

# Opportunities of euro area enlargement: the “in” and “pre-in” perspectives

**Ettore Dorrucci**

**Head of Convergence and Structural Analysis  
European Central Bank**

*The views expressed in this presentation are solely those of the presenter and do not necessarily reflect those of the European Central Bank*

**Bucharest, 26 October 2012**

# Outline

**1 Is euro adoption an “opportunity?”**

**2 Euro area perspective on newcomers**

**3 Newcomers perspective on the euro area**

**4 Conclusions**

# Outline

**1 Is euro adoption an “opportunity?”**

**2 Euro area perspective on newcomers**

**3 Newcomers perspective on the euro area**

**4 Conclusions**

# “OPPORTUNITY” Indeed the right word!

?

- A [redacted] for progress or advancement
- A time or set of circumstances that makes it [redacted] to do something
- Positively exploitable set of circumstances with [redacted] *uncertain* outcome, [redacted] of resources and involving [redacted] exposure to *risk*.

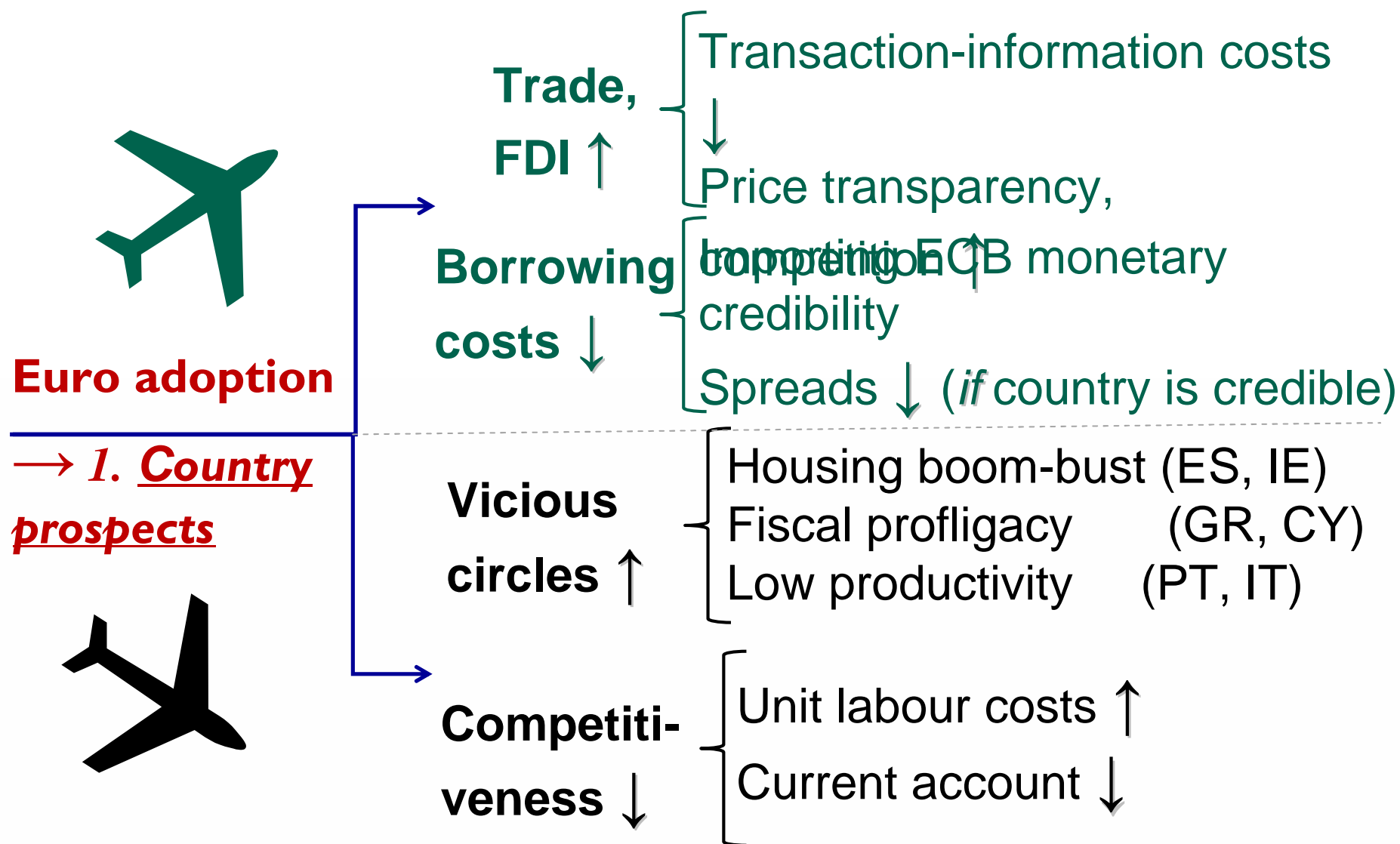
*Take  
advantage  
of*

**Opportunity**

*Lost/wasted*

*... cost*

# The opportunityplane ... can fly or not

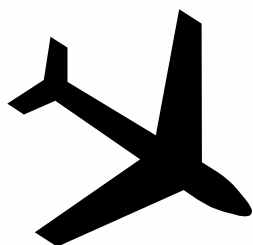


# The opportunityplane ... can fly or not



**Euro adoption**

→ 2. Euro area prospects



- Completion of Single Market
  - Area-wide monetary stability
  - More protection against external shocks
  - Enhancing the European house
- 
- Exposing EMU credibility
  - Impaired monetary policy transmission
  - Risks of endogenous vicious circles
  - Risk of cross-country resentment

# Outline

**1 Is euro adoption an “opportunity?”**

**2 Euro area perspective on newcomers**

**3 Newcomers perspective on the euro area**

**4 Conclusions**

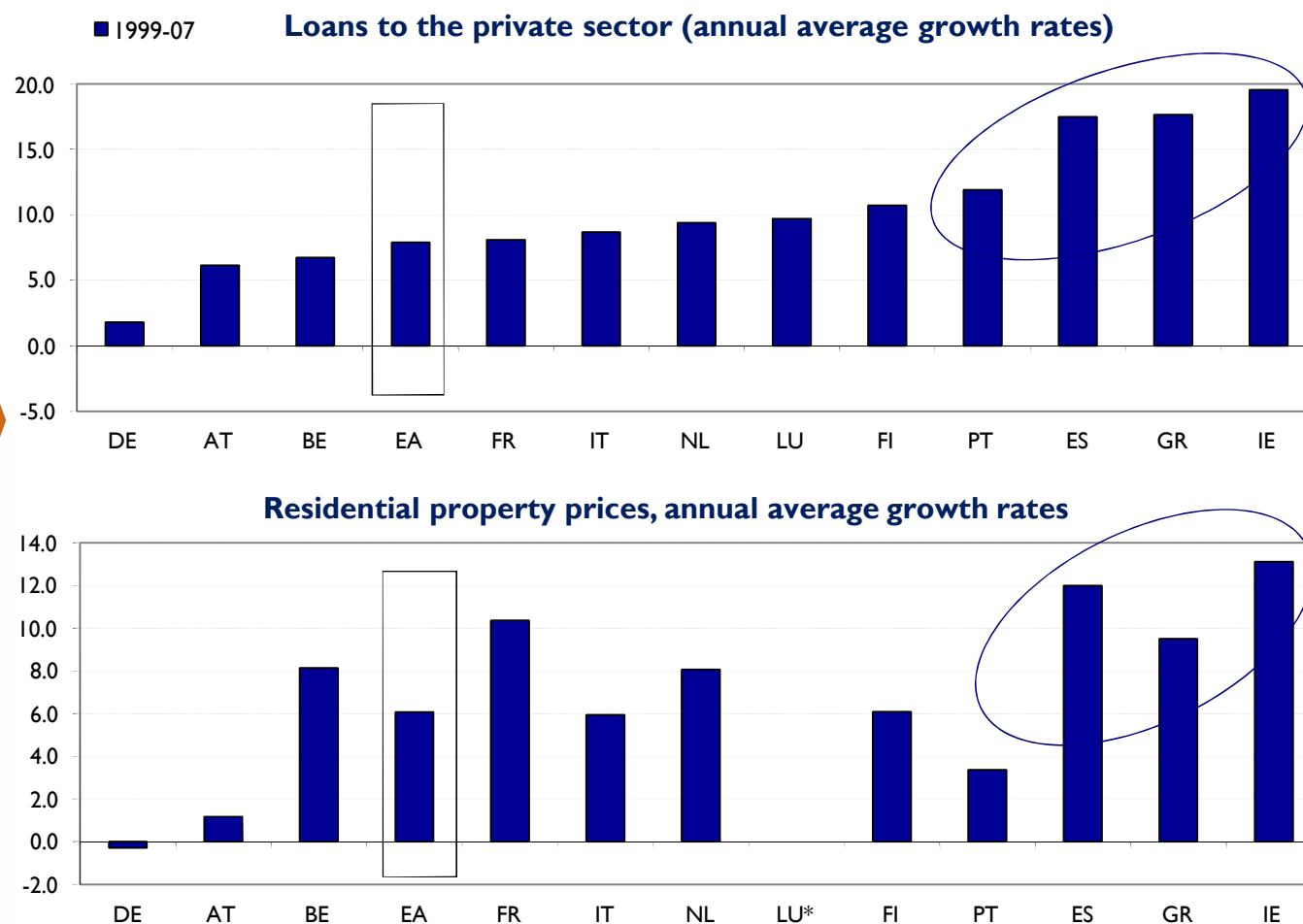
# Three experiences ...



# A) The experience with the “old-comers”

## I. Loans to private sector and house prices

“Too low”  
real interest  
rates in  
some  
countries  
supported  
strong  
credit  
growth and  
housing  
booms.



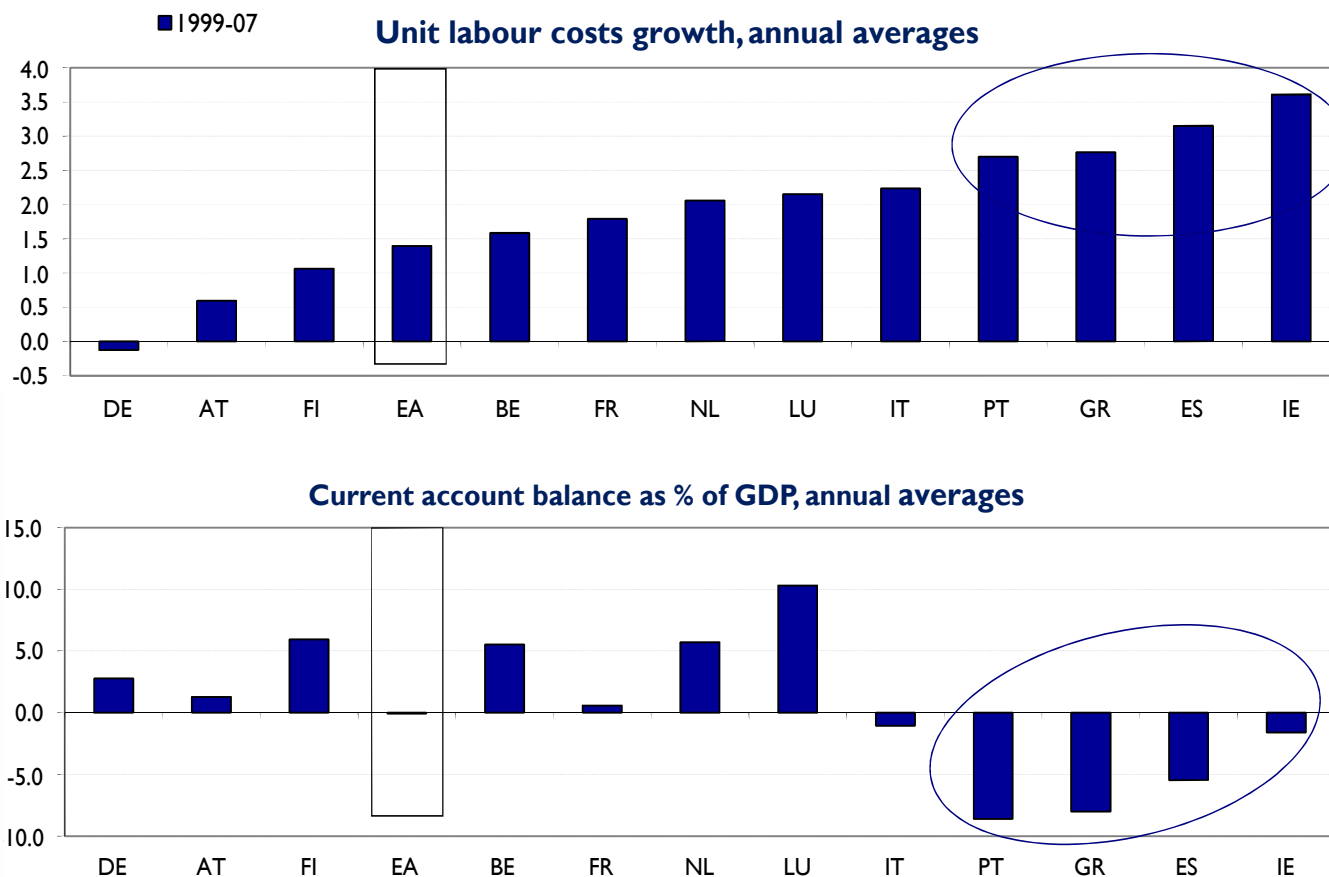
Sources: Eurostat and European Central Bank.

Note: Countries are ranked in ascending order according to the average loans growth in 1999-2007. \*House prices data for Luxembourg not available.

# A) The experience with the “old-comers”

## 2. Unit labour costs and current account

Rapid convergence in terms of financial conditions and overly optimistic income expectations contributed to macro-economic and financial imbalances gradually accumulating.



Source: Eurostat and European Central Bank.

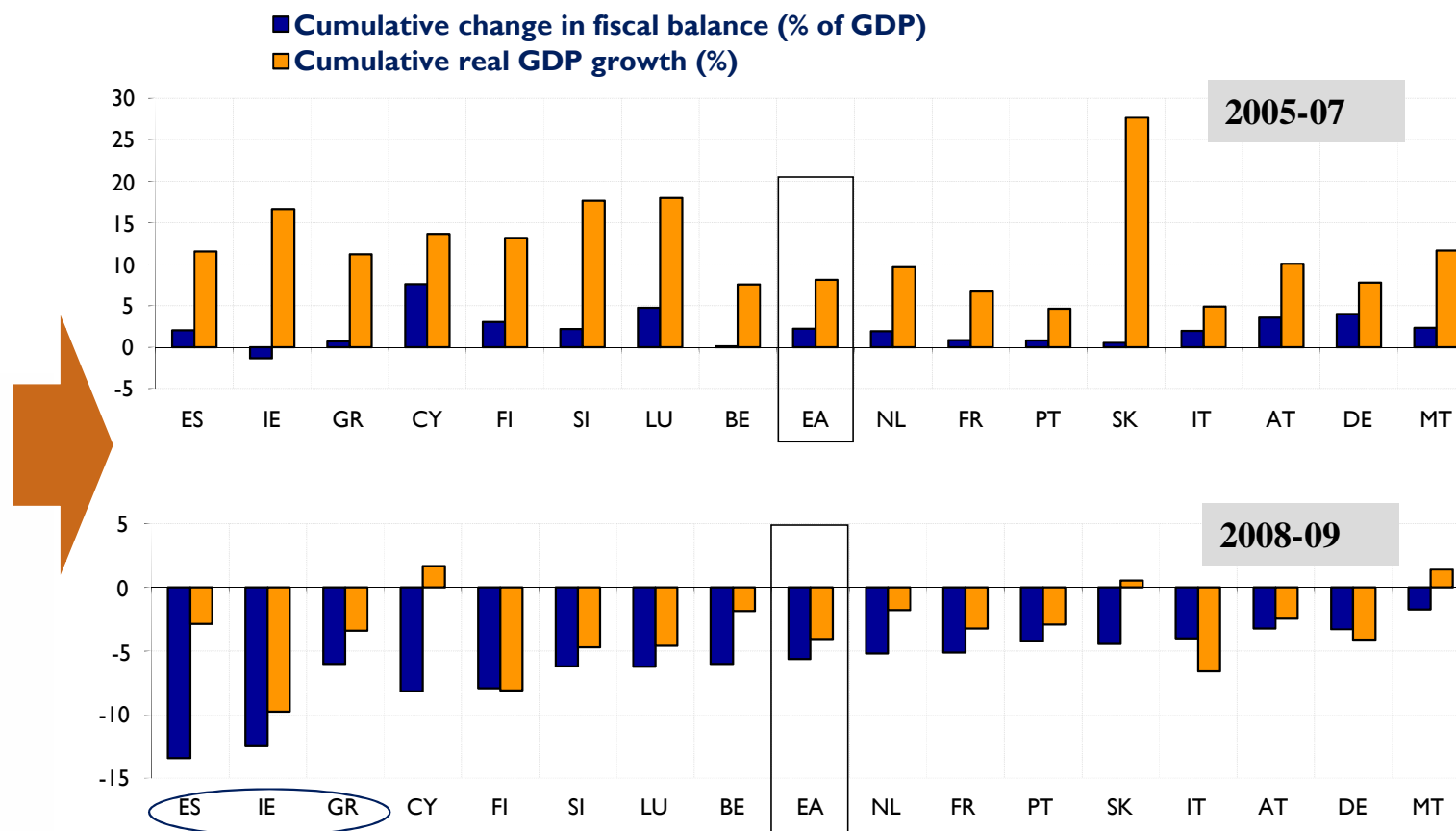
Note: Countries are ranked in ascending order according to the average unit labour costs growth in 1999-2007.

# A) The experience with the “old-comers”

## 3. Fiscal policy

During the boom period insufficient fiscal buffers were built up.

When the crisis came, public finances deteriorated markedly.



Sources: European Commission and Eurostat

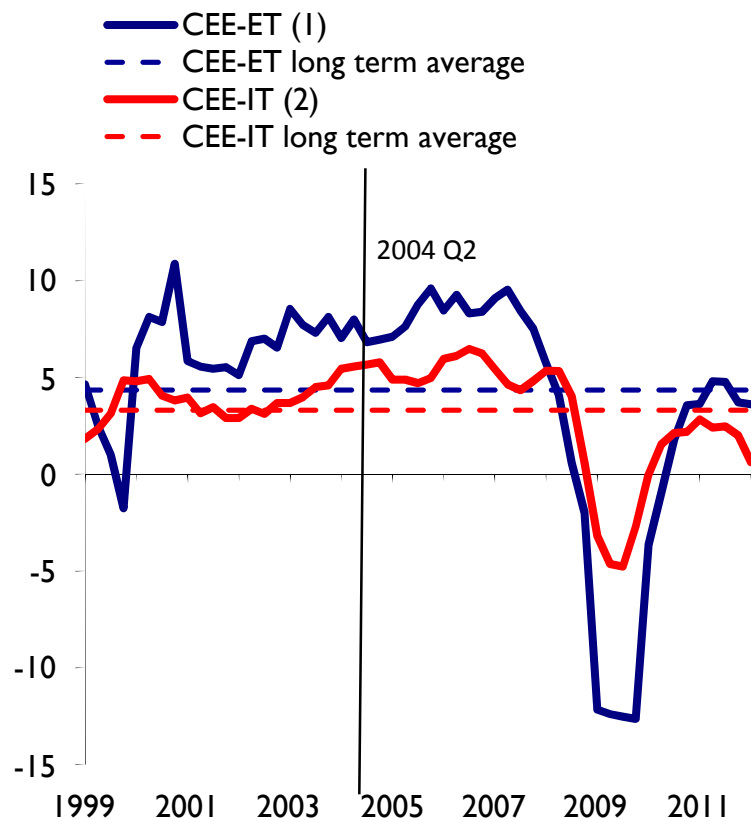
Note: Countries are ranked according to the change in the fiscal position over the period 2008-09.

## B) The experience with potential newcomers

### I. Economic activity more volatile in fixed exchange rate countries...

#### Real GDP growth

(quarterly data; percentages)



Source: Eurostat.

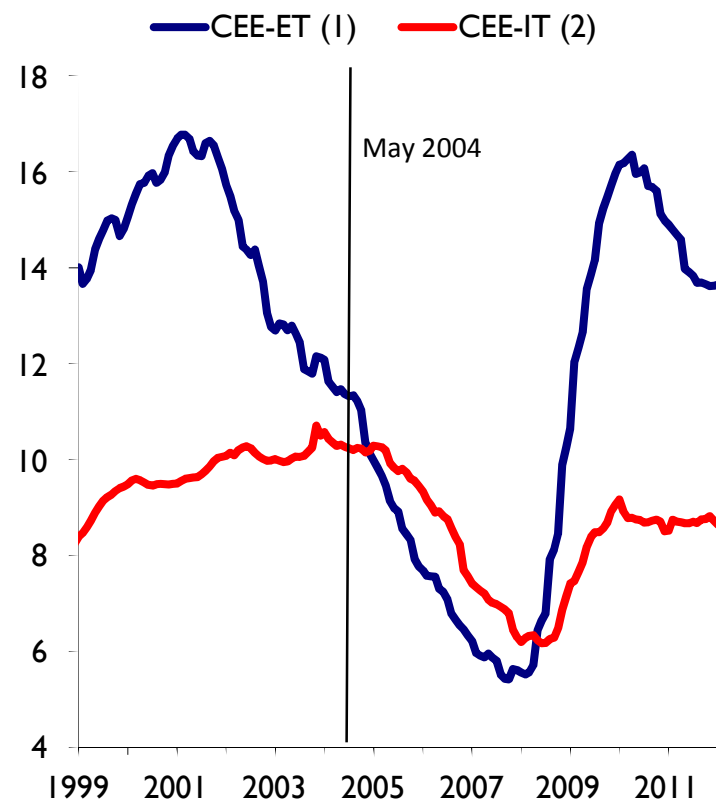
Note: Last observation: 2012 Q1. Long term average refers to 1999Q1-2012Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

#### Unemployment

(monthly data; % of labour force)



Source: Eurostat.

Note: Last observation: May 2012 for CEE-IT and March 2012 for CEE-ET.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

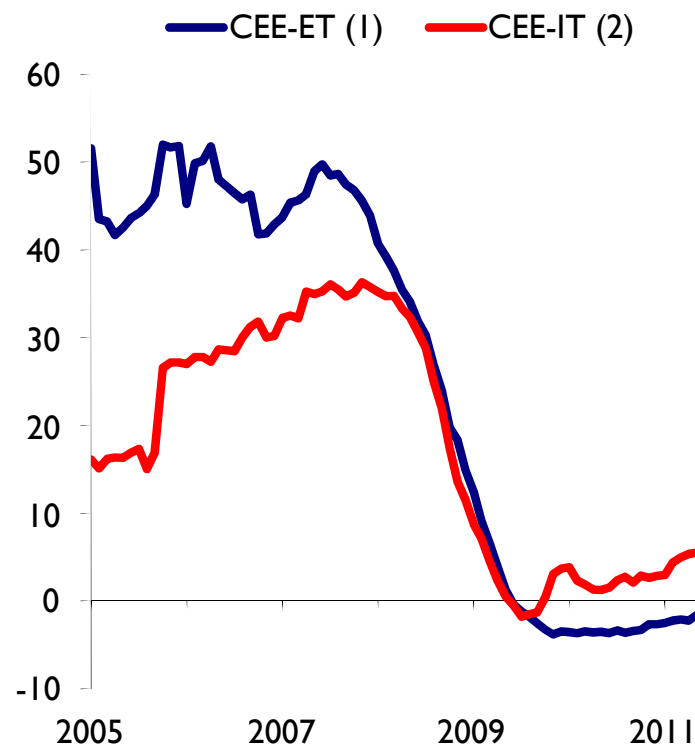
(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

# B) The experience with potential newcomers

## 2. ...reflecting domestic boom-bust cycles...

### Credit to the private sector

(monthly data; year-on-year percentage changes)



Source: European Central Bank.

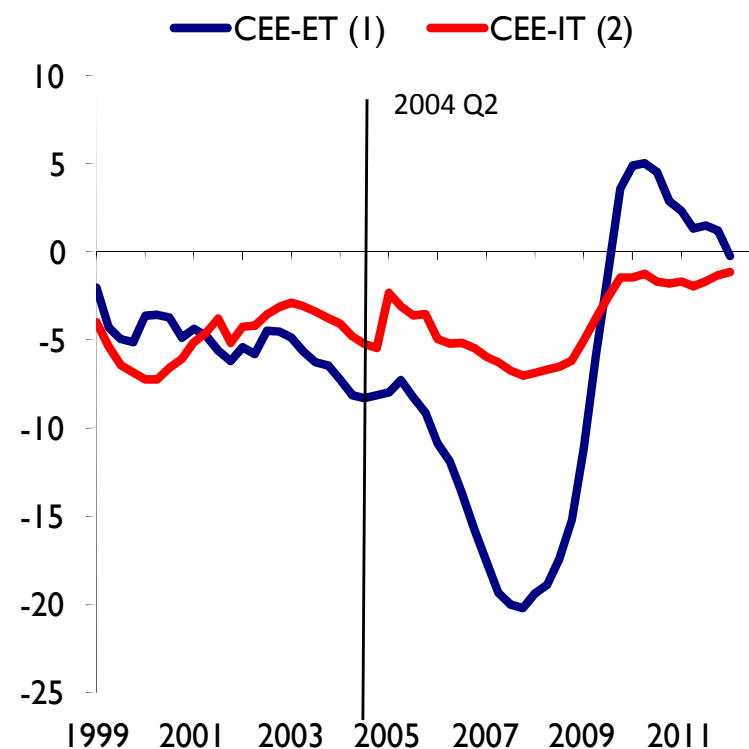
Note: Last observation: April 2012.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

### Current account balance

(quarterly data; percentage of GDP)



Sources: Eurostat and European Central Bank.

Note: Last observation: 2012 Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

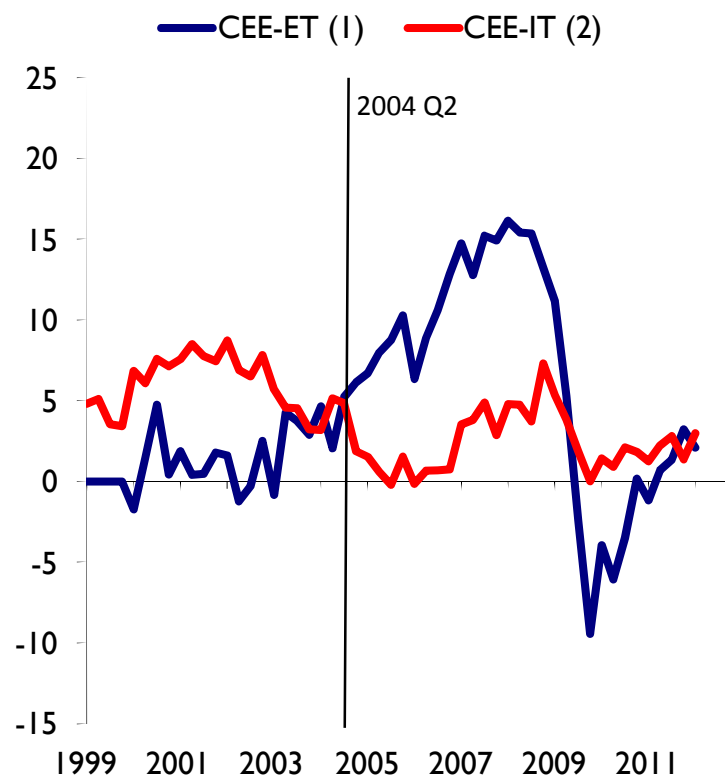
(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

## B) The experience with potential newcomers

3... and leading to competitiveness loss, especially in CEE-ET countries

### Unit labour costs

(quarterly data; year-on-year percentage change)



Source: Eurostat

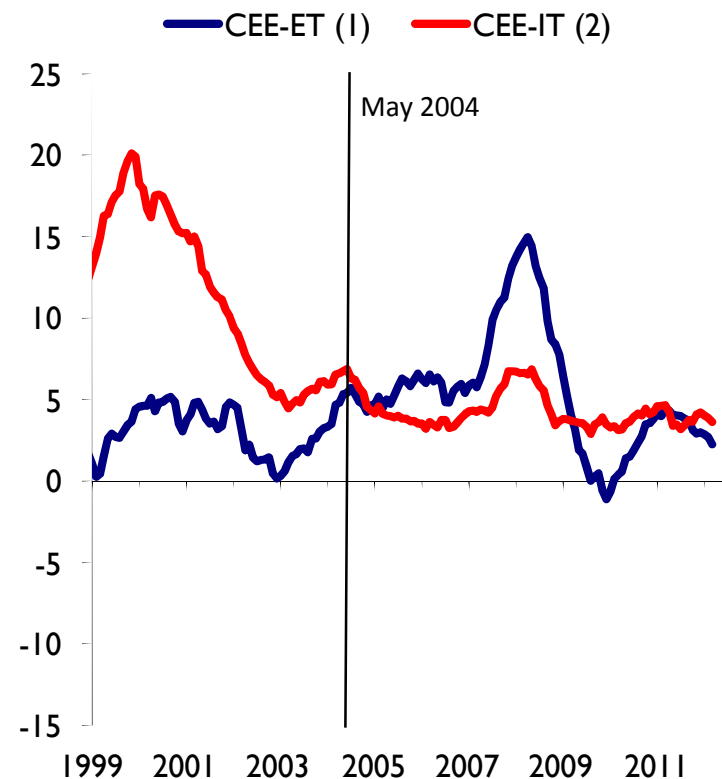
Note: Last observation: 2012 Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

### Annual HICP inflation

(monthly data; year-on-year percentage change)



Source: Eurostat

Note: Last observation: May 2012.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

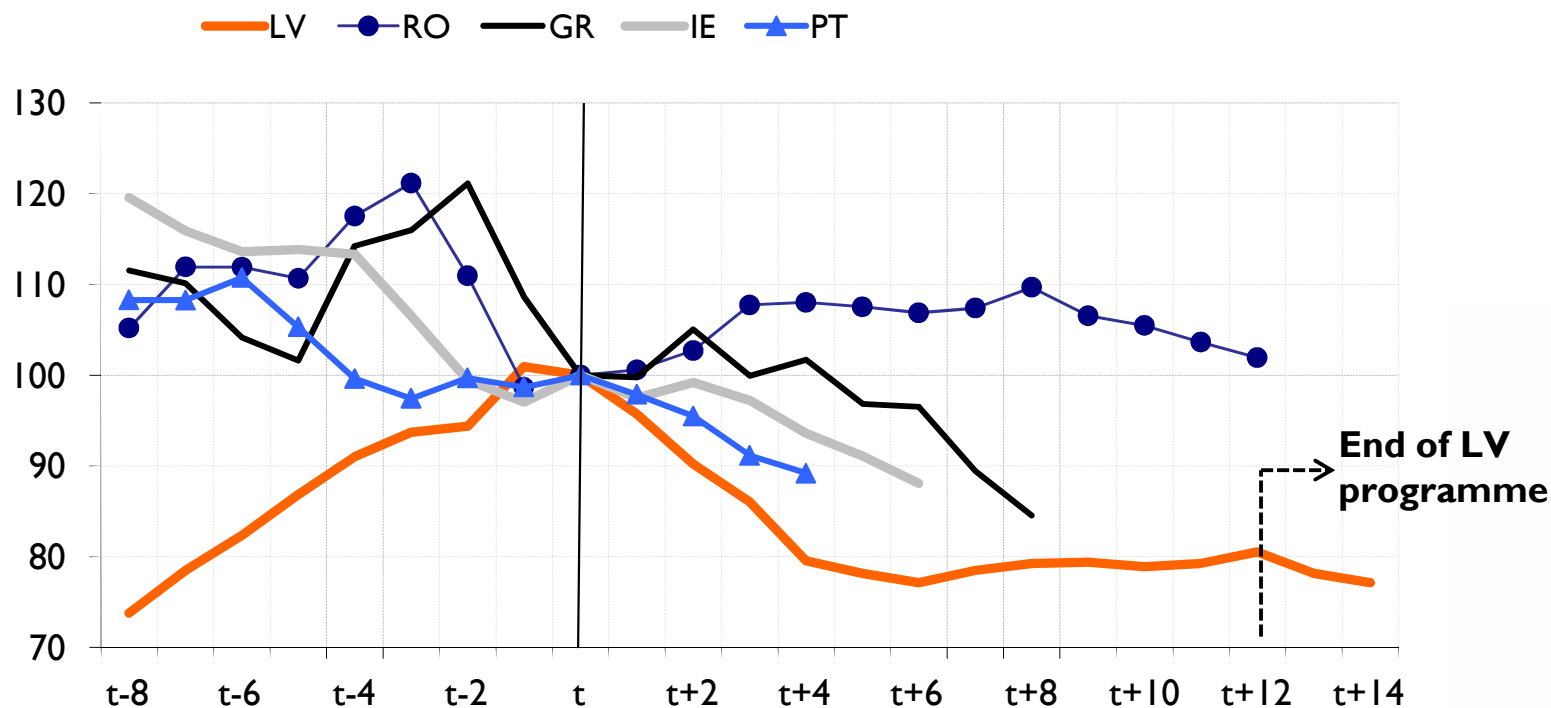
(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

# C) The experience with programme countries

## I. Competitiveness

### Real effective exchange rate (deflated with total economy ULC)

(quarterly frequency; index,  $t = 100$ ;  $t$  stands for the quarter in which the program started in the respective country)



Source: Eurostat.

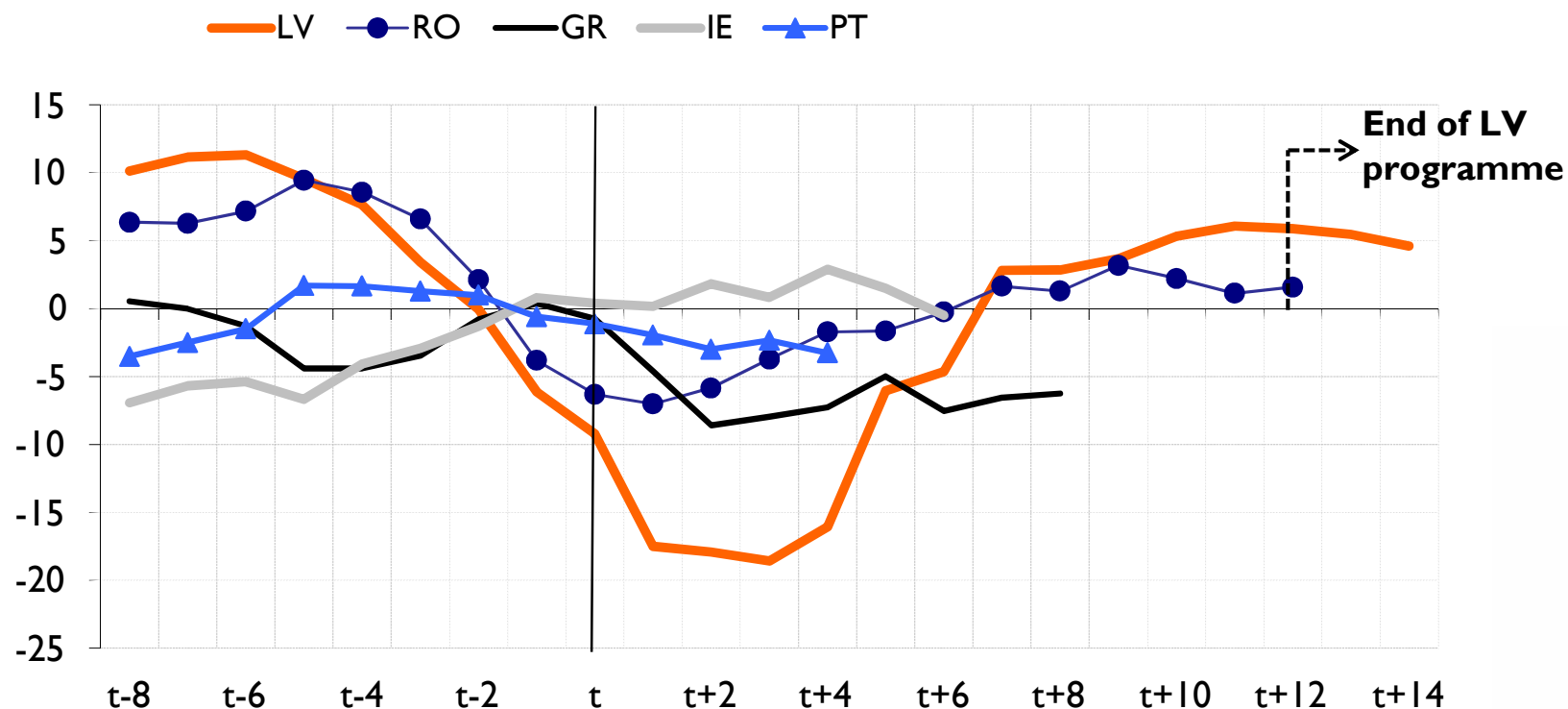
Latest observation: 2012Q2. Note: Calculated vis-à-vis 20 trading partners.  $t$  stands for the quarter in which the program started in the respective country: LV 2008Q4, RO 2009Q2, GR 2010Q2, IE 2010Q4, PT 2011Q2.

# C) The experience with programme countries

## 2. Real GDP growth

### Real GDP growth

(quarterly frequency; year-on-year growth rates;  $t$  stands for the quarter in which the program started in the respective country)



Source: Eurostat.

Latest observation: 2012Q2. Note:  $t$  stands for the quarter in which the program started in the respective country: LV 2008Q4, RO 2009Q2, GR 2010Q2, IE 2010Q4, PT 2011Q2. Data sa or wda and sa, GR: nsa.



**And three lessons ...**

## **Lesson I** – Fixing the exchange rate (irrevocably or not) always raises challenges

- Boom/bust cycles may be difficult to contain in the absence of an independent monetary policy, especially in countries with large catching-up potential
- With fixed exchange rates, other policy areas must provide the economy with the ability to cope with country-specific shocks and avoid the emergence of macroeconomic imbalances
- ... But support from other policies is also needed in inflation targeting countries

## **Lesson 2** – Sustainability and durability of euro adoption are key to prevent the errors of the past

**EU Treaty (Art. 140) talks about  
“a high degree of sustainable convergence” = more  
than fulfilling the convergence criteria at one point in  
time**



**Deep assessment is essential before a Member  
State can adopt the euro**



**Strong local institutions and compliance with new EU  
economic governance are important variables in the  
assessment of the sustainability of convergence.**

# Lesson 3 – “Internal devaluation” can work

Latvia's  
example

## Exogenous factors

## Endogenous factors

### *“Countries’ initial conditions”*

### *“Right policy does deliver”*

Latvia: Very country-specific

Latvia: Possibly in common  
with other countries

Magnitude of crisis shock and  
pre-crisis imbalances

Perceived lack of alternatives  
to hard peg

Magnitude of FX loans

Collective memory of past  
success crisis resolutions

Small open economy

Low stock of public debt at the  
beginning of the crisis

Downward wage and price  
flexibility

Sustainable financial sector

Electoral rules, form of  
government

Degree of party fragmentation  
and political (in-)stability

Appropriate IMF/EU  
conditionality

Frontloading of measures  
 (“Big Bang” approach)

Proper communication strategy

Overall government credibility

Distribution of costs

Government’s cohesion

# Outline

**1 Is euro adoption an “opportunity?”**

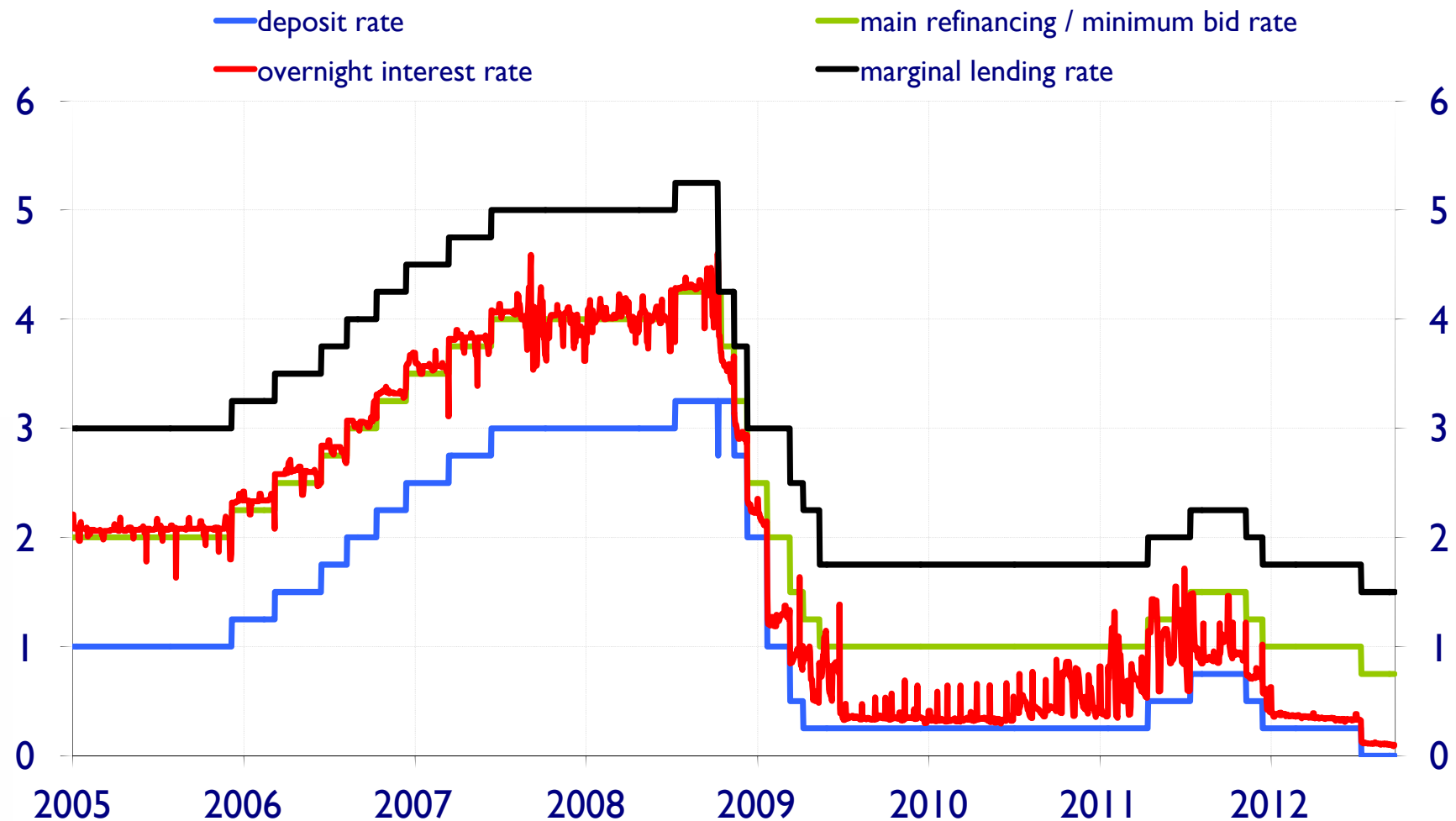
**2 Euro area perspective on newcomers**

**3 Newcomers perspective on the euro area**

**4 Conclusions**

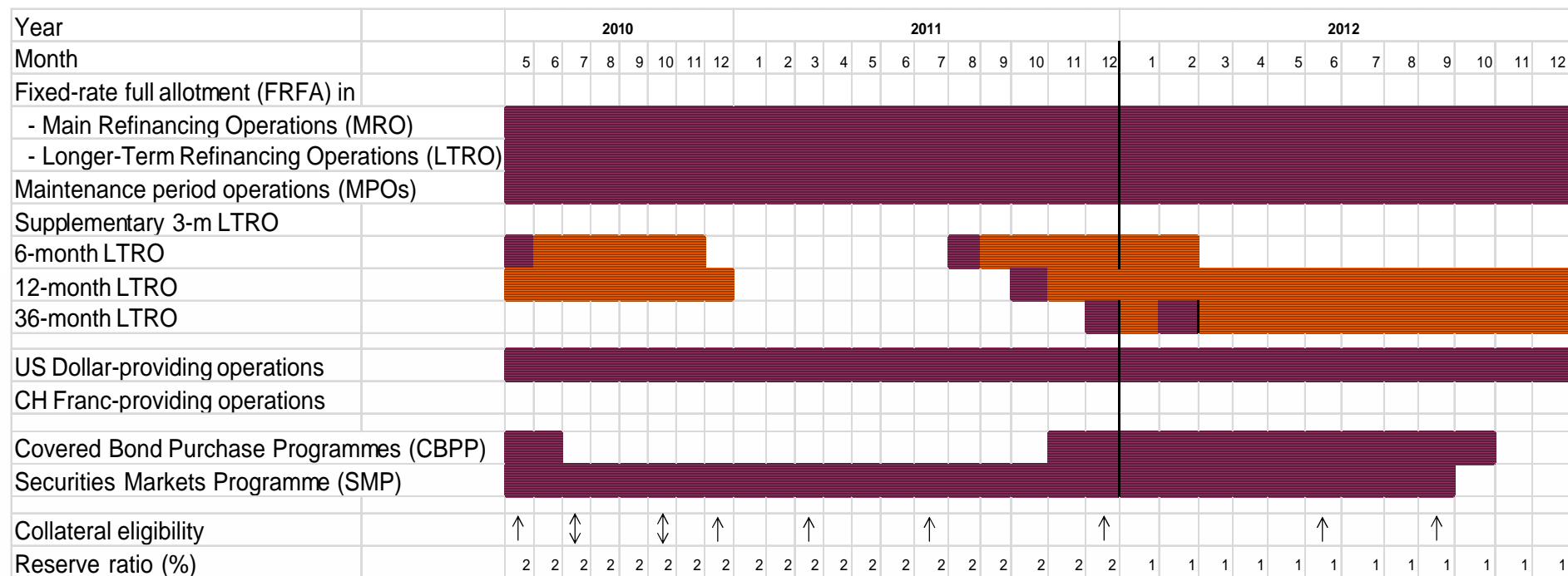
**IMonetary policyhas responded  
tothe crisis ...**

# The ECB interest rates were cut by 325 basis points within 7 months in 2008/09 ...



Source: ECB; percentages per annum; daily data.  
Latest observation: 21 September 2012

# ... and various non-standard measures have been taken

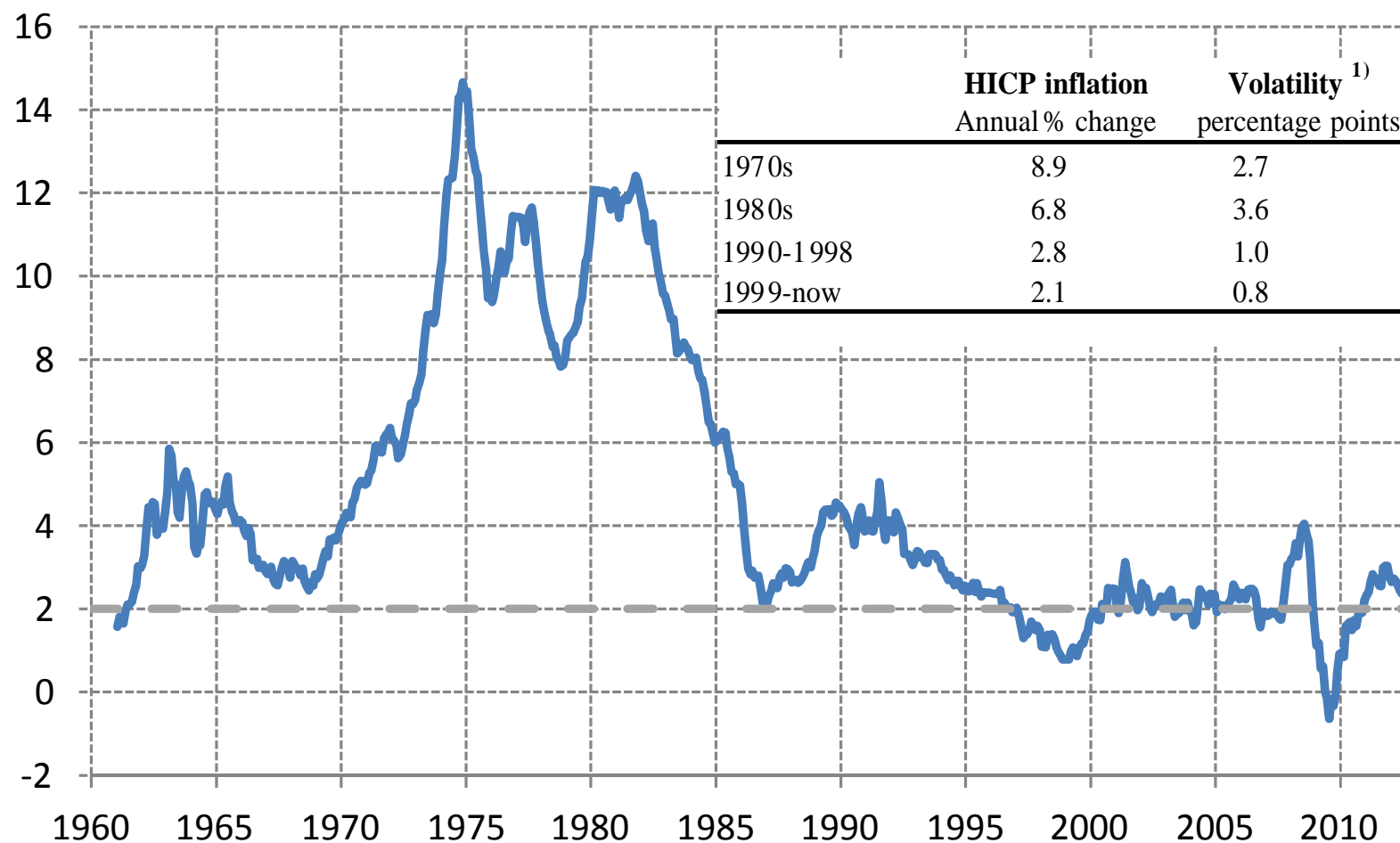


Source: ECB.

Note: The purple bars indicate that operations were conducted, or committed to be conducted, in the specific month, while the orange bars indicate that effects of past operations were in place. Upward arrows in the row “collateral eligibility” indicate an increase in collateral availability.



# ECB has not compromised on its mandate



Latest observation: August 2012.

Sources: Eurostat and ECB calculations.

Notes: Inflation in percentage change compared to previous year.

1) Unweighted standard deviation of monthly HICP inflation.

**II ... but reform needs go much  
beyond the scope of monetary  
policy**

# The original governance framework was incomplete ...

## A single monetary policy ...

- Clear mandate: price stability
- Independence
- Prohibition of monetary financing

**... but:**

- No effective surveillance and governance of fiscal, structural, macro-prudential, and financial supervision policies
- No crisis resolution mechanism

... but a lot of progress has been made in the meantime ...

**Strengthened surveillance (“6-Pack”)**

- - Enhanced Stability and Growth Pact
- - Macro and Excessive Imbalances Procedures
- - European Semester

**Fiscal governance**

- - Fiscal Compact
- - “2-Pack” (\*)

**Crisis resolution**

- - European Stability Mechanism

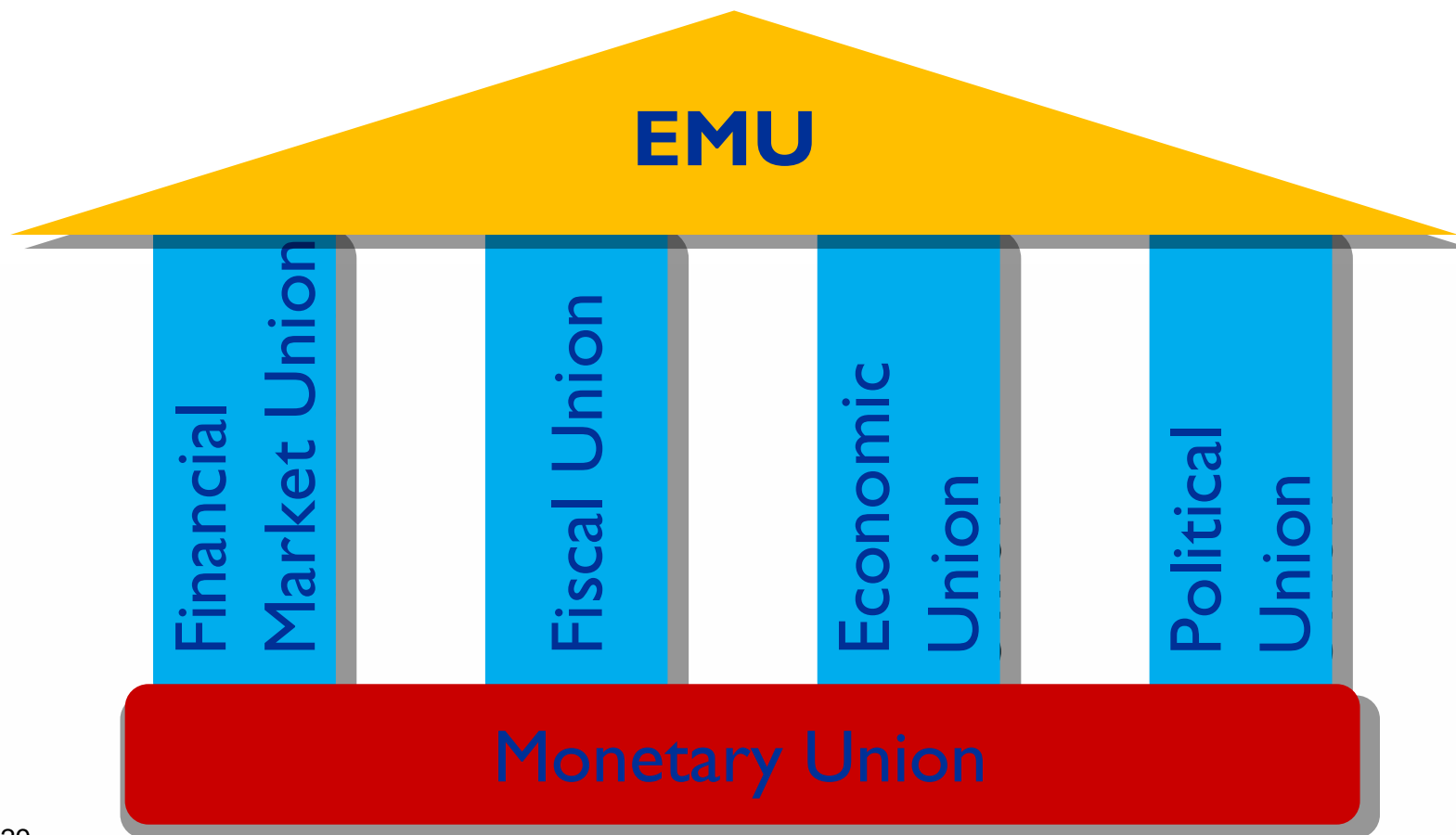
**Integrated financial framework**

- - European Supervisory Authorities
- - European Systemic Risk Board
- - Single Supervisory Mechanism (\*)

# EMU architecture is set for fundamental reform

## **Towards a genuine economic and monetary union**

*Report by the Four Presidents to European Council 28-29 June*



# Challenges going ahead

- **Fiscal union**
  - Shared sovereignty
  - Budget intervention rights
- **Economic union**
  - Coordination of structural reforms
- **Political union**
  - Democratic legitimacy

# Outline

**1 Is euro adoption an “opportunity?”**

**2 Euro area perspective on newcomers**

**3 Newcomers perspective on the euro area**

**4 Conclusions**

Euro is **irreversible** and still an **opportunity**  
... *but* lots of homework and cooperaton is still required!

**Euro irreversibility ...**



**Stronger European architecture + Homework euro area countries**



**Euro adoption still an opportunity**



**Sustainable convergence + Homework newcomers**



***Thanks!***

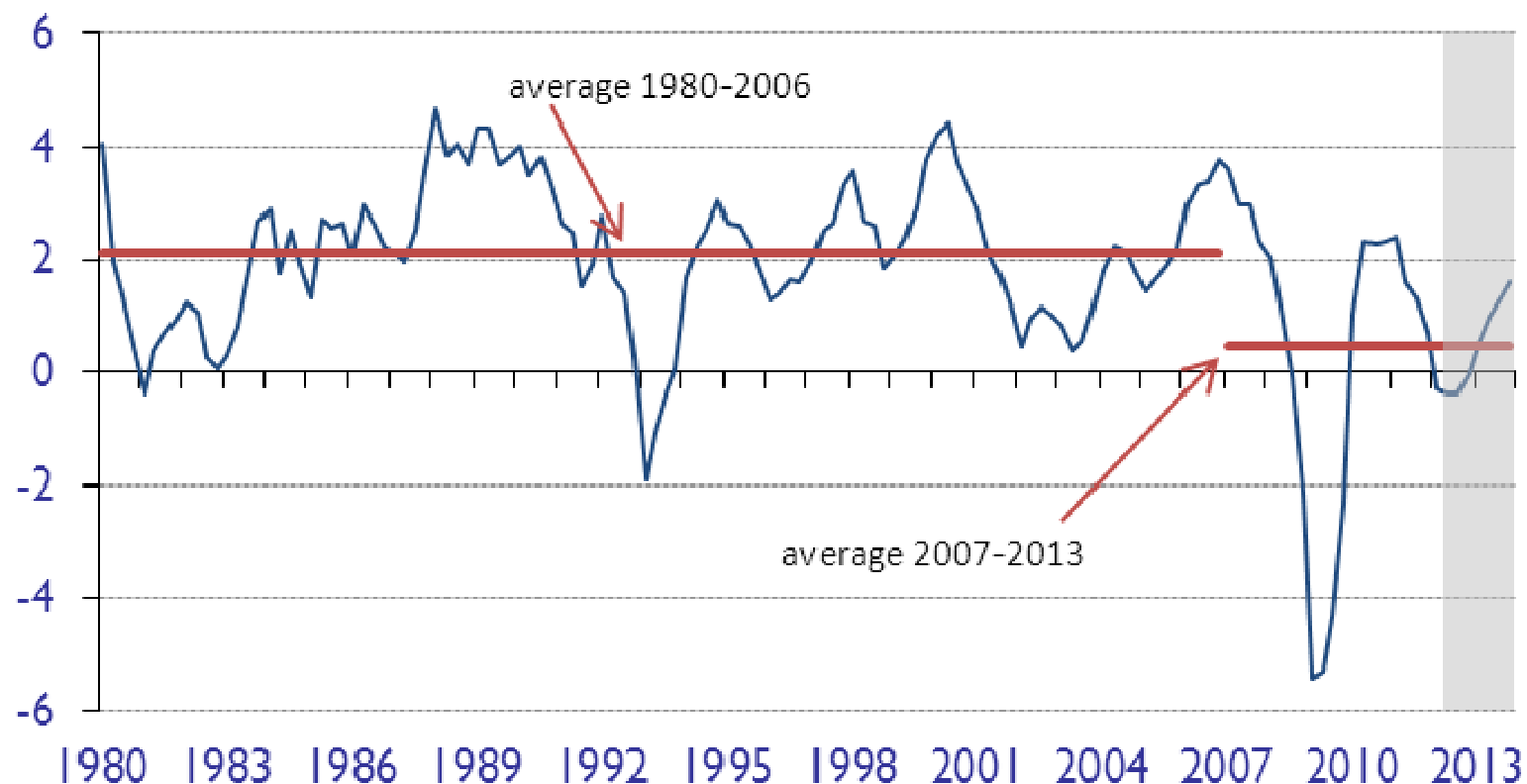
## **Backgroundslides :**

**I - Euroarea economy – where  
dowe stand?**

# Growth and growth prospects are weak

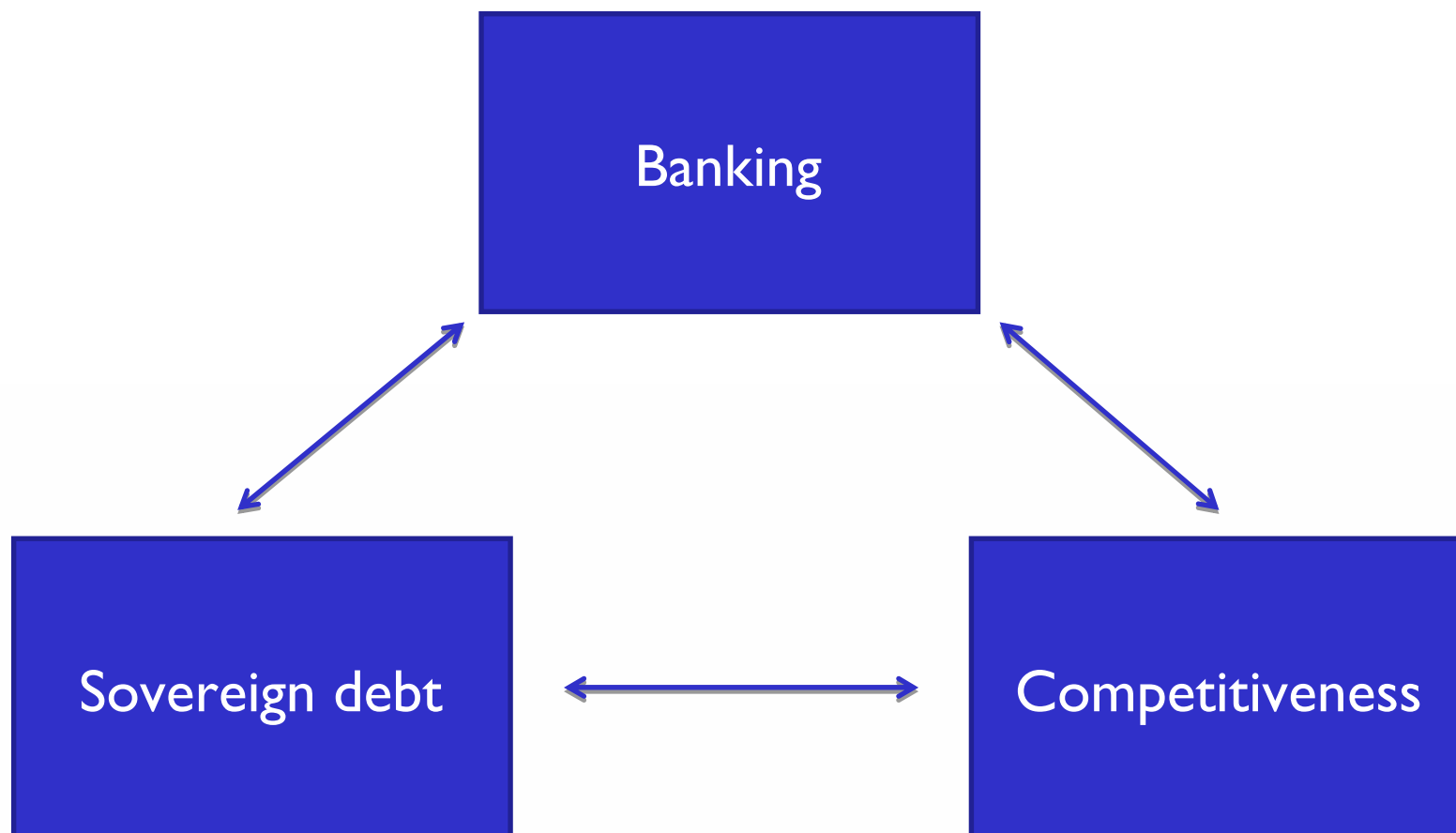
## Euro area real GDP

*(annual growth rates)*



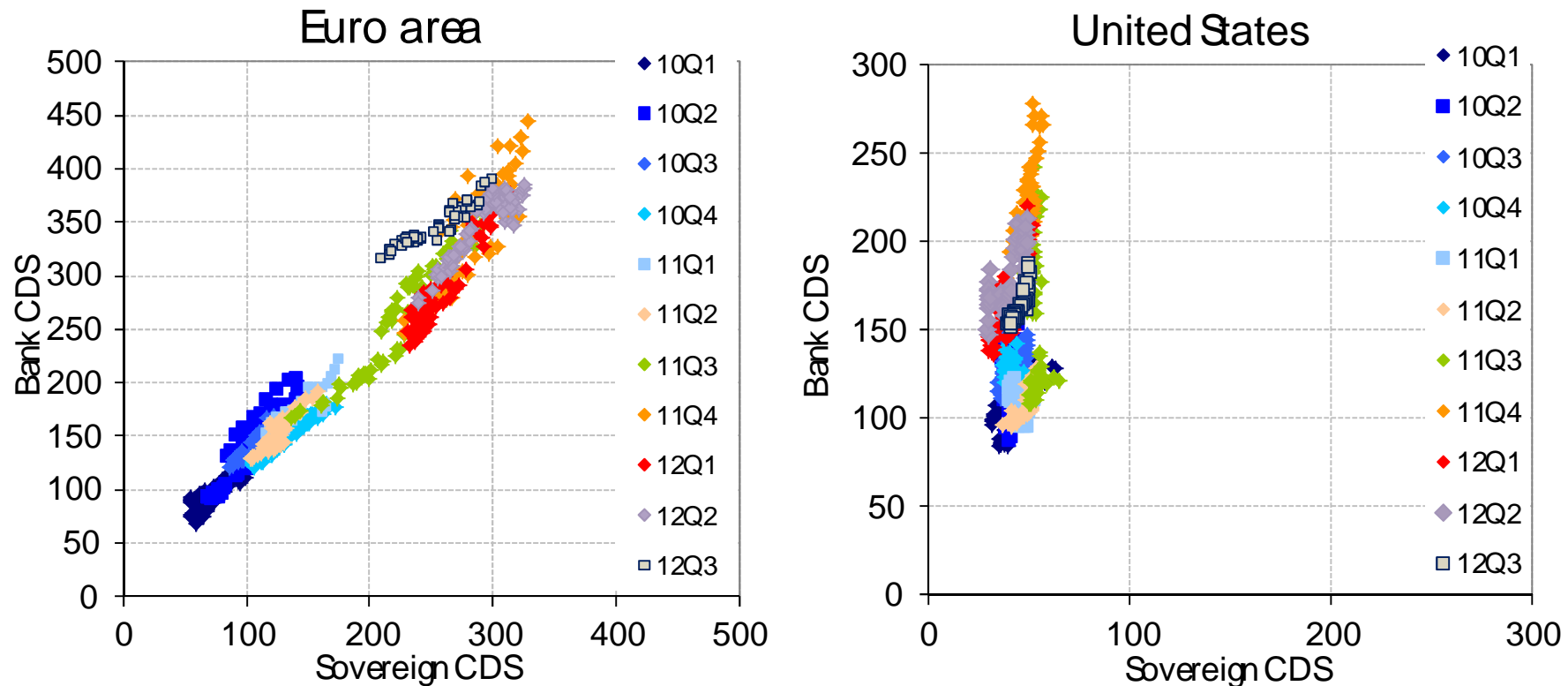
*Source: Eurostat and European Commission (Spring 2012 forecasts).*

# Euro area are conditions are heterogeneous



# Fiscal sustainability and financial stability have become strongly intertwined...

## Five-year Bank and Sovereign CDS (daily data, basis points)



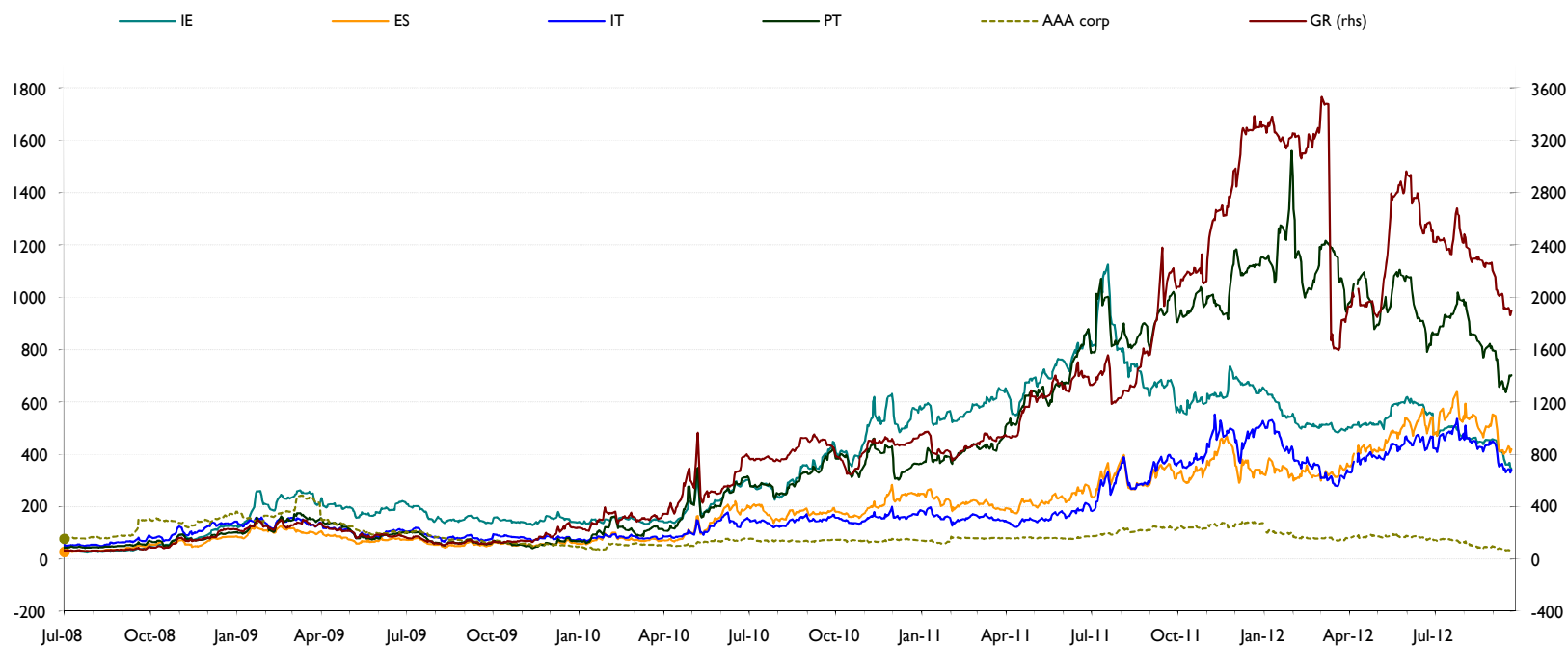
Sources: Thomson-Reuters and ECB calculations.

The sovereign credit default swap premia for the euro area are calculated as a weighted average of the five-year CDS premia of 11 euro area countries using the ECB's capital key as weights. The countries included are: DE, FR, IT, ES, NL, PT, BE, AT, FI, SK, IE. The bank CDS premia are calculated as the simple average across 10 large banks in the euro area. Each dot represents the pair of (sovereign CDS, bank CDS) on a certain day in each quarter.

# Spreads have at times reached extreme levels

## Spread over German 10-year government bond yield (basis points)

(Jan 2008 - 21 Sep 2012)



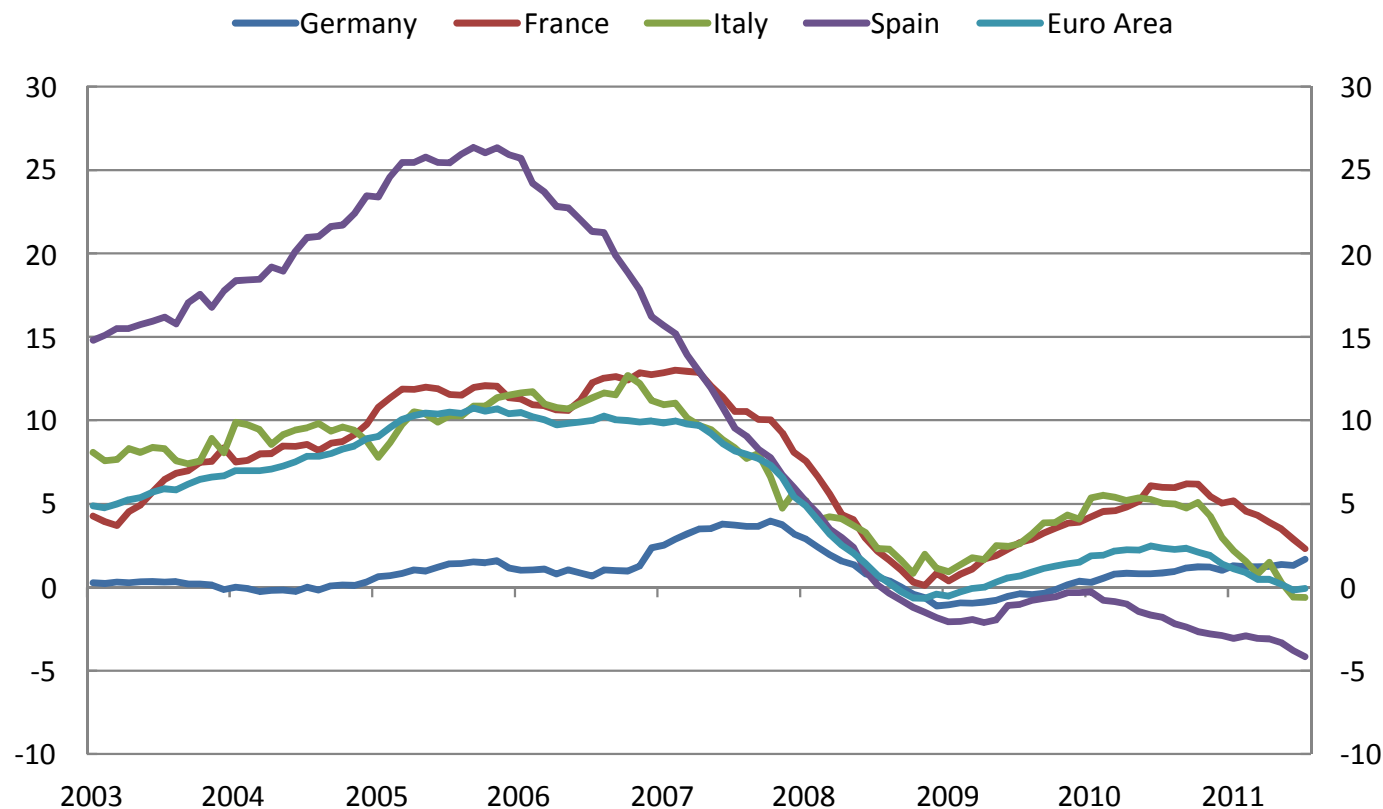
Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations.

Data: Bond yield spreads vis-à-vis the German 10-year government bond, end-of-the-month and end-of-day data (last value 21 Sep 2012, 18:00 CET; 21 Sep 2012)

Euro Area corporate AAA rated bond yields (maturity 7-10 years).

# Lending to private sector has been reduced, especially in vulnerable countries

## Lending to the non-financial private sector (y-o-y growth)

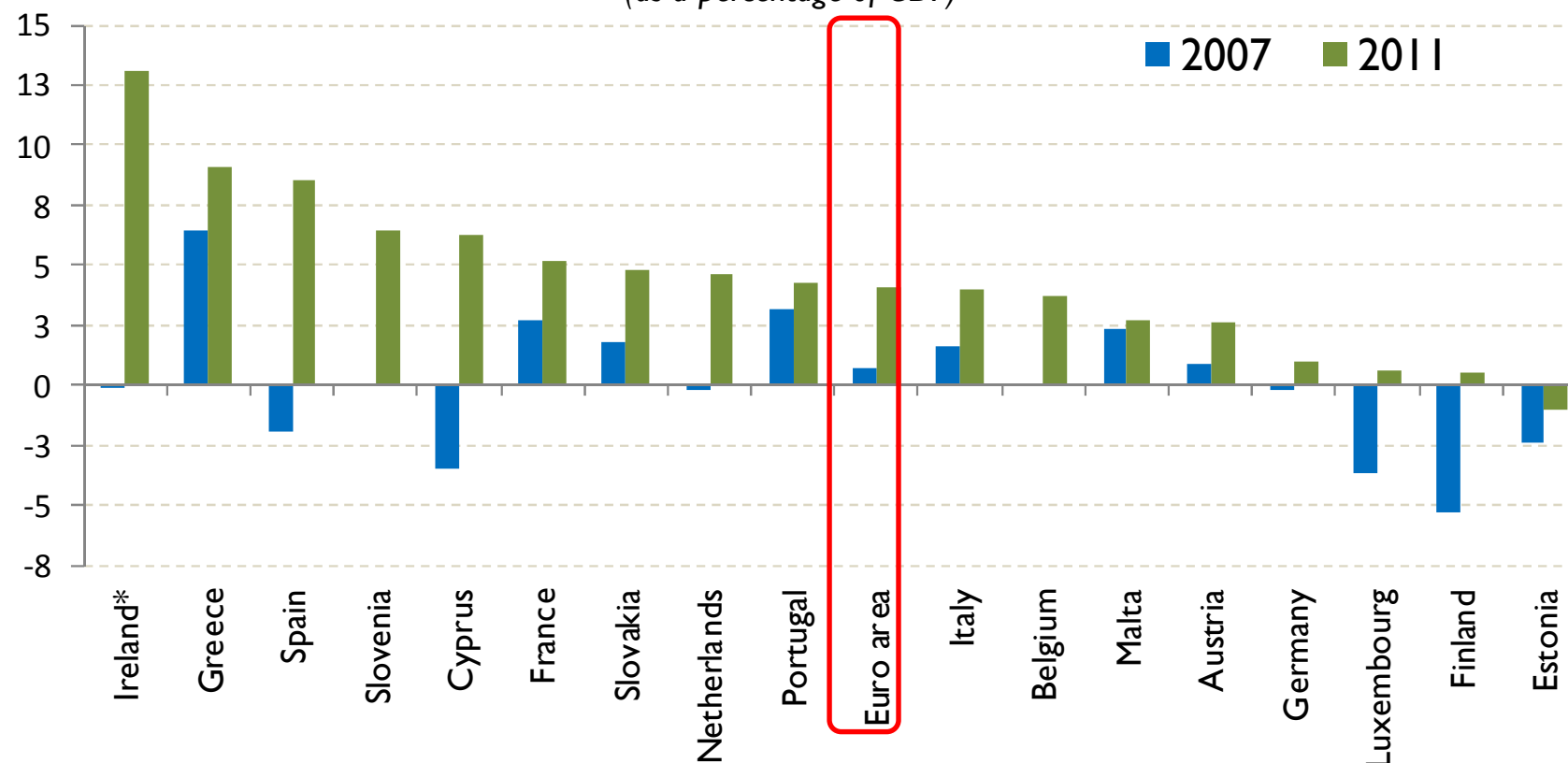


Source: ECB

# Fiscal deficits have risen ...

## General government deficit

(as a percentage of GDP)



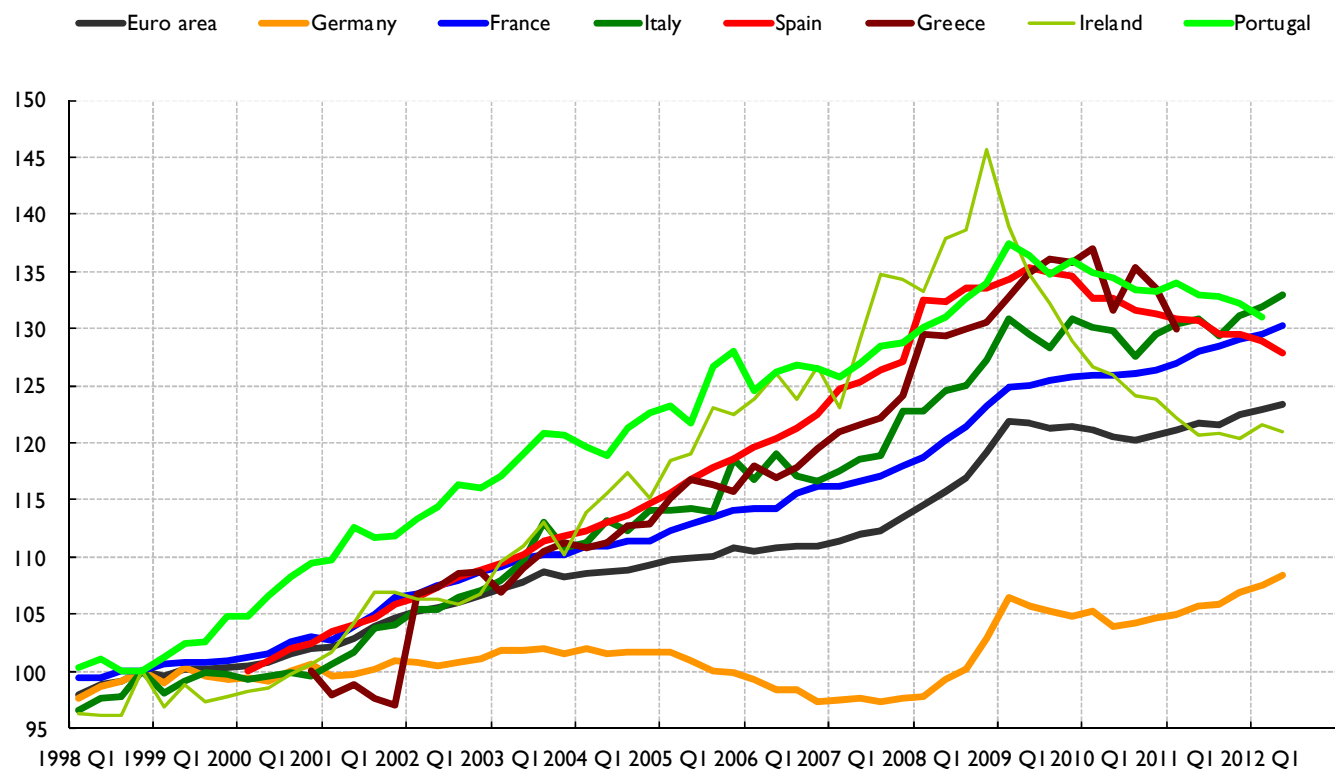
Source: European Commission's economic forecast spring 2012



# Some countries lost competitiveness, with rising unit labour costs ...

## Unit labour costs in euro area countries, nominal

(index 1998 Q4 = 100, based on sa data)



Source: Eurostat. Quarterly data up to 2012 Q1 for Portugal, else 2012 Q2, except Greece (2011 Q1).

Note: The ULC indices are set to 100 in the last quarter before the euro area accession of the respective country.

The ULC developments presented for Greece and Portugal might differ from the calculations made by the National Central Banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures.

## **Backgroundslides :**

# **2 – Countryadjustment and governancereforms**

# **Fiscal consolidation at country level**

# Significant deficit reduction, but balanced-budgets still far off

## Budget balance path for EA and selected countries (as a percentage of GDP)

	2009		2012	
	Budget Balance	Structural Primary Balance	Budget Balance	Structural Primary Balance
Ireland	-14.0	-7.6	-8.3	-4.1
Greece	-15.6	-9.6	-7.3	3.4
Spain	-11.2	-6.9	-6.4	-1.6
Italy	-5.4	0.7	-2.0	4.7
Portugal	-10.2	-5.8	-4.7	1.8
<b>Euro area</b>	<b>-6.4</b>	<b>-1.7</b>	<b>-3.2</b>	<b>1.1</b>

Source: European Commission's spring 2012 economic forecast.

# Fiscal consolidation may reduce growth in the short run, but is unlikely to be self-defeating

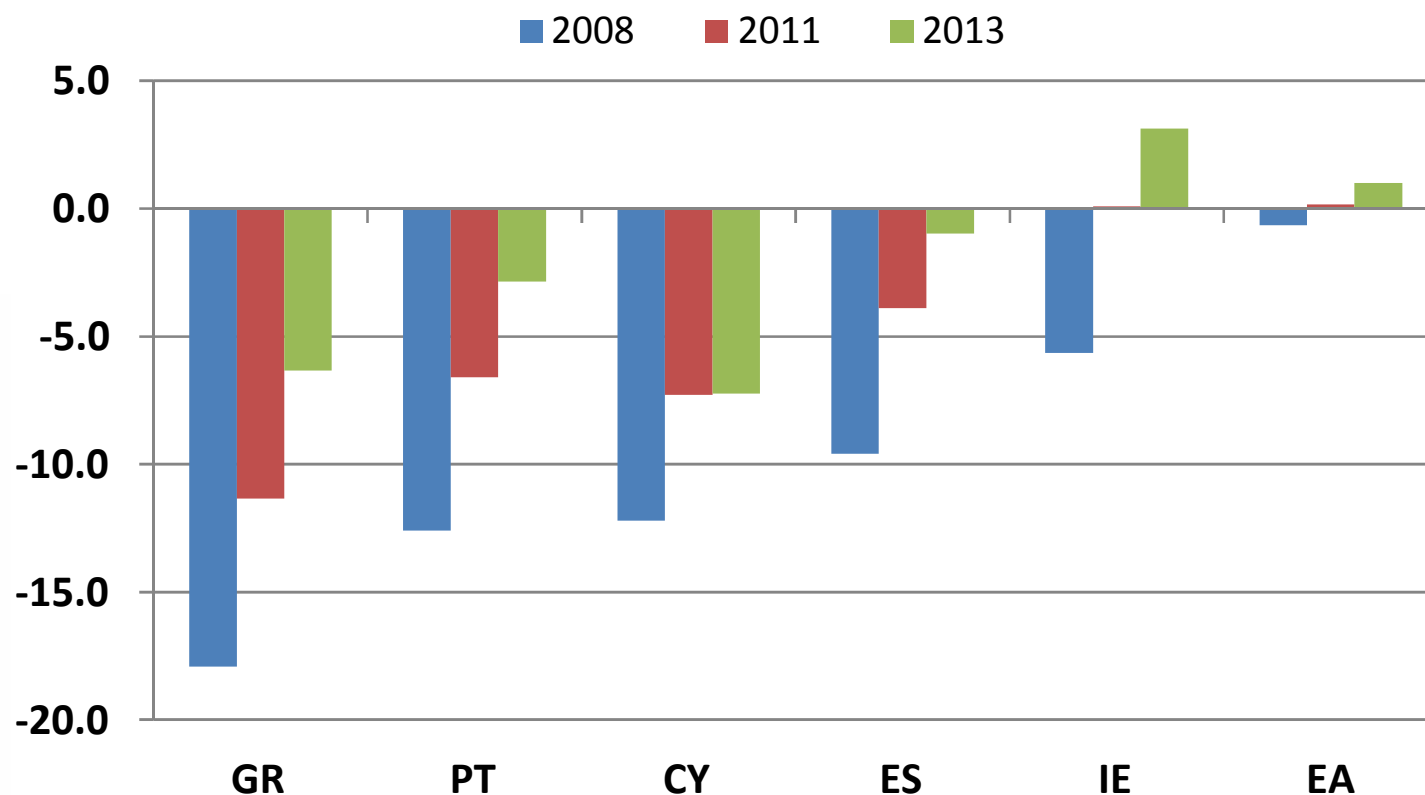
- Long term
  - *Low debt and deficits tend to be beneficial for growth*
- Short term
  - *Consolidation typically reduces growth ...*
  - *... but very unlikely to be self-defeating (especially if done properly), as this would require extreme fiscal multipliers*
- **The choice of consolidation measures is critical**
  - **To contribute to structural adjustment and reduce negative growth impact ...**
  - **And to maintain social and political cohesion**

# Structural reforms

# External imbalances are being reduced ...

## Current account balances

(percentage of GDP, National Accounts concept)



Source: AMECO.

## ... but structural reform needs remain strong

- Far-reaching labour market reforms
  - More flexible wage determination processes
- Product market reforms
  - Liberalisation, competition
- Boosting labour productivity, e.g. through
  - Privatisations
  - Innovation
  - Improving skills of the labour force
  - More favourable business environment
  - Fighting corruption and shadow economy



# Governance reform

# The gaps in economic governance are being filled

## Stronger surveillance and enforcement rules under the “six pack”

- **Strengthened Stability and Growth Pact**
- **New Macroeconomic Imbalances Procedure**

## Improved coordination of economic policies

- **European Semester**

# Fiscal surveillance is becoming broader and more intrusive

## **Fiscal Compact**

- **Balanced budget rule (structural deficit  $<0.5\%$  of GDP) of constitutional status with automatically triggered correction mechanism**
- **Decisions on existence of excessive deficit by reversed qualified majority (deficit criterion)**

## **‘2-Pack’ (under negotiation)**

- **Enhanced surveillance of countries receiving financial assistance or experiencing financial difficulties**
- **Ex ante coordination of budgetary policies**
- **Monitoring of in-year budgetary implementation when in EDP**

# **The European Stability Mechanism has been launched on 8 October 2012**

- **Stability support on the basis of strict conditionality**
- **Initial maximum lending volume of the ESM is set at € 500 billion**
- **Inaugural meeting of the ESM-Board of Governors took place in the margins of the Eurogroup meeting of 8 October 2012 in Luxembourg**

**Work on banking union is also advancing**

## **Draft legislation by European Commission**

- **ECB to supervise 6000 banks in euro area**
- **Common resolution scheme**
- **... but many details remain to be worked out**