Global and European setting

World economic activity

World economy still in recession

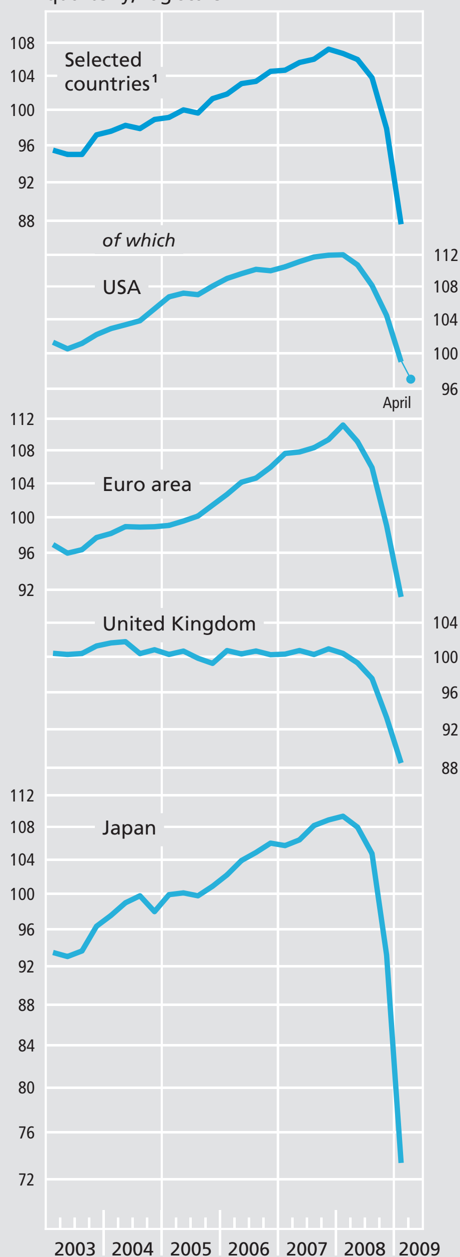
In the first quarter, the world economy continued the tailspin that had begun in the fourth quarter of 2008. However, the economy seems to have recently been contracting more slowly. In addition, the expectation components, in particular, have seen a visible improvement among firms and consumers in some surveys. This has coincided with the resurgence of commodity prices since the beginning of the year and the perceptible recovery of equity market prices in the past two months. However, one reason why a rapid and radical cyclical recovery is unlikely is that the global shock to confidence triggered by the financial crisis has not yet been overcome; another is that banks' balance sheets, which had hitherto reflected, in particular, the need for value adjustments on securitised instruments, are now being increasingly battered by a recession-induced deterioration in credit quality. Moreover, it will take some time before the economic stimulus programmes launched thus far, along with the very expansionary monetary policy and the extensive financial market stabilisation measures, can unleash their full effects.

Highly synchronised nature of downturn in industrial countries ...

The decline in global production is already significantly worse than in any of the cyclical downturns since the middle of the last century. An additional feature of this recession is the highly synchronised nature of the downward trend across the individual countries and regions. Manufacturing continued to be the sector most severely affected by the economic slump in the first quarter, with industrial output in most advanced economies and

Industrial output* in selected countries

2005 = 100, seasonally adjusted, quarterly, log scale



Source: national statistics, Eurostat and Bundesbank calculations. — * Including mining and energy, excluding construction. — **1** Besides euro area and other countries listed: Denmark, Norway, Sweden, Switzerland and Canada; weighted with the respective share of gross value added created by these countries' manufacturing industry in 2005.

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many emerging market economies shrinking at double-digit year-on-year rates. This was due mainly to the sharp fall in demand for durable and internationally tradable goods, especially automobiles, and the attendant adjustment in inventories (see also box on pages 14-15). The economies that were most severely affected by the collapse of global manufacturing activity were those economies with a large manufacturing share and which are simultaneously extremely export-oriented. These are chiefly the east Asian emerging market economies and, among the industrial countries, Japan and Germany. Moreover, countries suffering from crises in the real-estate markets, predominantly the United States but also the United Kingdom, Spain, Ireland and the Baltic nations, are undergoing a process of sharp contraction. In the first quarter of 2009, real GDP in the industrial countries is likely to have fallen somewhat more steeply than in the preceding period, in which it had declined by 1¾%.

... and in the EMEs

Among the major emerging market economies, Russia was hit hardest by the crisis. In the first quarter, its macroeconomic performance was down by 9½% on the year. At the same time, the situation in the labour market has deteriorated considerably; Russia's standardised unemployment rate hit an eight-year high of 10% in March. Owing in some measure to the sharp depreciation of the rouble, consumer price inflation averaged 13.8% in the first three months of the year, which was no lower than in the fourth quarter of 2008; this also put a strain on households. Following its fourth-quarter collapse, industrial output in Brazil has rallied somewhat; however,

it was still down 10% on the year in March. It was the Chinese economy that fared best in the winter months. Although published year-on-year GDP growth fell from 6.8% in the fourth quarter to 6.1%, rough estimates show that this implies a perceptible increase in the growth rate on the period. This is likely to be due mainly to initial stimuli from China's economic recovery program, which will amount to 6% of the cumulative GDP forecast for the years 2009 and 2010. In addition, private consumer demand received a boost from robust wage growth and a continuous, perceptible decline in consumer prices. Ultimately, however, China does not yet carry sufficient economic weight to give the world economy a meaningful boost in order to overcome the recession.

IMF forecast once again revised downward

The International Monetary Fund (IMF) once again revised its spring forecast downwards, predicting that global output will contract by an annual average of 1¼% for 2009 and then grow again by 2% in 2010. This is predicated on a 2½% rise over the course of 2010 following a contraction of ½% in 2009. The IMF predicts that it is mainly the emerging market economies that will contribute, albeit to varying degrees, to the recovery of the world economy that will ensue next year. It expects the south and east Asian emerging market economies, especially China and India, to grow at an accelerated pace, with Latin America returning to positive growth and central and eastern Europe (including the Commonwealth of Independent States) overcoming the current severe recession. Real GDP in the advanced economies will merely stagnate in 2010 following a 3¾% contraction in 2009. The pattern of growth predicted by the IMF looks somewhat better insofar as overall output in this group of countries will be down by 2½% on the year at the end of 2009 before then showing 1% year-on-year growth in the fourth quarter of 2010. The forecast average annual rates of GDP growth for the G7 for 2009 range from -2¾% (USA) to -6¼% (Japan); the euro area is predicted to see GDP fall by 4¼%. The range of forecasts for 2010 stretches from -1% in Germany, -½% in the euro area and 0% in the USA to as much as +1¼% in Canada. The risks to this outlook are, on balance, still on the downside.

IMF forecast for 2009 and 2010

Item	2007	2008	2009	2010
Real gross domestic product	Year-on-year percentage change			
Advanced economies [1]	+ 2.7	+ 0.9	− 3.8	0.0
of which				
United States	+ 2.0	+ 1.1	− 2.8	0.0
Japan	+ 2.4	− 0.6	− 6.2	+ 0.5
Euro area	+ 2.7	+ 0.9	− 4.2	− 0.4
Consumer prices [2]				
Advanced economies [1]	+ 2.2	+ 3.4	− 0.2	+ 0.3
of which				
United States	+ 2.9	+ 3.8	− 0.9	− 0.1
Japan	0.0	+ 1.4	− 1.0	− 0.6
Euro area	+ 2.1	+ 3.3	+ 0.4	+ 0.6
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies [1]	5.4	5.8	8.1	9.2
of which				
United States	4.6	5.8	8.9	10.1
Japan	3.8	4.0	4.6	5.6
Euro area	7.5	7.6	10.1	11.5

Source: IMF World Economic Outlook, April 2009. — **1** Including Taiwan, Hong Kong, South Korea and Singapore. — **2** Consumer price index; for the euro area, HICP.

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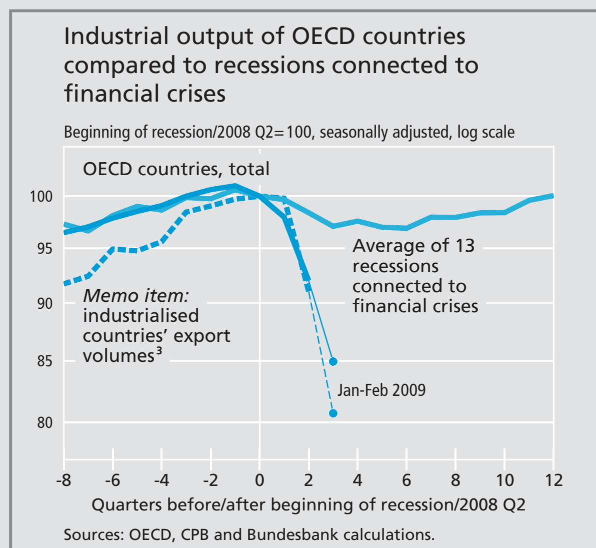
Exceptionally sharp contraction of world trade

The contraction of world trade, which the IMF forecasts will reach 11% in 2009, is, by historical standards, far out of proportion to

Financial market shock and downturn in industrial output in advanced economies

The global economy is undergoing a very severe downturn, which is being driven particularly by a decline in industrial output and in international trade in goods. The global recession is seen as being closely tied to the international financial market crisis, which peaked in early autumn 2008. According to a study by the IMF, recessions associated with financial crises tend to last long, to hit the advanced economies relatively hard, and to be followed by only a weak recovery.[1] Unlike other macroeconomic variables, industrial output development is not specifically discussed in this study.

If one averages the industrial output of the economies in question across those periods identified by the IMF study as being recessions associated with financial crises, and then examines the decline of this series between the start of the recession and its trough, one can see a very weak fall in production of 3%.[2] This can be partly explained by the differing patterns of each recession. Their asynchronicity means that the fluctuations over individual time series are smoothed out when forming an average. To start with, if one identifies the maximum output loss for each time series compared to the beginning of the recession (within the first eight quarters), one obtains mean declines of around 5½% (medians at just over 4%). By contrast, the total industrial output of OECD countries in the second half of 2008 actually fell by 8%.[4] In January-February 2009, it was even down by 15% from its level of the first quarter of 2008. Of the 15 recessions associated with financial crises, a maximum decline in industrial output occurred in only four of these cases, and with falls of around 10%, they barely come close to the magnitude of the current contraction.[5] Such a massive drop in industrial output is therefore in no way typical of a recession associated with a financial crisis.



Another reason why the latest contraction in industrial output in OECD countries has been so comparatively severe is that it is by and large globally synchronised. Regardless of the common trend, however, the mean hides the truly large differences in the strength of the downturn. What is noteworthy is the poor performance of several countries which themselves are not at the heart of the financial market upheaval. US manufacturing output in March 2009 was a seasonally adjusted 15½% down on its level at the beginning of 2008. However, over the same period, Germany's manufacturing output fell by 23%, while Japan's contracted by as much as 35½%.

These drops can be partly explained by Germany and Japan's greater reliance on foreign trade, as well as the dramatic world trade slump. The co-movement between industrial output and foreign trade in advanced economies is striking, but says nothing about the causes or its direction. However, there is good reason to believe that factors that hamper foreign trade in particular, such as financing constraints or protectionist measures, are not the main reasons in this case – at least not for the industrial countries. Otherwise, one would expect an increased

1 See IMF, From Recession to Recovery: How Soon and How Strong?, World Economic Outlook, April 2009, p. 103 ff. — **2** Seasonally adjusted quarterly data from the OECD's Main Economic Indicators were used for the industrial output (including mining and energy production). Only 13 of the 15 recessions identified in the IMF study were included: although the OECD data for New Zealand (1986 Q4 to 1987 Q4) and Norway (1982 Q2 to 1988 Q4) showed a clear rise in industrial output during the recession, this was not reflected in the manufacturing output figures and would have thus distorted the average. — **3** OECD countries excluding Turkey, Czech Republic, Hungary, Poland, Slovakia, Mexico and South Korea. — **4** The industrial output of OECD countries also represents an average (albeit a weighted average). Similar results are obtained by using an (unweighted) average of industrial output for those countries whose historical recessions associated with financial crises are also being examined here to depict the current trend. Although industrial output in OECD countries peaked in 2008 Q1, aggregate output peaked in the following quarter, which is why the second quarter was selected as a reference point here. — **5** These four cases are the United Kingdom (1973 Q3 to 1974 Q1), Denmark (1987 Q1 to 1988 Q2), Finland (1990 Q2 to 1993 Q2) and Japan (1997 Q2 to 1999 Q1). While the drop in industrial output was limited to a single quarter in Denmark, it first began in the United Kingdom around the

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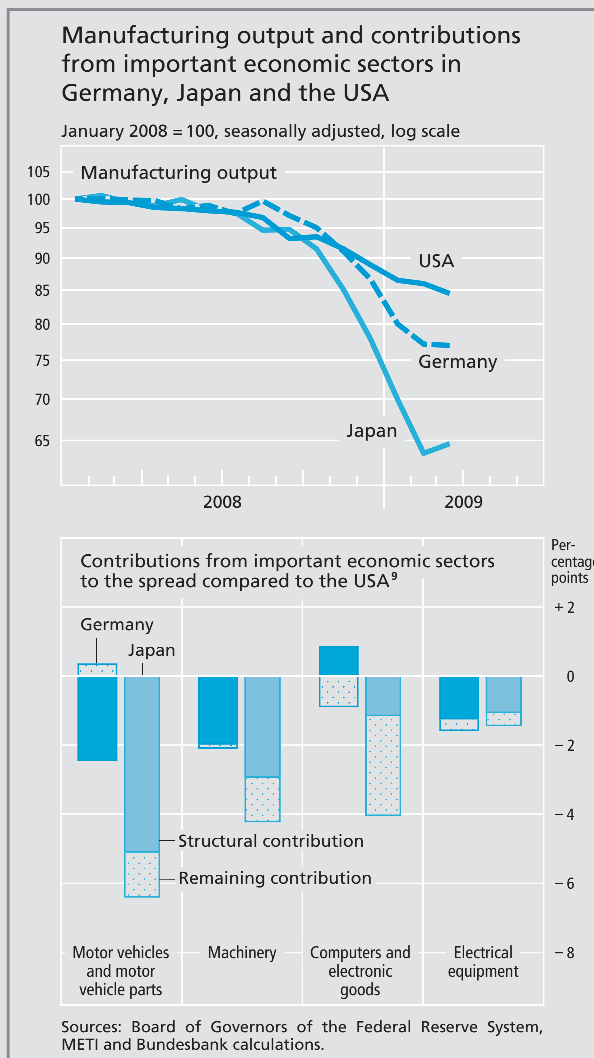
substitution of imported goods by domestic products and consequently a noticeably flatter curve in industrial output overall for OECD countries.

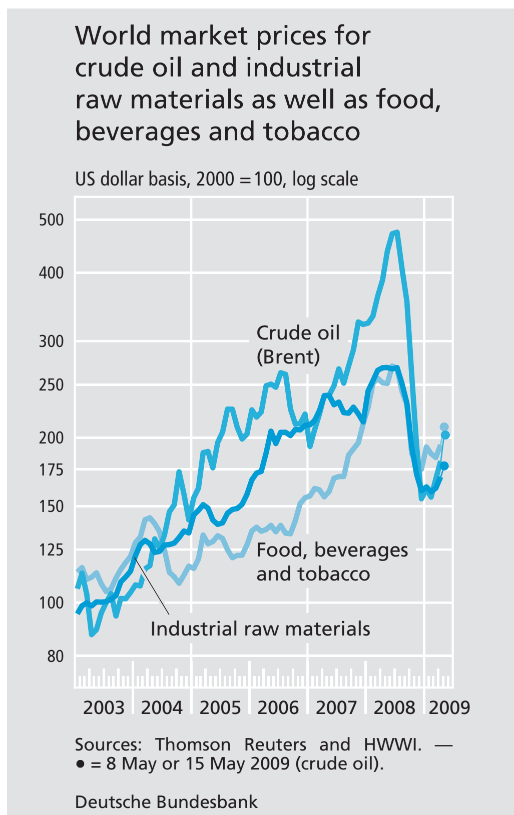
A disaggregated analysis shows that the steeper fall in German and Japanese manufacturing output compared to the USA can be greatly accredited to differences in the structure of these countries' industrial sectors. US automobile production has seen considerably more severe cutbacks than in many other industrial sectors. However its weight in the US manufacturing output index is only around half that of the same sector in Germany and Japan. The gap between Germany and the USA in terms of the drop in manufacturing output over the January 2008 to March 2009 period is 7½ percentage points, with 2½ percentage points stemming from the greater importance of car manufacturing in Germany. Germany and Japan's prominent position in the manufacture of machinery and equipment also provides an explanation.[6] Generally speaking, the manufacture of capital goods – and in this context also of intermediate inputs – has, on a global scale, been cut back much more greatly over the past few months than the production of non-durables. The German economy has been disproportionately affected by this global shock owing to the pattern of its specialisation.

Overall, the globally synchronised slump in output, with its focus on capital goods (including passenger cars), indicates that households and enterprises across the world greatly revised their expenditure plans regarding consumer and capital goods in the fourth quarter of last year. The pattern over time suggests that this is the reflection of a general loss of confidence as a result of the greatly increased uncertainty following the severe financial market upheavals of September 2008.[7] Given the global scale of the demand response, however, the immediate real economic effects of stricter lending terms are likely to have been little more than a footnote.[8] Enterprises responded to the sudden fall in demand and the resulting involuntary build-up of inventories by considerably cutting back their activities. The slowdown in the destocking of inventories is expected to generate short-term positive stimuli in the coming months.



Sources: Board of Governors of the Federal Reserve System, METI and Bundesbank calculations.

end of 1974 – in sync with the other advanced economies, but after the end of the recession as dated by the IMF. In the case of Finland and Japan, it coincided with several major trading partners undergoing a severe economic crisis. — **6** The manufacturing of information processing equipment and electronic products has declined much more strongly in Japan than in the USA, and has thereby made a significant contribution to the poorer performance of Japanese industrial output, despite the difference in weighting. Admittedly, this analysis still takes place on a comparatively high aggregated level, which means that the "remaining contribution" may contain a composition effect because of structural differences within each industrial sector. Differences between individual countries' national statistics with regard to defining categories should also be taken into consideration. — **7** See ECB, The recent sharp contraction in world trade from a historical perspective, Monthly Bulletin, March 2009, p 11 ff. — **8** Survey results in the USA show that manufacturing enterprises attribute the current reduced level of demand much more strongly to the generally weak economy and uncertainty about the future than their customers' increased credit constraints. See Federal Reserve Bank of New York, Empire State Manufacturing Survey: Supplemental Report, April 2009. — **9** Based on the decline in manufacturing output between January 2008 and March 2009.



the decline in global GDP. However, it does correspond to a large extent to the drastic decline in industrial output. In the second and third quarters of 2008, owing, not least, to major losses in purchasing power in the oil importing countries caused by high energy prices, a global economic slump had already been in the offing; however, this contraction appeared to be more on the moderate side and largely confined to the industrial nations. This changed drastically, though, following the collapse of US investment bank Lehman Brothers in September 2008; apart from its direct impact, it indirectly triggered a global confidence shock, high net wealth losses and an abrupt termination of capital flows to emerging market economies, especially those with large external debts. Demand for durable goods, which make up the majority of internationally traded goods, subsequently plummeted; automobile exports were affected particularly severely. At all events, the results of an IMF survey of major banks from industrial countries and emerging market economies[1] appear to implicate not only increased exchange rate risks but also growing export financing constraints caused by the upheaval in the international financial markets and owing to the economic slump-induced increase in default risk among firms engaged in foreign trade.

Commodity prices up slightly yet still at low level

The excesses in the commodity markets, which had put a severe strain on the global price climate as late as the first half of 2008, subsided rapidly because of the recessionary slump in demand. Brent crude oil rebounded from its December 2008 low (US$37¼) up to US$57½ by mid-May, especially owing to a brighter economic outlook; however, it was still down by just over one-half from its price a year earlier. The year-on-year decline was a little smaller (-47%) for euro-denominated oil prices owing to depreciation. The yield curve, which is distinctly pointed upwards, suggests that crude oil is likely to become more expensive over the short and medium term. The relatively slow progress in opening up new supplies of oil, especially among non-OPEC countries, could also have a price-driving impact. US dollar-denominated prices for industrial raw materials, after having been at a low level in the winter months, have likewise risen perceptibly since April. In early May, however, they were still down by 34½% on the year.

1 See International Monetary Fund, Survey of Private Sector Trade Credit Developments, Policy Paper, February 2009.

The prices for food, beverages and tobacco already halted their tailspin in early December and have been increasing incrementally since then. At last report, their year-on-year growth stood at -18%.

Low inflation rate in industrial countries

The moderate rise in commodity prices since the beginning of the year has had virtually no impact on consumer prices in the industrial countries. On average over the first four months, they were even down from the fourth quarter, by 0.5% after seasonal adjustment. Year-on-year inflation fell from its peak in July 2008 (+4.6%) to +0.2% in April. Core inflation (excluding energy and food), at 1.7%, was 0.3 percentage point lower than in the fourth quarter. The IMF's spring forecast assumes that consumer prices in the advanced economies will fall this year by 0.2% and rise only slightly in 2010 (+0.3%). The IMF staff now assesses the risk of deflation as being distinctly higher than in the years 2002 and 2003.

United States

In the United States, the sharp cyclical contraction that had begun in the autumn continued at an unabated pace in the first quarter of 2009. According to initial estimates, overall economic output fell by a seasonally adjusted 1½%, thus coming in at 2½% lower than a year earlier. This has also entailed considerable employment losses affecting nearly all sectors. On the whole, the number of non-farm jobs fell by 2% in the January to April period. This translates to a 3¼% year-on-year decline. The unemployment rate was a seasonally adjusted 8.9% in April, a level not witnessed since the third quarter of 1983.

Declining investment was the largest drag on real GDP, with commercial gross fixed capital formation and real housing expenditure 11¼% lower than in the fourth quarter of 2008. In addition, inventory depletion posted a negative contribution to growth of ¾ percentage point, and general government demand declined by 1%. By contrast, private consumption rose by ½%, with purchases of durables, which had fallen by just over one-tenth over the course of 2008, making the most notable recovery. Household consumption was promoted by an increase in transfer payments at the beginning of the year, which was relatively large owing to a preceding sharp rise in prices as well as a reduction in tax deductions. This more than offset the reduction in gross wages and salaries associated with the recessionary output trends. Another factor boosting household consumption was the positive purchasing power effect associated with the continued energy price-related decline in consumer prices by a seasonally adjusted 0.6% from the fourth quarter. However, the continued increase in the saving ratio, which at 4.2% hit its highest mark since the third quarter of 1998, had a dampening effect. Foreign trade likewise made a positive contribution of ½ percentage point to growth. This was based on a considerable 10% decline in real imports, which even exceeded the fall in exports (-8½%).

It must also be borne in mind, however, that a variety of economic indicators have been pointing to a slowdown in the recessionary developments over the past few months, with new orders for durable goods in February-March having tended slightly upward

over time. The Purchasing Managers' Index for the manufacturing sector improved perceptibly in April, although it remains in contractionary territory. Consumer confidence has also recovered perceptibly. Although the second quarter of 2009 is expected to see a further decrease in total output, this decline is likely to be considerably smaller than in the two preceding periods given the level of inventory depletion now achieved.

Japan

The Japanese economy remained in the grip of the global recession in the first few months of the year. In the first quarter of the year, seasonally adjusted real GDP is likely to have fallen sharply once again after having already contracted by 3¼% in the fourth quarter of 2008. The manufacturing industry, which saw its output fall in the first quarter by a seasonally adjusted 21¼% on the period and 33½% on the year, was hit particularly hard. The main cause was the sharp contraction of real exports, which amounted to a seasonally adjusted 29% compared with the final quarter of 2008. According to estimates by the Bank of Japan, it was exports to the USA (-36½%) and the smaller south-east Asian emerging market economies (-32%) which plummeted the furthest, whereas the declines in exports to the EU (26%) and to China (20½%) were somewhat more moderate. Broken down by sector, exports of automobiles and auto parts showed by far the worst performance (-48¼%). What the unfavourable quarterly figures do not show, however, is that in March Japanese industrial output rallied (after the factoring-out of seasonal fluctuations) and that exports did not slide any further. This may be regarded as an initial sign of a bottoming-out.

Private domestic final demand in the first quarter of 2009 was once again unable to form a counterweight to the negative external stimuli. In January-February, retail sales were 1½% down on the fourth quarter. The decline was probably not quite that strong in real terms since, on an average of the first three months of 2009, consumer prices were 0.8% below their fourth-quarter level. Prices remained virtually unchanged on the year.

United Kingdom

In the first quarter of the year, aggregate UK output shrank by a seasonally adjusted 2% on the period and thus by 4% on the year. The quarter-on-quarter decline is due mainly to the sharp drop – of 5½% – in real value added in the manufacturing sector (excluding construction). Construction dipped by 2½% and the performance of services, which were supported by growth in the public sector, by 1¼%. On the demand side, however, the UK economy benefited from households' increased retail purchasing activity (excluding cars), which in the first quarter was up by a seasonally adjusted 1%. The 19% decline in new car registrations tempers this picture, however. The unemployment rate averaged 7.1% over the January to March period, its highest level since mid-1997. Over the December to March stretch, consumer price inflation shrank by only 0.2 percentage point to 2.9%. This rate, which is high compared with other industrial countries, is related to the at times sharp rises in import prices caused by the depreciation of the pound sterling. Although the decline in house prices deceler-

ated somewhat after seasonal adjustment in the March-April period, they were still no less than 17¾% down on the year.

New EU member states

The new EU member states were likewise hit hard by the global financial crisis and worldwide recession. This was due mainly to their pronounced economic dependence on the struggling euro-area economy and high outflows of capital, particularly from countries with chronic current account deficits and low levels of foreign reserves. In the new EU member states (excluding Malta, Cyprus, Slovenia and Slovakia, which are all members of the euro area), industrial output fell by a seasonally adjusted 5% on the fourth quarter of 2008, in which it had shrunk by 7½%. The year-on-year decrease was 14¾%. Output fell particularly sharply in Estonia (-29%) and Latvia (-23¼%), whereas the cyclical setback was less pronounced in, for instance, Poland (-11¾%). The number of unemployed persons throughout this group of countries rose by a seasonally adjusted 606,000 from September 2008, when it hit its trough, to March 2009, with the rate rising by 1¼ percentage points to 7.5%. Consumer price inflation picked up in the January-April period to 1.3% compared with the fourth quarter of 2008, in which it had stood at 0.5%. This is associated, in particular, with the depreciation-related increase in import prices and higher crude oil prices. However, year-on-year inflation, at 4.0% in April, was lower than at any time since the second quarter of 2007.

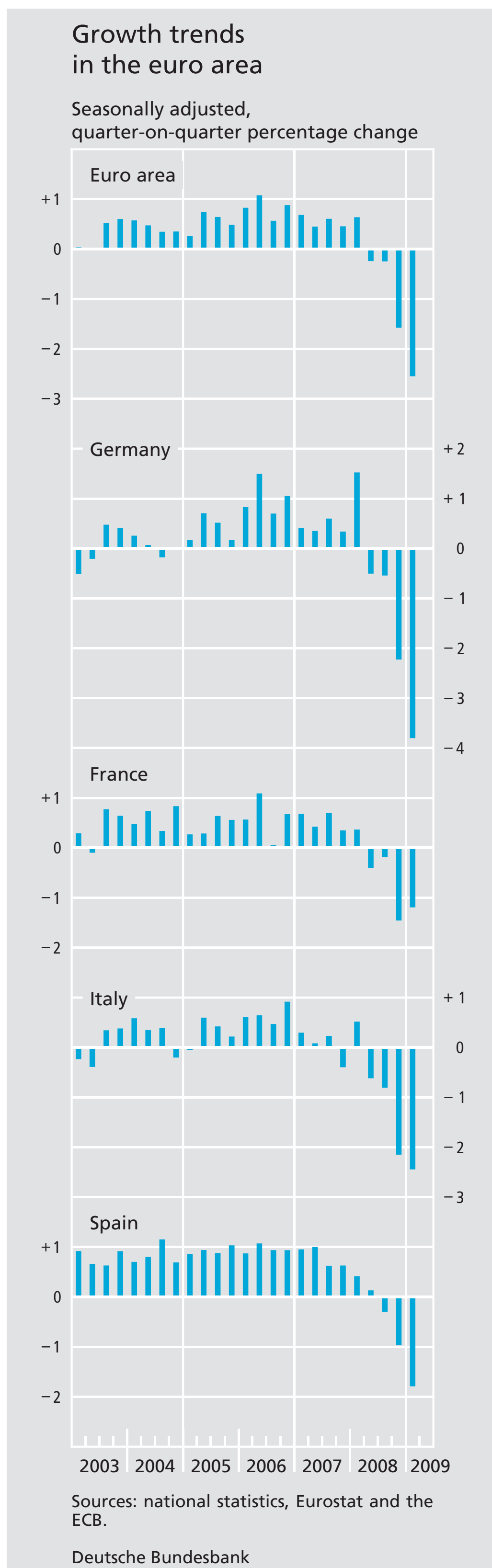
Macroeconomic trends in the euro area

GDP down more sharply in first quarter

In the first-quarter months, aggregate euro-area output, according to initial estimates, was down once again after seasonal adjustment; according to Eurostat's flash estimate, at 2½%, the decline was distinctly greater than in the final quarter of 2008 (-1½%). It was down 4½% on the year. Of the ten member states that have already published information, nine of them, including the four major members, reported negative quarter-on-quarter growth rates. However, the disparity in the pace of downward growth has grown larger compared with the fourth quarter of 2008. Whereas GDP contraction accelerated, at times considerably, in Germany, Italy and Spain, it weakened somewhat in France. According to the European Commission's spring forecast, euro-area activity is expected to bottom out in the final quarter of 2009 and the first quarter of 2010. Aggregate output will subsequently undergo only a very flat recovery until the end of 2010. This means that real GDP will fall by 4% on average over 2009 and stabilise at its depressed level in 2010.

Industry particularly affected ...

Industry was clearly front and centre of recessionary developments in the euro area, with output falling in the first quarter by 8% on the period and by 18¾% on the year. The sectors hit hardest by sagging output were intermediate inputs and capital goods production, with year-on-year growth of -25% and -23¾% respectively. By contrast, consumer goods (-8¼%) and energy production (-4½%) did not fare nearly as badly. The sharp drop in output caused capacity utilisa-



tion to fall distinctly. According to the European Commission's survey results, capacity utilisation in manufacturing in April was 4½ percentage points lower than three months previously and no less than 11½ percentage points below its long-term average. Industrial orders received continued to shrink after the turn of the year, yet the pace of the decline has slowed perceptibly, with orders in January and February down by an average of 1¼% from December, as compared with a month-on-month rate of -6½% in the August to December period. The industrial confidence indicator rebounded in April for the first time since going into a tailspin in August 2008; this is due in large part to the distinct rise in production expectations. The aggregate Purchasing Managers' Index also picked up perceptibly, though remaining in contractionary territory.

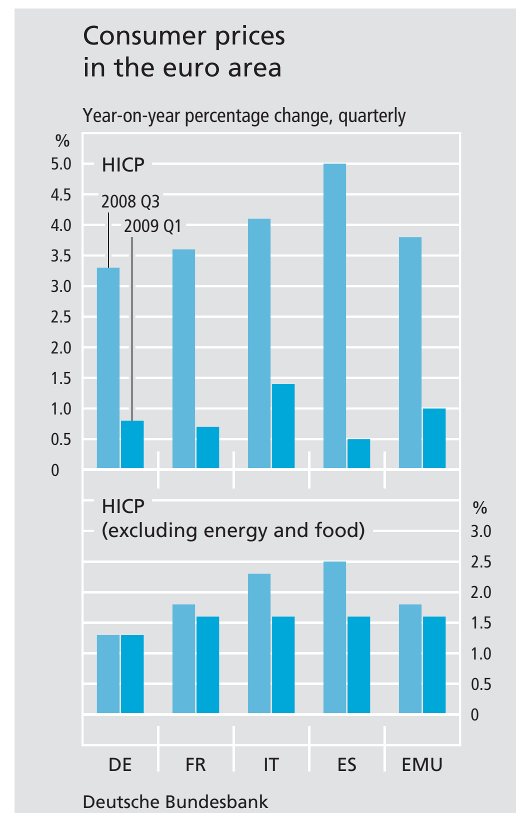
... owing especially to collapse in exports

The continued decline in industrial output is attributable largely to the collapse in exports to non-euro-area countries, which continued after the turn of 2008-09. Nominal exports contracted in January-February by a seasonally adjusted 10½% from their level in the fourth quarter of 2008, in which they had already fallen by 9¼%. The year-on-year decline was 22%. Imports fell at the same time, by a seasonally adjusted one-tenth from the fourth quarter and one-fifth on the year. The sharp contraction of capital goods production indicates that expenditure on new machinery and equipment in the euro-area countries has likewise decreased considerably. The decline is likely to have been more moderate in the case of construction investment; at all events, construction output in January-February was

down only 1% on the final quarter of 2008, with relatively inclement weather additionally hampering activity in the more northerly euro-area countries. Consumer demand for retail goods likewise tended to sag, with sales (excluding cars) in the first quarter of the year down ¾% from the fourth quarter of 2008. Account must be taken here, however, of the fact that orders for new cars were revived by government incentives, which may have led to a rerouting of purchasing power. This is not inconsistent, however, with a renewed reduction in new car registrations throughout the euro area in the first quarter, by 1% after seasonal adjustment. These figures also contain registrations by other groups of owners, which, in Germany, have been sharply tending downwards. It also stands to reason that consumers have been saving more for newly ordered cars. Starting from a very low level, consumer confidence rallied in April.

Further deterioration in labour market situation

The situation in the euro-area labour market grew even worse in the first quarter of 2009. The unemployment rate went up from 8.0% in the final quarter of 2008 to 8.7%. It rose particularly sharply in Ireland (1.8 percentage points) and Spain (2.6 percentage points). The number of employed persons fell in the fourth quarter of 2008 – more recent information is not yet available – by a seasonally adjusted 0.3% from the third quarter and thus back to its level of a year earlier. Despite the gloomy situation in the labour market, labour costs still went up perceptibly in the fourth quarter of 2008. Much like in the preceding quarter, they rose by 0.9%. Their year-on-year growth (calculated from the



index level after seasonal and calendar adjustment) increased slightly to 3.8%.

Consumer prices affected by previous year's developments

On average over the first three months of the year, euro-area consumer prices, after excluding seasonal variations, declined by 0.3% after having fallen 0.6% a quarter previously. This was due in large part to the continued decline in energy prices, which more than made up for the increase in the prices of unprocessed food and services, with industrial goods prices remaining virtually unchanged. Year-on-year HICP inflation went down from 2.3% to 1.0%. In some European countries, the aforementioned rates were even lower, with four countries posting negative inflation rates in March. The sharp decline in the year-on-year rates – which had averaged 3.8% as recently as the third quarter of 2008 – was

Fiscal developments in the euro area

Substantial increases in euro-area deficit and debt in 2008

At the end of April, Eurostat, the European Commission's statistical office, published the general government deficit and debt figures of the EU member states that had reported these figures as part of the European budgetary surveillance process. According to these reports, the euro-area deficit rose perceptibly last year from 0.6% of GDP to 1.9%. The European Commission's calculations show that this deterioration is only to a lesser extent attributable to the economic downturn which began in 2008. Instead, the structural deficit ratio (ie the deficit ratio adjusted for cyclical influences and temporary measures) alone rose by 1 percentage point (pp) to 2.8%.[1] In part, this reflected a sharp counterswing to the extraordinary revenue boom seen during the previous years and, in some countries, the incipient budgetary consequence of fiscal stimulus measures. Owing to only moderate revenue growth (+1.6%), the revenue ratio fell by 0.7 pp to 44.7%. By contrast, at 4.4%, expenditure increased more strongly than nominal GDP, which pushed up the expenditure ratio by 0.6 pp to 46.6%. The debt ratio also increased significantly from 66.0% to 69.3%. This rise was largely due to government support measures for financial institutions, which, for the most part, are not reflected in the deficit (for example, bank recapitalisations). According to the European Commission, overall, such measures amounted to 3.4% of GDP in 2008.

Drastic deterioration in public finances expected in the period ahead

Given the sharp recession and the fact that many countries have adopted expansionary fiscal policies, in its spring forecast, the European Commission expects the euro-area deficit ratio to increase further by 3.4 pp to 5.3% in 2009 – by far the highest level since the start of monetary union. The dramatic rise in the deficit level can mainly be attributed to the severe economic downturn, which, via the automatic stabilisers, leads to declining revenue and rising social expenditure (particularly unemployment benefits). According to the European Commission's calculation, these direct cyclical influences account for two-thirds of the increase in the deficit. The rise in the structural deficit ratio by around 1 pp is due, first, to the continued decline in revenue over and above the calculated cyclical influence and, second, to the numerous fiscal stimulus measures. Most member states – in accordance with the European Economic Recovery Plan (EERP) initiated by the European Commission – adopted large fiscal stimulus packages to bolster aggregate demand. As a result, revenue is expected to fall by 2.5%, with a sharper decline being prevented by the – relative to other lower revenue-bearing GDP components – ongoing robust development of private consumption and wages and salaries. The revenue ratio consequently remains largely unchanged (+0.1 pp). The forecast estimates that total expenditure will climb by 4.6%. Given a decline in nominal GDP, the expenditure ratio is expected to rise steeply by 3.5 pp.

The European Commission forecasts a further substantial deterioration in the fiscal balance in 2010. The deficit could reach 6.5% of GDP, with one-third of the increase caused by less unfavourable but nonetheless weak cyclical development. The largely structurally induced deterioration is mainly due to the same factors as in 2008. According to the forecast, revenue will hardly grow overall (+0.3%) and will fall in relation to GDP (by around ½ pp). Expenditure is expected to increase by 2.8%, which means that the expenditure ratio will rise by almost 1 pp.

According to the Commission's forecast, between the end of 2008 and the end of 2010, general government debt in the euro area in relation to GDP will shoot up by 14½ pp to 83.8%. This dramatic rise is above all due to a combination of exceptionally high deficits and very weak GDP development. In addition, where sufficiently robust data were available, the Commission also included debt-increasing measures to support the financial sector (which are not reflected in the deficit). However, at 1½ pp, these operations account for only a small part of the forecast steep increase in the debt ratio.

13 out of 16 countries will exceed the 3% limit

For 2008, five euro-area countries recorded a deficit ratio that exceeded the 3% reference value (France, Greece, Ireland, Malta and Spain) and are currently in the excessive deficit procedure (in the case of Malta, the existence of an excessive deficit has not yet been decided). In Greece, the tendency to make extensive revisions to the statistical data, which has already been evident in the past, continued, and these revised figures retrospectively show a significantly worse financial situation. The ECOFIN Council asked Greece to correct its overstepping of the reference value, which it reported retroactively in autumn 2008 for 2007 – the year in which Greece was released from its last excessive deficit procedure – in 2010. The correction periods granted to France and Spain extend up to 2012, while Ireland has been granted until 2013 to correct its excessive deficit. As a rule, an excessive deficit should be corrected during the year after its identification. But, given the exceptionally strong economic downturn, in these instances, the Council made use of the flexibility provided by the Stability and Growth Pact. However, countries in the excessive deficit procedure no longer have any room for manoeuvre to increase their expansionary fiscal policy, for example, by means of further economic stimulus programmes. Rather, the EU budgetary rules stipulate an annual structural consolidation of at least 0.5% of GDP as a benchmark. Yet, since it is permissible to relax this rule during exceptionally unfavourable economic periods,

1 At 2.8%, the structural deficit ratio changed significantly vis-à-vis the previous autumn forecast (1.6%). According to European Commission data, half of this deterioration can be explained by a downward revision of potential output on which the calculation was based.

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a case-by-case examination would have to be made to ascertain whether automatic stabilisers should be allowed to operate largely unhindered for the time being. However, in countries where the soundness of the public finances and confidence in them is acutely threatened, rapid perceptible consolidation measures are required, even amid an unfavourable economic development.

According to the Commission's estimate, in 2009 only three euro-area countries will comply with the 3% deficit limit (Cyprus, Finland and Luxembourg). At over 12%, Ireland will record the highest deficit ratio, followed by Spain with almost 9%. France, Portugal, Slovenia and Greece are expected to record deficits of between 5% and 7% of GDP. Although the 3% limit may be exceeded temporarily during a period of severe economic downturn, as long as the deficit ratio remains close to the reference value, in most euro-area countries the deficit is likely neither to be close to the reference value nor to exceed the reference value only temporarily. Therefore, according to the Stability and Growth Pact, an excessive deficit procedure should be launched in these cases.

Sustainability of public finances increasingly at risk

According to the Commission's forecast, the debt ratios will increase in all euro-area countries (with the exception of Cyprus) between 2008 and 2010. In some cases, this increase will be dramatic. It is estimated at +36 pp in Ireland and +23 pp in Spain, followed by France with +18 pp. In a further eight countries, the ratio is expected to go up by more than 10 pp. Alongside Austria, Belgium, France, Germany, Greece, Italy, Malta and Portugal, in 2009 Ireland is likely to become the ninth country not to comply with the reference value for the debt level of 60% of GDP. In 2010, the debt levels of the Netherlands and Spain are also expected to exceed the threshold value.

Particularly given that fiscal burdens will increase considerably in future in connection with ageing populations, the high debt levels are a cause for concern. Furthermore, the long-term sustainability of public finances is threatened in a large number of countries by in part high contingent liabilities from sureties and guarantees provided in connection with the financial crisis which, in most cases, will probably only be reflected in the Maastricht ratios after they are called. Unfortunately, Eurostat did not make a fundamental decision on this matter prior to the notifications, and a decision is currently still pending.

Since the start of the crisis, some countries have recorded marked increases in their risk premiums on government bonds. Calls have been made in this context from various quarters for the joint issuance of government bonds by the EU or euro-area states – Eurobonds. The associated common sharing of liability would mean that countries with high premiums on their national government bonds would benefit from lower financing costs, while countries with low risk premiums would effectively be penalised. As well as impeding the desirable disciplining of fiscal policy by the capital market, such Eurobonds would also have the character of an assumption of liability and would thus infringe the EC Treaty, which explicitly excludes this in order to strengthen the national member states' own responsibility for their fiscal policy.

	Budget balance (as % of GDP)				Structural budget balance (as % of GDP)				Debt (as % of GDP)			
Country	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Austria	– 0.5	– 0.4	– 4.2	– 5.3	– 1.8	– 1.8	– 3.2	– 3.8	59.5	62.5	70.4	75.2
Belgium	– 0.2	– 1.2	– 4.5	– 6.1	– 1.5	– 2.2	– 3.2	– 4.1	84.0	89.6	95.8	100.9
Cyprus	3.5	0.9	– 1.9	– 2.6	2.7	0.1	– 2.1	– 2.1	59.4	49.1	47.5	47.9
Finland	5.2	4.2	– 0.8	– 2.9	3.2	2.8	0.8	– 0.7	35.1	33.4	39.7	45.7
France	– 2.7	– 3.4	– 6.6	– 7.0	– 3.9	– 4.3	– 5.6	– 5.5	63.8	68.0	79.8	86.0
Germany	– 0.2	– 0.1	– 3.9	– 5.9	– 1.2	– 1.2	– 2.4	– 3.9	65.1	65.9	73.4	78.7
Greece	– 3.6	– 5.0	– 5.1	– 5.7	– 4.5	– 6.5	– 5.7	– 4.7	94.8	97.6	103.4	108.0
Ireland	0.2	– 7.1	– 12.1	– 15.7	– 1.8	– 7.5	– 9.8	– 12.2	25.0	43.2	61.2	79.7
Italy	– 1.5	– 2.7	– 4.5	– 4.8	– 2.9	– 3.4	– 2.6	– 2.8	103.5	105.8	113.0	116.1
Luxembourg	3.6	2.6	– 1.5	– 2.8	0.9	2.0	0.6	0.1	6.9	14.7	16.0	16.4
Malta	– 2.2	– 4.7	– 3.6	– 3.2	– 3.3	– 4.9	– 3.6	– 2.8	62.1	64.1	67.0	68.9
Netherlands	0.4	1.0	– 3.4	– 6.1	– 1.0	– 0.5	– 2.6	– 4.3	45.6	58.2	57.0	63.1
Portugal	– 2.6	– 2.6	– 6.5	– 6.7	– 3.3	– 3.8	– 5.5	– 5.1	63.6	66.4	75.4	81.5
Slovakia	– 1.9	– 2.2	– 4.7	– 5.4	– 3.8	– 4.7	– 5.0	– 4.7	29.4	27.6	32.2	36.4
Slovenia	0.5	– 0.9	– 5.5	– 6.5	– 1.7	– 2.5	– 4.9	– 5.2	23.4	22.8	29.3	35.0
Spain	2.2	– 3.8	– 8.6	– 9.8	1.6	– 4.0	– 6.8	– 8.2	36.2	39.5	50.9	62.3
EU 16	– 0.6	– 1.9	– 5.3	– 6.5	– 1.8	– 2.8	– 3.9	– 4.7	66.0	69.3	77.7	83.8

Source: European Commission, Economic Forecast Spring 2009.

largely the result of the correction following the exceptionally strong rise in energy and food prices in the first half of 2008. Eliminating these two volatile components from the HICP results in inflation rates of 2% or more for half of the countries. In the euro area as a whole, core inflation (excluding energy and unprocessed food) rose by 0.6 percentage point to 1.6%. A base effect resulting from the early Easter date, which dampened the year-on-year growth of the services component, also played a role. Euro-area consumer prices also rose slightly in April 2009. As in March, the year-on-year increase in the HICP stood at 0.6%.