THE EURO AT 10: SUCCESS AND CHANGES

CIRANO Note written by Thierry Warin, June 2009

A dream came true. Ten years ago, Robert Schuman's vision of a peaceful, integrated Europe, recognizing its common history, was finalized with the implementation of the euro. This achievement has lived for 10 years now, and is assuredly a success. But the euro area members continue to face the challenges of adjusting to the single monetary policy, abiding by the Stability and Growth Pact on the fiscal side, and implementing needed structural reforms. Europe is closer than ever, but is still a work in progress. Europe is not yet fully integrated. There are many and maybe too many chapters in the European story; Europe is plural. One immediately thinks of its two main postwar occurrences: the European Union (EU), and the Economic and Monetary Union (EMU). But there is also the European Free Trade Association (EFTA), the European Economic Area (EEA), and the Europe of Schengen. When one considers this plurality, then Europe's motto seems totally obvious: "United in diversity".

This plurality is at the root of Europe's successes but also its challenges. In the past 60 years, Europe has gone through an unbelievable number of steps to rebuild itself and integrate its economies to become both a new and peaceful Europe. From Robert Schuman's declaration on May 9th, 1950, to the rejection of the European Constitution on June 12, 2008, Europe is definitely not running a sprint, but a hurdle race. It is surely a slower, and more complicated process than was anticipated, but Europe continues to progress in its integration. From an economically motivated integration, Europe is now closer to the supranational entity once dreamt of by Robert Schuman and presented to the world in the "clock lounge" of the Foreign Affairs Ministry Haussmannian building.

The past ten years have been an incredible success for the euro. Relying on the foundations of the ECU, the euro is managed by a brand new central bank. The big and only challenge for the ECB in 1999 was to create and convince financial markets of its high reputation. In other words, the ECB had to be trustworthy. This challenge has been tackled with success. Every single country of the euro has benefited from this success. The interest on treasury bonds declined, and the spreads were never this low compared to Germany. In other words, countries with a higher risk premium before the euro were able to finance their deficits and then refinance their debts at a lower price (almost the same price as Germany). Not only does this help in lowering their debts, but it improves the quality of the debt.

In 2009, amidst the worst financial crisis since 1929, the ECB no longer has to worry about its credibility. And this is particularly true in an open world where the Fed injects liquidity almost for free, and where inflation does not seem to be the primary issue. Indeed, in a time of crisis, expectations are different. The question is no longer to find sound and inexpensive financing, it is to find financing. If the ECB does not change its priorities, the financial markets will come to believe that the only response to the crisis will come from fiscal and structural policy. In this context, one can expect that countries with higher deficits in normal times will now need to run even higher deficits. The question is to find liquidity: in a liquidity scarce world, these countries will pay more. Therefore, we can expect to see financial markets placing a higher risk premium on these countries for two reasons: first, they may be short of liquidity as they are facing a higher risk of defaulting, and second, since the SGP is no longer an effective control over public deficits, nobody knows how big deficits will be, meaning that there is no longer any reason to not put a higher risk premium on some countries (Greece, Spain, Italy, etc.).

Most of the next ten years will be constituted by challenges. Simulations for growth in 2009 and 2010 rely on various assumptions. A lot of the answers depend upon which scenario will be chosen to rely upon what combination of monetary, fiscal and structural policies will be used.

Broadly speaking, if monetary policy cannot be used as an answer—even partial—to guide Europe through the crisis, governments have no choice but to use their fiscal policies. This will have a snowball effect: not only will treasury bond interest rise due to the liquidity scarcity, but it will also rise because the fiscal discipline created by the SGP and the indirect policy-mix benefit associated with the SGP will no longer exist. Financial markets will demand a higher risk premium. Governments can also fall back on structural policies, but in tough times where unemployment is on the rise accompanied with social tensions, it is unlikely that governments will implement policies positively impacting Europe's competitiveness (lowering labor costs, etc.). Can this threaten the euro? Is it plausible that countries leave the euro? The answer is no. The euro still offers a protection in the form of a lower risk premium on debt. If countries were to leave, they would face a rise in their risk premium and would have an even tougher time at financing their deficits. It is in fact more plausible that some countries will join the euro, than the converse. Denmark? The United Kingdom? This is now possible. A likely scenario is a change in the ECB's monetary policy, or the emergence of a real coordination mechanism among fiscal policies instead of the —cooperation mechanism embodied in the SGP, and maybe even a real economic government for the euro area based on the foundations laid down by the Eurogroup. The 2008 financial crisis may help Europe become singular.

The complete Burgundy Report: *The Euro at 10: Success and Changes* is available at the following address:

http://www.cirano.qc.ca/pdf/publication/2009RB-05.pdf