The future of the Euro Area and Its Enlargement

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Outline

- EMU: lessons from the crisis
- When should Romania join EMU?

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

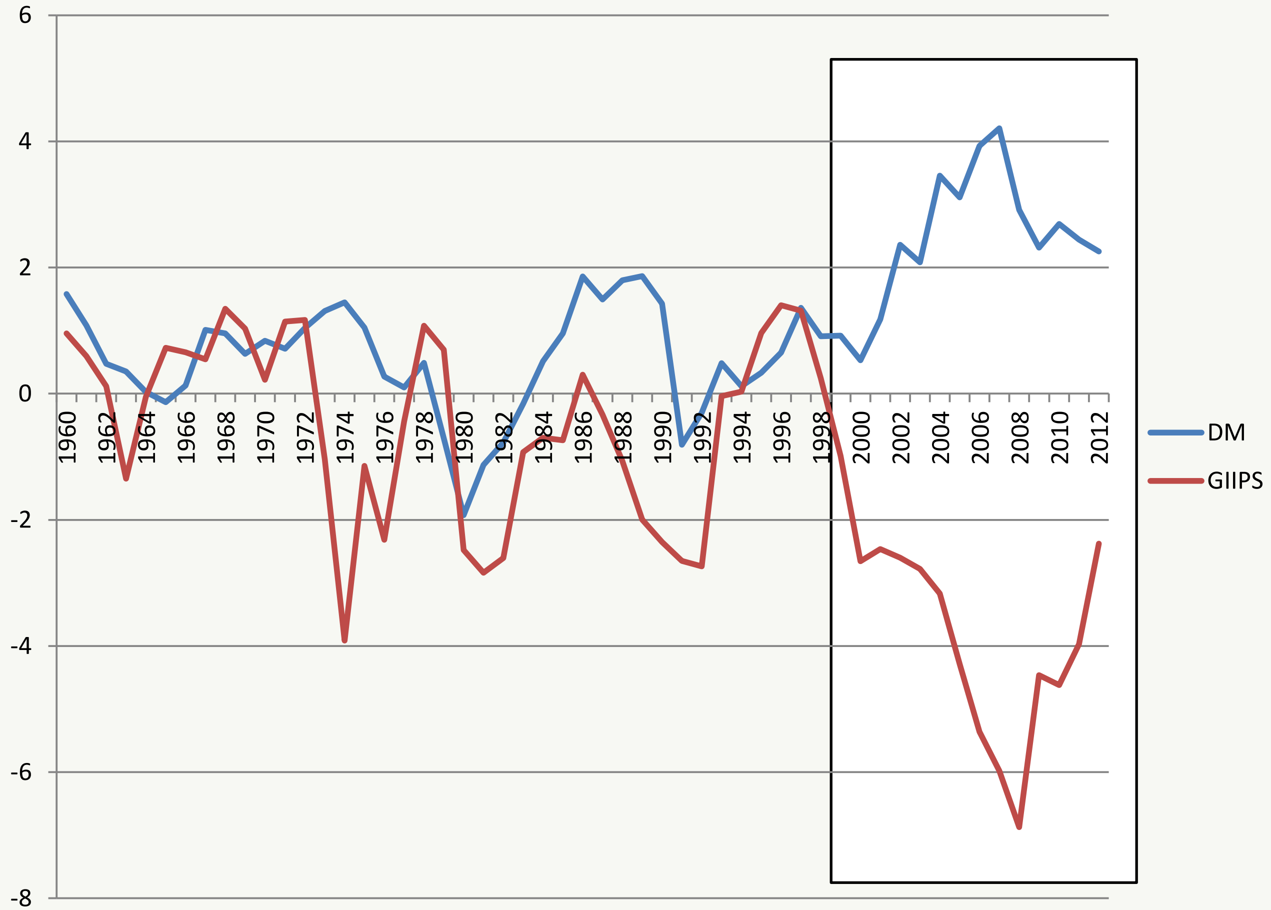
The EMU 1.0 system failed

- 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

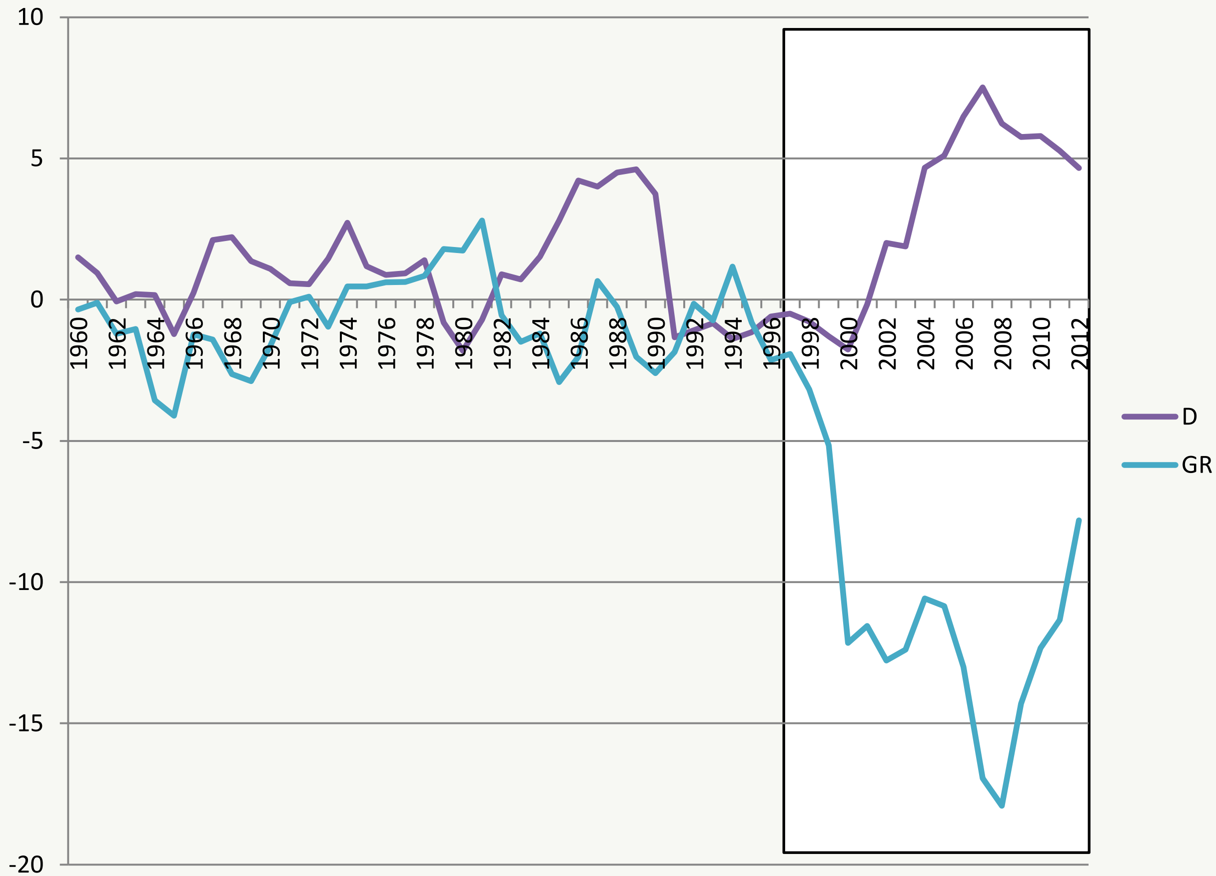


Correlation (GIIPS,DM)
1960-1998: +0.28

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

Data source: AMECO May 2012

Same for Germany and Greece

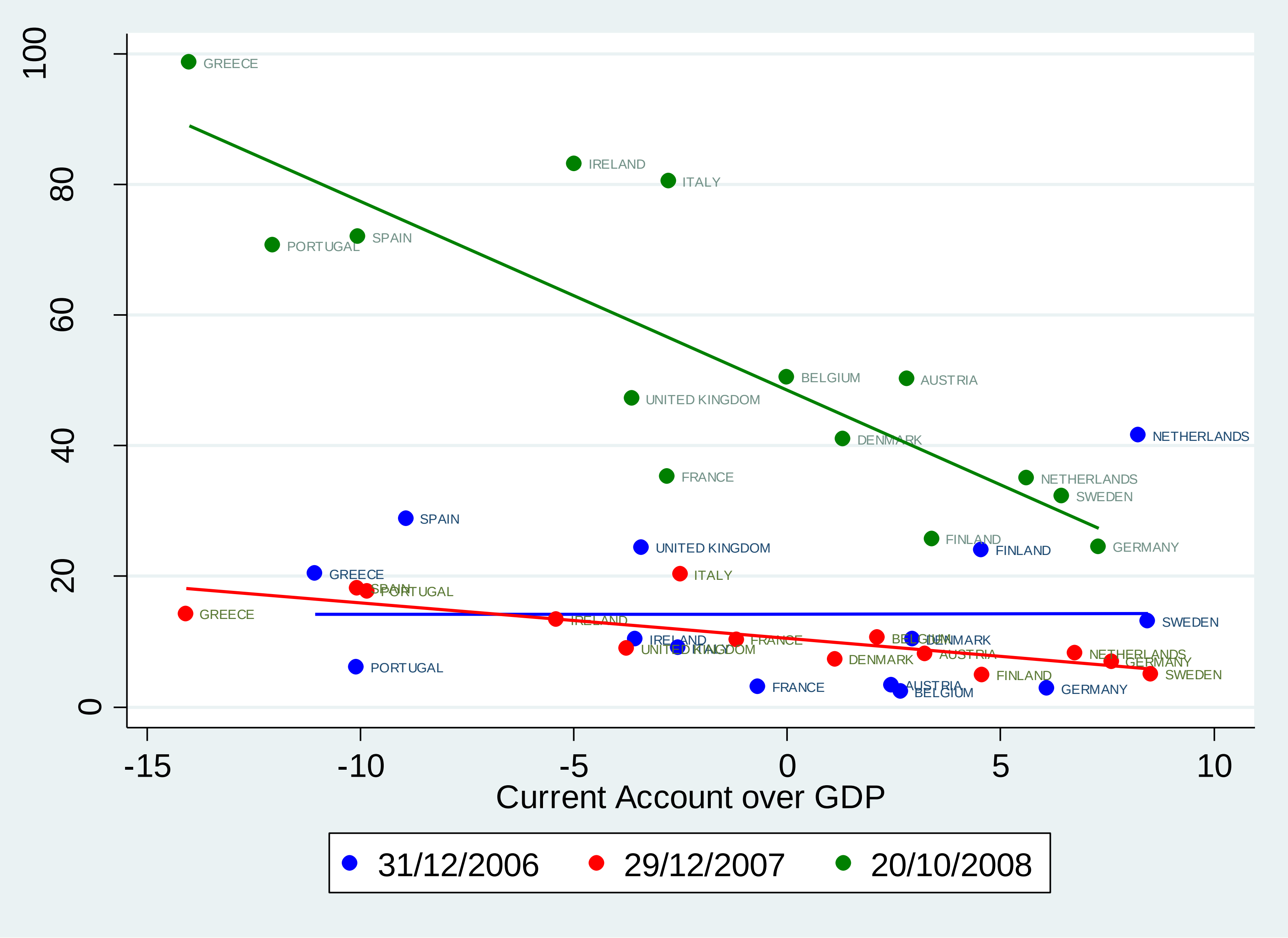


Averages 1960-1998
DE = 0.9
GR = -0.9

Averages 1999-2012
DE = 3.7
GR = -12.1

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
  - Eventually merge SSM, SRM and DIGM into one institution
  - Reduce bank dependence: Capital Markets Union

How can EMU avoid or deal with sovereign debt crises?

- EMU needs common mechanisms to lower national 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
    - Envisage Eurobonds/Eurobills
    - Replace ESM by EMF and include a European SDRM
    - Limit the exposure of banks to sovereign debt

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 Romania 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 Romania adopt the euro?

- Should Romania join the BU before adopting the euro?

The EU 2016 Convergence Report: Results for Romania

- Legal compatibility? NO

- Maastricht convergence criteria fulfilment?

  - Price stability: YES (but NOT in 2018 according to COM)
  - Public finances: YES (but NOT in 2017 & 18 according to COM)
  - LT interest rate: YES
  - Exchange rate (ERM2): NO

- Other relevant factors

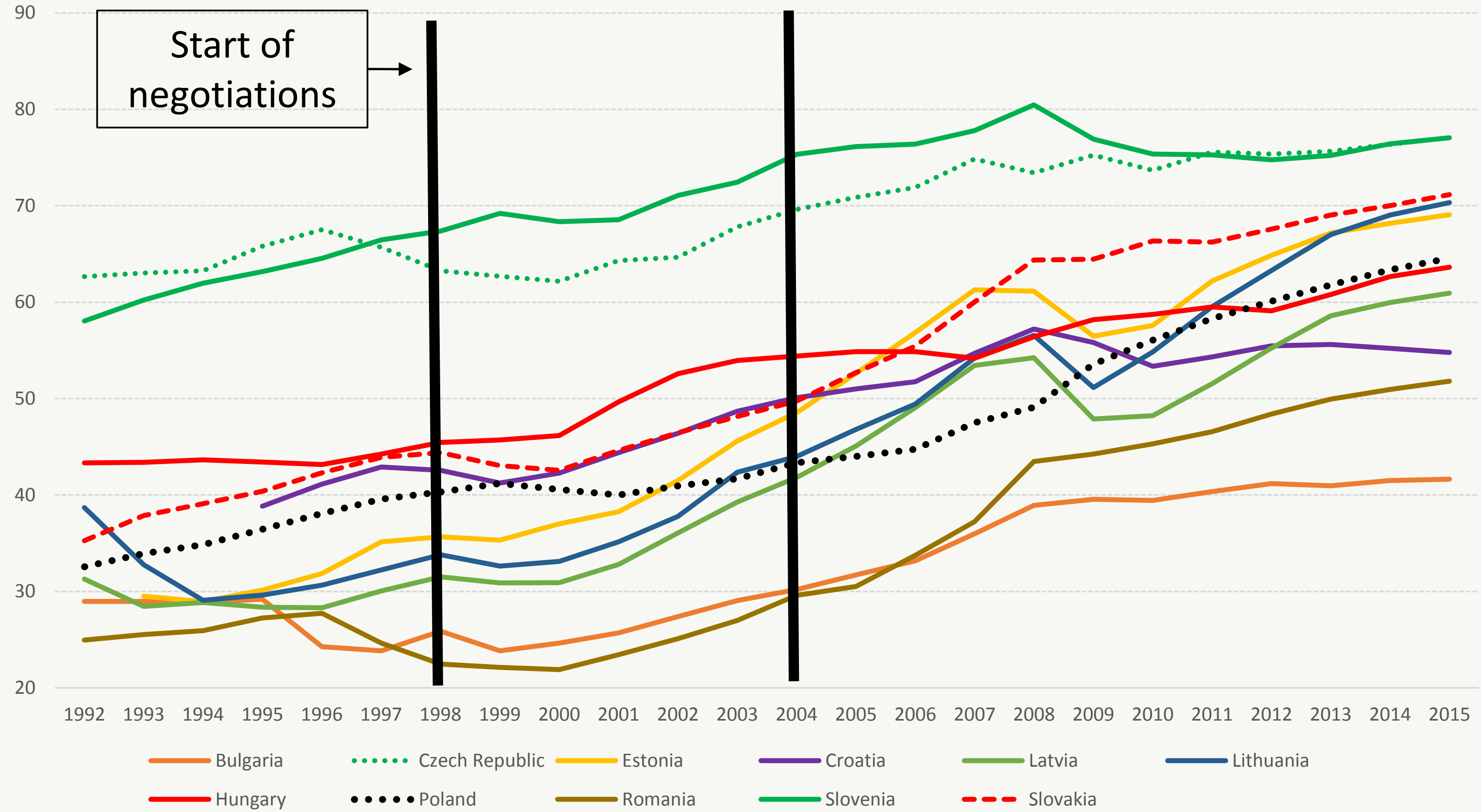
  - Macro (MIP): OK
  - Micro (markets, business environment): still problematic

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

Nominal vs. real convergence

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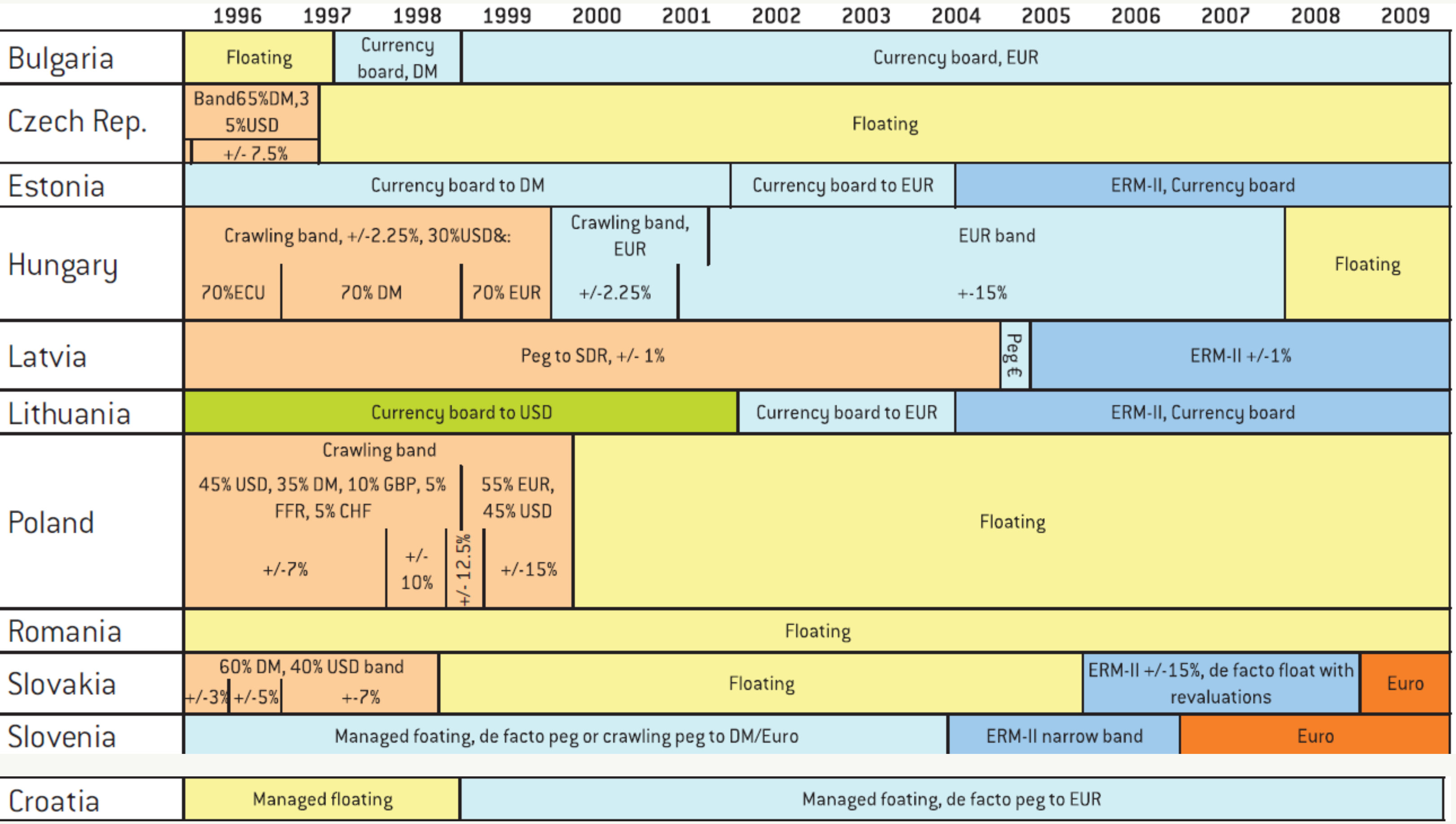
Rule of thumb

- 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
- With the second lowest GDP per capita country in the EU, Romania should be especially mindful
- Yet 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

Exchange rate regimes, 1996-2009 and 2017



2017

Currency board

Floating

Euro

Floating

Euro

Euro

Floating

Floating

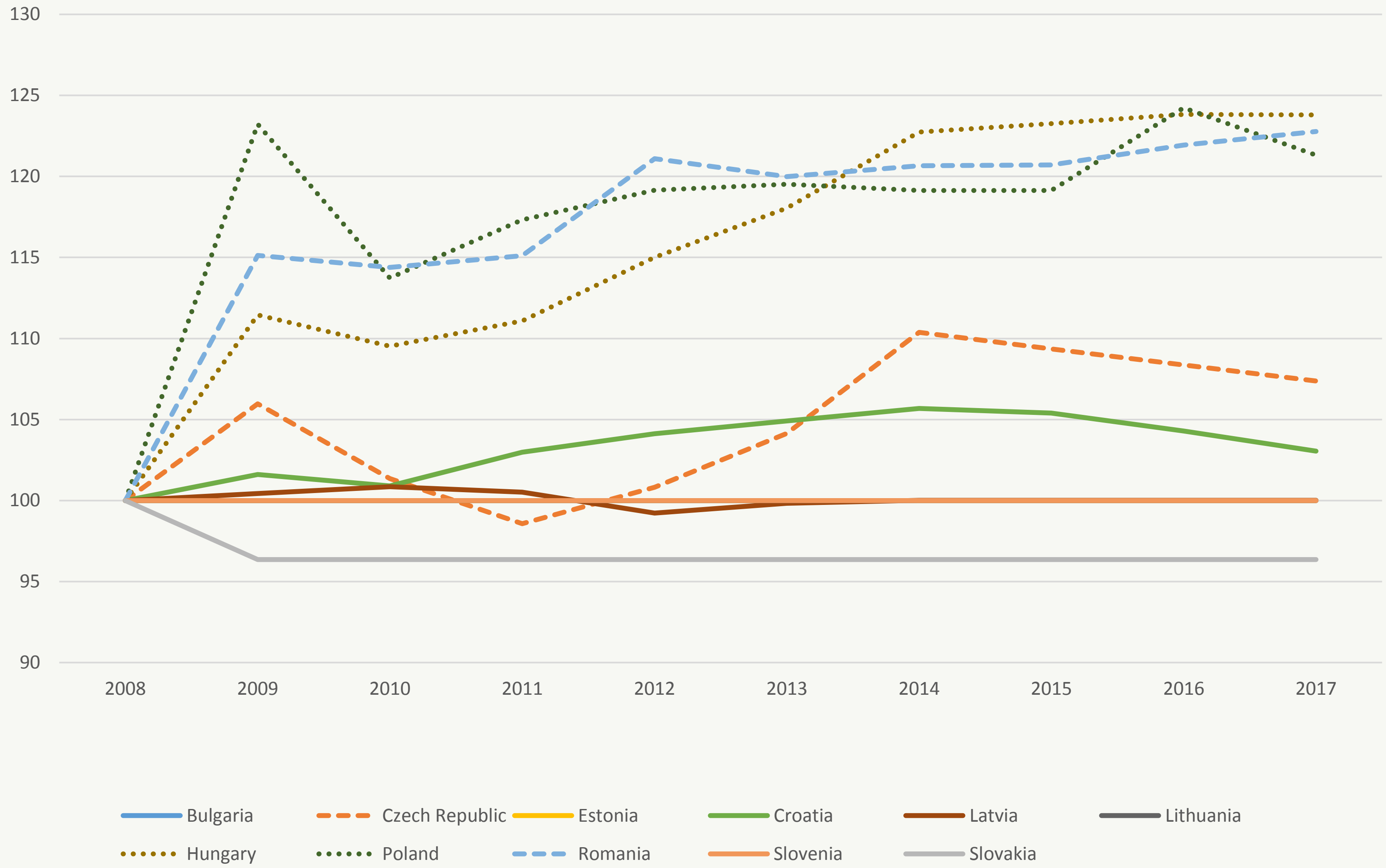
Euro

Euro

Managed peg

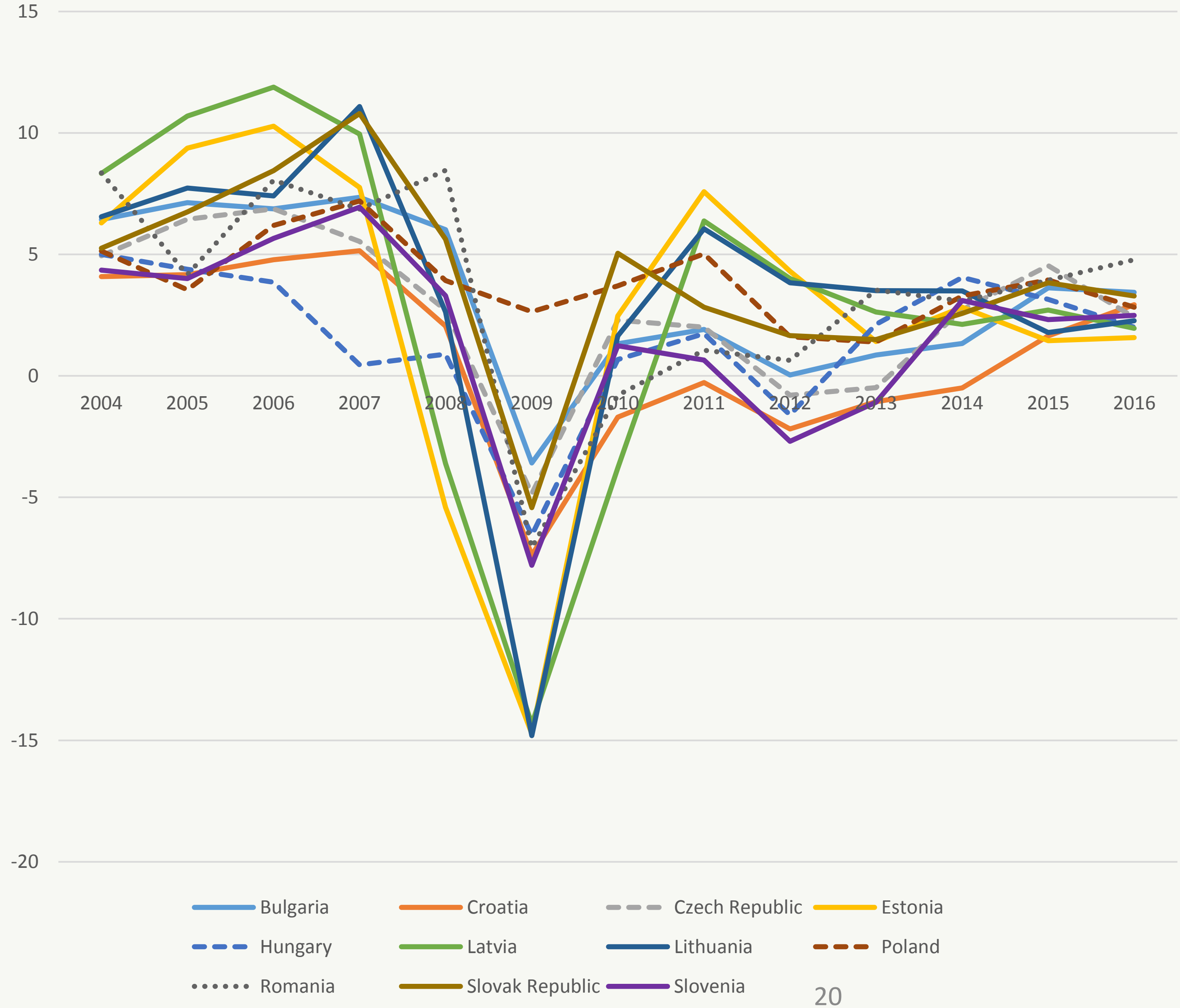
Source: Becker et al. (2010)

Exchange rates: national currencies against the euro 2008=100



Data source: WEO, IMF

GDP growth rates, 2004-2016: All CEECs



AAGR

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

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

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
- Cons
  - ?

Conclusion

- Only one CEEC with floating rates has adopted the euro
- Will Romania be the next one? When?
- Romania was on-track to meet Maastricht criteria
- But the crisis has reminded us that real convergence matters at least as much as nominal convergence
- EMU 2.0 is a significant improvement over EMU 1.0
- Still, Romania should take its time. In the meantime it should consider joining the banking union

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Thank you!