Brussels, 30 May 2008

BACKGROUND[1]
ECONOMIC and FINANCIAL AFFAIRS COUNCIL
Tuesday 3 June in Luxembourg

The Council will be preceded by a meeting of the ***eurogroup****, which will exceptionally, on the occasion of the tenth anniversary celebration of the European Central Bank, convene in Frankfurt, on Monday 2 June at 9.00. The eurogroup will discuss the economic situation, in particular price developments, and will meet with Alessandro Leipold, director of the European department of the IMF. It will also discuss the budgetary policies of the euro area member states.*

On Monday evening in Luxembourg, ministers will attend a reception to mark the 50th anniversary of the European Investment Bank and the inauguration of a new extension to its headquarters. On Tuesday at 9.00, they will meet in their capacity as governors of the EIB.

The Council will start on Tuesday at 10.30 and is due to close ***excessive deficit procedures*** *with regard to* ***Italy****,* ***Portugal****, the* ***Czech Republic*** *and* ***Slovakia****, following reduction of their government deficits to below 3% of GDP.*

It will examine reports from the Commission and the ECB on economic and monetary convergence. After an initial discussion in the Council, a proposal aimed at allowing ***Slovakia to adopt the euro as its currency*** *as from 1 January 2009 will be submitted to heads of state/government for discussion later in June, before returning to the Council for a decision at its meeting on 8 July.*

The Council is due to adopt conclusions on the ***clearing and settlement*** *of securities transactions, and will also discuss* ***rising food prices****, as well as* ***economic and monetary union*** *ten years after the decision to introduce the euro.*

Deposit guarantee schemes*, the* ***solvency of insurance companies****,* ***VAT on financial services****, general arrangements for* ***excise duties*** *and* ***harmful tax competition*** *are also on the agenda.*

At lunch, ministers will discuss developments on financial markets and will be debriefed on the eurogroup's deliberations the previous day.

Press conferences:

- after the eurogroup meeting *(Monday in Frankfurt, as from 12.00)*;
- after the EIB annual governors meeting (*Tuesday in Luxembourg, as from 10.30*);
- at the end of the Council, after lunch (*Tuesday in Luxembourg, as from 15.30*).

Press conferences and public events – including the eurogroup press conference in Frankfurt on Monday – can be followed by video streaming:
http://www.consilium.europa.eu/videostreaming

[1] This note has been drawn up under the responsibility of the press office

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Excessive deficit procedure - Closure of four procedures
- Italy, Portugal, Czech Republic and Slovakia

The Council is expected to adopt decisions, under article 104(12) of the treaty, abrogating decisions it took under article 104(6) on the existence of excessive government deficits in Italy, Portugal, the Czech Republic and Slovakia. This follows reduction by all four countries of their government deficits to below 3% of gross domestic product (GDP), the maximum threshold set by the EU's stability and growth pact.

As a result of these decisions, excessive deficit procedures – to which in May 2005 a majority of member states were subject – will only stay open as regards Hungary and Poland. With Italy and Portugal lowering their deficits, none of the euro area's 15 member states will remain in excessive deficit.

The draft decisions require two thirds of the weighted votes of 26 delegations (excluding the member state concerned) for adoption.

Italy

The excessive deficit procedure with regard to Italy was opened in July 2005, following government deficits of 3.5% of GDP in both 2003 and 2004. The Council adopted a decision under article 104(6) on the existence of an excessive deficit, and a recommendation under article 104(7) setting out measures needed in order to bring the deficit below the EU's 3% threshold by 2007 at the latest.

These included a 1.6% of GDP reduction in Italy's cyclically-adjusted deficit (excluding one-off and other temporary measures) over the 2006-07 period compared with 2005, as well as further fiscal consolidation in subsequent years and restoration of Italy's debt ratio to a declining path.

The deficit increased to 4.2% of GDP in 2005, before declining to 3.4% in 2006 and 1.9% in 2007, with the cyclically-adjusted balance improving by 3% of GDP over the 2006-07 period, well above the fiscal effort recommended by the Council. According to the Commission's spring 2008 forecasts, the nominal deficit is expected to increase to 2.3% of GDP this year and, under the assumption of unchanged policies, to 2.4% in 2009.

The Council is expected to conclude that Italy's deficit has been brought below the 3% of GDP threshold in a credible and sustainable manner.

As regards Italy's debt, after declining for a decade to just below 104% of GDP[2], in 2004 it remained way above the EU's 60% reference value for debt. It increased by 2% in 2005 and by a further 0.6% in 2006, before falling again to 104% in 2007. According to the Commission's spring forecasts, on a no-policy-change basis, the debt ratio is projected to fall to around 102.5% of GDP by 2009. This is still the highest debt ratio of any of the member states.

Under the stability and growth pact, where a government deficit exceeds the 60% reference value, the ratio must be sufficiently diminishing and approaching the reference value at a satisfactory pace. The Council is expected to conclude that Italy's debt has diminished in line with the correction of its deficit.

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[2] In 1994, it was above 121% of GDP.

Portugal

The excessive deficit procedure was opened in September 2005, after Portugal announced a projected government deficit amounting to 6.2% of GDP in 2005, with plans to bring the deficit below 3% of GDP no sooner than 2008. Government debt would remain in excess of the 60% of GDP reference value for debt, and continue rising until 2007.

The Council adopted a decision under article 104(6) on the existence of an excessive deficit, and a recommendation under article 104(7) setting out measures needed in order to bring the deficit below the EU's 3% threshold by 2008 at the latest. It called for a 1.6% of GDP reduction in Portugal's cyclically-adjusted deficit (excluding one-off and other temporary measures) in 2006 compared with 2005, to be followed by a further decrease of 0.75% of GDP in each of the two subsequent years.

The deficit declined to 3.9% of GDP in 2006 and to 2.6% in 2007, with a 2% of GDP improvement in the cyclically-adjusted balance in 2006 and a further 1% in 2007, well above the fiscal effort recommended by the Council. According to the Commission's spring 2008 forecasts, the headline deficit is expected to narrow to 2.2% of GDP this year and, under the assumption of unchanged policies, to rise again to 2.6% in 2009.

Portugal's government debt declined to 63.6% of GDP in 2007 from 64.7% in 2006, above the EU's 60% reference value for debt. According to the Commission's spring forecasts, the debt is expected to bounce back to 64% this year and 64.25% in 2009, against the backdrop of low growth rates and still relatively high government deficits.

The Council is expected to conclude that Portugal's deficit has been brought below the 3% of GDP threshold in a credible and sustainable manner.

Czech Republic

The excessive deficit procedure with regard to the Czech Republic was opened following a government deficit in 2003 that amounted to 12.9% of GDP (5.9% if a major one-off operation related to state guarantees is excluded). In July 2004, a few week's after the Czech Republic's accession to the EU, the Council adopted a decision under article 104(6) on the existence of an excessive deficit, and a recommendation under article 104(7) setting out measures needed in order to bring the deficit below the EU's 3% threshold by 2008 at the latest.

It set deficit targets of 5.3% of GDP for 2004, 4.7% for 2005, 3.8% for 2006 and 3.3% for 2007. Special circumstances – especially the structural shift in the Czech economy following the country's accession to the EU – allowed for correction of the deficit not in the short term but in the medium term.

In January 2005, the Council concurred with a Commission assessment that the Czech Republic had so far taken effective action regarding measures to achieve the deficit target for 2005. In 2006, the deficit dropped to 2.7% of GDP.

In March 2007 however, following elections the previous June, the Czech Republic announced new deficit projections of 4% of GDP for 2007, 3.5% for 2008 and 3.2% for 2009, thus missing the 3% threshold not only in 2008, but also in 2009. In July 2007, the Council therefore adopted a decision, under article 104(8) of the treaty, establishing that action taken by the Czech Republic was proving inadequate for bringing its deficit below the 3% threshold.

Given that the Czech Republic is not a member of the euro zone, the steps of the excessive deficit procedure provided for by article 104(9) and 104(11) do not apply. So in October 2007, the Council issued a new recommendation under article 104(7), calling on the Czech Republic to contain the budgetary slippage in 2007 and confirming 2008 as the target year for bringing its deficit below 3% of GDP.

To this end, it recommended an improvement in the cyclically-adjusted deficit (excluding one-off and other temporary measures) of at least 0.75% in 2008 compared with 2007, and set a deadline of 9 April 2008 for taking effective action.

In 2007, despite an expected fiscal expansion, the Czech Republic's deficit dropped to 1.6% of GDP, thanks to expenditure savings as well as strong growth. The cyclically-adjusted balance improved by 0.5% of GDP, while the Czech government introduced a range of measures aimed at consolidating public finances in 2008 and 2009. According to the Commission's spring 2008 forecasts, the headline deficit is expected to drop further to 1.4% of GDP this year and, under the assumption of unchanged policies, to 1.1% in 2009.

The Czech Republic's government debt amounted to 28.7% of GDP last year – well below the EU's 60% reference value for debt – and is falling.

The Council is expected to conclude that the Czech Republic's deficit has been brought below the 3% of GDP threshold in a credible and sustainable manner.

Slovakia

The excessive deficit procedure with regard to Slovakia was opened following a government deficit in 2003 that amounted to 3.6%, according to data available at the time. In July 2004, a few weeks after Slovakia's accession to the EU, the Council adopted a decision under article 104(6) on the existence of an excessive deficit, and a recommendation under article 104(7) setting out measures needed in order to bring the deficit below the EU's 3% threshold by 2007 at the latest.

It set deficit targets of 4% of GDP for 2004, 3.9% for 2005, 3.9% for 2006 and 3.0% for 2007. Special circumstances – especially the structural shift in Slovakia's economy following its accession to the EU – allowed for correction of the deficit not in the short term but in the medium term.

According to Eurostat, in the light of revised data notified by Slovakia in April 2007, its deficit in fact remained below 3% of GDP during the 2003-05 period. But the headline deficit increased to 3.6% in 2006 before falling to 2.2% in 2007, while the Commission's spring 2008 forecasts project it to fall to 2.0% this year and, under the assumption of unchanged policies, to rise to 2.3% in 2009.

Slovakia's government debt fell from 42.4% of GDP in 2003 to 29.4% in 2007 – well below the EU's 60% reference value for debt – remaining stable.

The Council is expected to conclude that Slovakia's deficit has been brought below the 3% of GDP threshold in a credible and sustainable manner. Closure of its excessive deficit procedure is a necessary precondition for Slovakia's adoption of the euro on 1 January next year (see below).

Economic and monetary union - Ten years on

The Commission will present a communication, entitled "*EMU@10: successes and challenges after ten years of economic and monetary union*", and the Council will hold an exchange of views (*doc. 9385/08*).

The communication suggests improvements as regards governance of the euro area, on which the Commission wishes to hold detailed discussions in the autumn.

On 2 May 1998, Europe's leaders took the historic decision to introduce the euro, the EU's single currency. The European Central Bank was established in June 1998, and the euro area has since expanded from 11 to 15 countries. Ten years on, the euro is a resounding success, though the Commission considers that it has fallen short of some of its initial expectations.

Among the successes cited in the Commission's communication:

- the launch of the euro has brought a sea change in the macroeconomic environment;
- monetary policy has anchored long-term inflation expectations;
- fiscal policies have supported macroeconomic stability;
- economic and monetary union (EMU) has fostered economic and market integration;
- the euro has acted as a powerful catalyst for financial market integration;
- EMU has improved the euro area's resilience against adverse external developments;
- EMU has brought significant benefits to member states engaged in a catching-up process;
- the euro has firmly established itself as the world's second international currency;
- the euro area has become a pole of stability for Europe and the world economy,
- the euro area has developed a sound structure of economic governance, and in this framework, the eurogroup has served as the key forum for euro-area finance ministers to address issues relating to the single currency, going beyond the treaty-based surveillance and coordination tasks;
- all these positive developments have culminated in the creation of 16 new million jobs during the first decade of EMU.

Among the remaining challenges, the Commission highlights that:

- potential growth, at around 2%, remains too low;
- there have been substantial and lasting differences across member states in terms of inflation and unit labour costs;
- the lack of a clear international strategy and the absence of a strong voice in international fora imply costs for the euro area in an increasingly globalised world;
- the public image of the euro does not fully reflect EMU's successful economic performance. Longer-term trends, such as globalisation, rising food and energy prices and ageing populations will produce policy challenges that are particularly compelling for the euro area.

To address these challenges, the Commission proposes a three-pillar strategy:

- The domestic agenda will require a strengthening of fiscal policy coordination and surveillance, a broadening of macroeconomic surveillance beyond fiscal policy and a better integration of structural reform in overall policy coordination.
- The external agenda will require enhancement of the euro area's role in global economic governance.
- Both agendas will require a more effective system of economic governance.

The presidency will report to the European Council on the outcome of the Council's discussion. In the coming months, the Council will examine, in coordination with the eurogroup, how to strengthen implementation of the economic framework of economic and monetary union.

Enlargement of the euro area – Convergence reports – Accession by Slovakia

The Council will hold an exchange of views on:

- reports from the Commission and the European Central Bank on the ten non-euro area member states with a derogation[3], examining their fulfilment of EU convergence criteria and of their obligations regarding economic and monetary union (*docs 9384/08 and 9117/08*);
- a proposal from the Commission for a Council decision aimed at allowing Slovakia to join the euro area as from 1 January 2009.

The Council is due to make a preliminary assessment of the proposal regarding Slovakia. It is expected to share the Commission's assessment that Slovakia has achieved a high degree of sustainable convergence and therefore fulfils the necessary conditions for adoption of the euro as its currency. The proposed decision would allow Slovakia to do so, by abrogating what is considered as a derogation (as from 1 January 2009).

The presidency will report on the outcome of the discussion to heads of state/government when they discuss the issue in the margins of the European Council meeting on 19-20 June. The Council is expected to take a decision at its meeting on 8 July.

The reports and proposals are based on article 122(2) of the treaty, which requires a qualified majority for a decision by the Council, after consulting the European Parliament and after discussion at a Council meeting in the composition of heads of state/government. Article 122(2) requires convergence reports from the Commission and the ECB at least once every two years.

Developments in food prices

The Council will hold an exchange of views on the recent rise in food prices, with a view to further discussion by the European Council at its meeting on 19-20 June. It will focus on the economic and financial aspects, on the basis of a note from the presidency.

The presidency will report to the European Council on the outcome of the Council's discussion.

The European Council will assess rising food prices and discuss the policy implications, including possible consequences for the common agricultural policy, development policy, trade policy, energy policy and climate change.

The world economy has faced a boom in commodity prices in recent years. After thirty years of falling global food prices in real terms, the trend has reversed since 2006 although, in real terms, today's food prices are still on average lower than they were in the 1980s. During the first half of 2007, wheat prices in Europe rose by about 80%, butter by almost 60% and poultry by 30%. The impact on inflation of varies from one member state to another.

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[3] i.e. Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. (Denmark and the United Kingdom have not expressed a wish to adopt the euro.)

The food price increases are mainly driven by factors outside the EU. These include increased global demand stemming primarily from higher incomes in emerging economies such as China and India, adding to the effect of global population growth. Higher oil and energy prices are driving up input costs for farmers, as well as higher costs for transport and food processing, while biofuel production is shifting supply from food crops to fuel crops. Temporary supply-side factors have added to the phenomenon.

The presidency note summarises the situation and its causes and outlines possible policy responses.

The Agriculture Council discussed developments in food prices at its meeting on 19 May, and development ministers at the General Affairs and External Relations Council meeting on 27 May. Both will provide their own contribution to the European Council's discussion.

Clearing and settlement of securities transactions

The Council is due to adopt conclusions on the clearing and settlement of securities transactions, following discussion by ministers at an informal meeting at Brdo pri Kranju on 4 and 5 April (*doc. 9720/08*).

The draft conclusions review progress on four separate initiatives that are currently underway, under a two-year timetable established by the Council in November 2006, aimed at tackling the fragmentation of European securities post-trading industries:

- a code of conduct for clearing and settlement;
  - launched by industry and promoted by the Commission.

  Industry reached agreement on the code on 6 November 2006, commitments on price transparency entered into force on 31 December 2006, access and interoperability commitments on 30 June 2007, and service unbundling and accounting separation arrangements on 1 January 2008.

  The Commission has presented a positive assessment of the code's implementation, whilst noting that it is too early to draw any conclusion about the last phase (unbundling of services and accounts). It emphasised the positive impact on price transparency, as well as some promising developments on access and interoperability;

- the "*Target2-Securities*" project for the settlement in central bank money of securities transactions in euros;
  - envisaged by the European Central Bank and the euro-area national central banks.

  The ECB governing council has launched a public consultation on draft user requirements and is expected to take a decision during the summer on whether or not to proceed with the project.

- o the removal of technical obstacles to securities market integration, as identified in the so-called Giovannini report[4];
    - work ongoing within the Commission's advisory groups.

  Work on identifying the exact nature of the various "Giovannini barriers" is ongoing. As regards the public sector, the Commission's report sets a timeframe for the removal of three types of barriers, namely fiscal barriers, legal barriers and other technical barriers.

- o work on the safety and soundness of post-trading arrangements in Europe;
    - led by the European System of Central Banks (ESCB) and the committee of European securities regulators (CESR).

  The ESCB and CESR have been developing safety and security standards since 2001 on the basis of worldwide recommendations, focusing on the scope, legal basis and contents of the standards. The Council is expected to agree that the draft standards should take the form of non-binding recommendations that are solely addressed to public authorities.

The solvency of insurance companies

The Council will take note of progress on a proposal for a directive setting new solvency rules for insurance companies ("Solvency II"), on the basis of a report from the presidency (*doc. 9673/1/08 REV 1*).

The proposal is intended to establish a new model for EU regulation and supervision in the insurance sector. It is also being used as an opportunity to recast 13 insurance directives into one legal text. The Solvency II project is aimed at further integration of the EU insurance market, the enhanced protection of policyholders and beneficiaries, improved competitiveness of EU insurers and re-insurers and promoting better regulation in the insurance sector.

Since the progress report submitted to the Council last December, the number of provisions on which substantial work is still needed has been significantly reduced, and the presidency has started exchanges with representatives of the European Parliament.

The supervision of insurance groups operating in several member states has in particular given rise to discussion, given the innovative nature of the Commission's proposal on the "group support regime" and the different circumstances in the member states and different views on how to ensure policyholder protection. Other issues on which discussions have not yet finished concern the treatment of equity risk, minimal capital requirements, surplus funds and participations.

[4] The Giovannini group, formed in 1996 and chaired by Alberto Giovannini (chairman of Unifortune Asset Management SGR), advises the Commission on inefficiencies in EU financial markets and on measures to improve market integration. On clearing and settlement, the group has produced two reports, in November 2001 and April 2003.

Deposit guarantee schemes

The Council will hold a policy debate on deposit guarantee schemes, on the basis of a note from the economic and financial committee (EFC).

Deposit guarantee schemes help ensure financial stability by preventing panic reactions by depositors in the event of a bank experiencing difficulties or lack of public trust. The Financial Stability Forum, an international forum of central banks, supervisory authorities, national ministries and international financial institutions, recently recommended a review of deposit guarantee arrangements in the light of the recent difficulties in the banking sector.

At EU level, the key policy question is whether there is a case for developing common principles and/or strengthening the regulatory framework.

Directive 94/189/EEC requires member states to ensure the existence of one or more deposit guarantee schemes that can reimburse depositors at least up to EUR 20 000 within three months if a bank is unable to pay back deposits. The cost of financing the scheme must be borne by the banks themselves, although the directive does not harmonise methods of financing.

The directive provides discretion to the member states in implementing the rules, so the schemes differ significantly across the EU. The main differences concern the share-out of roles between public authorities and the private sector, triggers for pay-outs, the types of deposits covered, the level of protection offered to customers and the financing of the schemes.

The Council debate is intended to provide guidance enabling the Commission, EFC and the financial services committee to prepare policy proposals before the end of the year. The EFC note contains a questionnaire to this end.

VAT on insurance and other financial services

The Council will take note of a progress report from the presidency on a proposal for a directive on the value-added tax (VAT) treatment of insurance and other financial services.

The proposal is aimed at clarifying the definitions and rules governing insurance and financial services – which are exempt from VAT – thus increasing legal certainty for economic operators and tax administrations, reducing administrative burdens and reducing the impact of hidden VAT in the costs of service providers. The existing definitions were established in the 1970s and have led to uneven interpretation by the member states.

The proposal is aimed at amending directive 2006/112/EC on the common VAT system. It is closely linked to a proposal for a regulation laying down implementation measures for directive 2006/112/EC as regards insurance and other financial services. Detailed work on the draft regulation will only proceed once a consensus has been reached on the draft directive.

General arrangements for excise duties

The Council will take note of a progress report from the presidency on a proposal for a directive establishing general arrangements for excise duties.

The proposal is intended to provide the legal basis for a modernised movement and control system, with an electronic message to replace the accompanying paper document that currently enables the control of intra-Community movements of excise goods.

Harmful tax competition - Code of conduct

The Council will take note of a report from a Council working group on implementation of a code of conduct aimed at eliminating situations of harmful tax competition in the EU. It will be called on to adopt conclusions.

The working group is responsible for assessing:

- the "rollback" of tax measures deemed as harmful (where favourable tax treatment in one member state attracts businesses from other member states);
- the monitoring of a "standstill" commitment by member states not to introduce new measures that are harmful.

The report summarises the group's work during the Slovenian presidency.