

Coming of Age

Report on the euro area

Questions and Answers for the Media

Why has Bruegel taken initiative to this report?

At the end of 2007, inflation in the euro area jumped to above three percent, growth is slowing down, unsteadiness in financial markets persists and the euro has appreciated to record levels against other major currencies. Looking ahead, there are important challenges and significant risks on the horizon.

With the euro approaching its tenth anniversary and with more countries joining, the time is right to look back and assess whether Economic and Monetary Union (EMU) is equipped to face a less favourable economic situation. This report is designed to be a contribution to this discussion.

The report surveys the economic performance of the euro area and gives recommendations about six policy challenges of major importance for the future of EMU: monetary policy, fiscal policy, structural reforms, financial stability, enlargement of the euro area, and the external representation.

The report identifies shortcomings in the current functioning of the euro area and singles out the Eurogroup as the essential institution potentially capable of fostering change.

What challenges is the euro area facing?

The report states that the euro is facing both political and economic challenges.

- The rejection of the Constitutional Treaty by French and Dutch voters in 2005 showed that citizens' support for EU matters cannot be taken for granted.
- The economic performance of the euro zone since 1999 has been acceptable, but not excellent, despite a favourable global environment. The years ahead might be less auspicious and the euro area may face a more adverse monetary and fiscal situation. The credit crisis in 2007 shows the potential risk of such shocks.
- Instead of increasing the incentives for economic reform, as many expected, the single currency seems to have insulated members from acute crises and may, in fact, have slowed down the pace of reforms. Fiscal discipline remains poor and the euro area lags behind other advanced economies when it comes to structural reform.
- The enlargement of the euro area has become a divisive issue. Although Slovenia, Cyprus and Malta have joined the single currency, most new member states (except Slovakia) are a long way from fulfilling the Maastricht criteria for membership in the euro, or are openly lukewarm about joining.

What is the euro's record so far?

The overall performance of the euro area since the launch of the new currency has been mixed.

On one hand:

- Inflation has on average been low, even though the public perception is that prices have increased. Importantly, expectations of future inflation have been low and rather stable.
- Long-term interest rates have been kept at low levels.
- The euro has become a major international currency.

On the other hand:

- Growth performance has been disappointing, despite the boom in 1999-2000 and the 2006-2007 upturn.
- Reform efforts have not accelerated. Member states have not sufficiently adopted the new policy framework.
- Despite the view of policymakers that a single currency would promote convergence of growth and inflation rates, the economic performance of the member states is uneven and the risk of asymmetric shocks therefore remains.

This uneven record questions the suitability and robustness of the EMU policy framework.”

What would a good policy system for EMU be?

The report starts from the essential requirements of an appropriate policy system. The EMU framework should:

- *deliver stability* – taking into account that price stability is only one aspect of it
- *ensure predictability* – that is, provide clear and transparent rules on how the various policy players should behave in the common interest
- *provide strong incentives* - for policies that are appropriate both from a national and from a European point of view
- *be adaptable* - in order to evolve on the basis of experience and adjust to changes in the world environment.

The report's overall message is that willingness to adapt the EMU policy framework in light of the experience gained is crucial to the long-term success of the euro. Over time, the return on the investment in the euro will depend on the participants' ability to learn and improve from experience.

What are the main reform proposals of the report?

A full list of recommendations can be found in the annex to this media memo. Key recommendations are:

- The ECB should fully implement an inflation target regime, and this should be officially endorsed by the Eurogroup.
- The focus of EU surveillance of fiscal discipline should increasingly be on **debt** rather than **deficit**.
- The Eurogroup should consider issuing formal recommendations to a country whose policy represents a threat to the proper functioning and the sustainability of the euro
- The Maastricht criteria for euro membership need to be adapted to be more economically relevant to different circumstances in new EU member states.
- There is a need for the euro area to speak with one voice on exchange rate matters. The president of the Eurogroup should be the natural spokesperson.

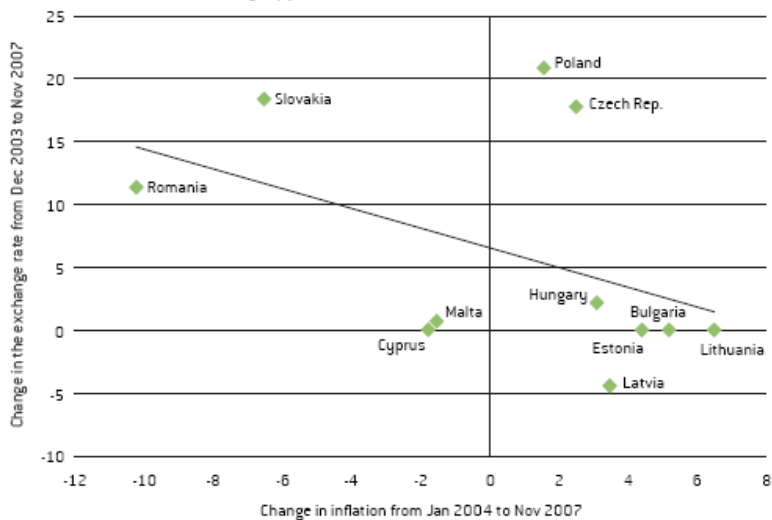
Should the new member states join EMU, and if so, on what criteria?

There are sound economic arguments both for and against the new member states (NMS) quickly joining EMU. There is neither a compelling argument for rushing into EMU nor for keeping the NMS waiting indefinitely at the door. Both the pace of economic development, the ability to respond to shocks, and the quality of policymaking institutions need to be taken into account when assessing whether a NMS should join EMU. At the moment, the EU is not doing this.

Economic catch-up must translate into real exchange rate appreciation, reflecting convergence of prices over time with those of the most advanced economies of Europe. In the countries that let their currencies float (that is, the Czech Republic, Hungary, Romania, Poland and Slovakia), nominal appreciation is the driver of real appreciation. In the countries that adopted some form of currency board (that is, the Baltic States and Bulgaria), domestic inflation is replacing nominal appreciation as the driver of real appreciation (See chart 7.9). The current Maastricht criteria for EMU membership (low inflation and exchange rate stability) do not allow for this equilibrium phenomenon.

On the basis of economic analysis alone, a case could therefore be made to replace some of the Maastricht criteria altogether. However, given the traditional importance of continuity and equality of treatment across member states, the report suggests adapting the criteria. This would preserve the Maastricht principles while making better economic sense than the interpretation given to the treaty provisions so far.

Chart 7.9: Nominal currency appreciation and disinflation



Can governance reform help?

The view of the report is that rather than additional guidelines and procedures, what EMU lacks is a sufficiently analytical approach to policy discussions, evidence-based decisions and mutual trust. More could be done both to prevent policies that have the potential to threaten the viability of monetary union and to provide incentives for good policies in order to steer policy action in a direction that will improve the overall functioning of EMU and the performance of its member countries.

The report argues for a more decentralised approach relying more on incentives and moral authority to influence policies in normal times, combined with a greater capacity to centralise decision-making when required in response to crises or exceptional circumstances. A lighter touch for high-frequency interference with national decision-making and a stronger hand for low-frequency interventions would avoid the drawbacks of procedure fatigue and prevent the risks of coordination failures.

What changes to the governance of the Eurogroup does the report recommend?

There is a need for a clearer distinction between the legally binding decisions aimed at preserving the proper functioning of the EMU on one hand, and proposals aimed at improving the quality of economic policies on the other. The report therefore proposes that formal Council recommendations should be given stronger political weight and reserved for situations when there is a need to prevent risks to the proper functioning of EMU.

Additionally the report proposes that it be possible to hold Council meetings in euro area format, including euro area summits (heads of state and government).

The report also recommends the creation of a single euro-area chair at the IMF.



Information about the authors

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Detailed information about Bruegel is available at <http://www.bruegel.org>.

Annex

Complete list of reform proposals in the report

Monetary Policy

- ECB to move to full inflation target regime
- ECB to publish forecasts that reflect the views of the Governing Council
- Eurogroup publicly to endorse ECB inflation targets

Fiscal Policy

- Focus more on comprehensive concept of debt sustainability
- More fiscal autonomy for countries with credible fiscal policy rules and institutions
- More differentiation in assessing national fiscal rules and institutions
- Eurogroup president to lead implementation of reforms and shaping of any common guidelines

Structural Reforms

- Eurogroup to push key EU-level reforms
- EU budget review 2008/2009 to switch funds towards helping national reforms
- More independent assessment, more Commission staff assessment of national reforms
- Eurogroup to consider formal recommendations if national policy threatens the euro
- Time-bound commitment to reach a specified debt-to-GDP ratio if reform leads to budget overrun

Financial Stability

- Euro area to push for European prudential and supervisory regime for pan-European banks

Enlargement

- Reference for price stability to be euro area inflation or the three euro area countries, closest to two percent
- Relax the obligation to join ERM2 for two years before joining the euro



- More emphasis on prudent debt limit for the new member states
- Target of budget balance or surplus during periods of fast growth

External Dimension

- Verbal discipline on exchange rates by national policymakers
- Euro area to express views on exchange rate policies of key third countries
- Eurogroup president to represent the euro area externally and lead delegations in talks with third countries

Governance reform

- Formal Council recommendations to be reserved for serious threats to the euro
- Council meetings, including EU summits, to be possible in euro area format
- Create a single euro area chair at the IMF