

Report on the 2009 annual statement on the euro area and public finances

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The Commission presents its Annual Statement on the Euro Area 2009.

1) The European Area Economy in 2009: the report states that in the wake of the shockwaves of the worst crisis since the 30s, **signs of economic stabilisation are emerging**. Important policy interventions have succeeded in achieving a degree of stability in the financial system. Financial conditions have improved over the summer, with several financial indicators returning to pre-crisis levels. Growth in the euro area is set to fall by 4% in 2009, unchanged from the Spring 2009 forecast. The stronger than expected contraction in activity in the first quarter was compensated for by a faster than projected stabilisation in the second quarter, especially in Germany and France.

However, the strength and resilience of the recovery has yet to be fully tested. While banks are in the process of strengthening their solvency ratios, the stabilisation in financial markets has yet to yield concrete outcomes for credit distribution to the economy, which has decelerated considerably throughout the first half of 2009.

The euro has acted as a valuable shield in the crisis, by protecting the euro area from the exchange rate and interest rate turbulence that had proved so damaging for Member States in episodes of financial market stress in the past. The financial crisis has increased the attractiveness of the euro for non-euro area Member States, eliminating the risk of sudden and disruptive exchange rate movements, but has also shown that the euro does not solve challenges related to internal and external imbalances. This experience confirms the rationale for achieving a high level of sustainable convergence prior to euro adoption.

The crisis is amplifying some challenges in the euro area, weighing on the sustainability of public finances and potential growth. As a consequence of the steep fall in revenues, fiscal stimulus measures under the European Economic Recovery Plan (EERP) and the operation of automatic stabilisers, **government balances have deteriorated sharply**. The average euro area budget deficit is now expected to increase from 2% of GDP in 2008 to over 5% of GDP in 2009. Almost all euro area Member States will post budget deficit ratios above the 3%-of-GDP threshold, with some countries exceeding the benchmark by a large margin.

2) Imbalances accumulated in the past rendered some euro area Member States more vulnerable when crisis struck. At a global level, the speed and intensity of the contagion from the Lehman Brothers bankruptcy came as a surprise. While the global, interconnected nature of the banking and financial system largely accounts for the contagion, the difficulties experienced by some Member States have underscored a number of vulnerabilities within the euro area itself.

Accumulated intra-euro area imbalances exposed some economies, more than others, to shocks. From a balanced position in 1999, surpluses steadily accumulated and reached 7.7% of GDP in 2007, while aggregated deficits rose from 3.5% of GDP in 1999 to 9.7% in 2007.

In countries in deficit, the divergence trend reflected the build-up of domestic imbalances. They materialised through excessive domestic demand pressures, a surge in house prices and a bloated construction sector. This was especially patent in Ireland, Spain and Greece, which consistently recorded higher growth and inflation than the rest of the euro area during the decade. Conversely, countries in surplus capitalised on their traditional strengths, with a growth model centred on their already-competitive

export sector. In these countries the engine of domestic demand never really kicked in to take over the export engine. The impact of the crisis revealed the vulnerability of this growth model to fluctuations in global demand, with implications for growth in the euro area as a whole.

Another source of imbalances lay in the rapid growth of the financial sector. Ireland has been a textbook case and following the crisis, ballooning impaired assets weakened the banking sector and put public authorities, acting as the lender of last resort, under pressure.

Such imbalances explain why the crisis has hit some Member States harder than others. **Overall, Member States pursuing unbalanced growth models have suffered particularly severe economic contractions. The impact of the crisis demonstrates the need for action.** Policymakers in Member States largely ignored these imbalances in good economic times. They should not be ignored any longer.

3) Unfinished business also hampered the euro area's capacity to respond to the crisis: deeper financial integration in the euro area was not matched by a parallel strengthening of supervisory arrangements. The Commission has acted effectively to fill this gap. It provided a common framework for the implementation of national banking rescue plans, in line with state aid rules, benefiting also from ECB support. While the fiscal house was mostly in order when the crisis struck, some Member States had limited room to respond to the crisis. Public debt levels remained high in Greece, Italy and Belgium, while fiscal consolidation was slow and indecisive in France, Greece and Portugal. In other countries, public finances became dependant on fiscal revenues either from the financial sector or the real estate boom whose slump added to the deterioration of public finances and greatly diminished the fiscal room for manoeuvre available to counteract the effects of the crisis. Globally, euro area governments did their fair share in the concerted global effort to sustain demand within the EU-wide coordinating framework of the EERP. The overall fiscal support amounts to about 4.6% of euro area GDP (about 5% for the EU as a whole).

The aggregate impact of the euro area economic policy response could have been faster and perhaps stronger if co-ordination had started earlier and been more comprehensive.

4) The way forward: ensuring efficient internal adjustment and sustainable growth in a challenging environment. The crisis has clearly demonstrated the urgency for euro area Member States to make rapid progress on the EMU@10 reform agenda: broadening and deepening macroeconomic surveillance. In its [EMU@10 communication](#) in May 2008, the Commission proposed a three-pillar agenda to improve the functioning of EMU in the face of a rapidly changing global environment, ageing populations and rising concerns about energy and climate change.

It also called for the deepening of fiscal policy coordination and increased surveillance.

Broader macroeconomic surveillance is urgently needed to spur a co-ordinated policy response to the competitiveness challenge. The broadening of surveillance should also incorporate financial market developments in earnest.

Surveillance should be deepened to ensure sustainable public finances. In the wake of the crisis, the combination of low growth and accelerating debt risks putting public finances in a precarious situation, just when the impact of ageing is starting to set in. If policies are unchanged, public debt in the euro area is projected to reach 100% of GDP in 2014. As part of a deeper fiscal co-ordination in the euro area, **a firm commitment is needed for a fiscal strategy that can appropriately balance stabilisation and sustainability considerations in line with the Stability and Growth Pact.**

Co-ordination across policies and Member States should be enhanced to permit judicious exit strategies. Differentiated policy responses will need to be incorporated in national exit strategies so as to achieve the best global output. In line with the Council recommendations to the euro area in the context of the Lisbon

strategy, progress is needed on the implementation of reforms that enhance potential growth and facilitate adjustment to shocks.

The crisis underscored the **need to reinforce the framework for euro area surveillance and governance**. The Lisbon Treaty provides the necessary platform for the further improvement of economic governance of the euro area. Highlighting the need to develop ever-closer co-ordination of economic policies within the euro area, a new Protocol attached to the Lisbon Treaty gives formal recognition to the Eurogroup and its President. The Lisbon Treaty also strengthens the role of the Commission in the surveillance of the functioning of EMU.

Lastly, the Commission considers that **united, the euro area can influence the global agenda**. The emergence of the G20 as the forum of choice for the promotion of global economic and financial governance reform raises the stakes for the euro area. In this context, the euro area should be considered as a single economic entity, which will continue to grow in importance as new members progressively join. For the euro area to speak with a strong voice at the global level, the EU external representation, particularly within the IMF, needs to be strengthened. Now is the moment, while discussions on quota and representation reform are gaining momentum.