Major challenges for accession countries on their way towards euro

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“Eurozone Enlargement: Exchange-rate Choices and Adjusting Markets”

Opinions expressed are those of the author alone and do not represent the official position of the Czech National Bank

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CZECH CNB NATIONAL BANK

Starting question

- While advanced pre-ins (UK, Sweden) do not seem to hurry so much to euro area (being probably very well prepared) most of accession countries seem to hurry to euro area quite a lot (being presumably much less prepared).
- Could it be the case that pre-ins underestimate their possibilities while accession countries overestimate them?

Major challenges

- Exchange rate regime: a panacea?
- Real appreciation: where it comes from?
- Real versus nominal convergence: is there any puzzle?
- Capital flows: are there some risks?
- Road to euro: slow or fast track?
- ERM2: just waiting room or something more?
- Low real interest rate: overheated economy?

Exchange rate regime: a panacea?

- 3 stages of exchange rate regimes:
  - fixed exchange rates
  - divergence to “corner solutions” (CBAs and pegs versus floaters)
  - back to more rigid arrangement?
- Some argue that ER regimes were not of first order importance for the medium-term performance of transition countries
- ER policies were often considered as the second-best policy to dampen failures in other areas
- However, the first-best is to remove those failures

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Exchange rate regime: a panacea?

- In CBAs: inflation tends to be a bit higher but its volatility could be a bit lower; they manage to neutralise the stochastic element of convergence play
- In flexible arrangements: inflation could be a bit lower but its volatility is somewhat higher
- Nevertheless, the essential precondition for successful ER policy is its consistency with other policies: fiscal prudence, flexible labour market, healthy financial sector
- Divergence continues:
  - CBAs do not consider exits towards greater flexibility
  - IT are not likely to adopt CBAs
- Conclusion: current ER regimes are likely to sustain as they are until the adoption of euro

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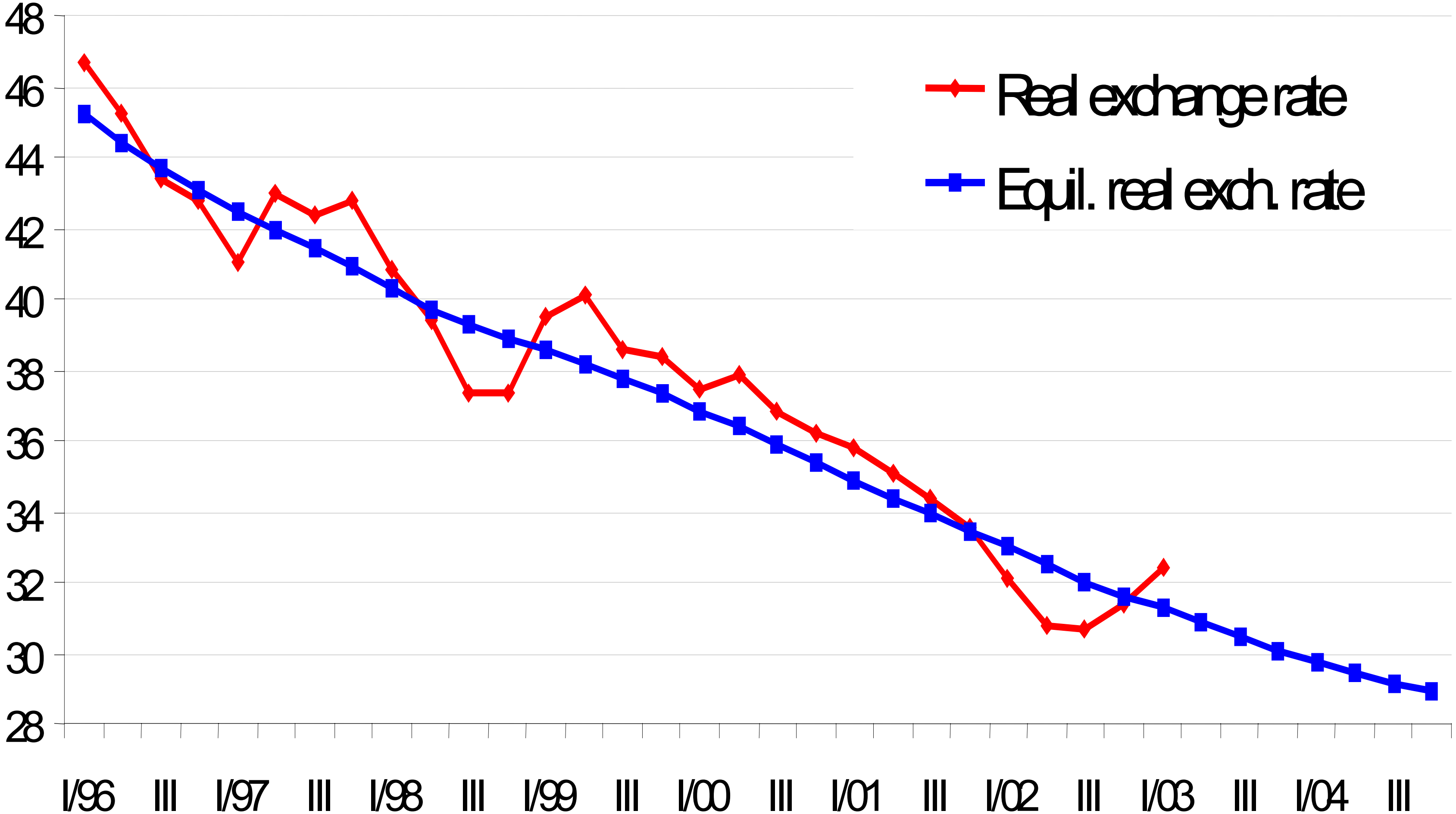
Real appreciation: where it comes from?

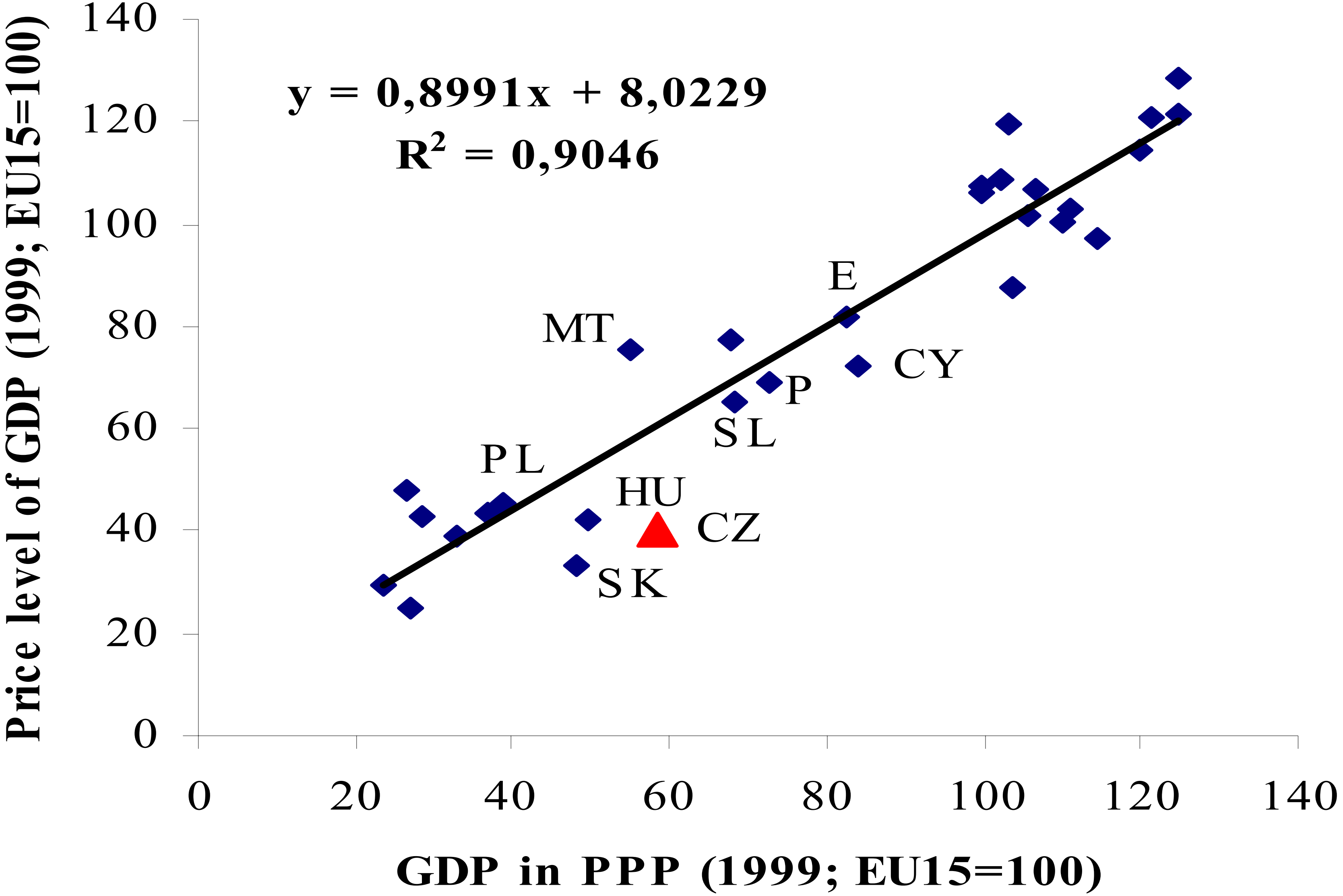
- Rather robust real appreciation has been observed in all accession countries in recent years
- It happened irrespectively to the exchange rate regime, although it was a bit stronger in countries with flexible r.
- It causes no problem if it remains in line with productivity
- However, Balassa-Samuelson effect is quite small in most AC (1 - 2 p.p. noticeably less than considered earlier)
- Puzzle: a larger part of appreciation thus remains unexplained by BS effect ⇨ search for other sources

Real appreciation in CR: 1996 - 2003



Average yearly real appreciation of koruna since 1996 is about 5,5 %

Czech Republic: price level outlier



Price level approach

- The relative price level of CR is by about 21 percentage points lower than its relative GDP
- Factors outside Balassa-Samuelson framework (Čihák, Holub, 2002):
  - government interference (price regulations, taxes, subsidies, etc.) - more present in CR in 1999
  - terms of trade (law of one price may not hold even for tradable goods; large share of value-added products in Czech exports; price compensation: larger share of industrial exports → lower average price level)
  - price convergence: while BS effects runs via prices of NT, ToT effect runs via prices of T (1 : 1)
  - imperfect mobility of labour across sectors (potentially significant factor but difficult to test empirically)
- Accounting for above factors yields satisfactory explanation of GDP-price level mismatch

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Relative price adjustment and macroeconomic development

- Adjustment of relative price → higher inflation when assuming that the prices are asymmetrically downward sticky
- Four inter-related variables:
  - GDP growth
  - real appreciation
  - inflation
  - downward flexibility of prices
- Pressure on some prices to decline with fast GDP growth, real appreciation, relative price adjustment and low inflation.
- Companies and labour unions in the "most tradable" sectors need to learn how to live with declining nominal prices of their products.

Capital flows: are there some risks?

- Lifting of capital controls (part of the preparation for the EU entry) is potentially worrisome:
  - some economists suggest that there is a huge potential for capital inflow (big investment opportunities, supply-side reforms, appreciating equilibrium real exchange rates, relatively high real interest rates)
  - likelihood of crisis increases if the flow is reversed
  - danger of overheating emerges if the flow is not reversed
- Coping with risks requires:
  - implementation of sound fiscal policy, prudent banking regulation (banking sector is vulnerable)
  - flexible exchange rate regime

Capital flows: Czech experience

- Capital inflow plagued the country in different periods:
  - in mid-1990s: fixed exchange rate + interest rate differential implied huge inflow of (debt) capital ⇨ overheating of the economy ⇨ accumulation of bad debts ⇨ sterilisation, etc.
  - rapid process of lifting the capital control but maintaining of the currency peg (bad exit strategy) led (fostered by fiscal- and current account deficits) to currency crisis (textbook example of Impossible Trinity)
  - since about 2000 there was a mounting expectation of huge FDI inflow (both private FDI and privatisation inflow) - bubble in 2002
- *Hypothesis*: The worst may be already over (managed float, no interest rate differential, not much government assets remaining, sterilisation agreement between Gov. and CNB, sound banking sector)

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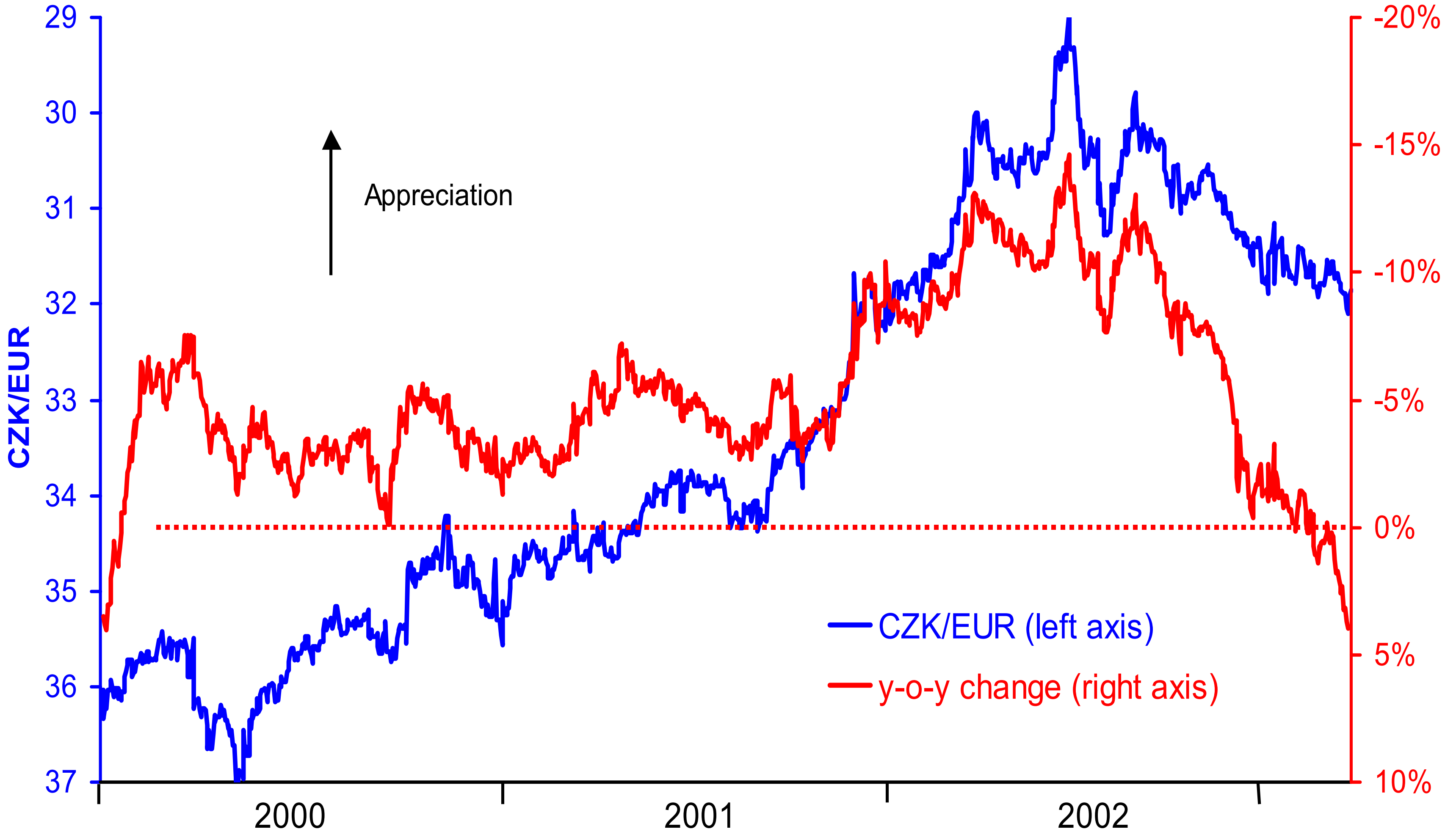
Exchange rate bubble in 2002



Road to euro: slow or fast track?

- Some 2 years ago: most AC declared their aim to adopt euro ASAP
- In some countries (Hungary) some studies were made to "prove" that the country is ready. In other countries (Slovakia) it was just "felt" that an early adoption is "desirable" (or it was fashionable to claim it)
- Since then a moderation of position can be observed:
  - ASAP ⇨ ASARP (Romania)
  - some other impediments emerged: too loose fiscal policy, inflexible labour market, imperfect synchronisation of cyc.
- Nowadays two groups:
  - front runners: (Estonia) quite advanced and "trained" from CBAs
  - late-comers: (CR and newly also Hungary)
  - Maastrich criteria seem to be a useful "disinfectant" to discriminate between eligible and non-eligible

ERM2: just waiting room or something more?

- ERM2 is a somewhat fuzzy concept (fixed but adjustable framew.):
  - disputable width of the band (+15 -2,25 %) appreciation is allowed
  - no rules for marginal and intra-marginal interventions (when?, under which circumstances?)
  - what is ERM2 expected to deliver?
    - too wide to fix expectations
    - is it supposed to prove that a given CB together with ECB are strong enough to keep the ER within the band? (device for displaying the ECB intervention power)
- ECB is not very keen to clarify the uncertainties (rather it seems to prefer to have a room for flexible interpretation)
- Because ERM2 is an intermediate regime it is potentially unstable
- It does not automatically guarantee higher stability of exchange r.

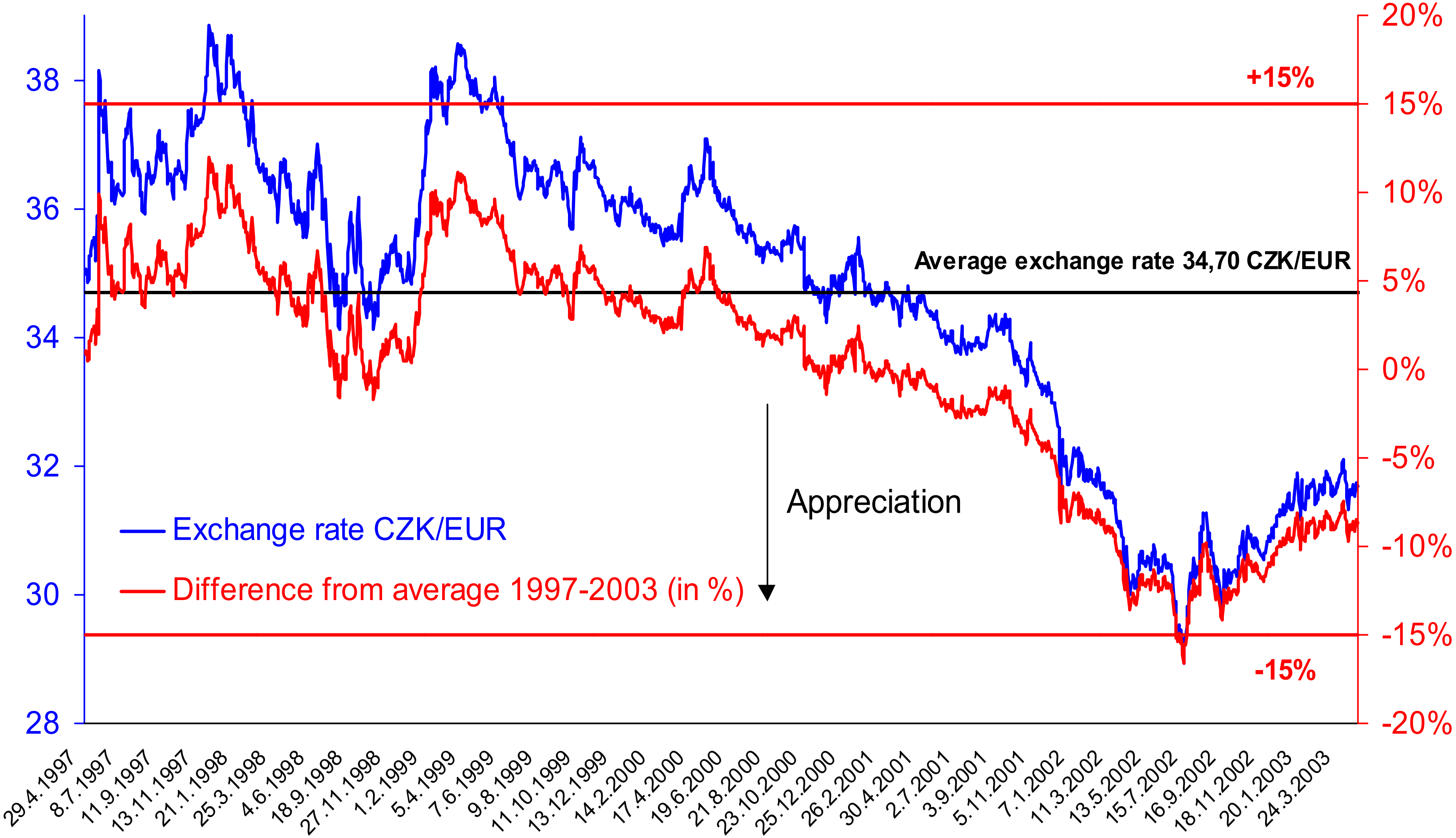
ERM2: just waiting room or something more?

- Just the opposite - market may be tempted to test the readiness of CB to defend the band (interventions on the depreciation side are typically an invitation for speculative attack)
- Conflict between targets of monetary policy (Hungary in January)
- Unnecessary early fixing of the parity vis-a-vis euro (in ERM2) increases the risk that euro-locking rate will be misaligned
- Those risks can be further multiplied by the lack of self-discipline of macroeconomic policies
- Hungarian lesson:
  - if you have IT, do not shadow ERM2
  - if you do shadow ERM2, keep your public budget under control
  - if you do not keep public budget under control, do not be surprised by the result

ERM2: just waiting room or something more?

- Due to many disadvantages of ERM2 accession countries typically perceive the regime just as a "waiting room" (gateway) and will attempt to minimise the length of stay (2 years) x ECB tries to sell the idea to them: "left lane of the highway to euro"
- Summary:
  - if the country is in troubles, ERM2 is (most likely) not a proper regime to solve or mitigate them
  - under normal circumstances the band should be wide enough to allow for real appreciation (2 years only)
  - nevertheless, countries which enter ERM2 with *currency board* may find fulfilment of Maastricht inflation criterion as a more problematic than those entering with *IT*: as the channel of nominal appreciation is basically locked for them, ERM2 can become a strait-jacket ⇨ incentives for "massaging CPI" (via regul. prices?)

Exchange rate band for koruna: wide enough?



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Low real interest rates: overheated economy as a main „tool" for catchin-up?

- Adoption of euro implies the „locking" of the exchange rate channel of real appreciation ⇨ inflation channel remains open (new conditions for former inflation targeters)
- Higher inflation (than in the rest of eurozone) implies lower real interest rate (instead of 2% → 0%) and substantially stronger incentives for investment and …. overheating
- But: no obvious risks related to overheating (no risk of currency crisis; some systemic risk for the banking sector?)
- Case of Portugal: overheated economy with happy consumers
- Summary: it can be the case that very adoption of euro will start an unprecedented catching up which would not be otherwise conceivable

Answer to the starting question

- Accession countries hope that adoption of euro will deliver a stability which was very much wanted during turbulent transition period - they are right
- Exporters generally would appreciate having euro “tomorrow at the latest” - they know their business
- Policy-makers believe that their economies are flexible enough to minimise the adjustment costs. Although no “objective” measures exist, I think that some countries are not eligible yet. Hesitation of UK to adopt euro and current problems of Germany can serve as a useful warning.