

Economic Survey of the Euro Area, 2007

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Summary

After several false starts, the economic recovery has taken hold. Activity was strong in 2006, firms and households are more confident about the future, business investment has picked up and unemployment has fallen below 8% for the first time since 2001. There are encouraging signs that the recovery is broadening to embrace household consumption as well. If in addition structural reforms continue, the expansion will become durable and self-sustaining, a prospect also supported by sound corporate and household balance sheets and favourable financing conditions. All this is good news, though it should be kept in perspective. Growth of around 2¼ per cent per annum projected for 2007 and 2008 is still modest by OECD standards, although the growth gap is smaller when measured on a per capita basis. Still, it could take until 2008 for cyclical slack to be fully absorbed.

With the recovery underway, **attention can shift back to the euro area's longer-term challenges:** subdued potential growth and a lack of resilience due to structural shortcomings. The early years of monetary union have shown that less flexible economies can have a rough ride, missing out on the full benefits of the single currency. Structural rigidities tend to reduce growth, make inflation more persistent and reduce the economy's ability to absorb shocks. Some countries are more flexible than others, and this matters because it implies that the common monetary policy will often be too loose for some and too tight for others. For that reason, the single currency would be more beneficial for everyone if structural reforms were put in place so that economies became more flexible and more tightly integrated.

The priorities for national and European authorities include:

- i) reducing labour market rigidities so that economies can cope with change more easily. A key part of this is to make wages more flexible;

This Policy Brief presents the assessment and recommendations of the 2007 OECD Economic Survey of the Euro Area. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

ii) boosting competition, especially in the protected service sector, to make inflation less sticky and take some of the pressure off monetary policy; and

iii) continuing to integrate and develop financial markets. Some countries are already a long way down the road of structural reform, and are performing well as a result. Others have some catching up to do.

Monetary policy has succeeded in anchoring inflation expectations around the price stability objective, despite the energy price shock. The monetary and economic analyses composing the European Central Bank's (ECB) strategy are intended to complement each other and thereby aim to develop a deeper insight into the risks to price stability at various horizons in order to ensure that the most appropriate policy decisions are made. However, the framework poses communication challenges, so the ECB should continue to enhance its communication strategy.

The recovery creates a golden opportunity to get fiscal policy back on track. Budget plans are falling short of what is needed to sustain welfare systems over the long term. Member states need to make greater efforts to achieve budget balance and pay down debt. An important tool to help achieve this would be to improve budgeting practices and national fiscal frameworks, for example with expenditure, deficit and debt targets, greater transparency and more focus on the medium term. It is too early to say whether the revisions to the Stability and Growth Pact in 2005 have helped. They have the potential to deliver better fiscal outcomes because the Pact may have more "ownership" by member states. However, it could also be less effective by making it easier to postpone adjustment. Thorough implementation is therefore important. ■

Economic and monetary union has promoted prosperity and encouraged economic integration. However, the euro area as a whole has experienced low growth and a lack of resilience. These issues are related. Many of the structural rigidities that restrain growth also reduce the economy's ability to absorb shocks. In the public debate, the union's poor performance in these two areas has often been blamed on the single currency itself. However, this criticism is misguided. The economic problems are mainly structural; the solutions therefore are largely in the hands of individual member governments. Thus, the primary policy challenge for the euro area is to improve growth and resilience by boosting economic flexibility. The second challenge is to get fiscal policy back on track. Population ageing will hold back growth in coming decades and will have large implications for fiscal policy in all euro area countries. This Survey discusses all these issues, but puts more emphasis on the macroeconomic factors. The more structural issues will be dealt with in greater depth in the 2007 *Economic Survey of the European Union*.

How strong is the recovery?

The latest economic news is encouraging and bodes well for the immediate future. The economic rebound is clearly under way and there are signs that it has begun to embrace households as well. Growth in the first half of 2006 was well above potential, driven to a large extent by a rebound in business investment. It seems that the pent-up investment demand that had been put on hold in 2005 due to economic and political uncertainty is now coming on stream. The recovery has been broad-based, with most member countries growing at a healthy pace. Employment growth has also picked up, albeit modestly, and the unemployment rate has fallen below 8%. While business and consumer confidence have eased back a little from their peaks in mid-2006, they remain fairly high. Incoming orders are strong and employment expectations are healthier than they have been for many years. All in all, this points to growth rates in the near term at or slightly above the economy's potential rate. Further out, the durability of the recovery depends on how consumers react and on progress made with structural reforms. Consumers should become more willing to spend so long as there are no more negative shocks, although consumption growth could remain constrained by fairly modest wage growth. Moreover, the consumption path may not be smooth as consumption in Germany is likely to be shuffled around by its value-added tax increase in January 2007. There are always risks, of course, the main ones being a sharper-than-expected slowdown in the United States, another jump in oil prices, a slump in construction activity if housing markets deteriorate and an abrupt appreciation of the euro if global current account imbalances trigger a realignment of exchange rates. On the other hand, oil prices may also come down, boosting real incomes and consumption, while the momentum behind the investment pick-up could be underestimated. But the most likely outlook for the euro

area is continued growth a little above potential, in which case economic slack should be absorbed fully by 2008 at the latest. This suggests that supply constraints could soon become evident again. A self-sustaining recovery will also depend on the willingness of euro area countries to pursue supply-enhancing structural reforms, especially those focused on boosting labour participation, competition and innovation. These are needed to address the euro area's Achilles heel: slow potential growth.

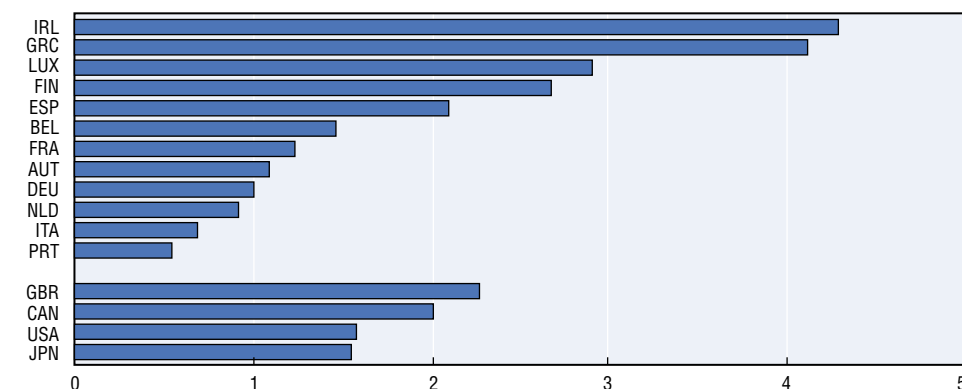
An important question is why it took so long for the recovery to take hold. Other OECD economies have dealt with international turbulence more easily. To be sure, the euro area has faced stronger headwinds from the appreciation of the euro and subdued confidence, which may have been partly caused by political uncertainties, notably concerning economic reforms. But even so, relatively low resilience caused by structural rigidities has hampered the economy's ability to bounce back quickly from negative shocks. In addition, markets are more flexible in some countries than in others, so macro policy has different effects throughout the union. Insufficient flexibility prevents the euro area reaping the full benefits of economic and monetary union. Pushing ahead with the implementation of the National Reform Programmes within the revised Lisbon Strategy should go a long way towards addressing these shortcomings. ■

Is monetary union working well?

The single currency has undoubtedly brought benefits. It has two basic aims: to deliver price stability and to foster economic integration. On the first goal it has been a clear success, especially for those countries which had a history of high inflation and erratic monetary policy. Inflation has been stable and inflation expectations have remained well anchored despite the large energy price shocks.

On the second goal, economic and monetary union has encouraged economic integration, but there has been more progress in some areas than others. Business cycles have become more synchronised, and the range of growth and inflation rates across euro area countries is broadly

Figure 1.
REAL GDP GROWTH PER CAPITA
 Average annual growth rates, 2000-05, per cent



Source: OECD, National Accounts of OECD Countries – online database and OECD Economic Outlook: Statistics and Projections – online database.

in line with regional divergences in other parts of the OECD, such as across states or provinces in the United States, Canada and Australia. The single monetary policy cannot address such cross-country divergences in the euro area. Divergences in performance are more persistent in the euro area, mainly because potential growth rates are so different. Inflation differentials are also persistent, a feature that seems to be unique to the European monetary union. Whether this is problematic depends on the underlying causes, and that has to be assessed on a country-by-country basis. For example, inflation differentials driven by a catch-up process are not a problem as long as they are backed by productivity improvements in the tradable sector. Moreover, price levels in the euro area are converging on average, not diverging. A more significant concern is that unit labour costs in a few countries have overshoot the euro area average, and ultimately that harms competitiveness and growth.

Monetary union has also encouraged stronger economic links through trade. Empirical evidence suggests that EMU has boosted euro area trade by around 5 to 15% so far and the long-run effects may be greater still. However, internal trade in services remains very low. In this respect, the prospective Services Directive would be a positive element although more ambition would have been desirable. Such product market reforms help squeeze out economic rents by boosting competition in shielded sectors. Financial markets have become more integrated since 1999, especially for wholesale products. However, retail banking and mortgage markets remain fragmented mainly because of differences in national regulations, although there are several initiatives in train to address these issues. Finally, direct investment between euro area members has increased only modestly as a share of total direct investment, although there are encouraging signs of a pick-up in cross-border mergers and acquisitions activity recently. ■

Can it work better?

A key lesson from the early years of economic and monetary union is that resilient economies tend to thrive whereas inflexible ones have a rough ride. The main built-in balancing mechanism – the competitiveness channel – has been slow to act. This can lead to boom-bust cycles in some countries and depressed activity in others. It is important to bear this lesson in mind as the union embarks on a significant wave of expansion, with Slovenia joining in 2007 and several other countries planning to join over the next few years. *The priority for current and prospective members should therefore be to ensure flexible and competitive markets so as to foster speedy adjustment to economic shocks and a more effective response to macroeconomic policy.* The key requirements include the following:

- *Ease employment protection legislation for regular contracts in those countries where it hinders adjustment to permanent shocks, and especially where it has led to a dual labour market.*

- *Boost wage flexibility.* Bargaining at the enterprise, rather than sectoral, level and linking wage developments to productivity would help firms absorb shocks by adjusting wages rather than employment and would give workers more incentive to lift productivity because they could share in the gains. Elements that cause wage rigidities such as administrative extension (where specific wage agreements are extended to larger parts of the economy) and implicit or explicit indexation should be, when possible, abolished, or at least it should be ensured that wage developments are closely aligned to productivity. Welfare reforms, especially stricter eligibility and job search conditions coupled with effective job-search support, could make wages more responsive to labour market conditions.
- *Reduce barriers to labour mobility,* for example, through pension portability and recognition of qualifications.
- *Reduce inflation inertia.* Boosting competition by cutting unnecessary product market regulations and lowering barriers to internal trade would help reduce prices and make the inflation rate more responsive to demand. It would raise the likelihood of current wage moderation getting passed on to consumers rather than being absorbed in higher profit margins.
- *Open financial markets further.* Monetary policy would be more powerful if retail banking was more competitive and if regulatory reforms made it easier for homeowners to borrow their way through a downturn. Countries would also be more likely to move in step with each other and a more integrated financial sector would make the economy less susceptible to credit cycles. ■

How can monetary policy be improved?

The ECB's monetary policy has succeeded in anchoring inflation expectations around the price stability objective. While inflation picked up slightly over the past year, peaking at 2.5% around mid-2006, it has eased back since then. Most of the increase is explained by the direct impact of energy prices, which have contributed around 1 percentage point to inflation in 2005 and 2006. Higher energy costs are beginning to push up other prices as they work their way through the production chain. Although there are few signs yet of second-round effects on wages, various measures of core inflation and industrial producer prices are signalling potential inflationary pressures over the next year or two. Against this background, the ECB has been withdrawing monetary stimulus since December 2005. The level of interest rates remains below most estimates of the neutral rate, so monetary policy is still supporting activity.

In this tightening cycle ECB statements have put emphasis on money and credit aggregates. The ECB argues that monetary growth, which has outpaced nominal GDP growth by 10 percentage points since 2003, is signalling risks to price stability over the medium term. The ECB is not alone in paying attention to money and credit developments but it is unique in elevating them to the status of one of the two pillars of its

monetary policy strategy. The ECB clarified the role of the monetary pillar in 2003 and now describes it as a “cross check” on the economic analysis (the other pillar), providing information on the outlook for price developments at medium to longer horizons. There is no question that central banks should monitor monetary developments and assess their implications for price stability. The relevant question is the appropriate weight to put on money relative to other indicators of future inflation. Some commentators believe that the ECB puts too much weight on monetary indicators, partly because of recent tentative evidence that money and credit aggregates may have become less reliable as guides for policy. At the same time, a few recent and, in part, preliminary studies find evidence in favour of the information content of money for inflation, especially over longer horizons.

The monetary and economic analyses are intended to complement each other and thereby aim to develop a deeper insight into the risks to price stability at various horizons in order to ensure that the most appropriate policy decisions are made. The ECB’s two pillar strategy is one response to the difficulty of finding a single model or analytical framework which encompasses both the economic and monetary analyses in a meaningful way. However, presenting monetary policy decisions to the public within this framework, which reflects the complexity of the decision-making process, poses communication challenges. In responding to these challenges, the ECB has now achieved a high degree of predictability for its monetary policy decisions over shorter horizons. Yet other challenges remain. Against this background, the ECB should continue to refine its communication strategy in order to enhance clarity. For example, concerning the economic analysis, the ECB could consider publishing more detailed staff projections and lengthening their horizon. Regarding the monetary analysis, it should describe more precisely and in more quantitative terms what today’s money growth implies for future inflation. More generally, the ECB should strive to deepen the cross-checking between the economic and monetary analyses and enhance their integration. ■

Is the fiscal situation improving?

In a number of countries, fiscal policies are falling well short of what is needed given the pressure that population ageing will put on public finances. While fiscal developments compare relatively well to other major economies, they fall short of outcomes in the best performers. There has been little overall fiscal improvement since the adoption of the euro, although the situation in some countries has improved. The area-wide debt level is almost unchanged as a proportion of GDP and the budget deficit has increased. In 2005, five of the twelve member countries had deficits around or above the 3% limit, including the three largest economies. On the positive side, another five were close to balance or in

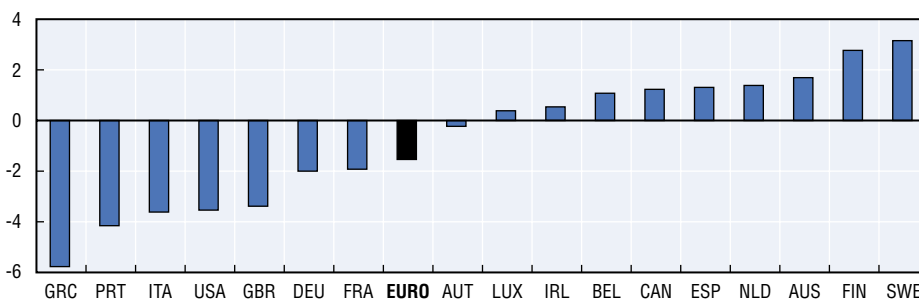
surplus. While the area-wide deficit for 2005 came in lower than expected and should do so again in 2006 it is likely to be some years before the euro area is close to balance or in surplus, and even that will not occur without greater efforts towards fiscal consolidation. For that reason, it is important that any revenue windfalls during the upswing are used to pay down debt. Since public finances are not yet in a sustainable position in the majority of countries, any planned tax reforms or expenditure increases should take into account the effect on long-term sustainability.

The 2005 stability programmes were not ambitious enough given the cyclical upswing. National budget plans for 2006 showed little improvement over the previous year. Among the countries that were not in the excessive deficit procedure (EDP), few planned to do more than the benchmark half per cent per annum adjustment asked for under the Stability and Growth Pact (SGP). At the same time, the planned budgetary consolidation in EDP countries has been broadly in line with the provisions of the Pact. One of the reasons why the Pact was reformed in 2005 was to boost incentives to consolidate in good times. The window of opportunity during the current upswing should not be missed, and programmes should be better specified and more frontloaded than they were in 2005. ■

Have the changes to the SGP helped?

The changes to the Pact after the enforcement mechanism broke down led to reforms in the preventive and corrective arms with the aim of improving its national ownership and credibility. Deficits above 3% of GDP may be permitted in some cases and countries have more time to reduce them. The new rules specify special factors to be taken into account, including structural reforms as well as any “other relevant factors”, under the restriction that the breach of the 3% limit is judged to be small and temporary. However, since the 2005 reform, all deficits in excess of 3% of GDP have been considered excessive, even when it was by a small margin and without countries invoking the application of other relevant factors. Member states in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5% of GDP in cyclically-adjusted terms, net of

Figure 2.
STRUCTURAL BALANCE
As a percentage of GDP,
2005



Source: OECD (2006), OECD Economic Outlook: Statistics and Projections – online database.

one-off and other temporary measures. Concerning the preventive arm of the Pact for countries not in excessive deficit, there is no minimum required adjustment, although an annual adjustment of 0.5% of GDP as a benchmark is requested. Slower adjustment can be acceptable in economic bad times, and more can be requested in good times. However, this is subject to the difficulties of a forward-looking assessment of cyclical conditions. Hence, it is uncertain whether the revised Pact will fully deliver on this count, or whether it will confirm concerns expressed by some that it may allow quite limited adjustment for quite some years. However, it is encouraging to note that, according to the 2005 update of the stability programmes, most member states have agreed to achieve the benchmark annual adjustment of 0.5% of GDP. Overall, the extra room for judgement in the Pact should be used only when clearly warranted on economic grounds.

All in all, the framework has moved towards more economic judgement within the rules-based framework. It is reasonable to wait more time before fully evaluating the results. The potential advantage is that it may improve national “ownership” of the Pact’s objectives and rules because authorities are no longer enforcing a system widely regarded as mechanical and inflexible. Fiscal assessments now have more economic focus and greater emphasis can be given to debt levels and long-term sustainability. A good example has been that some countries have set even more ambitious medium-term objectives than required. High debt countries also tend to have more ambitious medium-term objectives than other member states. These are clear improvements. The potential downside is that the Pact could become toothless by providing more room for excuses, arguments and delay. It has already faced a small test with the 2005 stability programmes, and the outcomes were mixed. On the positive side, there has been more peer pressure on member states, less argument with the Commission’s assessments and less use of creative accounting and overly optimistic forecasts. It is also positive that, in the context of the 2005 reform of the Pact, ministers have made a strong commitment to avoid pro-cyclical policies in good times. However, it is uncertain whether the reforms will deliver on their key objective of encouraging permanent fiscal improvement during an upswing. And while high debt countries tend to be amongst the ones that have set themselves more demanding medium-term objectives, their planned speed of adjustment towards these benchmarks is no faster than for other countries. ■

What other fiscal reforms would help?

The most important reforms are required at the national level:

- *Some countries need to be more ambitious.* Greater efforts are required not just to make public finances sustainable but also to boost growth in the longer

term. Governments often want to wait before tackling a fiscal problem, yet the economic and political costs of delaying reform are becoming large. Moreover, international experience suggests that getting the fiscal house in order is almost a pre-condition for reaping the rewards of structural reform. There have been rare exceptions, but in most cases reforming economies took off only after the deficit had been brought down. That may be because fiscal consolidation demonstrates that a government is serious about reform, generating confidence in the whole process.

- *National institutions should be reformed where necessary to put more emphasis on medium-term fiscal frameworks*, including expenditure and debt targets, greater transparency, better accounting practices (including accounting for implicit liabilities such as unfunded pensions), independent forecasts and external watchdogs. Governments could also produce medium-term fiscal projections on a no-policy-change basis because in many cases the current approach “predicts” a balanced budget to be just around the corner without specifying what policy measures will get them there, thus painting too rosy a picture.

The Community-level framework can support efforts by member states in the following ways:

- *Concentrate efforts on high-debt countries, taking into account debt dynamics and sustainability*, as they are the ones that are of greatest concern for the smooth functioning of the monetary union. Avoiding the free-rider problem was one of the main reasons for having area-wide fiscal rules in the first place.
- *Structural reforms should not be used as an excuse to delay fiscal adjustment*. Structural reform is an ongoing process, not a one-off effort with temporary impacts on the deficit. In any case, in most but not all structural reforms the initial negative fiscal impact tends to be small and is dwarfed by the longer-term savings.
- *Prepare the stability programmes earlier in the year*. Experience shows that a top-down process on the budgetary procedure can help finance ministers resist the pressures from spending ministries. Therefore some member states have proposed bringing the European timetable for stability programmes forward to April or May so as to precede national budgets. The hope was to shape the national debates, which usually take place in the northern autumn. However, in other member states this would not be helpful. Alternative ways to strengthen budgetary surveillance are therefore being explored.
- *Enforce the rules*. International experience with budget rules shows that fiscal prudence is seldom delivered without political buy-in by individual governments. Community-level policymakers therefore need to have

realistic ambitions for what can be achieved with fiscal machinery such as the SGP. But as a corollary, since the framework has been made more flexible, it should be well enforced.

- Finally, highlighting the long-term sustainability of fiscal positions in member states would help financial markets to discipline the poor performers. This has happened, with cross-country spreads on government bonds widening in 2006. ■

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