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Annual Statement on the Euro Area 2009

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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

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

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 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 a 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 spillover 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.

[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.

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-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.