Preliminary and incomplete

Two Roads to the Euro:
The Monetary Experiences of Austria and Greece

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Speaking Notes

for the Second Workshop on Macroeconomic Policy Research, organized by The Magyar Nemzeti Bank in Collaboration with The Centre of Central Banking Studies (CCBS) of The Bank of England, Budapest, October 2-3, 2003.

- **Motivation**
- **Theoretical background**
- **Two unequal E(M)U Siblings: Highlights from the economic and monetary experiences:**
- **Stories to tell**
- **Insights for New Members?**

The standard disclaimer applies!!

1. Motivation

- **Enlargement impending; final monetary aim: adoption of the euro.**
- **How to get from here to there? Timing? Fast or Slow? Risks? Role of ERM?**
- **Any insights from current members?**
- **Austria and Greece: why? → "corner cases"**

Austria	**Rich; Quasi MU since 1981; Convergence leader**	**Currency board equivalent**
Greece	**Poor; Convergence latecomer - 1995: various M-targets + implicit e-target 1995 – 2000: e-target; 1998: ERM**	**Relevant for countries with very limited convergence progress**
Austria	**EU entry = ERM participation**	
Greece	**Not in 1st tier Only in 2001**	
Both countries:	**Political dimension GR also national security issues**	

- **Marry economic theory with practical experience**

2. Theoretical considerations

Arguments why MU/fixed exchange rates may be beneficial for SMOPECs; and why the use of exchange rate as a shock absorber is questionable

- **exchange rate variability and trade**

  + ST variability may reduce trade because of risks and costs; but LT misalignments possible (both under fixed and flexible exchange rates)
  + The close the trade relationship the higher the benefits of fixed exchange rates

- **OCA (trade) endogeneity**
  Answers to (1) conditions for forming MU
  (2) benefits and costs of MU
  + Traditional OCA criteria (synchronicity of shocks, labor mobility, and wage flexibility) perhaps need not be fulfilled *ex ante* (Frankel and Rose) but only *ex post*;

+ Fixed exchange rates foster trade, financial and business cycle integration (Mc Callum, Frankel and Rose)

- **<u>Import of credibility; central bank independence</u>**

  + Time inconsistency literature (Calvo, Kydland and Prescott); optimal polices are time-inconsistent; incentive-compatible institutional arrangements: → CBI

  + Credibility literature (Barro and Gordon); cheating policy makers are punished: Hence: tying one's hand can be beneficial.

  + If economy lacks internal discipline and strong institutions a hard currency option can be beneficial.

→ Overall more benefits and fewer costs of MU than postulated by traditional OCA (Hochreiter, Schmidt-Hebbel-Winckler).

3. Austria and Greece 2 unequal E(M)U siblings

Some salient features:

	AUSTRIA	GREECE	NEW MEMBERS
EU Membership	**1995**	**1981**	**2004**
ERM	**1995**	**1998**	**?**
Euro	**1999**	**2001**	**?**
CBI	**1816 (!!)**	**1995**	**< 2004**
Capital lib. Completed:	**1991**	**1995**	**< 2004**
1981 – 1992	**1981: Q-MU why fixed e?[1] 1981 – 1985: structural problems 1985 – 1991: adjustment**	**Stagflation; Av. Growth 1.5% Inflation ~ 20% budget def. ~ 11%**	
1992 – 1994: Transition Period	**Fiscal slippage; no speculative attacks**	**Further falling behind; 1st attempts to tighten**	
1995 – 1998 (2001)	**EU accession ERM, fiscal consolidation**	**Hard drachma policy ; ERM ; convergence**	

[1] 1. „fear of Floating"; „fear of inflation", "import of stability".

4. Stories to tell

- **from AT and GR perspective benefits of MU higher than traditional theory thought**
- **Exchange rate stability and trade integration**

  + AT + GR more open → see table 2

  trade creation and some trade diversion

  + Some association between exchange rate stability and the rise in the EU trade shares of both Austria and Greece likely.

- **Endogeneity of OCA theory.**

  + Recent work on trade endogeneity: positive relationship between trade integration and a *common currency*, i.e., trade integration beyond fixed exchange rates (Rose and van Winncop 2001). BUT: AT and GR: too early to tell

  + BUT other endogeneity properties: AT: story of the 1980s; despite asymmetric shocks and lack of labor mobility fixed peg held up: → wage flexibility!! GR: monetary and fiscal tightening, incomes policy, → more flexibility!!

- **Elimination of national monetary shocks**

Independent monetary policy may be mixed blessing!!

+ National monetary shocks, often an important source of macroeconomic disturbances.

+ AT: even before 1981 ATS was shadowing the DEM quite closely. → NO room for autonomous monetary policy! Still, AT tried up until 1979 ("policy of nominal interest rate constancy"). Heavy loss of forex reserves → policy abandoned.

+ GR: Up to 1995, use of monetary policy for domestic purposes: Hence: MS policy ultimate cause for macroeconomic disturbances → gain though fixed peg!

- **speculative attacks and credibility: Application of Svensson test to AT and GR**

+ calculate rate-of-return band consistent with credibility; short term (3-months) and long term (10-year government benchmark bond)

+ Results for AT → Graphs 1 – 3: no devaluation risk!

+ results for GR → Graphs 4 – 5: 10 i: credibility only 1999.

- **ERM Issues: Timing of Entry, Duration of Participation and the proper Choice of the Central Rate**

+ Timing of entry, choice of central rate, width of band, duration of stay, conversion rate issues: (formal requirement; waiting and training room approaches)
+ What is the equilibrium exchange rate? SR, MT, LR?

+ AT: entry with EU accession; central rate no economic problem; (political) choice of width of band; central rate = conversion rate.

+ GR: not in 1st EMU tier due to noncompliance with (ALL!!) convergence criteria; 1995: hard drachma peg; 1998: ERM participation after significant convergence efforts AND 2001 EMU entry FEASIBLE; choice of central rate (devaluation of prevailing market rate 12.3 %) also forward looking (B-S effect); no presumption that central rate would be conversion rate; normal band to facilitate disinflation and possible B-S effect; FINAL realignment 01/2000 (revaluation) with presumption that this rate is conversion rate. → credible strategy!

5. Insights for New Members

- **The Austrian and Greek experiences are in a sense "corner cases" for paths to the euro. Nevertheless, there are some striking similarities which might provide useful insights for the New Member States:**
- **There was the strong and enduring political commitment to move to EMU. It provided strong support to enact and maintain stability-oriented and Maastricht-conform economic policies.**
- **In both countries fiscal consolidation proved to be the most difficult aspect to satisfy the Maastricht convergence criteria. At the same time it is true, that up to 1995 economic policies in Greece were inconsistent with low-inflation healthy and equilibrated growth.**
- **For both countries the benefits of joining EMU outweigh the cost.**
- **Both countries provide an example that monetary policy credibility can initially be borrowed but in the end has to be earned.**

There were also important differences, both of which relevant for the New Member countries:

- **Austria provides a good example that a straight peg can run smoothly also in the context of a SMOPEC under conditions of free capital mobility.**
- **As regards ERM entry Austria is an example for successful participation when the length of stay was initially uncertain. Greece is an example for joining the ERM at a time when convergence was already partially achieved and the endpoint in sight. Hence Greece chose a rather brief duration of 2 ½ years.**
- **While both countries opted for the standard band of +/- 15 per cent, Austria never had the intention or need to use it. For Greece using the wide band was important to be able to support required further disinflation and to consider the (equilibrium) exchange rate effects of a catching-up country.**
- **The choice of the central and conversion rate for Austria (1995, 1998) was clear and uncontroversial. In Greece the central rate (1998) was selected without presumption that it would correspond to the conversion rate. Yet, in the realignment in 2000 there was a presumption that the new central rate would be the conversion rate!**

All in all, there are more than one ways to the euro but all have to follow the stability-oriented road.