Michael C Bonello: The adoption of the euro by new member states - challenges and vulnerabilities

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The references for the speech can be found on the Central Bank of Malta's website.

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Distinguished Guests, Ladies and Gentlemen

I would first like to welcome you all to this seminar which has been jointly organised by the European Money and Finance Forum (SUERF) and the Central Bank of Malta. A special greeting goes to our foreign participants and guests, including some fifty members of SUERF from twenty-three countries.

The topic chosen for the seminar is particularly appropriate at a time when the ten NMS have just entered their third year of EU membership and are increasingly focusing their attention on monetary union. In these introductory comments I shall, therefore, attempt to highlight some key issues which must be dealt with on the path towards the adoption of the euro.

As our policy makers have become acutely aware during the past two years, this path is characterised by manifold challenges and vulnerabilities, not least those associated with real convergence, fiscal consolidation and capital account volatility. The orientation of economic policy in these areas will have to focus strongly, at the level of both national authorities and European institutions, on consistency, flexibility and credibility if we are to extract the maximum gains for all out of this next step in European integration.

Long run net benefits of euro adoption

In order to place this topic in its proper context it is first important to recall that the adoption of the euro is expected to produce significant net benefits for the NMS in the long run. A consistent body of literature points to the likelihood of substantial output growth arising out of increased external trade in countries forming currency unions. Recent studies suggest trade gains of between 6% and 15% from the creation of the euro after five years of its existence.[1] On the basis of these estimates, euro adoption could raise GDP by at least 1% to 2% over 20 years in the NMS.[2] These gains arise from the elimination of exchange rate volatility and risk, lower transaction costs, increased competition and price transparency, all of which lead to trade creation. Lower risk premia on borrowing costs and the stronger frameworks for policy discipline prevailing within the euro area are other potential sources of economic growth.

Such considerations will no doubt have played a part in the recent decision by the six members of the Gulf Cooperation Council to seek the advice of the European Central Bank (ECB) in developing a blueprint for forming a currency union and introducing a common currency by 2010. In a similar context, the announcement last week that Iceland is considering joining the euro is most significant. The country's Prime Minister is reported to have said, "It's clear [that] it's not easy to run a small economy and a small currency in a big market".

There will also, of course, be long-term costs arising from the adoption of the euro associated with the loss of monetary and, particularly, exchange rate policy autonomy. Studies based on the Optimum Currency Area (OCA) criteria, however, suggest that NMS are not likely to suffer from a more pronounced incidence of asymmetric shocks than the existing non-core euro area members.[3] Moreover, the nature of shocks to which the economies of these countries are generally subject do not

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[1] Faruqee (2004)

[2] Schadler et al (2005)

[3] Fidrmuc (2001), Boreiko (2002)

necessarily require intervention on the nominal exchange rate, provided that more efficient mechanisms for aggregate demand management are in place.[4]

Immediate concerns and inherent vulnerabilities

Against this prospect of net long-term benefits, and indeed if the NMS are to maximize the benefits of euro adoption, they will have to continue making substantial reforms to their economic, financial and social systems. While such changes are in themselves necessary to ensure a smooth adoption of the euro, they will continue to be endogenously engendered once these countries become members of the euro area. In the meantime, however, these reforms are posing major challenges to a number of NMS and are exposing vulnerabilities which, if not addressed, could threaten their successful participation in the euro area.

In the course of this seminar first-hand accounts of such challenges, and of the policy responses to deal with them, will no doubt reveal the rich diversity of country situations within an enlarged EU. Some challenges, however, will be common to most new NMS. One such is the need to catch up in terms of per capita income levels with euro area countries. In several NMS this catching-up process is taking place in good part due to the relatively low wage levels and high rates of return on capital in these countries relative to euro area economies. These characteristics of the real sector are creating challenges from a nominal convergence viewpoint. Chief among them are the issues of real exchange rate appreciation and the need to cope with large, and potentially volatile capital inflows.

Rising real exchange rates in NMS in part reflect productivity growth in the traded sectors giving rise to Balassa-Samuelson effects, as well as a growing demand for non-traded goods and the effects of price deregulation. These factors would lead to relatively high inflation rates unless countered by nominal exchange rate appreciation, both of which could potentially hamper the process of nominal convergence necessary to adopt the euro.[5] The broad conclusion which emerges from a number of studies on this issue is that Balassa-Samuelson effects on the real exchange rate in NMS are estimated to be of the order of 1% to 2% per year.[6]

With regard to capital inflows, these are usually perceived as a source of economic growth, especially when they take the shape of foreign direct investment (FDI). However, they can also usher in risks of volatility and speculative pressures on the exchange rate. This is indeed a factor that is currently affecting some NMS, as capital inflows appear to be shifting from FDI to portfolio flows of a more speculative nature, perhaps in part a by-product of the increased competition for productive investment from Asian countries. In the near future, capital outflows from NMS may also be occasioned by the creation of second pillar pension systems.

Needless to say, net capital inflows are accompanied by current account deficits, reflecting expansions in aggregate demand driven by investment expenditure or lower savings prompted by an expected growth in income. In the present scenario, pressures on the current account are being reinforced by the steady upward trend in international oil prices. Markets often view wide current account deficits as a sign of vulnerability, thereby fuelling volatility in capital flows. So far, a number of NMS with a flexible currency arrangement have managed such volatility through exchange rate flexibility, a tool which might, however, be progressively lost in the run-up to the adoption of the euro.

Developments in financial intermediation may also pose significant challenges in this regard. Thus far there has been a tendency for credit to be relatively low compared to economic activity in NMS, as banks, which are largely foreign-owned in a number of these countries, have been generally averse to advancing a significant amount of credit to enterprises, although tending to step up lending to households.[7] This implies the possibility that with a further internationalisation of the financial sector on account of the introduction of the euro, there could be a more rapid credit expansion through bank borrowing from abroad, with the attendant dangers of overheating and the formation of asset price bubbles.

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[4] Schadler et al (2005)

[5] Begg et al (2003)

[6] For example Cipriani (2000), Kovacs (2002) and Mihaljek and Klau (2003)

[7] Schadler et al (2005)

These considerations have important implications for the maintenance of financial stability in the NMS. While the regulatory and supervisory frameworks are generally recognised to be strong in these countries,[8] they will have to withstand increasing stress over the next few years arising from the growing internationalisation of financial markets and the complexity of the global financial architecture, as well as from domestic macroeconomic dynamics.

In the run-up to the adoption of the euro, most NMS will also continue to face the challenge of maintaining acceptable fiscal positions. Current expenditures in many of these countries are high relative to GDP, and in a number of them demographic profiles are casting doubts on the medium-term sustainability of public finance. This is a concern not only from the viewpoint of nominal convergence in terms of the Maastricht criteria, but also from the perspective of the need for flexibility in the area of fiscal policy in order to be able to counter the effects of asymmetric shocks.

Requisites for the successful adoption of the euro

In this scenario, the successful adoption of the euro by the NMS requires efforts on two fronts, namely the implementation of economic policies designed to meet the Maastricht criteria on a sustainable basis, and the mobilisation of strong support for euro adoption so as to endow the project with the necessary credibility.

With regard to the former, a continued emphasis on fiscal consolidation, with deficit and debt levels that would be even lower than the threshold values of the Maastricht criteria, would seem to be called for. In addition, reforms aimed at removing rigidities and expenditure trigger effects in social welfare transfers would also be appropriate in some countries. The capacity of economies to respond successfully to the challenge of euro adoption would be further enhanced by a greater degree of price and wage flexibility. Generally speaking, the NMS have a satisfactory track record on this count, at least compared with the non-core euro area countries, but the extent to which the existing flexibility is enough to enable a sufficiently rapid catching up process in the context of an increasingly competitive global trading environment is yet to be assessed.

An overriding consideration relates to the degree of vulnerability that an economy might experience during its participation in ERM II. This is now generally perceived as a testing period to be entered into once the economy is deemed a credible candidate for euro area membership, but not to be postponed to the extent of unduly retarding the adoption of the euro, with the consequent negative effects on policy credibility. Indeed, the exposure to the international markets which participation in ERM II implies requires NMS to follow even more prudent policies, especially on the fiscal front, compared to existing euro-area countries. This is needed to compensate for the vulnerabilities, not least that arising from capital account openness, which the NMS are facing. This aspect of ERM II appears not to be sufficiently understood by advocates of delayed euro adoption in some of our countries.

These policy prerequisites for adopting the euro may, on the other hand, complicate the mobilisation of strong popular support for the euro project. The case for fiscal consolidation may be compelling from a long run growth perspective, but the dividends of such a policy course may fail to materialise in a sufficiently short time to generate the necessary support. Likewise, the introduction of the euro may be perceived as entailing the prospect of higher prices, generating further scepticism among the social partners. And let us not forget that it is these same partners that have to be relied on to deliver the flexibility in the labour and product markets that is required for a successful transition to the euro. An active and constructive social dialogue is, therefore, necessary to support the process.

Given the considerable policy challenges inherent in the adoption of the euro, the European Commission and the ECB have an important role to play in providing the NMS with both practical and moral support for their efforts to achieve this next step in European integration. Such support might not only take the form of regular reports and consultations in order to reassure the markets, but also an effort to minimise uncertainties about the application of the criteria used to assess eligibility for euro adoption. In this regard, the challenge would seem to be to strike a balance between, on the one hand, ensuring transparency and a level playing field and, on the other, giving due weight to the track record of economic policy and performance in the NMS, as well as to the implications for these

[8] Schadler et al (2005)

countries, and indeed for the euro-area as a whole, of an unduly rigid interpretation of the provisions of the Treaty.

The application of the Maastricht criteria

In making this point I am clearly not suggesting, as some academics have done, that the Maastricht criteria are “neither necessary, nor sufficient”. On the other hand, there are some aspects of the criteria that could legitimately be the subject of reflection.

The calculation of the reference value of the inflation criterion is a case in point. Over the past few years there has been a debate about how one should define “best performance” in relation to inflation and also about the term “outlier”. And even about why countries outside the euro area should be included among the best performing countries. This debate appears to have resurfaced again during the preparatory phase of the current ECB Convergence Report.

Another, and currently very topical aspect that also has ‘level playing field’ connotations is the impact of the ongoing spike in the international oil price. The current reference value for the HICP inflation criterion is influenced by countries whose energy needs are satisfied in varying degrees by non-oil fuels. At the same time, of the NMS that would not have satisfied the inflation criterion on the basis of the March 2006 data, some are more heavily dependent on oil imports, so that price levels generally in these countries have been reflecting the higher cost of oil and energy to a much greater degree than is the case in the reference countries.

This argument could also apply to Malta in the future since not only is oil the sole source of electricity generation, but a high proportion of drinking water needs are also met by the transformation of sea water, a process that involves a high consumption of electricity.

The difficulty of controlling inflation in current circumstances is indeed also reflected in the fact that three of the present euro area members exceed the inflation reference value by an average of 1 percentage point, and there is evidence pointing towards a divergence in inflation rates between these countries over the past five years.[9] Moreover, the NMS have registered rates of inflation between 2002 and 2005 that were around one half those recorded during the preceding four-year period. This is indicative of the significant degree of macroeconomic stabilisation taking place, at the same time that progress continued to be registered in terms of real convergence. In fact, since 2000 real GDP growth in NMS was on average more than double that registered in the euro area member countries.

These considerations acquire greater significance when viewed in the context of fiscal developments. On the basis of 2005 data, among the NMS participating in ERM II only Malta failed to satisfy the relevant criterion, with a fiscal deficit to GDP ratio of 3.3%. Malta, however, expects to be within the reference value by the end of this year. This represents a considerable fiscal consolidation effort, especially when viewed in the context of an average ratio of 6.7% during the first five years of this decade. This progress is expected to prove durable, as it has been based not only on tax measures, but also on the restructuring of public sector entities, spending cuts and efficiency improvements. Challenges to fiscal sustainability in NMS remain, nevertheless, mainly arising out of the future dynamics of the welfare system combined with population ageing, but these are hardly different from those being faced by euro area members.

It is furthermore interesting to note that on average the NMS participating in ERM II recorded lower deficit to GDP ratios compared to the present euro area member countries in 2005, among whom five posted deficits in excess of 3%. The positive fiscal performance of these NMS is further underscored, with some individual exceptions, by their lower levels of public debt, which as a percentage of GDP average around one half of those of the current euro area member countries.

With regard to nominal exchange rates, it is a matter of some satisfaction that none of the NMS participating in ERM II have experienced undue volatility since their entry into the Mechanism. This to a large extent confirms the appropriateness to date of the chosen central parity rates. It is also a reflection of positive market sentiment.

The long-term interest rate is another important indicator of the suitability of economies to participate in ERM II and eventually adopt the euro, as it reflects the judgement of the financial markets regarding

[9] Busetti et al (2006)

the credibility of this process. All the NMS that are in ERM II currently satisfy this criterion, having achieved a consistent track record of downward trends in long-term interest rates over the past five years.

Conclusion

In conclusion, I think it is important in this case to look to the future with an eye on the recent past, and recognize that the ten NMS have come a long way in honouring their commitments to achieve the established macroeconomic targets and implement significant structural reforms, often against heavy odds. The magnitude of this undertaking must indeed be viewed not only in terms of the difficulty of the task itself, and the economic and social costs involved, but also against the background of an unfavourable global environment. At the same time they have striven hard to narrow the gap in living standards between themselves and the euro area member countries.

It is, therefore, important that in the examination that follows a country's request for a convergence report due consideration be given to the policy consistency and credibility of the applicant country. A comprehensive economic analysis that is not only quantitative but also qualitative, and which recognizes the difficultly of simultaneously satisfying all the Maastricht criteria in the current world environment would encourage EMU candidate countries to persist in their efforts to achieve even closer nominal and real convergence. It would also provide further evidence that the euro project is credible, that it is both feasible and realizable in a near-term perspective.

Let me conclude by thanking you again for being here to contribute to a deeper understanding of the challenges ahead. I also wish you a pleasant stay in our country.