
EMU@10 and beyond: on the way to an enlarged euro area

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Lessons for the New Member States*

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Outline

- **EMU: The first ten years**
 - Achievements and challenges
 - Lessons and policy agenda
- **On the way to an enlarged euro area**
 - A sequenced process
 - Many roads to the euro
 - Progress with convergence
- **Conclusions**

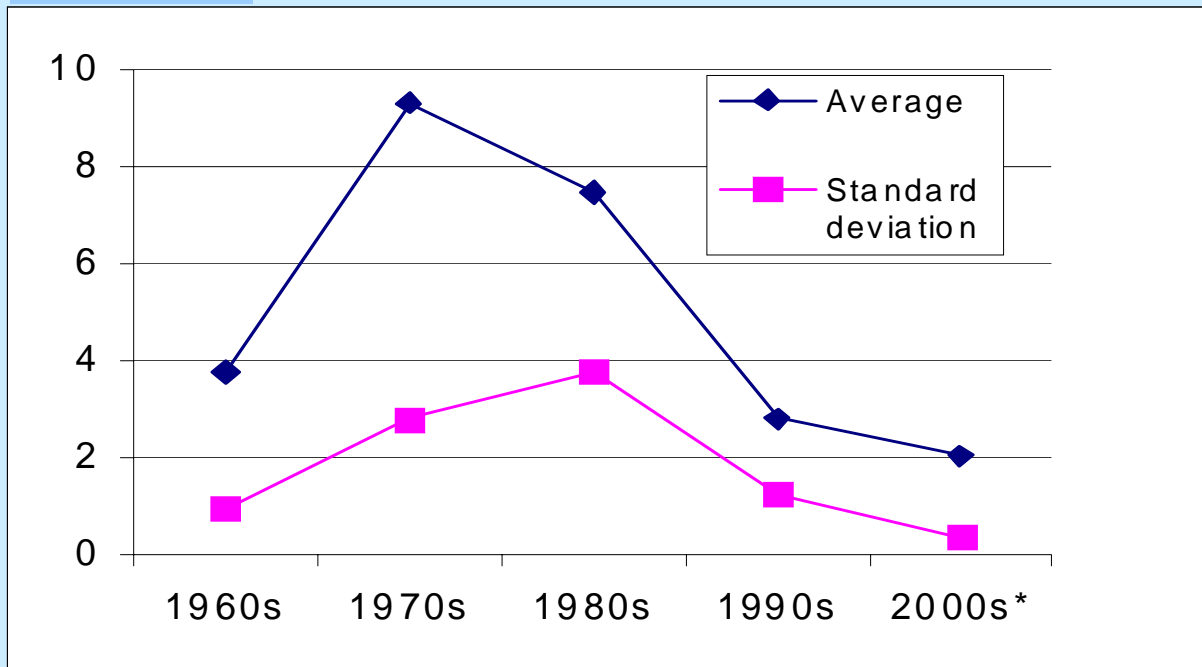
EMU: The first ten years

The achievements of EMU

- **Price stability and low cost of borrowing**
- Elimination of intra-area **exchange rate volatility**
- Increased trade and FDI ; financial **integration**
- Strong **job creation**
- Sounder **fiscal positions**
- Greater **resilience to external shocks**
- The euro is the 2nd **global currency**

Inflation performance has improved

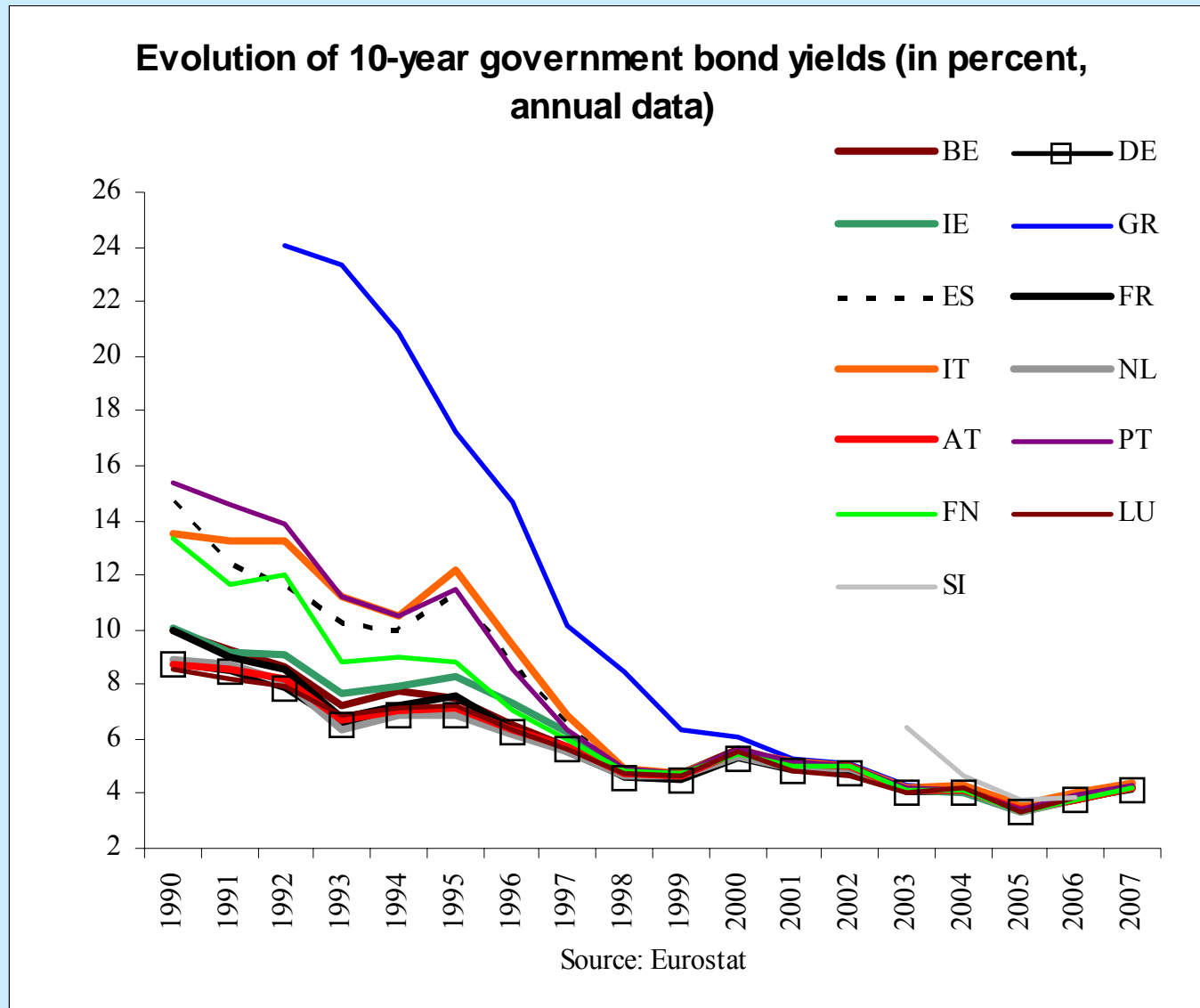
Inflation performance in the euro area



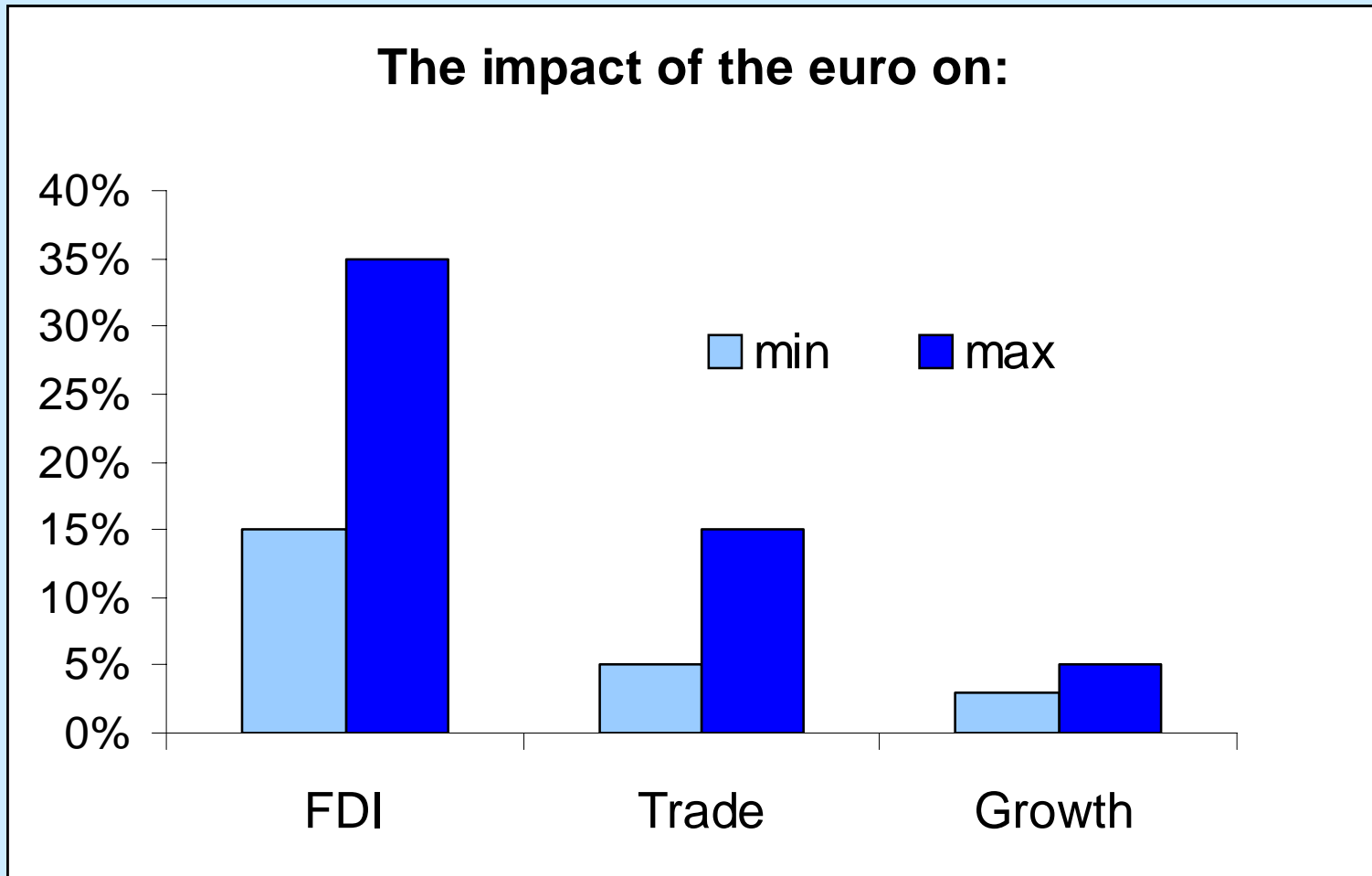
*Corresponds to the period since the start of Stage III of EMU.

Source: European Commission.

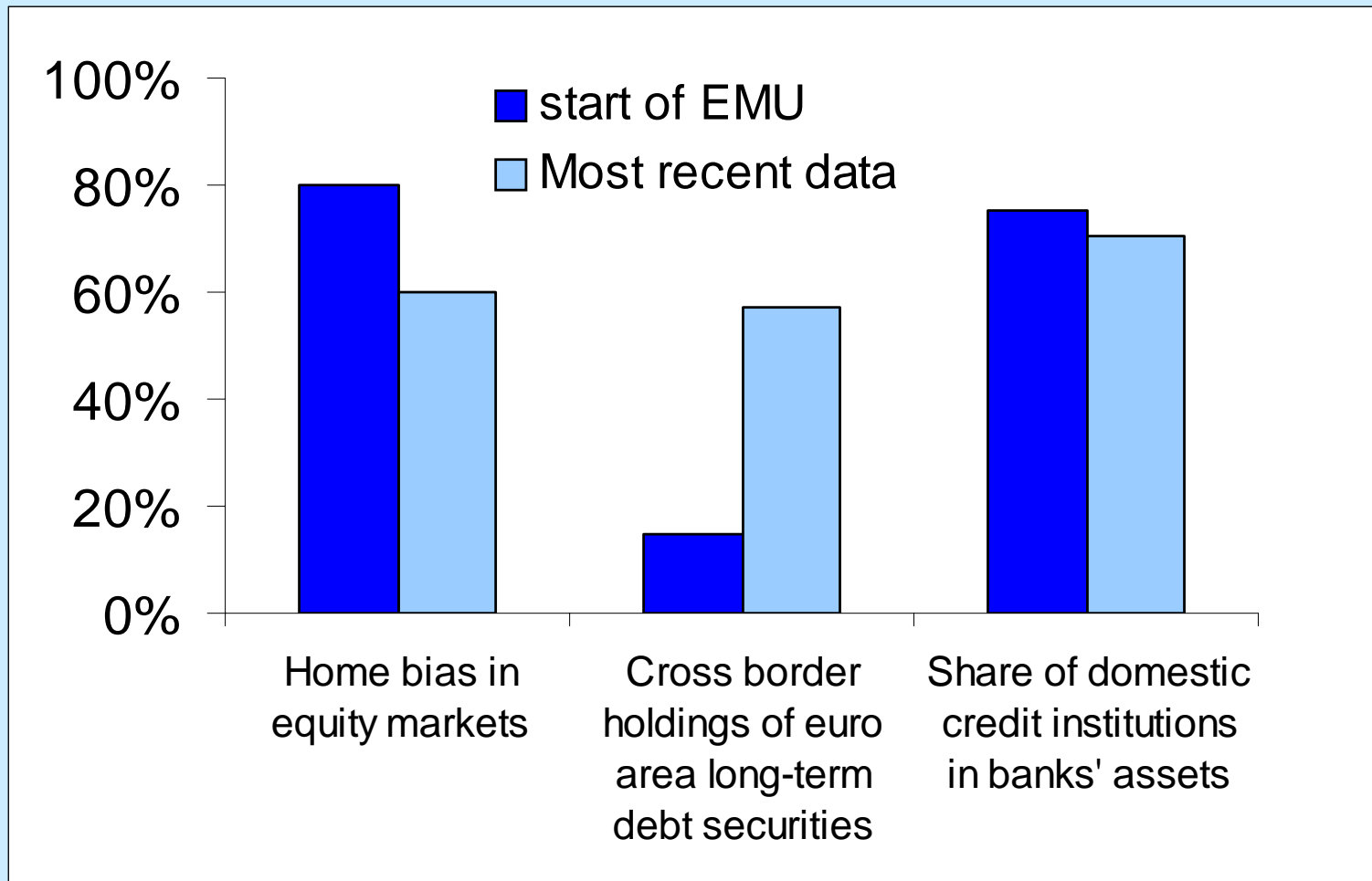
Cost of borrowing fallen dramatically



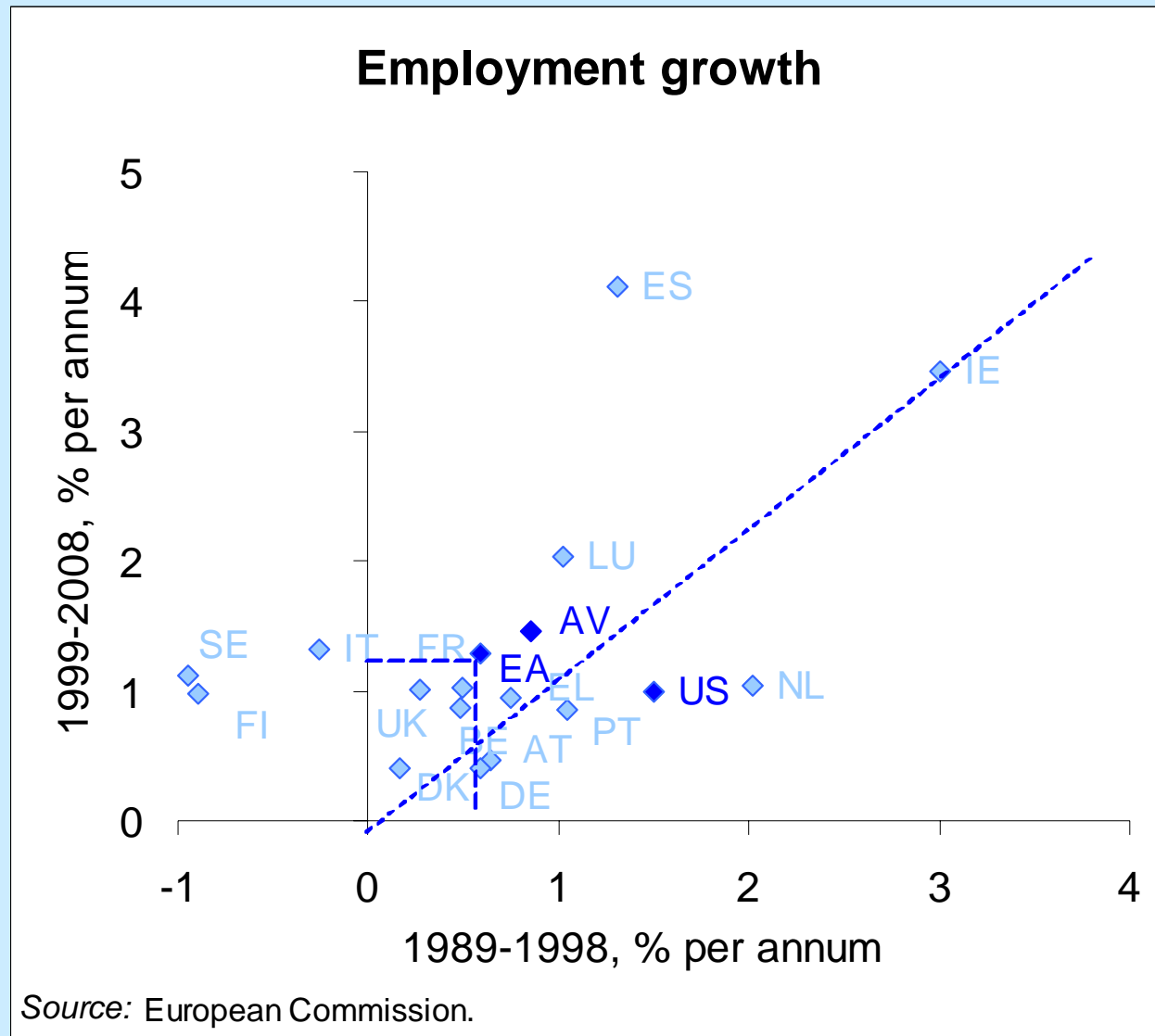
EMU boosted FDI, trade and growth



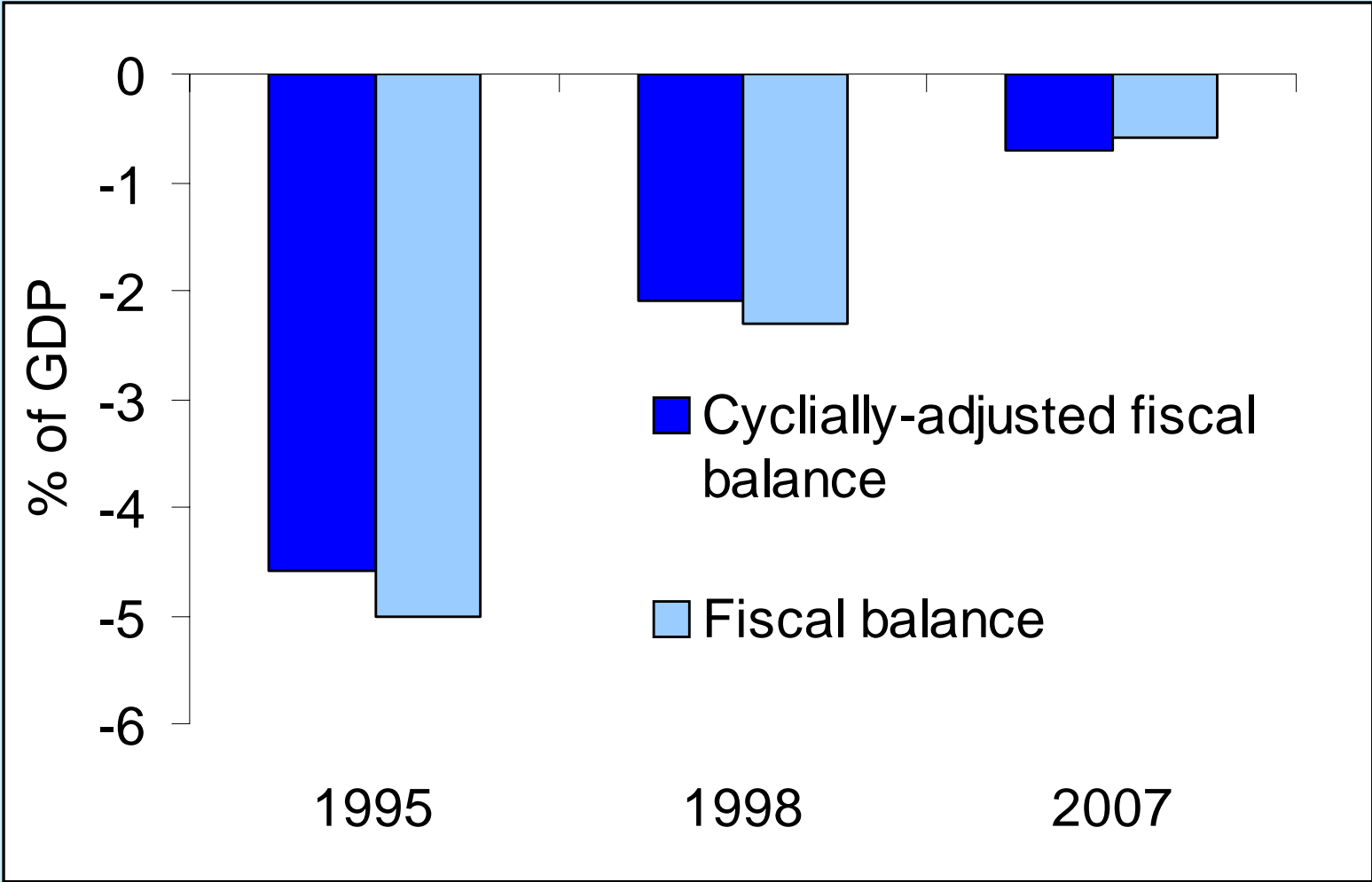
EMU promoted financial market integration



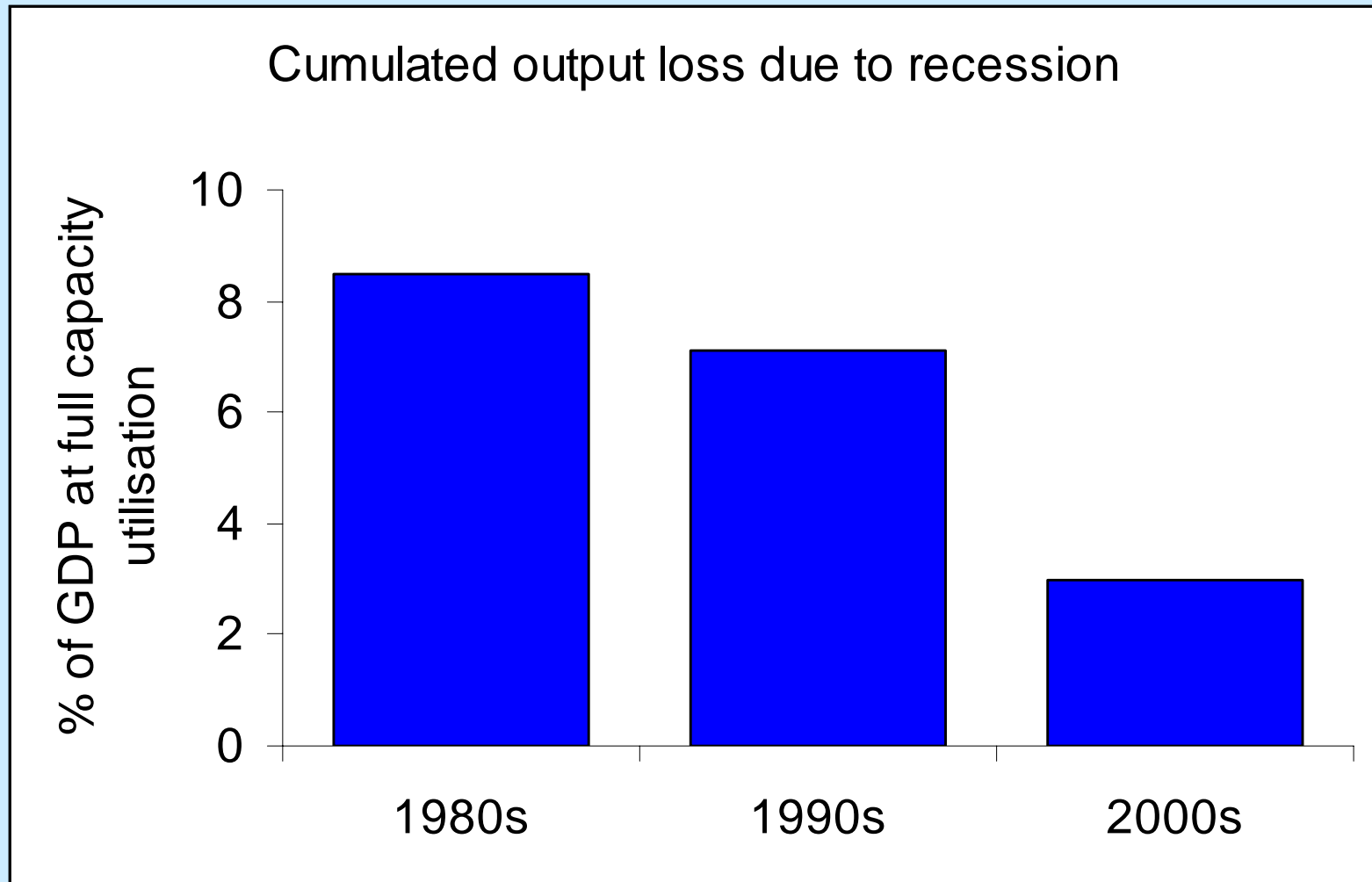
More than 16 million jobs created



Fiscal positions improved



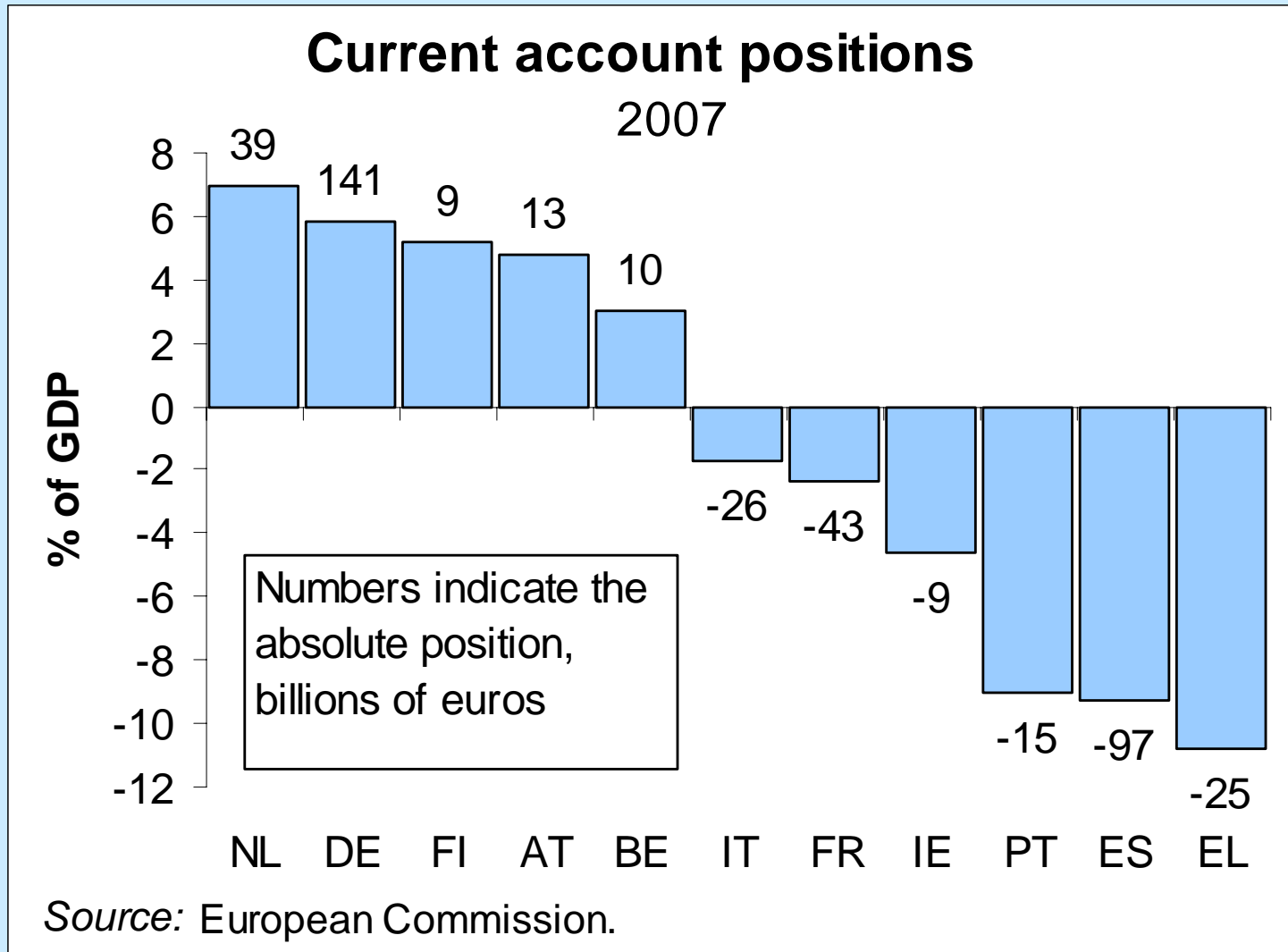
Increased resilience to shocks



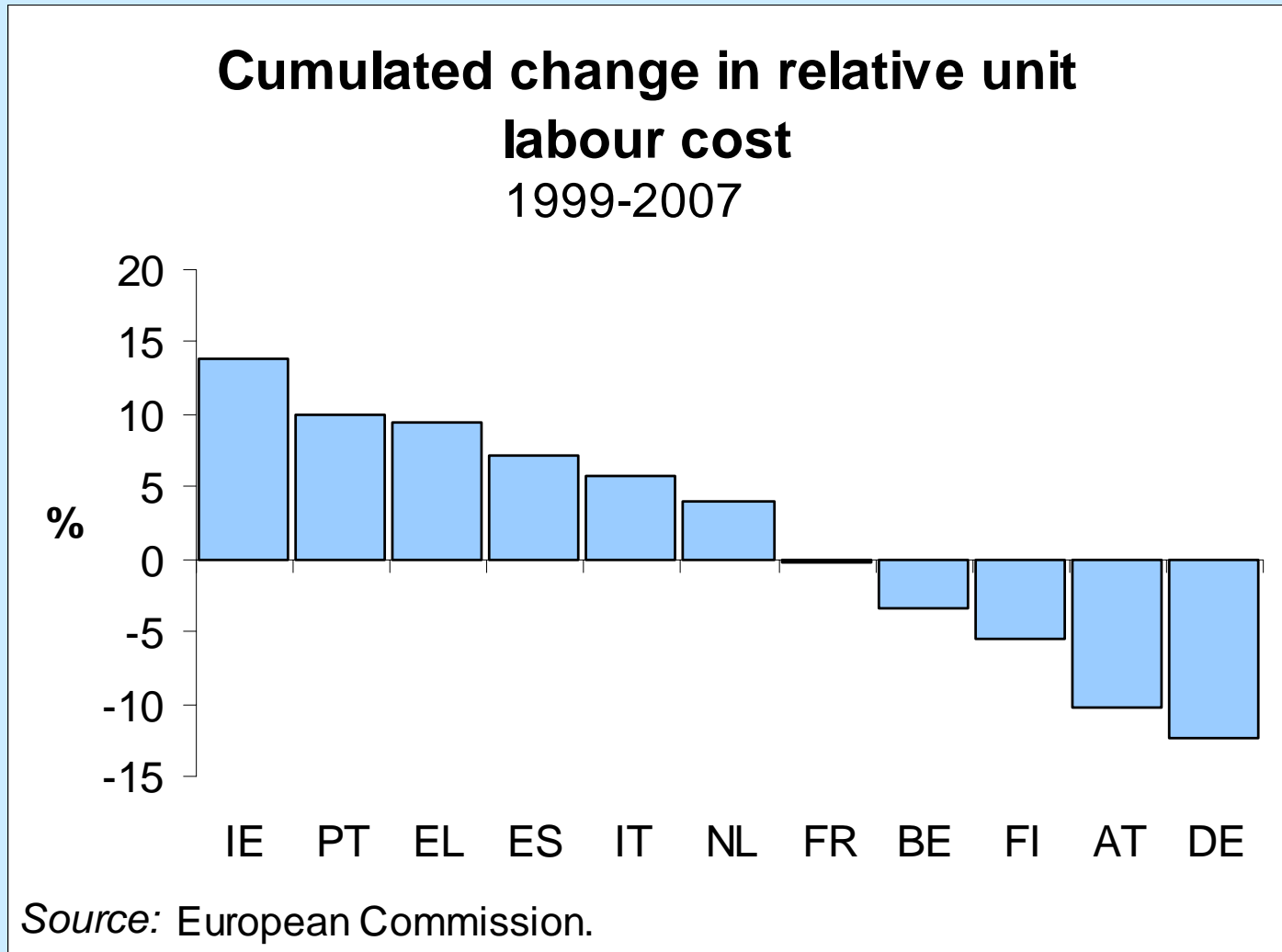
But not all expectations have been fulfilled

- **GDP** growth is slow in some countries, due to unsatisfactory productivity performance
- Rising divergences in **competitiveness** and large **current account imbalances** require correction
- In general, **structural reforms** have been less ambitious and frequent than in the rest of the EU
- Banking and financial markets are still predominately **nationally** organized and supervised
- Not much progress in **international representation**
- Weaknesses in **public perception** of the euro

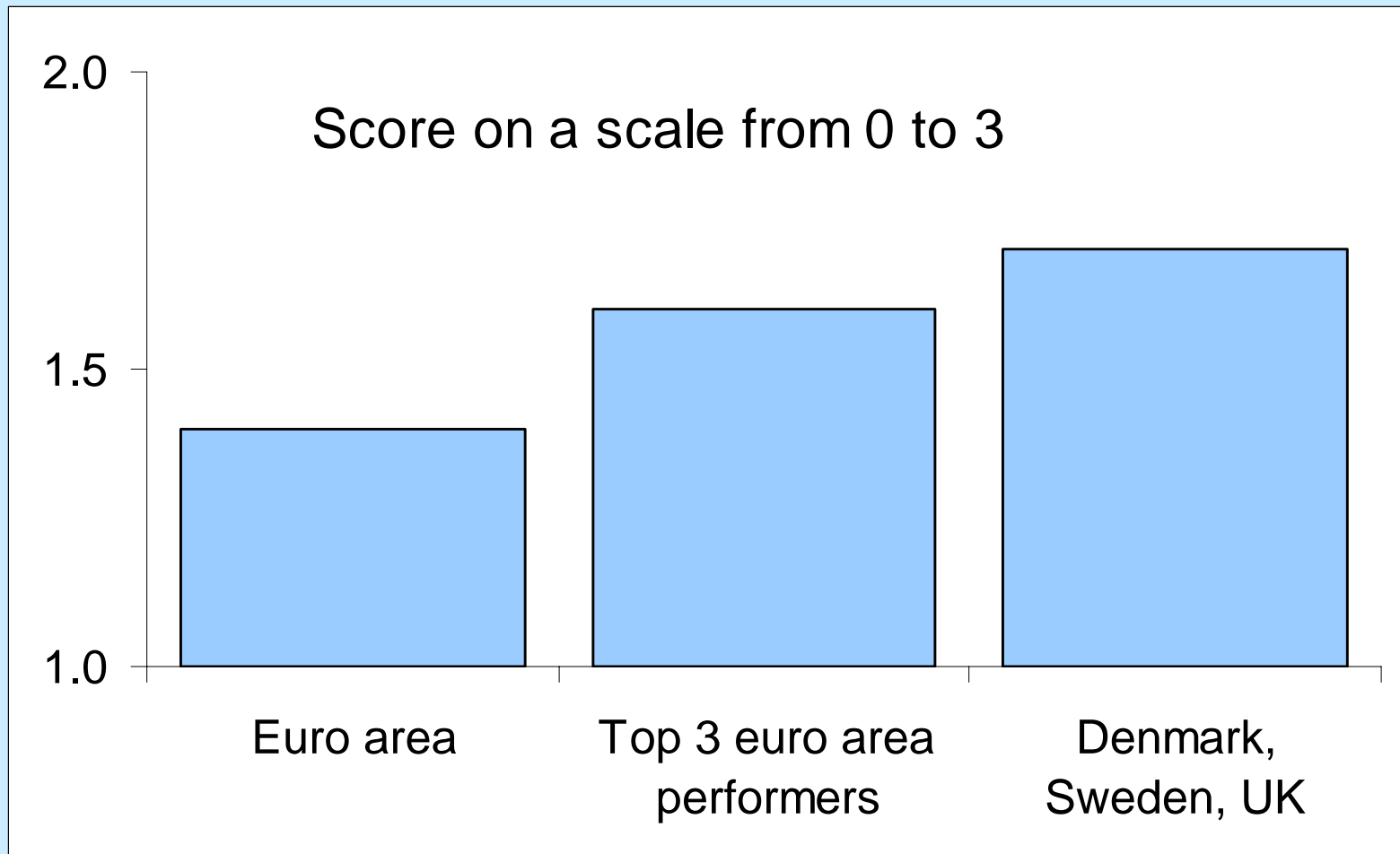
Major external imbalances built up



Driven by competitiveness developments

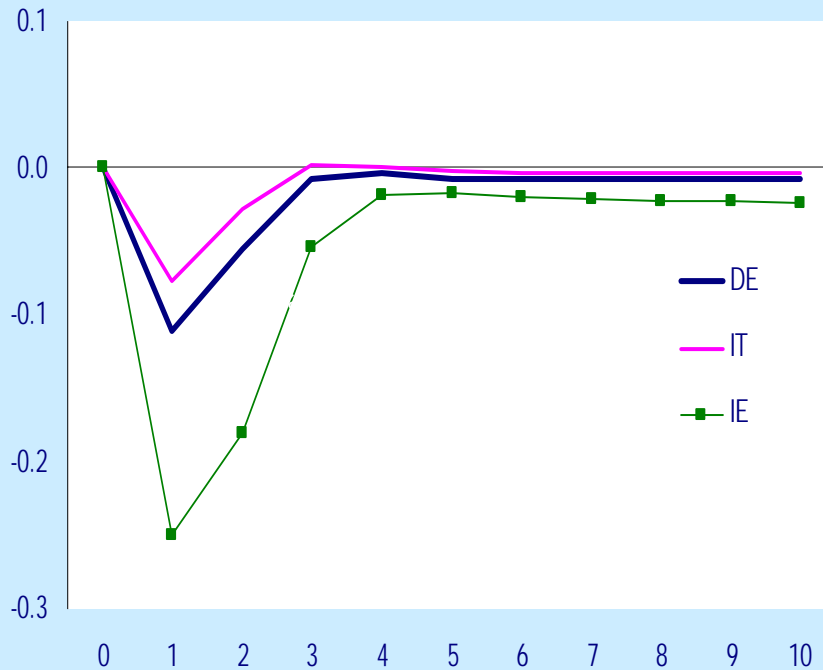


The implementation of structural reform recommendations has disappointed in some countries



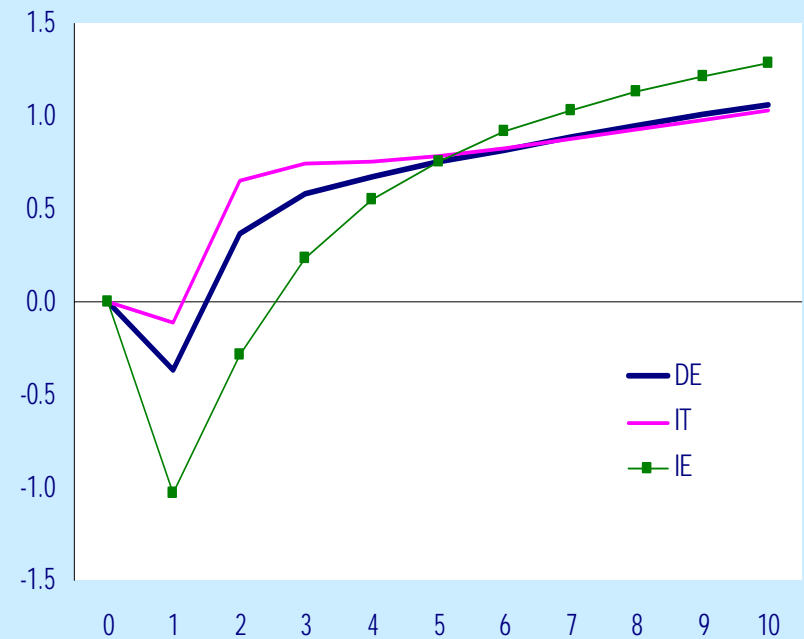
Asymmetric impact of common external shocks

US slowdown (1% of GDP fall in private consumption and investment)



Euro/dollar exchange rate shock

(risk premium shock leading to 10% appreciation)



(Source: QUEST III model simulations)

Lessons from EMU@10 for current and future euro area members (1 - challenges)

- **Price stability:** equilibrium real appreciation complicates inflation control ; shorter history of anti-inflation policy and lower credibility ; conflict between fiscal and monetary authorities ; wage catching up
- **Effective adjustment capacity (incl. stabilisation):**
 - To deal with shocks without exchange rate instrument (but nominal exchange rate flexibility acts also as shock propagator, hence less 'cost' of giving up the XR instrument);
 - Relatively more frequent and persistent common shocks with asymmetric impact (exchange rates, terms of trade, shifting comparative advantages...); asymmetric shocks still possible (see Spain, Ireland, ...)
 - Correction of large current account imbalances may require long and painful disinflation processes if coupled with stagnating productivity
- **EMU and financial integration** help efficient resource allocation and allow for longer adjustment periods, but managing credit booms can be a challenge (already well before euro adoption)
- **Long-term challenges:** sustain high potential growth (catching-up), in a context of ageing, globalisation (with more rapid shifts in comparative advantages)

Lessons from EMU@10 for current and future euro area members (2 – policy needs)

- Improved budgetary control to reduce the risk of fiscal policy pro-cyclicality; budgetary frameworks in NMS are less developed and assessing cyclical component even more challenging
- Flexible and integrated goods and factor markets
- Effective supervision and regulation of financial markets ; NMS experience accelerated financial development
- Sustainability of public finances
- Quality of public finances ; bias towards current expenditure in NMS
- Growth-enhancing use of capital inflows ; NMS are receiving huge inflows, included EU funds; utilisation has differed a lot across NMS
- More efficient use of labour resources (participation rates, structural unemployment, skill mismatches)
- Business environment and investment climate (innovation, FDI, education, favour entry /exit of firms)

The three policy pillars of EMU@10

Domestic agenda

- Deepening fiscal surveillance
- Broadening policy coordination
- Integrating structural reforms in policy coordination

External agenda

- Considering benefits, responsibilities and risks of a global currency
- Enhancing the international role of the euro area

Effective governance

- Exploiting existing tools better
- A stronger role for the Eurogroup, but ECOFIN remains the ultimate decision maker
- Stronger dialogue with other institutions and partners

Looking ahead – on the way to an enlarged euro area

Road to the euro – the starting position

- All EU Member States (except UK, DK) **committed** to join the euro under the Treaty
- Need to achieve a high degree of **sustainable convergence**, based on fulfilment of criteria
- **Sequenced process** – Member States have room for manoeuvre in managing their path towards the euro
- Thorough **preparation** essential
- Euro adoption an **opportunity for reforms**



Road to the euro – progress with convergence

- Impressive **real convergence**
- **Uneven** progress with nominal convergence
- NMS are overall **well placed** to benefit from euro adoption from OCA (stabilisation) point of view
 - ✓ High and growing level of integration (trade, FDI, financial)
 - ✓ Correlation of business cycles; similarity of structure
 - ✓ Relatively flexible markets



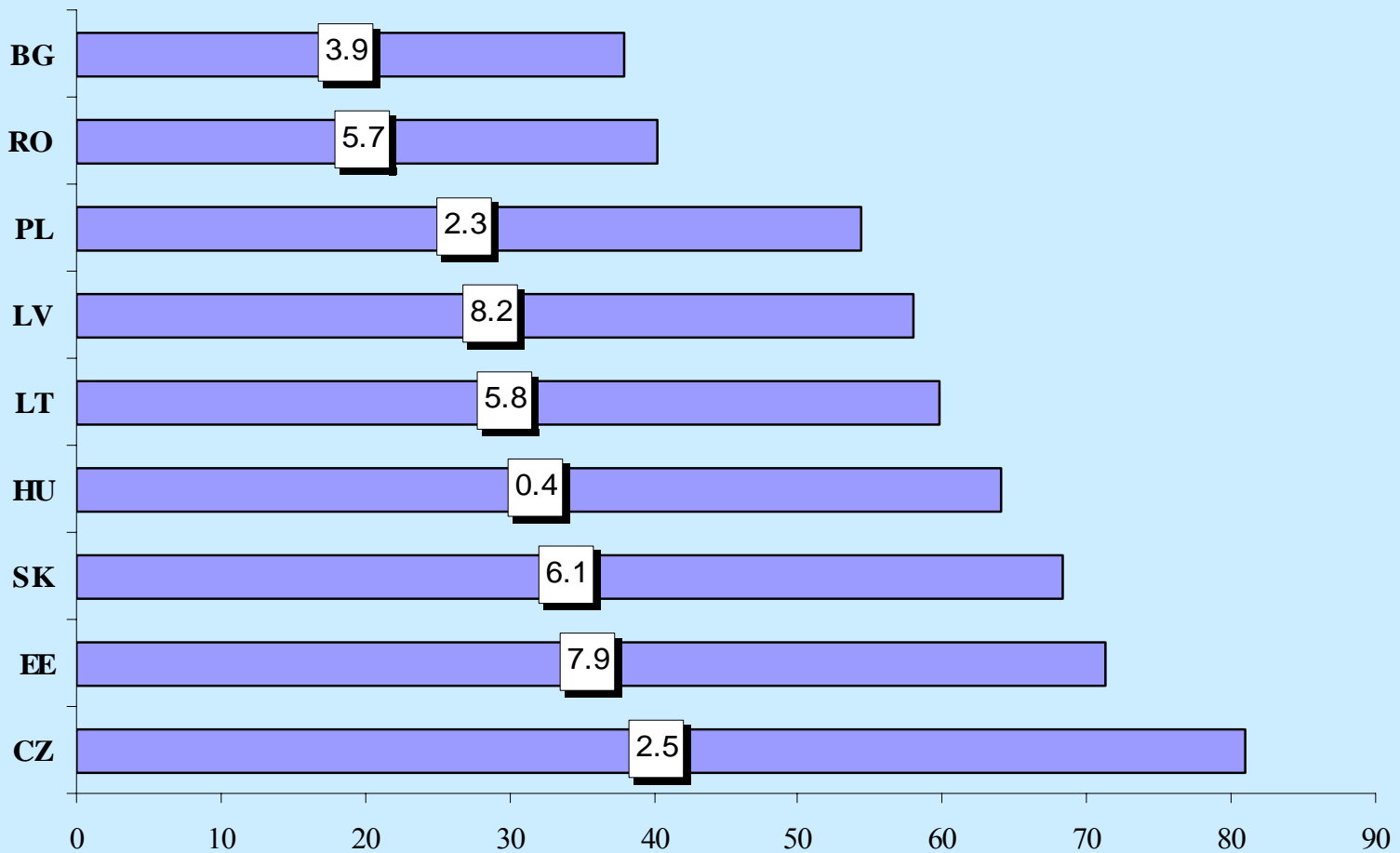
Many roads to the euro

- **No one-size-fits-all strategy**
- Exchange-rate policy is a matter of common interest (Art. 124) but **sovereign choice of exchange rate regime:**
 - Fixed exchange rate regimes (Estonia, Latvia, Lithuania, Bulgaria)
 - More flexible regimes (Czech Rep., Poland, Hungary, Romania)
 - Slovakia: ERM II, flexible regime
- **In ERM II:** Estonia, Lithuania, Latvia, Slovakia



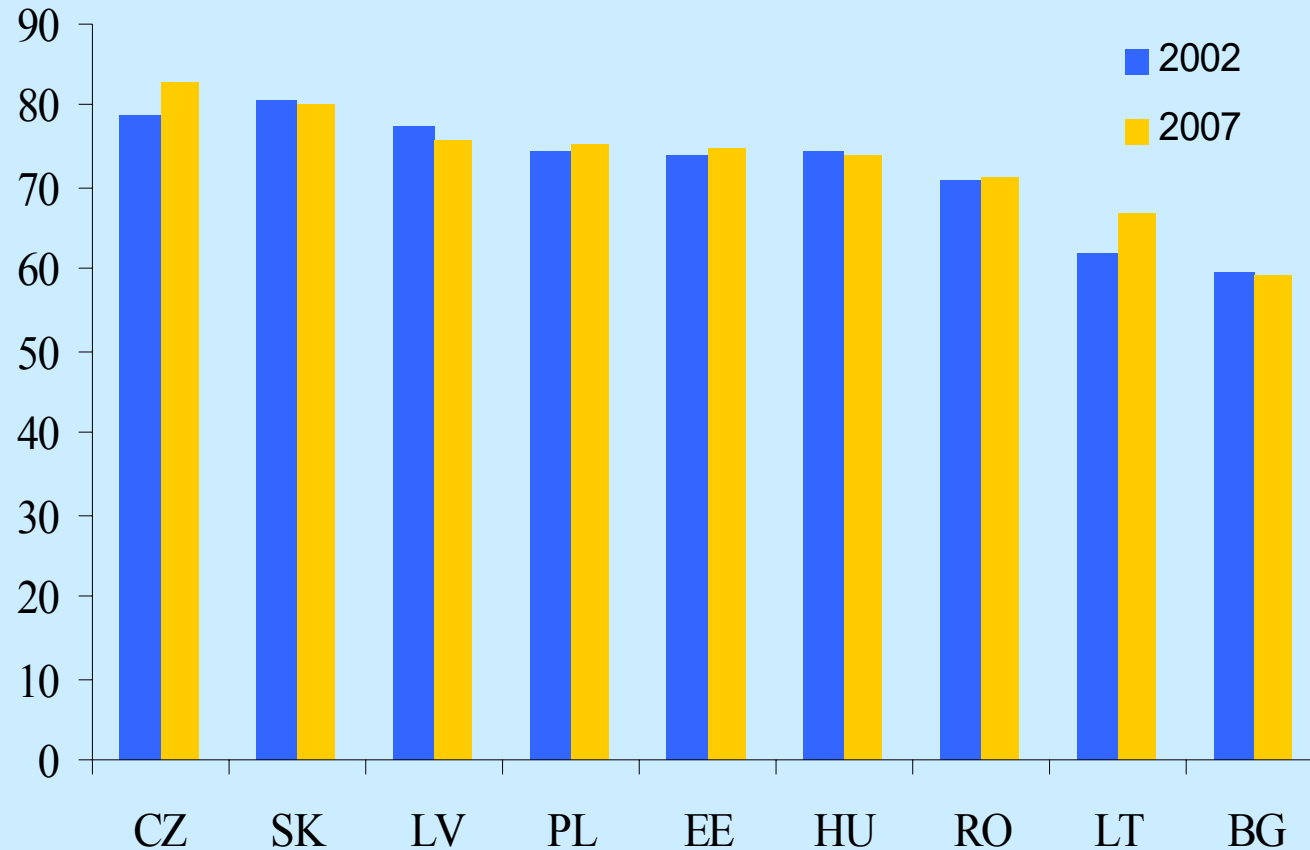
Catching-up is advancing, but remains long-term challenge

GDP per capita in 2007 (in PPS, EU=100) and average change over the period 2004-2007

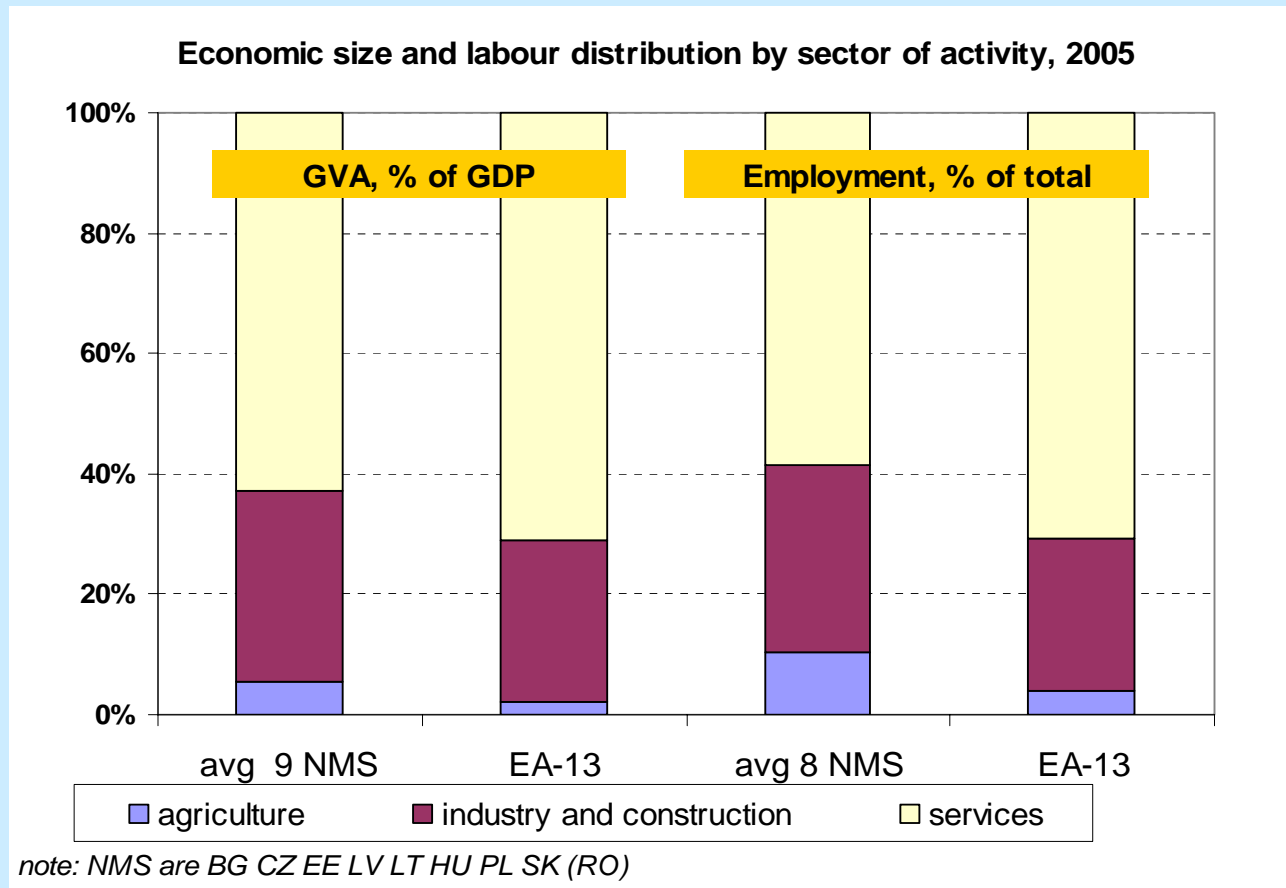


NMS are well-integrated with EU/euro area economy...

Share of intra-EU trade (exports plus imports)

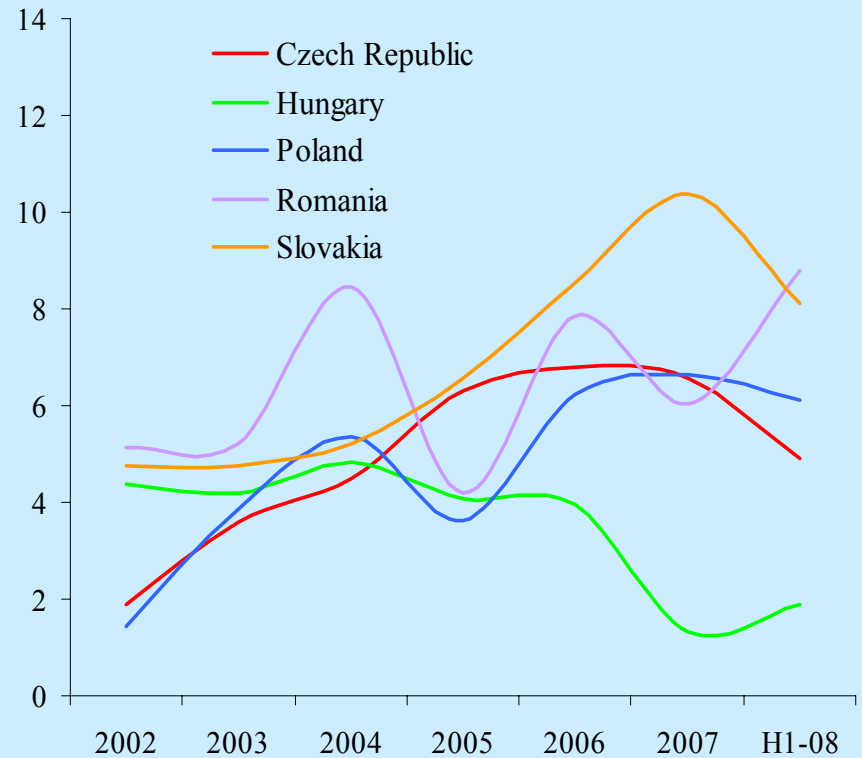
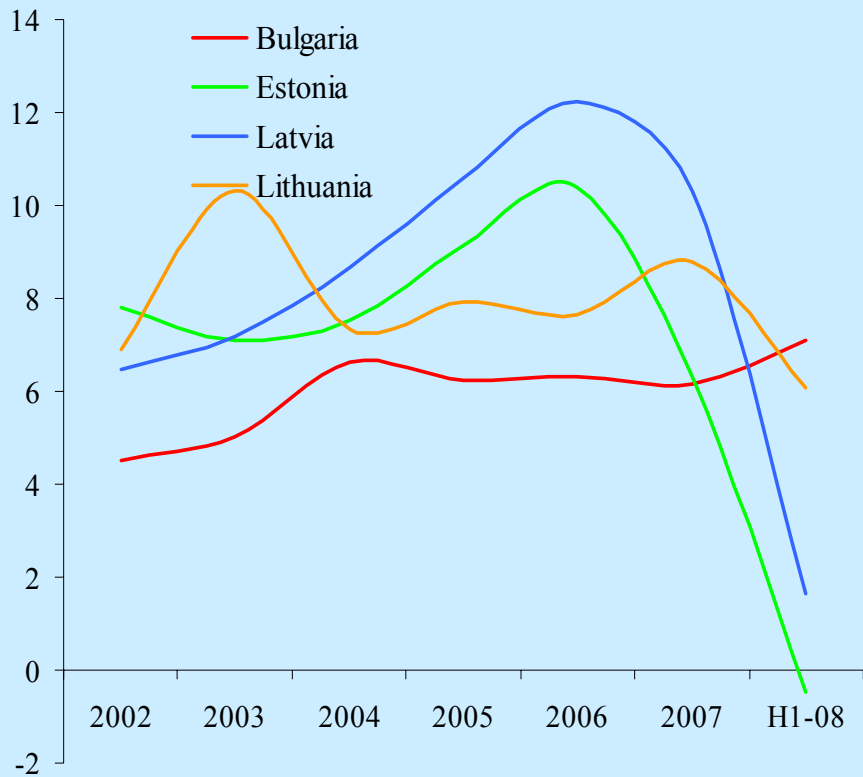


Structural convergence has advanced, but divergences remain



GDP growth rates

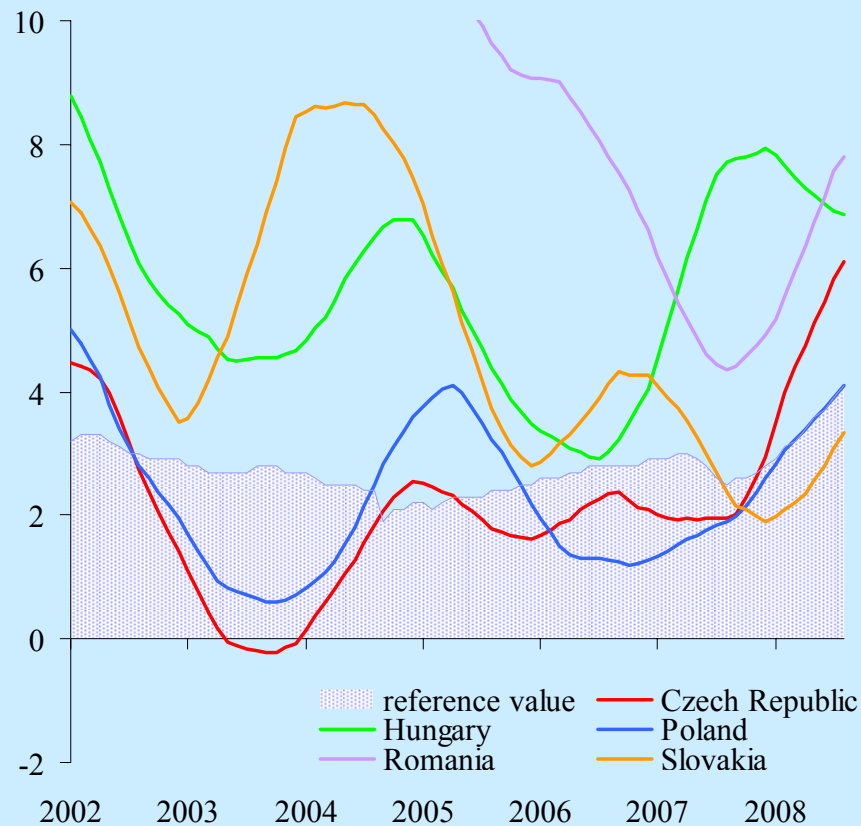
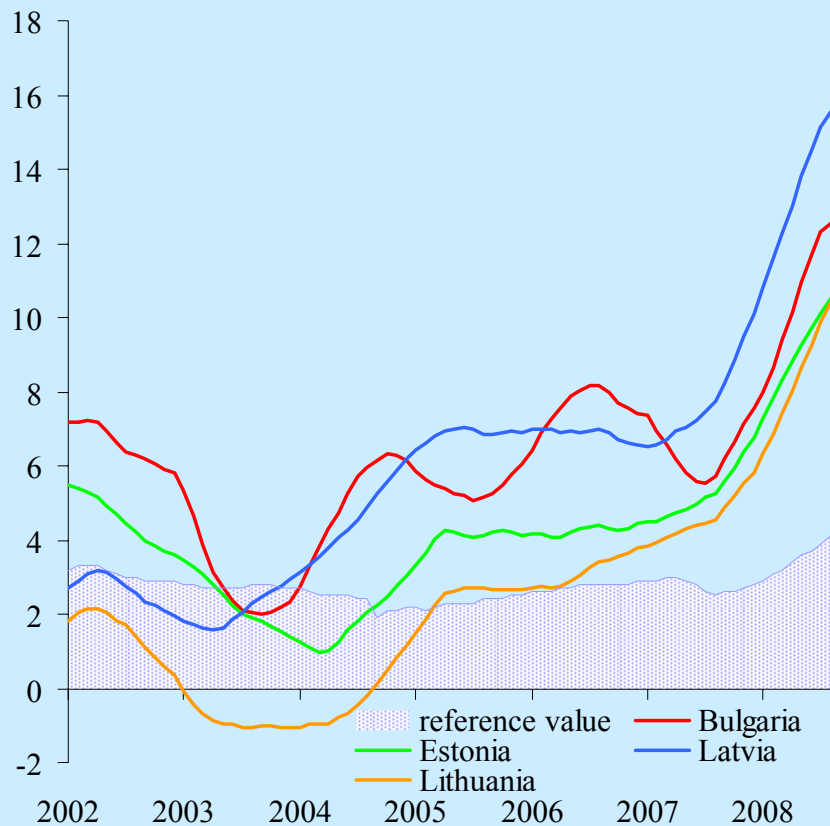
(in %, y-o-y)



State of convergence - HICP inflation

Rising inflation pressures due to supply and demand factors

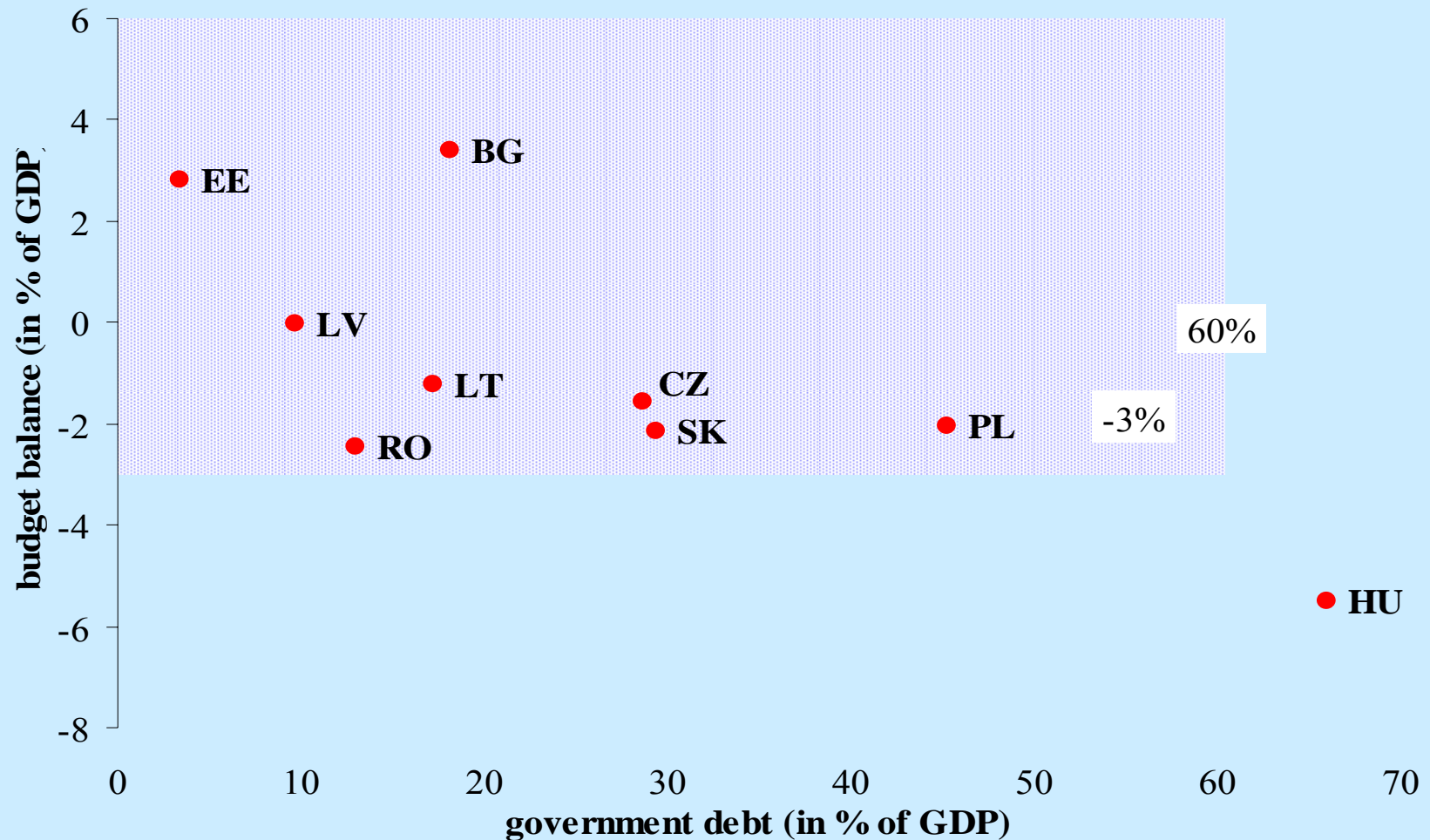
12-month average inflation (in %, y-o-y)



Fiscal positions

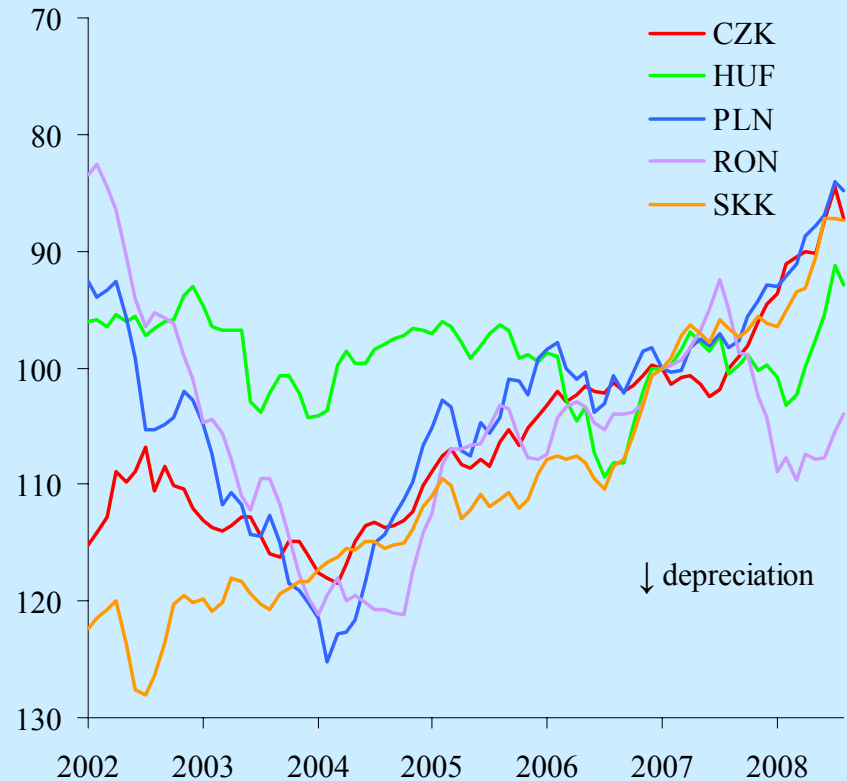
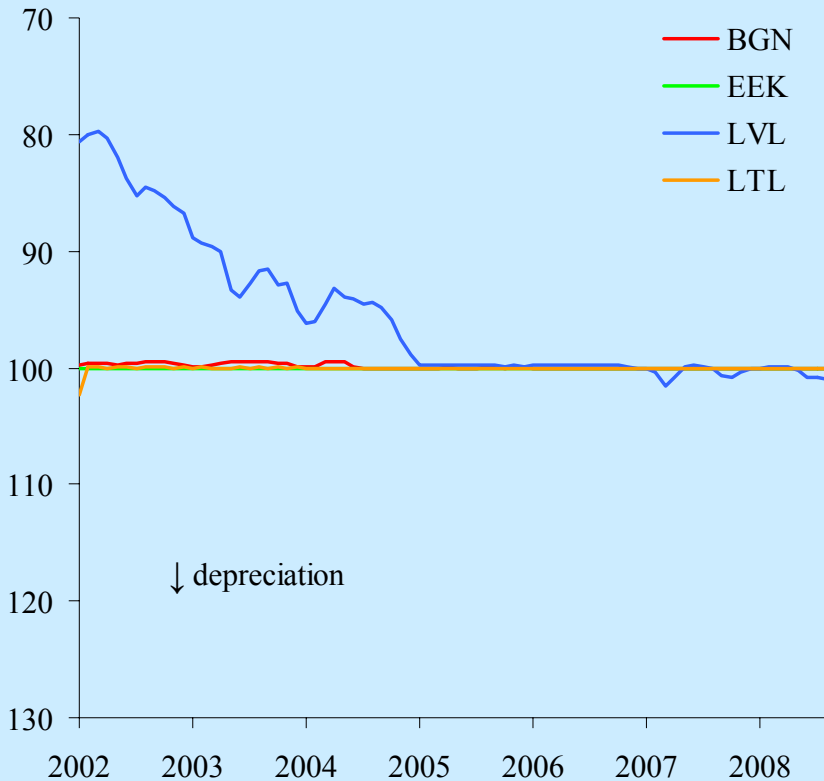
External constraints seem to matter for fiscal performance

General government balance and government debt (in % of GDP; 2007)



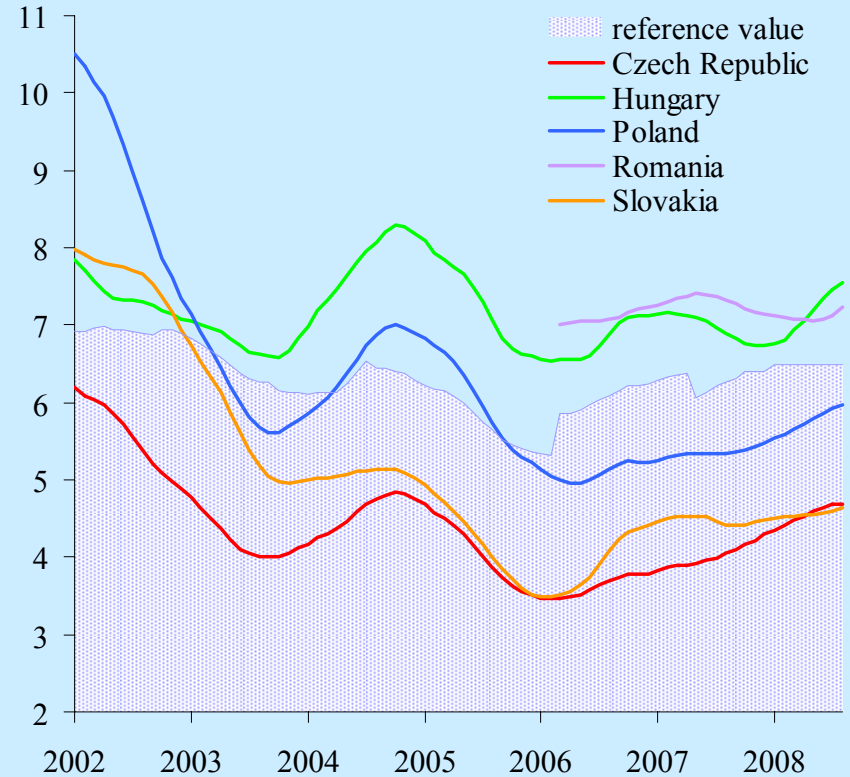
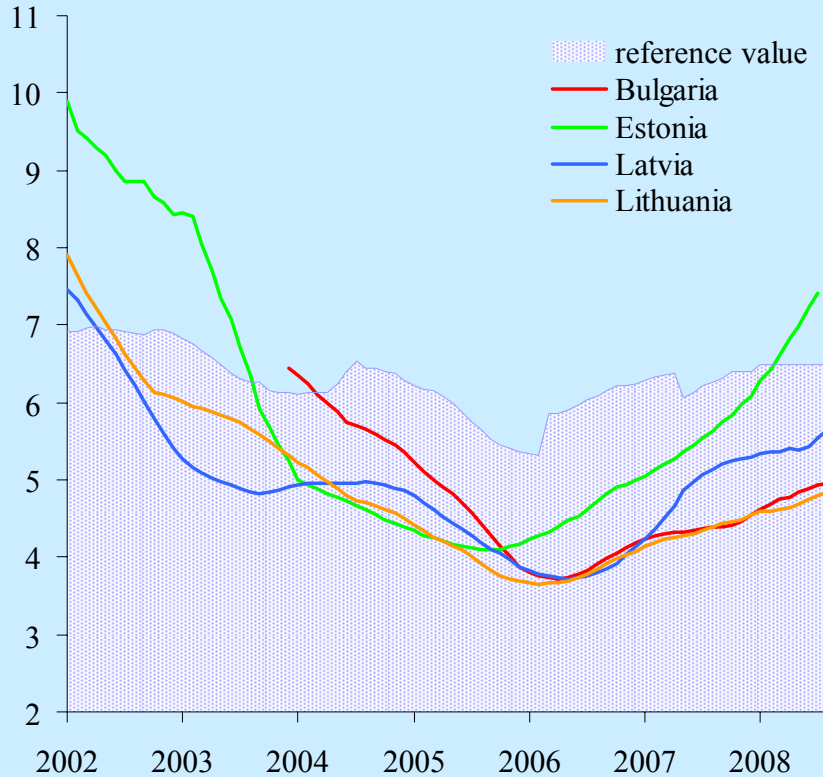
Exchange rate developments

vs. euro, monthly averages (index numbers, Jan 2007 = 100)

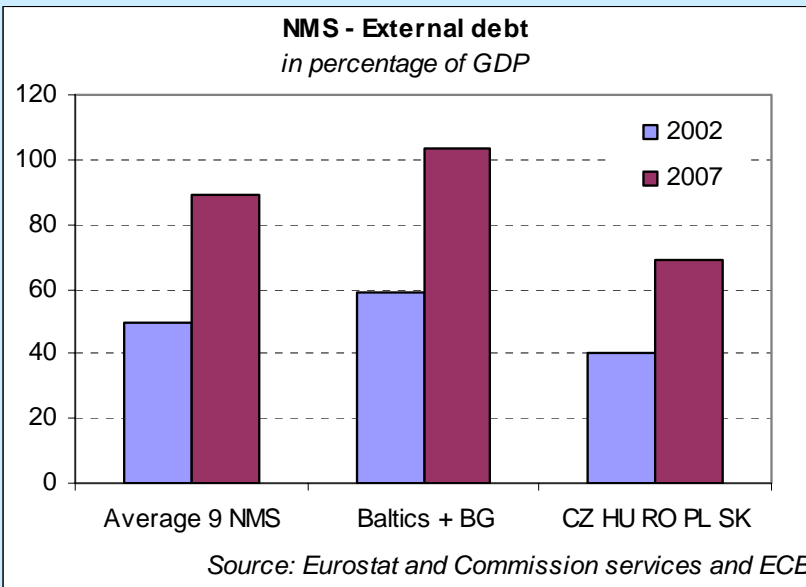
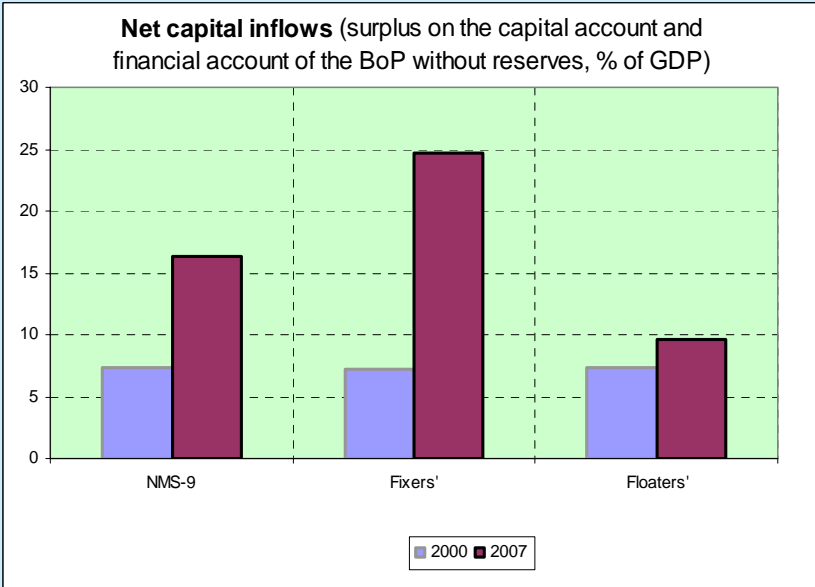


Long-term interest rates

12-month averages (in %, y-on-y)

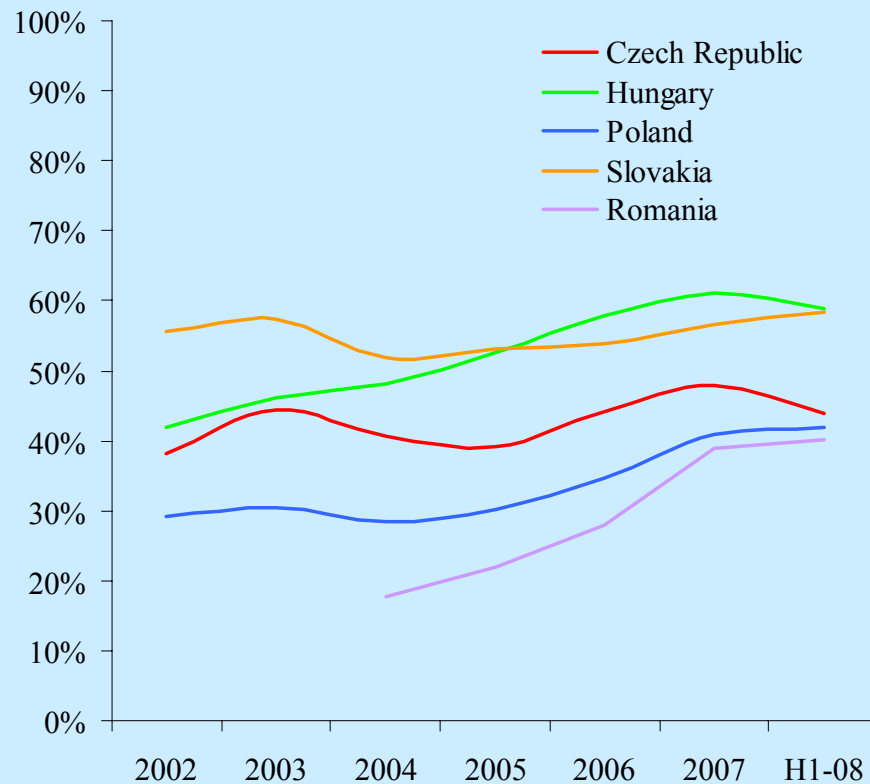
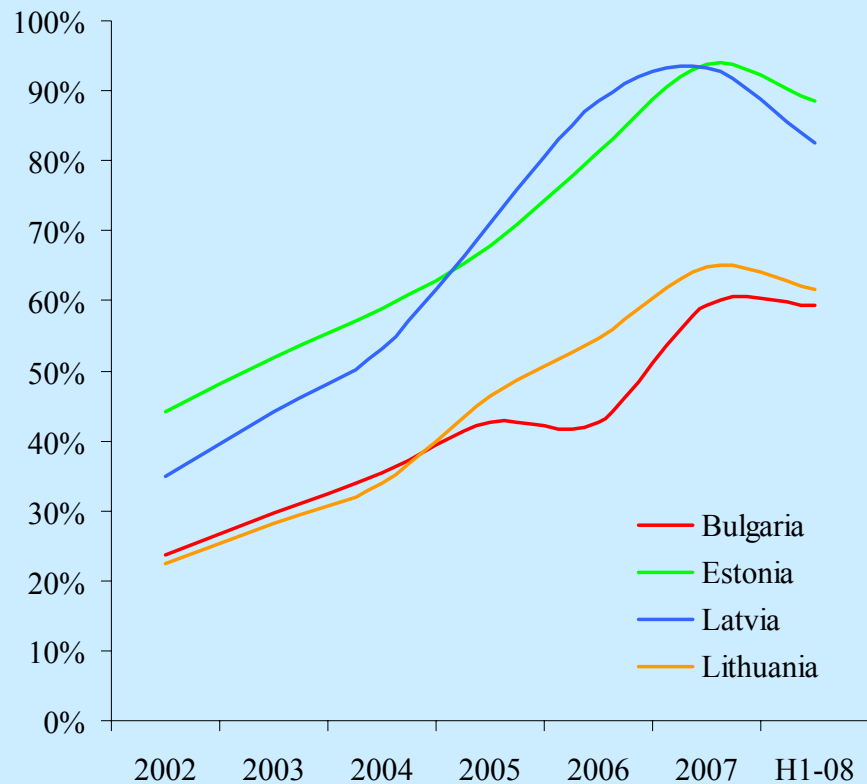


Financially-driven convergence – large capital inflows and extension of external balance sheets



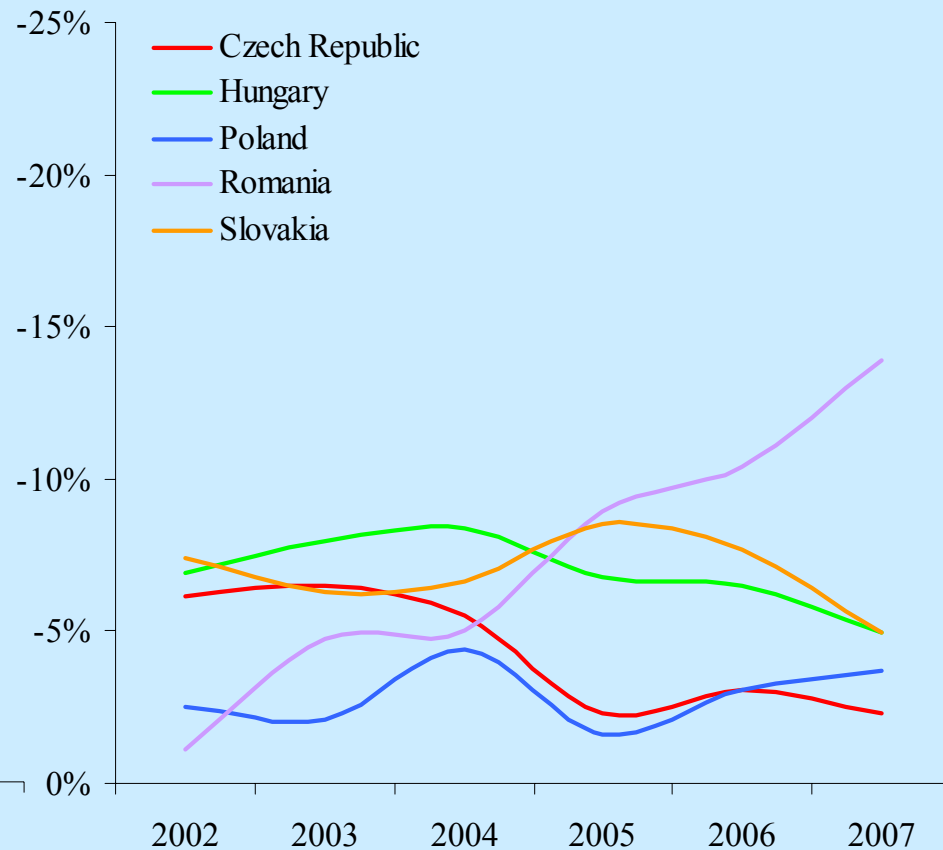
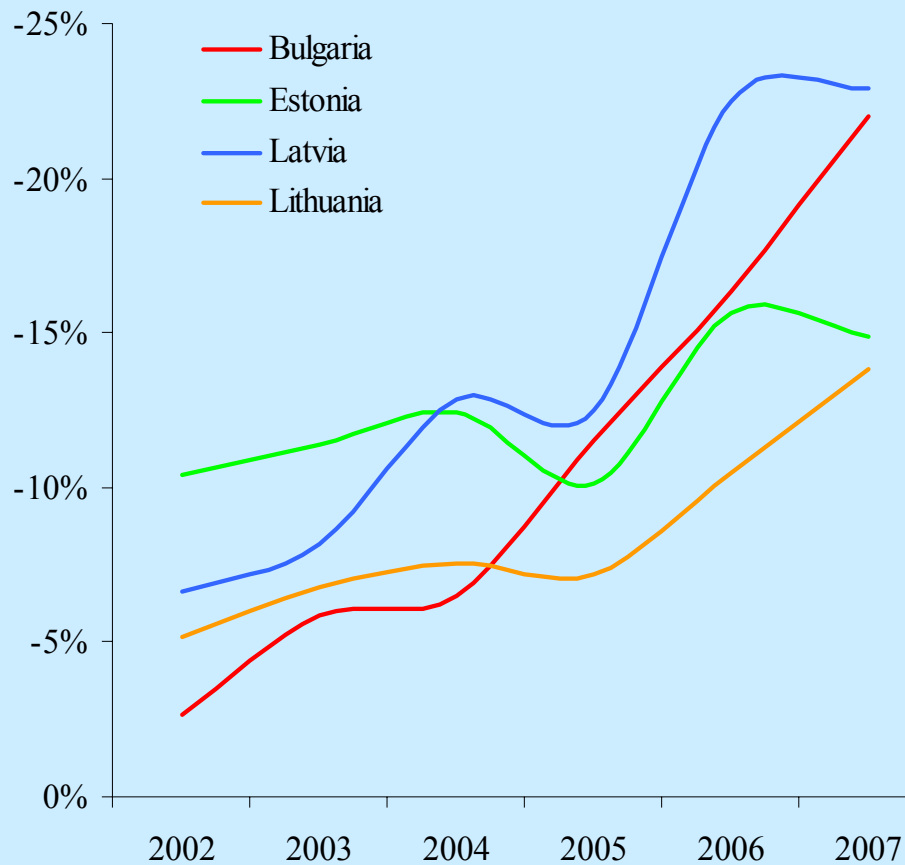
Rapid financial deepening from a low base

Domestic credit (in % of GDP)



Current account developments

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



NMS and the euro - Conclusions

- EMU@10 and beyond – building on the successes and meeting the challenges
- Specific challenges for NMS. Achieving catching-up, nominal convergence while preserving macro-financial soundness
- Euro area enlargement is ongoing; NMS have made considerable progress on the road to the euro
- Policies need to be attuned to country-specific circumstances; ownership and thorough preparation are key
- EMU@10 policy agenda will help
- Short-term challenges: deal with fall-out from the financial crisis

