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# New Challenges for the Fulfillment of Nominal Convergence Criteria in the New Member States of the European Union in the Context of the Global Financial and Economic Crisis

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## Abstract

*The financial and economic global crisis emphasized a series of imbalances in the new member states of the European Union, creating new challenges for these countries. Between 2009 and 2010 the economic growth has been and will still be seriously affected, as a consequence of the difficult credit conditions and the severe decrease of demand. The turbulences from the financial international markets produced a feeling of safety for eurozone countries, entailing many new member states to deal with the issue of accelerating euro adoption, taking into account the protection provided by the eurozone during the crisis. Nevertheless, in these conditions, the new member states of the European Union suffer great inconvenience in fulfilling nominal convergence criteria, as compared with the period before the crisis. In this article we propose to identify a series of new challenges for the fulfillment of nominal convergence criteria in the new member states in the context of the global financial and economic crisis and to make out possible obstacles for a quick adoption of the euro.*

**Key words:** *monetary convergence criteria, fiscal convergence criteria, European integration process, global economic and financial crisis*

**JEL Classification:** *F15, G01*

## Introduction

Finding themselves in the process of catching up, the new member states have to make serious efforts to create economic structures similar to those of the old EU member states, in order to achieve a sufficient level of real convergence. The situation is not at all convenient for Central and East European Countries, as they are bound to simultaneously fulfill all nominal convergence criteria, facing the biggest difficulties in the case of inflation, exchange rate and budgetary deficit criteria. It is well known that in the catching up process, in the case of a floating exchange rate regime the price convergence can be done either by a nominal appreciation of the exchange rate or by a higher inflation or by the existence of both phenomena at the same time, while in the case of a fixed exchange rate regime, the price convergence can be achieved through higher inflation.

In the context of the current economic crisis, to keep the convergence indicators at a level inferior to the reference values is a real challenge for new EU member states. The issue regarding the "relaxation" of the convergence criteria, so that the eurozone becomes more accessible for the new EU member states, did not found proponents in the European forums, even if the crisis generated reactions in the new member states regarding their quicker integration in the euro zone. The European Commission maintained its position, claiming that the fulfillment of nominal convergence criteria in their actual form would be a condition for assuring stability and credibility for the European integration process, by integrating only those economies that will not weaken the Economic and Monetary Union. By the same token, in order to appreciate the level of preparation for euro adoption, the analysis of the nominal convergence criteria fulfillment stage is an important element for the identification of syncope, of possible reasons and their retrieval in perspective.

## Difficulties in the Fulfillment of Nominal Monetary Criteria in the Context of the Economic and Financial Global Crisis

If we look at the inflation evolution in new EU member states, we notice that this criterion raised the greatest problems in the process of nominal convergence, before the effects of the financial crisis became visible in these countries. According to the last revisions of Eurostat data, in the period 2005-2006, the only countries that did not exceed or were at the limit regarding the inflation criterion were the Czech Republic and Poland, and in 2007, Slovakia was the single country with the annual inflation under the admitted limit. After 2007, none of the new EU member states registered such a performance. The adjustment of the real economy to the market dynamics and a series of exogenous factors represented the main reasons of the inflationary pressure in this period. At the same time, the strong internal demand contributed mainly to the maintenance of the inflation, while stimulated by a number of factors: significant increase of disposable income, the accentuated dynamics of the credit volume and its values, as well as the low level of the real interest rates which stimulated consumption. The positive perspective of the demand, the low level of real interest rates and the high profitability affected also the evolution of capital inflows, which rose substantially. Investments made in the analyzed countries contributed to the growth of the productive capacities, but also had an incentive effect on the internal demand. The emigration of the workforce represented a stimulating factor for inflation increase, many of the new member states encountering difficulties with workforce deficits, which determined in sequence pay rises over the dynamics of the productivity, especially in the Baltic States. The Baltic States and Bulgaria, the countries that pegged their currency to euro also have inflationary pressures as a consequence of this exchange rate regime: the process of income real convergence appeared in the exchange rate appreciation, reflected in higher inflation.

The economic growth based on consumption and the inflation pressure generated by the above-mentioned factors had an overheating effect in Estonian, Latvian, Lithuanian, Bulgarian, Czech and Romanian economies. Hungary was an exception from this economic overheating phenomenon, because the economic growth rate has been keeping up at relatively low level, reflecting both the short term effects of measures implemented in order to adjust the macroeconomic disequilibria, and the measures of fiscal consolidation.[1]

The correction of regulated prices and indirect taxes have also fuelled the inflation pressure in the new member states of EU, through the liberalization of regulated prices, especially in the

[1] In Hungary the fiscal consolidation Program, which has been applied in 2008, was efficient for engendering improvement of fiscal deficits in 2008 and 2009, as compared to 2007. Thus, unlike the fiscal deficit in 2007, this was about 5% of GDP, in 2008 it reached 3.4 % of GDP, expecting to keep the same value in 2009.

energetic and transport sectors. However, in the recent years, among many other countries, the Czech Republic, Hungary and Romania have decreased the value added tax[2], some of these having significantly reduced it, following up the harmonization with the EU countries. In some countries, these measures have induced an increased inflationary pressure, while in Romania they were implemented under disinflation conditions. The structural funds from EU have also engendered increasing inflation rate in some member states, as they stimulate domestic demand, on the short term and under the constraints of production capacity. At the same time, in some circumstances, the fiscal policy was not enough restrictive to sustain the inflation pressure retrenchment in these countries.

The rising of food and energy prices, with a strong influence in the EU new member states as a result of the large share of these components in the consumer basket, represents one of the most important factors of inflation increase. Besides the endogenous and exogenous elements of the inflation pressure, there are some corrective factors, which act as the Balassa-Samuelson effect[3]. Nevertheless, in some countries with flexible exchange rates (Czech Republic and Romania), the exchange rate appreciations have mitigated increasing prices. At the same time, the strong external competition, mainly from Asian emergence countries, and the globalization phenomenon have represented alleviating factors of inflation pressures in many of the new member states, especially for tradable goods.

Taking into account the emergence of the global financial and economic crisis in the new member states, we can see that this phenomenon has brought a cleavage of inflation development. Thus, before the crisis the main risk was the negative impact on inflation expectations through the vicious spiral, while after this moment, the factors which previously have, directly or indirectly, stimulated inflation (economic growth, consumption, wage policy, budgetary policy, and also global inflation pressure) have contributed to a strong moderation of inflation. Nevertheless, during the crisis, at the European level, the inflation rate has decreased stronger than the inflation rate recorded in the new member states of the European Union. Thus, the gap between the inflation rates recorded in these countries and the Maastricht reference value remains almost unchanged (see Figure 1).

Regarding *long term interest rate* criterion, one can notice that, before the crisis (2004-2007), all new member states of the European Union, excluding Hungary and Romania (and Poland, in 2004), have fulfilled this Maastricht criterion. An important modification of this situation took place in 2008, when the number of countries which did not meet this requirement increased, with Latvia, Estonia[4] and Poland joining the above mentioned countries (Hungary and Romania). If we look at the data for August 2009, the situation also extended over Bulgaria and Lithuania. In April 2009, the impact of the global financial and economic crisis had obvious signs so that all these countries exceeded the interest rate criterion (except only Slovakia, Slovenia, Malta and Cyprus). This situation is explained by the fact that long term interest rate is both a trustful resemblance of the disequilibria existing in the economy, and also a signal for the inflation expectations of the market.

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[2] In Hungary, during 2006, value added taxes (VAT) have been reduced by 5 pp, to 20%; in Czech Republic the decrease was made in 2003, by 3 pp, reaching 19% level; in Romania, the reduction of VAT by 3 pp, at 19%, became effective in 2000.

[3] Notwithstanding, according to Égert (2007), the Balassa-Samuelson effect does not seem a determinative factor for the convergence process (thus, between 1995 and 2005, the value of the Balassa-Samuelson effect, based on the real exchange rate appreciation, was low: yearly, between 0.2 and 1.4 %, as opposed to the annual average of the real exchange rate appreciation which was between 3 and 6%, in the same period). This points out the fact that there are other determinative influences on the price convergence process, the structural ones that explain the real exchange rate appreciation: the consumption preferences of population shift towards high-quality goods, evaluated at higher prices.

[4] As it is known, Estonia has not got such an instrument of evaluation. The information is based on aggregated data on monthly interest rates of equivalent instruments.

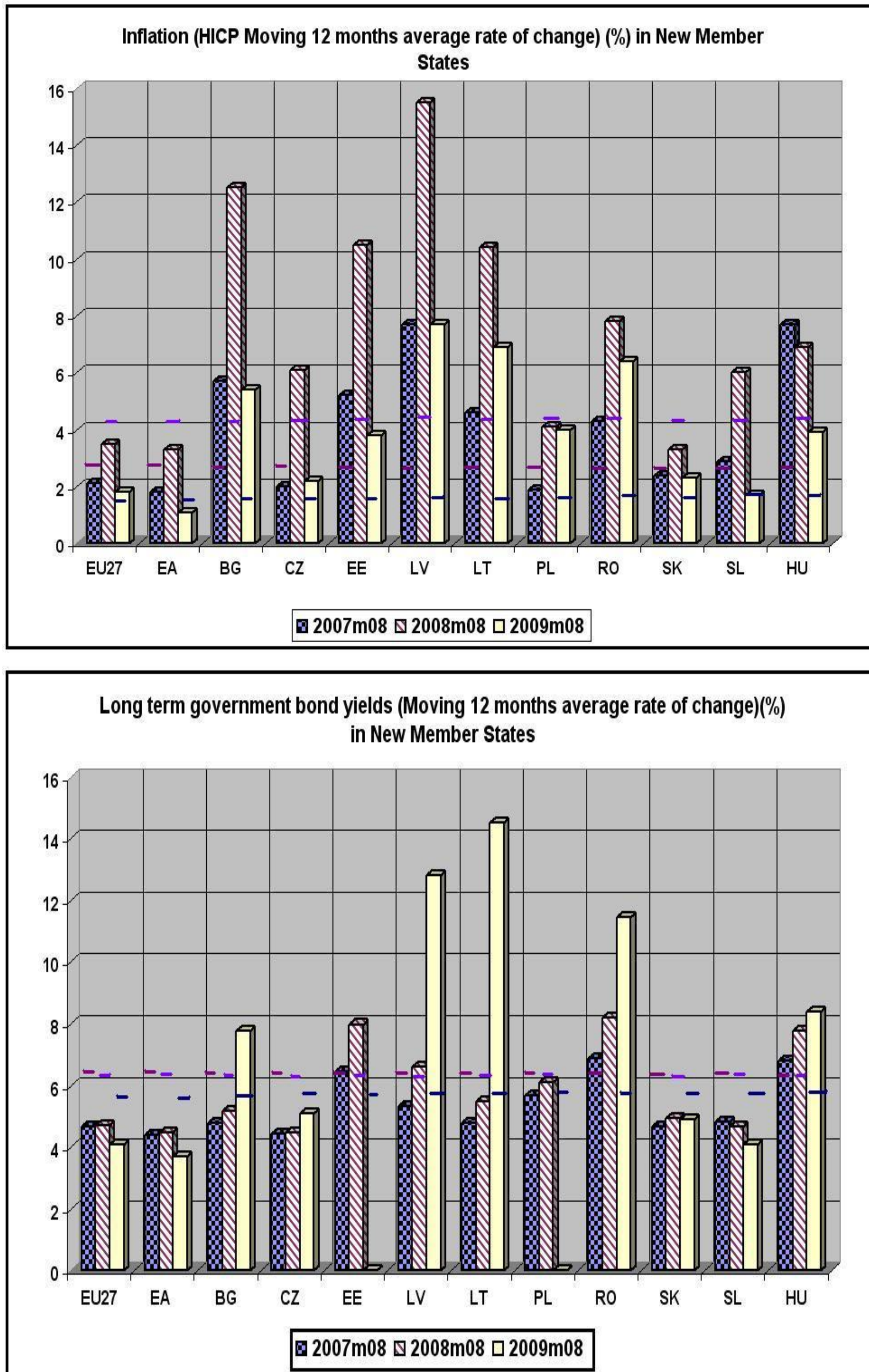



**Fig. 1.** Inflation rates and long term interest rates in the new member states (in August 2007, 2008 and 2009 respectively, monthly dates %)

Source: *Eurostat*

In the period before the occurrence of the crisis, providing higher yields than those of the Economic and Monetary Union, interest rates attracted large inflows of foreign capital, these in turn "pushing down" interest rates. Thus, by 2008, the reduction of market interest rates and the increased confidence in the sustainability of the economy sustained also a decrease of the long term government bond yields in the new member states, in the criterion's limit.

After 2008, although most of the new member states experienced crisis turmoil, the Czech Republic and Slovakia continued to meet the long term government bond yields criterion maybe also because of their healthier economic structure with less significant macroeconomic imbalances than in other new member states. However, the membership to the euro area of Slovakia (Slovakia acceding to the euro on January 1, 2009) has brought additional stability and credibility to this country, both in the year previous to joining the euro and after this moment, outlining the idea that countries belonging to the euro area are more protected from slippages in comparison with other new member states.

The inflation reduction, the market confidence regain, the return of inflow of investments to trends before crisis manifestation and the overall recovery of the new member states economies can cause a rapid return of interest rates and implicitly of long term government bond yields, so that the latter should fit smoothly into the compliance margin of the Maastricht criteria.

When referring to *exchange rate stability* criterion, we can see that all new member states fulfilled this criterion in the period 2004-2008. In 2008, the only currencies that appreciated were Slovak koruna, Czech koruna and Polish zloty. The Slovak koruna, which until January 1, 2009 was in the ERM II, enjoyed, even before entering the euro area, the protective "umbrella" of the European Central Bank.

However, after the appreciation in 2008, compared with its value in December 2007, the Czech koruna depreciated in the first four months of 2009, reflecting, like other currencies in the new member states, the tensions manifested by the financial markets. The same experience was felt also by the Polish zloty, which started to depreciate even from November 2008 (until then, it registered each month appreciation, compared to December 2007), a trend that was maintained during the first eight months of 2009.

It is worth mentioning that, as the appetite for risk has declined globally, it has been registered the withdrawal of capital from the emerging markets and the membership of the European Union turned out not to evince strong enough protection against capital outflows from the new member states. One explanation is that, after the onset of crisis, risk aversion has increased and liquidity has diminished considerably, which led to stronger "punishment" of the countries with larger current account deficits (regardless of their currency regime) by massive capital outflows and hence by a rapid deterioration of the exchange rates of the new member states economies[5].

In 2008, the currencies of Latvia, Hungary and Romania depreciated and the exchange rates of countries with currency board regime remained unchanged, as it was natural. In the first eight months of 2009, the currencies of Latvia, Hungary and Romania depreciated as compared to the value of December 2007, the Romanian leu felt the sharpest decline as it was recorded also during 2008[6] (see Figure 2). The Latvian currency, lats, started a strong depreciation in June 2008 as compared to December 2007; this development increased in October and maintained for the first eight months of 2009.

In October 2008, an extremely serious situation occurred in Hungary, when government securities market stopped and the Central Bank of Hungary had to intervene to make it recover. Besides, the collapse of financial markets in Hungary was prevented also by the financial

[5] The depreciation of the exchange rate was possible, naturally, only in economies of new member states that have not currency board regime.

[6]. The Romanian leu registered the greatest depreciation, the strong depreciation of this currency started in October 2008, as in the case of the Hungarian forint.

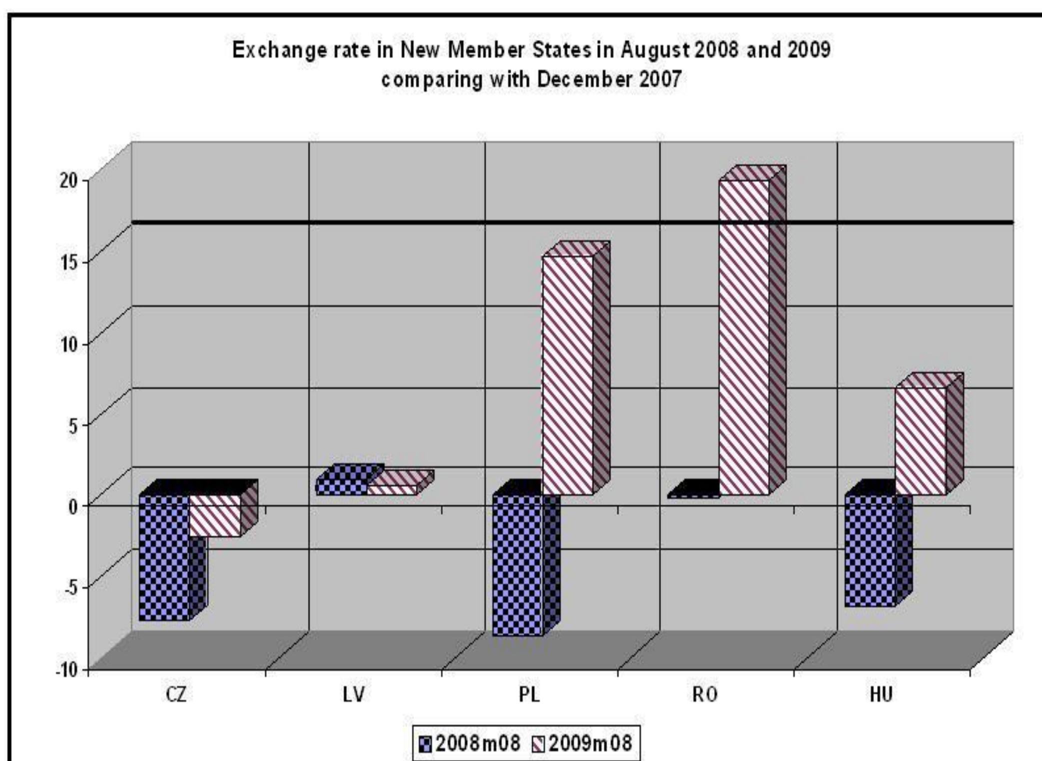
support received from the IMF and the European Union through a stand-by arrangement made extremely fast.

If we analyse the period February-April 2009, the countries that did not fulfill the exchange rate convergence criterion are Poland, Romania and Hungary. However, the situation was modestly fixed for Hungary and Poland, thus they came to meet this criterion by August 2009, while Romania maintained a high volatility of the leu exchange rate against the December 2007 value, over the 15% limit. If pessimistic forecasts, which indicated that Romania, Poland and Hungary would record high exchange rate volatility in 2009, were partially confirmed, this could be fixed in 2010.

Thus, although recent theories have been partially confirmed, theories which suggest that countries with a flexible exchange rate regime have this tool rather as a shock generator than as a shock absorber, however, the situation should be customized.

In this regard, it should be noted that, although countries with flexible exchange rate regime allow a high volatility of the exchange rate and implicitly they let the exchange rate channel transmit the economy the "viruses" of the global financial and economic crisis, this may be, on medium term, a relief valve for other imbalances such as: inflation outbreak, growing external deficits, acute budgetary imbalances, unsynchronized business cycles in relation to EU structures.

Thus, with appropriate monetary policy, these countries can use the exchange rate tool as an imbalances damper, a situation which can not be valid for countries with currency board regime. In this respect, we find that, for the new member states under fixed exchange rates arrangement (including currency board regime), the effects of the crisis have resulted in substantial increases in domestic interest rates and the sudden reduction of economic growth rates, in attempts to reduce excessive current account deficits.



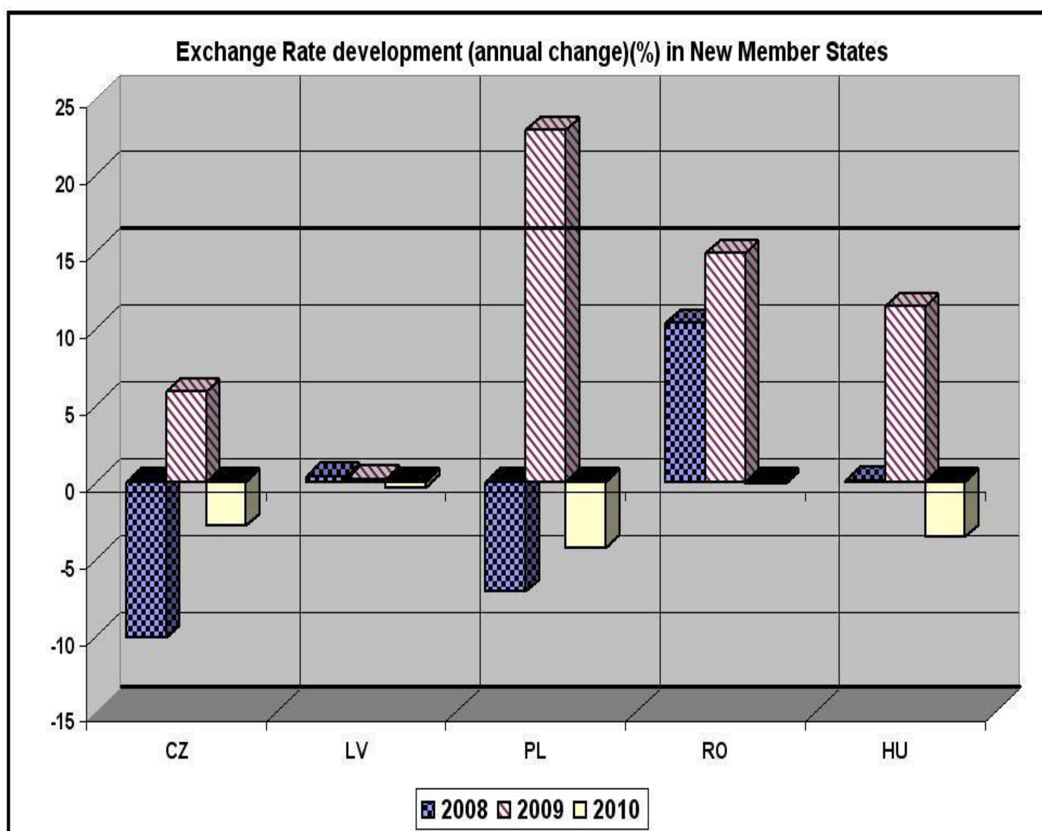



**Fig. 2.** Exchange rate developments in August 2008 and 2009 in the new member states, and the annual evolution of the indicator in 2008 and the prognosis for 2009 and 2010

Source: *Eurostat*, analysis only for the countries, which do not have currency board regime

In conclusion, in the context of the present crisis, being a member of the euro zone has proven to be extremely attractive to new member states because it protects against the currency risk and the shocks associated with the financial crises. But this objective can not be as easily reached as it was before the onset of the crisis.

## The Crisis – A Disturbance Factor for the Fulfillment of the Nominal Fiscal Convergence Criteria

As a result of the economic growth slowdown and the accumulation of imbalances in the current crisis conditions, the fiscal performances of the new member states have deteriorated in this period, the fulfillment of the fiscal criteria representing a real challenge for these countries (see Figure 3).

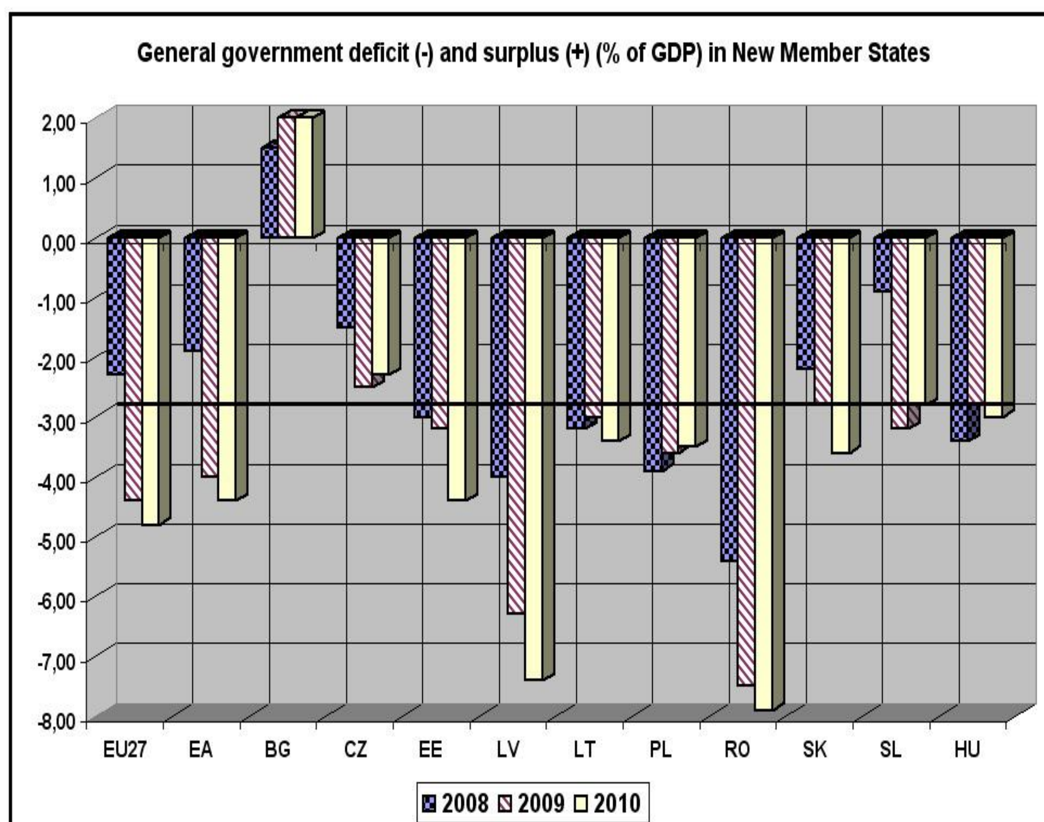
Considering that, also, in the next period, the economic growth remains below potential, as deterioration in the budgetary situation is expected for the period 2009-2010. In 2009, the development of the budget deficit was due both to cyclical factors, as well as to structural ones. Cyclical factors induce a significant increase in government deficits being determined by the slowdown of the economic activity. Also, the diminishing of corporate profits, the depreciation of assets, the slowing, stagnation or even reduction of the wage trend, the burst of unemployment and the increased number of bankruptcies among companies led to a dramatic decrease in budget revenues in 2009 in all new member states. In response to these events, the governments of these countries have already announced and even adopted discretionary fiscal

incentives for promoting the investments and supporting the demand, but despite these measures, the situation will remain serious during the next period.

Concerning the *consolidated general budget deficit,* Latvia and Romania face serious problems that are reflected in the strong growth of this indicator, against the background of the worsening of structural imbalances in these economies and the political instability (in the case of Romania).

However, all new member states suffered deterioration of the fiscal position in 2009, as compared to the previous year, as a result of the unfavorable economic growth and of the crisis implications at the fiscal-budgetary level (rise in the social assistance expenditures - particularly with the unemployment aid - and the reduction of budget revenues due to the diminishing of the contributions to the public budget). Moreover, the fiscal measures meant to help improve the situation, already implemented in the euro area countries, can be added to the general expenditures of the new member states' governments.

Regarding the *public debt*, it increased in all new member states (except for Bulgaria), as a result of growing deficits, bank recapitalization type of transactions and credits to private companies, but also due to international loans made to counteract the crisis effects. However, Hungary is the only country that has exceeded the reference value of this criterion in the last years, and the prognosis remains pessimistic for the future (2009-2010), according to Eurostat. An explanation of the situation in Hungary is given by the fact that government debt is mostly foreign, including the new loans obtained in the context of the crisis (the stand-by agreement with IMF), and the combination of pessimistic prognoses concerning the economic growth and the revaluation of debt expressed in foreign currency due to exchange rate depreciation (forint / euro) have made this indicator to increase significantly and to remain at a very high level.



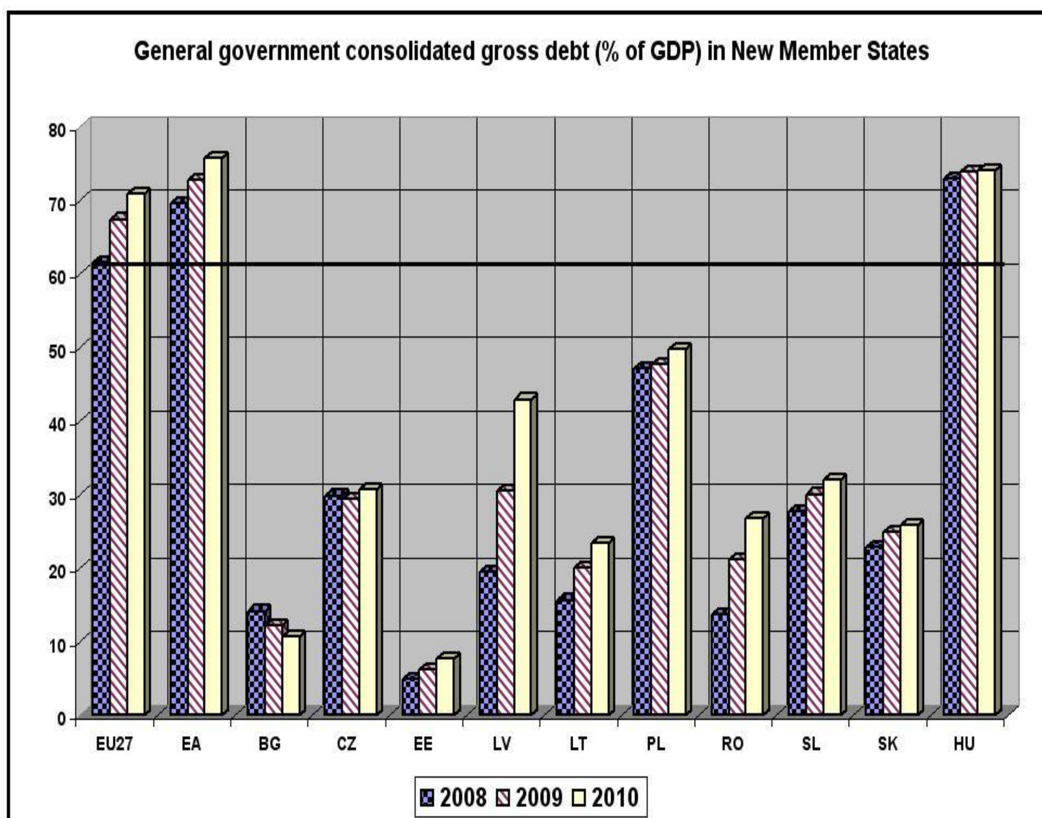



**Fig. 3.** The general public deficit and the consolidated gross public debt in the new member states (% from GDP, in 2008 and the prognosis for 2009 and 2010)

Source: *Eurostat*

## Conclusions

The global financial and economic crisis certainly affected the plans of the new member states concerning the euro adoption. Although it had an unexpected favorable effect on inflation, by "pushing" this indicator down, the costs of economic growth and financial stability of these countries can not be covered by this modest "benefit". Moreover, the crisis has caused an even more dramatic reduction of inflation in the EU 27, as a whole, and in the euro area, leading to a lower reference value of this indicator, making as difficult as before the compliance with the inflation criterion for the new member states.

However, the dramatic reduction in production, the stagnation of the investment inflow, the tensions from the international capital markets, the deterioration of the domestic economic environment, the idea that the emerging economies are more risky have led to the deterioration of long term interest rate criterion in all new member states (except for the Czech Republic, Slovakia and Slovenia) and to a higher volatility of the exchange rate in Poland, Romania and Hungary.

Also, in the new member states, the crisis seems to make a transfer of the pressure concerning the non-observance of the nominal convergence criteria from the monetary criteria towards the fiscal-budgetary criteria. Thus, the fiscal performance of the new member states deteriorate during this period and the situation will worsen in the next period, following the dramatic reduction in economic growth and, consequently, the much lower tax and excise revenues. However, the increase of unemployment and social problems is reflected in the public budgets, through a higher pressure on budgetary expenditures in all new member states.

Although the membership to the euro area could be beneficial in times of crisis, however, the adoption of the euro is not a solution against all risks. Being in the euro area implies among other things, the risk of losing competitiveness, but if one implements policies channeled towards productivity improvement, this risk can be reduced.

As regards Romania, the fulfilment of the nominal convergence criteria requires deep structural reforms: a budgetary deficit smaller or equal to 3% of GDP involves rebalancing and self-financing of the public pension system, and a stable exchange rate involves observing the correlation between productivity growth and real wage increase. In other words, the process of fulfilling the nominal convergence criteria must be accompanied by adjustment measures of the real economy, through a process of real convergence.

Romania needs also to adjust its macroeconomic policies to the new conditions entailed by the international financial crisis, being required the recalibration of economic policies mix in line with the challenges of the crisis.

The economic adjustment process cannot be completely programmed, but an institutional intervention is required by following consistent and credible economic policies in order to avoid dramatic corrections (hard landing). The "smooth" adjustment of the economy and the improvement of the foreign investors' perception require a combination of the macroeconomic policies in order to achieve both an external (current account deficit) and an internal (budget deficit) correction of imbalances.

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# Noi provocări privind îndeplinirea criteriilor nominale de convergență în noile state membre în contextul crizei economice şi financiare globale

## Rezumat

*Criza financiară şi economică globală a accentuat o serie de dezechilibre existente în noile state membre ale Uniunii Europene, creând totodată noi provocări pentru aceste țări. Astfel, în perioada 2009-2010, creşterea economică este şi va fi mult încetinită, ca urmare a condițiilor dificile de creditare şi a reducerii dramatice a cererii. Turbulențele de pe piețele financiare internaționale au creat sentimentul unei siguranțe mai mari a țărilor din zona euro, determinând multe dintre noile state membre să-şi pună problema accelerării adoptării euro, apreciind protecția asigurată de zona euro în perioadă de criză. Totuşi, în aceste condiții, noile state membre ale Uniunii Europene se află în situația de a nu putea să îndeplinească criteriile nominale de convergență la fel de uşor ca înainte de declanşarea crizei. Acest articol îşi propune să identifice o serie de provocări ale crizei economice şi financiare globale asupra îndeplinirii criteriilor nominale de convergență în noile state membre ale UE şi să identifice posibile impedimente în adoptarea rapidă a monedei euro.*