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Introduction

Alberto Alesina and Francesco Giavazzi

Ten years into the euro experience, one can evaluate the extent to which the single currency has met its promises. This volume brings together the first comprehensive collection of essays that help make such an assessment.

This introduction does two things: first, we lay out what we think we learned from reading these chapters; then, we go one more step. The conference from which this volume is drawn took place in the midst of the financial crisis (in October 2008), but the chapters had been written long before. Thus, the issues raised by the crisis are touched on only marginally in these chapters. We address some of the lessons for the euro from the crisis in the second part of this introduction.

One issue that has emerged from the conference is that there are benefits from membership in the euro area as well as challenges. In tranquil times, the benefits (and costs) are sizeable, and many chapters discuss them in a variety of different ways. But in a crisis, the benefits appear to be magnified.

Will the Euro Survive?

Is there a chance that the euro area might fall apart? This is the question addressed in chapter 1 by Barry Eichengreen. One can start asking what the answer to this question would have been before the 2007 to 2010 crisis and what it could be now. Before the crisis exploded, one might have been

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worried that countries such as Italy and Portugal that were doing so poorly could have succumbed to the temptation to exit to be able to use competitive devaluations to get out temporarily from stagnation. Inside the euro, both countries would have needed large real wage adjustment to restore a balance between nominal wage growth, productivity, and inflation. The possibility of either country abandoning the euro seemed rather remote, but the current Italian interior minister had expressed that view a few years back when not in office—and at some point, the issue was publicly debated in Portugal. Nevertheless, Eichengreen concludes that before the crisis, the event of a major country exiting and of EMU breaking down was highly unlikely in the medium run, and we agree. The crisis—perhaps paradoxically—has strengthened the euro area. Countries with traditionally weak currencies have realized that without the anchor of the euro, they would have experienced a spiral similar to that of developing countries: a speculative attack, a balance-of-payments crisis, interest rates jumping through the roof, and so forth.

The Euro and Structural Reform

The main reason why continental Europe—that is, most of the countries that now form the euro area—in the past twenty years has been unable to keep up with growth in the United States—and also in the United Kingdom and in the Nordic countries—is its reluctance to reform. Has the euro provided new stimulus for economic reform? Or as the evidence sometimes suggests, has euro membership produced "reform fatigue," in the sense that after having painfully met the Maastricht criteria, euro member countries have taken a break from reform?

Two chapters in the volume provide evidence on this question. In chapter 2, Alesina, Ardagna, and Galasso investigate whether the adoption of the euro has facilitated the introduction of structural reforms, defined as deregulation in the product markets and liberalization and deregulation in the labor markets. They find that the adoption of the euro has been associated with an acceleration of the pace of structural reforms in the product market. As for the labor market, the evidence is more complex. Reforms in the primary labor market have proceeded very slowly everywhere, and the euro does not seem to have generated much of an impetus here. On the other hand, in many countries—including many euro ones, such as France, Italy, and Spain—new forms of labor contracts have been introduced based on temporary agreements between employers and workers. The authors also explore whether the euro has brought about wage moderation: they find evidence of wage moderation in the run-up (1993 to 1998) of euro membership but not afterward. In chapter 3, Bugamelli, Schivardi, and Zizza further pursue this question from a different angle and find that productivity growth has been relatively stronger in those countries and sectors that relied more on

competitive devaluations to regain price competitiveness before the euro was adopted. This finding is confirmed when the authors analyze firm-level data from the Italian manufacturing sector. They find that low-tech businesses, which arguably benefited most from devaluations, have been restructuring more since the adoption of the euro. Restructuring has entailed a shift of business focus from production to upstream and downstream activities, such as product design, advertising, marketing, and distribution, and a corresponding reduction in the share of blue-collar workers.

These results run contrary to our prior and challenge the view that entry into the euro has produced "reform fatigue." They are encouraging for Europe, suggesting that at least in some parts of the economy—though probably less so in the labor market—firms have responded to the macroeconomic constraint imposed by the single currency and the single monetary policy by accelerating the pace of restructuring. These observations also bring to center stage issues of sequencing of labor market and product market reforms, as discussed in Blanchard and Giavazzi (2003). Further work is needed to test this proposition, but these two chapters strongly suggest that the euro might have accelerated the creation of new firms (or newly restructured firms) and the destruction of older ones—those that used to rely on the temporary breath afforded by competitive devaluations. If this is true, aggregate statistics—for instance, on the pace of productivity growth—could be misleading, as they might reflect a shift in composition: an acceleration of firms exiting and entering. It would be important to extend the work of Bugamelli, Schivardi, and Zizza by using firm-level data to investigate whether their findings also apply to other countries that were previously characterized by high inflation and repeated devaluations.

Business-Cycle Convergence

Another debate that took place while the euro was being designed was whether the single currency would induce convergence or divergence in the economic performance of member countries. The argument in favor of convergence was simple: a single monetary policy means no more idiosyncratic nominal shocks and thus one less reason for divergent economic cycles. The fiscal rules introduced with the Stability and Growth Pact added to this argument by limiting the size of idiosyncratic fiscal shocks. On the opposite side, increased economic integration (reduced transport costs, harmonized regulation, higher mobility of capital and labor) would have induced specialization. As countries, or regions, specialized in specific industries, they would have been subject to industry-specific shocks: this would have resulted in more, not less, macroeconomic divergence. The two mechanisms may refer to different time horizons: specialization takes time, while more synchronized nominal shocks were almost instantaneous with the creation of the European Monetary Union (EMU). The verdict remains open.

Chapter 4 by Giannone, Lenza, and Reichlin investigates the changes induced by the single currency on the business cycles of member countries. The authors produce forecasts of gross domestic product (GDP) per capita of each euro member country, conditional on their per-EMU structure and the observed path of euro area-wide growth. They find that in the first ten years, business cycles have hardly changed. In those countries that started from similar initial conditions in terms of real activity in the 1970s (Germany, France, Italy, Holland, Austria, and Belgium), business cycles are very similar, and no significant change can be detected since 1999. For the other countries (Spain, Portugal, Ireland, Finland, and Greece), there is a lot of uncertainty, and not much can be said—but in this group as well, no clear change since the EMU can be identified. This finding has a remarkable implication. Countries that benefited from a large reduction in real interest rates after joining the euro, such as Italy, have not shown output growth rates that are significantly different from countries that have faced smaller idiosyncratic shocks, such as Germany or Belgium. Moreover, although the costs of the elimination of exchange rate adjustments and of independent monetary policy are likely to have been different across countries, this factor does not appear to have magnified asymmetries.

The chapter also asks whether the single currency has affected the euro area-wide business cycle. The authors forecast euro area growth conditionally on the pre-EMU structure and on the observed path of U.S. GDP growth. They find that since 1999, growth has been lower than what could have been predicted on the basis of historical experience and U.S. observed developments. The gap between U.S. and euro area GDP per capita level has been 30 percent on average since 1970, and there is no sign of catching up or of further widening. Thus, the introduction of the euro does not appear to have significantly changed the historical transatlantic linkages. In spite of the relevant changes in the macroeconomic environment (the Great Moderation, German reunification, the euro area inception), the relationship between the U.S. and euro area real economic activity has remained stable.

The Euro and Infra-European Trade

The extent to which cycles are correlated is related, among other factors, to trade between member countries. The effect of currency unions on trade has received a large amount of attention since a very provocative paper by Rose (2000). This author finds an extremely large effect of currency unions on trade: these findings used evidence from existing unions, which, for the most part, involved small countries linked to large ones. A large literature has attempted to explain away the apparently unreasonably large effects found by Rose, with an uneven amount of success. In chapter 5, Frankel finds a 15 percent increase in trade over just seven years (1999 to 2006): this is small compared to the large effects found by Rose when studying other

currency unions—and Frankel goes thorough the possible explanations for this difference—but the effect is by no means negligible. The question is whether a 15 to 20 percent increase in intraeuro area trade is big or small. Without the Rose paper, most observers (us included) would have concluded that 15 percent in just seven years is quite a sizeable number. Obviously, it pales relative to Rose's number, but one should also consider that euro area countries were already quite integrated before the euro: further increases in trade of 200 or even 300 percent—the numbers found by Rose in other currency unions—are thus unlikely.

How the increase in intraeuro area trade affects the correlation of business cycles among euro member countries is an issue that remains to be explored.

Financial Integration

Could it be that the lack of stronger effects of the euro on business cycles is the result of the slow pace of financial integration? Two chapters in the volume address this question. In chapter 6, Kashyap and Gropp ask to what extent the single currency has created a single market in banking services. They go about it in a novel way by proposing a test of integration based on convergence in banks' profitability. They find evidence of convergence for listed banks (where an active market for corporate control is likely to work) but not for unlisted banks. They conclude that the banking market in Europe appears far from being integrated—in contrast to the United States, where the profits of both listed and unlisted commercial banks seem to converge, and high-profit banks see their profits driven down quickly. Incomplete banking integration could be one reason why the euro has had almost no effect on business cycles so far.

Chapter 7 by Alberto Giovannini focuses on a different and often overlooked aspect of financial integration: whether the euro area has a single integrated market for securities. The chapter explains what a single integrated market for securities entails, why efficient arrangements to deliver securities to a counterparty (posttrading) are essential for such a market to function properly, and why we do not have it yet. The chapter reflects on the political economic reason why this has not happened and suggests a path for future policy actions.

Fiscal Policy in the Euro Area

In chapter 8, Antonio Fatás and Ilian Mihov investigate the evolution of fiscal policy in the euro area. They do not present yet another discussion of the pros and cons of the Stability and Growth Pact but instead discuss the cyclical behavior of fiscal policy in the euro area from the point of view of the sustainability of fiscal stance, its cyclical behavior, and the behavior

of discretionary fiscal maneuvers. As a useful benchmark, they look at the fiscal policy of the United States. Given that reliable fiscal data are annual for most countries, and given the short life of the euro, it is quite difficult to discuss with much confidence this important subject, simply because we did not have enough time to evaluate cyclical patterns. The potentially large recession that is impending as we write (November 2008) may provide a very important observation in this respect. One of the most interesting conclusions of this chapter is that fiscal policy in the European Union has been mildly procyclical. That is, it has *not* been used as a stabilizing tool. This is either because automatic stabilizers have not functioned too well or because discretionary spending has gone up in good times and perhaps has gone down in bad times because of the Stability and Growth Pact. This is in contrast with the United States, where the properties of fiscal policy seem more countercyclical. In our view, these results are driven by the fact that several EU countries made a fiscal effort to be admitted into the euro area. Then, in 2000 to 2001, when their economies were doing relatively well, rather than accumulating surpluses—as an appropriate fiscal policy requires—these countries relaxed. Not having the constraint imposed by acceptance in the euro area, their government started spending again. Whether this is a onetime event or a permanent procyclical bias of some European government remains to be seen. Certainly, those governments that have been fiscally irresponsible in the more recent and more distant past will pay the price with less fiscal flexibility in the current recession.

Are Financial Supervision and the Lender-of-Last-Resort Function Sound Enough?

The decentralized structure of euro area supervision and of the lender-of-last-resort function has long been a source a concern. When the European Central Bank (ECB) was being designed, the influential paper "The European Central Bank: A Bank or a Monetary Policy Rule" (Folkerts-Landau and Garber 1992) vividly made the point that the new institution was not really a central bank; rather, it resembled an automaton, programmed to set interest rates on the basis of some rule. Critics used to say that in order to turn the ECB into a real central bank, a crisis was needed—provided the crisis was not too serious; otherwise, it might take away the ECB altogether. The crisis has now happened, and it is more serious than anyone could have imagined. How has the ECB performed in the crisis?

Although chapter 9 by Cecchetti and Schoenholtz was completed halfway through the crisis, it addresses a number of issues related to financial supervision and liquidity provision. In the area of liquidity provision as a lender of last resort, the authors give high points to the bank's management of the crisis so far. In August 2007, the ECB boosted liquidity supply early and aggressively to counter the sharp increases in funding rates as banks

turned cautious and alternative private sources of funding shut down. In order to deliver liquidity effectively, the ECB utilized the broad flexibility that it enjoys with respect to assets that it may accept as collateral or may acquire outright, including a variety of asset-backed securities. Some actions by the Federal Reserve came with a lag and were inspired by the ECB.

Cecchetti and Schoenholtz also discuss other, potentially more troubling aspects of the euro area stability framework. In contrast to liquidity matters that lie clearly within the ECB's mandate, solvency matters are addressed exclusively by national institutions, which may have different views about what constitutes a systemic threat and about how and when public resources should be employed. The fact that there is no euro area fiscal agent means that burden sharing across nations would be a challenge should a large (truly European rather than national) institution become unstable. Similarly, the decentralized structure of banking supervision—national supervision authority placed with different institutions, depending on the country—could create potentially dangerous incentive problems. These would not disappear by simply delegating the responsibility for supervision of national central banks—as some of the interviews on which the Cecchetti Schoenholtz chapter is based clearly demonstrate.

Has the Crisis Altered the Incentive to Join EMU?

In the final two chapters of the volume, we return to the longer-term issues addressed by Barry Eichengreen in chapter 1: how long will it take for all twenty-seven nations of the EU to adopt the euro, and has the crisis of 2007 to 2010 altered the incentives to join the EMU? To begin, misgivings about the euro in countries that were already in the union have completely disappeared. While several politicians—in Italy, but also in France and Spain—had complained about the straightjacket of the euro and the ECB policy before the crisis, since the summer of 2007, those voices have been silenced. The widespread feeling in Italy, for instance, is that without the euro, this country could have taken an Argentinean-style route of wild depreciation and currency attacks to the old lira. At the same time, countries that had decided to stay out of the union are reconsidering the wisdom of their decision. Some countries such as Iceland that are not even members of the European Union are starting the membership process for the sole reason of being able to one day adopt the euro. Two chapters in the book reconsider the decision by Sweden and the United Kingdom not to join. Although these chapters were written before the crisis, some of the findings are suggestive of why the crisis may have altered the incentives faced by these countries.

In chapter 10, Söderström finds that in Sweden, the exchange rate to a large extent has acted to destabilize rather than to stabilize the economy, pointing to the potential risks of an independent monetary policy. In chapter 11, Di Cecio and Nelson, studying the UK experience, make a similar point,

suggesting that euro membership would eliminate shocks to the uncovered interest rate parity condition, which they identify as a major source of exchange rate variation.

So far in Sweden, the issue has been muted, because since the start of EMU, the exchange between the krona and the euro has remained remarkably stable—so stable that one could have argued whether the Riksbank was really targeting domestic inflation. But since the crisis erupted, the krona has depreciated in a few months by almost 10 percent against the euro. This has confronted Sweden with a difficult policy choice: either raise interest rates to stabilize the krona-euro exchange rate (thus avoiding the costs identified in chapter 10) or lower rates to avoid financial trouble and a possible recession.

It is interesting that Denmark, Sweden, and the United Kingdom reacted to the crisis by moving in opposite directions. Sweden and the United Kingdom have given up on exchange rate stability and have lowered rates, whereas the Danish central bank has intervened heavily in the foreign exchange market and has been forced to raise interest rates from 5 percent to 5.5 percent—a full 1.75 points higher than the ECB's rate—in an attempt to stabilize the exchange rate.

As a result, a renewed debate about the benefits of euro membership has opened up in Denmark: some argue that the country should run a new referendum on the euro. Even Iceland now speaks about the benefits of the euro, although this country is not even a member of the European Union. We read that diplomats from Iceland are making discreet inquires in Brussels about accession, and a poll conducted in October 2008 found that approval for EU membership among Icelandic citizens has increased from 48.9 percent to 68.8 percent in one year.

Willem Buiter and Anne Sibert (2008) argue that Iceland is only an extreme case of a more general phenomenon—a small country with its own currency and with banking sectors too large to be bailed out by national authorities. Others are Denmark, Sweden, and Switzerland. The United Kingdom is larger, and according to Buiter and Sibert, also enjoys "minor-league legacy reserve currency" status (2). But some of the arguments apply to the United Kingdom as well. In fact, a renewed debate about euro area membership has started in the United Kingdom, too.

Similar problems have manifested themselves in Central and Eastern Europe. In Hungary, almost all mortgages are denominated in Swiss francs or in euros; currency depreciation has triggered a series of personal and banking failures. Thus, the country is struggling between the desire to stabilize the exchange rate and the need to provide liquidity to the economy. Recently, the International Monetary Fund suggested that several countries in Central and Eastern Europe should consider adopting the euro, even without a seat on the board of the ECB. The reaction of euro member

countries has been cautious. But this is another sign that during a crisis, the umbrella of the euro seems especially valuable.

In summary, there is no doubt in our mind that the crisis of 2007 to 2010 has altered the incentives to join the euro. It has also provided the countries that are already members with reasons to be more cautious about enlargement. The euro's second decade promises plenty of interesting developments.

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