The Euro Experience and Lessons for Latin America

Carlos Hurtado

It is natural to think, and economic theory predicts, that integration in an economic zone like Europe fosters growth and development, particularly when integration refers to trade opening among countries. It is expected that openness (to trade) promotes growth and being closed (to trade) deters it. Trade theory also concludes that (trade) integration is beneficial to all countries, large and small, and that small economies are likely to benefit relatively more from integration. This note reviews the development of the European Union’s euro zone and its impacts on growth and finds lessons that can be useful for Latin America.

Growth and Convergence in the Euro Zone

Introducing a common currency as a stronger form of integration would promote growth beyond trade integration alone, because of at least one reason: improved access to financial markets. Sovereign debt denominated in euros has lower interest rates and better conditions than individual currency debt of countries from those referred to as “peripheral” in Europe. After joining the euro zone, Greece, Portugal, Spain, and Ireland could suddenly, and nearly unlimitedly, access credit markets at lower costs. Capital inflows to those countries were huge between 1999 and 2007 and boosted expenditure in various forms. Figure 1 shows how sovereign risk relative to Germany virtually vanished for all countries. Governments of today’s troubled countries could sell debt and banks could buy it very much in the same way they bought German bonds. Significant capital flows poured into Greece, Portugal, Ireland, and Spain, which we call “emerging” economies after the establishment of the euro zone. Naturally those flows facilitated major increases in domestic absorption.

Table 1 shows the evolution of per capita growth in the euro zone countries in different time periods. Growth does not accelerate after the adoption of the euro for the group as a whole, but it does for the “emerging” economies, especially for Greece, Ireland, and Spain between 1999 and 2007. In contrast, Portugal’s gross domestic product (GDP) per capita growth decelerated strongly after the adoption of the euro.

The solid growth of 1999–2007 cannot be clearly attributed to the common currency. Non-euro zone members of the European Union also did better after the euro was adopted. The performance of Denmark, Sweden, the United Kingdom, the Czech Republic, Hungary, and Poland in terms of per capita real income was slightly below the euro zone group in the years before the adoption of the euro, 1990–99, but it was significantly higher in the euro years of 1999–2007.

In that same period, there was a tendency toward convergence in the European Union (again, not exclusive to the euro zone countries). Figure 2 shows the evolution of per capita income in U.S. dollars based on purchasing power parity of the emerging countries, including some outside the euro zone—Slovenia and the Slovak Republic were outside the euro zone from 1999 to 2007—relative to that of Germany, which is arbitrarily chosen as a reference for convergence. There was a tendency toward convergence, as the GDP per capita of the
Experience of the Euro Zone Emerging Economies in the First Nine Years

As relatively small economies join the common currency zone and enjoy easier access to financial markets at lower costs and strong capital inflows, their current account deficits enlarge (or their surpluses decline). Aggregate expenditure should increase spontaneously in the form of consumption or investment, and the higher absorption would appreciate the real exchange rate. If the appreciation is not accompanied by increased productivity, the economy would suffer a loss of competitiveness in the tradable goods sector. In general, that is the path, described below from 1999 to 2007, followed by the group of emerging European economies—Greece, Ireland, Portugal, and Spain—and also of Italy and France, with some notable exceptions:

- First, all of them absorbed significant resources from abroad, ran increasing current account deficits, and experienced major GDP growth and gains in terms of employment, with the exception of Portugal, whose rate of unemployment nearly doubled in that period.

emerging economies approached that of Germany and the trend was reinforced after the adoption of the euro in 1999. However, this phenomenon is not limited to the euro zone countries. In fact, Poland, the Czech Republic, and Hungary show the same behavior toward convergence as the rest, as do Slovenia and the Slovak Republic.

### Table 1. Real per Capita GDP in Domestic Currency at Constant Prices, Euro Zone Group (cumulative rates of growth, %)

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<td>18.9</td>
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<td>2.7</td>
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<tr>
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<td>15.2</td>
<td>-0.5</td>
<td>14.6</td>
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<tr>
<td>Portugal</td>
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<td>7.6</td>
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<tr>
<td>Spain</td>
<td>23.1</td>
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<td>-5.8</td>
<td>12.4</td>
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<tr>
<td>Average</td>
<td>21.9</td>
<td>19.5</td>
<td>3.9</td>
<td>13.6</td>
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**Sources:** IMF, World Economic Outlook Database

Note: Slovenia adopted the euro in 2007 and the Slovak Republic in 2009.
• Second, aggregate expenditure generally increased in the emerging economies, but in different fashions. Spain and Ireland saw their investment expenditure increase and generally kept their fiscal accounts under control. Conversely, Greece and Portugal experienced a period of high expenditure not reflected in investment—their ratio of investment to GDP declined in 2007 with respect to 1999, especially in Portugal, and they expanded public expenditure significantly.

• Third, in both Spain and Ireland there was a major reduction of public debt, and in both countries public indebtedness appeared manageable by 2007. Contrastingly, in Greece and Portugal, public debt as a proportion of GDP multiplied by about three times between 1999 and 2007, rising to over 100 and 60 percent, respectively.

• Fourth, from 1999 to 2007, Italy and France experienced growth, a decline in unemployment, absorption of resources from abroad, increased investment, and maintained control over their fiscal accounts. By 2007, the structural fiscal deficits of Italy and France were around 2.5 and 2.9 percent, respectively, and their public debt-to-GDP ratios were comparable to those of 1999.

• Fifth, and most importantly, unit labor costs increased in all the “emerging” economies under consideration by more than 20 percentage points over German unit labor costs between 1999 and 2007, reflecting a sharp loss of competitiveness.

The Euro Zone After 2007

During the first nine years of the euro, the emerging countries developed different kinds of bubbles, which eventually burst. Credit then came to a sudden stop, and the economies stalled and found themselves with extremely high levels of deficits and debt and lost competitiveness. Figures 4–7 describe in general terms developments from 2007 until 2011.

After 2007, growth turned to stagnation and recession and the trend toward convergence was interrupted and the unemployment decline reversed. The substantial current account deficits of 2007 have been reduced, but remain too high in the troubled economies. Fiscal deficits have decreased, but are still well above the desired targets. Public debt—from persistently high levels of public expenditure and/or from assumptions of debt from the financial sector—remains above desirable levels. And, drawing from figure 3, productivity gains and/or cost reductions to date have proven insufficient to return to 2000 levels of competitiveness, relative to more advanced economies, particularly Germany.

The Policy Issues in the Euro Zone

While things went well, several drawbacks or risks of the monetary union were not apparent in the early years, but are evident today. This section discusses some of the most important issues.

Adjustment in the euro zone has been difficult and elusive, partially due to the rigidity of the fixed exchange rate. The economies, whose aggregate expenditures grew significantly for years and faced a sudden stop in terms of capital availability, are suddenly forced to reduce the real values of several variables. That is, a real depreciation. But they have to do it without a nominal devaluation, which would facilitate it. They are forced to reduce nominal values of public and private expenditure, social security benefits, debts, assets, and wages. This has been called a fiscal devaluation, and has proven to be extremely difficult to carry out.

In contrast to the case of a state within a federation, in the European Union, labor and capital do not migrate to other member states fast enough, so that the shock is not mitigated and is reflected domestically in price reduction and unemployment. Factor mobility is not as high in the European Union. Notably, the lack of expeditious migration has resulted in a coexistence of historically high levels of unemployment in the emerging economies, with historically low levels in Germany. Additionally, capital flows were substantial, but were mainly cross-border transactions of claims and liabilities, while equity has not been as mobile, so that a good part of the capital losses have been realized domestically.
to appear, there has been much uncertainty and argument around the idea of aid or rescue for the troubled countries, which has made it difficult to gain credibility from markets. The point is, different from the United States, institutionally the European Union was not and still is not prepared to deal with massive financial failures.

The absence of stronger integration, like a fiscal union, has proven to be problematic. Euro zone countries do not have a mechanism to distribute losses and wins among states, as is the case in most federations. Further, there is no solidarity among constituencies, which complicates political commitments. Therefore, the political leadership of the stronger countries finds it difficult to come up with support for the troubled countries.

The absence of common budget authority and treasury impedes fiscal coordination. National public expenditure and/or debt in the troubled countries rose to unsustainable levels, and there is no overall European authority to oversee sustainability of the aggregate. And the Maastricht agreements were loosely defined and in the end not respected.

There is no lender of the last resort. Much related to the last point, it appears that before 1997 there was an implicit belief that somehow the European Union would act as a lender of last resort. But since the sovereign risk became (suddenly) evident, and the cases of insolvency and illiquidity started
Failures of financial supervision, both in internal and cross-border operations, also exacerbated the problems. This is evident when considering the real estate bubbles and the growth of banks’ balance sheets that took place before 2008. Moreover, banks in Europe had several incentives to buy the sovereign debt of any euro zone country, because the market and the European Central Bank in its repurchase operations treated all of them equally.

**The Way Ahead**

Much of the recent literature on the European crisis includes reasonable recommendations for solutions; but it has just not been possible to come up with a credible plan to implement them. Even after the financial arrangements were made to rescue Ireland, Portugal and Greece, the situation has remained rather unstable over the past year. On more than one occasion, the yields of Italian and especially Spanish bonds have gone up to alarming levels. After a difficult election and the formation of a new government in Greece, doubts continue to arise, not only regarding its capacity to carry out the required adjustments, but also on the likelihood of remaining in the monetary union. Spain has reluctantly accepted rescue funds from the European Union, but the markets remain doubtful.

It has not been possible to design an effective strategy to move past the crisis, maybe because it is extremely difficult to get agreements and solid commitments about difficult topics, including but not limited to:

- ways to isolate (firewalls) cases of insolvency and excessive indebtedness;
- definitions of financial arrangements and backstop mechanisms to deal with them;
- financial arrangements with sufficient resources to provide a backstop signal for countries with liquidity problems (these imply clearly defined and predictable support from the European Central Bank and the European Stability Facility);
- mechanisms to assure long-term fiscal sustainability;
- a commitment toward a “minimal” fiscal Europe, enforcing the disciplines of the agreements of the “fiscal compact” and strengthening both internal and cross-border financial supervision (referred to as banking union); and
- a carefully calibrated macroeconomic strategy to exit from the crisis, given the trade-offs between the awakening of demand and the eventually needed monetary tightening to control inflation, as well as between the conditions to restart growth and the fiscal adjustment.

Even if all these and other necessary actions are successfully taken, it is expected that policy decision making will be slow, troublesome and “bumpy,” and that the European Union will experience several years of slow growth with repeated episodes of uncertainty and instability in financial markets.

Meanwhile, the individual, most troubled emerging countries—Greece, Ireland, Portugal, and Spain—are being forced, by institutions or simply by the circumstances, to undertake extremely difficult domestic reforms and measures to retake control of public finances and, most importantly, increase competitiveness, as well as other plans including: aggressive and credible plans to reduce public expenditure and increase taxes; reduction of public debt; reductions of wages, pensions, and other social welfare benefits; and reform several pieces of legislation, notably labor laws.

The euro experience provides lessons for other countries, especially for Latin America. Obviously these measures and reforms can be difficult to implement, but it is much better to carry them out in times of growth and stability—that is an important lesson of economic policy.

**Policy Implications for Latin America**

Latin America has appropriately dealt with the economic downturn and instability and its economic growth has been historically strong. However, when compared with other successful experiences, it is not as strong and does not seem to be based on solid foundations. Some of the shortcomings are detailed below:

- Growth during the last nine years (2003–11) is higher than that of Europe in both cycles, 1994–2000 and 2003–11, but it is lower than growth experienced by East Asian countries in both 1981–95 and 2003–11, and by South Asian countries (plus Israel) in 2003–11.
- By any standard, Latin America’s productivity has been lagging behind other regions. This is also suggested by the increase of GDP per person employed in Latin America in 2003–8, which is lower than in East Asian countries during 1981–95 and 2003–8, and South Asian countries in 2003–8, and Europe in 1994–2000.
- Trade measured by exports as a percentage of GDP (2002–10) is well below the world average and the East Asian economies, even though Chile and Mexico are quite high. The region’s trade as a percentage of GDP is only marginally above that of South Asian economies.
- The World Bank’s Ease of Doing Business index rankings vary in the region: rankings are generally well below East Asian economies, while some countries’ rankings are comparable to “medium table” European economies, and other countries’ rankings are similar to those of South Asian countries.
- The World Economic Forum’s competitiveness index 2011–12 is lower than those of European and East Asian countries, and, on average, it is similar to those of South Asian countries.
- The quality of education as measured by the Programme for International Student Assessment (PISA) 2009 test results is clearly lower than in Europe and Southeast Asia.
Important structural problems remain and need reform. The main lesson that can be drawn from the European experience for Latin America is that it is advisable to take advantage of the current context of growth, stability, and optimism to carry out much-needed reforms that will leave the countries adequately prepared to face a downturn in the world economy.

Particularly important are reforms to increase productivity along with appreciation of the real exchange rate to avoid losing competitiveness. Specific areas for reform include social security and labor laws, competition and bankruptcy laws, property rights, and education and judicial systems, among others.

Similarly, fiscal policies and institutions could be reformed to tackle major deficiencies.

Tax regimes and administration—including customs—face significant challenges, and expenditures need to be controlled. Moreover, some countries would benefit greatly from structural deficit rules, and there are also instances where pension reform is urgently needed. In the financial sector, it would be worthwhile to review macroprudential regulation and supervision mechanisms as well as the role, size, and contingencies of the development banks.

About the Author

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Notes

1. Because of the condition of Ireland as a tax haven, it would be better to consider gross national product (GDP) as an indicator for several purposes. Ireland’s income is somewhat overestimated by GDP in the 1990s, when many enterprises located their headquarters there.
2. Non–euro zone countries not considered here include Bulgaria, Latvia, and Lithuania.
3. Real per capita GDP grew by 28.8 percent on average for these non–euro zone countries, compared to 19.5 percent in the euro zone. The former is strongly influenced by Poland’s growth, which has been especially high over the last two decades. But even without considering Poland, the non–euro zone countries real per capita GDP did better in the first nine years of the euro.
4. The effect of loss of competitiveness due to capital inflows and real exchange rate appreciation is similar to what is commonly referred to as “Dutch disease,” where the absorption of resources comes from high prices of a certain exportable commodity and the rest of the tradables sector is “squeezed.”
5. Hurtado (2012a) presents data supporting these assertions.

References

