The Euro at 20

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Since its inception in January 1999, the euro project has received much praise as well as criticism. As the currency turned 20, the Central Bank of Ireland, the IMF, and the *IMF Economic Review* jointly organized a conference on “The Euro at 20.” The conference took place in Dublin, Ireland, on June 25–26, 2018. As Managing Director Lagarde noted in her opening remarks, the event looked at the “past, present, and the future of euro area integration.” This volume of the Review features some of the work presented at the conference. Below we summarize their key contributions.

The Keynote Address was delivered by Philip Lane (Central Bank of Ireland, now at the European Central Bank). His remarks lay out the forces shaping asymmetric macroeconomic performance during the initial years of the euro, with a focus on the evolution of external imbalances. He argues that the current account imbalances observed in the first decade of the currency could not be attributed to the inception of the euro and were more likely to have been driven by the uneven effects of globalization. He then presents counterfactual scenarios to illustrate that counter-cyclical fiscal and vigorous macroprudential policies would have led to a shallower boom-bust cycle. He concludes that national and area-wide policymakers should use the improved institutional architecture to do a better job in terms of ex ante risk management and ex post crisis management.

An important way to managing risk in a currency union is through risk sharing as is well known in the Optimal Currency Area literature. The paper “Channels of Risk Sharing in the Eurozone: What Can Banking and Capital Market Union Achieve?” by Mathias Hoffmann (University of Zurich), Egor Maslov (University of Zurich), Bent Sørensen (University of Houston), and Iryna Stewen (Johannes Gutenberg University Mainz) takes a stab at this issue and documents the channels of risk sharing in the euro area before and after 2008. The paper’s empirical findings suggest that higher cross-border equity holdings and more direct bank-to-nonbank lending are associated with more risk sharing while interbank integration is not. Equity market

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integration in the euro area remains limited while banking integration is dominated by interbank integration. Further, interbank integration proved to be highly procyclical, which contributed to a freeze in risk sharing after 2008. Based on this evidence, and results from model simulations, the paper argues that direct banking integration and capital market integration are complements and that robust risk sharing in the euro area requires integration on both fronts.

The paper on “The Procyclicality of Banking: Evidence from the Euro Area” by Harry Huizinga (Tilburg University and CEPR) and Luc Laeven (European Central Bank and CEPR) confirms the importance of findings of the first paper by showing that, in the euro area, banking procyclicality can be related directly to the policy framework. Provisions for future loan losses set aside by banks are negatively related to GDP growth, i.e., they are procyclical. The study also finds that loan loss provisions tend to be more procyclical at larger and better capitalized banks. According to the paper, the procyclicality of loan loss provisions can explain about two-thirds of the variation of bank capitalization over the business cycle. Comparing provisioning procyclicality in other advanced economies, the paper finds that procyclicality in the euro area is about twice as large. It then argues that this difference reflects a larger procyclicality of provisioning in euro area countries already prior to euro adoption, and the divergent growth experiences of the euro area countries following the global financial crisis.

The paper “Immigrants, Labour Market Dynamics and Adjustment to Shocks in the Euro Area” by Gaetano Basso (Bank of Italy), Francesco D’Amuri (Bank of Italy), and Giovanni Peri (University of California, Davis) revisits a classic condition for optimal currency areas by analyzing the role of inter-regional labor mobility in absorbing labor demand shocks in the euro area and by focusing on foreign-born workers. The paper finds that the mobility of foreign-born workers is highly cyclical, while this is not the case for natives. Comparing European countries with US states, the paper finds that the population-to-employment elasticity estimated for foreign-born individuals is similar in the euro area and the USA, while euro area natives are significantly less mobile across countries than US natives are across states in response to labor demand shocks. This last result confirms that there is room for improving country-specific shock absorption through higher labor mobility in the euro area.

Another central policy question in a monetary union is the use of fiscal policy. The paper “Fiscal Stimulus in a Monetary Union: Evidence from Eurozone Regions” by Maria Coelho (IMF) estimates regional output and employment responses to federal expenditure shocks in the European Union. In particular, similar to the literature on foreign aid and growth, the paper relies on shocks to the supply of federal transfers (European Commission commitments) of structural fund spending by sub-national region as instruments for annual realized expenditure in a panel from 2000 to 2013. It finds a large, contemporaneous multiplier of 1.8, which translates into a medium-run multiplier of 4.1 3 years after the shock. Furthermore, using a novel dataset on bilateral trade between regions in the European Union, the paper finds evidence of demand-driven spillovers for up to 2 years after a shock.

Adjustment of relative prices in absence of nominal exchange rate adjustments in a monetary union is another area of high importance. The paper “Does Austerity Go

Along With Internal Devaluations?” by Luisa Lambertini and Christian Proebsting (both at École Polytechnique Fédérale de Lausanne) empirically shows that the austerity packages implemented in some euro area countries during 2010–2014 were only partially successful in generating internal devaluations. The paper finds that countries that cut spending indeed experienced a decline in nominal wages, a real exchange rate depreciation, a fall in the relative price of non-tradables and a shift of consumption toward non-tradables, whereas no such evidence is found for countries raising consumption taxes. Moreover, the paper argues that the output costs of correcting current accounts were higher than anticipated because neither policy was successful in raising exports through lower prices. Instead, current account improvements were solely driven by lower imports stemming from faltering domestic demand. Further evidence suggests that exporters absorbed lower wages through higher markups. A model with pricing to market predicts that, had firms kept their markups constant, output costs of correcting current account imbalances would have been cut by almost one half.

Given the timeliness and policy relevance of the topic, this issue also features two Policy Corner articles. The first of these articles titled “Revisiting the Economic Case for Fiscal Union in the Euro Area” is by Helge Berger (IMF), Giovanni Dell’Ariccia (IMF), and Maurice Obstfeld (University of California, Berkeley) discusses the conceptual issues raised by the evolution and architecture of Europe, and the tradeoffs involved. The study concludes that in the long run, the euro area will benefit from progressing along three mutually supporting tracks: introduce more fiscal risk sharing, helping to make the sovereign “no bailout” rule credible; complementary financial sector reforms to delink sovereigns and banks and foster capital markets union; and more effective rules to discourage moral hazard. It concludes that without decisive progress to foster fiscal risk sharing, the euro area will continue to face existential risks, setting aside the non-economics-related questions that would arise from more fiscal union.

The second Policy Corner article, “Fiscal Policy, Potential Output, and the Shifting Goalposts,” by Antonio Fatás (INSEAD, CEPR and ABFER), studies the negative loop caused by the interaction between pessimistic estimates of potential output and the effects of fiscal policy in Europe during 2008–2014. The paper argues that policymakers’ reliance on overly pessimistic views of potential output led to a large adjustment in fiscal policy. Contractionary fiscal policy, via hysteresis effects, caused a reduction in potential output that in part validated the original pessimistic forecasts and led to a second round of fiscal consolidation. The paper calls for alternative frameworks for fiscal policy that reduce procyclicality and recognize hysteresis to avoid negative loops in future crises.

We thank all the authors for their valuable contributions, and the discussants and referees for their helpful comments. We are also grateful to the Central Bank of Ireland and its staff for their hospitality.

We hope that you will enjoy reading this issue.

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