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III. A three-pillar policy agenda for the second decade

In order to address the challenges discussed in the previous section and prepare EMU for the next decade and beyond, the Commission has presented a broad three-pillar policy agenda. The first pillar is domestic. It 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. This should enhance the quality of public finances, entail a more effective implementation of the preventive arm of the SGP and help to identify emerging macroeconomic imbalances at an earlier stage. It should also help to remove the remaining barriers to product market integration, improve the functioning of labour markets, foster EU financial integration and enhance financial stability arrangements. The second pillar concerns the external dimension of the euro. It aims to enhance the euro-area's role in global economic governance by consolidating its external representation, with the ultimate objective of a single seat in the relevant international fora. The third pillar deals with governance issues. To ensure that EMU functions effectively it is necessary to fully involve the ECOFIN Council. ECOFIN remains the policy-setting and legislative forum for issues relating to EMU and much of the progress with the proposed policy agenda for the euro area will depend upon wider support in ECOFIN. But it is also crucial to develop the agenda and the debates in the Eurogroup to deepen and broaden policy coordination and surveillance in the euro area.

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 has proposed a broad policy agenda based on a domestic pillar, an external pillar and initiatives to strengthen EMU's system of governance.

1. 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, 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 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:

- 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.

- 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.

- 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.

2. 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.

3. 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.

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.

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.

4. Conclusion

Achieving this policy agenda swill 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.