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<u>**SERIES OF CONFERENCES IN THE UNITED STATES**</u>

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The Economic and Monetary Union

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1. The two pillars of Economic and Monetary Union (EMU)

The launch of the single-currency in January 1999 marked the beginning of a new era in the process of European economic integration. It was the start of the third and final stage of Economic and Monetary Union (EMU) as established by the Maastricht Treaty.

This Treaty, which could be considered as an «economic constitution» for Europe, provides the legal foundation for Economic and Monetary Union based on two pillars. On the one hand, the single monetary policy, and the creation of a federal monetary authority. On the other, the enhancement of the economic policies of the Community and economic policy coordination.

The European Council - which assembles the Heads of State of the European Union- at its meeting in Hanover in 1988, established a High level Committee for the study of Economic and Monetary Union. Following the preparatory work of this Committee, which I had the honour of chairing, the Treaty envisages a parallelism between the two pillars of EMU. Despite these provisions, it is today very clear that there is a notable imbalance between the economic and monetary components, to the severe detriment of the former.

In order to illustrate this situation, I shall now briefly outline the institutional arrangements which make up the two pillars.

1.1 The new monetary policy framework

Since the start of stage three of Economic and Monetary Union, the countries of the euro-area share not only a single currency but also a single monetary policy. The responsibility for conducting monetary policy has been assigned to the Eurosystem. This is Euroland’s new monetary authority, and like the American Federal Reserve System, it is a federal institution.

At its centre is the European central bank (the ECB), based in Frankfurt, Germany. The National central banks of the euro-zone countries are the second part of the equation. As a reminder, the countries of the euro-zone are Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland and, since January, Greece.

Albeit decentralised in its organisation, the Eurosystem has a totally supranational character. It has been given the clear mandate by the Maastricht Treaty to maintain price stability. In addition, the Treaty grants full independence to the ECB and all members of the Eurosystem, and it enshrines the above in a text of constitutional nature, rather than in ordinary legislation.

The decision making body of the Eurosystem is the Governing Council of the ECB. This Council comprises the six members of the ECB's Executive Board and the twelve Governors or Presidents of the participating national central banks. Decisions are made on a one person/one vote basis. However, it is important to note that members of the Governing Council do not represent their country or even their national central bank: they are appointed in an individual capacity. The Council conducts monetary policy in accordance with conditions in the euro area as a whole.

The Eurosystem was established in the model of the Bundesbank, to the point that the wording of its statutes is, in part, almost an exact copy of those of the German central bank. Thus the pre-eminence of price stability. In addition, unlike the Fed, the Eurosystem has given itself a quantified definition to its objective : a year-on-year consumer price increase of below 2%. While the Eurosystem is also required to support economic growth this is only to the extent that such support does not compromise its primary objective.

The ECB is still a very young institution, barely two years old now, which operates on largely uncharted territory. Despite its brief existence the ECB has already had to face its first tests. At the beginning of its mandate, in the wake of several emerging market crises, European growth was experiencing a significant slowdown. Then last year the long depreciation of the euro and rising import and energy prices introduced considerable inflationary pressures into the euro-zone. This would have been a turbulent and difficult childhood for any central bank, but it gave the ECB the chance to prove both its anti-inflationary credentials and its willingness to respond to economic developments in a pragmatic way.

For me, the ECB has often been the target of unjustified criticism. No central bank is infallible, but the ECB and the Eurosystem is a solid institution and so far has been doing good work.

Notwithstanding this overall positive assessment, let me just point out a couple of aspects of the monetary setting which I think might still be improved upon :

First, I am afraid that the 2% limit, even if understood as a medium-term target, may prove on some occasions overambitious, particularly if monetary policy is to sustain employment in times of slow economic growth. There are several factors which have a sizeable impact on prices. Two examples would be the exchange rate and indirect taxes, upon which the ECB can exert little influence. The Treaty gave a mandate to the Eurosystem to safeguard price stability, which the Governing Council of the ECB decided to specify in a quantified definition. This chosen target may be too low and therefore create a bias towards excessive caution.

Second, the ECB Governing Council, which today comprises 18 members, is already rather large compared to the equivalent American or British committees. The European Union will enlarge to the East in the coming years, and as soon as new members will fulfil the corresponding economic criteria, they will also adhere to EMU. One or two of the EU countries that initially decided to stay out of Monetary Union –Denmark, Sweden and the UK- might also join. Therefore Euroland is bound to grow in the future, and if the 'one member/one vote' principle that currently guides decision making remains unchanged, the Governing Council of the ECB will become far too large to execute monetary policy in an effective and timely manner. One possible reform would be to implement a rotating system among the national central bank governors or alternatively the creation of «constituencies» of Member states. Whatever the resolution, the system will have to be reformed if the euro-area is to expand without compromising the efficiency of its decision making process.

Obviously there is always room for improving any institutional setting, but as I have said, the new monetary policy framework is a very consistent one.

Let me now turn to the economic components of EMU.

1.2 The economic pillar of EMU

Economically, EMU is the final step of the Single market, and thus built on a number of existing elements such as :

- the common European market, characterised by free circulation of persons, goods, services and capital,

- competition policy, which is conducted at the federal level by the European Commission,

- and, structural and regional policies, focused at helping less developed regions to catch up with the richer areas of the Union.

The introduction of the Economic Union pushed further progress in the single market and called for a reinforcement of existing common policies. However, unlike the Monetary Union, the Economic Union did not require the pooling of further sovereignty nor the creation of any new supranational institution. Rather, Economic and Monetary Union necessitates further co-ordination of national economic policies. This was the strongest novelty introduced by the Economic Union as envisaged in the Treaty.

While monetary policy has been assigned to a federal institution the conduct of nearly all economic policies remains decentralised within the Member states. Fiscal policy, regulation of product and labour markets, taxation, social and employment policy... all remain the preserve of national and regional actors. This is by no means a handicap : it is actually desirable for some policy competences to be assigned at a lower level of governance. One can take as an example the case of wage settlements, which should take into account productivity developments at the regional or even local level, or public expenditure, which should reflect differing preferences, systems and traditions. The abolition of national currencies also makes it desirable that euro-area countries keep a certain discretion with regard to their fiscal policies. In this way, they are able to respond to national cyclical developments.

However, when implementing both micro and macro-economic policies euro-area countries cannot neglect the new interdependencies created by the advent of the single-currency. It is not only the stability or the credibility of the euro which is at stake, national and infra-national actions have a direct impact on the welfare of all participating countries.

Individual budgetary decisions (especially those of large countries) affect common macroeconomic variables, mainly area-wide inflation and the exchange rate. Any change in these variables will in turn have an effect on the interest rate moves taken by the European central bank. The same holds true for structural policies which affect the non-inflationary growth potential of the euro-zone.

Furthermore, given the small size of the federal budget, less than 1.3% of the zone's GDP, the definition of a consistent policy-mix at the euro area level can only be carried out through solid coordination of national policies.

In the field of structural reform, greater coordination between national governments may be a source of support for what at times might prove politically difficult measures. The multilateral commitment to common objectives, along with peer pressure, stimulates the implementation of reform programmes agreed at the European level.

The Treaty establishes several instruments which serve to enhance economic policy coordination, a necessary parallel to Monetary Union.

At the heart of these instruments is the *Broad Economic Policy Guidelines*. These include an annual general assessment of economic developments and policy options, as well as a large set of general and country-specific policy recommendations. They are adopted by the Council of Economic and Finance ministers, on the basis of a proposal of the European Commission. Member States thus commit themselves to ensure the consistency of their national policies with these Broad Economic Guidelines. Throughout the year, the Council of Economic and Finance ministers assesses the development of national policies and may issue recommendations whenever it finds that a Member State seriously deviates from the commonly approved guidelines. However, even if Member States are expected to follow these peer-recommendations, they are not in any sense binding.

The Treaty also established a procedure for avoiding excessive public deficits. This procedure was further enhanced, before the introduction of the euro, by the *Stability and Growth Pact*. The Pact forbids Member States' deficits from exceeding 3% of their GDP. This rule was necessary to avoid conflict between the common monetary policy and national fiscal policies. In addition, Member States adopted, in signing the Stability Pact, the objective of a balanced budget over the medium-term. In this context, the Council of ministers also carries assessments, known in the European jargon as *multilateral surveillance*. Nevertheless, as long as they respect the 3% deficit rule, Member States retain ample room for manoeuvre, and can thus both approach this medium-term objective at their own pace and define budgetary policies as they deem appropriate.

The European Council added several mechanisms to improve this institutional framework, but the Economic Policy guidelines and the Stability Pact still remain the principal elements. All participating actors have gradually learned to work within this setting and it has, thus far, functioned rather smoothly. However, it is my view that this institutional set-up has failed to achieve the minimum degree of policy coordination desired.

Policy actors have failed to use the existing instruments of coordination to their full potential. This is especially true for the Economic Policy Guidelines. Although these guidelines have fostered fruitful common assessments of appropriate policy measures and the exchange of best-practice, a real «culture of economic coordination» has yet to develop, and national objectives too often overshadow the common interest.

As for the Stability Pact, it is a necessary constraint to ensure a minimum of fiscal discipline, but its rules-based approach is inadequate to articulate an appropriate overall policy-mix for the euro zone. The aggregate fiscal policy stance, and thus the policy-mix, is still the by-product of individual decisions taken solely within the perspective of national circumstances. In addition, the Pact it is too synthetic an instrument to provide sufficient assessment of the soundness of public finances. For instance, it does not take into account implicit liabilities (such as those resulting from pension commitments) or the nature of expenditure, giving the same treatment to investment and consumption.

The Economic components of EMU are not yet up to the task. I believe that tackling the remaining weaknesses of the Economic pillar is of upmost importance for the future.

I will come back to this later. Let me first …

2. The structural transformation of Euroland

… draw your attention to the major structural changes that have taken place in Europe since the launch of EMU. These are mainly the result of two concurrent factors: the transformative forces unleashed by the single-currency and the increasing efforts of policy-makers to implement regulatory and structural reforms.

2. 1 The impact of the euro on the European economy

a) The single-currency environment

One of the main goals of the Single Market program, launched by the Commission in 1985, was to foster competition amongst European economies, and in particular within those sectors which had thus far been sheltered by either physical, technical or fiscal barriers. The euro has injected new momentum into this process. On the one hand, it exerts disciplining pressure on the participating Member States since they are no longer able to compensate structural weaknesses or economic policy failures through a devaluation of their national currency. On the other hand, it brings about major changes at the microeconomic level, creating new competitive pressures.

The most visible evidence of this is the wave of mergers and acquisitions that is has swept across Europe. These increased three-fold from 1997 to 1999 reaching a volume of 1.5 billion dollars, nearly half of which corresponded to cross-border alliances. There are two factors behind this : first the reduction in the cost of acquisitions triggered by the single-currency and the revolution in financial markets, and second, the removal of existing barriers to cross-border mergers.

The euro not only intensifies competitive pressures, it is also finally making Europe a genuinely single market. Companies of all sizes are shifting from national to European strategies as old economic boundaries disappear. In sectors such as telecommunications or energy, liberalisation and international competition have already led to significant efficiency gains and lower prices for consumers.

The coming introduction of the euro banknotes and coins is likely to add to this process by increasing the transparency and comparability of prices which is still somewhat blurred by the existence of national currencies.

b) Emergence of euro-area wide financial markets

Notwithstanding the changes induced in economic relations by the euro, by far the single currency's most fundamental impact has been on the operation of the European financial sector. Actually, EMU is transforming Europe's financial markets more quickly than anticipated by all but the most fervent euro-enthusiasts.

Bond markets

The first, and perhaps most notable example has been the rapid integration of government bond markets. The process started at the beginning of the final stage three of EMU when all euro area governments redenominated their outstanding debt stocks in euros. Since then, all new issues have also been made in euros. Moreover, bonds issued by any euro-area government are equally free of currency risk and equally eligible as collateral at the ECB. International bond issuance is nowadays split more or less evenly between the euro and the dollar.

Even more impressive has been the growth observed in Europe's corporate bond market. Corporate euro-denominated issuances increased more than 300% in 1999 compared to 1998 and maintained roughly the same level in 2000 despite worsening market conditions. Currently, US multinationals raise as much money in the euro bond market as in the dollar market. These recent developments of European bond-markets make it easier for European companies to raise funds and thus provide more efficient financing opportunities for investors.

Restructuring and consolidation of the financial sector.

The introduction of the euro has also fostered substantial restructuring and consolidation of the European financial sector.

Equity markets in Europe, even if the volumes traded are still low by American standards, are growing and changing rapidly. The first pan-European equity market has already been created : *Euronext*, the result of the merger of the Paris, Amsterdam and Brussels stock exchanges. While other cross-border merger attempts have not come to fruition, as was the case of the proposed merger of the Deutsche Börse and the London Stock Exchange, they are nevertheless revealing evidence of the existing pressure on European stock and derivatives exchanges to form cross-border alliances.

Financial intermediaries are also going through a process of consolidation. For the most part, mergers and acquisitions of financial institutions have up to now occurred between national players, although there are already some examples of cross-border merger activity. This is likely to intensify in the near future. Consolidation of financial institutions is, in turn, closely linked to the progressive shift from the traditional European model of universal banking to a predominantly market based financial system.

Improving financial supervision and the regulatory environment

The changes taking place in the financial sector, driven mainly by the introduction of the euro, but also by globalisation and technological advances, give rise to new challenges for regulatory authorities.

The emergence of large pan-European financial institutions, for instance, has far-reaching implications for prudential regulation. To ensure financial stability, new developments need to be matched by increased cooperation and coordination between national and European authorities. In addition, markets for financial services are still too segmented due to persistent differences in national rules. The resulting costs, in terms of efficiency, growth and employment, are still one of Europe’s major drawbacks : all remaining legal barriers preventing further market integration should be dismantled.

2. 2 The momentum for structural reform

Let me now turn to what is usually perceived as Europe's major weakness : namely its economic rigidities. It is certainly true that Europe's structural handicaps have tended to hold it back in terms of growth. However, the rhetoric in this field seems to be out of sync with the reality of the profound changes that have been taking place recently.

In fact, policy-makers across Europe are now focusing more than ever on overcoming these economic rigidities. At the Lisbon summit in April last year, the EU Heads of State established an ambitious agenda of comprehensive structural reform for the next decade. The agreed strategy sets quantified targets and clear goals for economic and social reform. It includes concrete action to :

- attain higher employment rates, especially for women,
- increase investment in research, education and long-life learning,
- modernise social protection
- prepare the transition to a knowledge economy and society
- achieve sound and sustainable public finances
- speed up liberalisation (notably of transport, energy and public procurement)
- speed up the integration of European financial markets and enhance access to venture capital

The European Council endorsed its commitments with the adoption of a new method of coordination that in the model of the Economic Policy Guidelines, is based on the establishment of common benchmarks, peer pressure at the European level and the exchange of best practices.

The Heads of State also agreed to devote a summit every Spring to take stock of the progress made, drawing on economic and social indicators, and thus to give renewed political guidance to the process. The summit that took place this last week-end in Stockholm (*23-24 mars*) was the first of these follow-up summits.

It is still too early to assess whether the Lisbon strategy will be a success, and even more difficult to tell if the «*New economy*» is finally arriving in Europe. We cannot but understand, when assessing recent developments, that improvements will come slowly in several areas. For instance, the delays witnessed in the adoption of an EU-wide patent or the ever cumbersome financial market regulations.

However, there are many signs that the Lisbon strategy has put Europe on the right track.

Labour market reforms have been introduced in a number of countries (for instance in France, Spain and the Netherlands, to name but a few). There is also a widespread implementation of both flexible labour practices and active employment policies. Low wage settlements in Germany despite falling unemployment, also point to an improved labour market. All these factors have surely played a role in the labour-intensive nature of European growth. In line with the objectives set in Lisbon, the EU has created some 2.5 million jobs in the year 2000.

Another field were Member states are making considerable progress is fiscal reform. Most euro-area countries recently adopted comprehensive tax reduction plans which include cuts in social security contributions and personal income taxes. These come into effect this year and should strengthen the supply side of the economy. Albeit to a lesser extent, a few countries have also revised benefit systems so as to increase employment incentives.

Fiscal reform has been especially important in Germany. The alleviation of the tax on banks' capital gains from the sale of industrial shares, along with the development of corporate-bond markets, provided a shock to the system of industrial cross-holdings. This entrenched and long-standing system, in which banks are the main shareholders of the corporations to which they lend, is progressively giving way to market-based practices such as desintermediation or securitisation.

Finally, in Stockholm, the European Heads of State have also addressed the reforms required to create more integrated and efficient financial markets. The European Council has adopted a resolution endorsing the «Report of wise men on the regulation of European securities markets», which intends to set the basis for a more flexible regulatory environment. A key innovation will be the creation of a Securities Committee which will assist the Commission in improving existing legislation. Another, more technical, committee will also be established so as to develop the details of regulations and directives which, from now on, should be more focused on framework principles.

2.3 EMU and policy action are already bearing fruit

All in all, I am confident that Euroland is gradually becoming a more dynamic and competitive economy. The sound policy framework and the reforms implemented have already started to bear fruit.

Today the general economic outlook is quite positive and EMU largely shields Euroland from the moderate economic prospects of the world economy. Although the US slowdown may have a negative effect on European exports, so far there are no convincing signs of a significant impact on the euro-area economy. GDP growth should be slower than last year but remains fairly robust, slightly below 3%. Unemployment, though still too high, is on a downward trend and should fall to 8.5% by the end of the year. External accounts are close to balance, and the steady appreciation of the euro along with the fall in oil prices are lowering short-term inflationary pressures. The overall outlook is thus favourable, and this convinces me that the economic foundations of Euroland are sound.

However there is no room for complacency. The impetus of structural reform has to be maintained in order to increase the growth potential of the euro-area. Besides, the weakening external environment calls for continued fiscal consolidation and a growth-supportive policy-mix. Finally, there is still work to be done in order to improve the institutional setting of the Economic and Monetary Union. I will devote the last minutes of this speech to what in my opinion are the remaining challenges of this European project.

3. The need for constant improvement of Euroland : the political implications of EMU.

3.1 The Loneliness of the ECB

The ECB has been granted higher independence than any other central bank. This allows it to pursue its policy objectives shielded from any political interference. But Euroland is quite a unique entity. The ECB, unlike other central banks, is a supranational body not embedded in the institutional and economic structure of a nation-state. This leaves the Eurosystem with no credible political or economic counterpart. This lack of a «Treasury» at the European level does not come free of risks.

The economy's response to monetary policy impulses and to shocks in general depends upon a full range of market conditions and budgetary developments, determined as much by structural characteristics as by the conjunction of the actions of trade unions, governments, enterprises, and the like. The behaviour of all these economic actors, public and private, exerts an influence on inflation. The Eurosystem, even if it plays a major role is by no means the sole agent responsible for economic developments in the euro zone. Thus, it should not be left to act in an isolated manner, divorced from the other economic and political actors, and particularly not from the fiscal authorities.

In the present circumstances, the ECB might be unfairly blamed for disappointing economic developments, as was the case in 1999 and 2000, due to the depreciation of the euro. Especially at this early stage of EMU, it is important to prevent any erosion of the confidence that European citizens may confer to their new Central Bank. In this context, the ECB would benefit from having a strong political counterpart, as is the case in the US, where the Treasury Secretary speaks for the dollar in international markets, and to public in general.

3.2 A strong need for enhanced economic policy coordination

The other side to the lack of a single economic counterpart is the multiplicity of policy actors which shape economic policies in Euroland. As I mentioned earlier, unlike monetary policy decisions, other economic policies remain the responsibility of national and regional actors. Better coordination of these decentralised policies is required not only to ensure an appropriate policy-mix but also to keep the stimulus of structural reform.

This is especially so with regard to budgetary policies, where the status quo is clearly sub-optimal. The fact that the euro-area aggregate fiscal policy stance is turning pro-cyclical is a cause for concern. As most countries are not matching the widespread tax reduction plans with expenditure restraints, the trend of fiscal consolidation is being reversed. In the wake of these negative fiscal developments, the ECB has repeatedly asserted that added public expenditure to an already strong internal demand risks exerting an upward influence on inflation. This restrains the margin of manoeuvre for the ECB to carry out a softening of monetary policy. As the current upswing its losing some of its strength, implementing the appropriate policy-mix is now of the utmost importance.

In this context, I believe that the present framework needs to be enhanced in order to ensure effective coordination between Economic and Finance ministers of the euro-area, and among these and the ECB.

Currently, the ministers of the twelve euro-zone countries gather informally once a month in what is called the Euro Group. The president of the ECB, Wim Duisenberg, regularly joins them at these monthly meetings. This assembly has provided the opportunity for national ministers to jointly evaluate economic developments, and to carry out frank and open discussions on policy options.

However, the informal nature of this gathering poses some serious drawbacks. No decision-making powers have been transferred to the Euro Group and all its statements and common positions have to be subjected to the unanimity rule. National governments find it hard to conceive policies based on common interest and the Euro Group meetings often fail to go beyond the mere exchange of information and mutual consultation.

Effective discretionary coordination has not yet been achieved. The Euro Group, this sort of « European Treasury», should be reinforced so as to assure consistent policies at the euro-zone level.

The Euro Group, were it to develop into a solid and credible body, might also progressively become the economic counterpart that the European central bank needs.

4.3 Euroland’s external responsibilities

The euro has far-reaching implications for international monetary and financial relations as well as for the world economy at large. Euroland is today the largest trading partner, main aid donor, and second largest GDP producer in the world. It holds, therefore, an important responsibility for the functioning of the global economy.

However, the influence that Euroland has in the shaping of global economic decisions is far below its economic weight or its share in the funding of the initiatives of international organisations. It is not unusual that Europeans end up paying the lion’s share of the bill for actions decided by Americans.

The misrepresentation of European views and interests at the international level arises from several elements. Firstly, the multiplicity of actors responsible at the different levels of economic policy making renders the formulation of a united and coherent European position in the international fora difficult. Second, the fact that all participating actors but Euroland are nation-states leaves the European representatives in a tricky position with little room for manoeuvre. Last but no least, the reluctance of national officials to leave *their* place to a European representative, even when that would be in their national interest, farther complicates the matters.

In the last G7 meeting in Palermo for instance, the president of the ECB and the Belgian finance minister, who currently holds the rotating presidency of the Euro Group, represented Euroland only during that part of the meetings which dealt with the global economy and exchange-rate developments. However, they both had to leave the room during the discussions on other international financial issues, where only national bankers and finance ministers were present. As for the Commission, it is just invited to participate in those topics in which it plays a direct role, such as aid to Russia. This leads not only to a ridiculous constant to-ing and throwing, but also to the paradox that the European Commissioner for economic and financial affairs talks about Russia, but not about the matters of upmost concern for the European currency. These unwieldy arrangements are inefficient and severely erode the negotiating position of European interests. The euro-zone has to find a better way of streamlining its external political representation.

4. Concluding remarks

As you may have realised all these remaining challenges are very closely linked. The «loneliness» of the ECB, the need for enhanced economic policy coordination, the lack of a coherent international representation of European interests… they are all the different pieces of the same puzzle. They all lead me to think that in the long run Economic and Monetary Union may bring a gradual reinforcement of the political links among European countries. In such a light, EMU is just one chapter in the ongoing story of an ever closer union in Europe. EMU is a big achievement, but it does not mark the end of the journey. For, as it reinforces the broader process of European integration, it also poses new challenges which push us to move ahead.

The coming introduction of the euro banknotes and coins will make European economic integration a palpable reality for the public. In only 9 months, the citizens of twelve European countries will be using the same currency in all their everyday transactions.

Also, those of you who come to visit us will realize what this change means. You will be able to travel from Finland to Portugal, not only without having to show your passport at any border, since there are no borders anymore, but also without having to visit a single currency exchange office.

I believe that the physical introduction of the euro will unquestionably increase the perception of an emerging European identity. It will also increase the visibility of Economic and Monetary Union, the major project that lies behind the euro and which I have tried to explain briefly to you in this statement.