Euro Area: Main Economic Indicators
(Percent change)

	2003	2004	2005	2006	2007	2008	2009	2010
							Staff projections	
Demand and Supply								
Real GDP	0.8	2.2	1.7	2.9	2.7	0.7	-4.8	-0.3
Private consumption	1.2	1.6	1.8	2.0	1.6	0.4	-1.5	-0.6
Public consumption	1.7	1.6	1.5	1.9	2.2	1.9	1.7	1.9
Gross fixed investment	1.3	2.3	3.3	5.5	4.8	0.0	-11.6	-3.6
Final domestic demand	1.3	1.7	2.1	2.7	2.3	0.8	-3.1	-0.6
Stockbuilding 1/	0.1	0.2	-0.2	0.1	0.0	0.1	-0.1	0.0
Domestic Demand	1.5	2.0	1.9	2.8	2.5	0.7	-3.4	-0.7
Foreign balance 1/	-0.6	0.3	-0.1	0.2	0.3	0.0	-1.2	0.4
Exports 2/	1.3	7.4	5.0	8.3	5.9	1.0	-16.3	-0.5
Imports 2/	3.2	7.0	5.7	8.2	5.3	1.0	-13.6	-1.5
Resource Utilization								
Potential GDP	1.9	2.0	1.8	1.6	1.7	1.4	-0.2	0.5
Output gap	-0.8	-0.6	-0.7	0.6	1.6	0.9	-3.7	-4.5
Employment	0.7	0.7	1.0	1.6	1.8	0.8	-2.3	-1.9
Unemployment rate 3/	8.7	8.8	9.0	8.3	7.5	7.6	10.1	12.0
Prices								
GDP deflator	2.2	1.9	2.0	1.9	2.3	2.3	0.4	0.5
Consumer prices	2.1	2.2	2.2	2.2	2.1	3.3	0.2	0.7
Public Finance 4/								
General government balance	-3.0	-2.9	-2.5	-1.2	-0.6	-1.9	-6.2	-6.9
General government structural balance		-2.9	-2.6	-2.0	-1.8	-2.4	-3.7	-3.9
General government gross debt	68.7	69.1	69.6	67.8	65.7	69.6	81.0	88.0
Interest Rates 3/ 5/								
EURIBOR 3-month offered rate	2.3	2.1	2.3	3.2	4.3	4.4	1.1	…
10-year government benchmark bond yield	4.0	4.0	3.4	3.8	4.4	4.4	4.1	…
Exchange Rates 5/								
U.S. dollar per euro	1.13	1.24	1.25	1.26	1.37	1.47	1.38	…
Nominal effective rate (2000=100)	117.6	122.0	121.7	122.6	128.9	137.0	135.8	…
Real effective rate (2000=100) 6/	121.6	128.0	129.6	130.3	137.8	146.8	140.7	…
External Sector 4/ 7/								
Current account balance	0.3	0.8	0.1	-0.1	0.1	-0.7	-1.1	-1.1
Trade balance 8/	1.3	1.2	0.5	0.1	0.5	-0.1	-0.4	-0.5

Sources: IMF, *World Economic Outlook;* DataStream; Eurostat; and ECB Monthly Bulletin.
1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ Latest available data for 2009.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.

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Statement by Klaus Stein, Executive Director for Germany, on behalf of the Euro Area Authorities
July 17, 2009

In my capacity as President of EURIMF, I submit this buff statement on the Article IV consultation with the euro area. It reflects the common view of the Member States of the euro area and the European Union in their respective fields of competence.

The authorities of the euro area Member States are grateful for open and fruitful consultations with the Fund staff and for their constructive policy advice. While broadly concurring with the staff's findings, views differ on a few aspects, as will be outlined in my statement. It will also provide an update recent economic developments.

Short-term economic outlook

The euro area, like other advanced economies, is in the midst of a **severe recession**. In the first quarter of this year GDP contracted at an unprecedented pace due to weaknesses in both domestic and foreign demand.

Following the disappointing first-quarter GDP numbers, **some tentative signs of stabilization** have emerged recently. A substantial inventory correction is under way, while indicators related to global trade have started to send promising signals. Reflecting these positive developments in global demand, the huge drag on euro area GDP from the export collapse may start easing.

On the domestic side, recent business sentiment indicators and available May industrial production data for the largest euro area economies are also sending encouraging signs, which may imply a **less negative outlook**. Low inflation and the fiscal stimuli will maintain a stimulating effect on the economy. However, for firms to resume investment, a parallel improvement in financial conditions is necessary, and indicators related to the latter are somewhat mixed. On the one hand, stock markets have recovered somewhat and money markets rates further declined. On the other hand, government bond yields have increased and credit standards remain tight.

While the first positive signals are clearly welcome, it is important to avoid reading too much into them. Most soft indicators remain still below the levels that mark the start of an expansion phase. In addition, their recent improvements are **still to be confirmed by hard data**. In the labor market, the full impact of the current crisis is yet to come, although unemployment has already strongly increased in many Member States.

Therefore, the authorities' assessment of the emerging positive signals is cautious. Nevertheless, the most recent indicators are in line with the view that the decline in activity should moderate throughout the remainder of 2009 and give way to a **modest recovery in 2010**. Euro area authorities concur with the staff that the growth outlook for the euro area economy remains surrounded by exceptional uncertainty.

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Financial sector issues

Safeguarding financial stability is one of the highest priorities for the euro area Member States. Since the outbreak of the current financial crisis, euro area governments, along with other EU Member States, have committed very substantial amounts of **public funding** in various forms – totaling around 25 per cent of euro area GDP – in support of the banking sector. Together with the substantial liquidity provided by the ECB to euro area money markets, these measures have averted a financial meltdown. The most acute phase of the crisis has now passed. Indeed, the main indicators of stress in the financial system are signaling a progressive stabilization.

Despite the financial stabilization achieved, **the banking sector in the euro area remains fragile**, as in other parts of the world,. The support to banks provided by Member State governments is apparently still needed to ensure a sufficient basis for the required recovery in confidence. Banks have not yet fully utilized the available amounts of public funds. Banks in the euro area as well as in the EU are still highly leveraged. Moreover, uncertainty about the quality of their assets remains. This has fuelled some concerns about the overall health of their balance sheets. As pointed out by the staff, restoring confidence in the viability of the banking sector is a precondition for sustainable recovery of the broader economy.

Upon request of the Economic and Financial Council, the Committee of European Banking Supervisors (CEBS) coordinates an EU-wide **forward-looking stress testing** of the banking system, in cooperation with the Commission and the ECB. The results of the test will be reported to Finance Ministers and Central Bank Governors in September 2009 and will provide additional information on the banking sector's ability to absorb possible shocks and the overall financial stability implications, and complement in this way the estimates made by the staff, the ECB and by analysts, on the potential losses to be incurred by the EU/euro area banking sector in case of an adverse macroeconomic scenario.

As indicated by the staff, the financial crisis has posed an important challenge for the functioning of the Single Market and the European financial system and underscored the need for the EU to **strengthen** its **financial stability arrangements**. Co-ordination of financial-market support measures among EU Member States has helped to limit market fragmentation and competitive distortions and to restore financial stability in the short-term.

Looking ahead, there is a clear need to **enhance the regulatory and supervisory framework** in order to reduce the possibility of similar crises in the future. To that end, the EU has decided to reform its framework for financial supervision. In June 2009, the European Council endorsed proposals by the Commission to establish a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS). The ESRB will monitor and assess potential threats to the stability of the EU financial system and, where necessary, issue risk warnings and recommendations for action and monitor their implementation. The ESFS will comprise three new European Supervisory Authorities with powers as regards the EU banking, insurance and securities sectors and coordinate responsibilities between national supervisory authorities, which will remain responsible for the day-to-day supervision of individual firms. Without impinging on fiscal responsibilities of Member States, the three authorities will have binding and proportionate decision-making powers in respect of whether

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supervisors are meeting their requirements under a single rule book and relevant Community law and in case of disagreement between the home and host state supervisors. These authorities will also have supervisory powers for credit rating agencies. The Commission intends to adopt the necessary legislative proposals in September.

In parallel to this supervisory reform, the EU is **revisiting financial-sector regulation on a broad basis**. Work is under way in a range of areas such as the capital requirements directive (i.a. addressing securitization and procyclicality), deposit guarantees, credit-rating agencies, hedge funds, OTC derivatives markets, and executive pay. These proposals need to be adopted swiftly in order for the new framework to be fully in place in the course of 2010. In addition, the Commission is working on a comprehensive cross-border framework for the prevention and management of financial crises, including the introduction of special resolution regimes for cross-border banks.

Monetary policy, inflation outlook, and liquidity management

The euro area authorities broadly agree with the staff assessment on the ECB's monetary policy, except on two points. (i) When assessing the **risk of protracted deflation** and its policy implications, views differ. The assessment of the ECB is that the risk of protracted deflation is at present **very limited**. Deflationary pressures are neither broad-based nor entrenched in inflation expectations, which are firmly anchored over the medium to longer term in line with the ECB's aim of keeping inflation rates below, but close to, two per cent over the medium term. (ii) In addition, the **transmission of monetary policy** to bank lending rates, while difficult to assess at such an early stage, seems to be broadly in line with the past behavior. In this respect, euro area authorities do not fully share the assessment of the staff with respect to somewhat lower efficiency of the transmission channel.

Turning to the **outlook for price developments**, the fall of annual inflation rates into negative territory in June is in line with previous expectations and reflects mainly temporary effects. After a return to positive inflation rates, price developments are expected to remain dampened over the policy-relevant horizon. Risks to the outlook for inflation are broadly balanced. On the downside they relate, in particular, to the outlook for economic activity, while on the upside they relate to higher than expected commodity prices and to unanticipated stronger increases in indirect taxation and administered prices.

The outcome of the monetary analysis confirms the assessment of **low inflationary pressure**, as money and credit indicators continue to be weak, the latest data confirming their concurrent deceleration. The flow of bank loans to non-financial corporations and households has remained subdued – with a moderate monthly contraction in the outstanding amount of loans to non-financial corporations over recent months –, reflecting in part the weakening in economic activity and the continued low levels of business and consumer confidence.

In sum, the Governing Council of the ECB expects the current episode of extremely low or negative inflation rates to be short-lived and price stability to be maintained over the medium term, thereby continuing to support the purchasing power of euro area households. Against this background, the **current key ECB interest rate**, which has been brought from 4.25 per cent to one per cent between October 2008 and May 2009, **remains appropriate**.

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This is also the case in view of the ECB's **enhanced credit support policy**. Since the financial crisis intensified in September 2008, the ECB has introduced monetary policy and liquidity management measures that are unprecedented in nature, scope and magnitude, with a view to protecting the flow of credit to the euro area economy.

The set of non-standard measures has been further enhanced with the **extension of the maturity of the longer-term refinancing operations** with a fixed rate and full allotment to 12 months, and a program of covered bond purchases. In particular, with the conduct of a 12-month refinancing operation in June this year, the Eurosystem has provided a significant amount of liquidity to euro area banks. A record number of 1,121 bidders received a total allotment of €442.2 billion, bringing the overall size of liquidity providing open market operations again to levels observed in late 2008. Euribor fixing rates have decreased by around 20 basis points since the announcement of the new one-year operation in early May 2009.

Outright purchases of covered bonds are another non-standard measure added in May 2009. Covered bonds are debt securities issued by banks, which give them access to funding of a longer-term nature than the ECB's refinancing operations. Covered bonds allow banks to better manage the maturity mismatch between their assets and liabilities. While it is expected to be effective in supporting credit provision by banks, the covered bond purchase program does not burden the Eurosystem with excessive credit risk. After the announcement of the measure, there has been a wave of new issuances of covered bonds, and the spreads on potentially eligible covered bonds have narrowed considerably.

All the measures taken, including the broadening of the list of assets accepted as collateral by the Eurosystem, have contributed to **improving financing conditions** above and beyond what could be achieved through reductions in key ECB interest rates alone. The improvement in financing conditions resulting from past reductions in key ECB rates and from the enhanced credit support measures should provide ongoing support for economic activity in the period ahead. All non-standard measures seek to maintain price stability over the medium term and to ensure that inflation expectations remain firmly anchored in line with price stability. Once the macroeconomic environment improves, the ECB will ensure that the measures taken are quickly unwound and that the liquidity provided is absorbed. Hence, any threat to price stability over the medium to longer term can be effectively countered in a timely fashion.

Fiscal policy

The euro area authorities share the staff assessment that the **discretionary measures** currently adopted are broadly appropriate. The fiscal stance will continue to be supportive into 2010 and **automatic stabilizers** are sizeable. In this context, it is worth noting that in 2010 deficits increase not only in nominal but also in structural terms. Further discretionary budgetary stimulus is not warranted, under the assumption of an expected stabilization and eventual recovery of economic activity in 2010.

The euro area authorities agree with the staff that the **composition of the fiscal stimulus** is crucial and that the discretionary fiscal effort should be coordinated and tailored to country circumstances. Calling for an immediate and **coordinated effort to boost demand**, the

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European Economic Recovery Plan (EERP), endorsed by the European Council in December 2008, provided guidelines on the types of measures which were likely to maximize the impact and to result in cross-country synergies and positive spill-over effects. The EERP also stressed that Member States had very different starting points in terms of fiscal room for maneuver. Indeed, a cross-country comparison of the fiscal policy responses to falling aggregate demand, both in terms of stimulus packages and aggregate fiscal stance, highlights significant differences in size. This, at least in part, reflects differences in the countries' perceived ability to expand without facing adverse market reactions.

In its *Orientations for fiscal policies in the euro area Member States* issued on June 8th, the Eurogroup stressed that the **pace of fiscal consolidations** should also be differentiated across countries, taking into account the pace of the recovery, fiscal positions and debt levels, but also the projected cost of aging, external imbalances and risks in the financial sector. Ministers also committed to improve the coordination of the implementation of national recovery measures.

The euro area authorities confirm their strong commitment to put in place **robust medium-term exit strategies** that will lead to timely correction of the excessive deficits and therefore underpin the credibility of fiscal policies. In line with the staff's suggestion to pre-announce the plans for fiscal adjustment to reduce uncertainty, the Eurogroup highlighted that the forthcoming round of stability programs would provide the opportunity for Member States to present exit strategies. Notably, the strategies should: (i) include ambitious and realistic budgetary targets; (ii) spell out the consolidation measures beyond the next budget year; (iii) strengthen the national budgetary frameworks to underpin budgetary discipline and make them more resilient to crises; (iv) implement structural reforms to ensure the long-term sustainability of public finances, in particular in the area of aging-related expenditure.

In this context, the euro area authorities agree with some of the avenues put forward by the staff to **improve the functioning of the Stability and Growth Pact within its current remit**, e.g. the emphasis on strengthening national fiscal frameworks and incorporating aging-related liabilities in the medium-term objectives (MTOs). In this vein, an agreement has been reached and confirmed by the Ecofin in its meeting of July 7th, on the way to incorporate aging-related implicit liabilities in the MTOs. By contrast, the authorities do not agree with suggestions that would imply altering the balance between the preventive and the corrective arms as established in the Stability and Growth Pact and in the Treaty (e.g. treating the MTO as the reference value under the Excessive Deficit Procedure).

Structural reforms

The European Economic Recovery Plan of December 2008 gives priority to reforms that support aggregate demand, employment, and household income in the short-run, whilst at the same time **improve the adjustment capacity and growth potential**. It also recognizes that the crisis presents a strategic opportunity to push forward with more ambitious reform agendas.

The recent Commission's analysis showed that this downturn will in all likelihood leave an important imprint on the European economy in terms of **lower potential output** going

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forward. This may be related *inter alia* to a generally lower risk appetite after the crisis, pro-cyclicality of R&D investment, as well as hysteresis effects in the labor market, which may also have an impact on potential growth. Given that the aging populations will have additional negative impact on long-term potential growth, a continued, even reinforced focus on productivity-enhancing structural reforms will be an important pillar of the Lisbon strategy post-2010.

On **labor market**s, the measures introduced in many EU Member States are helping to mitigate the impact on unemployment in the short-term. However, given the depth of the recession, there is a clear risk of a sharp rise in unemployment in the future, with all its social and economic costs. In order to counteract this, more emphasis is now needed on policies to **enhance wage flexibility and incentives for firms to create jobs**, and support the chances for the unemployed to find new jobs, especially by investing in training to enhance skills and by facilitating transition towards new jobs.

The implementation of the **Services Directive** is an essential measure to boost economic growth and job creation given the untapped potential of the Internal Market for services. Being an essential step in the structural reform process, the Directive is particularly important for those euro area Member States, which suffer from competitiveness problems, and hence a need to ensure the timely and full implementation of the Directive by December 2009.

Intra-EU spillovers

The **financial market situation in the New Member States** (NMS) has recently improved, in line with the market sentiment towards emerging countries. Decisive policy action over recent months, including the substantial increases in Fund and EU resources for financial assistance to countries with balance-of-payments difficulties, coupled with policy adjustment programs has contributed to this improvement. The EU is currently providing financial assistance to three NMS particularly affected by the crisis, in the context of financing and policy adjustment packages set up together with the Fund and other donors. In addition to BoP assistance, the EU is supporting the NMS through several other financial channels (e.g. frontloading of structural funds and EIB financing) and with policy advice in the context of EU economic surveillance.

The euro area authorities agree with the staff that **full coordination of financial crisis measures** is essential for the success of the assistance programs. This includes, in particular, private sector involvement, especially of banks. It is also important to note that the crisis did not affect all NMS with the same force. NMS which avoided large imbalances or policy weaknesses fared relatively better, underlining the importance of sound policies and the need for a differentiated approach towards individual countries in analysis and communication.

Trade policy

As noted by the staff, the EU attaches great importance to **countering protectionist pressures** resulting from the crisis. For the world economy to return to sustainable growth, it is absolutely essential to keep markets open for trade and investment, and encourage further market opening.

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