The Euro at 10: The global financial crisis and Euro enlargement

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The Euro at 10: Two Lessons from the Crisis

- The Euro as a mechanism to help prevent and resolve crises.
- The Euro as a mechanism to promote continued institutional transformation
Crisis hitting Euro hinterland

- Withstood pressures remarkably long
- Now hit with full force: *not just any crisis*
  - Large currency movements, but no collapse yet...
  - Financial sector: deposit withdrawals + bank failures
  - Real sector: industrial production dropping
  - Fiscal capacity to respond limited
  - IMF packages (Hungary, Ukraine, Serbia, Bosnia...)
Growth model under attack

- Capital from rich to poor (19th century US)
  - Large current account deficits
  - Financed through FDI (and parent banks)
  - Unparalleled financial integration

- Remarkably successful
  - Sustained high growth rates
  - Unprecedented institutional transformation

- But also vulnerable to current crisis
  - Current account deficits, credit growth, parent bank funding...
Huge current account deficits, but...
Euro-wide institutions not kept pace

- Strong interdependence
  - Example: Baltic states and Swedish banks

- Regulatory and supervisory failures
  - "Home country rule" lacks legitimacy

- Western banks rescued at the expense of Central and Eastern Europe?
  - Deposit guarantees – "beggar thy neighbour"
  - Bailouts discriminate against subsidiaries
  - Sovereign-backing distorts competition
Euro+ as a crisis defence

- Centralised regulation and supervision only effective and legitimate solution
- Common non-distortionary and non-discriminatory rules for crisis resolution
- Common currency necessary to defend New European growth model?
  - But model extends beyond current EU members and current candidates...
The Euro as a reform instrument

- **Outside anchor** (Berglof and Roland, 2000)
  - Size of benefits and costs of membership
  - How far into the future?
  - Certainty that, if effort made, membership granted

- **Club-in-the club** (Berglof et al., 2008)
  - Threat of forming inner club increase effort of less reformed members in original club (Maastricht)
  - Actual formation of inner club costly: trade diversion and undermines political cohesion
Crisis strengthens Outside Anchor

- Perceived benefits/costs of membership
  - Currency stability more treasured, even though flexible regimes better for inflation before crisis
- How far into the future is membership?
  - Slowdown facilitates Maastricht compliance
- Uncertainty about outcome of assessment
  - Political momentum inside Euro area stronger?
  - Link between effort and outcome weakened?
Crisis reduces risk of "club-in-the-club"

Before crisis:
- Inner club could become permanent with everyone incurring costs of division and Euro hinterland feeling "left behind"

After crisis:
- Achieving Maastricht criteria easier
- Stronger support for Euro in candidates
- Greater willingness to enlarge as insiders realise the costs of division?
Inflation main problem

CPI growth yoy

- Bulg., Baltics
- Croatia
- Slovak Republic
- Czech Republic
The Euro at 10: Lessons from the crisis

- Lesson 1: An enhanced Euro+ can help prevent crisis and mitigate cross-border spillovers of bank rescues
- Lesson 2: The crisis can strengthen Euro as a mechanism to promote continued institutional transformation