



## **CEPS POLICY BRIEF No. 3**

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# **FIVE YEARS TO THE EURO FOR THE CEE-3?**

**DANIEL GROS**

#### **ABSTRACT**

In terms of meeting the fiscal Maastricht criteria, the Czech Republic, Hungary and Poland are better placed today than were some of the current euro area members from the “Club Med” (Greece, Italy, Portugal and Spain) at a comparable point in time leading up to their joining EMU. The CEE-3 should thus be able to qualify for full membership by early 2006, following a decision by the EU as early as 2005.

But this does not imply that convergence will be smooth. Speculative attacks came in the early 1990s, exactly when the process of convergence seemed to have been successfully completed. Some of the CEE-3 share several characteristics of the economies worst hit by speculative attacks in the period 1992 to 1995:

- Large current account deficits,
- Large FDI inflows (which finance the current account deficits) and
- An appreciating real exchange rate.

On all three accounts, the potential disequilibrium is much larger for countries such as Poland today than it was for Spain, Portugal or Italy in the early 1990s.



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In most of Central and Eastern Europe, economic policy is motivated by the desire to join the EU, and eventually also the euro area. There can be little doubt today that these goals will be achieved, but opinions differ as to how long the process will take and whether convergence will be smooth. This paper focuses on the three largest accession candidates, the Czech Republic, Hungary and Poland, in short the CEE-3. These countries are well advanced on the convergence path, but still have some way to go to qualify under the Maastricht criteria. How long will it take them to qualify for EMU membership? The experience of some current euro area members suggests that this could happen sooner, rather than later. It is thus possible that the CEE-3 will have the euro already by 2006 – five years from now. Financial markets are discounting this possibility already to a large extent.

Experience also suggests, however, that the last stretch of convergence can be very difficult. In early 1992, countries such as Spain and Italy seemed within striking distance of full convergence, but in the middle of the year they were suddenly hit by speculative attacks and forced to abandon their peg to the DM. At the climax of a very volatile period, that lasted over three years, the Italian lira had devalued by over 60% against the DM and long-term interest rates had risen to unprecedented levels.<sup>1</sup> In the end, the Italian and Spanish governments did take the steps necessary to qualify for EMU, exchange rates appreciated and interest rates converged. This chapter thus had a happy ending, but it should serve as a warning that the final stretch of convergence can be the most perilous.

The two sides of the convergence saga are developed in what follows. Section 1 concentrates on the good news that satisfying the Maastricht criteria should not be a major problem. Section 2 concentrates on the bad news, namely that experience shows that this is not sufficient to protect against trouble in the presence of large current account deficits and potentially over-valued exchange rates. Concluding remarks are offered in a final section.

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\* Daniel Gros is Director of the Centre for European Policy Studies in Brussels. This paper was prepared for presentation to a client seminar organised by Deutsche Bank, London, 23 April 2001.

<sup>1</sup> A financial analyst, writing at this point in one Europe's leading newspapers, likened the bonds of Italian toll motorway companies to toilet paper.

## **1. The prospects of meeting the Maastricht criteria**

In the debate about enlargement, it is often taken for granted that membership in EMU will come long after accession to the EU because the candidates are supposedly not ready to meet the Maastricht criteria. The reason for this assumption is that most assessments of the prospects of the 10 candidates from among the Central and Eastern Europe countries (CEECs) to meet the Maastricht criteria start from current and past data and thus conclude inevitably that the candidates are a long way from being able to join the euro area. But this approach is misleading, as can be shown by simply asking what one would have concluded for the prospects of the present Southern member countries of EMU if one had used a similar approach in the early 1990s.

What would be the earliest date by which at least some CEECs could aspire to join the euro area? The starting point has to be full EU membership, and since this requires ratification by all 15 national parliaments, it seems reasonable that this is unlikely to happen before 1 January 2004, even if the negotiations are concluded quickly. The minimum delay between the start of EU membership and joining the euro area is two years of membership in the ERM (as for Greece and Italy). If advanced member countries join the ERMII immediately upon joining the EU, i.e. in early 2004, they could just join EMU by July 2006. The decision to admit CEE candidates to the euro area could then be taken by a European Council meeting in early 2006, based on data for 2005.<sup>2</sup> However, assessments of the readiness of the candidates for EMU membership are usually based on data from 1998 or 1999. But even current data cannot really say a lot about the ability of a country to satisfy the Maastricht criteria by 2005.

A comparison with the start-up of EMU is instructive in this regard. The decision on which countries could form the initial group was taken in 1998 on the basis of 1997 data. Judging the suitability of CEE countries on the basis of 1998 data would thus be similar to having made a prediction about the size of EMU in the early 1990s on the basis of data from 1990 or 1991. How do the candidates measure up on this yardstick?

Table 1 below shows the main variables that are relevant for the Maastricht criteria: interest rates, inflation, fiscal deficit and government debt. The table is organised in two groups of countries: the CEE-3 and the "Club Med". Within the latter group, the data for Greece are from two years later because this country joined EMU about two years after the others.

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<sup>2</sup> A similar procedure is being adopted in the case of Greece. A decision taken at a European Council meeting in early 2000 was based on data from 1999, and Greece was then able to join almost immediately.

*Table 1. Maastricht-relevant macroeconomic indicators*

	Interest Rates (long term early 2001)	Consumer Price Inflation (Expected 2001)	Gen. Gov. Balance (% of GDP) 2000	Public Debt (% of GDP) Expected 2001
Czech Republic	6.3	4.7	-4.2	31.0
Hungary	8.3	8.2	-3.5	62.2
Poland	10.2	7.3	-2.4	40.2
<b>1991/93 data</b>				
Portugal	18.3	12.2	-6.0	66.1
Spain	12.4	6.4	-4.5	43.1
Italy	13.0	7.0	-10.0	100.6
Greece	n.a.	14.2	-13.8	110.2
<b>Club Med (average)</b>	15.0	10.2	-8.6	80.2

Sources: Deutsche Bank, *Enlargement Monitor* and Pelkmans et al. (2000).

The bottom row of Table 1 provides an average for the Club Med. A comparison between the data for the CEE-3 and the corresponding data for the Club Med suggests a clear conclusion: the CEE-3 group is definitely much closer to meeting the Maastricht criteria than the Club Med countries were at a comparable time before the start of EMU. (This applies actually not only to the CEE-3, but to the Luxembourg group in general.) Consider the following:

- Inflation in the CEE-3 is about 5 to 10 percentage points lower than in the Club Med in the early 1990s.
- Fiscal deficits are already now close to 3% of GDP in the CEE-3, even less than one-half of those of the Club Med then (average 8.6% of GDP in the early 1990s).
- The same observation applies to public debt. Except for Hungary, the CEE-3 have debt/GDP ratios below 60%, versus about 80% for the Club Med in the early 1990s.

Moreover, in Italy and Spain, the debt to GDP ratio actually *increased* by over 20 percentage points between the early 1990s and the date of accession to EMU, whereas it has fallen over the last five years in most candidate countries (and by about 10 percentage points in Hungary over the last three years).

The data thus suggest clearly that the CEE-3 are already much closer to satisfying the Maastricht criteria than the Southern member states of the EU were in the early 1990s. Moreover, experience has repeatedly shown that a short and sharp adjustment is politically and economically less painful than a protracted, and hence supposedly but erroneously soft, one. The case of Greece, which was until recently regarded as a lost cause, provides a further illustration of this phenomenon. The relatively small fiscal adjustment that is still required of

the candidates could thus come rather quickly and is likely to be politically easier to implement than the slow adjustment of some established member countries. No “strikes against Maastricht”, as were called in France, are likely to happen in any of the candidate countries.

The relatively good starting position of the candidate countries in a historical perspective does not mean, of course, that there will be absolutely no problems in meeting the Maastricht criteria. But the problems that remain should be manageable, both for the deficit and debt criteria.

**Deficits.** Achieving a fiscal deficit below 3% is essentially a question of political will. Most of the candidates already satisfy this norm, and none of them has structural problems that would constitute an insurmountable obstacle. However, one can highlight certain features of public finances that might make it harder. Are there any longer-term factors that could put unbearable pressure on public finances in the candidate countries? It is often argued that such pressure might arise from the need to build a modern infrastructure in the CEE-3s, plus the pressure on their underdeveloped social system. However, a look at the data again shows that the problems are not worse in the Eastern half of Europe.

**Infrastructure needs.** The public infrastructure of the candidates is certainly less developed than that of current EU members. The candidates have fewer motorways and paved roads per inhabitant and square kilometre, fewer fixed telephone lines, etc., but this does not immediately imply that they therefore also need more investment in this area. What they have might actually be adequate for their level of development.<sup>3</sup> Research has shown this to be the case: The candidates have actually a larger stock of infrastructure than one would expect given their income per capita. It is thus difficult to argue that public infrastructure is their main impediment to growth.

There are more reasons to doubt the need for large public infrastructure spending:

- Within the EU one actually does not find any link between public investment and growth in GDP. Ireland, by far the fastest growing economy of the EU over the last decades, has a somewhat below-average ratio of public investment to GDP.
- Even if one wanted to give a country of Skoda drivers the motorways that are appropriate for Mercedes, there is still no need to run large public sector deficits. Given the changes in financial markets that have taken place over the last decade, it is now

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<sup>3</sup> See Gros and Suhrcke (2000).

generally recognised that most infrastructure projects could also be financed and sometimes even operated with substantial private sector involvement. Major projects, such as motorways, are already being undertaken on a mainly private sector basis in the candidates.

**Social policy.** All the indicators that should influence the pressure for spending in the social sphere show little difference between the EU and the CEECs.

- There is no significant difference in the age profiles between the EU and the 10 candidates. The pressure for spending on the elderly should, if anything, be somewhat less in the candidates as their elderly population is somewhat less important.
- In terms of public spending on health (as a % of GNP), there is also little difference between the candidates (5%) and the EU average (6%).
- The same can be said for public spending on education (5.6 versus 5.2% of GNP), which will be key to re-qualify the workforce into the “new economy” which offers the only growth path.

All in all, it thus appears that the pressure on budgets should be manageable over the foreseeable future in the CEE-3s, allowing them to achieve the required remaining deficit reductions.

**Debt.** The debt criterion should not constitute a major additional hurdle. Most candidate countries have at present a debt/GDP ratio that is below the 60% ceiling. Debt levels usually change only slowly so that the current data is more informative. But are the data too good to be true? As the Czech case has shown, the process of cleansing the accounts of the banking system can at times bring to light large liabilities of the public sector. Debt-to-GDP ratios might thus increase in some candidate countries as they clean-up their banking system. But most of this will be achieved before accession. Moreover, healthy growth combined with low deficits (say around 3%) should lead to rather strong downward pressures on the debt/GDP ratio so that some debt assumption can take place without putting in jeopardy the debt criterion.

**Skeletons in the closet? The sustainability of fiscal convergence.** Is it likely that there are any important skeletons in the closet? For example, it is sometimes argued that large contingent liabilities might be hidden in the banking system in the form of non-performing loans that the government will have to take over when the banking system is finally cleaned up. In other words, low debt/GDP ratios might simply be a symptom of an unfinished transition. However, in most countries, non-performing loans as a percentage of GDP (on the

basis of EBRD data) are rather low, usually in the low single digit level. With the exception of the Czech Republic, this is also the case for the CEE-3. It is thus unlikely that bad loans could push public debt above the 60% reference level. Moreover, in each of the CEE-3, the banking system is now dominated by foreign banks. Further pressure on public finances from this side should thus be limited.

## **2. Pitfalls during the final stretch of convergence?**

The CEE-3 should thus be able to qualify for full EMU membership by early 2006, following a decision by the EU that wraps up the process as early as 2005. But this does not imply automatically that convergence will be smooth. Speculative attacks destroyed the European Monetary System in the early 1990s, exactly when the process of convergence seemed to have been successfully completed.

Why did these attacks come about? Markets developed doubts that the countries concerned would be able to actually carry through the required fiscal adjustment and some currencies were overvalued. Given the much better starting position of the CEE-3 in terms of fiscal policy, the first reservation might be much less of an issue. But there are certainly signs that some of the CEE-3 currencies are overvalued.

In particular some of the CEE-3 share several characteristics of the economies worst hit by speculative attacks in 1992-95. They have large current account deficits, financed by large, supposedly stable FDI inflows and as a corollary an appreciating real exchange rate.

On all three counts, the potential disequilibrium is much larger for countries such as Poland today, than it was for Spain, Portugal or Italy then. It will be useful to document this for the three elements separately.

### **2.1 Current account deficits**

Current account deficits are usually presented as a percentage of GDP, which is useful if one wants to focus on the capacity of a government to service foreign debt. However, if one wants to have an idea of the exchange rate adjustment required to re-establish current account equilibrium, one should relate the deficit to overall export receipts (goods and services). Under certain reasonable conditions, one could actually argue that the deficit as a percent of export receipts gives directly the percent depreciation required to eliminate the deficit without



a contraction in domestic demand, i.e. a deficit equivalent to 30% of exports would require a devaluation of about the same magnitude.<sup>4</sup>

On this account, the data are not reassuring. The deficit of Poland amounts now to almost 50% of exports, compared to “only” about 20% for Spain during the early 1990s. (Portugal had only negligible deficits during this period.)

*Table 2. Current account deficits (as a percent of export receipts)*

	1998	1999	2000
Poland	-14.1	-28.9	-46.7
	1990	1991	1992
Portugal	-1.1	-2.4	-0.5
Spain	-21.1	-18.0	-17.3

*Sources:* IMF, IFS and Deutsche Bank.

These data imply that a country such as Poland would require a very large depreciation, almost 50%, should it ever need to achieve a balanced current account quickly. It is usually argued, however, there will be no need for this because the deficit is financed by stable flows of foreign direct investment. This argument was also frequently used prior to 1992 in the case of Spain and Portugal.

## 2.2 Large FDI inflows

Table 3 below shows that Portugal and Spain also had rather large inflows of FDI, again measured as a percentage of export receipts. For Spain, FDI flows averaged over 10 % of exports during the pre-crisis period, and for Portugal they were only somewhat smaller.

For Poland today, FDI flows are about twice as important. During 2000, they amounted to close to 30% of exports, financing most of the current account deficit.

*Table 3. FDI inflows (as a percent of export receipts)*

	1998	1999	2000
Poland	13.9	18.8	29.4
	1990	1991	1992
Portugal	11.4	9.2	5.0
Spain	12.5	9.0	1.1

*Sources:* IMF, IFS and Deutsche Bank.

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<sup>4</sup> The conditions are that imports are relatively price inelastic and that the demand curve for exports has an elasticity of 1, which is not far from typical estimates in the empirical literature.

The key question is thus for how long can the CEE-3 count on inflows of this magnitude. In recent years, the CEE-3 have enjoyed rather stable flows, which have on average increased year after year. But can this go on forever? The experience of Spain and Portugal is again instructive in this respect. FDI flows to Spain halved in the year after the first attack (1993) and then halved again after the second major attack (1995). By 1997, Spain became a net exporter of FDI. (The same applies to Portugal today.) With swings in external flows of this size, it is not surprising that a large adjustment in the real exchange rate of the peseta was needed.

This leads to the third issue: Are the currencies of the CEE-3 overvalued?

### 2.3 Real overvaluation?

During the early 1990s, there was a lively discussion whether the Club Med currencies were over-valued. There was no general agreement, because the judgement depended, as usual, on the indicator and the base period used. The two indicators most often used to measure competitiveness are (and were then) the real exchange rate deflated by the CPI and by Unit Labour Costs (ULC). These two usually give different indications. Now, and then.

*Table 4. Appreciating real exchange rates*

		Early 2001 relative to	
		1996	1999
Poland	CPI	21.1	18.1
	ULC	64.4	8.6
Club Med		End-1991 relative to	
		1980	1987
Italy	CPI	30.8	10.9
	ULC	-1.0	8.5
Spain	CPI	24.1	25.6
	ULC	1.9	28.0

*Sources:* Gros and Thygesen (1995, p. 216) for Club Med relative to Germany. Real effective exchange rates for Poland provided by Deutsche Bank London (weight of EU is 93%).

In the case of Spain, it was argued that there was no need for a large exchange rate adjustment because there was no real overvaluation – but only if one used ULC as the competitiveness indicator and 1980 as the base period. Not surprisingly, this was the position taken by the authorities. A similar argument was used in the case of Italy, where there was also a large discrepancy between the ULC- and the CPI-based measures.

Poland today presents a very similar picture. Depending on the base period and the indicator chosen, the zloty could be seen to be overvalued by any sum between 8 and 64%. (For Hungary and the Czech Republic, the discrepancies between the various indicators and base periods are much smaller.)

The argument that the zloty cannot be overvalued because Polish exports keep growing fast was also used in the case of Spain, where exports had actually doubled in dollar terms in the five years prior to the attack of 1992 – an even more impressive performance than Poland's. This is typical of countries that have recently opened to trade, such as the transition countries today, or Spain in 1992, when it dismantled its last tariffs within the, then, EC. In such cases both exports and imports tend to grow strongly, whatever the exchange rate, more and more sectors are exposed to international competition.

These data suggest that sooner or later an exchange rate adjustment might be needed. The discussion concentrated on the case of the zloty, where the potential over-valuation is largest because of the recent sharp appreciation. But the other CEE-3 countries might soon face a similar situation. What does this imply for the exchange rate policies pursued by these countries?

Poland and the Czech Republic officially follow a floating exchange rate, accompanied by domestic inflation targets. They are thus in a different situation than Spain and Italy in the early 1990s, which were members of a fixed exchange rate adjustment, the ERM. In theory, an exchange rate adjustment could thus come about gradually and without disruption.

However, experience has shown that large exchange rate adjustments almost always lead to some disruption in financial markets. This was the case even for Spain, which in 1992 had actually a rather large room for manoeuvre under the ERM (Spain had margins of +/- 6%). A sudden large depreciation usually forces the central bank to increase interest rates to limit the domestic inflationary pressures that would otherwise worsen inflation. Moreover, the terms of trade shock (deriving from the depreciation) in combination with higher interest rates might initially lead to a contraction in demand (as in Italy and Spain). This in turn puts pressure on the budget, leading initially to higher deficits; which then might undermine confidence and thus aggravate the depreciation.

Such a negative spiral does not need to develop. The case of Greece shows that a smooth "glide path" to EMU is possible. But it would certainly be very dangerous for the CE-3 countries to enter into an ERM-type arrangement that would tie their currencies to the euro

before they have a clearer view of whether the current exchange rate levels are sustainable in the long run.

### **3. Concluding remarks**

The CEE-3 seem to be well placed to enter the euro area rapidly once they have become EU members. But experience has shown that the final stretch of convergence can be the most dangerous, especially for countries with a potentially over-valued exchange rate whose level is underpinned by large capital inflows, which cannot be taken granted forever. The experience of some members of the euro zone is instructive in this regard. There are examples of countries that were able to converge rather smoothly, as was the case of Greece, and, to a lesser extent, Portugal. In the cases of Spain and Italy, however, EMU membership was preceded by an extremely volatile period during which time exchange rates depreciated heavily and interest shot up. Governments that are really determined to get into EMU can usually withstand the pressure from financial markets. In the case of Spain and Italy, markets calmed down eventually and convergence resumed at a rapid pace. There was a happy ending. But the intervening turbulent times were very costly for these countries – and some investors.

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