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Twenty years of the euro

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Authors: Daniel GROS, Cinzia ALCIDI (CEPS)
Directorate-General for Internal Policies
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Twenty years of the euro

Resilience in the face of unexpected challenges

Abstract

The first 20 years of the euro were very different from what had been anticipated. Deflation, rather than inflation became a problem. Financial markets, which had been neglected, became a major source of instability. However, the euro area proved resilient and support for the euro is at historic highs. Looking to the future, the greatest danger might not be another financial crisis, but sluggish growth and an increasing gulf between countries that have successfully adjusted their public finances and those where this goal remains increasingly distant.

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AUTHORS

Daniel GROS, CEPS
Cinzia ALCIDI, CEPS

ADMINISTRATOR RESPONSIBLE

Dario PATERNOSTER

EDITORIAL ASSISTANT

Janetta CUJKOVA

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

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To contact the Policy Department or to subscribe for updates, please write to:
Policy Department for Economic, Scientific and Quality of Life Policies
European Parliament
L-2929 - Luxembourg
Email: Poldep-Economy-Science@ep.europa.eu

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CONTENTS

LIST OF ABBREVIATIONS

EMU	Economic and Monetray Union
GDP	Gross Domestic Product

LIST OF FIGURES

LIST OF TABLES

EXECUTIVE SUMMARY

- The first 20 years of the euro were very different from what had been anticipated. Deflation, rather than inflation became the key problem. Moreover, financial markets, which had been neglected by the Maastricht construction, became a major source of instability for which the euro area was ill prepared.
- The economic performance of the euro area has been modest on average, when considering the two decades as a whole. However, other advanced economies have not done much better over the same period.
- The labour force participation rate in the euro area continued to increase and has surpassed that of the US today. Moreover, the growth rate on a per capita basis declined after 2007/8, but not more so than that of the US or the UK.
- This relative resilience of the euro area is also surprising in light of the fact that both fiscal and monetary policy were less used to stimulate the economy than across the Atlantic and across the Channel.
- In fact, the dramatic increase in public debt in the US and in the UK has not led to spectacular outperformance by these countries relative to the euro area.
- The modest economic performance of the euro, coupled with the ambivalence of many Europe's national leaders and the widespread tendency to blame the euro for most problems, has perhaps resulted in the euro being not much loved. However, the currency appears to be recognised as an integral part of European integration and of peoples' lives. Support for the euro reached historic highs in 2017 and 2018, with about 65% of the population expressing support for it.
- Financial markets were the neglected pillar in the construction of EMU and the main source of instability, both economic and political. The financial crisis and the understanding of how it played out in the euro area led to two important lessons. First, the financial cycle has become more important than the traditional business cycle, leading to very long expansions and sometimes deep recessions. The second is that while financial integration in the euro area is key for the purpose of the transmission of monetary policy, deep integration driven by cross-border exposures can contribute to financial instability, instead of risk sharing.
- The biggest challenge today for the euro might be to avoid looking in the rear-view mirror: the greatest danger for the euro area might not be another outsized financial crisis. If history is any guide, dynamics in the real economy (and politics) will shape the challenges in the years to come, rather than financial market turbulence.
- The resilience of EMU will be tested by sluggish growth in key sectors due to a lack of an integrated market and an increasing gulf between those countries that have adjusted successfully in bringing their public finances under control and those where this goal remains increasingly distant.

1. INTRODUCTION

January 1999 saw the start of the 'third stage' of Economic and Monetary Union (EMU), under which the exchange rates among the original 11 Member States were 'irrevocably' fixed. From that date the new European Central Bank was solely responsible for the monetary policy of this group of countries.

For ordinary citizens little changed in January 1999. The euro in the form of cash was only introduced three years later. However, the epochal change was still perceived by the public as well. Acceptance of the EMU 'project' increased just prior to 1999 to a positive balance of around 40 points of those favouring EMU compared to those against.[1]

Conventional wisdom at the time was that Germany had most to lose from the euro. First of all, the country had given up its monetary hegemony; thus exposing itself to the risk that the European Central Bank would not be as tough an inflation fighter as the Bundesbank had been for decades. Moreover, in 1999, the Deutsche Mark was over-valued and Germany was running a current account deficit. Fixing exchange rates at the level of the time exposed German industry to severe competitive challenges. For Italy, the opposite seemed to be the case: the country was running a current account surplus, partially because it had entered at a rather competitive exchange rate. Moreover, membership in the euro was lowering the interest burden on the sizeable Italian public debt.

Today, the opposite seems to have materialised: inflation is even lower then under the Bundesbank and Germany's persistently high current account surpluses are seen as a sign that German industry is too competitive relative to the other partners. Expectations were also not met for Italy, but in a negative sense. There, growth slowed down and, even after the crisis, the cost of financing the large debt remains a constant problem. Given this reversal of fortunes it is not surprising that that public opinion turned in both countries, with Germans becoming much more supportive of the euro, and Italians much less.

This reversal of fortunes is important if one takes a longer term view. The success of individual countries in the euro is not foreordained and any longer term evaluation of the economic performance of the entire area comprises different sub-periods during which the fate of countries changes. In this respect, the euro area can be usefully compared to the United States, where there have also been significant changes in the relative fortunes of different regions. But there is an important difference between the euro area and the US: reporting and popular perception of the euro area tends to be coloured by the countries that are doing badly, whereas for the US the national average dominates the news. To avoid this bias, this contribution will thus concentrate on euro area averages.

The euro area's constitution was crafted while looking in the rear-view mirror.[2] The main concern during the 1970s and 1980s had been high and volatile rates of inflation, often driven by double-digit wage growth. The design for the ECB was based on the intellectual consensus of the time: an independent central bank was needed to achieve low and stable inflation. In addition, price stability was expected to deliver financial stability. Financial crises had almost always been linked to bouts of inflation and had been limited because financial markets were much smaller and less interlinked.

All this was about to change radically. Wage pressures abated across all developed economies. By contrast, financial market activity, especially cross-border, grew exponentially (after having been repressed for decades). For example, the cross-border assets of euro area member countries, mostly in the form of bank and other credit, doubled between the introduction of the euro and the time the great

[1] See Roth et al. (2011).

[2] See Gros (2017).

financial crisis struck. This was the first crisis in living memory (in fact since the 1930s) that was deflationary and it was rendered all the more virulent by the mountain of debt that had accumulated in the meantime.

The euro area was of course not the only economy to be surprised by the financial crisis, which had actually started in the US with supposedly safe securities based on sub-prime mortgages. But the US was able to weather the crisis more quickly because it had a unified financial (and political) system.

In the euro area, the financial crisis of 2007/8 mutated into a crisis of many Member States and the euro survived only because, when pushed to the brink, its political leaders were willing to expend their political capital to make the necessary reforms. The design of the ECB also proved robust as its leadership recognised that it had to change from fighting inflation to fighting deflation. And, not least, because financial stability became an explicit ECB objective in addition to price stability.

The following section briefly reviews the overall performance of the euro area in terms of some key indicators, growth and employment, always in a comparative perspective. The last twenty years have been dominated by a number of global trends which have affected most advanced countries. It thus seems appropriate to look at the performance of the euro area relative to other large economies, rather than in absolute terms. There is no presumption that the introduction of the euro was responsible for any of the over- or under-performance of the euro area. Instead many judgements of success or failure of the euro are informed by the comparison with other advanced economies.

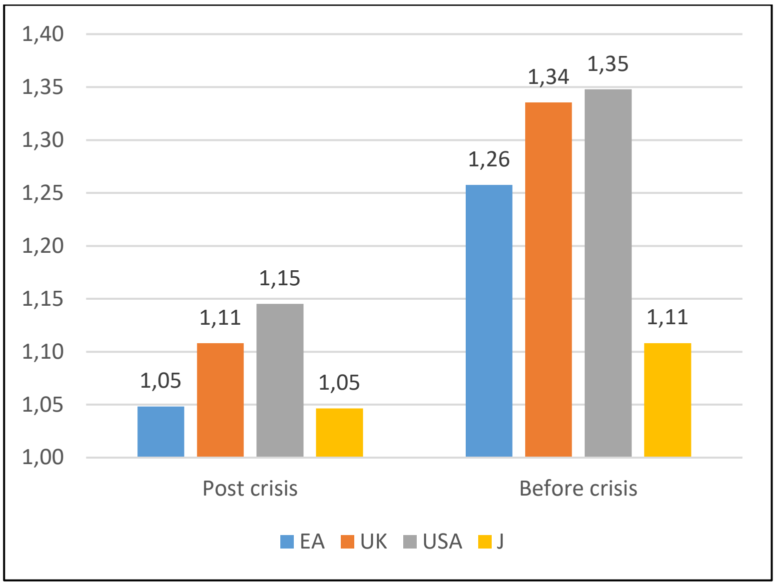
Section 3 focuses on financial stability and the links with financial integration, which, while often claimed as one of the biggest achievements of the monetary union, is also one of the factors behind the build-up of the imbalances which led to the crisis. The final section draws conclusions and offers some considerations about future challenges.

2. COMPARING THE PERFORMANCE OF THE EURO AREA TO MAJOR ADVANCED ECONOMIES

2.1. Economic growth

The general impression that growth in the euro area has been disappointing seems to be confirmed by the headline data for real GDP growth. The average growth rate for the euro area has only been about 1.5 % (p.a.) versus about 2.5 % for the US, since the introduction of the euro. Growth has been particularly disappointing for the euro after the Great Financial Crisis, with only about 0.5 % per annum (5 % total over a decade). However, as can be seen from Figure 1, growth also fell by a similar amount for the US (to about 1.5 % p.a.) so that there was little change in the transatlantic growth difference. The chart below shows that the UK experienced a similar dramatic slowdown, but Japan much less

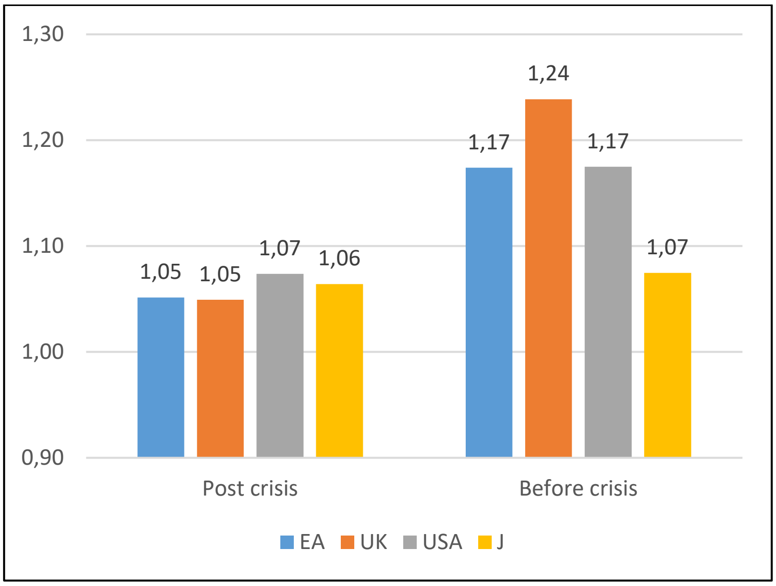
Figure 1: Total growth in real GDP, before (1997-2007) and after (2008-2017) the crisis, selected countries



Source: Own calculations based on AMECO data. GDP at 2010 prices.

However, headline growth rates can be misleading since there is also a substantial difference in the population growth rates across the Atlantic. From Figure 2, which shows the total growth in terms of GDP per capita, it is apparent that there is little difference among these four large economies following the crisis. The US does slightly better than the euro area, the UK and Japan on this account. But the difference is very slight; only 2 percentage points over ten years, or 0.2 % per annum. The impression that the euro was particularly hard hit by the financial crisis and its aftermath is thus only very partially correct. As mentioned in the introduction, this judgment depends largely on the experience of certain countries.

Figure 2: Total growth in real per capita GDP at constant prices, before (1997-2007) and after (2008-2017) the crisis, selected countries



Source: Own calculations based on AMECO data. GDP per capita at 2010 prices adjusted for terms of trade.

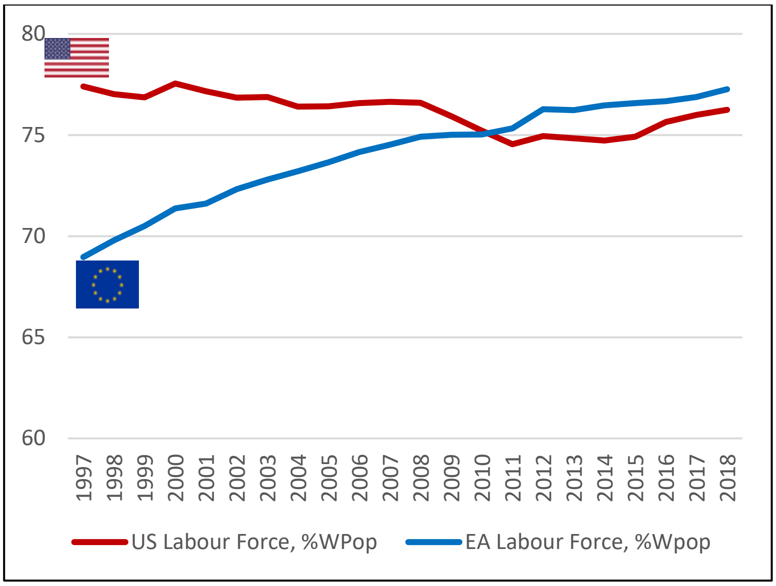
2.2. Employment

Labour markets constitute the one area where there has been undoubted improvement in the euro area over the last 20 years. During the 1980s and 1990s Europe's labour markets were widely considered sclerotic. Employment used to be much lower and unemployment much higher than in the US, which was widely seen as the benchmark to which the euro area should aspire. One key obstacle at the time was held to be that in Europe too few participated in the labour market.

There has been considerable improvement on this front. Figure 3 shows the labour force or activity rates (defined as the percentage of those in working age either employed or looking for a job) in the euro area and the US. It is apparent that there has been a continuous improvement, with the euro area starting out more than 8 percentage points below the US in 1997. Since 2010, the euro area has had a higher activity rate than the US.

The euro area has still a higher unemployment rate than the US (above 6%, compared to less than 4% for the US). But, on average, this has not stopped more people looking for a job. The fact that the activity rate in the euro area has continued to increase through the crisis years is important in itself because it is generally held that a prolonged period of high unemployment produces 'discouraged workers', i.e. persons who stop looking for a job when they cannot find one for a long time. The drop in the US activity rate after 2010, which is visible in Figure 3, has thus been ascribed to this discouraged worker phenomenon, especially among males. This did not occur in the euro area despite an even deeper recession. The labour markets of the euro area thus seem to have experienced one structural improvement.

Figure 3: Transatlantic comparison of activity rates, euro are and the US, 1997-2018



Source: Own calculations based on AMECO data.

The first reason for this different increase in participation rates in the euro area is that female labour market participation has shown a persistent increase since the 1980s. This was largely driven by the overall improvement in education levels, which are positively correlated with participation rates, as well as socioeconomic factors that increased the likelihood of new cohorts participating in the labour market. The latter seems a distinctive feature relative to the US.[3] At the same time, while male participation exhibits a secular decline in the US, in Europe the trend is more resilient, led by a rising participation among workers closest to retirement. Gradual tightening of early retirement schemes is likely to have contributed to such trend.

Educational attainments and social factors are clearly independent of the euro, although they are part of the Europe 2020 strategy, but the second factor, namely increase in the labour participation of those close to retirement age might have been reinforced by peer pressure and the fiscal rules, which tend to constrain pensions expenditures.

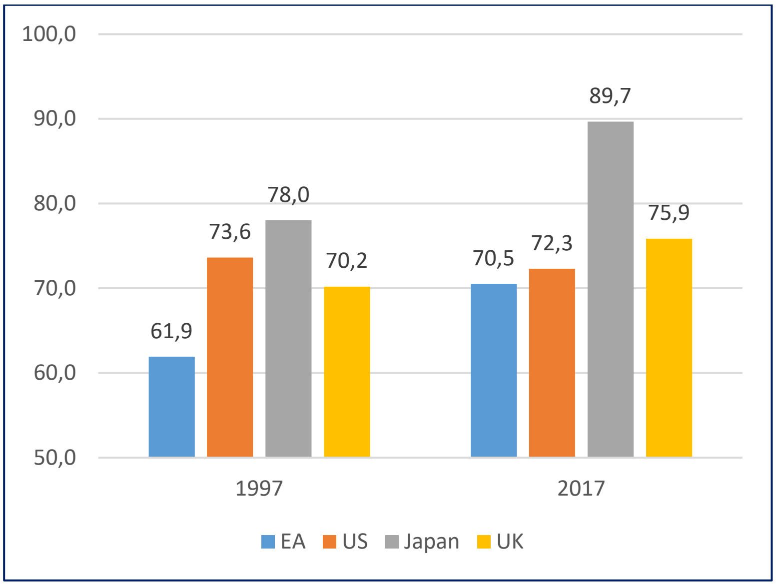
While an increase in activity rates increases the pool of potential workers, a key question is whether they also find jobs. From a political point of view, the more important variable is the employment rate, rather than the activity rate.

A key goal of the otherwise ill-fated 'Lisbon Strategy' (European Council (2000)) was: "to raise the employment rate from an average of 61% today to as close as possible to 70%". This goal has now been achieved. Figure 4 below shows that in 1997 the euro area had by far the lowest employment rates, defined as employed persons as a percentage of the working age population (age 15-64), of the four large advanced economies considered here. The gap between the employment rate in the US (73.6 %) and that of the euro area (61.9 %) was almost 12 percentage points. By 2017, this gap had shrunk to less than 2 percentage points (and it has approached zero in the meantime). The UK has also progressed in terms of employment rate, but less so than the euro area even if from a higher starting

3 See Fernández and Martínez-Turégano (2018).

point. Japan stands out in this comparison because of the extraordinary increase in the employment rates of its elderly.

Figure 4: Employment rates (employed persons as % of working age population - age 15-64)



Source: Own calculations based on AMECO data.

2.3. Fiscal policy

A key element of EMU construction were the Maastricht rules on deficit and debt. In this perspective, fiscal policy was and still is an important component of the 'euro package'.

There are many ways to assess the performance of fiscal policy. With a longer term view, it is preferable to concentrate on debt levels, as opposed to deficits. The evolution of debt (relative to GDP) irons out the shorter term effects of deficits on demand and differences in the evolution of the business cycle.

The Maastricht rules on 'excessive' deficit and debt are one key distinguishing feature of the euro area. The 3 % (of GDP) deficit limit has been honoured more often in the breach, but ex-post, over two decades, fiscal policy has been notably different in the euro area than elsewhere in the advanced world. This is illustrated in Table 1.

Table 1: General government debt (gross) as % of GDP, compared

	EA	US	Japan	UK
1997	73.8	59.3	115	44.0
2017	86.8	96.7	224	88.6
Change	13.0	37.4	109.0	44.6

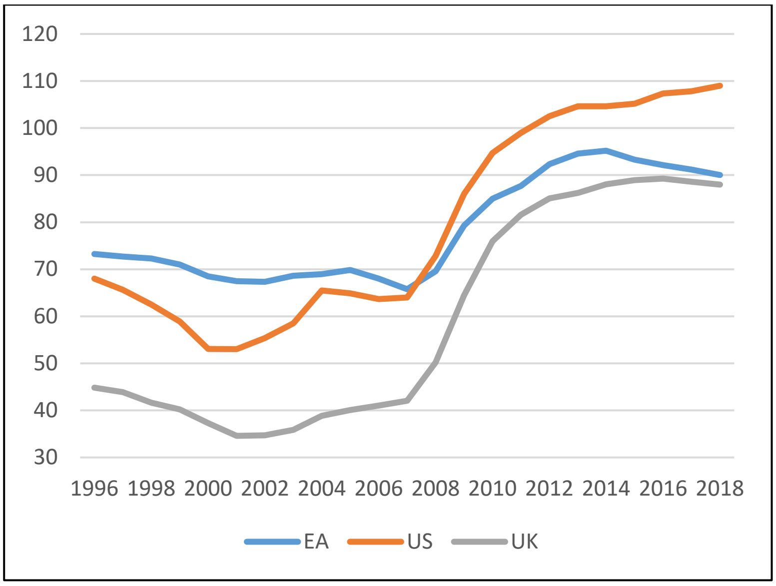
Source: Ameco.

Government debt as a percentage of GDP of the euro area was about 15 percentage points of GDP higher than that of the US in 1997, but it was 10 percentage points of GDP lower in 2017. Compared to the UK, the relative change has been even more significant: twenty years ago the debt to GDP ratio of the UK was about a third lower than that of the euro area. In 2017 it was at the same level.

This reversal (a total of 25 percentage points of GDP) relative to the US means that, on average, fiscal policy has been more 'austere' in the euro area than in the US and any other large advanced economies. As shown above, during these two decades the euro area slightly underperformed the US in terms of growth, but out-performed the US in terms of increases in employment and labour market participation. Combining these results suggests that the widespread perception that excessive austerity has kept the euro area back is not confirmed by this longer term overview of performance.

It is also interesting to look at the evolution of public debt separately over the decade before and that since the Great Financial Crisis. From Figure 5, which shows the gross debt of general government of the euro area, the US and the UK, it is apparent that a major change occurred around 2007/8.[4] Until that date, the debt ratios evolved in a parallel way in all these three economies. But following the crisis (when the US and the euro area had similar levels of debt) a transatlantic divergence started. The response to the crisis was different in that the debt ratio rose by more in the US than in the euro area. Compared to the UK, the change is again most evident only after 2007/8. The debt level of the UK, which had been much lower than that of the euro area increases by a similar amount to that of the US, bringing it up to that of the euro area.

Figure 5: General government debt, as % of GDP



Source: Ameco.

It has often been argued that a key problem for the euro area after the crisis was excessive austerity and that higher deficits would have stimulated the economy enough to result in lower debt-to-GDP

[4] A comparison with Japan is more difficult since the gross public debt figures for Japan are not comparable given that the postal savings system, which belongs to the state, is a large holder of government bonds.

ratios. However, the data on the debt ratios do not bear out this second argument: in the euro area the debt/GDP ratio has increased less than in the UK or the US 'despite' austerity.

The argument that higher deficits would have led to a stronger recovery is also not borne out in this, longer term, transatlantic perspective. There is very little difference in the decadal growth rates of GDP per capita between the euro area and the US (or the UK, for that matter) since 2007, and this is partially due to demography. This suggests that the much higher increase in the debt ratios of the US and the UK did not 'buy' any outperformance in terms of growth of GDP per capita.

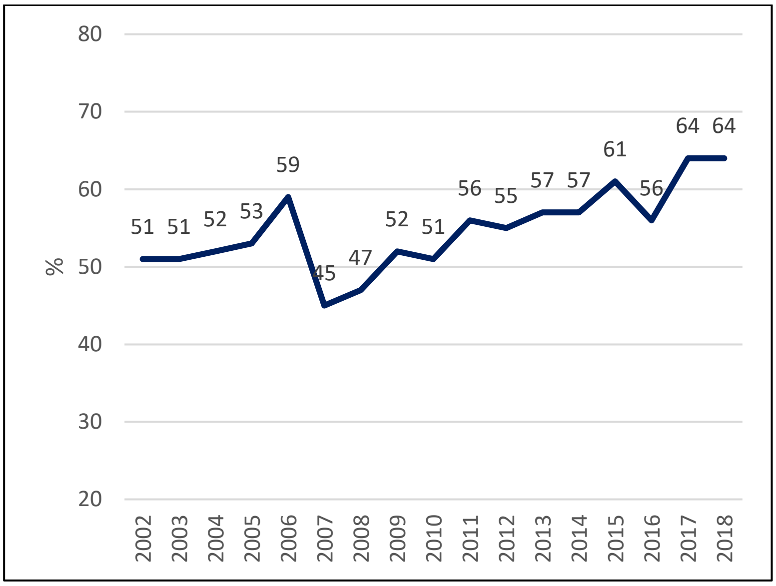
Though the Maastricht fiscal rules are usually pushed beyond their letter and spirit and the 3 % of GDP reference value for deficits has been breached dozens of times, it also seems that this value has become a soft threshold beyond which few governments dare to go for a prolonged period of time. One conclusion from the comparison above is that this has kept deficits lower than in most other large advanced countries, without any apparent impact on longer term economic performance, at least in relative terms.

2.4. Popular support

Popular support for the euro has held up well over the last two decades. This is even surprising to a certain extent, given the widespread tendency of national political leaders to blame the euro for their domestic problems.

Figure 6 shows the outcome of the Eurobarometer surveys since the introduction of the euro notes and coins in 2002 and suggests an upward trend in support for the single currency despite some blips. In particular, the proportion of respondents who think having the euro is a good thing for their country has continued to increase since 2007, reaching its highest ever level in 2017 and 2018. The balance between supporters and those against fell with the financial crisis, but since then both trends started to diverge.

Figure 6: Support for the euro (2002-2018)



Source: Eurobarometer, October 2018. https://ec.europa.eu/info/news/eurobarometer-2018-nov-20_en.

Note: Question: Generally speaking, do you think that...? Having the euro is a good or a bad thing for your country (% - euro area).

One simple reason for this continuing popular support for the euro might be that the euro has become a natural element of citizens' lives and is no longer a variable factor. Another reason could be that economic performance in the euro area has not been, on average, as bad as one could deduct from endless headlines about economic problems in euro area Member States. As documented above, the growth of GDP per capita has of course slowed down over the last 20 years, but not much more than in the US or other developed economies. Moreover, continental European labour markets have seen an under-reported structural improvement with the labour force participation rate increasing every year, even during the crisis. In addition, in recent years, employment has reached record highs and unemployment, though still high in some parts of the south, is declining.

3. FINANCIAL MARKETS: THE ACHILLES HEEL OF THE EURO

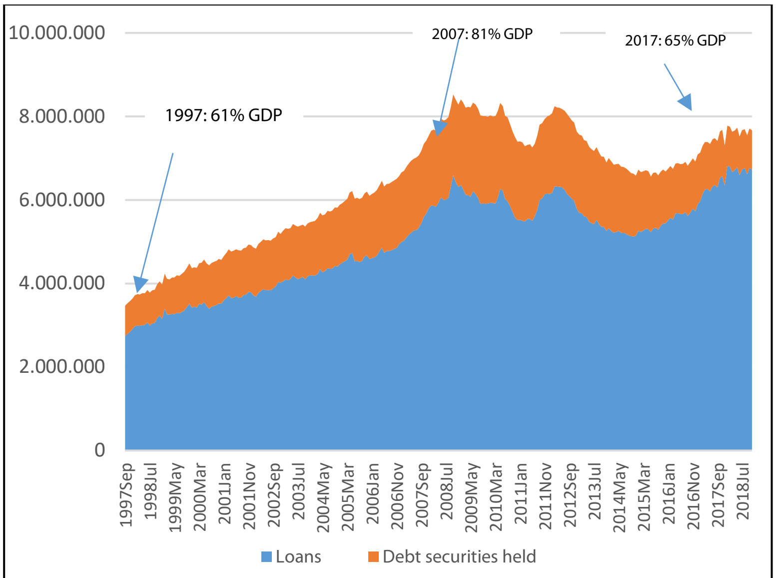
Until 2008 it appeared that the euro had ushered in a period of macroeconomic stability. The largely congratulatory evaluations of the first ten years of EMU were based on a track record of high growth in trade alongside monetary stability, with the ECB achieving almost exactly the goal it had set itself, namely an inflation rate of below, but close to, 2 %.

The financial crisis that started in 2007-08 destroyed this pretty picture. Two aspects of the financial crisis were difficult to reconcile with the philosophy underlying Maastricht: the global financial crisis had struck in the absence of any inflation; and in 2010, the crisis became a sovereign debt crisis, which had no parallel elsewhere.

With hindsight, the increasing potential for a financial crisis is apparent in the sharp increase in leverage, or debt-to-GDP ratios, almost everywhere, during the period of what was called the Great Moderation.

The increase in leverage had both domestic and cross-border dimensions. The domestic aspect mostly concerned the banking sector in Europe. As shown in Figure 7, inter-bank lending activity doubled between 1997 and 2007, and grew faster than GDP. It then declined before rebounding to approach the peak of 2008.

Figure 7: Euro area MFI loans and debt securities held vis-a-vis other Euro area MFIs, Million euro, 1997-2018



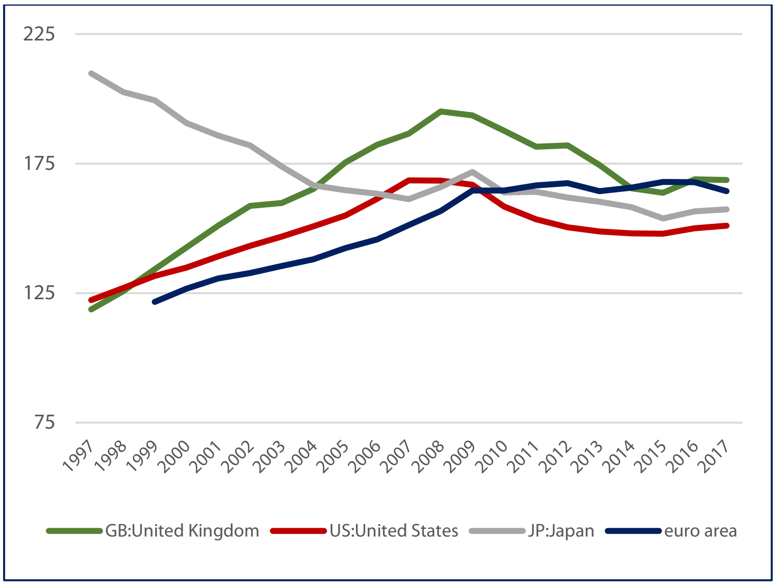
Source: ECB Statistical warehouse.

Overall, the ratio of credit to the private sector in relation to GDP increased by more than 50%, in the three 'Atlantic' advanced economies. BIS data show that that the euro area, UK and US shared the same broad trend: an increase in the credit ratio up until 2007/8, followed by a decline after the crisis.[5] This

[5] Japan, by contrast, had had its bubble and crisis earlier. Its credit to GDP ratio had been falling throughout the 1990s. It should also be noted that the picture would be very different if one were to include credit to the public sector. Ratios would be of the order of 100 pp of GDP higher in 2017 for euro area, UK and the US, with the UK being the highest line and not anymore hump-shaped. In fact, only in the euro area total credit is on a declining path in the last part of the

observation illustrates what has become part of conventional wisdom: a sharp increase in the credit-to-GDP ratio is a good predictor of a financial crisis. But this was not appreciated when the euro started and even less so at the time the Maastricht Treaty was signed.

Figure 8: Total credit to private non-financial sector, % GDP



Source: BIS, Core debt, Table F2.1 http://stats.bis.org:8089/statx/srs/table/f2.1?f=csv.

As Figure 9 shows, the external assets of the euro area countries, which amounted to little more than one-half of GDP in 1990, had more than doubled by the time EMU started, increasing the ratio of external assets to GDP to over 100 %. By the outbreak of the financial crisis the figure had again more than doubled, exceeding 300 % of GDP in 2007-08.[6]

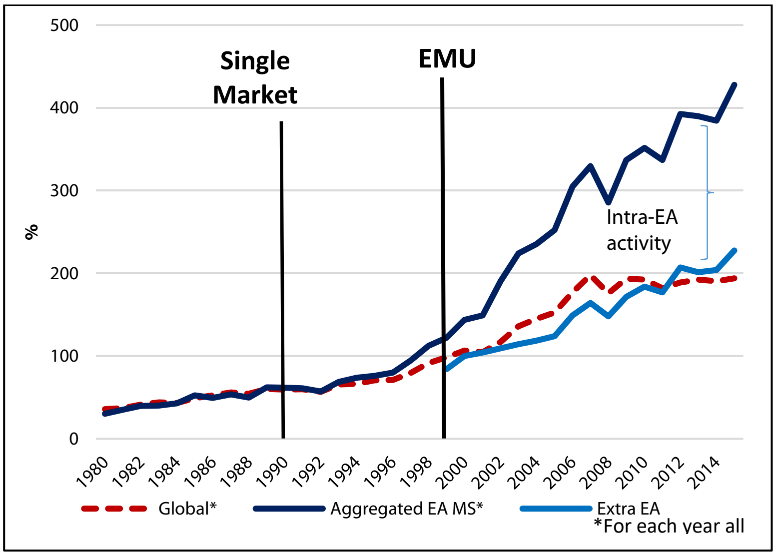
Figure 10 also displays the same ratio of external assets to GDP at the global level (dotted line). It is apparent that until about the mid-1990s Europe was not special in terms of cross-country financial activity. However, starting a few years after the completion of the internal market and the complete lifting of capital controls in the EU, the dark line for the euro area countries increases much more sharply than the global one. At the global level, cross-border assets peaked at close to 200 % of GDP just before the outbreak of the financial crisis, considerably lower than the value of over 300 % for euro area countries.

A large and increasing share of the cross-country assets of euro area countries involved intra-area financial activity, as can be seen in the difference between the two blue lines (the light blue line represents the position of the euro area as whole vis-à-vis the rest of the world). Within the euro area, cross-border claims increased from about 50 % of GDP at the start of EMU to over 150% of GDP just before the outbreak of the euro crisis and have now risen above 200 % of GDP.

sample. The case of Japan is special and the trend would be different than the one shown in Figure 8. Total credit increased from about 300% of GDP in 1997 to 370% in 2017.

[6] Figure 4 in the 2014 ASC report also shows that cross-border assets of the European banks (a subset of all foreign assets) grew exponentially during the 1990s and up to 2008.

Figure 9: Development in international investment positions (as % of GDP): world, euro area countries and euro area, 1980-2016



Source: IMF.

This extraordinary increase in intra-area cross-country financial activity was not recognised as a potential danger until it was too late. On the contrary, as mentioned above, as late as 2008, the explosion of cross-border lending was viewed as evidence of the financial integration driven by the euro and a benefit that supposedly allowed for a better distribution of risks.

As matter of fact, aggregate data hid large differences in the concentration of risk between euro area Member State. They are well described in the 2014 Report of the Advisory Scientific Committee (ASC) of the European Systemic Risk Board, which noted that:

"…bank credit-to-GDP had increased everywhere in Europe, but the extent of the increase varies. Four EU countries (Finland, Germany, France and Austria) experienced only modest increases in credit to GDP over 1991-2011. Elsewhere, bank credit grew very substantially relative to GDP: in nine countries, the ratio more than doubled. Five countries where bank credit grew most substantially –Cyprus, Ireland, Spain, Portugal and Greece – needed (and received) financial assistance during the crisis (2010-14)."

Total claims of EU banks vis-à-vis Ireland and Spain increased by about 8 times in less than a decade[7] and these two countries experienced very large house price bubbles and then painful bursts. When the crisis started, claims fell almost as quickly as they had risen. By contrast, domestic credit had barely increased in Germany where house prices were on a declining trend, but Germany was one of the main lenders.

The explosion of cross-border lending embedded two interlinked dimensions: first, within the euro area, a group of countries began running very large current account deficits, mirrored essentially in a growing German surplus. Second, the gross positions of all countries, both (current account) deficit and surplus countries increased rapidly. Obstfeld (2012) argues that both aspects deserve attention. In the case of the euro area, the crisis was caused by large gross positions, coupled with net debtor positions of some countries, which, *ex post*, appeared unsustainable. In the, 'naïve' (also *ex post*) or 'consenting

[7] According to BIS data.

adults' view of the 'One Market, One Money'[8] (OMOMO), the fact that the large net debt positions run up through large current account deficits in the periphery might have been unsustainable *ex post*, this should not have been too much of a concern since the individual debtors (firms, banks or even governments) would then simply have gone bankrupt. What neither OMOMO, nor most policymakers, appreciated was the fact that with large gross positions the insolvency of a large group of borrowers could bring down the entire financial system. It was this threat to systemic financial stability, combined with an outsized financial system overall, that made the bail-outs inevitable.

3.1. Financial integration and financial cycles

One additional aspect, which was only understood after the crisis, is that linkages between financial developments and the real economy had been underestimated and the implications of significant common swings in financial variables,[9] often dubbed financial cycles, can severely affect the real economy.

Financial integration, enhanced by the introduction of the euro, fuelled the expansionary phase of financial cycles in several countries through increased cross-border bank lending. By contrast, when house prices started to fall, the bubbles burst and the recessionary phase of the financial cycle started; banks cut their international exposures and, instead of risk sharing, there was financial disintegration.

Empirical findings[10] suggest that these financial cycles are often synchronised across countries, as they are driven by global factors. As illustrated in Figure 8 above, the credit boom that started in the mid-1990s was a phenomenon common to all advanced economies. In the euro area, as shown in Alcidi (2017), the beginning of the financial cycle coincided, in most Member States, with the introduction of the single currency in 1999. Alcidi (2017) also shows that within the euro area, cycles were highly correlated, with the notable exception of Germany where, the financial cycle has always been very flat and the correlation vis-á-vis any other euro area countries low and became lower since 1999. By contrast, Spain, Ireland and Greece experienced the largest swings in the cycle.

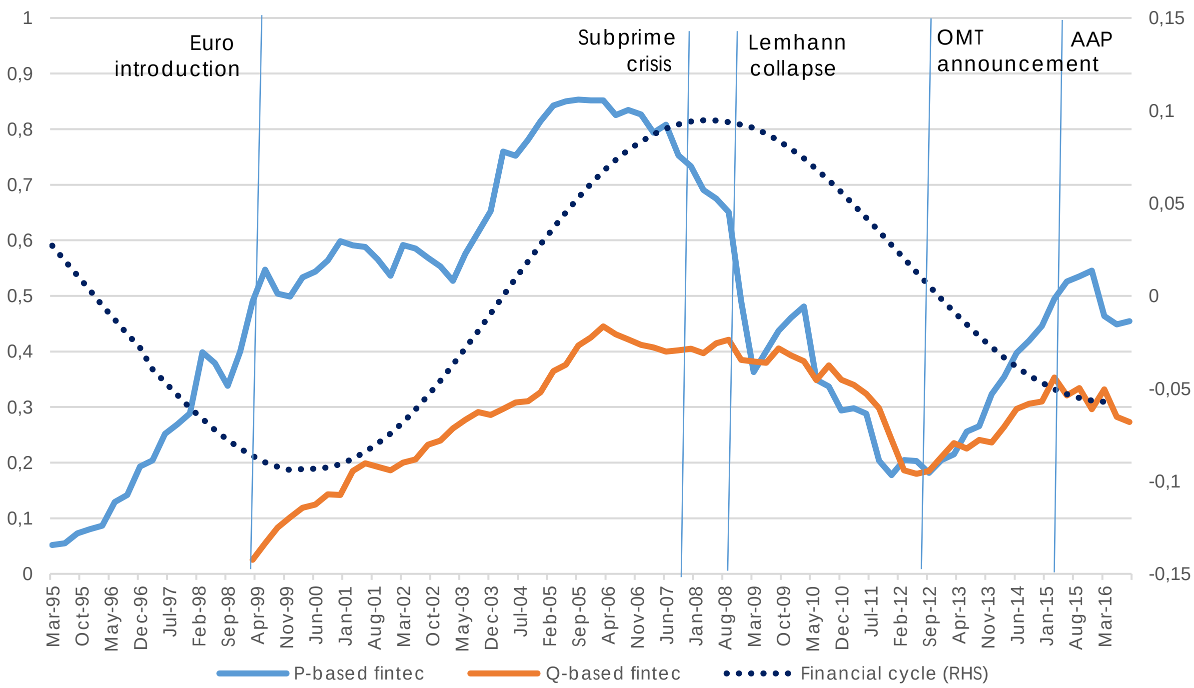
One interesting aspect in all this is that the process of financial integration in the euro area corresponded almost one to one to the booming phase of the financial cycle (see **Error! Not a valid bookmark self-reference.**).

8 The study published in 1990 constituted the basis for the evaluation of the potential benefits and costs of forming an economic and monetary union.

9 In principle, the set of variables is large and can include measures of credit, house prices, equity, other asset price aggregates and banks' balance sheets.

10 See for instance Drehmann et al. (2012).

Figure 10: Quantity- and price-based indicators of financial integration in the euro area and euro area (average) financial cycle



Source: Alcidi (2017).

Note: The variable 'financial cycle' is defined as common movements in credit growth, credit-to-GDP and house prices, at country level and then averaged out. Indicators of financial integration are provided by the ECB.

After 2008, financial integration declined, as did the financial cycle. The average financial cycle for the euro area shows a descending phase which bottomed out in 2016. As result, the latest euro area financial cycle – the distance from trough to trough – seems to correspond precisely to the life of the euro.

Two conclusions can be drawn from these observations.

The first is that high financial integration, while a desirable outcome for the functioning of the euro area, and monetary policy in particular, is not overall a guarantee for financial stability nor for the distribution of risks (risk sharing). On the contrary, high financial integration can fuel crises, and this is why prudential policies are crucial.

The second consideration is about future challenges. Historically, financial cycles exhibit a very long duration. In the euro area countries, data suggest their average length is about 17 years. Since the trough was reached around 2016, the next half decade should be associated with the ascending phase of the financial cycle. While these periods are still characterised by typical business cycle fluctuations, i.e. expansions and recessions, they tend to be relatively calm in terms of financial dynamics.

If this is correct, a large, systemic financial crisis should not be the main concern ahead for the euro area. Instead, weak growth dynamics in the real economy may be the main source of concern.

In addition to that, specific risks in individual Member States that struggle to correct increasing debt, whether private or public, will exacerbate the divide with other Member States that achieve the necessary adjustments and will test the resilience of the euro.

4. CONCLUSIONS

The first twenty years of the euro were very different from what had been expected. This should be the most important lesson of all: the future is likely to be different from the past. Only flexibility and the willingness to rise to new challenges will in the end ensure the success of Europe's common currency.

The crisis of 2011/12 showed that, when push comes to shove, when the very existence of the euro is in danger, Europe's political leaders find a way out.

The assessment of the performance of the euro yields a mixed picture. Growth was below expectations, on a per capita basis, if not significantly worse than in other advanced economies, including the US. Combined with the ambivalence of many of Europe's national leaders and the widespread tendency to blame the euro for any domestic problems, the result is that the euro is perhaps not much loved. However, the euro appears to be recognised as an essential part of European integration and of peoples' lives. About 65% of the population of the euro area supports the euro, with only 20 % against.

The biggest challenge today might be to avoid looking in the rear-view mirror. Today, attention is focussed on avoiding another outsized financial crisis. But the key problem for the next decade might be sluggish growth in key technological sectors due to the lack of an integrated market and an increasing gulf between those countries that have adjusted successfully in bringing their public finances under control, and those where this goal remains increasingly distant.

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The first 20 years of the euro were very different from what had been anticipated. Deflation, rather than inflation became a problem. Financial markets, which had been neglected, became a major source of instability. However, the euro area proved resilient and support for the euro is at historic highs. Looking to the future, the greatest danger might not be another financial crisis, but sluggish growth and an increasing gulf between countries that have successfully adjusted their public finances and those where this goal remains increasingly distant.
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