



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.7.2006
COM(2006) 392 final

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN
CENTRAL BANK**

– Annual Statement on the Euro Area –

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I. INTRODUCTION

1. ***Membership of the euro area strengthens the degree of economic interdependence between Member States through the existence of a single monetary policy and by fostering closer trade and financial ties and encouraging a closer coordination of economic policies.*** In view of this interdependence, euro-area members face economic challenges which are related to, and in some cases more immediate than, those confronted by all Member States of the European Union (EU).

2. ***The Annual Statement on the Euro Area, and its companion piece, the Annual Report on the Euro Area, present the Commission's views on the nature of these challenges and discuss the appropriate response of economic policies at the euro-area and Member State level.*** It aims to raise awareness and stimulate a broad debate on euro-area economic policies and developments; issues that are relevant for the 310 million people living in the euro area. It is also salient in the context of euro-area enlargement, with Slovenia becoming the newest Member State to join the euro area on 1 January 2007¹. By informing policy makers and the broader public, it complements the Commission's analysis of the euro-area economy in publications such as the Quarterly Report on the Euro Area, Public Finances in EMU and the EU Economy Review.

II. IMPROVING OUTLOOK FOR THE ECONOMY

3. ***Shaking off the sluggishness of the last five years, the euro area is experiencing a recovery in economic activity.*** Businesses are looking to the future with greater optimism thanks to strong corporate profits and low interest rates. Consumers, too, are gradually becoming more confident about the road ahead with expenditure expected to pick up gradually after several cautious years. The euro-area's better performance at home is supported by a continued strong growth in external demand. This reflects buoyant world trade, but also improving competitiveness at the global level.

4. ***Growth is going back to potential, but there are no grounds for complacency.*** The European Commission's latest forecast expects euro-area GDP to grow by 2.1% in 2006 – as compared with a growth rate of 1.3% in 2005. Consumer price inflation, which reached 2.2% last year, partly as a result of high energy costs, is expected to

¹ The current members of the euro area are Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland.

remain at this level. This year, over a million new jobs will be created in the euro area. Nevertheless, in spite of the recent substantial decline, the unemployment rate still remains at 7.9% of the labour force in May 2006, while with employment growth at 0.9% per annum, the pace of job creation in the euro area is still too slow. Similarly, the low rate of potential growth in the euro area, around 2% per annum, underlines, *inter alia*, the need for productivity-enhancing reforms. Redressing this balance is a top priority for euro-area policies in the years ahead.

5. ***Risks to the outlook are on the upside in the short term, but more on the downside over the medium term.*** Over the short term, job creation and the positive effects of past or ongoing economic reforms in the euro area could help to spur economic growth by more than expected. Over the medium term, the possibility of further rises in oil prices could dampen growth conditions in the euro area. The risk of a disorderly unwinding of global imbalances could undermine global growth and the euro-area's economic recovery. On the upside, the windfall profits of oil-exporting countries may translate into extra demand for euro-area goods and services.

III. SECURING SOUND MACROECONOMIC POLICIES

6. ***Macroeconomic policies have played an important role in the euro-area's economic recovery, building on the credibility of the policy framework created by EMU.*** Monetary policy helped to spur economic activity and confidence by keeping an accommodating stance, which led to historically-low nominal and real interest rates in 2005, while maintaining price stability. Fiscal policy has also been supportive of economic growth in the euro area. Indeed, most Member States were, thanks to previous efforts to promote fiscal consolidation, in a better position to allow the automatic stabilisers to play a broadly supportive role in recent years.
7. ***As the economic situation improves, the macroeconomic-policy setting must evolve.*** With respect to monetary policy, the monetary stimulus given in recent years is gradually being withdrawn. Budgetary authorities have a responsibility to recharge Europe's budgetary batteries after the economic slowdown by improving budgetary balances and paying off government debt. Securing the sustainability of public finances is also essential in view of the additional budgetary pressures that will stem from the ageing of the euro-area's population. According to the Commission's latest forecast, overall government borrowing in the euro area is expected to remain unchanged in 2006 in spite of the improved economic situation, although less temporary measures imply somewhat better structural balances. To fully implement the preventive arm of the Stability and Growth Pact, some euro area Member States will need to undertake a more ambitious budgetary adjustment in 2006 and 2007 than envisaged in their 2005 Stability Programmes.
8. ***Concerns that an adjustment in macroeconomic policy would cut short the economic recovery are unjustified.*** The real worry is that a failure to undertake such adjustment will undermine the conditions for continued economic growth in the euro area by postponing policy decisions that are necessary to sustain the recovery over the medium term. When it comes to macroeconomic policy, Europeans have learned the hard way that a strategy of wait and see will not do. In the 1970s and 1980s, a disregard for macroeconomic stability during the good times contributed to a crippling legacy of persistent inflation, high deficits and rising debt laying the ground

for low growth and high unemployment. More recently, the favourable growth at the end of the 1990s was not seized upon to complete the fiscal consolidation undertaken in the run up to EMU. With economic growth in the euro area experiencing a sustained pick-up for the first time since 1999, the European Commission considers that a prudent macroeconomic policy mix delivering price stability and reduced fiscal imbalances coupled with structural reforms to improve the functioning of product, labour and capital markets would be the appropriate policy response.

IV. ENHANCING ECONOMIC REFORM IN THE EURO AREA

9. ***Winning the battle for macroeconomic stability in the euro area and the war for growth and jobs is an economic and political priority.*** Twelve million men and women are still unemployed in the euro area. Growth and productivity are too low, especially when the challenges presented by our ageing population are considered. Technological advances and globalisation are not yet fully benefiting all Europeans. Whereas some lay the blame for the euro area's disappointing growth and employment performance over the last five years at the door of the single currency, the real reason lies in insufficient progress in product, labour and capital market reform. Stepping up the pace of economic reforms, fostering greater competition, and ensuring macroeconomic stability are central to the Lisbon partnership for growth and jobs.
10. ***Ensuring broad public support is central to the success of economic reforms.*** While there is a growing awareness in Europe of the need for macroeconomic stability, a few persistent myths about economic reform need to be addressed. One is that economic reform is about giving up a standard of living that Europeans can no longer afford. Although it can entail short-term adjustment costs, economic reform is ultimately about raising Europe's standard of living. According to a study by the European Commission, comprehensive economic reforms in product, labour and capital markets could raise potential growth in the EU from 2% to 3%. This means more jobs, higher disposable incomes and the modernisation of Europe's unique welfare state. Another myth is that economic reform is about making Europe less European by importing a different economic and social model. On the contrary, economic reform is about reconnecting with the European values of entrepreneurship and social concern that are embedded in the Treaty of Rome.
11. ***EU leaders have recognised that economic reform is part and parcel of euro-area membership.*** The Spring European Council earlier this year again underlined that, in a monetary union, well-functioning product, labour and capital markets have an important role to play in raising growth potential and also in cushioning the impact of economic shocks. Prices and wages that respond rapidly to changing economic circumstances are also essential for dealing with unwarranted inflation and growth differences between euro area Member States. Although all EU Member States stand to gain from the Lisbon reform agenda, the members of the euro area have an added incentive to enhance structural-reform efforts as the benefits of greater competition will accrue more quickly if members of a monetary union open up their markets in tandem.
12. ***It is paramount that euro area Member States take resolute steps on the path of economic reform identified in the Integrated Guidelines for Growth and Jobs for***

the period 2005-2008. The Commission's Annual Progress Report on the Lisbon Strategy, which was adopted in January 2006, notes that euro area Member States have shown commitment in their National Reform Programmes to achieving sustainable public finances, bolstering labour productivity and raising employment and participation rates while respecting the imperatives of sustainable development. Nevertheless, some euro area Member States will need to go further to ensure well-functioning goods, services, labour and capital markets for a dynamic and smooth-functioning EMU. Key priorities in this regard include stepping up the pace of R&D in the euro area, promoting greater competition in services and network industries, notably in energy, and achieving greater labour-market adaptability.

13. ***To ensure a sustainable social model, achieving higher growth and more jobs is critical.*** In this context, reforms pioneered by Nordic countries, which are often referred to as "flexicurity", may represent a source of inspiration for euro area Member States. These reforms have led to dynamic economies by promoting a high degree of adaptability in work organisation and labour relations while providing security for workers, *inter alia*, through substantial investment in life-long learning and retraining and activation policies for unemployed people. Although there is not a single, one-size-fits-all model of "flexicurity", the principle of increasing flexibility where needed in the labour market whilst safeguarding certain securities for workers may be implemented by various means². The experience of the Nordic countries may not be easily transferred to other Member States. Besides the fact that preferences may be different at the national level, policy makers must also give due regard to, for example, the budgetary implications of such reforms, especially in countries still running significant deficits or which may be under strain from the budgetary consequences of ageing populations.

V. ONE MONEY, ONE MARKET

14. ***In the 1980s, Member States recognised that establishing "one market" in Europe provided a powerful argument for the creation of "one money".*** Now that one money is a reality, euro area Member States must have the conviction to support policies that sustain the Internal Market. Over the last twelve months, some have challenged this goal by emphasizing the national imperative of protecting key industries from cross-border competition. But this prohibits companies from exploring all the possibilities offered by the Internal Market, and is to the detriment of consumers who forego the benefits of lower prices and increased choice. Fifty years ago, the signatories of the Treaty of Rome made a break from such policies by declaring their solemn commitment to the free movement of persons, goods, services and capital, providing the basis for Europe's economic prosperity and political stability in the second half of the 20th Century. The commitment to these principles has to be renewed by choosing economic policies that sustain the Internal Market and foster tangible economic benefits for the euro area and EU as a whole.
15. ***Economic reform within Member States is necessary to deepen the Internal Market and sustain EMU.*** The Internal Market plays a key role in achieving the objective of

² The Commission has started a process of reflection and analysis on the different concepts of "flexicurity" and intends to bring forward a Communication on this issue in the first half of 2007.

creating more growth and jobs. Supported by the single currency, it promotes a more efficient allocation of resources and offers greater trading opportunities to businesses and a wider choice to consumers. But the Internal Market can only achieve its full potential if legislation agreed at the European level is effectively implemented and applied by all Member States. In this respect, the poor performance of most euro area Member States in transposing and applying Internal Market legislation remains a source of concern. Seven euro area Member States have not reached the 1.5% transposition-deficit target, while the four largest euro-area countries are the worst performers among the EU-25 in terms of the number of infringement cases. To raise growth potential further and increase the responsiveness of the euro area to economic shocks, moving ahead with further economic integration through a fuller transposition and better implementation of directives will be essential.

16. ***Reforming the service sector is crucial for the euro area.*** The importance of promoting greater integration in the services sector should not be underestimated given that services account for around 70% of total jobs and value added in the euro-area economy. In this respect, the full implementation of the EU Services Directive, following its adoption later this year, is crucial to foster competition and economic dynamism in Europe and fully exploit the potential benefits offered by the single currency.
17. ***Financial market integration, in particular, offers real benefits by contributing to greater productivity and competitiveness and ultimately increasing the potential for economic growth.*** Removing the barriers to the creation of a Single Euro Payments Area would provide stronger incentives for trade, consumption and investment within the euro area by allowing citizens and businesses to make cross-border payments as easily, safely and efficiently as they already can within their own countries and subject to identical charges. Financial market integration can also contribute to the smooth functioning of EMU by promoting macroeconomic adjustment and increasing the resilience of the euro area to external economic shocks. Economic studies suggest that EU financial market integration could increase GDP by between 0.5 and 1.1% over time.
18. ***The EU and euro area must build on the achievements of the euro and the EU's Financial Service Action Plan.*** This calls for consolidating existing legislation on financial services and ensuring that Internal Market rules are implemented on time and enforced effectively. Further action will be required to open up Europe's fragmented retail financial services, for example, by making it easier for consumers to shop around for the best savings plans, mortgages, insurance and pensions. Another major challenge over the next five years is to develop a pan-European approach to financial market regulation and supervision to keep pace with the increasing cross-border integration of the financial industry. While this is essentially a positive – and even necessary – development to enhance the economic growth potential of the EU, it also means that national authorities need to be willing to adapt and adjust to the new financial landscape. In this context, the continuing tendency by Member States to add unnecessary provisions when transposing directives into national law must be curtailed if the full benefits of an integrated market for financial services are to be realised.
19. ***In order to generate sustainable improvements in productivity growth, the euro area needs to generate and, above all, absorb and exploit knowledge.*** A high degree

of competition and favourable framework conditions for companies to innovate are essential in this respect, including an integrated and efficient framework for the protection of intellectual property rights. Businesses need to enjoy a friendly regulatory framework, have sufficient supply of highly-qualified personnel and to have access to affordable sources of financing. In addition, more resources need to be invested in R&D and innovation and, in particular, Europe-wide economies of scale should be exploited by encouraging private spending in R&D and projects and activities with significant cross-border spillovers. R&D expenditures in the euro area stand at around 2% of GDP, thus significantly short of the EU-wide objective of 3%. All euro area Member States have set targets with respect to rising R&D expenditures when submitting their National Reform Programmes or thereafter.

20. ***Reforms that aim at increasing labour utilisation and human capital will also improve the adaptability and facilitate the mobility of the euro-area's workforce.*** Moreover, measures that focus on the matching of labour demand and supply, for example through an upgrading of public-employment services, can be expected to improve adjustment to shocks. Although some euro area Member States have undertaken reforms in this field, measures have generally targeted flexibility of work contracts for new entrants and people facing particular difficulties in the labour market through fixed-term contracts, job agencies, public employment schemes, while leaving unchanged some aspects of the legislation on permanent employment that may act as a barrier to labour-market adjustment.
21. ***In order to improve the supply of highly-skilled labour across the euro area, an upgrading of education and training systems in many Member States is necessary.*** Efforts should concentrate on upgrading the quality of human capital and the skills base of the workforce. Youth education attainment levels are significantly lower in the euro area than in the rest of the EU. Policies are also required to develop coherent and comprehensive life long learning strategies, which will help to promote flexible learning pathways from an early stage, a significant decline in early school-leaving, to increase completion rates at upper secondary level, and to improve the quality, relevance and attractiveness of vocational education and training. The quality of tertiary education needs to be improved to increase the contribution of universities to social and economic innovation. Excellence should be pursued through the networking of higher education institutions with research and technological centres and enterprises. An efficient use by Member States of available EU funding, in particular the European Social Fund and Education and Training Programmes, would contribute to meeting these goals.

VI. A DYNAMIC AND SMOOTH FUNCTIONING EMU

22. ***The persistence of cross-country growth and inflation differences in the euro area deserves attention.*** In 2005, for example, the gap between the fastest and slowest growing countries in the euro area stood at 4½ percentage points and the gap between the highest and lowest inflation rates stood at 3 percentage points. As discussed in the Annual Report on the Euro Area, growth and inflation differences are a normal feature of monetary unions and can reflect a variety of benign factors, including differences in population growth and the effect of catching-up by less-rich Member States. Cyclical differences have been substantially reduced in recent years, thanks to a closer alignment of cycles and the reduction of policy errors due to better

macroeconomic-policy coordination. This is a positive development for a monetary union. However, the decreasing importance of cyclical factors means that structural factors now account for a high share of the growth differences that remain. In particular, it appears that some Member States may be adjusting to economic shocks and long-term economic developments only very sluggishly. Unless policies change, this means that the gulf between the euro-area's fast and slow growing Member States may become entrenched over time, and that inflation differentials may translate into a serious loss of competitiveness, which would require a more significant adjustment the more action is delayed.

23. ***Getting to grips with growth and inflation differences requires a mix of sound budgetary policies and economic reforms.*** The action to be taken is identified in the Integrated Guidelines for Growth and Jobs for the period 2005-2008. Maintaining prudent budgetary policies, particularly during the good times, will allow the automatic budgetary stabilisers to cushion the economic shocks that drive growth and inflation differences. Economic reforms will also help prices and wages to react more rapidly to changing economic circumstances and favour a more efficient allocation of resources. Most Member States need to step up the pace of reforms to foster competition and raise productivity in the market for goods and services. Policies that deepen the Internal Market in the area of services, such as financial markets, could also help by promoting a closer alignment of national business cycles. Furthermore, some Member States may need to take steps to ensure that the process of wage determination pays sufficient regard to price stability, trends in productivity over the medium-term and differences across skills and local labour-market conditions.

VII. THE EURO AREA'S GLOBAL ROLE AND CHALLENGES

24. ***The euro is a key global currency, providing benefits to the euro area and underlining the need to pay due regard to international financial developments.*** The launch of the euro has led to a seismic shift in international financial markets. Today, the euro area represents about one sixth of world GDP and a fifth of world trade and the euro accounts for a substantial and increasing part in the denomination of the international debt market (31.5 % versus 44 % for the US dollar by mid-2005). The euro also accounts for a significant proportion of international bank liabilities and foreign exchange transactions. For example, since 1999, the euro has been the second currency of denomination of loans by euro-area banks to non-bank borrowers outside the euro area, with the share above 39% in the first quarter of 2005 (against 44% for the US dollar). The euro is also widely used to quote, invoice and settle external trade transactions between the euro area and third countries and, in some cases, between third countries. The euro also plays an important role as an international foreign exchange reserve currency, accounting for about 25% of world reserves, compared with 66% for the US dollar.
25. ***The unprecedented size and duration of global imbalances is a key challenge for the world economy and the euro area.*** In 2005, the United States posted the largest current account deficit in its history – equivalent to 6.4% of US GDP and 1.5% of world GDP. The deficit is mostly financed by capital inflows from Japan, China and other East Asian countries, and recently also from the Middle East (which profits from oil revenue windfalls). Although financial markets have been relatively

sanguine about this situation, the unprecedented size and duration of global imbalances means that they cannot go on indefinitely.

26. ***A disorderly unwinding of global imbalances could have a severe, negative effect on the growth of the world economy and international financial stability.*** Although the euro area has a roughly balanced current account, it would not be immune to the effects of such a crisis. A disorderly adjustment of global imbalances could affect euro-area trade due to changes in exchange rates and global demand. It would affect the value of assets held abroad by euro-area residents. Business confidence could also be severely hit, particularly in the event of a severe output contraction in deficit regions.
27. ***Tackling global imbalances in an orderly manner requires a gradual shift in global demand from regions with current-account deficits to regions with current-account surpluses.*** The United States can play its part by increasing private and public savings. Stability-oriented macroeconomic policies, and in particular sustainable public finances, could make an important contribution in this regard. In East Asia, the challenge is to reduce excess savings. A transition to more domestically-generated growth through improved social-security systems and financial market development would help to reduce global external imbalances. This would also support East Asia's longer-term development. As domestic demand accelerates in these countries, their savings (and current-account) surpluses will be reduced.
28. ***Economic reforms in Europe will help the euro area to adjust to potentially adverse global developments and to play a part in the orderly correction of global imbalances.*** Better-functioning product, labour and capital markets would make Europe more attractive to investors even if they would be unlikely to result in large changes in the current account, because both demand and supply would rise. Also, only a fraction of a change in the euro-area current account would appear as an improvement in the US current account. Nevertheless, economic reforms remain desirable from the point of view of improving the euro-area's performance, as they increase growth potential and strengthen resilience to possible adverse economic shocks. This issue is explored in greater detail in the Annual Report on the Euro Area.

VIII. INCREASING THE EFFECTIVENESS OF COORDINATION

29. ***Sustaining the economic recovery and promoting macroeconomic stability and structural reforms for a dynamic and smooth-functioning EMU requires commitment by Member States and strong leadership at the euro-area level.*** The Spring 2006 European Council recognised the special importance of enhanced structural reforms for Member States that share the euro and stressed the necessity of effective policy coordination within the euro area. Alongside the key role played by ECOFIN, the Eurogroup, which brings together, on an informal basis, the Finance Ministers of the euro area, the Commission and the ECB, is helping to promote a euro-area wide consensus on shared economic-policy challenges. Euro area Member States could benefit more from the Eurogroup meetings by engaging in a more thorough discussion of macroeconomic policies and a closer follow-up of structural reforms in the euro-area Member States, particularly where these are important for

the functioning of EMU. Steps could also be taken to increase the effectiveness of economic policy coordination in the euro area, for example, by eventually switching to an EU Semester for budgetary surveillance, coordinating national budgetary calendars among euro area Member States, and ensuring greater coherence between macroeconomic policies and structural reforms.

30. ***The growing importance of the euro as a global currency and the challenges posed by, inter alia, global imbalances, underlines the need for the euro area to show leadership on the world stage.*** The Commission recognises that some progress has been made in this respect in recent years. The appointment of a Eurogroup President for a two-year term of office in 2004 has, for example, brought greater stability to the external representation of the euro area. Nevertheless, the scarcity of common positions among euro-area authorities and the lack of firm commitments from its Member States on issues of shared strategic significance have made it difficult for Europe to show global economic leadership. The European Commission supports, and is ready to contribute to a better coordination of EU external representation in international financial institutions and fora.

IX. CONCLUSIONS

31. ***Sharing a single currency implies confronting common challenges and responsibilities.*** This Annual Statement on the Euro Area has highlighted the most salient challenges for the euro area. The improved outlook for the euro-area economy calls for a decisive adjustment of macroeconomic policies, notably by accelerating budgetary consolidation. In the microeconomic domain, enhanced structural reforms are essential for raising productivity and promoting growth and jobs. They are also important for the smooth functioning of EMU, as prices and wages are adjusting too slowly to economic shocks in some Member States. At the same time, euro-area members have a strong incentive to deepen the Internal Market, as increased economic integration will help to reap in full the benefits of the single currency and to respond rapidly to economic developments. In the external domain, the growing importance of the euro as a global currency and the challenges facing the world economy underline the need for a more prominent role on international issues. Meeting these challenges and fulfilling responsibilities requires commitment by Member States and measures to improve the effectiveness of economic policy coordination.