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**Article**

## The World in 2016: A Perspective for the Wider Europe

Vierteljahrshefte zur Wirtschaftsforschung

**Provided in Cooperation with:**

German Institute for Economic Research (DIW Berlin)

*Suggested Citation:* Gros, Daniel (2006) : The World in 2016: A Perspective for the Wider Europe, Vierteljahrshefte zur Wirtschaftsforschung, ISSN 1861-1559, Duncker & Humblot, Berlin, Vol. 75, Iss. 2, pp. 79-90,  
<https://doi.org/10.3790/vjh.75.2.79>

This Version is available at:

<https://hdl.handle.net/10419/99434>

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# The World in 2016 – A Perspective for the Wider Europe

By Daniel Gros\*

## 1 Introduction

The theme of this contribution is how Europe will evolve over the next decade. The key message is that over this decade Europe will be busy digesting the 12 members that joined in 2004 and 2007. Digesting in the context means that the new members will only gradually be incorporated and participating in important areas, such as labour mobility, EMU and Schengen.

Another challenge for the next decade is for some of the member countries of the euro area to adjust to the loss of the exchange rate as an adjustment instrument. This is an even more basic challenge for the EU because the enlargement challenge cannot be answered if the euro area falls apart because its member countries cannot adjust to the constraints of a stable common currency.

This contribution deals with these two basic challenges for the EU over the next decade. It starts with a brief review of forces that might threaten the euro area. The second section then details some crucial facets of the enlargement challenge.

## 2 Will EMU Survive the Next Decade?

What framework can ensure the stability of economic and monetary union? Before the final step was taken in 1998–99, many, including senior policy-makers, argued that monetary union would not be stable and could not survive in the long run if it were not accompanied by more economic flexibility and closer political union. The former was seen as necessary to allow better adjustment in the absence of country-specific interest and exchange rate changes; the latter was seen as necessary to establish democratic legitimisation for a stability-oriented monetary policy and the conditions for a fiscal policy consistent with this conduct of monetary policy. Without closer political union and the emergence of a European public will, it was feared that the European Central Bank could come under irresistible pressure from national governments to conduct a softer monetary policy and that fiscal policy would lack the necessary discipline to ensure price stability in the long-run. In other words, governments would pursue their narrow interests at the expense of the public good of price stability.

As preparations for EMU progressed and prospects for closer political union faded into the background, it was argued that the statutory independence of the ECB would shield it against political influence. Moreover, to ensure a minimum of fiscal policy discipline, the Stability and Growth Pact was agreed at the Amsterdam European Council meeting in 1997. EMU then started as planned without any noticeable step towards political union. (The constitutional Treaty agreed after a long process, which included the year long Con-

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vention on the Future of Europe and protracted negotiations among member states governments, was supposed to represent such a step. However, it failed the test with French and Dutch voters in 2005.)

## 2.1 The Challenge So Far: Slow Growth

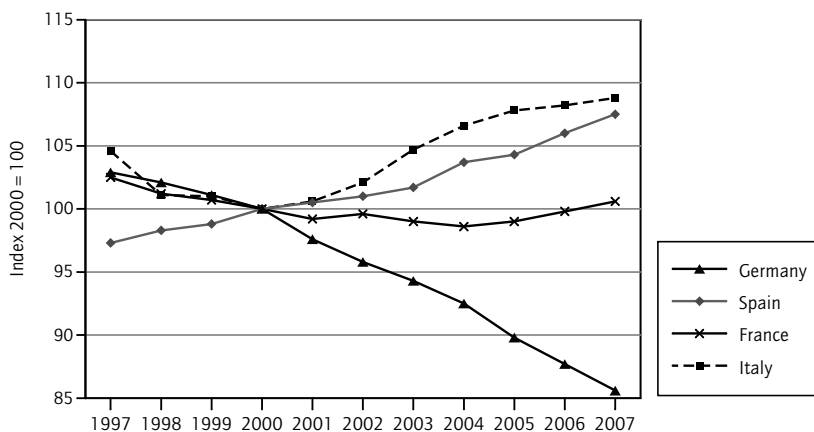
During the very first few years of EMU, neither the degree of economic flexibility, nor the stability of the fiscal framework or the independence of the ECB was severely tested. However, as growth faded, tensions increased. Optimists hoped that economic tensions would eventually break the existing structural rigidities. Unfortunately, it seems that the rigidities are prevailing while fiscal policy discipline was abandoned, especially by the large member countries way. However, as long as slow growth is a common phenomenon it might increase general dissatisfaction with the economy, but it does not threaten the euro area.

## 2.2 The Forthcoming Challenge: Intra-Area Divergences

Slow growth is not the only risk factor for EMU, however. The next half decade should see the emergence of another factor, namely increasing growth differentials among EMU member countries, which so far had remained rather limited and at a stable level. The weighted standard deviation of the growth rates of the euro area members has barely moved between 1999 and 2005 as the large three euro area members tended to move broadly together. The two main laggards in the eurozone were Germany and Italy, with France falling somewhere in between them and the more dynamic smaller countries. However, the apparent similarity between developments in Italy and Germany has been super-

Figure 1

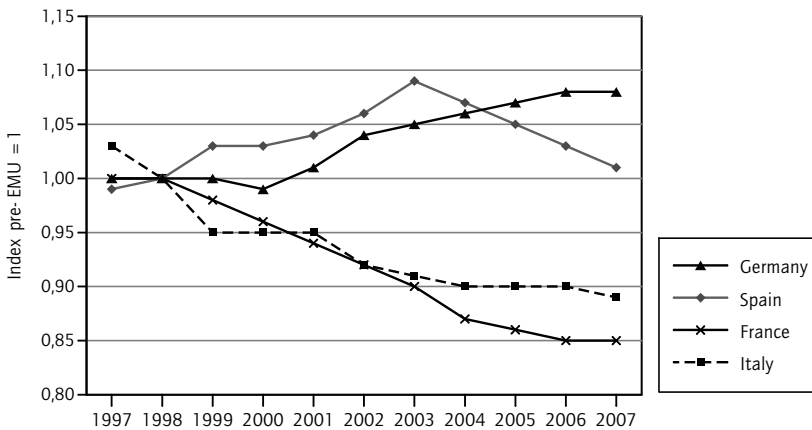
### Unit Labour Costs within EMU



Source: AMECO database.

Figure 2

## Share in Euro-12 Exports



Source: AMECO database.

ficial. It is now becoming clear that a chasm has opened up between them under the surface.

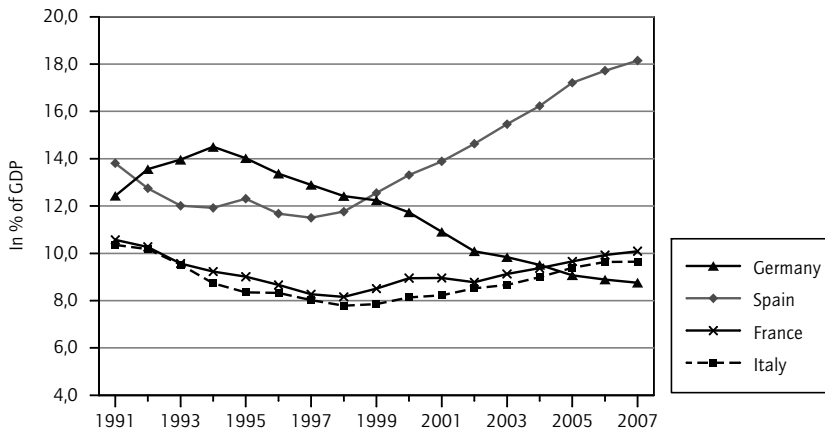
Germany entered EMU with an overvalued exchange rate, but it has regained competitiveness through a process that used to be called ‘competitive deflation’, i.e. extracting continuous concessions from trade unions on labour costs. By contrast, Italy has continuously lost competitiveness, and the French performance has again been ‘middling’. Figure 1 shows that Italy’s labour costs have increased by about 20% relative to those of Germany since the start of EMU. This loss of competitiveness has also translated in large movements in market shares as illustrated in Figure 2, with the difference between Italy and Germany again being around 20%. Somewhat surprisingly, the export performance of France is even worse than that of Italy, suggesting a corresponding lack of structural reforms.

These large relative movements in competitive positions and export performance did not translate earlier into different growth rates because of the offsetting tendencies in the housing markets. The low interest rate environment fostered by the ECB’s policy and the global ‘savings glut’ led to a housing boom in a number of countries, including France, Italy and Spain. These booms have so far sustained consumption in these countries, while overbuilding especially in the eastern part of Germany during the early 1990s led to persistent weakness in the real estate market and consumption in that country. However, the cumulated loss in competitiveness of some ‘Club Med countries’ has become so severe that its negative effects can no longer be offset by the housing boom.

Unnoticed by many, an even more severe disequilibrium is building up in the case of Spain, which so far has been regarded as a success story. The relatively strong growth of Spanish exports until about 2003 – despite an also rather strong increase in relative labour

Figure 3

### Investment in Construction



Source: AMECO database.

costs – suggests that indeed some reforms have made Spain more competitive. However, the continuing loss of competitiveness has now impacted on export growth and, even more importantly, the housing boom has been so strong in Spain that it has translated not only in a consumption boom, but a degree of overbuilding much worse than even that experienced by Germany in the wake of unification. Figure 3 shows that a construction boom has been a key factor in the relative strong growth performance of Spain over the last few years. Construction now accounts for over 17% of GDP in Spain, much more than the 14% it accounted for in Germany in the wake of unification. With so many houses being built, it is clear that at some point in the future the demand for new houses in Spain will decline drastically. Spain is likely to experience a protracted period of weak domestic demand to an even greater extent than has Germany in recent years. The only way to prevent unemployment from skyrocketing would then be to rely on increasing exports. But this would require a turnaround in competitiveness, just like in Italy.

The remainder of this decade is thus likely to see the North and the South of Europe trading places: Germany is likely to emerge with the strongest growth once its real estate market has bottomed out, whereas Italy and Spain are likely to experience a period of weak growth as their labour markets struggle with the problem of how to regain competitiveness through lower wages and extracting concessions on working time.

Unfortunately, however, the divergent trends in place since the start of EMU show no sign of changing soon. The latest forecast of the Commission implies that Italy and Spain will continue to lose competitiveness. The later the adjustment starts in these two countries, the more difficult it will become. The foreseeable period of weak growth in these countries is likely to lead to even greater budgetary difficulties, especially in Italy.

The real test for the EMU framework is thus likely to arise over the remainder of this decade. Once Germany has brought its public finances under control (probably around 2007), the pressure will mount on Italy whose relative position is likely to have deteriorated further. Over time, the global savings glut is likely to end and global interest rates are likely to return to more normal levels. The ‘one size fits all’ policy of the ECB is then likely to become very difficult to bear for countries like Spain and Italy, which will then have to enter a period of very low increases, or even declining, domestic price levels. A combination of slow growth, rising real interest rates and increasing pressures from Brussels to reduce spending will make EMU unpopular in these countries.

### 2.3 Conclusion: A Test the Weakest Cannot Afford to Fail

Could these tensions lead to a break-up of EMU? While this scenario was suggested even by some Ministers in Italy in the run-up to an election campaign in 2005/6, it is unlikely to materialise for the simple reason that the cost of breaking away would be prohibitive for a country with such a high public debt. The Italian public (and even the most populist politicians) know that leaving EMU, coupled with a devaluation to regain competitiveness, would increase by one stroke the debt/GDP ratio as all existing public debt would have to be serviced in euro. Moreover, interest rates on the new lira are likely to be much higher than within the euro area, thus increasing the cost of servicing public debt easily by several percentage points of GDP. In the end, Italy (and Spain) will thus have little choice but to bite the bullet and undergo their first full business cycle under a hard currency regime. EMU is thus likely to survive, but the sparks will fly for some time to come.

## 3 The Enlargement Challenge

The enlargement from 15 to 25 (and then to 27+) members is considered by many as the key challenge for the EU. But it is clear that this enlargement is not the end of the story. Before the middle of the second decade of the 21<sup>st</sup> century the EU is also likely to admit some further small countries from the former Yugoslav area. But the really important decision will have to be taken around 2016. This decision will not merely be to augment the number of member countries to beyond 30, but more fundamentally it will have to confront the dilemma: Western Europe or Wider Europe. In practical terms this will mean: Should the EU admit Turkey and/or Ukraine?

Taking both countries would imply an increase in the population of the EU of around 120 million. But it would be crucial in more than quantitative terms. There would be a jump from quantity to quality. An EU with more than 30 member states, which includes the Crimea and which borders on Iran and Iraq, forces us to change our “mental map” of Europe. This will be the choice between Western Europe or Wider Europe.

This contribution does not argue for or against widening. Its aim is merely to describe the post-enlargement “digestion” process. It is often forgotten that enlargement is a process, not a point in time, and at present this process is not going very well, at least if one looks at public opinion in some old member states. The enlargement process properly understood is in reality a very intensive programme of deepening on two accounts.

First, because the new member states are not yet participating fully in the euro, the Schengen area and in the internal market for labour.

Second, because the euro is only now developing its full impact on markets and because the intensive programme of integration in Justice of Home Affairs (JHA) that is a corollary of the Schengen area is still to have its full impact.

In analysing the likely developments over the next decade one has to keep in mind that this will be the continuation of a long process – a process which started in the 1980s (with the Iberian enlargement, preparations for EMU and Schengen). It continued during the 1990s with 1999 (EMU) and 2004/7 (enlargements) as high points, but these were not endpoints, but rather the starting points for a host of further developments.

The next section provides a brief overview of the likely evolution of the some key elements of the EU: monetary union and Schengen. The following section documents the three factors that characterise the enlarged EU, namely the huge diversity in income levels and the quality of governance, which is, however, coupled with a surprising similarity in education levels. Section 3 speculates how this cocktail will influence the “digestion” process. Section 4 concludes by asking: Where will the EU be in 2016?

### 3.1 Setting the Scene: Institutional Developments

In setting the scene for the next decade it is useful to start with the institutional developments that are already in the pipeline. One ongoing process is that of enlargement, which is almost guaranteed to lift membership to 28 (25 plus Bulgaria, Romania and Croatia), but 30+ is more likely as some other states from former Yugoslavia are likely to be admitted also over the next years. However, accession of these countries is unlikely to change the character of the EU as these countries are minuscule in economic terms and even the largest, Romania, increases the population of the EU by little over 5%.

More important will be three key substantial elements that will characterise the evolution of the EU over the next decade in institutional/formal terms. They are the following:

1. Labour mobility which is now restricted to within the EU-15 (and only the UK and Ireland for the new member states) will over time apply to all of the 28+.
2. The Schengen area which now encompasses 14 countries (some outside the EU) is likely to extend to over 30 countries.
3. Euro area membership is likely to increase from 12 to 27+.

The two key forces for deepening that will be working in the background are:

- An increase of trade among members of the (expanding) euro area.
- An increase in the need for judicial cooperation among members of the (expanding) Schengen area. (See also Treaty of Prüm.)

The extension of both the euro area and Schengen to a membership of probably in excess of 25 has one immediate implication: neither could be used to constitute a ‘core’ Europe. Within a decade the institutional map of Europe will become to resemble more and more the pre-2004 pattern: most of the continent participates in all the important domains of integration, but the UK (and some Scandinavian countries) may continue to opt out of two key areas of integration.

This development is likely to be more important than the opposite process that will be operating in the area of labour market integration: here the UK is ahead of the continent at present, but this will not last beyond the end of the decade.

The general pattern that is very likely to emerge over the next decade, namely continent versus UK (plus a few followers) is thus clear. However, it will play differently in the two key areas highlighted so far: EMU and Schengen.

## EMU

The existing members (and the ECB) have shown a considerable reluctance to admit new members. This aversion became apparent when some smaller member countries applied in 2006. The case of Lithuania is particularly revealing because this country has so far had an exemplary fiscal policy and a very strong growth record. However, during the year 2005, which served to determine the basis for the evaluation of the Maastricht criteria, this country had an inflation rate of 2.7% whereas the limit allowed for the criteria fixed in the Treaty was 2.6%. Lithuania was therefore not allowed to join the euro area. This excessively strict interpretation of the Treaty by the Commission (and the Council) was mainly dominated by the fear in the larger member countries that admitting a number of fast growing (albeit small) economies could only induce the ECB to increase interest rates, which might create difficulties for economies like France and Italy.

However, the case of Lithuania notwithstanding, it is likely that most of the new member countries will join EMU before the end of the next decade. With the exception of Poland they are all very open economies which would benefit immensely from joining a large currency area.

The opposite is likely to be true for the other outsiders, especially the UK. On present trends the UK will not join the euro area in the foreseeable future. Until now the economic performance of the UK has been very much superior to that of the euro zone in terms of employment and growth. It is unlikely that this difference will remain constant over the next decade as at least part of the superior growth performance of the UK has been based on its housing bubble. A narrowing of the growth gap is thus very likely (according to most forecasts the growth gap should shrink to 0.3 percentage points already in 2006/7). But it remains to be seen whether the euro zone can actually overtake the UK. In terms of labour market performance this is unlikely to happen over the next few years given the very bad starting position of the larger eurozone economies and the rigidities that persist in their labour markets. All in all it is thus unlikely that euro zone will have such a superior performance that it become attractive for the UK to join. But the image of the eurozone as a low growth club is also likely to fade.



## Schengen

The key difference between eurozone and Schengen membership is that the former is a question of all or nothing. However, this is not the case for the Schengen acquis. The UK (plus Ireland) is likely to keep passport checks on its intra-EU borders, but they are very well managed and are de facto no more than a slight nuisance to travellers. In most other aspects of the Schengen acquis, however, the UK does participate actively. But this is not always welcomed by the members of the Schengen zone. It is thus likely that over the next decade the UK will continue to want to play an active part in the growing acquis in Justice and Home Affairs (JHA), most of which is considered a corollary of the passport free zone established by Schengen. It will depend on the attitude of the Schengen members whether they are willing to accommodate the special situation of the UK in this area, or whether they prefer to press ahead, as a group, without the UK. The evolution of the membership of the Treaty of Prüm will constitute an important test case.

### 3.2 Diversity in an Enlarged EU

With the 2004/7 enlargement diversity is increasing. From an economic point of view this is good news since more diversity should mean more opportunities for, and thus higher gains from, trade. But more diversity also implies that there might be winners and losers and in general higher adjustment costs. (This point was already argued by Paul Krugman in an analysis of the Iberian enlargement.) Theory and experience so far suggests that the new, poorer, member states should do well, but the increase in diversity might be more difficult to manage by those of the old that have less flexible economies. The increase in diversity might thus also lead to tensions.

What is the starting point for the next decade?

The key issues can be illustrated by three stylized facts:

1. GDP per capita: more diversity, really two groups, old and new.
2. Human capital: little/no difference, no increase in diversity.
3. Quality of (national) institutions: more diversity, but more graduated.

The following two tables on page 9 document these facts with some numbers.

It is apparent that, at least upon impact, the enlarged EU will have a much lower income level (EU-28+ only about two thirds of EU-15). As numbers show there is a clear East-West divide in this sense. The variability, as measured by the standard deviation shown in table 2 almost doubles as one goes from EU-15 to EU-28+.

However, in terms of human capital levels the picture is completely different. In this area there is very little difference between the EU-15 and the rest. The second column in Table 1 shows that on one indicator, (the share of the population 18–24 with complete secondary education or in training) the average for the enlarged EU is actually better (at close

Table 1

**The Impact of Enlargement: EU-15 versus EU-28+: Average Values**

	GDP per Capita (US-Dollar)	Education (Enrolment Rates)		Government Efficiency
		Upper Secondary <sup>1</sup>	Tertiary <sup>2</sup>	
EU-15 <sup>3</sup>	33.1	75.9	62.6	1.64
EU-28 + <sup>4</sup>	23.2	78.6	57.2	1.12

<sup>1</sup> % of 18–24 year olds who are qualified or in further training, 2004.

<sup>2</sup> Gross enrolment ratio, 2003.

<sup>3</sup> Luxembourg has been excluded from the EU-15 while computing the average tertiary education enrolment ratio.

<sup>4</sup> EU-28 consists of the EU-25 countries, plus candidate countries of Bulgaria, Romania and Croatia. Luxembourg and Malta have been excluded while computing the aggregate value for the average tertiary education enrolment ratio.

Source: Eurostat and World Bank.

Table 2

**The Impact of Enlargement: EU-15 versus EU-28+: Standard Deviation**

	GDP per Capita	Education (Enrolment Rates)		Government Efficiency
		Upper Secondary <sup>1</sup>	Tertiary <sup>2</sup>	
EU-15	8.5	10.2	11.8	0.43
EU-28+	16.5	10.8	14.9	0.69

<sup>1</sup> % of 18–24 year olds who are qualified or in further training, 2004.

<sup>2</sup> Gross enrolment ratio, 2003.

Source: Eurostat and World Bank.

to 80%) than that for the EU-15 (77%). In terms of the enrolment rates in tertiary education the difference is of opposite sign, but remains very small. Table 2 shows that in terms of the standard deviation of these two rough indicators of human capital formation is very similar whether one looks at the EU-15 or the EU-28+.

### 3.3 How Will Integration be Digested?

The combination of large income differentials but high, similar level of schooling forces one to rethink the role of physical and human capital (education) in convergence (especially for the country at the core of the East/West fault line: Germany).

The similarity of (at least formal) education levels implies that one can consider labour as homogenous in the old and new member countries. The main difference between the old and the new is then the difference in the capital labour ratio. This then implies that convergence would require essentially a huge transfer of physical capital (plus technology). This is already happening on a large scale, but it requires time.

Table 3

**Member States and Candidate Countries Compared: Standardized**

	GDP per Capita (EU-15 = 100)	Education		Government Efficiency
		Upper Secondary <sup>1</sup>	Tertiary <sup>2</sup>	
Germany	103.4	-0.50	-0.60	0.86
Spain	79.9	-1.55	0.17	0.46
France	103.7	0.13	-0.28	0.70
Italy	89.9	-0.49	-0.18	-0.63
Poland	23.1	1.01	0.03	-1.16
United Kingdom	111.6	-0.17	0.34	1.34
Turkey	15.1	-3.29	-2.2	-2.59

<sup>1</sup> % of 18–24 year olds who are qualified or in further training, 2004.

<sup>2</sup> Gross enrolment ratio, 2003.

Source: Eurostat, IMF WEO and World Bank.

One issue that has received little attention so far is the simple question whether convergence within the enlarged EU will mean convergence to the new, lower average, or whether convergence will be towards the average of the old EU-15. This will have important economic and political consequences. If convergence is towards the new, lower average of the enlarged EU it will be both quicker and politically more painful because this would imply that the growth rates of the old member countries will go down.

However, given the high level of educational achievements in most of the new member countries it is more likely that convergence will be to the level of the old EU-15. This will then take more time, but also mean fewer problems in the EU-15.

### 3.4 Governance in the Enlarged EU

Another consequence of enlargement that has so far not received enough attention stems from the large differences in the quality of national governance. This should lead to a re-appraisal of the basic model of management of the EU model. In general this model means that the EU level sets only rules leaving implementation to the national level with minimal supervision. And enforcement left to the initiative of the private sector via the Court. This model will come under increasing strain as the private sector encounters public administrations of very uneven quality and inclination to implement not only the letter, but also the spirit of the *Acquis*. This problem is not confined to the new member states as attested by the problems faced by foreign banks attempting a takeover in Italy.

Will the increased diversity drive member states apart?

There is one force that will tend to counteract the centrifugal tendencies resulting from a more diverse membership. This is the increased integration among member states through

Table 4

**Divergence in the Importance of Intra-EU Trade among the Larger Member Countries?**

Intra-EU Exports of Goods and Services as Share of GDP

	1999	2004	2014 (Based on Extrapolation of previous 5 years)
Germany	19.1	23.9	33.4
Spain	18.1	18.9	20.5
France	18.2	17.9	17.6
Italy	15.9	14.8	12.7
Poland	17.0	27.3	47.9
United Kingdom	16.2	14.8	12.0

Source: Own calculations based on Eurostat data.

intra-area trade and investment. Since most of the new member countries have rather small and open economies their interest will in general be best defended by keeping the internal market as open as possible.

The countries most exposed to intra-EU trade, and thus presumably most interested in expanding or deepening the internal market, are on the continent, West of France (plus Ireland). They could be considered the economic core of the EU. By contrast the UK and Italy are relatively less involved in intra-EU trade.

Economic integration provides already now a very strong glue to keep the economic acquis of the EU together. Moreover, it is likely that this glue will actually become stronger over time. Over the last five years the share of intra-EU exports (of goods and Services) in GDP has increased by 4 points from 36 to 40% of GDP on average across all 27 member countries. If this trend continues the average should in ten years be close to 50% of GDP, thus forcing in effect most member countries to behave like small open economies.

Unfortunately, however, there has also been a diverging trend over the last years in this respect: Especially among the larger countries, those which already now have a relatively small exposure to intra-EU trade have seen it shrinking, this applies in particular to the UK and Italy, with Germany providing the opposite pole of a high and rising importance of intra trade. In about one decade there could then be two classes of member states, those strongly integrated, and those relatively little interested in the EU as a market. Germany's integration in the EU might then be almost three times as important as that of the UK or Italy.

#### 4 **Concluding Remarks: Where Will the EU be in 2016?**

This contribution has analyzed the forces that will shape the EU over the next decade. The main focus has been the economy. The simple justification for this focus is that unless economy improves, very little progress can be expected on the big institutional issues.

Without an economic revival the EU will become inwards looking, and, as the aftermath of the rejection of the draft constitution by French and Dutch voters has shown, economic revival might be a precondition for just holding the EU together.

EMU is likely to undergo a stress test over the next decade as some member countries have let their prices and costs drift too far away from others. However, it is unlikely that this will lead to a break-up of the euro area because the stress will be most intense for the weakest, but these are also the countries that can least afford to leave.

It is not widely realised that a strong process of de facto deepening will take place over the next decade. The two basic driving forces behind this process are the fact that the common currency is only now starting to have its full impact on markets and that the last enlargement was “incomplete”, i.e. the new member states do not yet participate in some important elements of integration (labour mobility, the euro and Schengen).

There will thus be very strong forces driving towards more integration. Will they be resisted? This will depend on the reaction of policy in the “old” member states, especially the bigger ones. Whether the old member states will be able to transform the looming integration challenge into an opportunity depends in the short run on the flexibility of their labour markets, and in the long run on the quality of their education systems.

The main immediate challenge at the EU level is to overcome the sense of paralysis created by the no vote in France and the Netherlands on the constitutional treaty. In this environment the services Directive has served as the lightning and measuring rod of the ability of the institutions to hold together in the face of an uninterested or sometimes even hostile public opinion. That a compromise was found for the services Directive shows that the EU machinery is still functioning, but only at the cost of always using the lowest common denominator.

The less visible, but more important and difficult challenge that remains over the coming decade is to ensure an even implementation of the Acquis, (including a services Directive) throughout an enlarged and more heterogeneous Union.

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