THE ROLE OF THE EURO
IN THE EUROPEAN INTEGRATION PROCESS

Photo: © European Union 2013

THE EURO

BASICS | ARGUMENTS | PERSPECTIVES

The euro is one of the most important projects that the European partners have committed to since the foundation of the European Union. The common currency is a symbol for European integration. It gives Europe a unique opportunity to have a global voice.

The global financial crisis and the European sovereign debt crisis gave us a clear lesson: Structural problems in individual member states can cause severe economic repercussions across the EU. However, the crisis in the eurozone is not a crisis of the euro itself. It is a sovereign debt crisis, a banking crisis and a competitiveness crisis combined. The roots of which lie in a series of inter-related issues starting with unsustainable fiscal policies all over Europe, lack of economic reforms and inadequate regulation of financial and labour markets. These were weaknesses which magnified the consequences of the global financial crisis that started in 2008.

In the interim many countries have adopted important measures to increase their competitiveness and strengthen economic stability. These reforms are now showing the first signs of success. However, no magic formula exists. Therefore, in the first major crisis in the history of the eurozone, the conclusions drawn should not be to abolish the euro and return to old currencies. The political and economic consequences of this would have far-reaching effects fraught with incalculable risks. In fact, it would be more constructive to further develop the monetary union and strengthen the European integration process.

Konrad-Adenauer-Stiftung and the Martens Centre are committed to the idea of European unity and economic prosperity. We would like to contribute to the ongoing process of European integration, both as messengers and mediators. We set the leaflet The Euro: Basics, Arguments, Perspectives in order to offer an overview of how the euro has transformed the European integration process and the lives of many Europeans since its introduction in 1999.

The European member states share rights and duties, opportunities and risks. Each member state has to make its own contribution to the ongoing recovery process. If we succeed in this, the euro offers more opportunities than risks.

This is a joint publication of the Wilfried Martens Centre for European Studies and the Konrad-Adenauer-Stiftung e.V.
This publication receives funding from the European Parliament. The European Parliament assumes no responsibility faor facts or opinions expressed in this publication or any subsequent use of the information contained therein. The processing of the publication was concluded in 2014.

Project coordination:
Cvetelina Todorova, Konrad-Adenauer-Stiftung e.V.
Eoin Drea, Martens Centre

Text:
Rebecka Jürisoo, Cvetelina Todorova, Eoin Drea
with the kind participation of:
Matthias Schäfer, Eva Rindfleisch

Technical and Scientific Assistance:
Cologne Institute for Economic Research

Graphic Design:
Cologne Institute for Economic Research Media

Cover Design and Layout:
SWITSCH KommunikationsDesign

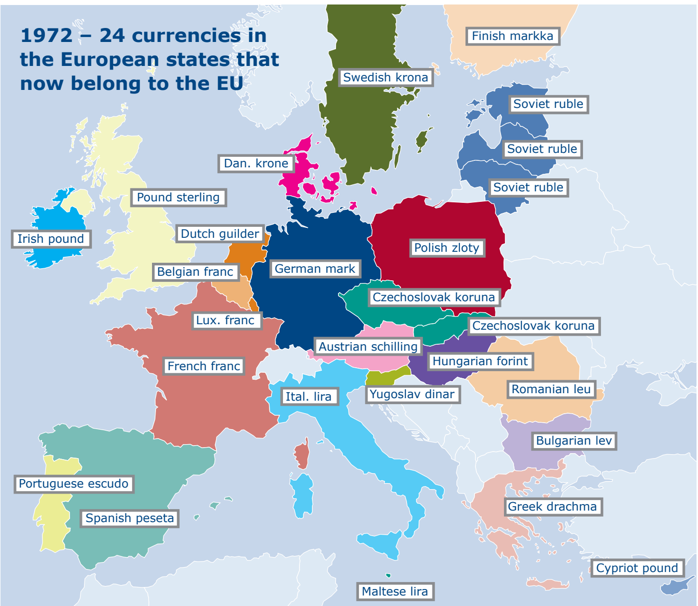
Print:
Infoflip is a registered trademark.
This Infoflip is Made in Germany by Infoflip Medien GmbH.
IF.G.09.00936.O.01

For more information please visit:

www.kas.de **www.martenscentre.eu**

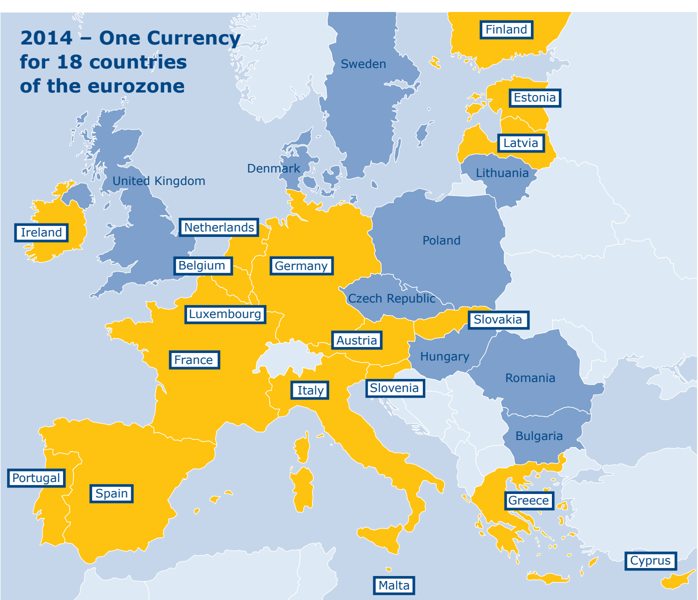
Wilfried
Martens Centre
for European Studies

Konrad
Adenauer
Stiftung



Today the euro is used by 18 countries in Europe. Its widespread presence, however, reaches far beyond the borders of the eurozone. The euro is a global currency – the second most actively traded in foreign exchange markets after the United States (US). Since its introduction in 1999, the euro serves to drive European unity forward and is a tangible sign of European integration. The reasons for introducing the euro were both political and economic. It was an important step towards achieving an operational internal market with free movement of capital, labour, goods and services while at the same time serving as a powerful sign of European unity and identity. The benefits of the euro are many, but it has particularly facilitated intra-eurozone trade as well as created an environment of low inflation and price stability in the eurozone member states.

The introduction of the euro was an ambitious and unprecedented monetary project which has transformed the European political and economic landscape. The deepening of European integration is still one of the European Union's (EU) most important political goals notwithstanding the difficulties associated with this process. Overcoming these obstacles has repeatedly led to further consolidation and, more importantly, created the potential for a new economic dynamic which serves to drive the integration process forward.



The Economic and Monetary Union (EMU) involves coordination of economic and fiscal policies, a common monetary policy and a common currency. Today, 18 out of the 28 member states are part of the common currency area, the eurozone.

In 1992, European leaders signed the Maastricht Treaty which laid down the foundation for the introduction of EMU. After intense preparations involving establishing the European Central Bank (ECB), regulating the competencies of the national banks and agreeing upon practical matters such as the name and design of the currency, the euro was launched on 1 January 1999 and officially became the currency of 11 member states. The ambitious project of introducing a common currency was carried out in two stages. When it was first launched in 1999, the euro functioned as a virtual currency for non-cash payments and was primarily used by banks and on financial markets. In 2002, euro banknotes and coins were introduced.

Monetary policy within the eurozone is now carried out by the ECB. The ECB is an independent institution with the principal aim of maintaining price stability within the eurozone. This is achieved by keeping the inflation rate around 2 %.

Since the introduction of the euro, 7 additional member states have joined. The eurozone now comprises 18 member states, Latvia being the latest addition as of 1 January 2014. The euro is now used by more than 333 million people.

TIMELINE OF INTRODUCING THE EURO

1992	*Treaty of Maastricht*
1997	*Stability and Growth Pact*
1999	*Introduction of the Euro as a virtual currency in 11 member states*
2001	*Greece joins the Euro*
2002	*Introduction of Euro banknotes and coins in the 12 member states*
2007	*Slovenia joins the Euro*
2008	*Malta and Cyprus join the Euro*
2009	*Slovakia joins the Euro*
2011	*Estonia joins the Euro*
2014	*Latvia joins the Euro*

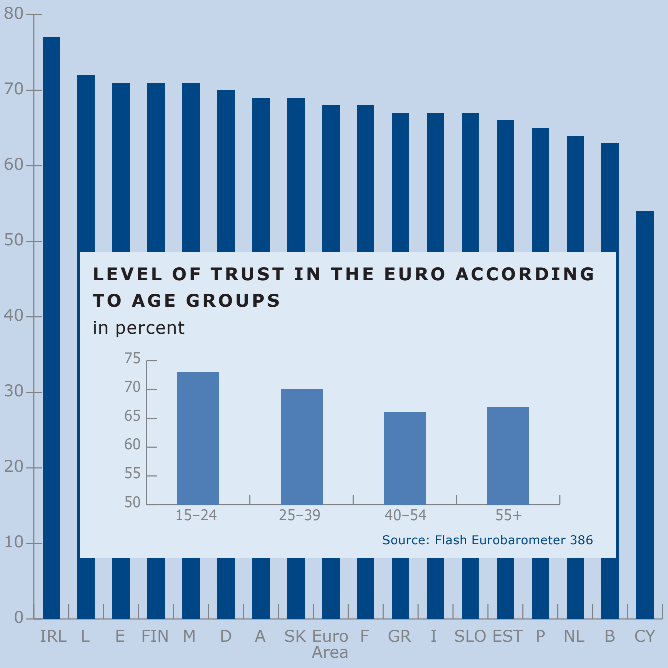
A representative study conducted by Eurobarometer in October 2013 shows that more than half of the European population supports the single currency, with 52% in favour of the euro and 41 % opposed. Among the eurozone countries, the support for the euro is even stronger with 57% regarding the euro as beneficial for their country and 68% thinking that it is a good thing for the EU.

In 15 out of the 17 eurozone countries (not including Latvia who joined in January 2014), more than half of each country's population favours the single currency. The support for the euro is particularly strong in Ireland (77 %), Luxembourg (72 %), Finland, Malta and Spain (71 %) and Germany (70 %).

Furthermore, the support for the euro within the eurozone is particularly strong among young people. 73 % of the population between the ages of 15 – 24 believe that the euro is a good thing for the EU.

Eurobarometer Studies indicate that the support for the euro has remained relatively stable during the financial crisis and has only fallen marginally. Even in the countries impacted most by the crisis, the majority of the population wants to keep the euro. The high support for the common currency, despite the effects of the economic and financial crisis, shows that the European population realises the benefits and potential of the common currency as a driver for economic growth.

LEVEL OF TRUST IN THE EURO IN COUNTRIES OF THE EURO AREA
in percent



Source: Flash Eurobarometer 386

The support of the euro in the eurozone member states is high, with an average of 68% regarding the euro as beneficial for the European Union. The support for the euro is particularly strong among young eurozone citizens.

When a country joins the eurozone it has far-reaching economic consequences. Whereas some advantages are immediately obvious such as the elimination of transaction costs, others, like for example low inflation and price stability, become more evident over time. Countries that wish to join the eurozone, such as Poland and Lithuania, know the long-term influence that the euro has on trade and economic growth.

The elimination of transaction costs and exchange rate risks significantly enhances the prospects for increased trade between the eurozone countries. It also stimulates the further development of the single European market. There are, however, two significant changes for monetary policy: First, there is one standard base interest rate for all member states of the eurozone. Second, exchange rates cannot be used as an instrument for controlling economic policy. This plays an important role for all kind of economic policy decisions in the long run.

The key benefits of adopting the euro are:

- Elimination of transaction costs
- No exchange rate risks
- Low inflation and price stability
- Stable long-term interest rates
- Price transparency
- Integration of financial markets
- Increased trade with other eurozone countries
- A stronger presence for all eurozone member states in the global economy

The external value of a currency is a relative, not an absolute, value. It has meaning only in relation to other currencies. The external value indicates the value of a currency in terms of another currency. This is where currency values have a direct influence on the valuation of goods, assets and services. This, in turn, is significant for price competitiveness and the efficient allocation of resources.

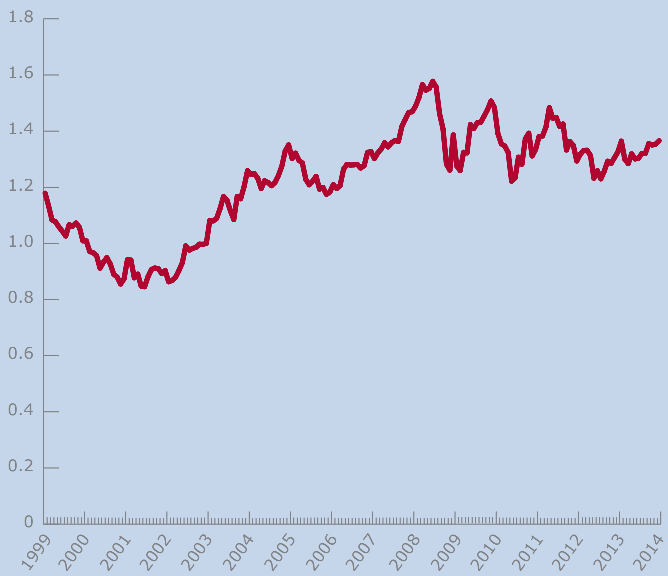
Since 2010, the sovereign debt crisis has been equated with a euro crisis. The argument cited is the weakening of the euro against the US dollar. The exchange rate (external value of the currency) has, however, moved in the range 1.20 and 1.45 USD/EUR since 2004 (exception: peak of 1.60 USD/EUR in the summer of 2008). It is therefore not subject to large fluctuations and in no way indicates a currency problem. Neither the exchange rate against the US dollar nor the inflation rates in the eurozone have deteriorated significantly since the start of the global financial crisis in 2008.

The task that remains is to avoid severe fluctuations in the external value, i.e. exchange rate shocks, as:

- Movements in the external value of the euro could have serious effects on the economies of member states due to the negative impacts on international trade. For example, the euro rising significantly in value against the US dollar has the effect of making eurozone exports to the US more expensive while simultaneously increasing the competitiveness of US imports entering the eurozone.
- The exchance rate of a currency is closely linked to the level of interest rates. A strong revaluation of the currency could result in higher interest rates and thus constitute a drag on the economy.
- The credibility and reputation of the ECB as a monetary policy maker could suffer if the exchange rate of the euro fluctuates significantly. An unstable exchange rate can result in a disturbed business environment as businesses postpone investment decisions, thus leading to lower economic growth.

EUR TO USD EXCHANGE RATE

Monthly averages



Source: Eurostat

The euro exchange rate against the US dollar has remained relatively stable since its introduction. Even in the midst of the financial crisis, the euro exchange rate did not fall below its 1999 level.

The main task of the European Central Bank (ECB) is to maintain the euro's purchasing power and thus price stability in the euro area.

The clear mandate of the ECB to pursue the objective of price stability helped establish its international reputation. In this way, the ECB, as a new institution, was able to gain a high level of credibility, both in the financial markets and publicly. The monetary policy of the ECB in general has been characterised by flexibility and pragmatism. An example of this is the focus on the price stability objective in the medium term, i.e. the ECB does not automatically react with rising interest rates for temporary price spikes. Interest rates only rise if so called second-round effects take place, e.g. if higher inflation rates are used as a benchmark for wage setting.

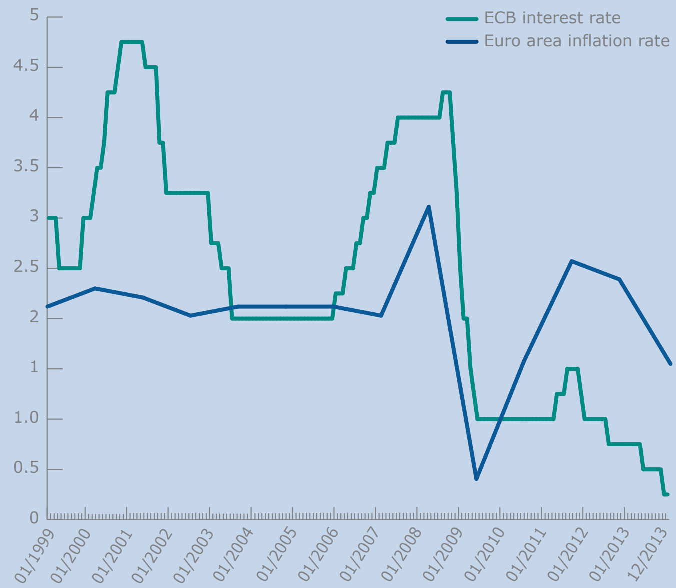
The ECB has played an important role in the response to the economic crisis which have impacted upon the EU since 2008. The ECB provided extensive support following the collapse of Lehman Brothers investment bank in September 2008 and again during the course of the sovereign debt crisis since 2010. This is highlighted by the very low interest rate levels which currently prevail.

The ECB, while bound by its underlying objective of maintaining price stability, has also acted to ensure the stability of the euro through the provision of Long Term Financing Operations (LTROs) to those eurozone banks requiring such liquidity support. These actions characterize the ECB's pragmatic approach to its monetary policy operations. Although this approach has increased the risk profile

of the ECB's balance sheet, its actions have firmly demonstrated to the financial markets that the ECB will act, where possible, to protect the stability and operational efficiency of the euro.

ECB INTEREST RATES AND INFLATION

in percent



Source: Deutsche Bundesbank

Since its establishment in 1999, the ECB has acted to maintain price stability within the eurozone. In late 2013, the ECB interest rate was reduced to 0.25% in order to stabilize the eurozone economy.

Several advantages of the common European currency have become clear during the financial and economic crisis. In such a crisis, a common currency is in many ways more stable since national currencies are more exposed to volatile movements in the global economy. In addition, the size of the eurozone economic area helps absorb asymmetrical shocks and is particularly beneficial for troubled economies.

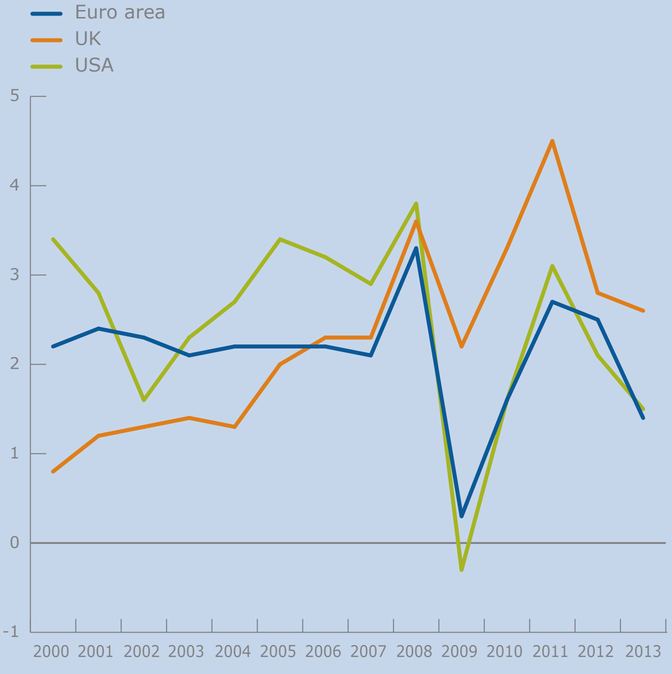
Currencies that are perceived as stable tend to be treated as 'safe havens' by investors, which causes an upwards revaluation of the currency. This is, for example, what happened to the German mark in similar economic crises in the past. A strong upward revaluation of a currency affects the export industry of the country and may cause its international price competitiveness to deteriorate; thus hindering growth and causing the loss of jobs.

On the other hand, currencies that are perceived as 'weak' or 'unstable' tend to be devalued in comparison to stronger currencies. This is particularly detrimental to countries that are heavily dependent on imports as it results in increased costs for imported goods. Furthermore, a weak currency increases the interest rates on government bonds.

The common currency excludes such crisis-driven revaluations and devaluations within the eurozone. The European Commission keeps a close eye on whether national measures are coordinated with neighbouring countries and ensures that domestic economic problems are not solved at the expense of other member state economies.

INFLATION

Percentage change of consumer price index from previous year



Source: OECD, Economic Outlook, 94

Low inflation rates are an important factor for a stable economic environment. Since 2000, the inflation rate in the eurozone compares favourably with the inflation rates in the United States and the United Kingdom.

The stability of the common currency has had a positive impact on the economies of the member states that have joined the eurozone. In times of crisis, the common currency has protected export countries, such as Germany and France, from a loss of price competitiveness due to revaluation. At the same time, it has protected countries that are very dependent on imports from increased import costs related to currency devaluation.

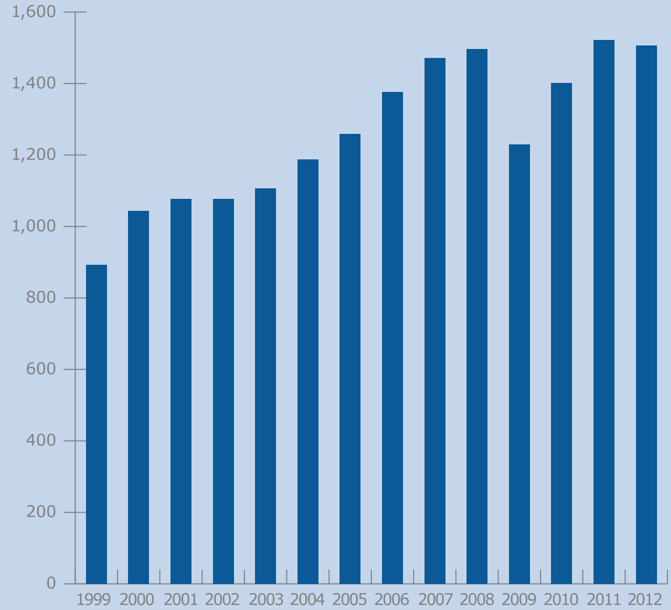
Having a common currency has also greatly facilitated trade among the eurozone countries. The majority of the countries that have joined the euro have experienced an increase in trade with eurozone neighbours. Studies, which isolate the impact of the euro, indicate that trade within the eurozone has increased by up to 11 % due to the currency union.

Before the introduction of the euro, businesses had to pay high fees on cross-border transactions. Through the elimination of these costs, an estimated €20 – 25 billion is saved every year – a capital stream that can be transformed into new investments and jobs. The common currency has also eliminated adverse exchange rate risks, which benefits both consumers and businesses. Before the euro was introduced, many businesses raised their prices abroad in order to cope with these risks, which made imports more expensive. Having one single currency also makes account management easier for businesses.

Finally, price transparency makes it easier for consumers to compare prices and thus find the cheapest supplier of products and services within the eurozone. Increased competition ensures that resources are allocated more efficiently, thereby supporting employment and growth.

INTRA EUROZONE EXPORTS

Billions of Euro



Source: Eurostat; Cologne Institute for Economic Research

Since 1999, intra eurozone exports have increased significantly. Recently, the level of intra eurozone exports returned to the levels of 2008.

Economic stability encourages economic growth and employment and is at the core of the ECB's monetary policy.

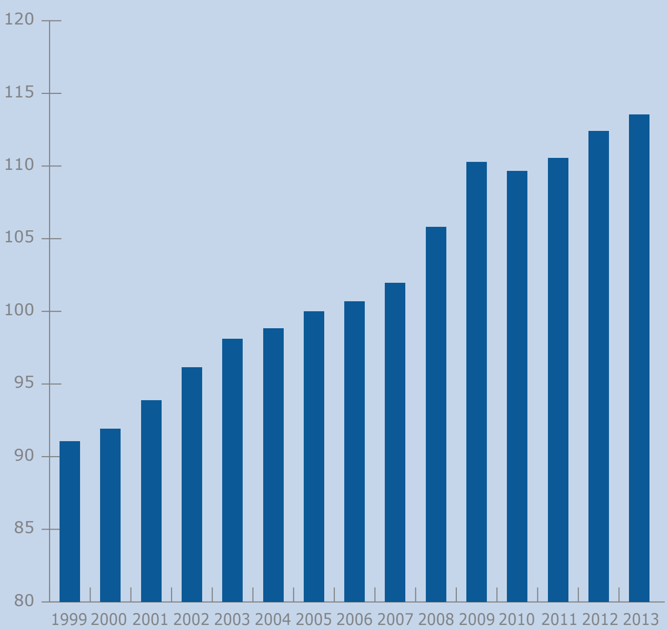
Price stability helps to moderate wage levels. A look at the relatively moderate development of unit labour costs within the eurozone shows that price stability in general has had a positive effect on wage levels. When prices rise too rapidly, people start demanding higher wages, which can lead to a spiral of rising prices and wages. The low rate of inflation within the eurozone has prevented this and thus has maintained Europe's overall price competitiveness. However, in several member states the lack of meaningful economic reforms did result in higher wage growth than would have been expected

With economic stability, consumers and businesses have the ability to make long-term investments and predict whether their investments will generate a profit. Furthermore, low inflation keeps interest rates stable. When the euro was introduced, interest rates fell significantly within the eurozone. Low interest rates in general create a good environment for starting up businesses and for existing businesses to invest and expand. However, while low interest rates generally contribute to economic growth, the easy access to credits facilitated a credit-fuelled boom in several member states.

Therefore, the on-going reforms of EMU at EU level are designed to ensure a more sustainable economic environment across all the member states.

UNIT LABOUR COSTS IN THE EUROZONE

Unit labour costs measures the employer's labour costs for one unit of output and is measured in relation to productivity.



Source: European Central Bank

Apart from the global economic crisis in 2008 and 2009, the increase of unit labour costs has been relatively stable and is broadly in line with the overall rate of inflation within the eurozone.

Before the introduction of the common currency, financial markets were mainly national with limited cross-border activities. However, the introduction of the euro in 1999 served as a catalyst for the integration of financial markets within the eurozone – an important step in fully completing the internal market. It also acted as a catalyst for the eurozone's integration into the global financial markets.

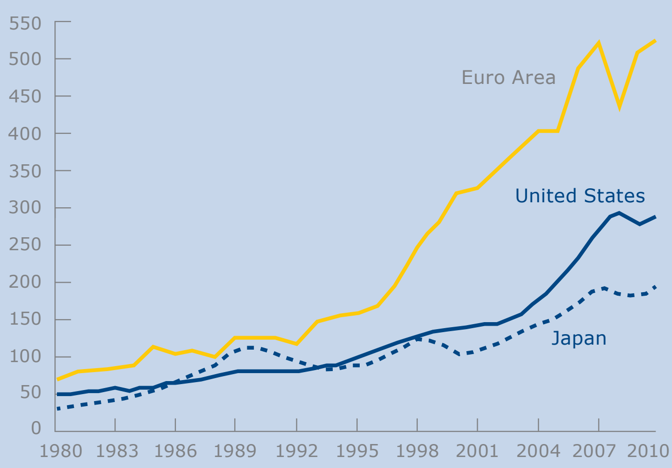
Integrated financial markets are vital to the EU economy as they generally provide a more efficient allocation of capital. Consumers and businesses can invest throughout the eurozone area to obtain the optimal return on their investments or attain the lowest interest rate on their credits. Consumers have more choices when it comes to investing in pension funds, bonds or credits, and can find the option which best suits their needs. With more options available, investors can also spread their risk more widely.

Furthermore, when there are more sources of capital, competition increases among financial institutions which keeps interest rates low. With access to cheaper credits, it is easier for businesses to invest and expand, which promotes productivity, the creation of jobs and economic growth. Increased competition has also decreased the costs of trading in equity, bonds and bank assets within the eurozone, as well as reduced financial costs such as bank charges. While a high integration of financial markets is beneficial to the EU economy, it requires a comprehensive regulatory and supervisory framework. The economic and financial crisis has revealed a high degree of interconnectedness between European financial institutions, highlighting the need for more comprehensive

and efficient regulations to maintain the stability of the European

banking system. Since the outbreak of the financial crisis, stricter rules for strengthening bank capital and liquidity have been implemented. In addition, the first steps have been taken towards creating a banking union. A banking union will, in the long-term, better ensure the stability of the European banking sector, decrease the dependency between national banks and governments and significantly reduce the likelihood of future banking crises.

INTERNATIONAL FINANCIAL INTEGRATION RATIOS



Source: Lane. P, Capital Flows in the Euro Area, Economic Papers 497, April 2013

The international financial integration ratio shows the ratio of foreign assets and liabilities to Gross Domestic Product (GDP). Notwithstanding a severe correction in 2007 and 2008, the eurozone is now more integrated into the global financial markets than ever before. The dangers posed by the international nature of the eurozone area are also been addressed by the banking reforms currently being implemented by the EU.

In order for the Economic and Monetary Union to maintain economic stability, the eurozone countries have to closely coordinate their fiscal policies. Under the Stability and Growth Pact (SGP), the eurozone countries are obliged to maintain their government debt and annual deficit at 60 % and 3 %, respectively, of Gross Domestic Product (GDP). The requirements set down in the SGP also need to be met by member states that wish to adopt the euro.

The citizens and businesses of the member states greatly benefit from economic stability and sound public finances. Through sound public finances, interest rates on government bonds remain low, which keeps the government's refinancing costs low. This saves tax-payers money that can be used for other purposes, such as tax cuts, investing in infrastructure, welfare or education.

The financial crisis, however, has revealed weaknesses in the economic governance of the Economic and Monetary Union. Through several important decisions, including the so-called 'six-pack' and 'two-pack' legislative packages, the enforcement of the SGP has been strengthened and the member states have committed to a closer coordination of their financial and budgetary policies.

Ultimately, the member states commitment to create sound public finances is a commitment to ensure sustainability, growth and long-term employment.

ECONOMIC REFORM PROGRAMMES

1992 **Treaty of the European Union (Maastricht)**
Maastricht criteria as entry conditions: fiscal deficit no more than 3 % of GDP, public debt no more than 60 %

1997 **Stability and Growth Pact (SGP)**
Continued relevance of fiscal Maastricht criteria

2005 **SGP-Reform (flexibilisation)**
Medium term targets for structural deficits
More exemptions (e.g. public investments and quality of public finances)

2010 **European Semester**

2011 **Six-pack**
More power for the EU Commission and earlier sanctions
More relevance for the public debt criterion of 60 %
Country specific recommendations in order to improve public finances

2012 **Fiscal Compact**
Transition of main SGP rules to national legislation

2013 **Two-Pack**
Commission can send back draft budget
Economic Reform programmes

Today, the eurozone constitutes the second largest economic area in the world and comprises a single currency area of 333 million people. This represents a larger population than in the United States. Combined with the benefits of the single European market, eurozone businesses and consumers increasingly benefit from a more integrated and self-contained eurozone economy.

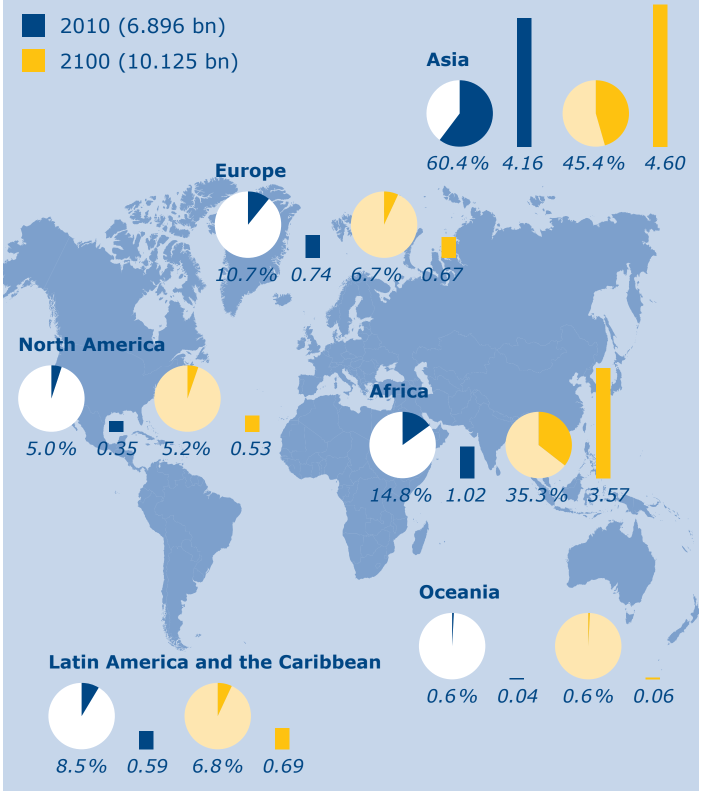
The percentage of Europeans in the world population is decreasing rapidly. Whereas Europeans still accounted for just 11 % of the world's population in 2010, in 2100 it will be 7 %. A dynamic economic and monetary area will then be even more important in order to ensure that the eurozone retains its influential role in global economic affairs. For this reason, a successful development of the eurozone as an economic bloc is essential in terms of prosperity, jobs and security.

The strength of the euro together with the size of the eurozone economy encourages international organisations, such as the OECD and the IMF, to treat the eurozone as one single block. This gives the EU a stronger voice in the global economy, e. g. in international economic forums, and thus enables the EU to more effectively contribute to shaping international financial stability.

Despite the current crisis, the euro remains the second most important reserve currency (after the US dollar) for foreign governments. This encourages trading partners from third countries to use the euro in transactions with eurozone businesses, which eliminates currency exchange costs and makes European businesses less vulnerable to currency fluctuations. Thus, the single currency not only benefits trade among eurozone neighbours, but also facilitates international trade for European businesses.

GLOBAL POPULATION GROWTH IN BILLIONS

and share of the world population in percent



The global financial crisis was triggered by the crisis in the US subprime market in 2007. The ensuing economic and financial crisis, which hit the rest of the world in 2008, quickly reached Europe where some member states had experienced a credit-fuelled boom and had accumulated high levels of private and public debt. In principle, the eurozone crisis consists of three elements: the sovereign debt crisis, the banking crisis and a growth and competitiveness crisis.

Sovereign debt crisis: The problems for the eurozone started in late 2009 when it was revealed that the Greek state deficit was more than double what had previously been reported. As the world feared a Greek default and a possible break-up of the eurozone, capital fled several eurozone countries. It became increasingly expensive for these governments to borrow money, which inevitably added more pressure to already high state debts and deficits.

Banking crisis: In some of the countries particularly affected by the crisis, such as Spain, Portugal and Ireland, the main problem was the high indebtedness in the private sector. While the common currency brought many advantages, such as lower inflation and cheaper credits, the illusion of perpetual economic growth caused financial institutions to lend money without proper credit controls. When the banking sector started to experience liquidity problems due to the collapse of several national property booms, private sector debt was transferred into state debt as the governments had to step in and recapitalise failing banks to prevent a complete collapse of their banking systems.

Competitiveness crisis: An important part of the problems highlighted above was a lack of competitiveness in many eurozone countries. In many of these countries, wages rose significantly faster than the EU avarage in the decade up to 2008. The inefficient structures of the labour markets hindered export industries. The lack of labour market reforms, which were necessary after the introduction of the euro caused some member states to struggle when the global financial crisis hit Europe.

CRISIS MANAGEMENT TIMELINE

May 2010	*Greece: first bilateral support programme Foundation of EFSF; ECB starts buying government bonds of Greece, Portugal and Ireland*
Oct 2010	*Principle agreement to create a permanent rescue fund ESM*
Aug 2011	*ECB starts buying government bonds of Italy and Spain*
Dec 2011	*Agreement reached on Fiscal Compact ECB starts LTROs of commercial banks*
Jun 2012	*Principle agreement on Banking Union and direct banking recapitalisation by ESM*
Sep 2012	*ECB starts Outright Monetary Transaction programme (OMT)*
Oct 2012	*Permanent ESM enters into force*
Jan 2013	*Fiscal Compact formally enters into force*
Aut 2013	*Banking union: important pillars finalised*

The financial and economic crisis has revealed the need to strengthen the stability of the eurozone economy. Several important decisions at EU level have been made to improve economic governance, mitigate the risk of future crises and promote growth and the creation of jobs in the long-term.

Six-Pack – The 'six-pack' came into force on 13 December 2011 and consists of six pieces of secondary EU legislation that strengthen the preventive and corrective arms of the SGP. It also includes rules regarding monitoring and controlling macro-economic imbalances within the EU.

Fiscal Compact – The Fiscal Compact is the fiscal part of the Treaty on Stability, Co-ordination and Governance (TSCG) which entered into force on 1 January 2013 and runs parallel with the six-pack and two-pack legislations. It is an intergovernmental agreement designed to enshrine the revised fiscal rules in national legislation.

Two-Pack – On 1 January 2014, two additional pieces of legislation known as the 'two-pack' came into force which aim to increase transparency on budgetary decisions within the EU and thus strengthen the coordination of budgetary policies and peer pressure among member states. For example, the European Commission now has the authority to examine each country's budget proposal to ensure that its economic policies are in line with the SGP.

Banking Union – It has become clear that more integrated financial markets need more integrated supervision of financial institutions.

The proposed banking union will strengthen the stability and safety

of Europe's financial system by limiting the dependency between banks and governments. The proposed banking union will consist of three pillars: The Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), which will deal with failing banks, and a common rescue fund of €55 billion financed by the banking sector.

EUROPEAN BANKING UNION

Single Supervisory Mechanism (SSM)

- *European Central Bank (ECB) is single supervisor over approx. 130 large and systemic relevant banks*
- *Supervision of the non-systemic relevant banks remains at the national level*

Single Resolution Mechanism (SRM)

- *Consists of a European resolution authority and a European resolution fund*
- *Covers all banks in the banking union*
- *Financed by a European bank levy*

Harmonization of national Deposit Guarantee Schemes (DGS)

- *Deposits up to 100.000 Euro per depositor and per bank are insured*
- *Repaid to depositor up to seven working days after bank insolvency*

The economic crisis demonstrated that high current account deficits in the EMU can cause severe imbalances in the eurozone. There is one uniform European currency policy, but 18 national financial and economic policies. Without a functioning coordination of economic policy, competitiveness can decline to such an extent that the monetary union comes under pressure.

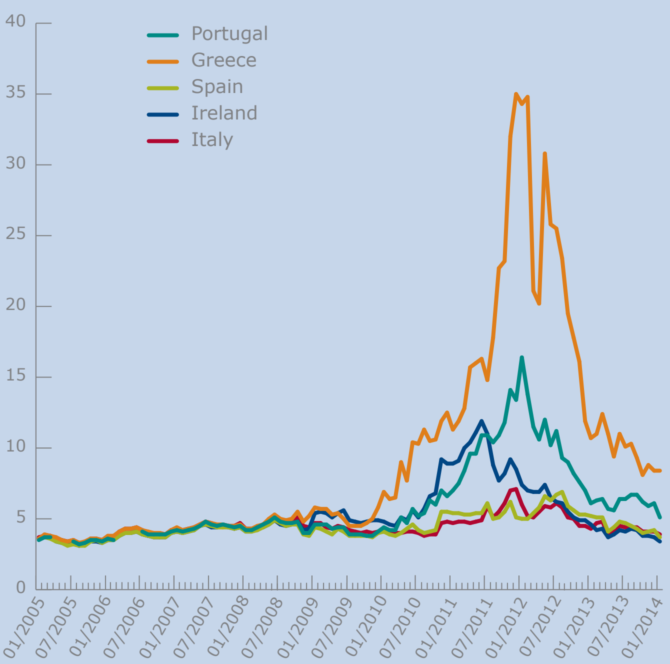
In order to avoid similar crises in the future, the rules governing EMU are being reformed and strengthened. The Fiscal Compact agreed to by 25 EU member states, serves to avoid excessive state debt. In addition, there is the Euro-Plus Pact giving incentive to member states to implement structural reforms. Likewise, the Europe 2020 strategy supports each country on this path by means of initiatives to promote education and innovation as well as combating unemployment and poverty.

The financial markets have demanded lower interest rates for government bonds of some of the countries particularly affected by the crisis in the period since 2011. This indicates that the new eurozone architecture is starting to gain credibility and to overcome its previous weaknesses. Furthermore, excessive budget deficits within the eurozone are starting to decrease.

With the new fiscal rules, we now have a better framework for creating economic stability and growth within the EU and the eurozone. Undoubtedly, there is much work to be done, but the EU and the eurozone are now on the right track towards achieving sustainable growth, prosperity and a better functioning EMU.

LONG TERM INTEREST RATES

Interest rates for ten year government bonds in percent



End of period data

Sources: Bloomberg

Interest rates on government bonds of the countries particularly affected by the crisis have stabilised significantly since 2012. For example, Greece's interest rate has experienced a fall from 35% to 8.4% since December 2011.

The crisis revealed weak spots in the structural systems of certain countries which needed to be addressed. Greece, Spain and Portugal started a fundamental restructuring of their labour markets and, in part, their social security systems. These reforms are hard and not easy to push through. Rigid wage-setting systems are being made more flexible, wage agreements revised, excessively high wage levels lowered and labour market regulations eased. The pension age is being adjusted to reflect naturally ageing populations. Product and service markets are being opened, thus creating more competition. On the whole, Greece has made the greatest strides amongst all the industrial countries since the start of the crisis.

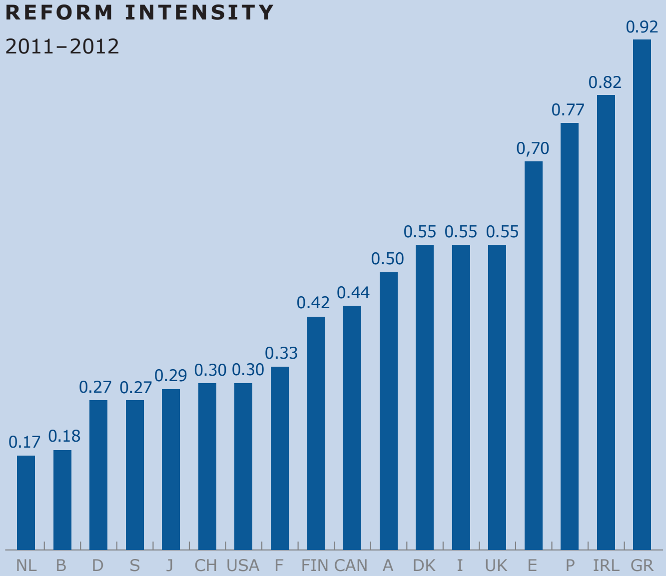
However, it remains an uphill struggle. Growth in the EU remains weak and debt levels remain very high. It is a tedious process, which does not promise quick successes. The fact that the countries have continued to make structural reforms shows their commitment to EMU.

Ultimately, the countries particularly affected by the crisis experienced reduced competitiveness since accession to the monetary union. The reasons for this are manifold: wage increases, lack of openness of the markets, high regulatory levels and excessive domestic consumption. The loss of domestic competitiveness, measured by the performance of unit labour costs, reduced the growth prospects of the crisis countries. However, many member states have been able to regain much of their competitiveness lost in the decade to 2010.

The European Union does not demand such reforms as a precondition of EU membership. In fact, the countries started this process of their own accord – even if under the pressure of economic and political realities.

REFORM INTENSITY

2011–2012



Reform Intensity: Ratio of reforms taken in 2011 und 2012 in different policy fields in relation to the reform recommendations of the OECD.

Source: OECD

The reform rates are particularly high in the eurozone members most impacted by the crisis.

Labour Mobility: Opportunities in the job crisis

More than 25 million people in Europe are currently unemployed. Several member states are experiencing a major jobs crisis. A sustainable, long-term solution can only be found through comprehensive structural reforms at the level of national governments. Structural reforms are a tough and long-lasting process. After reforms have been put in place, it usually takes 5 to 10 years for them to be effective.

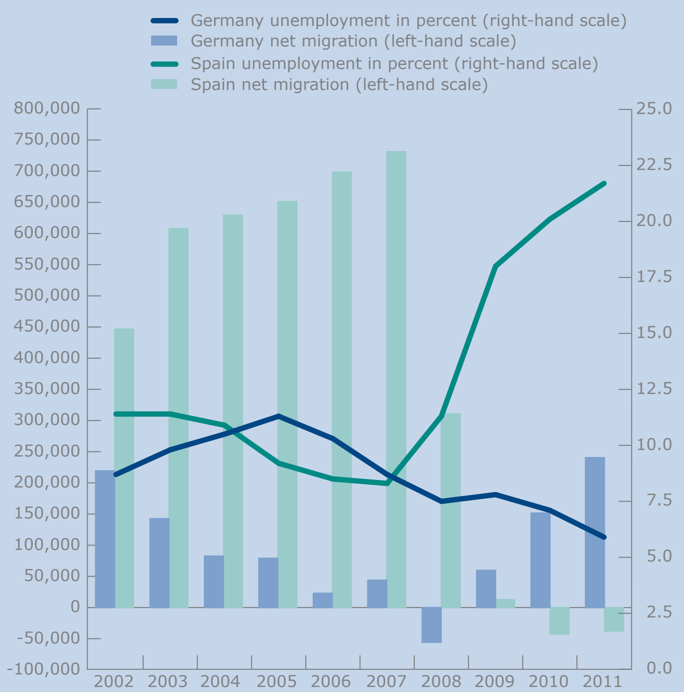
One of the most serious problems in this context is youth unemployment. However, it is not a new phenomenon in Europe. As a matter of fact, the youth unemployment rate has always been above that of the total unemployment rate in almost all European countries.

Through the severity of the debt crisis youth unemployment has become an enormously visible phenomenon. Today it is a key aspect of the international political agenda. Now is the time to tackle overdue reforms in labour market policies. During the adjustment process, many people have the opportunity to avail of employment opportunities throughout Europe.

While some countries have unemployment rates of over 20 %, others have problems filling vacant positions. Thus labour mobility between the markets of the member states assists in alleviating this imbalance, reduces unemployment and relieves the pressure on national welfare systems. Therefore, the mobility of employees is a decisive factor for the long-term stabilization of the eurozone.

UNEMPLOYMENT AND MIGRATION

Germany and Spain



Source: Eurostat

The examples of Germany and Spain illustrate that people in countries with high unemployment can and do move to other EU countries with a thriving labour market.

Consequences of a euro exit

Although some eurozone countries have been tempted by the idea of reintroducing their old currency, this is neither probable nor desirable. A euro exit of one of the member states would cause new uncertainties on the financial markets and entail incalculable risks. The consequences would be a deep recession in the global economy and a drastic increase in interest rates for states in the eurozone classified as 'risky'. An uncontrolled dissolution of the eurozone could then not be excluded. The consequences for the political future of Europe would be difficult to estimate. However, a north-south split could hardly be avoided.

Return of transaction costs and currency risks: Exiting the eurozone would necessitate the introduction of a new national currency. Given the uncertainty associated with leaving the euro in most of the cases this new currency would be significantly devalued by the markets. This would result in increased transaction costs and the re-introduction of currency risks. This, in turn, would lead to a significant loss of income and wealth.

Capital flight and danger of default: The devaluation of the new national currency would lead to a capital flight as savers and investors seek a safe haven for their investments. Such a capital flight would pose a real danger for other weaker economies. In addition, it would increase overall debt levels (for euro denominated bonds), cause a danger of default and ultimately result in banking and economic crises.

Potential for higher inflation and declining real income levels:

In tandem with these large capital outflows, devaluation would also result in an initial increase in price competitiveness resulting in rising export volumes in the medium term. However, these benefits would be offset by a rise in import prices and the danger of inflation if wages were to increase to compensate for higher import prices. Such a wage-price spiral would result in a significant rise in unemployment, declining real income levels and a loss of savings.

SHORT AND MEDIUM TERM OF A EURO EXIT OF A STRESSED MEMBER