

The Transformational Impact of EMU and the Global Financial Crisis

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Abstract

The headwinds facing the euro area are many and substantial: there is no pretence of denial. While most attention is correctly devoted to the size of rescue packages for some countries and the terms of crisis management and resolution mechanisms, we argue that these challenges must also be met from within the euro area. We are aided by a simple framework illustrating how the benefits the euro can generate depend on the degree of openness, flexibility and income correlation among euro area countries. Sharing the euro has steadily transformed euro area economies that are now deeply interconnected. This is generating largely benign effects that represent the intrinsic value of the euro area: it is a shared asset. Yet, such integration has provided the ground for the transmission of the sovereign crisis: through financial exposure, trade linkages and cross-country asset ownership.

The solution, however, lies not in severing these ties, but rather in turning the governance around. Some aspects stand out. While we had long understood the welfare costs of deferring structural reforms for too long, we now know that in a monetary union this may pose substantial risks to fiscal but also financial stability. Moreover, euro area countries need to more closely interpret domestic price developments, relative costs of production and unit labour costs, export market shares and productivity developments. This is reminiscent of the pegging of the nominal exchange rate of the past: it entails pegging real exchange rates. We note that the governance of the euro area has already turned around: yet this will take some time to ascertain. However, at heart, there is a need for more clearly explaining what EMU can and cannot do, and conveying the rationale for its unique governance. As the features of a novel and broadly accepted governance of EMU emerge, uncertainties will be gradually reduced. This will support the growth that is indispensable to heal the legacy of the crisis and complete the transformation of the euro area. The euro can provide an outside shield and foster internal stability to support this process while facing several global challenges that are 'too big to handle' for any euro area country alone.

Introduction

Various events have marked the 10th anniversary of the euro, which was launched in January 1999. There were many reasons to celebrate. The new monetary policy framework secured price stability. Economic and financial integration made important strides. No 'fortress Europe' was erected. Unemployment declined and labour market participation rose. Yet not all went as desired. There were failings in the economic governance of the euro area. Consequently,

various fault lines were allowed to build up over time: namely, weak public finances in a group of countries, persistent imbalances in another overlapping group and slow productivity growth in some others. The global financial crisis, whose epicentre seemed initially far away, has exposed and exacerbated these fault lines. The challenge is now acute in Greece and Ireland, but these are not the only problems we face. A wave of scepticism has ensued. Some commentators are now even contemplating a wave of disorderly defaults and failures of financial

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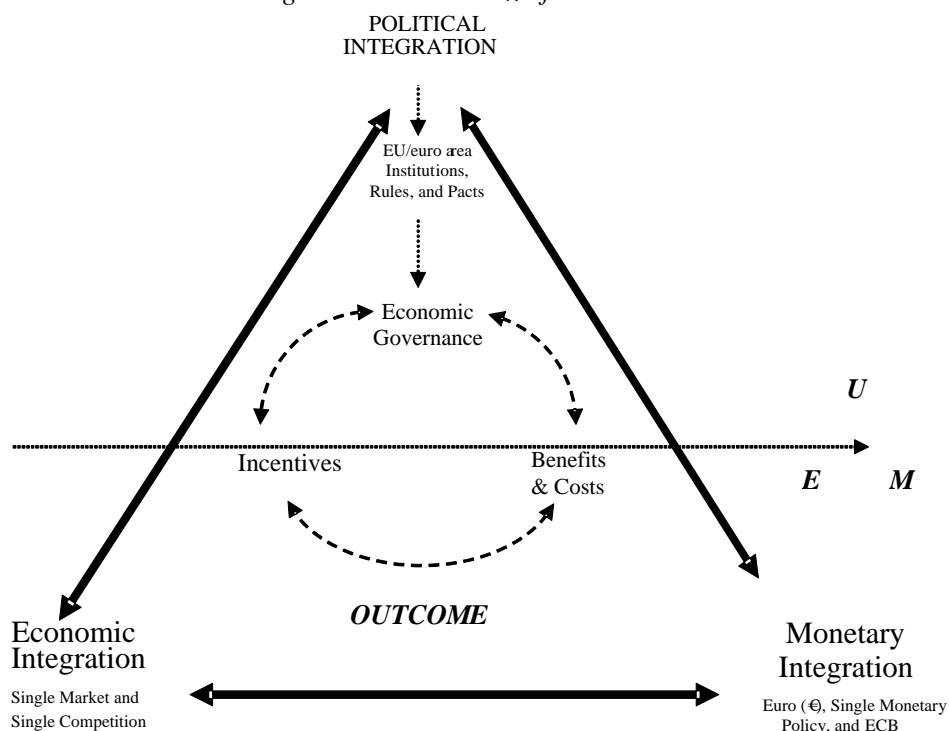
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institutions. Is there a framework to illustrate, at least in part, this turn of events? Looking ahead, how can we reduce such systemic risks?

Before answering these questions, we need to take a few steps back in time and ‘deconstruct’ the European Economic and Monetary Union (EMU), at the core of which lies the euro area. The euro area has been shaped by three main forces over several decades (Figure 1). The first is ‘**political integration**’. While early on, political vision was needed to dismantle national barriers and build supranational institutions

enabling it to work; we now need sound economic governance, a stepping up of structural reforms and courageous policy choices. The second force is ‘**economic integration**’ encompassing growing trade and financial linkages. The third force is ‘**monetary integration**’, a process that began with monetary cooperation in the 1960s, progressed through exchange rate coordination in the 1970-90s, and was completed by the launch of the euro. The outcome of EMU is determined by the interaction between these complementary forces.

Figure 1. The working of the euro area



The aim of this Policy Brief is to flag some considerations that seem missing in the current heated debate on bail-outs and bail-ins, the size of liquidity facilities, and the terms of a crisis resolution mechanism. While these mechanisms and schemes would be superimposed on the architecture and governance of EMU, we ask if part of the solution to the euro area crisis may not be found within EMU itself. Another consideration is that the three forces can have different dynamics. Over the last decades political integration has provided the impulses for EMU to advance, yet at times it has trailed the other forces.¹ On the other hand, economic integration advances slowly but steadily: it has been the driving

force since the late 1950s. Monetary integration and the launch of the euro represent instead a switch in regime.

This Policy Brief is organised in three sections. First we survey diverse outcomes since the launch of the euro. Here we illustrate how the benefits the euro can generate depend on the degree of openness, flexibility and income correlation among euro area countries: these are economic concepts which over time are affected by policies. In the second section we review the main failings and fault lines that brought us to the current sovereign crisis. In the third section we postulate that to exit the crisis we need to unravel the factors behind each fault line. We argue in this brief that the achievements of EMU are to some extent interlinked with the crisis. We stress the need for explaining what EMU can and cannot do and the rationale for its unique governance. As the situation is still evolving, we only offer some final observations.

¹ What does this mean? We can answer with two examples. Signing the Treaty of Rome was highly visionary and proved to be a successful choice for the whole continent. Instead, the Stability and Growth Pact may only now evolve into a viable and binding governance tool (some speak of the “SGP 3.0”).

1. What economic and financial effects has the euro had?

The euro area today is not the one that was imagined when the Maastricht Treaty was signed, or even when the euro was launched.

The euro is contributing to the **transformation of euro area economies**. From a strictly monetary policy perspective, these years may well have been as good as many had hoped (see Mongelli & Wyplosz, 2009). Inflation was low and inflationary expectations remained well anchored, even throughout the crisis. Interest rates were also low at all maturities for all countries (which, as we discuss later, contributed to the fault lines) until the intensification of the global financial crisis. The crisis could have had even worse effects were it not for the prompt action of the ECB, as well as other central banks, that shored up the financial system.

Financial institutions and companies now have a greater continental perspective and reach. Households increasingly hold assets from each partner country and consume each others' goods and services. For example, since 1998, trade among euro area countries has risen strongly. The most comprehensive study to date (Baldwin et al., 2008) concludes that the euro has probably increased intra-euro area trade by some 5% – a significant outcome considering that trade among European countries had already risen uninterrupted for over five decades. Over the same period, services trade also went up, rising from 5% to 7% of GDP. Hence, internal openness grew significantly (while extra-euro area trade grew even further). The financial crisis has temporarily dented trade.

The euro has also had a significant impact on several segments of the European financial markets (see ECB, 2008 and Buti et al., 2010). Money markets integrated after the introduction of the euro. In bond and equity markets a process of structural change and increasing integration is unfolding due e.g. to the removal of currency-matching restrictions. Since the launch of the euro, the euro area seems to have been a magnet for foreign direct investment (FDI) activities particularly in the manufacturing sector, while an increasing share of FDI flows is taking place between euro area countries. Between 2000 and 2005, the euro area countries accounted for as much as 57% of world FDI inflows. Integration of financial institutions and exchanges has instead proceeded more slowly.

We also saw a sharp decline in the 'home bias'. International ownership of public debt of euro area countries has risen from 32.5% in 1999, to 53.5% in 2009. In some ways, the contagion effect following the Greek sovereign debt crisis testifies to such deeper financial integration. In fact, there are now substantial holdings of Greek and Irish bonds, as well as those of

other countries, elsewhere in Europe. They were channelled through the financial system, which also built substantial cross-countries exposure. This is normal in a monetary union and leads to increasing efficiencies and fosters risk-sharing.

Observation 1. Such deeper economic and financial integration comes as no surprise: it had long been postulated by Frankel & Rose (1998) as the "endogeneity of the optimum currency area", which may require up to 30 years to fully materialise (see De Grauwe & Mongelli, 2005). These benign effects cannot be overemphasised: they represent the intrinsic value of the euro area and serve as a *shared asset*. This should provide the motivation and support for completing the transformation of the euro area.

Yet, greater integration also comes with greater spillover effects across euro area countries. More recently, these achievements have provided the ground for the transmission of the sovereign crisis from country-to-country: e.g. through financial exposures, trade linkages and cross-country asset ownerships. Thus, paradoxically, the proof that euro area countries have become more interconnected lies in the contagion from the Greek sovereign crisis. Yet, as we shall see, the solution lays not in severing these ties.

How about structural reforms? This debate matters due to the impact on flexibility and adaptability of euro area economies. Duval & Elmeskov (2006) observe that on average, the intensity of structural reforms between 1994 and 2004 was greater in the euro area than in the rest of the OECD countries, and that reforms have also been typically deeper and more comprehensive in the euro area. Thereafter, Germany undertook the Hartz IV reforms, while Italy and Spain relied more on a dual labour market (raising social inequality). The relevant question now is: have product and labour markets changed enough?

Observation 2. Despite these efforts, several euro area countries still have a substantial 'structural reform gap' that predates the launch of the euro. In some countries this gap has actually widened after the launch of the euro due, amongst others, to more direct cross-country competition. Moreover, all euro area countries are now exposed to a fiercely competitive global economic and financial environment (see Catte et al., 2010). A country like Italy can no longer rely on competitive devaluations. Instead, domestic structural reforms are needed to support economic governance and help to steer national competitiveness vis-à-vis the main partner countries. Accordingly, the benchmark for structural reforms has actually increased with EMU.

A useful diagramme. *Is there a way to represent these developments?* Yes, by referring to the optimum currency area (OCA) theory. At its most basic level,

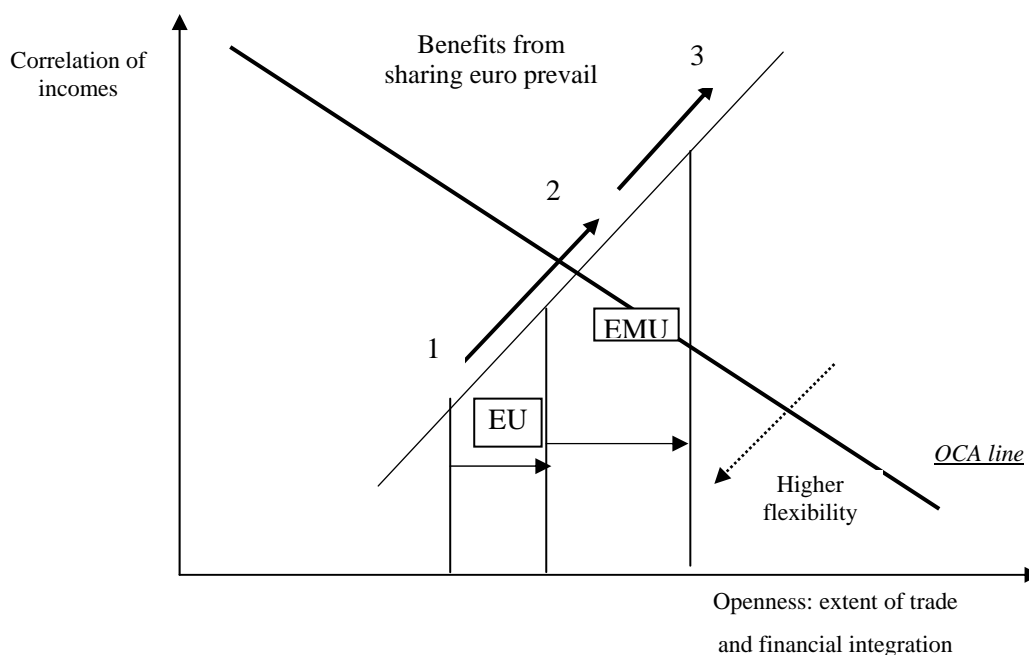
the OCA theory is about openness, flexibility and correlation. Members of an OCA need to be:

- ‘Open’ vis-à-vis each other in terms of trade and financial integration. This reduces the usefulness of national exchange rates, spurs competition and improves the allocation of resources across the area and fosters growth.
- ‘Flexible’ in terms of price and wage flexibility, but also the mobility of capital and labour (both occupational and geographical). Flexibility enhances efficiency and also facilitates the adjustment following a shock.
- ‘Highly correlated’ with each other. This implies the absence of persistent and irremediable divergence over the medium to long term. Correlation is promoted by low and similar inflation rates, highly diversified production and consumption diluting the possible impact of country-specific shocks, and broad similarity of policy preferences. Financial integration helps smooth asymmetric shocks and spurs correlation as does fiscal discipline.

While openness, flexibility and correlation will define the success of the euro area, the **motivation for launching the euro lies in the net benefits it can bring**. Monetary unions are meant to be welfare enhancing. Euro area countries expect to gain from improvements in microeconomic efficiency, such as from deeper trade and financial integration that boosts growth; from improvements in macroeconomic stability, such as from low current and expected inflation and interest rates, and increasing risk-sharing; and from the international role of the euro. Moreover, higher openness and flexibility reduce the costs from losing direct control over the exchange rate (for a detailed analysis, see Mongelli, 2010a).

Figure 2 plots various combinations of openness and income correlation. For points on the right and above the ‘OCA line’ the benefits from the euro prevail. The ‘higher’ the openness and correlation, the higher the advantages of sharing the euro. An increase in flexibility shifts the OCA line downwards, raising the benefits from the euro. The achievements of the euro’s first decade are captured by the shift from point 2 to point 3 and an increase in benefits.

Figure 2. The achievements of EMU



How about the single monetary policy? Higher openness, flexibility and income correlation spur further economic convergence and ease the implementation – and effectiveness – of the single monetary policy in the euro area. This in turn enhances the benefits from the euro.

Observation 3. *Is that all?* Not quite. There is in fact another dimension that over time pervades, and partly drives all others: members of an OCA also need to share a strong political will to make the monetary

union succeed (Mintz, 1970). This implies a resolve to make the monetary union work, fostering compliance with joint commitments, sustaining policy coordination and encouraging the building of shared institutions through which to channel policies. This falls under the umbrella of political integration of Figure 1.

2. Failings of economic governance

Despite the above benign outcomes, the euro area is now coping with various fault lines that have been building over a long period due to various failings. The crisis has exposed and exacerbated them.

National failings. In some countries, economic governance did not fully rise to the challenges of a new, and rapidly changing economic and financial environment. The depth and implications of this change in regime was widely underestimated. Benefits, such as easier access to credit as well as budget borrowing at lower interest rates than in the past, were taken. However, product and labour market reforms to further raise flexibility advanced slowly. Policy efforts might have been eschewed, some say, as a result of the fatigue from fulfilling the Maastricht convergence criteria. Yet, there was no lack of analysis and pressure from the ECB, the EU Commission and others (see ECB, 2008, for an analysis of the build-up of the fault lines). Greece suffered a sovereign debt crisis after systematic misreporting of persistently high deficits. It is now in an EU-IMF-ECB programme.

A failing of supranational monitoring. Prior to the crisis, there was uneven enforcement of fiscal discipline over time and across countries. On the one hand, we saw a clear break with respect to the past: while before the launch of the euro fiscal policies were largely pro-cyclical over the business cycle; after the launch of the euro they became slightly anti-cyclical or neutral. Moreover the euro area debt-to-GDP ratio declined from about 72% in 1999 to about 66% in 2007 (the year the crisis started). On the other hand, this reduction was both limited and uneven across countries: e.g. in Germany and France the debt rose. The preventive arm of the Stability and Growth Pact (SGP) didn't work as hoped for. This is one of the fault lines that needs mending.

Since the launch of the euro, real exchange rates of euro area countries – i.e. their relative competitiveness – changed quite substantially. In the 1999 to 2007 period, the harmonised competitiveness indicators appreciated by almost 23% in Ireland, about 15% in Spain and almost 10% in Portugal and Greece, while remaining practically unchanged in Germany, Austria and Finland (again see ECB, 2008). Changes in average annual unit labour costs also portray a similar dispersion: they declined by over 1% per year in Germany and Austria and grew by more than 1% per year in Greece, Ireland, Spain and Portugal. Such swings are in part explained by a catching up of price levels, and even some real exchange rate corrections: according to some, the German D-Mark might have been too strong in the run-up to the euro. But there was more. A look at cumulated changes in current account positions over

the 1999 to 2007 period reveals a surge of surpluses by about 6% in Germany and Austria, and a deterioration in current account deficits by about 6% or more in Ireland, Spain, Portugal and Greece. This is the second fault line.

What happened? In some countries the gradual build-up of current account imbalances originated from a domestic credit boom that propelled, in particular, the construction sector. For example, after 2001-02, Ireland started experiencing financial market-driven 'exuberance' that fuelled a boom in real estate. Income taxes were lowered and fiscal policies became increasingly reliant on tax revenues from building companies and the taxation of property sales: i.e. on the housing bubble. In the meantime, soaring domestic prices and wages led to progressive losses in competitiveness. Diverse manufacturing activities shrank, and jobs were lost. After the real estate bubble burst and the global financial crisis hit, fiscal policies became unsustainable.

How could these fault lines build-up for so long? There were **weak deterrents**. Various EU/euro area institutions did not have enough teeth to fully enforce the Stability and Growth Pact and push for and enforce more changes at national levels. Then, in November 2003, the SGP was even weakened at the behest of France and Germany. Multilateral surveillance failed. Moreover, financial market discipline was largely absent until well into the crisis. During the first decade of the euro, financial market participants and rating agencies did not discriminate between national issuers with different standings. In other words, bond markets were not vigilant: they did not operate as deterrents against excessive deficits and/or sustained high public indebtedness (that were however apparent). When they changed their assessment about sovereign solvency in Greece, spreads soared as did premia on credit default swaps (CDSs).

After the bankruptcy of Lehman Brothers in September 2008, the **world has been struck by a full-blown systemic financial crisis**, unprecedented in size, if measured by financial losses and fiscal costs, unprecedented in extent, if measured by its geographical reach, and unprecedented in speed and synchronisation, if measured by the precipitous fall in worldwide economic output. Money markets seized up. International trade plummeted, which affected euro-area economies disproportionately due to their high degree of openness. The construction sector in many countries came to a standstill and unemployment climbed to levels not seen for decades. Budget deficits soared in all euro-area countries due to a drop in many sources of revenues, the expense of shoring up the economy and the cost of various types of support to financial institutions.

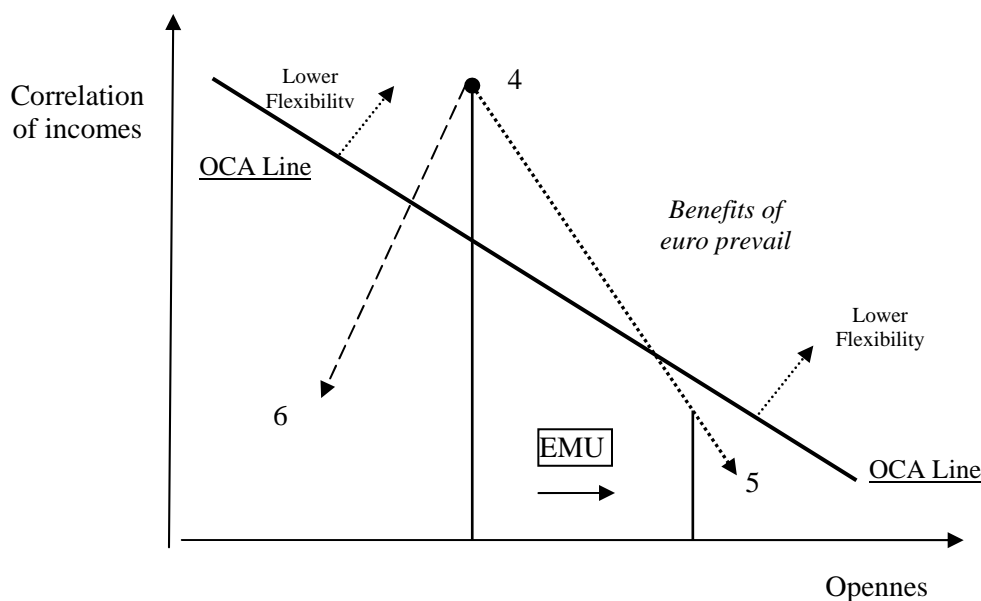
There was also an **institutional vacuum**. When the Greek sovereign crisis intensified in late 2009 and early 2010, the disruptive potential of financial market backlash and threat of rapid contagion had not been fully grasped. There was also an institutional vacuum that merits some explanations. The governance of EMU was designed without a framework to deal with a sovereign crisis in the euro area. *Why?* As a deterrent to underpin the no-bailout rule, there was no facility for crisis management and resolution: but we found out the hard way that this deterrent didn't work. Instead, a Medium-Term Financial Assistance facility is being used by diverse non-euro area EU countries. The current policy debate is mostly about how to fill this vacuum: i.e., it is about further elements of political integration.

Observation 4. There is no denying the severity of the current challenges. Since the fall of 2009, we have seen strong fiscal-financial linkages in several euro area countries: i.e. sovereign and bank's CDS spreads have been moving jointly. This is reminiscent of the emerging economies' crisis in the past. Moreover, by the end of 2010 public indebtedness in the euro area is

expected to exceed 80% of GDP. Yield differentials of several euro area government bonds have grown further apart exceeding, in some cases, the levels preceding the launch of the euro. In terms of Figure 2, this entails a weakening of flexibility and over time income correlation.

A diagramme to illustrate the failings. Figure 3 below plots the effect that the failings that we just discussed might have, if not corrected, in the coming years. A sustained decline in correlation ensuing from diverging fiscal consolidations and paths toward economic recovery may move the euro area from, say, point 4 to point 5. While financial integration might suffer in the aftermath of the crisis, trade in goods and services may instead recover its lost ground: thus openness might still continue rising over time. If not, then the move might be along the segmented line to point 6. Moreover, lack of fiscal adjustments will reduce flexibility – thus shifting the OCA Line outward. This would further hinder correlation of incomes and reduce the benefits from sharing a single currency. But it doesn't need to get to that point.

Figure 3. Failings of economic governance plus the crisis



Is that all? Again, not quite. Some suspect that sharing a single currency would spur country specialisation, thus reducing the differentiation in manufacturing. *Ceteris paribus* income correlation would decline and the risk of asymmetric shocks would rise: this is the so-called 'Krugman concentration hypothesis'. Yet, these developments may still be compensated by deeper financial integration raising 'risk sharing'. In other words, this would be equivalent to a market-based form of cross-country insurance. Another soothing factor is that nowadays the bulk of economic activity and growth

originates from services (that are very spread out and differentiated). These are empirical questions for the long-term, yet the answers will need to be considered in the future governance of the euro area as well.

3. Three lines of defence

Looking ahead, three lines of defence are jointly needed to reduce systemic risks, allow the euro area to work efficiently and secure the most benefits from the euro in the coming years.

1. Raising the acceptance for domestic reforms and for bringing public finances under control.

Various euro-area countries still have a substantial ‘structural reform gap’ because the need for flexibility and openness has risen with EMU. To allow the national competitiveness channel to work, product and labour markets must be freed up. *More specifically, what should be done?* To answer we enter the realm of national policies. Each country should formulate clearer national fiscal rules, like a domestic SGP, and permit an independent national fiscal assessment. Transparent domestic reform frameworks are also needed. For some countries enforcing reforms and securing fiscal discipline will require tough choices across generational divides and over time: improving education versus pension systems, infrastructures versus healthcare, research and development versus defence, etc. Strengthening of tax administration and treasury systems will also be crucial. Supporting the Europe 2020 reform agenda recently put forward by the European Commission, as well as National Reform Programmes, will be essential (as described in Mongelli, 2010b). Thus, each country needs to find its own tradeoffs and domestic support from within its population.

These considerations are not new. Yet, due to the crisis, they are now cast in a new dramatic light. While we had long understood the welfare costs of not-reforming, now we know that in a monetary union without flexible exchange rates there may be substantial risks to fiscal sustainability, but also financial stability, if reforms and budget consolidation are deferred for too long. Thus the domestic incentives to undertake product and labour market reforms have grown tremendously due to EMU. The speed at which such risks can exacerbate, and even become systemic, had not been fully understood. Thus, the rationale for the governance of the euro area needs to be better explained.

2. Enforcing tighter macroeconomic surveillance and prevention.

With growing trade and financial integration, events and policy choices in each euro-area country increasingly affect all others. In other words, there are greater spillover effects due to growing interconnectedness. This justifies a strengthening of mutual surveillance and peer review of national developments and economic policies. A warning system would identify risks arising from sustained budget deficits as well as large and protracted swings in competitiveness at an early stage (see Marzinotto et al., 2010). Thus the euro area needs stronger surveillance and prevention.

Observation 5. Does this sound familiar? Yes, in some ways this is reminiscent of the pegging of the nominal exchange rates of the past: it is akin to pegging the real exchange rate. But how? The monitoring of domestic prices, costs of production,

wages, unit labour costs, export market shares and productivity developments is involved.

3. Building stronger and credible deterrents.

In crisis times, unsustainable imbalances in any euro area country inevitably build up systemic risks for all: through trade, financial and confidence channels. Thus sound economic and financial assessments for each country – as well as the euro area as a whole – are indispensable. This will originate amongst others, from the European Commission, the ECB, the European Systemic Risk Board (once operational) and other institutions and fora. Two main deterrents will play a crucial role.

- The first deterrent is the corrective arm of the Stability and Growth Pact that needs strengthening. Budgetary targets need to bind. More credible sanctions are needed when proper enforcement of consolidation programmes fails. Fiscal discipline is indispensable to grant some flexibility but also to be able to tackle future challenges stemming from the ageing of the population and from climate change.
- We have seen how in times of crisis, financial markets and rating agencies can rapidly alter their assessment and, in extreme circumstances, even expedite a solvency crisis. For financial market-based discipline – that is the second deterrent – to work seamlessly over time, comprehensive data and transparent information are indispensable.

Observation 6. The strengthening of the first line of defence has a very high order of magnitude and potential. It is inescapable: without it, no other advancement will be viable in the long term. It requires a leap forward in the national understanding - and appreciation - of membership in EMU. Looking further ahead, there is no liquidity provision or bail out scheme that can match such an effort from within.

Some concluding observations

The global financial crisis has been a traumatic event in the still-short history of the euro area. It has aggravated diverse failings in EMU governance, and exacerbated various internal imbalances. The great vulnerabilities and forthcoming systemic risks entailed by weak public finances and the erosion of competitiveness in some countries were not comprehended on time. Once the sovereign crisis erupted in Greece, the dysfunctional policy debate that ensued, and the fractious national responses, were also harmful. Euro-area policy-makers, but also the vast public, were still in a pre-EMU mindset. Understandably, national disaffection rose as did scepticism about the euro area.

Can we identify a common thread behind these failings? Yes, that some prerequisites and

implications of EMU are still poorly understood by many. *Is there a general lesson?* Yes, that it is still difficult to coordinate the needs and interests of many sovereign countries that are sharing a single currency. Yet, due to economic and financial integration, that is the interconnectedness we were talking about: national needs are now more closely linked. We are all each others' stakeholders.

Observation 7. The imperative challenge is to bring back financial stability and confidence. Thus, most attention is now devoted to the size of rescue packages and the terms and conditions of a permanent crisis management and resolution mechanism (and correctly so). But there is more: a new governance is also within reach. Vigorous policy debate and policy actions have been stepped up since the fall of 2008. The economic governance of the euro area is being overhauled to remedy the various failings and prevent fault lines from reoccurring too soon. There are various steps forward, some more visible than others, including: enforcing tighter macroeconomic surveillance and prevention, strengthening the Stability and Growth Pact (also referred to as “SGP 3.0”) by granting some degree of automaticity to the corrective arm, and a redesign of macro-prudential supervision. Greece agreed upon a three-year recovery programme backed by the IMF and the EU through a European Financial Stability Fund (EFSF). Greece is subject to strict conditionality with which it is complying. Ireland has followed suit with a differently aimed EU-IMF programme. All other euro-area countries also announced more ambitious financial targets and reform agendas. There is also broad consensus that the EFSF may turn into a permanent European Stabilisation Mechanism (ESM).

Observation 8. It is fair to observe that the governance of the euro area has turned around: yet it will take some time to enforce and ascertain this transformation. *But might this be enough by itself to reduce future systemic risks?* No, there is a need for more clearly explaining what EMU can and cannot do, and conveying the rationale for its unique governance. As the features of a novel and broadly accepted, economic governance of EMU emerge, uncertainties will be gradually reduced. This will support the growth that is indispensable to heal the legacy of the crisis and complete the transformation of the euro area. Yet this will require time which in turn requires trust. *What else?* Looking ahead income correlation may temporarily decline as a legacy of the crisis, but also as a result of the “concentration hypothesis” that is reshaping euro area economies. There is no reason to worry though: financial based risk-sharing will strengthen, and structural reforms can enhance flexibility and adaptability. Over time this can unleash the growth potential of each euro area country.

Observation 9. All the factors that led to the launch of the euro are still valid. All three forces shaping the euro area – namely political, economic and monetary integration – must be realigned (and convincingly so). Yet, perhaps a paradox is that we are again calling for renewed political commitment, will and vision (as for the founding of the EU and EMU), only that this time political efforts must be oriented inwards.

There is much more to say and various thorny issues remain wide open. The euro can provide an outside shield and foster internal stability to support this transformation while facing several global challenges that are ‘too big to handle’ for any euro area country alone. What matters the most is that the high intrinsic value of EMU is worth all the efforts to make the euro area succeed in such a transformation.

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