EMU@10 and beyond: on the way to an enlarged euro area

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Conference – Common currency and its future – Lessons for the New Member States

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Outline

• EMU: The first ten years
  • Achievements and challenges
  • Lessons and policy agenda

• On the way to an enlarged euro area
  • A sequenced process
  • Many roads to the euro
  • Progress with convergence

• Conclusions
EMU: The first ten years
The achievements of EMU

- Price stability and low cost of borrowing
- Elimination of intra-area exchange rate volatility
- Increased trade and FDI; financial integration
- Strong job creation
- Sounder fiscal positions
- Greater resilience to external shocks
- The euro is the 2nd global currency
Inflation performance has improved

Inflation performance in the euro area

*Corresponds to the period since the start of Stage III of EMU.
Source: European Commission.
Cost of borrowing fallen dramatically

Evolution of 10-year government bond yields (in percent, annual data)

Source: Eurostat
EMU boosted FDI, trade and growth

The impact of the euro on:

- FDI
- Trade
- Growth

Bar chart showing the impact of the euro on FDI, trade, and growth.
EMU promoted financial market integration

- Home bias in equity markets
- Cross border holdings of euro area long-term debt securities
- Share of domestic credit institutions in banks' assets

Start of EMU vs. Most recent data
More than 16 million jobs created

Source: European Commission.
Fiscal positions improved

Cyclically-adjusted fiscal balance

Fiscal balance

% of GDP

Increased resilience to shocks

Cumulated output loss due to recession

% of GDP at full capacity utilisation

1980s 1990s 2000s
But not all expectations have been fulfilled

- **GDP** growth is slow in some countries, due to unsatisfactory productivity performance

- Rising divergences in **competitiveness** and large **current account imbalances** require correction

- In general, **structural reforms** have been less ambitious and frequent than in the rest of the EU

- Banking and financial markets are still predominately **nationally** organized and supervised

- Not much progress in **international representation**

- Weaknesses in **public perception** of the euro
Major external imbalances built up

Current account positions

<table>
<thead>
<tr>
<th>Country</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>NL</td>
<td>39</td>
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<tr>
<td>DE</td>
<td>141</td>
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<td>FI</td>
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<td>ES</td>
<td>-97</td>
</tr>
<tr>
<td>EL</td>
<td>-25</td>
</tr>
</tbody>
</table>

Numbers indicate the absolute position, billions of euros.

Source: European Commission.
Driven by competitiveness developments

Cumulated change in relative unit labour cost
1999-2007

Source: European Commission.
The implementation of structural reform recommendations has disappointed in some countries.

Score on a scale from 0 to 3

- Euro area
- Top 3 euro area performers
- Denmark, Sweden, UK
Asymmetric impact of common external shocks

US slowdown (1% of GDP fall in private consumption and investment)

Euro/dollar exchange rate shock
(risk premium shock leading to 10% appreciation)

(Source: QUEST III model simulations)
Lessons from EMU@10 for current and future euro area members (1 - challenges)

- **Price stability**: equilibrium real appreciation complicates inflation control; shorter history of anti-inflation policy and lower credibility; conflict between fiscal and monetary authorities; wage catching up

- **Effective adjustment capacity** (incl. stabilisation):
  - To deal with shocks without exchange rate instrument (but nominal exchange rate flexibility acts also as shock propagator, hence less ‘cost’ of giving up the XR instrument);
  - Relatively more frequent and persistent common shocks with asymmetric impact (exchange rates, terms of trade, shifting comparative advantages…); asymmetric shocks still possible (see Spain, Ireland, …)
  - Correction of large current account imbalances may require long and painful disinflation processes if coupled with stagnating productivity

- **EMU and financial integration** help efficient resource allocation and allow for longer adjustment periods, but managing credit booms can be a challenge (already well before euro adoption)

- **Long-term challenges**: sustain high potential growth (catching-up), in a context of ageing, globalisation (with more rapid shifts in comparative advantages)
Lessons from EMU@10 for current and future euro area members (2 – policy needs)

- Improved budgetary control to reduce the risk of fiscal policy procyclicality; budgetary frameworks in NMS are less developed and assessing cyclical component even more challenging
- Flexible and integrated goods and factor markets
- Effective supervision and regulation of financial markets; NMS experience accelerated financial development
- Sustainability of public finances
- Quality of public finances; bias towards current expenditure in NMS
- Growth-enhancing use of capital inflows; NMS are receiving huge inflows, included EU funds; utilisation has differed a lot across NMS
- More efficient use of labour resources (participation rates, structural unemployment, skill mismatches)
- Business environment and investment climate (innovation, FDI, education, favour entry/exit of firms)
The three policy pillars of EMU@10

Domestic agenda
- Deepening fiscal surveillance
- Broadening policy coordination
- Integrating structural reforms in policy coordination

External agenda
- Considering benefits, responsibilities and risks of a global currency
- Enhancing the international role of the euro area

Effective governance
- Exploiting existing tools better
- A stronger role for the Eurogroup, but ECOFIN remains the ultimate decision maker
- Stronger dialogue with other institutions and partners
Looking ahead – on the way to an enlarged euro area
Road to the euro – the starting position

- All EU Member States (except UK, DK) committed to join the euro under the Treaty

- Need to achieve a high degree of sustainable convergence, based on fulfilment of criteria

- Sequenced process – Member States have room for manoeuvre in managing their path towards the euro

- Thorough preparation essential

- Euro adoption an opportunity for reforms
Road to the euro – progress with convergence

- **Impressive real convergence**

- **Uneven** progress with nominal convergence

- **NMS** are overall **well placed** to benefit from euro adoption from OCA (stabilisation) point of view
  - [ ] High and growing level of integration (trade, FDI, financial)
  - [ ] Correlation of business cycles; similarity of structure
  - [ ] Relatively flexible markets
Many roads to the euro

- No one-size-fits-all strategy
- Exchange-rate policy is a matter of common interest (Art. 124) but sovereign choice of exchange rate regime:
  - Fixed exchange rate regimes (Estonia, Latvia, Lithuania, Bulgaria)
  - More flexible regimes (Czech Rep., Poland, Hungary, Romania)
  - Slovakia: ERM II, flexible regime

- In ERM II: Estonia, Lithuania, Latvia, Slovakia
Catching-up is advancing, but remains long-term challenge

GDP per capita in 2007 (in PPS, EU=100) and average change over the period 2004-2007
NMS are well-integrated with EU/euro area economy…

Share of intra-EU trade (exports plus imports)
Structural convergence has advanced, but divergences remain

Economic size and labour distribution by sector of activity, 2005

GVA, % of GDP

Employment, % of total

avg 9 NMS

EA-13

avg 8 NMS

EA-13

agriculture

industry and construction

services

note: NMS are BG CZ EE LV LT HU PL SK (RO)
GDP growth rates
(in %, y-o-y)

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State of convergence - HICP inflation

Rising inflation pressures due to supply and demand factors

12-month average inflation (in %, y-o-y)
Fiscal positions

External constraints seem to matter for fiscal performance

General government balance and government debt (in % of GDP; 2007)

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Exchange rate developments
vs. euro, monthly averages (index numbers, Jan 2007 = 100)
Long-term interest rates

12-month averages (in %, y-on-y)
Financially-driven convergence – large capital inflows and extension of external balance sheets

Source: Eurostat and Commission services and ECB
Rapid financial deepening from a low base

Domestic credit (in % of GDP)
Current account developments
Balance on current transactions with rest of world (in % of GDP)

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NMS and the euro - Conclusions

• EMU@10 and beyond – building on the successes and meeting the challenges
• Specific challenges for NMS. Achieving catching-up, nominal convergence while preserving macro-financial soundness
• Euro area enlargement is ongoing; NMS have made considerable progress on the road to the euro
• Policies need to be attuned to country-specific circumstances; ownership and thorough preparation are key
• EMU@10 policy agenda will help
• Short-term challenges: deal with fall-out from the financial crisis