The evolving role of Central Europe in the European economy: Unconventional monetary policy, the future of the euro area and its enlargement

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Outline

- A few remarks on current economic situation and QE
- EMU: lessons from the crisis
- What about euro area enlargement?

EU – brightening picture

- Strong (job) growth across Europe
- EMU is back to strong growth and high job creation,
  - 16 quarters of growth above potential
  - >1 million jobs in Italy
  - >5 million in EA
- Greater optimism on wanting to tackle things jointly: border control, climate policy, joint approach to Brexit negotiation
- Greater willingness by France and Germany to listen to each other again – yet positions remain far apart.
- But convergence in South has stopped or reversed, in central Europe it has slowed in some countries
- Significant long-term challenges: demography, technological change vs slow-down of macro productivity numbers, inequality

What about unconventional monetary policy?

- Inflation rates in euro area remain below target
- Expectations below target in policy horizon
- Arguably, ECB unconventional policy helped recovery, three considerations
- New Keynesian models and short comings
- Impact on financial system and asset prices
- Empirical evidence (Demertzis and Wolff 2016)

Lessons from the crisis: What was wrong with EMU 1.0?

- Impact of EMU on financial integration underestimated & consequences for financial stability ignored:
  EMU 1.0 was liable to financial crises

- Nature of EMU sovereign debt ignored:
  EMU 1.0 was liable to sovereign debt crises

- Loss of the ER instrument not compensated:
  EMU 1.0 was liable to adjustment problems

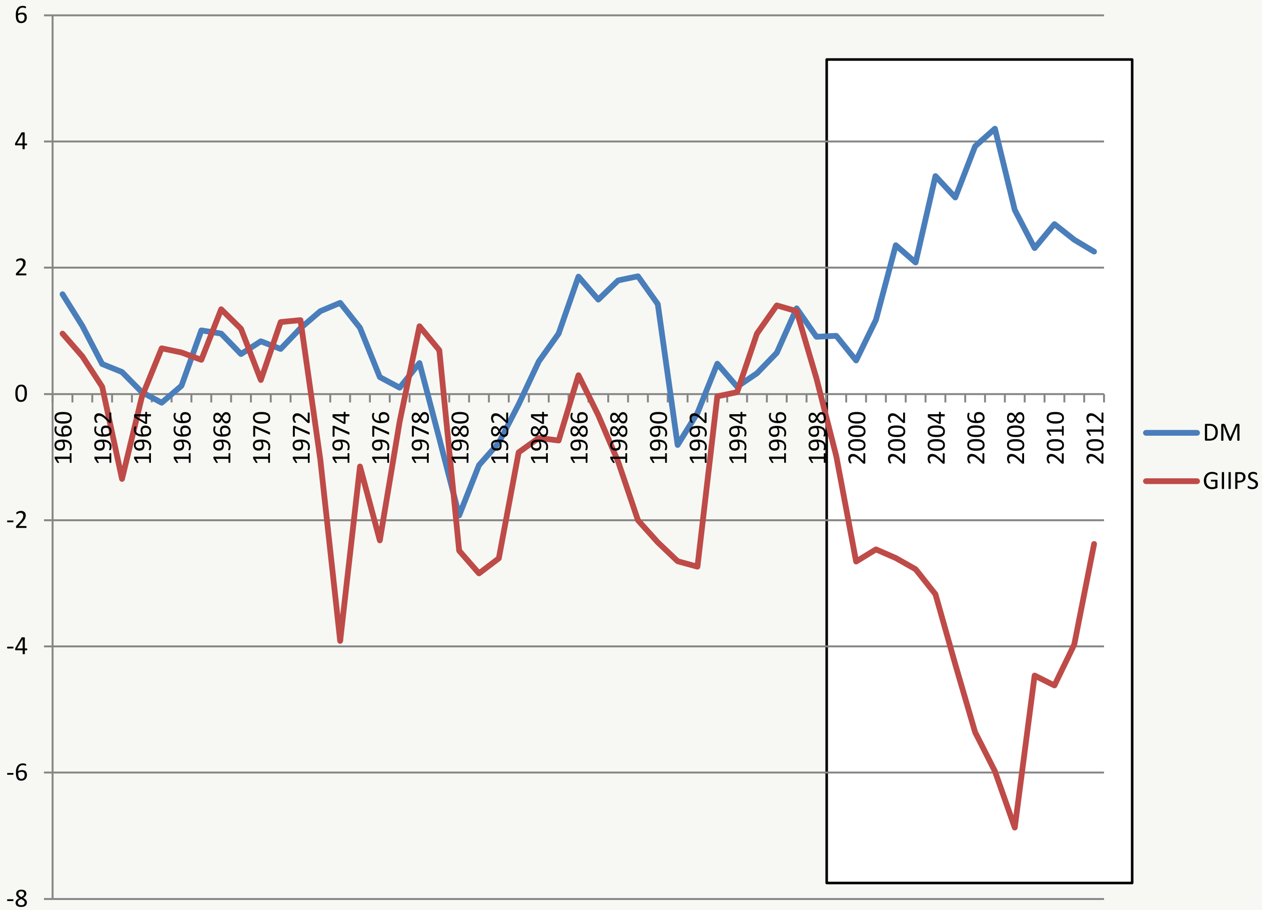
The EMU 1.0 system failed

- Prior to the crisis, surveillance was inadequate
  - It did not understand well the nature of the risks, including for BOP
  - Fiscal surveillance: SGP focus on deficit rather than debt sustainability
  - No EZ financial surveillance, inadequate national surveillance
- Prior to the crisis, adjustment mechanisms were inadequate
  - The REER channel did not work well: divergences in competitiveness were not corrected automatically or otherwise
- When the crisis occurred, the system lacked adequate tools to respond

The system allowed huge imbalances

- Very large current deficits
- Huge build up of private and public debts, and external debts
- Loss of competitiveness
- The music stopped when the financial crisis started

Effect of EMU on external imbalances: Current account



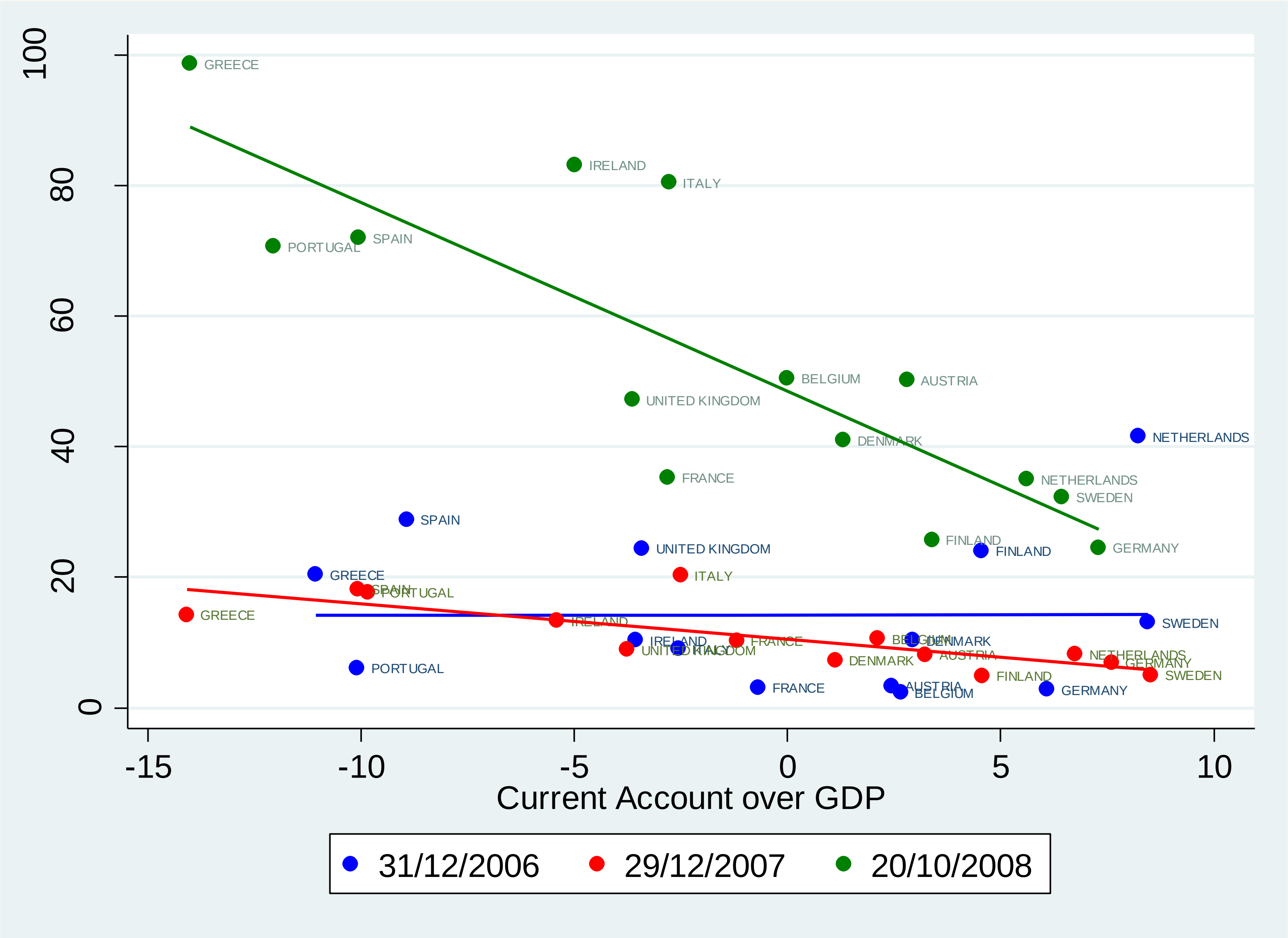
Euro period, but also global great moderation

Correlation (GIIPS,DM) 1960-1998: +0.28

Correlation (GIIPS,DM) 1999-2012: -0.73

Data source: AMECO May 2012

Risk of sudden stop not understood before Lehmann



How can EMU avoid or deal with financial crises?

- EMU needs a common mechanism for supervision, resolution and deposit insurance guarantee for banks
- EMU 2.0 provides a partial answer
- EMU 3.0 needs to
  - Improve SRM, create a common deposit insurance guarantee scheme
  - Reduce bank dependence: Capital Markets Union

How can EMU avoid or deal with sovereign debt crises?

- EMU needs to lower sovereign debt and to reduce the exposure of banks to sovereign debt
- EMU 2.0 provides a partial answer
- EMU 3.0 needs to
  - Better enforce fiscal rules to reduce debt levels
  - Replace ESM by EMF and include a European SDRM
  - Limit the exposure of banks to sovereign debt
  - Increase cross-border banking

How can EMU avoid or deal with adjustment problems?

- EMU needs national and common mechanisms to reduce or handle adjustment problems

- EMU 2.0 provides a partial answer

- EMU 3.0 needs to

  - Improve market mechanisms at national and EU levels
  - Improve fiscal mechanisms at national and EU/EA levels
  - Reduce heterogeneity among MS

When should countries join EMU?

- “The euro is meant to be the single currency of the EU as a whole...Member States that want to join the euro must be able to do so.” (JC Juncker)

- (When) should countries adopt the euro?

- Should countries join the banking union before adopting the euro?

Criteria

- Legal compatibility

- Maastricht convergence criteria fulfilled?

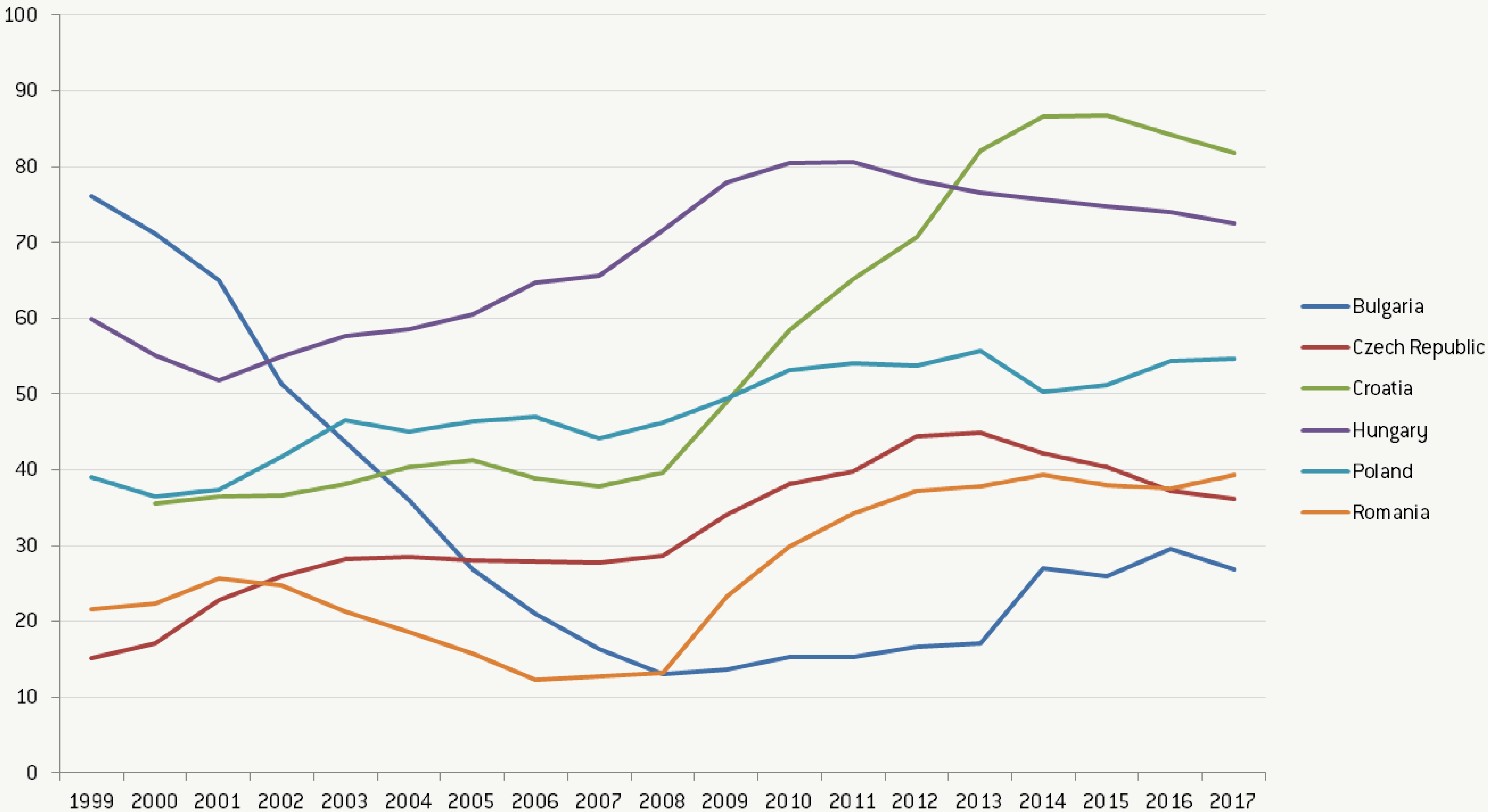
  - Price stability
  - Public finances
  - LT interest rate
  - Exchange rate (ERM2)

- Other relevant factors
  - Macro (MIP):
  - Micro (markets, business environment)

General government net lending/borrowing (% GDP)

Source: AMECO, May 2017

General government debt (%GDP)



Source: AMECO, May 2017

Nominal vs. real convergence

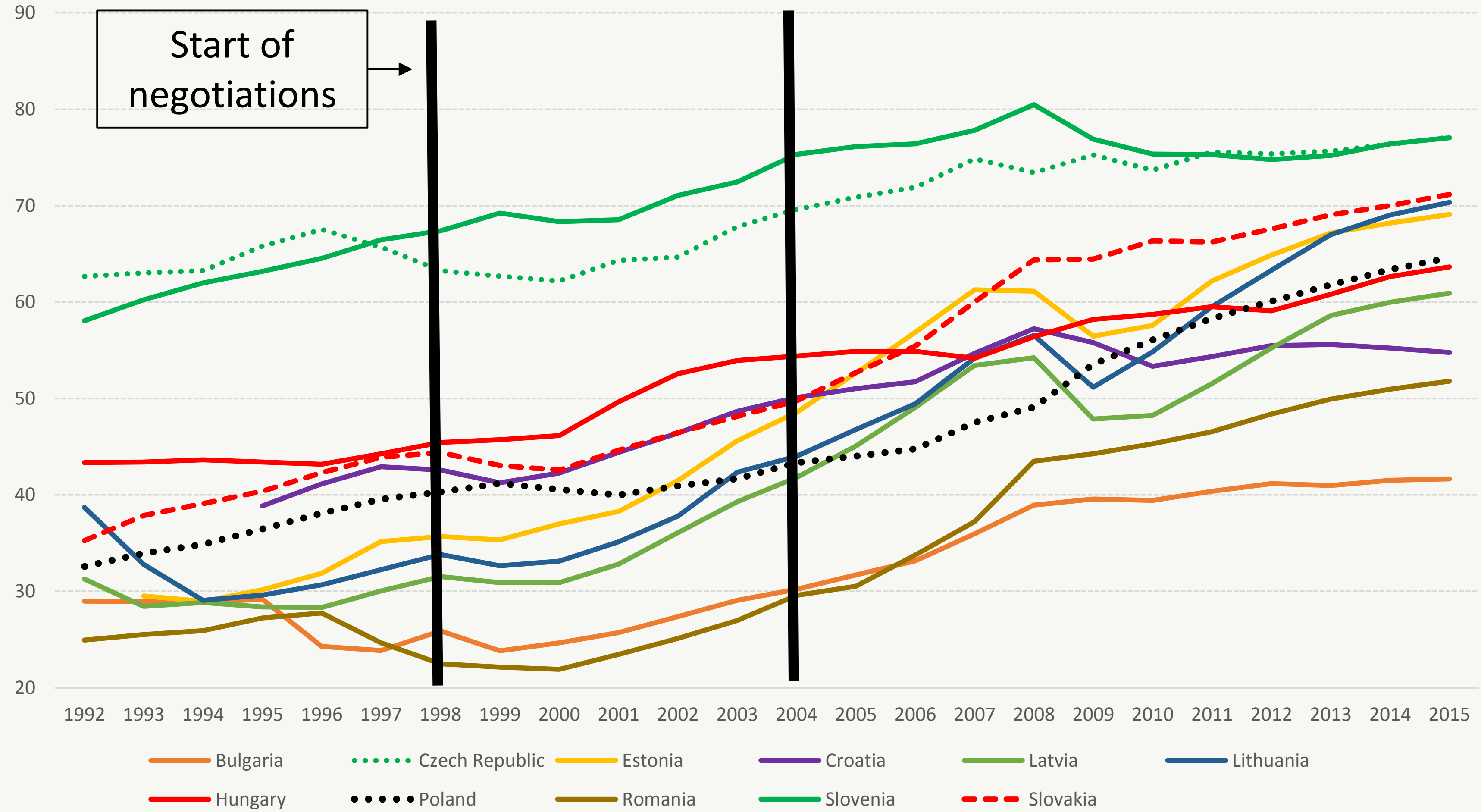
- The nominal convergence criteria are basically meant to ensure that countries can live with price stability

- They don’t ensure against macroeconomic imbalances (the MIP was introduced for that, during the crisis)

- Insufficient real convergence is a better indicator of the risk of macroeconomic imbalance

Convergence in the 11 CEECs that joined the EU in/after 2004

(GDP per capita at PPP, EU15 =100)

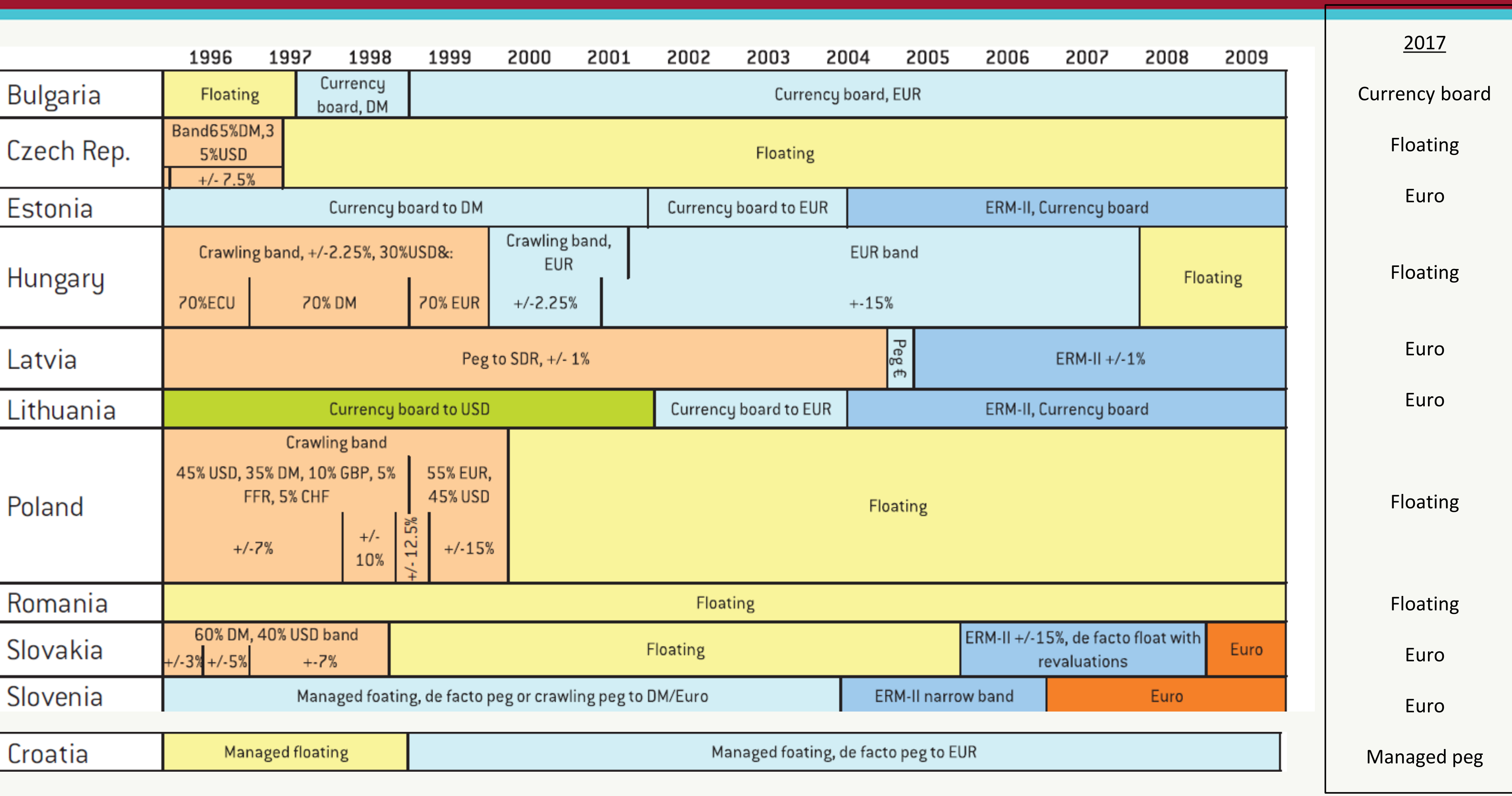


Simple average for the 11 countries			
40	41	49	64

Rule of thumb

- A good rule of thumb should that countries with relatively low GDP per capita
  - Should not abandon the ER instrument
  - If they do, they should be especially mindful of the risk of macroeconomic imbalances
  - And have very flexible product and labour markets
- Strong institutions are needed to prevent that capital flows become destabilizing (Greece, etc.)
- It is true that some CEECs have successfully adopted the euro when they had low pc GDP (Slovakia)
- No simple correlation between ER regime and growth
  - Value chains
  - Incomplete pass through
  - Capital-flow driven volatility vs adjustment to ER misalignment

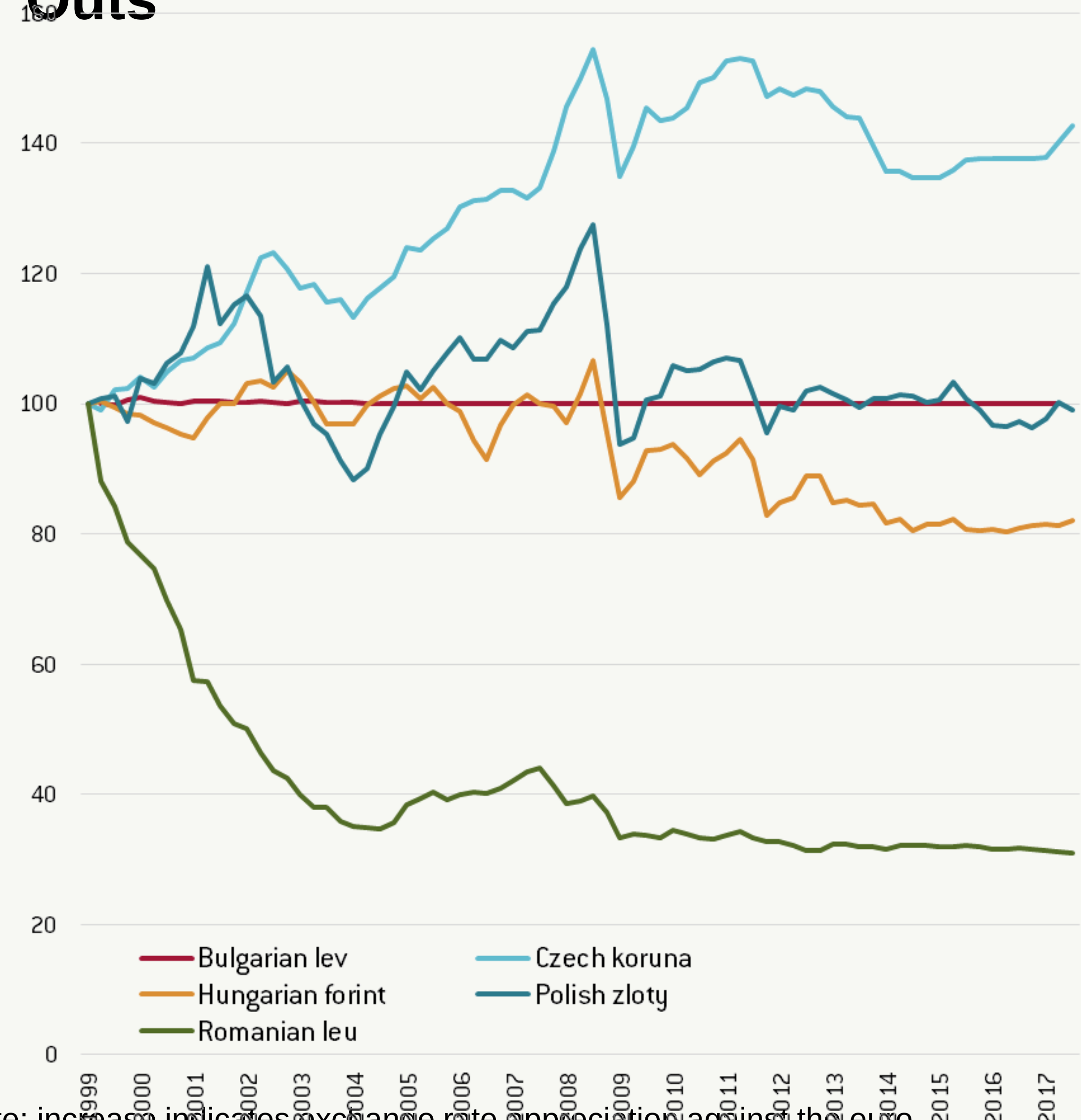
Exchange rate regimes, 1996-2009 and 2017



Source: Becker et al. (2010)

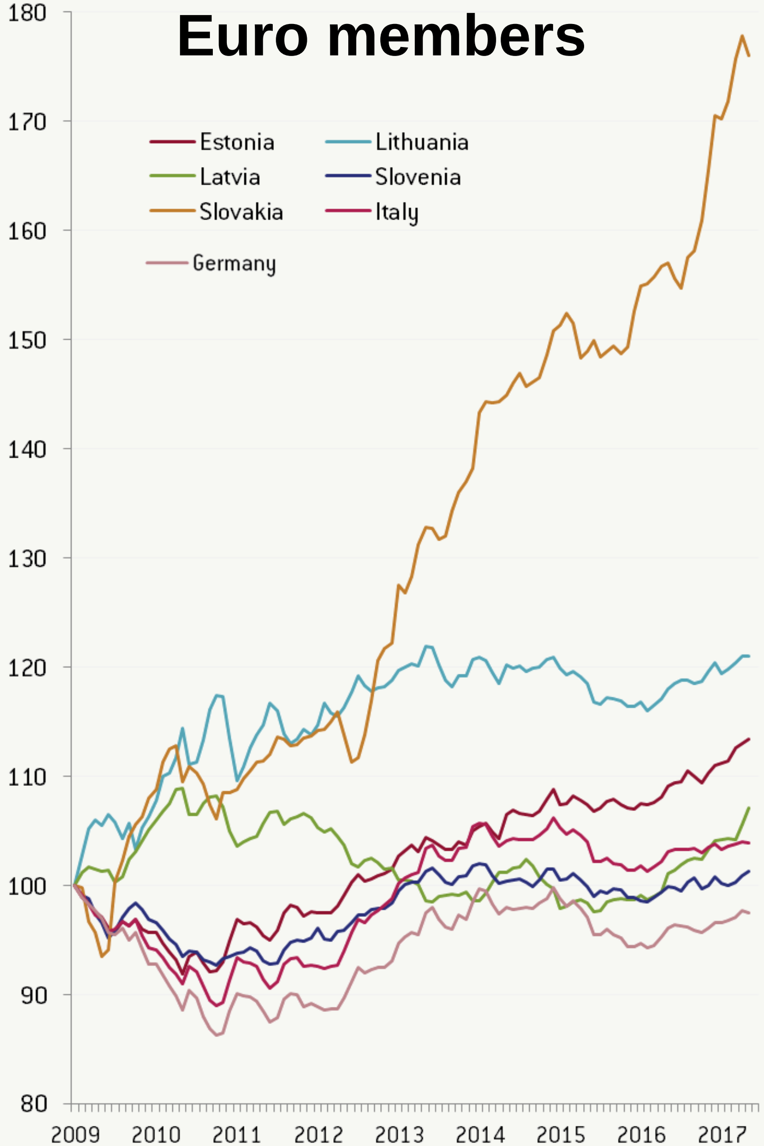
Nominal exchange rate against the euro (1999Q1=100)

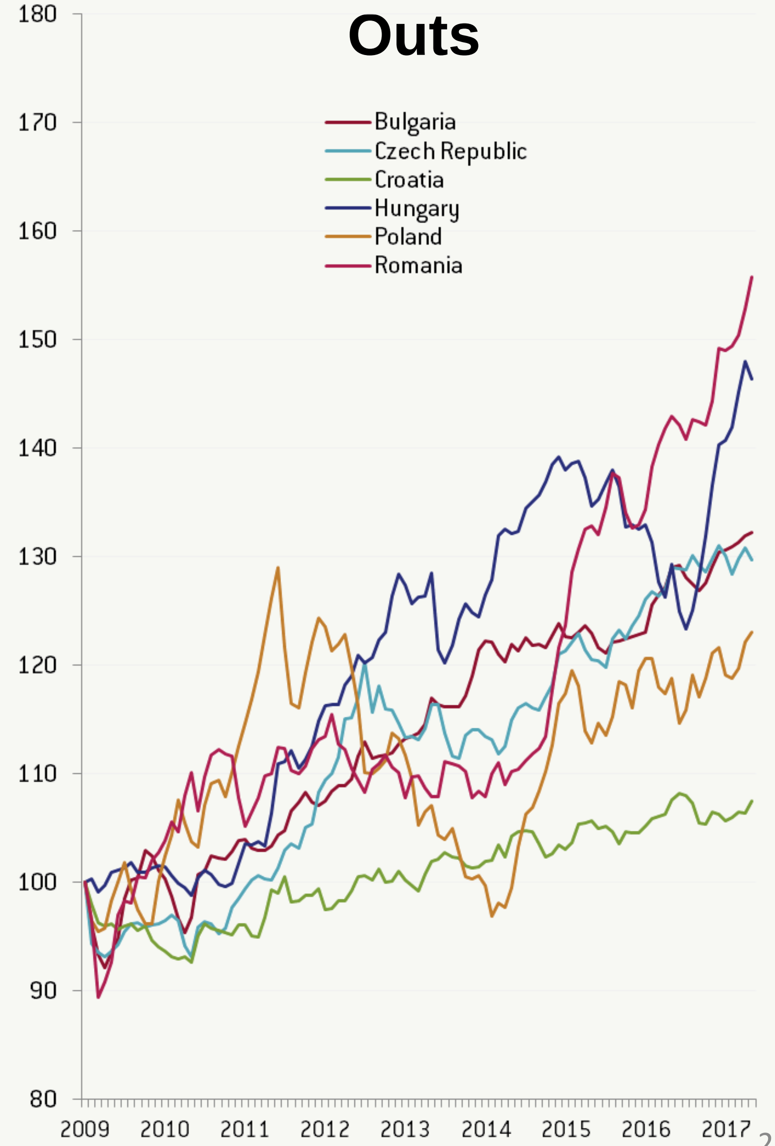
Outs



Note: increase indicates exchange rate appreciation against the euro

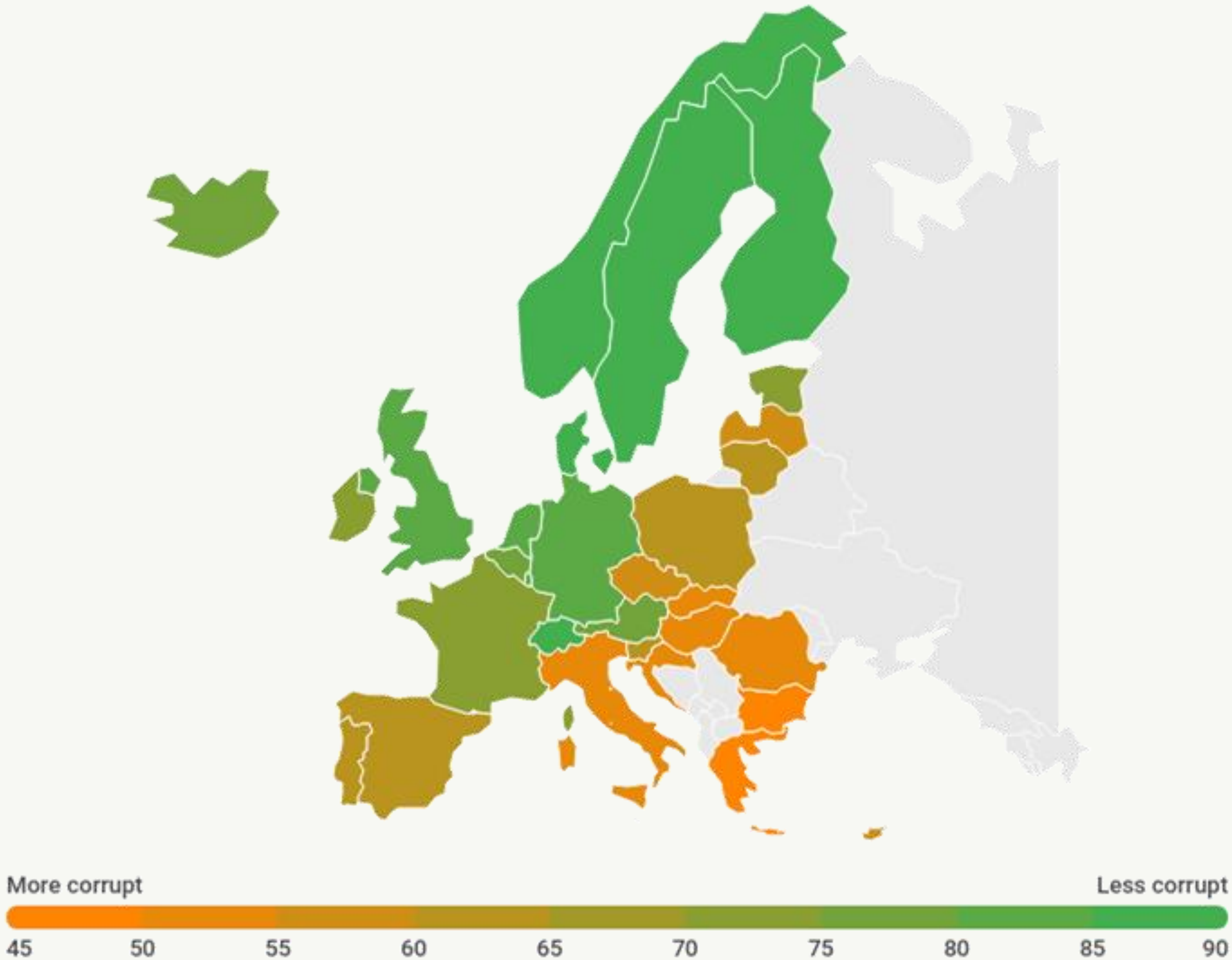
Real effective exchange rate, based on consumer prices (1999Q1=100)





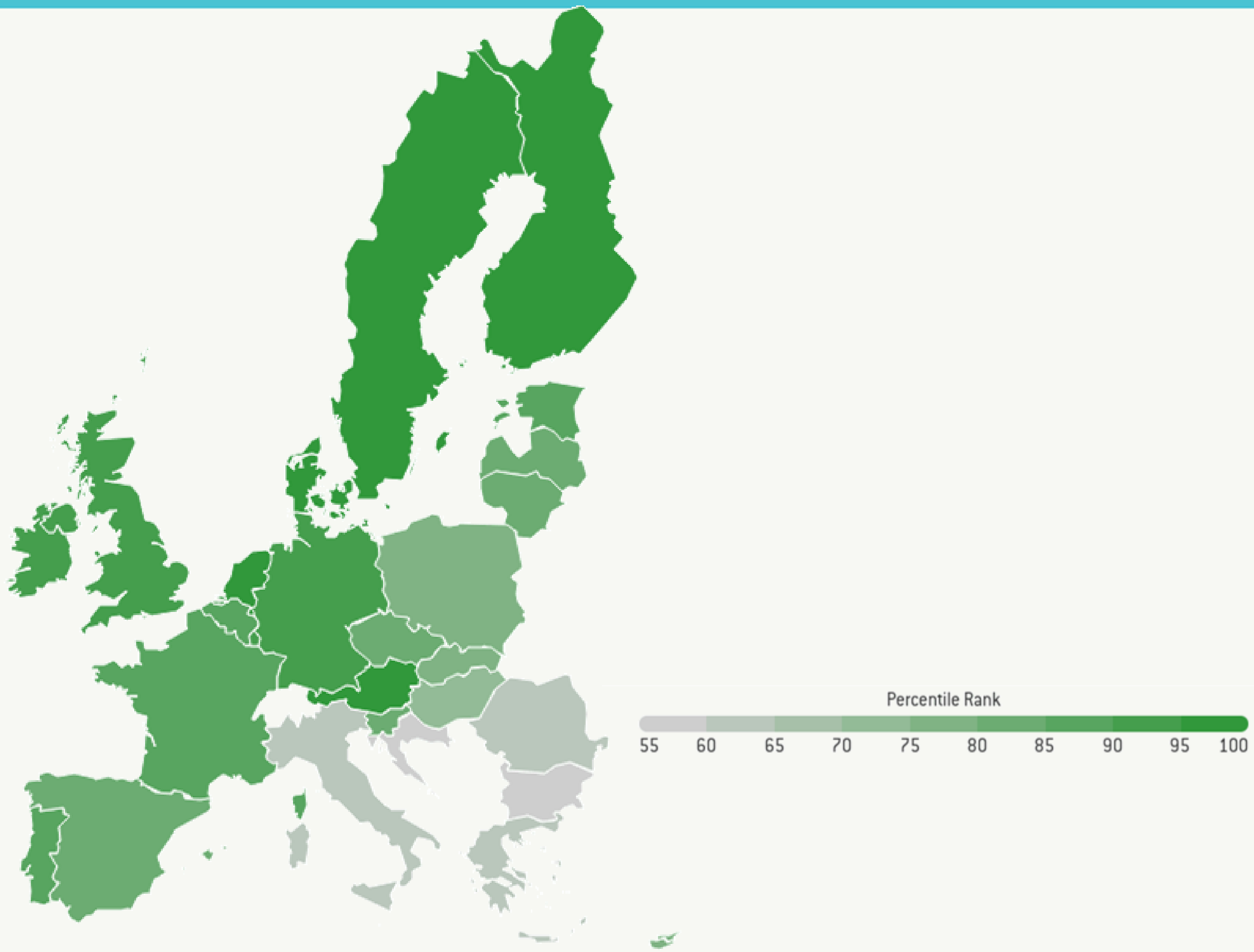
Note: increase indicates exchange rate appreciation against 138 trading partners

Governance indicators: Corruption Perceptions Index, 2016



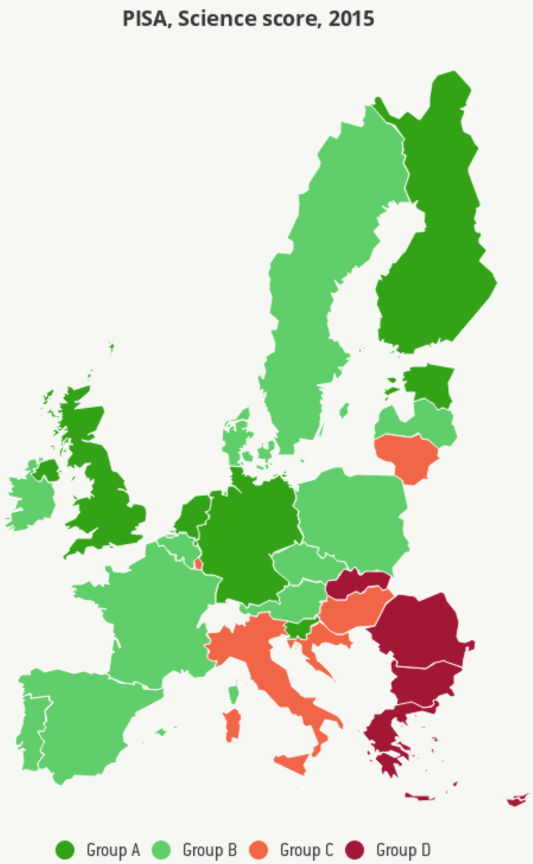
Source: Transparency International. Notes: The scores range from 0 (highly corrupt) to 100 (very clean).

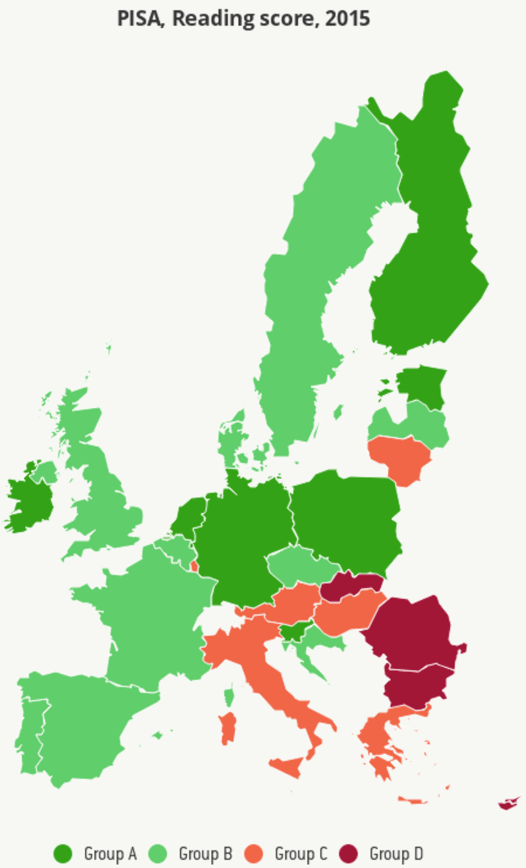
Governance indicators: Rule of Law



Source: World Bank WGI (2017).
Note:Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to lowest rank, and 100 to highest rank. Percentile ranks have been adjusted to correct for changes over time in the composition of the countries covered by the WGI.

Governance indicators: PISA Scores, 2015





Source: OECD

Adopting the euro: Economic pros and cons

- Joining EMU 2.0 is better than EMU 1.0, but EMU 3.0 would even be better though the waiting may be long

- Pros
  - Anchoring the fiscal framework
  - Less transaction costs => trade, investment
  - More financial integration
  - Financial stability: ECB access, banking union
  - ESM access
- Cons
  - Risk of macroeconomic imbalances during convergence process
  - Loss of ER instrument for stabilization
  - ESM cost
  - Still pretty unclear euro area governance, nature of debt changes

Joining the banking union: Economic pros and cons

- Pros
  - Financial stability, though without ECB access
    - Improved home-host coordination of supervision
    - Improved resolution of cross-border institutions
  - Improve single market for banking
  - External, possibly less political supervisor
- Cons
  - The SSM is young supervisor
  - The BU framework is incomplete, future EDIS uncertain, decoupling of control and ultimate financial responsibility, especially if outside the euro and no access to ECB liquidity window

Outs' banking in EA

Table 2: Top 10 banks outside banking union, end-2014

Banking group	Banking union market share	Total assets (€ billions)	Home	Banking union	Rest of Europe	Rest of world
HSBC (UK)	0.5%	€2,170	33%	6%	3%	58%
Barclays (UK)	1.3%	€1,745	37%	22%	2%	38%
Royal Bank of Scotland (UK)	0.2%	€1,350	74%	5%	0%	21%
Lloyds Banking Group (UK)	0%	€1,099	96%	1%	1%	1%
Nordea (SE)	0.4%	€669	24%	18%	57%	1%
Standard Chartered (UK)	0.1%	€598	12%	3%	1%	84%
Danske Bank (DK)	0.2%	€465	62%	12%	26%	0%
Svenska Handelsbanken (SE)	0.1%	€300	59%	8%	18%	14%
SEB Group (SE)	0.1%	€281	60%	14%	18%	8%
Swedbank (SE)	0.1%	€226	76%	10%	9%	5%
Top 10 banks outside banking union	**2.9%**	**€8,902**	**50%**	**10%**	**8%**	**32%**

Source: Bruegel. Note: See table 2. The top 10 is ranked by total assets.

Source: Hüttl & Schoenmaker (2016)

EA banking in Central and Eastern Europe

Table 4: Banking union and non-banking union share in % of total assets in the banking sectors of central and eastern European countries, end-2014

Countries	Total assets	Cross border assets	Branches	Subsidiaries	Banking union	Non-banking union	Rest of world
Czech Rep.	195.5	88%	10%	**78%**	77%	0%	1%
Croatia	56.6	80%*	0%	80%*	78%	0%	2%
Bulgaria	47.4	77%	7%	**71%**	58%	12%	1%
Romania	90.5	69%	9%	**60%**	55%	2%	4%
Poland	379.6	66%	2%	**64%**	58%	0%	6%
Hungary	109.6	45%	7%	**39%**	37%	0%	2%
Total	879.2	70%	5%	65%	(60%)**	(1%)**	(4%)**

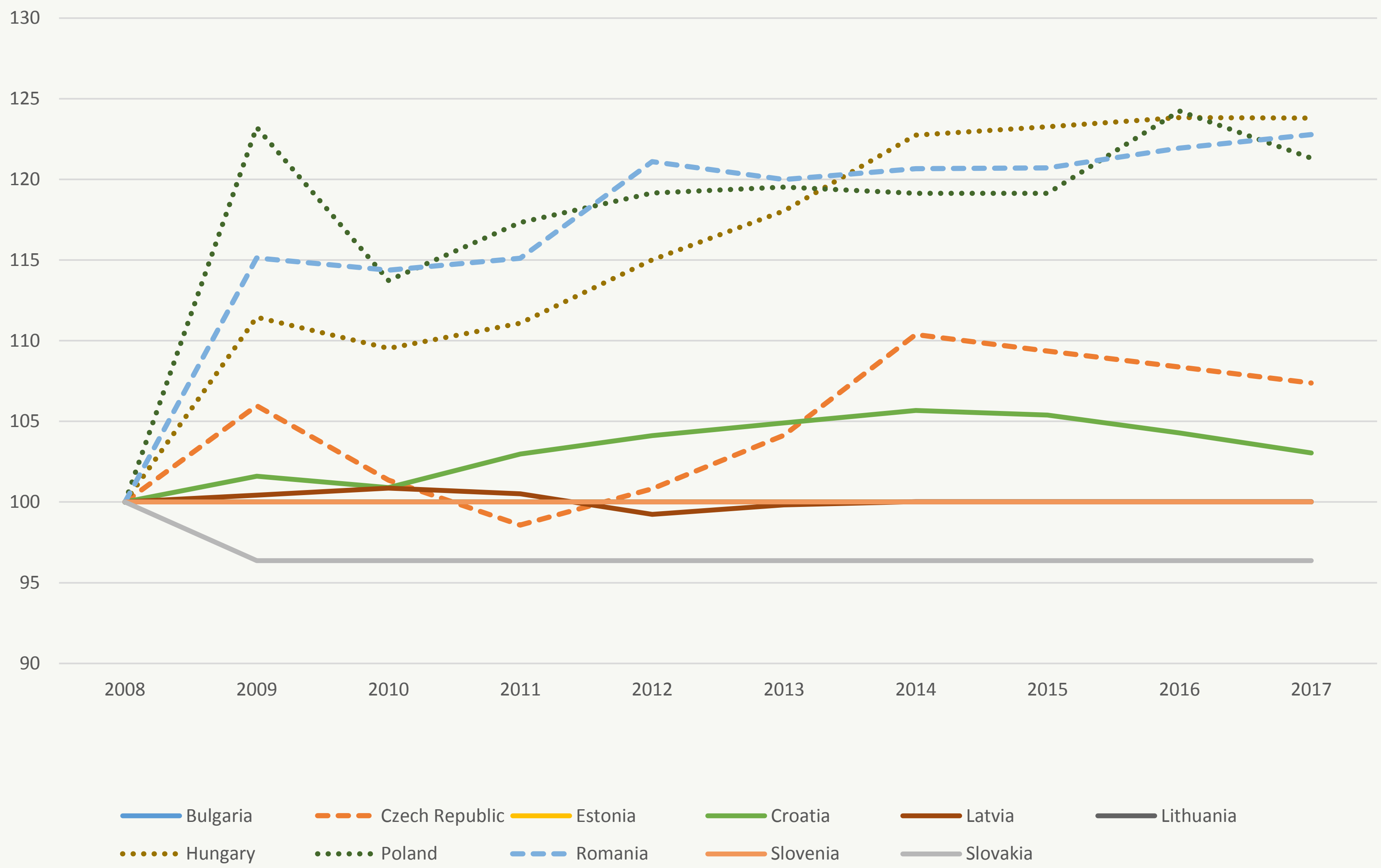
Source: Bruegel based on ECB and SNL financials (which refers to data on banking union, non-banking union and rest of world). Note: * the data for Croatia is taken entirely from SNL. Non-banking union is calculated as a weighted average (weighted according to total assets). The sum of SNL calculated data does not add up completely to the data provided by the ECB due to different methods of collection. ** percentage points of subsidiaries.

Conclusions

- Only one CEEC with floating rates has adopted the euro
- Meeting Maastricht criteria may be easy bit
- The crisis has reminded us that real convergence matters as much as nominal convergence,
  - especially when institutional quality is low and political system does not respect rules. A deterioration in the rule of law can have significant negative economic consequence.
- EMU 2.0 is a significant improvement over EMU 1.0, but the construction remains subject to change
- Countries should take their time to be politically, economically and institutionally ready. In the meantime some should consider joining the banking union
- Euro membership is a big political and strategic question

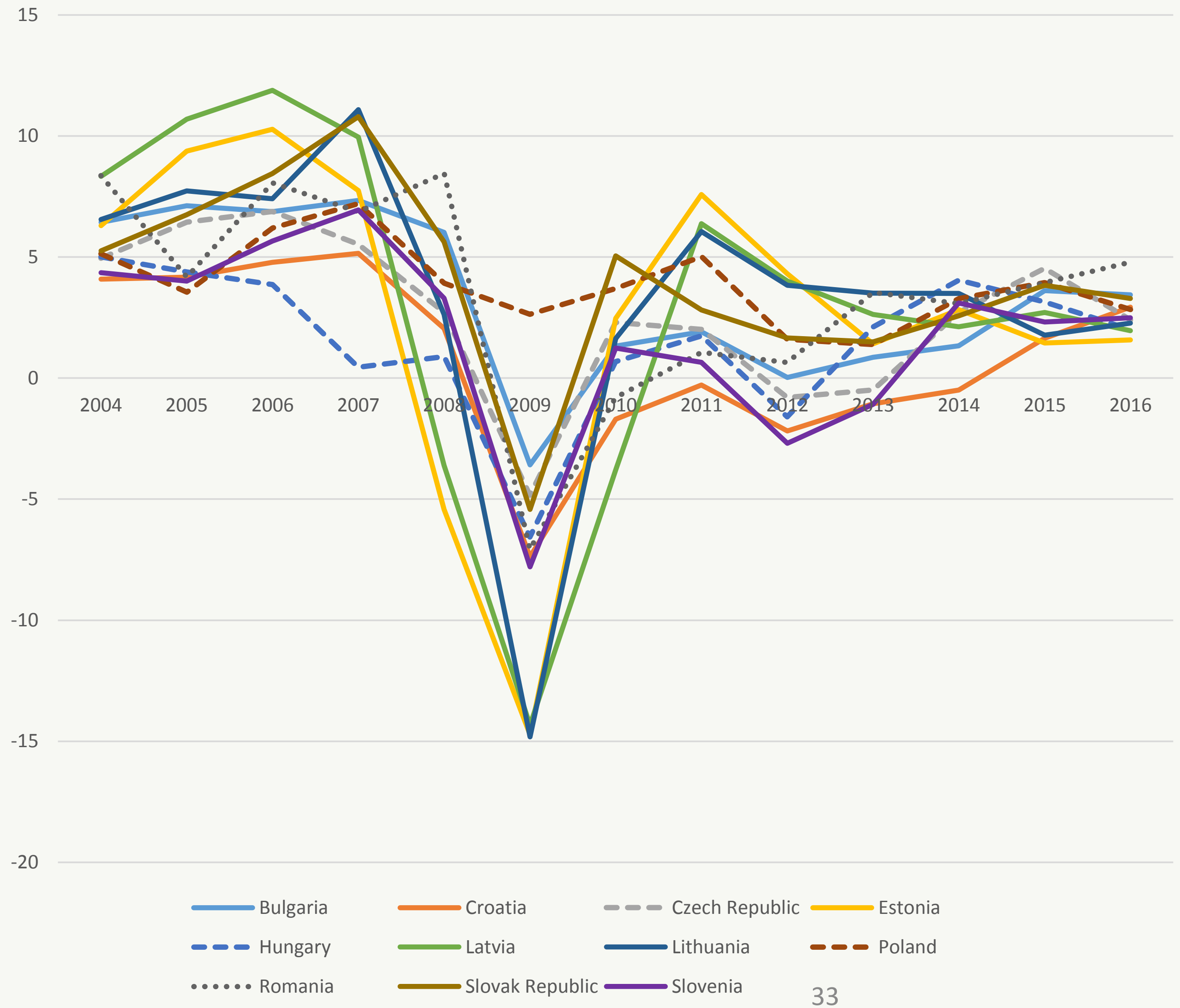
Thank you!

Exchange rates: national currencies against the euro 2008=100



Data source: WEO, IMF

GDP growth rates, 2004-2016: All CEECs



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SK	4.01	EE	2.70
PL	3.87	CZ	2.64
RO	3.47	SL	1.73
LT	3.32	HU	1.54
BG	3.29	HR	0.90
LV	3.00		

Data source: WEO, IMF