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Monetary and Exchange Rate Policies of the Euro Area

This report on the Monetary and Exchange Rate Policies of the Euro Area was prepared by a staff team of the IMF, following discussions with officials at EU institutions that ended on January 30, 2001. It is meant to provide the context for the bilateral consultations with euro-area countries whose reviews are not clustered around the annual Board discussion of euro area's policies. **The report was completed on March 16, 2001; updated macroeconomic projections will be released in the context of the forthcoming World Economic Outlook (WEO)**. The views expressed in the present document are those of the staff team and do not necessary reflect the views of the euro-area authorities or the Executive Board of the IMF.

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Monetary and Exchange Rate Policies of the Euro Area

(In the Context of the 2001 Article IV Discussions with Euro-Area Countries)

Prepared by the European I Department

Approved by Michael Deppler and Leslie Lipschitz

March 16, 2001

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I. Introduction and Summary

1. The euro area's economy—which welcomed Greece as its newest member on January 1, 2001—continued to perform well last year, making further progress in undoing a legacy of anemic growth and disappointing labor market outcomes. Strong employment creation and external demand underpinned real GDP growth of some 3½ percent, by far the area's best performance since the late 1980s. Moreover, notwithstanding upward pressures on headline consumer price inflation from the run up in oil prices and the depreciation of the euro, underlying inflation remained contained.

2. Toward year-end, however, faltering growth in the United States, renewed weakness in Japan, receding oil prices, and a stronger euro changed the euro area's external environment—from one of positive demand impulses combined with an adverse supply shock to the reverse configuration. This paper reports on discussions of these events—and their policy implications—in the context of an interim staff visit to the European Commission and the European Central Bank (ECB).[1]

3. At the conclusion of the last consultation on the monetary and exchange rate policies of the euro area (EBM/00/100), Directors agreed that favorable external developments and sound macroeconomic fundamentals had produced robust area-wide growth. Directors cautioned, though, that persistently high oil prices and a weak euro might undermine prevailing wage moderation and set in motion domestic inflation pressures. In this environment, Directors observed that monetary policy had been appropriately cautious, with the rise in interest rates helping to preserve medium-term price stability. On fiscal policy, Directors emphasized that national fiscal strategies should encompass tax and expenditure objectives that effectively bolster the growth potential of the euro area while avoiding procyclical impulses. While acknowledging that structural reforms had advanced, Directors stressed that further efforts were essential to create headroom for growth and prevent capacity constraints from choking off the expansion prematurely.

4. In the discussions,[2] the staff emphasized that global demand seemed poised for a possibly marked loss of momentum, increasing downside risks to area-wide output growth—

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[1] In accordance with the Executive Board's decision 98/125 on the modalities of surveillance over the monetary and exchange rate policies of the euro area, this report is issued only for information of Directors. It is meant to provide the context for the bilateral consultations with the euro-area countries whose reviews are not clustered around the annual Board discussion of the euro area's policies. A second report to be discussed by the Board after the 2001 Annual Meetings will be prepared following a mission to EU institutions in late June, 2001.

[2] The staff visited Frankfurt, Brussels, and Luxembourg during January 22-31, 2001. Meetings at the European Central Bank (ECB) were held with President Duisenberg, and

(continued...)

even though the euro area was a largely closed economy and domestic demand had proved resilient in the face of earlier external turbulence. On the inflation front, while headline inflation remained significantly above 2 percent because of the fallout from the external price shocks, domestic sources of inflation, particularly wage setting behavior, had been remarkably restrained. On balance, the staff thought the outlook for medium-term price stability was improving, opening up headroom for an interest rate cut if downside risks materialized. Nonetheless, at the time of the discussions, the staff thought it reasonable that, in light of the still problematic evolution of the headline inflation indicator, monetary policy await the arrival of more information before taking action. Developments since the discussions argue for a more proactive monetary stance. Fiscal and structural policies for their part need to keep a firm medium-term orientation toward fostering a climate favorable to sustaining the expansion.

II. Policy Discussions

5. The discussions at EU institutions focused on the policy implications of the shift in the euro area's external environment arising from the marked cool-down in the United States and weakness in Japan, the partial reversal in oil prices, and the modest turnaround in the euro. There was broad agreement that these developments had altered the balance of risks for growth and for medium-term price stability in the euro area. Views were more divided on the prospective policy requirements.

A. Recent Real Sector Developments and Prospects

6. Taking stock of recent developments, the mission and EU officials had the same reading of the euro area's macroeconomic strength and its underpinnings. For the past four years, the euro area's economy has steered a middle path between the United States' rapid expansion and Japan's persistent output weakness (Figure 1). Growth has proceeded roughly at the potential rate, without giving rise to some of the financial imbalances seen in the United States and Japan. Notwithstanding marked swings in net exports and industrial output, the area-wide expansion has been held on a steady course by robust domestic demand and service sector activity (Figure 2). The linchpin of the steady growth of domestic demand at some 3 percent per annum since late 1997 has been an improved labor market, where rapid employment growth raised labor force participation and made a significant dent in the area's high unemployment rate. Sustained wage moderation, reflected in real wages trailing labor

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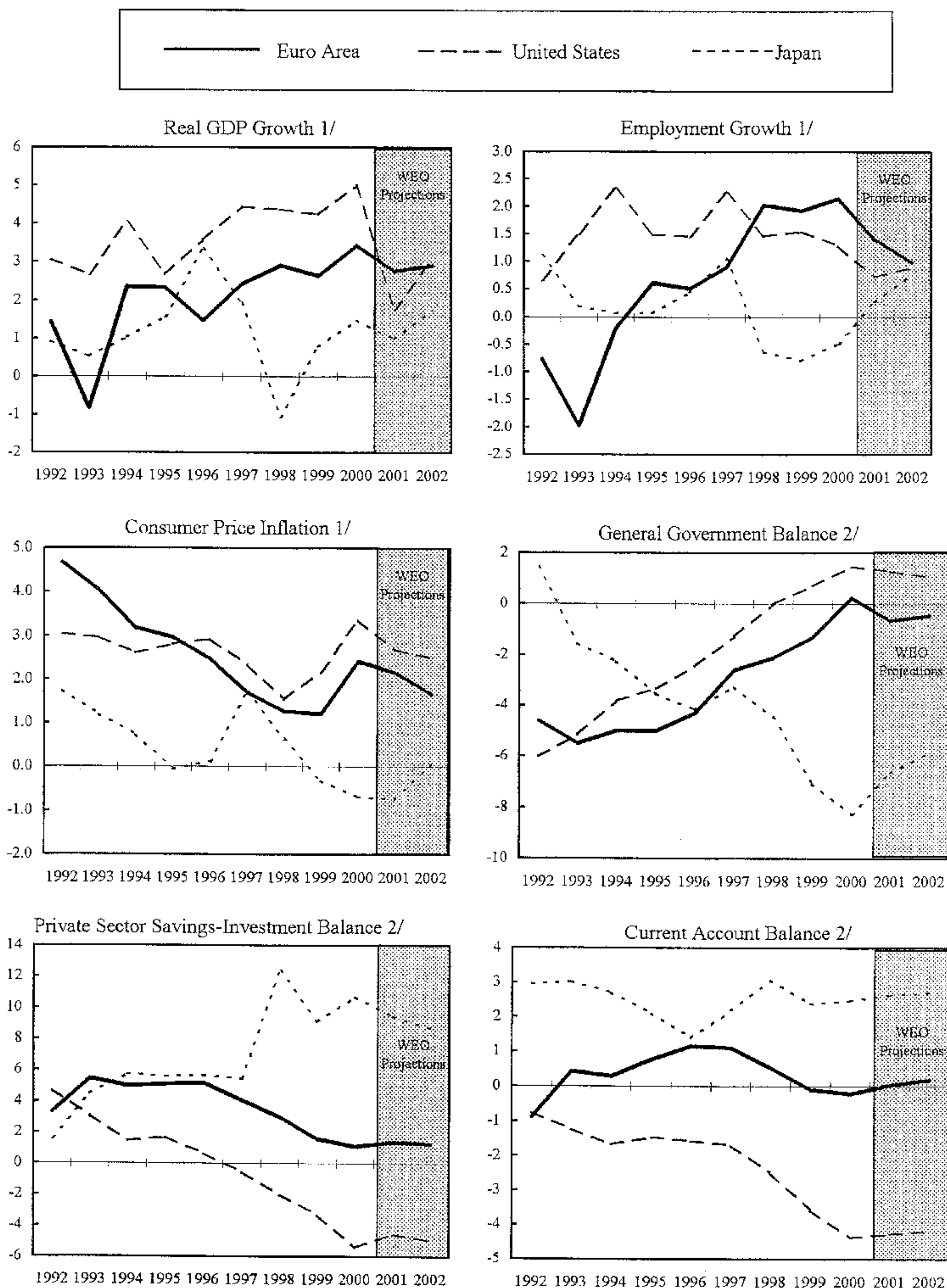
Ms. Hämäläinen, Mr. Issing, and Mr. Padoa-Schioppa (members of the Executive Board), as well as with senior staff. Meetings at the European Commission were held with Commissioner Solbes Mira, Mr. Ravasio (Director General for Economic and Financial Affairs), and other officials including at Eurostat. The staff presented the mission's concluding statement to the Economic and Financial Committee (EFC) and to the Eurogroup. The team comprised Messrs. Deppler (Head), Zanello, Jaeger, Ross, Kontolemis (all EU1), and Mr. Rosenblatt (PAR).

Figure 1. Euro Area: Macroeconomic Indicators for Major Currency Areas, 1992-2002

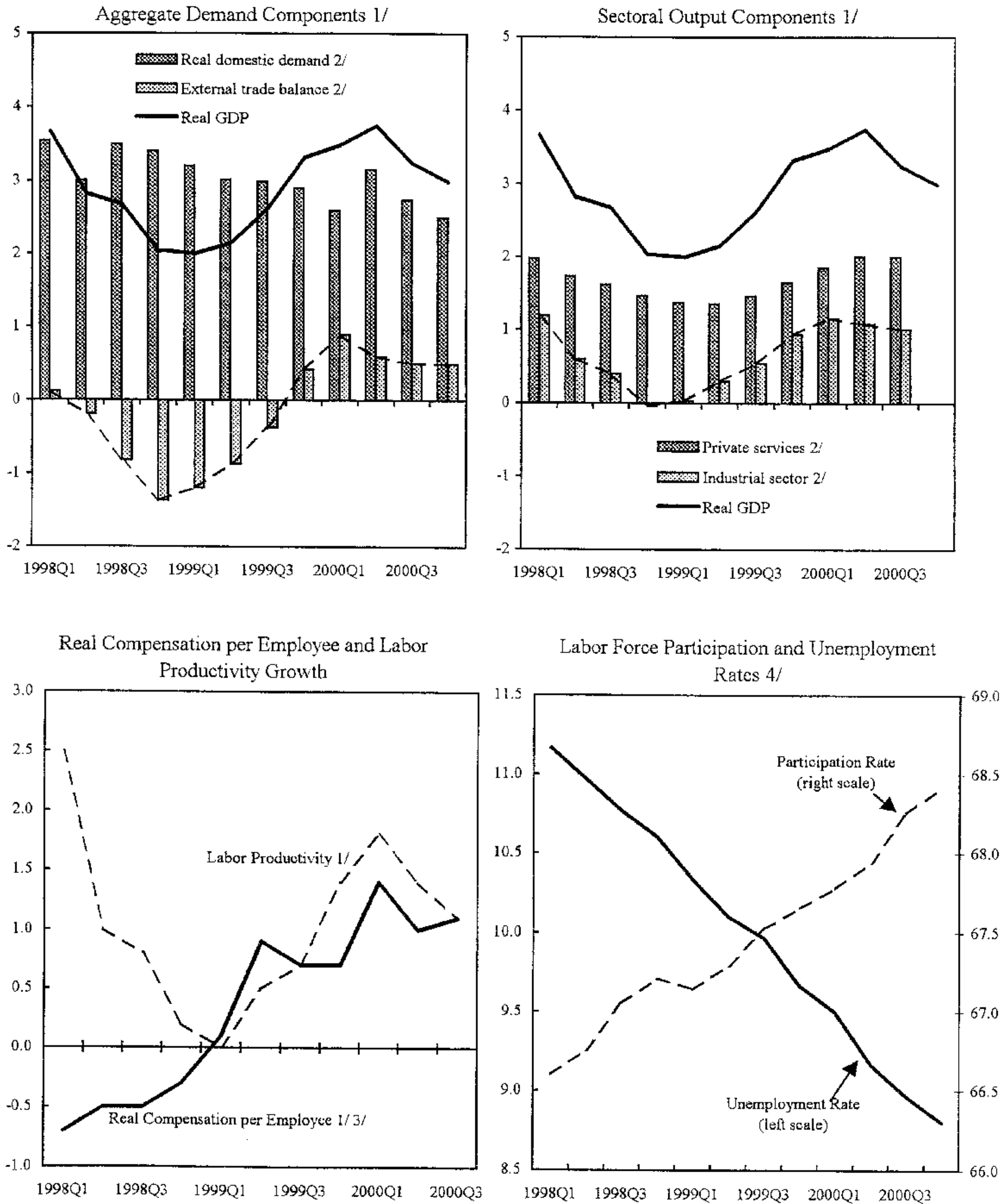


Sources: WEO database and staff projections; European Central Bank.

1/ In percent.

2/ In percent of GDP.

Figure 2. Euro Area: Real Output and Labor Market Developments, 1998-2000



Sources: European Central Bank; Eurostat.
1/ Year-on-year percent change.
2/ Contributions to real growth.
3/ Deflated by GDP price deflator.
4/ In percent.

productivity, and past structural reforms appear to be paying dividends in a transition to durably lower levels of unemployment.[3]

7. **The latest cyclical indicators, however, suggested that the euro area's expansion had slowed from its earlier brisk clip.** On preliminary data, (annualized) real growth in the second half of the year was about 2¾ percent, or about 1 percentage point less than in the first semester. Indicators of business and consumer sentiment also dipped in the second half, but remained at levels close to previous cyclical peaks (Figure 3). Developments varied significantly across countries, however, with consumption ending up quite weak in Germany (largely because of oil-related losses in household purchasing power), but rather buoyant in France and Italy (where tax cuts and employment growth offset the terms of trade shock).

8. **The officials at the Commission and the ECB shared the mission's view that domestic demand would continue to provide the bedrock for growth, barring a shock to confidence triggered by external events.** Internal demand appeared to have softened at end 2000, but, looking ahead, tax cuts were likely to offset the lingering effects of the rise in oil prices. In tandem with strong employment growth—job creation in the euro area has exceeded that in the United States for some years (Figure 1)—the area's domestic demand growth seemed set to remain robust—an assessment supported by recent cyclical indicators.

9. **Opinions differed, however, on the possible impact of the shift in the external environment on real GDP growth.** There was agreement that the downside risks to growth in the euro area, particularly from the slowdown in the United States, had increased, but with staff seeing growth slowing somewhat more—to 2¾ percent rather than 3 percent. The Commission stressed the limited trade linkages and the dispersion of stock ownership in the euro area, as well as the still supportive monetary conditions, to buttress its case. ECB officials agreed but were more cautious. They pointed to heightened volatility of energy markets, and raised the possibility of adverse confidence effects spilling over from the traded good sector or globally diversified euro-area companies, which could undercut the momentum of internal demand.[4] It should be noted that the impact of a U.S. slowdown very much depends on the exact configuration of shocks. The most damaging scenario would involve spillovers to the euro area from a further correction in the U.S. equity market—in particular, in the technology and telecommunication sectors—and a sizable depreciation of

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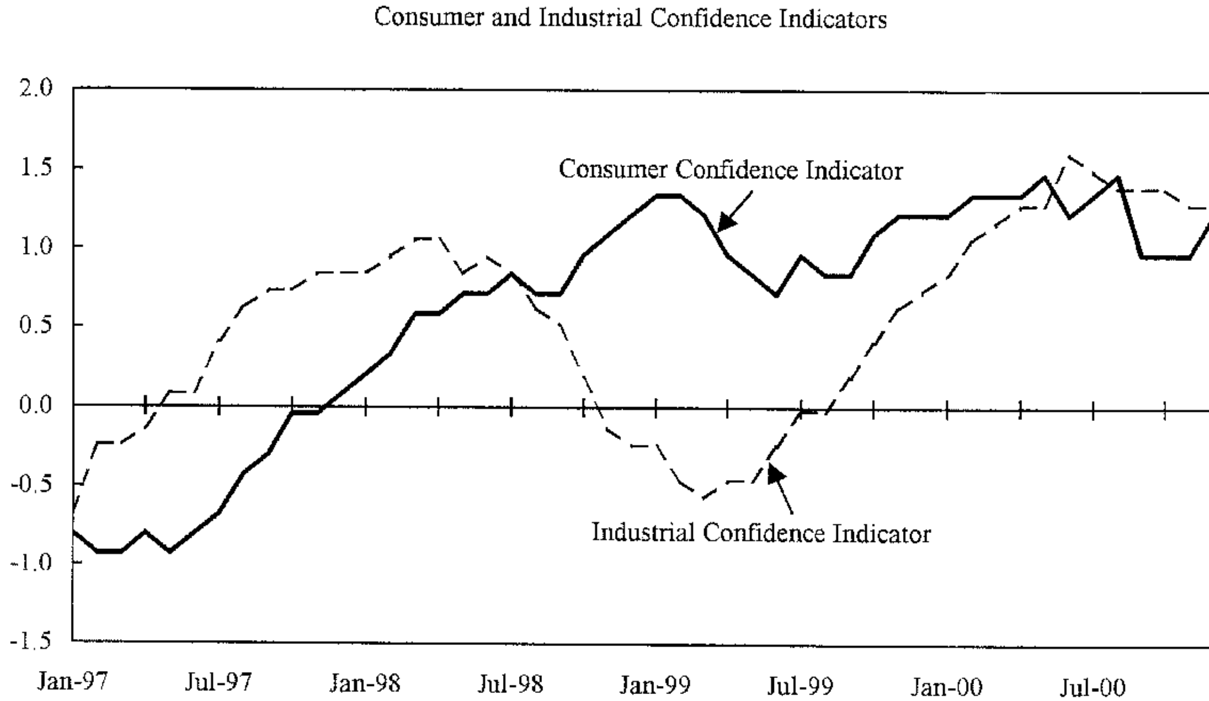
[3] This view is corroborated by econometric work by the staff, as well as at the OECD (Economic Outlook, December 2000) and the Commission (The EU Economy 2000 Review, November 2000.)

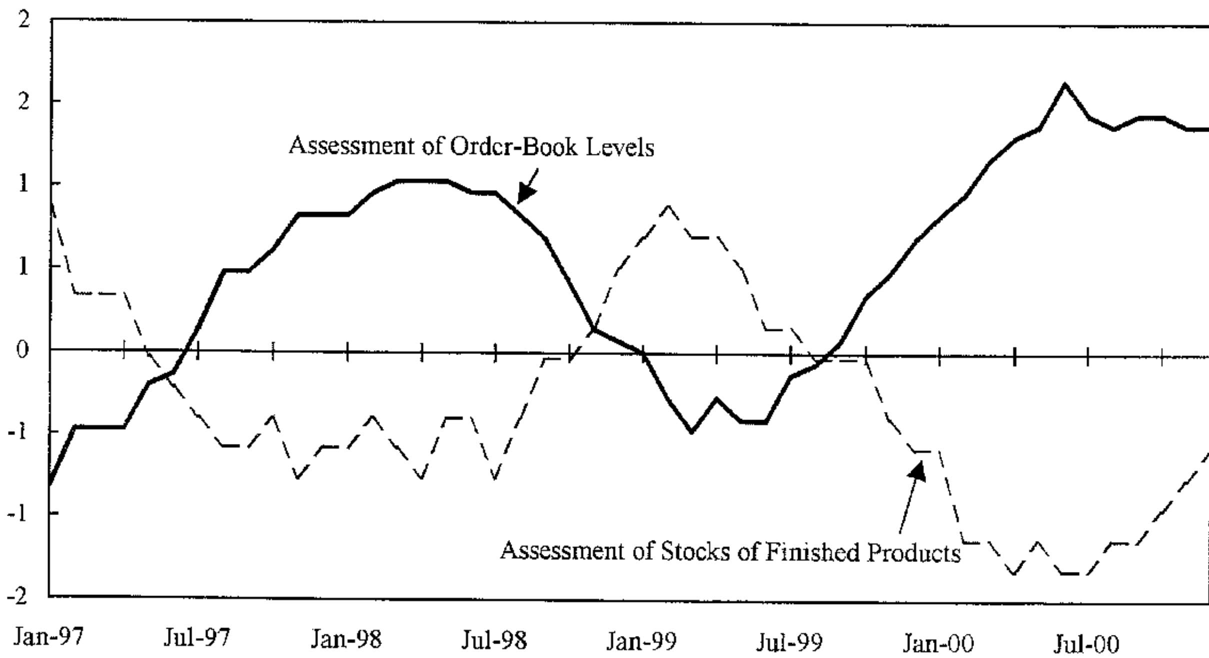
[4] In December, the ECB staff released GDP growth projections for the near term. For 2001, growth was then forecast in the 2.6-3.6 percent range.

Figure 3. Euro Area: Confidence Indicators 1/

Consumer and Industrial Confidence Indicators



Assessments of Order-Book Levels and Stocks of Finished Products in Industry 2/



Source: European Commission.

1/ Indices, standardized over 1985-2000.

2/ Positive values indicate that actual stock inventories exceed 1985-2000 period average.

the U.S. dollar (Box 1).[5] On current WEO projections—which by assumption rule out changes in the real exchange rate—the staff's expectation is for euro-area GDP growth of 2.7 percent in 2001 and 2.9 percent in 2002—some ¾ percentage points below the October 2000 WEO, and for 2001 broadly in line with the second configuration of shocks in Box 1. Were the euro to appreciate strongly, the output deceleration could be significantly more pronounced.

B. Monetary Policy and the Inflation Outlook

10. **Mostly because of external factors, inflation accelerated sharply in the euro area last year and led to widespread support for the ECB's policy of tightening.** Rising oil prices and the euro's depreciation pushed the Harmonized Index of Consumer Prices (HICP) inflation rate to 2.9 percent by November (year-on-year), significantly above the ECB's definition of price stability (i.e., an increase in HICP of below 2 percent) (Figure 4). Volatile food prices also played a role. Such an outturn, which had been more or less anticipated by late summer, had prompted the ECB to continue raising interest rates—by a cumulative 175 basis points for the year as a whole (Figure 5). This had been widely welcomed, including by staff, out of concern that the combination of the area's past indexation behavior and a strong expansion might prompt second-round inflationary effects.

11. **By the time of the discussions, it was agreed that the risks to price stability had become better balanced.** The tightening of monetary policy, the deceleration in area-wide output, the prospect of a global slowdown, the fall off in oil prices from earlier peaks, the halt in the euro's depreciation, the decline of monetary growth, and the continued moderation of wage behavior had all contributed to reduce the upside risks that had previously been seen to predominate. Views differed, however, on the extent of the rebalancing.

12. **For the ECB, medium-term risks to price stability had become at best balanced.** Headline inflation, while declining, would remain above the benchmark for price stability for some time to come, and pass-through of past energy price increases and exchange rate depreciation would continue to push up core inflation. Headline inflation excluding energy and unprocessed foods (HICPX) had continued to creep up, to 1.7 percent in January 2001 from 1.2 percent a year earlier. Moreover, this was a development that should be expected to continue as the recovery proceeded and labor markets tightened, all the more so given the weakness of the euro which would, if sustained, induce price and wage setters to attempt to restore eroded profit margins and purchasing power. More broadly, the positive surprises of the past few months might well reflect a delayed response rather than a breakdown of key relationships—particularly wage setting behavior. Moreover, while monetary growth had slowed, it had remained well above the ECB's reference value of 4.5 percent. The resulting

[5] In addition, financial vulnerabilities arising from the recent expansion of European banks' overseas operations and their exposure to the telecom sector could come to the fore.

Box 1. U.S. Growth and Macroeconomic Spillover Effects to the Euro Area

The impact of a growth slowdown in the United States depends very much on the shocks driving the U.S. slowdown. This is apparent from three illustrative simulations based on MULTIMOD, the Fund's macroeconomic model.

Three shocks were considered: an aggregate demand shock (AD shock) in the U.S.; a shock to the market valuation of capital that reduces Tobin's q (TQ shock) in the U.S. as well as in other major industrial countries; and an exchange rate depreciation shock (FX shock) that lowers the effective value of the U.S. dollar against other currencies. The AD and TQ shocks unambiguously crimp economic activity in the U.S.; by contrast, the FX shock is unambiguously positive for U.S. economic activity, but at the cost of lower activity elsewhere.

Three configurations of these shocks were considered and calibrated in such a way that each configuration reduced real GDP growth in the U.S. by 1 percentage point (relative to the WEO baseline). The first-year impact effects (in percentage points) on real GDP growth:[1]

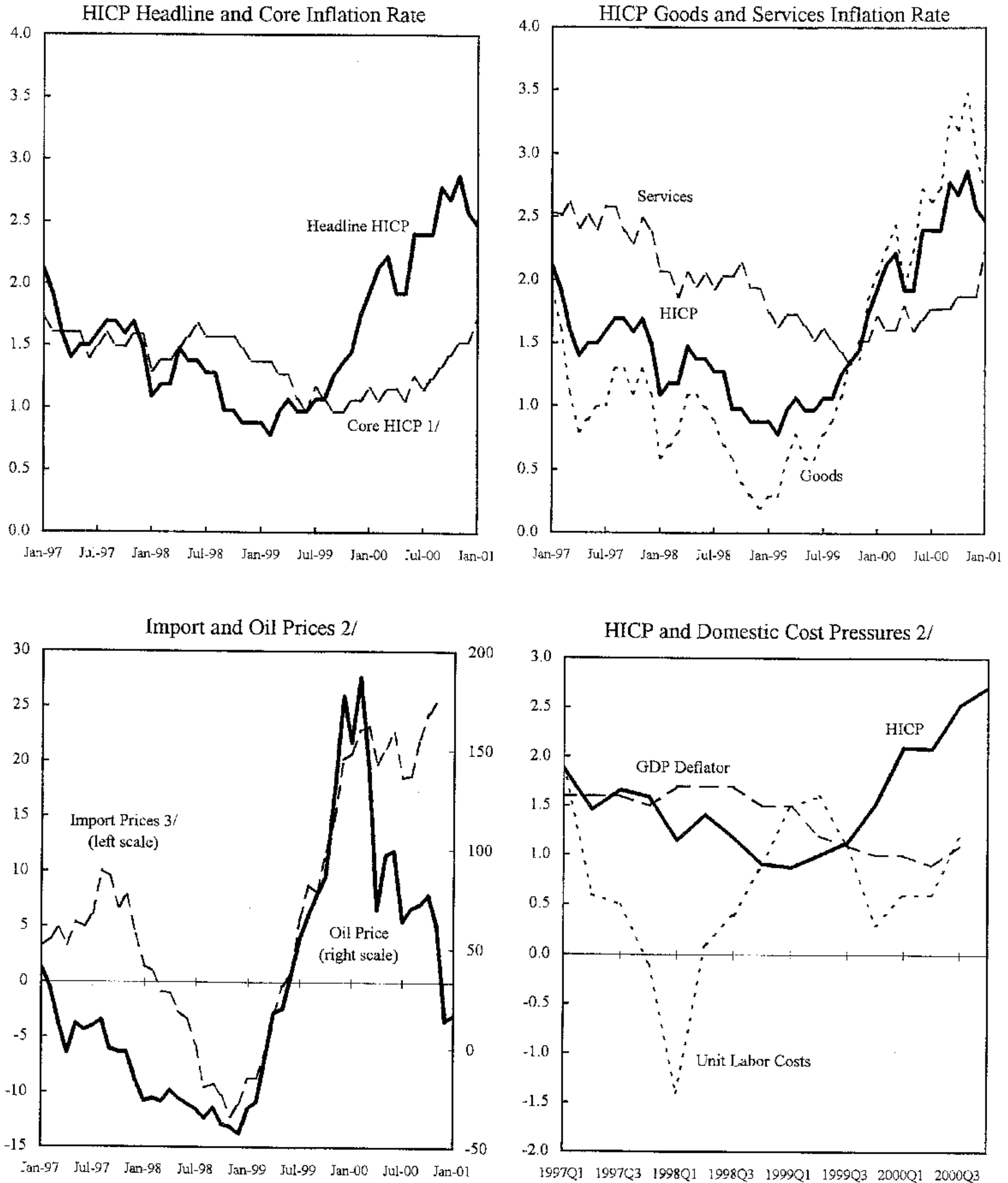
Shocks	U.S. GDP Growth	Euro-Area GDP Growth
AD shock only	-1.0	-0.1
AD and TQ shocks	-1.0	-0.4
AD, TQ, and FX shocks[2]	-1.0	-0.7

The simulation results for the first shock configuration (AD shock only) suggest that a U.S. growth slowdown triggered by an isolated adverse U.S. aggregate demand shock would reduce euro-area growth only moderately, reflecting the relatively small trade linkages between the two currency areas. By contrast, the other two shock configurations highlight that bringing financial market shocks and transmission channels into play results in markedly lower growth prospects in the euro area.

[1] On the policy side, the simulations assume forward-looking monetary policies that target medium-term price stability (core inflation targeting) and no discretionary fiscal policy responses (automatic fiscal stabilizers are allowed to operate fully).

[2] A version of this particular shock configuration (but also including a negative AD shock in Japan) underlies the Spring WEO's "hard landing" scenario in Annex I.

Figure 4. Euro Area: Harmonized Index of Consumer Prices (HICP)



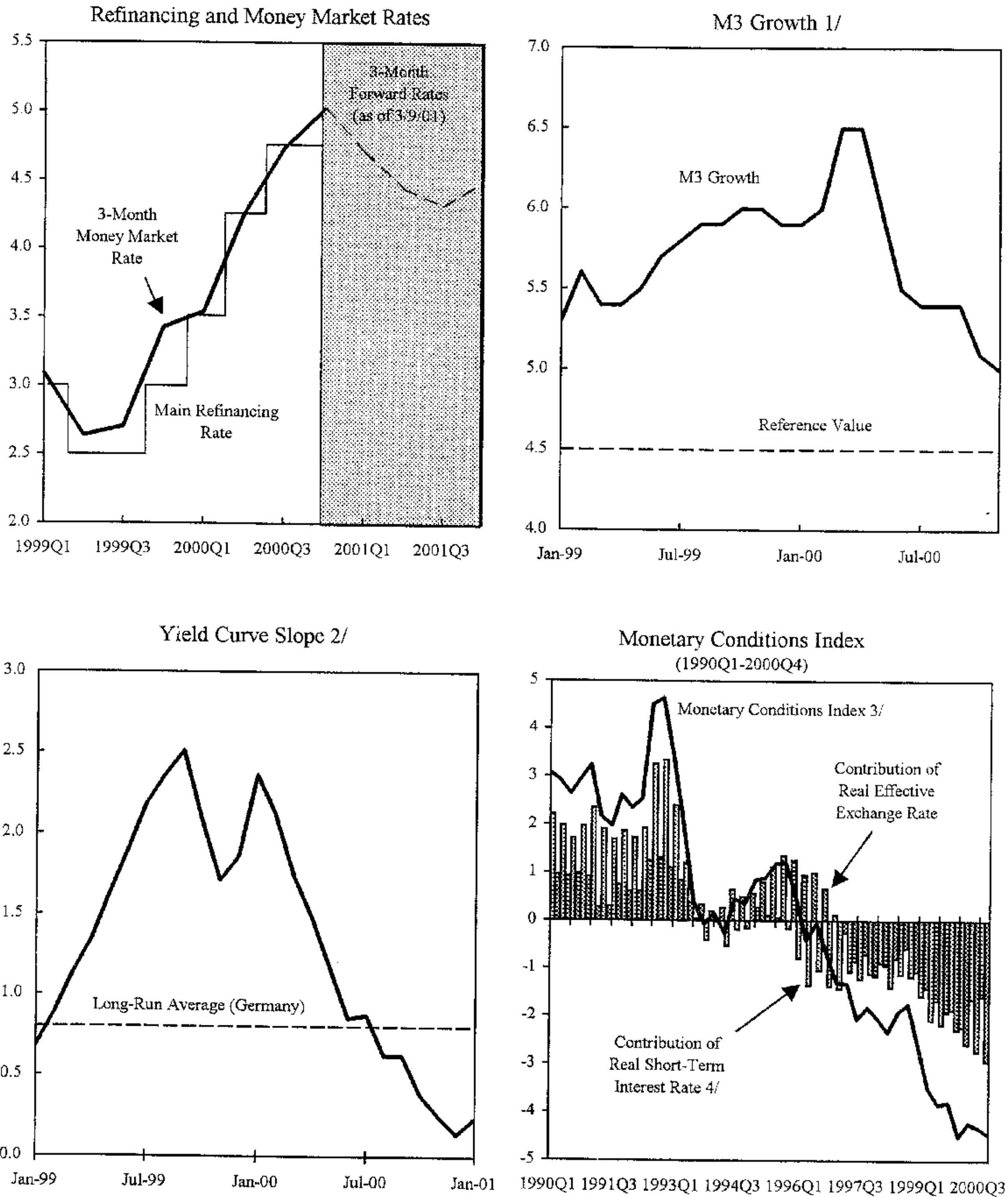
Sources: Eurostat; European Central Bank; IMF.

1/ Overall index excluding energy and unprocessed food.

2/ Year-on-year percent change.

3/ Import unit values.

Figure 5. Euro Area: Monetary Policy



Sources: IFS, IMF; European Central Bank; Bloomberg.
1/ In percent, 3-month centered moving average.
2/ 10-year government bond yield minus 3-month Euribor.
3/ Conditions relative to average over 1990-2000.
4/ Deflated by HICP inflation.

cumulative monetary overhang posed a lingering threat to medium-term price stability even if some of it could be viewed as absorbed by the terms of trade loss. Finally, while the various indicators of monetary stance used by the IMF or other international institutions (including the slope of the yield curve, Taylor rule calculations, and different monetary condition indices) gave somewhat different readings, most assessments by external observers suggested that conditions remained supportive and that real interest rates remained within their (likely) neutral range. In the ECB's view, while the risks had diminished they remained present and warranted a cautious policy setting—and certainly no preemptive monetary easing.

13. **The staff argued instead that inflationary pressures were largely absent and risks to price stability were tilted to the downside.** Admittedly, the continuing weakness of the euro and the prospect of a continuing recovery gave grounds for thinking that pressures might emerge in time. Nonetheless, several developments suggested that the balance of risks had been tilted to the downside over the time horizon when policies might be deemed effective. Foremost among these was the unexpected absence to date of any visible response in either wage setting or profit margins to the rise in oil prices and the euro depreciation. This was plain from the behavior of wages, which remained quite subdued even in areas where signs of labor market tightness would have suggested otherwise.[6] Unit labor cost increases had been well within the ECB's inflation boundary (2 percent), and seemed likely to remain so given more supportive external prices and the unfolding effects of past interest rate increases. In this regard, the staff was not convinced that HICPX was a good measure of core inflation, as it included the indirect effects of oil price increases (e.g. the effect of increased oil prices on airline tickets). Estimates of HICPX excluding such indirect effects suggested continuing stability, around 1¼ percent (Box 2). Taken together, these developments pointed to better functioning markets, thus allaying near- to medium-term concerns about wage behavior. In such a perspective (with "underlying" inflation in the 1¼ to 1½ percent range), real interest rates appeared to be on the high side of the neutral range. In the same vein, M3 growth was on a declining path. Indeed, the staff estimates that M3 growth could fall below its reference value soon, if interest rates remain at current levels.[7] Overall, therefore, the staff felt that, given the pipeline effects of past interest rate increases, headroom for price stability was emerging at current interest rates.

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[6] Wages have accelerated on a per hour basis, notably in France and Germany, but for reasons unrelated to wage demands (the 35-hour initiative in France, and working days adjustment in Germany). Compensation per employee and unit labor cost data continue to show a flat trend. No major wage rounds are envisaged for 2001 in France and Germany; ongoing ones in Italy do not appear to threaten wage moderation, while in Spain backward indexation might add to cost pressures.

[7] The latest observation confirms the downward trend: M3 growth fell to 4.7 percent (year-on-year) in January.

Box 2. External Price Shocks and Pass-Through to Consumer Prices

Since the start of stage 3 of EMU, sharp movements in the exchange rate and oil prices have buffeted the euro area. The impact of these external shocks on the short- and medium-term path of headline HICP inflation depends on a number factors including: (i) the degree of exchange rate pass-through to import prices, and on to consumer prices; and (ii) the direct energy use of households and the use of energy as an input in the production of other consumer goods. This box argues that the exchange rate pass-through may be smaller following the EMU regime change. It also examines the recent behavior of inflation shorn of the direct and indirect effect of energy price shocks. The discussion of the latter issue suggests that a standard measure of "core inflation" (i.e. headline inflation minus the direct energy use component) may not provide an adequate measure of the "permanent component" of inflation if the indirect effects of temporary energy price shocks feed through to prices with a lag.

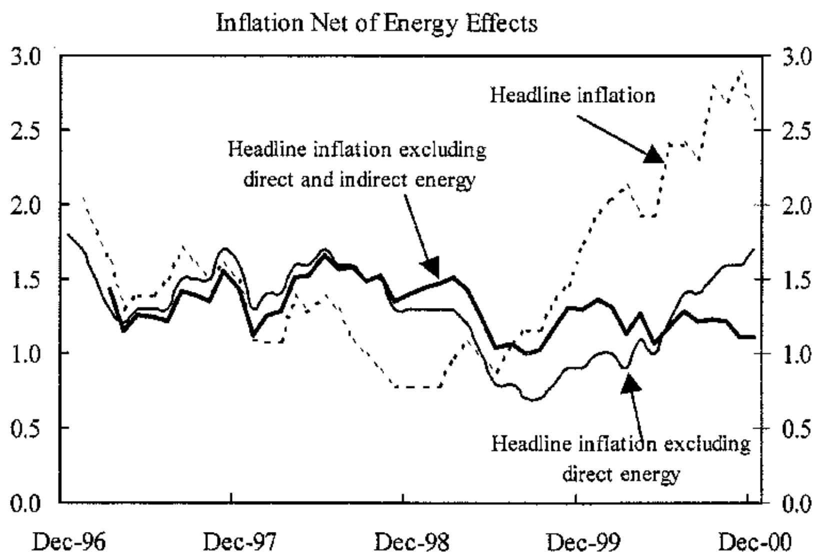
Exchange rate pass-through: The establishment of a large monetary union may have reduced both the speed and size of the pass-through of exchange rate fluctuations to consumer prices for three reasons:

Increased use of euro as an invoice currency: Euro-area countries have more of their imports invoiced in euros, reducing the pass-through of temporary exchange rate changes to consumer prices;

Increased credibility of monetary policy: It has been argued that a credible shift to a low-inflation regime reduces the "pricing power" of firms; as a special case of this argument, lower perceived persistence of cost changes due to exchange rate movements should lower pass-through to consumer prices.

Structural reforms' effects on domestic cost pressures: With more competitive pressures in the markets for goods and services due to product market reforms and the adoption of a common currency, it may be more difficult for importers and retailers to pass on higher costs to consumer prices.

Direct and indirect effects of energy price shocks: In the case of temporary energy price shocks, assessing underlying inflation trends requires an estimate of the temporary impact of the shock on headline inflation. As a first approximation, analysts use measures of headline inflation adjusted for the direct energy component to derive a measure of "core inflation." However, the prices of non-energy products are also affected by energy costs in production and distribution. Input-output analysis suggests that the indirect energy content of consumption is close to two thirds the direct energy content. Further adjusting the traditional measure of "core inflation" by removing these lagged indirect but temporary effects results in a measure of underlying inflation that appears to have remained subdued as the external shocks propelled the headline inflation rate upward. Thus, it would appear that most of the upward creep in (traditionally measured) core inflation reflects temporary pipeline effects from energy price shocks.



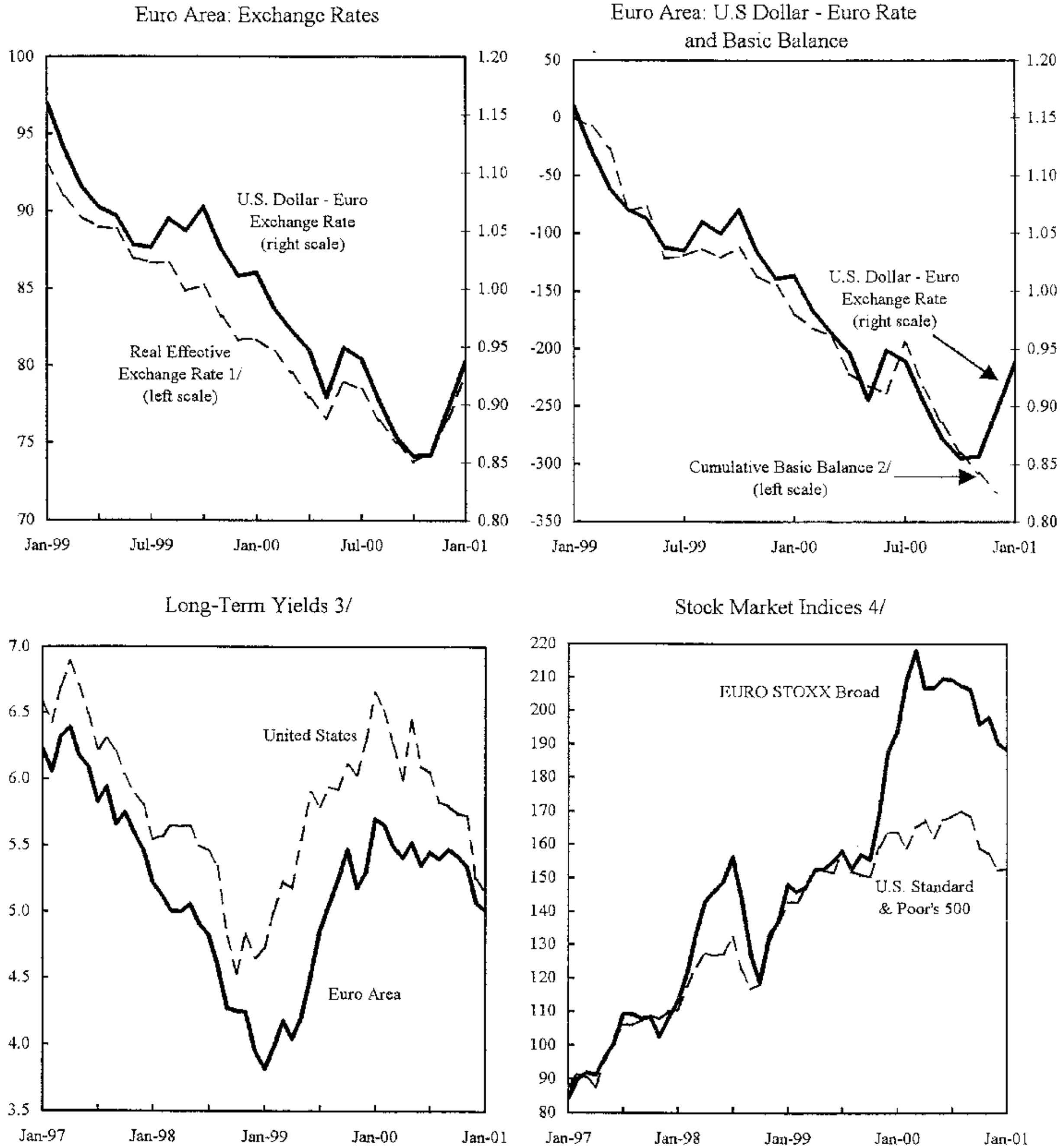
14. **These more benign, if uncertain, medium-term inflation prospects needed to be weighed, however, against still well-above target headline inflation rates, and the staff agreed at the time of the discussions that a wait-and-see attitude was warranted.** It argued, however, that scope for reversing the tightening cycle was emerging, and the ECB ought to stand ready to take action, especially if the euro appreciated or concerns about financial spillovers from the United States mounted. Developments since the discussions weigh in favor of the staff's view: the headline inflation rate has receded and is expected by the staff to fall below 2 percent soon, wage developments have remained quite moderate, growth has slowed in line with staff expectations (and beyond, in Germany), and prospects in the United States and Japan have weakened considerably relative to those envisaged at the time of the discussions.

15. **The euro remains quite weak.** The real effective exchange rate is significantly below its historical average. The slide in the euro's exchange rate since the beginning of Stage 3 of EMU has been mirrored by a similar trend in the area's basic balance (current account balance plus foreign direct investment and net portfolio flows) (Figure 6). By early fall 2000, the bilateral U.S. dollar-euro exchange rate had declined to a low of US$0.82, before recovering to above US$0.90 following several rounds of official exchange rate interventions. The euro remains competitive: the Fund's macroeconomic-balance approach suggests that the currency is undervalued by more than 25 percent against the U.S. dollar and by some 10 percent in effective terms. In line with developments in U.S. financial markets, stock prices in the euro area drifted downward throughout 2000, as have nominal long-term bond yields, but by less than in the United States.

16. **Interpretations of the sluggish rebound of the euro differed.** The Commission and the ECB staff thought that the euro's turnaround owed much to the downward revision of the growth outlook for the United States. At the ECB, the prevailing view credited also official interventions, whose timing matched evidence from the option markets of a shift in market sentiment (toward a higher probability for a large euro appreciation than for a large depreciation). The staff saw merit in both points and, in addition, drew attention to the role of euro-area investors' desire to diversify their portfolios, which appeared to have slackened in the second half of 2000 but might still not have run its full course.[8] There was agreement that exchange rate developments had been mostly driven by a host of different factors, which the euro-area policy mix—particularly the increases in interest rates—offset only in part. Nevertheless, all sides agreed that there was a distinct lack of understanding why the recent rebound in the currency had been fitful and—all in all—limited.

[8] See the forthcoming Spring 2001 WEO.

Figure 6. Euro Area: Exchange Rates and Financial Markets



Source: Eurostat; IFS, IMF; European Central Bank.

1/ Average for 1980-1999 is 100.

2/ Cumulative current account plus net FDI and net portfolio flows since January 1999.

3/ 10-year government bond yields.

4/ Average for 1997 is 100.

C. Fiscal Policy Issues

17. **In the fiscal discussions, there was widespread recognition that public finances improved in 2000, but largely because of fortuitous events.** Budget revenues were boosted by faster-than-expected growth and the windfall from the sale of UMTS licenses (Table 1). The area-wide fiscal balance moved into surplus in 2000—a first since the early 1960s—but adjusted for cyclical buoyancy and license receipts, the area's underlying fiscal balance had not improved. Moreover, it was projected to deteriorate marginally in 2001, although mostly as a result of welcome tax reductions in some key countries. The aggregate picture hides a great deal of heterogeneity: fiscal positions vary significantly across euro-area members (Figure 7).

Euro Area: General Government Structural Balances

	2000	2001	Change 2000-01
Euro Area	-0.5	-0.6	-0.1
Germany	-0.8	-1.5	-0.7
France	-0.6	-0.6	0.0
Italy	-0.4	-0.3	0.1
Spain	-0.9	-0.4	0.5

Source: Staff estimates.

18. **As regards short-term fiscal policy, the need to allow full play to the automatic stabilizers in case downside risks to growth materialized was not unquestioned.** Looking back, the mission noted that more—if not all—of the unexpected buoyancy of tax revenue in 2000 ought to have carried over into smaller deficits or larger surpluses. Symmetrically, if growth in 2001 were lower than assumed in the budgets, the automatic stabilizers should be permitted to operate in the other direction. In these circumstances, missing nominal budgetary targets would not be cause for concern for all but the few countries with clearly excessive debt-to GDP ratios. Although officials at EU institutions agreed with this strategy, some thought that safety margins built into most countries' budgets would leave room for achieving nominal deficit targets even in the event of a growth slowdown, while others thought that a failure to meet pre-set nominal targets might undermine confidence in EMU's fiscal framework. The mission acknowledged that contingencies built into the budgets might suffice to deal with a modest output deceleration.

19. **The updated Stability Programs suggested that medium-term fiscal policies in the euro area remained stability-oriented but unambitious especially as regards structural expenditure reforms.** In the last few months, all countries submitted updated Stability Programs to the Commission that in most cases envisage continued spending restraint and tax cuts. In the aggregate, the Stability Programs envisage a reduction in the actual balance from a deficit of ¾ of 1 percent of GDP in 2000 (excluding UMTS license receipts) to a surplus of ½ of 1 percent of GDP in 2004. The underlying fiscal position or stance remains roughly stable during the projection horizon—in line with the staff's own medium-term fiscal outlook for the euro area (Table 1). The staff noted—and the officials at the EU institutions concurred—that the updated plans were unambitious in the sense that the cut in the actual balance reflected exclusively non-discretionary fiscal adjustments (Box 3). Moreover, although spending restraint remained the cornerstone of the stability plans, it was not clear how restraint would be implemented and whether there was scope for doing more.

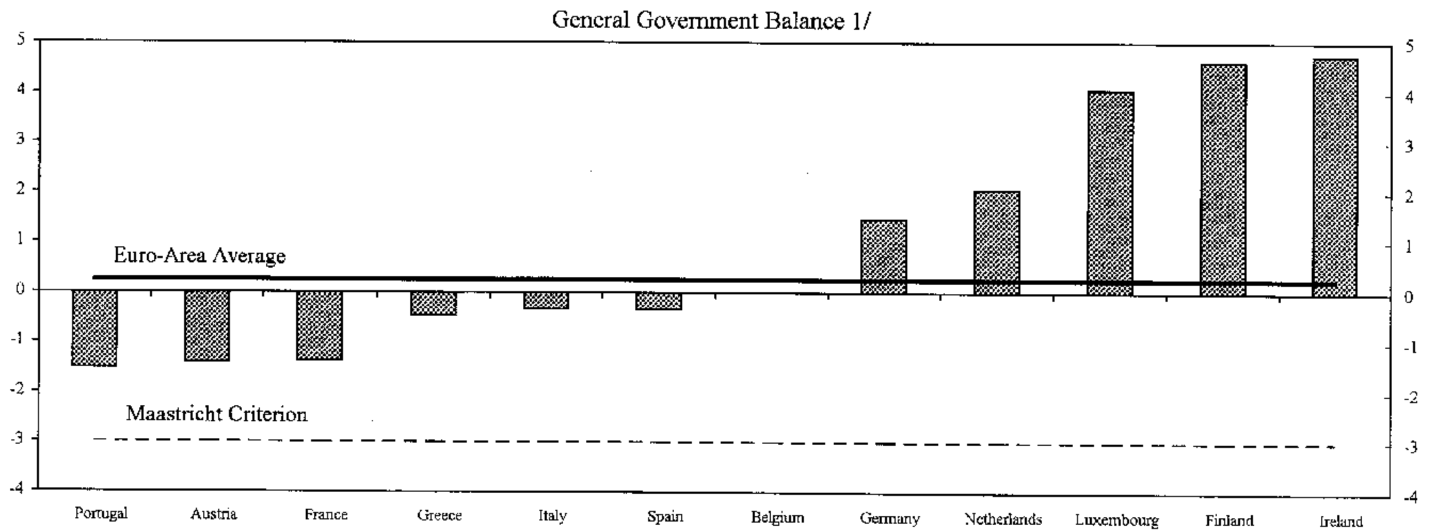
Table 1. Euro Area. Medium-Term Fiscal Projections of General Government Finances
(In percent of GDP unless otherwise noted)

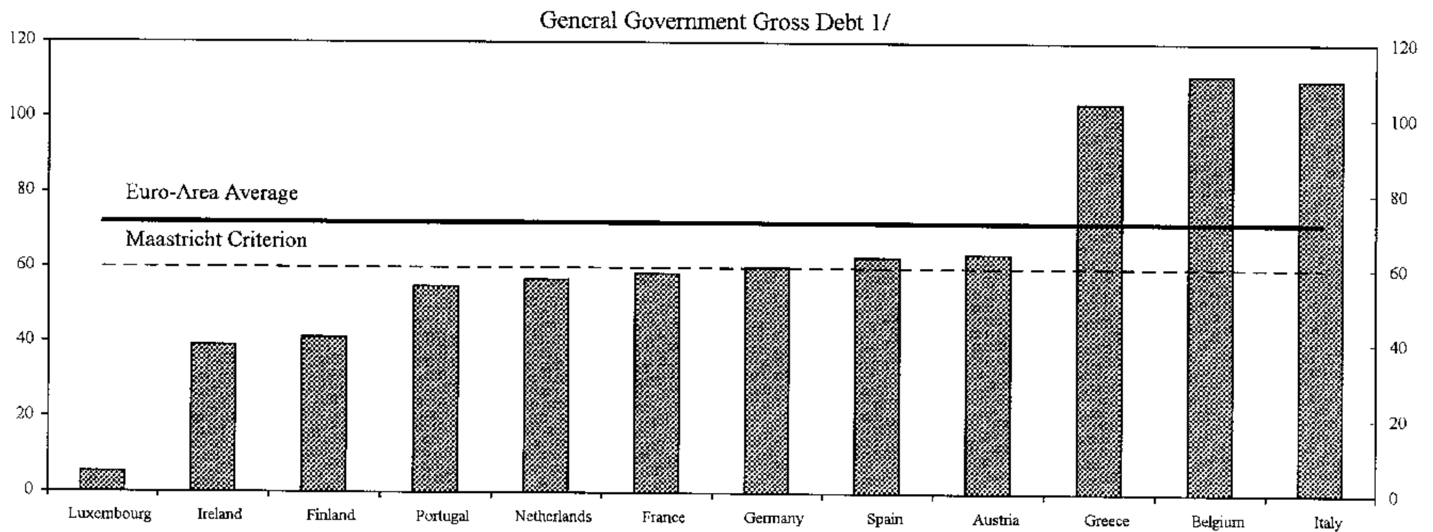
	1999	Proj. 2000	Proj. 2001	Proj. 2002	Proj. 2003	Proj. 2004
WEO Projections 1/						
Revenue	47.2	47.0	46.5	46.2	45.9	45.7
Expenditure	48.4	46.7	47.2	46.6	46.0	45.6
of which:						
interest payments	4.2	4.0	3.8	3.6	3.5	3.4
Overall balance	-1.3	0.2	-0.7	-0.4	-0.2	0.1
without UMTS revenues 2/	...	-0.8	-0.9	...	...	...
Structural balance	-0.6	-0.6	-0.5	-0.5	-0.3	0.0
Primary balance	3.0	4.3	3.1	3.1	3.4	3.5
Primary structural balance	3.6	3.4	3.2	3.1	3.3	3.4
Memorandum items:						
Real primary spending						
without UMTS revenues 3/ 2/	2.8	2.3	2.6	2.0	1.6	2.0
Real GDP 3/	2.6	3.4	2.7	2.9	2.8	2.7
Gross debt	74.0	71.8	69.1	66.9	64.8	62.4
Output gap	-1.2	-0.3	-0.2	0.0	0.2	0.2
GDP deflator 3/	1.3	1.3	1.9	1.6	1.6	1.5
Updated Stability Plans 1/						
Revenue	...	46.1	45.2	44.8	44.3	44.1
Expenditure 4/	...	46.8	45.8	45.1	44.3	43.8
of which:						
interest payments	...	4.1	3.9	3.8	3.7	3.6
Overall balance 4/	...	-0.7	-0.6	-0.3	0.0	0.4
Structural balance	...	-0.4	-0.6	-0.4	-0.2	0.1
Primary balance 4/	...	3.3	3.3	3.5	3.7	3.9
Primary structural balance	...	3.6	3.3	3.4	3.4	3.6
Memorandum items:						
Real primary spending 3/	...	2.3	1.2	1.3	1.3	1.5
Real GDP 3/	...	3.1	3.0	2.8	2.8	2.8
Gross debt	...	69.6	66.6	64.7	62.5	59.9
Output gap	...	-0.7	-0.2	0.1	0.3	0.5
GDP deflator 3/	...	1.3	1.9	1.7	1.6	1.6

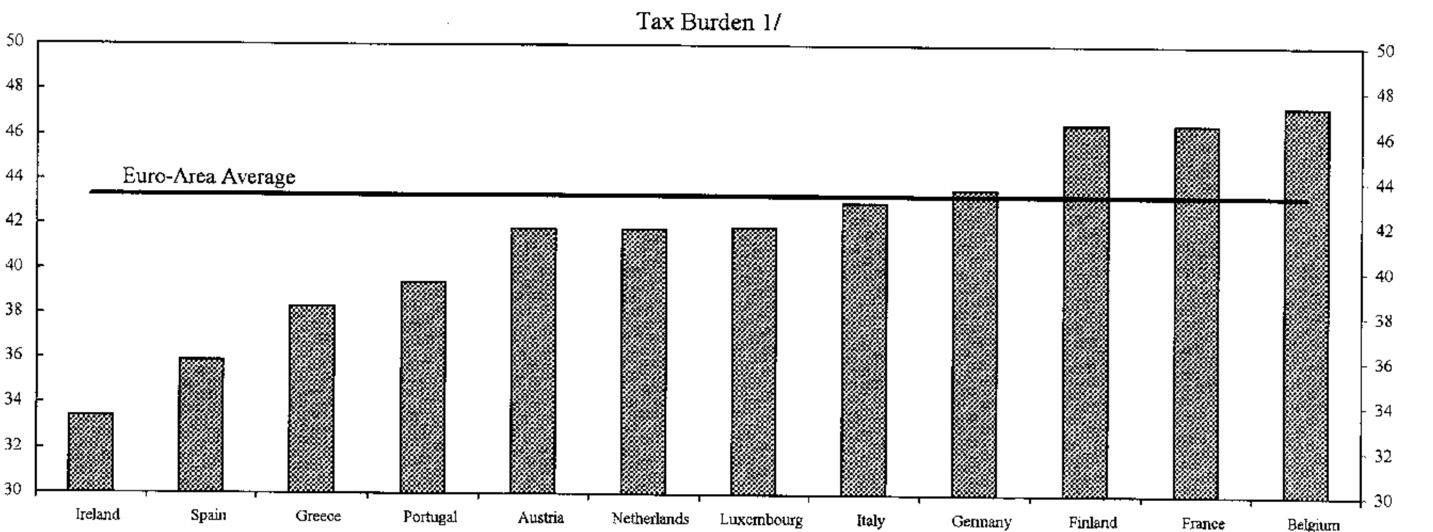
Source: European Commission; IMF, World Economic Outlook; and Fund staff calculations.

1/ Direct comparisons between WEO data and updated Stability Plans can be problematic due to different assumptions regarding real GDP growth, inflation, and the path of fiscal balances.
2/ The following countries reported UMTS revenues as a percent of GDP:
Austria 0.2 in 2000, and 0.1 in 2001; France 1.1 in 2001; Germany 2.5 in 2000; Italy 1.2 in 2000; the Netherlands 0.7 in 2000; and Portugal 0.4 in 2000.
3/ Percentage change.
4/ Excluding UMTS license receipts, which are recorded as negative capital expenditures.

Figure 7. Euro Area: General Government Finances, 2000







Sources: WEO database; European Commission.
1/ In percent of GDP.

Box 3. The 2001-2004 Stability Programs

In the aggregate, the updated stability programs envisage a strengthening in the euro area's fiscal balance from a deficit of ¾ percent of GDP in 2000 (excluding UMTS license receipts) to a surplus of ½ percent of GDP in 2004 (see text Table 1). The underlying fiscal position—as measured by the structural primary balance—remains roughly stable during 2000-04, in line with the staff's medium-term fiscal outlook for the euro area. Therefore, the bulk of the total improvement in the balance can be attributed to the operation of automatic fiscal stabilizers[1] (¾ of 1 percent of GDP), while the rest is due to a decline in the debt interest burden. Thus, good times are not used actively to speed up the attainment of medium-term positions able to deal with impending budgetary demands and further fiscal reforms.

On the spending side, the euro area's aggregated stability programs entail an average growth rate of real primary spending of 1½ percent during 2001-04, with especially strong expenditure restraint in Austria, Finland, and Germany (see Box Table 1). On the revenue side, spending restraint and the medium-term balance target create headroom for a cut in the euro area's revenue ratio by 2 percentage points—with cuts above 3 percentage points in Finland, Germany and the Netherlands. The euro area's gross debt ratio would be put on a steady downward trend, falling by some 10 percentage points to about 60 percent of GDP by 2004. But debt levels in three countries—Italy, Belgium, Greece—would remain in the 85-95 percent of GDP range in 2004.

Table 1. Euro Area: Selected Elements of Updated Stability Programs 1/ 2/

	Debt Ratio 2004	Fiscal Balance 2004	Change between 2000 and 2004				Average Growth Rate 2000-2004	
			Balance	Primary Expenditure	Interest	Revenue	Real Primary Expenditure	Real GDP
Euro Area	**59.9**	**0.4**	**1.1**	**-2.6**	**-0.5**	**-2.0**	**1.5**	**2.9**
Germany	54.5	0.0	1.0	-4.0	0.0	-3.0	0.2	2.6
France	52.3	0.2	1.6	-2.9	-0.3	-1.5	1.7	3.1
Italy	94.9	0.4	1.7	-2.5	-1.3	-2.1	1.5	3.0
Spain	49.6	0.3	0.6	-0.6	-0.1	-0.1	3.1	3.4
Austria	55.3	0.0	1.4	-2.1	-0.3	-1.0	0.8	2.8
Belgium	92.9	0.5	0.4	-0.2	-1.3	-1.1	1.8	2.5
Finland	32.2	4.9	0.4	-2.5	-1.1	-3.2	1.4	3.6
Greece	84.0	1.9	2.6	-1.7	-2.3	-1.4	3.9	5.1
Ireland 3/	24.0	4.6	-0.1	0.1	-0.8	-0.6	7.6	7.9
Luxembourg 3/	....	2.5	-0.5	-2.3	0.0	-2.9	3.5	6.2
Netherlands	46.7	0.3	-0.7	-1.5	-0.9	-3.1	2.4	2.6
Portugal	48.1	0.0	1.5	-0.5	-0.3	0.7	4.2	3.2

1/ Data based on stability programs submitted to ECOFIN in late 2000 and early 2001.
2/ In percent of GDP.
3/ Stability program is for 2000-2003 only; therefore all figures refer to data ending in 2003.

[1] This statement is sensitive to assumptions about potential growth and the NAIRU: e.g., if potential output is assumed to expand at 3 percent annually, the improvement of ¾ of 1 percent of GDP would be structural.

Finally, tax cut packages appeared not to be sufficiently targeted on supply-side problems, particularly the high tax burden on labor.

D. Structural Issues

20. **The need for further fiscal and structural adjustment was underscored by lack of clear-cut evidence on whether potential output growth in the euro area might be increasing.** The discussion suggested that many, in part offsetting, factors were at work. The Commission staff presented some evidence that the "new economy" had begun to raise the euro area's speed limit for growth, but ECB officials were more skeptical noting that other factors (including a shrinking working age population and plateauing participation rates) were reducing potential growth. The mission noted that, in the euro area's apparent transition to a state of durably lower unemployment, growth had become more employment-intensive, making it difficult to pin down the impact of the new economy on potential output growth.

21. **Against this background, the mission and the officials at EU institutions thought it disappointing that the pace of structural reforms in product and labor markets remained uneven.** Clearly, deregulation in the network industries—particularly telecommunications and electricity—and a more effective competition policy were paying off. However, reform efforts needed to be maintained and accelerated in the areas of gas, transport, postal services, and public procurement. Privatization also needed to be pursued more aggressively in key countries. By everybody's assessment, structural reforms of the labor market were being tackled more timidly, although some increase in flexibility appeared to have emerged as a result of non-conventional working arrangements and looser employment protection. The mission argued that more efforts were needed to allow better matching of wages, labor productivities, and reservation wages, including through an overhaul of national benefit and tax systems and, in some cases, wage bargaining systems—a task all the more urgent in view of emerging bottlenecks and the long gestation period for such reforms to bear fruits.

22. **Financial market integration was proceeding, but mostly as a market-driven process without integrated and transparent pan-European rules.** The Commission staff noted that the existing procedures for aligning national regulations were cumbersome and time consuming. As a result, financial integration was either stifled in some areas or developing outside a coherent area-wide framework in others (Box 4). There was agreement that the Lamfalussy report's suggestions for overcoming procedural roadblocks were timely and welcome.

23. **There was also agreement that internal EU surveillance on structural and fiscal policies was getting more prominent.** The Commission's call for a modification of Ireland's budget in violation of agreed economic policy guidelines was a case in point. The mission thought that the procedure that had been invoked could be a potentially important element in the framework for policy coordination, but needed to be applied evenly.

Box 4. Financial Market Integration: Status Quo and Remaining Obstacles

An integrated European securities market will be key to reaping the full efficiency benefits of EMU. Numerous barriers to cross-border activities have been hampering the attainment of that goal, including differences among member states in the legal traditions regarding eligible collateral and bankruptcy regimes; the tax codes; the restrictions on portfolio choices of pension funds; and the lack of integrated trading infrastructures. Incompatible clearing and settlement systems in some cases pose another daunting hurdle. While the processing of domestic trades has become standardized, cross-border trades generally cost 10-20 times more than domestic ones.[1] Nevertheless, market-driven integration appears to proceed at a rapid clip in some market segments, as reflected in mushrooming capital flows within the euro area, converging yields, and increasing correlation between stock market returns. This process is unfolding, however, at uneven speeds throughout the financial sector:

- **Money markets**, particularly unsecured deposit markets, have become closely integrated and standardized; but repo markets often remain divided along national lines owing inter alia to lack of harmonization of legal documentation and different tax treatments of bonds across euro-area member states. Segmented repo markets hamper the achievement of increased liquidity in securities markets.

- **Bond market** yields on government issues have largely converged across countries, with remaining spreads reflecting differences in liquidity and risk. Although the euro area's government bond market rivals the U.S. market in size, numerous smaller issues do not have comparable market depth. Corporate bond markets including a high-yield segment are developing, but outstanding amounts remain moderate relative to the U.S. market.

- **Equity markets** are expanding in terms of capitalization and turnover, underpinned by an emerging "equity culture," but investor portfolios retain a strong home bias, and attempts to provide trading platforms with a pan-European reach are confronted with regulatory and supervisory impediments. Risk (venture) capital markets remain highly fragmented.

A key obstacle to harmonizing the institutional framework for securities markets within the EU is the regulatory process. The process of adopting new regulations is slow, rigid, and produces ambiguous directives, which are often inconsistently applied in different countries. The EU has two key initiatives under way to address the inadequacies in the legislative and regulatory systems:

- The EU's *Financial Services Action Plan* identified more than 40 specific actions to dismantle barriers created by different national rules by 2005. This includes proposals on, for example, management of pension funds, market abuse, disclosure rules for publicly traded securities, cross-border collateral, and cross-border provision of investment services.

- The recently released *Lamfalussy report* identified key priorities of the *Financial Services Action Plan,* which should be adopted by the end of 2003, including the EU-wide adoption of international accounting rules, and reform of the rules for issuing prospectuses and admission to stock market listing. Moreover, the Lamfalussy report put forward proposals for establishing a speedier legislative and regulatory processes in the EU, including the establishment of a European Securities Committee, assisted by a sub-level committee, which would help flesh out detailed implementing rules and oversee the consistent implementation of agreed principles.

[1] See Danthine, Jean-Pierre, and others (2000), "European Financial Markets after EMU: A First Assessment," NBER Working Paper 8044.

24. **Available statistics for the euro area have improved, but much remains to be done, particularly for balance of payments data.** Staff at Eurostat pointed to marked progress in standardizing consumer price indices, government finance statistics, and national account statistics. At the same time, the timeliness (particularly at intra-year frequencies) and quality (notably, in the balance of payments[9]) of some key statistics was recognized as clearly unsatisfactory. These issues had been addressed by a Commission action plan endorsed by Ecofin, but as yet incomplete remedial steps at the national level left them outstanding.

25. **Trade discussions were focused on the status of the Commission's proposal for extending duty free access without any quantitative restrictions to all products (but arms) from the least-developed countries.** At the time of the staff visit the proposal was on hold, given a divergence of views within the Ecofin on the proposed liberalization of three "sensitive" products (bananas, rice, and sugar). In late February, a compromise proposal (basically, delaying to 2006 the liberalization timetable for bananas, and to 2009 for the other two products) offered by the EU Presidency was adopted by the General Affairs Council.

III. Staff Appraisal

26. **The euro area continues to do well.** The expansion that started in late 1997 has matured in a virtuous dynamics of sustained employment creation, rising disposable income, buoyant internal demand, and low inflation. Monetary unification has helped discipline wage developments and, together with a stability-oriented monetary policy, has anchored inflation expectations. Inflation appears under control.

27. **However, the external environment has shifted in recent months.** With the projected external slowdown, the partial reversal in oil prices, a stabilized exchange rate, and some moderation in area-wide growth, attention ought to shift from upside to downside risks.

28. **Domestic demand growth seems set to hold steady, but the outlook for GDP is more uncertain.** With declining export growth, downside risks to output growth loom large, notwithstanding the limited exposure of the euro area to external trade and the favorable internal dynamics. Real GDP is likely to expand by significantly less than expected in the October 2000 WEO, although the path ahead depends critically on the extent to which the global slowdown will affect investors' and consumers' confidence, and the exchange rate.

29. **In this context, monetary policymaking ought to reflect the shift in the balance of inflation risks.** Admittedly, the balance of the risks remains a fairly close call, and

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[9] Intra-euro area exports tend to exceed intra-euro-area imports by some 5 percent of the export values, or ¾ of 1 percent of area-wide GDP. In part, this reflects thresholds on reporting requirements that lead to underreporting of intra-euro area imports by smaller firms. The ECB published figures for the euro area that allow for this discrepancy.

headline inflation is still above the ECB's target range. Yet, with every passing month, the weight of the evidence shifts to a more upbeat view with all the indicators of "underlying" inflation (unit labor costs, profit margins, services price inflation, and core inflation purged of indirect energy effects) pointing to muted sources of domestic price pressures. Most notably, wage moderation in the face of last year's oil shock has made upside risks to price stability less proximate than six months ago, and bespeaks an inward shift of the inflation-unemployment trade off. In this situation, and with a pronounced retrenchment in global growth becoming more likely, a moderate downward correction in interest rates now seems appropriate, with a larger one being in order if the exchange rate were to appreciate sharply or indications of spillover effects from the slowdown in the United States were to mount.

30. **For the area as a whole, fiscal policies should continue to maintain a medium-term orientation, as there is little scope—or need—for counter-cyclical discretionary action in the near term.** Collectively, the successive vintages of stability programs have been disappointing. Beyond the failure to make sufficient headway toward fiscal positions that may provide the necessary room to smooth the budgetary impact of population aging, the fiscal strategy in the aggregate does not live up to the goal of releasing public resources to the private sector in order to strengthen the longer-term growth potential of the area as a whole. Expenditure policies need to be bolder: the scope for meaningful tax reductions to reinforce the supply side of the euro area—a goal only partly achieved in recent tax cut packages—remains constrained in several cases by overly timid steps in restructuring public spending, particularly for pensions and healthcare. From a conjunctural perspective, budget executions should not attempt to achieve a pre-set nominal target at all costs, if growth in 2001 falls short of budgetary assumptions. This principle seems well understood in the abstract, but it does not consistently inform fiscal conduct.

31. **With macro policies likely to be close to the mark, medium-term growth mainly depends on further structural reforms.** In some areas, the extent of structural improvements continues to surprise, for example as regards greater competition in product markets and added flexibility in some labor markets. However, more is needed. Two items stand out as requiring priority attention. First, in the labor markets, the lack of resolve to overhaul many national tax and benefit systems with a view to restoring work incentives inhibits effective labor supply and undermines sustained non-inflationary growth. Second, in the financial sector, the payoff from EMU will not be fully reaped without further actions to remove barriers to cross-border activities. The recent Lamfalussy report points in the right direction: better and consistent rules for financial integration are needed, and achieving this requires new procedural mechanisms to overcome parochial concerns.

32. **EU internal surveillance is becoming increasingly effective.** This is evident from the assessments of Member's Stability Programs, which the staff shares. Most recently, the Commission implemented for the first time an EU Treaty procedure to foster a coherent constellation of policies throughout the euro area. The principle thus established needs to be applied evenly across area's membership for it to pay off in terms of a strengthened monetary union.

33. **The need to design economic policies for the euro area as a whole has increased demands for high-quality and timely statistics.** While significant progress has been achieved in many areas including the standardization of consumer price indexes and national accounts, much remains to be done in other areas, particularly the collection of consistent balance of payments statistics. The current situation falls short of what is needed for effective regional surveillance and policymaking.

34. **The Council of Ministers' recent decision to grant duty- and quota-free treatment to the world's 48 poorest nations is a welcome development.** Notwithstanding a regrettably slow phasing out of restrictions on import of some agricultural products, the EU decision must be commended both for its economic significance and the signal it sends ahead of the forthcoming negotiations at the WTO on the launch of a new multilateral round.

35. It is expected that the next consideration by the Executive Board of the monetary and exchange rate policies of the euro-area countries in the context of their Article IV obligations will take place after the 2001 Annual Meetings.

Euro Area: Economic Indicators
(Annual percentage change)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001 1/	2002 1/
Real Domestic Demand	1.5	-2.2	2.1	2.2	1.1	2.0	3.7	3.3	2.9	2.5	2.6
Public consumption	3.0	1.3	1.0	0.7	1.6	1.0	1.2	1.7	1.8	1.2	1.3
Private consumption	2.0	-0.9	1.3	1.9	1.6	1.8	3.3	3.0	2.7	2.7	2.8
Gross fixed investment	0.1	-6.5	2.2	3.3	1.7	2.7	5.5	5.6	5.0	3.8	3.8
Final domestic demand	1.8	-1.7	1.4	1.9	1.6	1.8	3.3	3.3	3.0	2.6	2.8
Stockbuilding 2/	-0.3	-0.6	0.6	0.3	-0.5	0.2	0.4	0.0	-0.1	0.0	0.0
External balance 2/	0.0	1.4	0.3	0.2	0.3	0.5	-0.7	-0.5	0.5	0.1	0.2
Exports of goods and services 3/	4.0	1.2	9.1	8.1	4.3	10.8	6.7	4.3	11.8	8.7	6.4
Imports of goods and services 3/	3.8	-5.3	8.2	7.8	3.0	9.4	9.9	6.7	10.6	8.7	6.2
Real GDP	1.4	-0.8	2.3	2.3	1.5	2.4	2.9	2.6	3.4	2.7	2.9
Resource Utilization											
Potential GDP	2.3	2.2	1.9	2.0	2.1	2.3	2.3	2.4	2.5	2.6	2.7
Output gap (% of potential)	0.9	-2.1	-1.7	-1.4	-2.0	-1.9	-1.4	-1.2	-0.3	-0.2	0.0
Employment	-0.8	-2.0	-0.2	0.6	0.5	0.9	2.0	1.9	2.1	1.4	1.0
Unemployment rate (% of labor force) 4/	9.2	10.9	11.6	11.3	11.4	11.5	10.7	9.9	9.0	8.4	8.0
Prices and Wages											
GDP deflator	4.5	3.8	2.9	3.2	2.4	1.7	1.8	1.3	1.3	1.9	1.6
Consumer prices 5/	3.6	3.2	2.7	2.5	2.2	1.7	1.3	1.2	2.4	2.2	1.7
Manufacturing											
Hourly labor costs	7.3	5.7	3.4	3.8	4.3	3.1	1.8	2.6	3.0	3.2	3.1
Productivity	3.5	2.3	8.0	3.9	3.8	5.0	2.5	2.3	4.1	2.6	2.7
Unit labor costs	3.6	3.4	-4.2	-0.1	0.6	-1.7	-0.7	0.4	-1.0	0.6	0.4
Financial Indicators											
Fiscal balance 6/											
Central government	-4.2	-5.3	-4.8	-4.3	-4.1	-2.7	-2.4	-1.8	-0.3	-1.0	-0.8
General government	-4.9	-5.9	-5.3	-5.3	-4.4	-2.6	-2.2	-1.3	0.2	-0.7	-0.4
Structural balance	-5.3	-4.5	-4.2	-4.3	-3.2	-1.4	-1.3	-0.6	-0.6	-0.5	-0.5
Interest rates (in percent)											
Short-term	11.2	8.7	6.5	6.3	4.7	4.2	4.0	3.1	4.5	4.4	4.1
Long-term	10.0	8.3	8.4	8.7	7.2	5.9	4.8	4.6	5.4	4.9	5.0
Broad money 7/	7.1	6.4	2.3	5.4	3.9	4.3	4.8	6.2	4.9	...	...
Real effective exchange rate based on normalized ULC (1990=100) 1/	100.1	97.9	95.8	100.3	100.3	89.2	85.6	80.3	71.4	...	...
Nominal effective exchange rate (1990=100) 1/	100.7	97.0	95.3	99.5	99.7	90.9	90.8	86.7	78.5	...	...
External Sector 6/											
Current account balance	-0.9	0.4	0.3	0.8	1.1	1.4	0.7	0.4	-0.2	0.0	0.2
Trade balance	-0.2	1.2	1.3	1.6	1.9	2.4	2.0	1.5	0.9	1.0	1.1

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

1/ WEO, March 2001.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ Harmonized definition.

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

6/ In percent of GDP.

7/ Percentage change in the stock of M3.