EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

REP 51607 – 09/03/2006

The Institutions and Policies of EMU:

How the Single Currency Works

PRESENTATION BY MR. HERVÉ CARRÉ

Deputy Director General – DG Economic and Financial Affairs - European Commission

EMU Governance and Euro Changeover:

Slovenia on the Path to the Adoption of the Euro

Ljubljana, 17 March 2006

Ladies and Gentlemen,

I am very pleased to present the institutions and policies of EMU and exchange thoughts on EMU governance.

In my view good EMU governance is the *sine qua non* for successful performance in the euro-area. Good economic governance has two dimensions. It should foster growth- and stability-oriented macroeconomic policies but also structural reforms.

My presentation today consists of three parts:
1. First, I will briefly describe the institutions and policies of EMU.
2. Second, I will assess the euro-area's performance with respect to monetary policy, fiscal policies and structural policies.
3. Third, I will discuss some recent improvements in the governance of euro-area economic policies.

1. Institutions and policies of EMU

Macroeconomic policies in the euro-area are closely co-ordinated. The euro-area has a single exchange rate policy and a single monetary policy, which is the exclusive responsibility of the European Central Bank (ECB). Fiscal policies are in principle determined by the Member States. However, sound fiscal policies are essential for the success of a single monetary policy. Therefore, the Treaty and the Stability and Growth Pact provide for close co-ordination of Member States' budgetary positions so as to ensure the necessary discipline. The Pact provides, in the short run, for the necessary leeway for the free play of the automatic stabilisers in response to economic downturns. In the medium- to long-term, the Pact promotes sustainable public finances and a reallocation of public resources in line with government priorities. The SGP contains a preventive and a corrective arm which encourage countries to adopt the appropriate budgetary policies and to put an early end to an excessive deficit situation

Microeconomic policies usually are co-ordinated in a looser way since there are typically fewer spillovers between Member States[1]. Co-ordination can then, for example, take the form of exchanging information and best practices, or the formulation and adoption of general guidelines or agreement on objectives. The coordination of structural reforms in the context of the Lisbon Strategy falls in this category. The Integrated Guidelines are the EU's main policy coordination instruments here. They play an overarching role, and give strategic direction on key economic policy issues in the medium term. They concentrate on the contribution that economic policies can make to meet Lisbon's growth and employment goals.

2. Assessment of economic policies.

Let me now assess the euro-area's performance with respect to macroeconomic policies and structural reform, starting with the macroeconomic policies. Monetary policy makes the optimal contribution to future growth if it continues to deliver price stability in the medium-term. Clearly, the ECB has been successful in that respect and this is an impressive achievement. Inflation rates already started to decline significantly in the 1990s during the run-up to the launch of the euro. During the first 7 years of the euro's existence, inflation expectations have been remarkably stable and within the price-stability definition of the ECB.

The single currency has done more than delivering price stability. It also led to a dramatic fall of long-term interest rates and to the elimination of exchange-rate uncertainty in the euro-area. Price stability, lower interest rates and the elimination of exchange rate uncertainty within the euro-area have boosted trade and investment and thus made a significant contribution to economic growth.

Fiscal policies in the EMU Member States have also contributed to macroeconomic stability in EMU. Looking at the progress with fiscal consolidation, we see that an impressive degree of consolidation was achieved in the run-up to the launch of the euro. On average, budget deficits fell by more than 5% of GDP during the 1993-1998 period. However, since 2000 the performance on the fiscal front has been

[1] The exceptions here are competition policy (for which the Union has a single policy) and the single or internal market policy (which requires a close coordination, e.g. to maintain a level playing field).

disappointing and further fiscal consolidation is clearly and urgently called for. Recent experience has revealed some shortcomings of the Pact. This has led to a reform of the SGP which I will discuss later on.

Now let me briefly assess the contemporary macroeconomic policy mix in the euro-area, i.e. the current combination of monetary and fiscal policies. There are clear signs that the euro-area is recovering. GDP growth is expected to pick up from 1.3% in 2005 to 1.9% in 2006[2], although output is expected to stay somewhat below its potential. Monetary policy is still accommodating but the ECB has started to withdraw some of the stimulus by raising its key interest rates on 1 December and 2 March. The outlook for fiscal policies in 2006 and 2007 is disappointing: the euro-area is making little progress with consolidation. As the euro-area economy begins to reach its potential growth rate, a number of Member States should seek to undertake an annual adjustment in cyclically-adjusted terms that looks beyond the 0.5% of GDP benchmark foreseen in the Stability and Growth Pact. More stringent fiscal consolidation is necessary to reduce the high levels of public debt. Moreover, further fiscal consolidation is likely to contain inflationary pressures, which would reduce or postpone the need for the ECB to raise its interest rates. In this way fiscal consolidation could promote an investment-inducing and thus growth-friendly policy mix.

*

*   *

Apart from macroeconomic policies geared towards growth and stability, the euro-area needs to be able of quickly adapting to changing economic conditions and challenges and able to seize the opportunities that present itself in this changing world. Only in this way will it be able to sustain and increase the living standards of its people.

Mr. Almunia therefore rightly referred to the necessity of structural reforms in product, labour and capital markets and to the need for more investment to increase our human, physical and knowledge capital. Prompt action in these areas will be crucial for tackling successfully the enormous challenges that we are facing at the moment. These are – of course – the lack of growth and new jobs, the growing competitive pressures from an integrating world economy, and the consequences of

[2] Commission’s Autumn forecasts, confirmed by the interim forecasts.

an ageing population. To meet these challenges we need to step up our potential growth, by becoming more productive and increasing employment. But we must also become a global and dynamic economy, more resilient and flexible. This would enable us to move to growth sectors and processes and to embrace new markets while alleviating the social and economic costs of adjustment. Higher price and wage flexibility is, of course, of paramount importance to the euro-area, since participating countries cannot restore any loss in competitiveness through an exchange-rate adjustment.

The intentions and the recent progress of the Member States in the area of structural reforms were assessed in the Commission's Annual Progress Report. This report was published at the end of January and will be on the table of Heads of State or Government during the Spring European Council in Brussels next week. The Report showed that the EU is on the right track, but that the path ahead remains long and demanding. The report also identified four areas for urgent action: knowledge and innovation; business potential; globalisation and ageing; and energy policy. Measures in these areas should be implemented by 2007 and complement the medium-term priorities specified in the Integrated Guidelines.

One aspect of structural reform that is of particular relevance to the euro-area is financial market integration. Financial integration is crucial for enhancing the growth potential and enabling the euro-area to reap ill the benefits of the single currency. In an integrated market, savers and investors benefit from broader choices at lower transaction costs. At the macroeconomic level, this translates into higher saving, investment, productivity, and eventually economic growth. Economic studies have concluded that financial integration would bring substantial and durable benefits (order of magnitude: 1% GDP). This is why successive European Councils have established the integration of EU financial markets as a priority of economic reform.

However, even with the euro in place, the objective of a single financial market still remains to be achieved. It is true that the adoption of the euro has removed the most significant barrier to cross-border financial transactions. However, at the same time it has highlighted the opportunity costs of the remaining sources of fragmentation in the system. The implementation of the Financial Services Action Plan, the blueprint for EU financial integration will be a further significant step. As the measures contained in it have now been adopted at EU level and are being transposed in the national legislation of the Member States, the focus is now on implementation, enforcement and continuous evaluation.

3. Recent improvements in economic governance

As the final part of my presentation, let me address three recent developments that have strengthened the economic governance of the euro-area. These are: the new organisation of the Eurogroup, the reform of the Stability and Growth Pact and the new partnership between the Commission and the Member States in pursuing the Lisbon Strategy.

First, the Eurogroup. The Eurogroup plays a positive role in the overall economic governance of the euro-area. By gathering economics and finance ministers from all euro-area Member States as well as representatives from the ECB and the Commission, the Eurogroup provides a unique and successful structure for coordinating macroeconomic policies within the euro-area. Since the beginning of last year, the presidency of the Eurogroup is no longer on a 6-monthly rotating but on a 2-year basis. This brings greater coherence and continuity in international relations and could contribute towards a better representation of the interests of the euro-area on the world stage.

Second, I already referred to the reform of the SGP, which was agreed upon in March 2005. Let me give you four reasons why I am convinced that the reformed Pact has improved economic governance.

1. First, the revised Pact greatly clarifies the role and responsibilities of the Commission, the Council and the Member States in ensuring sound fiscal policies in Europe.

2. Second, it does more to prevent excessive deficits from arising in the first place. The emphasis here is on seizing the opportunities created by periods of buoyant economic growth to consolidate fiscal positions.

3. Third, when excessive deficits do occur economic analysis will play a more central role. This means that adjustment period can be adapted to country specificities and that exceptions to the 3%

deficit ceiling can apply when there is negative growth or a protracted period of very low growth.

4. I would also like to point out that our initial experiences with the revised Pact have been encouraging and suggest a renewed sense of national ownership of the framework. In the cases of Italy, Germany, and Portugal, the revision of the Pact allowed deadlines for the correction of excessive deficits to be set that were realistic about the appropriate speed of adjustment.

Finally, there has been an improvement in the economic governance of the reform measures to be taken in the context of the re-launch of the Lisbon strategy. This is the new partnership between the Community and the Member States which has made the distribution of tasks and responsibilities clearer and more streamlined. The EU issues advice on how to achieve the objectives mentioned above through the Integrated Guidelines package. This consists of the EU's main policy coordination instruments, namely the Broad Economic Policy Guidelines and the Employment Guidelines. The Member States are then responsible for their National Reform Programmes, which follow the general orientation given by the Integrated Guidelines but are tailored to their individual needs. Finally, the Commission assesses these programmes in its Annual Progress Report. Our expectation is that this organisation mode will lead to a stronger commitment of the Member States to implement the necessary reform measures.

4. Summary

To conclude, let me recap the main themes of my presentation today.

1 First, I discussed the institutions and policies of EMU. I touched upon the strong forms of co-ordination in the macroeconomic area (single monetary policy, strong co-ordination of fiscal policy) and explained that structural reform is subject to softer forms of co-ordination.

2 Second, I argued that EMU's monetary and fiscal policies have on the whole been growth and stability oriented. However, I also emphasized that further fiscal consolidation is called for. This should not be postponed any further, in particular since the euro-

area is about to enter “good times”. I also showed that EMU is making progress in the area of structural reform but that the pace has so far been insufficient and needs to be moved up a gear.

3. Third, I have explained why I am optimistic about recent initiatives to improve economic governance. In this context I mentioned the Eurogroup, the reform of the Stability and Growth Pact and the new partnership between the Commission and the Member States in dealing with the Lisbon Agenda.