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## **Making EMU fit for the 21<sup>st</sup> Century**

*Check Against Delivery  
Seul le texte prononcé fait foi  
Es gilt das gesprochene Wort*

The Brussels Economic Forum 2007 "Global Adjustment and EMU"

**31 May 2007**

Ladies and Gentlemen,

It is a great pleasure to be here this afternoon to participate for the third time in the Brussels Economic Forum. I would like to thank Klaus Regling and DG Ecfm for their excellent organisation and to all the participants and speakers for coming here and making this year's event a success.

This is a pivotal moment in the EU's history. During the coming weeks and months decisive discussions will also take place on the institutional domain, as we try to reach an agreement on the new Treaty after two years of political crisis following the negative results of the French and Dutch referenda. As such, the future of Europe will be put into sharp focus. At the same time, a strong and sustained economic recovery is taking hold just as the Economic and Monetary Union approaches its 10th anniversary in 2008.

In light of both the historic discussions taking place and the lead up to the 10<sup>th</sup> anniversary, this seems like an ideal opportunity to engage in a serious assessment of how EMU has performed during its first full cycle and to think about an improved policy framework for the future.

## **I. EMU: A DECADE OF ACHIEVEMENT**

There is a great deal to be positive about when we consider the benefits that EMU brings. I will recall EMU's five most important achievements and then say something about the euro-area's current, remarkably strong economic performance. However, my main purpose today is to outline the formula for a better functioning EMU.

### **Achievements of EMU**

First and foremost, EMU provides stability and protection in a fast changing global economy. The increased resilience to external shocks and removal of exchange rate risks have helped it achieve its second key success: consistently low and stable inflation rates. Inflation in the euro area has fallen from around 7% on average in the 1980s to just around 2% today, bringing substantial savings for citizens and businesses.

In parallel with price stability, EMU can boast a dramatic fall in both nominal and real euro area interest rates since its foundation. Financing conditions remain favourable even after recent interest-rate increases, thanks to the monetary policy of the ECB.

As a fourth achievement, EMU has boosted European economic integration. The euro has been a strong catalyst for trade, foreign direct investment and financial market integration in the euro area.

Finally the euro's rapid emergence as the world's second most important global currency in less than a decade is a remarkable accomplishment. The role of the euro in international trade, in foreign exchange markets and as an official reserve currency has grown substantially and continues to rise, reflecting the confidence placed both in the single currency and in its underlying economic policy framework.

## **A robust economic performance and a positive outlook**

These five achievements of EMU are contributing to the current economic recovery. President Barroso has already described this morning the very positive economic situation in the European Union, and the figures for the euro area are similarly encouraging. Although slightly less than in the EU, euro area growth in 2006 was well above the long term average and unemployment dropped to record lows.

There is no question that a cyclical upturn lies behind the positive figures. But I would argue that the EMU's stability-oriented macroeconomic policies and Member States' commitment to structural reform are also helping to drive the current upswing.

Our Spring economic forecasts, which were published earlier this month, give good reason for us to remain optimistic. The euro area economy is likely to remain buoyant with growth rates above potential for this year and the next. Employment prospects are encouraging as well: over the period 2007-2008, the euro area is expected to create nearly 4 million new jobs and the unemployment rate is expected to fall further to below 7%. Such a bright outlook is also having a beneficial effect on Member States' public finances, bringing the fiscal deficit down further to a forecasted 1% this year.

## **II. OUR MAIN ECONOMIC CHALLENGES**

It's clear when we cast an eye over the achievements of EMU that there is much we can feel proud of. But while we are enjoying economic good times, we ought to pay attention to the challenges ahead and to think about the future. It is only fair to say that EMU is encountering some important challenges that we need to tackle head on. Let me tell you what I perceive to be the most important economic challenges facing the euro area as we head towards the tenth anniversary of EMU.

### **Securing appropriate macroeconomic policies**

First, we need to ensure that appropriate macroeconomic policies continue to prevail in the euro area. The benefits brought by the euro are the consequence of a solid and unique framework created for EMU.

However there is scope for this framework to be strengthened further, primarily regarding fiscal policies, which are not totally sound in a number of Member States. Our experience with the revised Stability and Growth Pact has been very encouraging regarding the correction of excessive deficits. However, not all Member States are doing enough to further consolidate their public finances and to avoid pro-cyclical loosening of their fiscal stance at a time when tax receipts are buoyant and the growth outlook is positive. In doing so, they risk repeating the errors they made during the previous recovery.

National governments need to step up consolidation efforts in good times. Surveillance of fiscal developments in country-specific booms should be strengthened. Overall, better coordination of fiscal policies and shared objectives for the area as a whole would improve the policy mix and dialogue with the ECB so as to ensure a macroeconomic framework conducive to more growth and employment.

## **Enhancing adjustment dynamics and boosting the euro area's growth potential**

The problem of sluggish economic adjustment in EMU is the second key challenge we have to address.

Adjustment in the euro area is relatively protracted and is accompanied by large and persistent swings in economic activity. Consequently, growth differences are larger and more persistent than they need to be. We have analysed this issue in our EU Economic Review published last November.

Let me illustrate: the average annual growth rate over the period 2002-2006 was below 1% in Portugal, Italy and Germany, but above 3% in Spain, Luxembourg, Finland, Ireland and Greece. Not only this but prolonged inflation differences and large current account imbalances in some Member States of the euro area also indicate that adjustment is not functioning smoothly enough.

In theory, adjustment in the euro area should operate primarily through changes in a country's competitiveness. Below-average demand that reflects poor competitiveness in a given country should lead costs and prices to move downwards. The improvement in the relative cost situation should then improve that country's cost and price competitiveness and increase the pace of economic activity towards the euro-area average. The opposite forces are at work in countries with above-average demand.

But in practice, this competitiveness channel is not working optimally. Pro-cyclical fiscal policies and poor functioning financial, labour and product markets all act to hinder adjustment through this mechanism.

Addressing the adjustment challenge would help to boost the euro-area's growth potential, a problem that afflicts the euro area rather than the EU as a whole. One of the starkest difficulties faced by the euro area in the last five years was a lacklustre growth performance. Compare our growth since the 2001-2002 slowdown with our industrialised trading partners, with the rest of the EU, or indeed, with the euro area's own past performance, and the figures are disappointing.

I do not want to detract from the important reform efforts of Member States in recent years, which have been significant in certain sectors and are beginning to yield positive results. The President has referred to the positive effects of the revised Lisbon Strategy that are adding momentum to the reform process. Yet the overall pace of reform is still too slow and there remains an urgent need to improve the capacity to adjust and stimulate the euro-area's growth potential, especially against the background of ageing populations and an increasingly competitive global economy.

## **Fiscal policies for a better functioning EMU**

The third major challenge of EMU concerns using fiscal policy to improve the functioning of the euro area. I have already noted the importance of putting public finances in a firm position, as this contributes to a sound policy-mix at macroeconomic level. But in my view there are two other issues at stake here.

First, there is a need to increase the "quality" of public finances. Restructuring public expenditure and revenue is a necessary complement to budgetary consolidation and a support to the reform process of the Lisbon Strategy. As such, it should become a key objective for Member States. Adapting tax structures and directing government expenditure towards items such as education and R&D can increase productivity growth and growth potential and bring important social and economic benefits in terms of innovation and human capital accumulation.

These policies would also help to put Member States' public finances on a more sustainable footing and improve the functioning of social models within the euro area. Our forward looking work on social policy issues, like flexicurity, should increasingly address financing issues. Most important, improving the quality of public finances can provide a major contribution to smoothing adjustment in the euro area. We need to decide how we can put these objectives into practice.

Second, we must continue consolidating budgets to ensure that public finances are sustainable in the long run. Ageing will have a considerable impact on our economies, one that will probably begin to take hold as soon as 2010 in countries such as Germany and Italy. Even if the overall negative impact on our welfare systems only becomes apparent in 2020, the challenge remains urgent nevertheless.

Now is the time to act. If not, by 2050 the repercussions could be severe. The old age dependency ratio is projected to double and public expenditure is predicted to increase by up to 4% of GDP in the EU. This is the scenario that we face if current policies are left unchanged.

To avoid this fate, euro area members need to forge ahead with reforms of pension and healthcare provision systems while advancing budgetary consolidation in parallel. Here too, there is a clear euro area dimension in the issue of sustainability and we need to react accordingly.

Improving the coordination of economic and budgetary policies in EMU forms part of the much broader challenge to establish an effective system of economic governance for the euro area. This is the fourth and final challenge confronting EMU that I wish to touch on today.

## **Economic Governance**

Governing an economic and monetary union comprising 13 nations or more is a complex matter. The Eurogroup, lead since 2005 by an elected President, plays a key role as a forum for finance ministers to discuss shared policy challenges and to develop a common understanding on a number of important issues.

In this respect, the outcome of last April's meeting of euro area finance ministers is encouraging. A common set of orientations for fiscal policy was agreed and a constructive discussion took place on national budgetary developments in 2007, the preliminary policy outlook for 2008 and the implications for the euro area.

There are also reassuring signs that awareness of specific challenges for the euro area, such as improving adjustment and enhancing growth, are now becoming real policy issues. For example, the updated Integrated Guidelines on Growth and Jobs, endorsed by EU leaders at this year's Spring European Council, includes a new set of recommendations specific to the euro area.

These call for tighter fiscal policies and improved public finances, more adaptable goods and services markets, responsible wage setting mechanisms and faster progress in integrating our financial markets. Over recent months the Eurogroup has been considering how best to follow up these recommendations.

However, the Eurogroup has yet to assume the critical role that it could play in piloting the economic policies of the euro zone. At times, the collegiality necessary for common action has been missing and Member States have not always succeeded in coordinating their actions effectively or in ensuring that common interests take priority. We need to consider how to overcome these limitations because the Eurogroup is the sole body in which policy makers can together analyse their shared concerns and reach a collective response to economic challenges.

The overall pace of structural reforms could be accelerated in the euro area. EMU should provide stronger incentives for implementing those reforms. The synergies of carrying out various reforms in a coordinated matter must be taken into account better in policy making at euro area level. This is the real issue to be discussed, rather than debates about the independence of the ECB, which should not be put into question every month.

Improving economic governance becomes particularly important in view of the progressive enlargement of the euro area. Following Slovenia's example at the beginning of this year, Malta and Cyprus are now in a very good position to adopt the euro in just seven months from now. In the years ahead I look forward to seeing more EU Member States fulfil their commitment to adopt the euro. But it is true to say that euro area enlargement will test the architecture of EMU's economic governance.

We must avoid a 'two speed Europe' with EU countries divided between euro area and non-euro area members. The Eurogroup should never represent a closed club. Instead, cooperation and trust building among current and prospective participants will be of the essence.

It is clear that the internal governance of our monetary union needs to be strong and cohesive. But we also need to strengthen our role in the international arena. We are today a global currency actor, rooted in the world's largest trading bloc. Yet in reality the external representation of the euro area does not match our growing importance in the international economy, where trade, currency, financial and monetary issues are closely intertwined.

In the future, the creation of a single euro area chair in international financial fora would remedy this situation, although it is a difficult option. In the meantime, we need to improve effective cooperation on key international issues and establish a stable framework for bilateral dialogue with our most important partners. Strengthening our external representation would allow the euro area to help shape the evolving global system, to embed fair rules, open trade and stable finance.

## **CONCLUSIONS**

Ladies and Gentlemen,

I began by outlining EMU's successes. Stability and security, low inflation and interest rates, an integrated European economy and a credible international currency. In my mind there can be little dispute that the euro is bringing clear economic benefits.

But with the experience of almost 10 years behind us, it is evident that there is room for improvement in EMU. I have highlighted some of the central challenges and priorities today: sustaining our successes over the next decades, enhancing adjustment to economic shocks and raising potential growth, increasing the quality and sustainability Europe's fiscal policies and ensuring the effective governance of an enlarging euro area will be key concerns for the coming years.

Looking forward, a better functioning, well governed EMU will then provide a good basis to explain the benefits of monetary union to citizens, address popular misperceptions regarding the euro and promote greater confidence among Europeans in their single currency.

We have now launched a process appraising EMU's performance since its foundation and over its first full economic cycle. DG ECFIN and the Commission at large are working hard on this project. I intend to present the findings of this appraisal next year in the form of policy priorities that will set out how EMU, this crucial project of European integration, should work in the second decade of its existence. In 2008 I want to celebrate the tenth anniversary of monetary union with an updated vision and a clear roadmap for a stronger EMU in the 21st century.