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Euro Area Policies: 2008 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Germany, on behalf of the Euro Area Authorities

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with member countries forming the euro area, 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 23, 2008, with the 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, 2008. 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 21, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 25, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Germany, on behalf of the euro area authorities.

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

Selected Issues Paper

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

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EURO AREA POLICIES

Staff Report for the 2008 Article IV Consultation with Member Countries

Prepared by the European Department

Approved by Alessandro Leipold and Adnan Mazarei

July 2, 2008

- A staff team held discussions at the European Central Bank (ECB) and the European Commission (EC) during May 13–22, 2008. The team comprised Messrs. Leipold (Head), Čihák, Decressin, Fonteyne, Harjes, Stavrev (all EUR), Mr. Hardy (MCM), and Mr. van der Mensbrugghe, the Fund's Special Representative to the EU. Ms. Asmundson (PDR) covered EU trade issues in discussions at the EC.

- Meetings were held at the ECB with President Trichet, Vice President Papademos, Mr. Bini Smaghi, Mr. González-Páramo, Mr. Stark, Ms. Tumpel-Gugerell, and senior staff. At the EC, the mission met with Commissioner Almunia, Mr. Regling (Director General for Economic and Financial Affairs), Mr. O'Sullivan (Director General for Trade), and other senior officials. Mr. Leipold also met Eurogroup President Juncker, discussed the mission's preliminary findings at the May 22 Euro Working Group meeting, and presented its concluding statement to the Eurogroup Ministers on June 2. Mr. Stein (Executive Director) and Mr. Wijnholds (ECB Observer at the Executive Board) attended most of the meetings.

- The authorities released the mission's concluding statement and staff presented it in a press conference in Frankfurt on June 2, 2008.

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EXECUTIVE SUMMARY

The discussions took place around the 10th anniversary of EMU. Monetary union was widely hailed as a success, while economic union was recognized to remain work in progress. The rejection of the Lisbon Treaty in a country referendum has since dampened the mood.

- *How much reassurance can be drawn from past successes at the current juncture?* Over the past decade, inflation expectations have remained well anchored and employment growth robust, notwithstanding large terms of trade shocks. The euro area has clearly become more resilient, but it is not immune to the common global shocks. All official forecasts expect demand to slow, albeit to somewhat different degrees, owing to high energy and food prices, tighter financial conditions, slowing global activity, and the euro's real effective appreciation—to a level beyond that justified by medium-run fundamentals.

- *How should monetary policy react?* The response hinges on how wages and inflation expectations will evolve in the face of elevated energy and food prices, and whether the economic slowdown forecast by all will exert a sufficiently dampening effect. While the persistence of uncomfortably high headline inflation entails risks of second-round effects, markets have already implemented appreciable tightening since summer 2007 and, in a still strained financial environment, further tightening carries risks of its own. In this setting, the case for a policy shift does not appear compelling, and staff sees value in keeping rates on hold. For its part, the ECB—based also on a forecast of somewhat higher growth—sees upside risks to price stability and is pointing to a possible need to raise rates.

- *What can be done to normalize markets?* The ECB's liquidity management framework is viewed to have acted as a crucial stabilizer. Refinements remain under review. The area's financial system remains sound, although the outlook, as noted also in the ECB's most recent *Financial Stability Review*, remains highly uncertain. Addressing the issues raised by the turmoil requires active implementation of the recommendations by the Financial Stability Forum and others.

- *What is the right fiscal response?* There is general satisfaction with the operation of the SGP and the further fiscal adjustment recorded in 2007, though many countries continue to fall well short of their medium-run commitments. The broadly shared view is that a policy approach cast within the SGP serves countries best and that policies to protect vulnerable groups should avoid distorting adjustment to higher energy prices.

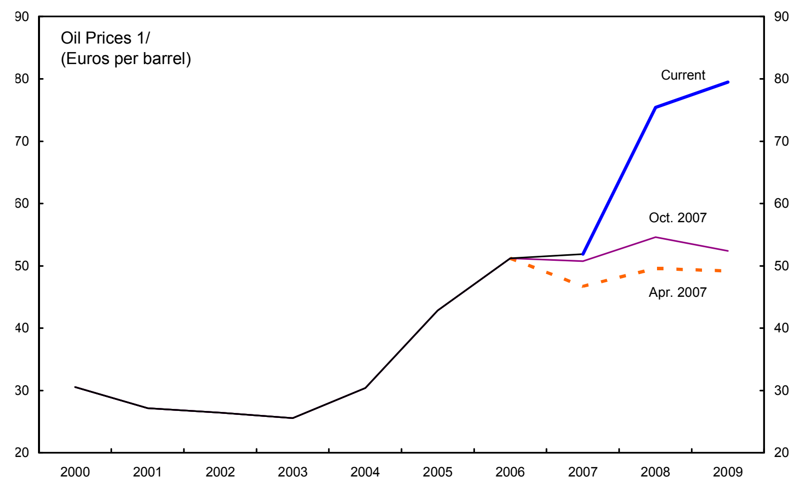
- *For longer-term financial stability in the EU, the main question for member countries is how to instill a greater sense of joint accountability and responsibility for EU-wide stability, consistent with the aim of creating a single financial market*. Important common principles have been adopted that emphasize collective crisis cost minimization and burden sharing. The challenge now is to fully align the legal underpinnings of national financial stability frameworks with these commonly agreed principles.

- *For economic union, the main concern is how to address large intra-area divergences*. There is agreement that national reform programs need to place greater emphasis on accelerating services market reform and financial integration. The European Commission proposes enhancing internal surveillance.

I. Cyclical Developments and Prospects

1. **Euro-area economic developments have contributed to global stability, but a series of largely external shocks are now moving the economy away from external and internal balance**. The area's external current account is still close to balance, fiscal policy has generally been sound, and structural reforms are advancing, broadly in line with commitments under the Fund's Multilateral Consultations. But prospects have deteriorated.

2. **Following a strong showing in 2008Q1, real GDP growth is decelerating, in the wake of several adverse economic shocks**. Growth in 2008Q1 was much higher than projected, reflecting a remarkably strong performance of the German economy—which, to an appreciable extent, was driven by special factors—but also greater robustness elsewhere. Abstracting from volatility in quarterly data, however, the current cycle peaked in 2006 (Table 1), with real GDP growth since then slowing (Figure 1). In particular:

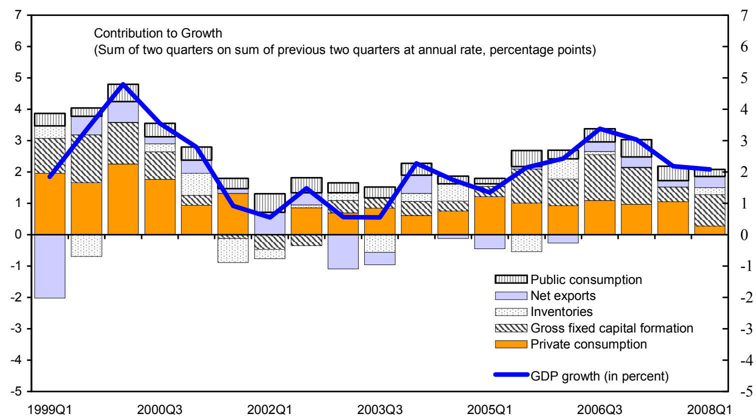


Source: IMF, *World Economic Outlook.*
1/ Simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh.

- The recent surge in oil and food prices will put further strain on already weak euro-area consumption growth, despite unemployment rates near 25-year lows (Figure 2). To the extent that the oil price shock is increasingly becoming a global supply shock, its negative impact on consumption will be less and less offset by growing external demand.

- Investment has been moderating, as interest rates and risk premia have been rising (Figure 3) and prospects for external demand weakening (Figure 4). The turmoil has directly affected parts of the area's financial system, and linkages with the United States remain important (Box 1 and Figure 5). But the area's growing trade with emerging market economies—where growth has remained relatively robust thus far—has been a supportive factor.

Economic activity in the euro area has slowed.



Source: Eurostat.

Box 1. Spillovers Between the Euro Area and the United States

This box summarizes the estimation results from a VAR and a generalized dynamic factor model for the size of the spillovers and the strength of the trade and the financial sector channels through which shocks between the euro area and the United States are transmitted (Figure 5).

The estimation results suggest that the degree of co-movement in activity and the financial sector between the two regions is high and has increased over time. In particular:

- The slowdowns in growth are highly synchronized—all significant US downturns have either coincided with or been followed by sharp slowdowns in the euro area.
- The spillovers seem large; on average a one percentage point decline in US real GDP growth shaves off ¼ percentage point of euro area growth within two quarters, with a maximum impact of close to ½ percentage point after one year. However, since the size of spillovers differs from case to case, these estimates cannot be applied mechanically.
- The cycles in the euro area and the United States have been largely and increasingly driven by common shocks. In particular, the share of euro-area real GDP growth explained by common shocks increased from 37 percent in 1980–1993 to 54 percent during 1994–2007.

Both trade and financial transmission channels have become stronger over time, with the trade channel likely playing mainly via third country effects.

Euro Area and United States: Contribution of Common Shocks
(Percent variance explained by one common factor)

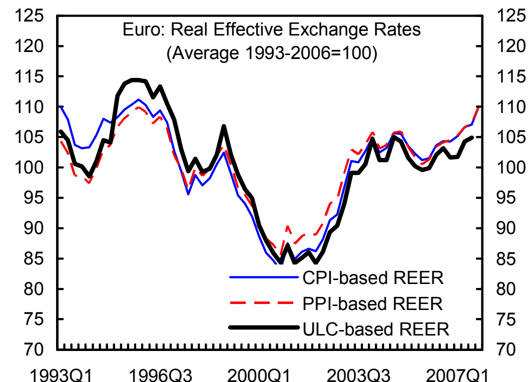
	GDP	Stock prices	Imports	Exports
		1980 - 1993		
Euro area	37	15	46	27
United States	39	41	37	45
		1994 - 2007		
Euro area	54	52	62	61
United States	37	36	52	48

Sources: Fund staff estimates.

Against this backdrop, discussions focused on the degree of resilience of the euro-area economy, which has been stronger than expected thus far, with past reforms having made for greater labor market robustness and more job-friendly wage setting.

3. **The current account has remained broadly balanced but competitiveness has been eroded, albeit to a limited extent** (Tables 2, 3 & 4). A steady increase in the investment rate of nonfinancial corporations has been funded by rising corporate and public savings, while household savings have moved broadly sideways. The area's exporters have weathered the appreciation of the euro well. In line with the strong performance of euro-area exporters, the ULC-based real exchange rate has changed little since 2003, suggesting that pressures from the appreciating euro have been offset by subdued unit labor costs. Nonetheless, the real effective exchange rate of the euro is currently some 15 percent higher than its 1993–2006 average, having appreciated by about 10 percent since end-2006, carrying the euro beyond its medium-run fundamentals—in a measure of at least 10 percent according to

Subdued ULC offset pressure from the euro appreciation.



Source: ECB.

staff estimates (Box 2). The effect of this appreciation depends on its source—staff estimates that it might shave off at least ¼ percent from real GDP growth over the near term. EC representatives underscored that its adverse effects would grow the longer it lasted, as currency hedges expire, wages accelerate from the unusually low growth rates observed during 2003–05, and production is adapted to lower profitability. There is also some concern that the reaction to currency appreciation may be non-linear, becoming abruptly more intense beyond a difficult-to-pinpoint threshold.

Box 2. Assessing the External Competitiveness of the Euro Area

The latest appreciation leaves the euro on the strong side relative to fundamentals. The projected medium-run current account deficit stands at about ¾ percent of GDP, while real exchange rate models put the equilibrium at a surplus of 0.2 percent of GDP.* Based on the latest exchange rates, CGER estimates place the euro's overvaluation in a range of
5–20 percent. However, staff considers the equilibrium real exchange rate (ERER) estimate too high since the commodity terms of trade used in the standard ERER calculation tend to overstate the degree of terms of trade deterioration for the euro area over the past several years, as suggested by recovering export margins since the dip in mid-2004 (Figure 6). By the same token, however, the trade elasticities with respect to the exchange rate might also be lower than implicit in the macroeconomic balance and external sustainability approaches. All in all, staff sees the real effective exchange rate of the euro at least 10 percent stronger than warranted by medium-run fundamentals.

CGER Assessment of the Euro Effective Exchange Rate
(Percent deviation from estimated equilibrium)

	Macro balance	Equilibrium real exchange rate	External sustainability	Overall
Spring 2008 WEO	8	17	4	5-15 above
Update 1/	9	20	5	5-20 above

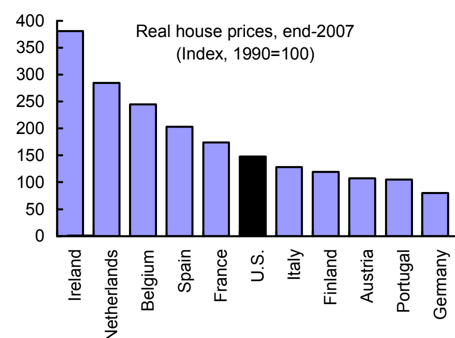
1/ Based on 3 percent real effective euro appreciation in May relative to the average in the base period (Jan. 30 - Feb. 27, 2008).

EC and ECB representatives broadly agreed with staff's assessment. They underscored their concern that the euro has been bearing an undue burden of the depreciation of the US dollar, while the area has made considerable progress toward delivering on its commitments under the multilateral consultations (Table 5).

* For details, see Exchange Rate Assessments: CGER Methodologies, IMF Occasional Paper 261

4. **Housing markets present risks but mainly from a medium-run rather than short-run perspective**. Many euro-area countries have experienced house price rises similar to those seen in the United States and residential investment has been well-above its long-term average. Prices are now slowing and investment is forecast to weaken noticeably. The impact of tightening lending conditions and reduced credit availability would be felt strongly in some member states, according to the Commission, and house price slumps in these "hot spots" could, via financial linkages, trigger a broader decline in other euro-area countries. However, EC and ECB representatives underscored that

House prices in some euro area countries are a downside risk.

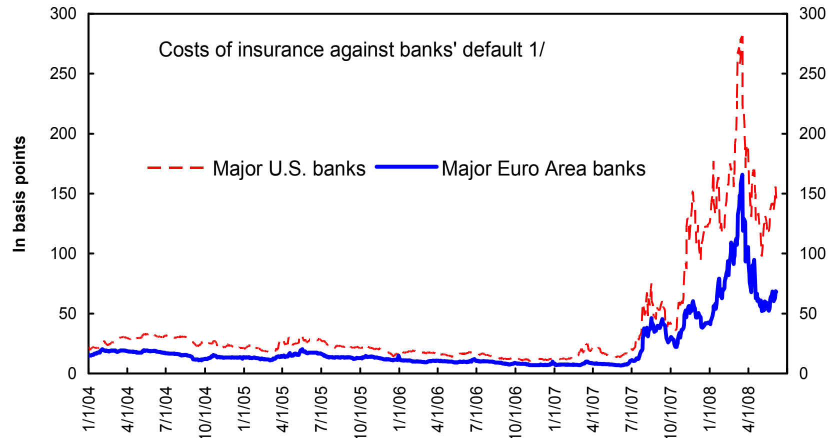


Source: Staff calculations.

the effects on growth for the area as a whole would be contained. The limited amount of non-prime lending, relatively low loan-to-value ratios, and few opportunities for equity withdrawal would limit the scope for pernicious feedback loops between the housing and financial sectors as well as the broader real economy. Staff agrees and sees adjustment in this sector making for important medium-run headwinds, after providing noticeable support over the past decade.

5. **Balance sheets outside the financial sector still seem relatively robust, which should support activity** (Figure 7). Balance sheets of corporations are stronger than at the onset of the last credit cycle downturn and there is scant evidence of a significant investment overhang. However, European businesses are relatively dependent on bank lending and are more leveraged than their US peers, which makes investment vulnerable to the ongoing tightening of credit. Amid tougher financing conditions and cost pressures, default rates are expected to rise from their recent historically low levels, with highly-leveraged corporations and real-estate related businesses being particularly vulnerable. Household leverage has been rising but generally remains appreciably lower than in the United States or the United Kingdom, while personal savings—at some 14 percent of household income—are much higher. Pockets of vulnerability exist among households in countries that have seen rapid house price appreciation, in particular where variable-rate mortgages are common.

6. **The latest ECB Financial Stability Review describes the outlook for financial stability as "highly uncertain," although the area's financial system remains sound** (Table 6).[1] The euro area's financial system entered the turmoil from a position of strength. Until mid-2007, financial sector profitability had been buoyed by strong loan growth, record low provisioning, and high trading revenue. However, the turmoil has materially impacted bank profitability, even though capital buffers remain largely intact, and banks' operating environment has become much more adverse. Funding costs have increased considerably, particularly for lower-rated banks, and balance sheet constraints have tightened as several market segments closed down (Figures 8 & 9). Interbank markets have dried up at longer



Source: Datastream.
1/ 5-year senior CDS spreads, simple average. U.S.: Citigroup, Bank of America, JPMorgan Chase, Wachovia, Wells Fargo, Washington Mutual. Euro area: Deutsche Bank, HVB, Commerzbank, BNP Paribas, Credit Agricole, Societe Generale, Unicredito, Banca MDP di Siena.

[1] See ECB Financial Stability Review, June 2008.

maturities and spreads have risen as banks started hoarding liquidity amid mounting concerns about running into liquidity constraints, and the need to bring off-balance sheet exposures back on balance sheet. Loan losses have started to increase. In this context, banks have retrenched from risk-taking and significantly tightened lending standards. The ECB sees the outlook for financial stability as depending on three factors: developments in asset markets—notably in the US and other housing markets—and in the broader economy; the way banks respond to their more challenging operating environment; and the extent to which initiatives and measures aimed at restoring confidence and strengthening financial system resilience are eventually implemented.

7. **Household credit has slowed significantly and credit to non-financial corporations, which has shown buoyant growth thus far, is generally expected to follow**. ECB staff viewed lending to households behaving in line with normalizing conditions in euro-area housing markets. Bank lending to euro-area non-financial corporations has, in contrast, continued to expand, seemingly unimpaired thus far by the financial turmoil (Figure 10).[2] However, credit standards reported in the euro-area bank lending survey point to an appreciable tightening of conditions (Figure 11). Unlike in recent episodes, the expected tightening of bank credit would probably not be offset by an increased availability of bond and equity financing. Staff analysis suggests that tightening financial conditions tend to have a significant impact on credit with a noticeable lag (Box 3). ECB representatives agreed that corporate credit growth would likely slow.

8. **However, absent further shocks, supply-side effects from the financial sector on activity were reckoned to be manageable** (Box 3). Market-based indicators of vulnerability have stabilized. EC and ECB representatives thought that good progress had been made with respect to loan loss recognition and recapitalization but felt that it was too early to conclude that the worst was over, considering also that many banks still have to release results. In this regard, the ECB noted lingering uncertainty about the possibility of further large losses disclosed over the next few quarters, with the adjustment process likely to be protracted. Still, in their view, the bulk of the euro area's many banks would not be directly affected by the subprime turmoil, offering some reassurance. Furthermore, it was noted that the losses disclosed by financial institutions have so far largely reflected mark-to-market write-downs on hard-to-value assets, with the related possibility that the credit loss outturns may ultimately prove less severe. The common view thus was that the shutdown of various wholesale market segments and rising risk premia would restrain credit but that an outright credit crunch would be avoided.

9. **Substantial uncertainty is associated with spillover risks between the euro area and emerging Europe, but growth in emerging Europe would still support euro-area exports**. The real and financial linkages between the euro area and emerging Europe have become much stronger in recent years.[3] The convergence trend of emerging Europe is

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[2] ECB analysis does not point to major re-intermediation effects.

[3] For example, econometric models suggest that the accelerated growth in emerging Europe in the past five years and the increased share of the euro area have contributed 0.2–0.4 percentage points to euro area annual growth (*Regional Economic Outlook: Europe*, November 2007).

projected to continue, albeit at a slower pace, as growth rates in recent years have been above estimates of potential for most countries and an adjustment is already under way. The risks to this scenario are considerable, since the emerging European economies, partly due to their openness, are more vulnerable to a global slowdown than those of the euro area,[4] and these vulnerabilities could be amplified through financial channels. However, so far spillovers from euro area financial and real sector developments to emerging Europe have been limited.

10. **Hence, the central scenario underlying IMF/EC/ECB projections is for a significant slowdown, but no recession or prolonged period of sluggish activity, such as during 2002–05**. Staff projections foresee real GDP growth moderating from an annual pace of about 1¾ percent in 2008H1 to just over ½ percent in 2008H2, before reaccelerating to a 1½ percent pace and above starting in 2009Q2. The output gap would widen to about 1 percent of potential GDP in 2009. Both EC and ECB projections foresee a broadly similar pattern of activity but with higher growth at the trough, mainly on account of more robust consumption.

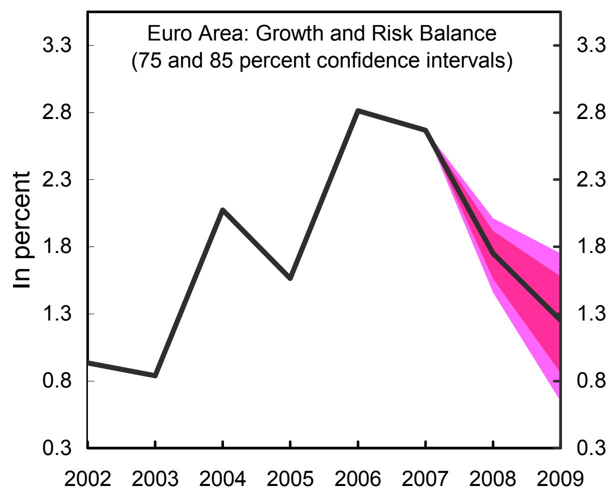
The euro-area economy slows significantly but avoids a recession.

	Vintage	Real GDP 2007	2008	2009
			Projections	
WEO	Current 1/	2.6	1.7	1.2
ECB	June	2.6	1.5-2.1	1.0-2.0
EC	April	2.6	1.7	1.5
Consensus	May	2.6	1.5	1.6
Memorandum items				
WEO Q4/Q4	Current	2.2	1.3	1.7

1/ Not adjusted for working days.

11. **The risks around the projections are considered large**. On the downside feature further increases in energy and food prices, including related protectionist pressures; an accelerated deleveraging that sets off broader asset price deflation and a global credit crunch; and an abrupt unwinding of global imbalances and sharp appreciation of the euro. On the upside, risks relate to still buoyant employment and therefore higher-than-projected consumption. There could also be some decline in energy and food prices, to the extent that speculative forces have played some role in these markets. Overall, staff considered the risks around its projection as broadly balanced, while EC and ECB staff—relative to their slightly higher projection for real GDP growth—saw them as tilted to the downside.

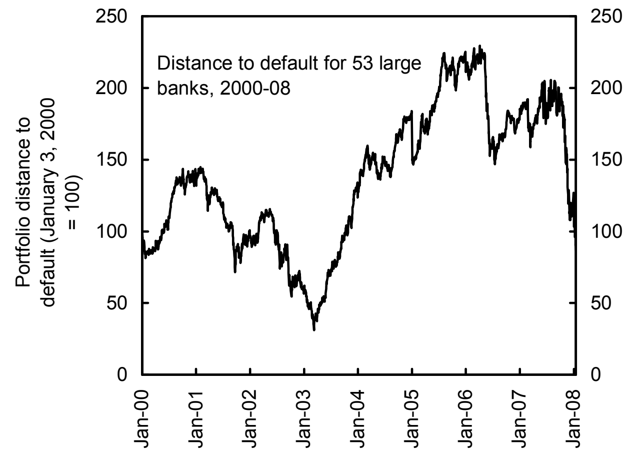
Risks to growth are broadly balanced.



[4] See *Regional Economic Outlook: Europe*, April 2008.

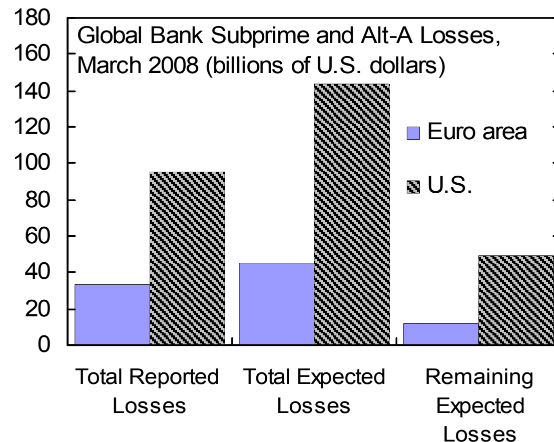
Box 3. Financial Sector Stress, Credit Volume, and Euro Area Output

An analysis* of linkages between the euro-area financial and real sectors shows that the supply of bank loans responds negatively to declines in bank soundness. Specifically, a two standard deviation drop in distance to default for large euro area banks (which is the decline observed in July 2007–May 2008) can be associated with a 3 percentage point reduction in real credit growth. The analysis also shows that, in turn, a 1 percentage point decrease in bank loan supply corresponds to a 0.1 percentage point decline in real GDP in the euro area.

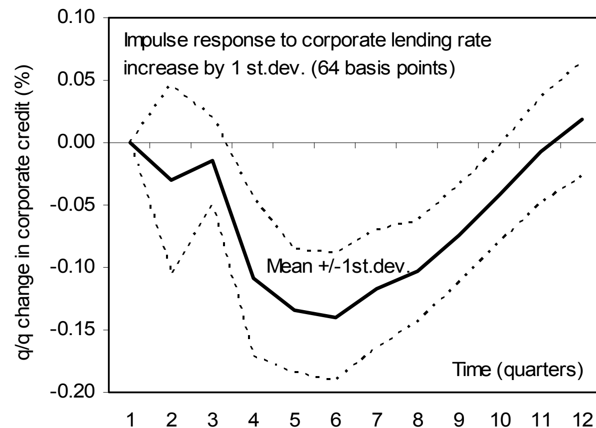


Sources: Staff calculations based on data from Datastream. Note: Distance to default is the difference between the expected value of assets at maturity and the default threshold, which is a function of the value of the liabilities. A higher distance to default is associated with a lower probability of default.

Based on these estimates, the developments in large euro-area banks' stocks since last summer imply a -0.3 percentage point impact on output. Alternatively, combining these estimates with April 2008 GFSR data on estimated losses in large euro area banks yields a -0.2 percentage point impact on output. EC work suggests similar numbers. These effects may be larger if banks are subjected to more shocks or if losses in non-euro area banks have an appreciable euro-area impact (euro-area banks account for only 37 percent of the "European bank" losses in the GFSR, the rest being accounted for mostly by Swiss and U.K. banks).



Regarding the linkages between interest rates, lending volumes, and output, VAR calculations confirm that higher interest rates transmit to loan volumes and output with lags. The maximum impact on loans comes with a lag of 6 quarters, while the first 3 quarters are characterized by very little impact on corporate credit (and even a small "hump" in household credit).



* See Selected Issues, Chapter I, and forthcoming IMF Working Paper "From Subprime Losses to Subprime Growth? Evidence from the euro area", by Martin Čihák and Petya Koeva Brooks.

II. Inflation and Monetary Policy

12. **All main forecasts expect headline inflation to decline appreciably**. Headline inflation is kept up around 3½ percent mainly by high energy and food prices and is forecast by staff to move below 2 percent some time in 2009, a projection that ECB and EC representatives considered "slightly optimistic", though it is not ostensibly out of line with their central scenarios. The key considerations are:

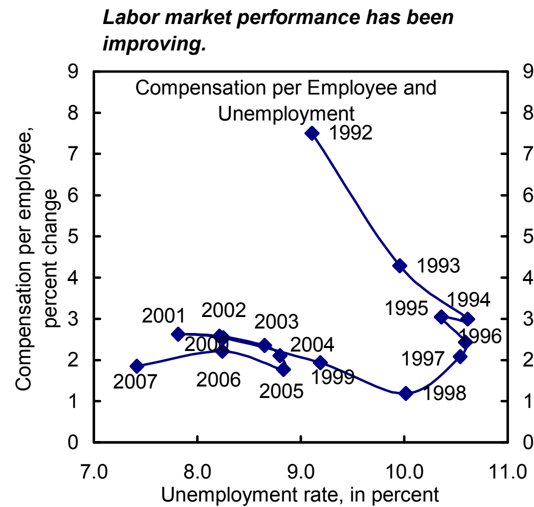
Inflation to decline during 2008/09

	Vintage	2007	2008	2009
			Projections	
WEO	Current	2.1	3.2	2.3
ECB	June	2.1	3.2-3.6	1.8-3.0
EC	April	2.1	3.2	2.2
Consensus	May	2.1	3.1	2.1

- Energy and food prices are assumed to stabilize in 2009 and inflation expectations have remained anchored. ECB surveys suggest that the probability that analysts attach to inflation reaching or exceeding 2 percent over the long term has been rising only gradually and that the average of analysts' point estimates is still holding at 1.9 percent.

- Compensation per employee has been growing at the low level of around 2½ percent per annum since 1999, despite large price shocks and falling unemployment (Figure 12).

Labor market performance has been improving.



Sources: OECD, ECB, and Fund staff estimates.

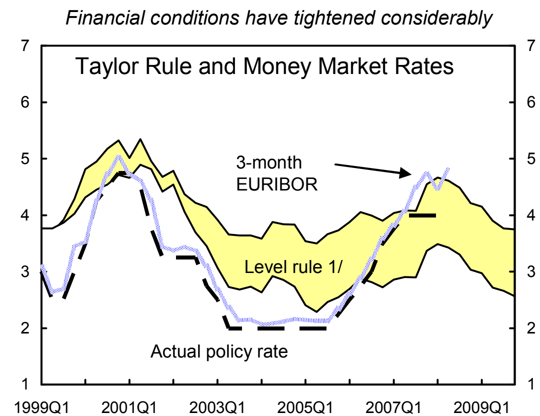
- Data for labor compensation in 2008Q1 suggest that wage hikes have reached the relatively higher 2000–03 range, with settlements in industry and construction pulling ahead. But with below potential output growth through 2009, staff projects that any further acceleration will remain contained. The Commission forecast is similar, with unit labor cost growth settling below 2 percent in 2009. While neither the EC nor ECB staff projections assume broad-based second-round effects, their representatives stressed the acceleration in labor compensation during 2007—with negotiated wages increasing 2.8 percent according to 2008Q1 data, up from 2.2 percent in 2007—and saw rising risks. Staff derives more reassurance from the past performance of the labor market: these wage increases are not out of line with projections and, usually, labor markets tend to peak after the cycle has turned.

13. **The inflation outlook is widely considered highly uncertain, with ECB representatives seeing the risks clearly on the upside**. Energy and food prices have been surprising on the upside repeatedly and headline inflation is hovering at levels that are the highest in a decade. There is also a risk that the effect of the ongoing catch-up of wages in Germany is not sufficiently countered by moderating wage growth in other parts of the area, or that it is even emulated. Both EC and ECB representatives stressed the upside risks related to second-round effects on account of inflation overshooting the 2 percent target for many months, pointing to the threat presented by wage indexation schemes in a number of

euro-area member countries. Staff viewed the related risks as relatively contained given the details of most of the indexation schemes in question and argued that downside risks to inflation become more relevant beyond the near term. There was agreement that these risks relate to a greater-than-projected weakening of activity, further euro appreciation, and a reversal of commodity prices, to the extent speculative forces have been at play.[5] But all of the mission's interlocutors—except the employers and trade unions—saw upside risks prevailing.

14. **Amid robust money and credit growth, the ECB has kept rates on hold thus far**.[6] The ECB has been drawing attention to "continuing very vigorous money and credit growth and the absence of significant constraints on bank loan supply up to now" (Figure 13). In its view, robust underlying monetary expansion continues to point to upside risks to price stability over the medium to longer term. Staff attaches less importance to monetary aggregates in assessing inflation prospects (¶17).

Financial conditions have tightened considerably



1/ The formula gives equal weight (0.5) to the deviation from the inflation target and the output gap; the lower band is based on an estimate of the natural rate from a factor model using a panel of international interest rates--the upper band is based on a natural interest rate equal to 4.15 percent.

15. **The discussions focused on how to balance the immediate upside risks to price stability from high commodity and food prices with the downside pressures stemming from weakening activity going forward**. Financial conditions have tightened appreciably since the summer of 2007: 12-month interbank rates are up 1 percentage point, reaching 5½ percent—a level last attained in the mid-1990s; risk premia have widened by 50–200bp; and the real effective exchange rate has appreciated by some 5 percent. At the same time, economic prospects have worsened. The question is whether policy tightening is needed to keep inflation expectations well-anchored and move inflation to below 2 percent over the medium run. ECB representatives have recently suggested that this may be the case, underscoring that the situation requires "a state of heightened alertness" and leading markets to price in a 25bp hike in July, with a small probability of another 25bp move by end-year (Figure 14). For its part, staff does not see a compelling case for further tightening. First, central projections of EC, ECB, and IMF staff foresee real GDP growth slowing to below potential, with inflation declining appreciably, at least to very close to 2.0 percent by end-2009 (or less in the case of IMF staff). Second, all market-relevant interest rates—the exceptions are ECB policy rates and government bond yields—are already noticeably above "neutral", which staff estimates in a broad range centered around 4–4½ percent. Thus, there is already a good deal of insurance against upside risks to price stability in the system. And third, tightening in the face of a still uncertain

[5] Rules of thumb suggest that a 10 percent real effective appreciation of the euro reduces prices by 0.5 percentage points in two years, while 10 percent permanent decline of oil prices reduces inflation by 0.1 percentage points in a year.

[6] This report was finalized before the July 3 meeting of the ECB Governing Council.

outlook for financial stability carries its own risks. Accordingly, staff considers that rates should stay on hold. Tightening, however, would be appropriate if, contrary to prevailing projections, forward-looking indicators no longer pointed to significantly growing slack, or wage settlements for 2009 hinted at accelerating labor costs.

16. **Regarding the monetary policy framework, ECB representatives stressed the usefulness of the two-pillar approach to monetary policy**. The motivation for the *monetary analysis*, which complements *economic analysis*, is that the ECB sees "the more drawn-out and persistent trends in inflation" to be "empirically closely associated with the medium-term trend growth of money." There is, therefore, in the ECB's view, a need to explicitly take information from monetary developments, which might otherwise risk being overlooked or underestimated, into due account in policy considerations. As an example, ECB representatives mentioned the hike in interest rates in December 2005, which hinged crucially on the upside risks to price stability identified by the monetary analysis. Currently, ECB work is geared toward further refining its monetary analysis with a view to gaining a better understanding of financial sector and asset price developments and their relations to economic growth and inflation.

17. **Staff welcomed the work on broadening monetary analysis but saw room for clarifying the relative role of monetary aggregates in the presentation of monetary policy decisions**. Monetary analysis has proven useful in understanding the recent financial turmoil—shedding light, for example, on the issue of re-intermediation—and its possible impact on economic growth. However, while monetary analysis has some value for gauging inflationary pressure over the policy-relevant medium run, this is limited (particularly in recent years) and not independent of non-monetary factors.[7] As a result, staff considers that the signals from the analysis of monetary aggregates are overemphasized in the presentation of monetary policy decisions. The fruits of the work on broadening monetary analysis, aside from bringing new medium- to longer-run considerations to bear on monetary policy (e.g., asset prices), could therefore usefully lead to a presentation of policy decisions that unifies economic and monetary analysis and that provides a clearer narrative of the relative role of monetary aggregates in influencing the policy stance.

III. Liquidity Management

18. **The ECB has taken a number of initiatives to ease tensions in money markets**. The ECB's broad list of eligible collateral and counterparties—other central banks have since moved in this direction—proved a significant advantage from the start of the turmoil; relatively high but flexible reserve requirements have provided a useful buffer to banks; and the ECB's toolkit allows significant scope for adapting its operations to the needs of the market. The ECB conducted fine-tuning operations, increased the share of liquidity provided

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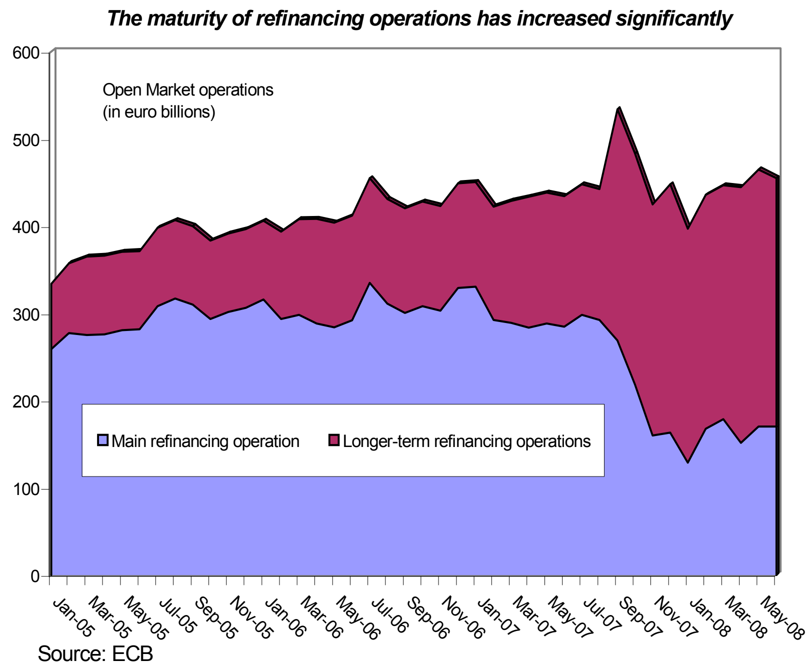
[7] See Selected Issues Paper, Chapter II; and forthcoming IMF Working Papers "The ECB's Monetary Analysis Revisited" by Helge Berger, Thomas Harjes, and Emil Stavrev; "The Information Content of Money in Forecasting Euro Area Inflation" by Helge Berger and Emil Stavrev; and "Does Global Liquidity Matter for Monetary Policy in the Euro Area?" by Helge Berger and Thomas Harjes.

through its three-month refinancing operations, and introduced six-month operations.[8] As a result, the maturity of refinancing operations has increased significantly, although there has been no net injection of liquidity over the respective reserve maintenance periods.

19. **While generally satisfied with the liquidity management framework, ECB representatives noted that it remained under active review**. The fact that interbank term spreads remain elevated is seen to reflect liquidity hoarding in response to bank balance-sheet stress—notably fear of potentially harsh market punishment—and counterparty risk, which has however been diminishing. There was agreement that little more was left for liquidity management *per se* to do to foster a return of markets to normal.[9] This did not exclude the possibility that the framework might be reviewed, if necessary to foster interbank transactions. Similarly, the collateral received remains under continuous assessment, to ensure it meets the Eurosystem's risk tolerance level and that the rules outlined in the collateral framework are strictly applied. In this context it was also noted that the possibility for banks to use as collateral asset-backed securities that they have originated themselves likely helped prevent a complete shut down of primary markets in the medium term. However, this could not be an alternative to the restoration of a deep and orderly functioning market offering true secured funding possibilities and thus the ECB stood ready to review this practice if necessary to restart markets. Staff also noted that, to limit moral hazard, liquidity management at the systemic level should be accompanied by a more rules-based approach to managing stress at the individual bank level (¶29). Longer-term, further integrating and developing secured interbank markets—via further progress in current efforts to integrate clearing and settlement systems—could reduce the risk and impact of similar stress.

The maturity of refinancing operations has increased significantly



Source: ECB

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[8] Also, currency swap lines have been established with the Federal Reserve to facilitate the provision of U.S. dollar liquidity in euro area markets.

[9] See Selected Issues, Chapter III, and the forthcoming IMF Working Paper "Bridge Over Troubled Waters: Liquidity Management in the Euro Area", by Martin Čihák and Thomas Harjes.

IV. Fiscal Policy

20. **The fiscal position of the euro area improved in 2007 and now compares favorably to that in other parts of the world, marking a success for the reformed Stability and Growth Pact** (SGP). In structural terms, the fiscal accounts of the euro area as a whole reached a close-to-balanced position (Figure 15). All excessive deficit procedures vis-à-vis euro-area countries have been closed, and about half of the countries reached or exceeded their "close to balance or surplus" medium-term objectives (MTO). Concurrently, the general government debt ratio continued to fall.

21. **However, a number of countries still face appreciable fiscal challenges, partly as a result of insufficient adjustment during the upswing**. Countries that have not reached their MTO include almost all those with high public debt. This is troubling, as population aging-related outlays are set to accelerate soon after 2010 and add some 3¾–5 percent of GDP to public expenditure by 2050. Also, the structural balance for 2007 may well turn out to be lower than presently estimated to the extent that tax elasticities have been procyclical; and overall stimulus in 2008 could turn out somewhat larger than the modest boost planned thus far (largely by relatively well-positioned countries), given pressures for measures to support citizens' purchasing power in the face of ever higher commodity prices. Staff argued that tax policy should not be used to limit the pass-through of rising energy prices. At the June ECOFIN, Ministers reiterated their Manchester commitment of 2005 to avoid policies that prevent adjustment; regarding energy and food price-related challenges facing poorer segments of the population, the commitment calls for interventions to remain short-term, targeted, and non-distortionary.[10] More recently, though, interpretations of this commitment appear to be varying across countries

22. **Some countries' fiscal deficits risk exceeding the Maastricht limit over the near term, potentially testing the reformed Pact's excessive deficit procedure**. The Commission has issued a fiscal *policy advice* to France, calling for strengthening the pace of budgetary consolidation so as to ensure that a suitable safety margin against breaching the 3 percent of GDP deficit threshold is soon attained.[11] Under EC and staff forecasts, other countries' safety margins (e.g., Italy, Portugal) also risk being rather narrow.

23. **There was broad agreement that the SGP rules provided the appropriate compass for fiscal policy in dealing with the current downturn**. Accordingly, automatic stabilizers should be allowed to play freely, except in countries where this might lead to breaches of the Maastricht reference value. Countries that have reached their MTOs could consider additional discretionary loosening, but others need to continue to adjust at a pace of at least ½ percent of GDP per annum, unless in "bad times" (as defined under the revised SGP). Several considerations support this approach: (i) a more activist stance would undermine the many benefits of countries' gradual moves toward a more rules-based fiscal

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[10] ECOFIN Manchester Press Release, September 2005.

[11] The *policy advice* is a new fiscal surveillance policy instrument, introduced under the 2005 reform of the SGP, which is available to the Commission and does not require Council approval.

policy; (ii) medium-run fiscal adjustment plans in Stability Programs still need to be backed up with measures; (iii) fiscal space needs to be preserved for higher aging-related outlays in the future; (iv) the implementation of fiscal actions that are high-quality, timely, temporary, and well-targeted faces high political economy hurdles in many countries; and (v) stimulus may lead to a further widening of government bond spreads in some countries while running counter to real exchange rate desiderata.

24. **The country authorities reiterated their support for the SGP**. Last year's commitment to reach MTO by 2010 had been made on the understanding that "good times" prevailed, notwithstanding negative output gaps in parts of the area. Ministers were generally intent on sticking with this objective, notwithstanding deteriorated cyclical prospects. For their part, Italy and France aim to attain their MTOs in 2011 and 2012, respectively. In virtually all countries, reaching these objectives will require the adoption of measures that have yet to be specified in Stability Programs.

V. Integrating Europe's Financial Sector

25. **The EU's financial stability framework is being reformed**. The core issue is that national authorities' fiduciary responsibilities are toward national governments and parliaments, limiting the incentives to work toward a common EU-wide stability framework, which is essential for full financial integration.[12] Growing recognition of the limitations of the existing arrangements and their tensions with financial integration, combined with the impetus provided by the financial turmoil, has forged a convergence of views in favor of reform. Staff has for some time been arguing for more information sharing; better crisis prevention, management, and resolution frameworks, including at national levels; and greater joint accountability and responsibility for EU-wide financial stability.

26. **New policy principles and a Memorandum of Understanding (MoU) ask member states to look beyond national borders when managing and resolving crises**.[13] The MoU commits member states to act in crises in ways that minimize the "potential harmful economic impacts at the lowest overall collective costs." If public resources are needed to achieve a cost-minimizing solution to a crisis, then "direct budgetary net costs are shared among Member States on the basis of equitable and balanced criteria." The formal recognition of a collective responsibility and of cost-sharing is an innovative step forward. However, it is widely recognized that tensions between national interests in times of severe crises would probably not be resolved via a non-binding MoU. Furthermore, staff noted its concern—shared by others—that the MoU risked adding a large number of bilateral, trilateral, etc. committees to an already complex supervisory cross-border set-up, rather than

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[12] See ¶25-28 in *Euro Area Policies: 2007 Article IV Consultation - Staff Report* and *Integrating Europe's Financial Markets*, by Jörg Decressin, Hamid Faruqee, and Wim Fonteyne.

[13] EU Memorandum of Understanding on Cross-Border Financial Stability
http://www.ecb.int/pub/pdf/other/mou-financialstability2008en.pdf

taking a true multilateral approach, which would also facilitate international coordination.[14] The MoU is to be tested with a crisis simulation exercise in 2009.

27. **Efforts are also underway to accelerate financial integration**. EU Directives typically provide considerable latitude for country-specific regulatory and supervisory policies and practices. It is now recognized that such broad latitude creates unnecessary costs for financial market participants and may hinder the completion of the single market. The current reform program seeks to reinforce the EU Committees of Supervisors (Lamfalussy level 3 committees—CEBS, CESR, CEIOPS)—which have been set up with a view to fostering regulatory and supervisory convergence—by giving them more resources, introducing scope for qualified majority voting, and strengthening the national application of the "Level 3 guidelines", while keeping their non-binding nature ("comply or explain"). In addition, the May ECOFIN called on member states to endow their supervisors' statutes with a European mandate so that they "are able to take into account the EU dimension in the performance of their duties, including having regard to the financial stability concerns in other Member States in exercising their duties."

28. **Moreover, a number of initiatives are underway to strengthen specific elements of the EU financial stability framework, including in response to the latest turmoil**. These include developing proposals to speed up work on the convergence of regulatory and financial reporting; improve Deposit Guarantee Schemes and, relatedly, allow for authorities to apply early intervention and reorganization measures to cross-border groups; and assess the obstacles to asset transferability that could hinder crisis management of cross-border groups, with a view to forestalling counter-productive ring-fencing of assets, and facilitating smooth crisis management. The response to the latest turmoil—on which the European institutions are working with international standard setters—covers four areas: enhancing transparency; improving valuation of financial products; strengthening prudential requirements; and making markets function better.[15] Priorities include introducing international standards for liquidity regulation; reducing incentives for regulatory arbitrage, off-balance sheet exposures, and exposure concentration; and strengthening the oversight of credit rating agencies.

29. **The mission welcomed the ongoing efforts and pressed for legal and practical steps to effectively implement the agreed policy principles**. In the wake of the financial turmoil, the political will should be found to make rapid progress in several areas:

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[14] Specifically, under the MoU countries that share a single or several financial groups are to conclude non-legally binding Voluntary Specific Cooperation Agreements for shared financial groups, which are to provide for "specific and detailed crisis management procedures", including the establishment of "Cross-Border Stability Groups" (CBSG) that build on "Domestic Standing Groups" (DSG) as well as existing "colleges of supervisors" (CS). These will operate alongside the level 3 Committees (CEBS, CESR, CEIOPS), the European System of Central Banks (ESCB), and the Financial Services Committee of EU Finance Ministries.

[15] For further details see May 15, 2008, "ECOFIN Council of Finance Ministers adopt conclusions on financial supervision and provision of financial stability in the EU".

- establishing a multilateral platform for real-time sharing of systemically relevant supervisory information among supervisors and central banks, including the ECB, given central banks' roles in providing liquidity, overseeing payments systems, and assessing financial stability; and the need for better coordination and early crisis detection;

- improving Deposit Guarantee Schemes: the standards for speed of payouts, limiting co-insurance, and informing depositors could be raised, without major legislative action;

- determining common criteria for applying early intervention and reorganization measures, especially to cross-border groups; ultimately, this will need to be supplemented with progress on thornier issues, such as moving to a convergent bankruptcy framework. Difficulties are considerable, as such progress would require substantial changes to EU members' legal frameworks.

- giving "teeth" to the planned European dimension in the mandates of national supervisory authorities, clearly ruling out "beggar-thy-neighbor"-type policies, supported by appropriate accountability (Box 4).

Box 4. A "European Mandate" for Financial Sector Supervisors *

Tendencies towards economic nationalism in financial sector regulation and supervision could in principle be countered if regulators and supervisors were mandated to take into account common European interests. The mission discussed proposals for a European mandate, bearing in mind several issues:

- **The European mandate should be formulated in such a way as to focus on financial sector stability and efficiency**. It could state an overall objective, followed by a more specific list of "dos and don'ts" (e.g., do work toward integrating EU financial markets; don't take unilateral actions with adverse spillovers on other EU countries).

- **At a minimum, member institutions of the so-called Level 3 Lamfalussy Committees (i.e., supervisors and regulators) as well as the Committees themselves should be covered**.

- **The mandate should preferably have the force of law and have precedence in case of conflict with national mandates**. Voluntary mechanisms can help implement a European mandate during normal times, but may seize up in stress situations.

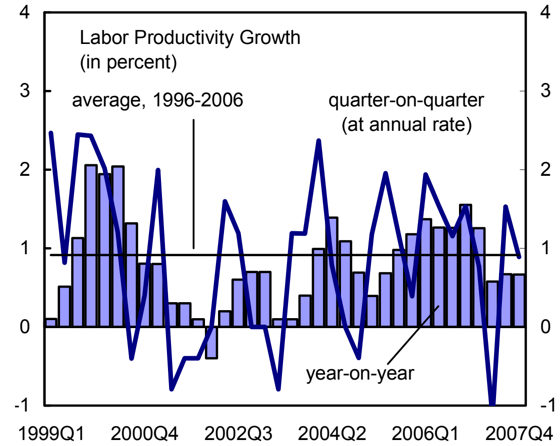
- **Accountability must match the mandate**. The EU Commission (with assistance of the Lamfalussy Committees) would be competent to review observance of a European mandate enshrined in an EU legal instrument. The private sector should also be empowered to assess whether authorities are fulfilling their mandates, and to challenge those that are not.

* For further details, see Selected Issues, Chapter IV, and the forthcoming IMF Working Paper "A European Mandate for Financial Sector Authorities in the EU", by Daniel Hardy.

VI. 10 Years of EMU: Progressing with Economic Union

30. **While monetary union has been a distinct success, economic union remains work in progress**. The labor market has performed better than anticipated by the many critics who considered the euro area as falling far short of an optimal currency area. Nonetheless, productivity growth has been lackluster and intra-area economic divergences are a concern. Specifically:

Labor productivity growth has been lackluster.



Source: ECB; and Haver Analytics.

- *Living standards have been improving but less than might have been hoped*. Labor utilization is no longer far off a trajectory that hits the 2010 Lisbon target (an employment-to-working age population ratio of 70 percent). This testifies to the success of past reforms that have boosted job creation to US levels, notwithstanding appreciably lower population growth. At the same time, however, productivity growth has been sluggish.

- *While integration is much higher now than before EMU, the euro area is still experiencing large internal imbalances*.[16] To a significant extent, these are adjustment dynamics that reflect convergence from different starting points and progressing integration following the introduction of a single currency; they will take time to work out in full. However, countries' imbalances also reflect important remaining structural differences and, in the current environment, constitute a source of vulnerability.

31. **The Lisbon Agenda is seen to offer a shared vehicle to address intra-area divergences but countries' reform programs need to be reoriented in a coordinated manner**. Staff and the Commission concurred that National Reform Programs (NRP) under the Lisbon Agenda need to focus more on making the single market a reality, particularly by opening up national services markets—including for financial services—to competition from EU partners. Tellingly, productivity growth has been particularly sluggish in services and differences in services price inflation account for a large part of inflation and competitiveness divergences. Progress in this direction is also consistent with the area's commitments under the Fund's Multilateral Consultations (Table 5). The Commission also underscored that financial market reforms could facilitate other structural reforms by helping advance their payoffs. Moreover, reforms need to focus on facilitating labor market adjustment in response to shocks, even if much progress has been made in this respect since the mid-1990s.

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[16] For further analysis see Stavrev (2007), *Growth and Inflation Dispersions in EMU: Reasons, the Role of Adjustment Channels, and Policy Implications*.

32. **The Commission saw a clear need to broaden and deepen intra-area surveillance to address internal macroeconomic imbalances**.[17] Spillovers and interdependencies meant that current account and competitiveness divergences represent a concern not just for the country in question but for the euro area as a whole—the same reasoning applied to euro-area candidate countries, notably those already in ERM-2. The Commission also thought that more could be done with existing surveillance instruments to strengthen the incentives to pursue reforms that foster internal adjustment. To that effect, it inter alia proposes establishing a peer review mechanism based on the analytical framework developed under the Lisbon Strategy to take account of fiscally costly but adjustment-friendly structural reforms when implementing the SGP. Lastly, the Commission highlighted the need to enhance the euro area's international role, by developing common positions and by consolidating its representation, ultimately leading to a single seat in relevant international financial institutions and fora.

33. **Staff supported the objective of improving internal surveillance but stressed the risks related to allowing for a trade-off between fiscal adjustment under the SGP and structural reforms**. Fiscal adjustment and structural reforms are often complements: successful reform countries have typically progressed on both fronts at the same time.[18] Moreover, such a trade-off would be difficult to implement objectively. This could undermine the benefits of a rules-based fiscal framework, including greater predictability of fiscal policy, as well as peer pressure to respect the SGP. The Commission was confident that these problems could be avoided, provided a rigorous monitoring framework is put in place.

VII. Trade Policy and Food Prices

34. **The EU continues to seek to conclude on the substance of a Doha Round agreement before the end of 2008**. Commission representatives were of the view that significant progress is being made with respect to agricultural products and were cautiously hopeful that a broad agreement on Doha could be reached this year. In its bilateral trade relations, the EU has entered into interim or final economic partnership agreements with more than thirty African, Caribbean, and Pacific (ACP) countries in the last several months and will seek more final agreements with these and other ACP countries in the coming year. These are intended to be WTO-consistent free trade agreements (FTAs) to replace the Cotonou preferences for the ACP countries. While it attaches top priority to multilateral trade liberalization, the EU is also pursuing FTA negotiations with India, Korea, and the ASEAN and Mercosur countries, and is negotiating international investment agreements on behalf of the member states.

35. **The Commission has launched various initiatives to address the challenges posed by rising food prices**. Its strategy is to help developing countries cope through targeted development aid; ensure that market incentives are in place for a supply response to develop; and discourage export taxes and other barriers to international trade. The EU has taken

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[17] For further details, see European Commission, EMU@10.

[18] See Annett (2007), *Lessons from Successful Labor Market Reformers in Europe*.

various measures, notably suspending the "set-aside" for 2008–09, which should increase its cultivated farmland by about 10 percent. The Commission is of the view that the reformed Common Agricultural Policy (CAP) offers the appropriate incentives to trigger a supply response to the high food prices from European farmers, contributing to a good harvest in 2008. A "health check" of the CAP will be conducted next year, and will include consideration of abolishing the "set-aside" as well as further efforts to reduce supply restrictions. The EU's policies on biofuels—the production of which consumes a small but growing fraction of grains—are being kept under review.

VIII. Staff Appraisal

36. **Ten years after its launch, monetary union is a distinct and promising success**. EMU's macroeconomic policy framework has brought stability, both inside and outside the euro area, and the union has been expanding, with Slovakia set to become its newest member. In particular, despite major terms of trade shocks, labor costs have been subdued and employment growth remarkably strong over the past decade. The relative protection offered by EMU must, however, not detract from the effort of building a vibrant economic union to realize monetary union's full potential. Notwithstanding important achievements, this remains work in progress.

37. **Conjuncturally, the 10th anniversary of EMU witnessed the euro-area economy being strained by a combination of decelerating activity and uncomfortably high inflation**. High commodity and food prices, tighter financial conditions, weakening real estate markets, and slowing external demand are buffeting the economy, as is the appreciation of the real effective exchange rate of the euro, which is now on the strong side of medium-run fundamentals. As a result, growth will likely slow substantially in the coming quarters, before reaccelerating toward trend in 2009 as the effects of the various shocks unwind. However, the uncertainties around this baseline projection are large.

38. **Monetary policy has to balance the risk of a broad-based increase in inflation with the prospect of gradually building disinflationary forces generated by the economic slowdown**. Much now hinges on how labor costs and inflation expectations evolve. As the economy slows, reduced demand for labor and pressure on employers' margins should act as restraining forces. Assuming stabilizing commodity and food prices, inflation should thus recede appreciably in 2009—as reflected in official forecasts. The uncertainties around the outlook for inflation are exceptionally large, and while the durable improvements achieved under EMU in the functioning of labor markets and in anchoring inflation expectations provide some reassurance, risks of second-round effects remain. As do, conversely, the risks that could stem—in an already strained financial environment—from a further tightening of financial conditions, beyond that observed since summer 2007, when economic prospects were distinctly brighter. In this setting, a case for tightening would nonetheless arise if, contrary to prevailing projections, forward-looking indicators no longer pointed to significantly widening slack or 2009 wage settlements hinted at accelerating labor costs, raising the risk of rising inflation expectations. In the absence of such signals, however, policy rates are best kept on hold.

39. **Further development of the ECB's monetary analysis would help strengthen an already solid policy framework**. The ongoing efforts to broaden the analysis of the determinants of inflation, including financial market and asset price developments, are welcome. This work could usefully lead to a unified presentation of policy decisions that integrates monetary and economic analysis, thereby providing a clearer portrayal of the relative role of monetary aggregates in influencing the policy stance.

40. **The ECB's liquidity management has been timely and proactive and its framework—while possibly subject to refinements—has proven flexible and robust**. The broad lists of eligible collateral and counterparties and relatively high but flexible reserve requirements have acted as helpful stabilizers from the very start of the turmoil. Nonetheless, banks' balance-sheet stresses and fears of liquidity shortages are likely to keep interbank term spreads high for some time. The ECB is appropriately keeping its operational framework under continuous review, assessing carefully the collateral it receives and ensuring that the framework's rules are strictly applied. Longer-term, further developing secured interbank markets could reduce the risk and impact of similar stress, underscoring the urgency of integrating clearing and settlement systems.

41. **Political leadership and a strong multilateral spirit will be needed to move decisively toward the greater joint responsibility and accountability for EU financial stability implied in recent ECOFIN decisions**. The agreed principles for cross-border crisis management are mould-breaking. The key challenge now is to fully align the legal underpinnings of nationally-anchored financial stability frameworks with the commonly agreed principles. The recent Memorandum of Understanding on crisis management and the intention to strengthen the Level-3 Committees of Supervisors are significant steps forward, but should be complemented by more binding arrangements. In this regard, the planned introduction of a European dimension in the mandates of national supervisory authorities should clearly rule out "beggar-thy-neighbor"-type policies and provide appropriate accountability. Also, a multilateral platform for real-time sharing of systemically-relevant supervisory information among supervisors and central banks, including the ECB, is urgently needed. Medium term, firmer arrangements are needed to underpin the principles of collective crisis cost minimization and sharing of fiscal costs based on equitable and balanced criteria. All these steps will require strong political leadership—in many ways akin to that leading to the creation of the common currency—in a multilateral approach that would also facilitate collaboration with non-EU countries, which is essential in a globalized financial system with large cross-border financial institutions.

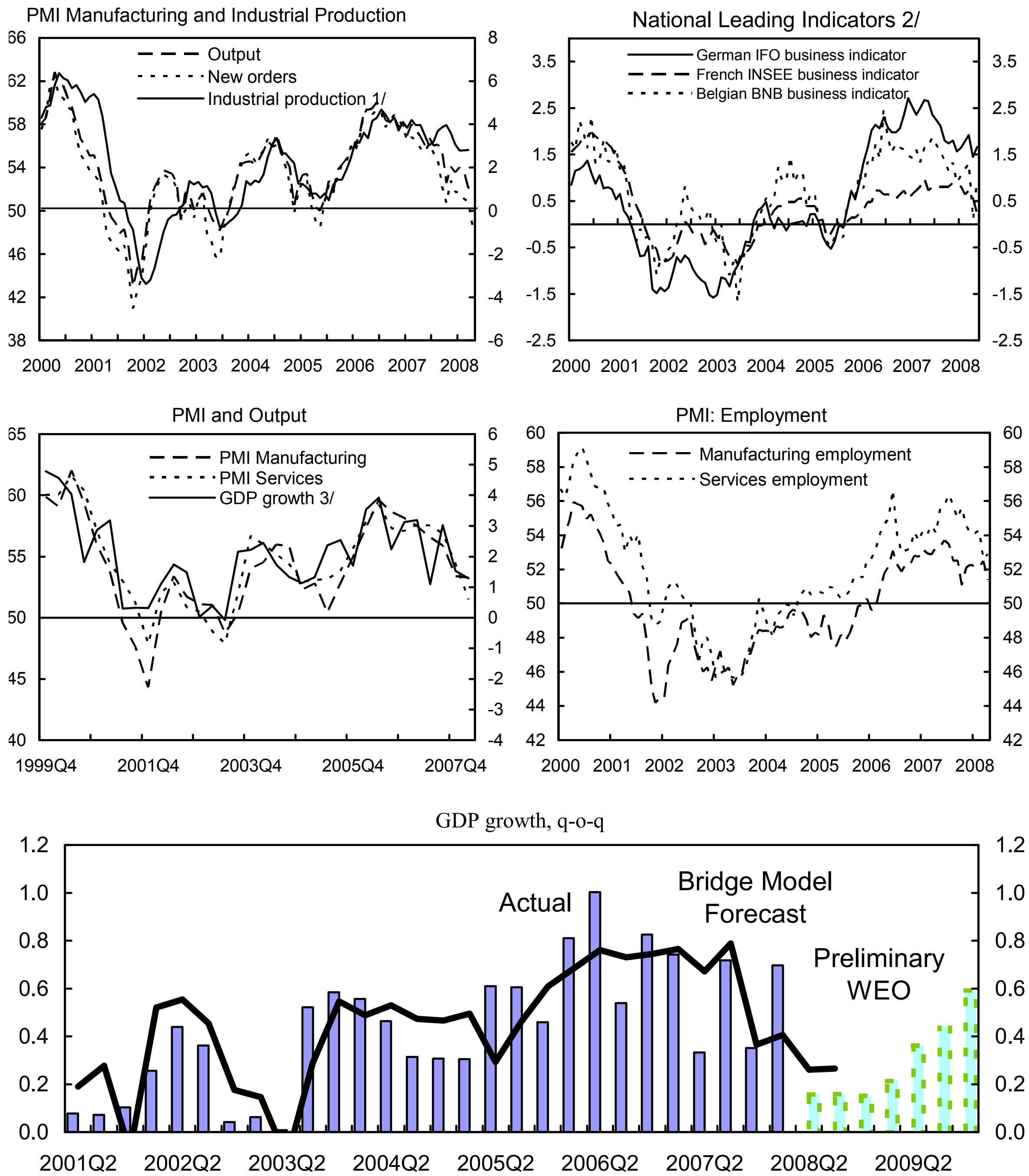
42. **A rules-based fiscal policy serves countries best, notably in today's uncertain environment**. The SGP has improved fiscal discipline, although about half of the euro area countries still face persistent challenges in meeting its objectives. Given growing expenditure pressures from catering to aging populations and the risk of unanticipatedly large cyclicality in fiscal fortunes, the room for policy adjustment in response to the current downturn must be a function of the leeway allowed by the SGP. Furthermore, tax policy should not be used to hamper adjustment to rising energy and food prices. Looking further ahead, stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries that struggle with relatively high public deficits and debt.

43. **The structural reform momentum needs to be kept up and re-oriented in a coordinated manner to improve adjustment in response to intra-area disparities and make further progress on commitments under the Fund's Multilateral Consultations**. The ongoing reforms are bearing fruit, contributing to the marked growth in employment and to improved productivity in liberalized sectors. However, large parts of the services sector remain unaffected, forfeiting important income, resilience, and inflation benefits. Accordingly, the reform recommendations under the Lisbon Agenda for the euro area as a whole appropriately emphasize accelerating services market reform and financial integration. Greater consistency of National Reform Programs with these euro-area recommendations is needed, requiring enhanced policy coordination.

44. **Prompt action is needed to conclude the Doha Round and bolster multilateral liberalization**. The right response to high food prices is to lower agricultural trade barriers and subsidies so as to foster the production and free trade of agricultural products. Approaches that emphasize self-sufficiency with respect to food production should therefore be resisted and biofuels policies kept under review. EU leadership in facilitating an ambitious and balanced conclusion to the Doha Round can provide a critical counterweight to rising protectionist pressures.

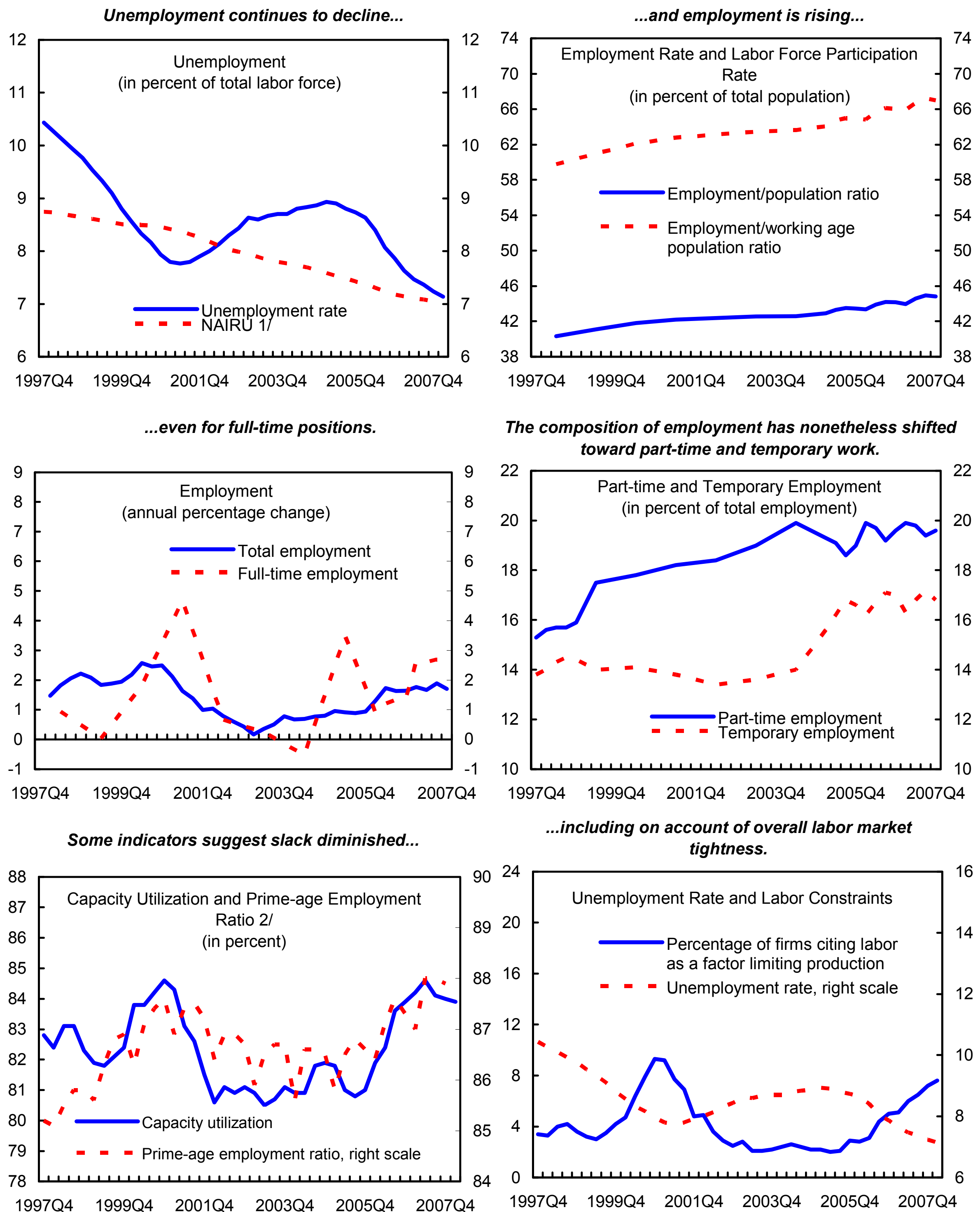
45. It is proposed that the next consultation on euro-area policies in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

Figure 1. Euro Area: Leading Indicators



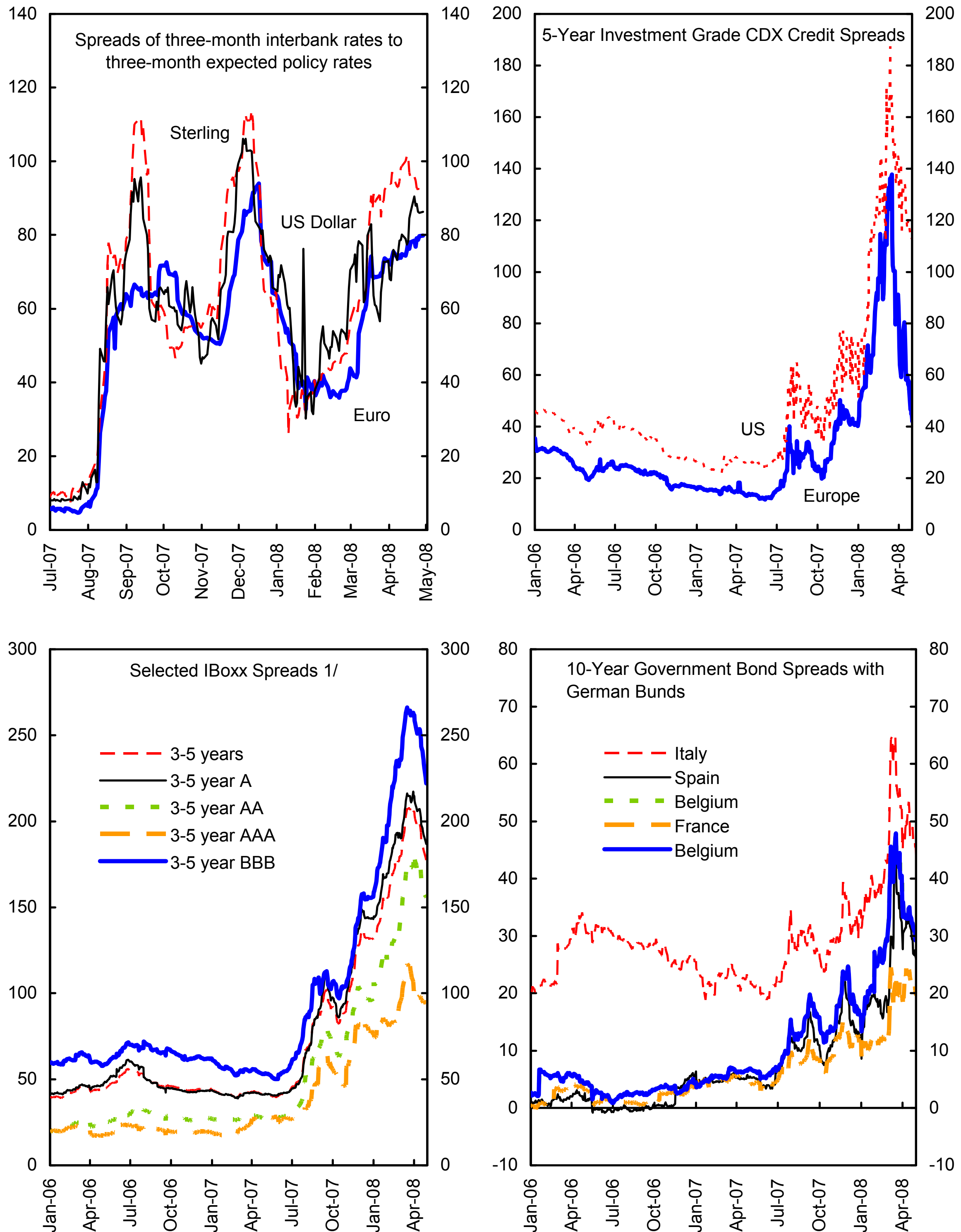
Sources: Eurostat, Reuters, IFO, INSEE, National Bank of Belgium, and staff calculations.

Figure 2. Euro Area: Labor Market Indicators



Sources: Eurostat; OECD; EC Quarterly Business and Consumer Survey; and IMF staff estimates.
1/ Excluding Greece, Luxembourg, and Slovenia.
2/ Prime-age males, 25-54 years old.

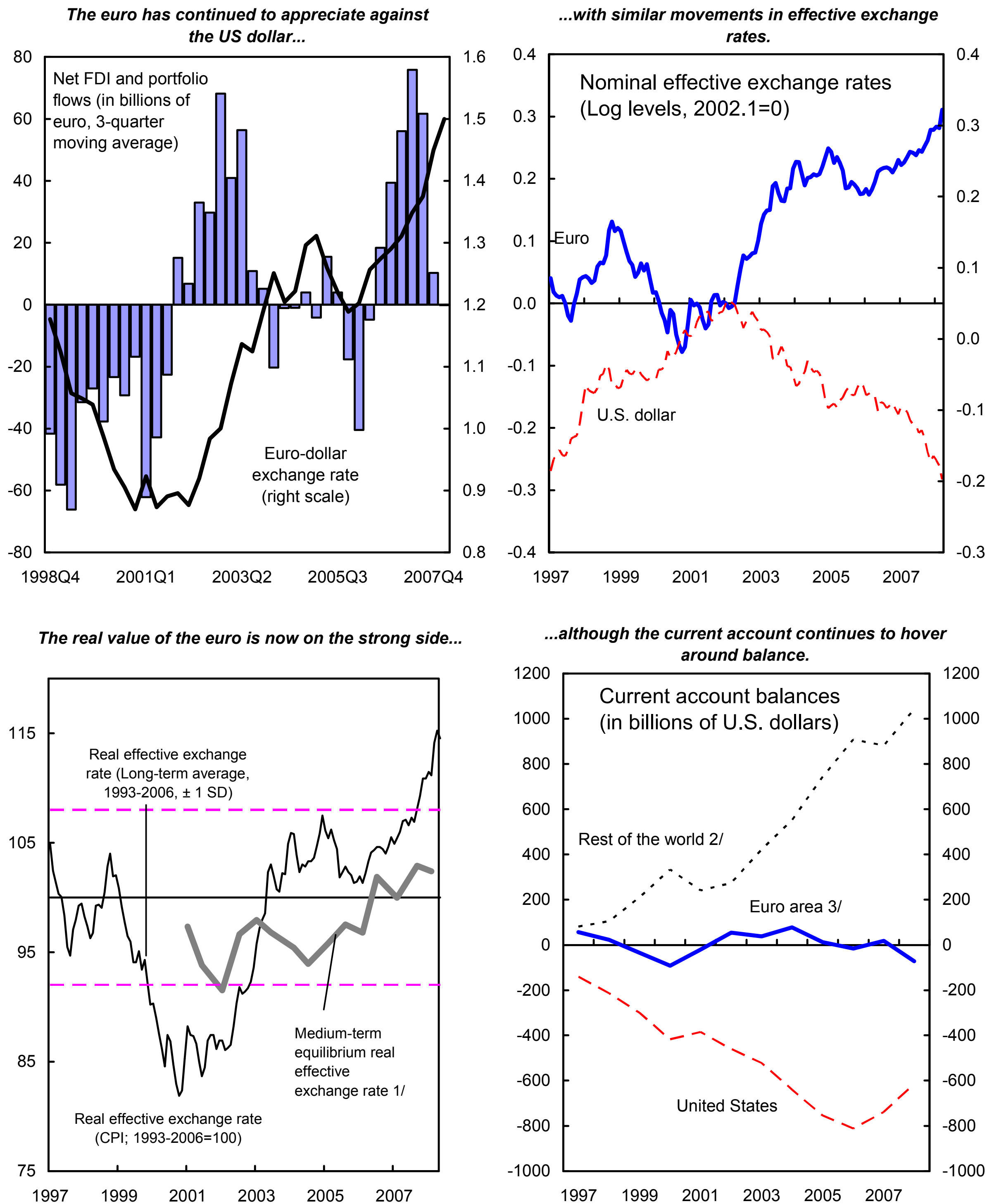
Figure 3. Euro Area: Financial Market Indicators



Sources: Bloomberg; and Datastream.

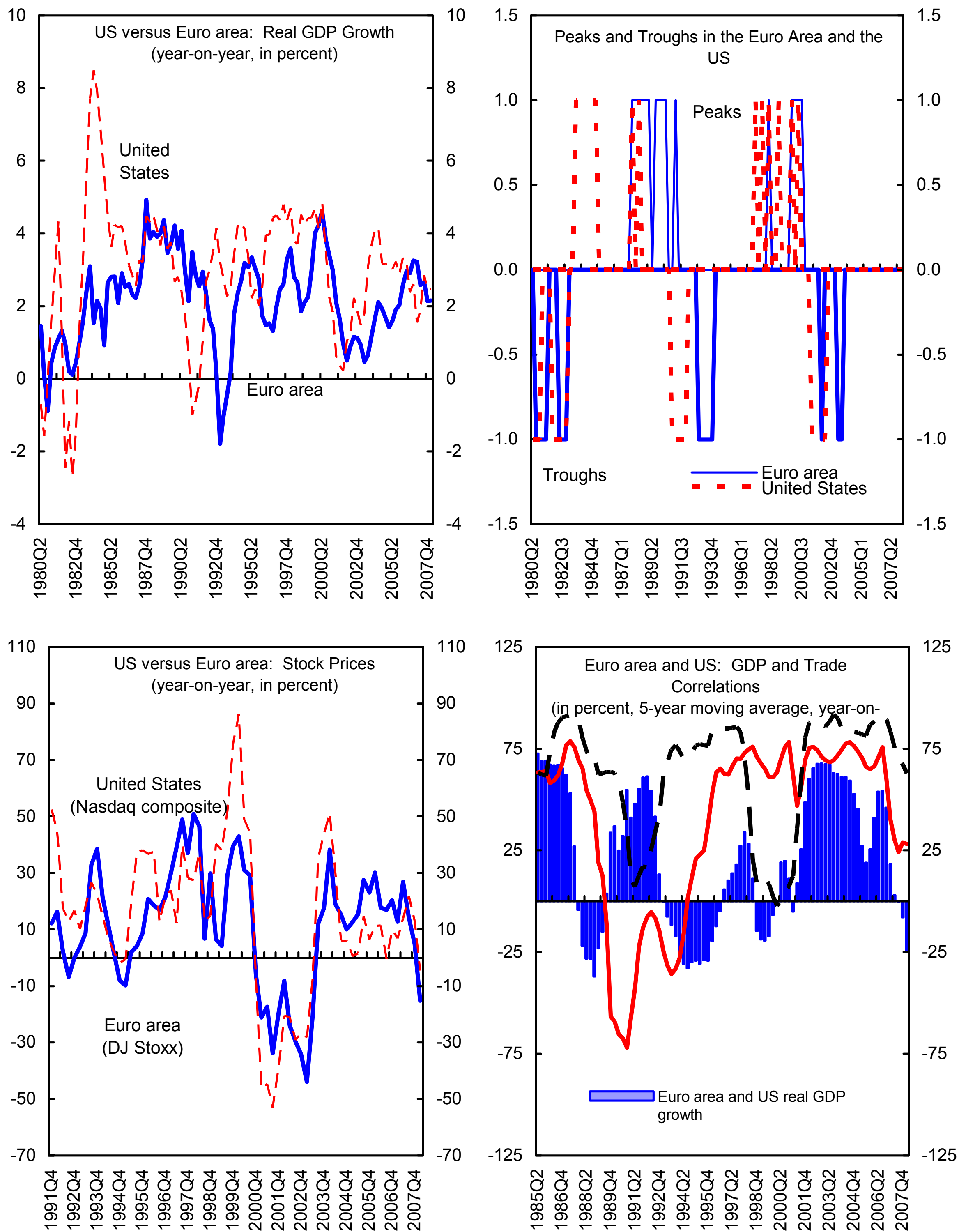
1/ IBoxx corporate bond rates over German benchmark bond yields.

Figure 4. Euro Area: External Developments



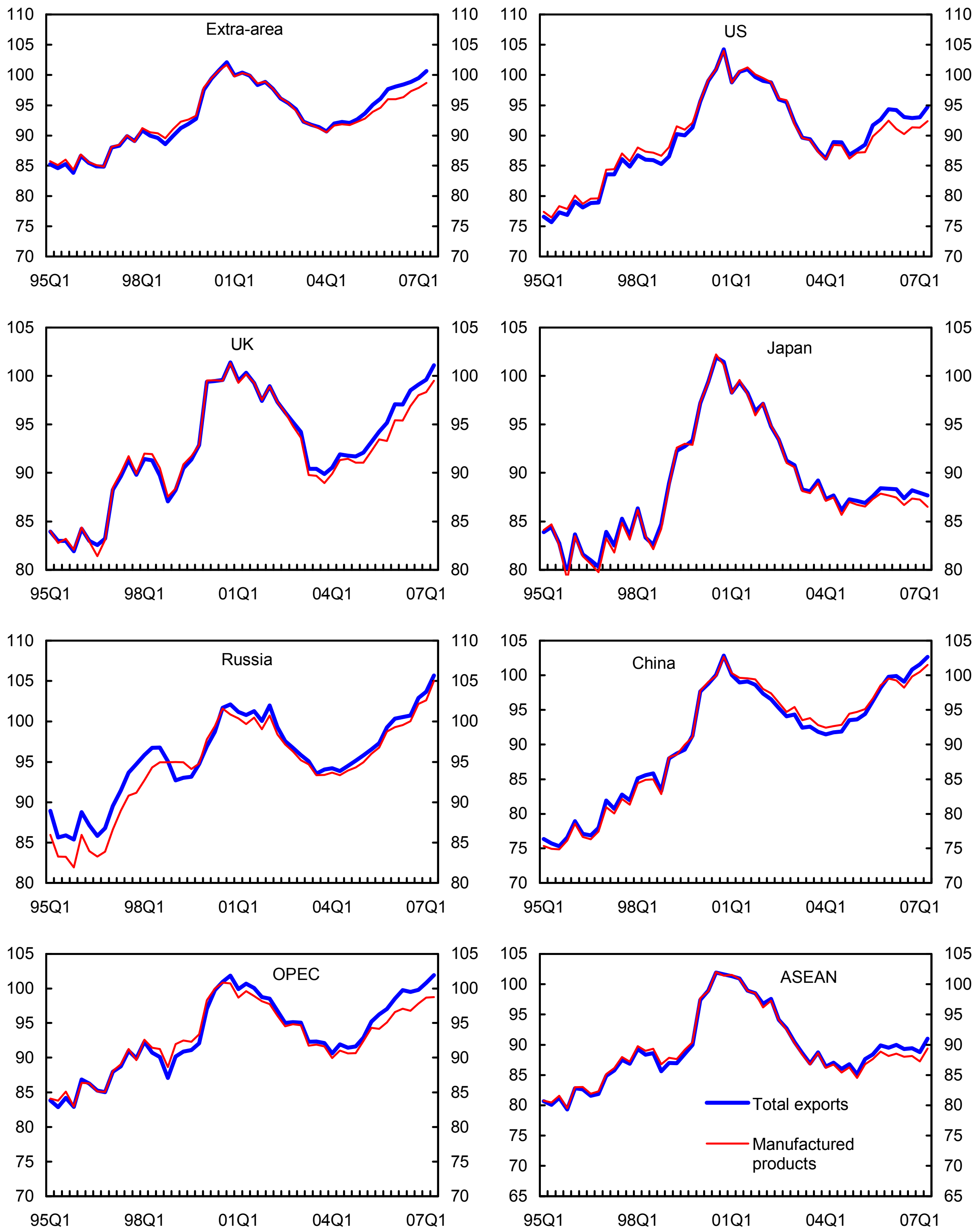
Sources: ECB; Haver Analytics; IMF, *World Economic Outlook*.
1/ Staff estimate, based on a time series estimate with stochastic trend, a macroeconomic balance approach, and an external sustainability assessment.
2/ Rest of the world calculated as residual (excludes global discrepancy).
3/ Excludes intra-area trade (ECB data).

Figure 5. Euro Area and United States: Co-movements in Activity and Financial Variables



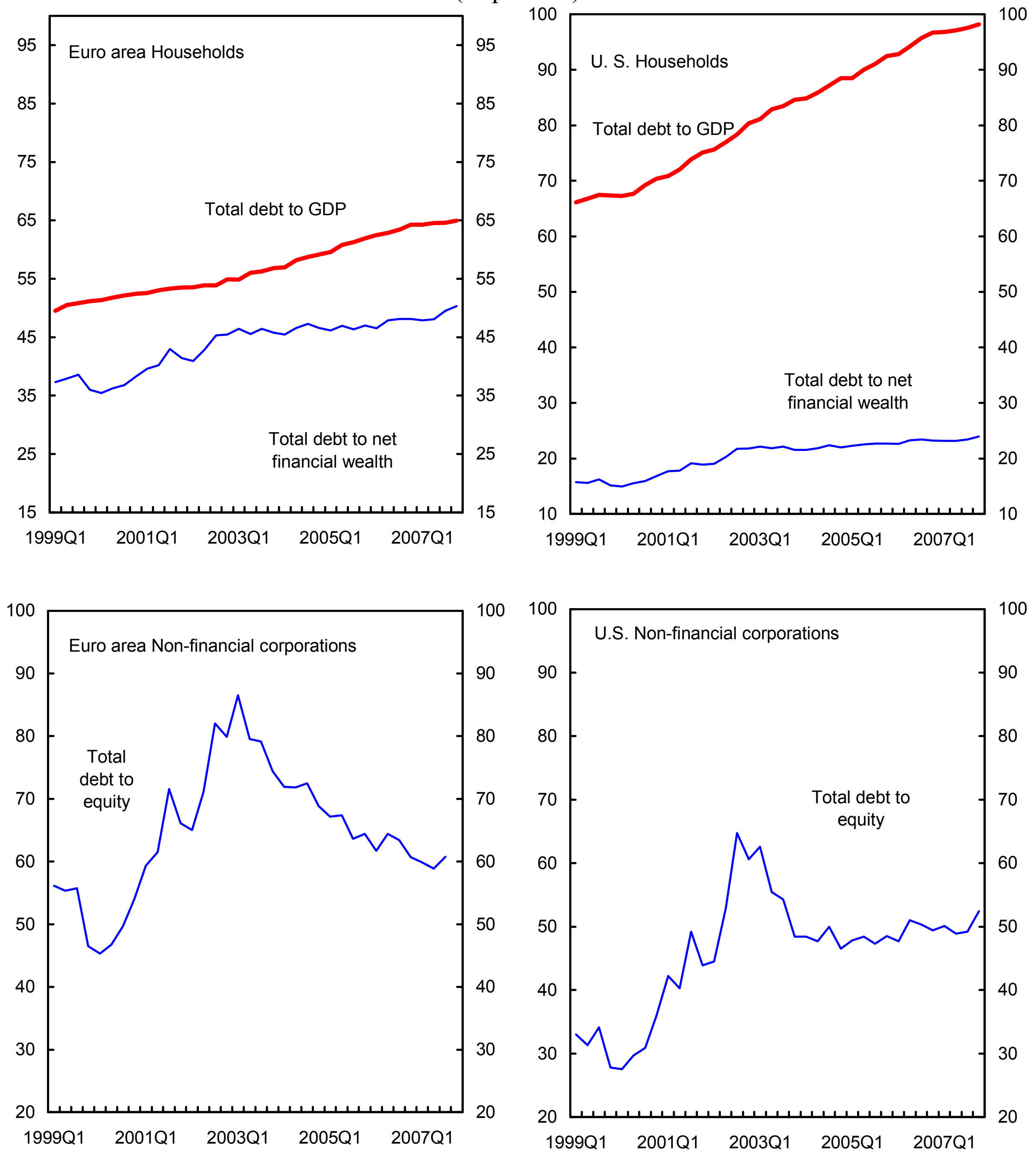
Sources: Haver, IFS, Eurostat, and IMF staff calculations.

Figure 6. Euro Area: Margins of Exporters to Main Export Destinations
(Export unit value relative to ULC in manufacturing, 2000=100)



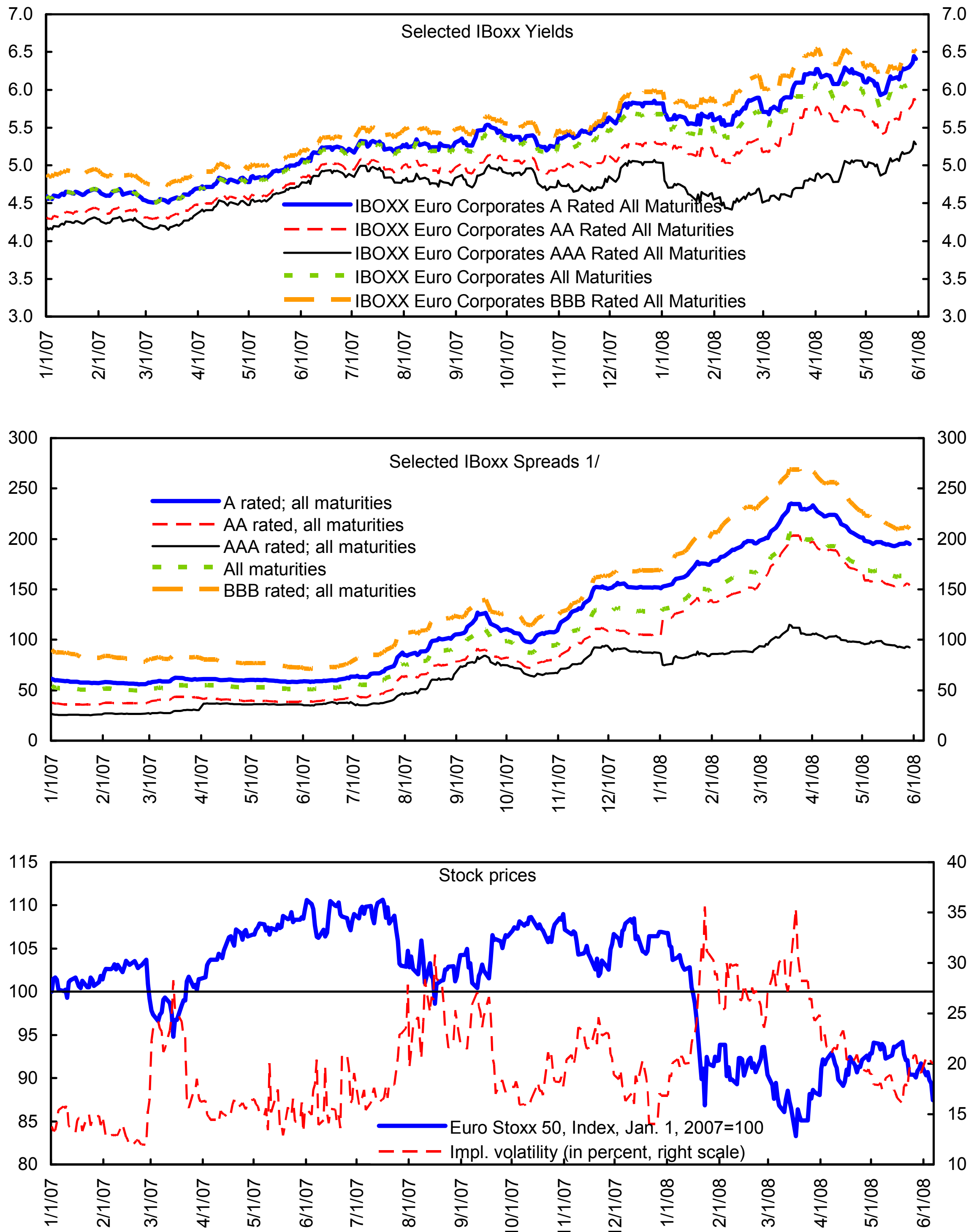
Sources: Eurostat, OECD, IMF staff calculations.

Figure 7. Euro Area and United States: Leverage Ratios
(In percent)



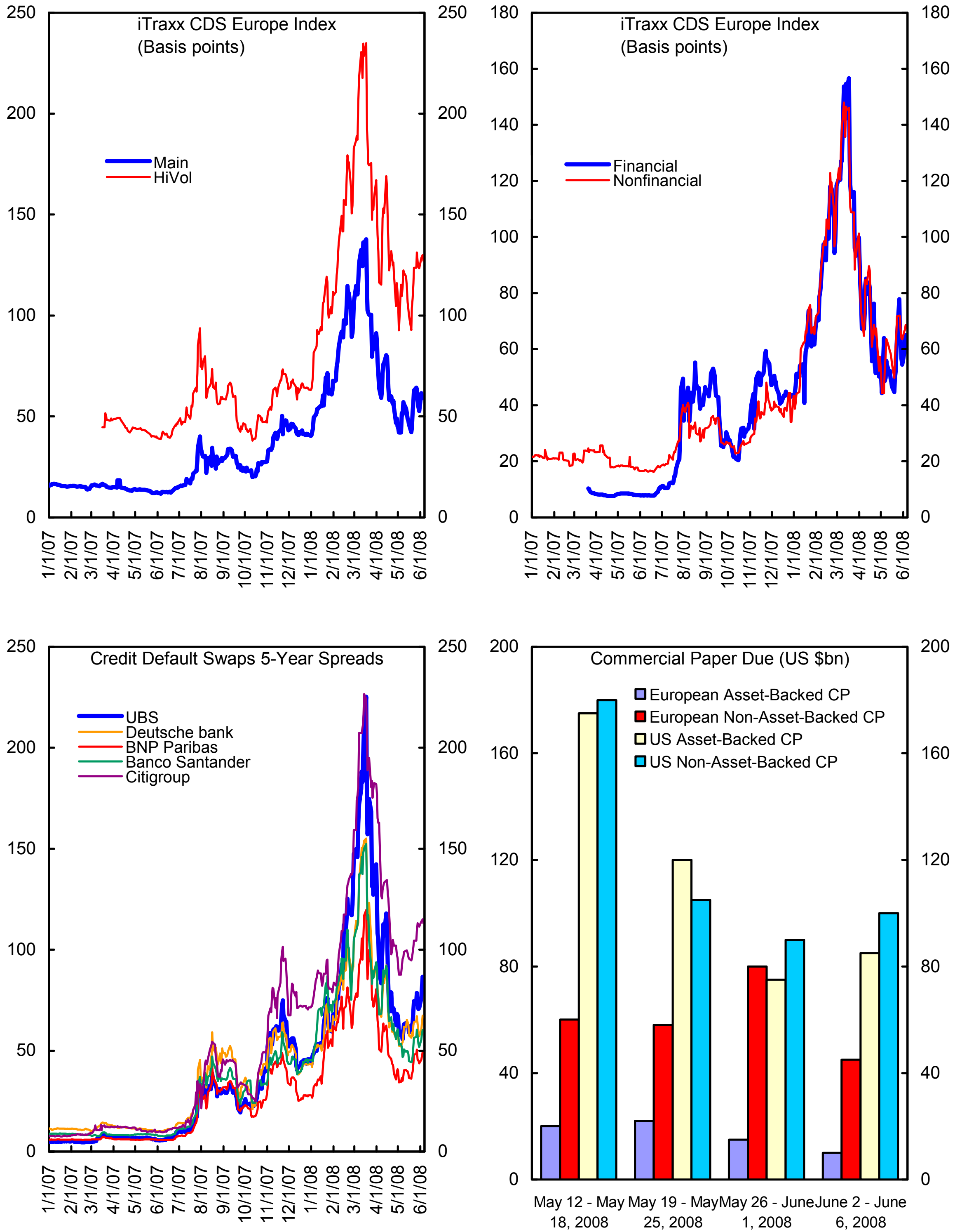
Sources: Haver Analytics; and IMF staff calculations.

Figure 8. Euro Area: Corporate Bond Rates and Equity Prices
(Yields in percent, spreads in basis points)



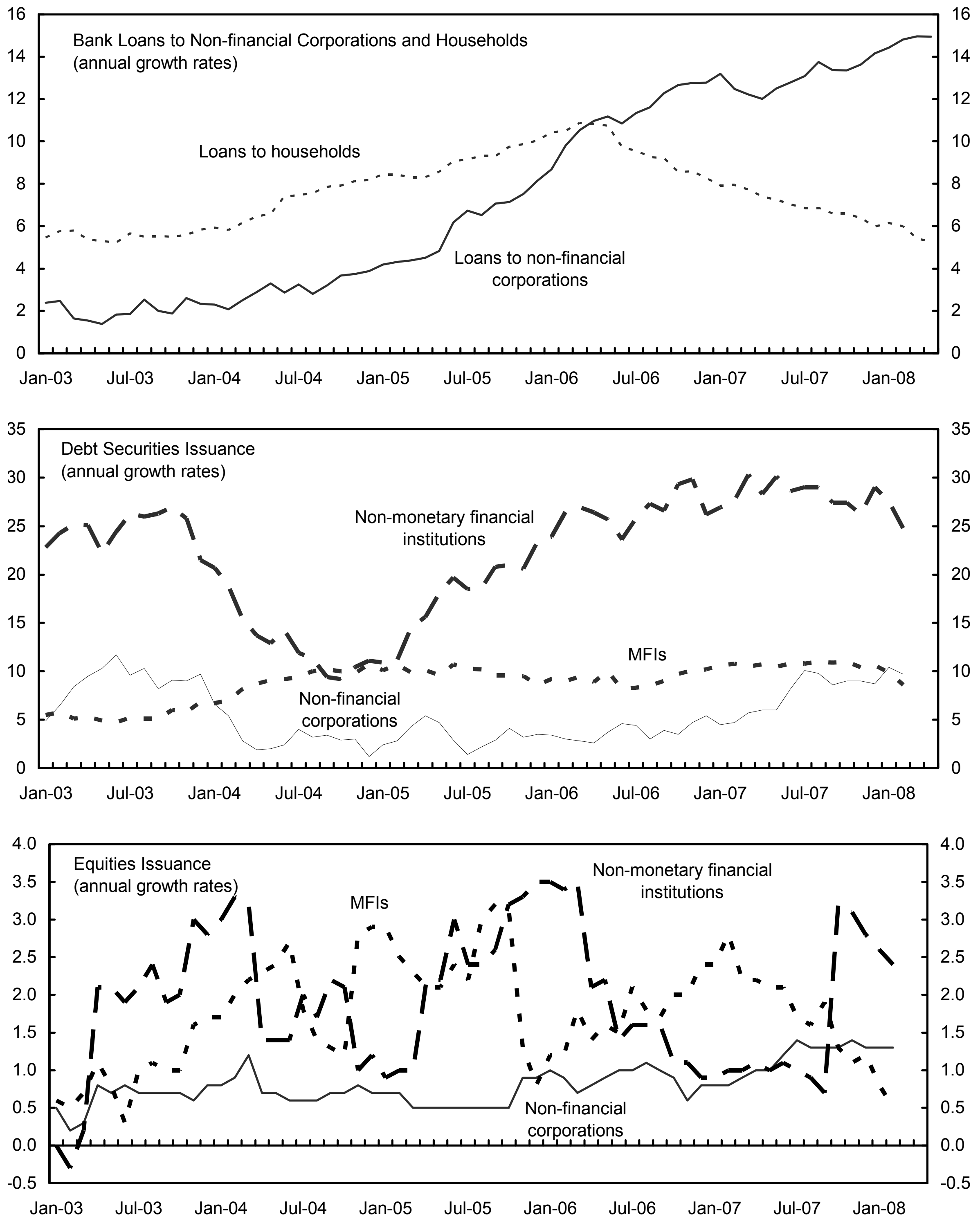
Sources: Thomson Financial/DataStream; and Bloomberg.
1/ IBoxx corporate bond rates over German benchmark bond yields.

Figure 9. Euro Area: Credit Markets



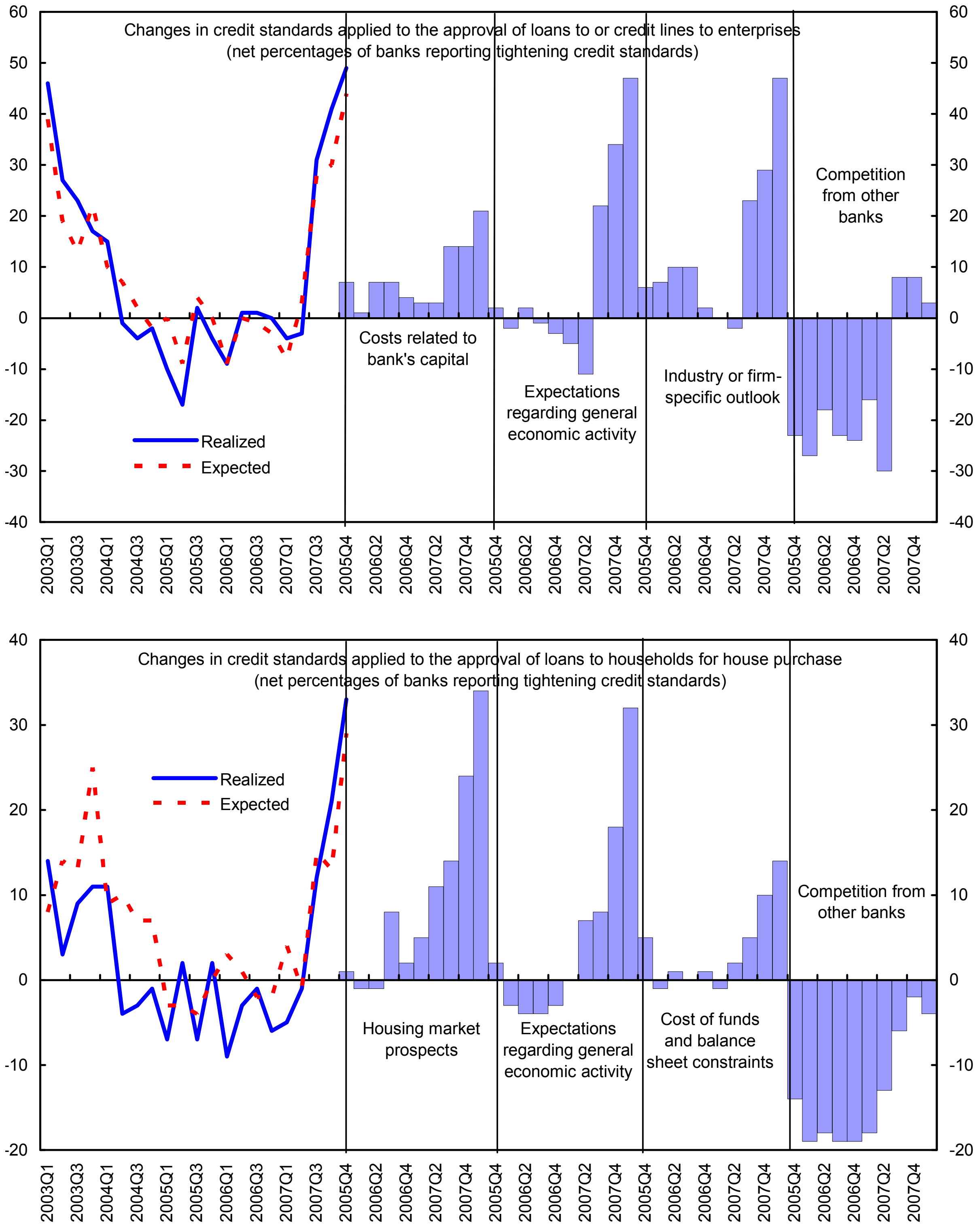
Sources: Thomson Financial/DataStream; Bloomberg; and CitiBank.

Figure 10. Euro Area: Growth in Bank Loans and Securities Issuance
(in percent)



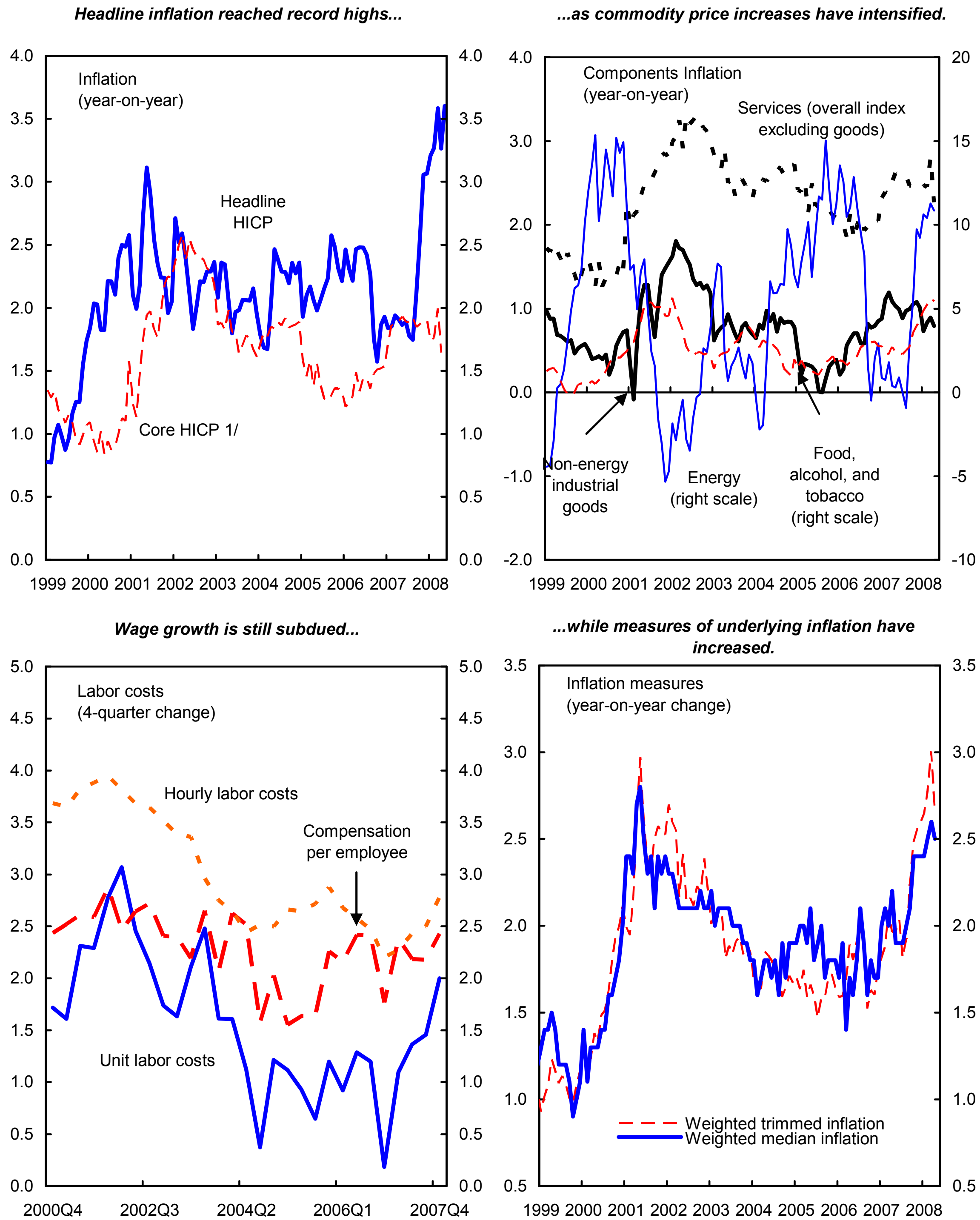
Source: ECB.

Figure 11. Euro Area: Changes in Credit Standards to Enterprises and Households



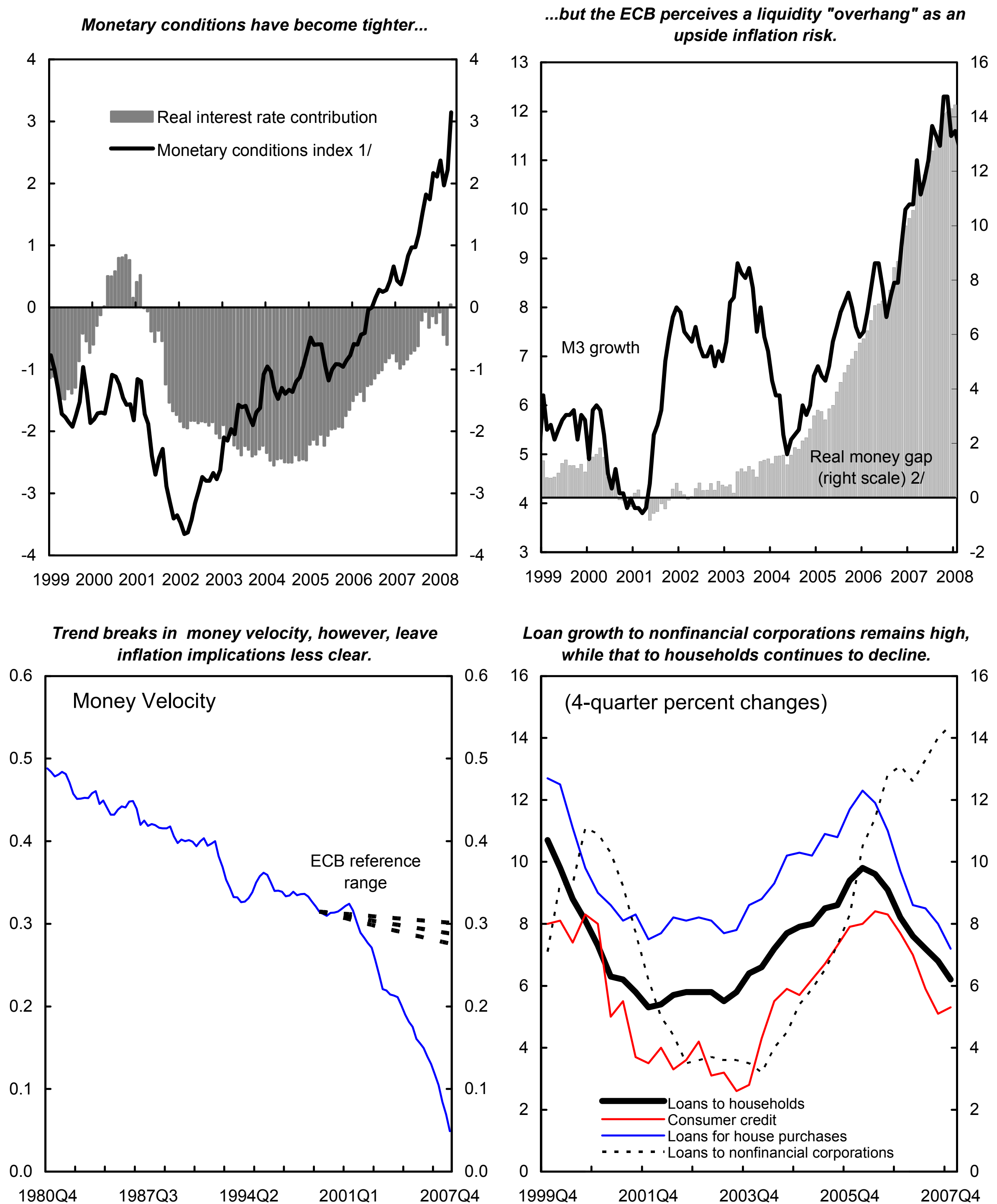
Source: European Central Bank.

Figure 12. Euro Area: Inflation and Labor Costs
(in percent, unless otherwise specified)



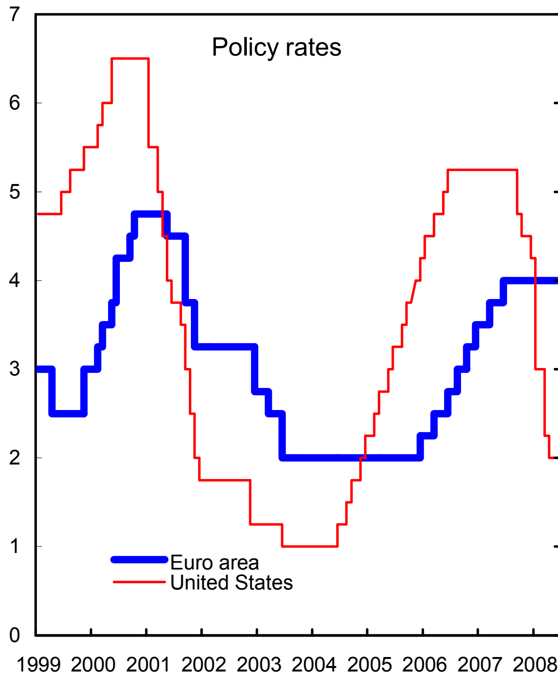
Sources: Eurostat; ECB; and Haver Analytics.
1/ Excludes energy, food, alcohol, and tobacco.

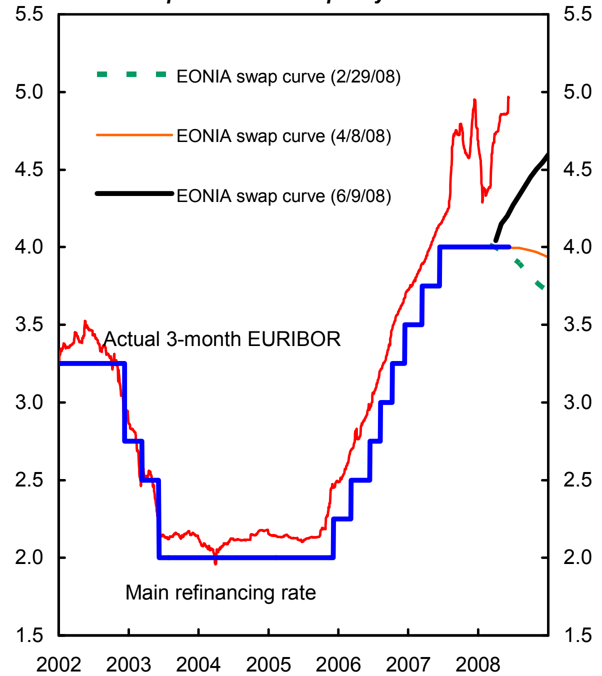
Figure 13. Euro Area: Money and Credit
(in percent, unless otherwise specified)

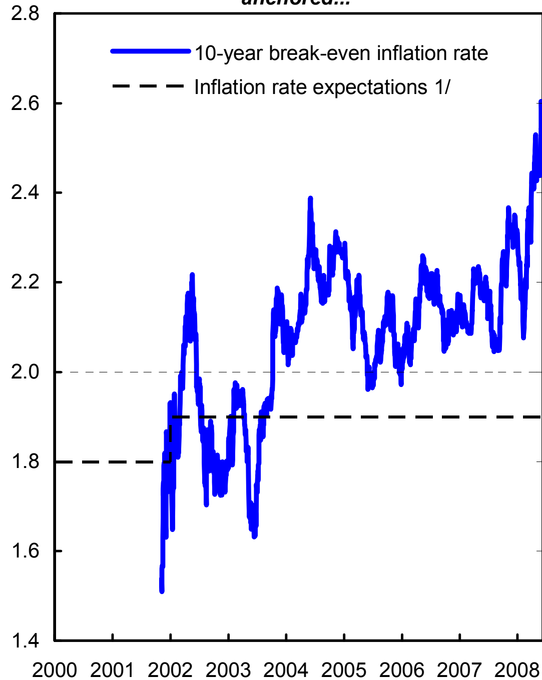


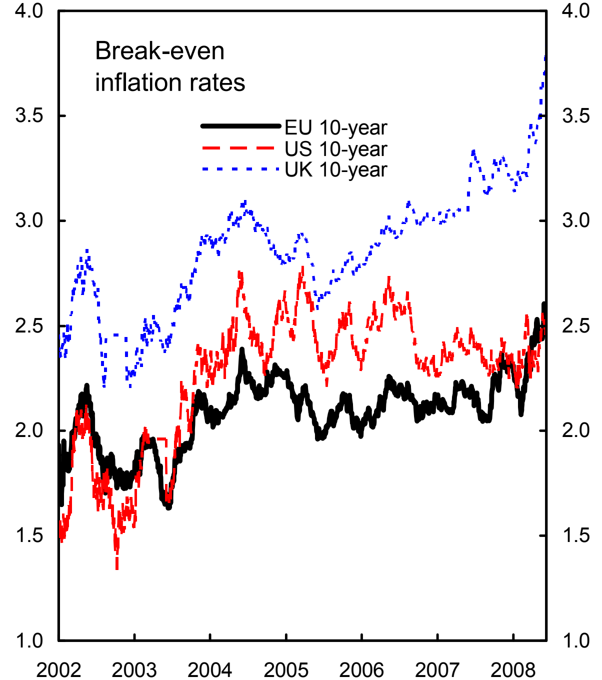
Sources: ECB; Datastream; Bloomberg; and IMF staff calculations.
1/ Deviations from 1990-2004 mean.
2/ Based on M3 corrected for the estimated impact of portfolio shifts. Deviation (in percent of the actual real stock, deflated by HICP) from an estimate of the long-run real stock that would have resulted from constant nominal M3 growth at its reference value of 4.5 percent and HICP inflation in line with the ECB's definition of price stability, taking December 1998 as the base period.

Figure 14. Euro Area: Monetary and Policy and Market Expectations
(in percent, unless otherwise specified)



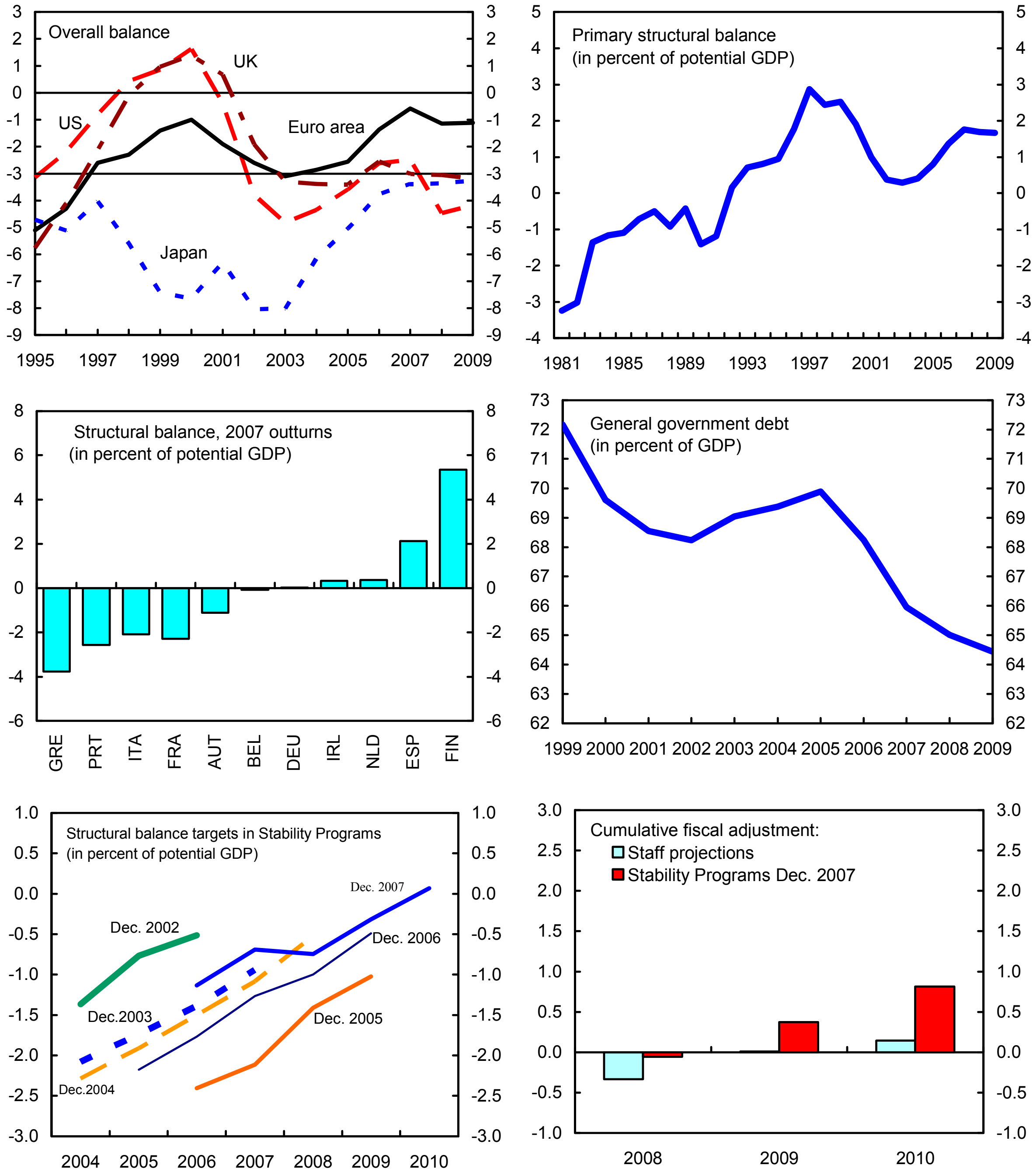






Sources: Bloomberg; Datastream; ECB; Eurostat; and IMF staff calculations.
1/ Survey of Professional Forecasters.

Figure 15. Euro Area: Fiscal Developments
(In percent of GDP, unless otherwise noted)



Sources: European Commission; IMF, *World Economic Outlook;* and IMF staff calculations.

Table 1. Euro Area: Main Economic Indicators
(in percent change)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
									Staff projections	
Demand and Supply										
Private consumption	3.1	2.0	0.9	1.3	1.6	1.6	1.8	1.5	1.3	1.1
Public consumption	2.4	2.1	2.4	1.8	1.4	1.5	2.0	2.2	2.1	2.0
Gross fixed investment	4.9	0.5	-1.4	1.4	2.4	3.0	5.0	4.3	3.5	1.2
Final domestic demand	3.4	1.7	0.7	1.4	1.7	1.8	2.5	2.3	2.0	1.3
Stockbuilding 1/	0.0	-0.5	-0.3	0.1	0.2	0.0	0.1	0.0	-0.2	-0.1
Domestic Demand	3.4	1.2	0.4	1.5	2.0	1.9	2.6	2.2	1.7	1.2
Foreign balance 1/	0.4	0.7	0.5	-0.7	0.2	-0.2	0.2	0.3	0.0	0.1
Exports 2/	12.2	3.9	1.8	1.2	7.2	4.7	7.9	6.0	5.1	3.8
Imports 2/	11.1	2.1	0.4	3.3	7.0	5.4	7.7	5.2	5.2	3.8
Real GDP	3.8	1.9	0.9	0.8	2.1	1.6	2.8	2.6	1.7	1.2
Resource Utilization										
Potential GDP	2.2	2.2	2.1	2.0	2.0	1.9	2.0	2.0	2.0	2.0
Output gap	1.7	1.4	0.2	-0.9	-0.8	-1.1	-0.3	0.2	0.0	-0.8
Employment	2.4	1.4	0.9	0.7	0.7	0.9	1.5	1.9	0.9	0.4
Unemployment rate 3/	8.1	7.8	8.2	8.7	8.8	8.6	8.2	7.4	7.3	7.4
Prices										
GDP deflator	1.3	2.4	2.6	2.2	1.9	1.9	1.9	2.2	2.2	1.9
Consumer prices	2.2	2.4	2.3	2.1	2.1	2.2	2.2	2.1	3.2	2.3
Public Finance 4/										
General government balance	-1.0	-1.9	-2.6	-3.1	-2.9	-2.6	-1.3	-0.6	-1.0	-1.1
General government structural balance	-1.6	-2.3	-2.6	-2.7	-2.4	-2.1	-1.2	-0.8	-1.1	-0.8
General government gross debt	69.4	68.3	68.2	69.3	69.7	70.3	68.5	66.4	65.2	64.4
Interest Rates										
Short-term deposit rate	4.5	4.1	3.3	2.3	2.1	2.3	3.2	4.2	…	…
Long-term government bond yields	5.4	4.9	4.8	4.0	4.0	3.4	3.9	4.4	…	…
Exchange Rates 5/										
U.S. dollar per euro	0.92	0.90	0.94	1.13	1.24	1.25	1.26	1.37	1.55	…
Nominal effective rate (2000=100)	100.0	101.6	105.1	117.6	122.0	121.7	122.6	128.9	136.4	…
Real effective rate (2000=100) 6/	100.0	100.7	106.6	122.3	130.0	129.1	128.8	134.8	142.3	…
External Sector 4/ 7/										
Current account balance	-1.5	-0.3	0.8	0.4	0.8	0.2	0.0	0.3	-0.5	-0.6
Trade balance 8/	0.1	1.0	1.7	1.4	1.3	0.6	0.2	0.6	-0.1	-0.2

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

1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ US dollar rate, as of June 23, 2008; nominal and real effective rates, as of May 2008.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.
9/ Eurostat data.

Table 2. Euro Area: Balance of Payments

	2000	2001	2002	2003	2004	2005	2006	2007	2007Q4
					(in billions euro)				
Current account	-101.9	-21.9	57.2	33.7	59.8	7.1	-13.7	14.9	-4.9
Goods	5.6	73.4	128.3	105.5	102.6	48.0	22.2	59.5	11.2
Services	-9.8	-3.0	17.7	22.5	28.5	31.6	35.3	42.6	8.9
Income	-48.2	-41.0	-39.2	-37.0	-10.3	0.5	5.6	-4.7	1.0
Current transfers	-49.6	-51.2	-49.6	-57.7	-60.8	-72.9	-76.9	-82.6	-26.1
Capital account	11.3	6.2	10.1	12.1	16.4	11.4	9.0	14.4	5.9
Financial account	75.4	-28.2	-15.3	-15.3	-16.8	24.3	117.9	1.7	-117.3
Direct investment	-14.4	-109.8	22.7	-10.3	-66.9	-208.8	-136.5	-108.3	10.9
Portfolio investment	-100.9	72.9	138.0	55.7	72.1	141.3	276.3	232.5	-45.9
Equity	-21.4	-4.1	-1.1	6.9	21.2	37.8	57.2	...	...
Debt instruments	2.8	0.0	-0.1	-0.5	0.2	0.5	1.9	...	...
Financial derivatives	-10.0	-0.7	-12.2	-13.7	-8.4	-16.3	2.5	-123.1	-51.1
Other investment	183.4	-8.5	-160.9	-74.6	-26.3	90.0	-23.3	5.5	-35.6
Reserve assets	17.7	18.0	-2.5	28.0	12.6	18.2	-1.1	-4.7	4.5
Errors and omissions	13.1	44.0	-51.9	-30.0	-61.5	-44.1	-114.1	-29.2	102.9
					(in percent of GDP)				
Current account	-1.5	-0.3	0.8	0.4	0.8	0.1	-0.2	0.2	-0.2
Goods	0.1	1.0	1.8	1.4	1.3	0.6	0.3	0.7	0.5
Services	-0.1	0.0	0.2	0.3	0.4	0.4	0.4	0.5	0.4
Income	-0.7	-0.6	-0.5	-0.5	-0.1	0.0	0.1	-0.1	0.0
Current transfers	-0.7	-0.7	-0.7	-0.8	-0.8	-0.9	-0.9	-0.9	-1.2
Capital account	0.2	0.1	0.1	0.2	0.2	0.1	0.1	0.2	0.3
Financial account	1.1	-0.4	-0.2	-0.2	-0.2	0.3	1.4	0.0	-5.2
Direct investment	-0.2	-1.6	0.3	-0.1	-0.9	-2.6	-1.6	-1.2	0.5
Portfolio investment	-1.5	1.0	1.9	0.7	0.9	1.7	3.3	2.6	-2.1
Equity	-0.3	-0.1	0.0	0.1	0.3	0.5	0.7	...	...
Debt instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...
Financial derivatives	-0.1	0.0	-0.2	-0.2	-0.1	-0.2	0.0	-1.4	-2.3
Other investment	2.7	-0.1	-2.2	-1.0	-0.3	1.1	-0.3	0.1	-1.6
Reserve assets	0.3	0.3	0.0	0.4	0.2	0.2	0.0	-0.1	0.2
Errors and omissions	0.2	0.6	-0.7	-0.4	-0.8	-0.5	-1.3	-0.3	4.6
Memorandum items:									
GDP (in billions of euros)	6759.8	7054.6	7300.9	7517.2	7822.6	8098.9	8478.9	8887.5	2237.1
Reserves of the eurosystem 1/ (in billions of euros)	378.0	392.7	366.1	306.7	281.0	320.1	325.8	347.4	347.4

Sources: ECB; Eurostat; Datastream; IMF, *World Economic Outlook*.
1/ End of period stocks.

Table 3. Euro Area: Net Investment Position 1/
(in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007Q4
Assets	103.3	110.9	102.5	106.7	113.0	136.5	148.4	155.7
Direct investment abroad	25.9	29.7	27.6	29.0	29.8	34.9	36.5	38.9
Portfolio investment abroad	35.2	35.7	31.5	35.5	39.0	48.1	52.6	53.7
Financial derivatives	1.6	1.8	1.8	2.0	2.0	2.8	3.4	0.0
Other investment abroad	35.0	38.1	36.5	36.2	38.6	46.8	52.1	58.6
Reserve assets	5.8	5.6	5.0	4.1	3.6	4.0	0.0	4.0
Liabilities	110.7	116.4	112.2	117.3	124.4	146.9	160.5	170.9
Direct investment in the EU	20.7	23.7	25.1	27.8	28.8	30.4	31.5	33.9
Portfolio investment in the EU	47.6	47.8	44.6	47.9	52.4	63.4	70.7	76.1
Financial Derivatives	1.5	1.8	2.0	2.3	2.5	3.3	3.9	4.9
Other investment in the EU	40.8	43.2	40.5	39.3	40.7	49.8	54.4	60.9
Net investment position	-7.3	-5.5	-9.7	-10.6	-11.4	-10.4	-12.1	-15.3
Direct investment	5.3	6.0	2.5	1.1	1.0	4.5	4.9	5.0
Portfolio investment	-12.4	-12.0	-13.1	-12.4	-13.4	-15.3	-18.1	-22.4
Financial Derivatives	0.0	0.0	-0.2	-0.3	-0.5	-0.6	-0.5	0.5
Other investment	-5.8	-5.1	-4.0	-3.1	-2.1	-3.0	-2.4	-2.3
Reserve assets	5.6	5.6	5.0	4.1	3.6	4.0	3.9	4.0

Source: European Central Bank.
1/ Data correspond to the end of the indicated period. They are expressed as a percent of the cumulated GDP of the four quarters ending on that date.

Table 4. Euro Area: Medium-term Current Account

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
						(Projections)					
						(in billions euros)					
Current account	33.4	62.2	18.2	-1.2	26.2	-45.8	-61.0	-62.9	-65.5	-69.4	-83.0
Goods	43.8	90.6	114.2	73.4	71.0	55.5	59.8	84.6	41.7	37.4	47.1
Services	-0.1	15.1	71.4	74.5	80.9	53.9	29.4	46.9	55.0	61.5	60.4
						(in percent of GDP)					
Current account	0.4	0.8	0.2	0.0	0.3	-0.5	-0.6	-0.6	-0.6	-0.6	-0.7
Goods	0.6	1.2	1.4	0.9	0.8	0.6	0.6	0.9	0.4	0.3	0.4
Services	0.0	0.2	0.9	0.9	0.9	0.6	0.3	0.5	0.5	0.6	0.5
Memorandum items:											
Gross national saving	20.7	21.6	21.2	21.9	22.5	21.9	21.4	21.4	21.5	21.6	21.5

Source: *World Economic Outlook*.

Table 5. Euro Area: Policy Progress and Plans Relevant to the IMFC Strategy

Commitments	Progress Made
Product market	***Limited progress so far; some initiatives in the pipeline.***
Reduce market regulation, improve business environment	The deadline for transposing the Services Directive at the national level is 17 months away. The Commission has published an implementation handbook. Countries are proceeding with preparatory work. It will be important to track their interim progress to ensure full and timely implementation.
	In *network services*, progress in deregulation has been limited to few euro area countries: rail (the Netherlands), energy (Spain, Netherlands), telecom (Finland, Greece, Slovenia). In February, the German utility company E.ON offered to sell its electricity grid, which may be a breakthrough. In *retail services*, progress has also been limited, even though some measures have been taken (Spain, Italy) or are expected (France). In *professional services*, although measures have been taken in some countries (Spain, Belgium, Finland, Italy, the Netherlands), the situation has not significantly improved, and competition remains insufficient in a number of countries. Reform initiatives are on the table in France and Italy.
	Several initiatives have been proposed by the European Commission to create a more level playing field in network industries (a new postal directive, to remove the outstanding "reserved segments"; creating a European Telecom Market Authority, and a package of legislative proposals in the energy sectors, aimed at achieving an effective separation of supply and transmission activities).
Labor market	***More progress in some areas and countries than others.***
Priorities coincide with those featured in the Lisbon National Action Plans to boost labor utilization and productivity	Regarding *increasing fiscal incentives to work* and further *adjusting benefits systems*, progress has been made in several countries: active labor market policies have been strengthened (Austria, Belgium) and social security systems improved (Belgium, Germany). The reform package in France contains a number of elements in these areas. In Germany, however, there have been some reform reversals (e.g., higher minimum wage for postal workers, longer unemployment benefit period for older workers).
	In *fostering flexibility and security* in the labor market, some countries have moved toward an integrated flexicurity approach (Austria, Finland, Ireland, the Netherlands), while others are taking steps in that broad direction (France, Italy).
	To better *align wage and productivity developments*, some countries have moved gradually toward more wage and working time flexibility. For example, there are signs that wage bargaining has become more decentralized in some countries (Austria, Spain, Finland, Italy). The reform package in France also contains measures in this area (e.g., making the 35-hour workweek less binding).
	Regarding *promoting labor mobility between countries and occupations*, this area has been the focus of recent EU initiatives, such as the recommendations on European Qualifications Framework and the European Job Mobility Action Plan. On the country level, however, progress on cross-border mobility has generally been limited, with some exceptions.
Financial market	***Progress has been more pronounced.***
Further integration across the EU	The *Payment Services Directive* was published in the EU Journal and has to be transposed at the national level by November 2009.
	The *Markets in Financial Instruments Directive* (MiFID) became effective in November 2007. Some non-euro area countries have yet to transpose it.
	Target 2 replaced Target as a platform for payments in November 2007. The development of the *Target2 Securities* project is proceeding, with a final report to the Governing Council to be presented in summer 2008.
	Implementation of the Financial Services Action Plan at the national level is close to completion. In addition to MiFID, several countries have yet to transpose the Transparency Directive. Regarding *financial stability arrangements*, recent steps include common principles for cross-border financial crisis management and the practical measures to improve the Lamfalussy process adopted by the ECOFIN in October and December, respectively. The common principles have found their way into an EU-wide Memorandum of Understanding on cross-border crisis management and resolution.
	Preparations for a new *Solvency (II) Directive* for insurance are ongoing. In February 2008, the Commission adopted an amended proposal for Solvency II. The (tentative) timetable for the directive extends to 2012.
	Integration of EU markets for housing finance: the Commission released the White Paper on Integration of EU Mortgage Markets on December 18, 2007. However, the White Paper proposes further investigation of the subject, and contains few immediate policy actions.

Table 6. Financial Conditions of Large and Complex Banking Groups in the Euro Area (2004 – H1 2007)

	min.	1st quartile	median	average	*weighted average*	3rd quartile	max.
Return on equity (%)							
2004	4.30	10.39	16.35	16.78	*17.22*	20.48	33.20
2005	9.00	14.88	17.40	18.74	*19.12*	23.13	37.00
2006	7.24	16.70	18.53	18.75	*18.99*	21.20	37.60
H1 2007	5.11	17.90	21.00	20.19	*20.21*	22.50	36.00
Return on risk-weighted assets (%)							
2004	0.20	0.92	1.11	1.13	*1.17*	1.49	2.03
2005	0.81	1.06	1.38	1.40	*1.43*	1.73	2.26
2006	0.77	1.11	1.42	1.48	*1.51*	1.84	2.66
H1 2007	0.81	1.51	1.84	1.86	*1.87*	2.20	3.22
Net interest income (% total assets)							
2004	0.43	0.71	0.90	1.04	*0.93*	1.30	1.87
2005	0.48	0.58	0.68	0.93	*0.89*	1.28	1.84
2006	0.24	0.55	0.69	0.95	*0.87*	1.28	2.03
H1 2007	0.22	0.54	0.74	0.91	*0.80*	1.25	1.98
Net interest income (% total income)							
2004	24.07	36.70	51.43	48.63	*47.66*	56.51	69.54
2005	23.53	29.59	46.95	44.57	*45.39*	58.69	68.70
2006	14.07	38.14	48.71	45.80	*43.48*	53.92	70.24
H1 2007	10.02	40.00	47.39	43.75	*40.55*	52.27	64.61
Trading income (% total income)							
2004	2.69	7.58	9.41	11.74	*12.91*	15.66	28.73
2005	2.58	6.88	10.37	13.32	*14.47*	16.43	37.14
2006	2.45	6.35	12.95	14.80	*16.97*	19.09	46.83
H1 2007	7.20	13.70	19.49	21.28	*23.63*	21.38	53.67
Fees and commissions (% total income)							
2004	15.90	20.84	29.45	29.32	*28.97*	36.12	44.15
2005	17.12	22.30	29.45	28.07	*28.11*	34.79	40.02
0 2006	18.20	23.36	27.61	28.87	*29.50*	31.18	43.03
H1 2007	11.31	24.97	29.18	28.38	*28.69*	33.59	35.98
Other income (% total income)							
2004	-3.07	2.79	4.93	6.87	*6.22*	7.53	26.70
2005	-0.76	2.82	4.71	5.71	*6.24*	2.82	16.73
2006	-0.15	1.42	5.26	6.53	*6.64*	11.00	21.54
H1 2007	0.76	2.04	3.51	4.47	*4.73*	5.64	13.21
Net loan impairment charges (% total assets)							
2004	0.03	0.06	0.07	0.11	*0.09*	0.09	0.40
2005	-0.02	0.02	0.05	0.08	*0.08*	0.11	0.29
2006	0.01	0.03	0.05	0.11	*0.10*	0.18	0.36
H1 2007	0.00	0.02	0.06	0.09	*0.09*	0.11	0.37
Cost-income ratio (%)							
2004	48.60	62.05	68.05	66.63	*68.49*	70.90	85.30
2005	43.20	58.70	63.65	63.37	*63.76*	66.95	89.40
2006	39.60	54.70	61.10	60.51	*61.69*	68.00	79.80
H1 2007	38.70	50.20	58.80	58.40	*59.67*	63.20	77.70
Tier 1 ratio (%)							
2004	6.32	7.10	7.80	8.02	*7.88*	8.38	10.90
2005	6.70	7.58	8.15	8.45	*8.25*	8.95	11.60
2006	6.70	7.42	7.80	8.33	*8.16*	8.90	10.50
H1 2007	6.09	7.55	7.90	8.21	*8.00*	8.40	10.80
Overall solvency ratios (%)							
2004	8.46	10.43	11.35	11.40	*11.04*	12.69	13.30
2005	8.50	10.80	11.55	11.70	*11.42*	12.47	16.30
2006	10.00	10.60	11.10	11.40	*11.36*	11.74	15.60
H1 2007	10.20	11.01	10.70	11.20	*11.13*	11.70	15.10

Sources: Individual institutions' financial reports and ECB calculations.

APPENDIX I—STATISTICAL ISSUES

EURO AREA POLICIES

Statistics for the euro area (and the EU-27) are produced by Eurostat and the ECB, generally on the basis of data reported by the statistical services of member states. These statistics are of sufficient quality, scope, and timeliness to allow effective macroeconomic surveillance. Nonetheless, certain gaps and weaknesses remain, and these can be difficult to resolve given institutional and other complexities, including the changing composition of the euro area and EU. Although a high level of harmonization has been achieved in the statistical systems of the EU Member States, national idiosyncrasies continue to represent fundamental obstacles that can affect the comparability of data, for example due to differences in the structure of countries' financial systems. The IMF's Dissemination Standards Bulletin Board (DSBB)[19] provides comprehensive information on the Euro area's statistical practices for the Special Data Dissemination Standard (SDDS) data categories. Recent and ongoing developments include:

- The introduction of NACE rev. 2 will have a significant impact on the availability of data.[20] NACE rev. 2 came into force on January 1, 2008, and will be introduced gradually during the 2008–11 period. It provides a better and more detailed classification of economic activities, tailored to the structure of a modern economy. It better captures services and outsourcing and will lead to an increase in the measured share of services in output. For the short-term statistics, Eurostat is working with the member states to ensure that time series are recalculated back to 2000. However, in other areas the limited potential for backcasting means that NACE rev 2 will lead to significantly shorter dataseries or statistical breaks. The publication of some series will be interrupted during the transition period.

- The Principal European Economic Indicators produced by Eurostat are under review. Consideration is being given to adding housing market indicators and further tightening timeliness standards (as most existing targets have been met). Production guidelines with respect to seasonal and calendar day adjustments have been approved and will come into effect in the second half of the year. Work to harmonize revision policies is ongoing, as is work on euro area vintage data.

- For the national accounts, the ESA 95 transmission program was changed substantially at the end of 2007, requiring member states to report more harmonized data in greater detail. Also, guidelines for seasonal adjustment and calendar

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[19] Available at: http://dsbb.imf.org/.

[20] NACE stands for *Nomenclature Générale des Activités Economiques dans les Communautés Européennes* and is the European classification system of economic activities. NACE is fully compatible with the UN's ISIC classification, but provides greater detail.

adjustment have been issued. Responsibility for the quarterly and annual sectoral accounts has been merged and their timeliness has improved. Work is ongoing to extend the annual series backward to 1995 and the quarterly series to 1999. Work on nonfinancial balance sheets is ongoing as a long-term project, given important technical challenges. Eurostat has discontinued the publication of national accounts at constant prices in favor of chain-linked data at previous year's prices.

- A new regulation was issued in November 2007[21] that focuses the Harmonized Indices of Consumer Prices (HICP) on "consumption segments" rather than products. The regulation prescribes quality adjustments and gives Eurostat the ability to issue standards for quality adjustment following a case-by-case approach. Pilot work on an HICP index at constant tax rates has not been completed, partly because some large countries decided not to participate. A regulation is being prepared to harmonize the treatment of seasonal items, and an HICP Manual should be finalized shortly.

- Work continues on the compilation of harmonized HICP data on prices for owner-occupied housing. A pilot project covering 12 countries was completed last year, and was followed by a new stage including 26 of the EU's 27 member states. Eurostat has also produced a manual on owner-occupied housing, and has embarked on a two-year project to produce an international manual for residential real estate prices.

- Eurostat has started the release of a quarterly Government Finance Statistics publication using the summary page presentation and of historic Excessive Deficit Procedure (EDP) data on deficits and debt (i.e., prior to the notification period that covers the last 4 years). It has also tightened the statistical accounting rules for securitization operations by governments and is looking into the treatment of government guarantees provided to financial institutions and of government debt issued specifically to swap against private financial assets. Eurostat's stepped-up monitoring of member states' fiscal accounts is improving and becoming more consistent. All related documentation is published on its website. Resources for fiscal monitoring have been increased significantly, with available staff doubling between 2004 and 2008, but the workload has expanded even more due to EU expansion and increased data volumes.

- A new framework regulation has been introduced to harmonize the compilation of quarterly data on job vacancies[22]. Work continues to enhance and harmonize the measurement quality of "hours worked," which serves as input for various other statistics including the Labor Cost Index. Work is ongoing with a view to improve the

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[21] Commission Regulation (EC) No. 1334/2007.

[22] European Parliament and Council Regulation (EC) No 4533/2008

models used for the calculation of the monthly unemployment rates published by Eurostat.

- In the area of short-term statistics, ongoing work focuses primarily on prices and output in the services sector. A series of workshops has been organized with price statisticians of Member States to ensure the harmonized compilation of Services Producer Price Indices, reporting of which will start later this year. Eurostat aims to produce an index of services production by 2012. A new series on import prices, compiled on the basis of reporting by importers, has recently been published and allows a clear differentiation between import prices and unit values.

- With regard to structural business statistics, a new regulation has been introduced covering statistics on business services and business demographics. An ad-hoc survey is ongoing on international sourcing and a survey on access to financial services by SMEs is being considered.

- A comprehensive 5-year overhaul of business statistics ("Modernization of European Enterprise and Trade Statistics", MEETS) is about to start with the objectives of improving the coverage and quality of data while also reducing the reporting burden on enterprises.

- The regulations covering Intrastat and Extrastat reporting[23] are being revised, in part with a view to reducing the reporting burden on enterprises. Asymmetries in intra-EU trade and balance of payment statistics persist; data confidentiality is among other things an obstacle for the ongoing efforts to reduce these asymmetries. The ongoing revision of the basic statistical legislation us expected to facilitate the exchange of confidential data between the EU Member States and Eurostat.

[23] Intrastat covers intra-EU trade and is based on reporting by businesses. Extrastat covers extra-EU trade and is based on customs declarations.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

Staff Report for the 2008 Article IV Consultation with Member Countries

Supplementary Information

Prepared by the European Department

Approved by Alessandro Leipold and Adnan Mazarei

July 18, 2008

1. This supplement provides an update of economic and policy developments since the release of the staff report (7/2/08). The thrust of the staff appraisal remains unchanged. Also attached is a draft background section of the Public Information Notice (PIN).

2. **Recent data confirm a marked slowdown in economic activity, as forecast by staff, but also somewhat higher inflation** (Table 1). Growth in 2008:Q1 was revised down modestly, to a still strong 2.9 percent on a quarterly annualized basis (2.1 percent over 2007:Q1). But industrial production data for May and purchasing managers' indices for manufacturing and services in June point to very weak activity ahead. Also, recent trade data for May show several euro area countries' exports slowing sharply, in particular to the United States. While inflation excluding energy and all food prices remained contained, at 1.8 percent in June, headline inflation reached 4.0 percent, essentially because of further sharp energy price increases, and staff has raised its inflation forecast for 2008 and 2009 slightly upward, to 3.4 percent and 2.4 percent, respectively.

3. **Financial conditions have deteriorated**. Over the past weeks, financial stocks have fallen substantially, borrowing costs and credit default spreads have risen, and term spreads in money markets have remained at elevated levels (Figure 1).

4. **As foreshadowed in the staff report, the ECB raised its policy rate by 25 basis points to 4.25 percent on July 3 and markets essentially do not expect further moves**. The decision was fully priced in by markets and, according to the ECB, was "taken to prevent broadly based second-round effects and to counteract the increasing upside risks to price stability over the medium term." The ECB considers that "the monetary policy stance following today's [July 3] decision will contribute to achieving our objective of price stability"—a phrase interpreted by markets as implying no further changes. Despite the staff's upward revision, inflation is still projected to fall below 2 percent by end-2009, assuming stabilizing energy prices, in line with oil futures markets data. Staff thus continues to believe that, going forward, policy rates are best kept on hold while, as stated by the ECB, continuing "to monitor very closely all developments over the period ahead."

Table 1. Euro Area: Main Economic Indicators

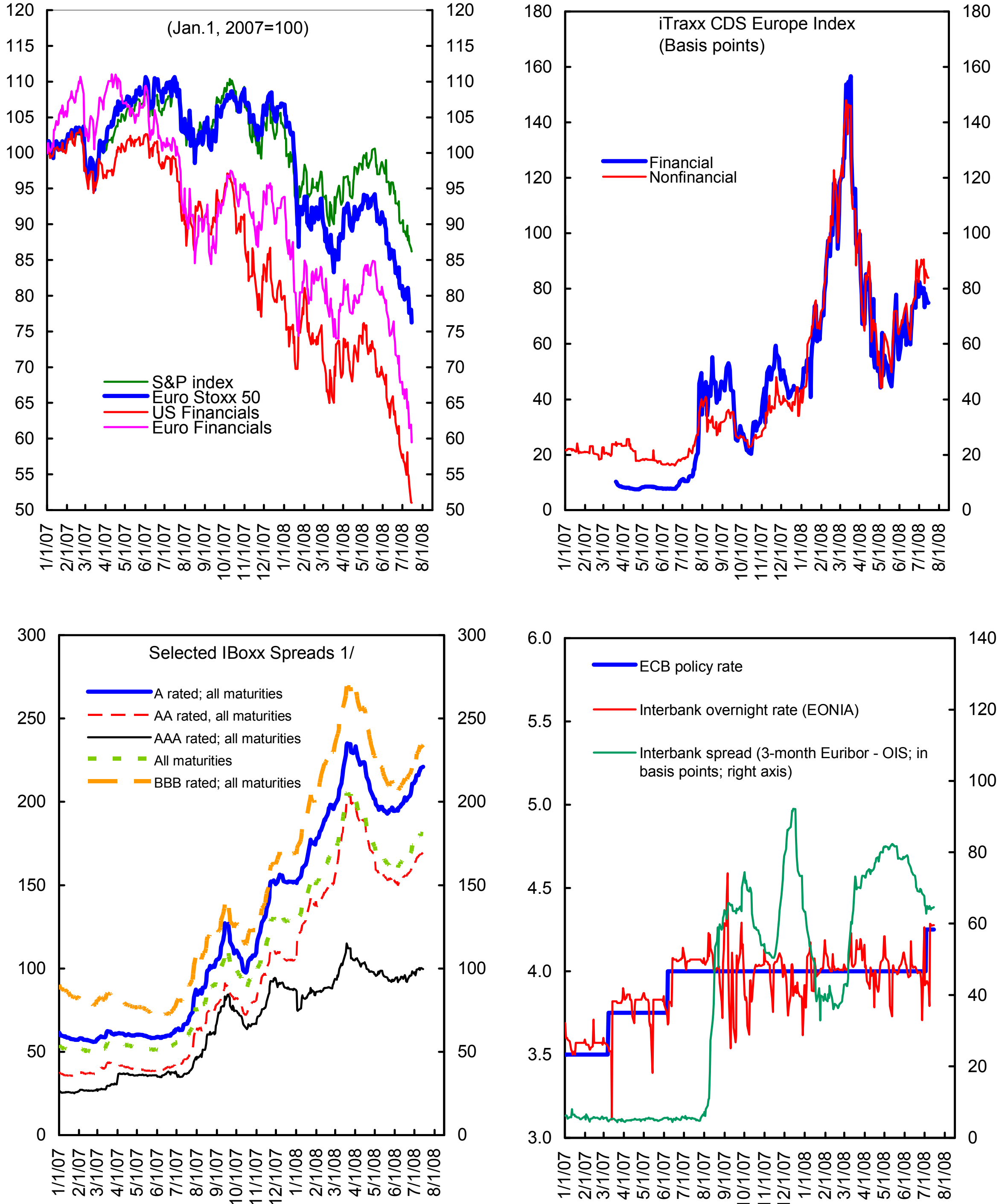
(in percent change)

	2003	2004	2005	2006	2007	2008	2009
						Staff projections	
Demand and Supply							
Private consumption	1.3	1.6	1.6	1.8	1.5	1.3	1.1
Public consumption	1.8	1.4	1.5	2.0	2.2	2.1	2.0
Gross fixed investment	1.4	2.4	3.0	5.0	4.3	3.5	1.2
Final domestic demand	1.4	1.7	1.8	2.5	2.3	2.0	1.3
Stockbuilding 1/	0.1	0.2	0.0	0.1	0.0	-0.2	-0.1
Domestic Demand	1.5	2.0	1.9	2.6	2.2	1.7	1.2
Foreign balance 1/	-0.7	0.2	-0.2	0.2	0.3	0.0	0.1
Exports 2/	1.2	7.2	4.7	7.9	6.0	5.1	3.8
Imports 2/	3.3	7.0	5.4	7.7	5.2	5.2	3.8
Real GDP	0.8	2.1	1.6	2.8	2.6	1.7	1.2
Resource Utilization							
Potential GDP	2.0	2.0	1.9	2.0	2.0	2.0	2.0
Output gap	-0.9	-0.8	-1.1	-0.3	0.2	0.0	-0.8
Employment	0.7	0.7	0.9	1.5	1.9	0.9	0.4
Unemployment rate 3/	8.7	8.8	8.6	8.2	7.4	7.3	7.4
Prices							
GDP deflator	2.2	1.9	1.9	1.9	2.2	2.2	1.9
Consumer prices	2.1	2.1	2.2	2.2	2.1	3.4	2.4
Public Finance 4/							
General government balance	-3.1	-2.9	-2.6	-1.3	-0.6	-1.0	-1.1
General government structural balance	-2.7	-2.4	-2.1	-1.2	-0.8	-1.1	-0.8
General government gross debt	69.3	69.7	70.3	68.6	66.5	65.2	64.4
Interest Rates							
Short-term deposit rate	2.3	2.1	2.3	3.2	4.2	…	…
Long-term government bond yields	4.0	4.0	3.4	3.9	4.4	…	…
Exchange Rates 5/							
U.S. dollar per euro	1.13	1.24	1.25	1.26	1.37	1.55	…
Nominal effective rate (2000=100)	117.6	122.0	121.7	122.6	128.9	136.4	…
Real effective rate (2000=100) 6/	122.3	130.0	129.1	128.8	134.8	142.3	…
External Sector 4/ 7/							
Current account balance	0.4	0.8	0.2	0.0	0.3	-0.5	-0.6
Trade balance 8/	1.4	1.3	0.6	0.2	0.6	-0.1	-0.2

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

1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ US dollar rate, as of June 23, 2008; nominal and real effective rates, as of May 2008.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.

Figure 1. Euro Area Financial Indicators



Source: Thomson Financial/DataStream.
1/ IBoxx corporate bond rates over German benchmark bond yields.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 08/98
FOR IMMEDIATE RELEASE
August 4, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation on Euro Area Policies

On July 25, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation on Euro Area Policies.[1]

Background

Ten years after its launch, monetary union is a distinct success and the euro area a zone of stability in the international economy. However, economic union remains work in progress. Improved wage setting and labor market reforms have contributed to the creation of some 16 million jobs over the past decade. Similarly, the single market program and product market reforms have raised productivity in affected sectors. However, important challenges remain, including large intra-euro area current account and competitiveness divergences.

More recently, the euro area has shown relative robustness to global shocks, but activity is expected to slow due to high energy and food prices, tighter financial conditions, slowing global demand, and the appreciation of the real effective exchange rate of the euro. Staff projects annual average growth of 1.7 percent in 2008 and 1.2 percent in 2009, which masks a deceleration in the course of 2008 and re-acceleration toward trend during 2009.

Headline inflation has recently reached its highest levels since the launch of EMU, pushed up by energy and food prices. Nonetheless, underlying inflation and labor costs have been well contained thus far, testifying to the high credibility of the European Central Bank (ECB). With the economy slowing down, and provided food and energy prices stabilize, inflation should fall appreciably from its current levels, although risks are high. In this context, the ECB raised

[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.

interest rates by 25bps on July 3, to 4.25 percent, while rising risk premia have pushed up key money market interest rates to levels last reached during the mid-1990s.

The fiscal position of the euro area improved in 2007, reaching close to balance in structural terms. However, a number of countries still face appreciable fiscal challenges. Many have not yet reached their medium-term close-to-balance or surplus objectives, including almost all those with high public debt. Furthermore, against the background of already some relaxation in 2008 budgets, expansionary impulses are mounting in several countries.

The outlook for financial stability is highly uncertain, although the area's financial system remains sound. While appreciable progress has been made with respect to banks' loss recognition and recapitalization, many financial markets have yet to return to normal and the global financial turmoil has led to a tightening of financial conditions. The pressure on firms and households from higher risk premia and stricter lending standards, though not yet evident, will likely build considerably over time. Balance sheets outside the financial sector, however, still seem relatively robust.

Executive Board Assessment

Executive Directors noted that, ten years after its launch, the European Monetary Union (EMU) is a distinct success, and they commended the EMU's macroeconomic policy framework for bringing internal and external stability. Economic fundamentals have improved, although continued efforts are needed to build a more vibrant economic union.

Directors observed that, conjuncturally, the euro-area economy is being strained by an array of shocks—including from the commodity and financial markets—that is driving a combination of decelerating activity and uncomfortably high inflation. They also noted that the euro is now on the strong side relative to fundamentals. Directors concurred that growth will likely slow substantially this year before reaccelerating toward trend during 2009.

Directors observed that monetary policy has to balance the risk of a broad-based increase in inflation with the prospect of gradually building disinflationary forces due to slowing activity. Much hinges on how labor costs and inflation expectations will evolve. Although durable improvements in the functioning of labor markets and in anchoring inflation expectations have been achieved under EMU, risks of second-round effects remain and will need to be guarded against proactively. At the same time, Directors noted that financial conditions have tightened substantially since last summer, and that the financial environment remains under strain from the ongoing turbulence. In this setting, a number of Directors were of the view that policy rates are best kept on hold, with the ECB continuing to monitor all developments very closely in the period ahead. Other Directors emphasized the importance of vigilance in the face of the upside risks to price stability, in particular should wage settlements hint at accelerating labor costs in 2009.

Directors agreed that the ECB's policy frameworks have served it well in coping with the current difficult environment. The ECB's liquidity management framework has proven flexible and robust. The key challenge going forward is to restore the depth and orderly functioning of interbank markets. Directors welcomed the ECB's plans to keep the operational framework under continuous review, notably with respect to the collateral it accepts, and to ensure that the framework's rules are applied strictly. Directors noted that the ongoing work on enhancing the ECB's monetary analysis would help further strengthen the monetary policy framework, and several suggested that this could lead in due course to a unified presentation of policy decisions that integrates monetary and economic analysis.

Directors welcomed the steps taken to strengthen the EU's financial stability framework. Given the significant financial linkages and the EU's commitment to build a single market for financial services, Directors looked forward to further moves toward greater joint responsibility and accountability for EU financial stability. This will require aligning national financial stability frameworks with the EU's commonly agreed principles for crisis prevention, management, and resolution. In the near term, Directors stressed the need for further improvements in information sharing among supervisors and central banks, including the ECB.

Directors observed that the rules-based fiscal framework offered by the Stability and Growth Pact (SGP) has generally improved fiscal discipline and served the euro area well. However, about half of the euro-area countries still face persistent challenges in meeting their medium-term fiscal objectives. Progress with respect to lowering general government deficits and debt will be key for these countries in order to better meet the population aging-related fiscal challenges that are expected to mount rapidly after 2010. Accordingly, Directors agreed that the room for fiscal policy responses to the current downturn should be a function of the leeway allowed by the SGP. Support for more vulnerable sectors of the population should be well targeted and not distort price signals. More generally, Directors noted that stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries facing relatively high public sector deficits and debt.

Directors observed that past and ongoing structural reforms are bearing fruit, but that large parts of the services sector still remain to be opened to EU-wide competition. They emphasized that the structural reform momentum needs to be maintained and re-oriented in a coordinated manner to address intra-area disparities. Progress with this reform agenda would also be consistent with commitments made under the Fund's Multilateral Consultation on Global Imbalances.

Directors looked forward to strong EU leadership in working toward an ambitious and balanced conclusion of the Doha Round. They viewed lower agricultural trade barriers and lower subsidies as the right approach to foster production and respond to high food prices, and in that context, looked forward to the review of the Common Agricultural Policy next year. Directors also welcomed the EU's intention to keep its biofuels policies under review.

The views expressed by Executive Directors today will form part of the Article IV consultation discussions on individual members of the euro area that take place until the next Board discussion of euro area policies.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation on Euro Area Policies is also available.

Euro Area: Main Economic Indicators

(in percent change)

	2003	2004	2005	2006	2007	2008	2009
						Staff projections	
Demand and Supply							
Private consumption	1.3	1.6	1.6	1.8	1.5	1.3	1.1
Public consumption	1.8	1.4	1.5	2.0	2.2	2.1	2.0
Gross fixed investment	1.4	2.4	3.0	5.0	4.3	3.5	1.2
Final domestic demand	1.4	1.7	1.8	2.5	2.3	2.0	1.3
Stockbuilding 1/	0.1	0.2	0.0	0.1	0.0	-0.2	-0.1
Domestic Demand	1.5	2.0	1.9	2.6	2.2	1.7	1.2
Foreign balance 1/	-0.7	0.2	-0.2	0.2	0.3	0.0	0.1
Exports 2/	1.2	7.2	4.7	7.9	6.0	5.1	3.8
Imports 2/	3.3	7.0	5.4	7.7	5.2	5.2	3.8
Real GDP	0.8	2.1	1.6	2.8	2.6	1.7	1.2
Resource Utilization							
Potential GDP	2.0	2.0	1.9	2.0	2.0	2.0	2.0
Output gap	-0.9	-0.8	-1.1	-0.3	0.2	0.0	-0.8
Employment	0.7	0.7	0.9	1.5	1.9	0.9	0.4
Unemployment rate 3/	8.7	8.8	8.6	8.2	7.4	7.3	7.4
Prices							
GDP deflator	2.2	1.9	1.9	1.9	2.2	2.2	1.9
Consumer prices	2.1	2.1	2.2	2.2	2.1	3.4	2.4
Public Finance 4/							
General government balance	-3.1	-2.9	-2.6	-1.3	-0.6	-1.0	-1.1
General government structural balance	-2.7	-2.4	-2.1	-1.2	-0.8	-1.1	-0.8
General government gross debt	69.3	69.7	70.3	68.6	66.5	65.2	64.4
Interest Rates							
Short-term deposit rate	2.3	2.1	2.3	3.2	4.2	…	…
Long-term government bond yields	4.0	4.0	3.4	3.9	4.4	…	…
Exchange Rates 5/							
U.S. dollar per euro	1.13	1.24	1.25	1.26	1.37	1.55	…
Nominal effective rate (2000=100)	117.6	122.0	121.7	122.6	128.9	136.4	…
Real effective rate (2000=100) 6/	122.3	130.0	129.1	128.8	134.8	142.3	…
External Sector 4/ 7/							
Current account balance	0.4	0.8	0.2	0.0	0.3	-0.5	-0.6
Trade balance 8/	1.4	1.3	0.6	0.2	0.6	-0.1	-0.2

Sources: IMF, *World Economic Outlook;* Eurostat, ECB Monthly Bulletin.
1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ US dollar rate, as of June 23, 2008; nominal and real effective rates, as of May 2008.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.

Statement by Klaus Stein, Executive Director for Germany, on behalf of the Euro Area Authorities
July 22, 2008

In my capacity as President of EURIMF,[1] I am pleased to submit this statement on the Article IV consultation with the euro area. My statement reflects the common view of the euro-area Member States and the European Union (EU) in their respective fields of competence.

The authorities of the euro-area Member States welcome the IMF staff's assessment of economic developments and prospects in the euro area. While broadly concurring with the findings of the IMF, on some issues views differ, as I will outline in my statement. I will also update the Board on recent economic developments.

10 years of Economic and Monetary Union (EMU)

The euro-area authorities welcome the staff's positive assessment of the first 10 years of EMU. The stability-orientated macroeconomic framework has helped to maintain stability during turbulent times. The disappearance of intra-euro-area exchange rate risk and lower cross-border transaction costs have helped further develop the Single Market and integrate product markets. The single currency has also acted as a powerful catalyst for financial market integration. Over the 10 years of its existence, the euro has firmly established itself as second most important international reserve and investment currency.

The euro-area authorities share the view that monetary union has been a success and that the numerous achievements that have been made over the past 10 years should not veil the fact that some economic developments, notably overall output and productivity growth, defied expectations. Economic union is not yet fully delivering. The euro-area authorities concur with the staff in this regard and clearly see the need to further pursue structural reforms and to address economic divergences in the euro area. In the reports on "EMU@10: successes and challenges after 10 years of Economic and Monetary Union" and on the "10th anniversary of the ECB" the European Commission (Commission) and the European Central Bank (ECB) respectively take stock of the past decade and look at the challenges ahead. Following the Commission's communication the Council of Economics and Finance Ministers (ECOFIN) and the Eurogroup are currently reflecting on practical measures to improve economic policies and the functioning of EMU.

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[1] EURIMF: An informal group of EU member state representatives at the Fund.

Short-term economic outlook

The global economy is cooling down markedly. So far, the slowdown in the euro area has remained relatively modest as improved fundamentals, sound budgetary positions in most Member States and past structural reforms have helped weather the strong global headwinds to a large extent. Indeed, economic growth in the first quarter surprised on the upside. However, there are divergences across Member States, reflecting, among other things, their exposure to the financial markets turmoil, external deficits as well as the ongoing corrections of housing markets. Nevertheless, as the strong first quarter was partly driven by temporary factors, a considerable moderation can be expected in the second quarter.

Survey indicators show a continued marked deterioration in economic sentiment since the peak last summer. While industrial confidence is currently still slightly above its long-term average, services and consumer confidence are already below. Also, negative news continues to flow from commodity and financial markets which could affect economic activity in a more pronounced way then expected. Additionally, the euro area has been experiencing an adverse exchange rate shock. Excessive volatility and disorderly movements in exchange rates are undesirable for economic growth. In this context, the euro-area authorities share the IMF analysis that the euro is now clearly on the strong side relative to fundamentals.

Looking further ahead, the economic outlook crucially depends on how the financial market stress will unfold and whether oil prices keep on growing, feeding into inflation. In the euro-area authorities' view, tighter financing conditions and higher risk aversion will continue taking a toll on investment, especially on housing in some countries, and, together with declining confidence, could also dampen consumption going forward. Similarly, the relentless increase in energy prices will weigh on consumption and investment. This in turn should have a moderating effect on prices and wages.

The euro-area authorities concur with the staff that, in spite of the resilience so far, economic growth could further moderate. In their view, the uncertainty surrounding the growth outlook remains high, and the risks are on the downside.

Monetary policy and the outlook for price stability

To prevent broad-based second-round effects and counteract increasing risks to price stability over the medium term, the Governing Council of the ECB raised the key ECB interest rate by 25 basis points on July 3. The latest data that have become available since the release of the staff paper fully confirms the existence of upside risks to price stability.

Turning to the outlook for price developments, inflation has risen considerably since last autumn, reaching worrying levels of around 4 percent in mid 2008. This mainly owes to sharp increases in oil and food prices. In recent months upside risks to price stability have intensified. First, these risks relate to possible further rises in commodity prices. Moreover, the possibility of broad-based second-round effects and associated additional price pressures

are of particular concern to the Governing Council of the ECB. Initial signs of such second-round effects are already emerging in some euro area countries. In this particular context, nominal wage indexation schemes should be avoided. Finally, unanticipated increases in administered prices and indirect taxes contribute to upside risks to price stability over the medium term.

The monetary analysis strongly supports the assessment of upside risks to price stability at medium to longer horizons. The sustained underlying strength of monetary and credit expansion in the euro area over the past few years has created upside risks to price stability. Over recent quarters, these risks appear to have become manifest as inflation has trended upwards. Thus, the continued strength of monetary dynamics represents an important signal of the risks to price stability over the medium term that the ECB has been addressing through its actions since end-2005. Moreover, a thorough assessment of the strength, maturity and sectoral composition of bank borrowing suggests that the correction in financial markets has, as yet, not significantly affected the availability of bank credit to the private sector.

The recent monetary policy decision demonstrates the ECB's strong determination to keep long-term inflation expectations firmly anchored in line with price stability, in accordance with its mandate. It is the ECB's contribution to preserving purchasing power over the medium term and supporting sustainable economic growth and employment in the euro area. In its current assessment, the Governing Council believes that the monetary policy stance following the decision to raise rates on July 3 will contribute to achieving price stability over the medium term. The Governing Council will continue to monitor very closely all developments over the period ahead. As has been repeatedly stressed, the Governing Council does not pre-commit to a specific course of action in the future.

Liquidity Management

In the last few months, the ECB has continued applying its existing framework for liquidity operations with a view to alleviate tensions in the euro money market and to continue steering very short term money market rates to the minimum bid rate. First, the ECB continued "frontloading" its liquidity supply over the reserve maintenance periods to properly respond to banks' liquidity demand pattern and in accordance to reduced tensions recently observed in the market, yet maintaining the average supply of liquidity unchanged over the entire maintenance periods. Second, the ECB continued providing temporary refinancing at longer maturities, by renewing in May and June 2008 the two supplementary three-month longer-term refinancing operations (LTROs) initiated in August and September 2007, and by introducing supplementary LTROs with a six-month maturity, in April and in July 2008. Third, the ECB continued the conduct of term auction facilities in cooperation with the US Federal Reserve System and other central banks. Accordingly, it provided US dollar liquidity to euro area banks, secured with Eurosystem eligible collateral. As on similar occasions, these operations did not affect the supply of euro liquidity. Overall, the fact that a broad range of counterparties has access to the Eurosystem's large scale refinancing

operations against a wide range of eligible collateral, allowed the ECB to effectively counter the stressed conditions in the short-term part of the money markets without having to change the framework itself.

Fiscal developments and fiscal policy

The euro-area authorities share the staff's assessment of the improved budgetary situation in 2007. However, significant budgetary challenges lie ahead. In particular, the euro-area authorities welcome the staff's overall positive assessment regarding the functioning of the reformed Stability and Growth Pact (SGP). Countries with excessive deficits have made significant structural efforts to correct their deficits within the deadlines established under the reformed SGP. Consequently, no euro-area Member State is currently subject to the excessive deficit procedure.

Despite these improvements, the euro-area authorities agree that in certain countries more ambitious fiscal consolidation is needed, partly as a result of insufficient progress towards the medium-term budgetary objectives during the upswing. In these countries safety margins vis-à-vis the 3 percent of GDP reference value are insufficient to make full use of the automatic fiscal stabilizers to smooth the economic slowdown without excessive deficits emerging.

In this context, the euro-area authorities also highlight the risk related to the reversal of accrued windfall revenues which could accentuate the budgetary effects of the economic slowdown. As rightly pointed out in the staff's assessment, while the jury is still out on the actual drivers of the tax buoyancy in recent years, experience suggests that a significant part of it may be short-lived. With growth abating, a reversal in revenue windfalls would strain the budgetary situation of those Member States which have not made sufficient use of the upturn to improve their budgetary positions, further reducing their capacity to let automatic stabilizers play.

The euro-area authorities confirm their strong commitment to the reformed SGP which provides the best guidance for the conduct of fiscal policies at the current juncture. Stability-oriented fiscal policies, in line with the SGP, allow achieving and maintaining sustainable fiscal positions before the effects of ageing populations fully set in. Thereby, the SGP supports confidence of consumers, producers and financial markets. Further progress towards the medium-term objectives, in particular by expenditure restraint, contributes to alleviating inflationary pressures, fostering an environment of sustainable growth. At the same time, the working of the automatic stabilizers dampens the impact of the global economic slowdown.

It is worth noting that Member States progressively develop strategies to improve spending efficiency with the use of performance indicators and of medium-term budgetary frameworks. Pursuing effective medium-term budgetary frameworks and fiscal rules at national level not only contributes to ensuring rigorous budgetary execution and compliance with plans, but it also contributes to improving the quality and sustainability of public finances. Increasing the efficiency of public spending and re-orientating it towards growth-

enhancing components can contribute to managing the ongoing growth slowdown and accelerating the pace of the recovery.

In line with the conclusions of the June 2008 ECOFIN meeting and the principles set in the Manchester 2005 ECOFIN meeting, the euro-area authorities concur with the staff's view that tax policy should not be used to limit the pass-through of rising energy prices. Considering that supply is highly inelastic, offsetting price increases with compensating tax cuts would distort necessary adjustment to higher energy prices and risk adding to the terms-of-trade loss experienced by the euro area as a net importer of energy. Other policies to protect vulnerable groups are likely to be more effective and efficient.

Financial sector issues

As pointed out by the staff, financial stability has become a focus of attention among EU policymakers. While financial integration has progressed significantly in recent years, the EU financial-stability arrangements remain very much national-based. Various measures have been taken to adapt these arrangements to reflect the growing cross-border dimension in financial activity within the EU. These measures have acquired increased importance in the context of the ongoing global financial turmoil. Particular attention has been given to strengthening the Lamfalussy framework, where the Level-3 Committees have a significant role to play in fostering supervisory convergence. Their functioning is to be improved by including an EU dimension in the mandates of national supervisors, streamlining the decision-making procedures and allocating to them specific tasks in promoting supervisory convergence.

The euro-area authorities share the staff's view on the importance of organizing an efficient exchange of information among supervisors, both in normal times and in times of crisis. To this end, the 2005 EU-wide Memorandum of Understanding between national supervisors, central banks and finance ministries has been significantly extended with effect from July 1 2008. The extension of the Memorandum of Understanding applies to both coverage and to content. The coverage has been extended to include supervisors not only from the banking sector but also from the insurance and securities sectors. As to the content, it has been extended by the inclusion of basic principles for cross-border crisis management, a common framework for assessing the systemic nature of a cross-border crisis and some procedural guidelines in crisis management. In addition, the use of colleges of supervisors for cross-border financial groups is to be extended.

Also, the ECOFIN decided on a roadmap of actions to further enhance EU financial stability arrangements. Among the issues to be addressed are relations between home-country and host-country supervisors, the transfer of assets within a financial group, determining criteria for applying early intervention and reorganization measures for cross-border financial groups and improvements in deposit guarantee schemes. These issues are highly complex and touch upon elements of national sovereignty. Therefore, the staff is right to highlight that reforms

in these areas will require strong political leadership and commitment. While complex to design, and politically sensitive to pursue, these reforms are nevertheless essential to safeguard the stability of the EU financial markets, and reap the maximum benefits from financial integration.

Structural reform

The euro area has a special interest in the success of structural reform. In a partnership approach between the Member States and the Commission, the Lisbon Strategy forms the basis for steering the reform process in the euro area as a whole and in the individual countries. The recommendations to the euro area, together with the country-specific recommendations made within the Integrated Guidelines of the Lisbon Strategy, provide the backbone for the coordination of structural reforms. The most recent assessments of progress with structural reforms carried out by the Commission and the ECOFIN show signs that the euro area countries have engaged in substantive structural reforms to tackle their economic, social and environmental challenges. Nevertheless, there remain a number of policy areas where challenges need to be tackled urgently, including strengthening the sustainability of public finances and increasing competition in product, services and labor markets.

The euro-area authorities agree with the staff that there is scope for National Reform Programs to pay more attention to the euro area recommendations, which aim to facilitate economic adjustment in the monetary union.

The euro-area authorities share the staff's concerns about the intra-area divergences and welcome the staff's support for improving internal surveillance. While some of these divergences can be benign – reflecting the catching-up process or even normal adjustment – they may also be harmful and the result of inefficient adjustment capabilities and/or excessive unit labor cost increases. In this case, broadened and deepened intra-area surveillance would be instrumental in early identifying of macroeconomic imbalances and competitiveness trends in euro-area countries and in helping Member States devising swift responses before divergences become entrenched. Going forward, it would be important to provide the right incentives for structural reforms at the national level and to enhance synergies between fiscal policies and structural reforms.

International issues

As noted by the staff, the EU will continue to strive for a comprehensive, ambitious and balanced conclusion of the Doha Round. EU representatives are 'cautiously hopeful' that an agreement can be reached this year, as they remain convinced that successful conclusion of the trade talks would be supportive of global growth in the longer term. The EU continues to play a key role in the efforts to push forward the negotiations. However, for negotiations to be successful, it is important that other participants are also forthcoming and take a constructive stand in the negotiations.

Parallel to the multilateral talks, which remain top priority, the EU is also pursuing free trade agreement negotiations with India, Korea, Latin America and the ASEAN countries, as well as regional partnerships with the African, Caribbean and Pacific countries. These agreements complement the multilateral framework for trade liberalization and are seen as stepping stones towards further trade integration.

Food prices are a major concern worldwide and the EU has launched initiatives to address the challenges faced by the Member States but also other countries. The European Council has endorsed several policy responses, both in the short- and in the long term. In the short term, European countries will mobilize resources for humanitarian aid to developing countries, examine the competitiveness in the food supply chain in the EU and the role of speculation in recent price developments. In the long run, the EU will promote sustainable production of biofuels and sustainable productivity growth in agriculture. It will undertake a review of the Common Agricultural Policy phasing out restrictions to production, making European farmers more responsive to price signals and to strengthen food security. The EU will also enhance support to investments in agriculture in developing countries.

By targeting development aid, ensuring that market incentives are in place for a supply response to develop, and discouraging export taxes, the EU's aim is to ensure that barriers to international trade are lifted. Both consumers and producers will better respond to price signals and market developments.