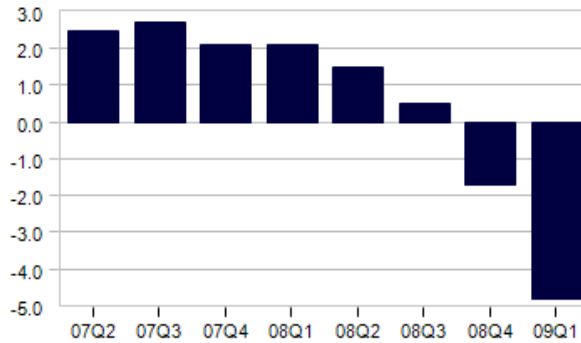


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## The Numbers

- » Euro zone GDP contracted by 2.5% in the first quarter of 2009 compared with the previous stanza. This was in line with the flash estimate released last month and is the largest contraction since euro area GDP records began in 1995.
- » The economic contraction for the fourth quarter of 2008 was revised down to 1.8% q/q from a drop of 1.6% q/q in the flash estimate.
- » According to member state breakdowns, Germany's GDP contracted 3.8% q/q and fell 6.9% y/y in the first quarter. France's economy contracted by 1.2% q/q and 3.2% y/y whilst Italy's economy slipped 2.4% q/q and 5.9% y/y. GDP in Spain contracted 1.9% q/q and by 3% in annual terms.
- » Gross fixed capital formation tumbled 0.9% q/q in the first quarter, following a similar fall in the previous stanza. On a year-ago basis, gross fixed capital formation contracted 2.3%, after falling by 1.2% in the fourth quarter of 2008.
- » Household spending contracted by 0.3% in the first quarter from the previous stanza, when it dropped by 0.2%. On a year-ago basis, household spending fell 0.6%, following a contraction of 0.3% in the fourth quarter. Households reined in spending as unemployment rose and consumer confidence fell to historical lows throughout the region.
- » Recession in key trading partners led exports to contract by 3.2% q/q in the first three months of 2009. Meanwhile, imports actually rose by 2.9% q/q. On a year-ago basis, exports contracted in the first quarter, dropping by 6.6%, while imports grew by 4.8%.
- » Government spending remained unchanged in the first quarter from the previous stanza but grew by 0.3% in annual terms. Public spending will likely increase in coming quarters as governments across the region implement their fiscal stimulus packages.
- » According to sector data, industry, trade, transport, communications and financial services all contracted on a quarterly basis. Meanwhile, agricultural and construction output remained unchanged from the fourth quarter.

## Behind The Numbers

The euro zone economy contracted at a record pace in the first quarter of 2009. The region's GDP fell 2.5% in the first three months of the year from the previous stanza, when output dropped 1.8%. This was the steepest decline in output since the data series began in 1995. In year-ago terms, output fell 4.8%, after slipping 1.7% in the fourth quarter of 2008.

Although the slump in activity was broad-based, with most countries heading deeper into recession, the outcome for Germany surprised the most. GDP in Europe's largest economy plunged 3.8% on a quarter-ago basis. Before the release of the flash estimates last month, the market was expecting a 3% contraction. Germany, an export-oriented economy, has been hit hard by the slowdown in global demand. The German banking sector is also laden with toxic assets. Output also fell sharply in the other big two regional economies. GDP in Italy, which like Germany has a large manufacturing base, contracted 2.4%. French GDP fell 1.2%.

As in most other regions around the world, some positive signs about economic activity in the euro zone have recently emerged. However, despite the improvement in some business surveys and key confidence indicators, nearly all of them remain at extremely depressed levels and are well below that which would suggest a stabilization or near-term recovery in economic activity. The euro zone economy will shrink until the end of 2009, though the pace of decline in economic activity will ease in coming quarters.

The recession in the region will also be deeper than in some other areas because the problems in the European banking sector are relatively bigger. According to the International Monetary Fund, European banks have more toxic assets than their U.S. counterparts and have made the least progress in dealing with them. In addition, some key euro zone countries are relatively more dependent on trade in investment goods, the demand for which is very prone to the economic cycle.

The policy response in Western Europe to the economic and financial crises has also been slow and insufficient. China and the U.S. account for more than half of the worldwide response to the global economic slowdown, while Western Europe provides less than 7% of the total. Meanwhile, the governing council of the European Central Bank is bickering over the bank's strategy after they lowered the key policy rate to a new record low of 1% in May and announced a plan to buy a modest €60 billion of euro-denominated covered bonds. Other major central banks have acted much quicker to support their economies. The Federal Reserve, the Bank of England, and Bank of Japan have brought their key rates to close to zero and are already buying government and corporate debt.

Enam Ahmed in London

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