Challenges of Monetary Integration in CEE

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1 Introduction

Since its creation in 1998, the ECB has taken a close interest in the monetary integration of accession and acceding countries. As early as November 1999, the Eurosystem organised a first high-level seminar on the accession process in Helsinki.[2] At that time, the ECB and the Eurosystem were considered to be far ahead of their time, since for most observers the accession process was still a distant and theoretical concept. In the meantime, accession has become reality, as evidenced by the two accession waves of 2004 and 2007. Two Central and Eastern European (CEE) countries (Slovenia and Slovakia) have in the meantime joined the euro area, and the three Baltic states have come to participate in ERM II.

Monetary integration consists of three distinct phases, which are nevertheless part of a continuum. The roadmap to the euro includes accession to the European Union (with the accession countries becoming members of EMU "with a derogation" upon entry), joining ERM II and the adoption of the euro. The first phase, EU membership, is subject to the fulfilment of the "Copenhagen criteria,"[3] which set the political, economic and legal requirements. Furthermore, entry into monetary union is subject to the Maastricht convergence criteria, and one of these criteria is related to ERM II membership.

This article is structured as follows: Section 2 recalls the ECB's preparations of the accession process up to 2004; section 3 discusses the experience with enlargement after 2004, section 4 touches on the prospects of monetary integration, and section 5 concludes.

2 A Look Back on the Preparations for Monetary Integration prior to 2004

The ECB conducted considerable analytical and policy work prior to the accession waves of 2004 and 2007, which resulted in a series of yearly high-level Eurosystem seminars on accession. In its work, the ECB was able to draw on the experience and knowledge of various national central banks, including the OeNB, which had built up a tradition of research and analysis of CEE.

In the discussions it was clear from the start that monetary integration into the euro area would be the natural endpoint of the accession process (e.g. no opt-out options would be provided). However, euro adoption is subject to the fulfilment of certain economic criteria, i.e. the Maastricht criteria laid down in Article 121 of the Treaty establishing the European Community. Strict adherence to these criteria is meant to ensure lasting convergence and a smooth participation in the monetary union.

The criteria are essentially defined in terms of sustainable convergence, requiring the achievement of a high degree of price stability, the sustainability of the government financial position, the stability of the exchange rate against the euro as confirmed by stable membership in ERM II for at least two years and the durability of the convergence achieved as reflected in the long-term interest rate levels. Understanding the need for nominal convergence is crucial, since in a monetary union, diverging inflation rates quickly become unsustainable, with the real

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[2] *See ECB (1999).*

[3] *As spelled out in the Presidency Conclusions of the Copenhagen Summit of June 1993.*

interest rates of more inflation-prone countries falling to too low levels. This eventually leads to credit booms, overheating, loss in competitiveness and current account deficits.[4]

The ECB recognised that this monetary integration process would be accompanied by a number of challenges. First, many of the prospective Member States showed strong real convergence. The Eurosystem took the view that real and nominal convergence can be complementary in the medium term and should be pursued in parallel. While the catching-up process may be a source of upward pressure on prices, structural reforms that improve the supply side of the economy and enhance potential growth and market flexibility are conducive to an environment of lower inflation and interest rates. Conversely, by anchoring inflation expectations and providing for macroeconomic stability, nominal convergence is likely to have a positive impact on trade and investment, thereby supporting the desired increase in living standards and per capita income levels. Econometric investigations confirmed this, showing that, via the benefits of lower inflation and reduced deficit and debt ratios, the Maastricht convergence criteria contributed positively to real per capita income growth and convergence in the EU.[5]

Second, there was a need to lay a solid foundation for price stability. This involved bringing central banking frameworks (including central bank independence) fully in line with the *acquis communautaire*. The Treaty calls on CEE central banks to strive for price stability from their entry into the EU.

The third challenge relates to the choice of appropriate monetary and exchange rate strategies on the road to the euro. In the early 2000s, the CEE region was – and, by the way, continues to be – characterised by a variety of exchange rate regimes. The Eurosystem argued at the time that no single strategy is "best," although it did emphasise the need for overall macroeconomic and structural policies to support exchange rate choices.[6] Overall, it is important to stress the need to ultimately strive for fulfilling the convergence requirements in a sustainable manner before the adoption of the euro. The ECB made it clear throughout the process that its assessments of convergence would be based on the principles of equal treatment and the strict observance of the entry criteria as laid down in the Treaty.

3 Five Years of EU Enlargement

Since May 2004, the EU has welcomed a total of 12 new Member States.[7] Owing to partly significant differences in the state of economic convergence and other country-specific circumstances, the speed of monetary integration has varied considerably across the new EU Member States. In fact, four of these 12 countries, including two CEE countries (namely Slovenia and Slovakia) have already adopted the euro, which reflects their high degree of sustainable convergence. The other new entrants are still faced with some important challenges to ensure sustainable

[4] *See e.g. Noyer (2007).*

[5] *See Afxentiou (2000) and also Afxentiou and Serletis (2000).*

[6] *Some exchange rate frameworks are nevertheless incompatible with the criteria for euro adoption, e.g. unilateral euro adoption or managed regimes with an anchor other than the euro.*

[7] *The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia joined the EU on 1 May 2004; Bulgaria and Romania joined on 1 January 2007.*

convergence with the euro area. Three new Member States have already come to participate in ERM II, while some countries intend to join the mechanism once they will have reached a higher level of convergence with the euro area.

The experience with EU enlargement has been generally positive not only for the new Member States, but also for the EU as a whole, although a number of countries have in the past years built up considerable external and domestic imbalances.[8] Having entered the EU, most new Member States experienced robust economic expansion, although starting from different levels. As output growth accelerated significantly, their income levels were moving closer towards those of the euro area, even though in most countries they remained well below the euro area levels. In 2004, the per capita income levels of the new entrants were on average about half of the level of the euro area. In several countries, namely in the three Baltic states and Slovakia, the catching-up was most pronounced, as their per capita income levels increased by 10 percentage points and more after 2004. The catching-up in their standards of living was driven mainly by large capital inflows (including EU cohesion and structural funds), strong productivity growth and robust investment growth. Although the catching-up process was a common feature of all new Member States, there has been some noticeable diversity across countries. Besides their different growth performance and GDP per capita levels, the economies considerably vary in terms of their structural features, including the respective underlying exchange rate regimes.

The enlargement of the EU has further strengthened the trade and financial links between the new Member States and the euro area. As trade and the share of their exports in world trade expanded strongly, the countries became even more open. In particular intra-industry trade of the new entrants with the EU, lately also among the CEE countries themselves, has increased notably in some countries since 2004. Although the vast majority of the new entrants' total exports continues to be directed to the EU, for many economies the importance of export markets outside the EU has also grown considerably in recent years. Increased financial links with the euro area and further financial deepening via bank lending have likewise played a pivotal role in financing growth. A key characteristic of the CEE countries' financial sector is the high degree of foreign ownership and a strong reliance on bank financing. In fact, the share of assets of branches and subsidiaries of EU credit institutions in total bank assets in CEE almost doubled in five years, standing at around 80% in 2007.

A number of important policy choices in line with EU requirements, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective as enshrined in the central bank laws, has helped to drive down inflation to single-digit levels in most CEE countries. This process has been further supported by the overall impact of globalisation, increased competition in labour and product markets and, in countries with more flexible exchange rates, the nominal appreciation of the national currency. All these factors have more than compensated for the mostly adverse impact of changes in administered prices following EU accession (e.g. adjustment in excise taxes), while food and energy prices have contributed to the high volatility of inflation developments.

[8] *See ECB (2009).*

Notwithstanding the general achievements in terms of real convergence, the catching-up process increasingly became unsustainable in a number of CEE countries. In some, domestic demand growth turned out to be excessive, reflecting robust growth in disposable income, low – and in some cases even negative – real interest rates as well as strong credit growth. In many countries, fiscal and incomes policies were not sufficiently restrictive to prevent the economy from overheating. Thus, fiscal policy was generally too loose and countries had failed to make sufficient use of past favourable growth conditions to progress with fiscal consolidation and to build up additional fiscal buffers that would have alleviated the ongoing output adjustment. The strong growth acceleration was further fuelled by large capital inflows, which also included EU transfers. Absorbing significant and potentially volatile capital inflows posed a challenge to the new Member States, as it led to a high degree of external indebtedness. While some countries found their fixed exchange rate regimes to be under pressure, others were exposed to exchange rate swings. The overheating of the economies, in turn, contributed to a strong pickup in inflation, which reached even double-digit levels in some countries, and rapid increases in real estate prices. As the labour market situation became very tight, with wage growth by far exceeding productivity gains, most CEE countries were facing an erosion of international price competitiveness. For the new Member States with fixed exchange rates, the loss in competitiveness was in past months further aggravated by the recent strong depreciation of the currencies of some competitor countries.

As a consequence, several countries in CEE were confronted with significant domestic and external macroeconomic imbalances. In particular, the countries with fixed exchange rates experienced a substantial deterioration in their current account balances and a significant increase in their external debts. Besides their substantial external financing needs, the structure of current account financing made the new Member States highly vulnerable to sudden changes in investor sentiment. For example, some countries, and here mainly the Baltic states, relied heavily on debt financing, mostly in the form of loans from parent banks. In addition, considerable currency and maturity mismatches have built up in the private sector of some countries, which exposes them to exchange rate swings. The risk of adverse balance sheet effects resulting from strong exchange rate movements poses a risk to financial stability.

The impact of the global financial and economic crisis on the region initially appeared to be relatively limited, but this changed dramatically following the collapse of Lehman brothers in September 2008. The tightening of external financing conditions and the dramatic fall in global demand for exports from CEE resulted in a sharp reduction in growth in the region after end-2008. Reflecting the partly significant exposure to interbank financing, some CEE countries were directly affected by the global deleveraging of financial institutions. Although not solely related to the crisis, real GDP of the CEE countries shrank by an average 1.5% in the fourth quarter of 2008 in annual terms, with some countries even experiencing double-digit declines. To put this into perspective, this contraction follows an average annual growth rate of 3.5% over the past five years. While the strong trade and financial links can go some way towards explaining the significant impact of the current global crisis on CEE, the build-up of domestic and external imbalances over recent years appears to have intensified the impact.

4 The Outlook – Challenges for Future Monetary Integration

The global financial crisis has highlighted how difficult it is to follow a fast and sustainable catching-up process. Moreover, it has underlined the need to implement sound macroeconomic policies and structural reforms. In fact, the countries that were most affected by the crisis are those that had built up large domestic and external imbalances in the past and had grown at unsustainable rates in previous years. This is particularly the case in some countries that had closely tied their currencies to the euro, such as the Baltic states, and had unsustainable fiscal positions, such as Hungary.

To return to a sustainable path of convergence in the medium term, countries face substantial policy challenges. In essence, the CEE countries need to reduce existing imbalances and vulnerabilities to ensure sound fiscal policies and to make further progress with structural reforms.

In particular, it is important that fiscal policies help to maintain confidence in the soundness of public finances, especially in the current situation of strongly deteriorating growth prospects and a shift in investor sentiment away from higher-yielding emerging market assets. Countries with large budget deficits are better advised not to stimulate growth by loosening fiscal policies. Instead, they should consolidate their public finances and keep a safe distance from the 3%-of-GDP deficit, the limit specified by the Stability and Growth Pact. Although many CEE countries still record low public debt levels, the expected worsening of budget balances is likely to substantially push up these levels. High debt positions pose a threat to the countries' long-term fiscal sustainability.

Moreover, policy measures should focus on fostering both competitiveness and sustainable growth. More effective labour and product market institutions would help to further improve the countries' adjustment capacities to swiftly react in case of economic shocks. In addition, it is essential that countries allow for a proper degree of competition in their product markets and that they create an environment that is conducive to higher investment in human and physical capital.

Furthermore, the countries in CEE need to strengthen their export performance by improving their competitiveness and to better absorb capital flows.

Going ahead, the ECB will continue to monitor and assess the prospects of monetary integration in CEE economies. Several new Member States will continue their process of convergence towards the euro area. A few other countries may join the EU in the years to come. With respect to the public discussion on whether to speed up the euro adoption process, it is important to recall the underlying principles of the process of monetary integration. In particular, prior to joining the euro area, a sustainable level of convergence has to be achieved, which requires sound domestic policies. Thus, adopting the euro cannot be a substitute for necessary domestic policy adjustments. This would go against the economic logic which underlies the convergence process in Europe specified by the Maastricht Treaty. Moreover, any premature adoption of the euro could make it considerably more difficult for a country to cope with the challenges ahead. Without sustainable convergence, the monetary policy stance of the ECB is likely to be inappropriate for the country concerned, which – lacking important tools to stabilise economic conditions at home – could face excessive output and inflation volatility.

5 Conclusions

The Central and Eastern European countries are currently experiencing their most severe economic downturn since the early 1990s. While this decline was also triggered by the global financial crisis, its scale is largely related to the significant imbalances and vulnerabilities that had built up in recent years. To unwind these imbalances, the countries have to undertake major economic adjustments. Looking ahead, Central and Eastern Europe has the potential to return to strong growth. However, to avoid any recurrence of a boom-bust cycle, it is important to ensure the sustainability of the convergence process and to avoid excessive output volatility. This requires the implementation of sound macroeconomic policies and structural reforms. Overall, the ECB is well prepared to deal with future cases of monetary integration, and the overall institutional framework based on the Treaty has proven its robustness.

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