4 THE EURO AREA AND THE COMMON MONETARY POLICY

The euro area and the common monetary policy

1 Economic conditions in the euro area

Economic developments in the euro area in 2008 continued to be influenced by the international financial instability. The further tightening of financial conditions and the considerable weakening in the external environment, in a climate of diminishing confidence and growing uncertainty, brought about a recessionary situation which was exacerbated in late 2008 and early 2009 following the heightening of the global financial crisis in the autumn. The notable deterioration in the situation during the year was reflected in public and private agencies' forecasts, which successively and substantially revised expected growth for 2009 downwards and set back the prospects of recovery, as analysed in Box 4.1.

Inflation in the euro area also turned around considerably in the course of the year. In mid-2008 prices were posting growth close to 4%, an unprecedented rate since the start of EMU and the result of dearer oil, food and other non-energy commodities. However, the weakness of global economic activity in the second half of the year contracted the demand for commodities and prompted a downturn in their prices. This, combined with the change in the economy's cyclical position, gave rise in the closing months of 2008 and early months of 2009 to a marked reduction in inflation and to a substantial downward revision of medium-term inflationary expectations.

This radical change in economic outlook was reflected in monetary policy measures, which focused from the autumn on preventing the disinflationary process in which the euro area was immersed from translating into inflation rates persistently below the medium-term price stability target. Thus, the ECB Governing Council decided from October on successive cuts to its official interest rate, taking it to 1% in May 2009. In parallel, the ECB made its liquidity provision policy more flexible in response to the heightening of the financial crisis, as detailed in Box 4.2.

The remaining strands of economic policy also adapted during the year to the change in cyclical conditions, and unprecedented measures were implemented in the closing months in all areas and, in some cases, as part of an internationally concerted move. Faced with worsening financial tensions, the euro area governments, in addition to bailing out certain systemic institutions, designed comprehensive plans to support the financial system. At the same time, and given the recessionary economic outlook, governments approved an ambitious economic recovery plan in December to ensure financial stability and counter the risks of a feedback loop between the worsening real economy and the financial tensions. The plans encompassed fiscal stimulus measures, structural reform and improved credit supply for the most vulnerable groups. At present, it is extraordinarily difficult to assess the effectiveness of these plans in stimulating demand in the short run. In any event, the strong impact the crisis is exerting on the euro area countries' public finances, combined with the commitments associated with population ageing and the increase in contingent liabilities derived from the financial bail-out plans, poses the need to ensure that the sustainability of public finances is not called into question. That will require firm budgetary consolidation commitments that allow a return to compliance with medium-term objectives once the current situation is overcome.

Despite all these measures, the prospects for growth are very unfavourable. On the latest estimates from public- and private-sector agencies, a sharp contraction in GDP for 2009 and a very gradual recovery in activity during the following year are projected, based largely on these economic policy initiatives. The scenario of recovery will be subject to downside risks arising essentially from the difficulties of containing the feedback loop between economic activity and

REVISION OF THE GROWTH OUTLOOK FOR THE EURO AREA DURING 2008 BOX 4.1

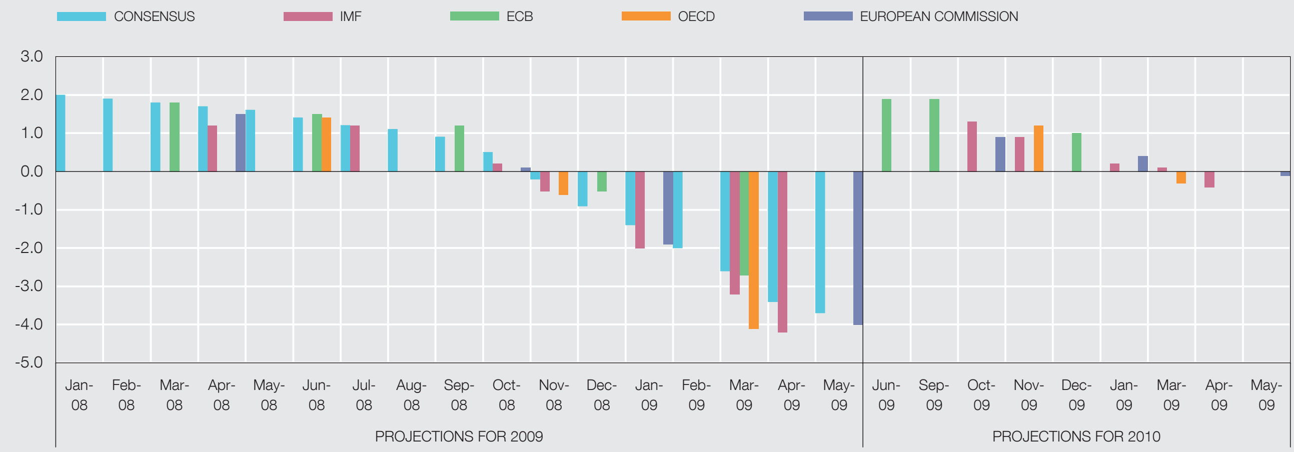
During 2008 and, especially from the autumn, the international financial crisis worsened considerably and became a global one. The real effects of the turmoil were felt in Europe with some delay, but they became evident in the second half of 2008. The year ended with the euro area economy deep in recession, and the level of GDP in Q4 was more than 1% below that a year earlier. The deterioration in the economic situation over the course of the year, and the way it intensified in the final stretch of 2008, were reflected in the successive downward revisions of growth expectations by public and private agencies.

As Panel 1 shows, in the first half of 2008 the projections of the main international organisations and of private analysts for 2009 were only moderately down (by 0.5 pp) to around 1.5%, while for 2010 an increase of close to 2% was envisaged. Underpinning this relatively favourable outlook was the expectation that the international financial crisis would not be of such a size as to deeply affect an economy such as that of the euro area, which had solid fundamentals thanks to the soundness of households' and companies' finances, the virtual non-existence of the subprime segment in its mortgage market and the greater weight of trade with regions which at that point seemed less exposed.

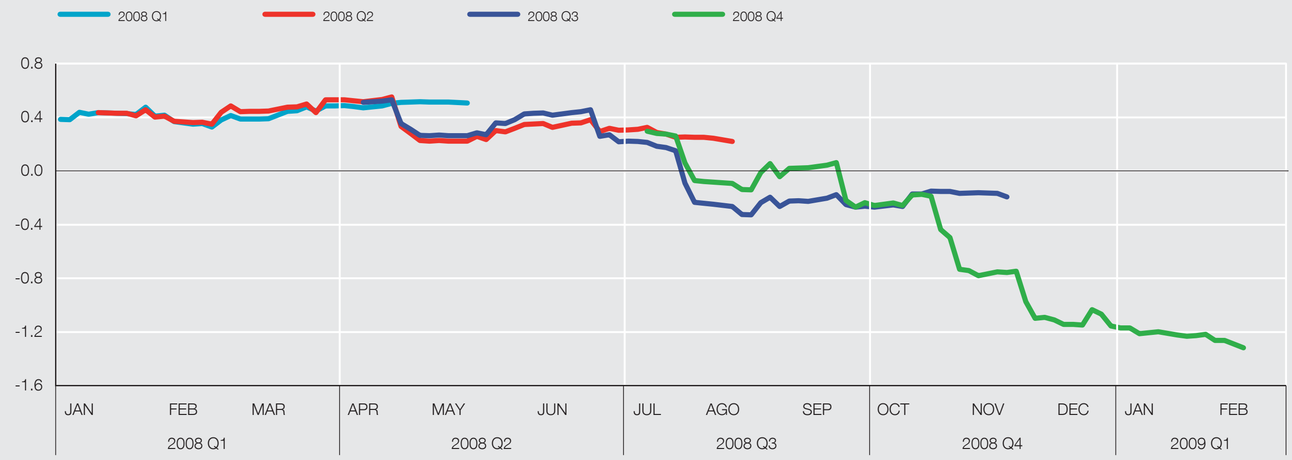
During the summer months, the build-up of unfavourable conjunctural data generated some doubts about the true scale of the turmoil and the capacity of the euro area to withstand it, which led to further, moderately downward revisions of projections for the whole forecasting horizon. However, the escalation of the financial crisis in September demonstrated its depth and global nature, and the potential of contagion to the real economy, which entailed a significant change in growth expectations. In November and December, the estimate for 2009 turned clearly negative, although it was still expected that the recovery would take place in the second half of that year. Finally, following the collapse of all conjunctural indicators in early 2009, the projections for that year sank and recovery was put back to late 2010.

To illustrate how the progressive deterioration in the economic situation during 2008 affected the revision of the growth outlook, Panel 2 shows the changes in the real-time forecasting of growth in euro area

1 PROJECTIONS FOR 2009 AND 2010



2 RTE MODEL ESTIMATES OF EURO AREA QUARTER-ON-QUARTER GDP GROWTH



SOURCES: Consensus, European Commission, Eurobarometer, IMF, OECD and SPF.

activity by the EUROSTING model.[1] This model predicts euro area GDP on the basis of nine indicators, four of which are survey-based, while the other five refer to quantitative variables. The projection is made up to six weeks ahead of the publication of the National Accounts figure. More specifically, Panel 2 shows the (almost) daily changes in the EUROSTING projections for each quarter of the year 2008. Each point of these lines reflects the projection of the GDP flash estimate for the quarter in question with all the information available up to that day.

According to this model, the economic situation in the euro area during the first half of 2008 was relatively favourable, with an estimated increase for Q1 close to potential, and somewhat less for Q2 and Q3. The first sign of deterioration in the economic situation came about in late July, when the first indicators available for Q3 reduced the projection for this period to below –0.2%. This more unfavourable perception was confirmed with the release on 14 August of a decline in GDP of –0.2% for Q2, which was a negative surprise since both the model and most analysts had estimated slightly positive growth. This fall in activity, combined with that expected by the model for Q3, placed the euro area in a virtual situation of technical recession. Following the bankruptcy of Lehman Brothers in late September and, above all, as the indicators relating to the closing three months of the year came to light, the model affirmed the sheer depth and scale of the recession in the euro area. The estimation of growth for Q4 progressively collapsed with each new figure, from values close to zero in late September to below –1% in mid-November. At that time EUROSTING was one of the models offering a more unfavourable view, but it was however outdone by the figure released by EUROSTAT.

1. M. Camacho and G. Pérez-Quirós (2008), *Introducing the EURO-STING: Short-Term INdicator of euro area Growth,* Working Paper no. 0807, Banco de España.

the behaviour of the financial markets. Against this background, inflation would hold at a very low level over a long period of time.

1.1 ACTIVITY AND EMPLOYMENT

Economic developments in the euro area were determined by the worsening of the financial crisis...

Set against the international financial instability and the progressive weakening of the world economy, euro area GDP showed a continuous loss of momentum during 2008 which intensified late in the year and ran into the opening months of 2009. Output posted negative rates of change from Q2 and ended the year with a quarter-on-quarter decline of –1.6%, a rate not seen since the 70s (see Table 4.1). This translated into growth of 0.7% in annual average terms, almost 2 pp down on the 2007 figure.

... which, through various channels, affected both euro area internal demand...

The financial crisis affected economic activity through various channels. As explained in section 3, the strong rise in credit premia raised the cost of financing through loans, securities and debt issues. Banks adjusted their lending standards to the new economic environment, which meant these standards duly tightened. Further, the crisis caused a loss in household real and financial wealth and prompted a decline in corporate earnings, a strong increase in uncertainty and a deterioration in expectations about future activity and employment. All these developments eroded business and consumer confidence, causing private productive investment and private consumption decisions to be deferred and saving to rise, which notably weakened internal demand (see Chart 4.1). Households also held back their spending on residential investment, which compounded the real estate adjustment process that certain countries in the area had embarked upon and led to a slowdown in credit for house purchases.

... and external demand

Another propagation channel whose significance grew as the financial crisis became more pronounced and global was the trade channel, with trade flows showing a gradual deterioration. That gave rise to a stagnation of euro area exports in mid-2008, to which the appreciation of the euro in the first half of the year also contributed, and to a sharp subsequent fall (see Table 4.1). In turn, the moderation of internal demand led imports to trend similarly, albeit with a less marked decline, which prompted a deterioration in the contribution of the net external balance to GDP growth.

EURO AREA: MAIN MACROECONOMIC INDICATORS (a) TABLE 4.1

	2006	2007	2008	2008 Q1	2008 Q2	2008 Q3	2008 Q4
DEMAND AND OUTPUT							
Gross domestic product	3.0	2.6	0.7	0.7	-0.3	-0.3	-1.6
Private consumption	*2.1*	*1.6*	*0.3*	*0.0*	*-0.3*	*0.1*	*-0.3*
Government consumption	*1.8*	*2.2*	*2.0*	*0.4*	*0.9*	*0.6*	*0.4*
Gross fixed capital formation	*5.9*	*4.3*	*-0.2*	*1.0*	*-1.3*	*-0.7*	*-4.0*
— Non-residential private investment	6.4	5.5	1.4	1.0	-0.7	-0.9	-1.8
— Residential investment	6.7	1.4	-3.4	1.1	-3.0	-2.2	-2.5
— Public investment	1.0	3.2	3.0	2.3	-0.8	0.4	0.5
Exports	*8.5*	*5.9*	*1.1*	*1.5*	*-0.2*	*-0.2*	*-6.7*
Final demand	*4.5*	*3.4*	*0.8*	*0.8*	*-0.3*	*0.2*	*-2.6*
Imports	*8.3*	*5.3*	*1.2*	*1.1*	*-0.5*	*1.3*	*-4.7*
Contibutions to GDP growth (b)							
Domestic demand	*2.8*	*2.3*	*0.6*	*0.3*	*-0.3*	*0.0*	*-1.0*
Change in stocks	*0.1*	*0.1*	*0.1*	*0.2*	*-0.1*	*0.3*	*0.3*
External demand	*0.2*	*0.3*	*0.0*	*0.2*	*0.1*	*-0.7*	*-1.0*
PRICES AND COSTS (c)							
Consumer prices (annual average)	2.2	2.1	3.3	3.4	3.6	3.8	2.3
Final demand deflator	2.4	2.0	2.6	2.7	2.9	3.1	1.8
GDP deflator	2.0	2.3	2.3	2.2	2.3	2.3	2.4
Unit labour costs	0.8	1.7	3.3	2.4	2.8	3.4	4.5
Compensation per employee	2.2	2.5	3.2	3.1	3.2	3.4	3.0
Labour productivity	1.4	0.8	-0.1	0.6	0.3	0.0	-1.4
GENERAL GOVERNMENT (d)							
Total expenditure	46.7	46.1	46.7				
Current expenditure	*42.9*	*42.3*	*42.9*				
— Interest payments	2.9	3.0	3.0				
Public investment	*2.5*	*2.6*	*2.5*				
Total revenue	45.4	45.5	44.8				
Primary deficit (–) / surplus (+)	1.6	2.3	1.1				
Deficit (–) / surplus (+)	-1.3	-0.7	-1.9				
LABOUR MARKET							
Total employment	1.6	1.8	0.8	0.3	0.1	-0.1	-0.3
Unemployment (e)	8.3	7.4	7.5	7.2	7.3	7.5	8.0
BALANCE OF PAYMENTS (d)							
Current account	0.0	0.2	-0.9	-0.7	-1.3	-0.9	-0.9

SOURCES: ECB, European Commission and *OECD Economic Outlook.*

a. Quarter-on-quarter rates, unless otherwise indicated.
b. Percentage points of the percentage change in GDP.
c. Year-on-year rates.
d. As a percentage of GDP.
e. As a percentage of the labour force.

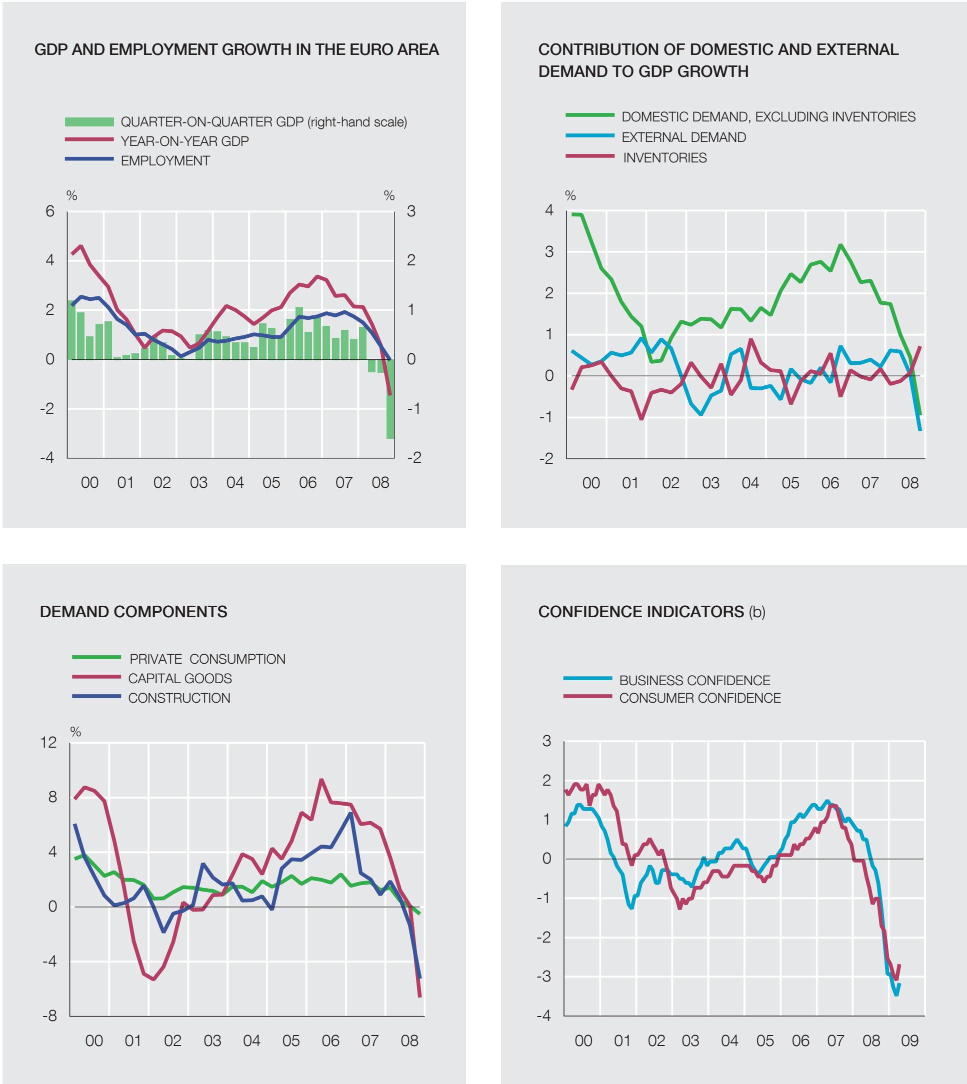
Action by the general government sector and the ECB mitigated the deterioration in activity

Action by the general government sector and the ECB contributed to sustaining expenditure. In the case of the former, this was through an increase in government consumption and public investment, the activation of the automatic stabilisers and the adoption of a broad raft of measures in the second half of the year; and in the case of the ECB, through a rapid and substantial cut in interest rates from October.

The recession spread to most productive branches...

On the supply side, the weakening in activity passed through to all the productive branches, with the sole exception of non-market services. Declines in value added were sooner and sharper in the construction and manufacturing industries, and only late in the year did they reach market services.

EURO AREA: COMPOSITION OF GROWTH AND CONFIDENCE INDICATORS (a) CHART 4.1



SOURCES: ECB, European Commission, OECD and Banco de España.

a. Annual percentage changes, unless otherwise specified.
b. Balance statistic. Normalised series.

... and adversely affected employment and productivity

After two years of very high growth, the employment generation process was interrupted in the second half of the year, making way for a decline in employment in Q3 and Q4 which continued into the opening months of 2009. That made for a substantial rise in the unemployment rate, from 7.3% in January 2008 to 8.9% in March 2009. Overall, the adjustment in employment was less than that in value added, whereby apparent labour productivity progressively slowed, to the point of posting negative rates of change and evidencing procyclical behaviour (see Chart 4.3).

Virtually all the euro area countries felt the impact of the recession

From Q2, almost all the euro area Member States experienced a significant decline in activity, although there were significant differences in terms both of the scale of the decline and its composition. The biggest reductions in output were in Germany and Italy, essentially as a result of the performance of the German net external balance and of Italian domestic demand. In the countries with the sharpest contractions in domestic demand and employment, mainly Spain and Ireland, the strong adjustment in imports prompted a more moderate decline in GDP.

The short-term outlook is negative, while in the medium term economic policy conduct is expected to be conducive to a progressive recovery in activity

The global, synchronised and deep-seated nature of the crisis augurs a prolongation of the recession in the euro area for some quarters more, followed by a gradual recovery in activity underpinned by several factors: the favourable effects of the financial system support plans on financing conditions; the sharp easing in monetary policy in the euro area and in the rest of the world; and the strongly expansionary nature of the fiscal authorities' aggregate demand stimulus plans, coupled with the effect of the automatic stabilisers. Further, the downward effect on consumer prices of the notable decline in commodities prices acts as an impulse to real household income. The effect of all these factors should enable the deterioration in confidence, demand and production to be contained, and later be propitious, into 2010, to a gradual economic recovery in the euro area. Nonetheless, this recovery scenario is subject to a high degree of uncertainty and the risks are on the downside, owing to the difficulty of stopping the feedback loop between the financial markets and real activity. Additional risk factors relate to the introduction of protectionist measures and to the possibility that the very duration of the uncertainty may force changes in economic agents' decision-making that entail not only the deferral of spending, but also a downward change in its permanent component.

1.2 PRICES AND COSTS

Commodities prices influenced the behaviour of consumer prices

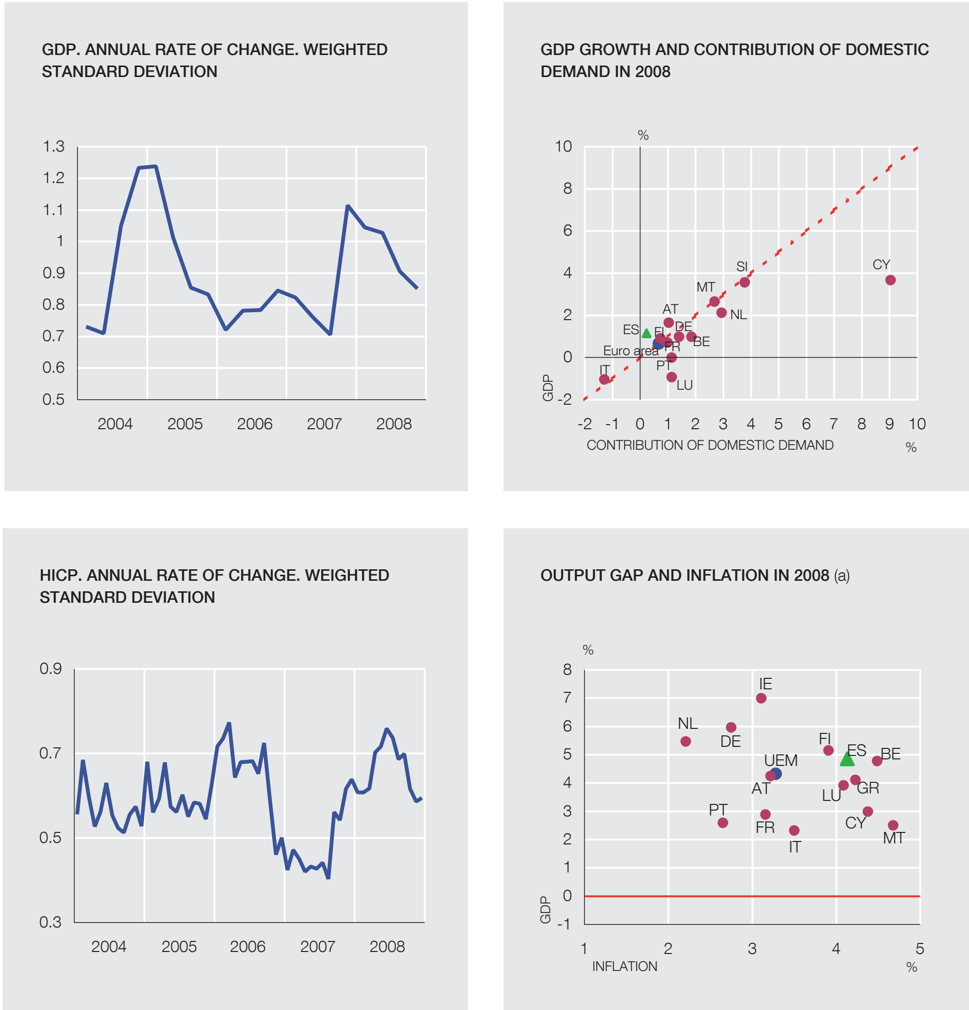
Inflation changed substantially during 2008. Over the year as a whole, the growth of the harmonised index of consumer prices (HICP) stood at 3.3%, peaking at 4% in July (the highest rate since the start of EMU) owing to the effect on its energy and food components of the rise in commodities prices on international markets. Thereafter, by contrast, the weakening of global activity began to have a negative bearing on commodities prices, which translated into a sharp reduction in inflation. However, the rate of change of the prices of the less volatile components of the HICP – non-energy industrial goods and services – held relatively stable in 2008 and in the opening months of 2009.

During 2008 and to date in 2009, the year-on-year rate of change of the HICP moved on a similar trend in all countries in the euro area, although marked differences were seen in the intensity of the acceleration and subsequent slowdown in inflation. That resulted in an initial increase in the dispersion of inflation rates within the area, followed by a decrease (see Chart 4.2). Essentially, this was a consequence of the different response of energy goods prices to dearer oil and other fuels, owing to the differing degree of energy dependence and to the welter of indirect taxation and price-setting arrangements for these goods.

Wages accelerated and business margins contracted, interrupting the trend observed in previous years

Wages accelerated substantially, as a result of the application of wage settlements reached at the end of the previous upturn, characterised by the high degree of labour utilisation (as attested by the historically low unemployment rate), which brought to an end the wage restraint prevailing in previous years. The growth of real wages outpaced labour productivity, giving rise to an increase in the wage share in total income, following a long period of progressive reduction (see Chart 4.3). Further, the loss of momentum in apparent labour productivity, combined with the increase in compensation per employee, led to a rise in unit labour costs. The decline in business margins – which, in annual average terms, had not been seen since 1997 – enabled the effect of wage costs on final prices (proxied by the GDP deflator) to be cushioned. Initially, the reduction in margins may have been attributable to the relative decrease in the demand for goods whose consumption is of a more discretionary nature, given the increase in spending on staple consumer products (food and energy goods), caused by the increase in the prices and the low price elasticity that characterises the demand for them. The subsequent steepening of the decline in margins may be explained by the generalised weakening in demand.

ECONOMIC PERFORMANCE BY COUNTRY IN 2008 CHART 4.2



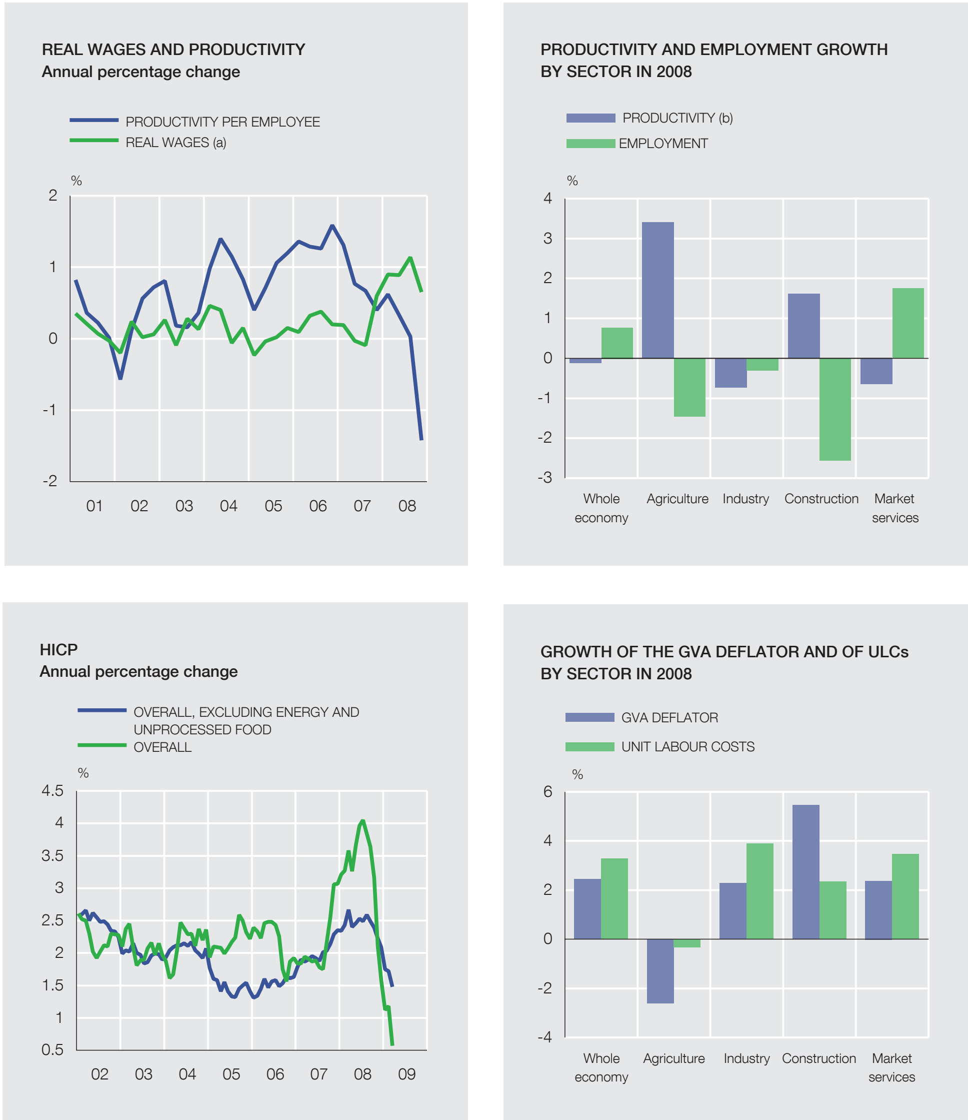
SOURCES: European Commission, Eurostat and Banco de España.

a. The output gap is defined as the difference between actual and potential GDP, as a percentage of potential GDP. European Commission estimates.

Inflation is expected to hold at a low – and even slightly negative – level, although there are both downside and upside risks to these expectations

Current forecasts point to inflation holding at a low level into 2010, which might turn negative around mid-2009, as a result of several factors: the decline in the cost of commodities; diminished wage pressures, linked in turn to the lower growth of consumer prices and to the weakness of the labour market; and greater competition, associated with the fall in demand and with overcapacity. That inflation expectations continue to be anchored at levels compatible with price stability reduces the risk of more unfavourable and extreme scenarios materialising, although marked uncertainty persists over the future course of activity, feeding through logically to that of prices. On one hand, a sharper-than-expected fall-off in demand would raise the present low risks of deflation. But on the other, a swifter-than-expected recovery in aggregate spending, set against the foreseeable reduction in the economy's growth potential – linked to the decline in investment and in employment – and the pursuit of expansionary policies, might lead to a rise in inflation.

EURO AREA: LABOUR MARKET AND PRICE INDICATORS. CHART 4.3



SOURCES: ECB, Eurostat and national statistics.

a. Difference between the change in compensation per employee and the GDP deflator.
b. Difference between the change in GDP and employment for the whole economy, and between the change in GVA and employment for the various sectors.

2 *Economic policies*

2.1 FISCAL POLICY

The financial crisis is strongly impacting euro area countries' public finances

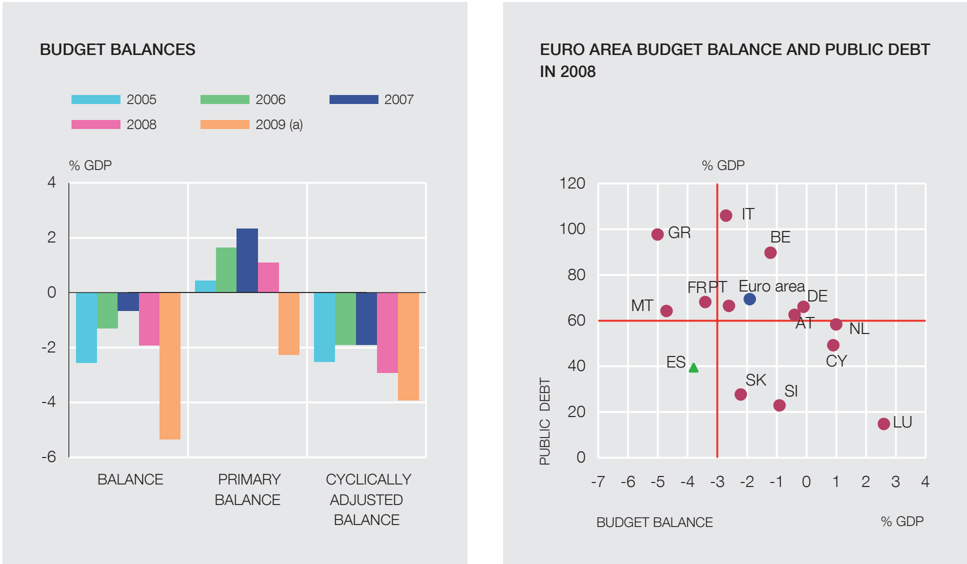
Fiscal policy in the euro area was influenced by the change in macroeconomic conditions observed in the second half of the year, which led the economic authorities to adopt exceptional measures aimed at stabilising financial markets, easing the rapid deterioration in activity and restoring confidence.

As part of the European Plan for Economic Recovery, demand-stimulating discretionary fiscal measures were adopted...

Most euro area countries introduced demand-stimulating discretionary measures from the autumn, in line with the objectives of the European Plan for Economic Recovery approved at the European Council summit on 12 December 2008. The plans unveiled to date amount overall to the equivalent of 1.1% of the area's GDP in 2009 (and 0.8% in 2010), with significant differences from country to country regarding both the scale and the composition of the response. Generally, the scale of the measures has been commensurate with the margin for manoeuvre available in each case, with such measures proving more ambitious in Germany

EURO AREA: FISCAL POLICY

CHART 4.4



SOURCE: European Commission.

a. EC forecasts.

and relatively moderate in France and Italy. As to the instruments involved, the programmes combine tax cuts and, above all, increases in public spending that tend to concentrate their effects on the groups and sectors most affected by the crisis. Finally, most of these measures have a temporary impact on public finances, although permanent rebates have been introduced into social security contributions and personal income tax in some countries. In any event, the exceptional situation that the euro area and the global economies face means that it is very difficult to assess the ultimate effectiveness of the fiscal impulse adopted (see Box 1.3).

... along with financial system support plans, which are having a high budgetary impact

The seriousness of the crisis also advised adopting sizeable financial system support plans, to avert the risk of certain systemic banks collapsing and to prevent an excessive adjustment of credit supply (see Box 1.1). From the standpoint of public finances, the public capital injections and asset purchases by governments in the period to April 2009 have had a limited impact on the deficit, but they could account for approximately 3 pp of public debt. The risks associated with guarantees of debt issues, which have notably increased general government "contingent" liabilities (by an amount close to 18% of GDP), must also be added to this.

Activation of the automatic stabilisers

Further adding to the foregoing was the activation of the automatic stabilisers. In Europe, and unlike in the United States, these are relatively powerful and are prompting an increase in spending on social benefits and a decline in tax revenue.

Consequently, in 2008 and 2009 there will have been a very sharp deterioration in fiscal balances and in public debt...

As a result of these developments, and on European Commission estimates, the euro area budget deficit stood at 1.9% of GDP in 2008, more than 1 pp up on the previous year. It is expected to rise to 5.3% of GDP in 2009, the highest level seen since 1996. The impact of the business cycle would account for 0.3 pp of the increase in the deficit seen in 2008, and for 2.4 pp in 2009, although these estimates may be subject to significant revisions since the uncertainty over the scale of the output gap and over the sensitivity of certain items to the business cycle is now extraordinarily high. Of particular note is the disappearance of revenue linked to the real estate market boom and to the rise in the value of financial assets, which in recent years contributed decisively to the budgetary improvements in various countries. Public debt rose to 69.3% of GDP in 2008 (3.3 pp up on the previous year) and might draw close to 78% in 2009 (see Chart 4.4).

... across the board

Most euro area countries in 2008 posted a deterioration in their budgetary balances compared with their estimates in the end-2007 stability programmes, which were framed in a much more favourable macroeconomic scenario than at present. The latest projections for 2009 suggest that this year 13 Member States will run a deficit of more than 3%, exceeding 6% in the cases of Spain, France, Ireland and Portugal.

The European Commission has opened an excessive deficit procedure in the case of several countries, applying the margins of flexibility laid down in the SGP

In this setting, the European Commission decided in February 2009 to initiate the excessive deficit procedure envisaged in the so-called "dissuasive arm" of the Stability and Growth Pact (SGP) for those countries whose deficit exceeded 3% of GDP in 2008: France, Spain, Ireland, Greece and Malta. The European Council reaffirmed that the Pact continues to provide an appropriate regulatory framework for the coordination of EU countries' budgetary policies and that it would apply the margins of flexibility introduced by the 2005 reform in respect of the periods laid down to correct excessive deficits and of the possibility of avoiding sanctions in exceptional circumstances. Indeed, France and Spain have until 2012, and Ireland until 2013, to bring their deficits below 3%.

There is a need to ensure the sustainability of public finances in the medium and long term

The magnitude of the crisis warranted adopting far-reaching measures to stabilise the financial system and stimulate demand, as agreed by the governments of the G20. But the budgetary impact of these measures is proving high, against a background in which the commitments arising from population ageing are compounded by the strong repercussions that the decline in asset prices is exerting on private pension schemes and public pension reserves. This poses new challenges and needs.

Accordingly, one of the main challenges the economic authorities currently face is to maintain confidence in the sustainability of public finances, so as to avert possible increases in long-term interest rates that would ultimately lessen the effectiveness of fiscal responses. In this connection it is necessary to lay down firm budgetary consolidation commitments and to resume compliance with the medium-term objectives established in the SGP as soon as possible. Further, these efforts must be consistent with maintaining the quality of public finances, preventing spending cuts from affecting those items which have most influence on long-term growth (such as spending on R&D and on education). Finally, it is essential to increase the degree of policy coordination and not to succumb to protectionist temptations, so that the measures adopted should not distort competition conditions and the functioning of the single European market.

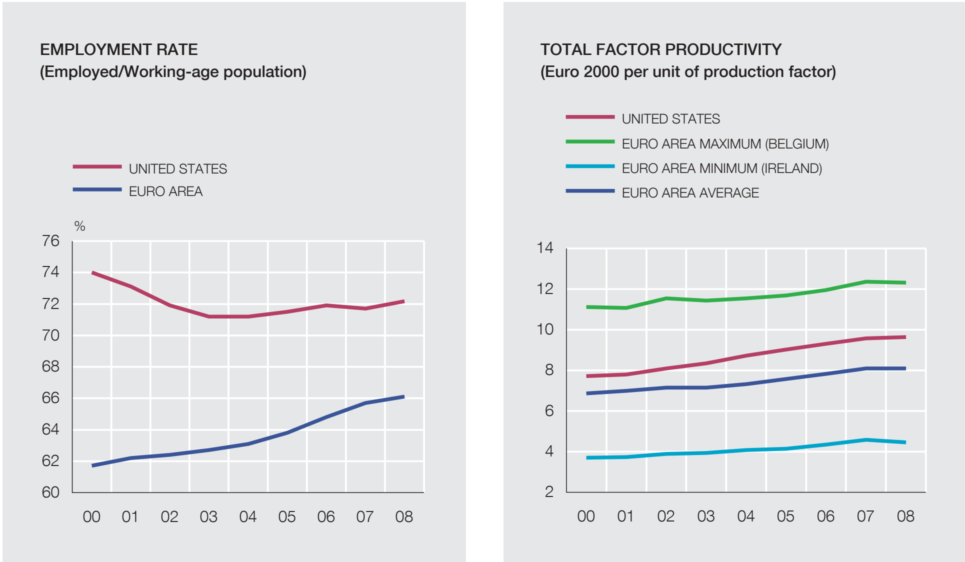
2.2 STRUCTURAL POLICIES

To ensure a rapid and sustained recovery, progress on the structural reform of the economy must continue

The consequences of the financial crisis, by inhibiting business investment and the participation in the labour market of certain groups, may continue for some time and affect the economy's growth potential in the medium term. Accordingly, although the economic policy response has focused on action aimed at averting the risks of financial collapse and at alleviating the recession, it is essential to increase the flexibility and efficiency of the euro area in order to pave the way for new investment opportunities and to retain the incentives for active job search.

With this rationale, the European Plan for Economic Recovery, along with the aforementioned fiscal stimulus measures, emphasised the need to make further headway with reforms in order to attain the medium and long-term targets set in the Lisbon strategy. In particular, it is vital in the current circumstances to make labour markets more flexible so as to contain the employment adjustment, without forsaking the social protection of the groups most affected by the crisis; to promote entrepreneurial initiative and improve access to funding for small and medium-sized enterprises (SMEs); to foment innovation and knowledge with a view to redirecting productive activity towards sectors with higher value added; and, ultimately, to foster competition, especially in services.

EURO AREA PRODUCTIVITY AND EMPLOYMENT CHART 4.5



SOURCES: Eurostat and Banco de España.

Most euro area countries introduced measures to ease the adjustment of labour markets

The pace of job creation was drastically corrected in late 2008 and the European Commission's projections suggest that the unemployment rate might exceed 11% in 2010. The employment rate held virtually stable (at around 66%) in 2008, far from the level of 70% set as a target in the Lisbon Agenda for 2010. This marked the interruption of a period of continuous advances in the use of the labour factor, to which the favourable economic conditions had proved conducive, as had too the labour market reforms tackled by most Member States in recent years centred on the strategy of "flexicurity", which concurrently promotes labour market flexibility, the protection of unemployed workers and active employment policies (see Chart 4.5).

Along these lines, practically all national economic recovery plans included employment-promoting measures. Most countries increased the funds for improving public services geared to assisting in job-search and training for the unemployed. Some governments also expedited their plans to reduce the "tax wedge" – the difference between the gross wage cost borne by the employer and the net wage received by the employee – by means of cuts to the social security contributions paid by workers and employers and to income tax, generally targeting the lowest-paid population segments. To the fore, however, were the initiatives allowing working hours to be more flexible while the crisis persisted, without terminating the contractual relationship. Overall, all these measures contrasted with those in the past, which sought to alleviate the employment adjustment by resorting to early retirements or to an increase in public-sector employment, and which ultimately exerted an unwanted effect on participation rates and public finances.

And headway was made in lifting barriers to worker mobility

At the European level, there were efforts to increase worker mobility, with the approval of the European Qualifications Framework in April 2008, which provides for the comparison of student and worker levels of qualification in the different Member States, although there are still considerable restrictions as far as pension and welfare benefit transfers are concerned.

It is essential to eliminate the barriers to hiring so as to avoid a deterioration in the incentives to participate in the labour market and a rise in structural unemployment

The progress in *flexicurity* has placed the euro area as a whole in a better position to face the crisis. But generally, few countries have embarked on reforms to employment protection legislation, which regulates the hiring and firing of workers. Accordingly, the weight of the adjustment is likely to fall mainly on workers with a temporary contract and on those groups with greater difficulties finding a job when the market is less dynamic (such as youths and elderly workers). At present, then, it is all the more necessary to further the reform of labour markets through the lowering of barriers to new hires and through boosting training and labour re-insertion policies in order to increase economies' adjustment capacity and to smooth the transition of workers to new jobs that arise after the crisis. The overriding challenge is that the social protection mechanisms being activated should not weaken the incentive to participate actively in the labour market. It is also important to eliminate rigidities in wage bargaining systems that prevent wages from adapting more rapidly to companies' situation, as reflected by the fact that, in 2008 Q4, wage settlements increased by 3.6% in the euro area as a whole, the highest rate seen since 1995.

The euro area's degree of efficiency has scarcely improved in recent years

The increase in labour utilisation in recent years has not been accompanied, however, by a substantial improvement in the economy's degree of efficiency. This is depicted in Chart 4.5, which shows total factor productivity for the euro area and for the United States. This illustrates the need for greater efforts in creating a sufficiently competitive business environment and for incorporating technological advances into productive processes.

Headway in incorporating technological progress and knowledge into productive processes has been limited

The insufficiency of the effort made is particularly notable in the case of innovation and knowledge. Specifically, the latest indicators show advances in the spread of the information society to households and in the availability of sources of funding for innovation (venture capital funds) (see Table 4.2). Nonetheless, research and development expenditure by the economy as a whole has yet to take off and remains rooted at 1.9% of GDP, far from the target of 3% set in the Lisbon strategy for 2010. Of particular significance is the lag vis-à-vis the United States in the effort in R&D conducted and financed by companies, the reflection of which is limited weight in the technology-intensive sectors with greater expansion potential. During 2008, the Commission set in train several initiatives in an attempt to move towards the creation of the European Research Space, promoting the international mobility of researchers, the reform of higher education to improve university performance and greater co-operation among research centres, universities and companies. But greater efforts are still needed by the Member States to eliminate the barriers to innovation, to smooth the passage of funding to innovative companies and to improve intellectual property regulations.

In the case of education, although the proportion of the population with higher studies has increased in recent years, rising to 21.3% of the working-age population in 2008 (5 pp up on the 2000 figure), the early school leavers rate remains high, and the quality and attractiveness of vocational training systems are insufficient.

The lowering of administrative barriers continues at a sound pace

In contrast to the foregoing, the progress made in promoting entrepreneurship and in improving the business environment are proving notable. During 2008 most Member States and the European Commission undertook projects geared to identifying and reducing the administrative and regulatory burdens that block the creation and expansion of companies. Moreover, bearing in mind the importance of SMEs (they account for 99% of total EU companies and for 70% of employment), the European Parliament approved the so-called "Small Business Act" in December 2008, establishing maximum periods for the creation of companies (one week, compared with the current 16 days) and for obtaining business permits and licences. Proposals are also included to foment the entrepreneurial spirit of SMEs, and to improve their innovation drive and openness to international markets. However, greater effort is still needed in simplifying accounting requirements and, especially, in improving SMEs' access to funding sources; after administrative barriers, the lack of financing is the obstacle most frequently mentioned by companies among the factors restricting their expansion, even in the period prior to the financial crisis breaking. Boosting the development of specialised institutions, such

EURO AREA: MAIN STRUCTURAL INDICATORS

TABLE 4.2

	2000		LATEST DATA		LATEST DATA
	EURO AREA	EURO AREA/US US = 100	EURO AREA	EURO AREA/US US = 100	
GDP PER CAPITA AND COMPONENTS					
GDP per capita (€ 1000 current ppp)	21.6	71.9	27.4	72.2	2008
Population aged 15-64 / Total population	67.2	101.5	66.5	98.9	2008
Employment rate	61.7	83.4	66.1	91.6	2008
Unemployment rate	8.3	207.5	7.5	129.3	2008
Total factor productivity	6.9	89.0	8.1	84.0	2008
TECHNOLOGICAL LEVEL					
Spending on R&D/GDP	1.8	67.4	1.9	71.3	2007
Spending on private R&D/GDP (EU 15) (a)	1.2	65.0	1.2	62.7	2007
Triadic patents per million inhabitants	29.5	57.5	29.9	56.2	2006
ICT spending per capita	1,153.7	34.9	2,242.6	65.6	2007
Broadband penetration per hundred inhabitants	0.4	16.9	21.9	100.4	2007
Venture capital in the early stages of the investment	0.1	22.9	0.0	60.6	2007
QUALITY OF HUMAN CAPITAL					
Public expenditure on education / GDP	4.5	77.7	5.3	100.2	2005
Private expenditure on education / GDP	0.6	24.7	0.6	25.0	2005
Labour force with tertiary education	*22.1*	*63.4*	*24.0*	*40.1*	*2005*
Labour force with secondary education	*43.4*	*84.2*	*38.7*	*128.6*	*2005*
Labour force with primary education	*33.8*	*247.0*	*36.2*	*362.4*	*2005*
Graduates in science and technology (EU 15)	10.0	103.1	12.8	124.3	2006
Continuous learning	5.4	—	8.4	—	2007
BUSINESS ENVIRONMENT					
Business start-up cost (% of GDP pc) (b)	9.6	1,371.9	7.6	1,090.9	2008
Time to start a business (days) (b)	46.3	772.4	16.6	277.3	2008
ENERGETIC EFFICIENCY					
Energy intensity of the economy (EU 15)	185.6	55.5	179.0	61.5	2006
Electricity generated by renewable sources (%) (EU 15)	14.6	—	15.3	—	2005

SOURCES: Eurostat, OECD, World Bank and Banco de España.

a. The series for spending on private R&D starts in 2002.
b. The series for business environment starts in 2004.

as venture capital companies and other individual investors (business angels), will contribute to lessening this limitation.

The implementation of the Services Directive might entail new employment opportunities and diminish the persistence of inflation in these activities

As regards promoting competition and strengthening the single market, one of the key features of the current recession is the downward stickiness being shown by services inflation in the euro area, despite the slowdown in the demand for services. Accordingly, the full implementation of the Services Directive envisaged for December 2009 is one of the cornerstones of the European reform strategy. To date, the Member States have conducted an exhaustive analysis of the national and territorial legislation that must be amended to eliminate the barriers to the international provision of services and to freedom of establishment. Progress can also be seen in the establishment of single windows, whose aim is to simplify companies' administrative formalities. But at present it is difficult to determine whether the transposition of the Directive is moving at the appropriate pace, since the most demanding phase must be implemented in the course of 2009. Moreover, there are some professional services for which the regulation is restrictive, and these have been left outside the scope of the Directive. It should further be said that there is still room to reinforce competition in certain network industries, such as electricity and gas, where progress must be made towards the effective segregation of production and distribution and where price regulation must be eliminated, and also in railway transport and in retail trade.

Far-reaching regulatory changes are needed in financial markets

Turning to the financial markets, the current circumstances have highlighted numerous shortcomings in financial regulation and supervisory arrangements. To palliate these deficiencies, European institutions are developing a series of plans and measures consistent with the guidelines agreed internationally (Financial Stability Forum and G20), the ultimate aims of which are to increase the transparency of financial reporting systems so as to raise supervisory capacity and improve risk assessment and investor protection. Also under discussion are reforms to reduce the procyclicality of the financial system, an increase in capital requirements, and changes in the regulation of risk rating agencies and of hedge funds (see Box 3.3).

A plan was approved in 2008 to increase energy efficiency and combat climate change

The high commodities prices prevailing until mid-2008 and the emergence of discrete problems in energy supply highlighted the importance of promoting energy efficiency and diversifying supply sources, as envisaged in European energy policy objectives. Along these lines, on 17 December the European Parliament approved the "Climate Change and Energy" package, which makes a commitment to lowering greenhouse gas emissions, along with a series of measures aimed at reducing energy consumption and at promoting the use of renewable energies. To attain these objectives, it will be necessary to develop interconnection infrastructures with energy-producing countries, to improve the functioning of the emission rights exchange system and, above all, to prevent the most environmentally respectful European companies facing competitive disadvantages. In that connection, headway must be made in the international coordination of policies to combat climate change at the Copenhagen summit in December 2009.

3 The common monetary policy and monetary and financial conditions in the euro area

3.1 MONETARY POLICY DECISIONS

The outlook for monetary policy in the first half of 2008 was particularly complex

During the first half of 2008 the outlook for monetary policy was particularly complex: on one side there were notable inflationary pressures derived from the cumulative increase in oil prices, and, on the other, contractionary risks stemming from the continuing strains on financial markets. As regards prices, the HICP grew at a year-on-year rate of over 3% from the start of the year and the analyses available projected a persistent deviation of above 2%. Further, the capacity utilisation indicators did not ease off and wages were increasing at a high rate. Against this background it was essential to ensure that medium and long-term inflation expectations remained at levels compatible with the price stability objective and that second-round effects did not emerge. In turn, the continuing financial tensions shaped more restrictive financing conditions than the level inferred by official rates, which exerted a contractionary effect on expenditure. Despite the fact that the high risk premia on markets were sustaining rising bank rates and that the Bank Lending Survey pointed to a progressive contraction in supply, the credit aggregates remained relatively robust. Moreover, as elsewhere indicated in this Report (see Box 4.1), the indicators of activity did not reflect until after the summer that the economy was moving into a sluggish phase as is today evident.

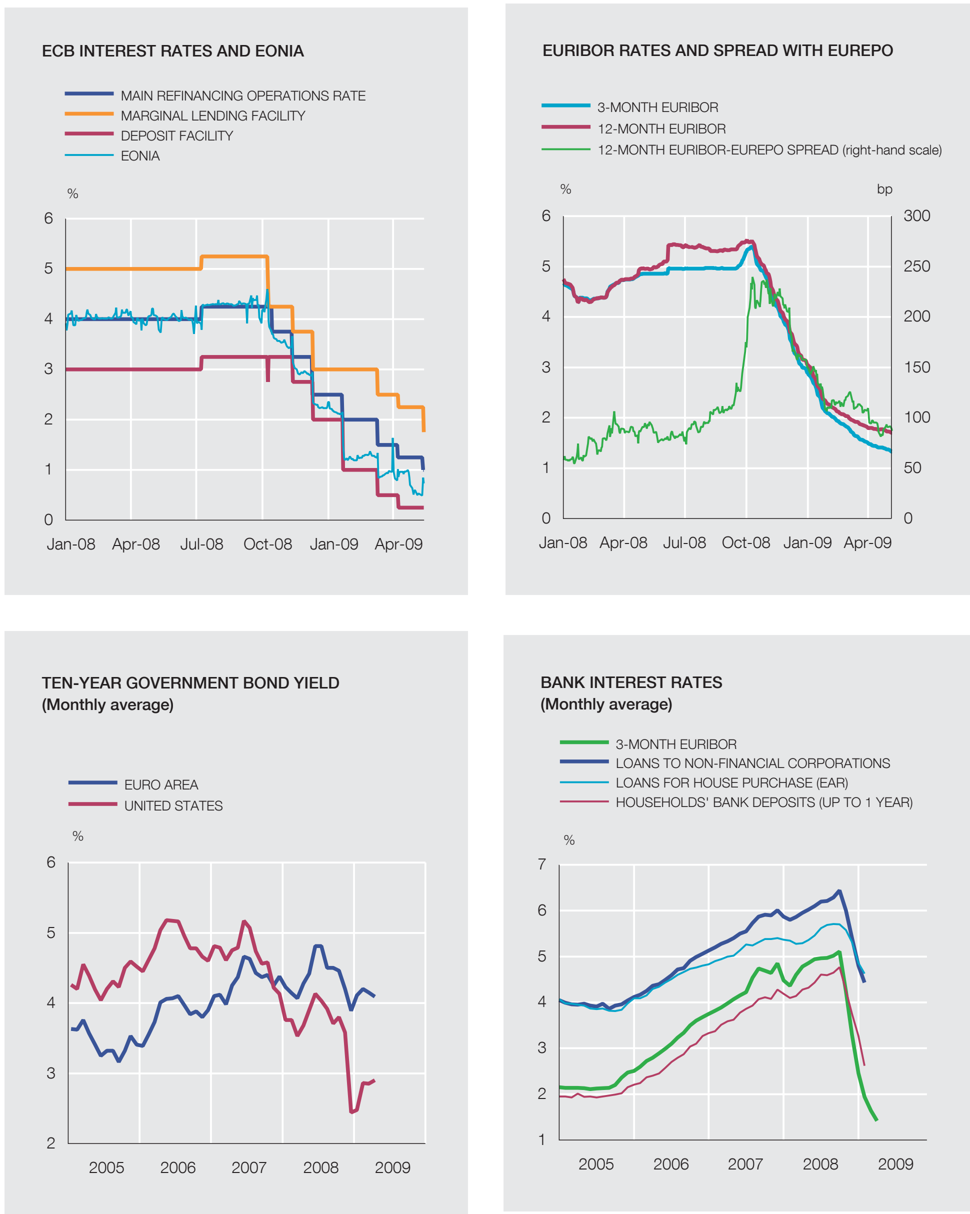
In July the ECB decided to raise its official rate by 25 bp while continuing to apply a policy of ample liquidity provision

In these circumstances, the ECB Governing Council held its official interest rate at 4% until mid-2008 (see Chart 4.6). In July, when the risks to inflation became more perceptible, it raised its intervention rate by 25 bp in order to ensure that medium and long-term inflation expectations remained anchored. These decisions combined with the continuation of a sufficiently accommodating liquidity injection policy which, as explained in Box 4.2, allowed euro area credit institutions' greater needs to be met and sought to ease the tensions prompted by the market dysfunctions.

From September, the change in the economic and price scenarios gave rise to a rapid easing in monetary policy and to added flexibility in the operational framework

From September, the deterioration in the growth scenario and the disappearance of the upside risks to price stability led to a full turnaround in the monetary policy stance. Hence, in October, a rapid process of easing began, starting with a cut in rates of 50 bp as part of a concerted and unprecedented action by the main central banks of the more developed economies. This decision was followed by further cuts, some of which on a sizeable scale (75 bp in December),

EURO AREA INTEREST RATES CHART 4.6



SOURCE: ECB.

which took the main refinancing operations rate to 1% in May 2009, a level not seen since the ECB was created. Also, as explained in detail in Box 4.2, the seriousness of the crisis required that the flexibility of the ECB's operational framework be harnessed to expand the supply of liquidity.

3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

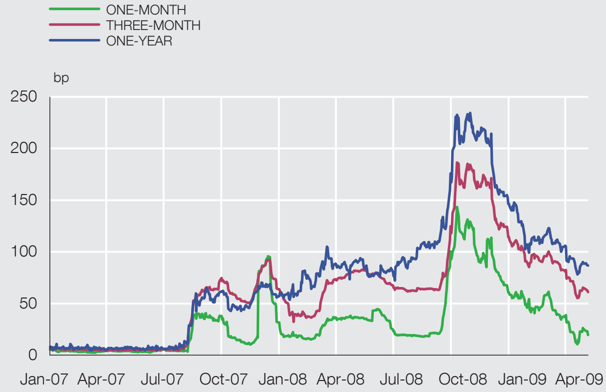
Financial conditions tightened and some markets showed very high volatility

Financial conditions in the euro area became more restricted during 2008, as a result of the rise in the cost of financing, stricter credit standards and the loss in value of assets. Capital and foreign exchange markets also showed very high volatility, particularly in the last quarter of the year.

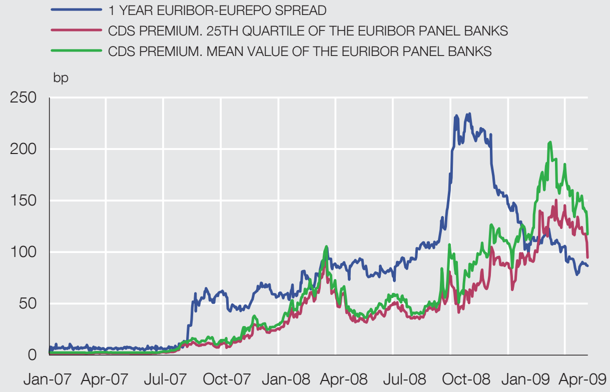
The worsening of the financial crisis in September

The worsening of tensions in the international financial system towards the end of the summer swiftly spread to the euro area, to the extent that several systemic institutions – such as Dexia, The international financial crisis that broke in the summer of 2007 had one of its most visible and immediate effects in the interbank markets. The change in the perception of credit risk in the banking sector and greater liquidity needs attributable to the precautionary motive were reflected in a substantial increase in the risk premia incorporated into EURIBOR-EUREPO spreads, and in a drastic reduction in activity in non-collateralised forward transactions. As Panels 1 and 2 show, these difficulties persisted in 2008 and 2009, and such a lengthy period of malfunctioning interbank markets is proving unprecedented. Moreover, the intensity of events heightened during specific high-tension episodes, such as the close of the year 2007, the collapse of Bear Stearns in March 2008 and, most notably and persistently, the bankruptcy of Lehman Brothers in September.

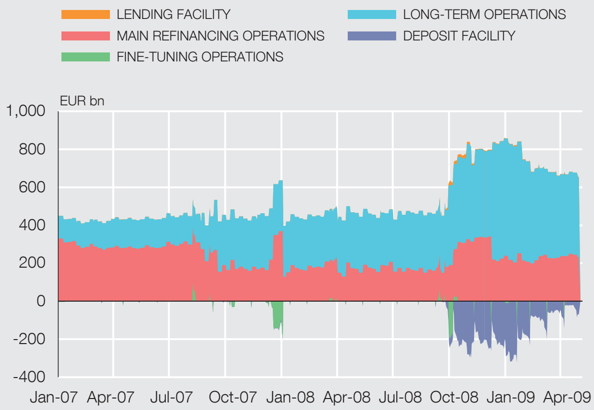
1 EURIBOR/EUREPO SPREAD



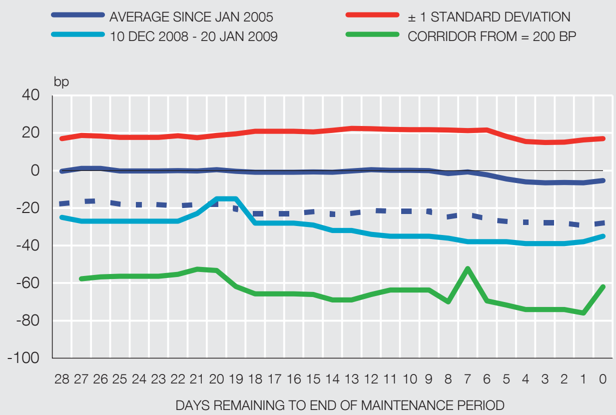
2 TWELVE-MONTH INTERBANK CREDIT RISK PREMIA



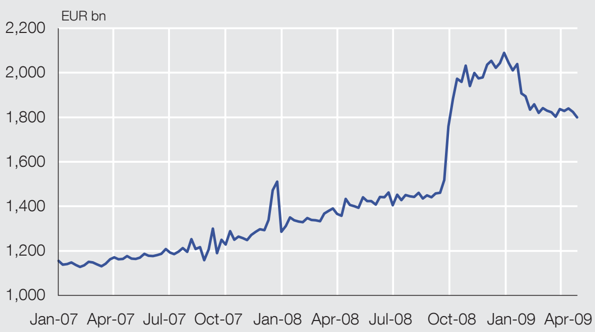
3 LIQUIDITY SUPPLY



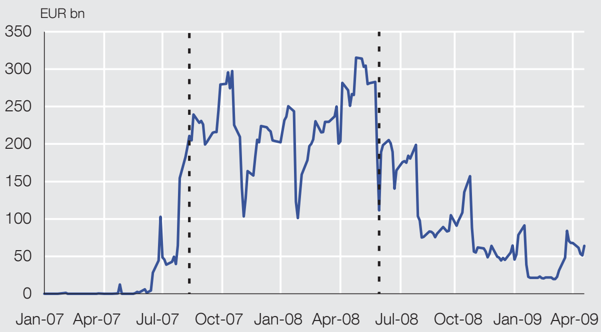
4 EONIA-MRO SPREAD



5 ECB BALANCE SHEET. TOTAL ASSETS



6 DEPOSIT FACILITY (a)



SOURCES: Datastream and ECB.

a. The period between the broken vertical lines coincides with the reduction of the marginal facilities corridor to 100 bp.

The importance of the interbank market in monetary policy transmission meant that further flexibility had to be added to the liquidity provision policy during 2008. To September, the measures introduced in 2007 were extended and reinforced without having to modify the operational framework. Firstly, banks' preference to satisfy reserve requirements in advance continued to be catered for, this being reflected in a greater supply of liquidity at the start of maintenance periods. Secondly, the number of supplementary three-month injection operations was increased, and additional six-month operations were added, further stretching out the maturity of the funding granted. Lastly, to meet banks' dollar requirements, the provision of funds in this currency was broadened by means of TAF (term auction facility) operations, extending the agreement with the US Federal Reserve.

The worsening of the crisis in September 2008 meant that the 12-month EURIBOR-EUREPO spread – which is a measure of the risk premium incorporated into the EURIBOR – surged to over 200 bp. This affirmation of the fact that the interbank market had ceased to function as an efficient interbank liquidity distribution mechanism led the ECB to take far-reaching measures, satisfying the gross liquidity requirements of the system and introducing modifications into its operational framework that would substantially increase the size of its balance sheet.

In particular, the traditional variable-rate auction system was replaced by a fixed-rate, full allotment procedure, which entailed giving up control of quantities. The change was applied to regular auctions, both weekly and LTRO (longer-term refinancing operations), effective at least until after the close of 2009, and also to forward operations in dollars. Also, the spread between the deposit facility and the marginal lending facility interest rates was narrowed to 100 bp. Furthermore, longer-term financing continued to be reinforced, by means of the rollover of the LTROs that were maturing and the introduction of new ones, so that at end-2008 LTROs accounted for more than 75% of the total funds lent in euro (see Panel 3). Adding to these measures were new liquidity-injection operations in dollars, with seven-day auctions supplementing the existing 28- and 84-day auctions, and the possibility of conducting currency swaps. Likewise, following an agreement with the Swiss central bank, liquidity in Swiss francs was provided, via swaps, initially at seven days and subsequently at 84 days, too. Finally, in the event of a shortage of collateral to resort to such a broad supply of liquidity, the ECB increased the list of eligible instruments, adding lower-graded securities (up to BBB– excluding asset-backed bonds), bond issues by credit institutions including certificates of deposit, negotiable subordinated debt and foreign-currency-denominated assets provided that they are issued and settled in the euro area.

Reflecting the situation of abundant liquidity was the tendency of the EONIA to stand systematically below the weekly tender rate, at a much greater distance as from January, when the spread between the marginal facility rates was restored to 200 bp (see Panel 4). In fact, from October the full allotment of applications in the weekly tenders came to replace the role of the credit facility, which has effectively shifted the ceiling for the EONIA rate.

As a result of these decisions, the ECB balance sheet increased considerably. Relative to the situation as at mid-2007, the ECB's assets grew by around 70%, accounting for around €800 billion or 8% of euro area GDP (see Panel 5). However, the net provision of liquidity was lower because surplus funds were not placed in the market; rather, banks made use of the deposit facility (see Panel 6). Encouraging this drainage mechanism was the reduction in the spread between this facility and the main refinancing operations. To restrict this practice, the facilities corridor was restored in January, which has contributed to the contraction of the balance sheet since mid-February (along with lower demand for refinancing in dollars).

In sum, the worsening of the international financial crisis in 2008 required, as in other parts of the world, an unprecedented adaptation of liquidity provision systems. The ECB's interventions contributed to alleviating the financial strains derived from the drying up of wholesale funding markets. However, these support measures, while necessary, have an inherently limited capacity to resolve the fundamental problems of confidence and attitude towards risk that continue to stifle the sound functioning of markets. Accordingly, interbank spreads and the indicators of credit risk in the banking sector have held at relatively high levels, despite falling gradually from their October highs.

At the ECB Governing Council meeting on 7 May 2009, when it cut its main refinancing operations rate to 1%, it also narrowed the corridor between the marginal lending facility and deposit facility rates from 200 bp to 150 bp and held the interest rate of the latter facility at 0.25%. In parallel, it announced the introduction of three new liquidity-injecting operations at as term of twelve months, and the broadening of non-standard measures to encompass the purchase of covered bonds issued by euro area banks.

necessitated extraordinary action by the ECB and by governments, which launched financial system support plans within an agreed framework of common principles

Fortis and Hypo Real Estate – had to be bailed out, and the ensuing alarm became manifest in large-scale demand for cash. These episodes and the high uncertainty over the strength of financial institutions' balance sheets prompted, as in other parts of the world, sharp downward reactions in asset prices and a heightening of financing problems. Action by the ECB and the launching of ambitious national support plans averted any far-reaching consequences, but high risk premia and tighter lending standards remained in place even in early 2009, despite the fact that banks gradually passed through official interest-rate cuts to their customers. The national financial system support plans, referred to in other sections of this Report, had amounts equivalent to more than 20% of euro area GDP assigned to them. Moreover, they were to some extent coordinated by the framework of common principles agreed by the Eurogroup on 12 October, with the aim of contributing to the greater effectiveness of the measures and avoiding potential distortions to competition. To maintain the flow of loans to the economy, some countries – including Germany, France, Spain and Ireland – made their measures conditional upon banks' expanding their supply of credit. This initiative was complemented in December with the European Commission's adoption of a framework of temporary measures (to 2010) to directly stimulate credit as part of the European Economic Recovery Plan.

The interbank market was particularly affected by the crisis, with the EURIBOR containing high risk premia that peaked in October

Capital market dysfunctions were most apparent in the interbank market, where there was an enormous reduction in activity, particularly in non-collateralised longer-dated operations. Reflecting this situation, EURIBOR rates throughout the year contained very high risk premia which rose at the times of the greatest financial instability, exceeding 200 bp at their peak in October. Thereafter, risk premia gradually declined, falling to levels similar to those prevailing before the bankruptcy of Lehman Brothers. This reduction and, above all, the sharp easing in monetary policy resulted in a notable decline in the three-month EURIBOR, which fell below 1.5% in April, down from over 5% in October 2008.

Public debt continued to be a safe haven and the spreads between sovereign bonds widened

Sovereign bonds acted as a safe-haven asset during the greatest bouts of financial turmoil, giving rise to wide fluctuations in their returns. Over the year as a whole, 10-year rates in the euro area declined moderately to close to 4%, which entailed a widening of the negative spread relative to US rates, where a sharper fall was observed. As the year unfolded, the prospect of lower growth in the economy and in prices coupled with the easing of monetary policy exerted downward pressure on long-term rates, while the foreseeable deterioration in public finances stemming from the fiscal stimulus and financial support packages tended to raise the cost of public debt issues. Indeed, sovereign bond spreads in the euro area over the German benchmark bond widened substantially and remain at a high level, which reflects the increase in credit risk premia and also a greater preference for liquidity (see Box 6.2).

Risk premia increased on private debt markets and financial institutions made sizeable securitisations which they retained on their balance sheets

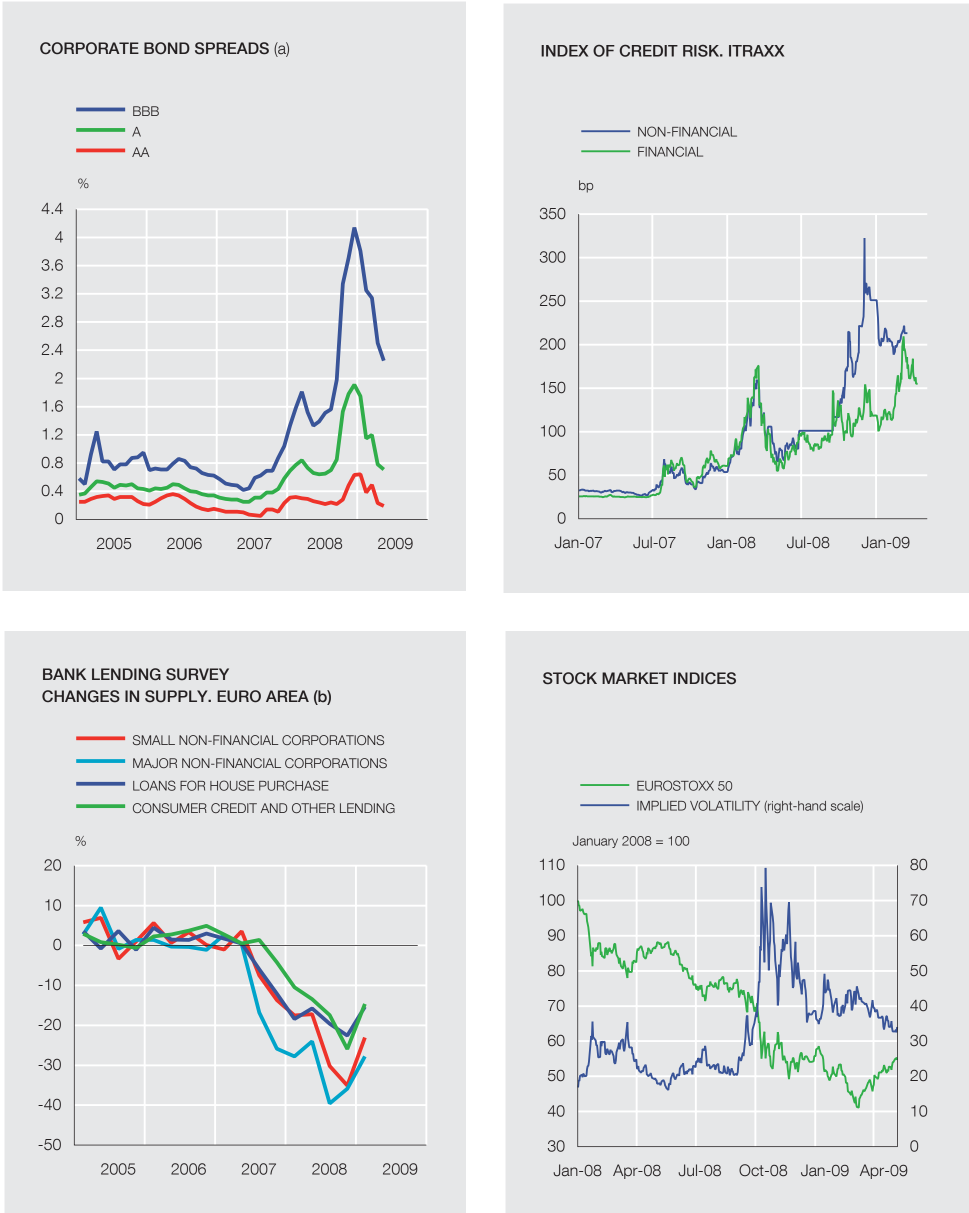
Funding conditions also tightened on private debt markets, where there were extraordinary increases in yield spreads, particularly in 2008 Q4, for financial and non-financial corporations alike (see Chart 4.7). Against this background, primary markets performed unevenly in respect of their various instruments. Low-grade bond issues declined substantially, as did covered bonds (which offer very high credit quality). However, financial institutions made sizeable securitisations, which they retained on their balance sheets in order to have collateral and thus the potential to gain access to Eurosystem financing. As from November, the State-backed issues envisaged in government support schemes also began to proliferate.

The supply of bank loans became more restrictive and credit to the private sector slowed, more markedly so in the final quarter

In the market for bank loans, interest rates also moved on a rising trend for most of the year, in line with the EURIBOR. This trajectory was interrupted in November when the cost of bank financing began to fall substantially as part of the more accommodating monetary policy transmission process. Nonetheless, the Bank Lending Survey continued to show a progressive tightening of supply conditions, reflecting above all the substantial deterioration in economic activity and in real estate markets in some of the Member States, and which took the form of greater requirements in respect of collateral, maturity and other non-price conditions.

Against this backdrop, credit to the private sector progressively lost momentum, more sharply so as from mid-2008 (see Chart 4.8). Loans to the private sector slowed by almost 5 pp to a growth rate of around 7% in 2008 in securitisation-adjusted terms, a trajectory

FINANCIAL CONDITIONS IN THE EURO AREA CHART 4.7



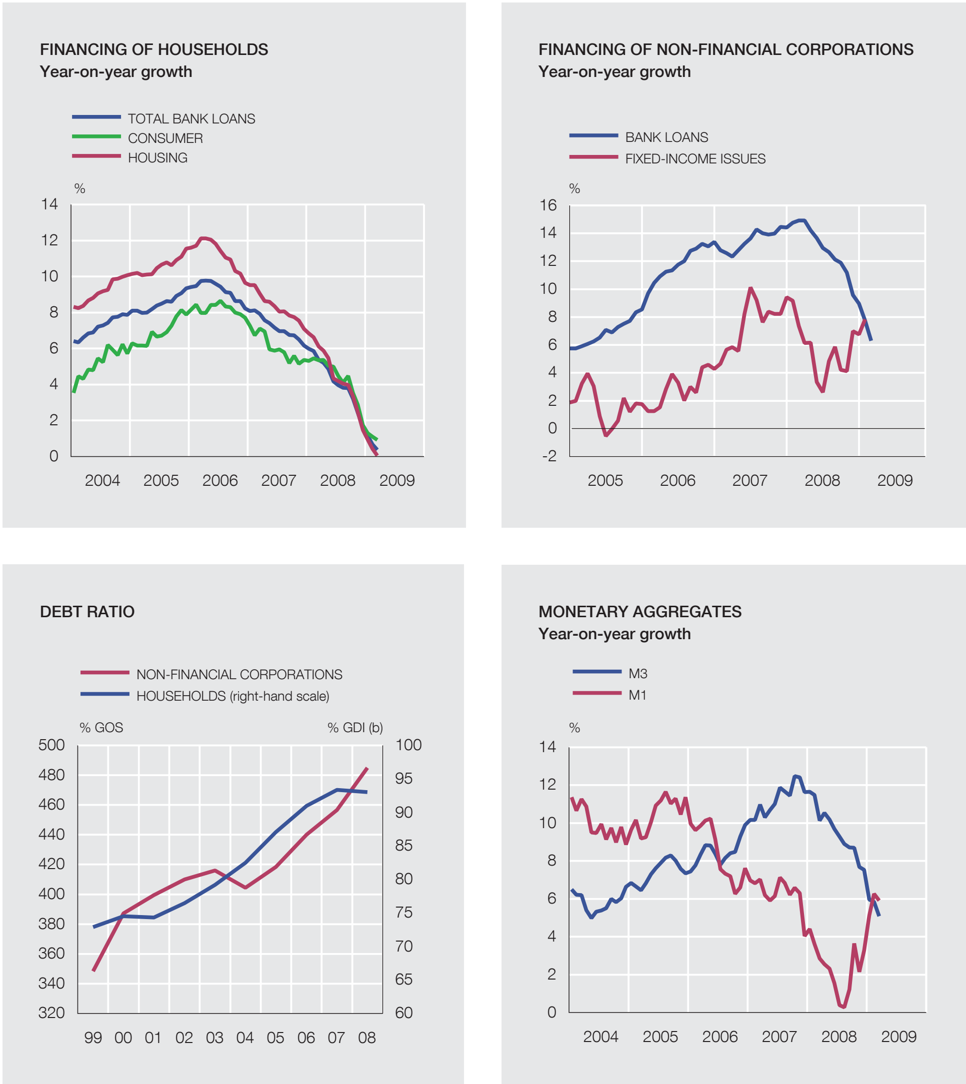
SOURCES: Datastream, ECB and Banco de España.

a. Issued by-non financial corporations and denominated in euro. Spread over AAA-rated bonds.
b. Indicator = % of institutions that report a considerable increase + % of institutions that report a certain increase x 0.5 – % of institutions that report a certain fall x 0.5 – % of institutions that report a considerable fall. A positive (negative) value denotes an increase (decrease) in the supply of loans from institutions with respect to the previous quarter.

that has become more accentuated in the opening months of 2009. In the case of households, both consumer loans and house-purchase loans were slacker. Their growth on bank balance sheets did not exceed 2% in 2008, compared with 6% in 2007, a reduction that has continued in 2009 to date. As a result, households' debt/gross disposable income ratio held stable, following six years of continuous growth. Loans to non-financial corporations also slowed, although they retained a higher growth rate (9%) over the year as a whole, entailing a further increase in the sector's debt ratio. Loans over €1 million were particularly dynamic, revealing that the slowdown particularly affected small and medium-sized enterprises, for which declines in year-on-year terms have been recorded since spring 2008.

MONETARY AND CREDIT AGGREGATES

CHART 4.8



SOURCES: ECB and Banco de España.

a. Gross operating surplus.
b. Gross disposable income.

Stock market prices plummeted while evidencing high volatility

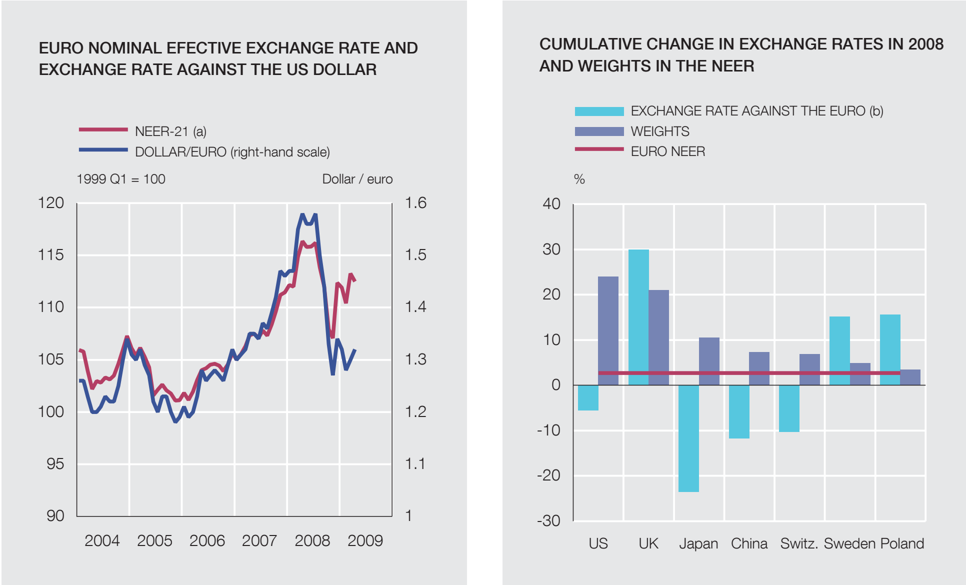
Stock market prices began to fall from the start of the year and volatility was very high. As the financial crisis worsened and its impact on economic activity became apparent, the fall in equity prices gathered pace and spread to all sectors. In 2008 as a whole, the EUROSTOXX 50 index fell by almost 45%, with declines of over 60% in the value of the bank sector. This behaviour continued into early 2009, but they began to be corrected as from March, when European stock markets, like other international equity markets, welcomed specific new measures from governments and central banks, particularly in the United States and the United Kingdom.

The euro appreciated in effective terms and showed high volatility

The exchange rate of the euro was also highly influenced by the instability of the international financial system and economic developments. In 2008 as a whole, the real effective rate of the euro appreciated by almost 3%, albeit with very marked upward and downward fluctuations and evidencing heterogeneous behaviour in relation to various currencies (see Chart 4.9). Over the course of 2008, the euro depreciated by 5% against the dollar and by 23% against the yen. By contrast, it appreciated by over 28% against sterling. In 2009 the euro has remained

EURO EXCHANGE RATE

CHART 4.9



SOURCES: ECB and European Commission.

a. The NEER-21 is the nominal effective exchange rate of the euro against 21 countries: non-euro area EU-27 countries in 2009 plus United States, Canada, Australia, Norway, Switzerland, Japan, China, Hong Kong, South Korea and Singapore.
b. A positive (negative) value denotes an appreciation (depreciation) of the euro.

volatile and on a rising trend as from March, particularly against the currencies of those countries that most aggressively eased their monetary policies.

There was an easing in the growth rates of the monetary aggregates, particularly the most liquid measures

Finally, the dynamism of the monetary aggregates was substantially contained in 2008 and early 2009. However, investment flows towards time deposits held up strongly for most of the year, owing to the attractive return involved, though this behaviour was interrupted in 2009. By contrast, the most liquid assets – M1, which includes cash and sight deposits – slowed notably, although at the height of the financial turmoil (in September and October) there was great demand for these instruments.