



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.7.2006
SEC(2006) 936

COMMISSION STAFF WORKING DOCUMENT

ANNUAL REPORT ON THE EURO AREA – 2006

Accompanying the

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN
CENTRAL BANK
- Annual Statement on the Euro Area -**

{COM(2006) 392 final}

ANNUAL REPORT ON THE EURO AREA – 2006

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SUMMARY

This Annual Report on the Euro Area, which was prepared by the Commission services, explores in greater depth the shared economic challenges facing euro-area members highlighted in the Annual Statement on the Euro Area.

Macroeconomic Developments and Outlook (Chapter 1): Following a comparatively sluggish recovery from the 2001-2003 slowdown, the outlook for the euro area in 2006 is more positive, thanks to a strengthening of domestic demand and the continuing strength of the world economy. According to the Commission's Spring 2006 forecasts, euro-area GDP will grow by 2.1% in 2006, with over 1 million new jobs being created this year. The short-term risks to the euro-area's continued economic recovery appear to be fairly balanced. On the internal side, upside risks include the possibility that past or ongoing structural reforms could spur consumer confidence by more than expected. On the external side, the possibility of a disorderly unwinding of global imbalances is among the downside risks.

The Macroeconomic Policy Setting (Chapter 2): The euro-area's economic recovery has been supported by EMU's macroeconomic framework, which has delivered a favourable policy mix of low interest rates and given greater scope for automatic budgetary stabilisers to operate. As the economic situation and outlook in the euro area improve, an adjustment of the macroeconomic policy setting is warranted. In particular, a more ambitious budgetary adjustment in 2006 and 2007 in line with the preventive arm of the Stability and Growth Pact is desirable in view of the improved economic and employment situation.

A Dynamic and Smooth Functioning EMU (Chapter 3): Although structural reforms offer benefits to all EU Member States, euro-area members have an added incentive to enhance structural reform. In the first place, the benefits of structural reform will accrue more quickly if members of a monetary union open up product, labour and capital markets in tandem. Furthermore, structural reforms are essential for the smooth functioning of EMU. For example, structural reforms to increase the responsiveness of prices and wages to economic shocks would help to reduce the unwarranted growth and inflation differences in the euro area which, though not usually large, have nevertheless persisted in recent years. Among the structural reforms that could help to promote the smooth functioning of EMU are measures to remove formal and informal mechanisms of wage indexation, promote greater differentiation in minimum-wage legislation, and ensure further liberalisation in network industries.

The External Dimension (Chapter 4): At the European Council at Vienna in December 1998, EU leaders agreed that the euro area should speak with one voice on issues of particular relevance to EMU. Since the launch of the euro, limited progress has been made in achieving this goal, with the result that the euro-area's representation in international financial institutions, such as the International Monetary Fund, International Monetary and Financial Committee, the G7 Finance Ministers Meetings and the G20 lacks coherence. These shortcomings make it difficult for the euro area to show leadership on global economic challenges, such as the need to promote an orderly adjustment to the large current-account imbalances that have built up in the global economy. The euro area can show global economic leadership by encouraging, *inter alia*, a gradual shift in global demand from regions with current-account deficits to regions with current-account surpluses. Within the euro area, enhanced economic reforms can help the economy to be more responsive to external economic shocks.

CHAPTER 1

MACROECONOMIC DEVELOPMENTS AND OUTLOOK

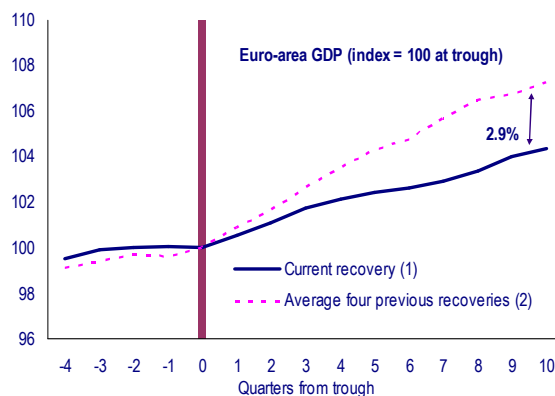
1. *Following a relatively mild downturn in 2001-2003, the euro-area economy experienced a comparatively slow recovery.* A key factor here has been weak domestic demand, which has lagged behind the average level experienced in previous downturns. The outlook for 2006 is brighter with the economic recovery expected to accelerate. Supported by strong investment, signs of greater confidence among consumers and a buoyant world economy, euro-area GDP is expected to grow by 2.1% in 2006, with 1 million new jobs being created.

1.1 THE ECONOMIC RECOVERY IN CONTEXT

2. *The economic downturn experienced by the euro-area in 2001-2003 was relatively mild when compared with past experience.* A comparison of the last three major downturns in the euro area shows that all started from a positive output gap of around 2%. In the downturn of the early 1980s, the output gap reached a trough of -2.7% four years into the slowdown, while during the downturn of the early 1990s it reached a trough of -1.7%. In the most recent downturn, the output gap has remained above -1% in the five years following the slowdown.

Graph 1.1: Comparison to previous

recoveries: GDP



(1) Starting 2003Q3.

(2) Starting 1982Q4, 1987Q1, 1993Q2, 1999Q1, respectively.

Source: Commission services.

3. *The current euro area economy has sluggish compared performance.* When average performance past four recoveries, economic activity in remained more current cycle, which The pick-up of was much more recoveries of 1982 stages of the current were more recoveries which 1999. However, in 2004, the euro-area

ground even to these milder economic expansions. The net result is that at the end of 2005, ten quarters after the beginning of the last expansion, euro-area output was about 2.9% lower than the average level recorded during the previous four recoveries (Graph 1.1).

recovery of the euro-been relatively with past economic measured against the of output during the the expansion of the euro area has subdued during the started in mid-2003. economic activity vigorous during the and 1987. The early expansion phase comparable with the began in 1993 and the second half of business cycle lost

4. *The sluggish performance of Italy, Germany and the Netherlands appears to be a key factor in explaining aggregate developments at the euro-area level* (Table 1.1). With the exception of Spain, output remains lower than the average level recorded for the previous recoveries ten quarters after the current recovery started in the largest euro-area countries. The size of this gap ranges from 0.1% in France to 0.6% in the Netherlands.

Table 1.1: **Growth of GDP components in the current and previous recoveries in selected Member States**

	Previous recoveries %	Current recovery %	Cumulative growth differentials pp.
Germany	0.7	0.3	3.8
France	0.6	0.5	1.7
Italy	0.7	0.2	5.8
Spain	0.8	0.8	0.2
Netherlands	1.0	0.4	5.7

Quarter-on-quarter average growth rate in the first ten quarters following the trough. Cumulative growth differentials over the same period.

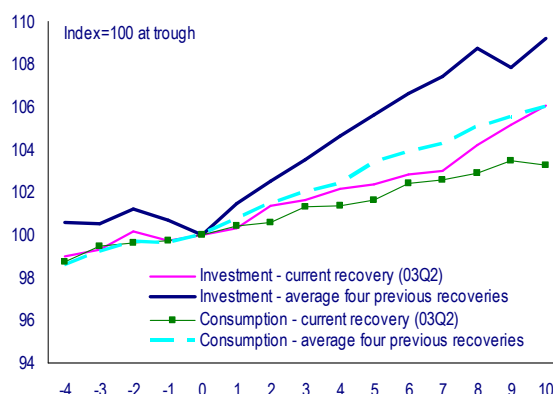
Source: Commission services.

1.2 FACTORS WEIGHING ON THE ECONOMIC RECOVERY

5. *There are a number of possible explanations of the euro-area's slow economic recovery.* It may be linked to the relative shallowness of the 2001 slowdown compared with previous downturns and thus be of a cyclical nature. It may also indicate a slowdown in potential growth, suggesting that structural explanations may be behind the euro-area's sluggish performance. Empirical estimates by the Commission suggest that less than half of the growth shortfall can be attributed to lower potential growth. The main reason for the euro-area's slow economic recovery appears to be the cyclical weakness in domestic demand.

6. *Total investment in the euro area has so far been disappointing compared with past recoveries.* Ten quarters after the beginning of the 2003 expansion, the level of gross fixed capital formation was around 3% below the average level recorded during the previous four recoveries (Graph 1.2). This low level of investment expenditure is due not only to cyclical factors i.e. weak domestic demand but also to structural factors. In particular, financial overstretching by the corporate sector in the late 1990s and concerns over the slowdown in the deceleration of the pace of technical progress registered in the euro area both appear to have dampened investment during the economic recovery. In Germany, the long-lasting adjustment to the significant construction oversupply in the wake of unification shows up in the investment figures for the euro area as a whole.

Graph 1.2: Investment and consumption during the current and past recoveries



Source: Commission services.

7. The current has also been private

and a half years after 2003 expansion, the consumption was the average level previous four (Graph 1.2). Weak is linked, in part, to level of saving. The during the period of 2001) and stabilised which followed. sustainability of

healthcare systems are likely to have kept the saving ratio high and have more than offset the downward pressure on saving exerted by EMU via lower interest rates and financial liberalisation. Uncertainties over the effects of economic reforms may also have weighed on consumption expenditure

economic recovery marked by weak consumption.

Two the beginning of the level of private around 2.8% below recorded during the recoveries

private consumption the relatively high saving ratio rose strong growth (2000- during the downturn Concerns about the public pension and

8. **Slow employment growth during the economic recovery has also dampened private consumption.** The euro-area labour market has proved more resilient in the last economic slowdown compared to earlier cycles. Employment growth remained positive throughout the downturn and the rise in unemployment was limited, with the unemployment rate peaking at 8.9% in the fourth quarter of 2004. However, the more limited response in the labour market in the downturn has been followed by a similarly more tempered response in the subsequent economic upturn.

1.3 A MORE POSITIVE GROWTH OUTLOOK FOR 2006

9. **After the protracted period of slow recovery, economic growth is expected to accelerate in the euro area in 2006.** According to the European Commission's Spring Economic Forecast, which was released on 8 May, GDP growth is expected to pick up to 2.1 this year¹. The dispersion of annual growth rates across euro area Member States remains significant. In 2006, Finland, Greece, Spain, Ireland and Luxembourg are expected to post growth rates of more than 3%, whilst Portugal is expected to see output growth of below 1%.

10. **The euro-area's economic recovery is underpinned by a strengthening of domestic demand, particularly investment.** In 2006, total investment is expected to grow by 4.2%, over one percentage point higher than expected in the previous forecast. This pickup in investment is due to historically-low interest rates, improved corporate balance sheets, wider profit margins, and an increasing need for replacement investment. Construction investment is expected to be strong in 2006, driven by the positive outlook in Germany.

¹ The full details of the European Commission's Spring Economic Forecast for 2006 are available at http://europa.eu.int/comm/economy_finance/index_en.htm

11. *The outlook for consumption in the euro area in 2006 is for a modest upturn.* The European Commission's latest forecast foresees an increase in household consumption expenditure of 1.7% this year – around 0.3 percentage points higher than expected in the previous forecast. This is consistent with consumer surveys, which have shown a gradual but sustained rise in confidence since the middle of last year. This confidence is due, in part, to the positive impact of the economic recovery on labour market conditions in the euro area (see below).

Table 1.2: Euro-area growth components, 2006

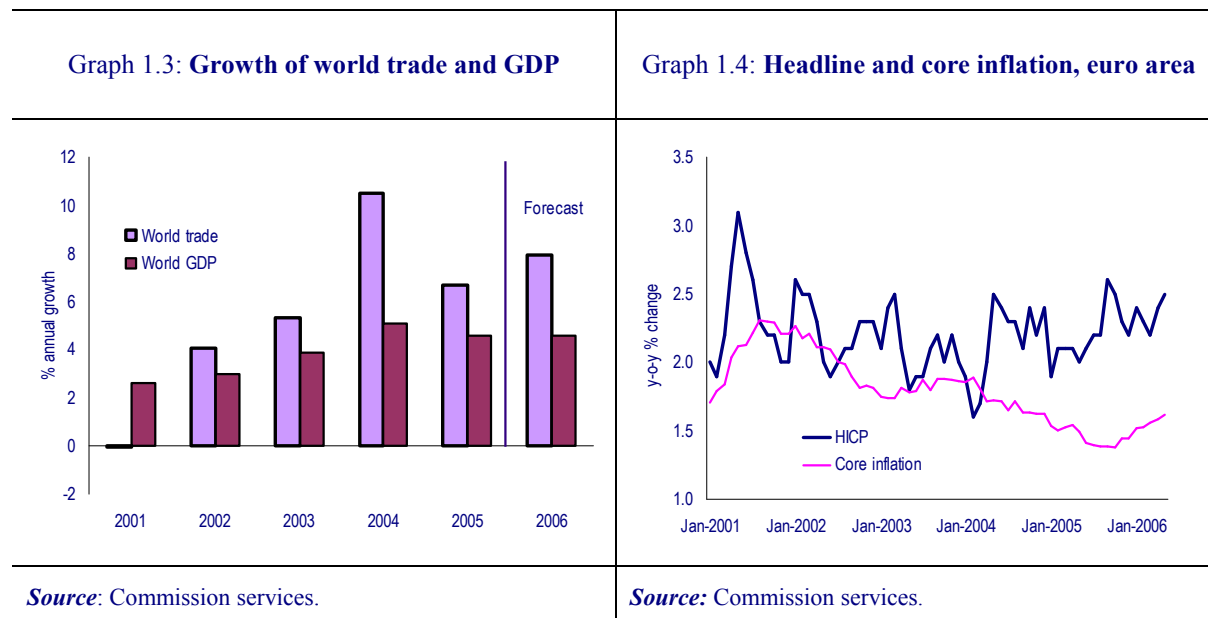
	% change on previous year	
	Spring	Autumn Forecast 2005
	Forecast 2006	
GDP	2.1	1.9
Private consumption	1.7	1.4
Government consumption	2.0	2.0
Gross fixed capital formation	4.2	3.1
Changes in inventories (% of GDP)	0.6	0.5
Exports of goods and services	5.4	5.0
Imports of goods and services	6.0	5.0
	contribution to change in GDP (% point)	
Private consumption	1.0	0.8
Government consumption	0.4	0.4
Gross fixed capital formation	0.9	0.6
Changes in inventories	0.0	0.0
Net exports	-0.2	-0.1

Source: Commission services.

12. *The euro-area's economic recovery is also being helped by the continued strong expansion of world output and trade* (see Graph 1.3). In 2006, world GDP growth will remain steady at 4.6%, only ½ of a percentage point lower than the record high attained in 2004. Robust global growth has been particularly pronounced in manufacturing, and strong overall performances by China, India, Japan and the USA have played an important role.

13. **The strong growth in world output has gone hand in hand with a healthy increase in world trade.** In 2006, world trade growth is projected to be in the vicinity of 8%. Exports from the euro area to the rest of the world area are forecast to grow by 5½% in 2006 – around

half a percentage point higher than expected in the previous forecast. Imports are projected to outpace exports in 2006, but this trend is expected to be reversed thereafter. As a result, the contribution of the external side to growth will still be negative in 2006, but is expected to turn positive next year.



14. *At the Member State level, the competitiveness of exporters in markets outside the euro area has changed markedly in recent years.* Gains have been made, for example, by Germany and Austria whilst competitiveness has deteriorated in Greece, Spain, Ireland, Italy and Portugal. This implies that the degree to which countries will be able to take advantage of the buoyant world economy in 2006 may differ significantly.

1.4 INFLATION OUTLOOK AND THE IMPACT OF HIGH OIL PRICES

15. *Oil prices have recently reached record high levels, with a barrel of Brent crude oil costing almost 70 USD in late June.* Robust growth in global demand, low spare capacity, disruptions to oil production in Nigeria and geopolitical uncertainty surrounding Iran and Iraq are all factors behind the surge in prices.

16. *The Commission's forecast expects oil prices to remain high over the forecast period.* It is assumed that the price of Brent will average 68.9 USD per barrel in 2006, in line with the profile suggested by futures prices. This corresponds to an increase in the average annual price of 27.4% compared to 2005.

17. *Against the backdrop, the Commission expects consumer price inflation to remain at 2.2% in the euro area in 2006* (Graph 1.3). This view is based on the evidence that, thus far, marked increases in oil and energy prices have not led to significant indirect effects on the Harmonised Index of Consumer Prices (see Box 1.1 for a more detailed discussion). Moreover, core inflation, i.e. consumer price inflation excluding energy and unprocessed food continued to decline in 2005 and stood at 1.5% in May 2006 (Graph 1.4). The dispersion of annual inflation rates across euro area Member States remains a source of concern. In 2006,

the gap between the highest and lowest inflation countries is expected to be 2.7 percentage points (see Chapter 3).

Box 1.1: The impact of oil prices on the euro-area economy

The Commission's macroeconomic model (Quest II) has been used to simulate the effects of a permanent 10 USD increase in oil prices from 60 USD to 70 USD per barrel, roughly in line with the change assumed in the Spring Economic Forecast. GDP growth in the euro area would be lowered by 0.3 percentage points in the first year, and by 0.1 percentage points in the second and third years. Consumer price inflation would be 0.2 percentage points higher in the first and second year.

Table: EU12 Permanent oil price shock 10 dollars (+17%) (baseline \$60)

Year	1	2	3	4	5
GDP	-0.27	-0.39	-0.45	-0.47	-0.49
GDP growth	-0.27	-0.11	-0.06	-0.03	-0.01
Consumer price level	0.19	0.37	0.35	0.32	0.29
Consumer price inflation	0.19	0.19	-0.03	-0.03	-0.03

Note: percentage (points) difference from baseline (i.e. oil price \$60)

Source: Commission services.

On the basis of these results, it appears that the negative economic consequences of higher oil prices are smaller today than in previous episodes of sharply rising oil prices. This is due to a number of factors. Firstly, high oil prices are partly due to strong demand for oil as a consequence of high global GDP growth. Secondly, the energy intensity of the advanced economies has decreased. Thirdly, increased competition in the tradable sector, due to globalisation and European economic integration, and the lower degree of wage indexation helps to curb the inflationary impact of higher oil prices. Finally, macroeconomic policies have improved, with clear price stability responsibility entrusted to independent central banks.

1.5 OUTLOOK FOR THE EURO-AREA LABOUR MARKET

18. *Employment growth in the euro area is expected to improve this year in line with the predicted acceleration in the economic recovery.* According to the Commission's Spring Economic Forecast, total employment will grow by 0.9% in 2006. Although this is the highest rate of employment growth in the euro area since 2001, it is nevertheless below the 1.1% growth rate expected in the Commission's Autumn Economic Forecast. This downward revision reflects, *inter alia*, the rise of temporary jobs and part-time employment and the effect of one-off country-specific factors on employment growth in 2005.

19. *Although the euro area is expected to create over one million new jobs this year, the decline in unemployment will be limited to around 100,000 persons.* This is because of the traditional influx of persons into the labour force when the labour market situation improves (and latent job-seekers return to the regular labour market in active search of employment). The unemployment rate is therefore expected to decline only modestly to 8.4% of the labour force in the euro area in 2006.

1.6 RISKS TO THE ECONOMIC RECOVERY

20. *At this juncture, the short-term risks to the euro-area's continued economic recovery appear to be fairly balanced.* On the internal side, there are both upside and downside risks, while on the external side, negative risks appear to be increasing over time.

21. *On the internal side, improving labour market conditions and the effects of past or ongoing structural reforms could spur consumer confidence by more than expected.* This would trigger a release of pent-up demand which has accumulated in the household sector and which could be realised through a reduction in the savings rate. On the other hand, while not a problem for the euro area or the EU as a whole, house prices seem to be stretched in some Member States and could pose a downside risk in these countries, especially if the price corrections are not gradual.

22. *There are positive and negative risks to continued investment growth in the euro area.* Positive risks arise from stronger growth of specific construction markets, stronger-than-expected external demand or higher productivity as a result of past IT-investments and reforms. Negative risks include higher oil prices, a disappointing development of aggregate demand and entrenched low-growth expectations.

23. *An additional risk to domestic demand is the uncertainty surrounding the impact of budgetary consolidation in the euro-area's largest economy, Germany.* The Commission's economic forecast expects German households to bring forward some purchases of durable consumer goods in anticipation of the VAT increase. As a result, private consumption is projected to increase strongly in 2006 and to fall slightly in 2007. Overall, the impact of the VAT increase on growth should be neutral. However, it cannot be excluded that the reaction of economic agents to the government's consolidation package may be different than expected with effects on GDP growth in Germany and the euro area.

24. *On the external side, despite some easing since last autumn, oil and energy prices remain exceptionally high and volatile.* With continuous high demand, the market remains vulnerable to supply disruptions. Price increases above those already assumed can thus not be ruled out and continue to be one of the main risks to the economic recovery. By the same token, if oil prices currently contain a high risk premium due to geopolitical tensions, an easing of these tensions could also imply the possibility of a decline in oil prices.

25. *The risk of a disorderly unwinding of global imbalances remains a threat to world growth.* The exceptionally large and persistent global current account imbalances have led to fears of disruptive exchange rate realignments, with significant global implications. Furthermore, the gradual withdrawal of monetary stimulus across world regions could affect financial markets more adversely than is usually assumed. The rapid growth in highly complex financial instruments, such as credit derivatives, and its potential impact on the stability of the international financial system is an additional source of concern.

26. *A stronger-than-expected adjustment of consumer behaviour in the USA as a consequence of a sharper-than-expected correction in the US housing market cannot be ruled out.* However, the strong momentum in the world economy and the buoyancy in many survey indicators also imply some upside risks to the world economy, especially on the shorter horizon. In addition to the USA, a stronger-than-expected consolidation of the recovery in Japan presents an upside risk.

27. *A further risk reflects the continued concern about a possible global pandemic originating from an avian flu.* However, the likelihood and the severity of a pandemic are extremely difficult to assess with any significant degree of confidence.

THE MACROECONOMIC POLICY SETTING

28. ***An adjustment of macroeconomic policies in view of the changing economic situation and outlook is warranted.*** Now that the recovery is becoming more firmly established, the stimulus provided by monetary policy is being gradually withdrawn. Against the background of a more favourable outlook for growth, it now appears necessary to step up fiscal consolidation to improve budgetary sustainability in the light of still high levels of public deficits and debt and the expected surge in public expenditures because of the ageing population. Adopting a "wait and see" attitude at this juncture would imply postponing improvements in structural balances until economic conditions are less favourable and budgetary consolidation is harder to implement. It is essential that fiscal consolidation goes hand in hand with growth and jobs by re-directing the composition of public expenditure towards growth-enhancing categories.

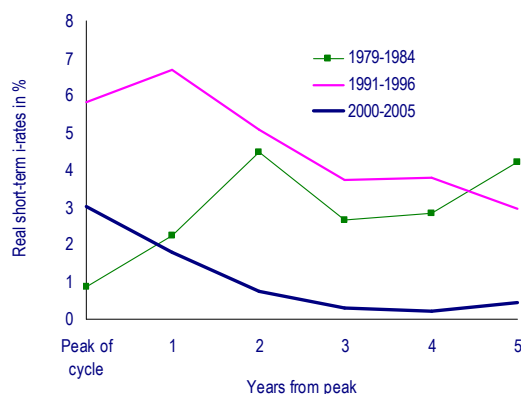
29. ***The overall aim of macroeconomic policy in the euro area is to keep output close to potential, whilst preserving price stability.*** Sound policymaking consists of a clear medium-term strategy as well as adequate short-term responses. The medium-term strategy minimizes the uncertainty of households and businesses about future macroeconomic policies and encourages consumption and investment decisions which in turn are supportive of stability and growth. The short-term responsiveness of policies is essential as economic circumstances change continuously. Policy makers must remain alert and be prepared to adjust their policy instruments if and when the need arises. To give an analogy, it could be said that the medium-term objective of macroeconomic policies is to get the cruise control right. The short-term objective is to accelerate or brake at the right moment and to the right degree. This chapter looks at monetary and fiscal policy from both a medium-term and short-term perspective.

2.1 MONETARY POLICY: GRADUAL WITHDRAWAL OF THE STIMULUS

Monetary conditions remain accommodating

30. ***Monetary policy has played an important role in the euro-area's economic recovery.*** Following the decline in economic activity since the cyclical peak in 2000, monetary policy has helped to spur economic activity and promote confidence through historically low nominal and real interest rates. Indeed, short-term interest rates have been much more accommodative in recent years than they were during previous economic downturns. For example, following the recent slowdown, real short-term interest rates were considerably lower than was the case following the recessions of 1979-80 and 1992-93 (Graph 2.1).

Graph 2.1: Short term (3 month) real interest rates



Source: Commission services.

31. Interest rates are historical

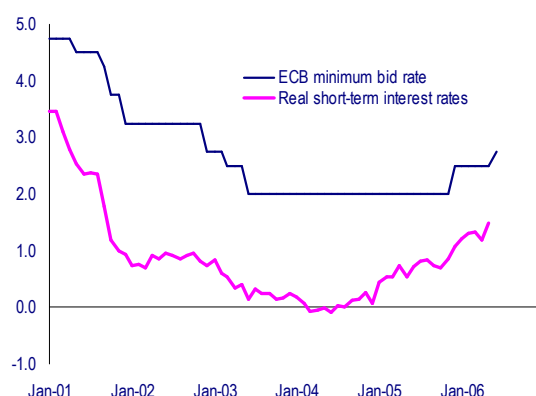
lower than most neutral rate. After rate by 275 basis and 2003, the ECB unchanged for more three recent hikes in December 2005, 2 2006 – were the first October 2000, main policy rate to The rate hikes should medium- to long-expectations, which

still low from a perspective and estimates of a lowering its policy points between 2001 left its policy rate than two years. The the policy rate – on 1 March and 8 June increases since bringing the ECB's 2.75% (Graph 2.2). help to anchor term inflation recently have

increased slightly. Despite these rate hikes, nominal and real short-term interest rates remain low by historical standards. For comparison, the lowest level of nominal interest rates ever attained by the German Bundesbank was 2.5%. The current level of interest rates is still below plausible measures of a neutral level for the euro area, which has fallen significantly during the last decade. Long-term interest rates experienced a sustained downward trend until late 2005, reaching levels last seen in the heyday of the Gold Standard. Since the end of 2005, however, bond yields have gradually increased by around 100 basis points but are still low from a historical perspective. These low interest rates, which are a global phenomenon, have sparked off a search for yield. Spreads between high-risk and low-risk investments have been dwarfed so that a misallocation of resources may have taken place – recent developments suggest that some correction may be taking place.

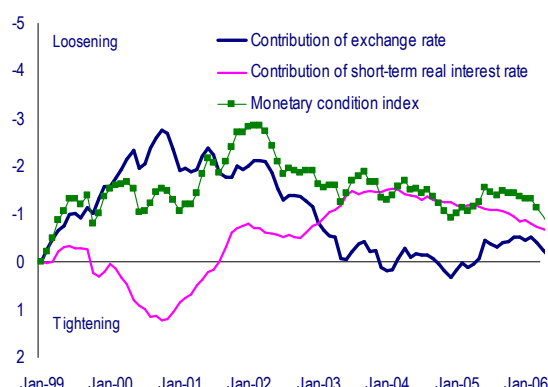
Graph 2.2: ECB policy rate

(nominal and short-term real interest rates)



Source: Commission services.

Graph 2.3: Monetary conditions index



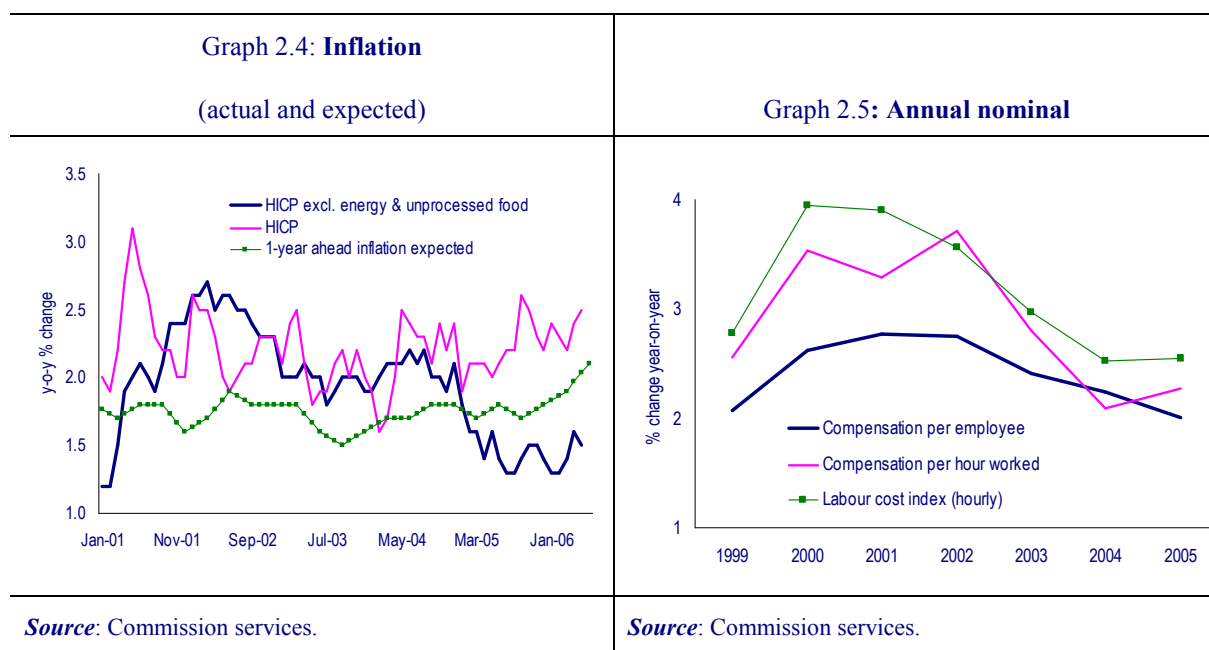
Source: Commission services.

32. Exchange rate developments have had a bearing on monetary conditions in the euro area (Graph 2.3). This can be seen from the evolution of the real effective exchange

rate (REER), which measures the real value (i.e. the value corrected by a price deflator such as consumer price inflation) of the euro relative to the currencies of the euro-area's main trading partners. In 2005, the REER depreciated, having a loosening effect on monetary conditions. This trend has been reversed in the first half of 2006. These changes in the REER are due, in part, to swings in the euro-dollar exchange rate that saw the euro lose some 15% against the US dollar in nominal terms in the course of 2005, before appreciating by 8% between February and June 2006 (see Chapter 4 for a more detailed discussion of exchange-rate developments).

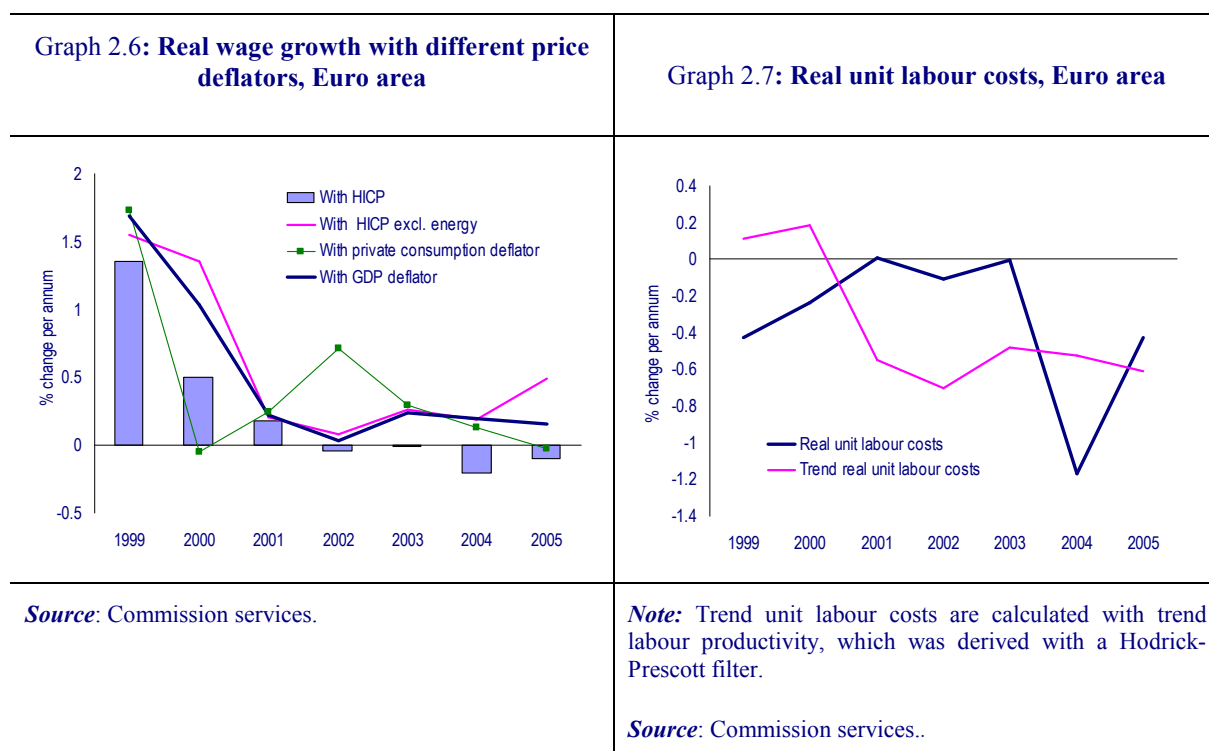
33. ***Overall, monetary conditions have remained relatively accommodative.*** A commonly used indicator for assessing monetary developments is the Monetary Conditions Index (MCI) which is calculated as a weighted average of the real short-term interest rate and the real effective exchange rate relative to their value in a base period. As a rule, the weights reflect the relative effects of these variables on aggregate demand. An examination of the MCI shows that recent monetary conditions have been relatively accommodative (Graph 2.3).

34. ***Ample liquidity poses inflation risk.*** Empirical evidence shows that prolonged periods of high inflation have always been associated with high monetary growth. Over the last years, there has been clear evidence of exceptional liquidity growth in the global economy. Quantitative measures such as the monetary base, broad money and credit to the private sector have increased substantially. In the euro area, M3 growth has accelerated rapidly over the last year. Private sector credit growth, loans to households for house purchase and loans to non-bank financial institutions are at their highest levels since 2001. At the current juncture, stronger monetary growth has been driven by low interest rates as reflected in the strong increase of the most liquid components of M3 and the increasing demand for loans. This is an important difference relative to earlier periods of strong money growth. For example, between 2001 and 2003, when monetary growth was comparable to today's rate, the main driver was sizeable portfolio shifts into money, seen as a safe haven at a time of heightened uncertainty. At present, stronger monetary dynamics can no longer be interpreted as reflecting heightened financial and economic uncertainties. To avoid strong monetary dynamics ultimately finding their way through to higher prices of goods and services there is a need to closely monitor monetary developments.



35. ***Inflation rates have stayed close to but above the 2% ceiling.*** Consumer price inflation has come down from rates of around 7% in the 1980s and above 4% in the early 1990s to slightly above 2% in recent years (Graph 2.4). However, core inflation (which excludes volatile components, such as unprocessed food and energy prices) is still below 1.5%. Long-term inflation expectations are below 2%, while short-term expectations are slightly above 2%. Inflation rates differ between Member States: the difference between the highest and lowest rates of inflation in the euro area stood at 3 percentage points in 2005. While inflation differentials in large monetary unions are a normal phenomenon, their persistence among some euro area Member States is worrying (see Chapter 3).

36. ***The euro-area's economic recovery has coincided with a remarkable degree of wage moderation.*** In 2005, harmonised wage indicators show that low nominal wage growth has prevailed in the euro area (Graph 2.5). The annual growth rate of compensation per employee was the same as that of consumer price inflation, leading to virtually unchanged real wages in the euro area in 2005. The use of alternative price deflators confirms the picture of very low real wage growth, albeit suggesting small increases each year (Graph 2.6).



37. *Since wage growth and inflation were almost equal in the euro area in 2005, wage moderation has contributed to declining real unit labour costs.* Indeed, real unit labour costs have not increased on an annual basis since the single currency was introduced. The combination of a weakening in economic growth and a gradual acceleration in employment growth in 2005 means that labour-productivity growth decelerated and therewith unit labour costs declined by less than in the previous year. This behaviour of labour productivity seems to be largely a reflection of cyclical movements, namely the lagged response of employment in 2005 to the acceleration of GDP growth in 2004. The change in trend unit labour costs suggests that a further, albeit small, deceleration took place in 2005, which largely reversed the relation of actual and trend unit labour costs recorded in 2004. Overall, it appears that real unit labour costs in the euro area have remained on a downward path.

38. *Market forces as well as the behaviour of social partners in collective bargaining have contributed to continuously moderate wage growth in the euro area.* According to the ECB's indicator of negotiated wages, the wage increase agreed in collective bargaining was 2.1% in 2005, the same rate as the year before. Although the economic recovery is likely to fuel calls for wage increases, continued moderation is essential. In the first place, low wage growth can help to reduce inflationary pressures that may jeopardise the economic recovery. Furthermore, as argued in Chapter 3, promoting employment growth through wage moderation is justified against the backdrop of high and persistent unemployment of well above 8%.

Market participants expect a further tightening of monetary conditions

39. *Over the long-term, low inflation rates in industrialised economies should not be taken for granted.* Some economists have argued that inflation rates in industrial countries have come down permanently because of intensifying competition from countries with low productions costs such as China and India or because of the credibility that central banks have acquired in delivering price stability. If this view is correct, excess liquidity is likely to feed

into asset prices rather than consumer prices with the potential risk of asset price bubbles and subsequent busts. Although globalisation is likely to have exerted downward pressure on prices in some cases, the opposite is also true in other cases. For example, the rapid economic growth of China and India and the resulting extra demand for primary products has contributed to increases in the prices of energy and other primary products. Moreover, asset prices, in particular equity and housing prices, have continued to rise, but – at the euro area level – the risk of bubbles so far seems low. Nevertheless, the excess liquidity and the potential build up of risks deserve to be closely monitored.

40. ***From a short-term perspective, risks to price stability are currently on the upside.*** Euro-area inflation was 2.5% in May. Despite the three recent interest rate hikes, monetary and financial conditions in the euro area have remained accommodative. As discussed above, both short-term and long-term interest rates are still very low by historical standards, and the Monetary Conditions Index (MCI) suggests that the monetary stance is still accommodative. This is confirmed by other indicators. The annual growth of money (M3) remains at a high level and growth rates of the most liquid components have even increased further in recent months. Moreover, credit growth is strong and asset prices, in particular equity and housing prices, have continued to rise.

41. ***Market participants expect a further tightening of monetary conditions.*** Market expectations as derived from futures contracts now fully price in another two hikes by 25 basis points each before the end of the year. A high probability is also given to another hike during 2007. Furthermore, the possibility of a continued appreciation of the euro's REER as a result of, *inter alia*, an unwinding of global imbalances, could weigh on monetary conditions (See Chapter 4 for a more in-depth treatment of this issue).

2.2 FISCAL POLICY: CONSOLIDATION NEEDED IN MOST MEMBER STATES

42. ***Fiscal policies remain the responsibility of individual Member States but the Treaty and the Stability and Growth Pact set out general requirements for the conduct of prudent national budgetary policies.*** This is because sound fiscal policies are essential for the success of a single monetary policy. Over the medium- and long-term this framework helps to promote sustainable public finances and certainty about their evolution. Once sound budgetary positions have been secured, governments would be able to let the automatic stabilisers work fully during downswings and upturns so as to smoothen fluctuations in economic activity in the short run².

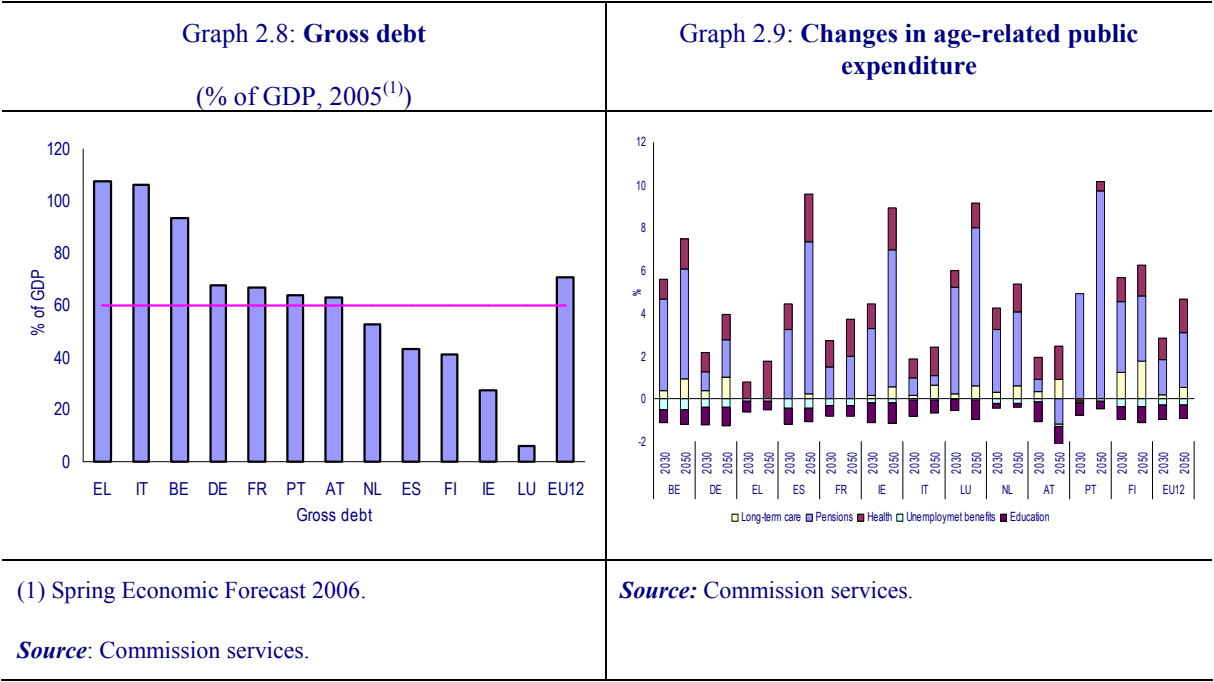
43. ***Member States can also make a positive contribution to economic growth by improving the quality of their public finances.*** Public finances in the euro area represent about half of the economy and, therefore, the way in which public budgets are spent and financed has significant implications for the attainment of the Lisbon Agenda objectives in terms of growth and employment. As decreases in interest payments fade out, the resources for redirecting spending towards growth-enhancing items will need to be found in other categories of public expenditure, for which those of transfers and consumption are by far the largest. Country

² A detailed examination of Member States' fiscal policies and the revised Stability and Growth Pact are presented Commission's report "Public finances in EMU - 2006" See http://ec.europa.eu/economy_finance/publications/european_economy/public_finances2006_en.htm

experiences show that Member States that succeed in maintaining fiscal discipline have been able to reallocate public resources in a more adequate manner. Furthermore, countries that have been at the forefront of institutional reforms, by introducing national expenditure rules and performance budgeting schemes within a medium-term framework, manage better to redirect public spending towards their expenditure priorities.

Medium term objective crucial in light of high current debt and ageing population

44. *One reason to improve the sustainability of public finances is that the euro area is already burdened with a too high level of debt.* The average debt-to-GDP ratio is just above 70% and 7 out of 12 Member States have debt levels above the 60% of GDP reference value of the Treaty (Graph 2.8). Against this background, the reformed Stability and Growth Pact requires Member States to set medium-term budgetary objectives (MTOs) which should guide the formation and implementation of yearly budgets. The higher the current debt ratio of a Member State, the more ambitious this MTO needs to be.

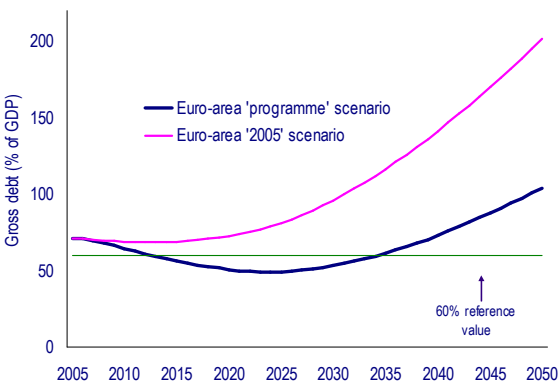
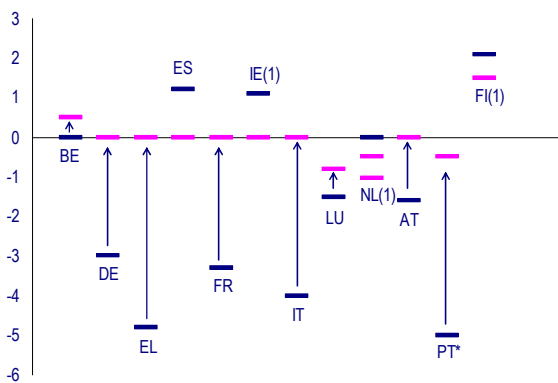


45. *Another pressing reason to improve the sustainability of public finances is the additional budgetary pressure that will stem from the ageing of the euro-area's population.* The old-age dependency ratio is projected to double in the coming decades: in the euro area of today there are four people of working-age for every elderly citizen, in the euro area of the future the ratio will be only two to one. This puts pressure on public finances in two ways: the ageing population (1) significantly lowers the euro-area's growth potential and (2) substantially raises age-related public expenditures³. The potential growth rate in the euro

³ See "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050". The link for this is

area between 2031 and 2050 is estimated to be 1.3%, which is roughly half of its potential growth rate today. In addition, public expenditures will increase significantly. With an ageing population governments typically spend substantially more on pensions, health care and long-term care. This is only to a minor extent compensated by lower expenses on education and unemployment benefits (Graph 2.9). Overall, the euro-area's public expenditure in 2050 is expected to be 3.7% of GDP higher than in 2004 on the basis of existing policies on these expenditures. There are, however, substantial differences in the budgetary challenges of different Member States, which mainly reflect different demographics and diverse arrangements for public pensions. To cope with the expected future surge in public expenditures, governments need to consolidate their public finances now and take structural measures to alleviate budgetary pressures associated with ageing populations (see Chapter 3).

46. The obtainment of the medium-term budgetary objectives is crucial. If Member States fail to undertake the budgetary adjustment foreseen in the latest update of their stability programmes, the euro-area's debt level will increase sharply because of the current levels of deficits and future higher expenditures on pensions, health care and long-term care (Graph 2.10). This underlines the need for a strict adherence to MTOs so as to reduce debt levels. At this stage, only 4 out of 12 Member States of the euro area have attained their MTO (Graph 2.11). In most Member States there is still a significant gap between their MTO established in the 2005 update of their Stability Programmes and their current structural balances (i.e. the cyclically adjusted balance, excluding one-offs and other temporary measures).

Graph 2.10: Debt development in the euro area, with and without medium term consolidation	Graph 2.11: Current structural balance and medium term objective (MTO)
	
<p><i>Source:</i> Commission services.</p>	<p>(1) Ireland has an MTO of "close to balance", Finland's MTO is "around 1.5% of GDP", the Netherlands has an MTO between -0.5% and - 1% of GDP and Portugal has an MTO of "at least -0.5% of GDP."</p> <p><i>Source:</i> Commission services.</p>

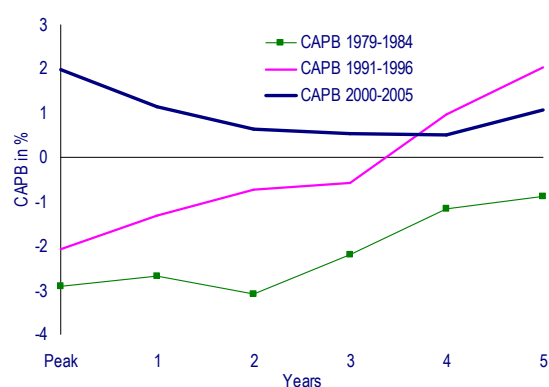
http://ec.europa.eu/economy_finance/publications/european_economy/2006/eespecialreport0106_en.htm

Fiscal consolidation is needed in most Member States

47. ***As in the case of monetary policy, fiscal policy has been supportive of economic growth in the euro area during the recent economic downturn.*** In this respect the euro area has benefited from automatic budgetary stabilisers which, due to the larger size of governments, and the progressiveness of the tax system, are roughly twice as large as in the USA. Discretionary fiscal policy has also been accommodative. In 2001 and 2002, the fiscal policy stance, which can be approximated by changes in the cyclically-adjusted primary balance (CAPB), was loosened as the euro-area's CAPB declined more than 0.5% per year (Graph 2.12). In 2003 and 2004, the fiscal policy stance was broadly neutral (absolute changes in the CAPB below 0.5%). Only in 2005 was there a tightening of the fiscal policy stance (positive change in the CAPB of 0.6%). By contrast, the fiscal policy stance was tightened continuously in the previous economic downturn which reflects the fiscal consolidation in the run-up to the euro. A similar pattern emerges for the downturn following the 1979 peak. Thus, fiscal policy has clearly been more supportive of the economy in the most recent downturn than in the previous two.

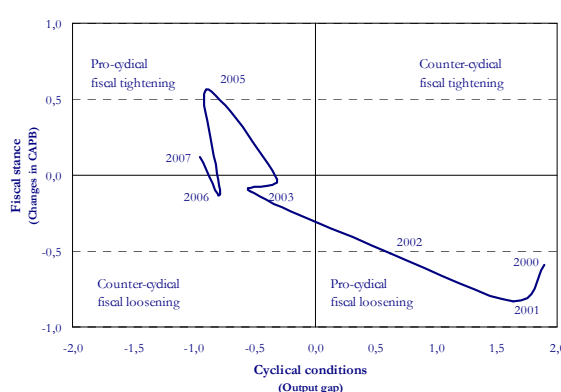
48. ***In view of the economic recovery and the urgent need to consolidate, the progress made in 2005 should not be wasted.*** In 2005, the fiscal stance improved due to better-than-expected revenues. Against the background of a broadly recognised need to put public finances on a more sustainable footing, the pace of fiscal consolidation over the next years should be stepped up, taking advantage of the current window of opportunity. However, Graph 2.13, which depicts the budgetary developments in relation to cyclical conditions, shows that the euro-area fiscal stance is projected to experience a marginal loosening in 2006, falling far short of the stability programme objectives. This gives an indication of the fiscal adjustment effort required in next year's budget in order to fully implement the preventive arm of the revised Stability and Growth Pact.

Graph 2.12: Cyclically adjusted primary balances



Source: Commission services.

Graph 2.13: Fiscal policy stance in the euro area

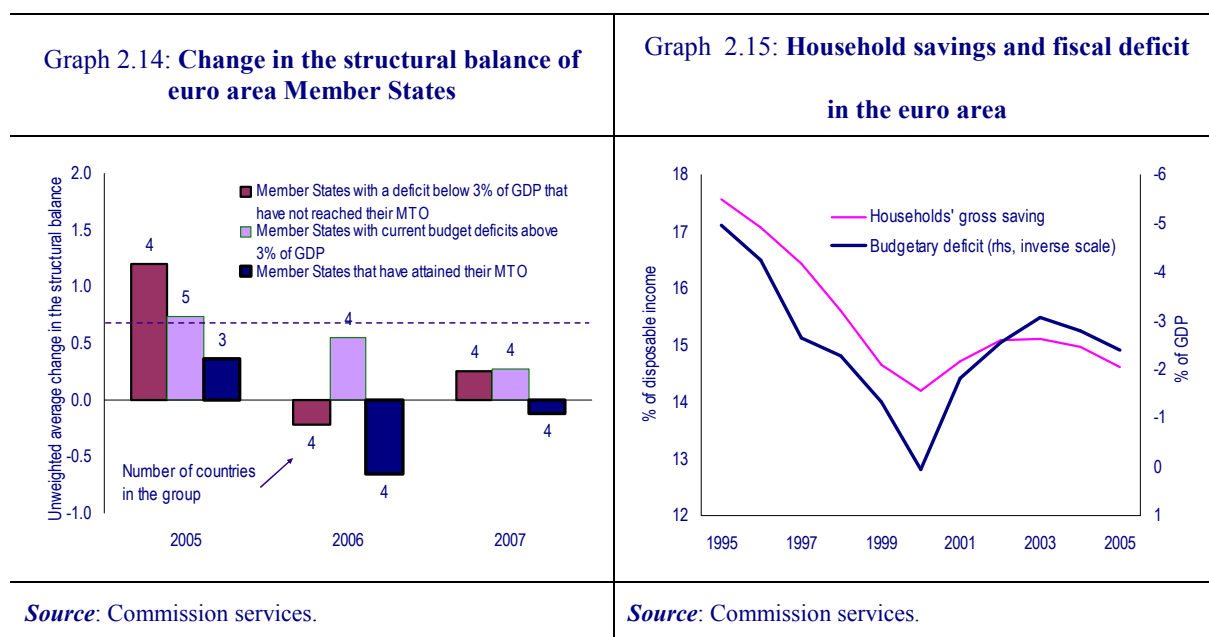


Source: Commission services.

49. *More fiscal consolidation is needed in most Member States but the amount of fiscal consolidation required differs.* Under the reformed Stability and Growth Pact, Member States have committed themselves to improve their structural deficit by 0.5% of GDP annually as a benchmark if they have not yet attained their MTO. In so-called good times, a greater effort is required, while the adjustment effort may be more limited in bad times. Now that economic and employment conditions are improving (see Chapter 1), an adjustment of at least 0.5%, and possibly more, would seem to be appropriate. By improving the quality of their public finances, Member States can redirect their public expenditures to finance economic reforms to enhance growth and jobs so as to ensure that fiscal consolidation and microeconomic reforms are fully complementary and a positive contribution is made to growth. The amount of fiscal consolidation needed differs between Member States. In this context three groups can be identified.

- For the *Member States that have attained their MTO* the main objective for the short term should be to avoid pro-cyclicality. These Member States are expected to let automatic stabilisers work freely and resist the temptation of fiscal loosening. The Commission's Spring Economic Forecasts, which are based on the budgetary measures that so far have been approved in Member States, indicate a loosening of the fiscal policy in 2006 and 2007. Further measures are to be considered to avoid this (Graph 2.13).
- For the *Member States with a deficit below 3% of GDP that have not reached their MTO*, the short term objective should be to improve their structural balance by at least 0.5% per year. On the basis of approved budgetary measures, the adjustment for 2006 and 2007 fall short of this threshold. So, the Member States in this group are strongly encouraged to exercise further fiscal consolidation now, taking advantage of the window of opportunity provided by the economic recovery.
- This applies even more strongly to the third group of countries, i.e. the *Member States with current budget deficits above 3% of GDP*. The adjustments so far approved for 2006 and 2007 are below the 0.5% threshold, requiring further fiscal consolidation to contribute clearly towards the correction of excessive deficits.

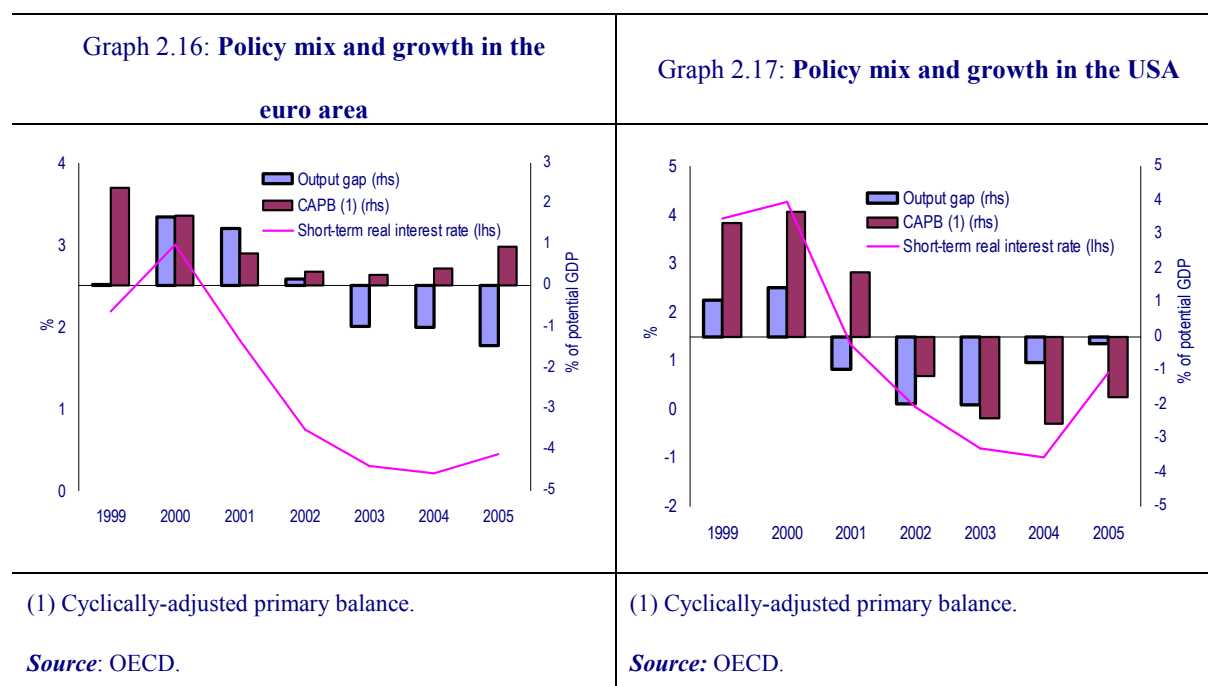
50. *Measures for fiscal consolidation should not be postponed as there is a considerable time lag between a change in fiscal policy and its effect on the economy.* A "wait and see" attitude could mean delaying improvements in structural balances until economic conditions are less favourable, hence making budgetary consolidation harder to implement. The previous cyclical upturn illustrates that this is a real danger. In the years 1999-2001 the fiscal policy stance was loosened leading to pro-cyclicality. Had the euro area then consolidated its public finances, we would have had lower debt levels and thus a better budgetary position today.



51. *Although budgetary consolidation could weigh on domestic demand in the short-term, this should be balanced against the positive effects of greater budgetary stability on the euro-area's economic outlook.* More ambitious fiscal consolidation is likely to contain inflationary pressures in the euro area and thus to reduce or postpone the need for a tightening of monetary policy. In this way, fiscal consolidation could actually promote private investment and thus stimulate growth. Moreover, there is a clear relationship between households' savings and the budget deficit: when governments spend less (i.e. lower their budget deficit), households tend to spend more (i.e. lower their savings rate) (Graph 2.15). Up to now, private consumption in the euro area has been quite weak (see Chapter 1). Uncertainty about pensions combined with the already high level of debt may well have encouraged households to save more. Governments that work actively on the sustainability of their public finance and on structural reform may thus boost confidence and thereby encourage households to consume more.

2.3 CONCLUSIONS

52. *EMU's policy framework has contributed to a very favourable macroeconomic policy mix.* The combination of a credible monetary authority and a commitment to sound budgetary policies has led to low interest rates and given greater scope for automatic budgetary stabilisers to operate, with the result that macroeconomic policy has been much more supportive than in recent downturns. Nevertheless, the economic performance of the euro area in recent years has been disappointing. Economic growth has been sluggish, unemployment high and the economic recovery has been much slower in comparison with previous recoveries in the euro-area and recent recoveries in other industrialised economies, such as the USA.



53. *On the whole, macroeconomic policy does not appear to have been less accommodative in the euro-area than in the USA* (Graphs 2.16 and 2.17). Although the US Federal Reserve's response to the 2001-2003 downturn entailed a bigger cut in short-term interest rates compared with the ECB, this should be seen in the context of a larger deterioration in the output gap in the US economy. Moreover, reflecting the different speed of the economic recovery, the ECB has thus far increased its main policy rate by considerably less than the US Federal Reserve, leaving the ECB rate well below that of the Federal Reserve at present. Similarly, although the decrease in the cyclically-adjusted primary balance (CAPB) in the period 1999-2002 was higher than in the USA, than in the euro area, their fiscal stance (measured by the change in the CAPB) was comparable in 2003-2005. Furthermore, the fact that the euro-area's automatic budgetary stabilisers are roughly twice as large as in the USA means that a comparison of the levels of cyclically adjusted balances does not tell the full story. Finally, account should be taken of the fact that budget balances and debt levels in the euro area were generally much less sound than in the USA at the onset of the slowdown, thereby limiting the scope for easing without compromising long-run sustainability.

54. *As the economic situation improves in the euro area, an adjustment in the macroeconomic policy setting is warranted.* As discussed above, a gradual withdrawal of the stimulus provided by monetary policy has been appropriate. Indeed, the ECB has raised its policy rate in three steps of 25 basis points each since December 2005. Financial markets have already priced in further action in the course of this year and next. In the area of fiscal policy, the opportunity should be seized upon to undertake the necessary fiscal consolidation. Fiscal consolidation is essential in the light of the high level of public debt and the expected surge in public expenditures because of the ageing population. Fiscal consolidation is also appropriately timed, as economic and employment conditions in the euro area are improving.

55. *Due regard should be given to the interactions between monetary and fiscal policies.* In the first instance, monetary and fiscal policies contribute to an overall macroeconomic stance that can be more or less supportive of the economic environment. During an economic downturn, the challenge is to trigger a macroeconomic response that is supportive of

recovery, but which contains inflationary pressures once economic growth resumes. At the current economic juncture, the challenge is to avoid inflationary risks and to undertake a budgetary consolidation without jeopardising the economic recovery. Appropriate fiscal policies can, by reducing the variability of GDP growth rates and favouring higher potential growth, create conditions in which monetary policy can more easily achieve its goals. During an economic upturn, the avoidance of overly lax budgetary policies can give greater scope for an accommodative monetary stance. Likewise, during an economic downturn, a credible commitment to preserve budgetary stability and, if necessary, undertake budgetary consolidation, should make it easier for monetary policy to quell inflationary pressures in a gradual manner. This in turn will make it easier for budgetary authorities to push through the necessary fiscal packages.

56. *It is also essential to ensure greater coherence between macroeconomic and microeconomic policies in the euro area.* For example, without policies to safeguard macroeconomic stability, the lower cost and price pressures from structural reforms will not translate into permanently lower prices. Similarly, without greater liberalisation in the retail banking sector, the benefits of the historically low interest rates resulting from EMU's sound macroeconomic framework cannot be fully reaped and the transmission of interest-rate changes will be less smooth. The need for coherence between macroeconomic and microeconomic policies underlines the important role played by the Eurogroup and the EU's Macroeconomic Dialogue in promoting consensus between policy authorities on shared structural reform challenges.

A DYNAMIC AND SMOOTH FUNCTIONING EMU

57. *Structural reforms in product, labour and capital markets are essential to complete the new policy framework of EMU.* They are important for achieving higher growth and more jobs: according to a study by the European Commission, comprehensive economic reforms in product, labour and capital markets could raise potential growth in the EU from 2% to 3%⁴. But reforms are also necessary to ensure a smooth adjustment to changing economic circumstances. Reforms that make prices and wages more responsive to economic shocks will help to reduce unwarranted cross-country growth and inflation differences and to contribute to an orderly unwinding of global imbalances. There is a strong incentive for euro-area members to coordinate their structural-reform efforts. This is because the benefits of structural reform will accrue more quickly if euro-area countries open up product, labour and capital markets in concert.

3.1 THE STRUCTURAL CHALLENGES OF THE EURO AREA

58. *The growth rates of GDP per capita in the euro-area and the USA have been fairly similar over the period 1999-2005.* During this period euro-area GDP per capita (in constant prices) grew at the average annual rate of 1.3%, compared with a rate of 1.7 in the USA. The relative closeness of these growth rates implies that the relative level of GDP per capita as a measure of welfare has remained fairly constant over time. In 2005, the euro-area's GDP per capita stood at around 70% of the US level, slightly below the 1999 level.

59. *However, there have been important changes in the composition of the GDP gap.* At the beginning of EMU, two thirds of the gap was due to lower labour utilisation while one third was caused by lower productivity per hour worked. Since then, it is notable that labour utilization in the euro area has improved relative to the USA while the productivity level has worsened. In 2005, the euro-area employment rate reached 88% of the US rate, as compared with 82% in 1999. Over the same period, euro-area productivity deteriorated from 92% of the US level to 87%. Overall, this means that the euro-area's gap in living standards with the USA is now attributable to lower utilisation of labour and productivity in broadly equal shares.

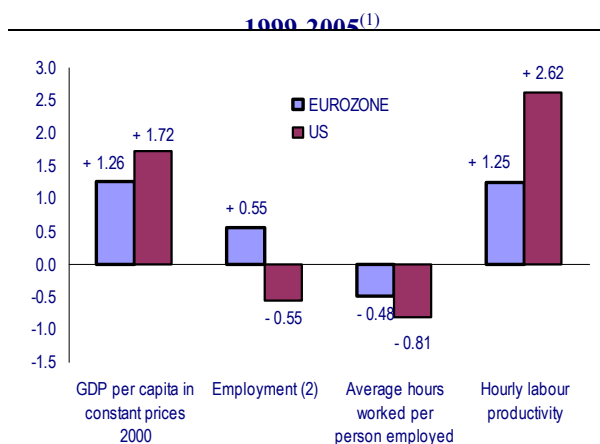
60. *A similar picture emerges if the factors driving growth rates in GDP per capita are examined.* Graph 3.1 shows that the growth in GDP per capita in the euro area was driven by employment increases of 0.5% annually and average labour-productivity growth of 1.3%. Average hours worked per worker contributed negatively by roughly 0.5% annually over the period. In the USA, on the other hand, the per capita growth was exclusively driven by strong labour productivity increases of 2.6% annually, while labour's contribution was negative as regards both the employment rate (0.5%) and average hours worked (0.8%).

61. *The encouraging development in terms of labour input in recent years has not been matched by a more robust performance as regards hourly productivity growth.* The euro area has thus been unable to make simultaneous progress on both fronts – boosting employment and increasing labour productivity growth. Some economists have argued that

⁴ DG Economic and Financial Affairs (2005). 'The economic costs of non-Lisbon. A survey of the literature on the economic impact of Lisbon type reforms', European Economy, Occasional Paper, No 16.

labour-market reforms to encourage lower skilled workers to take up jobs may have depressed labour productivity. It seems likely, however, that this effect has been limited and temporary.

Graph 3.1: Average annual real growth rates



(1) Data for 2005 are based on Commission estimates.

(2) Employment measures the impact of changes in the employment rate on GDP per capita.

Source: Commission services.

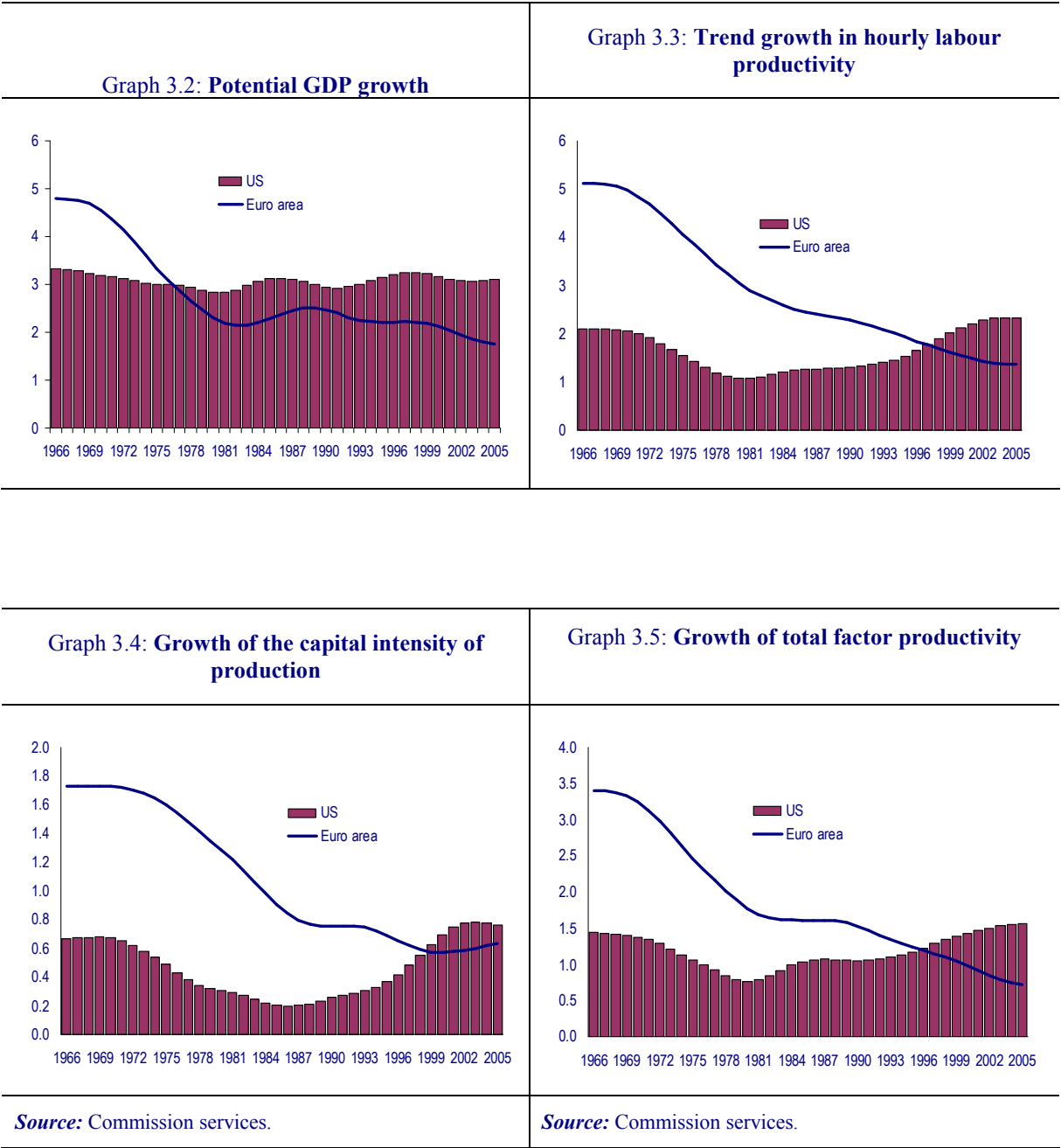
3.2

EXPLAINING THE POOR PRODUCTIVITY PERFORMANCE

62. *The importance of structural factors in explaining the recent economic performance of the euro area can be seen by looking at the evolution of potential growth* (Graph 3.2). At around 2%, potential growth in the euro area is relatively low in comparison with the levels of the early 1990s and by current international standards. In the first half of the 1990s, potential growth in the euro area averaged 2.3% before falling to an average of 1.9% over the last five years. In the USA, annual potential growth has remained fairly stable over the same time period. The gap between the euro area and US performance may be due, in part, to demographic factors.

63. *Labour productivity growth has been on a secular declining trend in the euro area* (Graph 3.3). It is worrying to see that, since the mid-1990s, actual productivity growth rates in the euro area have dropped below those recorded in the USA. This phenomenon appears to be due to both a decline in the growth of the capital intensity of production – i.e. the amount of capital per unit of labour – (graph 3.4) and lower growth in total factor productivity (TFP) in the euro area (graph 3.5). The decline in TFP growth, which measures, *inter alia*, technological progress and which is now a full percentage point lower than in the first half of the 1990s, is particularly worrying as it suggests that the euro-area's production structure is more concentrated on sectors with low technological progress.

64. *There are several possible explanations for the euro-area's low productivity growth, all of which seem to play some role.* First, as mentioned above, the progress in terms of increasing overall employment might have resulted in a temporary slowdown of productivity growth. Empirical evidence nevertheless indicates that the proportion of the slowdown in EU productivity that can be attributed to employment gains is rather low⁵.



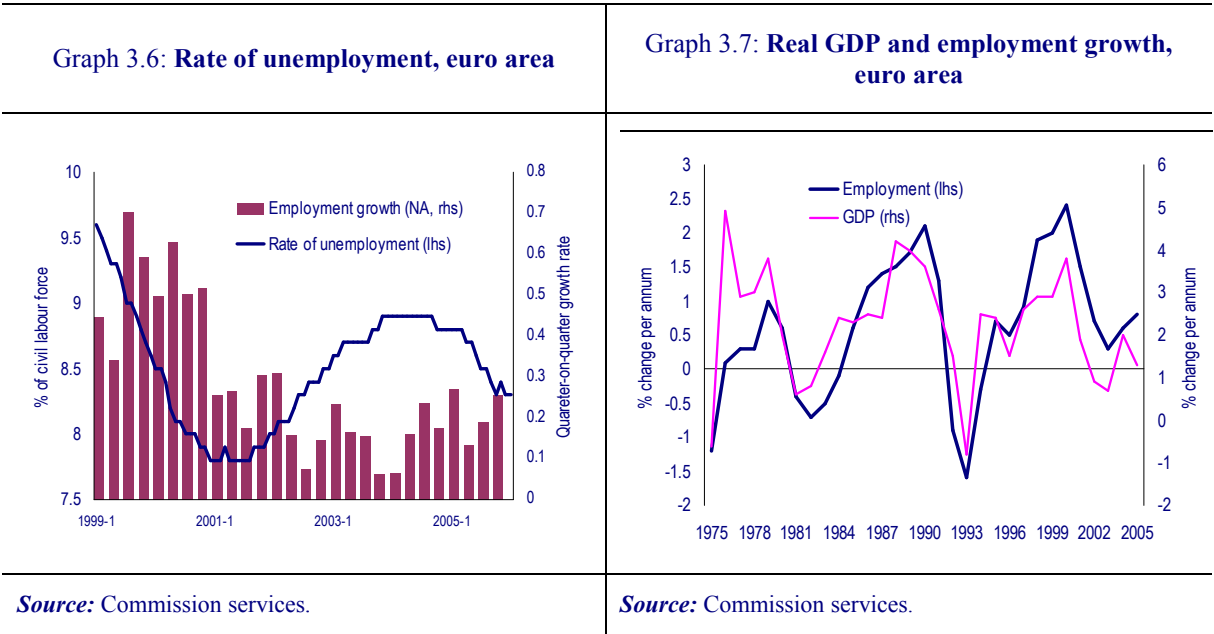
65. *Other explanations for the euro-area's low productivity growth relate to the euro-area's industrial structure.* In particular, there is a concern that the euro area, with its traditional

⁵ See European Commission, "The EU Economy: 2004 Review", Brussels, 2004, p. 163.

comparative advantage of medium-high-value-added industries, such as chemicals and the automobile industry, has not yet fully grasped the productivity gains experienced in cutting-edge technological sectors. An exception here is the communications sector, where European countries have secured a leading position. More generally, the euro area has been characterised by a lower productivity performance and size of ICT producing industries (including office equipment and semi-conductors) and a lower productivity performance in ICT using services (such as wholesale and retail trade and financial services) both sectors in which the USA has been a very strong performer. The lower share of highly innovative sectors and businesses also underlines the challenges for most euro area Member States of producing and absorbing new, more knowledge-based technologies.

3.3 LABOUR MARKET DEVELOPMENTS

66. *Against the background of the pick up in economic activity in the euro area, positive labour-market trends continued in 2005.* This is most visible in both the creation of more than 1 million new jobs in 2005 and a decline of the rate of unemployment to 8.3% in December 2005 from 8.8% a year earlier⁶. It means that while the improvement in labour-market performance was consolidated in 2005, the pace of improvement remained gradual, having been driven by rather than driving the pace of economic activity. The small acceleration in job creation and the already significant reduction of unemployment witnessed in 2005 indeed reflect a number of positive as well as negative factors, which in the end sum up to a rising employment rate but still substantial under-utilisation of the euro-area's employment potential.



67. *The 2005 labour market performance so far defies the predictions of jobless growth.* As employment growth in the euro area has been positive throughout the period of economic

⁶ Note that there is currently a significant discrepancy in the employment data from the national accounts on the one hand and the labour force survey on the other hand. The former points to an increase of 1 million jobs in 2005, the latter records more than 2 million new people employed in 2005.

slowdown (2001-03), some feared that the labour hoarding in the downturn would translate into below-par job creation during the next economic rebound. Though sluggish economic growth has restrained the pace of job creation, the fact that employment growth during the economic recovery has kept pace with real GDP growth is a positive development. It even appears that the shift toward a higher job-intensity of growth, which has taken place since the mid-1990s, is continuing. Since then, more employment has been created for a given rate of economic growth than in previous decades.

68. The average number of hours worked appears to have declined slightly in 2005 after a marginal pick-up in 2004. This means a continuation of the trend decline in hourly labour utilisation, which was assumed to have reverted or at least stopped in recent years. The reason for the further decline is to be seen in an increasing share of people in part-time employment rather than a fall in the average number of hours usually worked in main jobs in either full-time or part-time employment. The share of part-time workers in total employment rose from 17.5% in 2004 to 18.6% in 2005. In the same period, the average number of hours usually worked increased to 41.6 from 41.4 hours per week for those in full-time employment and remained constant at 19.5 hours per week in part-time employment.

Graph 3.8: Change in employment and participation rates, EUR-12 and USA	Table 3.1: Decomposition of the change in the employment rate, EUR-12		
		1999-2004	2004-2005
	Change in employment rate, p.a.	0.49	0.71
	Due to shifts in employment rate of		
	- Young	0.02	0.01
	- Prime age	0.27	0.32
	- Older	0.16	0.33
	- Male	0.07	0.17
	- Female	0.40	0.49
	Due to demographic effect:	-0.01	0.04
	Due to Interaction effect:	0.01	0.01
Source: Commission services.	Source: Commission services.		

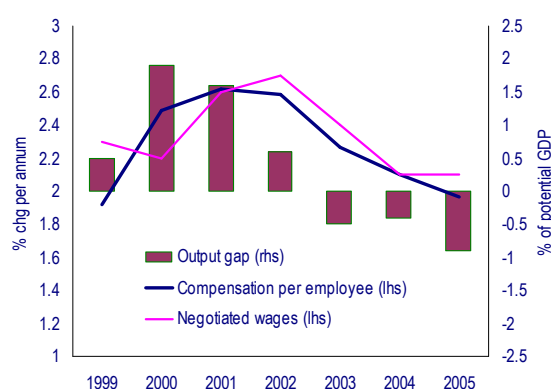
69. For more than ten years, euro-area employment has benefited from an increase in labour-force participation. While the increase in participation decelerated during the recent

economic downturn and – according to the latest data – even decelerated further in 2005, it remained positive, which contrasts with the experience of previous downturns and of the USA during the recent downturn. However, it should be noted that participation and employment rates in the euro area are still low in an international context. The euro-area employment rate was 62.7 % in 2004, which compares to rates above 70% in the USA, the UK, the Netherlands and all Scandinavian countries. It is estimated to have improved by 0.7 percentage points to 63.4 % in 2005. Unless there is an acceleration in the pace of labour-market reforms, the Lisbon target of achieving a participation rate of 70% would only be reached by 2035.

70. The trend increase in labour-force participation is linked, in part, to the higher number of women entering the labour market. Women's higher level of educational achievement compared with previous generations has strongly contributed to this trend. Changing financial incentives due to both old-age pension reforms and a reversal in the use of early retirement schemes also appear to have played a role. Compared to these factors, the demographic effect has been marginal but it is expected to play a more important role in future years.

71. Employment growth in the euro area has been supported by a remarkable degree of wage moderation. Neither the economic recovery nor the increase in energy prices have so far led to a visible upsurge in wage growth. The growth of compensation per employee decelerated to 2.0% in 2005 from an already low 2.2% in 2004. Labour-cost growth in industry as well as manufacturing continued its downward trend in 2005. A major determinant of continuous wage moderation has been the behaviour of social partners in collective wage bargaining. Negotiated wages are estimated to have increased by just 2.1% in 2005, identical to the rate of change a year earlier. Further important factors have been the strong pressure on profit margins from global competition and the increase in labour-force participation, which are both likely to have contributed to downward pressure on wages. Continued wage moderation seems necessary in order to help to reduce the euro-area unemployment rate substantially below the 8.4% expected for this year.

Graph 3.9: Actual and negotiated wages, EUR-12

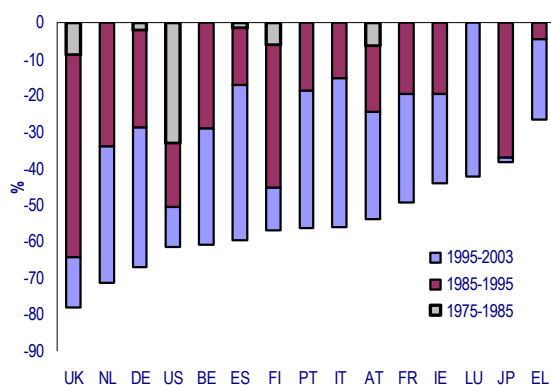


Source: Commission services and ECB.

3.4 FURTHER PRODUCT MARKET REFORMS ESSENTIAL

72. *In recent years, euro-area members have stepped up the pace of structural reform relative to other OECD countries.* An indication of this trend can be seen in the reduction in the stringency of regulation in selected non-manufacturing sectors during the period 1975-2003 (Graph 3.10). Between 1995 and 2003, euro-area members cut back considerably on regulations in these sectors. This contrasts with the experience of the United States and the United Kingdom, which exhibited higher reform intensity in the periods 1975-1985 and 1985-1995 respectively. Over the period 1975-2003, the intensity of reforms in the Netherlands and Germany was actually higher than in the United States, with countries such as Belgium, Spain and Finland lagging not far behind.

Graph 3.10: **Product market reform intensity in selected sectors, 1975-2003**



Note: The product market indicator of regulations is measured as a simple average of regulation in 7 non-manufacturing sectors: Rail, road, airlines, gas, electricity, telecom and post. The indicators are normalised, ranging from 0 to 1, expressed as a percentage of the maximum score across OECD countries, where 1 reflects a relatively regulated product market.

Source: OECD.

73. In spite of this progress, euro-area members continue to lag behind countries such as the United Kingdom and the United States when it comes to the overall level of product-market regulation. Even though more-regulated countries, such as Greece, Italy and Spain, have made significant advances in freeing up their economies from unnecessary regulatory burdens, less regulated countries such as the USA, the UK and Denmark have also reduced their overall levels of regulation in product markets. Therefore, the relative positions across countries have not changed significantly.

74. The decline in regulatory barriers in OECD countries has been driven by a reduction in government intervention and the elimination of barriers to trade and investment. A reduction in price controls and other restrictions on business has played a key role, as have lower tariffs and reduced restrictions on foreign investment. Progress has been less dramatic in reducing barriers to entrepreneurship, including, in particular, administrative burdens and legal barriers to entry in sheltered markets. The need for greater competition in the services sector is a key challenge given that services now account for around 70% of total jobs and value added in the euro-area economy.

Reinforcing the Internal Market

75. An example of the payoff from greater openness in product markets can be seen in utility markets. The partial progress so far towards liberalisation in gas, electricity and water utilities has already contributed towards an impressive increase in labour productivity in these sectors. This contrasts with the experience of the USA, where, in the absence of comparable reforms, these productivity gains have not been matched.

76. Nevertheless, the poor performance of many euro area Member States in transposing and applying Internal Market legislation remains a source of concern. For example, only three euro-area countries currently meet the 1.5% implementation deficit target. To increase the responsiveness of the euro area to economic shocks and to raise growth potential further reforms in sectors such as services or network industries will be essential. Due to excessive regulatory barriers, many services and professions are sheltered both from domestic and foreign competition. In network industries, progressive liberalisation has not always gone far enough from the point of view of opening markets effectively to new entrants. In both cases, productivity growth has been poor and the capacity to adjust to economic shocks has been limited.

Table 3.2: **Evolution of labour productivity per hour worked in gas, electricity and water utilities**

	1979-1990	1990-1995	1995-2001
EU-15	2.7%	3.6%	5.7%
USA	1.1%	1.8%	0.1%

Source: Commission services.

77. *It is a matter of concern that only a few Member States addressed these issues in their National Reform Programmes.* A positive example is Ireland which has strengthened its internal procedures for monitoring the implementation of Community directives. In order to avoid complicating legislation, several Member States actively discourage adding on further provisions when implementing Community directives (Austria, the Netherlands). In order to avoid late implementation, some Member States have put in place fast-track procedures (Italy, France).

78. *A further danger to the effective functioning of the Internal Market lies in measures which could shield domestic companies/sectors from competition.* Protectionism of any kind tends to negatively affect the competitiveness of the economy in the medium and long term. In this respect, measures impinging on the functioning of the Internal Market would go against the objectives of boosting efficiency through the optimal allocation of resources and exploiting the growth potential of the European economy to the fullest extent.

Creating a business-friendly environment

79. *On a positive note, euro area Member States acknowledge the need for a better business environment for companies and, in particular, for SMEs.* In their National Reform Programmes, better regulation including easier market entry (e.g. one-stop-shops) and exit (e.g. changes in bankruptcy legislation), and reductions in administrative burdens are considered as major tools in this respect. Moreover, some euro-area countries aim at improving the efficiency of public administrations, reforming their corporate tax systems, improving access of SMEs to financing, support for business start-ups, diffusion of ICT and upgrading infrastructure. These measures, together with those foreseen in the area of labour markets, are likely to lead to some reduction in costs for business and to contribute positively to economic dynamism.

Promoting innovation and investing in R&D

80. *In order to generate sustainable improvements in productivity growth it is, first and foremost, necessary to boost the euro-area's capacity to generate and, above all, absorb and exploit knowledge.* Favourable framework conditions for companies to innovate are essential in this respect. Businesses need to enjoy a friendly regulatory framework, have sufficient supply of highly-qualified personnel and to have access to affordable sources of financing. In addition, more resources need to be invested in R&D and innovation and, in particular, Europe-wide economies of scale should be exploited by encouraging projects and activities with significant cross-border spillovers. An adequate supply of highly-skilled labour is also essential for the euro area to be able to improve its growth and productivity performance. It is also a key policy instrument in tackling high structural unemployment, especially among the young.

81. *In terms of innovation performance, the euro area is lagging significantly behind top performers, such as the USA and Japan.* This is true when innovation is measured by inputs (e.g. R&D intensity) or by outputs (e.g. patent intensities). This overall picture, nevertheless, masks a significant variation among euro area Member States. According to the Commission's Innovation Scoreboard for 2005, only Finland and Germany are in the group of "leading countries", with a majority of the euro-area countries classified as average performers. Within the euro area, the weakest performers are Greece, Italy, Portugal and Spain, although Portugal and Greece show some signs of catching up.

82. *As regards R&D spending, there is considerable scope for improvement.* Total R&D spending in the euro area has been stagnating slightly below 2% since the launch of the Lisbon Strategy and continues to be significantly below the levels in the USA (3.0%) and Japan (3.2%). Nevertheless, there are considerable differences among euro-area countries, with Finland spending 3.5% of GDP on R&D while Portugal spends only 0.8%. No significant improvement has been made thus far in the reallocation of public resources towards productivity-increasing categories such as R&D. All euro area Member States have nevertheless set targets with respect to rising R&D expenditures in their National Reform Programmes. A further issue which requires full attention, as reflected in National Reform Programmes of many euro area Member States, is to ensure that public money is spent effectively. In particular, scientific and innovative excellence should be one of the key criteria for allocating resources.

83. *The promotion of private R&D and innovation is a major challenge for the euro area.* The share of business R&D spending is around 56%, compared to the target share of 2/3. For this purpose, a number of Member States introduced financial incentives to promote private R&D expenditures, like tax credits or vouchers. Nonetheless, significant improvements in the overall conditions for innovation should be seen as a major tool in this respect. Some euro area Member States are implementing measures to reinforce the link between science and industry and to generate synergies between public and private efforts in R&D. Some Member States are also committed to identifying and supporting clusters and innovation poles.

3.5 STEPPING UP THE PACE OF LABOUR MARKET REFORMS

84. *Many labour-market reforms have been conducted by Member States in recent years.* Although these reforms have mainly been directed at addressing country-specific challenges, they share some common features and have a direct bearing on the euro area. For example, this includes measures that aim at increasing both domestic labour utilisation and domestic labour productivity, which in turn are likely to raise potential GDP. Higher potential GDP growth can be expected to have positive consequences for the resilience of the euro-area economy to shocks. The same effect can be expected from reforms that target a better matching of labour demand and supply and at improving the adaptability of the workforce. Equally, measures to ensure that wages better reflect differences in productivity across sectors and regions as well as changes in local unemployment would have a positive impact on wage adjustment and inflation differences in the euro area.

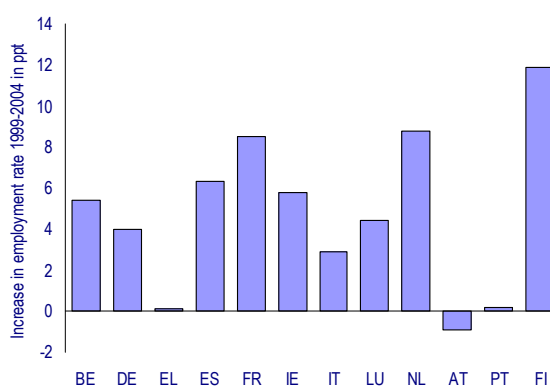
Improving labour market participation

85. *Many Member States have taken measures to improve labour-market participation.* The most promising policies have relied on a sharpening of financial incentives to take up work through reforms of the tax and benefit system. An example is the restructuring of income

support for the long-term unemployed in Germany, which creates stronger incentives for long-term unemployed to accept low-paid work and for short-term unemployed to avoid long-term unemployment. The Netherlands undertook a major reform of the unemployment insurance system, which involved a sharp reduction of the maximum period of benefit entitlement, a severe reduction of the level of benefits and a tightening of the employment-history requirement for benefit eligibility. Another example was the introduction and extension, respectively, of tax credits for low-income earners in Greece, Finland and the Netherlands.

86. *There are important signs that such reforms are beginning to improve incentives to take up work.* For example, the tax wedge on labour costs for low-wage earners, measuring the relative tax burden for an employed person, has continuously fallen in recent years, from a level of 43.4% in 1996 to 39.0% in 2004 for the euro area as a whole. Moreover, the unemployment trap, measuring the percentage of gross earning which is taxed away through higher tax and social security contributions and the withdrawal of unemployment benefits when an unemployed person returns to work, has fallen slightly over the 2001 to 2004 period. The same holds for the "low wage trap" for a single person without children – i.e. the percentage of the gross earnings that is "taxed away" by the combined effects of higher taxes and reduced or lost benefits, when an employed single person moves from 33% to 67% of the average earnings of a production worker.

Graph 3.11: Change in the employment rate of older workers 1999-2004



Source: Commission services.

87. *In many Member States, reforms have focused on those parts of the population where labour-market participation is low or unemployment is high.* These are predominantly young people, women and older people. The benefits of reforms to tighten the eligibility criteria for early retirement are beginning to materialize, with the participation rate of older workers increasing considerably in recent years (See Graph 3.11). In their National Reform Programmes, some Member States also foresee targeted measures for other groups with low labour-market attachment such as ethnic minorities (Netherlands), immigrants (Ireland), disabled people (Netherlands, Austria) and domestic residents (Luxembourg). Since reservation rates – which measure the ratio between income received when unemployed and net income when employed – have been high in many

Member States, reforms in this area and especially cuts in non-wage labour costs appear to be appropriate measures for the countries concerned.

Improving the match between labour demand and supply

88. ***Initiatives that aim to improve job placement have been widespread across Member States.*** For example, Germany, France and Italy reformed their public employment services, giving more scope for the involvement of private providers. Reforms of public employment services have either been adopted or are foreseen in the National Reform Programmes of Belgium, Greece, Luxembourg, Austria and Portugal. Often they are accompanied by a shift from passive to active labour-market policies. These reforms will be particularly valuable for tackling the different problems in the matching of labour demand and labour supply which exist in euro-area countries.

Reforms to education and training systems

89. ***Linked to the objective of enhancing the productivity of labour, many euro area Member States gave a prominent place to reforming training and education systems.*** Efforts have generally focused on improving the human capital of young people through reforms of school systems, for instance with the objective of reducing the number of early school leavers, improving vocational training and facilitating entrance to the labour market. The impact of these policies on labour productivity is likely to accrue gradually, as young people take up employment. In France, a new law adopted in 2005 and to be implemented in 2006 aims to improve the quality of and access to lifelong education and training, including the creation of a 'core knowledge and skills' curriculum for all students. In 2005, Italy increased the number of years of guaranteed state education and training for everybody to 12 years. In Finland, specific measures were adopted that aim at boosting on-the-job training in 2004 while Germany initiated a modernisation of the vocational training system.

90. ***According to their National Reform Programmes, workplace programmes are envisaged to play a role in Ireland and Finland.*** Measures concerning adult training and life-long learning could contribute to both greater productivity and the adaptability of the current labour force, but they featured less prominently in National Reform Programmes and it is difficult to say whether the effects will show up in aggregate productivity figures.

Improving the adaptability of the workforce

91. ***Reforms to boost the responsiveness of the labour market to economic shocks, which are critical for a dynamic and smooth functioning EMU, have been enacted mainly in indirect terms.*** For example, reforms that aim at increasing labour utilisation and human capital will also improve the adaptability and the flexibility of the workforce. Moreover, measures that focus on the matching of labour demand and supply, for example through an upgrading of public-employment services, can be expected to improve adjustment to shocks. The few measures adopted in the field of employment protection have targeted flexibility of work contracts for new entrants and disadvantaged people through fixed-term contracts, job agencies, public employment schemes, while leaving unchanged the legislation on permanent employment that may act as a barrier to labour-market adjustment.

92. ***In the area of working-time organisation, there are several positive examples of reforms.*** These include measures aimed at improving the access to sabbatical leave schemes (in particular the life-course savings scheme introduced in the Netherlands) or extending parents' rights – for instance in the form of longer career breaks or flexible working for family

reasons (Belgium, Ireland) – while at the same time introducing more flexible work-time arrangements to adjust employees' working hours to the changing needs for labour. This concerned in particular the regulation of overtime work (for instance in Greece and France) and the introduction/extension of working-time account schemes (e.g. in Germany and Greece).

93. *Legislation on permanent employment has been left unchanged in spite of labour-market reforms in, for example, Italy, France and Germany.* In Italy, measures enacted in 2004 were limited to setting the conditions for the implementation of new types of flexible contracts whereas a draft law proposing a marginal loosening of employment protection has not been pursued. France introduced a degree of flexibility in the procedure to be followed in case of collective dismissals (Fillon law) but plans for a new type of employment contract for entrants to the labour market (*Contrat Premier Embauche*) were withdrawn earlier this year. In Germany, the agreement on a prolongation of the probation period for new entrants has not yet been translated into law.

Reforms to wage setting systems

94. *Modest reform efforts have been devoted to the issues of wage developments, wage flexibility and wage differentiation.* Indeed, wage issues play a significant role in only a few of National Reform Programmes, most notably in Germany, the Netherlands and in Finland. Minimum-wage settings were at the centre of actual policy action in many countries, including France, Luxembourg and Spain. In Germany a debate on the usefulness of national minimum wages has been launched. Despite little activity by public authorities in reforming wage-bargaining systems and a general stability of bargaining institutions, it can be noted that social partners in some countries, for example, Germany, Italy, the Netherlands or Finland have embedded elements in collective wage contracts that allow for more flexibility. This has been done either through the introduction of opt-out clauses that allow firms to deviate from collectively agreed contracts or by widening the possibility for additional agreements at the company level within more centralised wage-bargaining systems. These measures contributed to wage moderation, but had little impact on wage differentiation. Therefore, it appears premature to expect any significant changes to the responsiveness of wages to economic developments in the euro area.

Investing in human capital

95. *In order to improve the supply of highly-skilled labour an upgrading of education and training systems in many Member States is necessary.* Efforts should concentrate on building human capital, developing comprehensive and coherent lifelong learning strategies and raising the quality of education and training. Improvements in school systems are necessary especially to reduce the numbers of early school leavers, to raise upper secondary completion rates and to improve reading literacy rates. The quality, relevance and attractiveness of vocational training need to be enhanced. Reforms should further the development of open and flexible pathways allowing individuals to update their skills when required throughout their working lives.

96. *While reforming primary and secondary education systems is important, a stronger emphasis in the euro area should be placed on pre-primary education.* Research shows that, whatever a country's level of development, economic as well as social returns to investment are highest from educational interventions at an early age. Benefits include higher levels of

education attainment and of participation in lifelong learning, resulting in improved economic competitiveness as well as reduced welfare spending.

97. *The quality of tertiary education needs to be improved in several Member States.* This is essential in order to seek excellence through better links between research, innovation and business and to increase the contribution of universities to social cohesion and economic growth. In this respect some euro area Member States have already made some (limited) progress. The impact of these steps on labour productivity is likely to accrue gradually as young people enter into employment.

98. *New measures in the area of training for adults that could contribute to both greater productivity and adaptability of the current labour force are important to increase human capital.* However, the progress with respect to lifelong learning has been slow and these measures feature less prominently in the reform plans of Member States. Few Member States are currently reaching the target of 12.5% set for participation in life-long learning.

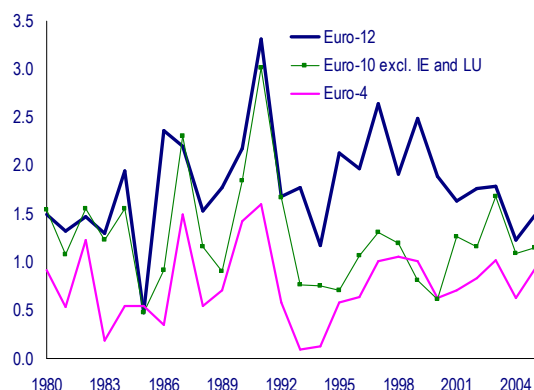
3.6 THE ECONOMIC IMPLICATIONS OF GROWTH DIFFERENCES

99. *The persistence of cross-country growth differences in the euro area underlines the added importance of structural reforms for euro-area Member States.* During the period 1999-2005, the difference between the fastest and slowest growing Member States in the euro area averaged 5.7%, with the gap widening slightly during the recovery from the 2001 slowdown. In 2005, this figure stood at 4½ percentage points.

100. *Growth differences can occur in large monetary unions for a variety of reasons.* They may be the result of temporary country-specific factors, such as differences in weather, consumer preferences, cyclical positions and the timing of national economic-policy decisions. They may also reflect longer-term factors, such as demographic developments and the evolution of employment levels, investment patterns and total factor productivity. Some growth differences are desirable: for example, differences in growth rates may be welcome to the extent that they result from an increase in the per capita income levels of catching-up countries.

101. *Recent growth differences in the euro area are not unusually large by historical standards.* Annual GDP growth data confirm that the dispersion within the euro area is not higher than in previous cycles (Graph 3.12). Since the mid-nineties, annual growth rates across Member States in the euro area have actually become more similar. Dispersion was not constant, however, and increased notably in 1996/97 when an economic recovery started. This was followed by a period of increased growth-rate convergence which lasted until 2000. In 2003, divergence peaked again (as another economic recovery started). Since 2004, growth rates in the various euro-area countries have again become more similar.

Graph 3.12: Dispersion in annual growth in the euro area⁽¹⁾

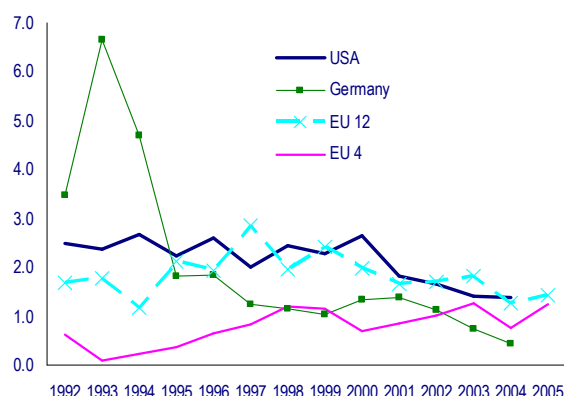


(1) Euro 12: all euro MS; Euro 10: all euro MS excluding IE and LU; Euro 4: DE, FR, IT, ES.

Source: Commission services.

Graph 3.13: Differences in growth dispersion⁽¹⁾

(Euro area, Germany, USA) (in % – 1992-2005)

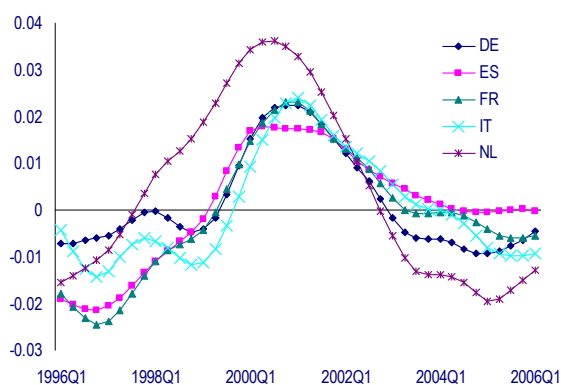


(1) Euro 12: all euro area members 4; Euro 4: DE, FR, IT, ES; Germany: 16 Bundesländer, USA: 50 States.

Source: Commission services.

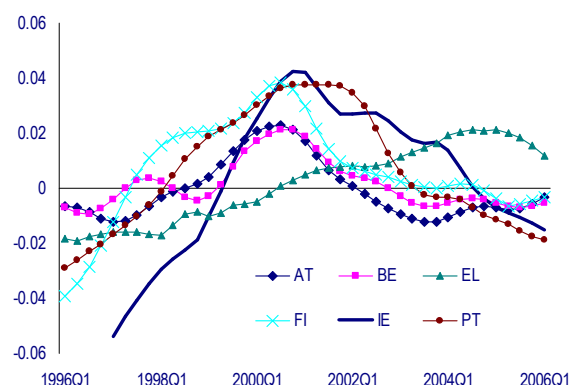
102. *Compared with other large monetary unions, euro-area growth differences are also not unusually large.* Graph 3.13 shows that growth dispersion – which is measured as the average percentage deviation from the statistical mean of a currency area – within the United States is clearly as large as those in the euro area. Similarly, intra-German growth differences have historically been as high as the dispersion across the euro area Member States. These comparisons should, however, not be over-interpreted: higher factor mobility, financial integration and fiscal transfers make it, in principle, easier to deal with growth dispersion within those countries than among euro-area members.

Graph 3.14: Output gaps in the five largest euro-area countries (as % of GDP)



Source: Commission services.

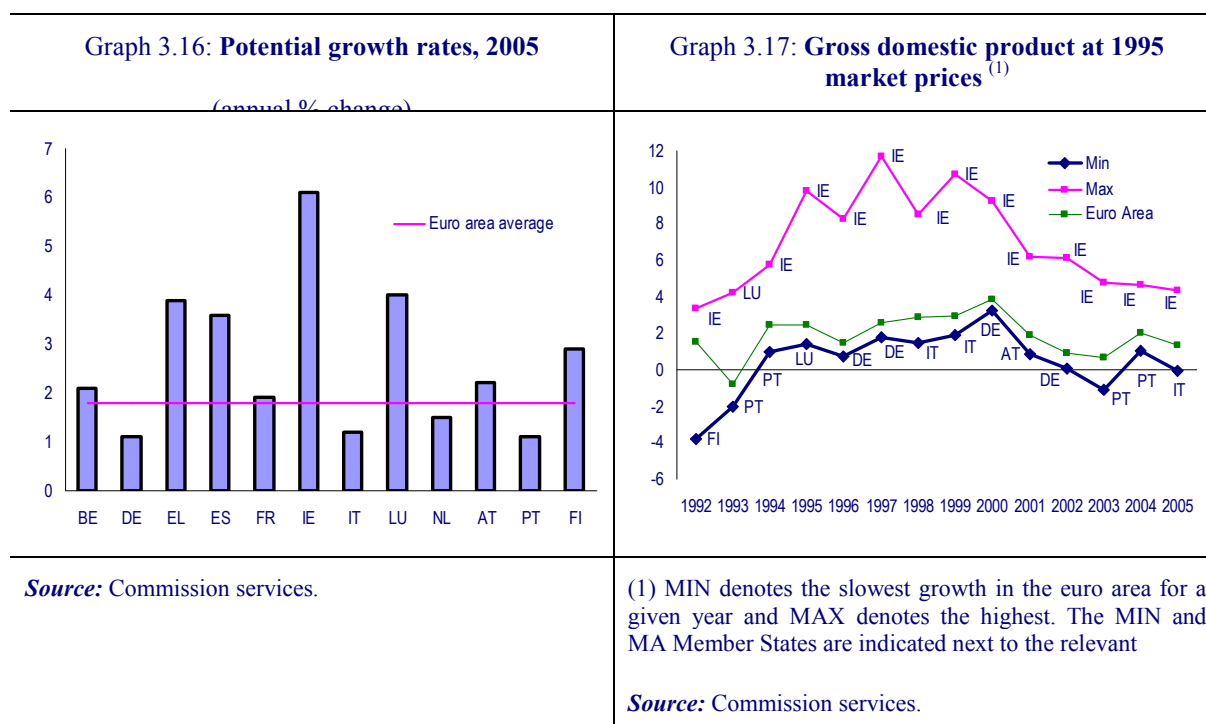
Graph 3.15: Output gaps in six smaller euro-area countries (as % of GDP)



Source: Commission services.

103. ***The dispersion of growth differences in the euro area has persisted in spite of a better synchronisation of Member States' business cycles.*** In fact, since the early 1990s, the economies of the euro area have become more closely aligned in cyclical terms. As can be seen in Graphs 3.14 and 3.15, the movement of output gaps – which measures the difference between actual and potential output – has become more similar across euro-area countries in recent years.

104. ***Greater cyclical convergence in the euro area may be due to the positive impact of increased trade-ties, greater financial-market integration and better macroeconomic management.*** It may also be partly attributed to increasing globalisation and the predominance of global shocks in explaining cyclical developments in the past few years. By itself, this is good news for EMU as monetary unions work best when their members enjoy a high degree of cyclical synchronisation.

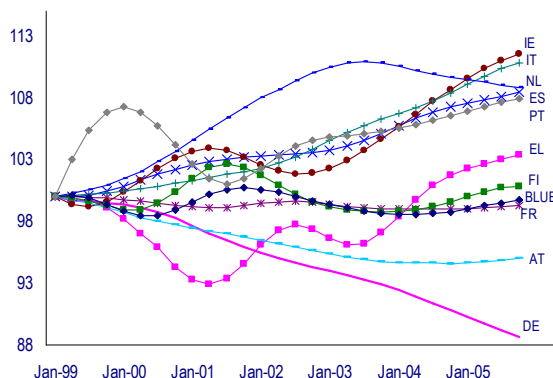


105. ***The decreasing importance of cyclical factors means that structural factors now account for a high share of the growth differences that remain.*** This is reflected in Graph 3.16, which shows that potential growth rates of euro-area Member States vary considerably. The persistence of growth differences in the euro area – to the extent that they are not explained by demographics or catching up – is a source of concern as it implies that the difference between fast- and slow-growing Member States in the euro could become entrenched over time (Graph 3.17)

106. ***Growth differences in the euro area reflect a variety of factors.*** For example, it appears that economic shocks, such as swings in exchange rates, equity and oil prices, as well as large fluctuations in the global economy, have affected Member States differently due to variations in economic structures and policy responses. Budgetary policies may also have fuelled

cyclical differences in the euro area. In particular, insufficient fiscal consolidation in a number of Member States during the good times of the late nineties may have contributed to overheating as well as hindering the free play of automatic stabilisers during the recent downturn. From a longer-term perspective, cross-country differences in the growth of employment and, to a lesser extent, total factor productivity have also played a role. Furthermore, empirical evidence suggests that growth differences cannot be fully explained by catching up in poorer Member States.

Graph 3.18: Developments in intra-area competitiveness



(1) Real effective exchange rate against 11 other Member States.

107. *A major characteristic of persistent growth the euro area is that price and cost competitiveness have tended to adjust too slowly in some Member States.* *Source:* Commission services. *characteristic of differences within*

Graph 3.18 displays a widely used indicator of price and cost competitiveness – the real effective exchange rate. Competitiveness is measured against other euro area Member States and calculated on the basis of unit labour costs. While fluctuations in intra-euro-area competitiveness are to be expected in the short term, the persistent deterioration of competitiveness in some slow growing Member States suggests a failure to adjust to economic shocks.

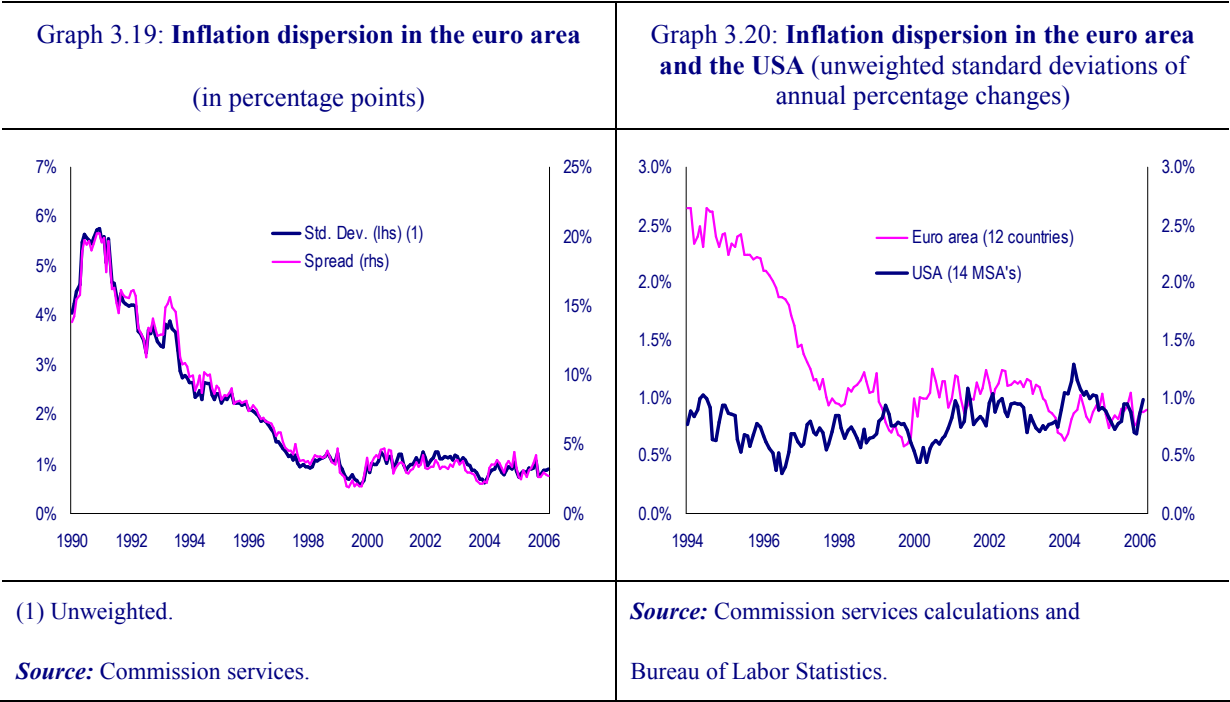
3.7 THE ECONOMIC IMPLICATIONS OF INFLATION DIFFERENCES

108. *Cross-country inflation differences in the euro area have also shown a high degree of persistence.* Since 1999, some Member States have consistently recorded price rises above or below the euro-area average. In 2006, the difference between the highest and lowest rates of inflation in the euro area stood at 2.7 percentage points.

109. *Inflation differences are also a normal feature of large monetary unions.* In the short-term, inflation differences could reflect real exchange rate adjustments in a monetary union, where by definition the nominal exchange rate between members is fixed. Temporary differences in inflation rates may be tolerable if they reflect productivity gains in the traded sector or if they help the economy to return to equilibrium following an economic disturbance. However, long-term inflation differences can lead to prolonged periods of overheating and overcooling, fuelling economic imbalances within the euro area. Moreover,

persistent inflation differentials complicate the task of the ECB in deciding on the appropriate stance of monetary policy for the euro-area aggregate

110. *The 1990s saw a remarkable degree of convergence in consumer-price inflation among euro area Member States.* The spread between the Member States with the highest and lowest (monthly) headline inflation rates fell from close to 20 percentage points in the early nineties to spreads of less than 2 percentage points in the period 1997-1999 (Graph 3.19, right hand scale). The unweighted standard deviation, another measure of dispersion which is less affected by outliers, followed a similar path, falling from over 5 percentage points in the early 1990s to historical lows of less than one percentage point in 1999, the year the euro came into being, and again in 2004 (Graph 3.19, left hand scale).



111. *The level of inflation dispersion has remained broadly stable at those low levels since 1999.* This remarkable degree of inflation convergence was achieved in the context of a generalised period of disinflation in the world economy. Moreover, disinflation in Member States partly reflected the need to fulfil the Treaty's convergence criteria for participation in EMU. By way of comparison, data for 14 US metropolitan statistical areas (MSAs) show that inflation dispersion in the USA, measured by the unweighted standard deviation, has been fairly stable and mostly below 1 percentage point since 1994 (Graph 3.20) The comparison shows that the high degree of inflation convergence achieved by Member States in the run-up to Stage 3 of EMU has brought inflation dispersion in the euro area to a similar level as that prevailing in the USA.

112. *There are many possible causes of inflation differences in the euro area.* Three appear to be particularly salient.

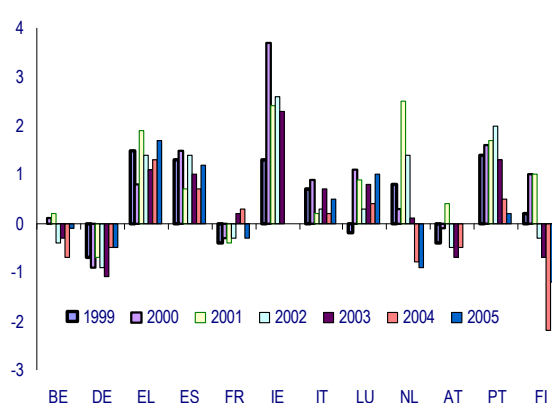
- Firstly, differences in productivity gains between the tradable and the non-tradable sectors – the so-called Balassa-Samuelson effect – may have contributed to

inflationary pressures across euro-area Member States. In particular, empirical studies suggest a negative link between income levels and price increases, implying that inflationary pressures were greater in catching-up economies. However, the correlation between income and inflation disparities over the 12 euro area Member States is low, indicating that the Balassa-Samuelson effect was not the only source of price dispersion in the recent past.

- Secondly, growth and inflation differences in the euro area appear, in some respects, to have been intertwined. Although Member States' business cycles have become more closely aligned in recent years, the cyclical differences that do remain have contributed to different inflation pressures across the euro area. In particular, inflation has tended to be higher in the euro-area's fastest growing Member States.
- Thirdly, since its very beginning, the euro area has experienced a series of price shocks, including large swings in energy prices and prices for unprocessed food. Due to differences in Member States' consumption patterns and in their exposure to extra-euro-area trade, these shocks have led to divergence in inflation rates. Energy, for example, contributed to as much as 23% to euro-area inflation dispersion in 2005 and the first quarter of 2006.

113. *These developments should, however, not disguise the fact that it is the so-called core inflation sectors that account for 80% of euro-area inflation dispersion over the period 1999-2005.* A look at these sectors (which include services, processed food and non-energy industrial goods) at the Member-State level is especially instructive.

Graph 3.21: Differentials in core inflation in relation to euro-area average



Source: Commission services.

114. *Some Member States have registered persistent inflation differentials relative to the euro-area average in the sectors that make up core inflation.* Given their significant weight in the overall HICP index, these differences can easily translate into lasting overall inflation

differentials. The persistence of such differentials could indicate that structural rigidities are the root cause of these developments and may have hindered competitiveness adjustment in some euro-area countries.

3.8 POLICY RESPONSES TO GROWTH AND INFLATION DIFFERENCES

115. *Although growth and inflation differences within the euro area are not unusually large, their persistence warrants close attention.* This is, above all, essential to allow EMU to function smoothly and to prevent the gap between fast and slow growing Member States from becoming entrenched over time.

116. *In the macroeconomic domain, budgetary policy holds the key.* The comparatively large size of the government sector in the euro area, the progressiveness of the tax system and the generosity of unemployment benefit mean that automatic stabilisers can play an important role in cushioning the initial impact of economic shocks that have country-specific effects. To be able to benefit from the full working of automatic stabilisers, Member States should run prudent policies, in particular in good times. This means that in the majority of cases, achieving and sustaining budgetary positions of close to balance or in surplus over the medium-term should be the highest priority.

117. *Budgetary policy can also make an important contribution in Member States with low potential growth by promoting a more efficient allocation of resources.* This can be achieved by redirecting expenditure towards growth-enhancing categories and ensuring that tax structures and their interaction with benefit systems promote higher growth potential through more employment and investment. A question for further discussion concerns whether, and under which circumstances, additional fiscal action may be required under EMU, particularly in the context of overheating or overcooling. In particular for the latter case, creating further margins in good times seems to be an important requirement. At the present juncture, this underlines the need for euro area Member States to seize the opportunity created by the economic recovery to undertake necessary budgetary consolidation.

118. *Getting to grips with growth and inflation differences also requires structural reforms to increase the responsiveness of prices and wages to changing economic circumstances.* In this context, particular attention has to be paid to reforms that enhance the responsiveness of real wages to economic developments and foster a sufficient degree of competition in product markets. Reforms to remove formal and informal mechanisms of wage indexation and to promote greater differentiation in minimum wage legislation could also help to reduce growth differences in the euro area.

119. *To ensure a strong link between wage flexibility and adjustment via the competitiveness channel, there must be a sufficient degree of competition in the market for goods and services.* Recent studies suggest that stringent product-market regulation is likely to slow an economy's return to potential growth after a negative disturbance. Evidence also reveals that profit margins in the euro area are less responsive to changes in economic activity than in other OECD economies, implying that the response of euro-area firms to economic shocks is more sluggish. Further deregulation and liberalisation would make a significant contribution to better growth and inflation performances.

120. *A stronger effort to raise potential output is paramount in those Member States that perform less well than the euro-area average.* In this context, structural reform is probably

the most important contribution Member States can give to making growth converge to high rates. While trade ties will continue to strengthen under EMU, Member States can help to speed up this virtuous cycle by removing the remaining barriers to trade and fostering competition in the Internal Market.

3.9 THE BENEFITS OF COORDINATED STRUCTURAL REFORMS

121. *Euro area Member States face a shared challenge of implementing structural reforms to ensure well-functioning product, labour and capital markets.* Structural reforms are important not only for achieving higher growth and employment, they are also vital for ensuring that prices and wages adjust smoothly to economic shocks. Smooth adjustment is critical for getting to grips with growth and inflation differences and, as argued in Chapter 4, for contributing to an orderly adjustment to the imbalances that have built up in the global economy.

122. *There are also economic benefits from promoting a coordinated approach to structural reform in a monetary union.* In the first place, the benefits of structural reforms in one Member State will have a greater effect on the rest of the euro area because of the increased economic interdependence that comes from sharing a single currency. Furthermore, opening up product, labour and capital markets across the euro area will allow the benefits of structural reform to accrue more quickly, thus increasing popular support for reform measures.

123. *The need for a coordinated approach to structural reforms in the euro area is central to the relaunched Lisbon Strategy.* In the Integrated Guidelines for Growth and Jobs 2005-2008, euro-area countries are encouraged to press forward with structural reforms that will increase long-term potential growth and improve productivity, competitiveness and adjustment to asymmetric shocks. To monitor the implementation of these reforms, the Commission's Annual Progress Report on Growth and Jobs includes a separate chapter on policies to promote a dynamic and smooth functioning EMU, recognizing that the euro area is more than just the sum of its parts. This point was acknowledged at the Spring European Council earlier this year, when EU leaders called for enhanced structural reforms to tackle asymmetric economic developments within the euro area. Further focus by the Eurogroup on tackling structural reform challenges will be essential for fostering progress.

THE EXTERNAL DIMENSION

124. *The creation of EMU has often been called the biggest change in the international monetary and financial system since the collapse of the Bretton-Woods system in the early 1970s.* Due to the size of the euro-area economy and thanks to its well-functioning stability-oriented framework, the euro area now carries a considerable weight in the global economy. Against this backdrop, this chapter explores the emergence of the euro as a global currency, the evolution of the euro's external value in recent years and the euro-area's developing role in international financial institutions and fora. It also looks at the potential role of the euro area in dealing with global imbalances.

4.1 THE EMERGENCE OF THE EURO AS A GLOBAL CURRENCY

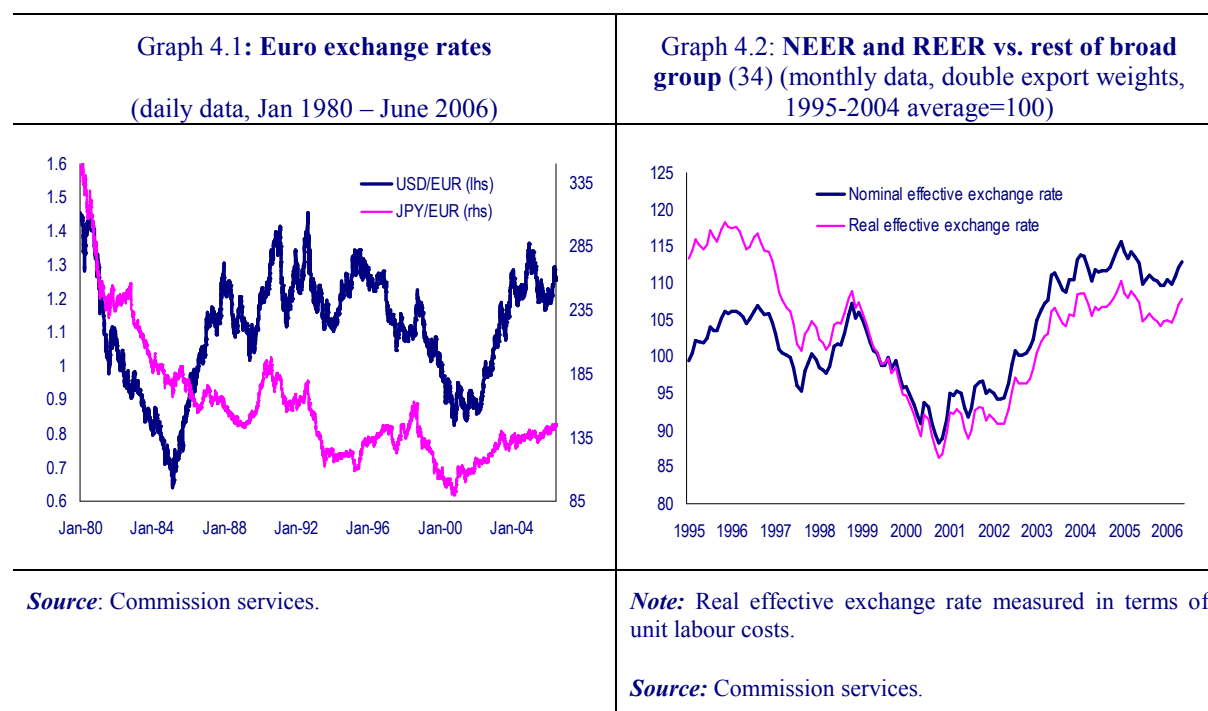
125. *Since its launch in 1999, the euro has risen in global prominence, rapidly becoming the second most important international currency, behind the US dollar.*

- Today, the euro accounts for a substantial and increasing part of the international debt markets (31.5% versus 44% for the US dollar by the end of June 2005), with European legal entities located in the vicinity of the euro area accounting for the largest share.
- The euro also represents a large part of international bank liabilities. For example, since 1999, the euro has been the second currency of denomination of loans by euro-area banks to non-bank borrowers outside the euro area, with the share above 39% in the first quarter of 2005 (against 44% for the US dollar).
- In foreign exchange markets, the euro is the second most actively traded currency, with a rather stable share. Between July 2004 and June 2005, it accounted for 21.5% of all foreign exchange transactions versus 45% for the US dollar.
- The euro is also used extensively to quote, invoice and settle external trade transactions between the euro area and third countries and, in some cases, between third countries. In 2004, in most euro-area countries for which data are available, the share of euro-denominated exports and imports was above 50%, for both goods and services.
- The euro plays a role as an anchor or reference currency, notably in acceding and accession countries, Northern Africa and the CFA Franc-Zone. A few countries, mainly in Central Europe and the Western Balkans, are using the euro as a *de facto* currency, sometimes in parallel to their own national currencies.

- Finally, the share of the euro in official foreign exchange reserves held by central banks around the world is gradually increasing (standing by end-2004 at 24.9% versus 65.9% for the US dollar), and significantly exceeding positions held by the national currencies that preceded the euro.

4.2 DEVELOPMENTS IN THE EXTERNAL VALUE OF THE EURO

126. *In the first half of 2006, the euro appreciated against the dollar and the yen, having depreciated in both cases in 2005, but the change in nominal and real effective exchange rates has been less pronounced.* Since the beginning of 2006, the euro has gained almost 8% against the US dollar and some 3.5% against the Japanese yen. In nominal effective terms the euro appreciated by around 4% (Graph 4.1). The nominal effective exchange rate of the euro is currently some 15% above its 1995 to 2004 average (Graph 4.2). In real effective terms, the euro exchange rate is slightly above its 1995 to 2004 average.



127. *Market expectations about the course of monetary policy in the US and the euro area were the main determinant of movements in the dollar-euro-segment in international foreign exchange markets in 2005.* The US Federal Reserve hiked its policy rate eight times by a total of 200 basis points over the course of the year, while the ECB only raised its key policy rates by 25 basis points in December 2005. Moreover, markets only started to take possible ECB hikes into account as of September 2005. The most recent episode of euro strength has been triggered by a change in interest rate expectations but it gained momentum after the IMF Spring Meetings in Washington in April which renewed financial markets' concerns about global imbalances.

Graph 4.3: USD/EUR and expected interest rate differential



Source: Commission services.

128. *Interest rate differentials and global imbalances will play a role in determining whether the remainder of 2006 will see a continued appreciation of the euro or a renewing of the 2005 dollar strength.* The interest-rate differential remains in the dollar's favour, as does the expected growth differential over the short-term (Graph 4.3). On the other hand, some of the factors that supported the dollar in 2005 may not be present to the same degree this year. Market observers expect the Fed tightening cycle to come to an end and some even expect a monetary-policy easing in 2007, which would slowly reduce the interest-rate differential between the US and the euro area. This should also reflect a scenario of slowing growth in the US and further strengthening in the euro area. Asian governments could be more inclined to allow their currencies to strengthen now that the holdings of foreign-exchange reserves are more than ample to insure against future crises and as domestic demand in the region picks up. In addition, currency appreciation could be beneficial from the perspective of keeping inflation rates in check. The dollar could also find itself under downward pressure if there were to be a re-emergence of concerns about global imbalances (e.g. due to a sharper than expected deterioration in the US current account deficit) or renewed geo-political tensions (e.g. heightened concerns over the security of oil supplies).

4.3 PROJECTING A STRONG VOICE ON THE WORLD STAGE

129. *In view of the euro's global reach the euro area needs to show leadership on the world stage and to contribute to the stability of the global economy.* This point was recognised by EU leaders at the European Council in Vienna in December 1998, where it was agreed that the euro area should speak with one voice on issues of particular relevance to EMU. In particular, it was agreed that such views would be presented at the IMF Executive Board by the relevant member of the Executive Director's office of the Member State holding the euro

Presidency, assisted by a representative of the Commission. It was also proposed that the Eurogroup President, assisted by the European Commission, should participate in meetings of the G7 Finance Ministers.

130. *In spite of the relatively modest scope of the Vienna European Council's aims, insufficient progress has been made towards their implementation* (see Table 4.1). In the IMF, the ECB was granted observer status in 1998 for selected IMF board discussions related to monetary and exchange-rate matters. Furthermore, euro-area positions are now presented by the Executive Director of the Member State holding the EU Presidency or the future holders of the Presidency in cases where non-euro-area countries are in the chair. However, the Eurogroup Presidency is not normally present at the IMF and the Commission does not play any role at all, with plans to put a Commission official in a European Executive Director office not yet coming to fruition. In the G7, the Eurogroup President now attends all agenda items at the G7 Finance Ministers Meetings. However, the Commission only attends certain parts of the meetings and, like the Eurogroup Presidency, is not fully involved in the G7 preparatory process. The ECB attends the whole meeting, while the relevant National Central Bank Governors of euro area Member States only attend certain parts of the meeting.

Table 4.1: External representation of the euro area: a selected overview

	Eurogroup Presidency	ECOFIN Presidency	European Central Bank	European Commission
OECD	<i>Participates in Economic and Development Review Committee examination of the euro area</i>		<i>Participates in Economic and Development Review Committee, Economic Policy Committee, and Committee on Financial Markets</i>	<i>Quasi-membership (no voting rights and does not contribute to OECD budget but participates in all meetings)</i>
IMF Executive Board		<i>Euro-area position represented by Executive Director holding EU/euro area Presidency</i>	<i>Observer status</i>	
Financial Forum	Stability		<i>Full participation</i>	
International Monetary and Financial Committee		<i>Full participation depending on the constituency agreement</i>	<i>Observer status</i>	<i>Observer status</i>
G7 Finance Ministers	<i>Full attendance but not involved in preparatory work</i>		<i>Full attendance but not involved in preparatory work</i>	<i>Partial attendance but not involved in preparatory work</i>
G20		<i>Full participation</i>	<i>Full participation</i>	<i>Attends meetings as part of the ECOFIN</i>

Source: Commission services.

131. ***The involvement of the euro area in other economic and financial institutions and fora varies considerably*** (Table 4.1). In the OECD, for example, there is a high degree of involvement with the Commission participating in all meetings and the ECB and Eurogroup Presidency playing a role in discussions that have a bearing on the euro-area economy. In contrast, the Commission is not a full participant in the G20 – an increasingly important forum for discussing issues pertaining to the global economy – and attends only as part of the EU Presidency delegation. Similarly, the observer status granted to the Commission on the International Monetary and Financial Committee is not commensurate with the Community's central role in promoting financial market integration in Europe. The participation of the EU Presidency but not the euro-area Presidency in this forum also makes it more difficult to address issues that are especially relevant for euro-area Member States.

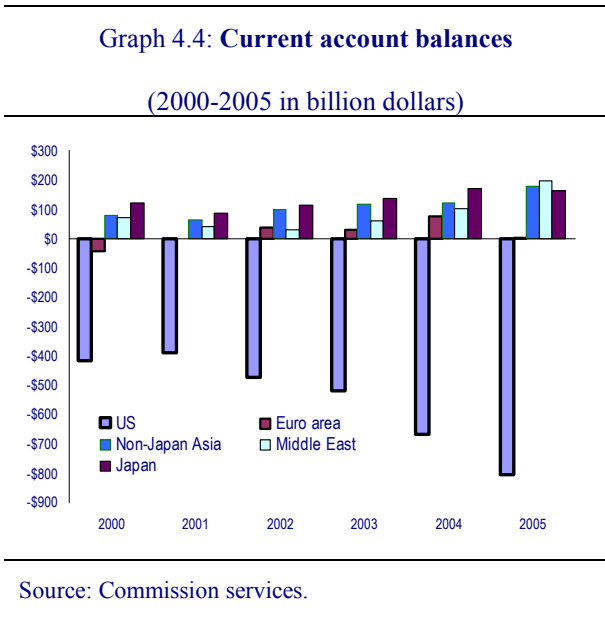
132. ***The external representation of the euro-area reveals the value-added of and the limits to informal coordination between Member States.*** Euro-area Finance Ministers and their officials now regularly elaborate common positions and understandings in preparation for international meetings. These Brussels-based co-ordination efforts are complemented by efforts from European representatives in the IMF who have stepped up the frequency of their meetings to enhance the co-ordination of positions taken in the IMF's Executive Board. While such endeavours are welcome, they tend to produce rather weak and defensive position taking that is not commensurate with the economic weight of the euro area in the global economy. Furthermore, it has proven difficult to adapt common positions to fast-changing discussions in the international fora. Finally, the list of issues subject to coordination remains limited and does not cover all the topics where the euro area is increasingly seen as a global actor by its international partners. These limitations were recognized by the European Parliament, which in a resolution adopted on March 14, 2006 strongly called for a better coordination of the EU positions within the IMF⁷.

133. ***The shortcomings in the external representation of the euro area make it difficult for Europe to project its voice on the world economic stage.*** This, in turn, makes it harder for the euro-area to fulfil its responsibilities as the world's second most important currency to promote the shared interests of euro-area Member States in international institutions and fora. This lack of influence on global economic issues is far from satisfactory at a time when Europe is being criticised in some quarters for being over represented in international institutions and fora.

⁷ European Parliament's Committee on Economic and Monetary Affairs, "Report on the Strategic Review of the International Monetary Fund", 1.2.2006, FINAL A6-0022/2006.

4.4 ADDRESSING THE CHALLENGE OF GLOBAL IMBALANCES

134. *Projecting a stronger voice on the world stage is made all the more important at the current juncture by the need for the euro area to show leadership in the face of global imbalances* (see Graph 4.4). In 2005, the United States posted the largest current account deficit in its history. It reached 6.4% of GDP in 2005 (\$805bn), up from 5.7% in 2004 (\$668bn). It represents more than 1.5% of world GDP, meaning that the US is absorbing roughly three-quarters of the net capital outflows of all countries running current account surpluses. Imbalances have also widened in major surplus regions (Japan, emerging Asia and oil-exporting emerging economies in the Middle East) amounting to around 1.4% of world GDP in 2004 (the last year for which data are available). In contrast to other major global regions, the euro area does not have a significant external imbalance. This may be a sign of macroeconomic health, but it may also partly reflect the subdued growth of domestic demand experienced in recent years.



135. *The widening of global imbalances in recent years is due to a combination of forces that have given rise to persistent differences in saving and investment behaviour and consequent divergences in the strength of domestic demand across major world regions.* These include differences in productivity growth and investor preferences for different assets, sharp declines in US savings, weak investment in much of Asia, and, arguably, rigid exchange-rate policies in many emerging Asian economies. Sustained higher oil prices have also contributed to widening imbalances, due to the high oil-content of US imports and weak investment in energy-exporting countries, notably in the Middle East and in Russia, that have benefited from higher oil revenues.

136. *The fact that imbalances continue to widen raises questions about the adequacy of current policy responses in countries with large deficits or surpluses and the efficacy of international efforts to promote an orderly unwinding of global imbalances.* Although time lags between the implementation of necessary measures and their effects may play a role, the implementation of the necessary measures has been far from sufficient. In this context, the IMF Managing Director has recently proposed a new framework for IMF surveillance. This new framework, by strengthening the multilateral component of surveillance, should make a positive contribution, provided that all relevant players contribute to reducing global current imbalances.

137. *While financial markets have remained broadly sanguine about the risks posed by global imbalances, the unprecedented size and duration of these imbalances means that they cannot continue to grow indefinitely.* There is now a broad acceptance among policy makers that an orderly adjustment of imbalances must be promoted. The key issue is how to work together to avoid a disorderly correction that could involve undesirable movements in exchange rates, disruptive capital flow reversals and negative effects on investor confidence.

138. *Although the euro area has a roughly balanced current account, it would not be immune to the effects of a disorderly correction in global imbalances.* Such an event could affect euro-area trade due to changes in exchange rate and global demand. It would affect the value of assets held abroad by euro-area residents, thereby moderating consumption. Business confidence could also be severely hit, in particular in the event of a severe output contraction in deficit regions.

139. *All major regions have a responsibility to put in place policies that will contribute to an orderly adjustment.* In the United States, a key challenge is to increase private and public savings. This could be achieved through a combination of fiscal and monetary policy. It would be based on a credible medium-term fiscal consolidation programme. Measures such as broadening tax bases, restraining discretionary expenditure and reforming age-related entitlement spending could be considered, as could an adjustment of fiscal incentives to encourage private savings. In relation to monetary policy, the US Federal Reserve has already raised short-term rates considerably since mid-2004. However, the effect of higher short-term rates on the real economy has been blunted by surprisingly low long-term interest rates, which

are nevertheless now starting to rise. Higher interest rates, particularly long-term rates, would contribute to higher national saving both directly and indirectly (through their likely impact on asset price inflation).

140. *Economies with large external surpluses, including those in Asia, could also contribute to the adjustment by shifting from export-led to domestically-generated growth.* As domestic demand accelerates in these countries, their savings (and current account) surpluses will be reduced. Some emerging Asian economies have already experienced faster growth of domestic demand, and there are encouraging signs from the continued revival in Japan. China is somewhat exceptional for Asia, in that it has experienced strong investment growth but weak consumption growth. There are a number of measures that Asian economies could take to stimulate consumption, and, outside of China, investment. These include developing financial infrastructure to make it easier for households and Small and Medium Sized Enterprises to obtain credit, and raising levels of social protection in order to reduce the need for precautionary saving.

141. *Furthermore, properly aligned currencies will be instrumental in encouraging investment in the non-tradable sector and growth of domestic demand more generally.* There is, therefore, a case for economies in the Asian region to allow their currencies to appreciate more. Exchange-

rate flexibility, while not directly addressing the underlying cause of the imbalances, would help to provide a more flexible environment for imbalances to be resolved. It would also reduce the need for Asian economies to continue to build-up large foreign exchange reserves, which is costly and potentially risky.

142. *The euro area itself, with its balanced current account, is not part of the problem but could be part of the solution.* Structural reforms in Europe could help the rebalancing process to the extent that they boost domestic demand. However, empirical evidence suggests that their contribution to reducing global imbalances, and particularly the US deficit, will probably be modest (even if their positive impact on the euro-area economy is substantial)⁸. This does not mean that the role of structural reforms in the euro area, especially of labour market flexibility, should be downplayed. In addition to boosting long-term growth, more flexibility would enhance the economy's resilience in face of shocks. The unwinding of global imbalances will imply restructuring of the euro-area economy, accompanied by the necessity of moving factors from one type of output to another. Where factor mobility is low, the misallocation and loss in output and welfare, respectively, are likely to be significant. Reforms that reduce rigidities may therefore prove to be crucial, particularly in the event of a disorderly rebalancing of current accounts.

⁸ See DG Economic and Financial Affairs, Quarterly Report on the Euro Area, October 2005.