



## **RISKS AND POTENTIAL BENEFITS OF ENLARGING THE EURO ZONE**

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### **Rezumat**

În mod logic, procesul extinderii Zonei Euro, cu asimilarea noilor state membre ale Uniunii Europene, presupune, în primul rând, îndeplinirea criteriilor nominale de convergență din partea țărilor candidate, iar în al doilea rând, adoptarea propriu-zisă a monedei euro. Analiza extinderii ZE ar trebui să pună în evidență costuri și beneficii potențiale importante care ar decurge din acest demers, obiectivul unei astfel de extinderi fiind obținerea unui efect net pozitiv pentru țările membre, atât pentru cele noi, cât și pentru cele vechi. Este dificilă, chiar imposibilă o analiză exhaustivă a acestui proces, de multe ori efectele extinderii ieșind la iveală după o lungă perioadă de la adoptarea monedei unice.

### **Abstract**

Logically, the process of enlarging the euro zone, by assimilating the new EU member states, presumes first that the candidate countries meet the nominal criteria of convergence and, second, the actual adoption of the euro. The analysis of euro zone enlargement should reveal the potential costs and benefits of such action, the purpose of such enlargement being a net positive effect both for the new member states, and for the older member states. It is difficult, even impossible, to make an exhaustive analysis of the process; many times, the effects of the enlargement surfacing only after a long period after the adoption of the single currency.

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### **Introduction**

The enlargement of the euro zone (EZ), which means the spatial enlargement of this monetary union through the adhesion of other EU member states, involves three stages: partial accession to the European Monetary and Economic Union, joining the Exchange Rate Mechanism II (ERM II) and actual adoption of the euro upon meeting the nominal criteria of convergence set by the Maastricht Treaty. This enlargement may be directed towards two regions of Europe: towards the east (assimilation of the Central and East European states) and towards the north (Nordic states: Denmark, United Kingdom, Sweden, Norway<sup>1</sup>). Between these two groups of states there are many differences arising from their historical experience and level of economic development, from the particular organization of their society and from their political view on the adoption of the euro (while the former communist countries were enthusiastic for this perspectives, the Nordic states are reluctant). Given the major differences between these two groups of states (the group of Nordic states and the group of Eastern states), we will only approach in this analysis those countries already facing (politically speaking) the EZ, leaving aside the enlargement towards north.

The potential risks and benefits (some of them) of the new EU member states accession to the euro zone can be identified using a logic model which separates on two levels the analysis of the enlargement process:

- One level presumes analysing the possible consequences arising from the process of meeting the nominal criteria, which shows internal characteristics of the new member states (NMS) that may induce positive or negative effects once the required measures are implemented.

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<sup>1</sup> *Norway is not even EU member.*

- Another level presumes analysing the possible effects on the domestic economy after the actual adoption of the single currency. This aspect is more difficult to evaluate due to the large array of problems that may arise over a longer period of time. The experience of the older member states (OMS) with the euro zone is a support to our analysis. We will not use the econometric models which are not only limited, but they are many times exceeded by the dynamics of the economy, by the various and increasingly often shocks rippling through the world, shocks which usually deviate the normal and expected evolution of the economic processes. The analysis of risks and benefits remains vulnerable in this respect.

Because the NMS can be grouped, based on the type of monetary policy they adopted, in two categories – countries targeting the exchange rate, either using a monetary council, or using a hard peg-type system (Bulgaria and the Baltic States) and countries targeting inflation (Czechia, Hungary, Poland and Romania) – the analysis we deal separately these components.

### **1. The process of meeting the nominal criteria of convergence and its implications**

1. Meeting the inflation criterion implies a level of convergence of the national monetary policies which should be analysed within a wider framework, that of sustainability. The sustainability of meeting this criterion presumes, on the one hand, price stability which may allow the countries to benefit of the single market advantages and, on the other hand, it represents a condition required to make the euro a strong currency.

The fulfilment of this criterion, as it is interpreted now, may generate the risk of long-term misbalances. The NMS suffer from a process of closing the gaps, of real convergence with the developed countries of the EZ, which also involves price convergence. Hastening the process of meeting the inflation criterion by discretionary measures may lead to sideslips after the adoption of the single currency. Under the conditions of a *fixed exchange rates*, price convergence may be done only by increasing inflation, while under a *flexible exchange rates*, price convergence may be done by an appreciation of the nominal exchange rate or by a higher inflation, or by both phenomena.

The inflation criterion is very hard to meet, particularly for the Baltic States and Bulgaria, which have fixed exchange rate systems. The

faster is the convergence process, the higher will have to be the inflation, which actually is an effect of adaptation of the economy to the conditions of the hard peg regime given the gap between the two regions. The structural factors of such an evolution will yield inflationist pressure even after the accession to the EMU. The authorities may be tempted to use various techniques – freezing the administered prices, reducing the taxes on consumption or limiting the increase of credit employing different short-term innovations – with the purpose to force the reduction of this indicator below the reference value. In other words, the countries wanting to adopt the euro as soon as possible may be tempted to just meet the nominal criteria using various techniques and methods efficient on the short-term, that will be discarded as soon as their goal is achieved, which might have contrary effects. The Baltic States and Bulgaria have higher inflation rates than the reference value and higher than the rates from the countries with flexible exchange rates. A combination of moderate nominal rates and higher domestic inflation automatically produces lower real interest rates; the tempering of the domestic demand induced by this situation can only be achieved through the fiscal policy and by the intense utilization of regulatory instruments which to prevent the appearance of speculative bubbles in relation with the price of assets.

In the countries with flexible exchange rates, the inflation criterion can be met by the appreciation of the nominal exchange rate. In fact, the experience of the recent years in the NMS, has shown that the success of the deflationist process in the countries with flexible exchange rates was the nominal appreciation of the exchange rates of the national currencies for the euro, appreciation which absorbed the pressure on the domestic inflation.

Comparing the two types of exchange rate regimes used in the NMS, one may observe, on the one hand, that the fixed exchange rate regime from the Baltic States and Bulgaria made it difficult and even inopportune for these countries to meet the inflation criterion; on the other hand, the countries with flexible exchange rates that want to join the EZ under the conditions set by the Maastricht Treaty, should paradoxically have to be available to accept higher inflation rates than the current ones (Jean Pisani-Ferry et al, 2008).

The price stability criterion was set under different conditions and for countries other than NMS, hence its interpretation should be adapted to the new situation. A strict interpretation only makes the

relationships and the functioning of the European mechanisms more rigid. The higher inflation from the NMS is a consequence of the gap closing process and meeting the inflation criterion doesn't mean that the values of this indicator will maintain after accession. In fact, from the experience of the countries which have joined EMU, and from that of the countries with a fixed exchange rate, the inflation rate might increase afterwards. This is one risk that the countries candidates to the euro zone run. The effort of meeting the inflation criterion might produce economic sideslips after the adoption of the euro.

2. The exchange rate stability criterion and the requirement to spend at least two years within ERM II seems to be, at the present moment, less beneficial because the countries with flexible exchange rates experienced a period of nominal appreciation, while those with a fixed exchange rate met this criterion automatically (in fact, the exchange rate criterion was taken into consideration in order to preclude from the direct admission into the EZ of those countries whose national currency depreciated, which is not the case of NMS. ERM II risks inducing higher inflation because of the real appreciation of the exchange rate. The higher inflation rates, however, might create problems on the financial markets when they perceive the possibility of not joining the euro zone (because of the inflation criterion), manifested by speculations and the risk of financial crises. This criterion should be interpreted more flexibly, also taking into account the exchange rate history in those particular countries (Jean Pisani-Ferry et al., 2008).

The NMS authorities targeting inflation should focus on consolidating the credibility of their economy upon joining the ERM II, avoiding thus to become victims of speculative attacks, which might compel them to reevaluate the central exchange rate and generate thus substantial costs for their economies. The National Bank should set an inflation target which to allow a stable evolution of the national currency within ERM II. In other words, central bank's credibility on inflation targeting is a necessary condition so it can act to prevent or eliminate possible speculative stressors. In these countries, the monetary policy has the capacity to reduce the pressure of the domestic demand through the interest rate, but it was observed that this instrument was not fully used for this purpose for fear of exchange rate flotation. The monetary authorities from these countries tried to avoid thus the situation in which the increase of the interest rate (to reduce the pressure from the domestic demand) may

attract too many inflows of capital, which might cause an excessive volatility of the exchange rate, thus compromising the fundamental objective of the monetary policy (price stability), with adverse consequences on the economic growth and current account of the balance of foreign payments. Joining ERM II is not a danger itself, the risk is generated by the incorrect determination of the central exchange rate.

3. The imposed fiscal criteria are generally more adequate to these countries which are working to close the gaps and which need institutional maturity and political capacity to discipline the public finances. However, in this case too, the strict interpretation of the criteria and sticking by some set numerical values risks to generate adverse effects, particularly under the conditions of the global financial crisis. Thus, the obligation to meet the criterion on the fiscal deficit may yield internal tensions and social costs. The new EU member states have fewer possibilities to fund their budgetary deficit, partial because of the crowding-out effects induced by the fiscal expansion of the developed economy. Under the conditions of the global crisis, the packages intended to stimulate the domestic demand or the investments will be difficult to implement if these countries try to stick with the limits imposed by the Maastricht treaty. Meeting this criterion implies the reduction of the budgetary expenditure and the increase of the revenue to the budget. Thus, Lithuania will rather have to implement a package of fiscal austerity, than one of stimulation, which should help alleviate the effects of the recession in 2009. The measures focus mainly on increasing the VAT, but don't intend to reduce the income tax. Hungary doesn't have the capacity to give stimulants because of the high debt and because of the national currency depreciation.

The values imposed by the Maastricht Treaty might be too rigid for the NMS, given that these are emerging countries, dynamic, with less developed financial markets. A public debt amounting to 60% of the GDP might be outside a reasonable safety margin for the fiscal sustainability.<sup>2</sup> At the same time, even a lower level of the public debt may be supported by higher fiscal deficits, given the prospects for a higher economic growth for the NMS. Thus, for economic growth

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<sup>2</sup> *Assessing the Sustainability of Public Debt in Emerging Market Economies*, World Economic Outlook, IMF, Washington DC, sept. 2003

rates in excess of 5%, the 60% public debt might be done for higher levels of the fiscal deficit. Because the NMS need more important investments in the public sector, in order to modernize the education, health care and public administration, and part of the investments should be debts financed out of economic reasons, the constraint of the general fiscal deficits for these countries might be counterproductive, becoming a hindrance for the long-term economic growth and, implicitly, for the process of convergence. The countries that are developing too fast can't allow themselves the kind of public expenditure cuts which the shift to the euro demands. They need a general infrastructure adequate to the development of economy, not just a road infrastructure, but also an institutional infrastructure (schools, hospitals). Therefore, the construction and consolidation of this infrastructure requires financing through loans from the capital markets. The deflationist policies of the European Central Bank are not too encouraging. For instance, Czechia maintained constantly the interest rate below the threshold set by ECB, in order to stimulate the growth (N. Pop et al., 2008), while Romania needs higher interest rates, not to depreciate the euro and thus cause inflation because of the imports. The new member states need flexibility when setting the interest rates in order to cope with the obstacles on the road to modernization.

The short-term strict observation of the nominal criteria of convergence, thus ignoring the situation of the real economy, risks yielding internal misbalances and social costs in the NMS.

However, a generally valid benefit for all NMS during this stage of meeting the criteria for nominal convergence is **enforcing political discipline**. The Government and the National Bank, the institutions responsible for the macroeconomic policies (fiscal-budgetary and monetary, respectively) must monitor and ease the fulfilment of these criteria, and the political discipline derives from the **responsibility** which they assume for this task and it involves more **firmness** in decision-making by applying strategies based on rules, less on discretionarity. Applying this behaviour gives more **credibility** to the national political institutions.

## **2. Possible risks and benefits of adopting the euro in the new member states**

Theoretically, all Eastern-European countries integrated within the European Union should get ready to become euro zone members. It

was considered for a long time thus such a quality would generate stability in countries which were still struggling to get rid of decades of state planning. The investors were waiting impatiently the shift to the euro for three reasons: restrictions on the public loans demanded by the European Union would prevent the governments from gathering large debts, would force them to remain within the European Union and would mean that the assets are evaluated in a stable, global currency – not in several smaller currencies which many people don't even know (N. Pop et al., 2008).

On the other hand, the global financial crisis whose consequences persist and worsen, changes the landscape of the shift to the euro. The outflows of capital, the worldwide slowing economic activity affected much the NMS, which intensified lately the debates on adopting the euro. The divergence of opinions on this issue remains, but the priority of these countries should be to develop and consolidate a domestic offer which to compensate the outflow of capital and the shrinking external orders.

The literature dealing with the monetary integration highlights the costs and benefits of adopting the single currency (see the box below). However, a correct analysis of these costs and benefits, under the current conditions and taking into consideration NMS features and their relations with the exterior, might lead to interpretations other than the theory.

**Box**

**Theoretical costs and benefits of adopting the euro**

Among the **general theoretical costs** of adopting the single currency are: technical costs of conversion; losses of the banking sector from the lack of banking transactions; loss of monetary policy independency as instrument stabilizing the economy; probability of a higher inflation from the catching-up process, because the adoption of the euro will exclude the nominal appreciation, any real appreciation coming at the expense of a higher inflation.

The **general theoretical benefits** of adopting the euro are both on the short-term – by the absence of the exchange rate risk towards the euro and by reducing the exchange rate risk towards the US dollar; by eliminating some transaction costs; by a higher transparency of the prices and by a higher resistance to the currency crises – and on the long-term, by a more intense trade between the members of the monetary union or by the higher flows of investments.



### 3. An interpretation adapted to the current reality

Generally, the EU member states (both those from the euro zone and those outside it), cross a difficult period reflected not just by the lower domestic demand for consumption and investments, and by the shrinking foreign orders (the case of Germany, country developed through exports, is eloquent). ECB has a **monetary policy** oriented towards adjustments at the EZ level (the so-called *one-size-fits-all* policy). Under the conditions of a divergence in terms of inflation between the NMS and the older member states (Germany and France, particularly), ECB, monitoring the EZ “average”, will run a more relaxed policy (lower interest rates) in order to stimulate the larger economies which are more rigid. Because the NMS need higher interest rates to temper the inflationist pressure (which persist, even during the economic recession induced by the crisis), the loss of this instrument will generate additional pressures on the demand. Thus, inflation tends to be higher in the NMS than in the EZ, which means real interest rates close to zero, affecting the saving and investments (deter saving and stimulate investments, thus spending). However, if this expenditure would be for production investments, the risk of the common monetary policy would not be as obvious. Given the experience of the older member states from the periphery, the pro-cyclic effect of the common monetary policy might be adverse for the NMS, but not as significant as that observed in the older member states.<sup>3</sup>

The accession to the EZ means lower costs with **currency transactions**, which should stimulate the trade with other EMU. For the NMS, the adhesion will probably stimulate the outsourcing relocation and intra-branch integration with EZ partners. On the other hand, given the recession affecting the European countries, it is not sure whether the adoption of euro within such a context would be an important benefit in terms of tighter trading relations. The adoption of the euro would, nevertheless, intensify the trading relations, but it is difficult to evaluate the net effect, because the NMS have already

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<sup>3</sup> Unlike the states which joined the EZ with the first wave, the convergence of the real interest rates already is very advanced in the NMS, particularly in the countries which are directly linked to the monetary policy of the ECB (the Baltic States and Bulgaria), under the conditions of a higher financial integration with the EZ countries.

more intense trading relations with the EZ countries, once they decided to be EU member states.

The elimination and reduction of the **currency risk** was an important benefit for the small countries which have tight trading and financial relations with the countries whose currencies are anchors for exchange rate targeting. This benefit might be valid more so as the global financial crisis increased the exchange rates volatility. Giving up the national currency doesn't guarantee financial stability, however, because the euro can be subject to external speculative pressures.

**Price transparency** is beneficial to the developed countries whose population has higher incomes than the population from some NMS, and a higher purchasing power. Price transparency eases price comparison, which might stimulate consumption of the population from the developed EZ countries in the NMS whose prices are lower in relation to the incomes of these consumers. There might be a migration of the consumption for some products (the "shopping tourism") from developed countries under recession towards NMS, which will yield inflationist pressure in the latter countries.

EMU functioning should reduce the probability of the *sudden-stop* like phenomena, which is the **reversibility of the inflows of capital**. This aspect is valid, none the less, under the conditions in which the global financial market is not affected by turbulences, by the increased aversion towards risk. Given the global financial crisis, even if the sudden-stop policies are no longer working (because of the adoption of the single currency), the reversibility of the capital inflows still is possible, as soon as the investors perceive the target countries as being high risk and vulnerable countries. The cost of the foreign capital might decrease after the accession to the EZ because the currency risk premium disappears, which increases the availability of capital.

In order to capture concretely some risks and benefits yielding from the enlargement of the EZ, we selected several macroeconomic elements that might give us a picture of the risks and possible benefits of adopting the euro in the NMS.

Thus, analysing some of the factors influencing **economic competitiveness** (real exchange rate, exchange rate of the national currency related to the currencies of the main partner NMS, preferences of the foreign demand, international situation – recession

or economic growth) and relating them to NMS economies, we may get some signals regarding the opportunity of adopting the single currency.

Analysing the **inflows of foreign direct investments attracted lately by the NMS** and their impact in the economy may give us further insights on the risks or benefits. The countries which directed all these inflows towards non-productive sectors are more vulnerable in terms of foreign debt and competitiveness after the adoption of the euro. On the other hand, the adoption of euro will also be a stimulus for the foreign investments which, in turn, might have a positive effect on the economy, depending on the particular economic branches.

Another aspect concerns the **real appreciation of the national currencies**, by the medium-term impact on the economy of the influence on the foreign competitiveness, effects on the purchasing power of the population and on population indebtedness.

Given the fact that the adoption of the euro means a monetary conversion of the private sector debt, the **proportion of the credit denominated in euro** within the total banking credit and within the GDP also is important.

The **economic competitiveness** is a channel used to adjust the misbalances when the exchange rate can no longer be used as instrument for such corrections. The adoption of the euro recently affected this means of correction in the economies of Slovenia and Slovakia through the conjugated action of the serious economic recession and on the appreciation of the euro in relation with other currencies. This conjecture oriented the domestic demand from these countries towards the offer of the neighbouring countries, which were not EZ members,<sup>4</sup> which benefited thus from a depreciated exchange rate of their national currencies in relation with the euro. The appreciation of the euro decreased the sales of some local companies and exporters, making it more difficult for these economies in recession to recover. The recent experience of these two countries may be a lesson for the NMS which will adopt the euro, particularly for the countries which still have an independent monetary policy, with a flexible nominal exchange rate. The most enthusiastic

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<sup>4</sup> According to Bloomerg, the inhabitants of Bratislava displayed lately a trend to go shopping in Hungary, this phenomenon of the shopping tourism being favoured by the adoption of the euro.

are the Baltic States which, paradoxically, having national currencies anchored to the euro, also have a higher level of commercial integration with the countries outside the EZ. If the recession will continue for a longer period, and the Baltic States would adopt the euro, they will continue to sustain losses of competitiveness on the background of the recent appreciation of the euro in relation with the national currencies of the commercial partner countries (Russia, Poland, Norway, Sweden). Actually, by adopting the euro or by maintaining it as nominal anchor, they will neither gain, nor lose too much.

The economic literature suggests that the macroeconomic performance of a country may be stimulated by the inflows of direct foreign investments (DFI), but the experience shows that not all DFI inflows had a positive impact on the development of the productive potential of the economy, rather those DFI inflows which contributed directly to the improvement of the trading balance (which is a gain of the integration).

The adoption of the euro is expected to improve the conditions under which the DFI<sup>5</sup> would be a rather stable way of internal financing for the lag between the saving and investments, reducing thus the risks pertaining to the current account misbalances, but the long-term benefits will depend on the way in which the DFI are managed and directed towards tradable sectors. Such inflows should generate transfer of technology, with the positive potential to increase productivity in the tradable sectors of the economy. The projects financed by DFI which develop the production of exportable goods or of goods that substitute imports and which help improving productivity and increasing the productive capacity of the economy, will also have a positive effect on the net export, and the real appreciations of the exchange rate will not necessarily affect the economic competitiveness. In other words, the real appreciation is "sustainable" only if the net gains from export are enough to prevent the increase of the net foreign debt above a specific safe level. In Czechia, the DFI inflows had a positive effect on the process of integration because

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<sup>5</sup> *This hypothesis is supported by several empirical studies (Ahearne, von Hagen, Schmitz, 2008) which suggest that a potential increase of the capital inflows in the NMS will occur after they adopt the euro (based on the significant differences between the income per capita in the NMS and the older member states).*

they improved the commercial balance by expanding the processing industry, which had a direct contribution to the development of the exports. The risk of adopting the single currency in this country will probably not exist in terms of economic competitiveness and foreign debt, particularly since the integration with the EZ countries is quite high (65% in 2008, according to Table 1.a from the Appendix).

We can not say the same thing about the countries which although have been “invaded” by foreign capital, suffered lately deteriorations of the trading balance. The explanation is that the DFI inflows have been directed towards those sectors which don't contribute to the increase of exports (non-tradables). For instance, in Latvia, Lithuania and Romania the DFI inflows on the trading balance because were directed mainly towards the real estate sector, constructions and financial services. These countries may be confronted in the future with sizeable increases of the foreign debt, massive decrease of incomes and deterioration of the competitiveness on the foreign markets, being more exposed when they adopt the euro.

The adoption of the euro is an additional risk for the countries having an independent monetary policy, foreign debt and high current account deficit (such as Hungary and Romania, as shown in Table 3.1 from the Appendix), because the exchange rate policy is no longer an instrument to make the necessary adjustments. The adoption of euro doesn't mean the prescription or reduction of the foreign debt, it means just monetary conversion. The correction of these misbalances only through fiscal measures would affect adversely the economic activity and the social situation (corrections using cuts of the budgetary expenditure and increased fiscality, aggravating thus the economic recession experienced by these countries). The reduction of the monetary policy interest rate which some NMS will bear after the adoption of ECB monetary policy may discontinue suddenly the adjustment of the foreign misbalance as it is currently done in these countries and may exert strong depreciating pressures on the national currencies. As shown in the table from the Appendix, Czechia and Poland have the best standings from this perspective.

One of the most acute problems of adopting the euro in the NMS is the **potential appreciation of the real exchange rate**, on the medium-term. Empirical studies (J. Babecký, A. Bulíř and K. Šmídová, 2009) noticed differences in the evolution of the

sustainable real exchange rate<sup>6</sup> during a wider time frame spread on two period, 1999-2007 and 2008-2013 (Table 1). Thus, Czechia and Hungary reduced significantly the speed of appreciation, while the Baltic States and Bulgaria increased the speed of real appreciation. Romania and Latvia passed from a period of depreciation of the real exchange rate to a period of speedy appreciation. For the countries undergoing accelerated appreciations of the real exchange rate on the medium-term, the preparation for accession to the EZ and the adoption of the euro may be more complicated because of the potential conflict with the requirements of the nominal convergence. For the countries which only experienced slight benefits from the integration (reflected in the improved trade balance), the moderated real appreciation of the exchange rate may be compatible with the Maastricht criteria, such as it is for Czechia.

**Table no.1**  
**Sustainable real exchange rate in the new member states(%)**

Country	1999-2007	2008-2013
<b>Countries which slowed the speed of real appreciation</b>		
Czechia	-2.8	-1.7
Hungary	-4.0	-0.8
<b>Countries which increased the speed of real appreciation</b>		
Bulgaria	-0.1	-2.0
Estonia	-1.0	-1.7
Lithuania	-0.3	-1.0
Poland	-0.6	-0.7
<b>Countries which passed from depreciation to real appreciation</b>		
Romania	1.5	-5.0
Latvia	2.1	-1.2

Source: J. Babecký, A. Bulíř and K. Šmídová, 2009

Note: „+“shows depreciation, and „-“ shows appreciation

<sup>6</sup> The authors define the “sustainable” exchange rate as that real exchange rate which provides a sustainable net foreign debt on the medium term. This concept differentiates the changes of the real exchange rates determined by fundamental factors (foreign demand for exports, initial foreign debt and DFI inflows) from the changes determined by conjectural factors.

On the medium term, the appreciation of the national currencies is not the only risk for adopting the euro. During this interval the national currencies might also be overevaluated, which will have an adverse effect on the foreign misbalance and on the foreign debt.

On the other hand, the current conjecture with volatile exchange rates, lower foreign demand, nominal interest rates close to zero and increased aversion of the foreign investors to the potential risk of the NMS (as emergent countries), changed the landscape for DFI. Thus, the positive impact of these investments on the foreign trade of some countries (Czechia and Hungary) may be slightly counterbalanced by the current international environment (by a potential phenomenon of capital outflow), and those countries may experience real depreciations of the exchange rate in order to preserve the foreign balance (by nominal depreciations which may affect inflation). However, the greenfield direct investments in productive sectors are harder to withdraw because they are strongly anchored in the economy and their withdrawal is not necessarily a gain for the investors. More vulnerable are those countries with a higher share of the investments directed towards real estate and constructions, such as it is in Latvia.

Supposing, however, that the NMS will continue with the appreciation of the real exchange rate because of the catching-up process, the adoption of the euro risks to increase inflation, which will affect the **purchasing power of the population** (under the conditions in which the nominal income of the population remain unchanged). Furthermore, if the private sector has a high level of indebtedness, it will have a more difficult time to shift to the euro. There are significant differences between the surveyed countries in terms of share of the banking credit to private sector within the GDP. Thus, the countries with high values of this indicator are Estonia, Latvia and Bulgaria (in excess of 70% of the GDP), followed by Lithuania and Hungary (50-60%) and by Romania, Poland and Czechia (40-50%)<sup>7</sup>.

The **NMS currencies targeting inflation** preserve a potential of appreciation, at least in real terms, towards the euro, on the background of the process of convergence. Under the conditions in

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<sup>7</sup> According to national banks data and Eurostat statistics. Data for the end of December 2008.

which inflation remains low (the basic goal of the national monetary policy), then the nominal exchange rate appreciates. If the central exchange rate of the national currencies in these countries would be set at the present value of the exchange rate, the currencies will be undervalued on the background of the potential appreciation, which will generate higher costs for those having taken credits. Within such conjecture, all the countries will be severely affected by the high proportion of the medium-term and long-term banking credits of the households within the total value of the credit to households (see Table 2)<sup>8</sup>.

**Table no. 2**  
**Medium-term and long-term credits to the private sector (which are influenced by the real appreciation of the exchange rate)**  
*(December 2008)*

Country	Medium-term and long-term credits to the companies (% within the total credits for companies)	Medium-term and long-term credits to the households (% within the total credits for households)
<b>Bulgaria</b>	60.5	85.0
<b>Czechia</b>	61.3	95.0
<b>Latvia</b>	82.9	93.7
<b>Lithuania</b>	77.2	98.2
<b>Hungary</b>	64.5	94.2
<b>Poland</b>	66.7	88.0
<b>Romania</b>	58.1	95.0

*Source: Central banks statistics*

The existence of a high proportion of **credit in euro** within the overall credit, eliminates the exchange rate risk, being a potential benefit for the countries with higher proportions. Estonia and Latvia seem to take most advantages from the adoption of euro because they have the highest proportions of this indicator (85.2%, and 88.4%)<sup>9</sup>. Among the countries targeting inflation, Czechia has a very low proportion of this indicator (just 8.7%)<sup>10</sup>, which might show that

<sup>8</sup> *The credit taken into consideration is the banking credit, because in these countries the banking sector dominates the financial market.*

<sup>9</sup> *According to Eurostat. 2008 data.*

<sup>10</sup> *According to Eurostat. 2008 data.*



the private sector will benefit less from the adoption of the euro, at least from the perspective of the existing credits. However, taking into consideration that the trading integration with the EZ countries is the highest among the surveyed NMS, Czechia might benefit from the adoption of the euro by enhancing its trading relations with the EZ countries. Although the existence of a dominant proportion of the credit in foreign currency (euro) would eliminate the exchange rate risk, the burden of the debt still remains anyhow.

The experience of the countries at EZ periphery shows that the adoption of the euro might be beneficial for the NMS in terms of the cost of the existing public debt service. This can be determined by the reduction of the risk premium for the long-term state securities following the financial integration and harmonization of the fiscal and monetary policies in the NMS.<sup>11</sup> The reduction of the risk premium will automatically reduce the cost of the existing debt service.<sup>12</sup>

By enlarging towards the east, the EZ gets increasingly diversified and the older member states, which tend to be more rigid and less dynamic, can be advantaged by the rising of the new member states by intensifying the relations with much more dynamic and maybe more flexible countries. It is hard to evaluate, nevertheless, how much will the NMS gain from giving up their national currency given the so fast and dramatic changes that occurred lately.

The political implication of enlarging the EZ differ according to the two types of exchange rates mechanisms. For the countries with a fixed exchange rate system, the challenges ahead remain important

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<sup>11</sup> *The harmonization of the monetary and fiscal policies on the way towards adopting the single European currency contributed substantially to the long-term convergence of the yields of the governmental securities in the EZ. However, empirical studies (D. Côté, C. Graham, 2004) show that this convergence can not be assigned primarily to the introduction of the single currency, because the same trend has also been observed in other countries which are simply EM member states, but didn't adopt the euro (Denmark, Sweden, United Kingdom) and in countries outside the EU and the EZ (Australia, Canada, Norway, Switzerland). This study also shows a gradual reduction of the risk premium after the signing of the Maastricht Treaty, and a drastic reduction after the adoption of the single currency.*

<sup>12</sup> *For instance, in the case of Greece, after the adoption of the single currency, the risk premium for the long-term state securities, compared to EZ average, decreased rapidly from 500 to 100 basal points, which decreased accordingly the cost with the service of the existing debt (J. Babecký, A. Bulíř and K. Šmidková, 2009).*

because they are confronted with more serious misbalanced, while the instruments for adjustments remain limited (fiscal policy and labour market measures). The adoption of euro will not eradicate the misbalances but it can alleviate some problems. For those countries with a flexible exchange rate system, the challenge for the coming period is to keep on a clear and systematic track for the adoption of euro, stressing on a good preparation rather than in a temporal determination of introducing the euro. (European Commission, 2008).

A comprehensive picture of the risks and benefits from the enlargement of the Euro Zone requires detailed analyses starting from the macroeconomic environment and ending with the microeconomic environment of each country, the analysis of the influence which this process will have in time on the activity of the companies and households, taking into account at the same time the world and European economic conjecture. Given the difficulty of getting a concrete plan of such objective because of the effects of the global financial crisis which changes the coordinates supporting previously such an analysis, this study limited to a brief presentation of some risks and possible benefits of the process of enlarging the monetary union.

### **Conclusions**

The analysis of this enlargement and its risks and benefits to the new member states must leave from the knowledge of the internal macroeconomic situation and from an analysis of the nominal criteria of convergence. The two stages of the analysis (the preparation to meet the nominal criteria of convergence and the actual adoption of the euro) have revealed some risks and potential benefits of enlarging the EZ towards the new member states, but the net effect is hard to evaluate because of the short period covered by the analysis, the effects of the enlargement surfacing after a longer period from the adoption of the euro. Furthermore, the rapid worldwide evolutions may change dramatically the present landscape of the Euro Zone.

In the case of the rigid exchange rate system of the Baltic States and Bulgaria, it is difficult and even inopportune to meet the inflation criterion, while for the flexible exchange rate system, the countries that want to join the EZ under the conditions set by the Maastricht Treaty should paradoxically be willing to accept higher inflation rates than the current ones. The monetary authorities of the NMS targeting inflation should focus on setting a central exchange rate of the

national currency as credible as possible. In fact, joining the ERM II is not a risk by itself, but the risk is generated by the improper setting of the central exchange rate, which may generate speculative attacks on the national currency. The effort of meeting the fiscal criteria (the fiscal deficit, particularly), made more difficult by the effects of the global financial crisis (through the mechanisms of automatic stabilizers) generates the risk of social costs; it may also influence adversely the long-term economic growth, and the process of convergence under the conditions in which the NMS develop fast and need massive investments in public infrastructure and a higher flexibility in order to cope with the obstacles on the road to modernization.

The strict observance of the criteria of short-term nominal convergence, while ignoring the situation of the real economy, risks generating internal misbalances and social costs in the NMS. However, a general benefit for all NMS during this stage is that of setting a political discipline.

The analysis of this subject revealed some potential risks and benefits from the actual adoption of the euro in these countries (presented synthetically in the table below); they were also identified from the past experience of the old member states, although the economic conditions changed a lot.

<b>No.</b>	<b>Elements of analysis</b>	<b>Risks</b>	<b>Benefits</b>
1	Economy competitiveness	<ul style="list-style-type: none"> <li>- Losses generated by the nominal appreciation of the euro in relation with other currencies;</li> <li>- Losses generated by the economic recession of the partner countries due to the lower number of orders from abroad.</li> </ul>	—
2	Commercial integration with EZ countries	—	<ul style="list-style-type: none"> <li>- A higher level of this indicator will support trade development.</li> </ul>
3	Inflows of capital	- Directing the	- Quite stable

*Financial Studies*

		inflows towards consumption or towards the non-tradable sector, with the risk of increasing the foreign debt, with potential massive decrease of incomes and poorer competitiveness on the foreign markets.	domestic funding of the gap between saving and investments - Transfer of technology through DFI, with positive potential for a higher productivity in the productive sectors of the economy.
4	Real exchange rate on the medium term	- The fast appreciation of the real exchange rate on the medium term complicates the process of adopting the euro by affecting the inflation and the purchasing power of the population; - Setting a central exchange rate at the present nominal exchange rate to join the ERM II (in the countries targeting inflation), risks to undervalue in time the currency (on the background of the real appreciation) increasing the debt burden of the medium and long-term credits.	—
5	Banking credit for the private sector denominated in euro	—	- A high proportion of this indicator within the total banking credit should be advantageous by eliminating the exchange rate risks in relation with the

*Financial Studies – 2/2010*

			euro.
6	Cost of the public debt service	—	- The reduction of this cost by the potential decrease of the risk premium for the long term governmental securities, by the financial integration with the EZ countries.

The NMS, irrespective of the stage or time frame which they have planned for the adoption of the euro, will be affected by risks if they don't have a sustainable position of their economy. Countries such as Latvia or Lithuania and Bulgaria, although are close to adopting the euro and want to join in as soon as possible, will be anyhow affected if they didn't develop a national offer, the economic growth being achieved during the recent years based on the demand, credits and development of the real estate market. Therefore, if the Maastricht criteria will be necessary for the adoption of the euro, they will not be enough for a sustainable long-term functioning of the analysed new member states; ultimately, what matters is the net gain obtained by giving up the national currency in favour of the community currency. Such a gain may not exist, after all, or it may be temporary. Time will show where this monetary union is heading.

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