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EMU @ 10:

EURO-AREA IMBALANCES AND FINANCIAL MARKET TURMOIL

Monetary union is an indisputable success and offers immense advantages including in the present period of intense turmoil and uncertainty.

The ECB's steps to ease liquidity constraints and lower its reference interest rates together with six other major central banks were timely, and should help to support confidence during the difficult months to come. These decisive and rapid actions, particularly on the side of liquidity interventions, would have been unthinkable with 15 national central banks.

The euro is also providing a shield for the most vulnerable economies which could have otherwise faced significant currency turbulences in the present circumstances. Similarly, the large public engagements to stabilise financial markets and recapitalise banks could arguably have led to heightened market concerns and rising long term interest rates in the absence of the euro.

However, despite the successes, the growing divergences between national competitiveness trends illustrate that substantial policy challenges lie ahead. Since 1998, countries like Italy, Spain or France have lost between 15% and 25% of their cost competitiveness vis-à-vis Germany or Austria.

Member states' loss of competitiveness will be felt even more severely in the current economic circumstances. The expected significant fallout of financial market turmoil on the real economy and the slowdown in global GDP growth will affect in particular those countries that have seen their competitiveness and external position deteriorate consistently over recent years. For example, labour market conditions are forecast to deteriorate most substantially in Spain and Ireland and least in Germany and Finland.

Countries which have seen their competitiveness deteriorate were either those going through substantial housing market booms or/and those suffering from important market rigidities. The necessary rebalancing of these economies will need to be supported by a continued reform process aimed at boosting market adaptability and productivity, in order to minimise the negative impact of future adjustments on unemployment and real wage developments.

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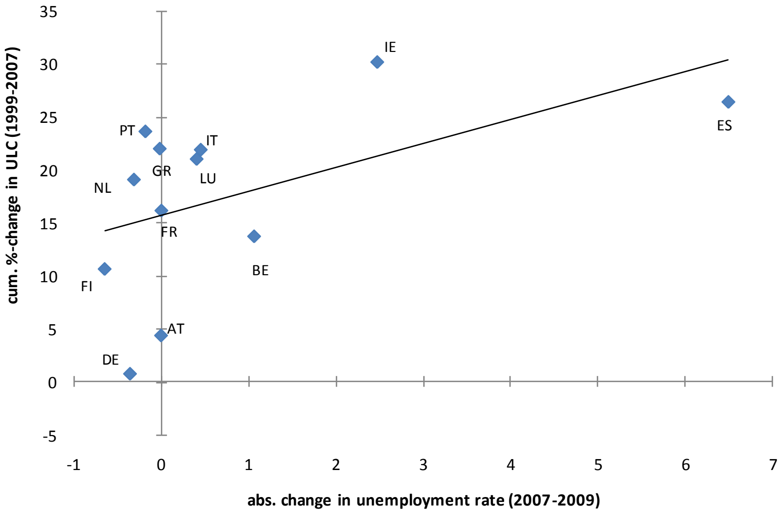
Chart: Unit labour cost developments and expected evolution of unemployment rates



Source: BUSINESSEUROPE, ECB, IMF

Policy action at national level is therefore needed in several fields. However, improving governance and policy coordination at EMU level seems equally essential in order to ensure sustainable and balanced growth across euro-area countries in the future.

<u>Strengthen the role of the Eurogroup</u>

- The single currency is a cornerstone of Europe's future economic success. To increase its benefits, present and future EMU participants will need to lift both their collective responsibility and individual commitments to fiscal discipline, reforms, sustainable competitiveness and a strong representation at the international level.

- The strong momentum that has been created by the collective action of euro-area member states in order to face the financial crisis should in this sense serve as a basis to also push forward other aspects that improve the functioning of EMU. In particular, the Eurogroup should be:
  - more vocal and be able to issue guidelines to national governments in case a severe deterioration of national competitiveness. A prolonged decline of unit labour costs of a euro-area member against its main trading partners should trigger a debate within the eurogroup and call for a national adjustment plan.
  - more outspoken as regards the follow-up process of national reforms, comment on successes and failures, and instil a real benchmarking culture.
  - better represented at the international level, in order to have an influence commensurate with its economic weight.

- Improved governance of the euro area will be conducive to deeper market integration in the wider EU and an enhanced role of the euro as an anchor of global economic and financial stability.

Reduce inertia in wage-setting procedures

- An overarching priority to avoid any long-lasting drift is to ensure that real wage developments are aligned with trend productivity growth, not only at the aggregate level but also across various segments of the labour market.

- Wage formation must also be responsive to the aim of reducing imbalances where they have emerged, related either to high structural unemployment in some countries and/or insufficient external competitiveness. Hence,
  - wage negotiations must be conducive to integrating more people in the labour market.
  - real wages must adequately reflect past losses in price competitiveness.

Implement labour market reforms

- Labour market rigidities and segmentations, high marginal tax rates and a lack of geographical and occupational mobility tend to increase adjustment costs associated with economic transformation. It is therefore essential for the functioning of monetary union that labour market adaptability is raised in line with the flexicurity principle.
- The level of contractual protection for regular and full-time jobs has barely changed across euro-area countries, and remains excessive in some Mediterranean and continental European countries.
- Significant efficiency gains are required in the field of active labour market policies, so as to facilitate transitions on the labour market and provide workers with the skills needed to adjust to change.
- Lastly, obstacles to labour mobility should be reduced to smooth the adjustments to country-specific shocks. This should be achieved by alleviating residual discrimination on the basis of nationality, by supporting efficient coordination of social security systems and by improving transparency of education and training qualifications.

Accelerate product market reforms

- Competitive product and capital markets are a crucial contribution to the effective functioning of monetary union, encouraging a better and faster allocation of resources leading to higher aggregate productivity as well as lower and more reactive prices.
- The internal market must make decisive headway in particular in the services sector. Transposition and enforcement at the national level should be enhanced.
- A key priority is to reduce compliance costs and simplify administrative procedures. The better regulation agenda pursued at both national and EU level should gain momentum to bring real alleviation on the ground.

Avoid pro-cyclical fiscal policies

- It is essential that budgetary policies effectively compensate the impact of the one-size-fits-all monetary policy and are hence strongly counter-cyclical.
- The revised rules of the Stability and Growth Pact agreed in June 2005 have induced some positive developments, including reinforced ownership at the

national level. But the new rules of the pact have not yet proved their effectiveness in delivering

- a stronger commitment of member states to fiscal discipline during good times
- ambitious medium-term objectives commensurate with the challenge of demographic ageing.

Conclusions:

The euro has greatly benefited companies and citizens during the last decade by bringing moderate inflation, low interest rates and a shield against financial market turbulences.

The eurogroup should build on the momentum created by the coordinated response of the 15 euro-area member states to the financial market turmoil to reinforce economic governance more generally. This crisis represents a unique opportunity to improve collective responsibility in a well functioning euro area economy, and reinforce individual commitments to maintain competitiveness and avoid internal as well as external imbalances developing in the future.