The Monetary Integration of CESEE EU Member States: Achievements and Prospects

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1 Introduction

This article reviews the process of monetary integration of the ten Central, Eastern and Southeastern European EU Member States (CESEE MS[2]) that joined the EU in 2004 and 2007.[3] We take briefly stock of the developments during the half decade since the 2004 enlargement. We then sketch current monetary integration plans, also featuring recent policy discussions against the backdrop of the global financial and economic crisis. Subsequently, we discuss the readiness of CESEE MS that have not become members of the single currency area yet (CESEE-8; i.e. the CESEE MS without Slovakia and Slovenia) to adopt the euro in the future. Finally, we conclude with some reflections on the future course of monetary integration.

To set the stage, let us recall that the monetary integration process in the EU is rule-based. When entering the EU, the CESEE MS undertook to strive for euro adoption by meeting the Maastricht convergence criteria. These prerequisites for euro area accession focus on macroeconomic stability (low inflation and long-term interest rates, a sound fiscal position and limited exchange rate movements) and must be fulfilled in a sustainable manner. Substantial structural and policy convergence before entering the single currency area is important to cope well with adjustment and stabilization challenges upon euro adoption (Papademos, 2004).

The exchange rate mechanism II (ERM II), a multilateral arrangement of fixed but adjustable exchange rates with central parities to the euro and fluctuation bands, is an important element of the monetary integration setup: Two-year participation in ERM II without devaluation and severe tensions is part of the exchange rate stability criterion. Though not subject to formal preconditions, ERM II entry is preceded by a consensus-building process of all parties involved to ensure that subsequent participation in the mechanism is smooth. To this end, major policy adjustments need to be undertaken prior to ERM II entry, and fiscal policy has to be on a credible consolidation path.

The European Commission and the ECB each prepare convergence reports every two years and, upon the request of a Member State, in the interim as well. These reports serve to inform decisions on euro adoption which are taken by the Council of the European Union, based on a proposal from the European Commission, after consulting the European Parliament and after discussion in the European Council.

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[2] *Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.*

[3] *See also Tumpel-Gugerell's contribution "Challenges of Monetary Integration in CEE" in this issue.*

2 The Record

Of the ten CESEE MS, Slovenia joined the euro area in 2007 and Slovakia followed two years later. Both countries had entered ERM II in 2004 and 2005, respectively.[4]

When reviewing past developments, it is instructive to compare the strategies of Slovenia and Slovakia in the run-up to euro adoption. The following stylized features stand out:

– Both countries stayed in ERM II for a relatively short period (two and two-and-a-half years, respectively, until they entered the euro area). While Slovenia kept its nominal exchange rate to the euro very close to the central parity during that period, the Slovak koruna appreciated strongly (two sizeable revaluations against the euro).
– On the fiscal front, Slovenia followed an incremental consolidation strategy, benefiting from a relatively good starting position, while Slovakia underwent several years of substantial fiscal restraint to bring budget balances in line with Maastricht requirements.
– Apart from the stabilizing effects of a stable exchange rate, Slovenia used tripartite mechanisms as well as some moral suasion and indirect tax policies to dampen inflation. In Slovakia, in turn, the exchange rate pass-through contributed to disinflation, although (according to empirical studies) to a lower extent than the size of the appreciation would suggest at first sight (namely by less than 1 percentage point in the reference period).

The Baltic states also entered ERM II in 2004 and 2005, respectively. All three countries were targeting euro area accession along similar timelines as Slovenia and Slovakia. However, Lithuania's quest for euro area accession failed in 2006, as the country was found to have missed the reference value for inflation by a small margin and as the sustainability of meeting the convergence criteria was not seen as having been sufficiently ensured. The other two Baltic countries have recorded inflation rates above the reference value in recent years, which has thus far thwarted their euro adoption plans. Finally, the other CESEE MS have not entered ERM II yet.

3 The Current State of Play

Table 1 provides a static and thus backward-looking snapshot on the current convergence performance of the CESEE-8 countries.

At the current juncture, Estonia is the only CESEE-8 country that could possibly meet the convergence criteria numerically in the near future. Inflation is falling fast in the context of moderating energy prices and a huge negative output gap. Inflation projections both by the IMF and by the European Commission suggest that Estonia could reach the price stability criterion by the end of 2009. However, meeting the budget deficit criterion during the ongoing deep recession will not be easy at all, even though the country had recorded sizeable fiscal surpluses until 2007 and has enacted consolidation measures to the tune of almost 6 percentage points of GDP this year. The fiscal outlook beyond 2009 is uncertain, as further fiscal adjustment measures for 2010 and beyond are currently still under discussion within the government.

[4] *Furthermore, Malta and Cyprus joined the euro area in 2008, after having entered ERM II in 2005.*

Table 1

The Convergence Criteria and the CESEE-8 at End-July 2009

	HICP	Long-term interest rates	Ongoing EDP	Fiscal balance		Public debt		ERM II participation	
	07/08–06/09 vs. 07/07–06/08	07/08–06/09		2007	2008	2007	2008		months
	%			*% of GDP*				*yes/no*	*duration*
Reference value	*2.6*	*6.4*							
Bulgaria	7.3	6.5	**no**	0.1	1.5	18.2	14.1	no	
Czech Republic	3.3	**4.8**	**no**	–0.6	–1.5	28.9	29.8	no	
Estonia	5.8	n.a.	**no**	2.7	–3.0	3.5	4.8	**yes**	61
Hungary	4.2	9.4	yes	–4.9	–3.4	65.8	73.0	no	
Latvia	10.0	9.3	yes	–0.4	–4.0	9.0	19.5	**yes**	51
Lithuania	8.6	10.5	yes	–1.0	–3.2	17.0	15.6	**yes**	61
Poland	4.0	**6.1**	yes	–1.9	–3.9	44.9	47.1	no	
Romania	7.0	8.8	yes	–2.5	–5.4	12.7	13.6	no	
Memo item:									
Euro area	*1.8*	*4.1*		*–0.6*	*–1.9*	*66.0*	*69.3*		

Source of fiscal and debt data: European Commission, Spring 2009 Forecast.

Note: Bold letters indicate that the criterion was numerically met at the given time.
Given its minimal public sector debt, Estonia has not issued a long-term government bond.
The table does not capture sustainability issues, the full spectrum of exchange rate stability aspects or legal convergence matters.

In Poland, euro adoption has become a focal point of the political debate since the fall of 2008, when the Polish government stepped up its efforts to prepare for euro adoption by 2012. This target date would have implied ERM II entry around mid-2009 (i.e. two years before the convergence assessment). The government has been trying to forge a consensus about the constitutional changes needed to achieve full legal convergence already before ERM II entry. So far, this consensus has, however, not been reached (and this might only change after the next parliamentary elections due in 2011). In the spring of 2009, the government took a more nuanced view on ERM II, arguing that it would aim at entering the mechanism once the global financial and economic crisis and the related exchange rate volatility have subsided to some extent.[5] At the end of July, the government effectively abandoned the 2012 target and announced that a revised plan for the adoption of the euro would be presented at a later point in time. The present downturn puts considerable stress on Polish fiscal accounts, as everywhere in the EU. The EU has opened an excessive deficit procedure (EDP) for Poland and has set a target date of 2012 for correction. If Poland made full use of this period and complied in 2012 (while fulfilling all other criteria at the same time), it could introduce the euro in 2014 at the earliest. While the Polish authorities are committed to reducing the deficit to below 3% of GDP by 2012, they hope to achieve this target earlier. At

[5] *The governor of Narodowy Bank Polski (NBP) takes a more pronounced "wait-and-see" position on the matter, citing global financial turbulence and exchange rate volatility as the main reasons for delaying ERM II entry. In early 2009, the NBP put out a comprehensive analytical report on the future accession of Poland to the euro area, which came to the broad conclusion that, overall, Poland would benefit from entering into the monetary union.*

any rate, a narrowing of the deficit will also be necessary to keep public debt safely below 60% of GDP.[6]

In late 2008, the Hungarian authorities also expressed the intention to get ready for ERM II entry (and speed up the process toward euro adoption), but macroeconomic fragility has stopped them, for the time being, from moving ahead on this track. More recently, after a new cabinet had taken office, the finance minister said that decisions on ERM II entry would most likely be made only by the next government, which is to take office mid-2010. Despite substantial achievements in fiscal consolidation in recent years, the budget deficit is still above 3%, and the EU has set a revised deadline of 2011 to correct the excessive deficit. Moreover, Hungary records public debt levels well above 60% of GDP.

Bulgaria had already in 2007 attempted to build a consensus for ERM II entry, but was not fully successful, given large and widening imbalances at the time. The country is considering renewing efforts, as macroeconomic disequilibria are narrowing substantially. Bulgaria has recorded fiscal surpluses in recent years and intends to keep its budget broadly balanced also in the current downturn.

The Czech authorities annually evaluate the country's readiness for future euro adoption. In past years, these assessments were not yet sufficiently supportive to move ahead with monetary integration and thus, as a first step, to prepare for ERM II entry. The next such evaluation is due in the fall of 2009. As in other countries, the current recession weighs on the fiscal accounts. The most recent fiscal outlook of the Czech finance ministry, released in May, projects budget deficits well above 3% of GDP up to the end of the projection horizon of 2012. This would imply euro adoption in 2015 at the earliest, provided that the excessive deficit is corrected by 2013 (and all other criteria are met).

Romania, in turn, plans to accede to ERM II in 2012 and to the euro area in 2015. This monetary integration strategy has already been in place for several years and has not been substantially revised since. Romania also belongs to those CESEE MS that are currently under an excessive deficit procedure, with 2011 set as correction deadline.

Inflation has started to moderate substantially in Latvia and Lithuania and could fall to very low annual year-on-year levels by 2010. At the same time, fiscal imbalances are high, despite major efforts to rein in deficits. An excessive deficit procedure was recently opened for both countries, and the EU set deadlines for correction by 2011 for Lithuania and by 2012 for Latvia. The situation in Latvia has been further aggravated by temporary pressures on the peg of the lats to the euro and by banking sector turbulence. Like Hungary and Romania, Latvia is currently undertaking an adjustment and reform program under the tutelage of the IMF and the EU.

Table 2 provides a comparative perspective of the current ERM II and euro adoption plans of the CESEE-8 and indicates the exchange rate regimes presently in place.

[6] *Poland also has constitutional rules in place which foresee automatic adjustment measures if public debt goes beyond 50% and 55% of GDP, respectively.*

Table 2

CESEE-8: Current Exchange Rate Regimes, ERM II and Euro Adoption Plans

	Exchange rate regime	ERM II: Actual or planned date of entry	Target date for euro adoption
Estonia	Euro-based currency board	June 28, 2004	2011
Lithuania	Euro-based currency board	June 28, 2004	As soon as the criteria are met *(2013 at the earliest according to EDP deadline)*
Latvia	Peg to euro, unilateral ±1% band	May 2, 2005	As soon as the criteria are met *(2014 at the earliest according to EDP deadline)*
Bulgaria	Euro-based currency board	As soon as possible	As soon as possible
Czech Republic	Managed float, inflation targeting	2½ years before euro adoption	Currently no target date
Hungary	Managed float, inflation targeting	Not specified	Currently no target date *(2013 at the earliest according to EDP deadline)*
Poland	Float, inflation targeting	By end-2009	New target date will be announced in August 2009 *(full use of correction period under the EDP would imply not before 2014)*
Romania	Managed float, inflation targeting	2012	2015 *(in line with EDP deadline, i.e. not before 2013)*

Source: NCBs, convergence programs, EDP correction deadlines as set by the EU.

Note: Five of the eight countries covered in this table are currently under an excessive deficit procedure (EDP). The table indicates in italics the year in which the euro could be introduced at the earliest if the deficit is corrected in the year that has been set by the EU as a deadline for the correction of the deficit and provided that other criteria are fulfilled as well at that point in time. (Furthermore, it is assumed for this exercise that euro adoption will take place at the beginning of a calendar year).

4 The Implications of the Global Crisis for Monetary Integration

The global financial and economic crisis has put the risk of large exchange rate-generated shocks into the spotlight, a risk which had not received much attention during the very benign financial market environment until mid-2007. The renewed concern about such shocks was also fed by the considerable and, in some cases, paramount role that foreign currencies play in the denomination of financial assets and liabilities in most CESEE-8 countries (except in the Czech Republic). Consequently, major exchange rate shifts would likely have important implications for both macroeconomic and financial stability.

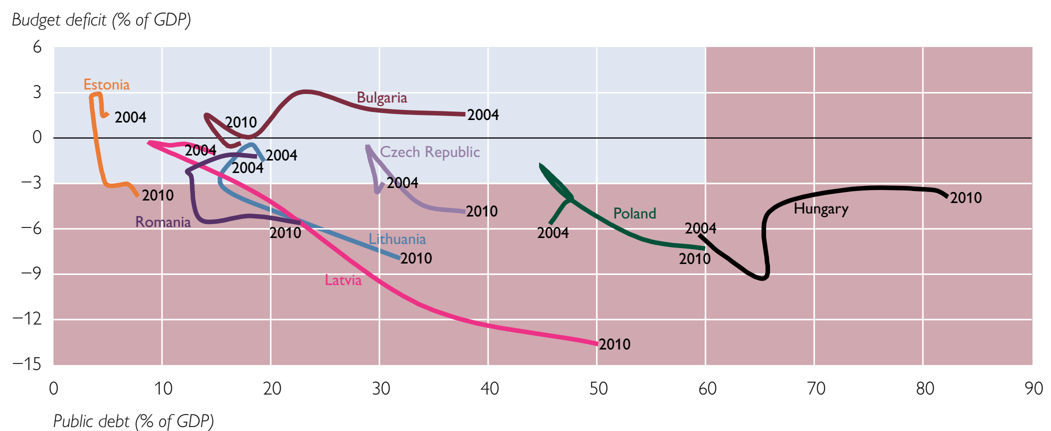
The arguments of the euro being an “umbrella” or “shelter” that protects countries from currency crises were particularly in vogue during late 2008 and early 2009 when most CESEE currencies, especially those with flexible exchange rates, came under strong pressure in a setting of very negative sentiment vis-à-vis CESEE countries. While the currencies softened substantially, there were no exchange rate collapses in CESEE MS despite the very harsh environment at the time. Since March 2009, risk aversion vis-à-vis emerging Europe began to moderate gradually, and CESEE currencies partially recovered as the EU, the IMF and other international financial institutions stepped up their support for CESEE countries and as global financial market conditions began to display tentative signs of some degree of stabilization.

At the same time, however, the deep real-sector ramifications of the crisis and their profound implications on fiscal balances became ever more visible. Headline fiscal positions in most CESEE MS had improved until 2007, in some cases until 2008. A closer look at past fiscal developments shows that favorable cyclical developments until 2008 had helped reduce headline deficits. Moreover, in a number (but not in all) countries, fiscal consolidation had been unambitious (especially in hindsight) and, in some instances, fiscal policy had even been procyclical during “good times” (Eller, 2009).

Since the fourth quarter of 2008, GDP growth has contracted sharply in CESEE MS from the boom levels recorded earlier in most countries of the region. Consequently, budget deficits soared and are projected by the European Commission to exceed the 3%-of-GDP level in 2009 in all CESEE MS but Bulgaria, with Estonia being marginally above this threshold. A further deterioration is forecast for 2010 (see chart 1).

Chart 1

Public Finances in the CESEE-8 from 2004 to 2010



Source: European Commission, Spring 2009 Forecast.

Note: The projections for 2009 and even more so for 2010 are subject to an unusually large degree of uncertainty. Moreover, they do not capture developments since April 2009 (revisions of growth projections, new fiscal measures). The Polish finance minister also argued that the GDP growth forecast underlying the fiscal projections had been too pessimistic from the outset.

It is noteworthy that most CESEE MS have not made substantial use of discretionary policies to stabilize their economies in the current downturn. Some CESEE MS have even engaged in procyclical fiscal contraction to retain or regain the confidence of international investors.

It will be a key challenge to reduce deficits to below 3% over the medium term, given that growth prospects after the current recession are rather subdued for several years to come for most CESEE MS, while unemployment will be substantially higher than in mid-2009.

This may again tip the balance of arguments and alter the timelines of prospective euro adoption in the public debate in CESEE countries. While immediate exchange rate concerns have faded somewhat, the perceived short-term costs of meeting the convergence criteria – in particular the budget criterion – any time soon have risen substantially.

5 Adjustment and Stabilization

To put the issues at hand into perspective, it is important to take a step back and ask what determines the performance of a country that is part of a larger currency area. At this point, structural and institutional characteristics come into play.

According to optimum currency area (OCA) theory, a country may take part in a monetary union with little cost while enjoying its benefits if it is exposed to similar shocks as the currency area as a whole. This is usually the case when business cycles are broadly synchronized, which is, in turn, promoted by similar economic structures as well as close trade (in particular intraindustry trade) and

financial integration. Should a country be exposed to idiosyncratic shocks, the costs of partaking in a currency union are limited if other adjustment mechanisms, in particular price and wage flexibility (as well as labor mobility), function properly and if fiscal policy can be effectively used to dampen short-term economic fluctuations. In addition, more recently it has been stressed that appropriate regulation and its proper enforcement[7] play a key role in preventing fluctuations from becoming overly large in the first place. Vice versa, participation in a monetary union would be costly for a country characterized by a high exposure to asymmetric shocks, weak microadjustment capabilities and poorly functioning macrostabilization tools.

Two additional considerations deserve to be mentioned: First, there is evidence (but no full consensus) that joining a currency union fosters integration and business cycle convergence, and thus dampens the exposure to idiosyncratic shocks (endogeneity of OCA criteria). However, the dynamics of such a process are difficult to anticipate and the path to the new steady state may well be protracted. This suggests the importance of functioning adjustment and stabilization mechanisms in the interim. Second, joining a monetary union is less costly if the effectiveness of autonomous monetary policy for macroeconomic stabilization is limited or if the exchange rate is a source of shocks rather than a shock absorber. Vice versa, the more effective monetary and exchange rate policy is as an adjustment tool, the higher the potential costs to give it up are – provided, of course, that an economy is exposed to idiosyncratic shocks in the first place and that other adjustment tools do not function sufficiently well.

How well suited are the CESEE-8 to monetary integration from these structural and institutional angles? Despite considerable cross-country variation, the following broad picture emerges:[8]

The alignment of the economic structures of the CESEE-8 with those in the euro area is fairly advanced, though with some differences at more disaggregated levels. The trade openness of the CESEE-8 is comparable with that of euro area countries of a similar size, and the euro area is the main trading partner for the countries under review here. Still, the trading partners of the Baltic states are somewhat more diversified as they comprise non-euro area Nordic countries and Russia. Intraindustry trade accounts for a substantial share of overall trade with the euro area for most CESEE-8 countries (except for Latvia and Lithuania). Financial integration has reached comparatively high levels across the region. Business cycle synchronization with the euro area is diverse, being more advanced in Hungary, Poland (and Slovenia) than in the other countries under review. Business cycle alignment decreased in a number of CESEE-8 countries after 2005. Essentially, this was due to the growth spurt that many countries of emerging Europe had experienced during recent years.

Empirical work on the degree of price flexibility in CESEE product markets is relatively scarce. Overall, inflation persistence seems to be broadly comparable with that in euro area countries, while underlying drivers may vary somewhat.

[7] *This not only includes prudential regulation and oversight of the financial sector, but more broadly also the abolition of regulatory incentives that may facilitate the buildup of asset price bubbles or excessive credit booms, or even the active use of regulatory disincentives. For a more detailed discussion, see Backé (2008).*

[8] *See Backé (2008) for a more detailed discussion and for numerous references to empirical studies on these issues.*

Price liberalization in the CESEE-8 is essentially complete, whereas in product markets there is room for further competition. Data on business regulations provide somewhat varied evidence across different sources. In very general terms these data show that the CESEE MS rank at intermediate levels, except for the Baltic states, which tend to score higher.

The flexibility of CESEE labor markets is diverse, ranging from intermediate to relatively high according to various empirical studies. There is evidence of wage flexibility at the micro level (studies are available only for a few countries), including at least some downward nominal flexibility. Labor mobility between the CESEE MS and other EU countries rose after 2004 despite continued temporary restrictions, before stabilizing again more recently.

As to stabilization policies, the room for fiscal policy maneuver is severely constrained for most CESEE-8 countries as a consequence of the mixed fiscal record and the blow that the current crisis exerted on fiscal balances (see previous section).

Furthermore, there is relatively little evidence in favor of the effectiveness of monetary and exchange rate policy for macroeconomic stabilization and shock absorption in the CESEE MS. Rather, the exchange rate has tended to be a source of shocks, according to several empirical studies, also in noncrisis times. Only in Poland, which is larger and somewhat less open than the other CESEE MS, does the exchange rate seem to have played some role as a shock absorber.

6 Concluding Remarks

Overall, the exposure to idiosyncratic shocks seems to be relatively contained for most CESEE MS, while market structures imply that there is some scope to adjust to such shocks through factor price movements. The susceptibility to asymmetric shocks is potentially more pronounced in the Baltic states. But markets there are also more flexible, allowing for greater microadjustment via prices and wages.

The current crisis has shown that budgetary positions in most CESEE MS need to be improved substantially over the medium term to enable the countries to use fiscal policy for macroeconomic stabilization. At the same time, major fiscal adjustments are currently being implemented, especially in Hungary and in the Baltic states. Empirical studies suggest that, in many countries, domestic monetary policy has displayed only limited effectiveness as a stabilization instrument, while the exchange rate has tended to generate rather than smooth out shocks. Thus, from a structural angle, the CESEE-8 would seem to be relatively well placed for a smooth future participation in the euro area. These countries should therefore have a clear incentive to proceed with their preparations for euro adoption and to make substantial efforts to this end.

The CESEE-8 will face multiple challenges on their way to the euro, in ensuring a high degree of sustainable convergence. Addressing fiscal imbalances is a paramount task, not only to qualify for euro adoption but also to be able to smooth cyclical fluctuations once the countries have joined the euro area. Ideally, fiscal imbalances would be addressed with the least impact on growth. This implies potentially substantial reshufflings of revenue and expenditure structures. At the same time, fiscal policy should provide essential support to those economic agents hit hardest by the current crisis and its aftereffects. Bringing public finances in order is a very hard and thorny task, given the abrupt reversal of many years of con-

solidation by the current crisis and the relatively subdued short- to medium-term growth outlook for many CESEE-8 countries.

In view of the challenges ahead, the monetary integration of the CESEE-8 is likely to proceed only gradually in the next few years. Mounting short-term costs associated with the implementation of macroeconomic and, in particular, fiscal adjustment may prevent a number of CESEE-8 countries from achieving a position in the foreseeable future in which they could reap the benefits of participating in a monetary union – benefits that would tend to be particularly tangible for small open economies that are highly integrated with the euro area.

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