

Staff Report on the Monetary and Exchange Rate Policies of the Euro Area; Supplement Updating Information on Recent Economic Developments and Policies in the Euro Area; Supplement on EU Trade Policies; Public Information Notice Following Consultation; Two Statements by Representative on the IMF Executive Board for France, on Behalf of Euro-Area and EU Members

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, prepared by a staff team of the IMF, following discussions that ended on July 5, 2000, with officials at EU institutions in the context of the Article IV consultations with the countries forming the euro area. The staff report was completed on September 22, 2000. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the IMF Executive Board.
- a staff report issued October 13, 2000, updating information on recent economic developments and policies that had become available since the issuance of the staff report.
- a supplemental staff report issued on October 13, 2000, on recent developments in EU trade policies.
- the Public Information Notice (PIN), which summarizes the views of the Executive Board as expressed during the October 16, 2000, Executive Board discussion of the staff report on the monetary and exchange rate policies of the euro area.
- two statements by Mr. Milleron, Executive Director for France, the country currently holding the Presidency of the European Council, on behalf of the euro-area and the European Union authorities.

Further background documentation prepared by IMF staff may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

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Monetary and Exchange Rate Policies of the Euro Area

(In the Context of the 2000 Article IV Discussions with Euro-Area Countries)

Prepared by the European I Department

Approved by Michael Deppler and Leslie Lipschitz

September 22, 2000

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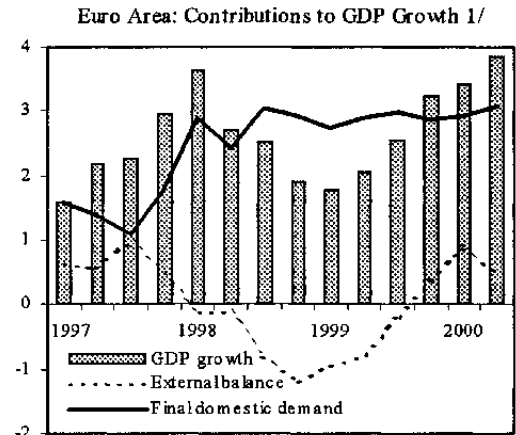
I. INTRODUCTION

- This paper¹ marks the conclusion of a second cycle of Fund surveillance of the monetary and exchange rate policies of the euro area, which were last discussed by Executive Directors on March 23, 2000 (BUFF/00/41).
- At that time, Directors noted that the near-term outlook for the euro area had brightened, and stressed that the key policy challenge was to create conditions for sustained rapid economic growth. To this end, they urged a monetary strategy firmly focused on price stability, national fiscal policies aimed at promoting public saving and favorable supply-side responses, and an intensification of structural reform efforts. Directors agreed that the prevailing weakness of the euro was undesirable from a global perspective but that a monetary policy reaction was unwarranted in the absence of clear risks to price stability. In acknowledging overall progress toward fiscal sustainability, Directors pointed out nonetheless that the adjustment effort had slackened in 1998-99 and should be reinvigorated. They commented that the updated stability programs for 2000-03 did not go far enough in providing the area as a whole with the necessary improvements in structural balances and reductions in the tax burden. Finally, Directors commended ongoing structural reform efforts but observed that the reform strategy was still too limited in scope to lock in durable reductions in unemployment, and urged a bolder attack on entrenched rigidities in the labor and product markets.
- The next Board discussion of the euro-area matters covered in this paper is scheduled for the second half of October 2000, when the Article IV consultations with Germany, France, Spain, and Portugal will also be concluded. In light of this clustering, discussions at EU institutions focused on broad themes and policy desiderata for the area as a whole, rather than on individual countries' developments and policy requirements.

¹ In preparation for the paper, a mission visited the European Central Bank (ECB), where it held talks with President Duisenberg, and Ms. Hämäläinen, Mr. Issing, and Mr. Padoa-Schioppa (members of the ECB Executive Board), as well as with senior staff. It also visited the Commission of the European Communities (Commission), where discussions were held with Commissioner Solbes Mira, Mr. Ravasio (Director General for Economic and Financial Affairs), and some of their colleagues. The staff presented the mission's concluding statement to the Economic and Financial Committee (EFC) and to the Euro Group of finance ministers, which endorsed its general release and the eventual publication of this staff report. The mission took place on June 27-July 5, 2000, and the mission team comprised Messrs. Deppler (Head), Zanello, Ross, Kontolemis (all EU1), and Mr. Rosenblatt (PAR). Mr. Auboin (PDR) joined the mission during its visit to the Commission.

II. THE ECONOMIC SETTING

1. **For the time being—and possibly for a considerable time to come—developments and prospects for the euro area are quite favorable.** With domestic demand growth maintaining the 3-percent pace of the past few years and the external environment shifting from adverse to distinctly supportive, activity has become quite buoyant. In the latest WEO, area-wide real GDP is expected to grow by about 3½ percent in 2000 and 2001, in a setting of broad price stability.² The unemployment rate is firmly on a downward trend, and the euro-area output gap is anticipated to shrink by 1 percent this year and the next, with output exceeding potential capacity by the end of 2001.



Sources: IMF and Eurostat.

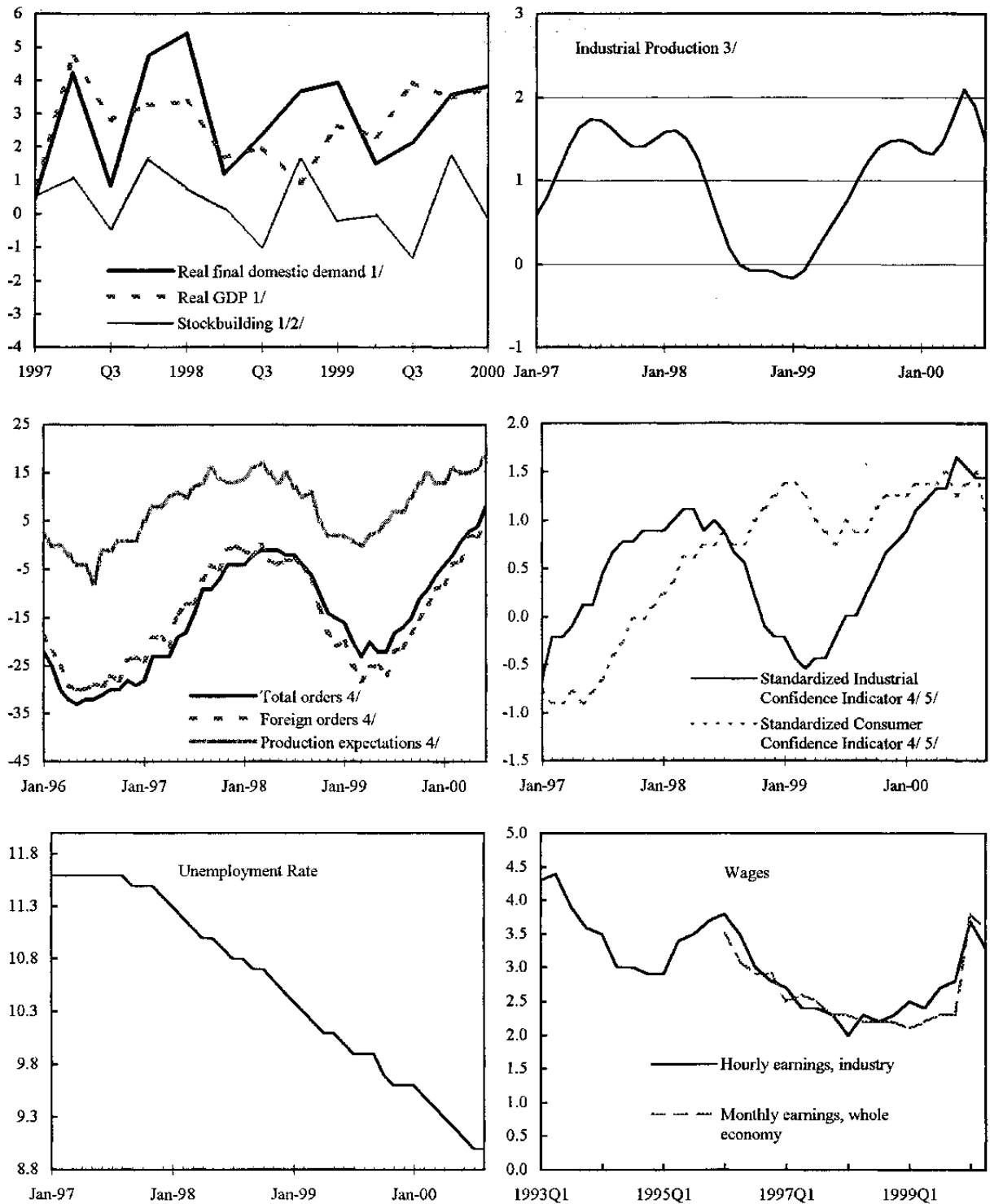
1/ Quarterly data, annual percent change.

2. **This upbeat outlook is underpinned by buoyant activity indicators and a supportive policy mix.** High household and business confidence, rising capacity utilization and industrial production, strong job creation, and—so far—employment-friendly wage settlements point to sustained activity in the near term (Figure 1). Because of the weakness of the euro, monetary conditions remain supportive of activity in spite of the recent round of interest rate increases, and were in early August 2000 as easy as 10 months earlier (Figure 2).³ The constellation of national fiscal policies is also supporting area-wide aggregate demand. Abstracting from the exceptional contribution to revenues from the sale of the third-generation phone licenses, the aggregate structural deficit is projected to slip by about ½ of 1 percent of GDP in 2000-01, thus marking a pause in the area-wide consolidation efforts after the overachievement of deficit targets in 1999 (Table 1).

² The Commission's latest forecast is for growth at an annual rate of 3.4 percent and 3.1 percent in 2000 and 2001, respectively, with average harmonized index of consumer prices (HICP) inflation at 1.8 percent in 2000 and 2001.

³ After the 50-basis-point increase on November 4, 1999 the ECB repo rate stood at 3.0 percent. Subsequent 25-basis-point hikes were undertaken on February 3, March 16, April 27, and a 50-basis-point increase took place on June 8, 2000. The latest 25-basis-point increase on August 31, 2000 brought the ECB repo rate to 4.5 percent. Ex post real short interest rates (conventionally measured) rose from approximately 1.6 percent in July 1999 to about 3.4 percent in August 2000, roughly in line with the historical German average. However, over the same period the effective real exchange rate fell by about 12 percent.

Figure 1. Euro Area: Recent Developments



Sources: IMF, World Economic Outlook; WEFA database; and Eurostat.

1/ Quarterly growth, annualized.

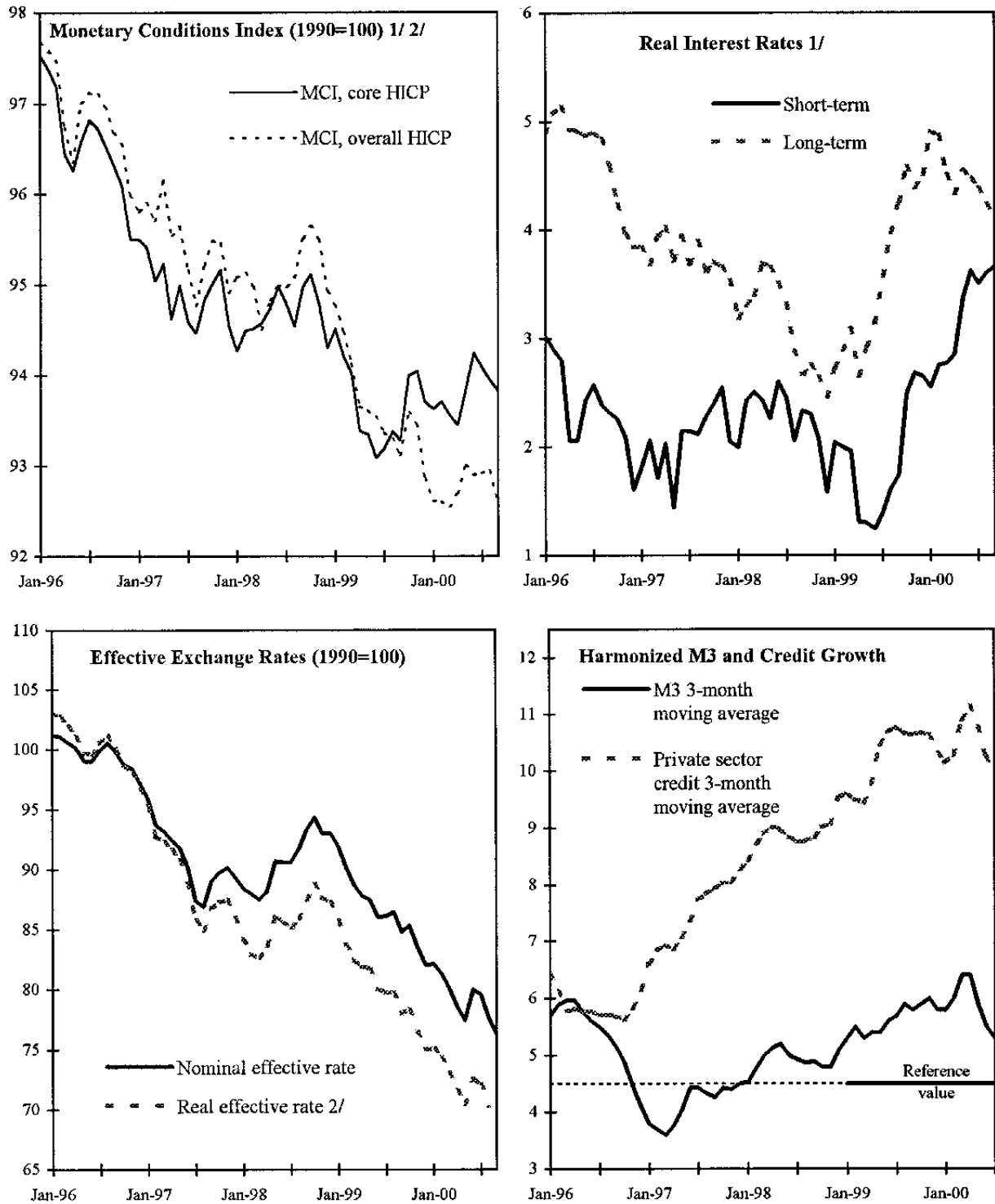
2/ Contribution to growth.

3/ Percent change of the average of the last 3 months over the previous 3-month average.

4/ Survey, balance of responses.

5/ Centered, standardized series; means and standard deviations refer to period June 1986 to present.

Figure 2. Euro Area: Monetary Conditions



Sources: IMF staff estimates; European Central Bank; Bloomberg.

1/ Real interest rates are defined as nominal interest rates minus core price inflation in the preceding 12 month period.

2/ The MCI is a weighted average of real interest and effective exchange rates with weights in a 1:7 ratio. The real effective exchange rate is ULC-based and the interest rate is deflated by either core or HICP inflation.

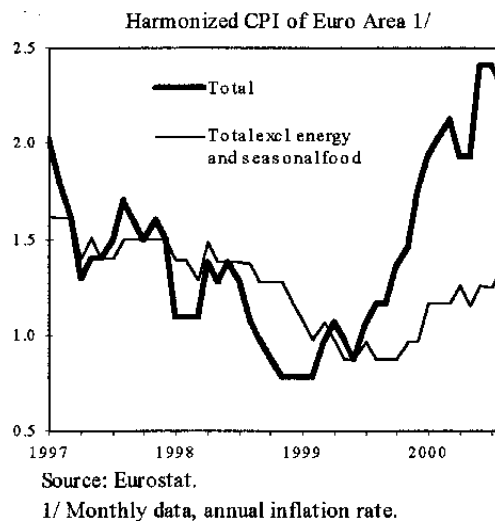
Table 1. Euro Area: WEO Medium-Term Fiscal Projections
(General government, in percent of GDP unless otherwise noted)

	1999	Proj. 2000	Proj. 2001	Proj. 2002	Proj. 2003
Revenue 1/	47.4	47.1	46.4	46.0	45.8
Expenditure	48.7	47.8	46.9	46.3	45.8
o/w interest payments	4.4	4.1	3.9	3.8	3.6
Overall balance	-1.3	-0.7	-0.6	-0.3	0.0
Structural balance	-0.5	-0.4	-0.8	-0.6	-0.4
Primary balance	3.0	4.2	3.6	3.5	3.6
Primary structural balance	3.8	3.7	3.1	3.1	3.2
Memorandum items:					
Gross debt	73.2	70.7	68.5	66.3	64.4
Real GDP (percentage change)	2.4	3.5	3.4	3.0	2.6
Output gap	-1.4	-0.5	0.3	0.6	0.6

Source: IMF, World Economic Outlook; and Fund staff calculations.

1/ Data do not include mobile telephone license receipts.

3. **Moreover, the macroeconomic fundamentals in the euro area appear much sounder than in previous recoveries.** Underlying inflation is in check and expected to remain so under the stewardship of the ECB; the aggregate budgetary position is closer to balance than at any time in recent memory; and past reforms in the product and labor markets have started to bear fruit in the form of enhanced competition and moderate increases in labor compensation despite employment growth at a pace not seen in a generation.⁴ Admittedly, high unemployment—the hallmark of continental Europe’s malaise—still mars the economic landscape, but is receding at the fastest pace in ten years.



4. **There are risks, but these appear broadly balanced and not to threaten the euro area’s near-term prospects for above-potential growth.**⁵ The main downside risk arises from a sharp reversal of the positive external shocks that have propelled euro-area growth to new heights—the strong pickup in global demand and the prolonged depreciation of the euro that has redirected a significant part of that demand to the euro area.⁶ It is also possible that the ongoing steep rise in oil prices might have more insidious effects on output than supposed.⁷ These risks have to be weighed, however, against the still supportive stance of macro policies, the competitiveness effects of the weak euro, and the resilience of domestic demand and employment growth over the past three years, which have withstood the test of global financial turbulence and ensured a broad-based recovery. Thus, although developments may be somewhat volatile, the underlying expansionary momentum should carry forward.

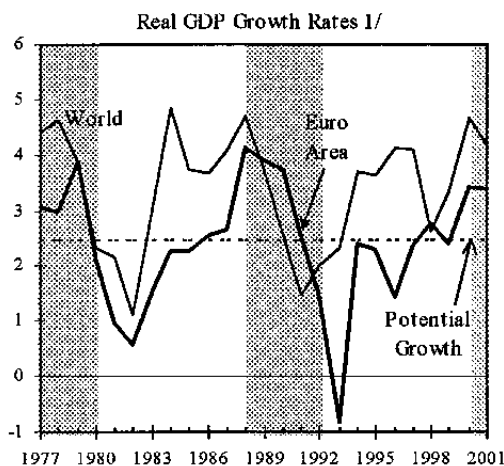
⁴ Employment growth in the euro area has been at about 1½ percent in the last three years. A comparable performance occurred in the 1960s.

⁵ Euro-area potential growth is estimated at about 2½ percent per year.

⁶ Simulations with MULTIMOD and the OEF econometric model suggest that the cumulative contribution to growth from extra-euro-area exports in the aftermath of approximately a 1 percent increase in world demand and a 10 percent effective depreciation of the euro would be on the order of 1 percentage point over about two years.

⁷ Simulations with the OEF model suggest that a €10 increase in oil prices depresses euro-area output growth by about 0.2 from its baseline level over 2 years. Expressed in euros, oil prices averaged €15 in 1993-97, fell to €9 in December 1998, and reached €35 in early September 2000.

5. **What about medium-term prospects? Are they as robust?** The cyclical history of the euro area over the past 30 years suggests caution. The upswings, while on occasion pronounced, have been both fairly short and followed by prolonged periods of sub-par performance. In the latest such episode, the euro area returned—gradually at first, and rapidly later—to potential in 1988; experienced two further years of quite rapid growth in 1989 and 1990 (at about 4 percent per annum); slowed and crashed in 1991-93; and took a long time to recover thereafter. Many, largely exogenous factors played a role in each of these cyclical developments—oil prices, the Single Market, the Gulf war, German unification, the ERM crisis, and the EMU convergence process, to name some of the more notable. Nonetheless, deep-seated internal dynamic and structural influences also seem to be at play in the area's macroeconomic history (Box 1). In this sequence of events, the recovery—typically triggered by a favorable external and exchange rate environment—becomes in time unsustainably paced by the combination of either pro-cyclical or insufficiently counter-cyclical fiscal policies and accelerating wage claims. Against the background of incomplete or piecemeal structural reforms unable to revitalize the supply side, demand soon outstrips productive capacity and price pressures mount. With labor market institutions that resist wage differentiation, the mismatch between productivity and labor costs intensifies, especially at the low end of the wage scale, fueling cost-push inflation and further wage demands. A sharp monetary tightening that usually exacerbates an ongoing real appreciation precipitates the downturn. In a context of structural rigidities undermining the economy's resilience to the policy or terms-of-trade shocks, adjustment takes the form of extensive labor-shedding of the unskilled, upward ratcheting structural unemployment, and prolonged output losses—again, typically amplified by pro-cyclical fiscal policies geared toward cushioning the impact of the contraction on unsound budgetary positions.



Source: IMF, World Economic Outlook.

1/ Shaded areas represent periods of positive output gaps (i.e., output exceeding potential).

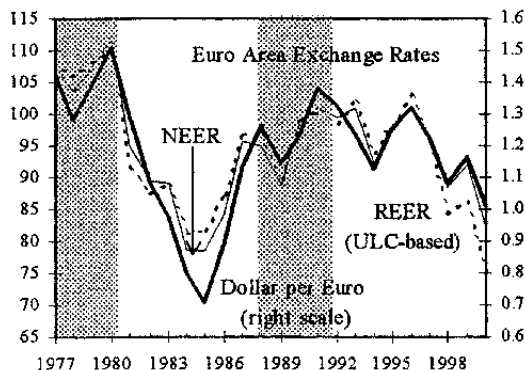
6. **From this angle, the core issue looking forward is whether the factors that eventually undermined earlier upswings may still be at play for the area as a whole, and—if so—what policy requirements may prevent a repetition of the past.** Arguably, the euro-area economy has changed in profound ways, but the longer-term prognosis for the ongoing expansion remains clouded by uncertainties about the scope of these changes and their effectiveness in reinforcing the economy's resilience. What is clear is that keeping noninflationary growth on track beyond the next few years hinges on policies that avoid exacerbating demand pressures and reinvigorate the supply side of the euro area.

Box 1. Euro Area: Will Economic History Repeat Itself? ¹

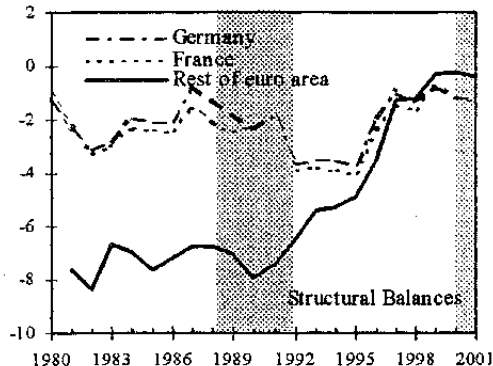
Over the last two decades, the economies of the euro area have, by and large, pursued policies which, in the context of the area's structural rigidities, resulted in a consistently lackluster growth performance. The sustainability of expansions has proven especially problematic, as deep-seated rigidities in labor markets—often evidenced by rapidly rising real wage costs as slack was being taken up—caused inflationary pressures to mount in the early stages of an upswing. These pressures tended to be aggravated by insufficiently counter-cyclical (or outright pro-cyclical) fiscal policies in key countries, and elicited a swift monetary response that—as a rule—precipitated a downturn.

Indeed, a few observations provide a first characterization of the euro area's experience in managing its recoveries over the last two decades or so:

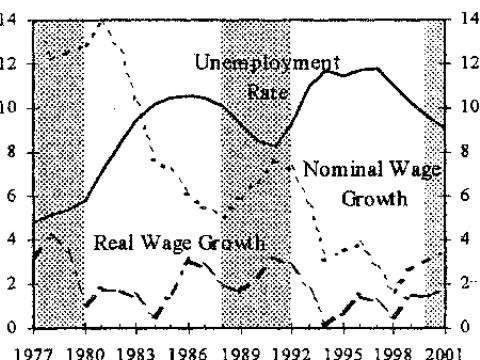
- **Competitive currency positions provided initial support to an expansion and the exchange rate appreciated as the cycle matured:** The evolution of the (synthetic) euro's external value, both vis-à-vis the U.S. dollar and in effective terms, suggests that competitive exchange rate positions helped to push the euro area out of its economic doldrums in the mid-1980s. Although a gradual appreciation of the exchange rate had started to impact the recovery by 1987, a sharp depreciation in 1988-90 triggered a new upturn.



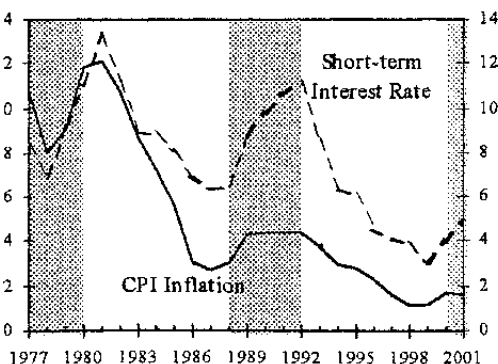
- **Insufficiently counter-cyclical or pro-cyclical fiscal policies exacerbated inflationary pressures during upswings.** Persistent deficits and growing stocks of debt were the hallmark of the euro area's fiscal policies in the last two decades. However, aggregate indicators of fiscal stance are misleading as fiscal policy in many countries was shaped by the pursuit of an exchange rate target. Focusing instead on the core countries reveals a tendency toward a deterioration in the structural fiscal position in both Germany and France during the upswing (for Germany, see SM/99/254; for France, see the 2000 Article IV staff report). A pro-cyclical bias persisted in contractions, as budgetary austerity was imposed to cushion the impact of the downturn—and rising unemployment—on unsound public finances.



- **Real wages accelerated quickly in response to improved cyclical conditions:** In a context of declining inflation, nominal wage growth had generally been on a downward trend since the late 1970s. Real wage growth, though, rose sharply at the outset of the upturn in the mid-1980s, perhaps reflecting the difficulty of inflationary expectations in catching up with the ongoing disinflation. The same pattern reappeared in the late 1980s as unemployment finally started to edge down for the first time in over a decade: wage compensation rose quickly again, with real wage growth approaching four percent.



- **The monetary authorities' response to a deteriorating inflationary environment was swift and marked:** Throughout most of the period under consideration, short-term interest rates had fallen from their late-1970s highs as the monetary authority in the anchor country—the Bundesbank—lowered policy rates gradually in line with declining inflation. With inflationary pressures building up in Germany and elsewhere near the peak of the economic cycle in the late 1980s, the Bundesbank raised interest rates by some 400 basis points in two years, with other national monetary authorities following suit. In the early 1990s, the outbreak of hostilities in the Gulf region heightened inflationary expectations and led to further interest rate hikes.



¹ Shaded areas on the figures represent periods of output exceeding potential.

III. POLICY DISCUSSIONS

A. Prospects and Policy Requirements

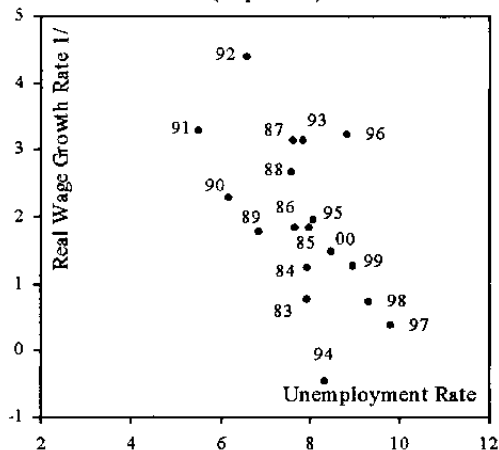
7. **There was general agreement that the near-term growth outlook was quite good, but perspectives on the longer term were more varied, with the staff being at the more guarded end.** The more hopeful appraisals pointed to the new institutional structures of EMU (a sound, rule-based fiscal framework and a monetary policy not exclusively geared to domestic developments in the anchor country), the lack of generalized signs that capacity constraints might soon bite, and the belief that labor supply was likely to be enhanced by a “discouraged worker” effect in reverse and more flexible labor markets than immediately apparent. Expectations of sustained noninflationary growth were above all rooted in the seeming change in the wage-formation process which, because of the discipline imposed on national wage-setters by the monetary union, was delivering wage moderation even in countries where slack was being absorbed at a relatively rapid rate. Moreover, while it was acknowledged that evidence of a “new economy” taking hold in the euro area remained anecdotal,⁸ in the opinion of many officials the area’s productive potential would be boosted by a falling NAIRU, as the dynamics linking actual and structural unemployment in an upward spiral reverse. Furthermore—and in addition to the cumulative effect of past reforms—the Lisbon summit’s strategy for structural and fiscal measures aimed at boosting the EU participation rate and fostering a knowledge-based economy would support the longer-term outlook for the euro area.

8. **The staff acknowledged that reforms in product and labor markets, progress in fiscal consolidation, and a possible impact of EMU on wage and expectation formation might have improved the macroeconomic structure of the euro area. Nonetheless, it cautioned that some developments might not hold up to a marked cyclical tightening.** Wage increases were, indeed, quite moderate and seemed likely to remain so through next year—judging from the signaling effect that recent German wage settlements had had on the area as whole. Beyond the near term, though, prospects were less clear. If the German authorities—who, not surprisingly given the still sluggish growth of employment, have a clear preference for continued wage moderation—had their way, wage moderation might continue to prevail throughout the area as a whole for a while longer. This would clearly help sustain price stability, even if it might also slow any needed intra-area re-balancing in labor markets and slow the contribution of domestic demand to the upswing. In the staff’s view, however, real wages in Germany had in the past reacted quickly to upswings (see accompanying chart). If so, wage moderation throughout the union might not withstand the test. Wage

⁸ “New economy” issues are treated in detail in the forthcoming background papers for the 2000 Article IV consultations with France and Germany. Both papers reach the tentative conclusion that the “new economy” is at best only slowly making an appearance in most of continental Europe.

demonstration effects could in time flare up across national borders, once fear of a loss in intra-area competitiveness weakened.⁹ In the same vein, the mission noted that recoveries tended to hide the critical role of rigidities in inhibiting smooth adjustment to external or policy-induced shocks. Indeed, as the recovery proceeded, insufficient wage differentiation was likely to intensify imbalances in the labor market that would gradually erode the euro area's resilience and come to the fore only in the next downturn. Moreover, the failure to profit from the upturn to complete needed fiscal consolidation in the area as a whole was reminiscent of past fiscal mismanagement in upswings and the associated crowding out.¹⁰ Overall, the mission saw grounds for not being complacent in taking the long-term view: past impulses seemed likely to resurface in time.

Germany: Real Wage Growth in Manufacturing Sector and Unemployment Rate (In percent)



Sources: IMF; OECD.
1/ Wages deflated by GDP deflator.

9. **With a broad consensus that prospects through 2001 were good, there was wide recognition that the core challenge was to lay the basis for a lasting and a resilient non-inflationary expansion.** From a regional standpoint, a durable expansion was needed to make up for the anemic performance of the past and continue to bring down the unemployment rate; from a global perspective, an economically strong euro area was key to a re-balancing of the uneven global pattern in demand. There was recognition that maintaining the momentum in world growth called for the euro area to pick up the slack in demand arising from a slowdown in the United States. There was also widespread agreement, on the corresponding policy requirements: at least neutral fiscal positions over the cycle; tax, expenditure, and structural reform policies geared toward increasing effective supply in both product and factor markets—especially labor markets; and a monetary policy firmly focused on maintaining price stability, in a context with evolving inflationary risks. It was less clear, however, how closely policies would align with these principles in practice—thus raising the concern that the policy mix might again become problematic for the area as the cycle matured.

⁹ The leadership effects of wage-setting in Germany are discussed in Chapter IV of “EMU: One Year On,” OECD, 2000.

¹⁰ Cyclically adjusted balances (net of the revenue from the sale of mobile phone licenses) are projected to deteriorate in six euro-area countries in 2000, and in eight in 2001.

B. Monetary and Exchange Rate Policies

10. **The ECB representatives largely shared the staff's view regarding the medium-term risks to the expansion.** They fully shared the view that fiscal policies should not be pro-cyclical, that tax cuts should be tied to at least contemporaneous (i.e., not future) cuts in expenditures, and that structural reforms were needed now to enhance effective supply and preempt the emergence of inflationary bottlenecks. While acknowledging that progress had been made over the years, these officials were skeptical whether enough was being done to strengthen the groundwork for lasting growth. Although this might in time have adverse implications for the policy mix, they considered the ECB's role in, and contribution to, sustaining the expansion in the euro area to be that of an unwavering commitment to maintaining price stability—a task that would necessarily be conditioned inter alia by the inflationary implications of fiscal, structural, and wage policies at the national level.

11. **Indeed, the ECB representatives considered monetary policy over the preceding six to nine months to have been very much in that mould, responding appropriately to an environment where inflationary risks had increased.** Monetary growth consistently in excess of the ECB's reference value, unexpectedly large and protracted increases in energy and commodity prices, lagged effects of the marked and sustained weakness of the euro, and improving prospects for the euro-area economy had all contributed to a progressive shift to the upside in the balance of risks to medium-term price stability since mid-1999. According to the ECB representatives, the tightening cycle (of 175 basis points, at that point in time) initiated last November had continued to be generally supportive of sustained non-inflationary growth and anchored inflationary expectations, as implied by the differential between yields on long-term indexed and nominal bonds.

12. **Since the discussions, inflation risks have increased: oil prices have continued to rise and the euro has slid to a new low against the U.S. dollar.** The direct inflationary impact of these combined events is not likely to be trivial, notwithstanding the much lower oil content of aggregate production since the energy crises in the mid 1970s and heightened competitive pressures. The possibility of sizable second-round effects cannot therefore be ruled out.¹¹

¹¹ As a result of rising energy prices and a weakening exchange rate, the index of euro-area import prices has increased by about 17 percent since mid-1999 and the hike in oil prices is directly responsible for about half of the 1.4 percentage-point increase in the headline inflation rate since then. As for indirect effects, the ECB estimates that a permanent 20-percent increase in import prices is likely to contribute around 1 percentage point to the cumulative increase in euro-area HICP inflation over a 2-3 year period. Second-round effects from changes in import prices are however harder to gauge, since they would depend on the behavior of wages, inflationary expectations, the stage of the cycle, and macroeconomic policy responses.

13. **Looking ahead, ECB officials thought at the time of the mission's visit that area-wide inflation would—on unchanged interest and exchange rates, and with oil spot prices falling in line with those in futures contracts—hover close to the upper bound of their target range through 2001, but they also pointed to the existence of inflationary pressures over the longer term.** This projection reflected expectations of further exchange rate pass-through (as importers' margins were reconstituted) and second-round effects that would in time push up core inflation and wage demands.¹² Regarding inflationary developments at the national level, officials at the ECB (and the Commission) agreed with the staff that price pressures in the more cyclically advanced economies reflected a variety of factors, including real convergence,¹³ and needed to be dealt with through fiscal and structural measures at the national rather than the area-wide level. In particular, they agreed that, where the analysis suggested overheating risks, special efforts should be made to accelerate structural reforms that would raise potential output and to front-load progress toward medium-term budgetary goals. More broadly, ECB representatives reiterated that monetary decision making was grounded exclusively on area-wide aggregate inflationary developments and was not directly shaped by country-specific circumstances.

14. **The staff concurred that, overall, monetary management had been appropriate.** The external shocks—oil, global demand, and the depreciation of the euro—had been unexpectedly large and sustained. As a result, headline inflation had crept up above the ECB's target range and seemed likely to remain there for a few months. Moreover, the shocks had become sufficiently sustained, and the pace of activity sufficiently buoyant, as to justify worrying about forestalling second-round effects.¹⁴ The monetary tightening thus was understandable in the context of establishing the credibility of the new regime and of the need for the young central bank to steer inflationary expectations. Indeed, the staff noted that further modest increases in interest rates could be in order if the euro remained as weak as participants in the forward and options markets anticipated, and if the evolution of core inflation implied more entrenched wage and price pressures (Box 2).

¹² The Commission has estimated a pass-through effect from the exchange rate to import prices of about 80 percent. However, the pass-through to final consumer prices could be less than complete, owing to aggressive pricing-to-market, the (presumably) temporary nature of the depreciation, and the relatively benign inflationary environment.

¹³ Policy issues faced by the fast-growing euro-area economies are analyzed from a cross-country standpoint in the staff's background paper, "Cyclically Advanced Euro-Area Economies: Consequences and Policy Options," SM/00/182.

¹⁴ The staff's estimate of the aggregate output gap for 2000 has been lowered by ¾ of 1 percent since the May WEO.

Box 2. Euro Area: Near-Term Inflation Outlook

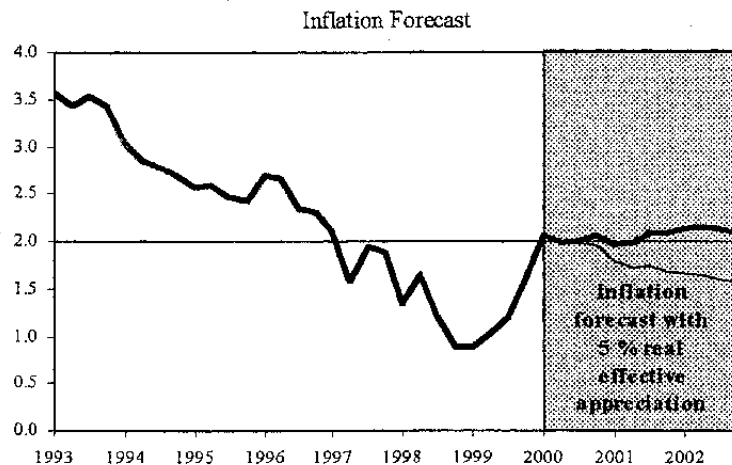
With (monthly) headline inflation near the upper bound of the ECB's definition of price stability, forecasting price developments in the euro area has taken on added importance. Although the outlook for inflation remains positive, a number of recent developments have contributed to a more cautious view of inflationary risks than at the time of the last staff visit at end 1999. Several factors account for the deterioration of the inflation outlook.

First, oil prices are higher than previously forecast. Second, on the strength of private credit demand, growth in broad money has continued beyond the reference value that the ECB considers consistent with medium-term price stability, in spite of rising interest rates. Third, defying most analysts' predictions, the euro has remained weak through mid 2000. Fourth, expectations for euro-area growth in 2000 have bounded ahead: the Consensus Forecast went from 2.7 percent in November 1999 to 3.4 percent in August 2000. Finally, the external environment has improved considerably. The world growth rate for 2000 has now been revised upwards to 4¾ percent from 4¼ percent in May 2000 WEO.

The staff estimated a VAR model for the euro area over 1980Q1-2000Q1, and used it to make dynamic projections for inflation over 2000Q2-2003Q4. The specification models the growth of money, prices, GDP, and interest rates, with the rates of change on the price of oil and the real effective exchange rate given exogenously. Two scenarios are presented for the real effective exchange rate. In the baseline, it is assumed that the real effective exchange rate remains unchanged throughout the forecast period. In the second scenario, a 5 percent real effective appreciation is assumed to take place over 2000-01. The latest WEO assumption on future oil prices is used in all projections, and the assumed interest rate path reflects forward rates embedded in the yield curve as of August 2000.

The figure shows the projected inflation path in the near term has the heavy line. The model predicts that the headline rate will hover around the 2 percent upper bound of the ECB's reference band for price stability, in the constant real exchange rate scenario. Under the second scenario of a modest appreciation of the euro, the inflation rate is projected to fall by about ¼ of 1 percent in 2001 (as shown by the thinner line in the figure).

In general, these results are in line with various studies that have examined the economic effects of a change in the external value of the euro. They should nonetheless be interpreted with caution, in particular because the model may overplay the role of money in the short run, while it ignores the wage moderation trend prevalent in the euro area, as well as the effect of deregulation and discretionary indirect tax cuts. This may explain, in part, why the model's projections differ from the WEO inflation forecasts, which are a weighted average of national inflation rates.



15. **The staff commented that policy appeared to have been strongly influenced by the external shocks and would need recalibrating as the impact of these shocks waned.** In its view, the factors that had sped up the pace of the euro area's recovery and the buildup of cost pressures were in time likely either to dissipate (e.g., the buoyancy of the United States' economy and the surge in oil prices) or to reverse (e.g., the depreciation of the euro). A turnaround of the external impulses would call for a flexible response on the part of the ECB and a more accommodating monetary stance than would otherwise be required.

16. **In reply, the ECB representatives stressed that the institution's monetary framework was by construction symmetric and prescribed responses in either direction as the balance of inflation risks shifted.** Policy decisions had been symmetric in the past and there was no reason to think that they would cease to be so in the future. Changes in the external value of the euro would—as in the past—affect policymaking only to the extent that they impinged on medium-term price stability and not because the exchange rate was a direct policy objective of the ECB. The mission did not dispute the point,¹⁵ but cautioned that monetary decision making might become more difficult in the future, if—as expected—domestic and external developments called for opposite policy actions. It shared the view, though, that policy should not target the exchange rate per se and that robust growth and sound policies in the euro area would ultimately be reflected in a stronger domestic currency.

17. **The discussions of the reasons behind the protracted weakness of the euro added little to the view developed in the course of the previous staff visit to EU institutions, in part because the exchange rate had firmed up some by mid-June 2000.** Since then, however, the euro has weakened further, to the point that the authorities have recently reiterated their concerns about the disconnect between markets' perceptions and economic fundamentals, and hinted at the possibility of official intervention on the foreign exchange market. The staff's latest assessment based on a saving-investment approach suggests that the undervaluation of the euro is on the order of 10-20 percent in effective terms and 30 percent or more against the U.S. dollar. A host of factors was generally seen at play, most notably the continued appetite for U.S. dollar-denominated assets, reflecting the desire of euro-area investors to rebalance their portfolios in light of higher expected real rates of return in the United States.¹⁶ The staff argued that such a portfolio adjustment would eventually run its

¹⁵ There are issues related to the ECB's "two-pillar" framework and communication strategy, including recurring misreadings of monetary decision making by market participants and ECB watchers. The staff will revisit these issues in the course of a future mission.

¹⁶ In the first quarter of 2000, net foreign purchases of U.S. stocks and bonds were a record US\$134 billion. According to United States Bureau of Economic Analysis, the increase was largely accounted for by an increase in European purchases. Net financial inflows for direct investment in the United States at US\$42 billion were marginally lower than in the last quarter of 1999. From the euro-area side, first-quarter data show a worsening of the current account and an exceptional improvement in the financial account due largely to a one-off transaction in
(continued...)

course, leaving room for the growing current account imbalances to redress the exchange rate. There was agreement that influencing the pace of this adjustment was beyond the reach of monetary policymaking at this stage. Rather, to the extent that the euro's weakness stemmed from structural deficiencies in the euro area, more rapid progress in structural reforms could have a positive impact on investors' perceptions and, thus, on the external value of the currency. In this view—the staff noted—the case for (sterilized) intervention rested mostly on the likelihood of a positive signaling effect.

Euro Area: Balance of Payments.
(In percent of GDP)

	1997	1998	1999	2000Q1
Current account	1.4	0.7	0.4	-0.1
Direct and portfolio investment	-1.3	-3.2	-2.7	-0.7
Other transactions	-0.1	2.5	2.4	0.8

Source: ECB Monthly Bulletin, August 2000.

18. **Turning to some institutional and operational aspects of EMU**, the ECB officials were pleased with the results of the first variable-rate auction format for their refinancing operations, where the chronic overbidding of the past had been resolved without—in their opinion—any loss in the signaling content of the policy rate, at least so far. On financial sector matters, the staff discussed a number of trends apparent in the euro area's markets, including strong competitive pressures and the tendency toward an accelerated consolidation of institutions—albeit mainly along national lines at this stage. Against this background, the staff probed the case for intensified supervisory coordination, for centralized monitoring of market positions, and, over time, for consolidating supervision of the financial institutions that constituted the core of the euro area's financial markets and payment systems.¹⁷ In response, both the Commission and the ECB officials argued that the present decentralized national arrangements were adequate for the task, although Commission officials saw a need for enhanced coordination among the relevant national authorities. In light of the depth and pace of change in euro-area financial structures, these officials were of the view that the present arrangements ought to be kept under regular review. Finally, the ECB representatives reaffirmed their intention to proceed with the publication of official economic forecasts including any for inflation, although the matter had not yet been vetted by the ECB Governing Council. The main concern was how to do so without (in their words) “complicating the communication of monetary policy decisions within the ECB's monetary strategy,” which in the staff's view meant leaving the erroneous impression that the ECB was shifting to an inflation targeting framework.

foreign direct investment. Net portfolio outflows were also affected by this transaction and reached €181 billion in the first quarter, almost three times their rate one year earlier.

¹⁷ The staff's suggestion was motivated by the forthcoming companion paper, “Euro-Area Banking at the Crossroads.”

C. Fiscal Policies

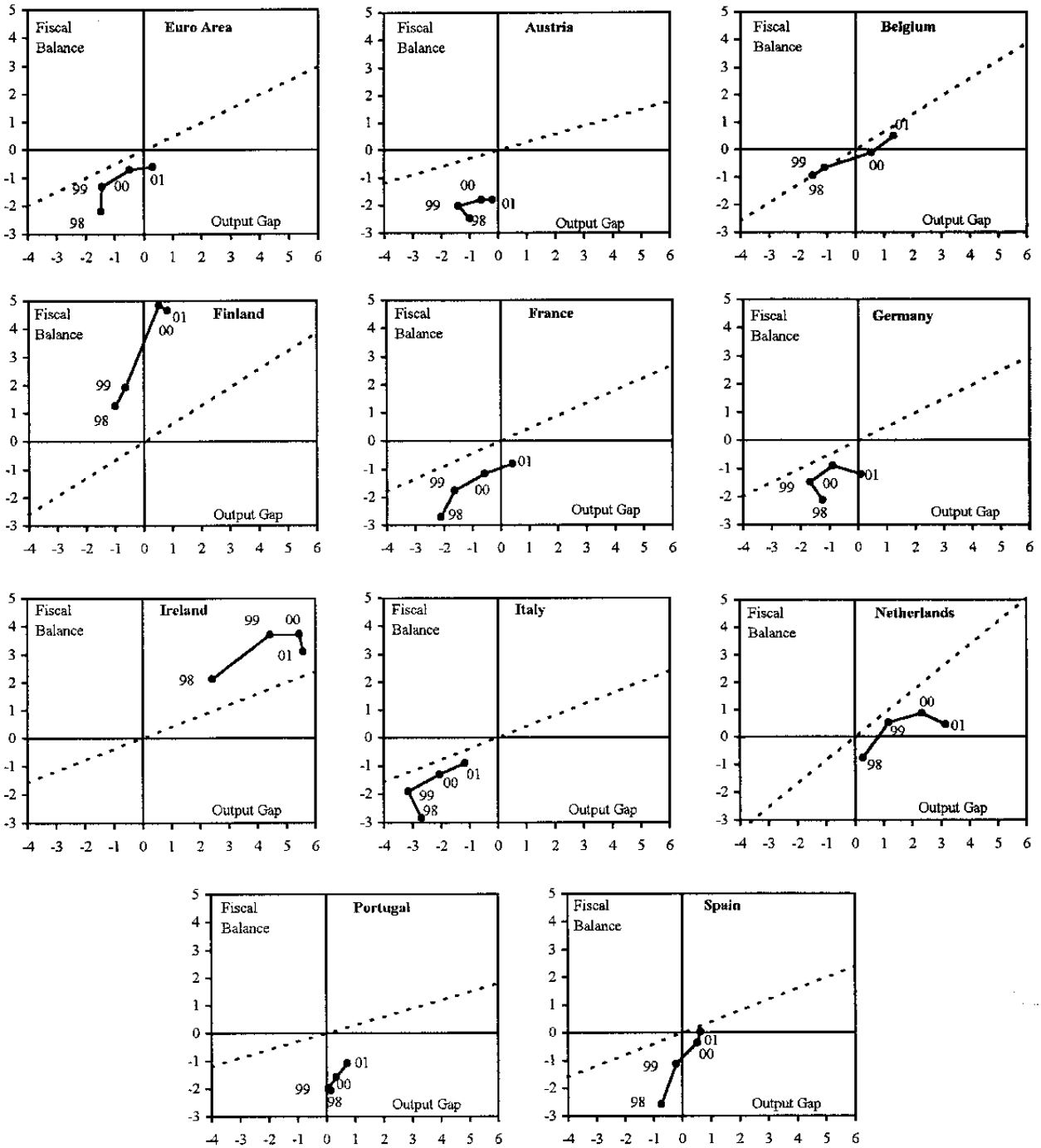
19. **Fiscal policies were viewed as facing a threefold requirement.¹⁸ First, they should avoid being pro-cyclical and instead use the recovery to achieve lasting consolidation.** Officials noted that significant progress had been made in reducing deficits, and that there was reason to expect this progress to continue. Indeed, some countries had established significant surpluses. Nonetheless, a number of euro-area countries were using cyclically buoyant revenues to reduce tax burdens (or, in some cases, increase government spending) rather than to hasten fiscal consolidation. As a result, fiscal consolidation in the area as a whole was not keeping up with the expansion (Figure 3 and Box 3)—a pattern that concerned officials at both the Commission and the ECB. Admittedly, the staff noted, the discretionary easing in 2000-01 remained moderate in the aggregate and was projected to give way to further consolidation in later years—in which case, it would not materially upset the current policy mix. However, these assessments were contingent on growth assumptions that were low by the standards of past upswings. By those standards, fiscal impulses could become significantly more expansionary as the recovery proceeded if the nominal targets in the Stability Programs were not revised and the expansion gathered as much steam as in the late 1980s.¹⁹ The political reluctance to target surpluses accentuated these concerns. Some national officials countered that the staff's concerns did not make allowance for the likelihood that budgets would overperform, partly because they had been premised on cautious assumptions. In reply, the mission noted that the experience to date suggested that better-than-expected outturns had translated into pressures to cut taxes and increase spending that in the event were (or would likely be) accommodated by sticking close to the pre-set nominal deficit targets.

20. **Second, while fiscal policies should avoid stimulating demand, they should simultaneously seek to reinvigorate supply by cutting taxes.** High tax burdens and marginal rates continued to depress the return to human and physical capital throughout much of the euro area and constrained its productive potential. Moreover, disincentives continued to issue from the interaction of national tax and benefit systems that boosted the reservation wage of the marginal non-employed and stunted participation in the labor force. With a solid

¹⁸ The Commission's view on these matters is in "Public Finances in EMU – 2000," Report of the Directorate General for Economic and Financial Affairs, European Commission, May 2000.

¹⁹ If growth in 2001-03 averaged the same as in 1988-90, adherence to the nominal deficit targets in the stability programs would lead to a deterioration in the (implied) structural position of the euro area as a whole on the order of 2 percent of aggregate GDP. The latest stability programs and staff's normative scenarios are presented in the staff report and accompanying background paper issued in March, 2000 (SM/00/42 and SM/0048) and posted on the IMF external web site.

Figure 3. Euro Area: Fiscal Balances and Output Gaps, 1998-2001. 1/



Sources: IMF, September 2000 World Economic Outlook; European Commission.

1/ Fiscal balances in percent of GDP, excluding 3G-phone license receipts. A positive output gap means that output exceeds potential. Positions on the dotted lines are in structural balance, with the slope of the lines reflecting estimates of the sensitivity of budgets with respect to changes in output gaps. Hence, countries' fiscal positions are the stronger the higher they are in relation to the dotted lines, and the more cyclically neutral the more they evolve in parallel with the dotted lines.

Box 3. Euro Area: Revenues from the Allocation of Third-Generation Mobile Phone Licenses

The allocation of third-generation (or 3G), broad-band mobile telecommunications licenses is scheduled to be completed by the end of 2001. In selecting an allocation method, European governments have opted for either a simple auction, a "beauty contest" format—whereby regulators review business plans and the quality of existing services to select which companies will be offered the opportunity to buy a license for a flat fee—or some combination of the two. So far, the process has been completed in four euro-area countries. While the beauty contest approach in Spain and Finland resulted in minor revenue gains for the national treasuries, auctions in the United Kingdom, Germany, and the Netherlands yielded substantial windfalls. The allocation process in France and Italy is also expected to yield sizable amounts of resources.

Euro Area: Third Generation Mobile Telephone Licenses

Country	Process	Amount to be raised 1/		Stage of the process
		EUR billions	Percent of GDP	
Euro area	...	100.1	1.6	...
Germany	auction	44.0	2.5	completed
France	beauty contest	20.0	1.3	set for 2001
Italy	combination	30.0	2.6	set for Fall 2000
Spain	beauty contest	0.5	0.1	completed
Netherlands	auction	2.7	0.9	completed
Belgium	auction	1.5	0.5	set for end-2000
Finland	beauty contest	0.0	0.0	completed
Austria	auction	1.0	0.5	set for Fall 2000
Portugal	combination	0.4	0.4	set for Fall 2000
Ireland	beauty contest	...	...	set for Fall 2000
Memorandum Item				
U.K.	auction	36.5	2.5	completed

Source: staff estimates.

1/ Estimates for countries that have not completed the process are from press accounts.

How these funds are recorded in the fiscal accounts has implications for the interpretation of reported fiscal data and the assessment of underlying fiscal positions.

Eurostat, the EU statistical institution, has recommended a common treatment for EU member states in recording the sales of mobile telephone licenses. The transaction should be treated as the disposition of a non-financial asset and the sale proceeds should be included "above the line" in general government revenues at the time the license is awarded, with an associated improvement in the actual budgetary position. (In special situations characteristics of the contract may allow the transaction to be viewed as a rent for the use of a non-financial asset, and thus recorded over the lifetime of the license. In this case, the effect on the budget would be spread throughout the duration of the contract.)

Although Eurostat's proposal is in line with the current version of *A Manual on Government Finance Statistics* (IMF, 1986) and its handling of similar transactions (e.g. privatization receipts), the statistical convention of recording exceptional revenue gains "above the line" has often been regarded as unsatisfactory for fiscal analysis. Indeed, fiscal accounts compiled by the IMF staff increasingly record privatization receipts as an element of deficit financing.

Receipts from the sale of licenses (e.g., broadcast or phone licenses, fishing or mining rights, emission rights, landing rights, or Internet domain names), proceeds from long-term lease contracts, or the outright sale of government assets have characteristics that warrant differentiating them from other government revenues in the design and assessment of fiscal policy. In particular, these receipts represent one-off resources which should not be counted upon to support the fiscal position permanently. Moreover, their lumpy and uncertain nature can distort the analysis of the underlying deficit and provide a misleading view of the sustainability of the fiscal position. These considerations suggest that it would be preferable to treat these proceeds as a "below the line" financing item in fiscal accounts. At a minimum, the receipts from the sale of 3G-phone licenses should be netted out in the calculation of structural balances and fiscal impulses.

upturn now seemingly underway, alleviating these disincentives was becoming more and more important. A particular challenge—highlighted by the Lisbon summit—was to begin to raise labor participation rates after decades of policies headed in the opposite direction. To that end, tax reductions ought to redress the most distortionary marginal effective rates with a view to sharpening incentives to work, and ideally complement comprehensive benefit reforms aimed at correcting high average replacement rates of incomes in and out of work.²⁰ Corporate tax relief in selected cases would also help to safeguard the euro area as a desirable business location and foster capital formation. Overall, officials viewed countries' tax reform plans as reasonably ambitious and supply-oriented, as evidenced in many cases by the emphasis on income tax cuts. The main concern was that tax cuts seemed to be outrunning the will to cut expenditures.

21. The third requirement facing fiscal policymakers was to consolidate expenditures, with a view both to aligning tax cuts with the fiscal deficit targets and to strengthening incentives and resource allocation through public spending reforms. With higher disposable income having an expansionary impact in the short run, officials at EU institutions and the mission shared the view that tax reductions required matching—and permanent—expenditure cuts in order both to contain the stimulus to aggregate demand in the current cyclical setting and to ensure their durability. In Commission parlance, with deficits approaching balance, attention now needed to be trained as much on the “quality” (i.e., the tax and expenditure composition) as on the “quantity” (i.e., deficit dimension) of the adjustment. In this vein, tax cuts needed to be carefully limited to those that had the most beneficial supply effects—e.g., reductions in income and labor taxes rather than in consumption taxes. Correspondingly, expenditure cuts should focus on sharpening the incentives embedded in the transfer systems and on increasing efficiency in the provision of public services, e.g., through better use of technology. Experience in this regard was recognized as mixed, with only limited progress throughout the euro area on structural rather than across-the-board cuts in public spending—Germany in 2000, for example, providing a welcome exception—and tax cuts running as a rule ahead of meaningful expenditure curtailment.

22. Opinions differed on how fiscal policymaking could best implement a strategy built around these three requirements. At one end, the Commission, the ECB, and Fund staff look at budgetary developments in cyclically adjusted terms. From that perspective, recent budgetary developments in several euro-area countries were clearly of some concern, although opinions varied as to their significance (in part, as a result of underlying methodological differences). The focus on structural balances is often criticized, however,

²⁰ A discussion of the positive labor-supply effects of fiscal reform is in Disney, Richard: “The Impact of Tax and Welfare Policies on Employment and Unemployment in OECD Countries,” July 2000, forthcoming IMF Working Paper. See also the Selected Issues papers for the 2000 Article IV consultation with Italy, SM/00/94, and for the 1999 Article IV consultation with Finland, SM/99/230.

particularly by national officials, on the grounds that the estimates are artificial constructs unintelligible to the general public; vary widely across analysts; are sensitive to the choice of underlying methodologies; and are inherently opaque and susceptible to manipulation. In this view, structural budgetary objectives were clearly inferior to the nominal targets featured in the Stability and Growth Pact (SGP), which had the advantage of being transparent (because they did not require potentially controversial cyclical adjustments), credible (because they were readily ascertainable), and not necessarily inconsistent with fiscal prudence (because they could be set to attain any desired structural position). While acknowledging many of these points, the mission noted that none of this spoke to the basic objection, namely that nominal targets to be achieved independently of activity risked condoning fiscal profligacy in good times and austerity in bad—the opposite of what would be called for in a well-functioning monetary union. Thus, while the simplicity of nominal targets had avowedly been useful during the period of necessary fiscal consolidation, it risked becoming increasingly costly in the years ahead, exacerbating cyclical developments and complicating the conduct of monetary policy. What was needed was the political willingness to view the fiscal targets as contingent on the stated growth assumptions and to interpret fiscal requirements not as applying “year-by-year” but “over-the-cycle,” i.e., as surpluses in good times, deficits in bad, and balance on average (Box 4).

23. **On the whole, a reorientation of the fiscal framework toward promoting sustained fiscal discipline and a sustained expansion was recognized at EU institutions as desirable but politically daunting.** Securing surpluses in good times would require convincing national constituencies of the virtues of making contingency provisions in the public finances. The staff thought that the upcoming demographic shock offered a compelling argument for doing so, and noted that the establishment of reserve funds dedicated to pre-funding future pension liabilities had proved in some cases a politically expedient means to safeguard revenue windfalls. Yet, it acknowledged, mobilizing popular support for structurally balanced budgetary positions as the linchpin of the medium-term strategy represented a core issue for euro-area policymakers—a task that had successfully been accomplished elsewhere. The general success in earmarking the revenues from the sale of broad-band phone licenses for debt reduction gave hope, however, that such support could indeed be garnered. Looking ahead, the staff thought that a reorientation of the fiscal framework toward emphasis on structural balance would have manageable consequences for future budgets: maintaining structural balance for the euro area as a whole in 2001-03 would call (under current WEO growth projections) for sustaining an aggregate nominal surplus on the order of $\frac{1}{4}$ of 1 percent over this period, or a cumulative improvement of about $1\frac{3}{4}$ percent of aggregate GDP in the area’s underlying fiscal position, spread over three years. Were this goal to be twinned with the objective of a 2 percent of GDP reduction in the aggregate tax burden (from

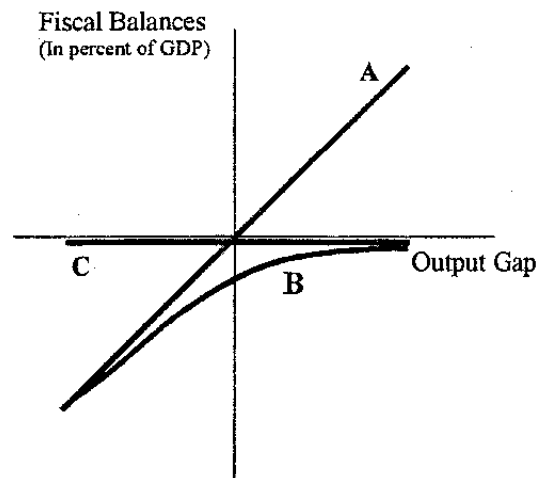
Box 4. Euro Area: Is the Stability and Growth Pact EMU-Friendly?

Institutional History. A key provision of the Maastricht Treaty, which launched the process toward EMU, required each Member to reduce its fiscal deficit to no more than three percent of GDP by the time decisions were to be made on membership. The Stability and Growth Pact (SGP) transformed this membership criterion into operational guidelines on the conduct of fiscal policy under EMU. The key provisions enshrine the three-percent ceiling, with breaches triggering a range of moral and financial penalties; specify that members should achieve balance or a small surplus over the medium term; and require members to submit annual plans (the Stability Plans) describing how they intend to achieve these objectives.

Fiscal Requirements of a Smoothly Functioning Monetary Union. It is widely agreed that the loss of monetary sovereignty embedded in monetary union puts a premium on allowing full play to the automatic stabilizers if the union is to deal successfully with shocks. This is all the more so if labor markets are not especially fluid and there is no centralized mechanism for fiscal transfers as in the United States. Absent such stabilizers, all of the stabilization burden associated with symmetric (common) shocks would fall on monetary policy and prompt potentially damaging fluctuations in interest and exchange rates; and asymmetric shocks would prompt undesirable cyclical tensions within the union, straining its value.

Strengths and Weaknesses of the SGP. Through their focus on achieving specific nominal deficit targets, the SGP—and the Maastricht Treaty before it—clearly effected a sea change in the management of the public finances in continental Europe. Moreover, the SGP allows for and supports systematic use of the automatic stabilizers as is clear from the gap between the medium-term norm of balance or surplus and the three-percent deficit boundary and further suggested by the clarification that “the time frame for interpreting the medium term would be the length of the business cycle.” In that vein, the overwhelming majority of analysts (including the EU Commission, the ECB, the OECD, and the IMF) strongly support the view that assessments of conformity with the medium-term norm should be based on “structural” or “cyclically adjusted” fiscal balances. In practice, however, the stability plans have been set out and assessed in good part simply on the basis of performance relative to the specified nominal targets—an inherently pro-cyclical exercise, given the vagaries of output over time. Moreover, governments with strong traditions of nominal deficit targeting have been circumspect—unless essentially forced to do so by economic circumstances—in setting out near-term targets that moved decisively toward balance, let alone surplus. This is hardly surprising given the political pressures such targets would prompt, but it also implies that fiscal policies have a bias toward being pro-cyclical—a bias that could well worsen as countries move toward high rates of resource utilization and the corresponding requirement for cyclical fiscal surpluses.

What does the future hold? Clearly, the framework is not per se the problem. It can allow full play for the stabilizers (as reflected in the hypothetical case A in the diagram). In practice, however, the framework has accepted outcomes that allow less than full play, and there are reasons to be concerned that the problem will worsen as a result of political resistance to targeting surpluses (case B). If so, the framework would in practice be pro-cyclical (in the measure of the vertical distance between A and B). However, present practice partly reflects a process of transition from the Maastricht three-percent entry requirement to a medium-term balance target. It is conceivable that, once achieved, the latter might be viewed by some as a year-by-year requirement, in which case the stabilizers would be systematically offset (case C). How the framework will work out in practice will very much depend upon how effective EU institutions will be in persuading the wider public of the need for EMU-friendly fiscal policies and in pressing national authorities to follow through.



47 percent of area-wide GDP in 2000 to 45 percent in 2003), real public spending would have to grow in real terms by about $\frac{1}{2}$ of 1 percent each year less than currently projected by staff on the basis of present policies.²¹

D. Structural Policies

24. **Structural policy changes were viewed as essential to strengthening the supply side of the euro-area economy, both on their own and as complements to tax and expenditure policies (Box 5).** The euro area's record of short upswings and prolonged downturns provided context for the concern that without comprehensive structural improvements the targets of lasting growth, higher employment, and deeper social inclusion could not be achieved. In previous cyclical episodes, surges in demand had prematurely met the hurdle of a productive potential shackled by inflexible labor and product markets, and growth had been choked off. Indeed, policies had often added to demand pressures without commensurate efforts to provide the needed supply-side support and raise the headroom for growth. There was agreement that—past progress notwithstanding—a renewed resolve to enhance the euro area's capacity was the key to a durable expansion, especially as tax reductions disconnected from broader reforms in public spending posed the risk that demand might again outstrip supply ahead of time. In a purely cyclical dimension, extending the envelope within which employment and growth could develop without creating inflationary pressures was widely recognized as particularly urgent in those countries fast approaching capacity constraints, since this would ease the need for restrictive macroeconomic policies for the area as a whole, contributing to growth in other economies.

25. **As regards labor markets, the staff noted that the policy requirements would call for a considerable change in mind-set.** The past decade had seen a constructive shift in the focus of policies from curbing labor supply and participation to increasing the demand for labor, notably through targeted reductions in social charges at low wages. The need was now to promote the effective supply of, rather than the demand for, labor. Abstracting from a few noteworthy exceptions (and the potential impact of tax reforms underway), structural policies so far had made only tentative inroads on this front. According to the mission, institutional reforms to facilitate part-time or temporary employment, as well as vocational training and social inclusion, had paid off but might also have reached their limits. What was needed now—the mission claimed—was the political resolve to increase labor supply by tightening eligibility for benefits and sharpening incentives for job search. More generally, strengthening the resilience of the euro area's economy necessitated a greater role for the price mechanism in labor markets, so as to foster a more efficient use of human resources and relieve wage/productivity mismatches.

²¹ Table 1 implies that real public spending would grow on average at an annual rate of about $1\frac{3}{4}$ percent over 2000-03.

Box 5. Euro Area: National Dimensions of Economic Policies

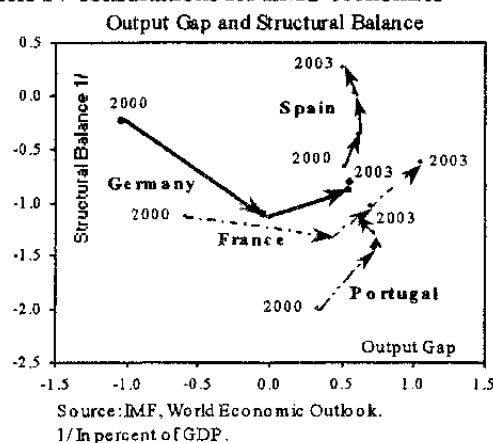
This report's emphasis on area-wide policy issues should not divert attention from the fact that fiscal and structural policies differ widely across euro-area countries. Besides deep-seated institutional and historical factors, this variety reflects differences in cyclical positions and policy priorities, as the table below suggests.

Summary of Macroeconomic Indicators

	Output Gap in 2000 (In percent of potential GDP)	Inflation Rate July 2000 (In percent)	Structural Fiscal Balance	
			1999 (In percent)	Change, 1999-01 (In percent)
Above Average				
	Ireland (5.4)	Ireland (5.9)	Finland (2.3)	Finland (1.9)
	Netherlands (2.3)	Spain (3.7)	Ireland (2.0)	Portugal (0.5)
		Portugal (3.3)	Belgium (0.1)	Spain (0.6)
		Belgium (3.1)		
Average				
	Belgium (0.5)	Finland (2.9)	France (-0.7)	Italy (0.0)
	Finland (0.5)	Netherlands (2.8)	Germany (-0.6)	Belgium (-0.4)
	Spain (0.5)	Italy (2.6)	Italy (-0.3)	Austria (-0.3)
	Portugal (0.3)		Netherlands (-0.1)	
Below Average				
	Italy (-2.0)	Germany (2.0)	Portugal (-2.0)	Netherlands (-1.2)
	Germany (-0.9)	France (2.0)	Austria (-1.2)	Ireland (-1.1)
	Austria (-0.6)	Austria (2.0)	Spain (-1.0)	Germany (-0.7)
	France (-0.6)			France (-0.7)

This diversity reflects a host of factors which result in rather different policy emphases across countries, even if common threads remain clear. This is well illustrated by the four Article IV consultations for EMU economies (France, Germany, Portugal, and Spain) also slated for Board discussion in late October.

Differences in prospective fiscal performance are apparent from the graph on the right. *France* and *Germany* envisage some deterioration of their underlying fiscal positions in the near term, which is fully reversed by 2002 only in France's budgetary plans. The deterioration is much more marked for Germany and reflects the front-loading of its tax reform. By contrast, cyclically (more) advanced *Portugal* and *Spain* are committed to further consolidation throughout the medium term.



While all four countries pursue fiscal strategies centered on expenditure reform and control, they differ in the extent to which expenditure savings have been (or will be) mobilized. *France* experienced in 1999 slippages from pre-set norms for public expenditure growth which were not clawed back in the 2000 budget. Lack of progress so far in reforming the civil service, and the pension and healthcare systems pose a threat to prospective expenditure goals. *Germany*, by contrast, has implemented targeted spending cuts focused on social transfers. Overall, they are expected to yield a reduction in the expenditure ratio of some 1 percentage point per year over the medium term. A wide-ranging pension reform is also planned. In *Spain*, spending control has been broadly effective at both the State and local level, although at the cost of compressed public investment (which is slated to increase in the future). Reform of the pension system is however incomplete. On the whole, fiscal plans stress the need for further reducing growth of primary spending, including the public sector's wage bill. *Portugal* too is aiming at slowing growth of real primary expenditure but the targeted reduction in the expenditure ratio through 2003 remains less ambitious than in the rest of the euro area. The unfinished agenda

	Fiscal Ratios			
	Revenues		Expenditures	
	1999	Change 2000-03	1999	Change 2000-03
	(in percent of GDP)			
Germany	47.1	-1.2	48.6	-1.5
France	52.0	-1.4	53.7	-2.9
Spain	40.0	-0.2	41.1	-1.2
Portugal	44.7	-0.4	46.6	-1.1

Source: WEO.

1/ Do not include mobile telephone license revenues.

Box 5. Euro Area: National Dimensions of Economic Policies (Cont'd)

involves tackling the burgeoning public sector wage bill; controlling healthcare spending, and reducing subsidies to state enterprises. Some first steps have been taken in pension reform.

The countries also differ in the extent to which expenditure control has been (or will be) used to finance tax reforms—which figure most prominently in the fiscal agenda of the two largest economies. In *France*, the 2000 revenue overperformance was allocated mostly to tax cuts (the one for the value added tax being the largest), but there appears to be increasing consideration of the supply-side effects of prospective tax changes. Past reform efforts have focused on reducing social security contributions at the low end of the wage scale. A multi-year plan to reduce the tax burden has recently been announced, including a reform of personal income taxation and the elimination of a surtax on corporate income. In *Germany*, a significant reform in direct taxation is underway, encompassing a medium-term, across-the-board reduction in personal income taxes and a deep reform in corporate taxation. *Portugal* does not plan any significant reduction in the tax burden (in percent of GDP) for the coming years, but is taking steps to increase the equity and efficiency of the tax system. Personal income tax reform is to take effect in 2001, but it is anticipated to be broadly revenue neutral; some streamlining of tax expenditures is planned in corporate taxation, and a reduction in the corporate tax rate is under consideration. *Spain* is planning a tax reform for 2002-03, in all likelihood aimed at reducing marginal tax rates across the board, but no details are as yet available.

France, Germany, Portugal, and Spain also differ significantly in their efforts to pursue structural reforms. In the product markets, *France* has generally been slow in the adoption of EU directives for the network sector, while *Germany* has been a pace-setter in deregulation and liberalization in these sectors. *Spain* has recently implemented steps to increase competition in some key sectors (i.e., telecom, electricity, gas, retail sales, and pharmaceuticals). *Portugal* has a record of steady implementation of EU directives, but there remains scope for further liberalization and privatization.

Progress in Structural Reform

	France	Germany	Portugal	Spain
Overall progress in implementing EU policy guidelines 2/	Some Progress	Progress	Some Progress	Progress
Product and service markets				
Improve transposition of internal market legislation	X		X	
Strengthen competition policy	X		X	X
Ease administrative burden on enterprises	X	X	X	X
Liberalize public procurement	X	X		
Promote technological innovation			X	
Reduce state aid	X	X	X	X
Capital markets				
Facilitate venture capital	X	X	X	X
Stimulate portfolio diversification by institutional investors	X			
Labor markets				
Ease tax pressure on labor	X	X		
Reinforce active labor market policies		X	X	X
Facilitate labor mobility	X	X	X	X

Source: *Annual Report on Structural Reforms 2000*, Economic Policy Committee, March 2000.

1/ The X's denote the need to further implement the specific reform recommendations.

2/ The table reproduces the qualitative assessment of the implementation of the Broad Economic Guidelines for 1999, as contained in section 4 of the EPC's Report.

Other countries were ranked as having shown: "very good progress" (Netherlands); "good progress" (Denmark, Finland, United Kingdom); "some progress" (Belgium, Italy); and "progress" (Austria, Ireland). The Report does not rank the different initial positions.

In the labor markets, the national dimension of policymaking is similarly clear. *France*, which had aggressively pursued policies to stimulate labor demand through targeted reduction in nonwage costs, is increasingly recognizing the need to redress the ways in which the tax and benefit systems interact to make work unrewarding. Some first steps to reduce inactivity traps have been taken. (The recent focus on stimulating labor supply contrasts with an earlier emphasis on promoting work-sharing and heavily subsidized employment programs). *Germany* is following a strategy much more focused on containing labor costs through across-the board wage moderation. No progress has been made (or expected) in tackling the distortions arising from open-ended unemployment assistance. *Spain* embarked in 1997 in a significant reform, whose centerpiece was the introduction of a new permanent contract with lower dismissal costs and lower social charges for new hires. Looking ahead, the highest policy priorities will be attached to fostering part-time work; reducing dismissal costs; and increasing the flexibility in wage bargaining. Finally, *Portugal* enjoys a peculiarly "non-European" labor market, characterized by low unemployment and relatively flexible arrangements. The key challenges there are to deal with the low level of educational attainment to better align skills and job requirements; and the need to increase labor mobility, including by relaxing relatively strict employment protection legislation.

26. **Officials at the Commission agreed on the need to step up reforms of the labor market, but had a more upbeat assessment of the progress so far.** They thought that the Luxembourg process had proved successful in refocusing the debate from policies directed at reducing unemployment to those enhancing job creation and the employability of the non-active labor force. The National Action Plans had, in turn, helped make employment policies more inclusive and transparent at the local level, adding to their political legitimacy.²² Gender issues and, most importantly, the need to re-evaluate the national systems of social protection with a view to fostering labor supply were also being given higher priority, as emphasized in the Lisbon Declaration. They shared the staff's view, though, that progress in revamping the benefit systems remained lackluster.

27. **Product market reforms were also viewed as essential complements to labor market policies to raise the productive potential and set the stage for a durable expansion.** In the view of the Commission staff, progress has been more visible in the transposition of single market legislation and the deregulation of the telecom and electricity sectors; less progress has been made, however, in liberalizing the service sectors, and dismantling the overregulation of some cross-border activities. Financial market integration had progressed markedly with the introduction of the euro and a further impetus was expected with the full implementation by 2005 of the Financial Service Action Plan.²³ There was agreement that further progress in product market reforms and the Lisbon summit's initiatives to promote a knowledge-based society would assist the euro-area economy in benefiting from the full potential offered by new technologies.

IV. INTERNAL SURVEILLANCE PROCESSES AND POLICY COORDINATION

28. **In the discussions on the effectiveness of the EU mechanisms for regional surveillance and policy coordination, officials at the Commission expressed overall satisfaction on how the processes in place were gaining strength and acceptability, but saw room for further improvement.**²⁴ The Commission staff claimed that greater dynamism

²² Updated country-specific recommendations for labor market reforms have been issued in mid-September by ECOFIN based upon an appraisal of National Action Plans by the Commission (see http://europa.eu.int/comm/dgs/employment_social/key_en.htm).

²³ The 2000 International Capital Markets report reviews in detail recent developments in the euro area's financial sector (see <http://www.imf.org>).

²⁴The discussion focused on areas subject to decentralized decision making, on the grounds that supra-national processes, such as those for the formulation of monetary, trade, or EU enlargement policies, involved a different type of group dynamics not institutionalized in a formal coordination mechanism or subject to formal surveillance. The mission's discussions at the Commission on EU trade policies are reported in a forthcoming companion staff report.

(continued...)

in labor and product markets throughout the euro area was in good part due to the steadfast exercise of EU-wide surveillance, the effectiveness of which had been enhanced by the participation of social partners in the policy discussions and the explicit identification of good practices. The mission acknowledged that the modalities for EU surveillance—namely, through the “Cardiff process” for product market issues, the “Luxembourg process” for employment policies, the “Cologne process” for the macroeconomic dialogue among social partners, and the Broad Economic Policy Guidelines—had catalyzed the public debate and were providing a helpful framework for the development of reform policies (aided by the quality technical work by the Commission staff), but suggested that these processes still lacked the clout needed to promote timely implementation of agreed guidelines. In response, the officials at the Commission countered that peer pressure and moral suasion provided a powerful leverage not to be underestimated in the regional political context. They thought, nonetheless, that surveillance would benefit from more concrete, country-specific recommendations, including quantitative targets and a timetable for their achievement, and from the development of structural performance indicators that might sharpen the identification of best practices.

29. **As regards fiscal policies, the Commission and ECOFIN’s annual review of the stability plans and peer pressure within the EFC were generally credited at EU institutions as having provided helpful avenues for fostering budgetary retrenchment, policy coordination, and the spread of best practices.** Looking forward, however, the mission wondered whether current surveillance procedures would be as useful when the policy emphasis shifted to sustaining medium-term targets, restructuring public expenditure, lowering the tax burden, reforming the tax and benefit system, and improving the long-term viability of public pensions and healthcare systems, since these dimensions of fiscal policy were not covered in the stability programs. The Commission officials shared these concerns, but argued that the framework of regional surveillance was likely to evolve toward greater emphasis on the quality of policies. In their judgment, an additional aspect where the surveillance mechanism needed strengthening was its interface with the national budgetary processes, which remained underdeveloped and failed to provide fiscal policymakers with the support of their euro-area peers in the national debates. The mission welcomed in this connection the increasing role of the Euro Group,²⁵ which could establish itself as a forum not only for promoting policy coordination but also for building popular support for needed reforms.

Issues related to the ongoing process of EU enlargement are discussed in the latest WEO (see <http://www.imf.org>).

²⁵ The Euro Group—formerly, the Euro-11—comprises the euro area’s finance ministers and generally meets on the eve of ECOFIN meetings.

30. **Finally, there was agreement that strengthening the statistical base of the euro area called for greater coordination among the producers of economic statistics at the national level.** The ECB has recently released a report highlighting the need to significantly improve the collection of statistical data necessary for the conduct of monetary policy. This is hampered by lack of standardized methods, insufficient sectoral coverage in some cases, staggered publication by the national sources (which undermines the timeliness of aggregate information), and the fact that meaningful euro-area statistics are often not just the sum of data from member states. The report endorses the recent ECOFIN initiative to establish action plans identifying statistical requirements for each member state and for each statistical area.

V. STAFF APPRAISAL

31. The euro area is doing well. The cyclical developments together with the strength of many of the fundamentals—pervasive wage moderation, fiscal positions nearing balance, supportive monetary conditions, and more dynamic labor and product markets—point to well above-potential growth over the next year. Although the external environment is generating conflicting forces that may make for somewhat volatile short-term dynamics, it basically continues to provide helpful support: aggregate real GDP growth will almost surely exceed 3 percent in 2000 and 2001.

32. The longer-term prognosis is more uncertain and not necessarily as reassuring. There is the risk of a sharp reversal of the favorable external shocks that have propelled euro-area growth to well above potential—the surge in world demand and the depreciation of the euro which has directed a large part of that demand to the euro area. More importantly, the cyclical history of the euro area over the past three decades suggests caution: all too often, pro-cyclical, or insufficiently counter-cyclical, policies had interacted with inflexible markets to undermine the upswing and aggravate the downturn. Indeed, longstanding vulnerabilities—linked to the inability of past structural reforms to revitalize the supply side to the extent needed to match an expanding demand—call into question whether the ongoing expansion can be sustained long enough to make a durable dent in the still unacceptably high unemployment rate. These vulnerabilities are masked in upswings but are reflected in the euro area's history of poor adaptability to shocks and less-than-optimally managed recoveries.

33. Arguably, EMU has changed the macroeconomic structure of the euro area, perhaps in profound ways: a rule-based fiscal framework is in place, monetary policy is no longer shaped by domestic considerations in the anchor country, and wage formation at the national level may have become more sensitive to intra-area competitiveness. But the import of these changes has not yet been tested by adversity, and uncertainties as to their scope or permanence caution against complacency. Moreover, despite improved public finances in the area as a whole, recent fiscal outturns suggest that tendencies toward pro-cyclical fiscal policies are still at play. In fact, the Stability and Growth Pact focus on nominal balances may again leave the door open for fiscal relaxation in upswings. In previous recoveries, this pro-cyclicality—or, at a minimum, an insufficiently counter-cyclical fiscal stance—compounded

inflationary pressures in a setting of widespread structural rigidities, eventually triggering a monetary contraction and precipitating an early downturn.

34. The pressing challenge, therefore—from a regional as well as a global standpoint—is to implement policies that will both sustain the expansion and make it more resilient. The policy requirements are widely accepted in principle: safeguarding price stability, avoiding fiscal pro-cyclicality, and strengthening the supply side through tax, expenditure and structural reforms. Yet, in some instances, actual policymaking falls short of these requirements, which are needed to ensure long-lasting growth and realize the Lisbon summit's hope that the euro area will become a high-performing economy. Meeting these goals is critical to re-balance the currently uneven pattern of world's growth—a task to which the euro area must eventually contribute, lest the slack created by a potential slowdown in the United States dims global prospects.

35. Cautious monetary management has preserved price stability in a volatile environment. The oil price shock and the depreciation of the euro have been unexpectedly large and protracted, and on balance have warranted a rise in policy rates to forestall second-round effects and anchor inflationary expectations. In fact, further steps toward a less accommodative stance could be in order as the cycle matures, if the euro remains as weak—and oil prices as high—as anticipated by market participants and the evolution of core inflation points to second-round effects becoming more significant than anticipated.

36. However, as the effects of the external factors that have contributed to a firming up of the recovery and the buildup of cost pressures—the buoyancy of the United States' economy, the hike in energy prices, and the weakness of the euro—dissipate or reverse in time, price pressures and GDP growth will ease, calling for interest rates to be recalibrated downward. Thus, the symmetric approach that has so far shaped policy should continue to be followed, with changes in interest rates in either direction as the balance of risks to medium-term price stability—usefully proxied by the evolution of core inflation—shifts.

37. In this perspective, movements in the exchange rate should not be a direct policy concern but be factored into monetary decision making only to the extent that they pose a threat to medium-term price stability. Regarding the level of the euro, the misalignment both vis-à-vis the United States dollar and in effective terms remains large; underlying portfolio adjustments, which are putting downward pressure on the exchange rate, will eventually run their course and this will lead to an exchange rate correction. Influencing the pace of this adjustment remains at this stage more a matter of receptiveness to structural reforms than of monetary policymaking.

38. In the fiscal domain, the key challenge is to avoid pro-cyclical policies while implementing supply-enhancing tax cuts. Meeting this challenge requires closely integrated tax and expenditure policies: tax reductions should not run ahead of offsetting, permanent cuts in public spending in order to contain the short-run demand stimulus and foster a lasting release of resources to the private sector. In addition, tax cuts should be carefully prioritized to

redress the most distorted incentives to labor force participation and capital formation, and be part of comprehensive benefit reforms aimed at correcting high average replacement rates of incomes in and out of work. At the present juncture, the appetite for tax cuts appears stronger than the stomach for expenditure reductions, so that fiscal policies are pro-cyclical now in the aggregate, and risk becoming increasingly so if fiscal surpluses do not grow to be politically more acceptable, particularly in the largest countries.

39. Achieving that outcome would seem to require de-emphasizing the importance of achieving nominal budgetary targets and reaffirming the need to evaluate fiscal positions—in the first instance—in relation to the cycle. A general acceptance of such a fiscal framework would make it more EMU-friendly. This is needed from the standpoint of sustaining the present expansion but also, institutionally, so as to impart a proper, symmetric role to the automatic stabilizers in the fiscally decentralized monetary union. The simplest way of doing so within the letter of the Stability and Growth Pact would be to accept that the its goal of fiscal positions “close to balance or surplus over the medium term” applies over-the-cycle rather than on a year-by-year basis, and that targeted deficit paths are conditioned on the underlying GDP growth assumptions. Convincing national constituencies of the virtues of securing surpluses in good times remains a daunting, but unavoidable, task facing euro-area policymakers.

40. A helpful reformulation of the fiscal paradigm should also encompass tax and expenditure objectives. Besides attaining the appropriate budgetary position, a restructuring of taxes and public expenditure is needed to effectively bolster the growth potential of the euro area and to tackle in many countries the growing imbalances in the public pension and healthcare systems. In this connection, tax cuts need to be carefully targeted so as to have the most beneficial supply effects; and expenditure reductions should focus on sharpening the incentives to seek work embedded in the transfer system, and on increasing efficiency in the provision of public services.

41. Structural policies are critical to shoring up the euro area’s longer-term growth prospects. Much has been achieved over the last decade, but the often-mentioned skeptical assessment by market participants of progress to date bears witness to the fact that in many instances reform efforts have not been commensurate to the need. Unless the groundwork is laid now for further revitalizing the euro area’s productive potential, there is the risk that once again demand will outstrip supply, and capacity constraints will choke off the expansion.

42. In the labor markets, more remains to be done to strengthen effective labor supply. To this end, the recommendations of the Employment Guidelines should be implemented resolutely, in particular reforms aimed at keeping older workers in employment and improving the quality of the labor force through vocational training for the young and the inexperienced. Beyond that, there is the urgent need to muster the political resolve to revamp welfare systems with a view to tightening eligibility for benefits and sharpening the incentive for job search, and to foster more market-oriented wage determination mechanisms.

43. In the product markets, by all accounts there is still ample room for promoting competition in some network sectors and removing administrative barriers to business formation and some cross-border activities. Regarding the financial sector, it will be important to review the adequacy of existing supervisory arrangements once the ongoing consolidation drive finally transcends national confines, and truly pan-European institutions emerge.

44. The processes for EU internal surveillance have proved helpful but could nonetheless be reinforced. The effectiveness of regional surveillance over structural reforms could benefit from the acceptance at the political level of greater candor in the Commission's assessments. EU surveillance over fiscal policies should continue through the annual appraisal by the ECOFIN Council of the stability programs, preferably with greater emphasis on the quality of adjustment, and will be enhanced by the increasing role of the Euro Group as a forum for peer review and policy coordination in the euro area, and as a catalyst for popular support of needed reforms. Finally, the call to strengthen the euro area's statistical base in the dimensions most critical for monetary decision making should be heeded without delay.

45. 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. An interim staff report will be issued for information of the Executive Board prior to the 2001 Spring Meetings.

Euro Area: Economic Indicators
(Annual percentage change)

	1992	1993	1994	1995	1996	1997	1998	1999	2000 1/	2001 1/
Real Domestic Demand	1.5	-2.3	2.1	2.1	1.0	1.9	3.5	3.0	3.0	3.3
Public consumption	3.2	1.4	1.0	0.5	1.6	0.9	1.2	1.3	1.4	1.3
Private consumption	2.0	-1.0	1.4	1.8	1.6	1.6	3.0	2.8	2.9	3.2
Gross fixed investment	0.2	-6.8	2.3	3.4	1.6	2.4	5.3	5.3	5.1	4.9
Final domestic demand	1.9	-1.7	1.5	1.8	1.6	1.7	3.1	3.0	3.1	3.2
Stockbuilding 2/	-0.3	-0.6	0.6	0.3	-0.5	0.2	0.4	0.0	0.0	0.1
External balance 2/	0.0	1.5	0.3	0.3	0.4	0.5	-0.6	-0.5	0.5	0.2
Exports of goods and services 3/	3.9	1.4	9.1	8.3	4.4	10.3	6.8	4.2	10.0	7.7
Imports of goods and services 3/	3.8	-5.3	8.2	7.9	2.8	9.0	9.8	6.3	8.8	7.6
Real GDP	1.5	-0.8	2.4	2.3	1.5	2.3	2.7	2.4	3.5	3.4
Resource Utilization										
Potential GDP	2.4	2.2	2.0	2.0	2.1	2.2	2.3	2.4	2.5	2.5
Output gap (% of potential)	0.9	-2.1	-1.7	-1.4	-2.0	-1.9	-1.5	-1.4	-0.5	0.3
Employment	-1.4	-2.1	-0.3	1.3	0.5	0.9	2.0	1.9	1.9	1.4
Unemployment rate (% of labor force) 4/	9.1	10.9	11.6	11.3	11.5	11.5	10.8	9.9	9.0	8.3
Prices and Wages										
GDP deflator	4.3	3.5	2.7	3.0	2.3	1.6	1.7	1.3	1.4	1.7
Consumer prices 5/	3.6	3.2	2.7	2.5	2.2	1.6	1.1	1.2	2.1	1.7
Manufacturing										
Hourly labor costs	7.3	5.5	3.1	3.6	3.9	2.8	1.6	2.7	3.1	3.1
Productivity	3.7	2.3	8.0	4.0	3.8	4.8	2.6	2.2	3.0	2.5
Unit labor costs	3.5	3.2	-4.5	-0.4	0.1	-1.9	-1.0	0.6	0.1	0.5
Financial Indicators										
Fiscal balance 6/										
Central government	-4.3	-5.2	-4.6	-4.2	-3.8	-2.4	-2.2	-1.5	-0.4	-0.7
General government	-4.7	-5.7	-5.2	-5.2	-4.4	-2.6	-2.2	-1.3	0.1	-0.4
Structural balance	-5.3	-4.5	-4.2	-4.3	-3.2	-1.4	-1.3	-0.5	-0.4	-0.8
Interest rates (in percent)										
Short-term	11.1	8.6	6.3	6.1	4.6	4.1	3.9	2.9	4.4	5.1
Long-term	9.8	8.1	8.2	8.5	7.1	5.9	4.7	4.6	5.4	5.3
Broad money 7/	7.1	6.3	2.3	5.7	4.0	4.1	4.6	6.1	5.4	...
Real effective exchange rate based on normalized ULC (1990=100)	100.1	97.9	95.8	100.2	100.3	89.2	85.7	80.2	71.9	71.1
Nominal effective exchange rate (1990=100)	100.7	97.0	95.3	99.5	99.7	90.9	90.8	86.7	79.2	79.0
External Sector 6/										
Current account balance	-0.8	0.5	0.3	0.8	1.2	1.4	0.7	0.4	0.9	1.3
Trade balance	0.0	1.4	1.5	1.8	2.2	2.4	2.0	1.5	1.7	2.0

Source: IMF, World Economic Outlook.

1/ WEO, August 2000.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ Harmonized definition.

5/ Based on national indices until 1995 and harmonized indices subsequently.

6/ In percent of GDP.

7/ Percentage change in the stock of M3. For 2000, annual percentage change as of June 2000.

Euro Area: Real GDP, Inflation, and Output Gaps 1/

	Real GDP			HICP Inflation			Output Gap		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
Euro-area	2.4	3.5	3.4	1.2	2.1	1.7	-1.4	-0.5	0.3
Austria	2.2	3.5	2.9	0.5	1.9	2.1	-1.4	-0.6	-0.2
Belgium	2.5	3.9	3.0	1.1	2.2	1.4	-1.1	0.5	1.3
Finland	4.0	5.0	4.0	1.3	2.7	2.5	-0.7	0.5	0.8
France	2.9	3.5	3.5	0.6	1.5	1.1	-1.6	-0.6	0.4
Germany	1.6	2.9	3.3	0.7	1.7	1.5	-1.7	-0.9	0.1
Ireland	9.9	8.7	6.9	2.5	4.8	3.5	4.4	5.4	5.6
Italy	1.4	3.1	3.0	1.7	2.5	1.6	-3.1	-2.0	-1.2
Netherlands	3.6	3.9	3.5	2.0	2.4	3.5	1.2	2.3	3.2
Portugal	3.0	3.4	3.5	2.2	2.5	2.3	0.0	0.3	0.7
Spain	3.7	4.1	3.5	2.2	3.1	2.4	-0.2	0.5	0.6

Source: IMF, World Economic Outlook.

1/ Output gap is positive when output exceeds potential.

Euro Area: Balance of Payments

	1997	1998	1999	2000Q1 1/
	(In billions euro/ECU)			
Current account	76.2	43.3	22.8	-7.9
Goods	124.8	118.8	99.5	9.3
Services	7.1	-0.9	-7.5	-5.3
Income	-15.2	-28.8	-26.4	-6.3
Current transfers	-40.5	-45.8	-42.8	-5.5
Capital account	13.1	12.7	13.3	2.8
Financial account	...	-69.1	-64.3	47.8
Direct investment	-48.1	-102.6	-138.8	148.0
Portfolio investment	-22.8	-85.3	-28.9	-192.6
Financial derivatives	...	-8.2	-1.0	2.5
Other investment	...	118.5	90.8	91.3
Reserve assets	...	8.5	13.7	-1.4
Errors and omissions	...	13.1	28.2	-42.7
	(In percent of GDP)			
Current account	1.4	0.7	0.4	-0.1
Goods	2.2	2.0	1.6	0.1
Services	0.1	0.0	-0.1	-0.1
Income	-0.3	-0.5	-0.4	-0.1
Current transfers	-0.7	-0.8	-0.7	-0.1
Capital account	0.2	0.2	0.2	0.0
Financial account	...	-1.2	-1.1	0.7
Direct investment	-0.9	-1.7	-2.3	2.3
Portfolio investment	-0.4	-1.5	-0.5	-3.0
Financial derivatives	...	-0.1	0.0	0.0
Other investment	...	2.0	1.5	1.4
Reserve assets	...	0.1	0.2	0.0
Errors and omissions	...	0.2	0.5	-0.7
Memorandum items:				
GDP (billions euro/ECU) 1/	5643.7	5865.4	6110.0	6412.4
Reserves of the Eurosystem 2/ (billions of euro)	...	329.4	372.5	384.1

Sources: ECB Monthly Bulletin, August 2000; IMF, World Economic Outlook; and staff estimates.

1/ Forecast of GDP in 2000 is from WEO.

2/ End of period stocks. The 1998 figure is as of January 1, 1999.

Euro Area: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000
External Indicators				
Broad money to reserves ratio (end-of-period) 1/	...	13.5	12.8	12.8
Central bank foreign liabilities (in billions of U.S. dollars) 2/ 3/	...	30.5	96.8	70.5
Foreign assets of the financial sector (in billions of U.S. dollars) 2/ 3/	...	1,834.7	1,754.4	1,741.1
Foreign liabilities of the financial sector (in billions of U.S. dollars) 2/ 3/	...	1,661.2	1,775.8	1,873.3
Official reserves in months of imports 4/	...	6.0	6.4	5.4
Exchange rate against U.S. dollar (period average) 3/	1.13	1.12	1.07	0.96
Financial Markets Indicators				
Change in stock market index (percent, end of period) 5/ 6/	37.0	29.8	39.5	2.0
Short-term interest rate differential between US and the euro area 7/	1.5	1.7	2.5	2.4
Financial Sector Risk Indicators 8/				
Foreign exchange loans (in billions of U.S. dollars) 9/ 10/	...	1,350.8	1,262.4	1,334.4
Net foreign exchange loans (in billions of U.S. dollars) 10/ 11/	...	-315.8	-367.8	-402.0
Share of foreign exchange loans in total lending (percent)	...	11.2	11.4	12.2
Deposits in foreign exchange (in billions of U.S. dollars) 10/ 12/	...	1,666.6	1,630.3	1,736.4
Share of foreign deposits in total deposits (percent)	...	14.6	15.5	16.9
Share of foreign denominated liabilities in total liabilities (percent) 13/	...	12.7	13.4	14.4
Share of real estate sector in loans to private sector (percent) 14/	...	29.2	30.8	30.5
Share of real estate sector in loans to nonfinancial private sector (percent)	...	31.0	32.9	32.8

Sources: ECB; European Commission; STOXX Limited.

1/ Data for 2000 refer to June 2000.

2/ Annual-average data.

3/ Data for 2000 refer to the average for the period January-June 2000.

4/ Calculated as: official reserves end-of-period positions / monthly average of imports. Data for 2000: official reserves refer to end-June 2000; imports refer to the period January-June 2000.

5/ Dow Jones EURO STOXX index.

6/ Data for 2000 refer to percentage change from December 1999 to June 2000.

7/ Three-month LIBOR rates were used for the United States; for the euro area, up to December 1998, annual average of national three-month LIBOR. Annual averages of the three-month euro interbank offered rates (EURIBOR) thereafter.

8/ Financial sector is defined as the Monetary and Financial Institutions (MFI) sector excluding the Eurosystem.

9/ MFI Loans (excluding Eurosystem) granted to MFIs and non MFIs of the euro area and to non-euro area residents denominated in non-MU currencies.

10/ Data for 2000 refer to Q2 2000, all figures are end-of-period-figures.

11/ Foreign exchange loans minus foreign exchange deposits.

12/ Deposits in MFIs (excluding the Eurosystem) placed by MFIs and non MFIs of the euro area and by non-euro area residents denominated in non-MU currencies.

13/ Total liabilities are defined for this purpose as currency in circulation, total deposits, money market fund shares/units money market paper, debt securities issued and capital and reserves.

14/ Real estate sector is define here as loans granted to households for house purchases.

INTERNATIONAL MONETARY FUND

Monetary and Exchange Rate Policies of the Euro Area

Supplementary Information

(In the Context of the 2000 Article IV Discussions with Euro-Area Countries)

Prepared by the European I Department

Approved by Michael C. Depler and Leslie Lipschitz

October 13, 2000

1. This supplement reports on information on economic and financial developments in the euro area available since the issuance of the staff report on the area's monetary and exchange policies (SM/00/212) to the Executive Board. The information does not alter the thrust of the staff appraisal.
2. Some recently released data suggest that the pace of the expansion in the euro area may be slowing somewhat, in line with the staff's (quarterly) projections. In September, a main indicator of aggregate manufacturing activity (the Purchasing Managers' Index) declined for the fifth successive month, while consumer confidence fell markedly in the largest economies, at least partly as a result of uncertainty about the impact of higher energy prices. On the other hand, the latest industrial production index for Germany points to strong activity, and area-wide employment creation remained buoyant—with the euro-area unemployment unchanged at 9.0 percent in August. Total nominal hourly labor costs in the area as a whole rose by 3.5 percent in the second quarter of 2000 (year on year), marginally less fast than in the first quarter but somewhat faster than in 1999. Recent wage settlements in Germany and France also suggest that wage moderation continues to prevail in spite of the mid-year uptick in headline inflation.
3. On September 22, 2000 the European Central Bank (ECB) and other central banks¹ intervened jointly in a defense of the euro that was appropriate under the circumstances. The move took markets by surprise and the euro initially appreciated sharply vis-à-vis the U.S. dollar but the exchange rate has since drifted back toward its pre-intervention level, which by the staff's assessment in SM/00/212 is a highly undervalued one. The intervention seems to have set a precedent that market participants may take into consideration in exerting further downward pressure on the euro. While on-going portfolio adjustments suggest that

¹ Beside the ECB, the central banks reportedly involved in the intervention included the United States' Federal Reserve, the Bank of England, the Bank of Canada, and the Bank of Japan.

capital account transactions may continue to bear on the euro for some time to come,² it is reasonable to expect this to end at some stage, in which case current account transactions will come to predominate and prompt an appreciation of the currency.

4. On October 5, 2000 the ECB increased its main refinancing rate by 25 basis points to 4.75 percent, citing heightened inflationary risks from the higher oil prices and persistently weak euro. With this adjustment, the ECB has now raised interest rates seven times since November 1999 by a cumulative 225 basis points. Although an interest rate increase was priced into the yield curve, the timing of the rate hike was largely unexpected by markets: the euro appreciated slightly vis-à-vis the U.S. dollar on announcement, but later lost the ground gained. Participants in forward markets appear not to have materially changed their expectations and no further interest rate increase is anticipated through the end of the year. Given the weakening of the currency since the second quarter of the year, monetary conditions for the euro area as a whole have not been substantially affected by the latest ECB move.

5. The staff has revised its macroeconomic projections for the euro area, based on updated country information, market expectations for interest rates, and a new baseline for oil prices (some US\$5 per barrel above the baseline in the published WEO, with an average oil price of US\$29 per barrel for 2000).³ Area-wide real GDP is now expected to grow by 3.4 percent in 2000 and by 3.2 percent in 2001 (compared to 3.5 percent and 3.4 percent, respectively, in SM/00/212), while inflation is projected to average 2.3 percent in 2000 and 2.1 percent in 2001 (compared with 2.1 percent and 1.7 percent, respectively, in SM/00/212). The overall fiscal balance is projected to remain unchanged with a deficit of -0.8 percent of GDP in 2000 largely because of revenue overperformance, and to reach -0.7 percent of GDP in 2001 (compared to -0.6 in SM/00/212), in part because of energy-related tax relief and slower growth. These revisions to area-wide aggregates result from combining preliminary country-level updates.

6. On balance, these revisions do not change the staff's policy advice. However, they point to heightened downside risks for the short-run, including as regards the smoothness of the growth path. Model-based estimates of the sensitivity of the euro area to oil shocks under an assumption of ongoing wage moderation are broadly consistent with the revised projections, but simulations suggest that the stagflationary effects would be considerably

² The pipeline of merger and acquisition transactions into the United States and out of the euro area is currently at an all time high. Similarly, the outflows from equity fund managers out of the euro area suggest continued downward pressure on the exchange rate.

³ The overall terms of trade deterioration since the launch of the euro amounted by mid-2000 to about 20 percent—equivalent to a rise in taxes of some 3 percent of GDP.

greater in the absence of such an assumption.⁴ Thus, wage moderation remains key to supporting the expansionary momentum. In this connection, the increasing emphasis on general tax cuts throughout the euro area may serve to sustain wage moderation, and might help contain downside risks to the near-term outlook and keep the expansion on track. However, cutting taxes on oil products or their complements in a setting of higher uncertainty in the energy markets may undermine the attainment of a desirable tax structure and prompt increases in world prices.

7. As regards the aggregate fiscal stance, the lower growth projection for 2001 lessens somewhat concerns about the insufficient ambitiousness of nominal fiscal targets. The key policy message remains that pro-cyclicality of policies must be avoided in either direction, i.e., also by letting automatic stabilizers come into play to cushion the impact of a negative shock when downside risks loom larger. Budgetary goals should be made contingent on the stated growth assumptions, and fiscal positions should be evaluated relative to the cycle.

8. As regards monetary policy, the recent information does not alter the advice that at this juncture monetary tightening should be aimed at forestalling second-round effects—which appear to be contained as long as wage moderation prevails—and might need to be reversed as the risks to medium-term price stability shift to the downside. Although the recent increase in the ECB refinancing rate completes the tightening cycle expected by staff through the end of the year, further increases should not be ruled out if a deterioration in the core inflation rate undercuts wage moderation.

⁴ For example, in a scenario of real wage rigidity, MULTIMOD simulations indicate that a US\$10 increase in the price of oil above baseline would trim about $\frac{3}{4}$ of 1 percent off the baseline projection for GDP and add about 1½ percentage points to the inflation forecast within two years. Because of less labor market flexibility, the stagflationary effect is worse than in the United States, raising the issue of a persistent cyclical divergence between the two blocks.

INTERNATIONAL MONETARY FUND

Recent Developments in Trade Policies of the European Union

Prepared by the European I and Policy Development and Review Departments

Approved by Michael C. Deppler and Leslie Lipschitz

October 13, 2000

1. Discussions on selected trade issues were held in Brussels on June 27-29, 2000 during a staff visit to European Union (EU) institutions.¹ Meetings at the European Commission were attended by senior officials from the Directorate-General for Trade, the Directorate-General for Economic and Financial Affairs, and the Directorate-General for Development.
2. The Commission representatives confirmed the EU's commitment to an early launch of a **new global trade round**—the Millennium Round—but admitted that the divergences that emerged in Seattle would require time to be resolved. Important differences of views persisted on the format and scope of negotiations, particularly on the inclusion of anti-dumping, investment, competition policy, and “societal issues” such as health and environmental standards. While negotiations in agriculture and services had started officially in the framework of the “built-in agenda,” precise negotiating mandates and timetables had yet to be agreed. The Commission representatives welcomed the opening of these talks but indicated that their success could not be expected until they were integrated into broader negotiations. The staff encouraged the Commission to work with others toward resolving outstanding issues on the agenda in order to allow a prompt and effective start of new multilateral trade negotiations.
3. More broadly, the Commission officials reaffirmed the intention to pursue a **more liberal trade regime**. They noted that within the EU there was growing recognition that external trade liberalization and single market reforms were mutually supporting processes, fostering structural change and economic efficiency in the region. The mission acknowledged that, in the context of its WTO commitments, EU tariffs had continued to decline gradually, with a fall of the unweighted average tariff from 10 percent in 1995 to 7 percent in 2000, and a reduction in the average industrial tariff from 6 percent to 4 percent. However, sectors such

¹A comprehensive review of EU trade policies was recently completed by the World Trade Organization (WTO) (see Box 1 and www.wto.org for the Concluding Remarks by the Chairperson of the relevant WTO meeting). This note focuses on issues of particular interest to the Fund. The mission team comprised Messrs. Deppler (Head), Zanello (EU1), and Auboin (PDR).

Box 1: Main Features of EU Trade Policies

Trade policies of the “Quad” trading partners (the EU, the United States, Japan, and Canada) are assessed every two years in the framework of the Trade Policy Review Mechanism of the WTO. The review is undertaken by WTO members, on the basis of reports by the Secretariat and the member under review. The latest review of EU trade policies was completed in July 2000.¹ Key points emerging from this review are summarized below.

The Secretariat report confirms the gradual reduction of border protection in the EU. Markets for non-agricultural products are largely open, with an average tariff of about 4 percent and few quantitative restrictions for trading partners with “most favored nation” status. Tariffs for most industrial sectors are now very low, but sensitive areas such as textiles and clothing, footwear, certain chemicals, automobile and consumer electronics continue to enjoy substantial protection. The report also confirms the reduced incidence of quantitative restrictions, which have largely been removed as a result of the implementation of the Uruguay Round and the Single Market Program: the last voluntary export restraint agreement in place—the EU-Japan “consensus” on cars—elapsed at end-1999. However, in the view of some WTO members (particularly developing countries), the pace at which the EU is dismantling quotas inherited from the “multi-fiber agreements” remains a cause for concern. (Under the WTO Agreement on Textiles and Clothing, these quotas must be eliminated by 2005.) The EU maintains some product-specific quotas vis-à-vis a few non-WTO members, but these barriers are being reduced gradually. The Secretariat report notes that the three-fold increase in the number of anti-dumping investigations launched by the EU against third-parties in 1999 is likely to result this year in a marked rise in the number of anti-dumping measures in force.

Access to EU agricultural markets continues to be severely hampered by the Common Agricultural Policy (CAP).² While the average tariff on agricultural imports has been reduced by about 8 percent since the end of the Uruguay Round, at over 17 percent it is more than four times higher than the average protection in the manufacturing sector. The highest tariffs affect imports of cereals, live animals, meat, dairy products, fresh fruits, sugar, and wine. Examples given in the Secretariat report indicate that duties levied on imports of fruits and vegetable juices range from 12 to 108 percent, while those on bananas range from 16 to 140 percent. The form of tariffication used by the EU (specific rather than ad valorem duties), while consistent with WTO rules, is cause for concern for many trading partners because it lacks transparency and is restrictive. On average, tariffs levied on processed foods are twice as high as those for raw agricultural products. In addition to border measures, agricultural markets remain distorted by pervasive CAP subsidies, accounting in 1999 for 45 percent of the EU budget (some US\$50 billion).

The WTO report confirms that the EU and its member states are continuing efforts to liberalize access to EU services markets, although the degree of openness differs across sectors. In financial services, non-EU suppliers already benefit to a large extent from “single passport” provisions, allowing an institution licensed in one country to operate freely throughout the Union. The EU market for telecommunications services has also been opened considerably in the past three years, as a result of both domestic integration and the relevant WTO Agreement concluded in 1997. However, the benefits of single market liberalization have not yet been extended to other partners in the transport sector, and the EU continues to restrict its markets for audio-visual services.

The EU operates the largest network of bilateral trade agreements in the world. New agreements have recently been concluded with Mexico and South Africa. The WTO Secretariat report indicates that the EU trades on a most-favored nations basis with only eight countries in the world, although these countries account for more than half of the EU trade. The EU has recently been taking steps to strengthen the compatibility of its trade agreements with WTO rules, by increasing their scope and coverage. It is also engaged in a process aimed at granting duty- and quota-free access to the exports of the least-developed countries.

¹ WTO Secretariat, *Trade Policy Review of the European Union*, forthcoming.

² The staff's view on the ongoing reform of the CAP in the context of Agenda 2000 are presented in SM/99/61.

as agriculture, processed food, textiles and clothing, footwear, and automobiles continued to enjoy a high level of protection, and anti-dumping activity seemed to be on the rise. In this connection, the mission also noted that slow progress in opening agricultural, textiles, and clothing markets frustrated many developing countries with a comparative advantage in those products, and that anti-dumping measures were concentrated in these sectors. High levels of protection in these areas are also a source of tension with industrialized countries, in particular as regards agriculture, which is often subject to high-profile disputes. The staff emphasized that the EU economy would derive substantial economic benefits from further liberalizing agriculture and other protected sectors because, as confirmed by recent studies,² the gains from trade liberalization accrue predominantly from the reduction of a country's own trade barriers.

4. The Commission representatives shared the staff's concern that in many countries **anti-dumping** in practice was used too often as a tool of protectionism; they indicated that the EU was supporting a review of anti-dumping rules at the multilateral level. In textiles and clothing, they argued that the EU was already trading on a duty- and quota-free basis with many low-income countries in the context of preferential trade agreements, and that remaining quotas under the Multifiber Agreement would be dismantled by 2005. In agriculture, they indicated that the second reform of the Common Agricultural Policy would eventually translate into improved access for foreign products from all countries, but—in their view—negotiations should also take into account other dimensions such as rural development and environmental issues. The officials noted that the EU was prepared to discuss greater access for processed food imports and was carefully looking at the effects of tariff escalation in that area. However, they indicated that improved access for foreign products would only be acceptable to EU citizens if their concerns about food safety and consumer protection were being addressed during the negotiation.

5. The staff and the Commission representatives discussed the **recent steps taken by the EU toward developing countries**. Bilaterally, the EU was reorganizing its complex system of trade preferences with a view to gradually harmonizing the treatments offered to African-Caribbean-Pacific (ACP) countries and non-ACP countries, and making preferential access more compatible with WTO rules. First, for the higher-income ACP countries, unilateral preferences will be progressively transformed into WTO-compatible free-trade agreements. Second, these unilateral preferences will be re-oriented toward the least-developed countries (LDCs).³ The staff welcomed the planned extension of unilateral preferences currently available to least-developed ACP countries to all other LDCs, and efforts initiated by the "Quad" (the EU, the United States, Japan, and Canada) in the WTO to

² See for example, *The Millennium Round: An Economic Appraisal*, European Commission (1999).

³ These include the 48 countries in the United Nations definition, for which exceptions to WTO permit differential treatment.

grant LDCs duty-free access on “essentially all products.”⁴ The staff and the Commission agreed that exceptions to such duty-free access should be minimized in order to make the offer economically meaningful. The staff hoped that, in the interest of the LDCs, rapid implementation of this initiative could be achieved and that it could be extended to include countries eligible for the HIPC Initiative.⁵ The Commission representatives pointed to other efforts undertaken by the EU in the multilateral context, in particular to grant developing countries more time to implement certain WTO Agreements, which was one of their main demands in Seattle, and to strengthen technical cooperation in support of LDCs to facilitate their integration in the global trading system.

6. Since the discussions in Brussels, the Commission has tabled a new proposal providing for full, duty- and quota-free access of LDCs exports (except arms) to the EU market. This proposal goes beyond earlier plans as exceptions—limited in the Commission’s proposal to sugar, rice and, bananas—would be phased out within three years.⁶ The proposal is expected to take effect as soon as it is adopted by the EU Council, and will be implemented unilaterally and immediately upon adoption.

7. With regard to **trade agreements**, the staff noted that the EU had continued to negotiate free-trade agreements with a range of countries and regions. It had recently concluded negotiations with Mexico and South Africa and opened new talks with Chile and MERCOSUR. The reform of trade arrangements with ACP countries will also involve new free-trade agreements. In this context, the staff expressed concerns about the risks of pervasive trade diversion, in particular for those countries which traded with the EU on a most-favored nation basis. The staff also noted likely difficulties in managing an unwieldy pyramid of preferences. In reply, the Commission representatives reaffirmed their commitment to multilateralism but argued that free-trade agreements represented for many countries a first step toward integration into the world economy. They agreed that the EU system of preferences required increasing coordination within the Commission, but noted that the level of preferences tended to diminish as a result of multilateral liberalization.

⁴ In May 2000, “Quad” members, as well as other members of the WTO, committed themselves to provide bound duty-free treatment to LDCs exports. The EU described its offer as one of the most generous, with exceptions limited to a few agricultural products. Textiles and clothing will be covered by the EU offer. Regarding the timing of implementation, the Commission indicated that EU Ministers will soon decide but expected support for a relatively rapid implementation.

⁵ There are ten WTO Members that are currently HIPCs but are not in the United Nations list of LDCs.

⁶ The trade preferences by the EU to ACP countries, which account for the bulk of the LDCs, already provide duty-free access on nearly 90 percent of the EU tariff lines. However, the preference system is complex, and contains numerous exclusions and exceptions in areas of interest to the countries concerned, particularly in agriculture.

8. Overall, the staff acknowledged the key role that the EU could play in achieving greater stability and openness in the world trading system. It welcomed the Commission's support for the launch of an ambitious round of global trade talks, and its initiative in providing free-access for exports of the world's poorest countries. In this connection, it is hoped that the latest proposal for duty- and quota-free access to the EU market for LDC exports is adopted promptly. In the staff's view, the EU could in addition step up efforts to resolve outstanding issues that have delayed the start of constructive, multilateral trade negotiations, including by addressing the most restrictive aspects of its own trade regime. From this angle, faster liberalization of agricultural markets—with a view to reducing costs to EU consumers and taxpayers, and to provide access to efficient exporters from developing countries—would be particularly desirable. In the same vein, a review of anti-dumping policy aimed at restricting its role to correcting non-competitive practices while preserving the benefits of negotiated market access would also be helpful. The EU, like all its trading partners, is encouraged to continue to bring its trade disputes to the WTO Dispute Settlement Body and to abide by its rulings. Finally, the staff urged the Commission to minimize incentives for trade diversion by pursuing regional and bilateral trade agreements in parallel with—and, if possible, at the same pace as—multilateral trade liberalization.

9. The staff intends to follow up on selected EU-trade policy issues in the context of its regular contacts with, and periodic visits to, EU institutions.



INTERNATIONAL MONETARY FUND

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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

On October 16, 2000, the Executive Board concluded the discussion on the monetary and exchange rate policies of the euro area (in the context of the Article IV consultations with euro-area countries). The background section of this PIN reflects information available at the time of the Executive Board meeting and the views of the Executive Directors are those expressed at that meeting.¹

Background

With domestic demand growth at about 3 percent and a more supportive external environment, euro-area activity has been buoyant so far in 2000, pushing the area-wide unemployment rate down to 9 percent in August. Real GDP growth for the area as a whole has been at a rate of 3.8 percent in the second quarter (year on year), after 3.4 percent in the first. Some recently released confidence indicators point, though, to a possible slowdown in the second half of the year.

Exchange rate pass-through and rising oil prices lifted headline inflation to 2.3 percent in August. Nonetheless, annualized core inflation (defined as the harmonized CPI net of energy and some food-related components) was subdued at 1.3 percent in August 2000. Recent wage settlements in some large economies suggest that wage moderation continues to prevail.

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. 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. The main features of the Board's discussion of the staff's report on the monetary and exchange rate policies of the euro area are described in this PIN. In the present case, the Fund staff held discussions with European Union institutions, including the European Central Bank (ECB), in the context of the Article IV consultations with the countries forming the euro area. The ECB's observer at the Fund participated in the meeting of the Executive Board.

In part because of the weakness of the euro, monetary conditions remain broadly supportive of activity in spite of the recent round of interest rate increases by the ECB (up a cumulative 225 basis points since November 1999). The constellation of national fiscal policies is also supporting area-wide aggregate demand, with pro-cyclical or neutral stances envisaged in the 2000 budgets of most countries after the overachievement of deficit targets in 1999.

On September 21, the ECB and other central banks intervened jointly in the foreign exchange market in support of the euro, leading to a sharp initial appreciation vis-à-vis the U.S. dollar. The exchange rate has since drifted back toward the pre-intervention level.

On current projections, euro-area real GDP growth is estimated at about 3½ percent for 2000 in a setting of broad price stability. Regional divergences in growth and inflation rates, reflecting in part the catching-up process in many EMU countries, are expected to continue, although narrowing somewhat. The main downside risks to the near-term outlook are linked to the possibility of a rapid turnaround of the external factors that have propelled euro-area growth, and of a worse-than-anticipated impact of high oil prices.

Executive Board Assessment

Executive Directors noted with satisfaction that favorable external developments and strong macroeconomic fundamentals have produced robust growth. Directors cautioned, though, that the persistence of high and volatile oil prices has heightened downside risks and might affect the otherwise favorable prospects for growth in the short run.

Directors were more uncertain about prospects over the medium and longer term, and noted in particular that lasting reductions in the level of unemployment in the euro area will not be possible if the ongoing expansion were not sustained. They saw risks both in a sharp reversal of the favorable external shocks that have helped to propel the euro area upturn and in the area's structural rigidities that in the past have often interacted with insufficiently countercyclical fiscal policies to undercut upswings and exacerbate downturns. Some Directors expressed concern at the possibility that the inflationary effects of higher energy prices and a weak euro might also undermine the prevailing wage moderation.

Directors recognized that the monetary union has strengthened the macroeconomic structure of the euro area, including by bringing about a euro-area-wide based monetary policy, a better coordination of fiscal and structural policies, and a greater awareness at the national level of the competitiveness implications of wage developments. They stressed, nonetheless, that the import of these changes has not yet been tested by adversity, and thought that the present favorable economic circumstances provide an important opportunity to forge ahead with needed reforms.

Directors thus agreed that the most pressing challenge, from a regional as well as a global standpoint, is to implement policies that both sustain the expansion and make it more resilient. In particular, they urged euro-area policymakers to adhere closely to the key requirements of safeguarding price stability, establishing structurally balanced fiscal positions and avoiding pro-

cyclical fiscal policies thereafter, and strengthening the supply side through a balanced and proactive strategy of tax, expenditure, and structural reforms.

Directors observed that monetary management has been appropriately cautious, with the rise in interest rates having helped to preserve medium-term price stability during a period of unexpectedly large and protracted oil price increases and euro weakness. They concurred that, as the effects of the external factors that have contributed to the firming up of the recovery and the buildup of cost pressures dissipate or are reversed, and if inflation shows signs of declining, the symmetric approach that has so far shaped policy would call for interest rates to be adjusted appropriately. In this context, it was also noted that the monetary authorities should focus on core inflation and be rather cautious in interpreting headline inflation.

Directors discussed the level of the euro and factors contributing to its recent evolution. They noted that the misalignment of the euro both vis-à-vis the United States dollar and in effective terms remains large. Directors considered that this misalignment should eventually correct, in part as cyclical divergences narrow and as underlying portfolio adjustments run their course, although they expressed a variety of views on the significance and nature of these portfolio adjustments. Several Directors commented that the correction would also be helped by further actions to address the structural rigidities that appear to have clouded euro-area prospects. Directors agreed that the September concerted intervention in support of the euro had helped in stabilizing the exchange rate by sending a signal that market participants will have to bear in mind in the future. They also considered that movements in the exchange rate should inform monetary decision making to the extent that they pose a threat to medium-term price stability.

In the fiscal domain, Directors agreed that the key challenge is how to implement supply-enhancing tax cuts while avoiding pro-cyclical fiscal policies. In this connection, they regretted that the current stance is somewhat pro-cyclical in the aggregate, and risks becoming increasingly so if the pace of consolidation does not keep up with the expansion. In future, closely integrated tax and expenditure policies that ensure that tax reductions do not run ahead of offsetting permanent cuts in public spending will be required.

More broadly, Directors stressed that the pursuit of at least neutral fiscal policies requires evaluating fiscal positions in relation to the cycle, thus targeting budgetary surpluses when activity is above potential. In their view, this would enhance the effectiveness of the monetary union by strengthening the policy mix and meeting the Stability and Growth Pact's objective of close to balance or surplus in the medium term, thereby also preserving room for countercyclical policies when growth weakens.

Directors emphasized that national fiscal strategies should also encompass tax and expenditure objectives that effectively bolster the growth potential of the euro area. From this angle, tax cuts need to be carefully targeted to achieve the most beneficial supply-enhancing effects, and expenditure policies should focus on increasing the efficiency of public services. In this context, they noted that progress has been mixed, especially as regards expenditure reforms. A few Directors also called for rationalization of subsidies, which remain high in relation to GDP in several euro-area countries.

While acknowledging that structural reforms have advanced, Directors stressed that further efforts are essential to create headroom for growth and avoid capacity constraints from again choking off the expansion prematurely. In this connection, they welcomed the Lisbon summit decision to put structural reforms at the top of the European Union's policy agenda.

In labor markets, Directors stressed the importance of strengthening effective labor supply, *inter alia*, by tightening eligibility for benefits and sharpening the incentives for job search as well as by fostering in many cases more flexibility in wage determination.

In product markets, Directors agreed that there is room to promote competition in key sectors and remove administrative barriers to business formation as well as to some cross-border activities. Regarding the financial sector, Directors welcomed the intention of the euro-area authorities to keep the adequacy of present supervisory arrangements under review in order to ensure that they continue to work effectively, particularly as the interbank market becomes more closely integrated and pan-European institutions result from a continuing process of consolidation. Directors also discussed whether some consolidation or strengthened coordination of the existing institutional arrangements would be desirable and expressed a variety of views on this matter. It was also noted that further steps are needed to increase the integration of capital markets and the transparency of banking institutions in the euro area, for instance, by addressing the relatively weak disclosure rules and by instituting greater uniformity in the provision of accounting information, including better reporting of nonperforming loans.

Directors acknowledged that European Union (EU) internal surveillance over structural reforms has proved helpful, but argued that its effectiveness depends on its candor. As for EU surveillance over fiscal policies, they shared the view that the annual appraisals of stability programs by the Commission and the ECOFIN Council have proved beneficial and should continue. In this connection, Directors also noted the increasing role of the Euro Group as a forum for peer review, policy coordination, and harmonization.

Regarding statistical matters, Directors acknowledged the adequacy of existing data for surveillance purposes, but called for strengthening the euro-area's statistical base in the dimensions most critical for monetary policy decision making.

With respect to the trade policies of the European Union as a whole, Directors welcomed the EU's commitment to an early launch of a new round of multilateral trade negotiations, and the Commission's initiative in promoting free access for the exports of the world's poorest countries. In this connection, they urged the EU to implement promptly its latest proposal in favor of these countries. Directors recognized, though, that support for new multilateral negotiations would be enhanced if the EU also addressed the most restrictive and complex aspects of its own trade regime, including through a faster liberalization of agricultural, textile, and clothing markets, a reduction of subsidies, and a review of anti-dumping policy. Looking ahead, the impact of the EU's policies on trade should also be kept in mind as the EU is enlarged. Directors expressed satisfaction that the EU has relied on the World Trade Organization's Dispute Settlement Body procedures to resolve its bilateral trade disputes and encouraged it to abide by the Dispute Settlement Body's rulings. Finally, Directors called on the EU to minimize the potential for

regional and bilateral trade agreements to lead to trade diversion by pursuing multilateral trade liberalization at a similar pace.

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

	1995	1996	1997	1998	1999	2000 ¹
	In percent					
Real Economy						
Change in real GDP	2.3	1.5	2.3	2.7	2.4	3.4
Change in final domestic demand	1.8	1.6	1.7	3.1	3.0	3.1
Change in consumer prices ^{2,3}	2.5	2.2	1.6	1.1	1.2	2.3
Unemployment rate ^{2,4}	11.3	11.5	11.5	10.8	9.9	9.0
	In percent of GDP					
Public Finance						
General government balance	-5.2	-4.4	-2.6	-2.2	-1.3	-0.8 ⁵
Public debt	75.8	76.7	75.9	74.1	73.2	70.7
	In percent					
Money and Interest Rates						
Change in M3 (end of year) ²	5.7	4.0	4.1	4.6	6.1	...
Money market rate (3 month money)	6.1	4.6	4.1	3.9	2.9	5.0 ⁶
Government bond yield (10 year bonds)	8.5	7.1	5.9	4.7	4.6	5.3 ⁶
	In percent of GDP					
Balance of Payments						
Trade balance	...	...	3.6	2.8	2.0	-0.5 ⁷
Current account	...	...	1.4	0.7	0.4	-0.2 ⁷
Official reserves (US\$ billion)						251.3 ⁸
	In percent					
Exchange Rates						
Nominal effective rate	4.5	0.1	-8.8	-0.1	-4.5	-12.0 ⁹
Real effective rate	4.6	0.1	-11.1	-4.0	-6.2	-14.2 ⁹

Sources: IMF, IFS; European Central Bank; EUROSTAT; national authorities; and Fund staff estimates.

¹ Staff projections.

² Harmonized definition.

³ For 1995 based on national definitions.

⁴ In percent of labor force

⁵ Data do not include mobile telephone license receipts.

⁶ October 6, 2000

⁷ Data for the first seven months of 2000, in percent of projected 2000 GDP.

⁸ Total reserves minus gold (Eurosystème definition); end July from IFS.

⁹ September 2000 relative to 1999 average.

**Statement by Jean-Claude Milleron on Monetary and
Exchange Rate Policies of the Euro Area
October 16, 2000**

As you may know, France presently holds the Presidency of the European Council. My statement expresses the common views of the Euro-area Member States and of the European Community/EMU in their respective fields of competence.

The Euro-area Executive Directors welcome the overall well-balanced assessment of economic developments and prospects in the euro area. They agree with the main conclusions.

While the staff suggests caution regarding the longer-term prospects of sustaining economic growth, it is important to recall that the level of integration as well as the inception of monetary union have substantially changed the landscape of policy making in today's Europe. Contrary to the 1980s, there is now a broad and uncontested consensus in Europe about the virtues of budgetary consolidation, low inflation, and continued wage moderation.

In addition, structural policies are now at the heart of Europe's reform agenda. The achievements in the field of deregulation and privatisation are substantial. Although their economic impact in terms of productivity improvement and expansion of productive potential is still difficult to measure, competition has intensified, prices have come down, and the functioning of products, services and factor markets has improved.

Assessment of short term economic prospects

The IMF paper draws a very positive picture for short-term growth prospects. The growth rate of around 3½% per annum this year corresponds to that of the European Commission. The maintenance of that growth rate for 2001 strongly depends on the underlying assumptions. A continuously high oil price could work as a brake for domestic demand, as growth in real disposable income would be dampened by a deterioration of the terms of trade.

Directors agree that economic fundamentals in the euro area basically remain conducive to growth. The clear commitment to macro-economic stability and continued structural reform should enable the euro-area economy to weather the adverse impact of the surge in oil prices whilst ensuring sustained economic growth and a steady decline in unemployment over the medium term. This will also be important in view of the needed adjustment in world current account imbalances.

Exchange rate developments

Directors share the view that the euro exchange rate is significantly undervalued at current levels. This is a matter of concern. Estimating the magnitude of this undervaluation is

an intrinsically difficult exercise. The unexpectedly robust performance of the US economy relative to that of the euro area can explain part of the depreciating trend of the euro since its launch. Amongst other factors is the need by institutional investors to diversify the currency composition of their portfolios. Moreover, the remarkable progress in broadening and deepening the euro capital market brought about by the introduction of the single currency has greatly enhanced the borrowing capacity of the corporate sector and has consequently enhanced its capacity to buy foreign companies, particularly in those areas where Europe is technologically leading such as automobiles or mobile phones. In the long run, these investments should increase the competitiveness of the euro area and support the euro. While Directors consider the current exchange rate of the euro as being out of line with economic fundamentals, they agree that this should be a temporary phenomenon, as cyclical factors should also work in favour of the euro, in addition to ongoing structural reform having an enhancing impact on economic efficiency of the euro area.

Directors believe that a strong euro is in the interest of Europe. Therefore, they welcome the statements by the Eurogroup Ministers and the ECB President of 8 May and 8 September 2000, which indicated that the level of the euro did not reflect economic fundamentals. They welcome the success of the 22 September 2000 intervention by the ECB, jointly with the FED, the central banks of the United Kingdom, Japan and Canada, in the foreign exchange markets.

Monetary policy and outlook for price stability

The ECB broadly agrees with the Fund's staff appraisal of the euro area monetary policy. During the year 2000, inflationary risks gradually increased in the euro area and this has led monetary policy to react appropriately, by raising interest rates in a pre-emptive manner.

First, the rising inflationary risks were signaled by the protracted deviation of M3 growth from the reference value set by the ECB. This and the high credit growth in the euro area indicated a situation of ample liquidity. Second, developments in oil prices and the depreciation of the euro exchange rate also contributed to shift the risks to price stability upwards. As emphasized by the Fund's staff, particularly in a phase of strong growth, the risk had to be taken seriously that increases in import prices gradually translate into consumer price inflation.

As regards the near-term inflation outlook, the ECB considers that, unless energy prices were to fall significantly in the coming months, HICP inflation rates may remain above 2% for a more protracted period than earlier expected. The ECB shares the concerns of the IMF on the potential development of second round effects of the rise in oil prices and the weakening of the exchange rate. Against this background, it is crucial for monetary policy to ensure that longer-term expectations of economic agents remain confident in the maintenance of price stability. In this respect, the latest increases in ECB interest rates should contribute to guide the wage and cost formation process in the euro area. However, if inflationary pressures in the context of the current upswing were to be aggravated further by too lax fiscal policies or excessive wage developments, monetary policy would have to react accordingly.

The ECB agrees with the view of the IMF that monetary policy has to follow a symmetric approach with respect to upside and downside risks to price stability. The ECB's monetary policy will always be based on the objective to maintain price stability in line with the definition published by the ECB. The focus on maintaining price stability is also crucial to sustain the expansion under way, creating a favorable environment for GDP and employment growth.

The weakening of the euro also raised concerns for the world economy. On 22 September, at the ECB's initiative, the monetary authorities of the United States, Japan, the United Kingdom and Canada joined the ECB in a concerted intervention in the foreign exchange markets. While it is still too early to assess the lasting effects of this intervention, so far the euro exchange rate has shown greater resilience. Nevertheless, the ECB considers that the euro continues to be out of line with euro area fundamentals.

Fiscal policy

Directors share the Staff's view that there is a risk of overall fiscal stance becoming pro-cyclical in the euro area. Therefore, Member States should avoid pro-cyclical fiscal policies. In this context, the three fiscal policy requirements identified by the Staff are relevant : using the recovery to achieve lasting consolidation, reinvigorating supply by reducing the tax burden and consolidating expenditure.

According to recent budgetary developments, the targets contained in Member States' budgetary plans for 2000 - the stability programmes - are likely to be overachieved, partly due to more favorable developments. The strong commitment of Member States to fiscal consolidation was stressed in the Broad Economic Policy Guidelines which called on Member States to introduce expenditure restructuring and reduce the tax burden while enhancing budgetary consolidation. In particular, a number of criteria have been put forward with respect to carrying out tax reforms : Member States should abide by the close-to-balance or surplus principle; tax cuts must not be pro-cyclical; account must be taken of the level of public debt and long term sustainability of public finances; and tax reductions should form a part of a comprehensive reform package.

Directors agree that the stability programmes of euro area countries could be further improved along the lines indicated by the IMF. First, in order to avoid a pro-cyclical bias in the implementation of the Stability and Growth Pact, the assessment of the medium term budgetary targets should focus on cyclically-adjusted budget balances, in spite of the uncertainties surrounding their calculation. Second, Directors are aware that budgetary strategies should be based on realistic assumptions on economic and budgetary developments.

Structural Policies

Directors underline the crucial importance of appropriate structural policies and reforms in improving the conditions for sustained economic recovery and growth. They welcome the recognition by the IMF that much has been achieved over the past decade, and generally subscribe to the IMF recommendations. EU Heads of State or Government decided at their Summit meeting in Lisbon in March 2000 to put structural reforms at the very top of the EU policy agenda. They detailed concrete initiatives in product markets, including the legal framework for electronic commerce, the review of telecom regulation and economic reforms for a complete and fully operational internal market. They decided to give further impetus to the deepening of financial market integration and development of risk capital and to the improvement of the quality and sustainability of public finances.

Directors fully agree with the emphasis that the IMF puts on labour market reforms and, in particular, on the need to strengthen effective labour supply. Policies in the areas of equal opportunities and active measures to improve "employability" have already contributed to meeting labour demand during a period of rapid employment growth. More progress could be made in certain areas, including through measures for older workers and comprehensive reforms of tax and benefit systems, as highlighted in the 2000 Broad Economic Policy Guidelines. The modernization of social protection systems, partly with a view to increasing labour market participation, has been put forward by the Heads of State or Government and has been recognized as a priority in a number of Member States' National Action Plans for employment.

Internal surveillance processes and policy co-ordination

Whilst acknowledging that the modalities of EU surveillance and policy co-ordination have strengthened, the staff assessment suggests that the process is still lacking the clout needed to promote timely implementation of agreed guidelines. Directors agree that the effectiveness of the processes could be further improved by a more timely and full follow-up of guidelines. Moreover, it is important to involve national parliaments in order to enhance public acceptance and to foster political support for the implementation of these guidelines at the national level. With a view to increase peer pressure and to gain public support for the needed reforms, the Commission has been invited to give its Implementation Report on the Broad Economic Policy Guidelines "more bite", and to increase the weight of country-specific analyses. As regards the Eurogroup, the Directors point out that efforts to strengthen its functioning have been made recently. Finally, Directors agree that to improve the understanding of economic developments in the euro area, urgent progress is needed in fulfilling EMU statistical requirements. They believe that the recently adopted Actions Plans set the right priorities and underlines the importance of a rapid and full implementation of these plans.

**Statement by Jean-Claude Milleron on Recent Developments
in Trade Policies in the European Union
October 27, 2000**

France presently holds the Presidency of the Council of the European Union. The report "Recent Developments in Trade Policies in the European Union," a companion paper to the staff report discussed in the context of Article IV discussions with the euro area countries, is based on meetings held between Fund staff and officials at the European Commission. My statement therefore represents the Commission's views on this paper.

The Commission broadly agrees with the thrust of the staff paper. It notes that the Fund supports Commission efforts to work with others in order to facilitate a prompt and effective start to a new set of multilateral trade negotiations.

The Commission is committed to building consensus in support of a new trade Round and to achieving results at Geneva. A successful Round will require trade-offs between WTO members on a variety of issues. A positive outcome can only be achieved if the agenda for discussions includes a sufficiently wide range of topics to allow such trade-offs to be made. This is why the EU does not advocate an incremental approach, where more straightforward issues are dealt with first, or a minimalist approach that would only deal with a limited range of issues.

This comprehensive agenda would, of course, include agriculture. The EU supports further liberalization in this sector, but emphasizes the multifunctional nature of agricultural activity. Concerns regarding human and animal health, the environment and food safety, among other issues, need to be addressed appropriately in this context.

The staff report is critical of the EU's use of anti-dumping actions. It should be noted that the EU is acting within WTO rules in this area and, moreover, is open to the inclusion of anti-dumping rules in the agenda of a new Round of WTO trade negotiations.

The Commission takes note of the risks of trade diversion from trade liberalization on a regional basis. However, this risk is lessened by the reduction of tariffs on a most-favored-nation basis. The Commission therefore highlights the continued reductions in average tariffs applied by the EU, as noted in the report.

The lack of strong progress towards the launch of a new Round of multilateral trade negotiations has not prevented the Commission from taking initiatives to further liberalize trade relations with developing countries. Among other developments, the recent Commission proposal to offer tariff and quota free access to the EU market to the Least-Developed Countries for "everything except arms" represents a further significant step towards trade policies that benefit the poorest countries. We hope that this and other Commission initiatives will act as a spur to others to take similar actions in favor of Least-Developed Countries.