

Euro Area Policies: Staff Report; Staff Supplement; 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 18, 2004, 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 2, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of July 22, 2004 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 26, 2004 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 Policies¹

Prepared by the European Department

Approved by Michael Deppler and John Hicklin

July 2, 2004

- A staff team held discussions at the European Central Bank (ECB) and the European Commission (EC) during May 9-18, 2004.
- Meetings were held at the ECB with President Trichet, Vice President Papademos, Mr. Issing, Mr. Padoa-Schioppa, and Ms. Tumpel-Gugerell (members of the Executive Board), 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 officials. Mr. O’Loghlin, Alternate Executive Director, and Mr. Wijnholds (ECB Observer at the Executive Board) attended most of the meetings. Mr. Deppler presented the mission’s preliminary conclusions to the Economic and Financial Committee in Brussels on May 24 and to the Eurogroup in Luxembourg on June 1.
- The team comprised Messrs. Deppler (Head), Annett, Estevão, Faruquee, and Jaeger (all EUR), Mr. Debrun (RES), and Mr. Dhonte, the Fund’s Special Representative to the EU. Mr. Hallaert (PDR) joined the mission at the EC to cover EU trade issues.
- The authorities released the mission’s concluding statement and have agreed to the publication of the staff report.

¹ Including the trade policies of the European Union.

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EXECUTIVE SUMMARY

Background and Outlook

The area's real GDP growth has picked up, responding to strong foreign demand and relaxed financial conditions. But domestic demand remains sluggish, especially in Germany. Higher oil prices and fiscal measures have pushed headline inflation above 2 percent. While the euro has stabilized at about \$1.20, global current account imbalances carry the risk of significant appreciation pressures. Staff and the authorities shared the central view that the recovery will be underpinned by a firming of final domestic demand, but the output gap will narrow only slowly. Staff was more cautious on the downside risks to growth, noting that the projected recovery of final domestic demand was uncertain given the area's slow and incomplete adjustment to past shocks. Headline inflation pressures are projected to subside by 2005, as continued economic slack and wage moderation are likely to contain second-round effects. All agreed that the area's main problem was lackluster potential growth, which threatened the financial viability of social protection systems given the prospect of rapid population aging.

Policy Discussions

Monetary policy: The ECB views the present stance as accommodative and has signaled that all policy options are open. Staff argues that this accommodative stance should be maintained until a sustained recovery in domestic demand takes hold, assuming the medium-term outlook for price stability remains benign.

Fiscal policy: While fiscal policy behavior during the protracted downturn was broadly appropriate, four countries including France and Germany are in breach of the 3 percent of GDP deficit limit, and the SGP is in abeyance. The Commission has put forward ideas aimed at rejuvenating the SGP, including making the excessive deficit procedure less rigid and mechanical. Staff argued that the SGP's procedures need to be better conditioned on the proximate reasons for deficit breaches, especially the role of poor policies versus a weak economic environment. Staff advised countries with weak underlying budgetary positions to undertake at least ½ percent of GDP high-quality adjustment a year while allowing automatic stabilizers to operate.

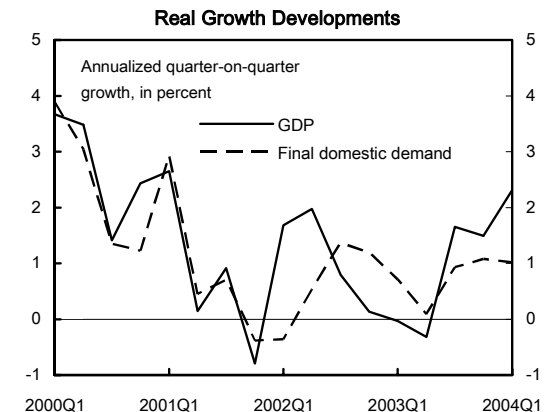
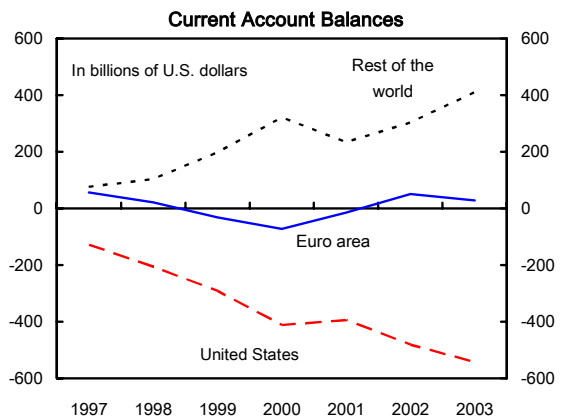
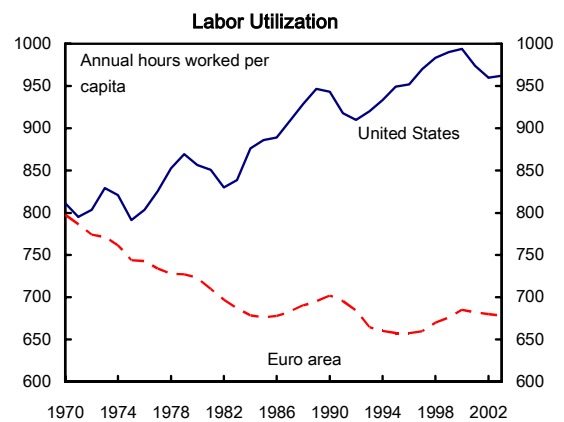
Structural policy: All sides agreed that the pace of structural reform should be stepped up. Staff also emphasized the need to reverse the area's secular decline in labor utilization. The Commission highlighted the need to also raise productivity. Liberalization in product and financial markets has continued, but progress on labor market reforms remains patchy. Staff argued that the Lisbon agenda needed to become more focused and that more peer pressure as well as leadership from the largest countries would be desirable.

Trade policy: Staff welcomed further steps to reform the CAP and the conditional offer to eliminate export subsidies in the context of the Doha round, but argued that more could be done to support an ambitious liberalization of market access.

I. INTRODUCTION

1. **The Article IV discussions focused on policy requirements for improving the euro area's lackluster growth performance while upholding hard-won financial discipline.** European integration is proceeding apace: another historic milestone was passed on May 1 when ten new member countries joined the EU, all committed to adopting the euro in due course; and on June 18 the European Council reached political agreement on a new Constitutional Treaty. Moreover, the euro passed its fifth birthday with aplomb. Nevertheless, there can be little doubt that the euro area faces formidable, and longstanding, economic challenges (Box 1):

- Foremost, the area's structural and fiscal policies do not add up to the forward-looking response needed to revive long-term growth and deal with the fiscal pressures arising from rapid population aging. In particular, social insurance systems will come under serious strain if the area's secular downward trend in labor utilization cannot be turned around (text chart). While strengthening incentives to work is ultimately the responsibility of national governments, past experience with product and financial market integration suggests that leadership at the EU level helps reform efforts at the national level.
- Second, the euro area is situated between regions running large current account surpluses and regions running large current account deficits, particularly the United States (text chart), a constellation carrying the risk of significant appreciation pressures on the euro.
- Third, although the booming global economy has for now imparted a strong external impulse to the area, final domestic demand growth remains sub-par (text chart). At the same time, headline inflation pressures have resurfaced, owing mainly to rising oil prices, complicating the management of monetary policy.



Box 1. Past Fund Policy Recommendations and Implementation

Monetary policy: During the 2003 Article IV consultation, the Fund saw considerable scope for monetary easing and called for maintaining an accommodative bent until a recovery in domestic demand is firmly in place. In June 2003, the ECB cut policy rates by 50 basis points. Since then, rates have been on hold in the face of a gradual recovery in growth, a hesitant pick up in domestic demand, and inflation declining more slowly than expected.

Fiscal policy: The Fund's advice on fiscal policy has sought to balance shorter-term cyclical considerations and the longer-term requirements of putting public finances on a sounder footing. It has argued consistently over the past few years that countries that do not meet the SGP's close-to-balance or in surplus requirement should undertake high-quality fiscal adjustments of at least ½ percent of GDP a year while letting fiscal stabilizers work fully around the consolidation path. Staff has argued that this standard should apply even if it implies serial breaches of the 3 percent deficit ceiling. At least the largest countries complied broadly with the ½ percent adjustment benchmark in 2003, although the quality of measures was mixed. The Commission and the ECB viewed the staff's position on allowing serial breaches of the 3 percent limit as incompatible with the SGP, but the Commission's proposals of last November for France and Germany seemed consistent with the staff's position.

Structural policy: The Fund has argued that lackluster growth and imminent population aging call for more vigorous implementation of the structural reforms envisaged under the Lisbon agenda, especially to raise labor utilization. The Commission agreed with this assessment, but implementation of labor market reforms is the responsibility of countries and there are few incentives the EU can provide to speed up the pace of reforms.

Trade policy: The Fund has repeatedly emphasized the need for strong EU leadership on the Doha round and for greater commitments to open markets, particularly for agricultural products. The EU has recently proposed to eliminate all forms of farm export subsidies and has taken additional steps to decouple agricultural production from domestic subsidies.

- Finally, the tension between rising fiscal deficits, caused largely by the protracted cyclical downturn, and the Stability and Growth Pact's (SGP) deficit limit has left the area's fiscal framework in procedural deadlock. Reasserting a credible framework that preserves fiscal discipline is key for the well-functioning of the monetary union, not least in view of the imminence of rapid population aging.

II. BACKGROUND

A. Cyclical Growth Developments

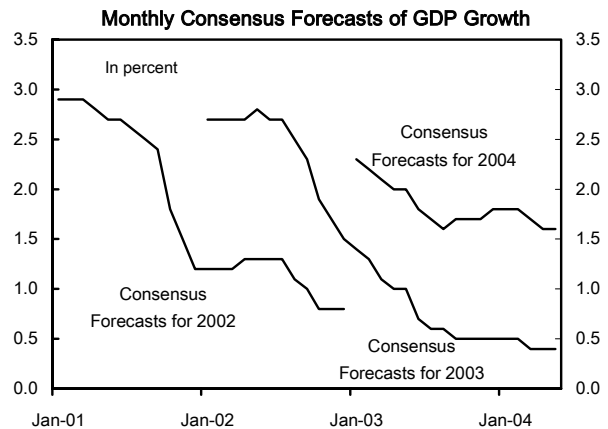
2. **The area's cyclical recovery is gaining momentum but lags the global upturn considerably.** An initial recovery attempt fizzled out during the first half of 2003, undercut on the external side by a pause in global growth and by euro appreciation. Since then, GDP growth has again rebounded, jumpstarted by booming foreign demand and bullish global financial markets. However, final domestic demand growth remains subdued, and the area lags global growth by a large and widening margin (Figure 1).

	2003			2004
	H1	Q3	Q4	Q1
Gross Domestic Product	-0.1	1.7	1.5	2.3
Final Domestic Demand	0.7	0.9	1.1	1.0
Private Consumption	1.1	0.5	0.5	2.3
Fixed Investment	-1.3	0.2	2.3	-0.5
Stockbuilding 1/	0.6	-0.8	1.9	-0.2
Net Exports 1/	-1.3	1.6	-1.4	1.5

Source: Eurostat.
1/ Contributions to growth.

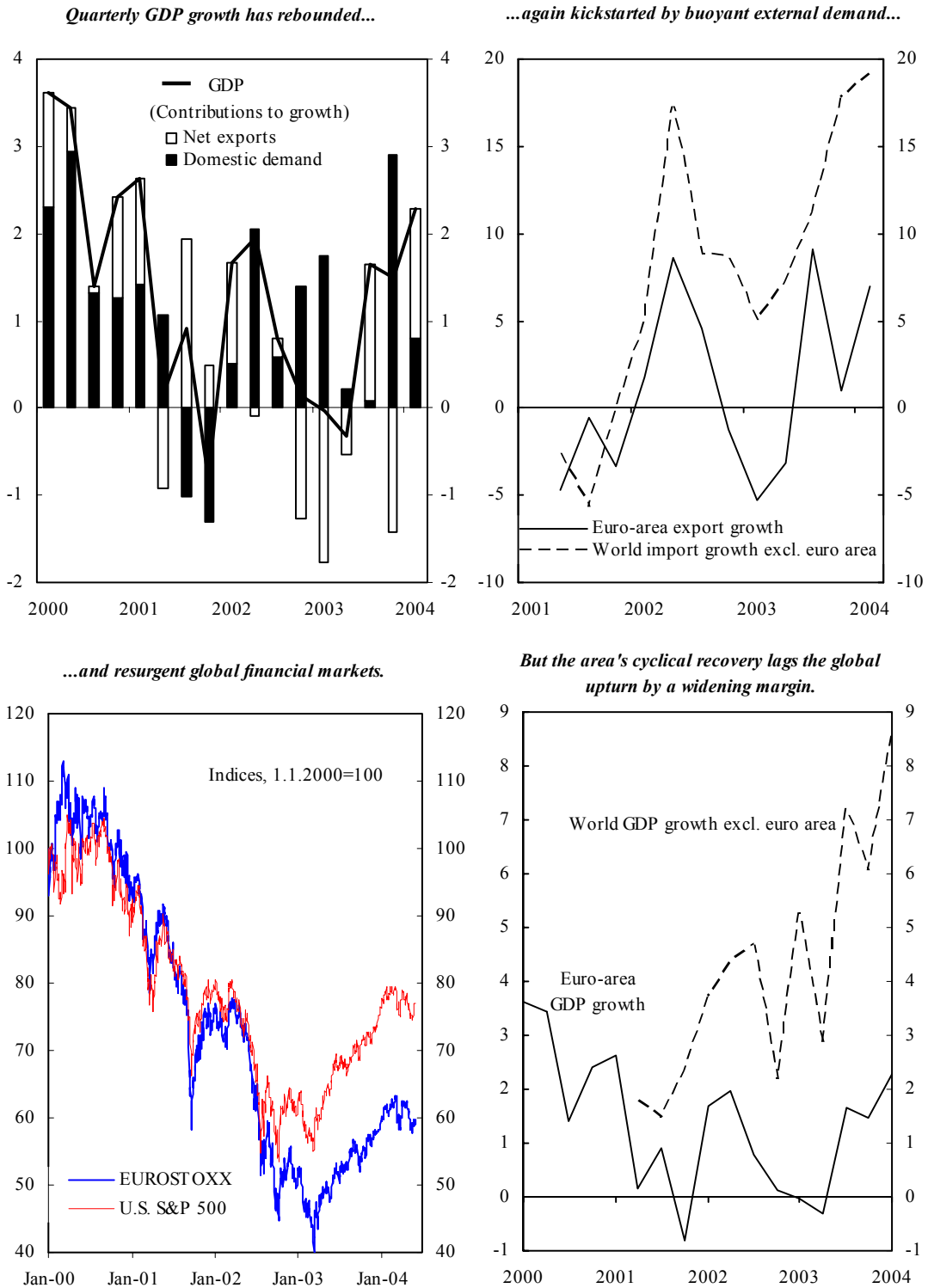
3. **Regional divergences in domestic demand growth remain marked.** While GDP growth across regions is responding to strong external demand, the upturn in internal demand growth is uneven (Figure 2). The momentum of final domestic demand in Germany and Italy remains particularly weak, but France and most of the smaller countries enjoy more balanced and buoyant growth patterns. Highlighting the sustained nature of regional divergences across the area since 2000, Germany's protracted domestic demand weakness combined with a strong export performance have led to a sharp increase in its current account surplus by some 4½ percent of GDP.

4. **The area's recent growth performance has consistently disappointed relative to forecasts (text chart).** The onset of the cyclical downturn was unusual by postwar standards in that neither significant macroeconomic policy tightening nor external price shocks were major precipitating factors. With some hindsight, the protracted downturn seems to have been shaped by an unusual amalgam of cyclical and longer-term factors—including a bust in corporate equity valuations and diminished longer-term growth expectations—that have surprised analysts by their persistent adverse effects on domestic demand.



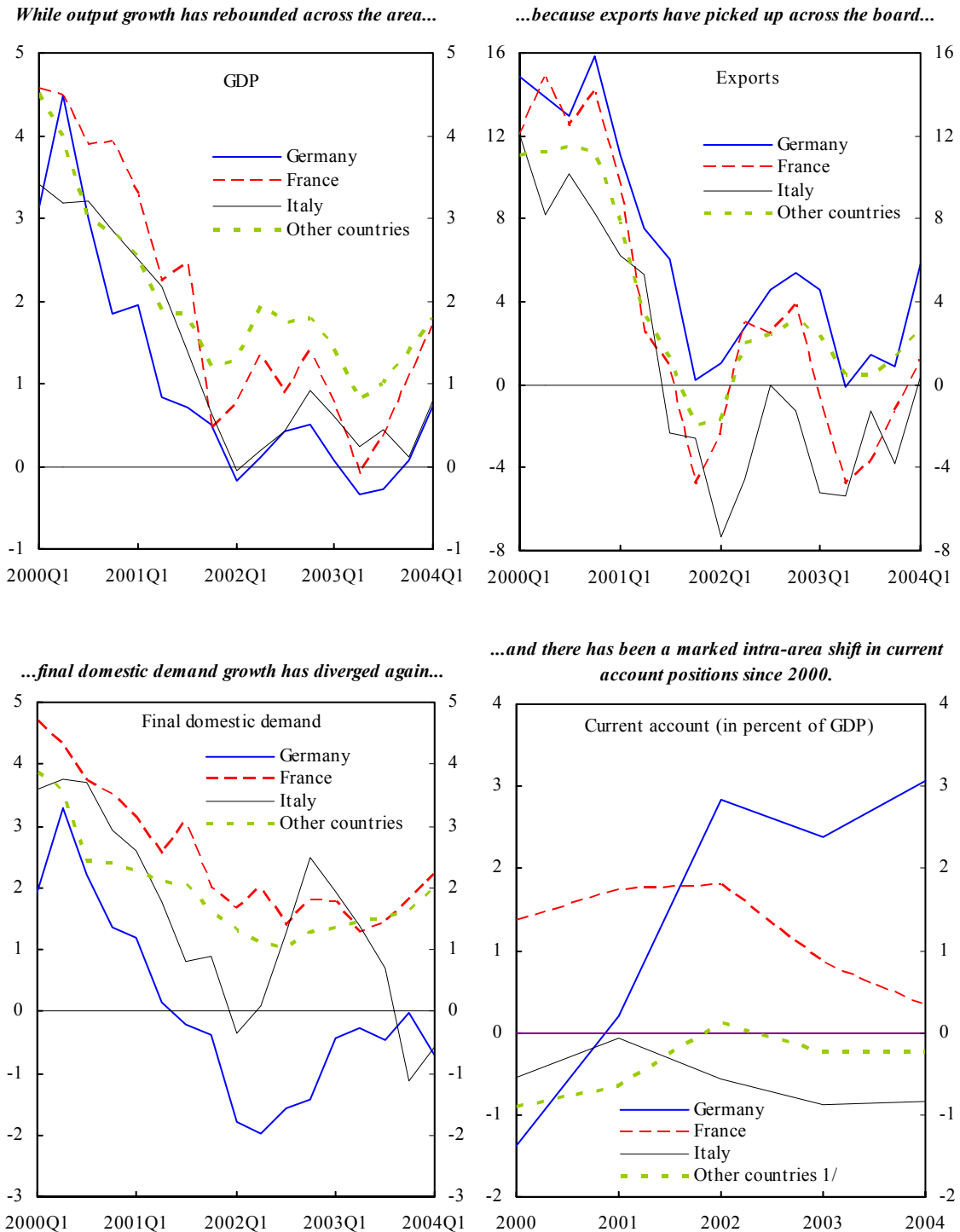
5. **Euro-area corporations have taken considerable time to adjust to the boom-bust cycle in equity valuations.** During the global equity boom of the late-1990s, the area's nonfinancial corporations spent aggressively on capital and financial assets, running up

Figure 1. Euro Area: Cyclical Growth Developments
(Annualized quarter-on-quarter percent change, unless otherwise specified)



Sources: Eurostat; Datastream; and IMF.

Figure 2. Euro Area: Cyclical Growth Divergences
(Year-on-year percentage change)



Sources: Eurostat; and staff estimates and forecasts.
1/ Sum of country balances.

massive financing gaps (Figure 3). Their post-bubble retrenchment has been relatively protracted, likely reflecting labor and product market rigidities that impeded restructuring and a more forbearing bank-based financial system. Nevertheless, the area's corporate balance sheets have improved, the investment-output ratio is low, and financing conditions are favorable—all factors pointing to a pickup in investment, particularly in shorter-lived IT equipment. At the same time, corporate debt and leverage remain relatively high and could become more constraining once interest rates revert to neutral levels. Moreover, the cautionary example of Japan during the 1990s suggests that boom-bust cycles in asset prices can trigger longer-lasting corporate retrenchment phases.

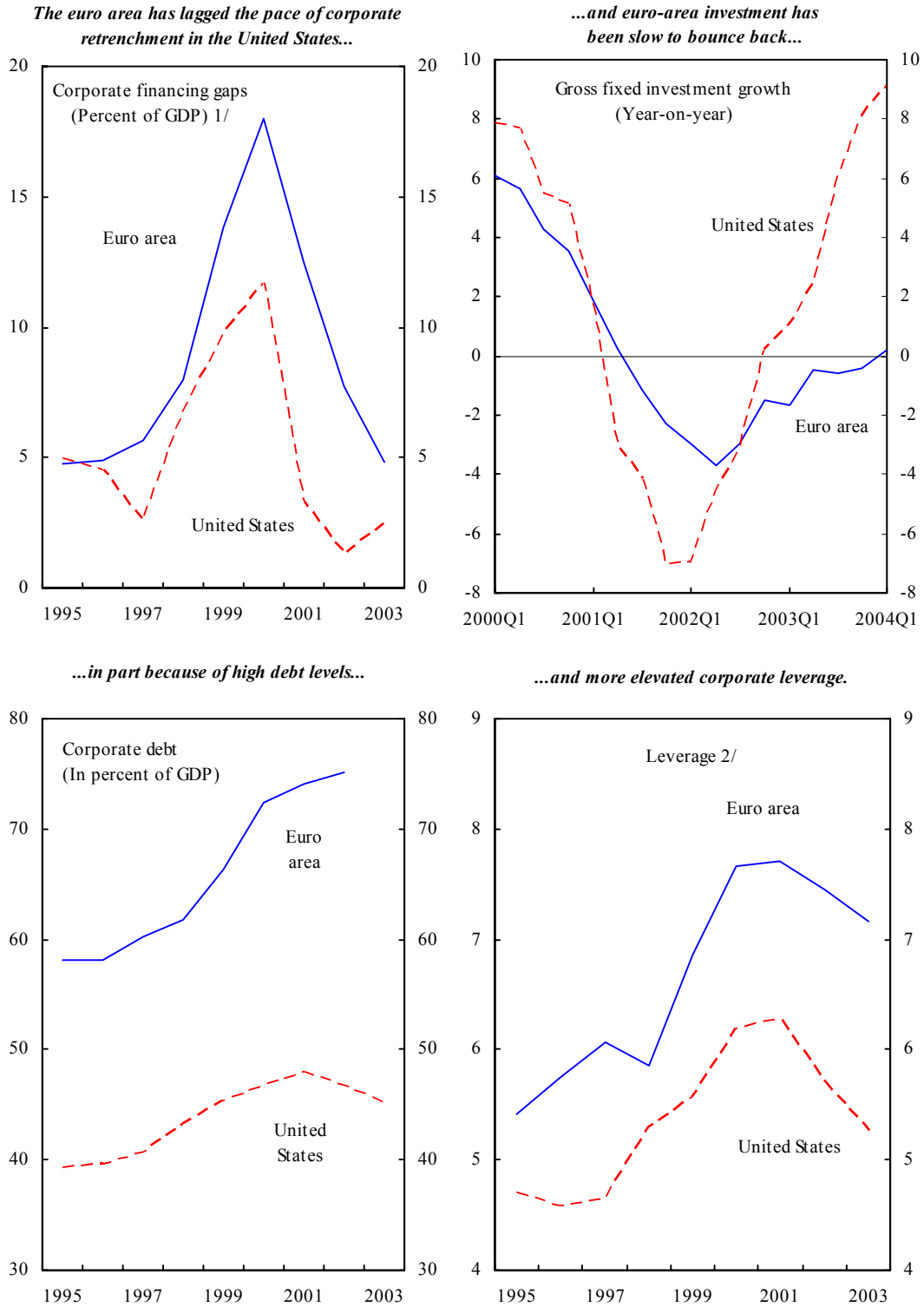
6. **On the supply side, while employment has been surprisingly resilient, potential growth seems to have slowed.** The latest cyclical downturn did not trigger the area's traditional pattern of labor shakeouts (Figure 4). Staff analysis indicates that the increased resilience of employment during the latest downturn reflects some increase in labor hoarding (number of employees) and, to a lesser extent, cutbacks in hours worked (per employee), owing to more flexible work contracts. This suggests that hiring during the early stage of the recovery could be slow to pick up, especially since reported labor shortages are at the low level reached during the trough of the early-1990s recession. Mirroring employment's resilience, labor productivity growth has slowed markedly. While this in part reflects labor hoarding, and will therefore prove temporary, staff has revised down—by about ½ percentage point—earlier projections of the area's potential growth to about 2 percent, with downward revisions spread fairly equally across countries.

7. **Diminished expectations of future income growth seem to weigh on private consumption.** Real disposable income growth decelerated sharply during the downturn, crimped by slower employment growth and a plethora of unfavorable price shocks. But private consumption growth has slowed even more than disposable income growth, and household balance sheet data do not suggest that declining wealth accounts for the procyclical increase in household savings (Figure 5). In fact, consumption growth seems to be weaker than predicted by standard consumption functions, suggesting a role for omitted forward-looking factors. In particular, lower longer-run income growth expectations—in line with the downward revisions of potential growth—would have a significant effect on estimates of permanent household income and therefore impact negatively on private consumption. In addition, households' increased concerns about the financial viability of unfunded pension and health care promises, particularly in Germany, may have led to more cautious, but also more realistic, assessments of longer-term income prospects.

B. Global Current Account Imbalances and the Exchange Rate

8. **The area's stable current account position contrasts with widening external imbalances elsewhere.** Burgeoning external deficits in the United States have been mirrored by broadly equivalent increases in external surpluses outside the euro area (excluding the global discrepancy). This pattern differs markedly from the 1980s when euro area countries were key counterparts to the swings in the U.S. current account. The evolution of

Figure 3. Euro Area: Corporate Balance Sheets

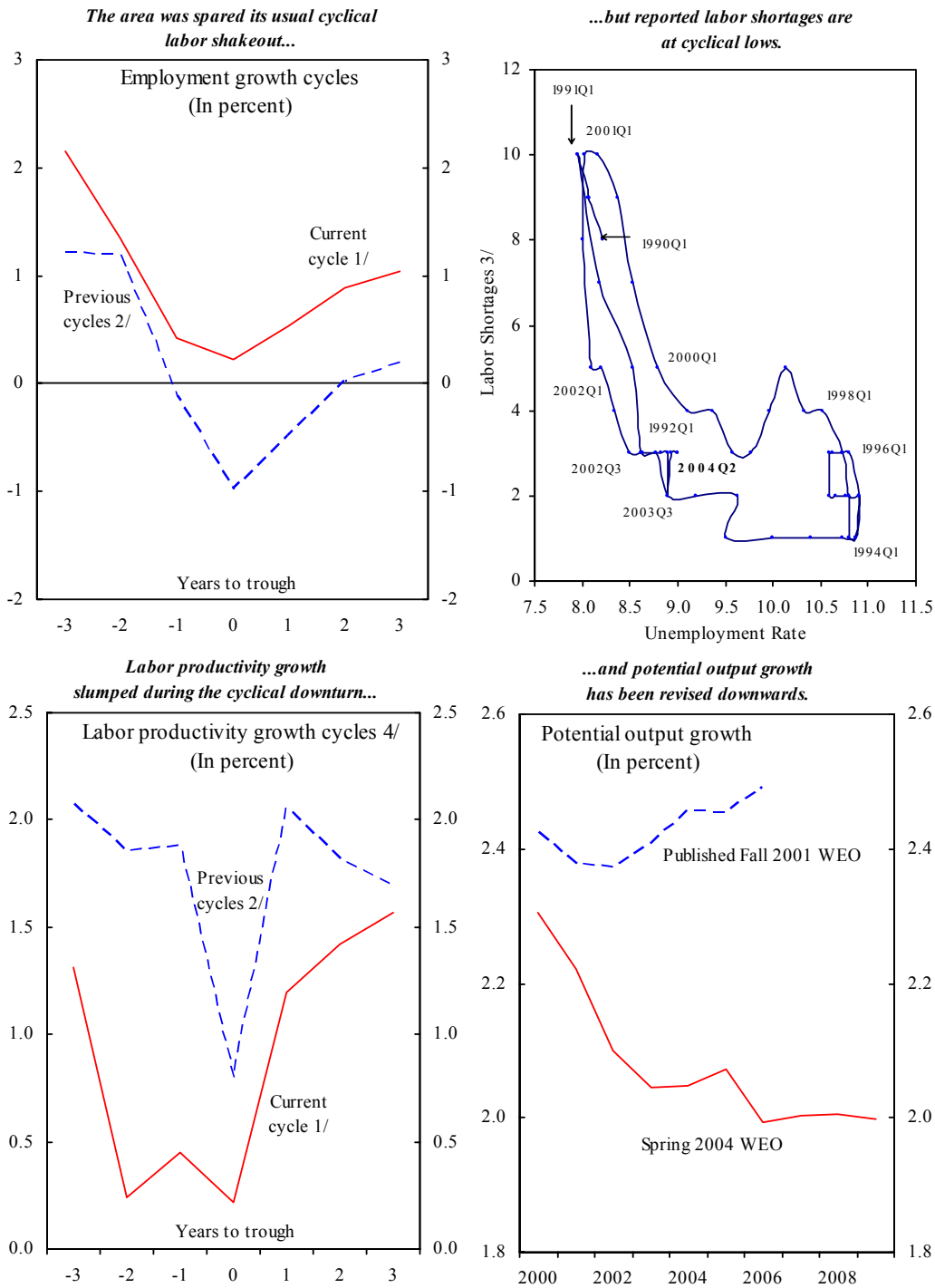


Sources: ECB; Federal Reserve; and staff estimates and forecasts.

1/ Spending on capital and financial assets not covered by internal funds.

2/ Defined as the ratio of corporate debt to internal funds.

Figure 4. Euro Area: Employment, Productivity, and Potential Growth 1/



Sources: European Commission; WEO, IMF.

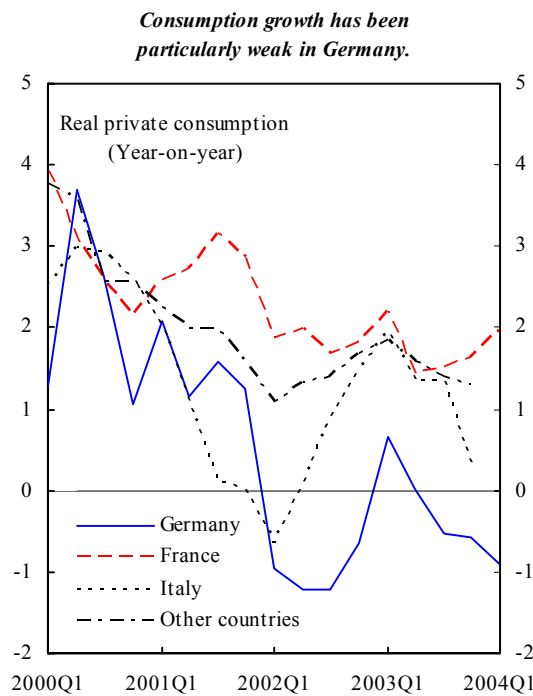
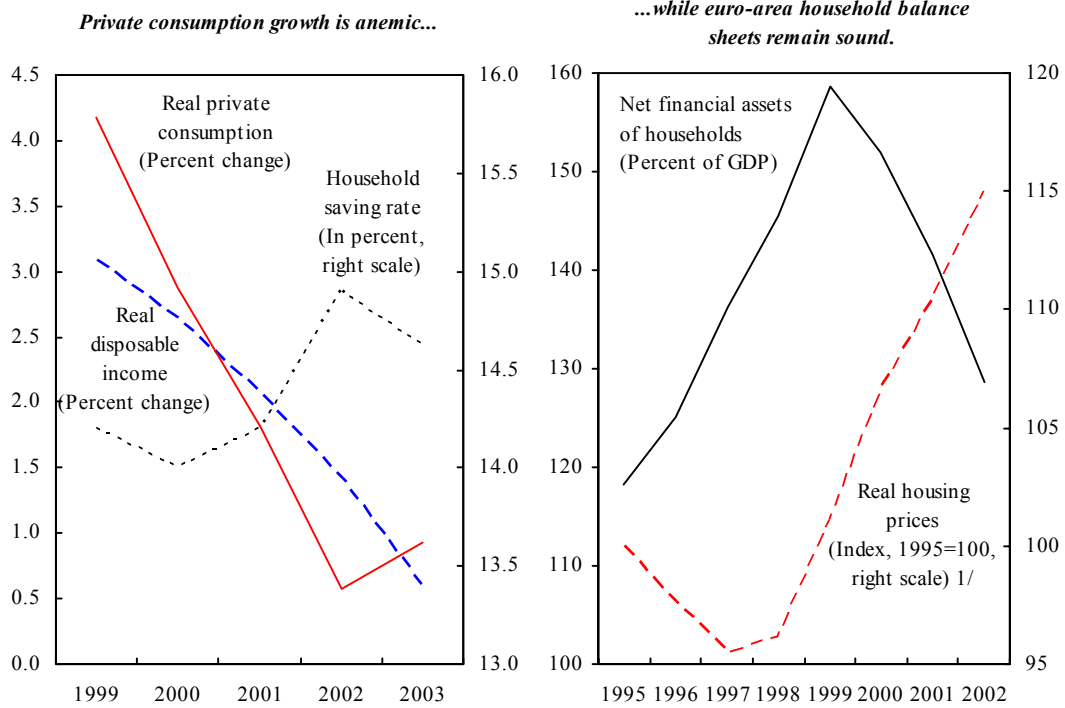
1/ Assumes a cyclical trough in 2003; recovery phase data from 2004 onward are WEO forecasts.

2/ Average of cycles in the early-1980s (trough in 1981) and early-1990s (trough in 1993).

3/ Percent of manufacturing firms reporting labor shortages to be a constraint on production.

4/ Real GDP per employee.

Figure 5. Euro Area: Household Consumption and Savings



Declines in potential growth can have large negative effects on permanent income.

Potential Output Growth and Discounted Values of Future Incomes

Potential growth	Discounted value of future incomes 1/
2.5	67
2.0	50
1.5	40

1/ As a multiple of current income; discount rate of 4 percent.

Sources: ECB; European Commission; BIS; WEO, IMF.

1/ Weighted average of housing prices in Belgium, Finland, France, Germany, Italy, Netherlands, and Spain (BIS data).

international investment positions and saving-investment balances brings the lopsided pattern of external imbalances into even sharper relief (Figure 6).

9. **Contrasting with the stability of the external position, the euro's value has seen large swings, both against the U.S. dollar and other currencies.** Following a persistent slide in its effective rate during the second half of the 1990s, the euro's fortunes reversed over two years of multilateral appreciation that crested in February 2004 (Figure 7). In real effective terms, the euro is roughly back in line with historical averages. Against the U.S. dollar, the euro peaked in the first quarter of 2004 close to \$1.30, before retreating to about \$1.20, prompted by widening long-term interest rate differentials in favor of the United States and waning net inflows of portfolio and foreign direct investment.

10. **The value of the euro is roughly in line with medium-term fundamentals.** Based on the macroeconomic balance approach,² staff assesses the present level of the real effective exchange rate to be broadly in line with economic fundamentals. This particular assessment, which is conditional on current WEO projections, also suggests that correcting global current account imbalances would require significant further dollar depreciation against the euro, offset by equally sizeable euro depreciation against other currencies.

C. Long-Term Growth and Labor Utilization

11. **For the past thirty years, Europe's per capita GDP growth has been fuelled by rapid labor productivity growth but sapped by a decline in labor utilization.** By the early-1970s, rapid postwar catchup growth had catapulted the area's per capita GDP to about 70 percent of the U.S. level. But during the next thirty years, the area's relative per capita income stagnated as the convergence of productivity to U.S. levels was fully offset by a secular decline in labor utilization, measured as relative annual hours worked per capita. The relative decline in labor utilization in turn reflected, in about equal measure, sharp declines in both the employment rate and the annual hours worked per employee. While the link between the area's rigid labor market institutions and poor employment outcomes has long been recognized, some analysts have attributed the large downward trend in annual hours worked per employee to European social preferences for leisure.

Euro-Area Labor Productivity and Labor Utilization
(As a percent of U.S. levels)

	1970	2000
GDP per capita	70.1	68.5
Labor productivity ¹	71.3	101.0
Labor utilization ²	98.3	67.8
Annual hours worked ³	101.2	85.3
Employment rate ⁴	95.2	78.2
Working-age population ⁵	102.0	101.7

Source: AMECO, OECD, and staff calculations.

¹ GDP per hour (PPP values). Employment from the national accounts.

² Total hours worked per capita.

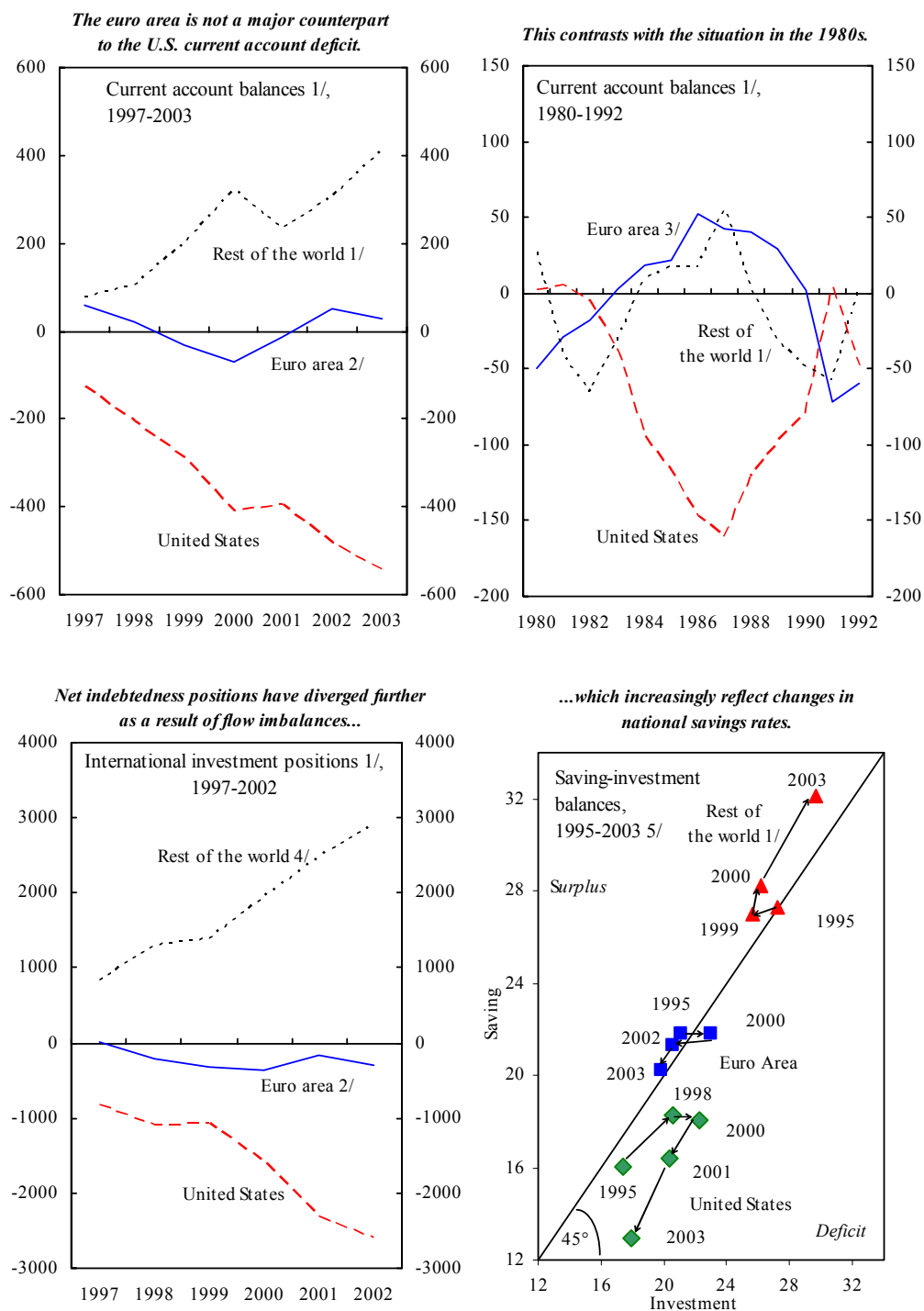
³ Per employee (OECD data).

⁴ Employment as a percent of working-age population.

⁵ Working-age population as a percent of total population.

² Based on the approach developed by the *Coordinating Group on Exchange Rate Issues* (CGER).

Figure 6. Euro Area: External Current Account Developments
(In billions of U.S. dollars; unless otherwise specified)



Sources: ECB; WEO, IMF; and staff calculations.

1/ Calculated as residual (excludes global discrepancy).

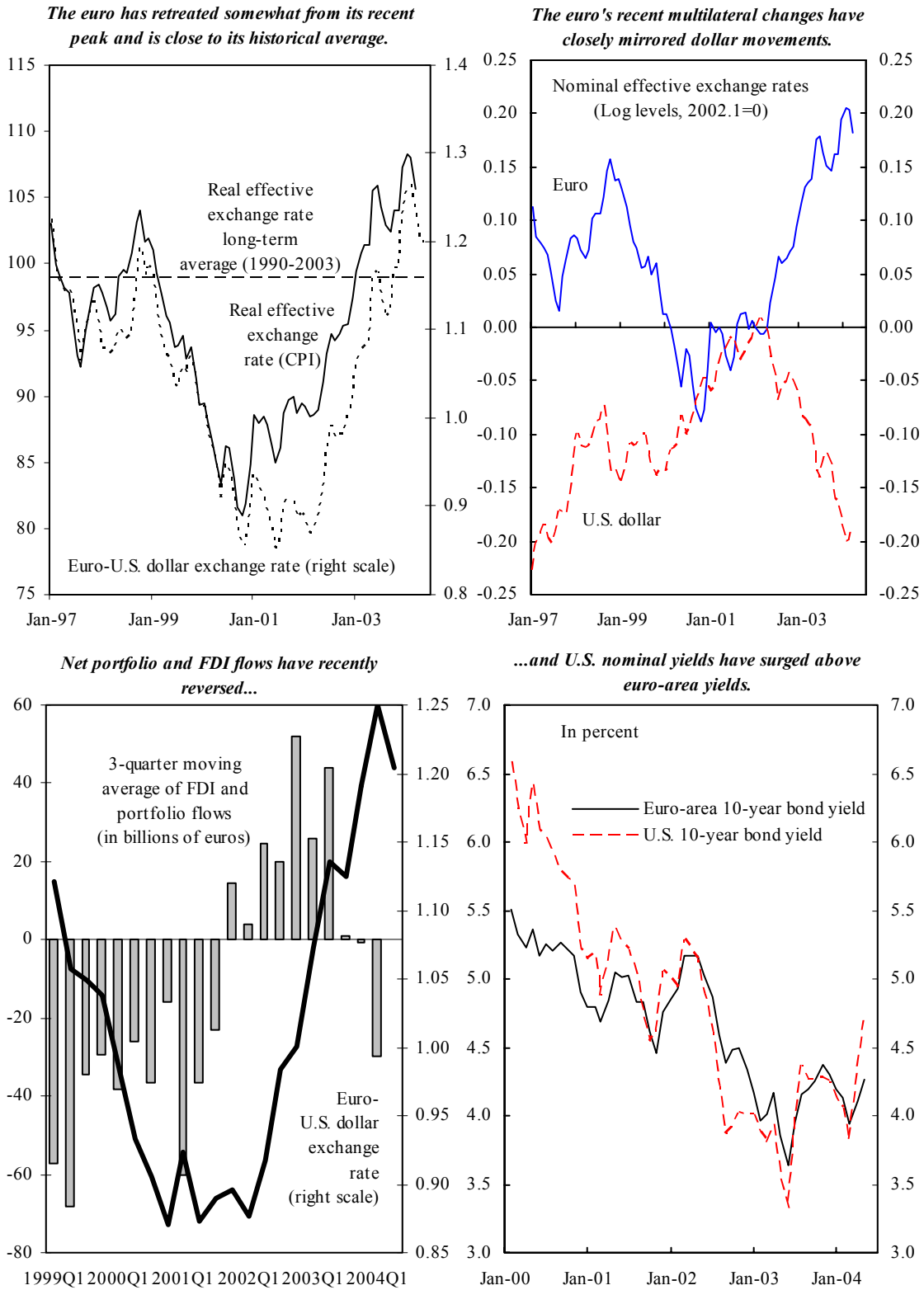
2/ Excludes intra-area trade (ECB data).

3/ Sum of individual country data.

4/ Calculated as residual (includes global discrepancy).

5/ In percent of GDP. Saving-investment balances made consistent with current account balances.

Figure 7. Euro Area: Exchange Rate Developments



Sources: ECB; Datastream; IMF.

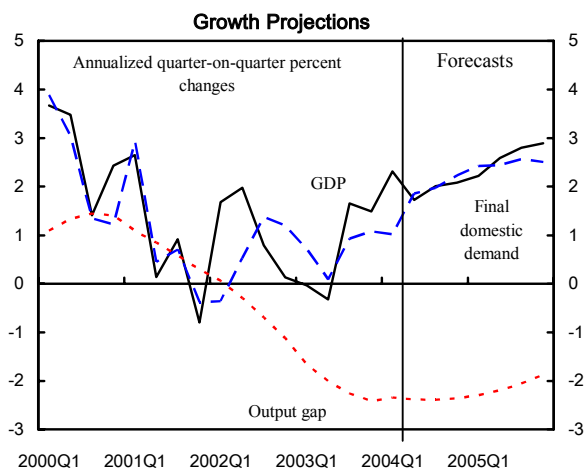
This is to ignore, however, the disincentives to work that have accumulated over this period. Moreover, the decline in annual hours worked per employee seems most pronounced in area countries with highly regulated labor markets, France and Germany in particular. The decline in labor utilization also seems to have gone hand-in-hand with the rise of bustling underground economies (Figure 8).

12. **Policies that boost labor utilization may well temporarily depress labor productivity growth.** During the 1990s, the area's labor productivity growth rate fell below U.S. levels for the first time in the postwar period. In fact, a break in relative labor productivity trends may have occurred around the mid-1990s (Figure 8). Staff analysis suggests that slowing labor productivity growth reflected in large part wage moderation and structural reforms that led to more labor-intensive growth and a re-balancing of the labor-capital mix; productivity growth should firm again once these adjustments are completed.³ But in contrast with the United States, the area did not benefit from an acceleration of productivity growth in IT-using services sectors including trade and financial services.

III. REPORT ON THE DISCUSSIONS

A. Cyclical Growth Outlook and Risks

13. **The shared central view is that the export-led recovery will increasingly be sustained by domestic demand growth.** Survey indicators of business confidence have strengthened further, consistent with above-potential GDP growth. The staff and the authorities' projections assume that, while exports should continue to support activity, final domestic demand will take over from external demand as the linchpin of GDP growth in the quarters ahead (text chart). This view rests on the presumption that strong external demand and relaxed financial conditions will spur corporations to step up capital spending and hiring, while private households will increase consumption in line with faster disposable income growth. Nevertheless, quarterly GDP growth is projected to exceed staff's estimate of potential growth by moderate margins, reflected in the slow narrowing of the output gap.

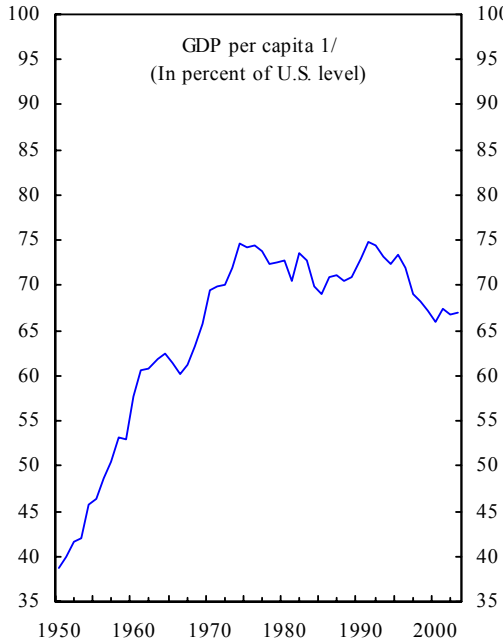


14. **Views on the balance of risks to growth were more nuanced, with staff taking a more cautious position on the robustness of domestic demand going forward.** The ECB

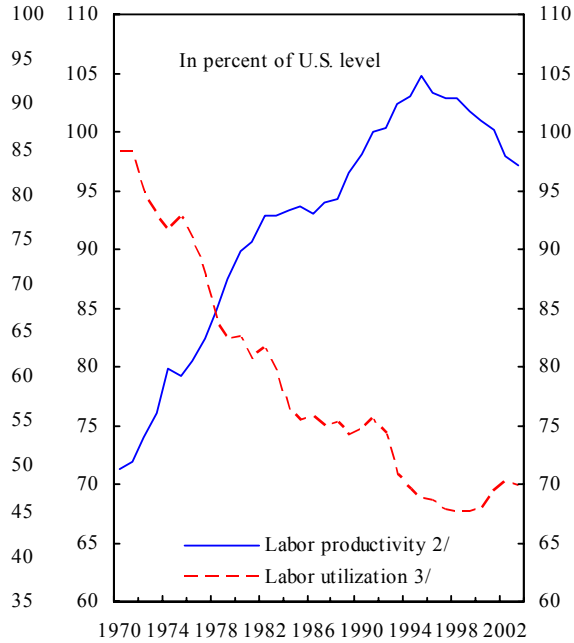
³ See *Selected Issues* paper "Why is Productivity Growth in the Euro Area so Sluggish?"

Figure 8. Euro Area: Long-Term Growth Trends

The area's per capita GDP has hovered around 70 percent of the U.S. level since 1970...



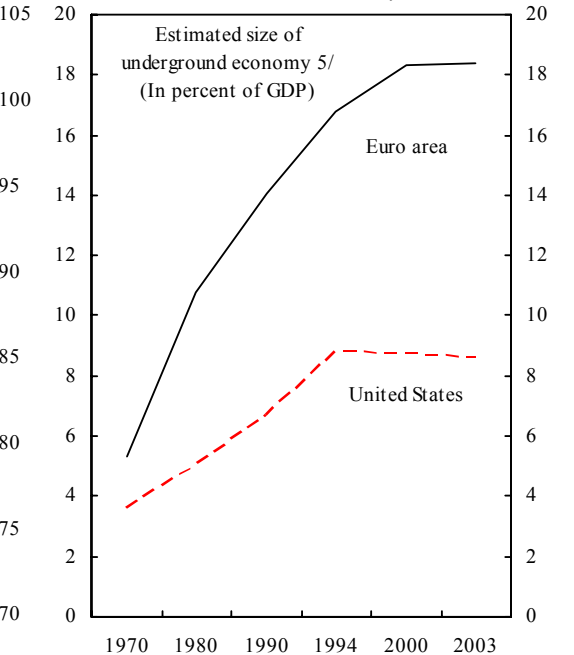
...which is the net result of a surge in relative productivity levels and a secular decline in labor utilization.



Both relative employment rates and annual hours worked per employee have declined...



...while the area's underground economy seems to have mushroomed since the early 1970s.



Sources: European Commission; OECD; staff calculations; and Schneider and Enste (2000) and Schneider and Klinglmaier (2004).

1/ Nominal PPP GDP per capita.

2/ Nominal PPP GDP per hour.

3/ Total hours worked per capita.

4/ Employment as a percent of working-age population.

5/ Estimates by Schneider and Enste (2000) and by Schneider and Klinglmaier (2004).

and the Commission saw risks to the growth outlook both on the upside and on the downside. In particular, the faster-than-projected growth at the beginning of 2004 could imply upside risks to present forecasts in the short term. Staff, while acknowledging that recent data releases paint a more reassuring picture, noted that there is still not much hard evidence of sustained domestic demand growth and argued that the balance of risks to growth should still be viewed as being tilted to the downside, owing mainly to factors rooted in the area's slow and incomplete adjustment to past shocks.

15. **Since the discussions, unexpectedly buoyant global growth and higher oil prices have complicated but on balance probably strengthened the short-term outlook.** The global economy seems to be growing faster than previously projected. Clearly, the stronger and the more sustained this external impulse, the more likely that it will kick-start internal demand in the euro area. This represents an upside risk to growth, particularly in the near term. At the same time, related to the booming global economy, oil prices have risen significantly. While both the Commission and the staff believe that the dampening effects of higher oil prices on this year's growth rate should be in the order of not more than $\frac{1}{4}$ percentage point, there is more uncertainty beyond the next few quarters. In the present WEO baseline, which is closely in line with the latest ECB projections on a comparable basis,⁴ area-wide GDP growth is projected to pick up from last year's $\frac{1}{2}$ percent pace to about 2 percent in 2004, rising further to $2\frac{1}{4}$ percent in 2005 (Table 1).

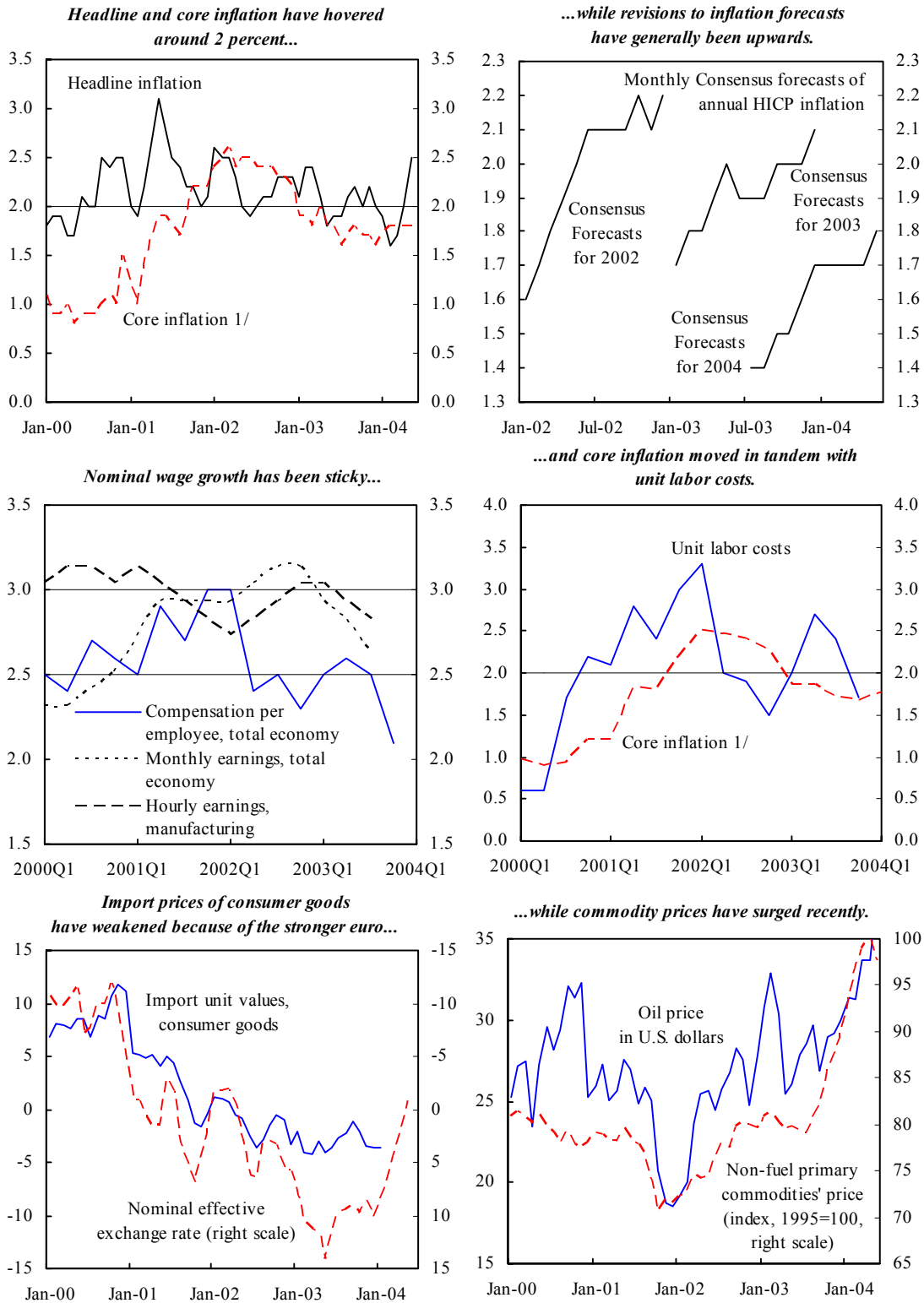
B. Inflation and Monetary Policy

16. **Headline inflation outcomes continue to surprise on the upside, but core inflation remains contained.** In 2003, inflation for the area again exceeded expectations, notwithstanding a widening output gap and an appreciating exchange rate (Figure 9). At the beginning of 2004, headline inflation briefly dipped below 2 percent, but higher oil prices pushed it back, while core inflation (headline excluding energy, food, alcohol, and tobacco) remained stable at $1\frac{3}{4}$ percent. Four main factors account for the past stickiness of inflation: (i) sagging productivity growth combined with low but sticky nominal wage increases boosted unit labor cost growth; (ii) the pass-through effects from the appreciated euro were small and operated with significant lags; (iii) energy and unprocessed food prices were generally higher than expected; and (iv) hikes in tobacco taxes and administered prices, mostly related to health care reforms accounted for $\frac{1}{2}$ percentage point of headline inflation in 2003 and 2004.

17. **Looking backward, there was agreement that the ECB's stance had been in tune with area-wide trends in inflation and growth.** Since June 2003, the main refinancing rate has been kept at 2 percent, a level the ECB considers as accommodative and no hindrance to growth, a view backed up by standard Taylor rule calculations and monetary conditions

⁴ Adjusting for about three more-than-usual working days in 2004 would reduce the staff's annual GDP growth forecast by $\frac{1}{4}$ percentage point.

Figure 9. Euro Area: Inflation Developments
(Year-on-year percent changes, unless otherwise specified)



Sources: European Commission; ECB; Eurostat; Datastream; Consensus Forecasts; IMF.

1/ Headline inflation excluding energy, food, alcohol, and tobacco.

indices (Figure 10). While many observers have considered the ECB to be overly concerned with meeting its price stability target at the cost of promoting growth, others have argued that it should have given more priority to controlling inflation.⁵ Noting these divergent strands of criticism, the ECB saw itself as taking a balanced approach, consistent with its mandate to deliver medium-term price stability and matching the nature of shocks and the structure of the euro-area economy. Staff broadly concurred with this assessment, noting that calls for the ECB to embrace the U.S. Federal Reserve's more activist behavior fail to take account of the substantial differences in past inflation and economic slack faced by the two central banks (Figure 10).

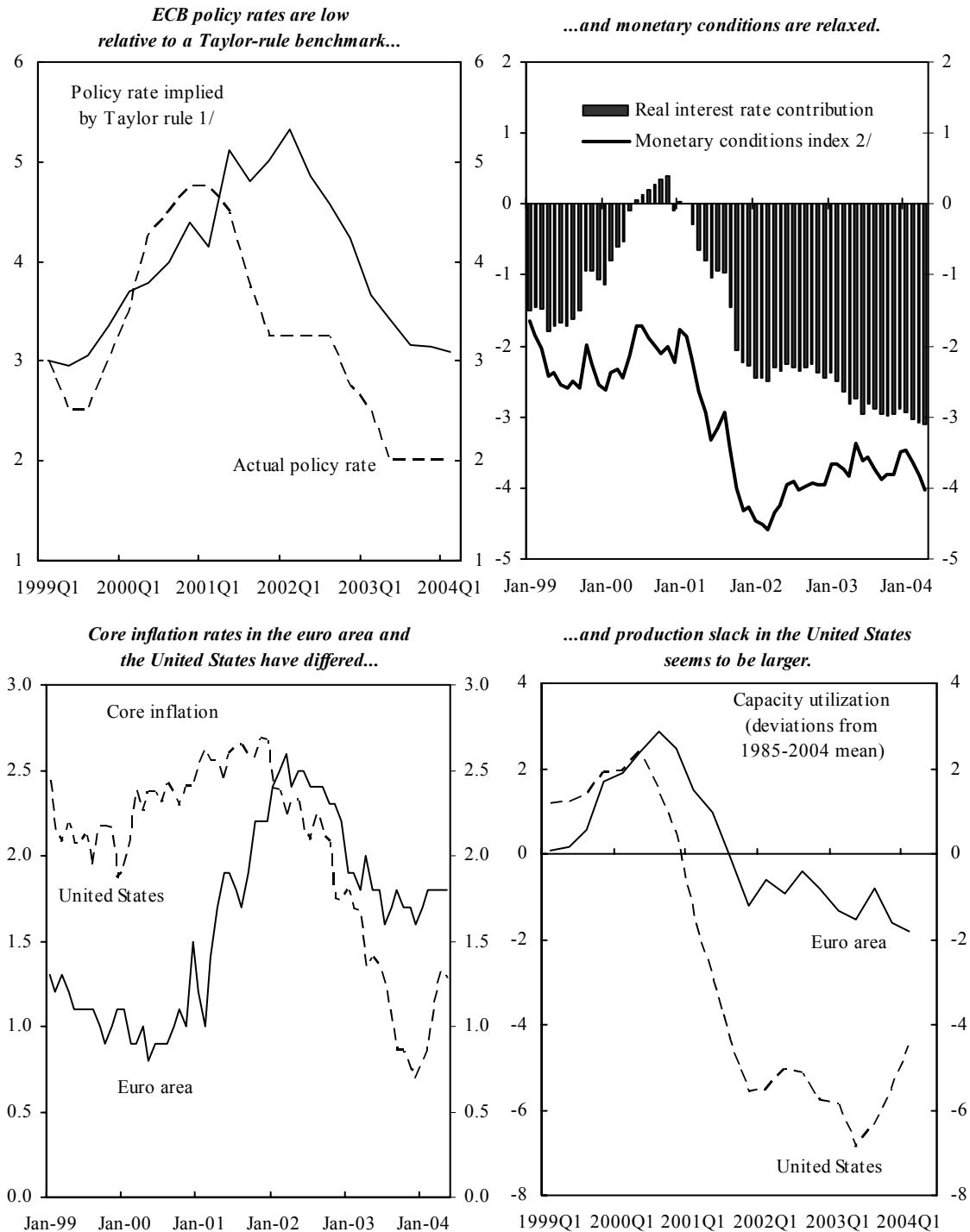
18. **Notwithstanding the recent surge in oil prices, headline inflation is expected to ease back below 2 percent in the medium term.** There was agreement that unit labor costs will decelerate significantly, reflecting continued moderate nominal wage settlements and a marked pick-up in labor productivity. Continued slack in labor and goods markets and delayed exchange rate pass-through will add to downward pressures on inflation. While significant increases in oil prices have added temporary upward pressure to headline inflation, these are expected to gradually fade away as oil prices are assumed to decline in line with their future prices. The ECB's and staff's projections see headline inflation staying close to 2 percent in 2004 and receding to about 1¾ percent in 2005-06, in line with the ECB's price stability objective.

19. **The ECB noted that its stance is firmly on hold—all options are open.** The ECB pointed to a favorable outlook for medium-term price stability—as reflected in its inflation projections—and remained cautious about the growth outlook, albeit noting that risks and uncertainties are balanced in both directions. On the inflation side, three risks were highlighted. First, oil prices could remain persistently high. Second, additional rounds of hikes in administered prices and indirect taxes could take place. Third, the ECB noted that liquidity in the euro area remained high and this could lead to inflationary pressures over the medium term (Figure 11). In this setting, the potential risk of second-round effects on inflation through wage settlements should be monitored closely. Measures of long-term inflation expectations were viewed as particularly informative, shedding light on the credibility of policy. But the ECB stressed that the recent increase in ten-year break-even inflation rates above 2 percent needed to be interpreted with caution, and inflation expectations based on surveys continue to have medium-term inflation anchored below 2 percent. Nevertheless, heightened vigilance was needed, also in view of the risks of a further steepening of the yield curve (Figure 11).

20. **The staff emphasized the need to maintain an accommodative course until the projected recovery in domestic demand is assured, assuming the medium-term outlook for price stability remains benign.** While acknowledging the upside headline inflation risks underlined by the ECB, staff saw the balance of risks to sustained growth as tilted to the

⁵ For the latter view, see the 2004 CEPR report on *Monitoring the ECB*.

Figure 10. Euro Area: Monetary Policy Stance
(Data in percent, unless otherwise specified)



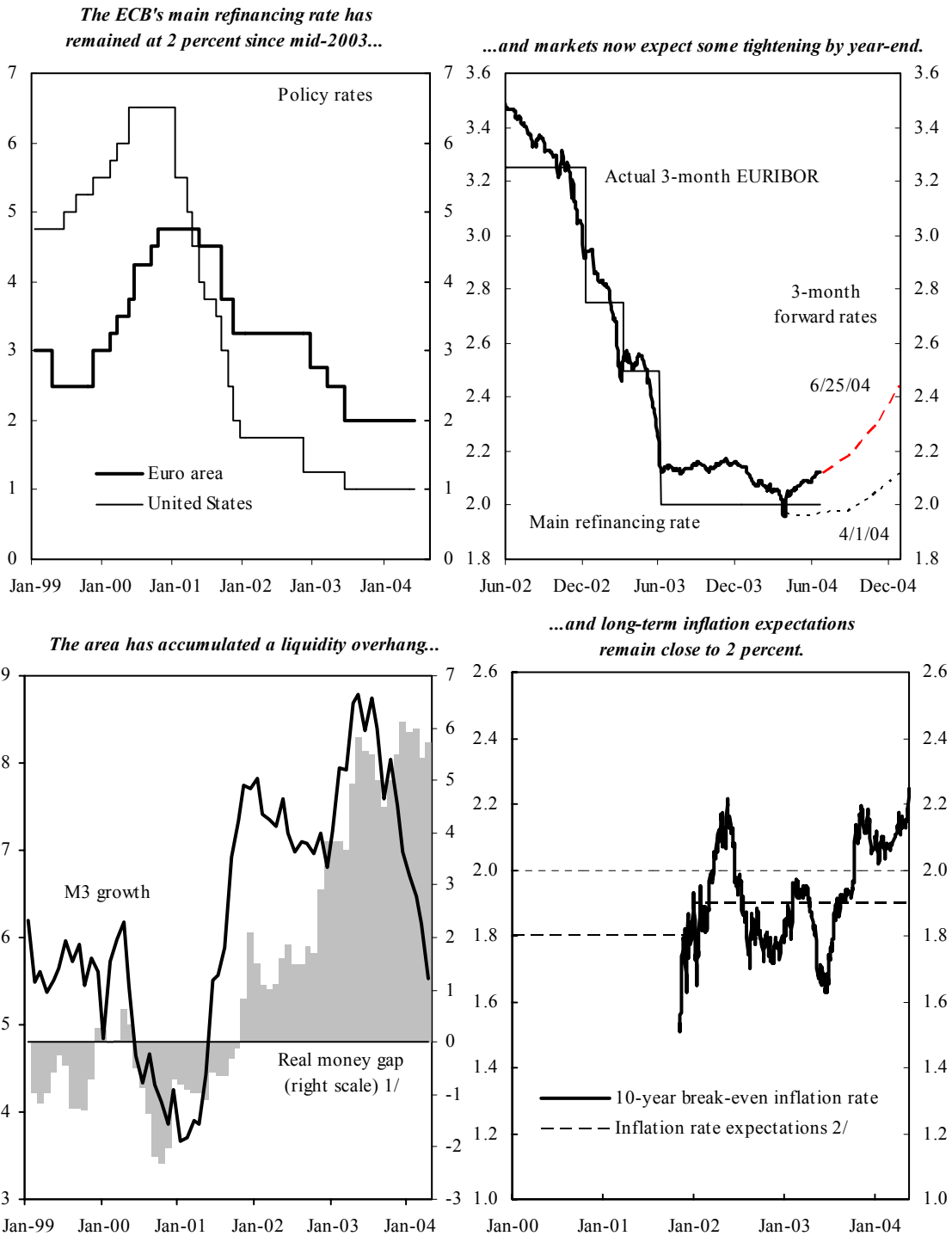
Sources: ECB; Eurostat; European Commission; Datastream; IMF; and staff calculations.

1/ Calculated using standard coefficients, core inflation, a neutral real interest rate of 2.25 percent, and an inflation objective of 1.75 percent.

2/ Deviations from 1990-2004 mean.

Figure 11. Euro Area: Monetary Policy Indicators

(Data 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.

2/ Survey of Professional Forecasters.

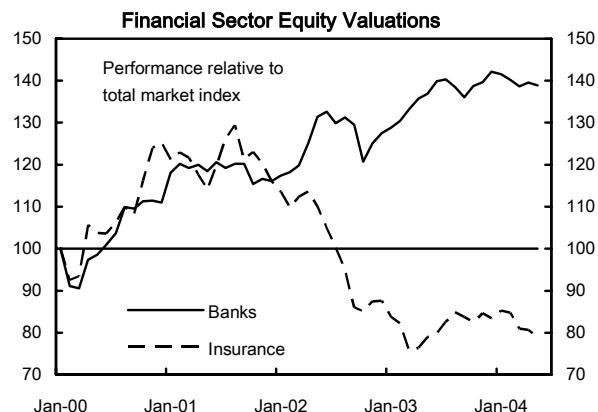
downside. In particular, staff noted that economies recovering from boom-bust cycles in asset prices in low-inflation environments can be vulnerable to relapses in domestic demand, particularly when new adverse shocks revive concerns about still unsettled balance sheet positions. While this line of reasoning is compatible with an “all options are open” position, it puts more weight on the need to signal patience in maintaining an accommodative stance until the projected sustained domestic demand recovery is in place, particularly if long-term interest rates were to rise in concert with global developments. Staff agreed that it will be important to monitor indications of possible second-round effects from higher headline inflation. However, it saw no indications that the pricing power of companies or workers currently gives rise to concerns. Moreover, the very moderate responses of wages to other recent oil price increases augur well for the assumption that second-round effects will be limited.

21. **Although the immediate threat of a sharp euro appreciation seems to have receded, staff noted that some global current account rebalancing scenarios point to serious adverse effects for the euro-area economy.**⁶ Depending on the nature of the global adjustment process, the implications for the area’s domestic and external variables range from mild to disruptive. Fundamental changes in the global pattern of relative domestic demand and potential output growth, facilitated by a strengthening of the euro area’s performance and multilateral dollar depreciation, provide the best chance for an orderly resolution of external imbalances. Adjustment more narrow in scope—such as one that relied excessively on exchange rates and changing market sentiment—could lead to more adverse scenarios for the area, particularly if the euro were to bear the brunt of weakening dollar sentiment.

22. **While the authorities viewed global imbalances as a risk to growth and price stability, they thought it was difficult to discuss policy responses absent a specific context.** The authorities agreed that a disorderly adjustment scenario could exert significant untoward effects on the euro area. In light of the euro’s recent pullback and the broadening global recovery, however, the ECB expressed some confidence that a soft-landing scenario seemed more likely to be achieved, particularly if the United States used the available window of opportunity to address its fiscal imbalances. As regards the possibility of abrupt exchange rate swings or overshooting, the ECB was hesitant to discuss specific policy measures given that such a situation would likely involve multiple actions by many players. It was noted, however, that recent verbal interventions seemed to have had the intended effect of pre-empting “brutal movements” in the exchange rate.

⁶ See *Selected Issues* paper “Global Rebalancing of Current Accounts: A Euro-Area Perspective.”

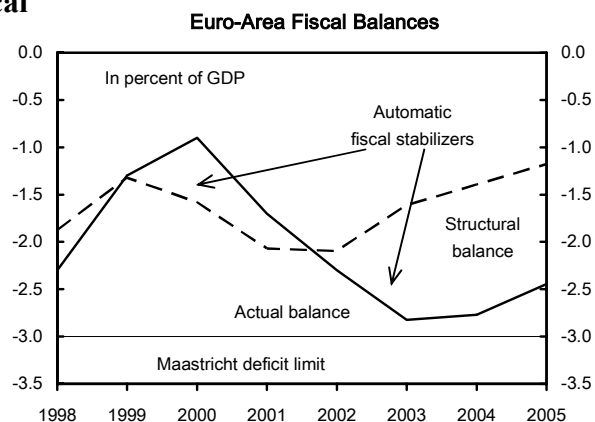
23. **Earlier concerns about financial stability have largely subsided.** The authorities noted that the mutually reinforcing effects of bullish financial markets and a gradual recovery have further improved the outlook for financial stability. In particular, bank profitability has picked up—most clearly outside Germany—owing mainly to lower costs and higher volumes, a trend reflected in market-based indicators including banks’ equity prices (text chart). At the same time, tough competition on some loans had led to declining interest margins, but risk management of real estate loans in particular was seen as being in good shape. The insurance sector—a significant concern during the past three years—showed less visible signs of improvement in profitability, but solvency concerns have receded. There were no indications of a major fallout from the Parmalat corporate scandal, although it has helped accelerate corporate governance reforms. The lessons from crisis management exercises conducted under the auspices of the Banking Supervision Committee pointed to the need for more communication among supervisors, for limiting conflicts of interest, and for facilitating more coordination among the main players including ministries of finance. Finally, on the Basel II accord, the authorities noted that the EU’s transposition of the accord will extend the coverage not only to all banks but also to investment firms to encourage across-the-board improvements in risk management practices.



24. **Some of the new member states have started the euro adoption process.** The new EU member countries participate in EMU with a derogation: they are committed to joining the area at a later stage upon fulfillment of the Treaty’s convergence criteria. Box 2 takes stock of some of the issues related to the new member countries.

C. Fiscal Policies

25. **Overall, fiscal policy during the cyclical downturn was in line with standard cyclical policy tenets.** Countries generally allowed their automatic fiscal stabilizers to operate in the face of serial, unexpected growth shortfalls (text chart), including in 2003 (Table 2). This contrasts with fiscal policy behavior during the pre-euro era, when most countries tended to conduct procyclical policies. Moreover, the area avoided the weakening of fiscal positions observed in other major currency areas, which could prove



Box 2. Historic Enlargement of the EU Comes to Pass

On May 1, 2004, the EU undertook the biggest enlargement in its history, adding ten new countries—Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia—to its membership. The enlarged and more diverse EU faces numerous challenges and opportunities as new members are increasingly integrated. Several post-accession developments are noteworthy:

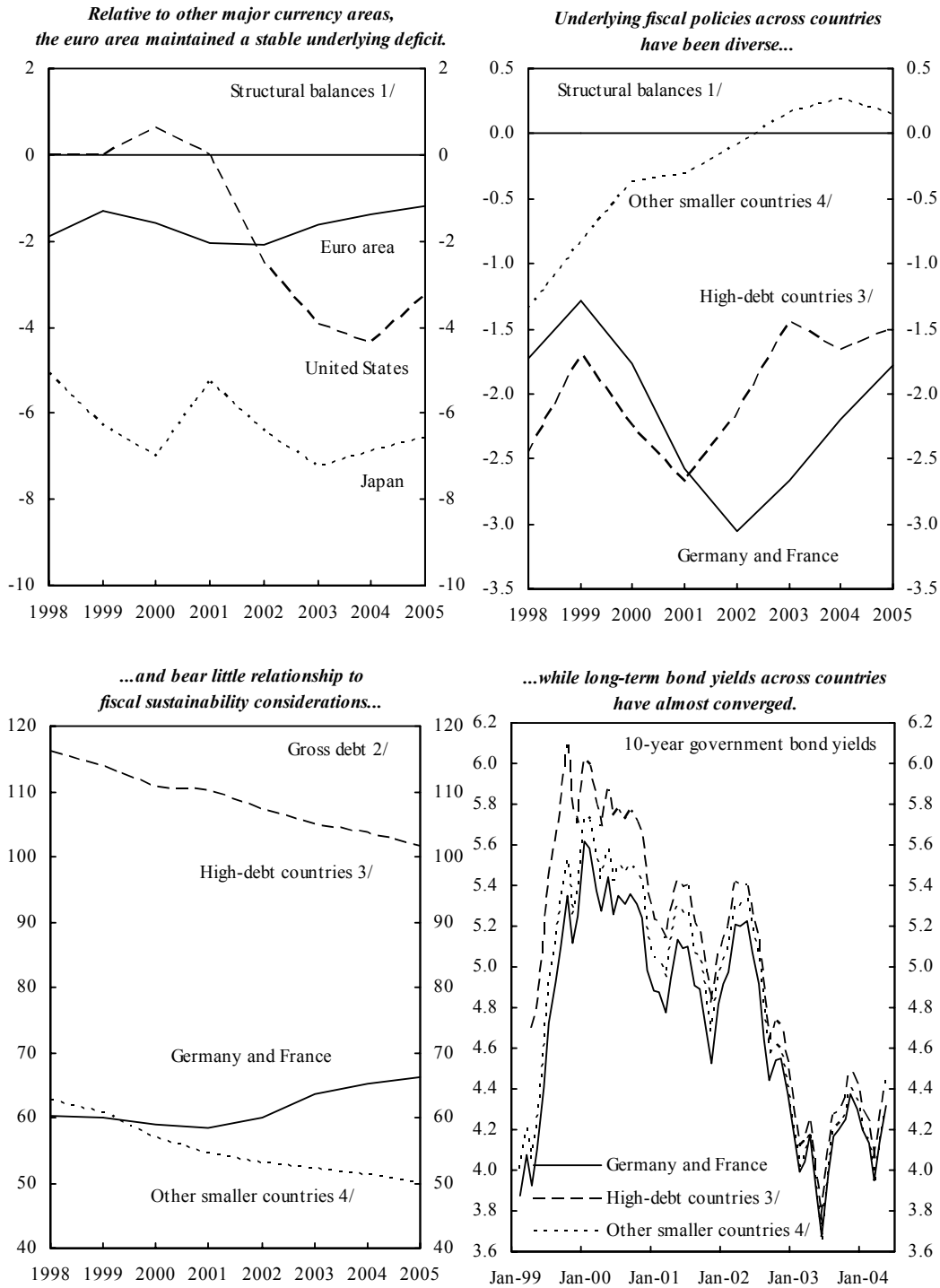
- **Moving toward euro adoption:** Estonia, Lithuania, and Slovenia joined the Exchange Rate Mechanism (ERM2) on June 28, 2004—a step required as a precursor to joining the euro area.¹
- **Status under the SGP:** Six countries—the Czech Republic, Cyprus, Hungary, Malta, Poland, and Slovakia—were deemed to have excessive deficits. Being outside the euro area, however, these countries are not subject to enhanced fiscal surveillance or sanctions.
- **Tax competition issues:** Reductions in statutory corporate tax rates are being considered in many new member states, where the average rate (20½ percent) is already well below the EU average. Concerns, particularly in Germany, over the effects on firm location will keep this a closely-watched issue.
- **Free movement of workers:** Transitional restrictions—up to seven years—can be placed on the free movement of workers from new to old member states. Only Ireland and Sweden will initially grant unfettered access to their labor markets. Several new member states, including Hungary and Poland, will impose restrictions on a reciprocal basis.

¹Schadler, Susan, and others (2004) *Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration*, Occasional Paper (Washington: International Monetary Fund, forthcoming) provide a comprehensive overview on issues related to euro adoption.

difficult to reverse and put pressure on global real interest rates, particularly if corporations seek to step up capital spending (Figure 12).

26. **Fiscal policy behavior before the downturn was less apt, however, and failed to take account of different sustainability requirements across countries.** EMU got off to an inauspicious start: the structural fiscal deficit in 1998 (2 percent of GDP) exceeded what was warranted by fiscal sustainability considerations, including the area's debt level (74 percent of GDP) and high implicit pension debts. Across countries, France and Germany—traditional bastions of fiscal discipline in the euro area—showed little inclination to live up to their

Figure 12. Euro Area: Fiscal Policy Developments



Sources: Datastream; WEO, IMF; and staff calculations.

1/ In percent of potential GDP.

2/ In percent of GDP.

3/ Belgium, Greece, Italy.

4/ Austria, Finland, Ireland, Netherlands, Portugal, Spain.

commitments to achieve underlying balance. Moreover, while the duration and depth of the slowdown surprised virtually everybody, in hindsight, real-time estimates of structural deficits before the cyclical downturn started provided misleading assessments about the soundness of underlying fiscal positions.⁷ At the same time, the area's high-debt countries, while generally managing to stay clear of breaching the 3 percent limit, in part by deploying one-off operations, have, for the most part, made little overall progress in reducing their indebtedness. Finally, most of the area's remaining smaller countries, which have traditionally relied on external commitments to constrain their fiscal deficits, have brought their underlying fiscal positions into rough balance, although their debt positions were significantly more favorable than those of other countries. Notwithstanding the different trends in fiscal policy behavior and positions since 1999, long-term bond yields have almost converged across member countries (Figure 12).

27. The updated Stability Programs (SPs) for 2004-2007 suggest that fiscal policies may again follow past patterns of fading consolidation efforts as the upturn takes hold.

In their SPs, countries with weak underlying budgetary positions, which have up to now consistently overpredicted adjustment, show little inclination to use the cyclical upturn for sustained consolidation efforts, particularly beyond the 2004-05 horizon (Table 3). Moreover, while announced fiscal adjustment efforts for this year and next seem generally consistent with the principle of improving the underlying position by about ½ percent of GDP a year, it remains unclear whether these commitments will be backed up by actual policy changes. Staff repeated its long-standing advice that underlying fiscal adjustment should amount to at least ½ percent of GDP based on high-quality fiscal and structural measures, and consolidation should be pursued more vigorously the stronger the upswing.

28. The SGP is effectively in abeyance. Because their current and prospective deficits remained well above the 3 percent of GDP threshold, the Commission in November 2003 recommended putting France and Germany under enhanced fiscal surveillance, one step short of sanctions. Germany remained on a fast track to sanctions notwithstanding its implementation of a package of fiscal measures equivalent to about 1 percent of GDP in early 2003. But ECOFIN, against the votes of most of the smaller countries, decided to hold the excessive deficit procedures against France and Germany in abeyance, albeit in the context of undertakings by these countries to reduce their deficits below the 3 percent ceiling by 2005. The Commission challenged what it viewed as ECOFIN's sidestepping of the SGP's legal procedures in the European Court of Justice. Since then, the Netherlands and Greece have also breached the 3 percent deficit limit in 2003 and excessive deficit procedures have been launched.

⁷ Staff's own upward revisions of structural deficits illustrate this problem: while the May 2001 WEO estimated the area's structural deficit in 2000 at ½ percent of GDP, the May 2004 WEO estimated the same deficit to have amounted to 1½ percent of GDP.

29. **There was full agreement that fiscal rules under the SGP should be tied closely to fiscal sustainability considerations and be consistent with symmetric policy behavior over the cycle.** More stress on fiscal sustainability would be consistent with the Treaty's emphasis on debt as well as deficit limits. And symmetric policy behavior over the cycle, while apparently difficult to enforce in practice, would seem to be a prerequisite for any rational fiscal policy rule.

30. **But it was also agreed that the crux of the SGP problem was not so much designing "optimal" but rather "enforceable" fiscal rules.** The SGP's basic design as a framework promoting fiscal rules that combines discipline and flexibility in line with the Treaty's provisions on fiscal limits remains appropriate. At the same time, the SGP's procedures and implementation needed some rethinking. While all agreed on these premises, views differed on whether this agreement called for substantive reforms of the SGP, particularly the regulatory details of the excessive deficit procedure.

31. **The SGP's enforcement problems were seen as rooted in several factors:**

- As a stylized fact, the larger countries had clearly proven unwilling to submit to the full discipline of the SGP, particularly the forward-looking requirement to reach sound underlying fiscal positions during good times. By contrast, most of the smaller countries conducted their fiscal policies in line with the SGP's preventive principles.
- In addition, staff noted that the larger countries, which tended to be governed by politically more cohesive parliamentary majorities, tended to rely more on internal devices to enforce fiscal discipline, such as delegating strategic dominance to finance ministers, and, as a consequence, could be less motivated by agreed external rules.⁸ By contrast, the smaller countries traditionally used external commitments to enforce fiscal discipline and were therefore more prone to exhibit time-consistent behavior in line with an agreed fiscal framework. The Commission thought that the fiscal difficulties of large "delegation countries" seemed to reflect weak enforcement of their own fiscal rules, or an incomplete design, rather than an incompatibility of the SGP with the delegation principle.
- The experience of the last few years also suggested that the SGP's excessive deficit procedure does not lend itself to distinguishing sufficiently between the relative roles of policies and economic circumstances, particularly protracted slow growth, in causing breaches of the deficit limit. The example of Germany in 2003 also shows that, under the current rules, countries can find themselves on a fast track toward sanctions even if they took the fiscal adjustment measures required under the procedure.

⁸ See *Selected Issues* paper "Enforcement and the Stability and Growth Pact."

- Finally, staff observed that the SGP's discontinuous use of "soft" and "hard law" was prone to lead to procedural impasses. The SGP relies on "soft law," essentially peer pressure, to goad countries toward respecting the Pact's *preventive* rules. Once the deficit limit is breached, the SGP shifts abruptly to *dissuasive* "hard law" to get countries to correct their fiscal positions. The Commission did not share the view that the mix of soft and hard law was at the origin of the impasse. The ECB noted that while hardening some of the SGP's soft law components was desirable, there was a case for maintaining the hard law elements to preserve the credibility of the pact's dissuasive function.

32. **The ECB saw no compelling reason to change the existing regulations and stressed the risk of a weakened fiscal framework emerging from a reform debate.** First, reform timing was seen as infelicitous, in part because there seemed to be a leadership vacuum on the SGP at the country level. Moreover, the ECB pointed out that ECOFIN already had considerable flexibility in applying the hard law provisions of the Pact, and this flexibility could be exploited without procedural gridlock. Finally, the ECB saw a risk that even well-intentioned reforms could unhinge the SGP's nominal deficit anchor by watering down the excessive deficit procedure.

33. **The Commission's staff sketched a number of tentative ideas aimed at rejuvenating the SGP.** The aim was to initiate a debate, not to make formal proposals for consideration by members. Such legislative proposals would need to be made by the next Commission. Ideas discussed included:

- **Redefining the conditions for establishing and eliminating an excessive deficit.** In particular, the exceptional circumstance clause could make allowance for protracted slowdowns, while the deadlines for correcting excessive deficits could depend on factors such as debt and the cyclical position. Nevertheless, the expectation would remain that countries have to respect the 3 percent limit under most circumstances, consistent with the anchor role of the deficit limit.
- **Beefing up the Commission's role.** The Constitutional Treaty included a number of changes which would strengthen the hand of the Commission in implementing the Pact, including: allowing the Commission to issue "direct warnings" in its own right; and making it harder for ECOFIN to amend certain Commission proposals by requiring unanimity rather than qualified majority.
- **Bolstering economic governance.** The Broad Economic Policy Guidelines (BEPGs) would become more effective by aligning them more closely, in timing and content, with the SPs and the national budget processes. The effectiveness of peer pressure and policy cooperation could be aided by stronger national institutions, including a greater oversight role for independent fiscal councils or national parliaments.

D. Structural Policies

34. **There was full agreement on the need to impart new momentum to growth through structural reforms, in line with the Lisbon agenda.**⁹ The area's pace of longer-term growth was deemed unsatisfactory, and Europe's social and economic model needed to be retooled to take advantage of the opportunities offered by globalization and new technologies and to meet the challenge of population aging. Indeed, a high-level group led by Mr. Kok had been appointed to make specific suggestions on how to revive the Lisbon agenda.

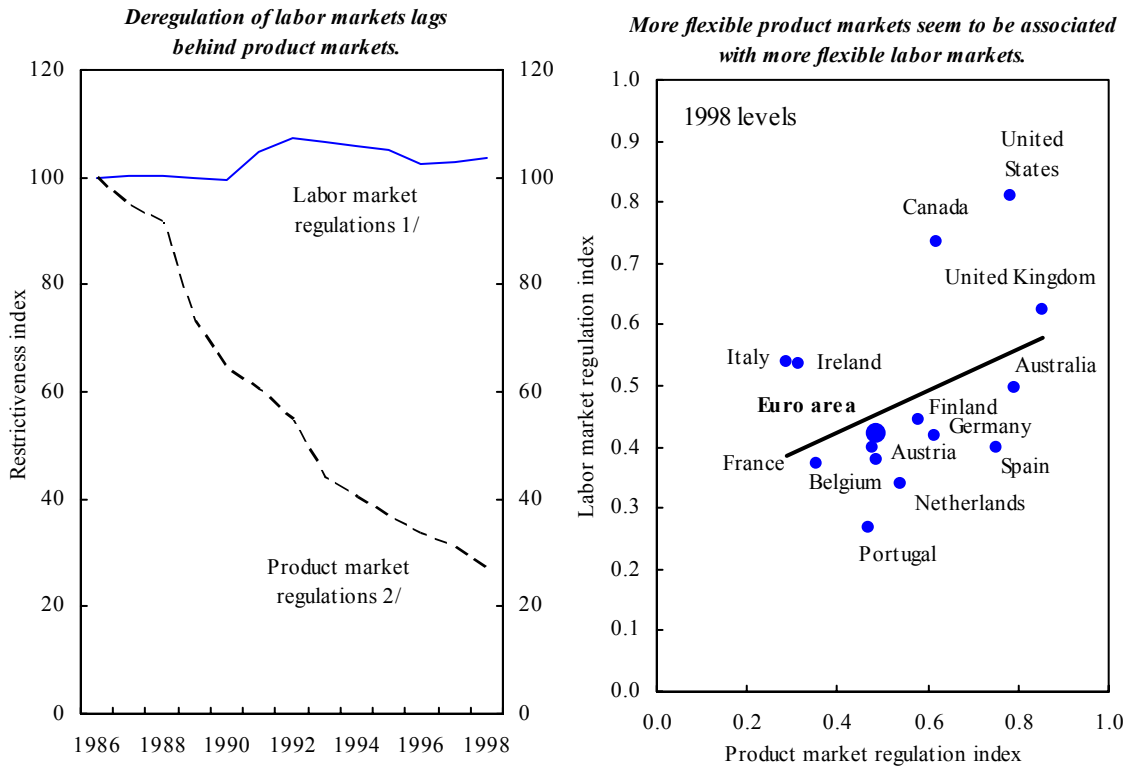
35. **Progress to date on structural reforms was viewed as significant, but facing increasing difficulties:**

- **Deregulation of product markets has been one the most successful reform undertakings, albeit not without its challenges.** Product market integration, originally launched under the Commission's Single Market blueprint of 1986, has led to significant deregulation and strengthening of competition (Figure 13). Recent progress included further market opening in the network industries (energy, transport, telecommunications) and in public procurement. Even here, however, progress was uneven across sectors and particularly countries.¹⁰ For instance, notwithstanding a new competition policy framework that strengthens the Commission's hand in ensuring a level playing field, some of the largest member countries seemed bent on attempting to protect or create "national champions" in so-called strategic sectors. More generally, the Commission cautioned that there were clear signs of reform fatigue, as evidenced by the adoption of a watered-down takeover directive and the stalled community patent.
- **Financial markets provided perhaps the strongest recent example of reform progress.** Most of the framework directives under the Financial Services Action Plan (FSAP) have been adopted, and an innovative process (the Lamfalussy approach) had been put in place to ensure that the framework directives are implemented at the national level (Box 3). Admittedly, the next phase could be arduous, but the authorities thought that the momentum behind these reforms from the center, including ECOFIN, was such that implementation would proceed. The Commission cautioned, however, against thinking that this approach could be generalized to other

⁹ The *Selected Issues* paper "Implementing Lisbon: Incentives and Constraints" provides background and analyzes political economy aspects of structural reforms.

¹⁰ Recent OECD evidence suggests that while product markets of virtually all OECD countries have become more market friendly, the pace of reform has varied significantly across countries, and especially within the EU. See "Regulation, Productivity, and Growth: OECD Evidence" by Nicoletti and Scarpetta, *Economic Policy*, April 2003.

Figure 13. Euro Area: Product and Labor Market Reforms



Sources: Nickell and Nunziata, 2001; OECD; European Commission; WEO, IMF; and staff estimates.

1/ Simple average of employment protection, benefit replacement rates, and benefits durations.

2/ Product market index from OECD: average of all product market sectors.

Box 3. Financial Market Integration: First Principles and National Implementation

The Financial Services Action Plan (FSAP) sets out the framework principles for harmonizing financial regulations across EU countries, with the aim of creating a fully integrated European capital market. Nearly all 42 FSAP directives—on issues ranging from corporate governance to accounting standards—have been adopted on time. Only three proposals in the areas of company law and capital adequacy for banks and investment firms remain outstanding. Although some compromises on quality had to be made to ensure timely completion, the framework principles of Level I of the Lamfalussy Approach to financial market integration are in place (see scheme below).

The next, and more difficult, steps are to consistently implement and enforce the framework principles at the national level—Levels II-IV of the Lamfalussy Approach. The efforts needed to translate EU legislation into consistent national legislation will require the effective functioning of lower level committees, especially at Level III. In the banking area, the ECB has advocated moving toward a single EU rulebook that is uniform across countries, flexible, and easily adaptable to the evolution of financial markets, and less burdensome for banks operating in more than one country.

Lamfalussy Approach to Financial Integration

LEVEL I—EU Framework Principles

Commission makes formal proposal (after consultation)



Council and EU Parliament reach agreement on broad framework principles and define Level II implementing powers (by co-decision).



LEVEL II—Technical Measures

Commission seeks and examines technical advice, drafts proposals, and adopts approved technical measures, subject to parliamentary oversight.

Advisory committees (e.g., European Securities Committee) advise Commission and vote on draft proposals.

National regulators prepare advice on narrow technical measures (after consultation with market agents).



LEVEL III—National Implementation

National regulators work cooperatively on joint interpretation, consistent guidelines, and common standards. They use peer review and compare regulatory practices to ensure uniform national implementation of community legislation.



LEVEL IV—Enforcement

Commission checks member state compliance and may pursue legal action if community law is breached.

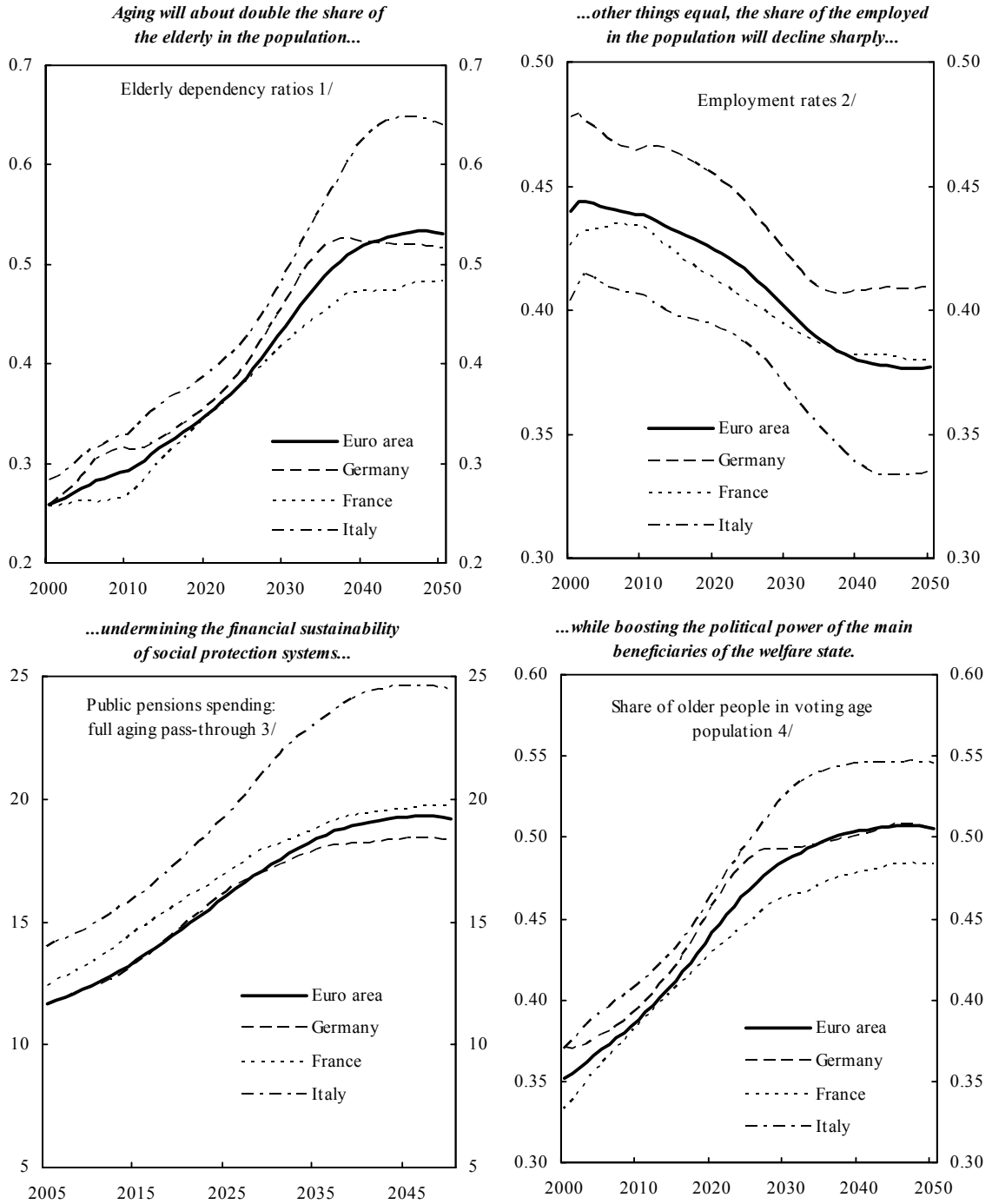
areas, noting in particular that there was broad political consensus on the need to facilitate financial integration following the introduction of the euro.

- **There has been some progress as regards labor markets as well.** Particularly welcome in this regard were the pension reform in France and the adoption of *Agenda 2010* in Germany. However, while indispensable and indeed only downpayments on the reforms needed, these steps had elicited strongly adverse political reactions. This did not bode well for further progress on this front.

36. **While welcoming progress to date, staff expressed concern that labor market reforms were not getting sufficient emphasis even though the payoff seemed greatest in this area.** Staff cited several considerations:

- **The policy leverage over raising labor utilization seemed relatively high.** To judge from past reforms, the causal linkages between policies that improve work incentives and labor utilization were relatively well established. At the same time, policies, other than deregulation, that seek to target economy-wide productivity growth are subject to more uncertainty, particularly if productivity levels are already within striking distance of the frontier.
- **Policies that improve work incentives are also most promising in yielding synergies between structural reforms and fiscal consolidation.**
- **Labor utilization provides the main financial lifeline for the typical European welfare state.** Assuming that the generosity of social benefits (as a percent of wages) is held constant, higher social spending can only be financed by increasing social contributions and budget transfers or by raising labor utilization. By the same token, declining labor utilization puts upward pressures on social spending and contribution rates, both by eating into the base for social contributions and by increasing the number of beneficiaries.
- **The ultimate stress test for the European welfare state, rapid population aging, is only one business cycle away.** After 2010, population aging will accelerate dramatically. The direct effect of aging will be to shrink employable labor resources and boost the number of beneficiaries, as illustrated by counterfactual simulations that assume population aging feeds through fully to pension spending given present benefit levels, i.e. ignoring the effects of past reforms (Figure 14).

Figure 14. Euro Area: Population Aging and Public Finances



Source: EPC (2001); and staff estimates.

1/ Defined as the ratio of population aged 65 and over to population aged 15-64.

2/ Assumes constant labor force participation and unemployment rates; in percent of total population.

3/ Assumes that all pension system parameters except elderly dependency ratio remain constant at current level.

4/ Defined as the ratio of population aged 55 and over to population aged 18 and over.

- **Options apart from raising labor utilization are circumscribed.** Scope for raising social contribution rates (or alternative sources of revenue)—the traditional “solution” for rebalancing social insurance finances—is limited. Paying down debt and using the interest savings to increase budget transfers could help accommodate part of the higher social spending but would not address the labor market disincentives and lower growth. Finally, Europe’s strong revealed preference for social cohesion is likely to constrain far-reaching benefit cuts, and this constraint may become more binding as the balance of political power shifts in favor of elderly voters. Thus, many area governments are likely to be faced with the need to put in place policies that will in time reverse Europe’s low level of labor utilization.

37. **With labor utilization thus key to achieving higher growth and sustaining Europe’s social model, staff saw a need for placing a higher priority on this aspect, including in the Lisbon agenda.** While that agenda was laudable and had served as a rallying point for reform, it was also unexceptional and hence not very helpful in supporting the member states overcome the obvious political opposition to labor market reforms.

38. **While agreeing that raising labor utilization rates was critical, the Commission argued that reform policies needed to pay equal attention to boosting productivity.** In this regard, they noted that even if the area’s long-term productivity performance had been relatively good, this was not true of the period since the mid-1990s, which showed the area to have lagged increasingly behind U.S. productivity growth trends. They were also less sanguine than staff that this reflected transitional effects of past labor market reforms. In any case, the Lisbon agenda was a declaration of political intent. As such it needed to be even-handed and foster the use of existing EU processes, especially the BEPGs. These provided detailed country-by-country recommendations focused on raising labor utilization and productivity (Table 4). The central problem was not the agenda, but the lack of implementation at the national level.

39. **The discussions touched on several ideas on how to help accelerate reforms in areas where national competencies loom large, particularly in labor markets.** The Commission noted that most progress on labor market reforms had occurred where it was relatively easy to implement, such as tax cuts or flexibility-enhancing measures that do not affect labor market insiders. But across-the-board changes in work incentives had proven extremely difficult to enact. Besides prioritization of the Lisbon agenda, staff suggested several other mutually re-inforcing routes to increase incentives at the national level for tackling difficult labor reforms:

- **Impulses from product market reforms.** Empirical evidence suggested that deregulated product markets often lead to more flexible labor markets by crimping product market rents. Pressing ahead with product market reforms could therefore have favorable spillover effects on labor market reforms (see Figure 13). While this indirect approach to reforms was viewed as promising, the Commission also noted that lagging labor market reforms could unduly squeeze profit margins.

- **More effective coordination**, including stronger peer pressure on national governments (“naming and shaming”) by ranking and publicizing relative country performances. The Commission noted that past reports on structural reforms had experimented with this approach and that it had faced resistance from parts of the membership.
- **Stronger leadership by the largest countries.** This would provide additional incentives for other member countries to step up their reform pace owing to competitive pressures.

E. Trade Policy

40. **The Doha Development Agenda remains at the center of the EU’s trade policy strategy.** The EU has offered to eliminate all farm export subsidies and to limit negotiations on the Singapore issues to trade facilitation, steps that should be helpful in moving toward an agreement on a new negotiating framework. The staff cautioned that the proposal to exempt “poor and weak” developing countries from committing to increase market access in the Doha round could leave the impression that trade liberalization represents a cost while in fact it has great potential for stimulating development and growth. The staff also emphasized the desirability of an ambitious offer on market access for farm products.

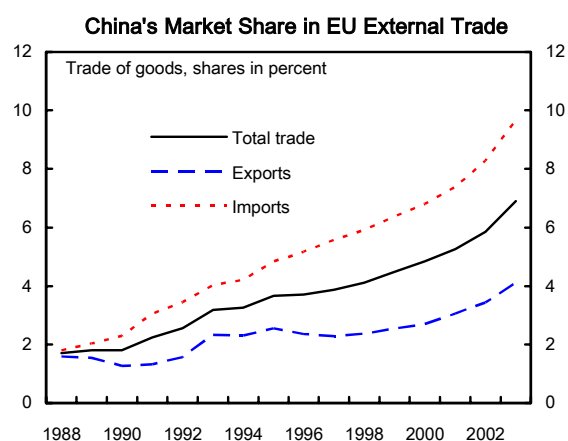
41. **The EU intends to abstain from launching new negotiations on preferential trade agreements until the Doha round is completed, but will continue negotiations that are already underway.** It has advocated a strengthening of the WTO rules governing preferential trade agreements. The Commission also noted that following enlargement the share of its external trade covered by regional agreements had dropped to about 25 percent. Negotiations continued in two main areas:

- The EU intended to conclude an agreement with Mercosur by October, which would liberalize 90 percent of the bilateral trade. Mercosur accounts for 18 percent of the EU’s agricultural imports and is a major producer of goods considered sensitive by the EU.
- Regarding the Economic Partnership Agreements (EPAs), the EU had started, or was about to start, negotiations with six regional groupings that encompass the African, Caribbean, and Pacific Countries group (ACP). EPAs will foster regional integration between the ACP countries. The staff encouraged the Commission to ensure that regional integration was combined with appropriate liberalization on a MFN basis to minimize trade diversion. It also emphasized that the loss of tariff revenue implied by the EPAs needed to be addressed.

42. **The recent agreement to further reform domestic support measures under the Common Agricultural Policy (CAP) is an important development, which will significantly reduce the distortive effects of the CAP.** The EU recently extended the reform agreed in June 2003 to the so-called Mediterranean products (olive oil, cotton,

tobacco, and hops). The decoupling of subsidies from production is an important step in reducing trade distortions and countering incentives for excess production. However, staff noted that trade distortions remain because the decoupling is only partial. The Commission responded that CAP reform is a gradual and balanced process which has been going on for more than ten years. On sugar, the Commission seemed set to propose reforms that would include significant cuts in EU sugar prices and the scrapping of its intervention system. Implementation of these proposals could significantly lower supply pressures on world sugar markets and create export opportunities for competitive suppliers in developing countries.

43. **China has become the EU's second-largest trading partner.** Over the past decade, trade with China increased at more than twice the rate of total EU external trade (text chart). The bilateral trade deficit has been persistently above 40 percent of bilateral trade since 1998, but the Commission stressed that it was not yet a major concern. The healthy increase in bilateral trade led to adjustment pressures in sectors such as textiles and electronics and to trade disputes, which were mostly related to the implementation of China's WTO accession commitments. The EU has refrained from imposing sanctions or safeguards, or from launching WTO dispute procedures, preferring to resolve differences through diplomacy and dialogue.¹¹



F. Statistics

44. **Statistical gaps continue to impede analysis.**¹² Staff noted that, despite improvements over the last few years, comprehensive and up-to-date statistics were lacking on the institutional income accounts, the labor market, extra-area trade, and the flow of funds. The reliability of budgetary statistics also remained a problem, with large data revisions sometimes taking place after new governments take office.

45. **The authorities responded that efforts to address remaining weaknesses in the statistics were underway.** It was noted that improving statistics takes time and had significant resource costs. In particular, the compilation of budgetary statistics consistent with the EU's *Code of Best Practice* was difficult, lengthy, and costly. Nevertheless, specific actions were underway to improve the state of euro-area statistics.

¹¹ See *Selected Issues* paper "Changing Patterns of EU-China Trade."

¹² See appendix on Statistical Issues.

IV. STAFF APPRAISAL

46. **On the heels of three difficult years, the area's economic performance is improving, but deep-seated challenges remain to be tackled.** Despite continuing sluggishness in domestic demand, a buoyant global economy and bullish financial markets are prompting a rebound in real GDP. Headline inflation also seems set to recede. Moreover, the usual area-wide macroeconomic fundamentals—fiscal deficits, private sector balance sheets, the external current account—seem relatively sound. However, potential growth has weakened appreciably; fiscal positions remain on an unsustainable track because of aging; the political resistance to measures to increase the utilization of labor has increased; and the SGP is in procedural limbo and in urgent need of rejuvenation. This is a tall agenda. The recovery will need to be used wisely.

47. **The prospects for a sustained recovery of domestic demand remain uncertain.** While a strong and sustained expansion in external demand could trigger a sustained recovery, the internal demand dynamics of the area remain fragile and heterogeneous. In tandem with the risk of renewed appreciation pressures on the euro owing to global current account imbalances, there is a risk that the recovery of domestic demand will remain halting.

48. **Monetary policy has responded appropriately to changing circumstances.** Inflation has been unexpectedly persistent, with outcomes generally surprising on the upside. Notwithstanding the many critics who view monetary policy as overly concerned with medium-term price stability, the ECB has taken a balanced approach and matched its policy stance to the area's inflation and growth environment.

49. **Looking forward, monetary policy should remain accommodative and supportive of a recovery of domestic demand as long as the outlook for price stability remains benign.** Notwithstanding renewed upward pressures on headline inflation owing to higher oil prices, the outlook for price stability remains favorable. While risks of second-round effects from higher energy prices, as well as from hikes in indirect taxes and administered prices, need to be watched, the slack in labor markets and indications of continued wage moderation are comforting. There thus appears to be scope to maintain an accommodative stance until a self-sustaining upturn in final domestic demand is in place.

50. **Although the controversies surrounding the SGP might suggest otherwise, fiscal policies during the slowdown have been broadly appropriate.** The rise in fiscal deficits in the main reflected the unexpectedly protracted slowdown rather than policy choices. Nonetheless, allowing free play to the automatic stabilizers combined with earlier policy shortsightedness has clearly strained the procedural fabric and credibility of the SGP, which was primarily intended to forestall deviant policies.

51. **The SGP's basic design as a framework that seeks to combine discipline and flexibility remains appropriate, but some facets need to be strengthened.** First, the incentives to adjust in good times need to be systematically strengthened both as regards letting the automatic stabilizers play fully and ensuring that the necessary corrections of

weak underlying fiscal positions are sustained. Second, underlying fiscal balance targets should be tied more explicitly to sustainability considerations to provide the framework with stronger economic underpinnings. Finally, the procedures of the Pact should be tuned to better differentiate between the respective roles of policies and the economic environment and in assessing breaches of the 3 percent of GDP deficit limit.

52. **Most importantly, however, a genuine consensus on upholding a strong and disciplining fiscal framework for the monetary union needs to be rebuilt.** Europe's fiscal policy mis-adventures of the 1970s and 1980s and political economy considerations speak clearly to the need to uphold the SGP's disciplinary force, particularly against the backdrop of today's medium- to long-term fiscal outlook. Failure to build a new consensus on the SGP could have potentially grave consequences for EMU and its member countries, many of which rely on the SGP as an external commitment device to maintain fiscal discipline.

53. **In this vein, countries should demonstrate a continued commitment to medium-term fiscal discipline when planning and implementing their budgetary policies.** In particular, countries with weak budgetary positions should undertake measured but high-quality fiscal consolidation that improves the cyclically-adjusted deficit by at least ½ percent of GDP a year while allowing the automatic stabilizers to operate. Fiscal consolidation efforts should be stepped up if the upswing proves more vigorous than projected.

54. **The area's key challenge, however, is to raise longer-term growth, in the first instance by strengthening the incentives to work.** The area's past growth was rooted largely in sustained productivity growth and constrained by a downward trend in labor utilization linked to the area's long-standing labor market rigidities. While rising productivity in the past may have allowed countries to increase the burden of social contributions and taxes to pay for the welfare state, contribution and tax levels of workers leave little scope for further hikes. With the onset of rapid population aging only a few years away, the preferred option for supporting the welfare state and maintaining fiscal discipline should be to boost utilization of labor by reversing its secular decline over the last thirty years.

55. **There has been measurable progress in, and toward, deregulating and integrating product and financial markets.** While much remains to be done, the basic directions and steps to be taken have been agreed and instigated by area-wide institutions. The issues going forward are in good part concerned with implementation, of making sure that the policies overcome the current segmentation of markets and re-shape incentives at the national level. In this regard, policies to protect or create "national champions" do not seem compatible with the EU's own sound economic principles that include bans on cartels and abuses of monopoly power.

56. **The greatest concern is over reform in areas where national competencies loom large.** While there has been some progress in these areas as well, particularly on labor and pension reforms in some countries, political fatigue set in early, and efforts fell short of the necessary restructuring of work incentives. The problem is not so much deciding what should be done at the country level. This is specified in the Broad Economic Policy Guidelines,

which are widely viewed, including by the Fund and the OECD, as charting the right course. Rather the issue is how to impart momentum at the national level through more decisive leadership at the EU level.

57. **The Lisbon reform agenda should be prioritized and focus on boosting work incentives.** The present agenda seems too diffuse and all-encompassing to provide leadership and generate momentum. Given the need to increase labor utilization, the priority should be strengthening incentives to work. Stepping up deregulation of goods and services markets, in line with the priorities of the Irish and upcoming Presidencies, could provide additional momentum for labor market reforms given evidence suggesting that product market deregulation provides strong incentives for governments and social partners to reform national labor markets. In addition, peer pressure on governments could be strengthened, including by “naming and shaming” cases of lagging structural reforms. Finally, leadership on structural reforms by the largest countries could provide additional incentives through competitive pressures on others.

58. **EU enlargement will have major benefits for both old and new members.** Each step in European integration has historically been a source of rejuvenation and growth throughout the union. There is no reason to expect otherwise on this occasion. In particular, adoption of the euro will benefit the new member states' growth and efficiency, and Estonia, Lithuania, and Slovenia have already taken the first major step, namely membership in ERM2. But the old members should also benefit from an expanded EU that allows the free movement of goods, capital, and labor. In this perspective, it is regrettable that most of the old member states have put transitory restrictions on the free movement of labor.

59. **The EU's new efforts to relaunch the stalled Doha round are welcome.** The EU's recent offer to phase out all farm export subsidies and further limit negotiations on the Singapore issues provide fresh—and much needed—impetus for reaching agreement on a negotiating framework, but it would be desirable to complement it with a more ambitious offer on market access. Moreover, the EU's proposal to exempt low-income WTO member countries from cutting their tariffs during the current Doha round could have unfortunate consequences as trade liberalization by developing countries has great potential for spurring their development and growth. The recent decision to decouple a large part of domestic support for the production of Mediterranean products and the far-reaching proposals to reform the EU's sugar regime are also highly welcome. Finally, in negotiating bilateral and regional trade agreements, including with Mercosur, the EU should aim for comprehensive product coverage.

60. **Area-wide statistics are adequate for surveillance purposes, but significant improvements are desirable.** The available statistics are not commensurate with the area's status as the world's second-largest economy and the role of the euro in global financial markets. At the same time, considerable efforts have already been expended—or are underway—to improve the area's statistics. Additional efforts should focus on providing more comprehensive and up-to-date statistics on the institutional income accounts, flow-of-

funds data, labor market data, and external trade statistics. Moreover, ensuring the integrity of fiscal data in line with the *Code of Best Practice* should be a priority.

61. 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)

	1998	1999	2000	2001	2002	2003	2004 1/	2005 1/
Demand and Supply								
Private consumption	3.0	3.5	2.7	1.8	0.5	1.0	1.6	2.5
Public consumption	1.4	1.8	2.1	2.5	3.0	2.0	1.1	0.9
Gross fixed investment	5.2	6.0	4.9	-0.3	-2.8	-0.8	2.6	3.7
Final domestic demand	3.2	3.7	3.1	1.5	0.3	0.8	1.7	2.4
Stockbuilding 2/	0.4	-0.2	-0.1	-0.5	0.1	0.3	0.0	0.0
Domestic Demand	3.6	3.5	2.9	1.0	0.4	1.2	1.8	2.4
Foreign balance 2/	-0.6	-0.6	0.6	0.7	0.5	-0.7	0.2	-0.1
Exports 3/	7.4	5.3	12.3	3.4	1.5	0.1	4.4	5.1
Imports 3/	10.0	7.6	11.0	1.7	0.3	1.9	4.1	5.7
Real GDP	2.9	2.8	3.5	1.6	0.9	0.5	2.0	2.3
Resource Utilization								
Potential GDP	2.2	2.3	2.3	2.2	2.1	2.0	2.0	2.1
Output gap 4/	-0.4	0.2	1.3	0.7	-0.5	-2.0	-2.1	-1.9
Employment	1.8	1.8	2.2	1.4	0.4	0.2	0.4	0.9
Unemployment rate 5/	10.2	9.5	8.5	8.0	8.4	8.9	9.0	8.8
Prices								
GDP deflator	1.2	1.7	1.4	2.4	2.6	1.7	2.0	1.9
Consumer prices	1.2	1.1	2.0	2.4	2.3	2.1	1.9	1.7
Public Finance 6/								
General government balance 7/	-2.3	-1.3	-0.9	-1.7	-2.3	-2.8	-2.8	-2.5
General government structural balance	-1.9	-1.3	-1.6	-2.1	-2.1	-1.6	-1.4	-1.2
General government gross debt	73.2	72.1	69.7	69.4	69.2	70.6	70.6	70.3
Interest Rates 5/								
Short-term deposit rate	4.1	3.0	4.4	4.2	3.3	2.4	2.6	3.2
Long-term government bond yields	4.8	4.7	5.5	5.0	4.9	4.2	4.3	4.6
Exchange Rates								
U.S. dollar per euro 8/	1.12	1.07	0.92	0.90	0.94	1.13
Nominal effective rate (1990=100)	90.8	86.7	78.5	79.7	81.7	90.1
Real effective rate (1990=100) 9/	88.7	84.3	75.1	74.9	76.7	83.9
External Sector 6/ 10/								
Current account balance	0.3	-0.5	-1.2	-0.2	0.8	0.4	0.2	0.2
Trade balance	1.5	0.9	0.1	1.1	1.9	1.5	1.6	1.4
Memorandum items 6/ 11/:								
Current account balance	0.9	0.4	-0.5	0.2	1.0	0.4	0.7	0.7
Trade balance	2.0	1.4	0.7	1.5	2.3	2.0	2.0	1.8

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

1/ WEO projections.

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/ Synthetic euro in 1998.

9/ Based on normalized unit labor costs.

10/ Based on ECB data, which exclude intra-euro area flows.

11/ Calculated as the sum of individual countries balances.

Table 2. Euro Area: 2003 Fiscal Projections and Outcomes

	Real GDP growth 1/				Overall balance 2/				Structural balance 3/			
	2002	2003			2002	2003			2002	2003		
		SP 2002	Outcome	Diff.		SP 2002	Outcome	Diff.		SP 2002	Outcome	Diff.
Euro Area	0.9	2.1	0.5	-1.6	-2.2	-1.8	-2.8	-0.9	-2.1	-1.4	-1.5	-0.1
Germany	0.2	1.5	-0.1	-1.6	-3.5	-2.8	-4.0	-1.2	-2.9	-2.0	-2.4	-0.4
France	1.1	2.5	0.5	-2.0	-3.2	-2.6	-4.1	-1.5	-3.2	-2.6	-3.0	-0.4
Italy	0.4	2.3	0.3	-2.0	-2.3	-1.5	-2.4	-0.9	-2.6	-0.9	-1.1	-0.2
Austria	1.4	1.4	0.7	-0.7	-0.4	-1.3	-1.4	-0.1	0.4	-0.9	-0.7	0.2
Belgium	0.7	2.1	1.1	-1.0	0.0	0.0	0.2	0.2	-0.1	0.3	1.2	0.9
Finland	2.3	2.8	1.9	-0.9	4.3	2.8	2.1	-0.7	4.5	2.7	2.6	-0.1
Greece	3.9	3.8	4.3	0.5	-1.2	-0.9	-3.2	-2.3	-1.4	-1.5	-4.1	-2.6
Ireland	6.9	3.5	1.4	-2.1	-0.2	-0.7	-0.3	0.4	-1.2	-0.6	0.9	1.5
Luxembourg	1.3	1.2	1.2	0.0	2.4	-0.3	-1.0	-0.7	0.0	1.8	1.1	-0.7
Netherlands	0.2	0.8	-0.7	-1.5	-1.9	-1.0	-3.2	-2.2	-2.2	-0.8	-2.3	-1.5
Portugal	0.5	1.3	-1.3	-2.6	-2.7	-2.5	-2.8	-0.3	-2.1	-1.5	-0.7	0.8
Spain	2.0	3.0	2.4	-0.6	0.1	0.0	0.3	0.3	0.5	-0.1	0.6	0.7

Sources: 2002 Stability Programs, Commission assessments, staff estimates

1/ In percent.

2/ In percent of GDP.

3/ In percent of potential GDP. Structural balances in column SP 2002 are based on Commission assessments of stability programs. Outcomes for structural balances are staff estimates derived by assuming no change in budget elasticities or potential output growth between 2002 and 2003.

Table 3. Euro Area: Comparison of Staff Projections and Stability Program Targets, 2003-07

	Real GDP growth 1/					Overall balance 2/					Structural balance 3/				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Euro Area															
2003 Stability Program	0.6	1.9	2.5	2.5	2.4	-2.7	-2.5	-1.8	-1.3	-0.8	-2.1	-1.7	-1.4	-0.9	-0.6
Staff projections	0.5	2.0	2.3	2.5	2.5	-2.8	-2.8	-2.5	-2.2	-1.8	-1.6	-1.4	-1.2	-1.0	-0.9
Difference	-0.1	0.0	-0.2	0.0	0.2	0.0	-0.3	-0.7	-0.9	-1.0	0.4	0.4	0.2	-0.1	-0.3
Germany															
2003 Stability Program	0.0	1.7	2.3	2.3	2.3	-4.0	-3.5	-2.5	-2.0	-1.5	-3.2	-2.5	-2.1	-1.6	-1.4
Staff projections	-0.1	1.7	1.9	2.4	2.4	-4.0	-3.6	-3.2	-2.7	-2.2	-2.4	-1.9	-1.6	-1.6	-1.6
Difference	-0.1	0.0	-0.4	0.1	0.2	0.0	-0.1	-0.7	-0.7	-0.7	0.8	0.6	0.5	0.0	-0.2
France															
2003 Stability Program	0.5	1.7	2.5	2.5	2.5	-4.0	-3.5	-2.8	-2.1	-1.5	-3.8	-3.2	-2.6	-1.9	-1.3
Staff projections	0.5	2.4	2.5	2.3	2.2	-4.1	-3.7	-3.0	-2.6	-2.2	-2.9	-2.5	-1.9	-1.5	-1.2
Difference	0.0	0.7	0.0	-0.2	-0.3	-0.1	-0.2	-0.2	-0.5	-0.7	0.9	0.7	0.7	0.4	0.1
Italy															
2003 Stability Program	0.5	1.9	2.2	2.5	2.6	-2.5	-2.2	-1.5	-0.7	0.0	-1.8	-1.6	-1.0	-0.4	0.1
Staff projections	0.3	1.2	2.0	2.3	2.4	-2.4	-3.6	-3.4	-3.4	-3.0	-1.4	-2.0	-1.8	-1.6	-1.6
Difference	-0.2	-0.7	-0.2	-0.2	-0.2	0.1	-1.4	-1.9	-2.7	-3.0	0.4	-0.4	-0.8	-1.2	-1.7
Other euro area countries															
2003 Stability Program	1.2	2.2	2.9	2.9	2.3	-0.9	-1.0	-0.8	-0.5	-0.2	-0.2	-0.2	-0.2	-0.1	0.1
Staff projections	1.1	2.3	2.7	3.0	3.0	-0.9	-1.0	-0.9	-0.7	-0.4	-0.3	0.1	0.1	0.2	0.3
Difference	-0.2	0.1	-0.1	0.1	0.7	0.0	0.0	-0.2	-0.2	-0.2	-0.2	0.3	0.3	0.2	0.2

Sources: 2003 Stability Programs, Commission assessments; and staff estimates.

1/ In percent.

2/ In percent of GDP.

3/ In percent of potential GDP. Stability program structural balances are taken from Commission assessments.

Table 4. Euro Area: Selected Broad Economic Policy Guidelines

	Labor Utilization	Labor Productivity
Austria	Increase retirement age; enhance incentives to work, especially for women and older workers.	Encourage business research and innovation; boost competition in telecommunications.
Belgium	Reinforce measures to postpone retirement and activate older workers; reform tax-benefit system.	Enhance competition in network industries and local services; reduce administrative burden.
Finland	Reform tax-benefit system; foster wage differentiation across skills in wage bargaining.	Enforce competition in network industries and nontradable sector.
France	Raise retirement age; implement new unemployment insurance system.	Ensure competition in gas and electricity sectors; streamline regulations; raise the transposition rate of internal market directives.
Germany	Strengthen incentives for later retirement; reform tax-benefit system; foster wage differentiation across skills and regions; improve efficiency of ALMPs; lower employment protection.	Create competitive environment; reduce regulatory and administrative burden; eliminate skill shortages.
Greece	Use public resources more effectively to enhance working capacity of the unemployed.	Increase skills, research and development, ICT diffusion; enhance competition in energy sectors; simplify business and taxation environment; raise transposition rate of internal market directives.
Ireland	Allow wages to reflect productivity and skill differentials.	Boost competition in network industries, retail distribution, insurance, and professions; raise research and development.
Italy	Increase labor force participation, especially among women and older workers; reform employment-protection legislation; adopt decentralized wage setting.	Promote education, research and development, ICT take up; reduce administrative burden; increase competition in services and energy; raise implementation of internal market directives.
Luxembourg	Review incentives for early and pre-retirement.	Strengthen competition and regulatory authorities.
Netherlands	Reform benefit system and disability scheme.	Improve regulatory framework, especially in construction and professional services; promote technology oriented education, and research and development.
Spain	Encourage labor market participation, especially among women; foster wage differentiation; reform employment protection; facilitate geographical mobility.	
Portugal	Secure wage moderation; allow wages to reflect productivity and skill differentials.	Promote research and development and ICT take-up; reduce early school-leavers; boost competition in utilities, raise transposition rate of internal market directives.

Source: Broad Economic Policy Guidelines, 2003-2005, including the 2004 update.

Table 5. Euro Area: Balance of Payments

	2000	2001	2002	2003	2004Q1
(In billions euro)					
Current account	-77.6	-16.7	54.5	25.9	13.6
Goods	7.8	73.6	133.5	107.8	28.3
Services	-6.1	-0.3	13.0	17.3	-0.7
Income	-28.4	-38.7	-44.2	-43.2	-7.5
Current transfers	-50.8	-51.4	-48.3	-55.8	-6.6
Capital account	11.8	6.5	11.0	13.3	3.2
Financial account	70.6	-34.3	-65.8	-43.4	-21.5
Direct investment	-16.0	-112.5	-4.8	-9.9	-27.2
Portfolio investment	-99.6	67.8	114.7	25.3	4.2
Equity	-234.1	131.0	48.3	39.5	-6.4
Debt instruments	134.4	-63.2	66.1	-14.5	10.4
Financial derivatives	-10.0	-0.8	-10.8	-13.7	1.2
Other investment	181.9	-6.6	-162.8	-75.1	-9.4
Reserve assets	14.7	18.0	-2.2	29.7	9.7
Errors and omissions	-5.0	44.2	0.3	4.0	4.7
(In percent of GDP)					
Current account	-1.2	-0.2	0.8	0.4	0.7
Goods	0.1	1.1	1.9	1.5	1.6
Services	-0.1	0.0	0.2	0.2	0.0
Income	-0.4	-0.6	-0.6	-0.6	-0.4
Current transfers	-0.8	-0.8	-0.7	-0.8	-0.4
Capital account	0.2	0.1	0.2	0.2	0.2
Financial account	1.1	-0.5	-0.9	-0.6	-1.2
Direct investment	-0.2	-1.6	-0.1	-0.1	-1.5
Portfolio investment	-1.5	1.0	1.6	0.3	0.2
Equity	-3.6	1.9	0.7	0.5	-0.4
Debt instruments	2.1	-0.9	0.9	-0.2	0.6
Financial derivatives	-0.2	0.0	-0.2	-0.2	0.1
Other investment	2.8	-0.1	-2.3	-1.0	-0.5
Reserve assets	0.2	0.3	0.0	0.4	0.5
Errors and omissions	-0.1	0.6	0.0	0.1	0.3
Memorandum items:					
GDP (in billions of euros)	6,453.0	6,842.6	7,079.4	7,236.4	1,818.8
Reserves of the eurosystem 1/ (In billions of euros)	391.2	392.7	366.1

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

EURO AREA—STATISTICAL ISSUES

Euro-area statistics have improved significantly since 1999, both in scope and timeliness. There is now a plethora of economic time series covering history and current developments available on the Eurostat and ECB websites; GDP flash estimates are published less than two months after the end of a quarter; and inflation flash estimates are available at the end of the reference month.

But considerable gaps remain, in particular on the income side of the national accounts, on labor markets, on external trade, and on the flow of funds:

- Data for the income side of the national accounts either lag significantly or are non-existent. As a result, private household behavior in particular is difficult to analyze. A lack of standardized data at the country level for many members seems to be the main obstacle.
- On labor market data, better quality and sampling should help improve the statistics by 2005, when labor market surveys will be conducted every quarter throughout the area. A continuous labor force survey promises to provide better information on hours worked and detailed labor force breakdowns based on demographic characteristics and type of jobs. However, prospects for improving the timeliness of data on labor costs are dim. The publication delay has been reduced from 90 to 80 days after the end of the quarter and new regulations will only allow a reduction to about 70 days.
- The link between balance of payments data at the country and area-wide level is still tenuous, owing to measurement problems regarding intra-area trade, transfers, and capital flows. Efforts to reconcile the discrepancies are underway. There is also a need to upgrade the quality and scope of extra-area trade data.
- Annual flow-of-funds data for the area as a whole are now available, but the provision of more up-to-date information and, in particular, quarterly data would be useful. The ECB has indicated that procedures are being introduced that envision shortening the time lag for annual data to six months, from a current lag of nine months.

As regards fiscal data, a key input to fiscal surveillance under the SGP, a *Code of Best Practice* was adopted in 2003 to improve the timeliness and quality of data. However, large revisions to general government data remain frequent and continue to raise questions about data integrity. Moreover, the discrepancies between accrual- and cash-based fiscal data in some countries remain uncomfortably large. At the same time, the procedures leading to Eurostat decisions on fiscal accounting issues were streamlined and accelerated.

INTERNATIONAL MONETARY FUND

Euro Area Policies

Supplementary Information

Prepared by the European I Department

Approved by Michael Deppler and John Hicklin

July 22, 2004

1. This supplement reports on **economic and financial developments in the euro area** since the issuance of the staff report. The new information does not alter the thrust of the staff appraisal.
2. **The area's export-led recovery remains on track.** The latest indicators support the staff report's outlook for a continued gradual recovery. In particular, industrial production in May rose at a solid pace (0.7 percent; m-o-m). But the indicators also suggest that, particularly in Germany, the transmission of growth momentum from external to final domestic demand remains sluggish, as illustrated by the weakening of area-wide retail sales in May (-0.9 percent; m-o-m).
3. **The outlook for medium-term price stability remains favorable, although headline inflation eased only slightly in June.** With oil prices at elevated levels, headline inflation declined only moderately to 2.4 percent in June, from 2.5 percent in May. At the same time, core inflation (headline excluding energy, food, alcohol, and tobacco) ticked up to 1.9 percent, after several months at 1.8 percent. On the wage front, there are, however, no clear signs that the energy-driven spike in inflation has caused a rise in wage pressures. Indeed, high-profile plant level agreements in Germany and France to raise weekly work hours without compensation are viewed as boding well for continued medium-term wage moderation. They also seem to point to greater labor market flexibility at the grassroots than sometimes perceived.
4. In **financial markets**, equity prices and bond yields have eased moderately since the issuance of the staff report, in line with developments in the United States. Inflation expectations in bond markets—based on ten-year break-even inflation rates—also declined, after peaking at 2.4 percent, but remain above 2 percent. During the first three weeks of July, the euro appreciated by 1½ percent against the U.S. dollar, reflecting in part expectations that the monetary tightening cycle in the United States is likely to proceed at a more measured pace than previously assumed.

5. **The European Court of Justice has ruled that the ECOFIN Council overstepped its authority last November when it put the excessive deficit procedures against France and Germany in abeyance.** In essence, the Council was wrong in seeking to act outside of the framework of Commission recommendations and past Council decisions. (The Council can only reject or amend recommendations made by the Commission, not issue its own recommendations or alter previous Commission recommendations accepted by the Council). As a result, the excessive deficit procedures against France and Germany remain open. By the same token, there is considerable agreement both on the substance of the requisite policies in the two countries and on the need for the procedures of the Pact to take better account of the economic circumstances. In this respect, the Court's ruling has enabled a reopening of the discussion on how to resolve the issues confronting the Pact. In the aftermath of the ruling, the Commission has announced that it will consult with the Council and the ECB to formulate more specific proposals for "strengthening and clarifying the implementation of the SGP," which would be discussed later in the year.

6. **Implementation of the SGP has continued:**

- After the staff report was issued, ECOFIN gave a recommendation to Greece to eliminate its excessive deficit by 2005, requiring action to be taken by November 5, 2004.
- It also addressed the excessive deficits in six of the new member states. While these countries are not subject to SGP sanctions, ECOFIN set target dates for bringing their deficits below the 3 percent of GDP reference value, with the dates reflecting these countries' different starting points and budgetary plans (2005 for Cyprus; 2006 for Malta; 2007 for Poland and Slovakia; and 2008 for the Czech Republic and Hungary).
- ECOFIN also opted not to issue an early warning to Italy, as the Italian government committed to implement measures to prevent its deficit from exceeding 3 percent of GDP in 2004. Nevertheless, the rating agency Standard & Poor's downgraded Italy's credit rating from AA to AA-, the first such event since the launch of the euro. There were no noticeable movements in bond yield spreads in response to the downgrade.

7. **The Commission has tabled far-reaching proposals to overhaul the EU sugar regime.** As expected, on July 14, the Commission among other measures proposed cutting back support prices for sugar, reducing subsidized sugar exports, and providing decoupled payments to sugar beet farmers to compensate for their income losses. The changes are proposed to be implemented over four years, with the reform process scheduled to start in July 2005. The proposals have been viewed by some member governments as too radical.

**Statement by Jeroen Kremers, Executive Director for Euro Area
July 26, 2004**

As the Netherlands holds at present the Presidency of the Eurogroup, my statement reflects 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. Although I am in broad agreement with the policy conclusions, I would like to make a few qualifying observations. In addition to outlining these observations, this statement will update the Board on recent economic developments and policy actions taken at the European level, including the implementation of the Stability and Growth Pact and trade policy.

Short-term economic outlook

After a hesitant start of the recovery in the second half of 2003, economic growth in the euro area gathered momentum in the first quarter of 2004. The acceleration of activity was caused by a pick-up in private consumption and strong export growth. Although the recovery may not yet be self-sustaining, growth in 2004 is likely to turn out higher than earlier expected. Conditions are in place for a continuation of the recovery: financing conditions in the euro area are favorable, business confidence has strengthened, equity prices have been recovering and corporate restructuring has advanced. Furthermore, the recovery in private consumption is expected to proceed in line with increases in real disposable income and stronger employment.

The authorities consider the risks for the economic outlook to be balanced. On the one hand, upside risks to the current forecasts may stem from the strength of external demand and recent economic indicators. On the other hand, the pick-up in domestic demand could be weaker than expected, because the restructuring of balance-sheets by non-financial corporations may still take more time to be fully completed. In addition, oil prices have remained high, affecting the euro area's terms of trade. More generally, concerns relating to the persistence of global imbalances continue to exist.

The recovery in the euro area has been lagging behind that of other parts of the world. One of the reasons seems to be the slow adjustment of the euro area to past shocks. Despite the increased resilience of employment, remaining rigidities in the labor market and insufficient competition in specific sectors make the euro-area economy sensitive to shocks and hamper potential growth. The authorities fully agree with the Fund that increasing the potential rate of growth is the main challenge for the euro area.

Exchange rate developments

The authorities concur with the view expressed by staff that the current value of the euro is broadly in line with medium-term economic fundamentals. They reaffirm that the external value of the euro should reflect such fundamentals. Excess volatility and disorderly movements in the external value of the euro are undesirable. Also it is important that all major countries and economic regions play their part in contributing to the adjustment of global imbalances by implementing appropriate economic policies.

Monetary policy and the outlook for price stability

The authorities welcome the conclusion of the IMF staff report on monetary policy. In particular, they appreciate the recognition that monetary policy has been appropriate, in light of the medium-term outlook for price stability in the euro area. The assessment of the Governing Council of the ECB of the current outlook for price stability is broadly in line with the analysis of staff.

Euro area inflation has risen over recent months, standing at an annual rate of 2.4 percent in June. Together with rises in indirect taxes and administrative prices, oil prices have exerted upward pressure on prices. If oil prices were to remain high, the inflation rate would most likely remain above 2 percent for longer than expected at the time of the Article IV consultation. Looking beyond the short term, however, the main scenario of the ECB remains consistent with its definition of price stability. In this scenario, it is expected that wages develop moderately, in line with the recent trends, at a time when unemployment remains high.

There are upside risks to this scenario. The strength of global economic activity may continue to exert upward pressure on commodity prices, including oil prices. There may also be upside risks stemming from the further evolution of indirect taxes and administered prices in the euro area. The potential risk of second-round effects of such one-off increases in prices via wage and pricing behavior needs to be monitored closely. Also measures of long-term inflation expectations derived from financial-market indicators remain relatively high. While these indicators should be interpreted with caution, their recent development calls for vigilance.

As regards the monetary analysis, money growth has fallen over recent months. While this decline partly reflects base effects, it also reflects a normalization of firms' and households' portfolio allocation behavior as the exceptional economic and financial uncertainties prevailing in early 2003 have receded. Despite the recent moderation in M3 growth, there remains substantially more liquidity in the euro area than is needed to finance non-inflationary growth. While a significant part of the excess liquidity has accumulated as a result of past portfolio shifts, low interest rates have also fuelled the build-up of liquid assets. The low level of interest rates also supports credit growth. The stock of excess liquidity, if it persists, may signal an additional upside risk to price stability over the medium term. Thus cross-checking with the ECB's monetary analysis also calls for vigilance.

The Governing Council of the ECB has maintained its key interest rate, the main refinancing rate, at the historical low of 2 percent since June 2003, considering that the outlook still remains in line with price stability over the medium term. This stance lends support to economic activity. The Governing Council will remain vigilant with regard to all developments which could affect the risks to price stability over the medium term.

Fiscal policies

The euro-area authorities agree with the staff's view on the key elements of the fiscal framework. Budgetary discipline, sustainability of public finances, the implementation of symmetrical policies over the cycle and the need for an appropriate composition of fiscal policies are crucial to promote balanced economic growth and price stability, and to support

an increase in the euro area's growth potential. The importance of all these elements has recently been reconfirmed by the European Council in their Declaration on the Stability and Growth Pact as part of the agreement on the European Constitution.

The authorities also agree with staff that fiscal policies have been broadly appropriate during the downturn, although the rise in fiscal deficits in some Member States not only reflected cyclical developments but also policy choices. In 2003 the fiscal stance was broadly neutral, while the output gap deteriorated sharply. Looking at 2004 and 2005, the planned budgetary improvements rely to a high degree on the projected budgetary consolidation in the larger Member States. The latest information suggests that budgetary outcomes in many countries of the euro area could fall short of the targets. This calls for continued monitoring of budgetary developments and application of the common rules. A major lesson from the past downturn is that budgetary positions should be strengthened as economic conditions improve, in order to ensure sufficient room for the automatic stabilizers in the next downturn and to contribute to the long-term sustainability of public finances.

The staff paper gives a fair summary of the current discussions on strengthening and clarifying the implementation of the Stability and Growth Pact. The 13 July European Court of Justice ruling was central in clarifying the respective roles of the Commission and the Council in the implementation of the Stability and Growth Pact provisions, thereby making budgetary policy coordination more transparent and more predictable.

Structural reform

In light of the low and gradually declining rate of potential growth in the euro area, the authorities welcome the emphasis given by the Staff report to structural reforms aimed at raising the level of potential growth, in line with the so-called Lisbon agenda of structural reform. The comments made in relation to the need for labor market reforms are justified, especially in view of the looming ageing implications. The staff paper rightly stresses the need for a higher labor utilization to safeguard the welfare state model. However, the need to raise productivity and to continuously increase productivity growth, a key aspect of the Lisbon strategy, requires equal attention.

Although paragraph 38 sets out the views of the European Commission on this point, I would like to elucidate differences in estimates of labor productivity levels. According to the paper, labor productivity in the euro area exceeded the US level in 2000 (according to the table in paragraph 11). The Commission estimates, by contrast, a level of 96.5 percent of the US level. The staff estimate is based on the euro area's business sector, not the total economy, and does not include a number of euro area countries.

A significant reduction in the disparity in productivity growth levels between Europe and the USA requires action in the fields of education, training, the diffusion of ICT, R&D and innovation. The results achieved in these fields since the adoption of the Lisbon agenda are mixed. On the one hand, many Member States have taken important steps to improve adult education and workplace training, and ICT use is spreading fairly rapidly. On the other hand, R&D expenditure is growing very slowly and is still far below the target of 3 percent of GDP. There is also a need for further reductions in the regulatory and administrative burden on enterprises and to improve their access to finance, particularly venture capital.

As regards structural reform in product markets, the authorities can agree with the overall assessment made by staff. Although much has been achieved in terms of market opening and stronger competition policy, much also remains to be done and the pace of reform in some areas does seem to be slowing down.

Trade issues

Finally, allow me to turn to the staff assessment of trade policy developments. The Doha Development Agenda (DDA) remains the EU's top trade policy priority. While the EU is adhering to its existing commitments to regional trade negotiations, notably with Mercosur and the ACP countries, the EU has not launched any new regional trade initiatives since 1999, in order not to detract from the DDA.

The rationale for the Doha Round and the main priorities of the EU for this Round remain unchanged after Cancun. The EU is committed to an outcome which should deliver ambitious trade liberalization and stronger multilateral rules, while supporting sustainable development. In order to inject further impetus into the negotiations, Commissioners Lamy and Fischler sent a letter on 9 May to all WTO Trade Ministers in which they made important new proposals:

- a parallel move on all forms of export subsidies, including the subsidy element of export credit, food aid and state trading enterprises, in the framework of a balanced package on all three pillars of agriculture (export competition, domestic support and market access), as well as on other elements of the negotiations;
- the withdrawal of investment and competition from the single undertaking, only pursuing negotiations in the framework of the DDA on trade facilitation and, possibly, on transparency in government procurement;
- the exemption of weak and vulnerable developing countries in a situation similar to that of LDCs from any new commitments, apart in the field of trade facilitation, and through raising their level of tariff bindings.

This initiative was much welcomed by the great majority of WTO Members. Intensive work is now on-going in Geneva to finalize framework modalities by the end of the month, which would provide a crucial staging post for a successful outcome of the Round.

The Commission recently tabled a proposal for a radical overhaul of the EU sugar regime, which demonstrates the continued commitment of the Commission to reform the Common Agricultural Policy in order to meet the needs and expectations of both consumers and producers in the EU and in the developing countries, and to adapt to a new world trading environment.



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IMF Executive Board Discusses Euro Area Policies

On July 26, 2004, 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 cyclical recovery is gaining momentum but lags the global upturn. A first recovery attempt fizzled during the first half of 2003, undercut on the external side by a pause in global growth and by euro appreciation. Since then, GDP growth has again rebounded, jumpstarted by foreign demand and bullish global financial markets. Domestic demand growth remains subdued, however, as both private households and corporations have been slow to step up spending.

The regional pattern of domestic demand growth remains uneven. Momentum is lagging in Germany and Italy, but France and most other countries are experiencing more balanced growth patterns. Highlighting the sustained nature of the regional divergences across the union since 2000, Germany's domestic demand weakness and strong export performance led to a 4½ percent of GDP improvement in its current account position.

Private consumption has been sluggish owing to labor market slack, uncertainties about employment, and diminished expectations of future income growth. Although the area's employment has held up well during the protracted downturn, there are indications that earlier

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. This PIN summarizes the views of the Executive Board as expressed during the July 26, 2004 Executive Board discussion based on the staff report. The ECB's observer at the Fund participated in that meeting.

expectations of underlying potential growth could have been too optimistic. Households' increased concerns about the financial viability of pension and health care systems could also play a role in constraining consumption.

Financial conditions in the area have improved along with those in global markets. In particular, monetary policy continues to be supportive, with policy rates unchanged at low levels since June 2003. The euro is in line with historical averages in real effective terms, but current account imbalances in the rest of the world represent a risk of future currency appreciation.

Against this backdrop, euro-area corporations have gradually adjusted to the bust in equity valuations, and their balance sheets have improved. In addition, low investment-output ratios and relatively high rates of capacity utilization should boost investment activity. On the downside, corporate debt and leverage remain elevated and could become more constraining once interest rates revert to neutral levels.

Headline inflation outcomes have remained sticky, notwithstanding sustained wage moderation, a widening output gap, and euro appreciation. In early 2004, inflation was boosted by increases in tobacco taxes and administered prices. More recently, higher oil prices pushed headline inflation above 2 percent. At the same time, core inflation (defined as headline inflation excluding energy, food, alcohol, and tobacco) has remained relatively stable at 1¾ percent since end-2003.

Fiscal policy in the euro area during the cyclical downturn has generally allowed automatic fiscal stabilizers to operate in the face of unexpected growth shortfalls. Fiscal deficits in four countries (France, Germany, Greece, and the Netherlands) exceeded the Stability and Growth Pact's (SGP) 3 percent of GDP limit in 2003. Successive breaches of the deficit limit by France and Germany led to procedural impasse in the implementation of the excessive deficit procedure under the SGP for these two countries.

Against this background, the staff projects real GDP growth to amount to about 2 percent this year and 2¼ percent next year, underpinned by a sustained increase in final domestic demand. While faster-than-projected global growth represents an upside risk, downside risks include possible appreciation pressures owing to global current account imbalances and reluctance by households and corporations to step up spending in view of incomplete adjustment to past shocks. The recent run-up in oil prices could keep headline inflation at about 2 percent in 2004, but it should fall below 2 percent in 2005 in an environment of maintained wage setting discipline, continued slack in goods and labor markets, and lagged pass-through effects from euro appreciation.

Executive Board Assessment

Executive Directors congratulated the European authorities on the most recent breakthroughs in European integration, welcoming in particular the accession of 10 new member countries on May 1 to the European Union and the political agreement on a new Constitutional Treaty reached on June 18.

Directors noted that the euro area's short-term outlook has brightened, but that longstanding structural challenges remain to be tackled. A buoyant global economy and bullish financial markets have prompted a cyclical rebound of growth, while the outlook for medium-term price stability remains favorable. Directors cautioned, however, that the transmission of the growth momentum to final domestic demand, particularly in some of the larger economies, remains sluggish. Looking to the longer-term prospects, Directors were concerned that structural and fiscal policies needed a more forward-looking response to revive potential growth and deal with the fiscal pressures arising from population aging. In particular, Directors stressed the need for structural reforms to reverse the area's secular decline of labor utilization and to raise productivity growth. They also noted that decisively tackling the structural obstacles to growth in the euro area would also ease the appreciation pressures on the euro in helping to resolve the global current account imbalances.

Directors broadly agreed that monetary policy has responded appropriately to the area's changing economic circumstances, particularly in view of the persistence of inflation during the cyclical downturn. Looking forward, Directors were of the opinion that monetary policy should remain supportive of the recovery in domestic demand as long as the medium-term outlook for price stability is favorable. While risks of second-round effects from higher oil prices, as well as from hikes in indirect taxes and administered prices, need to be watched closely, the slack in labor markets and continued wage moderation underpin an encouraging outlook for inflation. At the same time, Directors emphasized that renewed appreciation pressures on the euro owing to the global current account imbalances remain a medium-term downside risk to growth.

Directors concurred that fiscal policies during the slowdown have been broadly appropriate. They observed that the rise in fiscal deficits mainly reflects the unexpectedly protracted slowdown rather than concurrent policy choices. Nonetheless, Directors noted that allowing free play to the automatic fiscal stabilizers combined with earlier policy shortcomings have clearly strained the procedural fabric and credibility of the Stability and Growth Pact (SGP).

Directors agreed that the SGP's basic design as a framework that seeks to combine discipline and flexibility remains appropriate, though there was broad consensus that several aspects of the Pact should be re-examined. First, the incentives to adjust in good times needs to be strengthened, both as regards letting the automatic fiscal stabilizers play fully and ensuring that commitments to correct weak underlying fiscal positions are sustained. Second, underlying fiscal balance targets should be tied more explicitly to sustainability considerations to provide the framework with stronger economic underpinnings. Finally, Directors thought that the implementation of the Pact could be tuned to better differentiate between the respective roles of policies and the economic environment in assessing breaches of the 3 percent of GDP fiscal deficit limit.

Directors also stressed that a genuine consensus on upholding a strong and disciplining fiscal framework needs to be restored, in particular against the backdrop of the medium- to long-term fiscal challenges associated with rapid population aging. Most Directors felt that a failure to build a new consensus on the SGP could have potentially grave consequences for EMU and its member countries, many of which rely on the SGP as an external commitment device to maintain fiscal discipline.

In this vein, and with the recovery gaining traction, Directors called on member states to accelerate the pace of fiscal consolidation. In particular, most Directors agreed that countries with weak budgetary positions should undertake high-quality fiscal consolidation with the objective of reducing the cyclically-adjusted deficit by at least 0.5 percent of GDP a year while allowing the automatic fiscal stabilizers to operate fully, particularly if growth surprises on the upside.

Directors identified the euro area's key structural challenge as raising longer-term growth, in the first instance by strengthening the incentives to work. With the onset of rapid population aging only a few years away, Directors noted that reversing the secular decline in labor utilization through reforms of tax-benefit systems and lengthening working lives would need to be a key plank in the strategy to shore up social protection systems in most member countries.

Turning to the different reform areas, Directors welcomed the measurable progress in deregulating and integrating product and financial markets, but also urged more efforts to liberalize service sectors. While much remains to be done, the basic directions and steps to be taken have been agreed and instigated by EU-wide institutions. The issues going forward are in good part concerned with implementation, making sure that the policies overcome the current segmentation of labor markets and re-shape incentives at the national level. In this regard, Directors noted that policies to promote "national champions" would not be compatible with the EU's sound economic principles of fostering free competition.

Directors expressed concern over the lack of reform momentum in areas where national competencies loom large, particularly on labor and pension reforms. While there has been tangible progress in these areas, political fatigue seems to have set in early, and efforts fall short of the necessary restructuring of work incentives. The key challenge at the area-wide level was seen as imparting momentum to structural reforms at the national level through more decisive leadership at the EU level.

Many Directors believed that the Lisbon reform agenda should be prioritized and focused on boosting work incentives. Most Directors considered that peer pressure on governments could be strengthened, including through ranking and publicizing country performances. Furthermore, structural reforms by the largest countries could provide additional incentives through competitive pressures. Some Directors also regretted that some of the earlier EU member states have put transitory restrictions on the free movement of labor, noting that increased labor mobility across the union would add to potential growth.

Directors welcomed the EU's new efforts to relaunch the stalled Doha round. The EU's recent offers to phase out all farm export subsidies and further limit negotiations on the Singapore issues provide fresh—and much needed—impetus for reaching agreement on a negotiating framework, and Directors felt that it would be desirable to complement these efforts with a more ambitious multilateral offer on market access. Directors welcomed the recent decision to decouple a large part of domestic support for the production of Mediterranean products. Directors were also encouraged by the European Commission's far-reaching proposals to reform the EU's sugar regime.

Directors noted that the area's statistics are adequate for surveillance, but urged continuing efforts to improve them further, not least in view of the euro area's status as the world's second-largest economy. In particular, additional efforts should focus on providing more comprehensive and up-to-date statistics on the institutional income accounts, flow-of-funds, labor market, and external trade. Ensuring the integrity of fiscal data in the context of fiscal surveillance under the SGP should also remain a priority.

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

	1999	2000	2001	2002	2003	2004 ¹
	In percent					
Real Economy						
Change in real GDP	2.8	3.5	1.6	0.9	0.5	2.0
Change in domestic demand	3.5	2.9	1.0	0.4	1.2	1.8
Change in consumer prices ²	1.1	2.0	2.4	2.3	2.1	1.9
Unemployment rate ^{2,3}	9.5	8.5	8.0	8.4	8.9	9.0
	In percent of GDP					
Public Finance						
General government balance ⁴	-1.3	-0.9	-1.7	-2.3	-2.8	-2.8
Public debt	72.1	69.7	69.4	69.2	70.6	70.6
	In percent					
Money and Interest Rates						
Change in M3 (end of year) ²	5.7	4.2	8.0	6.9	7.1	4.7 ⁵
Money market rate (3 month money)	3.0	4.4	4.2	3.3	2.4	2.6
Government bond yield (10 year bonds)	4.7	5.5	5.0	4.9	4.2	4.3
	In percent of GDP					
Balance of Payments ⁶						
Trade balance	0.9	0.1	1.1	1.9	1.5	1.6
Current account	-0.5	-1.2	-0.2	0.8	0.4	0.2
Official reserves (US\$ billion) ⁷	256.8	242.3	235.0	247.0	222.7	209.8 ⁸
	In percent					
Exchange Rates						
Nominal effective rate	-4.5	-9.4	1.5	2.5	10.3	2.1 ⁹
Real effective rate	-4.9	-10.9	-0.3	2.3	9.4	1.3 ⁹

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

¹ WEO projections, June 2004; unless otherwise specified.

² Harmonized definition.

³ In percent of labor force.

⁴ Excludes UMTS revenues.

⁵ May 2004.

⁶ Based on ECB data, which exclude intra-euro area flows.

⁷ End of year. Total reserves minus gold (Eurosystem definition).

⁸ April 2004.

⁹ January-June average relative to 2003 average.