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The EU Economy: 2006 Review

STRENGTHENING THE EURO AREA: KEY POLICY PRIORITIES

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Over the past eight years since the creation of the euro area, the euro has established itself as a strong and stable currency on domestic and international markets, and has emerged as one of the pillars of the international monetary system. It is a major vehicle for global financial transactions, and has changed the face of international capital markets. It has embedded low inflationary expectations and economic stability throughout the monetary union. And it has shielded Member States' economies from the episodes of exchange rate turbulence that, in the past, at times engulfed them during global financial stress.

But this is not to say that the euro area is functioning with full efficiency, or that the policy agenda is complete. Continued subdued growth performance and persistent divergences in growth and inflation raise questions as to whether internal adjustment in the euro area is working smoothly, and whether members have internalised fully in their economic policy-making the implications of living in a monetary union. Such divergences, if they were to result in tensions, could weaken cohesion in the euro area, make policy co-ordination more difficult and complicate the task of the common monetary policy.

These challenges need to be seen in a context of intensified international competition, ageing populations and persistent global imbalances. To face the future with confidence and ensure sustained growth, policy-makers must ensure that economic incentives are right, that surveillance is well-targeted and that euro area governance is fully effective.

Challenges in the euro area must also be placed in a broader EU perspective so that key overlapping interests of all Member States are strengthened, not diluted, by targeted policy efforts of euro area members. Synergies can and should be pursued, for example, between smooth euro area adjustment and the broad structural priorities of the Lisbon, Internal Market and Trade agendas. Policy options need to be rapidly identified and spelled out, leading to concrete action. This means building on themes identified in the Annual Statement on the Euro Area – 2006, and deepening their analytical foundations[1].

The 2006 EU Economy Review[2], published together with this Communication, focuses on questions raised by recent adjustment experience in the euro area. Analysing this experience, the review highlights possible inefficiencies in the functioning of the monetary union, serving as a basis for action to strengthen the adaptability and resilience of EMU for the period ahead.

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1 "Annual Statement on the Euro Area", Communication from the Commission - COM(2006) 392, 12.7.2006.

2 2006 EU Economy Review, "Adjustment Dynamics in the euro area: experiences and challenges", European Economy, Directorate General for Economic and Financial Affairs, http://ec.europa.eu/economy_finance/publications/european_economy/2006/the_eu_economy_review2006_en.htm

Mixed experience in the early years of the euro area

The preparation of the monetary union in Europe was dominated by debate on the benefits and costs of the euro, and on the prerequisites for ensuring its success. In the run-up to its launch in 1999, the major question was already how the participating countries would adjust to shocks and differences in competitiveness in a context of low labour mobility, incomplete integration of product and services markets and the retention of national budgetary autonomy. During this time, many predicted that the European monetary union would not work and would be short-lived.

Experience has not supported these pessimistic forecasts. The euro quickly established itself as a strong and stable currency. The euro area economies responded surprisingly well overall to common shocks such as the more than doubling of the oil prices and the effects of international financial turbulence. Inflation also remained remarkably low and stable by historical standards, as evidenced by the very low impact of energy price rises on inflation and wages. In turn, this has enabled euro area members to enjoy the most favourable financing conditions ever in a context of increasingly deep economic integration resulting from the reinforcing effects of EMU and the Internal Market.

Despite these successes, the individual economies in the euro area have not always adjusted to country-specific developments as smoothly or swiftly as would be desirable. It is natural, under monetary union, for adjustment to take place through divergences in national inflation and growth rates. But long-standing differences in inflation and large current account imbalances in the early years of the euro have in some cases been the result of rather slow adjustment. The latter also accounts for some variations in growth rates, which have been wider than would be expected in terms of potential output. If adjustment had been more efficient, economies that were slowing down after losing competitiveness would have returned to their medium-term growth trends more swiftly. Similarly, periods of high national inflation (relative to the euro area average) would not have been so prolonged. More generally, the euro area has not yet been able to achieve high growth and employment over a sustained period.

It may seem tempting to blame such adjustment difficulties wholly on the fact that some euro area members lagged in their action to strengthen fiscal policy and structural reforms. While this certainly played a significant role, policy-makers and economic agents were also faced with the new experience of adjustment under monetary union, which posed challenges that had not been fully anticipated. For example, financial market developments played a greater role than expected in fuelling imbalances and influencing consumption and investment patterns. Moreover, economic developments interacted with one another, and with policy initiatives, in ways that often triggered mutually-reinforcing consequences.

The following elements can explain in greater depth the prolonged divergences in growth, inflation and current account imbalances within the euro area:

Developments during the ***run-up to monetary union*** can be linked to prolonged imbalances and shifts in real effective exchange rates during the first years of economic and monetary union. In some Member States, these included a strong decline in interest rates during the approach to euro adoption, and a relaxation of credit constraints on households following an improved access to credit in the more integrated financial market. Furthermore, German unification had a sizable impact on relative competitiveness within the euro area. There were also country-specific developments in productivity in the traded or non-traded goods sectors in addition to effects from migration and tourism.

An important factor in individual euro area economies has been the way that economic developments ***interacted*** in certain cases to make current account imbalances larger and more protracted. A prime example was the strong and sustained shift of resources into the non-traded goods sector, such as real estate investment, fed by the compound effect of declining risk premia, easier credit constraints, migration, tourism, and demographics.

In some cases ***national policies*** interacted with market behaviour in a way that inhibited smooth adjustment. For example, in the Netherlands pro-cyclical effects emerged in the labour and financial markets and, with the benefit of hindsight, in fiscal policy at the beginning of this decade. These factors contributed to a "boom-bust" cycle, a surprising occurrence for a country that had been in a de facto monetary union for some thirty years. A more general experience in the euro area was the difficulty in assessing underlying fiscal balances, during country-specific adjustment cycles, and this highlighted hazards in designing fiscal policies in "good times".

Prices and wages in some cases adjusted too slowly to changes in national cyclical conditions, especially at times of slowing activity. This lack of flexibility was present despite a general background of marked wage moderation, which helped foster a decline in structural unemployment. A contributory factor was low productivity growth, which placed the burden of real depreciation heavily on wages.

There is scope for significant ***spillover effects*** across euro area economies. Analysis of the adjustment experience shows, for example, that a housing boom in several economies will affect both the demand for traded goods and the level of interest rates for other euro area members. And fiscal and wage developments, as they interact during adjustment, will affect other economies in the monetary union through both demand and competitiveness channels.

Spillover effects from the ***global economy*** can also impinge on euro area members in ways that pose adjustment challenges within the monetary union. Due to diversity in their geographical and sectoral specialisation, Member States are affected differently by developments in world trade, in international price and export markets, and in the value of the euro with respect to the currencies of their main trading partners. These issues gain particular relevance given the significant imbalances emerging at global level.

Finally, experience with ***nominal and real convergence*** has varied considerably, partly reflecting national policy approaches. During nominal convergence, some economies, such as Spain, channelled savings in interest payments to achieve permanent budgetary improvement, whereas others (such as Italy) did not fully seize this opportunity. Furthermore, during real convergence, policy and market factors led to differing outcomes. In Portugal, expansionary fiscal policy during a strong boom added to cyclical pressures, and it also limited budgetary flexibility and the resilience of the economy during the subsequent downturn. Simultaneously, resources shifted strongly into the non-traded goods sector, while productivity performance was poor. The corollary was an insufficient basis for sustained catching-up. This contrasted sharply with the favourable experience at a similar stage of real convergence in Ireland.

Action is needed to ensure the smooth-functioning of the euro area

A number of possible policy lessons emerge from the above analysis. Such lessons can help foster an increasingly smooth functioning of monetary union in the future. On the one hand, national fiscal policies need to be prudently managed, so as to minimise negative spillover effects. Structural policies are also matter of common interest, given the high degree of interdependence as euro area economies respond to shocks or strive to increase their growth potential. Moreover, the challenges facing members must be seen in an international perspective.

Five specific policy considerations are outlined below, followed by suggestions of further avenues for progress that broadly fit within the Commission priorities for the period ahead:

Budgetary policies must be run even more prudently. This requires analysing fiscal positions carefully, improving the measurement of underlying balances, taking into account a broader range of indicators and increasing the focus on the composition of growth and real exchange rate adjustments within the euro area. This should allow making full use of economic "good times" to assure improvement in fiscal positions. These recommendations are closely in line with the reformed Stability and Growth Pact, which provides a stronger framework for guiding national policies throughout the cycle and takes into account long-term sustainability concerns.

Markets for goods and services must become more flexible and budgets more supportive of active adjustment. The experience with adjustment to shocks in the early years of the euro area calls for greater downwards price flexibility. Rigid prices are accompanied by an increased resistance to adapt nominal wages, since that would result in larger real wage losses. Thus adjustment costs in terms of output and employment are higher. Inertia in the re-allocation of resources across companies and sectors can also increase the pain of adjustment. Therefore, ensuring open and competitive product and service markets does not only foster the medium-term growth potential, but is also an indispensable element of any strategy to reduce the welfare cost of cyclical adjustment processes. From this perspective, tax and expenditure policies at EU, national and local level may also need to be reviewed.

Financial market integration needs to be accelerated. Important progress has been made across the EU, but more needs to be done to tap the potential and maximise the benefits of financial markets in the euro area. Greater financial integration can smooth the impact of economic shocks on incomes and on national credit markets. In this regard, full transposition and enforcement of the Financial Services Action Plan and ongoing efforts to enhance financial market integration should deliver further significant results.

Wage setting must internalise the implications of monetary union. Given that responsibility for well-adapted wage setting falls increasingly within the domain of social partners, it is important to ensure that the actors in the wage bargaining process have the necessary information concerning the challenges and the implications of different lines of action. Primarily this should allow for a better assessment of whether current and prospective wage and price developments are benign in terms of adjustment needs. It should also help to avoid significant overshooting in intra-euro area real effective exchange rates.

The global dimension must be taken into account. The international dimension needs to be considered in a more systematic way. The differentiated country implications of global developments – as well as the impact of the euro and the euro area on other players in the world economy through trade, financial and policy channels – must be factored into the assessment of policy stances at the euro area and country level. Moreover, the EU's Trade agenda and the deepening of the Internal Market can help strengthen the competitiveness of the euro area economy in global markets.

The way ahead to a stronger euro area

Monetary union has brought great gains to its members, but it remains to be deepened and completed, a priority that becomes all the more compelling in today's international environment. Recent divergences have to some degree reflected initial developments that affected member economies in the run-up to the euro area's creation in 1999. However, the future is expected to bring new challenges in the form of major changes in global markets, whether in terms of competitive pressures, export market slowing, or financial market shifts. In some cases, individual euro area members could face heightened adjustment challenges.

It is essential to ensure that the euro area economy as a whole responds to future shocks with adaptability and resilience. Indeed, it must prove capable of strong and sustained growth in an international setting where some other drivers of global activity may be slowing. This can contribute to keeping international markets open and growing strongly, and thus, crucially, increase the welfare of European citizens. As we approach the end of the euro's first decade, policies and institutions in the euro area must prove well equipped for this challenge.

Accelerating structural reforms and fostering integration

A first priority is to accelerate structural reforms. Together with the new governance of the partnership for Growth and Jobs, the current economic recovery provides a unique opportunity to vigorously pursue the necessary structural reforms[3]. These can improve growth potential over the medium term and boost the efficiency with which member economies respond to shocks. Market mechanisms will be more responsive, and higher productivity growth can ease adjustment, and here the goals of raising R & D expenditure to 3% of GDP and fostering innovation are most important. Structural reforms will also help address the longer-term challenges of population ageing and global economic change. In the euro area, therefore, the Growth and Jobs agenda, including Internal Market and Trade policies, assumes a special importance. A fuller and less uneven integration of markets could bring significant welfare gains and a smoother adjustment process. Among other priorities, the potential of financial markets to spread risks and smooth incomes has yet to be fully tapped. Euro area members must identify those structural measures, including those favouring the mobility of labour that is currently very low, which are most relevant to enhancing both growth and adjustment capacity, ultimately resulting in beneficial effects for the whole euro area. Already outlined above is the related priority for actors in the wage-setting process to fully internalize the euro area context, allowing adjustments in competitiveness to proceed smoothly.

[3] The European Competitiveness Report 2006 documents areas where additional efforts may be necessary. See in this respect the Communication from the Commission, "Economic reforms and competitiveness: key messages from the European Competitiveness Report 2006" - COM(2006) 697, 14.11.2006.

Further strengthening fiscal positions and improving the quality of national budgets

Fiscal policy, too, can make a stronger contribution to efficient adjustment and sustained growth. Experience in the early years of the euro underlines the need for policy-makers to make better use of "good times", and ensure medium-term adjustment in line with the reformed Stability and Growth Pact. Budgetary policy under the reformed Pact should increasingly address the quality of public finances, and notably the structure of tax and expenditure polices. Member States have agreed to use the next generation of national and regional programmes, supported by the Structural Funds and the Cohesion Fund, to implement the Lisbon Strategy, thereby enhancing the quality of public expenditure.

Reinforcing coordination within and outside the euro area

The above challenges should be considered in terms of national policy priorities. Yet at a deeper level they also pose a challenge for euro area governance. The euro has brought much greater interdependence, including through the speed and scale of financial flows. There is a clear role for EU institutions, and the Eurogroup, to coordinate progress across countries, policies and sectors. In this perspective, coordination instruments at the national and EU level take on even greater importance in fostering the efficient functioning of the euro area. Budgetary coordination under the reformed Stability and Growth Pact needs to be enhanced; and the euro area dimension of the Growth and Jobs Strategy must be duly emphasized. The integrated guidelines for Growth and Jobs adopted in July 2005 by the Council reflect this clear orientation towards an enhanced coordination between macroeconomic and structural policies, in particular through the guideline focused on the euro area. A clearer external representation, leading to a single voice, can make an important contribution to promoting the interests of the EU and the euro area.

Promoting the enlargement of the euro area

An improved functioning of the euro area will benefit its members and the entire EU economy. In the case of Member States that have not yet joined the monetary union, moreover, the euro has important potential to function as a policy anchor. At the same time, it is essential that policy-makers take full account of the lessons about moving to the euro that emerge from the experience of current members of the euro area. This will allow the countries preparing to join the euro to draw the full benefits of living with the single currency. On this basis, adoption of the euro can help stimulate trade and growth, and also help to protect these economies from turbulence in international markets – a benefit that is not always appreciated in periods when global liquidity is high and risk premia are compressed.

Getting closer to the citizens

A skilful steering of the economic and monetary union by policy-makers is not sufficient however, if the message is not reaching the citizen in the street. Citizens have in fact benefited in many ways from monetary union, gaining from stable prices, from cheaper and more easily available credit, from ever deeper economic integration, and from protection against the effects of turbulence in international markets. Yet while opinion polls find citizens aware of the euro's practical value, they are less clear on its wider macroeconomic benefits. Many people feel that its members could coordinate their policies more closely. There is hence scope to prove to citizens that membership of the monetary union is a path to strong and sustained increases in living standards, as well as to economic and financial stability.

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Looking back over the early years of monetary union, it is evident that a sound macroeconomic framework is successfully in place. The question now is to examine how well policies are implemented; how strongly structural reforms support the adjustment process; and how decisively euro area governance can be consolidated. This communication has highlighted priorities that should ensure the smooth functioning of an enlarging euro area, and enhance its contribution to the world economy. Achieving this will require deeper policy coordination and improved governance, in particular through the Growth and Jobs Strategy and in the context of the Eurogroup. Forging the necessary political consensus will be a challenging task. Yet this is essential if European citizens are to benefit fully from the economic and monetary union, and if the 10th anniversary of the euro is to be approached on a path of sustained growth.