5. **The European Court of Justice has ruled that the ECOFIN Council overstepped its authority last November when it put the excessive deficit procedures against France and Germany in abeyance.** In essence, the Council was wrong in seeking to act outside of the framework of Commission recommendations and past Council decisions. (The Council can only reject or amend recommendations made by the Commission, not issue its own recommendations or alter previous Commission recommendations accepted by the Council). As a result, the excessive deficit procedures against France and Germany remain open. By the same token, there is considerable agreement both on the substance of the requisite policies in the two countries and on the need for the procedures of the Pact to take better account of the economic circumstances. In this respect, the Court's ruling has enabled a reopening of the discussion on how to resolve the issues confronting the Pact. In the aftermath of the ruling, the Commission has announced that it will consult with the Council and the ECB to formulate more specific proposals for "strengthening and clarifying the implementation of the SGP," which would be discussed later in the year.

6. **Implementation of the SGP has continued:**

- After the staff report was issued, ECOFIN gave a recommendation to Greece to eliminate its excessive deficit by 2005, requiring action to be taken by November 5, 2004.

- It also addressed the excessive deficits in six of the new member states. While these countries are not subject to SGP sanctions, ECOFIN set target dates for bringing their deficits below the 3 percent of GDP reference value, with the dates reflecting these countries' different starting points and budgetary plans (2005 for Cyprus; 2006 for Malta; 2007 for Poland and Slovakia; and 2008 for the Czech Republic and Hungary).

- ECOFIN also opted not to issue an early warning to Italy, as the Italian government committed to implement measures to prevent its deficit from exceeding 3 percent of GDP in 2004. Nevertheless, the rating agency Standard & Poor's downgraded Italy's credit rating from AA to AA-, the first such event since the launch of the euro. There were no noticeable movements in bond yield spreads in response to the downgrade.

7. **The Commission has tabled far-reaching proposals to overhaul the EU sugar regime.** As expected, on July 14, the Commission among other measures proposed cutting back support prices for sugar, reducing subsidized sugar exports, and providing decoupled payments to sugar beet farmers to compensate for their income losses. The changes are proposed to be implemented over four years, with the reform process scheduled to start in July 2005. The proposals have been viewed by some member governments as too radical.

Statement by Jeroen Kremers, Executive Director for Euro Area
July 26, 2004

As the Netherlands holds at present the Presidency of the Eurogroup, my statement reflects the common views of the euro-area Member States and the European Community in their respective fields of competence.

The authorities of the euro-area Member States welcome the staff assessment of economic developments and prospects in the euro area. Although I am in broad agreement with the policy conclusions, I would like to make a few qualifying observations. In addition to outlining these observations, this statement will update the Board on recent economic developments and policy actions taken at the European level, including the implementation of the Stability and Growth Pact and trade policy.

Short-term economic outlook

After a hesitant start of the recovery in the second half of 2003, economic growth in the euro area gathered momentum in the first quarter of 2004. The acceleration of activity was caused by a pick-up in private consumption and strong export growth. Although the recovery may not yet be self-sustaining, growth in 2004 is likely to turn out higher than earlier expected. Conditions are in place for a continuation of the recovery: financing conditions in the euro area are favorable, business confidence has strengthened, equity prices have been recovering and corporate restructuring has advanced. Furthermore, the recovery in private consumption is expected to proceed in line with increases in real disposable income and stronger employment.

The authorities consider the risks for the economic outlook to be balanced. On the one hand, upside risks to the current forecasts may stem from the strength of external demand and recent economic indicators. On the other hand, the pick-up in domestic demand could be weaker than expected, because the restructuring of balance-sheets by non-financial corporations may still take more time to be fully completed. In addition, oil prices have remained high, affecting the euro area's terms of trade. More generally, concerns relating to the persistence of global imbalances continue to exist.

The recovery in the euro area has been lagging behind that of other parts of the world. One of the reasons seems to be the slow adjustment of the euro area to past shocks. Despite the increased resilience of employment, remaining rigidities in the labor market and insufficient competition in specific sectors make the euro-area economy sensitive to shocks and hamper potential growth. The authorities fully agree with the Fund that increasing the potential rate of growth is the main challenge for the euro area.

Exchange rate developments

The authorities concur with the view expressed by staff that the current value of the euro is broadly in line with medium-term economic fundamentals. They reaffirm that the external value of the euro should reflect such fundamentals. Excess volatility and disorderly movements in the external value of the euro are undesirable. Also it is important that all major countries and economic regions play their part in contributing to the adjustment of global imbalances by implementing appropriate economic policies.

Monetary policy and the outlook for price stability

The authorities welcome the conclusion of the IMF staff report on monetary policy. In particular, they appreciate the recognition that monetary policy has been appropriate, in light of the medium-term outlook for price stability in the euro area. The assessment of the Governing Council of the ECB of the current outlook for price stability is broadly in line with the analysis of staff.

Euro area inflation has risen over recent months, standing at an annual rate of 2.4 percent in June. Together with rises in indirect taxes and administrative prices, oil prices have exerted upward pressure on prices. If oil prices were to remain high, the inflation rate would most likely remain above 2 percent for longer than expected at the time of the Article IV consultation. Looking beyond the short term, however, the main scenario of the ECB remains consistent with its definition of price stability. In this scenario, it is expected that wages develop moderately, in line with the recent trends, at a time when unemployment remains high.

There are upside risks to this scenario. The strength of global economic activity may continue to exert upward pressure on commodity prices, including oil prices. There may also be upside risks stemming from the further evolution of indirect taxes and administered prices in the euro area. The potential risk of second-round effects of such one-off increases in prices via wage and pricing behavior needs to be monitored closely. Also measures of long-term inflation expectations derived from financial-market indicators remain relatively high. While these indicators should be interpreted with caution, their recent development calls for vigilance.

As regards the monetary analysis, money growth has fallen over recent months. While this decline partly reflects base effects, it also reflects a normalization of firms' and households' portfolio allocation behavior as the exceptional economic and financial uncertainties prevailing in early 2003 have receded. Despite the recent moderation in M3 growth, there remains substantially more liquidity in the euro area than is needed to finance non-inflationary growth. While a significant part of the excess liquidity has accumulated as a result of past portfolio shifts, low interest rates have also fuelled the build-up of liquid assets. The low level of interest rates also supports credit growth. The stock of excess liquidity, if it persists, may signal an additional upside risk to price stability over the medium term. Thus cross-checking with the ECB's monetary analysis also calls for vigilance.

The Governing Council of the ECB has maintained its key interest rate, the main refinancing rate, at the historical low of 2 percent since June 2003, considering that the outlook still remains in line with price stability over the medium term. This stance lends support to economic activity. The Governing Council will remain vigilant with regard to all developments which could affect the risks to price stability over the medium term.

Fiscal policies

The euro-area authorities agree with the staff's view on the key elements of the fiscal framework. Budgetary discipline, sustainability of public finances, the implementation of symmetrical policies over the cycle and the need for an appropriate composition of fiscal policies are crucial to promote balanced economic growth and price stability, and to support

an increase in the euro area's growth potential. The importance of all these elements has recently been reconfirmed by the European Council in their Declaration on the Stability and Growth Pact as part of the agreement on the European Constitution.

The authorities also agree with staff that fiscal policies have been broadly appropriate during the downturn, although the rise in fiscal deficits in some Member States not only reflected cyclical developments but also policy choices. In 2003 the fiscal stance was broadly neutral, while the output gap deteriorated sharply. Looking at 2004 and 2005, the planned budgetary improvements rely to a high degree on the projected budgetary consolidation in the larger Member States. The latest information suggests that budgetary outcomes in many countries of the euro area could fall short of the targets. This calls for continued monitoring of budgetary developments and application of the common rules. A major lesson from the past downturn is that budgetary positions should be strengthened as economic conditions improve, in order to ensure sufficient room for the automatic stabilizers in the next downturn and to contribute to the long-term sustainability of public finances.

The staff paper gives a fair summary of the current discussions on strengthening and clarifying the implementation of the Stability and Growth Pact. The 13 July European Court of Justice ruling was central in clarifying the respective roles of the Commission and the Council in the implementation of the Stability and Growth Pact provisions, thereby making budgetary policy coordination more transparent and more predictable.

Structural reform

In light of the low and gradually declining rate of potential growth in the euro area, the authorities welcome the emphasis given by the Staff report to structural reforms aimed at raising the level of potential growth, in line with the so-called Lisbon agenda of structural reform. The comments made in relation to the need for labor market reforms are justified, especially in view of the looming ageing implications. The staff paper rightly stresses the need for a higher labor utilization to safeguard the welfare state model. However, the need to raise productivity and to continuously increase productivity growth, a key aspect of the Lisbon strategy, requires equal attention.

Although paragraph 38 sets out the views of the European Commission on this point, I would like to elucidate differences in estimates of labor productivity levels. According to the paper, labor productivity in the euro area exceeded the US level in 2000 (according to the table in paragraph 11). The Commission estimates, by contrast, a level of 96.5 percent of the US level. The staff estimate is based on the euro area's business sector, not the total economy, and does not include a number of euro area countries.

A significant reduction in the disparity in productivity growth levels between Europe and the USA requires action in the fields of education, training, the diffusion of ICT, R&D and innovation. The results achieved in these fields since the adoption of the Lisbon agenda are mixed. On the one hand, many Member States have taken important steps to improve adult education and workplace training, and ICT use is spreading fairly rapidly. On the other hand, R&D expenditure is growing very slowly and is still far below the target of 3 percent of GDP. There is also a need for further reductions in the regulatory and administrative burden on enterprises and to improve their access to finance, particularly venture capital.