Euro Adoption: the Next Step in European Integration

Key points from the IMF staff study

Brussels Economic Forum
April 23, 2004

Main Conclusions

1. Adopting the euro has potential to significantly accelerate income catch-up but policy requirements are demanding.

2. Strategies for preparing economies to adopt the euro make a difference.

3. Optimal strategies will be crafted around key characteristics and vulnerabilities of the accession countries.

Long-term Benefits and Costs of Euro adoption

Benefits

- **Increase trade 10-70 percent**

- **Eliminate interest rate risk premia**

- **Discipline of euro area policy framework**

**=>3-20 percent increase in GDP over 20 years**

Costs

- **Potential increase in volatility without independent monetary policy (Are CECs OCAs?)**

=>income equivalent of possible loss difficult to quantify

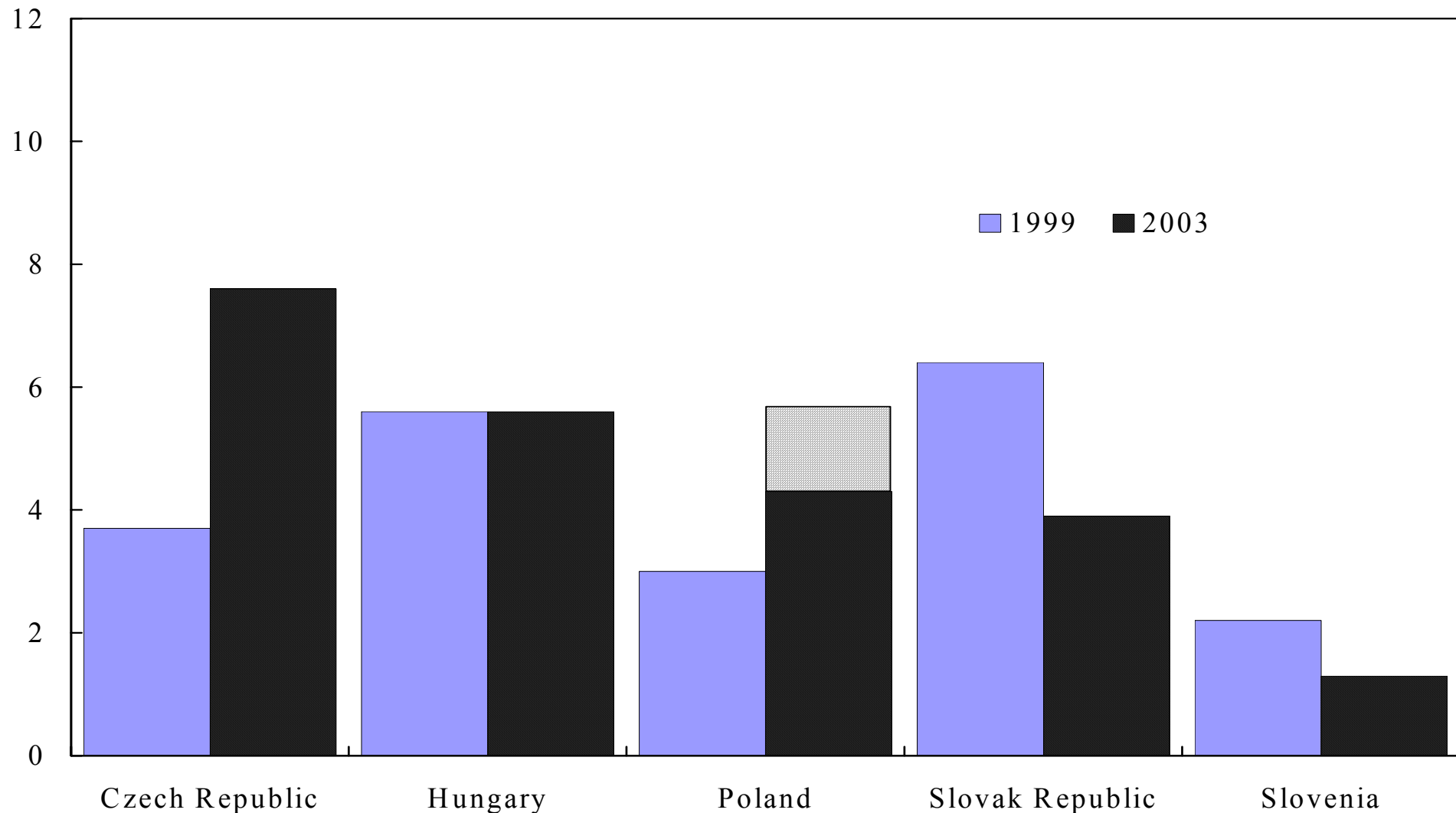# Key Characteristics and Vulnerabilities of the CECs

1. Macroeconomic features & policies

2. Financial sector features

Inflation has fallen sharply but it is not yet clear that these are euro area inflation rates.
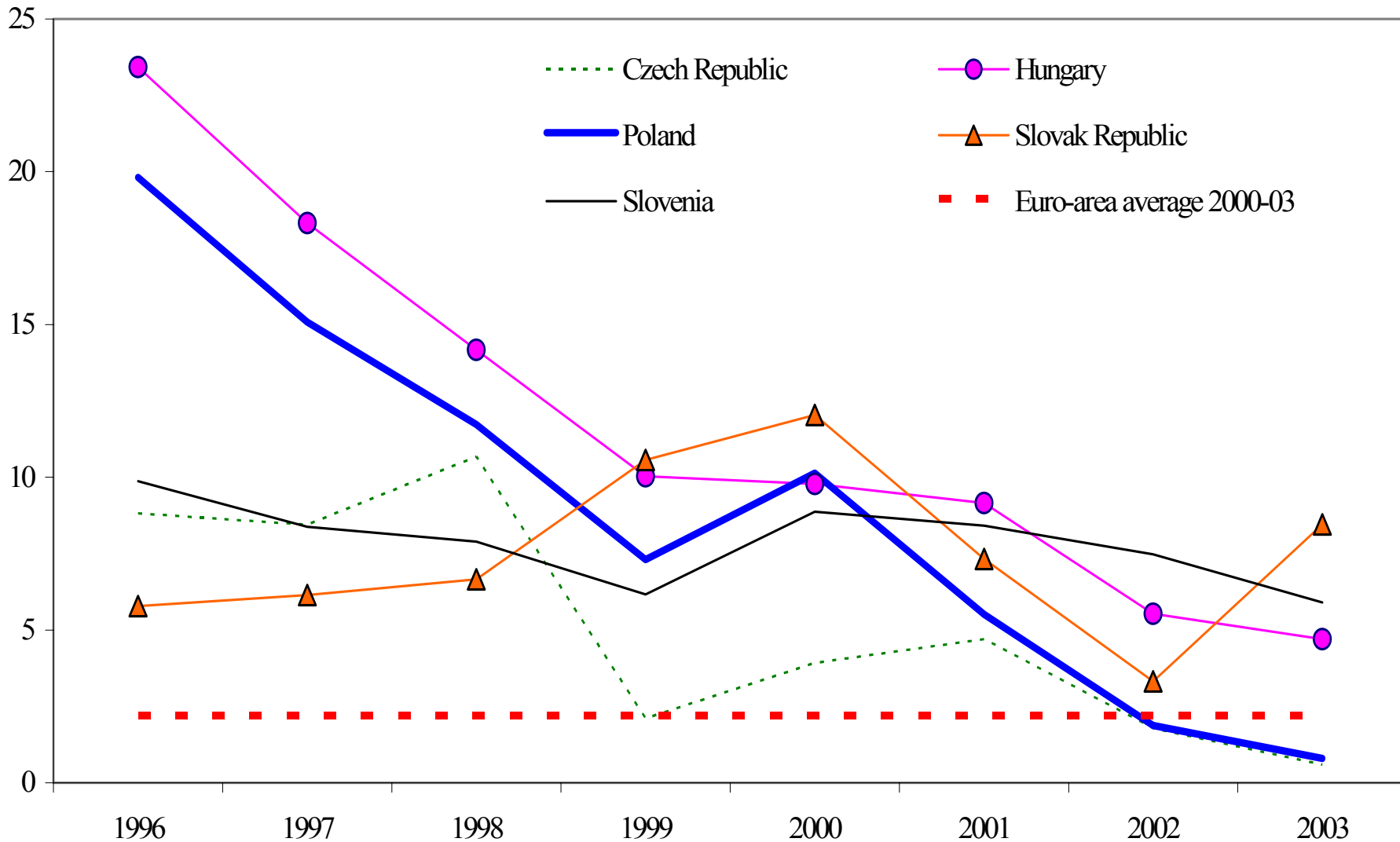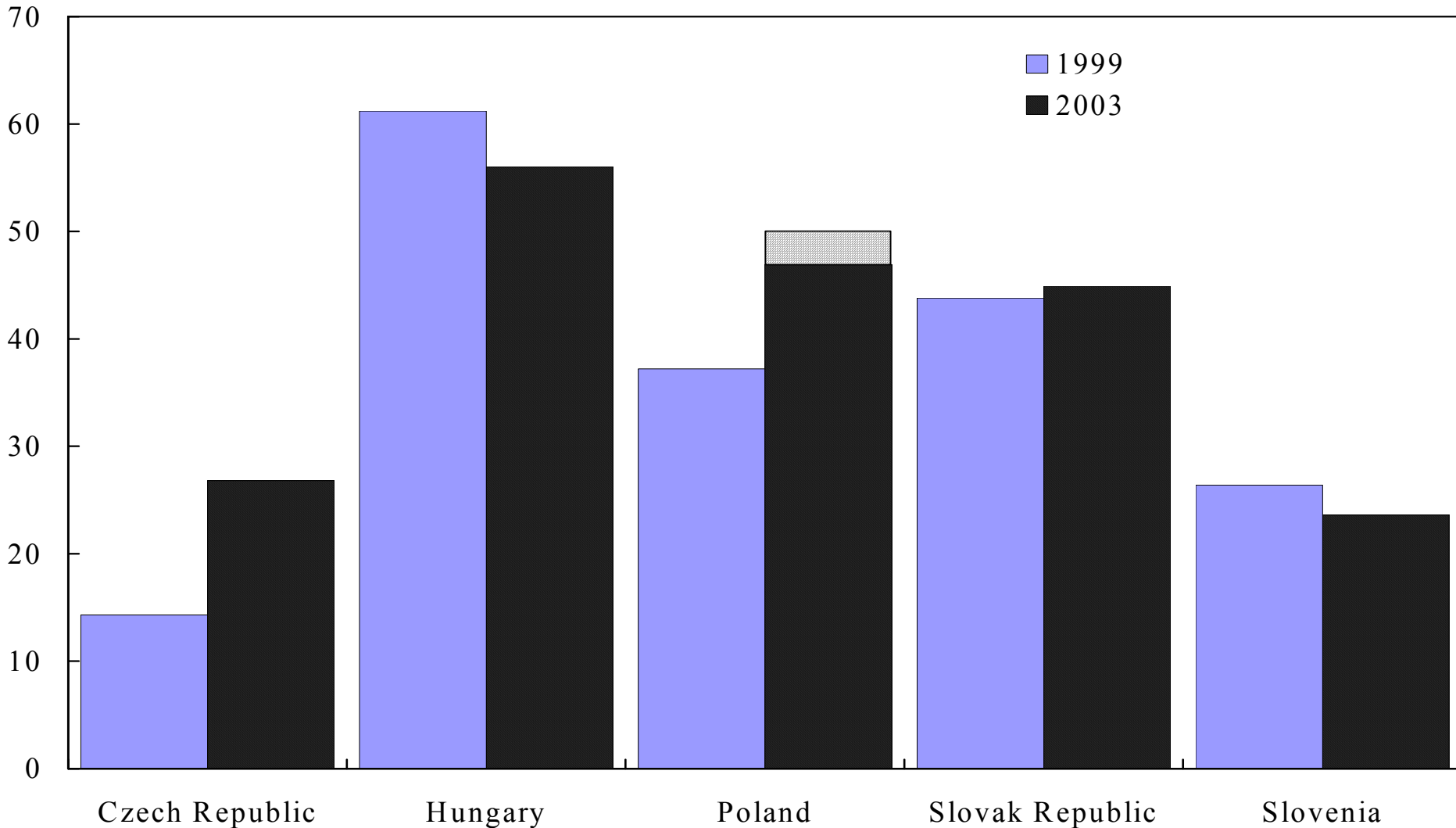
Fiscal deficits have risen and now substantially exceed the Maastricht criterion...
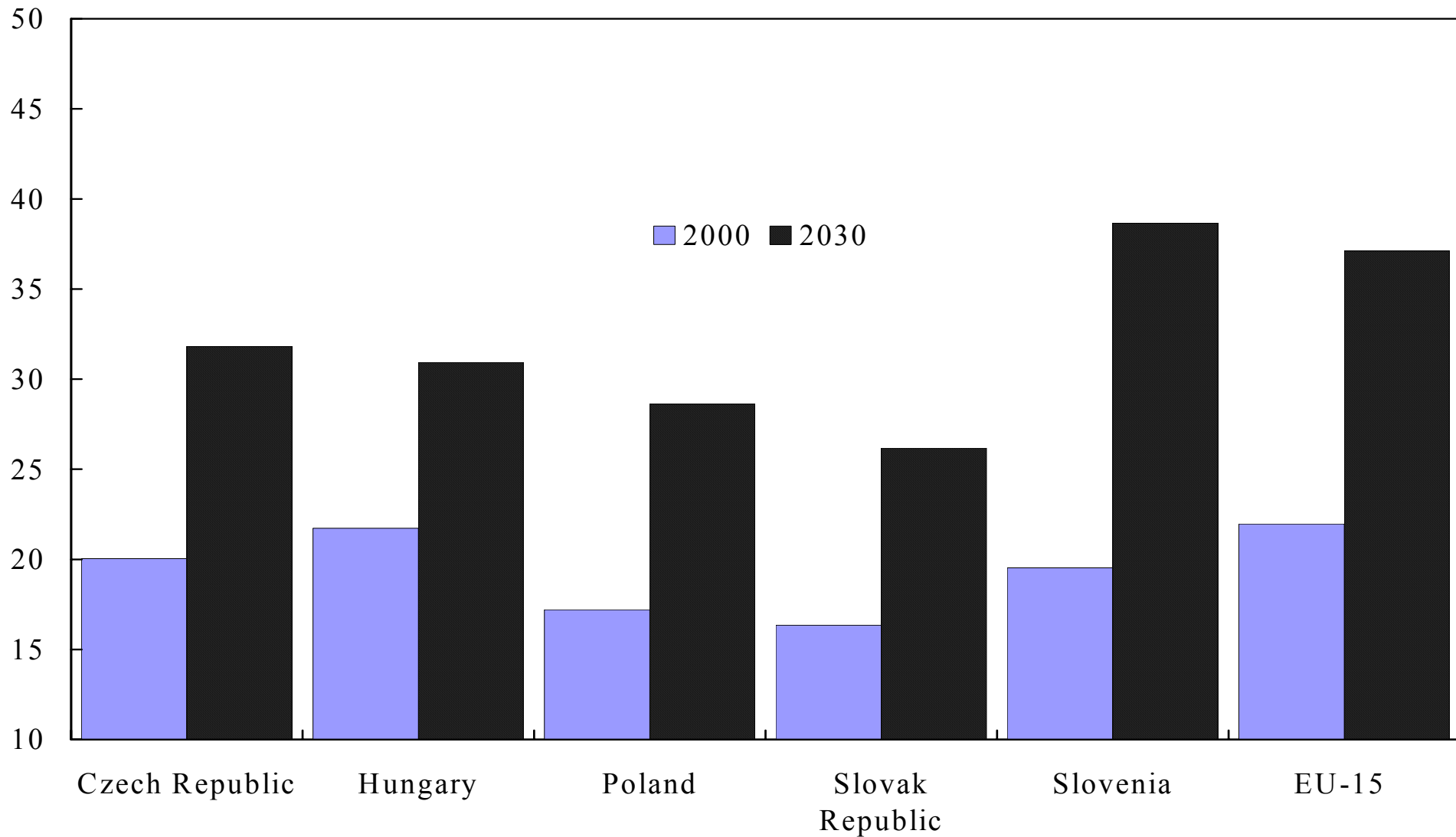### (in percent of GDP)

...but debt ratios are substantially lower...
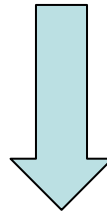### (in percent of GDP)

...while demographic pressures will generally be less
(population over 65 as a percent of working age population)

Why is Macro Policy Alignment so Important?

- Absent exchange rate changes, high inflation erodes competitiveness
- Even in a currency union, large fiscal deficits can crowd out private investment

Countries must position themselves to maximize potential gains of currency union

# Financial Sector Features and Risks

- Low intermediation in fledgling banking systems leaves much room for rapid credit expansion

- Open capital markets alongside relatively high interest rates induce large inflows and unhedged position taking

Bank credit to the private sector is low but starting to rise rapidly
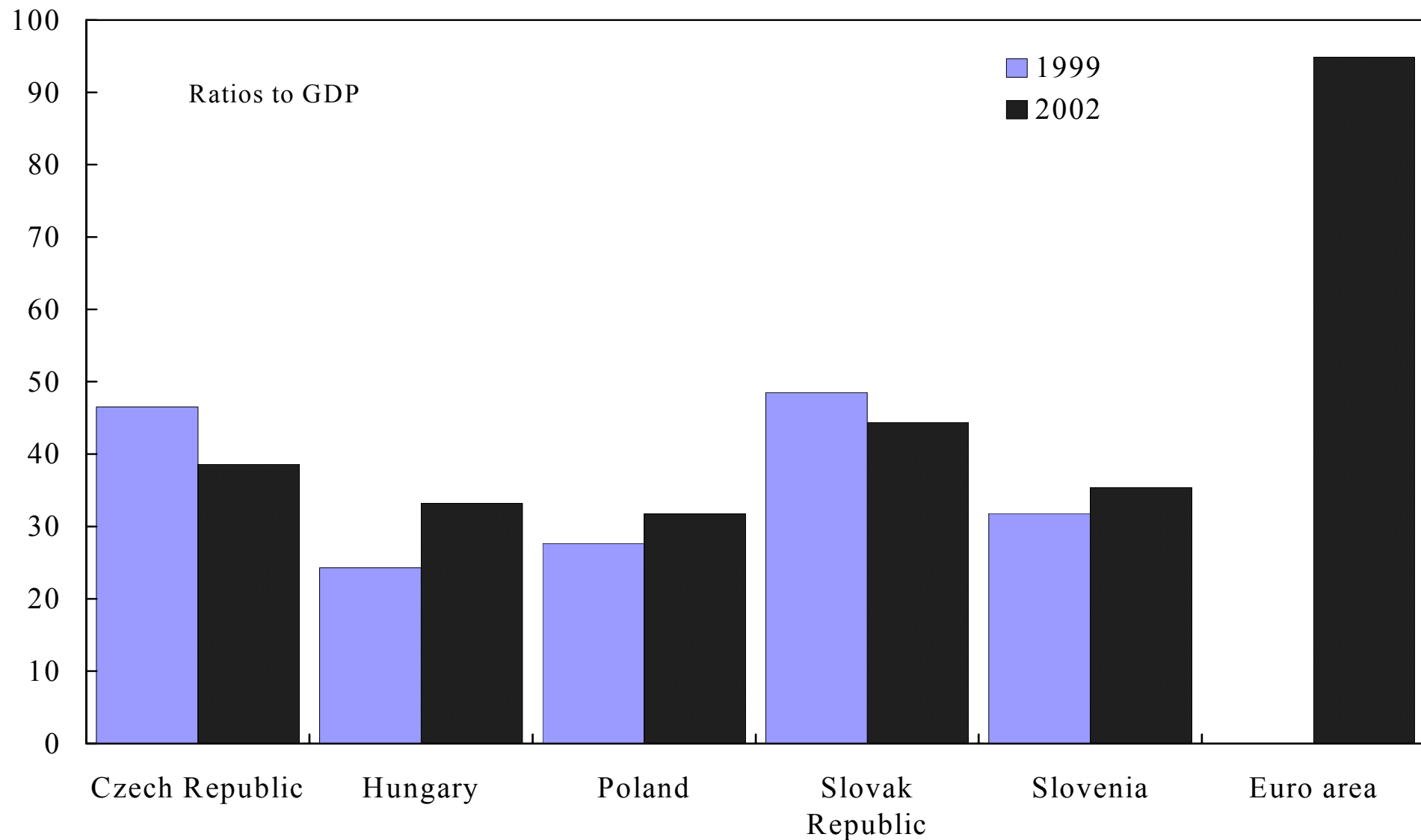
How fast will catch-up to euro-area bank intermediation levels be?

Bank Credit to the Private Sector in percent of GDP
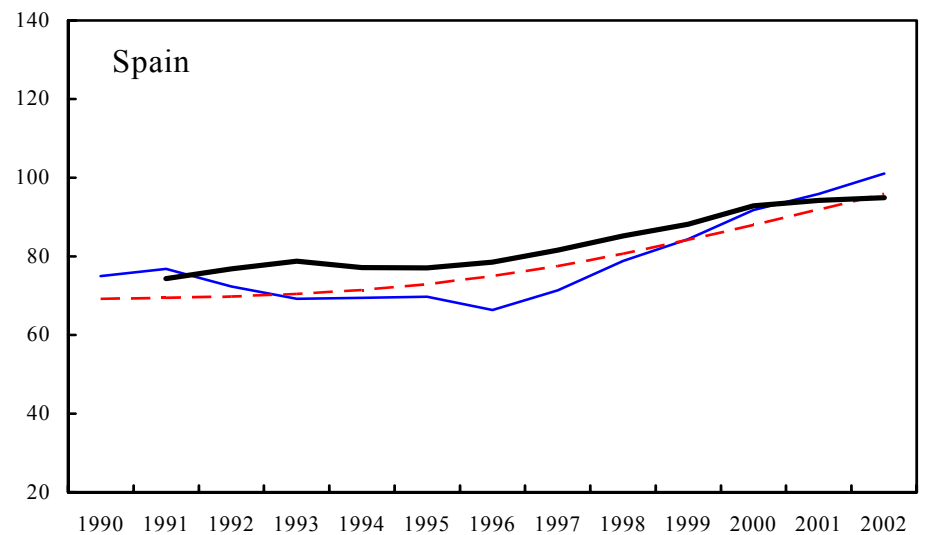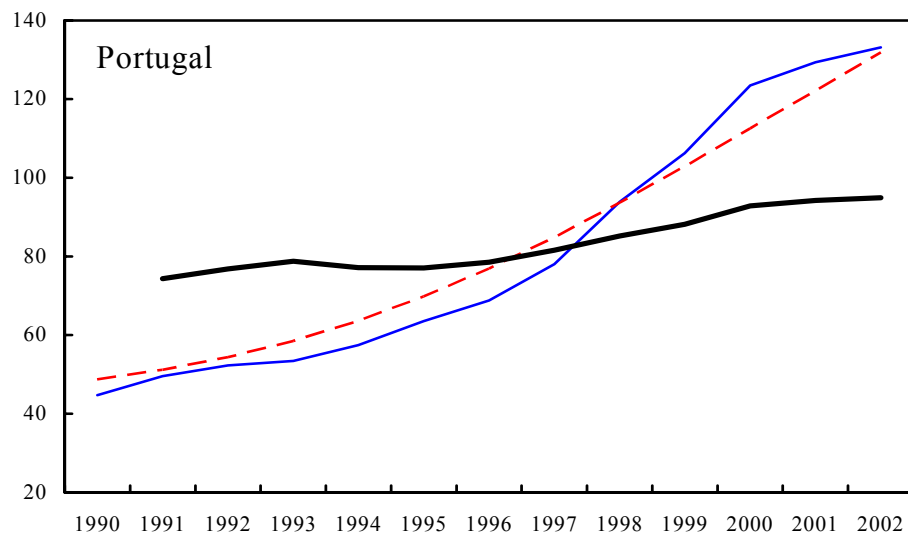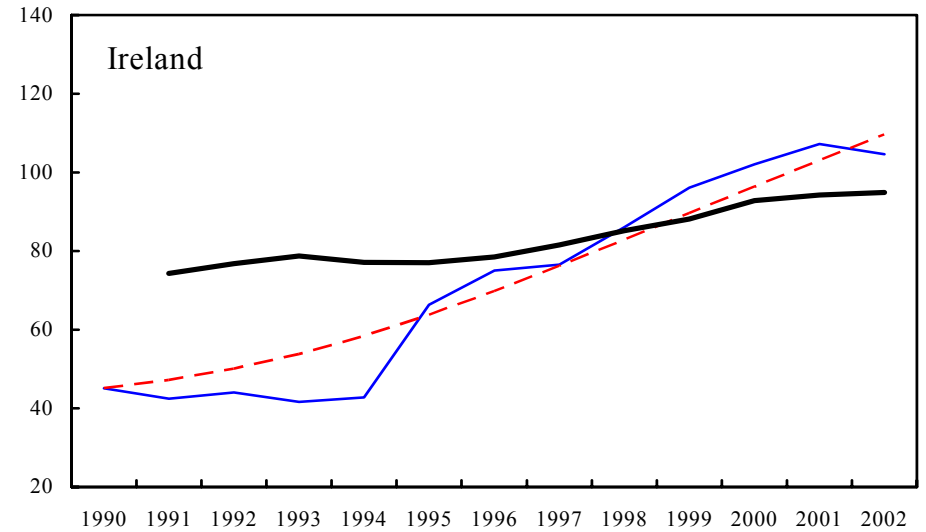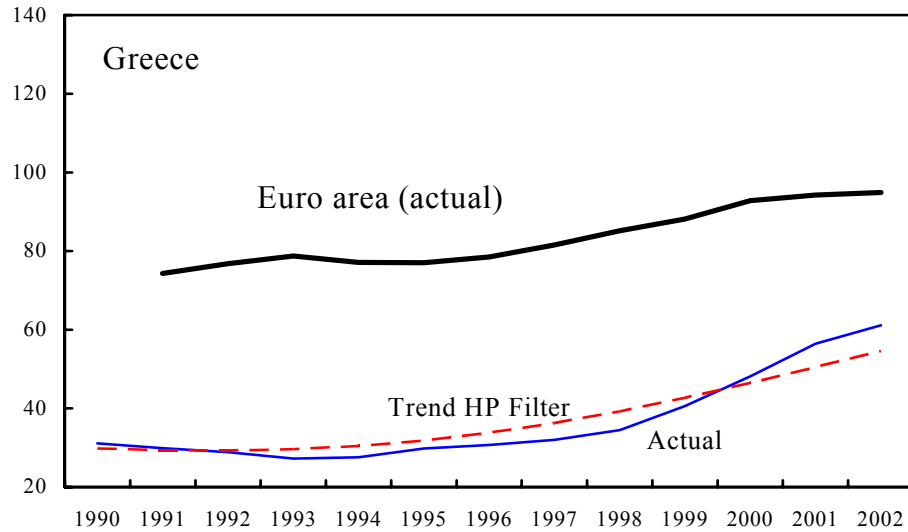
IMF staff estimates suggest rapid catch-up

- VECM estimates based on euro area data indicate that credit growth will be as high as in non-core countries.

- Most near-term annual estimates exceed thresholds linked to bank crisis.

- Risks of overheating, asset price bubbles

- But recall…

  - Adjustments would be toward equilibrium
  - Few exceed non-core where no crisis has occurred.
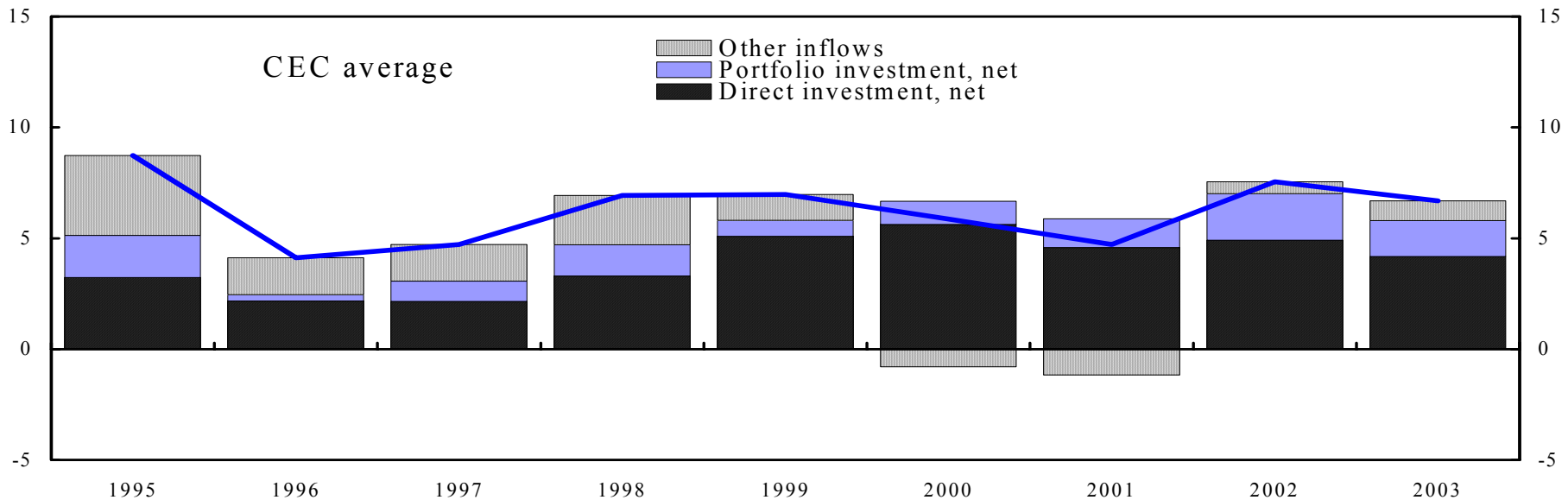 - Estimates are probably upper bounds.

Policy Responses to Rapid Credit Growth

- Strong financial supervision

- Fiscal restraint

- Remove structural features distorting credit use

- Tighten prudential standards—loan-to-value limits, preemptively link provisioning to distress signals

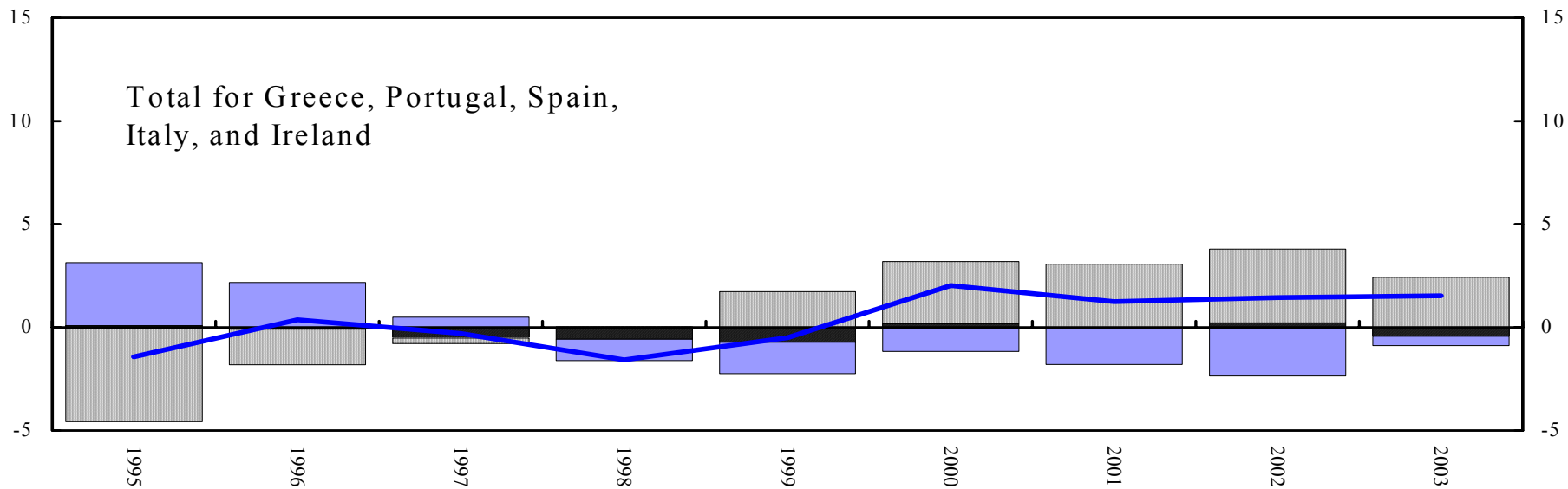- Administrative/tax restraints on credit or inflows

Balance sheet risks with large capital inflows

- Net capital inflows to CECs are large and potentially volatile

- Relatively high interest rates are incentive to insufficiently hedge foreign currency exposures.
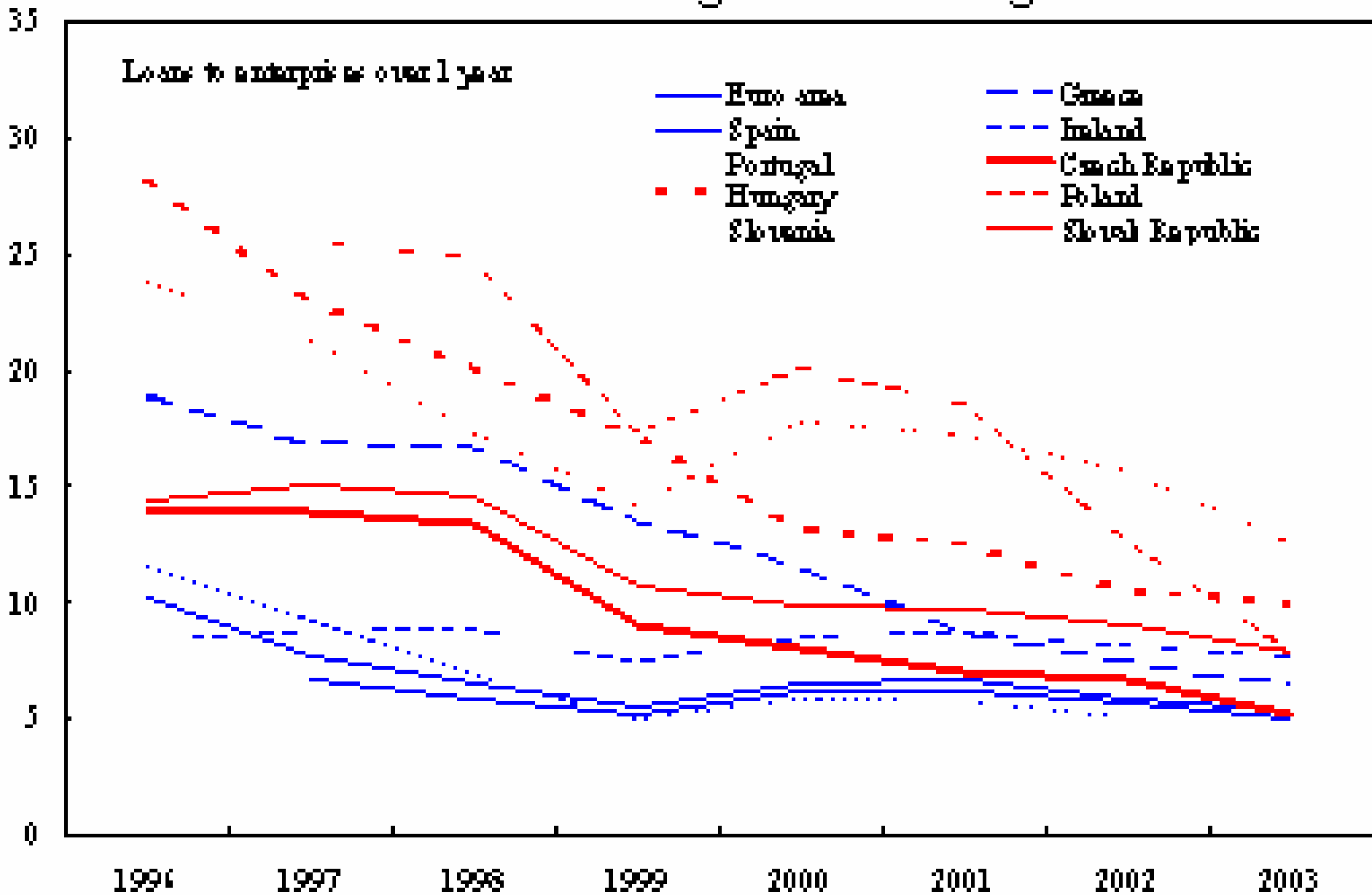
Net capital inflows are substantially larger...

CEC average

- Other inflows
- Portfolio investment, net
- Direct investment, net

1995 1996 1997 1998 1999 2000 2001 2002 2003

...than in the Southern EMU members.

Total for Greece, Portugal, Spain,
Italy, and Ireland

1995 1996 1997 1998 1999 2000 2001 2002 2003

Relatively high lending rates in the CECs may induce unhedged borrowing

Loans to enterprises over 1 year

Legend:
- Euro area
- Spain
- Portugal
- Hungary
- Slovenia
- Greece
- Ireland
- Czech Republic
- Poland
- Slovak Republic

Limiting risks from unhedged positions with capital flow volatility

- *Stick to "corner solutions".*

  Eliminate exchange rate risks—hard peg—or explicitly shift risks to market participants—exchange rate flexibility

- *Set a clear monetary policy framework.*

  Communicate to markets how monetary and exchange rate policy will respond to shocks

ERM2—What are the requirements?

- Announced central parity

- Maintain market exchange rate within $\pm$15 percent of central parity

- Meet exchange rate stability criterion-currency must trade against euro without severe tensions within the "normal fluctuation margins" of ERM2.

Monetary policy framework options in ERM2

-Narrow bands—not a corner solution

-Flexible rate options

   -IT within wide exchange rate bands

   -Medium-term exchange rate targeting within wide bands

-Hard peg

Conclusions

- Potentially large net gains from euro adoption in the CEC

- CEC risk factors—not-yet-aligned macro policies, potential credit booms, capital flow volatility—call for 3-pronged strategies

    -Low fiscal deficits and inflation

    -Strong financial sector oversight

    -Clear monetary policy frameworks

Figure 4. Selected Non-Core Euro Area Countries: Real Interest Rates, 1990–2002 1/
(In percent, period average)
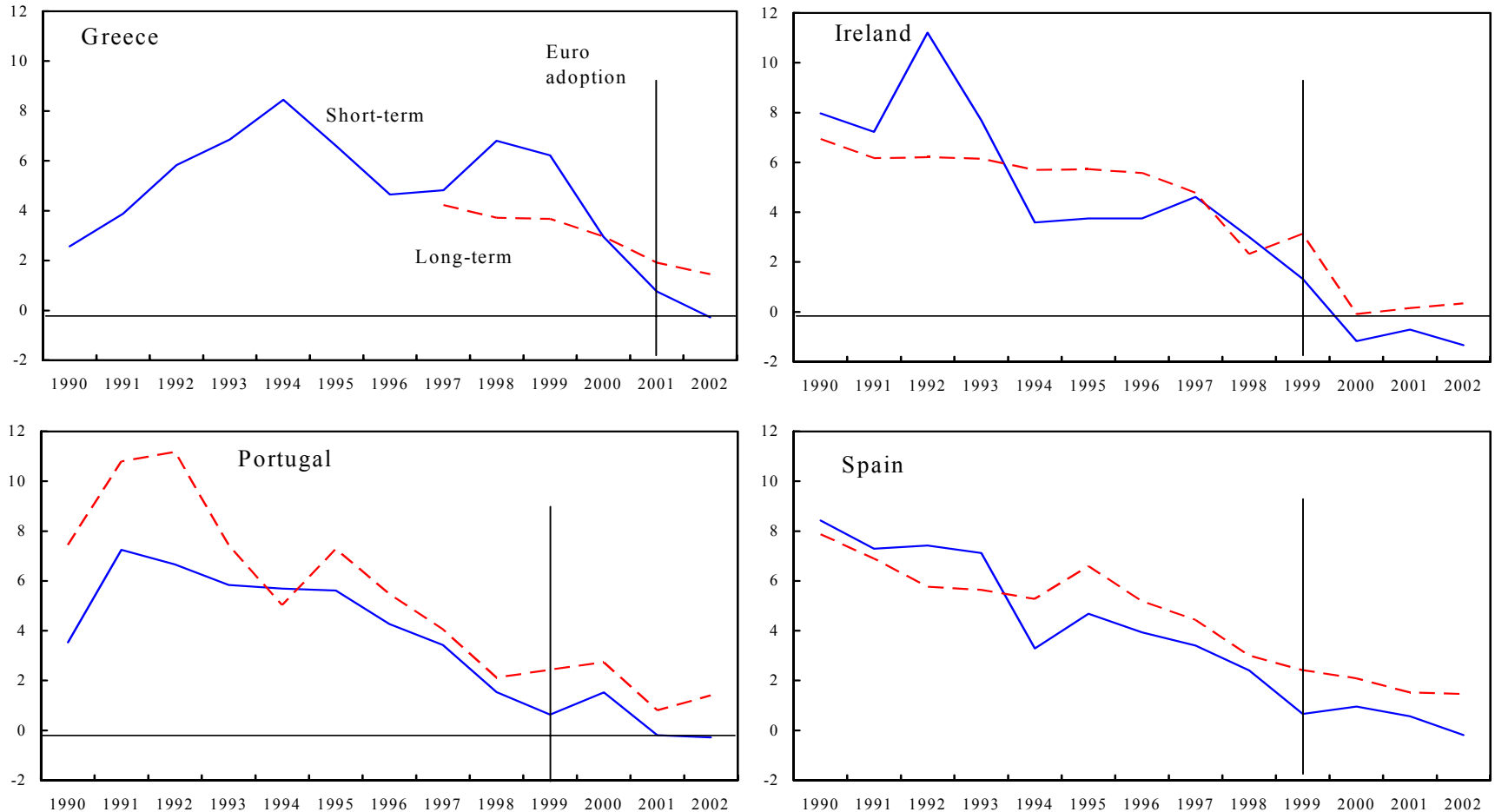
Sources: OECD; and IMF staff calculations.

1/ Short-term rates refer to 3-month interbank rate; long-term rates refer to 10-year benchmark bond yield. Deflated by CPI inflation during the preceding 12 months.

Figure 5. Selected Non-Core Euro Area Countries: Residential Price Indices, 1992–2002
(Index: 1992=100)
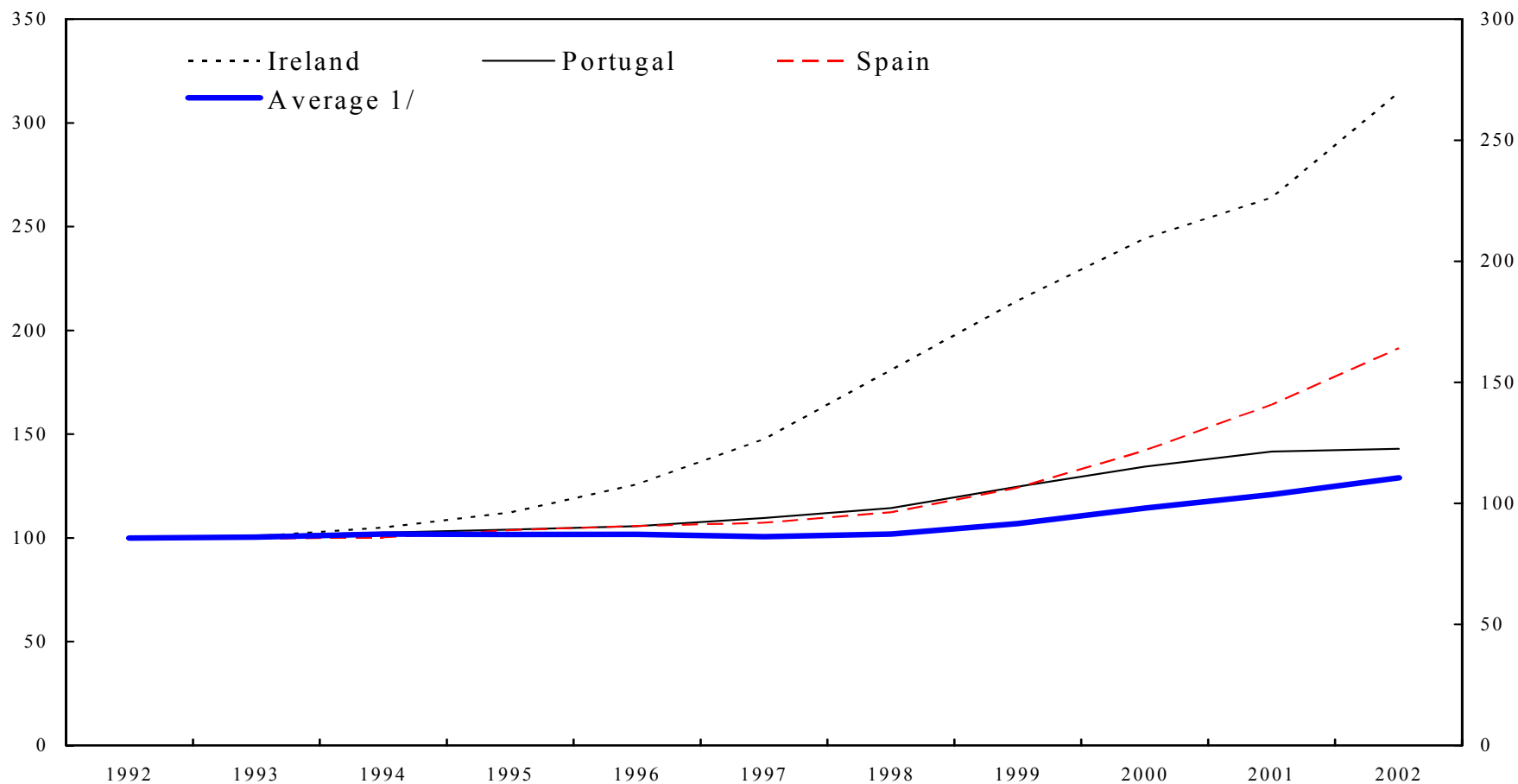
Figure 6. Euro Area and CECs: Interest Rates on Bank Loans, 1996–2002
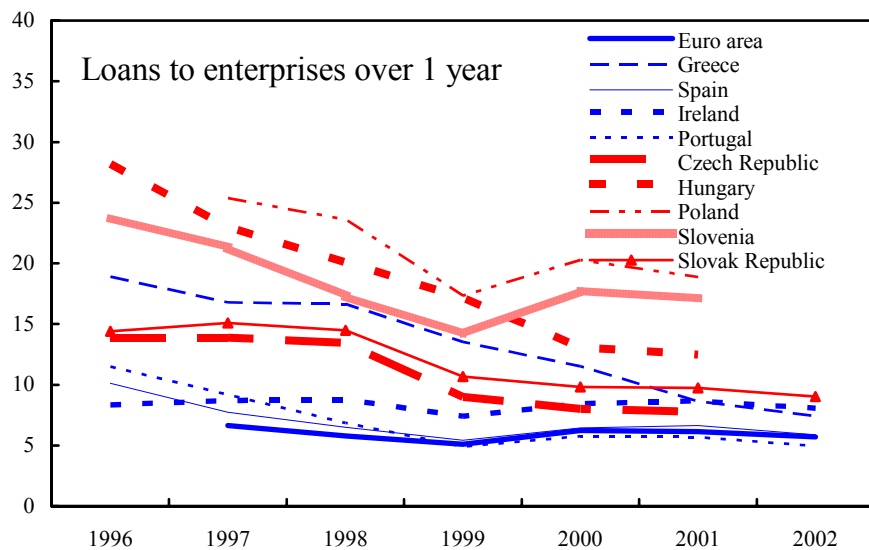## (In percent)

Loans to enterprises over 1 year

Legend:
- Euro area
- Greece
- Spain
- Ireland
- Portugal
- Czech Republic
- Hungary
- Poland
- Slovenia
- Slovak Republic

Loans to enterprises up to 1 year

Housing loans to households

Consumer loans to households
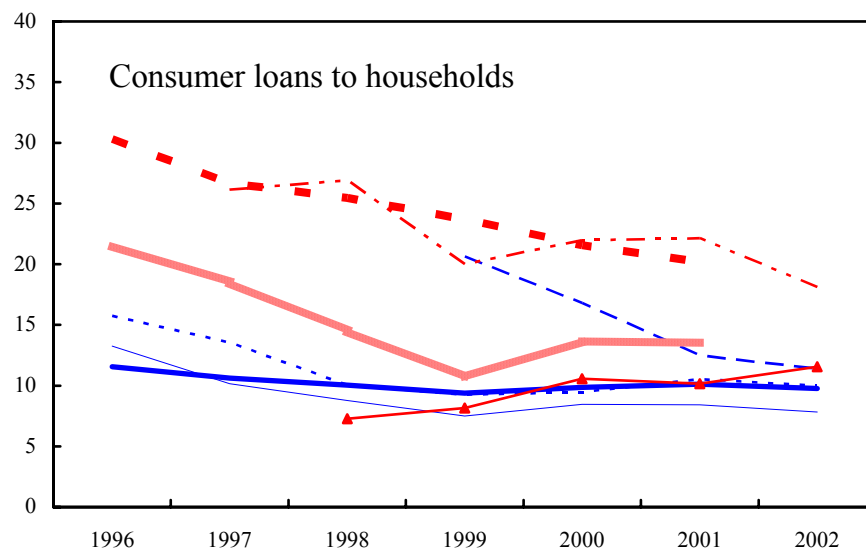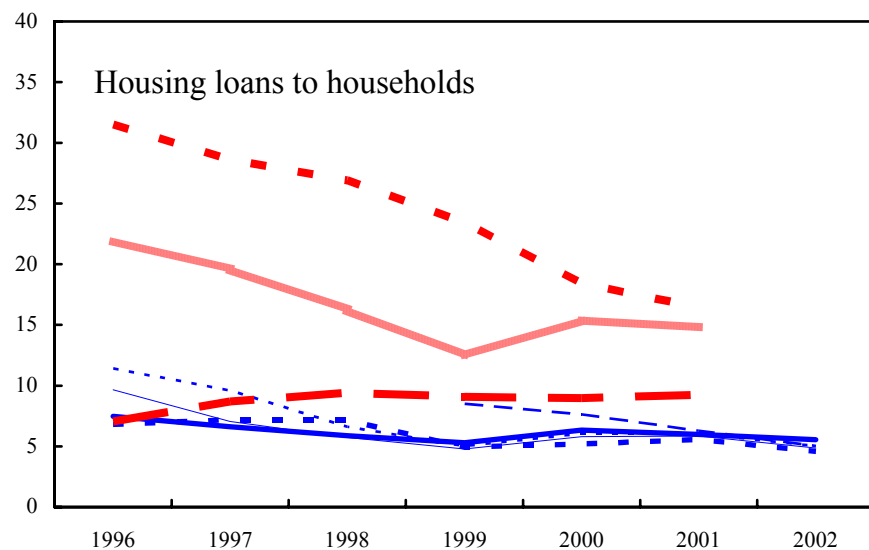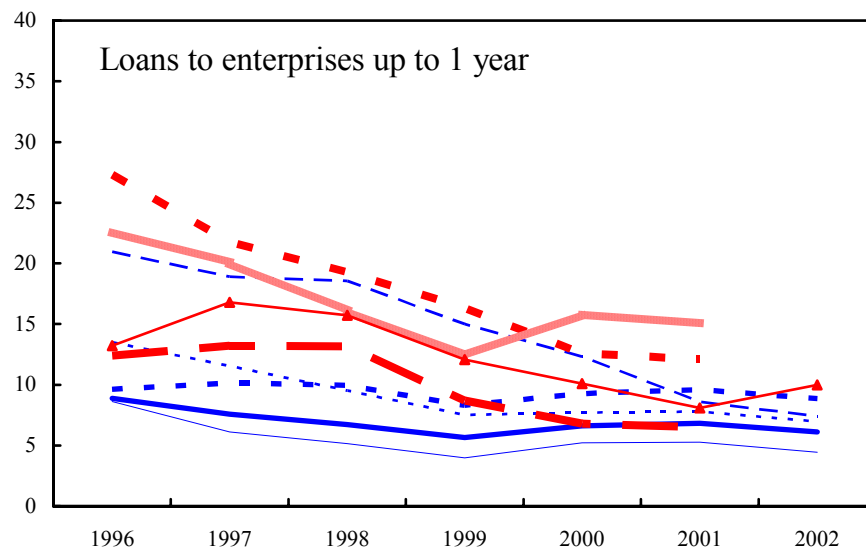
Figure 7. CECs: Net Foreign Liabilities, Credit to Private Sector, and Deposits, 1996-2002
(In percent of GDP)
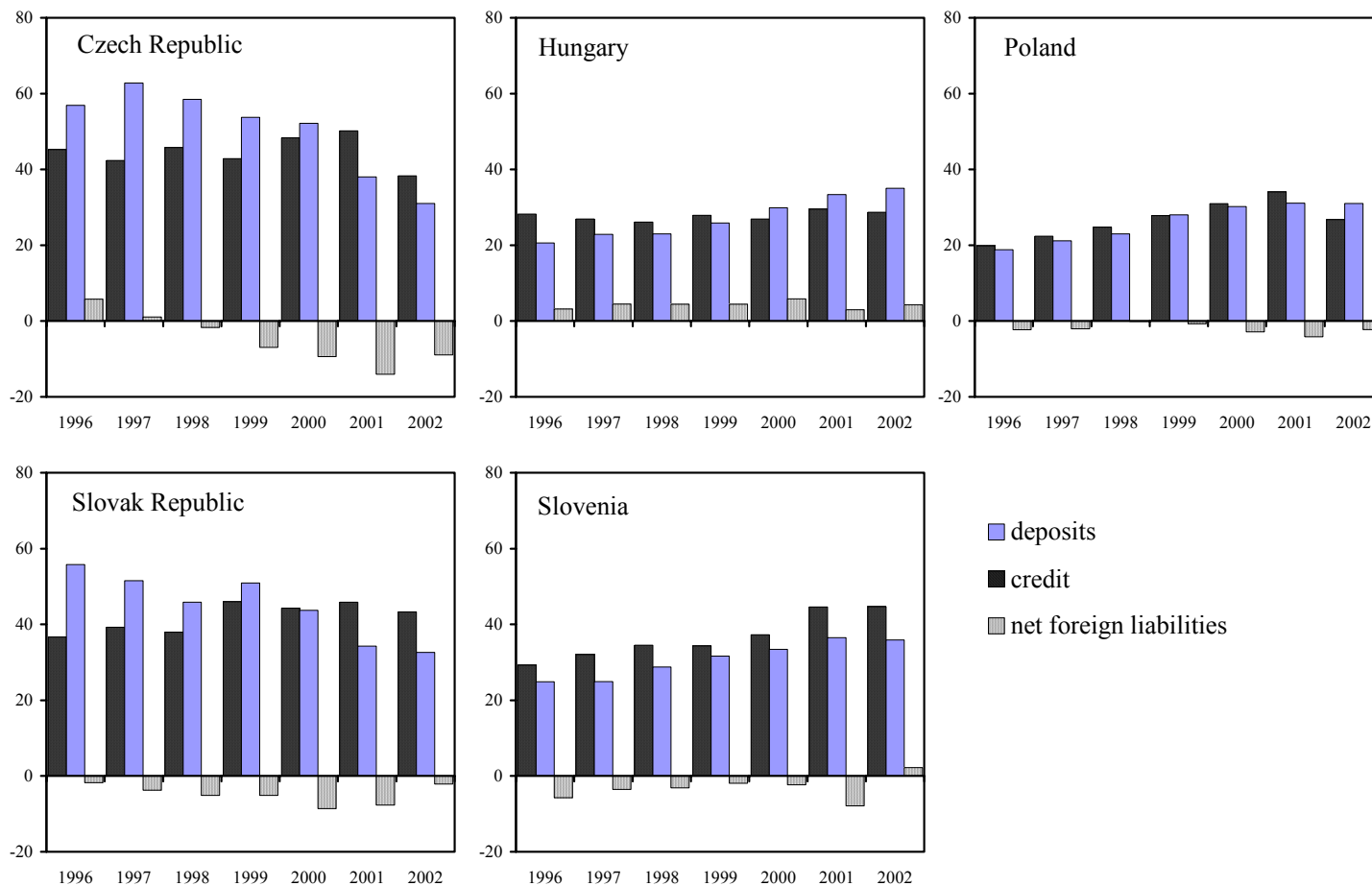
Figure 8. Euro Area: Bank Credit to the Private Sector,1997–2002
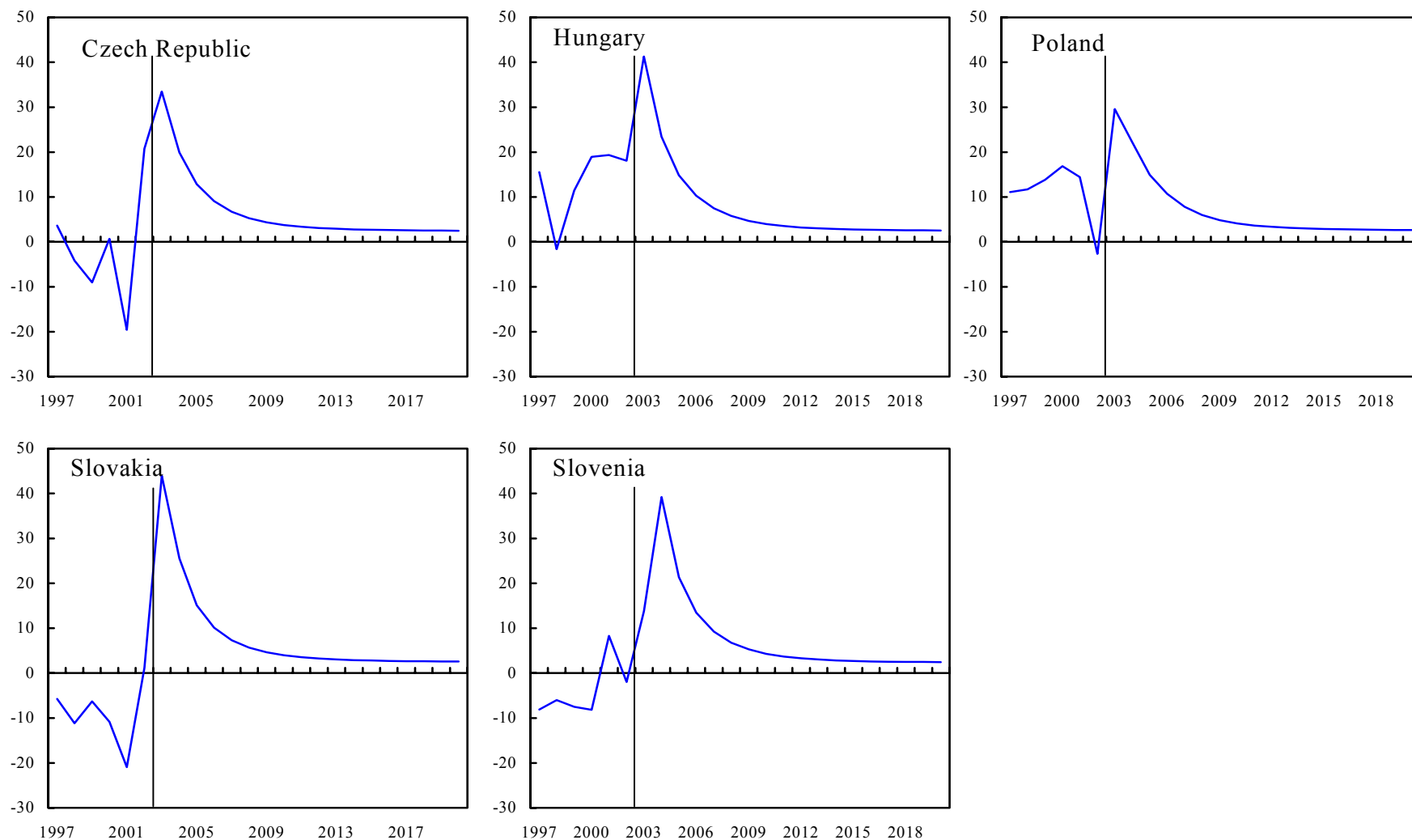## (In percent of GDP)
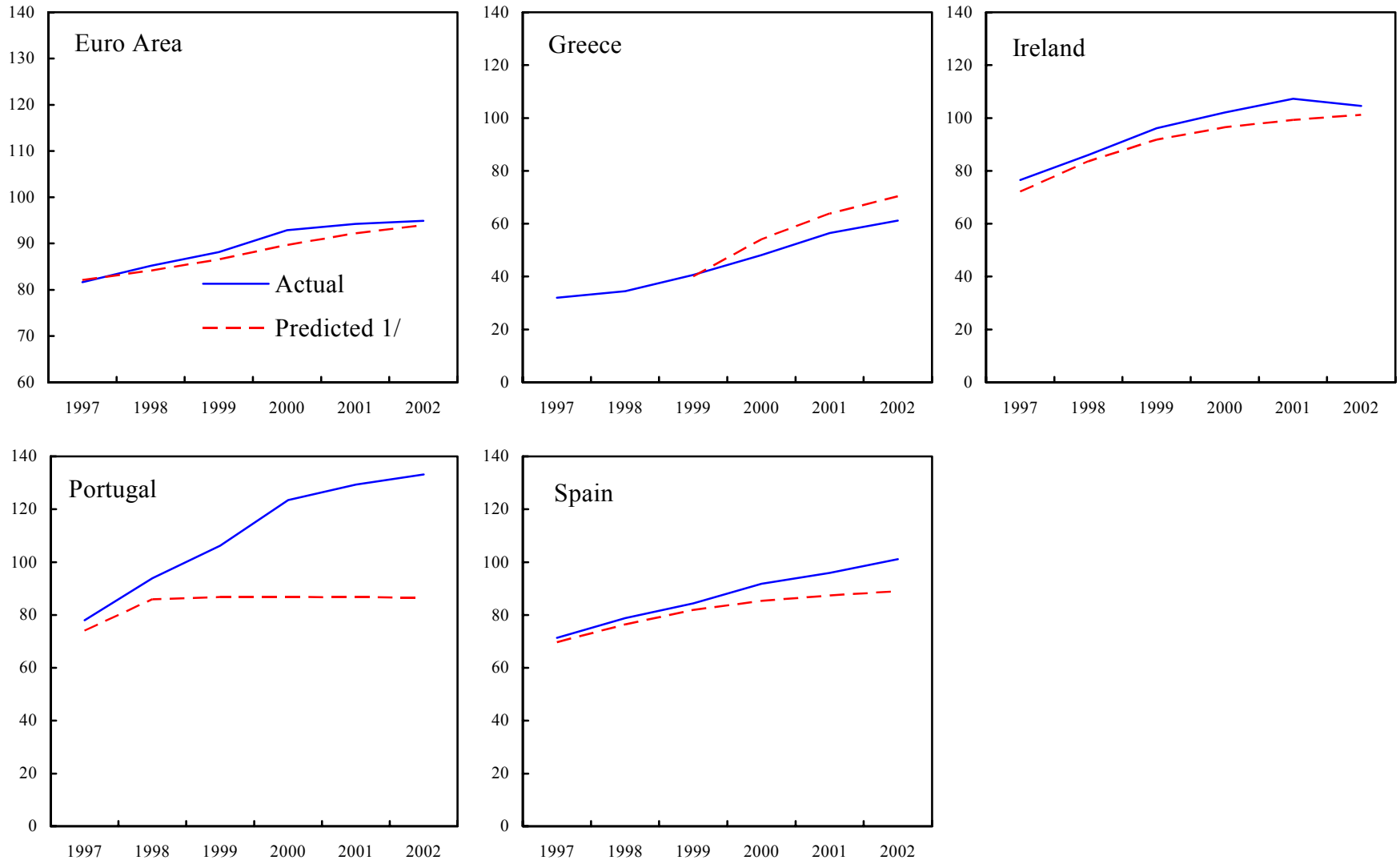
Figure 9. CECs: Real Bank Credit Growth to the Private Sector, 1997–2020 1/
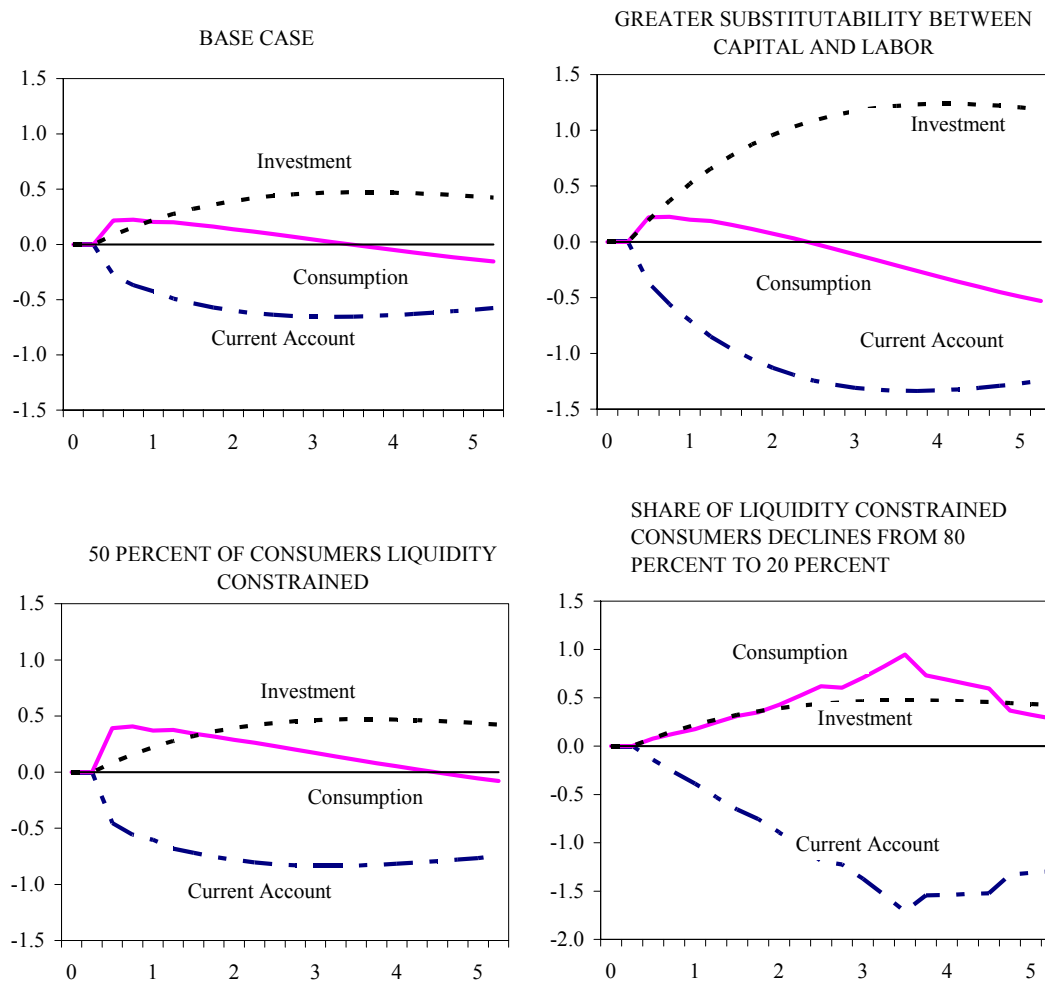## (In percent per year)

Figure 10. CECs: Baseline Simulations of Bank Credit to Private Sector, 1996–2020 1/
(In percent of GDP)
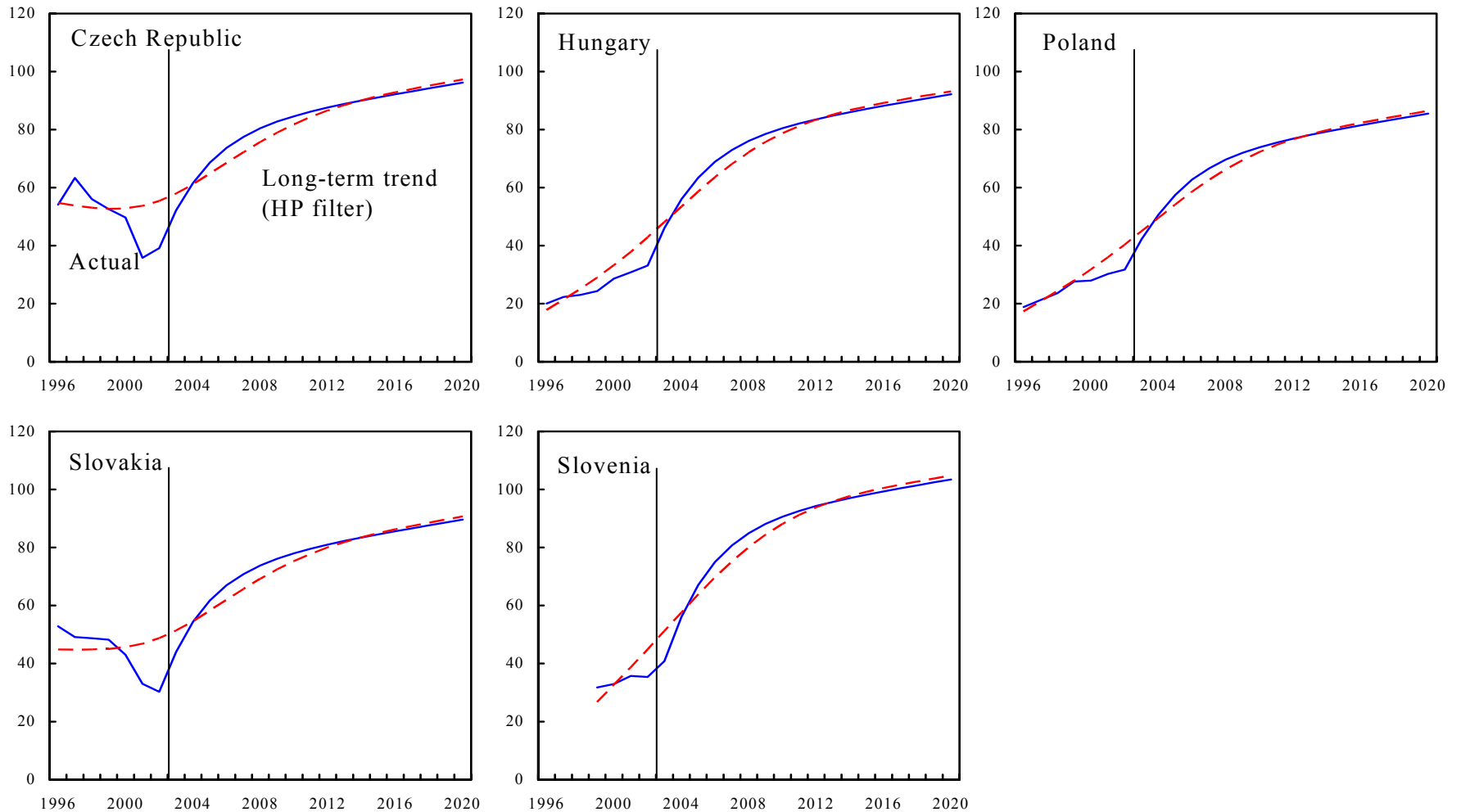
Sources: Eurostat; and IMF staff calculations.
1/Actual values for 1996-2002, simulated values for 2003-2020.

Figure 11. Simulated Effect of a 1 Percentage Point Reduction in Real Interest Rates on
Consumption, Investment and the Current Account
(Deviation from baseline in percentage points of GDP)

BASE CASE

GREATER SUBSTITUTABILITY BETWEEN
CAPITAL AND LABOR

50 PERCENT OF CONSUMERS LIQUIDITY
CONSTRAINED

SHARE OF LIQUIDITY CONSTRAINED
CONSUMERS DECLINES FROM 80
PERCENT TO 20 PERCENT

Investment

Consumption

Current Account

Source: IMF staff calculations.

Expected returns on investment are a multiple of those in Germany.
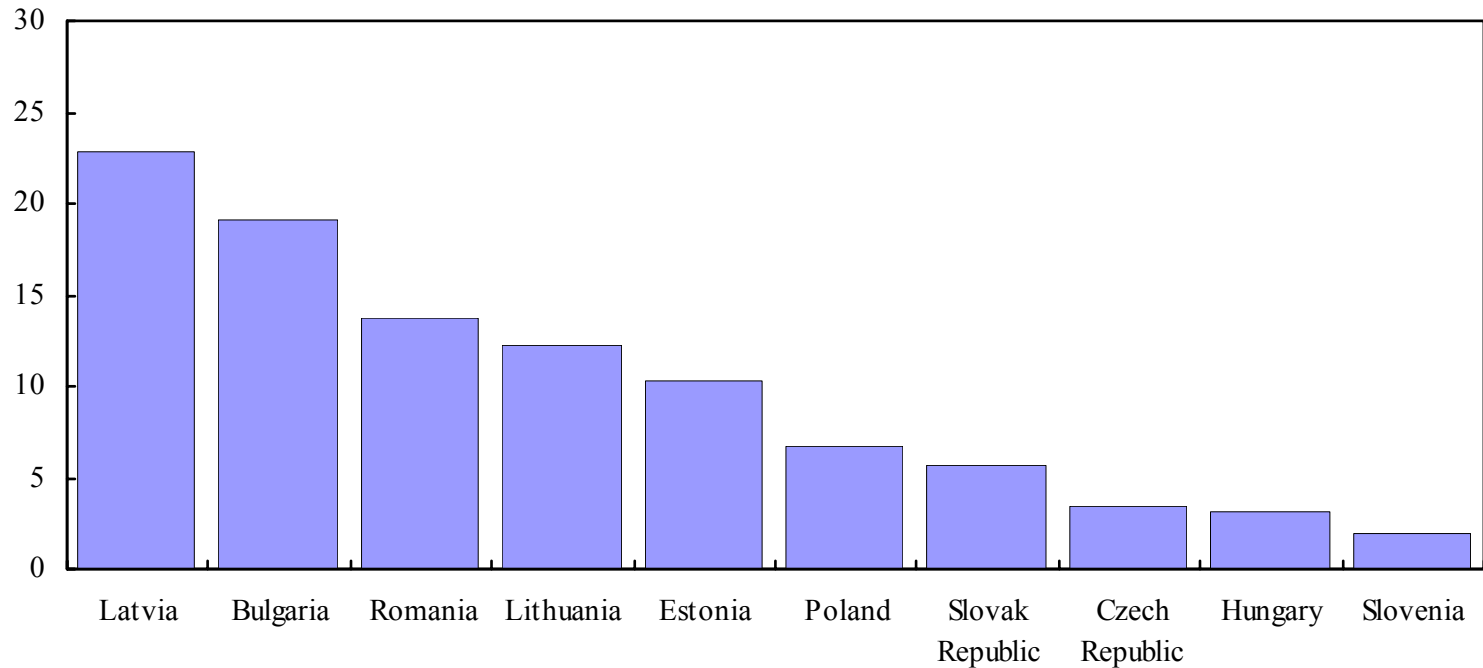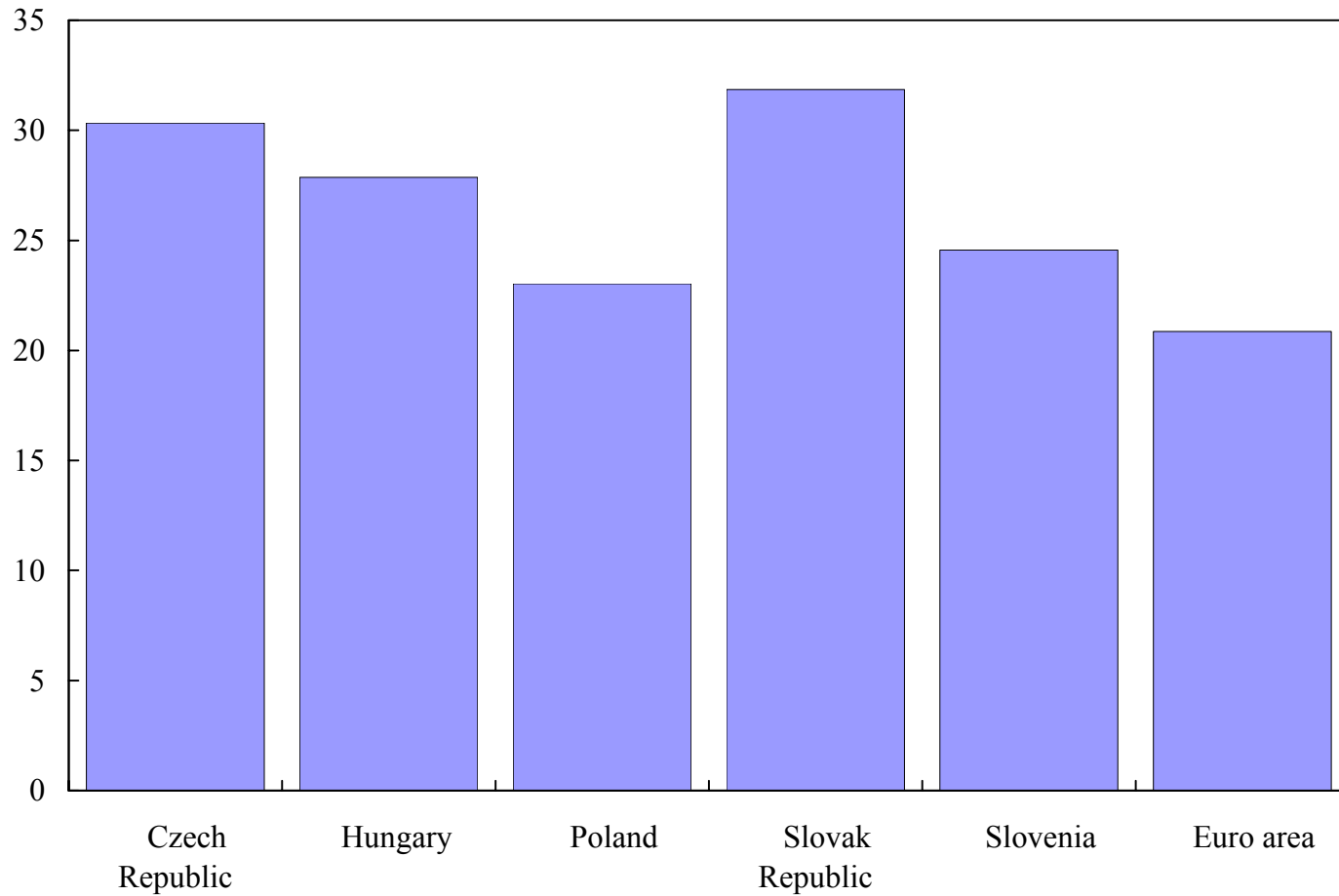
Saving rates are high...
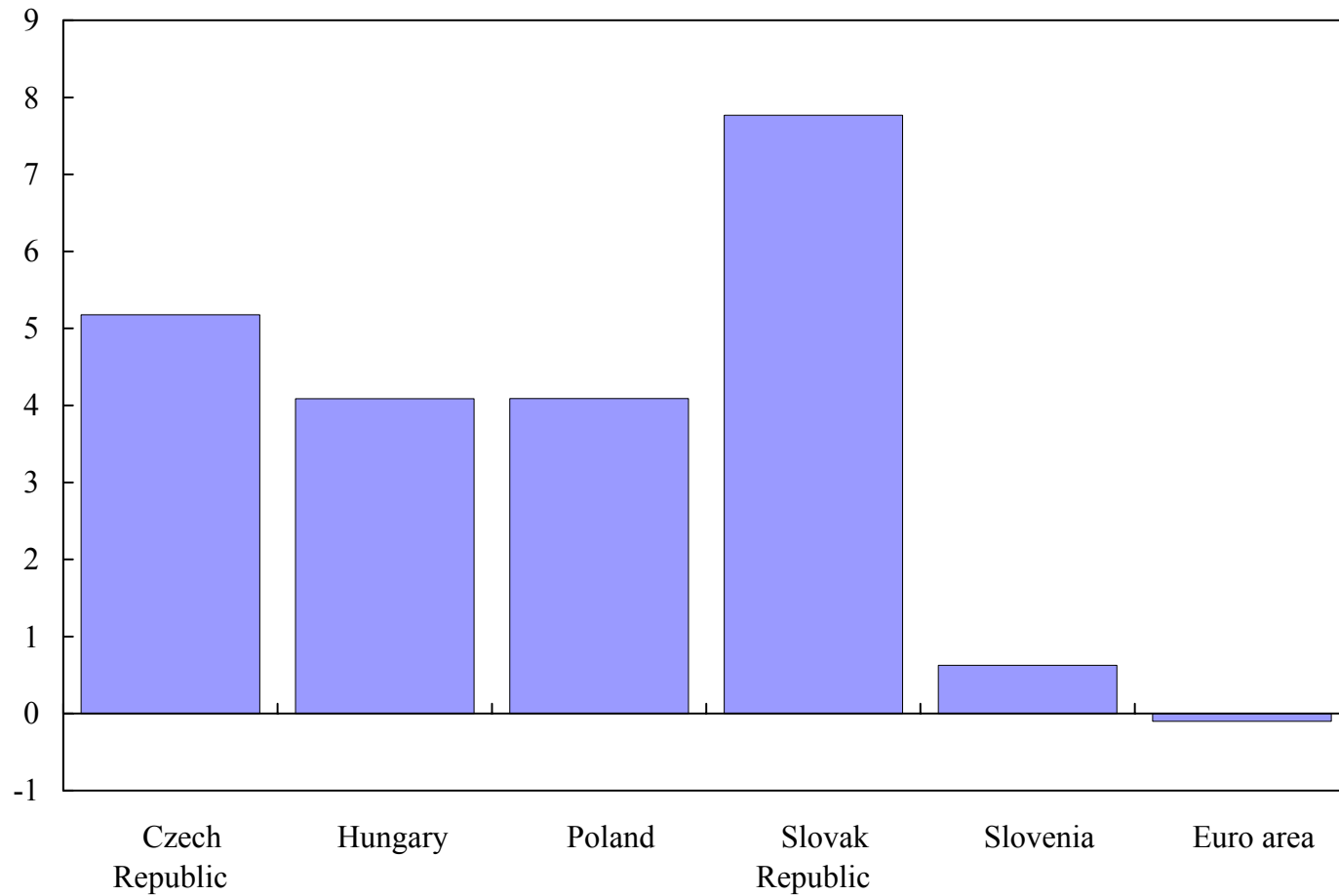(in percent of GD, avg 1996-2002)
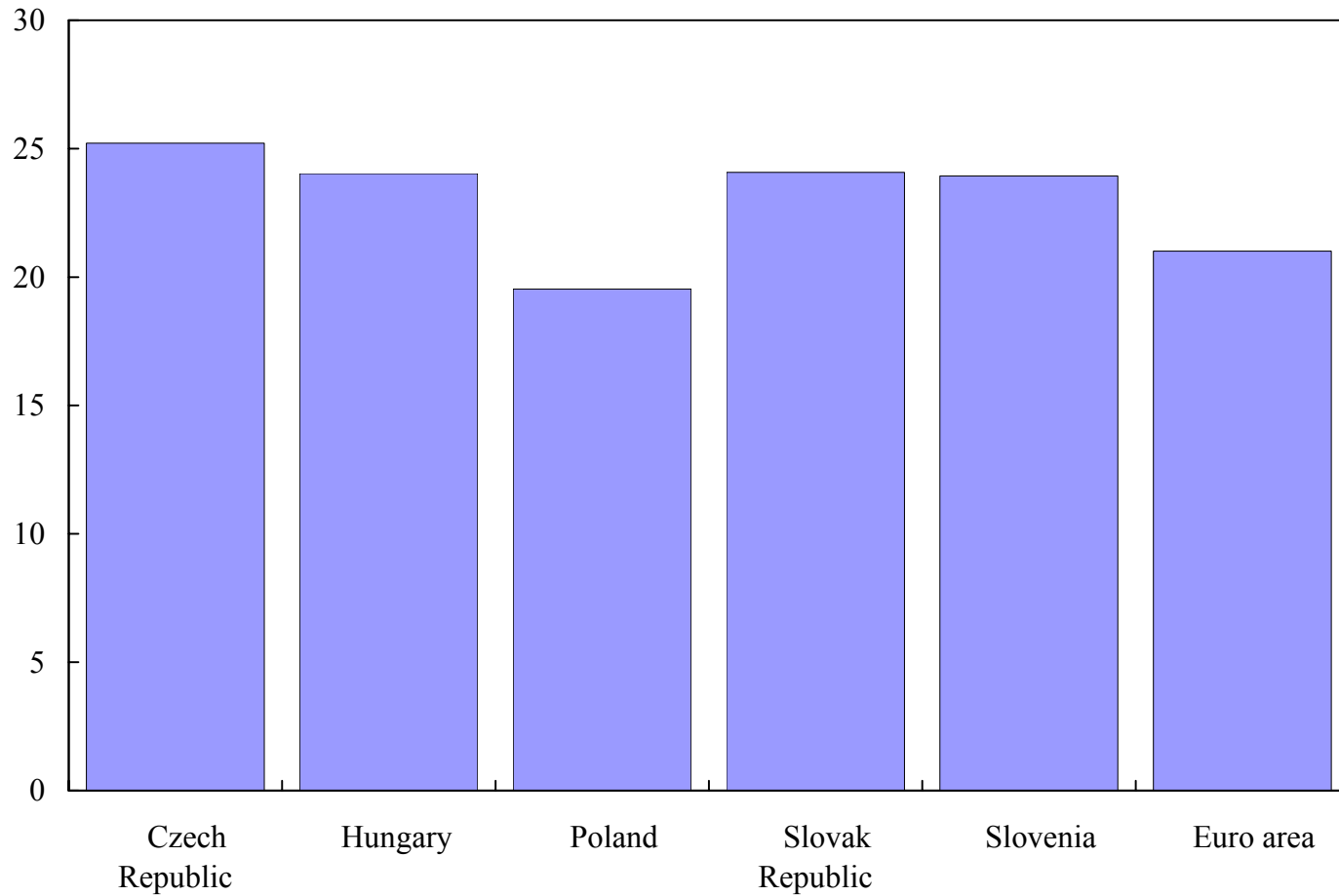
...but investment rates are higher...
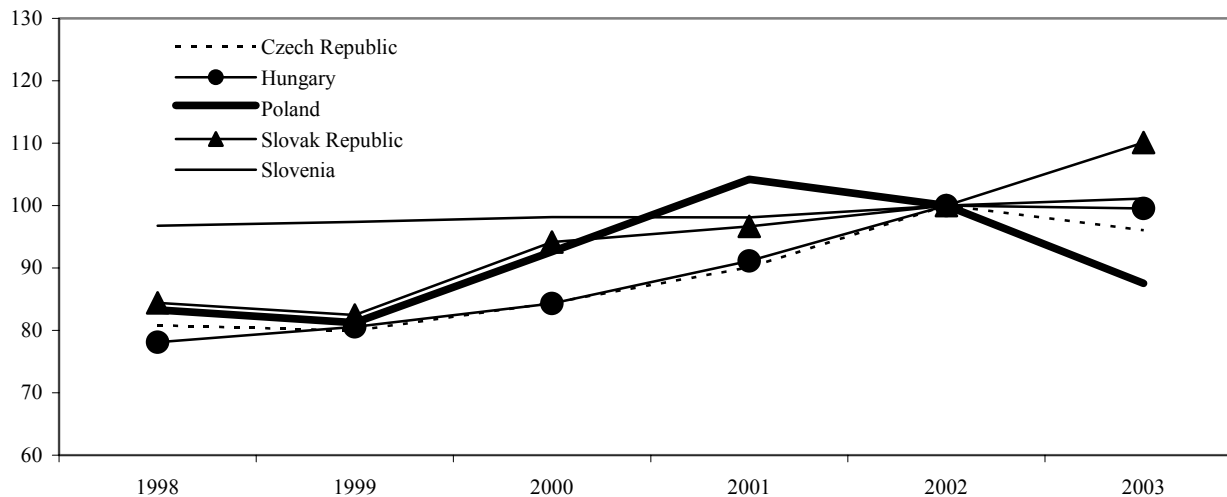
(in percent of GDP, avg. 1996-2002)

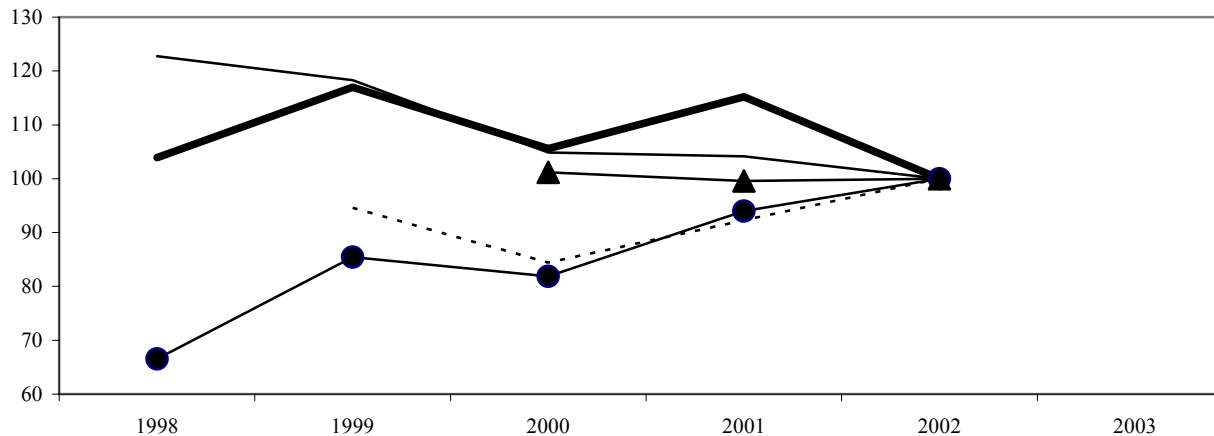# ...and current account deficits are large.

(in percent of GDP, avg. 1996-2002)

CPI-based Real Appreciations have exceeded Balassa Samuelson effects...

... but changes in unit labor cost measures have been more subdued.

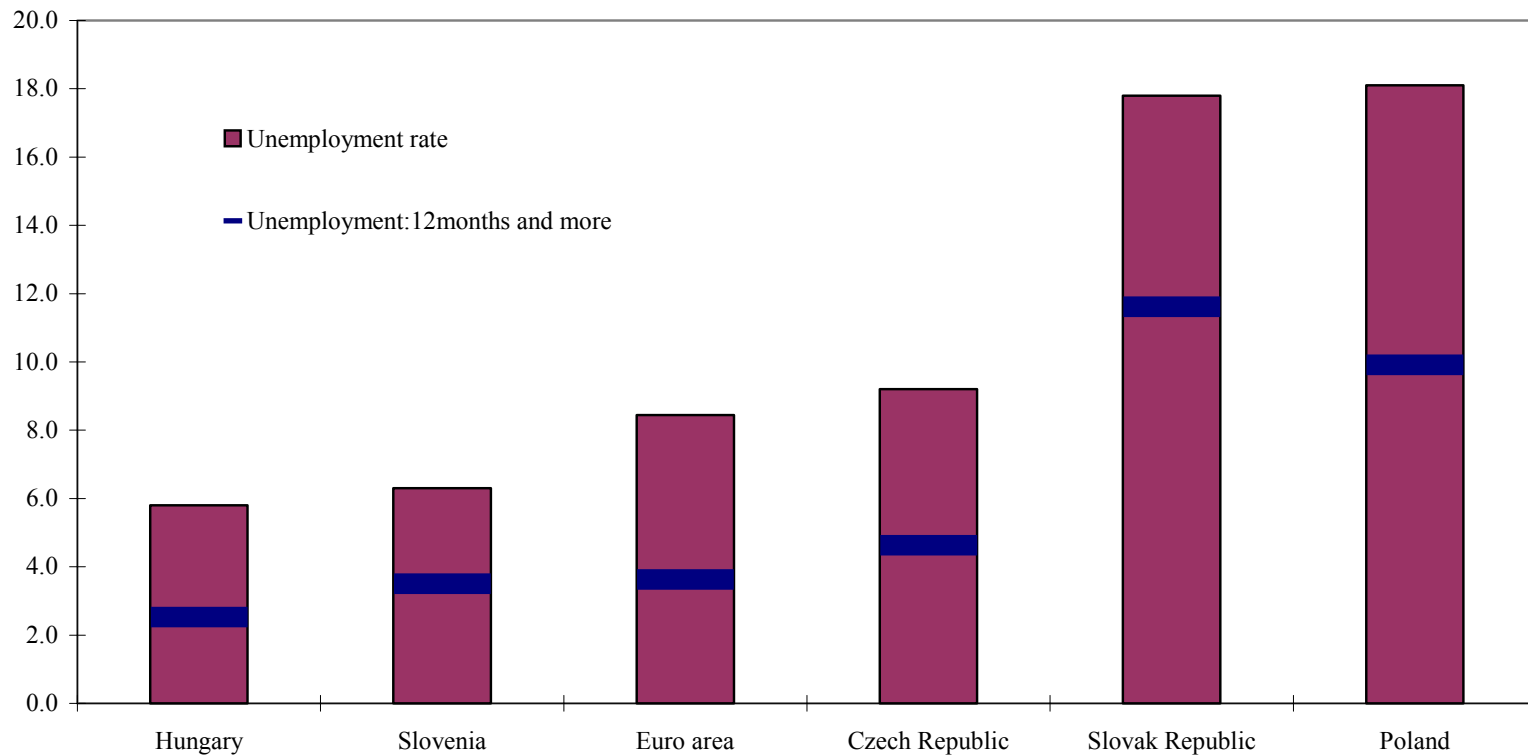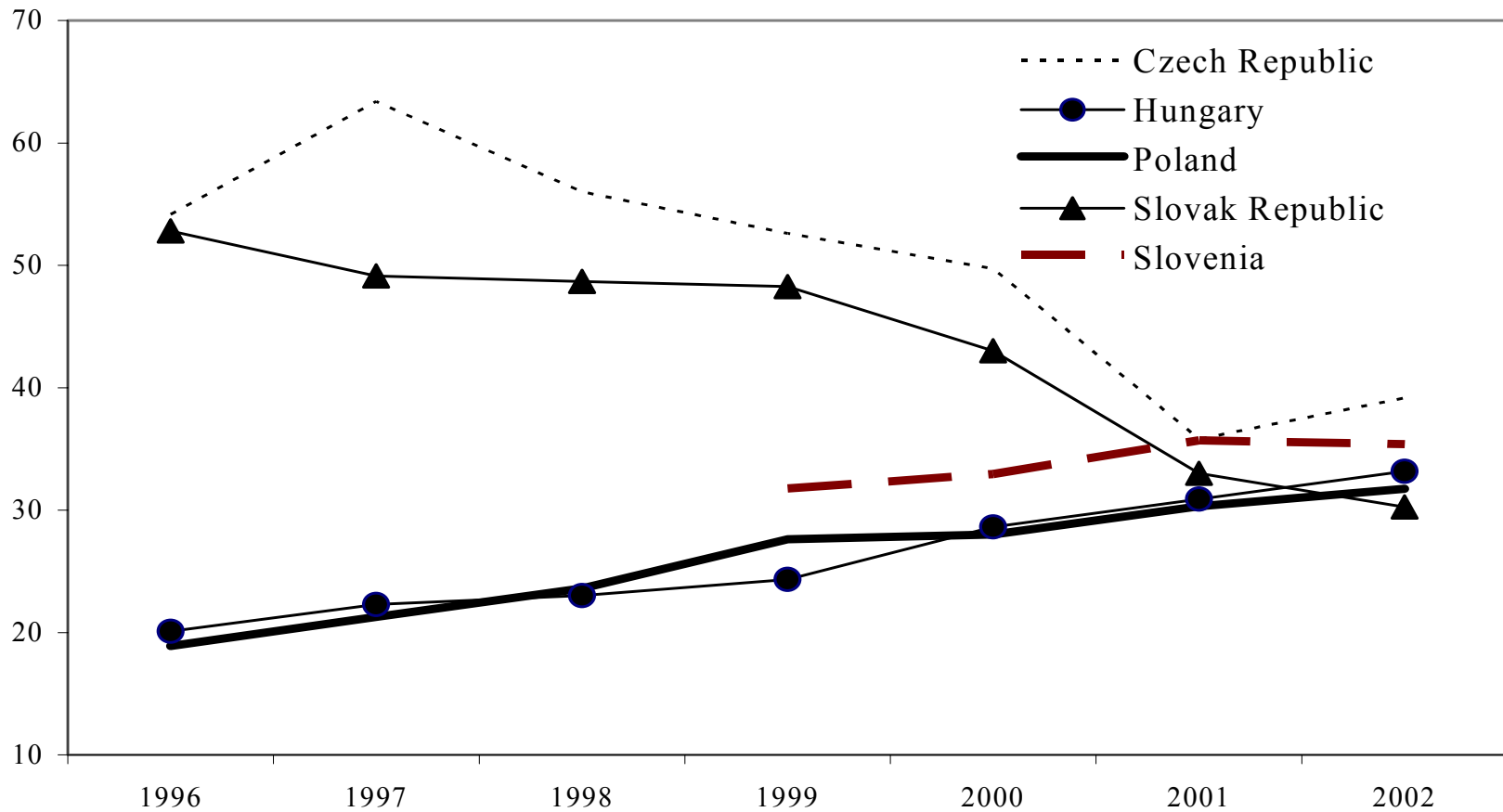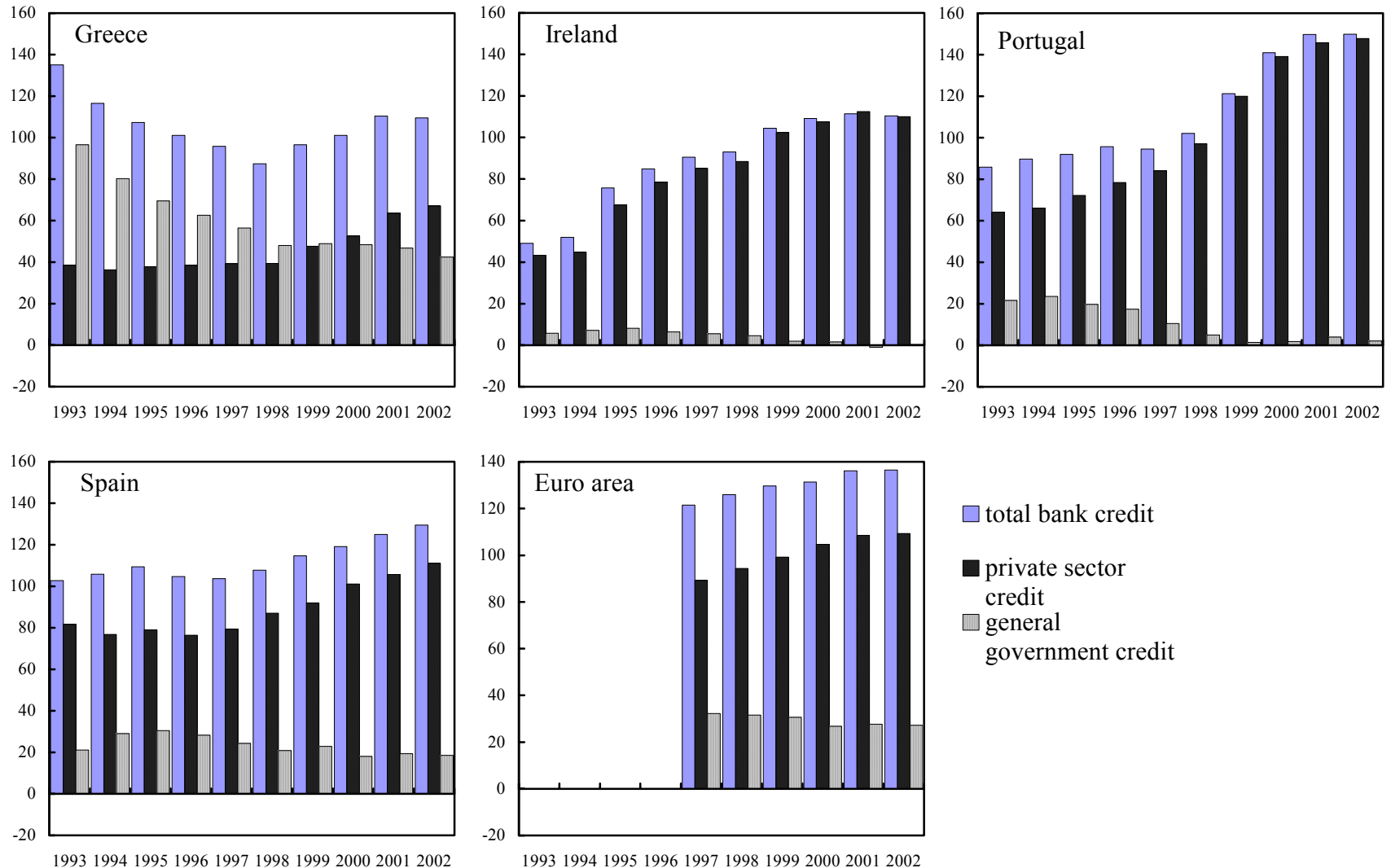# Unemployment rates vary widely with high long term unemployment

Figure 1. CECs: Bank Credit to the Private Sector, 1996–2002 1/
(In percent of GDP)

Sources: Eurostat and IMF staff calculations.
1/ Credit data for the Czech and Slovak Republics is unadjusted for loan write-offs
and changes in classification of financial institutions.

Figure 3. Selected Non-Core Euro Area Countries: Components of Bank Credit, 1993–2002
(In percent of GDP)

...while demographic pressures will generally be less

(population over 65 as a percent of working age population)