THE ECONOMIC CRISIS – SOME EFFECTS UPON THE EURO AREA

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The article makes a short analysis of the latest economic evolutions (since the beginning of the global economic crisis) in the Euro Area. These evolutions are placed in the global context of the recession and the findings are compared to the evolutions of the other two important zones: the Unites States of America and Japan. The authors also try to review the specialists' opinions regarding the end of this economic downturn.

Key-words: economic crisis, Euro Area, economic prospects

JEL Codes: E01, F01, O11

1. Introduction:

It is evidence now that what began six months ago with a massive de-leveraging in financial markets has turned into one of the sharpest global economic contractions in modern history. Analysts found that the global character of the recession has carried a dramatic impact on economic performance among high – income countries. Until mid-2008 the slowing of OECD domestic demand was partially offset by continued strong growth in exports of capital and higher – tech products, supplying the investment that underpinned fast growth in the developing countries. But conditions have reversed, as the collapse of high-income exports is reinforcing contraction in domestic demand in high-income countries. The tight global links between trade in manufactured products and the capital expenditures needed to support economic activity have transformed into a vicious circle. (World Bank, 2009)
The EU has not escaped this situation. The next lines are trying to analyze the impact of the global economic crisis upon the Union's economy for the next two years.

2. The facts

Studies conducted by many economic institutions proved that the euro area achieved a high degree of macroeconomic stability over the first decade of economic and monetary union. The last five years (2002-2007) had seen a sustained upturn in activity, boosted by strong export and investment growth. Consumption had nevertheless remained relatively weak, accounted for by a high rate of household saving and muted growth of disposable income. With demand tending towards capacity, monetary policy was tightened from December 2005. The euro appreciated steadily and, by mid-2008, was 30% higher in nominal effective terms than in mid-2002. It remains at an elevated level despite recent declines. (OECD, *Economic Survey of the Euro Area,* 2009, p.3)
At the present, the financial market turmoil since the summer of 2007 and the intensification from mid-September 2008 is having a major adverse impact on the world economy. Although the immediate cause of the turmoil lies in the US subprime mortgage market, euro area financial institutions and markets were part of the prolonged credit cycle of recent years, and have been hit by heightened financial market stress. (OECD, *Economic Survey of the Euro Area,* 2009, p.3)
Economic activity began to slow in the early part of 2007 and has steadily lost momentum, with output declining in both the second and third quarters of 2008.

It initially coincided with a very sharp increase in energy and food prices, as well as a substantial appreciation of the euro which mitigated the inflationary impact but reduced competitiveness.
Financial conditions have tightened further, driven by weaker asset prices, more stringent bank lending standards and high interest rate spreads. Credit growth to households and non-financial firms has slowed rapidly. These factors have raised financing costs for companies, generated negative wealth effects on household spending and added to uncertainty about economic prospects. (OECD, *The OECD Economic Outlook Interim Report*, 2009, p.74) It seems that, on one hand, more integrated and developed financial markets in Europe have contributed to economic growth and fostered resilience as larger and more diversified financial systems are better placed to absorb economic shocks. On the other hand, it also opened up additional channels for the transmission of financial shocks, including across borders. Moreover, several new financial products have contributed to more risk taking.

3. The future
Economic activity is projected to decline further until the end of 2009, with marked weakness in domestic demand being reinforced by the adverse impact of weak global demand growth on exports. Household incomes have benefitted from past falls in commodity prices, but consumption will be depressed by rising unemployment and negative wealth effects. Policy support, combined with an easing of financial conditions should induce a subdued recovery in 2010, although with growth remaining below trend throughout the year and unemployment continuing to rise. (OECD, *The OECD Economic Outlook Interim Report*, 2009, p.76)
As a conclusion, the economy in the euro area will not start to recover before the end of 2009. Instead, the financial crisis will curb production by rising financing costs, and in various indirect ways: it aggravates the housing crisis in Spain and Ireland and undermines housing markets where, as in France, they are in weak conditions. (EFN report Econ Outlook for the euro area in 2009 and 2010, p. 8).

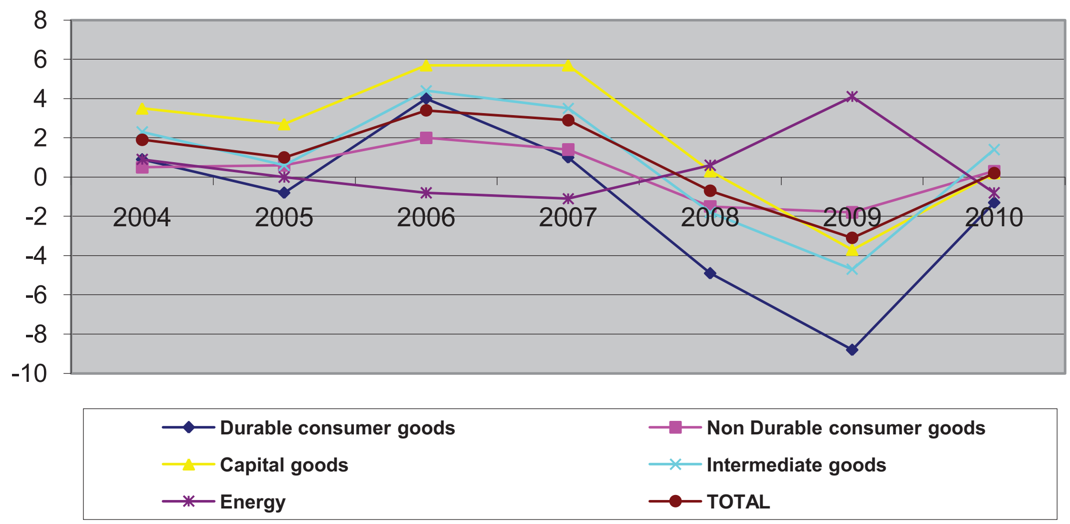

Figure 1. Annual Growth Rates Evolution for Industrial Production in Euro Area (2004 – 2010) - %

Source: Data presented in the EFN report Econ Outlook for the euro area in 2009 and 2010, p. 9

Overall, it is expected that euro area GDP to shrink by 0.5% in 2009, and to increase by a meager 0.8% in 2010. The fast fall in investment and exports and the limited ability of households to finance durable goods purchases is driving the industrial sector towards the worst crisis since the introduction of the common currency. Specialists (EFN report Econ Outlook for the euro area in

2009 and 2010, p. 9) expect industrial production to decline in all sectors during 2009 being energy the only exception. (Figure 1)

According to their forecasts, the year on year growth rate of the industrial production index will reach its bottom during the first and the second quarter, while it will start recovering in the second half of 2009, timidly at first, and not reaching positive rates until the second half of 2010.

Other relevant indicators are presented in Table 1. The figures indicate a sharp decline in global commodity prices while rising unemployment and the continued widening of the output gap prove further moderate wage and price pressures in 2009 and 2010.

	Percentage change, volume *(2001 prices)*				
INDICATOR	**2006**	**2007**	**2008**	**2009**	**2010**
Total domestic demand	2.8	2.3	0.7	-2.8	-0.3
Net exports	0.2	0.3	0	-1.3	0
GDP at market prices	3.0	2.6	0.7	-4.1	-0.3
GDP deflator	2.0	2.3	2.2	1.3	0.6
Harmonized index of consumer prices	2.2	2.1	3.3	0.6	0.7
Unemployment rate	8.2	7.4	7.5	10.1	11.7

Table 1. Euro Area: Demand, Output and Prices

Source: Data presented in the OECD, *The OECD Economic Outlook Interim Report*, 2009

The rapidly weakening domestic and global economy, combined with the possibility of a further deterioration in financial conditions means that the risks remain firmly weighted on the downside, with marked tail risks. In particular, declining activity will intensify pressures on financial institutions, possibly leading to further tightening of financial conditions, thereby generating additional negative effects on the real economy and additional obstacles to the effective transmission of monetary and fiscal policies. (OECD, *The OECD Economic Outlook Interim Report*, 2009, p.76)

3. Euro Area evolutions compared to U.S. and Japan

The situation in the United States of America seems even worst, with output contracting at an alarming pace and the labour market weakening rapidly: since December 2007, nearly 4½ million jobs have been lost. Industrial production has continued to fall steeply, and weak export orders and gloomy business surveys indicate that foreign demand for US goods and services has also declined further. Like in Euro Area, the intensification of the recession and the plunge in commodity prices have resulted in a marked drop in inflation.

US households' incomes are being depressed by the deterioration in labour market conditions, and their wealth has fallen markedly with declines in housing and equity prices. It is considered that a gradual recovery may take hold next year as financial conditions improve and macroeconomic policies exert a growing positive impulse. In response to the opening of a substantial output gap and with commodity prices assumed to remain flat, it is possible that inflation would fall noticeably and deflation might become a threat in 2010. (OECD, *The OECD Economic Outlook Interim Report*, 2009, p.67)

On the other side of the Pacific, Japan experiences the sharpest export decline in Japan's post-war era. The negative demand shock and the appreciation of the yen, by 25% in trade-weighted terms in the fourth quarter of 2008 (quarter-on-quarter), led to a sharp deterioration in profitability. The deterioration in financial conditions contributed to a double-digit increase (year-on-year) in the

number of bankruptcies during the first two months of 2009. Household income is falling as employment stalls and the decline in wages that began in late 2008 is accelerating, resulting in a contraction of household consumption. With the external sector remaining a drag on activity, output is projected to continue contracting during the course of 2009. Domestic demand is expected to lead a modest recovery in 2010, although growth will still be less than 1% by the end of the year. (OECD, *The OECD Economic Outlook Interim Report*, 2009, p.71)
A comparison of the main macroeconomic indicators (for 2009) of the three international actors is presented in the table below (Table 2).

	Percentage change, volume - 2009		
INDICATOR	**Euro Area***	**U.S.A.****	**Japan****
Total domestic demand	-2.8	-4.1	-2.8
Net exports	-1.3	0.3	-3.8
GDP at market prices	-4.1	-4.0	-6.6
GDP deflator	1.3	1.8	2.2
Harmonized index of consumer prices	0.6	-0.4	-1.2
Unemployment rate	10.1	9.1	4.9

** 2001 prices; ** 2000 prices*

Table 2. Comparison: Demand, Output and Prices (2009)

Source: Data presented in the OECD, The OECD Economic Outlook Interim Report*, 2009*

4. Effects of the crisis upon the principles of the EU
The effects of the crisis go beyond the economic field. Some voices (mostly American ones) wonder whether this situation would affect the very idea of “One Europe”. They seem to believe that this is the time when the European Union will have to “prove whether it is just a fair-weather union or has a real joint political destiny” (Stefan Cornelius, foreign editor of the German newspaper Suddeutsche Zeitung). Thomas Klau, Paris director of the European Council on Foreign Relations, an independent research and advocacy group, said that “This crisis affects the political union that backs the euro and of course the E.U. as a whole and solidarity is at the heart of the debate.” (Earlanger, S., Castle, S., 2009)
The crisis seems to have already laid growing rifts between members and exposed how woefully underequipped the EU's institutions are to deal with the situation. For all their lectures about global solutions to the economic crisis, EU members have mainly acted to save themselves. A number of Western governments have ordered their banks to pull back funds from foreign subsidiaries in the East and elsewhere, choking off capital to the region. France has ordered CEOs to close factories in Eastern Europe in order to save jobs at home. Last week World Bank chief Robert Zoellick warned Europe that unless it acted decisively to reverse this course, it risked the "tragedy" of once again splitting into two economic and political blocs – exactly 20 years after the fall of the Berlin Wall. By the end of the week the World Bank, along with two EU public-investment banks, finally scrambled to raise a 25 billion Euros loan package for Eastern Europe's banking systems. But calls for a much bigger bailout have so far gone unheeded. (Theil, S., Underhill, W., 2009)
Furthermore, officials of the EU are getting worried about the faith in a “certain brand of capitalism”. These officials understand the problem of the new members from the east: why their European partners are putting their own interests ahead of the “collective and necessary

solidarity". But the expectations are that the euro zone countries will bail each other out, if only out of pure self – interest.

Analysts estimate that the solution of the crisis lies in the capacity of the governments and international institutions to:

- establish a credible and effective mechanism for international policy coordination;
- fundamentally reform the existing systems of financial regulation and supervision, leading to a new internationally coordinated framework that can avoid the excesses of the past; reform the present international reserve system, away from the almost exclusive reliance on the United States dollar and towards a multilaterally backed multi-currency system;
- reform the liquidity provisioning and compensatory financing mechanisms, backed through, among other things, better multilateral and regional pooling of national foreign-exchange reserves which avoid the onerous policy conditionality attached to existing mechanisms. (U.N., 2009)

As to the specific financial market regulations, the main priorities are:

- improving transparency through enhanced disclosure of risk, improved valuation methods and a more comprehensive picture of off-balance sheet entities.
- changing the role of credit rating agencies and improving their functioning;
- strengthening risk management standards and procedures, and providing better incentives to hold appropriate levels of capital;
- regulators and supervisors should become more responsive to risks;
- ensuring that adequate deposit-insurance schemes are in place and that payouts are swift and predictable.
- designing developing policies to reduce the pro-cyclicality of financial regulations and policies that can be used to "lean against the wind" such as smoothing capital and provisioning requirements. (OECD, *Economic Survey of the Euro Area*, 2009, p.7)

The general opinion is that achieving a coherent system of financial supervision as well as managing cross-border risks calls for a more centralized and integrated approach. Recent events have made it clear that it is essential to reflect on how to elaborate a longer term and shared vision of the EU supervisory architecture, combining the need to safeguard EU financial stability with legitimate national interests.

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