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## QUARTERLY REPORT ON THE EURO AREA

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## Editorial

Economic growth in the euro area has turned out to be significantly weaker than anticipated. Recent indicators suggest that activity, which began to decelerate in the fourth quarter of last year, will remain sluggish during the first half of 2003. Growth may start to recover during the second half of 2003, but is expected to return to potential in 2004 only.

This disappointing performance is certainly linked to the geopolitical tensions that have built up over recent months and have sapped business and consumer confidence, further depressed equity prices and pushed up oil prices. In this uncertain environment, households and enterprises prefer to delay spending and thereby contribute to weak domestic demand in the euro area. The economic impact of a possible conflict in Iraq is analysed in some detail in this report.

However, the current weakness of the euro-area economy can not be solely explained by the impact of geopolitical tensions. Three additional factors are weighing on domestic demand at this juncture. First, the dramatic fall in equity prices since their peak in mid-2000 has had a negative impact on wealth and capital costs, thus hitting confidence and balance sheets, thereby hampering spending among consumers and businesses alike. Second, it is by no means clear whether recent cutbacks in business investment have been sufficient to restore corporate balance sheets. Corporate indebtedness, which increased markedly in the late 1990s, only began to decrease during the second half of last year. Furthermore, depressed equity prices keep leverage ratios at historical highs. It is likely to take still some time before sound balance sheets are restored. Finally, the economy suffers from insufficient resilience to shocks. Rigidities still stand in the way of quick and smooth adjustments. Wages have been slow to adapt to low productivity growth, thereby

squeezing profit margins. Low corporate profitability has delayed investment recovery. Although there are now signs of a modest pick-up in labour productivity, the profitability adjustment is slow and has probably not run its course. Overall, the Commission's Spring Report shows that while progress has been seen in almost all areas of the Lisbon strategy, it has generally not been fast enough.

How should policies, both in the macroeconomic and microeconomic sphere, react to this situation?

Significant monetary policy easing over the last three months has provided some necessary oxygen. The ECB cut its key interest rates by 50 basis points in December and again by 25 basis points early March. In the event of a conflict in Iraq, monetary policy could be used to respond to a possible collapse in confidence. This is, de facto, what happened in the nineties during certain episodes of international tensions in which Europe was involved. The role of monetary policy could be complicated by a surge in oil prices. Nevertheless, core inflation is currently on a downward trend and, contrary to previous oil shocks, which hit the European economy at times of large positive output gaps, the excess capacity currently prevailing would leave monetary authorities some room for manoeuvre.

In this context, special attention should be paid to developments in wages and salaries, in particular in those countries where wage developments are indexed to inflation. Wage growth should remain moderate in the context of a possible cyclical recovery in productivity or oil-price-hike-induced increases in inflation to allow for a restoration of profit margins to underpin job-creating investment growth. In the event of a conflict

in Iraq and soaring oil prices, the scope for a growth-supportive monetary policy will hinge on continued wage moderation.

On fiscal policy, there is not much room for manoeuvre. Automatic stabilisers should be allowed to work where necessary around the consolidation path. Resuming consolidation immediately, rather than waiting for economic conditions to improve, will support growth, as it will positively affect expectations, improve consumer and investor confidence, and help monetary policy to be accommodative. Overall, it is important to avoid repeating past mistakes of reacting to weak growth by bouts of fiscal profligacy.

Possible responses are not restricted to macroeconomic policies. Past experience suggests that Member States are likely to consider targeted measures aimed at reducing

the burden of higher costs for some of the most exposed sectors or economic agents. Here it is important to avoid an uncoordinated reaction as occurred in the context of rising oil prices in 2000. Those events showed that there can be significant demonstration effects from unilateral actions of Member States. Furthermore, a co-ordinated response is needed to maintain a level playing field and to respect the state aids regime. Finally, it is important to ensure that targeted measures avoid blurring the price signals sent by markets. Hence, direct financial assistance should be privileged over cuts in energy taxes.

A comprehensive assessment of the short-term economic outlook will be presented in the Commission Spring Forecasts to be released on 8 April.

Pedro SOLBES

MEMBER OF THE EUROPEAN  
COMMISSION



## I. Economic situation in the euro area<sup>1</sup>

*Economic activity in the euro area has stabilised on a slow-growth path. With weakening external demand, economic growth now relies essentially on domestic forces. The protracted period of sluggish growth since 2001 may have led to some pent-up demand which could propel economic growth once confidence returns. However, a number of factors are currently holding back domestic spending. Geopolitical tensions are pushing up oil prices and weighing on consumer confidence and equity prices. Demand is also hampered by domestic factors, including poor profitability and households' concerns about unemployment. On a more positive note, the gentle decline in core inflation, the progressive pick-up in labour productivity, the stabilisation of business confidence and lower interest rates have set the stage for a future recovery of activity. However, the downside risks associated with a possible conflict in Iraq are substantial and make the scenario of rapidly accelerating growth in the immediate future a rather unlikely one.*

### 1. Subdued GDP growth

Real GDP grew by a mere 0.8% in 2002. While economic activity recovered quickly from the trough in the final quarter of 2001, the expected acceleration of growth in the course of the year did not materialise. Momentum faded in the summer and quarterly real GDP growth decelerated to 0.2 % in 2002Q4 from 0.4% in the previous quarter. At the beginning of 2003, geopolitical uncertainties are weighing on the global outlook, but also on domestic confidence.

The composition of growth became more balanced during 2002 with domestic demand progressively replacing external demand as the mainstay of growth. However, domestic demand has recently turned out to be weaker than expected.

DG ECFIN's indicator-based short-term forecast model points to continuously weak economic activity in the first half of the current year. Quarterly real GDP growth is estimated to be between minus 0.1% and 0.3% in the first quarter and in the range of 0.2 to 0.5% in the second quarter of 2003.

Table 1: Euro-area growth components					
	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002Q4
<b>% change on previous quarter, volumes</b>					
GDP	-0.2	0.4	0.3	0.4	0.2
Private consumption	0.0	-0.2	0.4	0.4	0.4
Government consumption	0.6	0.7	0.9	0.3	0.5
Gross fixed capital formation	-0.9	-0.2	-1.3	-0.2	-0.1
Changes in inventories (% of GDP)	-0.3	-0.4	-0.3	-0.3	-0.2
Exports* of goods and services	-1.2	0.2	1.7	2.1	0.0
Imports* of goods and services	-0.8	-1.0	1.5	1.8	0.6
<b>% contribution to change in GDP</b>					
Private consumption	0.0	-0.1	0.2	0.2	0.2
Government consumption	0.1	0.1	0.2	0.1	0.1
Gross fixed capital formation	-0.2	0.0	-0.3	0.0	0.0
Changes in inventories	0.0	0.0	0.1	0.0	0.1
Net exports	-0.2	0.4	0.1	0.2	-0.2

\* Including intra-euro area trade.

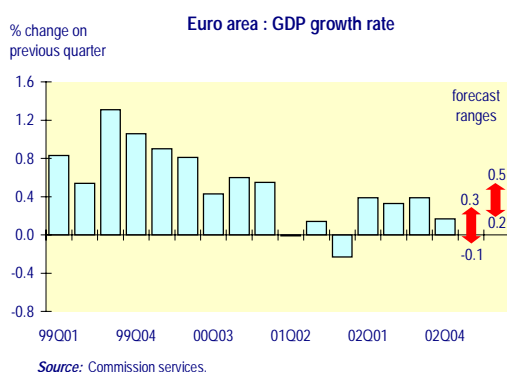
Source : Commission services.

<sup>1</sup> The cut-off date for statistics included in this issue was 14 March, 2003.

Table 2: Selected euro area and national leading indicators, 2002-2003

	SENT. IND <sup>1)</sup>	BCI <sup>2)</sup>	OECD <sup>3)</sup>	PMI <sup>4)</sup>	IFO <sup>5)</sup>	NBB <sup>6)</sup>
Long-term average <sup>7)</sup>	99.2	-0.18	2.0	52.6	100.2	-9.7
Trough in latest downturn	98.2	-1.25	-3.0	43.0	89.7	-21.1
May	99.5	-0.28	6.2	51.5	106.1	-1.6
June	99.4	-0.51	5.8	51.8	104.7	-5.5
July	99.1	-0.39	4.6	51.6	102.2	-7.4
August	98.7	-0.60	4.0	50.8	100.6	-7.6
September	99.0	-0.49	3.5	48.9	99.1	-9.8
October	98.8	-0.43	2.9	49.1	97.9	-10.5
November	98.4	-0.43	2.1	49.4	95.9	-9
December	98.6	-0.24	1.3	48.4	98.0	-12.9
January 2003	98.2	-0.32	1.1	49.3	98.1	-15.5
February 2003	98.2	-0.36		50.1	98.4	-10.5

1) Economic sentiment indicator, DG ECFIN. 2) Business climate indicator, DG ECFIN. 3) Composite leading indicator, six monthly change. 4) Reuters Purchasing managers index, manufacturing. 5) Business expectations, West Germany. 6) National Bank of Belgium indicator for manufacturing. 7) Jan-92 till last observation available, for PMI (manufacturing) since beginning of series in June-97.



Source: Commission services.

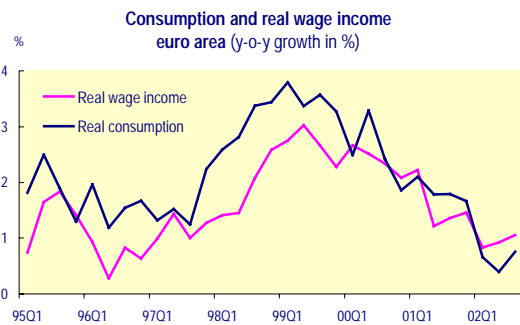
Survey-based indicators paint a mixed picture of short-term economic prospects. The Commission's industrial confidence indicator rose considerably in December, but fell back in January and February. Industrialists' negative assessment of expected production, stocks and order books shifted the Business Climate Indicator downwards. Accordingly, industrial production is expected to remain sluggish. This contrasts with the recent improvement in the manufacturing PMI, which rose to the 50 level that separates growth from contraction in February. No consistent picture emerges from recent service indicators. The latest Commission surveys show a marked improvement in retail confidence and a slight improvement of confidence in services. However the retail indicator has been rather volatile in recent months. Besides, the recent improvement in the outlook for services shown in the Commission surveys contrasts with the

no-growth indication of Reuters' services survey, which fell below 50 in February.

## 2. Private consumption loses momentum

After picking up in the second quarter of 2002, private consumption failed to gather further momentum during the second half of the year. Although private consumption remains the main engine of growth in the euro area, its recent pace of below 1.5% in annualised terms has been disappointing.

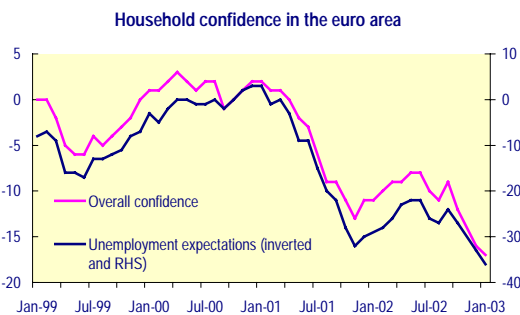
Higher energy prices have weighed on purchasing power since the fourth quarter of 2002; nevertheless, the current weakness of consumer spending can only partly be attributed to developments in disposable income. There are unfortunately no data on household disposable income at the quarterly level for the euro area as a whole but employment and wage data show a relative resilience of wage income in the current downturn. Growth in real wage income has decelerated significantly since the beginning of 2001 but has so far remained stronger than during the 1995-96 downturn despite a more pronounced GDP slowdown. In the second half of the 1990s, private consumption expanded more rapidly than wage income. The trend came to a halt at the beginning of the present downturn and was reversed in 2002.



Source: ECB and Commission services.

Several factors may account for households' current reluctance to spend, including falling stock prices, a perceived over-estimation of the inflationary impact of the euro changeover and increasing uncertainty on the income side due to rising unemployment and possibly also deteriorating public finances.<sup>2</sup>

Increasing uncertainty is reflected in the significant deterioration of household sentiment in the current downturn. Confidence fell sharply during the second half of 2001. It then recovered modestly during the first half of 2002 before dipping sharply again after September 2002. In February 2003, consumer confidence was back to levels not seen since summer 1996.



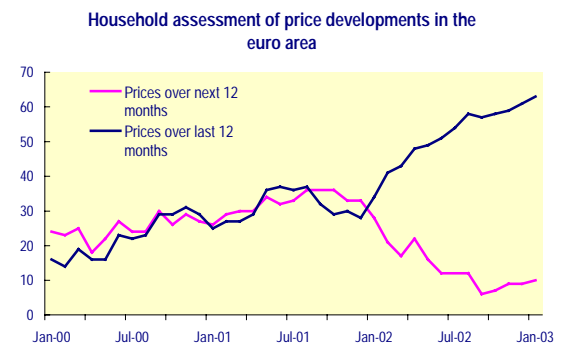
Source: Commission services.

Developments in consumer confidence show that worries related to unemployment have been a key source of consumption weakness in the current downturn. As shown in the graph above, the drop in households' unemployment

expectations was more pronounced than the drop in overall confidence in 2001 and was therefore the main driver of household sentiment that year.

Employment was growing sharply at 1.2% year-on-year until 2001Q3. Since then, job creation has continued to decelerate to stand at 0.3% in 2002Q3. On a quarterly basis, employment contracted by 0.1% in 2002Q3, posting a decline in the level of employment for the first time since 1994Q1. The adjustment in the labour market appears to have intensified while in the beginning of the slowdown firms concentrated more on cutting investment and inventories in order to stabilise their balance sheets.

Consumer survey data suggest that unemployment has recently not been the only source of concern for households. Two additional factors seem to have dented confidence in recent months. First, the rapid deterioration of households' assessment of the general economic situation since December could be a sign that geopolitical uncertainties related to Iraq have taken their toll. Second, the temporary rebound in confidence during the first half of 2002 was restricted to forward-looking measures of sentiment. Faced with a persistent deterioration of their current and past situation, households are now revising their expectations downwards. The gap is not yet closed and a further drop in the overall index of consumer confidence in the months to come is therefore possible.



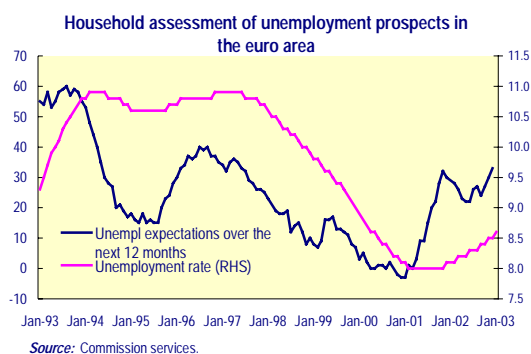
Source: Commission services.

<sup>2</sup> For a discussion of these factors see European Commission, *EU Economy: 2002 Review*.

Households' assessment of price developments offers an additional explanation for the subdued performance of private consumption in the past few months. The measure of price developments over the past 12 months is normally relatively closely correlated with HICP inflation. However, since the beginning of 2002, inflation as perceived by households has been significantly higher than actual inflation as measured by the HICP. The gap, which is generally attributed to a perceived over-estimation of price increases following the euro changeover, has shown no signs of narrowing in recent months.

After a year of steady decline, households' inflation expectations have been on a moderate upward trend since October. This reversal may be due to increasing worries concerning oil prices in the event of a conflict in Iraq but it could also reflect a shift in inflation expectations due to the persistently high level of perceived inflation.

Overall, recent sentiment indicators point to sluggish growth in private consumption during the first months of 2003. Nevertheless, recent data also suggest a certain amount of pent-up demand has built up, which could amount to a strong response of household spending to the future recovery of the economic activity. First, due to an over-estimation of the price increases following the euro changeover, households have been underestimating recent gains in purchasing power. A correction of this misperception is likely to be linked with a certain amount of spending catch-up.

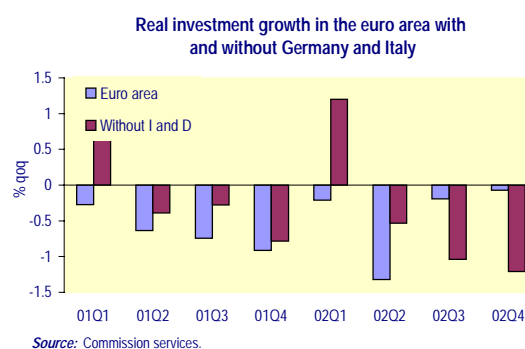


Second, comparing actual developments in the unemployment rate and households' perception of unemployment prospects, seems to suggest that households have been somewhat overstating unemployment risks since the beginning of 2001 (see previous graph). Recent business surveys point to a possible stabilisation of employment since the beginning of the year.

### 3. Investment recovery still on a shaky footing

Gross fixed capital formation shrank at quarterly rates of 0.1 and 0.2% in 2002Q3 and 2002Q4, respectively. While this suggests that the sharp contraction of investment, averaging minus 0.8% quarter-on-quarter over the 2001Q1- 2002Q2 period, may have come to an end, caution as to the short-term prospects for a return into positive territory is still warranted for a number of reasons.

First, the stabilisation is not broad-based among Member States. Despite the overall improvement, investment growth has improved in only 5 of the 9 countries for which data are available for 2002Q3 and in 2 of the 6 reporting countries for 2002Q4. To a large extent, the stabilisation was the result of special developments in Italy and Germany.



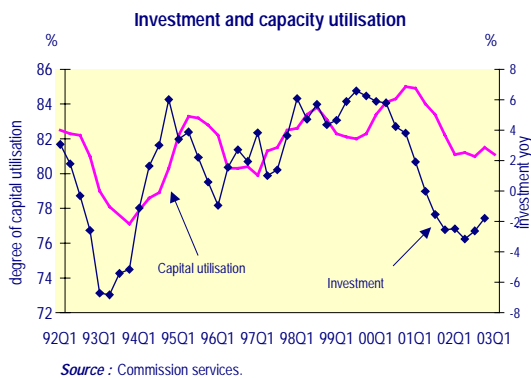
The graph above reveals that capital spending in Germany and Italy depressed the euro area aggregate until 2002Q2. But excluding data from these two countries would yield a negative growth rate with no improvement in the most recent quarters. In fact, the recovery in Italy is likely to have been strongly driven by the expiry





of the Tremonti Law, which created incentives to bring investments forward from 2003 to 2002. The marked improvement in investment in Germany may be due to two special factors, namely a technical correction of very weak investment in the first half of 2002 and the rebuilding of the sites destroyed by the floods in the summer.

Second, investment activity usually follows GDP growth quite closely, albeit with a higher variance. Interestingly, real investment growth was higher than real GDP growth in the 1990s when the latter exceeded 2% year-on-year. In this respect, the muted economic outlook bodes ill for a marked improvement in investment growth in the short term.



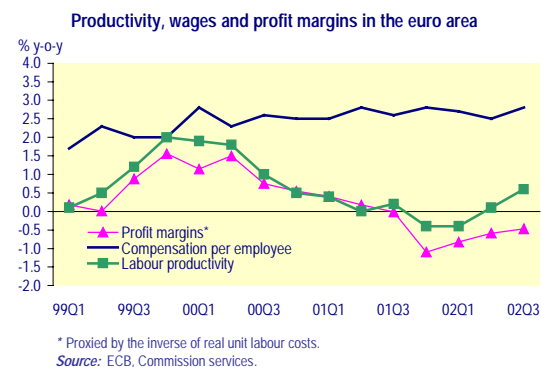
Third, capacity utilisation in manufacturing is still relatively high. It fell by about 5 percentage points from its peak in 2000 to a slightly below long-term average level of 81. However, contrary to the USA, for the euro area there is only weak evidence so far that sluggish investment could be the consequence of strong investment in the 1990s. Comparing the level of capital productivity and total factor productivity of the late 1990s with that observed during the boom period in the late 1980s suggests that the allocation of capital was not extremely productive.<sup>3</sup> Data on investment by sector at Member State level provide some weak evidence in favour of the over-investment hypothesis. Sectors in which investment expanded rapidly during the boom period of

<sup>3</sup> See European Commission, *EU Economy: 2002 Review*.

1995-2000 experienced the strongest deterioration afterwards. The evidence is, however, not robust to the specification chosen.

Fourth, it remains to be seen whether the increased reliance on external financing during the last boom in combination with the recent decline in profits has caused sustained balance-sheet problems that may enforce further balance-sheet restructuring rather than an expansion of production capacity. Depressed equity prices keep leverage ratios at historical highs and it is likely to take still some time before sound balance sheets are restored.

On a more positive note, some aspects of the economic environment are progressively becoming more conducive to investment and could pave the way for a strong recovery of investment once geopolitical and demand uncertainties diminish.



Profitability is an important determinant of investment. The very low productivity performance registered in the current downturn has weighed heavily on profitability in the past two years but there are now signs of a pick-up in labour productivity and profitability.

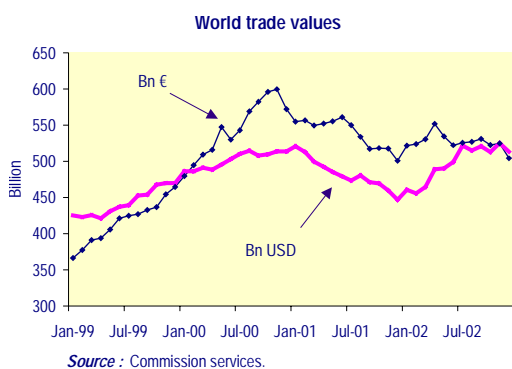
With an increasing part of investment devoted to ICT, where technical progress has been rapid and old equipment quickly becomes obsolete, it is generally assumed that capital's life span has shortened. Therefore, with faster depreciation, any adjustment of the capital stock to a past over-investment (if it did occur) may be faster

than in the past. In a similar vein, the rapid depreciation of the capital stock could fuel a strong investment recovery once the right demand conditions are in place.

Today, financial conditions weigh less on investment than they did in the summer of last year, but without being as supportive as in the late 1990s. Issuance of corporate bonds has significantly recovered in December and January. Rates charged for bank loans fell modestly between summer and the end of 2002, i.e. by about 20 basis points for short-term loans and 60 for loans for more than 1 year to enterprises.<sup>4</sup> Credit growth picked up slightly in the past two months, but remains relatively low.

#### 4. The fading momentum of trade

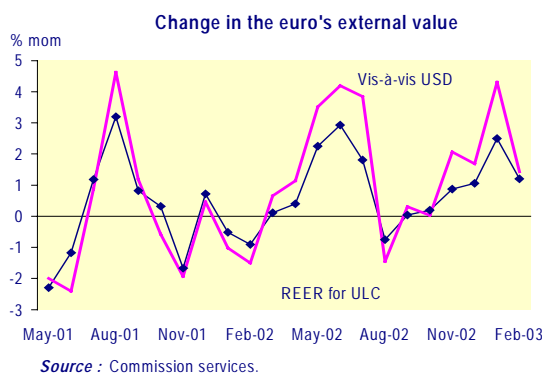
External demand stimulated growth at the early stage of recovery in 2002Q1. But the contribution of net exports to growth has faded in the course of 2002 due to rising demand for imports and stalling export growth. While import growth weakened in the fourth quarter of 2002 to 0.6% in real quarter-on-quarter terms, export growth decelerated even stronger and actually became flat.



ECFIN's indicator for world trade shows the weakening momentum of trade after summer

2002 (see graph above). A rapid pick-up of world trade appears unlikely at this juncture. Leading indicators have weakened recently in the USA, pointing to positive, but decelerating economic activity in the near future in that country. This deceleration in combination with the appreciation of the euro against the US dollar is expected to contribute to a more sustainable US external position but it will also weigh on world trade. On a more optimistic note, Asia and Eastern Europe seem to have weathered the global downturn so far. Recovery in Non-Japan Asia and the accession countries continued and GDP growth in Japan was stronger in 2002Q4 than expected.

The euro resumed an appreciating path against the US dollar in December 2002, after having traded close to parity in the second half of last year. In early March, the euro reached a level of \$1.10, which is about 16% stronger than the 2002 average.



The appreciation of the euro exchange rate has resulted in deterioration of the cost competitiveness of euro-area producers. Based on unit labour costs, the real effective exchange rate against the 12 industrialised countries rose by about 13% from February 2002 to February 2003. But it currently remains 3% below both its level in January 1999 and its 20-year average.

<sup>4</sup> For comparison: 3-year government rates also fell by about 60 basis points between June and December 2002. Over the same period, yields on 5-year government bonds and 12-month money market rates declined by about 100 basis points.



**Box 1: The impact of appreciation of the euro on growth:  
some lessons from model simulations**

Appreciation of the exchange rate can affect economic growth via various channels. It impairs price competitiveness and export growth but it can also support domestic demand via lower import prices and, possibly, lower interest rates if monetary policy is eased in response to reduced inflation pressures. The magnitude and interplay of these different mechanisms depend closely on the causes of exchange rate appreciation. To illustrate this point, two simulations were conducted with the Commission's QUEST model.

***Simulation 1: a 10% appreciation of the euro/dollar exchange rate resulting from sharp monetary easing in the USA***

In this simulation, the 10% appreciation of the euro relative to the dollar is the consequence of sharp monetary easing in the USA. The appreciation entails a drop of GDP of 0.6% in the euro area compared with the baseline after one year (see table below). The deterioration of competitiveness resulting from a stronger euro translates into a substantial decrease in the contribution of exports to growth. In contrast, reduced inflation pressures allows easier monetary conditions which, combined with a drop in consumption and investment prices, brings an increase in domestic demand relative to the baseline. However, the domestic demand effect is not sufficient to offset the negative impact of weaker exports.

**Impact of a 10% appreciation of the euro relative to the dollar**

Change relative to baseline after 1 year in %

	Scenario 1 Monetary easing in the USA	Scenario 2 Increase in demand for euro assets
Gross domestic product	-0.6	0.2
Private consumption	0.6	1.4
Investment	2.3	7.8
Net exports (1)	-1.3	-2.3
Consumer price index	-0.6	-1.4
Short-term interest rates (2)	-0.6	-0.7
Long-term interest rates (2)	0.0	-0.3

(1) absolute difference in the contribution to GDP relative to baseline.

(2) absolute difference relative to baseline.

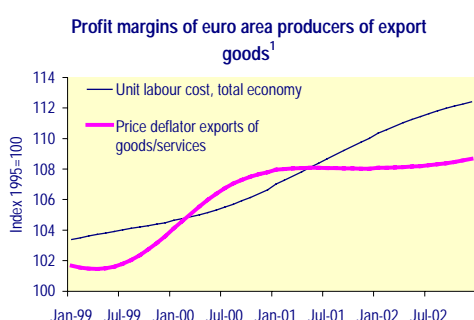
Source: Commission Services

***Simulation 2: a 10% appreciation of the euro resulting from an increase in the demand for euro-denominated assets***

In this simulation, the 10% appreciation of the euro relative to the dollar is the consequence of an increase in the demand for euro-denominated assets. The shift in demand is modelled as a reduction in the risk premium in the interest rate parity equation linking euro-area and US interest rates. In this second simulation, GDP is slightly higher than in the baseline after one year. As in the previous case, the deterioration of competitiveness translates into a lower contribution of exports to growth. However, the deterioration is more than offset by an increase in domestic demand and, in particular, in investment which is boosted by strong capital inflows. Another difference with the previous simulation is the more pronounced fall in the consumer price index. In the first scenario, the deflationary impact of the strengthening of the euro is partly offset by a build-up of inflation tensions in the USA due to a sharp monetary easing in that country. Because of a different assumption on the source of the appreciation, such inflation tensions do not exist in the second scenario.

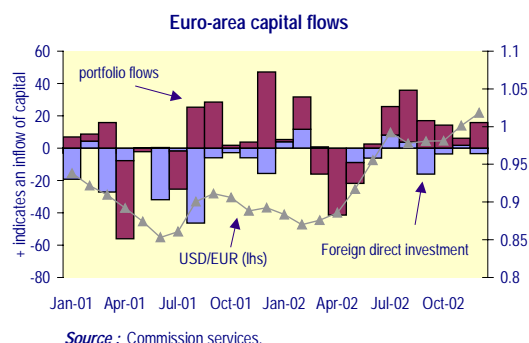
The recent strengthening of the euro is likely to be the result of a combination of factors and its actual impact on the economy is difficult to gauge. Nevertheless, the above simulations suggest that, if a reversal of capital flows is the dominant explanation for recent exchange rate developments, the growth impact of a stronger euro could actually be positive.

With trade data available only up to the end of 2002, the re-gained strength of the euro is not yet visible in the export performance. But the appreciation has started to exert downward pressure on import prices. Conversely, the evolution of export prices reflects only very partially the recent appreciation of the euro, implying that exporters squeeze their profit margins further. As big exporters usually hedge their currency risk, the adjustment process is likely to be gradual.



<sup>1</sup> Proxied by the difference between unit labour cost in the whole economy and price deflator of goods and services.  
Source: Commission services.

A number of explanations for the euro's appreciation have been put forward. To some extent, the strengthening of the euro may reflect the correction of previous undervaluation, probably triggered by signs of weakening US growth and an increasing difference between short-term interest rates in the USA and the euro area. It is also possible that market participants are now demanding a higher risk premium in view of the record US trade deficit which has recently brought the issue of the sustainability of the US current account position back into the limelight. Tying in with this explanation, the inflow of combined FDI and portfolio capital in 2002 suggests that the euro has acquired a certain safe-haven status in the current geopolitical tensions. The co-movement between capital flows into the euro area and the appreciating euro in 2002 provides some support for this hypothesis, even if some deviation from this trend is visible in the latest observation (December 2002).

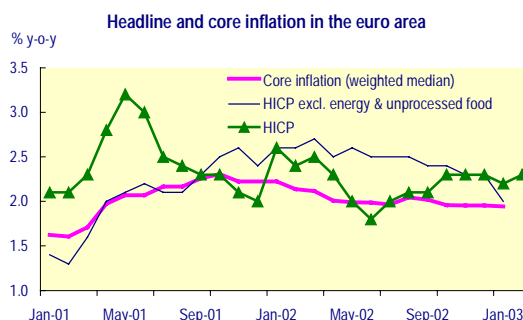


Source: Commission services.

Overall, the euro's appreciation should be welcomed. While a stronger euro will take its toll in terms of export performance, its impact on total growth will depend very much on the causes of the appreciation. Model simulations presented in Box 1 suggest that this impact is, on balance, positive if the appreciation is driven by a reversal of capital flows and a reduced risk premium.

### 5. Core inflation on a downward trend

Headline HICP inflation in the euro area decreased marginally from 2.3% to 2.2% (year-on-year) in January 2003. The decrease in headline inflation resulted from sizeable falls in the inflation rates of unprocessed food and non-energy industrial goods components, slightly outweighing a sharp increase in energy inflation. Indeed energy prices rose by a strong 6% in the year to January 2003, compared to 3.8% in the previous month. According to Eurostat's latest Flash estimate, headline HICP inflation could have reverted to 2.3% in February.



Source: Commission services.

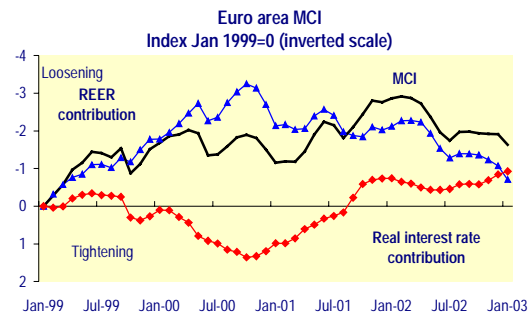


The good news continue to come from core inflation. In January 2003, growth in the HICP excluding unprocessed food and energy slowed to 2.0%, down from 2.2% the previous month. The recent decrease in core inflation is attributable to lower inflation in two of its three main components. The annual rate of price increases in non-energy industrial goods was 0.6% in January 2003, a marked 0.6 percentage points drop from the previous month, while the annual rate of price increases in the services component fell by a more modest but still encouraging 0.2 percentage points compared to the previous month. An alternative measure of core inflation known as the weighted median provides support for a favourable interpretation of recent developments in underlying inflation.<sup>5</sup> The weighted median for the euro area dropped from 2.0% in December 2002 to 1.9% in January 2003.

## 6. Monetary and financial conditions

On the grounds of continued sluggish economic growth and the strengthening of the euro, the ECB cut interest rates on 5 December 2002 (50 basis points) and on 6 March 2003 (25 basis points), leaving the minimum bid rate at 2.5%. Reflecting the ECB interest rate cuts, the intensified downward movement in nominal short-term interest rates that started in November 2002 has continued in the first part of 2003. At the beginning of March, the three-month money market rate was just below 2.5%.

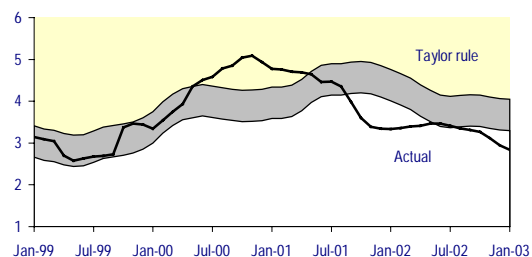
<sup>5</sup> The weighted median has the property of letting the data decide each month which extreme price variations are excluded, instead of systematically excluding the same sub-indices each month.



Source: Commission services.

Monetary conditions as measured by the Monetary Conditions Index (MCI)<sup>6</sup> were fairly constant in the second half of last year. This implies that the more accommodative policy stance associated with lower real short-term interest rates was balanced by a tighter stance associated with the higher real exchange rate. In January 2003, the MCI moved in the direction of tighter monetary conditions as the impact of the stronger euro outweighed the impact of lower real interest rates.<sup>7</sup>

Euro area. Short term interest rate.  
Actual and implied by the Taylor rule.  
Taylor rule based on median inflation, monthly figures



Source: Commission services.

At present, the 3-month interest rate is slightly below the Taylor band. However, one short-coming of the Taylor rule is that the direct impact of exchange rate developments is not taken into account.

<sup>6</sup> The MCI tries to capture the combined impact on economic activity of changes in the real effective exchange rate and the real short-term interest rate. The interest/exchange rate weighting is assumed to be 6:1. As long-term interest rates are also important for economic activity in the euro area, they could be included in a financial conditions index, on which work is ongoing. For both the MCI and the Taylor rule, median inflation is used as the inflation indicator.

<sup>7</sup> Owing to data availability, the last month in the MCI is January 2002.

### Box 2: The 2002 updates of the stability programmes

In accordance with the Stability and Growth Pact, euro-area Member States have to submit updates each year on their stability programmes in which they set out their medium-term budgetary objectives and the adjustment path towards it. The Commission and the Council have recently completed their assessment of the 2002 updates of the programmes (with the exceptions of the Netherlands and Austria which have not yet submitted their programmes). The salient features of the short to medium-term fiscal plans of the Member States are summarised below.

#### Aggregate picture for the euro area

The 2002 updates provide for large revisions of the budget balances, with the deficit for the euro area as a whole now estimated to be 2.2% of GDP in 2002 (see table below). As in the previous rounds of updates, Member States are generally projecting a gradual improvement in the budget balances over the period covered by the stability programmes with the deficit for the euro area falling below 1% of GDP by 2005 and approaching zero by 2006. For 2003 and 2004, Member States generally plan a more significant improvement of their budget balances than projected in the Commission's Autumn 2002 Forecasts. For the euro area, the ratio of the deficit to GDP is projected to be lower than in the Commission's forecasts by 0.3 and 0.7 percentage points in 2003 and 2004 respectively. These differences can be attributed to two factors:

- Despite sizeable downward revisions relative to previous updates, the growth projections underlying the budget balances in the 2002 updates are more favourable than the Commission's Autumn 2002 Forecasts, with a difference in GDP growth of about 0.3 percentage points in 2003. To some extent, this can be explained by the fact that national assumptions underlying the 2002 updates were established during the summer months, i.e. before the Commission released its forecasts. In view of the latest information available, the GDP growth assumptions, especially for 2003, now seem overly optimistic.
- According to the updates of the stability programmes, the cyclically-adjusted balance of the euro area is projected to improve by roughly ½% of GDP per year over the coming years. This is clearly more optimistic than what was forecast by the Commission in autumn. To some extent, the difference reflects the fact that some stability programmes incorporate intended policy measures that were not sufficiently specified to be taken into account in the Commission's Forecasts. It is also explained by the fact that the Commission forecasts were prepared assuming unchanged policies in 2004.

#### Budget balances and macroeconomic projections in the 2002 updates and the Commission Autumn 2002 Forecasts - Euro area (annual change in %)

	2002	2003	2004	2005	2006
<b>2002 updates of the stability programmes</b>					
Real GDP	1.0	2.1	2.7	2.7	2.7
Budget balance (% of GDP)	-2.2	-1.8	-1.1	-0.7	-0.1
Cyclically-adjusted budget balance (% of GDP)	-1.9	-1.3	-0.8	-0.5	-0.1
Gross debt level (% of GDP)	69.7	68.7	66.8	65.4	63.5
<b>Commission Autumn 2002 Forecasts</b>					
Real GDP	0.8	1.8	2.6		
Budget balance (% of GDP)	-2.3	-2.1	-1.8		
Cyclically-adjusted budget balance (% of GDP)	-1.9	-1.6	-1.5		
Gross debt level (% of GDP)	69.7	69.1	68.2		

*Source:* Commission Services. Discrepancies are due to rounding

Turning to the composition of the budgetary adjustment, the updated programmes show that both revenue and expenditure ratios are expected to decline over the 2002-05 period. The euro-area total government receipts are projected to fall by almost 1 percentage point of GDP between 2002 and 2005 to slightly below 46% of GDP in 2005. This is more than compensated by reductions in the expenditure ratio, which over the same period will amount to 2.0 percentage points of GDP. Although the information provided in the programmes on the budget components is not always complete, it would seem that the reduction in taxes in most countries in the euro area in 2001 and 2002 would not be repeated in the years ahead. As to expenditure components, social



transfers are set to decrease in the euro area by about ½ percentage point of GDP over the period. After a slight reduction in 2002 and 2003, gross fixed capital formation is set to increase slightly at euro-area level to 2.4% of GDP.

#### Details for some Member States

As shown in the table below, the overall improvement in the budget balance relies to a large extent on the sizeable budgetary consolidation projected in the largest Member States, such as Germany (a consolidation of 3.8% of GDP over the next four years in the actual balance), Italy (2.2%) and France (1.8%). Portugal (2.3%) and Greece (1.7%) also foresee large improvements in the actual balance. Most other euro-area countries also project improvements, albeit more modest ones, in their budgetary position over the coming four years. However, Finland and Ireland forecast budgetary deterioration.

#### Budget balances (1) in the 2002 updates and the Commission forecasts

	2002 updates of the Stability Programmes					Commission Forecasts (2)		
	2002	2003	2004	2005	2006	Autumn 2002	Autumn 2003	Autumn 2004
B	0.0	0.0	0.3	0.5		-0.1	0.0	0.3
D	-3.75	-2.75	-1.5	-1.0	0.0	-3.8	-3.1	-2.3
EL	-1.1	-0.9	-0.4	0.2	0.6	-1.3	-1.1	-1.1
E	-0.2	0.0	0.0	0.1	0.2	0.0	-0.3	0.1
F	-2.8	-2.6	-2.1	-1.6	-1.0	-2.7	-2.9	-2.5
IRL (3)	-0.5	-0.7	-1.2	-1.2		-1.2	-1.2	-1.0
I (3)	-2.1	-1.5	-0.6	-0.2	0.1	-2.4	-2.2	-2.9
L	-0.3	-0.3	-0.7	-0.1		0.5	-1.8	-1.9
NL	-0.7	-1.0	-0.7	-0.4	0.1	-0.8	-1.2	-0.9
A						-1.8	-1.6	-1.5
P	-2.8	-2.4	-1.9	-1.1	-0.5	-3.4	-2.9	-2.6
FIN	3.8	2.7	2.1	2.6	2.8	3.6	3.1	3.5
Euro area	-2.2	-1.8	-1.1	-0.7	-0.1	-2.3	-2.1	-1.8

(1) Excluding UMTS proceeds.

(2) For 2004 on the assumption of unchanged policies. For Ireland, based on pre-budget figures.

(3) Including for Ireland "contingency provisions against unforeseen developments" (respectively 0.4% and 0.8% of GDP in 2004 and 2005) and for Italy "future measures" (respectively 1.6%, 1.4% and 0.8% of GDP in 2004, 2005 and 2006).

Sources: Commission Services and 2002 updates of the stability programmes.

As to Member States' budgetary adjustment strategies, the following patterns are worth noting:

- In general, deficit countries plan a consolidation of at least 0.5% of GDP per year in cyclically-adjusted terms over the coming years. However, France and Greece would only start the adjustment in 2004.
- The initial budgetary positions matter: all countries showing large deficits in 2002 plan to reduce substantially their expenditure ratios. Large reductions in primary current expenditure are planned in Germany, Greece, Italy, Portugal and France. Excluding Portugal, which is expected to trim public investment somewhat, these countries plan to accompany the lower expenditure with tax cuts, albeit of limited size.
- Italy, Greece and Belgium expect to benefit from large falls in interest payments, which should finance to a large extent the planned higher public investment.
- A number of other countries, which need to improve their balance only marginally or are already in surplus, also expect to reduce the size of the public sector. This is most notably the case of Luxembourg, the Netherlands and, in smaller measure, Spain and Belgium.

After sharp increases in October and a levelling-off in November, the euro area 10-year benchmark government bond yield has declined since December, falling below 4% in mid-February. The decline reflects, in part, renewed flight-to-quality flows from stocks into bonds as market participants perceived the likelihood of a conflict against Iraq to have increased. Other traditionally safe assets, such as gold, have also seen a rise in their market value.

Since mid-January, international equity prices have been on a sharp and sustained

downward trend and fell below the levels recorded at the previous trough in October 2002. As was the case throughout the market correction in 2002, the decline in European equity prices has exceeded that in the United States. It has also been broad-based, affecting all industrial sectors, thereby confirming that investor sentiment is being influenced predominantly by global factors. In addition to geopolitical tensions, investors remain concerned about weakness in the global economy and the reliability of companies' financial statements.





## Focus

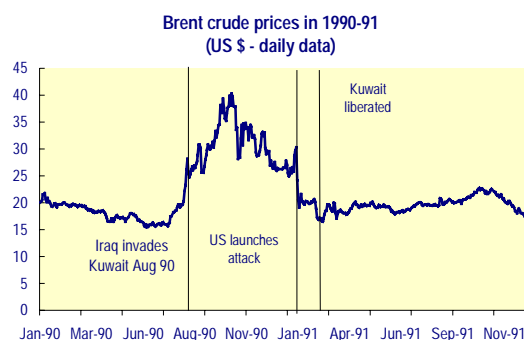
# II. The consequences of a possible conflict in Iraq on the economy of the euro area

*Without prejudging the outcome of current geopolitical tensions, this focus examines the economic consequences of a possible conflict in Iraq. The latter can affect the euro area via several channels, including higher oil prices, lower confidence, a drop in equity prices and swings in exchange rates. The magnitude of the risks involved is difficult to assess. When considering only the oil channel, model simulations suggest that the impact of a conflict on growth in the euro area could be relatively limited provided that the associated oil shock reverses rapidly. Nonetheless, there are important downside risks to this rather benign assessment. First, a more persistent increase in oil prices could impair the economy more substantially. Second, a conflict in Iraq could also affect growth in the euro area via other channels, most notably via a negative response in business and consumer sentiment.*

Given the complexity of its possible geopolitical implications, the consequences of a conflict in Iraq are difficult to assess. The dimension, duration and long-term consequences of the conflict are unknown. The present note discusses the various channels through which a conflict could affect growth, emphasising the role of oil prices and confidence effects. The analysis is of a short-term nature. Longer-term potential consequences, such as structural changes in oil supply, are not taken into account.

### 1. Possible consequences of a conflict for oil prices

An analysis of the possible responses of oil markets to conflict can draw on the experience of the 1990-91 Gulf War. Oil prices more than doubled within a few weeks, rising from a monthly average of \$17 in July to more than \$36 in August, with a daily peak above \$40. Prices already began to fall back in 1990 as it became clear that UN-backed military intervention would be launched. With the beginning of the allied counter-attacks prices temporarily picked up again before finally easing again to average less than \$20 in February (see next graph). Overall, the experience of the 1990-91 Gulf War suggests that oil prices can drop rapidly as soon as geopolitical uncertainties diminish.



Source: Datastream .

For illustrative purposes, Table 1 on the next page presents two possible scenarios for oil prices based on the assumption that a conflict begins in the second quarter. It is important to stress that these scenarios are only working assumptions for the macroeconomic simulations presented in the next section. They should not be seen as oil price forecasts.

#### Scenario 1: a one-quarter oil shock

In Scenario 1, oil prices are assumed to experience an increase that is comparable, *in absolute levels*, to the increase registered during the 1990-91 Gulf War. The price of the Brent rises sharply – above \$50 per barrel - at the start of the conflict but the spike is assumed to be short-lived. On a quarterly basis, the price of the Brent climbs to slightly above \$40 in the second quarter of 2003 before falling back to \$26 in the third quarter. Relative to

**Table 1: Possible oil price developments in case of a conflict (\$/bl)**

(working assumptions for macroeconomic simulations)

	<i>Scenario 1</i>	<i>Scenario 2</i>
2002		
Q4	26.5	26.5
2003		
Q1	31	31
Q2	41	57
Q3	26	52
Q4	21	26

Source : Commission Services.

the average prevailing over the second half of 2002, the scenario represents a 50% increase of oil prices over one quarter.

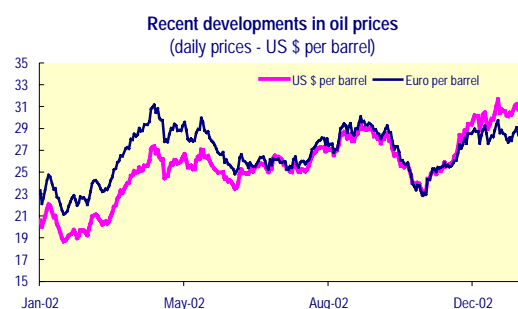
*Scenario 2: a bigger two-quarter oil shock*

In scenario 2, disruptions to oil supplies and persisting uncertainties entail a larger and longer increase of oil prices. The *relative* increase of oil prices is assumed to be approximately the same as during the 1990-91 Gulf War. This results in price levels above \$50 pb during the two quarters following the beginning of the conflict, implying temporary peaks of up to \$70 pb. Relative to the average prevailing over the second half of 2002, the scenario represents a 100% increase of oil prices over two quarters.

There are of course risks that could push prices beyond the levels assumed in Scenario 2, particularly if there were to be supply disruptions in other oil-producing countries. Another uncertainty is related to the length and impact of the Venezuelan crisis. When looking at the cumulated shortfall in production, strikes in Venezuela have already translated into one of the biggest

shocks to the world supply of oil in the past three decades. As a result, excess production capacity on world oil markets seems to be significantly lower at the current juncture than in 1991. In this context, the temporary removal of Iraq's supply could lead to greater price tensions than envisaged in Scenarios 1 and 2.

On the other hand, price increases in case of a conflict could turn out to be lower than in Scenarios 1 and 2. Current prices already factor in some of the risk of supply disruptions and may experience only limited further increases in the event of conflict. After dropping to \$23 per barrel in November last year, the price of the Brent has again been on a marked upward trend since in the past months, climbing above \$30 since January. Recent price rises partly reflect international tensions linked to Iraq. However, there is much uncertainty about the size of the corresponding war premium as prices have also been affected by other factors such as the political turmoil in Venezuela and cold weather conditions in the northern hemisphere.



Source: Datastream and Commission services.

Finally, based on the rapid reversal of price rises observed during the 1990-91 Gulf War, it cannot be excluded that prices could come down earlier than assumed in Scenarios 1 and 2..



### Box 1: Iraq as an oil producer

Iraq holds the second biggest oil reserves in the world after Saudi Arabia. Due to a lack of investment, Iraq is currently producing below its potential, estimated at 3-3.5 million barrels per day. Since 1990, UN sanctions prohibit foreign investment in the oil sector. In a post-conflict situation, when these sanctions are lifted, any new government will have a strong incentive to boost oil production to pay for reparation. However, in order to expand output to potential levels, Iraq will need substantial, largely foreign investment; and it will take a minimum of 3-4 years to return to potential output. In 2002, oil from Iraq made up only a small fraction of the euro area's total oil imports.

#### Major oil producers: reserves at end 2001 and daily production in Dec 2002

	Reserves in bn barrels	Share of total reserves in %	Production in mbpd
Saudi Arabia	262.7	24.4	7.9
Iraq	112.5	10.5	2.4
Iran	99.1	9.2	3.5
UAE	97.8	9.1	2.0
Kuwait	96.5	9.0	1.9
Venezuela	77.7	7.2	2.9 (1)
Russia	48.6	4.5	7.1
Libya	36.0	3.4	1.4
USA	22.0	2.1	7.9
Mexico	26.9	2.5	3.6
OPEC total	845.4	78.7	26.9
World total	1074.9	100.0	76.4

(1) November production levels; Venezuela's production was reduced to 0.8 mbpd in December in 2002.

Source: OPEC Annual Statistical Bulletin and Monthly Oil Market Report; IEA Oil Market Report.

## 2. The economic impact of a conflict on the euro-area economy: the oil channel

History teaches that large increases in oil prices can impart a serious contractionary shock to the economy. An increase in oil prices pushes up inflation, weighs on real income and profitability and depresses consumption and investment demand. If the oil shock is short-lived and does not trigger an inflationary price/wage spiral, its growth impact is likely to remain relatively subdued and to be largely reverted when oil prices fall. On the other hand, if the shock is persistent, as was the case in the 1970s, the growth impact is likely to be much more substantial. In that case, economic agents have to adapt to a lasting change in real

income and relative prices. Although households can respond to a fall in real income by reducing their savings, consumption smoothing is less likely to take place if the fall is perceived to be lasting. On the supply side, a persistent cut in profitability will weigh on investment whereas a persistent change in the relative price of oil will foster a costly substitution of energy with capital and will lead to a downward shift in potential growth and in the demand for labour.

Box 2 on next the page presents results of simulations carried out with the Commission's Quest model. These simulations suggest that the growth impact of higher oil prices should remain rather modest in the two oil price scenarios described in the previous section. In

### Box 2: The impact of higher oil prices in the euro area

This box presents the results of oil price simulations with the Commission QUEST model based on the two oil price scenarios presented in the previous sections.

#### *Scenario 1: a one-quarter oil shock*

To assess the potential macroeconomic effects of the oil shock in Scenario 1, the impact of a 50% increase in oil prices over one quarter was simulated with the Quest model. The overall macroeconomic impact of the shock remains marginal as the price hike is short-lived and price levels decrease swiftly. GDP is reduced by less than 0.1% over a year. The consumer price index rises only modestly by 0.1. The trade balance remains virtually unchanged.

Given that oil prices since the beginning of the year to some extent already factor in the possibility of a conflict, further price reactions in the event of commencement of conflict might be less severe than assumed, which would further mute the impact on growth. Also, it cannot be excluded that prices will fall below the assumed levels after the end of the conflict if the latter is quick and clearly successful.

#### **Impact of a temporary oil price increase on the economy of the euro area**

Percentage difference from baseline after a year

	Scenario 1 (50% rise in oil prices over 1 quarter)	Scenario 2 (100% rise in oil prices over 2 quarters)
GDP	-0.05	-0.34
Private consumption	-0.10	-0.41
Investment	-0.33	-1.73
Trade balance (1)	-0.02	-0.14
Consumer price level	0.12	0.50
Short-term interest rate (2)	0.10	0.46

(1) Percentage point difference in the share of the trade balance in GDP.

(2) Percentage point difference from baseline.

**Source:** Commission Services – QUEST model.

#### *Scenario 2: a bigger two-quarter oil shock*

The output loss is significantly higher in Scenario 2, at about 0.3-0.4 per cent. The acceleration of inflation is also more pronounced than in Scenario 1, with a 0.5% increase in the consumer price index.

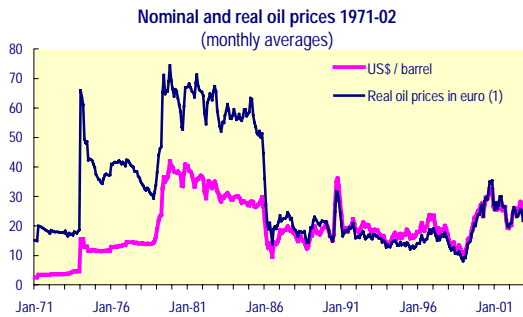
#### *Limitations to the results*

The QUEST simulations presented above serve as an illustration of the possible economic consequences of temporary increases in oil prices. The simulations do not encompass autonomous confidence effects, increases in uncertainty, or exogenous exchange rate variations.

It is important to stress that the assumed temporary nature of the simulated oil shocks is instrumental in explaining the relatively low impact on inflation and growth. The impact of a more permanent oil shock could be markedly more significant. Simulations of a permanent increase in oil prices of 50% show a decline in output of 0.5-0.8 per cent spread over a two to three-year period.



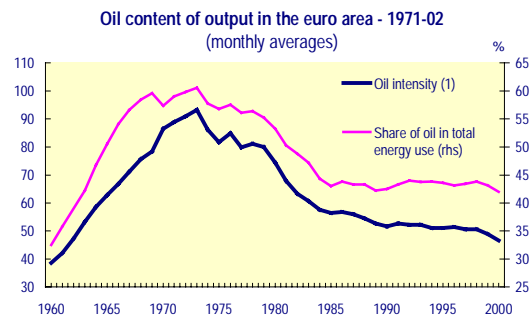
Scenario 1, GDP is on average 0.1 percentage points lower than in the baseline during the year following the beginning of the conflict. The loss is somewhat higher in Scenario 2, at 0.3 percentage points.



<sup>1</sup> deflated by the CPI.  
Source: ECB and Commission services.

Three factors explain this relatively benign outcome:

- First, the two scenarios assume a temporary and short-lived spike in oil prices. Evidence from futures prices suggests that economic agents largely view the potential crisis as a temporary one. Memories of the 1990-91 Gulf War should also push expectations in that direction. Model simulations show that the economic impact of a surge in oil prices can vary dramatically depending on whether the shock is temporary or persistent.
- Second, the simulated oil shocks remain relatively small by historical standards. Based on annual averages, oil prices in real terms and in euro nearly tripled between 1973 and 1974 and doubled between 1978 and 1979.
- Third, the vulnerability of the euro area to surges in oil prices has decreased sharply in recent decades. Partly in response to the significant and long-term price increases in the 1970s and 1980s, the oil and energy intensity of output in the EU has fallen considerably over the last three decades (see next graph).



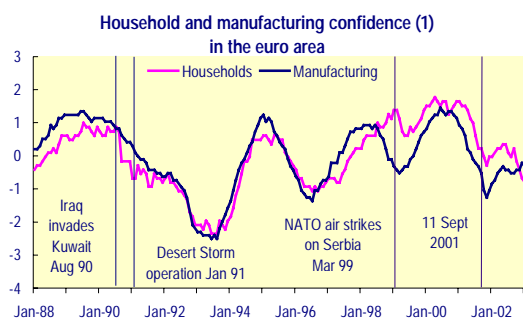
(1) toe per 1000 euro of GDP (95 prices).  
Source: IEA and Commission services.

The results of the simulations presented in Box 2 should be interpreted with caution. They are not predictions of future events but serve to illustrate how growth and other macroeconomic variables might react as a result of a conflict-related oil price shock. Also, the simulations do not take account of other transmission mechanisms such as the effects of a conflict on market confidence and exchange rates. These aspects are discussed in the next Section.

### 3. The economic impact of a conflict on the euro area: other possible channels

Oil prices are an essential transmission channel for the economic impact on the economy of the euro area of a possible conflict in Iraq. However, there are also other important transmission channels, including confidence, equity prices and exchange rate effects.

Past experience shows that major geopolitical crises can weigh heavily on confidence, especially for households. As illustrated in the graph on next page, the invasion of Kuwait in August 1990 was accompanied by a significant slide in household and business sentiment. In the case of households, the loss in confidence was particularly sharp and was brought to a (temporary) halt by the success of the Desert Storm operation.



The case of manufacturing is less clear-cut as confidence was already on a downward trend before the beginning of the 1990-91 Gulf War and remained negatively oriented after Desert Storm.<sup>8</sup> NATO strikes on Serbia in March 1999 had a visible impact on household confidence, but seem to have left business sentiment largely unaffected. In contrast, the events of September 11 hit both household and manufacturing sentiment briefly but substantially.

The evolution of confidence is notoriously difficult to predict but essential in the assessment of the impact on the economy. In the past few months, uncertainty about the possible conflict has weighed on confidence, which partly factors in the expected consequences of a conflict. Thus, drawing on the experience of 1990-91, military action has the potential to lift the veil of uncertainty and, if swift and successful, to boost confidence. However, it cannot be ruled out that confidence levels will take another temporary hit during the preparatory and the initial conflict phase.

Given that the political and economic situation currently appears more precarious than in 1990-91, a more substantial and lasting impact on confidence is also a possibility. Political and popular support for a military intervention is less coherent than in 1990, a factor which might make confidence more vulnerable to a conflict.

<sup>8</sup> However, it is interesting to note that in the USA business confidence plunged with the invasion of Kuwait and recovered strongly in February 1991 when Kuwait was successfully liberated.

On the economic side, it is important to bear in mind that the euro-area economy was at the peak of its cycle at the time of the Kuwait invasion. In contrast, current growth is low and the timing of recovery uncertain. In addition, stock markets have been on a declining trend over the last three years and corporate balance sheets remain fragile. Finally, business and consumer confidence is now significantly lower than in summer 1990.

The "pure" oil price shock scenarios presented in the previous section did not include any autonomous confidence effect. The quantitative impact of changes in confidence are difficult to assess but a confidence shock triggered by a conflict and surging oil prices could take a significant toll on GDP growth in the euro area. In addition to the negative impact of higher oil prices on households' purchasing power, private consumption would be hampered by an increase in savings. Investment would suffer from reduced profit margins but also from lower expectations in terms of demand and future profitability. Tourism and international travel could be affected, similar to the aftermath of the 11 September events. International trade could be hampered by continued geopolitical tensions, a worsening in relations with the Islamic world and the threat of terrorist attacks. Finally, reduced profit and demand expectations could also hit equity prices again, thereby weighing on consumption and investment via reduced financial wealth and higher capital costs. Under such a scenario, a stagnation or even recession in the euro area cannot be excluded.

The impact of conflict on exchange rates is difficult to foresee. The US dollar has traditionally held the function of a safe haven currency in times of geopolitical crisis. Equally, rising oil prices generally raise the demand for dollars. Nevertheless, the combination of large current account imbalances and possibly strong negative effects of a conflict on confidence in the USA could lead to further appreciation of the euro. In any case, volatility in the EUR/USD exchange rate might increase.



## Focus

### III. The role of financial markets in promoting sound public finances in EMU

*Financial markets can play an important role in disciplining governments to avoid excessive borrowing and placing debt on unsustainable trajectories. However, in the context of EMU financial markets are only likely to react powerfully when deficits and debts reach levels that are well above what would be considered appropriate to support the single monetary policy in delivering a stable macroeconomic environment. Some ideas to enforce the disciplining role of financial markets have been suggested. They relate to the use of capital adequacy rules, arrangements for joint issuance of euro-area government debt and the eligibility and pricing mechanism of collateral used by the Eurosystem. However, such suggestions to encourage investor discrimination between euro-area government bonds would introduce substantial distortions elsewhere in the economic and financial system and are therefore rejected.*

This focus examines the role of financial markets in applying pressure on Member State governments to run sound public finances in Stage III of EMU. This issue has surfaced against a background of deteriorating budgetary positions in several Member States that can only partially be attributed to the effects of the economic cycle and also concerns about the effectiveness of the rules-based framework for the co-ordination of budgetary policies. In this context, concerns had been expressed about whether financial markets were playing their role in terms of exercising timely and sufficient pressure on governments to pursue sound budgetary policies.

#### 1. The fiscal policy framework of EMU and the role of financial markets

Since the inception of the EMU project, sound public finances have been recognised as essential for the success and viability of monetary union.

Financial markets may have some role to play in disciplining governments to avoid excessive borrowing and placing debt on unsustainable trajectories. According to the market discipline hypothesis, the default premium on debt would rise with the level of borrowing and debt accumulation, thereby providing the borrower with an incentive to restrain excessive

borrowing and restore the sustainability of debt dynamics. Eventually, the credit markets will respond by denying credit to the borrower.

The Treaty facilitates the role of markets in putting pressure on governments to run sound public finances in several ways. Firstly, to the extent possible, governments are placed in the same position as any other borrower when going to the market for financing the borrowing needs. In particular, the Treaty forbids direct financing from the central bank (ECB or national central banks) to governments, other bodies governed by public law or public undertakings of Member States (Article 101); the Treaty also excludes any privileged access to financial institutions (except if it results from a measure based on prudential considerations) (Article 102). Secondly, the Treaty also establishes the no-bail out clause (Article 103) by which every Member State is liable for its own government commitments, and cannot be liable or assume commitments of other Member States.

However, the incentives which financial markets can impose on sovereign borrowers to run sound public finances may be inadequate leading to inconsistent behaviour in response to evidence of budgetary problems. There is considerable evidence that the link between an increase in default risk and rising yields may not be linear. Risk premiums may be small as long

as default risks remain within reasonable ranges. Markets tend to undertake rapid readjustments in their assessment of default risk once a perception arises of serious financial difficulties. Countries, however, are only likely to face the prospect of a significant increase in risk premiums after several years of running deficits which are much larger than the 3% of GDP reference value and gross general government debt levels are well above 60% of GDP. In contrast with non sovereign borrowers, the risk premium on government debt is lower since sovereign governments have the authority and capacity to increase tax rates if necessary to finance future financial obligations.

In brief, financial markets can eventually provide powerful incentives for government to return public debt onto a sustainable trajectory, but this is only likely to occur once deficits and debt reach levels that are well above what would be considered appropriate to support the single monetary policy in delivering a stable macroeconomic environment.

Against this background, fiscal framework of EMU (as established by the Treaty in Article 99 and 104 and the SGP) aims at securing sound

public finances principally via a rules-based approach to the co-ordination of fiscal policies. Indeed, the existence of EU fiscal rules and accompanying surveillance measures is likely to influence the manner in which markets assess and perceive default risks. If properly implemented, the SGP should result in Member States taking prompt corrective action if deficits breach the 3% of GDP reference value, and debt levels in all countries should fall below the 60% of GDP reference value within a reasonable period of time. Credibility in the rules-based framework would thus result in markets attaching a low risk premium to government debt. Markets view breaches of the reference value as important, not because a deficit level above 3% of GDP on a temporary basis calls into question the sustainability of public finances and the risk of debt fault (although this depends on the outstanding level of debt), but rather because they call into question the robustness of the rules-based framework and effectiveness of peer pressure.

## 2. Spreads in euro-area government bond yields

The launch of EMU was preceded by a

**Table 1: Spread over German 10-year benchmark bond, annual averages**

	1997	1998	1999	2000	2001	2002
B	11	18	26	33	33	20
EL	428	391	181	84	51	34
E	76	26	24	26	32	18
F	-6	7	12	13	14	8
IRL	65	23	22	25	21	23
I	122	31	24	31	39	25
L	-4	16	17	26	6	-8
NL	-6	6	14	14	16	11
A	4	14	19	29	28	18
P	72	31	29	34	36	22
FIN	32	22	23	22	25	20
DK	62	37	42	38	28	27
S	98	42	49	10	31	52
UK	149	102	52	6	21	13

Source : Commission services.





convergence in euro-area government bond yields to historically low levels. The convergence in yields contrasted sharply with the situation at the beginning of the 1990s, when several euro-area Member States had yields between 400 and 600 basis points above the 10-year (German) benchmark. The introduction of the euro and the consequent elimination of exchange risk between bonds of euro-area Member States was the main factor driving the convergence in yields. Exchange risk for an investor in a government bond can be determined by developments in a range of economic variables, including the (relative) inflation rate, the balance of payments and the public finances. The link between exchange risk for the government bond investor and public-finance developments reflects the fact that exchange rate depreciation is generally a more attractive means for a government to preserve or restore budget sustainability than outright debt default. Accordingly, investors in government bonds react to concern about budget sustainability by demanding an exchange risk premium which, in turn, is reflected in higher bond yields. As euro-area Member States have abandoned the exchange rate as an instrument of nominal adjustment within the area, investors no longer require an exchange risk premium between the different euro-area government bonds.

Since the launch of EMU, euro-area bond yields have fluctuated but have remained largely convergent. The maximum spread above the 10-year (German) benchmark has remained comfortably below 50 basis points, except in the case of Greece, which joined the euro area in 2001.

The improved budgetary performance of euro-area governments has also been accompanied by a convergence in their credit rating towards the highest levels. All of the euro-area Member States are now rated AA or higher, except for Greece which is rated A.

However, the persistence of spreads in euro-area yields indicates that investors do not

consider euro-area government bonds as complete substitutes. Investor discrimination between euro-area government bonds can hardly be ascribed to market distortions, as differences in tax treatment have been eliminated or reduced to negligible levels during the 1990s, the technical characteristics of bonds have been standardised in the run-up to EMU and, the euro has done away with currency-matching rules restricting the investment possibilities for certain types of large institutional investors. In the absence of exchange risk and significant market distortions, credit and liquidity premia are the obvious candidates to explain the remaining yield spreads.

**Table 2: Long-term credit ratings, January 2003. Outlook stable unless indicated**

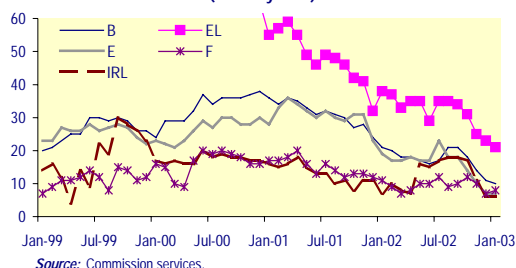
	S&P	Moody's	Fitch
B	AA+	Aa1	AA
D	AAA	Aaa	AAA
EL	A / Positive	A1	A / Positive
E	AA+	Aaa	AA+
F	AAA	Aaa	AAA
IRL	AAA	Aaa	AAA
I	AA / Negative	Aa2	AA
L	AAA	Aaa	AAA
NL	AAA	Aaa	AAA
A	AAA	Aaa	AAA
P	AA	Aa2	AA
FIN	AAA	Aaa	AAA

Source : Commission services.

A casual inspection confirms that the distribution of yields on euro-area government bonds is influenced by the credit rating of the issuer. In the fourth quarter of 2002, for example, AAA-rated issuers enjoyed a yield on average 13 basis points less than AA issuers. In a longer-term perspective, a study undertaken for the Commission and looking at longer time series showed a strong correlation between the credit standing of euro area countries and the yields on their government bonds, both before

and after the introduction of the euro.<sup>9</sup> While the correlation between yields and creditworthiness is in the expected direction, it has been suggested that yield spreads between issuers are “too small” to reflect an appropriate discrimination by investors between virtuous and less-virtuous governments.

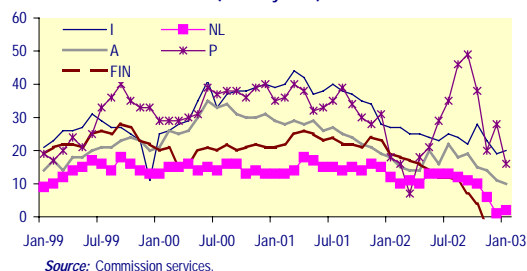
Yield spread over German ten-year bund , basic points (monthly data)



In this respect, even though the figures are not strictly comparable, it is interesting to note that the spread between AAA and AA euro area long-term (i.e. 7 to 10 years) corporate bonds was on average 17 basis points in the fourth quarter of 2002, i.e. the same order of magnitude as the prevailing spread on government bond markets. This tentatively suggests that the credit risk premia in euro area government markets are not out of line with market standards. However, credit factors do not explain fully the configuration of government bond yields in the euro area.

The persistent yield spreads between equally credit-rated issuers suggest that liquidity factors are also important for investors in government bonds. The relevance of market liquidity is further confirmed by the absence of a well-defined benchmark yield curve for the euro-area government market, with different national issuers enjoying benchmark status at different maturities. The composite euro benchmark yield curve, which is sub-optimal from a market perspective, is the natural consequence of having twelve separate issuing agencies competing for the same pool of funds.

Yield spread over German ten-year bund , basic points (monthly data)



In addition, the spreads within the euro area have shown a tendency to widen in times of international financial market turmoil, suggesting that liquidity considerations may carry an even higher weight with foreign (i.e. non euro area) investors. As might be expected, liquidity premia appear to be especially important for smaller-issuing Member States. Among the larger Member States, the preference enjoyed by the German ten-year Bund partly reflects the fact that the Bund is deliverable into the future contract in Eurex, which has become predominant in the euro area. Yield spreads between euro-area government bonds relating to liquidity factors are likely to persist in the absence of a move to more co-ordinated debt issuance by the Member States.

In sum, the elimination of exchange risk and the progress in budgetary consolidation associated with EMU validates the narrow spreads between euro-area government bond yields. Yield spreads of the current size, i.e. 0-50 basis points, were predicted by implied forward rates in the years immediately preceding the launch of EMU. The remaining yield spreads within the euro area are mainly comprised of premia relating to credit risk and liquidity risk, neither of which is very significant in the case of euro-area sovereign debt. Indeed, if euro-area yield spreads were substantially wider than today, there might be cause for concern about the credibility of the EMU policy framework.

<sup>9</sup> For details, see Quarterly Note on the Euro-denominated bond markets, July – September 2002, No. 43. [http://europa.eu.int/comm/economy\\_finance/publications/bond\\_markets/2002/bondq030\\_en.pdf](http://europa.eu.int/comm/economy_finance/publications/bond_markets/2002/bondq030_en.pdf).



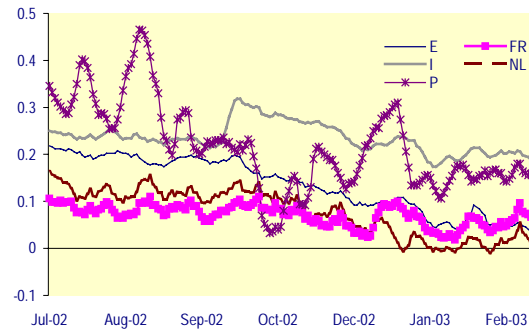
### 3. Evolution in yield spreads and recent implementation of the Stability and Growth Pact

Bearing in mind the context of convergent euro-area government bond yields, the relationship between the rules-based fiscal framework in EMU and the behaviour of bond markets deserves further consideration. In particular, it is necessary to address the concerns of some observers who have been surprised by the very muted bond market reaction to the recent breaches of the SGP by several Member States.

Despite these adverse developments, the level of government bond yields in the transgressing Member States has declined, due to factors that are largely exogenous to budgetary policy (e.g. declining inflation expectations, portfolio asset shifts, renewed net issuance of US Treasuries). More significantly, however, the yield spreads between the transgressing Member States and other euro-area Member States have been affected, but only to a limited extent.

Rating agencies have voiced some concerns about fiscal policy developments in the euro area, but have so far refrained from lowering credit ratings for any Member State. The most significant action so far has been the decision by Standard & Poor's (in January 2003) to change Italy's long-term outlook from stable to negative. In general, the bond markets have tended to ignore the problems in implementing the SGP and the implied limitations in peer pressure as a means to enforce budgetary discipline within the euro area.

Yield spreads over German ten-year bund, basic points  
(5-day moving averages,  
July 2002-February 2003)

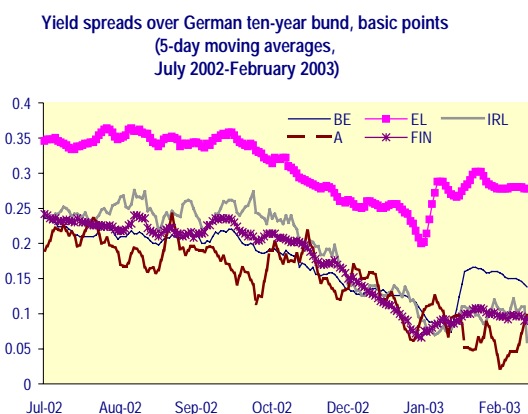


Source: Commission services.

The question arises whether the failure of investors to 'sanction' euro-area governments whose budgetary performance is inconsistent with the SGP signals a malfunctioning in the market or is instead consistent with efficient market behaviour. Several observations can be made in this regard.

First, abstracting from liquidity factors, investors in euro-area government bonds are concerned about credit risk, which reflects the long-term sustainability of the country's budgetary position and the potential losses in case of debt default. The widening in budget deficits in some euro-area Member States is a serious matter in the context of the rule-based framework of EMU. However, it is unlikely that the deterioration in budgetary deficits is sufficient to modify investors' assessment of the sustainability of public finances in the Member States concerned. Indeed, many market-based analysts perceive the current departure from budget discipline under the SGP as temporary i.e. likely to be rectified in the coming years. In this respect, one might interpret the limited reaction in euro-area yield spreads as a positive development, confirming the credibility of the SGP.<sup>10</sup>

<sup>10</sup> The charts in this section show moving averages over five business days, which were calculated to smooth out day-to-day volatility. Data for Portugal are somewhat anomalous, as the yield sometimes remains unchanged for several consecutive days, suggesting lack of trading activity. The spread for Luxembourg,



Source: Commission services.

Second, the broader economic and financial context should not be ignored. Since 2000, the global economy has experienced a combination of slow output growth, growing uncertainty concerning political and economic developments, financial crises in some emerging economies, and falling confidence in corporate governance and the integrity of financial markets. Monetary easing in the United States and in Europe has lowered short-term interest rates to historical levels, while the risk premia demanded by investors on private sector and emerging market assets have risen sharply. In such conditions, the investor preference for safe assets - such as euro area government bonds - has greatly increased (and has probably been reinforced by the current appreciating trend in the euro).

Third, the majority of market-based analysts have welcomed the prospect of a positive budgetary impulse to the euro-area economy in current cyclical conditions through the operation of the automatic stabilisers. The SGP has been criticised by some as imposing a pro-cyclical budgetary tightening in those Member States with budget deficits close to the 3% of GDP threshold but experiencing very low output growth. For these analysts, the costs of temporarily breaching the SGP rules appeared less serious than the risk of worsening the economic slowdown by raising taxes. With market sentiment moving in favour of some

not shown in the graph, has moved from moderately positive to strongly negative (up to -70 basis points in mid-January).

budgetary loosening, it is perhaps not surprising that government yields did not react very negatively to the problems in implementing the SGP.

#### 4. Possible avenues to reinforce financial market pressure

The reduced incentive for investors to discriminate between euro-area government bonds in the absence of exchange risk was anticipated before the launch of EMU. The Treaty responds to this feature of EMU through the excessive deficit procedure, as elaborated by the SGP, and by prohibiting Member States from being liable for or assuming the commitments of other Member States. These Treaty provisions can be seen as mechanisms by which peer pressure replaces and improves on market pressure as an instrument for enforcing budgetary discipline. This does not imply, however, that the scope for market pressure could not be improved in theory and this section explores several possible actions to this end. The conclusion is, however, that such actions would introduce substantial distortions elsewhere in the economic and financial system and are therefore rejected.

##### *Using capital adequacy rules to enhance budgetary discipline*

The idea in using capital adequacy requirements to enhance market pressure for budgetary discipline would involve linking the capital requirement on euro area (or EU) government bonds to debt and/or deficit levels, or to respect of SGP rules.

In the current capital adequacy approach, all OECD governments bonds are given a zero risk weighting. Under the new accord being finalised in Basel (the so-called Basel II), banks will be able to choose among three approaches for the measurement of minimum capital requirements: a simple standardised approach, similar to the one currently used; a simplified internal ratings based (IRB) approach; and a more sophisticated advanced internal rating based approach. In the standardised approach, the risk weightings of sovereign assets will be



determined on the basis of a government's credit rating, with the weights indicated in the table below.

In the IRB approaches, the risk weightings will depend on banks' internal assessment of default probabilities. Basel II will be transposed into the new Capital Adequacy Directive at EU level, providing an opportunity to introduce EU-specific changes linking the risk weighting of government bonds to budgetary performance.

It is uncertain whether it would be possible or desirable to adapt the new prudential rules on capital requirements under Basel II to discriminate between euro-area government bonds. In theory, it would probably be possible to impose a rule that the bonds of a government which has a deficit above 3% for more than one year would carry a 20% risk weighting in the standardised approach, regardless of the credit rating that it receives from market agencies.

Concerning the IRB approaches, an exception to banks' use of their credit assessment systems could be introduced to a similar effect. In practice, it would be very difficult to agree on such a distortion of the main purpose of the new capital accord, which is to arrive at capital requirements for banks that better reflect credit, market and operational risks. Any special rule could, therefore, apply only within the euro area or EU putting financial market participants in these areas at a disadvantage with respect to their international competitors. This is not a

reasonable proposition.

*Joint issuance of government debt as a means to enforce budgetary discipline*

The issuance of government debt jointly by Member States has been considered as a means to promote liquidity in the euro-denominated bond market, but could also be used to enforce budgetary discipline within the SGP. The idea would be to create a situation whereby a Member State participating in an arrangement for joint issuance would be excluded in the event that it was in breach of the SGP. Thus, the risk of additional borrowing costs implied by exclusion from a joint issuance arrangement – triggered by a breach in the SGP - could act as an incentive to budgetary discipline among the participating Member States.

The acceptability of using an arrangement for joint issuance as a tool for ensuring budgetary discipline would require that any sanctions should apply equally to all of the participating Member States. In practice, this might not be the case.

- Exclusion from a joint issuance arrangement would certainly raise the cost of borrowing for smaller Member States, whose individual debt issues would be less liquid - and hence less attractive to investors - relative to the joint issues.
- The disciplining effect of exclusion on any of the larger Member States would be less clear-cut. Exclusion of one (or several) of the larger Member States could reduce

**Table 3: Percentage risk weights for sovereigns in the new Basel accords**

S&P Credit Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	Unrated
Risk weights (%)	0	20	50	100	100	150	100

Source : Commission services.

significantly the liquidity of the remaining joint issues, which would limit any increase in the relative cost of borrowing for the excluded Member State(s).

- Exclusion of a larger Member State could have the perverse effect of raising the cost of borrowing for those Member States remaining within the arrangement. Accordingly, there is a clear risk that the effect of joint debt issuance as a mechanism for budgetary discipline would be asymmetric between the larger and the smaller Member States.

In addition to possibly asymmetric effects among Member States, the existence of an arrangement for joint government debt issuance could prove counterproductive in enforcing budgetary discipline.<sup>11</sup> The most relevant disadvantage is an inconsistency between the cross-default element of joint issuance of government debt and the Treaty provisions on budgetary discipline, notably Article 103 which prohibits Member States from being liable for or assuming the commitments of other Member States.<sup>12</sup>

*Use of government bonds as collateral in the Eurosystem's monetary policy operations*

Another theoretical possibility to enhance market discipline would involve restrictions in the use of government bonds in the Eurosystem's monetary policy operations. Article 18.1 of the Statute of the ESCB authorises the ECB and the NCBs to conduct credit operations based on adequate collateral. The collateral must meet high credit standards, and risk control measures are applied to the assets underlying monetary policy operations in order to protect the Eurosystem against the risk of a financial loss if underlying assets have to be

realised owing to the default of a counterparty. Credit standards are assessed taking into account, inter alia, credit ratings awarded by market agencies, guarantees, as well as some institutional criteria.

In general, the high credit quality assets that are eligible as Eurosystem's collateral would be expected to trade at a premium over non-eligible bonds, thus providing an opportunity to sanction Member States in breach of the SGP by downgrading their government bonds as collateral for use in monetary policy operations.

A decision by the Eurosystem to affect the relative attractiveness of government bonds issued by euro area governments would raise several technical and institutional problems.

From a *technical perspective*, it would not seem possible to discriminate between government bonds in the context of the current rules, which are uniformly applied across the whole range of eligible assets. While some of the risk control measures involve some judgement, it would be inconsistent with the current framework to introduce a restriction on the bonds of a particular euro area Member State in the absence of a signal from the market, such as a credit rating downgrade.

More likely, using the operational framework of the Eurosystem's monetary policy to penalise fiscal behaviour not consistent with the SGP would require the introduction of special rules for euro area bonds. For instance, the new rules could state that when a Member State has a budget deficit above 3% its bonds are excluded from the eligible collateral, or are subject to larger valuation haircuts. These ad hoc rules would amount to creating a distortion in bond markets, in contrast to the Treaty requirement that the Eurosystem act in accordance with the principle of an open market economy with free competition and favouring an efficient allocation of resources (for instance, Article 105).

Private institutions and individuals holding the government bonds concerned would suffer a

<sup>11</sup> The pros and cons of various possible arrangements for joint government debt issuance were examined in detail by the Giovannini Group in 2000.

<sup>12</sup> The predominant view in the Giovannini Group was that this inconsistency could only be resolved by an amendment of the Treaty, removing the "no-bail out" clause.



wealth loss. The Eurosystem itself would bear a cost, as it would be obliged to accept lower quality assets due to its discrimination against euro-area government bonds.

From an *institutional perspective*, a decision to discriminate between euro-area government bonds on the basis of budgetary performance would, in effect, assign the Eurosystem an institutional role in budgetary surveillance. This would be inconsistent with the allocation of responsibilities in the EMU economic policy framework.

To sum up, the operational framework for the single monetary policy is designed to achieve an efficient and safe implementation of monetary policy. Requiring it to play a role in budgetary surveillance would seem against the spirit and the letter of the EMU economic policy framework and would introduce distortions in the euro area bond market.

## 5. Conclusion

Overall, euro-area government bond yields confirm that financial markets in EMU where tax raising authority rests with Member States and when there is minimal risk of default on debt, are unlikely to provide strong incentives for governments to run sound public finances. Narrow spreads of some 0-50 basis between euro-area government bond yields can be explained by the elimination of exchange risk and the progress in budgetary consolidation in recent years which has significantly improved the sustainability of public finances. The remaining yield spreads within the euro area are mainly comprised of premia relating to credit

risk and liquidity risk, neither of which is very significant in the case of euro-area sovereign debt.

The limited reaction of euro area yield spreads in the face of non-compliance with Treaty and SGP budgetary requirements also seems consistent with rational and efficient behaviour in bond markets. It reflects markets' view that the present deterioration is too small to fundamentally alter the assessment of the sustainability of public finances. Indeed, it could be regarded as a signal of continued credibility in the SGP framework and that the deterioration will be temporary and corrected within a reasonable period of time.

Possible regulatory or administrative measures to increase the scope for market pressure (e.g. use of capital adequacy rules, arrangements for joint issuance of euro-area government debt and the eligibility and pricing mechanism of collateral used by the Eurosystem) therefore appear to be both unnecessary and unjustified. In particular, the measures to encourage investor discrimination between euro-area bonds on the basis of non-compliance with EU budgetary requirements would introduce distortions elsewhere in the economic and financial system.

Problems related to public finances should be tackled at source via the timely, efficient and transparent implementation of the SGP rather than indirectly via financial market instruments designed to pursue other policy objectives. To this end, the Commission in November 2002 adopted a Communication on "Strengthening the co-ordination of budgetary policies".<sup>13</sup>

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<sup>13</sup> [http://europa.eu.int/comm/economy\\_finance/publications/sgp/com2002668\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/sgp/com2002668_en.htm)

## IV. References to further work

### 1. Policy documents

EUROPEAN ECONOMY No. 1. 2003.

**The report on the implementation of the 2002 Broad Economic Policy Guidelines**

The Commission issued a report that occupies an important place in the economic policy co-ordination process. The "report on the implementation of the 2002 Broad Economic Policy Guidelines" gives an account of how well the 2002 and earlier Broad Economic Policy Guidelines have been carried out.

[http://europa.eu.int/comm/economy\\_finance/publications/implement\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/implement_en.htm)

**Joint report by the Commission and the Council on adequate and sustainable pensions**

[http://europa.eu.int/comm/economy\\_finance/epc/documents/pension\\_report\\_2003.pdf](http://europa.eu.int/comm/economy_finance/epc/documents/pension_report_2003.pdf)

**Joint report by the Commission and the Council on supporting national strategies for the future of health care and care for the elderly**

[http://europa.eu.int/comm/economy\\_finance/epc/documents/coreper\\_joint\\_health\\_care\\_report.pdf](http://europa.eu.int/comm/economy_finance/epc/documents/coreper_joint_health_care_report.pdf)

**Economic Policy Committee: Annual Report on Structural Reforms 2003**

[http://europa.eu.int/comm/economy\\_finance/epc/documents/ar03final\\_en.pdf](http://europa.eu.int/comm/economy_finance/epc/documents/ar03final_en.pdf)

OCCASIONAL PAPERS. No.2.

**Economic review of EU Mediterranean partners**

[http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/occasionalpapers2\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers2_en.htm)

OCCASIONAL PAPERS. No.1.

**The Western Balkans in transition**

The main purpose of this publication is to give an overview of recent macroeconomic and structural developments for the countries of the Western Balkan region by providing (1) a broad overview of macroeconomic trends in the region and EU relations; (2) a section on fiscal consolidation in the Western Balkans, and (3) a section on macroeconomic developments, structural reforms and international relations for each of the Western Balkan countries.

[http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/occasionalpapers1\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers1_en.htm)

**Activities.** Stability and Growth Pact (SGP) and fiscal surveillance

[http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

### 2. Analytical documents

ECONOMIC PAPERS. No. 181.

Michael A. Landesmann (The Vienna Institute for International Economic Studies)

**Structural features of economic integration in an enlarged Europe: patterns of catching-up and industrial specialization**

This paper discusses the evolution of competitiveness, industrial and trade specialisation in the manufacturing sector of the countries of Central and Eastern Europe (CEECs). It is shown that the paths taken by the different CEECs have been quite diverse and we attempt to apply a combination of a catching-up plus trade specialisation model which is required to understand the patterns of specialisation emerging in Central and Eastern Europe.

[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers181\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers181_en.htm)





ECONOMIC PAPERS. No. 180.

Marco Buti (European Commission), Sylvester Eijffinger (CEPR) and Daniele Franco (Banca d'Italia)

**Revisiting the Stability and Growth Pact: grand design or internal adjustment?**

The Stability and Growth Pact is under fire. Problems have appeared in sticking to the rules. Proposals to reform the Pact or ditch it altogether abound. But is the Pact a flawed fiscal rule? Against established criteria for an ideal fiscal rule, its design and compliance mechanisms fare reasonably well. Where weaknesses are found, they tend to reflect trade-offs typical of supra-national arrangements. In the end, only a higher degree of fiscal integration would remove the inflexibility inherent in the recourse to predefined budgetary rules. This does not mean that the EU fiscal rules cannot be improved. However, given the existing degree of political integration in EMU, internal adjustment rather than attempting to re-design the rules from scratch appears a more suitable way to bring about progress. Redefining the medium term budgetary target, improving transparency, tackling the pro-cyclical fiscal bias in good times, moving towards non-partisan application of the rules and improving transparency in the data can achieve both stronger discipline and higher flexibility.

[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers180\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers180_en.htm)

**Scheduled Events:** The Brussels Economic Forum, Brussels, 10 -11 April 2003

[http://europa.eu.int/comm/economy\\_finance/events/2003/events\\_brussels\\_0403\\_en.htm](http://europa.eu.int/comm/economy_finance/events/2003/events_brussels_0403_en.htm)

**Past Events:** Who will own Europe? The internationalisation of asset ownership in the EU today and in the future, Brussels, 27 - 28 February 2003,

[http://europa.eu.int/comm/economy\\_finance/events/2003/events\\_workshop\\_0203\\_en.htm](http://europa.eu.int/comm/economy_finance/events/2003/events_workshop_0203_en.htm)

**Past Events:** Europe, the Mediterranean and the euro, Athens 3-4 February 2003

[http://europa.eu.int/comm/economy\\_finance/events/2003/events\\_athens\\_0203\\_en.htm](http://europa.eu.int/comm/economy_finance/events/2003/events_athens_0203_en.htm)

### ***3. Regular publications***

**Euro area GDP indicator** (Indicator-based forecast of quarterly GDP growth in the euro area)

[http://europa.eu.int/comm/economy\\_finance/indicators/euroareagdp\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/euroareagdp_en.htm)

**Business and Consumer Surveys** (harmonised surveys for different sectors of the economies in the European Union (EU) and the applicant countries)

[http://europa.eu.int/comm/economy\\_finance/indicators/businessandconsumersurveys\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/businessandconsumersurveys_en.htm)

**Business Climate Indicator for the euro area** (monthly indicator designed to deliver a clear and early assessment of the cyclical situation)

[http://europa.eu.int/comm/economy\\_finance/indicators/businessclimate\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/businessclimate_en.htm)

**Key indicators for the euro area** (presents the most relevant economic statistics concerning the euro area)

[http://europa.eu.int/comm/economy\\_finance/indicators/key\\_euro\\_area/keyeuroarea\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/key_euro_area/keyeuroarea_en.htm)

**Monthly and quarterly notes on the euro-denominated bond markets** (looks at the volumes of debt issued, the maturity structures, and the conditions in the market)

[http://europa.eu.int/comm/economy\\_finance/publications/bondmarkets\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/bondmarkets_en.htm)

**Price and Cost Competitiveness**

[http://europa.eu.int/comm/economy\\_finance/publications/priceandcostcompetitiveness\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/priceandcostcompetitiveness_en.htm)

## IV. Key indicators for the euro area

		2001	2002	2003	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
<b>1 Output</b>										
Industrial confidence <sup>1.1</sup>	Balance	-10	-12		-12	-11	-11	-9	-10	-11
Industrial production <sup>1.2</sup>	Mom %ch	5.7	5.6		-0.1	0.0	0.7	-1.5		
		2001	2002*	2003*	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Gross domestic product <sup>1.3</sup>	Ann. % ch	1.5	0.8	1.8	0.4	0.3	0.6	0.9	1.3	
	Qtr. % ch				-0.2	0.4	0.3	0.4	0.2	
<b>2 Private consumption</b>		2001*	2002*	2003*	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
Consumer confidence <sup>2.1</sup>	Balance	-6	-11		-9	-12	-14	-16	-18	-19
Retail sales <sup>2.2</sup>	Ann. % ch	1.3	1.3		-0.9	0.7	-0.5	-1.1		
		2001*	2002*	2003*	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Private consumption <sup>2.3</sup>	Qtr. % ch	1.8	0.6	1.7	0.1	-0.2	0.4	0.4	0.4	
<b>3 Investment</b>		2001	2002*	2003*	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Capacity utilisation <sup>3.1</sup>	%	83.5	81.2		81.8	81.1	81.2	81.0	81.5	80.7
Gross fixed capital formation <sup>3.2</sup>	Qtr. % ch	-0.3	-1.9	2.0	-0.9	-0.2	-1.3	-0.2	-0.1	
Change in stocks <sup>3.3</sup>	% of GDP	-0.2	-0.1	0.1	-0.5	-0.4	-0.3	-0.3	-0.2	
<b>4 Labour market</b>		2001	2002*	2003*	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
Unemployment <sup>4.1</sup>	%	8.0	8.2	8.3	8.3	8.4	8.5	8.5	8.6	
		2001	2002*	2003*	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Employment <sup>4.2</sup>	Ann. % ch	1.4	0.4	0.4	0.8	0.7	0.5	0.3		
Wages <sup>4.3</sup>	Ann. % ch	7.8	3.8		5.0	5.0	4.0	3.0	3.0	3.0
<b>5 International transactions</b>		2001	2002*	2003*	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
Export order books <sup>5.1</sup>	Balance	-14	-22		-22	-20	-20	-19	-20	-19
Exports of goods <sup>5.2</sup>	Bn. EUR	767.4	776.9	823.4	89.7	98.0	92.8	84.4	92.0	
Imports of goods <sup>5.3</sup>	Bn. EUR	802.2	781.6	828.1	80.7	89.3	83.2	77.1	79.9	
Trade balance <sup>5.4</sup>	Bn. EUR	-34.8	-4.7	-4.7	9.0	8.7	9.6	7.4	12.0	
		2001	2002*	2003*	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Exports of goods and services <sup>5.5</sup>	Qtr. % ch	4.3	0.7	6.1	-1.1	0.2	1.7	2.1	0.0	
Imports of goods and services <sup>5.6</sup>	Qtr. % ch	2.1	-1.6	6.2	-1.2	-1.0	1.5	1.8	0.6	
		2001	2002*	2003*	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
Current account balance <sup>5.7</sup>	Bn. EUR	-12.3	9.6	11	8	3.7	10.3	8.1		
Direct investment (net) <sup>5.8</sup>	Bn. EUR	-101.5	38.1		-3.2	-5	3.9	9.6		
Portfolio investment (net) <sup>5.9</sup>	Bn. EUR	-21.0	50.4		16.8	19.4	9.7	-13.9		
<b>6 Prices</b>										
HICP <sup>6.1</sup>	Ann. % ch	2.5	2.2	2	2.1	2.2	2.3	2.3	2.2	2.3
Core HICP <sup>6.2</sup>	Ann. % ch	2	2.0		2.5	2.4	2.3	2.2	2	
Producer prices <sup>6.3</sup>	Ann. % ch	2.2	1.7		0.1	0.9	1.1	1.5	0.8	
Import prices <sup>6.4</sup>	Ann. % ch	0.4	-1.4	0.3						
<b>7 Monetary and financial indicators</b>		2001	2002	2003	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03
Interest rate (3 months) <sup>7.1</sup>	% p.a.	4.3	3.3		3.3	3.3	3.1	2.9	2.8	2.7
Bond yield (10 years) <sup>7.2</sup>	% p.a.	5	4.8		4.4	4.4	4.2	4.3	4.2	4
Stock markets <sup>7.3</sup>	Index	4047	3053		2450	2385	2559	2477	2377	2176
M3 <sup>7.4</sup>	Ann. % ch	5.3	5.6		7.1	7.1	7.0	6.9	7.1	
Credit to private sector (loans) <sup>7.5</sup>	Ann. % ch	7.9	7.7		5.1	5	4.5	4.7	5	
Exchange rate USD/EUR <sup>7.6</sup>	Value	0.9	0.94	0.98	0.98	0.98	1	1.02	1.06	1.08
Nominal effective exchange rate <sup>7.7</sup>	Index	80.1	82.2	83.7	97.7	97.9	98.9	100	102.6	104

\* ECFIN Autumn 2002 forecasts (*European Economy*, No 5/2002 -November 2002)



Number	Indicator	Note	Source
<b>1</b>	<b>Output</b>		
1.1	Industrial confidence indicator	Industry survey, average of balances to replies on production expectations, order books, and stocks (the latter with inverted sign)	ECFIN
1.2	Industrial production	Volume, excluding construction, wda	Eurostat
1.3	Gross domestic product	Volume (1995), seasonally adjusted	Eurostat
<b>2</b>	<b>Private consumption</b>		
2.1	Consumer confidence indicator	Consumer survey, average of balances to replies on four questions (financial and economic situation, unemployment, savings over next 12 months)	ECFIN
2.2	Retail sales	Volume, excluding motor vehicles, wda	Eurostat
2.3	Private consumption	Volume (1995 prices), seasonally adjusted	Eurostat
<b>3</b>	<b>Investment</b>		
3.1	Capacity utilization	In percent of full capacity, manufacturing, seasonally adjusted, survey data (collected in each January, April, July and October).	ECFIN
3.2	Gross fixed capital formation	Volume (1995 prices), seasonally adjusted	Eurostat
3.3	Change in stocks	In percent of GDP, volume (1995 prices), seasonally adjusted	Eurostat
<b>4</b>	<b>Labour market</b>		
4.1	Unemployment	In percent of total workforce, ILO definition, seasonally adjusted	Eurostat
4.2	Employment	Number of employees, partially estimated, seasonally adjusted	ECB/ Eurostat
4.3	Wages	Not fully harmonised concept, but representative for each Member State (mostly hourly earnings)	ECFIN
<b>5</b>	<b>International transactions</b>		
5.1	Export order books	Industry survey; balance of positive and negative replies, seasonally adjusted	ECFIN
5.2	Exports of goods	Bn. EUR, excluding intra euro area trade, fob	Eurostat
5.3	Imports of goods	Bn. EUR, excluding intra euro area trade, cif	Eurostat
5.4	Trade balance	Bn. EUR, excluding intra euro area trade, fob-cif	Eurostat
5.5	Exports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.6	Imports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.7	Current account balance	Bn. EUR, excluding intra euro area transactions; before 1997 partly estimated	ECB
5.8	Direct investment	(net) Bn. EUR, excluding intra euro area transactions	ECB
5.9	Portfolio investment	(net) Bn. EUR, excluding intra euro area transactions	ECB
<b>6</b>	<b>Prices</b>		
6.1	HICP	Harmonised index of consumer prices	Eurostat
6.2	Core HICP	Harmonised index of consumer prices, excluding energy and unprocessed food	Eurostat
6.3	Producer prices	Without construction	Eurostat
6.4	Import prices	Import unit values for goods	Eurostat
<b>7</b>	<b>Monetary and financial indicators</b>		
7.1	Interest rate	Percent p.a., 3-month interbank money market rate, period averages	Datastream
7.2	Bond yield	Percent p.a., 10-year government bond yields, lowest level prevailing in the euro area, period averages	Datastream
7.3	Stock markets	DJ Euro STOXX50 index, period averages	Datastream

7.4	M3	Annual percentage growth rate of seasonally adjusted flows, moving average (3 last months): from 1997 onwards corrected for holdings by non-residents	ECB
7.5	Credit to private sector (loans)	Annual percentage change, MFI loans to euro area residents excluding MFIs and general government, monthly values: month end values, annual values: annual averages	ECB
7.6	Exchange rate USD/EUR	Period averages, until December 1998: USD/ECU rates	ECB
7.7	Nominal effective exchange rate	Against 13 other industrialised countries, double export weighted, 1995 = 100, increase (decrease): appreciation (depreciation)	ECFIN

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Comments on the report would be gratefully received and should be sent to:

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