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Euro Area Policies: Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director on Euro Area Policies

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

- the staff report on euro area policies (including the trade policies of the European Union), prepared by a staff team of the IMF, following discussions that ended on May 25, 2005, with officials at EU institutions in the context of the Article IV consultations with countries forming the euro area. Based on information available at the time of these discussions, the staff report was completed on July 7, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 29, 2005 discussion of the staff report on euro area policies.

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

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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Euro Area Policies[1]

Prepared by the European Department

Approved by Michael Deppler and Carlos G. Muñiz

July 7, 2005

- A staff team held discussions at the European Central Bank (ECB) and the European Commission (EC) during May 17–25, 2005.

- Meetings were held at the ECB with President Trichet, Vice President Papademos, Mr. Issing, Mr. Padoa-Schioppa, Ms. Tumpel-Gugerell, and Mr. González-Paramo, as well as with senior staff. At the EC, the mission met with Commissioner Almunia, Mr. Regling (Director General for Economic and Financial Affairs), and other senior officials. Mr. Prader (Alternate Executive Director) and Mr. Wijnholds (ECB Observer at the Executive Board) attended most of the meetings. Mr. Deppler also met Eurogroup President Juncker, discussed the mission's preliminary findings at the May 26 Euro Working Group meeting, and presented the mission's concluding statement to the Eurogroup on June 6.

- The team comprised Messrs. Deppler (Head), Annett, Decressin, Estevão, Faruqee, Fonteyne (all EUR), and Mr. Dhonte, the Fund's Special Representative to the EU. Mr. McDonald (PDR) joined the mission at the EC to cover EU trade issues and Mr. Haas (ICM) to discuss financial market developments.

- The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

[1] Including trade policies of the European Union.

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EXECUTIVE SUMMARY

The low-flying recovery has hit a rough patch. With domestic demand lacking vigor in the midst of a difficult structural/cyclical transition, the ongoing recovery has run into significant headwinds, notably high oil prices and (until recently) a sustained appreciation of the exchange rate. Past structural reforms have improved employment performance and are expected to continue to do so. However, subdued wage growth and major price shocks have crimped real disposable incomes and consumption, leaving the recovery heavily reliant on global demand. Elements sufficient for a continuation of the gradual recovery remain in place. Nonetheless, repeatedly disappointing activity is taking a toll on adjustment efforts and the EU policy context.

With broad agreement on the economic outlook and risks, the discussions focused on the monetary policy stance, the Stability and Growth Pact (SGP), and structural reforms.

- **The monetary policy stance remains appropriate, for now**. While there was agreement on the baseline projection for inflation, the ECB emphasized that the distribution of risks to price stability was heavily skewed to the upside. Staff argued that the risks were more balanced and—while keeping rates on hold remained appropriate—a rate cut would be needed if, absent new information on inflation, evidence accumulated that the recovery was fading.

- **Fiscal policies are falling well short of consolidation requirements and the area remains insufficiently prepared for the looming demographic shock**. Past fiscal policy failures, notably insufficient adjustment during economic upswings, have strained the SGP, EMU's fiscal framework. Staff welcomed certain elements of flexibility in the SGP reforms, while regretting the vagueness and open-endedness of others. There was agreement that this left the effectiveness and credibility of the reformed SGP hinging largely on its implementation by the European Council. In the staff's view, this also underscored the need for stronger national institutions to assess policies, a proposal that was questioned by a number of national authorities.

- **Center-led structural reform programs have struggled to deliver**. While the Commission, the ECB and the staff broadly agreed on the need for reforms, views differed on their potential contribution to resolving global imbalances. Staff welcomed the greater emphasis on ownership in the reinvigorated Lisbon strategy, but expressed concern about insufficient prioritization and incentives for implementation. Staff questioned whether the programs underway to integrate Europe's financial markets would yield timely results. Interlocutors considered such concerns, including discussion of further centralization of regulation and supervision, premature.

I. INTRODUCTION

1. **The past few years have been difficult ones for the euro area and, by extension, for Europe more generally**. This became all too evident recently when the still elusive recovery, cutbacks in cherished welfare programs, fears of delocalization, and electoral calendars coalesced with other concerns to prompt French and Dutch referenda rejecting the EU constitution (Box 1) and an acrimonious European Council Summit on the EU budget. Although many-dimensional, these symptoms partly reflect a frustration with the size of the economic problems euro-area countries face and the sluggishness of the system in delivering suitable policy responses. In many quarters, perceptions of and patience with Europe reached new lows during this year's Article IV consultations.

2. **While the impatience is understandable, the pessimism seems exaggerated**. Repeated disappointments on both activity and inflation are raising questions about the health of the euro-area economy. However, both the policies and the economic fundamentals have gradually been laying the basis for a slow recovery. On the structural front, progress has been made in the past few years towards reducing rigidities and addressing the looming demographic shock (Box 2). Together with continued wage moderation, these policies should again lead to further improvements in the area's employment performance. On the cyclical front, significant progress has been made toward adjusting away the balance sheet strains stemming from the 2000 bust, leading to a strengthening of investment and consumption in 2004. While this progress has been interrupted by the economic and political ructions of the first half of this year, the underlying thrust of policies and developments over the past few years leads staff to continue to expect a gradual, modest, but strengthening recovery, albeit amidst preponderantly downside risks stemming from confidence effects or international headwinds.

3. **A more open question is whether policies will muster the decisiveness needed to address the area's still formidable problems**. Two considerations invite caution. First, policy decisiveness has been erratic, with the spate of structural reforms of the past few years possibly motivated as much by bad times as the need for a more forward-looking approach. In this regard, the fraying of the consensus on fiscal policies and the shift to water-treading policies in a number of countries does not bode well. Second, the stresses of the past few years have also led to a rebalancing—embodied in the reformed SGP and the revised Lisbon Strategy—in the respective roles of the center ("Brussels") and the member states, with more of the responsibility and initiative placed on the latter, and with the Council in an intermediate position. Officials point to these arrangements as providing a more realistic and ultimately sounder basis for strengthened policies. Ownership considerations support this view. However, absent stronger policy leadership and surveillance at the national level, these may take time to materialize.

Box 1. The European Constitution

The proposed European Constitution resulted from a desire to improve the EU's functioning, increase its democratic legitimacy, and consolidate, simplify, and replace existing treaties. Significant changes would include the increased use of majority voting and a modified voting system on the European Council—the present one, established in the Nice Treaty, would remain valid until 2009; the introduction of a President of the Council and a Union Minister for Foreign Affairs; a reinforced role for the European Parliament; and a smaller Commission. In the area of monetary policy, the Constitution preserves the existing institutional set-up, with only minor adaptations such as the formal recognition of the already existing Eurogroup and Eurosystem.

The Constitution enters into effect after all 25 EU member states have ratified it. As of June 6, 2005, ten member states had done so, while referenda in France and the Netherlands had resulted in rejections. Of the remaining countries, seven planned to hold referenda. While Luxembourg is going ahead with its referendum on July 10, 2005, others intend to reflect on the way forward and the original November 2006 ratification target date has effectively been dropped.

The implications of the French and Dutch referenda results are, as of now, difficult to discern. Since the Constitution leaves the monetary policy framework unaffected and does not directly affect economic fundamentals, it should not impede the functioning of the monetary union. The main risk is for policy paralysis in the longer run at the Commission/Council, if the EU's governance structure remains unchanged.

Box 2. Past Fund Policy Recommendations and Implementation

Monetary policy: Over the past few consultations, the Fund has argued that monetary policy should remain accommodative until a sustained recovery in domestic demand firmly takes hold. Policy rates have been on hold since June 2003. The ECB has generally stressed that the balance of risks for price stability was clearly toward the upside, while the Fund saw a more balanced distribution. In the event, headline inflation typically exceeded staff and ECB forecasts but underlying inflationary pressures remained contained.

Fiscal policy: The Fund has underscored that underlying (cyclically-adjusted) balance was an appropriate medium-term goal, especially in light of imminent population aging. Countries with weak underlying budgetary positions were to undertake high-quality fiscal adjustments of at least ½ percent of GDP a year (and more in good times), while letting fiscal stabilizers work fully around the consolidation path. In reality, while the stabilizers have been allowed to operate, adjustment has fallen well short of this target. The Fund also called for a new consensus on the SGP, embodying better incentives to adjust in good times and a clearer differentiation between policies and the economic environment in the application of the Excessive Deficit Procedure (EDP). A new agreement has emerged in the past year that addressed Fund concerns about the EDP, but that made the Pact less transparent and did not strengthen its preventive arm.

Structural policy: The Fund has argued that the area's key challenge has been to raise longer-term growth, especially by bolstering incentives to work. While progress has been made in recent years—including entitlement and labor reforms in key countries—labor utilization remains low and limited headway has been made in further developing the internal market. In this vein, the Fund has argued that the Lisbon Strategy remains an appropriate vehicle to foster reforms, as long as it is appropriately prioritized and undergirded by credible peer pressure, including through the use of benchmarking. The European Council adopted a rejuvenated Lisbon Strategy, which went some way toward better prioritization and improved governance structures, but stopped short of endorsing benchmarking.

II. Background

A. Recent Developments

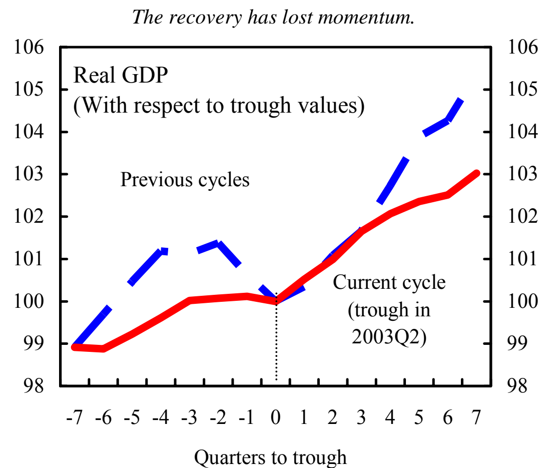
4. **The low-flying recovery has hit a rough patch**. Hard data paint a confusing picture of rising weaknesses. After showing promising gains during 2004, final domestic demand unexpectedly stalled in 2005:Q1. By contrast, after losing momentum last year, real GDP growth rebounded to 2 percent in Q1, primarily reflecting slowing imports. Initially on par with past recoveries, growth overall has slipped relative to previous upturns (Appendix I, Figures A1 and A2).

Euro Area: GDP and Final Domestic Demand
(Q-o-q annualized rates in percent)

	GDP growth	Final Domestic Demand (Contribution to growth)
2004:Q1	2.6	1.0
2004:Q2	1.7	1.1
2004:Q3	1.1	1.8
2004:Q4	0.6	2.3
2005:Q1	2.0	-0.1
2005:Q2	1.1	1.6
2005:Q3	1.4	1.7
2005:Q4	1.7	2.1

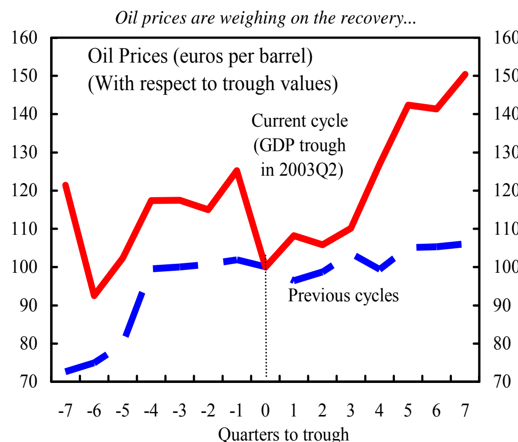
Source: IMF, World Economic Outlook.

The recovery has lost momentum.

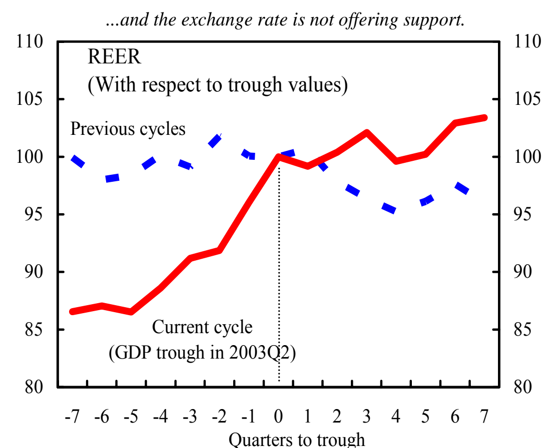


5. **A key reason for the area's disappointing recovery has been a high oil price and an appreciated exchange rate** (Figure A3). Oil price hikes since mid-2003 may have detracted about ½ percentage point from real GDP growth in 2004 and may do so again in 2005. In the meantime, the euro's appreciation has softened the impulse from the global expansion, subtracting almost ½ percent from growth in 2004 (Figures A4 and A5).

Oil prices are weighing on the recovery...

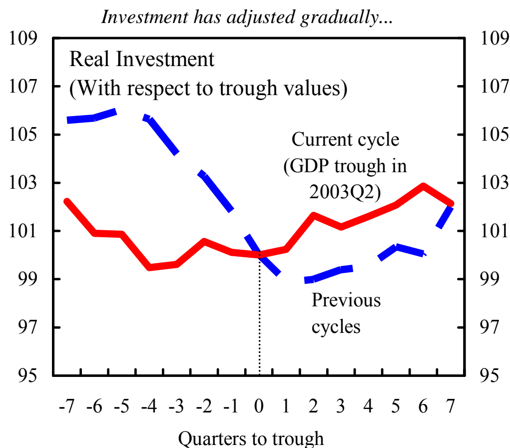


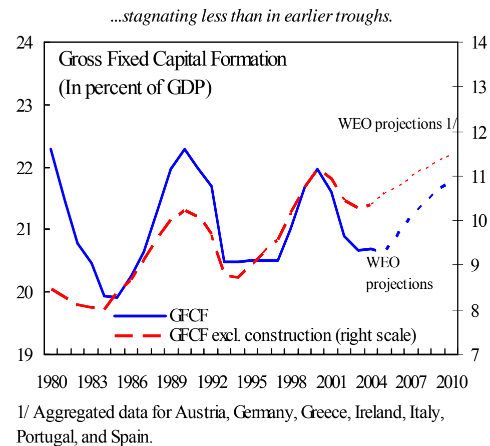
...and the exchange rate is not offering support.



6. **The fundamentals for a tepid recovery remain in place, particularly those surrounding improved labor market resiliency**. Past labor market reforms and continued wage moderation have made it easier for employers to preserve payrolls and adjust hours worked to reduce costs and avoid the typical labor shedding seen in past cycles (Figure A6). With the recovery, total hours have begun to rebound. Employment growth though has been modest, but wage settlements should be conducive to new hiring.

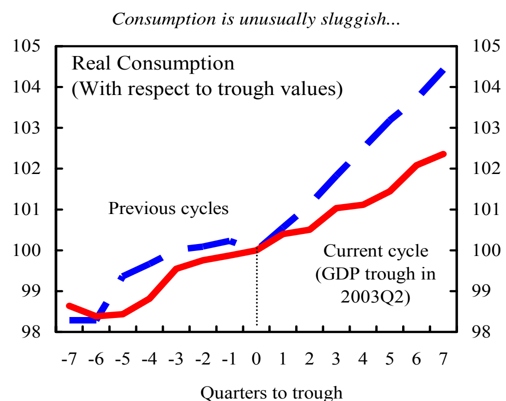
7. **Benefiting from restrained labor costs, businesses have raised profitability and improved balance sheets, setting the stage for stronger investment** (Figure A7).[2] With favorable labor costs, relaxed financing conditions, and buoyant external demand, firms—especially larger companies, many with overseas activities—have rebuilt profits despite euro appreciation and elevated oil prices. By and large, improved cash flows thus far have been channeled into balance sheet consolidation, dividend payouts, and replacing worn-out capital. Continued buoyant external demand, however, should eventually prompt a stronger response of investment and employment.





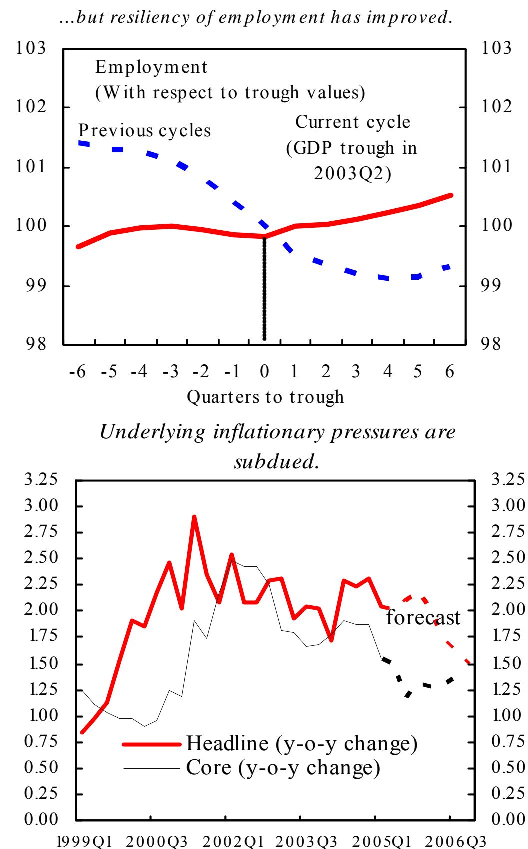
1/ Aggregated data for Austria, Germany, Greece, Ireland, Italy, Portugal, and Spain.

8. **The elements for a more vigorous, self-sustaining recovery have yet to come together, however, with household consumption a key missing link**. Reticent consumption growth has moved in line with small gains in disposable income, limited by modest wage earnings and unfavorable price shocks (Figure A8). On the domestic front, these have included unusually



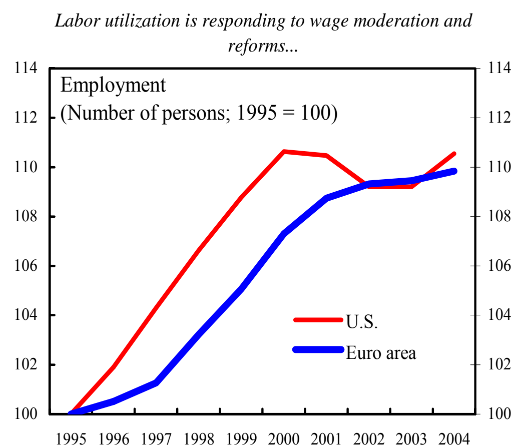
[2] Foreign direct investment (FDI) and "delocalization"—contrary to popular perceptions—appear not to have been a major source of diversion, although they may be forestalling higher wages.

large administered price hikes, which cut some 0.7 and 0.4 percentage point off real disposable incomes in 2004 and 2005, respectively. In tandem with increasingly uncertain benefit prospects, consumers have been disinclined to reduce saving rates, unlike in previous recoveries. Low interest rates have fueled demand for housing, but new home purchases and rising real estate values have not translated strongly into higher consumption expenditures, given relatively few avenues in Europe to tap into home equity. As energy price hikes slow and administered prices stabilize, headline inflation should gradually converge to underlying inflation—which is running around 1½ percent—and this should support real income growth. But more employment growth, which is being facilitated by wage settlements, and confidence are essential for consumption to propel activity.



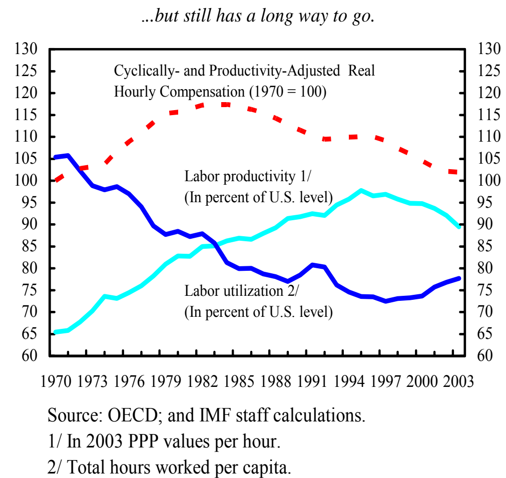
B. Structural Perspectives

9. **Structural adjustment has delivered on some counts and should continue to do so in the future**. Wage restraint and reforms of part-time and temporary work have enhanced cyclical resiliency and encouraged job-rich growth. Since the mid-1990s, employment has risen by some 12 million and been robust through the downturn, a performance that is comparable to that of the United States. More generally, past trend declines in labor utilization have been arrested and even begun to turn around. Indeed, since 2000 employment rates of those aged 55 to 64 years—a key source of problems in earlier decades—have risen by over 4 percentage points. Concurrently, wages are subdued, notwithstanding major shocks, testifying to improved labor market institutions relative to earlier decades. Furthermore, fiscal policy has generally performed better than during earlier recessions and entitlement reform has proceeded.



10. **Nonetheless, the challenges remain large**. The demographic shock looms ever closer. Employment rates remain low and, although partly reflecting the necessary increase in the employment intensity of output, disappointing productivity trends need to be reversed. More proximately, there is a need to reduce the 9–11 percent unemployment rates in the large states, which have helped fuel discontent with center-led policies.

...but still has a long way to go.



Source: OECD; and IMF staff calculations.
1/ In 2003 PPP values per hour.
2/ Total hours worked per capita.

11. **There is a risk that reform fatigue and discontent with Europe will delay the area's continued adjustment over the medium run**. The discontent finds expression in part in the view that the high unemployment rates in the larger countries reflect an increased divergence in countries' performances, at the expense of the larger countries, as a result of monetary union. In fact, divergences have been declining (Box 3). The weak performances are instead rooted in uneven efforts to implement labor and product market reforms and delays in addressing asymmetric shocks and losses of competitiveness (broadly construed) that have induced longer-term swings in countries' performances.

12. **While there may be a pause in the pace of reforms, fundamental changes in the course of policies do not appear in the offing**. Developments in area-wide spreads of government bond yields suggest that capital markets seem to share this assessment, including following the rejection of the draft EU Constitution by some electorates (Figure A9). Overall, staff sees potential output growth stuck at a low level of around 2 percent, with actual growth only modestly higher over the medium run to close an output gap of about 1½ percent of potential GDP.

III. Report on the Discussions

A. Near-term Prospects and Risks

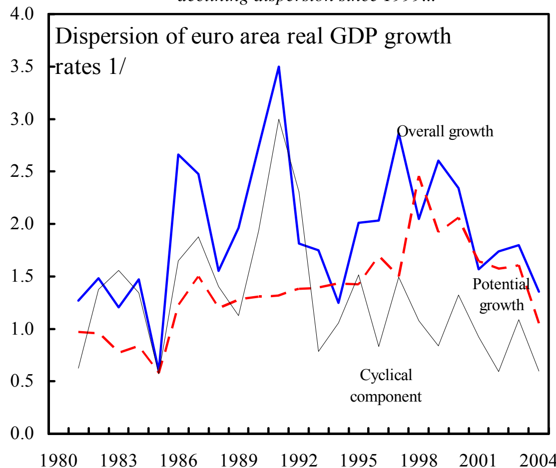
13. **The shared view was that the fog surrounding the state of the recovery has not been lifted and that recent data releases have heightened downside risks**. The abrupt halt in domestic demand together with the acceleration in real GDP growth in 2005:Q1 is difficult to explain. Oil prices increased from about euro 30 to 40 per barrel during the first quarter, possibly affecting forward-looking investment and employment decisions. Also, bad weather depressed construction, although calendar effects have had an opposite effect on headline GDP. "Pipeline" effects of past real exchange rate appreciation together with a sudden, presumably temporary, slowdown in global trade in the first part of the year pointed to weakness in goods production through the second quarter.

Box 3. Regional Divergences

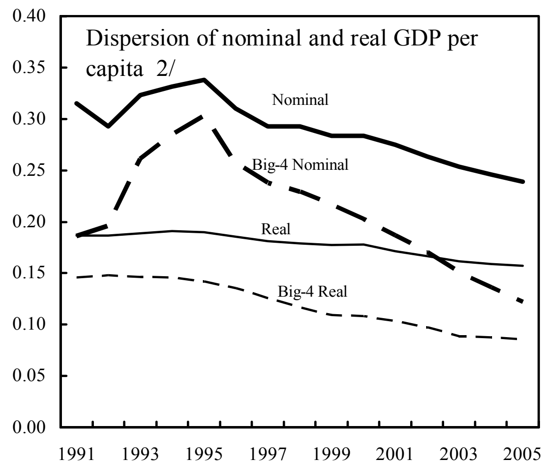
Increasing concern has been voiced about divergences in economic performance between member states, based in part on evidence from highly volatile quarterly data. In fact, area-wide annual numbers show no evidence of increasing dispersion in real GDP growth and inflation since the introduction of the euro in 1999, and currently observed differences appear to reflect partly an ongoing process of income-level convergence. Temporarily diverging dynamics can be triggered by the different speeds with which financial, nominal, and real variables converge.

While temporarily diverging dynamics are a normal feature both of the convergence process and the functioning of a mature monetary union, they may entail risks if, for example, due to structural rigidities or inappropriate policies, real wages move significantly ahead of productivity. This appears to have been the case in some members, notably those with weaker productivity performances. Avoiding that losses in competitiveness become deeply ingrained and prompt long-term swings in performance requires strategies that exploit fully the complementarity between structural and fiscal policies.

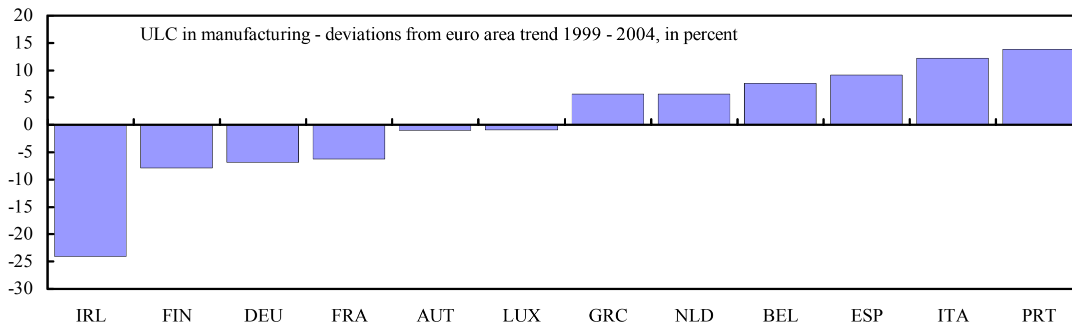
Cyclical and trend components of economic growth rates show declining dispersion since 1999...



...and remaining differences reflect at least in part ongoing convergence in income and price levels.



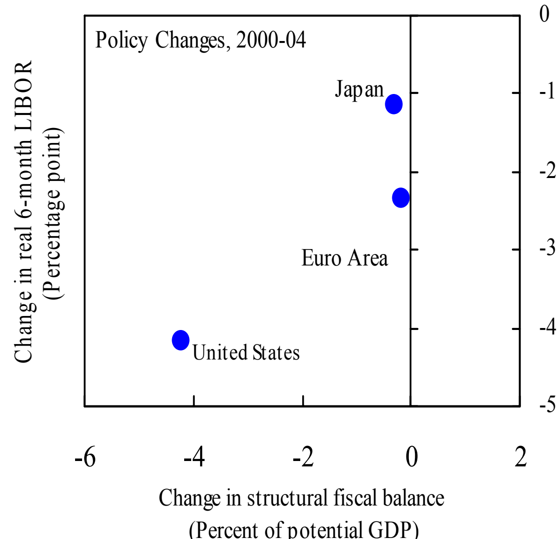
Nevertheless, developments in competitiveness require monitoring.



Source: IMF, World Economic Outlook database; and Fund staff calculations.
1/ Standard deviation used as measure of dispersion.
2/ Excluding Luxembourg and Ireland; big-4 = Germany, France, Italy and Spain; real GDP per capita is on PPP basis; coefficient of variation used as measure of dispersion.

14. **Nevertheless, elements sufficient for a continuation of the gradual recovery seem to remain in place**. With fiscal policies largely in water treading mode and interest rates at historical lows, macroeconomic policies and financial conditions are supportive. The recovery of hours worked should begin to translate into higher employment and, together with slowing administered prices, support household incomes. Also, the effect of past exchange rate appreciations should be waning. Crucially, world demand and trade are projected to strengthen again, following an oil price-related soft patch. Commission staff emphasized the toll of uncertainty—including that surrounding reforms and the political situation—on expectations and confidence (Figure 1). But absent evidence that the global recovery is veering off-track, Commission, ECB and Fund staff project similar central scenarios, i.e., where euro-area output regains momentum in the second half of this year—with 2005 real GDP growth around 1⅓ percent—and achieves growth at potential by 2006 (Table 1). Hard data released since the discussions point to resuming manufacturing and construction activity, while service sector indicators remain resilient, supporting the central scenario.

Policies were less expansionary but supportive in the euro area. 1/



1/ Comparative assessments of policy stances need to allow for the differences in the role of the automatic stabilizers (relatively large in the euro area), the volatility of output (relatively low), and potential growth (relatively weak and weakening). Adjusted for such factors, area-wide policies have been more supportive than often perceived.

15. **Absent stronger internal dynamics, the area-wide recovery remains exposed to external shocks and weakening confidence**. Principal among these are further oil price hikes and multilateral euro appreciation. The area's current account has played a minor counterpart role to growing external imbalances elsewhere (Table 2); and the staff's multilateral assessments suggest that the area's real effective exchange rate is somewhat above but close to medium-term fundamentals. However, all agreed that, in light of recent history and the euro's prominent and expanding international role (Figure 2), the risk of a major appreciation remained on the horizon. Since the discussions, risks for activity from the euro—which has depreciated by some 2½ percent in effective terms—have receded somewhat. However, risks from a stronger fall in confidence may have risen.

The outlook for oil prices is shifting rapidly.

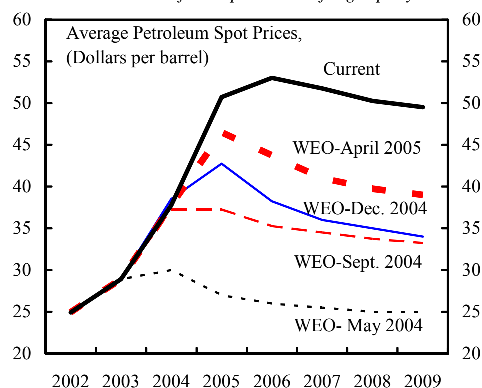
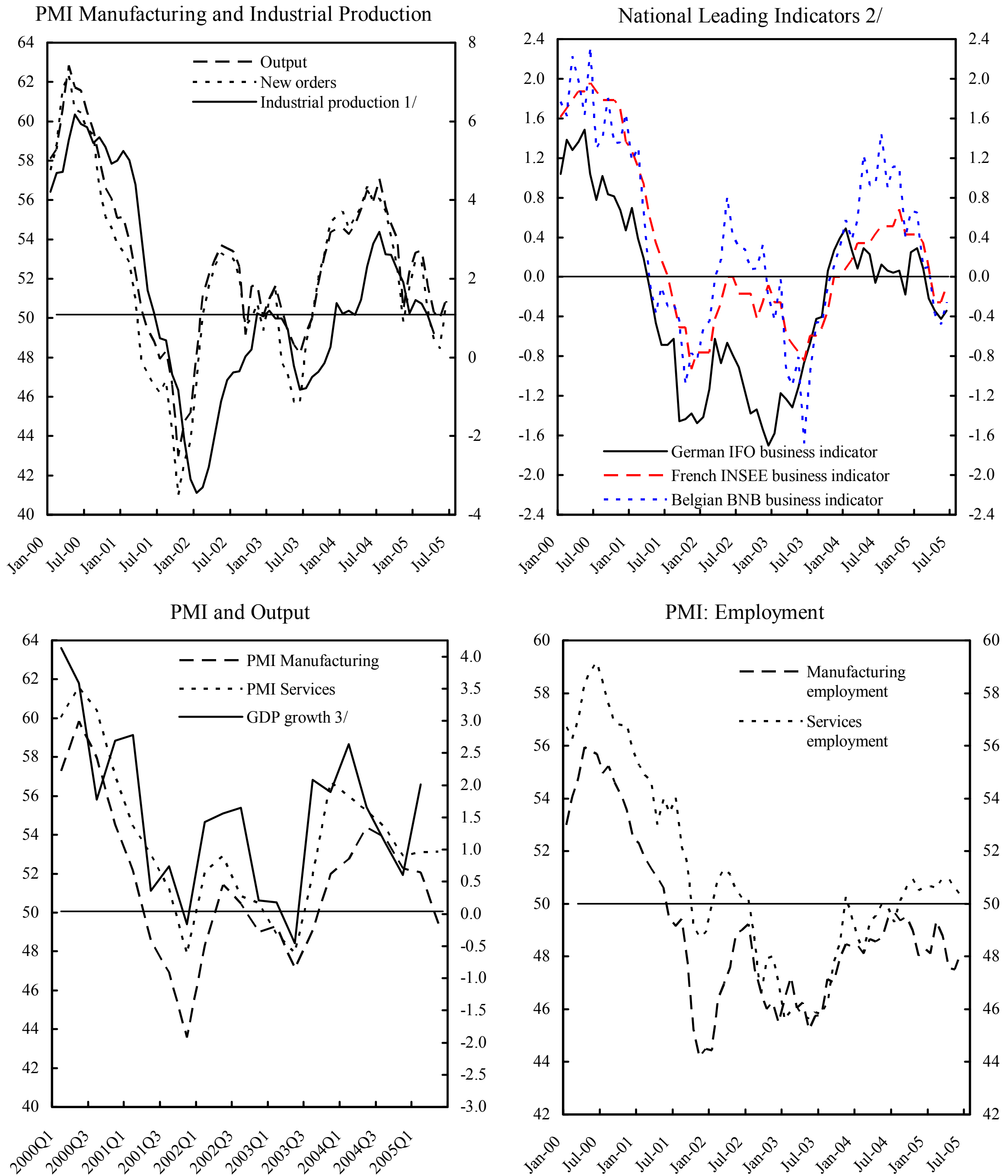


Figure 1. Euro Area: Leading Indicators



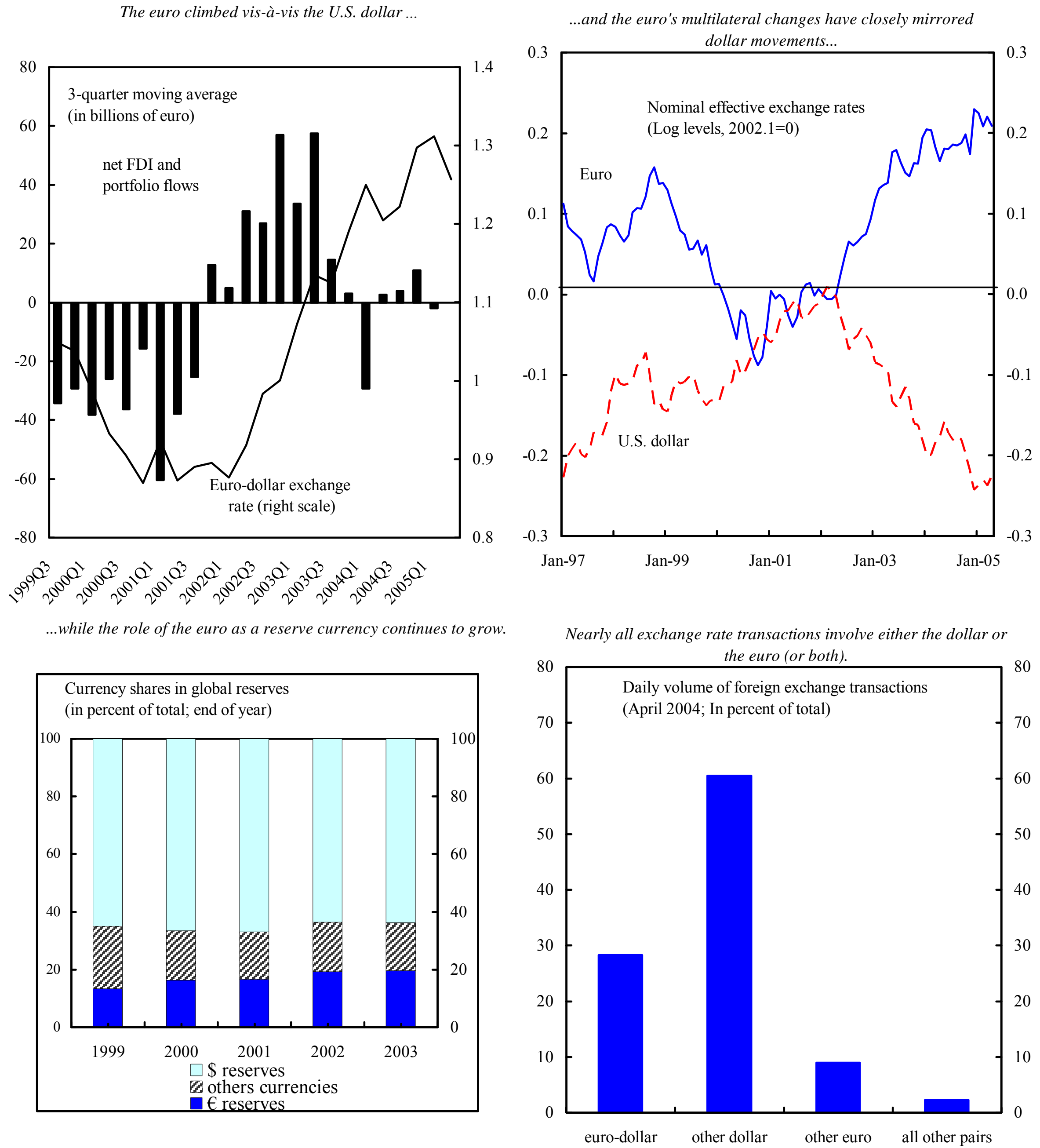
Sources: Eurostat, Reuters, IFO, INSEE, Banque Nationale de Belgique, and staff calculations.

1/ Year-on-year percent change, three-month moving average, right scale.

2/ Standardized over 1991-2004 period.

3/ Annualized quarter-on-quarter growth, right scale.

Figure 2. Euro Area: Exchange Rates



Sources: Revised Annual Report, IMF (2003); Bank of International Settlements; and ECB.

B. Inflation and Monetary Policy

16. **Although headline inflation has persisted at or above 2 percent, underlying inflationary pressures are easing** (Figure 3). Large increases in oil and administered prices had pushed up HICP inflation to 2½ percent by mid-2004 and continue to affect prices in 2005. But with modest wage setting and some cyclical bounce in labor productivity, unit labor costs have decelerated sharply and "second-round effects" from higher oil prices have not materialized. In the context of a modest recovery and lingering weakness in labor markets, both ECB and IMF staff foresaw core inflation falling close to 1½ percent over the medium term, with ECB staff seeing a modest acceleration beginning in 2007. Headline inflation would still run around 2 percent in 2005 and moderate to 1¾ percent in 2006, excluding a one-off reduction in administered prices.[3] Inflation expectations, particularly survey-based measures, have been broadly stable, and the more volatile market-based measures (i.e., break-even rates) have recently receded.

17. **ECB officials nonetheless saw the distribution of risks to inflation as heavily skewed to the upside**. They argued that indirect taxes, administered prices, and oil prices, which were essentially held constant in the projections, continued to pose upside risks for inflation. These had been the main factors behind the repeatedly optimistic forecasts and five years of at least 2 percent inflation. They remained major risks going forward, as suggested in particular by the persistently tight demand-supply balance in the oil market—a point that has again been borne out by price developments since the discussions. Second-round effects stemming from wage and price-setting might still emerge, particularly once the recovery gathered pace. Moreover, while survey- and market-based measures of inflationary expectations remained well anchored, they did not point to inflation falling substantially below 2 percent.

18. **ECB officials viewed monetary and credit conditions as also pointing to upside risks to price stability** (Figures 4 and A10). Policy rates had been on hold at 2 percent—well below the neutral rate—since June 2003 and the yield curve had flattened at the long end, providing supportive financial conditions for the recovery. However, low interest rates had also led to a rapid expansion of monetary aggregates, particularly the most liquid components. As a result, the ECB's monetary analysis pointed to liquidity exceeding that consistent with price stability over the medium to longer term. Similarly, on credit developments, loans to households—mainly, mortgage lending—had seen brisk growth and credit to nonfinancial corporates had shown renewed strength recently. Indeed, as a result of strong credit growth the ECB saw a need to carefully monitor whether risks to price stability were building in the context of strong house price increases in some regions of the euro area.

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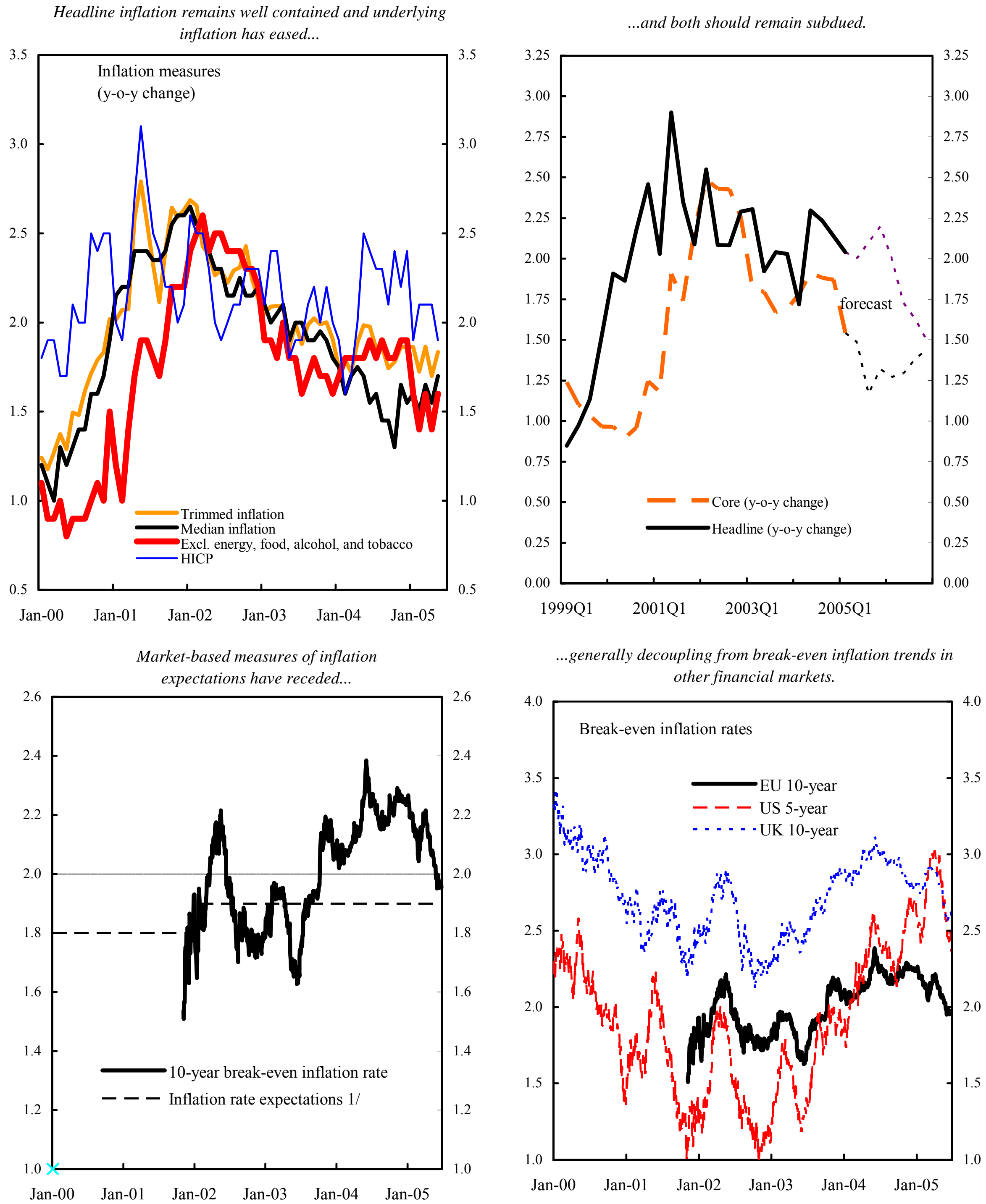
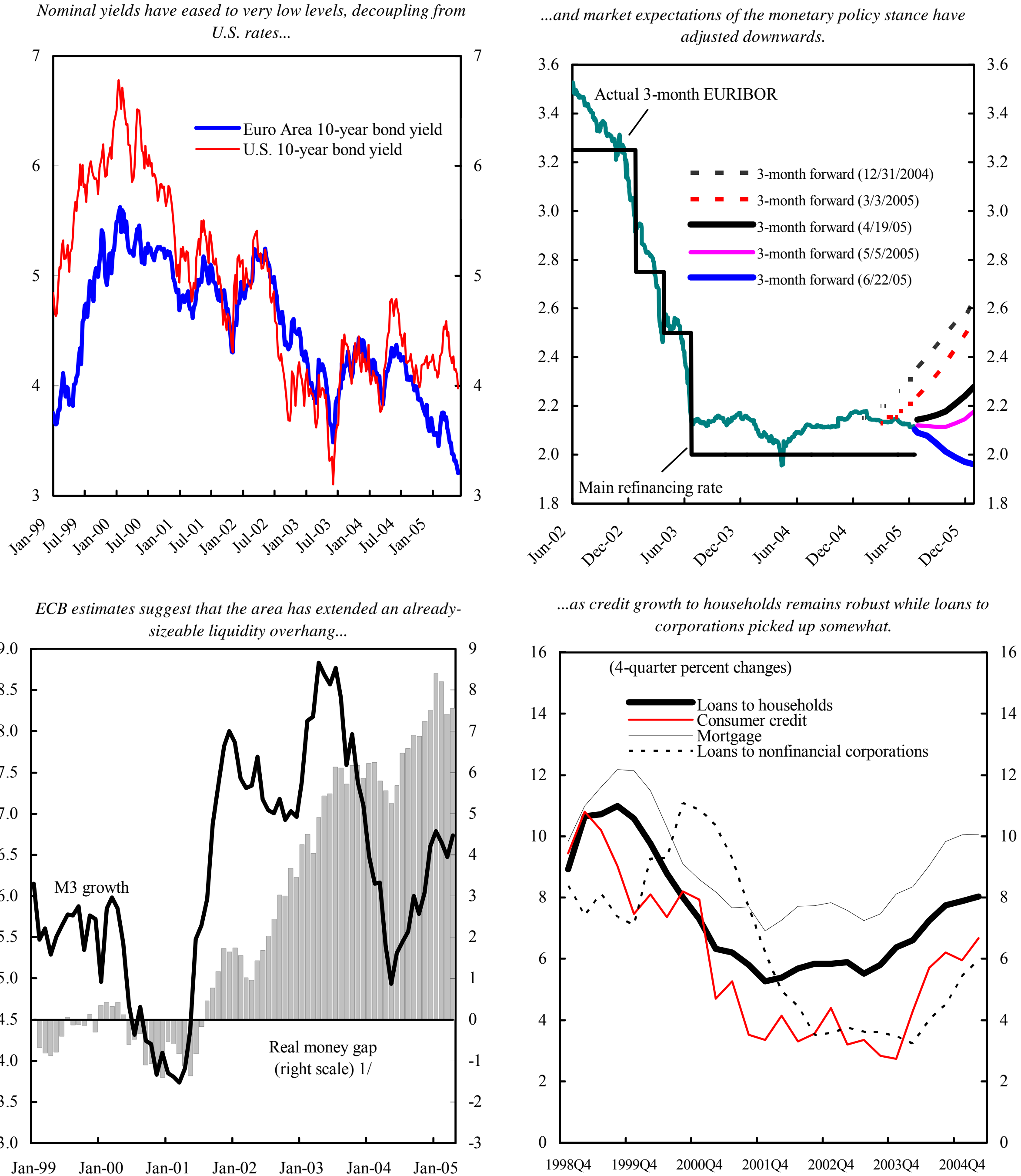
[3] ECB projections of June 2, 2005, place average annual HICP inflation between 1.8–2.2 (mid-point 2.0) percent in 2005 and between 0.9–2.1 (mid-point 1.5) percent in 2006. For 2006, this includes a one-off reduction resulting from a health care reform in the Netherlands that is projected to trim 0.2 percentage point from the area-wide price level.

Figure 3. Euro Area: Inflationary Developments and Outlook
(In percent, unless otherwise noted)



Sources: Datastream; Eurostat; and staff calculations and forecasts.
1/ Survey of Professional Forecasters.

Figure 4. Euro Area: Interest, Money, and Credit
(In percent, unless otherwise specified)



Sources: ECB; Datastream; Bloomberg; and staff calculations.
1/ Deviation (in percent) of the actual real stock of M3 from an estimate of the long-run real stock of M3, consistent with long-run inflation of 1.75 percent a year and assuming that the real money gap was zero in January 1999.

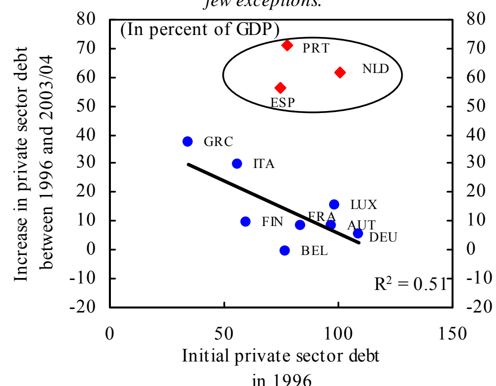
19. **Viewing risks to price stability as heavily skewed to the upside, ECB officials felt that it was not appropriate to entertain interest rate cuts, although their language is widely perceived to have softened since the discussions**. They noted that the highly accommodative policy stance would inevitably need to end. In the meantime, the ECB stood ready to raise rates rapidly in the event that inflationary expectations lost their anchor. They elaborated that their established credibility and readiness to act had delivered an enviable yield curve, with long-term interest rates having reached historical lows in all euro-area member countries. This achievement would be put at risk if rate cuts were to be considered at this stage. Since the discussions, however, ECB officials have no longer explicitly ruled out the option of cutting rates.

20. **Staff saw the risks to price stability as more balanced than suggested by the ECB**.

- As regards the "economic" pillar, it agreed that one-off shocks had been a continuing problem and that the resulting persistent over-shooting of the inflation target gave rise to both upside risks and credibility issues that needed to be taken into account. By the same token, wage and underlying inflation had been ebbing down and were expected to remain below levels consistent with the ECB's target even on a baseline that foresaw a recovery of activity. Moreover, second-round effects were notable mainly for their absence. This pointed to downside risks.

- As regards the monetary analysis, staff viewed the risks as too uncertain and long-term to motivate a change in policy stance at this juncture. While liquidity was ample, and appropriately so, robust cautionary signs of building medium-term inflationary pressures were lacking (Box 4).[4] Furthermore, except for a few outliers, rapid credit growth—mainly for mortgages—had been in line with financial "catch-up," which might help explain the dichotomy between the pace of activity in the area's real versus financial sector. Nonetheless, staff agreed that it would be imprudent to downplay concerns related to excessive house prices in some countries of the euro area. However, these could be addressed more effectively at the national level, for example, with fiscal measures or prudential monitoring, as evidence for area-wide excessive house prices was not strong. Beyond these measures, staff pointed to the benefits of further

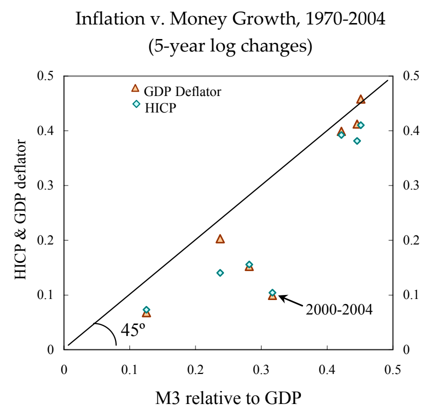
Credit developments reflect financial catch-up, with a few exceptions.



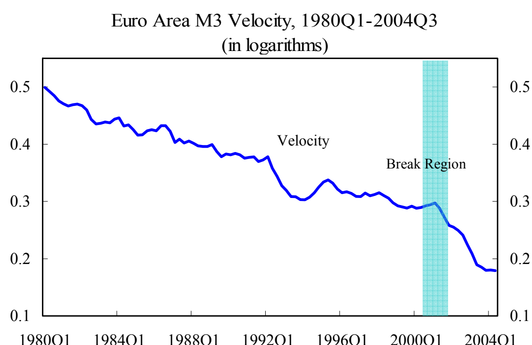
[4] See the Selected Issues chapter titled "Declining Velocity in the Euro Area: Implications for the ECB's Monetary Analysis."

Box 4. Evaluating Liquidity, Credit, and Inflation Risks After EMU

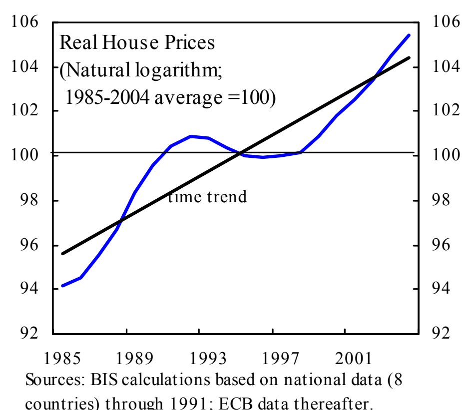
At the heart of ECB concerns over upside risks to inflation is "excess" liquidity. Historically, money growth in excess of real output growth has *over*predicted area-wide inflation, reflecting velocity's secular decline.



Staff analysis suggests a variable trend decline in velocity. Shifts could reflect temporary or more lasting factors, including portfolio shifts in the wake of the equity bubble, and/or more fundamental changes related to the creation of a large monetary union and the euro's expanding international role. This increases uncertainty surrounding the assessment of liquidity and its inflationary impact, compounding the inherent difficulties in drawing firm monetary lessons based on the history prior to EMU.



The ECB also worries that low interest rates are fueling asset price inflation. However, policy action faces hurdles related to reliably identifying financial bubbles; the complex links between credit, asset and consumer prices; and the accompanying spillovers for the real sector. While house prices have risen quite rapidly in some member countries, driven also by financial catch-up and a stronger pass-through of monetary policy to demand for mortgages and housing, evidence for area-wide "excess" is not strong.



Sources: BIS calculations based on national data (8 countries) through 1991; ECB data thereafter.

financial market integration for a more uniform passthrough of monetary policy to asset prices.[5]

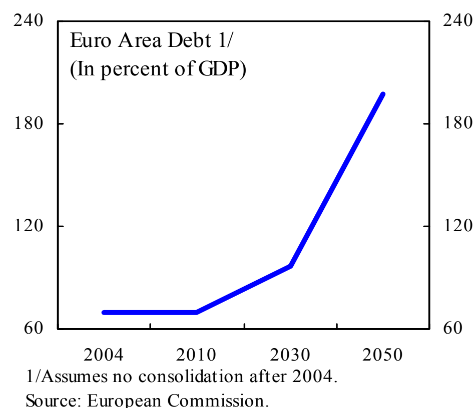
21. **Overall, staff considered that keeping interest rates on hold was still appropriate but that the need for a rate cut may be materializing**. Indeed, with inflation headed for rates below 2 percent and moderating further, a cut in interest rates would be appropriate if, contrary to projections, evidence for a fading recovery continued to accumulate. For the time being, however, the stickiness of overall inflation together with the uncertainty hanging over prospects meant that keeping interest rates on hold seemed appropriate.

22. **With internal demand lacking vigor, external risks also argued for some insurance**. Specifically, a sharp *multilateral* appreciation of the euro would open the case for monetary easing, other things being equal. If oil prices were to persist at heightened levels for the foreseeable future, maintaining a wait-and-see position on interest rates as insurance would be appropriate, according to Fund staff, insofar as second-round effects did not materialize. Since the discussions, however, the euro has depreciated by some 2½ percent in nominal effective terms; and oil prices have risen by about 10 percent. While these developments have little net effect on growth, they have a small positive impact on headline inflation.[6]

C. Fiscal Policy and SGP Reform

Fiscal Policy

23. **Fiscal policies are falling well short of what is needed to meet the area's fiscal consolidation requirements**. Absent action, the increase in aging-related expenditure after the end of the current decade will push debt in many countries onto clearly unsustainable trajectories. Staff viewed these pressures as calling for budgets to attain underlying balance by 2010 in tandem with continued progress with entitlement reforms. With the area-wide structural deficit close to 2 percent of GDP, achieving this objective required structural adjustment (net of one-offs and other temporary



1/Assumes no consolidation after 2004.
Source: European Commission.

[5] For a discussion of developments in housing markets and policy issues see the Selected Issues chapter titled "House Prices and Monetary Policy in the Euro Area."

[6] Accordingly, staff's latest forecast places headline inflation at 1.7 percent for 2006, or 0.2 percentage point above the ECB's forecast mid-point of June 2. A 10 percent rise in oil prices is estimated to lower growth by 0.1 percent and raise inflation by 0.2 percent; a 10 percent effective euro depreciation adds 0.4 percent to growth and 0.3 percent to inflation in the year ahead.

measures) of ½ percent of GDP annually. In fact, no significant area-wide consolidation has been achieved since 2000, and budgets for 2005 and targets for 2006 foresee little consolidation—with the larger countries being most prone to inaction (Figure 5). On staff projections, almost half of the countries in the euro area—France, Germany, Italy, Greece, and Portugal—would post deficits in excess of 3 percent in 2005–06, some by significant margins. Looking forward, the key problem was how to overcome the political economy biases toward postponing adjustment until rising market pressures force abrupt, potentially unsettling, action. More immediately, adjustment was also needed to secure an adequate safety margin to avoid a repeat of the breaches of the Maastricht ceiling during the next downswing.

24. **Some national authorities questioned whether the staff's views on fiscal policy would not undermine the support for structural reforms**. These authorities argued that, while recent entitlement reforms had, as acknowledged by staff, significantly reduced intertemporal imbalances, they had also led to sagging confidence and weak growth, which would be exacerbated by fiscal adjustment. Staff argued that the euro area's performance problems were pre-eminently long term and unlikely to be remedied by on-the-go fiscal fine tuning, particularly given the area's underlying fiscal unsustainability and its historical difficulty in reversing expansionary policies. In the staff's view, current uncertainties were mainly of a longer term character and due to the stop-and-go approach to structural reform and fiscal adjustment. Expectations would best be stabilized through the articulation and pursuit of a clear, consistent, and forward-looking strategy aimed at securing the longer-term sustainability of the social model.[7] While such a strategy would not preclude some ebb and flow in the role of its various elements, the underlying long-term complementarity between the area's structural and fiscal requirements limited the scope for such tradeoffs.

SGP Reform[8]

25. **The authorities fleshed out an agreement on a reformed Stability Pact that is seen as restoring needed order and discipline to EMU's fiscal anchor**. The Pact fell into procedural limbo in November 2003 when a badly split Council decided to suspend the Excessive Deficit Procedures (EDP) against France and Germany. The new Pact has been endorsed by all 25 EU members. The dissuasive arm—charged with ensuring that countries respect the limits on deficits and debt laid down by the Maastricht Treaty (3 percent and 60 percent of GDP, respectively)—has more flexible deadlines and allows consideration of a range of country circumstances. The preventive arm—which encouraged member states to

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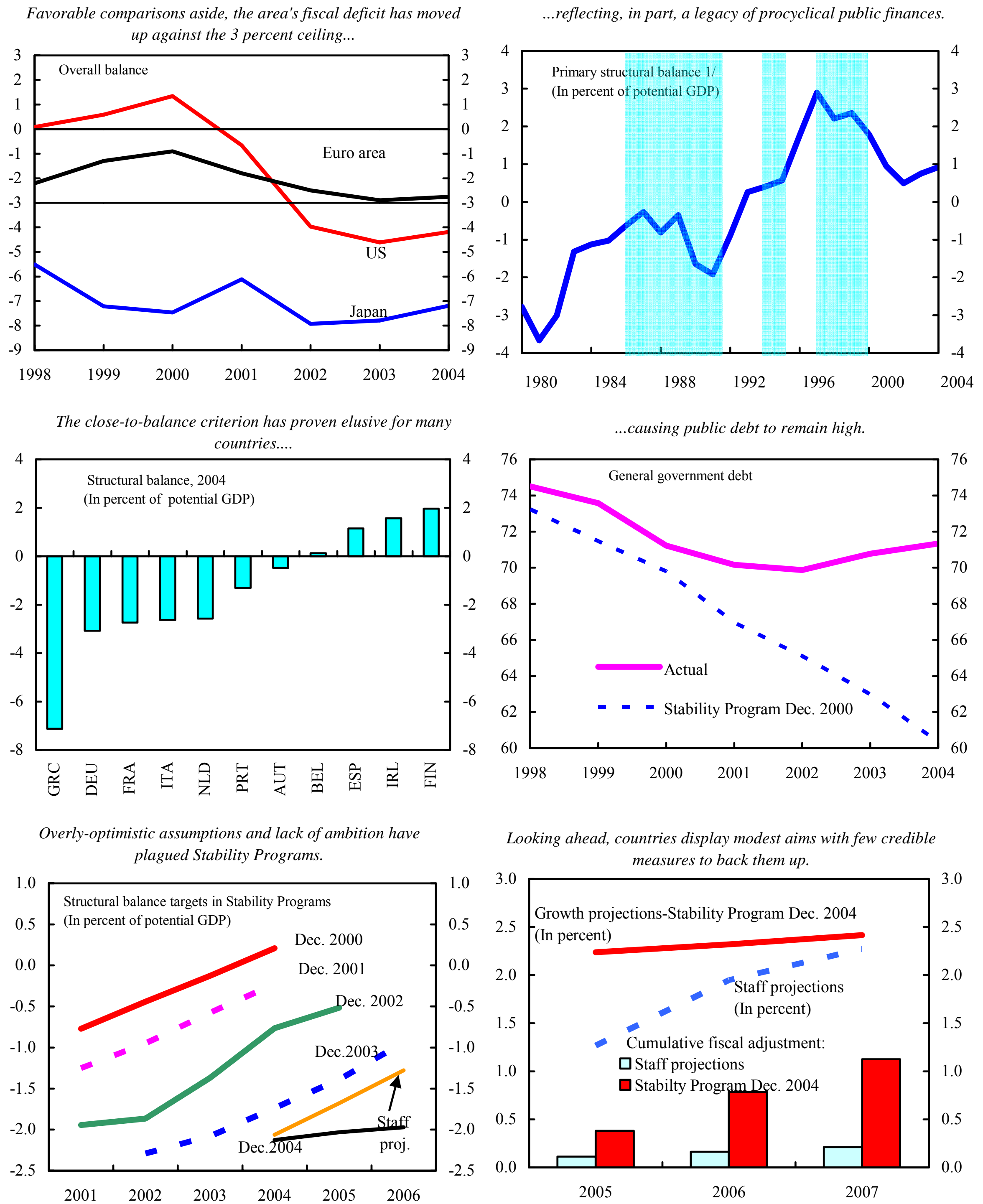
[7] For the general case against discretion, see for example, Fatás and Mihov (2003), "The Case for Restricting Fiscal Policy Discretion."

[8] See Annex II of the Council Conclusions of March 22–23, 2005 (No. 7619/05), available at http://www.eu2005.lu/en/actualites/conseil/2005/03/23conseileuropen/index.html.

Figure 5. Euro Area: Fiscal Developments
(In percent of GDP, unless otherwise noted)



Sources: European Commission; IMF, World Economic Outlook; and IMF staff calculations.
1/ Excludes Belgium, Luxembourg, and Greece. Shaded areas are periods of cyclical upswings.

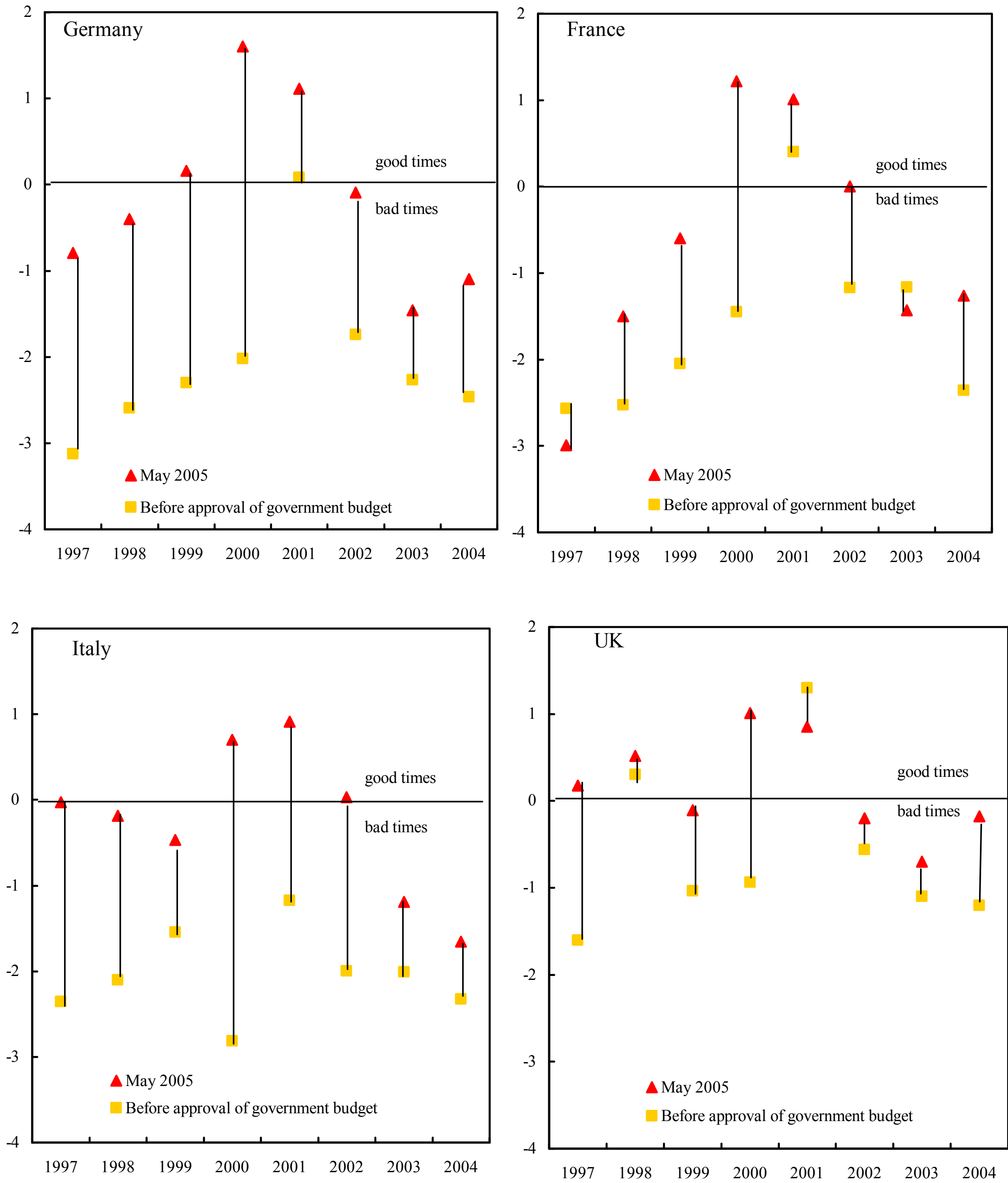
maintain budgets close to balance or in surplus (CBS)—would now set these medium-term objectives (MTOs) according to country conditions (i.e., potential growth and initial debt levels), up to a maximum deficit of 1 percent of GDP. The MTOs would subsequently be adjusted to incorporate implicit liabilities. National authorities and the Commission argued that these reforms improved the Pact's grounding in sound economic principles, thereby strengthening its potential for contributing to fiscal adjustment. In that regard, a clear step forward is the agreement to exclude one-off measures from assessments of policies under the reformed Pact.

26. **Views varied on the merits of introducing added flexibility into the dissuasive arm**. Some of the changes to the EDP are in line with staff views, notably the tighter link between adjustment deadlines and economic developments and the specification of a "minimum" annual adjustment in excessive deficits of at least ½ percent of GDP, net of one-offs and other temporary measures. On the other hand, the allowance for greater recourse to an open-ended list of "other relevant factors" is problematic as it could allow countries to avoid taking needed corrective action. The ECB, which is generally concerned by the complexity and vagueness of the reforms, viewed "other relevant factors" as a potentially serious watering down of the EDP. In response, the Commission argued that these factors could be invoked only if a breach of the 3 percent reference ratio was "temporary" and the deficit remained "close to the reference value."

27. **Staff's main concern is that the provisions of the preventive arm are such as to permit quite limited adjustment more or less indefinitely, including during upswings—the Achilles heel of the old Pact**. This stems from two provisions. The first states that the benchmark adjustment of ½ percent per annum is to be expected only when the level of output is at ("slightly below" if growth is high) or above potential. This is not the case at the current juncture and would excuse little adjustment for the foreseeable future. More fundamentally, however, the technique used to measure potential is such that this test is rarely if ever met in real time. It was not met by any of the largest countries even at the top of the 2000 boom (Figure 6).[9] This provision, which has the potential to vitiate the ½ percent adjustment benchmark, is exacerbated by a second that allows countries to deviate from their adjustment paths when they undertake major structural reforms. The provision would allow countries to scale back adjustment in proportion to the direct (through budgetary savings) or indirect (through raising potential growth) effects of reforms that improve long-term fiscal sustainability. Taken together, these provisions would seem to provide ample scope for so-minded countries to delay adjustment—as well as for lengthy debates on country assessments. While the authorities acknowledged these problems, they pointed out that the provisions for adjustment of the reformed Pact, while weaker than earlier expectations, now had a regulatory basis.

[9] See also ECB Monthly Bulletin February 2005.

Figure 6. Selected European Union Countries: Output Gap Estimates
(In percent of potential GDP)



Source: IMF, WEO.

28. **The complexity of the reformed Pact means that its effectiveness and credibility as a fiscal anchor will largely hinge on its implementation**. The Pact has up to now improved fiscal discipline in a number of countries, curbing runaway deficits and reducing procylicality. But the recent burgeoning of deficits and non-transparent actions—ranging from one-off measures, financial operations, and even misreporting—underscore the need to re-establish a credible fiscal framework under EMU to anchor policies and expectations. Agreement on a reformed SGP was therefore considered a welcome and necessary step forward. However, the reforms introduce less simple rules and new margins for discretion that could be misused. Staff thus argued that implementation, particularly by the Council, will be key, stressing the need for ambition relative to medium-term requirements, even-handedness in the application of the rules, and transparency under a more flexible but more complex Pact.

29. **With softer limits on fiscal policy at the center**, **staff argued for stronger national institutions to assess policies**, **a proposal that was questioned by a number of national authorities**. In the staff's view, popular disaffection pointed to the need to deepen public understanding at the national level of the longer-term issues facing countries and of the role of policies in addressing them. Steps in this direction—largely bypassed by SGP reforms—included debating Stability Programs in parliaments alongside budgets and strengthening or establishing independent, non-partisan fiscal councils. Such councils could assess policies, provide more forward-looking perspectives, help rally popular support for adjustment, better identify policy failures, and mark up reputation costs.[10] In so doing, they could provide some offset to the weaknesses of the disciplining devices of the center and contribute to the formulation of more realistic budgets. Several national authorities were not convinced, however, arguing that these councils already existed in various guises in several countries, that their effectiveness was not demonstrated, and that they could detract from policy implementation and muddy accountability. Staff acknowledged that requirements would depend on national institutional arrangements, and viewed steps in these directions as particularly important in countries with problems in policy implementation and where policies fell short of ensuring long-term sustainability.

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[10] A forthcoming FAD Board paper titled "Promoting Fiscal Discipline: Is There a Role for Fiscal Agencies?" discusses the role of Independent Fiscal Authorities (IFA) and Fiscal Councils (FC) in promoting fiscal discipline. It argues that Fiscal Councils can be beneficial, particularly if they engage in normative assessments and recommendations (as opposed to providing purely objective analyses), and if policies can be gauged relative to pre-existing fiscal rules. Moreover, staff work shows that macroeconomic and budgetary forecasts generated by independent entities tend to be more accurate than those produced by authorities.

D. Product and Factor Markets

30. **The basic issue confronting the euro area is how to strengthen the pace and effectiveness of reforms**. The Barroso Commission is pursuing a two-pronged approach. As regards the many reforms that depend primarily on the initiative of member states, the aim of the restructured Lisbon strategy is to shift the ownership and onus for the reforms onto the member states (no more "hiding behind Brussels"). An integrated policy framework would ensure more prioritization and coordination of the national reform efforts. This bottom-up approach is complemented and in a measure fostered by pressing center-led reforms that aim at strengthening product market competition and achieving integrated financial markets.

31. **While the need for reforms was common ground, views differed on the extent to which they should be motivated by their contribution to resolving global imbalances**. The Commission and ECB staff noted that the root causes of imbalances lied elsewhere in the world economy and thus believed that a convincing case for EU reform had to be motivated from a domestic perspective. The national authorities added that the effects of structural reforms on global imbalances were ambiguous, as they might raise both investment and saving. While agreeing that the net effect on current accounts was arguable, staff noted that after a lag reflecting confidence and other effects, structural reforms should boost domestic demand and growth. Hence, Europe—and at one removed the world economy—would be in a better position to withstand a market-driven, more abrupt resolution of the imbalances. Moreover, a cooperative approach to the resolution of global imbalances would help forestall abrupt scenarios.

Lisbon revisited

32. **The Commission has made the implementation of a reinvigorated Lisbon Strategy its top priority**. The original agenda—launched in March 2000 to make Europe the most dynamic, knowledge-based economy by 2010—has fallen short of galvanizing support for accelerating structural reforms. One key objective, raising the employment rate to 70 percent by 2010, is now out of reach. While most of the reforms in question are the prerogatives of governments, there is agreement that coordination at EU levels has also fallen short. The restructured strategy, endorsed by the European Council in March/June, features the following:

- *An integrated and focused agenda*. The objective is to make Europe a more attractive place to work and invest, to spread knowledge and innovation, and to create more and better jobs. The new strategy aims to promote greater consistency in reform programs through the promulgation and adoption of EU-wide Integrated Guidelines for Growth and Employment (covering three years) that regroup a number of up to now separate reform tracks managed by different ministries. In particular, the new guidelines encompass the former Broad Economic Policy Guidelines and Employment Guidelines.

- *A shift in the procedural locus from Brussels to the national level*. Governments are to prepare National Action Plans (NAPs) that fit within the Integrated Guidelines.

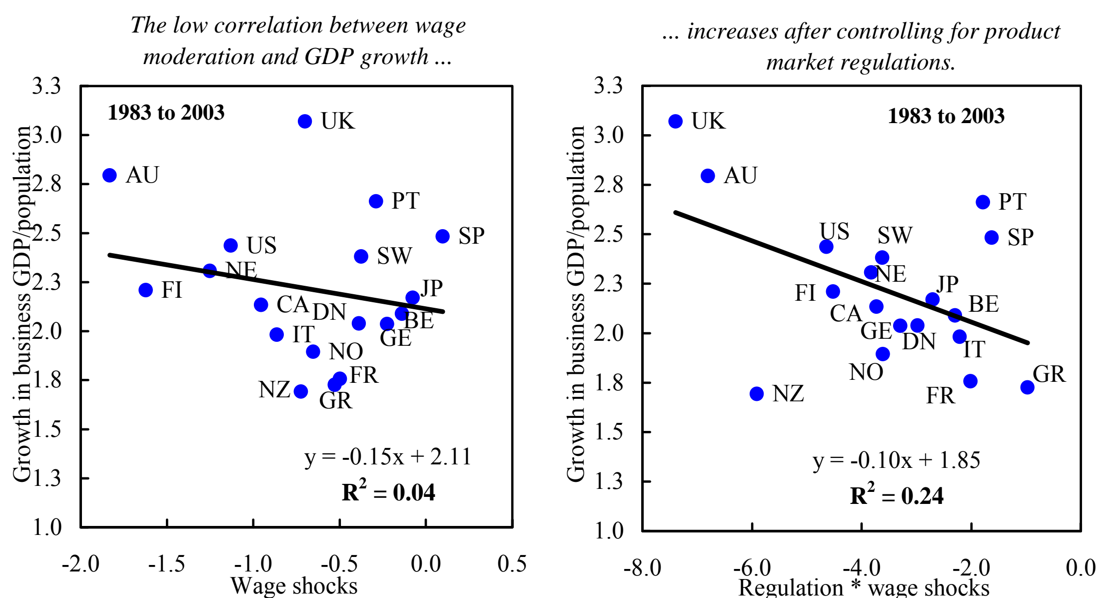
These plans are to include concrete measures and timetables for their implementation, all under the aegis of a national "Mr./Ms. Lisbon," who is to collaborate closely with all stakeholders, including national Parliaments. The objective is to strengthen national initiative and ownership.

33. **Staff welcomed the emphasis on integrated guidelines and ownership, but questioned whether prioritization had gone far enough and sufficient weight been given to peer pressure**.

- On the positive side, the emphasis on integrating agendas was on the mark as more and more analyses pointed to the importance of devising packages of measures that reinforced each other. An instance in point is the synergy between wage moderation and product market reforms documented by staff (see Box 5). Similarly, shifting part of the agenda-setting from Brussels institutions to the national arena seemed necessary to build lasting popular support for the course of reform.

Box 5. **Product Market Regulations and the Benefits of Wage Moderation**

Decelerating labor costs have had a stronger effect on growth and unemployment in economies with less regulated product markets. Lower wages raise profitability, prompting more entry, output, and employment in less regulated and thus more competitive economies. This evidence underscores the complementarity of labor and product market reform and partly explains why some countries benefited less from wage moderation than others.



Note: Wage shocks in the business sector are log changes in compensation per hour divided by the PCE deflator, minus log changes of labor-saving technology, minus log changes of unemployment rate multiplied by the elasticity of wages with respect to unemployment (0.1). For further details see **the Selected Issues paper chapter "Product Market Regulation and the Benefits of Wage Moderation**."

Source: OECD Analytical Database; EC - AMECO database; and staff estimates.

- On the other hand, prioritization still seemed insufficient. Increasing labor utilization, through sharpened incentives to work, and strengthening competition seemed the most effective levers at hand to boost the continent's potential output. With over 20 broad guidelines, the new Strategy provided ample opportunities to avoid politically difficult avenues. A diffused approach carried the risk of again failing to clarify issues and galvanize support. The staff also questioned whether the European Council's decision against benchmarking and naming/praising would not also weaken the impetus to reform. Commission staff explained that the framework did not preclude countries from orienting their reform program toward key national priorities. They also noted that the experience with naming/praising had been mixed, and that countries' progress would continue to be monitored using a cross-country database of structural indicators. The staff encouraged this work, pointing to the positive experience with the indicators presented in the OECD's PISA studies on education.

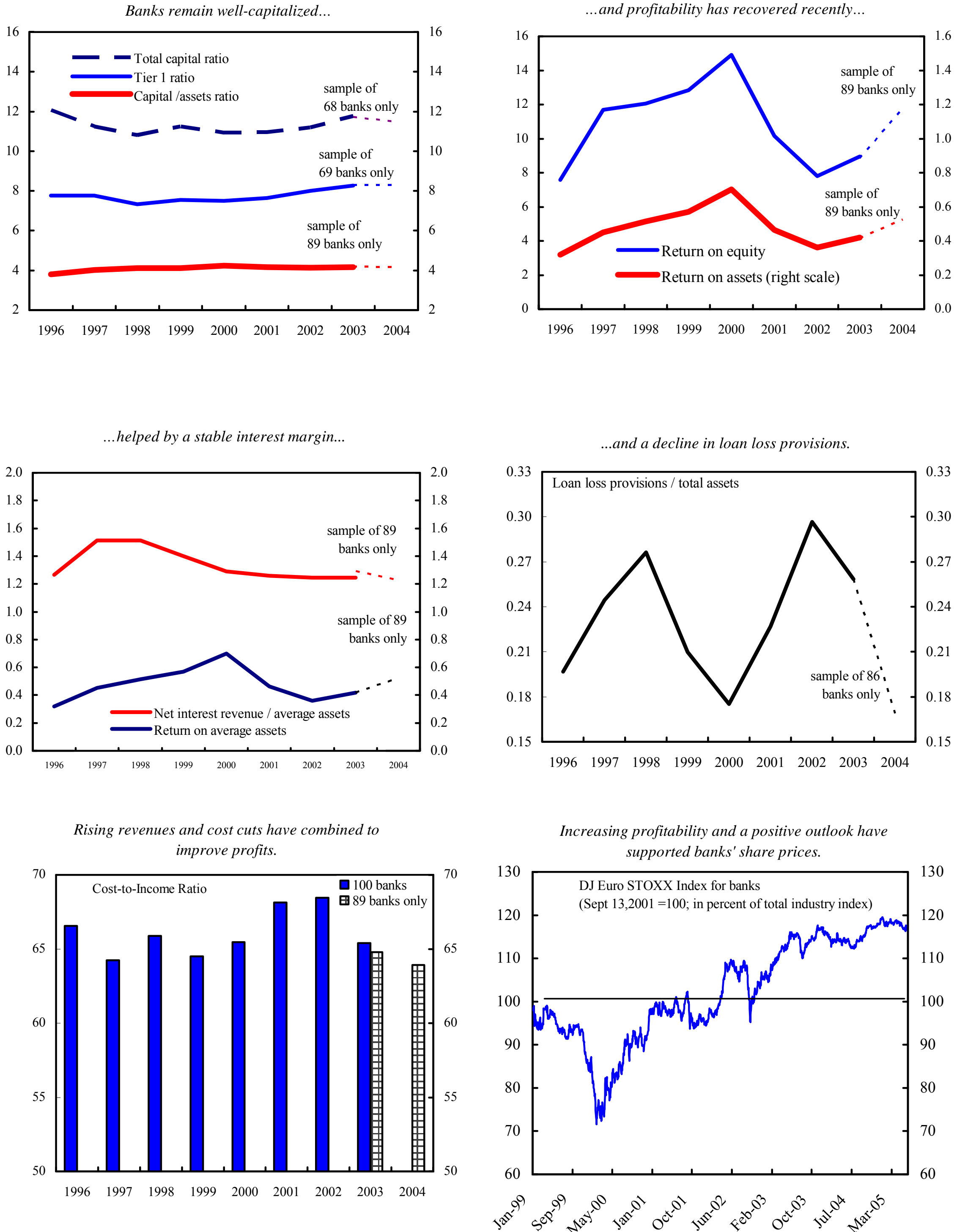
34. **Turning to more center-led reforms, the Commission's agenda to strengthen competition had suffered a setback when the EU Services Directive was sent back by the European Council for amendments, amid concerns that it would trigger social dumping**. The Directive guarantees the freedom to establish and provide services across the entire EU membership. For services rendered by a provider from another member state, the "country of origin principle"—where home (and not host) country administrative and legal requirements need to be met—would apply, albeit with a number of derogations for specific sectors. The Commission believed fears of social dumping to be misplaced, in light of various derogations and safeguards. Given that the country-of-origin principle is grounded in the EU Treaty, the Commission was hopeful that this approach would be maintained.

Financial market developments

A more resilient system

35. **The strength and resiliency of the financial system is improving** (Table 3). ECB staff explained that banks had weathered the latest downturn better than the recession of the early 1990s. Bank profitability continued to recover in 2004, reaching its highest level since 2000, supported by continued cost cutting, strong revenues from mortgage lending, and lower loan loss provisioning (Figure 7). While pockets of fragility might still exist in the banking sectors of some member countries, the overall banking system should not stand in the way of a more robust recovery, a point which the staff shared. The insurance sector had also recovered, buoyed mainly by equity markets, although some vulnerabilities persisted among life insurers faced with very low returns on fixed-income assets. The improved performance of the financial sector reflected reduced public sector involvement, greater market-discipline and transparency, and better risk management.

Figure 7. Euro Area: Banking Sector Developments
(100 Largest Banks; in percent, unless otherwise noted)



Sources: FitchIBCA database; Datastream; and Fund staff calculations.

36. **Financial sector risks relate mainly to global imbalances and the potential for an unwinding of benign market conditions, rather than to domestic factors**. On the domestic factors, ECB staff noted that household balance sheets expanded further in 2004, driven by rising house prices and mortgage debt. However, for the area as a whole and on reasonable swings in interest rates, this did not create undue credit risks for banks. On the corporate side, large firms had continued to improve their balance sheets, helped by rising profitability. Indeed, rating upgrades exceeded downgrades in 2004:Q4 for the first time since 1998:Q2. Nonetheless, sluggish domestic demand had left Europe's small and medium-sized enterprises more vulnerable. The key concerns among the mission's interlocutors on the external side were exchange rate volatility, a spike in long-term interest rates, and a sudden increase in the price of risk. These developments were seen as more likely to originate outside the euro area, and could cause losses among some financial institutions, notably those with exposures to hedge funds or over-the-counter derivatives markets. In this regard, the general lack of transparency regarding hedge fund activities and trading in derivatives were of concern to the mission's interlocutors.

An evolving financial landscape

37. **The authorities expect the current policy framework—the Financial Services Action Plan (FSAP) and the Lamfalussy process—to result in significant progress toward achieving an integrated market**. They noted that the framework had delivered a flurry of Directives essential to integrating Europe's financial markets. After their transposition at the national level through 2007, this would eventually yield major benefits on the ground. In their view, the FSAP and the Lamfalussy process have been the EU's most successful recent center-led programs of structural reform, forging consensus among national regulators and supervisors and across the political spectrum, including in the European Parliament. The Commission's priorities for the next five years are to (i) consolidate and streamline existing legislation and keep new legislative initiatives to a minimum; and (ii) ensure the effective transposition of European rules into national legislation and their enforcement by supervisory authorities. The new initiatives would include integrating clearing and settlement systems—widely perceived as a major hurdle toward the consolidation of Europe's securities markets; introducing a new insurance solvency framework; and improving crossborder payment systems. The plans also call for pressing for more integration at the retail level through use of competition policy, notably to identify the entry barriers and other obstacles to the provision of crossborder financial services.

38. **The staff questioned whether the process would yield sufficiently rapid progress toward financial integration**. Staff agreed that significant progress had been made, both on the ground, as evidenced by the progress made in integrating many wholesale activities, and in establishing the procedures to achieve further integration. However, in its view, more would be needed to fully reap the dividends of EMU, notably in terms of achieving an efficient allocation of investible resources, a greater buffering of country-specific shocks via the financial system, and an efficient monetary transmission. In particular, to varying degrees, governments, regulators, and market players continue to safeguard vested interests—as evidenced by state ownership of banks, difficulties in executing crossborder

mergers and acquisitions, differences in regulations and supervisory practices, and the slow integration of securities markets. In the same vein, business strategies—notably consolidation among banks—remained largely nationally oriented, which might be thwarting competition,[11] and financial innovation (e.g., securitization) was in some respects being pressed at the national rather than area-wide level. At the same time, risk profiles of the EU's large, publicly-traded financial institutions appeared to be converging around unimproved levels, albeit supported by improvements in risk management. This seemed to be part of growing crossborder activities, including increasingly among larger financial groups. In this overall setting, the ongoing evolutionary/organic approach to integration might not deliver quality regulation and supervision in a timely manner and entail high costs and risks. A more centralized approach to supervision, particularly for the systemically important financial groups, and regulation, building on existing arrangements, ought to be considered. A first step might be giving EU supervisory committees access to basic, up-to-date, institution-specific data (including information on strategies, risk profiles and the potential for contagion risks) covering the limited number of EU financial groups with major crossborder operations.[12]

39. **The authorities considered concerns about the pace and effectiveness of integration premature**. Thus far, progress had been on schedule, and financial institutions and their clients were increasingly taking a European-wide approach to their decisions. EU supervisory networks and committees already offered fairly centralized vehicles for rulemaking and coordination of supervision. Information exchange was also intensive between national supervisors of financial groups with large crossborder activities. The newly-agreed Memorandum of Understanding on cooperation in financial crises reinforced this. Further centralization of supervision, even if it was limited to the dozen or so largest financial conglomerates with pan-European businesses and built on existing arrangements, raised complex issues and was not called for at this stage.[13] Inefficient legislation or regulation would be reviewed, as proposed in the Green Paper. And recent cross-border takeover proposals finally offered an opportunity to open up national markets for financial services, supported by EU competition policy. In sum, all the mission's interlocutors were confident that the FSAP and Lamfalussy process could deliver an integrated market for Europe. The process would be re-assessed in 2007, by which time many of the newly adopted rules should have begun to deliver results.

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[11] On the state of competition in Europe's financial sector, notably among banks, see the Selected Issues chapter titled "Banks and Markets in Europe and the United States."

[12] See the Selected Issues chapter titled "European Financial Integration: Stability and Supervision."

[13] The issues revolve around incentives and the lender of last resort function, solvency support, and winding up rules.

E. Trade Policy

40. **The Commission explained its strong preference for the multilateral approach to trade policy**. Under the WTO's Doha Round, it sought to create genuine new market access opportunities, significantly improve WTO rules in areas such as anti-dumping, and contribute to economic development. Commission officials perceived an emerging "political will" to conclude the negotiations successfully and did not expect bilateral trade tensions with the United States to slow the negotiations. Staff welcomed the EU's role in keeping the Doha negotiations on track but encouraged more ambition in its agricultural market access offer. The Commission staff recognized that negotiations on regional trade agreements (RTAs) diverted attention and resources from the Doha Round and intended to refrain from new RTA negotiations while the Round continued. Staff welcomed EU support for negotiations aimed at enhancing transparency and strengthening WTO rules for regional trade agreements, including those among developing countries.

41. **While the Commission recognized the benefits to developing countries from reducing their own trade barriers**, **they expected substantial Doha-Round commitments only from the more advanced developing countries**. Staff saw further trade reform by developing countries as critical if they were to take full advantage of increased market access opportunities. Staff expressed hope that the EU's Economic Partnership Agreements (EPAs) with ACP countries would rationalize complicated and often overlapping existing RTAs, especially in Africa. Staff also suggested that the developing countries would benefit more by undertaking multilateral (M.F.N.) liberalization than by extending reciprocal preferences for EU exports.

42. **Officials expressed the view that the ability by the EU to manage the consequences of the rapid growth of textiles and clothing imports, especially from China, was necessary to maintain internal support for liberal trade policy**. These had strongly affected production in some regions of the area and thus they had taken steps toward imposing temporary import safeguards under special provisions of China's WTO accession protocol but insisted these would not lead to a reversal of earlier reforms. Staff encouraged the authorities to refrain from imposing safeguards, noting the 10-year adjustment period afforded to domestic firms and that any such measures diminished the credibility of future reforms. Since the discussions, China agreed with the Commission to limit, until end-2007, export growth to the EU of ten product categories accounting for half of EU imports of Chinese textiles and clothing. The EU has also launched an anti-dumping investigation on footwear imports from China.

F. Statistics

43. **More comprehensive data on flows of funds, balance sheets, non-factor services and trade are needed** (Appendix II). Problems have surfaced with the quality of budget statistics in some countries, resulting in significant upward revisions to historical deficit figures. Staff and officials concurred that efforts to improve statistical governance standards needed to be stepped up, including by granting greater independence to national statistical institutes and by endowing Eurostat with greater monitoring and auditing powers. Ongoing efforts to increase Eurostat's resources are welcome, but may not suffice.

IV. Staff Appraisal

44. **The euro area is in the midst of a difficult economic transition and it is essential that the authorities forge ahead decisively with the strategy to ready Europe's social model for the demographic shock through higher growth**. The broad outlines of the strategy have been there for over a decade: fiscal consolidation and entitlement reform; increased incentives on both the demand and, more recently, supply side of the labor market; and strengthened competition, whether via the internal market, enlargement or, indeed, elimination of exchange rates. Implementation has already yielded tangible results—the employment gains of the past decade—and more can be expected from recent structural reforms. However, a preoccupation with the short-term together with inconsistencies in implementation have generated uncertainties, including about basic directions. With the burden of accumulated rigidities and aging continuing to weigh heavily on performance and the sustainability of the social model, it is essential that policies become more forward-looking and consistent, harnessing the complementarities between and within fiscal adjustment and structural reform. In this regard, Europe's restructured policy frameworks still chart the right course and the increased weight placed on ownership can help build public trust. However, implementation, now more than ever, depends on leadership in national capitals and the European Council.

45. **Although the near-term economic outlook is uncertain, the fundamentals remain in place for the recovery to resume**. Continued wage moderation, improved corporate balance sheets, accommodative financing conditions, and reaccelerating world demand point to renewed momentum during the second half of the year. But the situation is hard to read and the risks lie mainly on the downside, including further oil price spikes, multilateral euro appreciation in the context of unwinding global imbalances, and a sudden reversal in benign global financial conditions.

46. **The monetary policy stance still remains appropriate**, **but a need for a rate cut may be materializing**. Underlying inflation is running well below target and seems likely to continue to do so, but headline inflation is still hovering around 2 percent. Moreover, the latest activity indicators do not paint a consistent picture of the future course of the recovery. Overall, keeping policy rates on hold for the time being is appropriate. However, absent new information on inflation, if evidence continued to accumulate over the coming months that, contrary to projections, the recovery was fading, a cut in interest rates would be appropriate. A rate cut would also be warranted if the euro appreciated significantly on a multilateral basis.

47. **Budgetary plans fall well short of meeting the key policy requirement for euro area public finances—to make steady progress toward achieving underlying balance by 2010**. Balance is needed both in anticipation of population aging and to move decidedly below the 3 percent Maastricht deficit ceiling. Absent adjustment, the anticipated spike in aging-related expenditure would push public debt in many member states onto an unsustainable path. Accordingly, policies need to consistently redress current and intertemporal fiscal deficits to anchor consumer confidence. This will require structural

reforms complemented by annual fiscal adjustment of ½ percent of GDP, net of one-offs and other temporary measures.

48. **The SGP needs to regain credibility as EMU's fiscal framework and this will require transparent, even-handed, and sufficiently ambitious implementation of the reformed framework**. The Pact has generally managed to tame runaway deficits and procyclical fiscal policies that were once commonplace in many countries and should remain a cornerstone of EMU's policy framework. But it has been increasingly undermined as more countries fail to undertake the requisite adjustment, either by allowing their deficits to breach the 3 percent limit or by resorting to one-off measures, creative accounting, or even misreporting to avoid doing so. The proposals that allow for a greater sensitivity to economic circumstances under the dissuasive arm and that call for ½ percent of GDP annual adjustment as a benchmark under the preventive arm are welcome. Nonetheless, because of various provisions, the reforms do not adequately strengthen the preventive arm, which is regrettable given that the failure to adjust during past upturns has been the Pact's Achilles heel. Potentially open-ended trade-offs between fiscal adjustment and structural reforms, alongside the restrictive definition of "good times" for adjustment to occur, could set the stage for a repeat of past mistakes. Agreement on reform of the Pact is a welcome step forward, but its credibility depends on an even-handed, transparent, and disciplined implementation by the Council of the new commitments.

49. **With agenda-setting shifting away from the center, the prospects for reform will hinge on the leadership and determination of national governments**. Action is needed to boost potential growth and employment, and also in part for Europe to play its role in facilitating an orderly unwinding of global imbalances. In particular, countries need to focus on reforming entitlement systems, boosting labor utilization, completing the internal market, and integrating national financial systems. In this regard, the new integrated guidelines under the Lisbon Strategy should aid in the formulation of consistent national policy matrices. The longer-term macroeconomic divergences within the monetary union are rooted in swings in competitiveness (broadly construed), and solutions must ultimately be based on increasing flexibility and integration through structural reforms.

50. **Garnering domestic support for strong, forward-looking policies in a more decentralized environment argues for strengthening domestic economic institutions**. Debating Stability Programs and National Action Plans in parliaments is an important step toward increasing transparency and building ownership. These objectives would also be served—especially in countries facing large consolidation and reform agendas—by developing independent, non-partisan institutions that would inform the public about the larger strategic economic issues they confront and assess policies and their implementation. Such domestically-driven surveillance mechanisms will, however, still need to be complemented by intensive, peer-driven multilateral surveillance of policies, including well-grounded benchmarking.

51. **The policy agenda on financial sector integration will increasingly need to emphasize the enforcement of existing rules, including competition policy**. Much progress has been made under the FSAP and the Lamfalussy process in laying the foundation

for further integration of financial markets and convergence of supervisory practices. Nevertheless, it remains to be seen whether this evolutionary approach will be able to overcome vested interests and deliver a high-quality, harmonized regulatory framework without acting as a brake on integration or exposing the system to unnecessary risk. The onus is now on member states to make the process work and on the Commission to enforce existing rules. Similarly, growing crossborder activities of major, complex financial groups are placing an increasing burden on national supervisors and a more formal approach to area-wide collaboration, including provision of up-to-date information on key groups to an existing area-wide structure, deserves consideration.

52. **On trade policy**, **the EU should continue to take the lead in fostering agreement on the Doha Development Agenda**. In particular, the EU should offer greater access to its agricultural markets and limit the use of sensitive product exemptions from tariff reductions. Recent moves to limit imports of textiles, clothing, and footwear are unfortunate. On the multilateral stage, there is merit in continuing to stress strong WTO rules over regional trade agreements and working with developing countries in liberalizing their trade regimes on a most-favored-nation basis.

53. **While broadly adequate, effective area-wide surveillance calls for improvements in the quality**, **availability**, **and timeliness of statistics**. Better fiscal data are a key priority for a number of countries.

54. It is proposed that the **next consultation on euro-area policies** in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

Table 1. Euro Area: Main Economic Indicators

(Percentage change)

	1999	2000	2001	2002	2003	2004	2005 1/	2006 1/
Demand and Supply								
Private consumption	3.3	3.0	1.9	0.9	1.1	1.4	1.4	1.6
Public consumption	1.9	1.4	2.2	2.6	1.3	1.5	1.2	1.8
Gross fixed investment	6.1	5.2	0.2	-2.3	0.4	1.9	2.1	3.1
Final domestic demand	3.6	3.2	1.6	0.5	1.0	1.5	1.5	2.0
Stockbuilding 2/	-0.1	-0.3	-0.6	-0.2	0.2	0.4	-0.2	-0.1
Domestic Demand	3.5	2.9	1.0	0.4	1.2	1.9	1.3	1.9
Foreign balance 2/	-0.7	0.9	0.9	0.6	-0.4	0.1	0.0	0.1
Exports 3/	5.4	12.4	3.8	2.1	0.6	6.0	3.5	5.2
Imports 3/	7.9	10.3	1.7	0.6	1.9	6.3	3.8	5.5
Real GDP	2.7	3.8	1.8	1.0	0.7	2.0	1.3	1.9
Resource Utilization								
Potential GDP	2.1	2.2	2.2	2.1	2.0	1.9	1.8	1.8
Output gap 4/	0.2	1.8	1.4	0.3	-1.0	-0.9	-1.5	-1.4
Employment	1.8	2.2	1.3	0.5	0.2	0.9	0.7	0.9
Unemployment rate 5/	9.2	8.2	7.8	8.3	8.7	8.9	8.9	8.6
Prices								
GDP deflator	1.5	1.6	2.4	2.5	2.0	1.8	1.7	1.8
Consumer prices	1.1	2.1	2.3	2.3	2.1	2.1	2.1	1.7
Public Finance 6/								
General government balance 7/	-1.3	-0.9	-1.8	-2.5	-2.8	-2.7	-3.0	-3.1
General government structural balance	-1.4	-1.9	-2.5	-2.6	-2.4	-2.1	-2.3	-2.3
General government gross debt	72.5	70.0	68.9	68.8	70.1	70.6	72.2	72.9
Interest Rates 8/								
Short-term deposit rate	3.0	4.4	4.2	3.3	2.4	2.1	2.1	...
Long-term government bond yields	4.7	5.5	5.0	4.9	4.2	4.2	3.3	...
Exchange Rates								
U.S. dollar per euro 9/	1.07	0.92	0.90	0.94	1.13	1.24	1.21	
Nominal effective rate (2000=100) 8/	111.5	100.0	101.2	104.3	116.1	120.0	121.1	...
Real effective rate (2000=100) 8/ 10/	113.4	100.0	99.2	102.2	112.8	115.5	115.5	...
External Sector 6/ 11/								
Current account balance	-0.5	-1.2	0.0	0.9	0.3	0.6	0.4	0.3
Trade balance 12/ 13/	0.9	0.1	1.1	1.8	1.4	1.4	0.8	...
Memorandum items 6/ 14/								
Current account balance	0.5	-0.5	0.1	0.7	0.3	0.4	0.4	0.2
Trade balance 12/	1.5	0.8	1.6	2.3	1.9	1.8	1.6	1.4

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

1/ WEO, June 2005.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ In percent of GDP.
7/ Excludes UMTS revenues.
8/ Data for 2005 are for May.
9/ Data for 2005 are for June 28.
10/ Based on normalized unit labor costs.
11/ Based on ECB data, which exclude intra-euro area flows.
12/ Data for goods.
13/ Data for 2005 are for 2005Q1.
14/ Calculated as the sum of individual countries' balances.

Table 2. Euro Area: Balance of Payments

	2000	2001	2002	2003	2004	2005Q1
			(In billions euro)			
Current account	-82.1	-3.3	64.6	20.4	45.3	5.0
Goods	7.6	73.3	128.5	102.7	103.5	14.7
Services	-6.0	0.0	16.4	19.5	27.1	2.3
Income	-32.5	-25.4	-31.9	-45.9	-29.6	-2.6
Current transfers	-50.8	-51.6	-48.6	-56.2	-55.7	-9.4
Capital account	11.8	6.4	10.2	13.3	17.1	1.0
Financial account	70.6	-43.8	-43.9	-5.8	24.3	35.5
Direct investment	-16.0	-122.0	0.6	5.4	-47.8	-25.3
Portfolio investment	-99.6	71.9	127.9	43.3	68.6	0.1
Equity	-234.1	130.9	47.3	50.5	48.0	-7.6
Debt instruments	134.4	-59.0	80.5	-6.3	21.5	7.9
Financial derivatives	-10.0	-0.8	-10.9	-12.2	-2.0	-9.6
Other investment	181.9	-10.5	-159.0	-72.5	-6.6	65.3
Reserve assets	14.7	18.0	-2.2	30.0	12.4	4.8
Errors and omissions	-0.6	40.8	-30.6	-27.7	-87.1	-41.4
			(In percent of GDP)			
Current account	-1.2	0.0	0.9	0.3	0.6	0.3
Goods	0.1	1.1	1.8	1.4	1.4	0.8
Services	-0.1	0.0	0.2	0.3	0.4	0.1
Income	-0.5	-0.4	-0.4	-0.6	-0.4	-0.1
Current transfers	-0.8	-0.7	-0.7	-0.8	-0.7	-0.5
Capital account	0.2	0.1	0.1	0.2	0.2	0.1
Financial account	1.1	-0.6	-0.6	-0.1	0.3	1.9
Direct investment	-0.2	-1.8	0.0	0.1	-0.6	-1.3
Portfolio investment	-1.5	1.0	1.8	0.6	0.9	0.0
Equity	-3.5	1.9	0.7	0.7	0.6	-0.4
Debt instruments	2.0	-0.9	1.1	-0.1	0.3	0.4
Financial derivatives	-0.2	0.0	-0.2	-0.2	0.0	-0.5
Other investment	2.7	-0.2	-2.2	-1.0	-0.1	3.5
Reserve assets	0.2	0.3	0.0	0.4	0.2	0.3
Errors and omissions	0.0	0.6	-0.4	-0.4	-1.1	-2.2
Memorandum items:						
GDP (in billions of euros)	6,619.8	6,895.1	7,134.4	7,328.2	7,611.0	1,890.3
Reserves of the eurosystem 1/						
(In billions of euros)	391.2	392.7	366.1	306.5	...	...

Sources: ECB; Datastream.
1/ End of period stocks.

Table 3. Euro Area: Macro-Prudential Indicators for the Banking Sector, 1999–2003
(In percent, unless otherwise indicated)

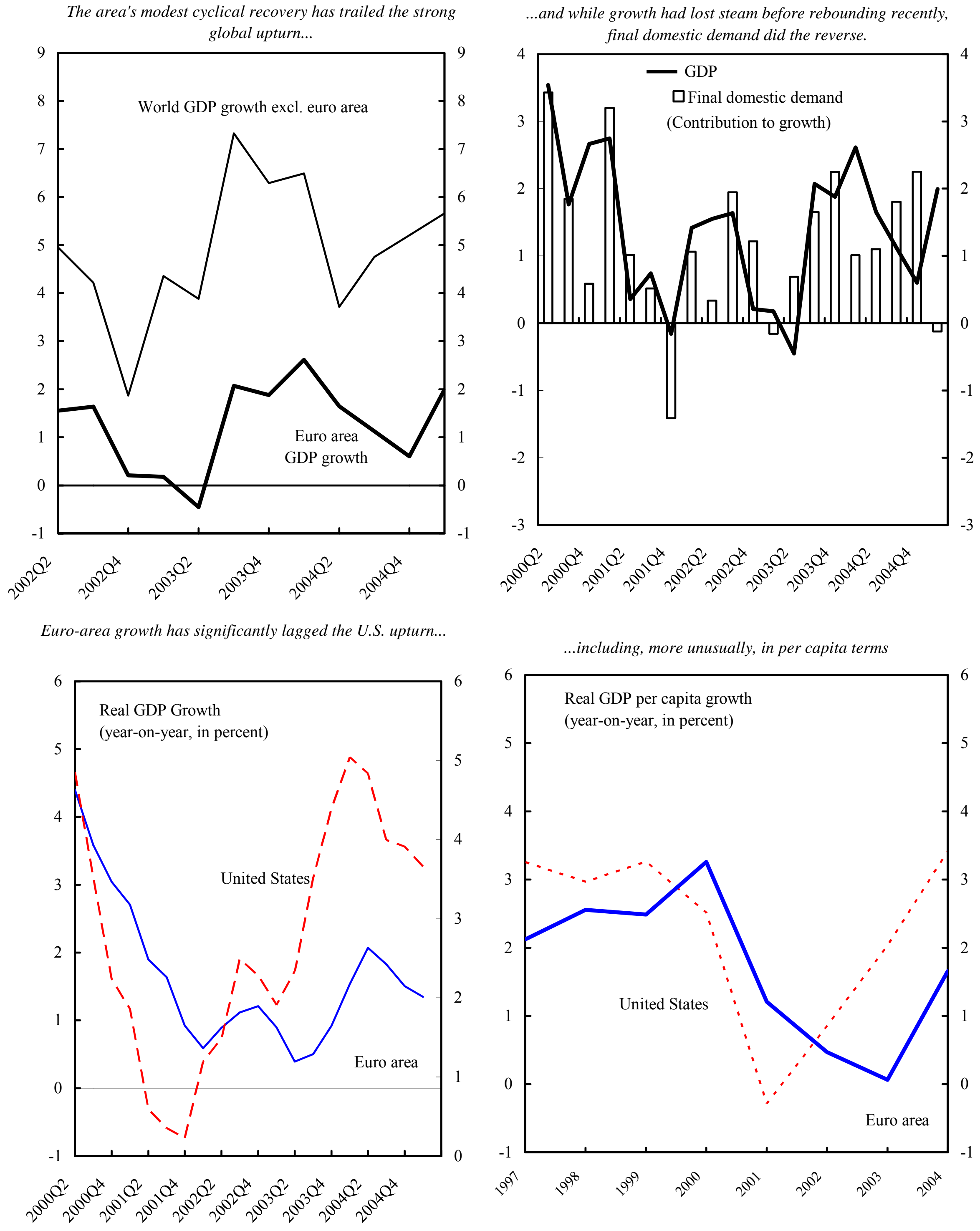
	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03
Capital Adequacy					
Regulatory capital to risk-weighted assets*		11.00	13.78	11.36	11.87
Regulatory Tier I capital to risk-weighted assets*		7.24	9.01	8.35	8.71
Capital (net worth) to assets				3.66	3.67
Asset composition and quality					
Asset composition (in percent of total assets)					
Cash and balances	1.21	1.08	1.16	1.31	1.39
Treasury bills	3.38	0.76	0.71	0.97	0.92
Loans to credit institutions	14.39	19.13	18.18	17.68	17.53
Debt securities	29.39	23.42	23.84	19.24	20.42
Issued by public bodies				7.25	8.27
Issued by other borrowers				11.99	12.15
Loans to customers	43.73	46.50	46.37	49.06	48.17
Shares and participating interest	2.00	4.56	4.10	3.35	3.41
Tangible assets and intangibles	1.24	1.17	1.13	1.38	1.36
Other assets	4.06	3.28	4.40	6.77	6.59
NPLs to gross loans*			3.60	3.44	3.39
NPLs net of provisions to capital*				19.77	17.74
Earnings and Profitability					
ROA*	0.19	0.29	0.22	0.30	0.31
ROE* 1/	11.54	7.51	5.74	7.62	7.87
Interest margin to gross income*	54.45	55.94	59.13	53.89	53.47
Noninterest expenses to gross income*	61.47	68.60	72.11	66.86	64.46
Personnel expenses to noninterest expenses	53.30	55.24	51.15	57.14	57.63
Trading and fee income to total income	37.08	38.75	34.97	31.96	32.72
Liquidity					
Liquid asset ratio 1 (cash and T-bills)	4.59	1.84	1.87	2.27	2.31
Liquid asset ratio 2 (ratio 1 + loans to credit institutions)	18.98	20.97	20.05	19.95	19.84
Liquid asset ratio 3 (ratio 2 + debt sec. issued by public bodies)				27.20	28.11
Customer deposits to total (non-interbank) loans		0.78	0.82	0.83	0.84

Sources: ECB (ESCB Banking Supervision Committee); and staff calculations.

* Included in the "core set" of FSIs.

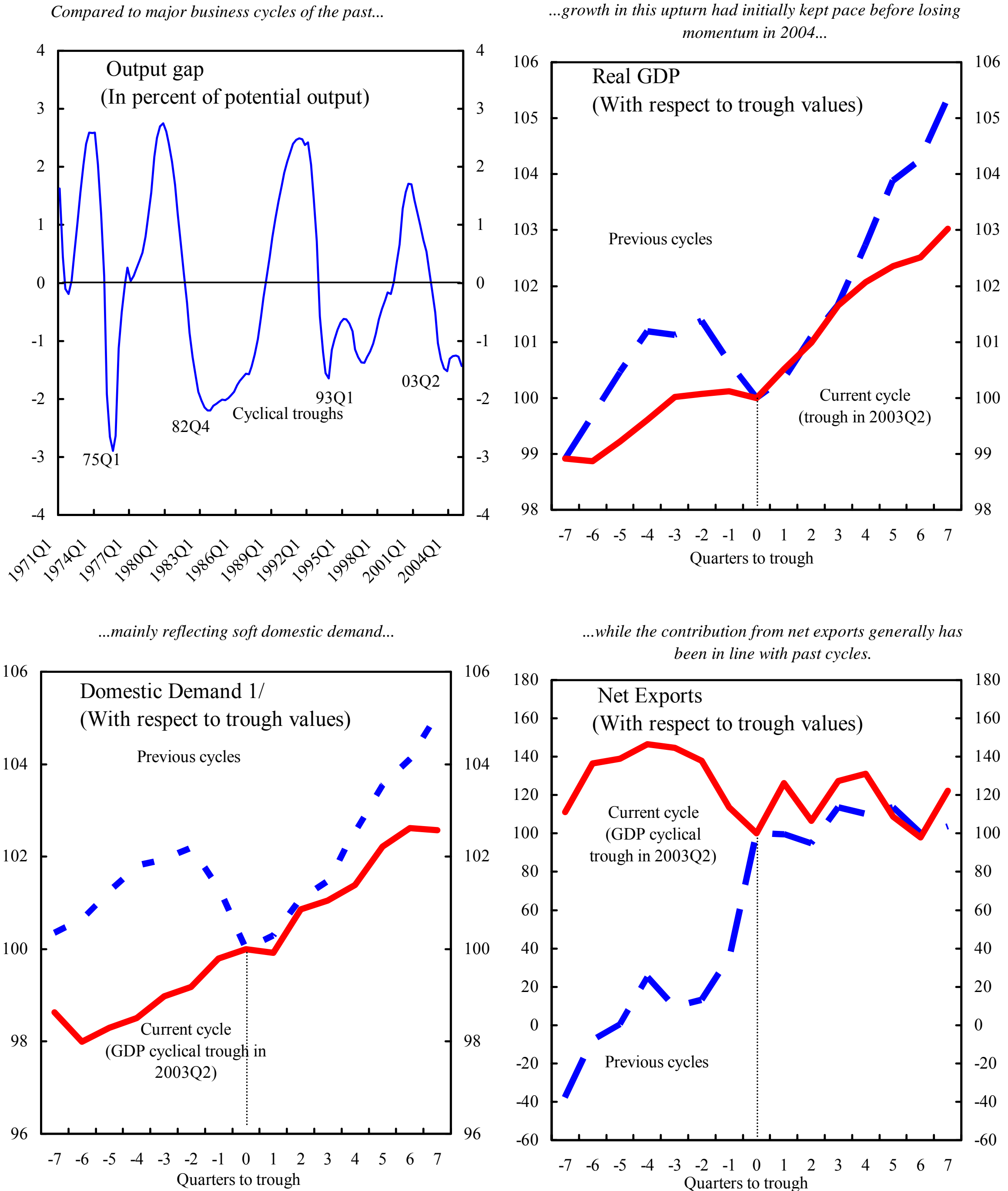
1/ After tax and extraordinary items.

Figure A1. Euro Area: Cyclical Developments
(Annualized quarter-on-quarter percent change, unless otherwise specified)



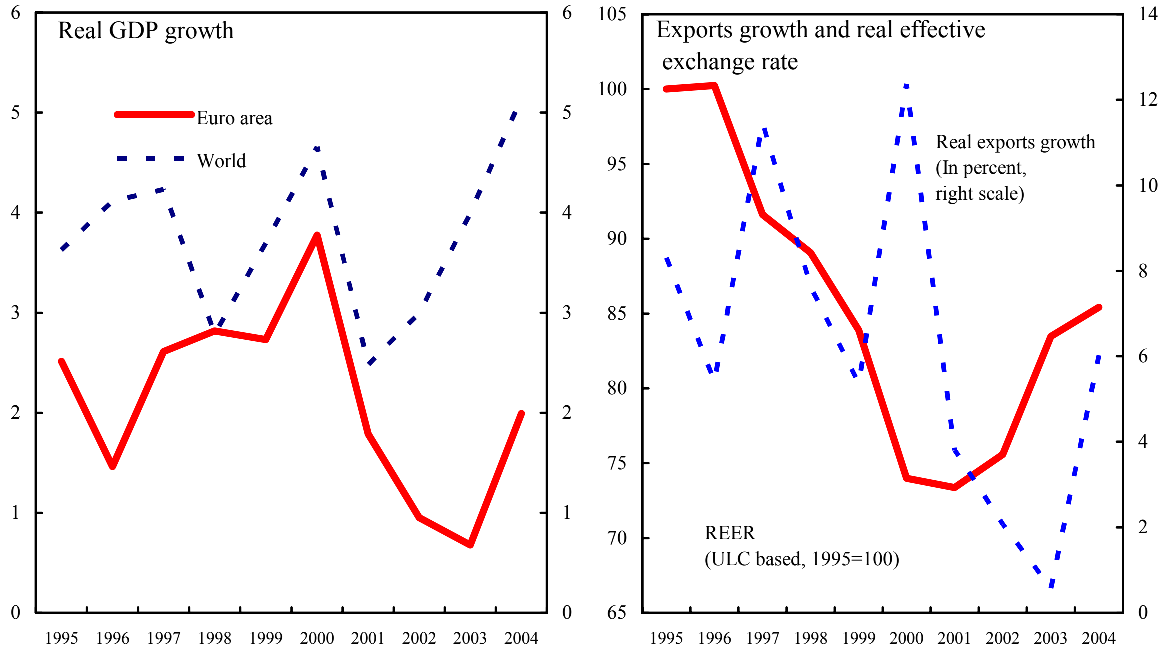
Sources: Eurostat; Datastream; and IMF.

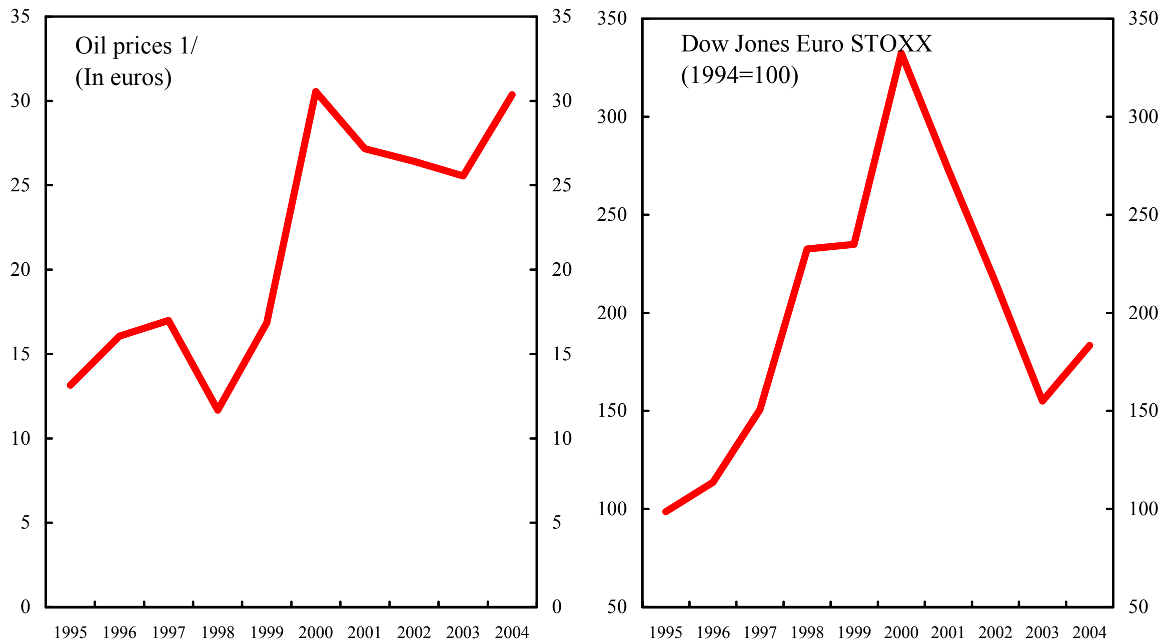
Figure A2. Euro Area: Comparison to Past Cycles



Source: ECB; IMF, World Economic Outlook; and Fund staff calculations.
1/ Includes inventories.

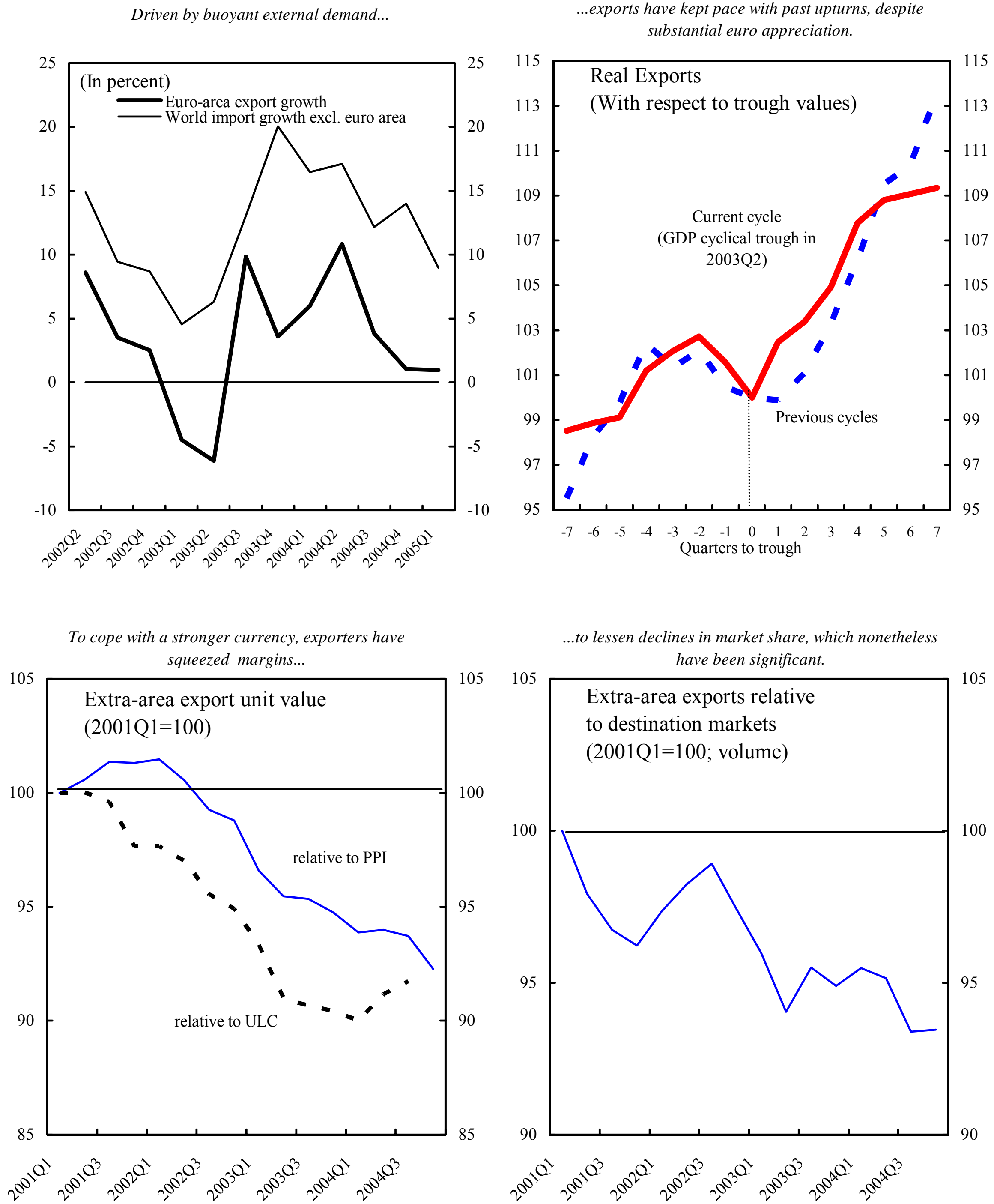
Figure A3. Euro Area: The Past Decade





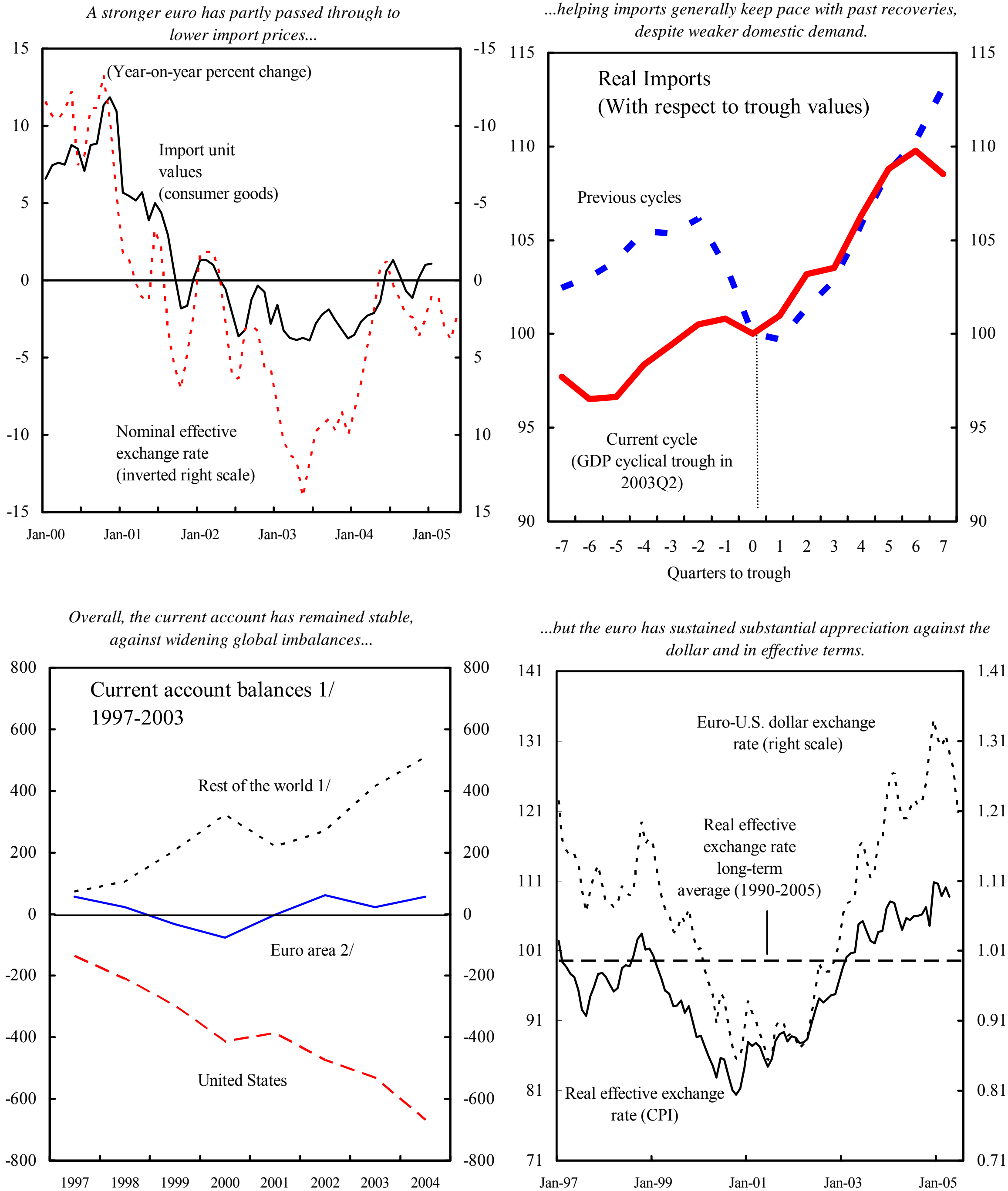
Source: IMF, World Economic Outlook.
1/ Simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh, euro per barrel.

Figure A4. Euro Area: Export Performance



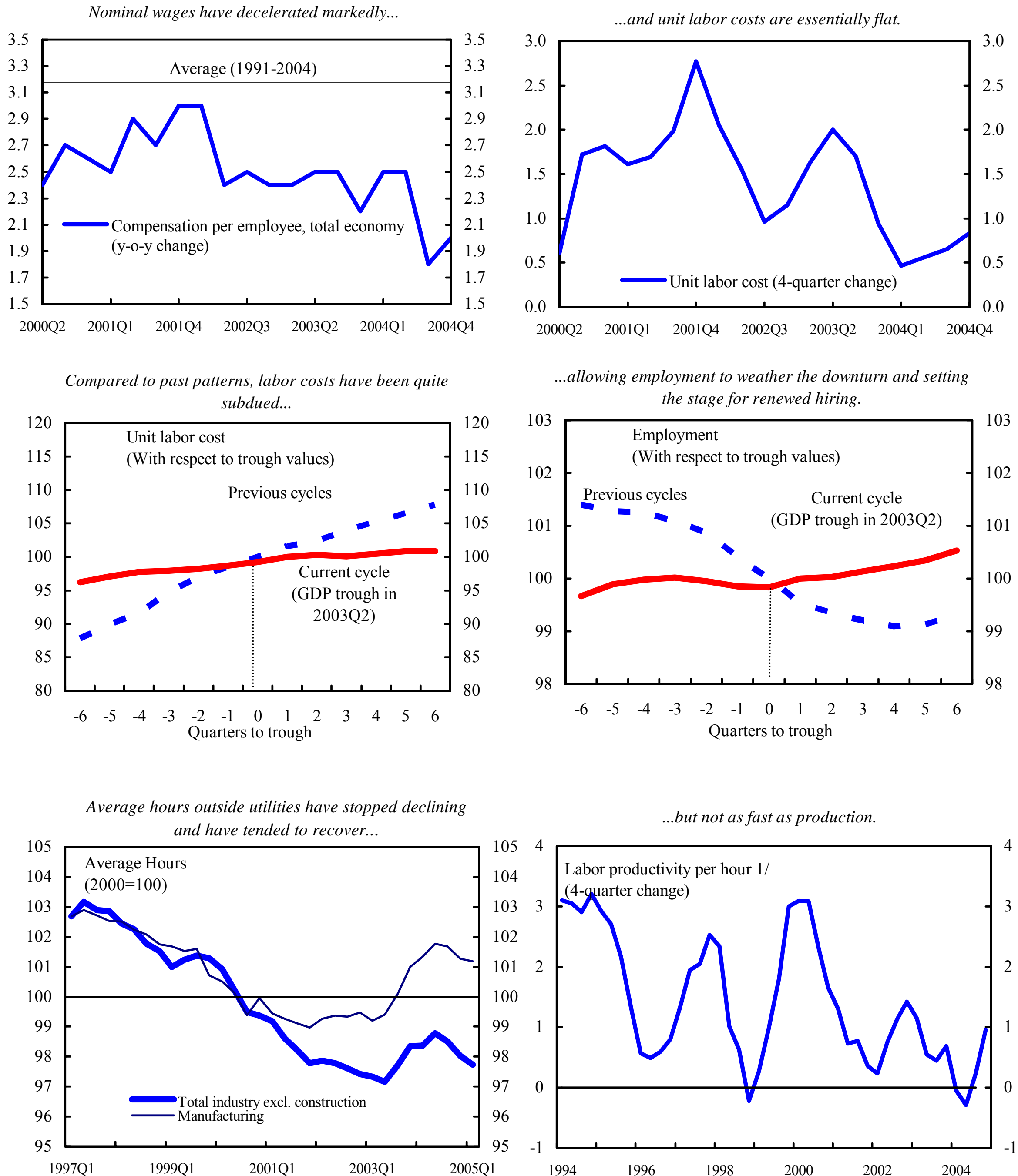
Sources: ECB; and Fund staff calculations.

Figure A5. Euro Area: External Developments
(In billions of U.S. dollars; unless otherwise specified)



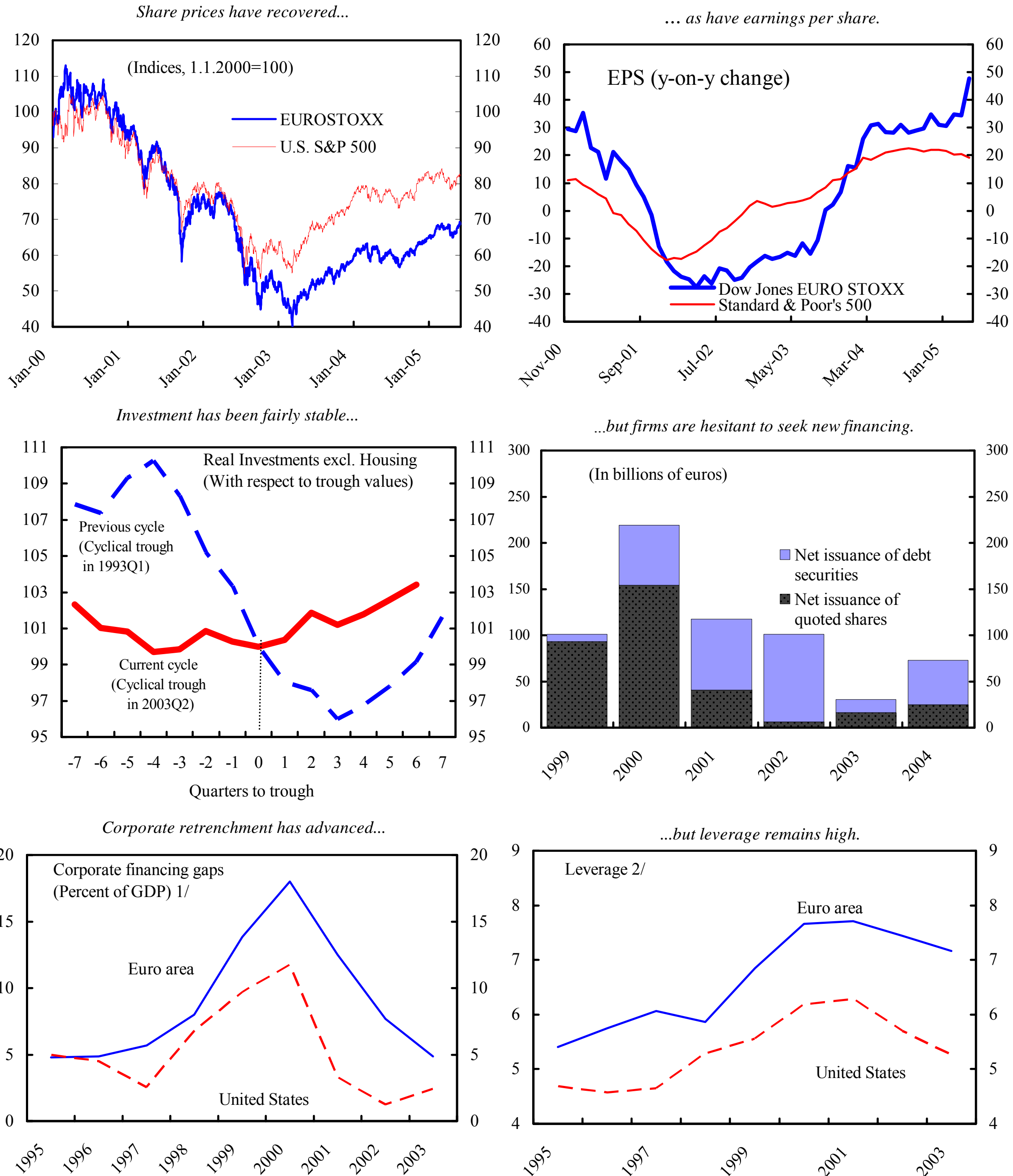
Sources: ECB; WEO, IMF; and staff calculations.
1/ Calculated as residual (excludes global discrepancy).
2/ Excludes intra-area trade (ECB data).

Figure A6. Euro Area: Employment and Wages
(In percent, unless otherwise noted)



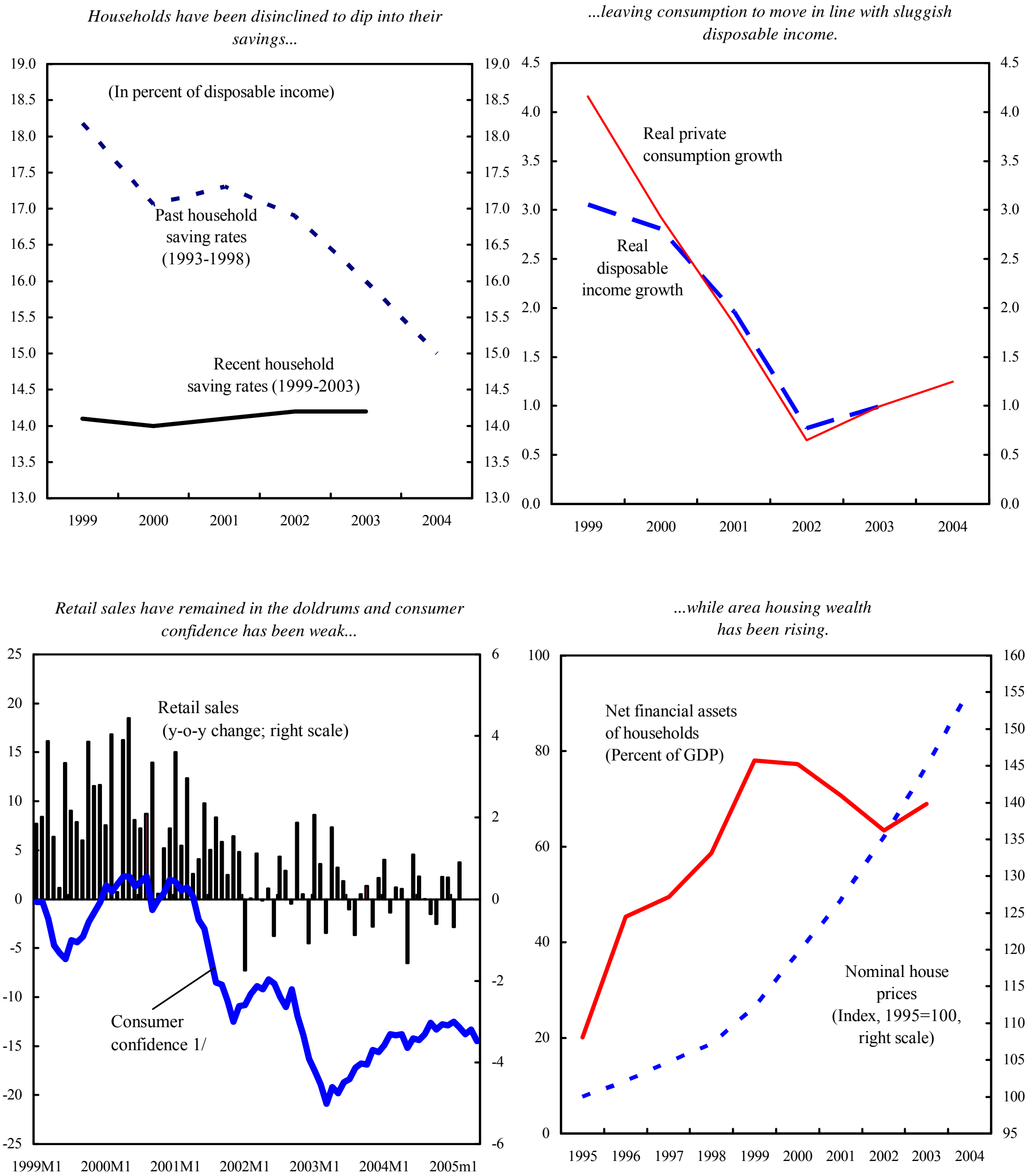
Sources: European Commission; ECB; Eurostat; and Datastream.
1/ Constructed with average hours in industry excluding construction.

Figure A7. Euro Area: Financial Markets and Corporates
(In percent, unless otherwise specified)



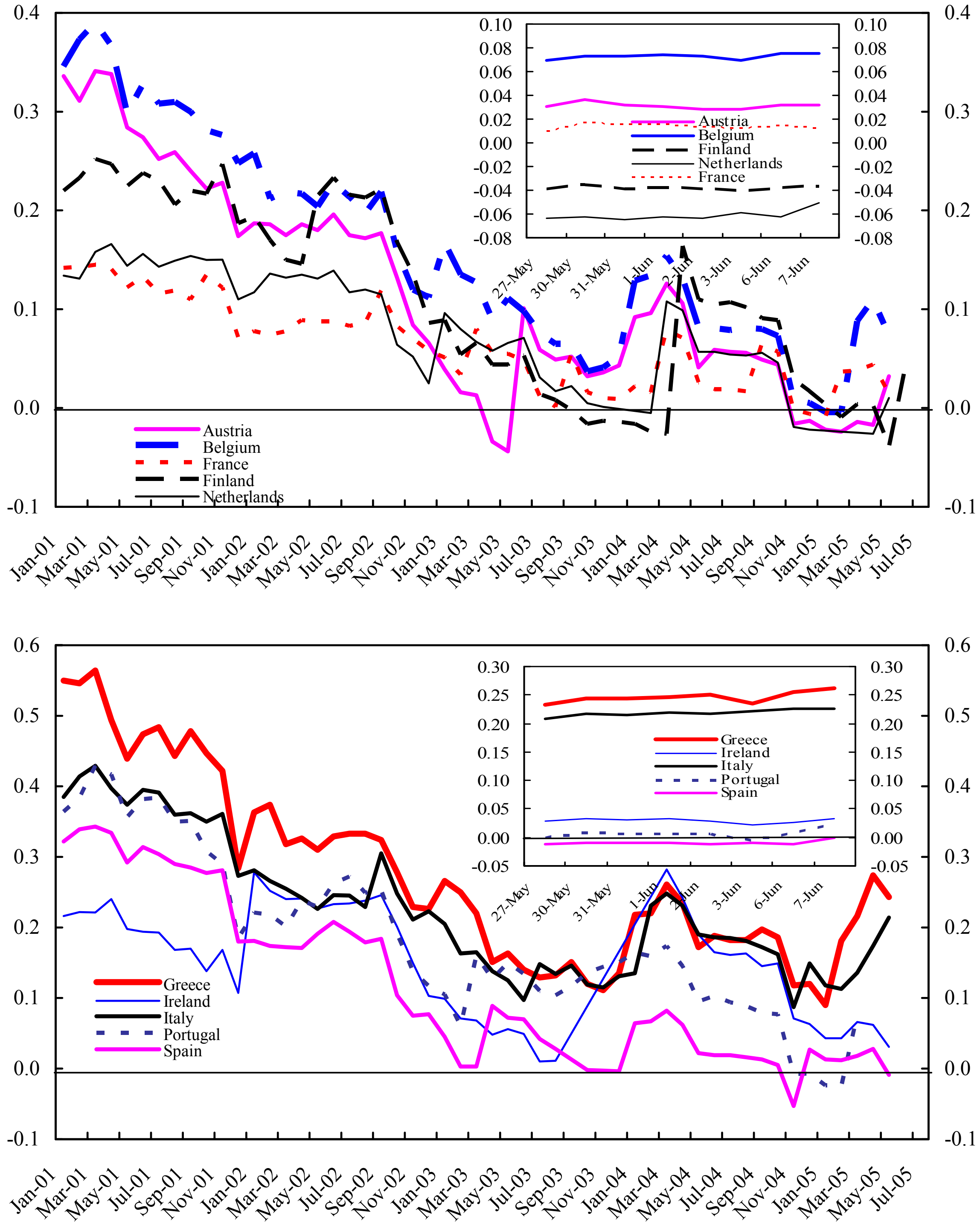
Sources: ECB; Federal Reserve; and staff estimates and forecasts.
1/ Spending on capital and financial assets not covered by internal funds.
2/ Defined as the ratio of corporate debt to internal funds.

Figure A8. Euro Area: Consumption and Savings
(In percent, unless otherwise noted)



Sources: ECB; European Commission; and IMF World Economic Outlook.
1/ Balance of opinion on financial and general economic situation.

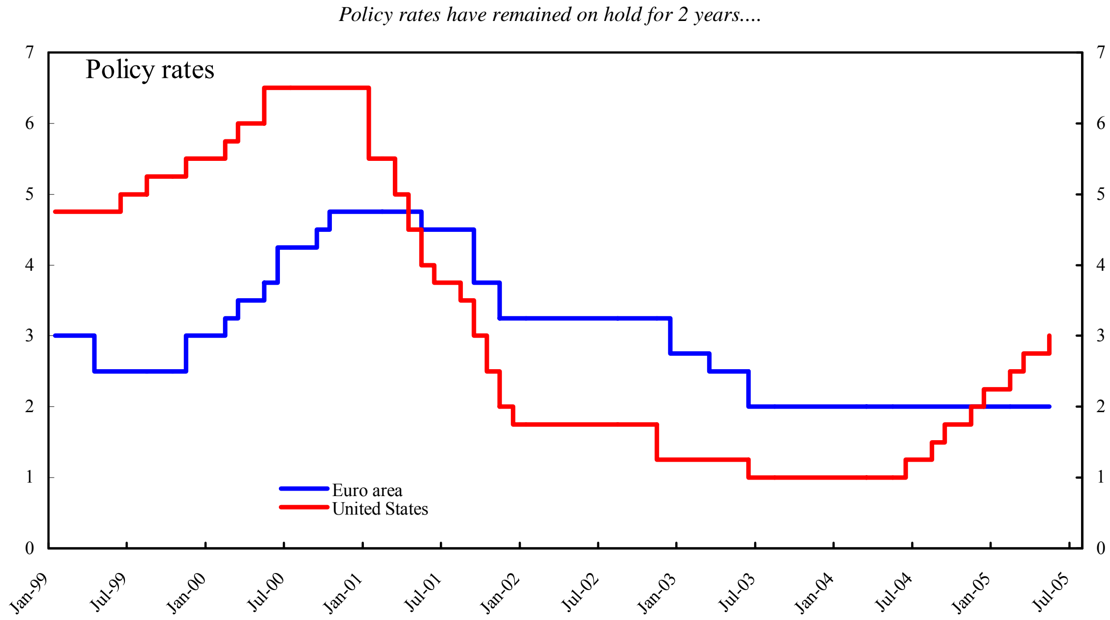
Figure A9. Euro Area: 10-Year Government Bond Spreads from German Bund
(In percent)



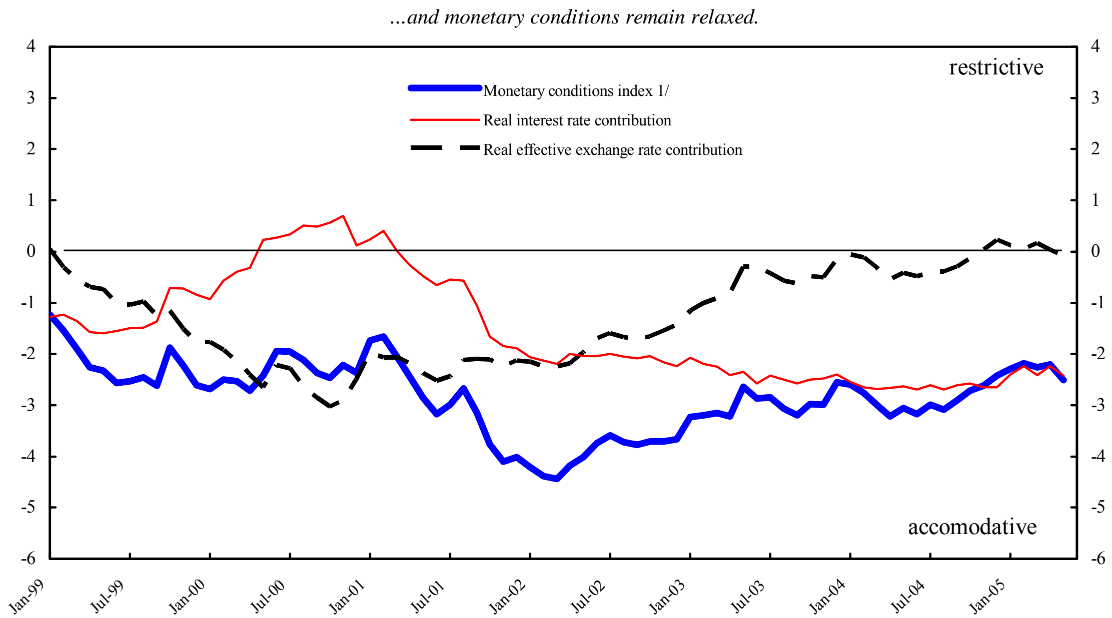
Source: Bloomberg.

Figure A10. Euro Area: Monetary Policy Indicators
(In percent, unless otherwise specified)

Policy rates have remained on hold for 2 years....



...and monetary conditions remain relaxed.



Sources: ECB; Datastream; Bloomberg; and staff calculations.
1/ Deviation from 1990-2005 mean.

STATISTICAL ISSUES

Economic and financial data provided to the Fund are broadly adequate for the conduct of area-wide surveillance. Eurostat and the ECB share responsibility for the production of euro-area statistics, as outlined in a March 2003 Memorandum of Understanding. Since the start of EMU, significant progress has been made in improving the scope and timeliness of euro-area statistics. A plethora of economic time series covering history and current developments is now available on the Eurostat and ECB websites, flash estimates of the main economic indicators are published with short delays, and Eurostat compiles a comprehensive set of structural indicators to support the Lisbon Strategy. Nevertheless, considerable gaps remain, in particular on the national accounts by institutional sector, on labor markets, and on the flow of funds (see IMF Country Report No. 04/234), and further improvements are still needed for external trade.

- EU member states are in the process of introducing two major changes in their national accounts: (i) the allocation of Financial Intermediation Services Indirectly Measured (FISIM) to consumption, net exports, and intermediate consumption, instead of only to the latter; and (ii) the use of chain-linking for the measurement of economic aggregates in volume terms. The expected effects of these changes include a modest upward revision of GDP levels, improved accuracy and international comparability of estimates of real growth, and the loss of additivity of volume data. While national authorities will implement these methodological changes at different times, euro-area aggregates will reflect them from the Q3:2005 statistical release onward. All EU countries have now implemented the European System of Accounts 1995 (ESA95). Euro-area quarterly statistics on national accounts by institutional sector integrating flow of funds and non-financial national accounts are being prepared by Eurostat and the ECB, with a view to publication from May 2007 onward. A revised *Nomenclature Générale des Activités Economiques dans les Communautés Européennes* (NACE) classification is planned for 2007, in the context of the UN's revision of the International Standard Industrial Classification (ISIC). Dates for the subsequent implementation in national accounts and other statistical areas are currently under discussion with EU Member States.

- Following several cases of misreporting, at the end of 2004 the Commission proposed a strategy to improve governance in the area of fiscal statistics. The implementation of the strategy is well underway: (i) a draft regulation is being considered allowing more in-depth monitoring visits to national statistical authorities by Eurostat and experts from other member states, in addition to current dialogue visits; (ii) Eurostat has allocated more resources to its services that work on national fiscal statistics—although the workload of these services has also increased as a result of EU enlargement; and (iii) a Code of Practice on European Statistics has been drafted to serve as a self-regulatory instrument to improve the independence, integrity and accountability of the national statistical authorities and Eurostat. Work on quarterly public finance statistics is ongoing, with partial publication expected from early-2006 onward.

- Asymmetries in the intra EU trade data reported by the different member states remain an issue. Work is ongoing to reduce these asymmetries, to increase the consistency between

balance of payments and national accounts data, and to improve the timeliness of aggregate euro-area external trade data.

- Labor market surveys are now conducted every quarter in all EU countries, which will enable the publication of complete quarterly data for the euro area from 2006 onwards. The current estimated series for the labor cost index will be replaced with an improved final series in the near future, based on a harmonized reporting system that became operational in June 2005. Better information on hours worked in the services sector is not expected to become available soon, in part due to concerns over the reporting burden on enterprises. Limited statistics on job vacancies are available for the euro area, and work is ongoing to develop harmonized short-term and structural data in this field. Monthly unemployment statistics are constructed on the basis of quarterly labor force survey (LFS) data, supplemented with monthly data for some countries. Data for some countries are not entirely consistent with the ILO definition.

- Efforts to harmonize and improve inflation statistics as measured by the HICP continue. Current priorities include quality adjustment and sampling, the development of a price index for newly-built houses (excluding land) on a net acquisition basis and of a self standing price index for (new and old) dwellings, as well as a number of further methodological improvements, such as a common base year and a harmonized price collection period. A pilot project is ongoing to construct an HICP at constant tax rates. Eurostat and the CBS are currently considering how the 2006 health care reform should be reflected in the Dutch HICP.

- A limited set of financial soundness indicators for the euro area is published in the fall issue of the ECB's Financial Stability Report. All euro-area countries are participating in the Coordinated Compilation Exercise for Financial Soundness Indicators, but the ECB's consolidation approach and frequency of compilation are not in line with the Fund's *Compilation Guide on FSIs*.

INTERNATIONAL MONETARY FUND
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August 3, 2005

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

IMF Executive Board Discusses Euro Area Policies

On July 29, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of euro area policies and the trade policies of the European Union. The background section of this PIN reflects information available at the time of the Executive Board meeting.[1]

Background

The area's low-flying recovery continues to struggle against the background of strong global growth. After losing momentum in the second half of 2004, real GDP rebounded in the first quarter of 2005, recording 2 percent growth (on an annual basis). However, domestic demand unexpectedly stalled, after showing encouraging gains at the end of last year. Lacking more vibrant domestic demand, as both households and corporations have been slow to step up spending, the economy has been more vulnerable to external shocks. Sharply rising oil prices and sustained euro appreciation in recent years have dampened growth, partly offsetting the impact of buoyant world trade on the area's external sector.

Headline inflation has moderated to 1.9 percent in mid-2005, after escalating energy prices and administered price increases had pushed up inflation to 2½ percent last year. Underlying inflation remains low at about 1½ percent. A key factor behind subdued inflation has been modest wage growth and the absence of "second-round" effects. Reflecting this and some cyclical rebound in labor productivity, unit labor costs have been declining in real terms.

[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.

With favorable labor costs and low interest rates, euro-area corporations have improved profitability and strengthened their balance sheets. Low investment-output ratios and relaxed financing conditions should boost investment activity. But firms, thus far, remain in a defensive posture, more content to consolidate balance sheets or payout dividends than to seek out new financing, invest in new capital, or hire new workers.

Reticent private consumption has been a key missing link to a self-sustaining recovery. Households have been hesitant to spend owing to uncertain job prospects, modest wage earnings, and unfavorable price shocks. Low interest rates have fueled demand for housing and rising real estate values, but this has not translated strongly into higher consumption expenditures.

Financial conditions remain accommodative. In particular, monetary policy continues to be supportive of the recovery, with policy rates at low levels and unchanged since June 2003. Benign global market conditions have also helped ease long-term interest rates near historical lows. The euro has retreated from its recent highs against the dollar and multilaterally, but persistent global current account imbalances still constitute a key risk for further euro appreciation in light of recent history and the single currency's expanding international role.

Fiscal policy in the euro area has been broadly neutral, with structural balances moving sideways and overall fiscal balances weakening—reflecting the operation of automatic stabilizers. Fiscal deficits, on staff projections, in five countries (France, Germany, Greece, Italy and Portugal) are expected to breach the Stability and Growth Pact's (SGP) 3 percent of GDP limit in 2005-6, some by wide margins. Moreover, public finances have not made progress toward the area's medium-term fiscal policy requirements of attaining close to balance or surplus in preparation for the looming demographic shock at the end of the decade.

Against this background, the staff projects real GDP to grow by about 1⅓ percent this year and 2 percent next year, underpinned by a resumption in final domestic demand growth. Downside risks include further hikes in oil prices, possible euro appreciation pressures owing to global current account imbalances and continued reluctance by households and corporations to step up spending. At present exchange rates and oil prices, inflationary pressures appear set to ease, with headline inflation expected to fall to 1¾ percent in 2006, in an environment of maintained wage setting discipline, and continued slack in goods and labor markets.

Executive Board Assessment

While expressing disappointment with the struggling recovery and continuing high unemployment, Executive Directors noted that the economic fundamentals in the euro area have continued to strengthen, reflecting significant structural reforms in several member states. In particular, past labor market reforms and continued wage moderation have further improved labor market resiliency, while corporate profitability has strengthened. At the same time, Directors observed that the burden of accumulated rigidities, and aging, continue to weigh heavily on the euro area, and fiscal policies fall well short of the area's fiscal consolidation

requirements. Furthermore, business and consumer confidence remains low, reflecting the still significant economic challenges facing the euro area.

Against this background, Directors called for a more decisive and consistent pursuit of forward-looking policies aimed at strengthening fiscal adjustment and structural reform, while harnessing the complementarities within and between fiscal adjustment and structural reform. In this regard, they considered that Europe's restructured policy frameworks chart the right course, and the increased weight they place on ownership will be helpful for strengthening public trust and confidence. At the same time, now more than ever, effective implementation will call for the leadership and determination of both national capitals and the European Council.

Directors considered that the fundamentals remain in place for the modest recovery to resume in the second half of 2005, but with downside risks continuing to prevail. Continued wage moderation, improved corporate balance sheets, accommodative financing conditions, and reaccelerating world demand point to renewed momentum during the second half of the year. Nevertheless, the outlook is uncertain, and the risks lie mainly on the downside, including from further sharp increases in oil prices, multilateral euro appreciation in the context of unwinding global imbalances, a reversal in the benign global financial conditions, and a potentially sluggish investment recovery in the face of weak business confidence.

Directors agreed that the European Central Bank's monetary policy stance remains broadly appropriate. While headline inflation is still hovering around 2 percent, underlying inflation pressures remain subdued. With the latest activity indicators not painting a consistent picture of the future course of the recovery, Directors agreed that a wait-and-see attitude remains appropriate. However, many Directors stressed that, absent new information on prices or wages, a cut in interest rates would be appropriate if evidence of a fading recovery continues to accumulate over the coming months. These Directors felt that a rate cut would also be warranted if the euro appreciates significantly on a multilateral basis. Some Directors, however, questioned the case for a rate cut, pointing to the upside risks to headline inflation and the predominantly structural nature of the area's sluggish activity. Given the considerable uncertainty surrounding the economic outlook, Directors encouraged the European Central Bank (ECB) to remain vigilant, and to stand ready to respond flexibly, as warranted.

Directors underscored the need to prepare the euro area's public finances for the looming demographic shock. This will require steady progress toward achieving underlying fiscal balance by 2010, when population aging is set to accelerate. Many Directors advocated policies that consistently correct current and intertemporal fiscal deficits to anchor consumer confidence. This will require sustained fiscal adjustment of about ½ percent of GDP annually over the medium term—complemented by further structural reforms that address fiscal liabilities and strengthen the tax base. Fiscal adjustment is also needed to achieve adequate safety margins below the 3 percent Maastricht deficit ceiling and restore the credibility of the Stability and Growth Pact. Directors reiterated the crucial importance of achieving these objectives, especially in view of the limited progress that has been made in shoring up the area's public finances over the past five years and the modest objectives for the medium term. Given the constraints imposed by the single monetary policy, a few Directors thought that fiscal policy

should continue to have some role in smoothing out cyclical fluctuations, taking account of country-specific circumstances.

Directors welcomed the renewed agreement on the Stability and Growth Pact but underscored that its credibility depends on effective implementation. The reforms that allow for a greater sensitivity to economic circumstances under the Pact's dissuasive arm, and call for minimum annual adjustment under the preventive arm, are improvements over the old framework. Nonetheless, many Directors cautioned that potentially open-ended tradeoffs between fiscal adjustment and structural reform and the restrictive definition of "good times" could be used to justify insufficient consolidation during upswings. A transparent, evenhanded, and sufficiently ambitious implementation of the reformed framework will thus be essential for Europe to address successfully its fiscal policy challenges.

Directors agreed that actions to boost potential growth and employment are crucial, and called for particular attention to the appropriate sequencing of product, service, labor, and financial market reforms. Key actions include reforming entitlement systems, boosting labor utilization, deregulating and strengthening competition, completing the internal market, and integrating national financial systems. In this regard, the new integrated guidelines under the revamped Lisbon Strategy were welcomed, as they should aid in the formulation of consistent National Action Plans. Directors observed, however, that with the agenda-setting shifting away from the center, the prospects for reform will hinge on the leadership and determination of national governments. In this regard, Directors acknowledged that national governments may be concerned about pressing ahead with structural reforms that may temporarily weaken demand. They nevertheless stressed that pursuit of clear and credible policy objectives that leverage the complementarities between product and labor market reforms should help boost investment without imparting undue effects on domestic confidence and consumer spending.

Many Directors considered that growth-enhancing structural reforms will be helpful in underpinning an orderly unwinding of global current account imbalances. While recognizing that global imbalances are attributable to a complex combination of factors, they noted that structural reforms needed from the euro area's own perspective—namely to unlock the area's productive potential, boost its demand, reduce its vulnerabilities, and enhance confidence—would also aid the global economy. However, some Directors believed that, while structural reforms will be crucial to raise the area's growth potential, their effects on the euro area's saving-investment balance remain ambiguous.

Directors agreed that the experience with the Stability and Growth Pact and the Lisbon agenda points to the importance of garnering domestic support for strong, forward-looking policies. They considered that debating Stability Programs and National Action Plans in parliaments would be important steps toward increasing transparency, informing the public, and building ownership. Many Directors believed that achieving these objectives would also be aided—especially in countries facing large consolidation and reform agendas—by developing independent, non-partisan institutions that are tuned to country-specific needs and inform the public about the larger strategic economic issues they confront, engage in the policy debate, and assess policies and their implementation. The policy mandate, however, should remain in

the hands of elected representatives. Some Directors noted, however, that similar institutions already exist in several countries and that additional focus on them might detract attention from policy implementation. Directors agreed that intensive, peer-driven multilateral surveillance of policies remains essential.

Directors welcomed the progress that has been made through the Financial Services Action Plan and the so-called Lamfalussy process in laying the foundation for further integration of financial markets and convergence of supervisory practices in Europe. The onus now is on all member states to take a pan-European view to make this process work effectively, and on the Commission to enforce existing rules, including through competition policy. Directors agreed that growing cross-border activities of major, complex financial groups are placing an increasing burden on national supervisors. Many Directors also thought that a more integrated approach to supervision, including provision of up-to-date information on key groups through an existing area-wide structure, deserves consideration. A few Directors, however, felt that entertaining such moves at this stage is premature, with implementation of the Plan still incomplete.

On trade policy, Directors welcomed the EU's continued commitment to playing a leading role in forging agreement on the Doha Development Agenda. They underscored the importance and the multilateral benefits from greater access to the EU's agricultural markets. Many Directors regretted the recent moves to limit imports of textiles, clothing, and footwear.

Directors stressed that effective area-wide surveillance calls for improvements in the quality, availability, and timeliness of statistics, and strengthened statistical institutes. While the availability of statistics is broadly adequate, better fiscal data remain a key priority for a number of countries.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Euro Area: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	1/
				In percent			
Real Economy							
Change in Real GDP	3.8	1.8	1.0	0.7	2.0	1.3	
Domestic demand	2.9	1.0	0.4	1.2	1.9	1.3	
Consumer prices 2/	2.1	2.3	2.3	2.1	2.1	2.1	
Unemployment rate 2/ 3/	8.2	7.8	8.3	8.7	8.9	8.9	
				In percent of GDP			
Public Finance							
General government balance 4/	-0.9	-1.8	-2.5	-2.8	-2.7	-3.0	
General government debt	70.0	68.9	68.8	70.1	70.6	72.2	
				In percent			
Money and Interest Rates							
Change in M3 (end of year)	4.1	8.0	7.0	7.1	6.6	6.7	5/
Money market rate (3 month money)	4.4	4.2	3.3	2.4	2.1	2.1	6/
Government bond yield (10 year bonds)	5.5	5.0	4.9	4.2	4.2	3.3	6/
				In percent of GDP			
Balance of payments							
Current account balance 7/	-1.2	0.0	0.9	0.3	0.6	0.4	
Trade balance 7/ 8/	0.1	1.1	1.8	1.4	1.4	0.8	9/
Official Reserves (US$ billion) 10/	242.3	235.0	247.0	222.7	211.3	200.0	6/
				In percent			
Exchange rates							
Nominal effective rate (2000=100)	100	101	104	116	120	121	6/
Real effective rate (2000=100) 11/	100	99	102	113	115	116	6/

Sources: Eurostat; European Central Bank; and IMF Staff, World Economic Outlook.

1/ WEO, June 2005.
2/ Period average; harmonized definition.
3/ In percent of labor force.
4/ Excluding UMTS license receipts.
5/ April 2005.
6/ May 2005.
7/ Excluding intra-euro area trade.
8/ Data for goods.
9/ 2005:Q1.
10/ End-of year. Total reserves minus gold (Eurosystem definition).
11/ Based on normalized unit labor costs.

Statement by Johann Prader, Alternate Executive Director for Euro Area
Executive Board Meeting

As Austria has been representing the Presidency of the Eurogroup of euro area finance ministers since 1 July, 2005, my statement expresses the common views of the euro area Member States and the European Community in their respective fields of competence.

The authorities of the euro area Member States welcome the staff assessment of economic developments and prospects in the euro area. They broadly concur with the policy conclusions in the staff appraisal. Nevertheless, some differences of view can be observed, which are outlined in this statement. In addition, I will update the Board on recent economic developments and policy actions taken at the European level.

Short term economic outlook

After a soft patch in the second half of 2004, economic growth in the euro area gathered momentum in the first quarter of 2005. However, contrary to expectations, the acceleration of activity was entirely attributable to net trade, with domestic demand, particularly investment, showing broad-based weakness. Moreover, available survey data suggest that activity slowed again in the second quarter of 2005. Accordingly, domestic demand remains fragile and growth for the year as a whole is likely to turn out lower than earlier expected.

The authorities share the staff's appraisal that, although the near-term outlook is uncertain, the fundamentals remain in place for the recovery to resume, and they view growth gradually returning to potential during the remainder of the year. Both hard data and surveys have recently improved, supporting this scenario. Monetary and financial conditions remain quite supportive, labor cost pressures are contained despite the oil-price hikes, and the recent weakening of the external value of the euro should provide further support to euro area exports. Moreover, there are early signs that the soft patch in the global economy may be ending and that world trade could pick again up during the second half of the year. Regarding the risks to the short term economic outlook, the authorities agree with the staff's view that currently they lie mainly on the downside. These include indeed further increases in already persistently-high oil prices, the unwinding of global imbalances leading to a multilateral euro appreciation, and a sudden reversal of benign global financial conditions.

A further issue that has been discussed by the authorities of the euro area is the increased divergence in growth rates and in the composition of growth shown across Member States, particularly among the four largest euro area Member States. While growth differences are a natural and inevitable feature of any large monetary union, the gap between weak and strong growth performers in the euro area risks becoming entrenched over time, which might be indicative of underlying structural problems. The persistence of growth differences in the euro area thus underlines the need for some Member States to boost their adjustment mechanisms in the face of economic shocks with different impacts.

Monetary policy and the outlook for price stability

The euro area authorities welcome the conclusion reached in the staff report that the current stance of monetary policy is appropriate. The analysis in that report is broadly in line with the ECB Governing Council's baseline assessment that there is no evidence of underlying domestic inflationary pressure building up in the euro area. The Governing Council has identified potential upward risks to price stability over medium to long-term horizons, pointing to a need for vigilance in order to maintain inflation expectations in line with price stability. In particular – and as recognized in the report – since the time of the Article IV discussions, oil price developments have evolved in a manner that implies the materialization of some previously identified upward risks to the inflation projections for the euro area.

As regards the economic analysis, annual HICP inflation remained at levels slightly above 2 percent in June, reflecting mainly recent developments in oil prices. However, wage increases should remain moderate because of weak labour markets. In addition, economic growth has remained subdued in recent quarters. At the same time, as already noted, there continues to be reason to expect a gradual improvement in economic activity in the euro area. On the domestic side, investment should benefit from the prevailing very favourable financing conditions, the robust growth of corporate earnings currently observed and ongoing improvements in corporate efficiency. Consumption should evolve broadly in line with expected developments in disposable income. On the external side, ongoing growth in global demand and improvements in euro area price competitiveness should support euro area exports.

The monetary analysis provides further insight into inflation prospects over medium to longer horizons. Monetary and credit growth in the euro area remains strong, mainly reflecting the stimulative impact of the low level of interest rates. In the context of the significant portfolio shifts between monetary and non-monetary assets in recent years, the signals for likely future price developments given by current monetary developments have become somewhat unreliable. Liquidity remains ample by all plausible measures, even when taking into account the fact that, as claimed by the IMF staff, part of the recent shifts in the evolution of velocity might be due to more structural factors. The combination of ample liquidity and strong credit growth could imply risks of strong asset price increases. Admittedly, the relationship between money, credit, asset prices and consumer prices is complex, but it would be imprudent for the ECB not to monitor these risks. Therefore, monetary developments continue to support the case for vigilance with regard to upward risks to price stability over medium to long-term horizons.

In sum, the economic analysis confirms that domestic inflationary pressures over the medium term remain contained in the euro area, although this scenario is surrounded by upside risks. Cross-checking the economic analysis with information from the monetary analysis justifies ongoing vigilance in order to anchor inflation expectations at levels in line with price stability.

Fiscal policy and SGP reform

The authorities of the euro area share the staff's view that further consolidation efforts are needed in the area in the years to come. Although the euro area deficit has declined in 2004 after having increased for three consecutive years, more budgetary room is needed, inter alia because of the pressures associated with rising ageing-related expenditures that will materialize starting from the next decade. The euro area authorities judge the size of the annual consolidation effort as defined by the staff (0.5 per cent of GDP in cyclically adjusted terms net of one-off and temporary measures) as appropriate and recommend that a bigger effort is needed by the countries posting deficits in excess of the Maastricht 3 percent reference value.

The authorities recognize the need to complement fiscal consolidation by structural budgetary reforms aimed at addressing forthcoming pressures in age-related expenditure by redefining entitlements to key expenditure programs, encouraging labor force participation and improving the growth potential. In this respect, the greater emphasis given to debt sustainability is welcome. It is also important to avoid pro-cyclical fiscal policies during good times. However, it is also acknowledged that a trade-off between reforms and fiscal consolidation may occur in the short-run, especially if reforms produce a significant budgetary deterioration compensated by savings in the medium-to-long term. This may occur, for example, in the case of pension reforms replacing PAYG schemes with funded schemes recorded outside the government sector.

The judgment expressed by the Fund staff on the reform of the Stability and Growth Pact (SGP) is partly shared by euro area authorities, but with a different view concerning the new provisions on the preventive arm of the SGP. Overall, the euro area authorities concur that the way the new system will be implemented will determine the definitive judgment on the SGP reform. Regarding the reform of the dissuasive arm of the Pact, there is agreement that the possibility of better modulating the adjustment path of the Member States in the excessive deficit procedure (EDP) according to economic circumstances provides the ground for inducing a credible adjustment achieved via structural rather than one-off measures. Concerning the new provisions that define the Treaty's reference to "other relevant factors", there is acknowledgment that Member States continue to be committed to the Maastricht deficit and debt ceilings and that these provisions outline how to deal with the room for judgment in implementing the EDP. The euro area authorities consider instead that the concern expressed by the staff on the reform of the preventive arm of the SGP is exaggerated. Here, the focus on overall fiscal sustainability will clearly be enhanced. The amended regulation explicitly refers to a benchmark annual adjustment towards the medium term objective of 0.5 per cent of GDP net of one-offs. As a result of the SGP reform, countries are now required to report in their stability and convergence programs the reasons for the lack of adjustment towards the medium term objective. These reasons will be discussed within the Council, with a likely increase in peer pressure.

Lisbon Strategy

In the context of the need for economic reforms to boost potential growth and employment, the authorities welcome the staff's attention for the reinvigorated Lisbon Strategy. In view of

the disappointing progress made in achieving the Lisbon objectives set in 2000, the Strategy has recently been refocused toward its growth and employment objectives. The changes made in the Strategy attempted to address the main weaknesses, namely the slow implementation of reforms in Member States and a gradual loss of political focus. The renewed Lisbon Strategy aims to increase the consistency and focus of the reform agenda through the identification of three major priorities: knowledge and innovation; making the EU an attractive place to invest and work; and more and better jobs. While the staff does not contest these priorities, its recommendations for reforms focus primarily on labor and financial markets and completing the Internal Market. However, appropriate attention needs to be devoted as well to the generation and effective use of knowledge and innovation which is the key factor for boosting Europe's competitiveness and long-run growth potential. In addition, one should not lose sight of the fact that growth and stability-oriented macroeconomic policies are necessary to reap the full benefits of reforms in terms of growth and employment.

Improvements in the implementation record of Lisbon reforms are to come through increased ownership of reforms by Member States and considerable simplification of the reporting and assessment process. The Integrated Guidelines Package is the first step in this process. It brings together, for the first time, the Broad Economic Policy Guidelines and the Employment Guidelines into an integrated package, and sets out broad priorities on the basis of which Member States will prepare their National Reform Programs. The continued use of multilateral surveillance for the BEPGs, supported by the active role of the Commission, should support Member States in addressing structural problems in a coherent manner and avoid the temptation to postpone politically sensitive reforms. It is certainly true that improved communication on the necessity and benefits of reforms is essential for a substantial breakthrough.

Financial market developments

The authorities concur with the staff's balanced analysis of financial-sector developments both in terms of stability risks and the ongoing process of integration. As the recovery proceeded, the financial sector became progressively more resilient to possible adverse shocks. However, this favorable assessment must be qualified by reference to a range of stability risks linked to persistent imbalances elsewhere in the financial system. As indicated in the staff report, these stability risks relate mainly to external factors such as tensions in the international balance of payments, a possible mis-pricing of risk in asset markets and the nature of markets for newer and more complex financial products. At the same time, it is important not to underestimate the significance of some domestic developments, notably strong price pressures in some real estate markets but also expanding credit and high private-sector debt levels under conditions of sustained below-par economic growth. In light of the risks from many different sources, vigilance in the prudential supervision of financial intermediaries will be key in the period ahead.

Now that the Financial Services Action Plan (FSAP) is almost fully implemented at the EU level, the process of financial integration has reached an important juncture. The FSAP is the blueprint for a common regulatory framework and is a pre-condition for an effective internal market in financial services. One of the main challenges now for the Commission and the

Member States is to ensure timely and consistent transposition of the various legislative measures in the FSAP to national law and, thereafter, to provide the mechanisms to ensure adequate enforcement. Even as the new regulatory framework is being put in place, the process of financial integration is increasingly evident in the actual functioning of the financial sector. While the pace of progress varies with the type of market (e.g. wholesale or retail) and the transaction (e.g. secured or unsecured), there is ample evidence of an acceleration in cross-border financial activity.

While the staff acknowledges that progress has been made in financial integration, it suggests that its pace may need to be accelerated so as to contribute more actively to ongoing efforts to boost overall economic performance. Staff concerns that institutional arrangements – particularly in the area of prudential supervision – may not be keeping sufficient pace to manage cross-border financial stability risk seem not fully justified. First, progress in financial integration is on schedule and is already delivering positive economic results. The next phase of integration will focus on consolidation, implementation and evaluation of existing legislation rather than introducing a broad new legislative programs. However, the momentum created by the FSAP should not be lost. The Commission has already identified several areas for possible action, such as the post-trading infrastructure for securities markets, the asset management industry and retail financial services. Second, the need to ensure adequate arrangements for crisis prevention and management in an integrated financial sector has been under consideration by the relevant EU authorities for several years. The result has been improved arrangements and structures among national supervisors, central banks and ministries on either a bilateral or multilateral basis, which would seem adequate to the task without the need, at this stage, to seek the more centralized solutions advocated by the staff

Trade policy issues

Finally, I would like to address the staff's assessment of trade policy issues. In this field the Doha Development Agenda (DDA) remains the EU's top priority. The EU aims for an ambitious outcome of the DDA which should deliver substantive trade liberalization and stronger multilateral rules, including on trade facilitation, while supporting sustainable development. The DDA is entering a critical stage with the Hong Kong Ministerial approaching. The EU has shown leadership in advancing the Round and is willing to continue to play a leading role. However, in order to secure an ambitious and fair outcome of the DDA others will have to take their responsibilities as well.

The EU attaches great importance to the development dimension of the DDA and strongly supports the view that an ambitious outcome is needed. An additional effort to address supply side constraints is needed in some countries to ensure that they will be able to take advantage of new and existing opportunities to trade. The EU and its Member States will therefore increase their efforts in the area of aid for trade. At the recent G8 meeting the President of the Commission, Barroso, pledged to increase EU Trade-Related Assistance to €1 billion per year.

Another priority of EU trade policy is the Negotiation of Economic Partnership Agreements with six ACP regions which focus on trade as a tool for development. A main aspect of the

talks is the promotion of economic integration as a stepping-stone towards integration into the world economy.

On textiles and clothing, the EU concluded recently a Memorandum of Understanding with China covering the import of 10 product categories for the period 2005-2007. This can be considered a satisfactory solution as it seeks to avoid repetitive recourse to safeguard action and, as such, an amicable solution to a difficult problem.