Deutsche Bank Research

July 23, 2008

The euro turns ten

Growing up

Many expectations with which the euro was launched in 1999 have been fulfilled. The euro has achieved successes in price stability, stimulating trade and investment, financial market integration and its international role. The main disappointments have been in terms of growth and EMU enlargement.

Low inflation rates have led to structurally lower interest rates. This created favourable financing terms for firms, consumers and the state, and stimulated growth and investment in the euro area.

The euro accelerated financial market integration and levelled the way for large, liquid financial markets. The integration is primarily market driven but was also actively supported by the creation of common regulatory framework conditions within the EU.

Insufficient structural reforms in the large member states threaten economic cohesion within EMU. The present economic slowdown is likely to intensify the internal centrifugal forces. Imbalances in competitiveness within EMU – which have accumulated over the last five years – need to be corrected. A collapse of EMU remains a risk but is deemed to be unlikely.

The reformed Stability and Growth Pact (SGP) has proved its worth in good times. However, the real test still lies ahead. The consolidation achieved to date is not sufficient to get through phases of economic weakness without budget problems. The challenges of an ageing society call for sustainability and more quality in fiscal policy.

EMU enlargement since 1999 has been soberingly slow. In most cases this is due to a lack of political resolve among those EU member states that have not joined. This also raises questions about EMU's regulatory framework.

The euro stages a successful international career. It has caught up on the dollar as a trade, investment and reserve currency, and even overtaken it in terms of currency in circulation. Globally, it still has potential. However, the dollar will remain the No. 1 currency long term. Nonetheless, there are still many deficits in EMU's level of international representation.

The euro's ascendancy was favoured by a decade of globalisation and strong growth worldwide. Stronger internal and external tensions cannot be ruled out given the signs of a deteriorating global economic environment.

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Introduction

Anniversary on January 1, 2009

The launch of the euro at the beginning of 1999 was a once-in-a-century project and a milestone in the process of European integration. The founding of the European Economic and Monetary Union (EMU) was one of the major integration projects in the EU, along with the Single European Market and the EU's enlargement to the East. The euro will turn ten on January 1, 2009. The "euro's guardian", the ECB, on the other hand, already celebrated its tenth anniversary on June 1, 2008. In its first three years the euro only existed on paper as an accounting currency and on the financial markets. It only became a fully-fledged currency with the introduction of notes and coins on January 1, 2002. For some observers the euro will therefore only be seven in 2009.

Economic and political goals

Economic and political goals were pursued with the introduction of the euro. In economic terms, the primary aim was to strengthen growth within the single market by permanently anchoring price stability and budgetary discipline within Europe, providing a more reliable planning basis for trade and investment by eliminating exchange rate risks, and improving financing and investment conditions through the creation of a large, liquid financial market. It was also intended that EMU would encourage greater price transparency and competition within the single market. The euro therefore also served as a complement to the single market. Another objective was to lend more international weight to Europe's voice in monetary policy matters. At the same time, the euro was to provide fresh stimulus for the process of political integration.

Key figures 2007 on international comparison

	Unit	USA	EMU*	Japan	China
Population	million	299.8	318.5	127.7	1,321
GDP	EUR trillion	10.1	8.9	3.2	2.2
Per capita income	EUR thousand	33.7	27.9	25.1	1.7
Share of world GDP (on a PPP basis)	%	21.4	14.7	6.6	10.9
Exports (goods and services)	% of GDP	11.9	21.6	17.7	41.9
Imports (goods and services)	% of GDP	17	20.9	15.9	33.8
Total public debt	% of GDP	63.4	66.6	162.5	45
Annual surplus/deficit	% of GDP	-1.2	-0.6	-0.8	-1.3
Current account balance	% of GDP	-4.9	0.1	5	9.2

* euro currency area including Malta and Cyprus

Sources: ECB, IMF, Global Insight

1

EMU's launch in 1999 created a large economic and currency area of international importance which – in terms of GDP at current exchange rates – is only a little smaller than that of the USA. Per capita income in the USA, on the other hand, is about 30% higher than in the eurozone. EMU's share of world GDP (on a purchasing power parity basis) is 14.7%, which is roughly a third smaller than the USA's but is much larger than China's (10.9%) and Japan's (6.6%).

EMU strongly integrated in the world economy

On the other hand, EMU is more strongly integrated in the world economy than the USA and Japan. Only China has a higher level of global integration. The dollar should remain the world's leading currency in the long term, followed by the euro in a good second place. While the Japanese yen has lost considerably in importance as an international currency, China's yuan should possess international potential in the long run.

Launched with expectations but also with reservations

The euro was launched in 1999 with great expectations and hopes. At the same time, however, there were widespread reservations and criticism. This was the case particularly in Germany where the D-Mark had been seen as the symbol of stability for decades and also stood for the country's rise and prosperity after the Second World War. A number of critics – especially from the Anglo-American side – even predicted an only short life span for EMU. Former Fed chairman Alan Greenspan, for instance, made no secret of his initial euro scepticism: "It will come to existence but it will not live for very long."

Euro a success story

However, ten years on, the sceptics have been proven wrong in many respects. EMU has turned out to be a clear success story. The positive expectations with regard to price stability, the stimulation of trade and investment, financial market integration and the euro's international role have been fulfilled or even surpassed. In the end Alan Greenspan, too, expressed respect and recognition for the euro, stating in an interview with the German magazine "Der Stern" in September 2007: It is "absolutely conceivable that the euro will replace the dollar as reserve currency, or will be traded as an equally important reserve currency." On the other hand, there have been disappointments, too, especially as far as growth and EMU enlargement are concerned.

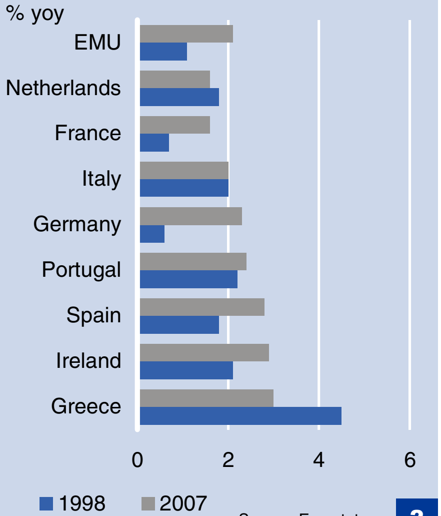
Still, ten years is not long for a currency. Nonetheless, we want to discuss the main experiences. We ask what conclusions need to be drawn, and what challenges, opportunities and risks EMU faces now, and will face over the next ten years. This includes an assessment of "economic governance" which is essential for EMU to function efficiently given centralized monetary policy but decentralised fiscal and economic policy. We then draw a number of economic policy conclusions from these considerations.

I. Internal track record: the positives predominate

1. ECB ensures price stability in difficult conditions

Change in HCPI 1998 and 2007

% yoy



Source: Eurostat

2

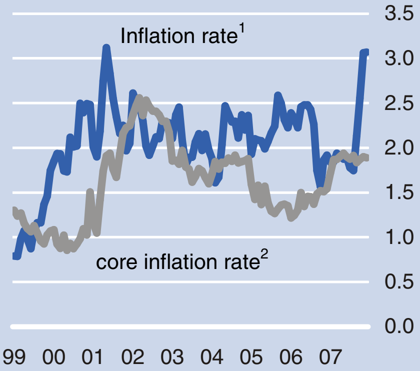
The ECB's clearly defined mandate is primarily to pursue price stability. However, it should also support general economic policy within the Community insofar as this is compatible with price stability. By definition, ECB monetary policy is aligned to price stability within the eurozone as a whole, in other words monetary policy cannot take account of the interests of individual countries. The basis for measuring inflation is the harmonised consumer price index (HCPI).

The ECB's stability track record is respectable on historical and international comparison. In the period 1999-2007 inflation rates have been much lower in EMU (and in Germany), averaging 2.0% (and 1.6%), than in the fifty years of the D-Mark and compared to the USA (2.7%). However, during this period inflation rates were lower in Great Britain (1.6%) and Switzerland (0.9%).

In assessing the stability track record it should obviously also be borne in mind that the eurozone has been exposed to considerable inflationary pressures at times. The oil price, for instance, has more than tripled in the period 2003 to 2008. While in the years 1999/2002 imported inflation as the result of sharply rising oil prices and the weak euro/dollar exchange rate was a threat to price stability, the much firmer euro versus the dollar in the following years

Moderate core inflation in Euroland

% yoy

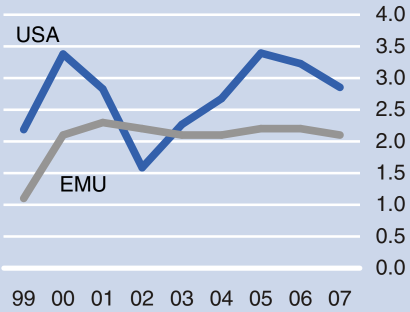


1) Harmonised consumer price index (HCPI)
2) HCPI excl. energy, tobacco, food & beverages

Source: Eurostat **3**

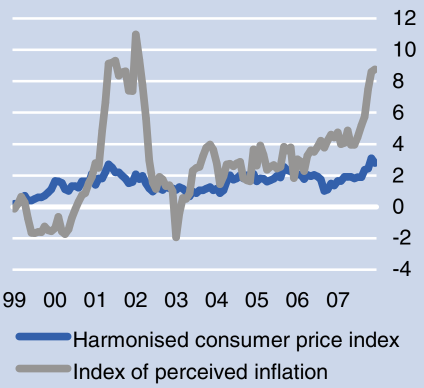
ECB stabilises inflation below US level

% yoy



Source: Eurostat **4**

Perceptions can be deceiving



Source: Destatis **5**

has helped to cushion the imported price pressures caused by the explosion in the price of oil and many other commodities.

Inflation in the eurozone touched peak monthly levels in May 2001 (3.4%) and in June 2008 (4.0%). Besides the boom in commodity and energy prices, the global rise in grain and dairy product prices has also made itself felt in 2007/08. While inflation should ease again in the further course of the year, the target level of just under 2% will not be achieved again in 2008. The higher price risks in 2008 are a challenge for the ECB. Cause for concern is that inflation is rising in many industrial and emerging countries just as the world economy is turning down. Critics already see a threat of stagflation like in the 1970s. Whether this will happen remains to be seen.

Although aligned primarily to price stability, the ECB has also displayed flexibility and pragmatism in its monetary policy. One example is that the price stability target is oriented to a more medium-term horizon, i.e. monetary policy is not automatically tightened in the event of temporary price jumps. This only happens if there are knock-on effects, for instance if temporarily higher inflation rates are taken as the basis for wage settlements. So far the ECB has succeeded in holding medium-term inflation expectations at a low level.[1]

The ECB also displays pragmatism in its definition of price stability. The central bank sees both inflation and deflation as a threat to price stability. For instance it reacted to the deflation debate in the years 2002/2003 with low key rates and by modifying its definition of price stability. While on the basis of its original definition price stability prevailed if the inflation rate was between 0 and 2% p.a., according to the modified definition price stability exists if the rate of inflation is below but close to 2% over the medium term. Inflation was only significantly below the ECB's new stability benchmark in 1999 (at 1.1%), and in the following years was slightly above it with rates of between 2% and 2.5%. Concerns that EMU would turn into an inflation community proved to be unfounded. However, since euro notes and coins were introduced, there has been controversy in several EMU countries whether the HCPI still measures inflation correctly as the inflation rate people perceive differs considerably at times from the rate actually measured (for more on the "Teuro" or "expensive euro" debate see Appendix). Still, the official price statistics are based on reliable methods that are internationally customary and are tried and tested.

2. Independence strengthens ECB's credibility

In addition to the clear mandate and its good stability track record, the ECB's independence helped it to win a high measure of credibility quickly as a new institution on the financial markets and among broad sections of the population. This independence should continue to be a mainstay for EMU in the future. Its anchoring in the EU Treaty provides for the independence of the ECB's Governing Council[2] in personnel, operational, institutional and financial respects.

1 As the basis for determining long-range inflation expectations the ECB mainly uses inflation-indexed bonds and the results of the quarterly ECB Survey of Professional Forecasters.

2 Six Executive Board members plus initially 11, now 15, national central bank governors. The members of the Executive Board serve for a single term of eight years; the national central bank governors have tenures of 5 years, which can be renewed once.

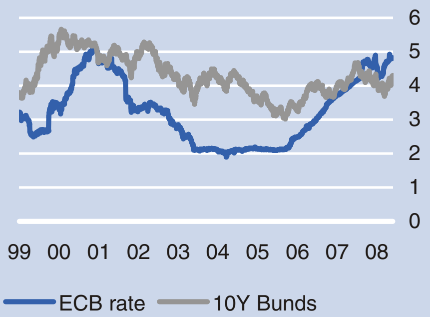
Globalisation and inflation: It's the net effect that counts

Ignoring exchange rate effects, globalisation has two opposing effects on inflation in the euro area. Imports of consumer goods from low-wage countries (such as textiles and toys from China) have had a price-dampening effect for years. In the case of consumer goods the share of EMU imports from low-wage countries rose from one third in 2000 to almost 50% in 2007, whereby the ECB estimates the resulting reduction in import prices in manufacturing industry in EMU to be about two percentage points p.a. on average. On the other hand, the rise in oil and (agricultural) commodity prices sparked by the sharply increased demand from the fast-growing emerging markets in Asia and elsewhere has a price-driving effect. The net effect has been positive for many years since 1999. From 2002 on, imported inflationary pressure was also mitigated by the underlying rise in the external value of the euro.

The sustained growth dynamic of the emerging markets has meanwhile also led to increased global demand for food, triggering price rises worldwide in the course of 2007 especially for dairy and grain products which have also driven up inflation rates in the euro area (to 4% in June 2008, the highest monthly rate since 1999). In view of rising prices for agricultural products, compounded by their use as alternative energy sources, it has to be assumed that the price-stabilising effect of globalisation will fade and that the net impact of prices could even turn negative despite a much firmer euro exchange rate. However, this is difficult to support with statistical evidence. Still, the ECB faces much higher price risks in 2008 – also as the result of globalisation.

Low nominal interest rates

%



Source: ECB 6

Securing the ECB's independence in its day-to-day operations was by no means matter-of-course for there were numerous attacks on its independence, especially from the political side. The fact that the EMU countries adopted the Maastricht principles in the early 1990s did not prevent subsequent governments from trying again and again to exert influence on ECB interest and exchange rate policy. One example is the hefty criticism of the ECB since 2007 by France's President Sarkozy, coupled with the longstanding French demand for the creation of an economic government as a counterweight to the ECB. After his nomination as president of the Eurogroup of EMU economic and finance ministers at the beginning of 2005, Jean-Claude Junker also attempted repeatedly to persuade the ECB to coordinate monetary policy more closely in advance with EMU fiscal policy even though this conflicts with the principle of independence. The ECB insisted successfully on its independence.

3. Low inflation leads to structurally low interest rates

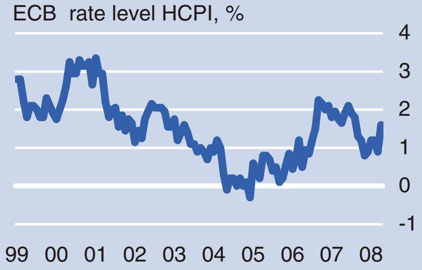
That the ECB was able to establish its credibility relatively quickly in the markets and peg inflation expectations at a low level contributed in large measure to the low interest rates on the money and capital markets in the eurozone since 1999. The development of large, liquid financial markets within EMU – e.g. for government bonds – and the growing acceptance of the new euro currency by international investors are also likely to have had a rate-dampening effect. Moreover, it did away with the interest risk premium demanded by the markets under the former regime of national currencies to defend the rate of exchange versus the D-Mark, which served as the anchor currency then.

After the interest rates of the former high-rate currencies had already converged closer into alignment with the low D-Mark interest rates ahead of EMU, nominal euro rates in the first ten years of monetary union were on average significantly below the level of D-Mark rates in the years 1989 to 1998. While money market rates have been uniform throughout the period of monetary union since 1999, the spreads between long-term rates in the respective participant countries were relatively low. For example, the yields on ten-year government bonds of Germany's EMU partner countries were in most cases significantly less than 50 basis points above those of German Bunds that serve as the benchmark within EMU for instance in the ten-year segment.

Relatively low interest rates create favourable financing conditions for firms, consumers and the state. This has encouraged growth and investment in the euro area. The main beneficiaries were the former high-interest-rate countries such as Italy, Spain and Ireland. However, this not only relieved public budgets, whose interest burdens were sharply reduced. For a country like Italy for instance it was the convergence of interest rates that enabled it to meet the fiscal policy convergence criteria for joining EMU in the first place. Firms, too, were able to save financing costs. Finally, consumers came to enjoy the benefits of relatively favourable financing costs, for instance for buying homes. However, there has also been criticism of a number of side-effects of lower interest rates in the euro area.

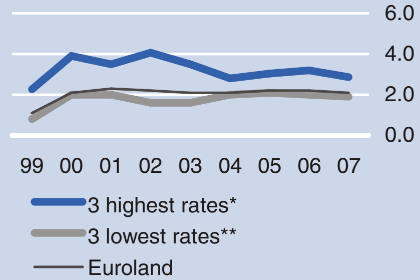
Firstly, it is argued that the relatively low interest rates had helped create a property bubble in some countries. In the wake of lower interest rates since 1999 there have been overheated property markets for instance in Spain, France and the Netherlands. Monetary policy needs to keep an eye on such wealth effects because this can boost consumption demand and reduce the

Reversal of short-term real interest rates
ECB rate level HCPI, %



Source: Eurostat 7

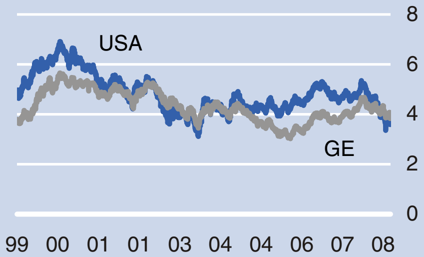
Inflation differential narrows
% yoy



* average: Ireland, Greece, Spain
** average: Germany, France, Belgium

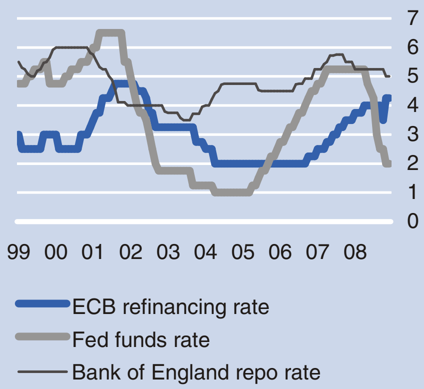
Source: DB Research 8

Long-term interest rates on the decline
10Y Bunds, %



Source: DB Research 9

Key rates over time
%



Source: DB Research 10

savings ratio for instance, while a bursting of the bubble can trigger or accentuate an economic crash. However, the ECB's scope of influence to prevent bubbles in individual countries is very limited. The ECB only conducts monetary policy on behalf of EMU as a whole. Moreover, the overheating of a country's property market can have other causes, such as favourable fiscal conditions for instance in Spain's case.

Secondly, it is criticised that the yield spreads for government bonds of the EMU countries are too low and thus do not adequately reflect the differences in the quality of economic and fiscal policy. Since bad policy is not "penalised" in the markets with higher rates and spreads, the inducements for good economic policy are distorted. Indeed, the market's interpretation of the non-bail-out clause in the Treaty of Maastricht is an interesting point. This clause states that countries that are in financial difficulties may not be bailed out through support measures by other EMU partner countries. The markets, however, do not believe that the non-bail-out clause will be adhered to, and that in view of the close economic interdependence mutual assistance will be provided within EMU in emergencies. Still, whether this alone explains why in the phase of excessive budget deficits from 2002-2005 Germany and France did not have to pay higher rates of interest on their government issues than solidly financed EMU countries is doubtful in view of their size.

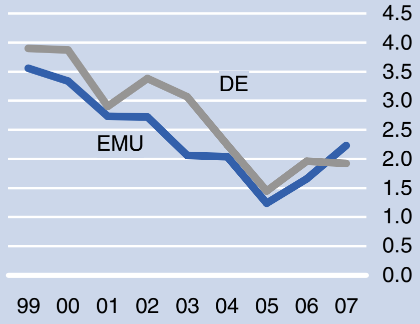
Thirdly, some critics claim that the D-Mark's nominal interest rate advantage that Germany enjoyed over its partner countries in Europe before the euro was introduced, and which was largely thanks to the Bundesbank's reputation, was higher than the interest rate advantage that Germany has enjoyed within EMU since 1999. This comparison is not without problems since a relative advantage before EMU is compared with an absolute advantage after the launch of EMU. However, for investments in Germany real interest rates are the deciding factor and these have fallen across all maturities since 1999. Short-term real interest rates fell through to 2005 to reach their lowest level for 30 years and for a time were even slightly negative. Long-term real interest rates also declined at the start of EMU and at 1-2 percentage points have been below those of the last ten DM years (2-4 percentage points) since 1999. However, the fact of the matter is that the lower interest rates stimulated growth in the European partner countries, from which German exports also benefited.

4. Boost to trade and investment

The introduction of the euro did away with the currency-related conversion costs and exchange rate risks for firms in the euro area. This provided a more reliable planning basis for firms for trade and investments in the euro area. The German Industry Federation (BDI) estimates for instance that the transaction and hedging costs eliminated by the euro produces savings for firms in Germany equivalent on average to ½% p.a. of their foreign trade revenues. Trade within EMU is very significant for the EMU member states since over half of the exports and imports of goods are conducted within the euro area. In Germany, EMU partner countries account for a much smaller share of foreign trade than in most other EMU countries; it is just under 40% in the case of imports and almost 43% for exports.

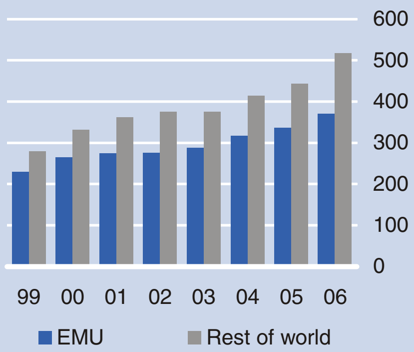
The expectations that the euro would stimulate intra-EMU trade have largely been fulfilled. Intra-EMU trade has risen from about 27% of EMU GDP in 1999 to around 32% in 2006. However, it only

Decline in long-term real interest rates
%, 10Y Bunds



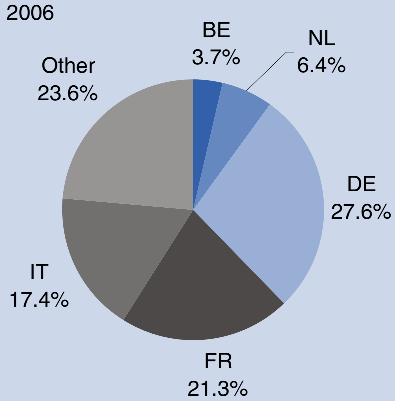
Source: Eurostat 11

German exports
EUR billion



Source: Eurostat 12

Share of Euroland GDP
2006



Source: Eurostat 13

had a pronounced trade-generating effect in the years 1999 and 2000. This suggests that the euro triggered a level effect but no perpetually higher export dynamic between the EMU partner countries. In various studies on intra-EMU trade the scale of the euro-induced growth in trade is estimated at between less than 3% and nearly 30%. This wide range can be explained among other things by the fact that when analysing the euro's effect on trade it is difficult to ascertain what growth is due to the euro and what growth is attributable to other factors.

An interesting point, however, is that the EMU countries' exports to the rest of the world have grown at an even stronger rate than intra-EMU trade throughout the period 1999 to 2006. This indicates that globalisation, deregulation and strong global economic growth – especially the dynamic of the new EU member states and the emerging economies in Asia – have contributed more than the euro to EMU's rising level of international trade. That the EMU countries have managed to increase their exports to third countries strongly even though the euro's exchange rate versus the dollar has risen considerably since 2003 is also due to firms' changed invoicing practices and foresighted hedging measures. In several EMU countries 45% to 65% of third-country exports are settled in euro; in Germany the figure is as much as 80%. However, this has only been able to cushion the exchange-rate-induced pressure on margins in export business to a very limited extent.

In the process of economic integration trade and direct investments often have a mutually reinforcing effect. The introduction of the euro and the removal of currency risks were therefore widely expected to strengthen the attractiveness of the euro area for direct investments. However, in contrast to the research on trade there have been few studies to date into the influence EMU has had on the inflow of direct investments. According to Eurostat statistics, there has been strong growth in direct investment into EMU since 1999, with the volume of direct investment in EMU rising from 23.4% of GDP in 2001 to 31% in 2006. In so far the expectations have therefore been fulfilled. However, it would be wrong to conclude that this has been due entirely to the introduction of the euro because the benefits of the euro are only one of several decision factors. This is demonstrated by the example of Great Britain which has seen a stronger inflow of direct investment than the euro area during this period without joining the monetary union. Obviously, the pound sterling's strong depreciation in the years 2007/08 has improved Britain's competitive position versus the euro area.

5. Catalyst for financial market integration

The introduction of the euro has furthered the integration of the financial markets in Europe and was a catalyst for structural change. Nonetheless, the euro was only one – but an important – factor for the convergence of the financial markets in Europe over the last ten years. Other factors, such as the successive liberalisation and harmonisation of financial market rules in the EU, the globalisation of financial networks and the tremendous advances in information and communication technology, also played an important part.

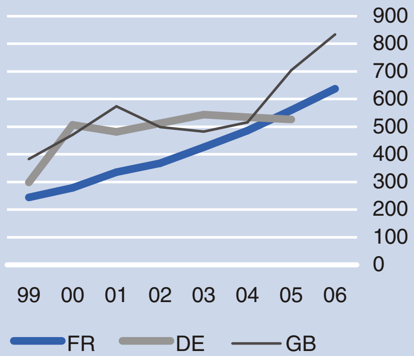
The creation of efficient financial markets is an essential part of completing the Single European Market. Logically enough, financial market integration was seen as an important political goal since 1999. The integration of the financial markets is primarily market driven. However, it needs to be actively supported by common regulatory framework conditions in the EU to surmount the many

FSAP is being implemented

The Financial Services Action Plan is composed of 42 individual measures aimed at harmonising the rules in securities trading, in the banking and insurance industry, for pension schemes and other financial services. It mainly covers the securities and wholesale markets. Examples of legislation passed at the EU level are the (revised) Investment Services Directive which enables investment banks to operate EU-wide, the Prospectus Directive which allows issues of equity and debt securities to be sold across the EU on the basis of a single prospectus, and the Market Abuse Directive which is designed to prevent or punish abusive practices on the financial markets in the form of insider dealing and market manipulation. Most of the individual measures were adopted by the year 2005 and are being implemented. However, a directive for the EU-wide operation of employment-related pension schemes is currently still under deliberation.

Direct investments rise

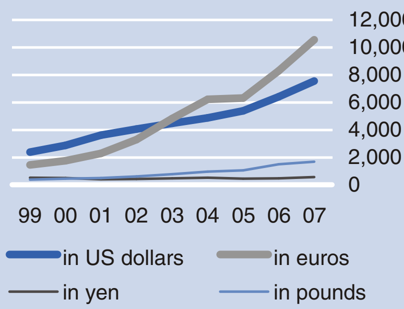
Stocks in EUR bn



Source: Eurostat **14**

Euro drives growth in int. bonds outstanding

USD bn



Source: BIS **15**

barriers between the national financial markets of the 27 EU member states and create a level playing field for the market participants. The regulatory framework conditions apply for the EU as a whole, and thus extend beyond the euro currency area. The "Financial Services Action Plan" (FSAP) in 1999 was a milestone in the process of financial market integration.

The creation of efficient financial markets is also desirable so that some of the benefits of the euro are transferred to the real economy. Generally speaking, it is not only the financial services industry and its clients that benefit from well functioning financial markets; the economy as a whole does, too, because growth and competitiveness are strengthened by the efficient supply of financial services. Various studies come to the conclusion that successful financial market integration can have the effect of increasing GDP in the EU by 0.5 to 1.1 percent. At the microeconomic level the advantage for customers lies above all in the availability of a broader spectrum of products and services on favourable terms and in liquid markets.

Investors derive various benefits from the fact that the euro has increased competition and market transparency in the euro financial markets. For instance, since the financial markets were switched to euro in 1999 investors have been able to directly compare the prices and yields of financial market products in the eurozone. The investment universe without exchange rate risks has been extended to the entire currency union. This has led to growth in cross-border portfolio investment over the past years. German investors for instance increased their foreign euro-based portfolio investments strongly between 1999 and September 2007 to almost € 600 billion. This is almost three times the level in 1999. According to a study by the ECB, banks[3] in the euro area increased the share of their portfolios invested in long-dated bonds of other EMU countries from 10% at the end of the 1990s to almost 60% at the end of 2005. This diversification of portfolio investments away from the national financial market and into the markets of other EMU countries has appreciably reduced the focus on the home market ("home bias").

However, the pace of integration in the different segments of the financial market – primarily the foreign exchange, money, bond and equity markets – has differed widely. The foreign exchange market was fully integrated from day one of monetary union. A liquid money market (interbank market) with uniform interest rates was also established already when EMU was launched. That was necessary to ensure that the ECB's common monetary policy can be implemented smoothly and in line with market conditions.[4]

Respectable advances in integration have also been achieved on the bond markets, which have grown strongly in breadth and depth. The greater market breadth is reflected in a wider diversity of financing, investment and hedging instruments. While the market for EMU country government bonds was rounded out, other segments flourished or were newly established. Corporate bond issuance expanded vigorously. The mortgage bond market grew appreciably as this segment was new to a number of EMU countries and profited from booming property markets, for instance in France and Spain.

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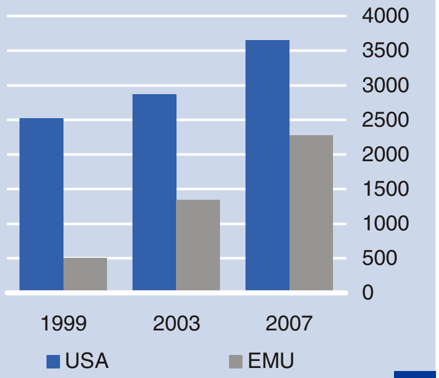
3 Monetary Financial Institutions (MFI) on the ECB definition.

4 TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system) has been a major contributing factor. This is the system for the real-time transfer of (gross) settlement amounts operated by the ECB and the EMU participants' national central banks. It is a network of different national systems and is being replaced successively by TARGET2 which operates on a common platform.

Finally, the spectrum of products on the bond market was supplemented by CRT products[5] such as credit derivatives and CDOs[6]. However, turnover and issuance in the markets for CRT products, mortgage bond products and corporate bonds has suffered heavily since August 2007 in the wake of the subprime crisis emanating from the USA.

Corporate bond issuance



Source: BIS 16

Much has happened on the equity markets, too, but the pace of integration here has been comparatively modest. A positive is that the introduction of new European stock indices has made it easier to measure performance and there has been appreciable growth in the pan-European diversification of equity investments. Monetary union has caused the focus in equity investments to become less country and more sector-oriented. The comparability of European stocks has also been improved as listed companies in the EU are required to prepare their financial statements according to IAS/IFRS standards[7] since 2005, i.e. provide capital-market-oriented financial reporting. Nonetheless, ten years on from the start of EMU the equity markets still remain very fragmented. The differences in taxation and in the legal framework still present considerable barriers to integration.

6. Banking structures under consolidation pressure

Retail market still highly fragmented

Integration in retail banking is the least advanced compared to other market segments. In retail business financial services are still marketed overwhelmingly through domestic distribution channels. There is little possibility - and inclination - for customers with conventional needs to procure financial services from a foreign provider unless it has built up a presence in the local market. This is probably because of the different cultures in the EMU countries and the lack of information about foreign providers but above all also because the cross-border offering of banking services is not attractive either for the provider or for the consumer due to different statutory frameworks (e.g. consumer protection).

More cross-border consolidation needed

Nonetheless, for the banks the introduction of the euro has intensified competition and brought a number of structural changes.[8] The stronger competitive pressure has been a driving force behind the consolidation process in the banking sector.[9] Since the start of EMU the number of banks in the eurozone (EMU-12) fell by 27% to 6,130 at the end of 2006. This decline has mainly been the result of mergers between small to mid-sized banks at the national level, e.g. in Germany in the savings and cooperative banks sector. All the same, the levels of concentration in the respective national banking markets still differ widely. While in Belgium, the Netherlands and in many of the new EU member states the top five banks have a market share of 80% or more, in Germany their market share is the euro area's lowest at around 22%. In future the consolidation

5 CRT stands for credit risk transfer.
6 CDO stands for collateralised debt obligations.
7 International Accounting Standards/International Financial Reporting Standards which, among other things, establish rules for companies' external reporting.
8 Some areas of business have fallen away (e.g. forex trading and currency exchange business in the former currencies of EMU participants), while in others the structures and framework conditions have changed (e.g. in bond issuance). The preparations for the launch of the euro were very costly for the banks but also brought a number of practical benefits. For many banks the introduction of the euro was a kind of fitness program as this went hand in hand with a modernisation of their IT systems for instance.
9 Schildbach, Jan (2008). European banks: The silent (r)evolution. It is the last 10 years that count, not the last 10 months, Deutsche Bank Research, EU Monitor 54, Financial Market Special, Frankfurt am Main.

process in the European banking industry therefore needs to include countries such as Germany but also more cross-border activities.

New trends in EU-wide retail banking

However, some trends are foreseeable that point to an intensification of pan-European retail strategies. Firstly, a customer segment is emerging with an increasingly international demand orientation. Secondly, the steadily growing importance of direct distribution channels will be a strong driver of cross-border banking business in the mid term. Thirdly, for retail banks expansion into other European markets is the only real growth option – given limited scope for expansion in the home markets. Finally, the raft of regulatory initiatives at the EU level will stimulate integration in the retail banking market.

Once the FSAP process is completed, further measures for the integration of the financial markets in Europe will be discussed at the EU level. Further reforms and liberalisation steps are needed, above all in the areas of retail banking[10], professional asset management[11] and the Europeanisation of the supervisory structures.[12]

7. Greater capacity to absorb shocks?

The creation of EMU with a large, increasingly integrated financial market naturally also raises the question of whether this has changed or improved the eurozone's ability to absorb external or internal shocks and, if so, how. This is a relevant point because, despite the great strides that have been made towards integration, it is widely criticised that EMU does not optimally fulfil the conditions of a currency area and therefore in the event of shocks is vulnerable to tensions that would accentuate the economic and employment risks within the monetary union.

EMU is not an optimal currency area

In theory an optimum currency area[13] exists if the participating economies fulfil the following criteria: a high degree of convergence (e.g. in terms of growth and inflation rates) and of openness and integration in external trade (exports and imports in relation to GDP), similar economic structures, flexible factor prices for labour and capital, and high labour mobility. In practice, there would probably be no monetary union at all – even within national boundaries – if all the conditions had to be fulfilled concurrently and in full. EMU was conceived on the basis of a high degree of convergence,[14] considerable openness and very close economic ties. At the same time, however, it was, and still is, obvious that EMU is still some way from being an optimum currency area in a few important respects, especially with regard to flexible factor prices for labour and capital and the freedom of movement of labour, which is restricted in Germany for instance for workers from the new EU member states

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[10] Dieckmann, Raimar (2006). EU-Retail Banking: Drivers for the emergence of cross-border business. Deutsche Bank Research. EU Monitor 34. Financial Market Special, Frankfurt am Main.

[11] Dieckmann, Raimar, Nikolaus Dominik Neundörfer and Immo Westphal (2006). EU Asset Management. Towards the creation of a single market in Europe. Deutsche Bank Research. EU Monitor 37. Financial Market Special, Frankfurt am Main.

[12] Walter, Norbert and Bernhard Speyer (2007). Towards a new structure for EU financial supervision. Deutsche Bank Research. EU Monitor 48. Financial Market Special, Frankfurt am Main.

[13] Mundell, Robert (1961). A Theory on Optimum Currency areas. The American Economic Review. November 1961.

[14] The Maastricht convergence criteria are low inflation and interest rates, a stable rate of exchange versus the euro, and solid public finances in terms of government budgets and debt. Italy only managed to take the 3% of GDP budget hurdle thanks to a Europe tax and much lower interest rates. Europe's new currency (1998). Deutsche Bank Research. Special Report.

until 2011. On the other hand, the removal of currency barriers has – as already mentioned – boosted further integration in the areas of trade and investment.

Shocks absorbed through several channels

In order to assess the ability to absorb shocks the following channels can be distinguished: capital markets, credit markets, budgetary policy and labour market. A long-term study for the USA[15] over a period of 27 years has shown that the capital markets absorb about 39% of the impact of an external shock on GDP, the credit markets 23% and budget policy 13%, while 25% cannot be allocated at all. Unfortunately, no comparable research has been conducted as yet for the eurozone. Still, it is worth making a few general considerations here as there have been a number of events especially since 1999 that have challenged the resilience of the financial markets, budgetary policy and the labour markets. The eurozone was able for instance to absorb negative external shocks on the demand side (such as the weakening of the US economy caused by the bursting of the new economy bubble in 2000 and September 11, 2001) and on the supply side (such as the tripling of the oil price since 1999) comparatively well.

Integrated financial markets are crucial

EMU's resilience to shocks depends largely on the integration of the financial markets. The latter is based not only on a considerably higher liquidity of many products and a broad spectrum of investment instruments but also on a diverse offering of hedging instruments that enable risks to be bundled, traded and diversified. The growing absorptive capacity and breadth of the European financial markets should have increased the eurozone's resilience to shocks. This is very important as EMU – in contrast to the USA – does not have a large central budget[16] and the absorption has to take place primarily through the national budgets, which requires that budget policies are coordinated within the framework of the Stability and Growth Pact. However, experience so far on assuring budgetary discipline over the economic cycle is far from encouraging. In assessing the capacity to absorb shocks conditions on the labour markets have also to be taken into account. As the labour markets in the EMU are comparatively rigid and there are narrow limits to the contribution that fiscal policy can make, other channels – especially the capital and credit markets – have to shoulder an even bigger share of the adjustment burden. Further integration of the financial markets is important also for this reason.

Debate about the most efficient financial market model

Closely connected with this is the debate in EMU and the EU over which financial market model is the most efficient, i.e. over the question of whether it should be mostly credit-based as in the past or capital market-based on US lines. This discussion will need to be continued regardless of the further development of the subprime crisis and its repercussions in Europe. Since 1999 the EMU financial markets have evolved from a strongly credit-based model in the direction of a capital market-based model, whereby the credit basis still predominates in Europe. However, according to the research paper on the USA cited above, the contribution the capital markets make towards absorbing shocks is particularly high. Consequently, EMU's resilience to shocks could be strengthened if the financial markets in Europe were to evolve further in the direction of capital market relationships. However, it is by no means certain whether

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[15] Adrubali P., B. Sorensen and O. Yosha (1996). Channels of Interstate Risk Sharing: United States 1963 – 1990. The Quarterly Journal of Economics, Vol. 111, No. 4, pp.1081 – 1110.

[16] EU budget expenditures amount to 1% of GDP (USA: 20%; Germany: 44%).

this conclusion drawn from an historical view of the USA can still be applied to EMU in view of the current developments in the subprime crisis.

Euro eliminates exchange rate tensions in Europe

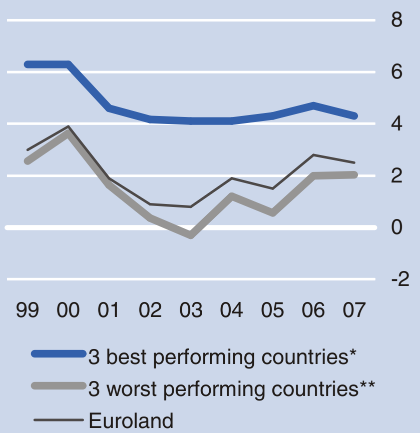
At the same time it should not be forgotten that the removal of currency risks and the creation of liquid financial markets has considerably reduced the economic risks in Europe. In the period between the late 1970s and the mid-1990s Europe went through several phases of exchange rate tensions within the EMS that threatened the economy, as the examples of the years 1992/93 and 1995 clearly demonstrated. The problem was that periods of pronounced dollar weakness versus the D-Mark, as the second largest investment and reserve currency, also led to tensions within the currency structure in Europe. The fact that the D-Mark was not only strong versus the dollar but at the same time also appreciated significantly against the currencies of its main trading partners in Europe was a considerable burden on Germany's economy and competitiveness at times. On top of that, the partner countries then often had to raise their interest rates to maintain their currency's parity to the D-Mark. It is thanks to the euro that since the dollar started to weaken in 2003 its dampening effects on the economy have not been additionally accentuated by exchange rate tensions within Europe. Moreover, disruptions in the European currency pattern would probably have been caused by internal shocks, too, such as the bomb attacks in Madrid in March 2004.

Moderate growth in Euroland
%

	average 1999-2007	2007
Euroland	2.1	2.6
Germany	1.5	2.5
France	2.2	2.2
Italy	1.4	1.5
Spain	3.7	3.8
Ireland	6.5	5.3
Greece	4.2	4
Portugal	1.7	1.9
USA	2.7	2.2
UK	2.8	3

Source: Eurostat **17**

Growth rates remain mixed
GDP growth in %



* Greece, Ireland, Spain
** Germany, Italy, Portual

Source: Eurostat **18**

8. Growth track record only moderate to date

It was widely expected that the launch of the euro would stimulate growth through several channels:

— Low interest rates improve financing terms for investments;

— Firms save costs for exchange rate risks and currency-related transactions;

— More price transparency and competition are an inducement to improve performance.

Monetary union started off with satisfactory growth rates of 3% and 3.8% in the years 1999/2000. The strong downturn in 2001, more or less in tandem with the USA, was disappointing, however. This dashed the hopes that the newly created eurozone with its large single market would be able to decouple itself from developments in the USA. After a dearth of five years growth in the eurozone only revived again in 2006. The spark from the booming world economy, underway since 2003 and driven by the USA and the emerging markets in Asia, only sprang over to the EMU countries after a considerable time lag. In 2008 it has again been debated whether the eurozone can decouple from the USA. Meanwhile, however, there are signs of weakening in the eurozone – emanating from the USA. Given the eurozone's still strong dependence on the US economy it is not surprising that the trends in long-term euro interest rates largely track those of their dollar counterparts. In other words, there has been no decoupling of market rates in the eurozone from the USA as some had expected.[17]

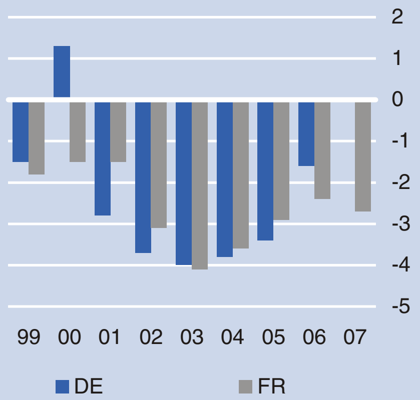
[17] This is the conclusion reached in the following study: Carlo Favero and Francesco Giavazzi (2008). Should the Euro Area be Run as a Closed Economy? American Economic Journal, May 2008. Notwithstanding, the ECB has usually pursued an independent monetary policy aligned to domestic requirements. The differences between the ECB and the Fed on the priority of fighting inflation have been clearly manifested in 2007/08.

In EMU as a whole GDP growth from 1999 to 2007, averaging 2.2% p.a., lagged that of the USA (2.8%). Moreover, the rate of growth in the EU member states not participating in monetary union was higher than in the eurozone, too. This was the case not only in Great Britain (2.8%) and Sweden (3.2%), but especially in the dynamic new EU member states.

Germany overcomes growth weakness

However, growth rates within EMU differed widely. At times the growth differential between the three most dynamic EMU states and the three weakest countries was over 4 percentage points. Thanks to its strong economic dynamic Ireland has overtaken Germany in terms of per capital income. By contrast, Germany and Italy especially posted relatively weak growth, albeit for different reasons. From 2001 Germany was criticised for its weak domestic demand and was called the "sick man of Europe". This was chiefly due to structural factors. That Germany returned to a growth track in 2006, and assumed the role of locomotive for Europe at times, is thanks to overdue structural reforms in economic policy (e.g. on the labour market) as well as massive restructuring efforts in the corporate sector and years of wage restraint. This has substantially strengthened Germany's international competitiveness.

Shortfall in budget consolidation
% of GDP



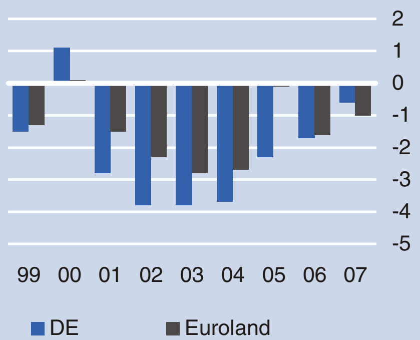
Source: Eurostat 19

Italy's growth weakness is due above all to its loss of international competitiveness as important areas of its foreign trade are exposed particularly strongly to competition from low-wage countries and wage increases have exceeded the weak development of productivity. In both countries the euro and the rules of monetary union were at times blamed for the modest growth.[18] Obviously, acceptance problems have to be taken seriously, but the introduction of the euro cannot be held responsible for the weak growth, which was largely due to insufficient structural reforms. The expectation that the introduction of the euro would increase competition between the member states to create attractive conditions for investment and thus lead to more structural reforms was therefore disappointed.

9. Budgetary discipline: lack of stringency

Budgetary discipline is a cornerstone of the monetary union. Before EMU there were concerns especially in Germany that budgetary discipline could slacken once the convergence test in 1998 for EMU participation had been passed and that after the start of EMU there would no longer be any "devaluation penalty" with higher interest rates for lax national budget policies. The Stability and Growth Pact (SGP) of 1997, based on a German initiative, was therefore conceived to ensure the necessary budgetary discipline through a regular coordination and monitoring of national budget policies and, as necessary, sanctions against budget offenders.

Ups and downs in budget deficits
% of GDP

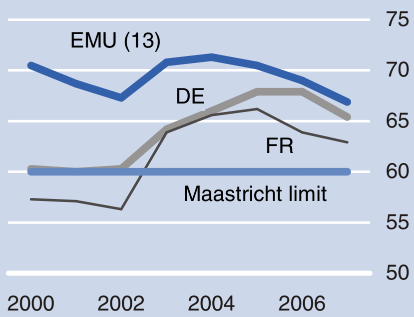


Sources: OECD, DB Research 20

A positive was that the race to qualify in the run-up to monetary union initially strengthened budgetary discipline among the EMU contenders, with budget deficits falling from 6% of GDP in 1993 to 2.6% in 1997, the reference year for EMU participation. Given a good economic trend the annual budget deficits sank further to around 0.5% of GDP on average for EMU as a whole in the first two years of EMU. After surging to 2.9% in 2004, the aggregate EMU budget deficit only more or less regained that level in 2007. The aggregate public debt to GDP ratio in the euro area showed a

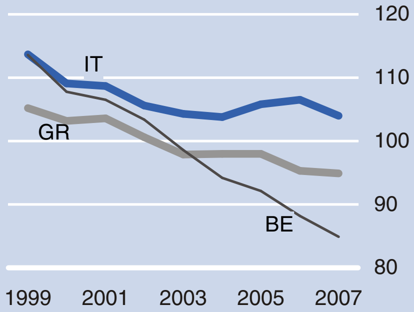
[18] La Malfa, Gorgio and Norbert Walter (2003). Reforming the Maastricht EMU rules for a new economic environment. Deutsche Bank Research. EMU Monitor No. 96.

Goal: Tolerable debt levels
Public debt as % of GDP



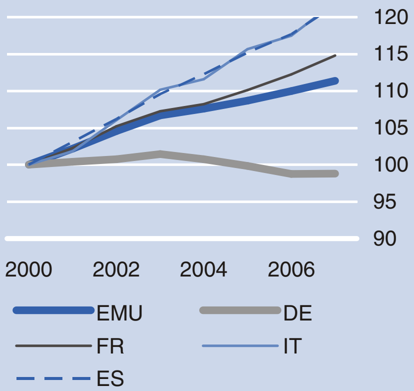
Source: Eurostat **21**

Only Belgium on a consolidation path
Public debt as % of GDP



Source: Eurostat **22**

Germany improves competitiveness
Unit labour costs, base year 2000 = 100



Source: Eurostat **23**

similar development. It fell to 66.6% of GDP at the end of 2007. A peak of 75% was reached in 1996.

The sharp rise in budget deficits from 2001 onwards shows that the good economic phase was not used sufficiently for consolidation. The upshot was that the budget deficits in Germany, France, Italy, Greece, and at times in the Netherlands, too, climbed above the Maastricht threshold of 3% of GDP. In accordance with the rules of the SGP the Commission initiated the excessive deficit procedure in these cases. However, from 2002 Germany and France were not prepared to submit to the rules of the Pact. Despite the excessive budget deficit Germany did not receive a rap on the knuckles in the form of an early warning recommendation. Germany and France then acted in unison to block the path to sanctions. In November 2003 there was a clash with the Commission when the ECOFIN Council closed the deficit procedures against Germany and France and deviated from the Commission's recommendations in its decision on consolidation measures for both countries. The failure of this test was what triggered the reform of the Stability Pact in 2005.[19]

The budgetary position for Germany and most other EMU budget offenders has eased appreciably in the wake of the good economic development in the years 2006/2007. All EMU member states were below the 3% of GDP threshold in 2007. The excessive deficit procedures against Italy and Portugal could therefore be closed. However, the homework created by the reformed SGP still needs to be done. This provides above all for stronger consolidation in good economic times. Countries with aggregate public debt in excess of 60% of GDP – which includes Germany and France, among others – should achieve budget surpluses over the economic cycle. However, this is not the case in Germany, which did not achieve a balanced budget until 2007, or in France, which has posted deficits of between over 2% and just under 3% since 2005.

Homework also needs to be done by those countries whose aggregate public debt ratio was even in excess of the 100% mark when they joined EMU. Italy and Belgium only passed the convergence test because the debt ratio in the reference year 1997 was on the decline in the direction of 60% of GDP. Here, the track records after 10 years of EMU are mixed. While Belgium was able to bring its debt ratio down from 123% of GDP at the end of 1998 to 88.2%, and thus well below the 100% mark, at the end of 2006, Italy's debt ratio was only reduced from 133% to 107% and has stayed at that level. Greece, which was admitted to EMU in 2001 on the strength of its budget data (which later turned out to be manipulated), managed to lower its debt ratio from about 110% of GDP at the beginning of the decade to 95.3%. The problem is that such high debt ratios sharply constrain the scope for automatic stabilisers and for building provisions to cope with the demographic problems. To reduce such high debt ratios budget surpluses need to be achieved over longer periods of time.

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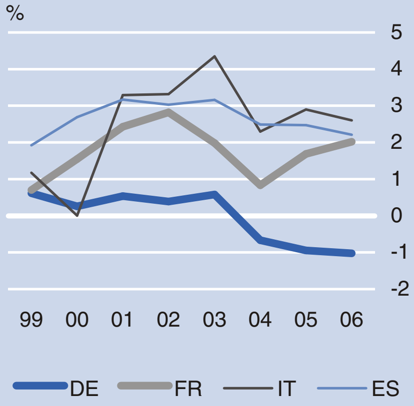
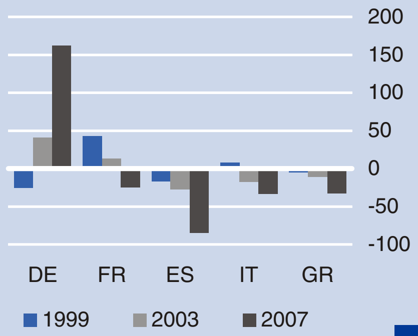
[19] Meeting of the European Council. Presidency Conclusions. Brussels, March 22 and 23, 2005, Annex II. Improving the Implementation of the Stability and Growth Pact.

Diverging growth in unit labour costs
%



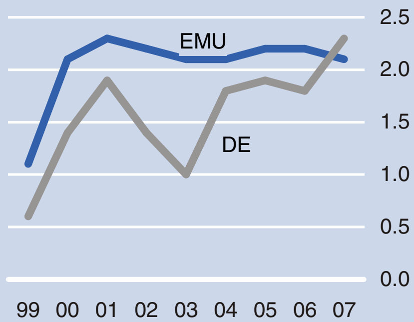
Source: Eurostat 24

Diverging trends in current account balances
EUR billion



Source: Eurostat 25

Germany below EMU inflation rate until 2006
HCPI, % yoy



Source: Eurostat 26

10. Divergences in competitiveness within EMU

The competitive position of the EMU countries has been marked in part by considerable changes over the past ten years which was reflected in diverging trends in current account balances and unit labour costs. In Spain, for instance, the current account deficit has climbed from 2.9% of GDP in 1999 to a massive 10% of GDP in 2007. In Italy and France surpluses at the start of EMU have reversed into deficits of 2% and 2.5% of GDP. Germany, on the other hand, which still posted a deficit in 1999, achieved a high current account surplus of 7.6% of GDP in 2007. Strong current account imbalances between individual members are not a problem for monetary policy purposes as the aggregate EMU current account has been more or less balanced in the past years. However, high national current account deficits do play a role in real economic terms since they represent the accumulation of an external debt position that has to be serviced in the future. The necessity of higher future external debt servicing can mean, ceteris paribus, that domestic demand may have to be damped down. The growth currently driven by domestic demand is therefore unlikely to be sustainable, making stronger export efforts essential.

The current account balances have also mirrored the disparate developments in unit labour costs since 1999. While unit labour costs have risen since then by about 20% in Italy and Spain and by 15% in France, they have remained more or less static in Germany. While wage settlements in the partner countries mentioned have mostly exceeded the growth in productivity, Germany has improved its competitiveness considerably through a mixture of massive corporate restructuring, wage restraint and (moderate) reforms, and returned to a growth path in 2006. A supplementary indicator is the development of inflation: as inflation in Germany was between a half and one percentage point below the EMU average until 2006, there was a devaluation in real terms in Germany's favour and a revaluation in real terms in Spain and Italy.

The real competitiveness channel is a term used when talking about improvements in competitiveness as a result of inflation differences over a longer time frame. This path is important since the classic option of countering losses in competitiveness through a devaluation of the currency has not longer been possible since the start of EMU. Withdrawal from EMU and the reinstatement of a national currency[20], as debated from time to time, is currently not a realistic option as this is likely to entail considerable economic and political drawbacks given the close interdependence in Europe. One of the biggest economic drawbacks is likely to be a sharp rise in interest rates, which would materially increase the interest burden for government, firms and households. Improvements in competitiveness are thus still possible after the nominal exchange rates were irrevocably fixed at the start of EMU through a devaluation in real terms, although they are difficult to achieve and take time, as the example of Germany shows. Three conclusions can be drawn from this:

First, the real competitiveness channel is an adjustment mechanism with a long lead time. However, it would probably be problematic to want to apply the German model of a real devaluation just described

[20] In this regard it should not be forgotten that banks, firms and the public sector spent huge sums to convert their activities to euro (prices, accounting systems, IT, taxes etc.).These costs would be incurred again if a new national currency were introduced.

to other countries on a one-to-one basis. Germany has suffered from weak domestic demand for many years and is still suffering with regard to private consumption. The more important option continues to be for an EMU member state to strengthen its competitiveness and growth primarily through structural reforms.

Second, Germany's way of improving its competitiveness has been criticised as a "beggar-thy-neighbour" policy because EMU's biggest economy for a long time weakened domestic demand through wage restraint and acted as an economic brake for Europe. The criticism is not justified insofar as Germany chose the path that is available under EMU rules.[21] The improvement in its competitiveness paved the way for the upswing from 2006, from which the European partners also profited.

Real interest rate channel versus real exchange rate channel

Third, an improvement in Germany's international competitive position was necessary after it had suffered considerable productivity losses and had to shoulder a higher tax burden in the wake of unification, with long after-effects in the form of moderate growth rates. In addition, the modest growth in exports and the current account deficit at the start of EMU suggest that the exchange rate at which the reunified Germany joined EMU was too high.

In the debate about competitiveness in EMU the real interest rate channel has also played a role since 1999 running counter to the real exchange rate channel. This is due to the fact that in countries with above-average inflation rates this not only leads to a deterioration in price competitiveness but, in a single currency area with uniform or similar nominal interest rates, also to a decline in real interest rates (in other words the difference between nominal interest rate and inflation rate). Another difference is that the real exchange rate effect cumulates if the inflation difference persists, while this is not so with the real interest rate channel.

In the phase of low ECB rates from 2003 to 2005 the "one-size-fits-all" problem of ECB monetary policy was an issue of lively discussion at times. One argument was that the real interest rates for high-growth countries such as Spain and Ireland were too low, with the result that monetary policy had a procyclical effect, as reflected in the booming property markets.[22]

Domestic and export demand diverge

It is not surprising that the opposing development of the real exchange rate channel and the real interest rate channel led to diverging trends in domestic and export demand in the various countries. While Germany witnessed a strong boost from export demand from 1999, domestic demand remained weak until 2005 and then it was only demand for capital goods that picked up. On the other hand, in countries with slightly higher inflation rates like Spain domestic demand was buoyant. Then there is the "mixed case" of France where below-average inflation was coupled with dynamic domestic demand.

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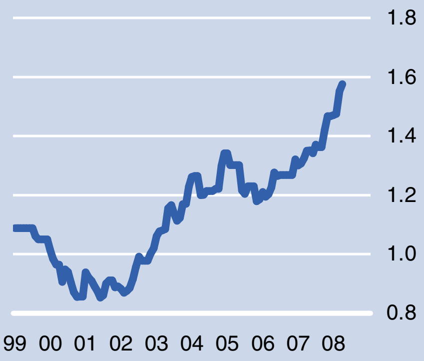
[21] Moreover, hourly labour costs in Germany (€ 29.10 in 2007) are nearly 30% above the EU average.

[22] In Germany's case the argument was the reverse: real interest rates were too high and growth dampened, so the ECB's rate of then 2% should be lowered further. This argument does not hold up, though, as real interest rates in 2003/2005 were only around 0.5 percentage point (given an ECB rate of 2% and an inflation rate of 1.5%).

II. External track record: euro in global demand but enlargement stalled

1. Exchange rate fluctuations affect price competitiveness

USD/EUR exchange rate



Source: DB Research 27

In the global context the euro's exchange rates – especially versus the dollar – are the crucial factor for the EMU member states' price competitiveness. The euro's exchange rate versus the dollar has undergone strong fluctuations since 1998. The euro showed a distinctly weak trend until 2002. As a new currency, it still had to stand the test internationally, while the dollar profited from strong US growth and attractive dollar yields. The euro reached a low of 0.83 USD/EUR in autumn 2000. This was a fall of 30% from its starting rate of 1.1789 USD/EUR. EMU exports to the dollar area profited from this.

All-time high against the dollar

Amid growing uncertainty caused by the rapidly rising US current account deficit and the Iraq conflict the euro then saw a prolonged upward trend versus the dollar from 2002 onwards. Over the longer term the euro has also gained ground against the yen, the Swiss franc and, since 2007, the pound sterling. The only longish break in the euro's upward trend was after the EU Constitution was rejected in the referendums in France and the Netherlands in June 2005. Uncertainties over the EU's and EMU's future politico-institutional structures weighed on the euro, which fluctuated between 1.20 and just over 1.30 USD/EUR during this phase. From summer 2007 the euro continued its climb amid growing signs of a weakening US economy and the subprime crisis, breaching the 1.60 USD/EUR mark for a while in April 2008, and again in July 2008 when the euro reached an all-time high against the dollar. This places a considerable adjustment burden in the reduction of the huge US current account deficit on the eurozone, which has a balanced current account. A marked appreciation of the Japanese and Chinese currencies against the dollar would be warranted, both countries having high surpluses.

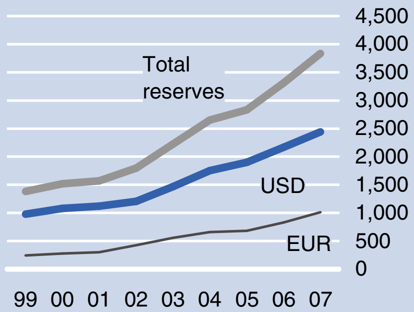
Euro firmly established internationally

Concern: Disorderly dollar crash

The euro's high exchange rate against the dollar has not been seen as all that much of a problem by policymakers and industry in Europe. No exchange rate arrangements have therefore been agreed in 2007/08 to support the dollar within the framework of the G7. However, the concern over a further disorderly fall in the value of the dollar is also recognised by the G7 states. Still, the euro/dollar exchange rate affects firms within EMU differently. Firms in Germany have coped relatively well with the euro's strength for some time because they have improved their global competitiveness through massive restructuring and possess a product portfolio including capital goods that is in global demand[23] On the other hand, the competitiveness of other EMU members which, because of their export structure, are exposed to intense competition from the dynamic emerging economies of Asia, is under massive pressure. One example is Italy's textile industry. The risks for Europe's economy from the euro's strength are considerable given the squeeze on margins on exports to the dollar area and – combined with weak US growth – are likely to have an increasingly greater dampening effect in 2008 and 2009.

[23] Above all they have pursued the globalisation of their value chains more strongly and are thus now profiting from "natural hedging" in the dollar area.

Sharp rise in exchange reserves...
USD bn



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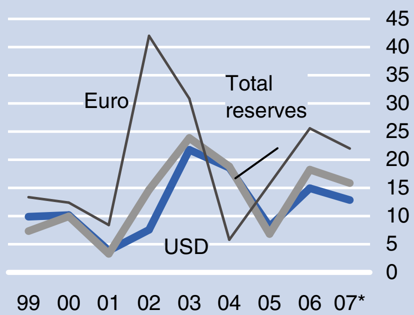
... with strongly fluctuating growth rates
% yoy



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Euro's share in foreign reserves on the rise again

	99*	01	03	05	06	07
USD	71.2	71.5	66.0	66.9	65.5	63.9
JPY	6.0	5.0	3.9	3.6	3.1	2.9
EUR	18.2	19.2	25.2	24.1	25.1	26.5
GBP	2.7	2.7	2.8	3.7	4.4	4.7

* 1st quarter

Source: IMF

30

2. Euro stages a successful international career

The euro's importance as an international trade, investment, reserve and anchor currency has grown considerably over the last years. The international monetary system, characterized until 1998 by the three poles of dollar, D-Mark and yen, has evolved into a bipolar system since the euro's introduction, with the dollar as the leading currency and the euro as the uncontested global No. 2 currency, while the yen has lost strongly in importance. The euro has caught up ground on the dollar almost everywhere since 1999, and has even overtaken it in some segments:[24]

— Almost 50% of *world trade* is settled in dollars according to earlier studies. However, the data situation for a currency breakdown is still poor. EMU external trade with third countries has been invoiced increasingly in euros in recent years (approx. 60% on average). 80% of German exports outside EMU are invoiced in euros, and 13% in dollars. Oil and other commodities are invoiced in dollars (exception: Iran settles its oil exports in euro).

— The euro's importance as an *investment currency* can be measured on the basis of new issues and the volume of international debt instruments outstanding. According to BIS statistics, 49% of new international bond issues in 2007 were denominated in euros and only 35% in dollars. In the previous years the euro had mostly taken second place (with shares of between 34% and 35%) after the dollar (39%-49%). The shares for the pound sterling (7.9% at the last count) and yen (2.7%) are far exceeded. In terms of the volume of international bonds outstanding the euro reached a share of approx. 32% at the end of 2007 as compared to 19% at the beginning of 1999, while the dollar's share fell from around 50% to about 44% and the yen's has roughly halved to 5.3%.

— As regards *currency in circulation* the euro is now used throughout the world. Based on the value of the currency in circulation, the euro overtook the dollar for the first time in 2006. The euro's global circulation amounted to EUR 697 billion at the end of 2007 as compared to EUR 525 billion for the dollar. Banknotes account for a good 97% of the currency in circulation in the case of the euro. The figure for the dollar is approx. 99%. However, an estimated share of almost 20% of the euro banknotes are used exterritorially as compared to 50-70% in the case of dollar banknotes.

— The dollar's share as the world's most important *reserve currency* has fallen from 71.5% of total world central bank foreign exchange reserves in 2001 to just below 64% at the end of 2007, while the euro's share has risen from a good 18% at the beginning of 1999 to 26.5%. However, the increase in the year 2007 was only due to the higher valuation of the euro. Nevertheless, the euro's share likely to increase to 30% to 40% by 2010 as many central banks have a strong need to diversify given the dollar's weakness and for return reasons. Whether the euro's weight will continue to rise versus the dollar beyond 2010 depends on the longer-term development in the USA (especially on a reduction of the US current account deficit) and the brake

[24] European Central Bank (2008), The international role of the euro.

Euro overtakes the dollar

Currency in circulation in EUR billion

	Euro	Dollar
December 2004	517	564
Decmber 2005	583	668
December 2006	647	619
December 2007	697	525
April 2008	690	521

Sources: ECB, Fed 31

marks that demographic trends make on potential growth in the EU.[25]

— The euro is used as an *anchor currency* for exchange rates by about 40 – mostly small – countries that are associated with the EU through close economic ties or geographic proximity. About 60 countries in the world are aligned to the dollar. Several countries manage their currencies on the basis of a currency basket whose main components are the dollar and the euro (e.g. China, Russia). This requires exchange reserves to be held in euros.

The euro has established itself as the second most important international currency and has thus taken over the D-Mark's legacy. However, it is far more successful internationally than the D-Mark ever was. That the euro has been in such demand internationally in its first ten years is a strong mark of confidence in the ECB, and is part of the success story.

The question of whether the euro is a strong challenger for the dollar and could even oust it one day from its role as the leading global currency was already a subject of controversial debate before EMU was launched. The debate has now been rekindled in the wake of the massive rise in global exchange reserves over the past years and in response to the US growth and currency weakness after the outbreak of the subprime crisis in summer 2007. From today's vantage point the euro still has further potential, e.g. as a reserve and investment currency, because EMU offers a financial market of comparable size and liquidity as the USA. Nonetheless, the dollar will remain the No. 1 world currency for the foreseeable future as the USA has a very powerful and efficient economy, can deploy monetary and fiscal policy more flexibly than Euroland and, above all, because it is a military and political superpower.[26]

The euro's weightier international role should also come to be reflected in the euro area's influence and responsibility in international forums – such as the IMF and the G7. Here, the Lisbon Treaty envisages improvements in two respects:

Strengthen EMU's representation at the international level

Firstly, the Eurogroup or ECOFIN Council is called upon to formulate common positions on monetary and economic policy in international institutions in order to ensure that the euro area's interests are better represented. Effective representation at the international level requires the political will to speak with one voice.

Secondly, the nomination of a president of the Eurogroup already in 2005 ahead of a subsequent amendment of the EU Treaty has created greater continuity and stability in external representation. The Eurogroup president's participation at the G7 summit has helped to ensure that issues of interest to the euro area were kept on the agenda.

3. EMU enlargement proceeding at a snail's pace

Goal: all EU countries adopt the euro

From the start EMU was conceived with the idea that as far as possible all EU member states would participate if they met the convergence criteria and had the political will to take this step. The fact that in 1999 EMU started not as a "core monetary union" (of

[25] Walter, Norbert and Werner Becker (2008): The euro hits the big time. International role of the euro. Deutsche Bank Research. EU Monitor 58. Frankfurt am Main.

[26] Becker, Werner (2007). Euro rides high as an international reserve currency. Deutsche Bank Research. EU Monitor 46. Frankfurt am Main.

about seven countries) but as a “grand monetary union” with 11 of the 15 EU member states was a surprise for many. It had not been expected for instance that above all Italy, thanks to a tour de force, would in fact qualify as one of the first participants. Others in turn interpreted the start of EMU with a relatively large number of participants as a sign that compliance with the convergence criteria had been taken not all that strictly.

The track record for new entrants since 1999 has been fairly sobering. EMU has only grown by four to 15 countries, while over the same period the EU has expanded from 15 to 27 member states. Greece was admitted in 2001. Among the 12 new EU member states, the only new entrants have been Slovenia (2007) and Cyprus and Malta (2008). It is disappointing, too, that the situation will not change much in the foreseeable future either. Only Slovakia will join in 2009.

3.1 No movement in Great Britain, Sweden and Denmark

Great Britain and Sweden: EMU not on the agenda

Although Great Britain, Denmark and Sweden would in principle have no difficulty meeting the convergence criteria, there is still no political interest in these countries in introducing the euro even after ten successful years of EMU. This has not changed with the participation of a number of new EU member states. Great Britain and Denmark have an “opt-in clause” under which they are not obliged to join but must be admitted if they declare they wish to and fulfil the convergence criteria.

Sweden does not have exemption status but – like Great Britain – does not fulfil the exchange rate criterion as it does not participate in the European Exchange Rate Mechanism (ERM) II. Denmark is de facto a silent partner in EMU as the Danish krone has participated in ERM II since 1999 and has a fixed exchange rate to the euro. In all three countries the political will is to make participation conditional upon a positive referendum. The governments of the three countries are not against EMU membership in principle but cannot be sure of the electorate’s support. The public fears the loss of national identity and autonomy in matters of monetary policy. Considering the high dependence on ECB monetary policy this is an illusion that never ceases to astonish. All the same, growth rates in Great Britain and Sweden have been higher on average and inflation rates lower than in the eurozone since 1999. This makes it difficult to convince the population of EMU’s advantages. A disadvantage of not participating in EMU, however, is the at times considerable exchange rate risks. While the pound sterling has depreciated strongly against the euro since 2007 after a long phase of exchange rate stability, the Swedish krone has witnessed considerable fluctuations against the euro since 1999.

The British government’s five economic tests

1. Cyclical convergence: Economic cycles in Great Britain and in EMU must be compatible.
2. Flexibility: Britain’s economy must be flexible enough to withstand asymmetric shocks as it will no longer have the instruments of monetary and exchange rate policy at its disposal within EMU.
3. Investment: Here it is examined whether in the event of EMU membership Great Britain will remain attractive to foreign investors as well as for foreign direct investments.
4. Financial services: EMU membership should have a beneficial effect on the competitive position of Britain’s financial services sector and especially strengthen the role of the “City of London”.
5. Employment and growth: Positive effects must be likely in the long term.

In Great Britain EMU participation depends not only on compliance with the convergence criteria and a positive referendum but also on the passing of five self-defined economic tests. According to polls a clear majority of the British public is still against joining EMU. The outcome of the review of the five economic tests in 2003 was negative. Only the “City of London”, which handles a very substantial part of the international euro financial transactions, passed the test. This came as no surprise as the formulation of the five tests is very vague and leaves the government wide discretion for interpretation. Since then the issue has no longer been on the agenda. This was also the case in Denmark and Sweden after the negative outcome of the euro referendums in 2000 and 2003. Still, Denmark’s premier Rasmussen announced in 2007 that the government intended to consider the possibility of another euro referendum. The outcome is still open.

3.2 New EU countries: Convergence and political hurdles

Delays among the new EU countries

Under the “acquis communautaire” the twelve new EU member states have committed to adopt the euro once they meet the convergence criteria. So, unlike Great Britain and Denmark, they have no exemption status. Even though the new EU countries can expect a significant growth boost from EMU participation, apart from the four countries mentioned there are no further entrants in the offing in the foreseeable future. This is because the convergence criteria have as yet not been met and/or there is little political interest in introducing the euro.

Main hurdles: inflation rate and political will

As far as convergence is concerned an important factor for the countries that joined the EU in May 2004 is first of all the exchange rate criterion that stipulates the currency’s tension-free participation in ERM II for at least two years. Thus, 2007 was the earliest date for EMU participation by the new EU member states. Joining ERM II can thus be seen as a sign of the political will to adopt the euro. Leaving aside the exchange rate criterion, since 2007 the Achilles heel for the convergence test has been primarily inflation (for all countries except Poland and Slovakia) and the budget deficit (for Hungary). Hungary is still some way from meeting most of the convergence criteria (see the convergence table). While the higher inflation rate is an entry hurdle for the three Baltic states (and for Bulgaria and Romania), Poland and the Czech Republic lack the political will at present. An argument for the hesitancy is the fact that in the economic catch-up process, in full swing for some years, there is still the need for an autonomous monetary and exchange rate policy as an adjustment instrument.

Who will enter the waiting room for the euro next?

	Inflation % yoy May 08	Interest rates[1] May 08	Fiscal balance % of GDP 2007	Public debt % of GDP 2007	ERM II	Criteria fulfilled	euro adoption
Reference value	3.6	6.2	-3.0	60.0	Tension-free participation for at least 2 years		
Czech Republic	5.1	4.6	-1.6	28.7	Managed Float (EUR)	**3**	**2012-14**
Estonia	9.2	5.3	2.8	3.4	ERM II since June 2004	**4**	**2011**
Hungary	7.2	7.2	-5.5	66.0	Free float	**0**	**2014**
Latvia	13.7	5.4	0.0	9.7	ERM II since May 2005	**4**	**2012-13**
Lithuania	8.6	4.7	-1.2	17.3	ERM II since June 2004	**4**	**2011**
Poland	3.6	5.8	-2.0	45.2	Free float	**4**	**2012-13**
Slovakia	2.6	4.6	-2.2	29.4	ERM II since Nov 2005	**5**	**2009**
Bulgaria	10.9	4.8	3.4	18.2	Currency Board (EUR)	**3**	**2012**
Romania	6.7	7.1	-2.5	13.0	Managed Float (EUR)	**2**	**2014**

[1] Maastricht definition. Other definition: Estonia

Sources: Eurostat, DB Research **32**

3.3 New, controversial debate over convergence criteria

Complex rotation process for ECB

The rotation model provides either for a two group version (upwards of 16 EMU countries) or for a three group version (upwards of 22 EMU countries). In both cases the six Executive Board members have full voting rights. For the rotation of the voting rights of the national central bank governors in the ECB Governing Council the EMU states are assigned to groups on the basis of their share of EMU GDP and the relative size of their financial system measured in terms of the aggregate total assets of the financial institutions in EMU. The size of the economies is weighted with a factor of 5/6ths and the size of the financial system with a factor of 1/6th.

In the two group model the first group of large countries has four votes and the other countries a total of 11 votes. The grouping is designed to ensure that the national central bank governors of the first group have the right to vote no less often than those of the second group. However, the fine-tuning of the groups depends on the actual number and size of the new EMU states. The first group of five large countries initially has full voting rights and the other countries a total of 11, which in the first step would be divided up among 12 countries, i.e. 11 of the 12 national central bank governors would have a vote while one has to abstain from voting on a rotation basis at each of the following meetings of the EC Governing Council. If the number of EMU countries rises to 19, then the large countries only have four votes and therefore also have to rotate. The two-group rotation model can already take effect in 2009 when Slovakia will join.

In the three-group model Germany, France, Italy, Spain and another country would be in the first group. Here, five large countries share four votes. The second group, which comprises half of the EMU states, has eight votes and the third group three votes. The frequency with which the national central bank governors of the first group vote is 80%, that of the second group 57%, and that of the third group 38%. A country like Germany or France is therefore entitled to vote only at four out of five meetings.

Future EMU entry has also sparked a controversial debate about whether the admission of the new EU member states would necessitate a modification of the convergence criteria of low inflation rates, interest rate convergence, budgetary discipline and exchange rate stability. So far the principle of equal treatment of all candidate countries, necessary for political reasons, has been applied. Nonetheless, it should be permissible to consider what can or needs to be improved in light of the experiences over the past ten years, whereby the focus is on the inflation and budget criteria.

The trigger for this debate was Lithuania which, together with Slovenia, had applied in 2006 for EMU membership in 2007 but whose application was rejected on the inflation criterion which it only just failed to meet. However, in Lithuania's case it would have been short of the mark if, in 2006, the inflation rate for the previous 12 months had been compared purely mechanistically with the reference value (i.e. the average inflation rate of the three most price-stable EU member states plus 1.5%). The low inflation rates must also be sustainable. This was not the case, however, as the rise in inflation to 5.8% in 2007 subsequently indicated.

In this connection it was argued[27] that in the convergence test for the new EU countries one should depart from the relative definition of the inflation criterion and take the ECB's inflation definition as the benchmark. The relative definition of the inflation criterion has the drawback that the three EU member states with the lowest inflation rates do not even have to be EMU participants and the average of the best three countries is systemically lower today than it was ten years ago. This objection is justified. The inflation criterion should therefore be reviewed.

It makes sense to take the eurozone's established benchmark and use the ECB's definition of price stability – inflation rate below but close to 2% – as the basis for the reference inflation rate. However, a problem is that the reference value (just below 2% plus 1.5 percentage points) would be over 3 percent and would no longer be compatible with price stability. But if the benchmark were defined as just below 2% plus a margin, e.g. of one percentage point, then the inflation criterion could be adequately considered. At the same time, the Balassa-Samuelson effect[28], which explains the structurally higher inflation in the new EU member states, could be taken into account. It should be possible politically to reach a consensus on such an adjustment and modify the rules in a similar way as with the adoption of the rotation principle for the ECB. However, if it requires a revision of the EU Treaty with all the associated ratification procedures, this would probably mean that the inflation criterion will stay as it is.

Inflation criterion: need for discussion

There has also been criticism of the budget criterion. It has been argued that the new EU countries need a fiscal policy that could be managed more flexibly than provided for in the reformed stability pact which retains the 3% of GDP deficit limit. It has even been

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[27] Zdenek Tuma (2007). Europe's club of nations needs a rule change. Financial Times. January 4, 2007.

[28] In their catch-up process the new EU economies have structurally higher inflation rates because the pressure of international competition in the traded goods sector leads to higher productivity growth and thus corresponding wage growth. Wage settlements in the international sector then serve as the benchmark for the services sector and other sectors addressing the local market with lower productivity growth.

Equal treatment politically necessary

demanded that the 3% limit should be lifted altogether for the new EU countries. However, this would be a massive breach of the principle of equal treatment. Moreover, it should not be forgotten that in the fast-growing new EU countries an expansive fiscal policy would tend to lead to higher inflation rates rather than higher growth rates. Finally, most of these countries have demographic problems that require a forward-looking, solid fiscal policy.

Catch-up process in the new EU countries intact

The goal conflicts between nominal and real convergence have also been a subject of controversial debate. The convergence criteria are based on nominal convergence. Real convergence, on the other hand, is understood as the catch-up process in the new EU countries that, through higher growth, brings them closer into line with per capita income in the old EU member states. This process has been intact for years. However, there is occasional criticism that nominal convergence and real convergence are not compatible, for instance because the necessary price stabilisation would have to be bought at the expense of growth. Real convergence should therefore have priority. In the short term this can cause a goal conflict. Given the wide gap in per capita income, which in the new EU countries was between 40% and 90% of the EU average in 2007, such an approach would push EMU participation into the distant future for quite a few new EU countries. The call for real convergence should not be allowed to place an added obstacle in the way of the new EU countries' accession to EMU. Moreover, the rules require that the progress in single market integration, the current account position and trend, the development of unit labour costs and other price indices are considered in the convergence review process. Finally, structural reforms and deregulation should be undertaken during the catch-up process in order to dismantle price distortions and to strengthen growth and the resilience to asymmetric shocks within EMU. Nominal and real convergence should proceed in parallel despite possible tensions.

3.4 ECB rotation model ante portas

Complex rotation model

The European Council already adopted a rotation model put forward by the ECB for the voting in the ECB Governing Council in 2003 in order to ensure efficient decision-making procedures also in a substantially enlarged EU and EMU. The ECB Governing Council consists of the six members of the Executive Board and the national central bank governors of the EMU member countries, of whom there are currently 15, with one member added for every new EMU entrant. With 27 EU member states entitled to join EMU, the ECB Governing Council could have up to 33 members in future, whereby only 21 members of the ECB Governing Council, however, would have a voting right.

The complicated rotation model will be introduced in two stages. The two-group version applies upwards of 16 EMU countries and the three-group version upwards of 22 EMU countries. The 16 member threshold will be reached on January 1, 2009 when Slovakia is expected to join. However, the ECB can decide by a two-thirds majority to introduce the rotation model only as from 18 participant countries. A decision is still pending.

In the EMU enlargement process 3-4 new entrants are likely at the most by the year 2012: the three Baltic states and possibly Denmark. From today's vantage point, it appears by no means certain that the next threshold – 22 countries for the three-group version – can be reached in the foreseeable future. The markets will therefore probably be confronted with the two-group model for some

Representation instead of rotation model

An alternative to the ECB rotation model would be, for instance, a representation solution on the lines of the US Fed where monetary policy decisions are taken by a 12-member committee (Federal Open Market Committee) consisting of the seven members of the Board of Governors (including Chairman Ben S. Bernanke) and five regional representatives. A body of this size is a good basis for an efficient decision-making process. The rotation principle has also worked well in the USA. Applied in modified form to Europe it would be conceivable to have the six members of the Executive Board and seven seats for the regional representatives. Unlike in the USA, the regional representatives would therefore be in the majority. While New York, as the financial centre, has a permanent seat among the regional representatives, the other four seats are allocated each year on a rotation basis. Transferred to the euro area this would mean that France and Germany, as the largest financial centres in continental Europe, would have a permanent voting right in the ECB Governing Council while the other five votes would rotate among all the other EMU countries.

time to come, i.e. an intermediate step could become a long-term solution. An advantage of the rotation model is that it ensures that all the national central bank governors participate in the monetary policy decision-making process and can communicate the results to the public in their respective home countries at first hand.

All the same, the serious drawbacks of the rotation model – in either version – are likely to outweigh. The two-group version is already complicated and intransparent as the rotation process changes with each new entrant. An ECB Governing Council with up to 33 members is too large and its effectiveness limited even if only 21 members have voting rights. A problem is also seen in the fact that, in the extreme case, the central bank governors of the many small and medium-sized countries in groups two and three can outvote the central bank governors of the four large countries and the six members of the Executive Board and could thus shift the focus of monetary policy away from price stability and more towards stimulating growth in the catch-up process. Another shortcoming is that France and Germany, the two biggest economies with the largest financial centres in the euro area, would no longer be represented with a permanent voting right in the ECB Governing Council. A simpler, more transparent solution would therefore be welcome.

III. Economic governance: reforms within proven structures

Coordination requires rules

Economic governance within EMU is characterised by a centralised monetary policy and (mostly) decentralised economic, fiscal and structural policies. This requires policy coordination within EMU. The member states of EMU (as in the EU) have pledged by treaty to view economic policy as a matter of common interest and to coordinate it so as to strengthen growth and employment. Aside from monetary policy, there are, of course, a number of other powers assigned to the EU level, especially the single market, trade policy, and competition and aid policy for instance.

Coordination of the policy areas remaining within the sphere of national sovereignty requires rules so as to prevent negative spillover effects from one country to the other EMU participants. For fiscal policy these rules are codified in the Stability and Growth Pact (SGP), while the integrated guidelines for growth and employment are aligned to economic and structural policies. In light of the experience since 1999 EMU's institutional arrangements and rules have mostly stood the test so far. However, there have been shortcomings in their implementation. At the EU summit in March 2005 the framework for the coordination of economic, fiscal and structural policy was therefore redefined in three respects:

Three reforms

— Firstly, the first major *reform of the SGP* was resolved.

— Secondly, there was a *streamlining* of the Lisbon Agenda (e.g. focus on growth, objective of overtaking the USA in terms of growth dynamic by the year 2010 dropped).

— Thirdly, the broad economic policy guidelines and the guidelines for employment policy were combined into *the integrated guidelines for growth and employment*. Key fields of the new Lisbon Agenda are part of the integrated guidelines. Their implementation is monitored within the framework of the integrated guidelines.

The discussion of EMU's track record in terms of economic governance therefore focuses on the experience with managing monetary policy and coordinating economic, fiscal and structural policies in the above three areas.

1. ECB's credibility rests on three pillars

Credibility objective achieved

As a new institution, it was essential for the ECB to win its own credibility on the model of the Bundesbank. The bridge to credibility mainly rests on three pillars:

— good policy based on independence,

— a convincing monetary strategy, and

— regular communication and accountability to the European Parliament, the public and the markets.

In the boom phases of 1999/2000 and 2005/2007 the ECB demonstrated stability policy resolve, undertaking several rate hikes in each case which strengthened its credibility in the markets and among the public. The ECB reacted quite flexibly in phases of weak growth, lowering rates for instance in 2002/03 when concerns over deflation were an issue worldwide. Nonetheless, the ECB was often criticised from the Anglo-American side but also from various political camps within EMU that it was focused too strongly on inflation risks and – in contrast to the US Fed – was not doing enough to stimulate the economy. This criticism was also voiced in the low interest rate phase from 2002 to 2005 although the growth weakness in that period was due more to structural factors, and an expansive monetary policy then runs the risk of fuelling inflation.

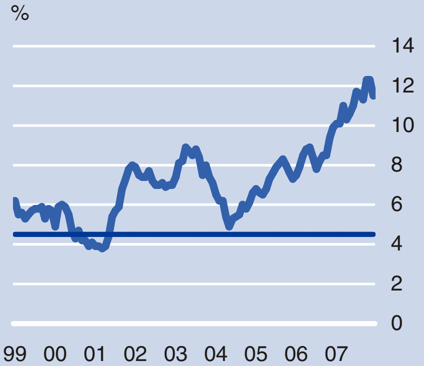
ECB and Fed have different objectives

The different objectives and focuses of the ECB and the Fed have been particularly manifest after the outbreak of the subprime crisis in summer 2007, coupled with a (global) oil and food price-induced surge in inflation in 2007/08. This is due to the fact that the ECB's mandate differs clearly from that of the US Fed, whose catalogue of objectives encompasses not only price stability but also sustainable growth and high employment. The ECB has not eased in deference to the primacy of price stability whereas the US Fed has pursued a policy of economic stimulation and financial market stabilisation through massive rate cuts, hoping that the inflation risks will be held in check by the weak economy. This increases the risk of stagflation in the USA, in other words weak growth coupled with relatively high inflation rates. However, the euro area will not be immune either if the ECB is not able to contain knock-on effects.

Modified two-pillar strategy

The ECB pursues the objective of price stability with a two-pillar strategy, consisting of an economic and a monetary analysis. It modified the strategy in 2003 in light of the experience since 1999. The definition of price stability was adjusted at the same time, i.e. the ECB's medium-term target is an inflation rate of below but close to 2%, rather than a band from 0 to 2%. In this way the ECB took account of statistical inaccuracies in measuring inflation and built in a buffer for deflationary risks. In addition, the order of the pillars was reversed. The analysis of the economic indicators (such as new orders, business sentiment indices, unit labour costs, budget deficits, etc.) that determines the short to medium-term price risks is followed by the monetary analysis that focuses on the medium and long-term inflation trends and is based on the development of money supply and lending. Finally, the reference value for inflation-free growth in M3 money supply (4.5% p. a.), which from the start

M3 money supply expands



Source: ECB 33

was formulated more loosely than the Bundesbank's money supply targets, has no longer been reviewed annually since 2003, underscoring the reference value's longer-term orientation. The monetary analysis reflects the fact that inflation is (also) a monetary phenomenon. It assumes a relatively stable correlation in the medium term between the development of money supply and the development of price levels, and identifies imbalances such as property price bubbles.

Modified strategy also criticised

The two-pillar strategy has also been criticised after its modification because it is intransparent and not easy to communicate. In addition, the two pillars can produce contradictory signals at times. For instance, the above-target money supply growth in the years 2001-03 pointed to inflationary risks while many economic factors signalled weak growth and easing inflation. Some critics even see no stable correlation between the development of money supply and the development of prices and recommend that the monetary pillar should be abandoned.

Convincing communication policy needed

Inflation target recommendable

A convincing ECB communication policy is essential to fulfil its accountability to the democratic institutions, to the public and to the markets. This is, as it were, the flipside to its independence. The ECB's communication policy draws frequent criticism although it uses numerous channels – regular press conferences, monthly reports, speeches, presentations by the ECB president to the European Parliament, etc. – to explain its monetary policy in public. In view of the shortcomings of the two-pillar strategy it is recommended that the ECB should pursue the strategy of a direct inflation target like the Bank of England. Such a strategy would be welcome as it is easy to communicate to the markets and the public and it is simple to track. For instance, if the inflation target were exceeded within a given period, the ECB would then react with a rate increase. However, a direct inflation target[29] should be more broadly defined than the ECB's revised stability definition at around 1 to 2.5% so as to allow more flexibility.

ECB improves its communication

Nonetheless, the ECB has initiated improvements in its communication, e.g. advance announcements of rate hikes since the end of 2005. The national central banks are coming to play a more and more important role in the communication of monetary strategy. Additional information does not necessarily provide greater clarity, for instance with the demand for greater transparency through timely publication of the minutes of the ECB Council meetings in mind. The ECB has rightly rejected this since the disclosure of the voting could easily lead to political pressure on individual Council members, jeopardise the ECB's independence and provoke national leanings among the national central bank governors in the EC Council.[30]

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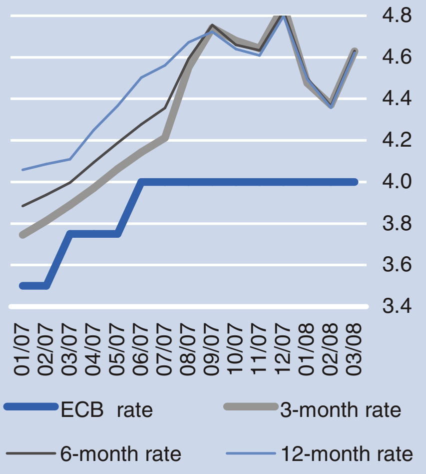
[29] DIW Berlin for instance proposes that the ECB should set an explicit inflation target of 2% p.a.: Lommatsch, Kirsten and Silke Tober (2003). Reform der geldpolitischen Strategie der Europäischen Zentralbank. Wochenbericht des DIW Berlin, No. 7/2003, pp. 110 ff.

[30] However, in actual fact the publication of the minutes would have had little effect to date as the ECB Council has very largely reached its decisions by consensus. Still, consensus decisions are not mandatory in the ECB Council; there could also be majority votes. That the minutes of the meetings are not published cannot be seen as a lack of transparency as the ECB explains its policy regularly through a wide range of activities such as press conferences.

2. Demands on ECB as "lender of last liquidity" in emergencies

ECB rates, 3, 6 and 12-month rates



Source: Eurostat 34

The euro money market is the ECB's main field of operation for implementing its monetary policy and the market platform for banks to exchange funds and balance out their liquidity positions. The euro money market, which had functioned smoothly since the start of EMU, has witnessed massive disruptions, like the money markets in the USA, Great Britain and other countries, since August 2007 in the aftermath of the crisis on the US mortgage market ("subprime crisis"). The ECB moved swiftly to defuse the tensions in the supply of liquidity in the interbank market and, according to the situation, injected funds in the high billions in order to hold money market rates close to the target ECB rate level. As the money market has remained strained since then, the ECB has had to provide additional liquidity temporarily again and again, acting in close cooperation with other central banks, especially the US Federal Reserve Bank and the Bank of England. The ECB passed up a rate hike that had already been announced.

ECB safeguards liquidity

That the ECB assumed its role as "lender of last liquidity" swiftly and has performed it professionally is positive. It has kept the lifeline of the euro financial markets in functioning order. The concerns that the after-effects of the subprime crisis could lead to a credit crunch have not been borne out so far. On the contrary: banks' lending to the private sector in EMU continued to rise in the first quarter of 2008 at a year-on-year rate of about 14%. While lending to the corporate sector expanded, the growth rates in consumer and home loans have weakened since mid-2006, which is probably a reflection of the subsidence of the property boom in some EMU countries.

Objective: restoration of the interbank market

The longer the tensions in the euro money market and the ECB's exceptional money market operations last, the more pressing the question becomes as to how far this could compromise the primary objective of price stability or give rise to a goal conflict between liquidity supply and price stability.[31] As the situation normalises, the ECB must increase the incentive for banks to use the interbank market instead of relying on central bank liquidity.

Need for effective crisis management

The crisis has shown up shortcomings in crisis management and in the institutional framework of supervision in the financial services sector. As the supervision of the financial services industry is still organised on a national basis in the EU, there is the risk for instance that in times of market strains the cooperation between the supervisory authorities is too slow or not comprehensive enough. Effective crisis management hinges on a well-functioning interaction of the main actors – central banks, financial services supervisory authorities, governments and market participants. The EU member states have recognised the problem and in August 2007 reached agreement on a framework for crisis management in the EU in the form of a "memorandum of understanding". However, it remains to be seen whether this stands the test in practice.

3. SGP deserves a second chance

Budgetary discipline is a cornerstone of EMU

The Stability and Growth Pact (SGP) is the only concrete agreement on the coordination of fiscal policies between the EMU countries. As budgetary discipline is one of the cornerstones of monetary union, the rationale behind the SGP still basically applies also after the

[31] For a detailed discussion see Walter, Norbert and Stefan Bergheim (2008). ECB objectives and tasks, price stability vs. Lender of last resort. Deutsche Bank Research. EU-Monitor 52. Frankfurt am Main.

reform in 2005. Firstly, it is a question of the “mix” between monetary and fiscal policy. The SGP’s aim is to prevent strains on monetary policy because fiscal polices are too lax. This risk exists if excessive national budget deficits fuel inflation within EMU, forcing the ECB to hike rates (or limiting its scope to lower rates). Secondly, fiscal policy in EMU has to prevent a “bandwagon“ problem since budget offenders can longer be penalised through a devaluation of their currencies and/or higher interest rates, and the repercussions of unsound policy would spill over to the euro area as a whole in the form of higher inflation and interest rates. Finally, budgetary discipline is also necessary in order to avoid imposing excessive debt burdens on the public and future generations.

Hefty criticism in the stress phase

Despite that, the SGP drew hefty criticism in the early years of EMU. This was the case especially in the stress phase in the years 2002-2005. Germany and France especially felt themselves constrained in their fiscal sovereignty and opposed the application of the rules including sanctions.[32] Germany for instance criticised that the prolonged phase of economic stagnation, the costs of reunification and its structural reforms had led to a difficult budget position that was not taken into account in the Pact.

In this stress phase of the Pact the governments received backing from economists who criticised for instance that the unreformed SGP was too rigid and had a procyclical effect.[33] They therefore called for an “economically meaningful” reform. The 3% of GDP limit for budget deficits especially was seen as a straightjacket that would prevent the necessary flexibility in economic policy in downswing phases. Furthermore, the basic objection was raised that fiscal policy within EMU needed to be more rather than less flexible because governments no longer had monetary and exchange rate policy at their disposal as national instruments to stimulate the economy. This argument is right in principle for the only economic policy action parameters left at the national level, besides fiscal policy, are structural policy and wage policy. So within EMU this means a permanent tension for EMU participants between budgetary discipline, on the one hand, and the necessary fiscal policy flexibility, on the other.

More flexibility through reform

The aim of the SGP’s reform in 2005 was greater flexibility and an economically more expedient interpretation of the rules, which was widely criticised as watering down fiscal policy. However, this view does not hold up. We need to differentiate between the preventive and corrective arms of the reformed Pact, whereby there are both expedient and problematic elements in each. To begin with, it is positive that the thresholds of 3% of GDP for budget deficits and 60% of GDP for total public debt were left untouched. In the case of the preventive arm, designed to avoid excessive deficits, the positive aspects predominate. An important one is the principle that, over the economic cycle, budgets should be balanced. Those countries whose total public debt is below 60% of GDP are allowed more fiscal policy leeway – that is a (small) cycle-adjusted budget

[32] Sanctions can be imposed in the excessive deficit procedure for budget deficits in excess of 3% of GDP initially in the form of a non-interest-bearing deposit with the ECB and, if effective corrective action is not taken, in a definitive fine that is allocated to the non-offenders. The amount of the deposit or fine consists of a basic amount of 0.2% of GDP and a variable component, with a total maximum ceiling of 0.5%.

[33] Roubini, Nouriel, Parisi-Capone Elisa and Christian Menegatti (2007). Growth Differentials in the EMU: Facts and Considerations. RGE Monitor.

deficit[34]. A central element is the EMU participants' express commitment to step up budget consolidation in economic good times and to reduce the structural deficit by 0.5% of GDP per annum without taking one-off measures into account.

The corrective arm is problematic

Sustainability is reinforced...

With the corrective arm for reducing excessive budget deficits, on the other hand, the critical points predominate. The Pact's reform did not remedy the problematic decision-making structure – budget offenders can participate in the decision on their own case in the ECOFIN Council. However, this is addressed in the upcoming Treaty of Lisbon. Positive is that the focus is placed on the sustainability and quality of fiscal policy and that the medium-term fiscal planning with a view to demographic problems is strengthened. Another important point is that structural reforms that burden the budget in the short term but further growth in the long term can be taken into account.[35]

... but broad scope for discretion

Among the negative factors is that the Pact's reform has considerably widened the ECOFIN Council's discretionary scope provided for by treaty. For instance, an excessive deficit is no longer deemed to exist "if an excess over the reference value is only exceptional and temporary and if the ratio (of budget deficit to GDP) remains close to the reference value of 3%". There is also broader scope for discretion in the event of weak growth, which under the old Pact was defined as a fall in GDP of between 0.75% and 2%. Here, the definition of a severe economic downturn has been considerably relaxed and the Council's right to make an assessment extended to cases of protracted stagnation or persistently weak growth. The reform also allows the adjustment path to correct an excessive deficit to be extended beyond one year. A risk is that the consolidation process is drawn out, there is not enough consolidation in the next upswing phase, and the SGP's preventive arm is weakened (see Appendix "Comparison of old and new SGP").

Proven in good times...

... but test still to come

The reformed SGP has proved its value since 2005 in good economic times. However, it should not be forgotten that the lion's share of the consolidation was thanks to the strong economic upswing since 2006. The political test of the reformed Pact under weak economic conditions is therefore still ahead. At the moment the markets' focus is on France, whose budget deficit will probably top the 3% of GDP mark in 2008 if policies are not changed. The Eurogroup's objective to achieve a balanced budget by 2010 was recently put off until 2012. The Commission responded with a policy recommendation to step up consolidation.

4. Eurogroup assigned more responsibility

Useful discussion forum

The Eurogroup, consisting of EMU finance and economics ministers, has come to play a very useful role as a forum for discussing common issues and for coordinating economic and fiscal policies within EMU. Occasional fears that the Eurogroup would increase the risk of a rift in the EU have not been borne out even

[34] Countries with "medium" debt of around 60% of GDP, on the other hand, should achieve a balanced budget or surplus. Countries with high public debt (e.g. around 100% of GDP) are required to achieve budget surpluses over the cycle.

[35] For instance, it will be possible to claim that the net government cost of introducing a mandatory fully-funded pillar in the pension system for the first five years from its introduction be considered in the assessment of an excessive budget deficit. This will be degressive, i.e. during a period of five years consideration will be given to 100, 80, 60, 40 and 20 percent of the net cost of the reform in the public pension system.

after its enlargement to the East and the admission of 12 new EU member states. After all, the majority of the EU member states participate in EMU (15 out of 27). Still, there have also been some weaknesses in the coordination of fiscal policies, especially with regard to the correction of excessive budget deficits which some EMU countries – above all Germany and France – posted in the years 2002-2005. In this phase peer pressure in the ECOFIN Council for instance proved to be a blunt weapon.

This made the nomination of Luxembourg's premier and finance minister Jean-Claude Juncker as president of the Eurogroup as from January 2005 all the more significant. Since then it has displayed greater leadership continuity, has enjoyed a better public image and has gained in international stature. The Eurogroup has been beneficial for monetary policy in that stronger governance has also helped to improve the coordination of fiscal policies within the framework of the reformed SGP.

Scope for coordination very limited

Provision is made by treaty for a regular exchange of views between the Eurogroup and the ECB on monetary and fiscal policy and on the policy mix.[36] However, since 2005 Eurogroup's president has repeatedly pressed for further meetings with the president of the ECB to intensify the cooperation. However, the ECB has little scope for manoeuvre in this direction as its independence places narrow limits on the (advance) coordination of monetary and fiscal policy. The ECB president has therefore rightly turned down a still closer cooperation.

Treaty of Lisbon strengthens Eurogroup

The Treaty of Lisbon's objective to moderately strengthen the role of the Eurogroup and to increase policy coordination within the euro area is therefore appropriate.[37] The Eurogroup is also officially recognised as "Euro ECOFIN Council" and the term "Eurogroup" is used in the treaty for the first time. This reflects the growing political influence of the Eurogroup within the EU and at the international level. Nonetheless, in the Treaty of Lisbon the Eurogroup is not regarded as an official version of the Council; only the existing practice of informal meetings is affirmed. The fact that the election of a president of the Eurogroup is formally written into the Treaty of Lisbon is merely in deference to the reality since 2005. Still, it is recommended that the Eurogroup should use the improved framework created by the Treaty of Lisbon to strengthen the coordination among its members. In addition, the Eurogroup will be called upon to play an increasingly important role in future in representation at the international level (e.g. IMF, G7) and in exchange rate policy.

Strengthen EMU's global weight

The Lisbon Treaty's objective to strengthen EMU's weight in international organisations is a reflection of the growing international role played by the euro. So far the rules for international representation have been complex and intransparent. In the case of the IMF and G7 the rules are complicated and are more of a transitional nature. A problem in bundling EMU's external representation in the G7 is that the national finance ministers and central bank governors of Germany, France and Italy have shown no readiness as yet to cede their seats in the G7 to the presidents of the Eurogroup and ECB.

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[36] Provision is made for three joint meetings a month which should be sufficient for an exchange of views between the ECB and the Eurogroup.

[37] At present the ratification of the Lisbon Treaty is pending due to the negative outcome of Irish referendum in June 2008.

Changes in the Eurogroup's favour are only likely here in the long term.

EMU must speak with one voice

In the case of the IMF the policy is that countries with quotas and voting rights are represented. Together, the EU member states hold over 30% of the quotas and the EMU countries about 23%. This compares with about 17% for the USA. The ECB only has observer status. Strengthening the role the eurozone plays in the IMF will mainly depend on two factors. Firstly, the Eurogroup must reach a common stance on important issues so that it can speak with one voice. The small and medium-sized EMU countries have a far greater interest in the eurozone's common representation in the IMF because – unlike the big EMU countries – they cannot exert influence through the G7[38]. On the other hand, a bundling of the eurozone's quotas would very likely have to be bought at the expense of a smaller common voting right compared to the aggregate votes of the EMU member states at present.[39] It is therefore likely to be politically difficult to position EMU as a currency area in its own right within the IMF. Nonetheless, a strengthening of the euro's representation within the IMF could take place within the framework of a readjustment of the quota structure which is necessary anyway to take account of the increased weight of the emerging economies.

Challenge of exchange rate policy

The Eurogroup could face new challenges in future exchange rate policy against the dollar. The exchange rate arrangement for EMU agreed by treaty – the ECB is responsible for day-to-day exchange rate policy and the Eurogroup/ECOFIN Council for the exchange rate regime (e.g. fixed or flexible rates against the dollar) – has stood the test better than expected, although a goal conflict between price and exchange rate stabilisation has been immanent since 1999. This has not materialised as yet because there was a system of flexible exchange rates between the leading currencies of dollar, euro and yen. However, this could change if, to reduce the euro's current overvaluation against the dollar, exchange rate agreements were to be reached for defending given target zones which could place the ECB in a goal conflict between price stability and exchange rate stabilisation. There was a comparable situation in 1985 with the Plaza Accord. However, then it was a question of bringing about an orderly as possible reduction of the dollar's overvaluation against the D-Mark and yen.

5. Economic policy guidelines place emphasis on structural reforms

Economic policy coordination takes place – beyond the SGP – also via the economic policy guidelines. These consist of broad guidelines for all member states as well as structural policy measures and priorities for individual countries. Structural policy reforms in the areas of labour market, taxation and welfare systems are designed to create more growth and employment. They are helpful for the

[38] The eurozone's representation in the G7 is complicated, too, because in this case it even depends on the matters to be dealt with on the agenda. While the president of the Eurogroup and the ECB president are always present, the national central bank governors of Germany, France and Italy only take part as well when it is a question of coordinating international economic policies or the financial architecture.

[39] A reorganisation of the IMF quotas is currently in progress to take account of the growing economic weight of the dynamic emerging and developing economies. Even without a common representation of Euroland in the IMF many emerging and developing countries are demanding a further reduction of the EU's "over-representation" in the IMF.

Integrated guidelines designed to coordinate economic policy

Under the reform pact agreed at the EU summit in March 2005 the economic policy guidelines and the employment guidelines were combined. The new document is called integrated guidelines for growth and employment. As an overarching economic policy coordination instrument it spans the whole spectrum of macroeconomic, structural and employment policy measures.

The integration of the economic policy guidelines and the employment guidelines is intended to create a greater coherence of the three dimensions. The integrated guidelines are agreed for a period of three years, currently for the years 2008 to 2010. The economic policy guidelines continue to consist of a general macroeconomic part (where there is usually little change over the three years) and a country part that can be adjusted each year.

functioning of monetary union as they make for greater labour market flexibility and labour mobility for instance and strengthen the ability to absorb asymmetric shocks.

The economic policy guidelines serve as a platform for implementing structural policy measures within the framework of the 2000 Lisbon Agenda that was revised in 2005. The earlier agenda had ambitious goals, for instance to make the EU the most dynamic and competitive economic area by the year 2010 and to achieve an average growth rate of 3%. Positives now are the tighter focus of the objectives, the emphasis on growth, and the clear demarcation of the responsibilities of the European Commission (above all for the single market) and the member states (for structural reforms). On the other hand, the targets, to raise the employment rate to 70% by the year 2010 and research and development spending to 3% of GDP, were rightly retained. At its summit in March 2008 the European Council took a mostly positive view of the results of the 2005-2008 cycle and resolved to leave the guidelines unchanged for the period 2008-2010, whereby the emphasis is on the implementation of structural reforms. In this connection the Council's main recommendation is to consolidate public finances in the medium term, to continue with deregulation and market liberalisation in the services sector, and to increase labour market flexibility. Full implementation of the Services Directive is a key element on the single market side.

Structural reforms start to take effect

The reduction of the unemployment rate in the euro area from 8.8% to 7.4% in the period from 2005 to 2007 was mainly due to the economic recovery. However, the structural reforms are also beginning to take effect, as the rise in employment rates among female and older workers in some countries indicate. Nonetheless, despite the progress employment rates in many Euroland countries are still below the Lisbon target of 70%. Research and development spending in most Euroland countries was below 2% of GDP in 2006, too, and is unlikely to reach the Lisbon target of 3% by 2010.

Further structural reforms desired

This suggests that the track record in economic policy coordination within the framework of the economic policy guidelines has been fairly modest so far. The instrument of peer pressure in the ECOFIN Council has proved to be a blunt weapon not only in the coordination of fiscal policy under SGP but also in the enforcement of structural reforms. A flaw in the coordination is that the EMU states show too little national commitment ("ownership") to structural reforms even though the EMU countries especially would need greater flexibility and mobility of production factors. The instrument of National Reform Programmes (NRPs), which was conceived in preparation for coherent structural policy measures in the member states, is not being used effectively. The NRPs filed with the Commission are often too long and too intransparent. They lack a standard format of the kind that exists for instance for EMU participants' annual stability programme reports to the Commission. It would therefore be recommendable for governments in future to set clear priorities for structural reforms in the NRPs and to conduct an economic policy debate on this at the national level. This would improve the chances of structural measures being implemented within the framework of the economic policy guidelines.

Limits to coordination

Coordination within the framework of the economic policy guidelines comes up against limits within EMU, as in the EU, since it is voluntary, is not linked to results, and depends on the political resolve. An important problem is that structural reforms that bring disadvantages for some groups in the short term and only promise to produce benefits in the long term are increasingly difficult to push through in a globalised world. An added factor is that the phase of strong global economic growth from 2003 to 2007 sparked a strong controversial public debate in many industrial countries over the growing imbalance in income distribution. On the other hand, the weakening economy should support the argument for tackling structural reforms as this would significantly improve the prospect of economic recovery. An objective of the European Commission is therefore to make structural policy measures more binding on policymakers. Under the new Treaty of Lisbon it can issue a warning – as under the SGP – if a country is behind with the implementation of structural reforms in line with the economic policy guidelines. However, whether this will succeed is open to doubt in view of the lack of political resolve.

IV. Outlook and recommendations for better economic governance

Risks to EMU's cohesion

Important for a beneficial development in the future is for EMU institutions and the member states to do their homework and abide by the proven rules of economic governance. Above all this includes the advocacy of price stability, the ECB's independence, budgetary discipline, and open markets. These principles will doubtless still apply after another ten years of EMU. With the reform of the stability pact and the creation of the integrated guidelines economic governance within EMU has already undergone a first major revision. Beyond that, there is at present no essential need for reform. However, there are a number of risks to EMU's future cohesion which those responsible for economic policy need to keep in mind.

Budget policy

Firstly, there is the insufficient budget consolidation in economic good times. Responsible consolidation is necessary, however, to increase the scope for anti-cyclical fiscal policy, at least through the automatic stabilisers. In addition, provision has to be made for the growing fiscal burdens caused by demographic changes. Insufficient consolidation would mean higher interest and tax burdens, and thus dampen growth prospects, for the increasingly smaller future generation.

Insufficient structural reforms

Secondly, insufficient structural reforms because the opportunities for a stronger flexibilisation of factor prices are not utilised. Growth potential would thus not be fully exploited and the vulnerability to external shocks increased.

Focus on distribution

Thirdly, the strong focus of the public debate on distribution aspects should be taken seriously. It reflects the concern among broad sections of the population that, as a result of globalisation, they are not participating or not participating enough in the fruits of the growth, and are the losers in the globalisation process although the winners are in the majority. This increases the risk that structural reforms go under in the political process.

Corrections needed in income taxes

Fourthly and closely connected with the third point, there is a need in a number of EMU countries to correct areas in the income tax tariff that discourage achievement and to relieve middle-bracket incomes. The intensive distribution debate could easily distort the perspective for where corrections in income taxes are necessary.

Diverging competitiveness

Fifthly, divergences have arisen in competitiveness within EMU that can put the acceptance of the euro and EMU's cohesion to a decisive test. The southern states for instance need to be more restrictive. Structural reforms must also play an important corrective role here.

Test of economic governance still to come

Finally, the reformed economic governance has yet to be tested under stress conditions – e.g. weak growth. This will probably be the case soon for, after five years of strong global economic growth, a slowdown – emanating from the USA – is now under way and, despite the continued dynamic development in Asia, will leave its mark on Europe. Moreover, the inflation trend in EMU shows that the ECB will need to keep a watchful eye in its stability policy. In Germany we are all too aware from the inflation experiences of the 1970s and 1980s how difficult it is to maintain price stability "at home" in times of globally rising or high inflation rates. The word stagflation is already in people's mouths. It is therefore likely that the monetary union boat will need to be steered through rougher global economic waters at the start of its next decade.

Nonetheless, the risks mentioned are unlikely to place the monetary union's continued existence in question. The political commitment to this project is firmly anchored in the participant countries. All the same, coping with the above risks will be easier if the EMU countries gird themselves in good time.

Ten conclusions

Looking ahead, the following ten economic and monetary policy conclusions might be worth considering to improve economic governance within EMU:

1. *EMU lacks the fiscal policy structures to enable it to take reflationary measures in the event* of a recession because – in contrast to the USA – the central budget is too small with expenditure of 1% of GDP and budgetary policy is largely decided decentrally. EMU therefore needs large leeway for automatic fiscal policy stabilisation at the national level so that an overrun of the 3% deficit limit can be avoided in the downswing phase.

Budget policy: building reserves in good times

<u>*Conclusion*</u>: *The member states must create the leeway for an anti-cyclical fiscal policy in which the automatic stabilisers can take proper effect. This means much stricter consolidation in boom phases than is currently the case (France is a bad example). The reformed SGP expressly requires such a fiscal policy course. The Commission and especially the Council need to enforce rule-compliant conduct more rigorously and for this purpose also use the instruments provided for in the Treaty of Lisbon.*

2. *EMU countries with high public debt of over 90% of GDP (Greece, Italy) are particularly vulnerable to a further deterioration of their budgetary positions* because a weakening of the economy or a rise in interest rates can quickly cause the budget deficit to rise above 3%.

Reduce high debt ratios

<u>*Conclusion*</u>: *The European Commission and the Council should agree a longer-term strategy with the countries concerned to bring public debt down in the direction of 60% of GDP*. If the consolidation targets are missed, an excessive deficit procedure should be initiated swiftly and sanctions imposed. Uncooperative behaviour should be communicated clearly to the markets (and rating agencies) to exert greater pressure for higher interest rates (via a higher risk premium) on the respective country's public debt.

3. *Economic policy coordination takes place – beyond the SGP – via the economic policy guidelines* consisting of broad principles for all member states and structural policy priorities and measures for individual countries. However, the coordination of structural policy measures within the framework of the economic policy guidelines comes up against limits within EMU, as in the EU, since it is voluntary, is not linked to results, and depends on the political resolve.

Set national priorities for structural reforms

<u>*Conclusion*</u>: The debate over growth-furthering structural policy measures needs to be firmly anchored at the national level. The governments should tighten up the National Reform Programmes and *set clear priorities for structural reforms. These often need political opinion leadership* to push them through.

4. *There are many proponents in favour of a stronger coordination of economic policy – catchword "European economic government"*. The integrated guidelines include the economic policy guidelines, which are concerned, among other things, with structural reforms, and employment policy, which has evolved from a marginal into a central part of the coordination. The open method of coordination has thereby played an important role as a lever for widening the EU's reach. This method has become established as a flexible path of voluntary coordination in areas where the EU has no powers by treaty.

Heed limits to coordination

<u>*Conclusion:*</u> *A more efficient coordination in the area of structural reforms within EMU is welcome. However, the demand for better coordination should not serve as a door opener for accumulating more and more powers at the EU level in other areas* such as labour market, employment and social policy. Flexible labour markets and labour mobility are beneficial for the euro. Structural reforms at the national level can contribute to this. System competition should not be impaired through excessive coordination since this simplifies price stabilisation with the euro.

5. *Germany has seen a devaluation in real terms since 1999 within EMU* because the inflation rate was below the EMU average. As a result, *Germany has been criticised* for pursuing a *"beggar-thy-neighbour" policy*. Germany has strengthened its competitiveness substantially through a combination of massive corporate restructuring, wage restraint and (moderate) reforms within the framework of the EU rules and has returned to a growth path.

Correct distortions in competitiveness

<u>*Conclusion*</u>: The "beggar-thy-neighbour" criticism is not justified as Germany used the adjustment possibilities available within EMU. Each country has to *pursue own avenues to strengthen its competitiveness* – according to its specific structures. Key elements here are budgetary discipline, structural reforms, wage restraint and corporate restructuring. In this connection a serious incentive problem will continue to exist in future in that bad economic policy on the part of an EMU participant is not "penalised" by (significantly) higher market rates. This is due to the markets' firm conviction that because of the close interdependence each EU member states can rely on the help of the partner countries in an emergency, i.e. the "non-bail-out" clause in the EU Treaty will not be exercised (see also point 2).

6. EMU enlargement makes the *decision-making process in the ECB Governing Council* more difficult. The rotation model – the ECB's answer – could already come into force from 2009.

However, it has serious drawbacks as it is very complicated and intransparent.

Rotation process: a simple solution would be better

Conclusion: A simpler, more transparent solution would be better, for instance a *representation solution* on the lines of the US model. In this model the regional representatives in the monetary policy-making committee also rotate while New York, as the international financial centre, has a permanent seat. France and Germany, as the biggest economies with the leading financial centres in the eurozone, should be permanently represented in the ECB Governing Council while the representatives of the other EMU countries rotate.

7. The debate over the ECB's role in coping with the repercussions of the subprime crisis in Europe has highlighted some short-comings in crisis management and in the institutional framework of the supervision in the financial services sector.

Strengthen crisis management

Conclusion: Increasing financial market integration and the growing importance of cross-border banking operations make a *Europeanisation of the supervisory structures in the financial services sector* more and more important. This applies both to crisis prevention and to effective crisis management which requires close interaction between central banks, regulatory authorities, governments and market participants. The EU member states have recognised the problem and in August 2007 reached agreement on a framework for crisis management within the EU in the form of a "memorandum of understanding". However, it remains to be seen whether this will stand the test in practice.

8. In the *EMU enlargement process* the issue has been debated again and again *whether the convergence criteria for EMU accession are still appropriate*. The convergence criteria have proven their value and should be retained in the interest of equal treatment.

Adjust inflation criterion

Conclusion: *Expedient modifications should not be ruled out from the outset.* The *inflation criterion* is relative, i.e. based on the average of the three best-performing EU countries. However, as 10 years on from the euro's introduction only 15 of the 27 EU member states have joined EMU, it might not be such a good idea to make a country's admission conditional on inflation rates of EU countries that are not EMU participants. The benchmark could be the average of the three EMU countries with the lowest inflation rates. However, a better solution would be to take the ECB's definition of price stability – inflation rate below but close to 2% – whereby the margin in the reference value would need to allow flexibility but be significantly less than 1.5 percentage points.

9. It is an explicit objective of the Treaty of Lisbon *to strengthen EMU's weight within the international organisations*. More responsibility and influence are appropriate in view of the euro's growing international role. So far the arrangements for representation in the international forums (e.g. IMF, G7) have been complicated.

Strengthen international voice

Conclusion: The Eurogroup should make active use of the improved framework conditions provided for in the Treaty of Lisbon to *speak with one voice at the international level and thus increase EMU's global weight. This requires first of all the resolve and commitment to internal opinion-forming including (internal) coordination among the E(M)U external* *representatives. Adjusting the structures of international representation then follows as the next step. But that stage will probably still be a long way off.*

10. The euro's value against the dollar is currently very high. Companies in the eurozone have to bear a considerable adjustment burden in the reduction of the huge US current account deficit, and the economic risks in Europe are on the rise. However, the current account balance in the eurozone is more or less balanced. As Japan and China are each generating high current account surpluses, a marked appreciation of the yen and yuan against the dollar would be appropriate.

Avoid excessive adustment burden

Conclusion: The possibilities for EMU to influence the exchange rate development of the major currencies are currently small. This was also demonstrated by the visit of EMU's three official monetary representatives – the Commissioner for Monetary Affairs and the presidents of the ECB and the Eurogroup – to China in October 2007. However, in EMU's interest a further strong overshooting of the euro/dollar exchange rate should be avoided at present. It would therefore be important for EMU to push through a corresponding exchange rate orientation within the G7.

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The author wishes to thank Tim Steffens for contributing to this study.

Appendix

1. The "Teuro" (expensive euro) debate: Perceived inflation higher than actual inflation

After the euro banknotes and coins were introduced at the beginning of 2002 there was a heated debate in a number of EMU countries over whether the official statistics still measured inflation trends correctly as the inflation rate perceived by the public ("felt inflation") was much higher than the official rate. In Germany this led to the coining of the word "Teuro" (expensive euro). According to a survey conducted by the European Commission in autumn 2002 over 75% of the population in the EMU countries claimed that prices had risen sharply during the year after the euro notes and coins were introduced. This compared with an officially measured inflation rate of only 2.2% on average in 2002 (Germany: 1.3%). The "felt" inflation detracted from the euro's acceptance and the credibility of the established official price statistics.

The fact of the matter is that with the introduction of the euro notes and notes Euroland witnessed a price jump in the official inflation rate from 2.0% in December 2001 (Germany: 1.7%) to 2.7% in January 2002 (Germany: 2.1%). The reasons were a strong rise in fruit and vegetable prices due to a bout of cold weather in southern Europe, hikes in consumer taxes in some countries, and appreciable price increases for frequently used services, especially in the gastronomy, hairdressing and cleaning trades. In the latter case the euro might have served as the opportunity but was hardly the cause of the price increases. The "Teuro" debate also resurged again and again in the following years, e.g. in 2007/08 in response to globally higher grain and dairy product prices.

The problem of felt inflation led to further studies. A special analysis by the Federal Statistical Office for Germany in 2005 revealed that, with an increase of 3.3%, prices had risen less strongly in the 30 months after the euro notes and coins were introduced than in the 30 months before currency conversion. Still, this did little to put the debate on a more objective basis. In collaboration with the Federal Statistical Office Prof. Brachinger (Freiburg University/Switzerland) developed a "perceived inflation index" (IWI). In the early stages of EMU the perceived inflation rate was even below the official rate at times but from 2001 to 2003 was three to four times as high.

The IWI index tracks the subjectively perceived rate of inflation by giving a stronger weighting to everyday staple goods. This takes account of the following insights in perception psychology: (1.) People perceive (purchasing power) losses as a result of rising prices more strongly than gains as a result of falling prices, (2.) Increases in the prices of frequently purchased staple goods and services are registered more strongly than price reductions in consumer goods that are purchased less often (e.g. PCs); (3.) Consumers compare the current prices not on the basis of year-earlier prices but with 2001 DM prices.

Conclusion: In the "Teuro" discussion it should not be forgotten that the official and the perceived inflation rates are based on completely different methods. The official measurement of the rate of price increase has proved its worth for years and remains the basis for important economic decisions, for instance in monetary policy or in collective wage bargaining. The IWI index is at best a complement but not a replacement for the official statistical measurement of inflation. Hence, the euro is not a "Teuro".

2. Euro banknotes and coins largely accepted

In the transition period from 1999 to 2001 the euro only existed as a currency on paper and the old national currency functioned as a "non-decimal sub-unit of the euro". This was difficult to communicate to the public and detracted from the euro's acceptance. It was only with the introduction of the euro notes and coins at the beginning of 2002 (and the withdrawal of the old national notes and coins from circulation) that the euro became a fully-fledged currency that was visible and tangible for people. The euro first became legal tender in 12 countries. Slovenia followed at the beginning of 2007, and Malta and Cyprus at the beginning of 2008. According to the ECB the total volume of notes and coins in circulation at the end of 2007 amounted to 697 billion euros. The 50 euro note is the mostly widely used. Coins account for only 19 billion euros, or 2.8%, of the total currency in circulation.

According to a Eurobarometer survey conducted in 2006 the euro banknotes and coins are no problem for most people. When buying staple goods and services they largely calculate in euros. This is also increasingly the case with major purchases (e.g. cars or homes). The biggest advantages are said to be cheaper travel within Europe and that prices can be compared more easily. Many people see the price increases with the introduction of the euro notes and coins as a drawback (see box on "Teuro")

The denominations of the euro banknotes and coins are now largely accepted after some problems with the use of euro coins in the early stages in those countries where there had more or less only been national banknotes in circulation before the euro notes and coins were introduced, for instance in Italy, Austria and Greece. In these countries coins were felt to be inconvenient. The popularity of banknotes in small denominations, widely used for tips, sparked a lively discussion about the introduction of a 1 euro note. The 1 dollar note, which enjoys great international popularity, served as a model. However, the ECB rejected this idea in 2004 on the grounds that EU-wide demand for a 1 euro note was small and it was more costly to print than it was to press a 1 euro coin.

Opinions on the circulation of 1 and 2 cent coins also differ. In Germany 1 and 2 cents are kept in circulation because catch prices (e.g. 99 cents) play an important psychological role in the retail trade and an additional price-inflating effect is feared if many retail prices might be rounded up to the next full 5 cents. Some countries, on the other hand, consider the minting of 1 and 2 cent coins and their use in the retail trade to be too costly. Finland for instance did not introduce these coins into circulation from the outset and only minted them for collector purposes. The Netherlands and Belgium withdrew the 1 and 2 cent coins from circulation again from 2004. In all these countries prices are rounded up to the next 5 cents.

3. Stability Pact	Old	New
Small, temporary excess allowed in case of:	an exceptional event, e.g. natural desaster a severe recession (fall in GDP > 2%) "other relevant factors"	additionally: financial strains as a result of structural reforms, "other relevant factors": research European policy goals international solidarity investment programmes pension reform consolidation packages particularly high EU contributions
Excessive deficit possible in case of:	fall in GDP > 2% fall in GDP > 0.75% additionally in case of: abrupt downturn loss of output other exceptional circumstances	additionally in case of: protracted economic stagnation, or very weak growth
Time frame for deficit reduction:	in the year after identification	additionally: savings of at least 0.5% of GDP p.a. taken into account in initial deadline in special circumstances initial deadline can be in 2nd year after identification deadline can be extended in the event of visible budgetary efforts and weak economy
Implementation of recommended measures:	in 4 months	in 6 months
Medium-term budget objectives:	balanced budget or surplus	1% deficit in case of low debt and high potential growth Otherwise, 0% deficit or surplus
Saving and debt reduction in good economic times		0.5% p.a. reduction, without one-off measures unexpected extra revenues to be used to reduce debt early warning

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EU Monitor

ISSN 1612-0272

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-0272 / ISSN Internet and e-mail: 1612-0280