



Economic Survey of the euro area, 2005

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Introduction

Economic policy in the euro area pursues the objectives of achieving solid economic growth, a better performance of labour markets and restoring sound public finances in the context of a single monetary policy which aims at maintaining price stability. Although inflation has remained just above the ECB's definition of price stability, longer-term inflation expectations remain firmly anchored to price stability. However, progress towards the other goals has been disappointing thus far partly owing to adverse shocks such as higher oil prices or exchange rate shifts. On unchanged policies and with population ageing the euro area's potential output growth is set to decelerate over the next decades and eventually stabilises at around 1% per annum by about 2020, as illustrated in the following scenario:

Euro area	Average annual growth rate				
	1995-2000	2000-05	2005-10	2010-20	2020-30
A. Trend employment	0.7	0.8	0.3	-0.3	-0.7
B. Trend labour productivity	1.2	1.2	1.6	1.6	1.6
C. Trend GDP	2	2	1.9	1.3	0.9
D. Population	0.3	0.3	0.2	0.1	0
E. Trend GDP per capita	1.8	1.6	1.7	1.2	0.9

This would widen the income gap with the United States considerably. Determination in pursuing structural reforms is needed to boost growth prospects and resume economic convergence with the OECD's best performers. At the same time macroeconomic stability needs to be assured:

- **Monetary policy is expected to remain accommodative as long as the medium-term inflation outlook is in line with price stability.** The recovery has been sluggish thus far and inflation has responded little to widening slack. Since the start of the recovery, the ECB has kept its main policy rate on hold at 2%. It would seem reasonable for the ECB to hold its rate stable as long as the outlook for price developments remains in line with price stability over the medium term, although policy would need to act if the inflation outlook were to change. Structural reforms

This Policy Brief presents the assessment and recommendations of the 2005 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.

would help to reduce inflation persistence and enhance the effectiveness of a stability-oriented monetary policy.

- **Fiscal policy should be rooted in long-term sustainability goals.** There is a need to take account now of the heavy longer-term ageing-related spending pressures. It is essential to move to a position where budgets are close to balance or in surplus over the business cycle. The March 2005 decision to shift the focus of EU fiscal surveillance procedures onto medium-term budget balances and onto the debt criterion could help provided that it is accompanied by strong ownership of the rules on behalf of the member states and better control of government spending.
- **Labour market institutions must be overhauled so as to remove obstacles and disincentives to work.** To establish a well-functioning labour market across the euro area, reforms should include adapting wage formation systems, easing employment protection legislation, cutting incentives to retire early or claim disability, lowering the tax wedge on labour and removing the obstacles to mobility.
- **Regulations impeding competition within and trade across countries should be removed and innovation fostered.** It is particularly important to preserve the core of the provisions of the proposed services directive. Further progress is needed in reducing segmentation in financial and transport markets. Policy settings for innovation should be improved. Changes should comprise implementing the Community Patent and, at the national level, deregulating product markets and basing research funding and researchers' pay on the results achieved. ■

What are the key challenges for economic policy?

Economic growth in the euro area has been lagging that of the best performing OECD countries since the mid-1990s. Moreover, the euro area has been slow to recover from the 2001-03 downturn, but inflation has hardly eased. This suggests a lack of resilience in the face of shocks but also a longer-term problem since potential growth may also have been declining. Creating conditions that will ensure that the euro area grows more robustly while keeping inflation low will also contribute to raise potential growth and should involve as key measures:

- **Utilising idle labour resources.** Notwithstanding some improvements, high structural unemployment and low labour market participation of older workers have remained the hallmark of the euro area economy. *Labour market reforms, such as reducing the labour cost of the less skilled, have improved performance to some extent, but the politically more difficult areas, such as easing employment protection legislation (EPL) for permanent workers, also need to be tackled.*
- **Boosting productivity gains.** The euro area is lagging in innovation while opportunities for efficiency gains via the integration of services markets are being left unexploited. *It is essential that the thrust of the draft services directive is maintained to prompt greater convergence of service price*

levels and to exploit the gains from enhanced trade in services. Improved framework conditions and better focused research and development (R&D) could lead to considerable gains from innovation.

- **Ensuring the long-term sustainability of public finances.** In a context of population ageing, a main challenge is to ensure long-term fiscal sustainability, which is far from assured in a number of countries. Boosting growth by structural reforms will make this easier to achieve. Both fiscal consolidation and structural reforms would boost confidence. *Member countries should maintain, or restore, sound public finances. This requires more realistic and transparent budgeting, greater restraint and better quality of public spending contributing to higher growth.* ■

What is the current macroeconomic situation?

Activity has been recovering since mid-2003, but growth has remained below the estimated potential of around 2% per annum. With the euro having appreciated considerably since 2002, net foreign trade has lent limited support to economic activity. Household confidence has been recovering hesitantly since early 2003, underpinning a gradual strengthening in consumer demand. Capital formation has finally begun to turn around after its virtually unabated decline since the onset of the downturn in 2001. Employment has remained relatively resilient all along, underpinned by wage moderation and policies to support the employment of the low skilled and temporary work in several countries. As a result, the unemployment rate has remained virtually stable at just below 9% for almost two years. Inflation, while moderate at close to 2%, has responded little to widening slack and the appreciating currency – with energy and administered prices and indirect taxation offsetting some weakening of price pressures for other items owing in part to the absence of second round wage effects so far.

While a gradual recovery is projected, a combination of new adverse shocks would be challenging. Growth is projected to slow to 1¼ per cent in 2005, slightly less than in 2004, and to firm to 2% in 2006. Domestic demand should be the main engine of growth, with both private investment and consumption picking up further, whereas net exports would contribute little. The unemployment rate is projected to decline slightly to 8¾ per cent in 2006. But there are significant downside risks to growth: on the external side, yet higher oil prices and the unwinding of global current account imbalances, which could result in renewed upward pressure on the euro exchange rate could dent the recovery; a sharper than expected increase in long-term interest rates in the United States could spill over to the euro area; and on the domestic side, household confidence and business expectations remain fragile. On the other hand, restored corporate profitability and balance sheets could spur business investment more strongly, especially if oil prices ease and consumption could recover once confidence has recovered more forcefully and lead to a lower savings rate than otherwise. ■

What are the constraints facing monetary policy?

With the output gap narrowing only progressively and the impact of the hike in oil prices waning, inflation is projected by the OECD to fall below 2% during 2005 and decline to 1¼ per cent in 2006. But substantial uncertainties surround this inflation outlook. On the one hand, activity is sluggish and the exchange rate strong. On the other hand, inflation has responded little to widening slack, and money and credit growth is buoyant, stimulated by the low level of interest rates. So far the European Central Bank (ECB) has adopted a “wait and see attitude”. It has kept its main policy rate on hold at 2% since the start of the recovery in June 2003. Over the same period, long-term interest rates have fallen significantly. It would thus be reasonable for the ECB to hold its rate stable as long as the outlook remains in line with price stability over the medium term. Monetary policy would need to act, if the medium-term outlook for price developments were to change. A significant appreciation of the exchange rate or a substantial weakening of activity that were to change the medium-term outlook for price stability, could lead to a reassessment of the monetary policy stance. At the same time, the ECB should continue to be vigilant to upside risks to price stability, such as those stemming from excess liquidity or second round effects from the oil price increases.

Seen in a longer-term perspective, inflation performance in the euro area has clearly improved. As the credibility of monetary policy was quickly established, inflation expectations have become – and remain – firmly anchored to the ECB’s objective of keeping inflation below but close to 2 per cent over the medium-term. However, in the recent downturn inflation has failed to come down decisively, and this has limited the scope for monetary policy to support economic activity in the short run. Moreover, the monetary transmission mechanism has been less effective in those countries where secondary mortgage markets play only a minor role. Services, which have a large weight in consumption, show a particularly high degree of inflation inertia. This inertia is linked to the lack of integration and competition in the internal market for services. There is also evidence of higher wage inertia in the euro area than in other economies, which may be due to high minimum wages, administrative extensions of wage agreements, catch-up clauses in collective agreements and *de facto* indexation of wages. *These sources of rigidity should be removed, not only to lift potential growth, but also to provide more leeway for pursuing an effective monetary policy, and strengthen the area’s resilience to adverse shocks. However, further liberalisation of and innovation in mortgage markets must be accompanied by prudent financial market regulation and surveillance to ensure financial stability.* ■

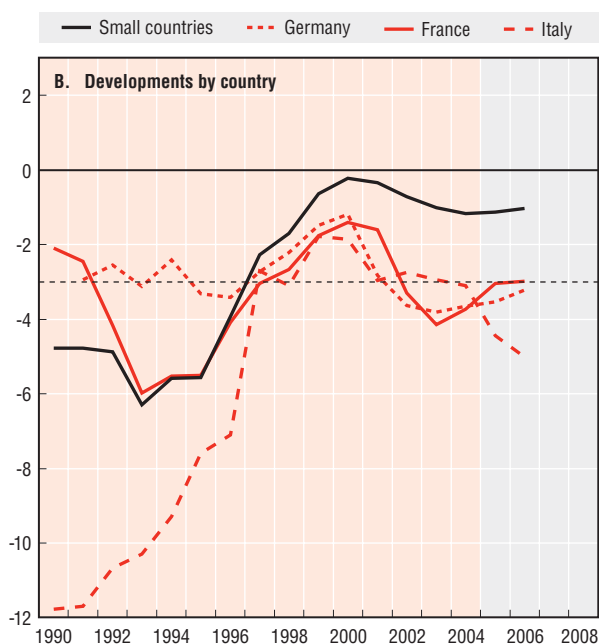
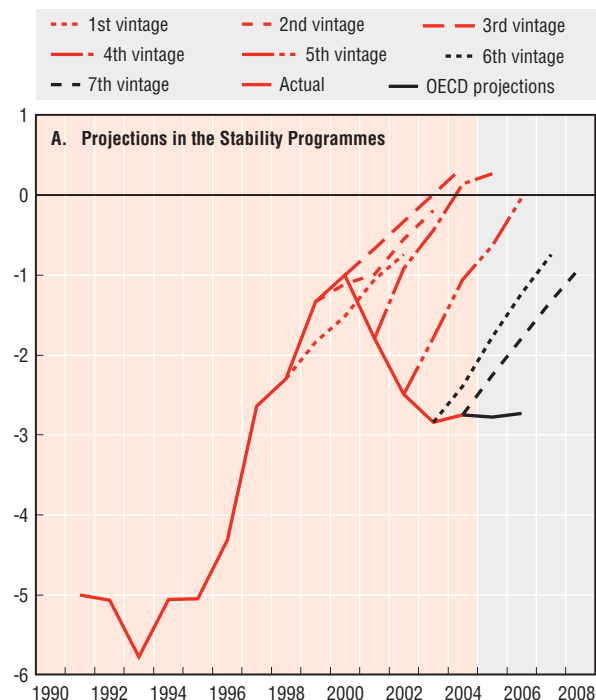
How can fiscal behaviour be improved?

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 very

costly. Fiscal consolidation since the early-1990s had been impressive. But most of it was realised in the run-up to monetary union as countries needed to comply with the convergence criteria stipulated in the Maastricht Treaty. Since the advent of the euro, the deficit bias has re-emerged, though not in all countries. In practice the 3% “reference value” has not been adhered to by a number of euro area countries. The excessive deficit procedure has been invoked (or threatens to be invoked) for half of the euro area countries, but its enforcement ended in a stalemate in November 2003. Since then, the rules have been amended, allowing under certain conditions more time to correct an excessive deficit. Moreover, the amended rules will in future cater for country-specific medium-term budgetary objectives, reflecting sustainability aspects. *To achieve sustainable public finances, reaching and maintaining the medium-term objective of keeping budget balances “close-to-balance or in surplus” over the cycle, as stipulated in the Stability and Growth Pact (SGP), will be essential.*

The fiscal rules embedded in the Maastricht Treaty and SGP have been praised for their simplicity, the flexibility in their implementation, their medium-term orientation, the reliance on automatic stabilisers and their explicit enforcement mechanisms. However, a long-standing criticism has been that they suffer from biased incentives: there is a “hard” 3% ceiling for the deficit-to-gross-domestic-product (GDP) ratio, but there are no legal instruments to enforce the “close-to-balance or in surplus” rule embedded in the SGP – which is nevertheless essential to provide the necessary room for manoeuvre in downswings. The rules have also suffered from weaknesses in reporting: in some cases the stability programmes which take stock of countries’ fiscal position and outlook have been biased by projections, which have proven too optimistic, by too favourable assessments of the structural fiscal position and by the use of one-off measures and creative accounting. Finally, the implementation of the rules has not been such as to ensure a swift correction of excessive deficits in all cases.

The Stability and Growth Pact has been reformed. Consequent to a decision of the European Council in March 2005, the interpretation of the “exceptional circumstances” clause – which provides a waiver if the rules have been breached – and the adjustment path towards compliance with the rules after a breach, will both become more flexible. Aspects of the reform that have attracted less attention are the provisions to heighten the surveillance of the fiscal rules by the EU authorities, including during periods of high growth and to reinterpret the close-to-balance or in surplus rule so as to make it tailor-made for individual countries, giving greater weight to the debt (as opposed to the deficit) criterion, long-term sustainability and countries’ structural reform efforts. The interpretation and implementation of the SGP is thus increasingly focusing on the longer term, which is welcome. Furthermore, due consideration will be given to relevant factors, such as R&D spending, public investment, or expenditure related to the unification of Europe, when assessing whether an excessive deficit exists. Moreover, these other relevant factors will be important in determining the adjustment path from a deficit above 3% to a deficit below 3% of GDP. Taking

Fiscal consolidation: moving targets¹General government balance in the euro area as a per cent of GDP²

1. The various vintages of the Stability Programmes were released over the following periods: 1st 1998/99, 2nd 1999/2000, 3rd 2000/01, 4th 2001/02, 5th 2002/03, 6th 2003/04, 7th 2004/05.

2. Excluding UMTS licence proceeds

Source: European Commission/Eurostat and OECD, *Economic Outlook 77* database.

into account “relevant factors” in assessing whether an excessive deficit exists is however subject to the overarching principle that the excess of the deficit over the reference value is temporary and that the deficit remains close to the reference value. A rigorous implementation of the amended pact will be key to fostering fiscal sustainability.

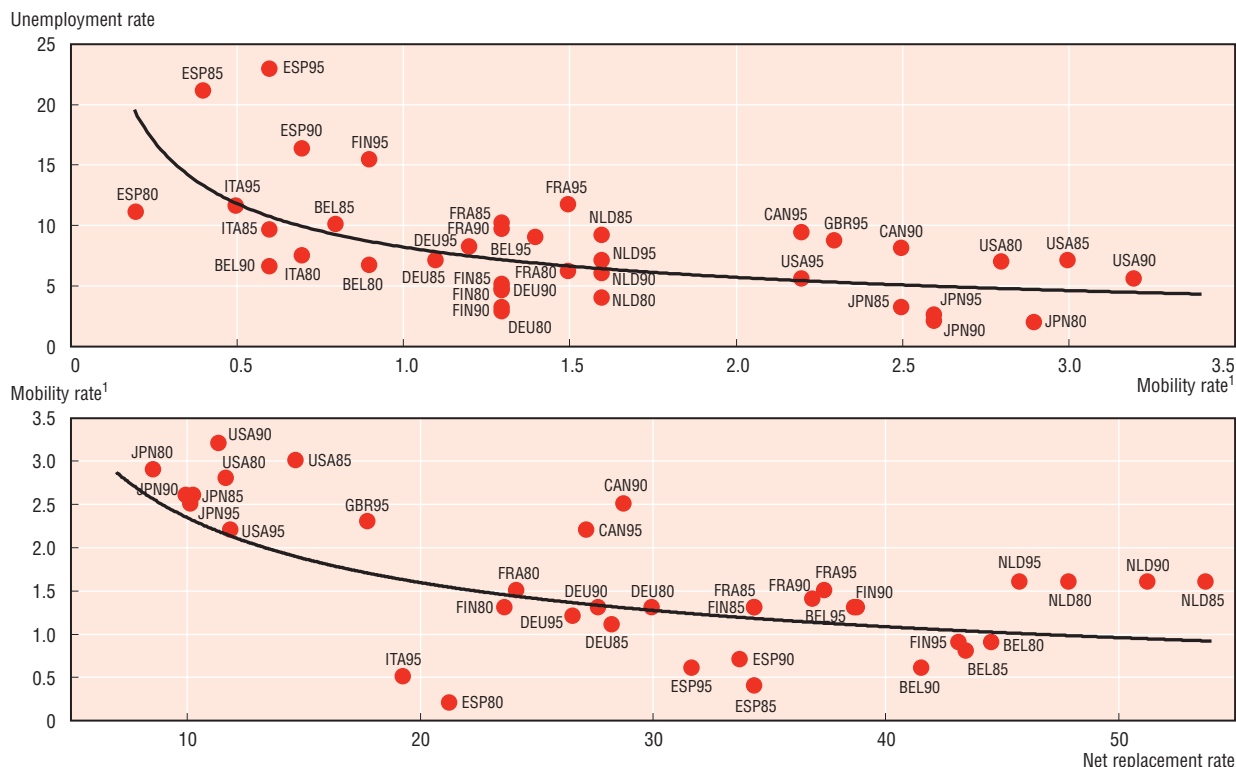
Inevitably, mechanisms that will ensure fiscal discipline at the national level have become more important. This requires stronger enforcement mechanisms within each country so as to address deficit bias at source. The decision-making rules governing the budget process influence the extent to which the externalities of fiscal policy are internalised so that full account is taken of the costs and benefits of public policy. Deficit bias essentially results from co-ordination failure. *A strong mandate of the finance minister to set deficit, debt and expenditure targets is a way to internalise the externalities resulting from government spending, which commonly benefits specific groups in society while financed from taxes to which all taxpayers contribute. Without such a strong mandate, the externalities are not taken into account and deficit bias results. The targets must be rooted in realistic short-, medium-, and long-term projections of economic growth, public revenues and social benefit entitlements. The stability programmes should be based upon, if not become the centrepiece, of such multi-year budgeting.* ■

What is the longer-term outlook?

The adoption of the euro by 12 members of the European Union represented a major step forward in the pursuit of economic integration, building upon and enhancing the achievements of the single market strategy. As a result, the euro area economy is undoubtedly in a better shape than it would have been without the continued progress towards monetary union – not least because it contributed to sustained low interest rates and enhanced financial stability. However, the economic integration that monetary union was seen as bringing has not yet translated into any visible strengthening of trend growth, while the recovery from the global downturn has trailed. *There are causes at play which must be addressed primarily by structural – as opposed to macroeconomic stabilisation – policies.*

Assuming no changes in labour force participation rates for relevant age cohorts, in structural unemployment and in labour productivity growth, potential GDP in the euro area is estimated to drop from about 2% in the period 2005-10 to 1¼ per cent in the period 2010-20 and 1% in the subsequent decade. This compares with growth rates of 3¼, 2½ and 2½ per cent in the United States. The euro-area’s per capita income gap *vis-à-vis* the United States would widen from about 30% at present to 37½ per cent by 2020. This scenario looks rather bleak against the optimistic EU goal of 3% growth in 2010 and beyond; to reach it, growth would have to at least double against the unchanged-policy baseline. Both productivity growth and labour force participation would have to rise substantially. ■

Geographical mobility, unemployment rates and unemployment insurance



3. Ratio of the total number of persons who changed region of residence over one year to the total population.

Source: OECD (2004), *OECD Economic Surveys: Euro area*.

How should the functioning of labour markets be improved?

At the start of the 1970s, unemployment in the euro area countries averaged 2% of the labour force, less than half the rate in the United States at the time. The oil shocks in the 1970s, the global recession in the early-1980s and deteriorating supply side conditions dramatically changed this picture, with the unemployment rate in the euro area ratcheting up to around 9%. The euro area is still grappling with the legacy of this episode. There are signs that change is slowly occurring, as reflected in modest falls in structural unemployment and, more significantly, increases in employment rates, especially in some smaller countries. Taxes on low-paid work have been cut, employment protection for temporary work eased and active labour market policies strengthened. However, there remains a large gap with the ambitions of the Lisbon Strategy. *Since the European Union has a restricted mandate in this area, member countries must address the other features of labour market institutions that lead to the persistence of high unemployment and low employment rates. In particular, they should reduce the long duration of unemployment benefits, ease strict EPL for permanent jobs, move away from intervention in wage setting through administrative extension, cut the cost of low-skilled labour further,*

reduce incentives to retire early or claim disability and lower the high tax wedge on labour. Moreover, obstacles to labour mobility should be removed to promote the efficient allocation of labour resources and enhance the resilience to shocks. The cross-border portability of social benefit entitlements should be allowed and the Health Insurance Card implemented to facilitate health care provision for workers temporarily posted in another member country. ■

What are the benefits of integrating service markets?

Services have become increasingly important for growth and employment in all OECD economies. The examples of the United States and the United Kingdom, where services account for an even higher share of employment than in the euro area, suggest that services offer considerable job creation potential. Services markets in the euro area are still largely segmented, country by country, and this is reflected in trade statistics: internal market integration for services is nowhere near what has been achieved for goods. The potential gains from the integration of services markets fall in two broad categories: *i) welfare effects associated with the convergence of prices towards the best performers; ii) faster*

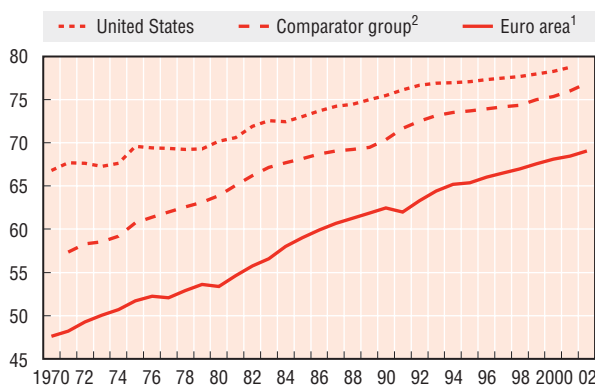
trend economic growth by realising economies of scale, better exploiting comparative advantages and improving the allocation of resources. *Regulatory obstacles to an integrated, competitive internal market for services should be removed, notably anticompetitive regulations within countries that act as entry barriers and rules that restrict the provision of services across national boundaries.*

The European Commission has identified a large number of obstacles in all parts of business sector services, and their removal is crucial for the completion of the internal market. These include the provision of some services by national monopolies, favourable tax treatment reserved to services purchased from local providers, residence requirements for shareholders, staff and regulated professions, lack of recognition of foreign diplomas, different company tax regimes and accounting rules, complicated rules for the reimbursement of value-added tax to cross-border service providers, restricted reimbursement of medical care provided abroad, and country-specific technical standards. In January 2004 the Commission tabled a draft services directive to remove the major obstacles. The draft directive is aiming at freedom to establish a business in another member state and free trade between member states. In order to reduce obstacles to the free movement of services, the proposed directive lays down a country of origin principle, meaning that service providers are mainly subject to the legal regime of their country of establishment. However, the host-country principle would continue to apply to employment conditions consequent to the Posting of Workers Directive, thus limiting the risk of “social dumping”. The proposal also aims at establishing a right for consumers to purchase services from foreign providers. Despite its anticipated EU-wide benefits, the services directive has met with heavy opposition from some quarters, echoed by a call by the March 2005 European Council to duly consider the social implications of the reform. The European Commission has flagged that it will reconsider the most contentious provisions of the directive. *In revising the directive it should secure*

the pursuit of the objective of free movement of services within the internal market. Against the backdrop of the call of the Spring 2005 European Council to make the internal market of services fully operational while preserving the European social model, ways should be found that facilitate the political acceptance of the services directive, while resisting a major watering down of its main objectives.

The services directive does not cover some activities such as financial services, transport and telecommunications where other Community initiatives are already underway, but where progress varies. The implementation of directives concerning the liberalisation of telecommunication networks varies across countries. The European authorities have urged those countries for which implementation gaps exist to take appropriate action. The Financial Services Action Plan, the Community’s central tool to foster financial market integration, is due to be fully implemented by end-2005. *However, it is important that political agreement at the EU level be reached on three proposed Directives relating to cross-border mergers, aspects of company law (including the transfer of headquarters to another EU member state) and capital adequacy. Moreover, the cross-border integration in financial retail markets evolves at a snail’s pace. Progress needs to be made to enhance competition and service provision, including in retail mortgage markets.* The air transport sector remains fragmented despite the adoption of the “single European sky” in 2004. EU efforts to liberalise the railways sector are also incomplete. The first railways package, passed in March 2001, established the principle of vertical unbundling between transport providers, infrastructure operators and regulators, but it is still not fully implemented. A second railways package provides that freight services will be fully open to competition as from 1 January 2007. A third railways package, which proposes the opening up of international passenger services as from 2010, is still under discussion in the Council. A directive on liberalising *port services*, despite a 25 year delay before exposing incumbents fully to competition, has met with fierce opposition and was rejected by the European Parliament in November 2003, even though a new reform package was tabled in late 2004. *The EU authorities should aim for faster progress towards competitive markets for financial and transport services, as this is crucial for the achievement of a fully-fledged internal market.* ■

Employment in services
As a share of total employment



4. Excluding Ireland.

5. Includes Australia, Canada, Denmark, New Zealand, Sweden and United Kingdom.

Source: OECD, STAN database.

How can innovation policy become more effective?

A key to better innovation performance at the EU level is to remove cross-border barriers to diffusion. Relatively weak innovation activity – including but not solely with respect to information and communication technology – is among the factors that have shaped the productivity slowdown in the euro area. As part of its Lisbon Strategy, the European Union has singled out R&D as an important lever for innovation policy, but leaving the primary competence for innovation policy in the remit of the EU member countries. *However, an important key to better innovation performance in the euro area is to remove the sources of market segmentation that*

currently hamper the diffusion of new technologies. At the EU level, a Community Patent – still not in place due to disagreements on several issues – should be implemented, and national research grant competitions should be open to interested parties from across the Community, which will create incentives to pool research budgets and thus strengthen the European Research Area. Moreover, a decline in market segmentation in the services sector would help raise the market potential for small innovative firms. At the national level, politically sensitive areas will need to be tackled, including the introduction of merit-based pay and research funding, greater university autonomy and a change of culture towards the commercialisation of research. Financial market conditions for technological development also need to be strengthened, so as to ensure that successful entrants in hi-tech industries are able to expand more rapidly. ■

What are the overall gains from structural reform?

Simulations suggest a strong impact of changes in structural policy settings affecting labour markets, product markets and innovation on overall economic performance. Even partial progress would enhance employment and growth prospects

significantly. Stronger potential growth would also help to improve fiscal performance so that the tax burden could be prevented from increasing or even eased, while unemployment would fall without rekindling inflationary pressure. Pushing ahead with reforms would launch a virtuous circle where growth and employment are rising and inflation declines, whilst at the same time the fiscal rules are respected. Enhanced ownership of common policy orientations in the aftermath of the Lisbon re-launch would drive forward this virtuous circle. ■

For further information

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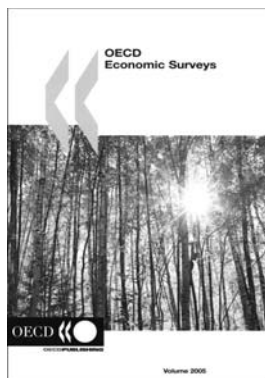
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- **Economic Outlook No. 77**, June 2005. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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