As regards structural reform in product markets, the authorities can agree with the overall assessment made by staff. Although much has been achieved in terms of market opening and stronger competition policy, much also remains to be done and the pace of reform in some areas does seem to be slowing down.

Trade issues

Finally, allow me to turn to the staff assessment of trade policy developments. The Doha Development Agenda (DDA) remains the EU's top trade policy priority. While the EU is adhering to its existing commitments to regional trade negotiations, notably with Mercosur and the ACP countries, the EU has not launched any new regional trade initiatives since 1999, in order not to detract from the DDA.

The rationale for the Doha Round and the main priorities of the EU for this Round remain unchanged after Cancun. The EU is committed to an outcome which should deliver ambitious trade liberalization and stronger multilateral rules, while supporting sustainable development. In order to inject further impetus into the negotiations, Commissioners Lamy and Fischler sent a letter on 9 May to all WTO Trade Ministers in which they made important new proposals:

- a parallel move on all forms of export subsidies, including the subsidy element of export credit, food aid and state trading enterprises, in the framework of a balanced package on all three pillars of agriculture (export competition, domestic support and market access), as well as on other elements of the negotiations;

- the withdrawal of investment and competition from the single undertaking, only pursuing negotiations in the framework of the DDA on trade facilitation and, possibly, on transparency in government procurement;

- the exemption of weak and vulnerable developing countries in a situation similar to that of LDCs from any new commitments, apart in the field of trade facilitation, and through raising their level of tariff bindings.

This initiative was much welcomed by the great majority of WTO Members. Intensive work is now on-going in Geneva to finalize framework modalities by the end of the month, which would provide a crucial staging post for a successful outcome of the Round.

The Commission recently tabled a proposal for a radical overhaul of the EU sugar regime, which demonstrates the continued commitment of the Commission to reform the Common Agricultural Policy in order to meet the needs and expectations of both consumers and producers in the EU and in the developing countries, and to adapt to a new world trading environment.

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IMF Executive Board Discusses Euro Area Policies

On July 26, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of euro area policies and the trade policies of the European Union. The background section of this PIN reflects information available at the time of the Executive Board meeting.[1]

Background

The area's cyclical recovery is gaining momentum but lags the global upturn. A first recovery attempt fizzled during the first half of 2003, undercut on the external side by a pause in global growth and by euro appreciation. Since then, GDP growth has again rebounded, jumpstarted by foreign demand and bullish global financial markets. Domestic demand growth remains subdued, however, as both private households and corporations have been slow to step up spending.

The regional pattern of domestic demand growth remains uneven. Momentum is lagging in Germany and Italy, but France and most other countries are experiencing more balanced growth patterns. Highlighting the sustained nature of the regional divergences across the union since 2000, Germany's domestic demand weakness and strong export performance led to a 4½ percent of GDP improvement in its current account position.

Private consumption has been sluggish owing to labor market slack, uncertainties about employment, and diminished expectations of future income growth. Although the area's employment has held up well during the protracted downturn, there are indications that earlier

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the July 26, 2004 Executive Board discussion based on the staff report. The ECB's observer at the Fund participated in that meeting.

expectations of underlying potential growth could have been too optimistic. Households' increased concerns about the financial viability of pension and health care systems could also play a role in constraining consumption.

Financial conditions in the area have improved along with those in global markets. In particular, monetary policy continues to be supportive, with policy rates unchanged at low levels since June 2003. The euro is in line with historical averages in real effective terms, but current account imbalances in the rest of the world represent a risk of future currency appreciation.

Against this backdrop, euro-area corporations have gradually adjusted to the bust in equity valuations, and their balance sheets have improved. In addition, low investment-output ratios and relatively high rates of capacity utilization should boost investment activity. On the downside, corporate debt and leverage remain elevated and could become more constraining once interest rates revert to neutral levels.

Headline inflation outcomes have remained sticky, notwithstanding sustained wage moderation, a widening output gap, and euro appreciation. In early 2004, inflation was boosted by increases in tobacco taxes and administered prices. More recently, higher oil prices pushed headline inflation above 2 percent. At the same time, core inflation (defined as headline inflation excluding energy, food, alcohol, and tobacco) has remained relatively stable at 1¾ percent since end-2003.

Fiscal policy in the euro area during the cyclical downturn has generally allowed automatic fiscal stabilizers to operate in the face of unexpected growth shortfalls. Fiscal deficits in four countries (France, Germany, Greece, and the Netherlands) exceeded the Stability and Growth Pact's (SGP) 3 percent of GDP limit in 2003. Successive breaches of the deficit limit by France and Germany led to procedural impasse in the implementation of the excessive deficit procedure under the SGP for these two countries.

Against this background, the staff projects real GDP growth to amount to about 2 percent this year and 2¼ percent next year, underpinned by a sustained increase in final domestic demand. While faster-than-projected global growth represents an upside risk, downside risks include possible appreciation pressures owing to global current account imbalances and reluctance by households and corporations to step up spending in view of incomplete adjustment to past shocks. The recent run-up in oil prices could keep headline inflation at about 2 percent in 2004, but it should fall below 2 percent in 2005 in an environment of maintained wage setting discipline, continued slack in goods and labor markets, and lagged pass-through effects from euro appreciation.

Executive Board Assessment

Executive Directors congratulated the European authorities on the most recent breakthroughs in European integration, welcoming in particular the accession of 10 new member countries on May 1 to the European Union and the political agreement on a new Constitutional Treaty reached on June 18.

Directors noted that the euro area's short-term outlook has brightened, but that longstanding structural challenges remain to be tackled. A buoyant global economy and bullish financial markets have prompted a cyclical rebound of growth, while the outlook for medium-term price stability remains favorable. Directors cautioned, however, that the transmission of the growth momentum to final domestic demand, particularly in some of the larger economies, remains sluggish. Looking to the longer-term prospects, Directors were concerned that structural and fiscal policies needed a more forward-looking response to revive potential growth and deal with the fiscal pressures arising from population aging. In particular, Directors stressed the need for structural reforms to reverse the area's secular decline of labor utilization and to raise productivity growth. They also noted that decisively tackling the structural obstacles to growth in the euro area would also ease the appreciation pressures on the euro in helping to resolve the global current account imbalances.

Directors broadly agreed that monetary policy has responded appropriately to the area's changing economic circumstances, particularly in view of the persistence of inflation during the cyclical downturn. Looking forward, Directors were of the opinion that monetary policy should remain supportive of the recovery in domestic demand as long as the medium-term outlook for price stability is favorable. While risks of second-round effects from higher oil prices, as well as from hikes in indirect taxes and administered prices, need to be watched closely, the slack in labor markets and continued wage moderation underpin an encouraging outlook for inflation. At the same time, Directors emphasized that renewed appreciation pressures on the euro owing to the global current account imbalances remain a medium-term downside risk to growth.

Directors concurred that fiscal policies during the slowdown have been broadly appropriate. They observed that the rise in fiscal deficits mainly reflects the unexpectedly protracted slowdown rather than concurrent policy choices. Nonetheless, Directors noted that allowing free play to the automatic fiscal stabilizers combined with earlier policy shortcomings have clearly strained the procedural fabric and credibility of the Stability and Growth Pact (SGP).

Directors agreed that the SGP's basic design as a framework that seeks to combine discipline and flexibility remains appropriate, though there was broad consensus that several aspects of the Pact should be re-examined. First, the incentives to adjust in good times needs to be strengthened, both as regards letting the automatic fiscal stabilizers play fully and ensuring that commitments to correct weak underlying fiscal positions are sustained. Second, underlying fiscal balance targets should be tied more explicitly to sustainability considerations to provide the framework with stronger economic underpinnings. Finally, Directors thought that the implementation of the Pact could be tuned to better differentiate between the respective roles of policies and the economic environment in assessing breaches of the 3 percent of GDP fiscal deficit limit.

Directors also stressed that a genuine consensus on upholding a strong and disciplining fiscal framework needs to be restored, in particular against the backdrop of the medium- to long-term fiscal challenges associated with rapid population aging. Most Directors felt that a failure to build a new consensus on the SGP could have potentially grave consequences for EMU and its member countries, many of which rely on the SGP as an external commitment device to maintain fiscal discipline.

In this vein, and with the recovery gaining traction, Directors called on member states to accelerate the pace of fiscal consolidation. In particular, most Directors agreed that countries with weak budgetary positions should undertake high-quality fiscal consolidation with the objective of reducing the cyclically-adjusted deficit by at least 0.5 percent of GDP a year while allowing the automatic fiscal stabilizers to operate fully, particularly if growth surprises on the upside.

Directors identified the euro area's key structural challenge as raising longer-term growth, in the first instance by strengthening the incentives to work. With the onset of rapid population aging only a few years away, Directors noted that reversing the secular decline in labor utilization through reforms of tax-benefit systems and lengthening working lives would need to be a key plank in the strategy to shore up social protection systems in most member countries.

Turning to the different reform areas, Directors welcomed the measurable progress in deregulating and integrating product and financial markets, but also urged more efforts to liberalize service sectors. While much remains to be done, the basic directions and steps to be taken have been agreed and instigated by EU-wide institutions. The issues going forward are in good part concerned with implementation, making sure that the policies overcome the current segmentation of labor markets and re-shape incentives at the national level. In this regard, Directors noted that policies to promote "national champions" would not be compatible with the EU's sound economic principles of fostering free competition.

Directors expressed concern over the lack of reform momentum in areas where national competencies loom large, particularly on labor and pension reforms. While there has been tangible progress in these areas, political fatigue seems to have set in early, and efforts fall short of the necessary restructuring of work incentives. The key challenge at the area-wide level was seen as imparting momentum to structural reforms at the national level through more decisive leadership at the EU level.

Many Directors believed that the Lisbon reform agenda should be prioritized and focused on boosting work incentives. Most Directors considered that peer pressure on governments could be strengthened, including through ranking and publicizing country performances. Furthermore, structural reforms by the largest countries could provide additional incentives through competitive pressures. Some Directors also regretted that some of the earlier EU member states have put transitory restrictions on the free movement of labor, noting that increased labor mobility across the union would add to potential growth.

Directors welcomed the EU's new efforts to relaunch the stalled Doha round. The EU's recent offers to phase out all farm export subsidies and further limit negotiations on the Singapore issues provide fresh—and much needed—impetus for reaching agreement on a negotiating framework, and Directors felt that it would be desirable to complement these efforts with a more ambitious multilateral offer on market access. Directors welcomed the recent decision to decouple a large part of domestic support for the production of Mediterranean products. Directors were also encouraged by the European Commission's far-reaching proposals to reform the EU's sugar regime.

Directors noted that the area's statistics are adequate for surveillance, but urged continuing efforts to improve them further, not least in view of the euro area's status as the world's second-largest economy. In particular, additional efforts should focus on providing more comprehensive and up-to-date statistics on the institutional income accounts, flow-of-funds, labor market, and external trade. Ensuring the integrity of fiscal data in the context of fiscal surveillance under the SGP should also remain a priority.