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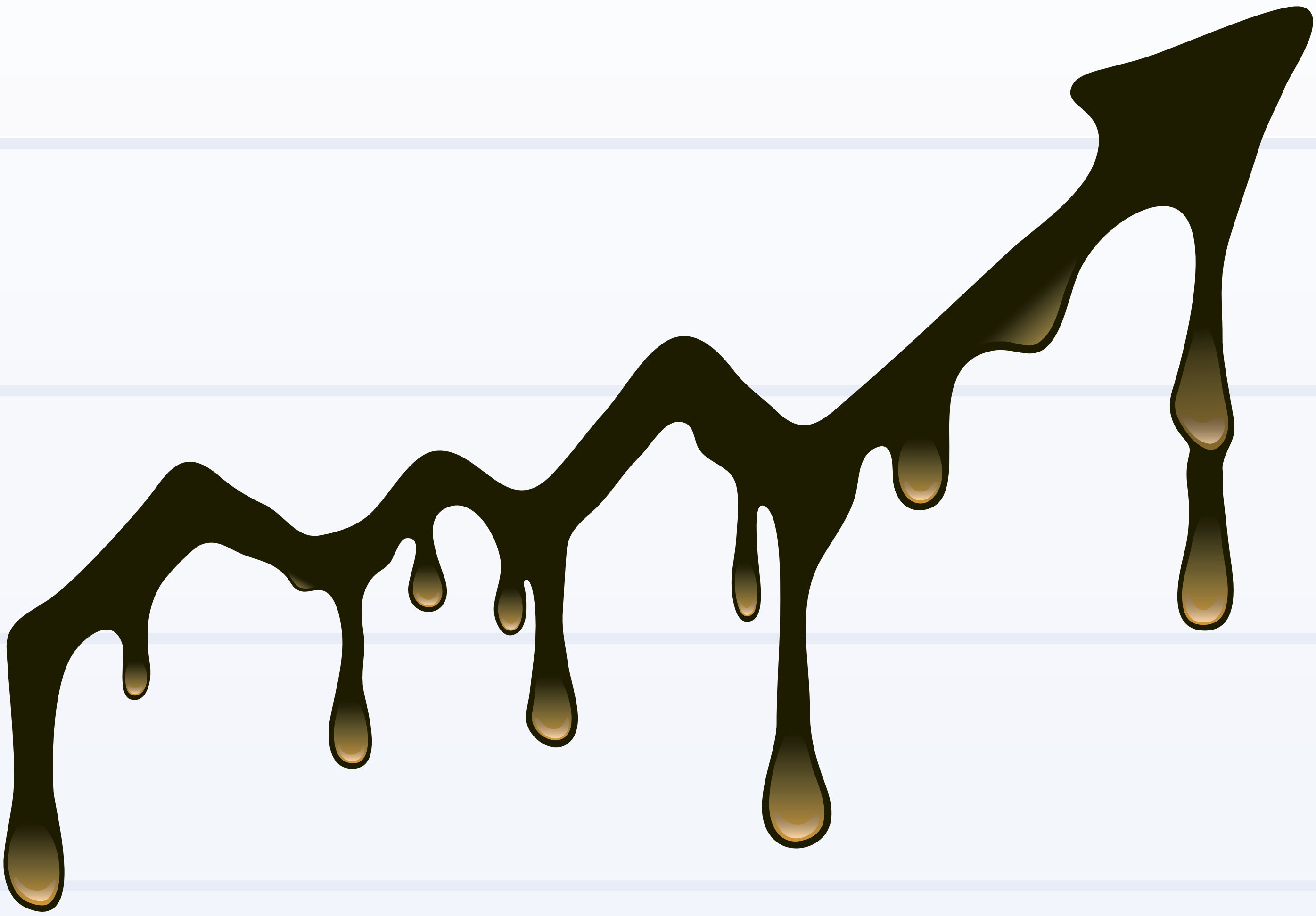
The price is tight



Magazine of the Directorate-General for Economic and Financial Affairs

EUROPEAN COMMISSION

Economic and Financial Affairs
DIRECTORATE-GENERAL

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Editorial

Marco Buti

Welcome to this edition of *European Economy News*. At the time of writing, the international financial system is in crisis. While the international financial community is pondering the appropriate response, time will be needed to address the fundamental shortcomings of the global financial system. In addition to the turmoil in financial and asset markets, world growth is slowing, inflation is well above target following massive rises in food and oil prices, and the slump in housing markets that started in the US has spread. The slowdown is being reinforced by the squeeze on credit and the collapse of consumer and business confidence, which are holding back spending and investment. While both the euro area and the EU as a whole enjoy sound economic fundamentals and are relatively better placed to ride out the storm than they have been in the past, Europe is not immune from the current shocks: its growth forecasts are down and the outlook is markedly gloomier than it was even a few months ago.

In this issue we take a close look at one aspect of the current difficult economic climate: soaring commodity prices. This phenomenon has hit ordinary people hard in both developing countries and the EU as everyday expenses have skyrocketed. Oil prices have been driven up by rising demand – outpacing supply – and falling reserves, while food prices have in turn been pushed up by the impact of high energy prices on production and transport as well as a growing population, changing diets in many emerging economies, and the effect of adverse weather conditions on agricultural production.

The strong euro has protected Europeans to some degree by partially offsetting high prices expressed in dollars. But, while prices are now coming down from their peak, there is no prospect that they will return to their earlier levels. While short-term measures, such as releasing agricultural stocks, are helping to alleviate immediate problems, long-term solutions must be found. DG ECFIN is making a significant contribution to the Commission's work on these issues, which include agricultural sustainability, diversification of energy sources, and energy efficiency.

Marco Buti
Acting Director-General, Economic and Financial Affairs DG

What's new

Meeting at the IMF

On 11 October 2008, the IMF's International Monetary and Financial Committee (IMFC) – its policy-guiding body – held its annual meeting in Washington, DC. Commissioner Joaquín Almunia represented the EU Commission at the gathering, which primarily discussed the ongoing impact of financial turmoil on the world economy as well as a new set of principles and practices for sovereign wealth funds. The Commissioner also attended the G7 Ministers of Finance meeting on 10 October in Washington.
www.imf.org/external/am/2008

European Parliament

Dialogue for constraint at the European Parliament

As part of the regular exchange of views between the European Central Bank and the members of the Economic and Monetary Affairs Committee of the European Parliament (ECON), ECB President Jean-Claude Trichet addressed the ECON committee on 10 September. Pointing to surges in international energy and food prices as the main cause, he forecast that euro-area inflation is likely to remain high for quite some time before moderating to 2.3%-2.9% in 2009. He went on to warn of the dangers of "second-round effects" in price and wage setting, meaning that higher wage settlements as a result of inflation would only stoke inflation further into an upward spiral. In particular, he highlighted the threat from national wage indexation schemes that do not reflect an economy's competitive position. These can harm stability and growth, he said, dampening output and employment, and leading to accumulating imbalances in national finances. He reiterated the ECB's resolute determination to keep inflation expectations anchored in line with price stability. President Trichet's speech can be found in the press section of the ECB's website.
www.ecb.int

DG ECFIN Annual Research Conference

Held on 16-17 October 2008, the 5th DG ECFIN Research Conference took as its topic: 'Boosting growth and productivity in an open Europe: the role of international flows of goods, services, capital and labour'. Increasing globalisation and progressive European integration are affecting the volumes and directions of international trade flows, not only for goods but also for capital, services and labour. Core questions for the conference participants were how international flows can affect growth and productivity, and whether policies for influencing these trade flows can support higher growth and productivity in the EU. Contributions to the Research Conference can be downloaded from the 'events' section of the DG ECFIN website.

Quarterly Report on the Euro Area: special edition

To mark the 10th anniversary of the launch of the euro, the June issue of the Quarterly Report on the Euro Area (QREA) is entirely devoted to EMU@10. With the title 'EMU@10 – Assessing the first ten years and challenges ahead', this special edition provides a three-part summary of the work presented in the recent Communication and report on ten years of the single currency. Part I of the QREA reviews the achievements and shortcomings of the first ten years of Economic and Monetary Union (EMU). Part II discusses forthcoming challenges. Part III presents the three-pronged policy agenda that the Commission has put forward to ensure that EMU can function even better in the future. The QREA special edition can be found in the 'publications' section of the DG ECFIN website.

Interim forecasts: a difficult and uncertain environment

A sharper-than-expected slowdown is how the September interim economic forecasts from DG ECFIN describe recent developments in the European economy. EU growth in 2008 is revised 0.5% downwards to 1.4% (1.3% for the euro area), and inflation revised upwards to 3.8%. "The continuation of the turmoil in the financial markets one year on, the near doubling of energy prices over the same period and the correction in some housing markets have had an impact on the economy," said DG ECFIN Commissioner Joaquín Almunia. Although inflation may be at a turning point, business and consumer confidence have been hit badly say the forecasters. The situation varies between Member States: some economies are at a standstill (UK and Italy), others are slowing (Germany and France), while some are struggling on (Poland and the Netherlands). And there are few silver linings ahead, warn the forecasters: the slump in housing markets appears to be spreading and, outside the EU, while emerging economies have maintained robust growth so far, a global economic slowdown is looming on the horizon – offering a bleak outlook for EU economies going forward. The latest forecasts can be found in the 'publications' section of the DG ECFIN website.

Bratislava castle, Slovakia

No harm to the citizen

Slovakia is busy preparing its administration, businesses and citizens to adopt the euro on 1 January 2009, following formal approval by the EU Council on 8 July this year. To replace the Slovak koruna (SKK) the National Bank of Slovakia is borrowing 188 million euro banknotes from Austria and has ordered 500 million euro coins with the Slovak design on the common side. Once the euro is introduced, stiff penalties are foreseen where unjustified price rises are detected – part of Slovakia's 'no harm to the citizen' initiative. Following the success of the adoption process in Slovenia, Cyprus and Malta, Slovakia is using the 'big-bang' process whereby hard euro cash is introduced immediately without a trial period as a 'virtual currency'. Furthermore, dual circulation of the euro and the koruna will only last 16 days, after which only the euro will be legal tender. Commissioner for Economic and Monetary Affairs, Joaquín Almunia contributed to a euro changeover conference in Bratislava on the preparations for euro adoption, hosted by the Prime Minister of the Slovak Republic, Robert Fico, on 22 September 2008. For more information on the Slovak strategy for adopting the euro see the national euro website. **www.euromena.sk**


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DG ECFIN workshop: keeping an eye on the markets

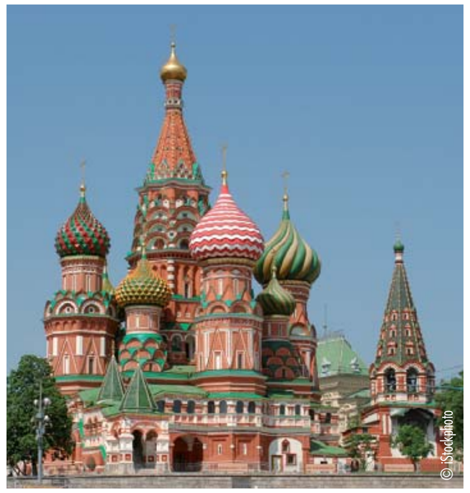
Held on 24 September, this workshop looked at new proposals for monitoring key markets in goods and services as part of the initiative to improve the governance of the single market and improve the functioning of individual market sectors. Methodologies for in-depth monitoring of various sectors, including the food supply chain, retail trade and electrical engineering, were covered by speakers drawn from across the EU and from the Commission. In addition, progress in applying the new methodologies at EU level, as well as the possibilities of implementing them at national level were discussed. For more information see 'events' on the DG ECFIN website.

Tracking microeconomic reforms

On 30 July, DG ECFIN launched the on-line Micref database, a tool for monitoring and analysing the reform process that is part of the EU Lisbon Strategy. In particular, Micref aims to improve the surveillance of microeconomic reforms and their implementation in three broad policy domains: open and competitive markets; business environment and entrepreneurship; and the knowledge-based economy. Information on the design and scope of such reforms is given and cross-country comparisons can be made. In co-operation with the Member States, the Micref database is constantly updated. It currently covers the years 2004-2006 and will shortly be extended forwards to 2008, and backwards to 2000. Micref complements a similar DG ECFIN database – Labref – which deals with labour reforms. More information and access to the database can be found in the 'economic databases and indicators' section on the DG ECFIN website.

ECB special edition

To mark its 10th anniversary, the ECB published a special edition of its monthly bulletin. It reports on the balance of the first ten years of a European Central Bank and also looks at challenges ahead. Chapters cover the institutional setting, the ECB's monetary policy strategy and its implementation, the euro's impact on trade, financial stability, financial integration and euro banknotes as a tangible symbol of European integration. In an annex, the bulletin gives ten years' worth of euro-area economic statistics and compares them to the wider EU, Japan and the US. The special edition can be downloaded from the ECB website.
www.ecb.int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St Basil's Cathedral in Moscow

An ECFIN conference on energy in Moscow

'The economic aspects of the energy sector in CIS countries' was the title of a high-level conference held at the EU delegation premises in Moscow on 27 June 2008. Inspired by the DG ECFIN Economic Paper of the same name, the conference focused on the macroeconomic aspects of the energy sector in the CIS and some of the challenges arising from their heavy reliance on it. Selected aspects of EU-CIS relations were covered as well as current trends and options for reform. Conference coordinator Lúcio Vinhas de Souza of DG ECFIN spoke on an impending energy crunch and the legal framework needed to avoid this crunch and allow the necessary investments to proceed. The conference contributions can be downloaded in the 'events' section of the DG ECFIN website.


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September Ecofin meeting in Nice

Commodity prices "going in the right direction"

"The fall in oil and food prices is going in the right direction and this should help to brake inflation," said Eurogroup President Jean-Claude Juncker at the Eurogroup/ECOFIN meetings on 12-13 September, although he went on to warn that, "This financial crisis will be on our agenda for a great number of months to come." Meeting in Nice under the French Presidency, the EU finance ministers turned away from the tax-cutting solutions being employed in the US and sought more structural answers. These include giving a boost to Europe's biggest employers, small and medium-sized enterprises, by asking the European Investment Bank to double its investment in such businesses – to 30 billion over three years – to help them through the credit crunch and protect employment and growth. "We're not simply adopting a 'wait and see' policy, we are not going to sit on our hands," said French Economy Minister Christine Lagarde, whose country holds the EU's rotating presidency. "We need to make sure that our economies perform well."

Further information
The latest news and press releases from DG ECFIN are available at:
http://ec.europa.eu/economy_finance/index_en.htm

Conference

The Lisbon Process: strengthening the delivery of reforms

How can the EU help Member States design the reform policies necessary to achieve higher economic growth and more jobs? Is the Lisbon Strategy effectively helping Member States? These and other questions lay at the heart of a conference – 'Strengthening delivery of Lisbon structural reforms in the Member States' – held on 19 September in Rome.


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In Rome on 19 September, key policy-makers and representatives from EU and international organisations discussed how to enhance the effectiveness of the Lisbon Strategy of structural European economic reform with a view to boosting jobs and economic growth inside the EU.

In his keynote speech, Marco Buti, acting Director-General for DG Economic and Financial Affairs, linked the critical importance of structural economic reform not only to the future prosperity of the EU in general but also to the euro area in particular.

Need to accelerate reforms

He explained that whilst EMU has been a great success, more economic reform in the euro area would have made it even more successful. Productivity and potential GDP growth would have been improved and the substantial and persistent differences in inflation and growth that exist across Member States could have been reduced.

Looking ahead, Buti argued, three long-term challenges – globalisation, climate change and an ageing population – are going to make it even more important that Member States, especially euro-area Member States, make extra efforts to enhance the flexibility of their economies by intensifying economic reforms. However, those extra reform efforts cannot be delayed; current economic difficulties mean that Member States already need to be enhancing their economic flexibility if they are to be able to hold off a downturn whilst containing the inflationary effects of record food and oil prices.

However, Buti told the audience, Member States' extra reform efforts needed to be well selected. Reforms specifically tailored to Member States' particular needs in meeting the current economic climate should be the priority. Broadly, such reforms would target economic resilience and adjustment capacity.

An evidence-based approach to reform

Naturally, tailoring reforms to individual Member States requires a good knowledge of their current state of reform and the progress that they are making. Lorenzo Codogno, Director-General of Economic and Financial Analysis and Planning at Italy's Ministry of Economy and Finance, and Chairman of the Economic Policy Committee's Lisbon methodology working group (LIME), and Gert-Jan Koopman, Director of Economic Service and Structural Reforms at DG Economic and Financial Affairs, made presentations on the progress Member States and the Commission have made to strengthen the analytical underpinnings of policy recommendations made under the Lisbon Strategy.

In particular, they outlined the LIME assessment framework, which is a consistent, evidence-based analytical approach that can be used to compare, in the context of the Lisbon Strategy, the performance of EU Member States in terms of GDP and 20 policy areas affecting growth.

This analytical framework[1] helps Member States assess the links between national reform policies and growth performance, as well as the channels through which reforms influence growth. In so doing, the framework and its underlying tools can be used to determine priorities amongst the different policy challenges facing each Member State. The framework also makes it possible to assess the reform effort required to tackle challenges in each policy area as well as the characteristics of successfully designed reforms.

The Rome conference served to inform experts and observers about the progress made in developing the analytical framework and to discuss how to advance it further.

Further information
http://ec.europa.eu/economy_finance/analysis_structural_reforms/growth_and_jobs249_en.htm

[1] *"The LIME assessment framework (LAF): a methodological tool to compare, in the context of the Lisbon Strategy, the performance of EU Member States in terms of GDP and in terms of twenty policy areas affecting growth", European Economy Occasional Paper (forthcoming).*

The rising cost of food and energy

Food and energy prices have reached troubling highs. In two Communications, the Commission has come up with a package of recommended measures that deal both with the immediate crisis and pave the way, in parallel with other EU policies, to a gradual shift towards more sustainability and efficiency.

Over the past couple of years, the world has endured the double blow of a food crisis and an energy crunch, with skyrocketing prices on commodity markets that hurt the poor and vulnerable – not only in developing countries but also in developed economies, fuel inflation and slow economic growth.

Several developing countries have witnessed food riots and some have put in place extraordinary measures, such as the suspension of exports of key foods and increased subsidies, to deal with the crisis. Jacques Diouf, the Director-General of the UN's Food and Agriculture Organisation, has warned that the current crisis is "a risk for peace and stability around the world".

While the effect is not as dramatic in Europe, many consumers have been feeling the pinch as food and energy together make up, on average, 30% of household spending. And, as winter approaches, there are worries that the "energy poor" may not be able to heat their homes adequately.

Between the end of 2006 and the first months of 2008, agricultural commodity prices rose by an average of 70% in dollar terms. For some staples, the rise has been even more dramatic, with rice rising by 217%, wheat 136% and maize 125%. Fortunately, for the euro area, this massive increase was cushioned somewhat by the strong performance of the euro against the dollar. At present, the worst seems to be over. In Europe, wheat prices have dropped by some 25% and butter prices by 35% compared with their peak levels.

Recent years have also seen the price of oil flare up to reach record highs. In dollar terms, prices more than doubled between the beginning of 2007 and the middle of 2008, and currently prices are about three to four times their levels in 2003. At the time of writing, oil prices were trading around US$100, compared with an average of around $73 per barrel in 2007. Again, the strong euro has taken some of the edge off that price shock. Given the high energy taxes in the EU, downstream price increases have been appreciable but less spectacular, with petrol prices at the pump rising by some 6%, diesel by 14% and heating oil by 17%.

Getting to the root of the problem

Although these two issues are important challenges in their own right, they are also intimately intertwined. "The changes in energy and food prices are interlinked," explains Michael Grams of DG ECFIN's unit for economic impact assessments and sustainable development strategies. "For instance, rising energy prices push up the cost of producing, transporting and processing agricultural commodities, while the rising cost of fossil fuels and supporting policies divert increasing amounts of agricultural produce to the production of biomass-based renewable energy, in particular biofuels."

"Agricultural and energy commodity markets are experiencing a complex mix of temporary and structural factors which are affecting prices. We can expect prices to fall away from their peak levels, as is already happening, but they are unlikely to reach the historical lows of recent years," notes Grams. "That means we have to take a longer-term view in our policies."

In the oil market, global demand, largely fuelled by emerging developing countries, has been rising faster than additional supplies can be tapped. "The rapid economic growth in developing countries is of course a positive development, but it is also one of the main factors behind the high oil prices," points out Asa Johannesson-Linden, also of the same unit. "OPEC has raised output this year, which should ease pressure, but no one believes that prices will fall back to their previous levels."

Although pumping and refining capacity is expected to catch up, the rising cost of extraction and the falling levels of proven reserves are likely to keep prices high. In the short term, this has been exacerbated by conflict and political instability in leading oil-producing regions, such as the Middle East and West Africa. The flight of investors from turbulent financial markets into 'safer' commodities, such as metals, oil and food, might also have played a role. There is a fairly common perception, too, that some of the volatility in commodity markets has been due to the activities of speculators.

In the food market, much like in the energy market, the structural shifts have been driven by the growth in world population and the growing demand for 'luxury' foods, such as meats, in emerging countries. As mentioned earlier, energy prices and biofuels are also playing a role. Temporary factors include adverse weather conditions, which may increase in the future with climate change.

"We can expect prices to fall away from their peak levels but they are unlikely to reach the historical lows of recent years. That means we have to take a longer-term view in our policies."

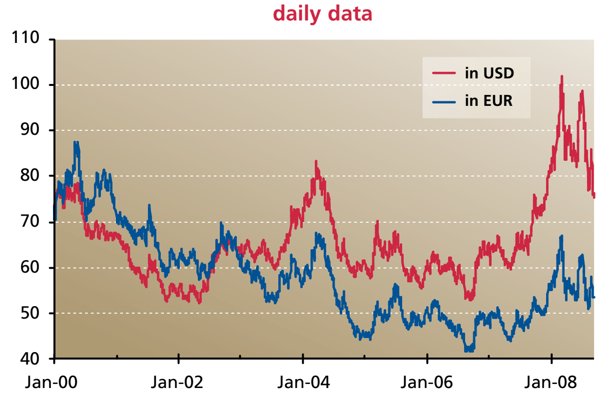
Michael Grams, DG ECFIN, Reforms under the sustainable development strategy unit

Rapid responses

In its two recent Communications on oil and food, the Commission proposes a broad range of policy responses to deal both with the immediate problems and the fundamental long-term challenges. Short-term actions include income support and food aid for the poorest and most vulnerable to enable them to weather the storm of higher food and energy prices.

On the food front, the usual market management under the common agricultural policy (CAP) has already contributed to filling the shortage by releasing intervention stocks. In addition, EU leaders agreed to put on ice temporarily the obligation that farmers leave fallow 10% of their arable land, to suspend import duties on most cereals and to raise milk quotas by 2%. "The

World, Dow Jones, Agriculture Index, Price Return
daily data



Source: Reuters EcoWin

Agriculture Commissioner Mariann Fischer Boel has ordered a 'health check' of the CAP to deal with the outstanding issues that had not been tackled by the last CAP reform in 2003," notes Grams. "The proposals would mean a further step towards market orientation in agriculture and enable European farmers to respond better to market signals."

On the energy front, the Commission has proposed a number of measures in the short to medium term, including promoting a dialogue between oil exporters and importers to stabilise international supplies. Mechanisms should also be found to encourage energy companies to invest in renewables and other alternatives.

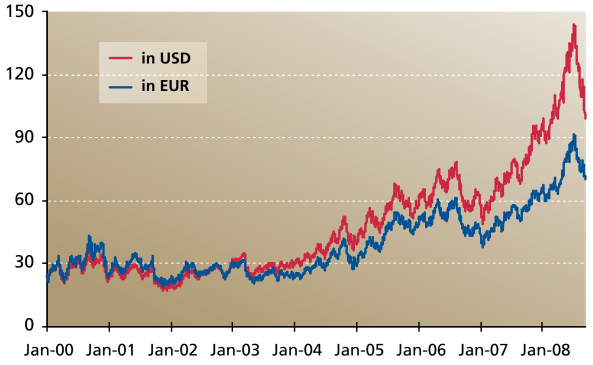
Johannesson-Linden warns against the temptation of reducing fuel taxes: "In the current situation, it may actually push up demand and will not help Europeans to make the necessary long-term adjustments. People and businesses are now beginning to change their behaviour," she observes. "Our policies need to encourage greater energy efficiency and the switch to cleaner energy."

At the request of the European Council, the Commission has also set up three task forces, co-chaired by DG ECFIN, to monitor price developments in commodity markets, investigate the potential impact of speculation on oil and food prices, and examine the competitiveness of the food supply chain across the EU.

In for a long haul

Since many of the challenges are structural, the Commission has presented a detailed prescription for what needs to be done. In the agricultural field, the sustainability of EU policy, and international policies, on biofuels needs to be enhanced to ensure that these energy sources are efficient and do not take food out of people's mouths. To this end, the Council is currently working on formulating sustainability criteria for biofuels. In addition, funding cutting-edge research into ways of promoting sustainable agriculture, boosting crop yields and dealing with the adverse effects of climate change on farming is an urgent priority.

Oil prices in EUR and USD
monthly data



Source: Reuters EcoWin

Globally, the Commission recommends that the EU should work towards the conclusion of the Doha trade talks, helping developing countries to make the necessary structural responses to deal with the demands of the future, and mobilising additional funds for short-term humanitarian aid to deal with food shortages.

In its energy, environmental and climate change policies, it is essential that the EU pursues energy efficiency and sustainability. Particular focus needs to be paid to energy-intensive sectors, transportation and the fishing industry. In addition, Europe should step up its assistance to oil-importing countries to help them switch to alternative sources.

If the EU does not pursue its renewables and energy diversification policies robustly, the Union's oil consumption is set to be 6% higher in 2030 than it is today, while renewables will only make up 12% of the energy mix. This would make the EU dependent on imports for two-thirds of its energy consumption, and 95% of its oil needs. ■

Further information
The two Communications: 'Facing the challenge of higher oil prices' and 'Tackling the challenge of rising food prices' can be downloaded from:
http://ec.europa.eu/commission_barroso/president/press/reports

Improving the quality of public finances

Public finances have improved significantly in the EU. However, the current economic downturn, demographic ageing, and global competition need addressing through a comprehensive fiscal policy approach that raises the quality of public finances and supports long-term economic growth, according to this year's 'Public Finances in EMU' report.

"The benefits of sound fiscal policies are clear: reducing deficits and debts and generally improving the quality of budgets would enable Member States to free the necessary resources to encourage innovation, investment, education and employment which, in turn, would allow them to face more confidently the challenges posed by globalisation and an ageing population," said Joaquín Almunia, Commissioner for Economic and Monetary Affairs, in presenting the annual Public Finances in EMU report in June.

Budget improvements in 2007

Member States markedly reduced fiscal deficits in 2007. Although differences remain large across countries, in 2007 the government deficit in the euro area was on average 0.6% of GDP, and in the EU as a whole 0.9% of GDP, the lowest levels since the early 1970s. The level of outstanding debt remained on a clear downward path, falling on average in the EU below 60% of GDP – the reference value set by the Stability and Growth Pact (SGP). In the euro area the average is approaching that target.

The improved budgetary balances resulted in a lower number of Member States subject to the excessive deficit procedure under the dissuasive arm of the SGP, an agreement under Economic and Monetary Union (EMU) on the conduct of fiscal policy in the EU. In January 2006, 12 countries were subject to the procedure. Two and a half years later, the number is now down to two. Five Member States have been removed from the list over the past year.

In 2007, some progress was also made with regard to medium-term budgetary objectives (MTOs) set in the annual stability and convergence programmes of the EMU countries. These targets are defined in structural terms; in other words, they are corrected for the cyclical ups and downs of the economy.

The MTOs, which currently range from -1% to +2% of GDP depending on the country, are meant not only to create a safety margin against budgets breaching the 3% fiscal deficit mark when the economy turns sour but also to ensure long-term fiscal sustainability in the light of the pressures from ageing populations. In 2007, about half of the Member States met or were close to their MTOs, but several others, including large economies such France and Italy, were still far away from them.

Facing challenges

Despite the overall improved public finances in 2007, Member States still face a number of major short- and medium-term challenges, which are compounded by shortcomings in fiscal prudence prior to improvements in 2007.

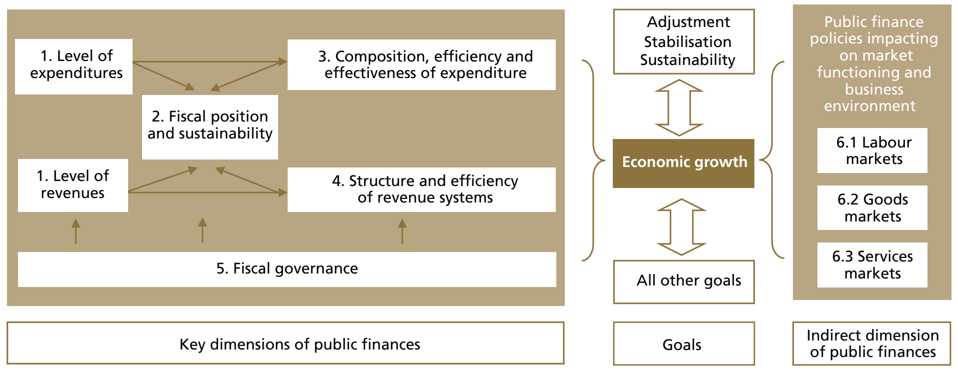
"Most fiscal plans envisaged more or less ambitious restraints of government expenditure combined with a reduction of the tax burden, but two-thirds of the planned budget balance improvements were not reached and three-quarters of government expenditure targets were overshot," the report states. "Moreover, fiscal corrections were often postponed, turning the medium-term budgetary objectives into moving targets rather than anchoring fiscal policy."

Lack of progress in reaching MTOs could come back to haunt some countries soon. As the economic outlook has darkened and GPD growth projections are being revised downwards, fiscal plans look increasingly difficult to attain in 2008 and onwards. Thus, some Member States risk breaching the 3% fiscal deficit ceiling, which would also make it more difficult to ensure the long-run sustainability of their public finances.

In addition, many Member States also tend to use public sector resources inefficiently. This reduces the much-needed room for manoeuvre to deal with the rising costs resulting from population ageing and to make public investment into areas that can strengthen Europe's competitive position in a globalised world. Thus, governments need to reconsider the relatively high tax, administrative and regulatory burden and to improve the provision of public services and goods so as to deliver better value for money, the report states.

"Although the budgetary situation has improved remarkably in the last few years, it is quite clear that there is still scope for progress in enhancing the quality of public finances."
Commissioner Joaquín Almunia

The quality of public finances: a multidimensional framework



A framework for change

One avenue to deal with the medium-term challenges, as the report recommends, is to raise the quality of public finances (QPF). The term refers to all fiscal arrangements and operations that support the main macroeconomic goals of government policies, in particular long-term economic growth. The report summarises all these aspects of fiscal policy-making into a multidimensional conceptual framework of QPF (see diagram) with the following key dimensions:

Government size: In general, overly large public administrations hinder economic growth, especially if such administrations are associated with high tax burdens on labour and capital, and the inefficient use of public resources, the report explains.

Fiscal position and sustainability: Sound and sustainable fiscal positions are preconditions for growth over the medium and long run and therefore form the basis of the EU's fiscal framework. Empirical work in the report confirms that higher public debt is, on average, associated with lower real GDP growth.

The composition and effectiveness of expenditure: Certain types of public expenditure, such as public investment or spending on education, are growth enhancing if they succeed in addressing market failures and providing public goods. At the same time, since pressures to contain overall public spending are rising, governments need to find ways to be more efficient in their use of public resources. For example, some Member States have fallen behind in their education attainments, as measured by the Programme for International Student Assessment (PISA), despite spending more on education than the best performing countries.

The structure and efficiency of revenue systems: Higher tax system efficiency can be achieved through simple rules and broad tax bases as well as by avoiding tax loopholes, unnecessary exemptions and special tax regimes. Moreover, the report suggests that a tax shift from labour to consumption, typically through lower payroll taxes, or social security contributions financed by an increase in VAT, can have positive but only limited effects on employment and growth.

Fiscal governance arrangements: They represent the institutional side of fiscal policy as it comprises the set of rules and procedures that determine how public budgets are prepared, executed and monitored. Evidence suggests that EU Member States with strong fiscal rules, medium-term budgetary frameworks and independent budgetary institutions, have been more successful in reining in fiscal deficits.

The report stresses that policy-makers need to consider all of the above dimensions simultaneously since they can be closely linked. For example, focusing only on additional spending on public infrastructure or education in support of better growth conditions may be problematic if financed through taxes or debt that impose a higher current or future burden on the economy.

Call for action

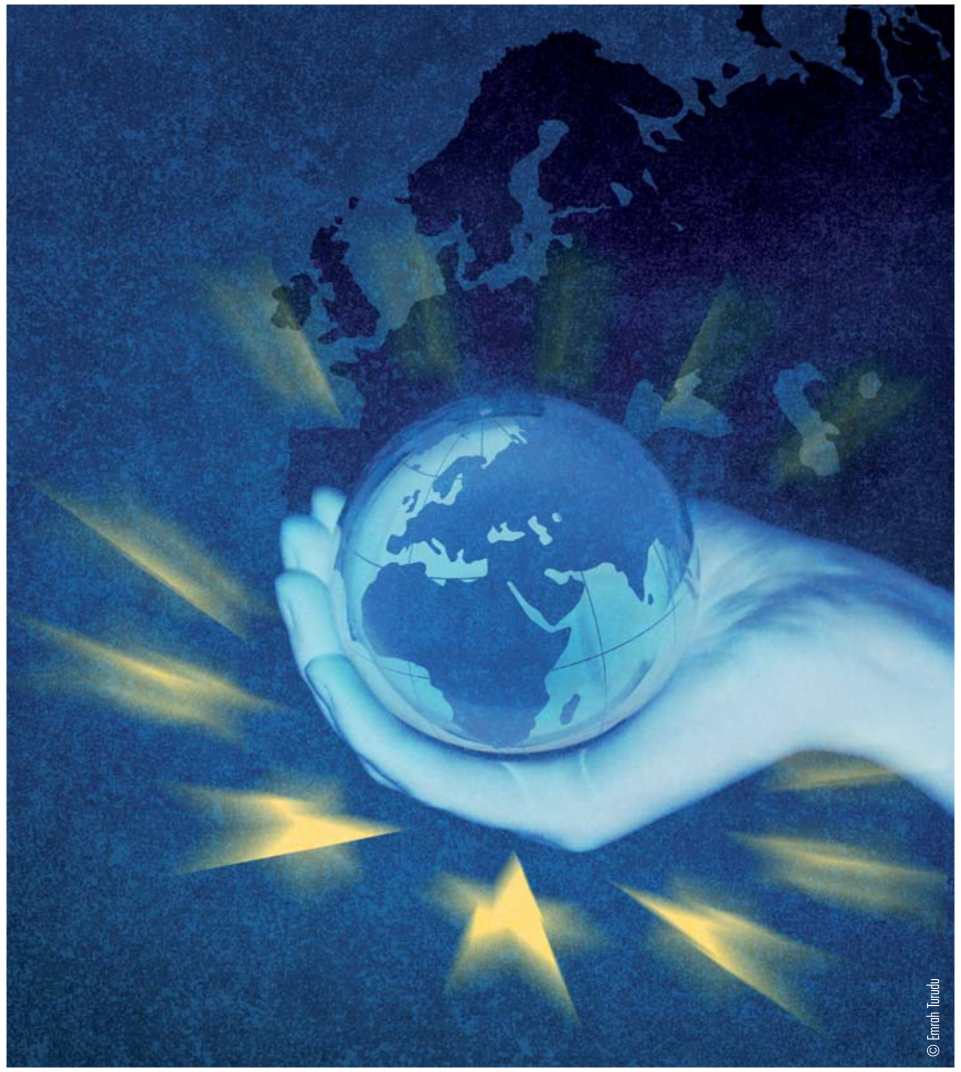
This year, a Commission Communication, 'EMU@10: successes and challenges after 10 years of EMU', called for a deeper and broader approach to fiscal and economic surveillance, with greater focus on QPF and its links to growth, as one of the key elements for the smooth functioning of EMU. Closely linked to that, the recent Public Finance in EMU report identified four specific areas for action. Member States should first, improve their reporting on quality of public finances; second, include performance information in their budgets; third, improve the efficiency of their tax systems; and fourth, regularly review the quality of their public finances.

A greater focus on QPF would open up a way to better link the different instruments of EMU economic governance, specifically the SGP and the Lisbon Strategy for Growth and Jobs. Both stress the importance of QPF but the practical implementation for surveillance and the link between the two surveillance instruments can be improved. But even with a greater focus on QPF, it is clear that the linchpin of fiscal policy-making and fiscal surveillance remains sound overall public finances.

Further information
The report 'Public finances in EMU – 2008' is available on DG ECFIN's website:
http://ec.europa.eu/economy_finance/publications/specpub_list9257.htm
Programme for International Student Assessment (PISA):
http://www.pisa.oecd.org/

Consolidating the euro's position on the world stage

Over the past decade, the euro has firmly established itself as a world currency, acting as a pole of stability for the global economy and an inspiration for other regional groupings. Alongside the benefits, Europe must rise to the stewardship responsibilities of the single currency's international status.



Prior to the launch of the third stage of Economic and Monetary Union (EMU) in 1999, speculation abounded about how much of an international role the single currency would play. The general consensus was that the euro would be welcomed internationally but opinion was divided between those who argued that the euro would be unable to challenge the mighty dollar and, at best, would become a strong regional currency, and those who maintained that it would eventually evolve into a major global currency.

So the rapid rise of the euro as an international currency surpassed the expectations of even the optimists. "The international role of the euro is one of the single currency's successes," emphasises Antonio de Lecea, Director of the International Affairs Directorate at DG ECFIN, responsible for the external aspects of EMU. "In some international currency functions, the euro has made substantial gains since its introduction. In particular, the euro has become a leading financial currency where, on some measures, it has even surpassed the dollar."

For instance, the euro's share of international debt securities, such as government and corporate bonds, is greater than that of the US dollar, with the single currency accounting for nearly half of the world's stock (see chart).

In addition, the euro has become the second most used reserve currency, accounting for about 26% of world official reserves, and the second most actively traded currency in foreign exchange markets worldwide, accounting for 37% of all transactions in recent years.

It has also become a major medium of international trade, particularly for euro-area and other European countries. The single currency is also used as a parallel currency in neighbouring regions, such as the Western Balkans, as well as several other transition and developing countries.

"The size of the euro area and its financial system, which is comparable to the US economy, as well as its stability-oriented macroeconomic framework, support the international role of the euro," explains de Lecea. "The recent volatility of the dollar may have also contributed."

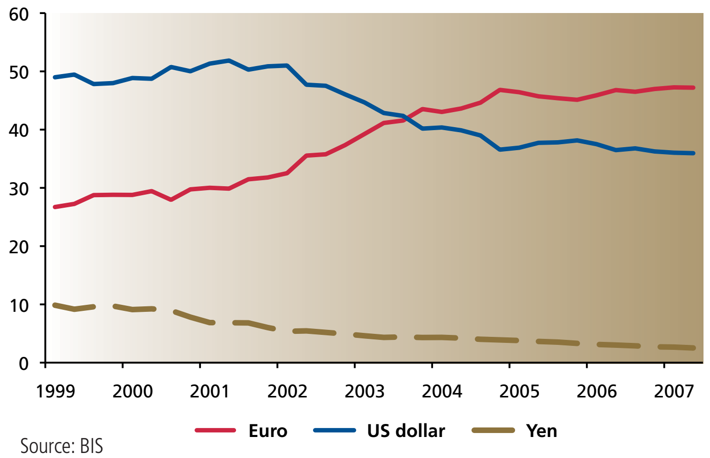
EMU as a source of inspiration

Other regional groupings around the world, from Asia to Latin America, Africa and the Middle East, are watching the EMU project with interest, hoping to draw lessons and inspiration for their own efforts to forge closer economic and financial integration and, possibly, monetary union.

"There is no EU policy aimed at 'exporting' the euro model to other regional blocs. Each region has its own unique conditions and the EU's experience is not necessarily applicable elsewhere," notes de Lecea. "But other regions can draw lessons from our experience and we are co-operating on financial and monetary integration issues with our ASEM partners in Asia, the MERCOSUR countries in Latin America and the Gulf Co-operation Council (GCC) in the Middle East."

"We have responsibilities towards ourselves and the rest of the world, so we need to rise to the challenge."
Antonio de Lecea, Director for International Affairs, DG ECFIN

Stock of international debt securities: broad definition[1]
(In % of total amount outstanding, at current exchange rates)



Source: BIS
(1) Including home currency issuance if targeted to the international market.

As a reflection of this, at this year's Brussels Economic Forum, Haruhiko Kuroda, head of the Asian Development Bank, spoke of how "Asia has been particularly interested to see how the euro has helped promote prosperity and financial security in Europe.

"The euro has played an essential role in fostering harmony among diverse economies which had conflicting monetary and fiscal policies, tariffs and other restrictions on trade and investment," he added. "This experience is extremely useful for Asia… In its move towards greater co-operation and integration, Asia is looking to Europe for practical experience."

Partly inspired by the success of the euro, the six-member GCC launched its own common market in 2008 and plans to launch its own single currency, provisionally called the Khaleeji.

The fruits of leadership

The international status of the single currency has conferred certain benefits on euro-area members. Perhaps the most important advantage is that, by attracting more investors, both within the EU and globally, it contributes to the deepening and development of the euro area's financial markets and of its financial system more generally. The single currency also reduces the costs of doing trade internationally by making trading partners more willing to pay and accept payments in euro.

Another relatively modest advantage is that of international seigniorage. In simple terms, seigniorage refers to the fact that non-residents and other countries strive to hold reserves denominated in that currency, enabling the issuing country to print a certain amount of extra money at little real cost. A related benefit is that euro-denominated government bonds become more liquid which helps euro-area governments to borrow at somewhat lower interest rates.

Then, there is the so-called 'exorbitant privilege', which enables the issuer of an international currency to cash in on the fact that its foreign assets are denominated in other currencies while its foreign liabilities are denominated in its own currency, thereby transferring the exchange rate risk to its trading partners. This, as well as the liquidity premium on its government bonds just mentioned, contributes to producing an excess return on its foreign assets over its foreign liabilities, which makes it easier for the issuer of an international currency to finance large current account deficits, while limiting the deterioration in its net foreign debt position. There is evidence that the US has benefited from this. However, the flip side of this benefit is that, as the US has learnt, it can fuel runaway deficits and potentially weaken the currency.

The euro has also benefited the wider world. Available evidence suggests that, at a time of dollar volatility, the euro has provided a much-needed anchor for the global economy. "The euro has fostered stability in the euro area. This has had global spillovers and the single currency has become a pole of stability in the world economy. The diversification advantage of the euro has brought with it a large measure of global stability," explains de Lecea.

Responsible stewardship

The global status of the euro also carries with it some risks and responsibilities. Left unmanaged, it could make the euro area vulnerable to economic shocks in other parts of the world, reducing the euro's global stabilising influence. The major challenge here is the fractured nature of the fiscal and financial policies of euro-area countries, and the fact that they act nationally in international fora.

"The euro has an important international role but our presence in international fora is still very fragmented," observes de Lecea. "We have responsibilities towards ourselves and the rest of the world, so we need to rise to the challenge."

Antonio de Lecea suggests that the euro-area countries should become more actively involved in global economic and financial governance. Ideally, this would involve consolidating the euro area's representations in international fora, such as the IMF and G7. This would not only give the euro area more international clout, but would also free up seats for emerging economic powers.

Naturally, this is an ambitious goal and will have to be approached gradually, but the foundations for this unified approach, including a stronger coordination of European positions within such fora as the Eurogroup and ECOFIN councils and their committees, are already in place and the EU has already achieved such a common position on external trade issues.

The euro's international role is likely to continue to grow gradually, but how far it will challenge the pre-eminence of the dollar depends on numerous factors, including progress in creating more integrated and liquid financial markets in the euro area, the capacity of the euro area to speak in a cohesive manner on global economic matters, and the US's own policies. While incumbency advantages and inertial forces will continue to favour the dollar for some time, the international monetary system is likely to evolve over time towards a more symmetric system, with both the euro and the dollar acting as the main international currencies.

The economy of Ireland: whither the Celtic Tiger?

Over the last two decades, Ireland achieved a remarkable economic transformation – from being one of the poorest to one of the richest Member States in the EU when measured by per capita income. It now faces a period of considerable economic uncertainty in common with many other European countries. Can the factors behind its transformation be harnessed in order to ensure the sustainability of its achievements during the current downturn? Furthermore, can the EU's newest Member States use the Irish example as a model for success? A recent seminar organised by DG ECFIN attempted to answer these questions.

Doonagore castle in County Clare, Ireland

During the early 1980s, Ireland was an economy in trouble, weighed down by slow growth, high inflation and unemployment, and increasing public debt. Ireland was an economic laggard, underperforming most other EU Member States. During the prolonged sluggish growth period from 1980 to 1986, real GDP[1] growth averaged only about 2.3% per year; total government expenditure was well in excess of 50% of GDP; annual budget deficits exceeded 10% of GDP in some years; and public debt increased to 113% of GDP by 1987. In addition, falling living standards and employment led to a high emigration rate. In net terms, 200 000 people left the country between 1981 and 1990.

But the economic and public sector reforms set in train in the late 1980s assisted by EU Structural Funds provided the basis for the turnaround that made the country the fastest growing economy in the EU during the 1990s. What is more, Ireland's economy outperformed Greece, Spain and Portugal, three other beneficiaries of the EU's Cohesion Fund. During the 'Celtic Tiger' period (1994-2000), Irish income per head reached and eventually exceeded EU-15 levels. Today, Ireland has the second highest level of income per head in the 27-Member State EU, behind Luxembourg.

The Celtic Tiger is born

According to those attending a recent seminar on Ireland, part of ECFIN's regular series on the economies of Member States, the country's massive catch-up benefited from a wide array of factors that left it poised to take advantage of the take-off of the global economy during the 1990s.

Ireland exhibited a number of classic ingredients for success – including an outward orientation and well-functioning markets. The catch-up phase was marked by a sharp increase in investment – especially foreign direct investment. A rapid growth in employment was fed by large labour inflows and higher participation rates. A period of sustained growth in productivity reflected greater investment in education and major structural changes within the economy.

From 1986 to 1996, these factors helped boost Ireland's real GDP to an average growth rate of 5.1% a year, compared to an OECD average of 2.4%. Total employment, which fell by an average of 0.8% per year between 1980 and 1986, rebounded over the next decade by growing at 2.1% per year, compared to an OECD average of 1% and the EU average of 0.3%. The growth in employment practically wiped out unemployment, while also absorbing an increase in the labour supply through an influx of immigrants attracted by the Irish economic boom.

Ireland's public finances were also transformed. The general government deficit as a percentage of GDP declined from 8.5% in 1987 to close to zero by 1996, with the result that the debt-to-GDP ratio fell to 72%.

Consensus on the need for a turnaround in Ireland's economic fortunes was embodied in a series of social partnership agreements from 1987 onwards between employers, trade unions, farming interests and government. The partnership structures established by successive governments created a forum for centralised wage bargaining that helped break the spiral of inflationary wage increases and ensured industrial peace.

Transformation to an export-oriented economy

The period was marked by a huge inflow of foreign direct investment (FDI), during which Ireland transformed itself into an export-oriented economy with a thriving manufacturing sector and, more recently, a growing service sector. Foreign companies, especially those based in the US, chose Ireland as their entry point into the EU and other European markets. The companies were attracted by Ireland's proximity to a large European home market, a young, well-educated, English-speaking labour force, and a low corporate tax rate.

In 1996, foreign firms accounted for 47% of the workforce employed in manufacturing and internationally traded services – such as information and communications technologies (ICT), chemicals, pharmaceuticals, medical technologies and engineering.

In this context, companies such as Wyeth, GlaxoSmithKline, Pfizer, Merck Sharpe & Dohm, and others have turned Ireland into an export economy serving global markets.

The decision in 1987 to establish an International Financial Services Centre in Dublin attracted major outside investment in such segments as banking, asset financing, fund management, and specialised insurance operations – and also boosted service exports.

After the high-growth period of the 1990s, when real GDP growth reached 11.3% in 1997 and 9.4% in 2000, Ireland's economy settled down into a more steady growth phase of between 4-7% over the following years until 2007.

During this period, Ireland's services exports continued to grow rapidly, accounting for one-third of total exports, with exports of goods and services currently worth about 80% of the country's GDP.

[1] *While GDP is used in the text for ease of comparison with other countries, the concept of Gross National Income (GNI) is typically used in Ireland. The country's GNI in the last three years was on average about 15% lower than GDP and the difference between these two concepts represents income paid to foreign investors in Ireland.*

"…Ireland's proven resilience and flexibility over the last 20 years suggests that the economy should quickly regain more 'normal' growth rates once the current needed adjustment has been completed."

Austin Hughes, Chief Economist, Irish Intercontinental Bank

Ireland
(Éire)

Currency: euro
Population: 4.3 million
GDP per capita in purchasing power standards (EU-27=100): 114% (2006)
Real GDP growth rate: 6% (2007)
Public sector deficit (as a % of GDP): 0.3% (2007)
General government debt (as a % of GDP): 25.4% (2007)
***Source:** European Commission*

Rebalancing of the economy under way

But the nature of the Celtic Tiger changed somewhat in the new millennium, as the main engine of economic growth switched to the domestic construction sector and consumer spending. Demand for housing rose along with income levels. However, by 2006 the construction market began to fall back from its previously unsustainable high levels and a significant rebalancing of the economy is now under way.

The effects of the shrinking construction sector and lacklustre productivity growth are taking their toll. While real GDP growth was 6% in 2007, the latest government forecasts suggest it will moderate in 2008 to about 0.5%, a rate not experienced since the late 1980s. This estimate primarily reflects lower housing construction, but also takes into account slowing consumer spending, investment and exports.

While the short-term outlook is disappointing, many economists have pointed to the underlying healthy position of the economy over the medium term. To capitalise on this position, Ireland must now re-examine the factors that will make it a more competitive place to do business. For example, through more and better infrastructure, further labour market reforms (especially within the public sector), and a rebalancing of the tax structure to counter falling government revenues.

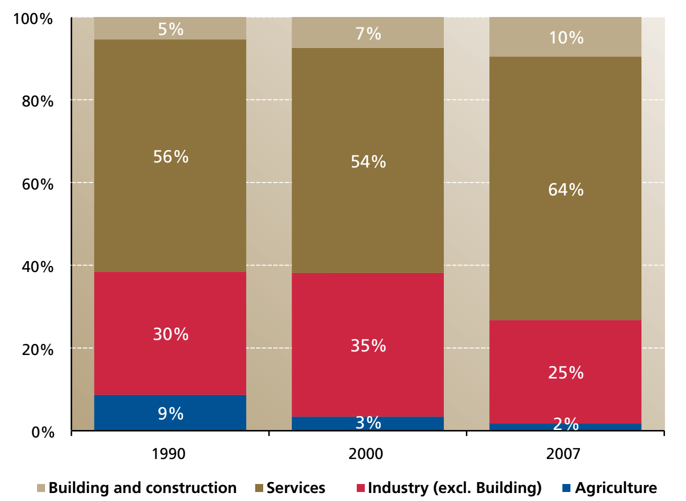
Focus on improving productivity

Over the longer term, the loss of wage competitiveness in recent years has meant that Ireland must improve productivity. Productivity growth was the most important factor behind the stronger increase in GDP per capita over 1980-2000, Irish economist John FitzGerald said at the DG ECFIN seminar. Demographic factors and higher female participation in the workforce also played a role, he added.

Marco Buti, DG ECFIN's Acting Director-General, noted that despite the unique features that helped Ireland achieve high growth during the 1990s, some lessons could still apply to other economies. Ireland's economic transformation showed that the key ingredients for success are good institutional and structural policies, coupled with an appropriate fiscal policy.

Sticking to a sound macro-economic policy mix and implementing a reform agenda would help ensure that Ireland's economic transformation is sustained in the years ahead.

Changing structure of the economy,
gross value added by sectors at current prices



The chart shows the increased importance of construction and services, and the diminishing significance of agriculture and industry.
Source: European Commission

Further information
More information can be found on DG ECFIN's website:
http://ec.europa.eu/economy_finance/eu_economic_situation/member_state8431_en.htm

Looking ahead

For your diary

13-14 November 2008, A DG ECFIN workshop in Brussels

Five years of an enlarged EU – a positive-sum game

Organised by DG ECFIN, in co-operation with DG Enlargement and the Bureau of European Policy Advisers, this workshop will emphasise the advantages that enlargement has brought – a larger Union and greater market access for all. Sessions will cover the challenges and opportunities of more open trade and more FDI; the impact of migration on labour markets and cash-strapped social systems; and the extent of financial integration – all with the aim of answering whether enlargement made a difference to openess, integration and growth. Speakers will come from across the EU and include the Director-General of BEPA, Vitor Gaspar, and the Acting Director-General of DG ECFIN, Marco Buti.

Jean-Claude Trichet cuts the ECB's 10th birthday cake on 2 June 2008

13-14 November 2008, 5th ECB Central Banking Conference

The euro at ten: lessons and challenges

This two-day conference will bring together experts and policy-makers to discuss topics such as: what has EMU brought to consumers and the corporate sector, the challenges for monetary policy and financial stability from globalisation, and an academic view of optimal currency areas. The President of the ECB, Jean-Claude Trichet, will participate and DG ECFIN Acting Director-General Marco Buti will contribute to the panel on 'The euro and enlargement: the challenges ahead'.

28 November 2008, A DG ECFIN workshop in Brussels

The quality of public finances and economic growth

The objective of the workshop is to understand the links between fiscal policy and long-term economic growth as part of efforts to improve the 'quality' of public finances (QPF). Improving QPF will help EU Member States meet the double challenge of ageing populations and globalisation. Contributions will cover how public expenditure and revenue systems can promote long-term growth, how the different elements of QPF can be embedded into macroeconomic growth analysis, and integrating QPF into the EU's surveillance framework.

Frankfurt: on the banks of the Rhine

15-16 December 2008, ECB conferernce in Frankfurt

Conference on financial markets and macroeconomic stability

The meeting will bring together academics and professionals to discuss the importance of financial markets for monetary policy and macroeconomic stability. Topics include financial market imperfections and business-cycle fluctuations, credit and the housing market, financial innovation and the transmission of monetary policy, and optimal monetary and fiscal policy in the presence of financial market imperfections.
More information: **www.ecb.int**

Golden Gate Bridge in San Francisco

3-5 January 2009, American Economic Association in San Francisco

Annual Meeting

The American Economic Association, along with over 50 other associations in related disciplines, will hold its 2009 annual meeting in San Francisco – a truly marathon event with over 450 sessions covering economic issues and applications in their widest sense. DG ECFIN's Acting Director-General, Marco Buti, will chair a session on 'The First Ten Years of the Euro: Achievements and Challenges'; while ECFIN research adviser Lars Jonung will participate in a panel discussion where he will talk on 'The euro: it can't happen, it's a bad idea, it won't last – the views of US Economists on EMU 1989-2002'. For more information see the AEA website: **www.vanderbilt.edu**

28 January-1 February 2009, The World Economic Forum, Davos, Switzerland

Connecting the dots: catalysing solutions

Leaders from industry, the creative sector, governments and international organisations and civil society will meet for the annual World Economic Forum in the Swiss town of Davos to exchange ideas on current and future challenges to the global economy.
More information: **www.weforum.org**

Further information
http://ec.europa.eu/economy_finance/events/

Commission agenda

October 2008

On 24-25 October, the Asia-Europe Meeting (ASEM) will hold a summit in Beijing, China in which President Barroso will participate. ASEM is a forum for political, economic and cultural co-operation between the EU and Asian countries. The main priorities at this seventh summit include trade and investment, sustainable development and regional economic developments.

November 2008

The G20 Finance Ministers and Central Bank Governors will meet on 8-9 November in São Paolo, Brazil. EU Commissioner for Economic and Monetary Affairs Joaquín Almunia and ECB President Jean-Claude Trichet will join the French EU Presidency in representing the EU and the euro area at this ministerial meeting.

November 2008

On 3 November, the Commission will publish the Autumn Economic Forecast for the EU and the euro area. DG ECFIN produces short-term macroeconomic forecasts twice a year, in the spring and autumn. These forecasts concentrate on the Member States, the euro area and the EU, but also include outlooks for candidate countries as well as some non-EU countries. Each forecast has at least a two-year time horizon (with an additional year added each autumn) covering the current year and the next.

November 2008

The Commission will publish the eighth report on practical preparations for the future enlargement of the euro area. These progress reports cover the state of play in the practical preparations in the Member States that are getting ready to adopt the euro, such as: the national plan for euro adoption; sectoral plans for administrations, financial institutions and businesses; and the communication campaign aimed at the general public.

December 2008

This year's final Quarterly Report on the Euro Area will be published by DG ECFIN. As well as giving an overview of economic developments in the euro-area economies, the report will focus on two further topics: structural reform priorities in the euro area, and the economic impact of ageing and the effectiveness of remedial measures.

Editorial information

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Recent research and analysis by DG ECFIN

European Economy Research Letter

The Directorate for Economic and Financial Affairs publishes a regular web-based newsletter on the research activities of its staff – the *European Economy Research Letter*. The current issue presents the main findings of the Commission report 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union', and also includes an interview with Nobel laureate Robert Mundell who looks back over the first ten years of EMU. The next issue, due out in November, will focus on DG ECFIN's annual research conference which was held in October. The *European Economy Research Letter* is available free of charge by e-mail subscription on the DG ECFIN website. **http://ec.europa.eu/economy_finance/publications**

To mark the tenth anniversary of the launch of Economic and Monetary Union, DG ECFIN economists and external academic contributors are producing research publications on aspects of the first decade of EMU and the euro. These publications are part of an EMU@10 umbrella project embracing a wide range of research activities. The publications can be downloaded via a dedicated website hosted by DG ECFIN, which provides information and resources on EMU for economists and non-specialists. The website can be found at: **http://ec.europa.eu/economy_finance/emu10**

Some titles from the EMU@10 series are:

- ECB credibility and transparency
- The evolution of economic governance in EMU
- Defying the 'Juncker curse': Can reformist governments be re-elected?

Research publications

DG ECFIN also publishes frequently on economic research relevant to the European Union, which is conducted by staff of the DG. These publications appear as part of the *European Economy* series, available as print and web versions. The main *European Economy* series includes major reports and communications to the Council from DG ECFIN on behalf of the European Commission.

Within the *European Economy* series, *Economic Papers* and *Occasional Papers* cover the analytical and policy work done by the staff of DG ECFIN, sometimes in co-operation with external researchers. The *Country Focus* series covers topical economic issues affecting one or more Member States. Some recent titles from these publications are:

Economic Papers

Recent publications include:

- The quality of public finances and economic growth
- Labour markets in EMU – what has changed and what needs to change
- An analysis of the possible causes of product market malfunctioning in the EU: first results for manufacturing and service sectors
- Quest III: an estimated DSGE model of the euro area with fiscal and monetary policy

Occasional Papers

Recent publications include:

- European Neighbourhood Policy: economic review of EU neighbour countries
- 2007 Pre-accession Economic Programmes of candidate countries: EU Commission assessments
- 2007 Economic and Fiscal Programmes of potential candidate countries: EU Commission assessments

Country Focus series

Recent publications include:

- Ireland's housing market: bubble trouble
- Exchange rate pass-through to inflation in Slovakia
- Estonia: overheating and sectoral dynamics
- German consumption: is there hope for a revival?
- Tax shortfalls in Greece

All research publications can be downloaded free of charge from the DG ECFIN website: **http://ec.europa.eu/economy_finance/publications_en.htm**

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