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TEN YEARS OF THE EURO -- LOOKING BACK AND FORWARD

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I. INTRODUCTION

Dear Minister Kalousek,

Dear Mr. Dedek,

Ladies and Gentlemen,

It gives me a great pleasure to be back in Prague, a magnificent city that has shown great resilience in overcoming past challenges and which, today, is rightly regarded as one of the most dynamic and vibrant places in Europe.

I would like to thank wholeheartedly our host, Mr. Miroslav Kalousek, Minister of Finance of the Czech Republic, for inviting me to this prestigious Conference taking place a few weeks before the Czech Republic will assume the Presidency of the European Union.

It is both a privilege and honour to be invited here today to speak for such a distinguished audience about the achievements and future challenges of the euro. The Commission, and the Council, have celebrated in May 2008 the tenth anniversary of the historic decision to launch the euro. The introduction of the euro was a historic milestone in the process of European economic, monetary and political integration, with wide-ranging implications for the countries concerned, future participants and global economies.

However, in the months since May, the economic context has changed dramatically. It almost feels as if we are in a new era.

What started as financial turmoil in the US sub-prime market has evolved into a full-blown global financial crisis with serious repercussions on the real economy around the world. No doubt, 2009 and 2010 will be difficult years.

Against this background, I will structure my comments this morning in three parts. First, I will briefly outline the main elements of the EU's response to the financial crisis; second, I will take a more medium-term perspective to look at the experiences of the first decade with the euro; and, finally, I will provide some thoughts on euro area enlargement, a major medium-term challenge both for the euro area and the countries with a derogation.

II. FINANCIAL CRISIS AND EU POLICY RESPONSE

This is neither the time, nor the place to give a full account of the evolution of events since the onset of the crisis in mid-2007. Save to say, that the collapse of Lehman Brothers – the fourth largest US investment bank – in September provoked a new and more intense phase of the crisis, sending a shock wave through the financial system and undermining what was left of investor confidence.

After the period of excessive risk accumulation, the financial system is now experiencing a painful correction. The system has entered a process of severe deleveraging, which has been characterised by dysfunctional credit markets, unprecedented write-downs in asset valuations, a generalised increase in risk aversion, and threats to the stability of the banking sector.

From the outset, the EU has taken decisive action to manage the crisis and these have been stepped up dramatically in the period following the bankruptcy of Lehman Brothers. Let me give you a cursory overview.

Already in October 2007, the EU assessed the mid-term consequences of the crisis for the financial system and adopted a comprehensive roadmap of policy responses. Implementation of this roadmap was well underway, when the crisis deepened in recent months. As the stability of the financial system has come progressively under threat, Member State governments, the Commission, and the ECB have worked closely together to contain the turmoil, protect savings and maintain a flow of credit for business and households.

The ECB stepped up its liquidity management and within four weeks lowered interest rates twice, by 100 basis points in total. Member State governments took unprecedented measures to guarantee and re-capitalise the EU banking system and restore lending between banks and to the broader economy. The measures - taken nationally but co-ordinated within a common European framework - not only averted the risk of a financial meltdown in Europe, but also set the tone for similar action in other jurisdictions.

The Commission was closely involved in the design and coordination of these policies – albeit perhaps not always fully visible in the public. The Commission has facilitated the rescue measures by speeding up its decisions on state aid aspects, taking account of the exceptional circumstances in the financial system while safeguarding a level playing field in Europe.

The Union also acted decisively in providing EUR 6.5 billion of balance of payments support to Hungary, in cooperation with the IMF. Finance Ministers agreed to expand the relevant EU Balance of Payment financing facility to a potential EUR 25 billion. Our action in this area is not only a strong signal of solidarity in Europe, it also signals that Europe has the means and the willingness to act rapidly when circumstances so require. An important signal to prevent the crisis from spreading further.

Even as we deal with the immediate crisis, we have to think further ahead. The crisis has exposed weaknesses in our financial system. The Commission continues to work with other bodies in implementing the October 2007 roadmap. In this context, we have accelerated work on a package of precise measures addressing some of the root causes of the crisis in order that a crisis of this scale does not and cannot happen again in the future.

This package includes reform proposals for capital requirements for banks, deposit guarantees, accountancy rules, the regulation of credit agencies, and an initiative on executive pay. We are also working on regulating derivatives, hedge funds and private equity. And a high level group chaired by Jacques de Larosière has been established to come up with proposals on how to improve cross-border supervision in Europe.

Given the global nature of international financial markets, we need to ensure that in parallel to our European efforts we take our international partners along. Such considerations explain European leadership in initiating the G20 Leaders' meeting held in Washington DC earlier this month, and the ambitious agenda of regulatory and institutional reform that has come out of that meeting.

Finally, we must not forget that the financial turmoil is having considerable fallout for the real economy. As companies and households find themselves increasingly credit constrained, economic confidence has declined sharply in recent months. Housing market corrections are weighing heavily on some advanced economies. And, with the

US and some European countries in recession, the outlook is darkening for emerging economies too. For the EU economy this makes for a very bleak outlook for 2009 and 2010, with worrying implications for employment and private households.

The outlook is also exceptionally uncertain. There is a real risk that if the financial stress intensifies further or lasts for a very long period, its impact on the economy could be even bigger, fuelling the negative feedback loop between the economy and the financial sector we are seeing at play already.

Given the severe risks of a deep and protracted recession, there is a strong case for coordinated complementary action to support the real economy. Faced with the most difficult economic situation in decades, the EU needs to mobilise a concerted and coordinated policy response as we have done in the financial sector. This means using all the policy instruments we have available to limit the slowdown, protect jobs and lay the ground for a sound recovery.

With this in mind, the European Commission proposed a framework to help us move from crisis to recovery on 29 October. This framework will be expanded in a Communication to be presented tomorrow.

III. EMU10 -- SUCCESSES AND CHALLENGES AFTER 10 YEARS

Let me now turn to the 10th anniversary of the euro and the Commission's EMU@10 report. I believe that current events – far from pushing the euro to the background – have highlighted the advantages of the single currency and shown the value of deepening euro area policy coordination.

Imagine for a moment the scenario of this financial crisis without the euro. Central bank policy co-ordination would have been hugely more complex, with a much higher risk of uncoordinated policy responses and vastly greater scope for speculative behaviour by market participants to seek to exploit policy differences.

The strong euro also helped attenuate the impact of the oil price hikes that hit before the summer. In general, our economies are better prepared to face the current slowdown, thanks to the sound macro-economic framework and fiscal rules that underpin EMU.

So the euro is proving a major asset in these difficult times.

But also if you look at the picture from a longer-term perspective, the benefits are striking. Inflation and interest rates that were close to double-digit levels in the 1980s have been brought firmly under control during the first ten years of EMU. Investment and employment growth has been spectacular. The euro area created 16 million new jobs between 1999 and 2007. This is an important bright spot as our economies enter into the current downturn.

Yet the crisis also underscores the case for improving the euro area economy. It makes the policy proposals of the Commission's spring 2008 EMU@10 report more relevant than ever.

The policy agenda of our EMU@10 report evolves around three main pillars:

First, in the so-called "Domestic Agenda" the report calls for better coordination and surveillance. This implies the deepening of our fiscal surveillance to improve in particular the effectiveness of the preventive aspects of our fiscal framework and to gear surveillance to achieving sound fiscal behaviour and securing sustainability in the face of population ageing.

The fiscal implications of the crisis make our recommendation for deepening fiscal surveillance particularly urgent. The public finances of many Member States are likely to be truly tested over the period ahead.

We want to improve the effectiveness of the preventive arm of the Stability and Growth Pact and gear surveillance to achieving sound fiscal behaviour and securing sustainability in the face of population ageing. Budgetary surveillance should also put greater emphasis on enhancing the quality of public finances - getting better value for public money by channelling spending into growth enhancing items such as education, research and development.

Effective budgetary surveillance and peer support will be essential for anchoring medium-term expectations of an orderly resolution of the crisis and to prepare for the long-term challenges related to ageing and climate change.

The "Domestic Agenda" also implies the broadening of our economic surveillance to better address macroeconomic imbalances or changes in competitiveness among euro area Member States before they become entrenched.

In light of the developments in financial markets, competitiveness and current account imbalances have become even more relevant.

Current account imbalances are not a problem per se. However, large and persistent capital flows increase net foreign liabilities and interest burdens of the economy. We have seen that capital inflows have been used for relatively unproductive consumption and have contributed to the emergence of house price bubbles in some Member

States. The unwinding of such imbalances can have significant spillovers to other euro area countries. Therefore, these matters are very much of common concern.

The Ecofin Council has recognised the importance of avoiding the build up of macroeconomic imbalances and in October agreed to broaden coordination beyond fiscal policy and to better monitor competitiveness developments, notably within the euro area but also for ERM II countries. A first round of discussions is under way in the euro group, and perhaps already under Czech EU Presidency next year, the Ecofin intends engaging all Member States in broader macroeconomic surveillance work.

The <u>second pillar</u>, refers to the <u>external dimension of the euro area</u> and its international role. Our proposals resonate strongly in today's climate. We have seen how exposed our economies and financial systems are to shocks originating in other parts of the world. As issuer of the world's second currency, Europe needs to have a stronger role in global policy debates.

In our report we argue that building on the successful first decade, the euro area must strive for a clear and comprehensive strategy on international and economic affairs and must play a more active and assertive role in multilateral fora and bilateral dialogues with strategic partners. We see the most effective way for the euro area to align its political influence at the global level with its economic weight by developing common positions on issues like financial stability, exchange rates or the macroeconomic and financial implications of high commodity prices.

Ultimately, our long-term goal is to consolidate the euro area's fragmented representation in international fora.

The third and final pillar touches on the effective governance of EMU and makes the case for enhanced coordination in Europe. In our view, the Group of Finance Ministers belonging to the Euro area, the so-called Europgroup, should continue to serve as an informal platform for the deepening and broadening of policy coordination. At the same time, the Ecofin Council is and remains the key forum for economic policy-decision making in the EU and should integrate more systematically EMU aspects fully into its work programme.

IV. POLICY CHALLENGES AFTER EURO ADOPTION

This brings me to my last point – the future shape of the euro area.

The financial crisis has sparked a great deal of renewed enthusiasm for the euro in a number of non-participating Member States.

The Treaty provides a clear institutional path for euro adoption. Each of the recently acceded Member States is expected and is indeed welcome to adopt the euro. Each will be able to do so as soon as it meets the convergence criteria.

Like for the original participants, the euro will bring significant benefits to future euro area countries. Those benefits can be organised in two groups: integration benefits and benefits from a coherent framework for stability-oriented macroeconomic benefits.

Moreover, the current context has highlighted the 'insurance' value of belonging to a successful and large currency area in times of stress. Even a virtuous country like Denmark has been facing market stress and is now paying a large interest rate differential with respect to the euro, essentially due to an increased liquidity premium.

In an integrated EU financial market in which cross-border ownership is extensive and the euro is effectively the funding (and lending) currency for a large part of domestic credit also for non-euro area countries, participation in the euro would allow a better access to emergency liquidity. The euro would of course not solve by itself issues of misallocation of credit and eventually resulting loan losses. If gone unchecked, easier access to credit in the euro could even make matters worse in this respect by allowing longer credit booms and fuelling asset price bubbles. Not a short-term concern in the current risk-adverse environment, but one to certainly keep in mind for the longer term.

Let me also stress that the institutional framework underpinning the euro, including the entry criteria, is in my view a key element for stability and ultimately the success of the euro. The long-term performance of the euro area will depend on the willingness and capacity of its members to work together for the common good.

Real convergence between recently-acceded Member States and the euro area has been rapid in recent years. The ratio to the average of the EU-15 reached 62% last year. In the years since accession, GDP growth in the new Member States averaged 6.4% compared with 1.8% for the euro area.

While catching-up is fast, the key policy challenge for new Member States is to ensure steady, sustainable and non-inflationary growth.

Countries with pegged exchange rates to the euro (such as the Baltics) have experienced high levels of inflation and countries with flexible exchange-rate regimes have seen currency appreciations (although this trend has been reversed in a number of cases in the context of the financial crisis). Large current account deficits have also developed in a number of countries, in particular those with fixed exchange-rate regimes versus the euro, but not only in those.

As the recent Hungarian case reminds us, when imbalances build up over time – in the specific case weak public finances, large external debt and a large share of private sector borrowing denominated in foreign currency - , they are not easy to reverse rapidly and make a country vulnerable to shift in external financial market conditions and sentiment. External financing can very suddenly become problematic.

Despite the diversity of country conditions, let me - in conclusion - formulate some common challenges and policy orientations for the road to the euro.

As regards challenges associated with euro area adoption, three stand out: (i) achieving real and nominal convergence simultaneously; (ii) managing the expansionary effects of trade and financial integration; and (iii) preserving external competitiveness.

To address these challenges, the following four general guiding principles for policy making seem essential.

First, in an economy that is growing strongly and experiencing profound structural changes, maintaining price stability will be key. With the scope for nominal exchange rate appreciation and monetary tightening reduced in the run-up to the euro, the responsibility for keeping inflation low will increasingly shift towards the fiscal authorities and the social partners.

Second, prudent fiscal policies are needed to curb excessive demand pressures and mitigate risks of overheating. At the same time, the quality of public spending should be targeted to increase medium-term growth potential. Furthermore, experience of other EU Member States clearly shows that countries would benefit from establishing tailormade, national rules-based, medium-term budgetary policy frameworks, fully compatible with Stability and Growth Pact.

Third, effective supervision of financial institutions and markets is needed, also in light of the large capital flows associated with the deepening economic and financial integration of the New Member States. Micro-level supervision must be complemented by a much enhanced attention (and policy reaction) to macro-prudential aspects, which have been largely ignored in most countries, and not only in new Member States. Fast-expanding private sector liabilities, often in foreign currency and unhedged, as well as sky-rocketing house prices have for long been identified as a major vulnerability in dozens of reports by official institutions and in other analyses, but the policy response has been weak and very belated in most cases. It is understandably hard for policy-makers to stop the party, but the price of not doing so is a much bigger hang-over.

Fourth, structural policies need to address underlying economic weaknesses, boost productivity growth, and foster the domestic capacity to adjust. Flexible labour and product markets are not only crucial for facilitating necessary adjustment of the economy, they are also important for keeping inflationary pressures down.

Ensuring balanced real and nominal convergence in a context of rapid financial deepening clearly puts a high demand on policies, and not all NMS have risen to the challenge. Looking ahead, the policy strategy in euro candidate countries, like elsewhere, will have to adapt to the current exceptional circumstances to weather the crisis as good as possible. Maintaining the appropriate medium-term focus for macroeconomic, structural and financial sector policies will however be essential to a smooth integration of NMS in the euro area in the years ahead.

IV CONCLUDING REMARKS

Ladies and gentlemen, let me conclude.

The past ten momentous years have been rich in achievements. The euro has been recognised as a resounding success. It has delivered significant economic benefits to euro-area members, including greater price stability and stronger real activity; it has fostered the integration of financial markets in Europa; it has undoubtedly established itself as a stable and credible currency, becoming the second important in the world after the US dollar; it has played an important role in insulating the euro countries from several adverse effects that the financial crisis could have had on their economies; and, last but not least, it provides a clear beacon for countries aspiring to adopt the euro .

These achievements are a solid foundation for our future. But we also know that the challenges lying ahead for the euro area are demanding. Over the next ten years and beyond, we need to consolidate the remarkable success of the euro, improve the performance of the euro area and assure a smooth and efficient enlargement of the euro area to all Member States.

Thank you very much for your attention.