

# EURO ADOPTION

IN CENTRAL AND EASTERN EUROPE:  
OPPORTUNITIES AND CHALLENGES



Editor  
Susan Schadler

International Monetary Fund



# **Euro Adoption in Central and Eastern Europe**

Opportunities and Challenges

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# I Introduction

Susan Schadler

The accession in 2004 of eight central European countries (CECs) to the European Union (EU) marks the end of the first phase of the integration of these economies with Western Europe. These eight countries have traveled a long road since the beginning, just over a decade ago, of their transition to market economy status. In many respects the macroeconomic similarities to Western Europe have grown: borders are open to trade and capital, the role of the state in production is far smaller than during the period of central planning, inflation rates are generally low and stable, and monetary and fiscal policy are for the most part transparent. Reasonably strong recoveries from immediate post-transition drops in output have been the reward for reform, and the bold step of taking these countries into the EU promises to further boost their growth prospects.

The next step in European integration—euro adoption in the new members—is both an obligation under the *acquis communautaire* and an opportunity to expand the benefits of EU accession. Seeking to consider the opportunities and challenges of the next step, a group of country officials and representatives of academic institutions, international institutions, and financial markets gathered in Prague in February 2004 to exchange views on the various dimensions of euro adoption in the new members. Broadly the objective was to consider the key questions surrounding euro adoption from the point of view of the central European countries—how they should prepare, whether an early move is optimal, and what are the pitfalls along the way.

The obvious starting point in this discussion was an examination of the suitability of conditions in the central European countries for joining the EMU. Jeffrey Frankel therefore opened by considering whether the potential advantages of joining a currency union for trade and capital flows outweigh the possible costs of losing monetary policy independence. Frankel examines four propositions. First, the effects on trade of joining a monetary union are large. After reviewing results and criticisms of studies which show that joining a monetary union can lead to as much as a tripling of trade with other members, he concludes that the largest estimates of the effect may be exaggerated, but the data support the contention that effects should be sizable. Second, increased trade with member coun-

tries will not only enhance the openness of the CECs (and hence make them a better fit for the monetary union) but also raise income growth. Third, countries that experience shocks that are asymmetric relative to those affecting the currency union should retain an independent monetary policy. Fourth, shock symmetry (the symmetry of shocks between a country and the currency union) is likely to change after the country joins the union. Thus, it is necessary to examine how changes in specialization and the structure of trade influence susceptibility to asymmetric shocks. Frankel concludes that, while some CECs now display a high degree of shock symmetry with the euro area, others might benefit from waiting—for example for five years—while their susceptibility to asymmetric shocks diminishes.

In his comments on Frankel's paper, Jean-Philippe Cotis agrees with the contention that potential gains from adopting the euro for trade and growth are substantial. To these he would add the scope for significantly higher foreign direct investment. Nevertheless, he also agrees that getting conditions right before entering is important and speaks to criteria for determining the optimal waiting time. While admitting that no precise calculation of the optimal waiting time is possible, he points to the importance of ensuring strong resiliency or flexibility of the economy in response to shocks, strong fiscal positions that permit the operation of automatic stabilizers, and low inflation to minimize the scope for sizable intercountry differences in the stance of the area-wide monetary policy.

Christian Thimann delves more deeply into the question of what the economic structures of the CECs tell us about the susceptibility of each to asymmetric shocks. He starts from the premise that the level of income in the CECs relative to that in the EU-15 is not directly important to the advisability of joining the euro area, but may be indirectly. Specifically, because lower income countries should have faster growth than higher income countries, they are likely to experience greater volatility in growth. Peaks and troughs of the economic cycle are less likely to be synchronized with the euro area than if income levels and economic structures are similar. Thimann explores a variety of measures of income levels, growth, sectoral structure,

and volatility and finds that indeed differences between each CEC and the euro area are important. But these differences do not necessarily imply that countries are prone to asymmetric shocks or asynchronized business cycles—the most important consideration in determining the cost of giving up an independent monetary policy. To determine susceptibility to asymmetric shocks, Thimann looks at correlations between the CECs and the euro area average of a variety of activity variables. He finds that the CECs fare better than some existing euro area countries (mainly the southern periphery) but worse than the core euro area countries or “pre-ins.” From this he concludes that a case-by-case approach to enlarging the euro area is warranted, with each country basing its monetary integration strategy on an assessment of its own activity dynamics.

Sue Owen speaks to the issues of preparedness raised in Thimann’s paper by reviewing considerations guiding the recent review of this issue in the United Kingdom. Comparing the Five Economic Tests—concerning convergence, flexibility, investment, financial services and growth/stability/employment—to the issues covered in Thimann’s paper, she notes several key points: first, while the first two tests focus on the costs of euro adoption, the latter three focus on the benefits of euro adoption which are not highlighted in Thimann’s paper; second, the central concern of the Five Tests is macroeconomic stability, without which the substantial benefits of joining the euro area could not be realized; and third, while Thimann concentrates on supply side differences between the accession countries and the euro area, the U.K. analysis finds demand side differences between the United Kingdom and the euro area—specifically the cyclical position at times that the United Kingdom might have joined the common currency—to be at least as important.

Having established a broad framework for assessing the costs and benefits for the CECs of adopting the euro, the conference participants turned to focus more narrowly on the contribution of monetary policy to economic stability and growth in these countries in recent years. Paul De Grauwe and Gunther Schnabl address the question of how the exchange rate regime followed in each CEC to date has influenced rates of inflation or output growth. They point to the evolution of views on the value of independent monetary policy (or virtually equivalently the scope for exchange rates to move); from the early optimal currency area literature that focuses on monetary policy as a stabilizer in the face of shocks, the literature has moved to the more capital account-oriented view of exchange rate variations as the source of shocks through the financial sector. The premise is that if exchange rate stability—de facto or de jure—has been associated with either significantly lower inflation or higher growth, then the loss of monetary policy independence would not only be

costless, it could even be a benefit. Obviously the inverse would also be true: if countries with greater exchange rate flexibility had lower inflation or higher growth, independent monetary policy is beneficial. Their empirical results point to the conclusion that exchange rate fixity has not been associated uniformly with any given inflation experience but it has been associated with higher output growth. They interpret these conclusions as support for the capital account-oriented view that exchange rate variability has been the source of shocks in the CECs and therefore that joining the euro area will tend to enhance growth prospects of the new members.

Michael Artis agrees with De Grauwe and Schnabel’s assertion that exchange rate flexibility in the CECs has probably contributed to capital account shocks more than it has smoothed asymmetric real shocks. He raises several questions, however, about the empirical work that attempts to link the exchange rate regime in the CECs to macroeconomic stability—an exercise he regards as highly ambitious for three reasons. First, the usable data sample is short. Second, the exchange rate regimes observed are chosen by the authorities with the macroeconomic outlook as a key consideration. Third, the macroeconomic performance of the CECs is highly informed by their prospects for joining the EU and thereafter the euro area. These considerations tend to favor a positive finding on the effects of exchange rate stability on growth and inflation—a finding, however, that may be a good indication of the real effect provided the countries actually do join the euro area.

Lipschitz, Lane, and Mourmouras take a different tack in examining the question of the usefulness of monetary policy in the CECs, exploring how much scope for an independent monetary policy the CECs in fact have. While inflation targeters in principle have enormous scope to move interest rates, in practice, the authors argue, the range of movements is limited by inherent risks in large capital flows that can be provoked by interest rate differentials. Their framework combines the interest arbitrage condition with a stylized characterization of the process of real convergence through increases in capital-labor ratios and resulting equalization of rates of return on capital. In this framework they show that with open capital markets, the scope for changing interest rates can be constrained: large increases will attract surges in inflows while large reductions will result in surges in investment, drops in savings, and large current account deficits or depreciations. In this setting, the value of monetary policy independence may not be all that it is in mature markets. Moreover, they point out that the fundamental forces in CECs that attract large and potentially erratic capital inflows—intrinsically low capital labor ratios and, relatedly, potentially high rates of return on capital alongside open capital markets—are fundamentally real in nature

and therefore invariant to the choice of exchange rate regime. They warn however that in the period before countries adopt the euro, when market speculation about implicit floors or target conversion rates could be rife, a flexible exchange rate with a relatively large amplitude of movement will best protect countries from vulnerabilities to swings in market sentiments.

Supporting the thrust of Lipschitz's conclusions, Jose Viñals qualifies them in three ways. He takes issue with Lipschitz's estimates of the size of gaps in rates of return between the CECs and more advanced countries. Viñals points to a variety of factors, such as technology, financial sector development, and research and development, that may contribute to larger differences in total factor productivity between the CECs and the euro area and therefore smaller gaps between rates of return on investments than Lipschitz portrays. Viñals also takes issue with the conclusion that policies are unlikely to exert much influence on the size or volatility of large capital inflows: in his view, policies that promote foreign direct investment and minimize public sector borrowing should help promote inflows that are orderly and relatively stable. Lastly, he argues that policies to increase the resiliency of the financial system should help prevent adverse consequences from sudden stops or reversals in flows.

Another set of issues the new member states must address is how to prepare their economies for euro adoption. Four particular dimensions of this question—the fiscal position, labor market conditions, the robustness and resiliency of financial markets, and entry conditions set by the European Union (the Maastricht criteria)—will have to be the focus of countries' efforts in the run-up to euro adoption. Essentially the aim of all these efforts will be to ensure that the CECs enter the currency union with well-developed mechanisms to absorb economic shocks in the absence of monetary policy and that financial institutions and supervision are strong enough to protect financial markets from any surges in credit growth as interest rates fall to euro area levels. Beyond these broad conditions, which each country must address to its own satisfaction, the CECs will have to meet the Maastricht criteria that set specific conditions on fiscal deficits and debt, interest rates, inflation rates, and the conduct of exchange rate policy. Several contributors addressed these issues individually.

On the fiscal front, Jürgen von Hagen points to the challenge for most CECs of restructuring the government without expanding it and molding budgetary institutions to better serve the goal of reining in fiscal deficits. Results from the estimation of a simple model of the size of government suggest that most of the CECs have governments that are rather large for their structural characteristics—measured in terms of per capita GDP and openness. Thus, even assuming relatively rapid GDP growth over the next several years,

government spending and tax revenue should not grow relative to GDP. At the same time, comparisons of the structure of the fiscal accounts with those in like-sized euro area countries suggest several directions for fiscal reform in the CECs: achieving greater distributional equity through the tax system by increasing effective direct taxation; reducing social security contributions, particularly in the smaller countries most open to trade; and controlling social transfer systems. Beyond these structural changes, the level of deficits will need to be reduced to meet the Maastricht criteria, and, equally importantly, to rein in demand in the face of strong capital inflows. To this end, von Hagen points to the role budget institutions will have to play. This will involve guarding against off-budget funds, “non-decisions” that occur when expenditures included in the budget are determined by developments exogenous to the budget process, mandatory spending laws, and accumulation of contingent liabilities such as guarantees. von Hagen argues that 2002 Pre-Accession Programs—macroeconomic and fiscal frameworks for three year-ahead periods presented to the European Commission each year by each accession country—indicate awareness of these practices, but little action to limit them.

Jiri Jonas provides a counterbalance to von Hagen's concerns about fiscal policy in the CECs. While agreeing that deficits in many CECs need to be reduced, he argues that most of the CECs have substantially lower debt burdens than the average for emerging markets, even though several structural features of the CECs suggest that they could sustain higher levels of debt than the typical emerging market country. He then examines whether von Hagen's concerns about large capital inflows and the need for a fiscal policy response are well founded. He concludes that while forces, as outlined by Lipschitz, to produce large capital inflows exist, there is little reason to expect these flows to be volatile. Thus the circumstances in which fiscal policy would need to respond to sharp changes in inflows are unlikely to occur. And even if they were, placing the burden for coping with sudden reversals on fiscal policy would excessively dilute the mandate of fiscal policy.

Beyond fiscal policy flexible labor markets will be another important avenue for adjusting to asymmetric shocks in the absence of monetary policy. Tito Boeri examines the challenges facing labor markets in the CECs after EU accession and leading up to the adoption of the euro. He points in particular to the increase in competitive pressures that will result from closer integration with the EU-15 and that will require a continuation of ongoing job reallocation in the CECs. Along with the more favorable environment for business start-ups and increased capital mobility induced by euro adoption, this could create a wedge between labor demand, which is bound to become more elastic, and labor supply. In this setting, Boeri asks whether existing

labor market institutions in the CECs are adequate. Two main observations are key here. First, wage-bargaining systems in most of the CECs are relatively decentralized, and unions are relatively weak. Second, during the transition, the need to soften hardships on labor during the transition to a market economy generally placed the heaviest emphasis on nonemployment benefits rather than job protection measures. As a result, quantity adjustments (resulting in low employment rates) were stronger than price adjustments, which were effectively constrained by the wage floor imposed by benefits. Yet Boeri argues that well-designed unemployment-insurance-based systems are more conducive to mobility than job-security-based systems and are less costly at times of turbulence or rapid changes in product and labor markets. Thus, Boeri concludes that nonemployment benefits should be reformed with three main goals in mind: to tailor cash transfers to the unemployed to the specific labor market problems a country faces (urban or rural unemployment, skill obsolescence, or high search costs); ensuring that benefits are not overly generous while increasing the coverage of benefits; and focusing on the enhancement of activation measures—especially enforcing work tests and sanctioning with benefit reductions those who do not actively seek employment.

Robert Feldman, commenting on the paper, agrees with the contention that flexible labor markets will be key to absorbing shocks to product and labor markets after euro adoption. The fact that in most CECs wage negotiations are decentralized provides some reassurance that such a flexible response could be expected. Nevertheless he argues that some sort of social pact on wage behavior, while not essential, could play a useful role in restraining wages during the run-up to, and possibly even after, euro adoption. He also argues that wage discipline in the public sector will play a crucial signaling role in economy-wide wage deals. Supporting the reforms suggested by Boeri, Feldman calls attention to the sequencing of reforms—particularly coordinating reforms to nonemployment benefits with fiscal goals.

Has the introduction of the euro changed the financial landscape the CECs face as they prepare their own financial markets for euro adoption? Laura Bottazzi and Francesco Gavazzi explore the evidence on the changes and portray an increasingly integrated market but one where the possibilities for deeper integration remain large. One problem in characterizing the effect of the euro on financial markets is separating the influences of recent general global trends toward more integrated and efficient financial markets, from the influences of the euro itself. Notwithstanding these difficulties they identify four main positive changes in the European financial industry consequent to the introduction of the euro. First, the source of funds for large firms has shifted from relationship lending to arm's-length financing, a

model that appears better suited for selecting the best investment projects, especially during times of technological innovation. Second, the degree of home bias in portfolios has fallen. Third, some consolidation of institutions has started, although this remains considerably behind that in the United States and therefore is likely to progress further in the future. Fourth, new financing opportunities have arisen for small entrepreneurs, though the experience of the new stock markets has been uneven, possibly because of the global downturn in equity prices as the expansion occurred. Taken together, trends suggest that the CECs will face both more competitive markets and greater opportunities for diverse funding and portfolio holdings.

Uldis Cērps narrows the focus to the key issues in the financial sectors in the CECs. He points to the dominant role banks play and will continue to play as the source of financing for local companies. While equity markets are developing in a few CECs, they are very small and, due to requirements on the quality of issuers, unlikely to be of value to small and medium-sized enterprises. Thus, risks to the banking system, rather than proactive measures to develop capital markets, should be the focus of policies directed toward the financial system. He also notes a strong home country bias in investment portfolios of CECs. Incentives for greater diversification (particularly risk management) exist, but may be offset by political pressures to keep savings through second-pillar pension schemes at home and prudential considerations as long as flexible exchange rates are maintained. Improvements in the operations of the financial sector will likely come through increases in efficiency in largely foreign-owned banking systems.

Deroose and Baras shift the focus to the merits of the Maastricht criteria for ensuring that each potential euro area member has achieved a high degree of sustainable monetary and fiscal convergence prior to adopting the euro as its currency. They examine in particular the price and exchange rate criteria. They begin by pointing out the analytical origins of these criteria: i) that on prices (that inflation should not exceed 1½ percentage points above the average of the three best performing EU members) aims to prevent having high-inflation members of the currency union that would derive substantial welfare gains at the expense of low-inflation countries; and ii) that on the exchange rate (that countries shall participate in the Exchange Rate Mechanism II (ERMII) with no significant strains on the level of its exchange rate) aims to prevent “end-game” devaluations and to provide a market test of the soundness of underlying macroeconomic policies.<sup>1</sup>

<sup>1</sup>In ERMII a parity value between a currency and the euro is set and countries are obliged to keep their exchange rates within a ±15 percent band of the parity. Fulfillment of the exchange rate stability criterion requires that this system be operated with no significant strains, an outcome that would require that the exchange rate remain close to parity.

The authors then examine the merits of the most frequently argued criticism of these two criteria: that they are inappropriate for the current circumstances of the CECs with a high degree of exchange rate flexibility, open capital markets, and important sources of structural inflation—namely Balassa-Samuelson effects that push up the prices of nontraded goods relative to traded goods and, in the presence of downward price rigidities, lead to rates of inflation higher than in high-income economies. To this criticism, Deroose and Baras respond with several considerations. On prices, while Balassa-Samuelson effects probably do result in structural inflation in the CECs above that in the higher income euro area members, the actual effect on inflation is likely to be small enough to be handled within the Maastricht Treaty definition of price stability. Any indication that it is larger is likely to involve serious enough measurement problems to prevent distinguishing “benign” inflation from other inflation and to be an inadequate basis for opening the door to inequality of treatment. On the exchange rate stability criterion, Deroose and Baras acknowledge that sustained capital inflows could push an exchange rate up on a permanent basis, but point out that the European Central Bank (ECB) and European Commission will assess conformity to the exchange rate criterion taking into account factors that may have led to a sustainable appreciation of the currency. Other sorts of pressures on the exchange rate are likely to be muted or even eliminated by strong and credible macroeconomic policies. The markets would perceive these as an indication of the readiness of policymakers to live up to the commitments required for euro adoption.

György Szapáry offers a different perspective on the risks and benefits of participation in the ERMII. Admitting that moderate Balassa-Samuelson effects could be accommodated within the exchange rate and inflation criteria, Szapáry cautions that countries should not enter ERMII until they are confident that other sources of inflation have been reduced to minimal levels. More generally, taking into account the risks that countries with a history of floating exchange rates will experience surges and reversals of capital flows, he argues that countries should enter ERMII only when two basic conditions are fulfilled: they enjoy broad political support for maintaining stable macroeconomic policies consistent with the Maastricht criteria and they have a clear target for exiting the arrangement in the near term.

Pulling together the various strands of the discussion thus far, the final two papers in the volume explore strategies for moving toward euro adoption. Hochreiter and Tavlas analyze contrasting paths of monetary policy prior to euro adoption in two current members. One, Austria, a small open and relatively high-income economy, established a credible, low-inflation informal monetary union with Germany almost two decades before euro adoption. The other, Greece, a small open

and relatively low-income economy, had to tame a high and persistent inflation rate just prior to euro adoption and used a heterodox approach to the task. Hochreiter and Tavlas consider these two countries as “corner cases” in the sense that each participated in ERM under quite different starting conditions and applied correspondingly different strategies to meeting the Maastricht criteria. Nevertheless, Hochreiter and Tavlas note several similarities between the two experiences: grounded in the view that benefits of joining EMU would outweigh costs both countries enjoyed strong and sustained political commitment to the project; for both, meeting the Maastricht fiscal criterion proved to be the most difficult hurdle; each used the exchange rate as a nominal anchor, but had to accept some adverse economic conditions—volatile capital inflows and high interest rates for Greece and asymmetric shocks and output volatility for Austria. Differences between the experiences were also important however: Austria joined ERM when the credibility of its policies was already quite high and had a smooth ride, with no exchange rate volatility, through ERM; Greece, in contrast, had to prove its commitment to fiscal adjustment during its participation in ERM/ERMII leaving no room for fiscal flexibility and requiring high interest rates and tight monetary policy; and for Austria, the parity was chosen at the existing market rate while for Greece a sizable depreciation before ERM entry and subsequent revaluation of parity supported the disinflation required prior to euro entry. Despite these rather significant differences, both countries adopted the euro.

Yet facing a quite different economic and financial landscape than the first wave of euro area members, the CECs will need to consider a range of different issues—some with important implications for vulnerabilities to capital account disruptions—in fashioning their strategies for euro adoption. Mitja Gaspari explores these issues for Slovenia—one of the new member states with the most ambitious agenda for adopting the euro as soon as possible. Gaspari reviews the reasons why the government believes Slovenia would thrive in the euro area. He then describes the starting conditions as Slovenia sets out to meet the Maastricht criteria and more generally prepare the economy for successful euro adoption. While acknowledging that there are risks inherent in a relatively rapid entry, he confidently concludes that policies to ensure successful entry into EMU are in place.

Schadler and others consider more generally the questions facing the five countries that have monetary regimes that now entail a significant amount of exchange rate flexibility and for which the switch to a currency union will pose the greatest challenges. Their premise is that the specific characteristics of these countries’ economies make the regime switch a time of important financial sector vulnerabilities and that

explicit strategies for addressing risks during the period leading up to euro adoption are critical.

They begin by setting out stylized facts characterizing the CEC economies and bearing on the choices they must make both pre- and post-ERMII entry. Key among these are the substantial income gap; the related scarcity of physical capital and abundance of human capital that should continue to attract large and potentially volatile capital inflows into these highly open markets; the tendency for Balassa-Samuelson effects to cause real appreciations, reflected in either higher inflation than in the euro area or nominal appreciations; extremely low bank intermediation in financial sectors that are rapidly modernizing; and to date, a tendency toward large fiscal deficits, albeit from positions of moderate debt levels by European standards. They then point to specific vulnerabilities that result from this bundle of characteristics. First, capital inflows are likely to remain large; and, during ERMII, with speculators influenced by additional factors—possible changes in target dates of euro adoption, the consistency of policies with the Maastricht criteria, and difficulties in responding to asymmetric shocks without changes in parity—volatility of these flows will become more of a threat. Second, uncertainties about the appropriate parity are substantial, and setting an overvalued parity would adversely affect the pace of income catch-up. Third, estimates of the likely rise in bank lending as bank intermediation rates catch up to Western European levels raise the specter of rapid growth of bank credit, with implications for the risk of property price booms, overheating, and strains on the quality of bank portfolios. The authors recommend that each CEC position itself to withstand challenges from these risks by (i) ensuring that parities are set at the low end of estimated ranges for equilibrium real exchange rates; (ii) reducing fiscal deficits below the Maastricht fiscal criterion of 3 percent of GDP so as to allow room for automatic stabilizers and for rapid private sector borrowing; (iii) ensuring that financial market supervision is sound; and (iv) mapping out monetary frameworks that clearly communicate how

exchange rates will respond to shocks—whether of financial or real origin—and contribute to protecting the economy from speculative shifts in capital flows.

Helmut Wagner takes issue with some of these conclusions. While finding the representation of vulnerabilities from volatile capital inflows exaggerated, he argues that other vulnerabilities—especially balance sheet effects from exchange rate changes, emigration of well-trained labor, and pressures for rapid catch-up of wages and welfare benefits—will be important as countries move to adopt the euro. Turning to questions about strategies for euro adoption, Wagner asserts that meeting Maastricht inflation limits should not be difficult in a global environment of low inflation. But trimming fiscal deficits while meeting expenditures needs for infrastructure development, cofinancing of EU funds, and rising pension obligations will be. This concern, together with the likelihood that the CECs will have difficulty adjusting to shocks without a flexible exchange rate, leads Wagner to the conclusion that countries will maximize the long-term benefits of euro adoption by avoiding hasty efforts to meet the Maastricht criteria that result in unnecessary economic costs. Rather they should focus on policies that promote real convergence in a sustainable and stable manner even if this means delaying euro adoption for some time.

The proceedings of the conference point to the complexity of the next stage in European integration for the CECs. Some countries—mainly those that currently have currency boards or rigidly fixed exchange rates—may see a relatively seamless entry to the euro zone. But others, for which euro adoption will entail a fundamental regime change touching on the key policies that have stabilized their economies in the face of rapid development and change, could face considerably more difficulty. The papers presented in this volume make it clear that euro adoption can play an important role in progressing toward the key goal of European enlargement—closing the large gap between incomes in the existing euro area and those in the new member states. But the opportunities will only be realized with careful preparation of each economy.