Preparing for the euro: Lessons learned and challenges ahead

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OeNB Conference on European Economic Integration

Vienna, 19 November 2007

Outline

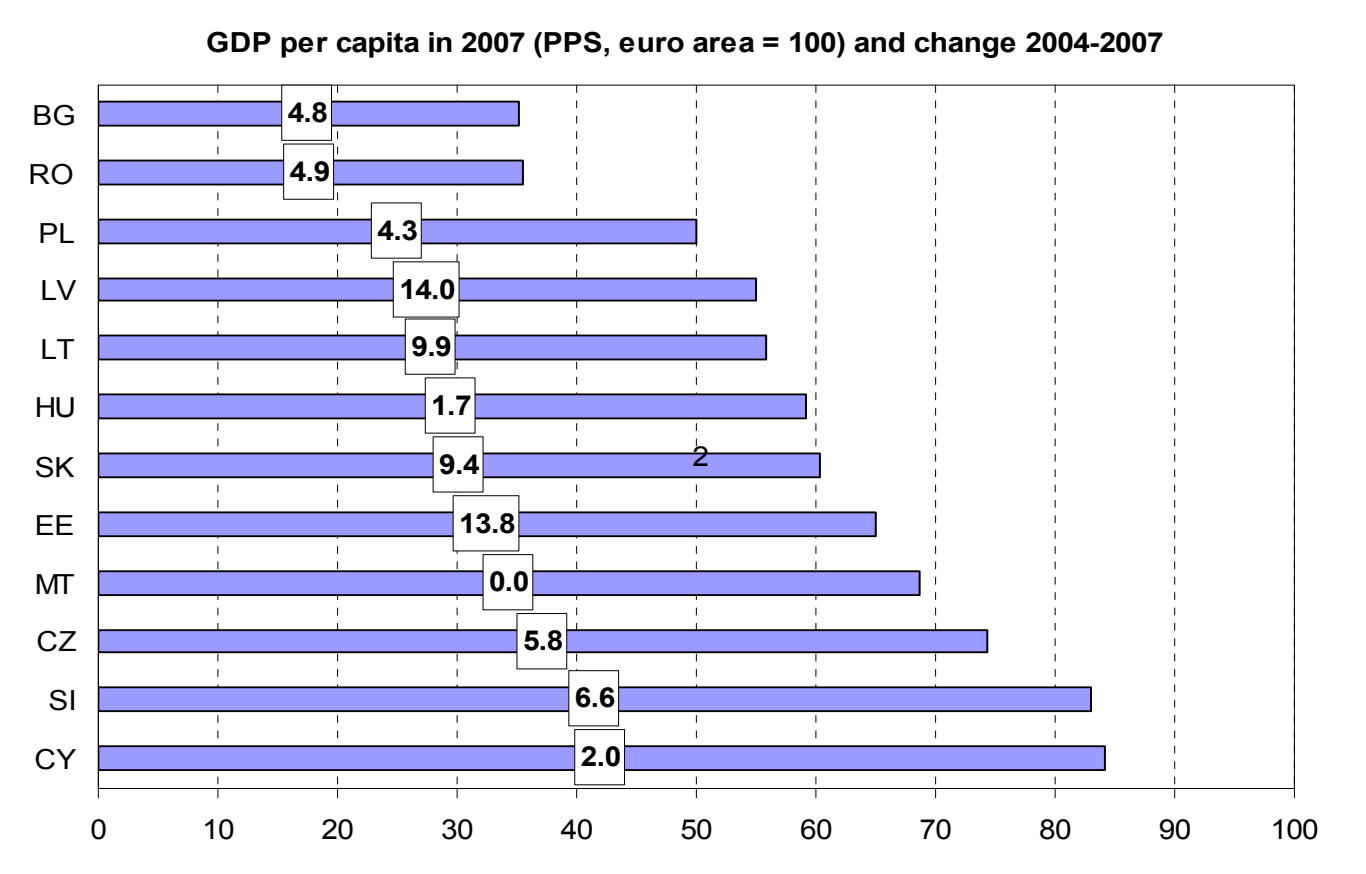
1. NMS on the way to the euro – performance and strategies

2. Prospects and challenges for convergence

3. The policy agenda ahead

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



1. NMS on the way to the euro

- **Optimum Currency Area conditions**
  - Cyclical correlation: broadly comparable to current euro area periphery
  - Sectoral structures: converging, but some diversity remains
  - Domestic adjustment capacity: generally better among exchange rate ‘fixers’, mixed evidence for ‘floaters’
- **OCA position strengthened by EU integration**
- **Endogeneity needs to be taken into account**

Euro adoption – When rather than whether

EU Treaty:

- Rules-based framework (Maastricht criteria)
- Leeway in calibrating convergence path.

⇒ Countries make a (difficult) judgment on :

- *when sustainable convergence can be achieved*
- *when they are fit to prosper in the euro area in the long-term*

The gateway to the euro
key elements of the assessment framework revisited

- **Rationale of the criteria package still fully relevant**: mimic life under the euro; reassure partners about 'policy convergence'

- **Reform Treaty** maintains framework (only change: stronger role for the euro area in the procedure)

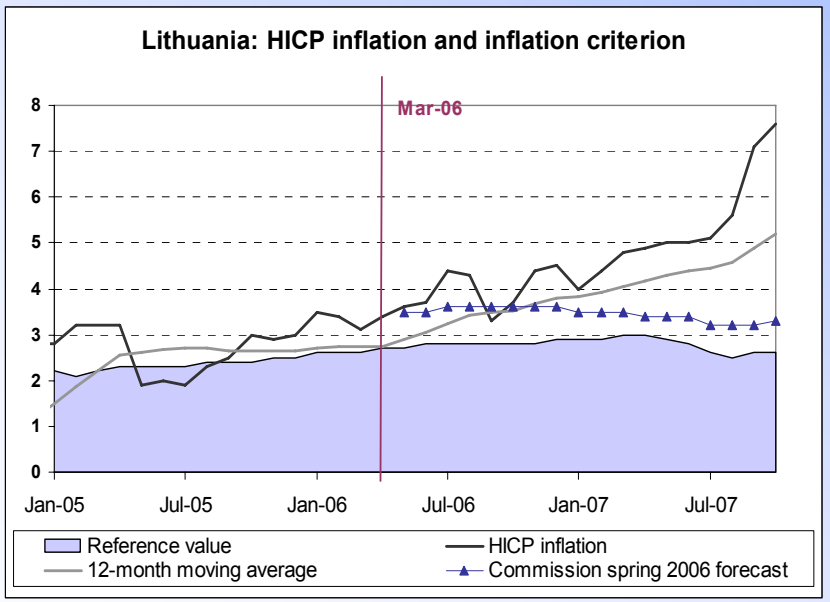
- **Rules-based** approach: fosters transparency and predictability; equal treatment for prospective entrants

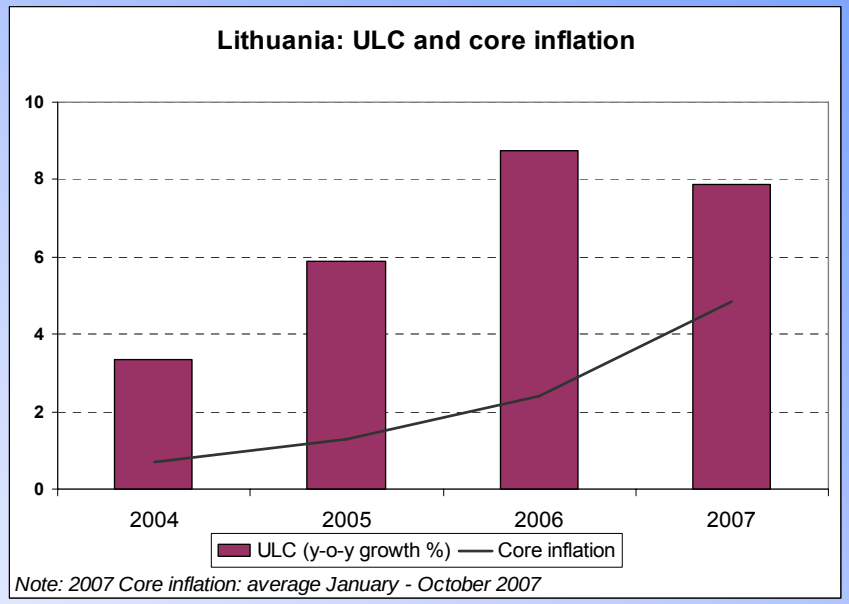
- **But not mechanistic** – assesses 'sustainable' convergence
  - Sustainability is implicit in all criteria and the additional factors, and explicit in price stability criterion
  - Inflation: backward-looking analysis of inflation drivers (import prices, ULC, administered prices, cyclical conditions) and forward-looking, with prudent use of forecast (short- to medium-term horizon)
  - Lithuania 2006: compliance with reference value was clearly unsustainable, reflecting emerging overheating risks (latest data: 7.6% CPI yoy Oct. '07)

- **Real convergence** process may interact with the achievement of nominal convergence – but it is not a separate criterion

1. NMS on the way to the euro

Inflation sustainability: Lithuania 2006





Euro adoption: how did the 'frontrunners' make it?

- **Relatively favourable starting positions**
  - Advanced income convergence (but MT somewhat lagging)
  - CY and MT no transition; early completion in SI
- **But policy adjustments required**
  - SI: exchange rate anchoring in ERM II to bring down inflation
  - CY and MT: fiscal consolidation
  - Broad based support for the euro and invovement of social partners
- **Euro adoption as anchor for reform**
  - Mainly with a view to fulfilling convergence criteria
  - Some progress with structural reforms, but outstanding agenda
- **Firm target dates seem to have helped** – but difficult to extrapolate
- **Key challenge: avoiding a hangover after the party**
  - Absorbing interest rate convergence
  - Managing expectations (wage setting, credit growth)
  - Maintaining momentum in fiscal and structural policies

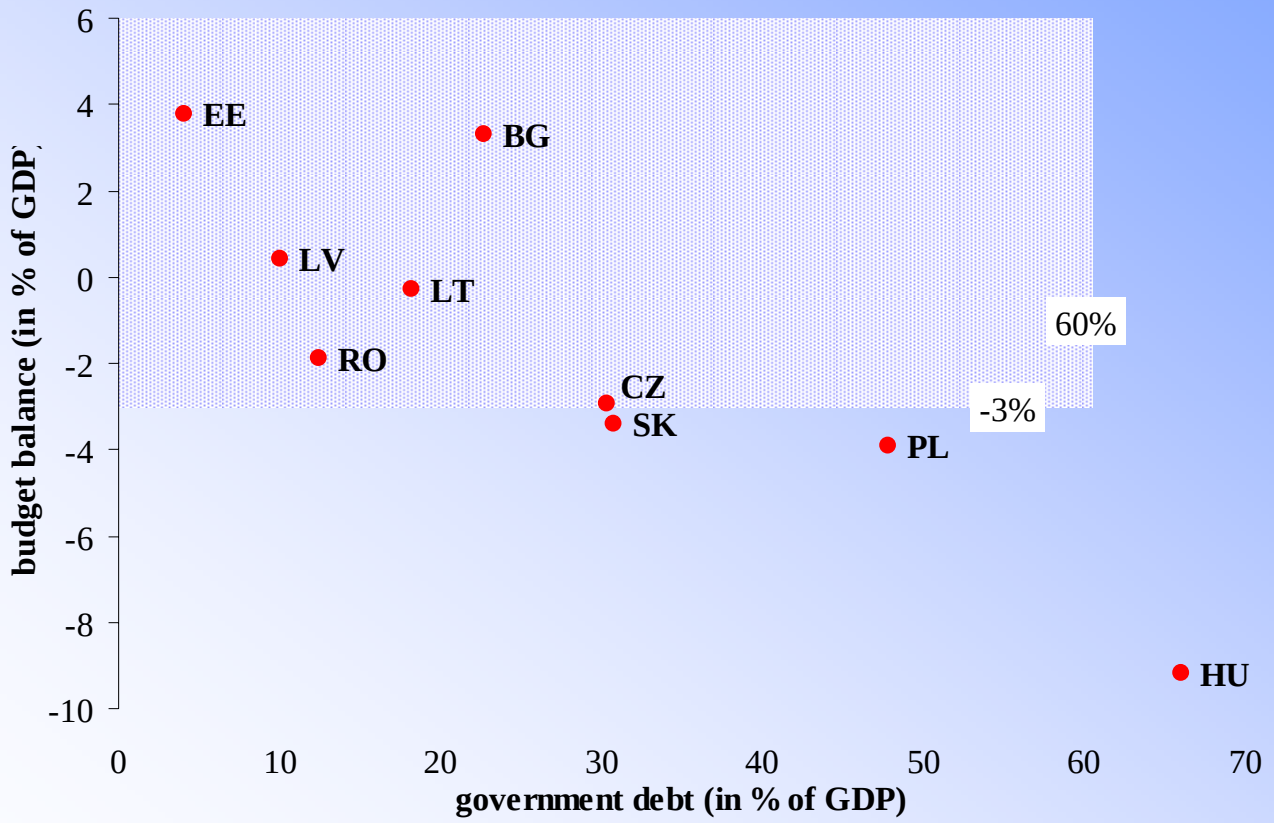
Many roads to the euro - initial monetary/ER regimes

- **No one-size-fits-all policy framework**
- **Two (and a half) groups of countries:**
  - Fixed exchange rate regimes (Estonia, Latvia, Lithuania, Bulgaria)
  - More flexible regimes (Czech Rep., Poland, Hungary, Romania)
  - *Slovakia*: SKK in ERM II

2. Prospects and challenges for convergence

State of convergence:
External constraints seem to matter for fiscal performance

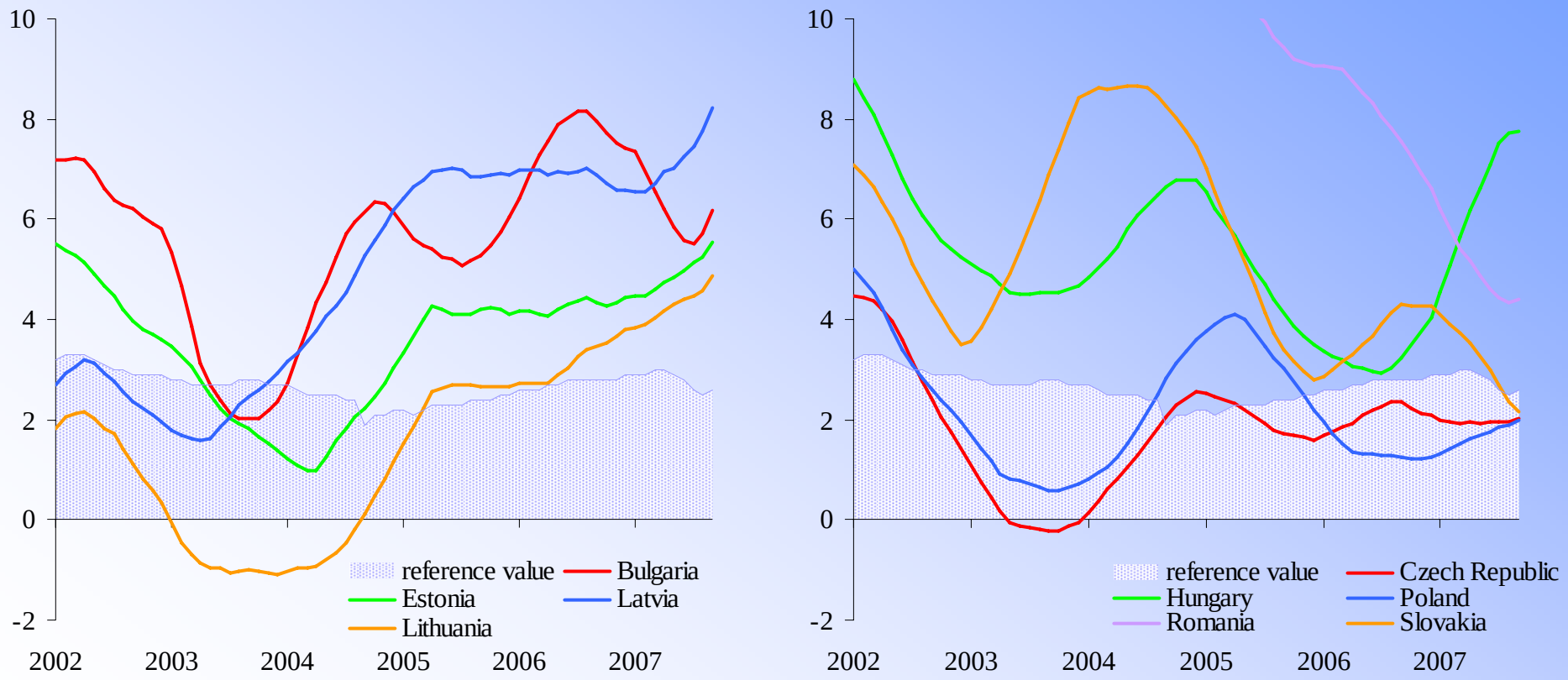
General government balance and government debt (% of GDP; 2006)



2. Prospects and challenges for convergence

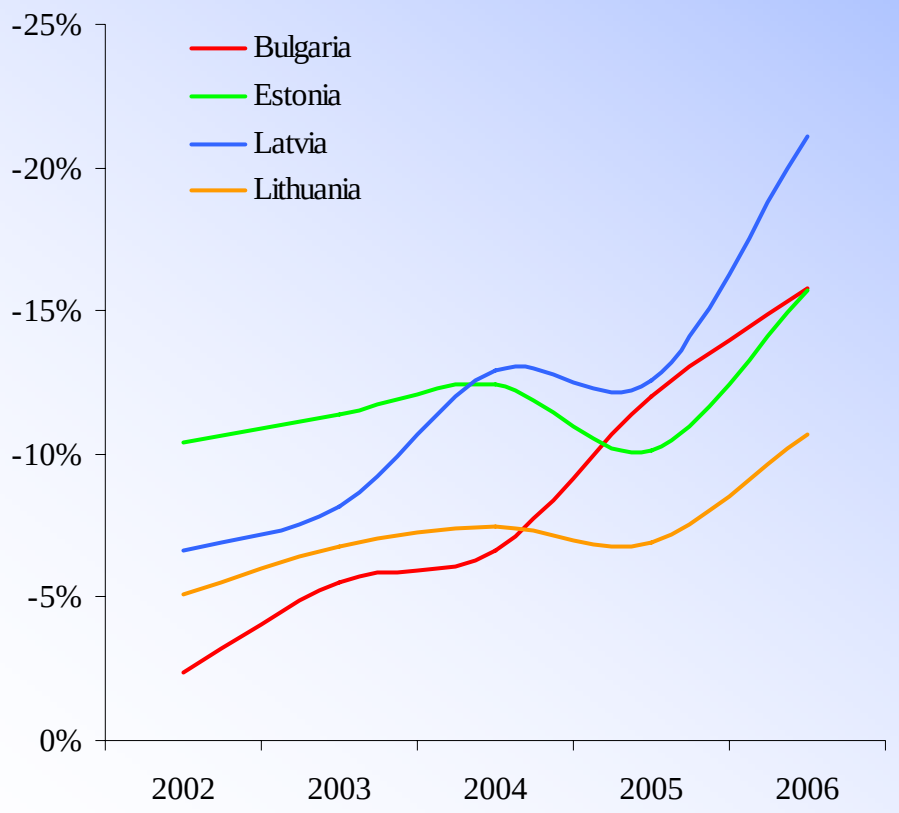
State of convergence:
'Floaters' disinflated later, but now surpassed 'fixers'

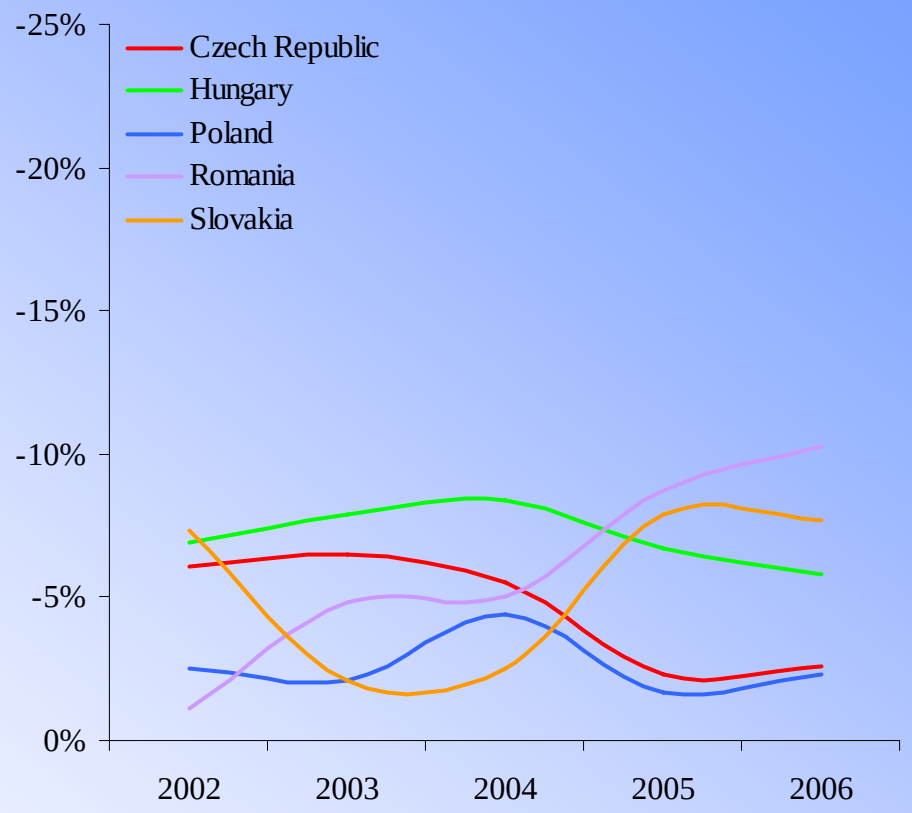
12-month average inflation (in %, y-o-y)



‘Fixers’: higher external imbalances and FDI

Balance on current transactions with rest of world (% of GDP)

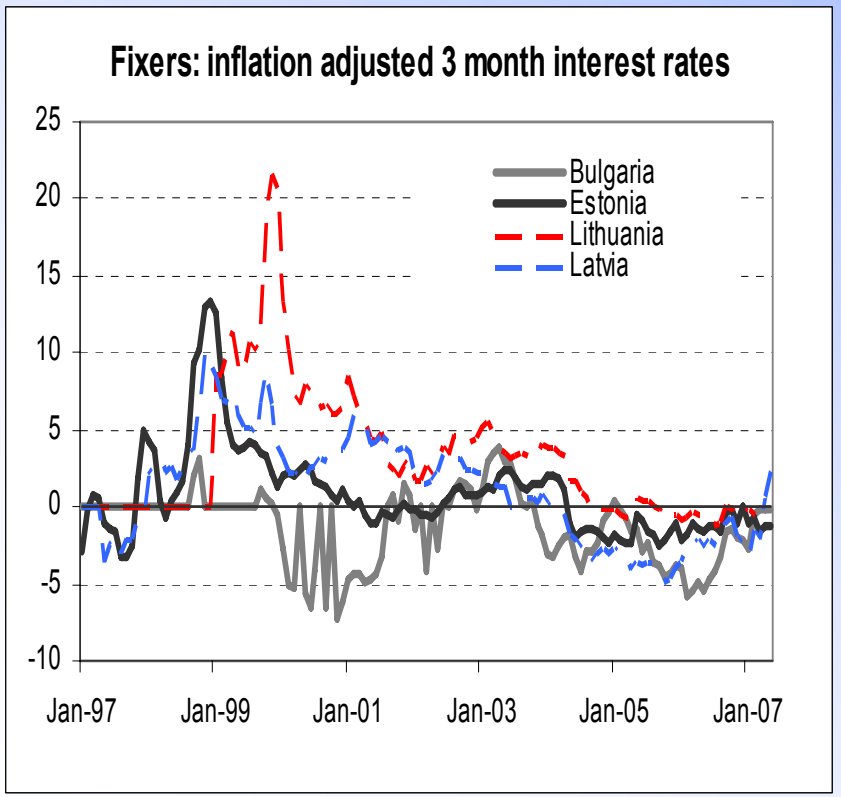


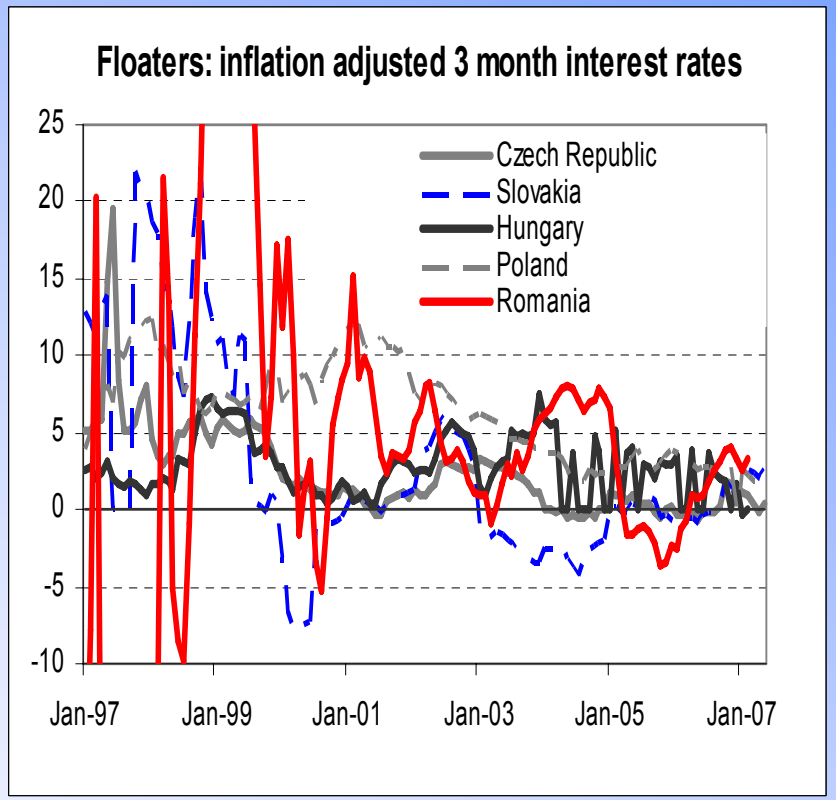


2. Prospects and challenges for convergence

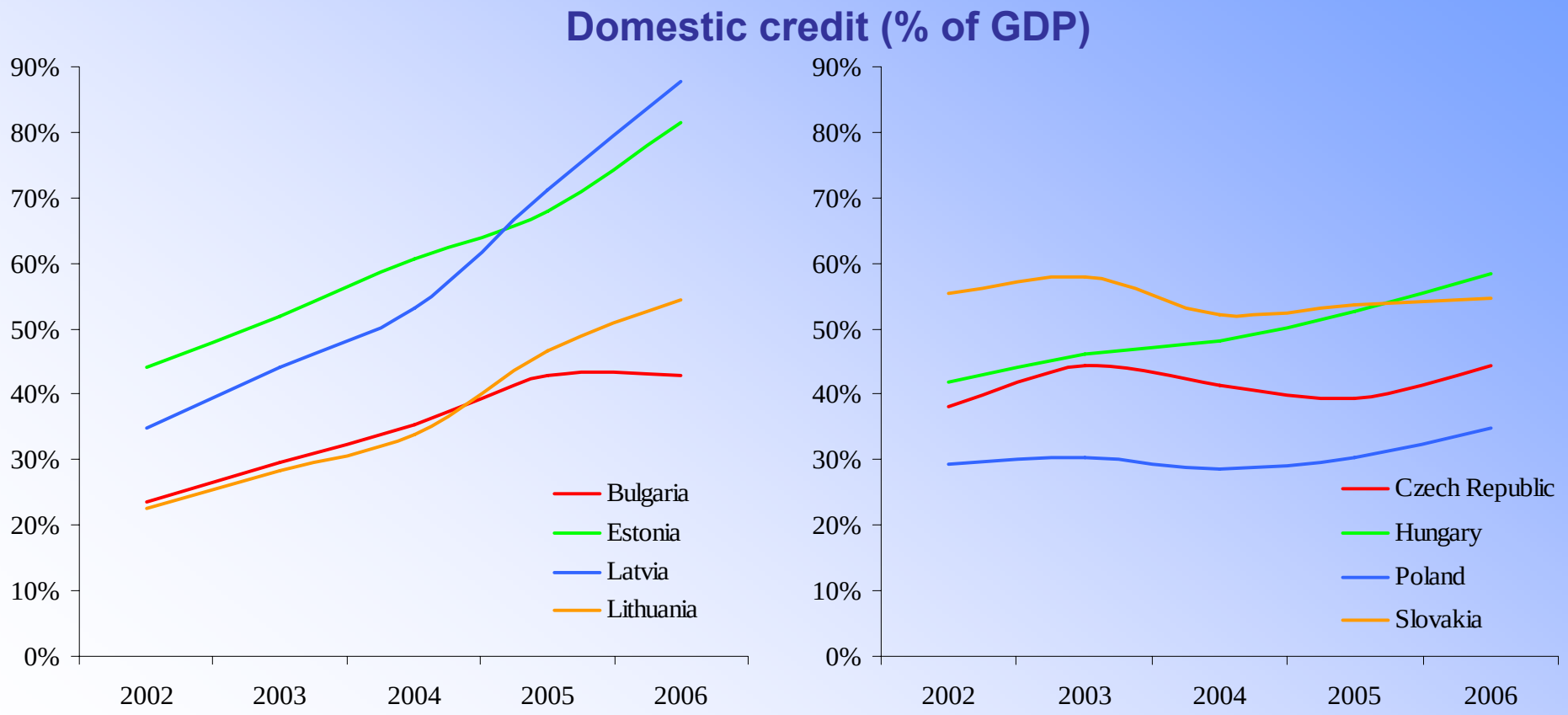
Short-term nominal interest rate convergence compresses real interest rates

(Inflation-adjusted 3-month money market rates)





Credit growth generally high in the NMS, particularly for the 'fixers'



Summary of key characteristics

« Fixers »

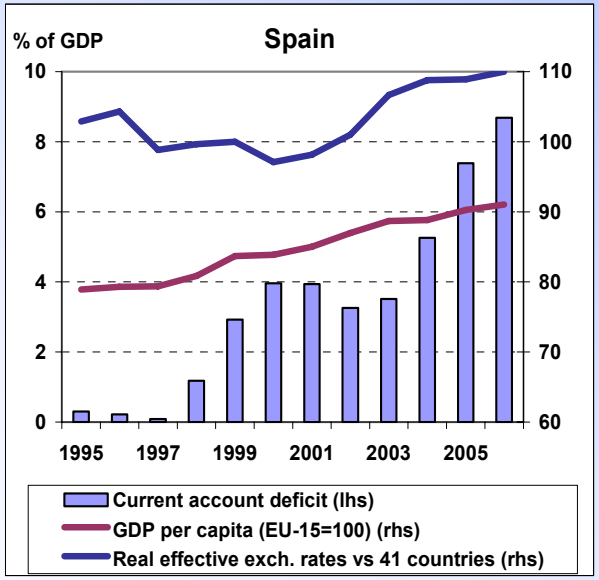
- *Smaller in size*
- *Earlier stabilisation*
- *Higher GDP growth (from lower levels)*
- *More solid fiscal position*
- *Pick-up in inflation*
- *Very large CA deficit*
- *Strong interest rate convergence*
- *Very high credit growth*
- *FX mismatch*
- *ERM II participation*
- *Early euro adoption plans*

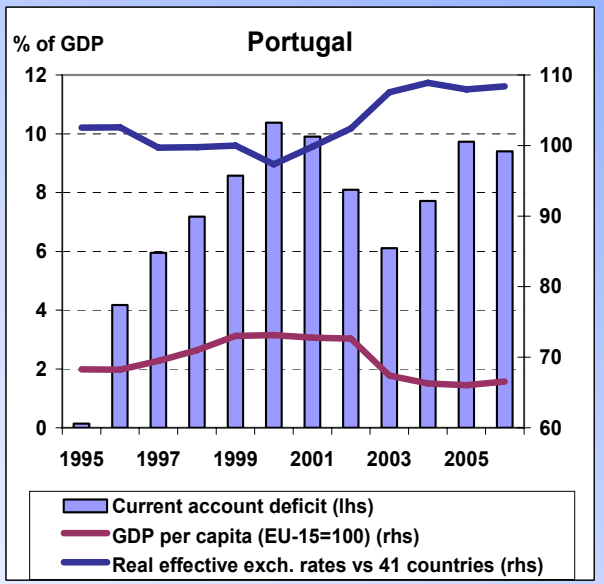
Other NMS

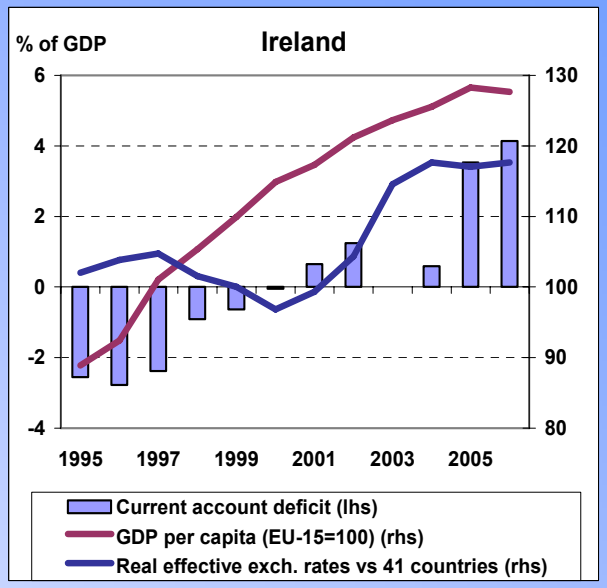
- *Larger in size*
- *Slower stabilisation*
- *Slower real convergence*
- *Often high budget deficits*
- *CA deficit*
- *Lower inflation*
- *Some interest rate spreads remaining*
- *Robust credit growth*
- *Lower FX mismatch*
- *Not in ERM II (exc. SK)*
- *No euro target date or late date*

2. Prospects and challenges for convergence

Experience of existing euro area members – risk of overheating/overcooling cycles







Key for smooth adjustment and robust real convergence:

- ***growth-enhancing use of capital inflows***
- ***supportive role of fiscal policy in containing demand pressures***
- ***efficient resource allocation on labour and product markets***

3. The policy agenda ahead

1. **Fiscal position**
- Fulfilment of the Maastricht criterion
- Need to avoid a pro-cyclical stance (prudence during booms)
- Quality of public finances (incl. absorption of EU funds)

2. **Competitiveness and adjustment capacity**
- Enhance the functioning of labour and product markets (incl. wage setting) to allow efficient resource allocation
- Business environment and investment climate (innovation, FDI)

3. **Safeguarding financial stability**
- Accelerated financial development puts a premium on effective supervision (though recognising limits for prudential intervention)

- **Reforms should not be undertaken because of the euro, but because they lay the ground for successful long-term economic performance**
- **Maintaining an orderly convergence path is key to preserve investor sentiment**

3. The policy agenda ahead

Short-term policy requirements vary across countries

- **Fixed exchange rate countries need to urgently address overheating.**
  - Mobilise all available domestic instruments under the constraints of fixed exchange rate regime ("if the brakes don't work, use the steering wheel")
- **Other NMS not fully protected from macro-financial risk either.**
  - Progress with fiscal consolidation
  - Structural reforms relatively lagging (with differences across MS and notwithstanding some recent progress) – step up to raise productivity and adjustment capacity
  - Address emerging financial imbalances in some countries

Conclusions

- **Main lessons learned**
  - No one-size-fits-all strategy
  - Thorough preparation is key
  - Take the long view
- **Main challenges**
  - Mobilise all domestic policy instruments
  - Don’t become ‘victim of own success’
  - Keep sight on ultimate goal