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tionalizing, if at all, fiscal policy coordination. In fact, proposals to develop the Euro Group towards a collective executive body, organizing the mutual exchange of information as well as being capable of defining and implementing common positions, are compelling in my eyes. Moreover, as suggested recently by Commissioner Solbes, the EU Commission here might serve in a supporting and coordinating capacity.²⁴

Concluding Remarks

With micro-benefits and macro-costs having always been embarrassingly balanced,²⁵ the economics of EMU has never been clinching. Hence, the decisive (and normative) arguments in favor of EMU have always been political.²⁶ At the same time, most of the queries reside here as well: a most urgent question thus is, how Euroland conceives of dealing with its structurally enhanced interdependence.

²⁴ This is a position argued in the paper by Pierre Jacquet and Jean Pisani-Ferry, *op. cit.*, as well as in Jürgen von Hagen: Co-ordination of Economic Policies and Employment, in: Alexandre Lamfalussy et al. (eds.): *The Euro-Zone: A New Economic Entity*, Brussels 1999, Bruylant.

²⁵ See on this Paul de Grauwe: *The Economics of Monetary Union*, Oxford 1996, OUP.

²⁶ See on this Klaus Gretschmann and Hans-Helmut Kotz: *The Politics of EMU: Problems in Creating Wahlverwandschaften*, in: *Kredit und Kapital*, 1997, Sonderheft 14, pp. 123-136.

While being critical of some aspects of suggestions by Pierre Jacquet and Jean Pisani-Ferry (for example on the ECB's two-pillared strategy or the external representation of Euroland), I largely sympathize with the bulk of their analysis, in particular that a debate about an economic policy charter – outlining principles and rules of the conduct of economic policy – should be launched. To arrive at a common position will be no mean feat. As a prerequisite, the respective positions should be acknowledged in a non-caricatural form. Of course, institutionalizing fiscal coordination must not impinge on the ECB's independence – as has, moreover, explicitly never been intended in the above-mentioned proposals. Indeed, according to the professed intentions, by creating a Euroland-level institution of fiscal policy and thus rectifying in the apt wording of Tommaso Padoa-Schioppa to some degree the “institutional solitude of the ECB at the Euroland level”, criticism otherwise aimed directly at the ECB might be deflected.

All of this entails that we probably have to discard the convenient idea according to which the institutional setup as well as the guiding philosophy have been written in stone in Maastricht. Stating this is, indeed, ending on a positive note. Since it acknowledges that Euroland is capable of reacting to new challenges – as they come up. EMU is very much an open arrangement.

Pedro Solbes*

The European Union, EMU and Enlargement

Looking back over the last few years, we have seen historical changes. The fall of the Iron Curtain, German unification and democracy in central and eastern Europe have changed the political landscape of our continent.

To exploit the new opportunities and to repeat the success of western European integration with our eastern and some new Mediterranean neighbours we need to strengthen European integration.

We should not forget that even an enlarged European Union has to stand the test of international

competition and to guarantee economic growth and employment. Our companies must adapt to a new knowledge-based economy, to globalisation and world-wide financial markets and to increased structural changes.

We have to be able to defend our common interest in international trade negotiations and to safeguard the basic values of a European model of society, which is based on competitiveness and solidarity.

To meet the challenges of the world economy successfully, Europe needs an integrated well-functioning home market.

With the internal market programme, the European Union has successfully abolished national barriers to trade in goods and services, has started to set common standards and has helped to build a more

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competitive European economy. But we still have to make further progress to exploit all our economic potential. To give you only one example: multinational companies. Amongst the twenty biggest companies in the world measured by sales, you will find nine American, six Japanese and only four European companies. If you look at the stock market value of the big companies, the picture is even more striking. Amongst the ten most valuable companies, you will find eight American, one Japanese and one European company.

I know very well that economic performance cannot be measured by the size of the companies. Flexible small and medium sized companies are an important asset for the European economy, but it is evident that Europe needs further market integration. This brings me to the most ambitious European project of the last years: Monetary Union.

The introduction of the euro was the logical consequence of the internal market programme.

European Monetary Integration

Monetary integration has always been a centre-piece of European integration. Let me remind you that this started already more than three decades ago. Even at the time of the launch of the European Monetary System in 1979, the process of monetary integration was not uncontroversial. Fixing the exchange rate limits the room for independent national economic policies. This is obvious for monetary policies but implications for other policy areas e.g. fiscal policy and wage developments are evident, too.

Therefore, it was not a surprise that different policy responses to economic developments led to a temporary set-back in the monetary integration process. Nevertheless, in the 1980s monetary integration got a further impulse from the domestic and external liberalisation of capital movements which enhanced the need for stability oriented and co-ordinated economic policies.

I am fully aware that, among economists, the introduction of a single currency, while leaving other policy areas in the responsibility of national authorities, is not uncontroversial.

When assessing developments in EMU, the pro and con arguments have to be seriously considered. But our assessment today has to start from the fact that EMU has been a reality for about two years and the euro is in place, though not yet in the form of coins and notes.

It is unfortunate that so much attention has been paid to short-term developments in the euro exchange rate. Naturally, I am convinced that a strong euro reflecting the economic fundamentals is in our interest, but the stability of a currency has to be assessed in terms of both its internal and external performance. In Germany too, internal stability – as measured by a lasting low inflation rate – has always been given priority over external stability. For example, the dramatic rise in the dollar against the Deutsche Mark in the 1980s was not seen as calling into question the Bundesbank's anti-inflationary credibility. Therefore, what really matters for the strength of the euro in the long term is the underlying inflation performance of the euro area. In this respect, the record of the euro has been highly encouraging.

The euro area has enjoyed very low inflation by historical standards. For most of 1999, the euro area inflation rate remained close to 1% – a performance not achieved in the previous thirty years.

The recent acceleration of headline inflation, almost entirely due to higher import prices, has not spilled over to higher inflation expectations as can be observed in stable long term interest rates. It will be crucial to contain wage settlements so that higher oil price induced inflation will not generate domestic inflation pressures.

Unification of European Financial Markets

The smooth change-over to the euro has paved the way for the development of truly European financial markets. While the single market has fostered real economic integration, the euro is acting as a powerful force to unify financial markets. Up to now, the situation in Europe has contrasted sharply with the highly integrated financial markets of the United States and Japan. This is now changing: let me give you three examples as evidence:

- the rapid development of the euro-denominated corporate bond market,
- the acceleration in the pace of consolidation of the banking sector, and
- the proposed links and alliances among national stock exchanges.

Given these favourable achievements, I think that the developments of the euro exchange rate have received an over-proportionate degree of attention in public. One way to respond could be to remind people of the huge swings that have been observed in the mark-dollar exchange rate in the eighties and nineties. We also do not know what kind of exchange

rate turmoil would have resulted in response to the oil price shock if EMU had not been established.

Until last summer, the depreciation of the euro was mainly attributable to relatively weak cyclical conditions in the euro area economy. Indeed, the US economy continually surprised – at this time – markets with ever more positive news. However, an appreciation of the euro was expected to coincide with evidence of a recovery in the euro area economy. Therefore, the euro's failure already to respond in the year 2000 to the improved economic outlook for the euro area had shifted attention to other possible explanations. In particular, structural factors have been mentioned as being important to the euro exchange rate because of market perceptions of the euro area economy as inflexible. The euro area may be seen by markets as a relatively less attractive location for investment. I believe that this is a misperception and underestimates the nature and extent of the ongoing structural change in Europe.

Reduction in Public Sector Deficits

Let me add some comments on fiscal policy coordination achievements. The EMU framework requires that the combination of fiscal and monetary policy is the appropriate one for non-inflationary growth.

This is the motivation behind the Stability and Growth Pact. The Pact requires Member States to adhere to strict fiscal discipline, while allowing them to respond – without inflationary risk – to cyclical developments in their national economies. All of the Member States have made significant progress in reducing their public sector deficits.

For the euro area as a whole, the public sector deficit was about 1½% of GDP in 1999 and in the meantime it fell further well below 1% of GDP. A number of countries have achieved the medium-term objective of a budget surplus or near-balance. Most of the other countries need to pursue fiscal consolidation efforts but should be in a position to reach this objective at the latest in 2002. Given the historical experience of divergence in terms of budgetary performances, the consensus about the role of fiscal policy and the optimal policy mix in EMU is a major achievement.

All in all, the experience with EMU is reassuring, and the euro has found its place in the financial market and in the business community. The introduction of notes and coins at the beginning of 2002 will complete the most ambitious single project of Euro-

pean integration. This will still need a lot of information and preparation by the Member States, the ECB and the Commission. Over time, I am convinced that the euro will develop into a milestone of European identity.

Many people living outside the EU are looking forward to becoming part of the EU and finally adopting the euro as legal tender, a clear sign of the attraction of the European Union. This brings me back to enlargement.

Widening the Euro Zone

Indeed, enlargement of the EU will also imply, at some later stage, a widening of the euro zone. A euro area of initially 11 and now 12 countries is only a first step in the process.

What kind of scenario should be envisaged to get from here to the ultimate monetary integration of the candidate countries in the euro area? What is the appropriate sequencing?

I firmly believe that in the transition countries, the reform agenda relating to accession to the EU must have priority over policy moves inspired by EMU participation such as meeting convergence criteria. In the run-up to accession, the candidates should concentrate primarily on furthering the process of structural and economic reform with an appropriate administrative capacity. The adoption of the single currency can only be the final step in what has been, and will remain, a lengthy process of economic integration with the EU.

The European Commission is closely monitoring the progress of all the candidate countries. In November 2000, the Commission finalised the third set of Regular Reports in which we assessed, inter alia, the economic progress made in terms of the Copenhagen accession criteria, and the extent to which the candidate countries are ready for membership. This annual exercise is crucial for the credibility of the overall enlargement strategy.

This year's conclusions pointed at the economic progress and pick-up of growth in the great majority of the candidate countries. This can of course be attributed to a large degree to the good economic performance of the EU. We also noticed a tendency for inflation to rise in a number of candidate countries, mainly on the back of the increase in oil and food prices, but without any great danger of things spiralling out of control.

As to the fulfilment of the economic criteria, it is clear that progress has been observed for a number

of consecutive years and negotiations are advancing at a steady pace.

Beyond the measurement of progress, however, how can we build a process of economic policy co-operation with the candidate countries to contribute to this successful, progressive integration into the EU and, ultimately, into the euro area? For its part, the Commission will be conducting with the candidate countries a pre-accession fiscal surveillance, which includes the establishment of economic programmes by the pre-accession countries.

Regarding future monetary integration, I believe the Treaty provides a relatively straightforward scenario for the progressive integration of the candidate countries into the EU and the euro area. In addition, I am convinced that this institutional framework provides sufficient flexibility to accommodate different regimes and different "paths" towards the adoption of the euro.

Unambiguously, the EU Treaty provides for a clear and unique institutional path towards the adoption of the single currency for the candidate countries. Upon accession, the new Member States will enter the EU and participate in EMU with the status of Member States with a derogation from adopting the euro. This status will be granted in the Accession Treaties. New Member States will have to treat their exchange rate policies as a matter of common concern and are expected to join the ERM2 at some point after accession. Then, for the adoption of the euro, the Treaty requires that new Member States reach a high degree of sustainable nominal convergence. This is the equal treatment principle, and it will be applied in full to the candidate countries.

The Treaty framework should provide sufficient flexibility to allow different exchange rate strategies. This is certainly the case now, in the pre-accession phase where there are no institutional obligations in this area, and where exchange rate policies should be essentially aimed at supporting other policies in furthering the transition and preparing for accession.

What is the scenario after accession, and the framework for exchange rate relations between new Member States and the euro area?

After accession, the ERM2 will provide enough flexibility to accommodate different regimes, provided that the countries' commitments and objectives are credible and in line with those of the mechanism. The only clear incompatibilities vis-à-vis the ERM2 that can be identified already at this stage are fully floating

exchange rates, crawling pegs and pegs against anchors other than the euro.

In principle, the option of maintaining a euro-based currency board until the adoption of the euro is available on a case-by-case basis, as an additional unilateral commitment to a greater degree of fixity against the euro, within an ERM2 participation. However, when a country with a currency board wants to join the ERM2, the request would have to be examined in the context of the common procedure set out in the ERM2 Resolution, and the central parity/conversion rate will have to be agreed multilaterally. This implies that some of the countries that would prove able to successfully operate a currency board to the euro with a sustained track record would not necessarily have to go through a "double regime change" (moving away to some flexibility before going back again to a harder peg and subsequently the irrevocable locking of the exchange rate).

Increased exchange rate fixity in the run-up to accession need not, however, be the preferred solution, and rather more the exception than the norm. Generally speaking, the candidate countries will, in the run-up to accession and participation in the ERM2, have to reconcile their ambitions for exchange rate stability and inflation reduction.

Concluding Remarks

To conclude let me come back to our starting point.

Europe has to deepen economic integration and has at the same time to develop a credible strategy for enlargement. The progressive widening of the euro area is such a realistic concept.

I am convinced that the Treaty spells out a scenario for the next five to ten years in this area which is based on equal treatment and makes sense in terms of economic policy challenges. Therefore, I see no reason to envisage a different approach to future monetary integration and the adoption of the euro by future EU Member States. No need, for example, to "reinforce" the convergence criteria, as is sometimes suggested.

What is necessary is a common effort to explain this policy and its advantages to the public inside the Member States of the European Union and also to the candidate countries.

People in general are afraid of changes but the European Union has to change. It is our common responsibility on the national and European levels to assure people that the changes will be for the benefit of all and not only a bargain for the few.