International Monetary Fund

IMF Executive Board Discusses Euro Area Policies

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On July 26, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of euro area policies.[1]

Background

After several years of disappointment, growth has picked up and broadened. Notwithstanding significant quarterly volatility, real GDP, final domestic demand, and household consumption all grew between 1¾-2 percent in the year through 2006: Q1 and the recovery has been gaining some traction in weaker parts of the area. Nonetheless, the pick up in activity remains fragile, relying on strong global growth. Employment and consumption continue to lag.

Monetary conditions remain accommodative, notwithstanding the policy rate hikes since December 2005, and external demand is strong. The area's external current account is broadly balanced and the exchange rate, while having appreciated somewhat lately, remains below the highs reached in 2004. Nonetheless, the area remains exposed to a disorderly resolution of global imbalances.

Besides supportive external demand and financial conditions the recovery reflects in part improved fundamentals in the corporate sector. Nonfinancial corporate profitability has been strong and leverage has been brought under control. Market-based financing activities have begun to recover from recent lows and, thus far, are not expected to be set back significantly by the latest market turbulence. Bank-based borrowing, which picked up more than a year ago, remains robust. While enterprise loans have largely funded restructuring and consolidation, lending surveys now indicate that capital expenditures are no longer a drag. Financial sector indicators also point to improving positions. Many banks are well capitalized and booking record profits, buoyed by low interest rates, low costs of risk, cost containment, and booming demand for mortgage loans.

Price pressures appear contained despite sharply rising oil and administrative prices. Headline HICP inflation reached 2.5 percent in May and is likely to stay above 2 percent for some time due to energy prices, further administered price hikes, and the expected VAT increase in Germany in 2007. However, core inflation is running around 1½ percent, reflecting limited indirect effects and absent second-round effects. Services price inflation is easing.

Although improving in 2005, public finances remain at a significant distance from close to balance or surplus, the area's medium-term fiscal objective given the looming demographic shock. Five countries are close to or above the Stability and Growth Pact's 3 percent of GDP limit. Moreover, absent further measures little improvement is expected for 2006-07.

Area productivity growth has been disappointing and the population is expected to begin to decline around 2010. Against this background, staff foresees actual growth around 2 percent in 2006-07. The balance of risks lies somewhat to the upside in the near term but to the downside beyond 2006.

Executive Board Assessment

Directors welcomed the broadening and strengthening of the recovery in the euro area, supported by accommodative financial conditions and strong global growth, restored business confidence, and improved financial positions. Price pressures have been contained notwithstanding sharply rising oil and administrative prices.

Directors were also encouraged that the reformed Stability and Growth Pact is regaining traction over fiscal policies, and welcomed the better-than-originally projected fiscal outcomes for 2005. Equally, they welcomed the ongoing progress with the reform of product and services markets and financial integration.

Looking ahead, Directors considered the balance of risks in 2006 to be on the upside, but for 2007 and beyond, however, they saw the risks tilting to the downside. In particular, they noted that the recovery of employment and consumption has yet to be firmly established, productivity growth continues to be sluggish, oil prices are volatile, and global imbalances remain unresolved. In light of these considerations, and more fundamentally reflecting the sluggish growth performance of the past few years and the looming demographic shock, Directors underscored the need for accelerated fiscal consolidation and further structural reforms that aim at strengthening incentives to work and invest.

Directors commended the deliberate pace of monetary withdrawal in the face of large exogenous price shocks that continued to keep the headline inflation above the ECB target, considering it in line with the ECB's mandate. Many Directors observed that inflationary expectations remain well anchored, wage growth is subdued, signs of second-round effects from oil and administrative price hikes are absent, and inflation is projected to ease over the next two years. Accordingly, these Directors generally saw a need for caution in raising rates further until a more balanced recovery takes firm hold. Several other Directors saw the timing of further tightening as unclear, but some Directors were more concerned about the upside risks to inflation, and urged the authorities to monitor developments closely and respond flexibly with a view to keeping inflation expectations well anchored.

On the structural front, Directors agreed that significant progress has been made over the years, as evidenced by the buoyancy of employment over the past decade. Nonetheless, much remains to be done as regards both labor utilization and productivity. Steadfast pursuit of mutually reinforcing fiscal and structural policies continues to be essential to strengthen growth and stimulate employment, prepare for aging, and facilitate the orderly unwinding of global imbalances.

In this regard, Directors thought that the key fiscal challenge is to achieve broadly balanced fiscal positions by 2010, when the area's population is projected to begin declining. Notwithstanding the recent improvements, however, Directors remained concerned about prospects for achieving the necessary adjustment toward balance during the upswing. They, therefore, encouraged countries to press ahead with fiscal consolidation. Countries at some distance from underlying balance need to identify measures equivalent to at least ½ percent of GDP annual adjustment over the coming years, focused on the expenditure side. Indeed, given the soft nature of the Pact's preventive arm, many Directors reckoned that the Pact could usefully be buttressed at the country level by strengthening non-partisan national governance mechanisms that spell out the implications of policies in a forward looking manner.

Directors pointed to the integrated National Reform Programs under the reformed Lisbon process as useful platforms for fostering ownership and carrying forward national product and labor market reforms. They observed that reforms that raise labor utilization continue to be paramount but that policies also need to devote more attention to boosting productivity, not just through R&D spending, but also by intensifying competition, especially in the services sector.

Directors welcomed the progress in integrating Europe's financial markets. However, with the area's lagging productivity, rooted in good part in the financial sector, policies need to become more proactive in removing the many remaining cross-border barriers to integration. This would require a forceful competition policy and public intervention in areas in which stakeholders stymie the establishment of open, market-based solutions. Directors welcomed the latest initiatives to strengthen crossborder collaboration among prudential authorities but thought that further integration of supervision over complex groups would be necessary to improve the effectiveness of area-wide prudential policies and crisis management. Directors welcomed the new Directive on AML/CFT and looked forward to its full implementation.

Directors also stressed the role of trade liberalization in boosting productivity. Expressing disappointment about the recent developments in the Doha round, they noted an urgent need to reconsider entrenched positions, and called for resistance to the temptation to resort to undisciplined bilateralism. For its part, the EU should endeavor to achieve the effective liberalization of agricultural market access. Several Directors also commended the EU's ambitious Aid for Trade agenda.

While the external position of the euro area is broadly balanced and the euro is seen as falling within a fairly-valued range from a medium-run multilateral perspective, most Directors noted that growth-enhancing structural reform is needed to limit downside risks to the euro area and facilitate orderly adjustment to global imbalances. While this could be achieved through a variety of measures, the most effective in the current context appear to be steps to strengthen competition in the services sector, which, besides boosting productivity, would help accelerate growth and demand. In this context, Directors welcomed the authorities' acknowledgment that reducing global imbalances is a shared responsibility, and welcomed their commitment to contribute to this outcome through enhanced structural reform.

Table 1. Euro Area: Main Economic Indicators

(in percent change)

	1999	2000	2001	2002	2003	2004	2005	2006 1/	2007 1/
Demand and Supply									
Private consumption	3.4	3.2	1.9	0.9	1.0	1.5	1.3	1.8	1.5
Public consumption	2.0	2.2	2.2	2.6	1.7	1.1	1.4	1.5	1.2
Gross fixed investment	6.1	4.9	0.5	-1.5	0.8	2.3	2.3	3.5	3.3
Final domestic demand	3.7	3.1	1.7	0.6	1.2	1.4	1.5	2.0	2.0
Stockbuilding 2/	-0.1	0.2	-0.5	-0.2	0.1	0.6	0.1	0.0	-0.1
Domestic Demand	3.6	3.3	1.2	0.4	1.3	2.0	1.6	2.0	1.9
Foreign balance 2/	-0.6	0.6	0.7	0.5	-0.6	0.1	-0.2	0.1	0.0
Exports 3/	5.0	12.0	3.6	1.7	1.1	6.5	3.8	7.3	5.8
Imports 3/	7.2	10.8	1.8	0.3	3.0	6.7	4.6	7.3	5.8
Real GDP	3.0	3.9	1.9	0.9	0.8	2.1	1.3	2.1	1.8
Resource Utilization									
Potential GDP	2.3	2.1	2.2	2.1	1.9	1.9	1.8	1.8	1.8
Output gap 4/	0.3	1.9	1.6	0.5	-0.7	-0.6	-1.1	-0.9	-0.9
Employment	2.0	2.4	1.6	0.7	0.4	0.6	0.7	0.9	0.8
Unemployment rate 5/	9.2	8.2	7.8	8.3	8.7	8.9	8.6	8.0	7.9
Prices									
GDP deflator	1.5	1.3	2.3	2.6	2.1	1.9	1.9	2.0	2.0
Consumer prices	1.1	2.1	2.3	2.2	2.1	2.1	2.2	2.2	2.2
Public Finance 6/									
General government balance 7/	-1.3	-1.0	-1.9	-2.6	-3.0	-2.7	-2.3	-2.1	-2.0
General government structural balance	-1.3	-1.7	-2.5	-2.7	-2.7	-2.4	-2.0	-1.8	-1.6
General government gross debt	72.1	69.6	68.3	68.1	69.3	69.8	70.8	70.2	69.6
Interest Rates 8/									
Short-term deposit rate	3.0	4.4	4.2	3.3	2.3	2.1	2.3	2.9	...
Long-term government bond yield	4.6	5.5	5.0	4.9	3.9	3.8	3.4	4.0	...
Exchange Rates									

U.S. dollar per euro 9/	1.07	0.92	0.90	0.94	1.13	1.24	1.25	1.27	...
Nominal effective rate (2000=100) 8/	112.2	100.0	101.6	105.1	117.6	122.0	121.7	122.9	...
Real effective rate (2000=100) 8/ 10/	113.4	100.0	101.8	107.5	121.3	127.5	126.5	127.6	...
External Sector 6/ 11/									
Current account balance	-0.5	-1.5	-0.3	0.7	0.4	0.6	-0.3	-0.1	-0.1
Trade balance 12/	0.9	0.1	1.0	1.8	1.4	1.4	0.7	...	...
Memorandum items 6/ 13/									
Current account balance	0.4	-0.6	0.2	0.7	0.5	1.0	-0.1	-0.2	-0.2
Trade balance 12/	1.3	0.6	1.4	2.1	1.8	1.7	0.9	1.2	1.2

Sources: IMF, *World Economic Outlook;* Eurostat, ECB Monthly Bulletin.
1/ Staff estimates and projections.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
6/ In percent of GDP.
7/ Excludes UMTS revenues
8/ Data for 2006 are for June
9/ Data for 2006 are for June 30.
10/ Based on normalized unit labor costs.
11/ Based on ECB data, which exclude intra-euro area flows.
12/ Data for goods.
13/ Calculated as the sum of individual countries' balances.

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.

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