Zdeněk Tůma: Euro adoption, acceding countries and financial stability

Speech by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the IMF Conference, Prague, 3 February 2004.

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Ladies and gentlemen, dear colleagues,

It is my pleasure and honour to address you during this high-level conference which we co-host at the Czech National Bank. Today we had an excellent opportunity to exchange views on the preconditions and implications of adopting the euro in the acceding countries. These debates will provide us with a springboard for our discussions on euro adoption strategies, which are scheduled for tomorrow.

Even though the actual enlargement of the euro area still lies in the relatively distant future, the acceding countries have to be prepared well in advance. That is why last year was marked in most acceding countries by co-operation between central banks and governments to define their joint positions on the euro. Many of the acceding countries subsequently published euro area entry strategies. In these documents they discussed the potential benefits and challenges of adopting the euro and outlined a roadmap for their entry.

According to the traditional cost-benefit framework, one can expect that the acceding countries, which are mostly small open economies, will derive numerous benefits from adopting the euro. These benefits involve, among other things, a reduction of foreign exchange risk, and the elimination of the danger of exchange rate turbulence and crises. Euro area entry provides an attractive solution to the "fear of floating" dilemma for these countries. The expected benefits should in the long run outweigh the costs associated with giving up national monetary and exchange-rate policies as adjustment tools.

Today, however, I do not want to focus too much on this traditional optimumcurrency-area debate. Instead, I would like to highlight another aspect of euro adoption, the implications of euro adoption for financial stability.

By reducing exchange rate risk and currency turbulence, monetary integration provides easier and safer access to foreign capital. Therefore, it can be expected that it would lead to more efficient allocation of resources, faster real convergence, better inter-temporal consumption smoothing and more efficient diversification of risk. In this sense, euro area entry augments the benefits of international financial liberalisation. At the same time, it reduces many of the financial stability costs associated with the liberalisation process, such as currency crises, currency mismatches in the economy, and high exchange rate volatility.

I would like to emphasise, though, that euro adoption should not be considered a panacea in terms of financial stability. The euro will not solve all the challenges faced by the acceding economies in a world of fully liberalised financial markets. The euro will address some of these challenges, but it may generate new ones, equally serious in nature. The benefits of freer access to foreign financing may be plagued by vulnerabilities and resulting turbulence. The only change may be in the type of risks, with a shift from exchange rate risk to other risks in the domestic financial system.

Let me elaborate on where these challenges may come from. It is a well-known fact that the size of the banking sector in most post-communist acceding countries still remains far below the EU average. In the acceding countries, bank credit to the domestic private sector typically has a ratio of 30 to 40 percent of GDP, while the EU average is around 100 percent of GDP. This difference is to a large extent natural, reflecting the lower GDP levels of the acceding countries, their history, and the recent weaknesses in their legal and institutional environments.

Nevertheless, it is quite likely that this legacy of the past will be overcome in the foreseeable future. The driving force might be the real convergence process. And perhaps more importantly, the acceding countries can capitalise on their reform achievements of recent years. Despite differences in their reform strategies and numerous transitional difficulties, most acceding countries have achieved great progress in building their financial systems. Their banking sectors are now mostly stabilised, privatised, and typically dominated by foreign ownership. Moreover, the acceding countries have also achieved considerable improvements in the functioning of their general legal and institutional frameworks.

Recent empirical studies by the IMF have shown that there might be scope for substantial convergence in bank credit in the acceding countries with EU levels. In some cases and in some periods, the real credit growth might reach as much as 30 percent a year, or even more. This is in line with the credit growth rates observed in some euro area members since the mid-1990s.

Some recent empirical literature has indicated that the probability of bank failures and banking crises increases with credit booms. Banks may become less cautious in granting loans during the boom, due to the prevailing optimism and good performance at the macroeconomic level. And even if the optimism is justified by the fundamentals, it may go a bit too far, leading to an eventual build-up of financial imbalances. Their subsequent bursting could hit the real economy to such an extent that it would have repercussions for the financial system.

Here I come back to the issue of euro adoption, which may be a very relevant factor in this debate for several reasons. First, by providing easier access to external financing for banks, adoption of the euro may amplify a credit boom. Second, it may be associated with a wave of optimism about the future economic prospects of the acceding countries, given the positive net benefits expected from euro area entry. Third, euro adoption requires nominal convergence, including a reduction in nominal interest rates to the euro area level. This may support a credit expansion to some economic sectors. Finally, in a currency union a national credit boom cannot be addressed by monetary policy actions.

To take the current euro area members as an example, the ratios of private credit to GDP a decade ago in Ireland, Portugal and Spain ranged between 45 and 75 percent. At present, this ratio exceeds 100 percent in all these three cases. The trend has been also growing fast in Greece, albeit from a lower base. In Portugal, for instance, domestic banks took the opportunity to issue eurodenominated bonds in euro area markets to increase rapidly the volume of domestic loans both to the corporate sector and to households. Capital inflows through banks financed a mounting current account deficit. It also fuelled fast growth of domestic demand and GDP in 1998-2000.

This experience could in principle be viewed as a manifestation of the expected potential benefits of monetary integration. In fact, it has been argued that euro area membership has enabled the participating countries to overcome the famous Feldstein-Horioka puzzle, i.e. the traditional strong link between domestic savings and investment. In other words, the current account constraint may become non-binding after euro adoption, which should lead to a more efficient allocation of capital in the long run.

However, it might be also questioned whether such a fast credit expansion will lead to a build-up of vulnerabilities in the balance sheets of financial institutions, firms or households. In the case of Portugal, for example, the debt burden of the household sector has exceeded 100 percent of yearly disposable income, even though a decade ago this ratio was comparable to the current situation of some acceding countries. As a result, one can think of adverse scenarios in which the repayment capacities of the banks' clients would deteriorate substantially, with adverse consequences for financial stability. Fortunately, this has not happened so far in reality. The economic cycle experienced by Portugal in recent years has, nonetheless, been a challenging experience.

I do not want to suggest that the materialisation of such, or even more severe, financial stability challenges linked to euro adoption is the most likely future scenario for the acceding countries. There may be many country-specific characteristics influencing the balance of risks in a favourable way. For example, countries that have operated currency board regimes for many years have got used to living without their own monetary policies and with low interest rates ahead of euro area accession. The acceding countries have in general made substantial progress with nominal convergence by now. It is also important to stress that the future development of the financial systems in acceding countries may be strongly influenced by the large presence of foreign capital in both their financial and corporate sectors.

I also do not mean to say that the challenges of euro adoption outweigh the benefits in terms of financial stability. First, the challenges are linked to scenarios which may have rather low probability and are at this stage being discussed only as part of prudential analyses. Second, the actual comparison of the benefits and challenges may differ from one acceding country to another. For instance, countries with currency boards or other fixed exchange rates are likely to face more serious currency mismatches in their financial sectors and economies, as hard peg regimes discourage hedging against exchange rate fluctuations. This residual risk can be eliminated by euro adoption, and fasttrack entry into euro area thus seems to be an optimal exit strategy from the current regime. In the case of countries with floating exchange rates, on the other hand, the direct exchange rate risk may be much smaller. The debate may therefore pay more attention to preconditions that should be met before entry to minimise the risks of excessive credit booms with undesirable consequences.

Let me conclude by saying that central bankers in acceding economies should focus on two issues in the period ahead. We should aim to meet the nominal convergence criteria in a sustainable manner and we should also provide good guidance in the area of financial stability.

And we certainly need much more discussion to find ways in which central banks, fiscal authorities and financial system regulators can foster financial stability in the monetary union. The balance of risks will depend very much on the particular legal and regulatory framework of each economy and the quality of corporate governance in financial institutions. The risks could become serious only if the inflow of external funds were to be intermediated by a weak domestic financial sector. Further improvements in the legal and regulatory framework are thus very important. We must also strengthen our capacities in macroprudential analysis, as early identification can help prevent financial vulnerabilities from building up further. On the supervisory front, we need to address the cross-border as well as growing cross-sector integration in our financial systems. Finally, sound fiscal policies also play a significant role in maintaining financial stability.

I am glad that this conference provides a good opportunity to discuss these policy challenges and their implications in more depth. Thank you for your attention.