Implications of the current crisis for the euro zone enlargement

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Executive summary

The crisis is raising again the question of the non-optimal nature of the euro area. In the absence of a federal budget which can overcome the regional divergences by transfers, the instrument alone devoted to such a mechanism is the Stability and Growth Pact. So the current crisis admittedly causes market suspicion vis-à-vis countries which did not respect the Pact rules until now and will suffer from very difficult future evolutions with the spontaneous impact of the recession. But if the spreads have enlarged for some countries, they remain far below the ones observed for some non member states. The "euro shield" is bending but not breaking. However, a solidarity mechanism is necessary as some countries in which the bubble bursting was dramatic could be in a very serious situation. Whatever its form, such a procedure must have sufficient visibility and credibility, for it would be disastrous for the credibility of the zone if a member state would be obliged to ask for the assistance of the IMF.

Concerning the position of the CEE countries in view of an eventual accession to the euro zone, the strict assessment of the respect of the criteria delivered mixed results. Some countries had very high inflation rates and contrasted fiscal situations but generally very high current account imbalances (which is not a criteria but is the sign of a severe macroeconomic disequilibrium and have caused wide exchange rates depreciations). Beyond the formal aspects of the criteria, strong reasons –poor real convergence, weak financial sector, fragility of the growth factors, saving deficits – were advanced for arguing that the accession of most of these countries was realistic at a medium-term horizon.

The current crisis is causing a violent deterioration of the situation of the CEE countries with foreign investment flows turning around, exports dramatically decreasing, general impoverishment of the economic agents, risk of banking system collapse and perhaps of quasi state bankruptcy. Some analysts think that the best solution would be to integrate, at least some of these counties, into the euro zone in order for them to benefit from the euro shield. But the crisis does not change the fact that these countries could not endure the constraints of a strong currency for, different from the ex GDR, they would not benefit from compensatory mechanisms provided by a national budget. Furthermore, an early accession would imply putting the criteria aside. Setting this precedence, it would be very difficult in the future to maintain credibility of recommendations and procedures for restoring sound public finances. In addition, a common monetary policy would become very difficult to manage with countries whose inflation rates exceed 10%. Finally, one can estimate that an early integration, by its brutal and totally off-norms characteristic would weaken the euro durably and structurally. However, these countries must be strongly helped. And the question of rescuing states can be asked in the future. Once more, it would be damaging for Europe to abandon the file to the IMF. It would be good to give to markets and observers a clear message about a time table for the accession of these countries, as it was undertaken for the introduction of the euro.

The question of the UK accession is different since this country has an opt-out clause and did not express any intention to join the euro zone, and its situation, while very serious, does not show the fragility symptoms of the CEE countries. Yet the question of an accession has been raised as the monetary independence of the pound has been relative and its dependence apparently broken by a sharp depreciation, which is globally, in our view, a bad thing, and could worsen the market appreciation of the UK signature, all the more so in that the UK government will have to finance huge deficits. But the country is not respecting, by far ,the

criteria, and it would be very difficult to determine what could be the good exchange rate of the pound against the euro.

1) Paradoxical and even contradictory analyses are presently circulating about the consequences of the current crisis on the euro area situation.

On the one hand, it is asserted that the crisis is a stress test which reveals the weakness of the zone, with limited homogeneity of economical, financial and banking structures and of economic actors' behaviours, a situation which is supposed to confirm the presumption that the single currency area is not an optimal economical zone. On the other hand, one can read and hear claims for the urgency of making the integration in the euro area of Central East European countries easier and faster, such a decision being considered as the best solution for avoiding the quasi collapse of these countries. But this solution would objectively, if achieved, make the zone even less optimal.

It is true that the crisis is the first big test for the euro area solidity and that some member states like Ireland, or Greece, seem right now, to some extent, not less affected than Eastern European countries. Many questions arise: What could be the real impact of these evolutions on the whole area's credibility? Are the current institutional mechanisms sufficient for dealing with such problems? Has the enlargement problematic changed? What could be the positive and negative effects, for the zone and for the presently European non-euro area member countries, of an early integration of some of them?

I will deal with the following questions:

- What could be the objective assessment of the impact of the crisis on the euro area situation?
- How can the CEE countries financial, fiscal, banking and economical current context be judged in the eyes of the accession process?
- Is there an opportunity for accelerating the process and what would be the result of such a choice for the zone and the concerned countries?
- Finally, I will devote some paragraphs to the specific case of the United Kingdom whose situation is of course very different from that of the CEE countries but for which the question of integration is also raised.

2) The question of the euro area homogeneity and of its optimal or non-optimal nature has been asked right from the single currency's creation. Such an issue was not really debated during the preparatory period as it was for a long time assumed that only a small number of countries – mainly, Germany, France, Belgium, the Netherlands, Luxembourg – would join the euro at the first stage. The situation seemed to have changed when eleven countries were finally considered as compliant for the single currency introduction, some of them having led very strict and courageous policies in order to meet the criteria for admission.

There is no shortage of arguments to support the view that the zone is rather heterogeneous: double or triple level differences in the per capita GDP exist; strong differences in the growth rates, shares of the banking and financial sector in the economy; inflation rates; differences in the financial structures and in economic agents' behaviours which cause unequally rapid and effective transmission channels of the monetary policy.

But beyond the negatively connoted view of a non-optimal area, one has to assess the real impact of these discrepancies on the stability of the global area.

Divergences are mainly the fact of small countries whose weight in the GDP of the total zone is small. The extreme levels of GDP per capita are those of Luxembourg, or Ireland, and Portugal. At the end of 2007, the widest inflation gaps were also observed in relatively small countries, except for Spain. Similarly, only one country, Ireland, was characterized by a larger than average banking sector weight. If one considered the block of the largest economies (Germany, France, Italy, Netherlands, Belgium), which represented 75% of the global GDP, per capita GDP and inflation rates gaps have been very small.

Therefore, if the relative heterogeneity of the zone may be a handicap for some countries it doesn't endanger the global stability of the area.

The financial and banking practices applied in Ireland and Spain, which strongly differ from those applied in the other countries, have been more serious. The use, on a large scale, of diabolic Anglo-Saxon practices like indexed credit interest rates and sophisticated instruments has objectively strengthened the bubble formation, its brutal collapse and the dramatic banking system problems in Ireland.

3) All monetary integrated zones are non-optimal areas. In France, the pure economic logic would imply the "Ile de France" currency to be different from the "Creuse" currency. But a unified economy and a common budget contribute to overcoming these divergences in mutualising the assets and handicaps of heterogeneous regions. In the euro zone, the sole instrument devoted to such a mechanism is the Stability and Growth Pact. But with the Pact, compulsory individual discipline (the non-respect of which can cause penalties) is making up for fiscal transfers that a federal budget allows. In other words, governments which respect the main heart of the Pact, that is to say the obligation to have balanced and even positive budget results when the economic situation is good, benefit from spontaneous resources when the economy is worsening.

So the current crisis admittedly caused market suspicion vis-à-vis countries like Ireland or Spain whose fiscal policy had been sound but in which the bursting of the bubble suggests dramatic deterioration of the fiscal situation (in Spain, a surplus of 2.7% of GDP in 2007 would be replaced by a 6% deficit in 2010). But markets are also punishing countries like Greece, Portugal, Italy and even France to some extent, less affected by the crisis but in which the poor respect of the Pact and the current high level of debt suggested very difficult future evolutions with the spontaneous impact of the recession on public finances. As a consequence, spreads on the ten year debt vis-à-vis the Bund rate are now for the three first countries respectively 252, 127, 128 basis points, when they were insignificant six months ago.

Should we conclude that the euro zone does not resist to the crisis? In my view it is not the case. To some extent one has to ask if it was not the previous situation which was abnormal. What has been called the "euro shield" consisted in all member states of benefitting from the credibility of the better-rated countries, with spreads sometimes not exceeding 15 basis points. It is not surprising that such a situation changes with the crisis. The shield is bending but not breaking as shown by the current long term interest rates in some European non-euro area members whose fiscal situation is not worse than in some member states.

4) But a stronger deterioration cannot be excluded and the absence of a solidarity mechanism could be more felt than during the past.

The proposition for creating a common European agency which would borrow collectively for all member states is probably doomed to failure. Indeed, if such an entity would lower the interest rates paid by the downgraded countries, it would probably increase the interest paid by the best signatures.

On the other hand, the existence of a mechanism for rescuing countries facing serious difficulties seems necessary. Currently, an intra-European entity devoted to this purpose does not seem to be accepted by all member states since bailing out is prohibited in the Maastricht Treaty and since such an apparently quasi automatic mechanism could create moral hazard behaviours (but is it possible to free oneself of moral hazard when one rescues banks and invoke it for states?). In any case, case by case approaches seem to be favoured, as shown by the French/German press release at the end of the last meeting of the two countries' finance ministers. Whatever the adopted solution, it is crucial for the concept to have sufficient visibility and credibility so that all observers and analysts can be convinced that the zone has the willingness and the effective means for resolving its own problems itself. It would be disastrous for its credibility if a member states would be obliged to ask for the assistance of the IMF.

5) Concerning the positions of the CEE countries in view of an eventual accession to the euro zone, the strict assessment of the respect of the criteria delivered, before the crisis, mixed results.

Except in Poland, inflation was in all these countries well above the average price increase in the euro area. Hence, in last July, while euro zone inflation was 4%, prices increases of 6.8% were observed in the Czech Republic, 7% in Hungary, and between 12 and 16% in the Baltic States.

Fiscal situations were more mixed. The Baltic countries, and more or less, the Czech Republic were in a relatively good situation for the budget balance, while Poland was on the verge of the criterion, and Hungary clearly above the 3% limit (5%). This country was also exceeding the 60% of the GDP limit for the debt while other countries were below.

But most of these countries were showing often huge current account deficits: 6,4% of the GDP in Hungary, 18,5% in Estonia, 22,5% en Bulgaria, “only” 4,6% in Poland. Admittedly, the current account balance is not a criterion for the admission in the euro zone but excessive imbalances reveal severe macroeconomic disequilibria.

Except for the Baltic countries whose currencies joined the ERM 2 and to a certain extent Bulgaria, other states have suffered from wide exchange rates fluctuations, with, for instance in 2008, 15% and 16% depreciations of the Hungarian Forint and of the Polish Zloty.

Finally, the Czech Republic (which did not seem urging for joining the euro), and the Baltic states could be considered to be in a situation of joining the zone within a reasonable time table (that is to say 2 or 3 years) provided they do serious effort for reducing their inflation.

6) But, beyond the formal aspect of the criteria, strong reasons were advanced for arguing that the accession of most of these countries was, at the best, a medium-term horizon problematic.

Real convergence was improving but remained very far from what would have been needed for belonging to a relatively high income monetary zone. On average, the per capita GDP of

these countries is 50% of the euro area level, while in the zone only one relatively small country has a per capita GDP below 75% of the area level.

In the financial sector, it is obvious that banks, even owned by euro zone financial institutions don't reach the level of solidity and governance requested by the "Copenhagen Criteria" as these criteria were assessed with more political than technical bias when these countries joined the EU. In addition these banks are promoting on a large scale foreign currencies operations (mainly in dollar and euro) with their domestic customers.

Another source of concern is the relative fragility of the growth factors: a disastrous demographic situation is worsened by a low activity rate (58 % on average against 64% in the euro area). So the potential growth is almost exclusively resulting from investment and productivity. Equipments are largely financed by banks and foreign investments whose stock can reach 60% and even 95% of the GDP, a situation which can be bearable when things are fine but which becomes very fragile when things worsen.

Finally one must observe that these countries don't seem to do great efforts for their future as they devote only 0.76% of their GDP to R&D (1.90% in the euro zone).

In its annual report for 2007, the BIS was noting this alarming weakness and concluded that, with a saving deficit of 4.4% of the GDP in the 3 largest CEE countries (14% for the others), annual foreign investment reaching in some countries 8% of the GDP (3% in France, and in the euro zone), and foreign currencies debt between 60 and 120% of the GDP (with spreads on three years CDS above 400 points for most of them), CEE countries were already on a high level risk scale.

7) The current crisis is causing a violent deterioration of the situation of the CEE countries as foreign investments flows turn around, exports dramatically decrease and financial situations of economic agents are worsened by the fall in the currencies exchange rate. In most of these countries, the growth is supposed to drop from more than 5% compared with its present variation rate, with a sharp decline in investment and strongly rising public debts.

Facing these evolutions two opposite conclusions can be made

- Considering the fragility of these countries which could be a factor of an explosive evolution with general impoverishment, banking system collapse and quasi state bankruptcy, and insofar as a fall of the exchange rate of the currencies is an important factor of worsening, the best preventive solution is to integrate at least some of these countries in the euro zone in order for them to benefit from the euro shield.
- Inversely, one can argue that the present context does not change the fact that these countries could not endure the constraints of a strong currency, with probably an unemployment explosion and that the medicine would be worse than the trouble. Indeed, different from the ex GDR, these countries would not benefit from compensatory mechanisms provided by a centralized national budget.

Furthermore an early accession of some CEE countries to the euro zone would imply, whatever procedure was applied, to put the criteria aside, or for using a more diplomatic expression, to assess their compliance with flexibility. Moreover, a leader of a great CEE country clearly asked for this in a recent statement: those who plead for this solution argue that there is no more justification for requiring the respect of the criteria from the new members since the criteria are currently broken by almost all member states. But these member states respected the criteria when they joined the zone and until the second half of 2008, almost all member states were respecting the criteria. In addition one can imagine that it

would be very difficult in the future, if not impossible, to ask member states to have credible plans for restoring their public finance soundness, if these criteria were officially broken.

In addition, the euro zone is a single currency and a single monetary policy area. It is already observed that in the present limits of the zone, monetary policy has not the same effectiveness everywhere as, in some countries with relatively high inflation rates, real interest rates are lower than in the others, and even sometime negative. With the integration of countries which currently have inflation rates between 6 and 16%, monetary policy would become very difficult to manage.

Finally, and even if CEE countries represent less than 10% of the global euro zone GDP, one can fear that their early integration would destabilize the zone by its brutal and totally off-norms characteristic. The euro would be durably and structurally weakened as, unlike the dollar for which fits of weakness are never fatal, the European currency has not the same political, diplomatic and strategic assets. This weakening would globally impoverish the euro zone citizens, and would not at all be an asset for facing the crisis as the worldwide demand is falling. In addition the currency depreciation would probably contribute to damage the effective competitiveness of the zone which would be handicapped when the recovery would occur.

7) In spite of these arguments CEE countries must be strongly helped.

If responsibility for facing the crisis is firstly in the competence of the CEE countries' governments with adequate measures (others than reducing the civil servant salaries which is the best means for introducing a deflationary process!), these countries must count on the other EU governments' solidarity.

The ECB already granted euro credits to Hungary. It is obvious that renewing such operations would show evidence that CEE countries are not let alone for facing exchange rate crisis.

The European Commission already engaged 6 billion euros in favour of these countries and emphasises that the management of such a crisis is not within its competences, but instead within the IMF ones. On has to ask about the pertinence of such a position, caused by the fact that these states issue national currencies. It would give a very bad signal as it would show that Europe is unable to conceive a rather large scale solidarity scheme. One can estimate that the integration of most of the CEE countries into the EU was premature, but now it is necessary to assume the collective responsibility of the Union. For the moment, it seems that the rescue projects have to be concentrated in favour of the CEE banking system (with the assistance of the EIB and of the EBRD), as some euro member countries banking sectors, mainly, Germany's and Austria's, are heavily engaged in CEE banks. But the question of rescuing states can be asked in the future and, once more, on this question, it would be damageable for Europe to abandon the file to the IMF.

Coming back to the question of accession to the euro zone, if an early accession with flexible assessments of the criteria would be a wrong response, it would be good to give to the markets and the observers a clear message about a timetable for the integration of these countries. As it was undertaken for the introduction of the single currency, one can imagine to determine two appointments (which could be different for each country), in order to assess the ability for adopting the euro, the second being considered as the ultimate date. Such a procedure could be a good way to recall that joining the euro area is, according to the Treaty, a duty for these countries.

8) The question of the accession of the UK to the euro area is arising differently than that regarding the CEE countries.

First, the UK has an opt-out clause in the Treaty and, consequently, is not obliged to adopt the euro as the other members of the EU are (except Denmark and the Swedish). Secondly, its government did not express any intention to join the euro zone (a large majority of the UK citizens are presently against such an issue). Thirdly, the economic and financial situation of the UK is very serious but the country does not show the fragility symptoms which characterise the CEE countries: importance of the foreign investments, local banks operating mainly in foreign currencies, strong dependence on the other European countries' demand and industry.

Yet, a lot of economists have recently raised the question of an accession, some pessimistic analysts even argue that the UK could become rapidly a gigantesque Iceland. It is of course an exaggerated worry but some elements could justify the question to be raised.

First, the monetary freedom of the UK had until the end of 2008 had become rather theoretical. It has been calculated that since 2002 the pound variations on the exchange market have been bound to the euro fluctuations in a proportion of more than 90%. This dependence was apparently broken for three or four months but the new situation is worse with a sharp depreciation of the currency (the euro/£ rate has risen from 0.70 to 0.90). How to assess this evolution? For some analysts, it is a good thing and will allow the UK to improve its exports and so limit the crisis impact. We consider it is a wrong opinion, for we are no more in the thirties as some analysts seem to believe. In the sixties and the seventies, things have already changed and the frequent UK uses of the depreciation of its currency for trying to overcome its economic problems gave very poor results for growth and a negative incidence on industry which lost competitiveness and attractiveness in becoming more and more “banal”, while the country was dramatically impoverished. It is obvious that an important element of the rise of the British economy at the end of the nineties and during the first years of the century has been the solidity of the pound. So, from this point of view, the UK would take interest in joining the euro area in order to benefit from a solid currency.

Secondly, and this element is closely linked to the previous, the size of the recession and the expenses already engaged for rescuing banks will cause a massive deterioration of the fiscal position (a deficit of 8% of the GDP is forecasted for 2009). A part of this deterioration is perhaps temporary if the government manages in the future to sell its shares in banks capital provided the situation of these banks improves. But during a relatively long period the UK will be in a delicate situation vis-à-vis the markets and could suffer from a heavy downgrading of its signature with unfavourable consequences for the long-term interest rates. Such an evolution would be of course softened if the UK could benefit from the euro shield.

In addition, it could be argued that an accession would give the exchange rate anchor which the UK has missed since it left the EMS, and has obliged the central bank to implement a special monetary policy with interest rates permanently higher than in the euro zone.

Finally there are relatively strong arguments in favour of a UK accession, furthermore since the crisis, whatever its conclusion, will probably contribute to reduce the relative importance of the financial sector in worldwide activity and, in this way, weaken the UK specificity.

But there are arguments against a UK accession. The first is that the country does not, by far, respect the criteria, especially in the fiscal field. The second is that it would be very difficult to determine what could be the good exchange rate of the pound against the euro. The third is not politically very correct but is obvious: even if a British government succeeded in convincing financial circles and the opinion of joining the euro zone, it is not assumed that the

euro member states would be enthusiastic about this prospect (even if they declare they would be very pleased), as the off norm character of the UK could create governance problems in the Eurosystem and perhaps, considering the importance of the London financial centre, reassess the widely decentralized framework of the monetary policy implementation.