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FOR AGENDA

SM/07/240
Correction 1

July 24, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Euro Area Policies**

The attached corrections to SM/07/240 (7/10/07) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 4, para. 2, second bullet, last line: for "(¶33)" read "(¶32)"

Page 9, first para., line 2–4: for "components), only partly reflecting temporary forces, according to ECB staff. Staff is skeptical about"
read "components), although its recent dynamism may currently overstate somewhat the robust underlying rate of monetary expansion, according to ECB staff. Fund staff is skeptical about"

Page 10, para. 11, penultimate line: for "to adjust by at least ½ percent of GDP"
read "to adjust by more than ½ percent of GDP"
para. 12, penultimate line: for "possibility, particularly because some countries"
read "possibility. The reason is that some countries"

Page 11, text table, row "MTO", column "Fin": for "1.5" to read "2.0"

Page 21, para. 29, line 5: for "if narrowly interpreted, amount to"
read "if taken to their limit, amount to"

Page 22, para. 30, lines 6–8: for "sustainability" meant that inflation had to be within Maastricht bounds without reliance on one-off factors and be projected to remain there in the year following the evaluation."
read "sustainability" in the context of the price stability criterion meant that inflation had to be within Maastricht bounds without reliance on one-off factors, with the assessment involving backward-looking analysis as well as a forward-

looking assessment with a prudent use of forecasts. Specifically, the examination uses Commission forecasts to assess medium-term prospects for inflation and includes a statement on whether the candidate country is likely to meet the reference value in the months after the examination."

Page 34, Figure 1, upper-right panel chart: revised

Page 51, Figure 18, bottom-left panel chart: revised
footnote 1: for "based on purchasing power parity benchmark, which matches assessment based on macrobalance approach."
read "based on a time series estimate with stochastic trend, a macroeconomic balance approach, and an external sustainability assessment."

Questions may be referred to Mr. Decressin, EUR (ext. 37140).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att : (8)

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Boxes

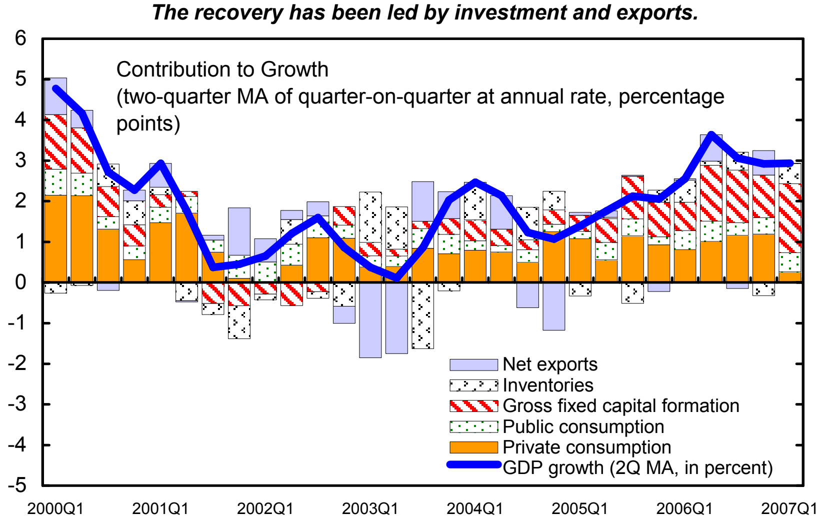
Appendixes

I. Report on the Discussions

A. Cyclical Developments and Prospects

1. **The economy is moving from recovery to upswing and the fundamentals are improving** (Figure 1, Table 1). Real GDP growth is running around 2½ percent; fiscal deficits are markedly lower than a few years ago; and strong export growth, improving profitability and balance sheets, and accommodative financial conditions have fostered a broad based upswing of investment and employment (Figures 2–4).

The recovery has been led by investment and exports.



Source: Eurostat.

2. **The external setting is generally considered propitious**. Specifically:

- Import demand growth in partner countries is projected to slow down only moderately, from about 7½ percent annually over the past couple of years to around 6½ percent through 2008.
- The area's external current account is broadly balanced and export growth has been dynamic, notwithstanding the recent appreciation of the euro's real effective exchange rate (¶32).
- Financial market volatility and risk premia remain historically low.

past rate hikes are feeding through (Figures 12–13).[2] Nonetheless, M3 continues to expand at a brisk pace (lately increasingly on account of less liquid components), although its recent dynamism may currently overstate somewhat the robust underlying rate of monetary expansion, according to ECB staff. Fund staff is skeptical about M3 as an indicator of short- to medium-run inflation.[3]

9. **Some further monetary policy action is likely to be necessary**. As expected, following the mission the ECB raised rates to 4 percent on June 6, 2007, and markets foresee rates just under 4½ percent by the end of this year. Concurrently, long-term interest rates have moved up noticeably as of late, implying some tightening of monetary conditions. With the area's growth projected to remain close to or above potential, and the possibility of some further upward pressure on factor utilization and prices, staff thought that (aside from global inflation trends) the scope and timing of further action would need to depend on (i) the extent to which reforms and demographics have improved labor supply; (ii) the extent to which the incipient acceleration of productivity is structural or cyclical; and (iii) the evolving distribution of (mainly demand-side) risks—including those related to the exchange rate (¶34)—to activity further out, which are presently seen to be on the downside.

C. Fiscal Policy: Adjusting During the Upswing

10. **Fiscal policy surprised on the upside in 2006**. Standard measures suggest that the area's cyclically-adjusted fiscal deficit fell by almost 1 percentage point of GDP in 2006—exceeding staff's ½ percent of GDP benchmark for countries at a significant distance from their medium-term objectives (MTO). This was led by large reductions in Germany, France, and (upon considering the expiration of one-off measures), Italy. Other EDP countries have also met their commitments and, more generally, higher-than-budgeted revenues have been allocated to debt reduction, even if not to the full extent by all countries.

Fiscal Developments, 2005-09

	2005	2006 SP 2005	2006 est.	2007 proj.	2008 proj.	2009 proj.
Overall fiscal balance	(In percent of GDP)					
Euro area	-2.5	-2.3	-1.7	-1.0	-1.0	-0.8
of which:						
Revenue	45.2	45.1	45.8	45.6	45.4	45.3
Expenditure	47.7	47.4	47.4	46.6	46.3	46.1
Structural fiscal balance						
Euro area 1/	-1.9	-1.7	-1.0	-0.8	-0.8	-0.8
of which:						
Revenue	45.7	…	46.1	45.7	45.5	45.5
Expenditure 1/	47.6	…	47.1	46.5	46.3	46.3
EDP countries 2/	-3.1	-3.1	-1.8	-1.3	-1.5	-1.3
Non-EDP countries	-0.7	-0.3	-0.1	-0.2	-0.2	-0.2
Germany	-2.4	-2.8	-1.3	-0.7	-0.9	-0.6
France	-2.7	-1.6	-1.9	-1.6	-1.6	-1.6
Italy 1/	-3.4	-3.1	-2.3	-1.8	-2.0	-2.2

Sources: WEO, ECFIN and Fund staff projections.
1 Excludes net deficit increasing one-off measures in Italy in 2006 (1.5% of GDP).
2 Germany, Greece, Italy and Portugal, as of May 31, 2007.

[2] Relatedly, house prices have been moderating but still climbed at an annual pace just under 7 percent until lately.

[3] See IMF Country Report No. 05/266, Chapter II.

11. **Spurred by these strong outcomes and buoyant prospects, the Eurogroup Ministers announced their intention to accelerate the consolidation of the area's public finances**. Specifically, they committed to achieve their (country-specific) MTO at the latest by 2010 and agreed, notwithstanding a still negative output gap according to agreed measurement techniques, that "good times" prevail. Under the Stability Growth Pact (SGP) rule book, this implies a commitment to adjust by more than ½ percent of GDP annually for those countries that have not yet reached their MTO.

12. **There was agreement at staff levels, therefore, that the reformed SGP had worked well thus far, but also concerns that the true test of its preventive arm still lay ahead**. The challenges remain sizeable, particularly in some countries. Despite progress under the SGP's dissuasive arm, cyclically-adjusted fiscal positions today are not appreciably different from those attained in 2000. Moreover, recollections of the very large negative corrections made ex post to the structural positions estimated for 2000 prompted caution about relying unduly on current estimates. Indeed, there was agreement that the standard cyclical adjustment might overstate the true structural adjustment that occurred in 2006 because it did not allow for the potential procyclicality of revenue elasticities. The shared view was that, pending deeper analysis, it would be prudent to consider only about half of the observed reduction in the deficit ratio as structural, a figure that is broadly consistent with the decline in the cyclically-adjusted expenditure ratio (adjusted for one-off operations). In addition, while significant progress had been made in preparing for the effect of the aging of the population on public expenditures,[4] conservatively estimated increases of 3¾ percent of GDP by 2050 remained in the pipeline.[5] Staff therefore argued that, even if growth was likely to be stronger, a repeat of the damaging SGP debates of 2002–04 was a distinct possibility. The reason is that some countries—Italy, and to a lesser extent France and Greece—would remain uncomfortably

EU: Aging-related Expenditure, 2004-2050
(In percent of GDP)

	2004		2030		2050	
	EU25	Euro area	EU25	Euro area	EU25	Euro area
	Level		Increase over 2004			
Pensions	10.6	11.5	1.3	1.6	2.2	2.6
Health care	6.4	6.3	1.0	1.0	1.6	1.5
Long-term care	0.9	0.7	0.9	0.2	0.6	0.5
Gross expenditure	**17.9**	**18.5**	**3.2**	**2.8**	**4.4**	**4.6**
Plausible alternative 1/	**...**	**...**	**...**	**...**	**5.8**	**6.0**
Education	4.6	4.4	-0.7	-0.7	-0.6	-0.6
Unemployment benefits	0.9	1.0	-0.3	-0.3	-0.3	-0.3
Net expenditure	**23.4**	**23.9**	**2.2**	**1.8**	**3.5**	**3.7**
Plausible alternative	**...**	**...**	**...**	**...**	**4.9**	**5.1**

Source: AWG Report, European Policy Committee.
1/ Assumes that healthcare costs rise in line with wages rather than per-capita GDP; and that the probability of receiving formal long-term care rises gradually.

[4] See European Commission, Special Report No 1/2006, Table 3.13.

[5] For further details, see IMF Country Report No. 06/288, Box 4.

close to the 3 percent ceiling given the stage of the cycle, a view that was shared by EC and ECB staff.

Structural Balance Medium-term Objectives and Adjustments Needed
(in percent of GDP)

	Euro Area	Aus	Bel	Fin	Fra	Ger	Gre	Ire	Ita	Net	Por	Spa	Slo
MTO	0.1	0.0	0.5	2.0	0.0	0.0	0.0	0.0	0.0	-0.5 to -1.0	? -0.5	0.0	-1.0
Adjustment needed [/1]	1.1	1.3	1.2	-	1.9	1.3	3.1	-	2.3	-	2.5	-	-

[1/] Based on Fund staff estimates for the 2006 structural balance.

13. **Staff therefore pressed for full adherence to the SGP's norm of at least ½ percent of GDP adjustment per annum by countries that remained short of their MTOs**. On present budgetary plans, staff thought that little adjustment was in the offing through 2008, particularly in some key countries, a concern that was shared by Commission and ECB representatives (Figure 14). There was broad agreement that various institutions, from independent ad-hoc committees to fiscal rules to medium-term expenditure budgeting are useful means to overcome political economy distortions to fiscal policy, depending on a country's institutional setting. The Commission observed that euro-area countries were making appreciable progress on this front, pointing to greater emphasis on medium-term planning, spending rules, and enforcement mechanism in stability programs (SPs). Staff welcomed these measures as they could help bring forward the credibility gains from adopting complementary fiscal and structural policies, but noted that peer pressure within the framework of the SGP would also need to play an important role.

D. Structural Policies: Integrating Europe and Raising Labor Utilization

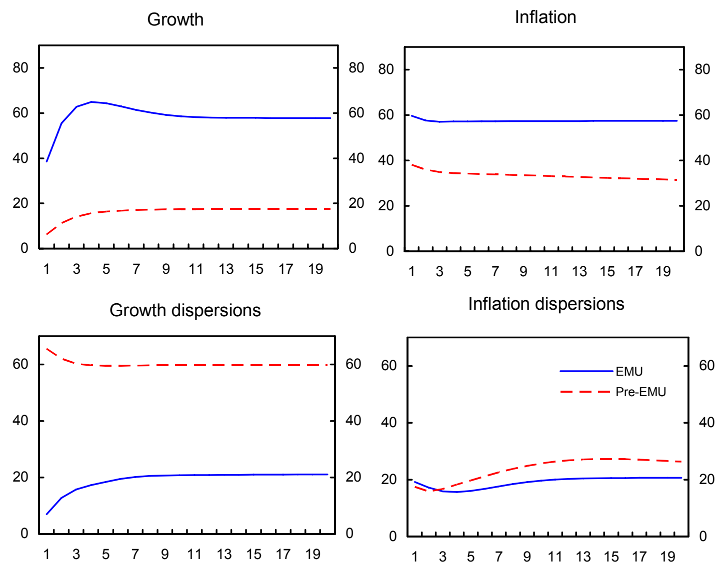
Advancing economic integration in the currency union

14. **The currency union countries have been integrating rapidly since EMU but structural reforms and more financial integration would help reduce remaining country dispersions and alleviate their repercussions on households and firms**. Area-wide shocks now explain the bulk of growth and inflation developments in individual member countries (Box 1), suggesting that the union has been integrating at considerable speed. As a result, the share of shocks that is country-specific is no longer high by international standards for currency unions. However, their persistence is still a concern, partly explaining appreciable divergences in national competitiveness (Figure 6). There was agreement that adjustments in national competitiveness needed to proceed more rapidly, notably through wage flexibility, and that continued labor and product market reform was critical to that effect. In addition, further financial integration could contribute to income smoothing among EMU members.

Box 1. EMU Dispersions

Under EMU, common shocks explain a much larger portion of member countries' output and inflation developments than before, and the transmission of shocks has become increasingly similar. In particular, common factors are driving around 60 percent of growth and inflation during EMU, up from around 20 percent for growth and 30 percent for inflation before EMU. To a small extent, common shocks still trigger different responses across countries, accounting for some 20 percent of growth and inflation dispersions, down from 60 percent for growth and 30 percent for inflation dispersions before EMU. Remaining country-specific shocks to growth and inflation, however, have a fairly large persistent component. Partly these shocks are driven by one-off factors that take time to unwind, notably the EMU-related declines of interest rates and increases in real estate valuations in various countries that featured high pre-EMU real interest rates. Partly they reflect income and price convergence. These two developments are difficult to account for separately, because the relatively less-wealthy countries were also those with relatively high pre-EMU interest rates. Staff research suggest that they can account for a large proportion of remaining country-specific shocks (see "Growth and Inflation Dispersions in EMU: Reasons, the Role of Adjustment Channels, and Policy Implications," forthcoming IMF Working Paper).

Euro Area: Contribution of Common Shocks Before and After EMU
(In percent)



Source: IMF Staff calculations.

Further integration of the financial system could increase risk sharing and income smoothing in response to remaining country-specific shocks. Staff research suggests that the financial system has played a role as a shock absorber however, it is still far from achieving its full potential. The results indicate that its role for risks sharing has not increased substantially over time. Findings in the literature suggest that the contribution of the financial sector to income smoothing could be increased significantly—by up to 20 percentage points—if its level of integration reached that of the United States.[1/]

[1/] See Marinheiro, C. F., 2003, "Output Smoothing in EMU and OECD: Can We Forego Government Contribution? A Risk Sharing Approach," CESIFO Working Paper No. 1051.

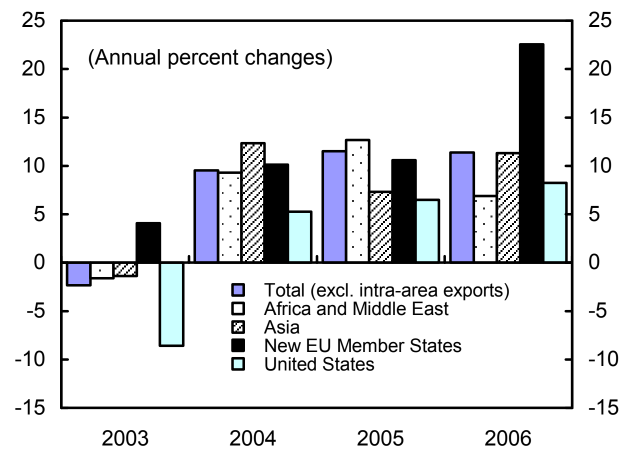
collective costs could be expected to accelerate work toward a balanced strengthening of Europe's financial stability framework, notably through establishing a database for sharing supervisory information on LCFI, including with the ECB; reducing differences in supervisory powers; enhancing pre-crisis sanctions and tools; harmonizing and improving the operations of deposit insurance; and understanding and improving the operation of bank insolvency laws in an area-wide context.[11]

F. Spillovers

Euro adoption

29. **With the Maastricht criteria for entry having been controversial, staff asked how euro adoption for the NMS would be managed**. The inflation and exchange rate criteria, if taken to their limit, amount to a real income convergence criterion.[12] While this has not been much of an issue thus far, per capita incomes in most NMS are appreciably lower than in the euro area. Hence, higher inflation or nominal exchange rate appreciation in these NMS can (but need not) be consistent with medium-term equilibrium. With real income convergence set to extend over a horizon stretching significantly beyond current market expectations on official plans for euro adoption, staff asked how the euro-adoption process—notably the emphasis on sustainability with respect to inflation convergence—would be managed. Clarification is particularly important in view of the fact that financial positions and transactions in NMS suggest that economic agents have expectations of euro adoption within the next 5–7 years.

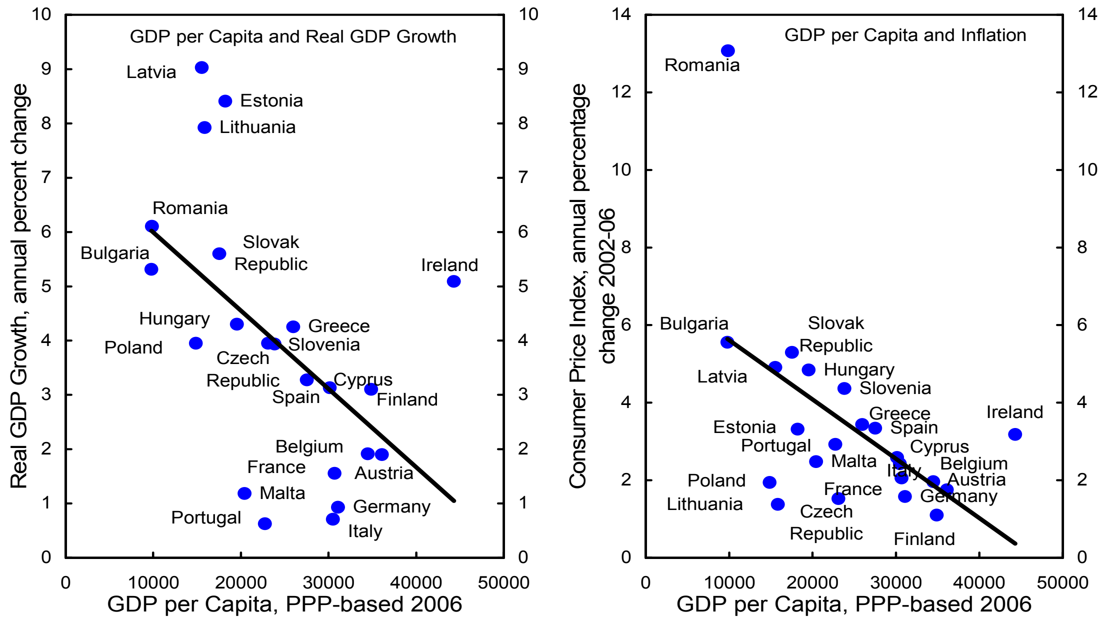
NMS are driving exports of euro-area countries.



Source: IMF, *Direction of Trade Statistics* and Fund staff calculations. Growth rates refer to exports of goods denominated in euros.

[11] With many of these steps requiring extensive harmonization across national legislation, an alternative approach would be to put in place a specific EU-level prudential regime (which could, for example, be elaborated within the Lamfalussy process). See "The Case for a European Banking Charter," forthcoming IMF Working Paper.

[12] See Selected Issues paper, Chapter II.



Sources: Eurostat; National Statistical Offices; and IMF staff estimates.

30. **Interlocutors responded that while the Treaty did embody an expectation to join, the timing was open and the euro-adoption process was well understood**. Expectations of early entry had over time been replaced by much more cautious statements by all involved, especially over the past year, without causing market tensions. Furthermore, EC officials stressed that the "real income convergence" argument was overstated. They clarified that "sustainability" in the context of the price stability criterion meant that inflation had to be within Maastricht bounds without reliance on one-off factors, with the assessment involving backward-looking analysis as well as a forward-looking assessment with a prudent use of forecasts. Specifically, the examination uses Commission forecasts to assess medium-term prospects for inflation and includes a statement on whether the candidate country is likely to meet the reference value in the months after the examination. In the meantime, all interlocutors considered it key that the NMS seeking euro adoption strengthen their policies further to ensure a successful operation in the monetary union. In this regard, EC and ECB officials underscored the useful disciplining effect of the Maastricht criteria. They also emphasized that the process was an open one, and countries meeting the criteria welcome, as was clear from the recent admission of Cyprus and Malta.

Europe's part in addressing global imbalances

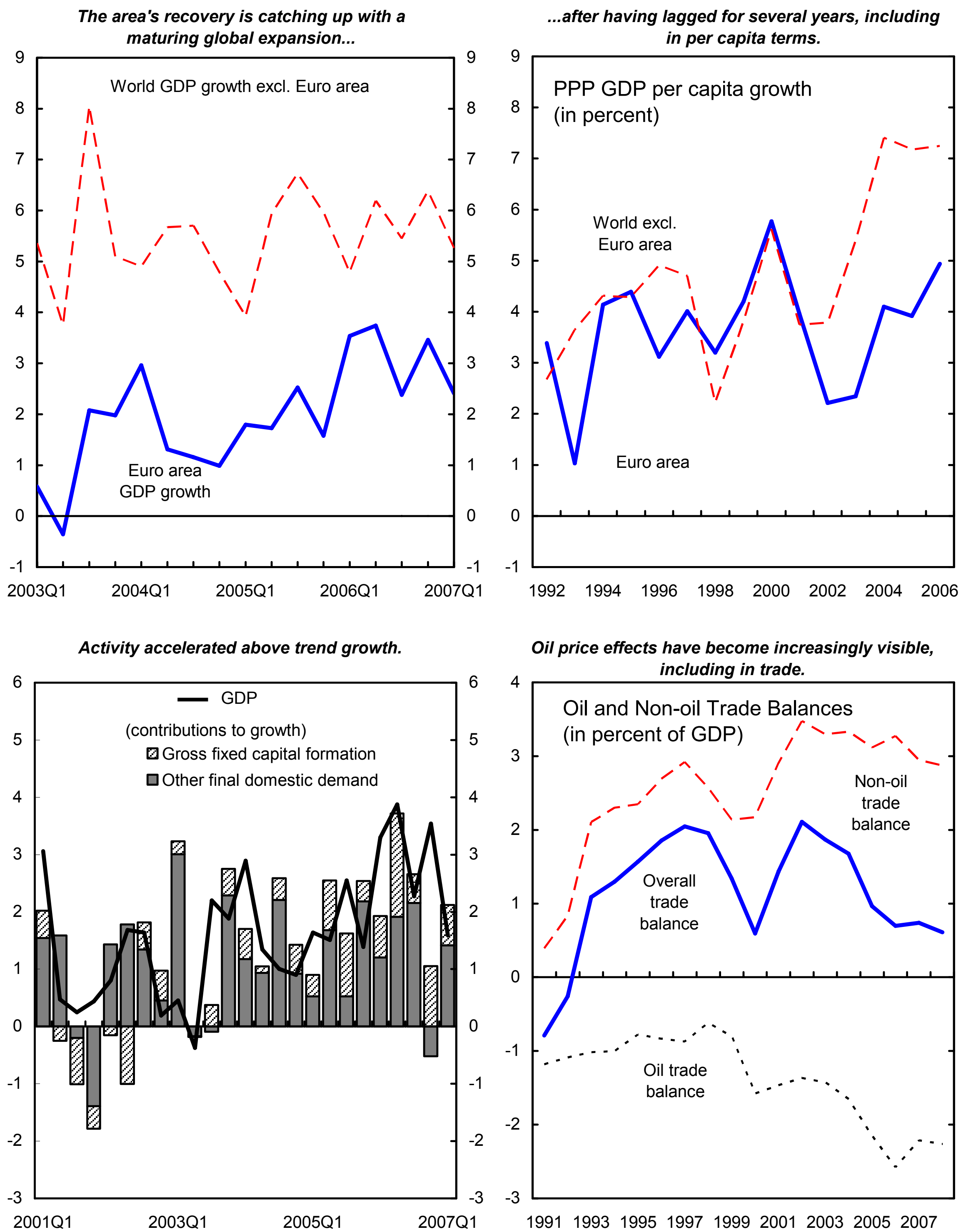
31. **Staff welcomed the broad-based structural reform efforts underway, as these would help strengthen prospects for an orderly resolution of global current account imbalances**. Structural reforms are of course necessary primarily for domestic reasons but they can help the adjustment process essentially by helping sustain world growth in the face of a U.S. current account adjustment. The authorities' multilateral consultation commitments are all in the structural and financial sector area (Table 3) and are a subset of the initiatives discussed above. They stressed that the implementation of these reforms is continuing.

Table 5. Euro Area: Net Investment Position 1/
(in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006Q4
Assets	102.9	110.7	102.4	106.8	113.1	134.8	147.8
Direct investment abroad	26.0	29.8	27.7	29.1	30.1	33.8	36.0
Portfolio investment abroad	35.3	35.8	31.6	35.6	39.2	48.3	52.7
Financial derivatives	1.6	1.9	1.8	2.2	2.2	2.9	3.5
Other investment abroad	34.4	37.6	36.2	35.8	37.9	45.7	51.7
Reserve assets	5.8	5.6	5.1	4.1	3.6	4.0	3.9
Liabilities	110.5	116.3	112.2	117.3	123.8	145.0	159.4
Direct investment in the EU	20.7	23.7	25.2	27.9	28.8	29.8	30.4
Portfolio investment in the EU	47.7	47.8	44.6	47.9	52.0	62.6	70.4
Financial Derivatives	1.5	1.8	2.0	2.3	2.4	3.1	3.6
Other investment in the EU	40.5	43.0	40.4	39.2	40.6	49.5	55.0
Net investment position	-7.6	-5.7	-9.9	-10.5	-10.7	-10.2	-11.6
Direct investment	5.3	6.0	2.5	1.2	1.4	4.0	5.7
Portfolio investment	-12.4	-11.9	-13.0	-12.3	-12.9	-14.3	-17.7
Financial Derivatives	0.0	0.0	-0.2	-0.1	-0.2	-0.2	-0.2
Other investment	-6.1	-5.4	-4.2	-3.4	-2.7	-3.8	-3.4
Reserve assets	5.6	5.6	5.1	4.1	3.6	4.0	3.9

Source: European Central Bank.
1/ Data correspond to the end of the indicated period. They are expressed as a percent of the cumulated GDP of the four quarters ending on that date.

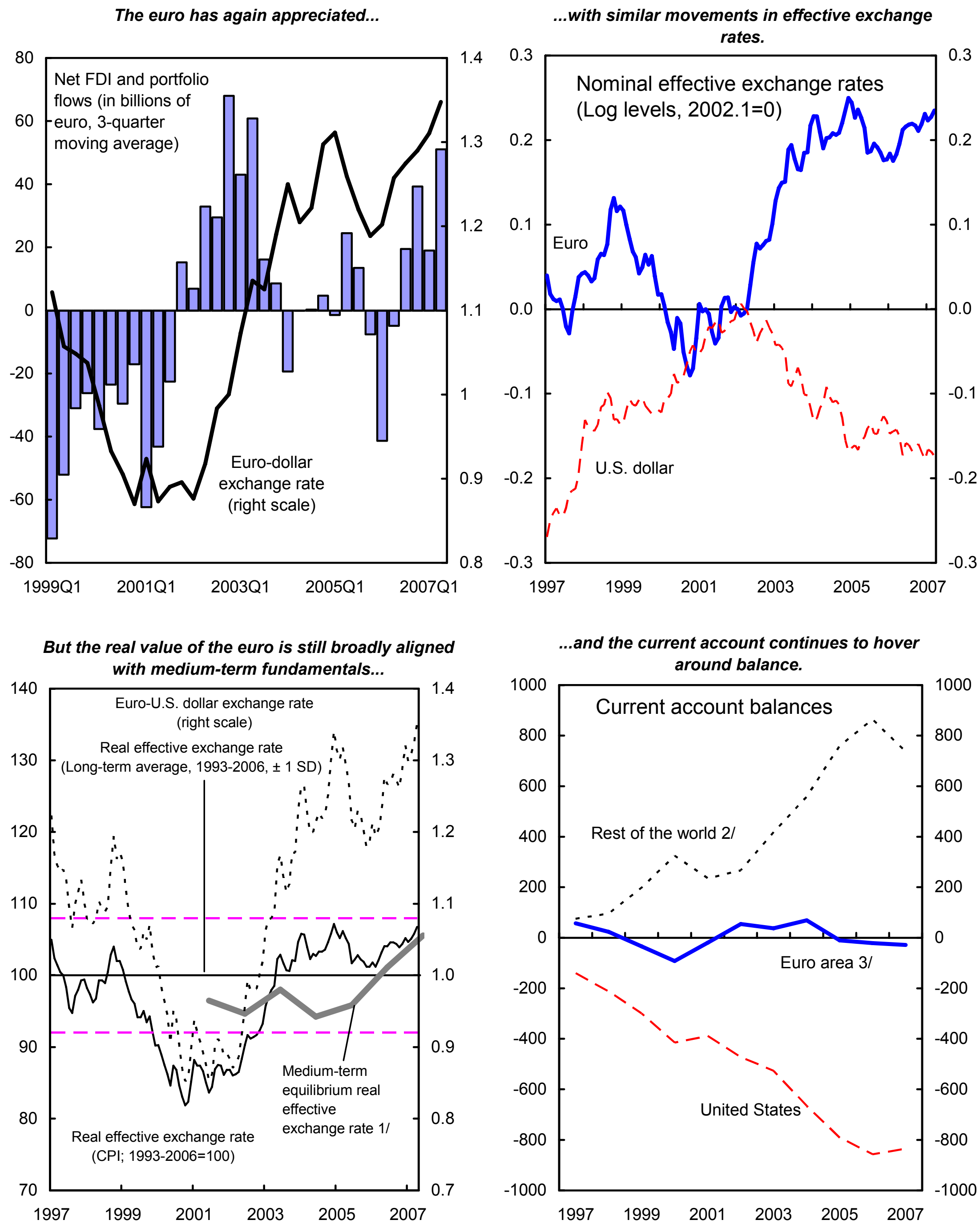
Figure 1. Euro Area: Cyclical Developments
(Annualized quarter-on-quarter percent change, unless otherwise specified)



Sources: Eurostat; Datastream; and IMF, *World Economic Outlook.*

Corrected: 7/23/07

Figure 18. Euro Area: External Developments
(in billions of U.S. dollars; unless otherwise specified)



Sources: ECB; Haver Analytics; IMF, *World Economic Outlook*.
1/ Staff estimate, based on a time series estimate with stochastic trend, a macroeconomic balance approach, and an external sustainability assessment.
2/ Rest of the world calculated as residual (excludes global discrepancy).
3/ Excludes intra-area trade (ECB data).

APPENDIX—STATISTICAL ISSUES

EURO AREA POLICIES

Statistics for the euro area (and the EU-27) are produced by Eurostat and the ECB, generally on the basis of data reported by member states. These statistics are of sufficient quality, scope, and timeliness to allow effective macroeconomic surveillance. Nonetheless, gaps and weaknesses remain, and many of these are difficult to resolve given institutional and other complexities, including the changing composition of the euro area and EU. In spite of these complexities, important progress has been made over the past year, including in particular with the publication of quarterly euro area (i.e., "national") accounts per institutional sector. The accessibility of euro area data has also improved thanks to the launch of the ECB's Statistical Data Warehouse.[13] Eurostat monitoring of member states' fiscal accounts is improving. Internationally comparable and higher-frequency financial soundness indicators, more housing market indicators, and improved statistics on non-bank financial intermediaries would be desirable. The IMF's Dissemination Standards Bulletin Board (DSBB)[14] provides comprehensive information on the Euro area's statistical practices for the Special Data Dissemination Standard (SDDS) data categories.

- Following up on last year's release of annual euro area accounts per institutional sector, Eurostat and the ECB published an initial set of quarterly euro area and EU-27 accounts per institutional sector in June 2007, covering 1999:Q1 until 2006:Q4. New releases will henceforth follow on a quarterly basis, with a delay that is to be gradually reduced to 95 days. The new quarterly data will also allow better timeliness of annual data. Work on non-financial balance sheets per sector continues.

- A revised *Nomenclature générale des Activités Economiques dans les Communautés Européennes* (NACE) classification, NACE Rev. 2, will be introduced gradually from 2008 onwards, applying to 2008 data and beyond. Its introduction will affect a wide range of statistical series and cause structural breaks due to the limited scope for back-casting.

- A European Statistics Code of Practice was adopted in 2005 for Eurostat and the national statistical agencies, with a coverage that is largely the same as that of the IMF's Data Quality Assessment Framework. Self-assessments using the Code of Practice have taken place, and peer assessments are now ongoing. The Code puts

[13] Available at: http://sdw.ecb.int/.

[14] Available at: http://dsbb.imf.org/.