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# The Euro: Opportunities and Challenges

Ragnar Nurkse-Lecture
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# 1 Introduction

Ladies and gentlemen

First, I would like to thank you for giving me the opportunity to speak here today. It is a pleasure and a privilege to visit Estonia, which not only provides one of the European Capitals of Culture in 2011 but is also the newest member of the euro area. I am also honoured to deliver this lecture dedicated to Ragnar Nurkse. Apart from being an outstanding economist of international renown, he was undoubtedly a true citizen of Europe. Not only is he said to have spoken seven European languages, including Estonian, Swedish, German, English and French, he also lived and worked in a number of European countries before eventually emigrating to the United States.

With that in mind, the obvious topic for today's lecture is Europe and its single currency. There is little doubt that Estonia has joined the euro area in turbulent times. Not only is Estonia, as a new member of the club, facing a number of challenges; the euro area itself has undergone considerable stress over the past months and requires an overhaul of its


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foundations. Nevertheless, before reflecting on the existing challenges, we should briefly take stock of the benefits that arise from our single European currency.

## 2 The benefits of a single currency and their preconditions

Currencies have always been an important symbol of national identity – the Estonian people know this all too well. Consequently, the euro has been a key element of European political integration. Moreover, a single currency also offers plain economic benefits. The most obvious of these is the absence of exchange rate movements and, hence, of exchange rate risk. This facilitates international trade and investment, which is especially important for small open economies. Looking beyond exchange rate movements, the existence of a single medium of payment also enhances transparency regarding price differentials across countries. The result is increased competition, a more efficient allocation of resources and, eventually, stronger economic growth. At the same time, a single currency also facilitates the integration of financial markets, again promoting an efficient allocation of resources.

However, it has been clear from the beginning that a single currency will not function on its own. With the introduction of the euro, a gap opened up between monetary policy, which is conducted for the euro area as a whole, and other areas of economic policy, which lie in the hands of what are now 17 national governments. Thus, to be efficient in maintaining price stability, the single monetary policy requires that member states be able cope with asymmetric shocks to which a common monetary policy cannot respond. This has been acknowledged right from the outset, and a number of criteria were introduced that countries had to meet prior to entering the euro area. These convergence criteria comprise low inflation, adequately moderate interest rates, stable exchange rates and sound fiscal policies. As the newest member of the euro area, Estonia was no exception to this


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requirement and succeeded in fulfilling all the necessary conditions – a remarkable achievement in the face of a global financial crisis and the severe contraction in output that Estonia experienced in 2009. Public deficits and debt levels were, in fact, outstandingly low, particularly in the light of developments in most other EU member countries.

In the 1990s, the need to meet the convergence criteria also served as a catalyst for economic policy reform in what were later to become the member states. However, as the years following the launch of monetary union have taught us, becoming fit to join a monetary union is not a one-off task that ends after becoming a member of the club. Rather, fulfilling the economic requirements that go along with monetary union also has to continue guiding economic policy afterwards in order to guarantee the functioning of the monetary union. Unfortunately, this has not always been the case in the first decade of EMU, a fact that has been ruthlessly revealed by the financial crisis. The deficiencies include misguided policies in a number of member states, as well as structural shortcomings in the institutional framework of monetary union.

## 3 The euro and the financial crisis – discovering deficiencies

The visible outcome of such misguided policies and institutional deficiencies were large government deficits in some member states as well as persistent current account divergencies between member states. While some countries, such as Germany or the Netherlands, had been recording persistent current account surpluses, other countries such as Greece, Ireland, Spain or Portugal, had been posting persistent deficits. In principle, this should not have been a cause for concern. It makes economic sense that capital flows from developed countries to countries that are still catching-up and thus offer ample investment opportunities.


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The problem with this development was that the deficit countries had not always used the inflowing capital in an efficient way. Instead of financing investments to increase productivity and to raise potential output, government and private consumption were propped up while, in some instances, capital imports helped to fuel bubbles on domestic real estate markets. The surge in demand, combined with inflexible labour and product markets, reduced the price competitiveness of the countries in question. As a result, current account deficits became entrenched or widened even more. Although these macroeconomic imbalances are domestic in origin, the associated problems are not confined to the national level. Given spillover effects in the closely integrated euro-area financial markets, macroeconomic imbalances in some member states can easily turn into a problem for the rest of the monetary union, especially if they are accompanied by a poor state of public finances.

Sustainable public finances are indeed essential for the functioning of a monetary union, both to be able to react to asymmtric shocks and to safeguard the independence of monetary policy. The main challenge in the pursuit of sound fiscal policy is that national governments have an incentive to enjoy the benefits of public debt, while its burden is borne by all members of the monetary union. A public deficit in one country boosts demand there but, at the same time, puts pressure on the interest rates in the whole monetary union, reducing economic growth in all member states. In extreme cases, such a free-rider policy not only puts pressure on the interest rates but might also affect the credibility and stability of the monetary union as a whole – as has been demonstrated by the debt crisis.

To ensure that sustainable public finances are regarded not just as an entry requirement for monetary union but also as an ongoing task, a strong institutional framework is needed; a set of rules that aligns the interests of national fiscal policymakers with the rest of the monetary union and bridges the gap between national fiscal policies and a union-wide monetary policy. This led to the creation of the Stability and Growth Pact (SGP). In essence,


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the SGP requires governments to keep their budget deficits within clearly defined limits. However, since its very inception, the SGP has been subject to political tactics which have greatly reduced its effectiveness. This problem reached its peak in 2005 when Germany and France insisted on a reform of the SGP that, all in all, softened the provisions of the Pact.

As a result, many governments did not seize the opportunity to consolidate their budgets during the ensuing economic upswing. Thus, when the financial crisis hit, a number of countries already had weak public finances. The subsequent expenditures to support the financial system and the economy did not improve the situation. And when, in the spring of 2010, sovereign risk came to the fore, it turned into a major downside risk for recovery in Europe. Within a short period of time, fiscal problems in Greece and other member states turned into an imminent danger to the stability of the financial system and the monetary union as a whole. Thus, European institutions decided to implement far-reaching fiscal measures to support the countries in question. These measures were justifiable given the risks associated with inaction. Nevertheless, they still placed a serious strain on the foundations of the monetary union. Consequently, we now have to strengthen these foundations again and create an institutional framework that supports a stable monetary union.

## 4 The challenge of creating an adequate institutional framework

As I have just pointed out, the crisis revealed two basic problems within the European Monetary Union: macroeconomic imbalances and excessive public deficits. Both problems have their roots within the individual member states. Consequently, it is first and foremost the responsibility of national governments to act by consolidating their budgets swiftly and amibitiously and by implementing comprehensive structural reforms.


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Nevertheless, reforms also have to be undertaken at the level of the monetary union. As a first step, the institutional framework has to be enhanced to prevent the occurrence of harmful macroeconomic imbalances or excessive public deficits. This requires a twofold approach: first, strengthening the SGP to guarantee sustainable public finances, and, second, implementing macroeconomic surveillance to detect structural developments within member states that might be harmful for the rest of the monetary union. Furthermore, as it will never be possible to prevent crises entirely, a third element should be a mechanism to solve potential crises in an orderly fashion – but without thwarting the stability-enhancing incentives set by the SGP and the surveillance mechanism. Let us now take a quick look at how far we have come in turning this approach into reality.

Given its track record before the crisis, it can no longer be denied that there is an urgent need to strengthen the SGP: more emphasis should be given to the debt criterion, while earlier and more consistent sanctions have to be placed on any breach of the rules. The reform measures that have been agreed so far do indeed entail a number of improvements. However, the measures lack the ambition to fully redress past failings and to bring about a fundamental improvement. The major shortcoming of the envisaged reform is that relevant decisions on sanctions are still to be taken at a political level by the European Council. This leaves too much room for discretion in interpreting and applying the rules of the SGP.

With regard to macroeconomic imbalances, I have mentioned the need to enhance macroeconomic surveillance in the euro area. Nevertheless, to make one thing clear from the outset: the objective of such an endeavour should not be to coordinate or fine-tune macroeconomic policies – member states have to remain responsible for their national economic policies. Rather, the objective should be to detect and address macroeconomic developments that might have serious negative spillovers on other member states or the euro area as a whole. Against this backdrop, the actual proposals that have been put


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forward are a step in the right direction. However, detecting such possibly harmful macroeconomic developments *ex ante* is notoriously difficult and some details still have to be discussed. Thus, even though enhanced macroeconomic surveillance is indispensable, its actual implementation might prove difficult and could easily lend itself to discussions that distract from the real challenges − past demands on Germany to implement a more expansionary wage policy and to set more fiscal stimuli being a case in point.

Having an eye on macroeconomic developments and placing limits on budget deficits and public debt by means of an enhanced SGP will certainly help to make the euro area more stable. Nevertheless, the occurrence of crises can never be ruled out. For that reason, it is necessary to have a crisis-resolution mechanism in place. As the current European Financial Stabilisation Facility (ESFS) and the European Financial Stabilisation Mechanism (EFSM) will expire in 2013, the European Council has decided on the main features of a European Stability Mechanism (ESM), which will then replace the EFSF and the EFSM. The “no bail out” clause has been affirmed as an essential element of the ESM: no member state is responsible for the debt of other member states. This certainly helps to maintain incentives for sound fiscal policy. Incentives are further strengthened by provisions that allow for a restructuring of private sector debt in case of insolvency. Faced with the prospect of losing money, financial markets should penalise unsound fiscal policies at an early stage and thus prevent the build-up of excessive deficits. In the further negotiations, it will be important that these basic features of the ESM are maintained.


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## 5 Conclusion

Ladies and gentlemen

The euro is probably the single most important European project from an economic as well as a political perspective. And history has shown that the promised benefits were not mere theoretical concepts but have indeed materialised over the past 12 years. Altogether, the euro has definitely been a success – and the financial crisis has not proven otherwise. On the contrary: throughout the crisis, the euro had a stabilising effect and the Eurosystem demonstrated its ability to conduct an effective crisis management. Nevertheless, it cannot be denied that the crisis revealed a number of structural deficiencies which require further reflection.

In my speech, I have outlined the reforms that are necessary to strengthen the institutional foundation of the euro area. Nevertheless, it is ultimately in the responsibility of the member states to act in a way that guarantees the stability of the monetary union. Here, it is indispensable that all member states acknowledge the economic preconditions that were identified as essential for the functioning of the monetary union and that are embodied in the convergence criteria applied to prospective members. Estonia has set an example that it is possible to muster the will to fulfil these criteria even in the midst of a global financial crisis. It is all the more the case that it should be possible to live up to the requirements of the monetary union after having joined – and that applies not only to Estonia, but to all its members.

Thank you for your attention.

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