

## **The euro and enlargement: challenges ahead**

**Contribution by Athanasios Orphanides, Governor of the Central Bank of Cyprus**, to the panel discussion at the 5<sup>th</sup> ECB Central Banking Conference

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I appreciate the opportunity to participate in this panel on the euro and enlargement. Coming from one of the smallest new member states of our great union, and one that has just joined the euro area, I feel that we are well acquainted with the potential benefits of completing the journey towards our economic and monetary union as well as the challenges presented along the way. In my remarks, I will share with you some thoughts on this issue, drawing on our perspective and experiences. Before I proceed, I should note that these thoughts are my own and do not necessarily reflect views of my colleagues on the Governing Council of the ECB.

As previous experience has shown, the new member states in the EU may find themselves confronted with a number of important challenges that test their economies in the run-up to ERM II and the adoption of the single currency. Apart from designing and pursuing the appropriate monetary and exchange rate policy that will eventually lead to the adoption of the euro, these challenges include strong consumption expenditure and significant credit growth following accession to the EU, higher inflation rates due to the convergence process, and destabilising capital flows triggered by interest rate differentials. The new member states may also be faced with inflated asset prices. As has already been exemplified, in order to mitigate the aforementioned challenges it is important for any new member state aspiring to adopt the euro to achieve a high degree of nominal and real convergence with the euro area before joining ERM II. Moreover, it is well established that the monetary and exchange rate regime in place and the response of a new member state to these challenges should not be seen in isolation from its initial starting conditions and historical/institutional evolution.

Regardless of the choice of monetary and exchange rate regime there are common challenges that the new member states will face on the road to euro adoption. A crucial role will be played by the initial conditions of the new member states. Per capita GDP and the general price level in the new member states are significantly below euro area levels. The very prospect of the catching up process presents a unique opportunity for raising the welfare of the citizens of the new member states but this is an opportunity that comes with challenges.

The initial level of development of a country, measured by its per capita GDP, and the speed of real convergence are the main determinants of relative inflation in the long-run---the Balassa-Samuelson effect. Therefore, the overall inflation rate in the new member states is expected to be higher during the catching up process. On the other hand, as the per capita income gap between the new member states and the euro area declines, we can expect the price level gap to decline as well. This price convergence can take place via a nominal appreciation of the exchange rate or via a relatively higher inflation rate, depending on the exchange rate regime.

Another major challenge for the new member states seeking to join the euro area is the considerable net capital inflows in the form of foreign direct investment (FDI) and portfolio investment. Most new member states have experienced strong non-FDI capital inflows encouraged by market expectations that these countries will join the euro area. In particular, they have been driven by initially higher domestic nominal interest rates and the expectation of yield convergence ahead of euro adoption, as well as by the favourable prospects for growth. In some new member states, these capital inflows continue to be the main source of financing, leading to a further build up of gross external debt as a proportion of GDP. Net inflows of FDI are also an important source of financing. In one case this constitutes about 20% of GDP. Compared with FDI, non-FDI flows may embody more serious risks since, among other things, they are sensitive to interest rate differentials and risk premia. In any event, the risk of a sudden stop in capital flows should be kept in mind by the governments of new member states. The aim should be to pursue prudent policies that minimise these risks and insure against the worst of possible outcomes. In the present environment of malfunctioning international capital markets and funding difficulties in banking, such risks have increased.

A related challenge is that of managing the potential for a rapid expansion of credit. Indeed, a number of factors have led to such an expansion in the new member states in the last few years. On the demand side, the initial low level of credit availability and indebtedness, the rapid output growth, the rise in income expectations and the increased market confidence associated with EU entry have led to a greater willingness of economic agents to take on debt. On the supply side, the development of the banking sector after privatisation and the welcoming of foreign banks have increased the lending capacity of the banking sector. At the same time, rising competition among banks resulted in strong incentives for banks to expand their lending to households. With low initial credit to GDP ratios which afforded greater potential for growth, this implied considerably faster credit growth during the transition to equilibrium. Indeed, credit to

households has risen the fastest in the five least developed new member states where the starting levels of credit were the lowest.

The fastest growing parts of the credit market have been household loans, particularly mortgage loans. The latter have been encouraged by deregulation in the property market, the rapid rise in property prices and expectations of further price increases which appear to have generated speculative buying, including by non-residents. Once again, the issue is how to properly pace the vast potential for welfare gains and the challenge for policy is how to prevent credit growth from becoming excessive, with the well known dangers of the resolution of the associated excesses.

Two other issues to take into account are whether the catching up process of the price level can be better managed inside or outside the monetary union, and whether the transition to the euro can be better managed with a floating or with a fixed exchange rate regime. Thus, the new member states are faced with the challenge of designing an appropriate exchange rate strategy that will eventually lead to the successful adoption of the euro. The EU position is that in the pre-accession phase no single strategy is prescribed. Accession countries are free to choose any regime they consider appropriate, ranging from a pegged exchange rate to inflation targeting.

We should acknowledge that alternative exchange rate strategies have different risks associated with them. However, recent experience has reaffirmed that successful adoption of the euro can be achieved with a number of these alternative strategies. For example, in the case of Cyprus and Malta, which joined the euro area in January of this year, the strategy was based on an exchange rate target. Although both countries used the same fluctuation band of  $\pm 15\%$ , Cyprus allowed the exchange rate to fluctuate within the narrow band of  $\pm 2,25\%$ , whereas Malta maintained the parity without fluctuations. In contrast, Slovakia, which is due to join the euro area on 1 January 2009, has relied on an inflation targeting strategy with wider variability in the exchange rate, tolerating fluctuations within a  $\pm 15\%$  fluctuation band around the central exchange rate with the euro. Apart from the primary focus of the strategy, both price stability and exchange rate stability vis-à-vis the euro need to be achieved for successful integration into EMU.

Regardless of the choice of the monetary policy and exchange rate strategies during the transition to EMU, proper assessment of the timing of euro adoption presents some challenges. The new member states should examine very carefully the consequences of either pushing for early euro adoption or postponing membership. On one hand, early

entry can provide the benefits of full membership of EMU. Delaying membership into the euro area risks exchange rate instability and should be avoided when a country is otherwise well-prepared to join. On the other hand, attempts to join before a country is ready can be problematic and it is useful to assess the risks from the perspective of where a country is in the catching up process. If the per capita GDP and price level gaps are still fairly large and the speed of catching up is fast, a country will have difficulty in controlling inflation once in the Monetary Union. Consequently, it might be advisable to postpone euro adoption until the gaps have narrowed.

Cyprus's aspiration to become a member of the EU started in the early 1990s and the debate as to which exchange rate policy would be the most appropriate was an important one. At the time, it was decided that the pursuit of an exchange rate strategy aimed at maintaining price stability through exchange rate stability was the appropriate regime that would lead to a smooth integration of Cyprus into EMU. This strategy involved linking the Cyprus pound to the ecu and later to the euro. Indeed, managing the exchange rate by pegging the Cyprus pound to a strong anchor delivered the desired price stability objective, in addition to high growth rates and low unemployment.

There are several critical elements for the success of this strategy. First, it was pursued by the Central Bank of Cyprus (CBC) with no devaluations even in the most adverse conditions. Thus, there was a clear and unambiguous policy stance which boosted credibility and facilitated future policies. The credibility of the CBC, reinforced people's belief in this strategy and thus anchored inflation expectations. Second, the authorities followed prudent economic policies for most of the time which ensured the sustainability of the regime. In this respect, the credit and current accounts served as warning indicators signalling possible threats to the sustainability of the fixed rate regime. Third, in cases of imbalances the CBC resorted to the temporary use of non-traditional tools such as credit ceilings. The strategy was also reinforced and augmented by the prudent monitoring of money aggregates and the judicious screening of external balances. In particular, the current account deficit was closely monitored and served as an indicator of nascent inflationary threats, with tightening measures being adopted when imbalances in the current account appeared to accumulate even under conditions where the short-term outlook for inflation appeared benign. Thus, even though a stable exchange rate was the operational focus of policy during the transition to EMU, risks to price stability were always closely monitored and measures taken to avert their materialisation.

In summary, during the run-up to ERM II and the adoption of the single currency, the new member states could experience challenges that might bring their economy into risk. To mitigate these challenges it is important for the new member states to achieve a high degree of nominal and real convergence with the EU economy before joining the ERM II. Even in the case of Cyprus and Malta, which had achieved a high degree of convergence, they still faced various challenges such as credit and housing booms and high capital inflows. During the transition period to the euro a crucial role will be played by the monetary and exchange rate regime that the countries follow. Nevertheless, it has been shown from the experience of the recent entrants to the euro area that regardless of the choice of regime, a country can successfully adopt the euro by displaying a strong commitment to following the appropriate strategies and having a clear agenda of reforms.

I would like to conclude by framing the issue at hand in a broader perspective. Ultimately, for the new member states, the challenges of successful completion of the journey towards the economic and monetary union are those of managing prosperity. Entry of a new state into the EU generates tremendous potential for wealth generation that should benefit all citizens of the union, both from old and new member states. The potential long-term benefits are arguably much greater for the citizens of new member states. It is an unavoidable element of human nature that new member state citizens may be impatient and wish to reap the full benefit that can be attained at the conclusion of the journey right away. The ultimate challenge for policy is to keep the long run perspective and not allow impatience to result in accumulating imbalances that would delay attainment of the goal.