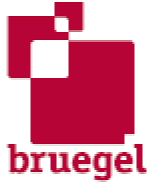

Should the crisis be the trigger for a reshaping of euro-area entry rules?

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Some new EU member states that have not yet adopted the euro have come under much greater pressure during the financial crisis than nations in the euro area. This column says that that does not mean the Maastricht criteria for euro entry ought to be relaxed. New member states suffering in the crisis are paying the price for their policy mistakes.

The single currency has gained new appeal for outsiders since the global financial turmoil intensified. In addition to policymakers in the new member states, even Danish officials could revise their views about the euro since the Danish central bank had to raise the interest rate to support the krone. Furthermore, the main anchor for Iceland's recovery strategy could be EU membership and entry into the euro area (Lane 2008). Some observers have suggested relaxing euro entry rules in order to allow applicants a much faster and less demanding way into the euro.

The euro has many well-known benefits in general, and it also brings two important forms of shelter to its users when there is a global financial crisis. First, lack of an independent currency obviously implies that it cannot come under pressure and it cannot depreciate, hurting households, corporations and governments with foreign-currency loans. As a consequence, interest rates are likely to be lower with the euro, an important factor when the world economy goes into recession. Second, commercial banks in the euro area can turn directly to the ECB for liquidity.

While these forms of shelter are no doubt helpful in managing a crisis, demands to relax the euro entry rules deserve closer consideration. There are various dimensions to this issue. A political and legal matter is whether it would be at all realistic to obtain support for such a change in the Treaty if there were economic underpinnings for it. The economic and moral issues are even more interesting. To start with, it is useful to look at how the countries were affected by the crisis and then ask whether the impact of the crisis is related to previous policies.

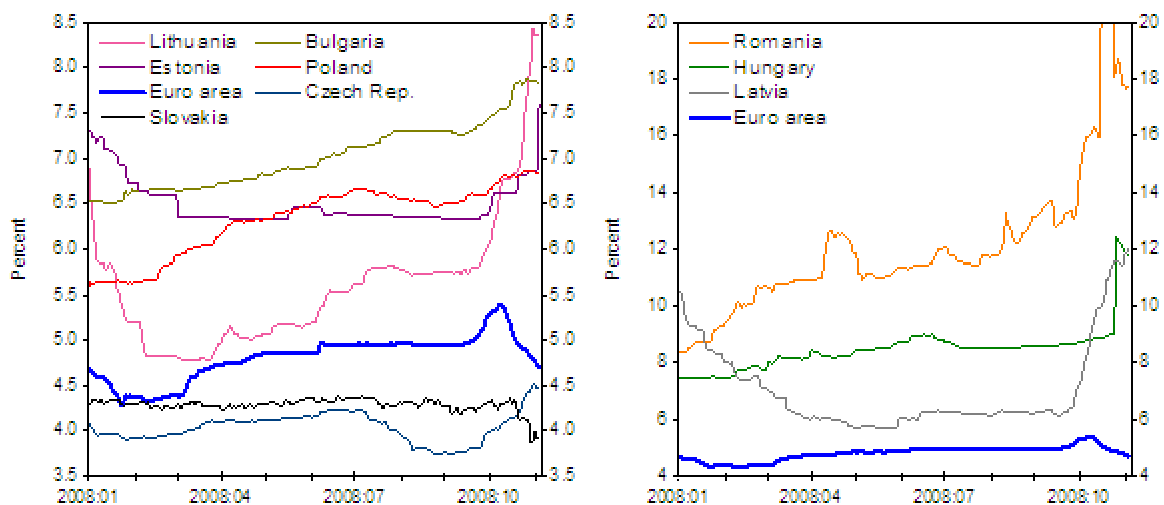
Effects of the crisis on money and currency markets of new member states

Due to their trade and financial openness, all new member states will be affected by the global economic slowdown and tighter global credit conditions. Stress on domestic financial markets can amplify these effects. Data on interest rates and exchange rates offer some tentative conclusions,

though a more thorough analysis could be made when volume data on interbank and retail lending and on capital flows become available for more recent periods as well.

All effects discussed below are conditional on the financing package offered jointly to Hungary by the IMF, EU and the World Bank – without that, the effects would probably have been much stronger, not just for Hungary but for some of the other countries as well.

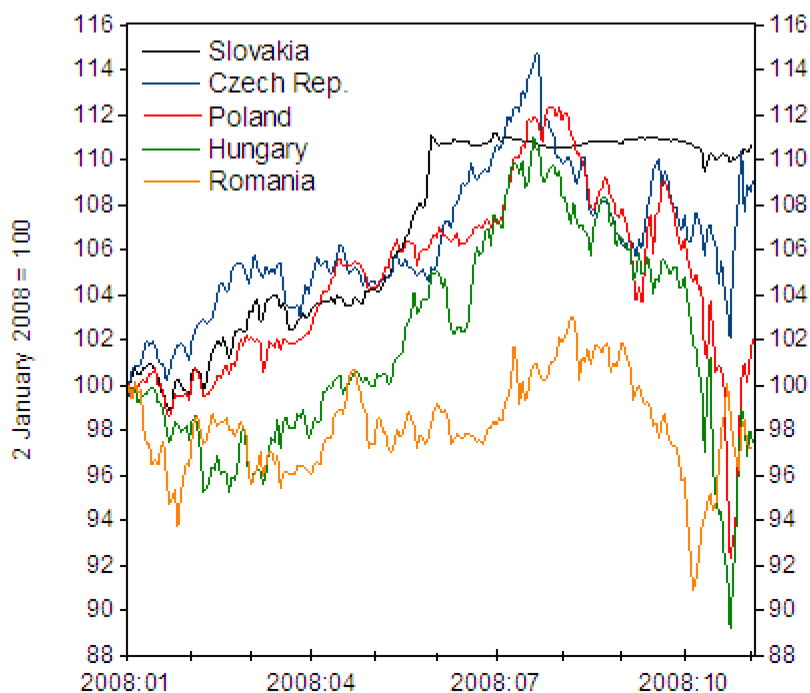
Figure 1 3-month interbank offered interest rates, 2 January – 4 November, 2008



Source: Datastream.
Note: the Romanian rate peaked at 49.81% on 20 October 2008, but for better readability of the right hand side panel the vertical axis has a 20% cut-off.

Figure 1 shows 3-month interbank interest rates in the euro area and in those new members states that are not yet members of the euro area. Romania, Hungary and Latvia were seriously hit and to a lesser extent Lithuania, Bulgarian and Estonia as well, but others did not seem to be affected much. Rising interbank interest rates quickly transmit to retail lending rates, causing high real interest rates for both the private and public sectors – a bad development in an economic downturn. Spreads compared to the euro area increased much less in Poland, while the Czech Republic and Slovakia kept their negative spreads even in October.

Figure 2 Nominal exchange rates against the euro, 2 January – 4 November, 2008



Source: ECB.

Note: an increase in the index indicates appreciation against the euro.

Figure 2 shows exchange rates against the euro for countries having floating exchange rate systems. Slovakia was not affected at all because of the scheduled euro-area entry in January 2009. The Czech Republic was somewhat affected but its exchange rate is still much stronger than it was at the beginning of the year. Hungary, Poland, and Romania were affected more seriously and the turnaround came after the 3 percentage-point interest rate increase by Hungary's central bank and the announcement of the joint financing package.

Consequently, it is important to highlight that domestic money and currency markets in the Czech Republic and Slovakia were barely affected by the crisis, while the effects in Poland were moderate.

Factors contributing to the severity of the crisis

The countries that were strongly affected were those that depend highly on foreign financing. Dependence on foreign financing was in turn affected by policies, see Darvas and Szapáry (2008). In that paper, we discussed in details the risks and challenges faced by the new member states on the road to the euro and the strategies for, and timing of, euro adoption. We argued that the large inflows of non-FDI capital entail several risks: (i) by boosting domestic demand, they can lead to overheating and large current account deficits and high inflation; (ii) they can put undue upward pressure on the exchange rates of countries with floating currencies; (iii) they might delay much-needed adjustments by giving the authorities time to indulge in inappropriate policies; and (iv) they expose the countries to sudden reversals of capital flows if there is a shift in the markets' assessment of a country's vulnerability. The

outcome of the first three of these risks was present in previous years while the last one arrived in October 2008.

The new member states coped with these risks differently. By entering the euro area, Slovenia, Cyprus and Malta opted for a safe harbour. These countries met the Maastricht criteria, and economic policy certainly played a role in that. These three countries also had good starting positions since their prices compared to the euro area were already reasonably high in the mid-1990s, which obviated the need for price convergence in later years.

In contrast, Slovakia (a soon-to-be euro-area member), and the Czech Republic had low prices compared to the euro area in the mid-1990s. These countries experienced significant economic and price convergence in the past decade. However, price convergence mainly occurred through nominal exchange-rate appreciation and not through higher inflation. Monetary policy doubtless played a role in this development as well as fiscal policy, since government debt stayed at moderate levels. Furthermore, structural policies were also conducive to economic growth and to attracting foreign direct investment. Low inflation led to low nominal interest rates, which in turn did not encourage interest rate-sensitive capital inflows and also did not encourage households and corporations to accumulate debt in foreign currencies.

The opposite case is that of Hungary. Hungary’s government debt increased from 52% of GDP in 2001 to 66% in 2007, of which one-third is held by foreigners. Hungary’s inflation rate has been also higher, partly because price convergence was not accommodated by nominal exchange rate appreciation. The resulting higher nominal interest rates attracted interest rate-sensitive capital inflows. Households and corporations also took out a large fraction of their loans in foreign currency. These developments increased the perceived vulnerability of the country. When contagion started to hit emerging economies as well, foreigners started to sell off their Hungarian government bonds, leading to severe tensions in the government bond market (Darvas 2008).

Conclusion

Consequently, we may conclude that previous policies also contributed to the severity of the crisis on financial markets of the new member states. It was not at all inevitable for new member states of the EU to be seriously affected. Calling for an easing of euro-area entry conditions is thus tantamount to calling for previous policy mistakes to be pardoned.

Still, the most seriously hit country - Hungary - has not been left to fend for itself. The much larger-than-expected financing package offered jointly by the IMF, EU, and World Bank indicates that these institutions care about emerging countries and want to stop contagion. The financing package has a price in the form of strict conditions and close monitoring in the future – in particular, the Hungarian government must cut the deficit while many other governments in the world are considering using fiscal policy to dampen the real-economy effects of the crisis. This is a high price to pay for previous policy mistakes, and Hungary, which has always expressed its wish to join the euro area as soon as possible but is instead the only new member state failing to meet any of the entry criteria, seems to be speeding up its efforts to this end.

Other countries that could not avoid risky economic structures are also suffering from high real interest rates and difficulties in obtaining foreign financing. They are now trying to adjust their policies.

However, as a by-product of policy adjustment and the disinflationary effects of global recession, these countries will be likely to able to meet the Maastricht criteria sooner than previously thought.

Looking beyond the short-run effects of the crisis, the longer-run fundamentals should not be overlooked. The success stories of the Czech Republic and Slovakia in simultaneously maintaining high growth, low inflation, and resistance to the contagion of the crisis of confidence on the one hand, and the disappointing economic performance of Portugal within the euro area on the other also call for proper consideration of economic structures and policies when thinking about euro area entry.

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