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IMF Executive Board Concludes 2008 Article IV Consultation on Euro Area Policies

On July 25, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation on Euro Area Policies.[1]

Background

Ten years after its launch, monetary union is a distinct success and the euro area a zone of stability in the international economy. However, economic union remains work in progress. Improved wage setting and labor market reforms have contributed to the creation of some 16 million jobs over the past decade. Similarly, the single market program and product market reforms have raised productivity in affected sectors. However, important challenges remain, including large intra-euro area current account and competitiveness divergences.

More recently, the euro area has shown relative robustness to global shocks, but activity is expected to slow due to high energy and food prices, tighter financial conditions, slowing global demand, and the appreciation of the real effective exchange rate of the euro. Staff projects annual average growth of 1.7 percent in 2008 and 1.2 percent in 2009, which masks a deceleration in the course of 2008 and re-acceleration toward trend during 2009.

Headline inflation has recently reached its highest levels since the launch of EMU, pushed up by energy and food prices. Nonetheless, underlying inflation and labor costs have been well contained thus far, testifying to the high credibility of the European Central Bank (ECB). With the economy slowing down, and provided food and energy prices stabilize, inflation should fall appreciably from its current levels, although risks are high. In this context, the ECB raised

[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.

interest rates by 25bps on July 3, to 4.25 percent, while rising risk premia have pushed up key money market interest rates to levels last reached during the mid-1990s.

The fiscal position of the euro area improved in 2007, reaching close to balance in structural terms. However, a number of countries still face appreciable fiscal challenges. Many have not yet reached their medium-term close-to-balance or surplus objectives, including almost all those with high public debt. Furthermore, against the background of already some relaxation in 2008 budgets, expansionary impulses are mounting in several countries.

The outlook for financial stability is highly uncertain, although the area's financial system remains sound. While appreciable progress has been made with respect to banks' loss recognition and recapitalization, many financial markets have yet to return to normal and the global financial turmoil has led to a tightening of financial conditions. The pressure on firms and households from higher risk premia and stricter lending standards, though not yet evident, will likely build considerably over time. Balance sheets outside the financial sector, however, still seem relatively robust.

Executive Board Assessment

Executive Directors noted that, ten years after its launch, the European Monetary Union (EMU) is a distinct success, and they commended the EMU's macroeconomic policy framework for bringing internal and external stability. Economic fundamentals have improved, although continued efforts are needed to build a more vibrant economic union.

Directors observed that, conjuncturally, the euro-area economy is being strained by an array of shocks—including from the commodity and financial markets—that is driving a combination of decelerating activity and uncomfortably high inflation. They also noted that the euro is now on the strong side relative to fundamentals. Directors concurred that growth will likely slow substantially this year before reaccelerating toward trend during 2009.

Directors observed that monetary policy has to balance the risk of a broad-based increase in inflation with the prospect of gradually building disinflationary forces due to slowing activity. Much hinges on how labor costs and inflation expectations will evolve. Although durable improvements in the functioning of labor markets and in anchoring inflation expectations have been achieved under EMU, risks of second-round effects remain and will need to be guarded against proactively. At the same time, Directors noted that financial conditions have tightened substantially since last summer, and that the financial environment remains under strain from the ongoing turbulence. In this setting, a number of Directors were of the view that policy rates are best kept on hold, with the ECB continuing to monitor all developments very closely in the period ahead. Other Directors emphasized the importance of vigilance in the face of the upside risks to price stability, in particular should wage settlements hint at accelerating labor costs in 2009.

Directors agreed that the ECB's policy frameworks have served it well in coping with the current difficult environment. The ECB's liquidity management framework has proven flexible and robust. The key challenge going forward is to restore the depth and orderly functioning of interbank markets. Directors welcomed the ECB's plans to keep the operational framework under continuous review, notably with respect to the collateral it accepts, and to ensure that the framework's rules are applied strictly. Directors noted that the ongoing work on enhancing the ECB's monetary analysis would help further strengthen the monetary policy framework, and several suggested that this could lead in due course to a unified presentation of policy decisions that integrates monetary and economic analysis.

Directors welcomed the steps taken to strengthen the EU's financial stability framework. Given the significant financial linkages and the EU's commitment to build a single market for financial services, Directors looked forward to further moves toward greater joint responsibility and accountability for EU financial stability. This will require aligning national financial stability frameworks with the EU's commonly agreed principles for crisis prevention, management, and resolution. In the near term, Directors stressed the need for further improvements in information sharing among supervisors and central banks, including the ECB.

Directors observed that the rules-based fiscal framework offered by the Stability and Growth Pact (SGP) has generally improved fiscal discipline and served the euro area well. However, about half of the euro-area countries still face persistent challenges in meeting their medium-term fiscal objectives. Progress with respect to lowering general government deficits and debt will be key for these countries in order to better meet the population aging-related fiscal challenges that are expected to mount rapidly after 2010. Accordingly, Directors agreed that the room for fiscal policy responses to the current downturn should be a function of the leeway allowed by the SGP. Support for more vulnerable sectors of the population should be well targeted and not distort price signals. More generally, Directors noted that stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries facing relatively high public sector deficits and debt.

Directors observed that past and ongoing structural reforms are bearing fruit, but that large parts of the services sector still remain to be opened to EU-wide competition. They emphasized that the structural reform momentum needs to be maintained and re-oriented in a coordinated manner to address intra-area disparities. Progress with this reform agenda would also be consistent with commitments made under the Fund's Multilateral Consultation on Global Imbalances.

Directors looked forward to strong EU leadership in working toward an ambitious and balanced conclusion of the Doha Round. They viewed lower agricultural trade barriers and lower subsidies as the right approach to foster production and respond to high food prices, and in that context, looked forward to the review of the Common Agricultural Policy next year. Directors also welcomed the EU's intention to keep its biofuels policies under review.

The views expressed by Executive Directors today will form part of the Article IV consultation discussions on individual members of the euro area that take place until the next Board discussion of euro area policies.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation on Euro Area Policies is also available.

Euro Area: Main Economic Indicators
(in percent change)

	2003	2004	2005	2006	2007	2008	2009
						Staff projections	
Demand and Supply							
Private consumption	1.3	1.6	1.6	1.8	1.5	1.3	1.1
Public consumption	1.8	1.4	1.5	2.0	2.2	2.1	2.0
Gross fixed investment	1.4	2.4	3.0	5.0	4.3	3.5	1.2
Final domestic demand	1.4	1.7	1.8	2.5	2.3	2.0	1.3
Stockbuilding 1/	0.1	0.2	0.0	0.1	0.0	-0.2	-0.1
Domestic Demand	1.5	2.0	1.9	2.6	2.2	1.7	1.2
Foreign balance 1/	-0.7	0.2	-0.2	0.2	0.3	0.0	0.1
Exports 2/	1.2	7.2	4.7	7.9	6.0	5.1	3.8
Imports 2/	3.3	7.0	5.4	7.7	5.2	5.2	3.8
Real GDP	0.8	2.1	1.6	2.8	2.6	1.7	1.2
Resource Utilization							
Potential GDP	2.0	2.0	1.9	2.0	2.0	2.0	2.0
Output gap	-0.9	-0.8	-1.1	-0.3	0.2	0.0	-0.8
Employment	0.7	0.7	0.9	1.5	1.9	0.9	0.4
Unemployment rate 3/	8.7	8.8	8.6	8.2	7.4	7.3	7.4
Prices							
GDP deflator	2.2	1.9	1.9	1.9	2.2	2.2	1.9
Consumer prices	2.1	2.1	2.2	2.2	2.1	3.4	2.4
Public Finance 4/							
General government balance	-3.1	-2.9	-2.6	-1.3	-0.6	-1.0	-1.1
General government structural balance	-2.7	-2.4	-2.1	-1.2	-0.8	-1.1	-0.8
General government gross debt	69.3	69.7	70.3	68.6	66.5	65.2	64.4
Interest Rates							
Short-term deposit rate	2.3	2.1	2.3	3.2	4.2	…	…
Long-term government bond yields	4.0	4.0	3.4	3.9	4.4	…	…
Exchange Rates 5/							
U.S. dollar per euro	1.13	1.24	1.25	1.26	1.37	1.55	…
Nominal effective rate (2000=100)	117.6	122.0	121.7	122.6	128.9	136.4	…
Real effective rate (2000=100) 6/	122.3	130.0	129.1	128.8	134.8	142.3	…
External Sector 4/ 7/							
Current account balance	0.4	0.8	0.2	0.0	0.3	-0.5	-0.6
Trade balance 8/	1.4	1.3	0.6	0.2	0.6	-0.1	-0.2

Sources: IMF, *World Economic Outlook;* Eurostat, ECB Monthly Bulletin.
1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ US dollar rate, as of June 23, 2008; nominal and real effective rates, as of May 2008.
6/ Based on normalized unit labor costs.
7/ Based on ECB data, which exclude intra-euro area flows.
8/ Data for goods.