

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

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

- the staff report on euro area policies (including the trade policies of the European Union), prepared by a staff team of the IMF, following discussions that ended on **June 28, 2003**, with officials at EU institutions in the context of the Article IV consultations with countries forming the euro area. **Based on information available at the time of these discussions, the staff report was completed on August 7, 2003.** 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 **September 8, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 10, 2003 discussion** of the staff report on euro area policies.
- a statement by the Executive Director for the country currently holding the Presidency of the European Council, on behalf of the euro-area countries.

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

Selected Issues

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<sup>1</sup>**

Prepared by the European I Department

Approved by Michael Deppler and G. Russell Kincaid

August 7, 2003

- A staff team held discussions at the European Central Bank (ECB) and the European Commission (EC) during May 16-28, 2003 in the context of the 2003 Article IV consultations with euro-area member countries.
- Meetings were held at the ECB with President Duisenberg, Vice President Papademos, Ms. Hämäläinen, Mr. Issing, and Mr. Padoa-Schioppa (members of the Executive Board), as well as with senior staff. At the EC the mission met with Commissioner Solbes Mira, Mr. Regling (Director General for Economic and Financial Affairs), and other officials. The team comprised Messrs. Deppler (Head), Chadha, Jaeger, Kieler, Huang (all EU1), Dhonte (EUO), and Faruquee (RES). Mr. Lankes (PDR) joined the mission at the EC to cover EU trade issues. Mr. Deppler presented the mission's preliminary conclusions to the Economic and Financial Committee (EFC) in Granada on May 23 and to the Eurogroup in Luxembourg on June 2.

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<sup>1</sup> Including the trade policies of the European Union.

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## I. INTRODUCTION

1. **The continuing weakness of activity in the euro area reflects an amalgam of cyclical and longer-term forces which are likely to shape the outlook and to challenge policies.** In the short term, the dynamics of the global equity market boom-bust cycle, prolonged by the structural characteristics of the area and the appreciation of the euro, continue to dampen growth. From a longer-term perspective, the boom-induced lull in reforms that has prevailed until recently, the sharply divergent performances across countries, and the aging of populations are casting a pall on both short- and longer-term prospects. Against this background and continued uncertainty about the global recovery, the discussions focused on:

- **The outlook and risks.** Incomplete adjustments to past shocks, both global and domestic, are limiting prospects for a robust bounce back in the near-term. Meanwhile, limitations on medium- and longer-term potential from slow structural reforms, the negative effects of population aging and associated fiscal sustainability concerns have been weighing on confidence and prospects.
- **The imperative of strengthening medium-term prospects and the need for policies to be more forward-looking.** Widespread expectations that EMU would trigger increased structural reforms, essential to raising the area's performance, have been disappointed, but there have been some hopeful signs recently.
- **The task for macroeconomic policies.** Policies have generally been supportive during the slowdown but have been constrained—monetary by inflation persistence and fiscal by past failures to adjust. Receding inflation prospects have increased the room for monetary policy actions, but past lapses mean that fiscal policies need to continue to tread a fine line between longer-run considerations of sustainability and credibility and of supporting activity in the short run.

## II. BACKGROUND

### A. Recent Developments and Cyclical Factors

2. **A lackluster recovery during the first half of 2002 has given way to virtual stagnation.** Household spending has been the key support of demand as the effects of past price shocks waned and disposable incomes were supported by rising real wages and widening fiscal deficits. The long fall off in investment

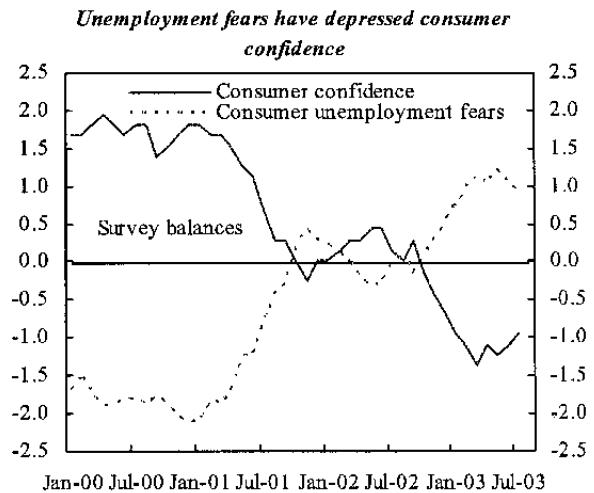
	(annualized quarter-on-quarter percent change)							
	2001		2002				2003	
	H1	H2	Q1	Q2	Q3	Q4	Q1	
Gross Domestic Product	1.8	0.1	1.6	1.6	1.3	0.3	0.2	
Final Domestic Demand	1.8	0.1	-0.2	0.2	1.6	1.3	0.2	
Private Consumption	2.7	0.7	-0.6	1.2	1.8	1.4	1.7	
Investment	-0.8	-3.1	-2.4	-5.5	0.5	0.9	-4.8	
Net Exports 1/	0.5	0.7	1.8	1.0	0.3	-1.4	-1.8	
Stockbuilding 1/	-0.4	-0.7	-0.1	0.5	-0.5	0.5	1.8	

1/ Contributions to growth.

spending in the aftermath of the equity bubble along with more modest external support, however, subdued growth. The subsequent build up of geopolitical uncertainties coinciding with the euro's appreciation at the turn of the year resulted in effectively no growth. Confidence failed to bounce back following the Iraq war, and indicators suggest little if any growth momentum in the second quarter of this year.

3. **Since the equity bubble burst, corporate balance sheets have been on the mend, but there remain uncertainties about whether adjustments have run their course.** Both the Commission and the ECB agree with the staff's earlier analysis<sup>2</sup> that euro area corporates participated in the borrowing and spending binge during the stock market bubble with as much abandon as U.S. firms (Figure 1). Cutbacks in investment since the bubble burst and sharply lower interest rates have notably improved cash flows, as in the United States, but preliminary indications are that the pace of adjustments in the area has been slower.

4. **Indications are that labor market adjustment is ongoing.** In contrast to the last cycle, employment continued to grow well into the slowdown, though greater variation in hours worked recently renders comparisons difficult (Figure 1). With corporate profits pressured by slowing demand and increases in unit labor costs, employment came to a standstill and unemployment began to edge up last year and is expected to continue to do so. There was agreement that rigidities stemming from employment protection legislation (EPLs) in the area, though weakened in recent years, made firms hesitant to lay off workers until the case for doing so became abundantly clear, i.e., a "trigger point" in the profit squeeze was reached. With Europe viewing itself early on as relatively insulated from the new economy bubble, and the downturn short-lived, firms had been slow to lay off workers.



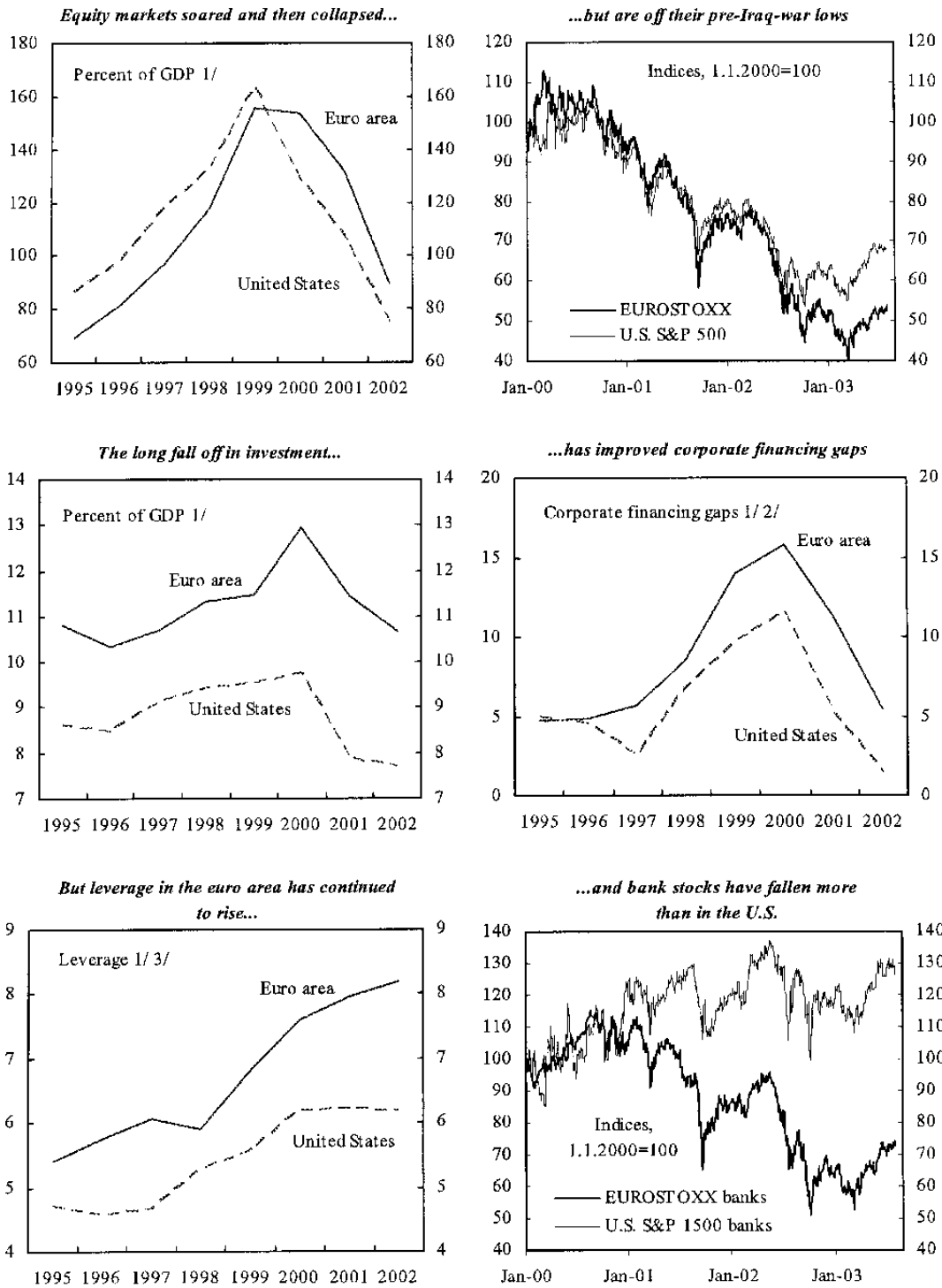
5. **The predominantly bank-based financial system has been more tolerant of the pace of corporate adjustments, with the consequence that its balance sheets have been one of the main shock absorbers in the system.** There was agreement that banks had been less prone to "pulling the plug" than capital markets are. Relationship banks, still the

	1997	2002
Euro area		
Loans	44.6	54.3
Debt securities	5.4	7.5
United States		
Loans	17.6	18.3
Debt securities	23.1	28.6

Sources: ECB; Federal Reserve.

<sup>2</sup> See "Corporate Balance Sheet Restructuring in the Euro Area" (in SM/03/38).

Figure 1. Post Equity Bubble Adjustment and Financial Conditions



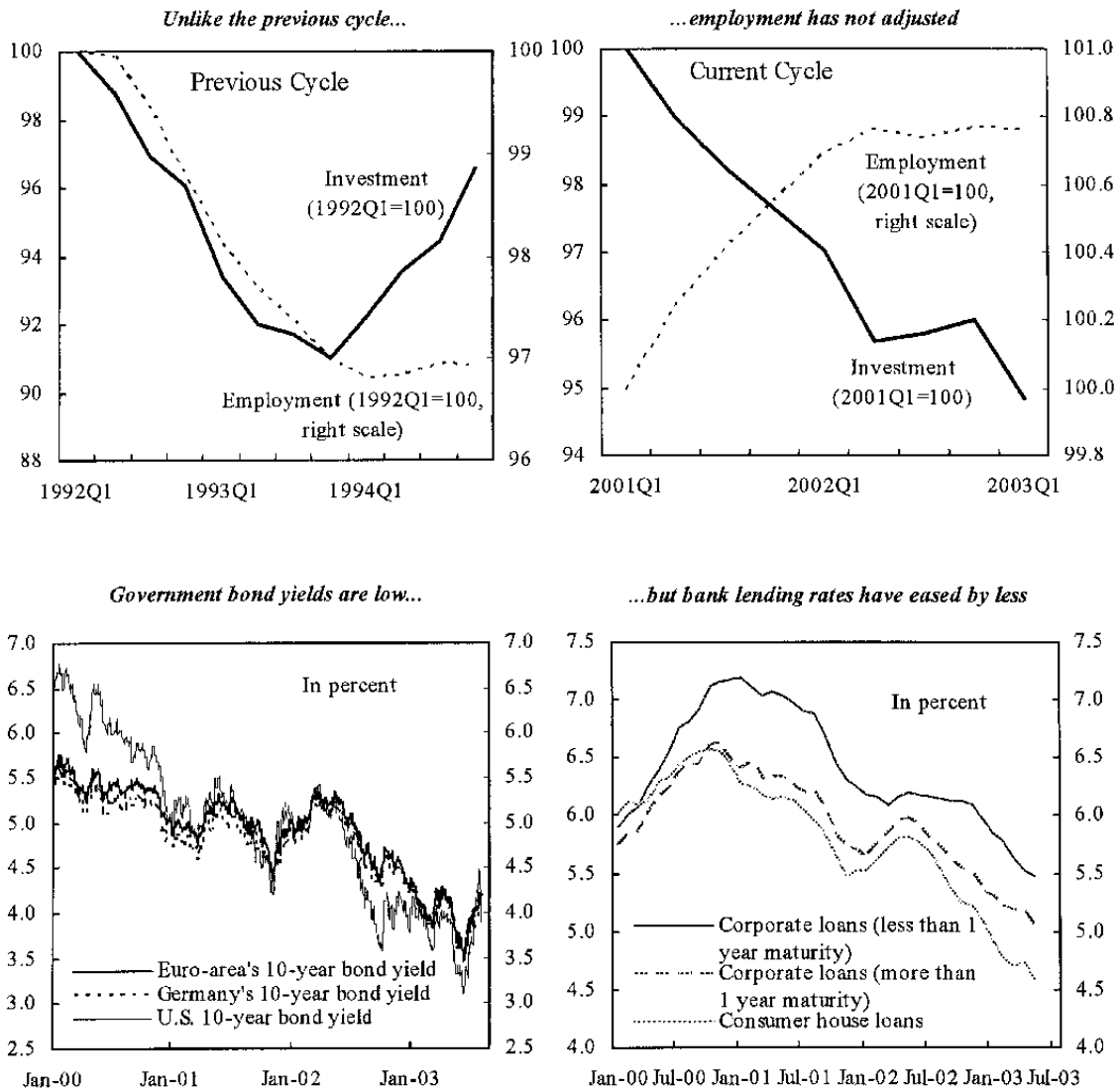
Sources: ECB; Federal Reserve; Datastream; and staff calculations.

1/ Data for 2002 are staff projections for the euro area and outcome of the first three quarters for the U.S.

2/ Spending on capital and financial assets not covered by internal funds, as a percent of GDP.

3/ Defined as the ratio of debt to internal funds.

Figure 1. Post Equity Bubble Adjustment and Financial Conditions  
(continued)

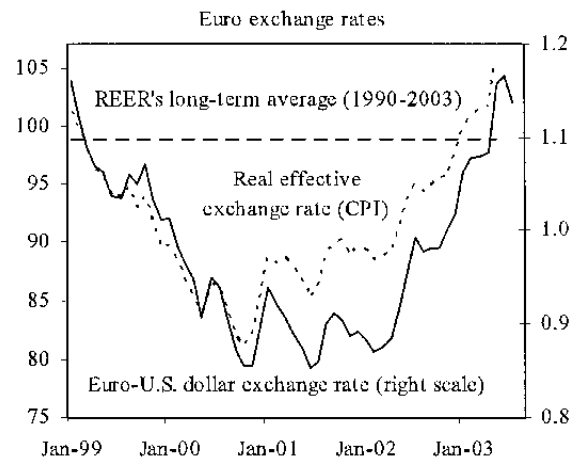


Sources: Eurostat; Datastream; ECB; and own calculations.

mainstay of European corporate finance, had been more forbearing, especially with their larger corporate clients. This feature of the economic-financial structure contributed to the larger declines in banking stocks in the area as compared, for example, to the United States, and often to proportionately larger movements in bank stocks compared to the broader market (Figure 1). Additionally, with losses of hidden reserves on equity markets, declines in capital markets activity, and credit losses, banks have seen their capital cushions grow thinner.

6. **Financial conditions in the area have eased along with those in global markets, though financial fragilities may be impairing the transmission to corporates.** After tumbling by a third last year, and another fifth by March on rising geopolitical tensions, equity prices have recovered, trading slightly up for the year (Figure 1). Government bond yields have backed up from their recent post war troughs but remain at low levels. Balance sheet considerations and deteriorations in the economic outlook have, however, limited the feed through of lower rates to firms, particularly in the case of bank lending rates, and indications are bank lending standards for the corporate sector continued to tighten earlier this year.

7. **The appreciation of the euro, welcome from a medium-term multilateral perspective, is detracting from the area's near-term prospects.** Since January 2002, the euro has risen by around 30 percent against the dollar and 18 percent in real effective terms, with most measures of the latter now at about their long-run averages. The staff and authorities welcomed the euro's appreciation as being of an equilibrating nature from a longer-term multilateral payments perspective (Box 1). There was also agreement that the traditionally important terms of trade effect in the area associated with exchange rate movements implied favorable impacts for prices, real household incomes, and the import costs of firms. However, the appreciation was already weakening net exports, an effect likely to grow over time. In addition, the staff emphasized the adverse effects on profit margins of the export and import-competing sectors, which would weigh on the process of corporate balance sheet adjustments as would the downward valuation of foreign assets acquired, particularly in the United States, during the cross-border investment boom years.<sup>3</sup>



<sup>3</sup> For a discussion of exchange rate pass-through in the euro area, see the accompanying *Selected Issues* paper.



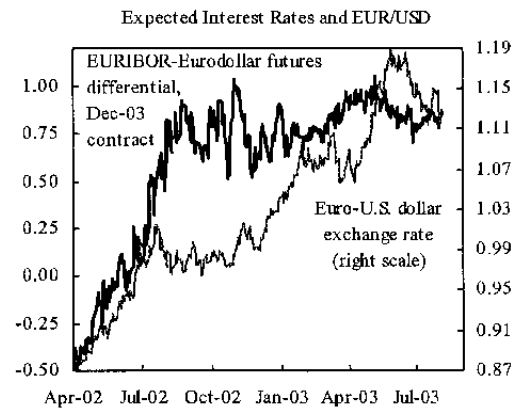
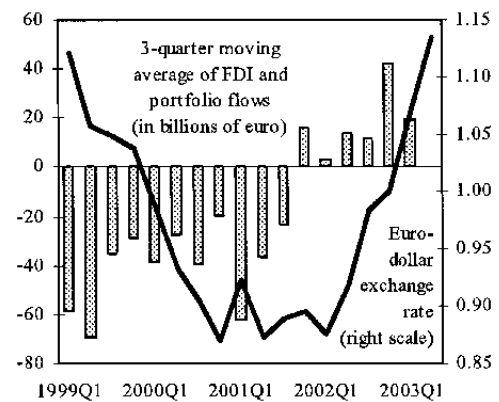
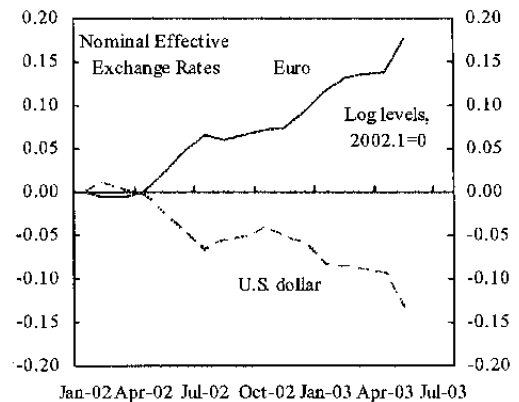
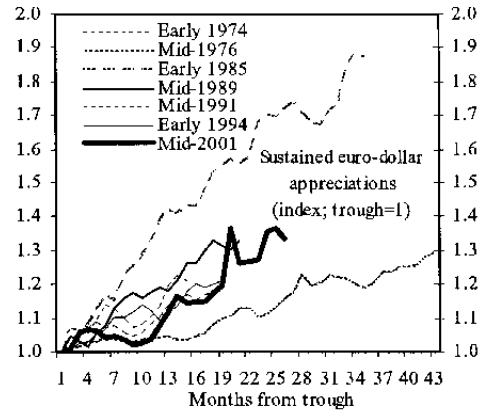
### Box 1. Perspectives on the Euro's Appreciation

The euro has now sustained a 2-year long appreciation against a broad set of currencies. Several **features of the appreciation** are noteworthy:

- On concerns about the strength of the U.S. recovery, mounting U.S. current account and fiscal deficits, and spurred by interest differentials, the euro's appreciation has been most **pronounced against the dollar**.
- The current **level** of the euro, both **against the dollar** and on a **real effective basis**, is now around the **mid-point of its historical fluctuation range**.
- The **pace** of the euro's advance against the dollar over the last two years has **not been unusual** by historical standards.
- The **euro has borne more than its fair share of the dollar's depreciation**, rising by more than the dollar has fallen on an effective basis.
- **Multilateral assessments**, based on calculations of purchasing power parities or the macro balance approach (which projects medium-term current accounts consistent with savings-investment norms), suggest the **euro is currently well-aligned on a real effective basis**, while the dollar remains strongly valued.

#### Looking forward,

- Many observers see **continued dollar weakness** from limited capital flows to finance the U.S. current account deficit.
- **Interest differentials**, and especially **capital flows**, with which the euro has been closely correlated since its inception, remain **in favor of the euro**.
- Multilateral assessments indicate that a **global realignment of current account imbalances would be better facilitated by a broader-based decline in the dollar**, rather than a further significant multilateral appreciation in the euro.



## B. Medium- and Longer-term Factors

8. **From a longer perspective, the area's low potential growth reflects in large part low population growth.**

Demographic trends explain much of the sustained disparity in performance with the United States, and the differential in GDP *growth* disappears when viewed in per capita terms.

9. **However, the record in terms of utilization of labor resources is weak, and there is considerable scope for raising the *level* of potential output.** The *level* of per capita income in the euro area

is around a third lower than in the United States. While part of the gap reflects differences in productivity, the bulk is due to lower rates of utilization of human resources: lower hours worked, higher structural unemployment, and lower labor force participation rates. The authorities have tended to view lower hours worked and labor force

participation rates in the area as partly reflecting lifestyle choices, while the staff has emphasized that these choices have been conditioned by economic incentives. Indeed, some recent research attributes the substantially lower average hours worked in Europe to the larger tax wedge between labor and consumption taxes.<sup>4</sup>

10. **In the absence of improvements in labor utilization rates, demographics point to a marked slowing of output growth over the medium to long term.** The looming, demographically-induced contraction in the area's working age population implies, other things equal, significant declines in potential output growth and major strains on public pension systems. In particular, potential output growth is at risk of slowing from the 2-2½ percent range currently to 1-1½ percent over the next several decades (Box 2).

### Euro Area and U.S. Growth Compared

	Growth, 1990-2000	
	Euro area	US
GDP	2.2	3.1
Labor input (total hours)	0.2	1.4
GDP per capita	1.8	1.8
Productivity (per man hour)	2.0	1.6
Average hours (per worker)	-0.5	0.0
Employment rate 1/	0.3	0.2

Sources: European Commission; OECD; IMF; and staff calculations.

1/ In percent of total population.

### Euro area and U.S. Levels of Per Capita GDP Compared, 2001 (US=100)

GDP per capita	Productivity (per man hour)	Average hours (per worker)	Employment rate 1/
68.7	88.3	86.7	89.8

Sources: EC; OECD; IMF; and staff calculations.

1/ In percent of total population.

<sup>4</sup> See "Prosperity and Depression", 2002 Richard T. Ely Lecture by Edward C. Prescott.

### Box 2. Shadows on Longer-Term Performance

The euro area faces a sizable demographic shock, implying declines in the potential labor force and an aging of the population. Low fertility and migration rates imply the area's working age population is expected to remain constant during this decade before declining. Combined with an increase in life expectancy, the dependency ratio is expected to climb from a little over 40 percent currently to about 70 percent over the next 50 years.

These trends could have two important implications:

- **Substantial prospective declines in potential output growth and lower expected lifetime income resources.**

Euro Area: Population Aging and Potential Output Growth, 2000-2050

	2000-05	2005-10	2010-15	2015-20	2020-50
Population growth	0.2	0.2	0.1	0.0	-0.2
Working-age population growth	0.0	0.0	-0.2	-0.3	-0.6
Dependency ratio 1/	43.8	46.8	50.1	54.6	69.4
Potential output growth 2/	2.1	1.5	1.3	1.2	0.9
Potential output per capita growth	1.9	1.4	1.2	1.2	1.1

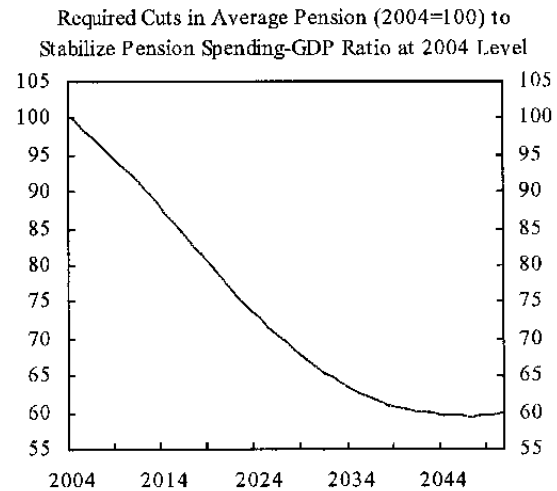
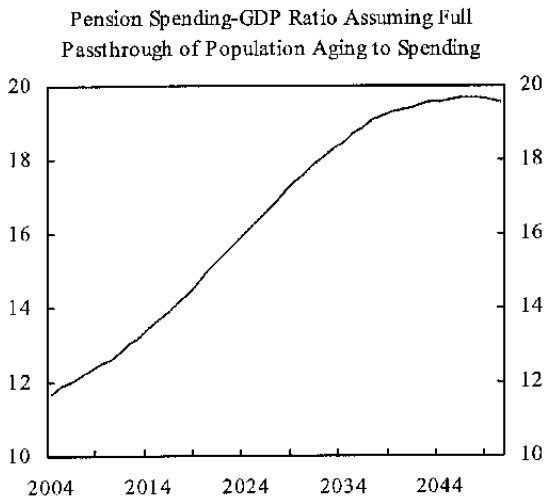
1/ Population aged 65 and over as a percent of population aged 15-64.  
 2/ WEO projection for 2003-05. Beyond 2005, projections assume a constant employment rate, labor-augmenting technical progress of 1.5 percent a year, and a constant capital-labor ratio.

Euro Area: Potential Output Growth and Discounted Values of Future Incomes

Potential growth	Discounted value of future incomes 1/
2.5	67
2.0	50
1.5	40
1.0	33

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

- **Public finances and retirement incomes could be impacted severely.**<sup>1</sup>



Sources: Economic Policy Committee; and staff estimates.

<sup>1</sup> Assumes unchanged public pension system parameters during projection period. For details, see *Selected Issues* paper on "Aging and the SGP".

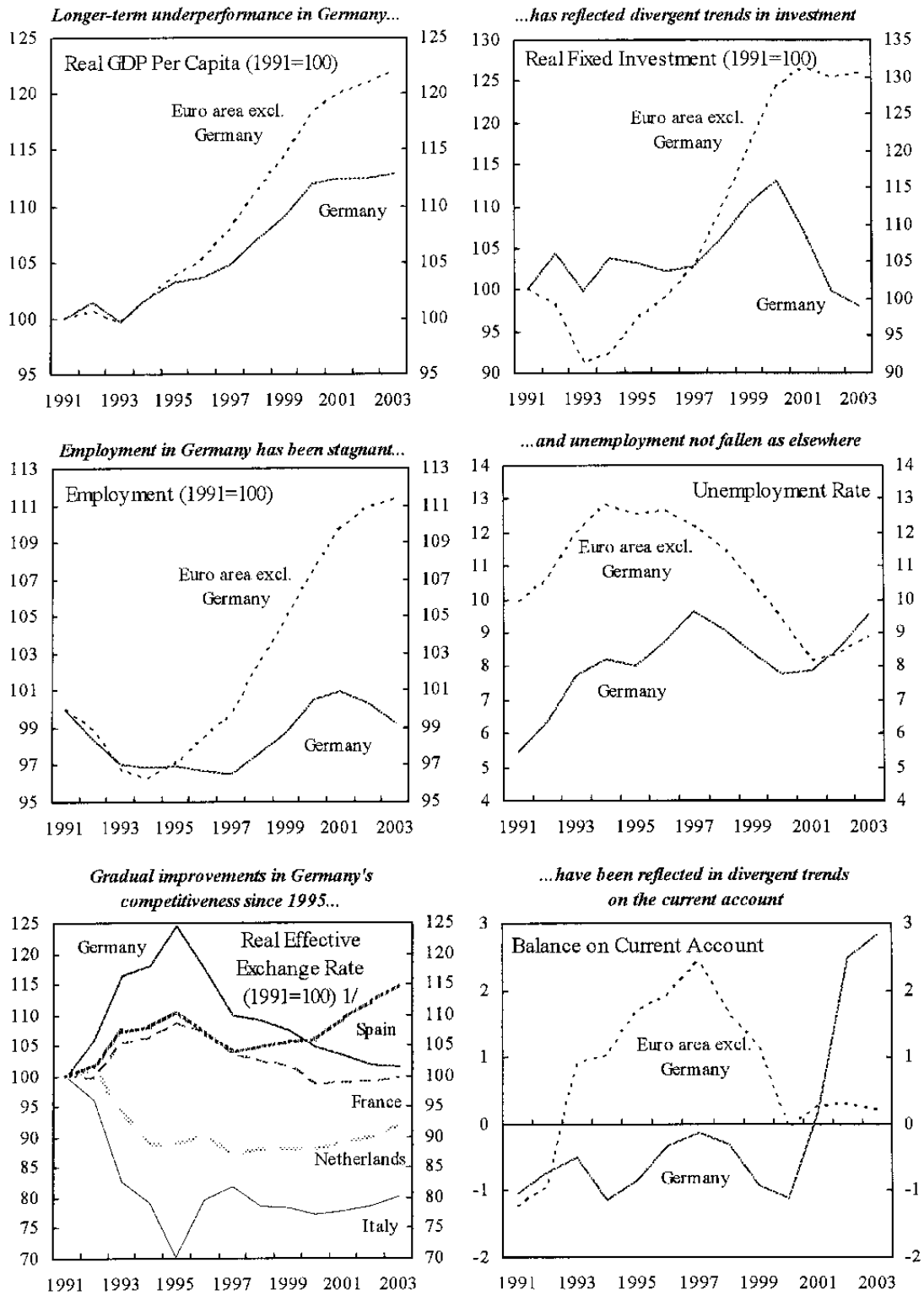
11. **Another non-cyclical factor is the marked and long-standing divergences in performance within the euro area, most notably between Germany and the other members of the monetary union** (Figure 2). The sources of this divergence are not well understood, but are commonly ascribed to a mix of the following: German reunification, which induced both a boom in Germany at the beginning of the 1990s and a supply shock to the labor market in the form of steep increases in labor taxes; the broadly obverse developments in the rest of the euro area where the prospect of EMU induced reforms aimed at strengthening competitiveness and labor demand; and the advent of EMU itself which amounted to a favorable interest rate shock for most countries and, in retrospect, may not have taken sufficiently into consideration Germany's competitiveness vis-à-vis its partners. More recent developments suggest that a process of rebalancing has been initiated: German competitiveness has been improving steadily vis-à-vis its partners, as also suggested by the strengthening of its current account and export performance compared to the rest of the union. It remains to be seen, however, whether the adjustment has come to an end.

12. **Although its influence is difficult to assess, a final factor conditioning the long-term outlook is the ebbing of the reform impulse in recent years.** As noted, the prospect of EMU together with the generally adverse conditions prevailing through much of the 1990s had prompted most countries into significant structural reforms, fiscal consolidation and wage moderation policies that contributed to notable improvements in performance in countries other than Germany from the mid-1990s (Figure 2). With the advent of EMU, the global boom, and the ensuing sharp drop in unemployment rates, these politically difficult reforms had, until very recently, moved off the agenda, especially in the larger countries.

### C. The Outlook and Risks

13. **Against this mix of cyclical and longer-run forces, the broadly shared baseline forecast sees the prevailing area-wide stagnation being overcome only gradually, with growth remaining sub par well into next year.** With muted growth the result of both exogenous (bursting equity bubble, reduced external demand, appreciated euro, and geopolitical uncertainties) and endogenous (gradual corporate and labor market adjustment) forces, the baseline foresees continued internal adjustments (rise in unemployment) to establish the preconditions for more robust growth. Overall, the staff expects growth to stagnate this year at last year's pace of  $\frac{3}{4}$  percent, before picking up to around 2 percent next year (Table 1). External demand is projected to be supportive as the recovery abroad is assumed to strengthen, but its role will be curtailed by an appreciated euro. Sustaining growth requires a strengthening of domestic demand. With household balance sheets relatively sound, private consumption expenditures are projected to pick up as real disposable incomes are supported by declines in inflation, continued real wage growth, and automatic fiscal stabilizers. However, increases in unemployment will temper the pace in the near term. With policy interest rates and real long-term yields low, capacity utilization rates not far below historical averages, and improved corporate cash flows, investment spending is projected to turn around gradually with increases in demand. Finally, re-stocking should provide some support.

Figure 2. Divergences in the Euro Area: Germany Versus Rest, 1991-2003



Source: European Commission; WEO, IMF.

1/ Relative to other EU countries; based on unit labor cost for whole economy.

14. **Past postponements of projected recovery underscore that the forces at play are imperfectly understood, and there is agreement the risks to the forecast are on the downside.** The key risks are:

- **Continued corporate balance sheet adjustment.** Investment spending firmed in the second half of last year, but this reflected largely one-off effects, and a more prolonged weakness remains a risk. Pressures on the corporate sector could also be amplified by further euro appreciation and tight financing conditions as bank balance sheets in some countries remain under pressure.
- **A faltering of the US recovery.** Recent developments have reinforced the notion that the fortunes of euro-area activity remain inextricably linked to developments in the United States.
- **The potential for euro overshooting.** Although the exchange rate stabilized around mid-year, the U.S. twin deficits, capital flows, and interest differentials suggest the potential for further euro appreciation. For the euro to remain fairly valued on a multilateral basis requires that further dollar weakness be accompanied by euro depreciation against other major currencies. Movements during the recent leg of euro appreciation, however, which saw many currencies follow the dollar down, give little comfort such a scenario will play out.

15. **However, indicators have generally been stable, albeit at low levels, with some confidence indicators ticking up lately.** This suggests that the risks are more of continued stagnation rather than of a marked deterioration in activity. Moreover, the increased seriousness countries are bringing to effecting structural reforms bodes well for an improvement in performance in the medium term.

### III. POLICY DISCUSSIONS

16. **There was agreement on long-term policy requirements and on the need for policies in the short run to be forward looking and geared toward achieving long-run goals, but less so on the extent fiscal policy should trade off these objectives in the short run.** An overarching priority is a much needed strengthening of medium- and longer-term prospects through structural and fiscal reforms to raise potential, improve flexibility, and address underlying social security and fiscal sustainability issues.

17. **Both own and global considerations argue for the euro area to support the global recovery, helping re-balance the uneven pattern of world growth in recent years, and to advance the agenda of multilateral trade liberalization.** Uneven growth explains in part the build up of international imbalances and higher euro area demand growth would, therefore, facilitate external adjustment in the world economy and possibly limit the risks of euro appreciation. On the trade front, commitments to increase access to local markets provide a signal of the resolve to tackle internal structural reforms and can impact the domestic momentum for such reforms.

### Box 3. Past Fund Policy Recommendations and Implementation

In concluding the last Article IV consultation on euro area policies on October 18, 2002 (EBM/02/106), Directors noted that, given the ongoing weakness in activity and expected declines in inflation, monetary policy should continue to maintain an accommodative stance. The ECB's subsequent policy actions have been in broad agreement with Fund advice. The Governing Council's recent clarifications regarding the price stability objective (to keep inflation below but close to 2 percent in the medium term) and the role of the money pillar (to focus the pillar on medium- to longer-term trends in inflation) were also in line with recommendations in last year's Article IV consultation.

The Fund's advice on fiscal policy has tried to balance shorter-term cyclical considerations and the pressing longer-term requirements of putting public finances on a sounder footing. Specifically, countries that do not meet the SGP's close-to-balance or in surplus requirement should undertake fiscal adjustments of at least 0.5 percent of GDP per year until the position was corrected but let the fiscal stabilizers work fully around the consolidation path. The Commission has stressed, however, that countries in excessive deficit positions must bring the deficit below the 3 percent limit within the appropriate deadlines. As regards a longer-term agenda for improving the SGP, staff has urged a more direct focus on debt sustainability. Most of the recommendations, including the 0.5 percent fiscal adjustment rule, were part of the Commission's proposals that were subsequently broadly supported by Eurogroup ministers and ECOFIN. Implementation of the advice by national authorities, however, has been mixed, as detailed in the present report.

Staff and the authorities have generally been of one mind as regards the need to step up structural reforms, but progress has been slow. Ultimate responsibility for implementing key structural and fiscal reforms, however, lies with national authorities. On the EU's trade policies, staff last year identified reform of the Common Agricultural Policy (CAP) as crucial for the success of the Doha Development Agenda. The recently adopted reform plans are an important step forward but fall short of what is needed.

#### A. Monetary Policy and Inflation

18. **Inflation has been persistent, but has turned.** While headline rates were buffeted by movements in oil prices, core inflation (headline inflation excluding energy and unprocessed food) decelerated from around 2¾ percent in early 2002 to around 2 percent by January this year reflecting growing economic slack, the appreciation of the euro, and the waning of price shocks. Core goods inflation fell sharply, while services inflation decelerated gradually (Figure 3). Concerns a year ago that the inflation overshoot would lead to

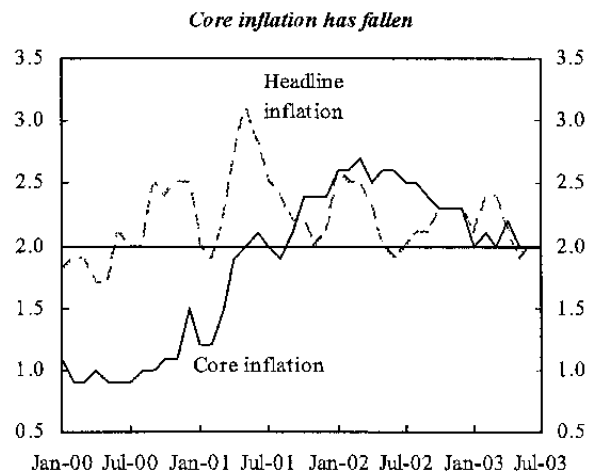
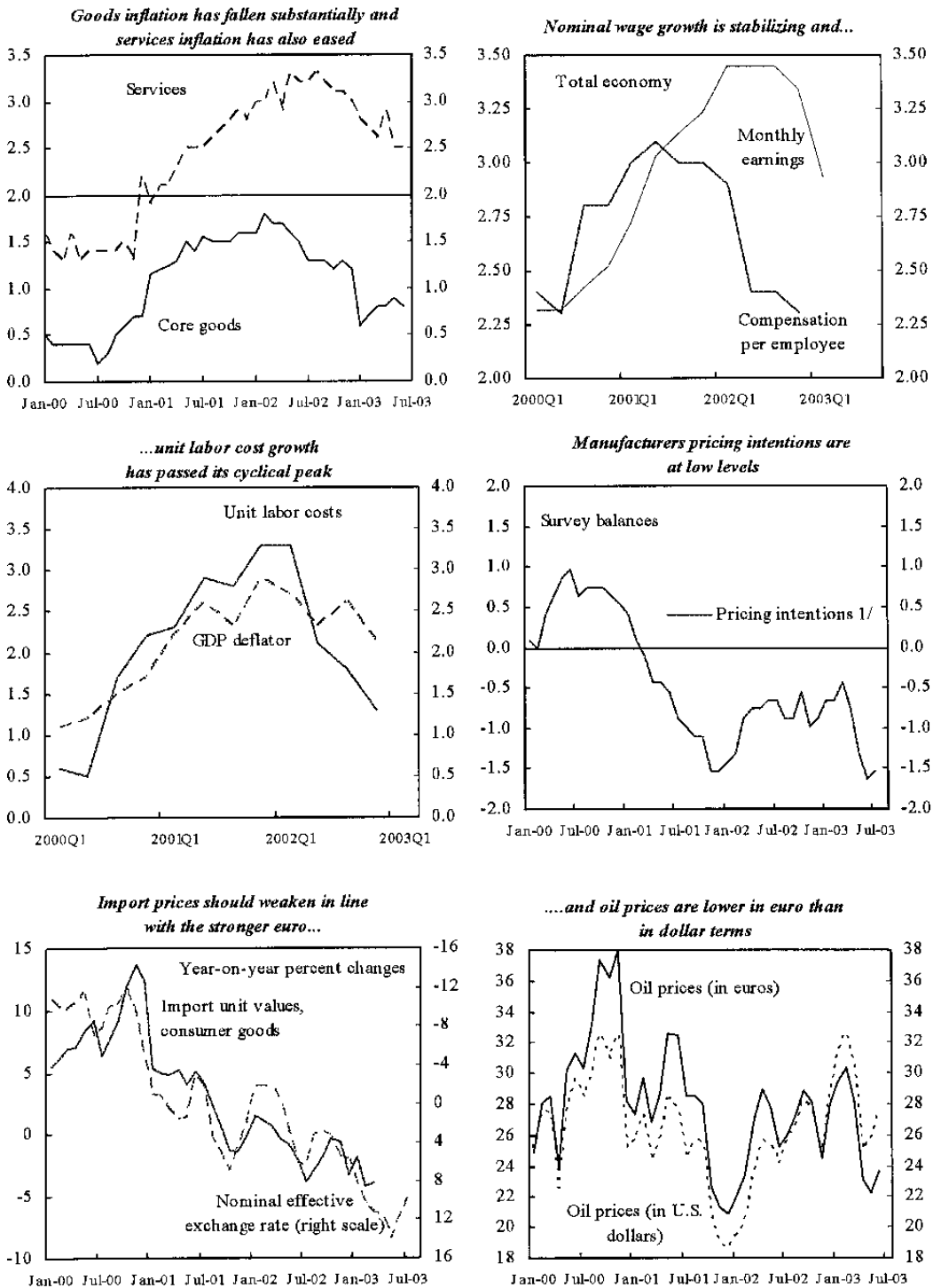


Figure 3. Inflation Is Coming Down  
(Data in percent, unless otherwise specified)



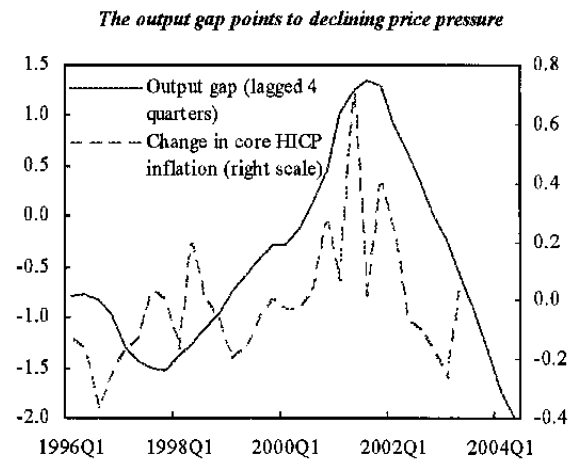
Sources: Eurostat; ECB; European Commission; Datastream; and staff estimates.  
1/ Standardized; i.e. charts show (standard) deviations from 1985-2002 mean.



extended second-round wage effects appear to have been averted. Indications are the upward drift in wage increases since 1998 has come to a halt, and unit labor cost growth eased.

19. **With growth slower, and smaller and fewer interest rate cuts than in the United States, the ECB has been perceived as less activist, but these comparisons overlook lower potential growth and the stickiness of inflation in the area.** The staff views the record of monetary policy as having been in line with inflation and output developments in the area. With the slowing in growth relative to potential in the euro area smaller than in the United States, and inflation somewhat higher, policy rates have been in line with, and generally lower than, standard Taylor rule yardsticks would imply, and are currently well below (Figure 4).

20. **The shared outlook is for inflation to decelerate significantly next year.** The staff's forecast sees the cumulative effects of weakness in activity, the recent large appreciation of the euro, a continued softening of labor markets, and the fall in oil prices as combining to push headline and core inflation below 1½ percent by late next year, and for price pressures remaining low for some time (Figure 3). The ECB also saw inflation falling significantly next year, though somewhat less so when excluding energy. The Commission, whose inflation forecasts have tended to be above consensus but closer to the mark over the last two years, saw a more gradual and smaller deceleration than the staff. Although there was consensus wage growth should not give rise to upward pressures on inflation, the Commission and the ECB saw some uncertainty about wage growth moderating in line with cyclical developments, and the Commission's estimates see less slack in labor and goods markets than do the staff's.

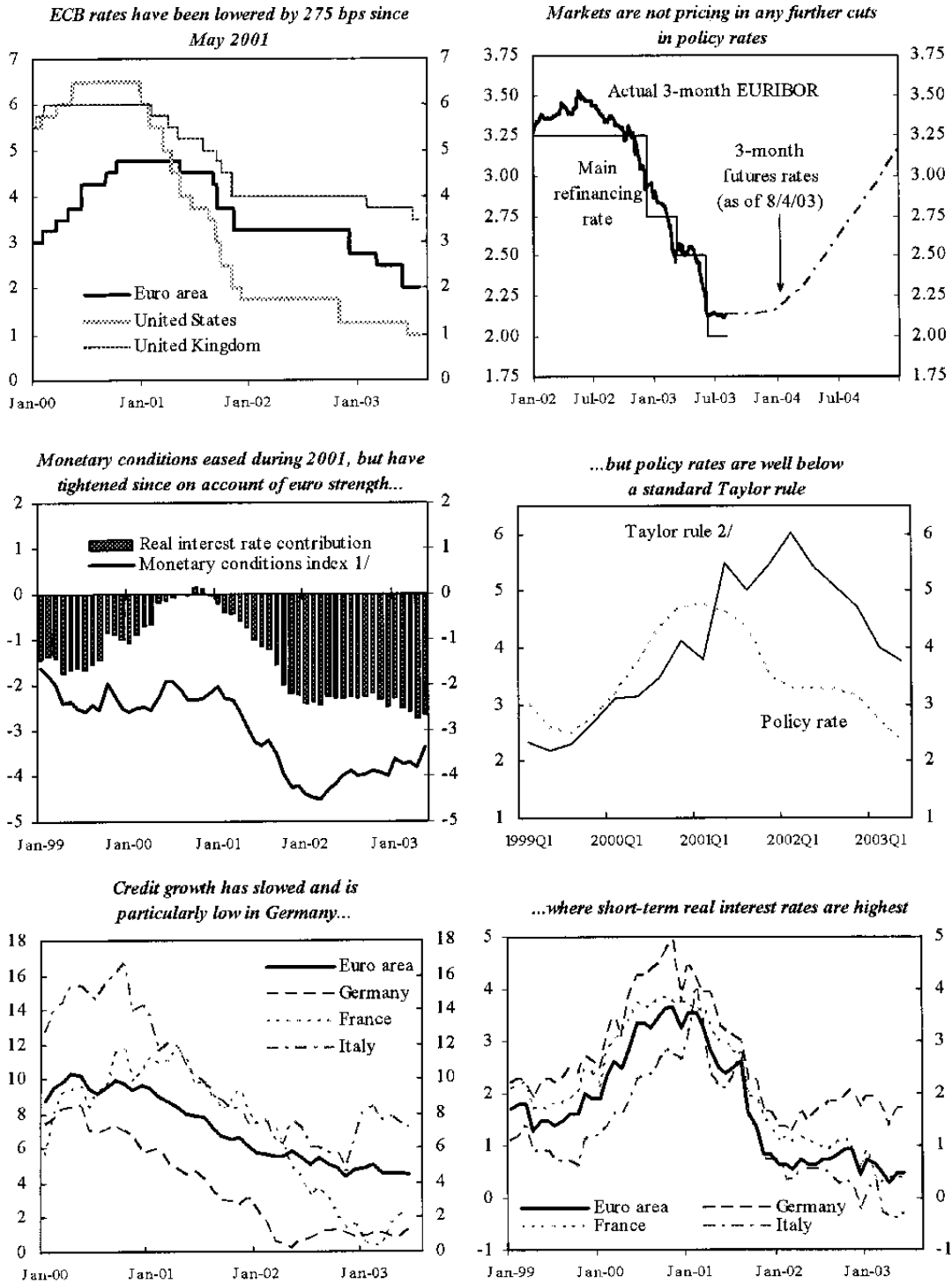


21. **These projections are subject to important uncertainties and risks.**

- **Structural persistence in inflation may be high in the area.** Stubbornly above target inflation rates well after the slowdown began, raise the question of whether inflation in the area is unresponsive to demand or monetary shocks. The staff's finding<sup>5</sup> is that inflation persistence is only moderately higher in the euro area than in the United States, if at all, and there is little firm evidence that structural sources of persistence play a bigger role in the euro area. By implication, the sluggish response

<sup>5</sup> See *Selected Issues* paper "Is Inflation Persistence Higher in the Euro Area than in the United States?"

Figure 4. The Monetary Policy Stance Has Eased  
(Data in percent, unless otherwise specified)



Sources: ECB; Datastream; Bloomberg; and staff calculations.

1/ Deviation from 1990-2002 mean.

2/ Calculated using standard coefficients, partially forward-looking core inflation, a neutral real interest rate of 2.25 percent, and an ECB inflation objective of 1.75 percent.

of inflation over the last two years is explained instead by the shallower downturn in activity and the series of one-off temporary shocks.

- **An elusive recovery has increased the weight of arguments potential growth may have slowed, and the variation in estimates of slack has risen.** In contrast with the United States where the natural unemployment rate tends to be relatively stable, the well-known tendency for hysteresis effects in European labor markets—whereby in principle temporary movements become permanent—creates a basic difficulty for estimating slack. In output markets, a key question—not restricted to the area—is the extent to which this cycle, a key element of which has been a sustained decline in equity markets, entails a longer-term increase in the cost of capital and a reduction in supply.<sup>6</sup> Against a background of substantial uncertainty, the staff's working hypothesis is that potential growth has continued at its recent historical pace.
- **Views differed somewhat on the prospects for wage increases.** The staff and the ECB saw the worrying wage increases of last year as partly reflecting compensation for inflation shocks. Looking forward, the staff saw the combination of lower inflation and ongoing weakness in labor markets as having a stronger influence in moderating wage increases than did the authorities.
- **The risk of area-wide deflation at this stage is remote.** Inflation has only recently come down to 2 percent after exceeding the ECB's price stability range for three years, and the room for lowering interest rates remains considerable. Only if the continued slowdown were to turn into a severe recession or were the euro to appreciate rapidly would a risk of deflation arise.
- **A period of declining prices, likely short, in Germany, is conceivable, but the risks of deflation small.** The staff argued that monetary union can both exacerbate and limit the risk of deflation in individual members. On the one hand, the lack of monetary policy instruments limits the ability of individual countries to steer clear of deflationary dangers through early and aggressive easing. There was agreement on the other hand that it is unlikely deflation could become entrenched in a part of the currency area as long as the area-wide price level is continuously rising since traded goods inflation is closely linked across the area, and inflation expectations are partly governed by area wide trends. Falling relative prices in a region of EMU would boost competitiveness, net exports, and investment. The staff emphasized, though, the stylized fact that balance sheet adjustments tend to be more prolonged at lower rates of inflation, and that broad price declines, especially in the face of financial fragilities, could hamper such efforts further.

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<sup>6</sup> See *Selected Issues* paper "Euro Area Business Cycles: The Role of Supply and Demand Disturbances".

22. **At the time of the mission, the staff saw on balance considerable scope for monetary easing, and in the event the ECB cut rates by 50 basis points in early June.** In so doing, the ECB noted that the outlook for price stability had improved since it cut rates in March, and it specifically noted that the interest rate reduction took account of downside risks to economic growth.

23. **In the staff's view, uncertain prospects of even a slow recovery combined with a benign inflation outlook argue for an easy monetary policy going forward, and further easing will be needed if inflation threatens to undershoot significantly because activity fails to pick up quickly or the euro rises appreciably.** The staff argued monetary policy should maintain an "accommodative bent"—a sustained easing bias—to support confidence until a self-sustaining upturn in domestic demand, especially of corporate spending, is in place. The continued sideways development of activity, the projected increase in economic slack through the middle of next year even given the recovery in the baseline, the persistence of corporate and financial sector fragilities in some countries, the risk of further euro appreciation, and downside risks to global growth suggest that the risks of undershooting the inflation objective in 2004-2005 are greater than the reverse. That these risks are also potentially the more consequential—with low inflation not helping balance sheet adjustments and providing less room for relative price adjustments within the area—strengthens the case for an easy stance. In the event, the ECB's emphasis on downside risks to growth at the time of the June rate cut was read by markets as a signal of a more accommodative bent, and the term structure of interest rate futures shifted down. The ECB's statements since then, however, have emphasized the record low level of interest rates, the appropriateness of rates from a medium-term perspective, and the substantial excess liquidity accumulated as a consequence of high M3 growth, thereby dampening such expectations.

24. **The ECB's review of its monetary framework has led to a welcome clarification of the inflation objective and of the role of money in its analysis.** The ECB has clarified its inflation objective as being "below but close to 2 percent". This has substantially reduced uncertainty regarding interpretation of the objective, and should provide a buffer against shocks that could threaten to lead to area-wide deflation while also providing scope for inflation differentials across countries. The ECB has moved to make "monetary analysis mainly serve as a means of cross-checking, from a medium to long-term perspective" indications coming from economic analysis (the other pillar), which is better suited for gauging near- to medium-term prospects. The format of press statements has accordingly been reworked. Both of these clarifications are in line with the recommendations discussed in last year's consultation.<sup>7</sup>

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<sup>7</sup> See the 2002 Staff Report (SM/02/203), and the accompanying *Selected Issues* (SM/02/311), in particular, "The Eurosystem's Definition of Price Stability" and "The ECB's Policy Strategy: An Assessment of the Role of the Money Pillar".

25. **The ECB is also preparing for enlargement.** The ECB's new voting modalities for future expansions of the euro area following enlargement envisage that the number of national central bank governors exercising a voting right in the Council should not exceed 15; once membership exceeds 15, a rotation system will determine members' voting rights. Regarding euro entry, EU officials have sought to clarify the criteria, particularly as regards ERM II membership and the exchange rate criterion.<sup>8</sup>

#### **B. Fiscal Policies: Long-Run Credibility and Short-Run Flexibility**

26. **There is broad agreement regarding the long-term requirements of fiscal policies in Europe.** These are threefold:

- On the structural front, countries need to scale back **unduly generous benefits** financed on the back of commensurately **high labor taxes**, which **severely distort incentives** and reduce supply, especially in labor markets.
- On the macroeconomic front, in line with the SGP, budgets need to move toward balanced underlying positions so as to begin to address the **fiscal unsustainability** embedded in the **aging** of the population.
- From the point of view of the **monetary union**, decentralized fiscal policies **require a credible fiscal framework**.

27. **There is a wider spectrum of views on short-run requirements.** At one end, some argue that the weakness of demand requires, if not reflationary policies, at least a neutral fiscal stance so as not to compound the weakness. At the opposite end, others, including the Commission, argue that the associated weakening of fiscal positions would undermine confidence. Credibility and growth prospects would be better served if countries lived up to their commitments under the SGP. The roots of these differences are many, varied, and deep. Views differ on the extent of downside risks to growth in the area and across countries, whether the ongoing weakness reflects demand or a longer-run slowing in potential, whether discretionary fiscal policy is viable or counterproductive, and the size and sign of fiscal multipliers. The empirical evidence on the impacts of fiscal policy on growth is mixed. The Commission's recent cross-country work finds that growth accelerated in about half the historical episodes of fiscal consolidation in Europe, with expenditure-based consolidations being more growth-friendly than those based on tax increases.<sup>9</sup>

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<sup>8</sup> A staff paper on the macroeconomic dimensions of euro entry is under preparation.

<sup>9</sup> See "Characteristics and Effects of Fiscal Consolidations in the EU: Evidence from Cross-Country Analysis", Public Finances in EMU, European Commission, 2003.

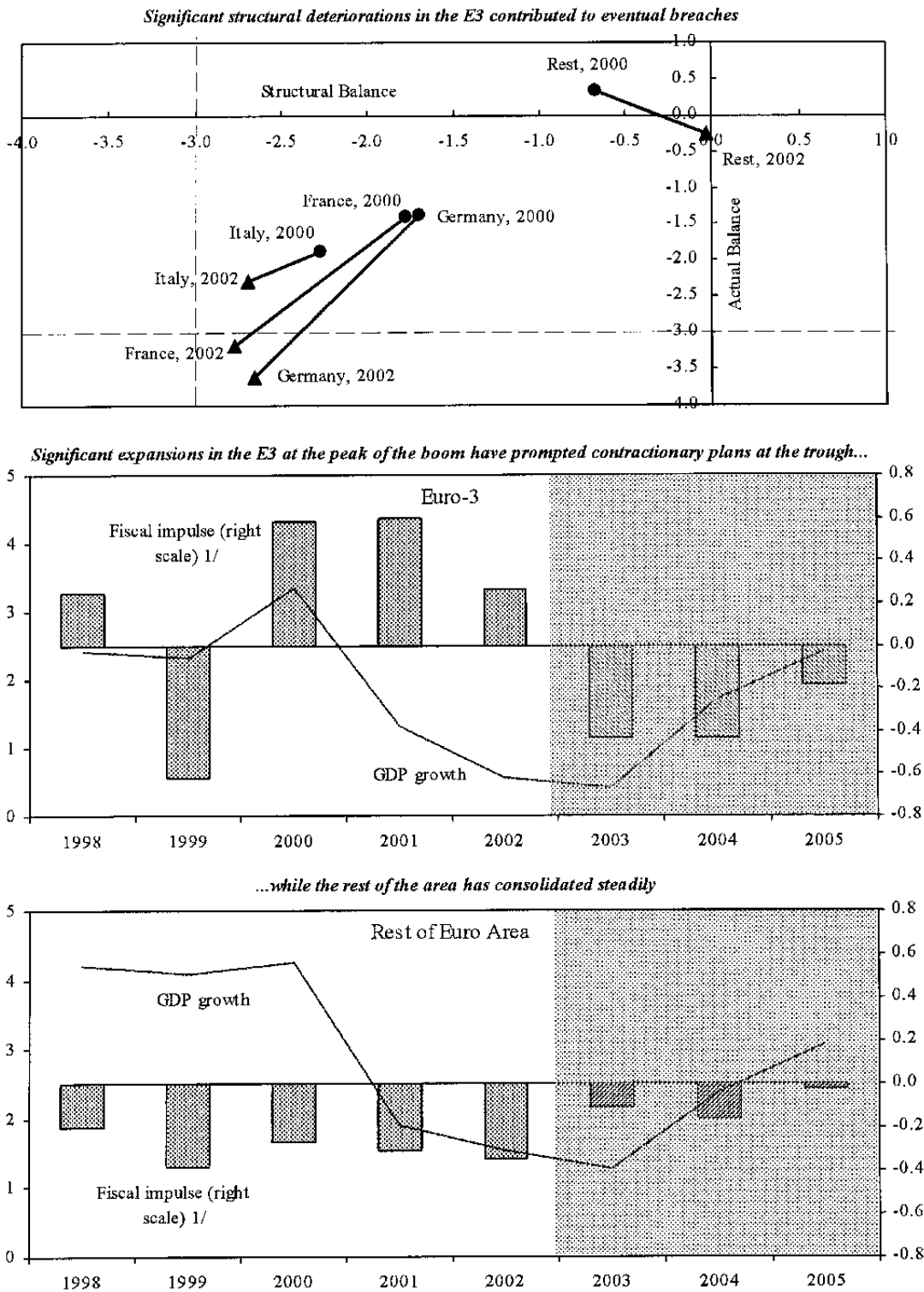
28. **Past lapses have limited the available choices.** From a medium-term perspective, running counter to the SGP requirement of moving toward underlying balance, large tax cuts initiated at the peak of the boom, combined with limited progress in reducing primary structural expenditures resulted in cyclically-adjusted deficits growing by between a ½ to 1 percent of GDP between 2000-2002 in Germany, France and Italy (Figure 5). From a short-term perspective, policies allowed full play to the automatic stabilizers, and consequently Germany and France (accounting for about half the area's output) joined Portugal in breaching the SGP's 3 percent deficit limit in 2002, while Italy avoided doing so mainly through various one-off operations.

29. **A consequence has been unsatisfactory tradeoffs between long- and short-run goals.** Correcting breaches of the SGP has led to fiscal retrenchment efforts this year and, while the effects on demand can be debated, the associated controversies have almost certainly hurt confidence. Moreover, a focus on meeting short-run targets, political constraints on the budget process, and gamesmanship have meant that these efforts have run in some cases counter to longer-run structural goals (by raising taxes). In other cases they have been at best irrelevant and sometimes harmful for achieving durable long-term adjustments (cyclical social security increases, tax amnesties, and expenditure freezes), with at best nonpositive effects for confidence.

30. **The picture for fiscal policies in 2003 is mixed and uneven across countries, with some area-wide consolidation envisaged.** Present staff projections see the area-wide deficit in 2003 widening further to 2¾ percent of GDP, with projected structural tightening (of ¼ percent) being more than offset by the operation of automatic stabilizers (¾ percent) as the output gap widens. The bulk of the area's structural adjustment is projected to come in Germany (¾ percent of GDP) from a variety of revenue raising measures. This adjustment comprises increases in social security contribution rates mandated by the pay-as-you-go system, in effect representing a temporary and procyclical increase in labor income taxation that harms employment, and other tax increases. A small adjustment (¼ percent) in Italy reflects in part tax amnesties that risk weakening future tax compliance. Net of one-off measures, the structural balance is projected to remain unchanged. In France, no adjustment is foreseen. Both Germany and France are expected to remain in breach of the 3 percent limit during 2003 and in 2004.

31. **The immediate issue confronting the SGP is how to deal with the series of breaches of the 3 percent deficit ceiling in an environment of weak growth.** The pact requires that, under normal circumstances, excessive deficits be corrected no later than the year following their identification. In practice this means deficits cannot exceed the ceiling for more than two years before risking sanctions. The SGP also foresees the possibility of "special circumstances", in particular unusually weak growth, in assessing a country's progress in correcting excessive deficits.

Figure 5. Fiscal Policies Have Not Played by the Rules



Sources: Eurostat; WEO.  
1/ In percent of potential GDP.

32. **The Commission emphasized the moral hazard and credibility risks for the area's fiscal framework were the 3 percent reference value not to be respected rigorously.** While sensitive to the weak growth conditions prevailing in the area, the Commission, based on its Spring 2003 forecasts, took a cautious view as to whether Germany would qualify for the special circumstance exemption that would allow the deadline for correcting the excessive deficit position to be extended. This assessment was based on estimates of current and prospective output gaps made using the commonly agreed methodologies between the Commission and member states. The Commission noted that the rules under the pact for correcting breaches “quickly” were clear. Relaxing agreed-to rules when they became binding could only increase the moral hazard in the system and damage credibility. The 3 percent deficit ceiling was necessary for encouraging countries to move toward appropriate medium-term balances, the other pillar of the pact, and softening it would run counter to such an objective. If persistent deviations were looked on benignly, especially *ex ante*, this would reduce the peer pressure for other countries to adjust. The Commission fully supports the focus on cyclically-adjusted—rather than nominal—balances in monitoring fiscal performance, and its proposals to this effect were endorsed by the Council earlier this year. It argued, however, that given the controversies surrounding practical estimation, a nominal anchor was also necessary, and would be needed in any workable multilateral fiscal framework.

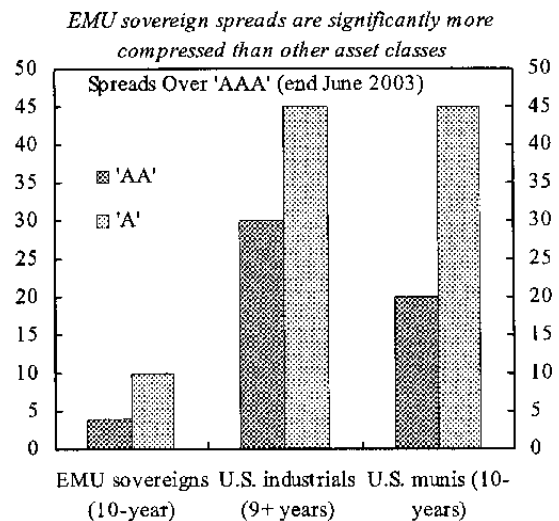
33. **While sympathetic to these arguments, the staff favors an approach that places a larger premium on the durable achievement of long-run goals.** The staff argued at the time of last year's consultation for balancing longer-run and cyclical considerations by requiring that countries with weak underlying positions take (*ex ante*) discretionary fiscal policy actions ensuring a sustained improvement of their structural balances by at least ½ a percent of GDP a year, but allowing (*ex post*) automatic fiscal stabilizers to play freely around the consolidation path. It has since argued that the same standard be applied even in the event of successive breaches, i.e., conditional on a minimum standard of *ex ante* consolidation measures, the stabilizers should be allowed free play even if this implies successive breaches of the 3 percent ceiling. The staff noted that over the last year it had become evident that the quality, durability, and evenness of fiscal adjustment efforts across countries left much to be desired. This experience suggests that for countries in a position to do so, credible and meaningful gains on the long-run structural and sustainability fronts would be worth trading off for delays in consolidation efforts to meet the SGP's medium-term norms. But short-run flexibility requires long-run credibility, and such delays could only be part of a politically credible longer-term structural-cum-fiscal process of stabilization and reform. Thus, underlying fiscal adjustment of at least ½ percent of GDP a year should remain the standard. Any delay in the pace of consolidation in 2004 needs to be compensated for by credible commitments to meet this standard on a *cumulative* basis, i.e. at least 1½ percent of GDP during 2004-06. Moreover, the overall pace of underlying fiscal adjustment may fall short of the standard in 2004 only if budgets include well-specified quality longer-term measures that add up to *gross* savings of at least ½ percent of GDP such as through quality expenditure adjustments.



34. **Looking to 2004 and beyond, there was agreement it is necessary for budgets to look hard at making progress toward achieving longer-term goals, aiming for higher quality, multiyear consolidation efforts which strengthen incentive systems and thereby alleviate the underlying unsustainability.** While there is broad agreement on both the long-run structural and macroeconomic requirements of fiscal policies in the area, progress in the three large countries has been limited. Progress is necessary both to strengthen the area's long-term potential and to enhance credibility (and hence mitigate the demand implications) of consolidation efforts. There is a need to impose a higher standard on the composition of adjustments than has been the case recently. Specifically, there is a need to eschew tax increases or recourse to one-off measures in favor of multiyear actions to curb current spending, especially on transfers and public sector employment.

35. **While there is wide agreement that a monetary union requires a fiscal framework, it remains controversial whether the SGP is the right framework.** In light of breaches of the parameters, recent controversy has focused in particular on:

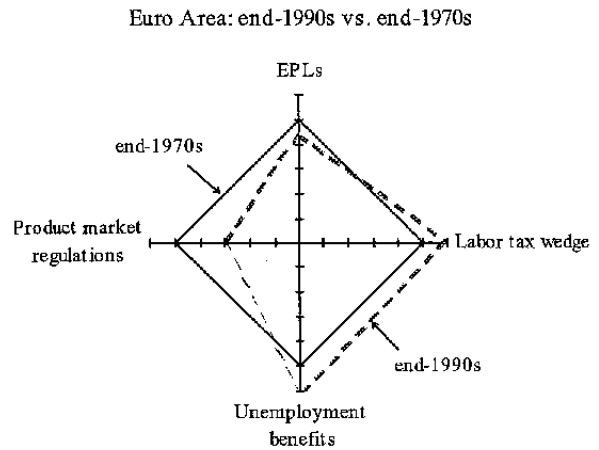
- **Are annual nominal flow deficit limits necessary?** It is generally accepted that markets discriminate *insufficiently* among members to provide the necessary discipline. Hence, the need for rules that prevent negative externalities in the form of higher required interest rates for all members in a monetary union from fiscal unsustainability in one member is widely accepted. Many argue, however, that a framework based more directly on the “fundamentals” of fiscal sustainability—on monitoring debt levels and contingent liabilities—would be both forward-looking and sufficient, obviating the need for flow constraints. The counterarguments are that just as markets discriminate *insufficiently amongst* countries they do so *insufficiently early* enough to discipline errant fiscal behavior on the part of one, thereby ultimately punishing all when they do react. Further, market imperfections imply that “flows”, i.e., new supplies of debt, do matter in that increasing flow deficits impact yields even when sustainability is not in question. From a political economy perspective, flow constraints are viewed as mechanisms to compensate for the failure of the political system to induce forward-looking policy adjustments during upswings. With the system otherwise tending to be asymmetrically pro-cyclical in upswings, flow constraints are devices to prevent the deficit from ratcheting (too far) off course over the cycle. Unfortunately if unavoidable (given the premise), this is achieved by imparting a correspondingly procyclical adjustment in downswings, making the output path more volatile.



- **Is 3 percent too tight?** There are three broad points here. First, some countries' underlying fiscal positions are inherently more sustainable (low debt and contingent liabilities) and the SGP could be viewed as unduly constraining for these countries.<sup>10</sup> The Commission has acknowledged the need to incorporate the sustainability of public finances more systematically into the assessment of countries' budget positions. Second, however, this debate is irrelevant for the current breaches. Addressing the fiscal implications of the aging of the population requires the 3 large countries to move at least to underlying balance. If they did so, and indeed had already done so, the 3 percent limit would likely not be breached except in extreme circumstances that would clearly qualify for special circumstances. Third, there are a number of arguments for why the flow limit chosen for EMU should be "conservative". A feature of the euro area, compared for example to the United States, is lower prospective potential growth rates of output and, therefore, a lower present value of tax revenues, the primary asset of the government. Since the intent is to limit negative externalities from any one member, it is also the case that in a monetary union with varying initial debt levels and historical proclivities for fiscal imprudence and, therefore, different degrees of fiscal credibility, the flow deficit limit needs to be set at a low enough prudential limit.

### C. Strengthening Medium-Term Prospects: Structural Policies and Pension Reform

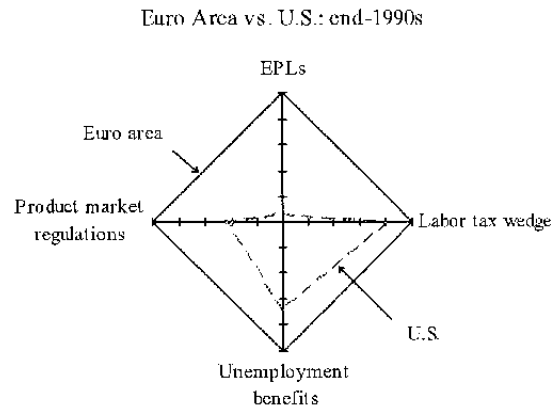
36. **While the key imperatives of the structural reform agenda are well understood and agreed, the problem has been implementation at the national level, especially in good times.** The Lisbon agenda agreed by the European Council in 2000, and its translations into specific targets by subsequent Councils, represent comprehensive goals for tapping into the area's spare potential and improving its resilience to adverse economic shocks. Despite progress in some areas, the overall record of implementation has been disappointing. Over the last 20 years, solid gains have been made in making product markets competitive, while labor market indicators suggest overall a deterioration. Staff and the authorities concurred that while past reforms had led to improvements in employment in particular, the pace of reform has slackened. Reforms at the national level have generally fared worse than area-wide initiatives spurred by Community directives.



Source: OECD.  
Structural indicators are normalized to 1 at end-1970s.  
(Values inside the diamond indicate improvements.)

<sup>10</sup> See last year's Staff Report (SM/02/203).

37. **Labor markets have been the Achilles heel of structural reforms.** Reforms in the mid- to late-1990s drew in lower-skilled and part time workers, with “jobs-rich” growth reabsorbing labor after a long decline. However, several years of relative inaction followed and, at 64 percent, the current employment rate remains well below the Lisbon target of 70 percent. On increasing labor supply, while some progress has been made in adapting tax and benefit systems to “make work pay” and encourage the search for jobs, measures have generally been piecemeal, focusing on the tax side rather than addressing generous out-of-work benefits. Similarly, the call to raise the effective retirement age by 5 years by 2010 has yet to be followed up by comprehensive active aging policies, including reforms of pension and early retirement schemes. On the demand side, comprehensive reforms of EPLs have yet to move on to the agenda in most countries.



Source: OECD.  
Structural indicators are normalized to 1 for euro area.  
(Values inside the diamond indicate improvements.)

38. **Contrary to expectations, the advent of EMU failed to provide an impetus to the pace of labor market reforms.** This partly reflected global boom conditions in the early years of EMU, which masked the need to address structural weaknesses, while the political calendar in a number of large countries delayed confronting realities at the onset of the downturn. In emphasizing the disparity of situations across countries, the Commission noted three types of experiences that impacted the incentives and timing of reforms:

- Labor market reforms seemed easier to implement when they were part of a broad agenda of economic reform whose benefits were clearly perceived—as was the case during the **convergence process** necessary to **qualify for EMU** membership.
- For **small open economies** the **loss of the exchange rate** as a potential adjustment mechanism had greater costs than for the larger more closed economies, increasing the former’s incentives for establishing more flexible labor markets.
- Recent events in Germany have reaffirmed that situations of **persistent unsatisfactory performance**—high and rising unemployment, unsustainable social security systems, and constrained potential growth—made the need for reform slowly self-evident to all social partners.

39. **There was strong agreement that increased divergences in performance across the area recently and the imminent aging of the population made structural reforms in the labor market urgent.**

- **Adjustments to asymmetric shocks** within a currency union require a high degree of flexibility in goods and labor markets to compensate for the loss of the exchange rate as

an adjustment mechanism. Indeed, limited cross-border labor mobility in the euro area imposes a higher requirement of flexibility than would otherwise be the case.

- **Long lags in affecting increases in participation rates** requires early concerted actions to slow—if not reverse—the aging-induced slowing in potential, per capita growth, and deteriorations in public finances.

Euro Area: Potential Output Growth and Labor Utilization, 2000-2020

	2000-05	2005-10	2010-15	2015-20
Baseline potential growth	2.1	1.5	1.3	1.2
Lisbon agenda scenario 1/	2.4	2.2	1.9	1.7
Lisbon agenda and increased work hours scenario 2/	2.7	2.8	2.4	2.3

Source: Staff estimates.

1/ Gradual increase of employment rate from 64 percent in 2003 to 70 percent in 2020.

2/ Gradual increase in employment rate plus gradual increase in annual working hours by 10 percent during 2004-2020 (reversing about half of the decline in hours since 1970).

40. **In product markets, following major advances in the early years of the internal market, progress has slowed.** Competition remains insufficient in a number of sectors, particularly in certain services. Progress in eliminating remaining barriers to cross-border trade continues to be hampered by obstacles to liberalizing the internal market for services, where differences in standards and regulations limit cross-border retailing and sales.

41. **There has been encouraging progress in creating a single market for financial services.** Concentrated in wholesale money and capital markets, this has provided a boost to market financing, providing a welcome counterbalance to the predominance of bank financing. Increased competition from integration should reduce the cost of capital and boost investment, while increased diversification opportunities within the union for investors should encourage savings. The momentum built up last year with agreement on the Lamfalussy process for speeding up the implementation of the Financial Services Action Plan (FSAP) in securities markets, is being followed up by its extension to the banking and insurance sectors, where integration has been slow. This momentum will need to be maintained to secure full implementation of the FSAP by the 2005 deadline. Progress in implementing the Risk Capital Action Plan (RCAP) has continued, but needs to be stepped up. Several initiatives have been launched to identify ways to reduce barriers to cross-border clearing and settlement, which remain a source of inefficiency. On the financial supervision front, several countries took steps to consolidate supervision across sectors, and a key Memorandum of Understanding between banking supervisory authorities and central banks on a set of principles for cooperation in relation to potential or actual crises with possible cross-border effects was signed.

42. **While increasing integration raises the demand for public goods at the community level (infrastructure, education, and research), effective mechanisms for providing and financing these public goods will need to be developed.** The present Italian presidency of the EU has launched an initiative to increase EU spending on public infrastructure by 0.5-1.0 percent of GDP, with extrabudgetary financing involving the European Investment Bank (EIB). The Council welcomed this Italian presidency priority and took note of the Commission's intention to launch an initiative in cooperation with the EIB to support growth and integration by increasing overall investment and private sector involvement in Trans European Networks (TENs) and major R&D projects. A number of

priority projects have already been identified. There seems to be general agreement that projects need to be subjected to sober cost-benefit analysis, but the details of implementation remain vague at this stage. Responsibilities for servicing contingent budgetary and extrabudgetary liabilities that would accumulate through this initiative will need to be assigned in a transparent manner.

43. **A number of developments point to the increasing seriousness attaching to effecting reforms at the national level.** The recent reform discussions in the larger countries, especially on labor markets and public pensions, are especially welcome. Staff also welcomed the recent shift in emphasis in surveillance at the area-wide level from the formulation of targets to implementation, evident in the streamlining and medium-term focus of the most recent Broad Economic Policy Guidelines to make them more effective<sup>11</sup>, in efforts to increase peer pressure through “naming and shaming”, and in the establishment of a European Employment Task Force charged with identifying practical reforms with the most direct and immediate impact. There was strong agreement on the potential synergies between structural reforms, improved economic performance, and fiscal sustainability. An increase in the effective retirement age, for example, would raise labor supply and growth, and reduce pressures on the public pension system.

44. **The particular challenge of putting pension systems on a sound longer-term footing illustrates both the urgency of, and synergies from, structural reforms.** Aging populations will constrain contributions while boosting entitlement expenditures, and create a growing imbalance in public pension systems<sup>12</sup>. “Parametric” reforms are clearly necessary, but they are not sufficient. Projections suggest, for example, that if pension incomes are maintained at their 2000 level, social security contribution rates would have to rise from their current level of 16 percent to 27 percent by 2050, creating serious disincentives for labor supply and increasing structural unemployment. The extent to which cutbacks in benefits will need to be made hinges on the extent to which they can be balanced by increasing the incentives for retiring later, broader-based labor market reforms that boost potential growth, and by reducing public debt in advance of the aging shock.

45. **The staff pressed the cases for developing significant private pension pillars to complement smaller public pension pillars, and for improving public understanding of the imminent risks to public pension finances.** Besides the arguments for a partially funded system in reducing contingent liabilities, increasing savings and hence potentially investment and longer-term growth, staff noted that older voters will form an electoral majority in most countries at a time when cuts in pension benefits are still being phased in, calling the time-consistency of policies and fiscal sustainability into question. Given the long implementation lags of pension reforms, time for action is running out fast. The staff noted that a key

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<sup>11</sup> See Broad Economic Policy Guidelines, European Commission, 2003.

<sup>12</sup> See *Selected Issues* paper “Aging and the SGP”.

ingredient for successful pension reforms appeared to be a better public understanding of the risks to pension finances. The publication of regular reports on the longer-term outlook of public pension finances by independent and credible national agencies with no direct interest in reform outcomes could, therefore, play a catalytic role.

#### **D. Trade Policy**

46. **Progress on the Doha Development Agenda is urgent.** The staff noted that failure at the forthcoming WTO Ministerial Meeting at Cancún would foster regionalism and exacerbate trade disputes, sending an unwelcome signal at a time of fragility in the world economy. Moreover, the EU has a central role in ensuring a successful outcome, given its pivotal position in resolving differences over agriculture. While the Commission acknowledged its role, it underlined the need for parallel progress in other areas, including initiating negotiations on WTO frameworks for investment, competition, government procurement, and trade facilitation, all areas where agreements would yield significant benefits for developing countries.

47. **The recently agreed internal reforms to the Common Agricultural Policy (CAP) fall short of fully correcting trade distortions.** The partial decoupling of subsidies from production levels—to take effect in 2005—is a central feature of the reforms and will help counter tendencies for excess production.<sup>13</sup> However, significant exceptions to decoupling would remain for cereals and meat production. Reforms in a number of important sectors, including sugar and Mediterranean products, remain to be decided. While welcoming the reforms as a step in the right direction, staff emphasized that they fell short of the measures needed to level the playing field in world trade. Crucially, the CAP reforms were silent on market access, which is of particular interest to developing country farmers, and the EU's WTO proposal to cut peak tariffs by a minimum of 15 percent lacks ambition.

48. **The Commission underlined the need to safeguard the interests of the poorest countries, most of whom enjoy preferential access to the EU market.** MFN liberalization would erode preferences and expose these countries to excessive competition. Given important externalities in agriculture, market forces could not be relied upon to reach development goals. Nevertheless, the authorities agreed that this did not justify lasting resistance to trade liberalization but called for careful design of, and assistance in, the transition process and beyond. The staff noted that further changes to the CAP would become more difficult after enlargement in 2004.

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<sup>13</sup> The staff's analysis of the impact of CAP reforms, "Reshaping the CAP: The Midterm Review Proposals", is presented in SM/03/38.

49. **EU enlargement will provide further impetus to trade integration, while trade diversion should be limited.**<sup>14</sup> Intra-industry trade has the greatest potential for growth within the enlarged EU, and would carry only moderate adjustment costs, but a certain amount of sectoral dislocation could nevertheless be expected for the poorer accession countries. The staff noted that in certain sectors, market access to the enlarged EU, especially from CIS countries, might become more difficult as a result of EU trade remedy actions and restrictions in agriculture not currently maintained by the new members. The Commission argued that third countries would generally benefit since tariffs in the new members would on the whole come down while growth would rise, and noted that an initiative had been launched to minimize any negative fallout in the EU's new neighbors.

#### IV. STAFF APPRAISAL

50. **Developments during the first five years of EMU have been more challenging than expected.** The global equity market boom-bust cycle has tested the mettle and foresight of policies on all fronts: monetary through an unexpectedly persistent upward drift in inflation; fiscal through a boom-bust cycle in revenues that has exposed earlier lapses in policies; and structural reforms, which moved off the agenda with the passing of the exchange rate constraint and the advent for a while of better times. These problems have been compounded by the unexpected economic weakness of the largest member of the union. The end result has been a rather disappointing performance. Looking forward, the challenges seem set to continue, with the demographically-induced slowing of labor force growth and aging of the population becoming an increasing drag on potential output growth, fiscal sustainability and old-age income security.

51. **Meeting these challenges successfully requires a sustained and systematic shift toward more forward-looking approaches to the formulation and implementation of national policies.** A history, particularly in the larger countries, of slighting fiscal and structural fundamentals in good times has left the union poorly poised to deal with adverse ones. While adversity has begun to induce more forward-looking policies, notably on the structural side, the deeper issue is whether these potentially promising steps will be sustained once present difficulties recede—that is, whether they are products of adversity or products of a deeper realization of the need for sustained adjustment. This uncertainty must be dispelled if trend growth is not to disappoint or policies not to find themselves in the same situation a few years hence.

52. **Near-term prospects of recovery remain uncertain.** The recent weakness has reflected a number of shocks: the bursting equity bubble; reduced external demand; the correction of the euro to longer-run equilibrium levels; and geopolitical uncertainties. But the dynamics of adjustment to these shocks have been impacted by structural features of the area:

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<sup>14</sup> See the accompanying *Selected Issues* paper "EU Eastern Enlargement: Impact on Trade and FDI".

rigidities in labor markets and a lesser reliance on market-based financing have contained the effects of past shocks, but also slowed both the post-bubble and intra-area adjustments. It is unclear how far along these various adjustment processes are. Consequently, the near-term baseline sees the prevailing area-wide stagnation being overcome only gradually, with growth remaining sub par well into next year. Moreover, in the absence of clear evidence of recovery, the risks as regards the timing of the pickup must be viewed as on the downside.

53. **Monetary policy has done well and established its credibility.** Policies have been apposite to the times, and the monetary framework has been appropriately adapted to the changes in circumstances that have occurred over the past 5 years. The ECB's clarification of its inflation objective as "below but close to 2 percent" substantially reduces the scope for misinterpreting its objective and provides a clear anchor for longer-run inflationary expectations. Such inflation outcomes over the medium term provide a buffer against shocks that could lead to area-wide deflation and provide scope for inflation differentials across countries. The echeloning of the two pillars was also right.

54. **Looking forward, the ECB needs to guard against downside risks to inflation.** Although persistent, inflation has turned. The cumulative effects of weakness in activity, the appreciation of the euro, a continued softening of labor markets, and the fall in oil prices should combine to push headline and core inflation below 1½ percent by late next year. The risk of undershooting the inflation objective of close to 2 percent are greater than the reverse. With low inflation not helping balance sheet adjustments and providing less room for relative price adjustments, the costs of doing so are also greater, strengthening the case for an easy monetary policy going forward. The ECB should signal and maintain an "accommodative bent"—a sustained easing bias—to support confidence until a self-sustaining upturn in domestic demand, especially of corporate spending is in place.

55. **Fiscal policies have fared less well: having failed to move toward long-run goals in good times, they have run up against prudential limits, resulting in unsatisfactory tradeoffs of long- for short-run goals.** While the fiscal framework has worked well for many countries, it has not for the three largest. In particular, the framework has not been able to induce these three countries to pursue meaningfully forward-looking policies, both in the boom and the bust phases. Most policies have had a short-term focus, whether in conformity with the framework or otherwise. Actions that were deemed forward-looking—tax cuts—turned out to be wishful as the boom turned to bust. The consequent need for consolidation efforts in an environment of weakness has hurt confidence. Moreover, in some cases these efforts have—by raising taxes—run counter to long-run structural goals. In other cases—through cyclical social security increases, tax amnesties, or expenditure freezes—they have been at best immaterial and sometimes harmful for achieving durable long-term consolidation, with little beneficial effects for confidence.

56. **EMU requires a fiscal framework, and from a longer-term standpoint the basic parameters of the SGP seem broadly appropriate.** To preempt the possibility of negative externalities for all from the errant fiscal behavior of one, a fiscal framework for the monetary union is essential. The current focus of controversies around the 3 percent limit is



misplaced. The aging of the population requires the 3 large countries move at least toward underlying balance over the medium term. If they did so, and indeed if they had already done so, the 3 percent limit would not be breached except in extreme circumstances, which the pact allows for.

57. **Fiscal policies thus need to become more forward-looking, an avenue that could create room for greater short-run flexibility.** The SGP should indeed focus on growth as well as stability, but growth means first and foremost structural reforms rather than short-term demand management. Within such an optic, however, there is scope to trade short-run consolidation for credible multi-year commitments to growth- and consolidation-oriented structural reforms. The staff continues to subscribe to the standard that countries with weak underlying positions take (ex ante) discretionary fiscal policy actions to achieve a ½ a percent of GDP a year of structural consolidation measures. Delays that provide meaningful gains on the long-run structural and macroeconomic fronts must meet the standard on a cumulative basis, i.e., 1½ percent during 2004-06. Budgets in 2004 need to look hard at achieving longer-term goals, eschewing tax increases or one-off measures in favor of multiyear actions to curb current spending, especially on transfers and public sector employment, thereby fostering sustainability and creating the room for necessary tax cuts over time.

58. **EMU also requires a more sustained and forward-looking approach to structural reforms.** The evidence is both that the task, and the opportunity cost of inaction (fiscal unsustainability, much lower potential growth), is very large and that the pay off is considerable. The area's low underlying growth reflects in large part low population growth, but there is considerable scope for raising rates of utilization of existing labor resources. Long lags in affecting the incentives for work and increases in labor force participation, effective retirement, and structural unemployment rates, requires early concerted actions to slow—if not reverse—the aging-induced fall off in potential per capita growth and deteriorations in public finances. The loss of the exchange rate as an adjustment mechanism within a monetary union, particularly one with limited labor mobility, imposes a further requirement on flexibility in goods and labor markets.

59. **In some countries, promising reform steps have recently been taken, but many more are needed.** The reform process in the larger countries, particularly as regards labor markets and social security systems, has been revived and, in some cases, progressed beyond earlier expectations. It reflects a growing political consensus in these countries that longstanding institutional arrangements in labor markets and social security systems have become a burden on growth. Moreover, there is a growing recognition of the largely unexploited synergies to be reaped between structural reforms, improved economic performance, and fiscal sustainability that hold the promise of improving medium term growth prospects and restoring the credibility of the SGP. However, the agenda of needed reforms is long, varied, and different. Moreover, resistance to reform has a long tradition, remains strong, and is likely to strengthen as the economic situation improves. It is essential that the new reform élan not become simply a response to economic adversity but be sustained for many years to come. The steps taken by the Commission, and endorsed by

ECOFIN, to toughen surveillance by making the Broad Economic Policy Guidelines both more targeted and forward-looking are highly welcome.

60. **The recent decision to reform the Common Agricultural Policy is welcome, but achieving the Doha round objectives will require greater commitment to opening EU markets.** While falling short of the Commission's proposals, the agreed "decoupling" of agricultural supports from production will lessen downward pressures on world prices. It also widens the Commission's negotiating margin at the WTO and may thus help to re-energize the Doha round. Yet, creating a multilateral trade environment supportive of economic development and poverty reduction would require the EU to set far more ambitious targets for tackling tariff peaks and escalation. Risks that generalized improvements in market access would hurt preferential suppliers are easily overstated and call for targeted support to facilitate adjustment, but cannot justify lasting protection. The EU's regional strategy for the ACP countries (based on Economic Partnership Agreements) can be a valuable tool in this regard to the extent that it helps to strengthen supply capacity and promote the diversification of exports.

61. **Area-wide statistics are adequate for surveillance purposes, but further improvements are desirable to meet or exceed existing best practice.** There is scope for improving the timeliness of quarterly national accounts data as well as the quality of labor market and short-term business cycle statistics. The recent publication of annual flow-of-funds data for the area as a whole is welcome, but the provision of more up-to-date and quarterly data would be useful given the increasing importance of asset price cycles in shaping the macroeconomic policy environment. The planned publication of quarterly general government data is essential for monitoring short-term performance under the SGP and should remain a priority.

62. It is proposed that the **next consultation on Euro Area Policies** in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

**Table 1. Euro Area: Main Economic Indicators**

(Percentage change)

	1998	1999	2000	2001	2002	2003 1/	2004 1/
<b>Demand and Supply</b>							
Private consumption	3.0	3.5	2.5	1.8	0.5	1.4	2.0
Public consumption	1.4	2.0	2.1	2.2	2.7	1.3	1.2
Gross fixed investment	5.2	5.9	4.9	-0.6	-2.6	-0.4	2.9
Final domestic demand	3.2	3.7	3.0	1.4	0.3	1.0	2.0
Stockbuilding 2/	0.4	-0.2	0.0	-0.4	-0.1	0.3	0.1
Domestic Demand	3.6	3.5	2.9	1.0	0.2	1.3	2.1
Foreign balance 2/	-0.6	-0.6	0.6	0.5	0.6	-0.5	-0.1
Exports 3/	7.3	5.2	12.6	3.0	1.2	2.3	4.2
Imports 3/	10.0	7.4	11.3	1.7	-0.4	4.0	4.8
Real GDP	2.9	2.8	3.5	1.5	0.8	0.7	1.9
<b>Resource Utilization</b>							
Potential GDP	2.2	2.2	2.3	2.2	2.1	2.0	2.1
Output Gap 4/	-0.5	0.1	1.2	0.5	-0.8	-2.0	-2.2
Employment	1.8	1.7	2.0	1.3	0.8	-0.1	0.5
Unemployment rate 5/	10.2	9.4	8.5	8.0	8.4	9.1	9.1
<b>Prices</b>							
GDP deflator	1.2	1.7	1.4	2.5	2.4	2.1	1.7
Consumer prices	1.1	1.1	2.1	2.4	2.3	1.9	1.4
<b>Public Finance 6/</b>							
General government balance 7/	-2.3	-1.3	0.1	-1.6	-2.2	-2.7	-2.7
General government structural balance	-1.8	-1.2	-1.6	-1.9	-2.0	-1.7	-1.5
General government debt	73.7	72.6	70.2	69.2	69.1	69.9	70.2
<b>Interest Rates 5/</b>							
Short-term deposit rate	4.1	3.0	4.5	4.2	3.3	2.9	2.9
Long-term government bond yields	4.8	4.7	5.5	5.0	5.0	4.3	4.4
<b>Exchange Rates 8/</b>							
U.S. dollar per euro 9/	1.12	1.07	0.92	0.90	0.94	1.11	...
Nominal effective rate (1990=100)	90.8	86.7	78.5	79.7	81.7	88.1	...
Real effective rate (1990=100) 10/	88.7	84.3	75.2	74.9	76.7	82.5	...
<b>External Sector 6/ 11/</b>							
Current account balance	0.4	-0.4	-1.0	-0.3	0.9	0.8	0.7
Trade balance	1.8	1.2	0.5	1.1	1.9	1.7	1.6
<b>Memorandum items 6/ 12/:</b>							
Current account balance	1.0	0.5	-0.3	0.3	1.2	1.0	0.9
Trade balance	2.0	1.4	0.7	1.6	2.2	2.1	2.1

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

1/ WEO projections as of July 29th, 2003.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ In percent of potential GDP.

5/ In percent.

6/ In percent of GDP.

7/ Includes UMTS revenues and Italy's real estate asset sales.

8/ For 2003, January-July average.

9/ Synthetic euro in 1998.

10/ Based on normalized unit labor costs.

11/ Based upon ECB data which excludes intra-euro area flows.

12/ Calculated as the sum of individual countries balances.

**Table 2. Euro Area: General Government Fiscal Balances and Debt**  
(Percent of GDP)

	1998	1999	2000	2001	2002	2003 1/	2004 1/
<b>Euro area</b>							
Revenue	47.7	48.2	47.8	47.1	46.6	46.5	46.2
Expenditure	50.0	49.5	47.7	48.7	48.9	49.3	48.9
Primary structural expenditure 2/	44.1	44.2	44.3	44.2	43.9	43.5	43.1
Actual balance	-2.3	-1.3	0.1	-1.6	-2.3	-2.8	-2.7
Output gap 3/	-0.5	0.1	1.2	0.5	-0.8	-2.0	-2.2
Structural balance 2/	-1.8	-1.2	-1.6	-1.9	-2.0	-1.7	-1.5
Gross debt	73.7	72.6	70.2	69.3	69.2	70.1	70.4
<b>Germany</b>							
Revenue	46.6	47.3	47.0	45.5	45.0	45.3	44.7
Expenditure	48.8	48.8	45.9	48.3	48.6	49.2	48.5
Primary structural expenditure 2/	44.5	44.9	45.3	44.7	44.3	43.9	43.1
Actual balance	-2.2	-1.5	1.1	-2.8	-3.6	-3.9	-3.9
Output gap 3/	-0.4	-0.1	0.9	0.0	-1.2	-2.6	-2.6
Structural balance 2/	-1.7	-1.2	-1.8	-2.7	-2.9	-2.2	-2.2
Gross debt	60.9	61.2	60.2	59.5	60.8	63.2	65.5
<b>France</b>							
Revenue	51.2	51.8	51.2	51.0	50.4	49.9	50.0
Expenditure	53.8	53.6	52.6	52.5	53.4	53.9	53.5
Primary structural expenditure 2/	49.1	49.4	49.7	49.6	49.7	49.2	48.7
Actual balance	-2.7	-1.8	-1.4	-1.4	-3.1	-3.9	-3.5
Output gap 3/	-1.7	-1.0	0.7	0.4	-0.6	-1.8	-2.1
Structural balance 2/	-1.6	-1.1	-1.8	-1.8	-2.8	-2.8	-2.2
Gross debt	59.5	58.5	57.1	56.8	58.9	61.0	62.5
<b>Italy</b>							
Revenue	46.5	46.7	45.8	45.5	44.9	45.1	44.9
Expenditure	49.3	48.3	46.5	48.1	47.2	47.8	47.7
Primary structural expenditure 2/	40.6	40.8	40.9	41.5	41.3	41.2	41.1
Actual balance	-2.8	-1.6	-0.6	-2.6	-2.3	-2.7	-2.8
Output gap 3/	-0.1	0.0	1.0	0.6	-1.0	-1.8	-1.7
Structural balance 2/	-2.8	-1.7	-2.3	-3.1	-2.7	-2.4	-2.1
Gross debt	116.4	114.6	110.4	109.5	106.7	105.7	104.0
<b>Other countries</b>							
Revenue	47.1	47.4	47.4	46.9	46.6	46.1	45.7
Expenditure	48.9	48.0	46.8	46.9	46.9	47.1	46.8
Primary structural expenditure 2/	41.3	41.0	41.0	40.9	40.4	39.8	39.5
Actual balance	-1.8	-0.5	0.6	0.1	-0.4	-1.1	-1.1
Output gap 3/	0.0	1.1	2.1	1.0	-0.3	-1.8	-2.2
Structural balance 2/	-1.3	-0.9	-0.7	-0.4	-0.1	0.0	0.1
Gross debt	72.2	70.0	66.1	64.1	62.9	62.3	61.0

Source: WEO, July 2003.

1/ Projections.

2/ Percent of potential GDP. Excludes one-off receipts from the sale of mobile telephone licenses (the equivalent of 2.5 percent of GDP in 2000 for Germany, 0.1 percent of GDP in 2001 and 2002 for France, 1.2 percent of GDP in 2000 for Italy). Also excludes one-off receipts from sizable asset transactions.

3/ Percent of potential GDP.

Table 3. Euro Area: Balance of Payments

	1999	2000	2001	2002	2003 First quarter
(In billions of euro)					
Current account	-23.7	-65.9	-19.3	59.7	2.7
Goods	75.7	31.5	75.6	131.2	17.4
Services	-16.5	-17.5	-3.7	11.2	1.0
Income	-37.1	-25.5	-39.8	-36.7	-12.6
Current transfers	-46.1	-54.7	-51.1	-45.9	-2.9
Capital account	12.8	9.8	9.6	11.6	2.0
Financial account	13.5	66.8	-25.0	-132.0	-30.6
Direct investment	-119.5	-16.4	-102.8	-33.7	-7.6
Portfolio investment	-41.4	-111.4	64.7	108.3	2.8
Equity	-63.3	-236.0	125.0	47.5	14.8
Debt instruments	21.9	124.7	-60.1	61.0	-12.0
Financial derivatives	3.3	-3.4	-3.5	-13.9	0.0
Other investment	161.0	180.9	-1.1	-190.8	-37.5
Reserve assets	10.3	17.7	18.0	-2.1	11.8
Errors and omissions	-2.5	-10.5	34.6	61.0	25.8
(In percent of GDP)					
Current account	-0.4	-1.0	-0.3	0.8	0.2
Goods	1.2	0.5	1.1	1.9	1.0
Services	-0.3	-0.3	-0.1	0.2	0.1
Income	-0.6	-0.4	-0.6	-0.5	-0.7
Current transfers	-0.7	-0.8	-0.7	-0.6	-0.2
Capital account	0.2	0.2	0.1	0.2	0.1
Financial account	0.2	1.0	-0.4	-1.9	-1.7
Direct investment	-1.9	-0.3	-1.5	-0.5	-0.4
Portfolio investment	-0.7	-1.7	0.9	1.5	0.2
Equity	-1.0	-3.7	1.8	0.7	0.8
Debt instruments	0.4	1.9	-0.9	0.9	-0.7
Financial derivatives	0.1	-0.1	-0.1	-0.2	0.0
Other investment	2.6	2.8	0.0	-2.7	-2.1
Reserve assets	0.2	0.3	0.3	0.0	0.7
Errors and omissions	0.0	-0.2	0.5	0.9	1.4
Memorandum items:					
GDP (billions of euro)	6,150.4	6,453.1	6,840.1	7,063.5	1,796.6
Reserves of the Eurosystem 1/ (billions of euro)	372.3	377.2	392.7	366.1	339.1

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

INTERNATIONAL MONETARY FUND

**Euro Area Policies**

**Supplementary Information**

Prepared by the European I Department

Approved by Michael Deppler and Leslie Lipschitz

September 8, 2003

1. This supplement reports on **economic and financial developments in the euro area** since the issuance of the staff report (SM/03/278). The new information does not alter the thrust of the staff appraisal.

2. **Recent indicators on recovery prospects in real economic activity have been encouraging.** The bellwether IFO and BNB (Belgian National Bank) surveys, typically good leading indicators of area-wide business sentiment, turned sharply up in August (Figure 1). Moreover, while survey increases in past months were driven by the expectations components, the August increases included an improved assessment of current conditions. Improving sentiment was echoed in the Reuters' Purchasing Managers Indices (PMIs) surveys for August, which showed broad-based increases for both the manufacturing and services sectors (Figure 1), though the manufacturing index remained below the 50 point threshold conventionally viewed as signaling a preponderance of contractionary forces. At the same time, the flash estimate for the second quarter indicated GDP stagnated, but subsequent country releases suggest the estimate is likely to be revised down to modestly negative growth. Reflecting the poor second-quarter outcome, the staff's forecast for growth in 2003 has been revised down from  $\frac{3}{4}$  percent at the time of the issuance of the staff report to  $\frac{1}{2}$  percent in the current WEO. Activity next year is still expected to expand at about 2 percent.

3. **Inflation has again proved sticky, continuing to hover around the ECB's target of below-but-close-to 2 percent.** The flash estimate for August indicates headline inflation rose slightly, to 2.1 percent from 1.9 percent in July, reflecting recent increases in energy prices (compounded by the depreciation of the euro), and the impact of the unusually hot summer on food prices. The persistence of these factors in September suggests inflation is unlikely to fall appreciably in the near-term. Beyond that, however, with the recovery projected to be very gradual, continued sub-par growth will add to economic slack and the staff continues to project inflation to decline significantly during the course of next year, though somewhat less than at the time of the issuance of the staff report. The forecast for inflation for 2003 has been marked up to 2.0 percent from 1.9 percent at the time of the issuance of the staff report, and that for 2004 to 1.6 percent from 1.4 percent. Longer-run inflation expectations seem to remain well anchored at levels below but close to 2 percent.

4. In **financial markets**, along with recent trends in global markets, equity prices in the area continued to rally, rising by another 5 percent since the issuance of the staff report (Figure 1), while bond yields have edged up by another 20 bps. The euro has fallen further, and has been trading around 1.10 per dollar recently as compared with its peak of 1.19 in early June (Figure 1). On a trade-weighted basis, the euro has fallen by around 3 percent since the issuance of the staff report and by around 4 percent since the ECB's June 5 meeting when it last cut interest rates.

5. At its latest meeting on September 4, the **ECB's Governing Council left policy interest rates unchanged**, with the main refinancing rate remaining at 2 percent. The Governing Council noted that downside risks to the baseline scenario for economic growth had declined over the past two months but not disappeared. Inflation was expected to continue to hover around 2 percent for the remainder of the year, before falling below 2 percent next year and stabilizing at levels consistent with price stability. In sum it saw the current level of interest rates as appropriate, as the medium term outlook for price stability continued to be favorable. Forward markets are continuing to price in no changes in policy rates in the near term and expect a hike by 25 basis points in March next year.

6. On fiscal policies, recent **upward revisions to official estimates of budget outcomes** in Germany and France during 2003 have been in line with staff projections contained in the WEO. With the budget planning process for 2004 now underway and most private sector and official institutions' projections—including the staff's—continuing to see both countries remaining in breach of the 3 percent deficit limit for a third year running, **tensions and debate about the Stability and Growth Pact (SGP) have once again intensified**. With some calling for more flexibility but others arguing for no relaxation of the rules, interpretation of the pact could be a key theme of the informal ECOFIN meetings at the end of this week. The **next critical test of the pact comes on October 3**. This is the deadline established under the pact's Excess Deficit Procedure for France to take measures to bring its excess deficit below the 3 percent limit in the year following its identification, i.e., 2004. In the previous excess deficit cases of Portugal and Germany, ECOFIN concluded that measures committed to by these countries at the time were sufficient to correct the breaches in the specified time frame. In the case of France, recent official announcements have so far stressed the need for further tax cuts, albeit moderate, thus reducing the initially envisaged structural adjustment ( $\frac{1}{2}$  percent of GDP) in the course of 2004.

7. In the staff's view, improved prospects abroad, rising confidence domestically, further gains in equity markets, and the strengthening of the U.S. dollar have all made the risks to the forecast more balanced. Nevertheless, **the basic thrust of the staff's appraisal in the issued report with regard to monetary and fiscal policies remains unchanged**, in particular:

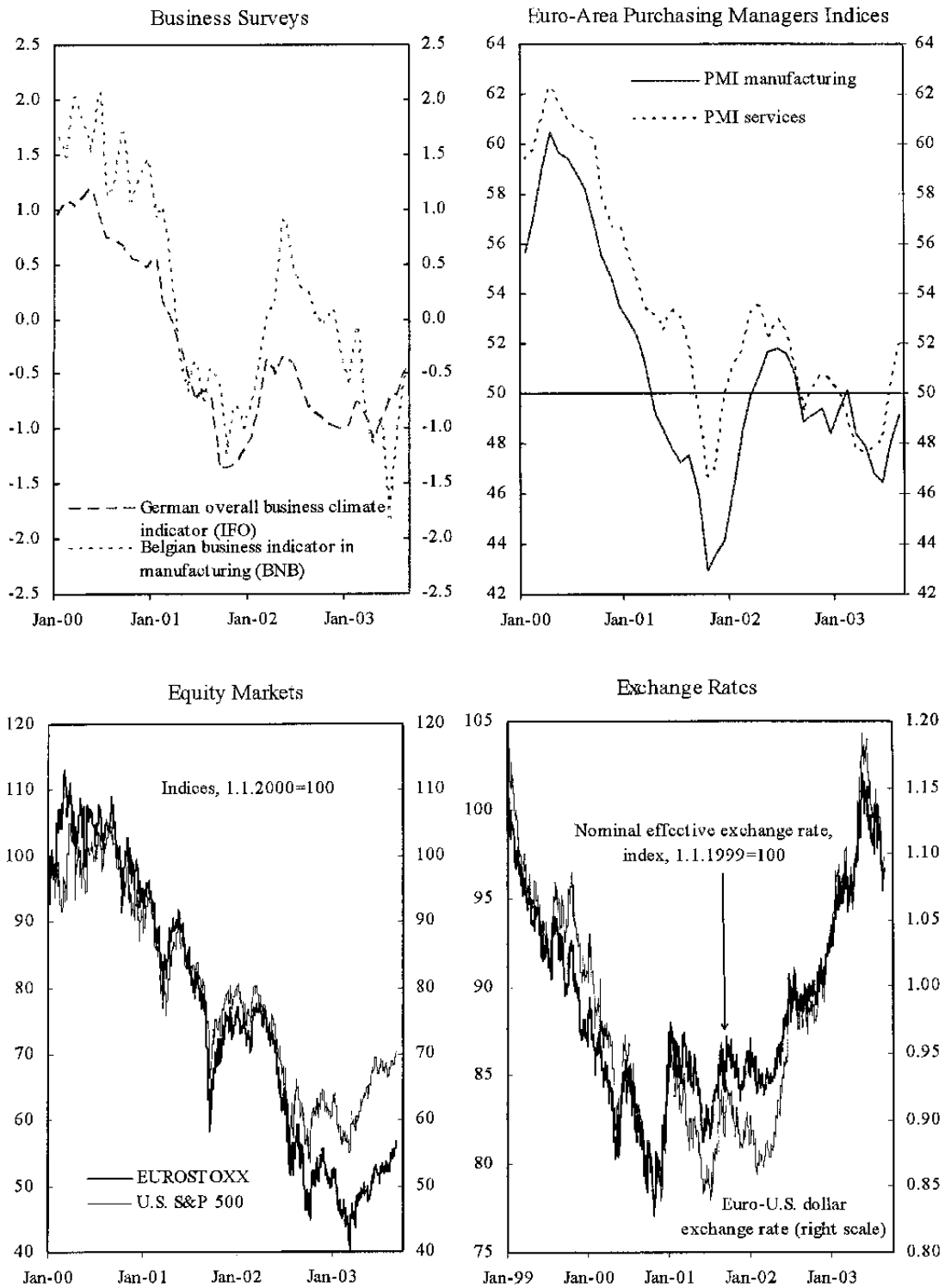
- With hard data on the recovery lacking, monetary policy should maintain an accommodative bent—a sustained easing bias—until a self-sustaining upturn in domestic demand, particularly of corporate spending, is in place. While inflation is likely to be sticky in the near term, the staff's forecast is still for a significant decline

over the course of next year. In the staff's view, the risks and costs of undershooting the ECB's inflation objective remain greater than those of overshooting it.

- On fiscal policy, a reasonable compromise between short- and medium-term policy tradeoffs continues to argue for underlying fiscal adjustment of ½ percent of GDP per year in countries with weak budgetary positions, or, if underpinned by tangible and credible fiscal consolidation and structural reform measures, cumulative adjustment of 1½ percent of GDP over 2004-06.



Figure 1. Recent Economic and Financial Developments



Sources: IFO Institute; Banque Nationale de Belgique; PMI surveys; Datastream; and staff calculations.



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International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Discusses Euro Area Policies**

On September 10, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of euro area policies and the trade policies of the European Union. The background section of this PIN reflects information available at the time of the Executive Board meeting.<sup>1</sup>

### **Background**

A lackluster recovery during the first half of 2002 lost momentum, giving way to virtual stagnation during the first half of 2003. Since the global equity bubble burst, corporate balance sheets have been on the mend but there remain uncertainties about whether adjustments have run their full course. Indications are that labor market adjustment is ongoing, and unemployment has continued to edge up since last year. At the same time, recent indicators on recovery prospects have been encouraging, with area-wide business sentiment picking up in both the manufacturing and the service sectors.

Inflation has proven unexpectedly persistent, but has turned. While headline rates were buffeted by movements in oil prices, core inflation decelerated from 2¾ percent in early 2002 to around 2 percent by January this year, reflecting growing economic slack, the appreciation of the euro, and the waning of price shocks. Concerns a year ago that the inflation overshoot would lead to extended second round wage effects appear to have been averted. Indications are that the upward drift in wage increases since 1998 has come to a halt, and unit labor cost growth has eased.

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<sup>1</sup> 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. The ECB's observer at the Fund participated in that meeting.

Financial conditions in the area have improved along with those in global markets, though financial fragilities may be impairing the transmission to corporates. Equity prices continued to tumble through March of this year but have since then picked up significantly. Money market and government bond yields remain at low levels. The past appreciation of the euro, welcome from a multilateral medium-term perspective, is detracting from the area's near-term prospects. Since January 2002, the euro has risen by around 25 percent against the dollar and 15 percent in real effective terms, with most measures of the latter at about their long run averages.

Monetary policy has continued to ease, with the ECB cutting its main refinancing rate by 75 basis points to 2 percent during the first half of 2003. Policy rates over the last few years have been in line with, and generally lower than, what standard Taylor rule yardsticks would imply. Fiscal policies in the area have been constrained by past lapses. Large tax cuts initiated at the peak of the boom, combined with limited progress in reducing primary structural expenditures resulted in cyclically-adjusted deficits growing by between a ½ to 1 percent of GDP between 2000-2002 in Germany, France and Italy. From a short-term perspective, policies allowed full play to the automatic stabilizers, and consequently Germany and France joined Portugal in breaching the SGP's 3 percent deficit limit in 2002, while Italy avoided doing so only through various one-off operations.

The present cyclical situation is also influenced by longer-term forces which continue to shape the outlook. First, long-standing divergences in growth and inflation within the euro area persist, most notably between Germany and the other members, the latter in part reflecting the lingering effects of German unification. Second, the impulse from structural reforms, particularly in labor markets, ebbed as pressures for reform receded during the upswing and following the introduction of the euro. Finally, the euro area faces a sizeable demographic shock implying substantial declines in the working-age population. The aging of the population could entail significant declines in potential output growth and lower expected lifetime income resources, which in turn could impact adversely on the sustainability of public finances and old-age income security.

Against this background, the staff's broadly shared short-term baseline forecast sees the prevailing area-wide stagnation being overcome gradually, with growth remaining sub par well into next year. Overall, the staff expects real GDP growth of ½ percent this year, before picking up to about 2 percent next year. External demand is projected to be supportive as the recovery abroad is assumed to strengthen, but its role will be curtailed by an appreciated euro. With household balance sheets relatively sound, private consumption expenditures are projected to pick up as real disposable incomes are supported by declines in inflation, continued real wage growth, and automatic fiscal stabilizers. With policy interest rates and real long-term yields low, capacity utilization rates not far below historical averages, and improved corporate cash flows, investment spending is projected to turn around gradually with increases in demand. Downside risks to this baseline forecast relate mainly to continued corporate balance sheet adjustments, the risks of a faltering U.S. recovery, and the potential for euro overshooting. The staff's forecast for HICP inflation sees the cumulative effects of weakness in activity, the recent large appreciation of the euro, a continued softening of labor markets, and the fall in oil prices as

combining to reduce headline and core inflation to about 1½ percent next year and for price pressures remaining low in the coming years.

### **Executive Board Assessment**

Executive Directors agreed with the thrust of the staff appraisal. They noted that recent developments in the euro area have presented euro area authorities with many policy challenges. In particular, economic growth has come to a virtual standstill since the last quarter of 2002, with declining net exports and investment, and unemployment is beginning to rise. Moreover, challenges loom ahead, with the demographically-induced slowing of labor force growth and ageing of the population becoming an increasing drag on potential output growth, fiscal sustainability and old-age income security. EU enlargement, while surely of benefit to all concerned, would also be a source of new challenges. Directors were of the view that meeting these challenges successfully will require a sustained shift toward more forward-looking national policies and the vigorous implementation of structural reforms. While adversity had begun to induce such forward-looking policies, notably on the structural side, it is essential that these potentially promising steps be sustained once present difficulties recede.

Directors considered that the recent weakness of area-wide activity reflected a number of shocks as well as structural rigidities and policy lapses. The shocks include the bursting equity bubble, low business and consumer confidence, reduced external demand, the correction of the euro to longer-run equilibrium levels, and geopolitical uncertainties. Rigidities in labor markets and lesser reliance on market-based financing have in some measure contained the effects of the shocks, but they have also slowed both the post-bubble and intra-area adjustments. As a result, the area-wide stagnation is expected to be overcome only gradually, with growth remaining sub-par well into next year. Directors were encouraged, however, by recent improvements in survey and confidence indicators, which signal a gradual pick-up in growth during the second half of 2003. They saw the risks to the outlook as having become more balanced.

Despite the possible implications of the recent appreciation of the euro for the area's short-term prospects, Directors viewed the appreciation as beneficial on balance, noting that it has helped curb inflation and that the competitiveness of the euro area is back to its long-term average. Most Directors agreed that the euro area has borne a disproportionately large share of the burden of adjustment to a weaker dollar, and called for a more equitable global distribution of any further adjustment burden to reduce imbalances in the global economy and to achieve balanced growth in the major currency areas.

Directors felt that monetary policy has done well and has established its credibility. Policies have been in line with inflation and output developments, and the monetary framework has been appropriately modified based on the experience over the past five years. In particular, the ECB's clarification of its inflation objective as being "below but close to 2 percent" substantially reduces the scope for misinterpreting its objective and provides a clear anchor for longer-run inflationary expectations. Most Directors noted that aiming for such inflation outcomes over the medium term provides scope for inflation differentials across member countries and a buffer

against shocks that could lead to area-wide deflation. Directors also welcomed the clarification of the relative roles of long-term monetary analysis and short-term economic analysis in the ECB's anti-inflation strategy. A few Directors felt, however, that the inflation objective is too tight, and that it may be difficult to accommodate high and persistent inflation differentials across countries.

Looking forward, Directors agreed that the ECB needs to guard against downside risks to inflation, noting that inflation pressures have subsided. While the downside risks have become somewhat more balanced recently with the pull-back in the euro, the cumulative effects of weakness in activity, a continued softening of labor markets, and the significant past appreciation of the euro should combine to push headline inflation well below 2 percent by late next year. Directors saw the costs of undershooting the inflation objective as greater than those of overshooting it. Low inflation would not help balance sheet adjustments, and would provide less room for, and hence increase the costs of, relative price adjustments across the area. This, together with the risk of euro appreciation, strengthens the case for monetary policy to maintain an accommodative bent in order to support confidence until a self-sustaining upturn in domestic demand is in place.

Directors stressed the need for forward-looking fiscal policies to improve the quality and ensure the long-term sustainability of the public finances in light of potential fiscal pressures created by population ageing. In this regard, they noted that fiscal developments have not been positive, particularly in the three largest economies where most policies have had a short-term focus and fiscal excesses during the boom years contributed to current difficulties in observing the nominal deficit ceiling. Directors agreed that these developments underline the need for a fiscal framework in EMU. Directors felt that from a longer-term standpoint the basic parameters of the EU Treaty and Stability and Growth Pact (SGP) are broadly appropriate. Noting the current focus on breaches of the 3 percent deficit limit, Directors stressed that past lapses in fiscal discipline, and not the fiscal framework itself, have been responsible for the limited amount of fiscal leeway in the three largest euro area economies. The ageing of the population requires that most euro-area countries move at least toward underlying balance over the medium term. If they did so, there would be room for the automatic stabilizers to work, and the 3 percent limit would not be binding aside from exceptional circumstances, which the pact allows for.

Directors noted the potential conflict between the short-term need for fiscal stimulus to boost economic growth and the need for fiscal consolidation to restore the credibility of the SGP and to achieve fiscal sustainability. However, they believed that more forward-looking fiscal policies could provide a bridge to long-term sustainability while permitting greater short-run flexibility. They agreed that the SGP should indeed focus on growth as well as stability, but that growth means first and foremost structural reforms rather than short-term demand management. Within such a framework, most Directors acknowledged that there is scope to trade short-run fiscal consolidation for credible multi-year commitments to growth- and consolidation-oriented structural reforms, notably by cutting spending and increasing incentives rather than raising taxes. Although it was recognized that this entails credibility risks for the SGP insofar as it implies further breaches of the 3 percent deficit limit, Directors agreed that the standard remains that countries with weak underlying positions should take discretionary fiscal policy actions to

achieve underlying high-quality fiscal adjustments of 0.5 percent of GDP a year. Many Directors agreed with the view, however, that, where underpinned by meaningful gains on the long-run structural and macroeconomic fronts, delays that meet the standard on a cumulative basis, i.e., 1.5 percent of GDP during 2004-06, would also strike an appropriate balance between long- and short-run goals. A number of Directors, though, cautioned against departures from commitments to achieve a steady underlying fiscal adjustment of 0.5 percent of GDP a year.

Directors called for more sustained and vigorous implementation of structural reforms. They noted that while the area's low underlying growth reflects in large part low population growth, there is considerable scope for raising rates of utilization of labor resources and for increasing rates of technological progress and innovation. Long lags in effecting increases in labor force participation rates require early concerted actions to slow—if not reverse—the ageing-induced fall-off in potential per capita growth and deterioration in public finances. In this context, Directors emphasized the importance of labor market and pensions reform. The loss of the exchange rate as an adjustment mechanism within the monetary union, particularly in the context of limited labor mobility, imposes a further requirement on flexibility in goods and labor markets.

Directors welcomed the promising reform steps recently taken in some countries, but emphasized that much more is needed to achieve the goals set out in the Lisbon agenda agreed by the European Council in 2000. Directors were particularly encouraged by progress in creating a single market for financial services. Moreover, the reform process in the larger countries, particularly as regards labor markets and social security systems, has been revived and, in some cases, progressed beyond earlier expectations. Directors also observed that there is a growing recognition of the largely unexploited synergies to be reaped between structural reforms, improved economic performance, and fiscal sustainability that hold the promise of improving medium-term growth prospects and restoring the credibility of the SGP. However, the agenda of needed reforms is long and varies across countries, while resistance to reform remains strong and is likely to strengthen as the economic situation improves. Directors considered it essential that the new reform momentum not become simply a response to economic adversity but be sustained for many years to come. Directors, therefore, welcomed the steps taken by the Commission, and endorsed by ECOFIN, to toughen surveillance by making the Broad Economic Policy Guidelines both more targeted and forward-looking.

Directors welcomed the recent decision to reform the Common Agricultural Policy. The agreed "decoupling" of agricultural supports from production will lessen downward pressures on world prices. Many Directors noted that greater commitment to opening EU markets will be crucial to achieving the Doha round objectives, and that creating a multilateral trade environment supportive of economic development and poverty reduction would require more concessions by the EU and other advanced economies to developing countries.

It is expected that the next consultation on Euro Area Policies will be held on the standard 12-month cycle.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

**Euro Area: Selected Economic Indicators**

	1998	1999	2000	2001	2002	2003 <sup>1</sup>
	In percent					
<b>Real Economy</b>						
Change in real GDP	2.9	2.8	3.5	1.5	0.8	0.5
Change domestic demand	3.6	3.5	2.9	1.0	0.2	1.1
Change in consumer prices <sup>2</sup>	1.1	1.1	2.1	2.4	2.3	2.0
Unemployment rate <sup>3</sup>	10.2	9.4	8.5	8.0	8.4	9.0
	In percent of GDP					
<b>Public Finance</b>						
General government balance	-2.3	-1.3	0.1	-1.6	-2.2	-2.8
Public debt	73.7	72.6	70.2	69.2	69.1	70.3
	In percent					
<b>Money and Interest Rates</b>						
Change in M3 (end of year) <sup>2</sup>	5.0	5.6	4.1	7.9	6.9	8.3 <sup>4</sup>
Money market rate (3 month money)	4.1	3.0	4.5	4.2	3.3	2.5
Government bond yield (10 year bonds)	4.8	4.7	5.5	5.0	5.0	4.3
	In percent of GDP					
<b>Balance of Payments<sup>5</sup></b>						
Trade balance	2.0	1.4	0.7	1.6	2.3	1.9
Current account	1.0	0.4	-0.5	0.2	0.9	0.8
Official reserves (US\$ billion) <sup>6</sup>		256.8	242.3	234.5	246.5	234.8 <sup>4</sup>
	In percent					
<b>Exchange Rates</b>						
Nominal effective rate <sup>7</sup>	-0.1	-4.5	-9.4	1.5	2.5	9.7
Real effective rate <sup>7</sup>	-3.4	-4.9	-10.8	-0.3	2.3	9.0

Sources: IMF staff and European Central Bank.

<sup>1</sup> Staff projections; WEO, September 2003.

<sup>2</sup> Harmonized definition.

<sup>3</sup> In percent of labor force.

<sup>4</sup> June 2003.

<sup>5</sup> Calculated as the sum of individual euro-area countries.

<sup>6</sup> Total reserves minus gold (Eurosystem definition).

<sup>7</sup> For 2003, average January-August relative to 2002 average.



**Statement by Pier Carlo Padoan, Executive Director for Euro Area Policies  
September 10, 2003**

Italy holds the Presidency of the Eurogroup at present, and my statement expresses the common views of the euro area Member states and the European Community in their respective fields of competence.

The authorities of the euro area Member States welcome the staff's assessment of economic developments and prospects for the euro area. They are in broad agreement with the policy conclusions. In addition to outlining where differences of view appear, this statement will update the Board on recent economic developments and policy actions taken at the European level.

**Short term economic outlook**

Economic growth in the euro area has practically stagnated in the first half of 2003, but a recovery is expected to start in the second half of the year. There are encouraging signs in this direction: real disposable income is rising, the quality of corporate balance sheets is gradually being improved, several forward-looking indicators have improved and more optimism is being priced in financial markets. Moreover, there are signs of growth picking up in many parts of the world, including in the US, which in turn should foster growth in the euro area. For the year as a whole, however, the growth rate in the euro area is most likely to be below earlier expectations as weak economic activity in the first half of the year weighs on the overall result. While GDP growth will be clearly below 1% in 2003, it will move towards the potential rate in the course of 2004.

The authorities agree with the Fund that the weakness of economic activity in the euro area reflects a combination of cyclical and structural factors. Growth was dampened by subdued international trade growth, low business and consumer confidence, the aftermath of the stock market bubble and the related growing debt at firm level in some sectors since the end of the 1990s. More fundamentally, structural rigidities in labour markets as well as insufficient competition in some sectors makes adjustments to shocks more difficult and hampers potential growth.

On the other hand, the factors leading to a pick-up in domestic demand are in place. Monetary and financial conditions are supportive to growth; the profit situation is improving; the stronger euro has helped in bringing inflation down, thereby underpinning real incomes; there are no major macroeconomic imbalances in the euro area; there may well be pent-up consumption demand; and there is room for private savings to decline.

**Exchange rate developments**

The euro area authorities view the rise of the euro over the past two years as beneficial on balance. From a global perspective, when the exchange rates of major currencies move to levels more consistent with fundamentals this is welcome, provided that

the movement is orderly. From an internal euro-area perspective, a stronger euro is reducing imported inflation and supports real disposable income. Whilst the appreciation of the euro has meant that profit margins of exporters are under pressure, it should be noted that their competitiveness position is now back to its long-term average. Looking at the recent trend, it seems that overshooting has been avoided so far, so that the stronger euro should over the medium term contribute to a re-balancing of the sources of growth from external to internal channels, and will, on balance, be a positive development both for the euro area and the global economy.

That said, the staff rightly points out that the euro area has borne a disproportionately large share of the burden of adjustment to a lower dollar. We share the staff's view that a more equitable global distribution of any further adjustment burden is both desirable and needed from the point of view of reducing imbalances in the global economy and achieving balanced growth in the major currency regions.

### **Monetary policy and the outlook for price stability**

We appreciate the conclusion of the IMF staff report that monetary policy has been appropriate in the euro area in the light of its economic conditions, as reflected in the outlook for price stability over the medium term. The assessment of the Governing Council of the ECB of the current outlook for price stability which is based on information from economic analysis and monetary analysis is broadly in line with the analysis contained in the report.

Starting with the economic analysis, economic activity stagnated in the first half of 2003, broadly in line with previous expectations. At the same time, as also indicated in the report, there is increasing reason to expect that economic activity will recover gradually in the second half of 2003 and strengthen further in 2004. Among the factors expected to support economic growth in the euro area, the low levels of interest rates and, more generally, favourable financing conditions should be highlighted. In line with the report, the ECB too assesses that the balance of risks to this outlook is tilted to the downside, although risks may have declined recently.

Turning to the outlook for prices, developments in food and oil prices may contribute to some temporary and limited volatility in inflation rates over the next few months. Beyond the short term, the outlook continues to be favourable. Annual inflation rates are expected to fall in 2004 and remain below 2 percent. In addition to base effects, further dampening effects stemming from the pass-through of the past appreciation of the euro are expected. Moreover, the gradual economic recovery should be accompanied by moderate wage developments and price setting behaviour, and is not therefore expected to contribute to price pressures. At the same time, the ECB is of the view that there is currently no risk of deflation in the euro area.

As regards the monetary analysis, monetary growth remained strong and there is significantly more liquidity available in the euro area than needed to finance non-inflationary growth. The low level of interest rates all along the maturity spectrum has contributed to a high demand for liquid assets, as well as to a stabilisation of credit growth in spite of the weak economic activity. Although a large part of the excess liquidity in the euro area has

been caused by portfolio shifts, the ample liquidity needs to be closely monitored. In view of the current economic situation, excess liquidity is not likely to translate into inflationary pressures at present. However, if it were to persist at the time of a significant strengthening of economic activity, it could cause inflationary pressures to build up over the medium term.

All in all, cross-checking the information from the two pillars points to a favourable outlook for price stability over the medium term. Reflecting this assessment, the Governing Council of the ECB decided at its meeting on 31 July 2003 that the current monetary policy stance is appropriate. The ECB will continue to monitor carefully all factors that might affect this assessment and will continue to conduct monetary policy with the aim to maintain price stability, in accordance with its mandate and following its monetary policy strategy.

The ECB appreciates the staff's reaction to the clarification of May 2003 regarding the monetary policy strategy. In particular, the staff has highlighted that the clarification of the definition of price stability has dispelled misunderstandings that might have occurred in the past. The ECB notes the staff's agreement that its definition of price stability provides a sufficient safety margin to avert the risk of deflation and is also capable of addressing the implications of inflation differentials within the euro area. Regarding the two-pillar framework, the ECB welcomes the IMF staff's understanding that monetary analysis is used to assess medium to long-term trends in inflation as a means of cross-checking the short to medium-term indications coming from economic analysis.

### **Fiscal policies**

The euro area authorities broadly agree with the staff's view on the key elements of the fiscal policy framework, notably as regards the importance of clear fiscal rules based on a target on the budget balance (a flow), while at the same time taking account of public debt levels (a stock). We also agree that more generally longer run and cyclical considerations have to be balanced. The increased emphasis on the long-term sustainability of public finances is also welcome as well as the link between budgetary consolidation and supportive structural reform.

The latest available information suggests that budgetary outcomes in many countries of the euro area will fall short of the targets in 2003, implying a continued deterioration of public finances. This strengthens the call for a strict monitoring of budgetary developments and application of the common fiscal rules. In implementing the Stability and Growth Pact, the impact of the economic cycle on budgetary positions has been taken explicitly into account, with a focus on cyclically-adjusted budgetary developments. However, the 3% reference value of the Maastricht Treaty remains a "hard ceiling" not to be breached. Those Member States that breached it have been put under the excessive deficit procedure (i.e. Portugal, Germany and France), which foresees the implementation of a credible consolidation path.

The authorities agree that automatic stabilisers play an important role in cushioning the slowdown. For Member States that have not yet reached a balanced position in

cyclically-adjusted terms, this should be done around a consolidation path of the cyclically-adjusted deficit of at least 0.5 a percent of GDP per year, and provided the 3 % limit is not breached. Those Member States in *excessive deficit* should correct it no later than the year following its identification in conformity with the Treaty and the SGP provisions which provides for some flexibility.

The euro area authorities agree with the staff on the need for more forward-looking policies to improve the quality and sustainability of public finances. For instance, short-term one-off measures should not be used to put off necessary structural reforms. While the euro area authorities agree with the staff on the importance of a durable achievement of long-run goals, we consider that achieving consolidation rather than postponing it is the appropriate way to ensure sound and sustainable public finances.

### **Structural reform**

The euro area authorities broadly concur with the staff's assessment on the need for structural reforms to step up growth potential. While the area's growth performance is similar to that of the US in per capita terms, there is considerable scope for making better use of labour resources—which is in itself important for raising social cohesion and growth potential, as well as for the functioning of EMU and the sustainability of public finances. We must therefore ensure that the momentum of reforms does not slow just after the benefits of earlier reforms and wage moderation began to manifest themselves in the years preceding the present downturn, notably in the form of reduced structural unemployment and increased labour force participation. This structural improvement is an important part of the explanation for why the impact of the current downturn on employment has been and remains relatively soft, compared to previous cycles.

The slow recovery however shows that structural reforms should go forward: in this respect, one should note that significant reforms have been initiated recently, including on pension systems in some of the large Member States (and contrary to what is said in paragraphs 12 and 50, structural reform has not been moved off the EU policy agenda). Steps have also been taken to strengthen the coordination of structural reforms at EU level, and we welcome the positive assessment by the staff on these steps. Of course, there is a considerable scope for further progress, and it is essential now that the agreed reform agenda is fully implemented and, as the staff notes, that this new spirit of reform will be sustained long into the future. Certainly, immediate, substantial and sustained progress, particularly on labour market reforms, will be required to maintain confidence in the Lisbon agenda of rising employment rates and improved competitiveness and dynamism more generally. Reform in product markets and measures to increase research and innovation are also main components of the EU's structural reform agenda. There is in particular a need to increase competition, integration in the network industries and to open up public procurement to greater competition and to raise R&D to the EU's target of 3% of GDP. On the positive side, recent progress in reforming the aviation, energy and railway should be noted as well.

With regards to financial markets, the staff report notes that there has been further progress in creating a single financial market. Eighty per cent of the original measures of the

Financial Services Action Plan (FSAP) have now been completed. Important agreements have been reached in 2003 on directives on insider trading and market manipulation, pension funds, company law, prospectuses and the taxation of savings income. However, there are still important measures pending (e.g. the directives on take-overs, investment services and transparency obligations for securities issuers). With the 2005 deadline in sight, the Commission is currently finalising the last set of legislative proposals (which will include capital adequacy, insurance solvency and reinsurance supervision). Consistent transposition and implementation of the FSAP will be facilitated by the extension of the four-level "Lamfalussy framework" for securities markets to banking, insurance and conglomerates. The new arrangements will speed up the legislative process and increase its transparency.

In response to concerns regarding corporate governance and statutory audit, the Commission published two communications on 21st May. The communication on corporate governance includes an action plan, covering key issues such as the disclosure by companies of their governance structures and practices, the reinforcement of shareholder rights, the role of non-executives or supervisory directors, the quality of corporate reporting, and the coordination of Member States' efforts in the area of corporate governance. On statutory audit, important short-term priorities are the incorporation of the principles on auditor independence in a Directive, and the strengthening of public oversight of the audit profession through European co-ordination.

## **Trade Issues**

The Doha Development Agenda (DDA) is currently the EU's number one trade policy priority. Half way through the scheduled negotiations, the Cancun Ministerial meeting of all WTO Members will be a key staging post of the Round. The EU's objective for Cancun is to achieve meaningful progress in the DDA negotiations, which must: (1) address all DDA issues and reflect the interests of all WTO members, (2) better integrate developing countries in world trade, and (3) make a significant contribution to sustainable development. In light of the current state of the international economy, the EU considers the conclusion of the DDA to be particularly important in order to boost global economic growth and development opportunities.

In order to re-launch the agricultural negotiations, the EU and the US in August presented a joint framework paper. It focuses on domestic support, market access and export competition. Moreover, the recently agreed reform of the European Common Agricultural Policy, designed to enhance the efficiency of the EU's agricultural market, is a significant contribution to correct trade distortions. Its positive effects will amplify as Member States are expected to introduce significant de-coupling of subsidies from levels of production. Furthermore, it should be recalled that a significant proportion of the EU's agricultural imports from developing countries, and almost all from least-developed countries, are duty free thanks to existing EU import preferences for these countries.

The EU, the US, and Canada, have also tabled in the WTO a joint paper to facilitate negotiations on market access - tariffs and non-tariff barriers - for industrial goods. The paper proposes ambitious tariff cuts and the reduction of differences in tariff rates across WTO

Members. This approach includes measures for granting developing countries special and differential treatment, as well as flexibility to manage their tariffs on the basis of their economic needs. In particular, the joint paper proposes a system of “credits” that allows developing countries to cut their tariff less than developed countries would do, when justified by their economic situation. Additional flexibility should also be granted to the poorest developing countries.