Euro Adoption in Central and Eastern Europe
Opportunities and Challenges

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Contributors
Comments on "Euro Adoption in the Accession Countries: Vulnerabilities and Strategies," by Helmut Wagner

I would like to congratulate the authors on their excellent survey of the vulnerabilities of the European Union (EU)’s candidate countries and the various possible strategies for euro adoption in these countries.

The paper touches on many points and is well balanced and well written but has its pros and cons. I agree with most of the authors’ arguments. However, as it is not my task just to praise the paper, I shall summarize its main arguments and concentrate on some relatively weaker or missing points. As the International Monetary Fund’s (IMF’s) Managing Director Horst Köhler emphasized in his keynote address (Köhler, 2004, p. 4), this "in-depth analysis prepared by IMF staff should be regarded as a basis for discussion, not its conclusion."

The objective of the paper is "to consider key features of strategies for shifting from current macroeconomic policy frameworks to ones that will be compatible with a successful experience in the euro area." The focus of the paper is on the choices facing the five Central European countries (CECs): the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia. The authors do not discuss the challenges the Baltic countries may be facing, because they think that "with fiscal policies closely aligned with those in the euro area, fixed exchange rates vis-à-vis the euro, and reasonably well-developed financial markets, apart from monetary policy for adapting to shocks, the three Baltic countries should enjoy a rather easy transition to euro area membership." Although this may be correct in principle, levels of current account deficits of around 14 percent of gross domestic product (GDP) in Estonia and 8 to 9 percent in Latvia (in 2003) could well be seen as a cause for concern.11

Key Characteristics of the CECs

In the "Key Characteristics" section of the paper, the authors point to several distinctive characteristics of the CECs. The most important of these stem, as they stress, from the fact that the CECs start from relatively low income levels. The characteristics highlighted in the chapter are as follows:

1. The CECs are capital-poor and labor-rich compared with the euro area.
2. Capital inflows are large, volatile, and virtually free of controls.
3. Investment in the CECs is high compared with the euro area.
4. Real appreciations have generally been sizable.
5. Notwithstanding B-S (Balassa-Samuelson) effects, inflation has fallen.
6. Financial sectors are small, dominated by foreign banks, and reasonably well supervised.
7. Fiscal deficits are generally large, while future demographic pressures differ.
8. Unemployment rates vary widely in moderately flexible labor markets.

These underlying characteristics are interpreted as pointing to several potential vulnerabilities that have to be considered in developing strategies—on both policies and timing—for euro adoption. Although the list of fundamental differences between the CECs and the countries in the euro area appears at first to be sufficiently extensive, it does not contain some other differences or characteristics that may also be very important, as they may point to further vulnerabilities of the CECs—institutional or cultural differences stemming from the fact that the CECs are still transformation societies. Transformation of societies and cultures implies change in socialization (social thinking and behavior) and takes more than just one or two decades. This is exhibited mainly in the decision processes, on various levels (e.g., in government and firms) and in the general understanding of the necessity of some of the reforms, which affects the implementation of policies or strategies. The success of economic transformation is based on how social transformation proceeds and how fast social values and thought patterns move in the direction of greater compatibility with a functioning, flexible market economy. This is not easy, as can be seen in the example of East Germany, which has had the best conditions imaginable for transformation from a bureaucratic planning system to a democratic market economy (i.e., large transfer incomes and stable, highly developed market and state institutions). Even there, the transformation process has clearly proceeded very slowly. The dependence on West German subsidies is still great and will remain so for a long time. Therefore, with regard to the CECs, just relying on the formal adoption of the acquis communautaire as the basis for quick adjustment to the core euro area with respect to market behavior and living standards may be a bit optimistic. That is, despite the adoption of the acquis communautaire, institutional or cultural differences will remain for quite a while, affecting the implementation of necessary reform strategies.

Vulnerabilities

In the "Vulnerabilities" section, the authors focus on three vulnerabilities derived from the key characteristics of the CECs, pointed out in the second section:

11However, particularly in the case of Estonia, it could be argued that this gap is financed largely by foreign direct investment (FDI) and caused primarily by substantial imports of machinery and equipment and not by a loose government spending policy.
capital account volatility, credit booms, and macroeconomic booms.

With respect to capital account volatility, the authors argue that, for the foreseeable future, large net capital inflows are likely to continue in the acceding countries. Large net inflows, however, have the potential for disruptive volatility there. Hence, the process in the run-up to euro adoption—particularly the stay in the Exchange Rate Mechanism II (ERM II)—may well increase vulnerabilities from capital account volatility. The authors determine three sources of risk that could produce capital account volatility: changes in market perceptions about the timing of euro adoption, asymmetric shocks, and policy inconsistencies. These sources of risk are present mainly in the ERM II. However, it is argued that even after euro adoption, there is substantial risk, as there may be large inflows to build up liabilities, particularly in the banking system. This could produce an increase in residents’ indebtedness with the scope for property price bubbles and general overheating. As the authors emphasize, large post-euro- adoption inflows may be short-lived but could create more lasting vulnerabilities. Exchange rate volatility may then be replaced by greater instability in demand and output growth. There are many theoretical arguments that can substantiate this conclusion. Nonetheless, a rather weak point in the analysis is that the authors do not differentiate between different kinds of capital inflows (FDI and portfolio capital) and between different uses of these capital inflows (for investment or consumption expenditures) in the single acceding countries (cf. footnote 1). Such different sources and uses of capital inflows may be decisive for the vulnerability of single acceding countries.

With respect to credit booms, the authors underscore the rapid credit growth that looms on the horizon for each CEC and that will raise equilibrium levels of private indebtedness in the CECs over time. They argue that a critical concern in such a rapid credit expansion is the risk of banking distress or even a banking crisis. It can be reduced most likely when a CEC has close ties with the EU, sound macroeconomic frameworks, and strong bank supervision.

In connection with macroeconomic booms, it is argued in the paper that potential credit booms could run the risk of turning into episodes of overheating that could produce strains on resources, inflation, unsustainable indebtedness, and asset price bubbles. Without a doubt, these macro-disequilibrium phenomena are key vulnerabilities the CECs may face in the run-up to or after euro adoption. When working out the danger of excess volatility and macroeconomic overheating, the authors conduct a very general, yet well-balanced, global macroanalysis of the potential dangers. What one could suggest here is to consider further aspects or reasons for vulnerabilities.

First, during the transition to the ERM II, some CECs may be hit by the problem of "original sin" (the inability to borrow abroad in one’s own currency). The market among residents for domestic currency-denominated debt is limited to the CECs as long as their domestic financial markets are not developed. Furthermore, their small size, compared with the United Kingdom or Sweden, for example, makes it unattractive for most foreign investors to manage exposures in their currencies. This can be regarded as the classical precondition for the problem of "original sin" (Eichengreen, Hausmann, and Panizza, 2003). Hence, CECs that have much of their debt denominated in foreign currency and maintain a flexible exchange rate regime are hit by balance sheet effects associated with adverse macroeconomic effects when the exchange rate moves.

Second, feared emigration of a well-trained labor force (inducing a brain drain in human capital) may simultaneously raise the risks of macroeconomic imbalances and increase the risk of stagflation.

Third, structural characteristics in the decision and implementation processes as described above may aggravate the macroeconomic vulnerabilities. In particular, there is a real danger that, particularly after accession to the European Monetary Union (EMU), as an endogenous effect, the demand for wage adjustment to the living standards of the EU core countries will increase in the new member countries. This may occur in the form of (1) higher-wage demands (the demand for wage adjustment will be stronger when the wages are directly comparable in the same currency and when labor flexibility increases within the EU, inducing threats to exit), and (2) demands to adjust the welfare legislation to that of the richer member countries. These demands could be substantiated (after accession to the EMU) by expected club solidarity expressed in transfer payments and bailout actions in economic crises (despite contrary agreements in the Maastricht Treaty). This solidarity may be enforced (3) through political pressure, that is, threatening to use blocking power (exercising veto rights and blocking decisions that are in the interest of the...
core countries), (4) through permanent dominance of EU summits with distribution debates, and (5) in the future, possibly also through increased union power based on centralization of the unions beyond country borders, enforcing adjustment to the more inflexible labor legislation in the EU core countries.14

If this danger of institutional inerstation materializes, the real convergence process would be slowed down, if not stopped. And this is an even more significant vulnerability than the instability phenomena highlighted in the paper.

Furthermore it should be borne in mind that the capability of the governments of the CECs to resist these vulnerabilities may decline because of the fiscal consequences of structural characteristics of the CECs (such as the augmenting demographic pressure and the strong locational competition).15

Strategies for Euro Adoption

In the “Strategies” section of the paper, the authors analyze various strategies for euro adoption. A caveat or weakness of this part is that these strategies have not been directly linked to or derived from the vulnerabilities worked out in the previous section.

The authors stress that macroeconomic policy between now and euro adoption will need to focus on several key tasks: reducing government budget deficits; lowering inflation, or keeping it low; and choosing a central parity and minimizing variations from it. The challenge is, as they emphasize, that all this must be done in an environment that remains vulnerable to volatile capital flows and demand booms.

On “taming fiscal deficits”

The authors stress that fiscal adjustment is likely to be the most burdensome hurdle for the CECs, apart from Slovenia. This assessment is likely to be generally accepted today. For example, Willem Buiter, chief economist of the European Bank for Reconstruction and Development, recently stated, “The fiscal challenges put before the accession candidates are formidable. They include inadequate infrastructure and a depleted environmental capital stock as well as unfavourable demographics and welfare state ambitions found elsewhere only in much richer countries. In addition, several... are entering... with general government deficits that are, by any measure, excessive” (Buiter and Grafe, 2002, p. 57).

The authors emphasize that the increase in deficits has largely been structurally caused and will require structural measures to reverse. They, however, do not address the question of which measures are needed. Moreover, they underline that the Maastricht criteria represent only minimum conditions and that clear yardsticks for the appropriate fiscal position in the CECs, prior to adopting the euro, do not exist. Optimal fiscal balances are linked to judgments about sustainable public debt levels. Now, the IMF’s World Economic Outlook of September 2003 already emphasized that the maximum prudent public debt ratio in the CECs is likely to be lower than in the existing euro area countries, because of the greater inherent volatility in the CECs than in the euro area. Based on this, the authors guess that a prudent public debt ratio in the CECs is around 45 percent of GDP. This would require the CECs to run a primary surplus of ½ percent of GDP on average or a headline deficit of about 1½ percent of GDP over the cycle. In 2003, however, general government deficits relative to GDP ranged from 2 percent of GDP (in Slovenia) to 7.6 percent of GDP (in the Czech Republic). In addition, as the authors state, future fiscal challenges in the CECs are demanding:

- To support long-term economic growth, infrastructure networks must be upgraded to standards imposed by the acquis communautaire.
- Pension reform is likely to involve substantial upfront budgetary costs.
- EU accession is expected to add 1–1½ percent to fiscal deficits in 2004–2006.

In the light of these challenges,16 the sudden optimistic conclusion that “for most countries, the needed fiscal adjustment could be achieved through changes that could well improve economic efficiency without diverting resources from infrastructure spending”—and in some cases even increasing it—appears to be quite surprising and not sufficiently well founded. The authors refer to windfall savings through interest convergence, declining public debt, and the possibility of cutting subsidies and social transfers and implementing a more efficient tax collection. However, they do not explain how to manage this.17

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14Both (3) and (4) would weaken the political decision-making capability of the EU organizations and centralize the EU.
15The development in East Germany (the new Bundesländer), after the currency union with West Germany, is sometimes used as a warning example, although the political conditions have been different (Sinn, 2002).
17Further challenges, not analyzed by the authors, for fiscal policy in the CECs stem from burdens resulting from bank and enterprise restructuring, from weaknesses in tax administration, from budgetary institutions, and from current and prior monetary and exchange rate regimes.
18This is typical for the paper as, somewhat contrary to the expectations raised in the beginning, the authors do not propose or work out concrete strategies but just emphasize subordinated targets such as “plans for supporting policies... need to be clearly communicated” (what are the plans?), “monetary frameworks need to be designed” (which monetary frameworks, and how should they be designed?), and “timing should be considered carefully before countries enter the ERM II” (what is the right timing?).
On “controlling inflation”

One could argue that the danger of inflation has declined worldwide over the past decade, partly due to the disciplinary effect (via competition) through the globalization process on inflationary policies (see, e.g., Wagner, 2001; Rogoff, 2003). One may further argue that inflation, as a hurdle for entering the EMU, is no longer the main problem for the CECs, as it used to be seen 12 years ago when the Maastricht Treaty was signed. Moreover, the inflation convergence criterion must be met only in the test date year, and the CECs have some discretion over the choice of the test date year. However, as the authors argue, the potential for inconsistency between the inflation and exchange rate stability criteria should not be disregarded. First, inflation pressure based on the B-S effect may be greater than estimated. Properly measured estimates of the B-S effect in the CECs suggest that real exchange rates should rise by some 1–2 percent per year (see Kovács, 2002). This means that either the nominal exchange rate or the inflation rate has to rise if there are no restrictive fiscal or monetary countermoves. Second, in each of the CECs except Slovenia, real appreciations during the past years have been much larger than estimates of the B-S effect would suggest. Third, and perhaps most important, “if markets assume that countries will rely on nominal appreciation to accommodate (possibly overestimated) B-S effects, pressures on currencies could be biased upward. Any overshooting of equilibrium would increase risks of disruptive changes in market sentiments.”

The authors go on to assert that “this evidence argues for recognition in the interpretation of the Maastricht inflation criterion that once in the currency union, catching-up countries are unlikely to be able to sustain inflation below 3–4 percent. The question arising from these observations is whether countries should delay adopting the euro until real convergence reduces inflation differentials attributable to structural and transition factors or whether such differentials are compatible with full integration in the monetary union.”

In principle, however, inflation should not be the main challenge for the CECs in the medium term (in particular, not after euro adoption). What is required (before and after euro adoption) is that fiscal consolidation be taken seriously. This will restrict inflation pressures by reducing aggregate demand and (what will be a bigger problem) keeping the rate of unemployment—which currently is already relatively high in some CECs—at a high level. Wage restraint and a firm monetary policy will also be important for keeping inflation in check.

On “choosing parities”

The authors argue that the operational question the CECs face before they enter the ERM II is where, within a range of equilibrium estimates, the central parity would best be targeted. Here, the asymmetry of risks in the ERM II (i.e., the fact that setting a parity too high is riskier than setting it too low) has to be taken into consideration. In particular, as the authors emphasize, the four CECs that use inflation targeting as their monetary strategy need to place greater weight on the nominal exchange rate in their interest rate decisions. This has to be balanced against the inflation objective and may create some conflict. The authors interpret this as “a consideration that argues for countries to wait until their ERM II rates are close to a level acceptable under the Maastricht criterion.”

When the authors consider the various options for monetary frameworks, they first raise the current usual objections against soft peg arrangements (Wagner, 2000; Fischer, 2001). For example, a narrow band (±2½ percent) around parity can be interpreted as such a soft pegging arrangement. Such a narrow band, however, would invite speculators to test the central bank’s determination and ability to enforce the margins. In contrast, a wide band (±15 percent or more) does not need to be an obstacle for the accession countries to defend the margins. There still is a risk of speculative attacks, however, particularly after large asymmetric shocks. The weaker the development of the institutional structure in an accession country, the higher this risk. In principle, the authors believe that “with some modification, a variant of inflation targeting with wide bands would be feasible in the ERM II. Inflation targeting in the ERM II, however, would need to be a hybrid of direct inflation targeting and exchange rate targeting, with all the problems associated with such a hybrid. Only when “supported by strong fiscal and incomes policies” will a hybrid inflation targeting framework “be capable of delivering the Maastricht criteria.”

However, one could argue that, in contrast to the United Kingdom and Sweden, for example, the new member states cannot float freely anyway, as much of their debt is denominated in foreign currency. Hence, when the exchange rate moves, they are hit by balance-sheet effects. This means that their floating exchange rates must be heavily managed anyway.

In the end, it is not clear what the authors would really suggest to the CECs. They emphasize the relative attraction of hard pegs but not without stressing that the policy demands would be rigorous (“fiscal policy and inflation would need to have been brought under control”).

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9 At the end of 2003, the rate of unemployment in Poland was around 10 percent, in the Slovak Republic more than 10 percent, and in the Baltic countries 10–12 percent.
Question of timing

Despite the two brief hints about a potential delay of adoption of the euro or of entrance into the ERM II cited above, the question of timing has not really been discussed or analyzed in the paper. That is, the core question has been diplomatically circumvented. This may be understandable, given the sensitivity of this topic for an international organization. Nevertheless, it may disappoint readers. With respect to timing, different aspects could have been discussed. One aspect is related to the question of when to enter the ERM II.

On the one hand, although entry into the ERM II is not subject to a set of preestablished criteria, to ensure smooth participation in ERM II, “it would be necessary,” as the ECB (2003, pp. 3–4) stresses, “that major policy adjustments—for example, with regard to price liberalization and fiscal policy—are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is being followed.” Already before entering ERM II, the CECs should (as much as possible) be capable of withstanding all potential asymmetric shocks and pressures without using the exchange rate instrument. Thereby, the danger of speculative attacks during participation in the ERM II could be minimized. This may suggest that countries should wait to enter the ERM II until they simply feel fit to withstand such pressures.

On the other hand, one might argue that CECs, that run a flexible exchange rate regime and have much of their debt denominated in foreign currency should enter the EMU and, as a precondition, the ERM II, as soon as possible, as they may be hit by balance-sheet effects associated with adverse macroeconomic effects when the exchange rate moves. However, this argument sounds less convincing in the case of the CECs as long as one assumes that the CECs are more hit by appreciation tendencies than by depreciation tendencies, as are South American countries, where this “original sin” problem requires the central bank to increase interest rates and thus to damage the economy.

Conclusions

Everybody should welcome European integration and its enlargement to the East. Nevertheless, the question of how quickly the acceding countries should try to adopt the euro after EU enlargement is still very controversial, and it cannot be answered without knowing what are the ultimate goals of the single acceding countries. For example, it is important to know whether the objective or policy horizon of an accession country is short-, medium-, or long-term.

If the objective of a new EU member country is to maximize the long-term benefits of euro adoption (and this, I think, is also the objective of the European Commission and of the incumbents), it should look at not just how to come into the EMU as soon as possible but how to proceed in the EMU with the smallest costs and the greatest benefits (i.e., how to optimize its strategy toward real convergence). Here, indicators such as stability or sustainability with regard to real convergence (dependent upon structural and institutional convergence) are the really important ones. The search for strategies for euro adoption should then concentrate on this goal. And the question of when to adopt the euro should also be decided against the background of this goal.

Each accession country has to be considered and treated as a specific case, as each country has its own structural and institutional characteristics. That means it needs very specific (i.e., country-specific) analyses that highlight the strengths and weaknesses of the single acceding countries to be able to indicate the vulnerabilities and strategies needed for euro adoption in each accession country.

Different optimal or appropriate strategies for euro adoption can be developed even for single countries. This can be done if one uses different assumptions with respect to the binding or continuance of current restrictions, such as the prescription that each accession country must participate in the ERM II, or to the sticking to the Maastricht convergence criteria and the criteria of the Stability and Growth Pact in the present form. These restrictions are not natural constants but may be changed or weakened in the political process over the coming years. This means that the optimal strategy for euro adoption in single acceding countries is also dependent upon the restrictions set by the incumbents and the European Commission and that these restrictions may be altered in the political process.

A “wait and see” strategy (or better, a “wait and improve” strategy) may not be a bad strategy for some acceding countries. Incidentally, proposing a “wait and see” strategy does not mean that one regards a country as second-rate. To wait and see means that one wins time to create stronger structures and institutions that may help a country withstand the pressure coming not only from external, country-specific shocks but also from internal conflicts. Such conflicts arise when a country tries to simultaneously conduct fiscal consolidation and improve its structural and institutional basis.
to achieve real convergence. By doing this, it may end up with high unemployment. Euro adoption will be more painful and uncertain with respect to potential welfare gains if the acceding countries try to adopt the euro too hastily. This would require the acceding countries to try to fulfill the Maastricht convergence criteria within a very short period of time to adopt the euro as quickly as possible. This may overstrain single countries as well as hurt the incumbents and eventually endanger the whole enlargement process, as it leads to structural as well as cyclical problems (Wagner, 2002, 2003). If EMU enlargement comes too hastily, the objective of real convergence may be hurt; that is, the danger of transitory real divergence may then arise (Wagner, 2002, 2003). This danger is based on the effects of restrictive fiscal policy (which is necessary to meet the Maastricht convergence criteria) on infrastructure in the acceding countries. I believe that the major challenge for the new member countries will be fiscal adjustment and that this adjustment process may be very painful. Fiscal adjustment will be the major challenge for the large accession economies in particular (although, as already stated, one should not lump all acceding countries together). With respect to fiscal adjustment, further research is still needed before one can come to a final conclusion about the country-specific strategies for euro adoption. This cannot or should not be done solely on a macro or global level, as is done in the authors' paper. Institutional and structural analyses of the fiscal side are also very important, to be able to derive the relevant vulnerabilities and the appropriate strategies for euro adoption in single acceding countries.

References


