



EUROPEAN COMMISSION  
DIRECTORATE GENERAL ECONOMIC AND FINANCIAL AFFAIRS

# The euro: past successes and new challenges in the wake of the crisis

**Marco Buti**

**Director-General**

**Economic and Financial Affairs**

**European Commission**

The background of the slide is a blurred image of the European Union flag, featuring a circle of twelve gold stars on a blue field. The text is centered over this background.

# **1. The first decade in retrospect**

# **A historic move**

- **Second largest single currency area in the world (after the United States)**
- **A defining moment in post-war economic history of Europe**
- **A unique stability-oriented policy framework**

# **A success story overall**

- **Inflation tamed**
- **Extra-ordinarily job-rich growth**
- **Integrating markets**
- **A balanced macroeconomic policy mix despite initial concerns**

The background of the slide is a blurred version of the European Union flag, featuring a circle of twelve gold stars on a blue field. The text is centered in the upper half of the image.

# **A selection of research findings in EMU@10**

# The euro boosted productivity

	error correction	ln(r&d)	ln(user cost)	ln(1+risk/user cost)	SMP	EMU
Austria	-0.089 (0.041)	0.235 (0.000)	-0.056 (0.000)	-0.284 (0.008)	-	-
Belgium	-0.241 (0.000)	0.190 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	0.021 (0.001)
Denmark	-0.377 (0.000)	0.150 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	-
Finland	-0.149 (0.009)	0.294 (0.000)	-0.056 (0.000)	-0.284 (0.008)	-	-
France	-0.077 (0.005)	0.267 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	0.021 (0.001)
Germany	-0.102 (0.000)	0.459 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	0.021 (0.001)
Italy	-0.092 (0.019)	0.324 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	0.021 (0.001)
Netherlands	-0.161 (0.004)	0.301 (0.000)	-0.056 (0.000)	-0.284 (0.008)	0.060 (0.000)	0.021 (0.001)
Sweden	-0.117 (0.011)	0.237 (0.000)	-0.056 (0.000)	-0.284 (0.008)	-	-
UK	-0.069 (0.029)	-	-0.056 (0.000)	-0.284 (0.008)	-	-
US	-0.147 (0.005)	0.380 (0.000)	-0.056 (0.000)	-0.284 (0.008)	-	-

Dependent variable  
= log skill-adjusted  
hourly productivity

SMP = single market  
programme dummy

EMU = euro dummy

'risk' = output  
volatility (RMSD)

There is a EMU  
effect (of 2%) over  
and above the SMP  
effect

Source: Barrell et al (2008), The Impact of EMU on Growth and Employment, European Economy – Economic Papers No. 318. Probability levels in brackets.

# The euro reduced output volatility

	volatility of inflation	inflation	emu	SMP	eumentry
Belgium	0.0715 (0.000)	0.0003 (0.000)	-0.003 (0.000)	0.0073 (0.000)	-
Denmark	0.0715 (0.000)	0.0003 (0.000)	-0.001 (0.000)	0.0012 (0.028)	-
Finland	0.0715 (0.000)	0.0003 (0.000)	-0.002 (0.111)	0.0162 (0.000)	-0.016 (0.000)
France	0.0715 (0.000)	0.0003 (0.000)	-0.003 (0.000)	0.0078 (0.000)	-
Germany	0.0715 (0.000)	0.0003 (0.000)	-0.000 (0.373)	0.0009 (0.098)	-
Italy	0.0715 (0.000)	0.0003 (0.000)	-0.000 (0.703)	0.0083 (0.000)	-
Netherlands	0.0715 (0.000)	0.0003 (0.000)	0.0005 (0.262)	-0.002 (0.000)	-
Austria	0.0715 (0.000)	0.0003 (0.000)	0.0019 (0.000)	0.0000 (0.873)	-0.001 (0.004)
Sweden	0.0715 (0.000)	0.0003 (0.000)	-0.001 (0.015)	0.0082 (0.000)	0.0001 (0.830)
UK	0.0715 (0.000)	0.0003 (0.000)	-0.000 (0.332)	-0.001 (0.050)	-
US	0.0715 (0.000)	0.0003 (0.000)	-	-	-

**Dependent variable  
= 'risk' in previous  
equation**

**SMP = single market  
programme dummy**

**EMU = dummy  
adoption euro**

**There is an  
additional EMU  
effect on  
productivity (1-3%)  
via the risk channel**

Source: Barrell et al (2008), The Impact of EMU on Growth and Employment, European Economy – Economic Papers No. 318. Probability levels in brackets.

# The euro raised exports and FDI

**Table 24: Euro effect on probability of exporting, Eurozone databases**

	Logit			Probit		
	EZ11 vs EZ01	s.e.	p-value	EZ11 vs EZ01	s.e.	p-value
Finland	3.1%	0.00	0.00	3.0%	0.00	0.00
Ireland	3.6%	0.00	0.00	3.8%	0.00	0.00
Austria	1.9%	0.00	0.00	1.9%	0.00	0.00
Greece	2.7%	0.00	0.00	2.8%	0.00	0.00
Portugal	3.0%	0.00	0.00	3.0%	0.00	0.00
Belgium	1.2%	0.00	0.00	1.1%	0.00	0.00
Netherland	1.9%	0.00	0.00	1.7%	0.00	0.00
Spain	3.2%	0.00	0.00	3.0%	0.00	0.00
Italy	1.9%	0.00	0.00	2.0%	0.00	0.00
France	1.9%	0.00	0.00	1.8%	0.00	0.00
Germany	0.8%	0.00	0.00	0.8%	0.00	0.00

**EMU increased the probability of exporting by about 3%**

**This finding is supported by firm-level analysis**

**There is also a significant effect on FDI and M&A**

Source: Baldwin et al (2008), Stud on the Impact of euro on trade and foreign direct investment, European Economy – Economic Papers No. 321. Probability levels in brackets.

# Price adjustment increased with euro

"Pure" price competitiveness and cyclical divergence: evidence from panel regressions

Dependent variable: $\Delta \log P$	1970-2006		1999-2006	
	GLS	GMM	GLS	GMM
Explanatory variables:	(1)	(2)	(3)	(4)
$\Delta \log P(-1)$	0.626 (20.69)***	0.546 (8.62)***	0.11 (1.22)	0.182 (2.18)**
$\log P(-1)$	-0.017 (7.54)***	-0.019 (2.87)***	-0.063 (3.01)***	-0.1 (2.78)***
Rel. output gap(-1)	0.265 (5.53)***	0.222 (3.23)***	0.386 (4.92)***	0.358 (5.65)***
$\Delta \log NEER(-1)$	-0.093 (4.57)***	-0.094 (2.75)***		
Observations	385	374	99	88

Notes: Sample includes 11 countries (the first wave plus EL less LU). GLS estimation includes fixed effects (not displayed) and allows for heteroskedasticity and auto correlated standard errors.

**Smaller  
autoregressive term**

**Higher speed of  
adjustment of  
relative price level**

**Stronger  
responsiveness of  
relative price  
change to relative  
output gap**

Source: European Commission (2008), EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union, European Economy No. 2.

# Reform incentives stronger if financial markets are more liberal

Dependent variable: 1 if the identity of the government chief executive does not change after elections, 0 otherwise.	OECD countries	EU countries only
	Reform dummy <sup>b</sup>	0.146 [0.78]
Overall index of market rigidity *reform dummy	-0.305 [2.40]**	-0.204 [2.04]**
Cyclical conditions <sup>d</sup> *reform dummy	0.77 [3.17]***	2.931 [5.22]***
Financial freedom <sup>c</sup> index *reform dummy	0.361 [5.07]***	0.374 [3.84]***
(Total Current Primary Expenditure / GDP) <sup>f</sup> *reform dummy	0.177 [2.23]**	0.176 [2.16]**
Change in cyclical conditions <sup>d</sup>	0.116 [2.37]**	0.117 [1.89]*
Change in inflation <sup>d</sup>	-0.027 [1.72]*	-0.007 [0.28]
Change in primary CAB <sup>d</sup>	0.058 [0.78]	0.1 [1.03]
Cyclical conditions <sup>d</sup>	-0.253 [2.69]***	-1.004 [5.09]***
Political controls <sup>g</sup>	V	V
Observations	101	71

**Probit regressions show that impact of reform on re-election is more favourable if:**

**Economy is already relatively flexible**

**Economy is booming**

**Financial markets are liberal (reform benefits better perceived)**

**Automatic fiscal stabilisers are powerful**

Source: Marco Buti , Paul van den Noord, Alessandro Turrini, Pietro Biroli, “Defying the ‘Juncker Curse’: Can Reformist Governments be Re-elected?”, *Empirica*, Vol. 36, No. 1, pp. 65-100. Coefficients are marginal probability effects, interaction variables normalised around sample mean

# Financial integration improves capital allocation

Dependent variable: Investment share	(1)	(2)	(3)	(4)	(5)
Lagged investment share	0.558*** (19.43)	0.557*** (19.49)	0.560*** (19.51)	0.559*** (19.44)	0.557*** (19.44)
Net marginal product of capital (NMPK)	0.125*** (5.43)	0.123*** (5.36)	0.123*** (5.13)	0.123*** (5.11)	0.122*** (0.86)
Debt integration	0.047 (1.13)			0.057 (1.39)	
Interaction of NMPK with debt integration	0.022** (2.52)			0.020** (2.10)	
Equity integration		0.056 (1.17)			0.051 (0.91)
Interaction of NMPK with equity integration		0.024** (2.38)			0.024* (2.00)
Financial development			0.026 (0.93)	0.012 (0.353)	-0.011 (0.29)
Interaction of NMPK with financial development			0.015* (1.86)	0.057 (1.39)	0.006 (0.86)
Observations	4365	4365	4298	4298	4298
R-squared	0.48	0.49	0.48	0.48	0.48

**Responsiveness of investment to net marginal product of capital increases if:**

**bond markets are better integrated**

**stock markets are better integrated**

Notes: OLS regression; controlling for sector specific heteroskedasticity; country, year and sector dummies. Absolute value of t statistics in parentheses: \* significant at 10%; \*\* at 5%; \*\*\* at 1%.

Investment share: log of the ratio between net real investment and lagged net real capital stock.

Net marginal product of capital: log (marginal productivity of capital) – log (user cost of capital).

Debt Integration: Cross-border holdings of assets and liabilities/GDP, debt instruments. Standardised variable.

Equity Integration: Cross-border holdings of assets and liabilities /GDP, equity instruments. Standardised variable.

Financial development: private sector credit as share of GDP. Standardised variable.

**Source: European Commission (2008), EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union, European Economy No. 2.**

## **Sceptics proved largely wrong**

- **The euro area did not fall apart (it expanded), price stability anchor is credible, policy mix is balanced, single currency reinforced the single market**
- **Not all objectives achieved: intra-euro area imbalances developed, growth and structural reform disappointed, and governance calls for attention**

# But the economic environment was exceptionally benign

- The 'Great Moderation' of output and inflation volatility facilitated macroeconomic policy making in the euro area
- New technologies and globalisation created favourable supply conditions that helped keep inflation in check despite soaring energy and food prices
- Demand was buoyed by low interest rates and (perceived) wealth gains
- Fiscal windfalls enabled governments to expand their budgets without raising alarm bells
- The tide suddenly changed when the global financial system and economy entered its most pervasive crisis since the 1930s

The background of the slide is a blurred image of the European Union flag, featuring a circle of twelve gold stars on a blue field. The text is centered over this background.

## **2. The second decade: new challenges ahead**

# Current priorities: tackling the banking crisis

- ***Full disclosure*** and proper valuation of impaired assets, a systematic stress testing of banks and decision on the amount of relief provided either by governments and private sector.
- ***Credible commitment for restructuring*** and returning to viability. The speed of this restructuring should be measured and progressing in function of, *inter alia*, the financial and economic situation.
- ***Co-ordination at the EU level***. Develop a comprehensive solution to the banking crisis. With the most acute phase of the crisis behind us, the fear of negative market reactions should no longer be allowed to dominate.

# Current priorities: continue to provide credible stimulus

- ***Continue to provide policy support*** to the economy in the short run without compromising the stability-oriented objectives.
- **Fiscal stimulus to factor in *differences in fiscal space and include credibility-enhancing measures*** (such as early reforms of entitlements and stronger national fiscal frameworks).
- **Develop a roadmap to deal with the crisis in a medium-to-longer term perspective ('*exit strategy*')**; so as to better cope with the aftermath of the crisis and enhance the effectiveness of the crisis resolution policies currently being implemented.

# Current priorities: designing viable exit strategies

- ***Exit strategy for fiscal policy*** must aim to put budgetary developments back on a sustainable path. This will have to include a reflection on the role of automatic stabilisers.
- ***Exit strategy for monetary stimulus*** must factor in incentives for the discontinuation of unconventional monetary policy and ensure that inflation expectations remain anchored. Reflection is needed on the role of asset prices in monetary policy.
- ***Exit strategy for structural reform*** should include the withdrawal of temporary measures that slow adjustment; measures to shore up the efficiency of labour and product markets; the review of welfare and tax policies; and promoting the EU's long-term environmental objectives. All this under the heading of the Lisbon strategy but with a stronger economic policy coordination tool ("Europe 2020")

# The euro facilitates the handling of the crisis

- The existence of a single central bank facilitates coordinated interventions in money markets
- Fiscal stimulus more effective in the absence of offsetting exchange rate movements. Benefits of coordination larger as spillover effects are stronger
- EU-backing of fiscal framework enhances its credibility and reduces the risk of 'non-Keynesian' responses to fiscal stimulus

# But the crisis may hit potential output and reforms

- **NAIRU increases, investment declines, part of capital stock obsolete, R&D is procyclical**
- **Mounting budgetary pressures may increase the urgency of reforms so as to restore fiscal soundness. But fiscal consolidation may exhaust the political capital available for introducing other reforms.**
- **A reversal of financial market liberalisation may weaken the incentives for structural reforms. The greater access to financial markets made electorates more forward-looking and more willing to reward reformist governments (see research reported earlier)**

**EMU@10 offers a policy agenda that can help prevent future crises and limit the damage from the current crisis**

- **Domestic agenda**
- **External agenda**
- **Governance agenda**

# Domestic agenda: propping up coordination and surveillance

- **Fiscal surveillance has not worked properly** in the 'good times' that preceded the financial crisis. The fiscal impact of asset cycles must be properly taken into account.
- **The crisis exposed harmful divergent external and competitiveness positions** within the area. Surveillance must be broadened to include competitiveness and balance of payment issues (including in euro area candidate countries).
- **No revision of the Treaty needed:** Article 99 stipulates that "Member States shall regard their economic policies as a matter of common concern" and "shall coordinate them within the Council".

# Domestic agenda: Integrating structural, financial and macro surveillance

- **Crisis demonstrates importance of spotting macro-financial risks early and need for reforms to boost potential growth and resilience to shocks.**
- **Adjustment must run its course. Avoid keeping ailing industries alive, resist protectionism, keep Internal Market intact. Shape tax and benefit systems so as to minimise disincentives to stay in the labour market. Promote competition in services and innovation.**
- **Financial markets must remain integrated, to help risk sharing and inter-temporal smoothing, steer capital to its best use and strengthen incentives for reform. But current account imbalances, bubbles and financial contagion points to need for closer cross-border crisis prevention/resolution and regulatory/supervisory arrangements.**

# The external agenda: a stronger global role for the euro area

- **The crisis points to a need for stronger global governance.** Being the second largest currency union in the world, the euro area is naturally disposed to be a major global player.
- **Euro area countries should coordinate within an overarching strategy for the EU as a whole.** Speak with one voice in the international dialogue (on exchange rate policies, global imbalances and global financial system).
- **The euro area should streamline its representation in the IFIs.** Better off with less seats and more effective coordination. Would also strengthen the international dialogue by creating room for the emerging countries.

# Governance agenda

- **Cross-border spillovers of policy action were revealed by the crisis, and calls for coordination become stronger.**
- **The ECOFIN Council should remain at the core of the governance of the euro area. This is the formal decision making body for all EU countries (including prospective euro area members). It covers a broader set of highly relevant policy areas – such as financial markets and taxation.**
- **The Eurogroup should serve as a platform for deepening and broadening of coordination and surveillance in the euro area. Focus should be on the prevention of pro-cyclical or unsustainable fiscal policies, or the recurrence of intra-area balance of payments problems, also in prospective euro area accession countries.**
- **The Commission should enhance its fiscal and macroeconomic surveillance and reinforce its role in fostering economic and financial integration – sorely needed in an environment where protectionist instincts risk resuscitating. It should also strengthen its role in the international dialogues and continue to provide an honest assessment of countries' readiness to join the euro area.**

# Impact of the crisis on the prospects of meeting the entry criteria

<b>Fiscal</b>	<b>More difficult to meet</b>
<b>Inflation</b>	<b>Easier to meet</b>
<b>Interest rate</b>	<b>More difficult to meet</b>
<b>Exchange rate</b>	<b>More difficult to meet</b>
<b>Other conditions</b>	<b>Easier to meet</b>

# Crisis-related euro-area entry factors for New Member States

	facilitates euro area entry	complicates euro area entry
1. Short-term risk associated with entry	Immediate exchange rate and balance sheet risks eases when entering	More difficult to compute the (optimal) entry exchange rate vis-à-vis the euro, considering also that the exchange rates of Member States remaining outside the euro will continue to fluctuate
2. Capacity to absorb the impact of the crisis	Entering the euro area is the way to preserve the previous “downhill-capital-flow” model	Lower potential growth makes deleveraging more painful while the fiscal space to support demand will also be smaller
3. Longer-term macroeconomic stability	Tighter financial market regulation reduces access to credit and raises risk premia, hence lower risk of credit booms and busts in the future	Tighter financial market regulation contributes to higher cyclical volatility due to diminished risk sharing opportunities
4. Reform incentives	Crisis may generate more favourable political economy conditions for structural reform.	Tighter financial market regulation weakens reform incentives as reform multipliers fall and voters become less forward looking.

# Conclusion

- **Economic and Monetary Union emerged from the currency crises in the early-1990s and the ensuing breakdown of ERM1. Despite a lukewarm reception it represented a leap forward in European monetary, economic and political integration.**
- **The first decade of EMU may not have been particularly challenging as economic conditions are deteriorating very rapidly. Speculation that this could lead to a break-up of the euro area is ill-founded. Europe's post-war history is one of progress and compromises, and this is likely to continue, not least since the euro proves an invaluable asset from which each country derives major benefits.**
- **In its initial stages the US federal system allocated very limited powers to the centre, with the system evolving towards more federalism with each major crisis. This may also be Europe's future. The crisis may well trigger another leap forward in the integration of the euro area and, ultimately, the European Union as a whole.**