity and the contracting housing market. Nonetheless, supply-side factors have contributed to the moderation in lending as well, as reported by the ECB Bank Lending Survey for the euro area.

Box 1.3: **Recent developments in food prices**

Recent years witnessed unusually high volatility of food prices with an important impact on overall consumer price inflation and real incomes. After having declined in real terms over the past thirty years, global agricultural commodity prices started to soar around the end of 2006 until early 2008: between September 2006 and March 2008 the Dow Jones Agriculture Index (in USD terms) rose by almost 90%. The index remained at a high level until July 2008, after which the initial price rise was more than reversed by a 50% drop in prices until December. In the first six months of 2009, agricultural commodity prices have slightly trended upwards without, however, returning to the level of summer 2006. Expressed in euro, the price volatility, although considerable, was somewhat mitigated by the appreciation of the euro over the same period.

On 9 December 2008 the Commission – responding to a request by the June 2008 European Council – adopted a Communication entitled 'Food Prices in Europe' ([1]), in which it presented the results of its analysis into the causes of the increase in food prices and the differential impact across Member States, as well as an analysis of the functioning of the food supply chain. On that basis it presented policy recommendations and set out a roadmap for its further work.

The surge in agricultural commodity prices in 2006-2008 resulted from a combination of structural and temporary factors ([2]): among the former, global population growth, rising incomes in emerging economies and the development of new market outlets have contributed to a gradual rise in world demand. Global supply was unable to keep pace due to a slowdown in the growth of food crop grain yields and the characteristics of world agricultural markets which are thin and typically constrained by the seasonality of production. Moreover, increasing production costs, due inter alia to rising energy prices, spilled over on agricultural commodity prices. The impact of these structural factors was amplified by large production shortfalls resulting from adverse weather conditions and trade restrictions imposed by several exporting countries. Exchange rate developments, growing speculative activity in the commodity derivative markets, and the close relationship between agricultural and other commodity markets, such as the oil market, also affected agricultural commodity price developments. While the global recession has a dampening effect on world demand, the underlying structural factors remain.

Against this background, the Commission proposes in its Communication to:

– Promote the competitiveness of the food-supply chain to increase its resilience to world price shocks. Specific recommendations have in the meantime been issued by the High Level Group on the Competitiveness of the Agro-Food Industry ([3]);

– Ensure a vigorous and coherent enforcement of competition at EU and national level and target those practices and restrictions that are particularly harmful;

– Review potentially-restrictive regulations at national and/or EU level. This exercise is ongoing in the context of the retail market monitoring exercise and the transposition of the Services Directive. Regulations that restrict the ability to compete on prices should be examined at national level;

– Ensure the ability of consumers to better compare prices;

– Examine together with regulators of commodity markets how to discourage excessive volatility in the markets that benefits neither producers nor consumers.

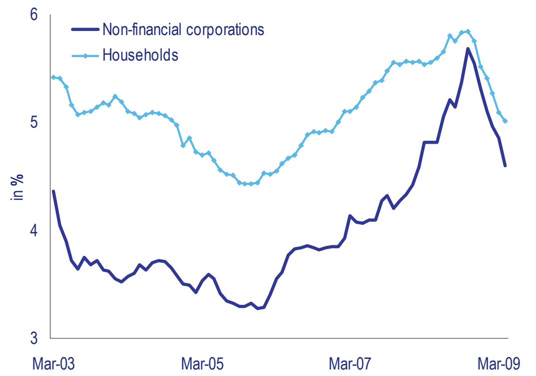
([1]) COM(2008) 821.
([2]) See also Communication COM(2008) 321, Tackling the challenge of rising food prices - Directions for EU action, 20 May 2008.
([3]) Report on the Competitiveness of the European Agro-Food Industry, 17 March 2009.

(Continued on the next page)

Box (continued)

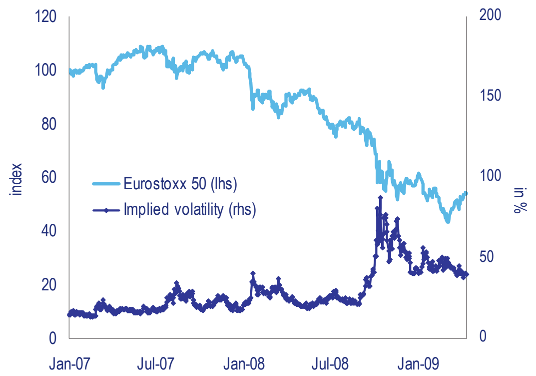
Furthermore, the Communication notes that to keep the balance in the global supply and demand for food, continued efforts are needed to ensure that agricultural production responds to market signals and to promote an open trade policy. By agreeing the Health Check of the CAP, the European Union has taken decisive steps to facilitate farmers' responses to changing market conditions. Moreover, the Doha Round of WTO trade talks aims to open up agricultural markets to developing countries. Incentives and assistance to raise the production potential in developing countries could also contribute to increasing global food security.

Graph 1.9: **Composite Financing Cost Indicators (CFCI) for the euro area (March 2003 to April 2009)**



Source: Commission services.

Graph 1.10: **Stock price index and implied volatility (Stock price: Jan 2007 = 100)**



Source: EcoWin.

20. ***The overall cost of finance for both euro-area non-financial corporations and households climbed during 2008.*** While this increase was mainly driven by higher costs of equity finance for non-financial corporations, the costs of bank loans and market debt increased as well (Graph 1.9). For households, as measured by the Commission services Composite Financing Cost Indicators (CFCI), the cost was on average 0.35 percentage points higher than in 2007, while financing costs for non-financial corporations were 0.93 percentage points higher. The CFCI for non-financial corporations and households has been declining in the first months of 2009, above all as bank lending rates were reduced, but also on account of lower costs of market-based debt.

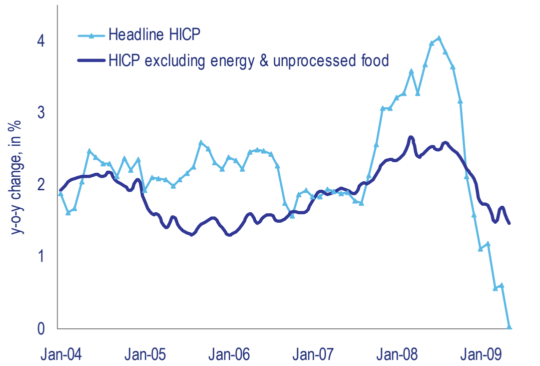
21. ***Stock market prices decreased substantially in 2008 on the back of negative prospects for earnings.*** The Dow Jones Euro Stoxx 50 declined in several waves, and most markedly after the above-mentioned failure of Lehman Brothers in September 2008 (Graph 1.10). From March onwards, stock markets regained some ground, but volatility remained elevated reflecting uncertainty about the impact of economic policy actions. Still, as of end-June 2009, the Euro Stoxx 50 had declined by 45% compared to end-2007. While the value of some troubled financial stocks tumbled (especially those of financial institutions with significant exposure to Central and Eastern European countries), the decline in equity markets was broad-based across sectors and countries.

Price developments

22. ***Surprising commodity price rises during the first half of 2008 caused upward pressure on inflation.*** Headline HICP inflation averaged 3.3% in 2008, about one percentage point higher than during the previous year (Graph 1.11).The increase was chiefly driven by energy and food sub-components (Box 1.3). They contributed as much as 2.4 percentage points to the average inflation figure of 3.6% in the first eight months of

2008. The contribution had been much weaker in the same period of 2007 (0.5 percentage point out of 1.8%). As a result, possible second-round effects remained under close scrutiny during the first half of 2008.

Graph 1.11: **Harmonised index of consumer prices (HICP), euro area**

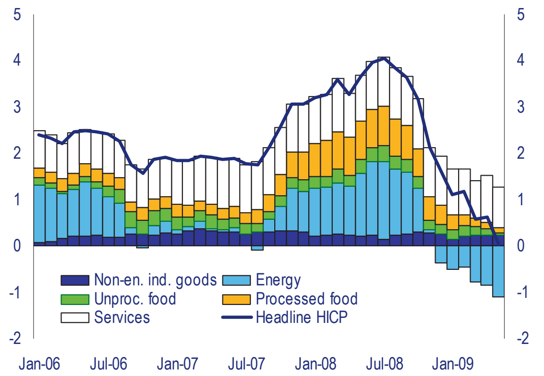


Source: Commission services.

23. ***Headline inflation eased considerably after September as commodity prices tumbled.*** HICP inflation fell from a peak of 4.0% in July 2008 to -0.1% in June 2009 (Graph 1.12). HICP sub-categories food and energy contributed only 1.3 percentage points to the 2.6% average inflation figure for the period September-December 2008. The contribution of services to headline inflation remained stable, but at a relatively high level (around one percentage point in 2008). The contribution from non-energy industrial goods to headline inflation also remained stable in 2008 at a low level (around ¼ percentage point).

24. ***Core inflation remained contained in 2008.*** Though much less pronounced, the pattern for core inflation (defined here as HICP inflation excluding energy and unprocessed food) followed the changes observed in headline inflation (Graph 1.12) ([3]). It accelerated to 2.4% in 2008 from 2.0% in 2007 and markedly decelerated in the first months of 2009 to reach 1.3% in June 2009.

Graph 1.12: **Breakdown of euro-area HICP inflation**



Source: Commission services.

25. ***Inflation is expected to remain subdued in 2009.*** Prices are likely to continue declining throughout most of 2009 on the back of weakening economic activity and moderating commodity prices. As a result of strong base effects ([4]) year-on-year inflation has turned negative in June 2009 (-0.1%), possibly remaining in negative territory for a few months. However, the risk of a deflationary scenario at the euro-area level, i.e. a persistent and self-reinforcing decline in a broader set of prices, appears limited at the current juncture (see Box 1.4). Inflation expectations remain anchored at levels consistent with price stability, whereas wage growth is expected to remain positive and capacity utilisation is at very low levels. According to the Commission services spring 2009 forecast, HICP inflation is expected to reach 0.5% in 2009. A gradual rebound in inflation to around 1¼% can be expected in 2010.

1.3. FISCAL DEVELOPMENTS

26. ***The fiscal situation had benefited from years of successful consolidation.*** By 2007, fiscal positions in the euro area had evolved favourably. The headline deficit was down to 0.6% of GDP while the reduction in the structural deficit was somewhat smaller (1¾% from 2½% in 2005). The debt ratio had decreased to 66% from 70% in 2005. No euro-area Member States ran an excessive deficit.

([3]) Core inflation is a measure of inflation that excludes or reduces the weight of the more volatile components of headline inflation. Different statistical methods are available to compute core inflation (i.e. trimmed means, weighted median and HICP excluding energy and unprocessed food).

([4]) A base effect occurs when the evolution of a variable's annual rate from month t to month t+1 varies because of the evolution of the variable's level twelve months before and not because of the variation of the variable's level between month t and month t+1.

Box 1.4: How large are the risks of deflation in the euro area?

While a reduction in prices – e.g. as a result of competition or efficiency-induced cost-savings – is generally considered desirable when affecting individual products, it may lead to adverse effects when it is broad-based. Deflation essentially refers to a decline in prices that is generalised, persistent and expected.

'Generalised' implies that overall price aggregates are falling and that the decline is broad-based across items and products. Within a currency area, it also implies that the price decline is geographically spread out and not restricted to a limited set of Member States.

'Persistent' indicates that the price decline is stretched out over a prolonged period of time. A one-off downward price adjustment as a result of an external shock (e.g. a sharp drop in oil prices), would thus not fall under deflation. There is no agreed definition as to how long prices have to fall in order to technically qualify as deflation.

'Expected' means that, as economic agents' inflation expectations turn negative, the perceived relative cost of future spending with respect to current spending falls. It follows that deflation should be distinguished from a deceleration in the inflation rate (disinflation), which may also involve spells of negative price changes, without however causing expectations to turn negative.

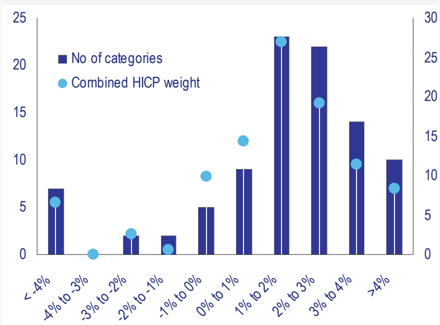
All currently-available forecasts do not foresee a prolonged period of negative price growth in the euro area, and deflation risks appear limited. Several factors contribute to this.

First, the price decline is not generalised since it largely results from price falls in two items: energy and food. As shown in Graph A, only 17% of HICP items (at the 4-digit level), accounting for a combined weight of about 20% in the HICP, recorded negative price growth in May. Items making up about 70% of the HICP basket registered price growth above 1%.

Second, base effects, mainly explained by energy and food price movements, will contribute positively to annual inflation from August 2009 onwards (see Graph B).

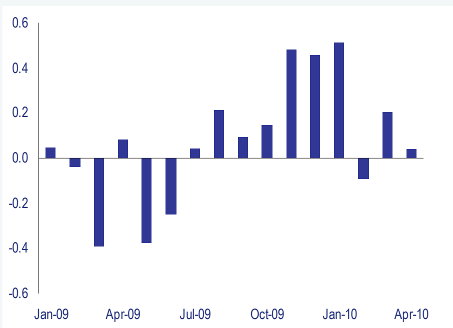
Third, market-based measures of inflation expectations appear to be well-anchored around the ECB price stability objective. The ten-year spot break-even inflation rate stands at 2.2% in June 2009. Finally, the monetary and fiscal policy response to the crisis is likely to have a pre-emptive effect with respect to deflation by supporting demand.

Graph A. HICP items sorted in ascending growth order (year-on-year change, May 2009)



Source: Commission services.

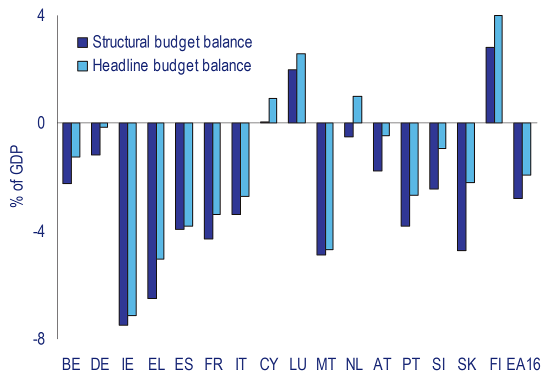
Graph B. Contribution of base effects to euro area HICP inflation (in percentage points, January 2009 to April 2010)



Source: Commission services.

27. ***The financial crisis hit public finances hard and budgetary positions deteriorated for the first time in five years in 2008***. The euro-area average headline deficit reached 1.9% of GDP, up by 1.3 percentage point of GDP from 2007 (Graph 1.13). Due to the economic downturn, the development in the headline deficit was matched by a smaller deterioration of the euro-area average structural balance, i.e. the budget balance net of cyclical factors and one-off and other temporary measures (Graph 1.15). Its deterioration was of the order of 1% of GDP, thus putting the structural balance at 2¾% in 2008. The result seems to suggest that the rise in the headline deficit was primarily of a structural nature. However, current estimates of the structural balance are likely to be affected by the volatile behaviour of tax revenues. While they were exceptionally buoyant in 2007, tax revenues dropped sharply as a result of the economic and financial crisis.

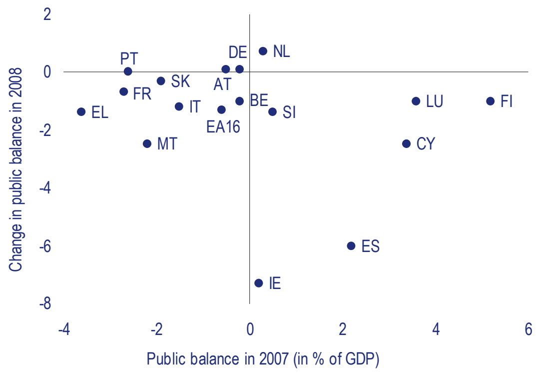
Graph 1.13: **Headline and structural budget balances in the euro area in 2008**



Source: Commission services.

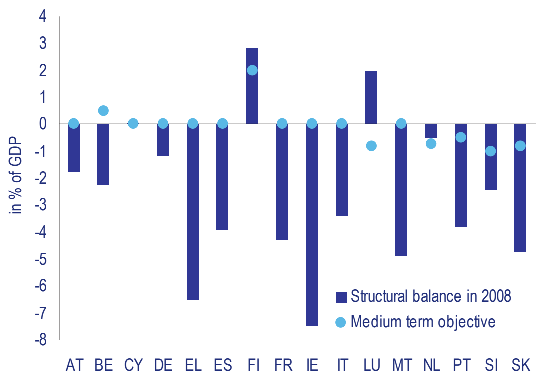
28. ***Dispersion in fiscal balances increased in 2008.*** Member States with initial budget surpluses exhibited different patterns over 2008 (Graph 1.14). In Ireland a minor surplus turned into a large deficit of more than 7% of GDP. In Spain the public balance swung from surplus (2.2%) to deficit (-3.8%). In Cyprus the large surplus shrank considerably (from 3.4% in 2007 to 0.9% in 2008). Conversely, the Netherlands increased its surplus from 0.3% to 1.0% of GDP. The large surpluses of Finland and Luxembourg were trimmed down, but remained strong in 2008 (respectively 4.2 and 2.2 percentage points). In Germany, the fiscal position remained almost unchanged and very close to balance. In countries still in deficit in 2007, a further deterioration was witnessed, but remained relatively contained, especially in Portugal and Slovakia. A more substantial deterioration in numbers was recorded in Malta, Italy and France. For France, the deficit deteriorated from 2.7% of GDP to 3.4%. On this basis, in April 2009, the Council decided that excessive deficits existed in France, Spain and Ireland. For Greece, EDP proceedings were started in 2008 on the basis of the 2007 outturn. In July 2009, on the basis of the Commission services' Spring 2009 Economic Forecast, the Council decided that Malta was in excessive deficit.

Graph 1.14: **Budget balances in the euro area (2007 levels and 2008 changes)**



Source: Commission services.

Graph 1.15: **Structural balances in the euro area**



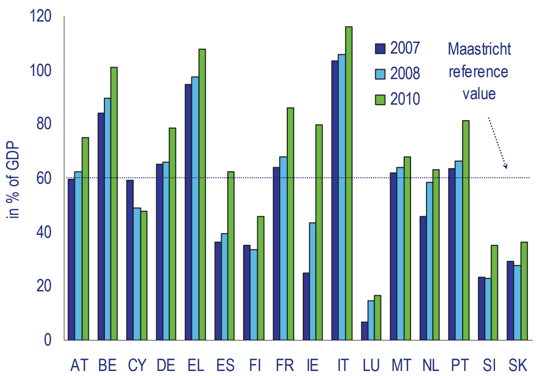
Source: Commission services.

29. ***Progress towards medium-term budgetary objectives was limited in the first half of 2008.*** At that time, policymakers were still mainly concerned with individual countries' speed of structural fiscal adjustment. With a view to

speeding up adjustment towards the medium-term budgetary objective (MTO), the Commission adopted a so-called policy advice on economic and budgetary policy for France in May 2008. The situation changed in the second half of the year, when the euro area was hit by the effects of the financial crisis, which led to a rapid deterioration in tax revenues.

30. ***Government debt bounced back in 2008, partly due to public interventions in the financial system.*** In the euro area, the debt to GDP ratio rose by 3.3 percentage points to 69.3% in 2008 (Graph 1.16). Ireland witnessed a particularly steep increase in its debt level, by 18 percentage points in 2008. In Belgium, the government debt ratio rose in 2008, after having remained on a steady downward path for almost a decade. Overall, the increase in debt reflected largely the acquisition of financial assets in the framework of financial rescue plans, most notably in Ireland (10.5 points out of a total increase of 18 percentage points), the Netherlands (12.6 points out of 15.7 points), Luxembourg (10.4 points out of 7.8 points) and Belgium (6.8 points out of 5.6 points).

Graph 1.16: **Public debt-to-GDP ratios in the euro area**



Source: Commission services.

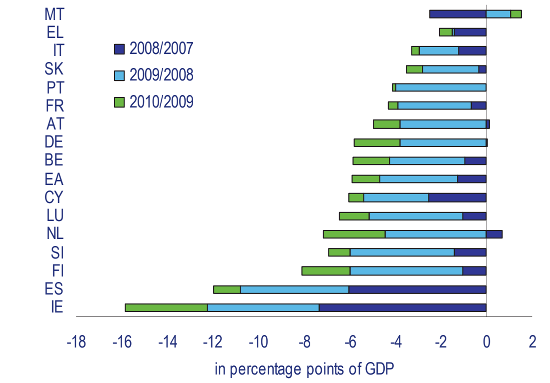
31. ***Revenue shortfalls explain much of the budgetary deterioration.*** In 2008, the observed deterioration in budgetary positions in the euro area was largely the result of a lower revenue–to–GDP ratio. On the expenditure side, the slight increase in the expenditure-to-GDP ratio was mainly due to higher social benefits and transfers, i.e. automatic stabilisers. On the revenue side, a strong negative contribution came from taxes on income and wealth, the latter not least due to rapidly declining corporate income taxes. Compared to the plans presented in the 2007 updates of the Stability and Convergence Programmes, significant nominal expenditure overruns came together with large revenue shortfalls.

32. ***Government revenue decreased markedly in 2008.*** Revenues in the euro area fell from 45.5% of GDP in 2007 to 44.8% in 2008. Many countries recorded shortfalls due to lower-than-expected growth (Portugal, Greece, Italy and France). The decrease in taxes was especially marked in Ireland due to the slump in housing boom-related taxes. In addition to the impact of automatic stabilisers, a number of countries took discretionary fiscal measures in 2008 to reduce income taxes (Spain) or social contributions (Austria). By contrast, Slovakia took revenue-raising discretionary measures in the form of a broadening of the corporate and personal income tax bases and an increase in the maximum ceiling of social contributions. Some other countries recorded better-than-expected tax revenues (Finland, Austria and Germany). The Netherlands benefited from stronger non-tax gas revenues.

33. ***Government expenditure edged up in 2008.*** Expenditure increased from 46.1% of GDP in 2007 to 46.6% in 2008. Localised overruns took place in some countries (Belgium, Slovenia). Greece recorded both large expenditure overruns and higher debt servicing. Higher-than-expected expenditure in Malta mostly stemmed from measures related to shipyards. In Italy, a sizeable increase in compensation of employees and intermediate consumption pushed current spending upwards.

34. ***Public finances are expected to be hit hard by the recession in 2009 and 2010.*** According to the Commission services' Spring 2009 Economic Forecast, the budget deficit is set to more than double in the euro area, to the equivalent of 5¼% of GDP by 2009 and 6½% in 2010. The rise in deficits, at unchanged policies, is again in part due to the impact of the economic slowdown, mirroring the importance of automatic stabilisers (Graph 1.17). However, it is now also

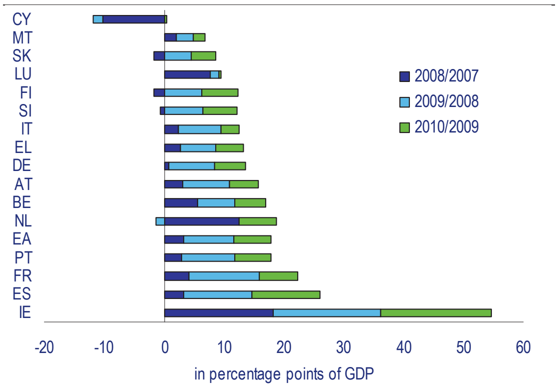
Graph 1.17: **Cumulated change in public balance, euro-area countries (2007-2010)**



Source: Commission services.

linked to the significant discretionary measures that were introduced in the context of the European Economic Recovery Plan. In particular, the expenditure ratio is set to increase by more than three percentage points of GDP in 2009 (and by a further percentage point next year) partly because of a rise in social benefits and transfers, but also due to the decline in nominal GDP. The revenue ratio is expected to decrease, reflecting inter alia the continuing reversal of past revenue windfalls and the erosion of some tax bases.

Graph 1.18: **Cumulated change in public debt, euro-area countries (2007-2010)**



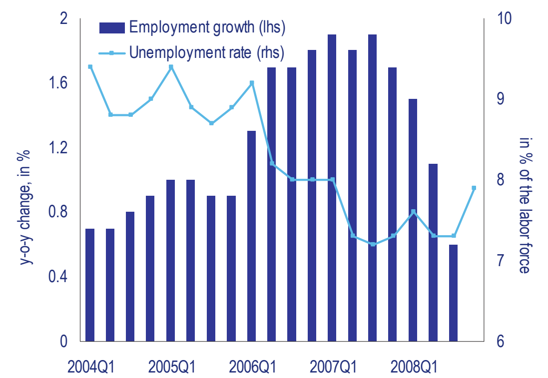
Source: Commission services.

In addition to the weakened budgetary situation, government debt will also be affected by sizeable "below-the-line" measures as part of the financial rescue plans, such as bank recapitalisations. Overall, gross debt is expected to increase from 69% of GDP in 2008 to close to 84% in 2010 (Graph 1.18).

1.4. LABOUR MARKET DEVELOPMENTS

35. ***Employment has reacted strongly to the current downturn, reflecting the severity of the crisis.*** Employment still rose by 0.8% in 2008, compared to +1.8% in 2007 (Graph 1.19), leading to the highest employment ratio in the euro area since its inception (66.1%).

Graph 1.19: **Euro-area employment growth and unemployment rate**



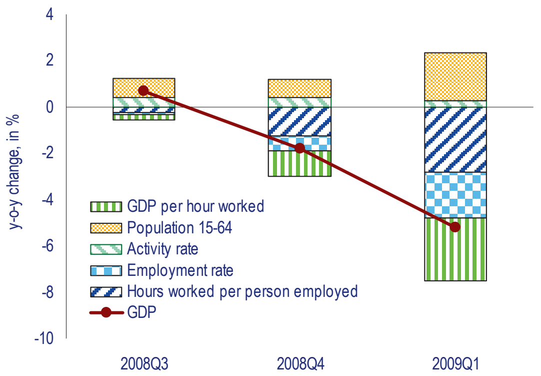
Source: Commission services.

Typically, employment reacts with a lag to economic fluctuations as companies attempt to hoard labour in uncertain times. In the first half of 2008, there was still some positive momentum, with employment growing by 0.5%. However, employment began edging down during the third quarter (-0.2%) and fell by 0.4% in the fourth quarter. The construction sector was particularly hit and lost 5.4% of its workforce from the fourth quarter of 2007 to the fourth quarter of 2008. In the manufacturing sector, adjustment took place mostly in the fourth quarter. Although the recession hit manufacturing hard, internal flexibility in many industries (flexible working-time arrangements, temporary closures etc.) has prevented more significant labour shedding so far. Employment contracted further in the first quarter of 2009 (-0.8% quarter-on-quarter). The deterioration in employment was especially severe in Spain (-6.4% year-on-year) and in Ireland (-3.9% year-on-year), owning mainly to the weight of labour-intensive sectors in these countries.

36. ***A sharp reduction in hours worked has prevented the unemployment rate from increasing faster*** (Graph 1.20). Euro-area unemployment stood at 7.5% in 2008, unchanged

from 2007. The quarterly profile however shows unemployment rising sharply to 8.0% in the fourth quarter of 2008 and 8.8% in the first quarter of 2009. Spain (+10.3 percentage points) and Ireland (+6.3 percentage points) recorded the largest increase in unemployment. Temporary agency work was also particularly hit by the downturn. Yet unemployment would have worsened in the absence of the significant reduction in hours worked per person employed that many firms (sometimes supported by state subsidies) have been implementing to avoid lay-offs (Graph 1.20).

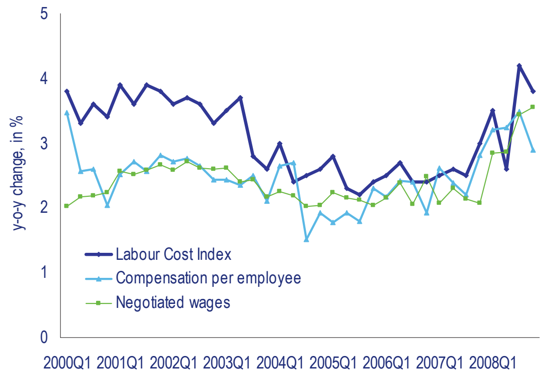
Graph 1.20: **Contribution of labour productivity and labour supply components to GDP growth, euro area**



Note: The euro-area GDP annual growth rate is decomposed into the growth rates of GDP per hour worked, hours per worker, the employment rate, the activity rate and the population aged 15-64.
Source: Commission services.

37. ***Wage developments were impacted with a lag during 2008.*** Labour costs continued to grow at a fast pace throughout the first three quarters of 2008 ([5]) (Graph 1.21). This was largely due to tight labour markets as well as to nominal wage indexation schemes linking wages to past inflation outcomes in some Member States (Belgium, Luxembourg, Cyprus, Malta and Spain).The annual growth of hourly labour costs even accelerated to 4% during the fourth quarter of 2008 on account of the large reduction in working hours implemented by many firms. However, the annual growth of compensation per employee fell sharply from 3.5% in the third quarter to 2.7% in the fourth quarter of 2008.

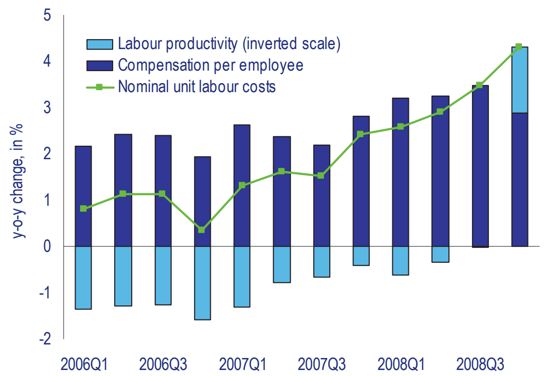
Graph 1.21: **Nominal wage indicators, euro area**



Source: Eurostat for Labour Cost Index and compensation per employee, ECB for Negotiated wages.

Taken together with the deterioration in employment and the relatively stronger growth in negotiated wages ([6]), this suggests that firms were actively reducing the variable pay component of compensation, such as overtime or bonus payments.

Graph 1.22: **Compensation per employee, labour productivity and unit labour costs, euro area**



Note: Compensation per employee, labour productivity and unit labour costs are based on employement in headcounts.
Source: Commission services.

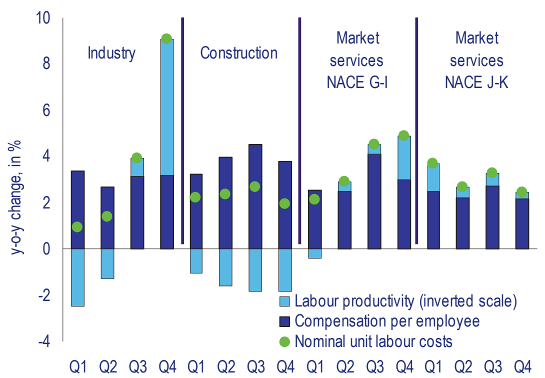
38. ***Unit labour costs picked up strongly following a contraction in labour productivity.*** Productivity growth gradually weakened over the

([5]) The Labour Cost Index corrects employment for effects of the number of hours worked, such as changes in overtime hours and part-time employment. Although it is meant to give a better estimate of labour costs than compensation per employee, caution is needed when interpreting it during the crisis, where a temporary reduction of hours worked has led to higher hourly labour costs, even though total labour costs as such have remained broadly constant. Derived from national accounts data, compensation per employee includes wages and salaries and social security contributions.

([6]) Negotiated wages measure the outcome of collective bargaining in terms of basic pay or salary (i.e. excluding bonuses).

first three quarters of the year, mainly on account of the relatively labour-rich growth composition (Graph 1.22). Unit labour costs increased strongly in the fourth quarter (4.5% year-on-year), owing to the cyclical slump in productivity (1.7% year-on-year). A breakdown by sectors indicates that cost pressures were most acute in the industrial sector, where measures to keep workers in employment helped alleviate the impact of the crisis, but resulted inevitably in a fall in labour productivity in the very short term (Graph 1.23). By contrast, labour shedding in the construction sector has resulted in higher productivity growth and relatively contained labour costs pressures in response to the crisis. Only in Spain did productivity experience a sizeable increase in line with the sharp drop in employment in construction as well as the fall in temporary employment affecting all economic sectors.

Graph 1.23: **Compensation per employee, labour productivity and unit labour costs by sectors in 2008, euro area**



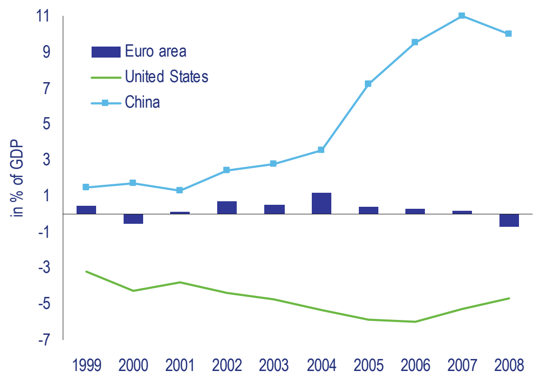
Note: Compensation per employee, labour productivity and unit labour costs are based on employment in headcounts.
NACE G-I refers to transport, trade, hotels and restaurants.
NACE J-K refers to financial intermediation and real estate.
Source: Commission services.

39. ***Labour market outlook is poor.*** According to the Commission services' spring forecast, the contraction in employment, which began in late 2008, is set to accelerate this year to around 2.5%. The unemployment rate would increase to 9.9% in 2009. Further job losses (-1.5%) are forecast for 2010. While the slack in the labour market should lead to a significant deceleration in nominal wages (to slightly below +2% in 2009 and +1.5% in 2010), very subdued consumer price growth might imply that real compensation growth may be the highest in a decade in 2009.

1.5. COMPETITIVENESS DEVELOPMENTS

40. ***The external position of the euro area as a whole has been balanced over the past decade.*** The euro area as a whole moved from a nearly balanced current account position (0.1% of GDP in 2007) to a small deficit in 2008 (-0.7% of GDP). This indicates that the euro area provided a net demand stimulus to the rest of the world. The euro area's generally balanced external position over the last ten years contrasts sharply with other major economies (Graph 1.24).

Graph 1.24: **Current account positions, euro area, United States and China (1999-2008)**



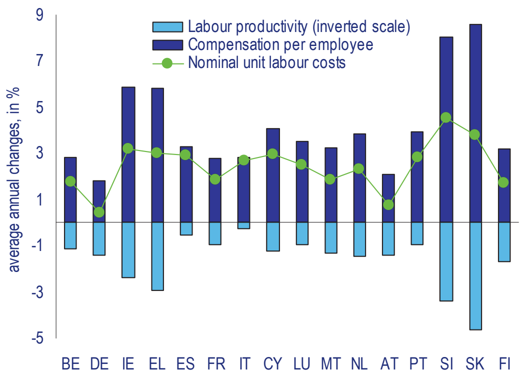
Source: IMF.

41. ***However, within the euro area, the issue of persistent differences in competitiveness has gained relevance.*** Some of it can be traced back to labour cost developments across euro-area Member States. Over the past decade, annual average nominal unit labour cost growth has ranged from around zero in Germany to 2.5% or more in some Member States (Ireland, Greece, Spain, Italy, Cyprus, Portugal, Slovenia) (Graph 1.25). Labour cost developments are important for the functioning of the competitiveness channel of EMU. In the face of a positive asymmetric demand shock ([7]), unit labour costs in the country affected by the shock should increase faster than in the rest of the euro area. The increase in unit labour costs

([7]) Theoretically, above-average demand in a given country should push costs and prices upwards. The deterioration in the relative cost situation should then worsen cost and price competitiveness for the respective country and slow the pace of economic activity towards the euro-area average.

implies competitiveness adjustment. However, such cost and price increases, if not offset by increases in productivity, lead to prolonged competitiveness losses and build-up of domestic imbalances. Evidence shows that in some Member States wage growth has been outpacing productivity growth for some time (Spain, Portugal, but also Belgium, Ireland, Italy) (Graph 1.25).

Graph 1.25: **Compensation per employee, labour productivity and nominal unit labour costs (1999-2008)**



Source: Commission services.

42. ***Distinguishing between 'benign' and 'harmful' developments in competitiveness is essential for policy intervention.*** Benign factors reflect the normal and healthy functioning of the euro-area economy, while harmful developments are related to the build-up of a range of domestic macroeconomic imbalances in some Member States. The harmful factors require policy intervention while adjustment to the others should be left to the market. In the euro area, benign factors such as Balassa-Samuelson effects ([8]), price convergence or cyclical differences have played a relatively minor role in driving the divergences in external performance. Differences in growth and inflation have tended to be significant and persistent, leading to large changes in Member States' relative competitive positions, notably in terms of price competitiveness but also in terms of current account imbalances and net foreign asset positions. Although part of the current account dispersion within the euro area can be seen as a sign of increased financial market integration, with the euro acting as catalyst, less 'benign' factors seem to have played a more important driving role ([9]).

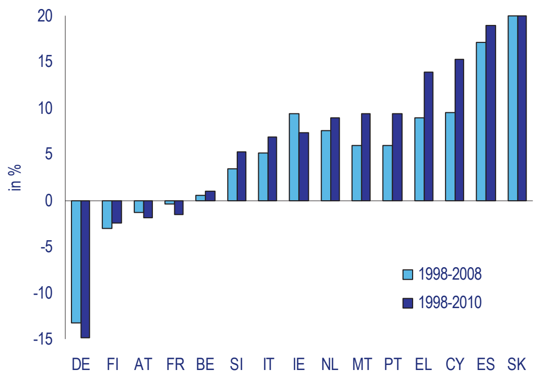
43. ***Differences in price competitiveness have been partly driven by an inappropriate response of wages to country-specific shocks in some Member States.*** Differences in current accounts reflect not only differences in price and cost competitiveness but also the build-up of domestic imbalances, mostly linked to excessive domestic demand pressures. Such pressures include high private-sector and external debt, a surge in house prices and increased vulnerability to abrupt changes in financial market conditions. Although catching-up economies in the euro area have benefited from large capital inflows, foreign capital has not always been channelled to the most productive uses, fuelling primarily consumption or housing investment. In some Member States, the deterioration of the current account positions can in part be explained by substantial losses in non-price competitiveness. In other Member States, fiscal policy has not always been sufficiently tight in the boom period. Graph 1.26 shows the divergence in price and cost competitiveness as measured by the real effective exchange rate (REER). The indicator shows significant divergences with Germany gaining 13% competitiveness and Spain losing almost 20% since 1998.

44. ***Divergence in price competitiveness has been associated with a steady widening of current account differences within the euro area***. Some Member States have registered large current account surpluses (Germany, Luxembourg, Austria, Netherlands, Finland), while others have seen large or very large deficits (primarily Greece, Spain, Portugal and Cyprus but also Ireland, Malta, Slovenia, Slovakia).

([8]) The Balassa-Samuelson hypothesis predicts that price levels will increase when relative productivity rises in the tradable sector. If prices in the tradable sector are fixed and if wages equalise across sectors, wages will increase both in the tradable sector and in the non-tradable sector. As a consequence, the cost of producing non-tradables will rise and the general price level will thereby increase.

([9]) For more details see Quarterly Report on the Euro Area Vol. 8 N°1 (2009), "Special report: Competitiveness developments within the euro area".

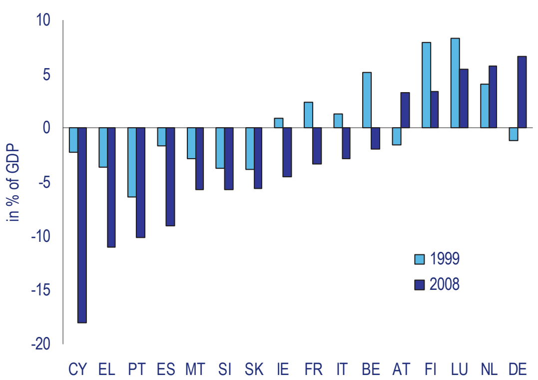
Graph 1.26: **Changes in intra euro-area Real Effective Exchange Rate (REER)**



Note; REER (GDP deflator) against other EA countries. (2) Belgium, including Luxembourg. (3) Slovakia is shown off scale. True rise in REER is 68% (1998-2008) and 76% (1998-2010) (intra).
Source: Commission services, 2010 data are based on the Commission services' spring forecast.

These positions have mostly built up since the launch of the euro (Graph 1.27), although some countries have entered Stage 3 of EMU with an already sizeable deficit (Greece and Portugal). A few countries have experienced significant drops in their current account in recent years although their balance remains in surplus or in a comparatively moderate deficit (France, Italy and Belgium).

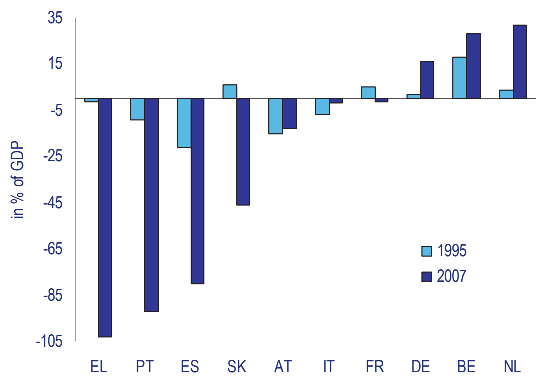
Graph 1.27: **Current account positions, euro-area Member States (1999 to 2008)**



Note: Net lending (+) and borrowing (-) from national accounts for all Member States except LU (balance of current transactions).
Source: Commission services.

45. ***The build-up of large external liabilities has increased exposure to financial shocks.*** The counterpart of large current account deficits in some Member States has been the build-up of large negative net foreign asset positions (NFA). In 2007, Spain, Portugal and Greece posted net external liabilities ranging between 80% and 100% of GDP (Graph 1.28). Slovenia and Slovakia have also registered a rapid deterioration in their negative NFA position in recent years. A few euro-area countries enjoy comfortable positive NFA positions (Belgium, Germany and Netherlands), but the orders of magnitude involved (15% to 30% of GDP) are, in relative terms, lower than in the case of countries with large net external liabilities. Moreover, the deterioration of the net external liabilities position is persistent for some euro-area Member States (Greece, Spain, Portugal and Slovenia). In the current downturn, financial markets have become more responsive to the net external financial asset position for the euro-area countries. Even if to a large extent the net external position is related to the private sector, the public sector can be affected by private-sector debt in the form of potential bail-outs and other fiscal implications.

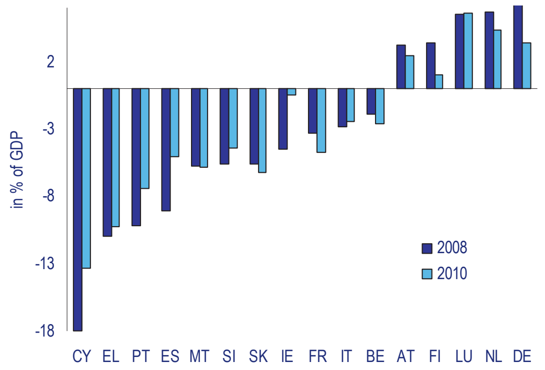
Graph 1.28: **Net foreign asset positions, euro-area Member States (1995-2007)**



Source: Commission services.

46. ***However, the ongoing financial crisis is speeding up adjustment to external imbalances.*** According to the Commission services' spring forecast, current account divergence should diminish between 2008 and 2010 as the financial turmoil forces correction of some domestic imbalances in the credit and housing markets. However, the convergence in current account positions is moderate and asymmetric across the euro-area Member States (Graph 1.29).

Graph 1.29: **Evolution of current account positions, euro-area Member States (2008 to 2010)**



Note: Net lending (+) and borrowing (-) from national accounts for all Member States except LU (balance of current transactions
Source: Commission services

The highest corrections are expected to take place in Spain (the current account deficit is to be reduced from -9% in 2008 to -5% in 2010) and Germany (the surplus is to diminish from 6.7% in 2008 to 3.4% in 2010). The Commission services' spring forecast suggests that the ongoing adjustments in current account positions are not primarily driven by price changes. The rebalancing of relative prices has been limited (Graph 1.26), and therefore the adjustment might come at high cost in terms of unemployment and underutilisation of capital. The adjustment will probably require a substantial rebalancing of relative prices within the euro area, although it will also imply changes in the domestic part of the economy concerned. There will be a need for reallocation of demand and productive resources between the non-tradable sector and the export sector, as well as changes in relative prices between the two sectors. The speed and the cost of the adjustment will very much depend both on the degree of price and wage flexibility and on the ease with which resources can be reallocated across sectors in the countries in question. Evidence shows that competitiveness adjustment in the euro area is working but could be slow. ([10]) Countries with greater adjustment needs are generally facing product and labour market rigidities above the euro-area average, rendering the process of regaining price competitiveness more difficult in terms of length and economic cost.

47. ***This divergence in competitiveness has implications both for the functioning of EMU and for economic governance.*** Persistent divergence in competitiveness is a matter of common concern as intra euro-area adjustments to external imbalances work slowly, are costly and can have negative spill-over effects across Member States. Effective functioning of EMU calls for early detection of these external imbalances in order to prompt an adequate and timely policy response. The macroeconomic framework and the economic governance aspect related to the competitiveness dimension are discussed in Chapter 4, Section 2.

([10]) European Commission (2006), 'Market adjustment, the competitive channel', chapter 4 in 'Dynamic Adjustment in the Euro area: Experiences and challenges', EU Economy Review 2006.

2. MACROECONOMIC POLICIES

48. ***These are testing times for economic policies.*** The exceptional character of the current economic downturn provides a litmus test as policy-makers strive to attenuate its impact and to prepare a sustainable exit strategy. This chapter provides an overview and assessment of macroeconomic policies. Section 2.1 underlines the unique nature and scope of the crisis, justifying the need for an active and co-ordinated policy response. Section 2.2 covers monetary policy developments while financial market policies are presented in Section 2.3. Section 2.4 describes the European Economic Recovery Plan (EERP), with a focus on its budgetary and structural pillars. Section 2.5 delivers a first assessment of the national measures taken under the EERP.

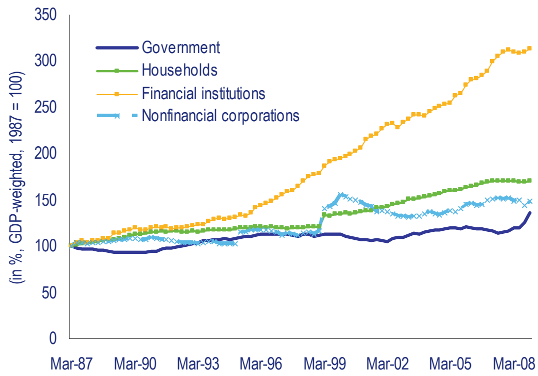
2.1. INTRODUCTION

49. ***By any standards the current crisis has unique features***. No region in the world escaped the fallouts. The turmoil in financial markets affected at a breathtaking pace the real economy during the fourth quarter of 2008. Business surveys, closely followed by hard indicators, such as industrial production and external trade, tumbled to historic lows. Two months after the demise of Lehman Brothers it was all too clear that the world was entering its first global recession since the Great Depression.

50. ***The financial sector has been in the eye of the storm.*** The banking sector fulfils key functions for an efficient allocation of financial resources between lenders and borrowers in time and space. Banking crises, a major source of economic fluctuations in the nineteenth century, had long been considered to be a thing of the past in advanced economies. Macroeconomic models assumed that the banking sector played a relatively neutral role in the transmission of monetary policy impulses. Models ignored the endogenous dynamics of financial innovation, following the deregulation waves of the 1980s and 1990s. Although the boom-bust dynamic led by excessive monetary creation was well-identified in the case of smaller economies [11], the possibility that 'sudden stop' patterns could materialise on a global scale was never envisaged. At the climax of the financial crisis, liquidity on financial markets evaporated overnight and the risk of bank runs became a looming threat.

51. ***Unsustainable debt build-up is at the root of the crisis.*** Ample global liquidity conditions, combined with irresponsible lending policies and poor supervisory oversight laid the groundwork for the emergence of a housing bubble in the US and other advanced economies (Graph 2.1).

Graph 2.1: **Debt-to-GDP ratios of various economic sectors among select advanced economies**



Source: IMF Global Financial Stability Report, April 2009.

Its duration was prolonged by apparently endless flows of capital from emerging countries with large external surpluses, notably China. Risk became mispriced and leverage increased for all economic agents, be they households, companies or financial institutions throughout the world, thanks to the enhanced financial interconnectedness. In the US, personal savings fell from 7% to below zero in 2005-2006. Private debt rose from 188% of GDP in 1997 to 295% in 2008. Domestic and global imbalances fed each other until breaking point.

52. ***Reducing over-indebtedness takes time and generates negative feedback loops.*** Three negative spirals can be at work in the current context. A first negative feedback loop involves bank losses. Capital losses on foreign financial products may force banks to curtail domestic lending to the real economy. The ensuing reduction in working capital for non-financial companies leads to higher default rates in the

[11] The larger the size and duration of a credit boom episode, the greater the likelihood of a crisis. Borio C., Lowe P. '*Asset prices, financial and monetary stability: exploring the nexus*' BIS Working Papers No. 114, July 2002.

economy and eventually more capital losses for banks. A second vicious circle arises from confidence effects. Households and companies save more and downscale their investment plans. What seems reasonable at the individual level is harmful collectively, amplifying the economic downturn at the macroeconomic level. A third vicious circle is caused by the debt-deflation mechanism ([12]). A disorderly deleveraging of banks and companies puts downward pressure on a large range of asset prices to the extent that the real value of residual debt increases as a result. All feedback loops imply strong negative spillover effects deriving from individual uncoordinated decisions of economic agents. Consequently, successive recessionary waves can hit the economy and turn recession into a depression. Indeed, historical experience shows that recessions triggered by banking crises are deeper and last longer than normal recessions (see Box 2.1). The economy is in need of a mutually supporting mix of financial and economic policies.

53. ***Regulatory repair of financial supervision is a prerequisite for policy-makers.*** Initial policy action took the form of fast interventions by central banks to compensate for the liquidity shortfall on money markets. This necessary immediate action had to be complemented by a comprehensive set of regulatory reforms to remove sources of pro-cyclicality in the financial sector (see Section 2.3). In addition, the credit channel had to be repaired through extensive support schemes for banks, ranging from recapitalisations and guarantees to asset relief programmes. It is expected that credit distribution will bounce back after banks have successfully cleaned out their balance sheets.

54. ***Sanitised balance sheets will maximise the expansionary turn of monetary policies.*** In all advanced economies, monetary policy has become strongly expansionary. It is expected that lower policy rates will translate over time into lower interest rates applied to households and businesses, providing major support for recovery. However, the effectiveness of monetary policies depends on the soundness of the banking system. Even if this prerequisite is fulfilled, conventional monetary policy is bounded by the fact that nominal interest rates cannot go below zero. However, central banks may rely on unconventional measures to enhance the effectiveness of monetary policy (see Section 2.2).

55. ***Fiscal expansion plays a decisive role.*** Public spending should help bridge the gap between currently credit-constrained economic agents and aggregate demand, so that irreversible losses in capital and professional skills are limited as much as possible. A strong stimulus will sustain demand, limit the fall in output and restore confidence and private spending. It would also defuse risks arising from negative feedback loops, boosting credit and confidence among economic agents. Finally, such policy would also limit the negative impact on potential growth, as private investment is set to be depressed in the current year and the next.

56. ***There is a particular need for coordination of fiscal policies within the EU and euro area.*** Given the large trade and financial spillovers between Member States the European Economic Recovery Plan sets out action at the European level. It aims to restore consumer and business confidence, restart lending and stimulate investment in the EU's economies, create jobs and help bring the unemployed back to work (see Section 2.4 for details).

57. ***Well-conceived exit strategies are crucial for long-term fiscal sustainability.*** The eventual removal of discretionary policies through adequate exit strategies would maximise the impact of the stimulus in the short run. Economic policy support must be designed in a sustainable way to be effective. If the stimulus is perceived to lead to snowballing public debt and rising inflation, the private sector might save more to prepare for the inevitable increase in taxes. In the euro area, the Stability and Growth Pact provides an effective framework that combines the short-term flexibility required to counter the crisis with a credible commitment to fiscal sustainability (see Section 2.4). This guarantees time-consistent fiscal policymaking.

58. ***The expansion should be coordinated on a global scale.*** Global crises call for global solutions. At the G-20 Summit in London, leaders of the world's largest economies agreed to a

([12]) The phenomenon was first identified in 1933. Fischer, I. (1933), '*The Debt-Deflation Theory of Great Depressions*', Econometrica, October, Volume 1, Issue 4, pp. 337-57.

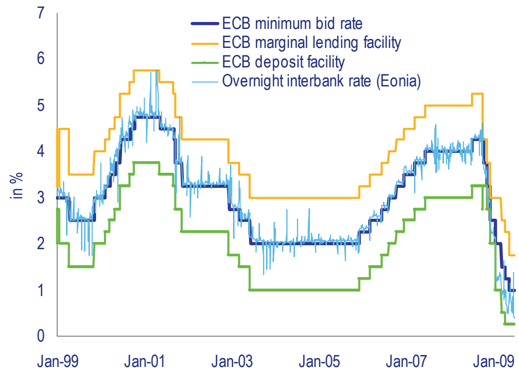
combined USD 1.1 trillion package of national measures to restore growth and jobs and rebuild confidence and trust in the financial system (see Chapter 3). With fiscal stimulus measures that countries had already announced, the combined stimulus would amount to some five trillion dollars by the end of 2010. This joint endeavour effectively averts the risk of beggar-thy-neighbour policies of a kind that amplified the downturn during the Great Depression of the 1930s.

2.2. MONETARY POLICY

59. ***The ECB policy response evolved in reaction to the changing challenges.*** In response to persistent money market tensions since mid-2007, the ECB developed a two-pronged approach. Liquidity injections catered for bank funding needs, while key interest rates were assigned to the preservation of price stability in a context of initially rising inflationary pressures. As the financial crisis unfolded, causing severe liquidity shortages in many financial market segments, and spread quickly to the real economy (Graph 2.2), the ECB mustered all available monetary policy instruments.

60. ***Until mid-September 2008, the fight against inflationary pressures took centre-stage.*** The ECB increased its key interest rate by 25 basis points to 4.25% in July 2008 amid heightened upside risks to price stability. Inflationary risks were driven mainly by increases in commodity and food prices (see Box 1.3). HICP ([13]) inflation reached 4% year-on-year in June and July 2008, well above the two-percent reference value for price stability. The surge in euro-area inflation raised concerns over second-round effects in price- and wage-setting, which was reflected in rising inflation expectations. Incoming data over the first half of 2008 suggested that euro-area real GDP growth would be moderate but remain fairly close to its potential both in 2008 and in 2009, predominantly driven by domestic demand. The ECB also took note that lending to the private sector, and in particular to non-financial companies, was still growing at a healthy rate. This suggested that tensions on financial markets were not affecting the supply of credit within the euro-area economy.

Graph 2.2: **ECB interest rates and Eonia**



Source: EcoWin.

61. ***The Lehman bankruptcy opened a new period of unprecedented market stress and falling demand.*** Central banks responded to the rapidly changing environment (Graph 2.3). The ECB, in a coordinated move with the Federal Reserve, the Bank of England, the Bank of Canada, the Sveriges Riksbank and the Swiss National Bank, lowered its borrowing costs by 50 basis points to 3.75 percent on 8 October 2008. Before the end of the year, the Governing Council lowered borrowing costs by another 50 basis points in November and 75 basis points in December amid growing evidence of receding inflationary risks and severe fallout from the financial crisis on the real economy. Two additional 50 basis point cuts followed in January and March 2009, before two 25 basis point reductions in April and May. Overall, in the period under review, the ECB reduced its benchmark policy rate by 325 basis points to 1%.

62. ***The ECB reacted to strong turbulences in money market activity since 2007***. Turmoil on money markets started in June 2007. The ECB was the first major central bank to address market tensions via enhanced liquidity provision to the banking system. From the fall of the US investment bank Bear Stearns in mid-March to the end of summer 2008, the ECB accommodated higher liquidity demand by allocating larger volumes in its main weekly refinancing operations.

([13]) Harmonised Index of Consumer Prices.

Box 2.1: **Banking crisis and growth: historical evidence**

Historical evidence on recessions combined with banking crises may shed light on the likely impact of the current crisis on the economy. Using a sample of major financial crises in history, Reinhart and Rogoff (2009) find that, on average, output falls by 9 percent, real housing prices decline on average by 35 percent, equity prices decline by 55 percent and unemployment increases by 7 percentage points. While equity prices' declines are somewhat shorter-lived, the duration of housing price declines is long-lived, averaging roughly six years. Banking crises require a painful restructuring of the financial system which weighs heavily on public finances: public debt rises on average by 86 percent.

For OECD countries, Haugh et al. (2008) find that recessions that are combined with financial crises have been, on average, twice as severe as 'normal' recessions (see Table). Moreover, the recovery is muted and investment and durables' consumption are disproportionately reduced. While business investment tends to rebound more strongly in the recovery phase, residential investment remains depressed during a protracted period of time. Exports play a strong role for the recovery.

Evidence regarding possible effects on potential growth of a banking crisis is mixed. The banking crisis in Japan was followed by a deterioration in potential growth partly due to a worsening in productivity performance, which may be related to the protracted nature of the banking problems and the resulting misallocation of capital. Following the Nordic banking crises, which were resolved more quickly, there was no major deterioration in productivity performance. Notably, Finland used the crisis as an opportunity for a fundamental restructuring in particular in the industries marketing information and communication technologies.

Table 1: **Banking crises and output losses**

	Duration of downturn (1) (quarters)			Cumulative output loss (% pts of GDP)			Recovery half-life (2) (quarters)		
	R&B	R	Ratio	R&B	R	Ratio	R&B	R	Ratio
Spain (1980-1987)	28	12	2.3	-10.1	-6.0	1.7	2	4	0.5
USA (1990-1998)	32	13	2.6	-11.4	-6.2	1.8	5	3	2.0
Finland (1989-1998)	28	15	1.9	-40.6	-5.2	7.9	14	5	2.6
Japan (1997-2006)	32	16	2.0	-12.3	-7.3	1.7	3	4	0.8
Sweden (1989-1998)	28	11	2.5	-16.7	-4.3	3.9	7	3	2.3
Norway (1986-1997)	35	9	3.9	-34.8	-6.5	5.4	1	1	1.0

Notes: A downturn is defined as a period of at least two years when the cumulative output gap is at least 2% of GDP and output falls at least 1% below potential output in at least one year.
R&B: recession combined with banking crisis. R: normal recession. (1) Number of consecutive quarters for which output gap is negative. (2) The recovery half-life is the number of quarters following the though before the though output gap is halved.
Source: OECD.

The severity of the present recession in the euro area becomes apparent when compared with previous euro-area "normal" recessions. According to the standard approach – recessions are identified as GDP contracting for (at least) two consecutive quarters – the euro area has experienced a total of four recessions since 1970 ([1]). 1974Q1, 1980Q1, 1992Q1 and 2008Q1 mark the peaks of the previous expansion phases and the turning points in economic activity. As the comparison is made over a common time span of twelve quarters (three years), data up to the fourth quarter of 2008 is complemented with projections for 2009 and 2010 with the Commission services' spring forecast.

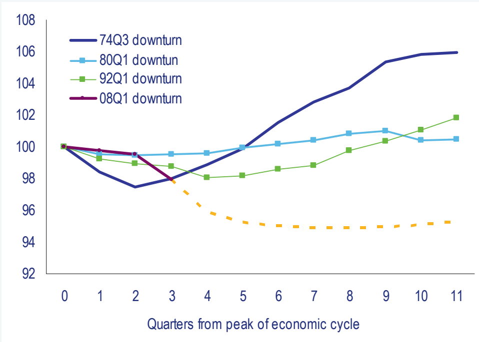
([1]) Data before 1995 do not include Slovakia.

(Continued on the next page)

Box (continued)

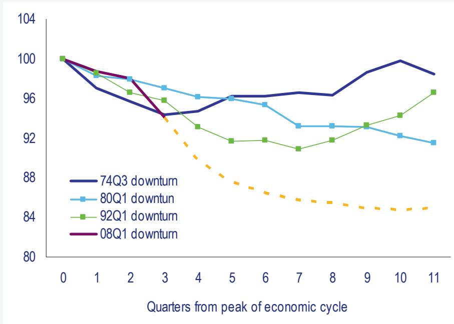
Graph A shows that the first crisis in 1974 was sharp but short-lived. GDP decreased by 2.5% at the bottom of the cycle. The recession due to the second oil shock of 1980 was the shallowest (a 0.5% GDP loss at the trough). However, the upswing was rather sluggish. The 1992 downward trend in growth –linked to the aftermath of German unification– was comparatively protracted. At its trough, GDP dropped by 1.9% four quarters after the start of the recession.

Graph A: GDP across recessions, euro area



Source: Commission services.

Graph B: Investment across recessions, euro area

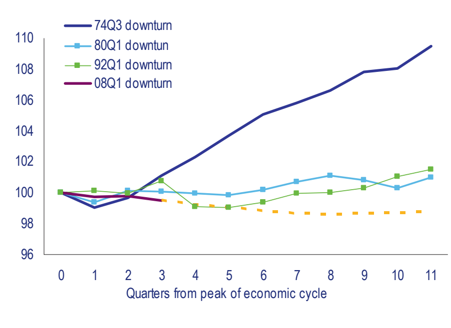


Source: Commission services.

The role of investment as a main driver of the GDP fall is pinpointed in Graph B. If forecasts are confirmed, the current steep decline in investment will have had no equivalent in its scale. By contrast, the recessions of the mid-1970s and early-1990s were characterized by a resumption of positive investment growth at a relative early stage of the business cycle and, as a result, the level of investment three years after the start of the recession was broadly back to the level of its previous peak.

Overall, the weakness of investment in the current recession is far greater than in previous recessions. This might eventually weigh on potential growth. By contrast, private consumption has always been resilient in times of recessions. Graph C exhibits different patterns. Consumption rebounded strongly in 1974 and recovered its pre-crisis dynamic trend after two quarters. The patterns of 1980 and 1992 were markedly different. Consumption was initially relatively resilient, but the upturn materialised only after four quarters.

Graph C: Private consumption across recessions, euro area



Source: Commission services.

Haugh, D., Ollivaud P. and Turner D. (2008), 'The macroeconomic consequences of banking crisis in OECD countries', OECD Economics Department Working Paper, No. 683.

Reinhart, C. and Rogoff K. (2009), 'The Aftermath of Financial Crises', NBER Working Papers, No. 14656.

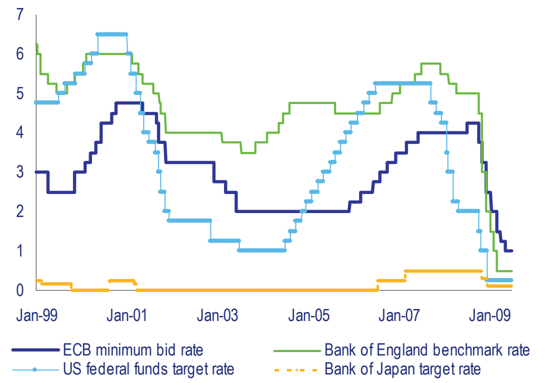
The ECB also raised the volume allotted in its three-month refinancing operations and introduced six-month refinancing operations, as from April 2008.

These policies were largely successful in stabilising money markets, with the differential between the Eonia (effective overnight interest rate) and the ECB's key policy rate remaining close to zero.

63. ***The ECB responded decisively to mounting tensions on the money market***. The ECB decided on 8 October 2008 to carry out its main weekly operations as fixed-rate tenders with full allotment. This meant that the ECB satisfied all liquidity bids at a fixed interest rate. The ECB

reduced the width of the corridor around its main refinancing rate from 200 basis points to 100 basis points ([14]). In addition, on 15 October 2008, the ECB expanded the list of collateral eligible for refinancing and reduced the minimum rating for debt securities, except asset-backed securities, from A- to BBB-. Debt securities denominated in the US dollar, pound sterling and Japanese yen were also accepted. The provision of liquidity in foreign currencies, initiated at the end of 2007, was substantially amplified after mid-September 2008. On 24 June 2009, the ECB allocated EUR 442 billion in its first long-term refinancing operation with a maturity of 12 months, carried out as a fixed-rate tender with full allotment.

Graph 2.3: **Central banks' policy interest rates**



Source: EcoWin.

Overall, ample liquidity provision and changes made to the ECB's collateral framework supported the continuity and functioning of the euro-area money market. At the same time, these interventions contributed to the growth in the size of the Eurosystem's balance sheet which increased by around EUR 700 billion ([15]) since the end of June 2007 to reach EUR 1.9 trillion by the end of June 2009. This figure is equivalent to 22% of the nominal GDP of the euro area ([16]).

64. ***The ECB recently added unconventional measures to its policy arsenal***. Following its Governing Council meeting on 7 May 2009, the ECB agreed to purchase euro-denominated covered bonds for a total amount of EUR 60 billion – a programme of credit easing which is similar in kind, although smaller in size, to those already implemented by the Federal Reserve and the Bank of England (see Box 2.2). Direct financing on capital markets plays a smaller role in the euro area than in the US and UK, which called for a more measured response ([17]). On 4 June, the ECB announced that the purchases would be distributed across the euro area from July 2009 and carried out by means of direct purchases on both the primary and secondary markets. As a rule, only covered bonds which were given a minimum rating of AA or equivalent by at least one of the major rating agencies (and in any case not lower than BBB) would be eligible for purchase.

2.3. FINANCIAL MARKET POLICIES

65. ***With the financial sector at the core of the crisis, policy repair was urgently needed***. In reaction to the financial crisis, the Commission launched an ambitious agenda of proposals to restore a stable financial system. The agenda was outlined in the Communication 'Driving European recovery' adopted on 4 March 2009. The programme was consistent with the ongoing efforts at international level coordinated by the G-20. It included reform of the EU micro-prudential and macro-prudential supervisory framework for financial services, which was highlighted by the de Larosière report (see Section 4.3). Several initiatives were taken to improve and remove gaps in existing legislation (e.g. concerning hedge funds, private equity and capital requirements for banks) to protect consumers and SMEs (e.g. initiatives to foster responsible lending and borrowing), to improve incentives to reduce excessive short-term risk-taking (e.g. initiatives on remuneration in financial services) and to strengthen sanctions for infringements of the rules. Since measures in all policy strands required action at EU and Member State' level, coordination between policy makers was essential. This holds in particular, for euro-area Member States, which

([14]) The decision was subsequently reversed in order to encourage banks to resume trading in the interbank market
([15]) The Eurosystem's balance sheet consists of the consolidated balance sheet of the ECB and the National Central Banks which are part of the euro area.
([16]) At the same time, the balance sheet of the Federal Reserve System was around USD 2 trillion or 15% of the US nominal GDP.
([17]) Outstanding debt securities amounted to 81% of GDP in the euro area in 2007 as against 168% in the United States. By contrast, the stock of outstanding bank loans to the private sector amounted to around 145% of GDP in the euro area, but only 63% in the United States.

Box 2.2: **Unconventional monetary policy measures**

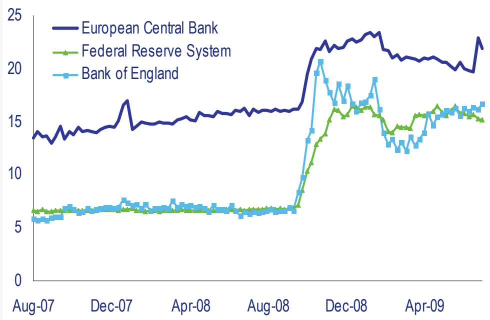
In normal times, central banks steer the level of key interest rates in order to manage liquidity conditions in money markets and pursue their objective of maintaining price stability. When interest rates fall close to zero, a central bank exhausts its capacity to provide stimulus to the economy via its conventional policy tools. The effectiveness of monetary policy is also impaired if the interest rate transmission channel is compromised. In such circumstances, policy-makers have at their disposal additional tools, such as quantitative easing, to alleviate financing conditions for the economy.

Such unconventional measures are generally associated with an increase in the size of central banks' balance sheets (see Graph). Through direct quantitative easing measures, the central bank purchases securities (usually government bonds) from banks in order to increase their liquidity.

It is expected that banks will, in turn, use this extra amount of liquidity to extend lending to the non-financial sector, as they will hardly earn any additional income from deposits in a near-zero interest rate environment. The expected ensuing flattening of the yield curve at longer maturity would also encourage investment.

A variant of quantitative easing, called direct credit easing, involves central banks' purchases of private papers to address liquidity shortages or excessive spreads in specific financial market segments. An alternative method, called indirect quantitative easing, involves lending to banks at longer maturities against collateral which includes assets whose markets are temporarily impaired.

Graph: Central banks' balance sheet size (in % of GDP)



Source: Commission services.

share highly integrated market segments, for instance in wholesale activity.

The financial crisis and the EU's immediate response

66. ***The banking sector in the euro area was not spared the contagion coming from the US.*** Although euro-area banks had not originated risky ('subprime') US loans, they were exposed to the consequences of US developments through several channels: (i) in a bid to enhance nominal returns, euro-area banks purchased complex securitised financial products on international financial markets ([18]). Their exposure to the US housing market became a liability after it had sharply deteriorated; (ii) the default of Lehman Brothers put in doubt the viability of even systematically-important financial institutions, with a significant rise in risk premia as a result, which made bank funding more difficult and costly; (iii) the aforementioned comprehensive reassessment of risk led markets to question the viability of highly-leveraged financial entities and overly ambitious business models. A number of vulnerable banks were put under stress as a result. Access to liquidity and short-term funding of a number of banks became difficult.

At the climax of the financial crisis in October 2008, banks preferred to park their available liquidity with the central bank instead of lending to other banks; (iv) fees and underwriting activity as a source of income suffered from the growing defiance of investors. As a result, the perception of default increased in successive waves, as evidenced through the prices of credit default

([18]) Banks purchased them either directly or through complex sponsored structured investment vehicles (SIV), mostly located in offshore centres.

swaps ([19]) and other financial instruments (Graph 2.4). Reduced expectations on banks' profitability over the medium term became apparent from September 2008 on, as bank equities underperformed the all-equity stock price index (Graph 2.5).

Graph 2.4: **Default risks of euro-area financial institutions**

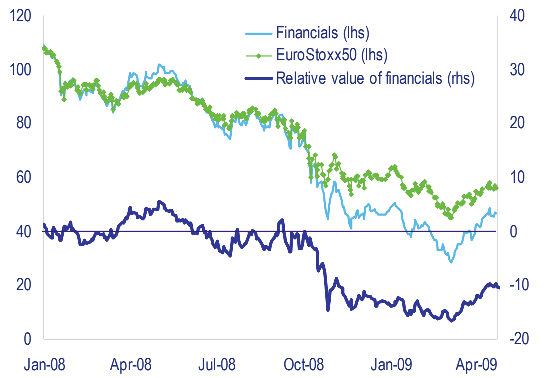
Note: As proxied by iTraxx yield spreads on selected financial instruments.
Source: EcoWin.

67. ***Throughout 2008 the risk of a negative spiral on financial markets remained high.*** Several structural features of financial markets were prone to pro-cyclicality. In other words, they amplified rather than cushioned the impact of the financial turmoil: (i) rating agencies overlooked risks when financial market activity was buoyant; they downgraded complex products only after it had become apparent to all that these products were not risk-proof; (ii) accounting rules tended to magnify capital losses on securities held in banks' balance sheets; (iii) capital adequacy rules did not promote provisioning against expected loss for credit risk over the entire economic cycle.

In retrospect, capital cushions proved to be insufficient in comparison to the amount of risk borne. The pressure to keep capital adequacy ratios constant compelled banks to engage in successive waves of recapitalisation, a process that became increasingly difficult as the crisis unfolded.

([19]) A credit default swap (CDS) is a derivate contract between two counterparties. The protection buyer makes periodic payments to the seller, and in return receives a payoff if an underlying financial instrument defaults. The price of a CDS evolves in tune with the probability of default.

Graph 2.5: **Equity prices in the euro area (January 2008 = 100)**



Note: A negative value means that the financial sector is under-performing the overall stock index
Source: EcoWin, Commission services.

Deleveraging their positions was another option chosen by financial institutions to relieve their capital position. It implied a reduction of financial institutions' asset portfolios, which could hamper the distribution of credit to the economy; (iv) liquidity in many financial market segments proved to be pro-cyclical, as it dried out completely in acute stress conditions, making it impossible for market participants to reduce their overall risk exposure. Tensions reached a climax in September 2008 with the demise of Lehman Brothers. Faced with the risk of illiquidity of major European players on financial markets and the associated contagion effects national governments resolutely embarked on large-scale rescue measures.

68. ***Immediate policy steps targeted the provision of liquidity and capital, coverage of deposit guarantees schemes and accounting relief.*** On 12 October 2008, an extraordinary Eurogroup Summit at the level of Heads of State and Government spelled out six principles and objectives for a coordinated approach to tackle the crisis:

(i) Ensure appropriate liquidity conditions;

(ii) Facilitate longer maturity funding;

(iii) Allow the provision of additional capital;

(iv) Commit to recapitalise distressed banks;

(v) Apply accounting rules more flexibly;

(vi) Enhance cooperation and information exchange.

These principles were eventually endorsed by the European Council for the 27 Member States the following week. First concrete steps within this framework included the Commission's proposal to revise EU rules on deposit guarantee schemes. It entailed an increase in deposit guarantee coverage to a minimum of EUR 50 000 as of 30 June 2009 and to EUR 100 000 by end-2010 as well as a reduction of the payout period. Improved deposit guarantee coverage was aimed at maintaining confidence in banks at a critical juncture. Further measures covered changes to accounting standards, allowing reclassification of financial instruments from the trading book to the banking book in an effort to avert the threat of a negative price spiral. For its part, the ECB counteracted the shortage of liquidity by adjusting its operational framework to changed market circumstances (for more on monetary policy measures, see Section 2.2).

69. ***Rescue packages for national banking sectors were rapidly set up.*** They comprised a set of national measures aimed at safeguarding financial stability, restoring the normal functioning of wholesale credit markets and underpinning the supply of credit to the real economy. The main instruments that had been used were:

(i) Capital injections to shore up banks' capital base, in order to avoid the dual threat of disorderly deleveraging and bankruptcy;

(ii) State-backed guarantees on bank liabilities to allow banks to tap private debt markets in order to refinance their lending activity;

(iii) Asset relief schemes in order to relieve banks' balance sheets of illiquid assets under specific conditionalities;

(iv) Increased access to liquidity from Central Banks (in some cases covered by state guarantees) as a means to allow business continuity.

70. ***National rescue plans, while guided by common principles, conformed to country-specific conditions.*** Their features varied along the following lines:

(i) Coverage of the schemes both in terms of financial instruments/markets and institutions considered;

(ii) Eligibility criteria for both the financial instruments/markets and institutions to gain access to the schemes;

(iii) Mechanism for implementing the scheme (e.g. creation of a special vehicle, form of the capital injection, etc.); and

(iv) Pricing aspects, conditionality and exit strategy.

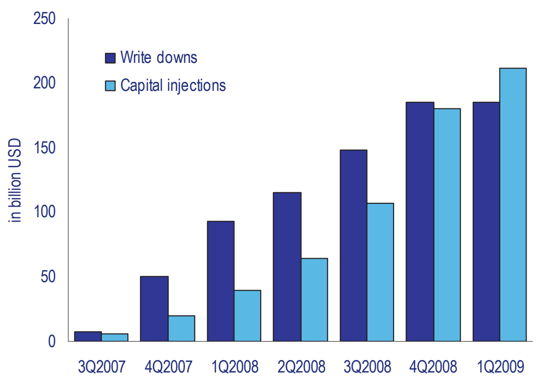
71. ***Rescue packages are subjected to State aid control.*** Although the EC Treaty generally prohibits State aid, it leaves room for a number of policy objectives for which State aid can be considered compatible, for example 'to remedy a serious disturbance in the economy of a Member State' (Article 87 (3) (b)). On this basis, the Commission adopted three major guidance documents outlining how State aid rules would be applied in the context of the current global financial crisis: the Banking Communication of 13 October 2008, the Recapitalisation Communication of 5 December 2008 and the Communication on the treatment of impaired assets of 25 February 2009. They were complemented by recommendations on the pricing of recapitalisations and government guarantees for bank debt issued by the ECB. These documents aimed to ensure legal certainty and a level playing field. As of the end of May 2009, the Commission had approved 11 schemes in the euro area and ad hoc interventions in two other euro-area Member States. On 23 July 2009 the Commission agreed a Communication explaining its approach to assessing restructuring aid given by Member States to banks. The 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.

Table 2.1: **Euro-area public interventions in the banking sector (in % of GDP)**

	Capital injections		Guarantees on bank liabilities		Relief of impaired asset		Liquidity and bank funding support		Total	
	approved	effective	approved	effective	approved	effective	approved	effective	approved	effective
Austria	5.0	1.7	25.7	5.1	0.4	0.4	1.6	1.5	32.8	8.7
Belgium	5.3	6.1	76.6	16.3	10.1	4.2	NA	NR	92.0	26.7
Cyprus	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.0	0.0	27.7	0.0	0.0	0.0	0.0	0.0	27.7	0.0
France	1.2	0.8	16.6	4.5	0.2	0.2	0.0	0.0	18.1	5.6
Germany	4.4	1.6	18.6	7.1	1.4	0.4	0.0	0.0	24.4	9.1
Greece	2.0	1.5	6.1	1.2	0.0	0.0	3.3	1.8	11.4	4.6
Ireland	6.6	4.2	225.2	225.2	0.0	0.0	0.0	0.0	231.8	229.4
Italy	1.3	0.0	NA	0.0	0.0	0.0	0.0	0.0	1.3	0.0
Luxembourg	6.9	7.9	12.4	NR	0.0	0.0	0.9	0.9	20.2	8.8
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	6.4	6.4	34.3	7.7	3.9	3.9	7.5	7.5	52.0	25.4
Portugal	2.4	0.0	10.0	3.3	0.0	0.0	0.0	0.0	12.5	3.3
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	0.0	0.4	32.8	0.0	0.0	0.0	0.0	0.0	32.8	0.4
Spain	0.0	0.0	9.3	3.2	0.0	0.0	2.8	1.8	12.1	5.0
Euro Area	2.7	1.4	20.7	8.7	1.1	0.6	1.0	0.8	25.4	11.5
Memo item EU-27	2.6	1.5	24.8	8.1	0.8	0.4	2.9	2.6	31.2	12.6

Note: NA - Not available indicates that the amount is not available in the state aid decision. NR - Not reported indicates that the amount was not reported by the Member State. Approved: Amounts approved in state aid decisions by the Commission under State aid rules. Effective: Amounts from schemes effectively implemented, for example capital effectively injected in banks or State guarantees effectively granted to banks on their issuance of liabilities. Data covers approved measures from June 2008 to 17 July 2009 and effective measures from June 2008 to mid-May 2009.
Source: Commission services.

Graph 2.6: **Write-downs and capital injections of main euro-area financial institutions**



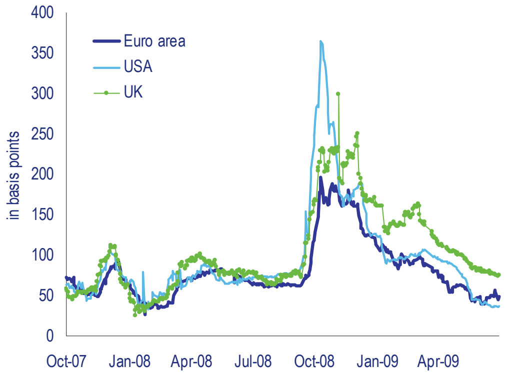
Source: Bloomberg, Commission services.

72. ***Member States allocated sizeable public means to banking rescue packages.*** State guarantees and liquidity support measures were the most widely-used measures in the early phase of these plans. Member States proceeded rapidly to inject capital into weakened institutions (Graph 2.6). As the impact of the financial crisis continued to impair the provision of credit to the economy, Member States started devising asset relief schemes.

Finland, Ireland, the Netherlands and Portugal notified guarantee schemes only, while France and Italy notified guarantee schemes in the first place and recapitalisation measures shortly after. Slovenia added a liquidity support measure as a complement to its guarantee. Another group of Member States, which included Austria, Germany and Greece, opted for schemes combining several measures from the start (guarantee, recapitalisation, other forms of equity interventions, etc). Spain notified a fund for the acquisition of financial assets. In addition to general schemes, several Member States have adopted ad hoc individual interventions in favour of certain financial institutions. Overall, the global sum committed and approved by the Commission for the re-capitalisation of banks is about EUR 240 billion (2.7% of the euro-area's GDP, see Table 2.1). As of mid-May 2009, effective injections amounted to about EUR 131 billion of this sum (1.4% of the euro-area's GDP). A sum close to EUR 1,870 billion (20.7% of the euro-area's GDP) has been committed and approved by the Commission to guarantee bank borrowing, of which an amount of about EUR 788 billion has been allocated (8.7% of the euro-area's GDP). These impressive figures compare to data on total US government support for financial assets and liabilities announced in 2008 and in the first months of 2009, which amounted to USD 13,900 billion ([20]).

73. ***These emergency measures averted a meltdown of the EU financial sector.*** Determined and timely action prevented a run on fragile banks, ensured confidence of savers and paved the way for an orderly return to normal market conditions. Short-term interbank lending on money markets gradually improved, as illustrated by the declining spreads between overnight and three-month interest rates. These peaked in October 2008 and fell steadily thereafter (Graph 2.7).

Graph 2.7: **Interest rate spreads (OIS over three-month Euribor, Libor in percentage points)**



Source: Sources: EcoWin, Commission services.

In June 2009 spreads were broadly comparable to those prevailing before the summer of 2008. However, they remained higher than before the emergence of the first tensions on interbank markets in 2007.

74. ***Still, global banks have incurred significant losses since the start of the financial turmoil.*** According to estimates published in the June 2009 ECB Financial Stability Review, by 28 May 2009 the total reduction in net income attributable to write-downs by global banks since the turmoil erupted has amounted to USD 1,042 billion. US, Canadian and Australian banks reported the bulk of the income losses – about 56% of the overall figure. A further 20% was suffered by UK, Swiss and other non-euro-area European banks, and another 20% by euro-area banks.

([20]) Data from 'Supervisory Insights' Vol. 6 Issue 1, Summer 2009, Federal Deposit Insurance Corporation.

75. ***Uncertainties related to total losses over the full credit cycle remain.*** In its Financial Stability Review of June 2009, the ECB staff estimated the total amount of write-downs on securities and loans of euro-area banks at USD 649 billion over the four-year period 2007-2010. Losses on securities could amount to USD 218 billion and losses on loan books to USD 431 billion. For its part, the IMF estimated in its Global Financial Stability Report of April that the total amount of write-downs of euro-area banks over the period 2007-2010 could reach USD 904 billion. The differing estimates of the write-downs reflect differences in assumptions made and in the methods used to calculate potential losses on loan exposures.

76. ***As a result, doubts about the ability of the banking sector to finance the economy remained.*** Most of the credit slowdown was driven by demand factors, i.e. related to the economic slowdown and housing-market corrections. Banks' deleveraging proceeded, with the bulk of the adjustment taken through trimming down external assets. Banks' issuance of debt securities recovered, yet with a high market share of state-guaranteed debt. Amid the difficulties in obtaining equity capital from private investors, public capital injections were instrumental in underpinning the level of bank capital. However, persistent uncertainty about the exposure of banks to toxic assets and the impact of the economic slowdown on their credit risk remained.

The medium-term perspective: regulatory reforms

77. ***In October 2007, the Ecofin Council laid down a roadmap to tackle the shortcomings of the existing regulatory framework.*** It focused on four main issues – transparency, valuation, prudential oversight and the functioning of markets. The EU could thus promote effectively its agenda in talks to reform the international financial system at the G-20 level and in the relevant international fora (see Chapter 3).

78. ***The work of credit rating agencies should be better framed***. The possibility to repackage loans and transfer the full credit risk to markets was considered as contributing to the rise in the volume of Collateral Debt Obligations (CDOs), which had been crucial for the build-up of financial imbalances in the US. Private investors

Box 2.3: Ongoing work on further bond market integration in the euro area

In light of the turmoil experienced in sovereign debt markets, national debt managers took steps to improve coordination of their bond issuance. In the context of the Economic and Financial Committee Sub-Committee on EU Bills and Bonds Markets, government debt managers meet on a regular basis to exchange views and promote further the integration and a better functioning of EU government bond markets. Several Member States introduced enhanced flexibility and adaptability in their auction strategies to cope with difficulties in accessing the market, including the use of syndications ([1]). This raised the issue of competing auctions among euro-area sovereign issuers. Competition for intermediaries and investors implies that governments face market pressures on prices and spreads. In order to enhance the communication in respect of issuance intentions, including syndicated issuance, EU debt managers agreed to update on a more regular basis the issuance calendars as well as to publish them on the Sub-Committee's web-page.

Most euro-area government debt managers (excluding Germany) agreed on a Harmonised Reporting Format for their Primary Dealers on their market activities, to be published by the Secretariat of the Economic and Financial Committee. Publication would be on a quarterly basis with a three month time lag. Work is further under way among government debt managers as regards the harmonisation of auction procedures.

([1]) Syndications are used when governments try to achieve cost-effectiveness by appointing a group of institutions which, for a negotiated fee, will subscribe to its bond issues and then sell them to other retail or institutional investors.

and financial institutions trusted too readily the ratings attributed to these financial instruments by credit rating agencies. In November 2008, the Commission proposed a regulation on credit rating agencies, setting out a framework for their authorisation, operation and supervision in the EU.

79. ***Smarter rules for bank capital and remuneration.*** At the beginning of 2008, the new regime for banks' regulatory capital entered fully into force (Basel II). While most banks were able to keep their capital positions above regulatory requirements, they came under stress due to inherent pro-cyclicality in both investors' strategies and regulatory rules. First, investors became more risk-averse as the financial crisis unfolded and markets tightened their view on sustainable capital positions. Banks were then under pressure to improve the size and quality of their capital positions in difficult funding conditions. Second, banks were obliged to hold capital in a fixed minimum ratio to their risk-adjusted assets. In October 2008, the Commission submitted a proposal (adopted by the Council and the European Parliament in April 2009) to amend the Capital Requirements Directive (CRD) introducing important changes so that:

(i) National supervisory authorities will have a better overview of the activities of cross-border banking groups;

(ii) There will be clear EU-wide criteria for assessing the quality of bank capital;

(iii) Rules on securitised debt will be tightened.

The latter will require that firms that re-package loans into tradable securities retain some risk exposure to these securities. It also imposes strict rules on the due diligence that firms must exercise before investing in securitisation positions. The aim is to ensure that firms fully understand the risks involved, including the risk characteristics of the underlying exposures. On 13 July 2009, the Commission adopted a proposal to make further amendments to the CRD, which would:

(i) impose higher capital requirements for re-securitisations, and further enforce the required due diligence for highly complex re-securitisations;

(ii) strengthen the capital requirements for market risks in the trading books;

(iii) require firms to have remuneration policies that are consistent with and promote sound and effective risk management, and bring remuneration practices within the scope of supervisory review. Banking supervisors will be given the power to sanction banks whose remuneration policies do not comply with the new requirements.

80. ***An adequate regulatory framework should cover all relevant areas of the financial system***. Parallel efforts have been undertaken with reference to other relevant segments of the financial sector:

(i) On 3 July 2009, the Commission published a Communication that explores ways to improve the transparency and stability of derivatives markets.

(ii) The Commission adopted on 29 April 2009 a proposal for a Directive on Alternative Investment Fund Managers (AIFM). The proposed Directive will plug a significant gap in existing legislation related to hedge funds and private equity. It will make all fund managers in the EU subject to authorisation and ongoing supervision. The purpose is to ensure that funds are transparent, with appropriate governance standards, and have robust systems in place for the management of risks, liquidity and conflicts of interest. The proposals differentiate between hedge funds and private equity, so there will not be a one-size-fits-all approach.

(iii) Since pay and bonus systems inside many financial institutions tended to encourage excessive risk-taking and reward short-termism, the Commission adopted on 29 April 2009 a Recommendation on remuneration in financial services. The Recommendation aimed to link pay and incentives to long-term performance and prevent excessive risk-taking behaviour. In addition, the proposed amendments of the CRD which were unveiled in July 2009 would impose binding principles for sound remuneration practices in banks and investment firms.

(iv) Finally, the Commission adopted on 29 April 2009 a Communication concerning investor protection in the field of packaged retail investment products.

2.4. THE EUROPEAN ECONOMIC RECOVERY PLAN (EERP)

81. ***The European Economic Recovery Plan constitutes Europe's integrated response to the crisis.*** As the financial and economic crisis intensified, the Commission presented in its Communication of 26 November 2008 a European Economic Recovery Plan (EERP) to combat the economic downturn. It was later endorsed by the European Council of 11 and 12 December 2008. The EERP aims at cushioning the blow of the recession in the short term by swiftly stimulating demand, boosting consumer confidence and lessening the human cost of the economic downturn. At the same time, the EERP promotes measures needed to reinforce Europe's competitiveness in the medium and long term through structural reforms and smart investment. Thus, the EERP is designed to ensure full coherence between immediate actions and the EU's medium- to longer-term objectives. As a result, fiscal policy developments in the euro area have been guided by this comprehensive EU response to the crisis.

The fiscal arm of the EERP

82. ***The budgetary pillar of the EERP is a major injection of purchasing power into the economy.*** Extraordinary circumstances combining a financing crisis and a recession justify budgetary expansion in the EU and the euro area (see Section 2.1). Member States and the EU agreed on an immediate fiscal impulse amounting to EUR 200 billion (1.5% of GDP). It consisted of a budgetary expansion by Member States of EUR 170 billion and EU funding in support of immediate actions of the order of EUR 30 billion (see Box 2.6).

83. ***The EERP sets out a framework for coordinating national budgetary measures.*** Since the EU budget is too small to be used for EU-wide economic stabilisation, national governments are enacting the bulk of fiscal measures. This multiplicity of decision-makers calls for proper coordination so that the positive impact of national decisions can be mutually supporting. Beggar-thy-neighbour policies or free-riding on the stimulus generated by others would be detrimental to both the EU and the euro area as a whole. To ensure effectiveness the Commission spelled out three conditions for fiscal action to be consistent with

the EERP: it should be timely, targeted and temporary.

84. ***Timely measures are much-needed to support demand in the short run.*** Fiscal policy is notoriously slow to deliver tangible results, owing to the need for governments to structure and adopt measures, and effectively disburse funds. These lags explain why the EERP had to be launched quickly with a view to steering national governments towards taking resolute and coordinated measures. Rapid action would boost demand, defuse the risk of vicious circles and complement other action taken.

85. ***Targeted measures must pinpoint vulnerable populations and sectors and prepare for the future.*** Governments must not repeat the mistakes of the 1970s, when wasteful broad-based fiscal stimuli had a deleterious effect on fiscal positions without much impact on potential growth. With necessarily limited resources, measures on the expenditure side must target low-wage earners, small and medium-sized enterprises, and economic sectors which are especially hard-hit by the recession. Credit-constrained households are likely to spend most of the additional purchasing power, with a fast impact on growth as a result. Well-designed financial incentives can provide at the same time relief for economic agents, facilitate the transition to a low-carbon economy and improve trend productivity (for instance, by introducing tax breaks for energy efficiency investment).

86. ***Temporary measures are warranted so that they can be reversed once the economy rebounds.*** The effectiveness of expansionary fiscal measures depends crucially on whether market participants perceive such measures as temporary. Calculations with the Commission services' QUEST III model show that the fiscal stimulus would be far less effective if households and companies were to believe that today's fiscal effort would be followed by extra taxes or eventually threaten debt sustainability (Table 2.2) ([21]). To avert this threat, commitments to reverse the impact of the fiscal stimulus must be taken and made credible enough to maximise effectiveness. Measures must have built-in reversibility features so that Member States can switch back to consolidation course when economic recovery picks up steam.

Table 2.2: **First year GDP effects of fiscal stimulus amounting to 1% of GDP**

Fiscal measure	Permanent stimulus	Temporary stimulus (one year)	Temporary with monetary accommodation (1)
Investment subsidy	0.46	1.37	2.19
Government investment	0.84	1.07	1.40
Government consumption	0.36	0.99	1.40
Consumption tax	0.37	0.67	0.99
Government transfers	0.22	0.55	0.78
Labour tax	0.48	0.53	0.68
Corporate profit tax	0.32	0.03	0.05

Notes: The table depicts the GDP percentage difference from baseline for global shocks of 1% of (baseline) GDP, assuming long-run financing through labour tax increases.
(1) Unchanged national interest rates for one year
Source: Commission services

87. ***However, not all Member States are in a position to contribute to the overall effort***. The fiscal effort should take account of the starting fiscal positions of each Member State. Countries which took advantage of good economic times to achieve more sustainable public finance positions have more room for manoeuvre. Countries which were lagging behind have less leeway. Countries saddled with high public debt and macroeconomic external or domestic imbalances should also exhibit prudence, since capital markets may adversely react to a further deterioration of such imbalances. These elements are encapsulated in the concept of 'fiscal space', that is 'the room in a government's budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy' ([22]).

According to QUEST III simulations, if risk premia on both sovereign and private debt increase because the fiscal stimulus is perceived to be non-credible, the short-term fiscal multiplier is reduced to close to zero. Therefore such countries are not

([21]) Roeger W., in't Veld J. *'Fiscal policy with Credit Constrained Households,'* European Economy Economic Papers 357, January 2009.

([22]) For more information see European Economy X/2009 '*Public finances in EMU – 2009*'.

Box 2.4: **Government accounts and bank rescue schemes**

Governments have mobilised substantial public funds in support of the banking sector. This box summarises how such government measures in support of the financial sector impact government accounts (in particular the government deficit and gross debt) compiled according to the European System of Accounts, which are relevant for the Stability and Growth Pact.

As a general ESA rule, transactions are recorded according to their economic substance, rather than on the basis of formal considerations. In 2008, governments in the euro area used four tools to support their domestic banking sectors:

(i) Recapitalisation includes the purchase of new (or existing) shares in quoted and unquoted banks. Most cases of purchase of equity are recorded without any direct impact on the government deficit, unless the government has paid for the shares more than their market price or fair value, or if the expected rate of return is deemed to be insufficient. In all cases, the purchase of equity adds to the government gross debt.

(ii) Granting a loan has no direct and immediate impact on the government deficit. However, there will be a need to record a deficit-increasing transaction in the future, in case of insolvency of the debtor. The debt increases in all cases.

(iii) Asset relief schemes, i.e. the purchase of impaired financial assets previously in the banks' balance sheet, are also neutral for the government deficit provided that the price paid by the government is estimated to be a fair value. However, a deficit-increasing capital transfer is booked in case the price paid was in excess of the fair value. Government disposal of these assets at maturity or earlier, will lead to holding gains or losses. These are usually recorded in the revaluation account and have no direct impact on the government deficit. As in the other cases, the debt also increases.

(iv) Guarantees to banks' liabilities (bonds or loans) have also been granted by governments. A guarantee is a contingent liability that has no direct impact on the public deficit and debt. In case the debtor honours his liability, the guarantee is never booked in the government finance statistics. However, in the cases the guarantee is called and the liability has to be taken over by the government because the debtor defaults, there will be an increase in both government deficit and debt at the time of the debt takeover. Governments usually collect some fees when they grant guarantees. These fees are recorded as sales of services and reduce the government deficit.

Most support to the financial sector has been directly provided by the government. However, there are a number of cases in relation to which one needs to consider the classification in government or in other sectors of the entities providing support. To make economic substance prevail over legal arrangements, a transaction in support of the financial sector carried out by a public corporation (e.g. a government-owned bank that is classified in the corporate sector) for public policy purposes under government instructions rather than for commercial reasons will be recorded in the government accounts. By the same token, support provided by privately-owned entities (like bad banks organized as special purpose vehicles established by the private sector) does not, in principle, enter government accounts. However, these bad banks often benefit from government guarantees; in that case, rules applicable to the treatment of guarantees apply.

encouraged to engage in net fiscal stimulus, but will benefit from the fiscal stimuli of neighbouring countries.

88. ***Automatic stabilisers will also contribute to smoothing out the economic cycle.*** This effect derives from progressive tax systems and social and unemployment benefits. Tax revenues decrease more than proportionately when GDP falls. Similarly, expenditure for social and unemployment benefits increases markedly in economic bad times. Both effects worsen the fiscal position and produce a smoothing countercyclical effect. They are called 'automatic' because their action does not require discretionary interventions by fiscal authorities. Because of the larger

government sector in the EU (in 2008 the expenditure-to-GDP ratio in the EU was almost 47% compared to 39% in the US), automatic stabilisers play a more important role than in the US. They explain why fiscal balances are also deteriorating in countries with no fiscal space to enact discretionary measures.

89. ***Supporting households' purchasing power relies both on automatic stabilisers and on discretionary measures.*** Against the background of a decline in private consumption for 2009, measures that support household disposable income and purchasing power help to sustain consumption and aggregate demand. They also provide income support for groups hit hardest by the downturn.

90. ***Bank rescue packages are also a component of the overall fiscal stimulus*** (see Section 2.2). Bank guarantees, asset relief schemes and capital injections have important macroeconomic stabilisation functions. They will weigh substantially on public debt (see Box 2.4 on the accounting treatment of bank rescue package measures) and reinforce the need for appropriate exit strategies.

91. ***The revised Stability and Growth Pact allows Member States to combine short-term fiscal stimulus with medium-term sustainability considerations.*** The 2005 revision of the Pact allows better account to be taken of cyclical conditions while strengthening medium- and long-term fiscal discipline. The resulting framework is more demanding in good times but affords more flexibility in bad times. It functioned broadly well in 2006-2007, as the general government deficit was reduced to 0.7% of GDP in the euro area, although its narrow scope meant that not enough emphasis was laid on growing macroeconomic imbalances within a number of EU and euro-area countries. Most Member States are now running deficits above 3% of GDP. But that does not mean that the functioning of the Stability and Growth Pact is impaired. Excessive deficit procedures have been opened against a number of countries (see Section 1.3). Member States putting in place counter-cyclical measures submitted an updated Stability Programme in December 2008, which spelled out the measures taken to eventually reverse the fiscal deterioration and ensure long-term sustainability. The Commission has assessed them against the following objectives, well in line with the SGP principles:

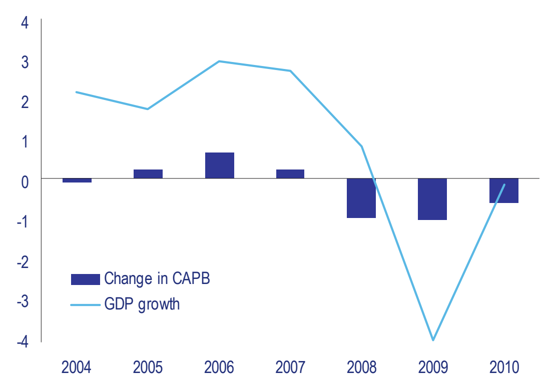
(i) ensuring the reversibility of measures that increase deficits in the short run;

(ii) improving budgetary policy-making in the medium term, through strengthening of the national budgetary rules and frameworks;

(iii) ensuring the long-term sustainability of public finances, in particular through reforms curbing the rise in age-related expenditure.

92. ***All in all, fiscal policy should provide support to the economy in the region of 5% of GDP over 2009 and 2010.*** According to simulations conducted with the Commission services' QUEST III model based on announced national measures, the stimulus measures will have a positive impact on GDP growth of slightly more than 0.75 GDP points in 2009 and 0.3 GDP points in 2010 for the EU as a whole. This shows that the EU and the euro area are doing their fair share of the work to support the global economy, in line with the outcome of the G-20 Summits in Washington and London (see Chapter 3).

Graph 2.8: **Fiscal policy stance in the euro area**



Note: Commission services' spring forecast for 2009 and 2010. CAPB: Cyclically-adjusted primary balance.
Source: Commission services.

The structural arm of the EERP

93. ***The European Economic Recovery Plan calls for 'increased efforts to implement structural reforms envisaged in the Lisbon strategy'.*** While the main aim of structural reforms

Box 2.5: **2008/2009 council recommendations to the euro area in the context of the Lisbon strategy**

• Ensure timely and consistent implementation of all pending and new EU financial services legislation and take measures to deepen cooperation among national authorities within the EU in the fields of crisis prevention, management and resolution.

• Taking into account the fiscal stimulus injected during the current economic crisis, euro area Member States should take appropriate measures to secure the sustainability of their public finances in line with the Stability and Growth Pact. Where appropriate address macroeconomic imbalances, contain persistent inflation divergences or trends of unbalanced growth.

• Improve the quality of public finances by reviewing public expenditures and taxation and by modernising public administration, with the intention to enhance productivity and innovation and to pursue a dynamic and competitive single market, thereby contributing to economic growth, employment and fiscal sustainability.

• Vigorously implement the EU Common Principles of Flexicurity in accordance with the specific circumstances of each Member State and fully compatible with sound and sustainable public finances; and enact measures to promote labour mobility across borders, regions, sectors and occupations; better align wage growth with productivity, employment growth and competitiveness at the aggregate, sector, regional and occupational level.

• Step up reforms that increase the flexibility and competition in goods and services markets and contribute to deepen the internal market.

is to tackle longer-term challenges, structural policies can immediately contribute to recovery efforts. A particularly relevant issue to consider is the interplay between short-term effectiveness and the challenge to provide proper incentives for employment and growth in the medium and longer term. Structural reforms improve the resilience of economies and contribute to the recovery by facilitating the adjustment process, which is all the more important in a monetary union such as the euro area. In addition, engaging in structural reforms can have macroeconomic and distributional effects in the short term that mitigate the economic and social impact of the downturn. Moreover, adherence to ambitious structural reform agendas can enhance the credibility of short-term policy responses to the economic slowdown. In this respect, the country-specific and euro-area Member State recommendations under the Lisbon strategy (see Box 2.5) offer guidance for structural reforms with a view to raising the growth and jobs potential over the medium term.

94. ***Labour market measures should combine immediate policies reacting to the rapid deterioration of employment levels with medium- and long-term reforms.*** Employment decreases more in countries that are more exposed to the boom-bust cycle in construction and finance. The slump in employment is expected to be more persistent where job-specific skills reduce workers' mobility across sectors. A first priority is to avoid job losses in sectors and firms that were fundamentally sound prior to the crisis. Policies that promote mobility from contracting to expanding sectors, adequate unemployment insurance and active labour-market programmes will facilitate the matching process. The Commission signalled in its communication to the Spring European Council that indiscriminate, tax-funded support for jobs in declining industries or regions should be avoided, as this could delay necessary restructuring.

95. ***Investment measures have the potential to influence trend growth***. Private investment has been hit hard in the current economic climate. Investment growth is forecast to remain negative in 2010. Against this background, investment

Box 2.6: **The community pillar of the EERP**

EU funds announced in the EERP have supported action in the most critical areas affected by the crisis. Funding of the order of EUR 30 billion in support of immediate actions help stem the loss of jobs, protect workers, and promote investments to modernize Europe's infrastructures. Progress with the implementation of Community measures to support growth and jobs is promising. Importantly, close cooperation between the Commission, the Council and the European Parliament was established which helped speed up decision-making and enabled the EU to take swift action.

Additional EUR 6.3 billion have already been made available for EU Member States in 2009 through the frontloading of Structural Funds to help underpin growth and employment and prepare our economies for recovery. This frontloading implies more than a doubling of the structural funds advances to Member States in 2009 and will support smart investment in growth-enhancing areas for employment and businesses.

To further lessen the human cost of the economic downturn, the Commission has proposed a renewal of the European Globalisation Fund (EGF). The European Parliament recently adopted this proposal. The renewed EGF will allow more workers made redundant in the crisis to be helped. In particular, funds will be made more easily available through: (i) an increased funding rate from 50% to 65% until the end of 2011; (ii) by lowering the eligibility threshold for EGF applications from 1,000 to 500 redundant workers in a sector, region or undertaking; and by (iii) extending the duration of EGF support to 24 months (from the current 12 months) to leave sufficient time for the measures to be effective in re-integrating particularly the most vulnerable workers into new jobs.

The European Investment Bank (EIB) is playing an important role in enhancing access to finance and in particular the financing of the development of new business opportunities. The EIB plans its lending to increase to EUR 70 billion in 2009, EUR 25 billion more than originally foreseen. Lending to small and medium enterprises (SMEs) and lending from the European clean transport facility loans is being strongly increased. The EIB expects to be able to provide almost EUR 7 billion in loans by July for automotive sector projects, while initially EUR 4 billion was foreseen.

Under the Trans-European Network programme (TEN-T) the Commission launched on 31 March a EUR 500 million call for individual projects. These funds have been brought forward to support works which can start in 2009 or 2010 and be largely implemented over this two-year period (or which have already started but can be accelerated over 2009 and 2010).

The Commission's proposal to mobilize EUR 5 billion for trans-european energy interconnections and broadband infrastructure projects has been approved by the European Parliament and the Council. This allows Europe to get moving immediately on projects that will provide a welcome boost to the European economy and make a real contribution to giving Europe more energy security and better availability of high-speed internet in the future.

A total of EUR 3.2 billion will be allocated from 2010 to 2013 for research projects through three public-private-partnership (PPP) initiatives with half of the funds coming from industry and half from the Community budget. The "Factories of the Future" PPP initiative (EUR 1.2 billion) aims at helping EU manufacturing enterprises, in particular SMEs, to adapt to global competitive pressures by increasing their knowledge and use of the technologies of the future. The objective of the "Energy-efficient Buildings" PPP initiative (EUR 1 billion) is to deliver, implement and optimise building concepts that have the potential to drastically reduce energy consumption and decrease CO^2 emissions, both in relation to new buildings and to the renovation of existing buildings. The "Green Cars" PPP initiative (EUR 1 billion) focuses on the development of renewable and non-polluting energy sources, safety and traffic fluidity in the automotive field.

measures lay the groundwork for a stronger recovery for two reasons. Firstly, economic growth would be positively influenced in the short run, given the relatively large multiplier effects associated with increased investment. Secondly, over the longer run, higher investment can remove various impediments to growth and enable faster recovery when conditions improve. From a competitiveness perspective, well-designed investment policies help to raise trend productivity and strengthen competitiveness. Conversely, a sustained fall in investment may have significant implications for future productivity growth rates. Such a contraction in physical investments would also be at odds with the need to adapt the infrastructure to climate and energy challenges.

96. ***In the short run business support measures can help counter unnecessary labour shedding and the exit of otherwise viable and sound companies.*** These take the form of three main types of action: i) measures to ease financing constraints on businesses; ii) sector-specific support, and iii) non-financial support measures. These measures can contain the negative effects of the crisis on potential output by preventing a permanent loss of knowledge and skills and a reduction of productive capacity. However, a trade-off exists between the desirable short-term aim and potentially adverse distorting effects over the medium term. In order to limit risks to competition and preserve a level playing field within the Single Market, the EERP underlines the critical importance of the temporary character – for the duration of the crisis – of business support measures.

2.5. FIRST ASSESSMENT OF NATIONAL MEASURES TAKEN UNDER THE EERP

97. ***Most Member States have drawn up national recovery plans in response to the EERP and they are now being implemented***. On the basis of a preliminary assessment, the Commission reported to the 2009 Spring European Council that the agreed level for a co-ordinated fiscal stimulus (1.5% of EU GDP) had been met. In response to worsening economic conditions, several Member States have announced additional discretionary fiscal measures on top of their national recovery programmes announced before the 2009 Spring European Council. As a result, in the euro area, the size of the announced discretionary financial stimulus over 2009 and 2010 has reached 1.8% of the euro-area GDP to date. This brings the total euro-area budgetary support to underpin growth and employment, which includes the support from automatic stabilisers, to 4.6% of the euro-area GDP (5% of GDP for the EU as a whole).

98. ***The scale of the measures varies greatly from one Member State to another***. In 2009 the largest fiscal stimulus in the euro area is being run in Spain (2.3% of GDP). Other sizeable stimuli are being undertaken by Austria (1.8%), Finland (1.7%), Malta (1.6%), Germany (1.4%) and Luxembourg (1.2%). Given their limited room for fiscal manoeuvre, some Member States make little or no contribution to the EERP. This category comprises Cyprus, Greece, Ireland, Italy and Slovakia. Overall, in structural terms, i.e. net of cyclical factors and one-off and other temporary measures, the projected deterioration in the euro area in 2009 (1% of GDP) is smaller than that of the headline deficit, but still significant given that many Member States support their economies with discretionary measures under the EERP (Table 2.3 and Graph 2.8). The fiscal stimulus is expected to be around 0.8% in 2010.

Table 2.3: **Total fiscal stimulus over 2009 and 2010 by Member State (in % of GDP)**

	2009-2010		
	Total	Expenditure	Revenues
AT	3.6	0.8	2.8
BE	0.8	0.5	0.3
CY	0.1	0.0	0.0
DE	3.3	1.2	2.1
EL	0.0	0.0	0.0
ES	2.9	1.6	1.3
FI	3.8	1.0	2.8
FR	1.0	0.7	0.3
IE	1.0	0.6	0.4
IT(1)	0.0	0.0	0.0
LU	2.6	0.1	2.5
MT	3.2	2.7	0.5
NL	1.9	0.8	1.1
PT	1.0	1.0	0.0
SI	1.1	0.9	0.2
SK	0.1	0.0	0.1
Euro Area	1.8	0.8	1.0

Note: Italy has adopted fiscal measures in response to the downturn, but their net impact is either neutral or deficit-reducing.
Source: Commission services

99. ***The funds allocated to the economy could be broken down in four categories***. Out of the 590 national measures reported by euro-area

Member States to the Commission: (i) 22% are supporting households' purchasing power; (ii) 25% are buttressing investment activity; (iii) 32% are in support of industrial sectors, businesses and companies; (iv) 21% should improve the functioning of labour markets. In volume terms, support to household purchasing power absorbs most of the additional budgetary resources over 2009–2010 (0.9 percentage points of GDP). These are followed by investment-related measures (0.5% of GDP) and measures aimed at companies (0.3% of GDP). Labour market measures make up a rather small part (0.1 percentage points of GDP) of total measures adopted so far. It should be noted, however, that some measures are of a cross-cutting nature as they can affect both household income and labour markets (for example measures in the field of tax and social contributions). The following paragraphs look at these four categories of measures.

Support to households' purchasing power

100. ***Support to households' purchasing power accounts for the lion's share of national measures***. Most measures relate to changes in income tax rates, tax bands or thresholds and to some extent also social contributions. Some measures are directed at alleviating mortgage payments for those hardest hit by the crisis. Some Member States have temporarily lowered VAT on selected consumer goods.

101. ***General changes in income tax schemes have been implemented in several Member States.*** Non-negligible reductions in effective income tax rates have been implemented in Germany and Finland, while other countries have made more limited changes to tax bands or other parametric changes (Luxembourg, Spain and Malta). On the one hand, general income tax reductions have the advantage of being transparent, easily implemented and unbiased towards specific sectors. They also tend to increase incentives to work. On the other hand, depending on the design of the tax cuts, high-income earners often benefit more (in absolute tax reductions), which may reduce the impact on aggregate consumption, given their relatively low propensity to consume. These measures are also often costly and liable to become permanent, which may explain their limited scope in many Member States. Several countries have also adjusted social security contributions paid by employees (for example Germany and the Netherlands).

Table 2.4: **Overview of structural reform measures relevant to national recovery programmes**

Breakdown of measures by category (number of measures)

	Supporting household purchasing power	Supporting investment activity	Supporting industrial sectors, businesses and companies	Supporting the good functioning of labour markets
AT	17	14	18	8
BE	11	9	16	17
CY	6	7	5	5
DE	12	14	13	8
EL	5	6	5	9
ES	17	11	36	14
FI	6	6	4	12
FR	18	12	21	12
IE	3	6	2	3
IT	9	10	8	7
LU	8	7	8	2
MT	1	3	5	2
NL	3	17	14	7
PT	8	7	16	6
SI	0	10	9	5
SK	4	6	12	8
EA	128	145	192	125
In %	22%	25%	32%	21%

Note: In some cases, a measure can be relevantly classified under two policy type headings or contribute to multiple policy objectives. In other cases, measures needing clarification are not included in the statistics of the table
Source: Commission services.

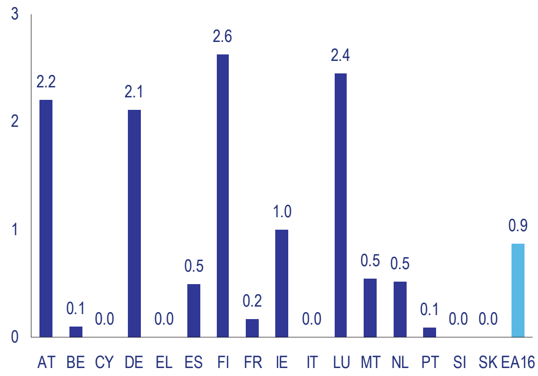
102. ***Specific support is provided to the most vulnerable group of citizens***. The focus of these measures is mostly on low-income households but also pensioners and families with children. Such measures are applied for example in Belgium, Spain, Germany and the Netherlands, although targeted measures are often of a limited overall size in terms of budget impact. Support is ensured through targeted tax cuts and benefits' increase. Finally, there are also measures that subsidise household consumption of certain goods and services. By focusing on groups with relatively high propensity to consume, such measures may be more cost-efficient than more general ones. While in some cases arguments could be raised as regards negative incentives to work, this may overall be less of a concern in a context of high, crisis-induced, unemployment.

Labour market measures

103. ***The financial crisis and the ensuing global downturn are beginning to impact significantly on labour markets.*** Recent data confirm that unemployment is now rising steeply, and projections indicate that employment will decline in absolute terms over the next two years

leading to a further steep rise in unemployment, which, on unchanged policies and labour market

Graph 2.9: **EERP - Measures aimed at supporting household purchasing power in the euro area (fiscal stimulus as % of country GDP, 2009-2010)**



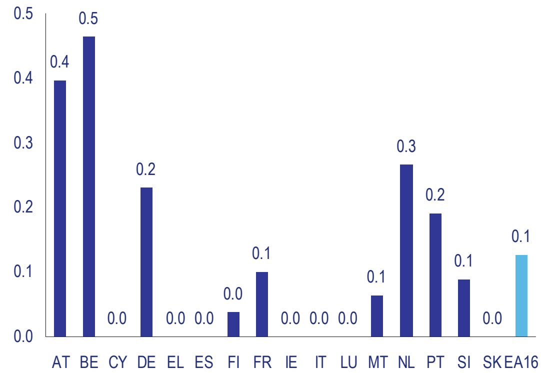
Source: Commission services.

behaviour, is set to exceed 11% in 2010. Overall, labour market measures represent a small proportion of the total discretionary fiscal impulse (Graph 2.10) but can be quite cost-effective in the present circumstances.

104. ***Flexible working time arrangements are being adopted in several Member States.*** Temporary working time reductions, temporary closures of factories and other forms of short-time work implemented by firms to prevent mass layoffs are underpinned by public support schemes. Many euro-area countries have either introduced new forms of public support for flexible working time or temporary unemployment (Portugal, Slovenia and Slovakia), or extended the duration or the level of existing public support schemes (Austria, Germany, France, the Netherlands, Belgium and Italy). Some Member States provide incentives for using the reduced hours for training activities (Austria, Belgium and Germany) in order to maximise the employability of workers on short-time arrangements. The experience so far with such measures is positive.

105. ***Training and active labour market policies should ensure that structural unemployment does not increase***. Almost all Member States are endeavouring to support and ease the re-integration into the labour market of recently laid-off workers. Training opportunities and incentives have been expanded in Austria, Greece, Finland, France, Portugal and Slovenia. Overall, it is too early to judge whether the measures taken are adequate and will thus reduce the risk of a detrimental increase in long-term unemployment.

Graph 2.10: **EERP - Labour market measures in the euro area (fiscal stimulus as % of country GDP, 2009-2010)**



Note: EA excluding Luxembourg.
Source: Commission services

106. ***Other measures attempt to boost labour demand through reductions in social security contributions.*** Measures such as reductions in social security contributions, cutting income taxes or changes in wage setting can influence –directly or indirectly– labour costs, depending on whether the measures are temporary or not. Rebates on social security contributions to boost labour demand have been applied in a number of euro-area Member States and have typically been made conditional on job creation (in Belgium, Spain, France, Portugal and Slovakia). Lowering labour costs for both employers and employees is already a feature of some medium-term national reform programmes and has gained additional relevance in the framework of the crisis (Belgium, France and Germany). Increased competitiveness has been sought in the Netherlands, where wage moderation over the medium term is traded against cuts in social security contributions for both employers and employees. In the same vein, Belgium has extended the inter-sectoral structural wage adjustment system, which is a scheme consisting of a reduction of wage costs and taking the form of a partial exemption from the withholding tax on wages. However, in countries with a deteriorated competitiveness position, such policy actions are less prominent.

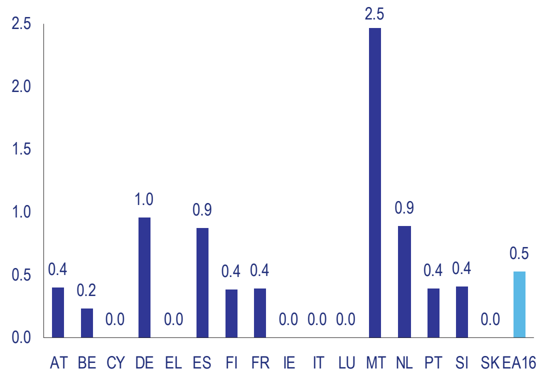
107. ***Improving the incentives to work embedded in the tax and benefit system is in line with long-term economic goals***. Apart from some countries where the tax pressure on labour was reduced, especially for low-wage earners (Finland and Malta), most measures appear to be temporary and contingent on the economic crisis. Income supplements and targeted in-work tax credits have been reinforced (Belgium, the Netherlands and Slovakia). Commuters' tax allowances have been increased (Austria and Slovakia) and the design of unemployment insurance has been modified so as to increase work attractiveness (Spain and Italy). Newly implemented social assistance schemes are conditional upon availability to work (France). A few measures were also taken to support female labour market participation (in Malta and the Netherlands).

Investment policies

108. ***Nearly all euro-area Member States have announced measures aimed at supporting investment in physical infrastructure***. The prominence attached to public investment in recovery efforts varies considerably across Member States, with the largest increases in spending as a percentage point of GDP observed in Germany, Cyprus, Spain, Malta, the Netherlands and Slovenia (Graph 2.11). By type of physical infrastructure, a majority of the measures aim at supporting investment in transport infrastructure. The bulk of these investments is related to the road and railway sectors. The information available suggests that investment in transport infrastructure is focused on traditional infrastructure with few measures geared to innovative solutions (such as modernisation of air traffic control infrastructure as in Slovenia).

109. ***The second biggest group of investment expenditure relates to the construction sector***. Many are focused on education facilities or other social infrastructure. Implementation is mostly planned for 2009 or 2010 but in practice projects often lag behind schedule. In this perspective, investment in maintenance tends to be timelier (especially for measures to renovate existing buildings in Austria, Spain, France and Portugal). A significant number of measures provide support to the building sector without being linked to energy efficiency improvements. In cases where the housing market has experienced a bubble such measures may implicitly contribute to postponing the necessary restructuring of the oversized construction sector and thus lead to lower long-term productivity.

Graph 2.11: **EERP -Measures aimed at stepping up investment expenditure in the euro area (fiscal stimulus as % of country GDP, 2009-2010)**



Source: Commission services.

110. ***Supporting energy-efficiency investment will mitigate the impact of the downturn while contributing to achieving long-term objectives.*** Speeding up the shift towards a low-carbon economy allows the EU to implement its climate change policy and reduce dependence on imported energy. Examples of specific measures include grants to small-scale energy-efficiency renovations (Ireland, Luxembourg, the Netherlands), public procurement for low-carbon or highly energy-efficient public buildings (France, Austria), tax and other financial incentives, etc. Such investments have the potential to stimulate job- and innovation-rich sustainable construction and renewable energy markets and are in line with long-term objectives. They will help minimise insolvencies of companies in the eco-innovation sector, which is expected to be dynamic and highly competitive when the economy starts recovering. Measures to support energy-efficiency investment focus on reducing the energy consumption of buildings, which account for over 40% of the EU's final energy consumption. Countries like Austria, Germany and Finland have reinforced guarantees and agreements with national public financial institutions to provide loans and other financial risk-covering instruments. The European Investment Bank has also announced a substantial increase in its lending in 2009 and 2010 for low-carbon and energy-saving infrastructure projects.

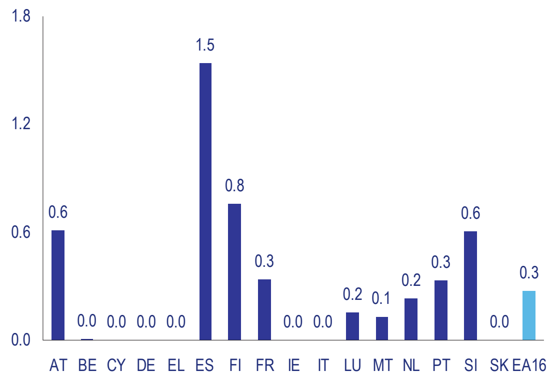
111. ***Research and Development (R&D) measures can increase productivity growth and competitiveness.*** R&D measures generally account for a small share of investment measures. Recovery measures mostly aim at helping R&D funding at a time when financial institutions tend to be more risk-averse. A significant proportion of R&D measures are targeted at SMEs. Firms' support takes the form of loans (Germany, Austria), R&D tax credits (Germany, Spain, Ireland, the Netherlands), depreciation rule (France and Germany) and direct subsidies (Austria, Germany, Finland). The preliminary assessment of recovery measures suggests that some countries are more successful in aligning their short-term actions with their medium- and long-term needs: for instance, Germany with detailed measures aimed at SMEs; Slovenia with measures aimed at fostering private R&D; Belgium and Spain, with fiscal incentives aimed at attracting researchers, as well as the Netherlands, reinforcing support instruments to stimulate private R&D. The EERP encourages Member States to conduct research on green technologies. Among the countries in the euro area, plans to invest in green technologies can be found in Spain, France, Italy and Germany. There might be a risk, however, that the crisis may widen the R&D gap between 'innovation leaders' and 'moderate innovators' and 'catching-up countries' ([23]).

Business support measures

112. ***The overall response to the crisis in terms of business support measures is strong***. Business support measures comprise: (i) the easing of financing constraints; (ii) sector support; and (iii) non-financial business support. The strong recourse to such measures can be explained by the fact that the crisis has severely affected European businesses and industries, firstly through tightening financial conditions, and secondly through a generalised contraction of global demand associated with a widespread loss of confidence among both consumers and businesses across the world. For an overview of business support measures at the individual country level, see Graph 2.12.

([23]) This terminology is taken from the European Innovation Scoreboard.

Graph 2.12: **EERP- Business support measures in the euro area (fiscal stimulus as % of country GDP, 2009-2010)**



Source: Commission services.

Easing financing constraints

113. ***Almost all euro-area countries have moved to counteract the drying-up of credit for businesses***. Examples of relevant policies are the extension of credit guarantees, including export credit, particularly for SMEs; the increase in the capital of public development banks to bring this about; easing conditions for access to and repayment of loans; temporary tax reductions and exemptions; and changes in depreciation rules favouring SMEs. These measures are for the most part horizontal in nature and are considered to be effective in the short term without major risks, as long as their temporariness is ensured.

114. ***Corporate taxation has been adjusted to improve the fiscal environment for businesses.*** In the euro area corporate taxes have been lowered on a permanent basis in some euro-area countries (France, Luxembourg and Slovenia) and on a more temporary basis in others (the Netherlands, Portugal, Greece and Spain). Already in 2008, Germany implemented a corporate tax reform that reduced the corporate tax rate from 25% to 15%, which is providing substantial relief for corporations over the period 2008-2012.

115. ***Other financial measures were also undertaken.*** Germany, the Netherlands, Austria, France and Finland indicated changes in the rules governing capital depreciation; the Netherlands, Spain and France adopted measures such as VAT acceleration payments, and Portugal, the Netherlands and Belgium sped up government bills. Some Member States have also moved to

ensure that financial sector problems do not undermine financing and insurance of foreign trade.

Sector support

116. ***Sectors receiving support account for a large and variable share in the economies***. All measures supporting specific sectors have an inherent potential to distort competition or hinder the process of economic restructuring within the EU. Most Member States have put in place horizontal frameworks that allow policy support to be given to sectors that are most affected by the crisis (e.g. cars, tourism, construction). Most measures seem temporary, targeted and timely. However, while the most affected sectors are broadly the same in all Member States, there is a considerable variation across Member States in terms of support actually provided – both in terms of sectoral composition and regarding the mix between supply- and demand-side measures. Therefore, even if schemes are consistent with internal market and state aid rules, they could nevertheless have an effect on the internal market through their differential impact on corporations depending on the Member State in which they are located.

117. ***Sector-specific measures focused on the automotive industry***. Ten euro-area countries (Germany, Spain, France, Italy, Cyprus, the Netherlands, Luxembourg, Austria, Portugal and Slovakia) have implemented car-scrapping schemes to support demand. These measures are temporary and make support conditional on the purchase of new or nearly new vehicles that should be less polluting. Most of the scrapping schemes were helping to generate additional car sales at the beginning of 2009, thus stimulating short-term demand. New passenger car registration increased in Germany, France and Slovakia by a significant amount (+40% on a year in Germany in June 2009).

118. ***Measures in the automotive industry have also been taken on the supply side***. The automotive sector is being supported in France ('Pacte Automobile' proposed in February 2009), Italy and Spain (Competitiveness automobile plan proposed in March 2009), Austria and Portugal. In addition, companies receive support through other schemes: greening of products (Germany, Spain and France) or subsidised loans (France). The environmental challenge to which the car sector is exposed makes it the main beneficiary of the greening schemes.

Non-financial business support

119. ***Non-financial business support includes reduction of administrative burdens and implementation of regulatory reforms.*** This set of measures is warranted where fiscal constraints may limit recourse to other options to enhance the business environment. Also, where such measures are already at an advanced stage, they can contribute to accelerating the adjustment process of the eventual recovery through an improved business environment, especially in countries where doing business was less easy before. Significant improvements in the business environment can be expected from a rapid and thorough implementation of the Services Directive and reforms in services going beyond the Directive.

120. ***Most of the measures undertaken in this area relate to the reduction in administrative burdens for businesses***. Such measures are being taken in Italy, the Netherlands and Malta. Others aim at stimulating entrepreneurship and SME activities, improving the conditions for starting up new businesses (Belgium and Spain). In 2008, prior to the crisis, structural reforms were implemented in the French services sector, especially in retail, where various constraints on opening new shops were lifted. Spain committed to accelerate the implementation of the Service Directive. The reform of professional services should also create positive effects. Finally, improvement of the administrative implementation of Structural Funds has been put on the agenda in Slovakia.

Overall assessment of national economic recovery measures

121. ***The preliminary findings are encouraging.*** Member States' recovery programmes constitute a robust response to the crisis and are broadly in line with the principles enunciated in the EERP, encompassing financial rescue packages, fiscal stimuli, temporary support to hard hit sectors and targeted support to vulnerable groups. Most measures seem

temporary, targeted and timely, although there are some questions relating to the reversibility of a number of policies. The stimulus package - alongside significant monetary easing and important bank rescue plans - has arguably put a "floor" to the collapse of economic activity in the EU and the euro area. Importantly, there are no obvious cases of rolling back past reform measures.

122. ***As regards progress with recovery measures in specific areas, the following insights can be drawn***:

Labour market policies in many Member States, notably through innovative short-term working measures and common guidance developed at EU level, have to date been rather effective in stopping unemployment from shooting up. Overall, however, labour market measures only represent a small proportion of the total discretionary fiscal impulse. Given the sharp projected rise in unemployment, and the large economic and social costs of long-term unemployment or withdrawal from the labour force, more emphasis is now needed on policies to support the unemployed. There is considerable variation across Member States in the composition of their labour market response by types of measures, and consequently there seems to be scope for policy learning between Member States.

123. As regards ***investment,*** a welcome finding is that new or accelerated spending on public investments forms a significant share of fiscal stimuli in line with the EERP. As the focus is mostly on projects already in the pipeline, most actions will support economic activity in 2009 and 2010. Moreover, there is a degree of focus on energy efficiency, although at the aggregate level there are few indications of a substantial shift towards green investment. Going forward, a key policy issue is whether the observed fall in private investment will have significant adverse repercussions on R&D spending, and in turn be detrimental to potential growth.

124. As regards ***business support*** measures, most Member States have put in place horizontal frameworks that allow temporary policy support to be given to sectors that are most affected by the crisis (e.g. automobile, tourism, construction). However, there is considerable variation across Member States in terms of support actually provided and the effectiveness of national schemes for industries that operate across the whole of the internal market could be somewhat limited. Risks remain that recovery measures adopted shortly after the outbreak of the crisis deepen rather than reduce intra-euro area macroeconomic divergences (see Section 1.5).

125. ***Overall, the preliminary analysis indicates that Member States have adopted a wide-ranging policy response to the economic crisis in line with the approach indicated in the EERP.*** The effectiveness and adequacy of measures will need to be continuously monitored in terms of the evolving economic situation. An exchange of best practices can help to improve mutual learning and enhance the effectiveness of measures in order to use the potential of the single market to the full. Devising detailed exit strategies would complement existing national frameworks and ensure the sustainable nature of the recovery.

3. THE EXTERNAL DIMENSION

126. ***The international financial crisis has pushed the world economy in its first global recession in post-war history***. This chapter looks at how the external environment of the euro area evolved over the last year. Section 3.1 starts by investigating how the shocks spread over the world economy and what measures policymakers of major economies took to alleviate the impact of the crisis. Section 3.2 goes on to describe the recent developments in the exchange rate of the euro. Section 3.3 looks at the impact of the crisis on global imbalances. Section 3.4 presents recent efforts by world leaders to reform the international financial system. Section 3.5 explores the impact of the crisis on the international position of the euro.

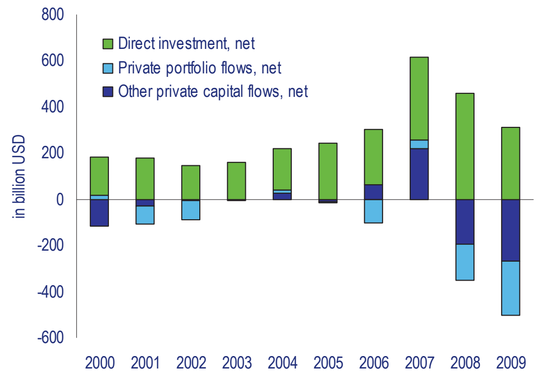
3.1. THE GLOBAL NATURE OF THE CRISIS

127. ***The financial crisis started in the advanced economies***… After the bursting of the US sub-prime bubble the crisis spread rapidly through financial channels to other advanced economies. Tightening financing conditions caused economic activity to slow down and advanced economies fell into recession in the fourth quarter of 2008.

128. ***…and spread to emerging markets afterwards.*** Emerging markets seemed to be initially sheltered from the financial turbulence thanks to their limited exposure to US subprime loans. However, the situation changed with the intensification of the financial crisis in autumn 2008. Sudden re-pricing of risk and flight to quality triggered massive withdrawal of funds from emerging markets. Funding provided to emerging markets by foreign banks dried up on the back of financing problems in their home countries. Internal imbalances in some emerging markets, veiled previously by favourable financing conditions, became exposed, adding to investors' risk aversion.

129. ***World trade suffered heavily***. At the end of 2008, trade collapsed as a result of the synchronised fall in demand in all parts of the world economy. World trade fell at an annualised rate of 24% in the last quarter of 2008. The scale of this drop was unprecedented and illustrated the depth of international trade linkages due to the rapid extension of global production chains during the last two decades ([24]). These developments had severe consequences for the export-oriented Asian economies, where exports contracted at double-digit rates. In addition to the slump in demand, increasing difficulties in obtaining trade credit and insurance also played a role.

Graph 3.1: **Capital flows to emerging and developing economies, annual flows**



Source: IMF World Economic Outlook database.

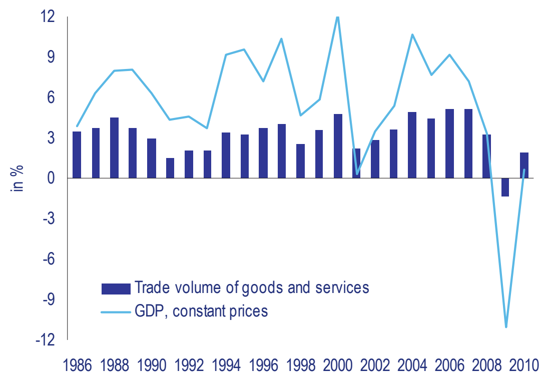
130. ***No economic area seemed to be spared***. With the exception of China and India, where the slowdown was nevertheless marked, growth is expected to be negative in most of the world's economies in 2009. Going by the past experience of financial and banking crises, world growth will be sub-par also in 2010. According to the Commission services' spring forecast, world growth is set to decrease by 1.4% in 2009 and to increase by 1.9% in 2010. World trade is expected to contract by 11% in 2009, and edge up (+¾%) in 2010. This outlook for global activity and trade is the bleakest since World War II. Emerging markets are likely to recover somewhat faster from economic doldrums as they might benefit more from the expected gradual recovery in trade.

131. ***The US economy entered a severe recession in the second half of 2008***. The bursting of the real estate bubble and the ensuing breakdown of the sub-prime mortgage market had acute consequences for the real economy. Tightened financial conditions and large capital losses depressed consumer confidence and consumption. Savings, which had been on a

([24]) The largest quarterly decrease recorded thus far was -11.1% in the first quarter of 1975.

declining path for two decades, rose sharply. In the face of the slump in demand, businesses cut production, employment and investment. Exports fell rapidly on the back of the collapse in external demand. Growth tumbled at an annual rate of 5.4% during the fourth quarter of 2008 and 6.4% during the first quarter of 2009. Growth decreased at a slower annual pace –1.0 percent– in the second quarter of 2009. A return to positive growth numbers is only projected for the second half of 2009. The magnitude of the contraction in 2008/09 is likely to exceed the decline in output during all previous recessions since the Second World War. Macroeconomic policy measures, a possible stabilisation of the housing market in the second half of 2009 and the downward adjustment in business inventories should translate into annual GDP growth of -2.9% in 2009 and +0.9% in 2010.

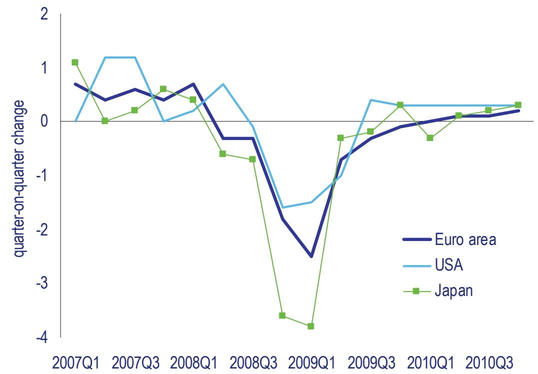
Graph 3.2: **World trade and GDP growth (annual average growth rate)**



Source: Commission services, IMF.

132. ***The Japanese economy was hit hard by the collapse in external demand***. Initially Japanese banks and financial institutions seemed relatively shielded from the fallout of the US subprime crisis because they had adopted cautious investment strategies following the banking sector crisis of the 1990s. Yet the Japanese economy was severely affected by the crisis. Due to its dependence on exports, the economy went into recession in mid-2008 as demand from the EU and US collapsed. The recession intensified and broadened to all sectors of the economy. Corporate profits were eroded, financial conditions deteriorated, and a negative feed-back loop between the real and the financial sectors materialised. The downturn affected the labour market, and unemployment surged to levels not seen since the Asian financial crisis. In 2009, the Japanese economy is expected to contract by -5.3% (after -0.7% in 2008) and to stagnate in 2010.

Graph 3.3: **Profiles of GDP growth in major economies (2007-2010)**



Source: Commission services' spring forecast.

133. ***The Chinese economy slowed down rapidly, but growth remained robust***. China fared better than many other economies thanks to its limited reliance on external financing. However, after the crisis spread worldwide, China's exports fell sharply, affecting private investment and consumption. After growing at an annual rate of 13% in 2007, GDP decelerated to 6.8% year-on-year in 2008Q4 and 6.1% in 2009Q1. Growth then accelerated again to 7.9% year-on-year during the second quarter, as a large fiscal stimulus programme unfolded.

Table 3.1: **GDP growth in major economies**

	2008	2009	2010
World	3.1	-1.4	1.9
USA	1.1	-2.9	0.9
Japan	-0.7	-5.3	0.1
China	9.0	6.1	7.8
Russia	5.6	-3.8	1.5

Note: Data for 2009 and 2010 from the Commission services' spring forecast.
Source: Commission services.

134. ***After a decade of robust growth, Russia is expected to fall into recession in 2009***. Similar to the situation in other emerging economies, the crisis became visible only in the second half of 2008. Hit by a dual shock of drying sources of external finance and dropping commodity prices, the economy stalled towards the end of 2008. In 2009, real GDP is forecast to contract by -3.8%,

and to recover only slowly in 2010. The large fiscal surplus that had been built up thanks to high commodity prices and robust growth is expected to turn into a deficit on the back of an expansionary fiscal policy.

Policy measures to sustain growth

135. ***The crisis triggered energetic policy responses to support growth***. International coordination of policy stimuli was crucial in order to ensure effective policy action. In an open economy parts of the national demand stimulus spills over across the borders thus limiting the growth impulse for the domestic economy. G-20 Summits were instrumental in fostering a worldwide coordinated approach to policy stimulus (see Section 3.4). As a consequence, in most large economies (advanced and emerging alike), policy actions were taken to support demand.

136. ***The US authorities made massive use of fiscal measures to combat the crisis***. Two large stimulus packages were adopted. The Economic Stimulus Act of February 2008 consisted mainly of rebates in personal income taxes and had a total budgetary cost of USD 168 billion (1.2% of 2008 GDP). Households seemed to have spent up to about half of the tax rebates received. It supported GDP growth temporarily in the middle of 2008. A second and much larger stimulus package (the American Recovery and Reinvestment Act) was adopted in February 2009. Its total budgetary cost was estimated at USD 787 billion (5.5% of 2008 GDP). Almost three quarters of this sum is foreseen to increase public spending: infrastructure projects, assistance to state and local governments, extension of unemployment insurance benefits and additional funding for other existing social programmes. The rest of the stimulus has financed cuts in personal income tax. Measures estimated to cost 2.1% of GDP were apportioned to 2009 and most of the remainder to 2010. This second stimulus package is expected to provide significant support to economic activity in the second and third quarters of 2009, but with a fading effect thereafter.

137. ***US monetary policy was loosened aggressively***. Continuing the cycle of interest rate cuts from the preceding year, the Federal Reserve gradually reduced the federal funds target rate from 4.25% at the beginning of 2008 to a range between 0 and 0.25% in December. This exceptionally low level was to be maintained for an 'extended period'. However, due to credit market disruptions, the effectiveness of interest-rate policy was reduced. Consequently, since the autumn of 2008, the Federal Reserve has been taking unconventional measures to ease inappropriately tight financial conditions. In particular, it resorted to 'quantitative easing' (see Section 2.2 for a definition), which involved a large increase in its balance sheet through the introduction or expansion of lending facilities, the purchase of vast amounts of agency (Government-Sponsored Enterprises) debt and mortgage-backed securities. In March 2009, the Federal Reserve started to purchase longer-term Treasury securities, thereby partially monetising the government deficit. Also in March 2009, the Federal Reserve launched the Term Asset-Backed Securities Lending Facility (TALF) – a USD 1 trillion programme aimed at restarting the securitisation process by providing low-cost funding to investors who purchase asset-backed securities.

138. ***The US authorities provided direct support to the financial sector***. Most prominently, the Troubled Asset Relief Program (TARP) was launched in October 2008. TARP received a total budget of USD 700 billion. The initial amount proved insufficient in the face of the losses in the financial sector. In February/March 2009, it was modified to more effectively relieve the financial system of impaired assets and to unfreeze credit markets. A Public-Private Investment Program was introduced and could eventually expand to USD 1 trillion in the process of removing impaired assets from the balance sheets of private banks. To assess the vulnerability of the banking system, US regulators carried out 'stress tests' to gauge the health of the 19 biggest US banks. This revealed that banks might require more reserves in the event of a further deterioration in the economic outlook. Ten out of the 19 banks were found to be in need of a combined USD 74.6 billion of extra funds to boost their reserves.

139. ***Japan adopted the highest-ever fiscal stimulus in spite of limited room for manoeuvre***. One of the lessons from the Japanese entrenched crisis in the 1990s was that policy reaction, in order to be effective, must be swift and decisive. In view of the severity of the situation, the Japanese

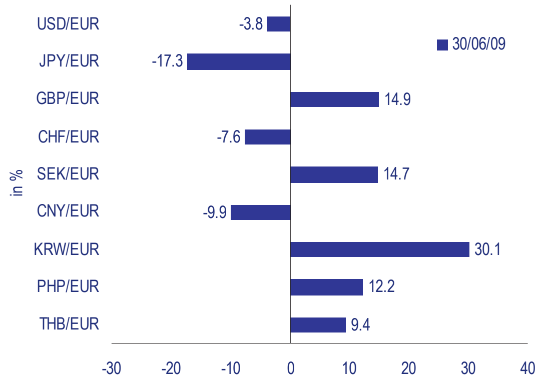
government announced a first policy package responding to the crisis in August 2008. Because of the worsening economic situation, another stimulus package, equivalent to 3% of GDP, was adopted in April 2009. These packages represent the biggest stimulus ever adopted in Japan. The measures focus on direct cash payments to households, tax cuts, investment support and subsidies. The government also decided to inject public funds into firms (including banks) that had become undercapitalised and were unable to secure financing because of the financial crisis. Other measures were designed to provide credit guarantees, in particular to SMEs and exporters. However, the highest debt-to-GDP ratio among OECD countries (almost 170% in 2007) limits the room for manoeuvre. The authorities' medium-term fiscal consolidation programme involves reaching primary surplus by financial year 2011 and a progressive reduction in the debt-to-GDP ratio afterwards. However, due to the sharp deterioration of the economic situation, the primary deficit is now projected to exceed 2% of GDP in Fiscal Year 2011, and debt is forecast to progressively approach 200% of GDP.

140. ***The Bank of Japan (BoJ) cut interest rates to virtually zero***. As interest rates had already been very low before the crisis, the BoJ adopted a wide range of unconventional monetary measures to support growth and counteract tightening financing conditions. The BoJ increased liquidity provision and broadened the range of eligible collateral. To support corporate financing and financial institutions, the BoJ has been buying commercial paper and corporate bonds, while providing long-term loans to banks at 0.1% interest.

141. ***The arsenal of policy instruments available to Chinese authorities is wider and deeper***. China can rely on many assets: (i) foreign reserves reached USD 1.95 trillion at the end of 2008; (ii) its debt level is low (18% of GDP); (iii) its fiscal position is relatively sound; and (iv) China's monetary policy still has room for manoeuvre. For these reasons China is in a better position to counter the negative consequences of the turmoil in the international economy than most other emerging economies. In the run-up to the G-20 summit in November 2008, the Chinese authorities announced a very large fiscal stimulus package amounting to RMB 4 trillion (around 13% of GDP). As a result, growth in the second quarter of 2009 benefited from the stimulus package. While investment in fixed assets is likely to remain buoyant, a stronger performance of private consumption is unlikely due to uncertainties for employment prospects.

142. ***The bulk of the fiscal stimulus was allocated to infrastructure and construction projects.*** The net additional spending was much lower than the headline figure of RMB 4 trillion, as the programme incorporated expenditure which had already been earmarked (e.g. reconstruction efforts following the 2008 earthquake in Sichuan province). Given that the central government is directly in charge of only RMB 1.2 trillion, the final impact of the package depends, to a large extent, on lower levels of government, which usually promote investment in fixed assets. A relatively small part of the stimulus was dedicated to social security schemes, in particular to the health sector, where reforms could help spur domestic consumption. As a result, China's trade and current account surpluses are likely to remain high in 2009 and in the following years.

Graph 3.4: **Changes in EUR cross-rates since 02 Jan 2008**



Note: "-" indicates euro depreciation
USD = US Dollar; JPY = Japanese Yen; GBP = Pound Sterling; CHF = Swiss Franc; SEK= Swedish Crown; CNY = Chinese Renminbi; KRW = Korean Won; PHP = Philippine Peso; THB = Thai Baht.
Source: Commission services.

143. ***After a long period of tightening, monetary policy was loosened in the second half of 2008.*** Faced with a real estate bubble, stock market exuberance, and inflationary pressures, monetary policy was further tightened in the first half of 2008. The financial crisis put a temporary end to these threats, and the strong decline in global commodity prices drove consumer prices

down. Therefore monetary policy was assigned to growth stimulation. The People's Bank of China (PBoC) reduced the benchmark lending rate from 7.47% in summer 2008 to 5.31% in April 2009. The reserve requirement ratio (RRR) was lowered from 17.5% to 15% for most banks over the same period of time. Equally important for easing monetary conditions was the lifting of limits on credit growth and the end of moral suasion on banks not to lend, which had been employed earlier to avoid overheating. This policy delivered results in the first months of 2009. Increased bank lending amounted to RMB 7.5 trillion in the first seven months of 2009.

144. ***In Russia, policymakers enacted an extensive set of policy measures on the fiscal side...*** The combined value of all the measures taken as a response to the crisis was estimated at 14% of Russian GDP, spread throughout 2008-2010. Measures in the fiscal package ranged from cuts in oil export duties, reduced corporate income tax to increased unemployment benefits. Responding to fears of banks' insolvency, bank deposit insurance was extended. The State started buying unsold real estate on the market to prevent a collapse in prices. Short-selling of stocks was prohibited, and caps were set for currency swaps and foreign assets of banks. The authorities re-capitalised several banks and encouraged further consolidation of the banking system.

145. ***… as well as on the monetary side***. To provide liquidity and support of stock markets, the Central Bank of Russia (CBR) and the Ministry of Finance resorted to frequent direct short-term injections of liquidity. The CBR provided loans to banks without any collateral. Banks could also be compensated for losses incurred on the interbank lending market and benefited from a long-term credit facility of RUR 950 billion (USD 36 billion) in the form of subordinated loans with a ten-year maturity. Banks with lower credit ratings were able to borrow on a repurchase agreement basis from the CBR. Companies and banks could obtain re-financing for maturing external debt. Moreover, exchange-rate policy has been used actively to encourage depreciation of the currency.

3.2. RECENT DEVELOPMENTS IN THE EURO EXCHANGE RATE

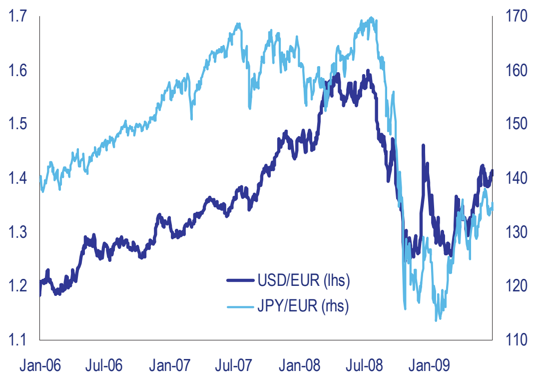
146. ***The financial crisis increased exchange rate volatility and triggered sudden trend reversals.*** In the wake of the financial crisis, foreign exchange markets were largely driven by portfolio shifts and changes in risk perception. In particular, in the second half of 2008, the increasing tensions in the global financial markets as well as the rapid global economic downturn led to diminished demand for risky assets. As a result, large and liquid currencies served as 'safe havens', while smaller currency areas saw waning demand and capital flight. The coordinated central bank actions, together with fiscal stimulus packages, eventually mitigated risk aversion and led to some exchange-rate stabilisation worldwide.

147. ***Since January 2008, the euro has depreciated by around 4% against the US dollar amid significant volatility***. In the first half of 2008, the euro strengthened against the dollar reaching a record high in nominal terms, slightly above USD 1.60 in mid-July 2008. The appreciation was driven by hopes that the euro area could decouple from the downturn in the US. The significant widening of the euro area-US interest rate differential also played a role. The ensuing reassessment of the outlook for growth and interest rates as well as precautionary flows into dollar assets led to a depreciation of the euro to USD 1.25 by the end of October 2008. The euro strengthened temporarily at the end of 2008 as the Federal Reserve embarked on a zero-interest-rate policy. However, rate cuts by the ECB and concerns over public finances in some euro-area Member States as well as worries about prospects for euro-area banks with Eastern European subsidiaries, pushed the euro lower again in early 2009. The euro started gaining ground again in mid-March on the back of the Federal Reserve's decision to enhance its quantitative easing policy and to directly buy government securities. On 30 June 2009 the euro stood at USD 1.41, some 4% below its January 2008 level (Graph 3.4).

148. ***The euro weakened substantially against the yen.*** Owing to the large interest rate differential, the euro appreciated strongly against the yen in the first half of 2008, reaching JPY 170 in July 2008, the highest level in the euro's history. In the subsequent months, the intensifying tensions

in financial markets led to a significant increase in risk aversion among investors. In addition, interest rate differentials between Japan and the euro area began to narrow. These factors led to portfolio shifts by Japanese enterprises and households and to the unwinding of carry trades ([25]). As a result, the euro depreciated sharply against the yen to JPY 116 in mid-January 2009. Since then, the euro has been recovering as the downturn in the Japanese economy intensified and the trade surplus fell. At the end of June 2009 the euro-yen exchange rate stood at JPY 135, which corresponds to a fall of 17.3% compared to the beginning of 2008.

Graph 3.5: **Euro exchange rates (daily data)**

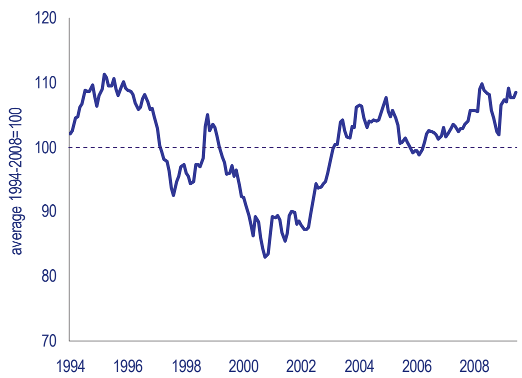


Note: Last observation is 30 June 2009.
Source: Commission services, ECB.

149. ***The British pound has been hit hard by the global deleveraging***. The pound sterling has been one of the currencies most negatively affected since the onset of the financial market crisis. After a sharp depreciation of the pound in December 2008, the euro reached a record high of 0.98 against the pound at the end of 2008. It amounted to a 34% appreciation over one year, half of which took place in December alone. The fall in the pound was the result of a change in market sentiment attributable to concerns about the UK's twin deficit (a large trade deficit coupled with a growing budget deficit and large contingent liabilities) and sharp interest rate cuts by the Bank of England at the end of 2008. There were also widespread fears that the recession in the UK would be deeper than in other advanced economies due to its dependence on financial services and to the bursting of the house price bubble. In 2009, this perception of divergence faded somewhat as growth forecasts in the euro area were also revised downwards. As a result, the pound regained some of the ground lost against the euro and stood at 0.85 at the end of June.

150. ***Other European currencies have also recorded significant depreciation against the euro***. These include the Swedish Crown and the currencies of the new EU Member States with flexible exchange rate regimes (the Czech koruna, the Polish zloty, the Romanian leu and the Hungarian forint), as well as non-EU currencies such as the Russian rouble. Increased risk aversion and the 'flight to quality' constituted the common factor behind these exchange rate moves. In times of elevated uncertainty investors seek the safety and liquidity of large international currencies. In some cases, however, a correction of the strong past appreciation experienced before the financial turmoil was part of the explanation.

Graph 3.6: **Euro real effective exchange rate (41 countries, CPI deflated)**



Source: Commission services.

151. ***Overall, the euro appreciated in effective terms.*** Weighting the bilateral exchange-rate movements by trade flows with its 41 most important partners, the euro stood about 3% higher in June 2009 than at the beginning of 2008. In real effective terms, i.e. taking into account the differences in consumer price inflation between the euro area and its trading partners, the euro appreciated by 2.6% over the same time span. However, volatility within this period was high. Two rounds of considerable appreciation (in early 2008 and since November 2008) contrast with a significant depreciation in the period from April to November 2008.

([25]) Carry trades consist of borrowing in currency at low interest rates (e.g. Japanese yen) in order to invest in a currency offering high interest rates (e.g. the euro).

3.3. GLOBAL IMBALANCES – AN UPDATE

152. ***Global imbalances – a cause for global concern.*** The term 'global imbalances' refers here to the pattern of current account deficits and surpluses that have been building up in the world economy since the late 1990s ([26]). The United States and some other countries developed large current account deficits, while other systematically important economies developed large surpluses (notably China, Japan, and oil exporting countries). There are two reasons to be worried about these asymmetries in external positions. First, correcting the imbalances to sustainable levels may require large exchange rate adjustments with possible disruptive effects on global financial markets and economic activity. Second, as the experience of the financial crisis shows, large global imbalances can contribute to the creation of excess global liquidity, the reinvestment of which can exacerbate asset price booms and sow the seeds of future global instability.

153. ***The crisis has so far led to some correction of the imbalances***. It is mainly due to the marked declines in domestic demand in the key deficit countries – the US and the UK, which together account for 60% of the total world current account deficit – and the fall in oil prices since August 2008. Table 3.2 shows that in 2008 current account imbalances narrowed in the US, the UK, Japan and China. The surpluses widened in 2008 in most of the oil-exporting countries on the back of the steep increase in oil prices in the first half of the year. Nevertheless, the annual data mask a marked reduction in the surpluses in the second half of the year. In China, the surplus increased in dollar terms despite falling as a percentage of GDP.

154. ***The US has led the reduction in current account deficits***. Reflecting the sharp deceleration in domestic demand and the effect of the dollar depreciation between 2002 and mid-2008, the US current account deficit narrowed from the peak of 6.0% of GDP in 2006 to 4.7% of GDP in 2008. The correction was briefly interrupted in the first half of 2008 due to the sharp increase in oil prices, but resumed in the second half of 2008 due to the weakness of US domestic demand and the marked fall in oil prices. The US income balance ([27]) improved and the surplus increased from 0.4% of GDP in 2006 to 0.9% of GDP in 2008. The decline in interest rates, which has been more pronounced in the US, resulted in a sharper decrease in income payments on foreign-owned assets in the US than in income receipts on US-owned assets abroad. As this phenomenon is temporary, this source of improvement in the US income balance is unlikely to last.

155. ***The UK also reduced its current account deficit.*** The current account deficit narrowed from 2.9% of GDP in 2007 to 1.7% of GDP in 2008. This follows a period of gradual increase in the deficit between 1997 and 2006, which resulted in a peak of 3.4% of GDP in 2006. The main factor explaining the recent improvement in the UK's current account deficit is the sharp increase in the UK's surplus on the income account, which primarily records investment income flows, including losses from asset write-downs. In 2008, the income surplus reached its highest value (2.3% of GDP) since records began in 1955. Much of this improvement is linked to the impact of the financial crisis on write-downs on UK assets held abroad and foreign assets held domestically. It seems that the losses of foreign investors holding UK assets have been higher than the losses of UK investors holding foreign assets. In the second half of 2008, the trade deficit showed an improving trend, reflecting the relatively deep and early downturn in the UK and the strong depreciation of the pound (see Section 3.2). Recently, however, the trend in the UK’s trade balance has been broadly flat.

156. ***Surpluses narrowed in Japan and China as a percentage of GDP***. Japan's current account surplus fell from 4.8% of GDP in 2007 to 3.2% of GDP in 2008, mainly driven by the decline in the trade surplus. Japan's trade balance turned into a slight deficit (0.1%) in 2008Q4 for the first time since records began in 1985. The marked decline

([26]) The current account of the balance of payments keeps a record of all current transactions (such as exports and imports, tourist expenditure, dividend and interest income) between a country and the rest of the world. The difference between exports and imports of goods and services (i.e. trade balance) usually constitutes the largest part of the current account. An economy posting current account deficits (surpluses) can be characterised as having a level of consumption higher (lower) than its production.

([27]) The income balance is a subcomponent of the current account balance. It traces net income deriving from direct investments, portfolio investments and other investments.

in global demand for Japanese exports and the lagged effects of the appreciation of the yen that had occurred between 2007 and 2008 seemed to be the main factors explaining the deterioration in Japan's trade balance. In addition, the income account – which had previously been stable – recorded a significant fall in its surplus on the back of falling overseas investment receipts (they declined from 3.1% of GDP in Q3 to 2.1% of GDP in Q4). In China, the current account surplus increased from USD 372 billion in 2007 to USD 426 billion in 2008 but fell as a percentage of GDP from 11% to 10.5%. Exports declined sharply in the second half of 2008 as a result of the contraction in global demand. Imports, however, fell even more sharply in value terms due to lower oil and other commodity prices. As a result, the trade surplus increased.

Table 3.2: **Current account balances of major economies (as % of GDP)**

	2005	2006	2007	2008
USA	-5.9	-6.0	-5.3	-4.7
Japan	3.6	3.9	4.8	3.2
Euro area	0.4	0.3	0.1	-0.7
UK	-2.6	-3.4	-2.9	-1.7
China	7.2	9.5	11.0	10.5
GCC countries	27.4	28.7	25.1	27.2
Russia	11.0	9.5	5.9	6.1

Note: GCC stands for Gulf Cooperation Council.
Source: IMF Spring 2009 World Economic Outlook and China's State Administration of foreign exchange.

157. ***Surpluses of most oil-exporting countries widened in 2008***. The increase in surpluses was mainly due to the steep rise in oil prices in the first half of the year. Current account data for Russia and trade data for the Gulf Cooperation Council countries (GCC) showed that the increase in surpluses in the first half of the year was partially reversed in the second half due to the sharp fall in oil and other commodity prices.

158. ***Despite some rebalancing, global imbalances have remained large and should stay on the policy agenda***. There is the risk that some of the recent improvements may unwind when the global recovery takes hold and international commodity prices increase again. In the medium term, the continuing reduction of global imbalances and a move towards a more balanced global growth path will be essential to limit the risks of another crisis in the future. IMF multilateral consultations in 2007 concluded that major economies should take bold policy measures over the medium term. In the US, measures should aim at increasing domestic savings (both public and private). In China, the share of private consumption in China's GDP should increase (facilitated by an orderly appreciation of the renminbi), while higher potential growth should be sought in the euro area and Japan.

3.4. REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

159. ***The global financial crisis exposed shortcomings in the international financial architecture***. Fragmented supervision of global financial market players and lack of macro-prudential oversight prevented early detection of the mounting financial problems and delayed remedies (see Section 2.3). Favourable macroeconomic conditions provided a fertile breeding ground for asset price bubbles and current account imbalances. In particular, overly accomodative monetary policy in some developed economies and insufficiently flexible exchange rate policies in some key emerging market economies contributed to the build-up of global macroeconomic imbalances and asset price inflation.

160. ***The global nature of the crisis underlined the need for truly global action***. After the intensification of the financial crisis in September 2008, there was a growing consensus among world leaders on the urgent need for joint action on a global scale. Against this background, the leaders of the Group of Twenty ([28]) (G-20) met for the first time in Washington on 15 November 2008. European heads of state and government played a key role in launching the G-20 summit. The EU Presidency, the President of the European Commission and the ECB represented the EU in the G-20 process. The Washington summit set out broad principles for reform, as well as some specific short- and medium-term actions in response to the crisis.

([28]) The Group of Twenty Finance Ministers and Central Bank Governors was established in 1999 and brings together the 19 biggest world economies plus the European Union, represented by the EU Presidency and the ECB. The countries are represented by the respective Finance Ministers and Central Bank governors. The Washington meeting was the first one on the level of state leaders.

161. ***As the economic situation was worsening, G-20 leaders further coordinated their responses.*** As the economic situation deteriorated further, the leaders of the G-20 met for the second time on 2 April 2009 in London. They hammered out further details of the collective action necessary to stabilise the world economy, to reform global financial regulation and supervision, and to strengthen the international financial institutions. World leaders showed their determination to work together to overcome the crisis and restore confidence. The EU contributed actively and substantively to the G-20 process, insisting on the importance of financial regulatory and supervisory reform, facilitating the coordination of positions among EU Member States and contributing financial resources to Summit agreements. Measures taken were aimed at: (i) restoring growth; (ii) improving financial regulation and supervision; and (iii) strengthening international financial institutions.

Restoring economic growth

162. ***Faced with an unprecedented downturn, the G-20 agreed on an unparalleled joint policy action.*** Overall, the leaders pledged an additional USD 1.1 trillion of resources aimed at fighting various facets of the crisis. These funds will finance a comprehensive programme by international institutions with the aim of supporting credit, growth and jobs in the world economy ([29]).

163. ***Decisive measures at national level contribute to mitigating the severity of the global downturn***. Leaders agreed to deliver the sustained fiscal effort necessary to restore world economic growth, within the constraints of ensuring medium-term fiscal sustainability. Central banks, fighting the crisis in the front line since its beginnings, pledged to maintain expansionary monetary policy and to use the full range of available instruments, while maintaining price stability. However, these actions could not be fully effective until domestic lending and international capital flows were restored. Therefore, repairing the credit channel and dealing with financial institutions' impaired assets were given high priority. Once the crisis was over and policy measures had served their purpose, the stimulus provided would have to be gradually withdrawn by both fiscal and monetary authorities.

164. ***Open markets, trade and free competition are part of the solution***. Leaders reaffirmed their commitment to open markets, free trade and investment and called for an urgent conclusion of the WTO's Doha Round. Rapidly falling world trade raised concerns in many countries as trade had long been a source of growth, in particular in developing countries. As a lack of trade finance was one of the causes of the steep fall in trade activity, the G-20 agreed to make available USD 250 billion for trade finance over the next two years.

Financial regulation and supervision

165. ***The London Summit agreed on an ambitious plan to reshape global financial regulation.*** In the future, all markets, instruments and institutions are expected to be subject to appropriate regulation and oversight. The EU has long called for such a step. This implies the elimination of existing supervisory 'blind spots'. Global colleges of supervisors for all large cross-border banks will be established. In addition, the Financial Stability Forum, renamed 'Financial Stability Board' (FSB), has been enlarged to include all G-20 members, plus Spain and the European Commission. Its mandate has been broadened to promote financial stability. Jointly with the IMF, the FSB will devise an early warning system designed to identify global macroeconomic and financial vulnerabilities.

166. ***The problem of tax havens and offshore financial centres has been addressed***. Action against non-cooperative jurisdictions in regard to anti-money laundering, tax information exchange and prudential matters was agreed. The political pressure exerted on non-cooperative jurisdictions since the outbreak of the crisis had already induced several of them to subscribe to international standards on the exchange of tax information before the London summit. The G-20 announced that it would monitor the situation and stand ready to deploy sanctions, if needed. Along with the FSB's new principles on executive pay and bonuses in financial institutions, which G-20 leaders endorsed, these measures represent

([29]) See the Communiqué from the London Summit on www.g20.org progress towards global regulatory convergence and stronger supervision.

International financial institutions

167. ***The resources of the IMF will see a threefold increase***. G-20 leaders agreed to triple IMF lendable resources to USD 750 billion, initially through bilateral loans from member countries and later through expanded and more flexible New Arrangements to Borrow (NAB). This expansion of resources will ensure that the IMF has the funds at its disposal to help countries with financing problems. EU Member States have done their fair share in offering financial support. They pledged to provide EUR 75 billion to the IMF (approximately USD 100 billion) via bilateral agreements. Leaders also supported a new allocation of Special Drawing Rights of USD 250 billion, which would provide low-income countries with an extra USD 19 billion. In addition, the IMF's ability to help emerging markets and low-income countries will be supported by using part of agreed sales of IMF gold for concessional lending and the possibility to borrow funds directly on the market, if necessary. In parallel, the IMF has created a new lending instrument that will help to prevent the withdrawal of external capital rather than to remedy its consequences. With its new Flexible Credit Line, the IMF makes available financial resources to its member countries with a good policy track record ('ex ante conditionality'). The resources can be used unconditionally when needed.

168. ***Multilateral Development Banks will increase lending and other forms of finance***. The G-20 stressed the need to ensure that the Multilateral Development Banks (MDBs) were adequately financed to contribute to the resolution of the crisis. MDB lending is set to increase by 50% to USD 300 billion over the next three years. For this purpose, MDBs have been encouraged to extend their balance sheets and to use other financial tools to leverage private capital more effectively. Moreover, the capital of the Asian Development Bank will be increased threefold and the corresponding needs of other MDBs will be reviewed.

169. ***Further coordination is warranted.*** The decisions taken by G-20 leaders have to be implemented. To ensure continued coordination and monitor progress, the leaders agreed to meet again on 24-25 September 2009 in Pittsburgh. The EU will drive the reform process forward both domestically, by implementing the G-20 agreements on all fronts, and internationally, by playing an active leadership role in the G-20.

3.5. THE FINANCIAL CRISIS AND THE GLOBAL ROLE OF THE EURO

170. ***The euro's role as the second most important international currency remains firmly established.*** Since its introduction in 1999 the euro has quickly become an important international currency, surpassing the combined international status of its legacy currencies. The share of the euro in foreign exchange reserves stood at 25.9% at the end of the first quarter of 2009, 4.6 percentage points higher than at the end of the first quarter of 1999, albeit below the peak of 28.4% that it reached in 2003 ([30]). In the first quarter of 2009, the dollar remained well ahead, with 65% of total reserves. As for international debt securities, evolutions differ depending on the measurement chosen ([31]). The broad measure, based on BIS data, consists of all bonds targeted at the international market, i.e. those placed by a syndicate of financial institutions in which at least one institution does not share the borrower's residency. According to this measure at constant exchange rates, the euro's share was 46.7% at the end of the first quarter of 2009 (-0.6 percentage point on a year), compared with 37.5% for the US dollar. By contrast, the narrow measure strips out from the broad measure all those debt securities that are issued in the currency of the issuer, thus counting only debt securities issued in a currency that is different from the issuer's home currency. Under this definition, the euro remains second

([30]) Data on the currency composition of foreign exchange reserves at the global level come from the IMF. The IMF database covers around two thirds of total official reserves but does not include assets managed by sovereign wealth funds.

([31]) Conceptually, an international debt security can be understood as a bond denominated in a currency that is either not the issuer's or not the buyer's home currency, or both. In practice, the identity (and hence residency) of the buyer is often unknown, which explains why several practical definitions might be used to approximate the concept. The broad measure might overstate the euro's share in the international bond market. The narrow measure might understate it.

Table 3.3: **Countries and territories with exchange rate regimes linked to the euro (as of 30 June 2009)**

Region	Exchange rate regimes	Countries/territories
European Union (non-euro area)	ERM II	Denmark, Estonia, Latvia, Lithuania
	Euro-based currency board	Bulgaria
	Inflation targeting, but officially with a managed floating system with the euro as reference currency	Czech Republic, Romania
Candidate and potential candidate countries	Unilateral euroisation	Kosovo (1), Montenegro
	Euro-based currency boards	Bosnia and Herzegovina
	Managed floating with euro as reference currency (de facto pegs)	Croatia, Former Yugoslav Republic of Macedonia
	Managed floating with euro as reference currency	Serbia
Others	Euroisation authorised by a monetary arrangement	Monaco, San Marino, Vatican City, French territorial communities (2)
	Euroisation without monetary arrangement	Andorra
	Peg arrangements based on the euro	CFA franc zone (3), French overseas territories (4), Cape Verde, Comoros
	Peg arrangements and managed floats based on the SDR and other currency baskets involving the euro	Algeria, Azerbaijan, Belarus, Botswana, Fiji, Libya, Morocco, Myanmar, Russian Federation, Samoa, Seychelles, Syria, Tonga, Tunisia, Vanuatu

Notes: (1) The euro replaced the Deutsche Mark, which was introduced by UNMIK in 1999. (2) Mayotte, Saint-Pierre-et-Miquelon. (3) WAEMU (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) and CAEMC (Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon). (4) French Polynesia, New Caledonia, Wallis and Futuna.
Source: ECB, Commission services.

after the US dollar, with 32.2% and 44.7% respectively at the end of 2008.

The share of the euro according to this narrow definition rose by about one percentage point between end-2007 and end-2008 at constant exchange rates ([32]). In global foreign exchange markets, the euro-dollar currency pair is the most actively traded one, accounting for more than a quarter of global turnover, but third currencies are traded substantially more against the dollar than against the euro (approximately 90% of foreign exchange transactions involve the US dollar; around 41% involve the euro). The euro is widely used as a reference currency for managed exchange-rate regimes, sometimes as part of a larger basket of currencies (see Table 3.3). It is used in this way mainly by countries in geographical proximity or with some historical or institutional ties to euro-area countries.

171. ***The financial crisis has so far had only limited impact on the relative positions of currencies in the world economy***. Over the course of 2008 the euro's share increased in many dimensions – including official reserves, debt securities, cross-border loans and deposits, foreign exchange trading and cross-border invoicing of those countries for which data are available. However, most variables posted only a modest rise over 2008. While in many market segments overall market size and transaction volumes have declined in the wake of the crisis, the currency composition has remained broadly unchanged.

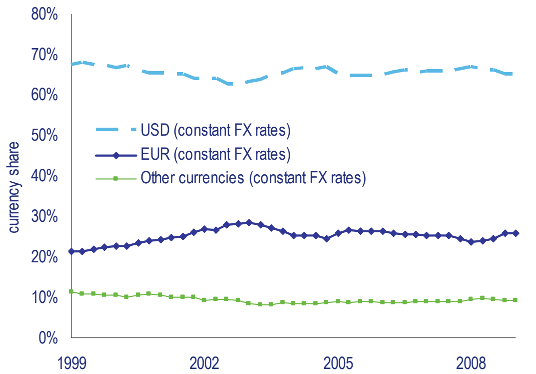
172. ***This relative stability challenged certain views on prospects for international currencies***. Before the current financial crisis and in its early stages, there was widespread debate on whether the large global imbalances in current account positions would trigger a decline in the international use of the US dollar. However, the trend appreciation of the US dollar at the height of the financial crisis was reminiscent of the flight-to-quality phenomenon, as capital was repatriated from markets perceived as risky (in particular emerging markets). This safe-haven status may also have helped the US dollar to maintain its position as the most important international currency through the crisis.

173. ***The euro meets many of the criteria of an international currency***. The credible stability-oriented framework of EMU has helped to build confidence that the euro is a reliable store of value for households, businesses and investors. The euro area also comprises countries with stable political systems. In economic terms, the euro area is large enough for its currency to be attractive for the rest of the world. Measured at current exchange rates, the euro area accounts for about 22% of world GDP and more than 18% of world trade. The future entry of other EU Member States into the

([32]) See the ECB's Annual Review of the International Role of the Euro (July 2009), available on the ECB website.

euro area will increase its weight in the global economy further. At the same time, financial market integration as part of the EU's single market has achieved a lot in terms of making euro-area capital markets larger, more liquid and more efficient. However, the euro still lags the US dollar in this respect; according to the 2008 RBS Reserve Management Trends Survey, whereas all Central Bank reserve managers rank US government bonds as 'highly liquid', only 74% have a similar opinion of euro-denominated ones. Still, the assessment of euro-denominated securities is markedly better than that of the Pound Sterling (50%) or the Japanese Yen (48%).

Graph 3.7: **Foreign Exchange Reserves of which currency is known (at constant end-2008 exchange rates)**



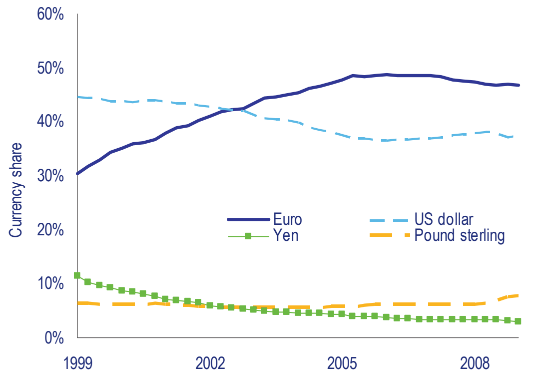
Source: IMF COFER database.

174. ***Even with the euro being an attractive currency in many respects, the development of its international role will be a long-term process.*** Inertia generally supports the incumbent currency. More specifically, network externalities, including simple convenience, favour the permanent use of just one currency for certain purposes, such as commodity price quotations. Furthermore, historical precedents underline the gradual nature of currency internationalisation ([33]). For instance, the erosion of the pound sterling as leading international currency throughout the 20th century was caused by a series of momentous events, including the two World Wars, but took place at a much lower speed than the effective weight of the UK in the world economy would have implied.

The process stretched over decades and included a period of coexistence of the pound sterling and the US dollar as international currencies.

175. ***It is too early to assess with certainty how the global financial crisis will impact on the international monetary system and the role of the euro within it.*** The significance of small short-term shifts in currency shares should not be overstated, in particular as the available data only cover a limited period since the intensification of the crisis in the autumn of 2008. However, the crisis has prompted some initiatives and proposals for reforms of the international monetary system.

Graph 3.8: **Total international bonds outstanding, broad measure (at constant end-2008 exchange rates)**



Note: The broad measure consists of all bonds targeted at the international market, i.e. those placed by a syndicate of financial institutions in which at least one institution does not share the borrower's residency
Source: BIS.

On 23 March 2009, the governor of China's Central Bank called for a greater role for the IMF's Special Drawing Rights (SDR) in global reserve holdings ([34]). Since then, the IMF has started to prepare an allocation of USD 250 billion (as supported by the G-20 summit in London, see Section 3.4) and the issuance of SDR-denominated notes, which Brazil, Russia and China have announced they would purchase.

([33]) See B. Eichengreen: 'Sterling's past, Dollar's future: Historical Perspectives on Reserve Currency Competition', NBER Working Paper No. 11336, May 2005.

([34]) The SDR is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of IMF member countries. SDRs are allocated to IMF member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organisations. Its value is based on a basket of key international currencies (euro, Japanese Yen, pound sterling and US dollar). The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members.

4. ECONOMIC GOVERNANCE IN TIMES OF CRISIS

176. ***Recent economic events have put the conclusions of the EMU@10 Report to the test***. To mark the tenth anniversary of the euro, the European Commission presented in May 2008 a Communication and an accompanying Report to review the experience of the first decade and to look to the future ([35]). Since the report had been released, the global economic situation has deteriorated dramatically. The global crisis is putting the Economic and Monetary Union to the test and underscores the need to improve its governance along the lines indicated in the EMU@10 Report. This chapter recalls its main conclusions and recommendations and highlights follow-up work in the light of the current economic and financial turmoil. Section 4.1 stresses how recent events have enhanced the relevance of the Commission's EMU@10 Report. Section 4.2 reviews the work carried out in 2008 regarding the broadening and deepening of macroeconomic surveillance. Section 4.3 looks at the recent substantial developments in financial governance. Finally, Section 4.4 highlights the continuing enlargement of the euro area since 2007.

4.1. THE EMU@10 REPORT IN THE LIGHT OF THE CRISIS

177. ***To address the challenges facing the euro area, the Commission proposed a three-pillar agenda in the EMU@10 Report***. First, the domestic agenda sought to deepen fiscal policy co-ordination and surveillance, to broaden macroeconomic surveillance in EMU beyond fiscal policy and to better integrate structural reform in overall policy co-ordination within EMU. Second, the external agenda aimed to enhance the euro area's role in global economic governance. Third, both agendas required a more effective system of economic governance.

178. ***The recommendations set out in the EMU@10 Report more than a year ago are more relevant than ever***. The manifold successes of the euro in the first decade were a blessing in disguise. The euro delivered macroeconomic stability through a consistent single monetary policy and improved fiscal behaviour in Member States. It fostered a decade of low inflation and interest rates, bringing substantial savings for consumers and business. It underpinned the Single Market, serving as a major catalyst for trade and investment and deepened financial integration. Economically and politically, the single currency has become the symbol of the European integration process. At the same time, the achievements have blunted the willingness of policy-makers to address the remaining challenges facing the euro area. Now, though, the crisis has brought those challenges fully into focus.

179. ***Deepening macroeconomic surveillance will prove essential to foster an orderly return to more sustainable fiscal positions***. The EMU@10 Report stressed the importance of securing the sustainability of public finances for the benefit of future generations. In response to the crisis, most euro-area Member States have engaged resolutely in fiscal stimuli to stabilise the economy. Bank rescue packages have inflated substantially public debt outstanding and increased contingent liabilities. Against this background, sustainability considerations have become more relevant than ever. Coordinated surveillance benefits considerably from the sound functioning of the Stability and Growth Pact, which provides a frame, an anchor and directions for deeper surveillance.

180. ***Broadening macroeconomic surveillance should address imbalances at an early stage***. The surveillance of fiscal policies has delivered immense benefits to the euro-area economy. However, economic imbalances can originate from other quarters. Over-indebtedness in the private sector could trigger unsustainable economic trends that should be detected and dealt with at an early stage. Macroeconomic surveillance should be broadened in this perspective. The EMU@10 Report stressed that *'while market integration, particularly in financial services, is beneficial overall for EMU, it can also, if not accompanied by appropriate policies, amplify divergences among the participating countries'*. The crisis demonstrated eloquently how fast the successive financial shocks hit the rest of the economy and how strong the feedback loops were. It also revealed that the resolution of financial crises might prove very costly in fiscal terms. Early detection of asset price booms and busts is

([35]) COM (2008) 238 final, 7 mai 2008, 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union'.

essential to avert costly corrections of fiscal and external imbalances at a later stage. Therefore surveillance should incorporate in earnest financial market developments and their interplay with the real economy. From a more operational perspective, the crisis showed that a gap existed between financial market watch on the one hand, and macroeconomic watch based on traditional national accounts data on the other hand. This gap should be bridged without delay by an all-encompassing macro-financial analysis (see Section 4.3).

181. ***Global crisis resolution accentuated the external policy agenda laid down in the EMU@10 Report***. Global macroeconomic imbalances lay at the root of the crisis. Although the euro area enjoyed balanced economic fundamentals, it was struck with considerable force by the global crisis fallout. The euro area cannot afford to be a bystander. It has to express itself more forcefully on the international scene to help solve global issues. The G-20 process, which the EU has successfully promoted, offers an opportunity to consolidate the representation of the euro area. In this respect, the EMU@10 Report stressed that 'the euro area must build an international strategy commensurate with the international status of its currency'. This issue was to some extent considered to be of a medium-term nature. The crisis acted as a wake-up call and urgent steps are needed in the short run instead. To be more influential in the ongoing overhaul of global governance, the euro area should rapidly consolidate its external representation and speak with one voice in international fora.

182. ***EMU's system of economic governance has been tested in times of crisis***. The EMU@10 Report stressed that the Eurogroup and the Commission should play a more active role in coordinating euro-area economic policies within the scope defined by the Treaty. The design and implementation of consistent response to the crisis has been challenging (see Section 4.3). More than ever, euro-area Member States should take the lead in driving policy action to combat the current crisis and contribute to the overall recovery of the EU economy.

183. ***As a follow-up to the EMU@10 Report, the Commission succeeded in triggering a deeper dialogue concerning EMU among the EU institutions and with the public at large.*** The dialogue increased awareness of the significant benefits of the euro, such as its role as a protective shield during the current financial turmoil. The discussions highlighted the need for closer economic policy coordination as well as broader and deeper surveillance and governance.

184. ***The European Parliament's resolution on the first ten years of the euro constitutes an important contribution to the discussion of this subject.*** Adopted in November 2008, the bipartisan Report from MEPs Pervenche Bères and Werner Langen affirms the consensus achieved on fundamental questions pertaining to the EMU ([36]). It highlights the success of the euro and supports the Commission's intention to strengthen the influence of the euro area in international financial institutions. Furthermore, the resolution sketches out an ambitious agenda for strengthening economic governance in the euro area. In particular, the Parliament supports the strengthening of the preventive arm of the SGP and a closer involvement of national Parliaments in the revision of the Lisbon Integrated Guidelines. It has put forward proposals for revising the existing banking and financial supervisory architecture and called on the Commission to examine the creation of European bonds and develop a long-term strategy on this issue.

185. ***The European Central Bank highlighted the achievements and responsibilities of the euro area.*** The ECB published a special edition of its monthly bulletin in May 2008 that looked back at the ECB's work over the past ten years. It also reviewed the challenges that the ECB and the euro area faced as they entered their second decade. In a speech at the January ceremony of the European Parliament marking the tenth anniversary of the euro, the ECB President mentioned some of these challenges ([37]). First, the euro area should overcome successfully the financial crisis by playing an active part in the global efforts to address the weaknesses in the global financial system and to redesign the regulatory and institutional framework. Second, the euro area

([36]) Report from the European Parliament A6-0420/2008 of 28.10.2008.

([37]) 'The euro@10: achievements and responsibilities' Remarks by Jean-Claude Trichet, President of the ECB, at the ceremony of the European Parliament to mark the 10th anniversary of the euro, Strasbourg, 13 January 2009.

should implement the Stability and Growth Pact in a firm and credible way and make efforts to render the economies of the Union more productive, innovative and dynamic, and avoid major competitive divergences within the euro area. Third, the handling of enlargement would be an inspiring and demanding challenge for all Institutions.

186. ***At its meeting of 24 March 2009, the European Economic and Social Committee (EESC) adopted an opinion on the EMU@10 Report, which highlighted the successes of the euro in terms of price stability.*** The opinion ([38]) stressed the need for better representation of EU institutions on the international scene. The EESC also noted the remaining challenges regarding the integration of goods and services markets and financial supervision, for which clear rules should be put in place. In particular, and in relation to the current crisis, the EESC called on all economic and monetary authorities to learn from the US subprime crisis and to thoroughly overhaul the policies underpinning the operation of the financial markets.

4.2. THE BROADENING AND DEEPENING OF MACROECONOMIC SURVEILLANCE

Overall, the dialogue with major stakeholders underlines the need for European policymakers to step up surveillance of the economies of euro-area Member States. This ought to include taking a closer look at competitiveness developments and paying more attention to the quality of public finances.

Broadening surveillance to cover competitiveness developments

187. ***Competitiveness developments warrant broader surveillance***. Since the launch of the euro, differences in growth and inflation have tended to be significant and persistent, leading to large changes in Member States' relative competitive positions, notably in terms of price competitiveness but also in terms of current account imbalances and net foreign asset positions. As a result, some Member States have recorded diverging current account positions since 1999.

([38]) Opinion CESE 633/2009 of 24 March 2009.

188. ***Intra euro-area divergences matter for the functioning of EMU***. It is a matter of common concern as intra euro-area adjustments to external imbalances work slowly and may have negative spill-over effects across Member States. Effective functioning of EMU calls for an early detection of these external imbalances in order to prompt an adequate and timely policy response. While some of the divergence is a sign of increased financial market integration, with the euro acting as catalyst, and normal convergence processes, less 'benign' factors have played a more important driving role. For instance, housing bubbles and credit-financed consumption have fuelled the divergence in some Member States (see Section 1.5 for details) ([39]).

189. ***Euro-area Member States have agreed to set up a framework for early detection of external imbalances.*** The Eurogroup agreed to conduct a surveillance exercise -in the spirit of the Mid-Term Budgetary Review regularly carried out for public finances- on macroeconomic imbalances and competitiveness divergences. It would be held within the Eurogroup at the end of the year 2009. Moreover, as agreed by the Ecofin Council in October 2008, the analysis of competitiveness developments should also be extended to non euro-area Member States. The findings would feed into both the Lisbon process and the assessment of Stability and Convergence Programmes.

Paying more attention to the Quality of Public Finances (QPF)

190. ***While QPF featured explicitly in the revised Stability and Growth Pact and the re-launched Lisbon strategy from 2005, its practical implementation under the EU's surveillance framework evolved recently***. First, in response to uneven reporting by Member States on QPF issues in the past, the Ecofin Council conclusions of May 2009 underlined the need for consistent data. This includes providing information on measures to improve expenditure control, tax reforms and value-for-money initiatives as well as detailed information on changes in Member States' fiscal governance, such as national fiscal rules, independent fiscal institutions and medium-term budgetary frameworks. Second, in the

([39]) For more details see Quarterly Report on the Euro Area Vol. 8 N°1 (2009), 'Special report: competitiveness developments within the euro area'.

Commission's assessment of the 2009 Stability and Convergence Programmes, QPF issues were more systematically addressed. In particular, the Council Opinions included a section focusing on key aspects of QPF and issued policy invitations to Member States. While the focus was largely on fiscal governance, other aspects such as the efficiency of public spending and revenue systems were to some extent covered. Third, progress was achieved in getting Member States to provide datasets on government expenditure by classification of functions of government (COFOG II). Such data are important for analysing trends in the composition of public expenditure and possibly identifying efficiency gaps. In its May 2009 conclusions, the Ecofin Council recommended that some selected COFOG II data should become mandatory to ensure further progress.

4.3. RECENT DEVELOPMENTS IN FINANCIAL MARKETS GOVERNANCE

191. ***The crisis tested the capability of European economic and financial governance to deliver swiftly.*** Financial contagion between markets and institutions, the threat of bank runs and the interplay between financial and economic variables called for a swift and coordinated response at the European level.

192. ***Initial crisis responses of national governments lacked clear EU and euro-area perspective***. In the early stages of the financial crisis, in the absence of a coherent pan-European crisis management framework, assistance to distressed financial institutions was conducted on an ad hoc basis in each country, sometimes leading to a reversal of past pan-European consolidation in the banking sector. These hesitant and rather disjointed early actions contrasted with the efficient and consistent handling of the situation on interbank markets by the ECB. On 4 October 2008, the EU G8 Members (France, Germany, Italy, United Kingdom) met, together with the President of the Commission, the President of the Eurogroup and the President of the ECB. At its regular meeting in Luxembourg on 7 October, the Ecofin Council agreed on 'conclusions on a coordinated EU response to the economic slowdown'. However, operational details on how to tackle the banking crisis remained evasive.

193. ***Euro-area governments eventually put up a united front.*** On 12 October 2008, the French Presidency organised the first Summit of the Eurogroup at the Heads of State and Government level. The British Prime Minister attended the meeting. They issued a common framework for the implementation of national banking rescue plans, which was affirmed by the European Council for the EU as a whole on 15-16 October. The European Council also announced the establishment of a 'crisis cell', aimed at improving crisis management among EU Member States through measures including informal warnings, information exchange and an evaluation mechanism.

194. ***The Commission reacted speedily to the evolving situation***. On 29 October 2008, the Commission issued a communication paving the way for a coordinated European recovery action plan. The Commission initiative called for a new EU architecture for financial markets, efforts to create jobs and drive growth, and a global response to the financial market crisis ([40]). As the economic situation was deteriorating, the Commission issued its European Economic Recovery Plan (EERP) on 26 November. It aimed at cushioning the impact of the financial crisis on the real economy (see Section 2.3). In January 2009, Commission services brought forward by a month their interim forecast to assess the magnitude of the slowdown and provide timely information to policymakers. In its contribution to the Spring European Council of 19-20 March 2009, the Commission drew a first tentative assessment of the effectiveness of financial plans and stressed the need for greater co-ordination in the implementation of measures decided under the EERP umbrella ([41]). The Eurogroup also monitored the economic situation throughout this period and regularly shared its assessment with the Ecofin Council.

([40]) Commission communication COM (2008)706 'From financial crisis to recovery' of 29 October 2008.
([41]) Commission communication COM (2009)114 'Driving European recovery' of 4 March 2009.

Box 4.1: **Activities of the Eurogroup in 2008 and 2009**

The Eurogroup is a corner-stone of euro area economic governance. It regularly gathers Ministers of Finance of the euro area on an informal basis. Over the last decade, the Eurogroup's responsibilities for the economic governance of EMU have grown markedly.

Table 1: **Activities of the Eurogroup during the year 2008 and the first months of 2009**

2008	
January	The EG assessed the introduction of the Euro in Cyprus and Malta. In addition, Ministers discussed guidelines within the Lisbon Treaty framework, with special emphasis given to the euro-area chapter.
February	The EG invited euro-area Member States to benefit from good economic times to consolidate public finances so as to reach a balanced financial stance by 2010.
April	The EG expressed concern on the high level of inflation within the euro area. The EG called for moderation in the adjustment of administered prices and prudence when rearticulating indirect taxation.
May	The EG discussed compensation schemes in the corporate sector.
September	The EG elected for a new mandate Jean-Claude Juncker at the head of the Eurogroup.
October	Summit of the Eurogroup Heads of State and Governments in Paris. A declaration on a coordinated action plan to fight the banking crisis is adopted.
November	Based on the autumn forecast of the European Commission, the EG discussed the resulting financial and budgetary consequences of the deterioration in economic activity. With respect to public investment in different Member States of the euro-area, Ministers exchanged views on the necessary coordination for efficient use of investment at the current juncture.
December	The EG discussed the Commission's European Economic Recovery Plan. It also decided to allow automatic stabilisers to work fully in 2008 and 2009.
2009	
January	The EG examined the economic stimulus packages of different Member States. It concluded that these stimulus packages correspond to the level of action required by the European Council in December 2008.
February	The EG expressed concerns about credit distribution to the real economy and affirmed its willingness to monitor closely the situation.
March	The EG approved Terms of Reference regarding the European Monetary System II, as a preliminary condition to an eventual adoption of the euro by non euro-area member states. It also prepared the discussion on specific recommendations to the euro area with respect to the "de Larosière report" on financial stability.
April	The EG reviewed the financial and budgetary situation of different euro-area member states. It called on Greece to take resolute measures, a position that Greek authorities shared.
May	The EG stressed the need to assess first the effectiveness of current stimulus packages before contemplating further action.
	Given the severity of the crisis in Ireland and the measures already taken by the Irish government, the EG agreed to grant Ireland an additional delay to comply with the Stability and Growth Pact. The public deficit should come below the 3% reference value by 2013 instead of 2012.

Source: Commission services

This reflects the growing political importance of the Eurogroup but also the increased number of items on its agenda, with the economic situation, inflation and euro-area responsibilities under the Stability and Growth Pact and Lisbon Strategy being among the topics that are regularly discussed within the Eurogroup. The appointment of its President for a two-year term from January 2005 added to the visibility of the Eurogroup. On 12 September 2008, Jean Claude Juncker was re-appointed for a third term.

Since the Eurogroup is an informal body, its deliberations are confidential and it does not release public statements. The table 1 in this box is based on regular press releases of the Ministry of Finance from Luxembourg and does not necessarily cover all the items that were discussed.

195. ***The financial crisis has highlighted the weaknesses in the EU's supervisory framework.*** Supervision remains fragmented along national lines despite substantial progress achieved in financial market integration and the ever-growing importance of cross-border entities. Around 70%

of EU banking assets are held by 43 cross-border banking groups. In particular, increasingly sophisticated financial products are increasingly dealt with on a pan-European basis. The Lamfalussy approach, started in 2001, largely succeeded on the regulatory side, by speeding up the adoption of EU financial service law, but progress was slow and uneven on the supervisory side. For instance, no common reporting formats for banks were agreed, while persistent divergences resulted in slow progress on standards for clearing and settlement.

196. ***Macro-prudential risks, both at the national and EU level, were not emphasised enough.*** One of the most serious challenges highlighted by the crisis is the fact that the present EU arrangements –like arrangements at national and global level– placed too much emphasis on the supervision of individual firms, and too little on risks to the stability of the financial system as a whole. Analyses were fragmented and performed by different authorities at different levels. In so far as risks were identified there was no EU mechanism to ensure that this assessment of risks translated into action. Information did not flow well between national supervisors, something that was compounded by the lack of consistent powers among Member States' supervisors. In particular, the so-called Level-3 Committees of the Lamfalussy process (Committee of European Securities Regulators, Committee of European Banking Supervisors, Committee of European Insurance and Occupational Pensions Supervisors) were designed as advisory committees for the Commission. They had neither the legal basis nor adequate resources to properly engage in crisis prevention and resolution. These shortcomings were laid bare in the current financial turmoil. Most notably, it resulted in the emergency 'de-consolidation' of several large financial institutions and their restructuring along national lines. Based on this widely-shared diagnostic, the Commission saw the need for new impetus in this area.

197. ***The de Larosière Group set out a comprehensive action plan.*** In October 2008, President Barroso took the initiative to give a mandate to a High-Level Group to make proposals to strengthen European supervisory arrangements. The Group, chaired by former IMF Managing Director Jacques de Larosière, released its report on 25 February 2009. In its conclusions, the European Council of 19/20 March 2009 agreed to the de Larosière report as 'the basis for action'.

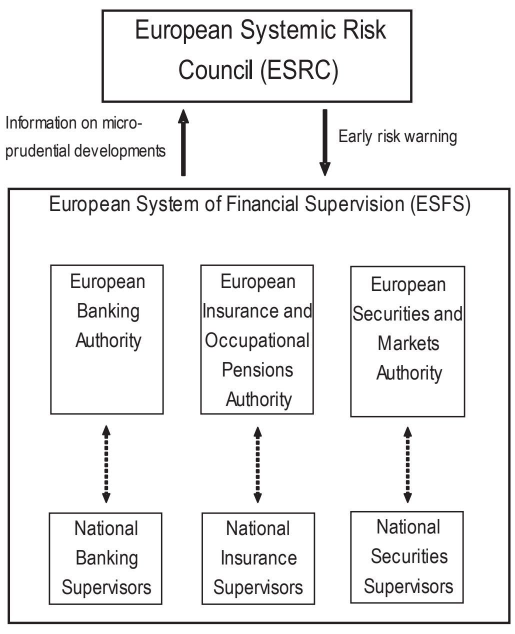
198. ***Macro-prudential concerns should be effectively catered for***. The de Larosière Group suggested establishing a new body – the European Systemic Risk Council (ESRC) – that would pool and analyse all information pertaining to macroeconomic conditions that is relevant for financial stability. The ESRC would be composed of the members of the General Council of the ECB, the Chairpersons of the three Level-3 Committees as well as one Member of the Commission. The ESRC would issue risk warnings to relevant bodies, including national supervisors, the EFC and the IMF depending on the nature of the threat. The ESRC may appeal to the Economic and Financial Committee if it feels that a supervisor has not responded in an adequate manner.

199. ***Micro-prudential aspects would be handled by a European System of Financial Supervisors (ESFS)***. The ESFS would be a decentralised network, still relying on national supervisors for day-to-day supervision. However, three new European Authorities would be set up, replacing the Level-3 Lamfalussy Committees. They would coordinate the application of supervisory standards and guarantee strong cooperation between national supervisors, including recourse to binding and proportionate mediation in case of conflicts.

200. ***A two-stage approach to implementation would combine harmonisation of rules and powers and supervisory reforms***. The de Larosière Group sketched out a roadmap for the implementation of its recommendations. The competences and powers of supervisors should be aligned with the most comprehensive systems in the EU, while regulation should be streamlined in order to get a consistent set of core rules. Colleges of supervisors should be set up for all systemically important financial institutions, both in the EU and internationally. These steps would pave the way for the establishment of the European System of Financial Supervision and the three Authorities. They should be independent and accountable to the Council, the European Parliament and the Commission. In addition, a review clause after three years would examine the possibility of merging banking and insurance authorities.

201. ***The Commission endorsed the de Larosière approach and laid the ground for a two-pillar framework for European Financial Supervision.*** The Commission capitalised on the findings of the report in its May Communication with a view to first decisions at the June 2009 European Council ([42]). The Communication set out a detailed proposal for the functioning and composition of the ESRC and the ESFS. It affirmed the leading role of central banks in macro-prudential supervision through the participation of the heads of the ECB and of all EU National Central Banks in the European Systemic Risk Council ([43]). The ECB would provide administrative support as well as technical expertise to the ESRC. Decisions of the ESRC should be taken by a simple majority.

Proposed financial governance arrangements according to the recommendations of the De Larosière Group:



Source: Commission services.

([42]) Commission communication COM (2009)252 'European financial supervision' of 27 May 2009.
([43]) The three Chairpersons of the European Supervisory Authorities and a Member of the European Commission will be members with voting rights as well. The Members without voting rights would be one high-level representative per Member State of the competent national supervisory authorities and the President of the Economic and Financial Committee.

The three existing committees of supervisors would be replaced by three new Authorities, each of which would have legal personality in order to contribute to the development of a single set of harmonised rules, improve the supervision of cross-border institutions by developing common supervisory approaches and help settle possible disputes between national supervisors. Each new independent Authority would have a Board of supervisors comprised of the highest-level representatives from the appropriate national supervisory authorities. The chairperson would be nominated after an open competition and confirmed by the European Parliament. In order to foster accountability, the ESRC and the three Authorities would report to the Council and the European Parliament on a frequent basis.

202. ***The European Council, in its conclusions of 19 June 2009, supported the creation of a European Systemic Risk Board (ESRB) ([44]) and a European System of Financial Supervisors (ESFS).*** However, given the potential or contingent liabilities that may be involved for Member States, the European Council stressed that decisions taken by the newly-created European Supervisory Authorities (ESAs), which are the mainstay of the ESFS, should not impinge in any way on the fiscal responsibilities of Member States. It agreed that the European System of Financial Supervisors should have binding and proportionate decision-making powers in respect of whether supervisors are meeting their requirements under a single rule book and relevant Community law and in the case of disagreement between the home and host state supervisors, including within colleges of supervisors. ESAs should also have supervisory powers for credit rating agencies. The European Council finally stressed that the new framework, comprising both macro-prudential and micro-prudential components, should be fully in place in the course of 2010.

203. ***The Commission adopted operational arrangements for the establishment of the ESRB and the ESFS.*** On 23 September 2009, the Commission adopted a package of legal texts underpinning the new framework. The package comprises:

([44]) The name was eventually chosen in lieu of ESRC.

(i) A proposal for a regulation on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board ([45]). The regulation defines the mission and tasks of the ESRB, lays out its organisation and governance, and sets procedures for the ESRB to issue warnings and recommendations.

(ii) A proposal for a Council Decision entrusting the ECB with specific tasks concerning the functioning of the ESRB ([46]). It lays out the modalities of the ECB's analytical, statistical, administrative and logistical support to the ESRB.

(iii) Proposals for three regulations establishing, respectively, a European Banking Authority (EBA) ([47]), a European Insurance and Occupational Pensions Authority (EIOPA) ([48]) and a European Securities and Markets Authority (ESMA) ([49]). The new Authorities will take over all of the functions of the Lamfalussy Level-3 committees. In addition, it will have certain extra competences, including the following: (a) developing proposals for technical standards, respecting better regulation principles; (b) resolving cases of disagreement between national supervisors, where legislation requires them to co-operate or to agree; (c) contributing to ensuring consistent application of technical Community rules (including through peer reviews); (d) the European Securities and Markets Authority will exercise direct supervisory powers for Credit Rating Agencies; (e) a co-ordination role in emergency situations.

4.4. THE CONTINUING ENLARGEMENT OF THE EURO AREA

204. ***From 2008 to 2009, the euro area has welcomed three new members***. The euro area grew from thirteen to sixteen Member States as Cyprus and Malta (in 2008) and Slovakia (in 2009) joined the group. The entry of these countries was the result of a successful convergence process, fostered by stability-oriented policies and structural reforms (see Box 4.2). With the successful entry of Slovakia into the euro area on 1 January 2009, 328.6 million people out of the EU's 499.7 million now share the single currency.

205. ***The recent introduction of the euro in Slovakia was managed successfully***. It did not lead to significant price increases. Thanks to detailed preparatory work, the technical aspects of the transition went well and almost all Slovak shops were giving change in euro as of the first days of January 2009. According to a European Commission Flash Eurobarometer survey conducted in January 2009, 90% of Slovaks felt well-informed about the euro. As a result, perceptions of changeover-related inflationary pressures were limited.

206. ***The next regular assessment of fulfilling the conditions for euro adoption will take place in the first half of 2010.*** Major differences remain between non euro-area Member States with respect to their progress with nominal convergence. Pursuing nominal convergence faces additional challenges in the current financial crisis environment. While inflation is decelerating rapidly in most new Member States, their fiscal balances, exchange rates and long-term interest rates as well as their ability to borrow on financial markets have been negatively affected by the financial crisis.

([45]) COM(2009)499.
([46]) COM(2009)500.
([47]) COM(2009)501.
([48]) COM(2009)502.
([49]) COM(2009)503.

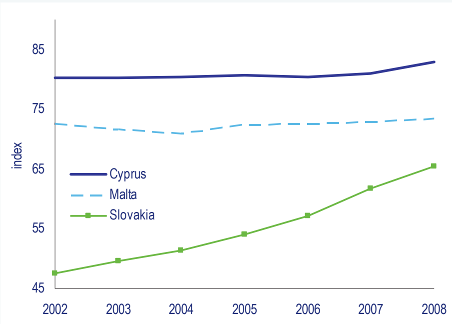
Box 4.2: The three new euro area Member States: Cyprus, Malta and Slovakia

The entry of Cyprus and Malta in January 2008 and Slovakia in January 2009 into the euro-area has been the result of a successful process of nominal convergence towards the euro-area. In recent years, inflation in Cyprus and Malta has been close to the euro-area average, standing at 2.9% in Cyprus and 2.7% in Malta on average in 2006-2008. Slovakia experienced more volatile and at times high inflation, reflecting the impact of external factors and adjustment of administrative prices. Developments of underlying inflation were on the whole favourable and HICP inflation averaged 3.4% in 2006-2008.

Before joining the euro area, interest rate convergence was largely achieved in the three countries, with spreads vis-à-vis the euro area for short-term and long-term interest rates having almost disappeared several months before euro adoption. The general government deficit has declined to below 3% since 2007 in Slovakia and since 2006 in Cyprus and Malta, but in the latter the deficit widened above the 3% threshold in 2008. In the three countries, the public debt as a share of GDP declined significantly in recent years. It amounted in 2008 to 49.1% in Cyprus, 64.1% in Malta and 27.6% in Slovakia.

Cyprus, Malta and Slovakia have also rapidly converged to the euro area in real terms. In 2008, their GDP per capita in Purchasing Power Standards (PPS) reached respectively 82.9%, 73.4% and 65.4% of the euro-area level. Their real GDP growth has been strong in the last decade, averaging 4.1% in Cyprus, 2.8% in Malta and 8.4% in Slovakia in 2006-2008. While the labour market situation in Cyprus compares well vis-à-vis the euro-area, with an unemployment rate of 3.8% in 2008 and a high employment rate (70.3%), the picture is less rosy in Malta and Slovakia with a relatively low employment rate (55.8% in Malta; 57.5% in Slovakia) and a higher unemployment rate (5.9% in Malta; 9.5% in Slovakia).

Graph: Convergence to the euro area: GDP in PPS (euro area=100)



Source: Commission services

Table: Recent macroeconomic performance (annual percentage change)

		2006	2007	2008
Cyprus	GDP	4.1	4.4	3.7
	Inflation	2.2	2.2	4.4
	General government balance (as % of GDP)	-1.2	3.4	0.9
Malta	GDP	3.2	3.6	1.6
	Inflation	2.6	0.7	4.7
	General government balance (as % of GDP)	-2.6	-2.2	-4.7
Slovakia	GDP	8.5	10.4	6.4
	Inflation	4.3	1.9	3.9
	General government balance (as % of GDP)	-3.5	-1.9	-2.2

Source: Commission services

These countries are small open economies, highly integrated in terms of trade and finance to the euro area. Malta and Cyprus are the two smallest economies in the euro area, contributing respectively 0.06% and 0.18% to euro-area GDP, and 0.13% and 0.24% to its population. Slovakia accounts for 0.73% of the euro-area GDP and 1.65% of its population. Trade with the euro-area represents about 53% of total trade of Cyprus and about 45% in Malta and Slovakia. In addition, a large share of foreign direct investments comes from the euro-area (42% for Cyprus, 43% in Malta and 74% in Slovakia in 2007).

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