July 2009
IMF Country Report No. 09/223

Euro Area Policies: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Member Countries

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 28, 2009, with the officials at EU institutions in the context of the Article IV consultations with member countries forming the euro area. Based on information available at the time of these discussions, the staff report was completed on July 1, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 17, 2009, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Germany, on behalf of the euro-area Member States and the European Community.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

Staff Report for the 2009 Article IV Consultation with Member Countries

Prepared by the European Department

Approved by Marek Belka and Tamim Bayoumi

July 1, 2009

- A staff team held discussions at the European Central Bank (ECB), the European Commission (EC), Eurostat, and the Committee of European Banking Supervisors (CEBS) during May 15–28, 2009. The team comprised Messrs. Belka (Head), Čihák, Everaert, Fonteyne, Harjes, Stavrev, and Ms. Sgherri (all EUR), Mr. Nier (MCM), and Mr. van der Mensbrugghe (EUO).

- Meetings were held at the ECB with President Trichet, Mr. Bini Smaghi, Mr. González-Páramo, Mr. Stark, Ms. Tumpel-Gugerell, and senior staff. At the EC, the mission met with Commissioner Almunia, Mr. Buti (Director General for Economic and Financial Affairs), Mr. O'Sullivan (Director General for Trade), and other senior officials. The mission also met with representatives of labor unions, financial market participants, and think-tanks. Messrs. Belka and Everaert discussed the mission's preliminary findings at the May 28 Euro Working Group meeting, and presented its concluding statement to the Eurogroup Ministers on June 8. Mr. Stein (Executive Director) and Mr. Pineau (ECB Observer at the Executive Board) attended most of the meetings.

- The authorities released the mission's concluding statement in Luxembourg on June 8, 2009.

Contents

EXECUTIVE SUMMARY

The euro area remains in recession, amid tentative signs of improvement and an uncertain outlook. Three key elements are weighing on the recovery: (i) remaining stresses in the financial system, including adverse feedback loops with the real sector as a result of the recession; (ii) soft demand associated with fragile confidence; (iii) and structural rigidities, especially in the labor market, which also constrain the area's potential growth. The discussions focused on actions needed to support the recovery, return to self-sustaining growth, and address cross-border spillovers in the EU.

Financial sector policies: There was agreement that the financial sector remains key to the shape and the robustness of the recovery. While a broad policy arsenal to shore up the sector has been put in place, take up of various measures, in particular of recapitalization, has been lagging. The staff recommended a more proactive approach consisting of a comprehensive review of the financial positions of banks to assess capital needs and viability, accompanied by follow-up action comprising disclosure, recapitalization, and, where needed, restructuring or resolution of financial institutions. The EC advocated a very similar approach, while the ECB emphasized the need for a speedy implementation of the measures already in place. There was broad agreement that the proposed new financial stability arrangements for the EU ought to be implemented on an ambitious time table.

Monetary policy: The ECB and the staff concurred that monetary policy has to maintain a supportive stance, keeping in mind both downside risks and exit strategies. The staff argued for keeping interest rates low by continuing to provide unlimited term funding at fixed rates as long as disinflationary pressures persist. All unconventional measures would need to remain under consideration to deal with the risk of protracted deflation. The ECB emphasized that the design of its unconventional tools reflected the concern to ensure a relatively straightforward exit and noted that, if needed, it could issue its own paper or offer additional short-term deposit facilities to mop up liquidity.

Fiscal policy: With a slow recovery ahead, authorities and staff agreed that a supportive fiscal stance should continue into 2010, while emphasizing the need for countries to cast any short-term fiscal actions in medium-term consolidation programs supported by the Stability and Growth Pact (SGP). The staff cautioned against a premature withdrawal of stimulus, while arguing for a pre-announcement of fiscal consolidation plans, to be implemented as soon as recovery takes hold. It was agreed that national fiscal institutions should foster ownership of consolidation goals, and that surveillance has to be stepped up at EU and national levels over progress toward medium-term objectives—which should better reflect the level of debt and costs of aging.

Structural and trade policies: With the crisis likely curbing potential growth, there was agreement that reinvigorated structural reforms are highly desirable, especially to support economic restructuring and keep the labor force attached to the labor market. All agreed on the importance of countering protectionist pressures from the crisis and concluding an ambitious Doha Round agreement to bring about new trade opportunities.

I. STAFF APPRAISAL

1. **The euro area is in recession with tentative signs of improvement yet to germinate into a recovery**. The euro area has been hard hit by the collapse in trade on the heels of the global financial turmoil, exacerbated by a correction of home-grown imbalances in some countries. Survey indicators have been recovering, and the fall in indicators of economic activity slowing. But stresses in the financial system, corporate defaults, rising unemployment, and fragile confidence are weighing on the recovery, while structural rigidities could undermine potential growth. Thus, while the decline in activity should moderate through the remainder of 2009 and give way to a modest recovery in 2010, such a scenario remains surrounded with high uncertainty.

2. **To support the recovery and return to self-sustaining growth, policymakers need to take further decisive action, especially in the financial sector**. A broad arsenal of financial sector, monetary, and fiscal policy tools have been deployed to address the crisis. It is now urgent to complete the task by implementing a proactive strategy to deal with remaining stresses in the financial system. The momentum to establish new financial stability arrangements in the EU should be seized without delay, and extended to efforts to deliver fiscal sustainability and to structural reforms, with the latter crucial to shore up flagging growth potential. More effective coordination of policy actions across areas and borders, including support for neighboring emerging economies, will be beneficial to help restore confidence in the region's economy.

3. **A resolute and coordinated clean up of the banking system is essential to restore trust in the financial system**. The financial positions of banks need to be reviewed to assess capital needs and viability, including a thorough forward-looking assessment of the impact of the ongoing recession on capital. Most importantly, this review should be followed up by comprehensive action involving disclosure, recapitalization, cleansing of the financial system of its impaired assets, and, if needed, restructuring of financial institutions. While national authorities will have to be in the driving seat, coordination of the exercise at the EU level will be essential for its effectiveness, including in boosting confidence. To avoid disorderly bankruptcy or recurring taxpayer bailouts of unviable institutions, national resolution toolkits should be expanded to allow national authorities to take control of financial institutions at an early stage.

4. **The ambitious reform of the EU's financial stability architecture agreed in June should be executed on the envisaged timetable**. Securing adequate resources, effective decision-making mechanisms, and independence for the new institutions will be essential, as will an unconstrained information flow among these bodies, central banks, and supervisors. The European Supervisory Authorities (ESAs) will need sufficient legal scope to establish a single rulebook, supported with effective transposition mechanisms at the national level and effective binding powers, which should not be unduly diluted by concerns over infringement

of national fiscal sovereignty. Central banks will have to play a strong leadership role in the European Systemic Risk Board, which should provide early warnings of a build-up of systemic risk and a much needed bridge between macroprudential analysis and supervisory and regulatory action. In parallel, the accelerated work under the ongoing crisis management roadmap should address crisis resolution and burden sharing issues, in the context solidly underpinning the single passport.

5. **With the euro area facing strong disinflationary pressures, monetary policy will need to remain supportive.** As a result of the ECB's far-reaching unconventional measures to support liquidity, initiated from the onset of the crisis, and its broad collateral policy, the liquidity premium in money markets has virtually disappeared and inflation expectations have remained well in positive territory. Still, headline inflation is likely to stay very low and a small deflation risk remains present, despite strong nominal rigidities. Thus, it will be essential to maintain the accommodative monetary stance as long as disinflationary pressures persist, by keeping interest rates low through the unlimited provision of term funding at fixed rates. The benefits of further cuts in the policy rate need to be weighed against their possible adverse impact on the functioning of money markets, but any potential margin for further reductions ought to be utilized as soon as possible. If downside risks were to intensify, a more forceful signal to keep interest rates low would be necessary. To deal with contingencies, all unconventional options, including active credit easing, will need to remain under consideration. Reassuringly, the ECB has taken care to secure a safe exit from its unconventional policies.

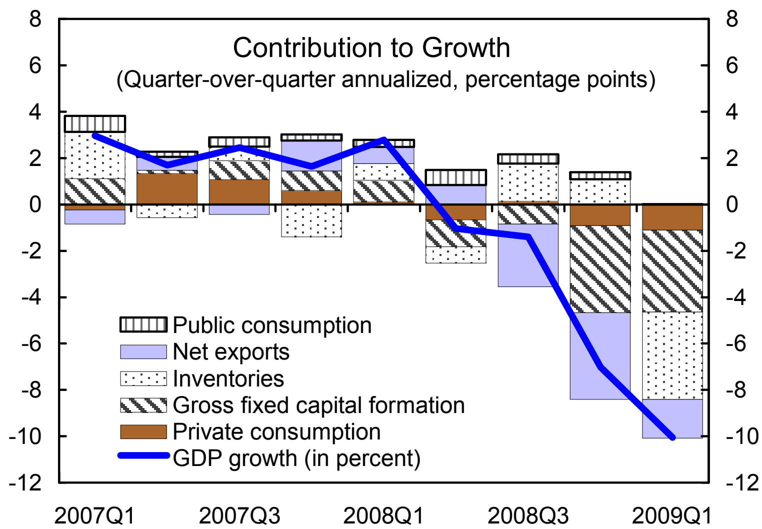
6. **While fiscal policy will need to continue to support economic activity in 2010, it is essential to embed short-term actions in credible medium-term consolidation programs to address solvency concerns**. Given the large automatic stabilizers, planned discretionary measures are broadly appropriate, with further stimulus to be readied in case the euro-area economy takes a notable turn for the worse. To boost effectiveness and to avoid distortions in the single market, more ex-ante coordination of fiscal measures would be beneficial. To address solvency concerns, short-term actions need to be combined with pre-announced fiscal adjustments, to be implemented as soon as the recovery takes hold and supported by application of the SGP. National fiscal institutions should foster ownership of consolidation goals and focus more on the level of debt and the cost of aging, as proposed by the EC. Surveillance over progress toward these medium-term objectives will have to be stepped up at both EU and national levels.

7. **Intensified structural reforms are vital to secure a durable post-crisis recovery**. Measures supporting shorter working hours and raising social benefits, while important during the recession, will need to be reversed to limit their adverse impact on potential growth. With economic restructuring ahead, a heightened focus on training, education, and job-matching will be very useful. And implementing the services directive, revamping the Lisbon agenda, and facilitating an ambitious and early conclusion of the Doha round will contribute to the foundations of a solid recovery.

8. It is proposed that the next consultation on the euro-area policies in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

II. Outlook, Risks, and Regional Spillovers

9. **The euro area economy has been experiencing a deep recession, with tentative signs of improvement yet to evolve into a recovery** (Figure 1, Table 1). The euro area was hit hard by the collapse in trade, amplified by tight financial conditions on the heels of the global financial turmoil and a correction of home-grown imbalances in some countries. Underlying factors of the economic decline are the large decrease in financial wealth (Figure 2), an associated rise in precautionary savings, increased difficulties in obtaining credit (Figure 3), and an adjustment of global imbalances. During the second half of 2008, a considerable buildup in inventories mirrored the surprise drop in demand, with the resulting inventory correction contributing significantly to a dismal first quarter in 2009. The recent improvement in sentiment and activity and leading indicators have thus far been signaling only a reduction in the pace of contraction in output. Owing to the tight financial and trade integration of the EU, feedback loops have been operating across borders and between the financial and real sector, with the recession now adding to the financial sector's woes. While the global crisis is the common driver, individual euro area countries are affected to varying degrees depending on the extent of their fiscal, financial, and external imbalances, and exposure to the global manufacturing cycle. Financial stresses differ across euro area countries: toxic legacy assets are unevenly distributed; home grown real estate busts feature large in Ireland and Spain but not at all in, e.g., Germany; and exposure to emerging economies is of considerable importance for Austria, Belgium, Greece, and Italy, but much less so elsewhere. And new member states (NMS) have been hard hit but with similar cross-country differences (Figure 4).



Sources: Eurostat; and IMF staff calculation.

10. **On the back of extraordinary policy support and a gradual decline in global risk aversion, financial conditions have improved, but remain relatively tight and corporate defaults are set to rise.** Growth in lending to households has been on a decelerating trend since before the beginning of the financial crisis in 2007, while bank lending to corporations slowed markedly in late 2008, primarily in response to weaker economic activity. Bank credit

to the private sector is very subdued and the banking sector will take time to fully resume its vital intermediation role. Supply effects seem to be negatively impacting recent bank loan developments, reflecting efforts to reduce leverage and capital shortages of banks. As cuts in policy rates were passed on—though not fully—and spreads fell, money market yields, including the one-year Euribor, declined significantly (Figure 5). Borrowing costs for investment grade companies fell back close to the historical average, but for lower-rated firms, credit costs remain high in real terms. And, while large non-financial corporations have managed to secure credit directly in financial markets, financing conditions for small and medium sized companies that have access to credit only through collateralized bank lending remain tight. Even though the corporate sector entered the recession in relatively solid financial shape, and structural reforms in some countries had increased its resilience, current credit spreads predict a sharp rise in default rates.

11. **After years of successful job creation and increasing participation rates, unemployment is set to rise appreciably in the euro area**. Past improvements in labor market performance stem from the introduction of flexible contracts, targeted cuts in social security contributions, and stepped up use of active labor market policies. As a result, job creation in the EU was strong during the last upswing. However, the duality between permanent and non-permanent jobs has increased. The current crisis will stress labor markets, and is likely to expose the inequity of this labor market duality.

12. **The recovery is likely to be slow and subject to considerable risks.** The decline in activity should moderate through the remainder of 2009 and give way to a modest recovery starting in the first half of 2010. Ongoing deleveraging, corporate restructuring, and rising unemployment will weigh on domestic demand. The adjustment of global imbalances and the relatively strong real exchange rate will limit support from the external side (Figure 6 and Box 1). Over the medium term, the euro-area’s remaining rigidities in labor and product markets, weak private balance sheets in some countries, and the larger role of the public sector are likely to constitute a drag on growth. Upside risks stem from low inventory levels, some pent-up demand, and further declines in the cost of credit which could support an earlier rebound in economic activity. Downside risks lie in a further weakening of the financial sector’s ability to support demand, globally as well as in Europe, abrupt adjustment of external imbalances, and a further deterioration of economic activity in key trading partners. Policy measures have significantly reduced negative tail risks in the financial sector and in emerging European economies that faced severe market pressures. Nonetheless some tail risks remain from a possible return of financial strains within the euro area, which could have adverse consequences on some member countries and emerging economies, or conversely from a deepening of the crisis in emerging Europe. Such tail risk could become more pronounced if policy support is prematurely withdrawn or policy coordination falters.

13. **The EC and the ECB broadly share this growth outlook**. The EC's forecast published in May sees growth in 2009 and 2010 slightly stronger than the staff, but also includes a significant, and retrospective, reduction in potential output. The authorities pointed out that adjustment, especially in countries with large home-grown imbalances, would reduce productive capacity and raise the structural unemployment for several years. The ECB staff forecast virtually coincides with the IMF's July WEO update. Consensus forecasts remain more sanguine.

The Growth Outlook for the Euro-area Economy

	Vintage	Real GDP 2008	2009 (Projections)	2010 (Projections)
		(Annual average percentage change)		
WEO	April 1/	0.8	-4.2	-0.4
WEO	July update 1/	0.8	-4.8	-0.3
ECB	June	0.6	-5.1 to -4.1	-1.0 to 0.4
EC	May	0.8	-4.0	-0.1
Consensus	June	-	-4.2	0.3

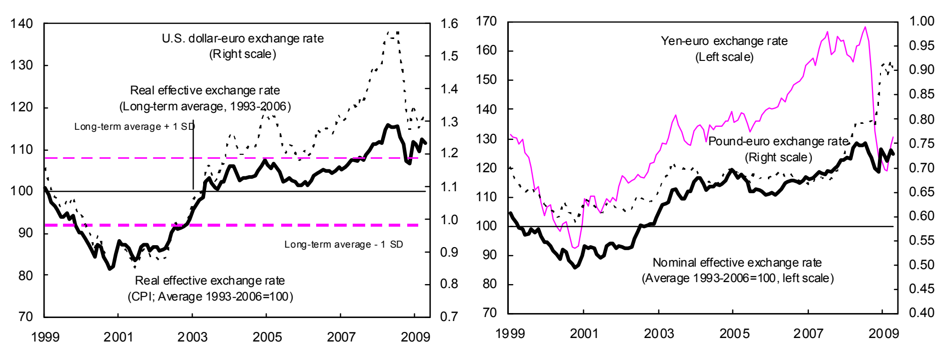
Sources: EC; ECB; and IMF.

1/ Not adjusted for number of working days.

Box 1. Assessment of the Euro

On the back of increased volatility over the past several months, the real effective value of the euro has depreciated by about 3 percent from its peak in mid-2008, reaching a level around 12 percent above its long-term average in May. This depreciation reflects a weakening vis-à-vis the US dollar (13 percent) and the Japanese yen (18 percent), partly offset by a strengthening mainly against the pound sterling (11 percent) and some East European currencies. The high volatility of the nominal effective rate of the euro since the beginning of this year reflect the high uncertainty in the foreign exchange markets as a result of the crisis. The current account turned to a deficit of 1 percent of GDP in 2008 from a small surplus in 2007 (Table 2).

Euro Area: Exchange Rate Developments.



Source: International Financial Statistics.

Staff assessment is that the euro is somewhat on the strong side relative to its fundamentals. Based on the exchange rate developments from February 25 to March 25, CGER estimates place the euro's overvaluation in a range of 0–15 percent. This assessment is broadly in line with developments of the margins of euro area exporters in the area's main trading destinations over the past couple of years (Figure 7).

CGER Assessment of the Euro Effective Exchange Rate 1/
(Percent deviation from estimated equilibrium)

	Macro balance	Equilibrium real exchange rate	External sustainability	Overall
Fall 2008 WEO	5	15	2	0-15 above
Spring 2009	5	17	0	0-15 above

1/ For details, see Exchange Rate Assessments: CGER Methodologies, IMF Occasional Paper 261.

14. **The crisis has amply demonstrated the importance of intra-euro area and intra-EU spillovers**. While all agreed that the increased economic and financial integration within Europe had been beneficial, it had also amplified the cross border transmission of shocks, while membership of the euro area clearly yielded protective benefits. The retrenchment of investors associated with the global increase in risk aversion and the flight to safety triggered a fanning out of sovereign spreads, even within the euro area, and underscored the vulnerabilities associated with large fiscal and external imbalances. Cross-border capital flows are likely to be lower permanently, causing serious adjustment problems for countries with large current account deficits. For euro area members and countries with pegged exchange rates, the adjustment will be more arduous in the short run than for countries with more flexible exchange rates. However, even in these cases, the task ahead will be difficult as exchange rate volatility may prevent use of monetary easing to support demand, while adverse balance sheet effects—households and businesses in many emerging economies hold sizable foreign currency liabilities—will dampen spending and raise nonperforming loans.

III. Policy Discussions: Ensuring a Sustainable Recovery

Discussions focused on the policies required to secure a durable recovery. EU institutions agreed that a more proactive and coordinated approach to relieve financial stress would be essential, and that backing from national authorities—which would have to be in the driving seat—would be key. Monetary and fiscal stances would need to continue to be supportive for some time, anchored in solid medium-term oriented frameworks with respect to price stability and fiscal sustainability. The staff underscored that policy actions would have to fully take into account cross-border spillovers. It welcomed the proposed new EU financial stability architecture, and encouraged the authorities to strengthen EU and national frameworks to achieve fiscal consolidation and structural reform.

A. Financial Sector

Managing the Crisis

15. **The financial sector remains key to the shape and the robustness of the economic recovery**. The ECB noted that euro area banks reported record credit losses for 2008, even though they were less exposed to toxic legacy assets than other advanced economies such as Switzerland, the United Kingdom, and the United States. While most banks still meet the minimum regulatory capital requirements, there is substantial uncertainty about the value of their distressed assets and the implications of the ongoing recession for asset quality. The perceived undercapitalization of banks by market participants is negatively affecting confidence, constraining credit flows and economic activity, and leaving the financial system hamstrung in fulfilling its vital intermediation role. The ECB—acknowledging the high degree of uncertainty and the gravity of the problems faced by the euro area's banking system—felt that capital needs would be lower than the GFSR estimates and released its own estimates of likely bank losses after the mission (Box 2). The ECB agreed that

Box 2. Large Bank Loss Estimates Call for Thorough Assessment of Individual Banks' Capital Needs

As a result of the current global financial crisis and the ongoing recession, euro-area banks are expected to incur substantial losses. Even though euro-area banks were less exposed to toxic legacy assets than banks in some other advanced economies, they reported large losses in 2007 and 2008. Staff and the authorities agree that a second wave of sizeable losses, tied to the recession, lies ahead. Subsequent to the mission, the ECB released its own estimates of likely bank losses and expected write-downs which are considerably lower than the Spring 2009 GFSR estimates.

Projected Euro Area Bank Losses 2007-10
(Billions of U.S. Dollars)

	GFSR (April)	ECB (June)
Total losses	904	649
Losses on:		
Loans	524	431
Securities	380	218
Recognized:		
Write-downs 1/	154	215
Provisions 2/	-	150
Further expected write-downs	750	283

Sources: ECB (Financial Stability Review June 2009); and IMF (GFSR April 2009

1/ As of December 2008 (GFSR), May 2009 (ECB).
2/ 2007 and 2008.

The differences between the GFSR and ECB estimates mainly reflect:

- **Asset coverage:** The GFSR covered all securities held by banks, except government securities, regardless of the jurisdiction of the assets. The ECB's coverage is somewhat more restrictive, however based on individual bank level data.
- **Loss estimation methodology and loss rates:** The ECB estimated loss rates for specific loan categories, including mortgages, using models based on relationships found in euro-area data, whereas the GFSR relies on models estimated using US chargeoffs with adjustments for the different macroeconomic outlook and loan characteristics pertinent to the loan book of euro area banks. The different approach results in the ECB projecting significantly lower loan losses, in particular on mortgage loans.
- **Treatment of provisions:** The GFSR does not net out provisions made in 2007 and 2008 to estimate further expected write-downs.

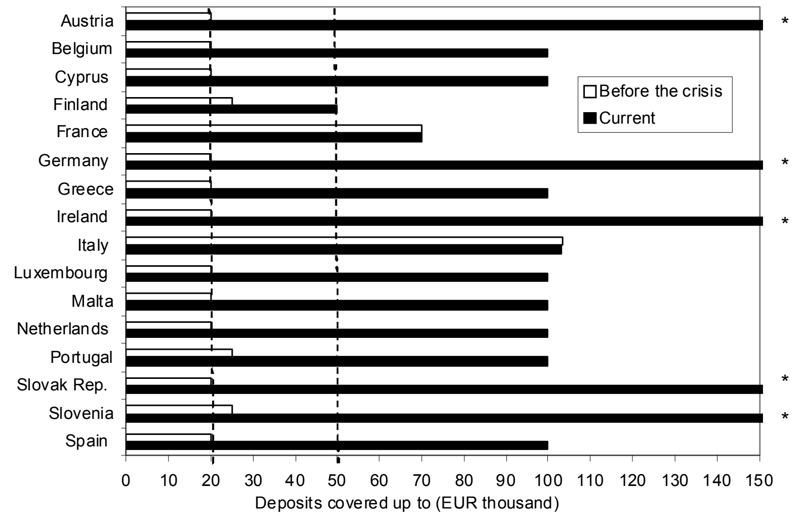
The substantial uncertainty about the resulting capital shortfalls underscores the need for a thorough institution-by-institution assessment. The ECB's write-down estimates imply significantly lower capital needs than those projected in the GFSR. However, the ECB does not present an estimate of capital needs on a comparable basis. In addition, it argues against using a simple leverage ratio as a capital benchmark, given differences in accounting systems affecting the measurement of assets, and the need to take into account differences in risk profiles and earnings capacity across institutions. The ECB agreed with staff that its analysis would need to be complemented by bottom up stress tests to assess individual banks' capital needs.

institution-by-institution estimates are needed to clarify capital needs, which it noted is the prerogative of national supervisors.

16. Actions undertaken by policymakers have helped contain systemic risk, but considerable stresses persist, and cross-country coordination remains challenging.

Policy actions have so far focused on stabilizing the banking system and preventing bank runs, but considerable stresses remain, including in the non-bank financial sector, as noted in the ECB's June 2009 Financial Stability Review published subsequent to the mission.[1] Coordination of policy actions improved over time as the scale and scope of the problems sank in, and the EC and the ECB undertook efforts to coordinate key parameters and underlying principles, but both institutions acknowledged that lack of integration of decision making at the EU level hampered the efficiency of the policy response. Recognizing the appreciable differentiation in financial systems, problems, and policy contexts across countries, a menu approach was adopted, accompanied by special guidelines on state aid and an accelerated approval procedure of interventions in the financial system. The minimum level of deposit guarantees, the provisions for guaranteeing debt securities, the pricing of public capital, and the conditions for treating impaired assets, including the principles of valuation, have largely been harmonized. Still, national authorities have explored the considerable leeway remaining within these parameters, resulting in some cross-border tensions (e.g., from remaining differences in deposit guarantees) and to some extent dampening confidence in the policy measures.

Euro Area: Increases in Deposit Guarantees During the Crisis



Source: IMF staff, based on data from country authorities.
Notes: * unlimited; dashed lines denote agreed EU minimums (before crisis and current).

17. **The take-up under existing programs, especially of public resources for recapitalization, was seen to be falling short.** Fairly large sums have been committed by member states since October 2008 to recapitalize financial institutions and more recently to cleanse balance sheets of toxic assets. However, just over half of the programs had been taken up by eligible financial institutions by end May 2009. Interlocutors cited the possible stigma and conditionality, including a review of viability and restructuring, attached to these programs as reasons for the poor take up. In addition, staff noted that the voluntary nature of participation could be an important factor as financial institutions have incentives to muddle through, holding on to shareholder upside and control, despite the potential aggregate costs of such behavior to the economy at large.

[1] ECB, June 2009 Financial Stability Review

18. **Against this background, the staff advocated a resolute and coordinated clean up of banks to fully restore confidence in the financial system**. Staff underscored three reasons why a more proactive approach to cleaning up the financial system remained a top priority. First, without a properly functioning financial system, monetary and fiscal policies will not be as effective as they could be in supporting demand. Second, with the wave of losses from the recession still to hit the financial system, there continues to be a significant risk of a further negative feedback loop with the real economy. Third, without further comprehensive action, the European financial system could well remain on a drip-feed of taxpayers' money for a long time to come. Private investors will not step in, and constraints associated with government intervention will reduce overall efficiency. This would be a recipe for a prolonged spell of slow growth.

19. **The staff called for such a clean-up to proceed in the context of a comprehensive strategy, involving an assessment of capital needs and viability, and immediate follow-up action.** Stress tests are currently being conducted at the national level and in a coordinated fashion for the largest 22 banks in the EU. The EC and the ECB are providing the common parameters for both the baseline and alternative scenarios. On current plans, the objective of these stress tests is to provide an aggregate view of the resilience of the financial system in Europe rather than to identify the capital needs on an institution-by-institution basis. Staff urged the authorities to shift gears and engage in a comprehensive review to assess capital needs and viability, also taking into account the impact of the ongoing recession on capital. Most importantly, such a review would need to be followed up with action comprising disclosure, recapitalization, and, where needed, restructuring or resolution of financial institutions. The EC advocated a very similar approach, while the ECB emphasized the need to raise the uptake of the measures already put in place. Both acknowledged that getting national authorities fully on board would be challenging.

20. **Establishing or improving resolution regimes for financial institutions is vital**. In the present circumstances, policymakers in many EU countries face the unappealing choice between disorderly bankruptcy and recurring taxpayer bailouts when dealing with unviable institutions. There was broad agreement that the resolution toolkit should be expanded—if necessary through a review of existing legal frameworks—to allow national authorities to take control of fragile financial institutions at an early stage and implement resolution action as needed. Some interlocutors thought that a special EU-level framework would be required for dealing with failures in cross-border banks—and initial discussions on such a framework are under way—but the staff pointed out that introducing special resolution regimes at the national level could be done quicker, and—when sufficiently harmonized—constitute a stepping stone toward an EU-level regime (see Selected Issues, Chapter II).

21. **Immediate adjustments to cross-border financial stability arrangements would help manage the ongoing crisis, while better coordinated supervision of national markets is equally necessary**. Experience with the resolution of cross-border financial institutions has been mixed at best, in one case leading to a break-up of the institution along

national lines. The staff called for countries to honor their commitment to adhere to the 2007 ECOFIN crisis management principles as well as existing bilateral MoUs, including with respect to emerging economies in the region.[2] The staff also pointed out that strengthening of the Committees of Supervisors (Level-3) and implementation of the June 2008 crisis management MoU need not await progress with broader reforms. While full-blown mediation in case of conflicts among national authorities may be difficult, the presence of a neutral observer from an EU institution could help diffuse tensions in cross-border crisis management and resolution and advise on the consistency of approaches with existing agreements and frameworks. Persistent efforts to remove distortions created in the early stages of the crisis (e.g., on deposit guarantee coverage and conditions for guarantees of bank liabilities, including in the euro area interbank market), and to achieve better ex ante coordination in the future are also needed. Finally, existing cross-border financial stability bodies should become more action-oriented. Interlocutors suggested that they were focused on the redesign of the overall architecture rather than on potential immediate improvements, leading the staff to express concern about their ability to deal with short-term risks should they materialize.

22. **The EU's competition authorities are mindful of preserving a level playing field.** EU institutions issued harmonized guidelines for public interventions in the financial system to avoid competitive distortions and secure an efficient and orderly exit from such interventions. Competition authorities are playing an important role in ensuring that restructuring plans lead to viable institutions. While their actions have yielded useful revisions to such plans in some important cases, staff felt that at this stage, the trade-off between speed and efficiency of intervention ought to be in favor of the former, overly tight deadlines for phasing out interventions ought to be avoided, and cross-border spillovers of restructuring plans (e.g., in the context of divestiture requirements) duly taken into account. Staff noted that it would be important to avoid discriminatory attempts to revive credit, with uncertain consequences for the behavior of foreign branches and subsidiaries.

Overhauling the EU's Financial Stability Arrangements[3]

23. **The EU has agreed to an ambitious overhaul of its financial stability arrangements**. This overhaul will seek to address existing shortcomings and the tensions with the EU's objective of creating a single financial market that have been exposed by the global financial crisis (see Selected Issues, Chapter III). Two new cross-border institutions are to be established:

---

[2] See Annex I of the October 2007 ECOFIN Council conclusions

[3] Further information is contained in: Marek Belka's recent speech; IMF Survey Article on IMF-Bruegel-NBB conference on the future face of Europe's financial system; De Larosière Group report; Turner review; Fund staff op-ed in the FT; European Commission Proposal; June 9, 2009 ECOFIN Conclusions; and June 18-19, 2009 European Council Conclusions.

- a **European System of Financial Supervisors (ESFS)**, bringing together the national supervisors with three independent supranational European Supervisory Authorities (ESAs)[4] accountable to the EU institutions. The ESAs will be mandated to establish a single rulebook, ensure consistent supervisory practices, centralize relevant microprudential data in a single European database, ensure the consistent application of EU rules, mediate and settle disputes among national supervisors, and directly supervise rating agencies. National supervisors, organized in colleges for cross-border institutions, will continue to conduct day-to-day supervision in all other cases.

- a **European Systemic Risk Board (ESRB)**, organizationally linked to the ECB/ESCB[5], to bridge the gap between macro- and micro-prudential oversight. The ESRB will comprise the Governors of the ESCB, the heads of the ESAs, and a representative of the EC, with supervisors and the president of the EFC participating as observers. Supervisors will also constitute an advisory body. A Steering Committee will seek to ensure the smooth functioning of the ESRB.

Framework Directives will allow the ESAs to set binding harmonized technical standards in certain areas. These would come into effect, subject to endorsement by the EC, from a fixed date.[6] The EC has proposed efficient decision-making mechanisms for the ESAs and ESRB, based on qualified majority and majority voting respectively.

24. **The staff and authorities agree that this overhaul should be executed on an ambitious time table**. The staff strongly supported the overhaul, which was under discussion at the time of the mission. It emphasized that it will be essential to secure adequate resources and effective decision-making mechanisms for the new bodies; achieve unrestricted flows of information among supervisors and central banks within the new structures; and establish efficient rule-making mechanisms to create and maintain a single rulebook. The staff and the EC agreed that the ESAs should have binding powers to mediate and settle conflicts between supervisors in the course of the regular exercise of supervisory duties, a position opposed by some member states who see this impinging on fiscal sovereignty. The staff argued that central banks should play a strong leadership role in the ESRB, which will need to use its broad mandate to provide early warnings of a build-up of systemic risk and recommend corrective action. The authorities plan to enact the necessary legislation by the end of 2009, with a view to establishing the new structure in the course of 2010.

[4] The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).

[5] European System of Central Banks.

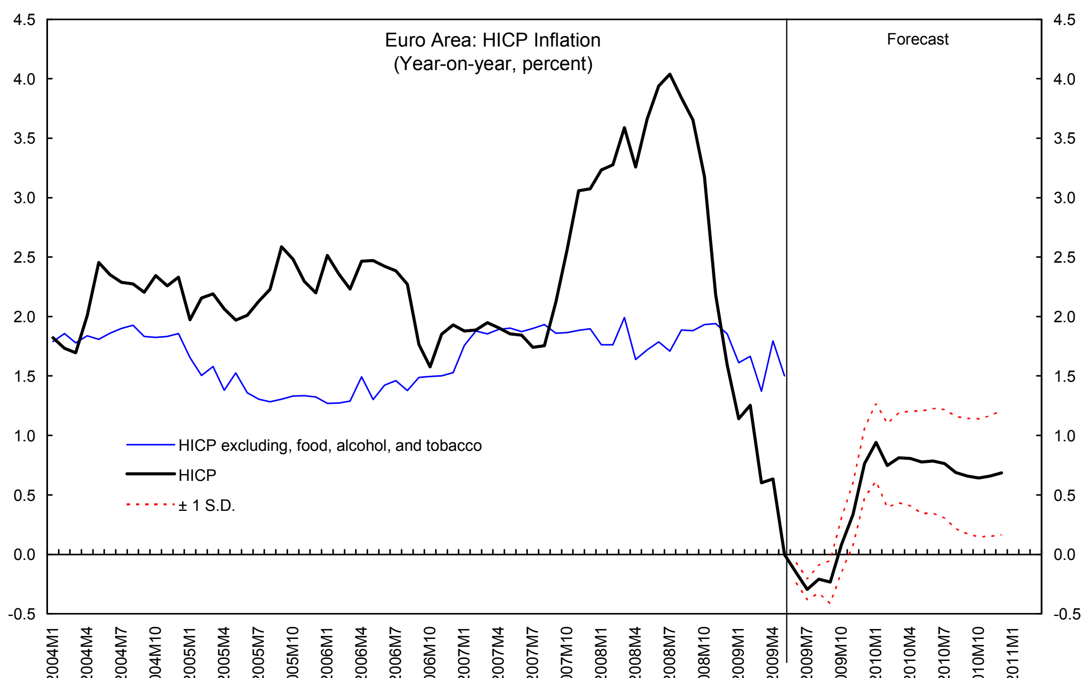
[6] Under the Lamfalussy structure, the Level 3 Committees only had an advisory role in rule-making, which remained the purview of the European Commission and European Parliament.

25. **Fundamental progress on crisis resolution is also needed.** In parallel to the supervisory overhaul, the EU is planning to accelerate the establishment of a comprehensive cross-border crisis management framework. The staff emphasized the importance of addressing the "too big to save" and "too big to fail" problems. Hence, the new framework should comprise tools for early intervention, a special regime to deal cost-efficiently with failing institutions outside regular bankruptcy proceedings, clear loss-allocation rules that apply losses to shareholders and unsecured creditors, and a private first-line funding mechanism for resolution efforts. While a fiscal backstop will be needed, such a framework should seek to reduce the dependence of the financial system on contingent fiscal support, thus facilitating agreement on a "burden sharing" mechanism.

26. **The mission pointed out that the supervisory overhaul would address some of the challenges facing countries with banking systems dominated by foreign ownership, especially the NMS**. In particular, the integrated system of supervisors could help to further improve the quality of supervision in the region. The ESRB could reduce the likelihood of an unsustainable buildup of risk in countries with a large foreign bank presence, if it paid sufficient attention to systemic risks in individual countries, and if it effectively managed to coordinate a response by supervisors and other relevant authorities. The proposed ESFS and the colleges of supervisors should result in better home-host cooperation and more effective supervision of cross-border risks, and give more voice to host-countries, such as the NMS.

B. Monetary Policy in Uncharted Territory

27. **The euro area is facing strong disinflationary pressures, with inflation widely projected to remain significantly below 2 percent in 2009–2010**. Mainly due to base



Sources: Eurostat and IMF staff estimates.

effects from the sharp fall of commodity prices, but also as a result of the significant weakening in economic activity, headline inflation has declined steeply to zero percent in May 2009 from its peak of 4 percent in mid-2008. Core inflation excluding energy, food alcohol and tobacco eased by less, declining to an average of 1.6 percent, after hovering around 1.9 percent during 2007–2008 (Figure 8). Staff projections for 2009 are similar to the EC and ECB staff projections and all agreed that headline inflation could be temporarily negative around mid-2009 due to base effects from commodity prices. There was also agreement that inflation will remain significantly below 2 percent in 2010, although both the EC and the ECB project somewhat higher inflation than staff, because of higher anticipated unit labor costs (ULCs). Staff acknowledged that ULCs have accelerated in 2008, but noted that this was largely owing to past tight labor markets, while more recently the increase was because of downward adjustment of hours worked in response to weakening demand. Staff also pointed out that growth of some labor cost measures has declined in 2008Q4 and reasoned that on the back of large and increasing output gaps and deteriorating labor markets it is likely for the ULCs to decline appreciably over the near term.

Inflation is Projected Significantly Below 2 Percent in 2009–2010

	Vintage	2008	2009	2010
			Projections	
WEO	April	3.3	0.4	0.6
WEO	July update	3.3	0.2	0.7
ECB	June	3.3	0.1-0.5	0.6-1.4
EC	May	3.3	0.4	1.2
Consensus	May	3.3	0.4	1.2

Sources: EC, ECB, and IMF.

28. **The ECB viewed the risks to the inflation outlook as broadly balanced, while the staff saw a small risk of sustained deflation**. Staff pointed out that the large output gaps and growing unemployment would eventually increase downward pressure on prices and noted that the key source of the tail risk of deflation lies in a possible deeper than-envisaged decline in economic activity stemming from an adverse feedback loop between the financial and real sectors. The ECB representatives argued, however, that a number of factors mitigate deflation risks. First, they noted that the sticky wages and prices in the services sector will cushion downward pressure on prices, despite the large projected output gaps, and pointed that the recent wage increases were not set based on deflation scenarios. Second, they maintained that the effect of the monetary policy easing already in the pipeline is expected to gather pace, as monetary transmission, although impaired somewhat, seems to remain functional, a view shared by staff (Box 3 and Selected Issues, Chapter I). Finally, they highlighted that the ECB has expanded its balance sheet significantly by implementing large passive unconventional measures, which have helped the transmission and resulted in effective interest rates at longer maturities (important benchmarks for market rates in the euro area) that are comparable to those of other major central banks (Figure 5).

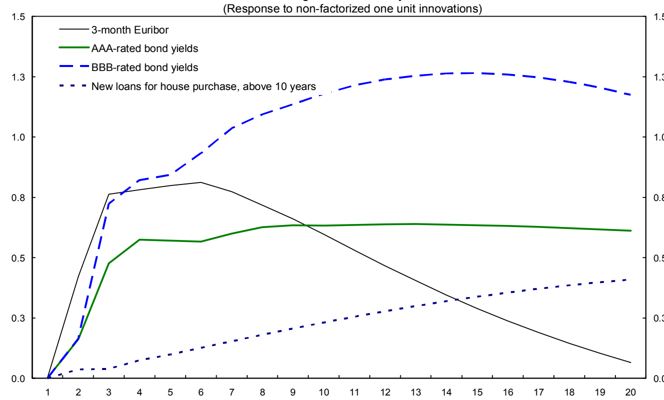
Box 3. Has the Financial Crisis Impaired Monetary Transmission in the Euro Area?

In the face of an unprecedented financial crisis, the ECB has eased monetary policy significantly since October 2008, bringing its policy rate down (by 325 basis points) to 1 percent. The cost of credit to both businesses and households also declined, but by much less, as credit spreads initially increased and eased only recently. These developments, as well as the tightening of credit standards, raise the question of whether the effectiveness of monetary policy has been reduced during the recent financial crisis.

The effectiveness of monetary policy and the role of expectations are analyzed using a set of bivariate vector autoregression (VAR) models comprising the EONIA and various market rates and a general equilibrium theory-based framework. The results suggest that the traditional transmission channels (interest rate, bank lending, and broad credit) have continued to operate, but at a lower efficiency. During the crisis, the transmission slowed down (the lags have become longer), the policy reaction needed to stabilize the economy became stronger, and the transmission subject to more noise. Also, inflation expectations, while remaining broadly stable, declined significantly in the last quarter of 2008, reflecting the major deterioration in economic activity.

The VAR impulse responses show that policy rate changes have been transmitted to market rates, although the degree and the speed of pass-through varies (first figure). The impact on the three-month euro interbank offered rate (Euribor) is close to one-for-one, and the speed of adjustment high, with the maximum impact transmitted within a month. The initial impact on corporate bond yields and new loans to nonfinancial corporations is similarly quick, although the full adjustment is more protracted and the impact on higher-grade bond yields is smaller than on lower-grade bond yields (0.6 to 0.7 percentage point for AA- and AAA-rated bonds versus 1.2 percentage points for BBB-rated bonds). The pass-through of the policy rates to loans for house purchases is somewhat smaller and the speed of adjustment lower.

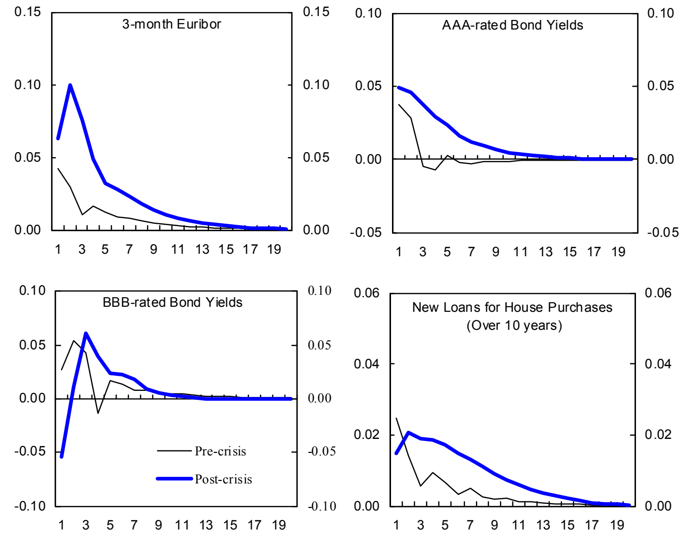
Euro Area: Pass-through of ECB Policy Rate to Market Rates
(Response to non-factorized one unit innovations)



Sources: ECB, Haver, and IMF staff estimates.

The VAR results suggest that the pass-through to all market rates has slowed since the crisis (second figure). In particular, impulse responses from the first difference bi-variate VARs imply that the time for the full adjustment of market rates has increased to over 12 months, from between 3 months and 6 months before the crisis. The transmission to lower grade corporate bonds seems to have been particularly negatively affected, following the crisis—the initial response of the BBB-rated corporate bond yields has switched from positive before the crisis to negative thereafter.

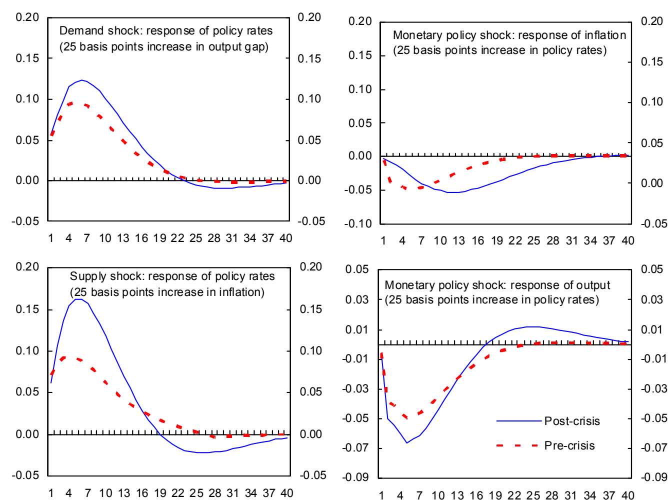
Euro Area: The Impact of Crisis on Policy Rate Pass-through
(VARs in first Difference, Response to Cholesky One S.D. Innovations)



Source: IMF staff estimates.

Impulse responses from the theory-based model support the results from the VARs that after the crisis the overall transmission has slowed. For both supply and demand shocks, the policy reaction needed to stabilize the economy is somewhat stronger, with the time needed for the policy feedback to pass through rising to about 2½ years, from about 1½ year before the crisis (third figure, first column). Similarly, the time for a full transmission of monetary policy shocks to inflation has increased after the crisis to close to three years, from about two years before the crisis (third figure, upper right panel). Compared with the findings from the VAR, these results suggests that not only the first stage of the transmission, the pass-through to market rates, but also the overall working of the transmission mechanism seems to have become less effective after the crisis.

Euro Area: Effectiveness of Monetary Policy
(Pre- and Post- Crisis, in basis points)



Source: IMF staff estimates.

29. **The ECB's actions have been helpful in cushioning the impact of the financial crisis**. The ECB initially focused on lengthening the term funding of its liquidity provision. Since October 2008 the ECB widened its collateral requirements to avoid them becoming a funding constraint and stepped up further liquidity operations by providing unlimited term funding at fixed rates, which seems to have eliminated liquidity premia (Figure 9). It also cut

interest rates by a cumulative 325 basis points to an all-time low of 1 percent (Figure 10). Recently the ECB extended the maturity of its refinancing operations to 12 months and engaged in purchases of covered bonds—a credit market segment particularly hard hit by the financial crisis. The first 12 month operation conducted on June 24, 2009 attracted widespread interest with 1121 banks participating and provided euro 442 billion in refinancing. There was agreement that these measures helped anchor inflation expectations and improved monetary transmission. As a result, the reduction in the policy rate has been transmitted to market rates, thereby easing financial conditions—though they remain tight. ECB staff felt that the deceleration of credit growth to private sector (Figure 11), did not contain conclusive evidence of supply constraints. Nevertheless, they agreed that the tightening of lending standards due to banks' funding conditions suggested that supply factors might play an increasing role (Figure 12).

30. **There was agreement that the supportive monetary policy stance needed to be maintained, while keeping in mind both downside risks and exit strategies**. Staff argued for keeping interest rates low by continuing to provide unlimited term funding at fixed rates as long as strong disinflationary pressures persist. While the benefits of further cuts in the policy rate have to be assessed against the possible adverse effects on the functioning of money markets, staff felt that any further room to reduce rates ought to be utilized as soon as possible. If downside risks were to intensify, a more forceful signal to keep interest rates low would be necessary. Furthermore, staff suggested that to deal with contingencies, all unconventional options, including active credit easing needed to be considered. The ECB representatives—while not suggesting that the current level of 1 percent should be considered a floor—pointed out that room for further rate cuts was limited as it would inevitably compress the margin with the deposit rate. The experience with a narrower corridor at end-2008 had shown that it was likely to hamper the functioning of the interbank market. The ECB also stressed that announcing a floor to the policy rate or pre-committing to keep interest rates low could be counterproductive, as it could create market distortions. On exit strategies, the ECB emphasized that by design, exit from the unconventional measures would be relatively straightforward. It also noted that, if liquidity needed to be mopped up, the ECB could issue its own paper or offer additional short-term deposit facilities. Staff flagged the potential high costs, if large absorption measures prove necessary, but agreed with the ECB that exit from several unconventional measures would be triggered automatically as their conditions become unattractive when the market returns to normal.

C. Fiscal Policy: Mitigating the Downturn while Ensuring Sustainability

31. **In response to the deepening financial crisis, governments are extensively using public balance sheets to shore up the financial system**. Governments in Europe have committed large resources to guarantee, recapitalize, and resolve financial institutions, as

well as support certain asset markets.[7] Altogether, the immediate impact of these support measures on government financing reaches 6.3 percent of GDP on average. Explicit guarantees provided so far are also quite large, especially in Ireland. Nevertheless, the costs are likely to be smaller. For European advanced economies, indicative estimates based on financial derivative pricing models suggest that outlays from contingent liabilities could average around 2–5 percent of GDP, cumulative for 2009–13.[8]

Headline Support for the Financial Sector and Upfront Financing Need
(As of April 15, 2009; percent of 2008 GDP)

	Capital Injection (A)	Purchase of Assets and Lending by Treasury (B)	Central Bank Support Provided with Treasury Backing (C)	Guarantees 1/ (D)	Up-front Government Financing 2/ (E)	
Austria	5.3	0.0	0.0	30.0	5.3	
Belgium	4.7	0.0	0.0	26.2	4.7	
France	1.2	1.3	0.0	16.4	1.5	3/
Germany	3.8	0.4	0.0	18.0	3.7	
Greece	2.1	3.3	0.0	6.2	5.4	
Ireland	5.3	0.0	0.0	257.0	5.3	
Italy	1.3	0.0	0.0	0.0	1.3	
Netherlands	3.4	2.8	0.0	33.7	6.2	
Norway	2.0	15.8	0.0	0.0	15.8	
Portugal	2.4	0.0	0.0	12.0	2.4	
Spain	0.0	4.6	0.0	18.3	4.6	
Sweden	2.1	5.3	0.0	47.3	5.8	4/
Switzerland	1.1	0.0	0.0	0.0	1.1	
United Kingdom	3.9	13.8	12.9	51.2	20.2	5/
Average 6/	2.5	3.7	2.1	25.0	6.3	

Sources: IMF, Update on Fiscal Stimulus and Financial Sector Measures (published April 26, 2009). http://www.imf.org/external/np/fad/2009/042609.htm)

1/ Excludes deposit insurance provided by deposit insurance agencies.
2/ Includes components of (A), (B), and (C) that require up-front government outlays.
3/ Support to the country's strategic companies is recorded under (B), of which 14bn euro will be financed by a state-owned bank, not requiring upfront Treasury financing.
4/ Part of the capital injection will be undertaken by the Stabilization Fund.
5/ Cost to nationalize Northern Rock and Bradford & Bingley recorded under (B), entailing no up-front financing.
6/ PPP GDP weights.

32. **With more time needed to repair the financial system and a slow recovery ahead, there is broad agreement that fiscal policy has to continue to support economic activity into 2010**. Most euro area countries are providing stimulus packages to counter the downturn and safeguard jobs. Although the discretionary fiscal impulse is estimated to turn negative in

[7] Almost all countries have provided capital injections and guarantees for financial sector liabilities. Some have purchased illiquid assets from financial institutions or extended direct loans. In several countries central banks have also extended assistance to financial institutions through credit lines, purchase of assets, asset swap, and liquidity provisions without direct treasury funding. While such operations do not require upfront treasury funding, they could eventually generate fiscal costs.

[8] These estimates are obtained by applying the expected default frequency implied credit default swap spreads—which are indicators of the "insurance" premium for providing the guarantee—to the guaranteed amounts.

2010 the functioning and magnitude of automatic stabilizers also need to be taken into account to fully assess the role of fiscal policy in cushioning the downturn. Indeed, in most euro area economies, the estimated effect of automatic stabilizers is expected to increase significantly in 2009 and continue to operate in 2010. Given the large automatic stabilizers, the discretionary measures currently adopted are deemed broadly appropriate, while additional stimulus should be readied for further contingencies—in case the euro-area economy were to take a significant turn for the worse—and if accompanied by actual measures to secure sustainability.

Euro Area Economies:
Estimated Cost of Discretionary Measures, 2008–10 1/
(Percent of GDP, relative to 2007 baseline)

	2008	2009	2010
Austria	0.3	1.5	1.7
Belgium	0.0	0.8	0.4
Cyprus	0.3	1.7	0.0
Finland	0.0	1.7	0.5
France	0.0	0.7	0.8
Germany	0.0	1.6	2.0
Greece	0.0	0.1	0.0
Ireland	0.0	0.0	0.0
Italy	0.0	0.2	0.1
Luxemburg	0.0	3.7	3.6
Malta	0.0	0.6	0.4
Netherlands	0.0	0.8	0.7
Portugal	0.3	1.0	0.0
Spain	1.9	2.3	0.3
Average 2/	0.3	1.1	0.9
Discretionary impulse 3/	0.3	0.8	-0.2

Source: IMF staff estimates.

1/ Figures reflect the budgetary cost of crisis-related discretionary measures in each year compared with 2007, based on measures announced through early March 2009. They do not include (i) "below-the-line" operations that involve acquisition of assets, (ii) discretionary measures that were already planned for, (iii) automatic stabilizers. Some figures reflect staff's preliminary analysis.

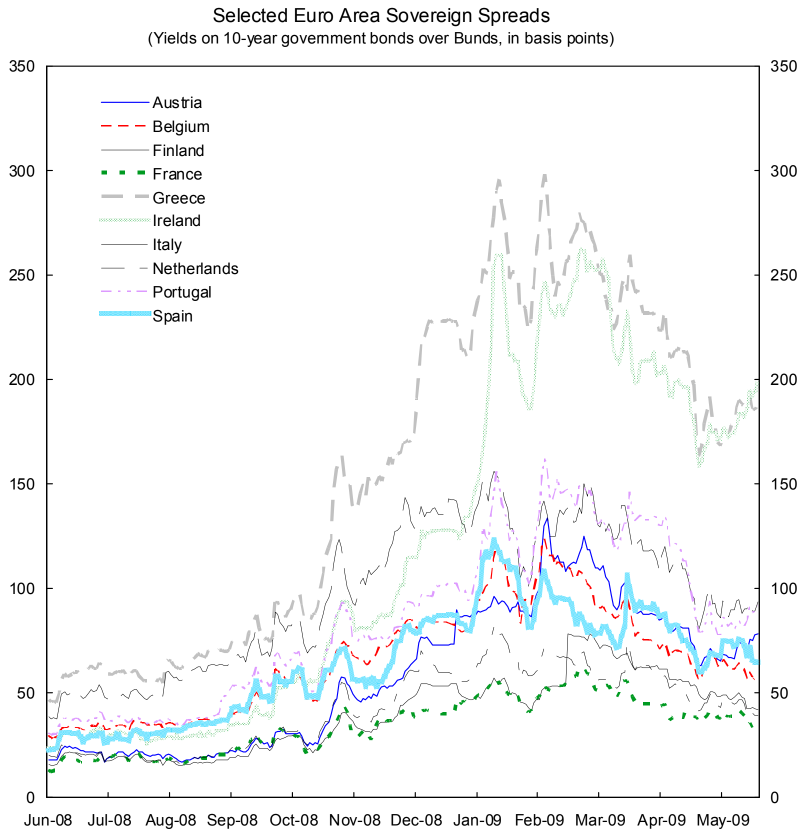
2/ PPP-GDP weighted. The average does not include Slovenia and the Slovak Republic.

3/ Change from previous year.

33. **The composition of the fiscal stimulus is seen to be as critical as its size, and coordination is essential**. The key is to ensure that fiscal initiatives boost activity over the relevant time frame, while seeking lasting benefits to productive capacity. The length and severity of the downturn justify greater weight on public investment in projects that typically have long lags but bring substantial longer-term benefits. Tax cuts, on the contrary, could be implemented quickly, but are likely to have a more modest growth impact. In a tightly integrated region such as the euro area, the benefits of fiscal expansion are likely to spill across borders while costs—namely increasing debt levels and potentially higher interest expenditure—amass locally. A simultaneous area-wide stimulus magnifies the growth effect of a stimulus in each single country. Tailoring discretionary fiscal efforts to country circumstances is also beneficial, with more action by countries with better starting positions in terms of debt and deficits, more robust financial systems, and more credible consolidation frameworks. The staff emphasized that in the context of the ongoing mid-term review of EU budgetary policies, some fine tuning along these lines would be helpful.

34. **While the use of public resources to shore up the financial system and cushion the downturn is necessary, it also implies a significant deterioration in the fiscal position of euro area economies.** Deficits are set to increase from 0.6 percent of GDP in 2007 to 6.9 percent by 2010, while public liabilities are projected to stock up substantially over the period (Figure 13). Financial markets seem to have responded to these

developments by requiring higher sovereign default risk premia for most countries, and differentiating across sovereign issuers much more than before. While global developments play a role in the recent increase in euro area sovereign interest rate differentials, country-specific factors—in particular rapidly rising projected debt levels and concerns about the solvency of national banking systems and their budgetary consequences—are becoming increasingly important.[9]



Source: Datastream.

35. **To address solvency concerns, short-term actions need to be embedded in credible medium-term consolidation programs—supported by the application of the SGP.** The EC underscored that the SGP had demonstrated sufficient flexibility to allow fiscal policy to support the economy, and would need to play a key role in anchoring fiscal adjustment, once the crisis abates. The ECB strongly endorsed this position, reiterating its view that to ensure trust in the sustainability of public finances, an ambitious and credible adjustment effort will be required. While there was general agreement that fiscal adjustment would need to be swift, tailored to individual country circumstances, and duly take into account the starting level of debt and the prospective cost of aging, the staff's suggestion to pre-announce the plans for fiscal adjustment to reduce uncertainty received less unanimous support. Staff felt that the concerns about the possible negative short-run impact of entitlement reforms are overstated, as—for example—raising the retirement age with life expectancy or well-designed health care reforms need not necessarily lower aggregate demand

36. **Various options were discussed to enhance the anchoring role of the preventive arm of the SGP**. Under the current framework, countries are required to steer fiscal policy in line with medium-term objectives (MTOs)—the so-called preventive arm. Nevertheless, the

[9] See Silvia Sgherri and Edda Zoli, "Sovereign Risks in the Euro Area" IMF Working Paper (forthcoming).

SGP has so far failed to provide sufficiently strong reasons for EU members to adhere to their targets. What could be done?

- *Encourage reforms putting national institutions and rules in tune with the SGP.* In particular, MTOs could be better integrated into medium-term fiscal frameworks at the national level, providing the SGP with a suitable institutional interface in each country. The EC noted such governance reforms are being emphasized in its surveillance exercises, but peer pressure on member states would need to be stepped up.

- *Strengthen the preventive arm.* One possibility would be to link the EDP and the MTOs, for instance by keeping the EDP in force until the MTO has been reached. Alternatively, MTOs could be treated as the reference value under the EDP for those countries deemed to have unsatisfactory debt dynamics. Since both options require an amendment to the EU Treaty, the authorities felt that the benefits do not outweigh the costs of reopening the treaty, at least not for now.

- *Enhance the commitment value of MTOs.* Staff felt that the process leading to the definition of MTOs was opaque, reducing their public visibility and, correspondingly, their signaling value and political relevance. The intent by the EC to link the MTOs explicitly to the level of debt and the cost of aging is a promising avenue, which would help put the MTOs at the core of EU budgetary surveillance and, more generally, public scrutiny.

D. Trade, Regional, Other Structural Issues, and Statistics

37. **EU officials were strongly aware of the importance of countering protectionist pressures from the crisis. Staff emphasized two key challenges in this respect**. First, governments should forego any scope within their WTO commitments to raise barriers or favor domestic industries. EC representatives broadly concurred, confirming that the EU is fully committed to the renewed pledge by G20 Leaders in their April Summit in London, and to ensuring that crisis measures taken across the world are no threat to open markets. Second, it was important to conclude an ambitious Doha Round agreement in order to tighten commitments and bring about new trade opportunities. While the EU trade regime overall remains very open, the reintroduction of dairy export subsidies has adverse economic effects for the EU and for its partners, and could complicate rather than facilitate a Doha agreement.

38. **Staff welcomed the authorities' efforts to further support trade-related development.** Especially since the outbreak of the crisis, the EU has been working to push on trade facilitation to help developing countries in a number of ways. Comprehensive Economic Partnership Agreements have either already been concluded or will be concluded with all African, Caribbean, and Pacific countries by the end of 2009 or in early 2010. Progress has also been made in the implementation of the reformed Generalized System of Preferences (GSP) for developing countries. The review of Rules of Origin (RoO) under

reformed GSP, announced last November, was an important step forward. In this aspect, staff encouraged liberal RoO that also promote South-South trade. Finally, staff welcomed that the EU (including its member states) is the largest contributor to Aid for Trade initiatives (committing more than EUR 7 billion per year) and encouraged the EU to build on this record given the added importance in present global economic circumstances.

39. **The EU authorities have provided support to countries hit hard by the crisis, though the staff felt that the EU's approach could be strengthened**. Several NMS have undertaken adjustment programs supported by financial assistance from the IMF and other bilateral and multilateral sources. In this context, the EU increased its balance of payment facility for non-euro area EU members to EUR 50 billion from EUR 12 billion to be able to cover a sizeable share of their financing needs and the ECB established repurchase arrangements with some NMS. Disbursement of structural, cohesion, and globalization funds, of which NMS are the main beneficiaries, is being accelerated. While welcoming these initiatives, the staff noted the merits of a more preemptive approach and underscored that with the crisis more deeper and protracted than envisaged further assistance and full coordination of financial crisis measures would be essential. Furthermore, plans to deal with adverse contingencies would have to be put in place.

40. **Structural reform efforts are being adjusted to boost the EU's recovery potential, in the context of the European Economic Recovery Plan**.[10] The crisis has curbed potential growth, jeopardized fiscal consolidation, and reduced external financing, requiring a narrowing of external imbalances and a reallocation of resources from nontraded to traded sectors, especially in countries facing financing constraints. In recognition of the need to boost potential growth, promote a solid recovery, and address fiscal sustainability concerns, the EU's efforts to address the crisis include a structural reform dimension. However, it also includes a set of demand support measures such as higher and longer unemployment and social benefits and subsidies for reduced working time. It was agreed that these measures would need to reversed to prevent lasting damage to potential growth. In this context, staff emphasized that it will be essential to focus on training and education, pension and health care reform, and building productivity-enhancing infrastructure with a regional dimension.

41. **While recent labor market reforms have paid off, the crisis is expected to put their effectiveness to a severe test**. Reforms had brought the EU within reach of the Lisbon employment rate target (of 70 percent), though the recent crisis constitutes a setback. The expected sharp rise in unemployment is likely to place an additional burden on public finances. At the same time, the duality of the labor market created by having different employment protection regimes for permanent and fixed-term contracts implies that the latter will bear the burden of the crisis, with possible strains on cohesion and reversal of migration.

[10] The European Economic Recovery Plan.

EC representatives felt that the fiscal burden of the flexicurity model would be modest as spending on active labor market policies had not increased much. They were more concerned about the risk that resolving the labor market duality would lead to an increase in overall employment protection with negative consequences on potential growth.

42. **The Lisbon process, which especially since its re-launch in 2005 has contributed to reforms, will need to be reinvigorated to sustain progress** (Figure 14).[11] There is evidence that it has helped where it was needed most, with countries in worse starting positions implementing more reforms. Reforms in the euro area have been somewhat stronger than elsewhere, which is indeed needed for the smooth functioning of the monetary union. In contrast, reform momentum in NMS has been slower, after an initial period of rapid progress. However, there was agreement that the Lisbon process had to be made more effective by adjusting goals and indicators in the context of renewing the process in 2010, possibly making more use of rankings, and establishing better accountability at the national level.

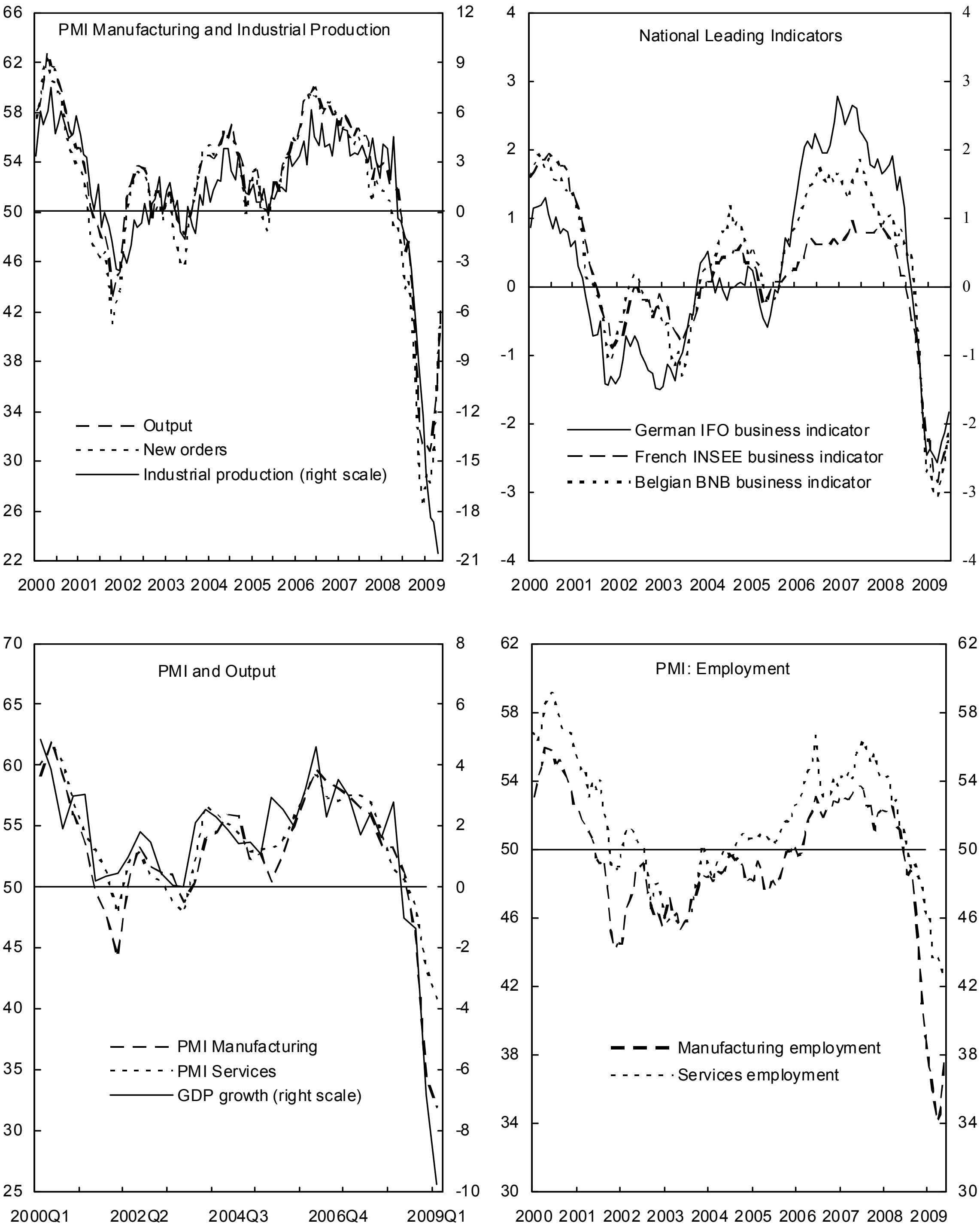
43. **Preparation for the creation of a single internal market in services is entering a crucial phase**. Countries are expected to ensure the comprehensive transposition of the services directive into national law by December 28, 2009.[12] With services constituting almost three-fourths of economic activity, effective implementation would deliver tangible benefits, especially to the battered consumer, and counterbalance inward-looking tendencies. Inter alia, adopting the services directive would do away with a considerable number of administrative and regulatory barriers. The pace of preparation will, however, need to be stepped up in several countries.

44. **While euro area statistics permit effective macroeconomic surveillance, the financial crisis has exposed new needs** (Appendix 1). The staff welcomed the ongoing and planned improvements in the quality, scope, and timeliness of data provision. The addition of house price and service sector statistics and the move to a 30-60-90 day system for GDP, main aggregates, and sectoral and financial accounts are noteworthy. The staff encouraged the authorities to continue their efforts to improve the availability of data to monitor financial developments and risks and to provide an efficient and effective information basis for the ESRB.

[11] EU website on the Lisbon strategy.

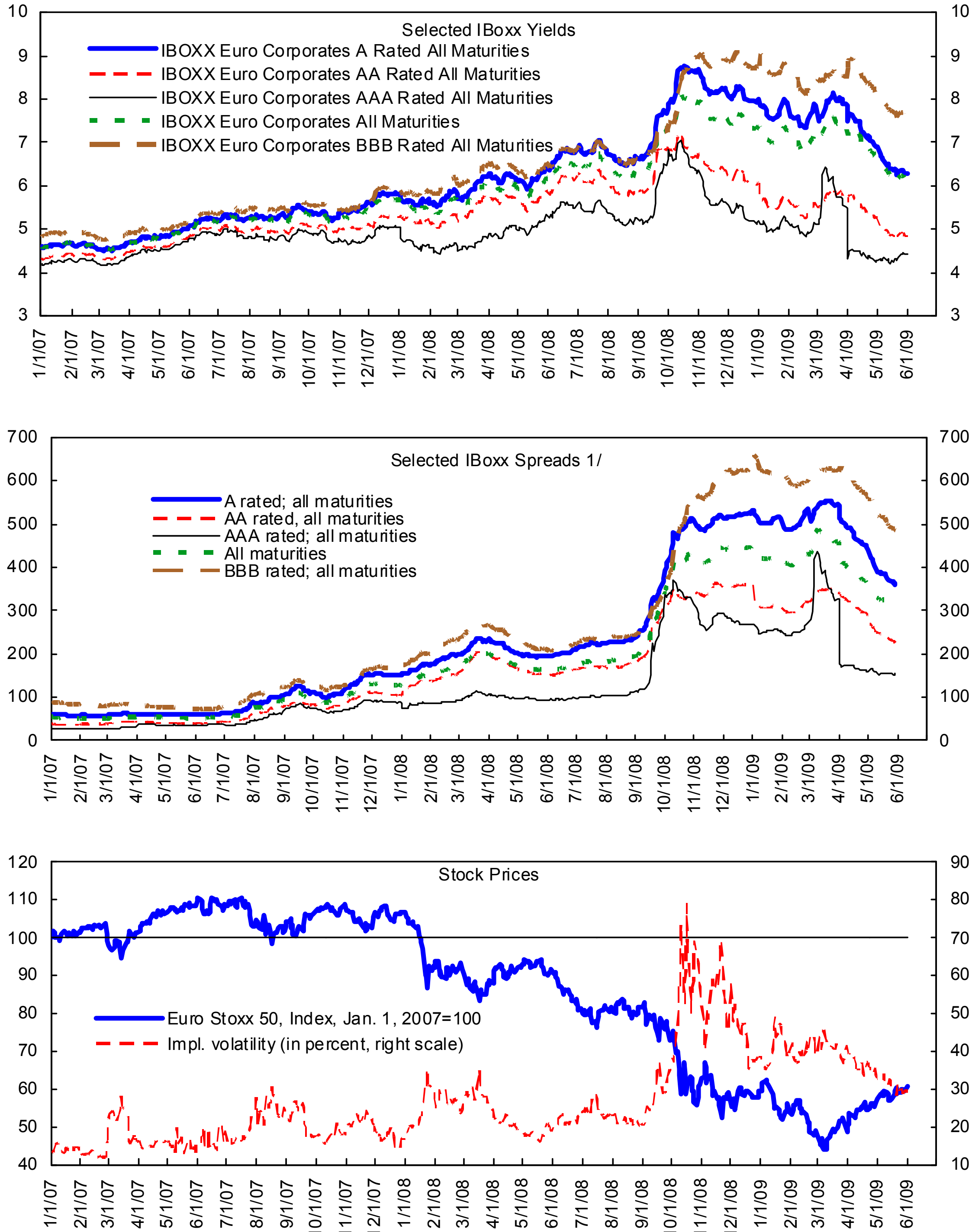
[12] EU website on the services directive.

Figure 1. Euro Area: Leading Indicators



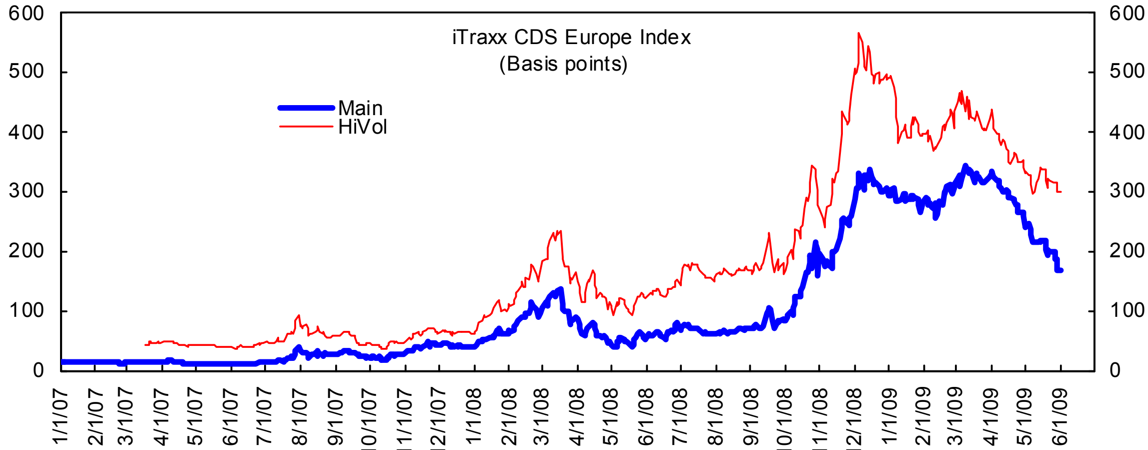
Sources: Eurostat; Reuters; IFO; INSEE; National Bank of Belgium; and staff calculations.

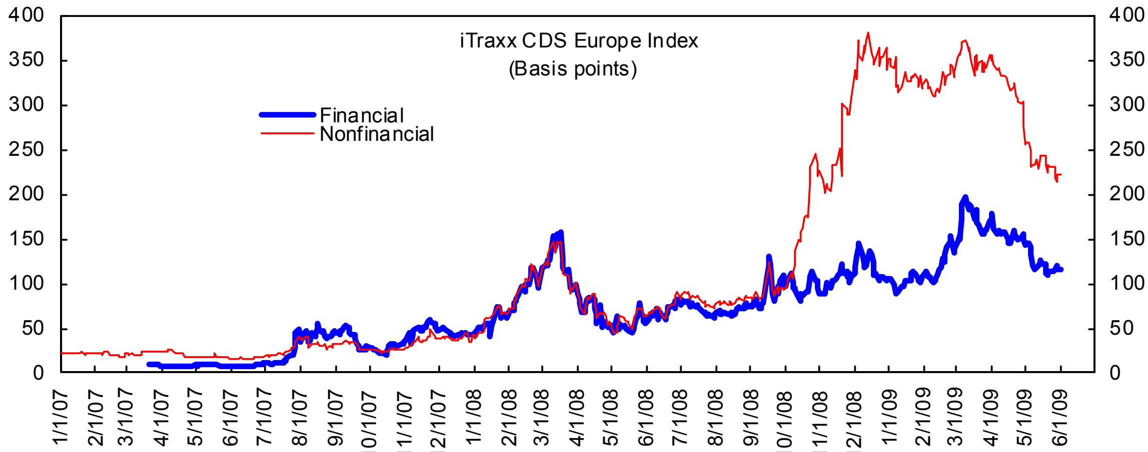
Figure 2. Euro Area Financial Indicators: Corporate Bond Rates and Equities
(Yields in percent, spreads in basis points)

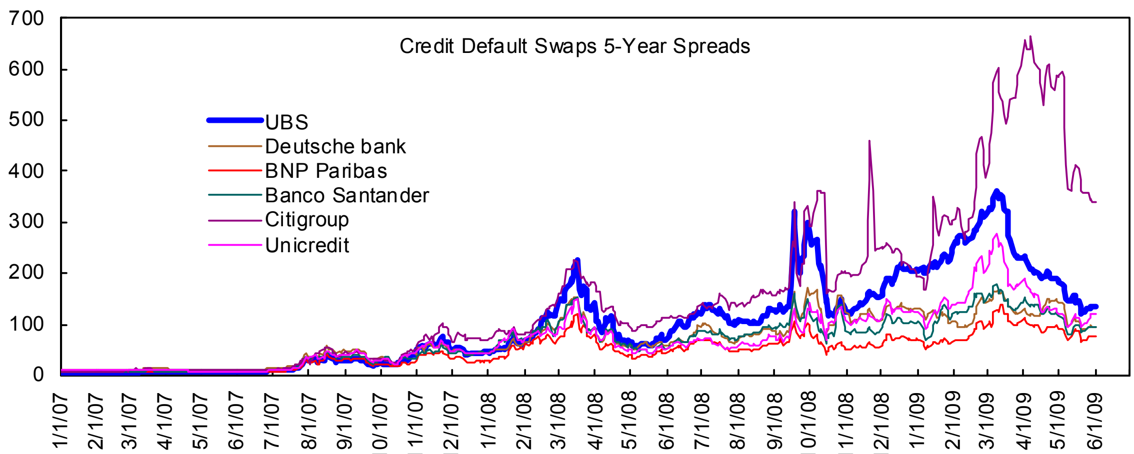


Sources: DataStream; and Bloomberg.
1/ IBoxx corporate bond rates over German benchmark bond yields.

Figure 3. Euro Area Financial Indicators: Credit Markets

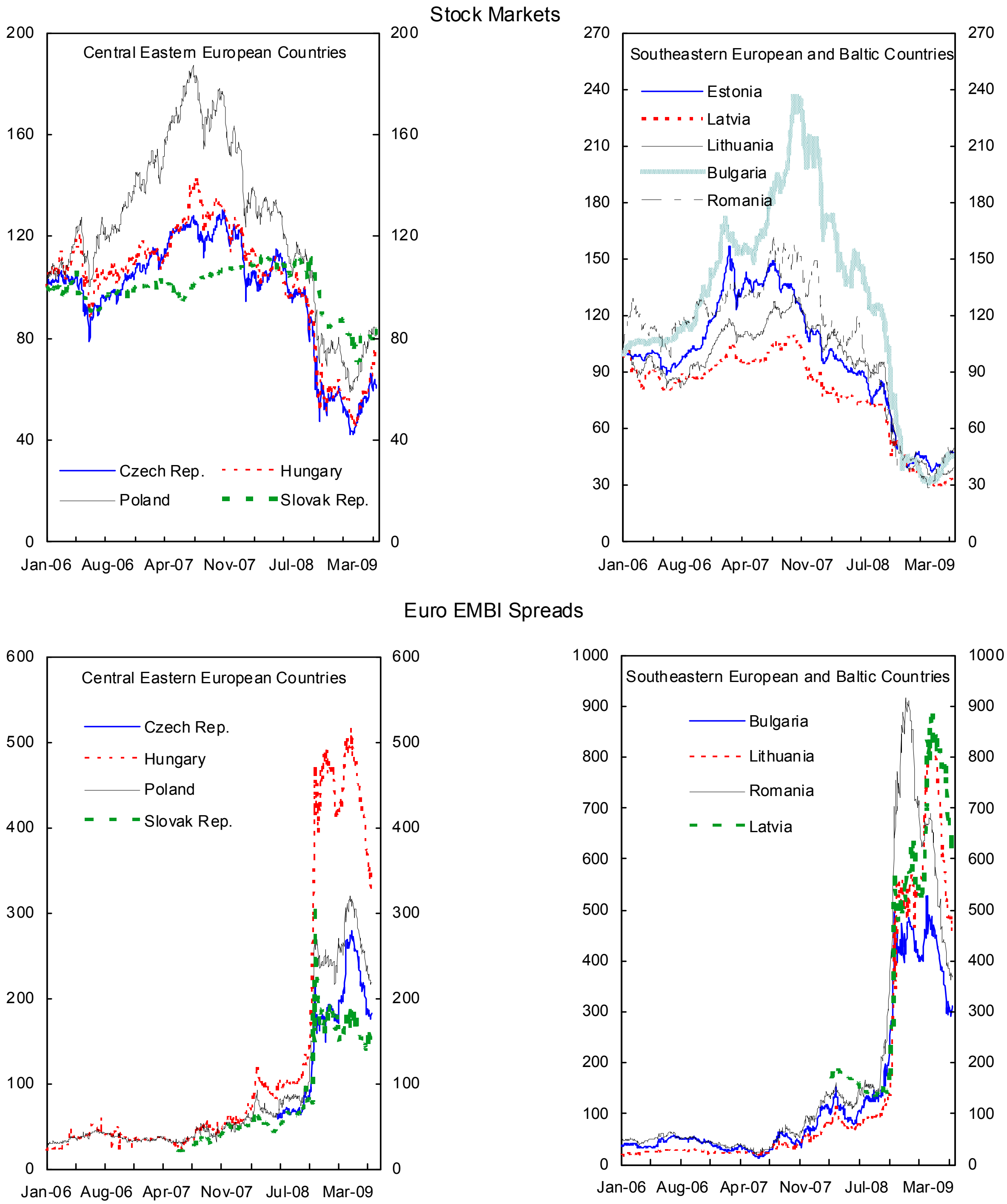






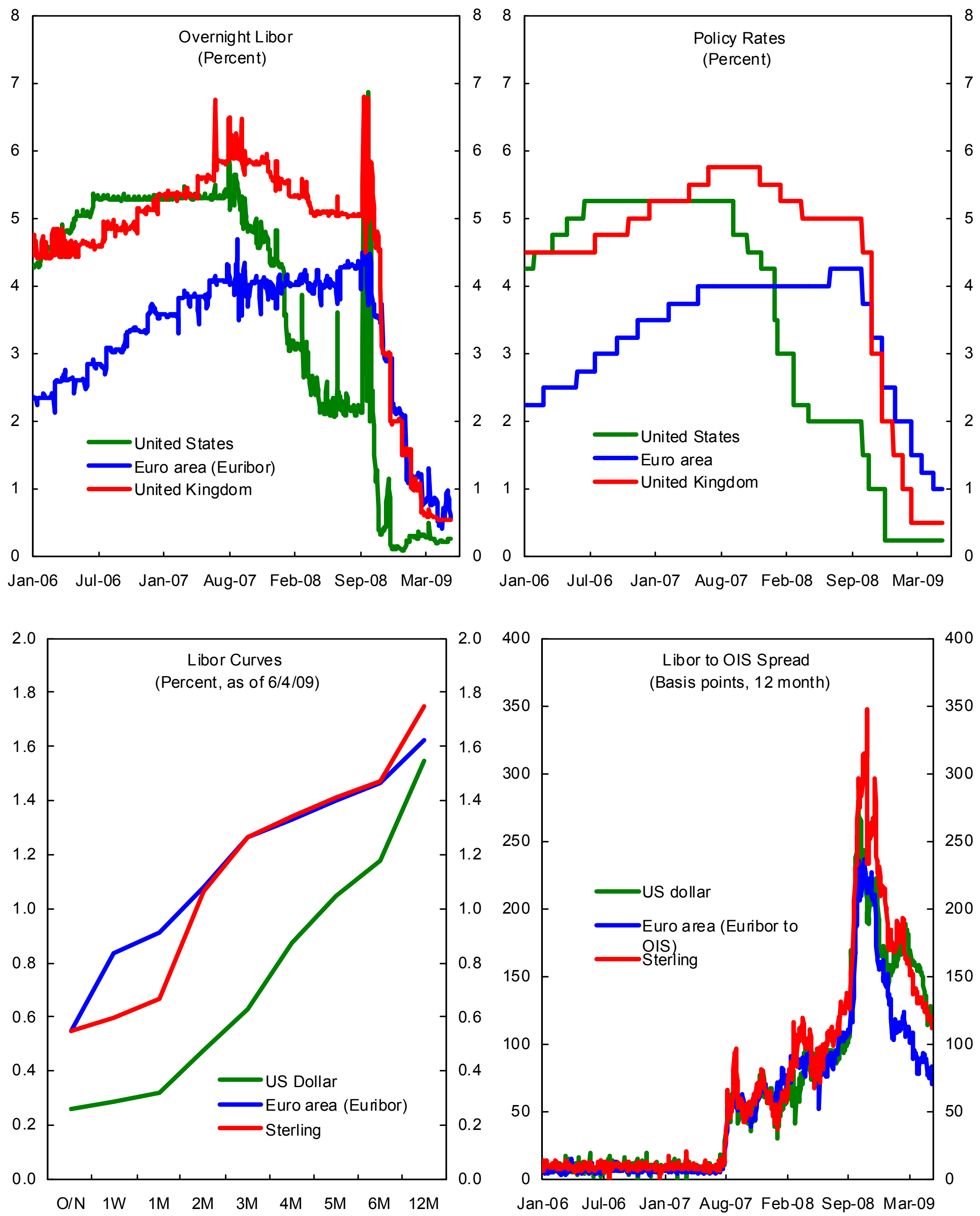
Sources: DataStream; Bloomberg; and CitiBank.

Figure 4. Financial Indicators in New Member States



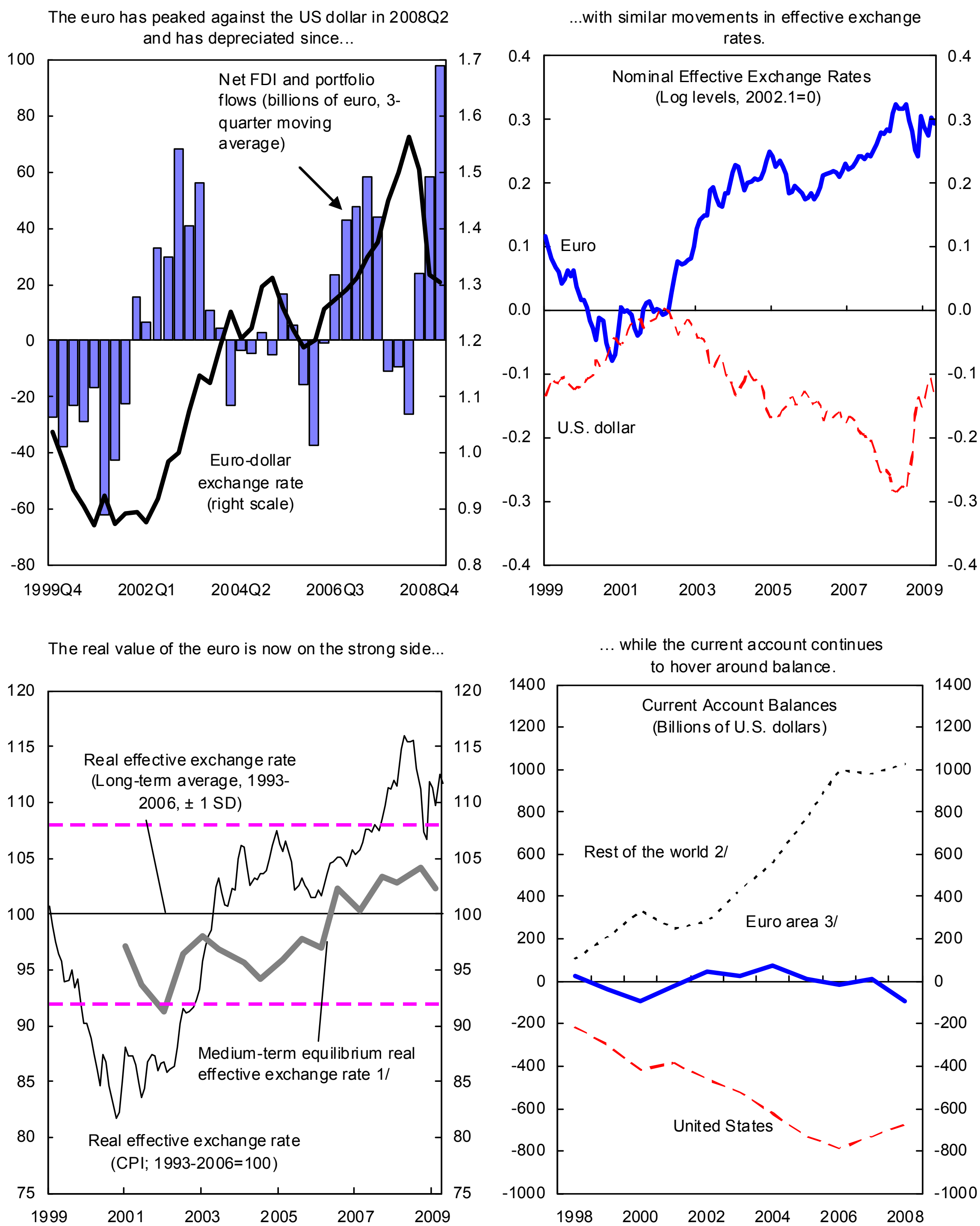
Sources: Bloomberg; and IMF staff calculations.

Figure 5. Libor/Euribor Rates, Policy Rates and Spread
(Units as indicated)



Source: Bloomberg.

Figure 6. Euro Area: External Developments



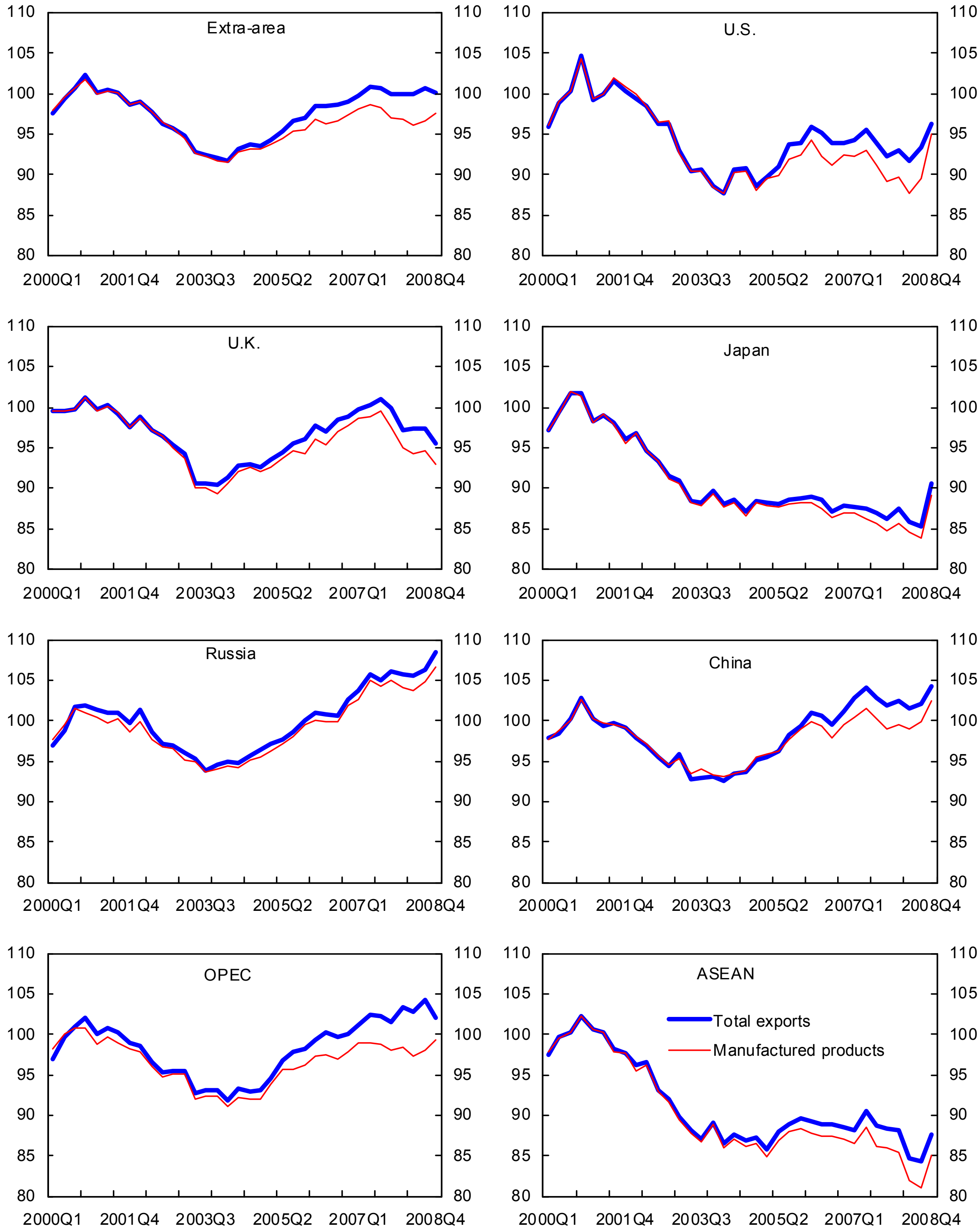
Sources: ECB; Haver Analytics; and IMF, *World Economic Outlook.*

1/ Staff estimate, based on a time series estimate with stochastic trend, a macroeconomic balance approach, and an external sustainability assessment.

2/ Rest of the world calculated as residual (excludes global discrepancy).

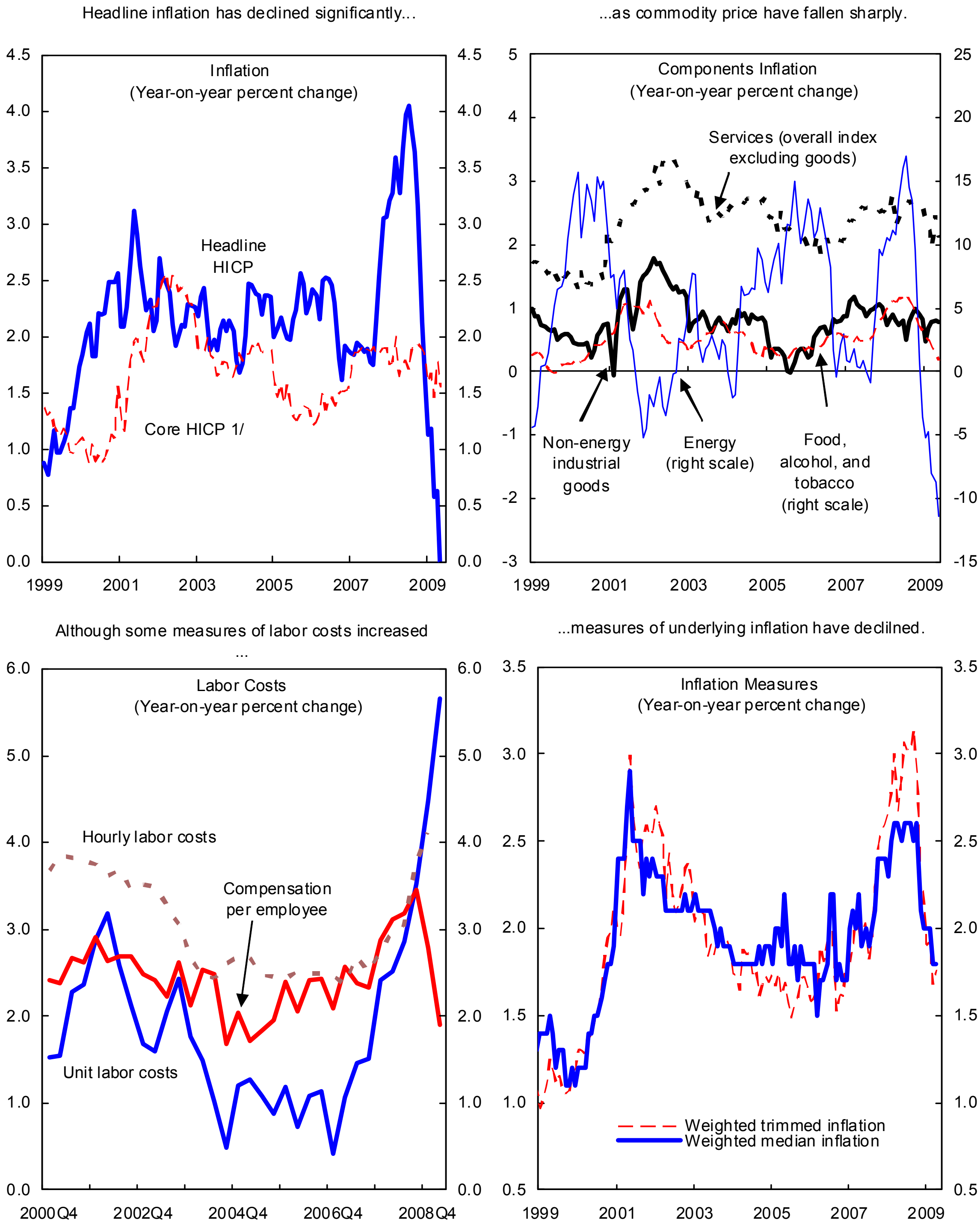
3/ Excludes intra-area trade (ECB data).

Figure 7. Margins of Euro Area Exporters to Main Export Destinations
(Export unit value relative to ULC in manufacturing, 2000=100)



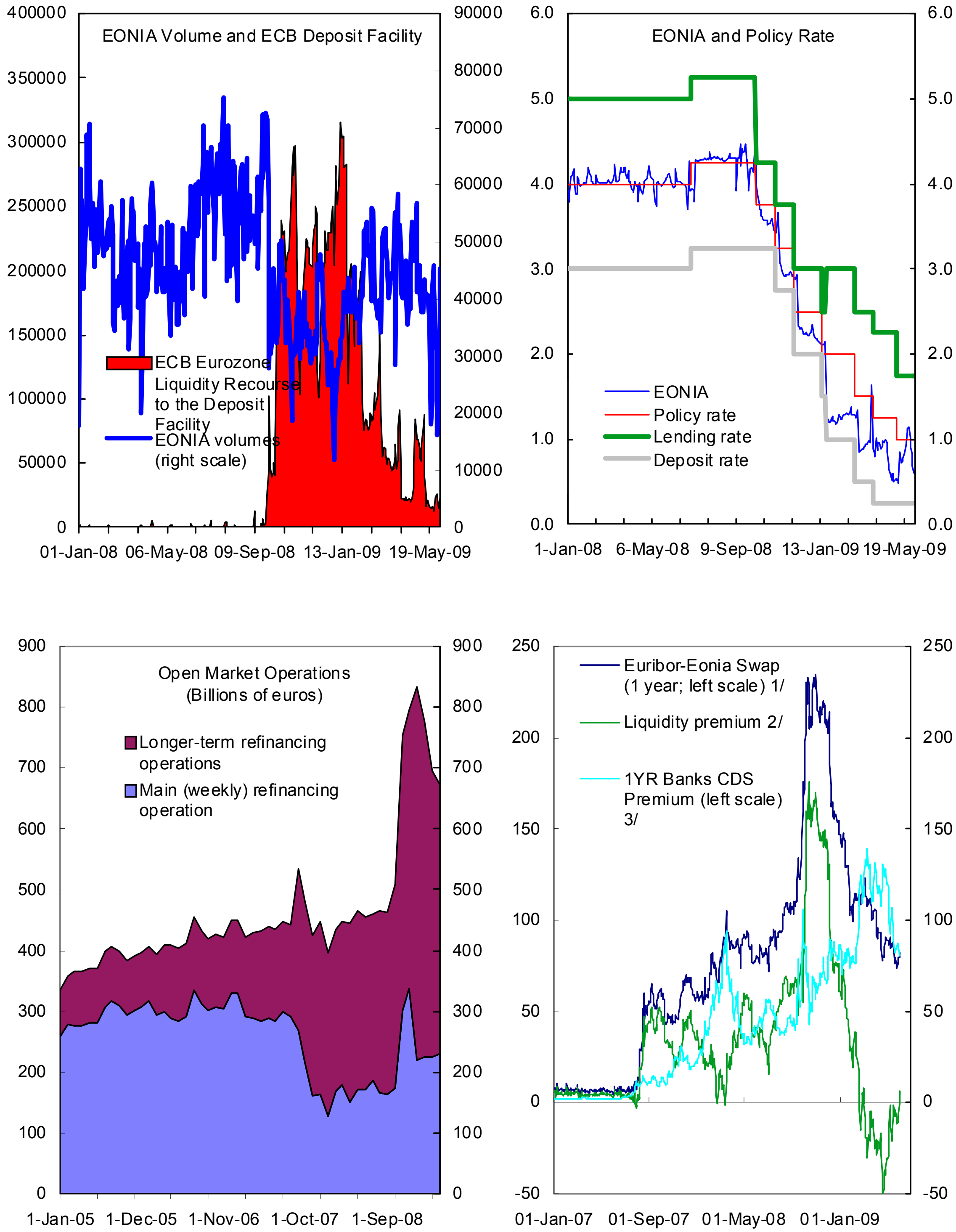
Sources: Eurostat; OECD; and IMF staff calculations.

Figure 8. Euro Area: Inflation and Labor Costs, 1999–2009
(Percent, unless otherwise specified)



Sources: Eurostat; ECB; and Haver Analytics.
1/ Excludes energy, food, alcohol, and tobacco.

Figure 9. Euro Area: Recent Developments of the ECB's Liquidity Operations



Sources: DataStream; and Bloomberg.

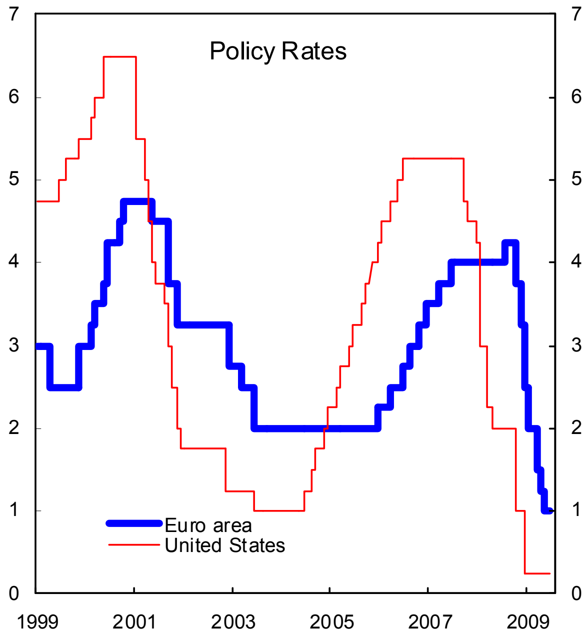
1/ Euribor refers to "the best price between the best banks" provided by Euribor panel members.

2/ The liquidity premium is the difference between the Euribor - Eonia Swap spread and the CDS premium.

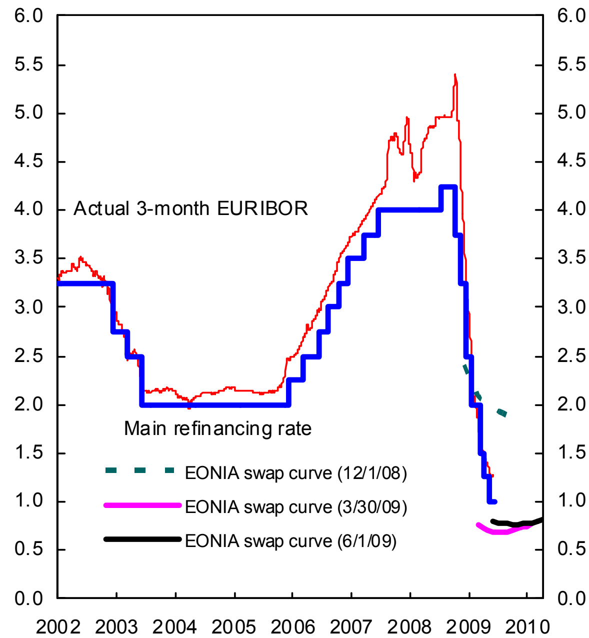
3/ The one-year banks CDS premium is the average of premia for the "best" five Euribor panel banks out of 24 with the lowest premium.

Figure 10. Euro Area: Monetary Policy and Market Expectations
(Percent, unless otherwise specified)

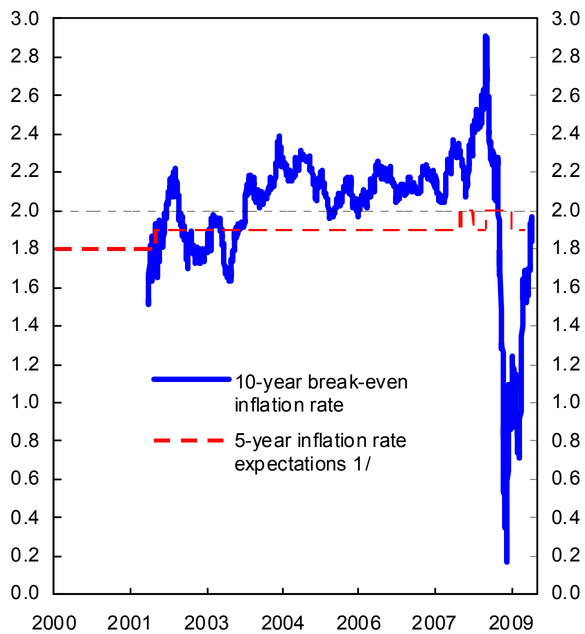
The ECB lowered rates by 325 bps since October 2008 to an all time low of 1 percent...



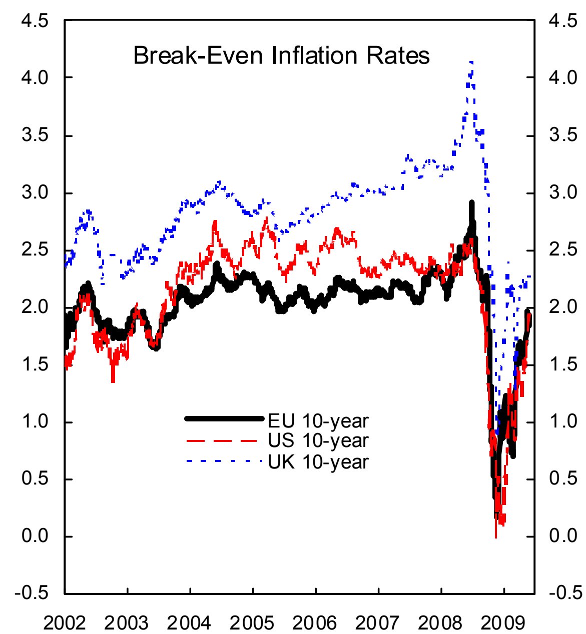
...and markets expect rates to remain low over the near term.



Analysts' inflation expectations remain anchored...

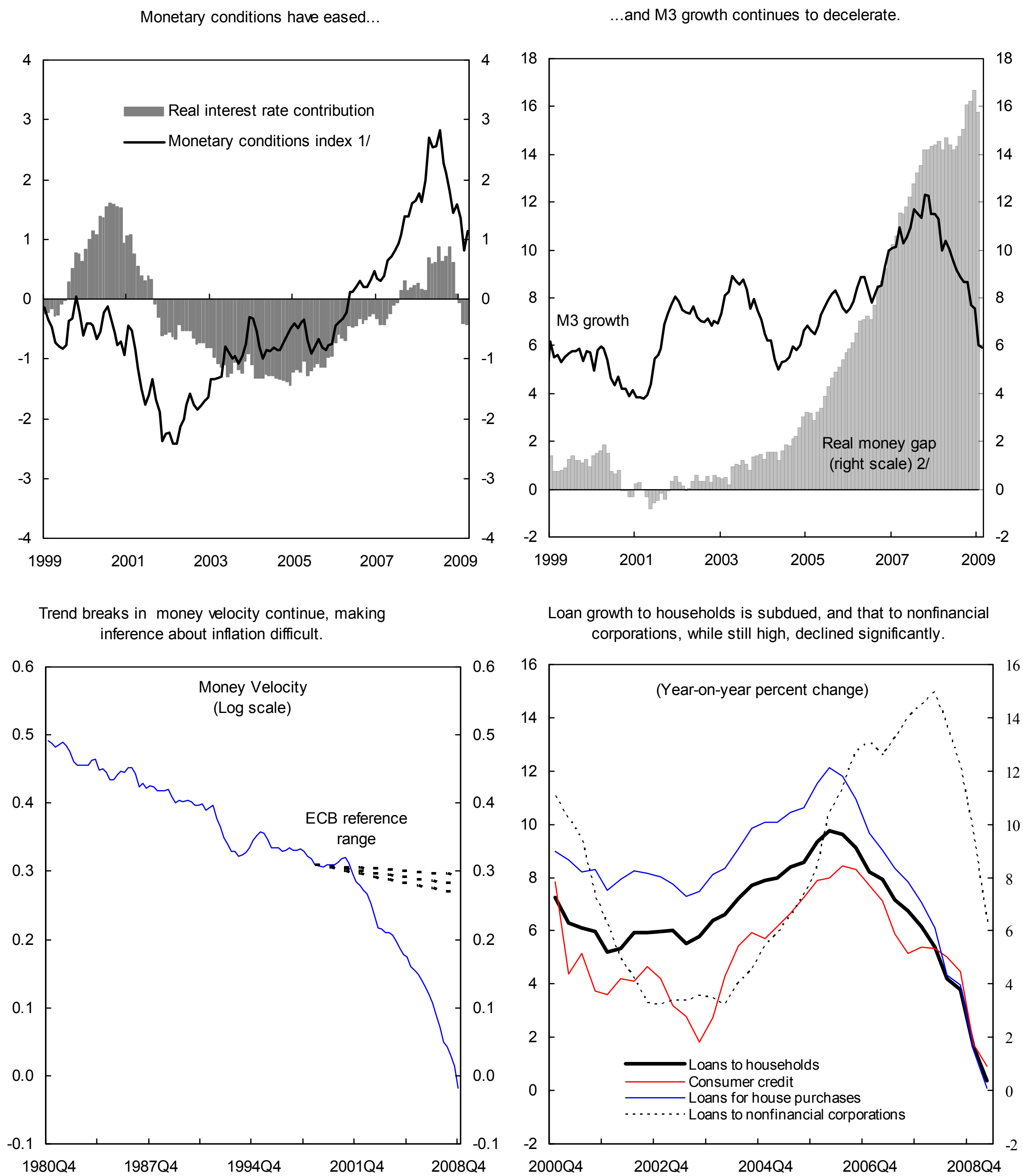


...while break-even inflation has recovered from the end-2008 lows and is in line with the ECB target.



Sources: Bloomberg; Datastream; ECB; Eurostat; and IMF staff calculations.
1/ Survey of Professional Forecasters.

Figure 11. Euro Area: Money and Credit, 1980-2009
(Percent, unless otherwise specified)

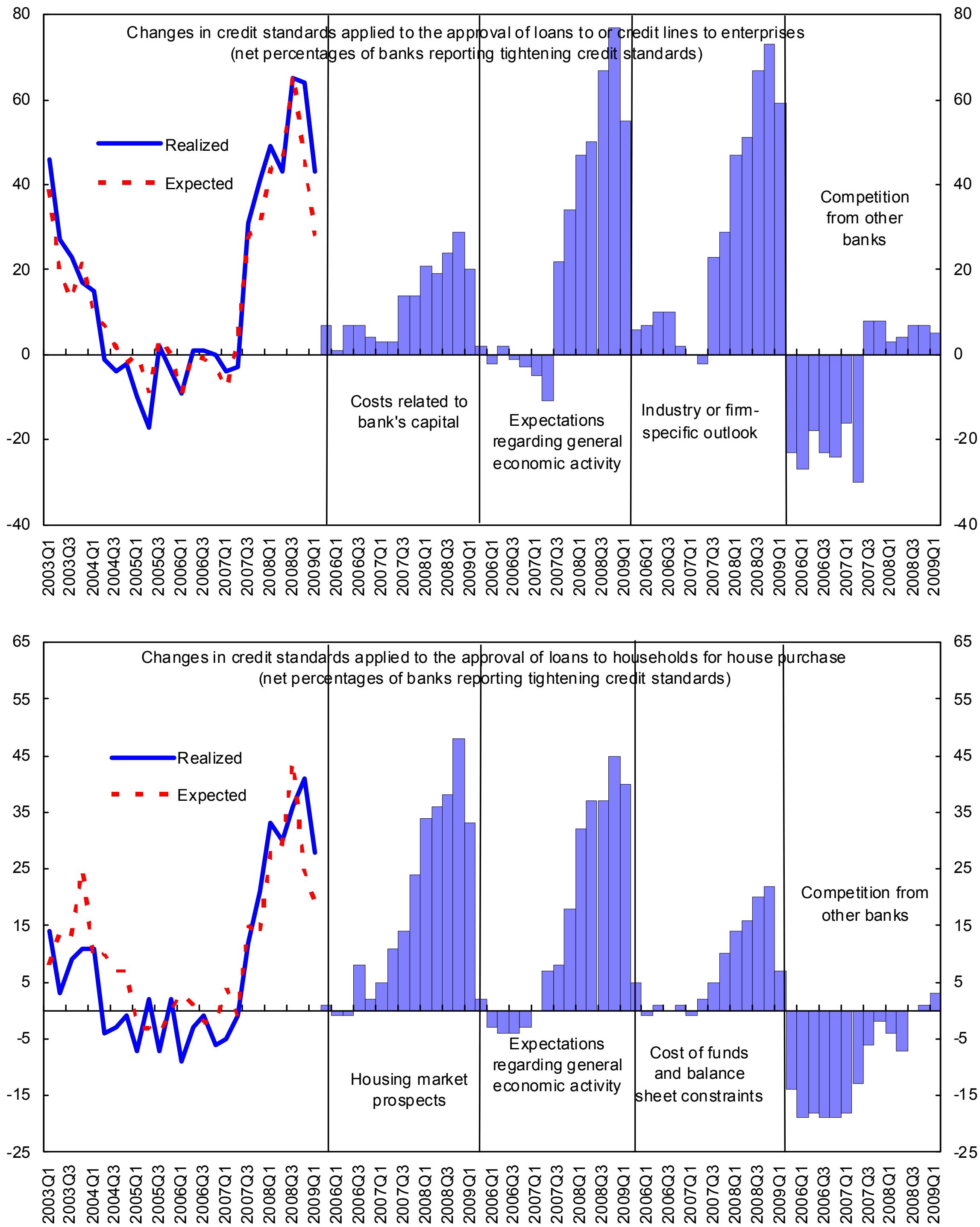


Sources: ECB; Datastream; Bloomberg; and IMF staff calculations.

1/ Deviations from 1993–2006 mean.

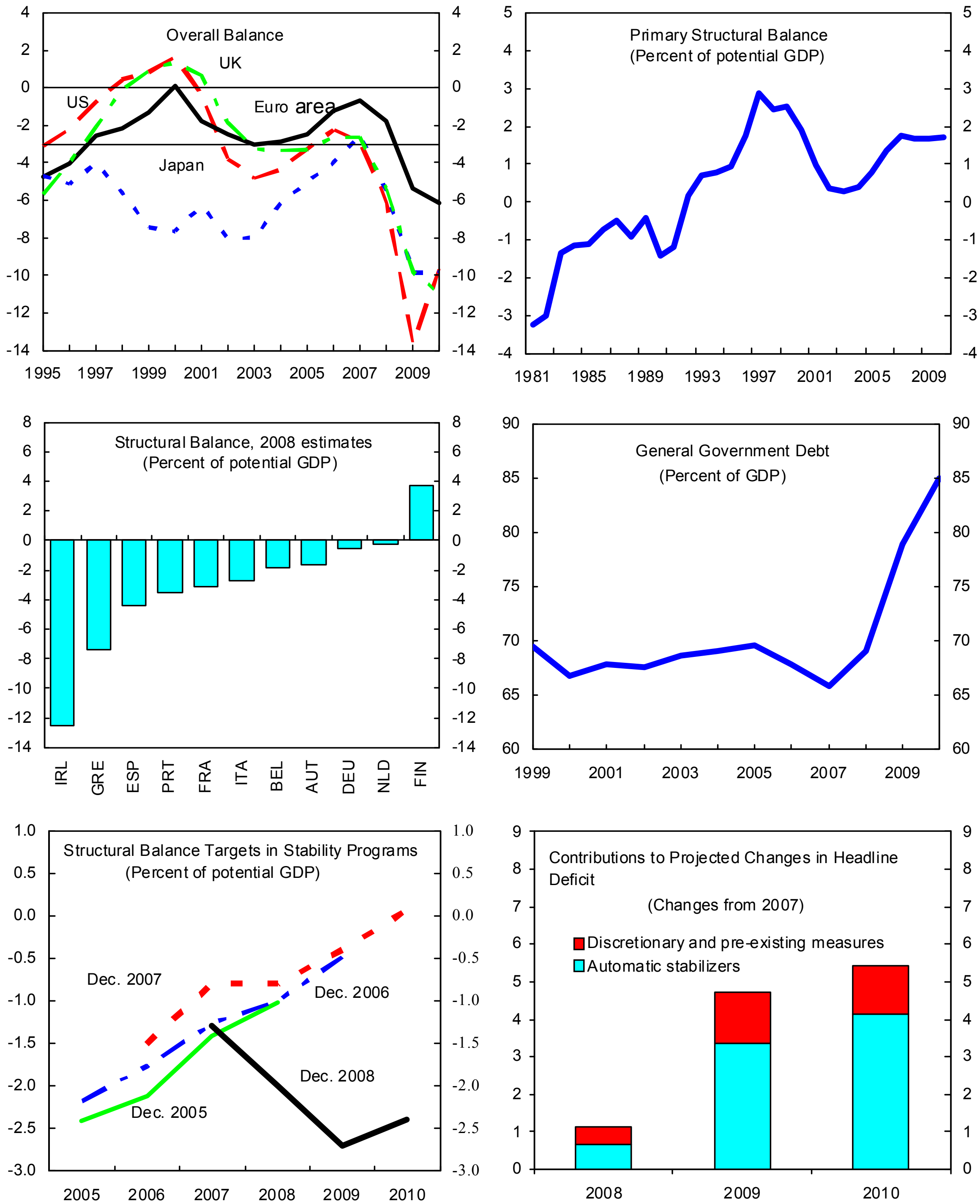
2/ Based on M3 corrected for the estimated impact of portfolio shifts. Deviation (in percent of the actual real stock, deflated by HICP) from an estimate of the long-run real stock that would have resulted from constant nominal M3 growth at its reference value of 4.5 percent and HICP inflation in line with the ECB's definition of price stability, taking December 1998 as the base period.

Figure 12. Euro Area: Changes in Credit Standards to Enterprises and Households, 2005–08



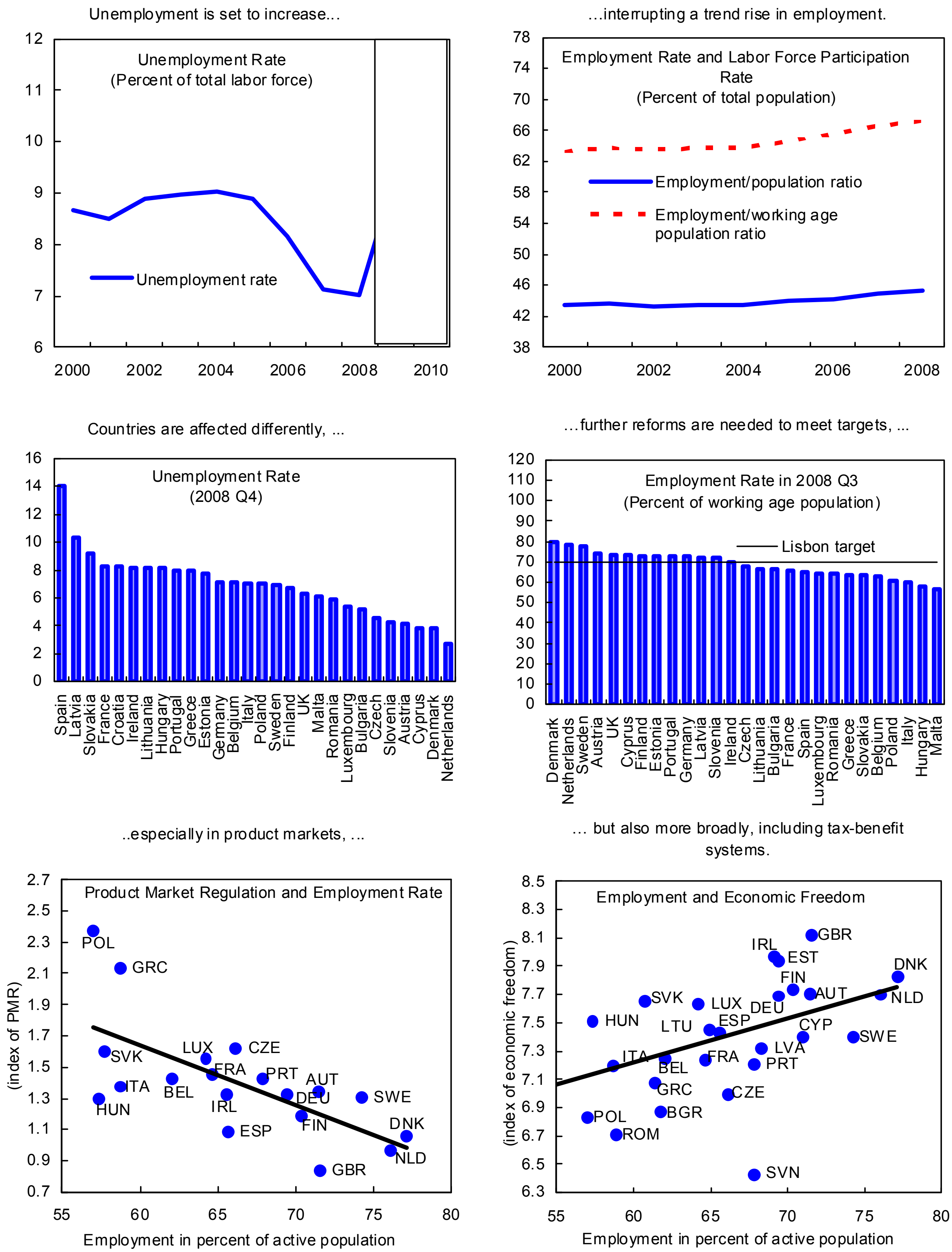
Source: European Central Bank.

Figure 13. Euro Area: Fiscal Developments
(Percent of GDP, unless otherwise noted)



Sources: European Commission; IMF, *World Economic Outlook;* and IMF staff calculations.

Figure 14. European Union: Labor Markets and Structural Reform



Sources: OECD; Eurostat; Fraser Institute; Haver; and IMF staff calculations.

Table 1. Euro Area: Main Economic Indicators, 2005–10
(Percent change)

	2005	2006	2007	2008	2009	2010
					Staff projections	
Demand and Supply						
Real GDP	1.7	2.9	2.7	0.7	-4.8	-0.3
Private consumption	1.8	2.0	1.6	0.4	-1.5	-0.6
Public consumption	1.5	1.9	2.2	2.0	1.6	1.9
Gross fixed investment	3.3	5.5	4.8	0.0	-11.6	-3.6
Final domestic demand	2.1	2.7	2.4	0.6	-3.1	-0.7
Stockbuilding 1/	-0.2	0.1	0.0	0.1	-0.2	0.0
Domestic Demand	2.0	2.8	2.4	0.7	-3.4	-0.7
Foreign balance 1/	-0.1	0.2	0.3	0.0	-1.2	0.4
Exports 2/	5.0	8.3	5.9	1.0	-16.7	-0.5
Imports 2/	5.7	8.2	5.3	1.0	-14.1	-1.5
Resource Utilization						
Potential GDP	1.8	1.6	1.7	1.3	-0.3	0.4
Output gap	-0.7	0.6	1.6	1.1	-3.5	-4.2
Employment	1.0	1.6	1.8	0.8	-2.3	-1.9
Unemployment rate 3/	9.0	8.3	7.5	7.6	10.1	11.9
Prices						
GDP deflator	2.0	2.0	2.4	2.4	0.4	0.5
Consumer prices	2.2	2.2	2.1	3.3	0.2	0.7
Public Finance 4/						
General government balance	-2.5	-1.2	-0.6	-1.9	-6.2	-6.9
General government structural balance	-2.6	-2.0	-1.8	-2.4	-3.7	-3.9
General government gross debt	69.6	67.8	65.7	69.6	81.0	88.0
Interest Rates 3/ 5/						
EURIBOR 3-month offered rate	2.2	3.2	4.2	4.2	1.1	…
10-year government benchmark bond yield	3.4	3.8	4.4	4.4	4.1	…
Exchange Rates 5/						
U.S. dollar per euro	1.25	1.26	1.37	1.47	1.38	…
Nominal effective rate (2000=100)	121.7	122.6	128.9	137.0	135.8	…
Real effective rate (2000=100) 6/	129.6	130.3	137.8	146.8	140.7	…
External Sector 4/ 7/						
Current account balance	0.1	-0.1	0.1	-0.5	-1.0	-1.0
Trade balance 8/	0.5	0.1	0.5	-0.1	-0.5	-0.6

Sources: IMF, *World Economic Outlook;* DataStream; Eurostat; and ECB Monthly Bulletin.

1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ Latest available data for 2009.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.

Table 2. Euro Area: Balance of Payments

	2001	2002	2003	2004	2005	2006	2007	2008	2009Q1
					(Billions of euros)				
Current account	-27.0	46.0	20.9	60.5	9.3	-10.5	11.1	-93.5	-25.5
Goods	67.9	121.8	98.7	94.3	43.6	12.2	46.5	-6.1	-6.3
Services	-2.8	16.9	22.5	32.1	38.7	43.2	49.3	41.8	4.2
Income	-40.3	-43.7	-44.8	-6.2	0.2	13.6	1.4	-32.4	2.1
Current transfers	-52.0	-49.1	-56.1	-59.5	-73.4	-79.5	-86.0	-96.9	-25.6
Capital account	5.5	10.9	12.2	16.6	11.3	9.1	13.7	12.4	3.1
Financial account	-28.4	-13.4	-14.1	-26.0	10.2	141.6	41.3	313.5	105.0
Direct investment	-109.6	22.6	-9.7	-79.6	-205.7	-157.6	-92.4	-251.4	-52.4
Portfolio investment	72.9	138.0	54.4	72.0	127.0	293.9	159.7	439.2	144.5
Equity	132.4	46.2	32.8	24.8	121.6	144.2	48.1	35.7	-51.0
Debt instruments	-59.1	91.9	21.4	47.1	5.7	149.7	111.4	403.2	195.4
Financial derivatives	-0.7	-12.2	-13.7	-8.2	-17.3	3.3	-67.1	-30.8	10.5
Other investment	-8.9	-159.3	-72.8	-22.4	88.7	3.0	46.2	160.5	-3.3
Reserve assets	18.0	-2.5	28.0	12.6	17.7	-0.9	-4.9	-4.1	5.6
Errors and omissions	49.8	-43.5	-18.9	-50.8	-30.8	-140.3	-66.0	-232.4	-82.7
					(Percent of GDP)				
Current account	-0.4	0.6	0.3	0.8	0.1	-0.1	0.1	-1.0	-1.1
Goods	1.0	1.7	1.3	1.2	0.5	0.1	0.5	-0.1	-0.3
Services	0.0	0.2	0.3	0.4	0.5	0.5	0.5	0.5	0.2
Income	-0.6	-0.6	-0.6	-0.1	0.0	0.2	0.0	-0.3	0.1
Current transfers	-0.7	-0.7	-0.7	-0.8	-0.9	-0.9	-1.0	-1.0	-1.1
Capital account	0.1	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.1
Financial account	-0.4	-0.2	-0.2	-0.3	0.1	1.7	0.5	3.4	4.7
Direct investment	-1.5	0.3	-0.1	-1.0	-2.5	-1.8	-1.0	-2.7	-2.3
Portfolio investment	1.0	1.9	0.7	0.9	1.6	3.4	1.8	4.7	6.5
Equity	1.9	0.6	0.4	0.3	1.5	1.7	0.5	0.4	-2.3
Debt instruments	-0.8	1.3	0.3	0.6	0.1	1.8	1.2	4.4	8.7
Financial derivatives	0.0	-0.2	-0.2	-0.1	-0.2	0.0	-0.7	-0.3	0.5
Other investment	-0.1	-2.2	-1.0	-0.3	1.1	0.0	0.5	1.7	-0.1
Reserve assets	0.3	0.0	0.4	0.2	0.2	0.0	-0.1	0.0	0.3
Errors and omissions	0.7	-0.6	-0.3	-0.6	-0.4	-1.6	-0.7	-2.5	-3.7
Memorandum items:									
GDP (billions of euros)	7,075.3	7,324.3	7,544.5	7,854.5	8,148.6	8,548.9	8,982.5	9,263.6	2,239.1
Reserves of the eurosystem 1/ (billions of euros)	392.7	366.1	306.7	281	320.1	325.8	347.4	383.9	395.8

Source: ECB.

1/ End of period stocks.

APPENDIX I—STATISTICAL ISSUES

Statistics for the euro area (and the EU-27) are produced by Eurostat,[1] in conjunction with national statistical agencies within the European Statistical System (ESS), and the ECB, working with national central banks within the Eurosystem/ESCB. These statistics are of sufficient quality, scope, and timeliness to allow effective macroeconomic surveillance, thanks to major progress made since the introduction of the euro. However, the financial crisis has exposed new needs, notably, new data and information systems to allow better macrofinancial risk monitoring and support the work of the new European Systemic Risk Board. The ECB has comprehensive statistical and logistical systems, a legal framework, and a program of ongoing work that could be built upon for this purpose. The IMF's Dissemination Standards Bulletin Board (DSBB)[2] provides comprehensive information on the Euro area's statistical practices for the Special Data Dissemination Standard (SDDS) data categories.

Recent and ongoing developments include:

- The legal and institutional underpinnings of the statistical framework have been strengthened. A new European Statistics Regulation[3] has revised the legal basis for the collection and compilation of statistics in the EU. It set forward the principles that govern the production and dissemination of data; established a European Statistical System Committee tasked with providing professional guidance to the ESS and regularly reviewing and updating the 2005 European Statistics Code of Practice; and revised confidentiality provisions to facilitate cooperation within the ESS. The institutional framework was also reinforced with two other new bodies: the European Statistical Advisory Committee (ESAC), a user group, and the European Statistics Governance Advisory Board (ESGAB), which monitors adherence to the European Statistics Code of Practice. [4]

- A decision has been made to add data to the Principal European Economic Indicators on housing starts and house prices, as well as some short-term indicators on activity

[1] Eurostat has introduced a new, more user-friendly website. See: http://epp.eurostat.ec.europa.eu/. The ECB has maintained a statistical data warehouse for euro area and related national statistics. See http://sdw.ecb.europa.eu/. The division of tasks between both statistical systems has been spelled out in a Memorandum of Understanding (http://www.ecb.europa.eu/ecb/legal/pdf/en_mou_with_eurostat1.pdf).

[2] Available at: http://dsbb.imf.org/.

[3] Regulation No. 223/2009 of the European Parliament and of the Council, published in the Official Journal of the European Union on March 31, 2009.

[4] Peer reviews form part of the European Statistical System implementation strategy of the Code of Practice in enhancing the integrity, independence and accountability of its statistical authorities. Peer reviews of individual National Statistical Institutes may be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/quality/code_of_practice/peer_reviews

in the services sector. New guidelines with respect to seasonal and calendar day adjustments have come into effect, and a draft guideline has been prepared to harmonize revision policies. The publication of vintage data is under consideration, but would require adapted IT solutions. Eurostat is also investigating ways to better monitor short-term output developments and identify turning points. The introduction of NACE rev. 2 is proceeding on schedule toward full implementation by 2011.[5]

- For the national accounts, Eurostat and the ECB are moving toward a "30-60-90" approach: publishing flash data after 30 days; European aggregates and the main income, expenditure and output components after 60 days; and the sectoral and financial sector accounts after 90 days. The quarterly savings and investment rates together with the investment rate and profit share of non-financial corporations are to be added to the Principal European Economic Indicators, with some country breakdown published as of October 2009. The European System of Accounts (ESA) is under review to align it with the UN's February 2009 revision of the *System of National Accounts 2008* (*2008 SNA*). Adoption is targeted by June 2010, and full implementation by 2014. Work is ongoing on Supply/Use and Input/Output tables for the euro area. The ongoing EU KLEMS project to create a database on productivity by industry, which aims to better measure multifactor productivity, is scheduled for completion by 2012-13.[6]

- A revised draft manual for the Harmonized Index of Consumer Prices (HICP) is being finalized. At the same time, implementation is underway of the transition toward measuring consumer prices based on consumption segments rather than specific products, which should broaden the scope of prices considered. Internal simulations for a dwellings price index for the euro area have been produced, with regular production planned from 2010 onwards. For the time being, the ECB publishes a half-yearly residential property price index for the euro area. Work on setting up an index of expenditure on home sales is proceeding.

- Various aspects of the statistical treatment of public interventions in the financial sector remain under consideration, notably with respect to public debt securities issued solely for lending to the private sector. For asset purchases and lending, the deficit impact depends on the degree of subsidy involved and the likelihood of

[5] NACE stands for *Nomenclature Générale des Activités Economiques dans les Communautés Européennes* and is the European classification system of economic activities. NACE is fully compatible with the UN's ISIC classification, but provides greater detail. NACE rev. 2 came into force on January 1, 2008, and is being introduced gradually during the 2008-11 period. It provides a better and more detailed classification of economic activities, tailored to the structure of a modern economy. NACE rev. 2 is linked with a revised Classification of Products by Activity (CPA) which is being introduced in parallel.

[6] See: http://www.euklems.net/

repayment. Despite improvements, resources for the monitoring of member states' government finance statistics remain tight as the crisis has raised the workload.

- The harmonized compilation of Producer Price Indices for services has started, with reporting gearing up. The next target is a production index on services possibly for dissemination by 2012.

- A Task Force on the quality of the Labor Force Survey has concluded its work, and follow-up action is being considered. A new legal basis has been established for the quarterly statistics on job vacancies, inter alia ensuring a full EU-wide collection and reducing reporting delays (first estimate at Q+45 days). It will apply for data from the first quarter of 2010 onward.

- New regulations have been introduced covering Intrastat and Extrastat reporting,[7] in part to reduce the reporting burden. The new Intrastat reporting strengthens quality requirements and introduces new statistics by business characteristics, but increases the reliance on extrapolation from 3 to 5 percent of imports. The revised Extrastat reporting reflects changes in customs systems and should better allow the identification of quasi-transit trade. Annual reconciliation rounds have been introduced to identify and address large bilateral asymmetries in trade and balance of payment data.

- The ECB is undertaking broad-based efforts to improve the availability of statistics to monitor financial developments and risks. During the next few years, it will expand the statistical coverage of non-bank financial intermediaries, notably investment funds, hedge funds (including a first legal definition), insurance corporations, and pension funds. It aims to introduce new securitization statistics by end-2010, new statistics on collateralization and exposure to credit risks, more advanced and timely interest rate statistics, a comprehensive micro database and standardized electronic reference data for securities, and enhanced consolidated statistics on financial institutions. In May 2009, together with the BIS and the IMF, the ECB released the first part of the *Handbook on Securities Statistics*, which covers debt securities issues.

- The ECB plans to introduce non-financial balance sheet data per institutional sector by end 2009, based on the progress made in measuring housing wealth in its quarterly financial accounts for the euro area. It is working with the Commission to establish a twice-yearly survey on financing conditions for SMEs, from later this year onward. It will also coordinate surveys organized by the national central banks on household financing and consumption, to be conducted every three years, the first results of which are expected in 2010.

---

[7] Intrastat covers intra-EU trade and is based on reporting by businesses. Extrastat covers extra-EU trade and is based on customs declarations.

- Moreover, the ECB and Eurostat participate in the IMF-led Inter-Agency Group on Economic and Financial statistics which has established a new website to provide comparable Principal Global Indicators (PGIs) for the G-20 economies including the euro area.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/95
FOR IMMEDIATE RELEASE
July 30, 2009

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2009 Article IV Consultation on Euro Area Policies

On July 17, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation on Euro Area Policies.[1]

Background

The euro area remains in recession, with signs of improvement yet to evolve into a recovery. The large drop in financial wealth, an associated increase in private savings, tight financing conditions, and the adjustment of global imbalances are key drivers of the economic decline, exacerbated by the correction of home-grown imbalances in some countries. Bank credit to the private sector is very subdued and efforts to reduce leverage and capital shortages of banks seem to be negatively affecting recent bank loan developments. Given the tight financial and trade integration of Europe, adverse feedback loops have been operating across borders and between the financial and real sector, with the recession now adding to the financial sector's woes. The recent improvement in sentiment and high frequency and other leading indicators has thus far been signaling only a reduction in the pace of contraction in output, while the shape and timing of the recovery remain highly uncertain. The ongoing crisis is also likely to dampen growth potential, in part reflecting structural rigidities.

The euro area is facing strong disinflationary pressures. Headline inflation has fallen sharply to zero percent in May 2009 from its peak of 4 percent in mid-2008, largely reflecting base effects from the steep decline of commodity prices, but also the significant weakening in economic activity. Core inflation excluding energy, food alcohol and tobacco eased by less, declining to an average of 1.6 percent, after hovering around 1.9 percent during 2007–2008. Given large output gaps, inflation is widely projected to remain significantly below 2 percent in 2009–2010. Against

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

this background the ECB has eased monetary policy significantly, with policy rates currently at 1 percent from 4.25 percent in early October 2008.

The euro area's financial system remains under considerable strain although actions undertaken by policymakers have helped contain systemic risk. The ECB has deployed a wide array of unconventional measures: it lengthened the term funding of its liquidity provision, widened its collateral requirements, and has been providing unlimited term funding at fixed rates since October 2008. Other policy actions so far have focused on stabilizing the banking system and preventing bank runs, but their take-up, especially of resources for recapitalization has fallen considerably short of amounts made available and disclosure has remained limited, reflecting differences in approach across countries. For the largest cross-border institutions, coordinated stress tests are under way with the aim to provide an aggregate view of the resilience of the EU's banking system.

The EU members have agreed to an overhaul of their financial stability arrangements. The two new cross-border institutions to be created—a European System of Financial Supervisors and a European Systemic Risk Board—will seek to address existing shortcomings in the EU's financial stability arrangements and the tensions with advancing the EU's single financial market objective that have been exposed by the global financial crisis.

The fiscal position of the euro area is projected to deteriorate significantly, as public finances are used to shore up the financial system and cushion the downturn. Euro area governments have committed large resources to guarantee, recapitalize, and resolve financial institutions. As a result, the euro area's fiscal deficit is projected to increase from 0.6 percent of GDP in 2007 to 6.9 percent by 2010, pushing up government debt significantly over the period.

Executive Board Assessment

The Executive Directors welcomed the broad arsenal of macroeconomic policies and financial sector interventions deployed by euro area authorities and Member States to address the crisis. Directors emphasized that further decisive policy action, especially in the financial sector, is essential to achieve a recovery and return to self-sustaining growth. They also noted that the crisis could dampen potential growth, calling for reinvigorated structural reforms.

Directors observed that the euro area is in recession, amid some tentative signs of improvement. While survey indicators have been recovering and the fall in indicators of economic activity slowing, the remaining stresses and risks in the financial system, and rising corporate defaults and unemployment are weighing on the expected recovery. Thus, Directors expected the decline in activity to moderate through the remainder of 2009 and to give way to a modest recovery in 2010, but underscored the significant uncertainty surrounding this scenario.

Directors considered that a resolute and well-coordinated approach to relieve financial stress is essential for a durable recovery, and that backing from national authorities will be key. They welcomed the intention of national authorities—in cooperation with the relevant EU institutions—to thoroughly assess the financial position of banks, including the impact of the recession. Such an assessment should be accompanied by comprehensive follow-up action involving suitable disclosure, recapitalization, measures to address the problem of impaired assets, and resolution of unviable financial institutions. To facilitate resolution, national resolution toolkits should be expanded to allow national authorities to take control of financial institutions at an early stage.

Directors welcomed the June 2009 European Council endorsement of an ambitious reform of the EU's financial stability architecture, including through the creation of a European Systemic Risk Board and the establishment of a European System of Financial Supervisors. They emphasized that the reform should be implemented according to the envisaged timetable and on a well-coordinated basis. Securing adequate resources, effective decision-making mechanisms, and independence for the new entities, as well as an unconstrained information flow within the new architecture, will all be essential. Directors underscored that the European Supervisory Authorities will need sufficient legal scope to establish a single rulebook, effectively transposed at the national level. In parallel, the accelerated work under the ongoing crisis management roadmap should address weaknesses in the crisis resolution framework, as well as burden sharing issues at the EU level.

Directors welcomed the ECB's far-reaching unconventional (ECB: non-standard) measures to support liquidity and credit as well as its accommodative monetary policy stance. They emphasized that, given large and increasing output gaps and inflation projected to remain very low for some time, it will be essential to maintain this stance as long as disinflationary pressures persist. Directors noted that this could best be done by keeping interest rates low through the unlimited provision of term funding. They emphasized that a crystallization of downside risks would require a more forceful signal to keep interest rates low, while retaining all unconventional options open to deal with contingencies. Directors commended the ECB for embedding exit strategies in the design of most of its unconventional policies.

Directors agreed that fiscal policy will need to continue to support economic activity in 2010, but emphasized that credible medium-term consolidation programs should be put in place to address solvency concerns. Directors were of the view that planned discretionary measures are broadly appropriate, given the large automatic stabilizers. They emphasized that application of the SGP, which would support fiscal consolidation once the recovery takes hold, will need to be bolstered by a strengthening of national fiscal institutions to foster ownership of consolidation goals. Accordingly, Directors noted that surveillance over progress toward medium-term consolidation objectives should be stepped up at both the EU and national levels.

Directors underscored that the crisis provides a window of opportunity to push forward with intensified structural reforms needed to address long-standing rigidities. With economic restructuring ahead, they encouraged a heightened focus on training, education, and job-matching. Directors emphasized that implementing the services directive, revamping the Lisbon agenda, and facilitating an ambitious and early conclusion of the Doha round will contribute to the foundations of a solid recovery.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with the Euro Area is also available.

Euro Area: Main Economic Indicators
(Percent change)

	2003	2004	2005	2006	2007	2008	2009	2010
							Staff projections	
Demand and Supply								
Real GDP	0.8	2.2	1.7	2.9	2.7	0.7	-4.8	-0.3
Private consumption	1.2	1.6	1.8	2.0	1.6	0.4	-1.5	-0.6
Public consumption	1.7	1.6	1.5	1.9	2.2	1.9	1.7	1.9
Gross fixed investment	1.3	2.3	3.3	5.5	4.8	0.0	-11.6	-3.6
Final domestic demand	1.3	1.7	2.1	2.7	2.3	0.8	-3.1	-0.6
Stockbuilding 1/	0.1	0.2	-0.2	0.1	0.0	0.1	-0.1	0.0
Domestic Demand	1.5	2.0	1.9	2.8	2.5	0.7	-3.4	-0.7
Foreign balance 1/	-0.6	0.3	-0.1	0.2	0.3	0.0	-1.2	0.4
Exports 2/	1.3	7.4	5.0	8.3	5.9	1.0	-16.3	-0.5
Imports 2/	3.2	7.0	5.7	8.2	5.3	1.0	-13.6	-1.5
Resource Utilization								
Potential GDP	1.9	2.0	1.8	1.6	1.7	1.4	-0.2	0.5
Output gap	-0.8	-0.6	-0.7	0.6	1.6	0.9	-3.7	-4.5
Employment	0.7	0.7	1.0	1.6	1.8	0.8	-2.3	-1.9
Unemployment rate 3/	8.7	8.8	9.0	8.3	7.5	7.6	10.1	12.0
Prices								
GDP deflator	2.2	1.9	2.0	1.9	2.3	2.3	0.4	0.5
Consumer prices	2.1	2.2	2.2	2.2	2.1	3.3	0.2	0.7
Public Finance 4/								
General government balance	-3.0	-2.9	-2.5	-1.2	-0.6	-1.9	-6.2	-6.9
General government structural balance		-2.9	-2.6	-2.0	-1.8	-2.4	-3.7	-3.9
General government gross debt	68.7	69.1	69.6	67.8	65.7	69.6	81.0	88.0
Interest Rates 3/ 5/								
EURIBOR 3-month offered rate	2.3	2.1	2.3	3.2	4.3	4.4	1.1	…
10-year government benchmark bond yield	4.0	4.0	3.4	3.8	4.4	4.4	4.1	…
Exchange Rates 5/								
U.S. dollar per euro	1.13	1.24	1.25	1.26	1.37	1.47	1.38	…
Nominal effective rate (2000=100)	117.6	122.0	121.7	122.6	128.9	137.0	135.8	…
Real effective rate (2000=100) 6/	121.6	128.0	129.6	130.3	137.8	146.8	140.7	…
External Sector 4/ 7/								
Current account balance	0.3	0.8	0.1	-0.1	0.1	-0.7	-1.1	-1.1
Trade balance 8/	1.3	1.2	0.5	0.1	0.5	-0.1	-0.4	-0.5

Sources: IMF, *World Economic Outlook;* DataStream; Eurostat; and ECB Monthly Bulletin.
1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ Latest available data for 2009.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.

Statement by Klaus Stein, Executive Director for Germany, on behalf of the Euro Area Authorities
July 17, 2009

In my capacity as President of EURIMF, I submit this buff statement on the Article IV consultation with the euro area. It reflects the common view of the Member States of the euro area and the European Union in their respective fields of competence.

The authorities of the euro area Member States are grateful for open and fruitful consultations with the Fund staff and for their constructive policy advice. While broadly concurring with the staff's findings, views differ on a few aspects, as will be outlined in my statement. It will also provide an update recent economic developments.

Short-term economic outlook

The euro area, like other advanced economies, is in the midst of a **severe recession**. In the first quarter of this year GDP contracted at an unprecedented pace due to weaknesses in both domestic and foreign demand.

Following the disappointing first-quarter GDP numbers, **some tentative signs of stabilization** have emerged recently. A substantial inventory correction is under way, while indicators related to global trade have started to send promising signals. Reflecting these positive developments in global demand, the huge drag on euro area GDP from the export collapse may start easing.

On the domestic side, recent business sentiment indicators and available May industrial production data for the largest euro area economies are also sending encouraging signs, which may imply a **less negative outlook**. Low inflation and the fiscal stimuli will maintain a stimulating effect on the economy. However, for firms to resume investment, a parallel improvement in financial conditions is necessary, and indicators related to the latter are somewhat mixed. On the one hand, stock markets have recovered somewhat and money markets rates further declined. On the other hand, government bond yields have increased and credit standards remain tight.

While the first positive signals are clearly welcome, it is important to avoid reading too much into them. Most soft indicators remain still below the levels that mark the start of an expansion phase. In addition, their recent improvements are **still to be confirmed by hard data**. In the labor market, the full impact of the current crisis is yet to come, although unemployment has already strongly increased in many Member States.

Therefore, the authorities' assessment of the emerging positive signals is cautious. Nevertheless, the most recent indicators are in line with the view that the decline in activity should moderate throughout the remainder of 2009 and give way to a **modest recovery in 2010**. Euro area authorities concur with the staff that the growth outlook for the euro area economy remains surrounded by exceptional uncertainty.

Financial sector issues

Safeguarding financial stability is one of the highest priorities for the euro area Member States. Since the outbreak of the current financial crisis, euro area governments, along with other EU Member States, have committed very substantial amounts of **public funding** in various forms – totaling around 25 per cent of euro area GDP – in support of the banking sector. Together with the substantial liquidity provided by the ECB to euro area money markets, these measures have averted a financial meltdown. The most acute phase of the crisis has now passed. Indeed, the main indicators of stress in the financial system are signaling a progressive stabilization.

Despite the financial stabilization achieved, **the banking sector in the euro area remains fragile**, as in other parts of the world,. The support to banks provided by Member State governments is apparently still needed to ensure a sufficient basis for the required recovery in confidence. Banks have not yet fully utilized the available amounts of public funds. Banks in the euro area as well as in the EU are still highly leveraged. Moreover, uncertainty about the quality of their assets remains. This has fuelled some concerns about the overall health of their balance sheets. As pointed out by the staff, restoring confidence in the viability of the banking sector is a precondition for sustainable recovery of the broader economy.

Upon request of the Economic and Financial Council, the Committee of European Banking Supervisors (CEBS) coordinates an EU-wide **forward-looking stress testing** of the banking system, in cooperation with the Commission and the ECB. The results of the test will be reported to Finance Ministers and Central Bank Governors in September 2009 and will provide additional information on the banking sector's ability to absorb possible shocks and the overall financial stability implications, and complement in this way the estimates made by the staff, the ECB and by analysts, on the potential losses to be incurred by the EU/euro area banking sector in case of an adverse macroeconomic scenario.

As indicated by the staff, the financial crisis has posed an important challenge for the functioning of the Single Market and the European financial system and underscored the need for the EU to **strengthen** its **financial stability arrangements**. Co-ordination of financial-market support measures among EU Member States has helped to limit market fragmentation and competitive distortions and to restore financial stability in the short-term.

Looking ahead, there is a clear need to **enhance the regulatory and supervisory framework** in order to reduce the possibility of similar crises in the future. To that end, the EU has decided to reform its framework for financial supervision. In June 2009, the European Council endorsed proposals by the Commission to establish a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS). The ESRB will monitor and assess potential threats to the stability of the EU financial system and, where necessary, issue risk warnings and recommendations for action and monitor their implementation. The ESFS will comprise three new European Supervisory Authorities with powers as regards the EU banking, insurance and securities sectors and coordinate responsibilities between national supervisory authorities, which will remain responsible for the day-to-day supervision of individual firms. Without impinging on fiscal responsibilities of Member States, the three authorities will have binding and proportionate decision-making powers in respect of whether supervisors are meeting their requirements under a single rule book and relevant Community law and in case of disagreement between the home and host state supervisors. These authorities will also have supervisory powers for credit rating agencies. The Commission intends to adopt the necessary legislative proposals in September.

In parallel to this supervisory reform, the EU is **revisiting financial-sector regulation on a broad basis**. Work is under way in a range of areas such as the capital requirements directive (i.a. addressing securitization and procyclicality), deposit guarantees, credit-rating agencies, hedge funds, OTC derivatives markets, and executive pay. These proposals need to be adopted swiftly in order for the new framework to be fully in place in the course of 2010. In addition, the Commission is working on a comprehensive cross-border framework for the prevention and management of financial crises, including the introduction of special resolution regimes for cross-border banks.

Monetary policy, inflation outlook, and liquidity management

The euro area authorities broadly agree with the staff assessment on the ECB's monetary policy, except on two points. (i) When assessing the **risk of protracted deflation** and its policy implications, views differ. The assessment of the ECB is that the risk of protracted deflation is at present **very limited**. Deflationary pressures are neither broad-based nor entrenched in inflation expectations, which are firmly anchored over the medium to longer term in line with the ECB's aim of keeping inflation rates below, but close to, two per cent over the medium term. (ii) In addition, the **transmission of monetary policy** to bank lending rates, while difficult to assess at such an early stage, seems to be broadly in line with the past behavior. In this respect, euro area authorities do not fully share the assessment of the staff with respect to somewhat lower efficiency of the transmission channel.

Turning to the **outlook for price developments**, the fall of annual inflation rates into negative territory in June is in line with previous expectations and reflects mainly temporary effects. After a return to positive inflation rates, price developments are expected to remain dampened over the policy-relevant horizon. Risks to the outlook for inflation are broadly balanced. On the downside they relate, in particular, to the outlook for economic activity, while on the upside they relate to higher than expected commodity prices and to unanticipated stronger increases in indirect taxation and administered prices.

The outcome of the monetary analysis confirms the assessment of **low inflationary pressure**, as money and credit indicators continue to be weak, the latest data confirming their concurrent deceleration. The flow of bank loans to non-financial corporations and households has remained subdued – with a moderate monthly contraction in the outstanding amount of loans to non-financial corporations over recent months –, reflecting in part the weakening in economic activity and the continued low levels of business and consumer confidence.

In sum, the Governing Council of the ECB expects the current episode of extremely low or negative inflation rates to be short-lived and price stability to be maintained over the medium term, thereby continuing to support the purchasing power of euro area households. Against this background, the **current key ECB interest rate**, which has been brought from 4.25 per cent to one per cent between October 2008 and May 2009, **remains appropriate**.

This is also the case in view of the ECB's **enhanced credit support policy**. Since the financial crisis intensified in September 2008, the ECB has introduced monetary policy and liquidity management measures that are unprecedented in nature, scope and magnitude, with a view to protecting the flow of credit to the euro area economy.

The set of non-standard measures has been further enhanced with the **extension of the maturity of the longer-term refinancing operations** with a fixed rate and full allotment to 12 months, and a program of covered bond purchases. In particular, with the conduct of a 12-month refinancing operation in June this year, the Eurosystem has provided a significant amount of liquidity to euro area banks. A record number of 1,121 bidders received a total allotment of €442.2 billion, bringing the overall size of liquidity providing open market operations again to levels observed in late 2008. Euribor fixing rates have decreased by around 20 basis points since the announcement of the new one-year operation in early May 2009.

Outright purchases of covered bonds are another non-standard measure added in May 2009. Covered bonds are debt securities issued by banks, which give them access to funding of a longer-term nature than the ECB's refinancing operations. Covered bonds allow banks to better manage the maturity mismatch between their assets and liabilities. While it is expected to be effective in supporting credit provision by banks, the covered bond purchase program does not burden the Eurosystem with excessive credit risk. After the announcement of the measure, there has been a wave of new issuances of covered bonds, and the spreads on potentially eligible covered bonds have narrowed considerably.

All the measures taken, including the broadening of the list of assets accepted as collateral by the Eurosystem, have contributed to **improving financing conditions** above and beyond what could be achieved through reductions in key ECB interest rates alone. The improvement in financing conditions resulting from past reductions in key ECB rates and from the enhanced credit support measures should provide ongoing support for economic activity in the period ahead. All non-standard measures seek to maintain price stability over the medium term and to ensure that inflation expectations remain firmly anchored in line with price stability. Once the macroeconomic environment improves, the ECB will ensure that the measures taken are quickly unwound and that the liquidity provided is absorbed. Hence, any threat to price stability over the medium to longer term can be effectively countered in a timely fashion.

Fiscal policy

The euro area authorities share the staff assessment that the **discretionary measures** currently adopted are broadly appropriate. The fiscal stance will continue to be supportive into 2010 and **automatic stabilizers** are sizeable. In this context, it is worth noting that in 2010 deficits increase not only in nominal but also in structural terms. Further discretionary budgetary stimulus is not warranted, under the assumption of an expected stabilization and eventual recovery of economic activity in 2010.

The euro area authorities agree with the staff that the **composition of the fiscal stimulus** is crucial and that the discretionary fiscal effort should be coordinated and tailored to country circumstances. Calling for an immediate and **coordinated effort to boost demand**, the

European Economic Recovery Plan (EERP), endorsed by the European Council in December 2008, provided guidelines on the types of measures which were likely to maximize the impact and to result in cross-country synergies and positive spill-over effects. The EERP also stressed that Member States had very different starting points in terms of fiscal room for maneuver. Indeed, a cross-country comparison of the fiscal policy responses to falling aggregate demand, both in terms of stimulus packages and aggregate fiscal stance, highlights significant differences in size. This, at least in part, reflects differences in the countries' perceived ability to expand without facing adverse market reactions.

In its *Orientations for fiscal policies in the euro area Member States* issued on June 8th, the Eurogroup stressed that the **pace of fiscal consolidations** should also be differentiated across countries, taking into account the pace of the recovery, fiscal positions and debt levels, but also the projected cost of aging, external imbalances and risks in the financial sector. Ministers also committed to improve the coordination of the implementation of national recovery measures.

The euro area authorities confirm their strong commitment to put in place **robust medium-term exit strategies** that will lead to timely correction of the excessive deficits and therefore underpin the credibility of fiscal policies. In line with the staff's suggestion to pre-announce the plans for fiscal adjustment to reduce uncertainty, the Eurogroup highlighted that the forthcoming round of stability programs would provide the opportunity for Member States to present exit strategies. Notably, the strategies should: (i) include ambitious and realistic budgetary targets; (ii) spell out the consolidation measures beyond the next budget year; (iii) strengthen the national budgetary frameworks to underpin budgetary discipline and make them more resilient to crises; (iv) implement structural reforms to ensure the long-term sustainability of public finances, in particular in the area of aging-related expenditure.

In this context, the euro area authorities agree with some of the avenues put forward by the staff to **improve the functioning of the Stability and Growth Pact within its current remit**, e.g. the emphasis on strengthening national fiscal frameworks and incorporating aging-related liabilities in the medium-term objectives (MTOs). In this vein, an agreement has been reached and confirmed by the Ecofin in its meeting of July 7th, on the way to incorporate aging-related implicit liabilities in the MTOs. By contrast, the authorities do not agree with suggestions that would imply altering the balance between the preventive and the corrective arms as established in the Stability and Growth Pact and in the Treaty (e.g. treating the MTO as the reference value under the Excessive Deficit Procedure).

Structural reforms

The European Economic Recovery Plan of December 2008 gives priority to reforms that support aggregate demand, employment, and household income in the short-run, whilst at the same time **improve the adjustment capacity and growth potential**. It also recognizes that the crisis presents a strategic opportunity to push forward with more ambitious reform agendas.

The recent Commission's analysis showed that this downturn will in all likelihood leave an important imprint on the European economy in terms of **lower potential output** going forward. This may be related *inter alia* to a generally lower risk appetite after the crisis, pro-cyclicality of R&D investment, as well as hysteresis effects in the labor market, which may also have an impact on potential growth. Given that the aging populations will have additional negative impact on long-term potential growth, a continued, even reinforced focus on productivity-enhancing structural reforms will be an important pillar of the Lisbon strategy post-2010.

On **labor market**s, the measures introduced in many EU Member States are helping to mitigate the impact on unemployment in the short-term. However, given the depth of the recession, there is a clear risk of a sharp rise in unemployment in the future, with all its social and economic costs. In order to counteract this, more emphasis is now needed on policies to **enhance wage flexibility and incentives for firms to create jobs**, and support the chances for the unemployed to find new jobs, especially by investing in training to enhance skills and by facilitating transition towards new jobs.

The implementation of the **Services Directive** is an essential measure to boost economic growth and job creation given the untapped potential of the Internal Market for services. Being an essential step in the structural reform process, the Directive is particularly important for those euro area Member States, which suffer from competitiveness problems, and hence a need to ensure the timely and full implementation of the Directive by December 2009.

Intra-EU spillovers

The **financial market situation in the New Member States** (NMS) has recently improved, in line with the market sentiment towards emerging countries. Decisive policy action over recent months, including the substantial increases in Fund and EU resources for financial assistance to countries with balance-of-payments difficulties, coupled with policy adjustment programs has contributed to this improvement. The EU is currently providing financial assistance to three NMS particularly affected by the crisis, in the context of financing and policy adjustment packages set up together with the Fund and other donors. In addition to BoP assistance, the EU is supporting the NMS through several other financial channels (e.g. frontloading of structural funds and EIB financing) and with policy advice in the context of EU economic surveillance.

The euro area authorities agree with the staff that **full coordination of financial crisis measures** is essential for the success of the assistance programs. This includes, in particular, private sector involvement, especially of banks. It is also important to note that the crisis did not affect all NMS with the same force. NMS which avoided large imbalances or policy weaknesses fared relatively better, underlining the importance of sound policies and the need for a differentiated approach towards individual countries in analysis and communication.

Trade policy

As noted by the staff, the EU attaches great importance to **countering protectionist pressures** resulting from the crisis. For the world economy to return to sustainable growth, it is absolutely essential to keep markets open for trade and investment, and encourage further market opening.

The EU is fully committed to the G20 standstill pledge, and **will keep its markets open** to trade and foreign investment. The EU also calls on other countries to demonstrate firm political commitment to the standstill pledges, and to ensure their full implementation at the highest political level.

The best insurance policy against protectionist pressures will be provided by a balanced, comprehensive, ambitious and quick conclusion of the **Doha Round** based on the progress that has already been achieved.

In parallel to the Doha Round, the EU has stepped up its engagement with a number of trading partners by pursuing negotiations on comprehensive new generation **Free Trade Agreements**, which aim to extend beyond present agreements both in scope and the depth of commitments. Furthermore, negotiations for Economic Partnership Agreements have either already been concluded or will be concluded soon. They are heavily asymmetric agreements to the advantage of our African, Caribbean and Pacific partners.

The EU also remains committed to continuing its **support to developing countries**, including through **Aid for Trade** and unilateral preferences, such as the Generalized System of Preferences (GSP), the additional preferences offered under the "GSP+" incentive arrangement and, for least developed countries, the Everything But Arms (EBA) initiative.