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EMU@10: successes and challenges after 10 years of Economic and Monetary Union

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A HISTORIC STEP

On 2 May 1998 Europe's leaders took the historic decision to introduce the single currency, the euro. The move to the last phase of EMU – Economic and Monetary Union – on 1st January 1999, marked a watershed in European integration. Although economic in substance, it sent a very powerful political signal to European citizens and to the rest of the world that Europe was capable of taking far-reaching decisions to cement a common and prosperous future for a continent that had all too often suffered from wars and economic and political instability. The launch of EMU – the most important monetary reform since Bretton Woods – was a bold move without precedent in modern European economic history and one that changed the global economic landscape.

Ten years into its existence, the euro is a resounding success. The single currency has become a symbol of Europe, considered by euro-area citizens to be amongst the most positive results of European integration together with the achievement of free movement within the EU and peace in Europe. One in two people in the euro area asserts that for them, the EU means the single currency. EMU has secured macroeconomic stability and boosted cross-border trade, financial integration and investment. The number of countries that share the euro has increased from the original eleven to fifteen at the beginning of 2008 and is set to increase further. EMU is an achievement of strategic importance for the EU, and indeed for the world at large, in which Europe has become a pole of macroeconomic stability, especially welcome in the present times of financial turbulence.

While the euro is a clear success, so far it has **fallen short of some initial expectations**. Output and particularly productivity growth have been below those of other developed economies and concerns about the fairness of income and wealth distribution have grown. In addition, a number of significant challenges which had not yet emerged or were only starting to become apparent when EMU was devised are now more pressing. Globalisation is progressing apace and natural resources are becoming increasingly scarce. Climate change and the effects of population ageing will place additional strains on the capacity of our economies to grow. Moreover, unwinding global imbalances are putting pressure on the exchange rate of the euro and the functioning of our financial systems. At the same time, while the progressive enlargement of the euro area will add dynamism to its economy, it will also increase the diversity of EMU, making stronger demands on its adjustment capacity.

This Communication and the accompanying Report[1] **assess the experience of the first decade of EMU, identify the goals and challenges facing the euro area and put forward a policy agenda** for EMU's continued success.

THE MAJOR SUCCESSES OF THE FIRST TEN YEARS

The launch of the euro represented a **sea change in the macroeconomic environment** of its participating Member States and beyond. A single monetary policy combined with national but coordinated fiscal policies has fostered macroeconomic stability. The exchange rate realignments that periodically traumatised the European economies have become a thing of the past. The European Central Bank (ECB), to which the euro area's monetary policy is entrusted, quickly established its credibility. Budgetary discipline has improved significantly, strengthened by the Stability and Growth Pact (SGP). The euro-area economy has pursued a faster track of economic and financial integration than the rest of the EU and its resilience in the face of external shocks has become stronger. Overall, progress has been made on many fronts, as the following highlights illustrate.

Monetary policy has anchored long-run inflation expectations at close to the ECB's definition of price stability. Inflation averaged just over 2% in the first decade of EMU, falling from 3% in the 1990s and a range of 8 to 10% in the 1970s and 1980s. Nominal interest rates have declined to an average of around 5% since the inception of the euro, down from 9% in the 1990s and 12% in the 1980s. In real terms, interest rates in EMU have come down to levels not seen for several decades, even in those countries which enjoyed the highest degree of stability before the adoption of the euro. Admittedly, inflation has increased recently, mainly due to soaring oil and commodity prices, while the turbulence in financial markets has led to tighter credit conditions for households and businesses. But a return to low inflation and more normal credit conditions is expected once these external pressures unwind – even though oil and commodity prices may continue to trend up with strong demand from fast-growing developing countries.

Fiscal policies have supported macroeconomic stability in EMU. Progress in fiscal consolidation has been impressive over the last few years and culminated in a deficit of only 0.6% of GDP in 2007 compared to an average of 4% in both the 1980s and 1990s. The reform of the SGP in 2005 not only contributed to greater discipline, but also promoted a more sustainable correction of excessive deficits by discouraging recourse to one-off measures. While not fully eradicated, pro-cyclical fiscal policies have also become less common. As a result, and thanks to windfall gains in tax revenues in the last few years, no euro-area country ran a deficit in excess of 3% in 2007 and the overall deficit for the euro area (at 0.6% of GDP in 2007), was the lowest in several decades. Indeed ten out of the fifteen euro-area countries either recorded a budget surplus in 2007 or were very close to balance.

EMU has **fostered economic and market integration.** The disappearance of exchange rate risk and lower cross-border transaction costs has helped develop the Single Market and integrate product markets. Intra-area trade flows now account for one third of the area's GDP, up from one quarter ten years ago, and available estimates indicate that the elimination of

[1] SEC(2008) XX "EMU@10 : successes and challenges after ten years of Economic and Monetary Union".

exchange rate volatility can explain up to half of this increase. What is more, intra-area foreign direct investment now stands at one third of GDP as compared to an initial one fifth. Here estimates suggest that up to two thirds of this increase can be directly attributed to the creation of the single currency. These developments have in turn produced major economies of scale, spurred competition and had noticeable effects on productive efficiency. Likewise, the decline in risk premia built into capital cost has boosted capital formation, which has now reached almost 22% of GDP – a level unseen since the early 1990s. Overall, through these various channels, the single currency is estimated to have boosted labour productivity per hour worked by as much as 5% since the launch of the euro.

The euro has acted as **a powerful catalyst for financial market integration**. Interbank money markets in the euro area have fully integrated, while cross-border interbank transactions have expanded steadily since 1999. Cross-border consolidation among banks has accelerated, with the sixteen largest banking groups now holding more than 25% of their EU assets outside their home country. A significant market in euro-denominated private-sector bonds has emerged, with an annual gross issuance of more than €1 trillion now substantially exceeding the approximately €800 billion raised through public sector issuance. Equity markets too have integrated faster than elsewhere, with the share of equity held in other euro-area countries rising from 20 to 40%. Financial market infrastructure has advanced, and progress has been made in cross-border wholesale financial services, while the Single Euro Payments Area is set to eliminate differences between national and cross-border retail payments. In parallel, a certain degree of regulatory and supervisory convergence has been achieved via the implementation of the Financial Services Action Plan and the operation of the Lamfalussy committees.

EMU has **improved the euro area's resilience against adverse external developments**. In its first decade the euro area has been exposed to a series of external shocks associated with the global business cycle, the most significant being the bursting of the dotcom bubble and subsequent downturn in the US in the early 2000s. Nevertheless, the ensuing slowdown in the euro area at the beginning of the decade was considerably more muted than in comparable episodes prior to the adoption of the single currency. Today once again, the euro area appears protected from the worst of the present global financial turbulence. The anchoring of inflation expectations has contributed to this improved resilience, as have the reforms carried out under the Lisbon Strategy for Growth and Jobs and the renewed budgetary discipline since the SGP reform.

EMU has brought **significant benefits to its member countries engaged in a catching-up process**. The environment of macroeconomic stability and low interest rates coupled with the support of the cohesion policy and its Structural and Cohesion Funds have created the conditions for accelerated catching up; the positive effects of sound economic policies have been reinforced by the development and integration of national financial markets with the rest of the euro area. Not surprisingly, therefore, participation in EMU is very appealing to the twelve Member States that entered the EU since 2004; indeed three have already successfully joined the euro area and Slovakia is ready to enter in 2009.

The euro has firmly established itself as **the world's second international currency**. Euro-denominated international debt securities surpassed those of the US dollar in 2004, while the percentage of bank loans issued by euro-area banks to non-euro-area borrowers which are denominated in euro now stand at 36% as compared to 45% in US dollars. The euro is the second most actively traded currency in foreign exchange markets worldwide, and is used in more than a third of all foreign exchange transactions. The official use of the euro has increased, with the worldwide share of disclosed reserves denominated in euro rising from 18% in 1999 to over 25% in 2007. Likewise, its role as a trade invoicing or settlement currency has risen, to reach more than 50% of the euro area's external trade. The euro has also become very important in many third countries, notably euro-area candidate and neighbouring EU countries, around 60% of whose trade is now invoiced in euro.

The euro area has become a **pole of stability for Europe and the world economy.** Thanks to the euro's rising international status and the sheer size of the euro-area economy, economic policies within EMU increasingly have a global impact. With an external position in balance, a credible macroeconomic framework and a sound financial system, the euro area has been contributing to an orderly evolution of the global economy, even during the highly turbulent period of the last few months.

The euro area has developed a **sound structure of economic governance**. While major economic policy responsibilities remain at the national level, a common understanding has developed among EMU Member States that sound public finances and flexible and integrated product, labour and financial markets are necessary for EMU to function efficiently. The reform of the Stability and Growth Pact in 2005 increased national governments' "ownership" of the budgetary governance framework. And the revised Lisbon Strategy for Growth and Jobs, the key instrument for the co-ordination of EU economic policies, spells out in Guideline No. 6 that Member States should "contribute to a dynamic and well-functioning EMU". **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. As its informal character encourages open and frank debates, the Eurogroup is well placed to develop common understandings and clear positions on macroeconomic issues pertaining to the euro area. Over time it has gained visibility and relevance, particularly since it appointed its first permanent President in January 2005. On the international front, collective action taken by the euro area has led to greater external influence, as demonstrated by the engagement of the Eurogroup troika – the Eurogroup President, the President of the ECB and the Commissioner for Economic and Monetary Affairs – in bilateral dialogues with China and other countries, and by last year's IMF-led multilateral consultations on global imbalances.

All these positive developments have culminated in the creation of **a record 16 million jobs during the first decade of EMU** in the euro area. Employment has risen by almost 15% since the launch of the single currency while unemployment has fallen to about 7% of the labour force, the lowest rate in more than fifteen years. Importantly, job growth outpaced that of other mature economies, including the United States. The bulk of these improvements reflect reforms of both labour markets and social security systems carried out under the Lisbon Strategy for Growth and Jobs and the coordination and surveillance framework of EMU, as well as the wage moderation that has characterised most euro-area countries. This clearly demonstrates that Europe's workforce is capable of rising to new challenges and making necessary changes that will ultimately result in further job creation and higher economic growth.

EMU'S REMAINING CHALLENGES AMPLIFIED BY NEW GLOBAL TRENDS

The overall picture of the first decade of EMU is thus a very positive one. However, not all expectations have been fulfilled.

At around 2% per annum, **potential growth remains too low**. Although employment has soared, and despite the positive impact of the single currency, productivity growth has slowed from 1 1/2% in the 1990s to around 1% this decade. As a result, the euro area's per capita income has stalled at 70% of that of the United States. While most of the smaller euro-area economies have done exceptionally well, potential growth should have been significantly higher in some of the largest Member States.

Moreover, **there have been substantial and lasting differences across countries** in terms of inflation and unit labour costs. The tendency for persistent divergences between euro-area Member States has been due in part to a lack of responsiveness of prices and wages, which have not adjusted smoothly across products, sectors and regions. This has led to accumulated competitiveness losses and large external imbalances, which in EMU require long periods of adjustment. Essentially, this protracted adjustment reflects the fact that structural reforms have been less ambitious than in the run-up to the euro. As is the case within the EU as a whole, product markets within the euro area are still only partially integrated and cross-border provision of services remains underdeveloped.

As an international currency the euro is a major asset for all euro-area members and for the EU at large. However, the **lack of a clear international strategy** and the absence of a strong voice in international fora implies costs for the euro-area in an increasingly globalised world**.** The global economic imbalances that have built up since the mid-1990s are starting to take their toll, with exchange rates excessively volatile and financial stability arrangements under heavy strain. The emerging economies' rapidly growing demand for scarce energy and other primary resources are hitting supply constraints, sending oil, food and other commodity prices soaring as a result. In this turbulent environment, the single currency provides a shield and can put the euro area in a unique position to play a key role in the global political arena in stemming the associated risks. However this potential is insufficiently exploited as the euro area has neither a properly defined international strategy nor effective international representation.

Finally, **the public image of the euro does not fully reflect EMU's successful economic performance**. The euro is often used as a scapegoat for poor economic performances that in reality result from inappropriate economic policies at the national level. Furthermore citizens in some countries believe that prices significantly increased because of the euro. Indeed, even if overall inflation was only marginally affected at the time of the changeover, occasional abusive price increases in specific sectors and countries have tarnished the image of the euro and continue to do so. At the same time, the lack of development of the economic leg of EMU, compared with the monetary leg, has also fed the concern that the euro area is incapable of addressing the key challenges facing it, further weakening its public image. Clearly important work still lies ahead. But beyond the fulfilment of initial expectations, the EMU policy agenda for the next decade will be marked by the emergence of new global challenges which will have an amplifying effect on the weaknesses of EMU outlined above.

- **Globalisation is progressing apace**, with emerging economies competing with developed economies in lower-skilled industrial activities and increasingly in higher value-added activities too. Globalisation offers major opportunities for market growth, yielding lower prices and greater choice for consumers, and efficiency gains for producers. However, it also puts strong demands on the adjustment capacity of the euro-area members as new activities will need to replace declining industries, and as research, innovation and human capital become ever more important drivers of economic dynamism. Moreover, globalisation further compels the euro area to take an effective role in global economic and financial governance.

- **Food and energy prices are on the rise**, spurred by fast growth of the global economy and changing consumption patterns in emerging economies. Climate change is also having a growing economic impact. These developments may act as a constraint on growth and could impair the distribution of income and wealth given that it is the least well-off who may be disproportionally affected. A complicating factor is that the tasks of containing climate change and keeping a lid on food and energy prices may not be easily achieved simultaneously. These problems can affect euro-area countries differently, adding to the need to ensure smooth adjustment to shocks.

- Meanwhile, the population of the euro area, as elsewhere, is **rapidly ageing**. As a result, the portion of the population dependent on pensions will increase, simultaneously reducing the economic growth potential. Indeed, the ratio of working-age to older people is projected to halve over the next four decades and on unchanged policies, the potential output of the area will slow to just over 1% per annum from around 2% at present. Ageing will also make relatively large demands on public spending, and unless reforms are made to pension and health systems it will increase the share of public expenditure in GDP by an estimated 4 percentage points over the next four decades. Ageing populations pose a serious challenge to the euro area's capacity to adjust and put the sustainability of its public finances and, more generally, its welfare systems at risk.

These longer-term trends, whose effects are increasingly being felt, will pose challenges for the performance of all advanced economies in terms of growth, macroeconomic stability, adjustment capacity, the sustainability of social security systems and the distribution of income and wealth. But they will produce **policy challenges that are particularly compelling for the euro area** considering its relatively low growth potential, its weaker adjustment capacity, high public indebtedness and the strong interdependence of its economies.

A THREE-PILLAR POLICY AGENDA FOR THE SECOND DECADE

The experience of the first decade of EMU, while overall very successful, reveals a number of shortcomings that need to be addressed. It will be necessary to consolidate the hard-won macroeconomic stability while: **(a)** raising potential growth and safeguarding and increasing the welfare of euro-area citizens; **(b)** ensuring a smooth adjustment capacity as EMU expands to take in new members; and **(c)** successfully protecting the interests of the euro area in the global economy. Importantly, these efforts will have to be made in a global environment that has changed considerably since the euro was launched, and failure to do so will be much more costly now.

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

- The domestic agenda aims to deepen fiscal policy co-ordination and surveillance, to broaden macroeconomic surveillance in EMU beyond fiscal policy and to better integrate structural reform in overall policy co-ordination within EMU.
- The external agenda aims to enhance the euro area's role in global economic governance.
- Both agendas will require a more effective system of economic governance.

I. The domestic policy agenda: better co-ordination and surveillance

Deepening and broadening surveillance

The corrective arm of the Stability and Growth Pact (SGP) should continue to be applied rigorously and **surveillance under the SGP's preventive arm should be improved**. Fiscal policy coordination should better guide national budgetary behaviour over the whole cycle, i.e. in both good and bad times. Budgetary surveillance should be deepened to cover two main areas:

(i) **securing the sustainability of public finances** for the benefit of future generations. At the national level, the adoption of medium-term fiscal frameworks could go a long way towards achieving stable and sustainable public finances. To be effective, such frameworks should encompass well-designed expenditure rules, which would allow the automatic fiscal stabilisers to operate within the limits of the SGP while attuning the composition of public expenditure to the structural and cyclical needs of the economy. At the euro-area level increased attention should be put on monitoring public debt developments, while medium-term budgetary objectives should be strengthened to address implicit liabilities. Moreover, long-term budgetary projections which identify the impact of ageing on public finances can support the preparation of national sustainability strategies and promote measures to reform pension and health systems and increase employment rates.

(ii) **enhancing the quality of public finances**. In other words, ensuring better value for public money, by channelling public expenditure and taxation systems towards growth-friendly and competitiveness-enhancing activities. Reforms of social expenditure programmes that offer better income protection while strengthening incentives to work – the flexicurity approach – would also greatly help to enhance the sustainability and quality of public finances while ensuring that budgets support macroeconomic stability.

But beyond budgetary surveillance, there is a clear need to **broaden surveillance to address macroeconomic imbalances**. Developments within Member States such as the growth of current account deficits, persistent inflation divergences or trends of unbalanced growth need to be monitored given that the occurrence of spillover effects and the growing interdependence of euro-area economies mean these developments represent a concern not just for the country in question but for the euro area as a whole. The evidence of the first ten years of EMU indicates that while market integration, particularly in financial services, is beneficial overall for EMU – as it can help absorb macroeconomic disturbances by providing risk-sharing opportunities and fostering reallocation of resources – it can also, if not accompanied by appropriate policies, amplify divergences among the participating countries. While some of these divergences can be benign – reflecting the catching-up process or even normal adjustment – they may also be harmful and the result of inefficient adjustment. In this case, enhanced surveillance would help the affected countries to devise early responses before divergences become entrenched.

Finally, a broader **surveillance of euro-area candidate countries,** akin to that proposed for current euro-area members, will be crucial to help them prepare for the challenges of sharing a single currency. Many future euro-area members are experiencing large capital inflows (reflecting expectations of continued fast income growth) and rapidly developing financial sectors, both of which can boost credit (typically from a low base) and result in external imbalances. Currently surveillance of prospective euro-area countries takes place via the assessment of Convergence Programmes. But there is scope to provide stronger policy guidance and closer surveillance of economic developments in particular for the countries participating in the Exchange Rate Mechanism (ERM) II framework, which is both an element of the euro adoption criteria and an instrument to foster sustainable nominal and real convergence. This should not mean imposing any additional constraints on euro-area entry.

Surveillance must build on the existing instruments. The key instruments for fiscal policy surveillance and economic policy coordination are clearly anchored in the Treaty and the SGP. The enforcement of the corrective arm of the SGP will remain a key pillar in dissuading non-compliance with the Treaty. The SGP provides for the definition and assessment of medium-term budgetary strategies through Council opinions on national Stability Programmes. Article 99 of the Treaty states that "Member States shall regard their economic policies as a matter of common concern" and "shall coordinate them within the Council". The euro-area and country-specific recommendations of the Lisbon process are key instruments for guidance and surveillance. There is, however, scope to improve the way such instruments are used. The analysis of the first 10 years reinforces the case for strengthening the preventive part of the SGP, as endorsed by the ECOFIN Council,[2] to support the achievement of sustainable budgetary policies and address broader issues which may affect the macroeconomic stability of a country and the overall functioning of EMU. These Treaty-based instruments are complemented by the Medium-Term Budgetary Review process undertaken by the Eurogroup in the spring of each year. While it has so far focused on budgetary surveillance, this peer review mechanism should broaden its scope to make the Treaty-based surveillance more effective.

Better integrating structural policies in the co-ordination process

The euro area has a **special interest in the success of structural reform**. Stepping up reforms – of course welcome in the EU as a whole – is an absolute must for the euro area. Importantly, improved market responses will pay a double dividend – by boosting growth in living standards over the longer haul while allowing better adjustment to shocks and fostering macroeconomic stability. Empirical evidence from our analysis indicates that structural reforms in countries sharing the single currency have higher "multipliers" than elsewhere: that is, those countries undertaking structural reforms can accrue more benefit while those falling behind may pay a higher price for their inaction. The Lisbon Strategy for Growth and Jobs, which has been instrumental in putting structural reform on the policy agenda, provides the basis for identifying the most pressing areas for action through Guideline No. 6 on the euro area and the euro-area-specific recommendations. In a partnership approach between the

[2] COM(2007) 316

Commission and the Member States, the Lisbon Strategy forms the basis for steering the reform process in both the euro area and the individual countries.

Removing remaining barriers to *product market integration* is essential for a well-functioning euro area. Yet despite the boost given by EMU and the Single Market Programme to the creation of more open and competitive economies, low productivity growth and entry barriers, especially in services, are still hampering efficient adaptation to changing economic circumstances in the euro area and are keeping up pressure on prices. Innovation and technology diffusion, important elements for enhancing both competition and productivity, are lagging behind in euro-area member states. The market monitoring system proposed in the Single Market Review should be used to specifically target these shortcomings.

Better-functioning labour markets are needed in the euro area to underpin adjustment in a globalised economy and raise growth potential in the face of ageing populations**.** Greater wage flexibility and differentiation across industries, occupations and regions, and investment in human capital are instrumental in boosting competitiveness and allowing the smooth reallocation of resources in the event of shocks. Numerous reforms to raise labour utilisation have been undertaken in the framework of the Lisbon Strategy – and have paid off. However, progress has been uneven across countries and should therefore remain at the core of reform strategies in the next decade. Reforms of social expenditure programmes and active labour market policies should aim to offer better income protection while strengthening incentives to work.

The euro area can draw **comparatively large benefits from promoting EU *financial integration.*** Significant progress has been made in integrating EU financial markets but further efforts are required to enhance the efficiency and liquidity of euro area financial markets. This would facilitate economic adjustment through risk sharing and promote a more uniform transmission of the single monetary policy across the euro area. In particular, increased effort is required to promote the cross-border provision of retail financial services, to improve the efficiency of corporate and government bond financing and ease regulatory and supervisory costs for financial intermediaries operating in a multi-jurisdictional environment. Given the shared responsibility of the Eurosystem and participating Member States to safeguard financial stability in the euro area as a whole, there is a growing need for stronger cross-border cooperation in arrangements for crisis prevention, management and resolution as financial integration proceeds. In light of these specific efficiency and stability considerations and taking on board the lessons of the current financial turmoil, the euro area should take a strong role in fostering the EU agenda for financial integration and in enhancing EU financial stability arrangements.

To reap the full potential of EMU, there is therefore a need to **strengthen the incentives to pursue reform** in the euro area. Integrating structural policies in the euro area coordination process can provide support via three avenues: (a) The recommendations to the euro area as a whole together with the country-specific recommendations made within the Integrated Guidelines of the Lisbon Strategy provide the backbone for the coordination of structural reforms; a closer monitoring of their implementation needs to be organised. (b) The reform of the SGP in 2005 created the possibility, when assessing progress towards the medium-term budgetary objectives, to take account of structural reforms that are fiscally costly in the short run but yield longer-term gains in terms of growth and fiscal sustainability. To ensure compliance with the commitments enshrined in the SGP, a peer review mechanism could be established based on the analytical framework developed under the Lisbon Strategy and ex ante information provided by Member States. (c) To achieve a better sequencing of reforms, particular priority should be given to improving the functioning of financial markets. This would not only have favourable effects on growth and adjustment, but would also help boost the incentives for other structural reforms to follow by bringing forward their longer-term benefits and allowing capital to flow to the new investment opportunities generated by these structural reforms.

II. The external policy agenda: enhancing the euro area's international role

The international status of the euro brings **advantages, responsibilities and risks.** It helps develop the financial industry in Europe, yields seignorage gains from the use of the euro as a reserve currency and reduces exposure to exchange rate volatility as pricing and invoicing in euros develops. But the sheer size of the euro area means that policy decisions and economic developments within EMU are felt elsewhere, not least because global financial markets are acting as an ever-stronger international transmission channel. And there are risks, as the growing international status of the euro exposes the euro area to disruptive portfolio shifts between key international currencies and asset classes. All in all, the growth of the euro as an international currency and the combined strength of the euro-area economy have changed the rules of the game for the members of EMU and for their international partners.

The euro area must therefore **build an international strategy** commensurate with the international status of its currency. Following a successful first decade, the euro area, which already provides a stability anchor for its neighbours, is now called upon to develop a clear and all encompassing strategy on international economic and financial affairs. It has to play a more active and assertive role both in multilateral fora and through its bilateral dialogues with strategic partners. It has to improve coordination and define common positions and – when appropriate – common terms of reference on all these issues. It has to speak with a single voice on exchange rate policies and assume its responsibilities in financial stability and macroeconomic surveillance issues. The risk that the unwinding of global imbalances disproportionately harms the competitiveness of the euro area and its members is adding to these needs.

The most effective way for the euro area to align its influence with its economic weight is by **developing common positions and by consolidating its representation, ultimately obtaining a single seat** in the relevant international financial institutions and fora. This is an ambitious aim and progress on the external agenda will depend first and foremost on a more effective system of euro area governance. Even though the EU and euro area are often seen by other countries as over-represented in international organisations (in terms of both seats and voting power), the euro area still punches below its economic weight in international fora. Consolidating the euro area's representation would strengthen its international negotiating power and reduce the costs of international coordination, both for the euro area and for its key partners. It would also free up much needed space for emerging market countries to increase their participation in international financial institutions.

III. Promoting effective governance of EMU

EMU's system of **economic governance must rise to the challenges** facing the euro area**.** That said, the current division of responsibility between the institutions and instruments that govern the conduct of economic policy in EMU is sound overall. Nevertheless, there is a clear need to adapt institutions and practices to tackle the emerging policy challenges.

A **strong involvement of all EU Member States within the ECOFIN Council** is key to ensuring that EMU functions effectively. From the outset the ECOFIN Council has been the forum for economic policy decision-making in the EU and, in view of the evolving overlap between the euro area and the EU, it should remain centre stage in EMU's system of economic governance by integrating EMU issues more thoroughly in its work. In particular, it could push for a more consistent approach within its own fields of competence – i.e. macroeconomic policy, financial markets and taxation – so as to ensure positive synergies between them. The current Treaty provides ample scope for more comprehensive coordination and surveillance along these lines across the whole EU. Moreover, while the new Lisbon Treaty, once ratified, will strengthen the role of euro area finance ministers on questions affecting the functioning of EMU, all discussions on these issues will take place within the ECOFIN Council.

The **Eurogroup should continue to serve as a platform for the deepening and broadening of policy coordination** and surveillance in EMU. In terms of fiscal surveillance, ex ante coordination of budgetary policy through the Mid-Term Budgetary Review should be geared to guiding fiscal behaviour over the cycle as a means to address any pro-cyclical bias. In view of the ageing challenge, a major task is to increase the effectiveness of the preventive arm of the SGP in fostering the achievement of ambitious medium term objectives. To avoid the build-up of imbalances and excessive divergences between euro area countries, the Eurogroup should exchange views, develop policy guidelines and monitor Member States' compliance in areas that foster adjustment capacity and macroeconomic stability. “Peer reviews” – multilateral discussions on relevant developments in one or several countries – should be strengthened to encourage ministers of finance to consider national issues and policies within a euro-area perspective. Moreover, the Eurogroup should devote greater attention to monitoring the euro-area Lisbon recommendations in order to increase potential growth and strengthen competitiveness through structural reforms.

The Commission should play a strong, supportive role to ensure the effective functioning of EMU. It is called upon to foster the coordination of policies while internalising the EMU dimension in its policy proposals. It should step up its fiscal and macroeconomic surveillance and promote further economic and financial integration. In its surveillance role, it should deepen the assessment of economic and financial developments of the euro area, focusing in particular on the spillovers of national policy measures. Work to improve the accuracy of cyclical and structural fiscal indicators should continue, in cooperation with the Member States. As to the international agenda, the Commission needs to enhance its role in international dialogues and fora. In sum, the Commission must support efforts to improve the functioning of EMU both domestically and internationally by assuming the responsibilities assigned to it by the Treaty as the guardian of sound economic policies. To this end it should endeavour to better exploit the instruments provided by the Treaty.

The new Treaty, once ratified, will provide scope to strengthen coordination and surveillance of economic policies within the euro area**.** Article 136 of the resulting Treaty on the functioning of the European Union would offer the possibility to "adopt measures specific to euro-area Member States: to strengthen the coordination and surveillance of their budgetary discipline; and to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance". Furthermore, the Treaty would enhance the Commission's role as an independent “referee” in the context of multilateral surveillance, with Article 121 giving the Commission the possibility to issue direct warnings to a Member State when its economic policies are not consistent with the broad guidelines or risk jeopardising the proper functioning of EMU.

EMU's governance system must **ensure that euro-area enlargement continues smoothly**. Over the next decade, the euro area is set to expand to encompass most current EU Member States and ensuring that this process proceeds appropriately will safeguard the effective functioning of the euro-area economy in the future. During participation in ERM II, countries should capitalise on the environment of enhanced macroeconomic stability to adopt sound macroeconomic and structural policies. As specified in the Treaty, the Commission should provide a regular, fair assessment of sustainable progress in the convergence process. The Eurogroup and ECOFIN in turn have a special responsibility to build trust, survey economic developments and provide the necessary guidance in terms of the policies and reforms necessary for prospective euro-area members' nominal and real convergence.

There is also a need to **improve the dialogue concerning EMU among the EU institutions and with the public at large**. The Commission should develop its dialogue and consultation with the European Parliament in particular, as well as other European and national stakeholders. In a similar vein, the Eurogroup should pursue dialogues with the ECB, the European Parliament and the social partners in the euro area. All these institutions, starting with the Commission, should improve communication on EMU issues to the wider public. In particular, there is a need to better explain the euro's significant macro- and microeconomic advantages, such as its role as a protective shield during the recent financial turmoil, and the significant, beneficial contribution of economic policies in EMU.

CONCLUSION

EMU is a resounding success. Ten years into its existence, it has ensured macroeconomic stability, spurred the economic integration of Europe – not least through its successive enlargements –, increased its resilience to adverse shocks, and become a regional and global pole of stability. Now more than ever, the single currency and the policy framework that underpins it are proving to be a major asset. Nevertheless, there is potential to reap further benefits from EMU. This -- coupled with the pressing challenges of globalisation, scarce natural resources, climate change and population ageing, -- calls for improved co-ordination of economic policies, further progress with structural reforms, a stronger global role for the euro area and an unwavering commitment by Member States to achieving these goals. The fact that the effects of these global trends are already being felt in high energy, food and commodity prices, financial turbulence and global exchange rate adjustment only underscores the importance of timely action.

Achieving the domestic and external policy agenda and improving governance as set out here will go a long way towards meeting the challenges that the euro area and the global economy are facing. It will also bring important positive benefits for all EU members:

- **EMU remains a milestone of EU integration**. Although its objectives and achievements are predominantly economic, EMU has never been solely an economic project. From the outset EMU was conceived as a crucial step in the process of EU integration. This role has become even stronger since the EU’s enlargement from 15 to 27 Member States since 2004, with all newly acceded EU member countries preparing for euro adoption. The prospect of euro-area accession has been one of the main drivers of those countries' convergence with the EU's standard of living.

- **A well-functioning EMU is a major asset for the EU as a whole**, not least since the overwhelming majority, if not all, of EU countries will eventually become members of EMU. A thriving euro-area economy will contribute to the wealth and dynamism of the whole EU, reinforcing public support for EU integration both within and outside the euro area.

- **A strong EMU will also foster the EU's leadership in the global economy.** A well-functioning euro area lays the foundations for EMU to play a strong role externally, both in the macroeconomic sphere and in the area of global financial supervision and regulation. Proving its ability to strengthen the euro area's external role and assume its global responsibilities will have positive spin-offs for other policy areas where the EU aspires to global leadership, e.g. sustainable development, development aid, trade policy, competition and human rights.

Political will and determination is required to implement this comprehensive agenda. . The very success of EMU shows that political initiative and ambition can generate considerable economic, social and political benefits. But to fully deliver these benefits, the continued involvement of all parties is crucial. Hence the Commission will encourage a wide discussion on these topics in the second half of 2008 and promote a broad consensus on the building blocks of this agenda with other EU institutions as well as a range of relevant bodies and stakeholders. Drawing on this discussion, the Commission will come forward with appropriate operational proposals.