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Staff Report on the Monetary and Exchange Rate Policies of the Euro Area; Supplement Updating Information on Economic and Financial Developments in the Euro Area; Public Information Notice Following Consultation; Statement by the Executive Director on Monetary and Exchange Rate Policies of the Euro Area

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

- the staff report on the monetary and exchange rate policies of the **euro area**, prepared by a staff team of the IMF, following discussions that ended on **June 27, 2001,** with officials at EU institutions in the context of the Article IV consultations with the countries forming the euro area. **Based on information available at the time of these discussions, the staff report was completed on September 21, 2001.** 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 **October 17, 2001** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 19, 2001 discussion** of the staff report on the monetary and exchange rate policies of the euro area.

- a statement by Mr. Kiekens, Executive Director for the country currently holding the Presidency of the European Council, on behalf of the euro-area countries.

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

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Monetary and Exchange Rate Policies of the Euro Area[1]

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

Prepared by the European I Department

Approved by Michael Deppler and Leslie Lipschitz

September 21, 2001

- A staff team visited the European Commission (EC) and the European Central Bank (ECB) during June 19-27, 2001, to conduct discussions in the context of the 2001 Article IV consultations with euro-area members.[2] During March 21-April 2, 2001, a staff team visited the ECB, other EU central banks, and the EC to assess the observance of the *Code of Good Practices on Transparency in Monetary and Financial Policies* as well as the *Core Principles for Systemically Important Payment Systems*; it is planned to circulate a report summarizing these assessments before the Board discussion of the euro area report. Appendix IV to this report outlines the main findings.

- In concluding the last Board meeting on euro-area policies on October 16, 2000 (EBM/00/100), Directors noted that monetary policy had been appropriately cautious in an environment of robust growth driven by favorable external developments and supported by improved fundamentals. In their view, however, fiscal policies needed a sharper focus on strategies to bolster the supply side while avoiding procyclical impulses—and further structural reforms were essential to lift the ceiling for long-term growth.

- A staff report on a January 2001 staff visit to EU institutions was issued in March to the Board for its information as SM/01/90 and is posted on the Fund's external website.

[1] Including the trade policies of the European Union.

[2] Meetings at the ECB were held with President Duisenberg, and Ms. Hämäläinen, Mr. Issing, and Mr. Padoa-Schioppa (members of the Executive Board), as well as with senior staff. At the EC the mission exchanged views with Commissioner Solbes Mira, Mr. Carré (Acting Director General for Economic and Financial Affairs), and other officials. The team comprised Messrs. Deppler (Head), Zanello, Jaeger, Kieler, Kontolemis (all EU1), and Messrs. Meredith (RES) and Rosenblatt (PAR). Ms. McGuirk (PDR) joined the mission during its visit at the EC to cover EU trade issues. Mr. Deppler participated in the meeting of the Economic and Financial Committee (EFC) in Noordwijk, and returned to Brussels on July 9, 2001, to present the mission's concluding statement to the Eurogroup.

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I. Introduction

1. The euro area's vigorous cyclical upswing has slowed sharply in the face of large adverse global shocks. Hit first by supply shocks that pushed up headline inflation, area-wide growth flagged further as the correction in the prospects of the technology sector and in equity markets more generally spread throughout the world economy. As a result, the area's growth prospects for the near term have dimmed noticeably, with staff estimates for 2001 sliding from 2.4 percent in the Spring WEO to "gravitating toward 2" at the time of the discussions, to 1.8 percent in the Fall WEO.

2. The discussions revolved around the roots of the slowdown and the role of policies going forward. As regards monetary policy, it was agreed that risks to price stability were diminishing, the main uncertainty being whether this would be recognized by wage setters in a context where past shocks had lifted headline rates to new peaks. Staff viewed the slowdown as limiting these risks and likely to lead to scope to cut interest rates once headline inflation rates fell back from their peaks. In announcing a 25 basis point cut on August 30, the ECB explained that "... recent data indicate that real GDP growth in 2001 will most likely be lower than was expected a few months ago" and that "...there are clear signals of lower inflationary pressures from the demand side."

3. There was less agreement as regards fiscal policy where staff disagreed with expectations under present EU arrangements whereby the euro area's largest countries—which lag in their consolidation commitments—needed to offset the effects of the automatic stabilizers. The underlying issue is whether the staff's position to allow automatic stabilizers to operate places medium-term fiscal discipline in the euro area at risk. There was a complete meeting of the minds on the need for structural reforms, with two areas receiving particular attention: the incentives structures underlying euro-area labor markets, where the needs were the greatest and the benefits most apparent; and fostering the integration of Europe's capital markets.

4. This Article IV Staff Report on the euro area focuses on area-wide issues. It is being circulated to Executive Directors in tandem with the corresponding reports for the Article IVs for France, Germany, Italy, and Finland. These provide country perspectives on some of the issues discussed in the present paper. The entire set of papers is also informed by a series of supporting staff papers, including two cross-country studies on rules-based fiscal frameworks and employment performances.[3]

5. Finally, this paper does not take account of the implications for prospects or policies of the terrorist attack on the United States on September 11. These will be addressed in a Supplement to be circulated ahead of the meeting of the Executive Board.

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[3] The studies (issued as SM/01/307) are titled *Rules-Based Fiscal Policy and the Fiscal Framework in France, Germany, Italy, and Spain* and *Job-Rich Growth in Europe*.

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II. Background

A. Growth and Inflation

6. **A series of adverse supply and demand shocks have brought the euro area's three-year expansion to a virtual standstill.** The cumulation, beginning in late 1999, of sharply higher oil prices, a weakening euro, animal diseases, and bad weather propelled headline HICP inflation sharply upward, from around 1 percent in 1999 to nearly 3 percent by late 2000 (Figure 1).[4] With wage moderation continuing to prevail, households' purchasing power was eroded and consumption growth slowed to near stagnation levels in the second half of last year (see table). This supply-shock induced slowdown coalesced with the bursting of the high-tech bubble, a downward correction in broader equity indices, and a slump in business confidence (Figure 1). As a result, investment spending slowed sharply beginning in the last quarter of 2000. Highlighting the global dimension of most of these shocks, the deceleration of GDP growth in the euro area and the United States was highly synchronized (Figure 2), and the area's rapid export growth came to an abrupt halt in the first half of 2001. Although for 2000 as a whole, GDP growth came in at 3½ percent (the best performance in a decade), quarterly growth rates halved between end-1999 and end-2000 (from around 4 to around 2 percent), and have ebbed close to zero in the second quarter of this year.

Euro Area: Output and Demand

(Percent change from previous quarter, annual rates)

	2000 Q1	2000 Q2	2000 Q3	2000 Q4	2001 Q1	2001 Q2
Real GDP	4.0	3.1	2.0	2.4	2.1	0.2
Total domestic demand	3.0	3.5	0.8	1.9	0.0	1.3
Private donsumption	2.9	3.1	0.8	0.5	3.1	2.4
Fixed investment	6.0	3.4	4.0	-0.5	0.2	-3.2
Inventories 2/	-0.3	0.6	-0.6	1.2	-2.2	0.5
Net exports 2/	1.0	-0.3	1.2	0.6	2.1	-1.1
Exports 1/	12.5	10.0	12.8	10.7	1.3	-4.8
Imports 1/	10.1	11.6	9.9	9.7	-4.2	-2.2

Source: Eurostat.
1/ Including intra-area trade.
2/ Contribution to GDP growth.

7. **Buoyant labor markets, that have been the hallmark of the recovery since 1997, have succumbed only gradually to the slowing of output growth.** With wage settlements remaining quite moderate, employment grew by some 2 percent in 2000, the best growth rate in many years, and unemployment fell by a full percentage point. However, the slowing of activity gradually took its toll: the euro area's unemployment rate, which had been falling steadily by about 1 percentage point per year since 1997, leveled out at 8¼ percent in the second quarter of 2001 and is at some risk of starting to rise even though employment growth, particularly in service sectors, has continued (Figure 2).

[4] In this context, the high degree of border protection enjoyed by the area's agricultural sector may have been deleterious as it foreclosed the discipline of international competition.

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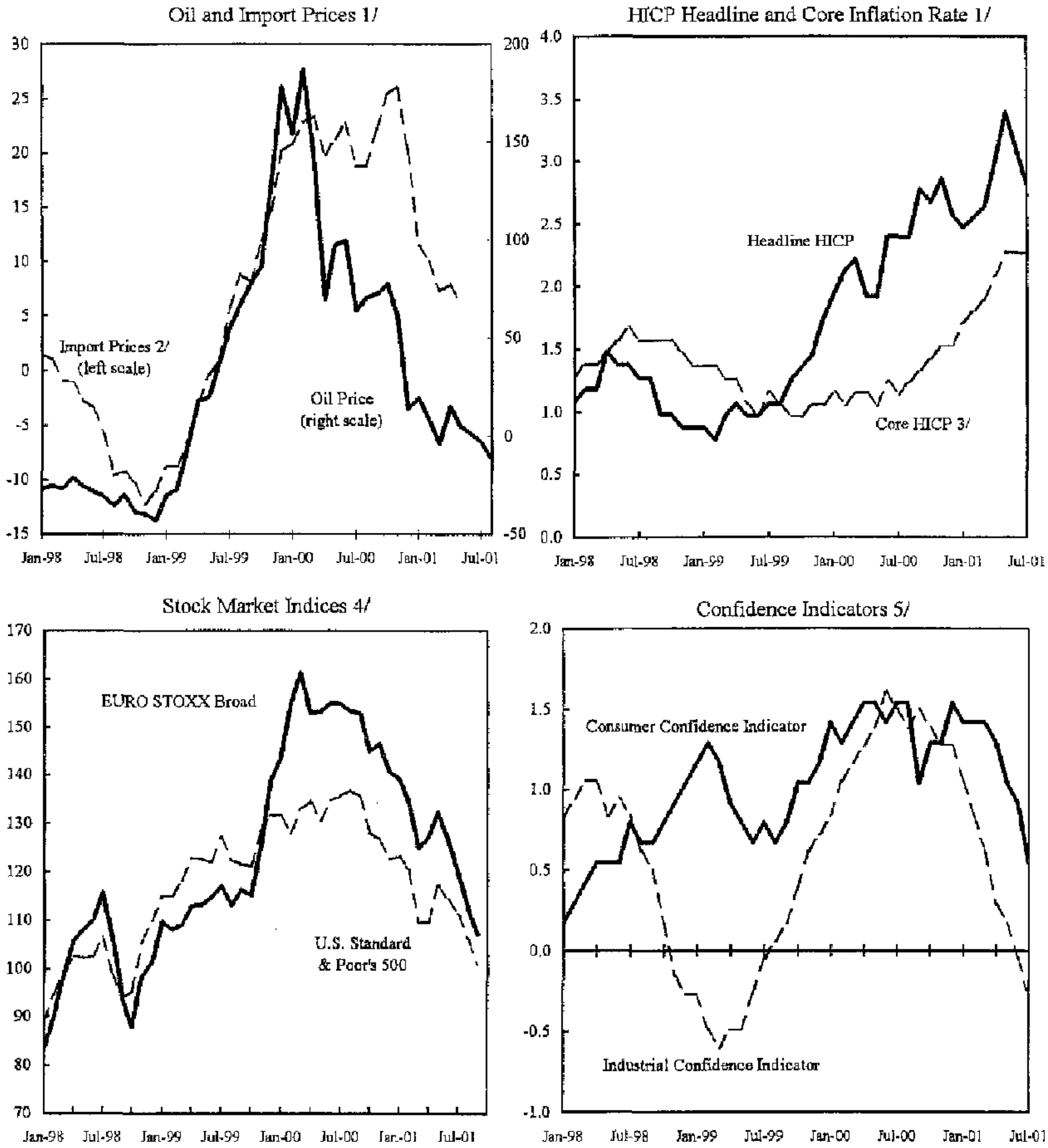
Figure 1. Euro Area: Macroeconomic Forces Behind Slowdown



Sources: Eurostat; European Central Bank; IMF.
1/ Year-on-year percent change.
2/ Import unit values.
3/ Overall index excluding energy and unprocessed food.
4/ Average for 1998 = 100.
5/ Number of standard deviations from 1985-2001 average.

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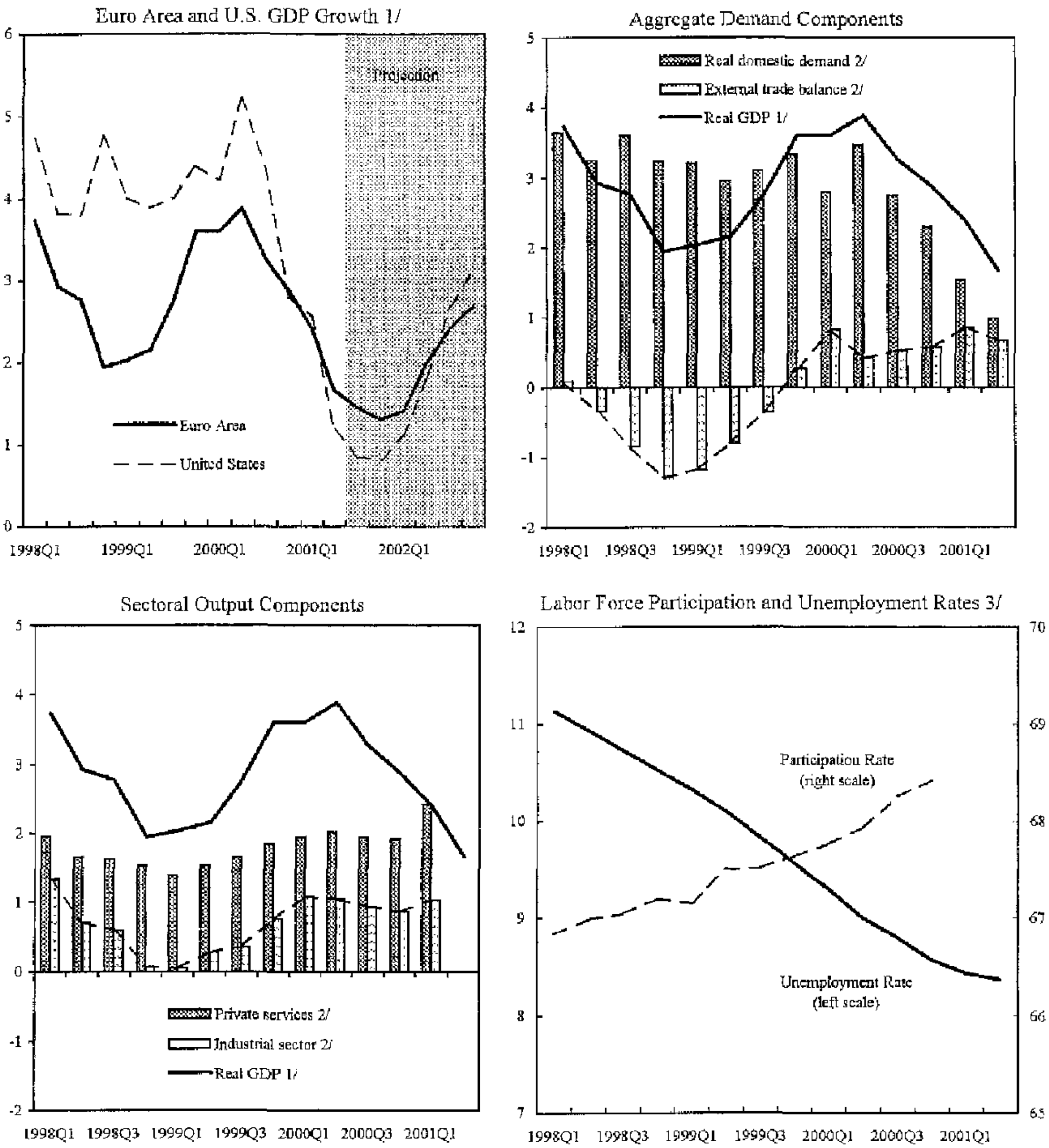
Figure 2. Euro Area: Real Output and Labor Market Developments, 1998-2001



Sources: European Central Bank; Eurostat; IMF; and staff projections.
1/ Year-on-year percent change.
2/ Contributions to GDP growth.
3/ In percent.

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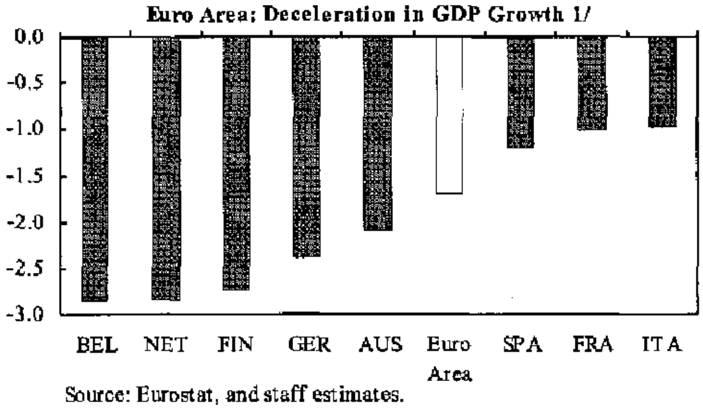
8. **The slowdown has been pervasive throughout the area, albeit unevenly and with different cyclical implications.** The slowdown has been sharper in those countries more exposed to a contraction of trade or with a larger technology sector. For some of the smaller economies in the periphery, which had led the pack in the upswing and by mid-2000 were showing clear signs of overheating, the output deceleration was, in a measure, welcome. In the core countries, however, developments have been more mixed. France has so far proved to be the least vulnerable to the weakening environment, while final domestic demand in Germany and Italy, two countries that account for 50 percent of area-wide GDP and which had all along experienced a less sure-footed recovery, slowed faster than the rest of the euro area. (Figure 3).[5] Inflation has crept up everywhere, and currently all 12 of the area's members have headline inflation rates above 2 percent. The dispersion of inflation rates at mid-year was, however, considerably less than a year earlier.



Source: Eurostat, and staff estimates.
1/ Difference in year-on-year growth rates between 2000H1 and 2001H1.

9. **Recent travails notwithstanding, the second half of the 1990s saw a significant improvement in the macroeconomic performance of the euro area.** In a setting of subdued inflation, improved fiscal positions, and a favorable external environment, output gaps have been closing in all member states since 1997, and growth has been significantly more employment-intensive than in previous upswings. The area's employment rate (employment as a percent of population aged 15-64 years) rose from about 58 percent in 1997 to some 62 percent in 2000, while the unemployment rate declined by about 3 percentage points. The strengthening in the area's performance in recent years has led to some catch-up with the United States. However, from the point of view of labor market performance, the gap remains considerable (Figure 4). By the same token, area-wide data mask important differences in performances across countries: intra-area (average) growth rates over 1997-2000 fell in the range of 2 percent (in Germany) to 10 percent (in Ireland), with the stronger performers to be found among the countries at the forefront of labor market reform and wage moderation.[6]

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[5] The comparative growth performance of France, Germany, and Italy is discussed in Box 1.3 of the October 2001 *World Economic Outlook*.

[6] A comparative analysis of employment creation in Germany, France, Italy and Spain is provided in a background paper to the corresponding Article IV reports.

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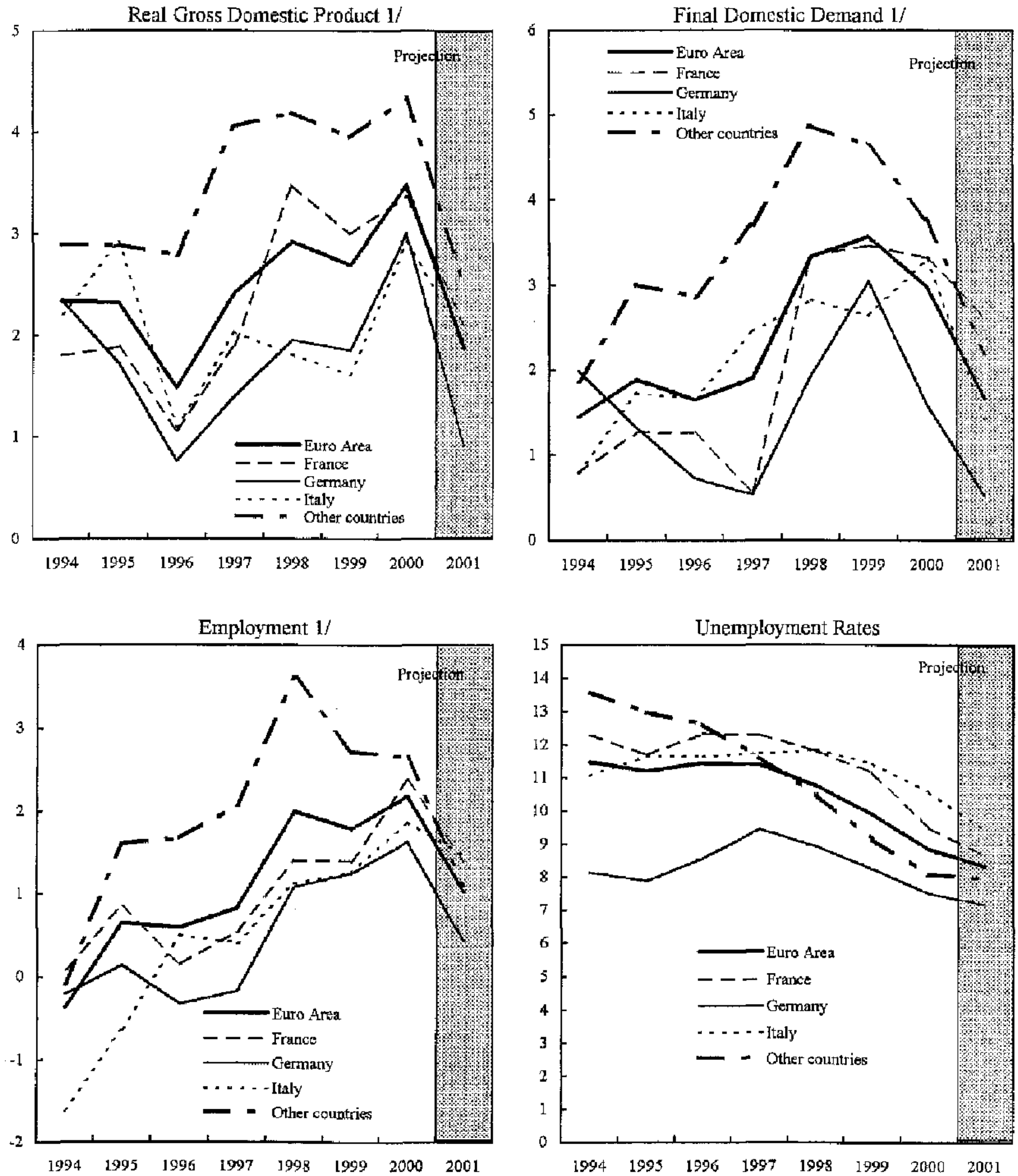
Figure 3. Euro Area: Relative Growth Performance, 1994-2001
(In percent)



Sources: World Economic Outlook, IMF; and staff estimates.
1/ Annual growth rates.

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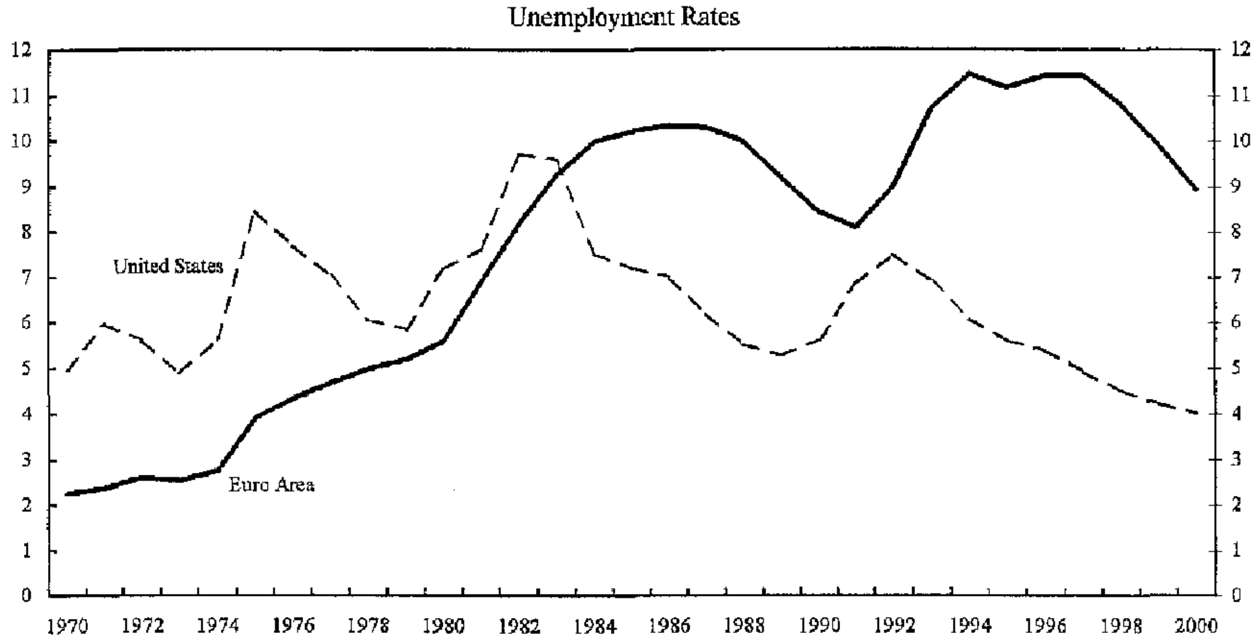
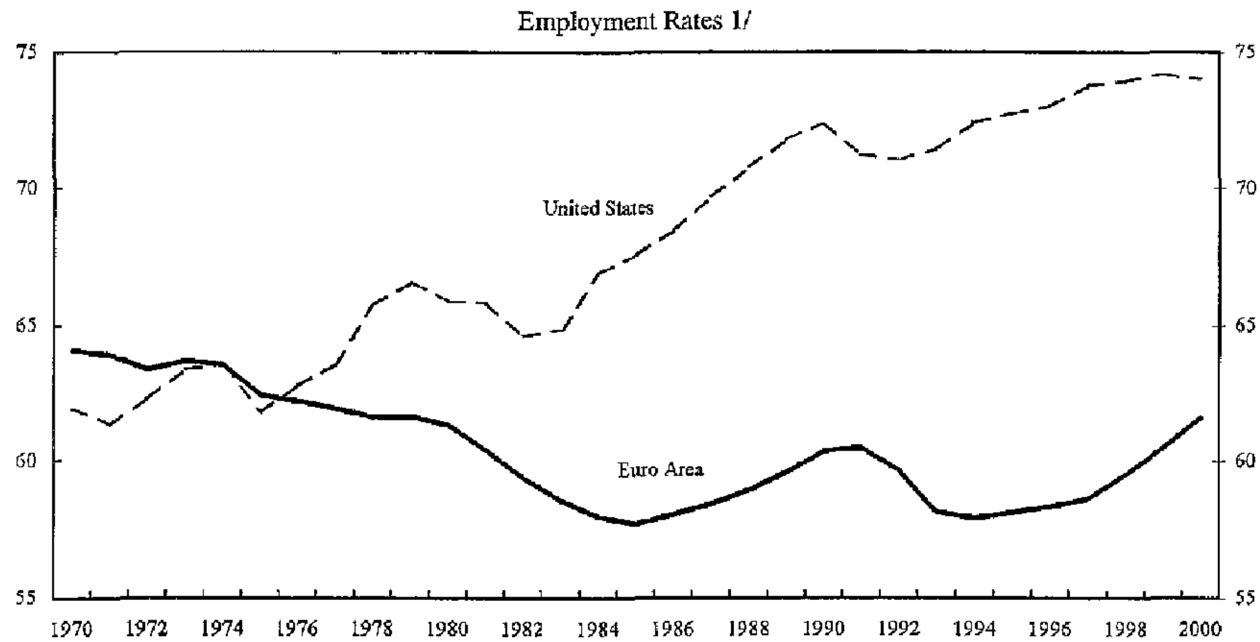
Figure 4. Euro Area and United States: Labor Market Indicators, 1970-2000
(In percent)





Sources: European Commission, Annual Macroeconomic Database; and OECD.
1/ The data are not fully comparable because of differences in definitions.

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B. The Policy Context

10. **Policy developments from late 1999 through 2000 were mixed, with monetary policy shifting to a tighter stance in the face of accelerating inflation and fiscal policy shifting away from earlier more restrictive positions—indeed turning expansionary in some countries.** As regards interest rates, the ECB raised the main refinancing rate by a total of 225 basis points to 4.75 percent between November 1999 and October 2000 (Figure 4). These actions were taken in response to what were widely seen as risks to medium-term price stability. In terms of the ECB's two-pillar framework, nominal M3 growth was well in excess of the reference value of 4.5 percent (first pillar); and inflationary pressures (due to the increases in oil prices, the depreciation of the euro, and the narrowing of the output gaps in the region) risked spilling over into wages (second pillar). The monetary tightening led to a flattening of the yield curve. Nevertheless, monetary conditions were appreciably looser than this suggests because of the weakness of the euro (Figure 5).

11. **Fiscal policies, although bound by the rules of the Stability and Growth Pact (SGP), tended to presume continuing rapid growth in both the near and medium term.** In 2000, budgets were set to coast, with rapid growth generating on average significant reductions in actual deficits, but none in cyclically-adjusted terms. In 2001, the consolidation pause continued, reflecting a series of tax cut initiatives. While the tax cuts have fortuitously supported faltering domestic demand, the area's actual and structural fiscal deficits in 2001 are likely to be back to where they were in 1999, medium-term consolidation commitments under the SGP notwithstanding (Table 1). This development is mainly due to the three largest countries, which, because they have yet to reach underlying fiscal balance, are in principle committed to taking (procyclical) measures to reduce their actual deficits to the levels targeted under their Stability Programs. This is discussed further below.

Euro Area: Fiscal Policy Stance

	Fiscal Impulse 1/		
	2000	2001	2002
Euro Area	0.0	0.0	-0.3
Germany	0.4	0.3	-0.6
France	0.2	-0.2	0.0
Italy	0.1	-0.2	-0.4

1/ Change in structural balance in percent of GDP (inverted sign).
Source: WEO, IMF.

III. The Issues

A. Prospects

12. **While the euro area's weakening growth prospects have been a moving target for both Fund staff and the authorities at EU institutions over the past year, the authorities tended to see the area's economy as more resilient than the staff did.** In the authorities' view at the time of the discussions, the resilience of the euro area in the aftermath of the emerging market crises of the late 1990s, the continuation of wage moderation, the buoyancy of employment, the high levels of consumer confidence, and the absence of evident financial imbalances were all evidence pointing to a limited impact of the adverse shocks. The prevailing sense at the ECB and the Commission was therefore that near-term growth would be "broadly in line with potential," and likely to recover soon

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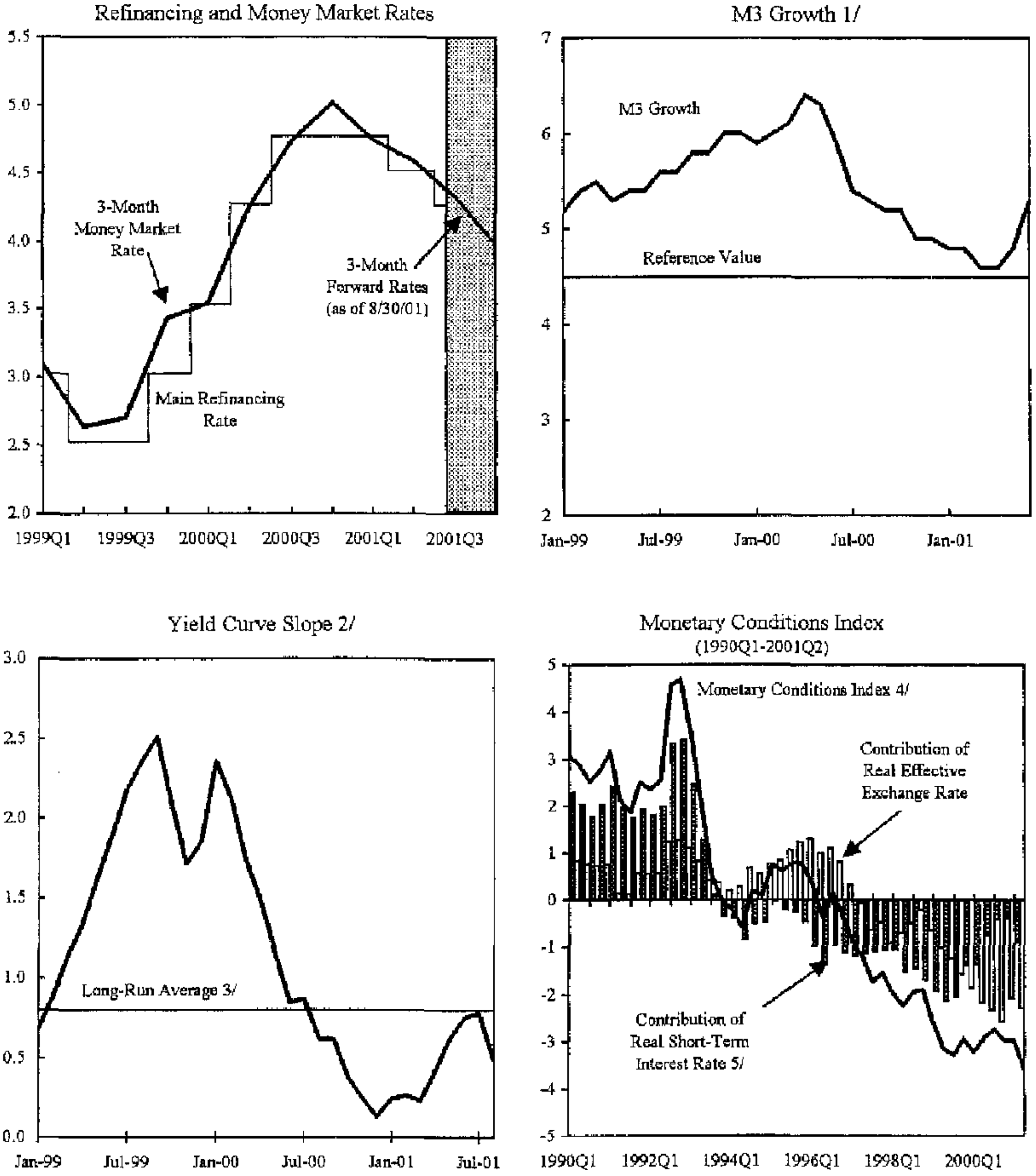
Figure 5. Euro Area: Monetary Policy Indicators



Sources: IFS, IMF; European Central Bank; Bloomberg.
1/ In percent, 3-month moving average.
2/ 10-year government bond yield minus 3-month Euribor.
3/ Average slope for Germany, 1985-2001.
4/ Conditions relative to average over 1990-2001.
5/ Deflated by core HICP inflation.

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

	1999	2000	Proj. 2001	Proj. 2002	Proj. 2003	Proj. 2004
Updated Stability Plans 1/						
Revenue	...	46.1	45.2	44.8	44.3	44.1
Expenditure 2/	...	46.8	45.8	45.1	44.3	43.7
o/w interest payments	...	4.1	3.9	3.8	3.7	3.6
Overall balance 2/	...	-0.7	-0.6	-0.3	0.0	0.4
Structural balance	...	-0.4	-0.7	-0.6	-0.5	-0.3
Primary balance 2/	...	3.3	3.3	3.5	3.7	3.9
Primary structural balance	...	3.5	3.2	3.2	3.2	3.3
Memorandum items:	...					
Real primary spending 3/	...	2.2	1.2	1.3	1.3	1.5
Real GDP growth 3/	...	3.1	3.0	2.8	2.8	2.8
Gross debt	...	69.6	66.6	64.7	62.5	59.9
Output gap	...	-0.6	0.1	0.5	0.8	1.2
GDP deflator 3/	...	1.3	1.9	1.7	1.6	1.6
WEO Projections 1/						
Revenue	47.2	46.8	46.4	46.1	45.8	45.7
Expenditure	48.5	46.6	47.3	47.1	46.4	45.9
o/w interest payments	4.2	4.0	3.9	3.7	3.7	3.6
Overall balance	-1.3	0.2	-1.0	-1.0	-0.6	-0.1
w/o UMTS revenues 4/	...	-0.8	-1.1	...	...	...
Structural balance	-0.7	-0.7	-0.7	-0.4	-0.1	0.2
Primary balance	2.9	4.2	2.9	2.8	3.1	3.4
Primary structural balance	3.5	3.3	3.2	3.4	3.5	3.7
Memorandum items:						
Real primary spending						
w/o UMTS revenues 3/ 4/	3.0	2.0	1.7	1.9	1.4	2.0
Real GDP growth 3/	2.7	3.5	1.8	2.2	2.8	2.9
Gross debt	73.9	71.4	69.7	68.4	66.4	64.1
Output gap	-1.1	-0.1	-0.8	-1.2	-0.9	-0.5
GDP deflator 3/	1.2	1.4	2.2	1.8	1.7	1.7

Source: EU Commission, WEO; and Fund staff calculations.

1/ Direct comparisions between the updated Stability Plans and WEO data can be problematic due to different assumptions regarding real GDP growth, inflation, and the path of fiscal balances.
2/ Excluding UMTS license receipts, which are recorded as negative capital expenditures.
3/ Percentage change.
4/ The following countries reported UMTS revenues as a percent of GDP:
Austria 0.4 in 2000, and 0.1 in 2001; Belgium 0.2 in 2001; France 0.5 in 2001; Germany 2.5 in 2000; Italy 1.2 in 2000; the Netherlands 0.7 in 2000; Portugal 0.4 in 2000; and Spain 0.1 in 2001.

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thereafter as real disposable incomes firmed with the fading of the price shocks and the stimulus of tax cuts. While recognizing that the fundamentals in Europe had improved noticeably, the staff thought the authorities were underestimating the global nature of the slowdown, the apparent weakness of the area's internal demand, and the fact that stronger financial linkages had reinforced the transmission of international shocks to internal demand. With global growth subject to downside risks, the staff saw the growth of the area "gravitating towards 2 percent" in 2001 and questioned whether the rebound would be either strong or very prompt .

13. **In the event, prospects have weakened further.** The estimates in the latest WEO foresee annual GDP growth rates of 1¾ percent in 2001 and 2¼ percent in 2002.[7] This is a sizable deceleration from 3½ percent in 2000, and reflects near-stagnant output around the middle of this year. The estimates do not, however, imply a recession. Indeed, recent data point to a strengthening of consumption during the first half of this year offset by a continued slide in fixed and inventory investment. Insofar as these adjustments within the business sector are on the way to being completed, it is possible that a rebound toward the end of the year is in the offing (Figure 2). On the other hand, the global outlook remains muted and subject to downside risks. These risks, which could trigger turbulence in financial and exchange markets, in tandem with the risk of rising unemployment, suggest output developments could remain quite weak beyond the presently envisaged cyclical turning point.

B. Monetary Policy

14. **Against the background of a shared assessment of diminishing risks to price stability in the medium term, the discussions were over the extent to which the still high current headline inflation rates might prompt wages to catch up.**

15. **With the growth of M3 reasonably close to its reference value, first-pillar considerations have not been viewed as signaling risks to medium-term price stability.** On May 10, 2001, the ECB had cut its refinancing rate by 25 basis points to 4.5 percent partly on these grounds. Revised monetary data had suggested that the M3 measure included substantial holdings of money market fund shares by non-euro area residents, and that changes in these holdings had contributed a significant upward bias (on the order of ½ percentage points) to the deviation of M3 growth from its reference value. Moreover,

[7] Weighted averages of data for individual euro-area countries valued at purchasing power parities (PPP). Using Eurostat weights, projected growth rates would be slightly lower (0.1-0.2 percentage points) in both years. The present WEO projections assume policy interest rates to be cut by ¼ percentage point over the next 4-5 quarters before reverting (slowly) to 5¼ percent, implying a steady-state short-term real interest rate of 3½ percent. These assumptions reflect monetary conditions before the ECB cut— in concert with the U.S. Federal Reserve—its refinancing rate by 50 basis points on September 17.

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revised M3 growth appears to be still subject to an upward bias reflecting non-euro area residents holdings' of money market paper and other short-term securities (a bias the ECB roughly estimates at ¾ percentage points). Recently, the declining trend in M3 growth has reversed, but transitory factors including the weakness in stock markets seem to be at play. More generally, the ECB's "money gap" analyses, which staff generally shares, suggest that monetary developments are consistent with continued medium-term price stability.[8] In this context, the staff thought that greater volatility of monetary aggregates should be expected during the euro changeover, and, as a consequence, first-pillar considerations should be weighed cautiously in the period ahead.

16. **As regards the second-pillar assessments of inflation dynamics, the analysis has two principal elements.** The first is prospects for headline inflation assuming underlying domestic inflation remains moderate. In this regard, it is generally agreed that the shocks that had fuelled past pressures are dissipating and that HICP inflation would likely fall below the 2-percent mark in 2002 (all else equal).[9] Differences are over the quarter in which that threshold might be crossed in 2002, not whether. Recent developments in international commodity prices and domestic food prices are favorable in this regard.

17. **Risks were also seen as diminishing as regards the likely evolution of home-grown, underlying cost and price pressures, but with some concern whether wage moderation would be fully sustained.** In this view, although the experience to date had been encouraging, the historical importance of indexation phenomena among euro area members, the limited progress in labor market reforms, and the fact that most wage settlements had pre-dated the rise in inflation cast some doubts over the notions that EMU had brought about a fundamental change in the wage formation process or that the NAIRU had fallen substantially.[10] Several years of shrinking output gaps also suggested mounting wage pressures ahead.

18. **The staff agreed that past experience made for caution, but thought that recent wage behavior and weak prospects pointed to continued moderation.** Indicators of domestically generated inflation had stayed well behaved, rising at annual rates of 1-2 percent since 1998. The conventional index of core inflation had admittedly accelerated

[8] Chapter II in the accompanying *Selected Issues Paper* evaluates alternative measures of "money gaps" as predictors of medium-term inflation pressures.

[9] Favorable developments on the inflation front have been heralded by the area-wide index of producer prices, which has been on a pronounced declining trend since October 2000.

[10] Chapter I in the accompanying *Selected Issues Paper* presents the staff's latest estimates of the euro area's NAIRU.

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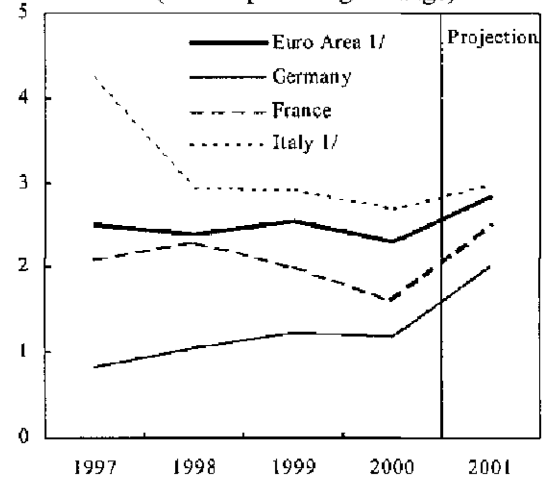
to above 2 percent recently, but in the staff's analysis this was due to the second round effects of past price shocks—for example, the impact on airline tickets of higher fuel costs—rather than accelerating domestic inflation. Abstracting from such effects, underlying inflation had remained stable around 1½ percent.[11] Similarly, the area's nominal wage growth had continued to be remarkably moderate, notwithstanding higher headline inflation for over a year now and considerable fears to the contrary, including by staff earlier. While one could not exclude some catch-up behavior, the tax cuts that were supporting take-home pay, the apparent acceptance of wage moderation as a successful employment strategy, the anticipated stabilization in the terms of trade, and—above all—the current softening of economic activity, suggested that the risks were contained.

Nominal Wage per Employee
(Annual percentage change)



Sources: European Commission; WEO, IMF; and staff calculations.
1/ 1998 data adjusted for tax reform in Italy.

19. **Nuances as regards wage prospects notwithstanding, it was agreed at the time of the mission that headline inflation was very high and monetary easing at that time ran the risk of sending the wrong signal and destabilizing inflation expectations.** Hence, any easing of interest rates should wait for headline inflation rates to fall back from their peaks, whereupon the staff saw emerging scope to cut interest rates, particularly if growth should slow further.

20. **Headline inflation has since receded, and the ECB cut interest rates by 25 basis points on August 30 against the background of a weakening of growth prospects.** Headline inflation slowed from 3.4 percent in May to 3.0 percent in June and 2.7 percent in August on a 12-month basis.[12] In its announcement, the ECB noted that growth had softened and wage moderation was likely to continue given the extent of the slowdown and falling inflation.

21. **As regards the monetary framework, the controversial aspect has been the first pillar (M3), where the ECB has faced data difficulties and persistent market skepticism about the cohesion of the two-pillar approach.** The ECB has significantly strengthened the

[11] Chapter III in the *Selected Issues Paper* discusses the pass-through of imported inflation to consumer prices.

[12] The harmonized index of consumer prices in August was roughly unchanged compared to May, underscoring the backward looking character of inflation measures based on 12-month changes.

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analytical underpinnings of its approach, including of the first pillar, and sought to make the implementation of the framework more transparent. However, a variety of developments have seriously complicated implementation over the past six months, prompting the ECB to unexpectedly resort to the first pillar to explain the May rate cut and to dismiss it for the August one. Officials argued that the approach was both fully consistent and transparent, giving weight to two different but equally valid strands of monetary analysis.

C. The Euro, the Current Account, and Capital Flows

22. **The euro has moved up and down but remains significantly undervalued.** Since the beginning of this year, and in spite of growth and interest rate differentials vis-à-vis the United States turning favorable, the euro has remained weak bilaterally and in real effective terms (Figure 6). Broad assessments based on the investment-saving balance and purchasing-power parity approaches suggest that the euro's real exchange rate is undervalued—by more than 25 percent bilaterally against the U.S. dollar and by about 10 percent multilaterally—relative to medium-run equilibrium levels.

23. **The euro's weakness reflects primarily capital account developments.** The area's current account has deteriorated over the last few years, from a surplus of about 1½ percent of GDP in 1997 to balance in 2000.[13] This deterioration reflects largely the sharp rise in energy prices and an increasing deficit on non-factor services but also a (so far) low response of trade flows to the sustained real exchange rate depreciation since 1996. Looking ahead, and assuming constant real exchange rates, the staff projects the area's current account to revert back to a surplus of some 1¼ percent of GDP by 2005. Euro weakness primarily reflects continued large net outflows in the foreign direct and portfolio investment accounts. Capital flow data for the first half of 2001 suggest that net foreign investment outflows continued unabated but net portfolio investment slowed to a trickle (Appendix II).

24. **Staff work on the exchange rate suggests that the slide in the euro and the associated capital account developments reflected two real (rather than monetary) factors (Box 1).** One element, which goes back to the mid-1990s, is the strength of the U.S. dollar vis-à-vis most currencies. This is viewed as rooted in global equity price increases, which led to a much sharper rise in stock market capitalization in the United States than in the euro area and to a (relative) U.S. demand boom. The other element reflects the advent of the euro itself, which prompted resident investors to diversify internationally and non- resident borrowers to increase their liabilities denominated in euro.[14] On this

[13] Calculated as the sum of the balances of individual euro area countries. ECB data on the current account that allow for a bias in intra-euro area exports to exceed intra-euro area imports (in part due to underreporting of imports by smaller firms) show a current account deficit of ½ percent of GDP in 2000 (Appendix II).

[14] Chapter II in the accompanying *Selected Issues Paper* discusses how these factors might have played themselves out.

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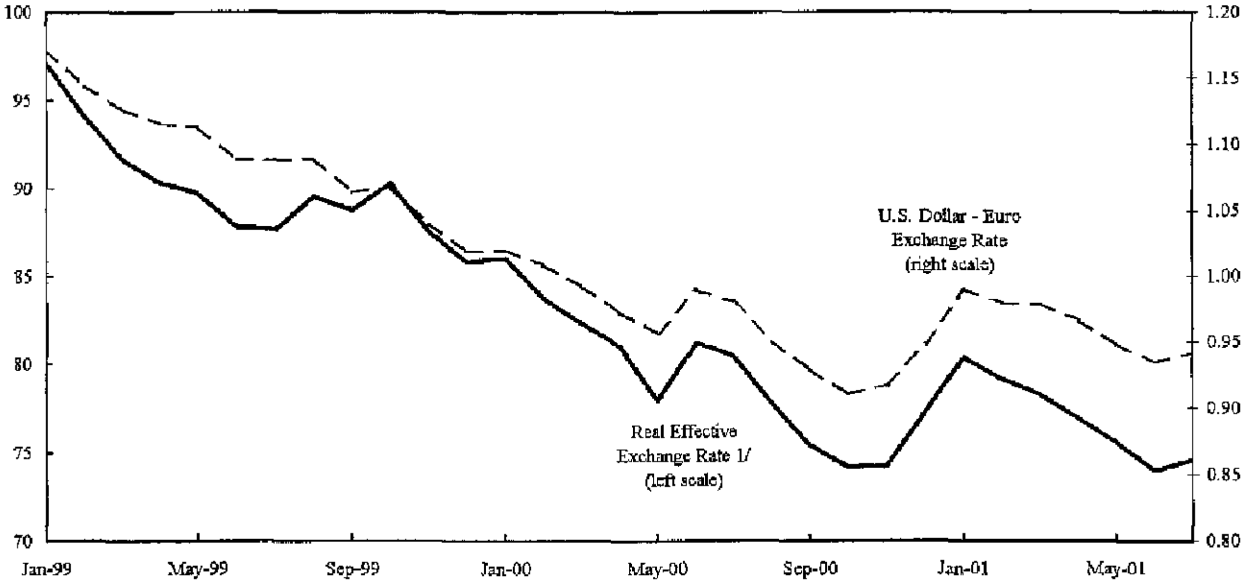
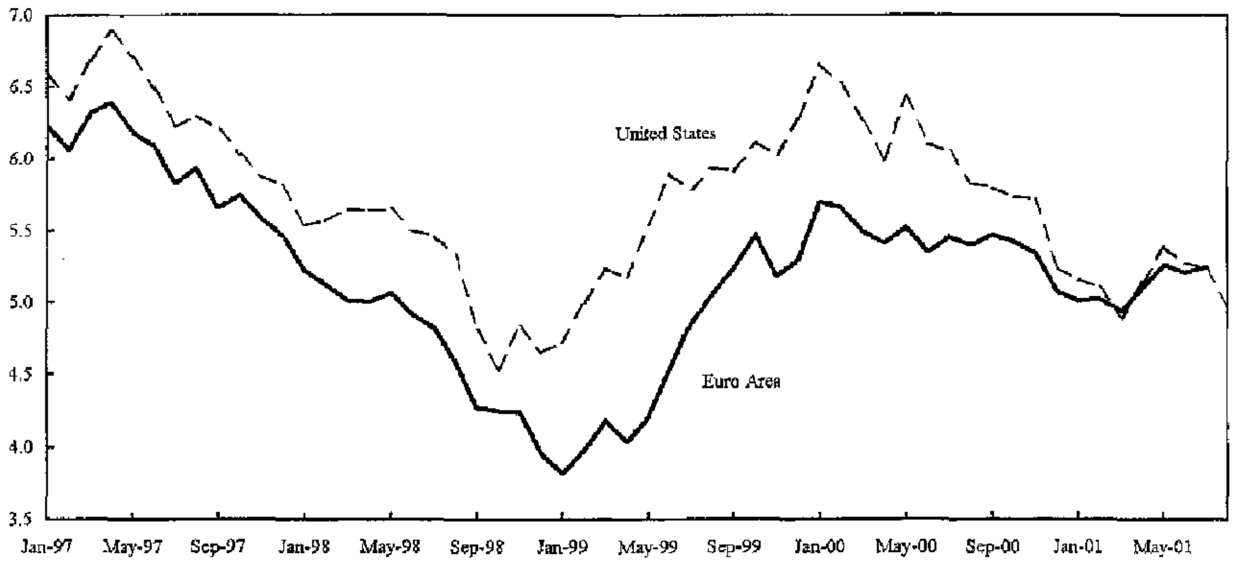
Figure 6. Euro Area: Exchange Rates and Long-Term Yields

Euro Area: Exchange Rates



Long-Term Yields 2/



Source: Eurostat; IFS, IMF; European Central Bank.
1/ Based on normalized unit labor costs; average for 1980-1999 is 100.
2/ 10-year government bond yields.

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Box 1. Explaining the Weakness of the Euro

The euro exchange rate has declined sharply since its introduction, contrary to the expectations of most observers. Various explanations have been offered for euro weakness, such as uncertainties about ECB policies and structural rigidities in euro-area economies. Many of these stories, however, are dubious on theoretical grounds or involve phenomena that pre-date the decline in the euro. In the event, the slide in the euro (and its legacy currencies) against the dollar began in the mid-1990s, briefly interrupted by a short-lived recovery in late-1998. On a multilateral basis against currencies other than the dollar, the depreciation in the euro is more recent, broadly coinciding with its introduction.

This timing suggests the weakness in the euro has two components. One reflects the flip side of the relative strength of the U.S. economy that began in the mid-1990s, while the other reflects factors specific to the euro. On the first issue, the drop in the euro against the dollar has been accompanied by rapid U.S. output growth, a rise in long-term yields on U.S. assets relative to euro-area yields; and a sharp widening in the U.S. trade deficit—factors that point to a positive demand shock in the U.S. relative to the euro area. These phenomena may be attributable to the run up in global equity prices in the second half of the 1990s. The U.S. was particularly affected by this rise given the importance of "new-economy" sectors, the high initial ratio of equity market capitalization to GDP, and a high propensity to spend out of equity wealth. Market capitalization in the U.S. rose by significantly more than in the euro area from 1994 to 1999 (Figure 1), with the gap rising from 40 percent of GDP to 90 percent. Model simulations incorporating these changes in equity values generate a large demand shock in the U.S. relative to the euro area due to higher consumption (through wealth effects) and investment (through lower capital costs). Higher demand in the U.S. drives up interest rates and attracts capital inflows, in turn pushing up the dollar and generating a trade deficit. The simulations are broadly consistent with the experience since the mid-1990s, and can explain much of the appreciation of the dollar that has occurred.

More recently, there has been a (partial) reversal of the equity market shock, yet the euro has weakened further against most other currencies. This may be associated with changes in euro-area capital markets brought about by the introduction of the single currency. From a borrower's perspective, the euro-denominated debt market provided much more depth and liquidity than did those for the legacy currencies. Consequently, international issues of euro-denominated debt have risen sharply since early 1999 (Figure 2). There is also evidence that euro-area borrowers have shifted to euro issuance from other currencies. At the same time, the introduction of the euro has provided scope for euro-area investors to diversify into other currencies, as assets in legacy currencies that were previously considered foreign assets would now be included in the domestic-currency component of portfolios. Explicit changes in portfolio guidelines in some cases reinforced this effect. These portfolio effects on both sides of the market would weaken the euro. While quantifying their importance is difficult, model simulations indicate that an assumed change of 0.4 percentage point on expected yields on euro assets implies a drop in the exchange rate of about 15 percent on impact. The presence of such a shock, in addition to the equity market shock, would explain virtually all of the euro weakness.

In these circumstances, there may be little that macroeconomic policies can directly do to address the weakness in the euro. Looking ahead, further declines in its value seem unlikely for the sources identified above. Indeed, the partial reversal in global equity prices should work to strengthen the euro over time, and portfolio effects moderate as assets stocks adjust. But market sentiment may play a predominant role in the short run, especially as uncertainties about fundamentals could have been amplified by recent volatility.

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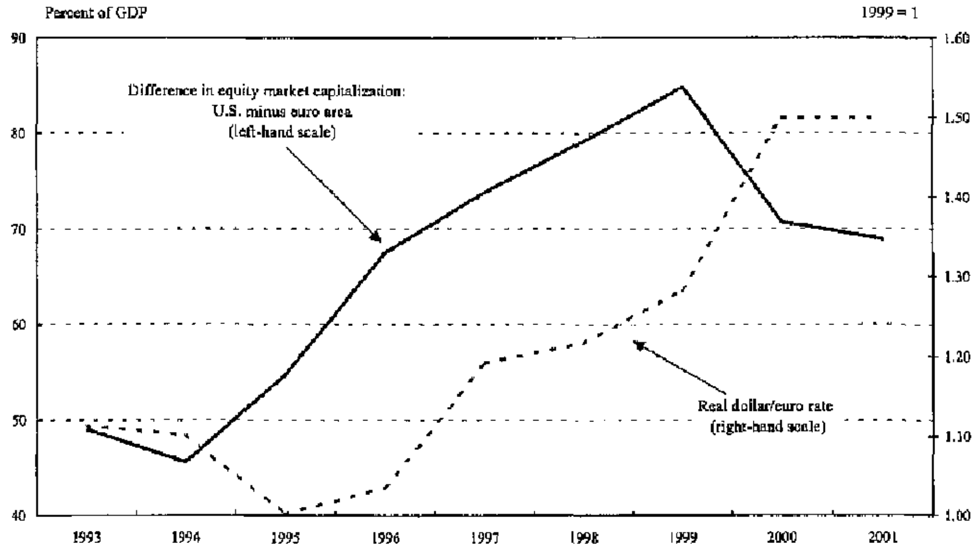
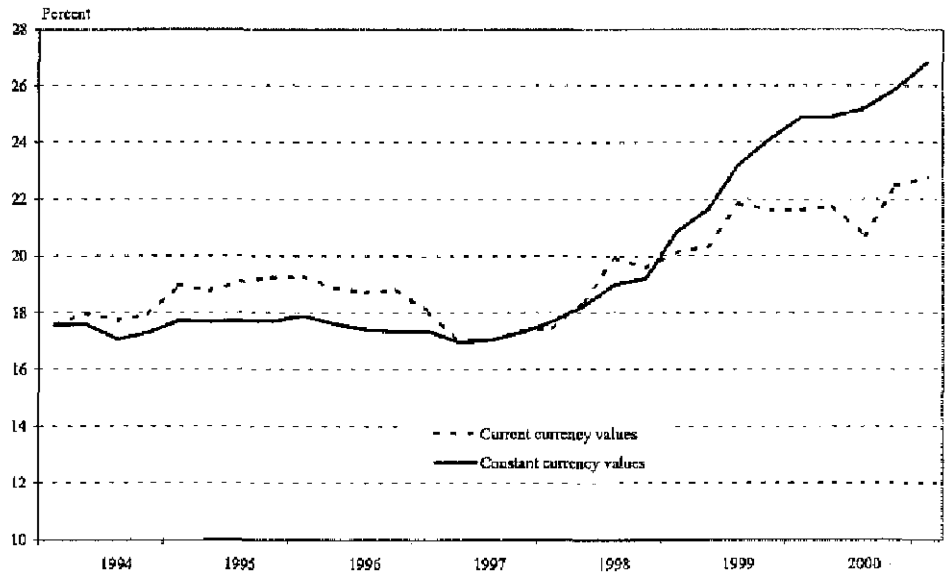
Box 1. Euro Area: Explaining the Weakness of the Euro (Continued)

Figure 1. Equity Market Capitalization Gap and Euro/Dollar Rate



Source: FIBV.

Figure 2. Euro-denominated Share of International Debt Issues



Source: BIS, and ECB staff calculations.

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this analysis, policy has not played a direct role in weakening the euro, and there is little scope for policy actions to affect what is deemed to be an undervalued exchange rate—a view with which the ECB agreed. By the same token, continuing correction in global equity prices could trigger a reversal of some of these forces and work in the direction of unwinding downward pressures on the euro.

D. Fiscal Policy

25. **Against the background of a shared concern to preserve the medium term stability-orientation of the SGP, the basic issue was whether priority should be given to expecting France, Germany, and Italy to abide by their nominal fiscal balance targets or instead to allow the free play of the automatic stabilizers.**[15] The background includes the following:

- The euro area is a fiscally highly decentralized monetary union with practically no central fiscal authority. As such, the union needs a framework and standard to coordinate and evaluate the fiscal policies of the member states.[16]

- The standard that has been agreed is the SGP, wherein each member has committed to achieve and maintain a fiscal position "close to balance or in surplus" in the medium term. This is mainly so as to permit countries to allow full play to the automatic stabilizers without encroaching on the Maastricht three-percent deficit limit. This fiscal anchor of the union has widespread support, including from staff. It is also a reasonably flexible anchor insofar as it specifies only a lower bound: countries are encouraged to opt for stronger medium-term targets to allow for special circumstances, including excessive levels of existing debt or prospective indebtedness due to population aging.

- For purposes of implementation, the SGP is complemented by annually submitted multi-year Stability Programs (SPs) that specify the annual fiscal balance targets whereby each member intends to live up to its medium term commitments.[17] These

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[15] For reports on discussions of these issues with the authorities of France, Germany, and Italy, see the Article IV Staff Reports for these countries.

[16] A coordination strategy is needed to foreclose the possibility of fiscal spillovers in EMU—effectively a free-rider problem whereby fiscal laxity is pursued at the expense of the rest of the membership once interest rates start reflecting area-wide developments and there is no risk of real appreciation for the fiscal profligate.

[17] Although the SGP details comprehensive information requirements for a proper assessment of the SPs by the Council in principle, in practice the focus has been on fixing—and achieving—targets for actual (i.e., nominal) budget balances. These requirements have

(continued)

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nominal targets are "binding" (in the sense of being commitments for which a member is accountable to other members), but preclude use of the stabilizers only for those members that have yet to achieve fiscal balance or surplus. As of 2000, 8 of the 12 members of the monetary union (and 11 of 15 members of the EU) had met this criteria. The four that have not are Germany, France, Italy and Portugal .

- The focus on annual nominal fiscal balance targets has been consistently questioned by staff on the grounds that it condones already deep-rooted procyclical fiscal behavior, i.e. that it fosters rather than dampens the transmission of shocks within the monetary union.

- The opposing view acknowledges that the SPs are procyclical, but argues that the credibility of the framework—years of painstakingly constructed fiscal discipline that had served the area well and has its own economic benefits—is at stake.

26. **Euro area countries have a long history of fiscal procyclical policies as a result of the focus on fiscal balance targets.** The historical roots of procyclical fiscal behavior in continental Europe are well documented. Basically, countries have a tendency, both ex-ante at the stage of budget elaboration and ex-post at the stage of implementation, to offset the effect of the cycle on preset fiscal balance targets. In practice, however, the pattern is not symmetric. Countries are more likely to let the stabilizers at least in part play in a downswing and to more than compensate for them in an upswing (Box 2).[18] This pattern carries over to the present. In 2000, all euro-area countries could have met with ease the budgetary targets in their SPs on the back of better-than-anticipated growth. Indeed, over the remonstrances of the Commission, the ECB, and staff, many countries used the revenue overperformance to finance tax cuts ahead of expenditure reductions or to increase spending, partly in 2000, but partly also in 2001 budgets. The slowdown underway shows the flip side of this procyclical behavior: in the current WEO, France, Germany, and Italy are estimated to fall short of their SP targets for 2001 by about ½ percent of their GDP, unless their fiscal stance is tightened accordingly, which would exacerbate the downturn. If slippages this year are tolerated, but the expectation becomes that they should be clawed back next year to meet SP commitments, the necessary adjustments in 2002 would be in the range of ¾ to 1 percent of GDP, roughly double the structural adjustment that these countries had envisaged in their 2000 SPS,

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been further spelled out in the Opinion of the Monetary Committee (later renamed EFC) on the content and format of the SPs (MC/428/98), which ECOFIN endorsed in 1998.

[18] See Chapter V in the accompanying *Selected Issues Paper*.

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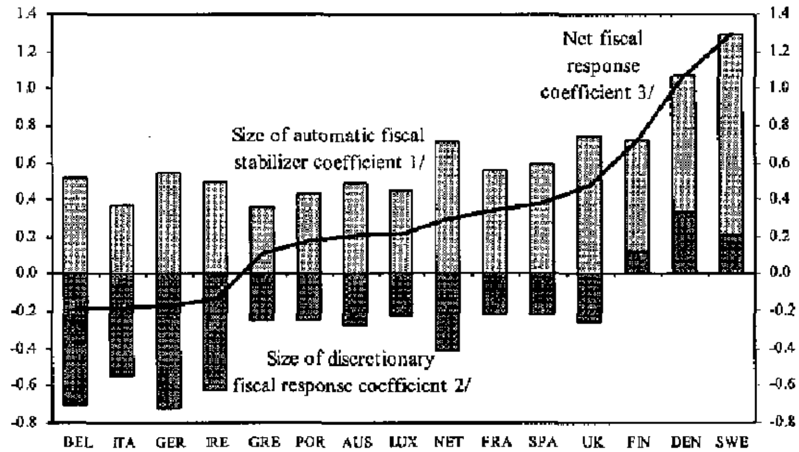
Box 2. Avoiding Procyclical Fiscal Behavior Under the Stability and Growth Pact (SGP)[1]

It is widely agreed that fiscal policy should avoid procyclical behavior as well as excessive deficits and debt accumulation. However, since the mid-1970s, fiscal policy conduct in most EU countries has delivered neither sustained fiscal discipline nor provided the economy with strong stabilizers. In particular, all EU countries except Denmark, Finland, and Sweden had a pronounced tendency to counteract the operation of their automatic fiscal stabilizers by procyclical discretionary policies (Box Figure). Moreover, the discretionary offset of automatic stabilizers appears to have occurred in an asymmetric manner over the cycle: during years of slowing GDP growth—defined as years with real GDP growth below average—automatic stabilizers were at least partly left to operate. However, during years of faster GDP growth—defined as years with real GDP growth above average—the contractionary impact of automatic stabilizers was often compensated by fiscal loosening. This pronounced (asymmetric) procyclical bias of fiscal policy implies an upward ratcheting of underlying fiscal deficits in good times. From this perspective, procyclical fiscal policy behavior and lack of fiscal discipline appear to represent two sides of the same coin.

EU Countries: Cyclical Fiscal Policy Behavior



Sources: European Commission; and staff estimates.
1/ Automatic change in general government balance-GDP ratio in response to a 1 percentage point increase in real GDP growth.
2/ Discretionary change in general government balance-GDP ratio in response to a 1 percentage point increase in real GDP growth.
3/ Sum of automatic fiscal stabilizer and discretionary fiscal response coefficients.

The Stability and Growth Pact (SGP) seeks to remedy these problems while providing a framework for fiscal policy surveillance in a highly decentralized monetary union. The pact obliges member states to reach and "*...adhere to the medium-term objective of budgetary positions of close to balance or in surplus.*" Reaching the medium-term objective would "*...allow member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent of GDP reference value.*" Thus, the SGP squarely addresses the need to constrain fiscal policy while leaving flexibility to stabilize output fluctuations. However, the SGP leaves unclear what countries should do if they have not reached their medium-term balance objectives and are faced with a sharp unexpected growth slowdown— the present situation in the three largest euro-area members (Germany, France, and Italy).

Policy makers in the EU have generally adopted the view that countries that have not reached yet a close-to-balance or in-surplus position should be held to the nominal balance (as a percent of GDP) targets contained in the Stability Programs (SPs). If growth slows unexpectedly, this view would call for procyclical spending or revenue adjustments in these countries. An alternative view would try to safeguard the operation of automatic fiscal stabilizers on the revenue side and allow balances to adjust to growth surprises. But countries would be held accountable for reaching the nominal spending paths laid out in their SPs to ensure that countries stay on the transition paths to their medium-term balance objectives. These interpretations are stylized in the sense that they could be further refined, for example by taking account of the automatic stabilizer properties of unemployment benefits on the spending side (staff estimates, however, suggest that 85 percent of the automatic stabilizer impact for the euro area as a whole occurs on the revenue side of budgets).

[1] This box draws on cross-country work on cyclical fiscal policy behavior in EU countries summarized in Chapter V of the *Selected Issues Paper*. A separate background paper focuses on fiscal management in the four largest euro-area countries and the design of rule-based fiscal policy frameworks.

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The significant downward revisions in real GDP growth for 2001 and 2002 in the present WEO relative to the assumptions of the SPs for Germany, France, and Italy are shown in the table below. The WEO projections of (higher) fiscal deficits relative to SPs indicate that automatic fiscal stabilizers are assumed to operate in 2001—as a rough rule of thumb, a 1 percentage point decrease in GDP growth raises the deficit by roughly 0.4 percentage points (see box chart above). At the same time, in 2002 Germany and Italy are expected to dampen their automatic fiscal stabilizers relative to SP projections. As regards nominal spending growth paths, the WEO projections suggest that Italy will slip significantly relative to its estimated SP benchmark in 2001, a slippage that is projected to be partially clawed back in 2002.

	Real GDP growth 1/		Balance-GDP ratio 2/		Nominal primary spending growth 1/	
Germany						
Stability Program	2.8	2.5	-1.5	-1.0	1.2	2.4
WEO projection	0.8	1.8	-2.2	-1.8	1.7	2.9
Difference	-2.0	-0.7	-0.7	-0.8	0.5	0.5
France						
Stability Program	3.3	3.2	-1.0	-0.9	3.1	3.0
WEO projection 3/	2.0	2.1	-1.4	-1.6	3.0	2.9
Difference	-1.3	-1.1	-0.4	-0.7	-0.1	-0.1
Italy						
Stability Program 4/	2.9	3.1	-0.8	-0.5	4.0	2.5
WEO projection	1.8	2.0	-1.3	-0.9	4.8	2.0
Difference	-1.1	-1.1	-0.5	-0.4	0.8	-0.5

1/ In percent.
2/ In percent of GDP.
3/ Excluding UMTS receipts in 2001.
4/ Nominal primary spending growth represents staff estimate.

The implications of the two stylized SGP interpretations for fiscal policy conduct relative to the SP projections can be illustrated by working out the implied additional fiscal adjustment under nominal balance and spending targets. As shown in the next table, a nominal spending target would by definition not require additional fiscal adjustments; however, achieving the nominal balance targets laid in the SPs would imply for all three countries strong procyclical fiscal actions in 2001 and less so in 2002.

	Implied fiscal impulse under: 1/			
	Nominal spending target		Nominal balance target	
	2001	2002	2001	2002
Germany	0.0	0.0	-0.9	-0.3
France	0.0	0.0	-0.6	-0.5
Italy	0.0	0.0	-0.4	-0.4

1/ Change in primary structural balance relative to Stability Program (with opposite sign) as a result of revisions of real GDP growth rates.

These illustrative calculations suggest several advantages of monitoring SGP implementation based on the nominal spending targets laid down in SPs: (i) the need for procyclical shifts in fiscal stance during an unexpected downturn would be avoided; (ii) by the same token, during cyclical upswings, SGP implementation based on nominal spending targets could help avoid the pronounced procyclicality of fiscal policy during good times; (iii) in view of the empirical evidence on asymmetric fiscal policy behavior in the past, nominal balance targets may give rise to credibility problems if these targets are not met in a slowdown; (iv) even if policy makers would aim for nominal balance targets during unexpected downswings, this is likely to inject uncertainty about fiscal policy conduct as growth forecasts tend to be moving targets; and (v), under nominal spending targets policy makers would be held accountable for a fiscal variable that can be better controlled than balances.

A shift to more emphasis on monitoring nominal spending commitments within the SGP framework may, however, require modifications of present surveillance procedures including clearer statements in SPs of countries' medium-term balance targets and more information on the implied spending paths (and tax policies) that would allow countries that have not reached yet a close-to-balance or in-surplus position to converge to the medium-term balance target or ensure that the other countries remain in line with this target.

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putting at risk a reversion of growth to trend for the area as a whole. The shortfalls are not, however, always attributable only to cyclical developments. Slippages in noncyclical spending have also played a role, including in Italy where the cyclical weakness in revenues has been compensated by their unexpected structural buoyancy. The staff's basic position both in this report and in the accompanying Article IV Staff Reports for France, Germany, and Italy is that the stabilizers should be allowed full play on the revenue side in 2001, expenditure slippages should be clawed back, and, with growth expected to be close to potential next year, any structural adjustment foreseen for 2002 in the SPs should be carried through to the 2002 budgets. In sum—let the stabilizers play, but, absent major changes in the outlook, no discretionary action above and beyond that previously planned.

27. **Reactions to staff pointed to competing considerations. On the one hand, the procyclicality bias of the ground rules could be seen as the unavoidable price to pay for unfinished consolidation**. Once their underlying fiscal positions are close to balance or in surplus (Figure 7), countries could grant full play to the automatic stabilizers. But allowing a breach of the SP commitments for the countries that have not reached yet a close-to-balance or in-surplus position put at risk the credibility of the overall framework, both as regards the ultimate objectives (balance or surplus) and the even-handedness of internal surveillance between large and small countries. Those countries had wasted consolidation opportunities in the buoyant times and should be held accountable by making up for the lost ground. In any case, the fiscal stances had had an expansionary cast from the outset, and keeping to the original balance targets would not be contractionary on a net basis, all the more so since the authorities had room to limit spending within existing budgets. Moreover, while there was no immediate risk of countries breaching the Maastricht limit, one could not exclude that possibility in the event of further adverse developments. A further concern was that relaxing the constraints provided in 2001 by pre-set nominal budgetary targets would send the wrong signal to countries where spending discipline was still an issue.

28. **Another interpretation implied a more cycle-friendly approach.** The call for letting the automatic stabilizers play is in line with the recent Gothenburg Council recommendation on policy guidelines (even if the recommendation was qualified by an ambiguous "where possible"), and that in practice the SPs were being evaluated at the technical level on a cyclically-adjusted basis. Doubts were also expressed about emphasizing the importance of the fiscal balance targets given the likelihood that they would not be respected. By the same token, nominal balance targets were seen as having been an effective tool for imposing and achieving fiscal discipline, not only in the past but also presently, where they viewed the focus on actual deficit targets as helpful in containing pressures for discretionary measures. They feared that the staff's position might open the floodgate of fiscal laxity.

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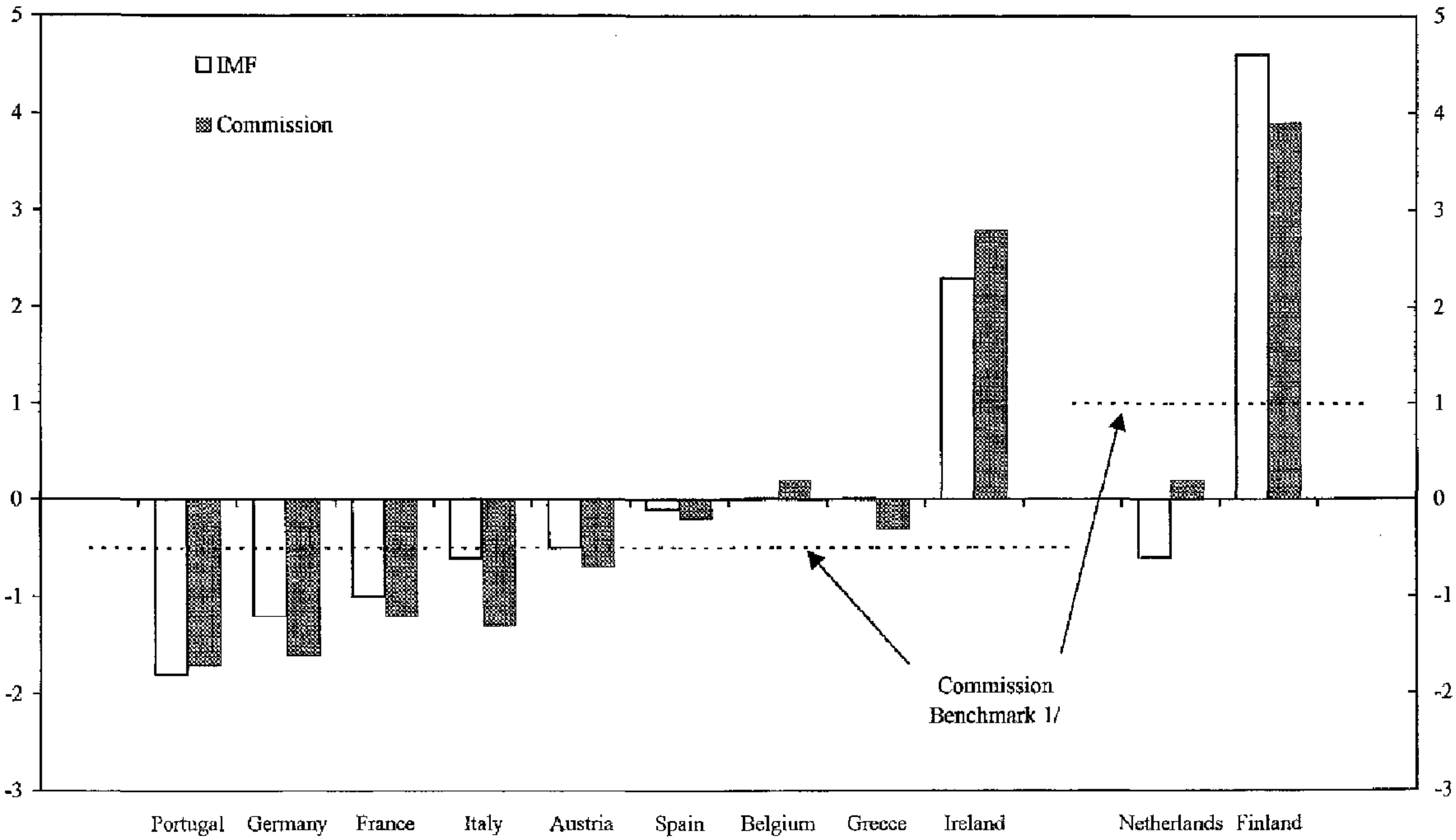
Figure 7. Euro Area: Structural Fiscal Balances, 2001



1/ As set out in *Public Finances in EMU--2001,* European Commission
Sources: IMF; and European Commission.

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29. **The staff acknowledged that the situation was difficult, but saw adaptations of the framework as likely to strengthen rather than weaken fiscal consolidation over time.** The situation was difficult because the framework was having to deal with a situation that had not been a key focus of its designers—namely a generalized slowdown triggered by large common shocks with, however, presumably cyclical effects on output. This was very different from restoring sustainability to fiscal positions or dealing with asymmetric shocks—typically supply shocks or country-specific proclivities to fiscal laxity—that the framework, with its focus on achieving fiscal balance targets, was primarily designed to tackle. Asymmetric supply shocks and potential backsliding on fiscal probity needed watching, but not at the expense of a constructive response to common adverse shocks, which, on the evidence of the past couple years, seemed to be the more important, particularly for the area's larger economies. In such a context, the focus ought to be on implementing the most suitable policies for the union rather than on insisting on requirements that had been overtaken by events, exacerbated cyclical swings in the past, and were at risk of again penalizing the growth of the area as a whole. To these effects needed to be added those of the loss of credibility that would result from countries' not meeting the nominal balance targets, which seemed likely, and the lack of transparency as countries shied away from acknowledging either likely shortfalls or the measures to make up for them.

30. **In the staff's view, a more promising avenue would be to move toward a framework where countries' progress toward their SGP-compatible medium-term fiscal objectives was monitored primarily on the basis of expenditure rather fiscal balance commitments.** Given a well-articulated medium-term fiscal framework,[19] an expenditure-based approach could be as transparent as targeting nominal balances, but it would not be procyclical since the bulk of the automatic stabilizers would be allowed to play. In a supported cycle, consolidation would be easier. The approach would also hold policymakers accountable for what they can (largely) determine—expenditures—rather than for something beyond their control in the short run—revenues. As such, it would provide an effective disciplining device for countries prone to overspending. The SPs would have to become more informative about the tax and expenditure plans underlying the trajectory of a desired fiscal position, but countries were already moving in this direction and this should be encouraged. An expenditure focus would moreover go some distance toward limiting the dependence of assessments of fiscal developments on technical and controversial cyclical adjustments, which had not gained currency in either political or public circles.

31. **That said, an expenditure-based approach is not a panacea.** An immediate question is whether to exclude cyclical spending (e.g. unemployment benefits) precisely because it is cyclical or to include it on grounds of increased transparency and

[19] That is, a strategy that specifies in a mutually consistent manner the medium term balance target, the path of output (typically converging to potential in the medium run), the likely path of revenues given present or foreseen tax policies, and the path of expenditures, with the whole implying (or being constrained by) a fiscal balance path.

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accountability.[20] Moreover, governments would still have to resist the temptation of using cyclical revenues to finance tax cuts. But tax cuts are visible, discretionary acts that carry forward into the medium term, and coming to a judgment about whether they conform to the SGP ought to be relatively straightforward. Issues of fiscal federalism might also be more difficult in an expenditure-focused setup since local governments faced with a preponderance of asymmetric (supply) shocks may be more amenable to balance than expenditure targets. Furthermore, there are fiscal institutions in many euro-area countries that have an in-built procyclical bent, linked, for example, to pay-as-you-go (PAYG) social insurance financing. These institutions weaken the control over the execution of spending plans.[21] Undoubtedly, these political economy/institutional aspects raise some implementation issues. However, similar issues beset the current arrangement; and they would not appear to be irresolvable. In any case, the targeting of central government expenditures would represent a considerable step forward and is in any case in step with the strategy of a number of governments. Finally, an expenditure focus would not spontaneously address, as the fiscal balance approach can claim to do, the issue of country asymmetric shocks. These, however, ought to be addressed at the country level including through reassessments of the medium-term balance targets.

32. **To close, a degree of uncertainty hovers over fiscal policies in the euro area.** There is a risk that they could be considerably more restrictive than is appropriate. On the other hand, past and present behavior suggests that these risks should not be exaggerated. Recent statements by EU officials to the effect that the larger countries should not let the stabilizers "play fully" are in the same direction. The "unchanged policy" assumptions implicit in the staff's WEO estimates for the larger countries are that the authorities will let the stabilizers play almost fully this year, but take some of it back in next year's budgets which are slated to be somewhat more restrictive (see table on fiscal stance in section II.B). This accounts for part of the staff's caution regarding the pace of the upturn.

E. Goods and Labor Market Reforms

33. **The greatest payoff to euro area performance would be from stepped-up reforms**. The experience of the last three decades in several euro-area countries has been one of drawn-out downturns, hesitant recoveries, and short-lived expansions as supply-side inflexibilities dampened potential growth, inhibited the reallocation of resources, and heightened the vulnerability to shocks. Indeed, in the context of the current cyclical episode, some of the weaker performances within the area's economy can be attributed to countries that have lagged in their reform efforts, especially in the labor market. By the same token, a

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[20] For the euro area as a whole, staff estimates suggest that about 85 percent of the automatic stabilizer response occurs on the revenue side. The remainder reflects the built-in response of unemployment benefits to the cycle, which, however, occurs in part with a lag of one year.

[21] Some of these issues are addressed in the accompanying paper *Rules-Based Fiscal Policy and the Fiscal Framework in France, Germany, Italy, and Spain*.

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stronger track record in structural reforms has paid dividends to the reformers in terms of faster and more employment-rich growth.

34. **There was agreement that reforms of product markets had been significant but needed to be pushed further.** Officials at the Commission noted that although the rhetoric in public declarations on this subject had been lately toned down, the momentum on the ground was holding up. As envisaged in the 2000 *Broad Economic Policy Guidelines*, the functioning of euro-area markets had been strengthened by increased transposition of internal market directives, stronger powers for competition authorities, the liberalization of the telecoms and—to a smaller extent—energy sectors, and improved coordination of national policies in different fields. Less progress had been achieved, however, in the areas of public procurement, state aid, administrative reforms, and the reduction of the regulatory burden on business, including as regards start-ups. Furthermore, the liberalization of transport and postal sectors in some countries continued to lag.

35. **Progress on labor market reforms had been more limited and in many countries the unfinished agenda remained large.** The mission and the authorities shared the view that past reforms had paid off in terms of greater labor market dynamism but the accomplishments had been uneven across area's members: high structural unemployment and wide regional disparities had not been sufficiently tackled in many cases.[22] While tax reform had been pursued in several countries, there remained the need to complement these efforts with reforms in the out-of-work benefit systems in order to bolster participation in the labor force and increase the employment ratio.

36. **More broadly, there remained an open question whether tripartite agreements on wage moderation have, at times, been secured by backsliding on structural measures.** A shared view was that the euro area needed revamped labor market institutions including more flexible wage formation processes, labor regulations, and work arrangements, which, by better aligning wage claims to labor productivity across skills, sectors and regions, would allow a transition from across-the-board wage moderation to more market-based wage discipline. This transition would lock in the gains from wage moderation (a shift in factor prices that favors job creation, and wage increases consistent with medium-term price stability) without the drawback of wage settlements that distort the wage structure in the pursuit of social objectives. There was some hope at the Commission that fiercer competition in product markets might eventually force structural adjustments in labor markets.

[22] The accompanying cross-country paper on *Job-Rich Growth in Europe* examines employment developments in the euro area's four largest economies and the proximate causes of the high employment content of growth in the current expansion.

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F. Financial Market Integration

37. **Integration of the euro-area financial markets is being held back by lack of harmonization of national regulations.** Although market-driven solutions had arisen at times—as evidenced by the rapid integration of corporate bond markets—Commission officials noted that there were still pervasive legal obstacles that could not be by-passed by market operators.[23] Against this background, the EU Financial Services Action Plan (FSAP) was in their judgment a milestone toward the removal of those barriers. Its implementation—scheduled for completion in 2005—was claimed to be broadly on track. Recently, the Commission had made proposals to the European Council concerning the supervision of financial conglomerates, investor protection, and harmonization of accounting standards, and it was preparing other proposals on investment services and capital adequacy rules. Negotiations had proved difficult in the areas of pension fund regulations, takeover bids,[24] and e-commerce, because it is often unclear what the standard for harmonization should be and, in some cases, because well-entrenched vested interests oppose reform. Yet, in the assessment of the Commission staff, consolidation in the financial industry was proceeding not just within but also across sectors, and cross-border mergers and acquisitions would likely increase in the period ahead. As regards the securities markets, the Lamfalussy report had charted a welcome course of actions to speed up decision making and integration within a realistic timeframe. The envisaged procedures will empower the Commission to directly refer proposed directives to the Council where a majority would be needed to reject them. A review of the effectiveness of these procedures is scheduled for 2004.

38. **Progress in financial sector integration and consolidation could raise systemic risk at the EU level, requiring closer cooperation among supervisors and central banks both in crisis prevention and crisis management.** Discussions at the ECB focused on a recent EFC report (Brouwer II) on these matters. The report builds on an earlier one that, while judging adequate existing institutional arrangements for cross-border supervision, urged an improved exchange of information (both cross-sector and cross-border) between the responsible authorities. In part because of these shortcomings in information flows, Brouwer II paints a cautious view of the effectiveness of the mechanisms for financial crisis management. The report calls for better harmonized national policies and stepped up contingency planning to reduce risks to the financial system. The ECB officials had sympathy for the report's emphasis on strengthening existing mechanisms (bilateral Memoranda of Understanding among national supervisors and committees to exchange information), but saw a need for a stronger role for central banks in the process. The mission

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[23] An in-depth discussion of integration of government securities markets is contained in Chapter IV of the August 2001 *International Capital Markets* report.

[24] The directive on rules guiding corporate takeovers was subsequently rejected in a vote by the European Parliament.

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was less sure that the existing mechanisms for decision making and information exchange would remain adequate for crisis management in an ever more integrated financial market.

G. The Euro Changeover

39. **Euro notes and coins will replace the national currencies of all euro-area members on January 1, 2002 (Box 3).** A currency reform of this scale and complexity is unprecedented and its logistical requirements are daunting. Extended public information campaigns have been underway for some time and will shift to a higher gear in the fall. The mission discussions touched mostly on the likely macroeconomic effects of the changeover. According to the Commission and the ECB, fear of once-off price hikes in the re-denomination of price labels might be exaggerated in the media and popular perception. In their view, heightened competition in product and service markets, extensive vigilance by consumer groups, and greater ease of price comparison across national borders after the changeover suggested that abuses will be limited and, in all likelihood, quickly corrected.

H. EU Trade Policy

40. **The discussions on trade policy focused on the progress toward a new trade round, the EU's relations with developing countries, and the restrictive aspects of the EU's trade regime.**[25] The Commission representatives emphasized the high priority the EU was giving to building a consensus for the launch of a new trade round at the upcoming WTO Ministerial Conference in Doha. The staff welcomed these efforts, particularly given the slowdown in the global economy, but expressed concern that the comprehensive agenda the EU advocated could complicate efforts to reach agreement on an agenda acceptable to others, particularly the developing countries. The authorities noted that the EU has developed its position in a number of areas, including investment, competition policy, and environment. They also noted the EU's greater emphasis on market access, both in agriculture and non-agricultural products; and its willingness to deal with implementation issues and areas of direct interest to developing countries such as antidumping.

41. **The EU had also taken significant steps to expand market access opportunities for least developed countries and assist their economic development.** As part of efforts to reorient unilateral preferences toward the poorest countries, the EU had adopted the

[25] See *Recent Developments in Trade Policies of the European Union* (SM/00/212, Supplement 2, October 13, 2000) for a description of the main features of EU trade policies. Changes to the trade regime since then pertain to trade preferences granted to developing countries as discussed above.

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Box 3: The Completion of the Changeover to the Euro

On January 1, 2002, the euro area will complete the changeover to the euro. Non-cash payments will thereafter be made only in euros, and euro notes and coins will be put into circulation. This will be a momentous event, considering that it involves advanced economies (with countless machines used for transactions), a population of over 300 million, and a new unit of account that bears no convenient decimal relation to the old one.

With the start of EMU on January 1, 1999, the euro assumed its role as the area's single currency in the foreign exchange market and was adopted for the money and capital markets. It also became available for non-cash transactions. While corporations with business across the area have increasingly used it, small and medium-sized enterprises, households, and public entities have so far done so only to a limited extent. To familiarize the public at large with the euro, prices and bank returns are already labeled in euros as well as in national currencies. Nevertheless, a survey conducted in May 2001 for the European Commission found that only one fifth of the population had used the euro and that at least one fourth had an imperfect understanding of the new currency. The authorities therefore plan increasingly intensive information campaigns for the rest of 2001.

Notes and coins will be introduced in several steps (for the national schedules, see this Box's Table 1). Financial institutions will start receiving them at some point in the last four months of 2001. The banks, in turn, will provide retailers with an early supply. The public at large will be able to obtain coins as of mid-December, mainly though banks and post offices. But it is not to have access to notes until January 1, 2002, on the argument that this is necessary to fight counterfeiting and other forms of fraud. The retail trade is expected to play a major role as a conduit to the public by giving change mostly in euros. To facilitate the transition, national notes and coins will continue to circulate for a brief period, but they may be converted into euros at the issuing national central banks (NCBs) even after they have ceased to be legal tender. Provisions have been adopted to facilitate the conversion into euros of euro-area national currencies held abroad.

The changeover is expected to be largely over within a few days. Still, the logistics will be formidable, not least because of the security problems raised by the frequent and massive transport of cash. Temporarily, the banks and the retail trade will have a sharply higher need for liquidity. To limit this burden, the banks will be debited by their respective NCBs in three equal installments in the course of January, while the banks will not debit retailers for the advance supply of cash until January 1. The availability of small-denomination notes is considered essential to avoid bottlenecks in retail payments. The banks have therefore largely agreed to load ATMs with such notes—national ones before January 1, and euro notes as of that date.

This scenario has been criticized for complicating the logistics by giving the retail trade a key role and for allowing for a period of dual circulation of euros and national notes and coins. Some fear that an initial shortage of small-denomination euro notes will cause bottlenecks in retail outlets and transportation, and they advocate giving the general public access to euro notes in the closing days of December. Sharing this view, the European Parliament adopted in July 2001 a Resolution in which it inter alia "urges the ECB to reconsider its position against the frontloading of small denomination euro notes to the general public."

What is the likely economic impact of the changeover (as distinct from the longer-term benefits of using a single unit of account in the euro area)? According to the European Commission (in its *Spring 2001 Forecasts for 2001-2002*), a small, temporary shift in consumption may be expected at the turn of the year. But, such a disturbance is unlikely to be perceptible at the macroeconomic level owing to the limited scope of cash payments. Another question is whether the changeover will be accompanied by a significant price increase, if only on account of an upward bias in the rounding of prices that the conversion into euros calls for. Consumers' vigilance, facilitated by dual pricing, and competition are expected to help avoid such a development.

Even after the changeover, transfers among euro-area countries will continue to cost more than within individual countries. In July 2001, the European Commission adopted a draft Regulation, which needs the approval of the Council of Ministers and the European Parliament, that would equalize the tariffs for intra-area transfers with those for transfers within countries. The banks object that this overlooks that costs arise because each country has a separate payments system.

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Box 3. Table 1. Elements of the National Cash Changeover Plans[1]

	Early supply to financial institutions	*Early supply to cash-in-transit (CIT) / retailers*	*Early supply of coins to public*	*End-date of legal tender*	*Exchange at banks after legal tender*	*Redemption after legal tender*[2]
Austria	Notes and coins: 9/1/2001	9/1/2001	12/17/2001	2/28/2002	To be decided individually by banks after 2/28/2002	Indefinitely
Belgium	Coins: 9/1/2001 Notes: from Nov. 2001	CIT: 9/1/2001 Retailers 12/1/2001	12/15/2001	2/28/2002	12/31/2002	Notes: indefinitely Coins: end-2004
Finland	Notes and coins: 9/1/2001	CIT, coins and notes: 9/1/2001 Retailers: beg. December 2001	12/15/2001	2/28/2002	To be decided individually by banks	Notes and coins: 10 years
France	Coins: 9/1/2001 Notes: 12/1/2001	CIT 9/1/2001 coins CIT (banknotes) and retailers: Dec. 2001	12/14/2001	2/17/2002 midnight	6/30/2002	Notes: 10 years Coins: 3 years
Germany	9/1/2001	9/1/2001	12/17/2001	12/31/2001[3]	At least until 2/28/2002	Indefinitely
Greece	10/1/2001	Notes: 12/1/2002 (€5, €10) Coins: 11/1/2001	12/17/2001	2/28/2002	Period to be defined	Notes: 10 years Coins: 2 years
Ireland	9/1/2001	Notes: 11/15/2001 Coins: earlier	12/17/2001	2/9/2002 midnight	Period not yet specified	Indefinitely
Italy	*Banks and post offices:* Notes: 11/15/2001 Coins: 9/1/2001	*Retailers:* Notes: 12/1/2001 Coins: 10/1/2001	12/15/2001	2/28/2002	Banks to exchange on a voluntary basis	10 years for notes and coins
Luxembourg	Banks and post offices: 9/1/2001	9/1/2001	12/15/2001	2/28/2002	6/30/2002	Notes: indefinitely Coins: end-2004
Netherlands	Notes and coins: 12/1/2001	Retailers: 12/17/2001. For training purposes, small quantities in October	12/14/2001	1/28/2002 midnight	12/31/2002 (banks may charge for the exchange as from 4/1/2002)	Notes: 1/1/2032 Coins: 1/1/2007
Portugal	Coins: 9/1/2001 Notes: 10/1/2001	Retailers: 12/1/2001	12/17/2001	2/28/2002	6/30/2002	Notes: 20 years Coins: end-2002
Spain	Coins: 9/1/2001 Notes: 9/1/2001	CIT and large retailers: 9/1/2001. Small retailers: 12/1/2001	12/15/2001	2/28/2002	6/30/2002	Indefinitely

Source: European Commission.
[1] Information as of June 26, 2001.
[2] At central banks.
[3] In line with the "Joint Declaration" the use of DM banknotes and coins is allowed at least until 2/28/2002 by the professional organizations, the retail trade and the financial institutions.

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"Everything-but-Arms" (EBA) decision providing duty- and quota-free access to the EU market for the exports of least-developed countries and taken steps to simplify and improve the EU's General System of Preferences (GSP).[26] Proposed revisions to the GSP maintain duty-free access for "non-sensitive" products and restore preference margins for "sensitive" products by reducing tariffs by 3.5 percentage points. The Commission was also in the process of revamping its delivery of trade-related technical assistance for capacity building to improve its effectiveness. These efforts were in part aimed to assist African-Caribbean-Pacific (ACP) countries in developing economic partnership agreements involving reciprocal free trade agreements (FTAs) as provided for in the Cotonou Agreement. The EU had also initiated negotiations of FTAs with MERCOSUR and Chile.

42. **While welcoming these steps, which could provide significant benefits to those eligible, the staff observed that they were no substitute for liberalization on a most-favored-nation basis.** Together with the continued expansion of the EU's network of free-trade agreements, these schemes had created considerable differences of treatment among those benefiting from preferences and others. To reduce incentives for trade diversion and for the EU market to derive maximum benefit from increased competition, they needed to be complemented by liberalization on a multilateral basis. In this regard, the staff noted the slow progress in liberalizing highly protected sectors such as agriculture, processed foods, textiles and clothing as well as continued significant antidumping activity. Opening up these sectors would provide significant benefits to the EU and enhance the trade and growth prospects of developing countries.

43. **The Commission representatives thought a new trade round provided the best prospect of making progress in these difficult areas.** But even outside a round, the EU had indicated a willingness to liberalize in areas such as textiles and clothing on a reciprocal basis. Attitudes were also changing regarding agriculture. The EBA and negotiations with MERCOSUR and Chile, where improved market access for agriculture was a priority, were exposing the costs of maintaining protection in a sector of declining importance. EU enlargement would also force eventual change. The staff was encouraged by these developments, but urged more rapid progress in liberalizing protected sectors, particularly agriculture. While implementation of Uruguay Round commitments and the first year of Agenda 2000 have shifted somewhat the composition of agricultural support away from the most trade-distorting instruments, market price support still accounts for more than three-fifths of total producer support and the EU remains by far the largest user of export subsidies.

[26] For three products (bananas, rice, and sugar), liberalization will be phased in over 6-8 year periods.

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These support policies continue to impose significant costs on the EU budget as well as trade partners and, without comprehensive reform, could delay EU enlargement (Box 4).[27]

I. Statistics

44. **The mission discussed at the ECB the status of ongoing efforts to enhance the statistical base for the area, in particular as laid out in the Action Plan for EMU Statistical Requirements.** Progress was reported on some methodological issues (concerning general government finance statistics and the balance of payments), but some high-frequency data needed for monetary policy making (namely, on labor costs and short-term cyclical indicators) remain inadequate. Information on the quarterly national accounts of euro-area members had improved. The mission noted that a fundamental hurdle was the decentralized approach followed by the EU in the statistical field, with implementation responsibilities mostly at the national level and varying degrees of technical capabilities across members. ECB officials noted that, in part because data for the euro area as a whole are by construction released with a lag compared to corresponding national statistics, German data are often considered by market participants proxies for area-wide aggregates, which can be highly misleading.

IV. Staff Appraisal

45. **Global shocks have sapped the recovery of the euro area and cloud immediate prospects.** The area's economic fundamentals are in many respects sound, however, and, given the macroeconomic policies in prospect, a gradual resumption of the recovery can be expected as these shocks fade. Hopes for a rapid resumption of strong growth and renewed declines in unemployment, however, would seem to hinge on a marked invigoration of structural policies, notably as regards the labor market.

46. **The shocks—the rise in energy prices, the correction in equity prices, especially for technology stocks, and the associated effects on trade—have been large and global.** The slowdowns in the euro area and the United States occurred in close tandem. Within the area, the shocks appear to have hit the most exposed first, including those with the weaker employment performances, but they have spread throughout the area.

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[27] Support to agriculture as measured by the OECD's Total Support Estimate averaged 115 billion euro annually in 1998-2000, compared to 100 billion euro in the base period (1986-88) for the Uruguay Round.

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Box 4. Agriculture and Agricultural Policy in the EU

The weight of agriculture in the EU's economy has continued to decline in recent years. In 1999, the latest year for which comprehensive information is available, the agricultural sector accounted for 1.8 percent of the EU's GDP and 4.5 percent of total employment. Agricultural products accounted for around 7 percent of both EU exports and imports in 1996-99, with agricultural trade yielding deficits in the range of U.S.$ 2–4 billion.

The regimes for the products covered by the CAP vary considerably but they generally share a number of characteristics. Minimum prices—mostly set at a level well above world market prices—are enforced by means of intervention purchases by public agencies and of border protection in the form of import duties and export subsidies. In addition, the production of milk and sugar is controlled by producer quotas. Artificially high prices have led to excess production, the build-up of stocks, and the export of surplus commodities. This in turn has adversely affected the EU's trade partners by depressing world commodity prices and deterring agricultural development and exports.

For many years, the EU has been engaged in a gradual reform of the CAP. The latest reform, adopted as part of the EU's *Agenda 2000*, provides for a cut in the level of support, with lower intervention prices for some major products, and for a further shift from production-related support to direct payments. It also increases the attention given to environmental issues, and sets rural development and job creation in the countryside as specific objectives to encourage a shift out of farming activity. A number of indicators, notably the sharp decline in some publicly-financed stocks, suggest that the reforms have had a favorable impact. However, it is hard to separate the impact of the reforms from the impact of the euro and of conditions on the world market, notably for cereals, which have recently been helpful to EU agriculture. Against that, BSE ("mad cow disease") has played havoc with the EU's market for beef and veal since 1996. While the situation had largely normalized by mid-2000, a new food scare later in the year again destabilized the market. In this light, the European Commission now expects the beef and veal market to remain unbalanced for a number of years.[1/]

Despite attempts at reform, agricultural protection has remained high. Agricultural support averaged the equivalent of 1.4 percent of GDP per year in 1998-2000, down from 2.6 percent of GDP in 1986-88, as measured by the OECD's *Total Support Estimate* (TSE)—total transfers to agricultural producers from consumers (including through border protection) and from tax payers.[2/] The EU appears open to further change. When it endorsed the current reform in 1999, the European Council invited the Commission to report in 2002 and, if necessary, to make new proposals. In addition to expenditure pressures, trade considerations are adding to the impetus for reform. As the EU has officially stated, it is ready to cut protection in tandem with similar measures by other countries in the ongoing WTO negotiations on agriculture. For the time being, however, the implementation of the current reform remains to be completed. Cuts in support to the dairy sector, for example, will not enter into force until 2005/2006. For sugar, the current regime has recently been extended until 2006, and no modifications have as yet been agreed. While the features of a future reform remain to be decided, it may well include a more clear-cut decoupling of direct aid from output, given the growing dissatisfaction with the present system whereby payments are generally based on the area available for crops and on the size of herds.

The EU's forthcoming enlargement presents another challenge for the CAP as many problems beset agriculture in the ten candidate countries in central and eastern Europe (CEECs). In these countries, agriculture has a much greater weight than in the EU (5.1 percent of GDP in 1999), with a high level of employment (22 percent of total) but low productivity. The land used for agriculture amounts to some 40 percent of that of the EU, but the labor force is 1.4 times as large. While the problems facing the agricultural sector vary among the CEECs, they are generally serious, with the infrastructure and the educational system often in urgent need of modernization and, in some countries, many holdings that are too small for modern farming. In the face of such problems, the CEECs have tended to support agriculture on a significant scale, including through border protection. However, as measured by the OECD's TSE for many of the CEECs, support, though still high, has generally declined in recent years.[3/]

1/ European Commission, Directorate-General for Agriculture, *Prospects for Agricultural Markets 2001-2008*, July 2001.

2/ Over the same period, Japan and the United States recorded TSEs equivalent to 1.6 percent and 1.0 percent of GDP respectively.

3/ See OECD, *Agricultural Policies in Emerging and Transition Economies, 2001*.

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47. **At the same time, however, the improvement in the overall performance of the euro area over the last few years suggests that the recovery that was underway had sound fundamentals, rooted in convergence, price stability, wage moderation, fiscal consolidation, and an element of structural reform.** There is nothing to suggest that these tendencies will not continue. Moreover, the differences in performance across the area suggest that these are attributable, in part, to differences in the duration of wage moderation and in the pace of labor market reforms. If so, the avenues for resuming a recovery leading to the achievement of the goals of the Lisbon summit are reasonably clear: deepen and accelerate structural and especially labor market reforms everywhere but especially in countries where adjustment is lagging; and stick to the medium-term virtues of wage moderation, price stability and fiscal consolidation, but in a way that dampens the transmission of shocks.

48. **The risks to price stability that emerged over the past two years are beginning to recede and monetary policy is properly reversing some of the tightening that rapid growth and especially supply shocks had triggered.** The main risk looking forward is wage behavior. It is one of the more remarkable features of the recent performance of the euro area that wage setting has remained moderate—in the face of at times quite buoyant labor markets and of a major exogenous acceleration in inflation. With headline inflation ebbing and activity slowing, the likelihood of this moderation being sustained has increased, and scope for further reductions in interest rates seems set to emerge, all the more so if the euro should begin to appreciate. Developments in M3 ("first pillar") appear to be broadly consistent with medium-term price stability, but could be erratic in the period to the changeover to the euro, and should not be given undue weight in policy assessments during this period. This is not going to comfort the credibility with markets of the ECB's two-pillar framework. The search for ways to reinforce market understanding of the application of the two pillars in policy formation needs to continue.

49. **In the fiscal domain, the Stability and Growth Pact (SGP) objective—balance or surplus in the medium term—must remain the fulcrum of the system.** It provides the right focus and all the necessary country and operational flexibility needed for a well-functioning fiscally decentralized monetary union.

50. **However, the implementation of that pact through Stability Programs that focus on annual nominal deficit targets has been unsatisfactory, especially for the larger countries.** Policies in these cases have been procyclical—exacerbating the upswing in 2000 and at risk of exacerbating the downswing this year and slowing the upswing next year. While the framework did not induce this behavior, it condoned it.

51. **Fiscal requirements going forward are thus on two levels—the countries and the framework.** With Maastricht's three-percent deficit limit not at risk even in the most vulnerable cases, countries' fiscal policies should allow full play to the automatic stabilizers. By the same token, countries should claw back non-cyclical slippages in budgets incurred this year and should carry through with existing commitments for undertaking structural fiscal adjustments next year.

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52. **At the framework level, considerations of macroeconomic and fiscal management and of surveillance and political accountability argue for moving toward a framework in which progress toward suitable medium-term balance targets is monitored on the basis of announced expenditure plans and given tax policies.** Such a framework, which is being practiced or elaborated in a number of EU countries, should be considered as an alternative to the present nominal fiscal balance focus of the framework.

53. **If fiscal policies need to become more cycle-friendly, structural policies need to become more growth-friendly.** Progress has been mixed. While full liberalization remains elusive in a number of sectors and countries, there have been measurable inroads toward more competitive product markets over the past few years. Labor market reforms have lagged, however. In most cases, little has been done to address the disincentives associated with the tax and benefit systems to seek and keep jobs. By the same token, the striking progress made by some countries on the basis of partial steps points to the major improvements in performance that could be unlocked if countries chose to be bolder. It can only be regretted that recent steps amount to treading water, with some of them in the wrong direction.

54. **Similarly, the integration of capital markets—surely one of the greatest potential benefits of EMU—remains impeded by the myriad of national regulations, and lack of harmonization in rules and standards.** The Lamfalussy Report recommendations aimed at streamlining the legislative process are a much welcome step, and it is hoped that the implementation of the Financial Services Action Plan proceeds in earnest. As regards financial crisis prevention and management, an increasingly integrated financial market poses new challenges for ensuring timely information flows among responsible authorities—an issue recognized in recent EFC reports. In particular, improving crisis management capacity may require a significant strengthening of existing information exchange and decision making mechanisms.

55. **Given its prominent role in the multilateral trading system, the EU should continue to accord high priority to reaching agreement on the scope of a new trade round in the run-up to the WTO Ministerial in Doha.** A new round would help contain protectionist pressures and provide a needed boost to global growth. While the general sentiment toward a round seems to have improved, substantive differences in the positions of key players still appear to be unresolved. Leadership and flexibility on the part of the EU will therefore be critical factors in achieving a consensus.

56. **After the welcome adoption of the "Everything-but-Arms" initiative, the EU recently took steps to simplify its General System of Preferences and to restore preference margins.** It has also continued to expand its network of reciprocal free-trade agreements with developing countries. These initiatives can improve market access for eligible countries, but they need to be complemented by multilateral liberalization to reduce trade diversion and improve the allocation of resources within the EU through increased international competition. In this regard, more rapid progress in liberalizing highly protected sectors (such as agriculture, processed foods, textiles and clothing) would provide significant

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benefits to the EU while enhancing the trade and growth prospects of developing countries, consistent with the provisions of the Maastricht Treaty regarding coherence of EU trade aid policies. Agriculture deserves particular mention in this context since high border protection and producer subsidies under the Common Agricultural Policy (CAP) continue to impose significant costs on trade partners by depressing world market prices and pre-empting markets. While reforms of the CAP under *Agenda 2000* are in the right direction, they still fall short of the comprehensive reforms needed to support the liberalization of agriculture and prepare for EU enlargement.

57. **The euro area's statistics need to be improved.** Notwithstanding significant progress in many areas including the standardized measurement of consumer prices, national accounts, and government finance statistics, significant lacunae remain, particularly in the areas of short-term cyclical indicators and the balance of payments statistics.

58. It is proposed that the **next consultation on the monetary and exchange rate policies of the euro-area countries** in the context of their Article IV obligations follow the standard 12-month cycle. An interim staff report will be issued for information of the Executive Board prior to the 2002 Spring Meetings.

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Euro Area: Main Economic Indicators

	1998	1999	2000	2001 1/	2002 1/
Real economy (change in percent)					
Real GDP	2.9	2.7	3.5	1.8	2.2
Domestic demand	3.8	3.3	3.0	1.3	2.1
Consumer prices (period average)	1.3	1.2	2.4	2.7	1.7
Unemployment rate (in percent)	10.8	9.9	8.8	8.4	8.4
Gross national saving (percent of GDP)	21.6	21.5	21.8	21.4	21.7
Gross domestic investment (percent of GDP)	20.6	21.1	21.9	21.2	21.2
Public finance (percent of GDP)					
Central government balance 2/	-2.4	-1.7	-0.4	-1.3	-1.3
General government balance 2/	-2.2	-1.3	0.2	-1.0	-1.0
General government structural balance	-1.3	-0.7	-0.7	-0.7	-0.4
General government debt	75.0	73.9	71.4	69.7	68.4
Balance of payments (percent of GDP)					
Trade balance 3/	2.0	1.5	0.9	1.3	1.5
Current account balance 3/	1.0	0.4	-0.1	0.3	0.4
Money and credit (end of year, percent change)					
M3	5.0	6.3	4.8	6.1 4/	...
Credit	9.2	9.9	10.0	7.8 4/	...
Interest rates (in percent)					
Short-term deposit rate	4.0	3.1	4.6	4.4	4.0
Long-term government bond yield	4.8	4.6	5.4	5.0	5.0
Exchange rates					
Exchange rate regime			Flexible exchange rate		
U.S. dollar per euro	1.11 5/	1.07	0.92	0.91 6/	...
Real effective rate (1990=100) 7/	89.1	84.9	76.0	75.8 8/	...
Nominal effective rate (1990=100)	90.8	86.7	78.5	79.6 8/	...

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

1/ WEO, September 2001.
2/ Including UMTS license receipts.
3/ Calculated as the sum of individual euro-area countries.
4/ June 2001.
5/ Synthetic euro.
6/ September 13, 2001.
7/ Based on normalized unit labor costs.
8/ January-July 2001 average.

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Euro Area: Balance of Payments.

	1997	1998	1999	2000	2001H1
			(In billions euro/ECU)		
Current account	61.5	31.1	-5.8	-34.7	-11.2
Goods	115.7	109.3	83.4	52.2	26.3
Services	3.1	-2.0	-11.8	-15.3	-2.3
Income	-15.2	-28.8	-32.4	-20.2	-17.3
Current transfers	-42.2	-47.4	-45.0	-51.4	-17.8
Capital account	13.0	12.4	13.5	10.4	6.5
Financial account	...	-61.2	19.1	6.8	4.5
Direct investment	-44.5	-83.2	-120.6	-22.8	-91.1
Portfolio investment	-24.3	-99.7	-41.7	-128.9	-6.5
Equity	...	0.4	-49.4	-273.3	63.8
Debt instruments	...	-100.1	7.7	144.4	-70.3
Financial derivatives	...	-7.5	8.1	-1.1	-3.3
Other investment	...	120.9	163.1	142.0	93.2
Reserve assets	...	8.2	10.2	17.5	12.1
Errors and omissions	...	17.8	-26.8	17.5	0.2
			(In percent of GDP)		
Current account	1.1	0.5	-0.1	-0.5	-0.3
Goods	2.0	1.9	1.4	0.8	0.8
Services	0.1	0.0	-0.2	-0.2	-0.1
Income	-0.3	-0.5	-0.5	-0.3	-0.5
Current transfers	-0.7	-0.8	-0.7	-0.8	-0.5
Capital account	0.2	0.2	0.2	0.2	0.2
Financial account	...	-1.0	0.3	0.1	0.1
Direct investment	-0.8	-1.4	-2.0	-0.4	-2.6
Portfolio investment	-0.4	-1.7	-0.7	-2.0	-0.2
Equity	...	0.0	-0.8	-4.2	1.8
Debt instruments	...	-1.7	0.1	2.2	-2.0
Financial derivatives	...	-0.1	0.1	0.0	-0.1
Other investment	...	2.1	2.7	2.2	2.7
Reserve assets	...	0.1	0.2	0.3	0.3
Errors and omissions	...	0.3	-0.4	0.3	0.0
Memorandum items:					
GDP (billions euro/ECU)	5,650	5,884	6,142	6,432	3,458
Reserves of the Eurosystem 1/ (billions of euro)	...	329.2	372.3	377.7	385.0

Source: August 2001, ECB Monthly Bulletin and August 23, 2001 statistical press release.
1/ End of period stocks. The 1998 figure is as of January 1, 1999.

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Euro Area: Indicators of External and Financial Vulnerability

	1997	1998	1999	2000	2001
External Indicators					
Broad money to Central Bank's reserves ratio (end-of-period) 1/	...	13.6	12.8	13.3	13.0
Central bank foreign liabilities (in billions of U.S. dollars) 2/ 3/	...	29.8	98.2	62.8	25.6
Foreign assets of the financial sector (in billions of U.S. dollars) 2/ 3/	...	1,839.9	1,782.5	1,754.5	1,974.5
Foreign liabilities of the financial sector (in billions of U.S. dollars) 2/ 3/	...	1,672.2	1,817.2	1,891.9	2,224.2
Official reserves in months of imports 4/	...	5.9	6.1	4.9	5.0
Exchange rate against U.S. dollar (period average) 3/	1.13	1.12	1.07	0.92	0.90
Financial Markets Indicators					
Change in stock market index (percent, end of period) 5/ 6/	37.0	29.8	39.5	-5.9	-10.4
Short-term interest rate differential between US and the euro area 7/	1.5	1.7	2.5	2.1	0.5
Financial Sector Risk Indicators 8/					
Foreign exchange loans (in billions of U.S. dollars) 9/ 10/	...	1,425.6	1,502.3	1,448.8	1,623.2
Net foreign exchange loans (in billions of U.S. dollars) 10/ 11/	...	-185.5	-250.5	-283.5	-357.1
Share of foreign exchange loans in total lending (percent)	...	12.0	12.1	12.6	13.5
Deposits in foreign exchange (in billions of U.S. dollars) 10/ 12/	...	1,611.0	1,752.8	1,732.4	1,980.3
Share of foreign deposits in total deposits (percent)	...	14.7	15.6	16.9	18.5
Share of foreign denominated liabilities in total liabilities (percent) 13/	...	12.8	13.5	14.7	16.0
Share of real estate sector in loans to private sector (percent) 14/	...	29.3	30.8	30.8	30.5
Share of real estate sector in loans to nonfinancial private sector (percent) 14/	...	31.1	32.9	33.1	32.9

Sources: ECB; European Commission; STOXX Limited.

1/ Data for 2001 refer to June 2001.
2/ Annual-average data.
3/ Data for 2001 refer to the average for the period January-June 2001.
4/ Calculated as: official reserves end-of-period positions / monthly average of imports. Data for 2001: official reserves refer to end-June 2001; imports refer to the period January-June 2001.
5/ Dow Jones EURO STOXX index.
6/ Data for 2001 refer to percentage change from December 2000 to June 2001.
7/ Three-month LIBOR rates were used for the United States; for the euro area, up to December 1998, annual average of national three-month LIBOR. Annual averages of the three-month euro interbank offered rates (EURIBOR) thereafter.
8/ Financial sector is defined as the Monetary and Financial Institutions (MFI) sector excluding the Eurosystem.
9/ MFI Loans (excluding Eurosystem) granted to MFIs and non MFIs of the euro area and to non-euro area residents denominated in non-MU currencies.
10/ Data for 2001 refer to Q2 2001, all figures are end-of-period-figures.
11/ Foreign exchange loans minus foreign exchange deposits.
12/ Deposits in MFIs (excluding the Eurosystem) placed by MFIs and non MFIs of the euro area and by non-euro area residents denominated in non-MU currencies.
13/ Total liabilities are defined for this purpose as currency in circulation, total deposits, money market fund shares/units money market paper, debt securities issued and capital and reserves.
14/ Real estate sector is define here as loans granted to households for house purchases.

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The ROSC for the Euro Area

At the request of the Eurosystem authorities—and in the context of the IMF's surveillance of financial sector issues—the staff has assessed observance of the monetary policy section of the *Code of Good Practices on Transparency in Monetary and Financial Policies*, as well as the transparency of financial policies for payment systems oversight in the euro area. The staff has also assessed the observance of the *Core Principles for Systemically Important Payment Systems* in the operation the euro area's two main payment systems, the Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET) and EURO1. The major findings of this exercise, detailed in a companion Report on the Observance of Standards (ROSC), are outlined below.

Transparency of Monetary Policy. The Eurosystem maintains a high level of transparency (as defined in the *Code*) in all aspects of its operations. Since its establishment, the European Central Bank (ECB) has provided extensive written documentation of its policies, procedures, and practices. The ECB has also pursued an extensive public relation program, providing ready access to public officials by the media, as well as maintaining contacts with market participants and the public at large. However, in the staff's assessment, some improvements could be made regarding several functions that remain in the purview of National Central Banks (NCBs), where disclosure practices vary (including as regards the terms of government deposits, participation in government securities markets, practices for emergency financial support, internal governance procedures, and standards of conduct for employees). Greater disclosure by some NCBs would strengthen the transparency of the Eurosystem as a whole. In addition, in the staff's view the allocation of responsibility for foreign exchange policy, as defined in the Treaty, could usefully be clarified—a point disputed by ECB officials.

Transparency of Payment System Policy. The ECB maintains a high level of transparency in payment systems policy. In the staff's assessment, a commitment to consult a wider range of potentially interested parties on proposed technical, regulatory, and policy changes would strengthen the system. The Eurosystem authorities, while noting that there is a presumption in favor of consultation of the public at large, did not see a compelling case for departing from current practices that they regarded as sufficiently flexible.

Observance of the Core Principles for Systemically Important Payment Systems. TARGET broadly meets the Core Principles and has proven effective in transferring funds throughout the EU, thereby contributing from the start to a smooth implementation of monetary policy within the euro area. Nonetheless, the staff's assessment points to opportunities for further improvements in operational reliability, risk assessment, consultation procedures, efficiency, and governance to ensure full adherence to the Core Principles. In those areas, the staff identified specific steps that could be taken and are discussed in detail in the ROSC. The EURO1 system is fully observant of the Core Principles. The staff identified possible improvements in one area, related to the reliability and security for ongoing EURO1 operations.

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Monetary and Exchange Rate Policies of the Euro Area

Supplementary Information

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

Prepared by the European I Department

Approved by Michael Deppler

October 17, 2001

1. This supplement reports on information on **economic and financial developments in the euro area** that has become available since the issuance of the staff report on the area's monetary and exchange policies (SM/01/289) to the Executive Board. In particular, the supplement addresses the implications for prospects and policies of these developments and the events of September 11. The new information does not alter the broad thrust of the staff appraisal.

2. Recent data on the pace of **real economic activity**, which mostly reflect developments prior to the events of September 11, suggest that growth in the third and fourth quarters of 2001 is likely to be more sluggish than projected in the staff report:

- In July-August, industrial production declined by ¼ percent (y-o-y), reflecting a further broad-based weakening of activity across almost all industrial sectors and countries. In September, the European Commission's industrial confidence indicator again edged lower, with particularly pronounced declines in Germany and France. And Reuters' Purchasing Managers' Indices (PMI) for September also pointed to a further weakening of activity in the area's manufacturing and the service sectors.

- Recent trade data continued to underscore the global dimension of the area's slowdown. Extra-area exports and imports of goods in July were broadly unchanged compared to June and have been flat since the beginning of the year (in nominal terms), following extra-area nominal and real growth rates for good exports of 21 percent and 11 percent, respectively, in 2000.

- The gradual decline in the area's unemployment rate appears to have bottomed out at 8¼ percent in July (from a peak rate of 11½ percent in 1998). Consumer confidence softened further in September but remains above its average during the 1990s.

3. In line with the staff report's projections, the **headline CPI inflation rate** in September dropped to 2.5 percent, down from to 2.7 percent in August and a peak headline inflation rate of 3.4 percent in May. Foreshadowing a further downward trend in headline

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inflation, producer prices only rose by 1.7 percent in August (y-o-y), mainly due to diminished pressures on energy and intermediate goods prices. Finally, area-wide hourly labor cost increases have continued to remain moderate (2.7 percent in 2001 Q2).

4. In concert with the U.S. Federal Reserve and other central banks, the **ECB cut its refinancing rate by 50 basis points** on September 17 (Figure 1). The ECB also acted to support the normal functioning of financial markets by providing extra-liquidity to the euro money market and meeting urgent U.S. dollar liquidity needs of European banks by conducting foreign exchange swaps. In commenting on the decision to cut policy rates, the ECB's Governing Council noted that the terrorist events "… have increased uncertainty about the U.S. and the world economy" and are "likely to weigh on confidence in the euro area and on the short-term outlook for economic growth." Against this background, the ECB's second-pillar assessment of inflation dynamics suggests that slower growth is likely to further reduce inflationary risks in the euro area. As regards the first-pillar assessment, growth in M3 has been trending upward sharply in recent months (from 5.2 percent in May to 6.7 percent in August) and remains significantly above the ECB's reference value of 4.5 percent. However, the ECB has noted that recent M3 growth figures in excess of its reference value need to be interpreted with considerable caution in view of continued measurement problems and possibly significant portfolio shifts linked to a relatively flat yield curve and increased uncertainty in equity markets.

5. **Financial market developments** in the euro area since September 11 have largely mirrored developments in the United States (Figure 1). Euro-area equities—already in a headlong retreat over the summer—plummeted in tandem with U.S. markets (by 10-15 percent). However, more recently, equity markets have staged a strong recovery, regaining the ground lost in the aftermath of September 11, but market uncertainty—as measured by implied stock market volatility—remains high. In government bond markets, long-term yields eased somewhat after September 11, but yield curve slopes have steepened more recently in response to cuts in short-term policy rates. Spreads of euro-area corporate bonds over government bond yields for some sectors including the high-tech sector have increased significantly as markets re-priced risk in an environment of heightened uncertainty. The euro had gradually strengthened against the U.S. dollar in the month prior to the terrorist attacks, a trend matched by evidence from "risk reversal quotes" based on option markets that pointed to an increased probability for a large euro appreciation. Following September 11, the euro first appreciated somewhat further but has since stabilized at about U.S. dollar 0.90 per euro.

6. **On balance, new information on slower-than-projected real activity and the likely effects of the events of September 11 both point toward diminished near-term growth prospects for the euro area.** The downward revisions due to indications of slower-than-projected growth before the September 11 events mainly impact on the third and fourth quarters of the current year. While these revisions have a small effect on annual GDP growth in 2001, the carryover effect alone is estimated to reduce annual growth in 2002 by ¼ percentage points. In the staff's preliminary revision to its growth projections, the rebound is now projected to reach above potential rates only in the second half of 2002 (as opposed to the first half of 2002 in the staff report) as both domestic and external demand are sapped by

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the economic fallout from the September 11 events. The assessment of these adverse spillovers via confidence, trade, and financial linkage effects is subject to substantial margins of uncertainty as regards both timing and strength.[1] The mainsprings of the rebound remain otherwise as before, namely a pickup in real personal income against the background of good fundamentals and an improved external environment. At the same time, risks to the area's medium-term price stability are receding both on the external side and on the domestic side, as the likelihood for continued wage moderation in 2002 and beyond has increased.

7. More specifically, in the context of the ongoing staff revisions to the economic outlook, and based on the preliminary assumptions,[2] area-wide real GDP is now expected to grow by 1.7 percent in 2001 and by 1.6 percent in 2002, compared to 1.8 percent and 2.2 percent, respectively, in SM/01/289 (Table 1).[3] These revisions for the euro area reflect both a top-down and a bottom-up (country-by-country) approach and are broadly in line with the most recent (post-September 11) *Consensus Forecasts*. Reflecting the lower growth prospects, the area's output gap is now projected to widen to about 2 percent in 2002 (compared to an output gap of 1¼ percent in SM/01/289), while the unemployment rate is projected to rise to 8.6 percent (compared to 8.4 percent previously). Headline CPI inflation is projected to ease in response to lower oil prices and slower growth to 1.5 percent in 2002 (compared with 1.7 percent in SM/01/289).

8. Although significant, the revisions to growth are not such as to warrant a different assessment of **fiscal requirements in 2002.** In all countries, including those that have not yet achieved positions close to balance or in surplus, automatic stabilizers should operate freely on the revenue side, while public spending should stick broadly to original plans consistent with the medium-term orientation of the SGP. In light of the projected rebound by mid-2002, discretionary countercyclical action in the upcoming 2002 budgets would not seem to be

[1] Staff work based on the IMF's econometric model of the world economy (MULTIMOD) suggests that "spillover coefficients" (defined as the percentage point reduction in euro-area growth given a 1 percentage point reduction in U.S. growth) can range from 0.1 to 0.7 depending on the nature of the shock and the transmission channels (see Chapter III of IMF Country Report No. 01/149 for the United States).

[2] Key assumptions underlying these revised projections include: (i) a downward revision in near-term GDP growth prospects for the United States relative to the published WEO; (ii) a new baseline for oil prices (US$21 per barrel in 2002, or US$3.5 less than in the published WEO); (iii) a new baseline path for nominal short-term interest rates (based on revised market expectations); and (iv) a constant real exchange rate consistent with an underlying nominal U.S. dollar/euro rate of 0.91 during 2002.

[3] Weighted averages of data for individual euro-area countries valued at purchasing power parities (PPP). Using Eurostat aggregation weights, which are based on 1995 ECU conversion rates, growth rates would be slightly lower (by about 0.1 percentage points).

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appropriate, except in countries that already enjoy strong underlying fiscal positions. Fiscal developments for the area as a whole are expected to remain broadly in line with these requirements. The area's overall fiscal deficit in 2002 is projected to reach 1.4 percent of GDP in 2002 (compared to 1 percent of GDP in SM/01/289), but this reflects the operation of automatic fiscal stabilizers (Table 2). In cyclically-adjusted terms, the area's revised deficits edge down from 0.8 percent of GDP in 2001 to 0.6 percent in 2002, i.e. are broadly neutral but with a slightly contractionary cast. Country developments differ, however. Despite its weak growth performance, Germany is on present plans projected to adopt a contractionary stance, in line with its Stability Program consolidation targets, while in France the draft budget and other measures being considered imply some discretionary easing. Italy's overall fiscal stance (excluding real estate asset sales) is projected to be broadly neutral. Nevertheless, Italy's nominal primary spending growth in 2002 is estimated to exceed by a significant margin the previous projection in the staff report and staff's estimate of primary spending growth in the Stability Program.[4] The smaller countries, some of which have the scope for discretionary action, are expected to take a neutral to cautious stance.

9. The area's broadly neutral overall fiscal stance provides a supportive backdrop for assessing **monetary requirements.** With the 50 basis point interest rate cut of September 17, the ECB properly accelerated (under exceptional circumstances) interest rate changes that had been in the offing and expected by markets before the events of September 11. Markets are currently pricing in interest rate reductions of a similar magnitude over the next three quarters, reflecting inter alia the weakened growth outlook, and the staff's revised projections embed these market expectations. The revised projections point to headline inflation decelerating further (to 1½ percent) and hence to continuing scope for monetary easing. This scope would widen if the euro were to appreciate. The main uncertainty in the inflation outlook is still wage behavior, which so far has remained benign.

[4] Recent fiscal developments in Germany, France, and Italy are discussed in more detail in separate updates of the Article IV staff reports for these countries.

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Table 1. Revisions to Macroeconomic Projections in Euro Area Staff Report (SM/01/289)

		Current Projections		Difference from SM/01/289	
	2000	2001	2002	2001	2002
Real economy (change in percent)					
Real GDP	3.5	1.7	1.6	-0.1	-0.6
Domestic demand	3.0	1.2	1.8	0.0	-0.3
Unemployment rate (in percent)	8.8	8.4	8.6	0.0	0.2
Consumer prices (period average)	2.4	2.7	1.5	0.0	-0.2
Memorandum items:					
Oil price (U.S. dollars per barrel)	28.2	25.0	21.0	-1.8	-3.5
LIBOR on euro deposits (in percent)	4.6	4.0	3.3	-0.4	-0.7
Real GDP (Eurostat weights) 1/	3.4	1.6	1.5	0.0	-0.6

Sources: October 2001 WEO; SM/01/289; and staff estimates and projections.

1/ Eurostat aggregation weights for euro area GDP based on 1995 ECU conversion rates.

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Table 2. Fiscal Projections in the Euro Area[1]
(In percent of GDP)

	2000	Current Projections 2001	2002
Euro Area			
General government balance	-0.8	-1.1	-1.4
General government structural balance	-0.7	-0.8	-0.6
Primary nominal spending growth	3.4	...	...
Germany			
General government balance	-1.3	-2.2	-2
General government structural balance	-1.1	-1.4	-¾
Primary nominal spending growth	1.8	1.7	-3¼
France			
General government balance	-1.4	-1.5	-2
General government structural balance	-1.1	-1.2	-1¼
Primary nominal spending growth	2.6	3.4	4
Italy			
General government balance[2]	-1.5	-1.4	-1½
General government structural balance[2]	-0.7	-0.6	-¾
Primary nominal spending growth	3.0	5.7	4
Other Euro Area Countries			
General government balance	0.4	0.1	-¼
General government structural balance	-0.1	0.0	¼
Primary nominal spending growth	5.7	...	...

Sources: WEO and staff estimates and projections.

[1]Excluding UMTS receipts.
[2]Excluding real estate sale revenue in 2001 and 2002.

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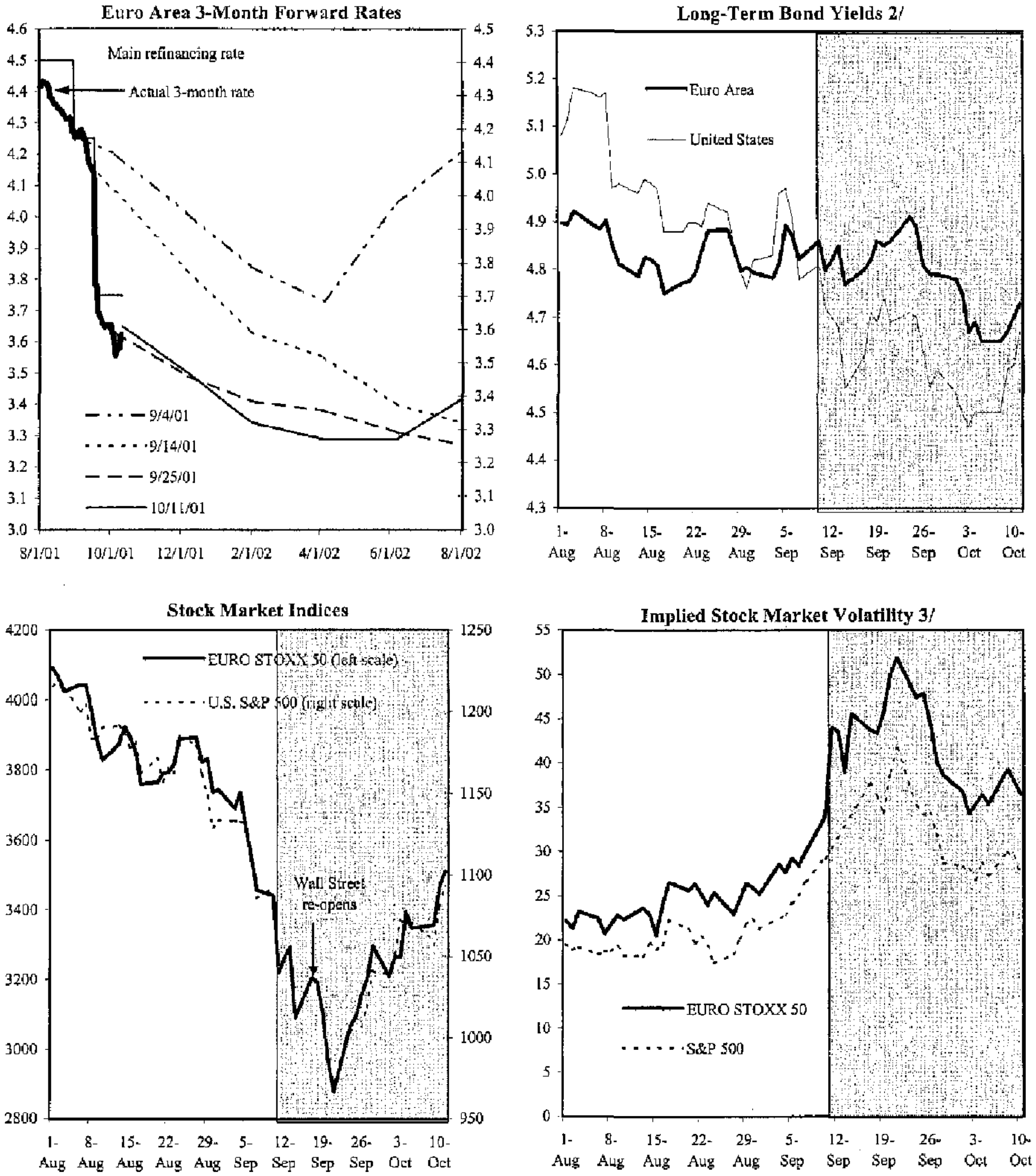
Figure 1. Euro Area: Financial Market Indicators 1/



Sources: Bloomberg; IMF; and staff estimates.

1/ Shaded areas represent post-September 11 period.

2/ 10-year government bond yields.

3/ Implied volatility has been extracted from the options market. It reflects market participants' expectation of the future volatility of the underlying asset (equities).

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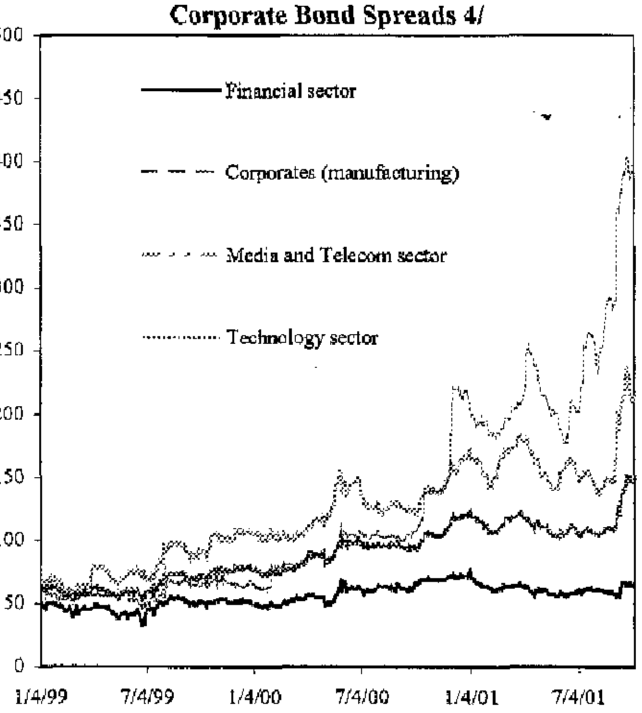
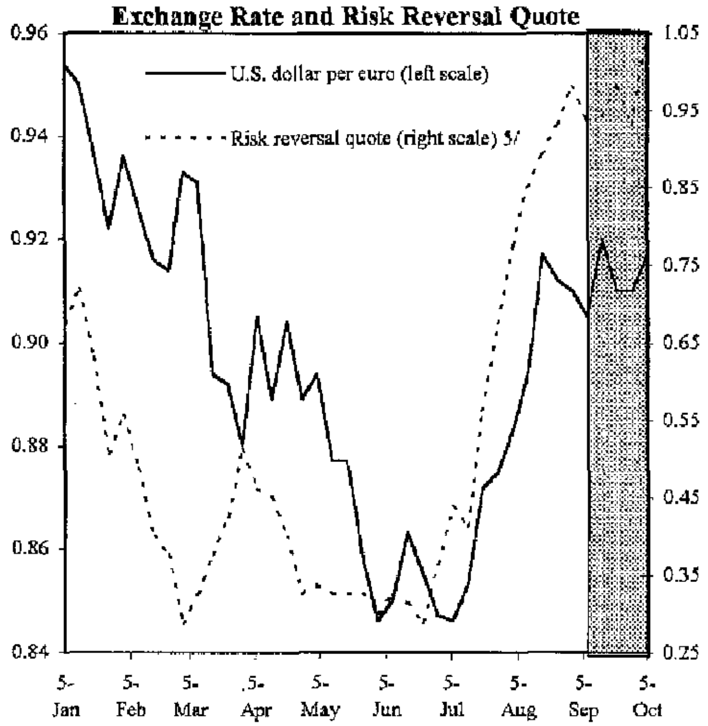
Figure 1. Euro Area: Financial Market Indicators (continued) 1/





Sources: Bloomberg; IMF; and staff estimates.

1/ Shaded areas represent post-September 11 period.

4/ Corporate bond spreads are calculated as the difference between the 10-year yield of individual sector bonds and the euro area.

5/ A positive risk reversal quote from the options markets indicates that a higher probability is attached to a large euro appreciation than to a large euro depreciation in the medium-term.

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Washington, D. C. 20431 USA

IMF Executive Board Discusses the Monetary and Exchange Rate Policies of the Euro Area and the Trade Policies of the European Union

On October 19, 2001, the Executive Board concluded the discussion of the monetary and exchange rate policies of the euro area and the trade policies of the European Union. The background section of this PIN reflects information available at the time of the Executive Board meeting.[1]

Background

Under a cumulation of adverse supply and demand shocks, the euro area's three-year old economic upswing came to a virtual standstill in the second quarter of 2001. Higher oil prices, a weakening euro, animal diseases, and bad weather propelled headline HICP inflation to 3.4 percent in May 2001, undermining purchasing power and consumer demand. In addition, a marked downward correction in global equity prices (particularly in the technology sector) and faltering business confidence have dampened business investment since the last quarter of 2000. With a deteriorating external environment, the area's export growth came to a halt in the first half of 2001. Cyclical indicators reflecting developments in the third quarter of 2001, including after the events of September 11, suggest that area-wide growth is likely to have weakened further.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. In the present case, Fund staff held discussions with European Union institutions, including the European Central Bank, in the context of the Article IV consultations with the euro area's member states. 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 the summary is transmitted to the country's authorities. This PIN outlines these views as expressed during the October 19, 2001 Executive Board meeting. The ECB's observer at the Fund participated in that meeting.

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With softening activity, headline HICP inflation has declined to 2½ percent in September, mostly as a result of falling oil and food prices. In spite of core inflation cresting at 2¼ percent in early summer, wage moderation has continued to prevail across the area.

The external value of the euro has been broadly stable, and it remains weak bilaterally vis-à-vis the U.S. dollar and in real effective terms. The area's current account has deteriorated from a surplus of about 1½ percent of GDP in 1997 to approximate balance in 2000, reflecting not only the sharp rise in energy prices but also a low response of trade flows to the sustained real exchange rate depreciation since 1996.

After raising interest rates by a total of 175 basis points during 2000, the European Central Bank (ECB) reversed some of this tightening in May and August (by 25 basis points each time). A further 50 basis points cut was announced by the ECB's Governing Council on September 17, in concert with the U.S. Federal Reserve and other central banks. Over the last few years, fiscal policy in the area as a whole has shifted away from an earlier more restrictive stance, indeed turning expansionary in some countries in 2000 against a background of faster-than-projected growth. In 2001, fiscal policy for the area as a whole is anticipated to be broadly neutral.

In the latest staff's estimates—which are subject to an unusually large margin of uncertainty—the euro area's real GDP is projected to grow by 1.7 percent in 2001 and 1.6 percent in 2002. The area's cyclical rebound is expected to take place in the second half of 2002, as both domestic and external demand start recovering from the economic fallout from the September 11 events. Headline inflation is currently expected to average about 2¾ percent in 2001 and ease back to about 1½ percent in 2002.

Executive Board Assessment

Executive Directors noted that, in the face of large and global disturbances–including the earlier rise in energy prices, the downward correction in equity markets, and the marked slowdown in world trade growth–the euro area's expansion has proven less resilient than anticipated. Against this already sluggish background, the economic repercussions of the events of September 11 will likely dampen near-term growth prospects yet further. Nonetheless, Directors considered the area's macroeconomic fundamentals to be sound, with low underlying inflation and much strengthened fiscal positions providing a base for a new cyclical upswing on the back of supportive policies.

Directors noted that the area's cyclical setback should not detract from the considerable macroeconomic achievements of the last few years rooted in price stability, employment-friendly wage setting, fiscal consolidation, and a measure of structural reform. These elements have provided the basis for faster income growth and job creation, especially in those countries that have implemented labor market reforms and sustained wage moderation. Structural rigidities remain pronounced, however, and Directors urged that reform efforts be stepped up across the area, especially in countries where labor market reforms have been lagging in recent years. More broadly, they highlighted the positive impact that growth-supportive macroeconomic and

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structural policies by the euro-area countries would have on global economic prospects at the present juncture.

Turning to monetary policy, Directors noted that risks to price stability are receding, and that the European Central Bank (ECB) has properly reversed a significant portion of the monetary tightening it undertook in 2000. Directors commended the swift action by the ECB, in concert with the U.S. Federal Reserve and other central banks, to shore up confidence and provide sufficient liquidity to the banking system in the aftermath of the events of September 11.

Looking ahead, Directors expected risks to price stability to diminish further, particularly as weaker growth prospects and abating price pressures have increased the likelihood for continued wage moderation in 2002. They noted that the recent growth in M3 in excess of the ECB's reference value appears to some extent to reflect temporary velocity shocks related, inter alia, to portfolio shifts, and should therefore not be given undue weight in policy assessments. A number of Directors encouraged the authorities to continue their efforts to improve market understanding of the policy framework underlying the ECB's monetary decisions.

Against this background, Directors saw room for further monetary policy easing, particularly if the euro appreciates, with some of them favoring early easing to further tip the scales in favor of a firmly grounded recovery in the course of 2002.

In discussing the factors responsible for the weakness of the euro's external value, many Directors noted the role played by the much steeper rise of stock market capitalization in the United States than in the euro area, the ongoing international diversification by euro-area investors, and the increased issuance by non-residents of euro-denominated liabilities.

On fiscal policy, Directors strongly endorsed the objective embedded in the Stability and Growth Pact (SGP) that member countries reach and maintain budgetary positions close to balance or in surplus over the medium term. In their view, this objective provides an anchor for assuring fiscal discipline while allowing for budget outcomes to vary over the cycle and across countries, as required for a well-functioning monetary union with a high degree of fiscal decentralization.

In considering how this might best be achieved, Directors discussed the merits of a framework that would combine the free play of automatic stabilizers with adherence to preannounced expenditure paths. In the view of a number of Directors, a key advantage of this approach would be to safeguard the medium-term orientation of the SGP while providing a stabilizing framework for monitoring each member state's position relative to its medium-term deficit objective. In contrast, focusing on meeting annual nominal deficit targets would, in the face of the global slowdown, require offsetting the operation of the automatic stabilizers, thus delaying the projected recovery. Other Directors, however, considered that reference to expenditure paths could usefully support the achievement of medium-term SGP objectives, but should not replace nominal deficit targets.

Directors welcomed recent indications that, albeit with variations across countries, fiscal developments for the area as a whole broadly appear to strike an appropriate balance between

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cyclical considerations and medium-term consolidation objectives. Most Directors agreed that, especially in light of the present generalized slowdown, the automatic stabilizers should be allowed to work. Directors generally did not see the need for significant discretionary fiscal policy actions to counteract the growth slowdown at this point, in view of the likely temporary nature of the adverse shocks and the effects such actions would have on fiscal positions.

Directors underscored the key role that resolute and broad-based structural reforms would play in raising the area's growth potential and rebuilding confidence. They welcomed the recent progress made toward more competitive product markets. Directors looked forward to further steps in areas such as public procurement, state aid, administrative reforms, and the reduction of the regulatory burden on business. Directors regretted that relatively little has been done to address the work disincentives associated with tax and social benefits systems in many euro area countries, or to free up labor markets, including through more flexible wage formation processes. Referring to the progress made by some countries on the basis of partial steps, Directors urged the authorities to aim for the major improvements in economic performance that should accrue from a more vigorous implementation of labor market reforms. Some Directors considered that a renewed effort toward structural reforms, aimed at enhancing the area's productivity growth rate, could also contribute to a stronger euro over time.

Directors expressed their appreciation for the intensive preparations to ensure a smooth changeover to the euro banknotes and coins, and welcomed assurances that the changeover would not lead to an increase in prices. They looked forward to a successful completion of this reform of unprecedented scope, which should result in greater price transparency and enhanced competition.

Referring to the integration of capital markets as one of the greatest potential benefits of the EMU, Directors expressed the hope that the Lamfalussy Report's recommendations for streamlining the legislative process would soon come into play, and encouraged the authorities to speed up implementation of the Financial Services Action Plan. Noting that integrated capital markets pose new challenges to financial crisis prevention and management, they highlighted the need for a significant strengthening of information exchange among supervisors and of their decision-making processes.

Directors considered that further improvements in the availability, timeliness, and quality of euro-area statistics would be highly desirable, particularly in the areas of short-term cyclical indicators and balance of payments statistics, and they urged the authorities to continue efforts in these areas.

Directors welcomed the completion of three Reports on Standards and Codes (ROSCs) for the euro area (covering payments systems issues, and the transparency of monetary policy and payments system oversight) and expressed broad agreement with their findings.

It is expected that the next consideration by the Executive Board of the monetary and exchange rate policies of the euro-area countries in the context of their Article IV obligations will be based on the standard 12-month cycle. An interim staff report will be issued for the information of the

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Executive Board to provide adequate context for bilateral consultations with euro-area countries prior to the 2002 Spring Meetings.

As regards the trade policies of the European Union (EU) as a whole, Directors expressed their conviction that a new trade round would provide a much needed boost to global growth prospects, and urged the EU to continue to accord high priority to reaching agreement on the scope of such a round, and to show leadership and flexibility as a means of furthering the negotiations. They welcomed the EU's "Everything-but-Arms" initiative for the least developed countries, and the proposed steps to simplify the EU's General System of Preferences. While these initiatives will be helpful in improving market access for eligible countries, Directors emphasized that more rapid progress in opening highly protected sectors to all trading partners would not only benefit developing countries, but also entail significant gains for the EU itself. In this regard, they highlighted the essential contribution that a comprehensive reform of the EU's Common Agricultural Policy would make both to support trade liberalization and to prepare for EU enlargement.

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.

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Euro Area: Selected Economic Indicators

	1996	1997	1998	1999	2000	2001[1]
			In percent			
Real Economy						
Change in real GDP	1.5	2.4	2.9	2.7	3.5	1.7
Change domestic demand	1.1	2.0	3.8	3.3	3.0	1.2
Change in consumer prices [2]	2.3	1.6	1.2	1.1	2.4	2.7
Unemployment rate [3]	11.4	11.4	10.8	9.9	8.8	8.4
			In percent of GDP			
Public Finance						
General government balance	-4.4	-2.7	-2.2	-1.3	-0.8	-1.1[4]
Public debt	77.7	76.9	75.0	73.9	71.4	69.7
			In percent			
Money and Interest Rates						
Change in M3 (end of year)[2]	3.9	4.2	5.0	6.3	4.8	6.4[5]
Money market rate (3 month money)	4.7	4.2	4.0	3.1	4.6	3.6[6]
Government bond yield (10 year bonds)	7.2	5.9	4.8	4.6	5.4	4.7[6]
			In percent of GDP			
Balance of Payments						
Trade balance	2.0	2.2	2.0	1.5	0.9	1.3
Current account	1.1	1.6	1.0	0.4	-0.1	0.2
Official reserves (US$ billion)				257.1	242.6	238.6[7]
			In percent			
Exchange Rates						
Nominal effective rate	0.1	-8.8	-0.1	-4.5	-9.4	2.3[8]
Real effective rate	0.6	-9.9	-3.2	-4.8	-10.5	0.6[8]

Sources: IMF staff and European Central Bank. Except for M3 and official reserves, aggregates are based on WEO PPP-weights rather than Eurostat's ECU-based weights.

[1] IMF Staff projections.

[2] Harmonized definition.

[3] In percent of labor force.

[4] Data do not include mobile telephone license receipts.

[5] August 2001, 3-month moving average of year-on-year percent changes.

[6] October 11, 2001.

[7] Total reserves minus gold (Eurosystem definition); end September.

[8] September 2001 relative to 2000 average.

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Statement by Willy Kiekens on Monetary and Exchange Rate Policies of the Euro Area October 19, 2001

Belgium presently holds the Presidency of the European Council. My statement expresses the common views of the Euro-area Member States and of the European Community/EMU in their respective fields of competence.

The staff assessment of economic developments and prospects in the euro area is overall well balanced. Many of the essential policy conclusions are broadly appropriate. However, the assessment of the prospects and the policy conclusions must be updated in the light of significant changes in the economic environment in recent weeks.

Assessment of short-term economic prospects

The economic situation and prospects in the euro area are now considerably weaker than expected a couple of months ago. Both the global nature and the strength of slowdown have been underestimated whilst the resilience to external shocks may have been overestimated. A gradual resumption of the recovery in the euro area, based on sound fundamentals, could be expected once the external shocks wane. However, the events of 11 September added to the already fragile economic situation. Rather than modifying the underlying reasoning, the implications are that the short-term growth prospects have dimmed further. Economic growth in the euro area seems now likely to be well below 2 % in 2001 and a bottoming out of the slowdown before the end of the year seems unlikely.

While there are clearly substantial uncertainties about unfolding events, one should not overlook that the economic fundamentals in many countries have in many respects improved in recent years, and that this leaves the world somewhat less vulnerable than it might otherwise be as was pointed out by the IMF's Economic Counsellor at a recent press conference.

The euro area maintains solid fundamentals. Thanks to the considerable improvement in the macroeconomic setting, including progress in fiscal consolidation, and to the ongoing process of structural reforms the euro-area economy is now in a better shape to deal with cyclical fluctuations. In addition, the progressive deceleration in inflation and in inflation expectations, recent tax reductions and favorable financing conditions are important conditions for a gradual strengthening of domestic demand in the euro area as a whole. Further declines in oil prices could contribute decisively to better conditions for stability and growth. The key to minimise the impact of the economic downturn and to restore sustained, non-inflationary growth lies in re-establishing confidence quickly. Against this background, it is worth noting that euro area policy makers have demonstrated their commitment to react rapidly and appropriately. The commitment to maintain sound budgetary policies and to continue with the process of structural reforms will help to bolster confidence.

Monetary policy and the outlook for price stability

The ECB broadly agrees with the Fund's overall assessment of euro area monetary policy.

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In the course of the year 2001, medium term inflationary pressures in the euro area have subsided significantly. Already prior to the attacks on the US on 11 September 2001, this has allowed the governing council of the ECB to reduce its key interest rates by 50 basis points in total (by 25 basis points on 10 May and 30 August). On two issues relating to this period, however, the staff report needs to be clarified. First, the ECB's analysis of monetary developments is not carefully enough reflected in the staff report. Second, the report gives too much weight to the decline in headline HICP inflation in the decision to reduce ECB interest rates on 30 August 2001. In this respect, it may also be worthwhile recalling that monetary policy decisions are not taken by focusing on one pillar only or on specific set of indicators but rather are made in a forward-looking manner, based on all the information available to the ECB Governing Council.

In the aftermath of the tragic events in the United States on 11 September, the Eurosystem ensured a calm and orderly functioning of the financial markets. To this aim, on the two days following the terrorist attacks, the Eurosystem carried out liquidity-providing fine tuning operations. In addition, in order to be able to provide European banks with liquidity in US dollars, the US Federal Reserve System and the ECB agreed on a foreign exchange swap operation.

In addition to these immediate measures, the Governing Council of the ECB considered it necessary to reassess the outlook for price stability and the monetary policy stance in the euro area. In the assessment of the Governing Council, the recent events in the US were likely to weigh adversely on confidence in the euro area, reducing the short-term outlook for domestic growth. As this was likely to further reduce inflationary risks in the euro area, a lowering of the ECB's key interest rates was deemed appropriate. As a consequence the Governing Council decided on 17 September to lower the ECB key rates by 50 basis points, in concert with a decision by the FOMC of the US Federal Reserve System on the same day. This decision was fully consistent with the monetary policy strategy of the ECB.

Looking ahead, the Governing Council is confident that the slowdown in economic growth in the euro area will be short-lived, given the sound economic fundamentals of the euro area economy. This notwithstanding, economic developments will be carefully monitored by the Governing Council in order to assess their effects on the outlook for inflation. In this respect, the ECB agrees with the Fund that the risk of too strong increases in wages, in a context of lower growth and declining inflation, seems not very acute at this stage, and actual wage growth observed so far has been moderate. Finally, it is worth recalling that monetary policy has to take into consideration developments on the fiscal front when assessing the outlook for price stability over the medium term.

Coming to the introduction of euro banknotes and coins in a few months time, the ECB has no reason to believe that this event should affect materially the outlook for price stability in the euro area. In this respect, we broadly agree with the arguments put forward in the report underpinning this assessment. Moreover, we believe that the commitment of the Governing Council to maintain price stability over the medium term is also an important contribution to ensure that the changeover does not affect price developments.

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The participation of the ECB in a ROSC exercise comprising three modules (Transparency in Monetary Policy and in Payment Systems Oversight, Euro 1 compliance with CPSS Core Principles for Systemically Important Payment Systems and TARGET compliance with the Core Principles) reflects its commitment to meet international standards and codes, as well as its support for the international financial institutions' efforts to foster compliance with best practices. Such participation should also be seen as a complement to the ROSC and/or FSSA modules prepared at the level of individual euro area Member States.

The ECB agrees with the overall assessment by the IMF staff. It shows that the ECB and the Eurosystem have achieved a very high degree of compliance with transparency principles applicable to monetary policy and payment system oversight, as almost all principles in the Code of Good Practices on Transparency in Monetary and Financial Policies are deemed to be observed. Areas where full observance has not yet been achieved are not directly related to the policy and operational frameworks of the ECB monetary policy. The reports also confirm that Euro 1, the Euro Banking Association's payment system, fully observes all the Core Principles, while TARGET, the real-time-gross-settlement system for the euro, has fulfilled the policy objectives for which it was set up and is almost fully in line with the applicable Core Principles, even if room for limited further improvement has been identified.

Exchange rate developments

The euro exchange rate remains undervalued. The IMF staff's conclusions on the euro's weakness are broadly appropriate. As regards the role of equity prices, in particular the markedly sharper rise in stock market capitalisation in the USA, the failure of the euro to appreciate in correspondence with the fall in equity prices since spring 2000 may not be accounted for by this explanation. Concerning the outlook for the euro, the staff's judgement that, since policy has not played a direct role in weakening the euro, there is little scope for policy actions to correct in the short-term what is deemed to be an undervalued exchange rate, is appropriate.

Fiscal policy

The most relevant issue is the degree to which automatic stabilisers should operate (and not "if" they should operate), depending on each country's particular budget situation.

The IMF staff plays down the virtues of the EU budgetary framework both in the run-up to EMU and in Stage 3. This framework, and in particular the focus on nominal balances, was instrumental to the success of the Maastricht fiscal retrenchment. Indeed, a majority of countries have now close-to-balance or surplus positions. Avoiding excessive government deficits is a central element in the architecture of economic policy in EMU. More generally, the favorable implications for cyclical stabilization of sticking to the spirit of the SGP, whereby achieving close to balance allows the automatic stabilizers to operate fully in the event of a cyclical downturn, are not adequately acknowledged.

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As to the IMF staff's suggestion for shifting the attention of the SGP from budget balances to spending targets, the framework provided for by the rules of the SGP is flexible enough to be consistent with different mechanisms which member states may develop to ensure compliance with medium term goals. Actually, a number of countries pursue fiscal strategies resting on expenditure targets. Thus, expenditure targets can usefully support the SGP goals, but should not replace them.

Revenue developments, as admitted by IMF staff, cannot be disregarded, and limiting the monitoring of budgetary developments to expenditure targets may not suffice in securing the avoidance of excessive deficits.

All in all, the SGP is working effectively and should be preserved. Its built-in flexibility allows combining strong discipline with cyclical stabilisation. The implementation of the new Code of conduct for the preparation of stability and convergence programmes, approved by ECOFIN ministers last July, should contribute to improve the effectiveness of the euro-area budgetary framework. The Code stresses the usefulness of taking into account the country's cyclical position when assessing its compliance with the SGP medium-term objective.

Structural policies

The IMF staff rightly emphasizes the benefits in terms of increased potential growth, employment and improved resilience to shocks, to be generated by resolute reforms of product and labour markets. Such reforms have been significant, especially of product markets, but further progress remains to be made.

A number of crucial obstacles have not yet been tackled in both markets. The strengthening in the functioning of euro-area product markets is significant, but in some areas progress has been slower, such as the creation of an Internal Market for services, liberalisation of energy markets, public procurement or administrative reform.

Further progress in labour market reform is clearly needed, especially on measures to strengthen the effective labour supply and labour participation. Whilst progress has been made in certain areas such as tax reform and in active labour market measures that address employability and equal opportunities, benefit system reform that addresses incentive structures, duration and eligibility remains largely untackled. Nevertheless, all Member States have taken action to various extents, and some have made good progress in labour market reform.

Financial market integration

Financial-market integration requires a common framework of market regulations for the Union as a whole. This common framework of regulations is to be put in place by implementation of the Financial Services Action Plan (FSAP). The Lisbon European Council identified financial-market integration as a priority of economic reform, and this is reflected in the deadline of 2005 set for implementing the FSAP. While implementation of the FSAP is

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broadly on track, there is a need to accelerate progress if the deadline is to be achieved. To this end, it is essential that the recommendations of the Lamfalussy Committee on EU securities markets regulation, which have been endorsed by the Stockholm European Council, should be put into operation immediately.

The systemic risk associated with financial-sector integration and consolidation points to a need for close co-operation among national supervisors and the central banks in preventing and managing financial crises. In response to concerns expressed in some quarters, including the Fund, the current arrangements for crisis prevention and management at the EU level have been studied. While no institutional changes were deemed necessary at this stage, a series of concrete proposals to improve cross-border co-operation in financial supervision have been put forward, in particular in an EFC report (Brouwer II), which was endorsed by Finance Ministers and Central Bank Governors in Spring 2001. Substantial progress has been made in implementing these proposals.

Euro changeover

The unprecedented event of the changeover to the euro banknotes and coins will come about in an efficient and organised manner. The Eurosystem, governments of participating Member States, the European Commission and other public and private bodies are all working together closely to ensure that the introduction of euro banknotes and coins will be smooth. The preparations, including operations to frontload banks and retailers, are already progressing satisfactorily. Communication efforts are being intensified, particularly to foster the awareness of small and medium-sized enterprises, local authorities and the public regarding the necessary preparations. Retailers and citizens, including vulnerable groups, are also being assisted to become familiar with the new banknotes and coins, including the security features, before their introduction. Finally, important progress has also been made in establishing a comprehensive framework against counterfeiting.

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Trade policy

The EC continues to work very hard towards the launch of a new Round of trade negotiations at the forthcoming Doha WTO Ministerial. The multilateral approach to trade liberalisation is the preferred method of the EC and the best way to ensure a strong and fair WTO system of multilateral rules, as is made clear in the 25th October 1999 Council conclusions that provide the basis for the EC negotiating position at the WTO.

A new Round should address those issues of most interest to developing countries, such as improved market access, including in products of most importance for those countries. The "Everything but Arms" initiative, which constitutes a unique and unprecedented policy move toward LDCs, improved trade related technical assistance and capacity building, and the proposed changes to the EC's GSP regulation constitute a major package of EC measures in favour of developing countries. The EC is also supporting significant progress on the further implementation of Uruguay Round commitments in advance of the Doha Ministerial. There is a need for an improved coherence in the international system, in order to make trade and other policies, such as environment and social policies, and food safety, mutually supportive.

Finally, in the year 2000, 31 new EC anti-dumping investigations were initiated: a 64 percent decrease on the 86 new investigations that had been launched in 1999. None of the new investigations in 2000 were in the agricultural or textile sectors.

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