THEORETICAL ASPECTS OF ECONOMIC AND MONETARY UNION

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Abstract:
The euro area can draw comparatively large benefits from promoting EU financial integration. Significant progress has been made in integrating EU financial markets but further efforts are required to enhance the efficiency and liquidity of euro area financial markets. This would facilitate economic adjustment through risk sharing and promote a more uniform transmission of the single monetary policy across the euro area. In particular, increased effort is required to promote the cross-border provision of retail financial services, to improve the efficiency of corporate and government bond
financing and ease regulatory and supervisory costs for financial intermediaries operating in a multijurisdictional environment.

Key words: *global, euro, monetary*

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On 1 January 1999 eleven EU Member States – Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland – adopted the European Union's single currency, the euro, in what may be considered to be the world's most radical monetary reform since Bretton Woods. This move established the second largest single currency area in the world (after the United States), which now produces two thirds of the EU's GDP and one fifth of the world's. Four other EU Member States have joined the euro area since its inception: Greece in 2001, Slovenia in 2007 and Cyprus and Malta in 2008. The area is set to expand further as most EU Member States currently outside the euro area are preparing to join at some point in the future.

The establishment of a single currency for Europe has been a leap forward in the process of European economic integration. Although the origins of the single currency go back to the 1970s, the process accelerated in the early 1990s when the lifting of the Iron Curtain and the ensuing political uncertainties prompted the
perception that stronger common goal setting in Europe was needed. Among the related political events of the early 1990s was the reunification of Germany, which had serious macroeconomic ramifications and contributed to tensions and turbulence in the European Exchange Rate Mechanism (ERM). This eventually led to the go-ahead for monetary union in Europe, as laid down in the Maastricht Treaty signed in 1992.

From then onwards EU Members willing to join the euro area in the first wave engaged in a process of convergence towards the reference values enshrined in the Treaty regarding price stability, exchange rate stability, interest rates, government net borrowing and government indebtedness. Eventually the eleven countries mentioned above qualified for participation in the first wave.

Before it was created there was a lively academic and political debate on the viability or desirability of a monetary union for Europe. There was a very broad spectrum of views on the subject: some predicted a bumpy start or even collapse, while others were more sanguine.

However, many tended towards a pessimistic view and this may have adversely affected perceptions of the euro area's performance in its early years. The assessments were coloured also by the global economic downturn in the early 2000s and the depreciation of the euro against the US dollar in the period 1999-2002, both roughly coinciding with the run-up to and
introduction of euro coins and notes in 2002.

Aside from the political motivations for the creation of a single currency for Europe, the euro was intended to serve a number of *economic goals*, which can be grouped under the following three headings:

• *Macroeconomic stability*. As noted, the single currency was a response to the episode of financial turbulence in the early 1990s. The use of the exchange rate and monetary policy instruments had lost much of their efficacy, especially in smaller countries. The underutilisation of resources stemming from this source of volatility was deemed to be costly in terms of both efficiency and equity – and hence its removal beneficial.

• *Growth and jobs*. The single currency was deemed to be a decisive move towards the completion of the European single market established in 1992. The reduction in transaction costs and risk premiums associated with the single currency were expected to boost intra-area trade and finance. As the exchange rate risks and currency transaction cost would diminish or disappear, a better use of scarce resources could be achieved, not least because greater transparency would foster competition.

• *Cohesion and convergence*. It was hoped that by fostering integration real economic convergence towards the best-performers would receive a boost. Moreover, as economies would become more similar, policies would become easier to co-ordinate as the importance of national desiderata diminished.

But even its fiercest proponents saw the creation and management of the single currency in Europe as *a major challenge*, essentially for the following two reasons:

• *First*, the European Economic and Monetary Union (EMU) is unique in that it comprises a single currency in combination with fiscal policies conducted at national level – albeit within a common framework – by its participating Member States. This is unlike federal monetary unions, like the United States, where a federal government is endowed with sovereignty to tax and to provide common public goods. The US federal budget acts as a powerful stabiliser, enabling fiscal transfers to automatically flow from booming to slumping states, whereas the euro area has no such transfer mechanism.

• *Second*, alternative mechanisms of adjustment in the euro area were deemed to be comparatively weak. Low labour mobility within and across borders, weak responsiveness of prices and wages to the business cycle, and the limited degree of integration of financial markets – along with the absence of cross-border fiscal transfers – were considered to create a risk of tensions between participating countries building up if their economies failed to move in sync. In such an environment the loss of the possibility of exchange rate adjustment could prove costly and the effectiveness of the single monetary policy – which by its nature could only be geared towards the needs of the area as a whole – questionable.

The use of fiscal policies to stabilise the national economies was seen as possible to some extent, but the experience of previous decades had given rise to growing scepticism. Indeed, from the outset it was recognised that countries would be tempted to "free ride" in the absence of the disciplining effect of exchange-rate risk premiums, by running budget deficits while neglecting longer-term considerations of fiscal sustainability. The adverse effects of fiscal profligacy would be all the more damaging as they risked spilling over, thus inflicting instability onto the area and squeezing productive capital formation in other participating countries. It would also hinder the

newly created European Central Bank (ECB) in doing its job of maintaining price (and by extension macroeconomic) stability.

These concerns led to the development of the convergence criteria for inflation, exchange rate stability, interest rates and public deficits and debt, which were enshrined in the 1992 Maastricht Treaty, and which countries must comply with to qualify for euro-area accession (see above). It also led to the adoption of the Stability and Growth Pact in 1997 which fixes rules for fiscal policy and penalties if those rules are breached. Concretely, countries are required to move towards and sustain a fiscal position 'close to balance or in surplus' over the medium term and will be subject to corrective measures if the fiscal deficit exceeds 3% of GDP and/or if public debt fails to converge towards or below 60% of GDP, unless 'special circumstances' can be demonstrated. Participating countries submit annually a Stability Programme which contains a record of current and expected fiscal outcomes and on which the assessment of compliance by the competent EU authorities (the European Commission and the European Council) is based.

The concerns over the weak adjustment capacity of the countries participating in the euro area also led to a growing role for the EU's Lisbon Strategy, which was adopted in 2000 to orchestrate structural reform in product, labour and financial markets. While the Strategy was designed to boost growth and jobs over the longer haul in the whole EU, there has been mounting evidence that structural policies also have favourable knock-on effects on the economic adjustment capacity of the countries participating in the euro area. Structural reform within the Lisbon Strategy therefore became instrumental to enhancing the adjustment capacity of the euro-area Member States – both present and future. As well, the integration and development of financial markets is seen to create opportunities for risk sharing and consumption smoothing, thus easing the stabilisation role of macroeconomic policies.

I will take stock of the performance of the euro area during its first ten years. The economy has gone through approximately a full business cycle, moving from the peak of the cycle at the advent of the euro to its trough in the wake of the dotcom bust, followed by a – first slow and then decisive – recovery. This makes it easier to avoid wrongly attributing observed economic tendencies to permanent, as opposed to cyclical, developments. At the same time the assessment is complicated by the fact that many of the changes in governance structures and policy orientations prompted by the single currency were already ongoing in the run-up phase, including – importantly – the pursuit of the Maastricht convergence criteria. Moreover, many participating countries were clearly not entering the euro area under 'steady state' conditions, but were still grappling with past economic disturbances.

Even so, the upshot of the analysis is that in many respects the euro area has performed better since the creation of the single currency than before, also in comparison with comparable economies, even if that performance has varied across countries. For example, while economic growth has been around 2% since the creation of the single currency, similar to its prior level, employment growth has been strong, fiscal performance has improved and real interest and inflation rates have fallen (Table I.) As well, the euro very quickly established its role in foreign exchange and international security markets and has become an important reserve currency. As a result, the global economy has begun to move away from a unipolar dollar-based financial system and as such the euro has become a valuable public good, both inside and outside the euro area. The sections below discuss these findings in somewhat more detail.

Table I

Macroeconomic performance indicators							
		Period averages					
		Euro area		Denmark, Sweden, UK		United States	
		1989-1998	1999-2008	1989-1998	1999-2008	1989-1998	1999-2008
Real GDP	% rate of change	2,2	2,1	2,0	2,7	3,0	2,6
Real GDP per capita	% rate of change	1,9	1,6	1,7	2,2	1,8	1,6
Real GDP per capita	index, US = 100	73	72	74	76	100	100
Employment	% rate of change	0,6	1,3	0,1	0,9	1,5	1,0
Labour productivity	% rate of change	1,6	0,8	1,9	1,8	1,5	1,6
Unemployment	% of labour force	9,3	8,3	7,9	5,2	5,8	5,0
Inflation	%	3,3	2,2	3,4	1,7	3,3	2,8
Fiscal balance	% of GDP	-4,3	-1,7	-3,6	-0,9	-3,3	-2,5
Gross public debt	% of GDP	68,6	68,6	48,7	43,0	67,8	60,7
Long term interest rate	%	8,1	4,4	8,6	4,9	7,1	4,8
Real long term interest rate	%	4,7	2,4	4,2	3,3	4,3	2,4

Source : European Commission, OECD

Macroeconomic stability, jobs and growth

The inflation performance of the euro area has decisively improved in comparison with previous decades, and this has been accompanied by greater stability also of GDP growth. The bulk of the disinflation in the euro area actually occurred in the 1990s as a result of the efforts to meet the Maastricht inflation criteria. Average inflation in the first ten years of the euro area has been broadly on a par with the ECB's benchmark of price stability of close to but below 2%. And even if inflation is currently well above this mark due to hikes in energy and food prices, various gauges of long-term inflation expectations remain consistent with the price stability goal, suggesting that this goal is well anchored and credible. The long-term decline in inflation is observed also in other developed countries, and hence the euro area is not unique in this respect. Even so, the institutional changes that have accompanied the creation of the single currency – such as the establishment of an independent central bank with a clear price stability mandate – have been instrumental in anchoring price developments in the euro area.

Another tangible economic achievement in the first ten years of the euro area has been *massive growth in employment* – with the creation of 16 million jobs and the unemployment rate plummeting from 9% in 1999 to an estimated 7% in 2008. This has occurred in spite of growing numbers of people approaching or exceeding retirement age, showing that labour market participation has soared. Indeed, on a per capita basis, job growth has by far outpaced that in other mature economies with generally more favourable demographics, including the United States. It would be inappropriate to attribute this achievement solely to the economic conditions generated by the single currency, and there is indeed evidence that labour market reforms have facilitated the labour market participation of 'marginal' workers (e.g. with low skills or limited job histories). But it is unlikely that job gains would have been as impressive under the more volatile monetary conditions and fiscal instability that used to prevail under the previous system.

However, the flipside of this development has been a significant *productivity slowdown*, with growth in output per worker halving from 1″ % in the period 1989-1998 to an estimated l’ % in 1999-2008. This is in sharp contrast with the rapid pace of productivity growth observed in the United States over the same period. It largely explains why the euro area has seen its growth rate stalling at around 2% per annum, the same as in the preceding decade – despite a much faster growth in labour utilisation. Even so, there is evidence that the introduction of the single currency has favoured productivity as it has offered firms even greater opportunities to trade and specialise. Without it, labour productivity would have been even weaker in the euro area than it has been. Nevertheless, the euro area continued to lag behind US living standards, with per capita income having stalled at 70% of the US level ever since the 1970s. Obviously it

is tempting to assume the recent jobs 'miracle' itself has caused the productivity slowdown. A tradeoff between more jobs and productivity may indeed emerge if faster employment growth leads to a lower capital use per worker and if greater numbers of low-skilled workers are employed. But this combined effect is found to be small, indeed tiny in comparison with the impact of the slow development and diffusion of new technologies and best work practices. A number of euro-area countries are not yet fully reaping the benefits of the information technology revolution and the spurt in the global division of labour.

The euro area has historically been characterised by slower recoveries from economic downturns than the United States, with the underutilisation of resources typically being more protracted. The main culprit behind this *lack of resilience* is the comparatively greater rigidity of prices and wages in the euro area which inhibit a rapid adjustment of supply and demand towards equilibrium. However, the euro area's record on this score has improved over the recent cycle, with the 2001-2003 downturn having been shallower than comparable episodes in previous cycles. This is partly a reflection of a tendency towards smoother business cycles globally – the so-called "great moderation" – possibly owing to better macroeconomic management, international risk sharing and consumption smoothing across the industrialised world. But the stabilityoriented macroeconomic policy framework adopted by the euro area itself has undoubtedly helped.

A growing concern is that the exchange rate of the euro vis-ŕ-vis key currencies has appreciated well beyond its fundamental value. While this partly reflects the relative strength of the euroarea economy and the widening interest differential between euro-area and US short-term interest rates, this is also being driven by the unwinding of global imbalances, in particular the large deficit on the US current account . Overall, however, the volatility of the effective exchange rates of the euro-area member economies has been relatively muted by historical standards.

One precondition for the favourable effects of monetary union to materialise was always considered to be that the business cycles of the participant countries must be more or less in sync. Otherwise, the one-size-fits-all monetary policy would be less effective – i.e. too loose for buoyant economies and too tight for the others.

This study examines the euro area's record on this score. It finds that:

• Business cycles have become more synchronised between participating countries during the decade preceding the creation of the single currency – possibly driven by the establishment of the Single Market in 1992 and the joint policy efforts in the run-up to the euro.

• The analysis also provides evidence that intra-area synchronisation is particularly strong when the business cycle turns down, but remains weak in the recovery. This suggests that the single monetary policy may be effective in choking off activity in the face of overheating, but is not uniformly effective in boosting countries out of the slump.

• Interestingly there have been no major further synchronisation gains since the single currency was created. In contrast, synchronisation between the euro area and the rest of the world has clearly accelerated.

This suggests that the euro area as a whole has been moving more in step with an emerging global business cycle. Despite the greater synchronisation of business cycles at higher frequencies, there is evidence of a more differentiated behaviour over the *medium term*. Two of the three largest countries in the euro area (Germany and Italy) have posted considerably weaker growth than the average. In the case of Germany this reflects the fact that it still had to work off the consequences of unification and the associated real appreciation of its exchange rate. Italy's sluggish performance has been due to continued losses in competitiveness associated with weak productivity growth

and an industrial structure that is particularly prone to competition from low-wage countries. By contrast, in the euro-area periphery a strong growth momentum had been building up prior to the introduction of the euro, owing to sharp declines in real interest rates along with successful structural reform and an associated strong growth potential.

Moreover, at the time of the admission to the euro area, several participating countries ad not yet fully completed the catching-up towards EU-average living standards that was seen as a precondition for a well-functioning monetary union. The performance of three of the four "cohesion countries" (Spain, Ireland and Greece) have since shown a satisfactory evelopment overall, while the fourth (Portugal) has disappointed. The strong performers have been thriving on investment booms, spurred by capital inflows attracted by comparatively high rates of return, with the single currency and the integration of financial markets acting as a
catalyst. Key to the much weaker performance of Portugal has been the comparatively poor fiscal management, with the tax burden increasing while public expenditure has been growthunfriendly – i.e. diverted away from productive public capital formation.

Overall, the divergences in growth and inflation among the euro-area countries have been longlasting, involving major shifts in intra-euro-area real effective exchange rates, which in some cases have gone beyond their longer-term equilibrium values. This has been reflected in divergent current-account positions across countries. Some, but not all, elements of these differences in inflation, growth and external positions can be attributed to structural convergence in living standards (real convergence). Even so, not all inflation differentials are harmful; some are merely a sign that competitiveness realignment is doing its job as an instrument of intra-area adjustment in the absence of exchange rates. Better functioning labour and product markets have helped strengthen this channel while the integration and development of financial markets have also helped smooth divergences by spreading their impact on broader groups of consumers and investors.

Macroeconomic policies

As noted, the adoption of the single currency implied a radical change in the macroeconomic policy framework. Monetary policy was henceforth centralised whereas fiscal policy remained in the remit of the participating countries, albeit subject to rules, surveillance and co-ordination at the EU level. The fiscal rules attributed a strong role to automatic fiscal stabilisers, which are deemed to be powerful in the euro area owing to the extensive public social safety nets and progressive taxes. Meanwhile discretionary fiscal policy should be geared to the 'close to balance or in surplus' target over the medium run. The Stability and Growth Pact, arguably the core of EMU's fiscal framework, was reformed in 2005, which reconfirmed and strengthened its "corrective arm" after difficulties were experienced with its enforcement during the economic downturn of 2001-2003.

The experience with this policy framework has been positive. Monetary policy has been largely successful in broadly maintaining price stability and providing stimulus to activity when cyclical conditions were weak and removing it as the economy recovered – even though monetary activism has generally been less pronounced in the euro area than in e.g. the United States.

Notwithstanding recurrent difficulties in enforcing the fiscal rules, budget deficits have declined significantly in comparison with previous cycles – and in the euro area more so than in non-euro EU members. Fiscal policy has continued to be somewhat pro-cyclical in 'good times', but less so than previously. The mechanisms underlying this behaviour appear to be quite complex, with the relatively long lags before boom conditions and the associated fiscal windfall gains are recognised as being unsustainable the main culprit. This initially led to breaches of the 3% of GDP deficit ceiling in some

countries when the economy turned down and difficulties in enforcing the Stability and Growth Pact. However, after its 2005 reform member countries regained ownership of the fiscal rules and enforcement has since considerably improved.

The early debates highlighted the risk of unbalanced policy mixes, with participating countries' fiscal policies working against, rather than supporting, monetary policy. In theory a succession of unbalanced policy mixes, already undesirable on its own account, also risks triggering volatile movements in the external value of the currency – with strong appreciations during upswings if monetary policy tightening is not supported by fiscal restraint. According to the analysis in this report these fears have in fact proved to be largely unfounded, with fiscal and monetary policies supporting each other, aside from a short spell of pro-cyclical fiscal policies during the ICT boom.

Structural policies and financial integration

The single currency was expected to spur governments to undertake structural reform, as this was seen as the only way to enhance the market-based adjustment capacity so as to offset the loss of the exchange rate instrument of intraarea adjustment – so that the so-called TINA (There Is No Alternative) hypothesis would apply. Some, however, argued that the disappearance of the exchange rate risk would rather weaken the incentives for structural reform. The evidence is not very conclusive, but it is clear that on balance the single currency has had little discernible effect on the pace of structural reform, which invalidates the TINA hypothesis. Notably, progress in the cross-border integration of services has been more muted than expected, which is particularly problematic. It is notably in this area that price rigidities persist. It appears that the political incentives to pursue rigorous reform in EMU are relatively weak. This has been recognised by the European authorities, such as the Eurogroup and the European Commission, which in turn has led to intensified surveillance of national structural policies in the euro area in the framework of the Lisbon Strategy for Growth and Jobs, which was revamped in 2005.

Meanwhile, there is strong evidence that the creation of the single currency has spurred the integration of financial markets in the euro area.

This has supported the financial sector's adjustment role in several ways: by encouraging the movement of cross-border capital towards its best uses; by diminishing the risk of local credit crunches; and by promoting risk diversification and associated cyclical smoothing. However, financial integration remains a work in progress.

While it has progressed substantially since – andpartly owing to – the introduction of the euro, several markets are still fragmented and the pace of integration varies from one country to another.

The remaining fragmentation represents an opportunity cost for the euro-area economy, which needs a high degree of financial integration not only to raise productive potential but also to improve its capacity to adjust to country-specific shocks.

The international role of the euro

At the outset there was a consensus that the euro would be well received internationally but would not match the US dollar's dominant position. In practice, the euro quickly emerged as the second most important international currency alongside the US dollar and continues to consolidate this position. The euro has become a prominent currency of denomination in international debt markets and its role as an invoicing and reserve currency has been growing as well. It plays an important role as an anchor or reference currency in the managed exchange rate regimes of about 40 countries. Even so, the US dollar remains the first global currency in many areas, in part due to incumbency effects, and the euro's international role remains relatively concentrated in the regions

neighbouring the euro area. This suggests that there is considerable scope for the euro to continue expanding its role as a global currency.

Despite the growing global role of the euro, attempts to improve the external representation of the euro area on financial and monetary matters have not made much progress. More generally, Europe's external representation in international financial fora – such as the Bretton Woods institutions – remains fragmented, reducing the actual influence of the euro area despite the large number of seats that EU (and euro-area) countries hold in them. Bilateral dialogues are held with strategic partners, but this involves the EU as a whole rather than the euro area as an entity in its own right – with one exception represented by the dialogue with China (where the Presidents of the ECB and the Eurogroup are involved together with the Commissioner for Economic and Financial Affairs).

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