After the crisis: what new lessons for euro adoption?

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Background and questions

- Among the first 15 EU member states, Mediterranean countries experienced unsustainable developments in 1999-2008 (partly related to their euro membership), and their overall economic record is weak
- Among the 13 countries that joined the EU in 2004-2013, 7 countries have entered the euro area. These newcomers are generally converging economies potentially subject to boom/bust developments.

➢ What was the macroeconomic performance of euro ins and outs among the newer member states?

➢ Did the lack of a stand-alone exchange rate of euro-ins made adjustment since 2008 more painful?

➢ What lesson to draw for further euro enlargement?

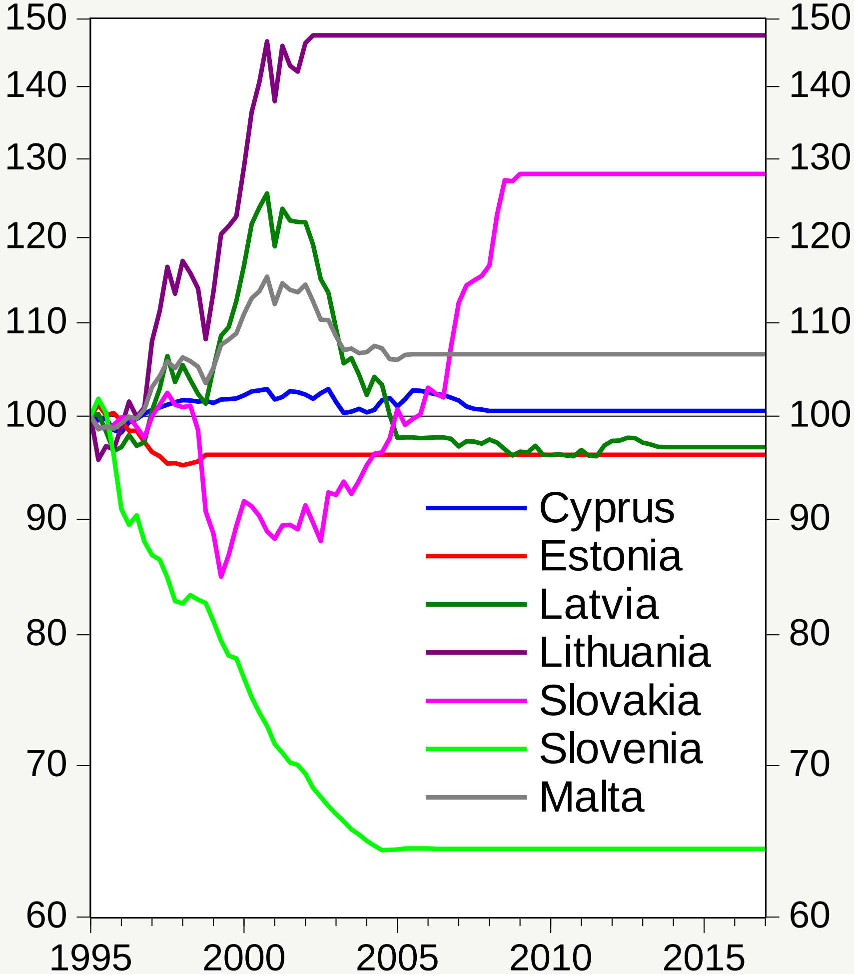
Exchange rate regimes of new EU members

Euro members			Non-euro members	
	entry date	**regime before**		**regime**
Slovenia	2007	tightly managed	Bulgaria	currency board
Cyprus	2008	tightly managed	Croatia	tightly managed
Malta	2008	tightly managed	Czech Republic	free float
Slovakia	2009	free float	Hungary	free float
Estonia	2011	currency board	Poland	free float
Latvia	2014	narrow band	Romania	free float
Lithuania	2015	currency board		

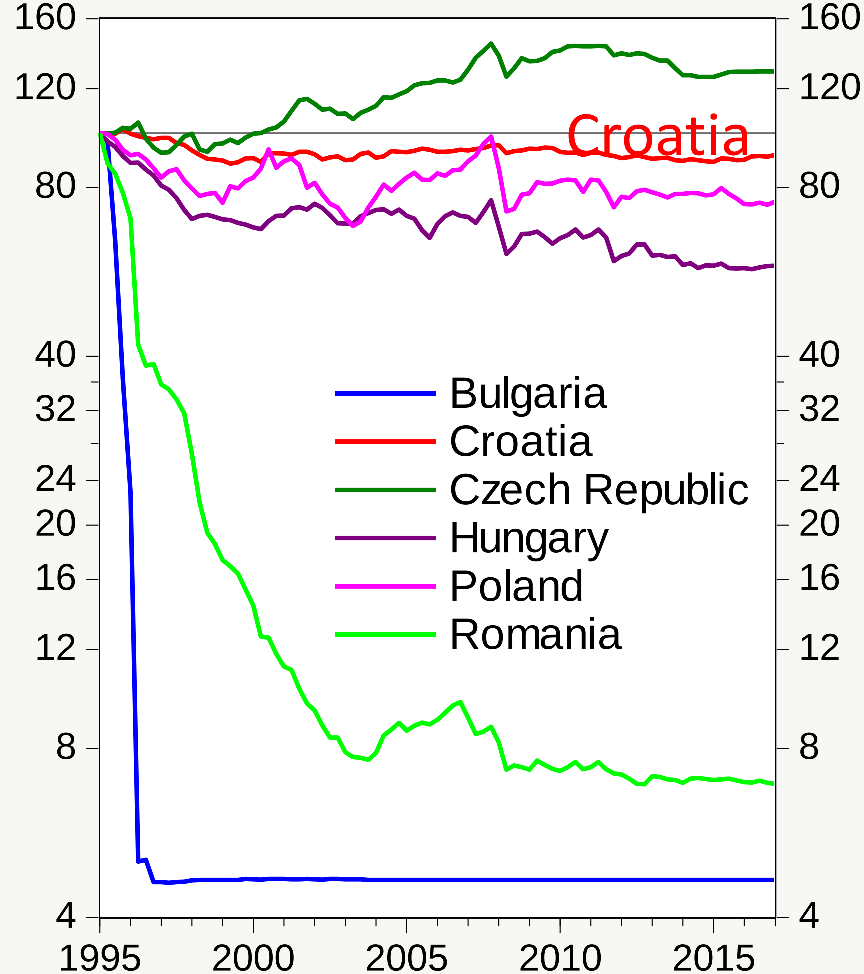
- **With the exception of Slovakia, all new euro members had rigid exchange rate regimes before joining the €**

Nominal exchange rate against the euro (1995Q1=100)

Euro members



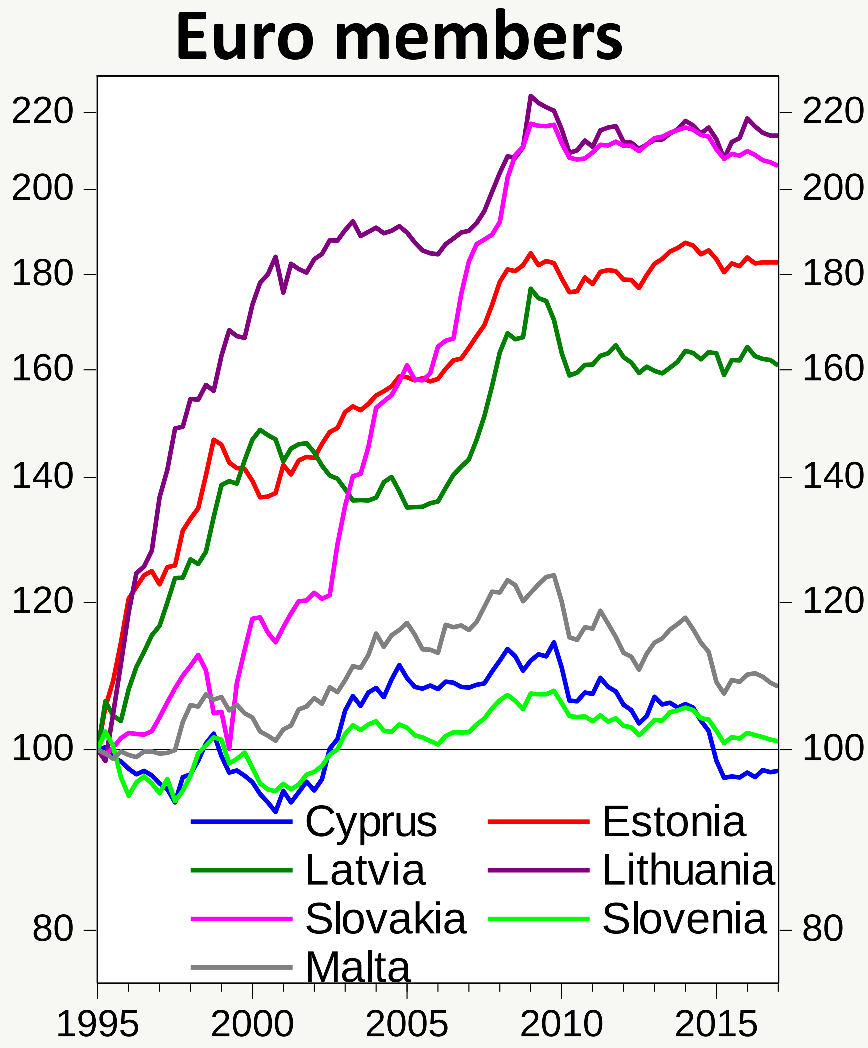
Outs

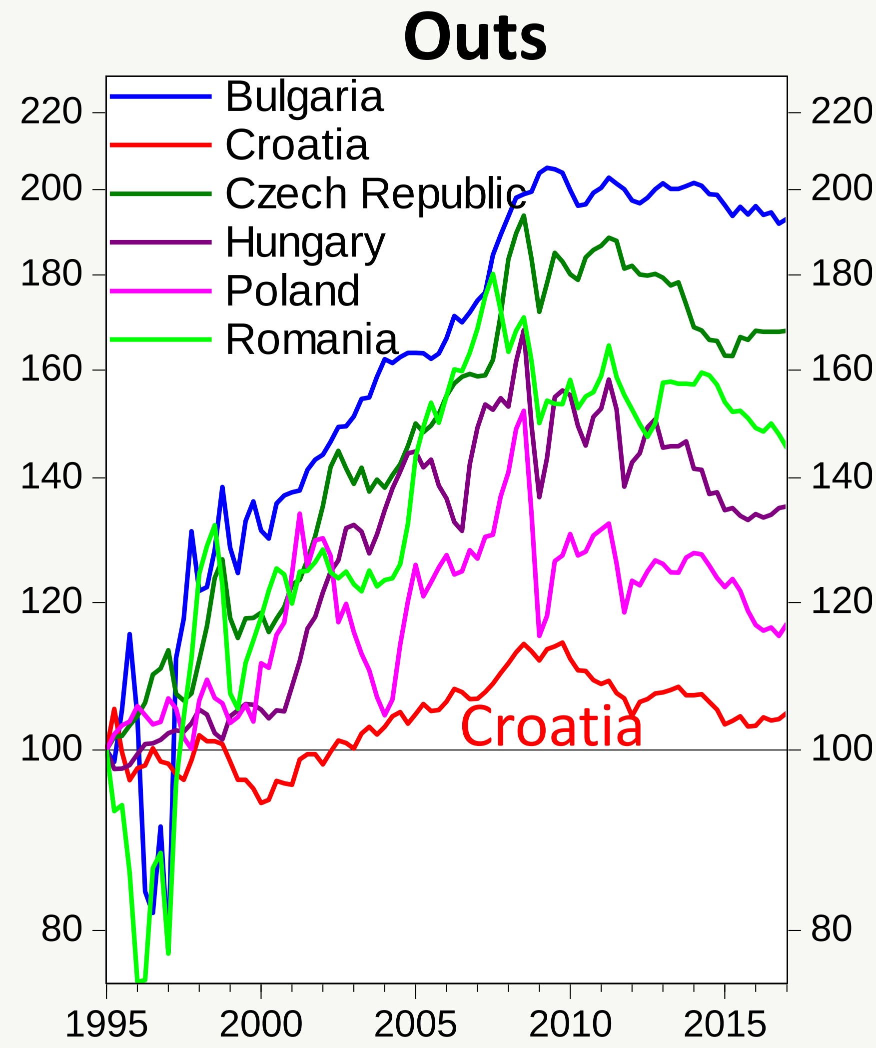


➢ **Diverse movements**

Note: increase indicates exchange rate appreciation against the euro

Real effective exchange rate, based on consumer prices (1995Q1=100)





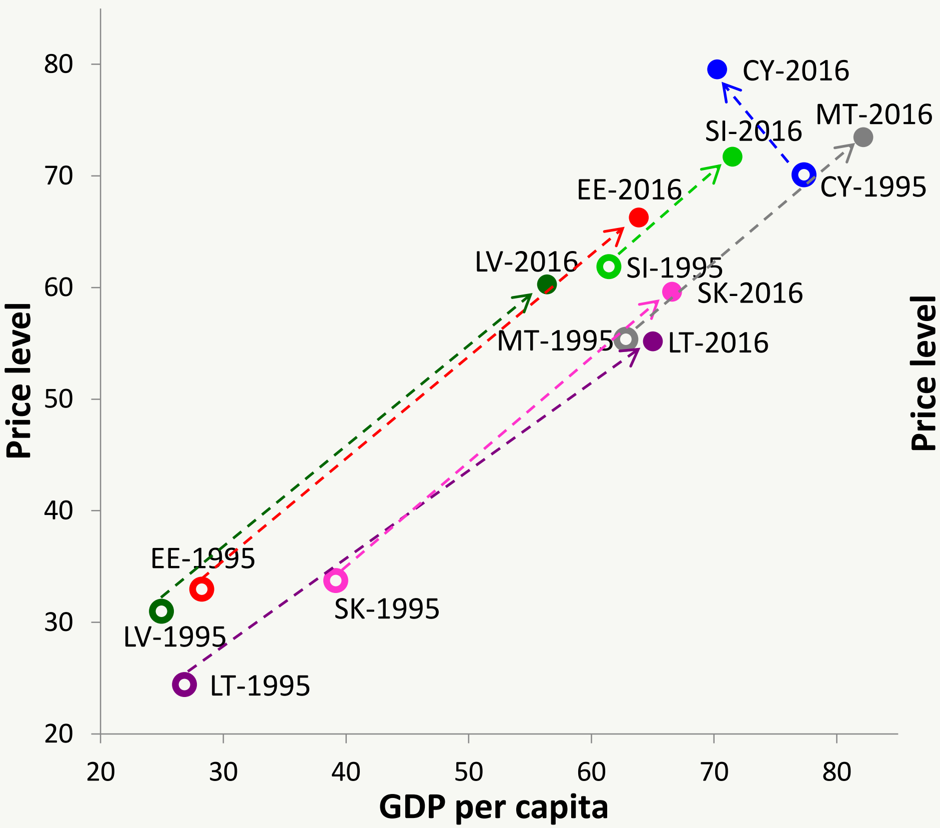
- **Diverse movements**

Note: increase indicates exchange rate appreciation against 138 trading partners

Convergence between 1995-2016

Convergence: GDP per capita (at PPS) and price level (% of 10 'core' EU countries), 1995 vs 2016

Euro members



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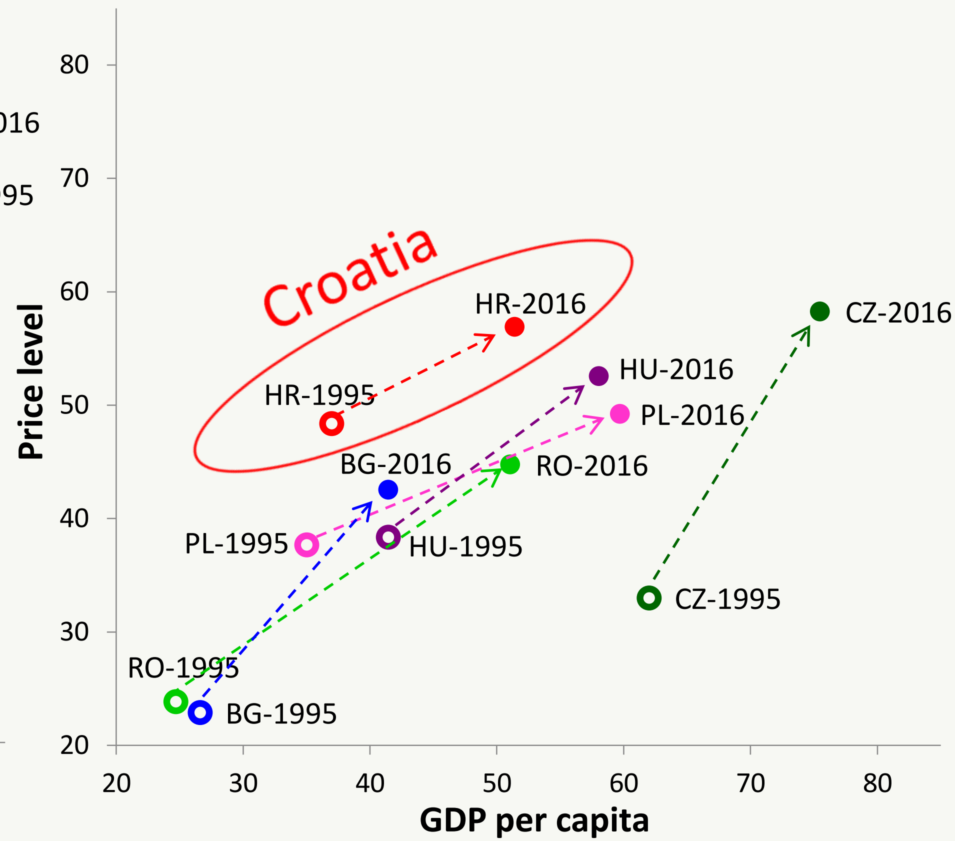


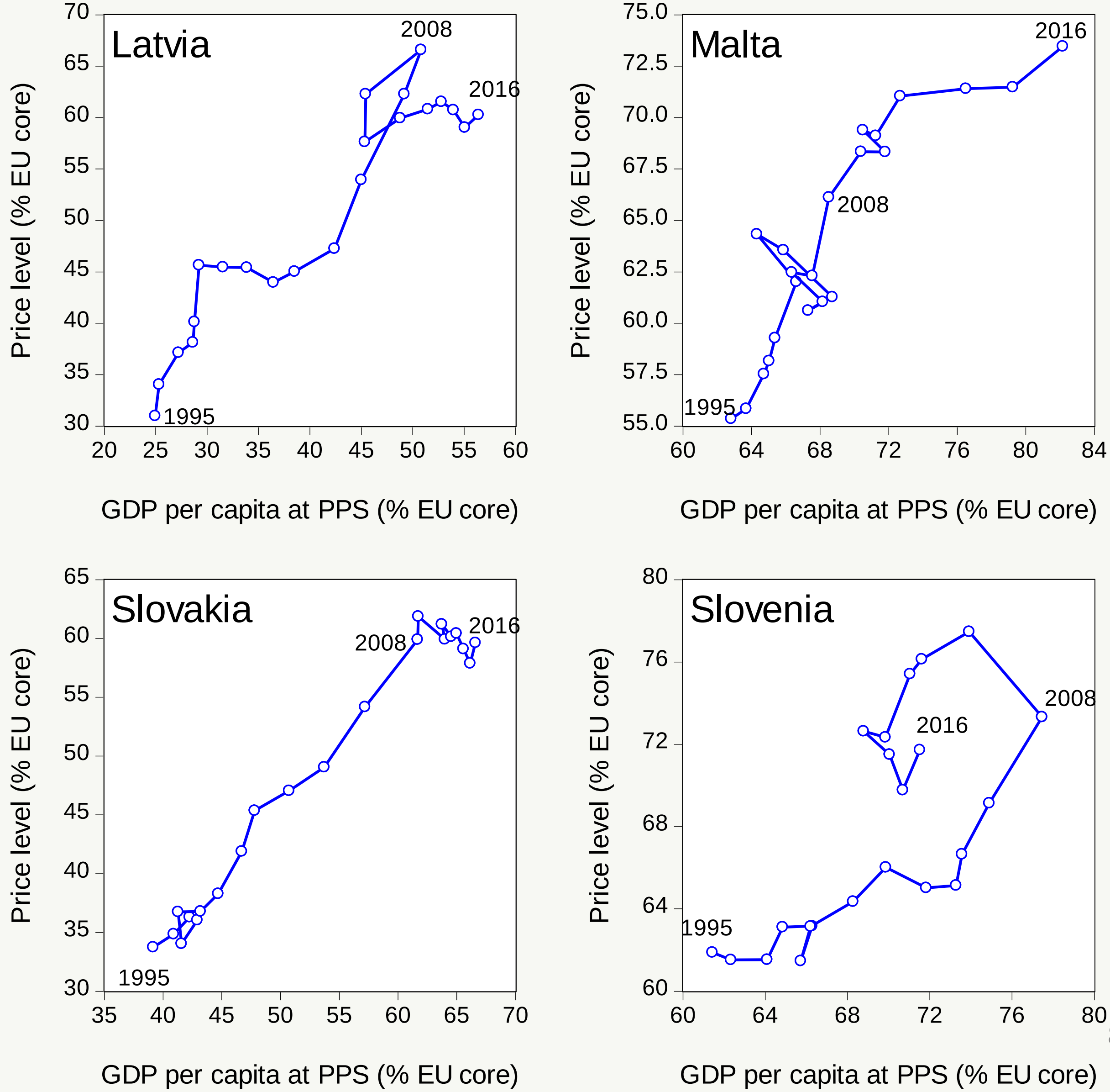
➢ **Clear convergence, most lines are parallel**

Note: the 10 ,'core' EU countries are: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, United Kingdom

Convergence: GDP per capita (at PPS) and price level (% of 10 ’core’ EU countries), annual developments

Four NMS euro members

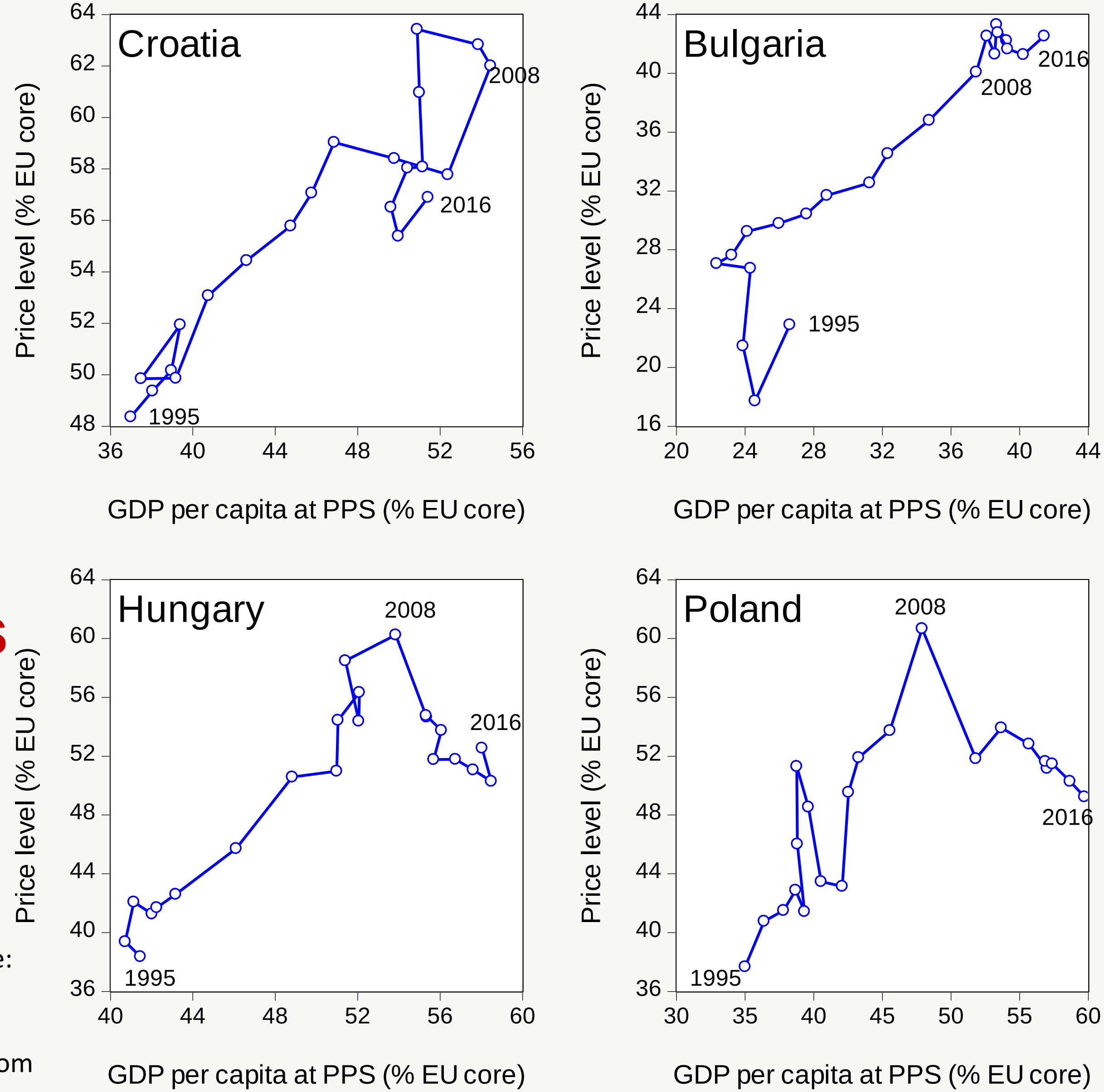
➢ **But annual movements not always straight**



Note: the 10 ,’core’ EU countries are: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, United Kingdom

Convergence: GDP per capita (at PPS) and price level (% of 10 'core' EU countries), annual developments

Four NMS
non-euro
members



- ➢ **Again, annual movements not always straight**

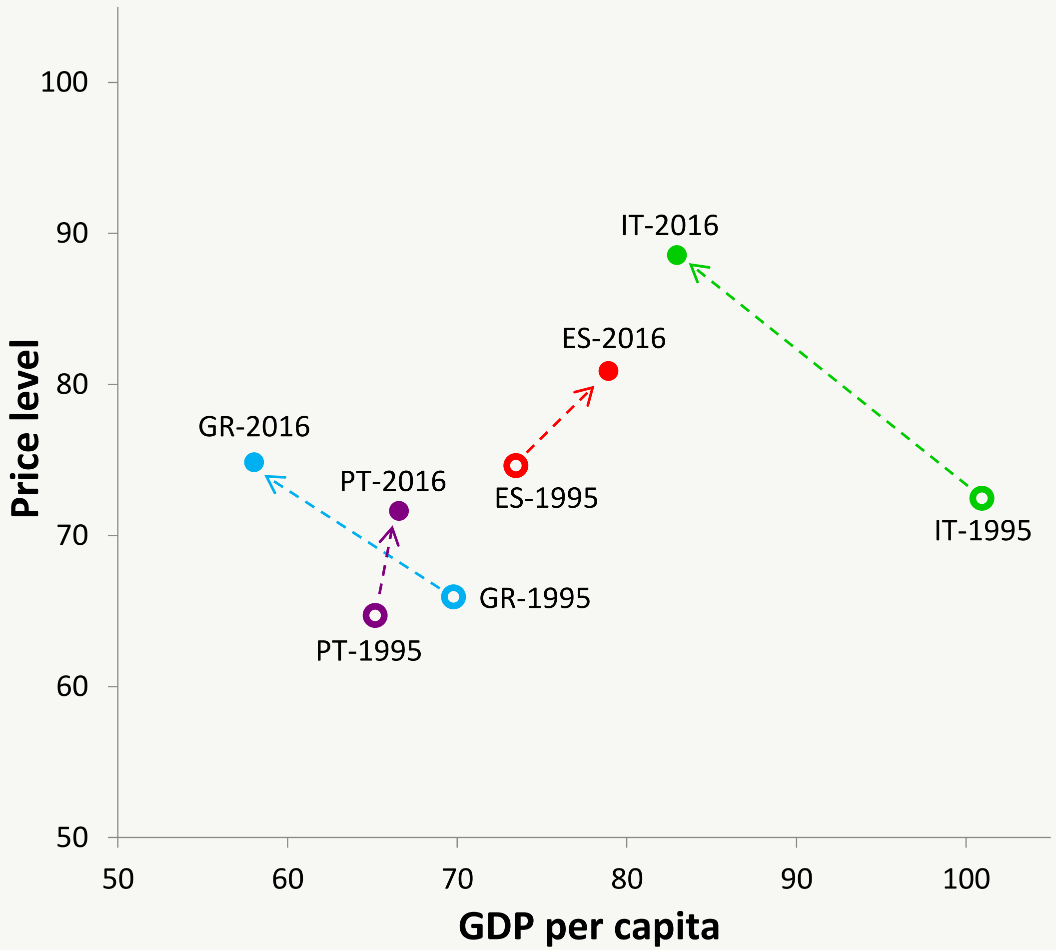
Note: the 10 ,'core' EU countries are: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, United Kingdom

Southern euro members' fate

Convergence: GDP per capita (at PPS) and price level (% of 10 ’core’ EU countries), 1995 vs 2016

- **Disappointing, even divergence in Greece and Italy**

Four pre-2004 EU members

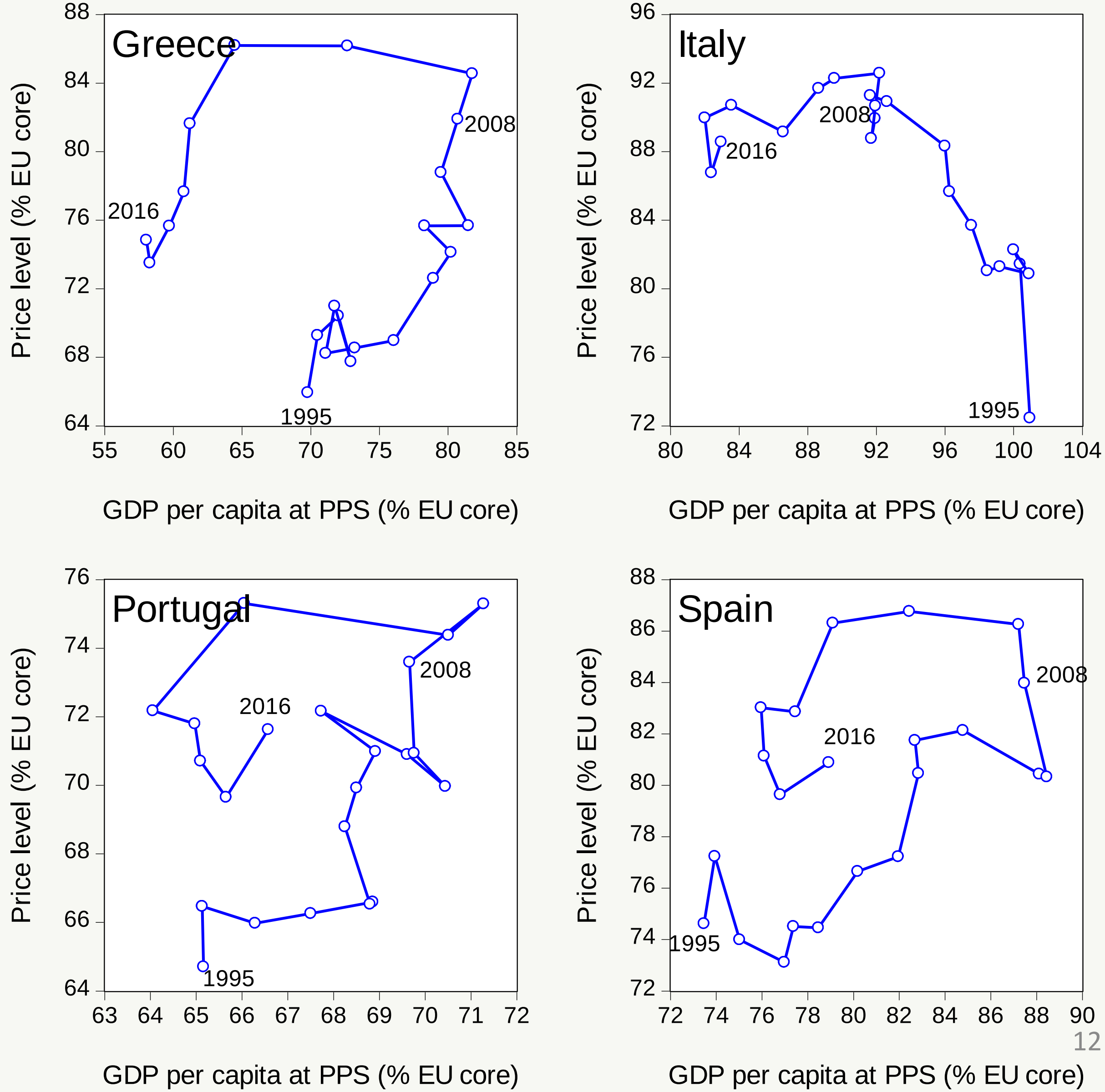


Note: the 10 ‚’core’ EU countries are: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, United Kingdom

Convergence: GDP per capita (at PPS) and price level (% of 10 ’core’ EU countries), annual developments

Four pre-2004 euro members

- **Annual data: long and painful adjustment in Spain and Portugal**

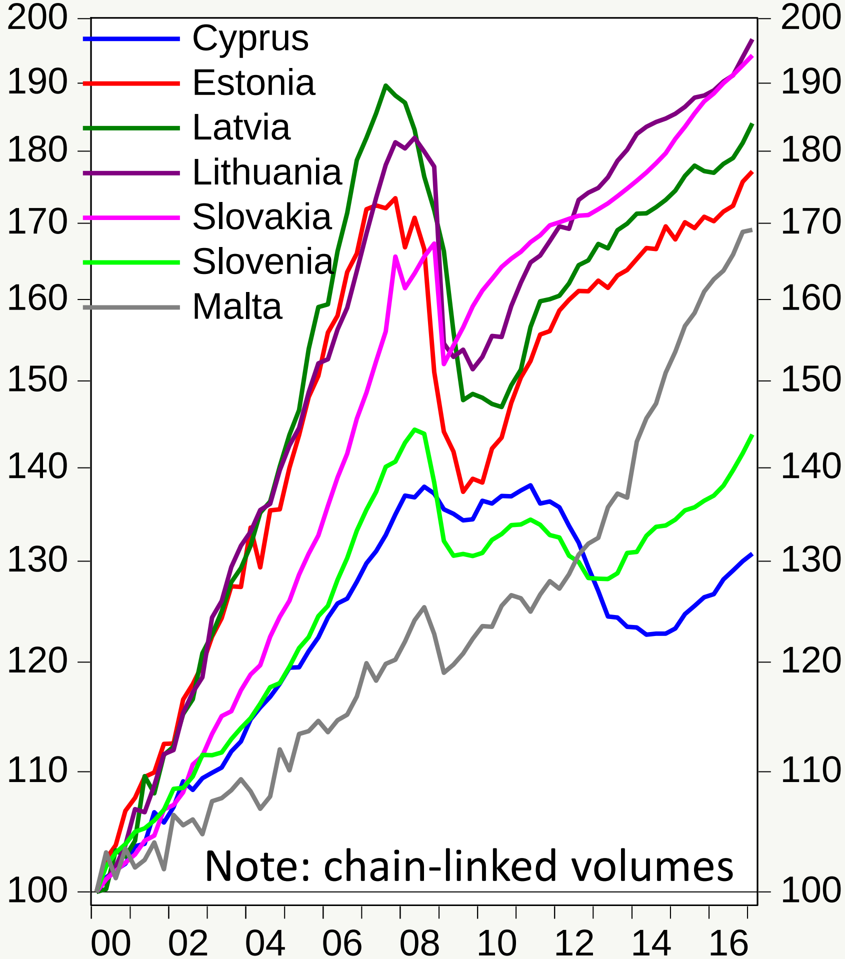


Note: the 10 ,’core’ EU countries are: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Sweden, United Kingdom

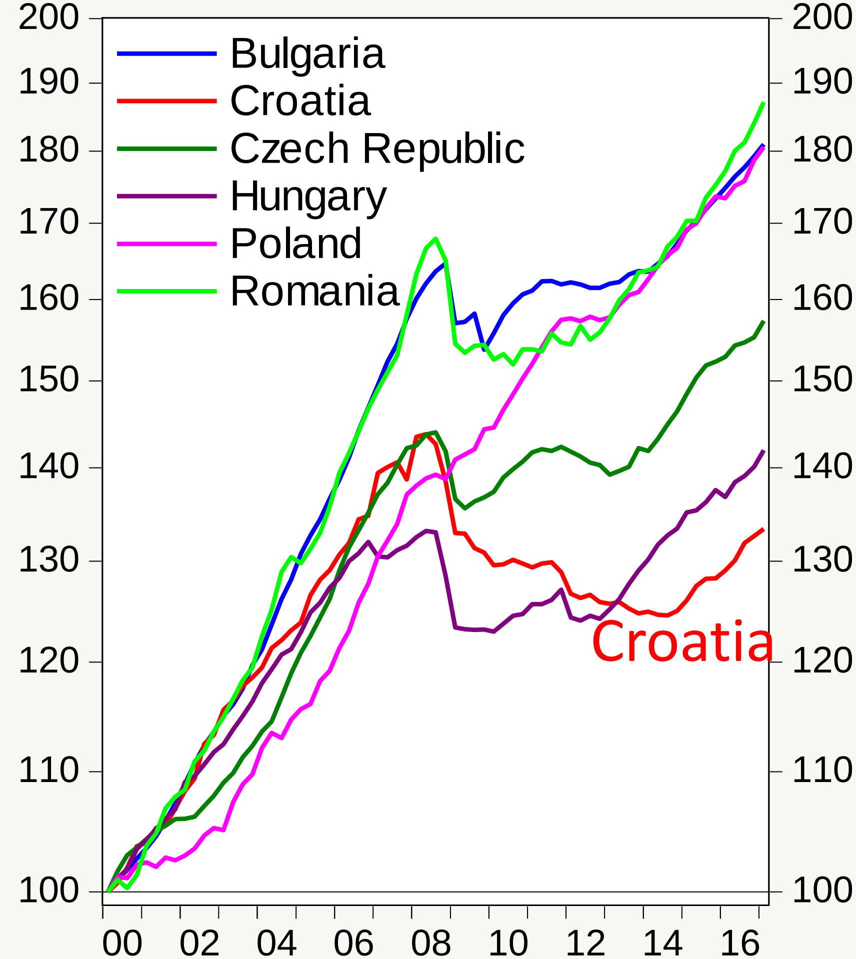
Recent developments in new EU members

Quarterly GDP developments since 2000 (2000Q1=100)

Euro members

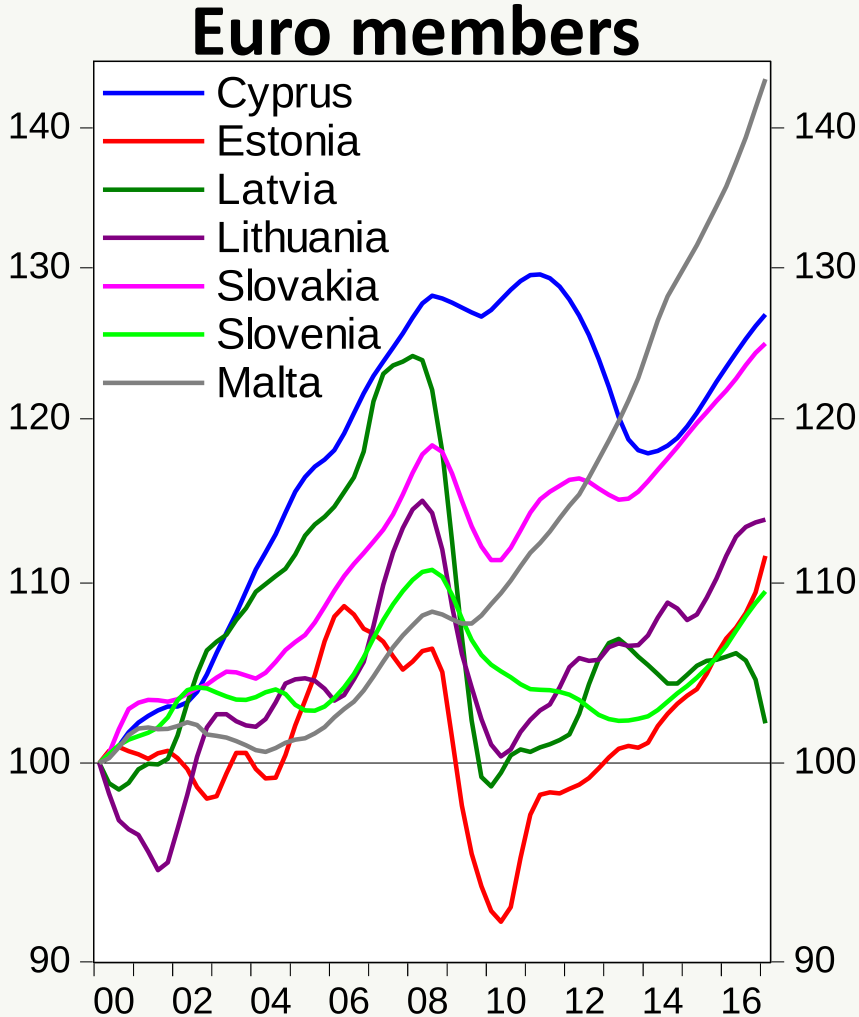


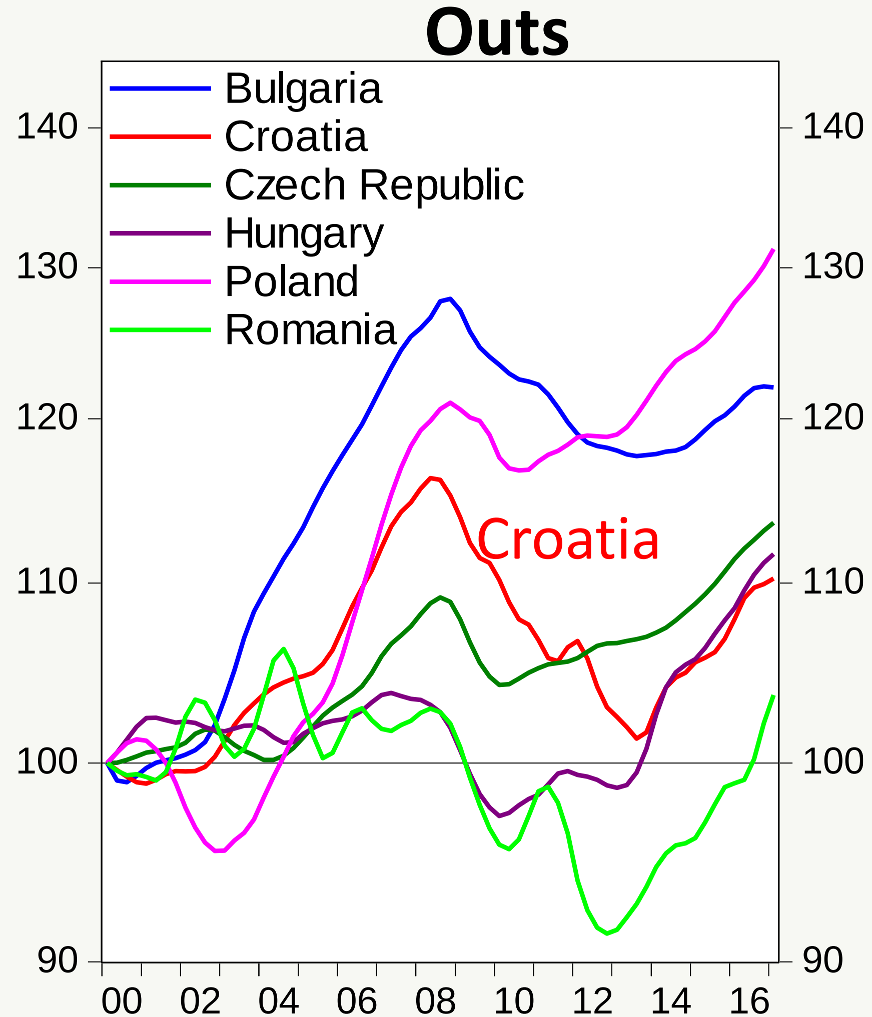
Outs



- **Boom & bust in some, but not all euro members**
- **Long-term: no clear ranking**

Employment, business sector excluding construction, real estate and agriculture (2000Q1=100)





- **No clear ranking**

Note: smoothed values

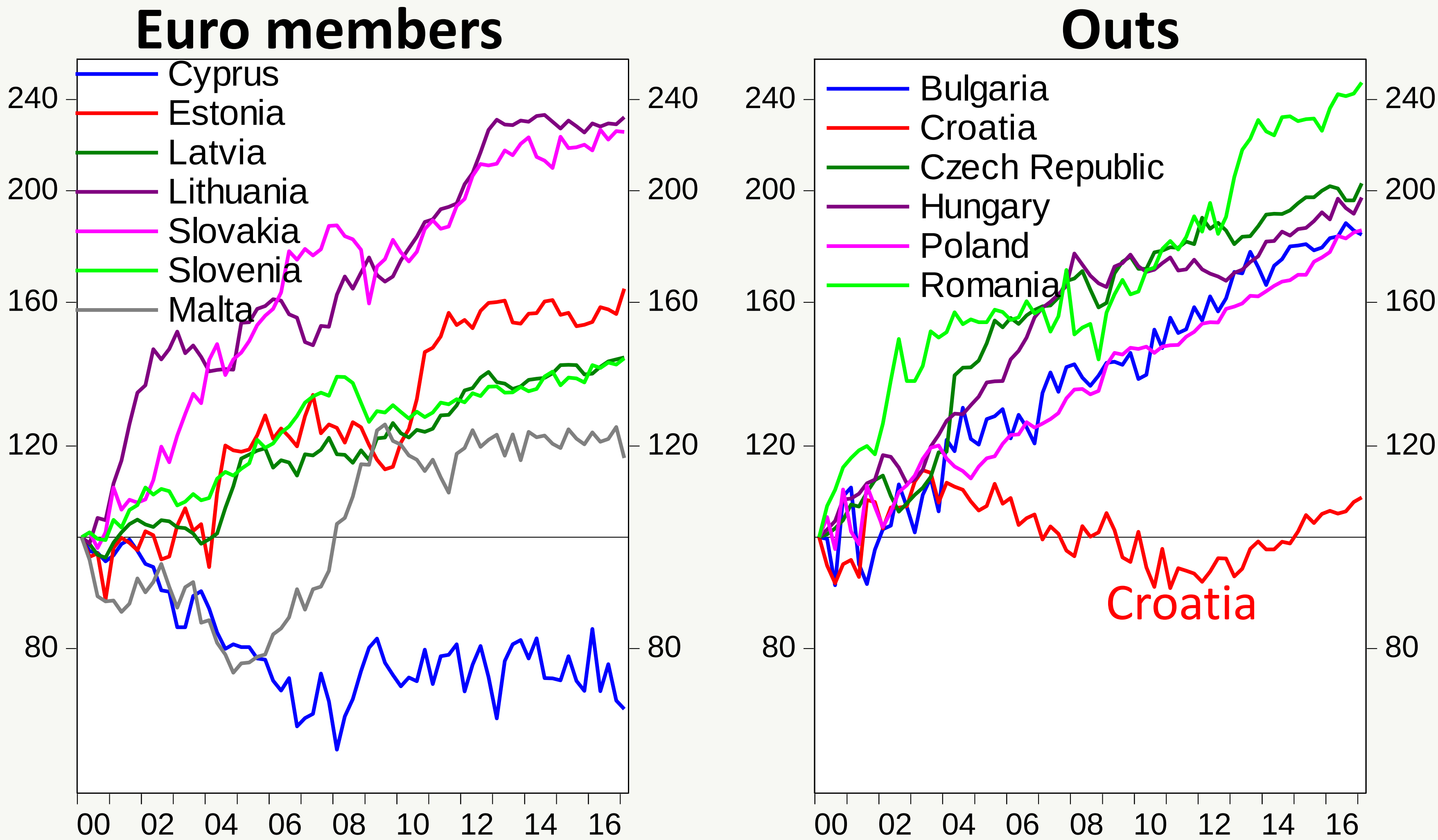
Net FDI inflow (% GDP, average 2010-16)

Euro members		Outs	
Malta	96.2	Bulgaria	2.8
Estonia	3.5	Croatia	2.3
Latvia	2.2	Hungary	2.1
Slovenia	1.4	Romania	1.9
Lithuania	1.2	Poland	1.7
Slovakia	0.8	Czech Rep.	1.5
Cyprus	-7.4		

➢ **No clear ranking**

Note: quarterly data is rather volatile, see next slide

Exports / imports of trading partners (2000Q1=100)



➢ **Fixers & floaters: quite similar (except Croatia)**

Note: goods and services; 41 trading partners considered, including Russia and Ukraine

Lessons

What went wrong in southern Europe?

- **Pre-crisis problems:**
  - Interest rate fall with euro entry, but higher inflation → low real interest rates → unsustainable consumption & credit booms, fuelling wage growth beyond productivity growth, external imbalances & indebtedness
  - Structurally weak fiscal positions
- **When the crisis hit:**
  - Sudden stop in capital inflows necessitated harsh current account adjustments (though ECB helped)
  - Strained fiscal positions necessitated procyclical fiscal tightening
  - Painful wage falls, unemployment increases, emigration
  - Inadequate crisis management framework of the euro area exaggerated the problem

Lessons from southern Europe

- Maastricht criteria inadequate for successful euro adoption

- Importance of preventing the build-up of macro vulnerabilities, like large foreign indebtedness and bank balance sheet fragility
    - ➢ Avoid the destabilising impact of low real interest rates (macroprudential policy & counter-cyclical fiscal policy)

- Importance of heathy fiscal positions

- Importance of labour market flexibility

NMS: both good and bad performances in both flexible and fixed exchange rate regimes

- ”Long-run”: convergence continues, despite 2008 crisis-related adjustments, in both euro members and non-members
- Pre-crisis: bubble in fixed-rate Baltics, but also in floating rate Hungary
- After 2008:
  - Slovakia (euro) better growth and employment performance than in the Czech Republic (float)
  - Poland (float) no recession, yet Bulgaria (fixed) mild recession and faster growth in 2009-16 than in Czech Republic (float) and Hungary (float)
  - Export market share of Poland (float) and Bulgaria (fixed) developed almost the same way
- New euro members so far avoided the fate of southern euro members

A few comments on Croatia

- Rather weak convergence in 1995-2016 compared to other new EU members; long-lasting economic weakness after 2008

- Yet the option of using the exchange rate to correct imbalances and absorb shocks was not used, Croatia maintained a tightly managed exchange rate

- Croatia is heavily euroized

- What’s the sense of keeping an own currency when not using it?