SM/07/240
Correction 2

July 30, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Euro Area Policies**

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

Typographical Error

Page 9, para. 9, last line: for "(¶34)" read "(¶32)"

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

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Att : (1)

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Department Heads

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~~32)—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.