

EBF Outlook N°27

Brussels, June 2009

Glimmers of hope



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Contact

Florence Ranson
Senior Adviser
Communications
f.ranson@ebf-fbe.eu

Elena Letemendía
Senior Adviser
Economic and Monetary Affairs
e.letemendia@ebf-fbe.eu

Viktorija Proskurovska
Adviser
Economic and Monetary Affairs - Associates
v.proskurovska@ebf-fbe.eu

Layout

Laura Cerrato
ICT Coordinator

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SIGNS THAT THE PACE OF RECESSION IS SLOWING

The world financial crisis, which started as a US-originated financial turmoil almost two years ago, coincided with some important, adverse economic changes: notably a sharp hike in commodity prices (particularly energy and food), high inflation rates and a stronger euro. This combination of factors ensured that the crisis spread rapidly to the real economy. The euro area is now facing the most serious economic slowdown in decades.

Since the recession began, in the second quarter of 2008, GDP growth has contracted for four consecutive quarters. The latest quarter's GDP fall, of 2.5%, has drawn attention to the fact that the US economy has been less hard hit, with growth over the same period falling by -1.6%. Around the euro area, the economic deterioration has been broadly-based among sectors and countries. The depth of the collapse in indicators of confidence suggests that the recession will continue for the time being, although there is a chance of bottoming out this summer. In general, the perception of the euro area's economy is gloomier than it was at the time of EMAC's last Outlook, in December 2008.

Gloom is hard to dissipate. Yet we are in uncharted territory, where governments and central banks are making immense efforts to manage events. These efforts require time to filter through to economic activity.

Despite the generally severe situation worldwide, some early positive signs have been detected on the radar of economic observers. On the economic side, in addition to real improvements in Asia, there has been a slowing in the fall in euro area activity at the beginning of spring. There are some positive signals from (still-weak) confidence indicators. In the financial markets, we have seen an improvement in access to liquidity and longer term fund-raising, accompanied by a reduction in credit spreads. The stock markets have rallied over the last couple of months. The momentum from the political commitment to restore confidence and restart growth by fiscal means is gathering. In the euro area, the ECB has played its part in improving conditions on the money markets, and its monetary policy easing - which has led to a main refinancing rate of 1% - is being transmitted to the economy, with the usual 6 to 9 month lag. These factors should favour a recovery. The dramatic contraction in the first quarter of this year could prove to be the low point, as measured by the rate of quarter-on-quarter decline in activity.

The consensus view among the Chief Economists assembled in the EBF's Economic and Monetary Affairs Committee is that the recovery in the euro area will begin this year, but that it will be subdued for the period of the forecasts – to the end of 2010.

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The fiscal and monetary stimulus, and the measures in favour of the financial sector, should be successful in putting a floor to the downturn. But the economy faces serious adjustments in the coming months: labour market contraction; continuing tensions in financial markets; the continued shrinking of bank and household balance sheets; and the correction of imbalances, for example in the housing sector, where the cycle is depressing growth. These are likely to hold back the recovery until perhaps the last quarter of 2009 or, on some estimates, no earlier than mid-2010. Last but not least, confidence must return.

The central forecast for **GDP growth** for the euro area in 2009 is -3.9%, with the spread of the forecasts ranging from -3.0 to -4.5%. Meanwhile in the US, growth estimates average -2.9% for 2009 and a more optimistic expectation of +1.1% for 2010.

The euro area will need a lift from external demand to help it out of the recession. This is likely to come from a speedier **recovery in the US and Asia towards the end of the year**. If this coincides with an improvement in business and consumer confidence, and a rebuilding of stocks, it will help important exporters such as Germany and Austria to turn the corner. Low interest rates at both short and longer term, and the gradual return to normal of the financial sector during the year, should set the scene for an improved economic picture in 2010. EMAC's economists forecast on average GDP growth for 2010 of 0.1%, with a spread of -0.6 to +1.0%. Clearly, a return to normal conditions in the financial and banking sector, and the effectiveness of public support measures - which may need supplementing in some countries - will be necessary conditions for a sustained recovery.

On the other hand, the euro area countries' economic growth is also affected by developments in the Central and Eastern European countries. A good number of large European banking groups hold large stakes in the emerging European economies, and have been affected by the recent fall in economic activity in the region (the end of the economic cycle, aggravated by their local housing bubbles and the global financial crisis). The sharply deteriorating economic situation in the Baltic States, Bulgaria, Romania and Hungary is partly a second-round effect of the financial crisis in Western Europe, but this could be aggravated further, should the Western banks reduce their investments in the region in order to protect their mother companies from further write-downs and overall losses. The Baltics and Hungary have been particularly reliant on foreign borrowing to fund domestic credit growth (which resulted in excessive current account deficits), so such a move could hit the emerging economies unprecedentedly, leading to further deterioration of finance and trade relations between the Eastern and the Western European economies. On balance, an East-European heavyweight, Poland, and prudent Czech Republic, have faced fewer difficulties and will continue to maintain a level of economic activity comparable to that of the rest of the EU.

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There is a **greater level of confidence in the view that the world economy is close to bottoming out this year, although in common with the euro area forecast, the upswing is expected to be weak.** Globally, the recession will be the deepest – and probably longest – in the post-war period. Most of the forecasts see world growth as likely to be modestly negative (-1% to -1.5%) for 2009. The chief economists see the recovery beginning from the end of this summer onwards, leading to weak, positive growth (around 2.0%, possibly up to 2.7%) in 2010. The global downswing has inflicted serious damage on international trade. Real **exports** are expected to drop by an average of 10.3% in 2009, reporting the first annual contraction since the inception of the statistical series in 1995.

LOWER DEBT LEVELS HERE TO STAY?

Worsening expectations for the economy and the high level of debt in households and non-financial corporations have led to a process of deleveraging, in other words reducing the ratio of debt to equity, in the non-bank private sector. Among banks, the normal reaction to economic weakness and uncertainty is to tighten credit standards and reduce leverage. Currently, as they face huge losses on their asset books and the need to rebuild balance sheets, these trends are accentuated. Deleveraging, on all sides, will weigh on growth for some time, as the economy emerges from recession. Looking to the longer term, reduced leverage and higher equity levels – last but not least because of changed regulatory rules – may be a lasting effect of the crisis.

Bank lending volumes will tend to reflect these processes, both on the supply side (banks' willingness to take on new debt and the pricing attached to it), and the demand side (companies' and households' requests for new loans). In fact, overall lending by the Monetary Financial Institution (MFI) sector in the euro area, monitored by the European Central Bank, has held up well through the last three quarters. The ECB figures show continuing although slower growth in the annual rate of lending to the non-financial sectors (a flat trend on a month to month basis since 3rd quarter 2008), with banks showing greater sensitivity to risk.

In the household sector, mortgage credit has been hit hard in a number of major economies, despite the fall in the cost of borrowing since the start of the year. In the case of Belgium, a reduction in VAT for residential construction (6% from 21%), combined with the substantially lower long term interest rates, has enabled the mortgage business to increase slowly. Elsewhere in the euro area, there is scope for fiscal measures to revive interest in mortgage loans, but consumers will remain cautious about over-extending themselves.

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Most EMAC economists' reports from around the euro area agree in generally seeing a continuation of the declining trend in overall lending business over the coming months, as both demand and supply decrease, reflecting the less favourable growth context for GDP as a whole, and also for investment. In economies such as Spain, where economic agents have built up high levels of debt, this effect is being accentuated, as companies and especially consumers retrench.

Looking further into the future, all the major economies may enter a period of slower trend growth. Consumers, companies and banks may undertake new financial commitments more cautiously than before the crisis, and with greater attention to their sustainability.

GROWTH DRIVERS... LOOKING TO EXTERNAL DEMAND

As anticipated in EMAC's last Outlook, consumer and industrial confidence is very weak. The average of EMAC members' forecasts shows **private consumption** falling by about -1% in 2009, as consumers reduce outgoings and try to build up their reserves. **Unemployment**, traditionally reacting to changes in economic conditions with a lag, is expected to rise throughout the forecast period, reaching 10.9% in 2010 according to the average of the EMAC projections, but with estimates for that year ranging between 9.8 and 11.8%. This uncertainty underlies the forecasts for consumer spending through 2010, which on average indicate zero growth, but in the view of the majority, will see a modest increase.

Gross investment, despite government efforts, is on average seen as declining two years in succession: by -9.8% in 2009 and with a slight recovery to -2.0% in 2010. However, industrial output may have reached its nadir in the first quarter of 2009. Stocks are low, and inventories will need rebuilding.

Much of the downside impetus in the euro area has come from external demand, which has hurt export leaders such as Germany hard. The weak state of the emerging economies reinforces the view that euro area exports will remain a drag on economic growth in the coming months. But when recovery in export markets sets in, competitive producers such as Germany should have the opportunity to recapture their markets. Since China is the largest importer of European goods, acceleration in its activity will underpin European exports.

FISCAL POLICY STRONGLY SUPPORTIVE

Public spending will grow by anywhere between 1.6 and 2% in each of the forecast years. Headline figures for the stimulus will need to be translated into new investment and demand, but structuring and

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implementing the measures takes time. Within the European single market, it is particularly important that the competitive effects of the support packages are fully monitored, and that the competition authorities have the opportunity to consider and approve measures which have the potential to distort market conditions.

Public debt and deficit levels will be under upward pressure from these spending plans, including measures in favour of the banking sector, transfers and fiscal cuts. The economic weakness will also be reducing public revenues. EMAC members forecast an increase in **general government debt** to 75-80% of GDP in both forecast years, with the **general government deficit** more or less steady at -5-6% on average.

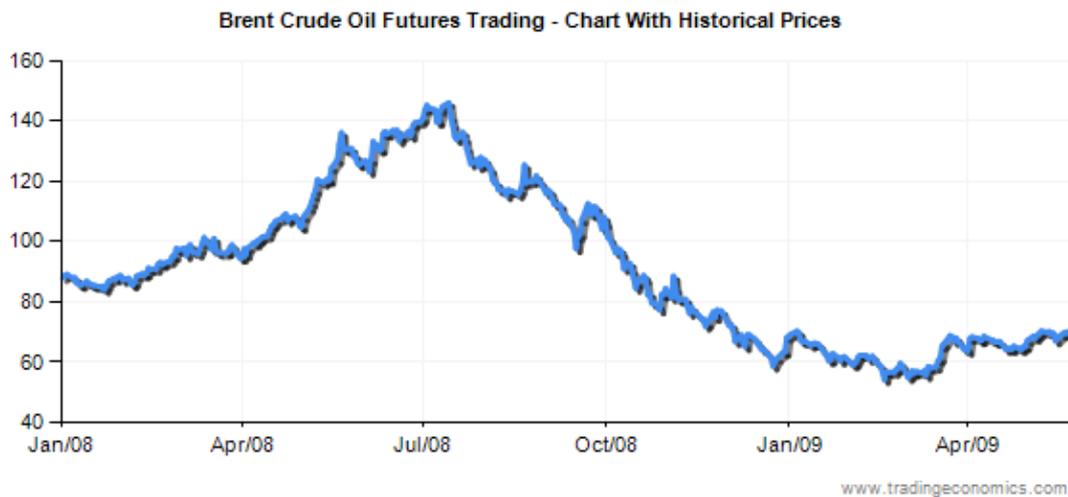
Since the last edition of the Outlook, the G-20 countries have given a further push to recovery plans, with an agreement announced on 2nd April to provide an additional \$1.1 trillion of support for the economy. Questions remain about how these funds will be spent, and how quickly. Rescue operations will need to address urgently the day-to-day financing difficulties faced by companies of all sizes, particularly in working capital and trade finance, so as to prevent the industrial base from shrinking. Once the economy has turned the corner, the timing of governments' exit strategy will be crucial.

INFLATION IS AN ISSUE FOR THE LONGER TERM

The euro zone's growing output gap, and moderate wage growth, will dampen core inflation for the next couple of years. There is a risk that positive economic surprises may boost growth, which could lead to a pick-up in inflation pressures, mainly from the risk of increases in commodity prices. The economists view this possibility as highly unlikely. Some see the output gap continuing to widen until mid-2010.

Commodity prices, especially **oil prices**, are expected to stay close to current levels, with oil at current \$60 per barrel levels. For 2010, the average of estimates is around \$66, with a range of \$58 to \$75, per barrel. Base effects from past oil price increases will help to push the inflation rate down - possibly temporarily negative - until around the third quarter of 2009, and thereafter push it modestly upwards.

Figure 3. Brent Crude Oil Futures Trading¹



Core inflation forecasts average around 1.2-1.3% for 2009 and 2010, with the **headline inflation** rate averaging 0.4% in 2009, increasing to 1.2% in 2010. Euro area monetary aggregates will not be a cause for concern, with **M3** growth fairly stable over the next 18 months at or below 6%.

In December 2008, EMAC advocated aggressive rate-cutting on the part of the ECB. This scenario has unfolded since the start of this year, as the main refinancing rate has cascaded down from 2.5% to 1%. Against a background of deepening recession and low inflation, the ECB has undertaken both conventional and unconventional policy measures to ease financing conditions. Although a good number of the economists favoured a more aggressive easing of rates, they unanimously endorse the range of steps taken so far.

Forecasts for the path of interest rates over the next 18 months differ modestly. Some of the chief economists foresee rates on hold until they begin to rise by the end of the first half of 2010 or later. Others see room for one or two additional rate cuts in the second half of 2009. They agree that the ECB may begin to tighten when it is clear that a stable recovery is in place (most likely in the second half of 2010), in a measured way. The difficulty will then be for the ECB to correctly time the cessation of emergency measures and the shift of interest rates to a more normal level, and to evaluate the likely reaction of markets and stakeholders.

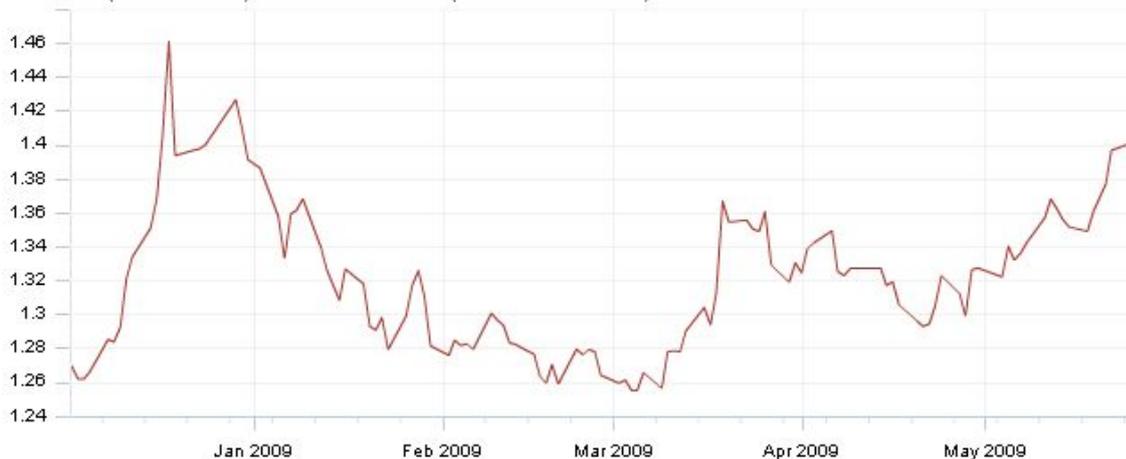
¹ Source: <http://www.tradingeconomics.com/Economics/Commodities.aspx?Symbol=COG1>

EXCHANGE RATE UNCERTAINTY: FURTHER DOLLAR WEAKNESS POSSIBLE

As high-spending economies such as the US rein in spending, and high-savers such as China try to consume more, there may be a rebalancing of the world economy. While a reduction of world imbalances is to be welcomed, it brings with it the possibility of further **US dollar** weakness.

Figure 4. US Dollar vs. Euro Exchange Rate²

Change from 2 December 2008 to 26 May 2009: ▲ +0.1211 (+9.54%)
Minimum (5 March 2009): 1.2555 - Maximum (18 December 2008): 1.4616



Uncertainty about the timing of the recoveries in the US and Europe is however reflected in the economists' exchange rate forecasts. Mean expectations for both year-ends 2009 and 2010 suggest a \$/euro rate of 1.30 (range 1.20 to 1.40).

RISKS TO THE MAIN SCENARIO

Although uncertainty is very great, the euro area economy seems at a crossroads. We may have reached the point at which positive risks are more likely to be realised than the negative. In the first instance, it will be the effectiveness of public measures, in rebuilding confidence and aiding restructuring in the financial sector, and supporting confidence and activity in the wider economy, which will determine the direction taken.

² Source: ECB (<http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html>)

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Expectations may be unduly pessimistic in a number of important areas. Evaluation of the effectiveness of the fiscal and monetary stimulus – still being reinforced with new solutions – is extremely difficult. It may be greater than generally foreseen, leading to unexpected improvements in the employment market. The financial crisis tightened financial conditions, depressing demand and triggering a downward spiral in the value of assets. Conversely, the restoration of normal financial market conditions, which appears to be on the horizon, could halt this negative trend. Monetary easing, lower commodity prices and general disinflation could stimulate private consumption more than expected. The recovery in global demand may occur sooner than expected, perhaps due to faster than expected recovery in China or the US. Every one of these influences would work in favour of a revival of confidence.

Even in this positive scenario there is a high risk that we will see some kind of “double dip”. There are at least two reasons for this: (a) because a policy-driven recovery often turns out to be a flash in the pan; and (b) the substantial structural problems (macroeconomic imbalances; adjustments in the housing / construction sector, rising public debt problems) will put a burden on long-term growth.

Bad news may come from any of these aspects of the economic landscape. The results of the fiscal stimulus may be disappointing, and there is a risk that the financial system may remain weak after these measures have been implemented. The effect of credit tightening on the economy may have been underestimated. Since the slowdown in demand in the US is partly structural - consumers need to save more – the Asian markets which are major suppliers to the US may face the problem of excess capacity. Another risk is that raw material and commodity prices could recover too quickly, as could interest rates. This would delay recovery and even aggravate a decline.

In this period of great uncertainty, the economists have been invited to comment on their **level of uncertainty about the euro area growth outlook**. The results of this enquiry point to a cautious outlook, there being a high probability of a positive (but quite low) growth rate for the euro area next year.

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Figure 1.
Histogram of EMAC's probability forecast of GDP growth in 2009³

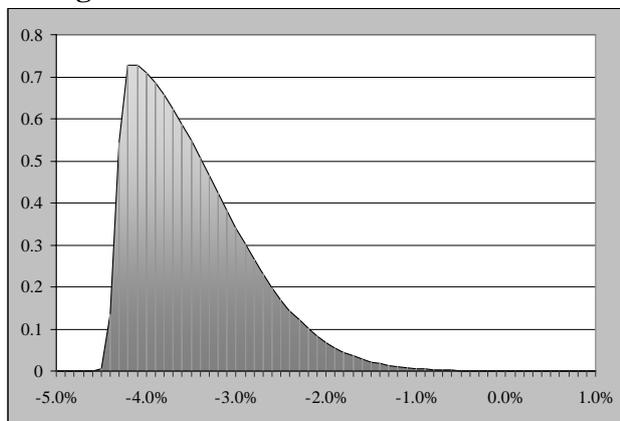
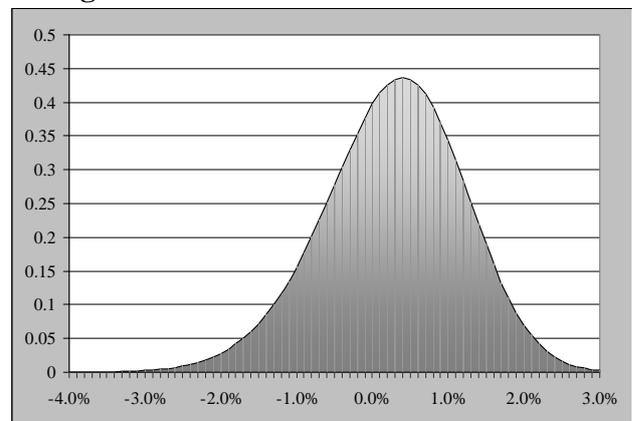


Figure 2.
Histogram of EMAC's probability forecast of GDP growth in 2010³



According to the probability histograms in Figures 1 and 2, the economists assign a strong likelihood (73% probability) of GDP dropping by 4.1% in 2009, with a lesser likelihood of the contraction being much deeper. The tailing off of the probability of the 2009 GDP contraction being less significant while still below zero, indicates the wide spread of possibilities for a less severe contraction. For 2010, the uncertainty is much higher. The chief economists see a growth rate of GDP of 0.6% p.a. as the most likely outcome (with a probability of 43%) but the risks are slightly skewed in the direction of still more sluggish growth next year.

³ We acknowledge the assistance of Andrés Manzanares in estimating derived probability densities, following the methodology of J.A. García & A. Manzanares, "What can probability forecasts tell us about inflation risks" ECB WP No. 825 (2007)

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Association of Banks Bratislava

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POLL ON THE ECONOMIC OUTLOOK FOR THE EURO AREA 2009-2010

TABLE 1	2007*	2008**	2009 Forecasts						
			EMAC Consensus			EMAC		COM Forecast	
			2009 mean	2009 range	End-2008	Mid-2008	Spring 2009	Autumn 2008	
1. Output and Aggregate demand: (Ann.% change)									
Gross domestic product	2.7	0.8	-3.9	-4.5	-3.0	-0.4	1.6	-4.0	1.2
Private consumption	1.6	0.5	-1.0	-2.0	0.0	0.0	1.5	-0.9	0.5
Public consumption	2.3	2.0	2.0	1.4	2.5	1.6	1.6	2.0	1.8
Gross investment (GFCF)	4.3	0.0	-9.8	-13.3	-6.6	-2.7	2.2	-10.4	1.2
Exports	6.0	1.2	-10.3	-14.0	-0.8	0.6	3.9	-13.2	3.2
Imports	5.4	1.2	-7.9	-12.0	-0.4	0.8	4.3	-10.5	2.6
2. Labour market and prices: (Ann.% change)									
Unemployment rate (%)	7.5	7.5	9.7	8.9	10.5	8.2	7.2	9.9	7.6
Wages (Unit Labour Cost)	1.7	3.3	3.2	2.0	4.1	2.3	2.1	3.4	3.3
Prices (HCPI)	2.1	3.3	0.4	0.2	0.5	1.7	2.1	0.4	3.5
Core HCPI			1.3	0.5	1.5	1.8	2.0		
3. Public Finances: (% GDP)									
General Government Balance	-0.6	-1.9	-5.0	-6.0	-3.0	-2.5	-1.0	-5.3	-1.3
General Government Debt	66.1	69.3	75.5	68.0	78.0	68.2	64.8	77.7	66.6
4. External sector: (% GDP)									
Trade Balance	0.7	0.4	-0.2	-0.5	0.7	0.3	0.5	0.1	0.7
Current Account Balance	0.2	-0.8	-0.9	-1.5	0.7	-0.2	-0.6	-1.4	-0.4
(p.m.) US growth (Ann.% change)	2.0	1.1	-2.9	-3.5	-2.4	-0.7	1.5	-2.9	1.5
(p.m.) Oil price (Brent) (US\$/bl)	71.1	97.0	54.9	49.0	60.0	65.5	99.4	52.9	104.0
5. Monetary and Financial Indicators:									
Interest rate on ECB's main refinancing operations	Jun-09	4.00	4.00	0.96	0.75	1.00	1.93	3.49	
	Dec-09	4.00	2.50	0.88	0.50	1.00	1.86	3.44	
3 month interest rate (EURIBOR)	Jun-09	4.15	4.94	1.27	1.03	1.80	2.65	3.74	
	Dec-09	4.85	3.29	1.21	1.00	1.30	2.49	3.71	
10 year government bond yield (Bund)	Jun-09	4.51	4.73	3.25	2.80	3.90	3.39	4.14	
	Dec-09	4.38	3.69	3.27	2.48	4.00	3.57	4.27	
M3 growth	Jun-09	10.9	9.5	4.87	2.80	7.00	5.70	8.41	
	Dec-09	11.6	7.5	3.30	-1.90	6.50	5.63	8.07	
Credit to private sector (Ann.% change, M3 definition)	Jun-09	11.5	11.2	2.43	1.10	4.60	6.00	9.50	
	Dec-09	12.8	6.8	1.50	-1.00	4.00	5.83	8.88	
Exchange rate USD/EUR	Jun-09	1.35	1.58	1.32	1.25	1.40	1.30	1.44	
	Dec-09	1.47	1.39	1.31	1.20	1.42	1.29	1.37	

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TABLE 2		2007*	2008**	2010 Forecasts						
				EMAC Consensus		EMAC		COM Forecast		
				2010 mean	2010 range	End-2008	Mid-2008	Spring 2009	Autumn 2008	
1. Output and Aggregate demand:										
(Ann.% change)										
	Gross domestic product	2.7	0.8	0.1	-0.6	1.0			-0.1	0.1
	Private consumption	1.6	0.5	0.2	-0.5	0.7			-0.3	0.4
	Public consumption	2.3	2.0	1.6	0.2	2.3			1.7	1.2
	Gross investment (GFCF)	4.3	0.0	-2.0	-5.5	0.3			-2.7	-2.6
	Exports	6.0	1.2	0.6	-1.0	1.8			-0.3	1.1
	Imports	5.4	1.2	0.7	-1.0	1.6			-0.8	0.6
2. Labour market and prices:										
(Ann.% change)										
	Unemployment rate (%)	7.5	7.5	10.9	9.8	11.8			11.5	8.4
	Wages (Unit Labour Cost)	1.7	3.3	0.5	-1.6	3.2			0.1	2.5
	Prices (HCPI)	2.1	3.3	1.2	0.8	1.6			1.2	2.2
	Core HCPI			1.2	0.4	1.7				
3. Public Finances:										
(% GDP)										
	General Government Balance	-0.6	-1.9	-5.4	-7.0	-2.5			-6.5	-1.8
	General Government Debt	66.1	69.3	79.4	67.5	84.0			83.8	67.2
4. External sector:										
(% GDP)										
	Trade Balance	0.7	0.4	-0.4	-0.6	0.0			0.1	0.9
	Current Account Balance	0.1	-0.8	-1.0	-1.6	-0.1			-1.5	-0.1
(p.m.) US growth	(Ann.% change)	2.0	1.1	1.1	-0.4	1.5			0.9	-0.5
(p.m.) Oil price (Brent)	(US\$/bl)	71.1	97.0	66.6	58.5	75.0			63.5	85.7
5. Monetary and Financial Indicators:										
	Interest rate on ECB's main refinancing operations	Jun-10	4.00	4.00	1.00	0.50	1.50			
		Dec-10	4.00	2.50	1.29	0.72	3.00			
	3 month interest rate (EURIBOR)	Jun-10	4.15	4.94	1.36	0.97	1.75			
		Dec-10	4.85	3.29	1.83	0.86	3.25			
	10 year government bond yield (Bund)	Jun-10	4.51	4.73	3.55	2.90	4.25			
		Dec-10	4.38	3.69	3.75	3.00	4.50			
	M3 growth	Jun-10	10.9	9.5	5.54	2.00	7.70			
		Dec-10	11.6	7.5	5.94	4.90	7.70			
	Credit to private sector (Ann.% change, M3 definition)	Jun-10	11.5	11.2	5.17	4.00	6.50			
		Dec-10	12.8	6.8	6.83	6.00	7.50			
	Exchange rate USD/EUR	Jun-10	1.35	1.58	1.32	1.15	1.46			
		Dec-10	1.47	1.39	1.30	1.20	1.48			