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AVOIDING A NEW EUROPEAN DIVIDE

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SUMMARY The financial crisis, which is now hitting the new member states severely, highlights the shortcomings of the existing institutional architecture in Europe. Current strains reflect a revaluation of risks but they also result from policy mistakes. For many years, growth in the new member states has relied on massive inflows of foreign capital that are now beinghas reignl te

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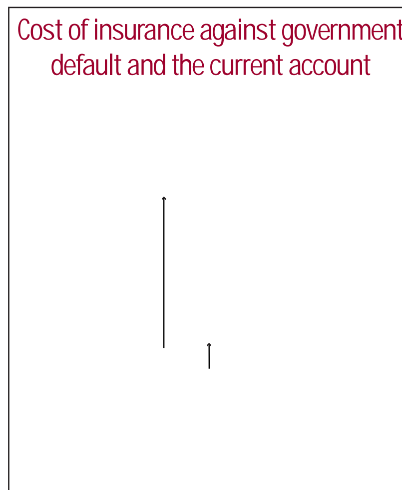
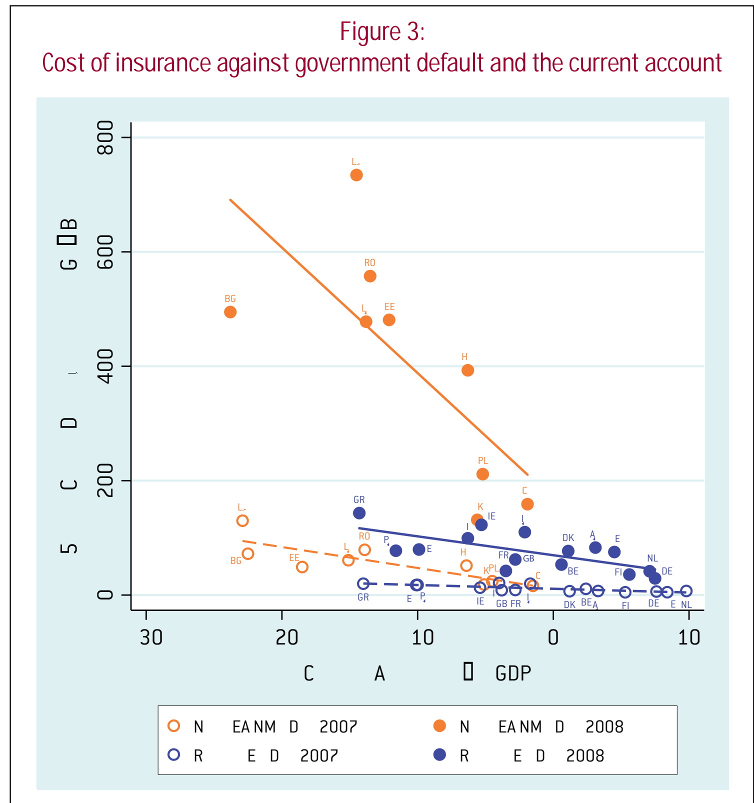

Cost of insurance against government default and the current account

Source: see Figure 3.

Figure 3:
Cost of insurance against government default and the current account



Note: A credit default swap (CDS) is a credit derivative contract between two counterparties. The buyer makes periodic payments to the seller, and in return receives a payoff if the underlying

could either be a rational response to deteriorating economic conditions in the new member states, or a result of commitments to maintain or increase credit in the home country as a counterpart to public recapitalisation.

Restricted access to euro liquidity. The near-paralysis of the euro-area interbank money market implies that (especially non foreign-bank owned) commercial banks in the new member states were largely cut off from euro liquidity. Domestic central banks could have provided euro liquidity through drawing on their foreign currency reserves, but in times of crisis, this is not deemed sensible.

Currency denomination of government bonds. The list of securities eligible for ECB refinancing does not include local currency-denominated bonds issued by the governments of the non euro-area new member states. While this was a perfectly natural provision when the European money markets worked smoothly, the liquidity shortage has made it unattractive for euro-area financial institutions to hold non-

foreign-currency borrowing attractive. Since the real exchange rate of new member states' currencies was expected to appreciate as a consequence of catching up, it was rational for those households and corporations that could manage any short-term exchange-rate fluctuations to take on foreign currency loans.

Looking ahead, a lesson from the crisis is that foreign-currency borrowing is a side-effect of financial integration that involves significant risks. Provided it is done in a non-discriminatory way, limiting the risks by containing such borrowing can be regarded as a legitimate policy objective.

Euro-area enlargement

Ten of the 12 new member states could by now have joined the euro area, had they met the admission criteria[1]. In fact, by January 2009, four of them will indeed be part of the euro area. Some of the others – Poland for example – have made the deliberate choice to postpone membership. Others were rejected (Lithuania) or discouraged from applying, and the EU can certainly be criticised for clinging to criteria ill-suited to catching-up countries (Pisani-Ferry *et al* 2008, Darvas and Szapáry 2008). Generally, neither euro-area governments nor European institutions expressed a wish for speedy euro-area enlargement. So the blame, if any, for slow euro-area enlargement must be shared.

External stability concerns would suggest early euro-area entry: being inside a large currency area helps considerably for small open economies in times of crisis. But the experience of the Czech Republic and Slovakia, two countries that have both maintained macroeconomic stability, shows that such concerns are primarily relevant for countries that have accumulated domestic vulnerabilities.

As for long-term growth and macroeconomic management, the crisis has also provided a new perspective.

On the one hand, if the operation of financial markets and capital flows normalises in the near future, then the argument that speedy euro-area enlargement may not be in the best interests of fast-moving catch-up economies will prevail (Darvas and Szapary 2008). Entering the euro area while the price catch-up is still far from complete may result in an excessively low real interest rate, which may in turn favour excess investment in property or unproductive capital. A severe adjustment crisis is possible within the euro area, too, as indicated by the case of Ireland and Spain (Ahearne *et al*, 2008) and Portugal.

On the other hand, for countries not in the euro area, the crisis has called into question the sustainability of relying excessively on capital inflows. The risk that these inflows will diminish in the foreseeable future has increased substantially. Countries whose domestic investment is heavily financed by capital inflows will hence face the dilemma of either staying out of the euro area and risking low growth, or entering the euro area and facing the risk of boom and bust cycles. There is no clear-cut and one-size-fits-all solution to this dilemma.

A special case applies to those countries in fixed exchange-rate systems. These countries are caught in a trap now. Given the large share of foreign-currency lending, an abandonment of the peg followed by sharp depreciation would have a devastating effect. However, under a fixed exchange rate the reduction in current account deficits made necessary by the reversal of private capital flows will probably imply severe recession, unless domestic prices and wages are sufficiently flexible. This macroeconomic dilemma is bound to dominate policy choices. It would not be solved by early entry into the euro area.

European surveillance

Finally, the current crisis highlights the shortcomings of the European surveillance system. EU institutions anticipated that, at some point, countries which had accumulated serious vulnerabilities would face severe adjustments and they did express concern, but the institutional framecominwork42(a

[1] This claim is not valid for Bulgaria and Romania, which joined the EU in 2007.