



# The First Decade with the Euro - Achievements and Challenges

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## **WHY DID ECONOMIC AND MONETARY UNION (EMU) BEGIN TO LOOK BOTH DESIRABLE AND FEASIBLE FROM THE MID-1980s?**

- THE PLAN FOR THE SINGLE INTERNAL MARKET IN GOODS AND SERVICES
- GROWING FREEDOM OF CAPITAL MOVEMENTS
- THE SEARCH FOR A MORE UNIFIED EUROPEAN VOICE IN THE GLOBAL MONETARY SYSTEM



A NUMBER OF EU MEMBER STATES HAD EXPERIMENTED WITH MONETARY COOPERATION BASED ON MUTUAL COMMITMENTS TO STABILISE EXCHANGE RATES SINCE THE BREAK-UP OF THE BRETTON WOODS SYSTEM

BUT NATIONAL INFLATION RATES CONTINUED TO DIVERGE INTO THE 1980S AND REQUIRED REGULAR REALIGNMENTS OF CURRENCY CENTRAL RATES

FINALLY, FROM 1986-87 NATIONAL INFLATION RATES CONVERGED TOWARDS THE LOW LEVEL IN GERMANY AND LOCKING UP EXCHANGE RATES MORE PERMANENTLY BEGAN TO LOOK POSSIBLE



SO EU GOVERNMENTS, JUST AFTER COMPLETING THEIR PLANS FOR FREEING CAPITAL MOVEMENTS, ASKED A COMMITTEE, LARGELY OF CENTRAL BANK GOVERNORS, HOW EMU COULD BE ACHIEVED

TO THE SURPRISE OF SOME EU HEADS OF GOVERNMENT THIS "DELORS COMMITTEE" CAME UP WITH A BLUEPRINT FOR THE FINAL STAGE OF EMU WHICH DID NOT LOOK IMPLAUSIBLE, ALTHOUGH THE TRANSITION TO IT WAS CLEARLY GOING TO BE LENGTHY AND DIFFICULT

SO THE THEN 12 GOVERNMENTS SIGNED THE MAASTRICHT TREATY IN EARLY 1992



## **THE STRUCTURE OF EMU IS UNPRECEDENTED – "SUI GENERIS" – THROUGH THREE FEATURES:**

- A CENTRALISED MONETARY POLICY CONDUCTED BY A VERY INDEPENDENT CENTRAL BANK WITH MEDIUM-TERM PRICE STABILITY AS PRIMARY OBJECTIVE
- DECENTRALISED NATIONAL BUDGETARY POLICIES, THOUGH SUBJECT TO RULES ON DEFICITS AND DEBT TO CONSTRAIN DIVERGENT BEHAVIOUR
- MOST OTHER ECONOMIC POLICIES ONLY LOOSELY COORDINATED (WITH IMPORTANT EXCEPTIONS FOR THREE JOINT POLICY AREAS: TRADE, COMPETITION AND SINGLE MARKET LEGISLATION)



## THERE WERE TWO MAIN PERSPECTIVES ON THIS RATHER LOPSIDED CONSTRUCTION:

- THE ROLE OF MONETARY UNIFICATION IN DRIVING POLITICAL INTEGRATION BOTH IN CONTIGUOUS AND IN WIDER AREAS
- THE DANGERS OF LETTING MONETARY UNIFICATION RUN FAR AHEAD OF POLITICAL INTEGRATION

NEITHER OF THESE TWO PERSPECTIVES HAS BECOME EVIDENT SO FAR: EMU HAS NOT TRIGGERED ANY MAJOR LEAP IN POLITICAL INTEGRATION, BUT IT STILL LOOKS ROBUST



## **A MORE PRAGMATIC APPROACH TO THE ACHIEVEMENTS OF AND THE CHALLENGES TO EMU WOULD RECOGNIZE ON THE POSITIVE SIDE:**

- THE LIBERATION FROM EXCHANGE-MARKET DRIVEN DISTURBANCES AND THE NEED TO ADJUST RELATIVE INTEREST RATES IN THE EURO AREA
- THE BOOST TO THE INTEGRATION OF FINANCIAL MARKETS IN EURO-DENOMINATED INSTRUMENTS
- THE COHESIVENESS AND PROFESSIONALISM OF DECISION-MAKING ON AND IMPLEMENTATION OF MONETARY POLICY IN THE EURO AREA



IT SEEMED A REASONABLE ANTICIPATION THAT THESE ACHIEVEMENTS IN THE MONETARY/FINANCIAL AREA WOULD HAVE ASSURED A GROWTH-FRIENDLY POLICY MIX OF LOW AND STABLE INTEREST RATES AND PRUDENT BUDGETARY POLICIES

AND THAT THIS IMPROVEMENT IN THE MACROECONOMIC FRAMEWORK WOULD ENABLE THE EURO AREA TO FOCUS ATTENTION ON THE REFORMS OF LABOUR AND PRODUCT MARKETS WHICH CONTINUE TO HOLD BACK GROWTH, IN PARTICULAR IN THE LARGEST EURO AREA ECONOMIES (GERMANY, FRANCE, ITALY)





## **THESE EXPECTATIONS HAVE NOT BEEN FULLY MET:**

- NATIONAL BUDGETARY POLICIES, WHILE LESS PROCYCLICAL THAN IN PRE-EMU TIMES, WERE NOT ADEQUATELY CONSOLIDATED IN THE EARLY YEARS OF EMU DUE TO WEAK INCENTIVES AND/OR MISJUDGEMENTS
- FOLLOWING INTENSIVE NEGOTIATIONS THE FISCAL RULES WERE MODIFIED IN 2005 LEADING TO CLOSER CRITICAL MONITORING OF NATIONAL BUDGETS IN RETURN FOR GREATER FLEXIBILITY IN APPLICATION



- WHILE SHIFTING THE BALANCE TOWARDS MORE DISCRETION AND LESS RELIANCE ON RULES IS ON PAPER A SOFTENING, IT HAS OF NECESSITY BROUGHT NATIONAL POLICY MAKERS INTO A MORE ACTIVE EUROPEAN ROLE AS REVIEWERS OF THEIR PEERS

A REMAINING CHALLENGE TO EMU IS TO STRENGTHEN NATIONAL STRUCTURAL REFORM EFFORTS WHICH ARE KEY TO THE LONG-RUN GROWTH PROSPECTS OF THE EURO AREA



## WHAT ARE THE SALIENT FEATURES OF THE ECONOMIC PERFORMANCE OF THE EURO AREA?

- ALMOST IDENTICAL GROWTH IN THE GDP PER CAPITA AS THE UNITED STATES – IMPLYING THAT THE LEVEL HAS BEEN A STEADY 30% LOWER. AT LEAST THE WIDENING OF THE GAP HAS STOPPED.
- EMPLOYMENT HAS GROWN MUCH FASTER IN THE EURO AREA THAN IN THE US (OR IN THE DECADE BEFORE EMU)
- BUT GROWTH IN LABOUR PRODUCTIVITY HAS SLOWED AND AVERAGE HOURS WORKED REMAIN LOW



WAGE MODERATION (UNTIL TODAY) HAS HELPED TO RAISE  
EMPLOYMENT AND MAINTAIN COMPETITIVENESS OF  
EXPORTS DESPITE A STRONG EURO

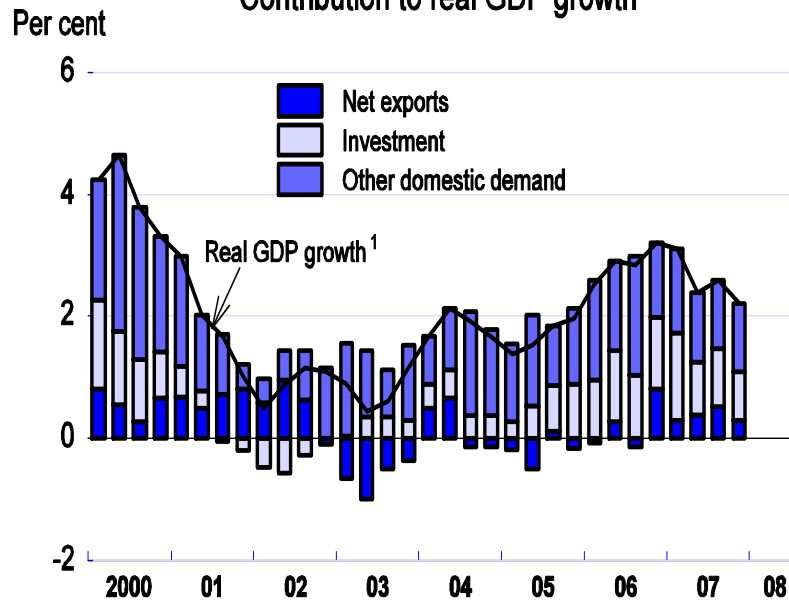
GROWTH OF DEMAND AND OF INDUSTRIAL PRODUCTION  
HAS HELD UP WELL, BUT CONSUMPTION IS NOW  
WEAKENING

THE DIVERSITY OF GROWTH INSIDE THE EURO AREA HAS  
NARROWED – THE FASTEST GROWING SMALLER ECONOMIES  
HAVE SLOWED TOWARDS THE RATES OF THE THREE  
LARGEST – 1½-2% IN 2008-9

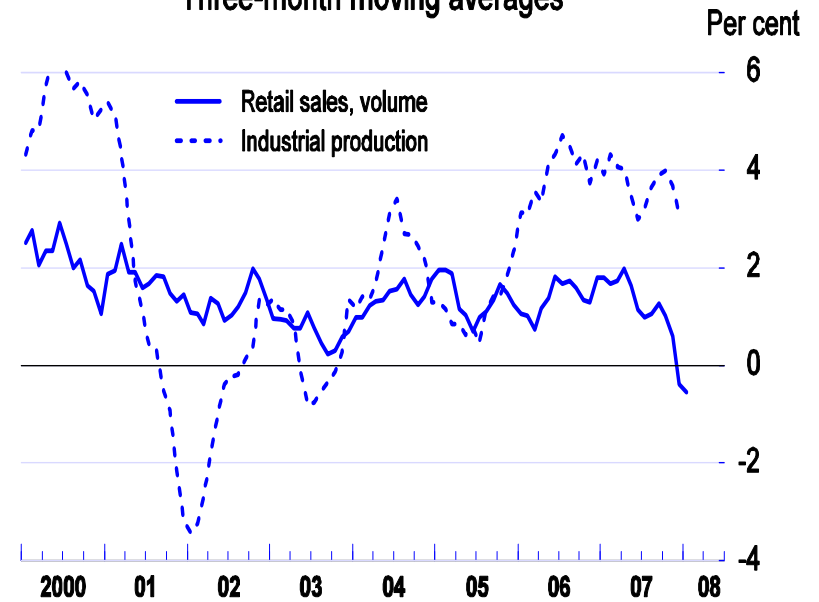


## Euro area

### The recovery has passed its peak Contribution to real GDP growth



### Retail sales have been subdued Three-month moving averages<sup>1</sup>

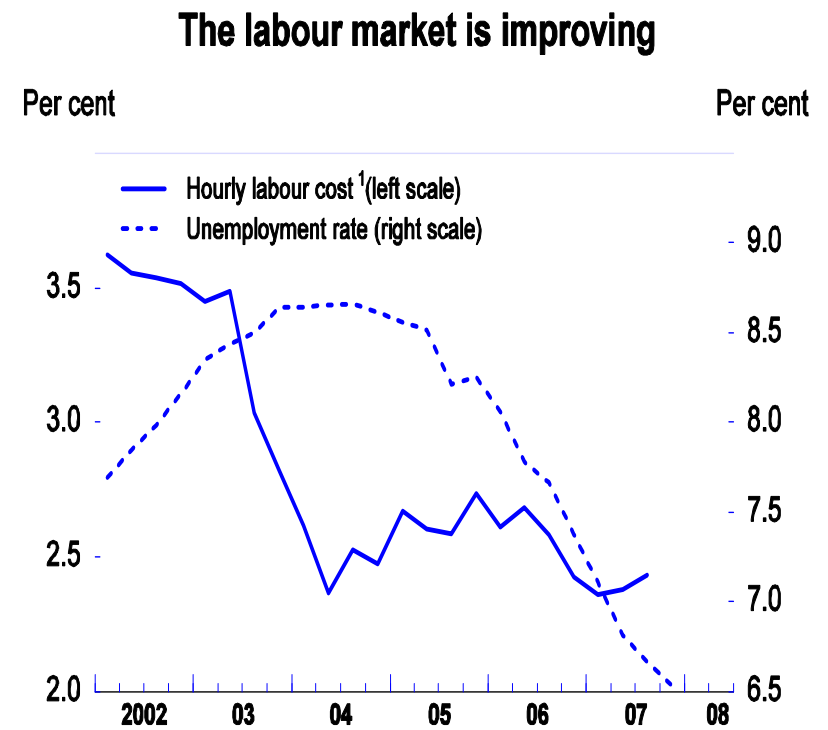


1. Year-on-year percentage change.

Source: Eurostat and OECD Economic Outlook 82 database.



## Euro area

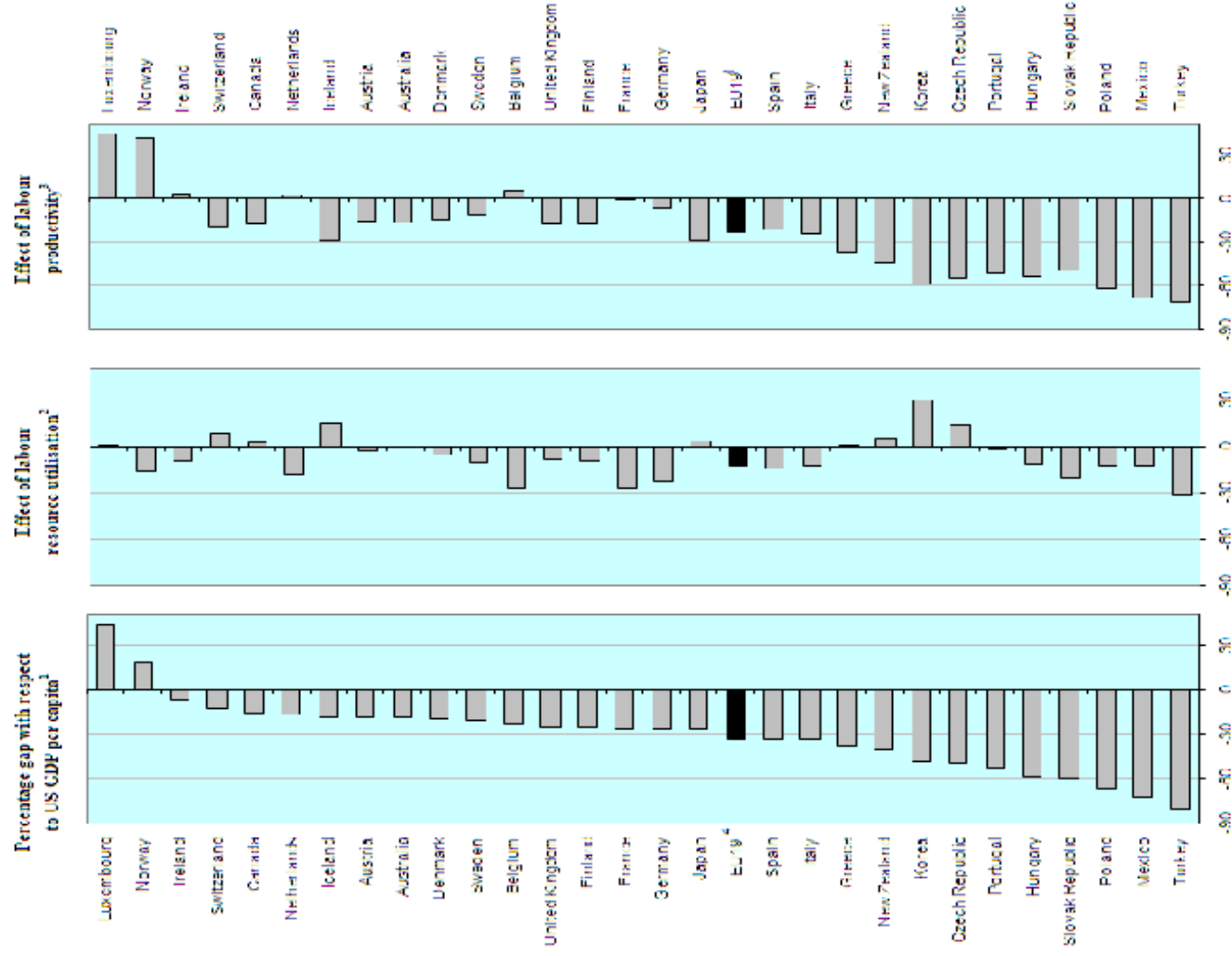


1. Year-on-year percentage change.

Source: Eurostat; ECB(2008), Monthly Bulletin, February and OECD Economic Outlook 82 database.



Figure 1.1 The sources of real income differences, 2006



1 Based on 2006 purchasing power parities (PPPs). In the case of Luxembourg, the population is aggregated by the number of trans-border workers in order to take into account their contribution to GDP. Data for Greece take into account a 10% upward revision to the level of GDP as agreed by Eurostat in October 2007.

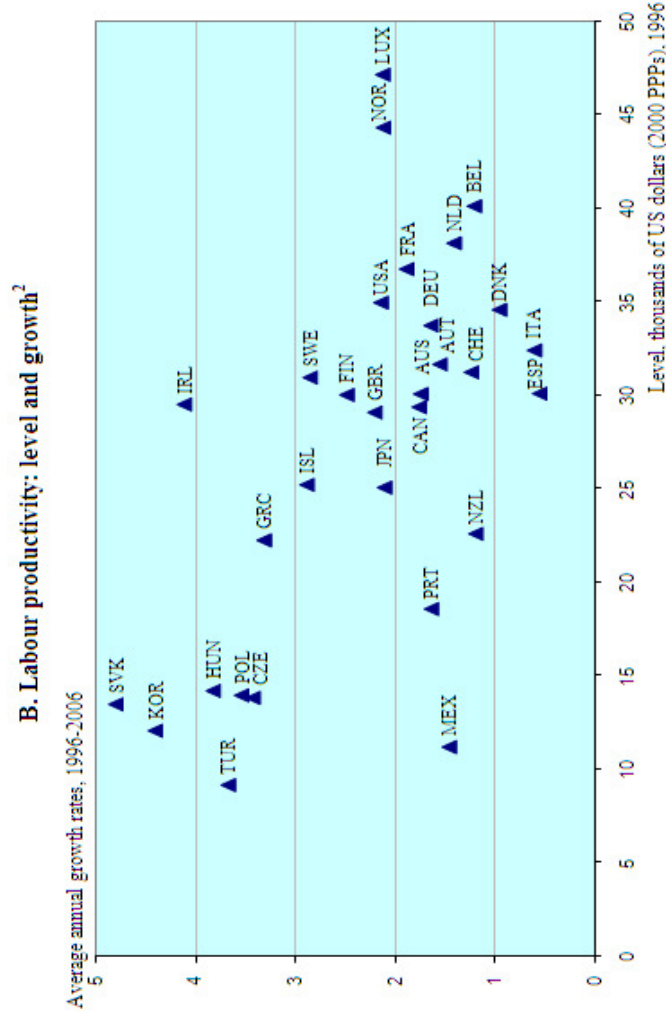
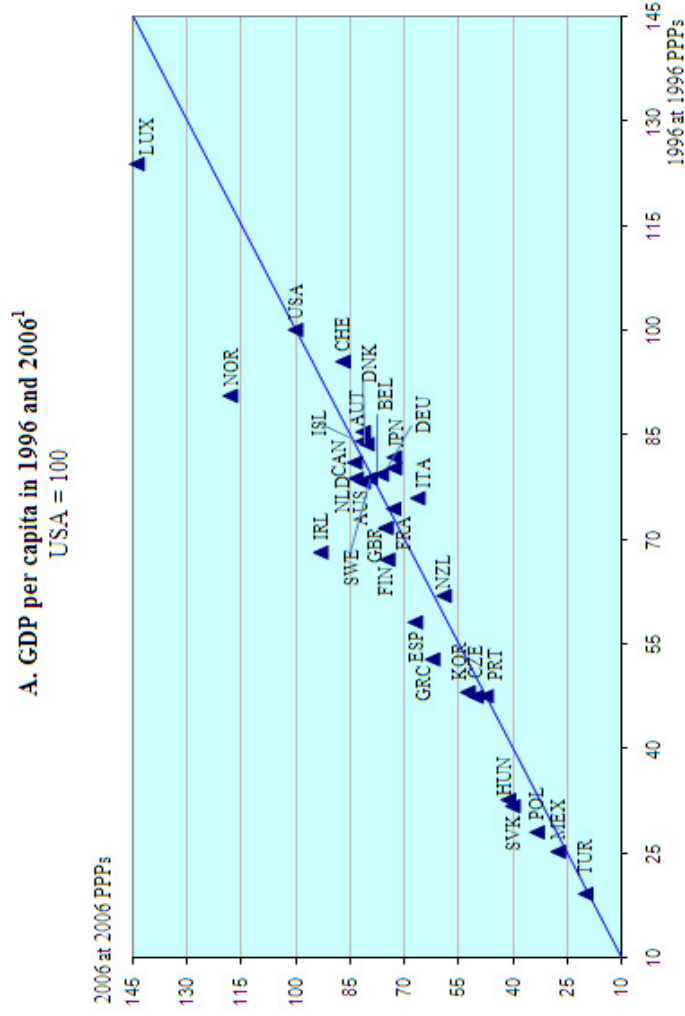
2 Labour resource utilisation is measured as total number of hours worked per capita.

3 Labour productivity is measured as GDP per hour worked.

4. EU9 is an aggregate covering countries that are members of both the European Union and the OECD. These are the EU9 countries plus Czech Republic, Hungary, Poland and Slovak Republic.

Source: OECD, *National Accounts of OECD Countries*, 2007; OECD *Economic Outlook*, No. 82; and OECD *Employment Outlook*, 2007.

Figure 1.2. GDP per capita and per hour worked: level and change



1. In the case of Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP.

2. Measured as GDP per hour worked in constant prices at 2000 PPPs. For Poland, the level refers to 2000 and the growth rate to 2000-2006.

Source: OECD, *National Accounts of OECD Countries*, 2007; and OECD *Employment Outlook*, 2007.







## WHY IS PEER REVIEW IN THIS AREA SO VAGUE?

- STRUCTURAL REFORMS ARE AT THE HEART OF DOMESTIC POLITICS
- HARD TO RECONCILE THE “NATIONAL OWNERSHIP” OF PROGRAMS WITH RIGOROUS COMPARATIVE ANALYSIS WITH BENCHMARKING
- THE EFFECTS OF REFORMS TEND TO BE BOTTLED UP WITHIN NATIONAL BORDERS – EXCEPT FOR THEIR IMPACT ON INSPIRATION/IMITATION



IN TERMS OF ECONOMIC GOVERNANCE THE MAIN CHALLENGE IS TO WIDEN THE EUROPEAN IMPACT ON POLICIES THAT REMAIN NATIONAL

THE FORUM FOR ENHANCING THIS PROCESS IS THE EUROGROUP OF MINISTERS OF ECONOMICS AND FINANCE IN THE EURO AREA

COMPACTNESS, CONFIDENTIALITY OF EXCHANGES AND A MORE PERMANENT CHAIRMANSHIP ARE POSITIVE FACTORS

COMPLEMENTARY TO, RATHER THAN COMPETITOR OF, THE EUROSISTEM/ECB



SOME NATIONAL POLITICIANS IN EUROPE HAVE CLEARLY SHOWN SIGNS OF FRUSTRATION AT LEAVING THE ENTIRE ECONOMIC POLICY STAGE TO THE CENTRAL BANK

BUT THOSE POLITICIANS WHO HAVE BEEN THE MOST VOCAL CRITICS OF THE FRAMEWORK TEND ALSO TO BE THE MOST IMPATIENT ON MACROECONOMIC ISSUES, NOTABLY ON THE EXTERNAL VALUE OF THE EURO, AND THE MOST RESISTENT TO PEER REVIEW OF THEIR BUDGETARY POLICIES AND OF THE SLOWNESS OF THEIR STRUCTURAL REFORMS



HENCE, MODIFICATION OF THE LOPSIDED CONSTRUCTION OF THE EMU CONSTRUCTION IS BOUND TO BE A SLOW AND GRADUAL PROCESS

A COMPROMISE BETWEEN THE NEED TO GIVE MORE ROOM TO ECONOMIC POLICY MAKING OUTSIDE THE AREA OF MONETARY POLICY AND THE NEED TO PRESERVE THE CAPACITY OF THE EUROSISTEM/ECB TO TAKE DECISIONS INDEPENDENTLY OF POLITICS

MOST EUROPEAN OBSERVERS ARE NOT ATTRACTED BY THE MODEL OF THE FEDERAL RESERVE WITH ITS DUAL MANDATE AND THE POLITICAL AND FINANCIAL SECTOR PRESSURES TO WHICH THE FED IS EVIDENTLY SUBJECTED