Preparing for the euro: Lessons learned and challenges ahead

Servaas Deroose
Director, DG ECFIN
European Commission

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Preparing for the euro

Outline

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

2. Prospects and challenges for convergence

3. The policy agenda ahead
1. NMS on the way to the euro

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

GDP per capita in 2007 (PPS, euro area = 100) and change 2004-2007

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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
1. NMS on the way to the euro

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

Lithuania: HICP inflation and inflation criterion

Lithuania: ULC and core inflation

Note: 2007 Core inflation: average January - October 2007
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 involvement 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
1. NMS on the way to the euro

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)

[Graph showing relationships between government debt and budget balance for various countries]
State of convergence:
‘Floaters’ disinflated later, but now surpassed ‘fixers’

12-month average inflation (in %, y-o-y)
2. Prospects and challenges for convergence

‘Fixers’: higher external imbalances and FDI

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

-25% -20% -15% -10% -5% 0% 5% 10% 15% 20% 25%

Bulgaria
Estonia
Latvia
Lithuania

Czech Republic
Hungary
Poland
Romania
Slovakia

S. Deroose, Director, Macroeconomy of the euro area
European Commission, Economic and Financial Affairs

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2. Prospects and challenges for convergence

Short-term nominal interest rate convergence compresses real interest rates
(Inflation-adjusted 3-month money market rates)

- Fixers: inflation adjusted 3 month interest rates
- Floaters: inflation adjusted 3 month interest rates

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2. Prospects and challenges for convergence

Credit growth generally high in the NMS, particularly for the ‘fixers’

Domestic credit (% of GDP)

- Bulgaria
- Estonia
- Latvia
- Lithuania
- Czech Republic
- Hungary
- Poland
- Slovakia

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
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
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