Assessment and recommendations

The key challenges for economic policy are:

The adoption of the euro by 12 European Union (EU) countries represented a major step forward in the pursuit of economic integration: financial markets have deepened and competition has been stimulated. Business cycles have become more synchronised and structural unemployment has declined. However, the protracted period of sub-potential growth since 2001 has exposed major policy challenges. Policy should focus on boosting non-inflationary growth and strengthening resilience to shocks, fostering cohesion and putting the public finances on a sustainable basis:

• Raising economic growth and resilience to shocks

- *Growth and resilience against shocks*. Income per capita is lower in the euro area than in the best performing OECD countries and the gap is widening. Moreover, although the epicentre of many of the adverse shocks that prompted the global downturn since 2001 was in the United States, slack has been more persistent in the euro area. Key challenges are to reduce the persistent underutilisation of labour resources, to boost productivity growth and to bolster the area's resilience against shocks.

• Fostering cohesion among countries and regions

- *Cohesion*. Differences in economic performance across euro area countries and regions have remained large. With labour mobility in the euro area low, a key challenge is to reap the benefits of further economic integration amid concerns that the resulting gains in activity may not spread evenly across countries and regions. The policies that influence convergence in living standards across the area are largely the same that shape the economic performance of the area as a whole.

• Ensuring sustainable public finances

- *Public finances*. Ensuring the sustainability of public finances in the face of ageing populations is another key challenge, not least because it also impinges on growth, resilience and cohesion. Bringing fiscal policies on to a sound footing, while avoiding a rise in the already high tax burden, is vital for confidence and economic efficiency.

These challenges have become even more pertinent with the accession of ten new EU members on 1 May 2004. Although the economic weight of the new members is relatively small, their entry into the Union has substantially raised its diversity. Rapid nominal and real convergence must be secured in the run-up towards their entry into the euro area.

A recovery is underway

In the past three years the world economy has been hit by an unusual series of negative shocks – the bursting of the bubble in the information and communication technology sector, accounting scandals, epidemics, terrorist attacks and geopolitical stress. While it is not surprising that the euro area went into a downturn following the 1995-2000 upswing, it is striking that growth has been recovering much more hesitantly than in many other OECD countries. Domestic demand has remained particularly weak, which is to some extent due to subdued consumer confidence, but has started to recover recently. Looking forward, the OECD projects a shallow recovery in 2004, which should gather steam in 2005 with growth of 2½ per cent. In these projections, the output gap would remain large and start to close only slowly in 2005. Helped also by the strong exchange rate, inflation is expected by the OECD to decline to 1½ per cent in 2005. However, there are upside risks to the inflation projections mainly due to high oil prices and uncertainties concerning further increases in indirect taxes and administered prices.

Monetary policy should remain accommodative as long as the medium-term inflation outlook remains favourable

In the May 2003 review of its policy strategy, the European Central Bank (ECB) reiterated its definition of price stability, but clarified that in the pursuit of price stability it aims to maintain inflation rates close to but below 2 per cent over the medium term in line with its past conduct of policy. At this juncture, policy-determined interest rates are likely to remain on hold as long as the medium-term inflation outlook remains favourable. If evidence of weakening of economic activity surfaces, moderating inflationary pressures, the ECB should stand ready to reduce its interest rates. At the same time, the ECB should continue to be vigilant to upside risks.

Fiscal co-ordination is under stress

The most acute macroeconomic policy challenge relates to fiscal consolidation and co-ordination, which is vital for the single currency, but currently under stress. The Stability and Growth Pact (SGP), which is the backbone of the co-ordination framework, commits governments to reduce budget deficits to close to balance or move to surplus and then let automatic stabilisers play unfettered while respecting the 3 per cent of gross domestic product (GDP) ceiling for the budget deficit stipulated in the Treaty. The experience with this framework is mixed, at best. In part reflecting the unexpected depth and duration of the downturn, balancing the overall budget has been put off by about five years compared with the "stability programmes" submitted by the governments to the Commission and the Council of Ministers at the eve of the downturn. At present six euro area countries (France, Germany, Italy, Greece, the Netherlands and Portugal) are, or are projected to be, experiencing deficits above 3 per cent of GDP. Several countries were already subject to an Excessive Deficit Procedure under the Treaty rules. In November 2003, the Council decided to "hold in abeyance" the procedure in two cases, which resulted in uncertainty regarding the implementation of budgetary surveillance.

Support for the fiscal framework has been diluted

The proximate cause of the successive breaches of the fiscal rules lies in the underestimation of the depth and duration of the economic downturn. However, the deeper cause lies somewhere else. Most countries that are likely to experience deficits above the 3 per cent threshold eased fiscal policy in the economic upswing of 1999-2000 and then found it hard to reverse this in the downswing. In particular, some member states implemented tax cuts that were based on the then prevailing strong growth assumptions. At that time they were considered to be in line with the requirements of the SGP but in an *ex-post* perspective they added to the deterioration in the fiscal balances. The impressive fiscal consolidation in the run-up to the single currency to meet the Maastricht Treaty convergence criteria apparently stalled as soon as the currency was created. The support for the SGP has been diluted, and the credibility of enforcement has suffered. This is of concern because the fiscal rules are essential for the macroeconomic management of the euro area. They are necessary to avoid lack of fiscal discipline in one or several member countries spilling over into the financial conditions facing the others. The rules had also established a medium-term anchor for fiscal policy, thereby creating room for the automatic stabilisers to smooth country-specific cyclical swings following the loss of national monetary policy instruments. More fundamentally, and even on an optimistic assessment of the fiscal impact of population ageing, the close-to-balance or in surplus rule is the minimum required in the next two decades to underpin fiscal sustainability beyond this horizon. Work should continue to assess the impact of ageing on longer-term fiscal sustainability on a comparable basis across countries.

A repeat of past fiscal policy mistakes must be avoided

With ageing-related fiscal pressures building up, a repeat of past policy errors – a weakening or reversal of consolidation efforts amid buoyant cyclical conditions – would be even more costly than they recently have been. Against this backdrop, it would be wise to strengthen the surveillance and enforcement of the rules during cyclical upswings and to take into account more explicitly countries' indebtedness. Specifically:

- *Countries should ensure that their budgetary procedures stem the inherent dynamics towards spending rising faster than* GDP, *in line with the* OECD Best Practices for Budget Transparency. *Fiscal policy should be rooted in medium-term frameworks that act as a hard budget constraint, based on prudent macroeconomic projections. Budgeting should be top-down, with new expenditure funded, a fortiori, by reallocation within or across spending ministries.*

- *The adoption of such* Best Practices *is needed irrespective of the* Union's *fiscal rules, but the rules could act as a catalyst for change if fiscal surveillance and enforcement could be strengthened, including during cyclical upswings.* The Commission *should dispose of the resources needed to see to it that the stability programmes are implemented.* The Early Warning Procedure *should become an effective preventive instrument in the hands of* *the Commission – rather than in the hands of the Council who is party and judge.*

- *Stronger surveillance and enforcement may create room for building more flexibility into the Pact. It could help to raise the countries' ownership of, and commitment to, the rules. Already in 2002, the Council endorsed the principle that the close-to-balance or in surplus rule should apply in cyclically-adjusted rather than in nominal terms. For instance, increased flexibility could be considered for countries that have achieved sound public finance and low levels of debt, to allow for financing possible upfront costs of pension reform (e.g. a move towards funded private pension schemes, while desirable for efficiency reasons, may lead to deficits in public pension schemes) or other structural reforms.*

Swift inter-country adjustment is crucial for the area's resilience

The efficiency gains stemming from the single currency in terms of lowering transaction costs and deepening the internal market are large. But for individual member countries the loss of monetary policy instruments carries a potential cost in terms of larger swings in economic activity, depending on the degree to which business cycles and the shocks that shape them still differ. In the absence of monetary policy instruments, and with the leeway for fiscal policy also limited, adjustment will have to rely on changes in external competitiveness operating through wages and prices. In the first five years of the euro area's existence, economic performance across the individual economies has differed considerably, with activity in Germany and Italy subdued, but strong in some smaller countries. Equilibrating forces coming through external competitiveness have been at work to some extent, but not uniformly so; where they were at work, the competitiveness gains were in some cases too small to pull the economy out of stagnation. Moreover, as inflation differentials between some of the more dynamic and the more sluggish economies widened, real interest rates reinforced cyclical differences, with soaring house prices in the dynamic economies producing wealth effects on consumption. Since country-specific shocks (and country-specific responses to global shocks) will remain a feature of the euro area, swift inter-country adjustment is crucial for the area's resilience – not least because it would allow a more effective monetary policy response.

Structural policies could help to generate faster adjustment

A number of priorities for policy in the pursuit of more rapid inter-country adjustment emerge:

- *The effectiveness of the competitiveness channel should be enhanced. In particular the integration of services sectors should be stepped up to raise intra-area competition so as to reduce price inertia.*
- *Wage flexibility should be raised. Nominal wage rigidities, which may become more prevalent in a low inflation environment, must be tackled to shorten the adjustment period after an adverse shock.*
- *Cross-country differences in housing market institutions are striking. Policies in the pursuit of well-functioning housing markets, while aiming to avoid excessive price volatility may help to smooth the cycle and stem country-specific shocks.*
- *The social security and tax systems that underpin the automatic fiscal stabilisers should be designed so as to ensure that the incentives to which they give rise strengthen the flexibility of labour and product markets.*

The convergence of living standards across the area has been slow

The convergence in economic development is a prime policy goal of the European Union. Various regions were hard hit by industrial restructuring and the successive waves of enlargement involved countries and regions whose per capita income was far below the average. Per capita GDP has tended to converge between countries, but evidence of convergence across regions is mixed. This slow pace of convergence may partly reflect the timid pace of integration, while the evolution of human and physical capital endowments was uneven across countries and regions, with a north-south divide in skills and technology diffusion being prominent. Moreover, ill-devised labour market policies tend to trap labour in lagging regions. Many of the obstacles to stronger convergence can be overcome. However, trade offs can arise if agglomeration gains are large as some regions will win and some will lose, although there is little evidence for increased specialisation so far. Therefore, to maximise the welfare gains from economic integration, while keeping a diversified industrial base, regional policies should seek to raise the attractiveness of lagging regions in a cost-effective way.

A single market for services is needed

The single market strategy is the Community's core instrument for product market policies, and it has largely achieved the creation of an integrated market for goods. However, there are numerous barriers to the integration of service markets, including impediments to cross-border establishment, posting of workers and service provision. Commission initiatives to cut red tape and enforce the mutual recognition principle are welcome, but the implementation will take considerable time and some sectors are excluded. Therefore:

- *The removal of cross-border barriers for services should be speeded up and the risk that the proposed measures will be watered down in the negotiations between the Commission and the member countries needs to be contained.*
- *Sectors for which the Commission's proposals foresee derogations or that are already covered by EU legislation should be included as far as possible in the liberalisation efforts. The coverage of the proposed services Directive should cast its net as wide as possible, taking into account the fact that certain sectors, among which financial and transport services, are already covered by EU legislation. For some other services, derogations may be foreseen as more analysis is needed before issuing a proposal.*

Financial services should be better integrated

By eliminating exchange risk on the bulk of financial flows within the EU, the advent of the euro has been an important factor in fostering the integration of financial markets, although the degree of integration varies from market to market. The interbank market is now fully unified, while bond markets are substantially integrated. However, cross-border equity investment is still relatively costly and retail markets, including mortgage markets, have remained segmented. While cross-border mergers of financial institutions are not widespread, there have been examples of regional consolidation *e.g.* in the Benelux and Nordic countries, and several significant pan-EU financial conglomerates have emerged. The bulk of the Financial Services Action Plan (FSAP) – the Community's central tool to foster integration of financial markets – has been largely completed at the EU level, with a deadline of end-2005 for transposition of the various legislative measures into national law. While it is too early to assess overall progress in transposition, the Commission has opened several infringement procedures against member states. Political agreement has not yet been reached on three proposed Directives relating to cross-border mergers, aspects of company law and capital adequacy. Looking forward, the Commission has launched a process to take stock of progress in financial integration, to address the need for effective implementation and enforcement of the measures agreed in the FSAP and to identify remaining barriers to further integration.

- *At this juncture, the key issue is to achieve fast and consistent implementation of the Directives at national level so as to reap the gains from integration.*
- *The Takeover Bid Directive, which was finally passed by the European Parliament last December, risks favouring national champions. It allows countries to opt out and fails to address issues that allow a minority of (national) shareholders to keep control over a company. This is unfortunate.*
- *The European Union has adopted the Regulation on International Accounting Standards (IAS) in 2002. Accordingly, all European securities issuers will have to respect IAS standards as from 2005 (with a few exceptions as from 2007). Another measure of the FSAP – the Transparency Directive which was agreed at political level in spring 2004 – covers inter alia third country securities issuers, which will have to prepare financial statements either under IAS or under third country generally accepted accounting principles provided the Commission recognises the latter as equivalent in the meantime. That directive will not be applicable before autumn 2006. On the IAS-Regulation, member states should also facilitate timely change to IAS for EU companies. On the future Transparency Directive, the Commission is invited to ensure legal certainty for third country issuers on the equivalence issue at the earliest possible stage.*

The conditions for innovation and diffusion should be improved

A broad range of indicators measuring innovation and the diffusion of new technology reveal a considerable gap for the area and the best performing OECD countries. In addition, within the area there appears to be a "north-south" divide – with the southern European countries lagging. In any event, the aim of policy should not be to ensure that all regions can contribute equally to innovation, but rather to ensure that all regions can take full advantage of innovation by encouraging them to implement ambitious innovation strategies. There are three levers for policy: improving (tertiary) education, raising research and development (R&D) investment and fostering business creation. Community action – aside from serving as a platform for mutual learning and exchange – concentrates among others on enhancing supply and mobility of researchers and mobility of students, fostering cross-border research projects and co-ordination of national and regional research programmes, as well as implementing mutual recognition of diplomas and the Community Patent. There is scope for improved settings for each of the three policy levers:

- *Investment in higher education should be raised by seeking a more balanced mix between public and private funding to facilitate the development of first grade institutions.*
- *Bankruptcy laws should be streamlined and restrictions on individual debtors of a pecuniary or criminal nature should be eased to encourage business creation. Early insolvency procedures should be developed and rescue and restructuring proceedings simplified.*
- *Private funding of R&D, which is well below that in the United States, should be encouraged by improving framework conditions, including pursuing the Community Patent, applying the provisions for cross-border public procurement to research as well and establishing a single market for research that favours the emergence of centres of excellence.*

Labour markets should become more integrated and flexible

With the exception of certain areas where economic integration is already high, labour mobility in the euro area is low. Several peripheral regions have a high proportion of the least mobile low-skilled workers with unemployment staying stubbornly high. Regional differences in employment and unemployment persist partly because of low interregional and (*a fortiori*) cross-country mobility of workers, while wages are often not in line with local labour market conditions. The fact that local wage costs are usually bound by a national wage floor deters capital flows within countries, making it difficult for lagging regions to take off. While the Community has only limited competence on labour market policies, the 2000 Lisbon European Council and the 2001 Stockholm European Council set ambitious targets for the

Union as a whole. Making progress towards achieving the targets depends to a large extent on progress in creating more flexible labour markets at the regional level. Specifically:

- *Wages should be made more responsive to local conditions.*
- *Overly strict employment protection legislation, which tends to limit the geographic mobility of insiders while unduly raising their bargaining power, should be reformed.*
- *Tax and benefit systems that simultaneously hamper labour mobility and trap workers in inactivity should be recalibrated to strengthen incentives to search for a job.*
- *The portability of occupational pensions should be promoted, in particular regarding the acquisition and preservation of pension rights in a fund and the transferability of pension capital between funds. Wherever there is scope to improve the cross-border portability of other benefit entitlements, this should also be facilitated.*
- *To foster mobility, tax incentives for owner-occupation that squeeze the rental market should be reduced, high transaction costs for property lowered and re-queuing requirements to qualify for access to social housing in another region eased.*
- *Finally, once the transaction cost of mobility has been reduced, unemployment benefits should be administered on the basis of a mutual obligation whereby beneficiaries receive benefits and job search services while showing readiness to accept a job in other locations.*

Regional policy could be better focused

The Community's cohesion policy aims to speed up regional convergence and competitiveness, with structural and cohesion funds topping up national or regional development programmes. Regions mainly become eligible to EU funds if their level of per capita income falls short of the EU average by a certain margin or if they face problems with economic restructuring. There appears to be considerable scope to raise the effectiveness of this policy. A number of changes could be instrumental in this regard:

- *Given the limited financial scope within the EU budget and the need to raise efficiency, it might be better to allocate the structural funds and the cohesion fund to those countries and regions that most need them. This better focus appears especially pertinent with the enlargement of the European Union and the wider* *disparities it entails along with the persistent backwardness in other regions of the* Union.

- It *is important that regional development orientations and programmes be focused on real convergence in line with the* EU *priorities for sustainable growth and be consistent with the* EU *economic policy framework and the* Broad Economic Policy Guidelines. *The* Commission *has proposed to base regional policy on three major goals: cohesion, competitiveness and co-operation.*
- EU *spending on regional development should be conditional on the capacity of the region or country to properly channel and absorb the funds and there should be more adequate evaluation of the costs and benefits for the region and beyond – capacity building is important in this context. Sunset clauses, making the funds' availability limited in time should be introduced.*
- *The* Common Agricultural Policy (CAP) *has a regional dimension. An important reform of the* CAP *was agreed by the Council in* June 2003 *involving a significant further step towards decoupling support from production decisions. Support will remain linked to farms' historical entitlements and significant levels of price support will remain in some sectors, although for some products which were not included in the reform measures were agreed in* April 2004 (*tobacco, cotton, hop and olive oil*) *while the revision in the sugar sector is still ongoing. The continued pursuit of the ambitious goal set with the* 1992 *reform of the* CAP, *namely to increasingly expose agriculture to foreign competition, would heighten efficiency and lower prices.*

Summing up

The euro area has shown disappointing resilience to shocks and its income gap against the best performing countries remains large and is widening. The differences between individual euro area countries are even more striking and the forces that influence convergence in economic performance across the area are largely the same as those that shape the economic performance of the area:

- *Structural policies need to focus on speeding up price and real wage adjustment and raising labour mobility so as to enhance resilience against shocks and to avoid inter-regional and inter-country differences becoming entrenched.*
- *Goods, services and financial market integration must be deepened with a view to raising the area's growth potential. The take-*

up of new technologies and human capital investment must be encouraged.

- *Fiscal policy must become more forward looking to improve the sustainability of public finances and, by increasing consolidation in good times, avoid pro-cyclical biases and create room for greater short-run flexibility. This requires both national budget institutions and the surveillance and enforcement at the EU level becoming more effective.*

If product and labour market policies in the least-performing areas were to be aligned with the euro-area average, employment and economic growth would rise substantially in the area as a whole. Importantly, this would bring performance closer to the Lisbon targets and would help to move towards sustainable fiscal positions and meet the requirements of the SGP. These challenges have become even more pertinent with the accession of ten new EU-members on 1 May 2004.

Acronyms and abbreviations

APW	Average production worker
BEPG	Broad economic policy guidelines
CAP	Common Agricultural Policy
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
EPL	Employment protection legislation
EPO	European Patent Office
ERDF	European Regional Development Fund
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
EU	European Union
EU15	15 members of the European Union before the May 2004 enlargement
EU25	25 member countries of the European Union
EUR	Euro
FDI	Foreign direct investment
FSAP	Financial Services Action Plan
GAAP	Generally accepted accounting principles
GBP	Pound sterling
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
IAS	International Accounting Standards
ICT	Information and Communication Technology
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
JPO	Japanese Patent Office
M1	Money aggregate: Currency in circulation and overnight deposits
M2	Money aggregate: M1 and other short-term deposits
M3	Money aggregate: M2 and marketable instruments
MCI	Monetary conditions index
MFI	Monetary and financial institutions
MFP	Multifactor productivity
NAIRU	Non-accelerating inflation rate of unemployment
NASDAQ	National Association of Securities Dealers Automated Quotation System
NCB	National central bank
NUTS	*Nomenclature des unités territoriales statistiques* (Nomenclature of territorial units for statistics)

NYSE	New York Stock Exchange
OCA	Optimum currency area
PPP	Purchasing power parity
PPS	Purchasing power standard
R&D	Research and development
RCAP	Risk Capital Action Plan
RDR	Rural Development Regulation
SDR	Special drawing rights
SFP	Single Farm Payment
SGP	Stability and Growth Pact
UCITS	Undertakings for the Collective Investment of Transferable Securities
UMTS	Universal Mobile Telephone Systems (third generation mobile telephone systems)
US	United States
USD	United States dollar
USPTO	United States Patent and Trademark Office

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BASIC STATISTICS

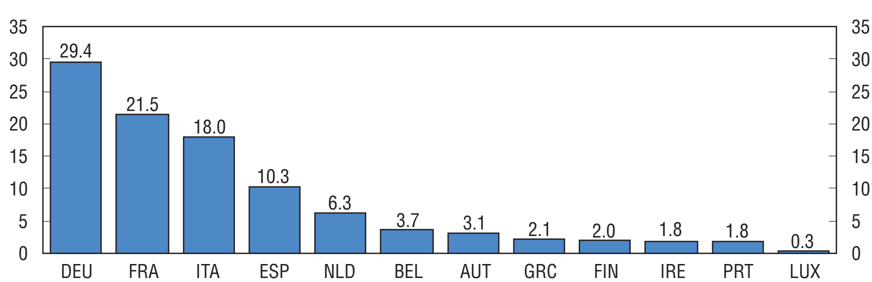
2003

	Euro area	United States	Japan
LAND AND PEOPLE			
Area (thousand km²)	2 456	9 167	395
Population (million, in 2002)	304.9	288.6	127.4
Number of inhabitants per km²	124	31	323
Population growth (1995-2002, annual average % rate)	0.3	1.3	0.2
Labour force (million)	142.6	146.5	66.7
Unemployment rate (%)	8.8	6.0	5.3
ACTIVITY			
GDP (billion USD, current prices and exchange rates)	8 183.4	10 857.2	4 300.9
Per capita GDP (USD, current prices and PPPs, in 2002)	25 566	36 121	26 852
In per cent of GDP:			
Gross fixed capital formation	19.8	18.4	23.9
Exports of goods and services	18.8	9.5	11.8
Imports of goods and services	17.1	14.1	10.2
PUBLIC FINANCES (per cent of GDP)			
General government: Revenue	45.3	30.7	29.2
Expenditure	49.0	35.7	37.7
Balance	–2.7	–4.8	–8.0
Gross public debt (end-year)	76.2	62.8	157.3
EXCHANGE RATE (national currency per euro)			
Year average		1.13	131.0
January		1.06	126.1
December		1.23	132.4

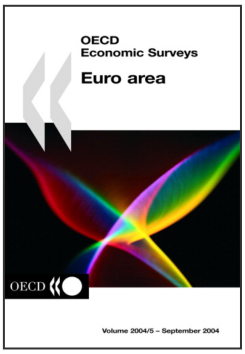
EURO AREA – EXTERNAL TRADE IN GOODS (main partners, % of total flows, in 2002)

	Exports	Imports
Denmark, Sweden, United Kingdom	23.8	19.4
New European Union member countries	10.3	9.4
Other Europe	15.2	15.3
OECD America	19.6	14.9
OECD Asia/Pacific	5.6	8.6
Non-OECD dynamic Asian[1] and China	7.1	11.9

SHARE IN EURO AREA GDP (current market prices)



1. Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore and Thailand.



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