



FIT WITH THE EURO: CHALLENGES TO IMPROVE THE ECONOMIC PERFORMANCE OF THE EUROPEAN MONETARY UNION

**ANALYTICAL NOTE ACCOMPANYING THE BUSINESSEUROPE REPORT PUBLISHED ON 31
MAY 2007**

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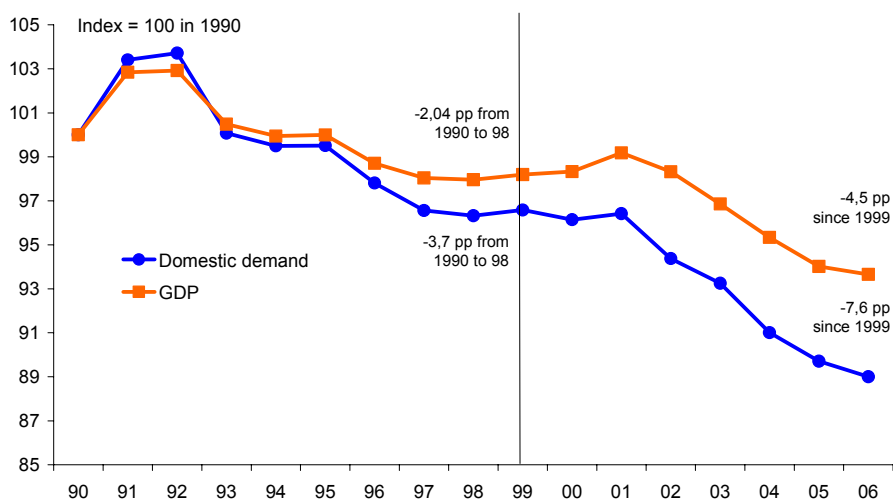
1. Introduction

Monetary union and the internal market are two great achievements of European integration for the business community. The benefits of the single currency have been clearly noticeable. Externally, the euro has rapidly acquired the status of a global currency, displacing the dollar in terms of notes in circulation, and on international bond markets.

Internally, the alleviation of exchange rate risks, the credible commitment of the European Central Bank to price stability, and increased transparency in transactions have fostered an environment conducive to investment and job creation.

However, a disappointing growth performance since the start of monetary union in 1999 (see Chart 1), together with growing competitiveness divergences across countries sharing the single currency, illustrate persistent obstacles to the efficient functioning of the euro area economy. As developed in this note, competitiveness divergences and weak growth are related to structural rigidities interacting with inadequate budgetary and wage policy responses to country-specific circumstances.

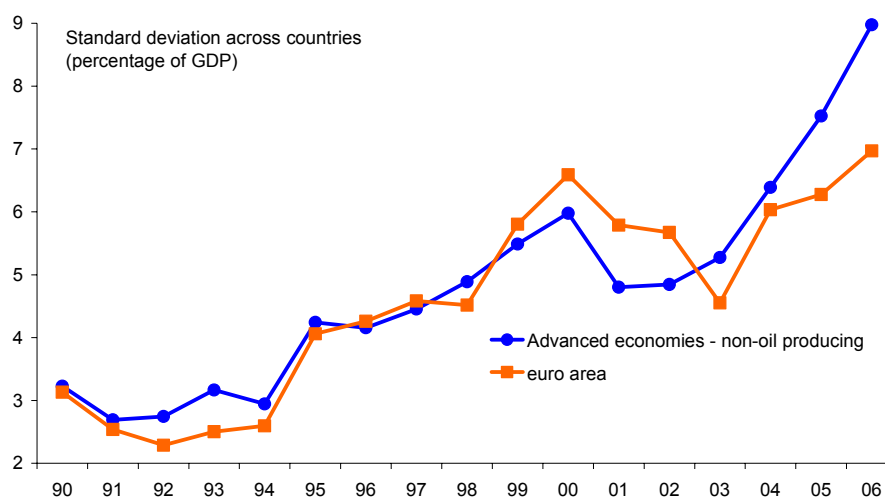
Chart 1: euro-area relative performance compared with main trading partners



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

One of the major economic developments over the last decade has been the steady increase in current account imbalances at global level. This trend was until now accompanied with remarkably strong world GDP growth. What is less often acknowledged is that current account imbalances within monetary union have also steadily increased over the last decade, and in fact roughly at the same pace as in the rest of the industrialised world (see Chart 2). Contrary to developments at global level, current account imbalances in the euro area have been associated with disappointing growth over the last decade.

Chart 2: standard deviation of current account balances (in % of GDP)



Source: BUSINESSEUROPE based on IMF (April 2007)

2. Current account and competitiveness imbalances

Current account divergences in monetary union need not necessarily be a problem. The deterioration in a country's external trade position could for instance reflect rapid economic catch-up or financial liberalisation, both implying that strong import growth goes hand in hand with massive capital inflows and foreign direct investments. Probably a good example of such experience is Ireland over the last decade. On the other hand, a country needing to regain external competitiveness will do this by rebalancing activity from the non-tradable to the tradable sector, hence implying an improved current account position. This has been the case for instance in the Netherlands in recent years. These must be considered normal adjustments in monetary union.

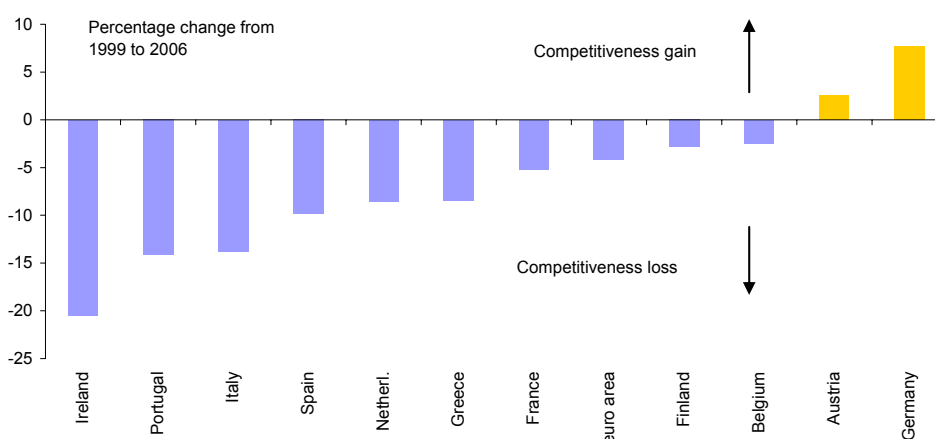
Imbalances emerge when competitiveness is allowed to drift away for a long period of time without being corrected, and when the subsequent adjustment to regain the lost ground is sluggish and accompanied by a prolonged episode of weak economic growth.

A typical case in point is Portugal. Its current account deficit has increased from zero in 1995 to around 10% today (see tables in annex for country-specific developments). From 1995 to 2000, the increase was largely related to EMU entry and its boost to domestic demand from low real interest rates and expectations of accelerating productivity. Fiscal policy was also excessively loose around that period, partly because the underlying strength of the economy was overestimated. These overblown expectations and imprudent fiscal policy ended up in a significant overheating episode in late 1990s, which has been followed by economic stagnation for most of the last five

years. But despite weak activity and rising unemployment in recent years, external competitiveness has continued to deteriorate and current account positions have failed to improve (see chart 3). It is widely acknowledged that significant reforms supporting productivity, wage flexibility and sustainable public finances will be needed before Portugal returns to a more sustained growth path.

The country with the second largest current account deficit in the euro area is Spain. Strong domestic demand, notably bolstered by a housing market boom, continues today to foster strong import growth and capital inflows. But the current account deficit now topping 9% of GDP also reflects drifting price competitiveness, due to both weak productivity growth and excessive inflation. Spain appears today in much better situation than Portugal in 2000, because of its more flexible structures and healthier public finances. But also in Spain there is a risk of a disorderly unwinding, unless measures to rebuild productivity growth and competitiveness in the tradable sector are stepped up rapidly.

Chart 3: real effective exchange-rate developments since 1999



Source: BUSINESSEUROPE based on AMECO (May 2007)

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

Italy is a more worrying case of drifting competitiveness, combining weak growth potential and unsustainable public finances. In fact, Italy is the only euro-area country that has had a significant domestic demand underperformance before and after monetary union with deteriorating current account positions and cost competitiveness. Large budget deficits and still rising public debt also contribute to an unpromising outlook in the absence of a stronger reform momentum.

At the other end of the spectrum of current account developments, the case of Germany since the start of monetary union shows that steadily improving competitiveness and a strong external trade position can coexist for a long period of time with weak domestic demand, before delivering their benefits to the wider economy. In fact, since 1999, domestic demand in Germany has lost around 13% against its main trading partners, and while investment and employment is strengthening in the ongoing recovery, there is still some uncertainty regarding the outlook for a sustained upturn in consumer spending. This prolonged domestic demand slowdown has been largely associated with conditions prevailing prior to EMU entry (overvalued exchange rate, poor public finances and a large overhang from unification, especially in the construction sector). However,

the German case also demonstrates the slow workings of the competitiveness channel to rebalance domestic demand growth within monetary union.

We will argue in the following analysis that unnecessarily long adjustments at the country level stem most notably from the interplay of structural rigidities and a pro-cyclical macroeconomic policies, leading to a slow unwinding of internal imbalances in monetary union. Several policy recommendations are identified to improve the economic governance of monetary union towards more sustainable and balanced growth across euro-area countries.

3. Reasons for the slow working of the competitiveness channel

a. Role of inflation and wage inertia

Slow competitiveness adjustments are obviously the outcome of excessive inertia. However, this inertia can have either microeconomic explanations – product and labour market rigidities – or macroeconomic ones – extended episodes of overheating and overcooling in the business cycle.

Table 1 illustrates that both factors are at play and interact with one another. It presents regression results explaining relative unit labour cost inflation across the euro area by three factors: intrinsic inertia (captures micro aspects), cyclical conditions (macro), and the level of GDP per capita. This last variable makes allowance for the fact that catching-up economies naturally have higher inflation but without this necessarily being a major problem.

Table 1: measuring inertia in unit labour cost inflation

Panel data model ⁽¹⁾		
Explanatory variable	Dependent variable: Unit labour cost inflation ⁽²⁾	
	1991-1998	1999-2006
	Coefficient value and significance ⁽⁵⁾	Coefficient value and significance ⁽⁵⁾
Lagged unit labour cost inflation	0.30***	0.37***
Cyclical conditions ⁽³⁾	0.47***	0.49***
GDP per capita ⁽⁴⁾	-0.05***	-0.01***
R-square	81%	
Durbin Watson	2.13	

Source: BUSINESSEUROPE based on EC AMECO, IMF, OECD and Eurostat

Note:

- (1) Estimates are based on a pooled model combining 15 years of observation across 11 euro-area countries (15*11=165 observation). The estimation method allows for cross-section heteroskedasticity and contemporaneous correlation between country residuals
- (2) Unit labour cost of each country relative to 23 main trading partners – annual percentage change
- (3) Output gap - i.e. deviation between actual and potential output levels – deviation from euro-area average
- (4) Level of GDP per capita – deviation from euro-area average
- (5) Probability of coefficient being insignificant: *** less than 1%, ** between 1% and 5%, * between 5-10%

First of all, the level of GDP per capita has a significant effect on relative unit labour cost developments in the euro area, although this effect seems to have been more important in the period preceding monetary union than since the euro was adopted. This impact is not necessarily a source of concern as long as it reflects price level convergence in the non-tradable sector and is consistent with the maintenance of external cost competitiveness through rapid productivity gains in the tradable sector. A typical example of this catching-up effect is Ireland, where economy-wide unit labour costs have increased significantly whereas the exporting sector was able to maintain its external position.

Second, cyclical conditions are also a determining factor for competitiveness trends, and their influence seems to have remained broadly unchanged before and after monetary union. While cyclical divergences are actually fairly limited in the euro area, the next section will demonstrate that they are actually very persistent – notably under the effect a pro-cyclical macroeconomic policy mix at the national level.

Third, irrespective of prevailing economic conditions in individual countries, relative unit labour costs show themselves a high degree of inertia, and this inertia is estimated to have increased since 1999.

In terms of price-setting, this reflects insufficient competition and segmentation of product markets. This emphasises the importance of deepening the internal market and reducing national barriers to competition, especially in services where most inflation divergences across countries originate. Hence, improved adjustment dynamics in monetary union is strongly conditional on progress towards more integrated markets and lower barriers to competition.

Wage formation takes also a central role in determining competitiveness. 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. At the firm/sector level, wage differentiation tends to reduce wage inertia and thereby the impact of asymmetric shocks on competitiveness, growth and employment. At the individual level, wage dispersion rewards effort and creates incentives for more education and on-the-job training, which in turn supports aggregate productivity and firms' performances.

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. On the first aspect, it is essential that wage negotiations not only reflect insider preferences, but seek to integrate more people in the labour market. Over the last decade, the positive impact of wage moderation has already been visible, as it has been instrumental in the observed decline in structural unemployment and rising employment levels.

On the second aspect, there is evidence of downward real wage rigidities contributing to lasting competitiveness drifts in countries like Italy or Portugal for instance. In those countries, real wages have failed to adequately reflect past losses in price competitiveness and current weak productivity trends. Currently available wage forecasts indicate that widening competitiveness imbalances will continue to prevail over the next years, hence emphasising the urgent need to take action in these areas.

Beyond competitiveness imbalances, strong inflation inertia also reduces the ECB's margin to respond to changing economic conditions. This contributes to the popular,

albeit misguided, perception that the ECB is insufficiently concerned with growth and employment developments and lacks activism in the face of an economic slowdown.

Policies aimed at raising price and wage flexibility would therefore have pervasive positive consequences for the functioning of monetary union but also on the credibility and support of its monetary policy framework.

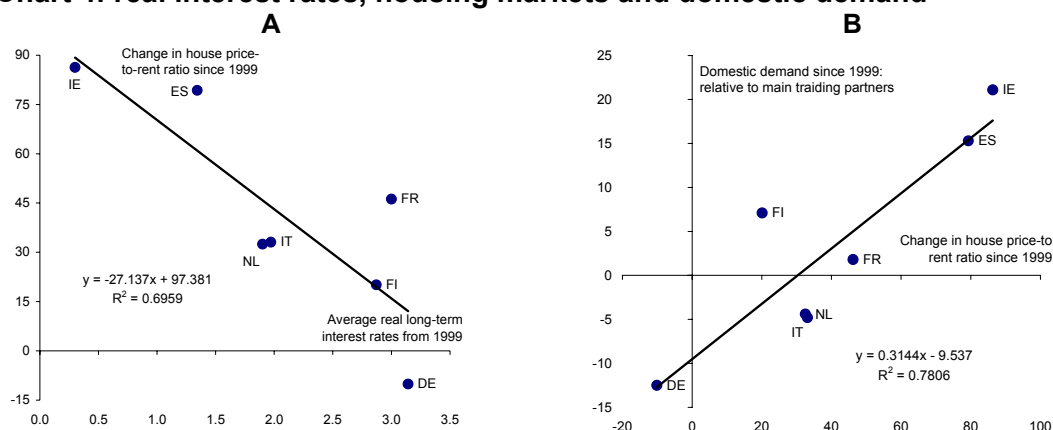
b. Role of monetary and fiscal policies

Beyond price and wage inertia, the slow working of the competitiveness channel is also the result of an inadequate macroeconomic policy mix at the individual country level, lengthening rather than speeding up country-specific adjustments.

First of all, with uniform nominal interest rates prevailing across most euro-area countries (long-term interest rate differentials being close to zero), countries enjoying above-average growth and inflation also tend to benefit from lower real interest rates. These real interest rate differentials can therefore act as a “destabilising” force in the presence of large cyclical imbalances, providing excessive stimulus to overheating economies and insufficient support to domestic demand in countries in need to regain competitiveness through disinflationary measures.

Beyond their direct effect on savings and investment decisions, these real interest rate differences can also be amplified through asset price developments. Indeed, a dominant feature in developments across countries since the start of monetary union has been the diversity of housing market trends, bolstering domestic demand growth in countries such as Spain or Ireland, while constraining it in others such as Germany or Austria. In this respect, Charts 4A and 4B show a strong correlation between real interest rate levels and house price developments across countries, and also between house price developments and domestic demand conditions.

Chart 4: real interest rates, housing markets and domestic demand



Source: BUSINESSEUROPE based on EC AMECO and OECD

Moreover, access to lending for some categories of households and firms have been more difficult in countries with rising unemployment and weak income growth, while being easier in faster growing economies. These credit constraints, associated within insufficient competition in some banking and mortgage market segments, are another factor generating heterogeneity in financing conditions across countries.

The exact impact these developments is difficult to assess in practice but it appears that real interest rate differences have had a significant effect on cyclical divergences both in

the period running up to monetary union (period of nominal convergence) and since the start of it (see Table 2). The “destabilising” impact of a single monetary policy could have been initially underestimated, due to insufficient considerations of the asset price and credit constraint channels.

Table 2: cyclical divergences and macroeconomic policies

Panel data model ⁽¹⁾		
Explanatory variable	Cyclical conditions ⁽²⁾	
	1991-1998	1999-2006
	Coefficient value and significance ⁽⁵⁾	Coefficient value and significance ⁽⁵⁾
Lagged cyclical conditions	0.67***	0.77***
Real interest rates ⁽³⁾	-0.17***	-0.17***
Structural fiscal balance ⁽⁴⁾	-0.04**	-0.06***
R-square	96%	
Durbin Watson	2.06	

Source: BUSINESSEUROPE based on EC AMECO, IMF, OECD and Eurostat

Note:

- (1) Estimates are based on a pooled model combining 15 years of observation across 11 euro-area countries. The estimation method allows for cross-section heteroskedasticity and contemporaneous correlation between country residuals.
- (2) Output gap - i.e. deviation between actual and potential output levels – deviation from euro-area average
- (3) Nominal short-term interest rates deflated by consumer price inflation – deviation from euro-area average
- (4) Cyclically adjusted primary balance – deviation from euro area average
- (5) Probability of coefficient being insignificant: *** less than 1%, ** between 1% and 5%, * between 5-10%

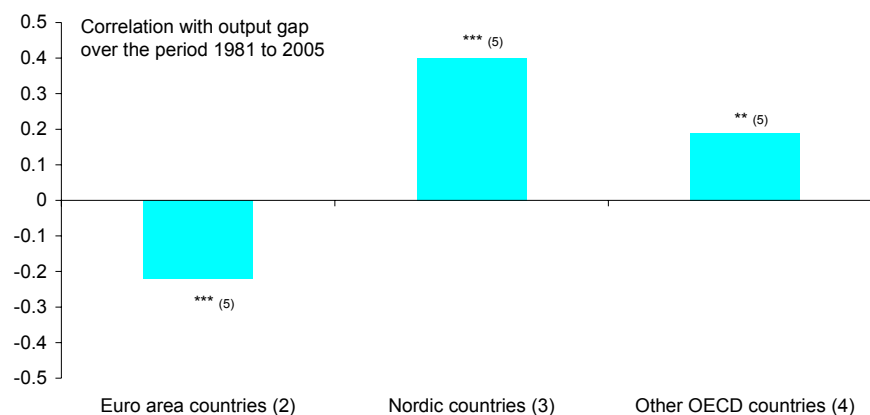
Two policy considerations can be drawn from this. First, financial liberalisation has to be pursued in view of limiting asset price misalignment at the country level and to facilitate and even out access to financing during different phases of the business cycle.

Second, it is essential that other macroeconomic policies, and most importantly budgetary policy, effectively compensate the impact of the one-size-fits-all monetary policy and prevent the emergence of cyclical imbalances in the first place.

In fact, counter-cyclical fiscal policies have become in monetary union the main instrument to avoid overheating and overcooling at the national level, and are therefore essential to maintain an appropriate macroeconomic policy mix across different parts of the euro area. But fiscal policies do not play this role at this juncture, mainly because of a lacking commitment to consolidate public finances during good times. This is illustrated in Table 2, indicating a negative correlation between cyclical conditions across euro-area countries and the evolution of structural budgetary balances.

In other words, against the principle of effective macroeconomic governance, fiscal policies have a tendency to be pro-cyclical across euro area countries, hence reinforcing rather than alleviating cyclical divergences. These findings are in line with other studies (see Chart 5), showing that pro-cyclical fiscal policies in the euro area stand in contrast with developments in other developed economies. This poor record indicates significant room for improvement in the area of fiscal policy management.

Chart 5: counter-cyclicality of discretionary fiscal policy ⁽¹⁾



Source: OECD (2007)

Note:

- (1) As measured by the correlation between changes in cyclically adjusted primary balance and output gaps
- (2) Euro area countries excluding Finland
- (3) Finland, Denmark, Norway and Sweden
- (4) US, Japan, UK, Canada, Australia, Korea, New Zealand and Switzerland
- (5) Probability of correlation being insignificant: *** less than 1%, ** between 1% and 5%, * between 5-10%

The revised rules of the Stability and Growth Pact agreed in June 2005 have induced some positive developments, including a reinforced ownership at the national level. But the new rules of the pact have not yet proved their effectiveness in delivering on two other crucial objectives: (i) strengthen the commitment to fiscal discipline during good times, and (ii) ensure ambitious medium-term objectives commensurate with the challenge of demographic ageing.

Concentrating on the first aspect, the experience over the last decade shows that governments are unwilling to step up consolidation efforts when growth is strengthening, due to a mix of political economy constraints (i.e. it is more difficult to build a consensus for structural consolidation measures when the economy is strong) but also due to the intrinsic difficulty of having a good assessment of underlying economic conditions in real time. In fact, a demand-driven upturn can at first be easily mistaken for supply-side improvement, therefore reinforcing the impression that no additional measures are needed to ensure fiscal sustainability.

An extreme example is Portugal again. We know today that, back in 2000, it had a structural fiscal deficit of more than 4.5% of GDP. This means of course that there was insufficient consolidation during the previous years of strong economic growth. However, in 2000, the structural deficit was estimated to be less than half what we now know it was. The awakening was painful and has been followed by years of weak economic growth reinforced by punitive fiscal consolidation.

It is important for the good functioning of monetary union that these experiences are not repeated in the future. Public finances must contribute more strongly to stabilising business cycles around a sustainable long-term path. This requires strict implementation of the preventive arm of the Stability and Growth Pact and improving the instruments to monitor and assess underlying fiscal positions.

In particular, pressure on countries in the upper part of the business cycle has to be stepped up significantly so that structural consolidation is delivered, while the

instruments to assess the underlying state of public finances and the wider economy must be reinforced and based on more realistic, comparable and cautious assumptions.

Moreover, the rule based discipline of the Stability and Growth Pact should be encouraged and reinforced by an appropriate pricing of the quality of public finances by financial markets. However, market mechanisms appear too weak to yield clear differentiation of euro-area government bonds.

Despite sizeable differences in individual fiscal positions, interest rate spreads are very low between euro-area countries and narrowed further since the start of monetary union. For instance, in 2006, budget balance varied from a 3% surplus in Finland to 4.6% deficit in Portugal, debt ranged from 7% in Luxembourg to 107% in Italy, but spreads on government bonds never exceeded 30 basis points. Default risk premiums contained in government bond yields show some degree of correlation with fiscal developments, but it is largely insufficient to generate market-driven discipline.

One of the policy instruments that could be envisaged to support market differentiation is the collateral framework of the Eurosystem. The collateral policy defines the assets that the Eurosystem accepts as collateral for the credit it provides to monetary and financial institutions. In 2005, it amounted to 8.2 trillion euros, 55% of which was EU member states' government debt.

In any case, while market forces could exert useful pressure on governments to keep their public finances under control they are unlikely, for instance, to produce sufficient marginal incentives for governments systematically to adopt counter-cyclical discretionary fiscal measures. A credible Stability and Growth Pact and its strict implementation are therefore the main instrument to achieve sounder public finances in monetary union.

4. Structural reforms and monetary union

Whereas the macroeconomic policy mix at the individual country level has done nothing to alleviate divergences across countries, it is mostly a lack of flexible economic structures and insufficient efforts to reform which has allowed competitiveness imbalances to become entrenched.

Euro-area membership was initially expected to trigger reforms improving national economic performance for two main reasons. First, reduced costs of trading, increased mobility of capital and more transparent pricing would enhance product-market and investment competition, which should engage member states in competitive structural reforms. Second, in the absence of national monetary policy, less flexible economies experience a loss of competitiveness if they fail to undertake a market-based adjustment to cyclical conditions, while slowing down the adjustment capacity of the euro area as a whole.

Empirical evidence counters these initial positive expectations. Over the last decade, the euro-area's potential output growth has not exceeded 2% to 2¼% according to recent estimates. This weak growth potential has been contemporaneous with fast globalisation and deep technological changes and reflects the persistence of major structural impediments, particularly in large member states, making it more difficult for companies to adapt, innovate and hire under fast-changing conditions.

Contrary to expectations, the uncovering of these structural drawbacks, reflected in dismal productivity growth, have not so far triggered an acceleration of structural reforms able to alleviate them.

a. Labour markets

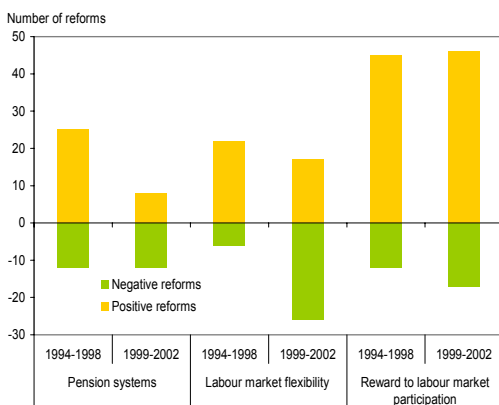
Starting with labour market reforms, strict employment protection rules, high marginal tax rates and a lack of geographical and occupational mobility tend to increase adjustment costs associated with economic transformation. In particular, stringent labour regulations hamper the creation and growth of new businesses, decrease the speed of adjustment to shocks, and eventually curb productivity growth. It is therefore essential for the functioning of monetary union that labour market adaptability is raised through more flexible contractual arrangements, better reward to labour market participation and more efficient active labour market policies.

Policies to integrate more people in the labour market have been relatively successful in recent years, underpinning a rise in employment rates in particular for female and older workers, but this has left reforms towards more flexible labour regulations relatively unaffected. Moreover, Chart 6A records if anything lower incidence of positive labour market reforms in the first years of monetary union, and even some counterproductive measures in the field of labour market flexibility.

Chart 6B also confirms at the individual country level that no significant steps have been taken to lower distortions from overly strict labour regulations since joining the euro area. The level of contractual protection for regular and full-time jobs has barely changed across euro-area countries, and remains excessive in most Mediterranean and continental European countries. Significant efforts will be needed to tackle this situation, not only to address the structural employment challenge in those countries but also to raise adaptability as a necessary condition for successful EMU membership.

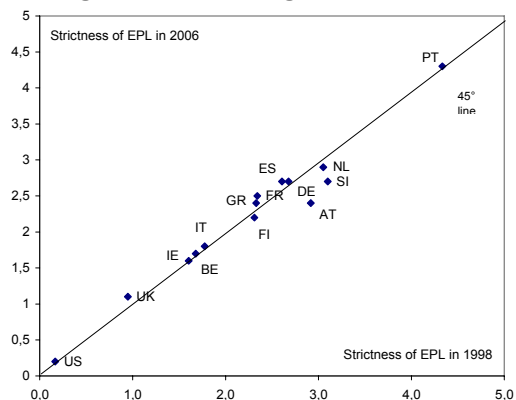
Chart 6: labour market reforms

A
Pace of labour market reforms before and since EMU



Source: BUSINESSEUROPE based on European Commission

B
Strictness of employment protection legislation for regular contracts



Source: BUSINESSEUROPE based on OECD, European Commission and IMAD (2006) for Slovenia

* 2003 data for UK and US, 2004 for Slovenia

There is also significant efficiency gains 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.

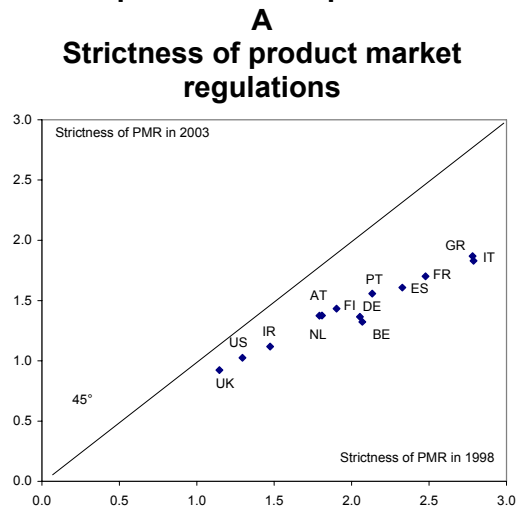
b. Product and financial markets

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. In addition, fostering competition can also improve the functioning of labour markets and raise the employment gains of labour market reforms. In this regard, there is growing evidence showing that labour and product market reforms complement each other and have mutually reinforcing effects.

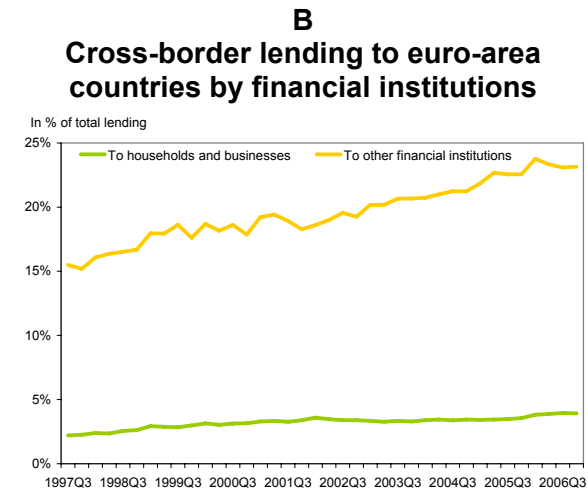
This certainly strengthens the case for further market integration in Europe by completing the internal market and removing outstanding barriers to cross-border activity, especially in the services sector.

Chart 7A shows that several member states have undertaken reforms to open their product markets, particularly in countries where restrictions were more stringent. Nevertheless, the regulatory burden still appears to be a significant obstacle to adaptability, particularly in large continental European countries which have experienced weak productivity growth over the last decade. A key priority in this regard 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.

Chart 7: product and capital market reforms



Source: BUSINESSEUROPE based on OECD



Source: BUSINESSEUROPE based on ECB

It is also crucial that the internal market moves forward and that transposition and enforcement at the national level is enhanced.

In November 2006 the European Parliament adopted the services directive whose objective is to remove legal and administrative barriers to the development of service activities between member states. The business community expects real benefits derived from the freedom of establishment but regrets the reduced scope of the directive and the legal uncertainty of certain provisions on cross-border provision of services.

It will be crucial to ensure that member states transpose and enforce the directive correctly, avoiding delays and respecting the spirit of the text and the two fundamental freedoms of establishment and service provision enshrined therein. The Commission should actively monitor the process.

Concerning financial integration, it has progressed significantly since the start of monetary union. However, as Chart 9B illustrates, retail financial services still remain fragmented due to constraining national regulations. Opening further these markets would make households' and firms' access to capital less susceptible to credit constraints, and would improve the mechanism of monetary policy transmission, contributing to a smoother economic adjustment across countries.

c. Reform sequencing: the experience of successful reformers

Regarding the appropriate mix of reforms, there is no single recipe for success. Responding to different circumstances and challenges, countries adopt different reform programmes. Nonetheless, a number of common trends emerge from the analysis of successful experiences. Countries like Denmark, Ireland, the Netherlands or the UK have at some point during the last decades undergone deep and effective structural reforms. All these experiences show the importance of embarking first on expenditure-based fiscal consolidation, alongside policies to boost labour supply and product and labour market deregulation.

In fact, reduced government spending gives room to lower labour taxes, which increases labour supply and supports wage moderation. At the same time, competitive product and labour markets allow labour supply reforms to translate into more jobs rather than higher rents, and higher employment in turn generates further fiscal revenue, which paves the way for further fiscal consolidation. In the most successful cases, the same mix of fiscal, product and labour market policies continued for many years, and the principle of boosting labour supply through moderating wage demands became entrenched.

BOX 1: ENLARGEMENT OF THE EURO AREA: Maastricht criteria and beyond

The Maastricht criteria, which lay down the rules for EMU accession, have provided a useful and indeed necessary framework for the setting-up of monetary union.

The five main criteria are the following: (i) the inflation rate of the candidate country must be within 1.5% of the average of the three lowest inflation rates in the EU; (ii) the long-term interest rate must be within 2% of the average interest rate of the three lowest inflation countries in the EU; (iii) the currency must remain within the Exchange Rate Mechanism (ERM II) bands for at least 2 years with no realignment; (iv) the fiscal budget deficit must not exceed 3% of GDP; (v) the public debt/GDP ratio must not be more than 60% or must be falling rapidly to that level.

These criteria are still valid benchmarks for successful EMU membership. A locked-in exchange rate against 13+ other nations and the loss of monetary authority is quite demanding on economic structures. It requires flexible markets and well designed microeconomic, budgetary and wage policies.

In order to measure candidate countries' ability to meet these requirements, and in the absence of proper coordination in most of these policy areas, nominal convergence criteria are justified. For instance, participation in the Exchange Rate Mechanism (ERM-

II) tests candidate countries' adaptability in a context of limited exchange rate fluctuations and acts as a self-discipline exercise.

Table B1: state of play with member states obliged to adopt the euro, 2006¹

Member state	Euro adoption date ¹	Inflation ² (%)	General government balance ² (% of GDP)	Government gross debt ² (% of GDP)	Current account balance ² (% of GDP)
Bulgaria	na	7.4	3.3	22.8	-15.8
Cyprus	1 January 2008	2.2	-1.5	65.3	-5.9
Czech Republic	To be determined	2.1	-2.9	30.4	-4.1
Estonia	1 January 2008 (to be confirmed)	4.4	3.8	4.1	-14.2
Hungary	To be determined	4.0	-9.2	66.0	-5.9
Latvia	To be determined	6.6	0.4	10.0	-21.1
Lithuania	To be determined	3.8	-0.3	18.2	-10.7
Malta	1 January 2008	2.6	-2.6	66.5	-6.3
Poland	To be determined	1.3	-3.9	47.8	-2.3
Romania	na	6.6	-1.9	12.4	-10.3
Slovakia	1 January 2009	4.3	-3.4	30.7	-7.7
Sweden	To be determined ³	1.5	2.2	46.9	7.0

¹ Source: Fourth report on the practical preparations for the future enlargement of the euro area COM(2006)671 final

² Source: Commission's economic forecast Spring 2007

³ Preparations to join the euro area stalled since the negative outcome of the referendum of 14 September 2003

Regarding fiscal policy, adhering to the principle of counter-cyclical budget policies around a sustainable long-term path is a fundamental objective at the national level for all EU countries and a building block of a well functioning monetary union. The revised rules of the Stability and Growth Pact agreed in June 2005 appear to have increased ownership of the pact regarding excessive deficit procedures but its preventive arm needs to be better enforced by EMU members, EMU candidate countries and indeed all EU member states.

The inflation criterion is another important reference in aiming at nominal convergence. However, it is necessary to acknowledge that a benchmark using the average of the three lowest inflation rates leaves some room for discussion, as this average can for instance include EU countries that are not in the euro area. The ECB's definition of

¹ Denmark and United Kingdom have a special status allowing them to decide if they want to join the euro area or not.

price stability could be in this case a more appropriate benchmark, notably because EU enlargement potentially increases the range of inflation trends at the national level.

Table B2: participants in ERM II in view of EMU accession

Currency	Date of adhesion to exchange rate mechanism II (ERM II)	Central rate	Fluctuation margins ($\pm 15\%$) vis-à-vis the euro	Average fluctuation since adhesion
Cyprus pound	2 May 2005	0.585274	$\pm 0,087792$	-0,006
Estonian kroon	28 June 2004	15.6466	$\pm 2,34699$	0
Latvian lats	2 May 2005	0.702804	$\pm 0,105421$	-0,002
Lithuanian litas	28 June 2004	3.45280	$\pm 0,51792$	0
Maltese lira	2 May 2005	0.4293	$\pm 0,064395$	0
Slovak koruna	28 November 2005	35.4424	$\pm 5,3164$	On 16 March 2007, the central rate was revalued by 8.5%.

Source: European Commission and ECB

Ultimately, what is really at stake is the process of sustainable convergence in monetary union. The Maastricht criteria are an important set of instruments to create awareness and foster reforms to support this process.

But what matters most at the national level is flexible micro- and macroeconomic structures to respond and adapt to country specific circumstances. It is therefore essential that prospective members are given, in the context of the EU growth and jobs strategy, clear guidance as regards structural reforms needed for successful euro-area membership.

5. ECB's independence and relationship with other EU institutions

a. Independence

There is now a consensual recognition that, in the long term, monetary policy can contribute to high sustainable growth only by ensuring price stability, thereby fostering an environment conducive to long-term investment, innovation and the development of human capital.

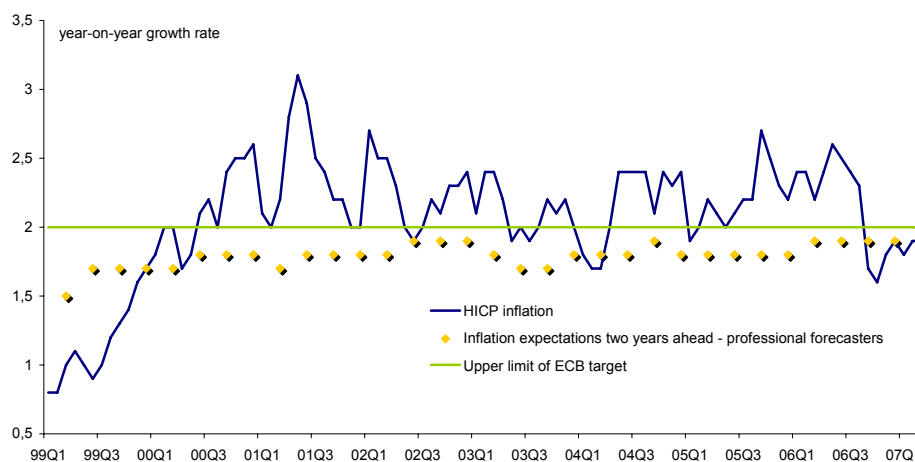
As a consequence of this recognition, there has been over the last two decades a tendency to delegate the responsibility for conducting monetary policy to independent central banks. This is based on the view that independence is the cornerstone of a central bank's credibility, implying that it can deliver price stability at lower interest rates.

The ECB is considered to be formally, and probably also in practice, the most independent central bank in the world. This has allowed the ECB to establish its credibility quickly and anchor inflation expectations at a level consistent with its definition of price stability, despite a number of price shocks keeping actual inflation above its formal target (see chart 8).

In practical terms, the ECB's independence means that no member of its decision-making bodies is allowed to take instructions from European Community institutions or

bodies, from any government of an EU member state or from any other body. Community institutions and bodies and the governments of the member states must respect this principle and not seek to influence the members of the decision-making bodies of the ECB (Article 108 of the Treaty).

Chart 8: inflation and inflation expectations in the euro area



Source: ECB

b. Public accountability

Accountability can be seen as a complement, if not a necessary requirement for independence. A central bank cannot be made fully independent if its objectives are not clearly and precisely defined; it cannot remain independent if it does not give a public account of its actions. The criticism about the ECB’s excessive independence often comes from the perception that it is insufficiently accountable.

However, the Treaty and the ECB statute offer clear rules of accountability: a definition of the ECB objectives; reporting requirements to the European Parliament, the European Council of Ministers; Annual Report and Parliamentary Hearings; Quarterly Report and weekly consolidated financial statements.

Additionally, the ECB has taken further steps through: a specific definition of price stability; presentation of a monetary policy strategy, monthly rather than quarterly reports, more frequent visits to the European Parliament, frequent speeches.

Despite a series of reporting obligations, the ECB only rarely deviates from the public statements made at its monthly press conference.

c. Dialogue with the Eurogroup

The EC Treaty provides guidance on how the ECB and the Council should interact. Under Article 113 of the Treaty, the President of Ecofin (now Eurogroup President) and a member of the Commission may participate in (but not vote at) meetings of the Governing Council of the ECB. In reciprocal fashion, when Ecofin is discussing matters relating to the objectives and mission of ECB, the President of the ECB is invited to participate.



Article 114(2) sets up the Economic and Financial Committee (EFC) as the main supporting committee for the Ecofin Council. The Member States, the Commission and the ECB can each appoint up to two officials as members of the EFC.

Finally, and most importantly, the Eurogroup was designed as a platform to exchange information and improve the overall mix between fiscal, monetary and other economic policies in the monetary union. The ECB has a standing invitation to Eurogroup meetings.

But Ministers of Finance have voiced their frustration with the quality of the dialogue with the ECB, which has led to an unprecedented public disagreement over euro-area monetary policy stance throughout most of 2006, and the call by Eurogroup President Juncker to intensify and improve working relationships with the ECB. Close ties between the Eurogroup and the ECB should intensify in the full respect of the ECB's independence and in the context of a non-binding dialogue.

STATISTICAL APPENDIX

Current account balance

Percent of GDP

Country	1991	1999	2006	1991-1999	1999-2006
Austria	-0,5	-3,2	1,8	-2,7	5,0
Belgium	2,3	7,9	2,5	5,6	-5,4
Finland	-5,3	5,9	5,3	11,2	-0,6
France	-0,5	2,9	-2,1	3,4	-5,0
Germany	-1,3	-1,3	5,1	0,0	6,4
Greece	-4,9	-6,9	-9,6	-2,0	-2,7
Ireland	-0,4	0,2	-4,1	0,6	-4,3
Italy	-2,4	0,5	-2,2	2,9	-2,7
Netherlands	2,4	3,9	7,1	1,5	3,2
Portugal	-0,8	-8,6	-9,4	-7,8	-0,8
Spain	-3,6	-2,9	-8,8	0,7	-5,9

Source: IMF

Real effective exchange rates

Performance relative to the rest of 23 industrial countries: double export weights, 2000 = 100

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	105,1	104,5	101,8	-0,6	-2,7
Belgium	102,7	105,1	108,1	2,4	3,0
Finland	150,8	105,8	114,7	-45,0	8,9
France	107,3	105,6	109,0	-1,7	3,4
Germany	103,3	106,4	111,7	3,1	5,3
Greece	88,3	107,0	99,0	18,7	-8,0
Ireland	117,1	105,5	116,0	-11,6	10,5
Italy	136,7	105,8	126,7	-30,9	20,9
Netherlands	97,9	101,8	120,8	3,9	19,0
Portugal	87,6	100,3	109,5	12,7	9,2
Spain	118,8	102,6	113,0	-16,2	10,4

Source: AMECO database

Domestic demand

Including stocks, performance relative to the rest of 23 industrial countries, 2000 = 100

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	99,3	100,1	97,4	0,9	-2,7
Belgium	102,8	99,7	99,5	-3,1	-0,2
Finland	107,8	99,8	106,8	-8,0	7,0
France	104,8	99,1	100,5	-5,7	1,4
Germany	106,2	101,6	88,0	-4,7	-13,5
Greece	96,7	98,1	116,4	1,4	18,3
Ireland	69,8	94,2	119,1	24,4	24,9
Italy	110,7	100,9	95,2	-9,8	-5,7
Netherlands	94,2	100,7	96,5	6,5	-4,3
Portugal	90,3	100,4	90,7	10,1	-9,8
Spain	95,7	98,4	116,0	2,7	17,7

Source: AMECO database


GDP per capita (current prices, per head of population)

PPS: EUR-15 = 100

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	114,6	113,7	114,0	-0,9	0,3
Belgium	109,5	104,9	109,5	-4,6	4,6
Finland	98,3	102,3	104,8	4,0	2,5
France	104,9	103,2	99,1	-1,7	-4,1
Germany	109,7	103,2	102,1	-6,5	-1,1
Greece	67,5	64,3	78,9	-3,2	14,6
Ireland	77,3	110,0	129,7	32,7	19,7
Italy	106,0	103,5	92,2	-2,5	-11,3
Netherlands	107,1	111,6	116,4	4,5	4,8
Portugal	69,1	73,1	65,3	4,0	-7,8
Spain	79,4	83,8	90,5	4,4	6,7

Source: AMECO database

Output gap (deviation of actual GDP from potential)

% of potential GDP, at 2000 prices

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	2,3	1,3	-0,2	-1,0	-1,5
Belgium	1,8	0,5	-0,6	-1,3	-1,1
Finland	-2,4	2,0	0,1	4,4	-1,9
France	1,0	0,8	-0,8	-0,2	-1,6
Germany	3,6	-0,3	-0,2	-3,9	0,1
Greece	2,0	-1,9	1,5	-3,9	3,4
Ireland	0,6	4,0	-1,4	3,4	-5,4
Italy	1,0	-0,2	-1,0	-1,2	-0,8
Netherlands	1,4	2,3	-1,2	0,9	-3,5
Portugal	4,9	2,0	-2,0	-2,9	-4,0
Spain	2,4	0,7	-0,9	-1,7	-1,6

Source: AMECO database

Prices

Price deflator GDP, performance relative to the rest of 23 industrial countries, 2000=100

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	108,9	99,8	97,8	-9,1	-2,0
Belgium	105,4	100,0	98,8	-5,3	-1,3
Finland	105,5	99,7	93,4	-5,7	-6,4
France	114,7	100,8	97,8	-13,9	-3,0
Germany	114,4	103,5	90,9	-10,9	-12,5
Greece	65,2	97,3	102,7	32,1	5,4
Ireland	90,2	96,5	108,3	6,2	11,8
Italy	96,2	100,2	102,4	4,0	2,2
Netherlands	102,2	97,6	102,6	-4,6	5,0
Portugal	79,3	98,9	104,4	19,6	5,5
Spain	91,9	98,8	110,3	7,0	11,5

Source: AMECO database



Productivity

GDP at 2000 prices per person employed, performance relative to the rest of 23 industrial countries, 2000=100

Countries	1991	1999	2006	1991-1999	1999-2006
Austria	99,7	99,9	99,1	0,2	-0,8
Belgium	103,8	100,3	98,2	-3,5	-2,1
Finland	90,8	99,5	103,4	8,7	3,9
France	102,3	101,0	97,3	-1,3	-3,7
Germany	93,2	99,8	101,6	6,6	1,8
Greece	106,1	97,7	111,5	-8,4	13,8
Ireland	85,1	97,0	104,1	11,9	7,1
Italy	101,7	100,4	91,4	-1,3	-9,0
Netherlands	105,6	100,1	101,1	-5,5	1,0
Portugal	96,6	99,7	95,3	3,1	-4,4
Spain	107,9	102,1	95,9	-5,8	-6,2

Source: AMECO database

Real long-term interest rates (using private consumption deflator)

Weighted geometric mean (weights private consumption at current prices in ECU/EUR)

Countries	1991*	1999	2006	1991-1999	1999-2006
Austria	4,9	3,9	2,3	-1,0	-1,6
Belgium	6,3	4,6	1,6	-1,7	-3,0
Finland	6,0	3,2	1,8	-2,8	-1,4
France	5,9	5,2	2,5	-0,7	-2,7
Germany	4,5	4,2	2,4	-0,3	-1,8
Greece	8,0	3,9	0,6	-4,1	-3,3
Ireland	6,4	0,1	1,1	-6,3	1,0
Italy	6,0	2,9	1,3	-3,1	-1,6
Netherlands	5,3	2,7	1,9	-2,6	-0,8
Portugal	2,4	2,5	0,6	0,1	-1,9
Spain	5,6	2,4	0,2	-3,2	-2,2

Source: AMECO database, * 1993 data for Greece

Households' indebtedness

Percentage of GDP

Countries	1995	1999	2005	1995-1999	1999-2005
Austria	41,95	45,73	54,21	3,78	8,48
Belgium	39,73	44,47	45,69	4,74	1,22
Finland	37,28	32,35	49,92	-4,93	17,57
France	41,68	46,47	56,11	4,79	9,64
Germany	59,59	72,67	70,03	13,08	-2,64
Greece	11,10	19,06	44,31	7,96	25,25
Ireland	na	na	na	na	na
Italy	20,65	26,68	36,05	6,03	9,37
Netherlands	54,30	77,29	114,10	22,99	36,81
Portugal	40,80	65,45	94,30	24,65	28,85
Spain	40,53	51,02	77,55	10,49	26,53

Source: Eurostat

House prices

Actual price-to-rent ratio (2000=100)

Countries	1991*	1999	2004	1991-1999	1999-2004
Finland	103,2	116,0	136,1	28,6	20,1
France	111,6	91,8	138,0	-4,1	46,2
Germany	126,2	101,1	91,0	-14,7	-10,1
Ireland	77,5	204,5	290,8	118,0	86,3
Italy	100,0	88,7	121,8	-11,3	33,1
Netherlands	76,2	112,0	144,5	27,6	32,5
Spain	141	106,9	186,2	-6,7	79,3

Source: OECD

* 1994 data for Italy

General budget

Net lending (+) or net borrowing (-): general government: Excessive deficit procedure

Countries	1991*	1999	2006	1991-1999	1999-2006
Austria	-2,9	-2,2	-1,1	0,7	1,1
Belgium	-7,2	-0,5	0,2	6,7	0,7
Finland	-1,0	1,6	3,9	2,6	2,3
France	-2,8	-1,7	-2,5	1,1	-0,8
Germany	-2,9	-1,5	-1,7	1,4	-0,2
Greece	-11,0	-3,4	-2,6	7,6	0,8
Ireland	-2,8	2,7	2,9	5,5	0,2
Italy	-11,4	-1,7	-4,4	9,7	-2,7
Netherlands	-2,6	0,4	0,6	3,0	0,2
Portugal	-7,2	-2,7	-3,9	4,5	-1,2
Spain	-6,5	-1,3	1,8	5,2	3,1

* 1995 data for Spain

Source: AMECO database

Structural budget

Cyclically adjusted net lending (+) or net borrowing (-) of general government, adjustment based on potential GDP

Countries	1991*	1999	2006	1991-1999	1999-2006
Austria	-3,9	-2,8	-1,0	1,1	1,8
Belgium	-8,1	-0,8	0,5	7,3	1,3
Finland	0,3	0,6	3,7	0,3	3,1
France	-3,3	-2,1	-2,0	1,2	0,1
Germany	-4,5	-1,4	-1,5	3,1	-0,1
Greece	-11,8	-2,7	-3,3	9,1	-0,6
Ireland	-3,1	1,2	3,0	4,3	1,8
Italy	-11,9	-1,7	-3,8	10,2	-2,1
Netherlands	-3,5	-0,9	1,1	2,6	2,0
Portugal	-8,9	-3,5	-2,9	5,4	0,6
Spain	-5,1	-1,6	2,3	3,5	3,9

* 1995 data for Spain

Source: AMECO database