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

Data source: AMECO May 2012

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

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

![Graph showing current account over GDP and 5-year credit default swap on government bonds for selected countries as of 31/12/2006, 29/12/2007, and 20/10/2008.](image-url)
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)

Start of negotiations
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.
A good rule of thumb should be 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

<table>
<thead>
<tr>
<th>Country</th>
<th>Regime Details</th>
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<tbody>
<tr>
<td>Estonia</td>
<td>1996: Crawling band, +/- 2.25%, 30%USD 1997-2010: Currency board to DM</td>
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<tr>
<td></td>
<td>2001: Currency board to EUR 2002-2010: ERM-II, Currency board</td>
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<td></td>
<td>2005: Floating</td>
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<tr>
<td>Lithuania</td>
<td>1996: Currency board to USD 1997-2009: Currency board to EUR</td>
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<tr>
<td></td>
<td>2010: ERM-II, Currency board</td>
</tr>
<tr>
<td>Poland</td>
<td>1996-1998: Crawling band, 45% USD, 35% DM, 10% GBP, 5% FFR, 5% CHF</td>
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<tr>
<td></td>
<td>1999-2004: 55% EUR, 45% USD, +/- 7% +12.5%</td>
</tr>
<tr>
<td></td>
<td>2005-2009: Floating</td>
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<tr>
<td>Romania</td>
<td>1996-2004: Floating</td>
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<tr>
<td></td>
<td>2010: Floating</td>
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<tr>
<td>Slovenia</td>
<td>1996-2000: Managed floating, de facto peg or crawling peg to DM/Euro 2001-2009: ERM-II narrow band</td>
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<td>2010: Euro</td>
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<tr>
<td>Croatia</td>
<td>1996-2000: Managed floating</td>
</tr>
<tr>
<td></td>
<td>2001-2009: Managed floating, de facto peg to EUR</td>
</tr>
</tbody>
</table>

**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

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
Thank you!