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Staff Report on the Monetary and Exchange Rate Policies of the Euro Area and the Trade Policies of the European Union; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director on Monetary and Exchange Rate Policies of the Euro Area

The following documents have been released and are included in this package:

- the staff report on the monetary and exchange rate policies of the **euro area** and the trade policies of the European Union, prepared by a staff team of the IMF, following discussions that ended on **July 3, 2002,** with officials at EU institutions in the context of the Article IV consultations with the countries forming the euro area. **Based on information available at the time of these discussions, the staff report was completed on September 26, 2002.** 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 staff supplement of **October 16, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 18, 2002 discussion** of the staff report on the monetary and exchange rate policies of the euro area.

- a statement by the Executive Director for the country currently holding the Presidency of the European Council, on behalf of the euro-area countries.

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Monetary and Exchange Rate Policies of the Euro Area[1]

Prepared by the European I Department

Approved by Michael Deppler and Leslie Lipschitz

September 26, 2002

- A staff team visited the European Central Bank (ECB) and the European Commission (EC) during June 24-July 3, 2002, to conduct discussions in the context of the 2002 Article IV consultations with euro area members.[2]
- In concluding the last Board meeting on euro-area policies on October 19, 2001 (EBM/01/106), Directors noted that the euro area's expansion had proven less resilient than anticipated. Against a background of sluggish activity they saw room for further monetary policy easing and argued for letting automatic fiscal stabilizers operate, but thought the case for discretionary fiscal actions was weak. They encouraged continued efforts at improving market understanding of the monetary policy framework. Directors urged that structural reforms be stepped up.
- A staff report on a December 2001 interim staff visit to EU institutions was issued to the Board for its information in March as SM/02/80.

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[1] Including the trade policies of the European Union.

[2] Meetings were held at the ECB with President Duisenberg, Vice President Papademos, Ms. Hämäläinen, Mr. Issing, and Mr. Padoa-Schioppa (members of the Executive Board), as well as with senior staff. At the EC the mission exchanged views with Commissioner Solbes Mira, Mr. Regling (Director General for Economic and Financial Affairs), and other officials. The team comprised Messrs. Deppler (Head), Chadha, Jaeger, Kieler, and Ross (all EU1). Mr. Lankes (PDR) joined the mission during its visit at the EC to cover EU trade issues. Mr. Deppler participated in the meeting of the Economic and Financial Committee (EFC) in Brussels on June 27, and returned to Brussels on July 11, 2002, to present the mission's concluding statement to the Eurogroup.

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I. INTRODUCTION

1. **The 2002 Article IV consultation discussions took place as sharp sell-offs in global equity markets and the dollar cast a pall over the global recovery.** Increased downside risks around a lower baseline of growth brought to the fore nagging concerns about the performance of the euro area, its contribution to global recovery prospects, and mixed public perceptions of the fiscal and monetary policy frameworks of the Union. Against this background, the discussions focused on:

- **The risks to the recovery.** With prospects of a slower recovery abroad and an appreciated euro curtailing external demand, sustaining growth requires a strengthening of domestic demand. Historically, however, domestic demand has tended to follow rather than lead recoveries.

- **The extent to which monetary policy is hampered by persistent inflation.** Despite the slowdown, inflation persisted above the ECB's price stability range (of below 2 percent). Policy interest rates were cut by less, and have been held higher, than in other advanced countries, while criticisms that the definition of price stability may be too ambitious and about the role of the money pillar in communicating policy decisions have persisted.

- **The appropriateness of the Stability and Growth Pact (SGP) as a fiscal framework for the euro area.** As cyclical weakness has added to the three largest countries' difficulty in bringing fiscal deficits close to balance, there have been widespread calls for flexibility in implementing, or changes to, the SGP.

- **The need to improve the area's underlying real performance.** Sluggish growth and the area's susceptibility to shocks have focused attention on the growing delivery gap in implementing the broad structural reform and integration agenda of the Union.

II. ECONOMIC DEVELOPMENTS AND POLICY ISSUES

A. Output and Demand: Sluggishness to Lift Only Gradually

2. **The euro area is experiencing a gradual recovery from the downturn that began in late 2000.** The rebound in North America and emerging Asia in early 2002 supported a timid recovery in euro-area output, but export growth and significant policy easing failed to spur a broader-based recovery (table). Retail price hikes coinciding with the euro cash changeover at the beginning of 2002—and household perceptions of its impact in raising inflation well in excess of any

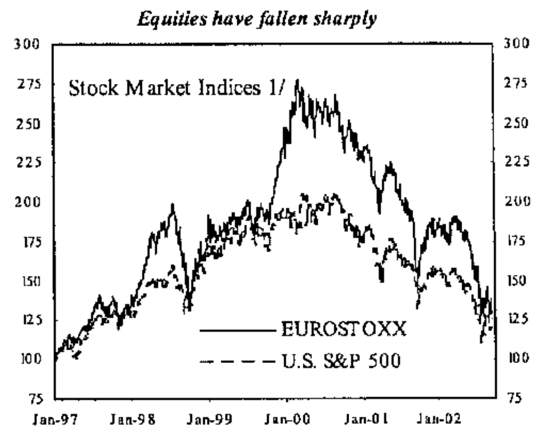
Euro Area: Output and Demand
(annualized quarter-on-quarter percent change)

	2001				2002	
	Q1	Q2	Q3	Q4	Q1	Q2 1/
Gross Domestic Product	2.0	0.2	0.7	-1.2	1.4	1.4
Final Domestic Demand	2.2	1.0	-0.1	-0.6	-0.3	0.5
Private Consumption	4.0	2.1	0.4	-0.1	-0.7	1.6
Investment	-1.5	-2.5	-2.5	-3.6	-2.3	-3.2
Net Exports 2/	1.5	-0.8	1.8	-0.3	1.2	0.6
Exports	-0.5	-4.6	-1.3	-6.6	0.5	8.0
Imports	-4.4	-2.8	-6.0	-6.4	-2.9	6.9
Stockbuilding 2/	-1.5	0.0	-1.0	-0.3	0.5	0.3
Employment (y-o-y)	1.9	1.4	1.1	0.8	0.7	-
Unemployment rate	8.0	8.0	8.0	8.1	8.2	8.3

Source: Eurostat.
1/ Staff projection.
2/ Contributions to growth.

reasonable estimates—sapped consumers' disposable incomes and hurt spending, even as the labor market held up uncharacteristically well during the downturn. Capital spending has contracted for six consecutive quarters following the bursting of the ICT bubble, and the inventory cycle is only beginning to turn. On the positive side, employment continues to grow and unemployment has risen only slightly from its 10-year low. The resilience of the job market reflects wage moderation and structural reforms enacted in recent years that boosted the use of labor in production and lowered the NAIRU.

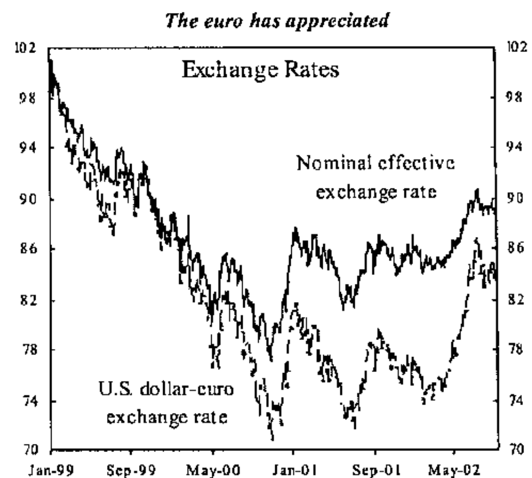
Equities have fallen sharply



Sources: Bloomberg; and staff estimates.
1/ Indices are equal to 100 in January 1997.

3. **The global shift out of equities could have a sizable impact on euro area activity.** Most indices have fallen by more than their U.S. counterparts for a variety of reasons, including a greater weight of telecom issues, harder-hit financial stocks (as corporate default risk is borne to a greater extent by financial institutions rather than markets), and a smaller off-set from falling bond yields. In view of the relatively lower share of household wealth invested in equities, and the predominance of bank lending in corporate financing, the direct impact should not be large. However, the indirect effects, via external demand, possible knock-on effects on business and consumer confidence, and tighter credit conditions in response to higher firm debt-equity ratios, could be more significant (Box 1).

The euro has appreciated



Sources: Bloomberg; IMF; and staff estimates.

4. **The effects of the euro appreciation should be more mixed.** The appreciation was welcomed by the authorities and staff, both as a sign of renewed confidence and as an antidote to inflationary pressures. The initial effects on real disposable incomes and consumer confidence should be favorable, but displaced in time by negative effects on net exports. However, the latter may not be as large as model-based assessments suggest (see table). The competitiveness of euro-area exporters remains healthy and responses to the appreciation are likely to be as muted and slow as they were to the

Effects of a 5 percent euro appreciation in mid-2002 1/
(deviation from control, percent).

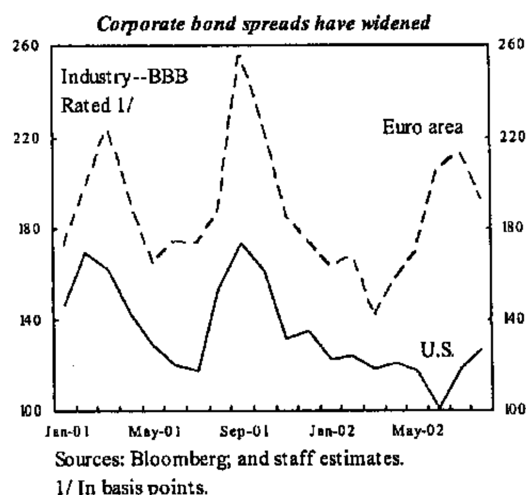
	2002	2003
GDP growth	-0.1	-0.3
CPI inflation	-0.1	-0.4

Staff simulation of OEF model.
1/ For unchanged policy rates.

depreciation.[3] Both medium-term savings-investment-balance and PPP approaches continue to suggest the euro remains undervalued on a multilateral basis and against the US dollar.

5. **While systematic information is limited, there are indications that corporate balance sheets may be more stretched than generally assumed.** Flow-of-funds data suggest that the corporate sector's investment spending remains constrained by relatively low levels of internal funds. Signs of corporate strain are also evident in default rates on European corporate bonds which last year roughly matched the early-1990s peak. For the banking system, while there are sectoral (telecom and insurance subsidiaries) and country-specific concerns (such as exposure in Latin America), the overall share of non-performing loans in total loans remains low by historical norms, the home-market franchises are strong and sustainable, and risks to solvency are judged to be low. Bank balance sheets, though, will likely continue to deteriorate during 2002, as asset quality weakens with a lag to activity and this could lead to tighter credit conditions—of which there is anecdotal evidence in some countries.

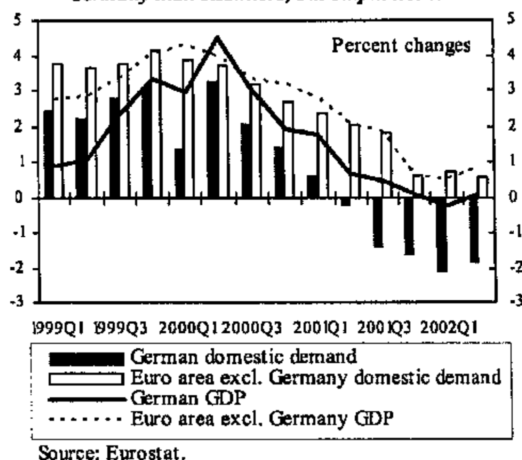
Corporate bond spreads have widened



Sources: Bloomberg; and staff estimates.
1/ In basis points.

6. **A further source of vulnerability is the weakness of domestic demand in Germany.** While the cyclical slowdown has been relatively synchronized across the euro area in terms of GDP, domestic demand in Germany has been exceptionally weak. This primarily reflects a decline in investment, focusing attention on a possible "overhang" from the TMT bubble period, tight credit conditions, and the continued construction slump.

Domestic demand has dropped off more sharply in Germany than elsewhere, but output less so



Source: Eurostat.

7. **The baseline prospect remains a recovery, but at a more gradual pace than previously expected.** There was broad agreement that the fundamentals for a recovery remain in place: inventories have been run down substantially, arguing for an early correction; declining inflation should boost real disposable incomes, to which private consumption in the euro area remains closely tied; higher capacity utilization rates than in

[3] See *Selected Issues* paper, *Euro Area Trade Flows and the Exchange Rate: How Much Disconnect?*.

previous troughs in economic activity suggests increases in demand should promptly lead to increased investment outlays; monetary policy remains accommodative; and finally external demand was projected to strengthen, although less than expected earlier. At the same time, the countervailing effects of slower global growth, the sell-off in equity markets, and tighter credit conditions had taken their toll on business confidence, while households' misperceptions of the inflation impact of the changeover has not dissipated as expected. In sum, while the basic prospect remains one of an upswing back to potential growth, it would be at a slower pace than previously expected. The staff has scaled back growth projections for the euro area considerably, to growth of 0.9 percent in 2002 and 2.3 percent in 2003, both about ½ percentage point lower than expected in the April WEO.

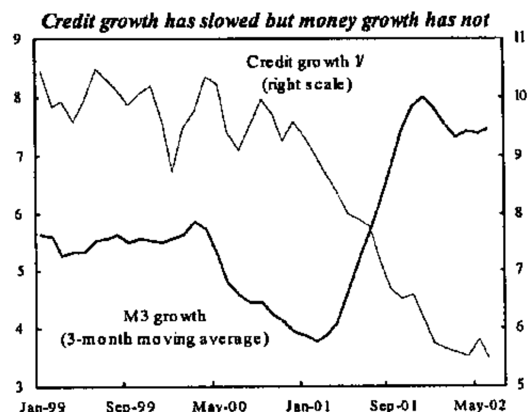
8. **But there are significant external and internal downside risks, especially in the near term.** The interaction of recent shocks with stretched corporate balance sheets and wary consumers could delay recovery. At the time of the mission, the authorities tended to stress the external sources of risk, in particular those stemming from slower U.S. growth, the sell off in global equity markets, further increases in oil prices, and the existing imbalances in the world economy, while noting the area continues to maintain sound fundamentals—in particular the lack of a buildup of major imbalances that have been evident elsewhere. The staff pointed out that the euro area's "lack of resilience" during the 1990s, whereby structural features or rigidities prolonged or aggravated the effects of temporary negative shocks, could also reassert itself in the current environment. This lack of resilience is variously attributed to underdeveloped retail credit markets that contribute to consumers seeming inability or unwillingness to bridge temporary fluctuations in disposable income through variations in the savings rate; product and labor market rigidities, in particular difficulties in firing labor that exacerbate profit downswings and make firms hesitant to expand employment; procyclical tendencies in fiscal policy; and perceptions of monetary policy as insufficiently responsive to output fluctuations. The authorities noted that some of these factors, such as limited household borrowing and a monetary policy firmly oriented toward guarding price stability beyond the shorter term in the face of large variations in asset prices, had also contributed to macroeconomic stability by constraining the buildup of balance sheet problems in the private sector.

B. Monetary Issues

Monetary policy and inflation

9. **Starting in May last year, the ECB significantly eased monetary policy.** In the context of the ECB's framework, the interest rate cuts were in response to reduced risks to medium-term price stability emanating from second pillar considerations (reduced growth and reversal of oil shocks). First pillar signals from rapid growth of money aggregates were discounted—earlier as having been biased by increased nonresident

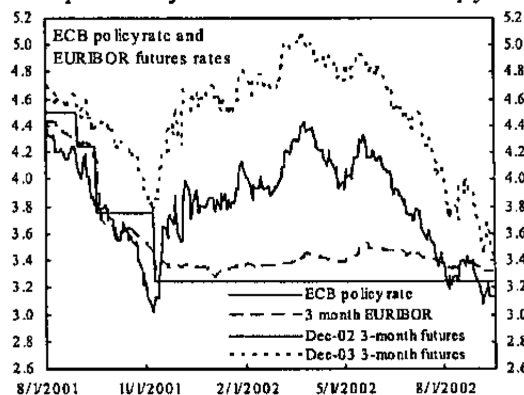
Credit growth has slowed but money growth has not



Sources: ECB and Eurostat.
1/ Private sector credit.

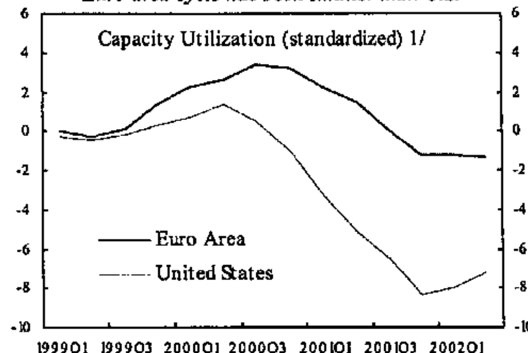
deposits and later as representing a portfolio shift in response to increased uncertainty in financial markets—and appear to have played little role in the decisions. The main refinancing rate currently stands at 3¼ percent, having been cut in four steps by a total of 150 bps. With inflation expectations around 1.8-1.9 percent, real short-term rates stand at about 1¼ percent, significantly below historical averages. Other indicators, including monetary conditions indices and M3 growth well in excess of the 4½ percent reference value also suggest that monetary conditions were substantially loosened last year—though the euro's appreciation has taken back some of that easing.

Expectations of rate hikes have diminished sharply



Source: Bloomberg.

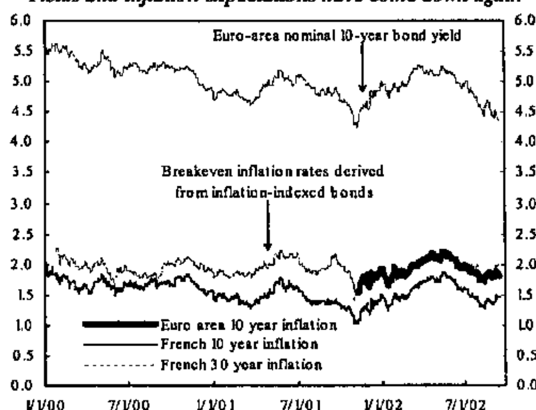
Euro area cycle has been smaller than U.S.



Sources: European Commission; IMF; and staff estimates.

1/ The 1985-2001 average is equal to zero.

Yields and inflation expectations have come down again



Source: Bloomberg.

10. **Looking back, the staff acknowledged that monetary policy had responded appropriately to the changing risks to growth and price stability, and provided a firm anchor for inflation expectations.** This was in the face of a particularly challenging environment as negative global demand shocks coincided with a series of cost-push shocks that raised inflation.

- **The interest rate cuts in 2001 had been consistent with cyclical developments.** Taylor rule yardsticks for evaluating the setting of rates suggested that policy reacted aptly to the area's economic slowdown. While policy easing had been less pronounced than in the U.S., the slowing in activity, particularly relative to potential growth, was also more modest in the euro area (chart).

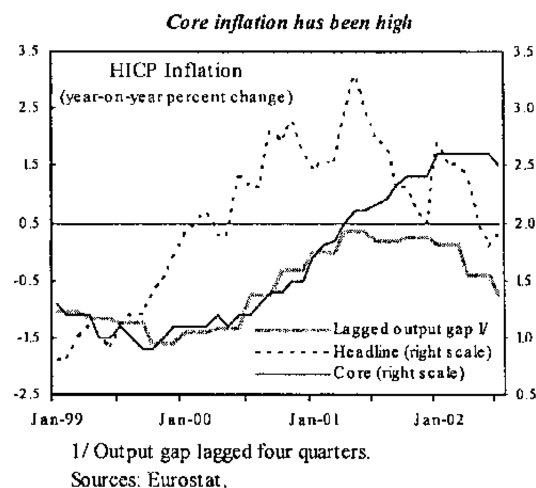
- **Policy had appropriately allowed inflation to rise above the medium term objective in response to transitory shocks.** The ECB had successfully "seen through" the transitory impact of cost-push shocks.

- **Longer-term expectations remained in line with the ECB's definition of price stability.** After moving briefly above 2 percent earlier this year, measures of expected inflation derived from inflation-indexed bonds have fallen back to 1.8-1.9 percent. The temporary upward movement, which occurred also in

other countries, likely reflected short-term financial premia unrelated to long-term inflation expectations. Consensus forecasts of inflation in 2003 also remain below 2 percent.

11. **Nonetheless, developments in the main price indices have been problematic.** After receding strongly to 2 percent in the second half of last year, headline inflation increased to 2.7 percent in January, in part because of shocks to fresh food prices and price increases associated with the euro changeover. It eased back slowly to below 2 percent in the summer months, aided by lower energy and food prices.[4] Core inflation (excluding unprocessed food and energy) rose continuously through 2000-01 and remained stuck at 2.6 percent in the first half of this year with the first tentative signs of a deceleration (to 2.5 percent) appearing only in July (chart). While goods price inflation peaked in February this year and has declined steadily since, service price inflation has been more stubborn.

Core inflation has been high



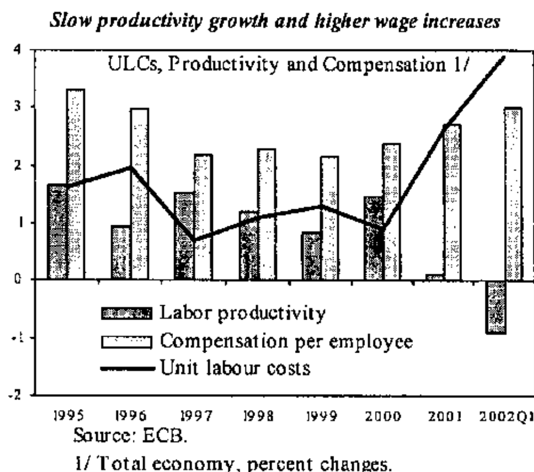
1/ Output gap lagged four quarters.
Sources: Eurostat.

12. **There are two competing explanations for the rise in core inflation:**

- **Series of one-off shocks.** Staff analysis indicates that a traditional model of the inflationary process—relating price increases to inflation expectations and the output gap—explains the behavior of euro-area inflation well (Box 2). It points, however, to substantial lags in the impact of the output gap on, and pass-through of shocks to, core inflation. The estimates suggest that shocks—of which there have been unfortunately many over the last two years, including to food, energy, the exchange rate, and from the euro changeover—played an important role in explaining the acceleration and persistence of core inflation.

- **Underlying wage pressures and slower productivity growth.** Following several years of notable restraint, the rate of wage growth gradually rose. Although earnings growth eased during 2001 in the manufacturing

Slow productivity growth and higher wage increases



Source: ECB.
1/ Total economy, percent changes.

[4] Eurostat estimates changeover effects added up to 0.2 percentage points to core inflation, most of it in services.

sector, it continued to rise in other sectors. Higher rates of wage increases combined with a cyclical drop off in labor productivity growth caused a sharp acceleration in the area's unit labor costs.

13. **The euro's appreciation and slower growth prospects have improved the outlook for inflation but views differ on the balance of risks to price stability.** At the time of the mission, the ECB saw stubbornly high core inflation, in particular the behavior of services prices, nominal wage developments, and the behavior of money and credit aggregates as keeping the balance of risks to price stability "tilted to the upside." The staff's analysis, emphasizing the role of one-off factors, saw the risks as closer to being balanced. With unemployment widely estimated to be near but still somewhat above the NAIRU, the staff argued it was difficult to attribute the acceleration in wage increases to general tightness in labor markets, though this could be the case in particular sectors such as services. The generalized acceleration was consistent with labor seeking compensation for past inflation surprises. More recently, in view of subdued demand developments and the stronger euro the ECB has argued that the risks to price stability have become "rather" balanced. The staff now sees the risks as being on the downside. The staff's latest projections see monthly (year-on-year) inflation rates as hovering around 2 percent in the remainder of 2002, reflecting in part base effects, then falling to about 1½ percent by late 2003. Though there are upside risks from wage earners seeking compensation from yet another round of price surprises, oil prices rising further, or the euro's rally fizzling, the staff sees the downside risks from the impact of slower growth, a premature disruption of the recovery, and a faster waning of one-off shocks as predominating.

14. **Accordingly, while there was agreement monetary policy should remain in a wait-and-see mode, views continue to differ on the bias.** With a baseline prospect of slower growth, the required shift in the composition of aggregate demand, and increased downside risks to recovery, the staff argued that monetary policy needed to continue to remain accommodative. The ECB, after signaling a tightening bias in May, then gradually seeing the risks to price stability as having become more balanced, has recently stated it sees current rates as "appropriate"—a neutral bias. In the staff's view, with the risks to price stability now residing primarily on the downside, an easing bias is called for.

Evolution of the monetary framework

15. **After some 3½ years of policy operations, aspects of the ECB's monetary framework have remained under question.**[5] Criticisms of the framework have focused on two elements: the definition of price stability (inflation of less than 2 percent over the medium term); and the role of the (first) money pillar in guiding policy decisions. In its first

[5]See, for example, the submission to the European Parliament's Committee on Economic and Monetary Affairs by Svensson (2002), *A Reform of the Eurosystem's Monetary Policy Strategy is Increasingly Urgent.*

comprehensive assessment of the framework at the beginning of 1999,[6] staff agreed that it was sensible and pragmatic to avoid overly-formalized approaches in view of the high level of uncertainty following the EMU regime change, but argued that the lower bound in the definition of price stability should be more clearly specified, and that the ECB would need to undertake special efforts to communicate how its hybrid monetary strategy—which combines the monetary and inflation targeting traditions—leads to policy decisions. This year's discussions revisited the key elements of the framework.[7]

16. **On the definition of price stability, staff welcomed recent statements by ECB officials indicating a preference for inflation in the upper half of the price stability range.** The statements[8] recognize that a small positive rate of inflation, "say between 1 and 2 percent", would significantly reduce the risks of getting trapped in a deflationary spiral, and stress the need for vigilance were inflation to fall toward an excessively low level. The ECB's policy reactions since the inception of EMU appear consistent with these perspectives. Staff's reading of the empirical evidence is that the risks of monetary policy being constrained by the zero-interest rate floor are minor for inflation targets down to 1½-2 percent, whereas they increase progressively for targets of 1 percent or less.

17. **ECB officials were unpersuaded that trend inflation towards the upper end of the 1-2 percent range could have a positive role in facilitating adjustment across the union.** Staff argued that, because of downward rigidity in nominal wages, a target at the upper end of the price stability range (2 percent) would facilitate inter-country relative wage adjustment in response to shocks. Staff argued that the inflation target should also allow for varying trend inflation rates across EMU members reflecting productivity differentials, and prospective price convergence—in particular if EMU were enlarged to incorporate countries with quite different per capita GDP levels. ECB officials believed that downward nominal wage, but especially price rigidities were not as prevalent as commonly assumed and likely to disappear as agents adapted to the price stability regime. They did not feel it was time yet to consider the consequences of future enlargement on the monetary strategy.

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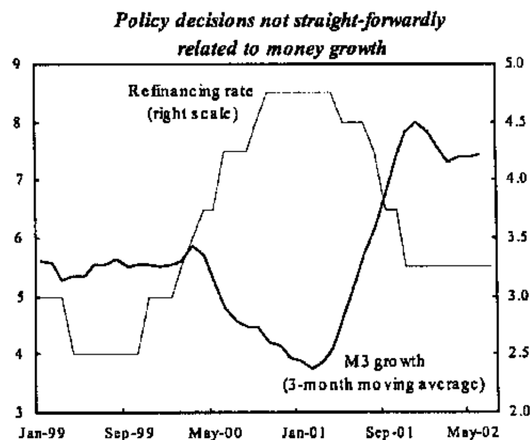
[6] SM/99/61.

[7] See the three *Selected Issues* papers: *The Eurosystem's Definition of Price Stability*; *The ECB's Policy Strategy: An Assessment of the Role of the Money Pillar*; and *Central Bank Decisions and Financial Markets*.

[8] See *"Monetary Policy and the Role of the Price Stability Definition,"* speech by Otmar Issing at the 2002 ECB Watcher's Conference.

18. **The communication of the role of the first (money) pillar in guiding analysis and policy decisions has been subject to mixed perceptions.** Staff suggested that the ECB's earliest communications had tended to portray the first pillar as a dominant input into policy analysis based on a relatively mechanical analysis of M3 growth developments relative to its reference value. Communications since then have emphasized that M3 growth may temporarily over- or undershoot the reference value without necessarily being a cause of concern. The ECB representatives emphasized, however, that, in their view, communication of the first pillar's role had been consistent over time and that judgments on the information content of monetary data were always based on a comprehensive analysis linking M3 developments to the information contained in banks' aggregated balance sheets and, more recently, to the newly available flow-of-funds data. Staff noted that public perceptions of the two-pillar structure appeared to remain mixed. Recent improvements in communication may in fact reflect market perceptions of a de-emphasis of first-pillar developments for medium-term inflation pressures by the ECB.

Policy decisions not straight-forwardly related to money growth



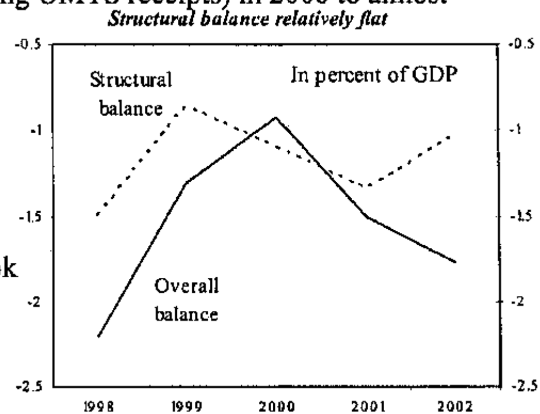
Sources: ECB and Eurostat.

19. **The ECB saw prominent roles for money both as a long-run nominal anchor and as a medium-term gauge of inflationary pressures.** Staff noted that the collective monetary history of the euro area and other cross-country evidence strongly supported a long-run nominal anchor role for money; moreover, cross-country evidence on asset price bubbles also pointed to a useful role for the first pillar in detecting early warning signals that the underlying monetary stance could be pitched at an inappropriate level. However, the empirical basis for using nominal money growth as a key information variable to gauge inflation pressures 1 to 3 years ahead seemed to be much weaker. Accordingly, staff noted that communication would benefit if analysis and policy decisions were more clearly tied to the different time horizons of the two pillars, with the second pillar (the broad-based assessment of inflation based on all indicators apart from money) assigned priority for gauging medium-term inflation pressures. ECB officials argued, however, that recent expansions of first-pillar analyses, including the construction of "money gaps" and the use of newly available flow-of-funds data have increased the usefulness of the first pillar for diagnosing medium-term inflation pressures.

C. Fiscal Policy: Balancing Long- and Short-Run Requirements

20. **The overall fiscal stance in the euro area has been broadly neutral.** The area-wide deficit rose from about 1 percent of GDP (excluding UMTS receipts) in 2000 to almost 2 percent of GDP in 2002. This deterioration reflected the effects of the cycle: the area's structural deficit was broadly unchanged over the period at 1 percent of GDP.

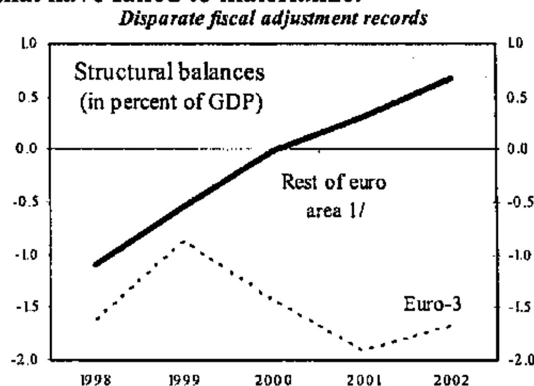
Structural balance relatively flat



Source: IMF; and staff estimates.

21. **This development masks contrasting fiscal performances across members of the area.** In particular, while eight countries undertook significant cumulative fiscal adjustment over the past five years, the structural deficit (free of large one-off non-financial asset operations) of the three largest countries (France, Germany, Italy) increased over the period.[9] In Portugal, the deterioration was pronounced, with both the actual and structural deficit reaching 4 percent of GDP in 2001. Leaving aside that rather special case, the root of the difference in performance is the decision of the larger countries at the peak of the boom in late 1999-early 2000 to undertake tax cuts that were premised on unduly buoyant growth assumptions, cyclical windfalls in revenue, or expenditure cuts that have failed to materialize.[10]

Disparate fiscal adjustment records



Source: IMF; and staff estimates.
1/ Excluding Portugal.

22. **These disparate developments are at odds with the requirements of the SGP.** The framework requires fiscal balances be kept below the 3 percent deficit mark in all but exceptional circumstances and to be adjusted so as to ensure a close to balance or surplus fiscal position over the medium term. In addition, gross debt is to be brought down to and kept below 60 percent of GDP. These rules are backed by detailed procedures and the submission of annual Stability Plans laying out governments' fiscal plans. If observed, these rules

[9] The improvement in small country structural balances in 1998-2002—some 1½ percentage points of GDP—stemmed from reductions in structural expenditures. In the larger countries, smaller reductions in underlying expenditures were offset by tax cuts.

[10] The long-standing procyclical bias in these countries' policy stance during cyclical expansions is documented in Chapter VI of the *2001 Selected Issues Papers* for the euro area (SM/01/297).

would ensure fiscal sustainability and provide room to give full play to the automatic stabilizers. In this perspective, the smaller countries clearly moved into compliance with the SGP over the past five years whilst the three largest countries and Portugal have not.

23. **The unimproved underlying fiscal positions of the three largest countries together with the weakness of activity has led to controversy both within and outside official circles.** Actual fiscal balances have deteriorated sharply, and have been at increasing risk of breaching the 3 percent limit—a risk that materialized in the case of Portugal in 2001. These developments, together with the lack of underlying adjustment, led to an increasing insistence—amidst considerable public controversy because of the transparency of SGP procedures—that countries commit and follow through on their commitments to achieve close to balance or surplus positions by 2004, as these countries stated in their latest 2001 Stability Plans. Looking forward, renewed controversies are likely either because of countries being at risk of breaching the 3 percent limit or because they find achievement of their nominal deficit targets too arduous. Adding substance to these controversies is the possibility that countries might need to undertake significant procyclical fiscal adjustments in the midst of a sluggish upturn.

24. **These developments have led to repeated calls from official circles to abide by the SGP.** The Commission, the institution charged with the implementation of the Pact, argued at the time of the mission that the three largest countries (and Portugal) needed to be held to their commitments of reaching near balance positions by 2004. These countries' lack of adjustment—with structural balances actually deteriorating at the peak of the last cycle—had raised basic credibility issues about their willingness or ability to adjust and their commitments to fiscal discipline under the SGP. These countries, therefore, needed to be held accountable for meeting their commitments. The ECB's views were similarly anchored in the conviction that fiscal policies in line with the requirements of the Pact are essential to the credibility of the Pact and the good functioning of the monetary union. In the same vein, ECOFIN, in its endorsement of the Broad Economic Policy Guidelines has emphasized the importance of confidence effects from a credible budgetary framework for EMU.[11] The Commission was also of the view that, controversies notwithstanding, the Pact remained intact, and indeed had in some respects emerged strengthened from the tests.

25. **Despite these official views, however, there have been repeated calls from other fora for a more flexible SGP, which is viewed as too restrictive in both the long and short run.** In the long run because the constraints on fiscal balances imply that gross debt falls to zero, and this without regard to public investment levels. And in the short run because the SGP is viewed as paying insufficient attention to cyclical considerations. These issues are discussed in turn.

[11] See 2002 Broad Economic Policy Guidelines.

26. **Is the SGP too restrictive in a long term perspective? The short answer is no because most members face steep increases in indebtedness because of aging.** Public spending is set to rise substantially in all euro-area members—including the three largest countries—to meet rising pension and health care costs in the coming four decades (see table). For these relatively indebted countries, the SGP norms are but a down payment on the adjustment that will be needed to preserve debt sustainability. While this adjustment would be better effected through pension and health-care reforms, countries have so far found it difficult to make notable headway. It is thus only prudent to presume that some—if not a substantial proportion—of these costs will eventually have to be borne by government budgets. By the same token, some countries' underlying positions are more sustainable, and the SGP could be viewed as unduly constraining for these countries. The Commission has acknowledged the need to incorporate the sustainability of public finances more systematically into the assessments of countries' budget positions.

Cost of Demographic Shock
(in percent of GDP)

	Flow Cost[1]	Present Value	Debt-Stock (end-2001)
Germany[2]	4.3	85.5	59.8
France	5.6	111.5	56.9
Italy	3.3	65.6	109.8

Source: Staff estimates.
[1] Estimate of savings needed per year to cover growth in future liabilities.
[2] Excludes long-term care health costs.

27. **Is the SGP too restrictive in the short run? No for countries that meet the SGP norms, more arguably so for others.** The confusion on this score is rooted in the fact that, although now generally understood to be contingent on cyclical developments, the policy commitments that flow from the SGP are specified in nominal terms. This is not a problem for countries that have met the norm of "close to balance or surplus in the medium term", because their budget targets are clearly understood to be contingent on growth, and their past adjustment efforts give them, by construction, the room to let the automatic stabilizers play fully. The situation is more complicated for countries that have not met the norm, however, because there is more ambiguity about the contingent nature of the commitments in their case.[12] In this vein, at the time of the mission, with the recovery still seen as broadly on track, the Commission viewed the commitments to achieve balanced or close to balanced positions by 2004 as binding, at least in an ex ante sense. While officials firmly believed in letting the stabilizers play, particularly as regards ex post assessments of policies, this applied fully only to countries that had met the close to balance test and were well shy of the 3 percent limit. The accompanying emphasis on nominal targets, especially in public discourse, among both area-wide and national officials has been widespread and fed perceptions of the SGP as cyclically insensitive when growth prospects changed rapidly. In fact, however, in such circumstances, and absent risks to the 3 percent limit, the contingent nature of the commitments has in time consistently come to the fore in Commission analyses and

[12] This ambiguity persists despite the German and French authorities' explicit provisos that their commitments were growth contingent.

statements. In the end, therefore, countries have been held accountable only for the underlying adjustment implicit in their nominal commitments. This is appropriate, and not cyclically insensitive except insofar as the pace of underlying adjustment countries committed to at the outset is deemed to be so. The confusion generated along the way has, however, had its cost in terms of the credibility of the SGP.

28. **Adjustment by the three largest countries would have measurable, but most likely smaller than feared effects on activity.** The Commission and the ECB believed that the credibility effects of putting the SGP on a firm footing would soon outweigh any adverse negative effects on demand. While the staff subscribes to the importance of credibility in impacting outcomes, this concept is difficult to quantify. As regards the pure demand effects, these are also uncertain but likely less than implied by the "multiplier of 1" perspective. The effects are reduced further still insofar as the three countries were to adjust simultaneously, essentially because the adjustment in interest rates would be larger and apply to each of them. On that basis, the adverse effects of adjustment could be small (see Box 3). Finally, it needs to be borne in mind that the automatic stabilizers are relatively powerful in Europe—about twice as large as in the US. The need for and wisdom of fiscal fine tuning is correspondingly less.

29. **The staff argued for balancing cyclical and longer-run considerations by allowing automatic stabilizers free play around adjustment paths of ½ to ¾ percent of GDP a year—roughly the pace of adjustment postulated by the three large countries' Stability Plans as submitted.**[13] The basic idea is that the three large countries should proceed with the underlying adjustment warranted by both national requirements and their Stability Plans,[14] but the pace of this adjustment should not be hostage to the vagaries of the cycle via cyclically-sensitive nominal deficit targets. In the staff's view, the focus on nominal deficit targets was excessive and accounted for much of the negative perceptions of the SGP. The test should rather be measurable progress toward structural balance. The exception would be breaches of the 3 percent deficit limit, in which case sustaining the credibility of

[13] For the euro area as a whole, staff estimates suggest that about 85 percent of the automatic stabilizer response occurs on the revenue side.

[14] The perspectives and policies of the three national authorities, which vary significantly, are described in the corresponding national Article IV staff reports, also to be discussed by the Executive Board in the second half of October. On present policies, the combined structural balance of the three countries is projected to improve by about ½ percent of GDP in both 2003 and 2004.

the framework required that countries pursue policies to bring the deficit back into compliance.[15]

30. **To ensure credibility, however, adjustment would have to steer clear of creative accounting maneuvers.** On the question of how to deal with countries' incentives to structure their fiscal operations so as to meet the statistical requirements of the SGP, both the Commission and the ECB felt that such activities were inherent to any rule based system, and that not much could be done about it except speeding up reporting and the process of resolving whether new operations were statistically legitimate. The staff agreed that this was the only realistic option, but argued that for purposes of economic analysis, one needed to focus on underlying fiscal positions exclusive of one-off operations.

D. Structural Reform: Raising the Area's Potential

31. **The area's underlying output performance is both stronger and weaker than often perceived.** Stronger because the oft-noted differences with the US in GDP *growth* largely disappear when viewed in per capita terms. But also weaker because the *level* of per capita income in the euro area is close to a third lower (table). While part of the gap in per capita GDP is due to differences in productivity, the bulk is due to much lower rates of utilization of human resources, be it in terms of hours worked or the employment rate. The authorities view lower hours worked and labor force participation rates as partly reflecting lifestyle choices, but the staff emphasized that these choices are also heavily conditioned by economic incentives.

Euro Area and U.S. GDP Compared

	Growth, 1997-2001		Level, 2001
	Euro area	US	Euro area 1/
GDP	2.6	3.4	74.4
GDP per capita	2.2	2.4	68.1
Productivity (per man hour)	1.3	2.2	88.8
Average hours (per worker)	-0.3	-0.1	86.7
Employment rate 2/	1.2	0.3	88.4

Sources: European Commission; OECD; IMF; and staff calculations.
1/ Index, US=100.
2/ In percent of total population.

32. **There was broad agreement that while performance had begun to improve, much remained to be done.** On the improvement side, the main point was the reabsorption of labor observed since 1997 after many years of decline. This improvement, rooted in past wage moderation and labor market reforms, which drew in especially lower-skilled and part time workers, has led to a transitory slowing of productivity growth. That said, employment and productivity levels remained well below what could be achieved, and there was an urgent need to reinvigorate the Lisbon agenda and the pace of labor market reform in particular.

[15] The Pact requires that a country bring its deficit back into compliance the year after a breach is reported. On this basis, the staff's policy advice would be sufficient to address breaches of the 3 percent limit in all but exceptional circumstances.

33. **The staff welcomed the increased priority being given to structural reform issues, but noted that the gap between words and deeds remained substantial.** At the national level, announced steps towards freeing up and rationalizing labor markets in France, Germany, Italy and Spain were heartening. However, the changes remained to be realized and fell well short of what was needed to address the core of Europe's labor market problems—cumbersome employment regulations and generous out-of-work benefits. At the EU level, in product markets, recent evidence suggested advances in integrating goods markets had been slowed by obstacles to liberalizing the internal market for services, linked mainly to differences in standards and regulations that continued to limit cross-border retailing and sales.

34. **In financial markets, the staff welcomed the agreement on the Lamfalussy process for speeding up the implementation of the Financial Services Action Plan (FSAP) in securities markets as a major procedural success.** There appeared to be a growing awareness of the importance of an integrated financial market for growth[16], as well as a sense of urgency in bolstering the area's overall financial resiliency, particularly in light of the increasing international concern over corporate governance and accounting standards, many of which would be addressed by the FSAP. Staff noted that the backlog of FSAP directives awaiting adoption by the Council and the EU Parliament remained sizable, however, and swift action was required if the 2005 deadline for the FSAP (2003 for securities markets and risk capital) was to be met. The authorities indicated that though headway had been made in integrating wholesale financial markets—particularly in the money and government bond markets—the degree of integration in the retail and banking sector continued to be blocked by various tax and legal obstacles.

35. **Banking sector reform and supervision issues are also being addressed.** The basic plan is to extend the Lamfalussy process to fast-track the pace of banking and insurance legislation. This has, however, raised concerns the timetable may be too tight, not allowing for a thorough and informed consideration of the issues surrounding banking regulation and supervision.

E. Trade Policy

36. **Staff expressed concerns about whether transatlantic trade tensions might undermine moving the multilateral trade liberalization process forward.** While the EU and the United States have played important roles in launching a new round of multilateral trade liberalization at Doha, their own trade relations have deteriorated since the beginning of the year. In response to U.S. safeguards on steel, the EU invoked its own safeguards to counter a possible surge of steel imports diverted from the U.S. market. Retaliatory action has—to date—been put on hold, as has the imposition of record trade sanctions to which the EU is entitled following a WTO judgment on the tax regime for U.S. Foreign Sales

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[16] See the *European Financial Roundtable.*

Corporations. The Commission was also monitoring implementation of the new U.S. farm bill for possible breaches of WTO commitments, but did not anticipate any formal WTO action at this stage.

37. **The Commission stressed that the successful conclusion of an ambitious round of multilateral negotiations remained its key objective.** The EU favored a comprehensive negotiation agenda, including an extension of multilateral disciplines and rule-making to issues such as government procurement, trade facilitation, competition and investment as defined by the 1996 Singapore WTO Minesterial. Staff noted that progress under the Doha round will likely require that the EU adopt a flexible approach on covering "behind-border" areas.

38. **The authorities underlined their commitment to preferential market access for developing countries.** The Commission had obtained a mandate for negotiating Economic Partnership Agreements (EPA) with the 77 ACP countries, which would be based on WTO compatible reciprocal free trade, with sub-regions, aimed at deepening regional integration among beneficiaries. The EPAs might ultimately offer market access privileges to the EU comparable to the Everything-but-Arms initiative, which showed early signs of success in promoting LDC exports. The staff noted that preferences and proliferating regional and bilateral agreements must not turn into an obstacle to broader liberalization. The Commission underlined that the multilateral approach remained its overarching priority.

39. **Agriculture and textiles remain protectionist pockets in the EU's otherwise largely open trading system.** The staff welcomed proposed plans for a reform of the Common Agricultural Policy (CAP). The core of the proposals is to achieve a further decoupling of subsidies from production.[17] Adoption—which is uncertain in view of strong opposition from a number of member states—would likely reduce downward pressures on world commodity prices stemming from over-production, simplify the mechanisms of the CAP, and the transparency and execution of the budget. The staff noted that EU export subsidies and import tariffs remain among the highest in the world and create a large burden for developing country producers. The Commission saw no scope for accelerating quota removal under the WTO agreement on textiles and clothing, under which it had back-loaded liberalization of 80 percent of restrictive quotas to the end of the implementation period in early 2005. The staff expressed concerns EU consumers and competitive suppliers were paying a high price for the remaining protection and there was risk of an "adjustment shock" in 2005.

[17] See *Market Access for Developing Country Exports—Selected Issues* (SM/02/280).

III. Staff Appraisal

40. **Although marked by notable achievements, the past year has been a more difficult one for the euro area than anticipated.** The foremost achievement was the smooth change-over to euro notes and coins, a spectacularly successful finale to the establishment of the Economic and Monetary Union. But macro policies also were broadly on the mark, adjusting appropriately to the changing circumstances. Further, significant progress was made in some aspects of structural reforms, notably of financial markets, and labor markets performed better than expected on the heels of earlier steps toward wage moderation and greater flexibility.

41. **These achievements notwithstanding, the overall economic performance has been disappointing: growth has been weaker and inflation higher than generally expected.** To a large extent, this is the result of a series of unanticipated shocks—oil prices and animal diseases earlier, the global slowdown and the associated financial market turmoil more recently. However, the performance also appears to reflect a greater than anticipated vulnerability to shocks. Inflationary pressures despite weak demand, the absence of shock-absorbing behavior in personal savings rates, and the continuing dependence of activity on foreign demand point to rigidities that undermine performance.

42. **Looking forward, there is a need to gear policies toward achieving a more robust and sustained performance, one more in keeping with the euro area's potential.** In the near term, a moderate recovery should unfold, in step with global developments. This is the right setting to impart a more decisive and longer-term direction to the fiscal and structural policies of the members of the euro area without which the performance of the area as a whole would remain disappointing.

43. **By the same token, past vulnerabilities accentuate the presence of downside risks, and monetary policy will need to remain alert to their implications for activity and prices.** Monetary policy has continued to strike the right balance between the risks stemming from shock-driven cost push forces and from the on-going weakness of activity. Alleviating those tensions is ultimately a matter of structural reform—greater labor market flexibility and service sector competition. In the meantime, with the recovery expected to be subdued and inflation to gradually move back within the target range, monetary policy should remain accommodative until domestic demand follows through. However, with the downside risks to the recovery continuing to predominate, a bias toward interest rate cuts is needed. Monetary policy will need to be particularly alert as to the near-term impact of fiscal policies pursuing medium-term consolidation objectives.

44. **The ECB has taken several steps to lessen the tension perceived by market participants between the monetary framework and the otherwise generally-deemed-to-be-sound policies that issue from that framework.** One such step is the de facto narrowing of the range of desired inflation outcomes to the upper half of the 0-2 percent official definition of price stability. This is a useful step toward balancing the benefits of an ambitious inflation objective and those from speedier adjustment to shocks in the presence of

downward rigidities in nominal wages and from the insurance moderate inflation provides against the risks of deflation. Nevertheless, with labor markets still both rigid and segmented along national lines, outcomes closer to the upper end of the range would seem desirable. The ECB has moved toward integrating broader financial market and real developments into its analysis of first (or money) pillar developments for inflation. However, the first pillar remains in public perceptions quintessentially a matter of comparing M3 developments with the representative rate—a comparison that comes into its own only in the longer term. Therefore, the two pillars of the monetary policy framework provide indications of inflation at different time horizons—a feature that will remain a key challenge for the ECB's communication strategy.

45. **Fiscal policies need to strike an ambitious balance between short and longer run considerations.** Longer run considerations clearly point to the case for ambition on the part of the larger countries. Aging considerations alone point to the need for adjustments considerably larger than those implied by the SGP. Pending the implementation of pension and health care reforms, which have so far proven difficult and partial, the SGP norms can only be considered prudent. Ambition is also warranted by the adverse effects current controversies are having on the credibility of the fiscal framework of the monetary union. Absent credible adjustment by the larger countries, it is to be feared that the adjustments undertaken by the smaller countries might slip. It is also likely that the future would see a repeat of past procyclical fiscal behavior during the upswing, exacerbating the cycle, prompting greater than otherwise monetary reactions, and feeding perceptions of a rather shock-prone monetary union. By the same token, the cyclical outlook is not entirely robust and the demand implications of adjustment, while not as large as sometimes feared, cannot be disregarded. It is important, therefore, not to let the pace of adjustment be determined by cyclical influences on the budget, as would be implied by literal applications of the SGP.

46. **The way forward is twofold:**

- **A concerted and credible commitment by the three largest countries to adjust their underlying fiscal positions by at least ½ percent of GDP per year over the next several years.** This would impart badly needed fiscal credibility at both the national and area-wide level, all the more so if fiscal consolidation was anchored in needed expenditure reforms. Via endogenous declines in interest rates and credibility effects, this would significantly reduce and shorten adverse short-run demand effects.

- **A comprehensive understanding especially in public discourse that—absent breaches of the 3 percent limit—the stabilizers should be allowed to play fully about those adjustment paths.** This would impart a clarity to policies that is lacking and will become the more necessary as governments come under pressure to spend cyclical windfalls during the forthcoming upswing.

While such policies would not meet the nominal "close to balance" targets set for 2004, they would initiate needed domestic adjustments and impart a clarity to the union's fiscal

framework, thus beginning to resolve the core of the fiscal problem confronting the euro zone.

47. **In sum, while the SGP is not beyond improvement, its thrust is basically in line with the requirements of both the union and its members.** It provides a sensible, forward-looking framework, reasonably well-tuned to the long-term requirements and the past policy failings—notably as regards a procyclical bias in upswings—of the members of the euro area and, thereby, to the requirements of a fiscally decentralized monetary union such as EMU. The core of the recent difficulties is not the SGP, but the difficulties the three largest countries are having in implementing fiscal consolidation. By the same token, perceptions that the SGP holds these countries accountable for particular nominal targets—independent of the cycle—results in procyclical responses and has hurt public perceptions of the framework. Recent announcements emphasizing the focus on structural balances are welcome. Over the longer term, further changes should be considered, e.g. to focus more directly on debt sustainability within a context that takes account of contingent liabilities or to anchor tax reforms in contemporaneous expenditure commitments. At this juncture, however, any changes of this sort would be deleterious to credibility and to policies, both at the euro and the national level.

48. **The scope for raising the area's potential through structural reforms remains large.** Following eight quarters of sub-potential growth the agenda has become increasingly urgent to implement. The reabsorption of labor remains key to improving long-term performance, and the "new European paradigm" of employment-intensive growth, though it has meant slower productivity growth, has been a welcome development. As the employment generating effects of past reforms wear off, however, maintenance of the paradigm and bringing badly needed flexibility that is necessary for bolstering the area's resilience requires that further reforms to the labor market—and wage restraint—be a priority. The increased integration of product markets, a long-standing rationale for the EU's very existence, is being hindered by the slow progress in liberalizing trade in services, and should be another priority. The new impetus and awareness of gains from financial sector integration are welcome but need to be harnessed to pass the backlog of directives and keep the process on track.

49. **With its prominent role in world trade, the EU has particular responsibilities to advance the agenda of multilateral trade liberalization and improve access for developing country exports.** It is encouraging that further escalation over transatlantic trade disputes, which could have impacted progress under the Doha round, has so far been avoided. The EU's commitment to increasing developing country access is welcome, and the CAP reform proposals are an important step forward. But the EU should indicate clearly that it intends to tackle tariff peaks on sensitive products—often exactly those in which developing countries have an interest—and to eliminate agricultural export subsidies. In textiles and clothing trade, quota removals should be accelerated in order to help smooth the adjustment in both EU industries and in those developing country suppliers currently protected by the quota system.

50. **Area-wide statistics are adequate for surveillance purposes but there is considerable room for further improvements.** In particular, there is scope for improving the timeliness of quarterly national accounts data and the quality of labor market and short-term business cycle statistics. The recent publication of more comprehensive flow of funds data is welcome.

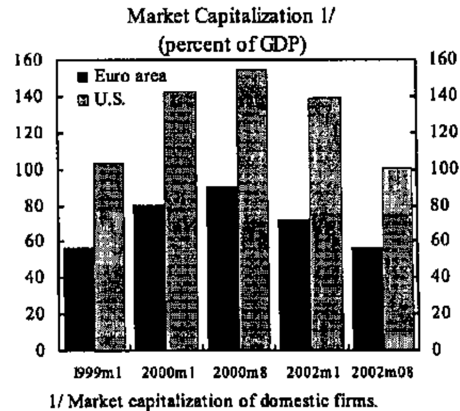
51. It is proposed that the **next consultation on the monetary and exchange rate policies of the euro-area countries** in the context of their Article IV obligations follow the standard 12-month cycle.

Box 1. How Exposed is the Euro Area to the Global Equity Market Slump?

Although share prices in the euro area have plummeted more than in the United States, direct wealth effects on **consumption** are likely to be moderate (see October 2002 *World Economic Outlook*):

- Reflecting the **smaller size of the equity market**, the erosion of wealth in the euro area has been less than in the U.S. (see figure). (Losses on cross-border holdings are unlikely to substantially affect this conclusion.)

- Euro-area households appear to have a **smaller propensity to consume out of stock market wealth.** Staff estimates the marginal propensities to consume out of wealth after two years to be 4¼ cents on the dollar in the U.S. and 1 cent in the euro area. The fall in equity prices this year could reduce private consumption by about ¼ percentage point.



1/ Market capitalization of domestic firms.

However, the impact on **investment** and **exports** may be more substantial:

- Euro area **firms rely less on equity financing** and more on bank loans than U.S. corporates (see table). But increasing debt-equity ratios may constrain **firms' ability to borrow**; and in countries where financial institutions have large equity holdings, the impact of lower stock prices on banks' balance sheets could impinge on their **willingness to lend.**

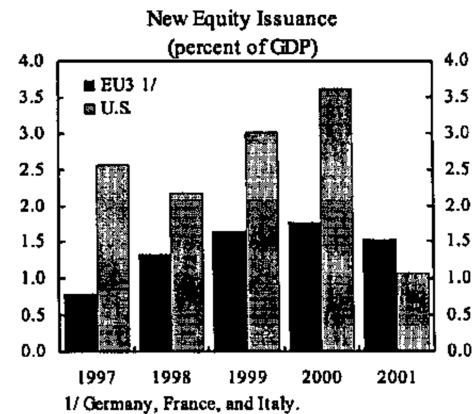
Corporate financial structure
(percent of GDP)

	Corporate credit 1/		Equities 2/
	Bank loans	Debt securities	Market capitalization
Euro area	46	6	56
Germany	40	4	46
France	37	22	71
Italy	50	6	31
U.S.	13	27	97

1/ Data for 1999.
2/ End-July 2002. Corporate and financial stock.
Source: ECB, OECD, Eurostat; staff calculations.

- **Equity issuance has grown** in recent years, and as a share of GDP exceeded that in the U.S. during 2001 (although partly driven by privatizations and financial restructuring) (see figure).

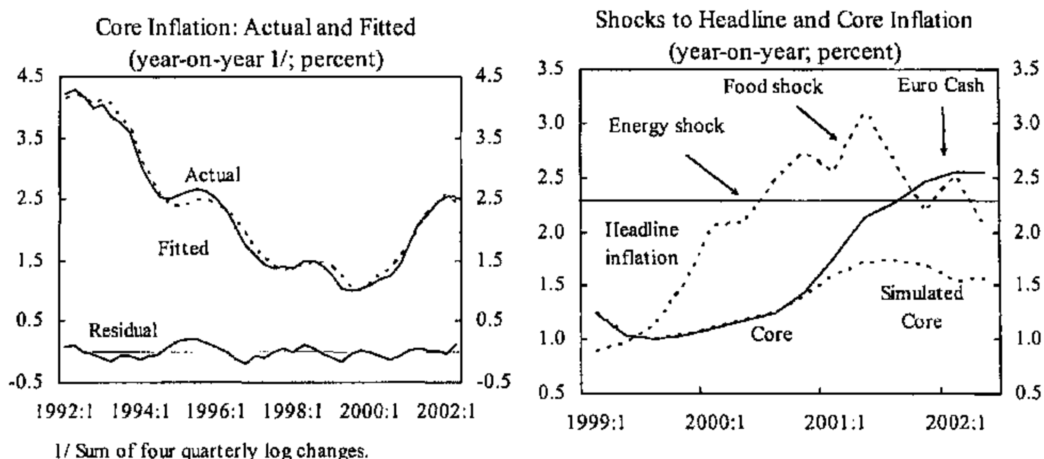
- The area's reliance on external demand to kick-start recovery in early 2002 makes it **vulnerable to a slowdown in global demand.** With corporate linkages to the U.S. having grown following the M&A boom, **business confidence** could deteriorate substantially if the equity shock has a larger-than-anticipated impact on the U.S.



1/ Germany, France, and Italy.

Box 2. Explaining the Stubbornness of Above-Target Inflation

The **inflation process in the euro area is well described by an extended Phillips-curve model** that relates quarterly core inflation to inflation expectations, the output gap, indirect pass-through of energy price shocks, and one-off shocks linked to food prices and the euro changeover. Inflation expectations are modeled as a linear combination of the monetary authorities' inflation objective and past inflation. One-off shocks may have persistent (but ultimately transitory) effects on inflation via expectations and indexation mechanisms.



1/ Sum of four quarterly log changes.

A counterfactual simulation suggests that **cost-push shocks and their pass-through explain most of the acceleration in core inflation since mid-2000**. Absent shocks to core food prices and the euro changeover, and holding energy prices and the exchange rate at their 1999 levels, core inflation would have risen from 1¼ percent to 1¾ percent in mid-2001 on account of a narrowing output gap (with inflation peaking about one year after the peak in activity). Core inflation would subsequently have eased back to 1½ percent by now.

The results imply:

- Absent renewed price shocks, the current level of resource utilization and demand pressure is consistent with **declining inflation going forward**.
- **Inflation in the euro area responds sluggishly to demand pressure** in the short run—although the output gap has a sizeable effect on inflation in the medium term.

Box 3. The Output Effects of SGP-Related Fiscal Adjustment

The three largest countries' SGP commitments imply sizable underlying fiscal adjustment over the next few years. With increased downside risks to the outlook, a key issue is the likely output costs of undertaking these adjustments:

- The **conventional wisdom**, borne out by simulations of the IMF's multi-country model (MULTIMOD), is that fiscal multipliers are close to unity, implying substantial output effects. In the model, reduced government expenditures feed directly into lower disposable incomes and growth. However, given lower inflationary pressures, the monetary authority lowers interest rates, with trade and financial channels creating spillover effects to other countries.

- The simulations indicate that a **coordinated consolidation** may lead to smaller output losses for each adjusting country as a deeper area-wide deflationary impulse allows for a more robust reduction in interest rates.

- This more favorable outcome, however, is critically dependent on a swift and marked forward-looking **reaction of monetary policy in** response to fiscal consolidation, highlighting the importance of **credibility and predictability of the consolidation efforts**. It is also dependent on a concurrent export-stimulating depreciation of the **exchange rate**, movements in which—as is well known—have been hard to explain according to any model.

Output Effects of Fiscal Policy Adjustment

	2003	2004
Adjustment by Germany alone		
Germany 1/	-0.6	-0.3
EA12 1/	-0.1	-0.1
Short-term interest rates 2/	-0.3	-0.4
All three countries adjust		
Germany 1/	-0.2	-0.1
EA12 1/	0.0	-0.1
Short-term interest rates 2/	-0.8	-1.1
Memo item:		
Baseline expenditure shock 3/	-0.5	-1.0

Source: staff estimates.
1/ Outcomes reflect differences from WEO baseline growth rates.
2/ Difference in percentage points from baseline level.
3/ In percentage points of GDP; difference from baseline level.

- In sum, the staff's view is that—as the recent empirical literature has begun to argue—the effects are likely smaller than the conventional wisdom predicts. However, because of credibility issues they are probably not as benign as the simulations indicate. The **eventual impact is a function of the implementation of policies**—how credible and predictable the fiscal consolidation efforts are; which will in turn determine how swiftly monetary policy can respond.

Table 1. Euro Area: Main Economic Indicators

(Percentage change)

	1998	1999	2000	2001 1/	2002 1/	2003 1/
Demand and Supply						
Private consumption	3.1	3.5	2.5	1.8	0.8	2.3
Public consumption	1.4	1.9	1.9	1.9	1.8	1.3
Gross fixed investment	5.2	5.9	4.8	-0.6	-1.6	2.1
Final domestic demand	3.2	3.7	2.9	1.3	0.5	2.1
Stockbuilding 2/	0.4	-0.2	0.0	-0.4	0.0	0.2
Domestic Demand	3.6	3.4	2.9	0.9	0.6	2.3
Foreign balance 2/	-0.6	-0.6	0.6	0.6	0.4	-0.1
Exports 3/	7.3	5.3	12.4	2.5	0.9	5.2
Imports 3/	10.0	7.4	11.1	1.1	-0.1	5.9
Real GDP	2.9	2.8	3.5	1.5	0.9	2.3
Resource Utilization						
Potential GDP	2.3	2.4	2.3	2.3	2.3	2.4
Output Gap 4/	-1.0	-0.6	0.5	-0.4	-1.7	-1.8
Employment	1.7	1.7	2.1	1.4	0.4	0.8
Unemployment rate 5/	10.7	9.8	8.8	8.0	8.4	8.2
Prices						
GDP deflator	1.2	1.8	1.3	2.4	2.2	1.8
Consumer prices	1.2	1.1	2.4	2.5	2.1	1.7
Public Finance 6/						
General government balance 7/	-2.3	-1.3	0.1	-1.6	-1.9	-1.6
General government structural balance	-1.5	-0.9	-1.1	-1.4	-1.1	-0.6
General government debt	73.7	72.6	70.2	69.3	69.4	68.2
Interest Rates 5/						
Short-term deposit rate	4.1	3.1	4.5	4.2	3.3	3.7
Long-term government bond yields	4.8	4.6	5.4	4.9	5.0	5.2
Exchange Rates						
U.S. dollar per euro 8/	1.12	1.07	0.92	0.90	...	...
Nominal effective rate (1990=100)	90.8	86.7	78.5	79.7	...	...
Real effective rate (1990=100) 9/	88.7	84.3	75.1	74.9	...	...
External Sector 6/ 10/						
Current account balance	0.4	-0.2	-0.7	-0.2	0.5	0.4
Trade balance	1.1	0.5	-0.2	0.7	1.2	1.1
Memorandum items:						
General government balance 11/	-2.3	-1.3	-0.9	-1.7	-2.1	-1.7
Current account balance 12/	1.1	0.5	-0.3	0.4	1.1	1.0
Trade balance 12/	2.1	1.4	0.8	1.7	2.2	2.1

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

1/ WEO, September 2002.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ In percent of GDP.
7/ Includes UMTS revenues and Italy's real estate asset sales.
8/ Synthetic euro in 1998.
9/ Based on normalized unit labor costs.
10/ Based upon ECB data which excludes intra-euro area flows.
11/ Excludes UMTS revenues and Italy's real estate asset sales.
12/ Calculated as the sum of individual countries balances.

Table 2. Euro Area: Balance of Payments.

	1997	1998	1999	2000	2001	2002Q1
		(In billions euro/ECU)				
Current account	62.1	31.9	-18.3	-59.9	-2.3	11.1
Goods	116.4	109.0	75.6	35.6	79.2	27.4
Services	3.1	-1.1	-11.9	-16.1	3.5	-4.7
Income	-15.2	-28.8	-35.7	-26.7	-36.8	-8.9
Current transfers	-42.2	-47.2	-46.3	-52.6	-48.2	-2.6
Capital account	13.0	12.4	12.9	9.7	8.5	3.1
Financial account	...	-68.4	10.9	93.4	-72.3	-28.3
Direct investment	-44.5	-81.3	-118.1	17.6	-103.3	-16.8
Portfolio investment	-24.3	-110.0	-45.7	-111.5	36.4	-54.8
Equity	...	-12.2	-63.9	-243.4	144.3	-1.1
Debt instruments	...	-97.8	18.2	131.9	-107.9	-53.7
Financial derivatives	...	-8.2	4.5	-1.7	-20.6	0.3
Other investment	...	123.0	160.1	171.5	-2.7	46.1
Reserve assets	...	8.2	10.1	17.6	17.8	-3.1
Errors and omissions	...	24.1	-5.5	-43.2	66.1	14.1
		(In percent of GDP)				
Current account	1.1	0.5	-0.3	-0.9	0.0	0.6
Goods	2.1	1.9	1.2	0.6	1.2	1.6
Services	0.1	0.0	-0.2	-0.2	0.1	-0.3
Income	-0.3	-0.5	-0.6	-0.4	-0.5	-0.5
Current transfers	-0.7	-0.8	-0.8	-0.8	-0.7	-0.1
Capital account	0.2	0.2	0.2	0.2	0.1	0.2
Financial account	...	-1.2	0.2	1.5	-1.1	-1.6
Direct investment	-0.8	-1.4	-1.9	0.3	-1.5	-1.0
Portfolio investment	-0.4	-1.9	-0.7	-1.7	0.5	-3.2
Equity	...	-0.2	-1.0	-3.8	2.1	-0.1
Debt instruments	...	-1.7	0.3	2.0	-1.6	-3.1
Financial derivatives	...	-0.1	0.1	0.0	-0.3	0.0
Other investment	...	2.1	2.6	2.7	0.0	2.7
Reserve assets	...	0.1	0.2	0.3	0.3	-0.2
Errors and omissions	...	0.4	-0.1	-0.7	1.0	0.8
Memorandum items:						
GDP (billions euro/ECU)	5,649.0	5,882.6	6,144.9	6,440.4	6,810.6	1,734.0
Reserves of the Eurosystem 1/ (billions of euro)	363.3	329.4	372.6	378.0	391.2	...

Source: August 2002, ECB Monthly Bulletin.
1/ End of period stocks. The 1998 figure is as of January 1, 1999.

Euro Area: Policy Recommendations and Implementation

While the staff and authorities have generally been in broad agreement on the appropriateness of monetary policy, staff has at times, but particularly in early 2000, argued for an easier stance than was actually implemented; subsequent developments appear to have vindicated the authorities' stance. As regards the monetary framework, staff advocated in 1999 inter alia a more precise definition of the price stability objective and the provision of more information by the ECB on the underlying reasons for policy decisions. As detailed in this report, the framework has evolved since then, moving broadly in the advocated direction.

On fiscal policy, staff has strongly supported the Stability and Growth Pact (SGP) as a viable option to combine fiscal discipline and flexibility in a monetary union with decentralized responsibilities for decision making. Staff has stressed that it is important to allow the operation of automatic fiscal stabilizers (as long as countries are not in clear danger of breaching the fiscal deficit limits), but that countries be held accountable for meeting underlying consolidation targets, the latter requiring refinements of the SGP that allow tracking consolidation efforts. While the authorities have in some of their communications emphasized that nominal deficit targets need to be met notwithstanding unexpected growth shortfalls, they also generally supported the operation of automatic stabilizers ex post, and, more recently, the Commission has undertaken considerable conceptual efforts to improve the monitoring of underlying fiscal adjustment efforts based on an agreed methodology for calculating structural balances.

The EU authorities have generally agreed with staff calls to step up and deepen structural reforms in the product, labor, and financial markets. While progress is inherently slow, there has been significant progress in selected areas, most recently on integrating financial markets. In view of the subsidiarity principle, however, responsibility for the ultimate implementation of most structural reforms lies with country authorities and, as detailed in the country Article IV reports, a delivery gap has opened between "words and deeds," particularly in the area of labor market reforms.

INTERNATIONAL MONETARY FUND

Monetary and Exchange Rate Policies of the Euro Area

Supplementary Information

Prepared by the European I Department

Approved by Michael Deppler and Martin Fetherston

October 16, 2002

1. This supplement reports on **economic and financial developments in the euro area** since the issuance of the staff report (SM/02/303). The new information does not alter the thrust of the staff appraisal.

2. Recent data on the pace of the area's **real economic activity** point to a continued tepid recovery during the second half of the year, particularly in the case of Germany. Readings of business and consumer confidence during August-September changed little, but the Reuters' Purchasing Managers Indices (PMIs) for September fell back below the 50 points threshold, conventionally viewed as signaling a preponderance of contractionary forces. At the same time, new releases of industrial production and retail sales data were consistent with real GDP growth at about the same pace as in the first half of the year. Finally, reflecting the continued resilience of the area's job market, the unemployment rate in August was unchanged at 8.3 percent, close to its trough in 2001 (8.0 percent). Overall, area GDP growth during the second half of this year is likely to fall somewhat short of the issued report's baseline projection, with average annual growth now gauged at ¾ percent (compared with 0.9 percent in the staff report). Activity during next year is still expected to expand at a quarterly pace close to potential, yielding annual growth of about 2 percent in 2003, somewhat lower than the 2¼ percent in the issued report owing to carryover effects.[1] Recent financial market turbulence (see below) has, however, added to the already considerable downside risks surrounding prospects for the recovery in 2003.

3. In line with staff's projections, the **headline HICP inflation** rate has hovered around 2 percent, with inflation rates rising slightly in August and September (2.1 percent), reflecting recent increases in energy prices. Core inflation (headline rate excluding energy and unprocessed food) in August and September was unchanged at 2.5 percent. At the same time, households' perceptions of consumer price trends over the last 12 months in September

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[1] The *Consensus Forecasts* for area-wide real GDP growth stand presently at 0.8 percent (2002) and 1.9 percent (2003), and have been revised downward significantly in recent months (the *Consensus* is mostly based on forecasts by financial institutions).

remained stuck at an unusually elevated level, markedly out of line with actual inflation trends. Nominal hourly labor costs increases eased—albeit to a still high—3¾ percent (y-o-y) in the second quarter (after 4 percent in the first quarter); a new indicator of negotiated wage increases constructed by the ECB also suggested that nominal wage increases have eased slightly.

4. In **financial markets**, in line with global trends, euro-area equities tumbled during the last few weeks before reversing part of the steep losses more recently (Figure 1). Declines were particularly hefty in Germany, where since the beginning of the year Frankfurt's DAX index has lost more than 40 percent of its value. Recent declines in shares have been especially pronounced in the financial sector, in part reflecting investor concerns about the financial situation of some banks. These developments require heightened vigilance by supervisory authorities, especially if downside risks to the recovery materialize.[2] In the bond markets, the area's long-term government yields continued to ease in recent weeks but at a markedly slower pace than in the United States. As another reflection of investor re-pricing of risk, spreads of euro-area corporate bonds over government bond yields have widened markedly, particularly for "new economy" companies. In foreign exchange markets, the U.S. dollar/euro exchange rate has remained stable and close to 0.98.

5. At its latest meeting on October 10, the **ECB's Governing Council left policy interest rates unchanged**, with the main refinancing rate now left at 3¼ percent since November 2001. The Governing Council noted that the strength of the expected recovery has become subject to increased uncertainty, not least in view of the sharp declines in equity markets and uncertainties about oil prices related to the volatile situation in the Middle East. Against this background, the Council saw the risks to price stability over the medium term as balanced and kept policy rates unchanged.[3] Forward markets are pricing in an easing in policy rates equivalent to some 25 basis points by the end of the year (Figure 1).

6. On **fiscal policy**, most member countries are in the process of finalizing their budgets for 2003 and preparing updates of their Stability Programs.[4] The Commission recently

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[2] At the ECB's press conference on October 10, President Duisenberg characterized the capital positions of financial institutions as generally robust and also noted that there appear to be no signs of a credit crunch (at least for the area as a whole) as private loans have continued to expand at a rate of above 5 percent, in line with the area's longer-term averages.

[3] At the meeting on September 12, the Governing Council had viewed risks to price stability as "rather balanced" (instead of "balanced") and had explicitly noted that the level of policy rates was "appropriate;" some ECB observers have interpreted the more recent language adjustments as signaling a slight easing bias.

[4] The *Code of Conduct* on Stability Programs specifies that program updates are to be submitted shortly after governments have presented their budgets to parliaments but no later than December 1.

(September 24, 2002) elaborated on its position regarding the definition and monitoring of countries' obligations to reach underlying fiscal positions close-to-balance or in surplus under the Stability and Growth Pact (SGP). The Commission proposed:

- Making more explicit that Stability Program commitments on the future deficit path are conditional on agreed growth paths and that progress on bringing underlying fiscal positions in line with the close-to-balance or in surplus target should be monitored using estimates of the cyclically-adjusted budget balance.
- Countries that have so far failed to meet their medium-term fiscal consolidation commitments should at a minimum undertake structural fiscal adjustments equivalent to 0.5 percent of GDP per year, with the required adjustments higher in countries with high deficits or debts. According to the Commission's estimates of underlying fiscal positions, implementation of these rules would imply that all countries would reach close-to-balance positions (in structural terms) in 2006 at the latest.
- As mandated by the Treaty, the 3 percent deficit limit remains the cornerstone of the SGP—any deficit in excess of this threshold would need to be dealt with as forcefully and swiftly as possible.

7. **The Commission's proposals met with diverse reactions among the authorities,** reflecting member countries' past fiscal adjustment efforts (see Figure 2) and already announced budget plans for 2003. The authorities of some of those countries that have already fulfilled their fiscal adjustment obligations expressed concern about the proposals' impact on the longer-run credibility of the SGP. In the Eurogroup's official response to the proposals, all member countries' re-affirmed their commitment to avoid excessive deficits and "to achieve and maintain budgetary positions close to balance or in surplus over the cycle." It was also agreed that members that had not achieved that objective should "pursue continuous adjustment of the underlying balance by at least 0.5 percent of GDP per year," with "all Ministers but one accept[ing] this to start no later than in next year's budget." In contrast with the Commission's proposals, the Eurogroup's statement set no explicit deadline for reaching budget balance (either in actual or structural terms).

8. Looking ahead, there are now indications that fiscal adjustment efforts in the three largest countries will fall short of a coordinated consolidation approach, implying diverging underlying fiscal positions among these countries that could further strain the SGP's credibility. In particular, while the area's overall structural balance in 2003 could still improve by some ½ percent of GDP, as projected in the staff report, the bulk of this adjustment among the three largest countries will be owing to Germany and to a lesser extent to Italy, although in the latter case adjustment largely reflects the authorities' announced intention to change the accounting treatment of some spending items and to cut transfers to railways and postal services. France is budgeting a basically unchanged fiscal stance for 2003. More detailed updates on recent fiscal developments and assessments of the pace and quality of fiscal adjustment in the three largest countries will be issued in the separate supplements to the respective Article IV papers.

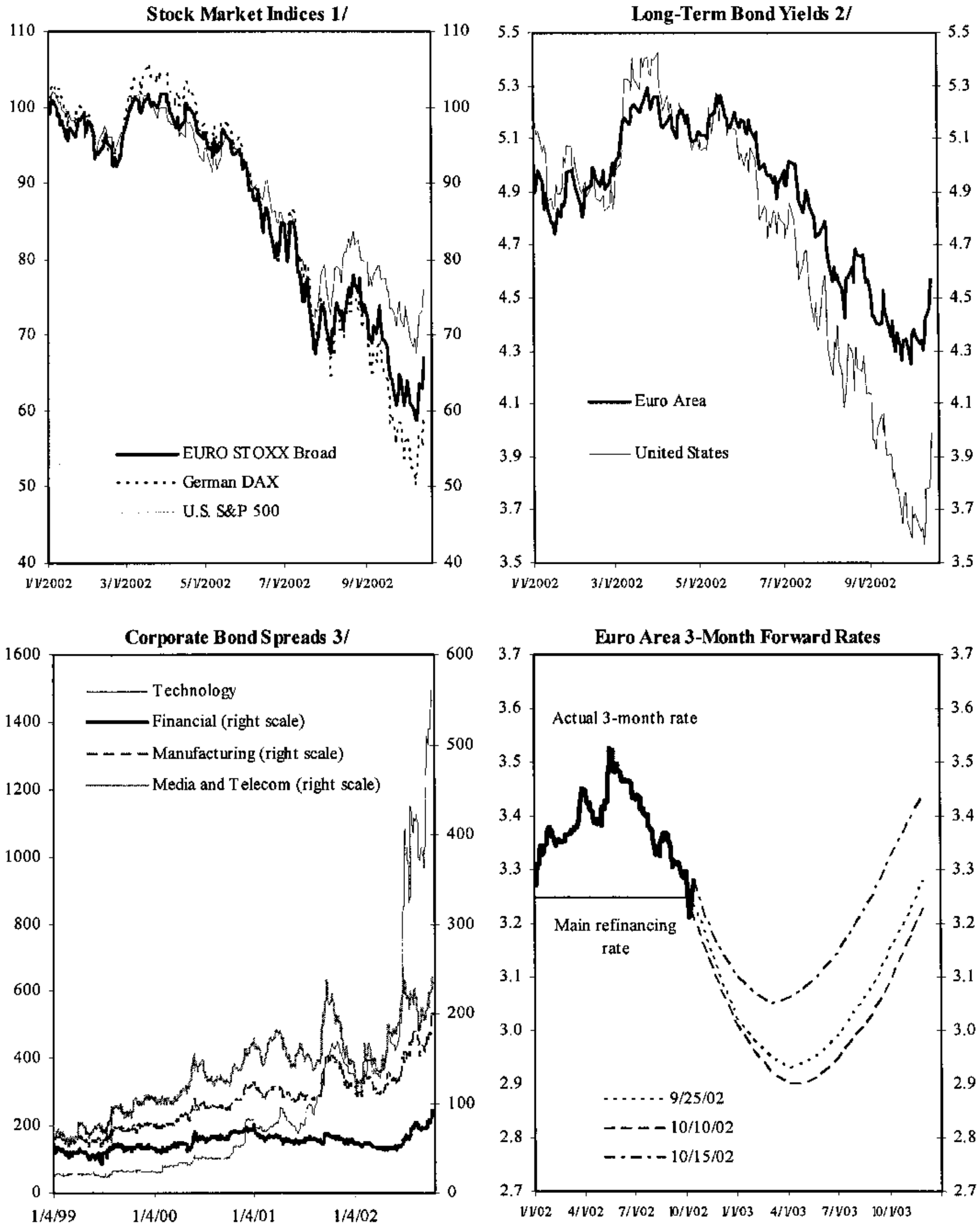
9. At their latest ECOFIN Council meeting on October 8, EU ministers of finance agreed to a plan that would extend the Lamfalussy process for securities market integration to also fast-track the pace of banking and insurance legislation.

10. In the staff's view, the still sluggish signals emanating from the cyclical indicators, the recent declines in equity markets and the associated tensions in the financial system portend somewhat slower growth during the second half of the year than projected in the staff report and have added to the downside risks for the area's growth prospects next year. Nevertheless, **the basic thrust of the staff's appraisal in the issued report with regard to monetary and fiscal policies remains unchanged.**

- Monetary policy will need to continue to strike a balance between the risk of inflation persisting for a while above the upper (2 percent) limit of the ECB's definition of price stability and the downside risks to the recovery. The increased downside risks to the recovery, however, strengthen the staff's case for a clear easing bias and increase the likelihood that monetary easing may be needed soon.

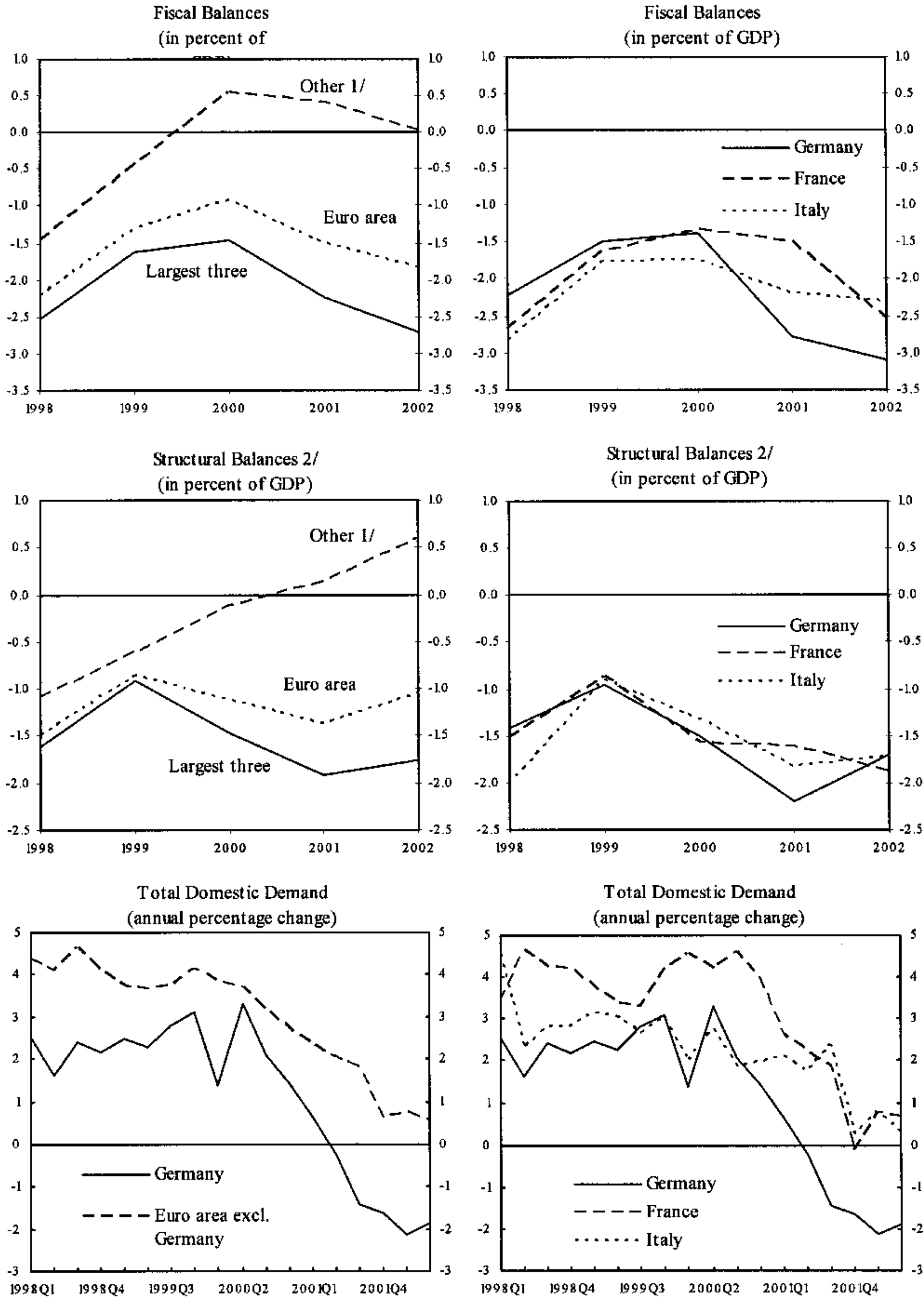
- On fiscal policy, the authorities' collective reaffirmation of their commitment to the letter and spirit of the SGP is welcome. Except for the staff's insistence on excluding the effects of one-off measures, the focus on year-by-year improvements in structural balances is fully in line with staff views, as stated in the mission's Concluding Statement and the issued staff report. Moreover, perceptions to the contrary notwithstanding, the approach does not amount to a weakening of the SGP, as suggested by some observers, but rather an upholding and a clarification of the core principles of the framework. At the same time, as noted above, fiscal policy intentions in the three largest countries appear to be diverging, explicitly so for 2003, regrettably creating risks of new strains on the credibility of the SGP framework.

Figure 1. Euro Area: Financial Market Indicators



Sources: Bloomberg; IMF; and staff estimates.
1/ Indices are equal to 100 on 1/1/2002.
2/ 10-year government bond yields.
3/ Corporate bond spreads are calculated as the difference between the yield of individual sector bonds and the government bond yield.

Figure 2. Euro Area: Divergences in Fiscal Performance



Sources: Eurostat; IMF; and staff estimates.
1/ Excluding Portugal.
2/ Cyclically adjusted fiscal balance, excluding asset sales.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/122
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October 29, 2002

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

IMF Executive Board Discusses the Monetary and Exchange Rate Policies of the Euro Area and the Trade Policies of the European Union

On October 18, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of the monetary and exchange rate policies of the euro area and the trade policies of the European Union. The background section of this PIN reflects information available at the time of the Executive Board meeting.[1]

Background

The euro area is recovering gradually from the downturn that began in late 2000. The rebound abroad in early 2002—in North America and emerging Asia—supported a timid recovery in euro-area output, but export growth and significant policy easing failed to spur a broader-based recovery. Retail price hikes coinciding with the euro cash changeover at the beginning of 2002—and household perceptions of its impact well in excess of actual inflation trends—sapped consumers' perceived disposable incomes and hurt spending, even as the labor market held up uncharacteristically well during the downturn. Capital spending has contracted for six consecutive quarters, and the inventory cycle is only beginning to turn. On the positive side, employment continues to grow and unemployment is up only slightly from its 10-year low. The

[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. In the present case, Fund staff held discussions with European Union institutions, including the European Central Bank, in the context of the Article IV consultations with the euro area's member states. 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 PIN summarizes the views of the Executive Board as expressed during the October 18, 2002 Executive Board discussion based on the staff report. The ECB's observer at the Fund participated in that meeting.

resilience of the job market reflects wage moderation and structural reforms enacted in recent years that boosted the use of labor in production and lowered the Non-Accelerating Inflation Rate of Unemployment.

Despite the slowdown, inflation has been persistent. After receding to 2 percent in the second half of last year, headline inflation accelerated sharply in January, in part because of shocks to fresh food prices and price increases associated with the euro changeover. It eased back slowly to below 2 percent in the summer months, aided by lower energy and food prices. Core inflation (excluding unprocessed food and energy) rose continuously through 2000-01 and remained stuck at 2.6 percent in the first half of this year with the first tentative signs of a deceleration appearing only in July. While goods price inflation peaked in February this year and has declined steadily since, service price inflation has failed to decelerate so far.

Starting in May last year, and especially following the events of September 11, the European Central Bank significantly eased monetary policy. In the context of the ECB's framework, the interest rate cuts were in response to reduced risks to medium-term price stability emanating from second pillar considerations (reduced growth and reversal of oil shocks). First-pillar signals from rapid growth of M3 were discounted as largely representing portfolio shifts in response to increased uncertainty in financial markets. The main refinancing rate currently stands at 3¼ percent, having been cut in four steps by a total of 150 basis points.

The overall fiscal stance in the euro area has been broadly neutral. The area-wide deficit rose from 0.8 percent of GDP (excluding UMTS receipts) in 2000 to a forecast 1.9 percent of GDP in 2002. This deterioration reflected the effects of the cycle, and the area's structural deficit was broadly unchanged over the period at 1 percent of GDP. Performance across members of the area, however, diverged. In particular, while eight countries undertook significant cumulative fiscal adjustment over the past five years, the structural deficit (net of large one-off non-financial asset operations) of the three largest countries (France, Germany, Italy) increased over the period, a divergence that has more recently given rise to an intensive debate on the modalities of the Stability and Growth Pact (SGP).

Progress on structural reforms in labor, product, and financial markets has been mixed. On the one hand, labor and to a lesser extent product market reforms continued to lag behind the pace needed to fulfill the ambitious aspirations of the Lisbon agenda. On the other hand, the speeding up of the implementation of the Financial Services Action Plan based on the Lamfalussy process marks a major procedural success.

The baseline prospect remains a recovery, but at a more gradual pace than previously expected. The staff has scaled back growth projections for the euro area considerably, to growth of ¾ percent in 2002 and 2 percent in 2003. The staff's projections see the year-on-year inflation rate as hovering around 2 percent in the remainder of 2002, reflecting in part base effects, then falling to about 1½ percent by late 2003.

Executive Board Assessment

Executive Directors congratulated the authorities for the smooth and successful changeover to euro notes and coins at the beginning of the year, which marked another milestone in European integration. During the past year, overall economic performance in the euro area has been disappointing, with growth weaker and inflation higher than had been expected. Directors noted that while unanticipated shocks—including oil price increases and animal diseases earlier, the external slowdown and financial market turmoil more recently—contributed to this setback, it also reflects a greater-than-anticipated vulnerability of the euro area to shocks. Directors pointed in particular to structural rigidities as underlying factors responsible for the continued dependence of activity on foreign demand and for the persistence of inflationary pressures despite weak domestic demand.

Looking ahead, Directors expected the recovery to be rather gradual, with indicators pointing to continued tepid growth in the near term. The recovery should pick up in 2003, led by consumption, as past price shocks dissipate, and in step with global developments. This will be helped by the overall sound economic fundamentals and the progress achieved on structural reform as reflected in the relative robustness of the labor market. Directors noted, nevertheless, that considerable downside risks remain, including those related to the fragile external environment and the impact of the recent turbulence in financial markets. Against this backdrop, Directors agreed that policies should focus on increasing both the pace and robustness of the area's performance thus helping to strengthen world growth and facilitate an orderly adjustment of international payments imbalances. In this regard, macroeconomic policy in the period ahead will need to take account of possibly heightened uncertainty, and decisive action on structural reforms will be key to lifting the euro area's growth potential and reducing its vulnerability to shocks.

Directors considered that, in the current difficult environment, monetary policy has continued to strike the right balance between the risks to inflation stemming from adverse one-off supply shocks and the ongoing weakness of activity. With the recovery expected to be gradual and inflation expected to move back below the ECB's 2 percent upper limit for price stability, Directors agreed that monetary policy should maintain its present accommodative stance. In view of the predominance and recent increase of downside risks to the recovery, they considered that a clear bias toward further monetary easing would be appropriate. A few Directors saw a case for an early rate cut.

Directors welcomed the steps taken by the ECB to further clarify to market participants the relation between the monetary framework and the policies that issue from that framework. They saw the de facto narrowing of the range of desired inflation outcomes to the upper half of the 0-2 percent official definition of price stability as a useful step toward balancing the benefits of an ambitious inflation objective against the benefits of providing for easier adjustment to shocks and guarding against the risks of deflation. A few Directors encouraged further consideration of an inflation target that would better take account of the challenges faced by members during their transition toward convergence. Directors also welcomed the ECB's move toward integrating broader financial market and real developments into its analysis of first (or money)

pillar developments. A number of Directors considered that this pillar continues to serve a useful purpose as part of the ECB's two-pillar framework. A number of other Directors, however, noted that the first pillar is likely useful for predicting inflation only in the longer term, and felt that the prominence of money developments in the assessment of risks to price stability over the medium term will remain a challenge for the ECB's communications to market participants. These Directors, therefore, suggested a further reduced emphasis on the role of developments in monetary aggregates, which should be used primarily as long-term information variables to support policy decisions. Several Directors highlighted, in this context, that money and credit developments can provide valuable signals of emerging financial imbalances that could lead to asset price bubbles.

Directors had a broad-ranging discussion on the appropriateness of the SGP as a fiscal framework for the euro area, and in particular on how, going forward, it should best guide the adjustment of members that have not yet met the Pact's consolidation objectives. Directors generally considered that the thrust of the SGP is basically in line with the requirements of both the area members and the fiscally decentralized monetary union, and that it provides a forward-looking framework that is reasonably well-tuned to the long-term pressures and debt sustainability issues stemming from the costs of aging populations. But several Directors also highlighted that the SGP's standing had been hurt by public perceptions that countries are held accountable for achieving nominal balance targets independent of cyclical developments, resulting in pro-cyclical fiscal policy responses. These Directors, therefore, welcomed recent announcements emphasizing the focus on structural balances, although a few Directors cautioned that these may be more difficult to explain to the public.

Directors welcomed the recent collective reaffirmation by the euro area authorities of their commitment to avoid excessive deficits and to the SGP objective of achieving and maintaining budgetary positions close to balance or in surplus over the economic cycle. They noted that a coordinated consolidation approach will be helpful for further enhancing the credibility of the Pact. Directors also noted the positive role that the Pact has played in supporting most members of the euro area in achieving a close-to-balance or surplus underlying fiscal position. They welcomed these fiscal consolidation efforts, and urged that fiscal policies in these countries allow full play to the automatic stabilizers, as envisaged by the Pact.

In several countries, most notably the three largest countries, fiscal adjustment has lagged, in particular during periods of strong growth. These countries, Directors suggested, face the particular challenge of striving to maintain the ambitious medium-term target of achieving fiscal balance while being cognizant of the shorter-term fragility of the cyclical outlook and the demand implications of adjustment. Meeting this challenge will require choosing a path of adjustment to medium-term fiscal targets that both signals credible adherence to SGP rules and maintains a sustainable pace of consolidation. In light of this, Directors endorsed the view that the best way forward will be a concerted and credible commitment by the three largest countries to adjust their underlying fiscal positions by at least ½ percent of GDP per year over the next several years until they reach close-to-balance structural positions. Such an approach would impart needed fiscal credibility at both the national and area-wide levels which could significantly lessen the short-term negative demand effects of the adjustment, particularly if

fiscal consolidation is anchored in expenditure reforms. They also saw a need for a comprehensive understanding that—absent breaches of the 3 percent limit—the automatic stabilizers should be allowed to play fully around those adjustment paths. A few Directors considered that a higher priority should be given to supporting the recovery at the present stage, while making a decisive start with much needed pension and health care reforms.

Directors stressed that the scope for raising the area's potential through structural reforms remains large, and that it has become increasingly urgent to implement the remaining agenda with perseverance, in particular to support the reabsorption of labor. The "new European paradigm" of employment-intensive growth has been a welcome development, but as the employment generating effects of past reforms wear off, further labor market reforms—together with continued wage restraint—become an increasingly pressing priority to maintain the paradigm and bolster the area's resilience. Directors also emphasized the priority that should be given to the further integration of product markets, which is a long-standing rationale for the EU's very existence and continues to be hindered by the slow progress in liberalizing trade in services. The new impetus to, and awareness of gains from, financial sector integration is welcome, and, in this context, Directors noted, in particular, the agreement on the Lamfalussy process for speeding up the implementation of the Financial Services Action Plan in securities markets, and the recent agreement on its extension to the banking and insurance sectors.

Directors acknowledged that area-wide statistics are adequate for surveillance purposes but called for improving the timeliness of quarterly national accounts data, and the quality of labor market and short-term business cycle statistics.

With respect to trade policies of the EU, Directors emphasized that, given its prominent role in world trade, the EU has a special responsibility to pursue liberal trade and agricultural policies, improve access to developing country exports, and advance the agenda of multilateral trade liberalization. They welcomed the leading role played by the EU in the successful launch of the Doha round of trade negotiations and the priority given by EU trade policy to further liberalization and better trade rules in the multilateral context. They were encouraged by the fact that further escalation over transatlantic trade disputes, which could have undermined progress under the Doha round, has so far been avoided. Directors considered that reform of the Common Agricultural Policy should be a key policy priority for the EU, given the costs it imposes on EU consumers, trading partners, and agricultural markets. The proposals under the mid-term review of the CAP, which involve delinking financial support from production, are a first crucial step in this direction, and determined political leadership is now required to pursue reform comprehensively, including by aiming to eliminate agricultural export subsidies.

Directors welcomed the EU's commitment to increase developing countries' access to its market and urged the EU to go further by being prepared to eliminate or reduce tariff peaks and tariff escalation, including on export products of interest to developing countries. In textiles and clothing trade, quota removals should be accelerated in order to help smooth the adjustment in both EU industries and in those developing country suppliers currently protected by the quota system.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Euro Area: Selected Economic Indicators
(In percent, unless otherwise noted)

	1998	1999	2000	2001	2002 [1]
Real Economy					
Change in real GDP	2.9	2.8	3.5	1.5	0.7
Change in domestic demand	3.6	3.4	2.9	0.9	0.5
Change in consumer prices [2]	1.1	1.2	2.4	2.5	2.1
Unemployment rate [3]	10.7	9.8	8.8	8.0	8.4
Public Finance					
General government balance (percent of GDP) [4]	-2.3	-1.3	-0.8	-1.7	-1.9
Public debt (percent of GDP)	73.7	72.6	70.2	69.3	69.4
Money and Interest Rates					
Change in M3 (end of year) [2]	5.3	5.5	3.9	7.9	7.1 [5]
Money market rate (3 month money)	4.1	3.1	4.5	4.2	3.3 [6]
Government bond yield (10 year bonds)	4.8	4.6	5.4	4.9	4.6 [6]
Balance of Payments					
Trade balance (percent of GDP)	2.1	1.4	0.8	1.7	2.2
Current account (percent of GDP)	1.1	0.5	-0.3	0.4	1.1
Official reserves (US$ billion) [7]	...	257.1	242.6	241.8	241.5
Exchange Rates					
Change in nominal effective rate	-0.1	-4.5	-9.4	1.5	3.7 [8]
Change in real effective rate	-3.4	-5.0	-10.9	-0.3	3.5 [8]

Sources: European Central Bank; Eurostat; Bloomberg; and IMF staff projections.

[1] Staff projections.

[2] Harmonized definition.

[3] In percent of labor force.

[4] Data do not include mobile telephone licence receipts.

[5] July value for 2002.

[6] October 21, 2002.

[7] Total reserves minus gold (Eurosystem definition); end September value for 2002.

[8] September 2002 relative to 2001 average.

Statement by Harilaos Vittas on
Monetary and Exchange Rate Policies of the Euro Area
October 18, 2002

Greece presently holds the Presidency of the Eurogroup. My statement expresses the common views of the euro area Member States and the European Community/EMU in their respective fields of competence.

The authorities of the euro area Member States welcome the staff assessment of economic developments and prospects in the euro area. They are in broad agreement with the policy conclusions. In addition to outlining where differences of view appear, this statement will update the Board on recent economic developments and policy actions taken at the European level, including on the implementation of the Stability and Growth Pact.

Short-term economic outlook

The recovery that started in the first quarter of 2002 has failed to gather momentum, as internal demand remains sluggish and the external environment has become less favorable. Recent data suggest that a modestly paced recovery will continue for the remainder of this year before accelerating in 2003. The authorities expect that the average growth rate for 2002 will be below 1 percent but will move towards potential in 2003.

The euro area authorities agree that uncertainty has increased, with significant downside risks coming from outside the euro area. Within the area, the prospects for a recovery in demand remain mixed, albeit relatively sound on the whole. On the one hand, the process of adjusting inventories has been largely completed; monetary policy is supportive of growth; and real disposable incomes are expected to increase; moreover, there are no major macro-economic imbalances (the household savings ratio is high and the current account is close to balance). On the other hand, the sharp decline in equity prices since early 2000 has contributed to weaken the balance sheets of corporations and financial institutions and has lowered confidence. We broadly concur with the Fund staff that labor market rigidities in Europe may exacerbate corporate profit downswings – through reduced productivity growth and increased unit labor costs – and that with more flexible labor markets, the macro-economic costs of adverse economic shocks could be significantly lowered and the recovery further strengthened. However, rigidities of this sort should not put a strong damper on the present recovery and the observed increase in unit labor costs is partly due to the pro-cyclical behavior of productivity and the lagged impact of the economic slowdown on employment.

Exchange rate developments

The euro area authorities are of the view that the appreciation of the euro has been a welcome development, as it now better reflects the fundamentals of the euro area. However, the euro

area authorities share the view that the euro is still undervalued in effective terms. The appreciation has helped to reduce inflationary pressures and, through the terms of trade effect, will lead to higher real purchasing power and stronger domestic demand. Despite the recent appreciation, the price and cost competitiveness of European firms is still favorable in a long-term perspective.

Monetary policy and the outlook for price stability

The ECB appreciates the focus on the medium term in the IMF staff report and the acknowledgement that monetary policy in the euro area has provided a firm anchor for inflation expectations. Coming to the assessment of the outlook for price stability and the implications for monetary policy at the current juncture, however, our analysis differs slightly from that contained in the IMF staff report.

The analysis of the ECB is based on information under both pillars of its monetary policy strategy. Starting with the first pillar, recent data continue to suggest that monetary growth is strong and that liquidity is ample in the euro area. The interpretation of monetary developments at the current juncture is complicated by the fact that the strong demand for liquidity is not only related to the low level of interest rates, but also reflects portfolio shifts in an environment of heightened financial market uncertainty. Ample liquidity, if sustained, might signal upward risks to price stability in the medium term. This notwithstanding, the ECB agrees that in the near future it is unlikely that it will translate into inflationary pressures, given the environment of subdued economic growth and high uncertainty.

Turning to the indicators under the second pillar, the ECB broadly agrees with the assessment for the outlook for economic growth contained in the IMF staff report. The recovery both in the euro area and in the world economy has progressed more slowly than previously expected and there was a need to scale down our expectations for economic growth in 2002. In addition, the exchange rate of the euro strengthened and we have seen some rather turbulent periods in financial markets. All these factors contributed to balancing, in the euro area, the risks to price stability over recent months. Still, we expect the recovery to proceed, partly because interest rates – across all maturities – are at relatively low levels in the euro area at present.

Over the past couple of months, we have seen HICP inflation rates hovering around 2 percent. These developments remained broadly in line with previous expectations of inflation rates for the remainder of the year, but latest upward tendencies indicate that the short-term trend has been affected by oil price developments. While subdued activity and the stronger euro should contribute to dampen inflationary pressures, for inflation to fall below 2 percent in 2003 it is necessary that wage growth remain moderate and oil prices do not escalate.

Overall, the ECB considers risks to price stability over the medium term to be balanced at this stage. Recent trends in economic activity and the exchange rate of the euro imply

downward pressure on inflation rates, but other factors, in particular monetary developments, wage trends and oil prices, need to be monitored for their potential upward impact on inflation. Against this background, the Governing Council of the ECB decided at its last meeting on October 10, 2002 to keep key ECB interest rates unchanged.

Monetary policy strategy issues

The ECB appreciates that its awareness of the need to prevent inflation rates from getting too close to zero is being widely acknowledged in the Report. We note that our definition of price stability is recognized to provide a sound safety margin to avert the risk of getting trapped in a deflationary spiral and we agree that it is appropriate in most cases to focus in particular on the 1-2 percent range within our definition of price stability. In this respect, we would like to emphasize that we do not expect that the enlargement process should affect the definition of price stability (or any other aspect of the monetary policy strategy of the ECB). Rather, we would expect the enlargement process to proceed in a manner that is based on the sustainable convergence of economic developments.

Regarding the assessment of the first pillar of the ECB's monetary policy strategy, the analysis put forward by the IMF staff highlights two important aspects implicit in a systematic monitoring of monetary developments. First, giving a prominent role to monetary aggregates – in addition to the announcement of a precise quantification of the price stability objective – endows monetary policy with a firm anchor. Second, by a systematic monitoring of monetary and credit developments a central bank can be made aware of early signals of financial imbalances that could lead to asset price bubbles, or more generally of unsustainable financial positions building up in the private sector.

The ECB also agrees that the indicator properties of money developments lie particularly in the analysis of medium-term price trends. However, it would like to emphasize that academic research and several ECB analyses – published in the ECB's working paper series – have shown that some monetary indicators may also contain information, additional to that contained in real-side indicators, for forecasting inflation at shorter horizons.

On the ECB's external communication regarding the first pillar of its monetary policy strategy, we would like to emphasize that the ECB has been consistent over time. Since its inception, the ECB has made it clear that there is no mechanical reaction of monetary policy to deviations of M3 growth from the reference value. Furthermore, the first pillar has always embraced the analysis of the components and counterparts of monetary aggregates in the balance sheets of Monetary and Financial Institutions. The ECB considers that this broad framework for analyzing money developments is best suited to derive the information content of money for risks to price stability in an optimal manner.

Fiscal policies

The authorities of the euro area Member States welcome the clear description and appreciation of all facets of the budgetary framework. The staff appraisal describes the Stability and Growth Pact as the operational application of general principles of sound fiscal behavior, put together in a transparent and predictable framework with a fair amount of flexibility. The Pact has resulted in eleven out of fifteen countries having reached a fiscal position that is balanced or in surplus over the economic cycle within the EU. Continued implementation of the agreed principles of the Pact will underpin consumer and producer confidence and support the recovery of the euro area economy.

Against a background of slower-than-expected growth, expenditure overruns and unfunded tax changes in some countries, and their impact on budgetary positions, the Eurogroup discussed the budgetary situation in those countries that are still in transition to a position of close to balance or in surplus over the economic cycle. At its meeting of October 7, 2002, the Eurogroup endorsed the objective of a reduction of the underlying deficit by at least 0.5 percent every year for the countries concerned, and all ministers but one agreed that this reduction should start no later than in next year's budget. For any member state with an excessive deficit, the adjustment should be even stronger.

This adjustment of at least 0.5 percent in structural terms – also advocated by the staff – is substantial, but the euro area authorities agree with the staff's view that its real economic impact might be mitigated inter alia by its positive impact on confidence and credibility. The euro area authorities agree that the actual effect of such a fiscal adjustment in the Member States concerned would turn out significantly positive, even though confidence effects are generally intangible. In order to reinforce the credibility of the Pact, it is also crucial that Member States provide more reliable and timely data on public deficits and debt. Further efforts have to be made to ensure adequate statistics.

Structural reform

The euro area authorities broadly concur with the IMF staff's view on structural reforms. They note the staff point that the area's underlying growth performance is stronger than often perceived, when viewed in per capita terms. More flexible and efficient product and labor markets will help to bring about benefits in terms of increased potential growth, employment and improved resilience to shocks. In this context, they point to past wage moderation and progress on structural reforms which in recent years have helped to bring about the relatively muted impact of the economic downturn on the labor market. They note that employment in the European Union has increased by 3.5 million from the first quarter in 2000 to the first quarter of 2002.

Progress is also being made in meeting the 2005 deadline for the implementation of the Financial Services Action Plan (FSAP), which is the blueprint for completing the Internal Market in financial services. By the end of this year, a series of additional legislative

measures should have been adopted. The measures cover, among other things, the use of International Accounting Standards (IAS) to enhance the comparability of companies' financial statements, the definition of a common EU company prospectus to facilitate raising capital on a pan-EU basis, and rules to allow pension funds to develop an effective and safe investment policy. Work is also under way to improve the procedures for day-to-day regulation and supervision of financial markets and institutions at the EU level, following the "Lamfalussy Report" on the regulation of the securities market. The Council of European Economic and Finance Ministers endorsed on 8 October an EFC report that proposed to extend this approach to other financial sectors such as banking and insurance.

Underdeveloped retail credit markets in the EU may not be the central factor, as hinted by the staff, behind the lack of a 'buffer role' played by the savings rate. Other factors, such as the increase in precautionary savings when economic prospects worsen, also play a major role in the euro area, unlike in the US. Finally, in light of the loss of credibility suffered by audit and accounting activities, the EU has taken a leading role in improving the relevant aspects of corporate governance. Actions have been adopted in, at least, four areas: the development of an Action Plan on Company Law; the requirement for almost all listed EU companies to use International Accounting Standards by 2005; a principles-based recommendation on auditor independence; and the initiation of a consulting process on the disclosure requirements that should apply to companies on a regular basis.

Although there has been substantial progress in recent years with respect to the structural reform agenda, the EU recognizes that more needs to be done to ensure that the performance targets set at the Spring 2000 Lisbon European Council are fully met. Earlier this year, the Barcelona European Council reaffirmed the determination of the European Union to speed up reform efforts, aimed at an increase in both the employment rate and the level of labor productivity. Concrete measures include the further liberalization of the energy sector, increased investment in research and development, mostly to be financed by the private sector, and the reduction of state aids.

Trade issues

The EU has played a leading role in the successful launch of the Doha Development Agenda (DDA) negotiations in November 2001, and is now working hard towards progress in the various negotiating groups. The overarching priority for EU trade policy is further trade liberalization and better trade rules, via the multilateral route of comprehensive progress in the DDA negotiations. For non-agricultural goods, the EU seeks global reduction or, as appropriate, elimination of tariff peaks, high tariffs and tariff escalation that might impede developing and least developed countries from reaping the benefits of liberalization.

Development issues are a crucial part of the DDA. The EU has taken the lead, via the Everything But Arms initiative, on market access for the least-developed countries. The EU's emphasis on a comprehensive approach in the DDA, including issues such as anti-dumping rules, trade, and investment, is also important in this context, since good quality rules are

necessary to avoid market access being granted at the border, only to be negated by anti-import "behind the border" measures. Economic Partnership Agreements are the cornerstone of the EU's future trade relations with the ACP countries and aim to foster sustainable development in these countries and support their fuller integration into the global economy.

The EU is fully committed to completing Textiles and Clothing quota removal in line with Uruguay Round commitments. The recent IMF paper "Market Access for Developing Country Exports - Selected Issues" confirmed the EU's moderate average tariffs in these sectors (4.5 percent in textiles, 5.3 percent in clothing, with no peaks above 15 percent). On agricultural market access, the EU notes that a significant proportion of its agricultural imports from developing countries, and almost all from Least-developed countries, are duty free due to the preferences that these countries receive from the EU. However, the EU is also fully committed to negotiations aimed at further improvements in market access for agricultural products, without prejudging the outcome of these negotiations.