JOINING THE EURO ZONE: FROM THE PERSPECTIVE OF EMERGING EUROPE COUNTRIES

The more countries that suffer from credit-boom problem the more likely Polish policy makers are to draw appropriate lessons

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1. Introduction

Initially, the literature on the prospects of joining the euro zone by the Central Eastern and South Eastern Europe (CESEE) countries was focused on Balassa-Saumelson effect (BSE) that might increase the difficulty of meeting the Maastricht inflation criterion. Subsequently, the high rate of credit growth in the CESEE countries gave rise to a number of publications that investigated whether this phenomenon reflected financial deepening or a beginning of unsustainable credit booms. This paper suggests that the boom-bust cycles that occurred in

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several European countries will initiate the research on the architecture of banking supervision in Europe that should equip the CESEE countries with effective macro-prudential tools enabling them to shield their economies from unsustainable lending booms after joining the euro zone.

The remainder of the paper is organized as follows. Section 2 focuses on causes of boom-bust cycles in some euro zone countries. Section 3 highlights the role of massive foreign exchange lending to households in the CESEE countries as the major factor leading to unsustainable lending booms in the region. Section 4 focuses on the changing role of the banking supervision after the global financial crisis. Section 5 analyzes the choice of the exchange rate regime before joining the euro zone. Section 6 offers policy conclusions.

2. Boom-bust cycles in euro-zone countries

Before the creation of the euro zone, it was assumed that the competition in the common European market (so called *competitiveness channel*) would eliminate over time differences in member countries competitive positions within the monetary union. This turned out to be the case in a number of the euro-zone countries with the exception of Ireland and the Southern Cone member states. In Portugal, Spain and Ireland the erosion of their competitiveness positions within the euro zone resulted mainly from unsustainable lending booms in their economies.

The unstable lending booms were triggered by the combination of too optimistic expectations and a fall in real interest rates. The booms fuelled domestic demand and thereby tightened labor markets, which – despite the mechanism of price competition in the common European market – led to a relatively rapid growth in unit labor costs (ULC). The lending booms were reinforced by the negative feedback loop between the high rate of growth in credit and the fall in real level of interest rates that entered negative territory in case of Ireland and Spain. The lending booms produced inflationary differentials that resulted in long-lasting deterioration in the competitive position of the Portuguese, Spanish and Irish economies. The important reason for the rise in ULC in Spain and Ireland were the low rates of their productivity growth as the increasing share of economic resources was absorbed by the construction sector characterized by low productivity.

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The structural factor that gave rise to unsustainable lending booms in the euro zone countries was the earlier shift in the banking industry activity towards the consumer lending. This resulted from the development of the corporate bond market and the technological change in banking.

The development of corporate bond markets made it cheaper for large companies to borrow directly from capital markets. This is because mutual funds tend to accept lower yields on corporate bonds since unlike banks they do not have to bear the costs of managing the risk that is transferred to customers. Accordingly, the development of corporate bond markets narrowed banks’ possibilities to lend to large companies. Banks had to seek for other sources of income. One of them was consumer and mortgage lending.

The shift toward consumer and mortgage lending was facilitated by technological change, because new information technologies made it possible to collect and process large amounts of data. This enhanced banks’ capacity to estimate probability of defaults for different groups of households. The above-outlined changes made it possible the arms length lending and mass “production” of standardized consumer and mortgage loans.

The rapid growth in consumer and mortgage lending was funded through securitization and wholesale borrowing on global interbank money market. The increased use of external funds facilitated unusually long-lasting lending booms. Between 2004 and 2008, the net borrowing of Irish banks from abroad increased from 10 to 60 percent of GDP. The growing use of external wholesale funding was possible due to globalization of financial markets and the loophole in banking regulation that allowed banks to finance long-term mortgage loans with short-term deposits.

The unsustainable lending booms resulted in demand-led real convergence. In Portugal and Spain GDP per capita was continuously growing in relation to euro zone average levels, but at the cost of decelerating rate of productivity growth. The lending booms thus played an important role in the widening of

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competitiveness differentials within the euro zone that originated from the lack of coordination in social, fiscal and wage policies\(^\text{12}\).

The lending booms were accelerating GDP growth and thus downplayed the need for structural reforms\(^\text{13}\). Another factor that delayed structural reforms in countries experiencing lending booms were the increased revenues from property taxes that contributed to budget surpluses in Ireland and Spain. This was giving the impression of very prudent fiscal policies conducted by both countries\(^\text{12}\).

There was a substantial difference in the regulatory response in Ireland and Spain to the lending booms. The Irish supervisory authorities did not change much its supervisory policy despite the large scale of the boom and the rapid deterioration in banks’ lending standards\(^\text{15}\). In contrast to that the Spanish supervisory authorities implemented a substantial change in the banking supervision by introducing the dynamic provisioning system. They adopted this measure despite harsh criticism coming from Spanish banks which complained that such a policy worsened their competitive position against foreign banks\(^\text{16}\).

The actual outcome of the new system was that it helped to secure stability of the Spanish banks after the outbreak of the global banking crisis, whereas the Irish government had to cover large losses of the banking sector. However, the dynamic provisioning system did not suffice to protect the Spanish economy from the damaging boom-bust credit cycle.

### 3. FX lending as the major source of lending booms in CESEE euro-accession countries

As highlighted in the previous section, an important factor that contributed to long-lasting lending booms in Ireland and Spain was the growing use of external financing by banks in both countries. The same phenomenon occurred

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\(^{14}\) Lane P. R., Setting a Course for Irish Fiscal Policy, Economic and Social Research Institute, Budget Perspectives 2009 Conference, October 7th 2008, www.esri.ie

\(^{15}\) Honohan P., The Case of Ireland. Presentation for Bank of Slovenia conference Small Countries Coping with EMU, Ljubljana, October 26, 2006 www.bsi.si/en

in many CESEE countries taking the form of foreign exchange lending. From this point of view the CESEE region was unique among emerging economies.

In Latin America the strategy of Spanish, British and American banks’ subsidiaries was to use local funding. This created a situation in which the rate of growth in loans depended on the rate of growth in domestic savings. Such a strategy shielded Latin American countries from lending booms and prevented excessive dependence of local banks on foreign funding which was so detrimental during the currency crisis that occurred in Latin America at the beginning of the 1980s, in 1994 in Mexico, and in 2001 in Argentina. This time, the lack of dependence on foreign short-term funding protected Latin American countries from the global financial turmoil.

The strategy of international banks in the CESEE countries was, however, different. The high rates of growth in loans resulted from foreign exchange lending to household sector. Subsidiaries of international banks were funding their foreign exchange loans with credit lines provided by their parent banks and were borrowing extensively on the global foreign exchange swap market. This generated a strong dependence of the CESEE banks on foreign funding. After the collapse of the Lehman Brothers the global foreign exchange market came to a standstill. This had the effect of cutting off the CESEE banks from the foreign funding, which in turn led to credit crunches and pushed a number of the CESEE economies on the verge of a full blown currency crisis. Sharp depreciations of the CESEE currencies inflated the value of banks’ foreign exchange loan portfolios in terms of domestic currencies. This lowered sharply their capital adequacy ratios that added to the dramatic fall in bank lending.

Similarly to the previous experiences of developed countries, the structural factor underlying the high rate of lending to households in the CESEE countries was the shift in bank lending towards consumer and mortgage loans. This shift was initiated by foreign owned bank with strong retail banking expertise.

Like in Portugal and Spain the unsustainable lending booms accelerated demand-led real convergence also in the CESEE countries, as reflected in their GDP per capita catching up with a level of more developed countries. However, this was achieved at the price of relative deterioration of the CESEE competi-

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17 Canales-Kriljenko J.I., Coulibaly B., Kamil H., “The Tale of Two Regions. Foreign-bank lending to emerging markets during the global crisis different from continent to continent”, *Finance & Development*, March 2010


tiveness positions as the rapid growth in consumer lending produced overheating in their economies. The resulting tightening of labor markets led to a rapid growth in ULC growth, despite foreign price competition. The appreciation of the real effective exchange rates contributed to large current account deficits in a number of the CESEE countries. In particular, trade deficits in the Baltic states ranged from 10 to 15 percent of GDP.

The Baltic states have currency board regimes. Accordingly, monetary authorities in these countries could not prevent the development of the negative feedback loop between unsustainable lending boom and a fall in real interest rates. However, central banks in many other CESEE countries were also not able to control the rate of growth in loans. The reason was the rapidly growing share of foreign exchange lending to households. Central banks in Hungary, Romania and Serbia were increasing interest rate level, but this was only strengthening households incentives to borrow in foreign currencies. Thus, the massive foreign exchange lending led to a situation in which central banks in many CESEE countries effectively lost their control over the rate of growth in credit, despite they still possessed the autonomy to change the level of domestic interest rates. A similar process started also in Poland. However, the National Bank of Poland could control the rate of growth in credit as the volume of foreign exchange lending to households, accounting for 11% of GDP, was much lower than in many other CESEE countries.

In several CESEE countries, the authorities attempted to limit the scale of the foreign exchange lending to households. Nonetheless, as evidenced in the period preceding the recent crisis, the effectiveness of the adopted measures turned out to be limited, mainly due to the fact that foreign exchange lending was a part of international banks strategy in the region.

The depth of the banking crises that occurred in a number of the CESEE countries was so large that a number of international banks considered withdrawing from the region. This was avoided due to the so called Vienna initiative that resulted in agreement between the IMF and international banks in Bosnia, Hungary, Latvia, Romania, and Serbia. The agreement helped to shield the region from serious currency crises.

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22 Slawiński A., Lessons From the Euro Zone Experiences for the CEE Entrants, Argumenta Oeconomica, No. 1 (24) 2010


24 Andersen C., “Agreement with Banks Limits Crisis in Emerging Europe”, IMF Survey online, 28 October 2009
The negative experiences with foreign exchange lending to households in the CESEE countries call for a withdrawal of banks from such activity. International banks that are present in the region do recognize that foreign exchange lending brought about negative effects. In spite of that, they argue that they are not in a position to withdraw from extending such loans to households. They argue that the shortage of domestic long-term funding in the CESEE countries leaves them no other option but to rely on long-term funding from their headquarters. They also stress the possibility of “responsible” foreign exchange lending by offering their customers instruments possibilities to hedge against the exchange rate risk.

The above outlined attitude of banks reflects a real problem. There is indeed a shortage of domestic long-term funding in the CESEE countries. Households, however, even if they were offered an easy access to hedging instruments, would still not be willing to use them as the cost of hedging against the exchange rate risk is by definition equal to interest rate differential. A continuation of massive foreign lending to households would again limit central bank’s ability to control the rate of growth in loans in the CESEE countries.

The experiences of Spain, Ireland and the Baltic states show that, contrary to the previous literature assumptions, prudent fiscal policy and liberalization of labor markets are not sufficient to shield an economy from the risk of unsustainable lending booms. This emphasizes the necessity to equip supervisory authorities in the CESEE countries with a set of macro-prudential instruments that would effectively protect their economies from the risk of unsustainable lending booms, not least joining the euro zone.

4. The changing role of banking supervision

The boom-bust cycles that have recently occurred in so many countries have brought about a general consensus that supervisory policy should support monetary policy in shielding the economy from excessive rate of growth in loans.

In the period preceding the global banking crisis, the general approach to banking supervision reflected assumptions of the efficient markets hypothesis. It was assumed that prices reflected long-term rational expectations of economic agents. Therefore, risk premiums were to properly reflect the volatility of prices. This led to the conclusion that VaR methodology (measuring potential bank

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loses from volatility of market prices) adequately estimated the volume of capital that was necessary to hedge banks against insolvency risk. Thus, it was believed that the system of capital adequacy ratios was sufficient to preserve financial stability. Accordingly, it was concluded that the role of banking supervision was to control the adequacy of procedures adopted by banks to measure their risk (potential losses). It was also believed also that market discipline forced banks not to take excessive risks.

The adverse experiences with unsustainable mortgage booms in a large number of countries have shown that the main source of the systemic risk in the banking system is the procyclicality of bank lending. This has brought about a consensus that the main function of the macro-prudential policy should be preventing unsustainable credit booms.

The above mentioned conclusion is consistent with the proposal put forward by Charles Goodhart and Avinash Persaud. It links the capital adequacy ratios directly with the rate of growth in loans. The general idea is that Financial Stability Committee (FSC) in a given country (comprising representatives of central bank, ministry of finance and supervisory authorities) should assess an optimal rate of growth in loans under a given phase of a business cycle. The FSC would set such a target rate similarly as the Monetary Policy Council does for inflation, with the obvious difference that the target for rate of growth in loans would change with the business cycle. The FSC could increase capital adequacy ratio once there was a risk that the rate of growth in loans would rise substantially above the target level/band. Similarly, the FSC would lower the rate of capital adequacy ratio, if there was high probability that the rate of growth in loans would fall significantly below the target level/band. The Goodhart-Persaud proposal in fact recommends that supervisory policy be conducted in a similar way as monetary policy. The FSC would react to the deviations of the rate of growth in loans from the target level in a similar fashion as the MPC react to deviations of inflation from the target.

The critics of the Goodhart-Persaud proposal focused mainly on uncertainty of models that would be used to assess the unobservable variable of an optimal rate of growth in loans. A likely mistake, they emphasize, may result in decisions on changes of the capital adequacy ratio that might actually exacerbate, rather than mitigate procyclicality of credit growth. However, it is worth to remind that a very similar argument was used many years ago by Milton Friedman who was convinced that bank should not use interest rate policy in an active way due to uncertainty about the exact level of natural unemployment.

27 A Possible Macro-prudential Approach, British Bankers Association, 21 February 2010
rate. Nowadays, however, uncertainty no longer prevents central banks from taking decisions, despite the benchmarks for their decisions being forecasts of GDP and inflation as well as estimates of unobservable variables such as potential rate of economic growth, natural rate of interest or equilibrium exchange rate.

In July 2010, the Basle Committee on Banking Supervision proposed a tool that would allow to use capital adequacy ratio in a way similar to that proposed by Charles Goodhart and Avinash Persaud. Supervisory authorities would have a mandate to increase the capital adequacy ratio once the credit to GDP ratio would deviate substantially from a long-term trend. The credit-to-GDP gap was chosen as a benchmark for calculating additional capital requirements as it proved to be a powerful predictor of banking crises.

The implementation of the BIS proposal would provide new opportunities to use macro-prudential tools to shield economies of different countries from unsustainable lending booms. However, the experiences with dynamic provisioning in Spain illustrate that additional capital requirements might not be sufficient to avoid unsustainable lending booms. Thus, the Spanish experience calls for a dynamic use of additional supervisory instruments such as caps on loan-to-value, loan-to-income and debt-to-income ratios.

Characteristics of the unsustainable lending booms illustrate that they are mostly a local phenomenon. This stresses the need to provide local supervisory authorities with discretion and possibility to use supervisory tools that would be tailored to domestic conditions and thus effective in preventing excessive bank lending. However, there is a risk that such a situation may not come to effect. The reason are the differences between the interests of international banks (capital groups) and the countries whose banking systems are dominated by subsidiaries of international banks. On the one hand, bank capital groups would like to be able to manage capital and liquidity at a group level. On the other hand, however, this might impair the ability of the host countries’ supervisory authorities to use appropriate supervisory tools to prevent excessive growth in loans. The solution to this conflict of interests should take into account the necessity to equip the host countries’ supervisory authorities with effective tools shielding their economies from unsustainable lending booms.

30 Countercyclical capital buffer proposal, BIS, Basel July 2010
5. The exchange rate regime and the risk of lending boom

The necessity to equip the CESEE countries with effective macro-prudential tools is an important issue related to their prospective euro-zone membership, because – as catching-up economies – they will be particularly exposed to the risk of negative feedback loop between lending boom and a fall in real interest rate after joining monetary union and delegating monetary policy autonomy to the ECB.

Catching-up economies undergo the process of real convergence characterized by a higher rate of productivity growth and a higher rate of GDP growth than in more developed economies. The higher rate of productivity growth results in (1) inflationary pressures stemming from the Balassa-Samuelson effect (BSE), (2) appreciation of the equilibrium exchange rate and (3) higher level of natural (equilibrium) interest rate than in developed countries. The higher rate of growth in GDP per capita brings about additional inflationary pressure stemming from the convergence of the domestic price level towards the price level in developed economies. If a catching-up economy runs a currency board regime or joins a monetary union, it “imports” interest rate policy from a country (region) whose currency serves as an anchor for a domestic exchange rate. Thus, its interest rate level decreases below its equilibrium (natural) level even if the only reason for the higher rate of inflation is the BSE (so called good inflation). Under such circumstances optimistic expectation may trigger an unsustainable credit boom.

This was the case in the Baltic states. Implementation of the currency board system gave rise to optimistic expectations, because initially it brought about stabilization of inflation and acceleration of economic growth. However, the resulting lending booms produced overheating in Baltic economies that triggered the negative feedback loop between the high rate of growth in loans and the fall in real interest rates. Increasing production, in order to satisfy the booming domestic demand, required that domestic firms paid higher wages. This accelerated the rate of growth in ULC, despite international price competition. Domestic firms had to pay higher wages once they wanted to take part in the booming domestic demand. The rise in ULC led to appreciation of the REER and a gradual loss of the international competitive position of the Baltic economies.

The Czech Republic experiences illustrate that floating exchange rate may be useful instrument in shielding a catching-up economy from a negative feedback loop between an unsustainable lending boom and a fall in real interest rate. The nominal appreciation of the Czech Koruna (resulting from the appre-
cation of equilibrium exchange rate) was containing inflation pressure stemming from the BSE and the convergence of the domestic price level towards that in the euro zone. The rate of Czech Koruna’s nominal appreciation was more or less in accordance with the strengthening of the equilibrium exchange rate. Thus, the exchange rate appreciation was neutralizing inflationary pressures stemming from the real convergence without harming competitiveness of domestic producers.

The Czech experiences show the exchange rate nominal appreciation of the exchange rate may help to control inflation and stabilize the REER at its equilibrium level, whereas the fixed exchange regime may trigger lending boom and a rise in inflation that produces excessive appreciation of the REER as evidenced in the Baltic states. The important benefit derived by the Czech Republic from a floating exchange regime was that nominal exchange rate appreciation enabled the authorities to keep the interest rate at a relatively low lower. The interest rate differential was narrow enough not to trigger household demand for foreign exchange loans as was the case in other CESEE countries.

Nominal appreciation of the Polish zloty also helped monetary policy authorities to increase the restrictiveness of their policy. Nonetheless, inflationary pressures remained too high to allow the MPC to reduce the interest rate to the level that would make foreign exchange rate borrowing unattractive for households. Thus, the appreciation of the Polish zloty was reducing inflationary pressure, but at the same time it was tempting households to borrow in foreign currency.

The experiences of the CESEE countries illustrate that floating exchange rate may help to reduce the risk of adverse effects stemming from a massive foreign exchange lending. However, once domestic inflationary pressures do not allow authorities to reduce substantially the interest rate differential the only effective option to shield an economy from the risk of unsustainable lending boom is to impose much stricter supervisory rules as regards foreign exchange lending than those used in the recent past.

6. Concluding remarks

The experiences of Portugal, Spain and Ireland illustrate that joining a monetary union may increase the risk of a negative feedback loop between lending boom and a fall in real interest. The experiences of the Baltic states illustrate that such a risk is larger in the catching up economies than in developed countries due to higher inflationary pressures caused by the Balassa-

35 Analysis of the Czech Republic’s Current Economic Alignment with the Euro Area, Czech National Bank 2009
Samuelson effect in the former and the convergence of their prices towards the level in developed economies. An additional factor increasing the risk of unsustainable lending boom after implementing a currency board or joining a monetary union is the higher level of natural rate of interest in emerging economies than in developed economies.

The experiences of the CESEE countries prove that foreign exchange lending erodes central bank ability to control the rate of growth in loans. This may result in unsustainable lending boom as evidenced by the experiences of these CESEE countries where commercial banks were massively extending foreign exchange loans. Due to the rising share of foreign exchange loans in commercial bank lending central banks in Hungary, Romania and Serbia effectively lost ability to control the rate of growth in loans, even though they did not have the currency board regime.

The experiences of Portugal, Spain, Ireland and many of CESEE countries demonstrate that giving up the autonomy of monetary policy may bring about demand-led real convergence at the cost of deteriorating competitiveness of a given economy, because inflationary pressures stemming from lending booms produce a rapid growth of ULC despite the international prices competition.

In the recent past it was assumed that once business cycle in a given economy converged with the business cycle in a monetary union, the costs of giving up the autonomy of monetary policy would be negligible. Such reasoning was supported by the assumption that these costs would be limited additionally due to the large pro-trade effect accelerating the convergence of business cycles\(^{36}\). Such reasoning was questioned, however, because pro-trade effects turned out to be substantially lowered than assumed previously\(^{37}\).

The recent boom-bust cycles in the euro zone and the CESEE countries have shown that there are the two potential cost of giving up autonomy of monetary policy: the first is the risk of unsustainable credit boom endangering financial stability. The second is the risk of deterioration of a country’s competitiveness resulting from demand-led real convergence that increases ULC. The experiences with unsustainable lending booms in several euro zone and many CESEE countries have also reminded that housing booms are often a local phenomenon due to a number of structural factors including differences in demographic trends. This stresses the necessity to use additional countercyclical tools that would replace monetary policy in “leaning against the wind” of credit booms in the euro zone candidate countries.


During the debate on joining the euro zone by Sweden it was proposed to establish an independent Fiscal Policy Councils that would conduct countercyclical fiscal policy. Nonetheless, it was underlined that fiscal policy, as a countercyclical tool, was much less flexible than monetary policy. Moreover, an attempt to establish such a body was considered to be politically very difficult (Calmfors 2003, Wyplosz, 2005). Nowadays, an increasing number of countries, including EU member states, have established fiscal councils or fiscal agencies. These institutions, however, mainly play an advisory and/or supervisory role and are not responsible for conducting fiscal policy.

The recent experiences of Spain, Ireland and the Baltic states have illustrated that even achieving fiscal surplus may not suffice to shield an economy effectively from the boom-bust cycle. Thus, the only effective countercyclical instrument that might replace monetary policy in protecting and economy from such booms are macro-prudential tools. The need for adopting such tools is especially important in emerging Europe accession countries, because their economies are undergoing a long-term real convergence process. Accordingly, for a relatively long period of time they will be exposed to the risk that inflationary pressures stemming from the real convergence will expose them to a negative feedback loop between a high rate of growth in loans and a fall in real interest rates.

The risks that unsustainable lending boom may pose to financial stability and competitive positions of the euro zone candidate countries are so important that the appropriate solution would be to implement Goodhart-Persaud proposal to use macro-prudential tools in a way resembling the conduct of monetary policy. Financial Stability Councils would then acquire an independent status similar to that of Monetary Policy Councils. The FSC would be responsible for identifying potential risks to financial system and the economy. It would set the target band for the rate of growth in loans adjusted for the phases of the business cycle. The FSC would change capital adequacy ratios and other supervisory tools (e.g. LTV ratio) in order to keep the rate of growth in loans within the target band. FSC’s minutes should be published as an important form of communication policy to explain to the public the rationale underlying the supervisory policy decisions. Hopefully, the mentioned BIS proposal to link capital adequacy requirements to the gap between credit and GDP rates of growth will initiate the above outlined, and much needed, evolution of supervisory policy.

38 L., Calmfors L., Fiscal Policy as Stabilisation Policy Tool in the EMU. Speech at the EPRU Network Conference on “International and Danish Economic Policy”, Copenhagen, 23 May 2002

39 Countercyclical capital buffer proposal, BIS, Basel July 2010
There were the two main factors behind the recent boom-bust cycles in some of the euro-zone countries. The first was the negative feedback loop between the high rate of growth in loans and a fall in real interest rate. The second was the growing use of external funding by local commercial banks. The same factors caused unsustainable lending booms in several CESEE countries. The Baltic states could not suppress the negative feedback loop between a high rate of credit growth and a fall in real interest rate because under the currency board regime they were not able to rise interest rates. However, unsustainable lending booms occurred also in these CESEE countries that had autonomy of setting interest rates, because effectiveness their monetary policy was impaired by a rapidly growing volume of foreign exchange loans. The recent experiences with unsustainable lending booms in several European countries demonstrate that the euro-zone accession countries should be equipped with a set of effective macro-prudential tools that would shield their economies from the risk of boom-bust cycles after joining the monetary union.