Tim Phillips [00:00:00]:
Today on VoxTalks Economics; the Euro at 25. Welcome to VoxTalks Economics from the Center for Economic Policy Research. My name is Tim Phillips. Every week we bring you the best new research in economics, so remember to subscribe wherever you get your podcast. Follow us on Instagram as well. On the 1st January 1999, the exchange rates between the Franc, the Passata, the Deutsche mark, the Lira and seven other currencies as well were permanently fixed. The Euro had been launched. And at 25 years that have followed, despite several moments when it seemed the entire project might implode, the Euro has proved to be extremely resilient. So what have we learned from the first 25 years about the strengths and the weaknesses of Europe's economic and monetary union? And how can the Euro continue to thrive in the next quarter of a century? Marco Buti and Giancarlo Corsetti of the European University Institute are the authors of a CEPR policy insight that has attempted to answer these questions and others, and they join me now.

Tim Phillips [00:01:17]:
Marco, welcome.

Marco Buti [00:01:19]:
Thank you. Thank you very much, Tim.

Tim Phillips [00:01:20]:
And Giancarlo, welcome as well.

Giancarlo Corsetti [00:01:22]:
Thank you.

Marco Buti [00:01:26]:
With Beethoven's ode to joy and with champagne, the super currency was launched.

Tim Phillips [00:01:31]:
Marco, the recent passing of Jacques Delore, it reminded many of us of that generation of politicians whose life work was about creating a stronger and a more unified Europe. And that included the Euro project. In the 1990s, when the Euro was first dreamed up, what did the architects believe that a single currency could achieve?

Marco Buti [00:01:56]:
Actually, the passes on Jacques Delore took place at the same time as the passing of Wolf and Schoiber virtually the same day. And it is telling in a sense, because both had an idea of a more unified Europe. When we created the Euro back in 1999, and the project had been actually ongoing since the approval of the master treaty, the idea was indeed to create a more unified Europe. Some, as we say in the paper, thought that this would bring nirvana. I think the official line at the commission, the Euro enthusiast, saw the future as extremely bright, and sharing sovereignty on the monetary side would bring sharing sovereignty on the rest, also. Prompting

the reforms which would put Europe on a higher growth path. They were skeptics, clearly, at the time, but the official line was, here we are responding to the call of history. So it was anchoring Germany to the core of Europe for them, giving up the Deutsche mark. But joining a currency area based on strong stability was what was the project. And that went hand in hand with completing the single market, which was the second huge project that associated with Jacques Delore.

Tim Phillips [00:03:27]:
And at the time were the economists convinced by this vision of nirvana that was linked to the Euro?

Giancarlo Corsetti [00:03:37]:
Convinced by nirvana, I would not say so. But remember economists were actively involved in the debate. Some of the economists were actually proposing various way of monetary and economic integration weighing heavily on the debate. I guess the persuasion of the economists started to crack about the modalities of the integration. But at the end of the day what was the crux of the debate was whether countries were ready in different ways to integrate but most important how to bring them together. And that was where the sticky point came in the debate. So I must say that the economists were convinced in the long run about the project but the way to go there created lots of reservation.

Tim Phillips [00:04:27]:
Yes, and as we've been discussing on VoxTalks many times, sometimes it seemed like we didn't discuss much else. The Euro was created with a common monetary framework but the individual national governments kept control of fiscal policy. Did at the time, the designers of the Euro, did they think that this wouldn't cause any problems or was it the best that they could achieve at that moment?

Marco Buti [00:04:50]:
Yes, there was awareness actually there was awareness also in the policymaker, not only amongst the economists that the architecture of the Euro was somehow incomplete. But there were two views sometimes talked about explicitly in other cases, especially in policy. For more implicitly there were two views on how to complete monetary union. On the one hand there was the German view which was based on the expectations that pooling monetary sovereignty, depriving Euro area members of the exchange rate and independent monetary policy would then trigger reforms in other areas so that the adjustment would be made at the national level in a smooth manner. It was the tina theory. There is no alternative than making the structural reforms which would allow member states to adjust to shocks properly. Then what was the opposite view and was more associated with the French view is that look, the Euro architecture is incomplete. We are going to complete it in due course by setting up a Euro area budget. Also counting on the understanding in the inverted commas that ECB independence would then respond properly when the shocks come and at the end of the day it will be the policymakers ECB makers in Frankfurt would behave. So there were basically these two views one bottom up

as we say in the paper the German one and one top down a bit more like the French. At the end of the day neither of the two views were fulfilled and the project is still in the making. I think we have made great strides but the shantier of economic and monetary union is still open and there are big challenges in front of us.

Tim Phillips [00:06:47]:
Yeah, before we move on Marco, I want to ask you if I'm correct, you were working in the commission at the time the Euro was launched. What do you remember the emotion was like there. Was it fear? Were people excited? Were they afraid it wouldn't work?

Marco Buti [00:07:01]:
There was certainly great excitement. I would say we came at the time of the period of the 1970s with the two oil price shocks, stagflation, what was called Eurosclerosis at the time. The combination in the second half of the 1980s, between the 1992 project of completing the single market, the single currency, which was seen as a complement of the single market, plus the huge historical events linked to the reunification of Europe, the fall of the Berlin Wall, et cetera, created clearly a great excitement. We thought we were there pushing the frontier of history. That was very tangible at the time. So certainly, especially at the European Commission, where the blueprint was designed, we thought that, yes, a lot of technocratic work are the services of a much bigger dream.

[Voiceover] [00:08:08]:
In 2022, we spoke to Giancarlo, along with Agnès Bénassy-Quéré, about the implications of above average inflation in the Euro area. Did their predictions come true? To find out, listen to Inflation and Europe's public finances from June 2022.

Tim Phillips [00:08:39]:
So what happened next? Let's focus on the years before the global financial crisis, during the great moderation, maybe the first decade, I suppose, of the euro's existence, did it deliver on its promise during this time?

Giancarlo Corsetti [00:08:54]:
Lots of excitement. The Euro sales on. But remember, the Euro sales on with a very small constitution, economic constitution, basically independence of ECB, with a clear mandate, no bailout clause, and basically the stability and growth pact. The ECB was in charge of monetary policy, but everything else was delegated to states. They had to underweight the necessary reforms. So the first decade of the Euro was the Euro of the great moderation, and I would say also the great misallocation. Everything was flowing very easily. A very small interest rate differential across sectors, across individuals, many subjects that would never have access to credit, access to credit. So this great missile location in Europe was similar to the US, but it had also a very strong geographical differential. You see, what we call the periphery or the south of Europe, or the future crisis, countries investing very heavily in real estate, and the north keep going, investing still in manufacturing and other sectors, but especially financing the big real

estate investment in the south. So money went to what we call the wrong sector, but also using the wrong instrument, which is basically short run banking flows. This was not only in Europe. In Europe had the problem that we had this geographical connotation on top of that Europe, when the crisis came, had much less instrument to absorb the consequence of the misallocation than in other regions where fiscal and monetary policy could be integrated.

Tim Phillips [00:10:36]:
So in 2008, we had the global financial crisis. What, around that time became apparent were the weaknesses in the way that the Euro had been constructed?

Giancarlo Corsetti [00:10:49]:
Well, you can make a list of what was not included in the constitution of Europe, like a banking union, crisis mechanism, regulation of markets to certain extent. All I'm saying is that once everything is delegated to national states and it's very clear that we will never go to a federation, as there was the initial constitution of Europe, meaning there was basically no sense of pushing out the integration at some level of fiscal policy, then we lack the instruments to deal with the problem. So especially we lack the instrument, we lack the resources, we lack the determination, we lack the institutional framework, but especially we lack the cooperation among national policymakers. The clear victim of the crisis was tasked across policymakers, and in part in the paper, we sort of stressed the fact that, let's say it is odd. The crisis in Europe started with a fiscal crisis in Greece, instead of a banking crisis in Ireland and other places. The fact that started with a fiscal crisis marked by alleged cheating on the budget, really contributed to the dissipation of any residual trust among policymakers that made the next few years dealing with the shock, dealing with the crisis, extremely difficult by European level.

Tim Phillips [00:12:04]:
We are racing through history here, but in the years that followed, I remember there was regular speculation that the Euro was going to collapse, that some countries were going to leave the Euro. What held the Euro together in the end?

Marco Buti [00:12:21]:
I remember very vividly, I mean, I was in my office in Brussels at the time as director general in the commission, and I remember the CNN covering the Euro area crisis live was when pulled up, or bank hostages, et cetera. So it was indeed the markets thought and speculated on the Euro not surviving, but not surviving in the next 25 years, not surviving till the next week. That was the actual feeling. I think the markets underestimated heavily and burnt their fingers the political capital that had been invested in Europe and in the Euro, that generation of policymakers eventually found the courage to do what was needed. In particular, you will remember the three famous words, whatever it takes, of July 2012. That was the feeling. What is interesting, and we documented in the paper, is that whilst the Euro was undergoing this existential crisis threatening survival, the Euro area continued to expand. And there, I think there was certainly some economic consideration, but especially what was key was the geopolitical and geostrategic reasoning behind that. Look at that in retrospect now with what is happening in

Ukraine. The fact that in that period, the three Baltic countries joined the Euro area was actually to join the core of European integration as a way to protect themselves from the very threatening neighbor. So that was, I think, an important element. But clearly, the management of the crisis, as Giancarlo recalled, because of the original sin, left then to the kind of pound of flesh that was extracted from the countries which had to undergone adjustment programs supported by the IMF and the EU. It was this paradigm which expired, which went away when the COVID hit the Europe and the Euro zone.

Tim Phillips [00:14:28]:
Now, before then, there was a period of reform, wasn't there? Because everyone was acutely aware of what you call the original sin. Did those reforms go far enough to fix the institutional weaknesses?

Marco Buti [00:14:42]:
They went part of the way. I mean, certainly banking union with the establishment of the first pillar, the SSM with the second pillar, the single resolution mechanism, went a long way in setting the goals and the operational mechanisms, but they were not completed. So one thing that we have learned from Europe is that, in a sense, the Jamon dictum is there at work, namely that we make big strides when we are under threat. But the second half of the Jamon prediction is that as soon as the shock and the pressure is lifted, then the temptation to roll back is very strong. That's why with banking union, we went a certain way, but we were not able to complete it. So this is one element. The second element, which characterized the institutional response during the great financial crisis as a sovereign debt crisis, was the intergovernmental nature of a number of institutions and rule books that were adopted at the time. So the ESM, very much intergovernmental. So with the need of national parliaments to ratify any decision of support, which led to the ultimarazio, as we say in the paper, also the fiscal compact, which toughens the fiscal rules, which is also an intergovernmental nature. And we know very well, intergovernmentalist does not go down well in terms of building trust.

Giancarlo Corsetti [00:16:13]:
There is also an important, I would say, intellectual point made through the crisis, which is, what is the minimal constitutional requirement for a monetary union? The first answer was, every country should do its own job, they should do the reform, their homework, and we can live with an independent monetary policymaker. Basically, the answer clearly was not satisfactory. It was not resilient, was not stable, and the crisis showed that we needed to have important changes. I remember very vividly that at some point, the Euro was dubbed a foreign currency for Euro members. There was loss of sovereignty, in the monetary sense, in the Euro members. And it took some time to understand that that was not true. And it took an important change in the way the ACP operates. With the outright monetary transaction. Also, it took all this intergovernmental initiative to understand that we need transfers of some kind. To ensure stability in the interest of everybody in the Europe. Because the fragmentation and the crisis through decades. Created losses that vastly avoidable through a joint action. Containing instability in the markets and containing fragmentation within Europe. So that was a breakthrough that could not happen in

the first decade of Europe, just because we were distracted.

Tim Phillips [00:17:41]:
Eventually, Covid presented the challenge, the opportunity for massive collective fiscal action in the Euro area. It would have seemed extremely unlikely before the COVID crisis. Has that created more of an appetite for this type of reform, this type of collective fiscal action.

Marco Buti [00:18:07]:
The response to Covid was clearly a breakthrough of enormous proportion. One should never underestimate the kind of red lines that have been crossed, when Covid hit the Europe, the european economy. It is telling to understand why the response was a different one. Different not only in size, but also in sign. Was the fact that unlike the global financial crisis and the sovereign debt crisis. Covid is seen as an exogenous shock. So it is not due to mistakes that were made in terms of policies. Clearly, one can always attribute Covid to capitalism's globalization and things. You can go back to the very first origin. But in terms of proximate reasons, it was not due to policymakers mistakes. So this led to the paradigm of moral hazard. Which dominated during the global financial crisis, to get out of the window immediately. And so that's why we had the response on the monetary side, the PEP program. And on the fiscal side, at the European level. Sure. So to support the labor markets and next generation, you, which is 750 plus billion. So this was clearly a breakthrough. However, what we say in the paper is that this took political courage. But it was on the back of what we call a benign coincidence. So, beside the nature of the shock, there was also a political calendar, which was extremely favorable. So there were no elections looming. And the three main characters in the policymaking at the European level, Emmanuel Macron, Angela Merkel and Ursula Border Lion. Had in front of them, for different, sometimes opposite reasons, had in front of a long time horizon. So, as we say in the paper, they had a very low political discount rate. That they could look to the future and not be worried about the domestic repercussions. Because we have an election in the lender in two months time. So this peaceful political calendar actually helped the decision making. And if one judge is then exposed at the end of the day, this benign coincidence helped a lot more than the actual change of structural preferences which are still there. It's something to build on, but one should not take it as automatic. Now we are going to proceed to fiscal union, to complete banking union, without further political advancement and efforts.

Tim Phillips [00:20:56]:
Okay so making expost judgments is really what we're all about today. So I wanted to ask you if you can look back on the last 25 years of the Euro, this original sin, the incompleteness of the institutional framework, how economically damaging has that been?

Giancarlo Corsetti [00:21:15]:
Well, we cannot make it counterfactual, so we don't know what would have happened to the Euro. That would have been the way to answer your question. But with lots of sympathy for the project, we cannot close our eyes on the fact that the minimal constitution of Europe, the very start of Europe, done with a sense of urgency, with a sense that there is no alternative to the

decision degree in the Madrid Samuel. That kind of rationing to the Euro had some consequences. We cannot really blame the Euro for the miss allocation in the first decade, it was everywhere. We can, however, think of an alternative scenario in which better instruments at the European level would have moderated the floor capital in their own sectors. Would have helped, using risky financing, risky instrument rather than bank loans. But again, this is a parallel universe. Most important, at the beginning of the great financial crisis, the blackhole instrument made the shock much, much larger, persistent, disruptive in Europe than in other regions of the world. So there was a price to pay for the scrambling to find the solution out of a crisis. The paradigm in Europe, and there is a lesson there which is leaping forward through prices may be a pattern that may work for some time, but is not costless. We may not be able to afford it in the future. When one can reasonably expect a variability, not to take a geopolitical risk, take climate, we may easily expect shocks of the same size if not larger than what we experienced in the past. A bad arrangement has costs. The question is what lessons we can take now and what would be the way to make the best use of those lessons now that Covid is over and the trade offs are back?

Tim Phillips [00:23:06]:
Yes, that's enough of looking back. Let's look forward and say if we make use of those lessons, learn those lessons. What is the potential for the Euro project in the next 25 years?

Marco Buti [00:23:21]:
Awareness of leaving the architecture incomplete, I think is a starting point and the costs related to that. What I think is very important is that in order to do what is necessary, it is key to change the narrative. And I think if one looks back 25 years and the lessons learned and what we have now, I think two elements clearly stand out in terms of differences. I think one has to build on those two elements. The first one is a green and digital transition. So the need to tackle the climate crisis, also to the competitiveness crisis of Europe in broader terms. So to what extent the policies should be geared towards putting ourselves in the right line to deliver on the green and digital transition. So this is one element. The second element is the geopolitical relevance of Europe and the Euro zone. Now we are in a world of crude power. Politics is a world that is a bit at odds with the DNA of Europe. We tend to reason in terms of positive sum gains. So integrating more with the rest, with the trade, with each other, we all gain. Now, in a world of crude politics, pure logical power, at best you have a zero sum gains, at worst you have negative or super negative gains, where everybody loses. So I think here, in order for Europe not to be marginalized, if not sandwiched between great powers, especially now with the war very close to our borders, I think we need to realize that leaving these issues open would also damage us on both these fronts. If we do not complete banking union, capital markets union. Very difficult to believe that one would deliver on the green transition. You need to mobilize private capital in order to deliver that. It's not only a question of public investment. And second, if we do not have a safe asset with no, again, banking union, but also fiscal union, difficult to believe that one would be able to sustain competition on the global area. So what we say in the paper is that we have to change tact in certain cases, fine tuning the objectives, making it politically credible in other cases. The narrative is key for delivering on that front. And we say

that the approach of thinking in terms of European public goods in the economic area, but also in the non economic area, take security of defense, is key in changing the political perception and make us sharing sovereignty the way it's needed at the present juncture.

Tim Phillips [00:26:23]:
Is there the political will, though, to make those changes and to evolve the Euro? That's where this process has often fallen short in the past.

Marco Buti [00:26:33]:
Look, if we go back to the very beginning, we had Helmut Cole, Francois Mitterran, Jacques Delore. When he came to the response to the COVID crisis. We had Angela Merkel, Emmanuel Macron and Ursula Border Lion. I think the hope, at least personally, is that come the next European elections that would gather sufficient dynamism and visionary leaders to push forward the frontier of integration. So this is the first order. Leadership Question one may be optimistic or less so, but without political leadership we are not going to be able to make the decisive breakthrough that is needed.

Giancarlo Corsetti [00:27:17]:
But Tim, if you look from a distance, what you see in the Euro area and northern general Europe, you see an aging society with large accumulated debt for good reason, because we survive many crisis basically by borrowing. We are more worrisome. A technology gap which is very large with the US and narrowing with all the other regions in the world. So we cannot predict where politics go. But there is a very common basis, which is the idea that a stable, integrated economic area may be extremely beneficial to keep Europe standing. So this is the challenge. Going, seeing through the monetary arrangement, going seeing through the fiscal arrangement, addressing very basic needs of Europe that I think it would be almost impossible to ignore or postpone.

Tim Phillips [00:28:12]:
We shall have to get together again in 25 years time to discuss how this has all worked out. But for now, Marco and Giancardo, thank you very much.

Marco Buti [00:28:23]:
Thank you, Tim.

Giancarlo Corsetti [00:28:24]:
Thank you.

Tim Phillips [00:28:33]:
So much to talk about that we didn't have time to get to. If you want to find out more, then the policy insight is good place to start. It is number 126 from CEPR. It is called The First 25 years of the Euro. The authors Marco Buti and Giancarlo Cosetti.

[Voiceover] [00:28:54]:
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