

Avoiding a new European divide

By Zsolt Darvas and Jean Pisani-Ferry

Memo Questions & Answers

Why this policy brief?

There is a growing concern that the recent financial crisis and the way it was managed in the euro area, adversely affected the new member states that are not yet member of the euro area. In fact, over the past four months, new member States have often felt the euro area crisis management as biased towards the interests of the economies of the euro-area which could lead to a new economic and political divide if not properly addressed. The ECB, for instance, recently provided liquidity to Denmark

How did the crisis spread to central and eastern European countries so quickly?

The authors identify a series of transmission channels based on mitigating factors on the one hand, and amplifying factors on the other, which are useful to understand in the context of the euro area crisis management debate.

EU membership, foreign ownership of banks in new members states, **EU participation in multilateral crisis lending** and **repurchasing agreements between the ECB and central banks** are identified as mitigating factors making the spread of the crisis natural.

Amplifying factors include, for instance, **country-specific vulnerabilities** in terms of deficits, **uncoordinated sequence of deposit guarantee upgrades** from euro area governments or asymmetric liquidity and credit management between west and east, leading to restricted access to euro liquidity in the east.

Has the euro area helped in terms of economic stability during the crisis?

Yes. On page 5, Darvas and Pisani-Ferry show in a graph, depicting the credit default swaps of government bonds and current accounts, that belonging to the euro-area has been very beneficial in terms of economic stability during the crisis. Although there is an increase in terms of deficit all across Europe, the increase for new member states, not belonging to the euro, is alarmingly steep.

Do the authors then recommend changing the criteria to join the euro and go for early adoption?

No, early adoption of the euro is not recommended by the authors as it could create unwanted boom-bust cycles. Nor should the EU envision changing the criteria to join the euro. The authors take the opportunity to stress that joining the euro should remain a case by case scenario.

What should be the role of the ECB?

The authors believe that the euro area institutions need to recognise that the consequences of their actions are not confined within the limit of the currency area and should therefore take their broader effects into account when taking decisions.

Consequently, Darvas and Pisani-Ferry advocate for a larger spread of ECB responsibility across the non euro-area:

1. **Swap agreements.** The ECB should introduce temporary reciprocal currency arrangements (swap lines, Box 1, p...) with central banks of the new member states to provide them with euro liquidity against their own currencies, as it did for the Danish central bank and as the US Fed did for 14 central banks.
2. **Wider collateral.** The ECB should temporarily accept as eligible securities for its repurchase transactions with counterparties government bonds issued not only in euros, but also in the domestic currencies of the new member states.
3. **Avoidance of asymmetric credit constraints.** Supervisors should take the European interest into account when addressing banks with significant cross-border activities.
4. **Policy action within the new member states.** Central banks and governments in the new member states should prevent credit contraction and provide a strong fiscal boost where budgets allow.