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**ECONOMIC OUTLOOK FOR THE ENLARGED EMU:
THE EURO AFTER EIGHT YEARS: SUCCESSES AND CHALLENGES**

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ECONOMIC OUTLOOK FOR THE ENLARGED EMU: THE EURO AFTER EIGHT YEARS: SUCCESSES AND CHALLENGES

I. INTRODUCTION

Ladies and Gentlemen,

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I would first like to thank Governor Gaspari for inviting me to this prestigious event. It is both a privilege and pleasure to participate in this conference to celebrate the adoption of the euro by Slovenia on January, 1st.

I would also like to take this opportunity to congratulate the Slovenian authorities. The impressive convergence process and the very successful changeover operations will undoubtedly serve as a beacon for other EU Member States that are looking to enjoy the benefits, both economically and politically, of EMU. I wish you and your country every success in this new chapter in your economic and monetary history.

Witnessing the introduction of euro notes and coins in this country first hand reminds me what a momentous step EMU is for the EU. The euro is a potent symbol of Europe's determination to forge ever closer union through strong and mutually beneficial economic, monetary and financial ties and an unheralded degree of economic policy coordination between sovereign states.

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I am grateful to the organisers of this conference for allowing me to be the first speaker of this session. This puts me in the fortunate position of opening the discussion and, in this way, to set the scene and the tone. Before we look at the future of the enlarged EMU, I thought it would be useful to take stock of developments to date. As other new

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members of the EU line up to follow Slovenia and adopt the euro, the experience of the founding euro-area members offers useful insights about the benefits and policy challenges that EMU membership may bring.

My reflections are organised along three main lines. *First*, I will highlight some of the main benefits of the euro. *Second*, I will discuss the main successes and challenges of the euro. *Third*, I will address a number of issues that are of specific relevance for the newest EU Member States in general and for Slovenia in particular.

II. THE BENEFITS OF EMU

There is sometimes a tendency to forget what a huge achievement the euro is, so it is useful to recall its benefits. Microeconomic benefits spring easily to mind: transaction-cost savings, reduced uncertainty and greater price transparency. On the macro side, let me refer to five key benefits.

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- Firstly, the euro has acted as a catalyst for trade and foreign direct investment. Although precise estimates are hard to calculate and historical data is still limited, most studies estimate that the euro has boosted trade between EMU members by between 5% and 15%; the long-term effects may even be twice as big. EMU has also already had a positive impact on inward FDI flows in the euro area, with estimates ranging from 17% to 39%.

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- Secondly, EMU has delivered on its promise of price stability. Since the introduction of the euro, inflation has been hovering around two per cent and financial market expectations of future inflation have been consistent with the ECB's price stability objective, which testifies to its credibility.

Despite this impressive track record, there have been persistent misperceptions that the euro has led to significant price increases. Admittedly, the cash changeover did have some undesirable effects in a couple of services categories, but they played a very limited role in the aggregate inflation performance.

- Thirdly, the euro area has successfully weathered several severe shocks in the past few years (the ICT bubble, the economic consequences of September 11, the recent trebling of oil prices). In marked contrast to the experience of previous decades, when such shocks had sizeable, adverse consequences for growth and monetary stability, the economy has been remarkably resilient.
- Fourthly, EMU has acted a catalyst for fiscal discipline in the euro area. In the run-up to the euro, the Maastricht criteria were instrumental in achieving an impressive degree of consolidation; after 1999, there was a pause in budgetary consolidation but Member States did not indulge in reckless behaviour, as they often had in the past. Even though the Stability and Growth Pact has undergone difficult times, the 2005 reform of the SGP paves the way for stronger fiscal discipline in the future.
- Fifthly, and lastly, the euro has quickly established itself as the second leading global currency after the US dollar. The euro's advancement as an international currency has been particularly pronounced as a denomination currency for the issue of international debt securities and foreign exchange transactions.

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These achievements are a stepping stone for tackling the current challenges faced by the euro area economies. Let me turn now to the achievements of, and challenges facing, the euro area.

III. SUCCESSSES AND CHALLENGES

III.1 *Improving the euro-area's growth performance*

From a short-term perspective, the recent growth record of the euro-area ranks as an impressive achievement. According to the European Commission's latest forecast, the euro-area economy will grow by 2.6% this year, its fastest rate of growth since 2000. This is an encouraging development in a global economy facing geopolitical tensions, large current-account imbalances and high and volatile energy prices.

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From a medium-term perspective, however, the euro-area's growth performance has been more lacklustre. By mid-2006, twelve quarters after the beginning of the current upswing, euro-area output was 2.7% lower than the average recorded during the previous four recoveries. The euro-area's growth performance has also been sluggish compared to its main trading partners. Between 1999 and 2006, annual GDP growth was around a percentage point lower in the euro area than in the USA. This gap remains significant even when the impact of the euro-area's comparatively slower population growth has been taken into account.

The cause of the euro-area's disappointing medium-term growth performance, I would like to stress, lies not with macroeconomic policy, but with a lack of progress in the reform of product, labour and capital markets.

III.2 *Ensuring smooth adjustment in EMU*

A second issue that deserves our attention concerns the capacity of euro-area members to adjust to country-specific developments.

The Commission published a comprehensive report on adjustment under EMU towards the end of last year. A key finding was that EMU has already encouraged a smoother

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adjustment to certain categories of economic disturbance. In particular, euro-area members have been shielded from the episodes of exchange rate turbulence that, in the past, engulfed them during periods of heightened global financial stress.

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Despite this achievement, the Commission's report notes with concern the persistence of cross-country growth and inflation differences in the euro area in recent years. During the period 1999-2006, the difference between the fastest and slowest growing Member States in the euro area averaged more than 5 percentage points. Over the same period, the gap between the highest and lowest inflation Member States stood at 2 percentage points.

Our analysis suggests that the persistent growth and inflation differences in the euro area reflect a variety of factors.

- In a number of countries, initial conditions mattered. The strong decline in interest rates in the run-up to EMU inflated consumption and investment in the sheltered part of the economy, such as real estate. These developments were fuelled to a certain extent by financial exuberance and the credit cycle.
- Price and wages were too slow to adjust to changes in national cyclical conditions. Beyond "wage moderation" at the aggregate level, "wage flexibility", which is paramount for the reallocation of factors of production, remained insufficient.
- Last, but not least, some budgetary policies were pro-cyclical and failed to seize the opportunity to create room for manoeuvre in accordance with the principles of the reformed Stability and Growth Pact.

The message that emerges from the Commission's report on adjustment under EMU is that Member States that share the euro must ensure an agile capacity to adjust to country-specific developments. There are a number of priorities in this respect.

- Euro-area Member States should make use of the favourable cyclical situation to aim for more ambitious budgetary consolidation towards the medium-term objective of close to balance or in surplus, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark.
- Euro-area Member States should enact measures that lead to more competition, especially in services.
- Euro-area Member States should improve flexibility and security in labour markets by, *inter alia*, better aligning wage and productivity developments, balancing employment protection and security and enacting measures to promote labour mobility across borders and occupations.
- Finally, accelerating financial market integration can help euro-area members to cushion the impact of country-specific shocks.

III.3 Accelerating the pace of financial market integration

In view of the general importance of financial market integration for the smooth functioning of EMU, let me say a few words about the progress achieved in this field over the last eight years. On a general level, it is clear that the introduction of the euro has given a positive boost to financial market integration in the euro area.

Deeper integration is reflected in more homogenous markets, a wave of consolidation among intermediaries and stock exchanges, and the emergence of new products and techniques.

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By no stretch of the imagination, however, has the process of financial market in the EU been completed. Let me cite three examples.

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Firstly, clearing and settlement in the euro area remains fragmented as a result of technical, regulatory, fiscal and legal barriers. Secondly, the need for further integration in banking is suggested by the relatively limited degree of cross-border M&A activity in this sector since the launch of the euro. Thirdly, the lack of cross-border banking integration is also reflected in the dispersion of national retail interest rates. This can be seen, for example, in relation to interest rates on loans to households for both consumption and household purchases. In addition to cross-country differences in real interest rates, a variety of factors may be at play here. These may include differences in consumer protection rules and the degree of competition in the banking sector.

IV. IMPLICATIONS FOR NEW MEMBER STATES

In the final part of my presentation, I will reflect on what the euro holds in store for the EU's recently acceded Member States, drawing three important lessons from the first eight years of EMU.

The first lesson is that joining the euro area remains a highly rewarding prize. As I noted earlier, the single currency has already brought substantial macroeconomic and microeconomic benefits to the founding euro-area members. Slovenia, too, is beginning to reap these benefits. For example, long-term interest rates have fallen from around 9½ % in early-2002 to just below 4% today thanks, in part, to a falling country-risk premium. Over time, Slovenia's industrial specialisation and geographical location should allow ample scope for higher trade with the rest of the euro area. Other potential gains include increased access to foreign savings, higher FDI flows and the development of cross-border production networks.

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The second lesson for recently acceded Member States is that policy makers need to remain especially vigilant of the need for macroeconomic stability following euro adoption. Falling interest rates and easier credit conditions are a major benefit of EMU but they should not be allowed to trigger excessive exuberance among consumers and the construction sector, as they did in Member States such as Ireland and Spain. To safeguard macroeconomic stability, new euro-area members should be ready to tighten the fiscal stance and to pay close attention to macro-prudential policies. This advice is particularly salient for Slovenia, where domestic credit growth in both the household and corporate sectors has increased sharply in recent years.

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The third lesson is that the EU's newest members must prevent catching-up in per-capita-income level from generating excessive economic fluctuations under EMU. Let me stress that having a relatively low per-capita-income level is neither a legal nor an economic impediment to joining the euro area. Greece, Portugal and Spain all had a relatively low-per-capita income when they adopted the euro. Nevertheless, the divergent experience of these Member States over the last eight years serves as a warning for the recently acceded Member States. Unless euro-area members have sufficient adjustment mechanisms to deal with country-specific developments, catching-up can be associated with a destabilising cycle of overheating and overcooling.

In its latest progress report on the Lisbon Strategy, the Commission commended Slovenia for making good progress in implementing its National Reform Programme. In particular, tangible progress has been achieved in the reform of employment policies and measures to encourage entrepreneurship and better regulation. Progress with respect to innovation and competition has been less impressive. In the labour market,

further effort is required on the implementation of the active ageing strategy and on the removal of barriers to youth employment.

Budgetary policy is another important adjustment mechanism EMU, particularly in catching-up countries. Inside the euro area, fiscal policy will have to assume a three-fold responsibility.

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- Firstly, it will be a key instrument for maintaining macroeconomic stability, smoothing the business cycle and for withstanding economic disturbances. In this respect, Slovenia would be well advised to make good use of the current favourable economic developments to accelerate its fiscal consolidation process and move as quickly as possible to the medium-term budgetary objective of -1% of GDP, or even beyond.
- Secondly, it should continue to support real convergence.

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- Thirdly, fiscal policy needs to assure the sustainability of public finances and provide a cushion against financial distress. It is also essential to cater for the long-term sustainability of public finances by keeping public debt on a sustainable path. Such advice is particularly important for Slovenia, where low fertility rates and other demographic factors mean that the long-term economic and budgetary costs of ageing will be acute.

V. CONCLUSION

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In conclusion, the economic outlook for the enlarged EMU gives grounds for cautious optimism. The euro is a success. The single currency has proved to be a force for economic stability and growth in the euro area, despite not always so easy conditions. The euro is already yielding benefits for its thirteenth member, Slovenia, and it will continue to do so in the future.

Adopting the euro is not an end in itself but a potent means to achieve sustained increases in living standards. The authorities should be ready to confront to fresh challenges that accompany success.

The opportunity of euro introduction should be seized to carry forward the necessary structural and fiscal reforms. These reforms are necessary in their own right, but they become indispensable for a successful participation in the euro area.

In addition, Member States that share the euro must work together to boost the euro-area's medium- and long-term growth prospects, enhance intra-euro-area adjustment mechanisms and complete the process of financial-market integration.

Thank you very much for your attention.