Preface

The end of the 2000s and the beginning of the 2010s was characterized by a severe economic crisis, starting in financial markets and spreading to the entire economy. In such unstable times questions like ‘Which factors have added to instability?’ and ‘What are the stabilizing factors?’ were raised by many an economist or policymaker. In answer to these questions the natural candidates include currencies or exchange rate regimes. Thus, the euro came under close scrutiny, not only with regard to the euro area as such, but also with regard to our neighbouring region, the Central, Eastern and South-Eastern European (CESEE) countries.

Among this group of countries, only Slovenia and Slovakia have managed to introduce the euro so far. The others are still on their way, debating the right timing, but also the most appropriate exchange rate regime up-front. These questions are inherent to the enlargement process of the European Union (EU), and are thus anything but new issues. But has the crisis changed the answers? Did we get new insights concerning the right speed and the necessary preconditions for euro adoption? It is not clear if euro adoption will speed up in the near future, or if countries may refrain at least for a while, as they have found the exchange rate instrument to be a valuable tool that helped them survive the crisis relatively well.

The answers may depend on the starting point, de facto on the initial exchange rate regime of the countries concerned. Fixed-peg and flexible exchange rates ask for different solutions. Among countries with pegged exchange rate regimes, the crisis reinforced the prevailing euro-adoption strategies. Euro adoption was perceived as a credible exit strategy propping up confidence (by residents and non-residents alike) in the pegs, and as offering a relief to liquidity constraints and eliminating exchange rate mismatches while not imposing additional challenges on economic policies. For countries with floating exchange rates, the crisis had highlighted the vulnerabilities coming from large fiscal deficits. However, euro adoption should not be seen as a quick fix to economic vulnerabilities, but rather as part of a broader long-term policy strategy. Membership in the euro area was enhancing resilience, but it had not eliminated the need to work out underlying imbalances.

Another aspect is the degree of euroization. In the CESEE region this is an important issue, and it brings a completely new element into the
The euro and economic stability

stability debate. Has the euro been a safe haven for households’ assets in CESEE countries before and during the economic and financial crisis, and will it be a safe haven in the near future? The answer to all three questions, provided by the Oesterreichische Nationalbank’s (OeNB) Euro Survey, is ‘yes’, in particular for South-Eastern European (SEE) countries. Although the SEE economies stabilized and prospered in the 2000s, the extent of euroization of households’ total financial assets still ranges from 31 per cent to 88 per cent in SEE. In particular, foreign currency cash holdings are an important component in households’ portfolios. However, this phenomenon is not a completely new one. One can draw several comparisons with dollarization, which we find in Latin America as well as in Central Asia. But euroization involves several special issues, given that introducing the euro as legal tender is definitely an aim for all CESEE countries, at least in the very long term. And in this respect, the introduction process must follow a certain path defined by the institutional framework of the Eurosystem.

Without any doubt the euro area has weathered the crisis storm quite well. Although failing to prevent the build-up of internal and external imbalances, the common currency had indeed cushioned the effects of global shocks in the euro area. Overall the euro was an important stabilizing element in this battle. But one has to acknowledge that the euro area is not completely homogeneous, or not as homogeneous as economic textbooks would imply. Still, after several years of unification the euro area has transformed itself into a solid conglomerate that is characterized by a certain degree of economic divergence. This is due to country-specific factors, such as different industrial and trade structures, more or less openness and different labour force qualifications. Also prices have converged only moderately within the euro area so far, which could be attributed to certain ‘reform fatigue’ among member states. Euro area member states shared a high degree of product market regulation with little improvement happening over the last decade. After all, some euro area members still find themselves in a catching-up process. For our focus on CESEE, the last point is the most interesting one. Analysing the euro area in this respect increases our knowledge of catching-up processes in general, but also helps us to better understand and support the ongoing convergence processes in CESEE countries. Learning from each other has always been an issue, but like with other sciences, we can learn even more when the whole system is under stress.

The banking sector played a central part in the catching-up process of CESEE. For more than a decade, financial deepening and financial intermediation were positive elements, supporting growth and driving the economy. Domestic and foreign investments, based on high credit growth,
were important factors; the foreign exchange component, which was (and still is) quite high in some of the CESEE countries, was risky, but under control.

In the crisis, Western banks found themselves in the middle of the storm, and irrespective of whether they had been instrumental in triggering and spreading the crisis or were its victims, they had to face enormous challenges in their home markets, and even bigger challenges in CESEE. The CESEE-related challenges were judged differently by the markets from one day to the other: prosperous countries which a bright EU or euro area perspective suddenly turned into risky emerging markets.

The mainly foreign banks weathered the storm quite well. In fact the banking system had been remarkably resilient, although some currencies had witnessed a sizeable depreciation during the crisis. Especially for economies with a floating exchange rate regime, an additional risk of foreign exchange fluctuation had been created by the high volumes of foreign currency loans granted in some Eastern European countries. The main strategy of the banks was not to pull out of the region and therefore not to destabilize markets and expectations further. In parallel, the financial support of several international and European institutions helped to stabilize the situation. These two elements and the supportive behaviour of many others – national economic policies to international investors – have prevented the worst. Still, banks would therefore have to adapt their business model accordingly. At least some of the most risky elements, such as foreign currency-denominated credits came under heavy debate, and regulators are looking for a new, more coordinated approach to react in an appropriate and timely manner, and to prevent circumvention right from the beginning.

Before the crisis, the argument that the introduction of the euro will sooner or later solve the problem was a common one. While this ‘wait and see’ approach may still seem attractive, it is no longer feasible. On the one hand, the crisis has shown that foreign currency credits add an additional risk to an already non-performing loans portfolio; on the other hand, some countries have postponed euro introduction even further. Therefore the crisis intensified the need for action.

This book, which is based on a Conference on European Economic Integration (CEEI) that the Oesterreichische Nationalbank (OeNB) held on the theme ‘The Euro’s Contribution to Economic Stability in CESEE’ in Vienna on 16 and 17 November 2009, addresses the specific range of issues mentioned above. In addition, it contains a more broad-based academic contribution from Paul De Grauwe. He points out the discrepancy between the causes of the current crisis on the one hand and mainstream macroeconomic modelling on the other: whereas the crisis had come about
as a result of inefficiencies in the financial market and economic agents’ poor understanding of risk, standard macroeconomic models which have become popular in recent years were based on the unrealistic assumption that agents are capable of using and processing all available complex information. Hence, these rational expectations top-down models, as Professor De Grauw refers to them, need to be replaced by what he dubs bottom-up systems, in which individuals understand only small bits of total information and apply simple decision rules.

Although these ideas are only a first step, they are quite important, as they prove that economic theory tries to find new paths and explanations for what is going on in our economies. This reassures us that theory and reality will come closer in the future, for the sake of preventing another global financial and economic crisis.

Ewald Nowotny
Peter Mooslechner
Doris Ritzberger-Grünwald