The Prospects of Euro
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** The opinions expressed are those of the author, they do not necessarily represent those of the CNB.*

EMU is not an easy project

- **EMU took 30 years of negotiations**
- ***Why?***
- **It is not so straightforward to compare (political and economic) benefits and costs of having common monetary policy for Europe**

- **EMU rules are still re-negotiated from time to time**
- ***Why?***
- **There is a trade-off between equality (rigid entry criteria) and flexibility required by the fact that EMU is a dynamic project in which gradually 27 (and maybe more) countries are involved**

30 years of negotiations

- 1969 Werner Report (fix the exchange rates, Bretton Wood enough, no euro)
- 1971 Collapse of the Bretton Wood (new situation)
- 1979 European Monetary System (EMS) and ECU – to prevent volatilities
- 1989 Delors Report (new target: EMU)
- 1992 Maastricht Treaty
- 1998 European Central Bank (from EMI)
- 1999 Common monetary policy in place
- 2002 Euro (coins and banknotes)

Dynamic project

1999 11 countries joined (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain) that spent on average 31 years within the EU and 8 years by preparing for euro (See next table for details)

2001 12 members (Greece joins after 20 years spent within the EU and 11 years by preparing for euro)

2007 13 members (Slovenia joins after 3 years within the EU)

2008 15 members (new members - Cyprus, Malta - spent 4 years within the EU)

2011 17 members (Slovakia joins after 5 years within the EU, Estonia after 7 years)

Two major questions regarding EMU

- First, why did EU countries create EMU?
  - OCA formed arguments for EMU although it did not guide policymakers on practical level very well
- Second, when should a new EU member be let in and when should an adept country want to be let in ?
  - OCA guided mainly adept countries (national tests), but not so much entry tests (Maastricht)

- OCA = optimal currency area theory is a good analytical framework to answer them (various applications ...from general cost-benefit analysis to partial empirical estimates)

The simple cost-benefit analysis I

A list of benefits and costs	Benefits	Costs
Economic perspective	Lower transaction costs Lower financial risks (think also exchange rates)	Loss of independent economic policies (monetary and exchange rate)
Political perspective	International co-operation (instead of wars)	Loss of national symbol

The simple cost-benefit analysis

Enhancing factors:	Benefits	Costs
Economic perspective	High interdependence in trade+financial flows (think CR and SR in 1992) Low credibility of domestic currency (think Italy)	Weak adjustment mechanisms (weak mobility, weak flexibility, inflexible domestic fiscal policy, no fiscal federalism) A lot of asymmetries (think Finland versus Greece)
Political perspective	A history of non-operation that was costly (think two world wars)	National pride (think D-mark replaced with „teuro“) Differences in preferences

How was OCA used in practice ?

- **1960s pioneering phase**: OCA born
- **1970s cost-benefit phase**: benefits should exceed costs to join CA
- **1980s-1990s reassessment phase**: low usefulness admitted
- **Current empirical phase:** shocks and cycles measured

1969 Werner Report (no to euro)

1975-1986 period of Euro-pessimism (momentum of integration lost)

1989 Delors Report

1993 Maastricht criteria

1999 EMU

2001-2011 enlargement(s)

Arguments for EMU

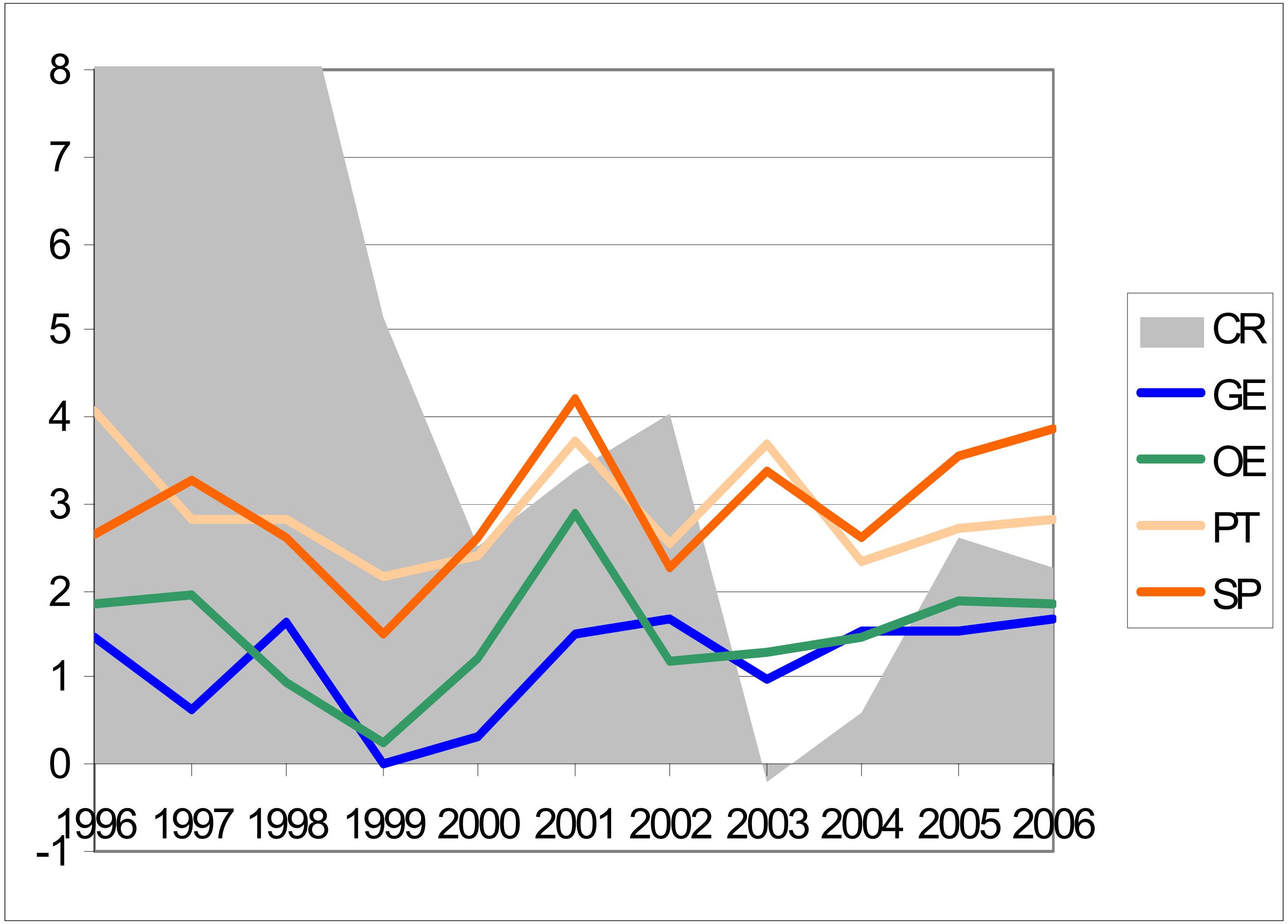
Not much support for Maastricht

Empirical support for national tests

Economic challenges

- EMU has to deal with serious economic challenges
  - lack of real convergence in medium-term
  - weak medium-term growth performance
- These challenges are structural, complex economic policies (or efficient markets) must find solutions to them
- They are not a direct consequence of euro, but euro made some „easy“ solutions inaccessible:
  - common monetary and exchange rate policy eliminate two potentially useful policies from the mix available to national authorities
  - euro created medium-term illusions of credibility (for PIIGS) and of growth prospects (recall the initial high expectations of the impact of euro on prosperity)

Inflation does not converge in EA

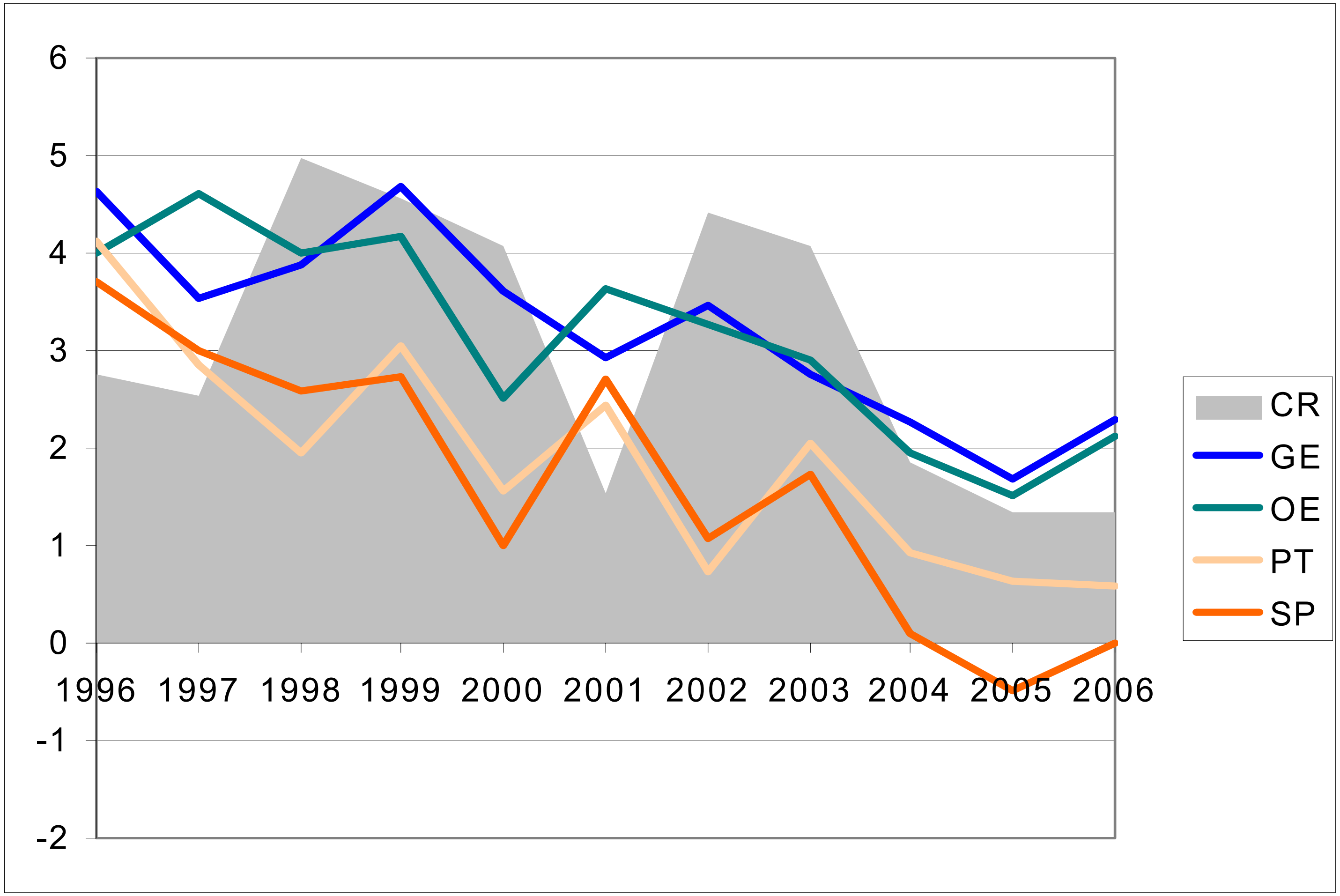


Two groups selected to illustrate divergence problem: high (Portugal, Spain) and low (Germany, Austria) inflation.

Note: CR only for comparison

Inflation rates (%)

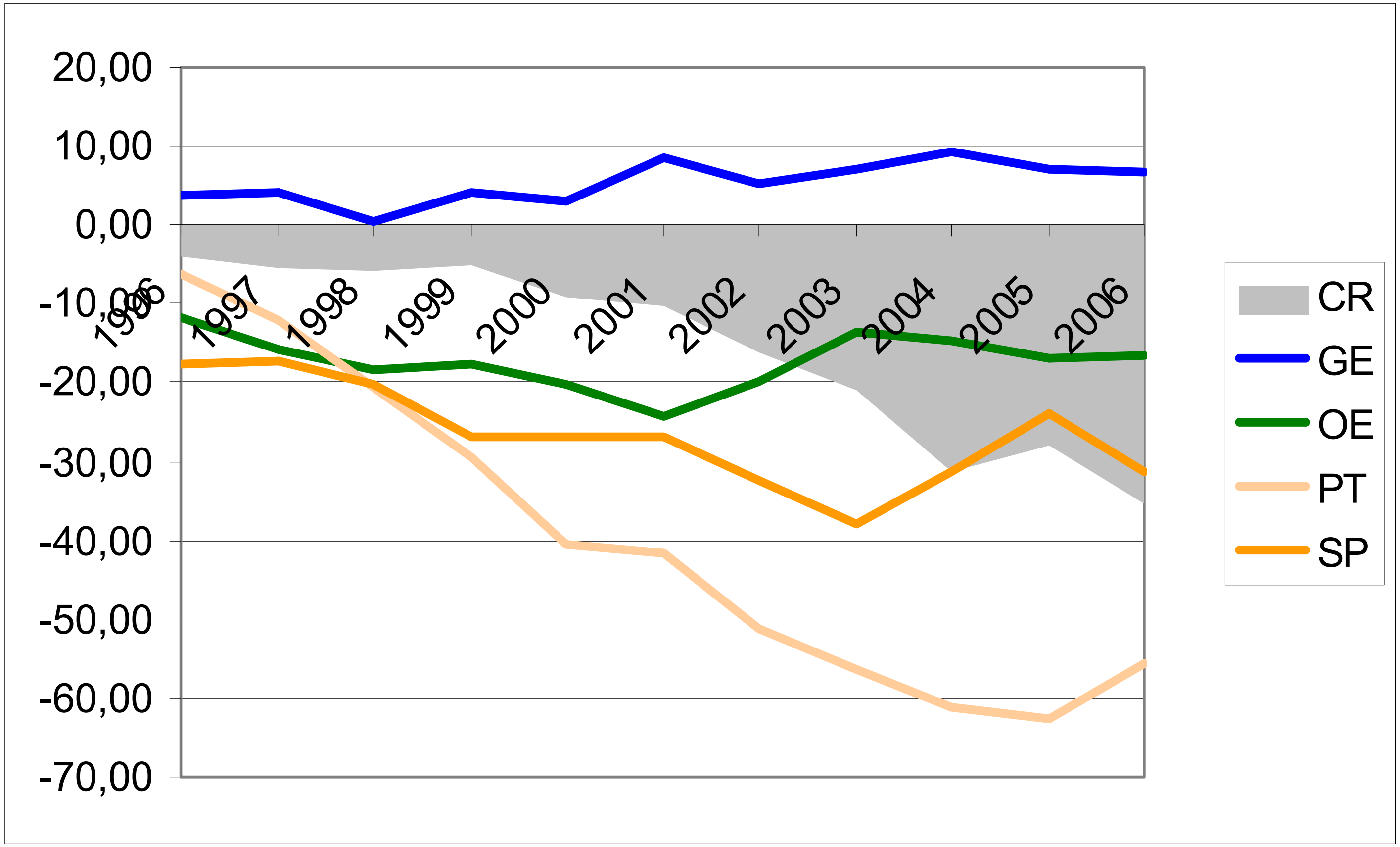
Costs illustrated: real rates



Real interest rates (%)

Two groups have different real interest rates.

Costs illustrated: indebtedness



Foreign debts (% of GDP)

- Foreign indebtedness differs as well
- Negative real rates lead to excessive borrowing

National decisions about euro

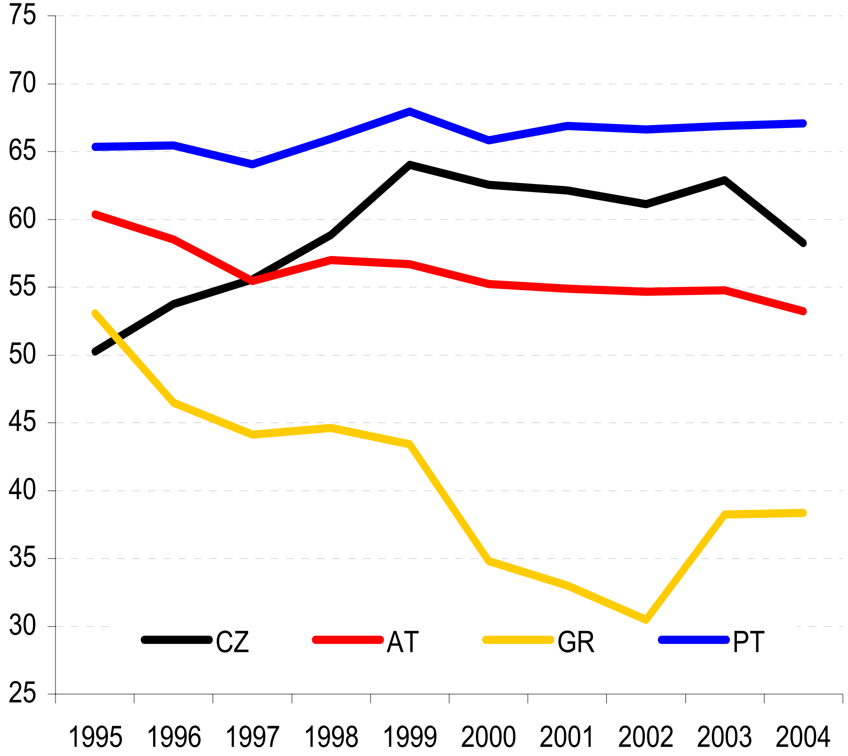
- Although researchers admit difficulties with measuring OCA, national decision-makers still need to decide when/if adopt euro
- Various countries adopt various approaches:
  - political decision without supplementary economic analysis
  - decision based on a set of „national tests“ that are broader than Maastricht criteria (pioneered by UK famous tests, applied also by the CNB)

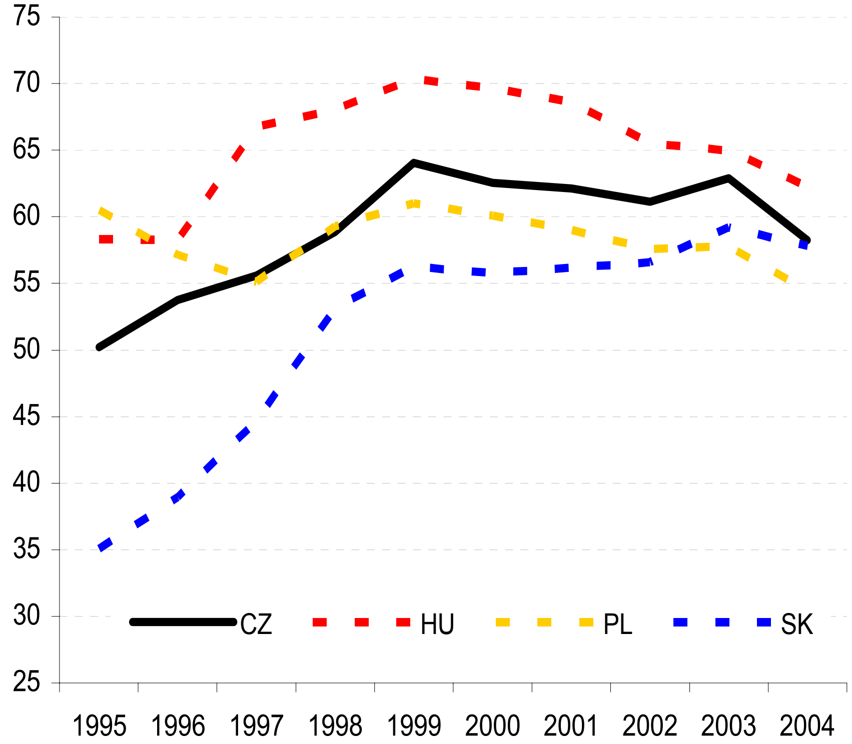
CNB reports

ANALYSES OF THE CZECH REPUBLIC'S CURRENT ECONOMIC ALIGNMENT WITH THE EURO AREA

- The CNB report is another example of document containing „national tests“ that are much more complex than Maastricht criteria
- Good example to see that decision not easy: some indicators give good argument for euro adoption (trade integration), some give good reason to wait (different cycles)
- That is why it is often claimed (also by critics of OCA): that euro adoption should be a political decision

Argument for: trade integration

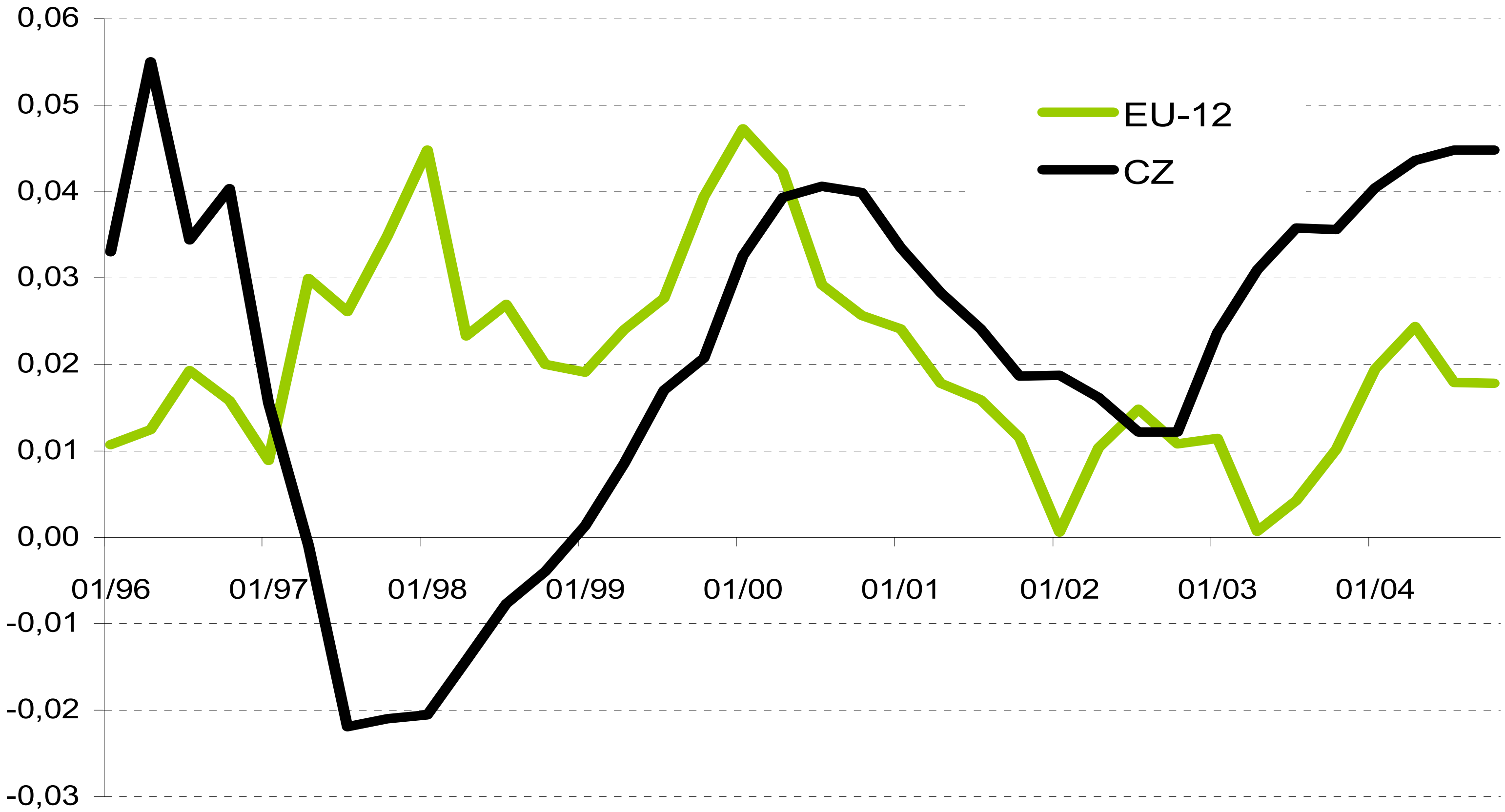




Zdroj: IMF (Direction of Trade Statistics), výpočet ČNB.

High share of EU-12 in Czech exports speaks in favour of the euro adoption

Argument against: different cycles



The Czech business cycle not much synchronized with the euro area, situation improves only slowly (output gaps)

Threats to EMU: lessons from history

- There are/were various monetary unions: U.S. (signed 1789), Germany (1870s), Italy (1860s), Latin monetary union (1860s), Scandinavian monetary union (1870s), Czech-Slovak monetary union (1993)
- Bordo, James (2008) analyze the most frequent causes for collapse of these unions:
  - political tensions (nationalism) that increased political costs of union too much
  - large exogenous shock (World War I) that caused members to diverge economically
  - incompatibility of two goals (price stability became less important, growth mattered more)

Summary

- **EMU was created due to arguments given by OCA, political benefits dominated**
- **Practical design did not follow OCA and this omission now complicates both enlargement process (Maastricht criteria do not correspond to OCA) as well as conducting credible monetary policy in the euro area**
- **Adept countries rely on national tests designed more in line with OCA and they get different conclusions than proposed by Maastricht**
- **The recent financial crisis made economic challenges more demanding**

Thank You for Your Attention!

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