

## Assessment and recommendations

The euro area achieved a high degree of macroeconomic stability over the first decade of economic and monetary union. The end of exchange rate turbulence and realignments within the euro area has proved to be a major asset. However, the financial market turmoil since the summer of 2007 and the intensification from mid-September 2008 is having a major adverse impact on the world economy. Although the immediate cause of the turmoil lay in the US subprime mortgage market, euro area financial institutions and markets were part of the prolonged credit cycle of recent years, and have been hit by heightened financial market stress. The current turmoil is the first financial crisis the euro area has had to face. It initially coincided with a very sharp increase in energy and food prices, as well as a substantial appreciation of the euro which mitigated the inflationary impact but reduced competitiveness. Today's priority for all member states is to find responses to the financial crisis and ensure their swift implementation. In reacting to these developments, policy actions that would undermine longer term objectives should be avoided. The necessary response to the possibility of financial instability touches many areas of policy making. It involves financial regulators, supervisors, central banks and finance ministries. This Survey reviews recent developments, looks at both monetary and fiscal policy and focuses on the nexus of issues related to financial markets. The macroeconomic analysis covers the euro area, while many aspects of financial regulation relate to national and European Union responsibilities within the European single market. Other structural issues related to growth will be dealt with in greater depth in the 2009 *Economic Survey of the European Union*.

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### *The economic cycle has turned and growth has slowed*

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Economic activity began to slow in the early part of 2007 and has steadily lost momentum, with output declining in both the second and third quarters of 2008. The previous five years had seen a sustained upturn in activity, boosted by strong export and investment growth. Consumption had nevertheless remained relatively weak, accounted for by a high rate of household saving and muted growth of disposable income. With demand tending towards capacity, monetary policy was tightened from December 2005. The euro appreciated steadily and, by mid-2008, was 30% higher in nominal effective terms than in mid-2002. It remains at an elevated level despite recent declines. Since growth began to slow, the euro area has been hit by three major macroeconomic shocks: energy and food prices have risen sharply, the global credit cycle has turned, leading to prolonged and severe turmoil in international financial markets, and the housing cycle has peaked in several countries.

The turmoil was triggered by events in the US subprime mortgage market, which had a widespread impact on financial markets. These events marked the turning of a much broader and sustained credit cycle, in which long-term interest rates fell to well below their long-run average, risk-taking increased and asset prices rose. The credit cycle boosted housing markets in many countries: euro area house prices have increased by around 50% over the past five years. As the cycle has reversed, market participants have become more risk averse, the cost of capital has increased and financial asset prices have declined. The aggregate effect of these shocks has begun to be felt in the euro area, despite the cushioning impact of the euro appreciation on import prices, the lower oil intensity of output, the less pronounced housing cycle, the relatively strong household balance sheet position, and greater distance from the financial activities at the heart of the crisis. The latest OECD projections suggest that output will decline further in the fourth quarter of 2008 and the first half of 2009 before recovering gradually. Growth is not expected to move above trend rates until the latter half of 2010.

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*Monetary policy must ensure that price stability is maintained in the face of volatile rates of inflation and the impact of the ongoing financial turmoil*

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Monetary policy was tightened between late 2005 and July 2008, with the policy rate increasing from 2 to 4¼ per cent to address upside risks to price stability. Policy rates were reduced by 50 basis points in October 2008 in co-ordination with six other central banks, reflecting declining commodity prices, moderating inflationary pressures, and diminishing inflation expectations. An additional 50 basis point cut was made in early November. Furthermore, the intensification of the financial turmoil in the second half of September 2008 has augmented the downside risks to growth and diminished further the upside risks to price stability. *Ex ante* real rates now appear to be close to or below their long-run average. But credit spreads remain elevated due to the financial market turmoil and bank lending standards are tighter than before the turmoil, although the pace of credit expansion to the non-financial sector has slowed only gradually. The nominal exchange rate appreciated substantially, although it has fallen back somewhat since the spring of 2008. Despite the recent substantial cut in policy rates, financial conditions are not particularly accommodative.

Inflation rose substantially from the early part of 2007, reaching 4% in mid-2008. It had previously remained close to, but above the European Central Bank's definition of price stability. The sharp increase in inflation was largely due to an unanticipated surge in global energy and food prices, over which domestic monetary policy has little influence. Core inflation (excluding energy and food) has remained below 2% and services inflation has been steady at around 2½ per cent. This suggests that broad-based second-round effects have remained limited so far, although unit labour cost growth has risen, suggesting that underlying price pressures remain. Higher energy costs also dampen potential growth. Headline inflation has declined since July 2008 and if the recent weakening in commodity prices is sustained, it could drop well below 2% during the course of 2009 according to the OECD projections. With weak output growth, sizeable economic slack may develop, provided potential growth does not slow excessively, moderating underlying wage and price pressures. Given these baseline projections, room for further easing of monetary

policy would emerge. However, there is an unusual amount of uncertainty surrounding this baseline scenario. If financial conditions were to be more severe than anticipated, or activity to drop particularly rapidly, deeper interest rate reductions could prove necessary. On the other hand, if inflationary pressures are stronger than anticipated, room for manoeuvre will be constrained. Monetary policy should be ready to react should long-term inflation expectations become unanchored.

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*The ECB has established a sound policy framework, but the communications framework could be refined*

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The euro has successfully established itself as a stable currency and the ECB has developed a sophisticated framework for setting monetary policy. Over the first ten years of monetary union, inflation has been close to, but just above, 2% on average and has been relatively stable around that level both compared with past experience and the performance of other developed economies. This achievement has been underpinned by the ECB's two-pillar strategy. Clear communication is an important part of this success, although further enhancements should be introduced. It is recommended that the ECB publishes forecasts showing to the public quarterly profiles sufficiently far into the future for first-round effects from shocks and policy changes to be completely absorbed, as they may help shape expectations about future inflation. However, any enhancement of the current projections should be done in full accord with the ECB's two-pillar strategy which already links medium-term inflation expectations to monetary developments. In this context, more detailed and regular explanation of analysis under the monetary pillar of the ECB's framework could provide more information to the public about the implications of current monetary growth for future inflation and the basis on which policy rates are set. The decision of the Governing Council of the ECB from 2007 to further enhance its monetary analysis along a number of well-defined avenues should help to address the need for further information.

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*Liquidity management has contained the immediate impact of the financial turmoil on money markets*

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The current episode of financial instability has seen marked turmoil in the money markets. The difficulty of assessing the value of exposures related to the US subprime mortgage market made banks reluctant to lend to each other. As a result, money market interest rates rose sharply. The ECB and other central banks provided liquidity to the banking system through various types of refinancing operations. Although greater liquidity provision contained the increase in spreads on money market lending during the first phase of the financial turmoil, the intensification of financial stress in September and early October of 2008 caused spreads to increase dramatically. This in turn has brought about further co-ordinated liquidity injections from the ECB and other central banks. The ECB has needed to make relatively few changes to its operational framework as a wide range of collateral was already accepted, many institutions had access to its monetary operations, and banks are required to hold relatively high levels of reserves, which are remunerated. The ECB has used the flexibility of its framework to enhance market

liquidity, particularly since the intensification of financial turmoil in mid-September 2008. For example, the ECB introduced a fixed rate tender with full allotment for its main refinancing operations and widened its list of eligible collateral. Action and communication by the ECB helped to contain the increase in market interest rates, although these remain higher than before the turmoil began. Consideration should be given to the lessons that can be learnt from this episode for collateral pricing and risk control.

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*European financial markets have become deeper and more integrated, transforming the financial landscape*

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Considerable progress has been made in integrating and deepening European financial markets during the first decade of monetary union, including the cross-border consolidation of financial companies and infrastructures. The introduction of the euro has created broader and deeper capital markets for debt securities and equity financing, and new policies have helped to bring down barriers to the provision of financial services across borders and create new common payments infrastructures. Financial innovation and enhanced market integration have increased competitive pressures and facilitated financial deepening. The assets and liabilities of households, businesses and financial institutions have risen markedly relative to incomes and output, and the geographical distribution of assets has become more dispersed. But, impediments to cross-border provision of financial services remain, especially in mortgage markets, and policy should do more to foster integration, for instance, by improving the access of foreign institutions to national credit and land registries and harmonising the cost and duration of foreclosure procedures. Supervisory and regulatory practices will have to keep pace with deeper cross-border integration.

Financial market growth and financial innovation have widened the range of financing and investment opportunities available to households and companies. Ultimately, such changes should be beneficial for growth prospects. The changes will also affect the speed and extent to which monetary policy decisions are transmitted to the euro area economy. Some channels of policy transmission have strengthened over the past decade and new channels have appeared, while others may have become weaker. Greater opportunities for risk-taking are likely to exacerbate potential non-linearities in the transmission of policy, with policy-induced changes in asset and collateral values also affecting risk perceptions and risk tolerance. The overall balance of such changes is difficult to evaluate, given the comparatively short time period for which data are available, but the analytical work of the Eurosystem Monetary Transmission Network should be revisited and updated.

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*Sound financial regulation is needed to manage risks to financial stability*

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More integrated and developed financial markets in Europe have contributed to economic growth and fostered resilience as larger and more diversified financial systems are better placed to absorb economic shocks. However, it may also open up additional channels for the transmission of financial shocks, including across borders. Moreover, several new financial products have contributed to more risk taking. The appropriate design of

regulation is a complex issue, which requires the balancing of stability, innovation and growth considerations. It is unlikely that future episodes of instability can be avoided altogether. It will always be challenging for regulators and supervisors to stay informed, because of information asymmetries, about the institutions they supervise and to keep pace with innovations and their potential impact on the stability of financial markets. The European single capital market continues to be heavily reliant on co-operation between national regulators working within differing supervisory structures, having different responsibilities, instruments and powers. Against this background, it is necessary to continue efforts to ensure a level playing field, to enhance the sharing of information between regulators and supervisors and to align the incentives of national authorities with the cross-border impact of their institutions.

The on-going global financial market turmoil has raised a number of issues about how institutions should be regulated and supervised. European authorities are participating in a number of international initiatives to respond to the weaknesses revealed by the financial instability. In October 2007, the Economic and Financial Affairs Council (ECOFIN) agreed a specific roadmap of policy actions in the wake of the onset of financial turmoil, consistent with recommendations made at the international level, i.e. notably the Financial Stability Forum and the G7. The Council agreed on a work programme, aimed at reviewing, along with the EU's international partners, how to further improve transparency, valuation processes, risk management and market functioning. EU authorities should continue to follow international initiatives closely. The main policy priorities are:

- Improving transparency through enhanced disclosure of risk, improved valuation methods and a more comprehensive picture of off-balance sheet entities.
- Changing the role of credit rating agencies and improving their functioning.
- Strengthening risk management standards and procedures, and providing better incentives to hold appropriate levels of capital. Liquidity risk management should be improved.
- Regulators and supervisors should become more responsive to risks. This requires: better information about financial developments; a well-defined framework for liquidity provision in conjunction with the monetary authorities; enhanced mechanisms for identifying and dealing with failing banks at an early stage; more effective and specific bankruptcy procedures for banks; and better cross-border supervisory arrangements.
- Ensuring that adequate deposit-insurance schemes are in place and that payouts are swift and predictable.
- Developing policies to reduce the pro-cyclicality of financial regulations and policies that can be used to “lean against the wind” such as smoothing capital and provisioning requirements.

Concrete steps have been taken by the EU authorities in these areas. The European Commission has already put forward a revision of EU rules on deposit guarantee schemes. In response to the intensification of the financial turmoil in September and early October 2008, individual countries initially pursued a wide variety of responses, including comprehensive packages to recapitalise the banking system, *ad hoc* measures to recapitalise or provide emergency funding to individual financial institutions, providing blanket guarantees of all retail deposits, and guaranteeing that no financial institutions would be allowed to fail. These initiatives were followed by a co-ordinated rescue plan for

the EU banking system adopted by the European Council in mid-October. This committed governments to:

- Ensuring appropriate liquidity conditions for financial institutions.
- Providing financial institutions with additional capital resources and allow for efficient recapitalisation of banks.
- Adopting changes to accounting standards to mitigate the consequences of the exceptional recent turbulence in financial markets.
- Enhancing co-operation procedures among European countries.

Moreover the Council also decided to establish a financial crisis unit to ensure a rapid EU response to crisis situations and improve the co-ordination of measures taken by individual member states. The European Commission is playing its part in ensuring that national rescue plans are implemented quickly by providing rapid decisions on their compatibility with state aid rules. Member governments have since announced the details of how these guidelines would be translated into actions in their respective countries. While indicators for the financial sector have started to show some improvement since mid-October, indicators for non-financial companies and emerging markets have been deteriorating further, reflecting concerns about the weakness of the global economy.

Policy interventions in financial markets need to be designed carefully. For instance, allowing institutions to deviate from strict application of marking their assets to market may give them some breathing room during the current crisis, but it may also undermine price discovery. It is also unclear whether guarantees to prevent banking failures are appropriate when some institutions, which are not systemically important, may prove insolvent. However, in real time it can be difficult to distinguish between insolvency and illiquidity. As agreed by the European authorities, interventions should be timely and temporary, mindful of tax payers' interests, and ensure that existing shareholders bear the consequences of the intervention and that management does not receive undue benefit. Detailed consideration will also have to be given to how countries exit from the commitments they have made when the turmoil eventually dissipates. Finally, while differences in liquidity and solvency concerns mean that it is appropriate for countries' responses to the crisis to differ, countries should keep externalities for other European countries to a minimum, and competition should not be distorted.

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*Financial regulation and supervision need to reflect Europe's integrated capital market and cross-border risks*

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The main challenge is to manage systemic and cross-border risks in order to ensure financial stability in an integrated financial market. The Capital Requirements Directive establishes the key standards for banking solvency. Banking supervision, however, has primarily remained the responsibility of national supervisors. The single EU banking passport sets out many areas where home country supervisors are responsible for branches of cross-border banks, while subsidiaries are supervised by host country supervisors. The Lamfalussy structure provides a framework for updating EU financial regulations as well as converging supervisory practices. Co-ordination between national supervisory authorities is encouraged both through the Lamfalussy level 3 committees

(covering banking, insurance and securities markets) and the Banking Supervision Committee.

This current regulatory regime in the EU has a number of advantages. It aligns regulatory and legal responsibility for firms with political and fiscal responsibility, should things go wrong, and with the operation of national insolvency law and the operation of national deposit guarantee schemes. However, the EU's current regime and the patchwork of different instruments, institutions and responsibilities does carry some disadvantages, especially as large complex financial institutions have extensive cross-border activities and the potential to have a significant impact on the wider economy. There is a risk that differences in regulation between countries lead to regulatory arbitrage, undermining the objectives of the regulation and distorting the operation of the European single market in capital services. The existing system relies heavily on close co-ordination and information sharing between different regulators with a variety of responsibilities and approaches. It also imposes a considerable burden on cross-border firms that have to report to an array of different authorities. National supervisors are closer to the institutions they supervise, but a more centralised and uniform system for supervising large complex financial institutions would also have advantages by pooling information, regulating in a consistent way, enhancing preparedness for a crisis and reducing regulatory costs. Although the ECB carries out macro-prudential supervision in the euro area, there is a need for better linkages between macro and micro-prudential supervision. The envisaged co-operation between the Committee of European Banking Supervisors and the ESCB Banking Supervision Committee regarding a semi-annual risk assessment in the EU is a useful step in this direction. Moreover, further convergence of regulatory and supervisory practices would be desirable.

Progress is being made to improve EU regulation: ECOFIN adopted a roadmap on improving the Lamfalussy framework in December 2007. This improves and streamlines the processes for developing financial regulations and enhances the role of the level 3 committees. The Commission is working on a revision of the Commission Decisions establishing these Committees. By the end of 2008, they will be assigned specific tasks, such as mediation, drafting recommendations and guidelines and having an explicit role to strengthen the analysis and responsiveness to risks to the stability of the EU financial system. In October 2007, the Council adopted conclusions setting out further steps at both EU and national levels for the development of financial stability arrangements. The conclusions included common principles, a new Memorandum of Understanding for crisis management, and a roadmap for the enhancement of co-operation and preparedness and for reviews of the tools available for crisis prevention, management and resolution.

Proposals are being formulated or considered to deal with a number of issues, including the cross-border transfer for assets and other questions within the review of the Winding Up Directive and amendments to the EU regulations relating to Deposit Guarantee Schemes. Moreover, in October 2008, the Commission adopted a proposal for a revision of the Capital Requirements Directive. Elements of this proposal relate to the establishment of Colleges of Supervisors to enhance cross-border co-operation between supervisors, the mandatory exchange of information between supervisors to help detect signs of financial stress, reducing banks' exposure to interbank lending markets, and requiring firms issuing asset-backed securities to hold a portion of the securities on their balance sheets. In this context, a coherent group-wide supervision could be supported by strengthening the role

of the “consolidating supervisor”. In the meantime, guidelines concerning the public support for banks have been issued.

Achieving a coherent system of financial supervision as well as managing cross-border risks calls for a more centralised and integrated approach. Possible options might include the establishment of a single EU financial supervisor or a European system of supervisors, with a central agency working in tandem with national supervisors. Either option has the potential to improve the monitoring and containment of systemic risks within the rapidly growing and increasingly integrated European financial market. A European system would probably be easier to integrate with the existing framework and might be able to ensure cultural and geographic proximity of supervision. In principle it should be possible to balance the interests of both home and host countries. However, if such a system was unable to overcome national biases and the externalities that arise from them, a single supervisor should be considered. As a matter of urgency the principles and procedures for burden sharing should be specified in greater detail, a European dimension should be added to the mandates of national supervisors to align their incentives, regulations should be more closely harmonised to limit compliance costs and EU-wide reporting forms introduced. Colleges of supervisors should also have enhanced powers to foster effective supervision, and the role of level 3 committees should be expanded to ensure that the colleges work effectively. Recent events have made it clear that it is essential to reflect on how to elaborate a longer term and shared vision of the EU supervisory architecture, combining the need to safeguard EU financial stability with legitimate national interests.

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*The public finances have improved,  
but the downturn will test  
the Stability and Growth Pact*

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Fiscal performance improved in recent years. The overall euro area fiscal deficit shrank from 2.5% of GDP in 2005 to 0.6% in 2007 and the cyclically-adjusted fiscal deficit declined as well. Some countries achieved impressive fiscal positions but some high-debt countries made little effort to improve their fiscal position. The last economic expansion was particularly rich in revenue and generated strong growth in receipts from corporation tax and taxes related to capital gains and property, so that the measured improvement in the underlying fiscal position is likely to be overstated. The economic downturn, unfavourable developments in tax elasticities, and the actions being taken by governments to stabilise financial markets will add to fiscal pressures. The euro area actual fiscal deficit is expected to increase by 0.8% of GDP in both 2008 and 2009, reversing much of the decline in 2006-07. Government debt had fallen as a share of GDP, but is now set to rise again. The major challenge for long-run fiscal sustainability remains ageing and healthcare costs: the most recent estimate from the European Commission suggests an increase in the share of age-related spending of 4.4% of GDP between 2010 and 2050, bringing this share to about 28% of GDP but the actual costs could be much higher. Consideration should be given to how this challenge will be addressed through structural reforms and pre-funding.

The revised Stability and Growth Pact (SGP) agreed in 2005 has been successful up until recently, but has yet to be tested in an economic downturn, or a financial crisis. Euro area countries had emerged from Excessive Deficit Procedures under the “dissuasive arm” of the Pact in recent years. The greater discretion under the revised Pact has hardly been used so far and should be used only sparingly. In fact this is exactly what has happened since

the 2005 reform of the Pact. The SGP's "preventive arm" has continued to develop, with greater focus on the achievement of long-run fiscal sustainability. Nevertheless, the existing range of the country-specific medium-term budgetary objectives (MTOs) does not fully reflect the fiscal sustainability challenges facing different countries: the current proposals to take implicit liabilities into account when setting MTOs should be implemented. The objective of attaining the MTOs by improving the structural balance by 0.5% of GDP or more in "good times" has had mixed results. The definition of good and bad times and the calculation of their impact on budgetary balances could be refined further. There should be greater emphasis on asset prices and a disaggregated analysis of revenues in assessing structural balances.

Fiscal policy in some euro area member states tightened as the economy expanded in recent years, but policy has remained pro-cyclical in others and a few were forced to tighten policy under adverse cyclical circumstances. In the context of the current economic slowdown and the exceptional measures being taken to support the financial system, discretionary fiscal policy may be appropriate where room for manoeuvre exists. Any discretionary easing should be timely, targeted and temporary and take into account specific challenges of the country concerned. The reformed Stability and Growth Pact provides sufficient flexibility to allow for fiscal policy to play its normal stabilisation function. The relatively large automatic stabilisers in Europe will help cushion the slowdown. The priority should remain improving long-run fiscal sustainability, given the challenges stemming from ageing. This is in line with the conclusions of the October 2008 ECOFIN Council. In addition, fiscal incentives to invest in housing exacerbate the housing cycle and should be phased out in the long run. Moreover, in some cases there is opportunity for property taxation to be designed more efficiently, allowing it to function as a built-in stabiliser. However, due account would need to be taken of the timing of these changes, especially with regard to the risk of exacerbating further the present difficulties in the housing market.

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#### *The quality of public finances should be raised further*

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The efficiency of government intervention is an important way in which fiscal policy can contribute to raising living standards, with key factors including the ways in which money is spent and the design of the tax system. This is a key issue for the euro area because public spending accounts for around 45% of GDP on average. Infrastructure investment can help to raise living standards, although it should be well-designed and policies such as user charges can contribute to its efficient use. The efficiency of public spending is hard to assess. But, there is some evidence that euro area countries could benefit from improving value for money: educational attainment could be raised by following international best practice or raising the efficiency within national systems towards those of the best performing schools; and health spending could be better used to improve outcomes. The design of the tax system should be improved by increasing the use and efficiency of consumption taxes, which would be less distorting than the current degree of reliance on personal income taxes, although in seeking such reform it is important to consider the effect on the distribution of real incomes. Moreover, strong fiscal governance frameworks can help to ensure sound budgetary positions and improve the efficiency of public spending.