Introduction

The Euro at 10—Successful, but Regional

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The euro is now in its tenth year of usage, successfully performing all the functions of a currency for European citizens using it and providing price stability to the euro area.[1] The monetary union and its central bank are in the process of passing the test of a major financial crisis and have held up well so far. In spite of market commentaries and spreads contemplating the euro area's breakup, one result of the crisis has been that more countries want to join the euro area than before, not fewer.

Given its success to date, however, the euro could be more than an anchor for some participating countries and an aspiration for others. At a time when voices in China and other emerging countries advocate a multipolar monetary regime, the euro could become a currency for all of Europe or even a global currency. At a time when investors wonder about fiscal sustainability in the United States and ponder the risks of monetization, it could represent a partial alternative to the US dollar as a store of value. The papers in this volume address this issue of the euro's impact on the international monetary system so far and its potential role beyond the euro area over the next decade.

All authors started from two questions. The first was: Is the euro en

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1. A general assessment of the impact of the euro on the euro area's and the European Union's own economic performance is given in Pisani-Ferry et al. (2008), DG ECFIN (2008), and ECB (2008). An earlier assessment predicting that the euro would be successful on its own terms, but without an important global role, is in Posen (2005).

route to becoming a global currency and thus to either challenging or equalling the dollar in its reserve and leadership role? Their largely common answer is that it has already become a dominant regional currency, whose role extends to areas bordering the euro area or the European Union, but it is very far from rivalling the US dollar on a number of fundamental criteria. One can consider this a success or a failure but, more importantly, it is a fact: By all standards the euro is an overwhelming success in the European Union and its neighborhood, and by all standards it is junior to the US dollar in international monetary affairs.

The second question for all authors was: What has the global financial crisis, and the euro area policy response to it, revealed about the resilience of the euro and its international prospects? Again the largely common answer is that the existence of the euro contributed to macroeconomic stability within the euro area, and thus to stability globally, but that the crisis revealed weaknesses in the governance and crisis management capabilities of the euro area. Doubts about the euro area's ability to respond to cross-border banking problems also persist. Furthermore, the euro did little to improve the crisis response of neighboring countries in Central and Eastern Europe.

Responses to these two questions together highlight the gap between the euro's current reality and its potential. But they also highlight the regional role and responsibilities of the euro area. The euro, as a successful regional currency but not a global currency, provides stability to its current members and helps some of them ward off the effects of the crisis—and this should be a primary policy objective for euro area decision-makers. At the same time, the Eastern and Southeastern European countries tied to the euro area include some of the emerging markets worst hit by the crisis (some of which belong to the European Union and are among its major trading partners). Even if the formal mandates of the European Central Bank (ECB) and the Eurogroup (where the ministers of finance of the area meet) do not formally include it, broader stability in the region should be a major economic and political objective as well. Inability to provide it (beyond the provision of balance-of-payments assistance within the framework of the International Monetary Fund [IMF] programs) must accordingly be seen as a failure of euro area policymaking and needs to be rectified. In essence, while the crisis promoted the attractiveness of euro area membership for those within it, the euro area's limited crisis response demonstrated the defensive crouch in which European policymakers continue to treat shocks to the euro area—and thus undercut its regional importance, not to mention its positive influence.

As with many other aspects widely discussed—such as the Stability and Growth Pact on fiscal policy, the criteria for enlargement, or the insistence on ERM2[2] membership prior to euro area entry—the European

2. ERM2 is the exchange rate mechanism that links the euro and EU countries in a formal

Union's approach to monetary arrangements appears to be bound by a narrow and exceedingly formal definition of its objectives, be it monetary stability within its borders or equal treatment across candidates whatever the circumstances. This is at the potential expense of both broader stability, political and economic, over the long term and Europe's ability to address strategic challenges. The analogous focus on national responses to banking crises, when there are major two-way spillovers between the euro area and Eastern European financial systems, reinforces this tradeoff—and the air of defensiveness as though the euro's viability indeed were deemed fragile by its very guardians.

Similar concerns arise as regards the euro area's role in global monetary arrangements and their likely evolution. The facts that flight to safety by investors during the current crisis has been primarily to dollar-denominated assets and that calls by Chinese and other governments for post-dollar-dominated reserve currency arrangements have primarily focused on non-euro alternatives underscore the limitations on the global role of the euro to date. But as one of us quotes sage Rav Hillel in the opening of his paper regarding the euro's geopolitical limitations (Adam Posen in chapter 2), "If I am not for myself, who will be for me? Yet, if I am for myself only, what am I? And if not now, when?" In other words, if the euro is neither eagerly promoted nor widely adopted as the alternative to the dollar at a time when US policymakers have made arguably the greatest postwar errors and when dollar-denominated asset values and credibility have suffered the greatest losses, will it ever become a global currency? The authors in this volume expect that there will be steady increases in the euro's share in foreign exchange reserves, in financial and trade transactions, and even in exchange rate pegs and baskets in the coming years, where trade and financial linkages with the euro area grow for real-side market-driven reasons. They do not, however, expect any sudden shift to the euro as a global currency, as a result of either the crisis or fundamentals. And they are pessimistic for the long term as the weight of Europe in the world economy is set to diminish.

Does the euro's lack of global role really matter? Empirically, it is an interesting question both on its own terms of forecasting significant capital flows and as a means of testing various fundamentals as explanations of the euro's (and dollar's) relative performance. Normatively for policy, the importance of the issue is less self-evident. As Lawrence Summers puts it in the closing discussion in chapter 4, "My view is that the United States is best served by not conceptualizing itself as in competition with the euro.... To have two currencies trying to be in complete equipoise risks substantial instability, as things rush from one direction to the other. None of this is

peg to it. It succeeded the exchange rate mechanism of the European Monetary System when the euro was introduced in 1999. Membership in the ERM2 is a precondition for joining the euro area.

to say that the United States should seek to thwart the euro." Similarly, Erkki Liikanen states, "I think we, as European central bankers, should not promote the euro [into a bipolar role with the dollar], and that the euro's international role should rather reflect the economic development of the euro area." We, the editors, acknowledge this responsible view of senior policymakers and admire its freedom from nationalist cant on both sides of the Atlantic. It is no doubt correct to consider the euro primarily in terms of the economic performance of the euro area and in those terms to view it as a success.

Yet, we believe this focus is too narrow in three senses and that under the present circumstances the lack of serious discussion about the potential global currency status of the euro is reason for some concern:

- First, the fundamental factors limiting the euro's international role and usage do reveal weaknesses in the European Union's economic integration and performance, which need to be addressed (we summarize our authors' evidence from chapter 2 on this score in the next section).
- Second, the erosion of US monetary and financial leadership may well be secular and even accelerated by the current crisis, in which case, absent a globally ready euro, a vacuum in the international economic system may arise and potentially cause instability.[3] We recap below the likely developments in regional ties to the euro and in regionalization of monetary arrangements (particularly but not only in Asia) as set out by our authors in chapter 3.
- Third, as already noted, we view the insufficient response of the euro area to the crisis impact in Eastern Europe, particularly among the European Union's newer member states, as harmful to solidarity and performance within the union, if not to the European project itself.[4] It is ironic that at the very same time that euro area membership becomes all the more appealing, even for traditionally reluctant states like Denmark and Poland, the entry criteria are losing relevance: (1) the inflation criterion is becoming too easy to fulfill, and (2) the budgetary criterion is becoming virtually impossible to reach. Lack of consideration for regional spillover effects of national choices and lack of flexibility turn euro area enlargement into a mechanical exercise at a time when Europe is confronted with a strategic choice.

Drawing on the work of our authors and our own additional research, we outline some practical steps to reduce these harms.

3. The classic statement of the dangers from such an absence of monetary leadership at a time of economic contraction is given in Kindleberger (1986).

4. See also Darvas and Pisani-Ferry (2008).

Why Has International Success Been Limited?

Several reasons account for the euro's limited international success so far. The most obvious one is the dollar's incumbent status. Scholars of international monetary history have often warned that inertia resulting from network externalities makes the status of dominant international currency hardly contestable (Matsuyama, Kiyotaki, and Matsui 1993). Some have also argued that shifts in dominant currency, when they occur, take place abruptly rather than gradually, and that policy errors in the home country can provide the opportunity for a switch, if an alternative currency is available (Bergsten in chapter 4). More recent historical interpretations of the lengthy decline of the pound's role in the 20th century, among other cases, suggest however that reserve or leading currencies can coexist (Eichengreen 2005, Eichengreen and Flandreau 2008). So the incumbent role of the dollar is a less compelling argument than is sometimes suggested.

However much weight one chooses to put on the network effects and persistence of incumbent currency status, the gap between the euro and dollar in reserve portfolio holdings, in number and breadth of countries pegging (soft or hard) to them, in commodities priced in them, in share of trade invoiced in them, and in share of investment portfolios is far larger than one would expect based on the euro area's economic size and price stability relative to the US economy (Chinn and Frankel 2007; Portes, Papaioannou, and Siourounis 2006). Furthermore, all but one of the countries pegged to the euro are major trading partners of Europe whereas a large number of countries whose currency is pegged to the dollar trade with Europe as much as with the United States—if not much more as in the case of Ukraine. This is evidence of strong asymmetry.

On one measure—that of private-sector financial depth in some assets, particularly regarding international bond issuance—the euro area has roughly caught up with the United States (see Kristin Forbes' paper in chapter 2).[5] This if anything emphasizes the difficulty in explaining the gap between the euro's and dollar's global role by network externalities: If market preferences have been revealed and changes have happened on international bond markets, why not for other markets? Similarly, if bipolar monetary systems have been known to exist in the recent past, and the US relative economic performance, or at least relative policy credibility, has been damaged by the current financial crisis, then it is all the more difficult to understand why there has not been a greater shift to the euro in various channels than has been seen over the past two years.

Thus, both the euro's relatively limited global role versus what some

5. The usual Bank for International Settlements data on the relative role of the dollar and the euro in international bond markets give a distorted image of reality as they count intra-euro area cross-border holdings as international. Corrected data put euro bond outstanding second to dollar outstanding, but by a narrow margin.

simple economic factors would indicate and its limited take-up as a result of the US-initiated financial crisis (and arguably US global imbalances, at least as widely perceived) instead argue that we need a better understanding of the sources of global currency adoption. The papers in this volume provide specific reasons why the euro has not yet achieved world currency status:

- *Limited economic base*. The euro area is somewhat smaller in economic weight than the US economy (16.1 percent of world GDP at purchasing power parity exchange rates compared with 21.4 percent in 2007, according to the IMF) but more importantly, it does not have a strong growth potential. Medium-term projections indicate that absent significant enlargement or revolutionary increase in productivity trend, its weight in the world economy will shrink continuously (Posen 2004; Forbes and Pisani-Ferry and Sapir in chapter 2).
- *Financial fragmentation*. It was initially assumed that monetary integration would trigger financial integration within the euro area. In the event, Europe's financial center is London, not Frankfurt or Paris, there are several euro-denominated government bond markets instead of one, and cross-border securities trading has developed to a much lesser extent than anticipated.[6] In other words, monetary union has not driven full financial integration. This has proved workable in normal times, but the sustainability of this combination of offshore markets, national bank oversight, and euro area–wide monetary operations is questionable in the long run. During the recent crisis, governments have further realized that whatever comparative advantage some countries could have in the banking industry, an industrial specialization model might not be viable because it implied too large a banking sector for national budgets in case of the need to bail out distressed banks. This threat to the existing model of cross-border integration may lead to a return to fragmentation.
- *Uncertain governance*. Although monetary policy is centralized within the euro area, and product and capital market regulations are to some extent harmonized throughout the European Union, countries within the euro area still have different fiscal, tax, and labor-market policies. There are no prospects of centralization, so how to combine monetary centralization and fiscal/structural/financial decentralization should be a matter for consensus, but there is enduring disagreement as regards the desirable degree of coordination of national policies in these areas. Furthermore, the crisis has exposed the degree to which ac-

6. In contrast, cross-border banking and bond issuance have blossomed but are not sufficient to constitute full financial integration. Forbes, Martin, Mayer, and Liikanen in this volume all make balanced assessments of the data supporting this characterization.

countability to domestic taxpayers can trigger competing or contrasting reactions. Although somewhat fashionable in the United States or the United Kingdom, talk of a euro area breakup is mistaken, based at best on shallow comprehension of the functioning of the Economic and Monetary Union (EMU). Nevertheless, as long as the rest of the world sees the future of the euro area and its membership as partially uncertain, this will remain a limiting factor. Thomas Mayer's market view in chapter 3 of this volume depicts this perception in a very reasoned manner, emphasizing the market impact from likely intra–euro area strains of adjustment, rather than an infeasible breakup—but these market discounts are real.

- *Noneconomic limitations*. The euro area is certainly not a hard power. It includes countries with differing stances on international affairs, and there is no common foreign and security policy as yet. So long as the United Kingdom keeps its national currency, the euro area does not include the country with the largest military projection capacity in the European Union. As one of us (Posen 2008) has argued, the few nonneighboring countries that have pegged to the euro tend to be those with security ties to euro area members (notably France, the one hard power within the euro area), while a number of countries pegged to the dollar have geopolitical ties with the United States that outweigh their trade and financial linkages. In chapter 2 of this volume, Posen further contends that this noneconomic factor is a significant brake on the international development of the euro and that strictly economic rules–based treatment of crisis-hit Eastern European countries may actually weaken the euro's global role by demonstrating the limits of political commitment.
- *A discouraging stance toward a global role*. The ECB and the European Union are officially neutral as regards the international role of the euro, as Lorenzo Bini Smaghi (chapter 1) and Liikanen (chapter 4) state in this volume. However, while professing that it neither discourages nor encourages its development, as with the position taken by the Bundesbank and the Bank of Japan in the 1980s (Eichengreen 2005), the European Union has come out clearly against the de jure adoption of the euro by third countries.[7] During the 2008–09 crisis the ECB adopted a cautious approach toward the provision of euro liquidity to neighboring, de facto partially euroized countries, unlike the US Federal Reserve, which early on extended dollar swap lines to several central banks throughout the world. Clearly, the euro area does not fully see itself as a monetary hub and does not take action to become one.

7. Prior to the crisis, unilateral euroization by EU members with euro currency boards in place was prevented. The ECOFIN Council had already formally adopted in November 2000 the position that unilateral euroization is not compatible with the treaty and cannot be a way to bypass the convergence process required for euro membership.

It is not easy to delineate the role of each of these factors in the limited development of the international role of the euro. Our conclusion from the studies in this volume is that they jointly represent a significant force beyond the dollar′s incumbency offsetting the euro area′s economic size and stability.

What Are the Consequences?

Is the euro area consciously or unconsciously squandering part of the potential benefits—either to its members or to the world economy—that could be realized if the euro became a global currency? The advantages of issuing an international currency are often overestimated by observers and politicians, and an economist's first reaction is always to emphasize that the benefits of monetary unification are first and foremost domestic. It should also be recognized that being a global currency has potential costs as well[8]: As illustrated by the "conundrum" of low long-term interest rates prior to the crisis and the role of global imbalances in the crisis, the issuance of an international currency implies that the demand for securities denominated in this currency partially depends on external rather than solely domestic developments. This can affect both the exchange rate and market interest rates as has been the case in the United States. Europe's fragmented markets and uncertain governance in some way partially protect it from instability coming from abroad. As long as it is not equipped with strong enough policy institutions to respond to such shocks, this might be a blessing in disguise.

However, these considerations should not lead policymakers to overlook the potential but not always realized international benefits of issuing a world currency. Seigniorage is a second-order issue here (and the euro area actually already benefits from it since the euro is widely used in the region, including for illegal or semilegal purposes). A much more significant gain to the issuer of a global currency is that the international role of the currency contributes to increasing transactions of securities denominated in it, and thereby to the depth and liquidity of the markets for its government bonds and ultimately the demand for them. In spite of mone-

8. Bergsten and Henning in contributions to this volume question whether the United States has actually benefited on net from the global role of the dollar, with Bergsten claiming less certain dollar dominance might have led to greater discipline. We and most of our authors agree with Summers' characterization of that threat as likely to do more harm than good and believe that having a global currency does little harm so long as it is consistent with the economic fundamentals. The United Kingdom trying to maintain a global role for sterling long after the UK economy declined was indeed harmful. The euro area presents the opposite situation, however, where the global currency status is far short of its economic weight and thus of its potential stabilizing influence on the international financial architecture and on its neighbors.

tary union, government bond markets in the euro area remain fragmented and the largest one, that of the German Bund, is about one-fourth the size of the US federal bond market. For non-European residents this reduces the attractiveness of euro government assets and thereby the liquidity and depth of corresponding markets, as indicated in Kristin Forbes' paper (chapter 2). The widening sovereign risk spreads of some euro area debt issuers over Bunds during the crisis, while far smaller than they would have been absent the euro, are in part also indicative of these costs.[9] Other potential benefits to issuing a global currency include low exchange rate risk and transaction costs. As indicated by Linda Goldberg (chapter 2), trade invoicing in euros is still limited. Even France and Germany invoice about a third of their exports in US dollars, and the Asian countries almost never use the euro. Finally, the dollar remains the dominant currency for the quotation of commodities.

In the absence of the euro's exerting itself globally, countries around the world are finding monetary stability harder to come by as the dollar suffers through a relative decline (whether temporary or lasting). Contributors to this volume systematically examine the role of the euro in various regions of the world. Unsurprisingly, C. Randall Henning (chapter 3) finds that it remains modest in East Asia in spite of the roughly equal weights of the United States and the European Union in the region's foreign trade and in spite of stated intentions to move to a more balanced international system. Instead of baskets involving the euro, except perhaps the special drawing rights (SDR), Asian monetary integration has received a boost—which, though unlikely to culminate soon, adds to global fragmentation. Similarly, Maria Celina Arraes (chapter 3) finds that despite the increase in trade and investment linkages between Latin America and the euro area—and, it should be added, the emergence of Brazil as a G-20 member and world economic player—the strongest monetary relationship in the region remains with the US dollar, even beyond Mexico. Mohsin Khan (chapter 3) makes the assessment that Middle East and North Africa (MENA) and the Gulf Cooperation Council area are dollar zones and likely to remain so, in spite of trading more with Europe than with the United States. This reinforces and is reinforced by the pricing of oil and gas, as well as most commodities, in dollar terms, which may be optimizing but also increases the impact of dollar swings on the world economy.

György Szapary (chapter 3) shows that only in Central and Eastern European countries has the euro taken a dominant role, including in the non-EU member countries of Southeastern Europe. Even Russia has included the euro in its reference currency basket. Real integration in trade as well as cross-border investment—including in the banking sector—have driven this process. It would have been a shock not to see the euro

9. Part of the spreads reflects solvency concern and part liquidity premia. There is no established methodology to separate the first effect from the second.

emerge as dominant here. So the picture is one of clear regional success and global limitations. Yet that brings us back to the concern that the euro area's inward orientation if not defensive insecurity is exacerbating the divisions within Eastern Europe in ways that will ultimately be harmful to the euro area economies as well, when more assumption of at least regional responsibility would pay off. One of us (Posen) contends in chapter 2 that economic disregard may turn into politically driven monetary diversification or self-insurance.

Impact of the Crisis

Most of the preceding paragraphs could have been written before the crisis. The global financial crisis, however, has made some of the euro's strengths and weaknesses more apparent and has pointed to the need for immediate responses to the latter.

On the positive side, in 2007 and 2008 the ECB reacted to episodes of acute liquidity shortage more decisively and forcefully than generally expected. The ECB's hands-on stance was made very clear in Lorenzo Bini Smaghi's presentation at the conference, which took place at the height of the liquidity crisis (see chapter 1) and is also pointed out in the paper by Pisani-Ferry and Sapir in chapter 2. Both the Federal Reserve and the Bank of England played catch-up with and learned from the ECB's actions in this regard, and if anything the ECB benefited from being a newer central bank with a repo system better suited to today's markets.

On the less positive side, the crisis has exposed how difficult it can be for an institutional construct like the euro area to depart from fixed routes and explore new avenues in response to unforeseen problems. This was most evident in the cases of bank bailouts and the response to the widening of government bond spreads within the euro area. In chapter 2 Pisani-Ferry and Sapir contrast a "fair weather" governance regime that is based on rules and aims at predictability with the requirements of "stormy weather" governance: initiative, flexibility, and even when needed centralization (in chapter 3 Mayer uses parallel imagery of a happy childhood giving way to a troubled adolescence for the euro). At the height of the crisis in October 2008 a coordinated response to the banking crisis was found outside the normal institutional framework, but with meltdown breathing down the policymakers' necks and only through ad hoc means—including pressure from UK actions outside the euro area. The one institution intended to act flexibly because it was not bound by rules and procedures, the Eurogroup, failed to seize the initiative. This indicates the limits of existing institutional arrangements, despite decent crisis management in the worst of the crisis so far.

In addition, the euro area's response to the widening of bond spreads within it is still unclear. Country risk differentiation is natural in a union where governments remain solely responsible for their own debt. However, levels reached by the spreads in winter 2009 indicate that the possibility of a funding crisis for some euro area member states must be considered seriously. Apart from saying that they would not call the IMF, policymakers in the euro area have not clearly indicated so far how they would respond in the event of such a crisis. As Mayer points out in chapter 3, what would happen, for example, if banks of a fiscally troubled member country presented bonds dedicated to bail out these very banks to the ECB's discount window? Euro area policymakers have tried to calm markets but without being specific about the modalities and limits of potential assistance to a member government. The assumption of the Maastricht Treaty and the euro area's design was that there was no need for crisis management because, by being part of a single currency, members would eliminate the risk of national financial crisis. This may not be sufficient in situations that could arise in the context of deteriorating public finances and persistent market nervousness.

In short, the euro area has an incomplete governance problem. Among other things, for example, this leads to the bizarre result that EU members that are not euro area members are eligible for financial assistance, but euro area members are not because of the no-bailout restrictions. No European instrument could completely substitute for the IMF, especially given the reluctance of EU political institutions to impose conditionality on fellow members. But there are some alternatives short of that and these alternatives would be better than assuming that crises cannot occur within the euro area.

A Pragmatic Agenda

Our first conclusion from the analyses presented in this volume is that for the euro's international role to develop, participants in the single currency need first and foremost to act on the domestic front. Their priority should be to address the weaknesses exposed by the crisis. This requires strong action on financial integration and clarification of cross-border bank supervision, beyond that already called for in the Lisbon Agenda or in the May 2009 Commission communication on European banking supervision (European Commission 2009), neither of which will be enough to remove the limitations and thus the risks identified here. This also requires a rethinking of multilateral surveillance on the basis of lessons learned from the failure to spot vulnerabilities ahead of the crisis and the adoption of principles and procedures for crisis management—including for possible crises within the euro area.

Such improvements in euro area internal governance are a prerequisite to the necessary consolidation of external governance. The fragmented external representation of euro area membership at the IMF and other international financial institutions reveals the constraints on the euro area's ability to respond to global—and thus external—shocks. While some incumbent member states' reluctance to give up their exaggerated roles is part of the reason why consolidation of external representation has not yet occurred, we believe that there is more to it. Internal decision-making is unclear, making citizens and their member states reluctant to centralize external representation. We fear in fact that there may now be even less appetite for consolidated external representation than before the crisis. Awareness of fault lines in euro area governance, the natural, if unfortunate, political pressures to look after one's parochial interests in times of hardship, and the perception of larger member states that direct participation in the G-20 serves their interests better than lengthy negotiation to define a common position among the EU-27 all contribute to reluctance. As Commissioner Joaquín Almunia says in his contribution to chapter 1, "Current events provide a strong case for deepening coordination with the euro area...and to present a united front in international fora to better influence the global decision making process." This is indeed correct but also indicates that in the absence of progress toward the former objective, attainment of the latter may be jeopardized.

If other factors limiting the euro's global role, like the persistence of trade invoicing in dollars or the absence of hard power projection by the European Union (let alone the euro area), are beyond domestic influence, so be it. The euro area will have enough to do and sufficient benefits for itself, for the full EU membership, and arguably for the world by being the best regional currency it can be.

This brings us to our second conclusion, which is that the regional dimension has to be taken very seriously, so the euro area can do much beyond the domestic agenda. If a currency is not a successful regional currency, it does not become a global currency and an effective influence for stability, let alone one of the international financial architects. We have argued that a successful regional currency role comes with responsibilities toward countries in the region that have adopted the euro as an anchor or whose financial systems are partially euroized. That requires playing beyond the script as envisaged by the treaty, considering the situation not just of full club members but also of shadow members, honorary members, and future members. The euro area has to confront this reality. So far the euro area has taken some initiative to stabilize specific countries—mostly in support to IMF programs—but it has not recognized the full extent of its regional responsibilities.

In the near term, the Eurosystem needs to provide more aggressive support to the euroized and near-euro EU member states. This would start with extending swap lines in euros to a number of emerging markets, as the Federal Reserve has done, and, as discussed by Henning, has even been strengthened in East Asia. The euro area is now in a position of sufficient stability and size to no longer fear being disrupted or left hanging by such measures. The Eurosystem could also begin to accept non-euro assets for repos, with appropriate discounts, for countries that are integrated with the euro area financial system but have been prevented from euroizing. There remains too great a risk of financial crisis responses in euro area countries with financial headquarters disadvantaging banking systems in Eastern Europe, although to date it has not been a major problem (both the Commission and the European Bank for Reconstruction and Development have played constructive ad hoc roles in forestalling such issues). The euro area should coordinate with Eastern European governments on crisis responses concerning such things as deposit guarantees and lending limits that have potentially major spillovers.

An immediate agenda is for the euro area to provide a clearer and more sensible path to euro membership for EU members in Eastern Europe. Note that we said more sensible, not easier, path. At a minimum the Commission and Eurogroup should offset the ways in which the crisis has made euro accession more distant even for countries with good policies. While the Maastricht criterion on inflation is now interpreted to exclude calling for deflation,[10] when that is the average of the three lowest inflation rate economies (as it would be today), surely setting a floor for the inflation criterion at no lower than the ECB's long-term goal of near 2 percent harmonized index of consumer price inflation would be sensible. While some measure of exchange rate stability vis-à-vis the euro must be a prerequisite to euro area entry, surely it would make sense to disregard the sudden huge depreciation of all Eastern European currencies in fall 2008—irrespective of their economic fundamentals—rather than resetting the ERM2 clock to zero (or even keeping the waiting period so long).[11] An analogous case can be made with regard to the debt and deficit criteria, given (as Pisani-Ferry and Sapir point out in chapter 2) that even paragons of fiscal virtue like Ireland and Spain have seen their positions completely erode following their busts. In chapter 3 Szapary notes that many new member states will now have challenges meeting the fiscal deficit and long-term interest rate criteria for reasons beyond their control.

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10. When calculating the average inflation of the three best performers among the EU-27 as called for by the treaty, countries whose inflation is negative are counted as having zero inflation. In a deflationary environment this implies that the reference inflation rate is zero instead of being negative (we are grateful to Marco Buti of DG ECFIN for clarifying this point). The fact of this decision, which is not explicit in the treaty, shows that there is more room for sensible reinterpretation and evolution than commonly acknowledged, as was seen with the 2005 reform of the Stability and Growth Pact.

11. Goldberg reminds us in her contribution to this volume that "If the periphery countries use the center country's currency on their bilateral international trade transactions, they are more sensitive to the center country's monetary policy, and their own national monetary policies are less effective at influencing prices in local markets." In other words, euro area monetary policy is responsible for a meaningful share of outcomes in EU member economies that are "only" trade integrated, absent formal monetary arrangements.

Behind our specific policy suggestions, the euro area has a broader principle and approach to adopt regarding its Eastern European neighbors. We believe that it is harmful to European solidarity, not just to the euro's global role, and eventually to European economic and political stability over the medium term to set member state against member state in trying to distinguish themselves. The Czechs insist they are not the Hungarians, the Estonians that they are not the Latvians, the Bulgarians that they are not the Romanians, and that each must be treated accordingly—and the euro area's present approach encourages this behavior. In a narrow rules-based mindset, such a separating equilibrium seems to make sense, for all that matters are the membership criteria. And indeed competition for performance has more than once been a powerful recipe for virtuous convergence. As we have argued, however, in a crisis such inflexibility will lead to bad outcomes.

In the run-up to the euro's creation 10 years ago, southern EU member states undertook many short-term measures to get through the hoops, strictly speaking, for euro area entry. The result has been that those same countries have continued to suffer from justified doubts about their ability to undertake real adjustment and control their fiscal situations, despite euro area membership. So the premise that enforcing rules, even under the guise of IMF conditionality, will force Hungary or Romania to see the error of their ways is empirically suspect and at best highlights the hypocrisy of enforcement within euro core versus periphery. At worst, the euro area would be pushing a number of Eastern European member states down a very dangerous path economically and politically, which would hurt the competitiveness and stability of their neighbors as well. The euro area needs to step up to its regional responsibilities and can do so only by taking a long-term view of what the region needs, rather than going into a defensive crouch of sticking to the fair weather rules.

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