

## Executive summary

**A**fter a sustained period of good macroeconomic performance, new challenges have emerged for the euro area economy. Output growth moderated through 2007 and continued to lose momentum through 2008, with GDP declining in both the second and third quarters of the year. The slowdown has been compounded by the international financial market turmoil that began in August 2007 and intensified in September 2008. World economic activity has slowed markedly. Earlier increases in commodity prices drove inflation well above the European Central Bank's price stability objective, though it has subsequently fallen back.

Although the euro area initially weathered these shocks, output is now expected to contract in the second half of 2008 and the first half of 2009, with growth remaining below trend until mid-2010. Money market pressures had been contained by the central bank until recently but credit conditions for the private sector have tightened. However, a sharp contraction in bank credit has not yet occurred. Although upside risks to price stability have not completely disappeared, there is little evidence as yet of broad-based second-round effects and price expectations appear to have remained well anchored. There are, however, serious risks to the growth outlook. National and European authorities need to continue to assess and respond to developments in financial markets and the wider economy. This episode of financial instability has highlighted the need for adequate regulation of financial activity, which is a particular challenge in Europe's increasingly integrated capital market. It poses challenges for the authorities in the short term. In reacting to these developments, policy actions that would undermine longer term objectives should be avoided. There remain long-run challenges to achieve fiscal sustainability, improve macroeconomic resilience and raise living standards by enhancing structural reforms in European markets.

**Financial innovation and integration have changed the landscape.** The European financial system has developed and become more integrated, although more could be done to enhance competition in retail banking. Credit growth has been buoyant, large complex cross-border banking groups have emerged and financial innovations have created possibilities for greater risk diversification, but have also increased risk-taking. This has increased the inter-linkages between national markets and is likely to have changed the transmission of monetary policy to economic activity.

**Strengthening the policy framework to deal with systemic risks in the financial system.** The on-going financial market turmoil associated with an unwinding of the credit cycle and the recent freezing in the interbank market has posed a major challenge to policy makers. Co-ordinated action by the European and national authorities has been taken to restore confidence in financial markets. Recent events also point to weaknesses in regulatory and supervisory frameworks which are being addressed at the European and international level. Although progress has been made, it is essential to reflect on how to align national supervisory systems to deal with cross-border risks by moving towards more centralised and EU integrated supervision. Policies need to be developed to deal with macro-prudential risks and ensure that regulation does not increase the pro-cyclicality of the financial system.

**The balance of risks to price stability has changed.** Headline inflation has reached very high levels but has recently decreased, and inflation expectations remain well anchored. With inflationary pressures diminishing, the ECB has cut its policy rate in concert with other central banks. The OECD projections suggest that substantial economic slack would develop over the next year, helping to bring down inflation further. Given these baseline projections, room for further easing of monetary policy could emerge. However, there is an unusual amount of uncertainty surrounding the economic outlook. If inflationary pressures turn out to be stronger than anticipated, room for manoeuvre will be constrained. Monetary policy should be ready to react should long-term inflation expectations become unanchored.

**Fiscal discipline should be improved further.** Fiscal performance in the euro area improved following the revision of the Stability and Growth Pact, helped by very favourable revenue growth, although in some member states sizeable deficits remained. The economic downturn and the costs of emergency actions taken by governments to stabilise financial markets will add to fiscal pressures. The long-run challenges due to the ageing of the population remain large and, in general, there is no strong case for discretionary fiscal expansion as the economy slows. Improving the quality of public finances, both on the spending and taxation side, would help to raise living standards.