



EMU@10

II. Challenges ahead

In spite of an overall positive assessment of its first 10 years, EMU now faces new challenges that were not fully apparent when it was devised. Globalisation is progressing apace and natural resources are increasingly scarce. Changing terms of trade on world markets and the unwinding of global imbalances could have highly asymmetric effects on the economies of the Member States. The progressive enlargement of the euro area will also make economic structures increasingly diverse within it. These developments will require a high degree of resilience from euro-area economies and an efficient intra-area adjustment capacity. Climate change and the effects of population ageing will put additional strains on the capacity of the euro-area economy to grow. Promoting growth and employment, ensuring efficient intra-area adjustment, enlarging the euro area smoothly, and successfully meeting the area's increased responsibilities in global macro-financial governance, are key priorities for the coming years. The extent to which these objectives will be achieved will depend on the capacity of euro-area members to build a common understanding on the issues ahead and to implement adequate responses both at national and euro-area/EU level.

1. A changing world landscape

Global trends ahead

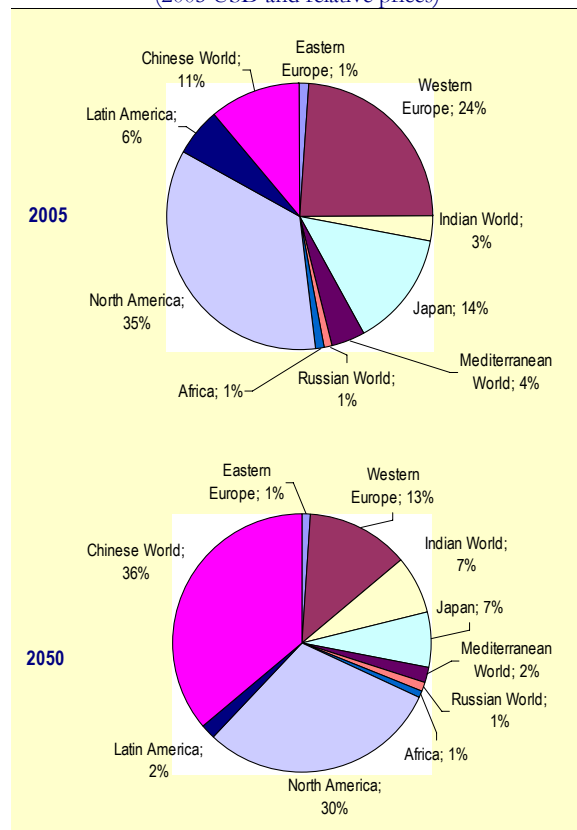
Looking ahead, the global landscape looks different now from how it did at the launch of EMU.

Globalisation has been progressing apace. Emerging economies have become a powerful engine of growth and current projections indicate that their role in the world economy will increase still further (Graph 13). Financial markets are becoming increasingly integrated, with cross-border financial flows outpacing trade flows and financial markets in the emerging world gaining global importance. Meanwhile, the export-driven growth strategies in emerging economies along with dissaving in the United States have contributed to the build-up of global current account imbalances. The risk of a disorderly unwinding of these imbalances has been lurking for some time and while the downturn in the US and the recent depreciation of the dollar go some way towards easing the pressure, they continue to pose a threat for the stability of the world economy.

The growing scarcity of natural resources and climate change may become more acute and act as a constraint on non-inflationary growth in the developed world. The possible end of the disinflation pressures brought by the integration of China's and India's labour force into the global economy and substantial changes in relative

prices caused by climate change and tensions on natural resources markets – which are manifesting themselves in temporarily higher inflation – are likely to present an increasingly stiff challenge to monetary policies. Moreover, this not only makes a strong call on the capacity

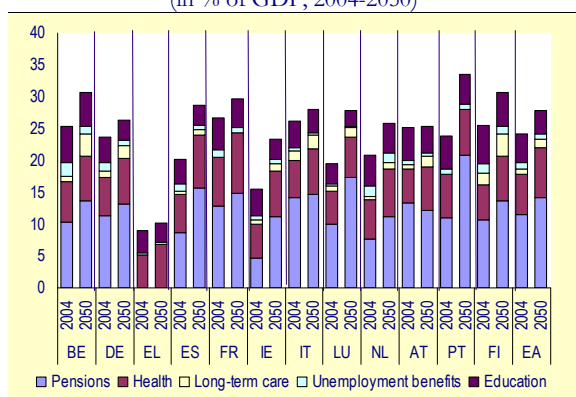
Graph 13: World GDP in 2005 and 2050
(2005 USD and relative prices)



Source: Poncet, S. (2005), 'The long-term growth prospects of the world economy: Horizon 2050', CEPII Working Paper 2006/16.

of economies to adjust, it is also a concern in terms of the adverse income redistribution effects that stem from commodity price inflation – which come on top of the redistribution effects of globalisation combined with technological developments, via a shift in labour demand away from low-skilled work.

Graph 14: Age-related expenditure in the euro area (in % of GDP, 2004-2050)



Source: Commission services.

The rapid ageing of populations is bound to leave its mark on the growth potential and public finances of the advanced economies. It calls for policies to reinvigorate labour market participation, raise labour productivity and strengthen fiscal governance. The lower adaptability of an ageing population will make adjustment to shocks more difficult. Upward pressure on age-related expenditures (Graph 14) and consequently on public finance positions, reinforces the need to keep fiscal policies in check and maintain a focus on the longer-term sustainability of public finances.

Implications for the euro area

These global trends will pose challenges for the performance of all advanced economies in terms of growth, inflation, macroeconomic stability, adjustment capacity, the sustainability of social security systems and the distribution of income and wealth. Euro-area countries are well-equipped to adapt to a globalising world. European trade integration and monetary unification were major leaps forward towards globalisation and the perception that past challenges were successfully dealt with provides comfort for the future. Euro-area economies have long been relatively open economies not

only towards other euro-area and EU countries but also towards other advanced, emerging and developing trade partners. Euro-area participation also offers a clear advantage in terms of stable macroeconomic conditions. However, in several respects, the ongoing global trends produce a number of policy challenges that are even more compelling for – if not unique to – the euro area.

First, the euro area has limited natural resources, and is rapidly ageing while public indebtedness is high. Therefore, many euro-area countries tend to be more exposed and less equipped to respond to ongoing trends which have implications for potential growth. A new impetus for structural reform, building on the Lisbon Strategy for Growth and Jobs, is a priority in the EU as a whole, but an absolute necessity in the euro area, since the lack of efficient markets affects not only the growth potential but also the adjustment capacity of euro-area countries.

Second, from the outset the occurrence of country-specific demand shocks was seen to be a major concern for EMU in the absence of internal exchange rates. They proved to be less of a concern in the first ten years, partly because macroeconomic stability at the national level improved with the adoption of the single currency, and partly also because the global macroeconomic environment has been relatively benign.¹⁹ Going forward, while country-specific shocks are less of a concern than feared before the inception of EMU, notably due to reduced risks of idiosyncratic fiscal shocks, the global environment is set to become more challenging for intra-area adjustment, since exchange rate and terms of trade shocks, are likely to become more prominent. These common shocks affect participating countries differently due to differences in exposure to trade, raw materials and finance (see Box 6).

Third, the relatively greater prominence of adverse supply shocks heightens the risk of conflicts between fiscal policies and monetary policy. The strong counter-cyclicality of interest

¹⁹ It has been shown that reduced volatility of fiscal positions is associated with more synchronised output (Darvas, Z., A. Rose and G. Szapáry (2005), 'Fiscal divergence and business cycle synchronization: Irresponsibility is idiosyncratic', *NBER Working Papers*, No. 11580).



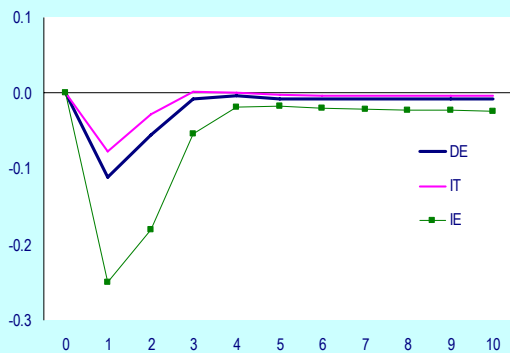
Box 6: Asymmetric effects of common external shocks

The direct exposure of the euro area to extra-euro area trade is only about 17% of GDP but the diversity across Member States is large, which implies that common shocks may have important cross-country repercussions. This is illustrated with simulations with a multi-region version of the two-sector (tradables and non-tradables) QUEST model (European Commission 2006). Simulations are run for three representative countries: Germany, Italy and Ireland. Germany has a trade exposure to the rest of the world in line with the euro-area average, while Italy has a specialisation pattern biased towards more 'traditional' sectors and is more exposed to competition from emerging markets. Ireland has an above-average degree of openness and a high trade exposure to the rest of the world.

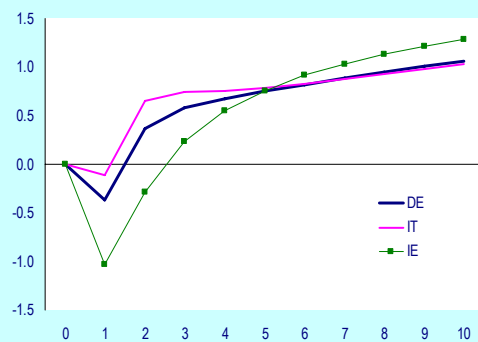
A negative shock to US private demand (both private consumption and investment are assumed to fall by 1%) leads to a reduction in US import demand and exports in euro-area countries. Under flexible exchange rates, a more exposed country like Ireland would have depreciated vis-à-vis other less exposed European countries. However, in the euro area, more exposed countries only depreciate in real effective terms and this requires a stronger relative drop in GDP than under a flexible exchange rate regime. As shown in the first graph below (top left), GDP in Ireland falls more heavily just after the shock than in Germany and Italy.

In the second graph (top right), a shift in investors' preferences away from dollar-denominated assets towards euro-denominated assets leads to a risk premium shock, with the bilateral exchange rate of the dollar with respect to the euro falling by about 10 %. In the first year, the nominal effective exchange rate appreciation amounts to 2.8 % for Italy, 3.7 % for Germany and 5% for Ireland. The shift in investors' preferences raises real interest rates in the US and lowers those of the euro area, which boosts domestic demand in the euro area even if competitiveness deteriorates. The net effect on output is negative in the first stage but becomes positive in the medium run. The initial effects are again strongest in Ireland and weakest in Italy, but the medium run gain is largest in Ireland.

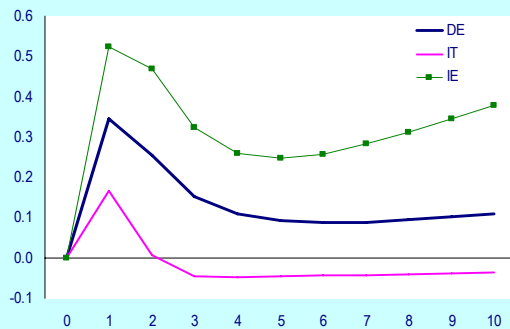
GDP spillovers of a US slowdown
(deviations from baseline in pp)



GDP effects of a euro appreciation due to an increase in investors' preference for the euro
(deviations from baseline in pp)



GDP effects of higher productivity growth in Asia
(deviations from baseline in pp)



In the third graph, higher productivity growth in emerging economies in the tradable goods sector yields lower import prices to the benefit all euro-area countries, but harm exporters in countries that exhibit a specialisation pattern biased towards more traditional sectors, like Italy. Lower import prices boost consumption and raise GDP. A more open economy like Ireland benefits more from this shock. Exporters in Italy, however, are more exposed to competition from Asian producers and lose more market share. Italy's GDP fall in the medium run, unlike in Germany and, even more strongly so, in Ireland.

Source: Commission services

Reference:

European Commission (2006), 'The EU Economy 2006 review – Adjustment dynamics in the euro area, *European Economy*, No. 6.

rates observed in the past decade in the euro area suggests that the trade-offs between inflation volatility and growth volatility have so far remained limited, possibly as a result of a prevalence of demand over supply shocks. Moreover, in past years, many euro-area countries benefited from a substantial improvement in the conduct and credibility of monetary policy.²⁰ However, in the future, not only may inflationary supply shocks become more frequent, but further improvements in the conduct of monetary policy are unlikely. Policy makers may seek to offset the adverse effects of supply-shock-driven inflation by fiscal stimulus, protectionist measures or other quick fixes. However, this would ultimately jeopardise distribution goals, endanger the sustainability of public finances and overburden the single monetary policy. Hence countries will be called on to demonstrate their willingness to fully embrace the objective of macroeconomic stability.

Fourth, there is a unique and pervasive link between the single currency and financial market integration. In the absence of nominal adjustment via internal exchange rates it is essential that other channels of shock absorption are developed. Financial markets are a particularly important one as they facilitate risk sharing and consumption smoothing, and can also make the transmission of monetary policy more powerful whereas fiscal policy will become less effective.²¹ In addition, financial integration can leverage the benefits of structural reforms, allowing capital to flow freely to its best uses, and foster good incentives to reform product and labour markets (see Box 7). However, in light of the disappearance of exchange rate premia, the counterpart of the benefits from financial integration can be widening current account imbalances, increased risks of housing bubbles, boom-bust cycles and financial contagion, risks which are aggravated if supply rigidities in the

real sector are not corrected and if regulation and supervision remains fragmented across euro-area countries.

Fifth, rising global financial and trade integration is contributing to the emergence of the euro as an international currency alongside the dollar. This tendency is irrevocably altering the role of euro-area currency diplomacy and creates new responsibilities for euro-area countries in global macro-financial governance.

In sum, the euro area shares with most other developed economies a rapidly changing global landscape, ageing populations and rising concerns about energy and climate change. These global trends have major implications for the euro area over the next ten years and beyond and call for determined efforts to promote growth and jobs, ensure efficient intra-area adjustment, improve the quality and sustainability of public finances, secure a smooth enlargement of the euro area and carefully manage the euro-area's global role.

2. New goals and challenges for the euro area

Promoting growth and job creation

While job creation has been impressive in the euro area during the past 10 years, total factor productivity (TFP) growth stalled compared with other advanced economies, notably the US. If left uncorrected, this tendency could be very costly in terms of slowing down income growth, jeopardising fiscal sustainability amid ageing populations, complicating the achievement of price stability as primary commodity prices soar, and ultimately putting a brake on employment growth. Indeed, the available longer-term projections indicate that potential growth is expected to halve in euro-area countries in the coming decades (Graph 15). This tendency will crucially be driven by falling labour inputs associated with ageing.²² Against the background

²⁰ E.g. Cecchetti, S. G., A. Flores-Lagunes and S. Krause (2006), 'Has monetary policy become more efficient? A cross-country analysis', *Economic Journal*, No. 116(511), pp. 408–433, April.

²¹ For a survey of arguments on the risks and benefits of financial integration in the euro area see e.g. European Commission (2007), 'EU financial integration and euro-area adjustment', *Quarterly Report on the Euro Area*, Vol. 6, No. 2.

²² See, e.g., Carone, G, C. Denis, K. McMorro, G. Mourre and W. Röger. (2006), 'Long-term labour productivity and GDP projections for the EU-25 Member States: A production function framework', *European Economy — Economic Papers*, No. 253.



Box 7: Financial market integration and capital allocation

Enhanced financial integration among euro-area countries is one of the most notable achievements of EMU. However, while research on the impact on financial integration on growth in the EU (e.g. Guiso et al. 2004) or on risk-sharing (e.g., Kalemlı-Ozcan et al. 2004) are quite abundant, much less work has so far been carried out on assessing the impact of the integration of financial markets on the allocation of capital. Improved capital allocation across productive activities is a key channel through which financial development and integration can deliver higher growth (higher TFP growth associated with a more productive distribution of resources across alternative uses).

Against this background, this box assesses the impact of financial integration on the responsiveness of capital to changing productivity and cost conditions (see also Hartmann et al. 2007 and Roeger, Székely, and Turrini 2008). To this end, an investment variable was regressed against a measure of the 'net marginal product of capital', namely, the difference between the marginal product of capital and the user cost of capital. The elasticity of investment to this variable measures how much capital grows (or falls) in response to a positive (or negative) difference between its marginal product and its cost. A higher (or lower) elasticity is interpreted as characterising a more (or less) efficient allocation of capital, i.e., one in which there is a more (or less) effective response of capital whenever the (static) conditions for an efficient capital allocation are violated. This elasticity is allowed to vary depending on whether countries have adopted the euro and depending on the degree of financial market development and integration. In order to capture inertia in investment, the estimated equation also includes the 1-year lagged dependent variable. To capture the impact of possible omitted variables, country, sector and year fixed effects are included. Since variables are expressed in logarithms, the regression coefficient of the net marginal product of capital measures the elasticity of investment. The impact of financial integration on capital allocation is obtained by interacting the net marginal product of capital with indicators of integration of debt and equity instruments.

The table below reports the results for the baseline investment equation. Data on investment, capital productivity, and costs are taken from the EUKLEMS sectoral database. Data on financial integration are taken from Lane and Milesi Ferretti (2006). Data vary across sectors, countries and time. The sample includes 7 euro-area countries (DE, ES, FR, NL, IT, AT, FI) and 3 non-euro area countries (DK, UK, US). For these countries, a full set of variables including capital stock, investment, TFP etc. is available. As expected, investment reacts positively and significantly to the net marginal product of capital. Separate regressions for countries / years corresponding to euro participation (i.e., for euro-area countries and after 1998) reveal that investment in the countries which adopted the euro exhibits a stronger response to differences between the marginal product of capital and the user cost of capital (column (3)). The interaction of a euro dummy with the net marginal product of capital shows that in the euro area the elasticity of investment is significantly different compared with the rest of the countries (column (4)). Moreover, as revealed by the significant coefficient of the (non-interacted) euro dummy, the euro per-se appears to be associated with increased investment growth, possibly reflecting expectations of lower cost of capital.

Basic capital allocation equation				
Dependent variable:	All years and countries	Non-euro countries	Participation in euro	All years and countries
Investment share	(1)	(2)	(3)	(4)
Investment share(-1)	0.561*** (19.47)	0.548*** (17.74)	0.626*** (7.55)	0.560*** (19.27)
Net marginal product of capital	0.126*** (5.49)	0.115*** (5.12)	0.173** (2.56)	0.118*** (5.18)
Net marginal product of capital * euro dummy				0.047* (1.83)
Euro dummy				0.174** (2.10)
Observations	4365	3657	708	4365
R-squared	0.48	0.48	0.53	0.48

Notes: OLS regression, controlling for sector specific heteroskedasticity. The specification includes country, sector and year fixed effects. Absolute value of t statistics in parentheses: * significant at 10%; ** at 5%; *** at 1%.

The euro dummy identifies countries part of the euro area and years after 1998.

Investment share: log of the ratio between net real investment and lagged net real capital stock

Net marginal product of capital: log (marginal productivity of capital) – log (user cost of capital)

The table below reports results on the link between financial integration and capital allocation. The first column of the table analyses the role of integration in terms of debt instruments, while column (2) looks at cross-border

holdings of equity assets. The financial integration variables are standardised to have zero mean and unit variance, so that the interaction of such variables with the net marginal product variable indicates how much the elasticity of investment increases for a one-standard deviation increase in the degree of financial integration compared with the average. Both the integration of debt and equity markets appears to raise significantly the elasticity of investment. Conversely, those variables do not exert a significant direct impact. Since rising financial integration has coincided to some extent with enhanced domestic financial development, the analysis has been repeated by controlling for the share of credit in GDP as a measure of financial development (columns (3)-(5)). It appears that the financial integration variables maintain a significant impact on the elasticity of investment also after controlling for the effect of financial development.

Capital allocation and financial integration					
Dependent variable: Investment share	(1)	(2)	(3)	(4)	(5)
Investment share(-1)	0.558*** (19.43)	0.557*** (19.49)	0.560*** (19.51)	0.559*** (19.44)	0.557*** (19.44)
Net marginal product of capital	0.125*** (5.43)	0.123*** (5.36)	0.123*** (5.13)	0.123*** (5.11)	0.122*** (0.86)
Debt integration	0.047 (1.13)			0.057 (1.39)	
Net marginal product of capital * Debt integration	0.022** (2.52)			0.020** (2.10)	
Equity integration		0.056 (1.17)			0.051 (0.91)
Net marginal product of capital * Equity integration		0.024** (2.38)			0.024* (2.00)
Financial development			0.026 (0.93)	0.012 (0.353)	-0.011 (0.29)
Net marginal product of capital * Financial development			0.015* (1.86)	0.057 (1.39)	0.006 (0.86)
Observations	4365	4365	4298	4298	4298
R-squared	0.48	0.49	0.48	0.48	0.48

Notes: OLS regression; controlling for sector specific heteroskedasticity; country, year and sector dummies. Absolute value of t statistics in parentheses: * significant at 10%; ** at 5%; *** at 1%.

Debt Integration: Cross-border holdings of assets and liabilities/GDP, debt instruments. Standardised variable.

Equity Integration: Cross-border holdings of assets and liabilities /GDP, equity instruments. Standardised variable.

Financial development: private sector credit as share of GDP. Standardised variable.

Overall, the results lend themselves to the following interpretation. The euro seems associated with greater efficiency in the allocation of capital across sectors and countries. Empirical work shows that the response of investment to differences between the marginal product and the user cost of capital has indeed increased in euro-area countries since 1998. Such an effect seems to be mostly explained by an accelerated pace of financial integration in euro-area countries in the late 1990s, for which the liberalisation of cross-border financial investment and monetary unification are assumed to have acted as major triggers.

References:

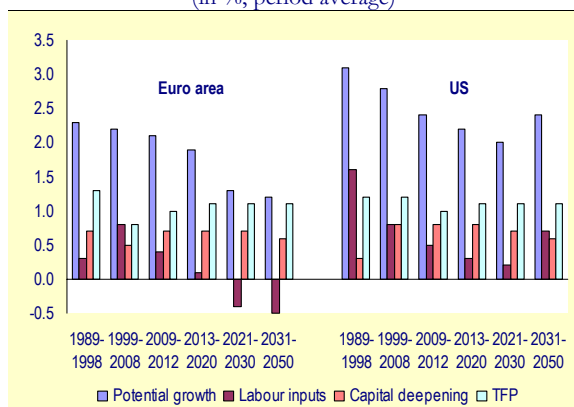
- Guiso, L., P. Sapienza and L. Zingales (2004), 'Does local financial development matter?', *Quarterly Journal of Economics*, Vol. 119(3), pp. 929–969, August.
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of an expected contribution of capital deepening in line with that of other advanced economies, re-launching TFP growth will be key to containing the long-term reduction in euro-area growth potential.

A crucial challenge will thus be to ensure that TFP growth rebounds in a context of shifting global comparative advantages. Financial integration – itself fostered by the euro – would clearly help in this respect as it increases the



Graph 15: **Recent potential growth performance and projections: euro area and US**
(in %, period average)



Source: Commission services.

responsiveness of investment to cross-country differences in the marginal return on capital, which will thus flow more abundantly to countries where structural conditions are most favourable (Box 7).²³ This will tend to accentuate intra-area differences in growth performance, unless structural reforms are implemented in earnest in countries where structural conditions lag. This will require those countries to ensure that their firms are better able to compete at the technological frontier.²⁴ This calls for better human capital formation, the availability of financial instruments to reward projects with high returns and risk, a policy framework supportive of R&D investments, and a growth-friendly regulatory environment, notably with

²³ Firm-level evidence shows that reallocation effects account for roughly half of the total aggregate productivity growth (Bartelsman, E., J. Haltiwanger and S. Scarpetta (2006), 'Reallocation and productivity growth: The FAQs', *2006 Meeting Papers*, No. 293, Society for Economic Dynamics).

²⁴ Recent economic theory has emphasised the role of framework conditions in enabling countries to grow via innovation rather than adoption of new-vintage existing technologies (Aghion, P. and P. Howitt (2006), 'Appropriate growth policy: A unifying framework', *Journal of the European Economic Association*, No. 4, 269–314. Recent evidence based on the EU KLEMS sectoral growth database confirms the view that TFP growth in EU countries is increasingly driven by competition taking place 'at the frontier' (Havik, K., K. McMorrow, W. Röger and A. Turrini (2008), 'The role of total factor productivity in explaining EU–US productivity differences: A macro, sectoral and industry level perspective', *European Economy — Economic Papers*, forthcoming).

respect to start-up firms and would-be market entrants.²⁵

Reforms in labour markets and welfare systems geared towards removing distortions in individual incentives regarding labour supply decisions would also be welcome.²⁶ This would help contain the reduction in labour inputs associated with ageing, where the larger euro-area countries in particular are lagging. Encouraging the labour participation of older and female workers would also be beneficial, as would a smoother transition from education to work. Reducing the costs associated with workers' relocation across economic activities and regions would enable a better match between supply and demand in the labour market. 'Flexicurity' arrangements that facilitate flexible labour market responses in exchange for income security would support this further.

Ensuring efficient intra-area adjustment

The working of the intra-area adjustment channels may improve over time as a result of trade integration and a better anchoring of inflation expectations and an associated decline in nominal (wage and price) rigidities. Increased financial integration would also help by increasing risk sharing, thus permitting a more stable pattern of consumption over time and across countries. However, tensions cannot be ruled out, especially for those euro-area countries that are more exposed to increasing competition from emerging economies or to external exchange rate shocks. Structural policies are

²⁵ See, e.g., Scarpetta, S. and T. Tressel (2002), 'Productivity and convergence in a panel of OECD industries: Do regulations and institutions matter?', *OECD Economics Department Working Papers*, No. 342; Nicoletti, G. and S. Scarpetta (2003), 'Regulation, productivity and growth: OECD evidence', *World Bank Policy Research Working Paper*, No. 2944; Aghion, P. and P. Howitt (2005), 'Growth with quality-improving innovations: An integrated framework', in P. Aghion and S. N. Durlauf (eds): *Handbook of Economic Growth*, Vol. 1A, Amsterdam, North-Holland, pp. 67–110.

²⁶ On the debate on working hours and labour supply in Europe versus the US see Blanchard, O. (2004), 'The economic future of Europe', *NBER Working Papers*, No. 10310; and Prescott, E. C. (2004), 'Why do Americans work so much more than Europeans?', *Quarterly Review*, Federal Reserve Bank of Minneapolis, pp. 2–13, July.

Box 8: Are reforms politically costly?

Although structural reforms figure high on the European agenda, progress is slow. The main reasons why reforms are blocked or delayed have been analysed in theoretical literature (see e.g. Drazen (2000) for a survey), including that they may be politically costly. Since the gains from reforms often occur with a time lag and are thinly spread across the electorate, while possible costs may materialise in the short run and prompt strong reactions by vocal interest groups, electorally concerned governments may have little incentives to carry out bold reforms. Although this argument is common, analysis verifying whether it is supported by the data is scant.

A recent study sheds some light on this issue, and finds that reforms are not necessarily costly in electoral terms (Buti et al. (2008)). It looks at the history of re-elections of heads of government in 21 OECD countries from 1985 to 2004 and examines whether their re-election was affected by major reforms taking place before elections in the unemployment benefit system, labour taxes, employment protection legislation, product market regulations or retirement schemes. Controls are included for the generally accepted determinants of re-election probabilities, i.e. cyclical factors, inflation, the stance of fiscal policy, the political system (e.g. parliamentary vs. presidential, proportional vs. majoritarian) and the political juncture (e.g. margin of majority of the executive in Parliament, political polarisation between parties in the government and opposition). The study finds that reform in the election or in the preceding year does not significantly affect the probability of re-election of the chief executive (see table below). Voters do tend to reward politicians for improving cyclical conditions, while they tend to dislike an increase in inflation. But the fiscal stance as captured by the change in cyclically-adjusted budget balance, is not statistically significant for re-election probabilities.

Re-election probability and economic reforms - Evidence from probit regressions

Dependent variable ¹ : 1 if the identity of the government chief executive does not change after elections.	(1) Baseline	(2) Baseline adding interaction with initial conditions	(3) (2) adding interaction with fiscal stance	(4) (3) adding interaction with both financial regulation and government size
Reform dummy²	-0.015 [0.09]	0.104 [0.56]	0.13 [0.70]	0.146 [0.78]
Overall index of market rigidity³ *reform dummy		-0.243 [2.16]**	-0.241 [2.21]**	-0.305 [2.40]**
Cyclical conditions⁴ *reform dummy		0.579 [2.81]***	0.591 [2.94]***	0.77 [3.17]***
Change in primary CAB⁴ *reform dummy			0.154 [0.86]	
Financial freedom⁵ index *reform dummy				0.361 [5.07]***
(Total Current Primary Expenditure / GDP)⁶ *reform dummy				0.177 [2.23]**
Change in cyclical conditions⁴	0.075 [2.24]**	0.07 [1.82]*	0.069 [1.76]*	0.116 [2.37]**
Change in inflation⁴	-0.022 [1.65]*	-0.024 [1.78]*	-0.025 [1.82]*	-0.027 [1.72]*
Change in primary CAB⁴	0.086 [1.41]	0.099 [1.87]*	-0.018 [0.12]	0.058 [0.78]
Cyclical conditions⁴	0.035 [1.64]	-0.18 [2.16]**	-0.179 [2.32]**	-0.253 [2.69]***
Political controls⁷		v	v	v
Observations	103	101	101	101

Notes: coefficients are marginal probability effects, robust z statistics in parenthesis (absolute value). **, and *** denote, respectively, significant at 10%, 5%, 1%. All interacted variables are standardised.

1/ Constructed using 'Database of Political Institutions', Beck et al. (2001). 2/ 1 if in the past two years at least one of five structural indicators (unemployment benefit, labour taxes, EPL, product market regulations, retirement schemes) improves by more than the median positive change. 3/ Two-year average of the overall index of market rigidities constructed in Duval (2005). The index rises as distortions fall. 4/ Two-year average of output gap, cyclically adjusted primary balance, inflation and their y-o-y change. Source: OECD Economic Outlook, June 2007. 5/ Two-year average of the index of financial freedom. Source: Fraser Institute for Economic Freedom. Higher scores denote higher freedom. 6/ Two-year average of total current primary expenditure, % of GDP. Source: European Commission AMECO database. 7/ In presidential systems, veto players are defined as the president and the largest party in the legislature. In parliamentary systems, veto players are defined as the prime minister and the three largest government parties. Source: Beck et al. (2001).

Source: Commission services



Results change once the reform variable is interacted with the summary index of initial structural conditions. Such interaction make it possible to capture whether the fact that reforms takes place in already 'reformed' countries or in 'unreformed' ones matters in electoral terms. A further interaction considered is with the cyclical conditions, as captured by the level of the output gap. Results in column (2) show that reforms are less politically costly for those countries that are in more urgent need of structural changes and when reforms takes place in 'good times', i.e. when output is above potential.

Column (3) adds to the specification in (2) the interaction of the reform variable with the fiscal stance. The hypothesis tested is whether re-election is harder when reforms take place in periods of fiscal consolidation. Results show that this does not seem to be the case. The hypothesis tested in column (4) is whether, on top of the factors considered in specification (2), more deregulated financial markets and more effective automatic fiscal stabilisers matter for the impact of reforms on re-elections. It appears that less intrusive financial market regulation increases re-election probabilities when reforms are carried out, which is consistent with the expectation that, by bringing forward the future benefits of structural reform and hence increasing the net benefits of reform in the short run, more developed financial markets help reforming governments to be re-elected. Results also confirm that larger automatic fiscal stabilisers, as captured by the share of primary current expenditure on GDP, also reduce the short-run cost of structural reform, thereby increasing their electoral reward.

These results are broadly in line with the recent reform history in advanced economies: countries with more developed financial markets (e.g. Anglo-Saxon countries) and more effective redistribution by the government (e.g. Nordic countries) scored better than others in terms of reform activism in several areas.

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therefore required as an insurance against shocks with an asymmetric impact. Reducing nominal rigidities, especially in the services sector, will help adjust price competitiveness in a stabilising fashion.²⁷ The costs associated with the reallocation of labour will have to be reduced, including by reforms of employment protection, and strengthened active labour market policies and incentive-compatible safety nets.²⁸

Aside from risk sharing, increased financial integration will help adjustment by facilitating the reallocation of investment across activities and national boundaries. However, financial markets act as accelerators of both benign and perverse developments. Hence, the potential for increased resilience against shocks and consumption smoothing needs to be weighed against the increased risk of contagion, bubbles, and boom-bust cycles associated with enhanced financial integration, issues that require an adequate response in terms of national and supra-national prudential and regulatory policy.

Advancements in terms of risk sharing via financial markets weaken the need for shock absorption via fiscal policy, as households are in a better position to smooth income shocks. The impact of ageing on public budgets will call for an accelerated public debt reduction, and this constraint will bite harder as financial markets become more developed. Against this backdrop, it will be important to correct any pro-cyclical fiscal stance in upturns so as to remove deficit

²⁷ Dhyne, E., L. J. Alvarez, H. Le Bihan, G. Veronese, D. Dias, J. Hoffmann, N. Jonker, P. Lunnemann, F. Rumler and J. Vilminen (2006), 'Price changes in the euro area and the United States: Some facts from individual consumer price data', *Journal of Economic Perspectives*, Vol. 20(2), American Economic Association, pp. 171–192, spring.

²⁸ Recent evidence indicates that the competitiveness channel of adjustment in the euro area reacts less efficiently in the presence of tight product and labour market regulations (Biroli, Mourre and Turrini (2008), 'Market regulation and euro-area adjustment: An empirical assessment', *European Economy – Economic Papers*, forthcoming).

bias over the longer haul and support macroeconomic stability. Improved national-level governance, enhanced fiscal indicators, and effective budgetary surveillance within the framework of the revised Stability and Growth Pact would help in this regard.²⁹ This will also help to prevent inconsistencies between Member States' fiscal policies and between monetary and fiscal policies at the euro-area level.

Improving the quality and sustainability of budgets

Extensive social safety nets are a characteristic of most countries participating in the euro area. The financing and management of these safety nets is a main driver of the budgets of participating countries in the euro area. It is thus important that they deliver value for money and can be funded without compromising the macroeconomic stability of the country concerned or the area as a whole. With ageing kicking in soon, the window of opportunity for participating countries to put their fiscal house in order without major disruptions is rapidly closing.³⁰

On the expenditure side, public funds need to be used more efficiently and the growth-friendliness of programmes needs to be enhanced. The same holds true for taxation, as well as for the interaction between tax and benefit systems which still tend to discourage labour market participation in a number of countries. Overall, while measures have been taken to address the economic and budgetary effects of ageing, in several countries there appears to be room for further efforts to enhance the quality of public expenditure and taxation alongside sustainable fiscal positions.

²⁹ See e.g. European Commission (2006), 'Public finances in EMU — 2006', *European Economy*, No. 3/2006 and Debrun, X., L. Moulin, A. Turrini, J. Ayuso-i-Casals and M. S. Kumar, 'Tied to the mast? — The role of national fiscal rules in the European Union', *Economic Policy* 23(54), 297-362, April.

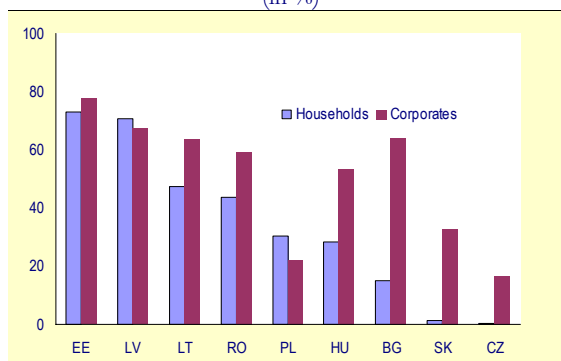
³⁰ For a comprehensive assessment of fiscal sustainability in the EU see European Commission (2006), 'The long-term sustainability of public finances in the European Union', *European Economy*, No. 4/2006.

Enlarging the euro area smoothly

From a longer-term perspective, all new EU Member States will eventually be members of the euro area. In the process, the composition of the area is changing and becoming more diverse. Although the economies of the new Member States are comparatively small, their entry into the euro area would clearly widen the spectrum of economic development levels across the area. For some time, these countries will continue to grow faster, exhibit higher Balassa-Samuelson-induced inflation, and remain more vulnerable to shocks, overheating and rapid reversals of capital flows.

Against this background, it is important that euro adoption strategies go beyond the achievement of 'nominal' convergence (in respect of the Treaty criteria) at the point of entry. The nominal convergence criteria set out by the Treaty were mainly concerned with preserving price stability, which is an indeed necessary but not sufficient condition for macroeconomic stability. Although these countries have made substantial progress in achieving greater resilience via flexible product and factor markets – arguably more so than some current euro-area members – the first major stress test is still to come.³¹

Graph 16: Share of foreign currency borrowing in domestic credit, New Member States, 2004-2006 (in %)



Source: ECOWIN and Central Banks

Challenges ahead of euro adoption are to some extent specific to the exchange rate regime

³¹ Boeri, T. and P. Garibaldi (2006), 'Are labour markets in the new Member States sufficiently flexible for EMU?', *Journal of Banking and Finance*, No. 30, pp. 1393-1407.



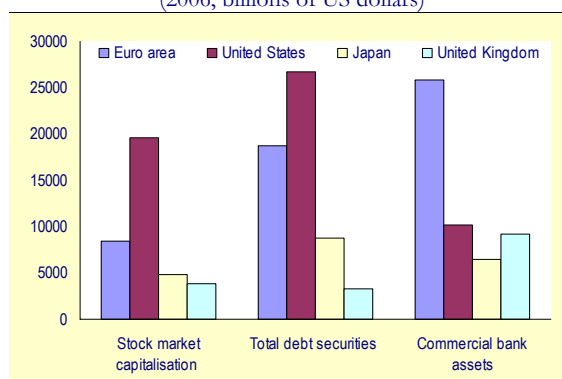
adopted by each candidate euro-area member.³² While the overall track record of policies in the new Member States with exchange rate pegs has been largely reassuring, the policy responses to the recent overheating episodes have not always been appropriate. Challenges are likely to remain significant, as in some cases these countries have incurred large liabilities denominated in euros, while policy instruments to smooth the unwinding of these positions remain limited (Graph 16). Against this backdrop, fiscal policy needs to be geared towards countering overheating and containing external imbalances, including by increasing private sector incentives to save. Structural and supervisory policies have an important role to play in safeguarding growth potential and macro-financial stability. Those countries that still avail themselves of exchange rate flexibility should gear their policies, including monetary policy, towards macroeconomic and financial stability so as to support a smooth nominal and real convergence process.

Managing the euro-area's international role

The single currency also has a global dimension, which will undoubtedly gain strength as economies and financial systems become more intertwined.³³ The creation of a new economic entity matched in size only by the US, the emergence of the euro as a key international currency, and EMU's powerful effect on the integration and development of the euro-area's financial markets are likely to have far-reaching consequences for the world economy and the international financial system. While the longer-term role of the euro is thus clearly a global one, there are inertial forces that are restraining the euro's international expansion for now. The US

offers a broad and deep financial market for international investors and will continue to benefit from rapid expansion in its potential output due to demographic reasons. Furthermore, the euro-area's ability to keep pace with global financial market developments may be somewhat constrained by the European regulatory and supervisory patchwork. But portfolio diversification considerations, the euro-area's prudent policy framework and the gradual integration and broadening of its financial markets will continue to support a rising international use of the euro in the future.

Graph 17: Selected indicators of capital market size, (2006, billions of US dollars)



Source: IMF, Global Financial Stability Report, September 2007.

An enhanced international role of the euro brings both benefits and costs. On the one hand, greater use of the euro by non-euro-area residents brings seigniorage and competitive advantages for euro-area exporters and financial institutions.³⁴ On the other, it could also lead to a possible increase in macroeconomic volatility.³⁵ In the medium term, however, the advantages of having an international currency are likely to outweigh the costs.

³² See, e.g. Schadler, S., P. Drummond, L. Kuijs, Z. Murgasova and R. van Elkan (2005), 'Adopting the euro in central Europe: Challenges of the next step in European integration', *IMF Occasional Papers*, No. 234.

³³ In some empirical assessments, the euro is projected to replace the US dollar as the main international currency (Chinn, M. and J. Frankel (2005), 'Will the euro eventually surpass the dollar as leading international reserve currency?', *NBER Working Paper Series*, No. 11510, July). A recent comprehensive assessment is contained in Papaioannou, E. and R. Portes (2008), 'The International Role of the Euro: a Status Report', *European Economy – Economic Papers*, 317.

³⁴ An aspect that has been discussed in recent debates is the so-called 'exorbitant privilege', namely the premium on the returns on net foreign assets benefiting the country issuing the leading international currency (Gourinchas, P. O. and H. Rey (2007), 'From world banker to world venture capitalist: US external adjustment and the exorbitant privilege', in R. Clarida (ed.): *G7 current account imbalances: Sustainability and adjustment*, Chicago, IL: The University of Chicago Press).

³⁵ See e.g. Wyplosz, C. (1997), 'An international role for the euro?', report prepared for the European Capital Market Institute (ECMI).

The euro also brings benefits to the global economy as a whole. By promoting macroeconomic and financial stability inside the euro area, EMU works in favour of global stability, particularly in neighbouring regions. By providing deep and liquid euro-denominated financial instruments, the euro facilitates international risk sharing and consumption smoothing not only among euro-area countries but also among third countries.³⁶ At the same time, a wider use of the euro worldwide may amplify the impact of euro-area developments on the rest of the world, which increases the relevance of macroeconomic policy decisions in the euro area for financial markets worldwide. The international status of the euro and the increasing global relevance of euro-area economic developments thus bring with them new global surveillance responsibilities and raise the issue of how to ensure adequate formation, representation, and communication of common euro-area positions in the main multilateral fora.

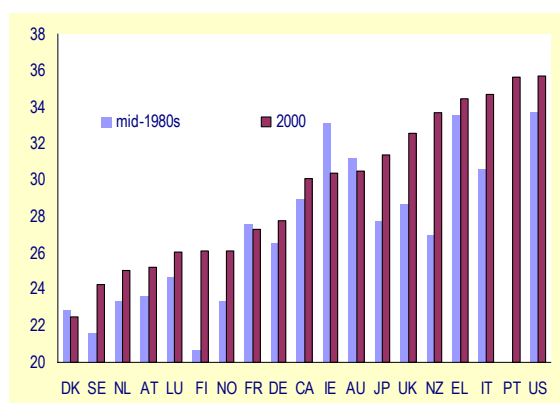
3. Exploiting policy synergies

Most of the policy objectives that appear worth pursuing in the context of the euro area – including boosting growth, enhancing the adjustment capacity and ensuring macroeconomic stability – are not mutually conflicting. Indeed some are even mutually reinforcing. Policies aimed at raising potential growth would also help to ensure that public finances evolve on a stable footing. Reforms aimed at improving price signals in goods and factor markets and at reducing the costs of reallocating labour across economic activities and regions will contribute to employment and productivity growth and also make euro-area economies more resilient to shocks. Improved supervision and regulation of financial markets would limit the risks of boom-bust dynamics, thus contributing to macroeconomic stability in euro-area incumbents, and would at the same time ease some of the trade-offs likely to arise on the convergence path for the countries that have yet to join the euro.

³⁶ Gerlach, S. and M. Hoffmann (2008), 'The impact of the euro on international stability and volatility', *European Economy – Economic Papers*, No. 309.

A concern may be that the price to pay to accelerate the growth potential is a more unequal distribution of income. Income distributions have become more unequal in most countries since the 1980s (Graph 18). This rise in income inequality – and the concomitant change in the distribution of wealth – is commonly attributed to the observed shift of labour demand from unskilled to skilled workers associated with globalisation and skill-biased technological progress. Such tendencies are likely to get stronger in the future. However, in view of the diversity of national experiences, both in terms of timing and magnitude of the changes in income distribution, domestic institutional factors must also play a role.³⁷ Labour market and welfare institutions have had a key role in transmitting trade and technology shocks to relative wages and unemployment rates.³⁸

Graph 18: Gini indexes of income



Source: OECD

Although possible tensions between structural reforms and income distribution are not necessarily ruled out, such tensions can be contained if policies are appropriately designed and certain framework conditions are in place.

³⁷ Atkinson, A. (2003), 'Income inequality in OECD countries: Data and explanations', *CEISifo Economic Studies*, Vol. 49(4), pp. 479–513.

³⁸ Atkinson, A. (2000), 'The changing distribution of income: Evidence and explanations', *German Economic Review*, Vol. 1(1), pp. 3–18; Gottschalk, P. and T. M. Smeeding (1997), 'Cross-national comparisons of earnings and income inequality', *Journal of Economic Literature*, Vol. 35, pp. 633–687, June; Checchi, D. and C. Garcia-Peñalosa (2005), 'Labour market institutions and the personal distribution of income in the OECD', *CEISifo Working Papers*, No. 1608.



Some EU countries show a stronger performance in terms of both growth and employment on the one hand and inequality and poverty on the other, while other countries perform poorly on both scores.³⁹ This suggests there is room for improving economic performance without compromising income distribution by improving the efficiency of institutions. It needs also be taken into account that increased inequality associated with a number of labour market reforms is mainly transitory, since it is related to the hardship of job reallocation.

Moreover, some growth-friendly reforms may create positive synergies with income distribution rather than a trade-off. Policies to increase skills help to contain the dispersion of income by leading to a lower wage differentials between skilled and unskilled labour. Policies aimed at reducing long-term unemployment reduce inequality as well. Measures aimed at reducing obstacles to financial market integration help to ease credit constraints facing low-income earners.⁴⁰

Finally, it needs to be stressed that a strong growth potential is a pre-requisite to underpin the comparatively generous social welfare systems present in most euro-area economies. In this respect, growth-friendly reforms and income distribution are not at odds in the longer term.

4. Reaping the benefits of policy co-ordination

In general terms, there is a rationale for economic policy coordination wherever the effects of policies in one country spill over to other countries. Economic policy spillovers in EMU differ from those arising under flexible exchange rate arrangements. Members of EMU share a large amount of 'club goods', including monetary stability, interest rates, the external exchange rate and the current account

position.⁴¹ The existence of club goods raises the issue of free-riding in monetary unions, where some members may lack incentives to fully and voluntarily contribute to the effective functioning of the monetary union.

The Treaty and the Stability and Growth Pact provide the institutional framework to deal with free-riding in the fiscal domain. However, the proper functioning of a monetary union also depends on other club goods, most prominently: (i) the efficiency of intra-area adjustment in the absence of an internal exchange rate mechanism, and (ii) the ability to reach common positions in global macro-financial policy making and pursue them effectively.⁴² On these aspects the policy co-ordination of EMU appears to be less equipped to deal with free-riding.

With regard to intra-area adjustment, the current EMU set-up refrains from placing specific constraints on national policy-makers other than that policies should be conducted in accordance with 'the principle of open market economy with free competition' and should be considered as matters of 'common concern' to be coordinated 'within in the Council' (EC Treaty Article 99). The institutional arrangements for coordination of adjustment-friendly structural policies have evolved considerably, in particular with the re-launch of the Lisbon strategy. Even so, less weight is attached to coordination of structural reforms than is given to the provisions on fiscal policy in the EMU set-up despite the fact that it is in euro-area countries' common interest that partner countries carry out reforms that improve their adjustment capacity. Indeed, as shown in the model simulations in Graph 19, should nominal rigidities be reduced in the euro area spillovers from asymmetric shocks would be reduced. Also, the current set-up of economic coordination in EMU is not strongly equipped to ensure consistency among national policies

³⁹ Sapir, A. (2006), 'Globalisation and the reform of European social models', *Journal of Common Market Studies*, Vol. 44, pp. 369–390.

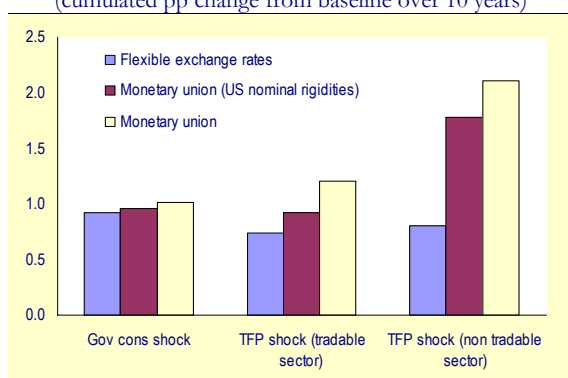
⁴⁰ Levine, R. (2005), 'Finance and growth: Theory and evidence', in P. Aghion and S. Durlauf (eds): *Handbook of economic growth*, Elsevier Science.

⁴¹ See Cohen, D. and C. Wyplosz (2006), 'European monetary union: An agnostic evaluation', *CEPR Discussion Papers*, No. 306. and Jacquet, P. and J. Pisani-Ferry (2001), *Economic policy coordination in the eurozone: What has been achieved? What should be done?*, London: Centre for European Reform.

⁴² Von Hagen, J. and S. Mundschen (2003), 'The functioning of economic policy coordination', in Buti, M. and A. Sapir (eds.), *EMU and Economic Policy in Europe – The Challenge of the Early Years*, Edward Elgar.

with direct implications for competitiveness. In this respect, while in the European Exchange Rate Mechanism (ERM) that preceded EMU, exchange rate realignments were perceived as a common concern and were subject to commonly agreed principles, no similar framework is available in EMU to discuss internal devaluations and other policies with a direct bearing on competitiveness.

Graph 19: Cumulated spillovers under alternative exchange rate regimes
(cumulated pp change from baseline over 10 years)



Source: Commission services.

Regarding the role of the euro area in global macro-financial policy making, although an increasing degree of co-ordination is already taking place among euro-area countries, including in the realm of multilateral consultations on global imbalances, co-ordination gains are still far from being fully exploited.

Overall, although there could also be tendencies that raise the costs of coordination, such as the increasing number of member countries and their diversity, the ongoing global trends will most likely raise the need of fully reaping the unexploited co-ordination gains in EMU. In particular, enhanced co-ordination will be required to foster reforms that improve growth and adjustment, to endow the euro area with a surveillance framework aimed at ensuring that macroeconomic policies are consistent with adjustment needs, to ensure orderly financial market developments, and to raise the ability of the euro area to speak with one voice in multilateral fora.

5. Concluding remarks

In its first ten years the policy agenda of EMU has pursued macroeconomic stability via the anchoring of inflation expectations and safeguarding fiscal discipline. This agenda has been supported by EU policies to promote structural reforms in product, labour and financial markets and address divergences in macroeconomic performance across countries. Although progress has been made on all these policy objectives, further progress is needed.

The experience of the first ten years has shown that a call on macroeconomic policy discipline, and delivery on that goal, does not automatically entail progress with structural reform and market integration, nor does it ensure high quality and sustainable public finances in the longer run, or secure a smooth enlargement and a strong global presence of the euro area. Yet these are necessary conditions for robust growth, flexible adjustment to disturbances and the smooth operation of EMU at large. 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.

In order to address these challenges and prepare EMU for the future, the Commission has presented a three-pronged policy agenda in its EMU@10 Communication and Report, based on a domestic pillar, an external pillar and initiatives to strengthen EMU's economic governance. This policy agenda is presented in more details in the next section.