Commentary

Building on the Euro

by Guido Tabellini

The euro is now six years old. It is past time to consider how it is performing, and whether it has lived up to the expectations that accompanied its birth.

Those expectations were not modest. By reducing transaction costs and removing exchange-rate uncertainty, the single European currency was expected to lead to fully integrated product and financial markets. This, in turn, would bring greater gains from trade, stronger competition, larger cross-border capital flows, lower borrowing costs, and more opportunities for sharing risk, all of which were expected ultimately to boost investment and productivity.

Reality has disappointed. Compared to the five years before the euro's launch in 1999, productivity growth has since slowed in Italy, Germany, Spain, and the Netherlands, while over the same period it accelerated or remained constant in Denmark, Sweden, and the UK, the European Union members that remained out. Indeed, with the main exception of France, the euro does not seem to have been a blessing for the countries that adopted it.

Why this disappointment? Have the expected benefits of the new currency failed to materialize? Several recent economic studies addressed this question, looking at a variety of indicators.

Here is what emerges:

· The single currency *has* boosted international trade within the euro area, by about 10%. Although a larger effect was expected, it remains too early for a complete assessment. In any case, this is an important positive outcome, because international trade is generally regarded as a key determinant of faster growth and higher efficiency.

· The euro was expected to increase price transparency, thereby strengthening competition in product markets. No evidence exists that this happened. Prices did converge during the implementation of the Single Market program, in the early 1990's, but then price convergence stopped.

· Cross-border investment towards the euro area has increased, although here it is more difficult to disentangle the effect of the single currency from other concomitant events (such as privatizations or corporate mergers).

· Money and bond markets are now fully integrated in the euro area, implying a reduction in the cost of capital for large corporate borrowers. Retail banking, however, remains segmented by national borders, so that households and smaller producers have not been much affected.

· The euro was expected to acquire an international role, eventually improving Europe's resilience in the face of economic shocks. There has been a surge in euro-denominated international bonds, but the liquidity of foreign-exchange markets is no higher for the euro compared to the national currencies it replaced, and the euro remains a long way from challenging the supremacy of the dollar.

Of course, the euro was never just an economic project. One of its backers' main motives was to boost Europe's political integration. Indeed, the euro has quickly become a symbol of European unity. When asked, "What does the EU mean to you personally," 50% of citizens in the 15 countries that were EU members before enlargement in May 2004 say "the euro" – the second most common response (just behind "the ability to travel, study, and work anywhere in the EU").

Yet, this symbol has not made the EU or the euro area any more popular. Support for EU membership within the pre-enlargement EU-15 remains where it was in the mid-1990's (and below the peak reached in 1990), while support for the euro is no higher now than it was in 1997.

To be sure, the introduction of the euro was a true revolution, and we cannot yet see all its effects. But what is clear is that the revolution took place on shaky national economic foundations, transforming the upper floors of the European economy – financial markets and macroeconomic policy institutions – while leaving intact the *ancien* underpinnings of supply-side distortions induced by misguided national policies in the 1970's and 1980's.

These distortions, not any shortcomings of the single currency, account for the euro area's dismal economic performance. The countries that adopted the euro had poor labor-market institutions, bloated pension systems, high taxes on labor income, and inefficient service sectors in the late 1990's, and they still do now.

The more fundamental problem with the euro is that its adoption has not pushed countries to address these underlying deficiencies. It was expected that full integration of product and financial markets would expose inefficiencies, steering investment flows away from laggards towards the more efficient countries. Yet, while reform efforts intensified throughout Europe in the late 1990's both inside and outside of the euro area, there is little evidence that "ins" enacted more far-reaching and significant supply-side reforms than the "outs."

Larry Summers, the former US Treasury Secretary and now president of Harvard University, once called the single European currency a "distraction" from the serious supply-side reforms Europe needed to confront. This judgment may be too harsh, because we do not know whether the EU and the single market would have survived without the single currency. But one thing is certain: Europe cannot afford other "distractions." Overhauling Europe's shaky supply-side foundations is the key challenge facing the euro revolution, and it is a challenge that needs to be addressed at its national-level roots.

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