

euinsight

EU Economic and Monetary Union and the Euro

A Decade of Achievements

The EU's Economic and Monetary Union (EMU) is unprecedented in modern European economic history and has transformed the global economic landscape.

A decade after its launch, the euro provides stability for businesses and national economies and guards against speculative runs on national currencies. A single monetary policy for the 16 euro area Member States, combined with coordinated national fiscal policies, has fostered macroeconomic stability, spurred the economic integration of Europe, and boosted cross-border trade, financial integration and investment. Budgetary discipline has improved significantly thanks to the rules-based Stability and Growth Pact, and the exchange rate realignments that periodically traumatized European economies have become a thing of the past.

EMU has also increased the EU's resilience to adverse shocks and fostered the EU's leadership in the global economy. As the impact of the current global financial upheaval on Europe has intensified, EU leaders responded rapidly with a rescue plan that allows governments to guarantee interbank lending, provide short-term liquidity, and buy into banks to increase their capital. Member State governments have committed substantial funding to the EU's effort to restore confidence and stability, and the European Economic Recovery Plan, adopted by the European Council in December 2008, provides for a coordinated EU response to the downturn in the form of a timely, targeted and temporary fiscal stimulus equivalent to 1.5 percent of EU GDP (with measures being adopted at both the EU and the Member State level).

Paralleling its immediate response to the current turbulence, the European Commission (the EU's executive arm) is also taking decisive action to reinforce the regulatory framework for the future, and has accelerated implementation of its 2007 Economic and Financial Roadmap designed to address weaknesses in the financial system.

In the longer-term, the best approach is to comprehensively rethink regulatory and supervisory rules for financial markets—including banks and other lenders, hedge funds, and private equity—and continue with economic reforms aimed at improving the underlying competitiveness of European businesses and the skills of the European labor force.

International Role and Impact of the Euro

After just a decade, the euro is already the world's second most important international currency, after the U.S. dollar. It is the second most actively traded currency in foreign exchange markets worldwide, and is used in more than one-third of all foreign exchange transactions. In 2004, euro-denominated international debt securities surpassed those of the U.S. dollar.

The official use of the euro has increased, with the worldwide share of disclosed reserves denominated in euros rising from 18 percent in 1999 to more than 25 percent in 2007. Similarly, its role as an invoicing or settlement



currency has increased to cover more than half of the euro area's external trade. A number of non-EU countries, notably EU candidate and neighboring countries, invoice approximately 60 percent of their trade in euros.

Thanks to the euro's rising international status and the size of the euro area economy, economic policies within EMU increasingly have a global impact. With a credible macroeconomic framework and a sound financial system, the euro area has been contributing to a more orderly evolution of the global economy, even during this period of economic turbulence.

Tangible Benefits: Ten Years of Economic and Monetary Union

- **Closer economic and financial integration.** Internal EU trade now accounts for one-third of GDP, and total private and public investment within the euro area has risen to 22 percent of GDP. The euro has also driven the integration of interbank money, bond, and equity markets, and the single currency eliminates transaction costs associated with currency exchange.
- **Economic stability.** During the first decade of EMU, inflation averaged just two percent per year, and nominal interest rates declined to an average of nine percent.
- **Jobs.** Almost 16 million jobs have been created in the euro area since 1999, and the unemployment rate dropped to an estimated seven percent in 2008, the lowest rate in 15 years.
- **Sound public finances.** Public budget deficits fell to a record average low of 0.6 percent of GDP in 2007.
- **International role of the euro.** The euro has rapidly become one of the world's most important currencies, and has overtaken the U.S. dollar in the international bond market.

A Brief History of Economic and Monetary Union

The EU's Economic and Monetary Union (EMU) encompasses the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro. EMU, the culmination of visionary EU leadership over the years, represents a milestone in advancing European economic integration, a process begun when the EU was founded.

EMU, achieved in three main stages, is based on the concept of a single market for sovereign nations. During the first stage, beginning in 1990, the EU ensured completely free movement of capital within the EU and established the single market. Stage two (1994–1999) included the introduction of the European Monetary Institute (EMI), the precursor to the European Central Bank. The final stage, launched in 1999, witnessed the birth of both the euro and the European Central Bank's single monetary policy for the euro area.

Although all EU Member States are part of the Economic and Monetary Union, not all EU countries are part of the euro area, which includes only those that have adopted the euro as their currency and are subject to the monetary policy of the European Central Bank (ECB). All EU Member States—with the exception of Denmark and the United Kingdom, which negotiated “opt-out” clauses—are required to join the euro area once specific economic convergence criteria

are met. EU member countries that have acceded since 2004 will join the euro area once they fulfill the necessary conditions; Slovenia, Cyprus, Malta, and Slovakia have already adopted the euro.

Economic policy under EMU requires that Member States ensure coordination of their economic policies, provide for multilateral surveillance of this coordination, and demonstrate financial and budgetary discipline. Monetary policy underpins the single currency's stability through price stability and respect for the market economy.

Fiscal policy (tax and spending) remains in the hands of individual national governments, as do policies about labor, pensions, and capital markets. However, sound public finances and flexible and integrated product, labor, and financial markets are vital for EMU to function effectively. Governments commit to respect commonly agreed rules on public finances through adherence to the Stability and Growth Pact, which requires governments to maintain an annual budget with a deficit no greater than three percent of GDP and public debt at 60 percent of GDP or less, and coordinate their structural policies to better achieve continental-level stability, growth, and development through the Lisbon Strategy for Growth and Jobs.

The Lisbon Strategy for Growth and Jobs.

First adopted in 2000 and relaunched in 2005, the Lisbon Strategy aims to boost growth, create more and better jobs, and make Europe an attractive place to invest and work through national structural reform programs. By combining economic dynamism with sustainable growth through investment in skills and education, leadership in research, and equipping people for change, the Lisbon Strategy creates an environment that fosters creativity, modernization, and the capacity of European enterprises to offer more innovative products and services more quickly.

Non-Euro Area Countries and ERM II. Once a Member State adopts the euro, an exchange rate is irrevocably fixed between its national currency and the euro throughout the transition to full use of the single currency. Member States outside the euro area can also choose to link their currencies to the euro under the Exchange Rate Mechanism (ERM II), in which participating currencies fluctuate within a specified margin (+/- 15 percent) around a stable but adjustable central rate. ERM II was established to ensure that exchange rate fluctuations between the euro and other EU currencies do not disrupt economic stability within the single market, and to help countries prepare to join the euro area.

Slovakia—A New Addition to the Euro Area

The euro was launched as a “virtual currency” on January 1, 1999, followed by the introduction of banknotes and coins in 2002. The euro area has expanded from its initial 11 members to 16 with the January 2009 addition of Slovakia.

Countries earn their way into the euro area through adopting the economic, monetary, and fiscal discipline necessary to comply with the required economic convergence criteria (“Maastricht Criteria”):

- The inflation rate should be no more than 1.5 percentage points above the previous year's rate for the three EU countries with the lowest inflation. Slovakia's 12-month average inflation was 2.2 percent, well below the 3.2 percent reference calculated for the same period.
- The national deficit generally must be below three percent of GDP. Slovakia's deficit was 2.2 percent of GDP and falling.
- National debt should not exceed 60 percent of GDP, although a country with a higher rate can still adopt the euro, provided its debt level is falling steadily. Slovakia's debt was 24.9 percent of GDP and falling.
- Long-term interest rates should be no more than two percentage points above the previous year's rate in the three EU countries with the lowest interest rates. Slovakia's average long-term interest rate was 4.5 percent, below the reference rate of 6.5 percent.
- The national currency's exchange rate should have remained within the authorized fluctuation margins for two years. The Slovak koruna participated successfully the Exchange Rate Mechanism, in which currencies fluctuate within a specified margin (+/- 15 percent) around a stable but adjustable central rate.



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