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978-9-279-09842-0 - The Euro: The First Decade

Edited by Marco Buti, Servaas Deroose, Vitor Gaspar and Joao Nogueira Martins

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## *The Euro*

On 1 January 1999 eleven EU Member States adopted a new currency – the euro. The introduction of the euro was a remarkable feat in the history of European monetary, financial, economic and political integration. It was an event of worldwide significance. Despite much criticism and predictions that it would quickly collapse, the first decade of the euro has been a remarkable success. The euro area has now expanded to sixteen members with a combined population of 326 million and contributes 16 per cent of global output. This book is the first to provide a wide-ranging strategic review of the first decade of the euro. Written by an impressive line-up of academic and professional economists, *The Euro: The First Decade* is an invaluable reference for scholars and policy makers who wish to know more about the successes and failures of the euro and the challenges that lie ahead.

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Cambridge University Press

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# The Euro

The First Decade

Edited by

MARCO BUTI,

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VÍTOR GASPAR

and

JOÃO NOGUEIRA MARTINS



CAMBRIDGE  
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CAMBRIDGE UNIVERSITY PRESS

Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore,  
São Paulo, Delhi, Dubai, Tokyo

Cambridge University Press

The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York

[www.cambridge.org](http://www.cambridge.org)

Information on this title: [www.cambridge.org/9789279098420](http://www.cambridge.org/9789279098420)

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First published 2010

Printed in the United Kingdom at the University Press, Cambridge

*A catalogue record for this publication is available from the British Library*

ISBN 978-9-279-09842-0 Hardback

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*To Klaus Regling*

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Cambridge University Press

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Cambridge University Press

978-9-279-09842-0 - The Euro: The First Decade

Edited by Marco Buti, Servaas Deroose, Vitor Gaspar and Joao Nogueira Martins

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## *Foreword*

The creation of an Economic and Monetary Union (EMU) in Europe in 1999 was a major and unprecedented event in economic history, and the most tangible step forward in European integration since the Treaty of Rome.

The euro is still a young currency. However, in the short space of a decade, it has accumulated a reputation of solidity and stability, and brought overwhelming benefits to the European economy: both to citizens and to businesses. The contributions collected in this book demonstrate that EMU has been a resounding success. This view is now consensual among economists, although not everything has been perfect. Nevertheless, those who promoted and laid the foundations of EMU have been vindicated; the Cassandras and sceptics who thought the euro was an impossible project or predicted disaster were proven wrong. Testimony to its success is the fact that since its creation, the euro-area membership has been extended from the original eleven to sixteen members, and several other EU countries are lining up to join in future, as soon as they fulfil the convergence criteria of the EU Treaty. The economic advantages of EMU are overwhelming for all its members. In fact, the advantages of belonging to a monetary area with a solid and stable currency increase, and are better perceived by citizens and businesses, in times of hardship.

The European economy – together with the rest of the world – is experiencing testing times. The turmoil that originated in the US sub-prime mortgage market in the summer of 2007 spread into financial markets and impacted economies the world over, in particular after the failure of Lehman Brothers, in September 2008. A squeeze on credit, falls in real estate prices and tumbling stock markets have reinforced a slump in consumer confidence, consumption and investment. Given the



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*Foreword by Joaquín Almunia*

global nature and magnitude of the recession, the euro area could not escape unscathed.

I am very much aware of the economic difficulties felt by many European citizens during this crisis, which is the most severe in our lifetime. The Commission, together with the European Central Bank and EU governments have taken every available measure to restore confidence to financial markets and return economic growth.

Clearly, the crisis constitutes a major challenge for the euro-area economy. However, I am profoundly convinced – and there is ample evidence to confirm – that the impact of this global crisis would be disproportionately more severe if each country had to respond to events individually, to worry about the reputation of its national money in foreign exchange markets, to prepare its economy against unexpected depreciation in partners' currencies and sudden changes in competitiveness.

Indeed, the euro is protecting its members from the worst of the economic and financial crisis in several important ways. First, the euro has permanently eliminated the exchange-rate instability and speculative attacks that its members could have expected during the financial turmoil. It suffices to study the foreign exchange crises at the beginning of the nineties to understand how painful disorderly movements in exchange rates can be for highly integrated economic areas. Second, the euro area benefits from an independent central bank whose swift actions to ease liquidity constraints and coordinate monetary policy have helped to avert a financial meltdown. Such rapid, coordinated, steps by sixteen national central banks would have been unthinkable. Moreover, the reputation of the ECB and its strong commitment to price stability were of paramount importance in ensuring that the acceleration in prices in the last months of 2007 and first half of 2008 – because of unexpected and abrupt changes in commodity prices – were transient and did not imply damaging second-round effects. Third, the increase in financial integration over the first decade of the euro has contributed to sharing risks, and a larger financial market contributed to absorbing reverberations in a much more effective way than with segmented domestic markets. Fourth, the EMU's stability-oriented macroeconomic framework has better prepared euro-area countries to deal with a downturn. The fiscal rules of the Stability and Growth Pact helped the euro-area countries to improve fiscal positions and to widen their margins of fiscal manoeuvre, which they can now use to fight the crisis. However, the crisis has also revealed a

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number of shortcomings and unfinished business for EMU, notably in terms of structural reforms, long-term fiscal sustainability and the external representation of the euro area.

Beyond the current global crisis, I see several clusters of challenges for the euro area. The first concerns the reform of the international financial architecture. This crisis has shaken the foundations of the global economic and financial system. We bear a heavy responsibility in ensuring that such a crisis cannot occur in the future. This requires putting in place a new financial system, one based on transparency, rigorous supervision and vigilant risk management. Although the genesis of the crisis was not in Europe, we have already tabled a number of important legislative proposals to tackle some of the failings that contributed to its propagation. We have taken steps to protect bank depositors, adapt accounting rules, regulate the activities of credit rating agencies and strengthen rules on capital requirements. A priority is to finally resolve the issue of cross-border supervision in Europe. After years of piecemeal advances, we can no longer push this issue to the side.

Before the emergence of the global crisis, in our report ‘EMU@10’, the Commission had already identified a number of megatrends that would drive the agenda of euro-area reform in the years to come. These trends, namely globalisation, population ageing, climate change and the increasing scarcity of natural resources will, over the next decades, pose challenges for the performance of all advanced economies in terms of growth, macroeconomic stability, the ability to withstand, and adjust to, shocks, and the sustainability of social protection institutions. However, they are even more compelling for the European economy considering its relatively low growth potential and adjustment capacity, and the need to safeguard our European social model. To manage these trends and avoid them running counter to our economic goals, the euro area needs to deepen and broaden macroeconomic surveillance with the aim of identifying and correcting macroeconomic imbalances in a timely fashion; to foster structural reforms and better integrate them in EMU coordination mechanisms; to build an international strategy for the euro area that is commensurate with the international role of our currency, and to adapt accordingly our institutional practices and governance of the euro area.

Making EMU work better in the future will embed stability in Europe in a world of intense transition and fierce competition. It will increase

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prosperity for citizens of the EU and serve as a tool for alleviating social inequalities. A well-governed, successfully enlarging euro area will deepen integration between Member States and strengthen and extend the EU's sphere of influence. It will give us crucial leverage to influence global dialogue and decision making.

In an increasingly complex world, effective policy makers need to be in permanent discussion with the academic world, learning from new ideas, identifying relevant insights and avoiding the pitfalls revealed by research. The European Commission has a long tradition of interacting with academia. This book is one more example of that fruitful cooperation.

All the economists who have contributed to this volume are both distinguished scholars and active participants in the policy debate. Over the years, they have greatly helped policy makers, at the national and EU level, to identify and understand the issues involved in the running of EMU. I have learned a lot from them and am grateful for their contribution to this book. I hope that this book will prompt constructive discussion and inspire new analyses both to detect new challenges and to help shape our responses to the current ones.

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Cambridge University Press

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## *Acknowledgements*

This book would not have been possible without the concerted efforts of many people. We would like to thank, first and foremost, all the authors and discussants for their contributions and for coping with our repeated and pressing requests.

Our thanks go also to Klaus Regling, Director-General of Economic and Financial Affairs at the time the preparation of this book started, for his support and encouragement.

We are also grateful to several colleagues of the Directorate-General of Economic and Financial Affairs and of the Bureau of European Policy Advisers, who provided valuable suggestions on the initial versions of each chapter.

We are also indebted to Aurélie Thérace and Christina Jordan for help in preparing the ‘manuscript’ and the index.

Finally, Chris Harrison and Philip Good guided the publication process at Cambridge University Press.

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