BUSINESSEUROPE

FIT WITH THE EURO

Challenges to improve the economic performance of European Monetary Union

31 MAY 2007

MONETARY UNION AFTER EIGHT YEARS: FACTS AND FIGURES

INTRODUCTION

The benefits of monetary union are indisputable...

The alleviation of exchange rate risks, price stability, and increased transparency in transactions have fostered an environment conducive to investment and job creation.

The European Central Bank's strong institutional independence and clear mandate has played a positive role, allowing it to establish its credibility quickly and anchor inflation expectations at a low level. Chart 1 shows that despite a series of price shocks keeping actual inflation above 2%, expectations over a two-year period have remained consistently in line with ECB's definition of price stability. This credibility is reflected in low interest rates across the entire maturity spectrum, and has permitted all euro-area countries to benefit from the favourable financing conditions that only few previously enjoyed.

Externally, the euro has rapidly acquired the status of global currency, for instance displacing the US dollar on international debt securities markets (see Chart 2). The growing importance of the euro at the international level is also reflected in the fact that more than 50% of imports from non-euro-area countries are billed in euros, while this share increases to around 60% for exports to the rest of the world.

Chart 1
Inflation and inflation expectations in the euro area
Source: ECB

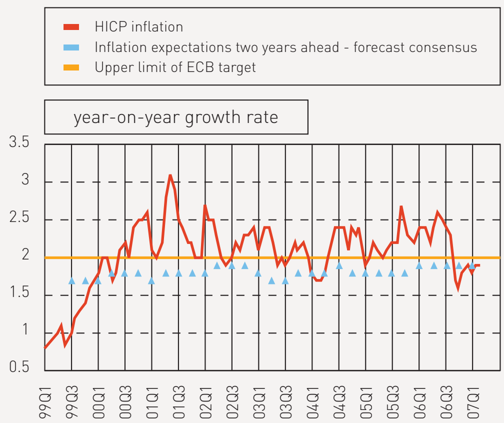
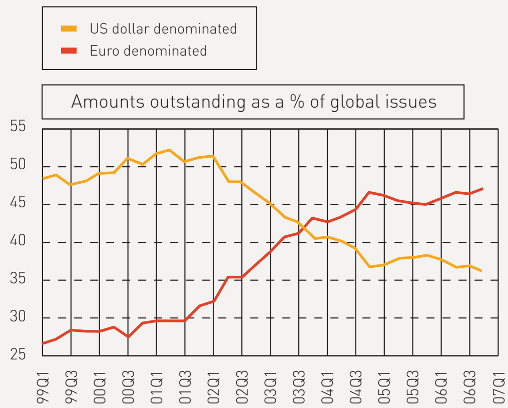


Chart 2 International bonds and notes by currency of issue
Source: Bank of International Settlements (BIS)



But important policy challenges still need to be tackled...

At the same time, rising competitiveness divergences and insufficient productivity growth should remind policy-makers that there is room to improve the economic performance of monetary union. Factors hampering growth and those allowing competitiveness imbalances to develop are not unconnected: they are both related to structural rigidities interacting with inadequate budgetary and wage policy responses to country-specific circumstances.

This, together with the presence of extensive cross-border policy spill-overs, calls for a strengthened and effective framework of economic governance at euro-area level. Through the single monetary policy and exchange rate, but also through trade, labour market and financial market channels, difficulties in one country have a substantial knock-on effect in the rest of the euro area, while reforms can have pervasive positive effects. Spill-overs have been recognised in the area of fiscal policy within the framework of the Stability and Growth Pact, but implementation has been unsatisfactory, and policy interactions in other areas have receive more limited attention thus far.

This BUSINESSEUROPE report highlights key policy priorities to improve the functioning of monetary union and outlines the responsibility of various policy stakeholders.

SALIENT FACTS

Competitiveness and current account imbalances have reached worrying levels…

Current account imbalances within monetary union have steadily increased over the last decade, and, as shown in Chart 3, at a pace roughly comparable with the much publicised global imbalances.

Among the five OECD countries with the largest current account deficits (in % of GDP), three are in the euro area – Spain, Portugal and Greece – mainly compensated by large surpluses in Germany, the Netherlands or Finland. In the absence of country-specific exchange rate risks and of substantial differences in risk premia at national level, these developments have more diffused effects. However, they are far from benign and illustrate the present difficulties in coping with economic and policy heterogeneity in the euro area.

Large and growing external deficits in Spain, Portugal and Greece, but also in France or Italy, are tightly linked to drifting competitiveness, unabated by market forces or active policies. Chart 4 shows that these countries have lost between 15% and 25% of their cost competitiveness against Germany since the start of monetary union[1]. On the other hand, the accumulation of considerable current account surpluses, in particular in Germany, reflects strong competitiveness gains but also the slow dissemination of these gains to domestic demand.

Chart 3 Standard deviation of current account balances (in % of GDP)

Source: BUSINESSEUROPE based on IMF (April 2007)

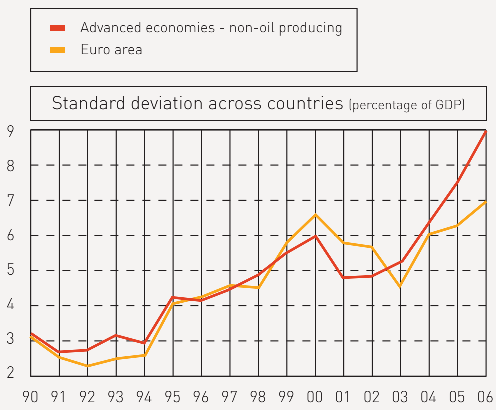
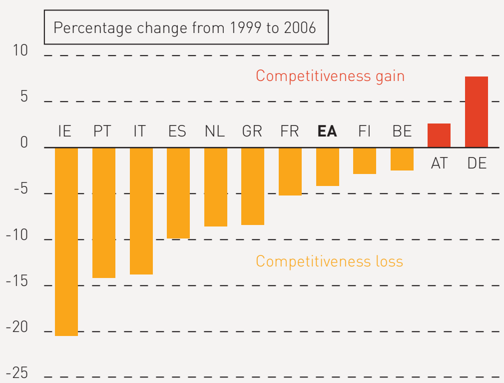


Chart 4
Cost competitiveness developments since 1999

Source: BUSINESSEUROPE based on European Commission's AMECO database (May 2007)

Note: cost competitiveness is measured by the relative evolution of unit labour costs against 24 trading partners expressed in local currencies



Insufficient reforms and pro-cyclical policies are the root cause of the problem…

The main reasons for the slow rebalancing of competitiveness positions in monetary union are associated with two groups of factors. First, at microeconomic level, they are the consequence of structural rigidities dampening productivity and leading to excessive price and wage inertia.

Second, imbalances tend to be reinforced by an inadequate macroeconomic policy mix at the individual country level. In monetary union, countries with above-average growth and inflation tend to receive stronger support from the single monetary policy, reflected in below-average real interest rates, strong credit growth and buoyant housing markets. In contrast, countries that are regaining competitiveness through disinflationary measures tend to struggle with higher real interest rates, more stringent credit conditions and depressed housing markets. The link between the diversity of real interest rate levels and housing market developments in the euro area is illustrated in Chart 5.

An appropriate response to this latent heterogeneity in monetary conditions can only come, at macroeconomic level, from sustainable and counter-cyclical budgetary policies at the individual country level. However, this is an area where the economic governance of monetary union has been relatively unsuccessful.

Fiscal policy is found to have been pro-cyclical in most euro-area countries, hence reinforcing rather than alleviating cyclical divergences at the national level. Chart 6 shows in particular that insufficient fiscal consolidation during the boom of the late 1990s was widespread, leaving no margin to absorb the subsequent slowdown, particularly in countries with weaker growth momentum such as Germany, Italy, Portugal and France. Regarding the ongoing recovery, consolidation plans for the next two years are more ambitious than in the past, but they remain excessively dependent on revenue windfalls and they generally fall short of the structural adjustments required by the Stability and Growth Pact.

Chart 5
Housing markets and real interest rates
Source: BUSINESSEUROPE based on BIS and Eurostat

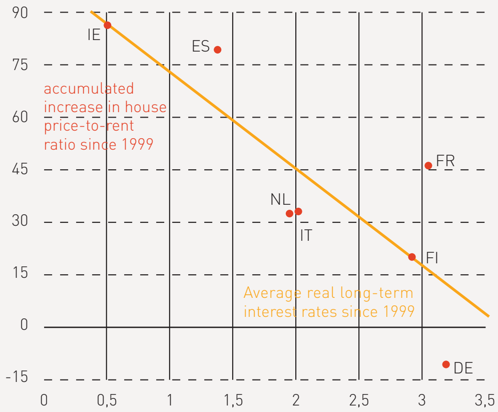
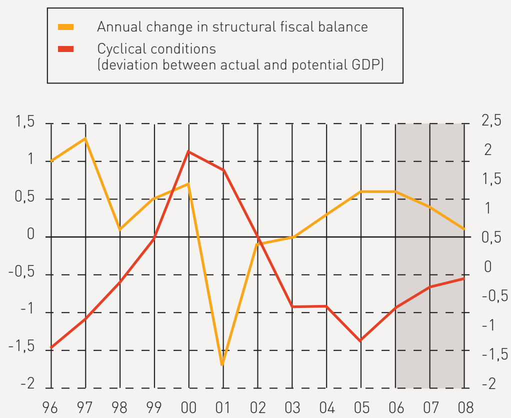


Chart 6
Budgetary policies and cyclical conditions
Source: BUSINESSEUROPE based on AMECO (May 2007)



1 The case of Ireland must be considered separately. Its rapid catching-up process and strong domestic demand boom has had a significant effect on inflation hence leading to an apparent loss of cost competitiveness. However, the exporting sector has seen rapid productivity growth thanks to a shift towards high-tech industries and has been able to maintain its global competitiveness.

On the side of structural reforms, and despite earlier expectations, euro-area membership did not trigger an acceleration of labour, product and services market liberalisation. In the first years of monetary union, governments have in fact shown a certain reluctance to push for ambitious reforms, in particular those required to enhance workers' and companies' adaptability. For instance, Chart 7 gives evidence that no noticeable progress has been achieved towards a reduction in the rigidity of employment protection legislation for regular contracts.

Significant steps forward have been achieved in other areas such as financial integration, but there also challenges remain in place with persistent market segmentation in the area of retail financial services. Chart 8 illustrates that the share of cross-border lending to companies and households is low and has not noticeably increased since 1999.

Competition and market adaptability are essential to improve adjustment dynamics…

Chart 7 Strictness of employment protection legislation for regular contracts
Source: BUSINESSEUROPE based on OECD, European Commission and IMAD (2006) for Slovenia

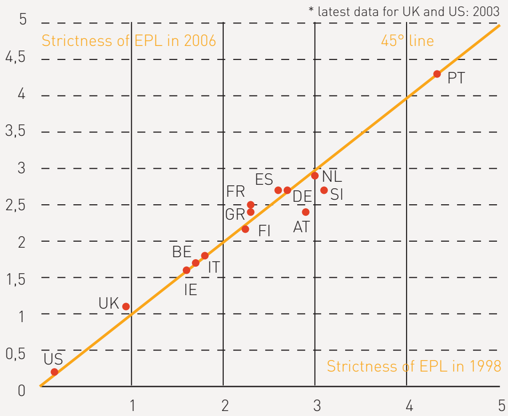
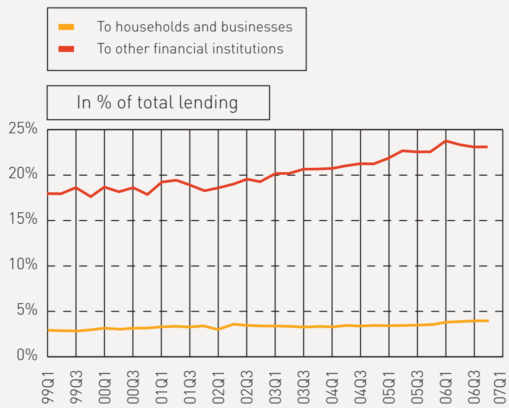


Chart 8 Cross-border lending to euro-area countries by financial institutions
Source: BUSINESSEUROPE based on ECB



The re-launch of the Lisbon Strategy in 2005, more focused on growth and jobs and with new instruments, has clarified the agenda for reforms and has to some extent reconnected Member States with the exercise.

During spring 2007, BUSINESSEUROPE asked its national member federations to assess progress achieved in their countries and results were presented in the "EU Reform Barometer Spring 2007" (www.businesseurope.eu/growthandjobs).

It emerged from this survey that reform initiatives were taking place in virtually all member states but varying degrees of commitment were observed across countries and policy areas, and implementation was considered to be slow.

As usual in an economic recovery, there is today a distinctive risk that structural difficulties become less apparent, hence leading to reduced incentives to reform. Such complacency must be resisted at both EU and national level. The upswing should instead be seen as an opportunity to make decisive steps to tackle competitiveness imbalances and raise the growth potential of the euro area.

KEY PRIORITIES FOR EURO-AREA COUNTRIES

Less flexible and fiscally imprudent member states not only reap fewer benefits from euro-area membership, but also contribute to cyclical and competitiveness divergences, which come at a collective cost for all countries sharing the euro. BUSINESSEUROPE identifies six areas of action to improve the economic performance of monetary union:

1. **Ensure that national budgetary policies deploy their automatic stabiliser effects around a sustainable long-term path for public finances.** This notably requires stricter enforcement of the preventive arm of the Stability and Growth Pact. Structural consolidation must be stepped up in the upper part of the business cycle, in order to allow sufficient room for manoeuvre during any subsequent downturn and to lessen cyclical divergences across euro-area countries. Increasing focus should be given to issues of fiscal sustainability and to the effectiveness of national fiscal institutions in preventing pro-cyclical policies. It is also crucial that budgetary conditions are assessed cautiously, avoiding overly optimistic assumptions about the underlying state of public finances during a recovery.

2. **Ensure that wage developments are consistent with productivity trends not only at the aggregate level but across various segments of the labour market.** Wage policies, autonomously set by social partners, have to reflect the diversity of developments at the country, sectoral and company level. Furthermore, to overcome lasting imbalances, wages should be more responsive to labour market and competitiveness conditions.

3. **Boost productivity through heightened competition, better framework conditions for research and innovation, better education and training.** Higher productivity growth is the basis for raising the euro area's growth potential, and is key for an orderly rebalancing of competitiveness positions across countries. The main priorities are to make education and training systems better attuned with the needs of a competitive economy, reduce compliance costs, simplify administrative procedures and improve the quality of general and business infrastructure.

4. **Complete the internal market, especially in the services sector** where a lack of competition is a major factor contributing to weak productivity growth, inflation inertia and competitiveness divergences. Completing financial market integration and removing existing barriers to cross-border activities, especially in the more segmented retail financial services area, is crucial as well. Euro-area countries must be at the forefront of the EU agenda for market liberalisation, while demonstrating diligence in the transposition and appropriate enforcement of internal market provisions. Implementation of the EU services directive agreed in November 2006 will be a test case.

5. **Raise labour market flexibility and provide new forms of employment security in a changing labour market.** This is the flexicurity approach which is based on a combination of employment-friendly labour laws, effective active labour market policies and modern social protection systems. This approach is particularly relevant in the euro area as it can contribute to improved adjustment dynamics. Removing obstacles to labour mobility can also help increase adaptability benefiting employment and productivity levels.

6. **Pave the way for a successful euro-area membership for future participants.** The Maastricht convergence criteria are an important set of instruments to test candidate countries' ability to maintain competitiveness and ensure sustainable public finances in monetary union. However, these criteria are necessary albeit not sufficient conditions for successful euro-area membership. It is essential that prospective members are also given clear guidance, in the context of the EU growth and jobs strategy, as regards structural reforms needed to ensure sustainable convergence and high competitiveness in the single currency area.

IMPROVING THE GOVERNANCE OF THE EURO AREA

The responsibility to reform along the lines identified above lies primarily with national governments and social partners. European institutions play an important role as well, both in building awareness of policy challenges and by ensuring an effective system of monitoring and peer pressure.

Looking forward, policy spill-overs across countries sharing the single currency will need to be better acknowledged in the context of the EU Growth and Jobs Strategy and appropriately reflected in the EU Integrated Guidelines and in National Reform Programmes.

In parallel, the surveillance of fiscal policies and structural reforms and the enforcement of collectively agreed rules and legislation also need to be strengthened, requiring an active and forceful role of the European Commission and of the Eurogroup (i.e. the informal Council of Finance Ministers of the euro area).

BUSINESSEUROPE issues to the following recommendations for the various policy stakeholders :

Member States should demonstrate a strong sense of collective responsibility and avoid complacency in setting their reform agendas, particularly when economic conditions are improving. National reform programmes have a prerequisite for success: monitoring their implementation and evaluating their effect through a well established set of indicators and through strict time schedules. Past experience shows that there is no lasting "cocoon" effect to euro-area membership, and that delaying necessary measures will only lead to more painful adjustments in the future.

Social partners play a crucial role in a properly functioning monetary union by ensuring that wage policies are flexible and responsive to the triple objective of price stability, full employment and high competitiveness.

European Commission should keep a vigilant eye on member states' implementation of reform commitments under the EU growth and jobs strategy and contribute to a better understanding of policy spill-overs in the euro area. Quantitative instruments to measure reform progress and implementation should continue to be developed and improved. The Commission must exert its right of alert when national policies are inconsistent with commitments or when they impede on the proper functioning of monetary union.

Eurogroup has made significant headway in recent years, as a renewed political consensus on the Stability and Growth Pact illustrates. However, policy challenges are mounting in an environment where competitiveness imbalances continue to grow across euro-area countries. To cope with these challenges, the Eurogroup must advance with a common vision of policy priorities. An appropriate representation of the euro area at the international level is also warranted. Close ties between the Eurogroup and the ECB should develop in the full respect of the ECB's independence and in the context of a non-binding dialogue.

ECB has been successful in delivering on its primary objective of price stability and underpinned favourable financing conditions to support growth. It has also made a useful contribution to the debate in the area of fiscal and structural policies. ECB's communication has reached a good level of clarity but more efforts to emphasise the positive contribution of its policies for high sustainable growth and job creation in the euro area would be appreciated.

In the discussions on the future of the Constitutional Treaty, BUSINESSEUROPE urges that the provisions on economic governance are safeguarded. These notably include a reinforced role of the Commission in both fiscal and structural reform surveillance. Recognition of the Eurogroup, improved decision-making processes and voting rules in the Council are also crucial to move euro-area governance forward. Finally, BUSINESSEUROPE is against any change in the status or mandate of the ECB, and in this regard fully supports the current provisos of the Constitutional Treaty.

WHO ARE WE?

BUSINESSEUROPE, the Confederation of European Business, is the voice of more than 20 million small, medium and large companies.

BUSINESSEUROPE's members are 39 central industrial and employers' federations from 33 countries, working together to achieve growth and competitiveness in Europe. Our priorities to boost Europe:

1. Implement the reforms for growth and jobs
2. Integrate the European market
3. Govern the EU efficiently
4. Fight national protectionism
5. Take advantage of the opportunities of enlargement
6. Reform European social systems to make them sustainable

WHY THIS PUBLICATION?

The well functioning and effective governance of monetary union is of crucial interest for BUSINESSEUROPE, not only because it presents the national business federations in the 13 countries sharing the euro, but because fully exploiting the benefits of the euro will have pervasive effects on the wider EU and its position in the global economy.

A sense of collective responsibility is needed for euro-area countries, and a willingness to improve the cohesion of monetary union without this creating divisiveness with other EU member states.

This report was presented on 31 May 2007 by Ernest-Antoine Seillière, President of BUSINESSEUROPE, on the occasion of the Brussels Economic Forum: "Global adjustment and the European Monetary Union".

The report draws on a longer analytical paper which can be downloaded from BUSINESSEUROPE's growth and jobs website: www.businesseurope.eu/growthandjobs

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