4 THE EURO AREA AND THE COMMON MONETARY POLICY

1 Sovereign debt crisis in the euro area

The sovereign debt crisis prompted a reform of the institutional framework and an overhaul of the priorities of economic policy

The economic recovery proceeded throughout last year and 2011 to date, driven by the strength of the world economy, the expansionary economic policy stance and the fiscal policy stimulus in the first half of the year (see Chart 4.1). Nevertheless, in 2010 the euro area faced a severe sovereign debt crisis which affected various member countries and posed a serious threat to the stability of the area. The gravity of the situation called for substantial reform of the institutional framework underpinning the euro area, directed particularly at the mechanisms of economic policy coordination and supervision. The role of structural policies was also strengthened so as to achieve greater efficiency in the use of factors of production and return to a path of sustained economic growth, which is vital in those economies that have to reabsorb imbalances accumulated in the past.

The crisis stemmed from major imbalances in some Member States

The doubts about the sustainability of public finances in various euro area member countries, which are at the origin of the sovereign debt crisis, stemmed from a combination of diverse factors. General government finances deteriorated notably as a result of the activation of automatic stabilisers during the crisis, the roll-out of discretionary stimulus measures and, in some countries, the loss of the extraordinary revenue associated with the real estate boom and the use of public funds to stabilise the banking sector. Moreover, in some cases the starting level of public debt was already high at the outset of the crisis, a situation which was aggravated by the high contingent liabilities arising from the foreseeable impact of progressive population aging on the public pension system and by the uncertainty surrounding the return of the funds invested in bank restructuring processes. However, leaving aside these purely fiscal developments, the growth outlook for some euro area economies was inauspicious due to the accumulation of macroeconomic imbalances over the past decade, which has given rise to high levels of private indebtedness, substantial loss of competitiveness and elements of fragility in banking systems.

... but also evidenced deficiencies in the design and functioning of policy coordination and crisis prevention and resolution mechanisms in the EU and the euro area

The crisis also highlighted fundamental fragilities in the instruments of coordination and macroeconomic supervision of the euro area, which proved to be insufficient to instil the necessary degree of discipline and give due attention to the macro-financial imbalances developing in some economies and requiring corrective economic policy action. It also became apparent that the euro area authorities did not have formal mechanisms for coordinated crisis management and resolution, which meant that the required financial assistance had to be hastily designed and implemented. Both of these shortcomings take on greater importance in a situation in which, as the current crisis has shown, shocks are propagated between euro area countries substantially more rapidly and intensely: the drastic repricing of one country's sovereign risk was rapidly transformed into a heightened perception of bank vulnerability, a change in the assessment of the economic situation in other countries and a widespread crisis of confidence in the euro area.

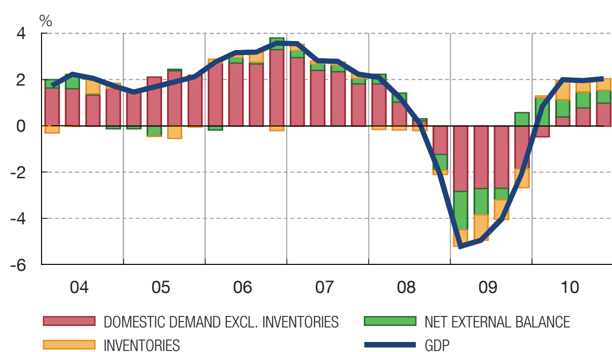
Sovereign spreads widened to differing extents

The credit rating of public debt was downgraded in all of the most strongly affected countries and sovereign spreads rose suddenly, albeit to differing extents depending on the fiscal and economic situation and outlook of the countries involved (see Chart 4.2). Greek public debt was downgraded to speculative status and its spread over the German bund exceeded 1,200 basis points (bp) despite the financial assistance received in May. The rates in Ireland and Portugal climbed to 700 bp and 600 bp, respectively, above the German bund. The deterioration in sovereign risk premia in Spain, Italy and Belgium was more limited, but significant at times, particularly in Spain.

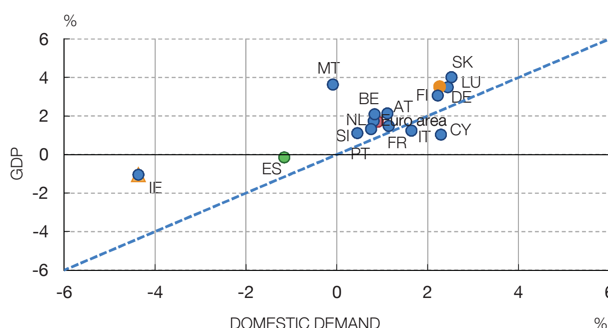
EURO AREA: GROWTH, LABOUR MARKET AND PRICES

CHART 4.1

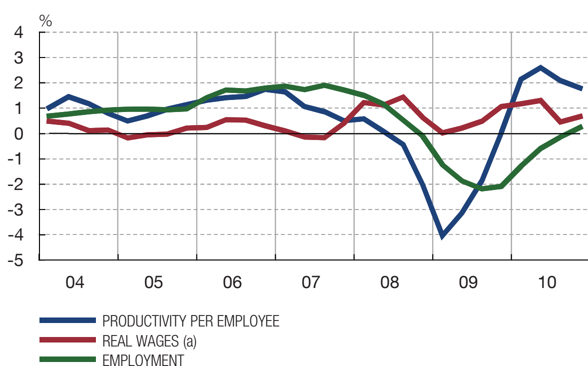
ANNUAL PERCENTAGE CHANGE IN GDP AND CONTRIBUTIONS OF GDP COMPONENTS



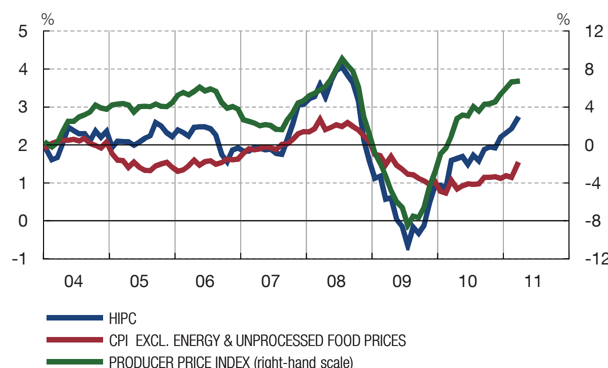
GDP GROWTH AND CONTRIBUTION OF DOMESTIC DEMAND IN 2010



REAL WAGES AND PRODUCTIVITY
Annual percentage change



CONSUMER AND PRODUCER PRICES
Annual percentage change



SOURCE: Eurostat.

a Difference between the change in compensation per employee and the GDP deflator.

... and tension was appreciable in other financial markets

The tension also affected other financial variables, in some cases very unevenly across sectors and countries. The euro exchange rate depreciated by more than 10% in nominal effective terms from October 2009 to end-2010, against a background of high volatility. The EUROSTOXX 50 index fell by 6% in the year and, save the German DAX which rose by more than 16%, the main European stock exchanges fell sharply, particularly in the financial sector and in the countries hit hardest by the crisis (see Chart 4.3). Moreover, the fall in government bond prices exposed the euro area banking sector to losses in their available-for-sale asset portfolios, while the perceived greater fragility of the public sector weakened the explicit or implicit guarantee that it can provide to the financial system. The institutions of the most affected countries faced more limited access to the wholesale funding markets and encountered serious liquidity problems, having to resort to Eurosystem funds and, in extreme cases, to emergency liquidity assistance from their respective national central banks. By contrast, non-financial corporations and, above all, households were comparatively less affected by these tensions, since they scarcely passed through to the availability and cost of bank loans, although countries did vary somewhat in this respect. Against a background of notable weakness in demand, lending followed a similar cyclical pattern to that observed historically.

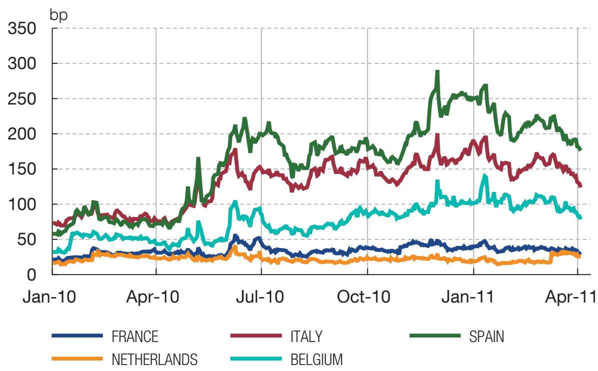
The institutional response of the euro area initially calmed the tensions...

After serious deficiencies were found in the statistical information on its public accounts and various months of hesitation and reluctance, Greece finally requested financial assistance in May. This support amounted to €100 billion, provided under a programme of

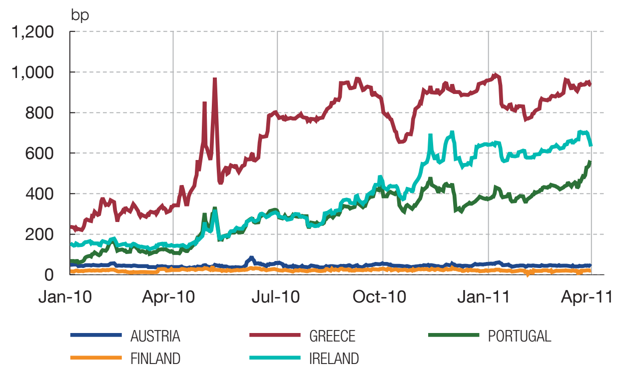
EURO AREA: SOVEREIGN SPREADS OVER GERMANY

CHART 4.2

TEN-YEAR BONDS



TEN-YEAR BONDS



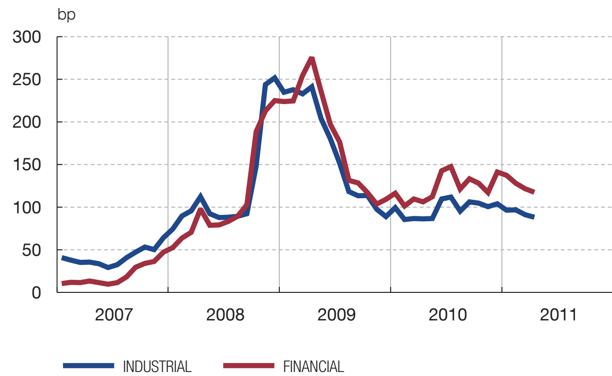
SOURCE: Eurostat.

FINANCIAL CONDITIONS IN THE EURO AREA

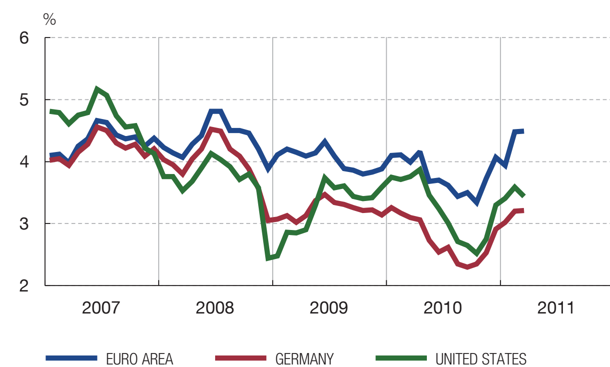
CHART 4.3

STOCK MARKET INDICES
End period

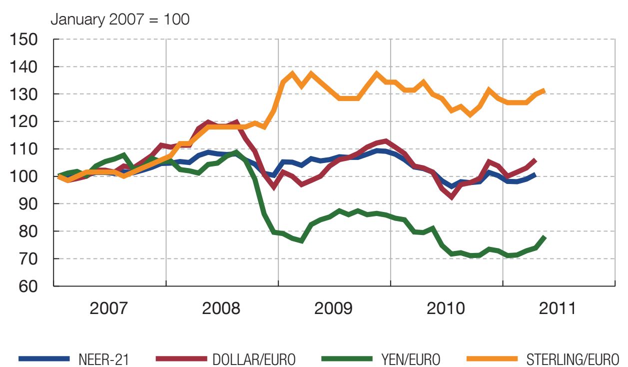
CORPORATE BOND SPREADS



TEN-YEAR GOVERNMENT BOND YIELD
Monthly average



EXCHANGE RATES FOR THE EURO



SOURCES: ECB and JP Morgan.

bilateral loans from euro area countries (€80 billion) and from the IMF, subject to strict conditionality. Further, to reduce the risk of contagion, a new financial assistance scheme was designed which, under similar conditions to those of the Greek programme, would be available until mid-2013 to any euro area member needing it. This scheme comprises: the new European Financial Stabilisation Mechanism (EFSM), a euro area

instrument able to mobilise up to €60 billion; the European Financial Stability Facility (EFSF), able to grant loans with a maximum guarantee of €440 billion from euro area Member States; and IMF financing equal to up to 50% of the amount drawn from the EFSM and the EFSF. The tensions during the summer were eased by establishment of these instruments, along with the commencement of work to improve European governance, the publication of bank stress tests and the expediting and strengthening of fiscal consolidation plans with a firm commitment to introduce structural reforms in some euro area Member States.

... but the worsening of the situation of the banking sector and of the Irish public finances, and the difficulties in agreeing on an internal economic adjustment programme in Portugal (in 2011) required activation of the new support mechanisms

However, the situation changed when in Ireland the deterioration in the financial position of its banks sparked a fresh outbreak of tensions. The excessive size of the Irish banking sector relative to the economy as a whole, the concentration of real estate risk and its dependence on wholesale financing made this sector extremely vulnerable to the international financial crisis (from 2008), to the intense domestic recession and to the adjustment in the Irish real estate sector. These circumstances forced activation of the financial support mechanisms at the end of November, with an assistance programme valued at €85 billion, which included funds to be contributed by the Irish government itself and bilateral loans from the United Kingdom, Sweden and Denmark.

Later, in April 2011, Portugal also requested financial support from the European institutions and the IMF. The institutional paralysis in this economy following the resignation of the government, when a fresh fiscal adjustment plan was rejected in parliament, made it the focus of the tensions. Its problems achieving fiscal consolidation objectives had previously been highlighted, against a background in which the competitive imbalances accumulated in recent years and the high indebtedness of firms and households hampered the attainment of a sustained rate of growth. The support programme approved in May amounted to €78 billion, to be distributed equally between the EFSF, the EFSM and the IMF, and, like the previous programmes, it is subject to strict conditionality, with relatively ambitious structural reform measures required.

In March 2011 substantial changes to the institutional framework of the euro area were adopted, but the area continued to confront the biggest challenge of its history

The recurrent bouts of instability during the first few months of 2011 were also fuelled by the lack of determination on the part of the governments to clarify certain details of present and future support mechanisms. In this context, in March the European Council sanctioned the legislative reforms in progress to strengthen the domestic economic policy coordination and mutual supervision mechanisms and adopted significant measures to further the design of the future European Stability Mechanism (ESM), which will begin to function in July 2013. Also, to strengthen the governments' resolve to establish policies more favourable to growth and more consistent with the financial integration environment achieved in the euro area, the heads of state and government of the euro area decided to establish the Euro Plus Pact. The new strengthened governance framework was thus practically given its final shape. In the medium term, this new framework will reduce the probability of a repetition of situations like the present one and, in the event they do occur, give the area the necessary tools to manage them effectively.

However, in the shorter term, sovereign risk spreads continue to fluctuate sharply, reflecting the complexities of the situation in Ireland, in Portugal and, fundamentally, in Greece. The difficulties that have become apparent in complying with the timetable envisaged in the programme for Greece are presenting the euro area with a challenge unprecedented in its short history; a significant effort will be required to rule out the possibility of unpredictable traumatic scenarios for the common European project.

EURO AREA: MAIN MACROECONOMIC INDICATORS

TABLE 4.1

	2008	2009	2010	2010			
				Q1	Q2	Q3	Q4
DEMAND AND OUTPUT (quarter-on-quarter rates):							
Gross domestic product	0.3	-4.1	1.7	0.4	1.0	0.4	0.3
Private consumption	0.4	-1.1	0.8	0.3	0.2	0.2	0.4
Government consumption	2.3	2.5	0.7	-0.1	0.2	0.4	0.1
Gross fixed capital formation	-1.0	-11.2	-1.0	-0.2	2.1	-0.2	-0.5
Non-residential private investment	0.3	-14.9	0.7	0.7	2.5	0.4	0.8
Residential investment	-5.3	-10.7	-3.6	-0.6	0.7	-0.3	-0.2
Public investment	1.6	5.1	-3.4	-3.8	-0.1	-0.4	-1.5
Exports	0.7	-13.1	10.9	3.0	4.5	2.1	1.5
Imports	0.6	-11.7	9.0	3.6	4.2	1.5	1.0
Contributions to GDP growth in percentage points:							
Domestic demand	0.5	-2.5	0.4	0.1	0.5	0.1	0.1
Change in stocks	-0.2	-0.9	0.5	0.4	0.3	0.0	-0.1
External demand	0.0	-0.7	0.8	-0.1	0.2	0.3	0.4
PRICES AND COSTS (year-on-year rates):							
Consumer prices (annual average)	3.3	0.3	1.6	1.1	1.6	1.7	2.0
GDP deflator	2.1	1.0	0.8	0.5	0.8	1.1	1.0
Unit labour costs	3.7	3.8	-0.4	-0.5	-0.5	-0.6	-0.2
Compensation per employee	3.2	1.4	1.7	1.6	2.1	1.5	1.6
Labour productivity	-0.4	-2.3	2.2	2.2	2.6	2.1	1.8
GENERAL GOVERNMENT (% of GDP):							
Total expenditure	46.9	50.8	50.8				
Current expenditure	43.1	46.6	46.6				
Public investment	2.6	2.8	2.7				
Total revenue	44.9	44.5	44.4				
Primary deficit (–) / surplus (+)	1.0	-3.5	-3.5				
Deficit (–) / surplus (+)	-2.0	-6.3	-6.3				
Public debt	69.8	79.2	84.2				
LABOUR MARKET:							
Total employment (quarter-on-quarter rates)	0.8	-1.8	-0.4	0.0	0.1	0.0	0.2
Unemployment (% of labour force)	7.7	9.5	10.1	10.0	10.1	10.1	10.0
BALANCE OF PAYMENTS (% of GDP)							
Current account	-1.4	-0.3	-0.4	-0.8	-0.8	-0.3	0.2
DEBT RATIOS:							
Households (% of GDI)	95.6	97.4	98.7	97.3	98.4	98.4	98.7
Non-financial corporations (% of GOS)	494.4	555.5	538.1	554.3	549.4	545.8	538.1

SOURCES: ECB, European Commission and OECD.

2 Macroeconomic developments: consolidation of the recovery

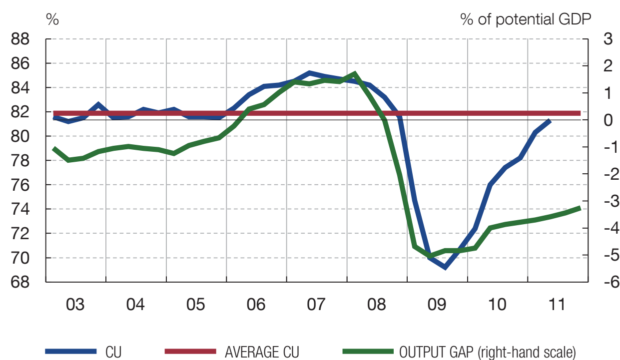
In 2010 the recovery in the euro area firmed, underpinned by foreign trade and the change in the inventory cycle

During 2010 the recovery in economic activity that commenced in mid-2009 continued, so that GDP grew by 1.7%, following a decline of 4.1% in 2009. As seen in Table 4.1, goods and services exports grew notably, following the collapse recorded in 2009, thanks to the boost from world trade, while the increase was somewhat more contained in the case of imports, in line with their smaller decline in the recession. Accordingly, the contribution of net external demand was very positive, and the largest to have been recorded since the start of Stage Three of EMU. The contribution of the change in inventories was also large in historical terms.

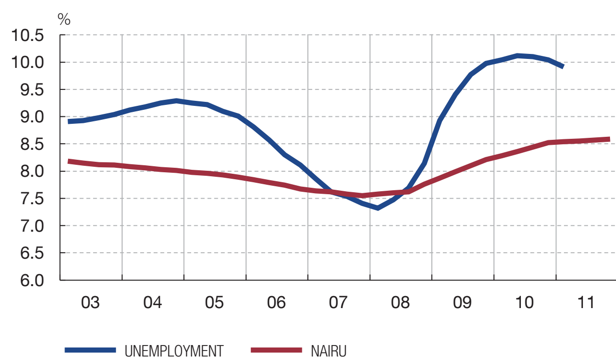
SLACKNESS OF ECONOMIC CONDITIONS

CHART 4.4

CAPACITY UTILISATION AND OUTPUT GAP



UNEMPLOYMENT RATE AND NAIRU



SOURCES: European Commission and OECD.

While growth in domestic demand was weaker

Domestic demand also recovered, although less strongly. Among its components, private consumption – notable on account of its relative importance – increased, despite the reduction in disposable income, driven by the growth in financial and non-financial wealth and by the improvement in expectations regarding the economic situation. Fiscal consolidation in the euro area countries resulted in a notable slowdown in government consumption and a sharp fall in public investment. Finally, there was a pick-up in business investment, spurred by the expansion in final demand, while residential investment fell for the third year running, since the adjustment in the real-estate sector in some euro area countries has still not been completed.

Employment stabilised

Euro area employment declined slightly in 2010 as a whole, but tended to stabilise over the year as hours worked recovered to their pre-crisis levels (see Charts 4.1 and 4.4, and Box 4.1). However, the rate of unemployment increased again, with joblessness concentrated among young people and the long-term unemployed, which involves a loss of human capital.

The divergence in the performance of activity across the euro area countries has been very marked

By country, significant differences in the performance of activity were recorded, with a vigorous increase in GDP in Germany and significant falls in Greece and Ireland, as a consequence of the general collapse in the components of their domestic demand, largely associated with the low levels of confidence and the application of the highly restrictive fiscal policies needed to restore fiscal sustainability and market confidence. Increased buoyancy in the German economy was based partly on the export growth, assisted by the robust growth in the world economy, but also by the business restructuring and structural reforms undertaken over the last decade, which have resulted in competitiveness improvements. In addition, German domestic demand displayed a comparatively strong recovery, owing to the buoyancy of equipment investment, which was driven by exports, and of government consumption, given the limited need for fiscal adjustment.

Inflation rose, impacted by the surge in commodity prices

Since the beginning of 2010, the developments in the harmonised index of consumer prices (HICP) have been determined by the strong rise in its energy and food components, linked to the progressive increase in commodity prices. This tendency intensified from the end of the year, as a consequence of the rise in the price of oil stemming from the bouts of political instability in certain oil producing countries, so that inflation reached 2.8% in April 2011, up from 1% in January 2010 (see Chart 4.1). The year-on-year rate of change in the prices of the most stable components of the HICP (services and non-energy industrial

During the recent economic and financial crisis, there has been less job destruction in the euro area as a whole, in relation to the fall in activity (see table below). However, this aggregate performance masks very diversified behaviour. In Austria, Belgium and Germany, despite the contraction in activity, the decline in employment has been very limited or even zero, in contrast – especially in Germany – with the crisis experienced at the beginning of the 1990s. At the opposite end of the spectrum, Spain and Ireland stand out not only because employment over-reacted to the fall in activity, with the numbers employed declining by more than 8%, but also because job destruction has lasted longer (see Panel 3).

The diversity of employment's reaction to the fall in activity seems to be in response to the combination of three factors:[1] the idiosyncratic nature of the recession in certain countries, aside from the global financial shock; the structure of national labour markets; and the different economic policy responses implemented by governments.

In Spain and Ireland the contraction in activity has been accompanied by a specific shock in the real estate sector. Thus, in Ireland, the decline in the construction sector seems to have directly explained half of the job destruction (see Panel 1), with a reduction of this sector's weight in the labour force of more than 4 pp during the crisis. In Spain 40% of the jobs destroyed were in construction,[2] a sector that represented 12% of total employment in the economy at the beginning of the crisis.

The labour market legislative framework in each country has also played an important role in limiting or amplifying the scale of the contraction in employment.[3] In line with economic literature, job destruction has been more contained in countries with greater stability in contracts (linked to higher firing costs) and with more flexible collective bargaining systems. This positive effect of the institutional framework on incentives to maintain employment has been particularly important in those countries with higher demand for skilled labour in which, therefore, the potential costs to firms of laying off employees are higher. This has been the case of Germany and Austria, where, although the proportion of skilled workers among new generations joining the labour market is constantly increasing as a result of the inversion of the population pyramid, these workers are not sufficient to replace those leaving the labour force (see Panel 2, where skill is approximated by educational attainment level).

Finally, all the governments in the euro area have implemented new economic policy measures or have strengthened existing ones with a two-fold objective. On one hand, this was to stimulate employment demand, either through specific employment policies (short-time work programmes, cuts in social security contributions) or through fiscal stimulus programmes (reduction of direct taxes, creation of public-sector employment, aid for specific sectors, such as the automobile sector). On the other, it was to mitigate the adverse effects of unemployment (training programmes, the strengthening of job seeking agencies, the increase in unemployment assistance benefit). However, the economic situation and structural framework of each country prompted certain governments to use certain measures more intensively. For instance, countries like Germany, Belgium and Italy have strengthened their short-time work programmes, which was reflected in the contraction in the number of hours worked per employee – by up to 4% in Germany and 2% in Italy and Belgium. In countries with more specific shocks, government efforts were focused on supplementing the income of the unemployed, updating their training and fostering new activities.

Ultimately, the varied response, in terms of employment, of the various euro area countries to the recent contraction in activity has underlined the importance of an institutionally flexible labour market within a monetary union. Moving towards wage bargaining models which permit flexible adjustments to changes in the economic situation of firms; hiring models which encourage the investment in human capital; and education systems which enhance future workers' adaptability and mobility have become a key element, not only for cushioning the negative effects of a recession but also for boosting the recovery of activity. Accordingly, those countries which weathered the recession best in terms of employment (Germany, Belgium and France) are those which began to record the first signs of job creation in 2010 (see Panel 3).

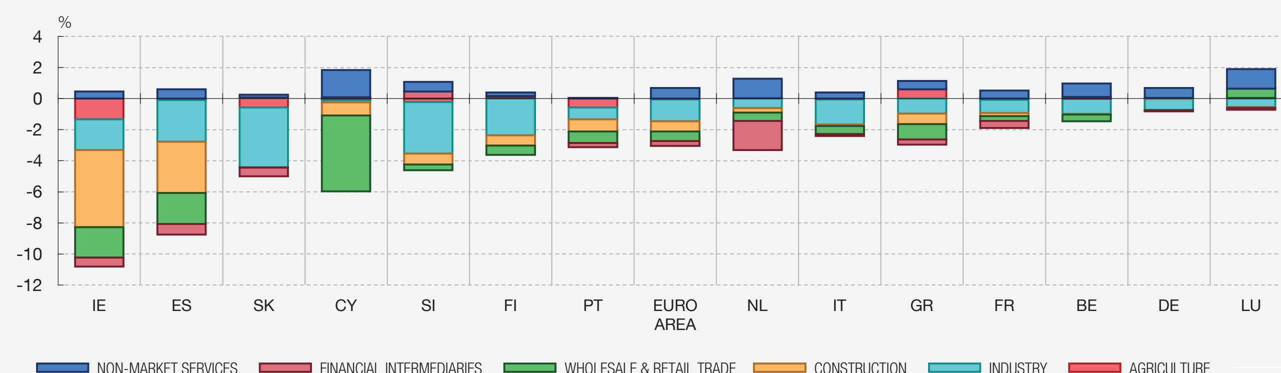
---

1 See *OECD Employment Outlook* 2010.
2 In the *Boletín Económico* December 2010 the contraction of housing investment is estimated to account for 60% of the jobs destroyed during the crisis in Spain, if the spill-over effects on other sectors of the economy are considered.
3 See Chapter 3 of *IMF World Economic Outlook* April 2010 and the ECB *Final Report of the Wage Dynamics Network* (December 2009).

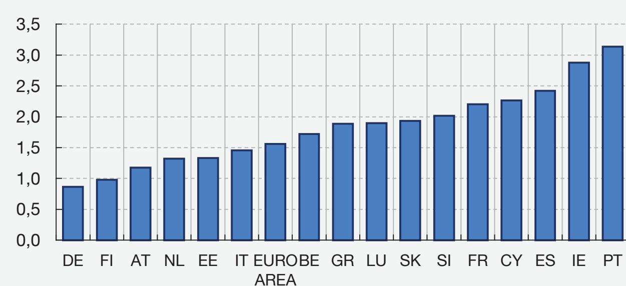
RATE OF CHANGE AND ELASTICITY OF EMPLOYMENT

	Rate of change in employment (%) (d)	Elasticity of employment to GDP (b)	
	Crisis 2008 Q3 - 2010 Q1	Crisis 1992 Q1 - 1993 Q2	Crisis 2008 Q1 - 2009 Q2
Ireland	-10.3	0.5	1.0
Spain	-8.1	1.8	1.7
Finland	-3.2	2.8	0.3
Portugal	-3.1	0.8	0.6
Euro area	-2.4	1.0	0.3
Netherlands	-2.0	1.1	0.1
Italy	-2.0	1.0	0.2
Greece (a)	-1.8	n.a.	0.2
France	-1.4	0.5	0.1
Austria (a)	-1.0	n.a.	0.3
Belgium	-0.5	0.5	-0.1
Germany	-0.1	1.0	0.0

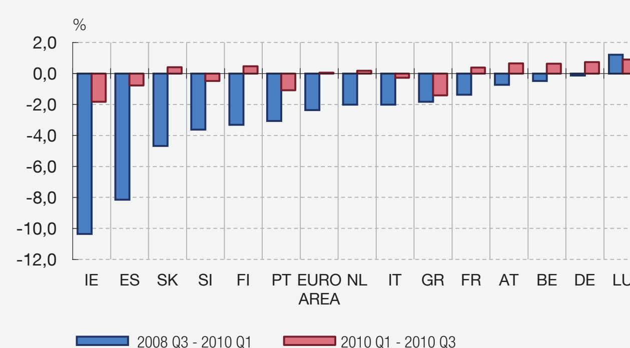
1 SECTORAL CONTRIBUTION TO JOB DESTRUCTION. 2008 Q3 - 2010 Q1 (c)



2 LABOUR FORCE WITH UNIVERSITY STUDIES IN 2010. RATIO BETWEEN THE SIZE OF AGED 25-34 COHORT AND THAT OF THE AGED 50-59 COHORT (c)



3 JOB DESTRUCTION AND CREATION IN THE EURO AREA BY COUNTRY (d)



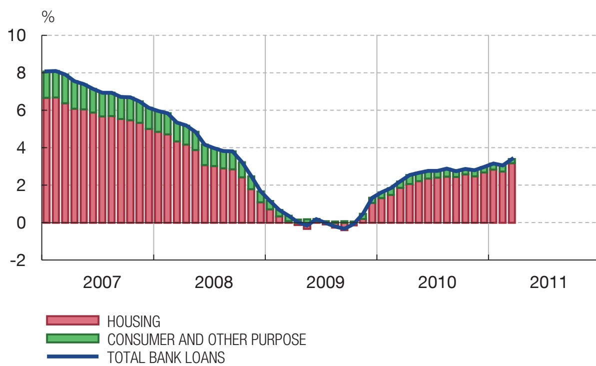
SOURCES: Eurostat and OECD.

a The data for Austria and Greece are from Eurostat and are only available to 2009 Q4.
b The contractionary stages are defined as the period between the last quarter of positive quarter-on-quarter growth of activity in the euro area as a whole and the last quarter of quarter-on-quarter decline.
c A ratio value of less than 1 means that the labour force with university studies aged between 50 and 59 is more numerous than the corresponding group aged between 25 and 34. This is the case of Germany and Finland. At the other extreme would be Portugal where the labour force with university studies aged between 25 and 34 is three times higher than the corresponding group aged between 50 and 59.
d The change in employment was calculated from the last quarter of positive quarter-on-quarter growth in employment in the euro area as a whole and the last quarter of quarter-on-quarter decline.

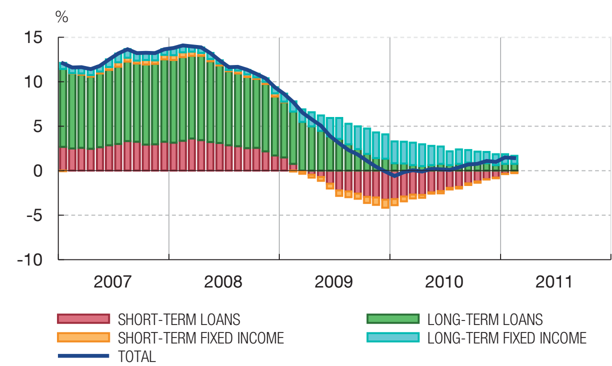
PRIVATE SECTOR FINANCING

CHART 4.5

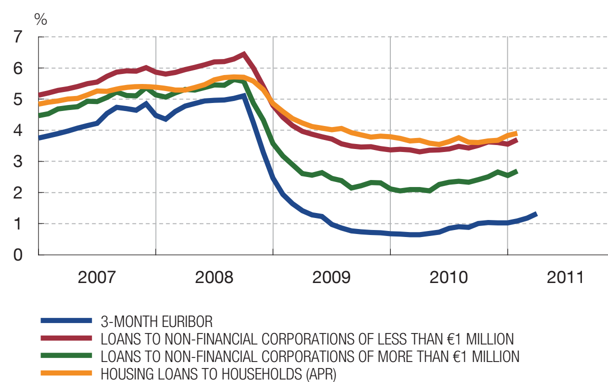
FINANCING OF HOUSEHOLDS



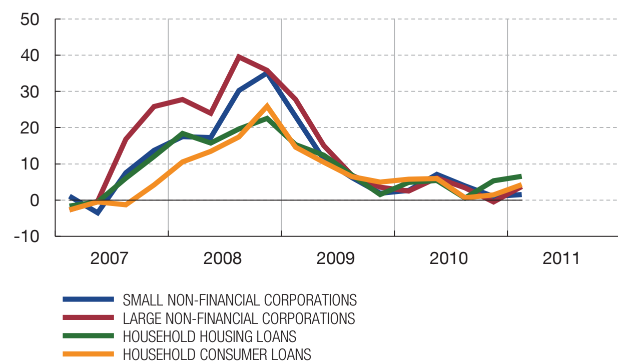
FINANCING OF NON-FINANCIAL CORPORATIONS
Contributions to year-on-year growth



BANK INTEREST RATES



BANK LENDING SURVEY
Tightening of supply conditions (a)



SOURCE: ECB.

a Indicator = % of institutions that have considerably tightened standards x 1 + % of insitutitons that have tightened standards to some extent x 1/2 - % of institutions that have eased standards to some extent x 1/2 - % of institutions that have considerably eased conditions x 1.

goods) held at low levels, owing to the persistence of a high degree of economic slack in the area and wage moderation, which have offset the increases in indirect taxes and the recovery in profit margins that followed their sharp fall during the recession.

The growth in loans to the private sector was contained

Against this background, and with some differences across countries, loans to households and non-financial corporations displayed a mild tendency to recover, which has continued in 2011, while the credit standards for the approval of loans maintained the restrictiveness built up in the past (see Chart 4.5). This increase in financing, along with the weakness of income in these sectors, caused the household debt ratio to rise slightly, while that of firms was corrected downward somewhat (see Table 4.1).

3 The role of demand-side policies: reaction and limitations

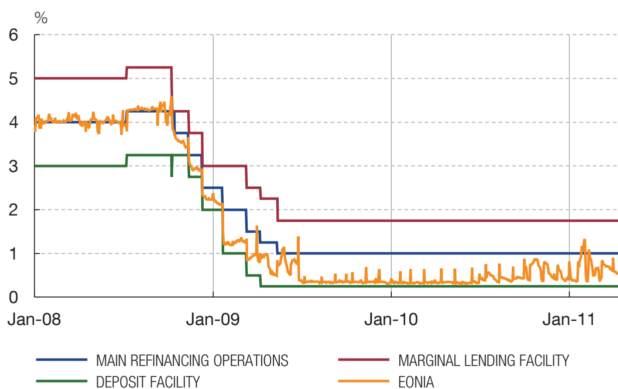
The expansionary capacity of demand-side policies was becoming exhausted. Monetary policy maintained its expansionary stance and a broad range of non-standard measures

During 2010, it became clear that the policies to expand demand deployed with full force to combat the financial crisis in the previous period had reached their limits. Monetary policy remained expansionary, against a background of an absence of medium-term inflationary pressures and slow growth. The ECB's Governing Council kept its key policy rate at 1% until its meeting of 7 April, when it decided to raise it by 25 bp (see Chart 4.6). At the same time, the situation in the markets led the Eurosystem to extend the duration of its full allotment liquidity tenders. The extraordinary six and twelve-month loans that were introduced when tensions on the financial markets were at their highest matured, without the generation of frictions, reducing gross liquidity. Also, the covered bond purchase programme

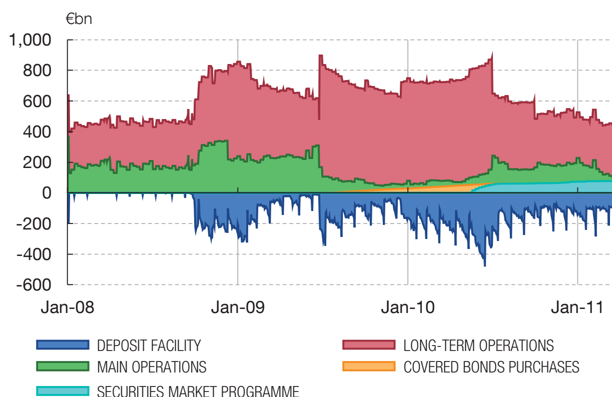
EURO AREA MONETARY POLICY

CHART 4.6

OFFICIAL INTEREST RATES AND EONIA



LIQUIDITY SUPPLIED BY THE EUROSYSTEM AND THE SECURITIES MARKETS PROGRAMMES



SOURCE: ECB.

came to an end in June following the staggered purchase of €60 billion. This measure had been established in 2009 to mitigate the distortions generated by the crisis in this market segment and so avoid repercussions for the flow of bank credit and the interest rates charged for such credit. Similarly, the heightened tensions in certain public debt markets and their negative impact on the transmission mechanism led to the establishment of the Securities Markets Programme in May 2010, which concentrated on the sterilised purchase of government bonds in the secondary markets of the countries most affected. During the first few months of this programme the purchases amounted to €60 billion. Subsequently, more purchases were made for smaller amounts, and the total portfolio acquired had risen to somewhat more than €76 billion by the end of April.

Fiscal policy contributed to the recovery, but began to change direction towards fiscal consolidation...

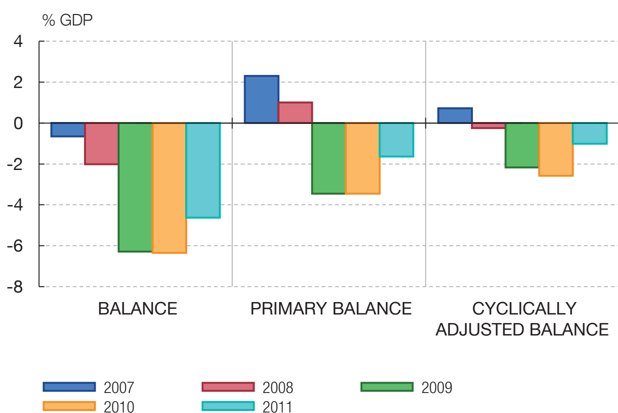
In 2010 in the euro area as a whole, fiscal policy continued to make a decisive contribution to the recovery in economic activity, through the operation of automatic stabilisers and support to the banking system. However, after the first few months of the year the discretionary measures to stimulate demand and support the labour market that had been deployed during 2009 were progressively phased out and the excessive deficit situation in most of the euro area countries forced them to draw up medium-term fiscal consolidation plans, against a background in which the economic recovery began to firm. This change of direction in fiscal policy meant that the euro area deficit remained practically unchanged from the previous year, at 6% of GDP, although this represents a deterioration of almost 6 percentage points (pp) from 2007. The cyclically adjusted deficit barely rose, as compared with an increase of 1.8 pp in 2009 (see Chart 4.7). The debt ratio for the euro area as a whole reached 85.4% of GDP, historically a very high level.

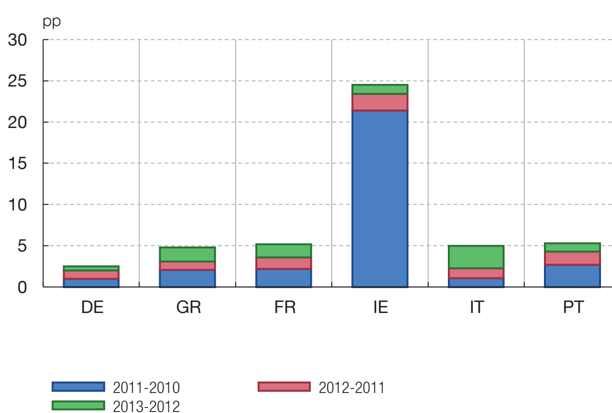
... a change that was speeded up by the sovereign debt crisis, which forced some economies to bring forward their fiscal consolidation plans

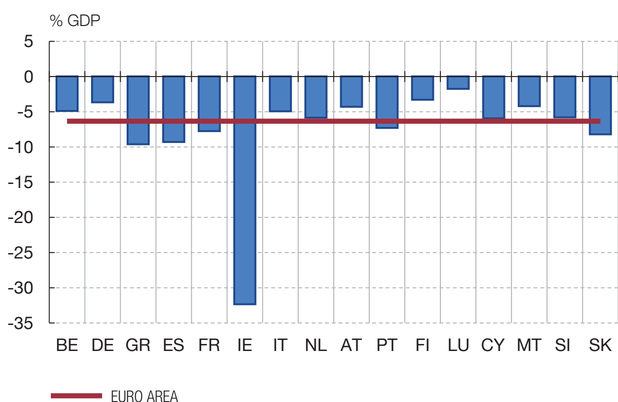
The tensions in the sovereign debt markets in April and May focused attention on the risks inherent in a situation of widespread excessive deficits and forced decisive and relatively rapid corrective measures to be taken to allay investors' doubts regarding the sustainability of public finances. The sovereign debt crisis thus led not only to the need to abandon the expansionary stance with which fiscal policy had responded in Europe to the first effects of the international financial crisis, but also to some urgency to turn it around so as to reduce long-term interest rates (by reducing the risk premium), giving space to private spending to recover momentum and contribute to a revival in activity. The first economy to step up its efforts was Greece, in return for the concession of financial assistance. Following the extraordinary meeting of the Ecofin Council at the beginning of May, Spain introduced

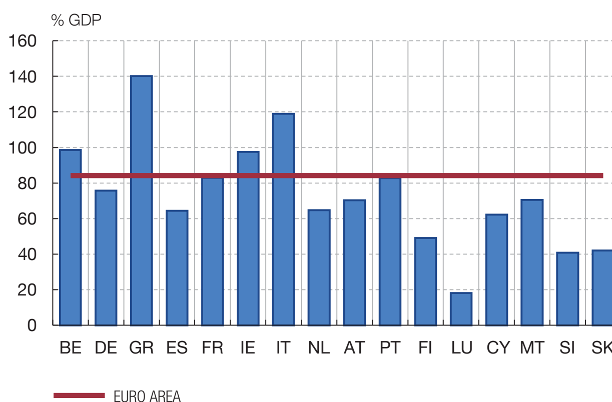
EURO AREA: FISCAL POLICY

CHART 4.7









SOURCE: European Commission, Stability and Convergence Programmes.

a EC forecast for 2011.
b Stability programmes prepared in 2010.

consolidation measures to supplement those envisaged in its stability programmes and brought forward some of those planned for 2011. In the final quarter of the year it was Ireland that, after recognising a deficit of close to 30% of GDP in 2010, largely linked to the cost of the bank rescue operations, had to draw up a fiscal consolidation plan. Portugal also adopted packages of additional measures on various occasions. The other economies designed austerity programs which have generally begun to be applied this year. Under the consolidation plans established, the euro area general government deficit is expected to decline to almost 4% of GDP in 2011, and to below 3% in 2030.

4 European governance review and other economic policy initiatives

The crisis has highlighted structural weaknesses in the institutional architecture of the euro area

The turmoil in the sovereign debt market has highlighted structural weaknesses in the institutional architecture of the monetary union, which were not given sufficient attention during the years of expansion but which now pose an unprecedented challenge to the area's stability. Since the start of Stage Three of EMU, the agreed arrangements for economic governance have been based on the principle of subsidiarity, whereby each state has maintained sovereignty over all economic policy decisions other than those of monetary policy, although they have been subject to coordination mechanisms of varying degrees of strictness, designed to reduce the negative externalities that measures introduced in one economy may have on the other countries in the area. In the case of fiscal

policy, the Stability and Growth Pact was established to maintain budget discipline, while macroeconomic and structural policies were subject to laxer peer review-based coordination mechanisms. This framework has proved insufficient to achieve the degree of economic policy consistency necessary in a monetary union. On one hand, the SGP was not capable of promoting sustained fiscal consolidation during the expansionary phase, to give countries sufficient leeway to confront the downturn. The degree of discretion existing in the application of this procedure allowed many EU countries to fail to comply with the established deficit and debt thresholds repeatedly, without any effective mechanism being put in place to resolve the situation (sanctions or some other type of incentive). In many economies high levels of private indebtedness, substantial competitiveness losses and weaknesses in banking systems built up, which were not given due attention. Nor were there instruments available to channel financial support rapidly and transparently to those countries that might need it as part of an orderly crisis management process. As a backdrop to all this, an unprecedented degree of trade and financial integration significantly increased the speed and force with which difficulties are transmitted from one economy to another.

A three-pronged governance reform process is under way

The European institutions and governments decided to undertake a far-reaching review of this governance regime to correct the problems detected and to avoid similar situations occurring in future. The "Special Van Rompuy Group" was set up for this purpose in spring 2010, with the mandate of studying how to make the architecture of the euro area more solid. The EU, ECB and all the EU Member States participated in this working group. The review of the institutional framework undertaken as a result of the group's conclusions focuses on three fundamental areas: strengthening the SGP to increase fiscal discipline, improved supervision of macroeconomic imbalances and the creation of a permanent crisis-management mechanism. Although there are still aspects that may be changed during the process of approval by the European Parliament, which should be concluded in June 2011, the fundamental elements are already well defined.

The strengthening of fiscal discipline through reform of the SGP

In the fiscal sphere, the reform assigns greater importance to the public debt criterion, as originally envisaged by the SGP. First, a more rapid adjustment path towards medium-term objectives is proposed for countries with a level of debt of over 60% of GDP and, second, when this threshold is exceeded an excessive deficit procedure (EDP) will be opened or, if one has already been opened, will not be closed, even if the deficit is below 3% of GDP, as long as the debt-to-GDP ratio is not being reduced satisfactorily. Moreover, the incentives for governments to achieve a greater degree of compliance are strengthened, with the introduction of a broader, more transparent system of sanctions, to be activated at an earlier stage. It is also intended to make the application of these sanctions more automatic through the reverse voting procedure, which involves automatic approval of the Commission's proposals, unless they are rejected in time by a qualified majority of the governments. In addition, reform of the national fiscal frameworks is proposed, including the need for the accounts, statistics and forecasting practices to be adapted to EU rules, the adoption of multi-year fiscal planning to guarantee the medium-term objectives agreed, the establishment of rules limiting the expansion of public spending and indebtedness, and the creation of independent fiscal councils to supervise the design and execution of budgetary policy.

A new procedure for the surveillance and correction of macroeconomic imbalances is introduced

The reform introduces a new framework for the prevention and correction of excessive macroeconomic imbalances, including an early warning mechanism to prevent such imbalances from jeopardising financial stability in the euro area. On its preventive side, this new mechanism will seek to identify the countries with a potential risk of "excessive imbal-

ance", using a set of economic indicators complemented by expert analysis. The excessive imbalance procedure will be initiated once it is considered that said imbalance reaches an excessive scale. It will recommend the adoption of a series of corrective measures over a specific period for the country in question, and it might conclude with sanctions if the recommendations are repeatedly not fulfilled.

And a permanent crisis-management and resolution mechanism is created, the European Stability Mechanism

The strengthening of the fiscal and macroeconomic surveillance instruments will minimise the possibility of vulnerabilities arising in the future that may jeopardise euro area stability. However, it is not reasonable to believe that this or any other framework might be capable of obviating that probability. The third pillar of the reform, therefore, resides on the setting up of a permanent crisis-management mechanism, the European Stability Mechanism (ESM), which will come into force in mid-2013, replacing the EFSF. To do this, article 136 of the EU Treaty has had to be amended, leaving the no bail-out clause in article 125 intact. This mechanism has an effective lending capacity of €500 billion, and it is intended to provide funds to solvent economies facing liquidity problems, under strict conditionality and at non-concessional interest rates. The financial assistance will normally take the form of loans and, in exceptional cases, of debt purchases on the primary market, without therefore attaining the operational flexibility that the Eurosystem had proposed. In exceptional cases of insolvency, the mechanism will provide for an orderly restructuring of debt, which will be tackled on a case-by-case basis through negotiation with private creditors.

January 2011 saw the start of the European Semester, for the coordination of different economic policies

To provide for better coordination of the various economic policy decisions under this new framework, it was agreed to set up the European Semester. This will take place during the first six months of each year and will conclude with the formulation of specific fiscal, macroeconomic and structural recommendations for each country. In January this year, the EC presented its *Annual Report on Growth*, which contains a roadmap for the euro area-wide economic policy that the different governments should take into consideration when setting out their respective Stability Programmes and their National Reform Plans. Also integrated into this new instrument is the revision of the preliminary structural reforms under the Europe 2020 strategy, approved in spring 2010 and whose main objectives are the increase in employment rates and social cohesion, the promotion of innovation (where hardly any improvements have been observed since the Lisbon strategy was set in place), the use of renewable energies and energy efficiency, the reduction in the early school leavers rate and an increase in the proportion of the population completing higher studies. The aim is to re-launch growth-boosting policies that lessen the impact the crisis may have exerted on potential GDP and that prevent the re-emergence of imbalances.

Priority is given to the reform of pensions systems and improvements to fiscal institutions...

Significant among the recommendations in the aforementioned report is, in the fiscal area, the advisability of pursuing the ongoing reform of pensions systems which many euro area economies have tackled in recent years, adapting benefits to the changes in life expectancy and in the population pyramid, while encouraging people to work to a later age. Emphasis is also placed on the need for national fiscal frameworks and institutions to include rules restricting public spending and debt levels, in line with SGP commitments.

... and to the revision of collective bargaining arrangements in some countries, the full transposition of the Services Directive and improvements in active employment policies

For progress in correcting macroeconomic imbalances, the economies that have built up losses on competitiveness should revise their collective bargaining arrangements so as to attain greater consistency between wage increases and changes in productivity. The countries with persistent current-account surpluses should analyse the causes that check the buoyancy of their demand. It is also considered important to boost the potential of the single market by means of the full transposition of the Services Directive in all the Member

States, the liberalisation of professional services and the development of instruments to attract private capital to finance growth, such as private equity funds. And, finally, it is recommended that social security contributions be reduced, setting this off by bolstering other taxes, that employment contracts be made more flexible and that disincentives to a second member of a family unit joining the labour market, which are present in some income tax systems, be eliminated.

The heads of state and government signed the Euro Plus Pact

While all the foregoing measures involve a substantial improvement to the European governance framework, the final results will obviously continue to depend largely on governments' readiness to meet the commitments undertaken. To reinforce this commitment, the euro area heads of state and government signed the Euro Plus Pact in March 2011 with the aim of fostering competitiveness and employment, contributing to the sustainability of public finances and reinforcing financial stability. The priorities and measures considered in the Pact largely coincide with those in the EC's *Annual Growth Report* under the aforementioned procedures and instruments for the oversight of compliance therewith. But the Pact raises governments' commitment to the maximum political level.

The European Systemic Risk Board will be responsible for macroprudential supervision in the EU

Finally, in the financial field, the crisis has also highlighted the shortcomings of a regulatory framework based exclusively on the prudential supervision of individual institutions, one that is insufficient to appreciate in full the complex interrelatedness of financial assets and intermediaries that ultimately give rise to systemic risks. These considerations have led to the definition of a new, specific economic policy area, namely macroprudential policy. This area has an eminently pre-emptive gearing and has the dual aim of making the financial system as a whole more resilient to shocks and minimising the impact on the real economy in instances of crisis. The pursuit of macroprudential policy is being addressed through numerous national and international initiatives. In the European Union, this task has been assumed by the European Systemic Risk Board (ESRB), which has been fully operational since January 2011. This body is part of the European Financial Supervision System, which incorporates three new European supervisory authorities entrusted with microprudential duties. The ESRB, in which the ECB and the ESCB central banks participate, will oversee the European financial system as a whole. It will be tasked with identifying systemic vulnerabilities and with issuing non-binding warnings and recommendations, so that corrective measures may be adopted.

5 Outlook and challenges

The speed of exit from the crisis will depend on the measures adopted

The projections available generally suggest that the pick-up in activity will continue to firm this year and next, albeit at a slower pace and in an environment still shrouded in uncertainty, which poses highly complex risks on both the domestic and European fronts.

The economies that built up the biggest imbalances will have to correct them in an environment of weak growth

In the domestic policy sphere, several economies have to readjust spending in a way that will enable their public and private debt levels to become more sustainable. And, at the same time, they must restore lost competitiveness through productivity gains and wage containment. Strict compliance with fiscal consolidation commitments, which is a prerequisite for the area as a whole, poses a challenge which is all the greater the lesser the growth prospects for each country. In this connection, it is also essential to see through far-reaching structural reforms which, in addition to bringing adjustments about, increase growth potential, prevent the crisis from exerting a durable impact on labour markets and enhance the capacity to export to markets where the competitive pressures from the emerging economies are increasingly more demanding.

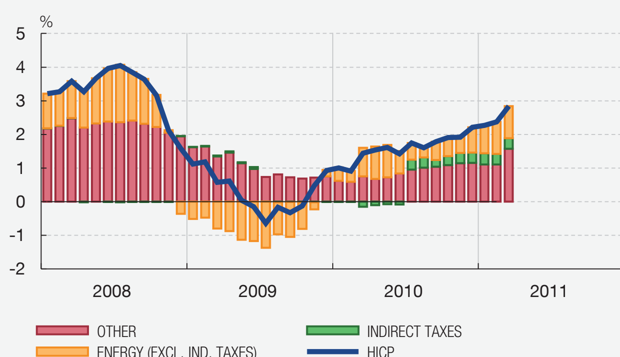
In recent months euro area inflation has risen notably due largely to dearer commodity prices in international markets and to the increase in certain indirect taxes as a result of fiscal consolidation efforts. In particular, according to an accounting breakdown of the year-on-year growth of the HICP, it is estimated that the direct impact of these components' behaviour would explain around 60% of the increase in the inflation rate between February 2010 and February 2011 (see Panel 1). On the basis of historical evidence, these factors could generate indirectly upward pressures on prices. For instance, certain estimates indicate that a permanent increase of 10% in oil prices would represent, after three years, an average increase in the euro area HICP of 0.5 pp. 0.1 pp would be due to price rises in goods which use any of the dearer inputs and another 0.1 pp would be as a result of the second-round effects arising when the revision of inflation expectations prompts agents to demand increases in wages and margins.[1] However, according to economic theory, inflation depends positively on future inflation expectations but also negatively on the level of economic slack and, consequently, these indirect effects could have a more limited impact in a situation such as the present one.

The most recent empirical studies which approximate the level of slack using the output gap or the distance between recorded and potential growth have shown that, in practice, it is difficult to find a stable relationship between these three variables. This can be attributed basically to three factors. Firstly, potential growth is measured with a high level of imprecision. Accordingly, Panel 2 shows that, at a time of great uncertainty such as at present, the discrepancies between international organisations' forecasts about the level of economic slack in the euro area for the period 2010-2012 may be high. In any event, all the estimates agree that the level of euro area activity is clearly below its potential and will remain so for the next two years. This is confirmed by the behaviour of the indicator of production capacity utilisation and of several measures of slack in the labour market.

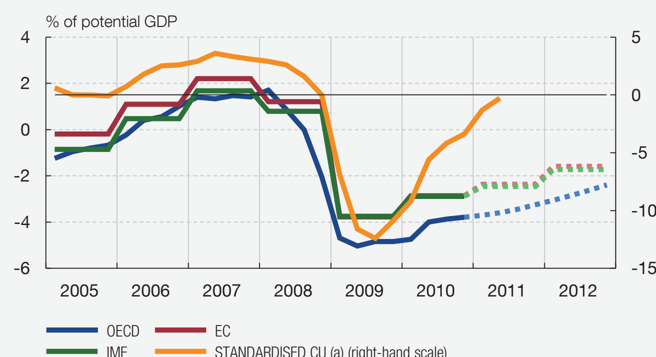
Secondly, it is difficult to estimate which part of the temporary price variations ultimately feed through to households' and firms' inflation expectations. Accordingly, Panel 3 shows that, although

1 See Strauch et al. (2010), *Energy Markets and the Euro Area Macroeconomy,* Occasional Paper no. 113, European Central Bank.

1 CONTRIBUTION OF ENERGY AND INDIRECT TAXES TO THE YEAR-ON-YEAR RATE OF CHANGE IN HICP



2 ESTIMATES OF THE OUTPUT GAP



3 HICP: SHORT AND LONG-TERM FORECASTS (b)

	2011	2012	Long term
Consensus (July 2010)	1.5	1.5	1.9
Consensus (October 2010)	1.6	1.5	2.1
Consensus (March 2011)	2.3	1.8	2.1
Eurobarometer (July 2010)	1.5	1.6	1.9
Eurobarometer (October 2010)	1.4	1.7	1.9
Eurobarometer (March 2011)	2.2	1.8	2.0

4 RATE OF CHANGE IN THE PRIVATE CONSUMPTION DEFLATOR

			2010			
	2009	2010	Q1	Q2	Q3	Q4
Rest of the world (c)	-0.5	-0.1	-0.6	0.1	0.1	0.0
Oil prices	-0.2	0.4	1.0	0.3	0.2	0.3
Financial factors	0.3	0.2	0.3	0.3	0.0	0.1
Wages and prices	0.1	0.1	0.2	0.1	0.1	0.0
Private demand	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Government demand	0.2	-0.1	0.0	-0.1	-0.1	-0.1
Productivity	-0.1	0.1	0.1	0.0	0.1	0.0
Private consumption deflator	-0.4	0.5	0.9	0.7	0.3	0.2

SOURCES: EUROSTAT and Banco de España.

a Production capacity utilisation.
b The *Consensus* of July 2010 did not include forecasts for the long term or for 2012 and, consequently, the forecasts published in April 2010 were used. The *Consensus* of March 2011 did not include long-term forecasts and, consequently, those published in October 2010 were used. The Eurobarometer of March 2011 did not include long-term forecasts and, consequently, those published in January 2011 were used.
c The rest of the world includes global demand, world prices and the world interest rate.

inflation forecasts for 2011 have been revised upwards due to the recent rises in oil prices, both the forecasts for 2012 and the long-term inflation expectations remain stable at approximately 2%.

Finally, it should be noted that the degree of correlation between inflation and the output gap depends on the nature of the shocks affecting the economy. In particular, shocks which raise production costs, as is the case of oil prices, tend to reduce current and potential output to a similar extent and, consequently, the increase in prices is not accompanied by significant variations in the output gap.

In this connection, according to the Banco de España's BEMOD model,[2] which distinguishes between different types of shocks, the rise in oil prices explains a very significant part of the increase in European inflation (approximated in this case by the private consumption deflator) during the second half of 2010 (see Panel 4). Similarly, in the first three quarters of the year wages have grown slightly higher than would be suggested by their determinants, compared with the moderation seen in the first decade of this century. By contrast, the fiscal consolidation plans and timid recovery of private demand are helping to contain price rises, which suggests that the output gap remains negative. Finally, accommodative monetary policy contributed to the recovery during 2010 and to containing deflationary pressures. Thus, supply shocks seem to explain a relevant portion of the increase in inflation in a situation of relative production slack.

Consequently, the final effects on inflation of the current rise in prices, which is closely linked to the increase in oil prices, will depend crucially on the capacity of economic policy to keep inflation expectations anchored.

2 See J. Andrés, P. Burriel and Á. Estrada (2006), *Bemod: a DSGE model for the Spanish economy and the rest of the euro area,* Working Paper no. 0631, Banco de España, and J. Andrés, S. Hurtado, E. Ortega and C. Thomas (2010), "Spain in the euro: a General Equilibrium Analysis", *SERIEs Journal of the Spanish Economic Association,* Vol. 1, pp. 1 and 2.

Diligently addressing the restructuring of the banking sector will allow financial stability to be preserved

The possibilities of growth spreading throughout the euro area also depend on the ongoing European banking system restructuring, downsizing and recapitalisation processes being satisfactorily concluded. Preserving financial stability will help break the vicious circles in which risks to economic growth, fiscal imbalances and bank funding difficulties all combine, impairing agents' confidence and translating into unwished-for tightening of financing conditions.

Monetary policy faces a complex scenario of slow economic recovery and latent tensions in debt markets

In the European arena, monetary policy also faces a complex horizon in which it will have to progressively adapt its current accommodative stance to the present cyclical upturn in the area as a whole, ensuring inflation expectations are anchored so as to prevent the recent tensions stemming from dearer commodities and food from causing second-round effects on wages (see Box 4.2). Further, the ongoing withdrawal of the unconventional measures that were introduced at the most critical junctures of the financial crisis must be finalised, as retaining them longer than necessary might impair their effectiveness and detract from the central bank's credibility, give rise to distortions in relative asset prices and delay reforms in the banking sector. Such a task, however, will call for careful timing of decisions, so as to prevent tensions arising on markets where the situation is still one of relative fragility.

Reform of the institutional framework should be ambitious and should not disregard the challenges arising from the singular situation besetting Greece

The level of financial integration and economic interdependence attained in the euro area means a high degree of ambition must be maintained in the process of revision of European governance. Along these lines, the Eurosystem has called for the inclusion of more demanding criteria for the correction of imbalances and - especially in the fiscal area – greater automaticity for supervision and sanctioning procedures so as to make them less vulnerable to the willingness of national governments to comply with the commitments they have undertaken. It is also essential that the various mechanisms established by euro area governments to preserve financial stability across the area should have sufficient resources and the appropriate instruments to effectively perform their functions. Finally, it

would also be advisable to reflect on how to deploy the other instruments available to the EU (including the budget) to support the adjustment and reform processes in countries facing difficulties.

More immediately, Greece's apparent difficulties in returning to the market in 2012, as initially envisaged in their financial support programme, have raised uncertainty among investors and given rise to untimely debates about how realistic traumatic scenarios of slippage in the degree of economic integration attained in Europe and, therefore, of backtracking in the common European project may be. So that the considerable efforts to shape a new and more effective governance framework may come to fruition, this challenge - perhaps the most difficult one faced by the euro area since its creation - must first be conclusively overcome.