Euro: the engine of integration or the seed of dissolution?

EURO: motor integrace nebo sémě rozkolu?

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Abstract: The common currency Euro is considered one of the biggest achievements of the European political and economic integration. However, it is necessary to stress that Euro was always first and foremost a political feat. Economists by and large pointed out that the EU – even in its 1992 reincarnation – is not an optimum common currency area (OCA). But politicians and some economists hoped that the existence of Euro itself may accelerate the processes toward the OCA. However, this did not happen and the divergence processes inside the Eurozone accelerated after 1999. Today, the Eurozone stands near the crossroad – where some countries may be increasingly tempted to leave.

Key words: Euro, optimum currency area, asymmetric shocks, divergence

Abstrakt: Euro jako jednotná měna je považováno za jeden z největších úspěchů politické a ekonomické integrace v Evropě. Je však nicméně nutno zdůraznit, že Euro bylo vždy především politickým aktem. Většina ekonomů poukazuje na to, že Evropská unie není – a to ani po své reinkarnaci z roku 1992 – optimální měnovou oblastí (OCA) pro společnou měnu. Politikové a někteří ekonomové však doufali, že sama existence Eura může proces vytvoření OCA urychlit. To se však nestalo a divergenční procesy uvnitř Eurozóny po roce 1999 zesílily. Současná Eurozóna stojí již téměř na křižovatce, na které některé země budou stále silněji motivovány ji opustit.

Klíčová slova: Euro, optimální měnová oblast, asymetrické šoky, divergence

The objective of this paper is the analysis of the coming challenges and policy dilemmas facing the Eurozone and, by implication, the whole European Union in the next 10 to 15 years.

It is commonly recognized that the today's EU falls behind the US in the areas of the economic and productivity growth. This is exacerbated by the expected fiscal and social impacts of a demographic shift. Ageing of the population increases the demand for pensions and healthcare related public expenditures at the same time when the faltering growth reduces public revenues. Results are the growing public deficits and the reduced flexibility of the fiscal policy (Table 4.)

Simultaneously, the common currency (Euro) means that the individual EU countries have no domestic monetary and/or exchange rate policies. This, indeed, increases the importance of fiscal policies. But, perhaps more importantly, it increases the importance of the reforms of the European economic systems. These reforms should be aimed at the acceleration of the convergence process among the Eurozone countries.

However, the EU is not a country in a conventional sense, but a loose confederation of independent countries at the best. Fiscal transfers between the member states are miniscule – the EU wide budget is 1.06% of the combined EU GDP compared to the US federal budget of over 20% of GDP.

Under these circumstances meaningful fiscal transfers which would accelerate, convergence processes are all but impossible.

Indeed, it was hoped that the introduction of Euro will speed up the processes of economic reforms. These include fiscal harmonization and reforms facilitating the greater flexibility in resource allocation and trade – first and foremost the substantial and penetrating labor market reforms, but the fiscal reforms (especially pensions and health) and liberalization of services and factor movements as well.

However, the reforming effort designed to bring the Eurozone area closer to the OCA (Optimum currency area), promising in the run up to the introduction of Euro in 1990's, effectively fizzled out after 2000.

Contrary to expectations, the differences in economic performance among the Eurozone area countries increased in the beginning of the 21st century.

Moreover, this divergence in performance is far from uniform. Performance of some countries (Ireland, Denmark, Finland) is reasonable even by the US standards, whereas the core Eurozone countries – Germany, France, Italy and the Low countries – remain sluggish. On the other side, the competitiveness within the Eurozone area (measured by the unit labor costs) of Germany – and to a lesser degree of France and the Low countries – improved markedly, whereas Italy, Spain, Portugal and Greece appear to lose ground rather rapidly.

Consequently, the monetary policy of the ECB is becoming controversial and is facing increasing resentments across the member states – most pronounced in France and Italy.

Under these circumstances, it is not inconceivable that some (especially Mediterranean) Eurozone member states, faced with a declining competitiveness, rising fiscal pressures and a political deadlock as far as reforms are concerned, may consider some form of a re-introduction of the domestic currencies.

This step is not imminent, but it is certainly not impossible and may not actually be too far in the future.

Could the EU survive a collapse of the Eurozone area? Perhaps, but in what form?

THEORY BEHIND THE CONCEPT OF THE EUROZONE: OCA AND ITS CRITICS

The inquiries into the characteristics and economic properties of single currency areas encompassing more than one national economy begun with the seminal work of Mundell (1961). His work was extended by McKinnon (1963), Kenen (1969) and later, especially in 1990's, by a large number of other authors.

The initial analysis of 1961 was, however, significantly modified by the Mundell himself (1973). Another seminal work, analyzing the choice between an international and the national money from a somewhat different viewpoint than Mundell's "optimal currency areas" approach, is that of Fischer (1982).

Today, the bulk of the work on the multinational currencies and their economic pros and cons is known as the Optimal Currency Areas (OCA) approach, honoring the title of the Mundell's pioneering work.

The underlying problem for a country in deciding whether or not to join a common currency area – encompassing presumably more than one national economy – stems from the fact that by joining a transnational currency block, a country looses two out of the three basic macroeconomic policy tools – the monetary autonomy and the exchange rate.

The question then is: Being left with the one macroeconomic tool only (the fiscal policy) – but with the full panoply of microeconomic policies – what are the conditions under which forming a common currency area is an optimal policy step?

The OCA theory (in its "classical" version) concludes that the forming of a common currency area (a currency union) will be desirable if:

(a) All members of the union face common – i.e. the symmetric – shocks and the asymmetric shocks (i.e. the shocks experienced by only few members, not the union as a whole) are limited both in time and duration.

The gains from the currency union are then enhanced if, in addition to a):

(b) A group of countries is closely integrated economically, with unrestricted mobility of goods, services, capital and labor among them; and:

(c) Goods and services markets, labor markets and capital markets both within the individual countries and across the union are flexible at the microlevel. That includes the formation of new businesses.

The reasoning is as follows: A common currency brings gains from the expanded trade (Baldwin 2006) and an improved allocation of resources. Trade expands due to a reduction of transaction costs (no need to shift between currencies), an increased transparency and comparability of both costs and prices and the elimination of the currency risk. The last two phenomena, together with an unrestricted capital mobility, then improve the allocation of capital, leading to a higher productivity and the faster economic growth.

In a case of a symmetric shock, like the increase in energy prices which affects simultaneously all members of a currency union, the common monetary authority can react in the interest of all members.

In contrast, if shocks are asymmetric – for example a negative demand shock which affects one country only – the common currency will not be optimal. Assuming that b) and c) do not hold perfectly, both output and employment in the affected country will decline. Lacking the ability to change either relative prices (via the exchange rate depreciation) or real wages (via an inflation) the only options left are either a fiscal expansion or microeconomic reforms aimed at the improving markets in the directions b) and c) above.

However, the ability to use fiscal tools may be limited in the currency union by the need to provide a fiscal stability for the common monetary authority and/or by the fast growing and eventually unsustainable debt levels if the shocks are of a longer duration. And the micro-oriented reforms often face a public resistance.

Hence, the "classical" OCA theory concludes that if a country faces dominating asymmetric shocks, it should preserve its own currency – i.e. to preserve the options of the monetary and exchange rate policies.

The OCA theory was later modified by Robert Mundell himself. In his 1973, article he analyzed two additional aspects of monetary unions in the context of the OCA theory.

First, he pointed out that a currency union, by eliminating (with the finality) the exchange rate risk, facilitates the cross-national asset diversification. Such a diversification then mitigates the impact of asymmetric shocks on the single country, making the desire for country's individual monetary and exchange rate policies less pressing.

Second, he pointed out that in reality, they are often the monetary and exchange rate policies reacting disproportionately to even small transitory disturbances which are the major source of asymmetric shocks.

Hence, this second Mundell approach (dubbed Mundell II by Ronald McKinnon (2004)) posits that a membership in the currency union can be optimal for a country even in the presence of the asymmetric shocks, provided that an asset diversification facilitated by the currency union offers a sufficient "income and wealth insurance" and when the individual exchange and monetary policies are the major source of asymmetric shocks. The latter is of course more important the more integrated is the market of the affected country with other countries – (members of the currency union).

On the opposite side, Fischer (1982) pointed out the importance of the domestic currency not only for the conduct of domestic exchange and monetary policies, but for the fiscal policy as well. Countries prone to a deficit financing – for whatever reason (an excessive social spending for the political gain, an inefficient tax collection, rising expenditures in the environment of a sluggish growth due to exogenous (demographic) factors etc.) may prefer to preserve the domestic currency for the purposes of collecting the seigniorage. (Let us remember that if the budget deficits are consistently in the area of 3–4% of GDP, a seigniorage revenue of only 1% of GDP is of an importance.)

The recent economic research developed several modifications of the OCA theory. Of these, probably the most important is the application of the "commitment vs. discretion" approach as elucidated, for example, by Paul de Grauwe (2005).

In simple terms, this approach points out that if a country is prone to discretionary monetary and exchange policies which are then themselves sources of asymmetric shocks (like in Mundell II above), then both this country and its close economic partners may benefit from the "commitment" provided by the common currency (and hence the common monetary and exchange policies), the remaining asymmetric shocks notwithstanding.

Other important modifications of the OCA theory concern the recognition of the very important role played by the economic structures (and their differences) in the countries participating in a monetary union, including the different stances in fiscal policy.

Specifically, the issue of the different degrees of the integration of different economic sectors in a monetary union is gaining an increasing attention. For example, if the mobility of labor is much less compared to the mobility of capital and the market integration excludes the services sector, then the possibility of differential inflations and differential wage developments arises. If the capital remains mobile (i.e. the nominal interest rates tend to be equilibriated across a monetary union), then the producers in different countries will face both different real exchange rates and different real interest rates. Finally, the segmented labor markets imply the possibility of the differing dynamics in the unit labor costs.

Theoretical consequences of such a dynamics are the rising divergences between the monetary union member countries, affecting both their relative growth performances and competitiveness.

Lacking any other macroeconomic policy tool, the governments of the "falling behind" countries tend to rely on the fiscal tools to rectify the situation. But such a behavior just introduces another set of asymmetric shocks into the system. The calculation of costs and benefits of the monetary union becomes increasingly distorted. That affects both the policies of the central monetary authority and the internal cohesion of evolving common markets.

OCA AND EUROZONE

The EMU (Economic and Monetary Union) – the treaty which established the common European currency Euro – is considered by many the one of the EU's finest achievements. In the words of Wim Duisenberg (the first President of the European Central Bank): "The Euro is much more than just a currency. It is a symbol of European integration in every sense of the word" (quoted from Tilford 2006).

However, it is necessary to recognize that Euro and its existence today is much more the result of the political will to advance the European integration than the economic logic.

The collapse of the Soviet Empire and the unification of Germany in 1990 established the new political reality in Europe. In addition, it was clear that in this new reality, the US commitment to the transatlantic relationship – and hence the US leadership role in Europe exercised more or less effectively since 1945 – was weakening.

European political leaders suddenly faced the new and rather unexpected situation. Germany, already the strongest European economy, was becoming stronger. Many feared that the new unified Germany will simultaneously become stronger and will move its attention and interests away from Europe and toward the expected new opportunities in the East. And the weakening US engagement in Europe indicated the possibility of a renewal of the intra-European instabilities and rivalries of the sort which torn the continent apart in the first half of the 20^{th} century.

(Few people remember today that it was the US policy under the leadership of then president George H.W. Bush who strongly supported then West German chancellor Helmuth Kohl in his push for the German unification when the opportunity rather suddenly and certainly unexpectedly presented itself in 1990. At the same time, other European leaders like the former French President Mitterand and the powerful British interests represented by the former trade minister Nicholas Ridley actually opposed "the rush to the unified Germany".)

The political response of European leaders to this new reality was twofold. On the one side, they aimed at the deepening of the European political and economic integration. The result of this effort was the so-called Maastricht Treaty. Here the concept of the Economic and Monetary Union was formally established and its basic characteristics defined. Those included the goal of the common currency (later – and today – known as Euro) and the commitment to further deepen the processes of economic liberalization and the removal of the barriers preventing the (newly renamed) European Union from becoming a single market.

The German commitment to the Maastricht principles, especially to the creation of the new pan-European currency (Euro), was seen as especially significant. In the German eyes this latter commitment (and, indeed, the abandonment of their vaunted DM) constituted the clear expression of the German desire to anchor it in the – preferably integrated and unified – new European political and economic realities. And, indeed, these sentiments toward the "new Europe" were shared by the leaders of the other EU countries as well.

On the other side, the European leaders committed themselves to the expansion of the new EU to the east. This process – inevitably slower compared to EMU – resulted in the admission of 10 new member states into the EU in May 2004 and other two new members (Bulgaria and Romania) joined in January 2007.

To facilitate this dual process of deepening and broadening, the EU changed and adjusted its internal organization and functioning, as expressed by the treaties of Amsterdam (1997) and Nice (2000). And it was expected that this process will culminate by the adoption of the new, unprecedented "European Constitution" in 2005–2007 period.

The EU constitution, of course, was derailed by the French and Dutch referenda in the late spring of 2005. This certainly leaves the European integration process incomplete. But, perhaps more importantly, the attention inevitably shifts back to the dynamics (and survivability) of the EMU.

Indeed, one cannot overemphasize the fact that the whole process of the European integration from the 1990 onward was driven first and foremost by political and security considerations. Economic considerations and analysis, albeit not unimportant, took decidedly the second place.

Indeed, most economists never considered the EU (including both the EU-12 – the 12 countries which eventually formed the Monetary Union (15 countries today with the addition of Slovenia January 1^{st}, 2007 and Malta and Cyprus in 2008) and the broader concepts of the EU-15 or today's the EU-27) to be the OCA. For details of this analysis see Bayoumi and Eichengreen (1997), DeGrauwe and Vanhaverbeke (1993) and numerous others.

In their analysis, economists pointed out to the various realities within the EU which are at odds with the OCA criteria. In the static sense, in 1980s and 1990s Europe was still the subject of sometimes significant asymmetric shocks. European labor markets remained segmented and regulated, with a limited mobility both within and between the countries. The financial sector remained segmented too, with different regulatory and supervisory practices in the individual countries. Tax policies differed between the countries as did the overall fiscal stance and the preferences for inflation.

On the positive side, the product markets were becoming more integrated and hence more competitive across the EU, albeit even here significant domestic regulatory obstacles remained, especially in the area of a new business creation.

However, by taking a dynamic view, some economists and, more significantly, the European Commission as such, were becoming more optimistic. They often concluded that even if the EU may not be the OCA currently (i.e. in the mid 1990's), it is on its way to become one in the not so distant future.

In the seemingly all important areas of symmetric vs. asymmetric shocks, some studies (Artis, Zhang 1995) indicated that European business cycles became more synchronized in 1980s and 1990s. That would indicate the fading away of the most important "exogenous" source of asymmetric shocks.

In addition, the major asymmetric shocks of 1990's (including the currency crisis of September 1992) could be clearly traced to the German policies in the aftermath of the unification and/or (especially in Austria and Finland) to the effects of the disintegration of the Soviet Empire. Obviously, such events were unlikely to be repeated in the future.

The remaining asymmetric shocks were often traced to the domestic monetary policies trying to respond to the short term negative effects of the fiscal consolidation. Such policy actions would be obviously impossible in the common currency area.

It was expected that the common currency will be a major boost to the financial sector cross border consolidation and integration. Moreover, the trade and hence the competion and integration in product markets should be further enhanced.

Labor markets, albeit somewhat liberalized, remained rigid and regulated, with a limited cross-border mobility. However, this phenomenon was often ascribed to language and cultural barriers.

Finally, especially the second half of 1990's witnessed a significant fiscal consolidation and the improvement of the fiscal discipline across all the EU members. This phenomenon was enhanced by the conclusion of the Stability and Growth Pact (SGP) in 1997. It was assumed that the SGP will provide both the fiscal underpinning and a necessary fiscal stability to the common currency concept.

Hence, whereas it was recognized that the Eurozone is not the OCA, the advent of the common currency in 1999–2001 period was greeted with optimism. European integrationists had high hopes that, with the processes in place and the additional restrictions and incentives provided by the existence of the common currency, the Eurozone will relatively quickly develop into the closest approximation of the multicountry OCA.

EUROZONE 1999–2006

This optimism soon proved to be rather misplaced. Indeed, the launch of Euro went smoothly both on the business and the retail-consumer sides. By July 2001, the former domestic currencies in the 11 original members of the Eurozone (Greece was accepted

Table 1. Real GDP growth annual rates 1999–2005

Country	1999	2000	2001	2002	2003	2004	2005
Austria	3.4	3.5	0.8	1.1	1.2	2.6	2.0
Belgium	3.1	3.7	1.2	1.5	0.9	2.4	1.5
Finland	3.9	5.0	2.6	1.7	1.8	3.5	3.3
France	3.0	4.1	1.8	1.1	1.1	2.0	1.2
Germany	2.0	3.2	1.2	0.1	–0.2	1.6	1.0
Greece	3.4	4.5	4.6	3.8	4.6	4.7	3.7
Ireland	10.7	9.2	6.2	6.2	4.4	4.5	4.7
Italy	1.9	3.7	1.7	0.3	0.1	0.9	0.1
Netherlands	4.0	3.5	1.4	0.1	–0.1	1.7	1.1
Portugal	3.9	3.9	2.0	0.8	–1.1	1.2	0.4
Spain	4.2	4.4	3.5	2.7	3.0	3.1	3.4
Eurozone	2.8	3.9	1.9	1.0	0.8	1.8	1.4

Source: OECD

only in 2004) ceased to circulate and the Eurozone economy became fully "Euroized".

However, as indicated in Table 1, the economic growth slowed down significantly after 2001, as did the growth of the total factor productivity (Table 2). In contrast, for most of the Eurozone countries inflation remained within or close to the stated goal 0–2%, as elucidated by the European Central Bank (ECB) (Table 3). (Recently, the ECB changed its statement regarding the desired inflation for the Eurozone as a whole to: "close to, but below 2%".)

Table 2. Growth in total factor productivity1995–2000 compared to 2001–2005

	1995–2000	2001–2005
Austria	1.7	0.2
Belgium	1.7	0.3
Denmark	1.4	0.3
Finland	3.3	2.0
France	1.4	0.5
Germany	1.3	0.6
Greece	1.9	1.8
Italy	0.2	–1.2
Ireland	4.4	2.0
Netherlands	0.6	0.2
Portugal	1.0	–0.3
Spain	–0.3	–0.5

Source: OECD

In contrast to inflation, the fiscal performance deteriorated significantly for all large countries except Spain (Table 4). Fiscal performance of smaller countries (except Portugal and Greece) is comparatively much better. In addition, being unable to enforce the SGP – the basic fiscal rule of the currency union – the European Commission modified the pact significantly in 2005. However, for many observers this modification is equivalent to a de facto SGP abandonment.

As far as the continuing processes of internal product, services, financial and labor markets liberalizations are concerned, the results are mixed. Whereas the liberalization and opening of products markets to a cross-Eurozone (and the EU) competition continued apace, the original "service directive" was abandoned. This directive, designed to open the markets in services (over three quarters of the EU economy) to a vigorous cross-border competition was replaced by a much watered down version which preserved much of the existing segmentation and protection of national services markets.

Integration of financial services continued, albeit slowly. It is true that capital flows within the Eurozone and the EU as a whole are fully liberalized. Banking sector (which is still the dominant form of the European finance) competition increased via both domestic and cross-border mergers and the increased cross border lending activities. (This is somewhat obvious, but a significant consequence of the existence of a common currency.) On the other side, the equities and fixed income securities markets still remain segmented, with a little progress toward an

Table 3. Consumer price inflation average annual rates 1999–2005

Country	1999	2000	2001	2002	2003	2004	2005
Austria	0.6	2.4	2.6	1.8	1.4	2.1	2.3
Belgium	1.1	2.6	2.5	1.7	1.6	2.1	2.8
Finland	1.2	3.4	2.6	1.6	0.9	0.2	0.9
France	0.5	1.7	1.6	1.9	2.1	2.1	1.7
Germany	0.5	1.5	2.0	1.4	1.1	1.7	2.0
Greece	2.6	3.2	3.4	3.6	3.6	2.9	3.5
Ireland	1.6	5.6	4.9	4.7	3.5	2.2	2.4
Italy	1.7	2.5	2.8	2.5	2.7	2.2	2.0
Netherlands	2.2	2.6	4.2	3.3	2.1	1.2	1.7
Portugal	2.3	2.9	4.4	3.6	3.3	2.4	2.3
Spain	2.3	3.4	3.6	3.5	3.0	3.1	3.4
Eurozone	1.2	2.2	2.5	2.2	2.0	2.1	2.1

Source: Eurostat

integration of the rules, regulations, trading practices etc. (Potentially important and certainly positive is the recent (November 2006) decision of the European exchanges to reduce simultaneously the trading fees. The actual impact and the practical implementation of this decision still remain to be seen.)

The liberalization of labor markets and the improvement of labor mobility and the flexibility both within the individual countries and across the Eurozone are considered by many economists a basic condition for both the acceleration of the economic growth and the reduction of a persistently high unemployment. In this sense, it is one of the keys for the establishment of the Eurozone as the OCA – and hence for the lasting success of the EMU.

However, the labor market reforms which seemed to be gaining momentum in the run up to the introduction of the Euro and its immediate aftermath came recently to a standstill. (In this context, one should mention that the process of ageing which is very pronounced in the Eurozone and which tends to reduce the effective labor supply may itself provide for the increased labor market flexibility if it leads to an excess demand for labor. For the interested reader, the detailed analysis of the market reforms dynamics can be found in Duval and Elmeskov, 2005.)

The important factor for the economic cohesion of the Eurozone – i.e. whether the Eurozone develops into the OCA or if it will encounter increasing problems – is the dynamics of the internal competitiveness. That is, large and growing divergencies in the internal competitiveness are equivalent to an increased frequency and duration of asymmetric shocks.

And it is in this area – in addition to a fiscal deterioration – where the development is the most worrisome. Things do not seem to be too serious if we use the conventional definition of the real exchange rate as the measure of competitiveness, as long as the inflation rates among the major Eurozone countries remain closely together.

A somewhat different picture emerges when we look at the dynamics of the unit labor costs (Table 5) and the current accounts (Table 6). (Indeed, the balance of payments measures – like the current account – have a little economic meaning within the monetary union. However, in the context of our discussion, the current account dynamic is indicative of the dynamics of trade flows within the EMU. And that certainly reflects the dynamics of the internal competitiveness.)

The numbers in Table 5 indicate that compared to the pre-Eurozone period, unit labor costs somewhat declined or remained stable in Austria, Finland, Germany and Ireland. In the same time, the unit labor costs significantly (over 20%) increased in Italy, Netherlands, Portugal and Spain. The remaining countries are in the middle, with the unit labor costs increasing between 6% and 13%.

In the current account area (Table 6), there is a significant improvement for Austria and Germany and the significant deterioration for the Portugal, Spain and Greece. Again, the other countries are in the middle, with the current account generally worsening from mild surpluses to accelerating deficits.

Finland, Ireland and Netherlands appear to be outliers. In the Finnish and Irish cases, the current account worsened despite the good performance in

Table 4. Public deficits as % of GDP 1996–2005

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	−4.0	−2.0	−2.5	−2.4	−1.7	0.1	−0.4	−1.4	−1.3	−1.9
Belgium	−3.7	−1.9	−0.7	−0.5	0.0	0.6	−0.1	0.0	−0.1	−0.1
Finland	−2.9	−1.3	1.6	2.2	7.1	5.2	3.9	1.6	1.3	2.7
France	−4.1	−3.0	−2.6	−1.7	−1.5	−1.6	−3.2	−4.2	−3.7	−2.9
Germany	−3.3	−2.6	−2.2	−1.5	1.3	−2.8	−3.7	−4.0	−3.7	−3.3
Greece	−7.4	−4.0	−2.5	−1.8	−4.2	−3.7	−3.8	−4.6	−6.9	−4.5
Ireland	−0.1	1.4	2.3	2.4	4.4	0.8	−0.4	0.2	1.5	1.0
Italy	−7.0	−2.7	−3.1	−1.8	−0.9	−3.1	−3.0	−3.5	−3.5	−4.1
Netherlands	−1.5	−0.9	−0.6	0.7	2.3	−0.3	−2.0	−3.2	−2.1	−0.5
Portugal	−4.6	−3.4	−3.0	−2.7	−3.0	−4.3	−2.9	−2.9	−3.2	−6.0
Spain	−4.7	−2.9	−3.0	−0.9	−0.9	−0.5	−0.3	−0.1	−0.2	1.1

Sources: Tilford (2006)

the unit labor costs area, reflecting most likely the above Eurozone average economic growth. The Dutch case is somewhat puzzling unless we assume that the original conversion rate of the former Dutch gulden into Euro was strongly undervalued. That would explain a strong Dutch current account performance, the significant increase in the unit labor costs notwithstanding.

The discussion of the dynamics of both the unit labor costs and the trade flows (current accounts) indicates significant asymmetric shocks within the Eurozone. And what is perhaps more worrisome is that it hints on the developing North-South fissure in the fabric of the Eurozone.

The discussion in this part can be concluded by stating that it is rather unlikely that during the first seven years of its existence the Eurozone came closer to being the OCA. In fact, the evidence points out in the opposite direction – i.e. that today the Eurozone is probably further away from being the OCA than it was in its inception in 1999.

Indeed, there were positive developments. Product markets became more integrated and the cross-border trade between the Eurozone members in-

Table 5. Unit labor costs 1999–2005 (Euro based, 1998 = 100.0)

Country	1999	2000	2001	2002	2003	2004	2005
Austria	97.5	91.1	90.2	90.9	90.7	88.8	89.1
Belgium	100.6	101.0	101.8	102.9	103.8	104.4	106.7
Finland	98.3	93.4	99.9	98.4	98.4	98.6	100.4
France	101.2	102.0	104.5	107.4	108.9	109.9	111.7
Germany	101.1	101.4	102.1	102.7	102.7	102.1	100.8
Greece	102.0	103.0	102.8	106.7	109.3	109.8	113.2
Ireland	91.1	87.2	80.9	82.6	84.2	86.8	93.1
Italy	102.4	102.4	105.2	111.1	115.2	115.9	119.9
Netherlands	102.7	106.2	112.2	117.7	121.5	121.3	121.9
Portugal	103.9	110.1	115.6	120.8	125.3	131.0	135.3
Spain	103.0	106.9	110.7	114.5	118.2	121.7	130.6
Eurozone	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

N.A. = not available
Source: Tilford (2006)

Table 6. Balance of the current account 1999–2005 (percentage of GDP)

Country	1999	2000	2001	2002	2003	2004	2005
Austria	–3.2	–2.5	–1.9	0.3	–0.3	0.3	1.3
Belgium	5.1	4.0	3.4	4.6	4.1	3.4	1.7
Finland	6.2	7.4	7.1	7.6	4.4	5.2	2.6
France	2.9	1.4	2.1	0.8	0.7	–0.4	–1.8
Germany	–1.3	–1.7	0.0	2.0	1.9	3.7	4.1
Greece	–4.3	–6.9	–6.2	–7.2	–7.2	–6.5	–6.1
Ireland	0.3	–0.4	–0.7	1.0	0.0	–0.8	–1.9
Italy	0.7	–0.5	–0.1	–0.8	–1.3	–0.9	–1.5
Netherlands	3.9	2.0	2.4	2.5	5.5	8.9	6.4
Portugal	–8.6	–10.4	–9.8	–7.8	–5.9	–7.3	–9.3
Spain	–2.9	–4.0	–3.9	–3.3	–3.6	–5.3	–7.4
Eurozone	0.3	–0.7	0.1	0.6	0.5	0.8	–0.1

Source: Eurostat

creased (Baldwin 2006). Some progress was made in the integration of the financial services (indeed, limited to the banking only). But the progress in integrating the service sector remains slow. And whereas some advances were made in liberalizing the internal labor markets in the individual countries, this process recently suffered some reverses. And the cross border labor mobility still remains almost non-existent.

The most negative, however, is the combination of the deterioration of fiscal positions with the increasing asymmetric shocks stemming from the changes in competitiveness.

The question then naturally arises: In these circumstances, what is the future for the Eurozone?

THE FUTURE SCENARIOS FOR THE EUROZONE

In discussing the future scenarios for the Eurozone, we should always remind ourselves that all the process of the European integration is and always was the result of the interplay between the political wishes and desires and the economic reality. And those two do not necessarily go hand in hand. More often than not, an economic price has to be paid to achieve a political goal. And, indeed, sometimes a political price has to be paid to achieve an economic goal. And it is very important to remind ourselves that the economic prices paid in this environment are highly asymmetric.

To preserve the Eurozone – and, by implication, the EU itself – it is likely that European nations will have to pay both political and economic prices (for a somewhat different, but essentially parallel analysis of this issue, se De Grauwe 2006a, 2006b).

The creation of the Eurozone and the adoption of the common currency by 11 countries in 1999–2001 period (12^{th} country – Greece – joined only in 2004) was essentially a political phenomenon (see the discussion above), with a little economic rationale to support it.

However, this "political drive" came to a halt in May–June 2005, when French and Dutch people rejected rather decisively the continuing transnational European political integration embodied in the draft of the "European Constitution". And, according to many observers at the time, this rejection signified the resistance to a further emasculation of national sovereignties and the continuing concentration of the decision-making power with the transnational authorities in Brussels and Strasbourg. Equally so, the rejection of the European Constitution signified the rising resentment toward the economic policies aimed at liberalizing the cross-border labor mobility (Netherlands) or at the continuing expansion of the single European markets (the "original" service directive in France).

Clearly, the European nations are increasingly reluctant to pay what they perceive as the rising prices of the political centralization and an economic liberalization and the integration on the Eurozone scale. But these are exactly the kinds of actions the Eurozone promoters hoped will take place in the common currency environment in order to foster the Eurozone as an OCA.

The analysis in the previous part demonstrated that – contrary to the hopes and expectations of some – the creation of the Eurozone did not accelerate the development toward the OCA. In fact, rather the opposite tendencies appear to be increasingly significant. And the discussion above indicated that these trends are unlikely to be reversed in the near to medium future at least.

So what are the perspectives of the Eurozone in these circumstances?

Three possible future scenarios can be identified. The first is basically no change in the present trends. Assuming that the current mild recovery will continue (which, of course, is highly unlikely given the fact that the "potential" long run GDP growth in the Eurozone is estimated at 1.25% (McMorrow, Roeger 2006), the fiscal pressures should ease somewhat across the Eurozone. In adddition, if the ECB continues its recent more relaxed approach to its inflation goals, the inflation differentials may increase among countries. Optimistically, that would facilitate the lower real wage and hence the lower real unit labor costs in some – especially southern – countries. In turn, this would slow down, if not arrest, the growing divergence in the competitiveness between the individual members of the Eurozone.

And, indeed, under this scenario the reform effort in the areas of labor markets, services and the financial integration would continue, albeit slowly and under the auspices of the individual countries rather than the Eurozone wide.

This scenario is probably the one most "wished to" by the individual Eurozone member countries today. After all, it preserves the status quo and does not require any potential politically painful and hence unpalatable radical reforms.

But is it realistic? In the short run undoubtedly but in the medium run (5 years or so), its underlying assumptions appear to be unduly optimistic, mirroring the failed convergence optimism which prevailed in the early months of the Eurozone creation.

Given the demographic dynamics (Commission of European Communities Green Paper, March 2006), the return to the "potential" rate of the GDP growth will renew the fiscal pressures on the individual countries, rising budget deficits and hence the public borrowing requirements and the public debt as a percentage of GDP. And even if the ECB does not react decisively to the resulting inflationary pressures (which in all likelihood it would), the structure of labor markets today, without radical reforms, mitigates against any policies of reducing real wages and hence the real unit labor costs. Hence the divergent trends in the individual countries' competitiveness among the Eurozone countries are likely to continue, perhaps even to accelerate.

The combination of a slow economic growth, a growing public indebtness and the increased divergences in the area of the competitiveness may then place some countries into a very difficult position. And this situation will only become the more complicated if the ECB (presumably under the pressure from the inflation more conscious countries) will return to a more strict monetary policy aimed at the long term achievement of its inflation goal.

Obviously, this scenario is not sustainable in the long run – perhaps not even in the medium run. Consequences of this – and the possible future options – will be discussed below, as the third scenario.

But before that, let us mention the second scenario, the "optimistic one". True, it is rather unrealistic in the current environment and circumstances, but it is certainly not impossible and hence should be mentioned.

This scenario assumes that "everything" will be done right in the economic area, even in the absence of the future political centralization.

That would imply that:

1) Substantial reforms will be undertaken in the fiscal area to balance budgets over the business cycle in each country. Implicit here is the need to substantially redesign the pensions and healthcare systems
2) Labor markets are reformed substantially to increase the flexibility and a labor mobility both within and among the individual Eurozone countries. A substantially increased competition and the efficiency of labor markets, together with the pension and healthcare reforms mentioned under 1), would enable the reversion of the trend of the diverging competitiveness and hence an increase of the productivity and the potential GDP growth.
3) Financial markets should be fully integrated – with the single regulation, accounting and supervision rules, settlement rules etc. across the Eurozone.
4) The integration of product markets should be completed and the services should be fully included.
5) The implementation of points 1) to 4) would then enable the ECB to adopt a more flexible monetary approach, further accelerating the economic growth.

Indeed, the implementation of 1) to 5) would bring the Eurozone as close to the OCA as possible, given that the Eurozone includes countries which are and will remain diverse linguistically, culturally and by their historical traditions and heritage. The common currency would become the common bond, the source of the strength, enhancing the economic growth and wellbeing.

Practically, this scenario, albeit economically feasible, is not likely. The reforms mentioned above under 1) to 5) are likely to be painful in a short run and hence politically very difficult. That applies especially to the pensions and health care reforms in the ageing society and indeed to labor markets reforms in the society used to decades of the labor and income protection. And as the recent experience with the "Service Directive" indicated, even the completion of the single market in the real sector runs into a significant political opposition. And, indeed, the strong financial special interests are prevailing today with respect to the acceleration of the financial markets integration.

The third scenario analyzes the situation where the present trends (as discussed in the previous part) continue or even accelerate.

Here it is assumed that the reform effort remains desultory. As a consequence, the economic growth stays close to its estimated long run potential (1.25% a year). A slow growth combined with only a limited progress in the area of fiscal reforms (especially pensions and health) tends to increase both budget deficits and the public debt to GDP ratios.

Similarly, due to the lack of labor market reforms, the divergent trends in the unit labor costs will continue, further opening gaps in the competitiveness between the individual Eurozone countries.

Thirdly, the financial markets will remain essentially segmented, with the continuing negative impact on the innovation and hence the economic growth (Rusek 2004.)

The combination of a sluggish growth and the rising public indebtness is the "trigger mechanism" for problems. Today, the European financial markets see the public debt of the Eurozone countries as co-equal, i.e. there are only very small differences in interest rates on bonds issued by the individual Eurozone countries.

(This trend is encouraged by the ECB who treats the individual countries bond issues as exactly the same in its refinancing operations. Many analysts see this closeness of returns on the individual countries government bonds as an evidence of a "fast progressing" financial integration. However, that presupposes that the risk associated with the individual countries bonds is the same – or at least very similar.)

However, in the environment of large differences in the public debt levels between the individual Eurozone countries (Table 7) and the diverging competitiveness, this phenomenon – which implies that markets assign the same risk to government bonds issued by different countries – may not be sustainable. Countries with a large public debt and the rising unit labor costs (i.e. the declining competitiveness) will be eventually perceived as a grater risk of default than other countries. This implies a larger interest rate differential on these countries bonds and the increasing refinancing difficulties.

The Eurozone does not have (and most likely will not have in the future) any "solidarity" fund which could help the countries in refinancing difficulties. Given the general financial stress across the Eurozone, the bilateral help (of any significance) is unlikely as well. The ECB could help in this situation, but this is very unlikely because it would imply a monetary expansion and the resulting inflation shocks to other Eurozone countries, unaffected by the refinancing difficulties.

In those circumstances, the affected country (in the present Eurozone context Italy is the most likely candidate) will have two options only.

In a crisis situation, an affected country could institute a radical fiscal adjustment, however painful the associated reforms in taxation and spending (especially pensions and healthcare) may be. Such reforms should project a long term budget surplus leading to a long term sustained reduction in the public debt to GDP ratio. Simultaneously, such reforms should imply a prolonged restriction on the domestic aggregate demand, leaving the domestic nominal wage growth below the Eurozone wide inflation, which would facilitate a decline in the real unit labor costs and hence the improving competitiveness.

To prevent a significant rise in unemployment as the consequence of these restrictive policies, labor market reforms increasing significantly the labor mobility and employment flexibility would have to be an organic part of the adjustment and reform packages.

The second option is to abandon the Eurozone and to reintroduce the national currency. If an appropriate devaluation is made (compared to the pre-1999 "conversion rates") and the re-introduced domestic currency floats afterwards, the competitiveness could be regained in one stroke and maintained afterwards with the floating exchange rate regime.

On the fiscal side, the domestic currency means the regained seigniorage which would ease the fiscal stresses. Indeed, given the dynamics of the ageing process, some fiscal reforms would still be necessary, together with the continuing liberalization of labor markets.

However, these reforms would be much milder and hence much less painful compared to what would be needed if a country elected to stay in the Eurozone.

Table 7. Public debt as % of GDP 1996–2005

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Austria	69.2	66.5	63.9	66.3	67.2	66.9	66.9	65.5	64.9	65.1
Belgium	127.8	122.5	117.2	113.5	107.5	106.0	103.0	98.5	94.9	93.3
Finland	56.6	54.9	50.0	46.8	43.9	43.0	41.3	43.0	41.3	39.0
France	54.9	57.0	57.3	57.6	55.6	55.3	56.7	60.5	63.3	65.8
Germany	57.0	58.6	59.2	59.7	59.0	58.3	59.3	62.2	64.5	66.8
Greece	113.3	108.2	105.8	105.2	114.0	114.4	111.8	109.1	107.5	106.9
Ireland	76.0	67.6	55.5	50.2	41.5	36.0	33.3	31.4	29.9	26.7
Italy	120.6	117.9	114.8	113.7	108.8	108.2	105.5	104.2	103.9	106.3
Netherlands	71.7	67.5	63.7	60.6	54.6	50.5	49.9	51.0	51.8	52.7
Portugal	60.0	56.1	52.2	51.4	50.4	53.0	55.5	57.0	58.7	63.9
Spain	66.7	65.3	63.2	61.6	59.2	55.6	52.6	48.9	46.4	43.2

Sources: Tilford (2006)

The choice between these two options is, indeed, political. What will be chosen depends on many factors specific to the actual situation as it develops in the future. However, one cannot overemphasize the following facts:

1) Without significant reforms, the continuation of the current dynamics is likely to result in a significant fiscal crisis in one or more Eurozone countries in the near to medium future.
2) The later such a crisis occurs, the relatively more radical will have to be the solution. That is, the later the crisis occurs, the more economically painful the reforms will have to be if the Eurozone is to be preserved.
3) In such a situation, it is not unlikely that leaving the Eurozone and reintroducing the national currency may appear to be the preferred solution considering the political and social costs of staying in the Eurozone for a country in crisis.

In short, there are realistic circumstances in which at least one country (Italy) could leave the Eurozone within the next decade (but probably sooner than that).

If this happens, what will be next? The restoration of the Italian competitiveness will put pressure on the weaker countries like Spain, Portugal and Greece and perhaps even on France. The first three countries then could be tempted to leave the Eurozone as well, even if their fiscal situation is much better than that of Italy. All would then depend on whether the "Italian experiment" with the re-introduction of the national money is perceived to be successful or not.

The "core" of the Eurozone – i.e. Germany, France, Belgium, the Netherlands, Luxembourg, Austria will be preserved, seconded by the peripheral countries – Ireland, Finland, Slovenia and, eventually, Baltic Republics. This "rump" Eurozone would be closer to the OCA than the current one. But the role of Germany would increase – something which can make the remaining members (especially France) rather uncomfortable. So, back to the Maastricht drawing boards?

CONCLUSION: CAN THE EU SURVIVE?

The answer to this question is: Probably, in some form. However, the collapse of the Eurozone, if (or rather: when) it happens will increase the doubts of both the public and the objectively thinking professionals regarding the feasibility of the European project.

Europe will remain a commonwealth of nations – no more, no less. And perhaps this is right. Historically, the attempts at the European unification were made by force. And they failed to the centrifugal forces of diverse and competing national identities. Truthfully, there is no European nation, but there are European nations.

So, let us look forward to 2017. The European Union (including its past re-incarnations) will be 60. The time to retire?

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