

4 THE EURO AREA AND THE COMMON MONETARY POLICY

1 Introduction

In 2009 euro area GDP posted an unprecedented fall of 4.1%. Nonetheless, in the second half of the year a faltering recovery began which, on available projections, should firm up throughout 2010, albeit with relatively moderate increases in activity. Inflation also showed a very pronounced change in trajectory, falling in the first half of the year and subsequently rising, which was largely linked to developments in energy goods prices. The increase in the harmonised index of consumer prices (HICP) averaged 0.3%, its lowest rate since the start of EMU (see Table 4.1). Existing projections point to inflation stabilising at low and slightly higher than current levels against a backdrop of a modest pick-up in activity, under-utilisation of productive capacity and subdued wage growth derived from the sluggish labour market.

In any event, these central scenarios envisaged for GDP and inflation are subject to a high degree of uncertainty, partly linked to factors external to the euro area, such as changes in global activity and commodities prices on international markets, but especially to internal factors related to weak demand, labour market developments and the need for financial institutions to continue to strengthen their balance sheets. Similarly, the fiscal crisis in Greece gave rise to bouts of extreme instability in 2010 H1 posing most considerable challenges and triggering unprecedented institutional reactions in the euro area as a whole. The role of economic policies will be key in determining the pace and speed of the recovery. It is essential to undertake structural reforms and ambitious, lasting fiscal consolidation to ensure the sustainability of public finances and to safeguard financial stability in the euro area, and also to strengthen the institutional framework of economic governance. These are the main issues which will be described in the following sections.

2 The intensity of the crisis and the economic policy measures implemented

The worsening of the financial situation and expectations resulted in a sharp contraction in activity...

The recession dating from spring 2008 worsened in the half-year from October 2008 to March 2009, turning into a slump in activity - of more than 4% - unprecedented in the history of the euro area (see Chart 4.1). This contraction was not unrelated to the protracted and deep global financial crisis, the resurgence of which from mid-2008 resulted in notably higher risk premia, sharp falls in financial asset prices - with the consequent impact on bank balance sheets and on household wealth - and tighter bank lending standards. As a result of the global and synchronised nature of the crisis, external demand contracted sharply, as evidenced by the strong fall in exports. The recession in the euro area, in conjunction with the additional deterioration in financial conditions, prompted a marked worsening of agents' expectations as to the behaviour of activity and employment. This spurred household saving to the detriment of household consumption and discouraged spending on house purchases, thus quickening the downward adjustment which had begun previously in residential investment in some euro area countries. For their part, firms sharply restricted productive investment - which fell by nearly 12% between October 2008 and March 2009 - and began to run down inventories, following a possibly undesired accumulation associated with the decrease in sales.

... the size of which varied across euro area countries

GDP fell in all euro area countries, albeit to varying extents largely reflecting the differing weight and degree of deterioration of residential investment and exports (see Chart 4.1). Thus, in countries such as Spain and Ireland, which had seen a bigger real estate boom, the downturn in residential investment was sharper and resulted in greater job losses, which in turn seem to have contributed to a sharper contraction in private consumption (although the impact on GDP was cushioned by the fall-off in imports). In others, such as Germany and Finland, the heaviest strains came from the external sector (given their specialisation in the production of capital equipment, hard hit by the worldwide fall in investment), so the main downward pressure on

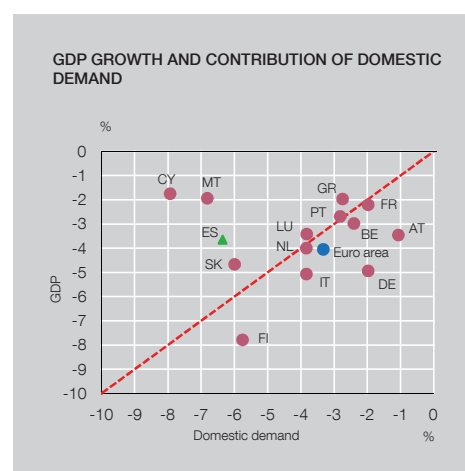
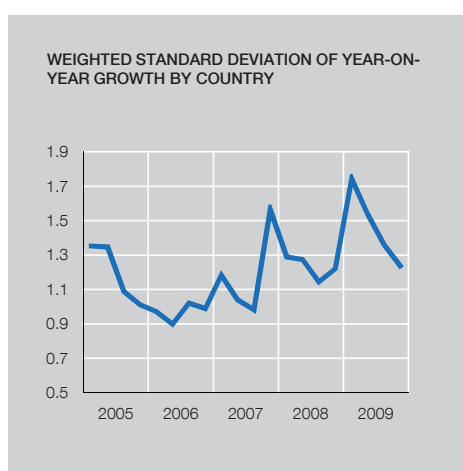
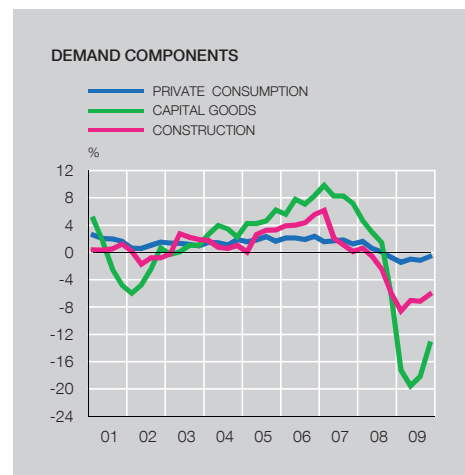
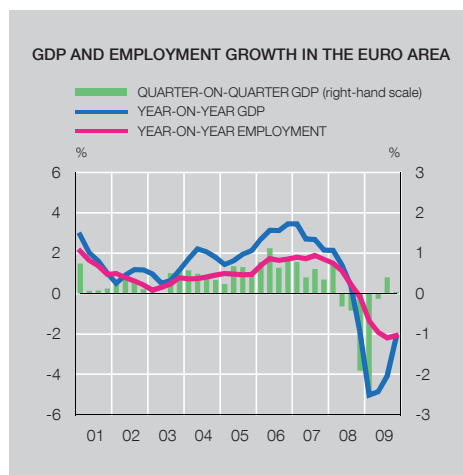
	2007	2008	2009	2009			
				Q1	Q2	Q3	Q4
DEMAND AND OUTPUT (quarter-on-quarter rates)							
Gross domestic product	2.7	0.5	-4.0	-2.5	-0.1	0.4	0.0
<i>Private consumption</i>	1.6	0.4	-1.0	-0.5	0.1	-0.1	0.0
<i>Government consumption</i>	2.3	2.1	2.3	0.6	0.6	0.7	-0.1
<i>Gross fixed capital formation</i>	4.7	-0.9	-10.8	-5.2	-1.6	-0.9	-1.3
— Non-residential private investment	6.2	0.6	-13.2	-7.7	-2.0	-1.1	-0.3
— Residential investment	0.9	-4.6	-10.3	-2.8	-2.5	-2.2	-1.3
— Public investment	4.8	0.9	2.4	0.5	1.2	0.8	1.0
<i>Exports</i>	6.3	0.8	-12.8	-8.0	-1.1	2.9	1.9
<i>Imports</i>	5.5	0.9	-11.4	-7.6	-2.8	2.9	1.3
Contributions to GDP growth in percentage points							
<i>Domestic demand</i>	2.4	0.4	-2.5	-1.2	-0.1	-0.1	-0.3
<i>Change in stocks</i>	0.0	0.1	-0.9	-1.0	-0.7	0.5	0.1
<i>External demand</i>	0.4	0.0	-0.7	-0.2	0.6	-0.1	0.2
PRICES AND COSTS (year-on-year rates)							
Consumer prices (annual average)	2.1	3.3	0.3	1.0	0.2	-0.4	0.4
GDP deflator	2.4	2.3	1.1	1.8	1.1	0.9	0.4
Unit labour costs	1.6	3.4	3.7	5.7	4.6	3.4	1.3
Compensation per employee	2.5	3.2	1.5	1.8	1.4	1.4	1.2
Labour productivity	0.9	-0.2	-2.2	-3.7	-3.0	-1.9	-0.1
GENERAL GOVERNMENT (% of GDP)							
Total expenditure	46.0	46.8	50.7				
<i>Current expenditure</i>	42.3	43.1	46.5				
<i>Public investment</i>	2.6	2.5	2.8				
Total revenue	45.4	44.9	44.4				
Primary deficit (-) / surplus(+)	2.3	1.0	-3.5				
Deficit (-) / surplus (+)	-0.6	-2.0	-6.3				
LABOUR MARKET							
Total employment (quarter-on-quarter rates)	1.8	0.7	-1.9	-0.8	-0.5	-0.5	-0.3
Unemployment (% of labour force)	7.5	7.6	9.4	8.8	9.3	9.7	9.8
BALANCE OF PAYMENTS (% of GDP)							
Current account	0.2	-1.6	-0.6	-1.7	-1.0	-0.2	0.3
DEBT RATIOS							
Households (% of GDI)	94.2	94.3	95.4	94.0	94.5	94.9	95.4
Non-financial corporations (% of GOS)	455.8	492.2	543.8	508.2	529.9	540.9	543.8

SOURCES: ECB, European Commission and OECD.

activity was from net external demand. Meanwhile, France showed a more moderate contraction of GDP, since it is less exposed to the aforementioned factors. That is in contrast to Italy, where the crisis exacerbated both the lack of vigour of exports (linked to such factors as the pattern of productive specialisation and the cumulative loss of competitiveness) and the persistent sluggishness of domestic demand.

The impact of the crisis on employment was relatively cushioned, with large differences between countries

Euro area employment responded to the fall in production with a slight lag, in an adjustment process which has been prolonged despite the slight recovery in activity. This was reflected in a notable increase in the unemployment rate, which reached 10% in the opening months of 2010. The downturn in employment is proving to be relatively subdued, if the sharp fall in output is taken into account. This is clearly different from the recent experience in other economies (including most notably the United States) and from previous



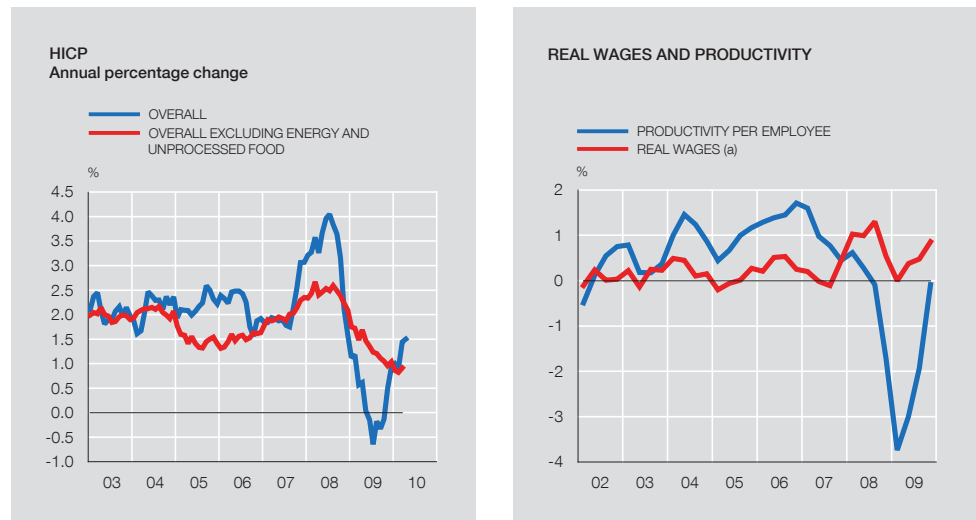
SOURCES: Eurostat and Banco de España.

recessions in the euro area, and could be a consequence of the reforms stemming from the Treaty of Lisbon, progressively adopted in the labour market over the past decade, and also of the incentives in several countries, such as France, Italy and Germany, to contain job destruction and human capital loss through subsidised reductions in working hours.

The response of employment varied widely from country to country, not only because different economic policy measures were implemented, but also because of the different productive structures and labour market regulations. Thus, in Germany employment fell by practically zero, while in other countries, such as Spain and Ireland, the fall reached figures of around 10%.

Inflation fell sharply, initially affected by the more volatile components of the HICP and subsequently also by the more stable ones

After reaching a high of more than 4% in July 2008, inflation turned downwards and posted negative values in mid-2009 (see Chart 4.2). This substantial fall was basically due to the decline in commodities prices, particularly those of energy, which fed through to the energy and food components of the HICP. Compounding this was the weakness of domestic demand and the under-utilisation of plant capacity which, along with the lagged effect of lower commodities prices, slowed the rate of change of the less volatile components of the HICP (services and non-energy industrial goods).



SOURCE: Eurostat.

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

Financing to the private sector continued to slow, markedly so in the case of non-financial corporations

Private-sector financing slowed further in 2009 and in the opening months of 2010, in line with its customary cyclical pattern. In the case of non-financial corporations, the slowdown was extensive to all euro area countries and reflects the influence both of demand factors, due to the lesser need for funds to finance diminishing productive investment and current assets, and of supply factors, due to the aforementioned tightening of bank credit standards (see Chart 4.3). For some larger firms it proved possible to partly offset the fall in bank loans, the main component of corporate finance, through direct recourse to the capital markets.

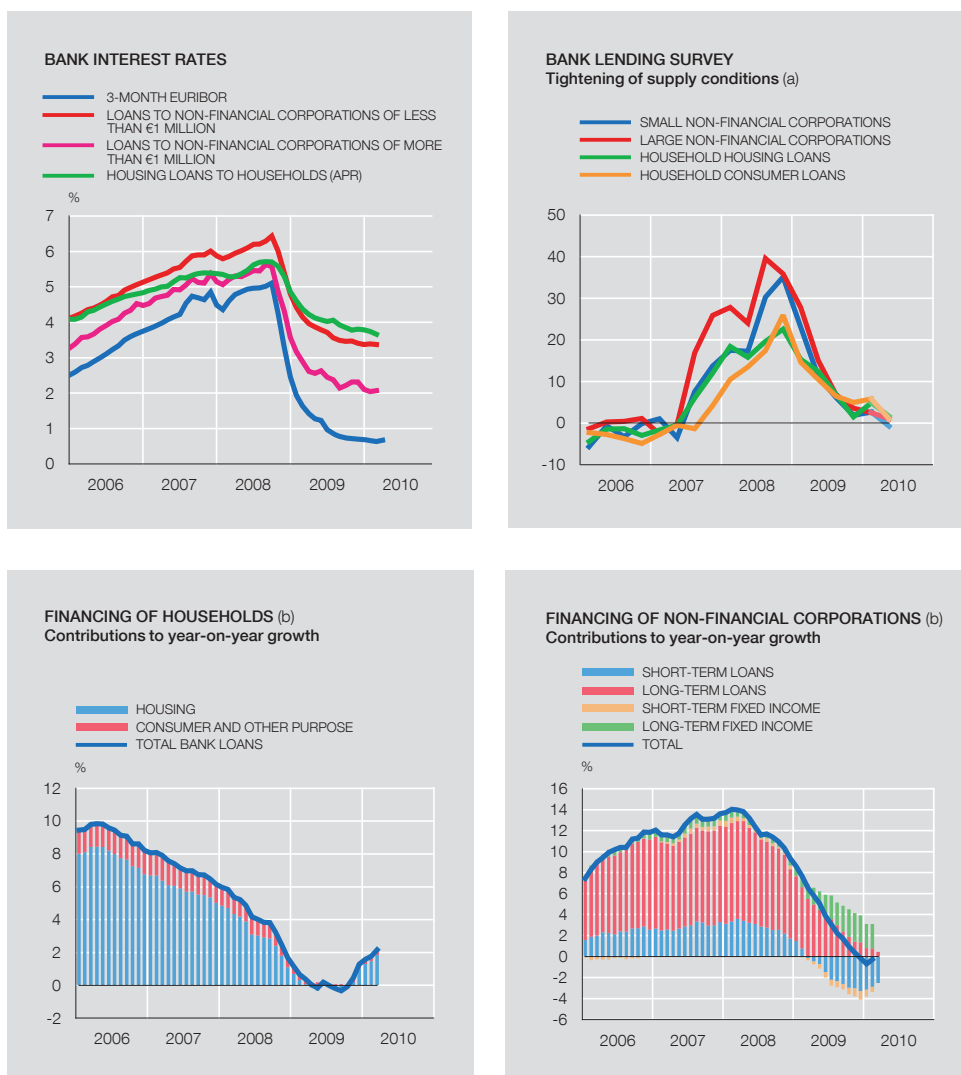
In the case of households, credit eased less sharply, following the strong loss of momentum over the past two years. The slowdown affected consumer loans to a greater degree while house purchase loans began to show muted signs of recovery in 2009 Q4. This pick-up, according to the Bank Lending Survey, would reflect a rise in demand against the backdrop of a marked decrease in interest rates and declines in house prices.

Given the seriousness of the situation, economic authorities continued to apply crisis-combating measures...

Urgent action taken by European governments following the escalation of the financial crisis in autumn 2008 contributed, together with the Eurosystem's generous liquidity provision policy, to checking the deterioration of the main financial stress indicators. However, in early 2009 the absence of any signs of improvement in the economic situation and the high uncertainty on financial markets prompted the economic authorities to implement additional support measures. This action, further to specific objectives such as enhancing the interest rate transmission mechanism, containing the slide in aggregate demand and remedying the difficulties of certain banks, sought to sustain and improve private agents' confidence and to prevent highly unfavourable scenarios from materialising. The measures taken generally fulfilled their aims.

... with conventional and non-conventional monetary policy measures...

The ECB continued to cut monetary policy rates, lowering the rate on its main refinancing operations to 1% in May, which made for a total cut of 325 bp from October 2008 (see Chart 4.4). These decisions were accompanied by a policy to support credit using non-conventional measures. In particular, certain measures adopted in 2008 were continued, such as the extension of the list of assets eligible as collateral and the supply of funds in longer-term and foreign currency operations, using fixed interest rates with full allotment in all tender operations. In



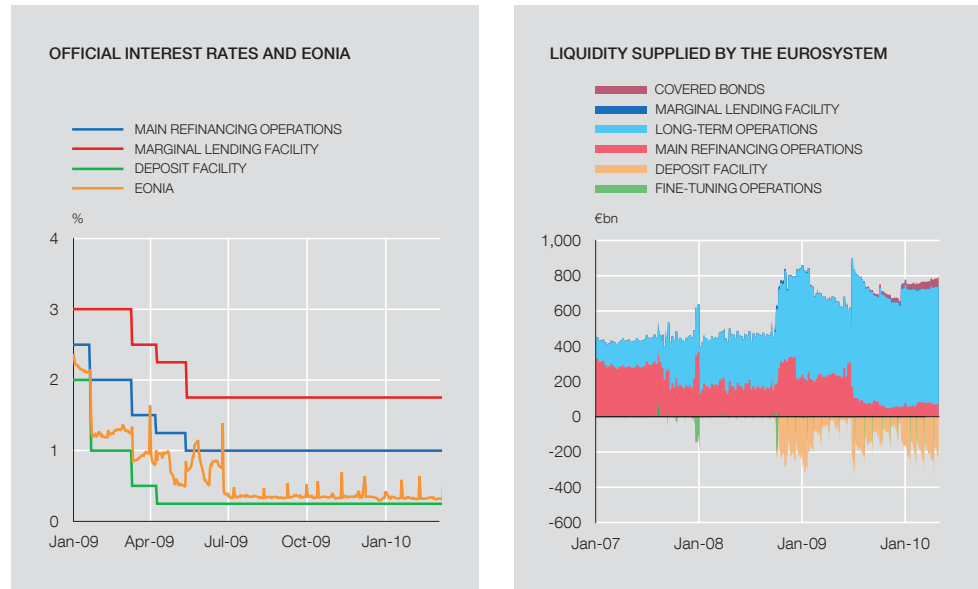
SOURCE: ECB.

a. Indicator = % of institutions that have considerably tightened standards x 1 + % of institutions that have tightened standards to some extent x 1/2 - % of institutions that have considerably eased conditions x 1.
 b. Not adjusted for securitisation.

addition, three new twelve-month unlimited liquidity-providing operations and a covered bond purchase programme were introduced. The Eurosystem's aim hereby was to provide for a swift and sharp fall in market interest rates and in those set by financial institutions in their asset-side operations, to alleviate the lack of activity on wholesale funding markets and, in short, to strengthen the flow of credit to households and firms.

... discretionary tax measures...

The tax authorities of euro area countries progressively adopted discretionary tax measures to stimulate demand, largely as part of the November 2008 European Economic Recovery Plan. These actions accounted for an estimated amount of 1.1% of GDP in 2009 and will total 0.8% in 2010 as a whole. The provisions adopted included cuts in taxes and social security payments, and increases in transfers and direct government spending, which was largely targeted at construction and infrastructure renewal. The fiscal drive in the various countries gave rise to very different outcomes, essentially depending on the initial situation of public finances and the impact of the crisis.



SOURCE: ECB.

... and plans to support the financial system

Lastly, governments also deployed plans to support the financial system, approved in many cases during autumn 2008 within the common framework of principles agreed in the EU to ensure effectiveness and avoid the possibility of distorting competition. The measures, which initially focused on the liabilities-side of banks' balance sheets by applying guarantees to debt issues and capital injections, were subsequently extended to the assets-side with programmes for restructuring impaired assets and guaranteeing their value.

3 The improvement in financial conditions, the beginning of the recovery and the Greek fiscal crisis

From 2009 Q2, following the far-reaching action of central banks and governments in the euro area and in the rest of the world, financial conditions gradually returned to normal over the year, feeding off the more optimistic signs from the real sector. However, from 2009 Q4 there were some localised bouts of instability, such as that of Dubai World in November, while the deterioration in Greece's fiscal situation began to generate growing strains in the euro area's government debt markets.

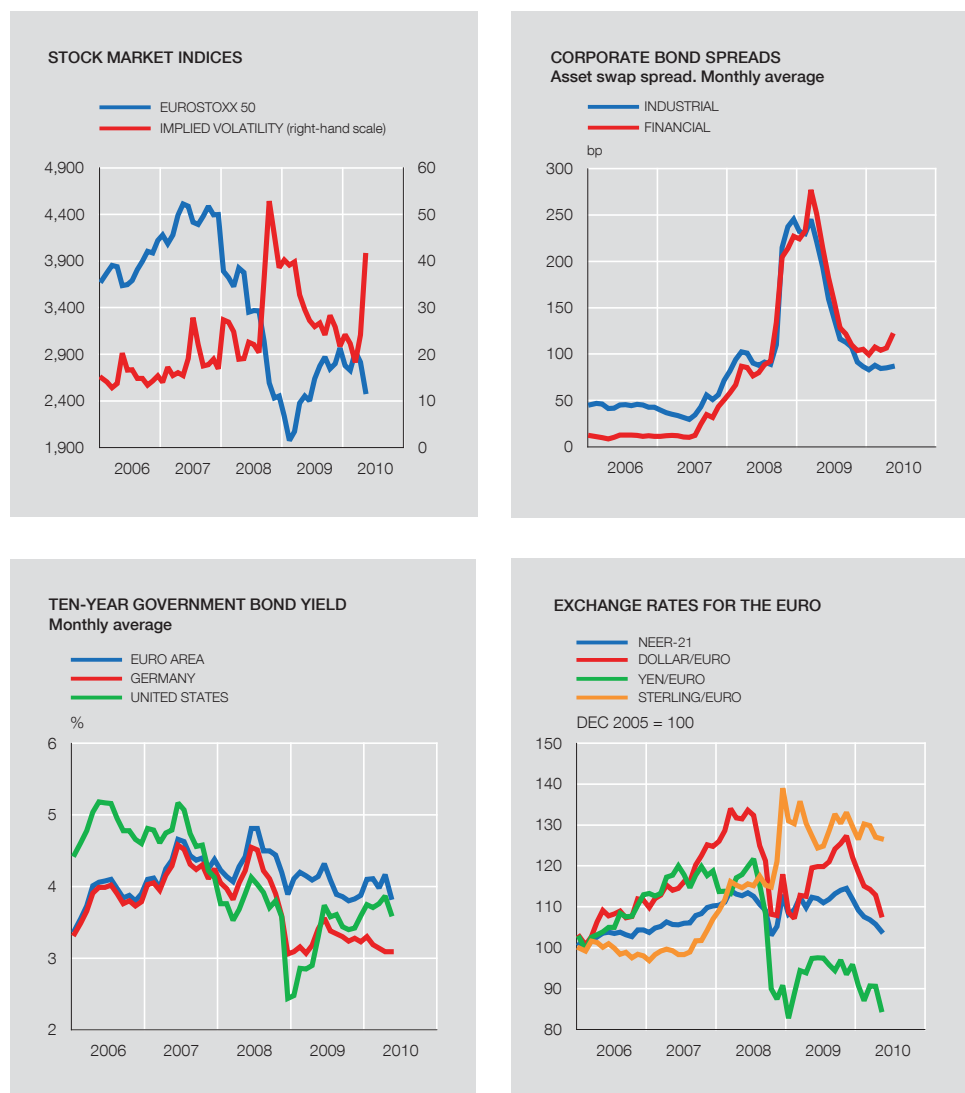
3.1 THE IMPROVEMENT IN FINANCIAL CONDITIONS AND THE BEGINNING OF THE RECOVERY

Following the unprecedented action of central banks and Governments, financial strains gradually eased over 2009...

EURIBOR interest rates reached minimum levels in September 2009 in the wake of monetary policy stimuli and the narrowing of risk premia. The twelve-month EURIBOR stabilised at around 1.2% and the risk premium, measured as the difference between the twelve-month EURIBOR and the twelve-month EUREPO, fell gradually to levels close to 50 bp, after it had exceeded 200 bp at the height of the tension. The abatement of investor uncertainty was also discernible in less volatile financial asset prices and a substantial recovery in share prices for the year as a whole, although they did not reach their pre-crisis levels. In this respect, risk premia fell notably, particularly sharply for debt instruments of poorer credit quality (see Chart 4.5).

... which meant that banks were less reliant on public aid and private debt markets recovered

As a result of improved financial conditions, banks resorted less to State guarantees for their debt issues and some even repaid the public funds received during the period of greatest instability. Also, the lower cost of financing boosted activity on primary securities markets, par-



SOURCES: ECB and JP Morgan.

ticularly in the case of non-financial corporations' issues, in contrast with the sharp moderation in financing through bank loans.

The progressive return to financial stability, together with the recovery of external demand and support from economic policies, was conducive to the euro area emerging from recession in 2009 H2

This process of financial market stabilisation during 2009, together with the recovery of some non-euro area economies and the effect of the economic policy stimuli implemented in the euro area, enabled the euro area economy to emerge from the recession in 2009 H2. It posted positive quarter-on-quarter growth rates, although these were low and subject to a certain degree of volatility. This pick-up was underpinned by export growth (in keeping with the momentum of international trade), by the expansion of government consumption and investment, and by the positive contribution of stockbuilding, while household consumption and private investment remained depressed.

Inflation turned positive due to the effect of energy prices

Euro-area inflation turned positive in the closing months of the year and reached 1.5% in April 2010, mainly as a result of the rise in the energy component of the HICP (tied to the gradual increase in commodities prices). Conversely, the prices of the less volatile components of the

HICP (services and non-energy industrial goods) remained on a slowing path against a backdrop of continued weak domestic demand.

The euro appreciated gradually during 2009, although this trajectory was interrupted at the end of the year due to the outbreak of the Greek crisis

In this setting the euro exchange rate progressively appreciated, a movement interrupted at year-end due to the worsening of the Greek crisis and the release of some relatively unfavourable macroeconomic data. Nevertheless, it was subject to notable fluctuations and did not perform uniformly against the major currencies. Its appreciation against the US dollar, the yen and Asian currencies tied to the dollar was partially offset by its depreciation against sterling and the Swiss franc (see Chart 4.5).

The Greek crisis conditioned developments on financial markets in the final stretch of 2009 and in early 2010

From end-2009 the markets were highly conditioned by the Greek fiscal crisis, which heightened sharply in spring 2010. That resulted in a drastic correction of trends on euro area financial markets. In addition to the strains on sovereign debt markets which are discussed below, share prices fell sharply, particularly in the banking sector due to its exposure to sovereign debt. And on the foreign exchange markets there was a correction in the euro in May 2010 that brought it to levels close to those recorded during the Lehman Brothers' crisis in autumn 2008. This build-up of risks to financial stability in the euro area led European governments and authorities to adopt further extraordinary measures on 10 May, which are detailed in the following section.

3.2 THE DETERIORATION OF PUBLIC FINANCES AND THE GREEK FISCAL CRISIS

In 2009 there was an unprecedented deterioration in public finances...

Government action, which in many cases exhausted the available room for manoeuvre, and, in particular, the operation of the automatic stabilisers prompted an unprecedented deterioration in public finances in the euro area countries. The euro area budget deficit stood at 6.3% in 2009, its highest level in recent decades and considerably up on the figure of 2% posted in 2008 (see Chart 4.6).

... due to the increase in public spending and, to a lesser degree, to the fall in revenue

This was firstly the result of strong growth in expenditure, which stood at more than 50% of GDP (4 pp up on the previous year), due to the increase in social benefits, and in government consumption and investment. Furthermore, the fall in revenue (to 44% of GDP) was steeper than that observed in other recessions not only because of the tax cuts introduced but also because of the sharp contraction in certain sources of revenue which, during the previous upturn, had shown unusually high elasticity to GDP (such as revenue linked to the real estate boom in certain euro area countries and that linked to business profits).

It will be difficult to correct the fiscal imbalance since the structural component of the deficit is very high and public debt may reach close to 90% in 2010

As a result, the permanent or structural component of the fiscal downturn has been considerable and, on European Commission estimates, it would account for practically half of the total deterioration. Therefore, neither the gradual withdrawal of the stimulus measures nor the incipient economic recovery will permit a notable reduction in the fiscal imbalance. Furthermore, forecasts indicate that public debt will rise to close to 85% of GDP in 2010, despite the fact that government intervention to stabilise the financial system to date has had a limited impact on debt levels (less than 3 pp) (see Chart 4.6).

13 of the 16 euro area Member States are running an excessive deficit

The fiscal deterioration was common to all euro area countries and resulted in an exceptional situation as far as the application of the Stability and Growth Pact is concerned. In spring 2009, Ecofin resolved to initiate the excessive deficit procedure for Greece, Spain, France and Ireland, whose deficits had exceeded 3% of GDP in 2008, and in December a further eight countries (Belgium, Germany, Italy, the Netherlands, Austria, Portugal, Slovenia and Slovakia) were added. Consequently, 13 euro area member states were subject to this procedure (including Malta), and in May 2010 the European Commission initiated the same



SOURCE: European Commission, Stability and Convergence Programmes.

procedure for the three remaining countries, although when this report went to press the initiation of these proceedings had not been decided upon by the Council.

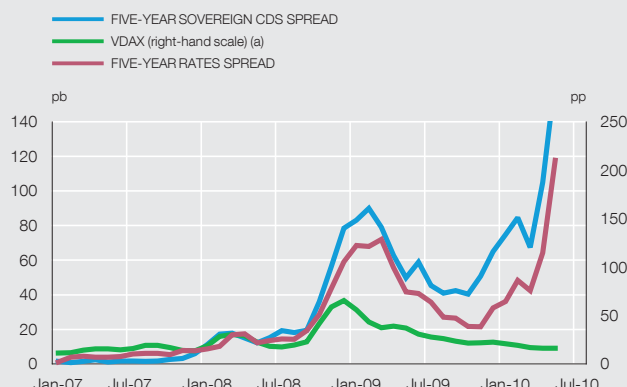
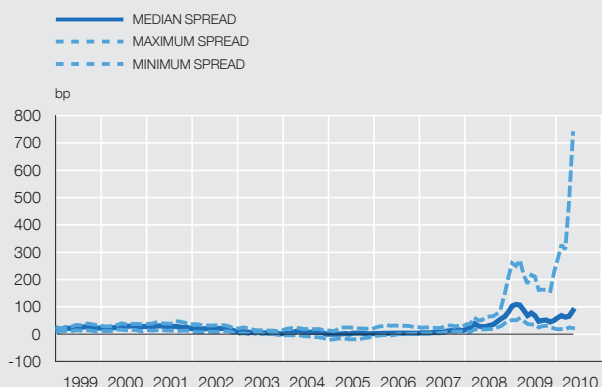
The fiscal deterioration and the Greek crisis triggered severe bouts of financial instability on sovereign debt markets

As shown in Box 4.1, the deterioration of fiscal positions against a backdrop of more prudent risk pricing was reflected in the widening of sovereign spreads in the euro area during 2009. This situation came to a head in spring 2010 as a consequence of the Greek crisis. The high levels of public debt in Greece, together with the deterioration of its economic outlook and its loss of credibility as a result of the serious shortcomings detected in its statistics, heightened uncertainty about the Greek government's ability to refinance its debt. The Greek authorities were compelled to design various tax adjustment measures at the same time as the Eurogroup, the European Commission, the ECB and IMF made progress in designing a mechanism to support these measures through the provision of conditional financial assistance to the Greek economy. However, these measures did not manage to stabilise the situation. On the contrary, Greek bonds continued to lose value and this trend began to spread to those euro area economies whose public finances had deteriorated most as a result of the crisis.

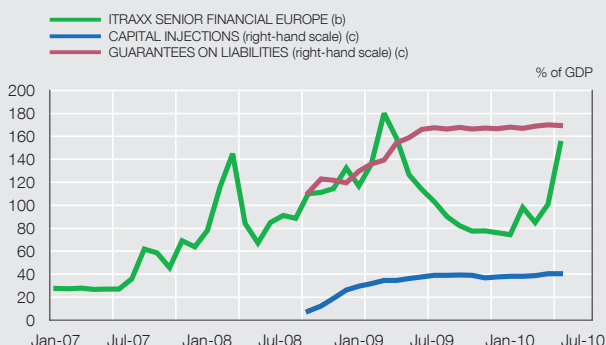
Since the creation of the European Monetary Union, yield spreads between the various euro area sovereign bonds had held at relatively low values (see Panel 1). With the onset of the financial turbulence in mid-2007, greater spreads began to be observed. These widened notably during the period of most financial instability, following the bankruptcy of Lehman Brothers in 2008. Relatively high sovereign spreads persisted during 2009, and in recent months high tensions prevailed in the area's public debt markets as a result of the Greek crisis and following revelations of this country's serious statistical shortcomings, which masked a worrying fiscal situation. In late January and early February 2010, the yield on 10-year Greek bonds rose to 7%, while the German benchmark stood at around 3.2%. The Greek yield shot up to over 12% on 7 May, the day before the approval by the Ecofin and the ECB of a package of measures to preserve stability in the euro area (discussed in the main body of this chapter). The tensions also affected the other sovereign bonds in the euro area, albeit unevenly so depending on the issuer. Irish and Portuguese bonds, after those of Greece, lost most value (with yields standing at 6% on 10-year debt), followed by Italian and Spanish benchmark bonds (whose rates stood at over 4%).

In a monetary union, differing yields on government bonds - with the same maturity - are reflected in liquidity and credit risk premia. The latter would reflect the return demanded by investors for exposing themselves to the risk of a bond default event, a return that could also be approximated by the cost of credit default swaps (CDSs), a financial instrument which enables insurance to be taken against this event. As Panel 2 illustrates, tracking the course of the sovereign CDSs for the euro area countries relative to the German sovereign CDS, default risk premia would account for a major part of the yield spreads over Germany since 2007. These premia will depend both on the amount of sovereign risk perceived by investors, which will be related to the country's solvency, and on the price of the risk, which will be determined by investors' readiness to assume risks.

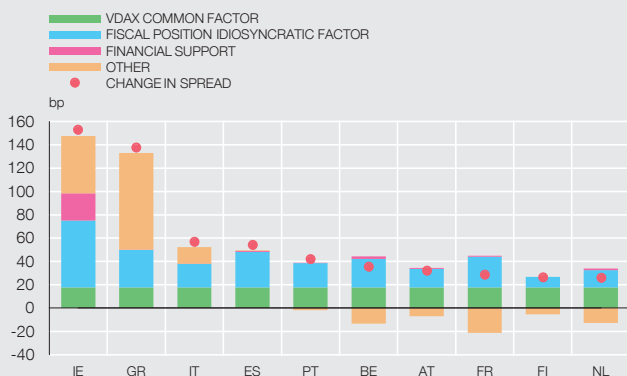
From 2007, then, part of the spreads should reflect the increase in the price of risk, against a global background of high uncertainty, particularly since the bankruptcy of Lehman Brothers. Faced with a situation of unprecedented instability, investors demanded greater compensation for bearing risks, which affected countries with weaker fiscal positions to a greater extent. For this same reason, the finan-



3 ITRAXX AND SUPPORT FOR BANKS



4 CONTRIBUTIONS TO CHANGE IN SOVEREIGN SPREADS (JUN 2007-NOV 2009)(d)



SOURCES: European Commission, Datastream, Markit Economics and Banco de España.

- a. VDAX is the expected volatility or fluctuation band of the German DAX stock index over the next 30 days.
- b. ITRAXX senior financial Europe is a CDS premia index of 25 European financial institutions.
- c. Estimate of the volume of public aid for the countries of the area, excluding asset write-downs.
- d. On the model specification (see footnote in text).

cial stabilisation in train globally since spring 2009, which led volatility back to close to its end-2007 levels, had a favourable bearing on sovereign debt spreads in the euro area.

However, the increase in premia should also reflect a change in the perception of euro area countries' sovereign risk. The crisis has entailed a rapid deterioration in the member countries' fiscal situation and the massive deployment of public aid to the banking system has also exposed their fiscal position to the possible fragilities of financial institutions¹ (see Panel 3). That led to a situation in which several euro area countries saw their credit ratings downgraded during 2009. The Greek credit rating was downgraded on two occasions by Fitch and S&P to BBB+, while Moody's downgraded it a notch to A2 (equivalent to A). Ireland lost the AAA rating that three agencies had assigned to it, and was downgraded to AA- in the case of Fitch. Finally, S&P downgraded Spain a notch to AA+, and Portugal to A+. The spread of tensions in spring 2010 led to further downgrades in Portugal and in Spain, and above all in Greece, where S&P withdrew the investment-grade rating for Greek debt, assigning it a rating of BB+.

To sum up the significance of the determinants, Panel 4 gives a breakdown of the change in 10-year sovereign spreads since mid-2007 using a simple regression model.² The exercise runs only to November 2009, given the information available at the time of this report going to press. As can be seen, the increase in spreads over the German Bund during this period was generalised, though the scale of the increase by country differed greatly. Firstly, a com-

mon overall factor of higher risk is identified, which would have pushed yields upwards, and which has been approximated by the implied volatility of the German stock market index, or VDAX. A relevant role is not obtained, however, for liquidity (due possibly to the difficulties of approximating this variable in this framework of analysis), although the common factor might be partly incorporating the presence of higher liquidity premia at a time of greater uncertainty. A positive contribution by the idiosyncratic factors associated with the countries' fiscal position is obtained. Finally, the volume of public aid to the banking sector would have played a determining role only in the case of Ireland.³ The presence, nonetheless, of a sizeable unexplained component in the cases of Greece and Ireland might indicate non-linear behaviour by the spreads and, in the case of Greece, the credibility problems that had been disclosed.

Accordingly, sovereign debt yield spreads in the euro area during the crisis, and particularly in spring 2010, illustrate how investors may show enormous sensitivity to weakened fiscal positions, a reaction which is exacerbated at times of global instability and which entails notable financial risks. The persistence of high risk premia may be expected to feed through to the cost of debt when governments refinance it, which will hamper fiscal consolidation plans. A public spending structure entailing higher interest payments might also be detrimental to the economy's potential growth. This reinforces the importance for governments of safeguarding fiscal stability in the medium term. Further, as a result of the crisis, investors will tend to be more cautious in the face of risks, at a time in which a portion of such risks is feeding through from the private to the public sector. Under these conditions, a greater degree of discrimination on public debt markets may be expected as may, therefore, conditions that are particularly unfavourable for government paper issued by States that do not adopt credible consolidation strategies with the urgency that the situation requires.

1. Support to the financial system is not in the main reflected in the budget deficit and public debt figures. This is due to the nature of these measures - e.g. public guarantees only generate contingent liabilities - and, in some cases, to their implementation through companies classified outside the public sector. 2. What is involved here is a linear regression of the sovereign spreads of 10 euro area countries over the German Bund with data from June 2007 to November 2009. Used as explanatory variables are the VDAX - to approximate the overall common factor of uncertainty - and the idiosyncratic factors which show the European Commission's budget deficit and public debt projections (interacting with the VDAX to capture the greater relevance of the fiscal position at times of instability). A liquidity variable approximated by the weight in the euro area of the country's long-term issues is included. All the variables are expressed relative to the related German benchmark.

3. Most of the increases in sovereign spreads came about further to the announcement of the financial bail-out plans. Ireland has considerably greater exposure, owing to the fact that in September 2008 its government approved, for a period of two years, a guarantee on the liabilities of the main banks, which initially entailed contingent liabilities close to 200% of GDP.

On 23 April the Greek government formally requested the activation of the support programme designed by the Eurogroup, which met this request on 2 May through the unanimous approval of a programme of bilateral loans of up to €110 billion over three years (€80 billion from the euro area Member States and the remainder from the IMF). This plan is subject to strict conditionality and close monitoring, which is detailed in 2 of the April 2010 *Economic Bulletin*. On the same day, and as part of the strict conditionality, Greece approved an ambitious fiscal adjustment and structural reform programme jointly negotiated with the IMF, the European Commission and the ECB. The implementation of this programme will be evaluated quarterly. Further, in keeping with its favourable assessment of the Greek government's ad-

justment plan, the ECB decided to suspend the application of the minimum credit rating threshold for Greek debt.

Following its initial positive impact, activation of the support plan for Greece was insufficient to halt the worsening of the strains which continued to spread to other member countries. In response, governments undertook on 10 May to bring forward their budgetary consolidation plans and Ecofin announced the creation of a European Financial Stabilisation Mechanism capable of mobilising \$500 million of European funds (more than 5.5% of euro area GDP), which will be supplemented by further funding from the IMF and, as in the case of the Greek support plan, will be subject to strict conditionality. Similarly, in order for the monetary policy transmission mechanism to function normally again, the ECB decided to conduct sterilised interventions in the dysfunctional segments of public and private debt markets through a Securities Markets Programme; to strengthen liquidity provision during May and June by reactivating some measures previously adopted in relation to three and six-month tenders; and, in coordination with other central banks, to resume US dollar liquidity-providing operations.

4 Outlook and economic policy challenges

Available forecasts point to a period of weak and gradual recovery, with low inflation, and it will be some time before production reaches its pre-crisis levels

Available forecasts point to a period of moderate and faltering growth with low inflation in 2010 H1. Internal demand is expected to remain weak, given the high degree of slack in the economy (low capacity utilisation and high unemployment), low business margins and the progressive petering out of the impulse of the policies applied. And this in a setting in which bank, corporate and, in some cases, household balance sheets remain fragile and in which general government faces, in some countries, the need to pursue, with some degree of urgency, ambitious fiscal consolidation measures (see Chart 4.7). The subdued nature of the pick-up in activity, along with the under-utilisation of plant capacity and the wage restraint that may be expected given the slackness of the labour market, will enable inflation to hold at a lower level. In any event, these projections are subject to considerable uncertainty: on one hand, because of the continuing presence of vulnerabilities, on which the pace of the emergence from the crisis may hinge; and on the other, because this pace will also depend crucially on how the economic authorities address the challenges facing them.

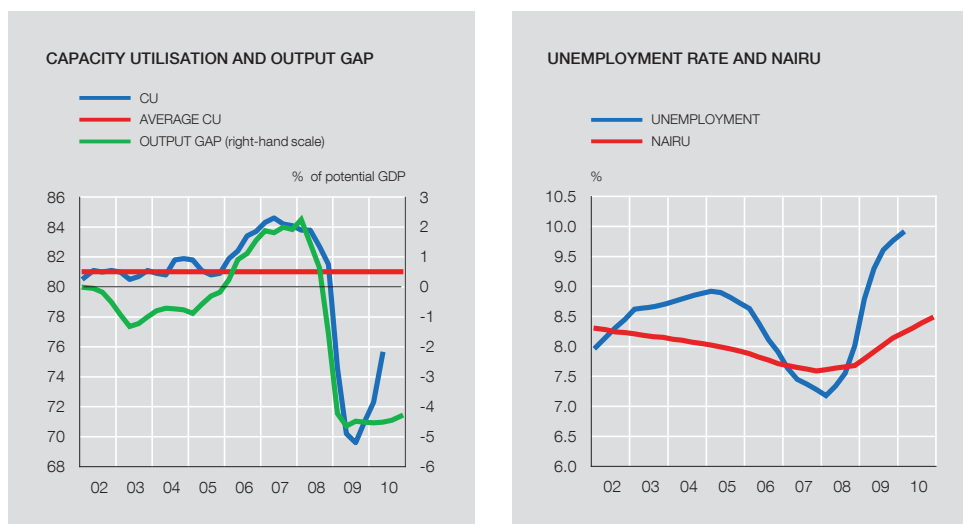
In the financial field, banks continue to address the repair of their balance sheets and the restructuring of the sector

Primarily, the international financial crisis and economic recession have severely affected the banking system. As the ECB and the IMF have highlighted, banks remain exposed to potential losses in light of the foreseeable materialisation of credit risk on their books. Further, the banking system, which remains highly reliant on the public aid received, will be subject to regulatory changes and to redimensioning.

To date, the adjustment of bank balance sheets has essentially involved the reduction of their foreign assets and of interbank positions. However, it cannot be fully ruled out that, if the process continues, it will ultimately affect the supply of bank financing and, therefore, the pace of the recovery.

Surplus plant capacity will detract from investment and the labour market situation will hinder a rapid recovery in consumption

The crisis generated excess plant capacity, which will tend to delay the need for new investment, while the redimensioning needed in certain productive sectors - the car industry, construction and the financial sector - may continue to bear negatively not only on the demand for labour, but also on supply. Potential employees will need to acquire the appropriate skills to improve their employability in the more dynamic sectors. Further, the foreseeable re-establishment of standard working hours poses doubts about the true dynamism of employment during the recently initiated phase of recovery. This unfavourable labour market outlook and the losses in wealth that have built up might translate into greater-than-expected precautionary saving.



SOURCES: European Commission and OECD.

Action by governments and the ECB will be key in determining the pace of emergence from the crisis

In this situation, the robustness of the recovery will hinge crucially on how skilfully euro area governments and the ECB time the withdrawal of the exceptional measures adopted and duly undertake those other measures needed to ensure financial stability in the area, to minimise the risk of a fresh slump in activity and to promote higher potential growth.

4.1. MONETARY POLICY

There was a regulated and gradual withdrawal of the extraordinary measures in the spring of 2010, with a very generous liquidity provision policy being maintained

Progressive financial normalisation and the improved economic outlook over the course of 2009 meant that the Eurosystem, so as to prevent the market distortions that might arise if the extraordinary measures were maintained longer than needed, was able to begin withdrawing those measures that were no longer necessary, while maintaining a generous liquidity-provision policy. Thus, after holding the third and final one-year refinancing operation in December, six-month injections were not extended after the operation in March this year. Subsequently, the ECB Council decided that, as from 2010 Q2, its regular three-month refinancing operations would resume the habitual variable-rate procedure, while weekly and special one-month tenders would continue to be at a fixed rate with full allotment, at least until October.

This gradual winding down of the extraordinary measures had to be regulated as a result of the market tensions stemming from the Greek crisis. The ECB decided to reinforce once again the provision of liquidity at three and six months and to resume dollar-denominated operations, while it adopted a programme of intervention in those government and private debt market segments whose dysfunctionality was hindering the proper working of monetary policy transmission mechanisms. These interventions are being neutralised so as not to affect the policy stance and not to interfere with expectations as to the future course of official interest rates.

In the medium term, the main challenge is to maintain price stability, in a setting of low growth but exceptional uncertainty

Once the tensions have been overcome, the exit strategy should be resumed in order to converge on an operational framework that reflects the lessons of the crisis; and, in this respect, the initial framework is a good point of reference in light of the flexibility and robustness it has demonstrated.

In addition, monetary policy will have to calibrate the risks to price stability, in a scenario of slow growth and high uncertainty. Moreover, it will be highly dependent on the measures implemented in other economic policy areas.

More specifically, due regard must be had to the risks of the still-ongoing normalisation of the financial system being interrupted by occasional tensions that hamper satisfying the greater demand for credit that will arise once the pick-up in activity takes root. But, above all, the recent experience in Greece illustrates the severity of the problems that would arise from an insufficient commitment by governments to the necessary fiscal consolidation.

4.2 BUDGETARY CONSOLIDATION AND THE SUSTAINABILITY OF PUBLIC FINANCES

To restore soundness to public finances, sustained improvements will be needed in structural balances over the coming years

In late 2009 Ecofin approved a roadmap for the fiscal consolidation of the EU countries and for the correction of excessive deficits

The initial Stability Programmes revealed substantial differences across the Member States' fiscal consolidation strategies

And many countries have yet to design their consolidation strategy

The challenge facing fiscal policy is to set in place budgetary consolidation plans that ensure sound public finances in the medium term and which provide the room for manoeuvre needed to withstand future crises and the consequences of population ageing. At the start of the recovery, uncertainty over the economy's capacity to sustain growth, once the demand-stimulus and credit-support measures were withdrawn, advised regulating the necessary spending cuts and tax increases with prudence. But the recent bout of tensions on European debt markets stemming from the Greek crisis has highlighted a growing sensitivity to the budgetary position of certain countries that advises accelerating the design and, in some cases, the implementation of sufficiently ambitious fiscal consolidation plans.

The EU Council of ministers took these considerations into account when establishing the basic guidelines for the fiscal consolidation process in the coming years. In particular, it was agreed in December 2009 that the adjustment should broadly begin in 2011 and that it would be conditional upon the situation of each country. Under the Stability and Growth Pact, the year 2013 was set as a deadline for the correction of excessive deficits in most cases, except for Ireland and Greece (2014) and Belgium and Italy (2012). The annual structural adjustment that each country must make on average during the established correction period ranges from 0.5 pp in the cases of Germany and Italy to almost 3 pp in that of Greece.

At the start of 2010, all the euro area countries submitted their respective Stability Programmes to the European Commission. The Commission's assessment at the end of March acknowledged the effort made by the Member States in their response, but expressed certain reservations. In particular, it warned that the fiscal projections in most of the programmes were based on relatively favourable macroeconomic scenarios and, at the same time, it requested more details on the specific measures governments intended to adopt.

According to these Programmes, euro area fiscal policy in 2010 will continue contributing to sustaining the economic recovery and the deficit may rise to almost 7% of GDP, although there are notable differences in the various members' fiscal exit strategies. In Germany, tax cuts and the other measures agreed upon entail a stimulus on a similar scale to that in 2009 (2 pp of GDP), and in France, too, investment-boosting initiatives have been introduced. Conversely, Ireland, Portugal, Greece and Spain implemented fiscal adjustment plans at the start of the year which were stepped up in the three latter countries in May, against the background of the enormous instability generated by the Greek crisis. The Spanish programme and its subsequent reinforcement are explained in detail in chapter 5 in this *Annual Report*.

At the behest of Ecofin, Greece submitted additional budgetary measures in mid-March, quantified at 2% of Greek GDP, and on 2 May it approved a new fiscal adjustment package aimed at cutting the deficit by 5 pp of GDP in 2010, placing it below 3% in 2014. Progress in the implementation of this plan is subject to strict monitoring by the IMF and the EC, on a quarterly basis.

In contrast, in later years the adjustment will be of a more generalised nature if the commitments established are met. These posit a gradual reduction in the overall euro area deficit to below 3% in 2013. But most of the countries have yet to undertake the unavoidable task of

designing, as soon as possible, ambitious and credible fiscal consolidation measures that prevent growing financing needs from pushing long-term interest rates upwards, and thereby hampering the recovery in investment and private consumption.

The potential adverse effects on growth in the short run will be less if the measures are sufficiently ambitious and accompanied by other structural reforms

The implementation of these plans might have an adverse impact on aggregate demand in the economy, which will be less if the greater budgetary discipline contributes to reducing sovereign risk premia and the interest rates on public debt. In this respect, past experience reveals the existence of certain episodes where the effects of fiscal consolidation on economic growth were limited (see Box 4.2).

In addition, in a scenario such as that at present, marked by low potential growth, the implementation of a sustained structural adjustment may prove more complex than in past episodes. It is thus important, firstly, that consolidation should be pursued bearing in mind the impact of the measures on the supply side of the economy (in particular, the potential disincentive effect on employment and saving entailed by some taxes and the effects of public spending on innovation and on education). But it will also be essential to accompany these measures with other complementary reforms. These include most notably the reform of pensions and social security systems to lessen the consequences of demographic changes on spending projections and, above all, those reforms aimed directly at raising the economy's potential growth and at ensuring the area's financial stability.

4.3 OTHER STRUCTURAL REFORM POLICIES

The crisis may have had a significant adverse impact on the euro area economies' potential growth ...

The economic crisis may conceivably have reduced the euro area's productive capacity. Constricted investment, the greater uncertainty associated with risky projects such as innovation and the loss of human capital linked to high unemployment levels may readily result in a persistent reduction in the level of potential output. There are, in fact, estimates that place this contraction at close to 4% over five years.

... the duration and intensity of which will depend on the economic policies adopted

To reduce the scale and persistence of this impact, initiatives are needed to promote economies' ability to create new business opportunities and to ensure the necessary flexibility is in place to reallocate resources towards these market segments. At the same time, it is important to eliminate the support measures for specific sectors that may hold back the adjustment, distorting the competitive conditions of the single market (see Table 4.2). The recovery will only take on self-sustaining dynamism once the effects of the transitory stimulus policies are removed.

Improving the labour market through training for the unemployed, lifelong training and youth education ...

To date, the increase in unemployment has been centred particularly on countries that have been subject to marked sectoral restructuring and/or that show high labour market segmentation. But even in those countries where job destruction is proving more moderate, there are groups in which the effects of the crisis have been very virulent: temporary workers, the young and the low-skilled.

Training the unemployed to ease their transition towards new jobs and to prevent unemployment from becoming structural is therefore essential. Lifelong training and the improved education of the young would enhance the capacity of these groups to respond to the needs of the labour market, preventing circumstances such as those at present from leading ultimately to a permanent full-off in their participation rates, with the subsequent adverse effects on the economy's potential growth. Further, it is advisable to review collective bargaining arrangements, to lessen the downward stickiness of wages in recessions and to allow for a better adaptation by firms to economic conditions.

Over the coming years, European countries will have to effect a highly demanding adjustment of their budgetary imbalances. Indeed, in some instances this has already begun. Although there is broad consensus regarding the benefits of fiscal consolidation in the medium and long run, the short-term effects are subject to greater uncertainty.

The literature on past fiscal consolidation experiences reveals the existence of numerous episodes where the effects on short-term economic growth were limited or even positive. The most closely studied instances are the consolidation processes undertaken in Denmark (1983-1986) and Ireland (1987-1989), which were accompanied by a significant pick-up in economic growth.¹

Other papers suggest that these findings are not confined exclusively to small economies: for example, Giudice et al. (2007) as-

certain that approximately half the consolidation processes undertaken by EU countries in the last 30 years have been accompanied by high growth, relative to the prior and subsequent periods.²

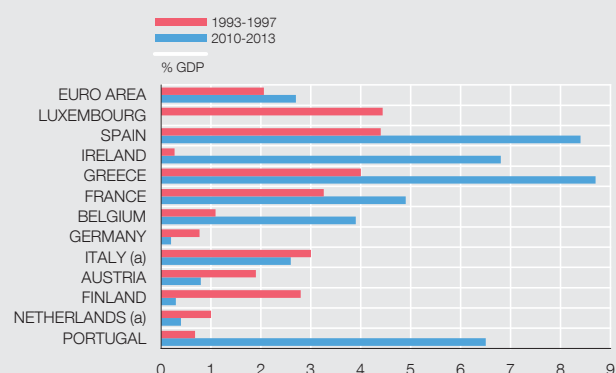
But consolidation had never been so global or so demanding; and, therefore, transferring these experiences to the current situation is a questionable exercise. One recent episode was that experienced by the European countries during the 1993-1997 period, when compliance with the convergence criteria governing entry into the euro area entailed a widespread and large-scale fiscal consolidation. Specifically, the correction of the cyclically adjusted primary balance in the euro area countries was 2.2% of GDP (3.1% if the total balance is used). This figure is only slightly down on the reduction of the cyclically adjusted pri-

1. See Giavazzi and Pagano (1990), "Can severe fiscal contractions be expansionary? Tales of two small European countries", NBER Macroeconomic Annual, 5, pp. 75-111.

2. G. Giudice, A. Turini y J. in't Veld (2007), "Non Keynesian fiscal adjustments? A close look at expansionary fiscal consolidations in the EU", Open Economic Review, 18, pp. 613-630.

FISCAL CONSOLIDATION EFFORT

Reduction in the cyclically adjusted primary balance



1 IMPACT OF GOVERNMENT CONSUMPTION ON PRIVATE CONSUMPTION IN THE EURO AREA

Equation estimated with panel data for the 1982-2008 period

Explanatory variables	EQUATION 1		EQUATION 2	
	Coeff.	t-stat.	Coeff.	t-stat.
Constant	0.00	0.4	0.00	0.5
Change in private consumption in t-1	0.09	2.7	0.09	2.6
Change in GDP	0.73	18.4	0.73	18.4
Change in gvt. consumption (DGC)	0.06	1.8	--	--
Consolidation dummy * DGC	--	--	-0.01	-0.2
Non-consolidation dummy * DGC	--	--	0.07	2.0
Observations	286		286	

2 FISCAL CONSOLIDATION IN THE 1993-1997 PERIOD

	Euro area	Germany	France	Italy	Spain	Greece	Ireland	Portugal	Finland	Belgium	Netherlands	Austria	Japan	United States	United Kingdom
Budget balance	3.1	0.4	3.1	7.4	3.9	6.0	4.1	4.2	7.0	5.2	1.6	2.4	-1.7	4.1	5.8
Structural balance	2.2	0.1	3.2	6.3	3.9	6.2	1.5	4.2	2.8	4.2	0.7	2.2	-1.9	3.4	4.3
Public spending	-2.8	0.1	-0.8	-6.1	-7.3	-1.5	-8.0	-2.3	-8.5	-3.7	-8.2	-2.7	-1.0	-2.7	-4.5
Government consumpt	-0.7	-0.2	-0.2	-1.7	-1.6	3.2	-2.6	0.7	-1.9	0.1	-1.7	-0.5	1.5	-1.7	-2.0
Public investment	-0.6	-0.9	-0.6	-0.4	-1.1	0.3	0.3	0.7	0.3	-0.4	-0.3	-1.3	-0.5	0.1	-0.9
Public revenue	0.3	0.5	2.3	1.3	-3.4	4.5	-3.8	1.8	-1.5	1.5	-6.6	-0.4	0.1	1.5	1.3
Direct taxes	0.2	-0.3	1.3	0.1	-0.1	1.9	-0.9	0.9	2.8	1.3	-3.9	1.0	-1.5	1.8	1.0
Indirect taxes	0.5	0.0	1.3	0.5	0.3	0.3	0.4	0.7	-0.2	0.8	0.2	-0.4	0.4	-0.2	0.8
Public debt	8.5	13.8	13.0	2.4	8.1	3.5	-30.4	-0.2	-1.5	-12.0	-10.3	3.5	28.6	-4.6	5.2
Average GDP growth	1.7	1.3	1.4	1.4	2.1	1.7	7.6	2.2	3.3	2.0	3.0	1.9	1.4	3.6	3.1
Difference from average for 1980-2009	-0.3	-0.4	-0.4	-0.2	-0.5	-0.2	2.0	-0.4	0.6	-0.1	0.5	-0.2	-0.7	0.6	0.7

SOURCES: European Commission and Banco de España.

a. 2010-2012.

mary deficit of 3% of GDP (4% in terms of the total balance) that the euro area countries will have to tackle on average over the 2010-2013 period, to place the deficit below 3% within the term agreed upon under the SGP, as inferred by the Stability and Growth Programmes submitted at the end of January 2010. Nonetheless, there are notable differences between both periods in terms of the level of interest rates and the degree of slack in the economy. Both then as now, the consolidation efforts differ greatly from one country to another (see accompanying chart).

As can be seen in the accompanying table 2, despite the generalised and intense nature of the fiscal consolidation, GDP growth in 1993-1997 was only slightly lower than that observed for the 1980-2009 period on average. Indeed, in Ireland, Finland and the Netherlands, growth was higher than the historical average. Unquestionably, this result reflects the influence of many other factors, such as the improved financing conditions during that period or, in some cases, the impact of the devaluations in the early 1990s. However, the figures at least suggest the absence of a notably adverse impact on economic growth.

The composition of the consolidation plans in that period might have influenced this result, since although the empirical evidence available is not unanimous, various papers show that the likelihood of this circumstance occurring increases if the consolidation is based on primary public spending cuts, as occurred in those years in almost all the countries, with the exception of Greece. There is also evidence that these episodes are more likely when preceded by a fiscal crisis, with high levels of public debt.

To verify the scale and the sign of the macroeconomic effects associated with episodes of fiscal consolidation, one habitual strategy in the literature consists of estimating an equation for private consumption, such as that presented in the accompanying table 1. Here, in addition to the habitual domestic income variables, fiscal variables are included. Dummy variables associated with the fiscal consolidation episodes are introduced into the equation, which interact with the fiscal variables, in order to test whether the impact of the latter on private consumption varies in the consolidation episodes.³ The choice of private consumption is warranted not

only by the significance of this variable in GDP, but also because, from a theoretical standpoint, the fiscal consolidation episodes that have a limited impact on economic growth are based on the presence of agents with rational expectations, who anticipate that the current improvement in the budget balance will be accompanied in the future by tax cuts – and by the attendant distortionary effects – and who, consequently, do not change their consumption decisions in the face of changes in fiscal variables.

The first column shows the estimated equation for the 1982-2008 period. On average for the period, the short-term elasticity of private consumption is limited (around 0.06) and significant at the 90% confidence levels. Nonetheless, the second column shows that this parameter is not significant when we confine its calculation to fiscal consolidation episodes. That is to say, the negative impact of a reduction in government consumption on private consumption disappears in times of fiscal consolidation.

In short, the experience from the 1993-1997 period and the econometric evidence presented in this box point to the existence of fiscal consolidation episodes that may have moderately impacted economic growth in the short run. That said, all due caution is necessary when transferring past experiences to the current situation, since the effects of fiscal policy depend on many factors, such as the country's economic and financial situation, the composition of the plans and, most especially, the impact of the fiscal consolidation commitments on agents' expectations and on sovereign risk premia. Indeed, the costs in the short run might be less if the adjustments prove credible and contribute to reducing sovereign risk premia and the interest rates on public debt. Further grounds for caution in this analysis stem from the fact that the fiscal consolidation episodes that may finally be undertaken are not usually accompanied by significant contractions in economic activity, since that would entail the potential risk of such plans being abandoned.

³ The equation is estimated with panel data (fixed effects) for the euro area countries (12) during the 1982-2008 period. All the variables are in logarithms and in per capita terms. The unemployment rate and real interest rates were also introduced, without proving significant. The equation was also estimated including OECD income, without this altering the conclusions discussed here. Furthermore, only the results obtained on estimating the equation with government consumption among the fiscal variables are presented, since net taxes did not prove significant.

... the full implementation of the Services Directive...

In the market for goods and services, the full implementation of the Services Directive might contribute to generating new business and employment opportunities by allowing freedom of establishment and free provision of services, and the start-up of the so-called "single window" to reduce administrative formalities for companies. The transposition of this Directive should have been concluded at the end of 2009 and, although the European Commission has not yet made a full diagnosis of the degree of transposition, it appears to have been delayed in some Member States. It will further be desirable to build on the progress made in recent years regarding the lessening of administrative burdens, which have a comparatively greater influence on small and medium-sized enterprises, those most affected by the economic crisis, and where there is still considerable room for improvement.

	2000		LATEST FIGURE		LATEST FIGURE
	EURO AREA	EURO AREA/US = 100	EURO AREA	EURO AREA/US = 100	
GDP PER CAPITA AND COMPONENTS					
GDP per capita (€1000 current ppp)	21.4	70.2	25.6	69.6	2009
Population aged 15-64/Total population	67.2	101.6	66.5	98.9	2009
Employment rate	61.7	83.3	66.3	96.3	2009
Unemployment rate	8.3	207.5	9.4	101.1	2009
Total factor productivity	6.9	89.0	6.8	84.4	2009
TECHNOLOGICAL LEVEL					
Spending on R&D/GDP	1.8	67.4	1.9	69.2	2008
Spending on private R&D/GDP (EU 15) (a)	1.1	56.4	1.1	57.9	2008
Triadic patents per million inhabitants	36.4	71.7	37.7	71.6	2007
ICT spending per capita	5.3	80.3	2008
Broadband penetration	0.4	16.9	26.4	98.9	2009
Venture capital in the early stages of the investment (EU 15)	0.1	24.8	0.0	45.8	2008
QUALITY OF HUMAN CAPITAL					
Public expenditure on education	4.5	77.7	5.0	100.2	2006
Private expenditure on education	0.6	24.7	0.6	25.0	2006
<i>Labour force with tertiary education</i>	21.9	62.9	23.2	38.1	2007
<i>Labour force with secondary education</i>	44.1	85.6	44.4	151.2	2007
<i>Labour force with primary education</i>	33.4	243.5	31.4	330.5	2007
Graduates in science and technology (EU 15)	10.0	103.1	12.8	124.3	2006
	5.4	...	8.4	...	2008
BUSINESS ENVIRONMENT (b)					
Business start-up cost (% of GDP)	9.6	1,371.9	5.5	783.7	2010
Time to start a business (days)	46.3	772.4	15.9	264.3	2010
ENERGY EFFICIENCY					
Energy intensity of the economy	174.6	80.6	162.1	85.5	2007
Electricity generated by renewable sources (%) (EU 15)	14.6	...	22.0	...	2010

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.

... the promotion of innovation ...

Another key element in the strategy to improve the economy's potential capacity would involve promoting innovation, which has been much afflicted by the high sensitivity it traditionally shows to the business cycle, and by the increase in risks and the shortage of funding characterising the recent situation. Innovation policy has been highly geared towards increasing public spending on R&D and towards the introduction of deductions and subsidies to raise private spending, and a more comprehensive approach should surely be adopted, accompanying these measures with others aimed at raising the number of science and technology graduates, improving the safeguarding of intellectual property rights and access to funding (via, for example, the development of venture capital funds), and promoting public/private cooperation projects and joint funding.

... and the reform of the financial system are key to achieving a firm and sustained recovery

Lastly, the challenges in the financial sector involve, on one hand, ensuring that the deleveraging of the banking system comes about in an orderly fashion and, on the other, pushing through internationally coordinated regulatory reforms that contribute to setting in place a safer global financial system, but which at the same time do not prevent its development. Box 3.2 reviews the main international developments in this area. Significant progress has been made in Europe towards a new supervisory architecture, based on the recommenda-

tions made in the so-called “Larosière Report”. Specifically, significant steps have been taken towards the creation of the ESRB (European Systemic Risk Board), which responds to the need to establish a macroprudential supervisory framework that allows the risks to the stability of financial systems to be identified. The microprudential realm, geared to the supervision of individual institutions, will also be reinforced by the network of supervisory authorities grouped together in the ESFS (European System of Financial Supervisors). The creation of these agencies and higher levels of capital required of financial institutions are essential elements for preventing crises of this nature from recurring in the future.

The bolstering of the Lisbon agenda sought by the adoption of the EU-2020 Strategy is a step in the right direction...

On 3 March the European Commission published its Europe 2020 Strategy, aimed at revamping the Lisbon Strategy. This marks the start of a process that should lead to its approval by the European Council in mid-2010. The Strategy aims to achieve economic growth based on knowledge and innovation, the effective use of resources and social and territorial inclusiveness. In this connection it defines a set of specific targets for the 2020 horizon, including an increase in employment and investment in R&D, a reduction in pollutant gas emissions, a reduction in the percentages of early school leavers and people without tertiary studies, and a reduction in those at risk of poverty. In a more resolute way than its forerunner, the Europe 2020 Strategy should drive the implementation of the structural reforms Europe needs.

... and also envisages the need to improve the institutional framework of European economic governance

One of the novelties of the Europe 2020 Strategy is its attention to strengthening governance and the multilateral surveillance procedures so as to ensure that the commitments made under the Strategy translate into effective action on the ground. The need to reinforce the European institutional framework - and, in particular, to improve economic policy coordination in the euro area - has undoubtedly been one of the lessons to be drawn from the recent Greek public debt crisis. Indeed, in mid-May the European Commission unveiled a proposal for reforms in three key areas: the reinforcement of surveillance procedures in respect of competitiveness and macroeconomic imbalances, setting in place a systematic framework for their diagnosis; the reform of the Stability and Growth Pact, to strengthen its preventive arm, to give greater relevance to public debt and to aspects relating to the sustainability of public finances, and to strengthen the incentives and mechanisms that ensure strict compliance with the commitments acquired; and, finally, to push through the design of a permanent mechanism for the resolution of potential future crises in which, inevitably, any financial support decision would be subject to the principle of strict conditionality.