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10 Years of the Euro: Achievements, Challenges & Lessons for Asia

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ABSTRACT

The creation of the Economic and Monetary Union and the euro ten years ago was a leap forward in the process of European integration. This brief looks at the achievements of the first decade of the euro and the challenges as we go ahead. It finds that the euro and the EMU have generally been a success. At the same time, the successes of the past decade were helped by relatively benign conditions in the world economy which have abruptly ended with the onset of the international financial crisis. The crisis is the first major test and a significant challenge for the euro-area. It has exposed existing imbalances within the euro-area that were mitigated by the favourable economic developments and raised the stake for economic coordination. In spite of looming challenges, the EMU offers important protection for its members and can mitigate the effects of the crisis. The experience of the past decade with the euro offers lessons for the ongoing economic integration in Asia. Any lessons, however, should take into account the existing differences between the two models of regional integration.

Designing The European Economic And Monetary Union

The introduction of the euro was a leap forward in European integration. Today, more than 320 million European citizens share the same currency and enjoy its benefits. On January 1st, 1999 eleven European countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) irrevocably fixed their bilateral exchange rates. At that moment the euro came into existence for all cashless transactions, while national notes and coins remained in circulation. It was only 3 years later that, after thorough practical preparations, the euro notes and coins were introduced, replacing the national currencies. Since 1999 more countries in the European Union fulfilled the Maastricht criteria and introduced the euro: Greece in 2001, Slovenia in 2007, Cyprus and Malta in 2008 and Slovakia at the beginning of 2009.

The Economic and Monetary Union is the response to macroeconomic instability in the past. The economic turbulences of the 1970s and 1980s inspired Europeans to look for ways to ensure macroeconomic stability through closer cooperation in Europe. The decision to achieve full monetary integration through the creation of an Economic and Monetary Union (EMU) with its own single currency was enshrined in the Treaty on the European Union (also called Maastricht Treaty) in 1991. The Treaty set out the ground rules for the introduction of the euro. The road to the euro was divided into three stages, each with its own goals:

- Stage I (till the end of 1993): completing the internal market in particular by removing the remaining restrictions on the free movement of capital;
- Stage II (1994-1999): preparing for the establishment of the European Central Bank (ECB) and strengthening efforts towards economic convergence;
- Stage III (1999 onwards): irrevocably fixing the exchange rates and launching of the euro.

Economic convergence started already before the euro. To introduce the euro, EU Member States were required to meet a number of criteria (the so called Maastricht criteria) to ensure a high degree of nominal convergence. Specifically, they concern:

- Price stability – inflation cannot exceed by more than 1.5 percentage points that of the three best performing member states in terms of price stability;
- Sustainability of the government financial position – budget deficit should not exceed 3% and government debt not 60% of GDP;
- Exchange rate stability – the exchange rate has to stay within agreed fluctuation margins for at least two years before the introduction of the euro;

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- Durability of convergence – measured by long-term interest rates which should not exceed by more than 2 percentage points those of the three countries with the best performance in terms of price stability.

The Maastricht criteria were instrumental in fostering convergence in the run-up to the euro. The prospects of the euro served as a significant incentive for Member States to enact reforms and triggered remarkable efforts towards achieving macroeconomic stability, particularly with respect to fiscal consolidation.

With the creation of EMU a unique stability-oriented policy framework was established. The single currency is the central part of Economic and Monetary Union, which is an overarching economic framework designed to bring macroeconomic stability and to create the foundations for sustainable economic growth in Europe. At the same time, the euro is a natural complement to the Single Market, where persons, goods, capital and services flow undisrupted between member states.

The European Central Bank (ECB) has been established as the single central bank for all euro-area countries. The ECB's primary objective is to ensure price stability in the euro-area, based on the conviction that price stability is a necessary condition for achieving long-term growth. Decisions on policy interest rates are taken by the ECB's Governing Council, which comprises the governors of the euro-area national central banks and the members of the ECB's Executive Board. Monetary policy decisions taken by the Governing Council are then implemented by the national central banks, which together with the ECB form the European System of Central Banks (ESCB).

Member states coordinate their fiscal policies in the framework defined by the Treaty and the Stability and Growth Pact (SGP). Sound fiscal policy has always been considered crucial for a smooth functioning of EMU where the conduct of fiscal policy remains under the responsibility of member states while monetary policy is centralised and independent. The Treaty and the SGP provide a rule-based framework for the coordination of national fiscal policies. This framework is based on the constant monitoring of fiscal developments in Member States against agreed benchmarks. The European Commission has a key role in the fiscal surveillance but Member States' attitude and peer support are equally important.

Structural policies are coordinated in the context of the Lisbon Strategy for jobs and growth. Well-functioning product, labour and capital markets have an important role to play in raising growth potential and in cushioning the impact of economic shocks. In 2000, European Union leaders set out the so-called Lisbon strategy as a framework for fostering and coordinating structural reforms in the EU. Monetary and exchange rate policy in a monetary union can no longer play an adjustment role for individual countries. Therefore, more emphasis needs to be placed on market mechanisms to adjust. Euro-area countries have thus a special stake and common interest in advancing structural reforms in every member state.

A Successful First Decade

Initial expectations were cautious. The unprecedented nature of EMU implied a high degree of uncertainty with regard to its future functioning. Academics and policy makers raised questions primarily about the ability of the single monetary policy to deal with country-specific shocks. Although alternative adjustment mechanisms could in theory take over, they were deemed relatively weak in Europe (wage and price flexibility, migration) or undesirable (fiscal transfers). Fears of fiscal profligacy leading to an unbalanced policy mix were widespread.

Ten years after its start there is a broad consensus about the euro's success. Most of the pessimistic expectations did not materialize. The single currency has become a symbol of European unity. It has boosted integration and secured macroeconomic stability. On January 1st, 2009 Slovakia became the 16th country in the euro – area, thus confirming the appeal of the single currency even in the hard times of global financial crisis.

The primary goal of macroeconomic stability has been fully achieved. Prices and interest rates have converged to lower levels and have stabilised within the euro -area (see table 1 and chart 1). The ECB has achieved low inflation, on average, and well-anchored inflation expectations and acquired a high degree of credibility in a rather short period of time. This is particularly noteworthy given that only ten years ago it was a new institution without a track record. Fiscal coordination within the SGP has resulted in significant achievements (see chart 2). Fiscal deficits have fallen to record-low levels (only 0.6% of GDP in 2007), and the pro-cyclical behaviour of public finances has been reduced. It has not been all plain sailing, however. Deficits increased in the beginning of 2000s, calling into question the efficiency of the coordination mechanisms. The reform of the SGP in 2005 built on the experiences of the first years of EMU and has visibly improved the coordination of fiscal policies. Last but not least, currency turmoil within the euro-area – a regular feature during previous decades whenever there was a crisis somewhere in the world – is no longer possible.

Table 1

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

Chart 1

Inflation performance in the euro-area

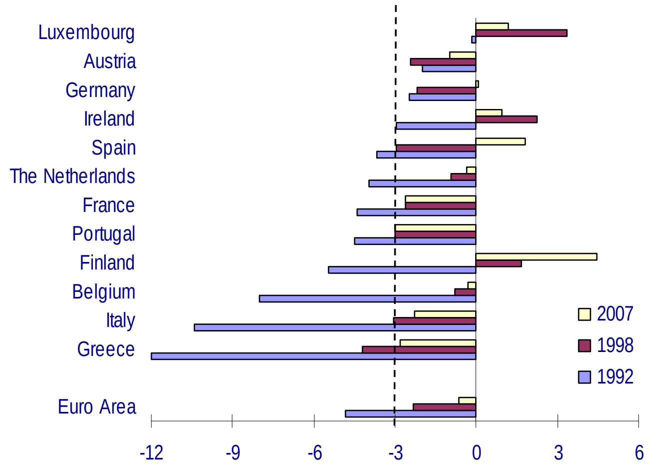
(in %, decade averages)

*Corresponds to the period since the start of Stage III of EMU, of which the last 2 years are forecast values.
Source: European Commission.

Chart 2

Development of Fiscal Positions

(in % of GDP, 1992, 1998 and 2007)



Job creation has surged but growth has not picked up. 16 million jobs have been created in the last decade, outpacing other mature economies with generally more favourable demographics, including the USA. However, productivity growth remained disappointing and offset the potential impact of higher employment on output. As a consequence, growth, at little more than 2% per annum, has remained broadly unchanged compared to the previous decade, although matched that of the USA in per capita terms.

Trade flows increased and product market integration progressed. The elimination of exchange-rate risk and the disappearance of the associated costs have resulted in increased trade flows within the euro-area and also with other countries. The existence of the euro has probably encouraged more firms to sell their goods abroad, increasing the availability of more products on the market and hence consumers' choice and utility. This effect has been particularly visible for intra-industry trade, thus reducing the impact of asymmetric shocks in the euro-area. Moreover, with growing trade, competition has increased and prices have been reduced in the euro-area. The volatility of export prices has fallen and the increased price transparency reduced the scope for price discrimination between national markets.

The euro has acted as a powerful catalyst for financial market integration. Interbank money markets in the euro-area have fully integrated, while cross-border interbank transactions have expanded steadily since 1999. Cross-border consolidation among banks has accelerated. A significant market in euro-denominated private-sector bonds has emerged and equity markets' integration has progressed faster than outside the euro-area. More integrated financial markets have encouraged more efficient allocation of resources and generated greater opportunities for risk sharing, diversification and greater resilience to shocks.

The euro has emerged as an important international currency. Although fostering the international status of the euro has never been a goal of the euro-area authorities, the euro has rather quickly established itself as the second most important international currency in the world behind the US dollar. The euro provides the possibility for international public and private investors to diversify their asset allocation, and for borrowers to diversify their sources of funding.

In its international role the euro has surpassed the combined status of its legacy currencies 10 years ago (see table 2). The share of the euro in global foreign exchange reserves has been rising since 1999 and stands at more than a quarter of all reserves today (see chart 3). In global foreign exchange markets, the euro-dollar currency pair is the most actively traded one, accounting for more than one-quarter of global turnover. In debt securities markets, the amount of outstanding euro-denominated international debt securities has surpassed that of the US dollar, with the euro accounting for almost a third of the world's stock of international debt securities. The single European currency is also widely used for invoicing in foreign trade. The process of the internationalisation of the euro is ongoing and the euro continues to consolidate its position.

The internationalisation of the euro is characterised by a strong regional and institutional pattern. With the exception of some functions (notably its use as an international financing currency), the international use of the euro is concentrated in countries neighbouring the euro - area, in other countries with special economic and political links to the EU, and in transactions directly involving euro-area economic agents. At the global level the US dollar remains the most important international currency in many areas – partly because of inertia and network effects that create a bias in favour of the incumbent inter-

Table 2

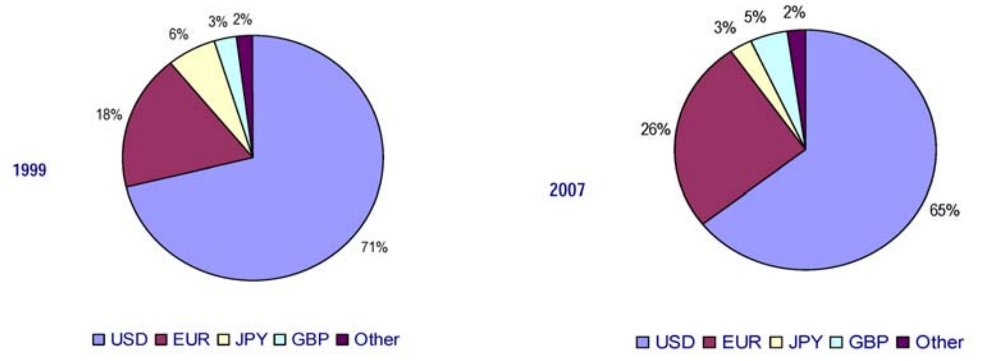
International role of the euro: Key Data		
	End of 1999	End of 2007
Share of the euro (% of world) in:		
- stock of international debt securities[1)]	25.0	32.2
- all cross-border loans[1)]	19.0	22.1
- cross border loans from non-euro area banks to non-bank borrowers outside the euro area (narrow measure)[1)]	10.5	20.9
- all cross-border deposits[1)]	27.1	21.0
- cross-border deposits of non-euro area non-banks in banks outside their country of residence excluding the euro area	18.9	20.6
- daily turnover in traditional foreign exchange markets[3)]	37.6[4)]	37.0[4)]
- settlement/invoicing of goods' exports from selected euroarea[5)] countries to non-euro area countries	39.3 to 57.5[6)]	38.8 to 67.8[6)]
- settlement/invoicing of goods' imports of selected euro area[5)] countries from non-euro area countries	31.9 to 55.9[6)]	33.6 to 59.4[6)]
- share of the euro in global foreign exchange reserves	17.9[7)]	26.1[7)]
Cumulative net shipments of euro banknotes to destinations outside the euro area		€71.1 billion[8)]

1) At constant 2007 Q4 exchange rates.
2) Latest data as of 2008 Q3.
3) Daily averages in April. Given the convention to account for both sides of each trade in Foreign exchange markets, percentages add up to 200%, meaning that the euro's actual share in total turnover is half the percentage reported in this key data sheet.
4) Historical data as of 2001. Latest data as of 2007.
5) Belgium, France, Germany, Greece, Italy, Luxembourg, Portugal, Spain.
6) Historical data as of 2002. Latest data as of 2006.
7) At current exchange rates. Historical data as of December 1999. Latest data as of 2008 Q3.
8) As of December 2007; ≈ 11% of currency in circulation for that month.

Source: BIS, ECB, IMF 2008

Chart 3

Currency Shares in Foreign Exchange Reserves



Source: European Commission

national currency – but its dominance has declined. Over time, the world economy is likely to move towards a multi-polar currency system centred around the US dollar, the euro and one or two Asian currencies. The euro would therefore not replace the US dollar; but the US dollar would no longer be the single dominant currency in the global monetary system.

The euro has become a valuable public good. The past decade has seen the emergence of new players in the global economy and the international financial system has become increasingly multi-polar in nature. The euro-area and the euro are playing an increasingly important role in supporting the stability of the world economy and the global financial system (see table 3). To some extent, the intra euro-area stabilization has also reduced volatility in the world economy. Moreover, non-EU countries increasingly perceive the euro-area (and the EU as a whole) as a pole of stability, a source of new capital, and also a reference of advice and expertise on integration and regulatory approaches.

Challenging Times Ahead

The success of the euro was helped by the benign economic environment across the globe. The years up to 2007 saw very supportive financial conditions in the world economy. Globalization helped to contain inflationary pressures, and asset booms contributed to fiscal windfalls. The benign decade came to an abrupt end with the onset of the international financial crisis.

The ongoing crisis exposes imbalances within the

Table 3

The euro area in the world: key figures (2007)

	Euro area (15)	EU-27	US	Japan	China
Population (millions)	320	496	302	128	1329
Share of world GDP (% at PPP)	16.4	22.5	21.6	6.7	10.9
GDP growth (%)	2.6	2.9	2.0	2.1	11.9
GDP per capita growth (%)	2.1	2.5	1.0	2.1	11.2
Unemployment (% of labour force)	7.4	7.1	4.6	3.9	4.0
Inflation (%)	2.1	2.4	2.8	0.1	4.8
Share of world trade (% of goods excluding intra-EU trade)	16.3	21.1	11.2	7.1	11.9
Current account Balance (as % of GDP)	0.0	-0.9	-5.1	4.8	10.8

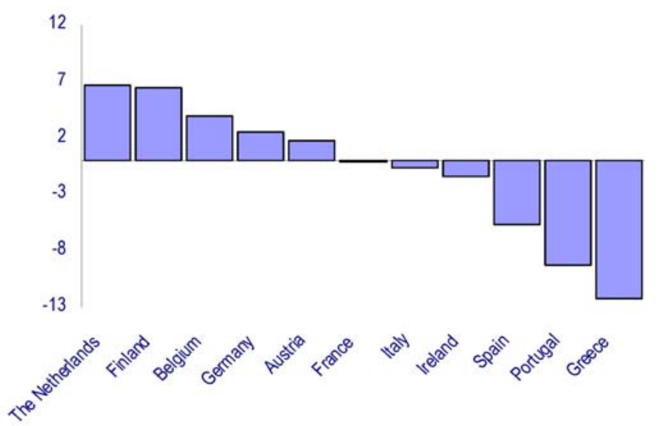
Source: European Commission and IMF

euro-area. Easy access to foreign capital has led to misallocation of resources and macroeconomic imbalances in some euro-area countries in recent years (see chart 4). Money was flowing to property markets, fuelling excess construction activity and housing bubbles. An adjustment channel to correct competitiveness differences exists in the euro-area (in principle like in any other currency area) but works only very slowly. Therefore, rising indebtedness and falling competitiveness in overheating economies led to large external deficits in some countries. The long-postponed adjustment, triggered by the current re-pricing of risks, might be costly and will pose particular policy challenges in coming years.

The euro offers important protection to its member states in times of crisis. In the past, before the introduction of the euro, global currency turmoil frequently led to intra-European exchange rate fluctuations that were often

Chart 4

Average Current Account positions
(in % of GDP, 1999-2007)



Source: European Commission

costly in terms of growth. From a more general perspective, the single currency underpins the Single Market and prevents Member States from sliding back into protectionism, as is often the case in times of crisis, with negative implications for recovery. The Single Market and the euro make spillovers more tangible and motivate coordination of national rescue packages. Moreover, the macroeconomic policy stimulus is likely to be more effective in EMU than it would have been without the euro:

- the single currency removes the offsetting exchange-rate movements that would have appeared in case of heterogeneous national stimuli in a world without the euro;
- the common fiscal framework, based on the Stability and Growth Pact, has two valuable features: it supports the credibility of the fiscal stimulus and can also help to safeguard the fiscal sustainability after the stimulus has played its role.

Last but not least, the single central bank makes it easier to coordinate any emergency measures among the Member States and to intervene in the troubled money market. From an international perspective, with the single European Central Bank, concerted monetary actions have become much easier in times of stress.

Nevertheless, the crisis raises major challenges. In the short term, a pressing necessity is to support the banking systems in the member states in a coordinated way. The actions taken at the EU level have already bore some fruit and prevented a systemic financial meltdown. However, the banking system is still ailing, yet its functioning is crucial for the effectiveness of monetary and fiscal policy. Additionally, in view of the gloomy economic forecasts, another short-term challenge for the euro-area authorities was to provide the necessary macroeconomic stimulus to avoid a severe recession; relevant decisions have been taken in most member states. Although the single monetary policy removes the burden of monetary coordination, on the fiscal front coordination is crucial in order to internalise cross-border spillovers and avoid free-riding.

It is not too early to think beyond the crisis. First, it is imperative to ensure that short-term crisis measures will not endanger the hard-won gains of macroeconomic stability in the long term. Therefore, monetary and fiscal impulses will need to be reversed after serving their purpose. Applied with the flexibility foreseen for such circumstances, the SGP remains the cornerstone of the EU fiscal framework also during the crisis, thus providing certainty about the future conduct of fiscal policies and supporting private sector confidence. Second, times of crisis often serve as a trigger of bold reforms. This opportunity should not be wasted. The crisis makes a good case for stepping up the integration of financial markets and for determined implementation of the EU regulatory and supervisory arrangements.

The rising international status of the euro carries new risks and responsibilities for the euro-area. It raises the exposure of the euro-area – including its financial system – to shocks originating in other parts of the world and to disruptive portfolio shifts between key international currencies. And it is precisely such shocks that are likely to occur more frequently in a world characterized by financial and economic globalization. The current financial turmoil provides a compelling argument for a better monitoring of risk and a better enforcement of global responsibility. To effectively meet the responsibility stemming from its position in the world economy, the euro-area must be able to speak in a more assertive and coherent manner in the international financial institutions and fora. The current attempt to reform the global economic governance is a good opportunity to streamline and consolidate the euro-area's external representation.

Some Lessons For Regional Integration In Asia

Economic and monetary integration in Europe can serve as a good point of reference for regional integration in Asia. The lessons that can be drawn from the process of European integration are of two types: (i) lessons related to the European reserve and exchange rate arrangements of the past, which have some similarities with East Asian arrangements currently being implemented or under consideration; and (ii) lessons related to decision-making and governance.

Major differences must be taken into account. Both politics and economics differ across the two regions – apart from culture, traditions and geographical conditions. The geopolitical context in the period when the European Union was built is also very different from current times, in which East Asia is trying to boost its economic and political links. Integration in Europe has been a step-by-step process which started in the 1950s with the pooling of sovereignty in the coal and steel industries and, almost 60 years later, it is still advancing.

The question about the types of currency reserve arrangements and monetary cooperation in Asia is a complex one. Three options, which could also be part of an evolutionary process, seem to emerge in the Asian context: (i) bilateral swap arrangements, (ii) the multilateralisation of such arrangements, and (iii) exchange rate and monetary coordination, possibly evolving towards a monetary union. Up to now, the value added of the bilateral swap arrangements under the Chiang Mai Initiative has been limited because it has never been used and because the amount of bilateral arrangements (raised to 120 billion US dollars in February 2009) seems relatively small compared to the amount of reserves (USD 3.22 trillion) available in the region. Over time, the emergence of a regional forum for policy dialogue on monetary and financial issues and for multilateral surveillance – probably a pre-condition for the active use of the Chiang Mai Initiative - will be important. The ASEAN+3 decision to multilateralise the swap arrangements under the Chiang Mai Initiative may well give new momentum to the integration process and could put in place an effective mechanism to provide help in case of currency turmoil or liquidity needs.

The integration process in Asia has been mainly market-driven but it will profit from clear cooperative procedures. The European integration has been more institution-based compared to the Asian integration process so far. However, even a more market-driven monetary unification process requires effective surveillance. The European lesson in this respect is clear: mutual surveillance works and is effective, especially if it is backed by clear procedures carried through by independent regional institutions. It can evolve over time from simple peer review to structured forms of monitoring with specific rules and possible sanctions (as in the case of the SGP). Whatever its nature, some form of policy surveillance remains the most important precondition to advance exchange-rate and monetary policy coordination, and to make progress towards, perhaps one day, an Asian monetary union.

Political will is necessary to move forward. In Asia, up to now, the commitment of the political leadership to pool some of the national sovereignty seems to be weak and effective surveillance mechanisms are not yet in place. This is the most important challenge for economic and monetary coordination in East Asia. With the political commitment to regional surveillance and to the creation of some form of institution able to enforce it, monetary and exchange rate coordination could work well and economic integration could advance faster.

Conclusion

The current global economic crisis is a challenge for Europe and Asia but also provides new opportunities. The macroeconomic stability brought about by the Economic and Monetary Union and the euro now offers an important protection for the members of the euro-area. Nevertheless, the crisis, with its wide-ranging impact, has exposed internal challenges and global interdependencies, which call for truly global cooperation. To resolve the crisis, both regional and global coordination should progress while taking into account the changing economic weights in the global economy. With its established macroeconomic stability and the growing international role of the euro, there is scope for the euro-area to assume a more prominent role in shaping the reform of the global economic architecture. In the same vain, the G-20 process, where Asia is represented with five countries, provides an opportunity for Asian countries to play a much more important role in global economic decision-making. But to play a productive role in international fora, Asian countries need to develop capacities and coordination mechanisms to be able to provide input and to speak with one voice. In this context, Asia could benefit from looking at the long European experience with economic integration. While differences have to be taken into account, the European integration model can serve as a good point of reference for Asian efforts to make progress with regional economic and monetary integration.

Reference:
Further references to the euro and European Economic and Monetary Union:
European Commission -
http://ec.europa.eu/economy_finance/index_en.htm
http://ec.europa.eu/economy_finance/emu10/index_en.htm
European Central Bank -
http://www.ecb.int/home/html/index.en.html

[1] European Commission, Directorate General for Economic and Financial Affairs. The views presented here are of the authors only and do not necessarily present the position of the European Commission.

The Long Road To EMU

Economic and monetary union was a recurring European goal from the late 1960s onwards. The general instability on international currency markets characteristic of the late 1960s put in danger the stability of the then European Economic Community. In response to these turbulences, in 1969 European leaders decided to form a high-level group led by Pierre Werner, the Luxembourg Prime Minister, to report on how economic and monetary union could be achieved.

The Werner group submitted its report in 1970, setting out a three-stage process to achieve EMU within a ten-year period. The report called for closer economic policy coordination, with interest rates and management of reserves decided at Community level, as well as agreed frameworks for national budgetary policies. The launch of the Werner plan was interrupted by a new wave of currency instability on international markets after the break-down of the Bretton Woods system, the first wave of oil price increases, and a lack of economic policy convergence in Europe.

A new proposal for EMU was put forward in 1977 by the then president of the European Commission, Roy Jenkins. It was taken up in a more limited form when the European Monetary System (EMS) was launched in March 1979.

The EMS was based on fixed but adjustable exchange rates defined in relation to the newly created European Currency Unit (ECU) – a currency basket composed of EMS currencies. Within the EMS, currency fluctuations were controlled through an Exchange Rate Mechanism (ERM) and kept within predetermined fluctuation limits. The EMS constituted an important pooling of monetary sovereignty because any changes in central parities of exchange rates in the system needed approval by all participating Member States. Over time, the mechanism helped to achieve a relatively high degree of convergence in economic policies and in economic results, and thus exchange rate stability. This was helped by a policy mix oriented towards converging inflation rates and interest rate management which targeted the exchange rate.

The success of the EMS led European leaders to set up a Committee for the Study of Economic and Monetary Union in 1988. The Committee was chaired by the then President of the European Commission, Jacques Delors, and included central bank governors and other monetary experts. Their report, submitted in April 1989, defined the objective of a monetary union as a complete liberalisation of capital movements, full integration of financial markets, convertibility of currencies, irrevocable fixing of exchange rates, and the possible replacement of national currencies with a single currency. The report pointed out that this could be achieved in three stages, moving from closer economic and monetary coordination to a single currency with an independent European Central Bank and rules to govern the size and financing of national budget deficits. The report's findings and proposals were incorporated in the Maastricht Treaty that laid the legal base for the creation of the EMU.

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