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The European Union in EMU and beyond

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EMU is the big event of the year. It is not a leap in the dark: it is the completion of a very long--standing ambition. As early as 1969, the Heads of State and Governments had assigned EMU as a goal for the European Community.

We are now little less than a year from 1 January 1999 and the prospects for a successful launch of EMU are highly encouraging. This is why I will focus on the state of play in preparations for the launch and functioning of EMU, before addressing a much more difficult topic: Europe with EMU and Europe beyond EMU.

1. Where do we stand?

The high credibility of EMU is the result of several factors.

Firstly, progress in convergence. Preparations for EMU began with the signing and ratification of the Maastricht Treaty. Among the immediate objectives at that time was an acceleration in the process of convergence among Member States towards price stability, sound public finances and a stable exchange rate — now, five years later, this process is well advanced. The vast majority of the fifteen member states are now very close together in terms of low inflation and sound public finances. As an illustration, it is worth noting that annual inflation rates in the member states ranged between 2.4 % and 19.8% in 1991 but that range will have narrowed to between 1.3% and 6% last year. Member-state budget balances in 1991 ranged from a surplus of 1.9% to a deficit of 11.5% in terms of GDP but this range has narrowed to between a surplus of 1.4% and a deficit of 4.9% in 1997. These achievements in convergence are even more impressive in view of the weak cyclical conditions experienced by most of the member state economies since 1992.

Another vital factor contributing to EMU credibility is without doubt the depth of *political commitment* to the project among the governments of EU member states. The willingness of governments to reach agreement on far-reaching and politically-sensitive issues relating to EMU has been demonstrated time and again. Furthermore, many unpopular economic policy measures have been taken by the national governments and endorsed by their parliaments in preparation for EMU.

The steady *progress in technical preparations* for EMU has also fostered credibility. These technical preparations for economic management in EMU are complicated but it is essential that we get them right. The Amsterdam European Council in June 1997 put in place the main elements of the framework for economic management in EMU. These elements include the legal framework for use of the euro, the Stability and Growth Pact, the Resolution on Growth and Employment and a new exchange rate mechanism to be known as ERM2.

The importance of a *robust legal framework* is heightened by the fact that the euro and national currency units will co-exist — albeit as denominations of the same currency — during the first years of EMU, until 1 January 2002. *The Stability and Growth Pact* is also essential to the smooth functioning of EMU by ensuring a high level of budgetary discipline among the Member States. The Pact has twin objectives. Firstly, excessive budget deficits will be prevented by better surveillance of budgetary performance in the Member States. Secondly, in the event of a persistent excessive budget deficit, the relevant Member State will be required to eliminate it. Otherwise, sanctions — including financial penalties — could be applied. *The Resolution on Growth and Employment* was a late addition to the Amsterdam agenda — but is no less important for that. The Resolution lays down a firm commitment on the part of the EU to keep the issue of employment firmly at the top of its political agenda. The aim of the *ERM2* will be to prepare the «pre-in» countries for participation in the euro area by helping them to maintain discipline in their exchange rates with the euro. The functioning of the ERM2 will be supported by the enhanced convergence procedures under the Stability and Growth Pact.

Preparations are also proceeding in other areas. Private enterprises are adapting their information technology and retraining their staff to handle the euro. The investment costs of the changeover to enterprises are generally quite substantial — although these vary from sector to sector and from company to company. These investments are essential to allow enterprises to reap the full benefits of EMU and so are worth the cost. Many enterprises have calculated how long it will be before their investments are paid off by higher future returns and, in some cases, less than one year will be required. Public administrations are also gearing up for the euro. Administrations in most of the member states already have a comprehensive changeover plan. Many will offer a «full eurooption» in their dealings with other sectors of the economy from the outset of EMU.

This brief description of the current state of play in the preparations for EMU explains why we can look forward to 1 January 1999 with considerable optimism. I would now like to move on to the issue of how EMU will impact upon the future of Europe.

2. How EMU will work?

The watchwords for economic policy-makers in EMU will be «stability» and «discipline». EMU will mean that participant member states will share a common monetary policy and price stability will be the primary objective of that common monetary policy. The European central bank (ECB) will be responsible for monetary policy and will be afforded the highest degree of statutory independence. Other economic policies will remain the responsibility of the member states. However, the «monetary leadership» implied by EMU will impose important constraints on national policy-makers. In formulating their policies, they will be required to safeguard the sustainability of EMU by ensuring consistency with the monetary-policy objective of stable prices. In particular, consistency between the common monetary policy and national fiscal policies will be essential. To this end, the excessive deficit procedure of the Treaty and the Stability and Growth Pact have been designed to ensure a proper balance in the so-called «macroeconomic policy mix».

In order to ensure consistency between the common monetary policy and other economic policies within EMU, there may be a need for greater co-ordination between the Member States. The Luxembourg European Council in December last year agreed on the ways and means to strengthen policy co-ordination within EMU. On the one hand, it should be recalled that the Treaty already provides the necessary framework for policy co-ordination. This will be enhanced by the provisions of the Stability and Growth Pact. On the other hand, it will be useful for member states in EMU to «speak with only one voice» when appropriate and, to this end, a forum for informal contacts and discussions has been set up. Needless to say, this forum will be subordinate to the ECOFIN as the principal decision-making body under the Treaty.

The importance attached to low inflation and policy discipline in EMU reflects the integral relationship between macroeconomic stability and the achievement of sustainable output growth and employment creation. However, I would not like to give the impression that EMU will imply major adjustments of «economic culture» among the participant member states. The discipline of operating within a competitive single market is already familiar to the member states. Moreover, the disinflation and budgetary consolidation which the member states have already achieved in preparing for EMU illustrates that they have operated within a framework of stability and discipline for some time. EMU merely formalises that framework — making any possibility of «backsliding» toward inflationary policies even more unlikely than at present.

3. Where do we go?

EMU is not an end in itself. It is a step in the process of building an «ever closer union» among the people in Europe. As we do not know the precise meaning of these words «ever closer union», it is difficult to describe the future of the European construction/adventure. However, I will try to outline some of the main features which are likely to cast a light on our common future.

1) an improved economic policy framework
EMU represents an historic opportunity to enhance economic prosperity in Europe. Our experience of «stagflation» in the 1970s and early 1980s has proven the importance of stability for sustainable economic growth and employment creation. Meanwhile, the need to respond to an increasingly competitive world economy means that efficient resource allocation must rely as far as possible on market forces.

The foundations upon which EMU is built will guarantee the highest standards of macroeconomic stability and market competition. An independent European central bank will ensure that monetary policy is geared toward the primary objective of price stability. The Stability and Growth Pact will ensure that fiscal policies are also consistent with the price stability objective. The single currency will intensify market competition within Europe and so will help to create a more efficient EU economy. Thus, EMU provides the best economic environment in which to achieve a sustainable improvement in the living standards for all EU citizens.

2) an incentive to enhance market flexibility
EMU will have significant implications for structural policies and particularly in regard to the labour market. Given the discipline imposed by EMU at the macroeconomic level, it will be essential that member state labour markets should have the capacity to respond to changes in economic conditions. Otherwise, there is a risk of regional concentrations of low economic growth and high unemployment within EMU. Worker mobility within the European Union is low, leaving the EU labour market highly segmented between the member states. Measures to improve the mobility of workers within the EU are envisaged but cultural and language barriers are certain to limit the scale of any improvements — at least in the short-to-medium term. In consequence, labour market adjustment within EMU will occur predominantly at the member state level. It is vital therefore that steps are taken to enhance the flexibility of member state labour markets.

Already high levels of unemployment have provoked important labour market reforms with the objective to increase flexibility in the use of labour and in wage determination. However, further efforts are required. I would like to take this opportunity to dispel any notion that structural reform can be avoided outside of EMU. The effects of structural rigidities in the EU labour market are already reflected in the steady rise in structural unemployment since the 1970s. The need to address these rigidities is made all the more urgent by globalisation. In this regard, the case for exchange rate flexibility is exaggerated. Exchange rate adjustment has proven to be a poor substitute for structural reform in the EU economies where exchange rate effects on economic growth and employment have been transient. Economic rigidities are best treated at source, making labour-market reform unavoidable with or without EMU. However, the macroeconomic discipline implied by EMU will reinforce the pressure to implement such reform sooner rather than later.

3) a boost to financial markets
EMU is undoubtedly a major event for financial markets. From 1 January 1999, the European central bank will define and implement its monetary policy in euro. All new issues of government debt — and existing stocks of debt in most cases in EMU will be denominated in euro. From the outset of EMU, the volume of new government debt issued in euro will be at least equal to that currently issued in dollars by the US Treasury. I expect that private companies will be encouraged by these developments to begin issuance of euro-denominated debt and equity.

The interbank markets, money markets and capital markets of the Member States in EMU will switch rapidly to the euro. The result will be the emergence of broad and highly liquid euro financial markets. Apart from the greater size and liquidity of financial markets in EMU, the euro will also create a demand for a wider range of financial instruments. Clearly, the advantages of EMU for financial market operators will be enormous. These advantages should more than outweigh any loss of business associated with the elimination of exchange rates between the Member States in EMU.

4) a new major international currency
By ensuring macroeconomic stability and responding to the challenges of globalisation, EMU will allow the EU economy to operate more efficiently. The benefits of a stable and more efficient EU economy will certainly not be confined to Europe but will spill over to other parts of the international economy.

The most direct effect of EMU on the international economy will be the introduction of the euro as a new currency. EMU will mean the disappearance of existing national currencies in Europe so that trade between the Member States participating in EMU will be denominated in euro. It is also likely that the euro will be used as a vehicle currency and as a reserve asset by those countries having strong trade and financial links to the European Union. These would mainly include the countries of central and eastern Europe and the Mediterranean countries. The euro will be backed by large and liquid financial markets with an ample supply of euro assets. Given these developments and its inherent qualities of stability and credibility, the euro can be expected to make a positive contribution to the functioning of the international monetary system.

With these building blocks it is possible to imagine a bright future for our continent. At the very least, the European Union will be well equipped to face the next challenges ahead — enlargement and globalisation.