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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE, THE COMMITTEE OF THE REGIONS
AND THE EUROPEAN CENTRAL BANK**

– Annual Statement on the Euro Area 2007 –

[SEC(2007) 550]

I. INTRODUCTION

1. ***Earlier this year, European leaders endorsed a solemn declaration in Berlin to mark the 50th Anniversary of the Treaty of Rome and reaffirmed their commitment to a project that has paved the way for peace and prosperity in Europe.*** Economic integration is central to this European success story. A gradual elimination of economic barriers over the last half-century has helped to raise living standards, ensure a fairer deal for consumers, create new opportunities for investors and foster closer economic and political ties between Member States. As the Berlin declaration says, "the common market and the euro make us strong".

2. ***Economic and Monetary Union (EMU) is the most advanced stage of European economic integration to date and it will continue to be an important driver of ever closer union in the coming years.*** For the 318 million people that use the euro on a daily basis, the single currency is a tangible symbol of the shared successes and challenges facing Europeans. Since the euro was launched in 1999, EMU has delivered a high degree of macroeconomic stability and encouraged closer trade and investment ties and deeper financial-market integration in the euro area. During this time, the euro has emerged as a major global currency and is now widely used as an anchor or reference currency in foreign-exchange arrangements and as an official reserve currency. These and other benefits from EMU should represent strong incentives for countries to sign up to the euro.

3. ***Encouraged by Slovenia's adoption of the euro on 1 January 2007, other Member States are stepping up their preparations to enter the euro area.*** Earlier this year, Cyprus and Malta submitted formal requests to the European Commission and the ECB to prepare Convergence Reports on the basis of which the Council of Ministers will decide whether these Member States can join the euro area on 1 January 2008.

4. ***There is a growing awareness that being a member of the euro area means confronting common challenges and responsibilities.*** At this year's Spring European Council, EU leaders, in their annual assessment of the renewed Lisbon Strategy, endorsed a new set of euro-area specific recommendations in the context of the Integrated Guidelines for Growth and Jobs. The recommendations emphasise the need for prudent fiscal policies, improvements in the quality of public finances and greater adaptability in the markets for goods and services. They also call for a better alignment of wage and productivity developments and an accelerated pace of financial-market integration.

5. ***The Annual Statement on the Euro Area, and its companion piece, the Annual Report on the Euro Area, present the Commission's views on how euro-area countries can meet their shared responsibilities and challenges.*** They are also designed to inform the debate on the euro-area's economic performance and the functioning of EMU. The Annual Statement on the Euro Area also serves as a contribution to the European Commission's dialogue with the European Parliament on euro-area economic policy.

II. THE EURO-AREA'S RENEWED ECONOMIC VIGOUR

6. ***Since last year's Annual Statement on the Euro Area, the euro-area's economic recovery has gone from strength to strength.*** The euro-area grew by 2.7% last year, its fastest growth rate since 2000, and well-above its long-term average. Employment growth accelerated to

around 1.5% in 2006 in the euro area, yielding an increase of close to 2 million new jobs. Inflation remained around 2% in 2006 but it came down towards the year's end as energy prices eased.

7. *The euro-area's positive growth performance partly reflects the current cyclical upturn but it may also show that structural reforms are beginning to take effect.* There are signs of an increased resilience to global disturbances. The employment effect of recent growth has been particularly intense. In December 2006, the unemployment rate dropped to 7.5%, its lowest level in 15 years. Labour productivity growth in the euro area averaged 1% in 2006, compared with an annual average rate of 0.7% during the previous decade, and several factors indicate that this rebound could be more than just cyclical in nature. Overall, these developments suggest that Member States are being rewarded for their efforts to, *inter alia*, increase labour participation rates, boost R&D and innovation, develop human capital and create a more attractive and competitive business environment. They also show the benefits of a macroeconomic framework that is designed to enhance stability and promote greater certainty about medium-term economic prospects.

8. *Domestic demand is an important driver of economic growth in the euro area.* This is reflected in the continued buoyancy of investment spending and the revival in household spending thanks, in part, to greater consumer confidence and the euro-area's strong employment performance. Euro-area exports also made a positive contribution to growth despite less favourable economic conditions in some of its key trading partners and the appreciation of the euro.

9. *The prospects for continued economic growth in the euro area are more favourable in 2007 than they have been for many years.* Domestic demand is expected to maintain its relatively strong momentum, with investment benefiting from ongoing favourable financial conditions, improved corporate balance sheets, the need for replacement investment, productivity gains and a positive outlook for profits. Global economic growth is likely to moderate somewhat but euro-area exports are well placed to continue their strong performance.

10. *As ever, there may be economic surprises around the corner.* A disorderly correction of global imbalances, exchange-rate tensions and geo-political developments are among the factors that could lead to lower-than-expected growth in the euro area. Conversely, a stronger labour market performance and a more-benign-than-expected impact of ongoing fiscal consolidation efforts could lead to higher-than-expected growth.

III. PUTTING THE MACROECONOMIC HOUSE IN ORDER

11. *Macroeconomic policy needs to be on a sound footing for the euro-area's economic recovery to continue.* Since December 2005, the European Central Bank has been withdrawing the stimulus provided in recent years in view of the medium-term risks to price stability. Alongside this, the process of wage determination in euro-area members must pay sufficient regard to price stability, trends in productivity over the medium-term and differences across skills and local labour-market conditions. Wages in the euro area continued to grow moderately in 2006 in spite of price developments and strong output and employment growth. Although significant cross-country differences remain, overall wage growth in the euro area appears to have been dampened since the 1990s, thus reducing the potential for second-round

effects induced by the previous oil price increases. In the budgetary sphere, it is essential that Member States seize the opportunity created by the economic upturn to complete the consolidation of their budgetary positions before the end of the decade. Such fiscal consolidation would also enhance the euro-area's overall fiscal-monetary policy mix.

12. *Euro-area members have made a concerted effort to correct excessive budget deficits.* On 30 January 2007, the Council decided that the excessive deficit procedure against France should be closed as its budget deficit remained below 3% also in 2006. In Germany, the economic recovery has helped to bring the budget deficit below 3% of GDP one year ahead of schedule. In Greece, there has been a strong correction in 2006 which has led the budget deficit to remain at 2.6% of GDP. Portugal and Italy have also recorded a significant structural improvement in 2006, masked in the case of the latter by the effect of one-off measures. In the euro area as a whole, the quality of the adjustment has increased, with less reliance on one-off measures, and a decrease in public expenditure. Overall, the combination of the consolidation efforts, notably in countries with excessive deficits, and improved economic developments, leading to substantially higher-than expected revenues, has reduced the euro-area's budget deficit to 1.6% of GDP in 2006, down from 2.5% of GDP in 2005.

13. *Member States, especially those that are in the process of correcting excessive deficits, must press ahead with budgetary consolidation to meet their medium-term budgetary objectives.* Some Member States planned little or no improvement in their structural balances in their 2006 Stability Programmes, even though the Stability and Growth Pact calls for budgetary consolidation that goes beyond the benchmark of 0.5% of GDP during the good times. France, for example, in its programme, plans to improve its structural balance by just 0.3 percentage points of GDP in 2007. Germany in its stability programme plans no improvement of its structural balance in 2008 even though "good times" are forecast. Some euro-area members that have reached their medium-term objectives are at risk of a pro-cyclical fiscal stance in 2007, notably in the Netherlands where a significant deterioration is expected this year even though "good times" are forecast. This situation calls for renewed efforts: Member States that fail to make sufficient progress in spite of the favourable growth may not achieve a sufficient safety margin against breaching the 3% of GDP deficit threshold if and when the pace of economic growth slows, thus repeating the policy mistakes of the late 1990s. At the same time the reappearance of structural deficits in countries already in balance or in surplus should also be avoided.

14. *On 20 April 2007, the Eurogroup adopted orientations for fiscal policies in euro area Member States, recalling the commitment to actively consolidate public finances in good times and to use unexpected extra revenues for deficit and debt reduction.* With a view to improving the coordination of fiscal policies, euro area Finance Ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area. Firstly, they committed to build on the better-than-expected budgetary outcomes in 2006 and to pursue more ambitious budgetary targets than those set in the 2006 Stability Programmes. Secondly, they agreed to implement budgets for 2007 as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt. Thirdly, it was agreed that fiscal policy plans for 2008 should be carefully designed so as to accelerate adjustment towards the medium-term budgetary objectives for Member States which have not reached it and for those which have reached it to avoid fuelling macroeconomic imbalances.

15. *The euro-area's strong growth performance presents a golden opportunity for all euro-*

area members to put their fiscal houses in order. On the revenue side, there is a strong economic case for using revenue windfalls – i.e. from unexpectedly high economic growth – to reduce government borrowing. On the expenditure side, the experience of some Member States suggests that reductions in government spending tend to provide a more durable approach to deficit reduction. After the Stability and Growth Pact has successfully supported Member States in the reduction of the excessive deficits, the functioning of its preventive part should support Member States in eliminating deficits altogether in order to deal with the looming challenges. Following the orientations of the Eurogroup on fiscal policy would mean that most euro area members would achieve their medium-term budgetary objectives in 2008 or 2009 and all of them should aim for 2010 at the latest.

16. *Securing sound public finances will help euro-area members to address the economic implications of ageing populations.* Dramatic changes in the demographic structure of European populations mean that the old age dependency ratio is expected to increase from 25% at present to more than 50% by 2050 in most Member States. Some of them have already taken significant action to address this challenge. If the necessary measures are not taken soon, ageing will have a substantial budgetary impact in several euro area countries. Age-related public expenditure in the euro area, which includes spending on pensions, healthcare and long-term care, is projected to increase on average by around 4% of GDP by 2050 under a no-policy change scenario. This underlines the need for all Member States to achieve and maintain sound budgetary positions over the long-term in order to reduce significantly debt ratios and contain the subsequent projected increases in expenditure. This need is particularly acute in Member States, such as Greece and Portugal, which run the risk of posting double-digit increases in age-related public expenditure over the next decades.

17. *Safeguarding the long-term sustainability of public finances in the euro-area requires a three-pronged policy approach.* Firstly, Member States should, as already noted, step up efforts to consolidate their fiscal positions and meet their medium-term budgetary objectives under the Stability and Growth Pact. Secondly, the implementation of further structural reforms under the Lisbon Strategy will help to foster higher productivity growth and job creation thus countering the economic impact of ageing populations. Thirdly, reforms to pensions and health care systems and investment in improving years of life spent in good health have the potential to improve government finances over the long term.

18. *Ensuring the quality of public finances is also important, as recognised in Member States' National Reform Programmes and the EU's Integrated Guidelines for Growth and Jobs.* A key challenge for Member States is to meet budgetary targets while ensuring that tax and expenditure systems promote an efficient allocation of resources. Adapting tax structures and directing government expenditure towards items such as education and R&D can increase productivity growth and growth potential and bring important social and economic benefits in terms of innovation and human capital accumulation. Such policies can also help to put Member States' public finances on a more sustainable footing and improve the functioning of social models within the euro area.

19. *Political commitments to sound public finances should be reflected in national budgetary rules and institutions.* Research shows that Member States with well-designed numerical expenditure and revenue rules usually maintain a stronger grip on government borrowing. As discussed in this year's Annual Report on the Euro Area, Member States should, when designing these rules, pay careful attention to their coverage and the stabilisation function of fiscal policy. Effective fiscal institutions at the national level also have a role to

play. For instance, parliamentary budget committees can support the conduct of sound fiscal policies and, thus, reinforce the preventive arm of the Stability and Growth Pact.

IV. SECURING SUSTAINED ECONOMIC GROWTH

20. *As the euro area reaps the fruits of the Lisbon Strategy, it must also sow the seeds of further structural reform.* As emphasised by EU leaders at this year's Spring European Council with the adoption of specific recommendations for the euro-area, the Lisbon economic reform agenda is critical for boosting growth and jobs in all 27 Member States but it has an added dimension for the countries that share the single currency. In the first place, economic reforms will reduce inflationary bottlenecks in the euro area and help to sustain the economic recovery. In addition, well-functioning product, labour and capital markets are essential for ensuring a smooth adjustment to country-specific economic disturbances under EMU.

21. *The slow adjustment of some euro-area members to country-specific disturbances is proof that economic reforms need to go further.* A comprehensive study of adjustment by the European Commission finds that although the process of competitiveness adjustment in the euro area is dynamically stable, some Member States are adjusting too slowly to country-specific developments. This slow competitiveness adjustment has contributed to the persistence of cross-country growth and inflation differences in the euro area, thereby exacerbating the costs of policy inaction at the national level.

22. *The Internal Market is indispensable not only for the economic prosperity of the EU but also for the smooth functioning of EMU.* A dynamic and mature Internal Market can potentially encourage a closer alignment of national business cycles and speed up the adjustment of prices and wages to economic shocks. A key priority for euro-area and EU Member States alike is to ensure that the Internal Market is equipped to meet the opportunities and challenges of the 21st Century. When the Single European Act entered into force 20 years ago, a fairly homogenous European economy was strongly reliant on the mass manufacture of standardised products. In today's world of globalisation, new technologies and EU enlargement, an increasingly heterogeneous European economy is more and more reliant on knowledge-based and service sectors with a greater degree of product differentiation.

23. *At the request of EU leaders, the European Commission has prepared a vision paper which calls for the single market to adapt to new realities.*¹ The crux of the Commission's argument is that to deliver more tangible benefits for European citizens, entrepreneurs, workers and consumers the single market needs to go beyond measures to tackle cross-border legal obstacles to business. Today's policies to deepen the single market must be more impact-driven, more effective and more globally-oriented. The Commission will present a full review of the single market with concrete proposals for policy action in the autumn.

24. *In the area of financial market, the euro area should ensure leadership in stepping up the pace of integration at EU level, adding to the impetus already given by the euro.* Euro-area members have a particular need for financial integration as a means of boosting growth potential and facilitating adjustment to economic shocks. The Member States that share the

¹ 'A Single Market for Citizens', Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, Interim Report to the 2007 Spring European Council, Brussels, 21.2.2007, COM(2007) 60 final.

single currency are now already benefiting from highly integrated markets for derivatives, corporate bonds and money. The project to create a Single Euro Payments Area (SEPA) will also enable consumers, companies and other economic actors to make and receive payments in euro, whether between or within national boundaries under the same basic conditions, rights and obligations, regardless of their location. Further integration would provide more opportunities for cross-border risk sharing and favouring a more efficient allocation of resources across the area. Areas where progress should be sought include for example cross-border clearing and settlement transactions, euro-denominated government bond and bills markets – still segmented on the supply side – and mortgage markets at the wholesale (i.e. funding) and retail level.

25. *The Commission's White Paper on Financial Services Policy in 2005-2010 provides a road map for further financial market integration in the EU and euro area.* A timely and coordinated implementation and rigorous enforcement of the various legislative measures of the EU Financial Service Action Plan at the Member State level is of a considerable importance. There is also a need for continuous consultations, ex-post evaluation of existing EU policies and rules and impact assessments for new proposal. Alongside these measures, further efforts will be required, *inter alia*, to ensure that EU supervisory arrangements are well adapted to an integrated European financial market from the perspective of efficiency and stability.

26. *Labour-market reforms are bearing fruit in terms of employment and participation, but more can be done to facilitate adjustment in relative wages across sectors, promote labour participation and facilitate sectoral and geographical mobility.* Flexibility-enhancing labour-market reforms, heightened global competition and a reduction in the oil intensity of production and the strength of the euro exchange rate are among the factors that may have altered the process of wage formation in the euro area. This development notwithstanding, wage moderation remains essential for, *inter alia*, prolonging the economic recovery, anchoring inflation expectations and facilitating competitiveness adjustment.

27. *In the area of product market reform, euro-area members have also made progress but there is a need to further enhance competition, innovation and dynamism.* The adoption of the Services Directive in December 2006 is a major achievement. Ensuring its rapid implementation is a key priority and the euro area would benefit from coordinated efforts to achieve this goal. In its assessment of Member States' National Reform Programmes for Growth and Jobs, the Commission noted that all euro-area members had taken steps to promote better regulation and encourage R&D and the diffusion of innovation but called for more ambitious measures to tackle low productivity in the services sector. Further steps to enhance competition, including by better exploiting the potential of public procurement, and improvements to the business environment (e.g. access to financing, restrictive employment protection legislation) would allow consumers to benefit more widely from productivity gains and the best performing firms in the euro area to grow rapidly. Innovation is another area where there is a need to focus efforts. The challenges in high tech sectors and the persistent innovation deficit require the creation of a truly competitive Internal Market for services and an Internal Market for innovation. A clearer and more efficient Intellectual Property Rights system is currently lacking and the European Research area is still too fragmented.

28. *Following the Commission's proposal to establish a new Energy Policy for Europe, EU*

leaders agreed at this year's Spring European Council on targets to combat climate change and boost energy security and competitiveness. These goals will be reinforced by, *inter alia*, further efforts to create a true internal market for energy and gas and the development of a common external policy approach in support of energy policy. The EU's new energy policy, while paramount for all EU Member States, is relevant for the euro-area in view of possible implications for, *inter alia*, current-account and price developments.

V. INCREASING GLOBAL INTERDEPENDENCE

29. *The euro area is part of an increasingly interdependent global economy.* A notable development in 2006 was the euro's rising value against key trading partners. Over the year, the euro appreciated by around 11% against the US dollar and around 12½% against the Japanese yen. This strong performance has continued in the early months of 2007, leading in effective terms the exchange rate of euro area to just above its long-term level. Exchange rates should reflect economic fundamentals and excess volatility and disorderly movements in exchange rates are undesirable for economic growth. In emerging economies with large and growing current account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments will occur.

30. *Widening global imbalances are a warning sign for the global economy.* For the year as a whole, the US current account deficit widened to USD 857 billion, the largest in its history. In Japan, emerging Asian economies and oil exporting economies in the Middle East, current account surpluses continued to increase. China's global current-account surplus increased to USD 238.5 billion, exceeding its record in 2005. The euro-area's current account is close to balance but Europe would not be immune from the effects of a disorderly unwinding of global imbalances. Global imbalances remain an important challenge, and while they are showing some signs of stabilising, helped by some rebalancing of domestic demand growth, ensuring their orderly correction remains a priority. This will be important to avoid potential risks to financial stability and to minimise the risk of protectionist reactions.

31. *There is a now a broad consensus among policy makers on how to tackle the problem of global imbalances.* This has emerged as the outcome of the multilateral consultation process launched in April 2006 by the IMF, in which the euro area has actively participated along with four other major global players. This process of consultation on global imbalances has delivered positive outcome and the IMF should continue to monitor progress. The actions that key participants have agreed to implement are (i) increased national saving in the USA with measures to reduce the budget deficit and promote private saving, (ii) further structural reforms in Japan, including fiscal consolidation; (iii) greater exchange rate flexibility in a number of surplus countries in emerging Asia, in particular China, (iv) efficient absorption of higher oil revenues in oil-exporting countries, and (v) implementing structural reforms to sustain the growth potential and boost domestic demand in the euro area. The euro area is demonstrating its commitment to press ahead with further structural reforms. The priority now is for the other relevant actors to implement the agreed policy agenda in a timely manner in line with the IMF's multilateral and bilateral consultations.

VI. PROJECTING A STRONG VOICE ON THE GLOBAL STAGE

32. *Since last-year's Annual Statement on the Euro Area, several steps have been taken to*

improve the external representation of the euro area. EU Finance Ministers have asked EU Member States' IMF Executive Board Representatives to elect a longer-term chair. Details of these recommendations have been agreed upon but are not yet implemented. It was also agreed to appoint a Commission official in the office of a euro area IMF Executive Director, but, here too, implementation has not been achieved yet. Furthermore, the EU and Member States have agreed to support the Commission's participation in the G7 on all items within its competence. Euro area representatives, including the Commission, have also participated in all phases of the IMF multilateral consultation during the last year and euro area common positions and terms of references have been developed prior to the G7 and IMFC meetings.

33. *Further steps are needed before the euro-area's external representation is commensurate with its growing weight in the global economy.* A stronger external representation would also allow the euro area to show leadership on issues of its competency, such as global imbalances. While the best option for representation of the euro area in the key international financial fora and institutions remains the creation of a single euro-area chair, there are obstacles to achieving this in the short term, due, in part, to divisions among Member States. Building on the Communication, "Europe in the World", the Commission will continue to contribute actively to the development of develop common positions on the crucial issue of external representation.

34. *Global governance also needs to take greater account of emerging market economies and least developed countries.* This was reflected by the quotas-and-voice reform package agreed at the Annual Meetings of the IMF of Singapore in September 2006, which led to an increase of quotas for China and other emerging market economies. The discussion is now continuing on further reforms and representation at the IMF and the World Bank. Together with the euro area's ambition to speak with a single voice, the economic rise of the key emerging market countries is likely to act as a powerful wind of change for the international financial system.

35. *The euro area is fostering closer macroeconomic and regulatory cooperation with new partners as well as with existing ones.* Last year, the European Commission's annual macroeconomic and regulatory dialogue with the Chinese Ministry of Finance was complemented by a new dialogue with the Chinese National Development and Reform Commission. The regular dialogues with Japan continued and a new macroeconomic and financial regulatory dialogue with the Russian Government was held in 2006, reflecting the growing importance of Russia as a strategic partner of the EU. A new regular macroeconomic dialogue between India and the EU is also scheduled to begin this year. New macro-economic dialogues with Brazil and South Africa are also being explored to take into account of the role these countries pay in their respective regions and their strategic partnership with the Union and the euro area.

VII. PROMOTING EFFECTIVE AND LEGITIMATE POLICY MAKING

36. *To meet shared economic challenges, euro-area countries need an effective system of collective governance.* In this respect, the Eurogroup plays an increasingly important role in promoting a common understanding among euro-area members of shared policy challenges. Over the last twelve months, the Eurogroup has, with input from the Commission, sought to deepen its consensus on structural reform challenges and other matters relevant for the euro area, as highlighted by the euro-area recommendations in the context of the Integrated

Guidelines for Growth and Jobs. Some progress has been made towards improving the coordination of economic policies, as witnessed by the adoption of public orientation for budgetary policies and the increased attention to the coherence of macroeconomic policies and structural reforms. The goal now should be to turn this common understanding into concerted policies to meet these challenges and maximise the benefits of the single currency. A clearer propensity by Member States to engage in cooperative solutions may help policy discussions.

37. *The effectiveness of policy making in the euro area is important but so too is its legitimacy.* Mindful of this goal, the European Commission stands ready to participate in, and contribute to, the European Parliament's proposed dialogue on the key challenges facing the euro-area economy. The Annual Report on the Euro Area contributes to this understanding by presenting an analysis of the economic situation in the euro area, macroeconomic policy developments, structural-reform challenges and the external dimension of EMU.

38. *As EMU approaches its 10th anniversary, the European Commission will devote increasing attention to evaluating the functioning of EMU and identifying ways to maximise the potential of the euro-area economy.* A range of issues are relevant here including how well-equipped euro-area economic governance is to meet current and future challenges and whether policy makers at the European and national level can do more to achieve a policy mix that is conducive to higher growth and employment.

VIII. CONCLUSION

39. *Policy makers should seize the opportunity created by the euro-area's renewed economic vigour to secure sound public finances and push through further structural reforms.* The Annual Statement on the Euro Area has highlighted the most salient challenges for the euro area at this juncture. In the fiscal domain, Member States must resist the temptation of fiscal loosening by intensifying efforts to meet and maintain their medium-term budgetary objectives and improving the structure and quality of public finances. Putting the Eurogroup's recent orientations on fiscal policy into practice will be very important to complete the consolidation at the level of the euro area as a whole, further strengthening the credibility of budgetary authorities, and benefiting the fiscal-monetary policy mix. In the structural domain, Member States are benefiting from past policies but further reforms are indispensable for enhancing the smooth functioning of EMU and boosting long-term living standards. At the global level, the euro-area has taken steps over the last year to strengthen its external representation in international institutions and fora and to foster macroeconomic dialogues with strategic economic partners, also with a view to addressing global imbalances. Further steps will be necessary, however, before the euro area can truly speak with one voice on international economic issues.