

There's many a slip twixt the cup and the lip.

Ben Franklin

Monetary Policy Challenges on the Road to Euro

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Introduction

In May 2004 and January 2007, the European Union was enlarged to include ten new members from Central and Eastern Europe, following an extraordinary structural and institutional transformation from socialist central planning.¹ The post-socialist transition, began in the early 1990s, was by no means linear and the chosen policy strategy differed across countries. However, already prior to membership, most of the accession countries had declared their intention of joining the euro area soon upon meeting the Maastricht requirements.² Against this backdrop, the motivation for writing this paper is twofold.

First, considerable criticism was leveled at the conduct of macroeconomic policies in these countries, in preparation for EU membership. For example, Estonia's prolonged adherence to a currency board arrangement and lack of an exit strategy were questioned. On various occasions, application of inflation targeting was characterized by some observers as fanatic in Poland, confusing or inconsistent in Hungary, and less than transparent in the Czech Republic. Slovenia's approach of targeting broad money, while managing the exchange rate, was viewed with skepticism. In addition, fiscal policy in several countries has been widely regarded as indulgent and opaque.³

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¹ Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia in the first round; Bulgaria and Romania in the second round. (Malta and Cyprus were in the first round as well, but excluded herein.)

² With the exception of Denmark and the United Kingdom, under an opt-out provision of the Maastricht Treaty, eventually all members are bound to adopt the euro.

³ Perhaps the most critical view of macroeconomic management in the accession countries was expressed in a *Financial Times* editorial entitled "Hungary's forint follies continue" (December 3, 2003).

The second motivating factor is an ongoing guessing (or betting) game on the likely date of euro adoption by the new members. Having met the Maastricht criteria, in Slovenia, the euro has been the legal tender since January 2007. For the Baltic members, and particularly for Slovakia, already operating formally within the ERM-2 exchange rate regime, analysts and investors predict entry in the euro area at the latest by the end of the decade. Meanwhile, the entry date of the larger members has slipped well beyond the end of the decade.

Whereas much of the above criticism of policies pursued by the new members may have been valid in the past, the question arises as to the extent that it still holds at present. By the same token, doubts expressed about the date of euro adoption for some new members are warranted and the issue will be open to debate for some time. The paper seeks to shed light on both of these issues.

The paper begins with an examination of the policymaking environment in the new member states. Subsequently, the discussion focuses on the conduct of monetary policy and economic performance under two distinct monetary policy frameworks. Particular attention is devoted to the Central European members, in view of their larger relative weight and the complexity of their situation. Least coverage is given to the Southeastern European countries (Bulgaria and Romania), with a much shorter membership record. The paper assesses the prospects for adopting that euro and concludes with a summary of major monetary policy challenges..

Policy environment

In several respects, the new EU member states face conditions that are largely akin to those prevailing in emerging market economies in general.⁴ These conditions typically include: openness to capital flows, shallow domestic financial markets, collateral-constrained access to financing, weak linkages between domestic and foreign financing, and a fragile banking system.⁵ Many of these economies are exposed to high macroeconomic and financial volatility, often prompted by terms of trade shocks and aggravated by procyclical policies.⁶

⁴ I have drawn an analogy between the conduct of monetary policy in emerging markets and sailing in Lake Balaton, in Hungary. A shallow lake—the largest in Europe—located on an open plain and exposed to strong winds, the Balaton is an ideal sailing venue. However, sudden shifts in wind direction and velocity can turn a peaceful sailing excursion into a nerve-wrecking experience. Complacency by the skipper, imprudent maneuvering by the crew or structural weaknesses in the boat can lead to disaster. On a nice summer day, it is not unusual to see a number of capsized boats after an unexpected storm. As for the strains imposed by loose fiscal policy, imagine having to sail in the Balaton next to an unwieldy monster-whale. See “No Smooth Sailing” *Wall Street Journal Europe* (September 23, 2005), p. 6.

⁵ See a discussion of these conditions in reference to Latin America in Caballero (2000) and Hausmann (2004).

⁶ For a recent analysis and evidence of procyclical fiscal and monetary policies in emerging markets, see Kaminsky, Reinhart and Vegh (2004).

In addition, they experience strong productivity gains in the tradable sector, resulting in an appreciating equilibrium real exchange rate—the so-called Balassa-Samuelson effect.⁷

Externally, the new EU members are completely open to short- and long-term capital movements, and internally, financial markets are shallow. Since the second half of the nineties practically all these countries had liberalized their external capital account while domestic financial intermediation remains fairly thin. Bank credit averages around 40% of GDP (except for the Baltics) and stock market capitalization reaches barely 40%, as compared to the old EU15 average of 150% and well over 60%, respectively (Chart 1).⁸ Nonbank financial intermediaries (insurance companies, pension funds, etc.) play a small, though increasing, role in domestic financial markets.

In emerging market economies, access to domestic and external financing is tends to be constrained by the value of collateral—mostly consisting of foreign exchange earnings—as evidenced by low bank credit to GDP ratios and moderate current account deficits. In the new EU members the domestic constraint holds, but interestingly, the external does not. In fact, in five countries the external current account deficit stands well in excess of 5% of GDP and in three of these countries more than half of the imbalance seems to be financed with debt-creating instruments, that is, by other than direct investment inflows (Chart 2).

As in other emerging market economies, external and domestic financial markets in the new members are connected through weak linkages, as reflected in premia which enter prominently the uncovered interest parity condition. Currency risk remains significant for several countries, as illustrated by spreads on local currency-denominated government bonds (Chart 3). Default risk, captured in foreign currency-denominated sovereign spreads, has declined considerably since before EU accession (Chart 4).⁹ In recent months, however, as a consequence of international financial turbulence, risk premia have rebound for more vulnerable economies in the region.

Unlike other emerging market economies, the new EU members are no longer saddled with weak financial regulations and banking supervision, or with questionable central bank independence. Accumulation of nonperforming debt is a phenomenon of the past, capital adequacy ratios are now met, and commercial banks are subject to basic transparency requirements.¹⁰ All new member countries are in compliance with the relevant EU banking

⁷ An initial analysis of this effect in post-socialist transition can be found in Halpern and Wyplosz (1997).

⁸ See ECB (2004a).

⁹ Kopits (2002) estimated that, in 2001, spreads on foreign currency government bonds issued by EU accession candidates were significantly more than 200 basis points lower (after controlling for other determinants) than on comparable bonds of other emerging market economies.

¹⁰ Nonetheless, some new members, much like a number of old members, have yet to extend effective supervision to the nonbanking sector (savings associations, insurance companies, etc.).

directives and financial standards. An overwhelming share of banking assets is owned by EU-based parent banks, subject to more experienced home-country regulatory supervision—albeit the effectiveness of cross-border has yet to be tested in the Union (Chart...). In addition, these countries are endowed with well-functioning autonomous central banks—a key condition for membership—and their banking systems are stable, solvent and profitable.¹¹

Shallow domestic financial markets in combination with the ebb and flow of foreign investment—driven by shifts in investor sentiment—contributes to macroeconomic and financial volatility in the new members. Anticipation of EU accession, strengthened by the Irish referendum in October 2002, constituted a major pull factor for foreign investment. This was further reinforced by the push factor of ample global liquidity conditions prevailing since the turn of the century in all emerging markets.¹² In some new members, these positive factors were periodically offset by episodes of country-specific erosion in policy credibility and procyclical macroeconomic policies, as shown below. However, they have seem to be less by volatility in terms of trade typically experienced by primary commodity-producing economies.

On the real side, emerging market economies are characterized by a secular convergence (*vis-à-vis* advanced economies), driven by relatively high productivity increases in the tradable sector. The trend toward international price equalization—in accordance to the law of one price—and eventual spillover of productivity-based wage increases onto the nontradable sector, leads to equilibrium real appreciation, manifest in consumer price inflation and/or nominal exchange rate appreciation, with no consequence on competitiveness. Real convergence, with the ensuing upward pressures on the price level and the exchange rate, has been particularly strong with major efficiency gains during the market-oriented transition. Indeed, only a part of the economy-wide real effective exchange rate appreciation tracked for most of the EU8 countries (Chart 5) represents an overvaluation.¹³ Although difficult to gauge with precision, it is estimated that up to 2% of yearly real appreciation is attributable to the Balassa-Samuelson effect.¹⁴ Consequently, it is difficult (if

¹¹ For an overview, see ECB (2004b).

¹² For an empirical analysis of push and pull factors, see Ferrucci and others (2004).

¹³ The evolution of the real effective exchange rate should be interpreted with care, especially over an extended period of time. Although the data have been reweighted to capture shifting trade market shares, they are open to distortions. In general, Slovenia displays a remarkable stability in part presumably due to a successfully managed float regime. Since the late 1990s, while Poland's real depreciation reflects strong wage flexibility, Hungary's appreciation is attributable to excessive wage awards in the public sector, as well as some spillovers in the private sector, following the 2002 elections.

¹⁴ See Kovács (2004).

not impossible) to achieve both low inflation and nominal exchange rate stability—as required under the Maastricht criteria for entering the euro area.¹⁵

Besides the above characteristics, since the late 1990s, these countries benefited—much like any other country—from the tailwinds of globalization, manifest in downward price pressures worldwide.¹⁶ The disinflationary pressures were further compounded by enhanced competitive forces upon accession to the EU. The combined windfall eased the burden on monetary policymaking in the new members. Over the past two years or so, the tailwinds gave way to headwinds as a result of a reversal of previous wage moderation in low-income exporting economies and increasing tightness in key commodity markets. As a result, monetary policy is now under strain from both these external price pressures and the possible adverse repercussions of the unfolding financial turbulence.

Needless to say, these conditions have potentially important implications for the conduct of monetary and fiscal policies. Apart from a sound financial sector, easier and cheaper access to external financing, and milder macroeconomic volatility, the new EU member states have many of attributes that can be found in other emerging market economies and are similarly exposed to rapid shifts in investor sentiment that can place considerable strain on policymaking.

Exchange rate-based framework

The Baltics (Estonia, Latvia, Lithuania), Bulgaria and Slovenia have chosen a policy strategy essentially anchored in the foreign exchange rate. These countries operate with a pegged regime over a wide range: currency board arrangement (CBA) in Bulgaria, Estonia and Latvia; fixed exchange rate in Lithuania; and managed float in Slovenia. A common feature of these countries is their small size and large share of trade (primarily with other EU members) in economic activity. Historically, much like in other post-socialist economies, including Poland and the Czech Republic, the hard peg was intended to tame expectations during the transition and build policy credibility. In the Baltics, lengthy adherence to the peg helped avoid the inflationary bouts experienced in the neighboring former Soviet republics. In Bulgaria, the CBA has helped stabilize the economy, following a major financial crisis.

In all these countries, it was well understood that for the exchange rate peg to survive, or to discourage potential speculative attacks, it must be buttressed with strong fundamentals, particularly on the fiscal and wage-setting fronts. By the same token, it was necessary to undertake wide-ranging reforms in the banking system and in public finances. The hard peg in the Baltics for more than a decade and a half was made possible by a high degree of policy

¹⁵ See Kenen and Meade (2003) and Buiters (2004).

¹⁶ See, for example, the analysis by Rogoff (2007).

consistency and wage flexibility,¹⁷ and supported with reform of the social security system, privatization of state-owned enterprises and banks, and liberalization of the external sector.

Thus, fiscal discipline and productivity-based wage determination were fully aligned to the fixed exchange rate since the beginning of the transition. For Bulgaria and Estonia, fiscal rectitude was further ensured by an implicit balanced-budget rule that since 1998 has been rigorously observed by successive governments. This fiscal rule was operated along with a stabilization fund, financed from accumulated budget surpluses during an upswing and to be drawn down to offset budget deficits during a recession. In this manner, the fund served as a useful countercyclical device, compensating for the absence of monetary control. It was successfully utilized—allowing for a large budget deficit—to offset the contractionary impact of the Russian crisis in 1999 (Chart 6). The expansionary fiscal stance was entirely acceptable to investors, since it was built on well-earned credibility.

Although Latvia and Lithuania followed a somewhat less orthodox path than Estonia, their policy strategy evolved in a similar pattern (including a countercyclical fiscal stance), characterized by reform of public finances, shrinking government indebtedness, and modest role of government in economic activity. Slovenia, instead, adopted a more pragmatic variant, characterized by large government outlays, gradual reform and protracted privatization of the banking sector. There too, the soft peg was accompanied by fiscal discipline. As a matter of fact, in all these countries, government accounts are in approximate balance (Chart 7) and debt is small and sustainable over a long-term horizon (Chart 8).

Overall, economic performance has been excellent in Bulgaria and the Baltic members, with record growth in the Union, well in excess of 6 % rates over the past five years (Chart 9), underpinned by buoyant foreign investment—facilitated by major improvement in market confidence. By 2003-04, inflation decelerated to close to a zero rate and remained moderate, as relative price changes during the transition did not translate into inflation expectations. The spillover of wage inflation into the nontradable sector from strong productivity gains in the tradable sector, in the presence of the hard peg, contributed to a rebound in inflation to around 5% annual rate or more (Chart 10). In Slovenia, presumably because of less intensive restructuring, growth averaged around 4% yearly, and with a soft peg, inflation declined to a 3% rate.

However, since 2005, inflation accelerated far above what can be attributed to the Balassa-Samuelson theorem. (In the case of Latvia, it has climbed into double digits.) In fact, the confluence of a surge in foreign direct investment and a consumer credit boom—that in turn fed a housing bubble—created strong price pressures that could not be easily contained

¹⁷ This was in sharp contrast with Argentina's unsuccessful experiment with the currency board arrangement in the nineties, which was undermined on both counts: wage rigidities plus runaway budget deficits, averaging more than 4% of GDP over the decade; see Teijeiro (2001).

lacking an active monetary policy. Stepped-up financial regulation, along with further fiscal adjustment, became the only means to dampen inflation.

Inflation-targeting framework

In the initial stage of the transition, much like the Baltics and Slovenia, the Central Europe countries introduced a fixed or a crawling peg. The fixed rate regime was abandoned in Poland and later, in the wake of currency and banking crises, in the Czech Republic and Slovakia. By the mid-1990s both Hungary and Poland switched to a preannounced crawling rate and crawling band, respectively, with the twin objectives of restoring policy credibility and maintaining competitiveness. In 1997, the Czech Republic was among the first emerging market economies to adopt an inflation-targeting framework, followed by Poland in 1999 and Hungary in 2001. In both Poland and Hungary, the inflation target was specified in the context of a wide exchange rate band (+/- 15% around a reference rate), under the assumption that this would conveniently lead to eventual participation in ERM-2. Early on, however, Poland dropped the band and proceeded to float; most recently, Hungary abandoned the band as well.¹⁸

Like in many other emerging market economies, the main appeal of inflation targeting in these countries lies in its usefulness as a disinflation tool. In this respect, it differed from its application in advanced economies where the objective is simply of maintaining price stability. As inflation targeting evolved over the past few years, each country built both the institutional and technical infrastructure underlying the framework.¹⁹ As an exception, Slovakia launched inflation targeting at the beginning of 2005, followed by Romania a year later. Therefore, their framework is still *en rodage*, and it lacks sufficient track record.

On the institutional front, the key preconditions for successful application are central bank independence and transparency. As required for all EU members, the accession countries were expected to grant statutory independence to their central banks in the conduct of monetary policy. By now, instrument independence is well established—despite occasional

¹⁸ For a description of the initial phase of inflation targeting in these countries, see Jonas and Mishkin (2003).

¹⁹ A comprehensive overview of inflation targeting can be found in Truman (2003) and of its appropriateness for emerging market economies in Mishkin (2000). For a review of institutional and technical requirements, see Schaechter and others (2002). However, some countries introduced inflation targeting out of sheer necessity, while hardly fulfilling these requirements—much like “flying without instruments” in turbulent weather conditions. The most vivid illustration can be found in Brazil following the collapse of the peg under the *Plano Real* in early 1999. To avert a possible rekindling of the inflationary spiral of the early nineties, the authorities adopted inflation targeting almost overnight. Recently, Batini and Laxton (2005) reported cross-country evidence of successful inflation targeting in emerging markets even without fulfilling all preconditions. Although strict compliance with all the preconditions might not be indispensable, it is highly desirable to meet them to the extent possible for greater effectiveness.

rhetorical attempts by governments at influencing interest-rate decisions—with responsibility for collective decision-making assigned to a monetary policy council.²⁰

In addition, in line with international best practice, major strides have been made in all new members toward transparency and communication: clarity of targets, inflation reports, financial stability reports, and information on decision-making meetings. The target is clearly defined as the headline consumer price inflation in all these countries. In the Czech Republic, Hungary and Poland, comprehensive inflation reports are published quarterly, containing standard inflation forecast fan charts and detailed analysis of macroeconomic developments and policies. While not responsible for banking supervision, each central bank publishes semiannual financial stability reports. In the Czech Republic and Hungary, the central bank publishes minutes of interest rate-setting meetings of the council. In Hungary and Poland, council members are identified by votes cast at each rate-setting meeting.²¹

The technical infrastructure is surprisingly well developed, considering the relatively brief experience with the regime, ongoing structural changes, as well as numerous data limitations in these countries. The monetary transmission mechanism has been traced fairly reliably and model-based conditional inflation forecasts are prepared on a regular basis, though with some variation across countries. In the Czech Republic, Hungary, and Poland, the central bank issues disaggregated monthly forecasts using expert opinion, in the context of a comprehensive estimated quarterly macroeconomic model, complemented with greater or lesser reliance on calibrated parameters and judgment. At this stage, forecasting capacity of Romania and Slovakia can be described as work in progress. Some countries are experimenting with the application of a DSGE model for the purpose of testing the quality of existing forecasts and of introducing endogeneity and formation of expectations.

However, in Central Europe, interest rate decisions cannot be predicated solely on deviations between forecast inflation and target inflation, as practiced (possibly supplemented with the output gap) in advanced economies. As in other emerging market economies, it is necessary to respond as well to fluctuations in risk premium reflecting volatility of capital movements. This is not an easy task, absent a reliable leading indicator that incorporates changes in push factors and pull factors, whether country-specific, regional or global. Readily available spreads on medium- to long-term sovereign paper (spot and forward) in secondary markets provide an imperfect proxy for the risk premium. In particular, long-term sovereign spreads reflect expectations of so-called convergence investors as regards the likely date of euro adoption. For instance, the spread may rise simply because of a government announcement that the date is postponed, with no change in fundamentals.

²⁰ Poland's monetary policy council is known as central bank board in the Czech Republic and Slovakia, and monetary council in Hungary.

²¹ All reports and minutes can be found on the website of each central bank. For Romania and Slovakia, considerable information is available on the bank's website.

In spite of much progress in developing the technical and institutional capacity, the learning curve has not been without pitfalls during a period characterized by wide swings in capital movements. An instance of favorable swing affecting all new members was the investor exuberance following the Irish referendum in late 2002 (clearing in fact the last hurdle in the accession process) confirmed by across-the-board upgrades by rating agencies, on top of an already rising appetite for risk for emerging market issues. Meanwhile, the new members were exposed to overall fluctuations, mostly improving, in world liquidity conditions, as well as to market response to country-specific policies and developments.

These developments were exacerbated by teething problems in the initial years of inflation targeting. Such problems included lack of transparency, lagged and/or excessive policy reaction to shifts in investor sentiment, and occasional miscommunication by the authorities. Examples of such practices were: the “net” inflation target (besides a headline inflation target) in the Czech Republic until 2002; arguably excessive tightening in response to a fiscal stimulus in 2002 in Poland; one-off (2.5 %) downward shift of the exchange rate band in Hungary in mid-2003; and targeting of both the inflation rate and exchange rate in Hungary through 2003.²²

Since the beginning of 2004, these problems have been largely overcome. Likewise, early institutional hiccups and indirect tax hikes have been largely neutralized. Two institutional changes involving the composition of the council,²³ at the time seen by markets as potentially disrupting and destabilizing, were met with cautious rate-setting. Increments in effective value-added tax rates in Slovakia and Hungary, in 2003 and 2004, respectively, were reflected in price level increases, but thanks to a sufficiently cautious monetary stance and appropriate communication, these changes did not enter inflation expectations and had no perceptible second-round effect on inflation.

In all, inflation targeting has proved to be an effective instrument of disinflation. Whereas growth performance in these countries was not as impressive as in the Baltics (Chart 11), inflation declined from double digit rates in the late nineties to below 4% at present (Chart 12), despite some missed targets. More important, the deceleration in inflation—admittedly assisted by a jump in price competitiveness following EU accession—helped cement the reputation of central banks and monetary policy has become credible and predictable in financial markets.

²² In June 2003, the Hungarian authorities depreciated the entire exchange rate band (+/- 15% around the central parity) by 2.5 % apparently with a view to restoring competitiveness. Announcement of an exchange rate target through the end of 2003 was of course incompatible with inflation targeting, given an open capital account—in contravention of the so-called “impossible trinity,” popularized by Frankel (1999).

²³ These contemporaneous replacement of 8 out of 9 members of Poland’s monetary policy committee in January 2004, and enlargement of Hungary’s monetary council from 9 to 13 members as of April 2005

As a tangible accomplishment, these countries have moved from setting end-year inflation targets to a continuous target (with one percentage point margins) as practiced in advanced economies—a key step toward meeting the inflation and interest rate reference values for joining the euro.²⁴ The permanent inflation target has been set at a 2 ½ % rate in Poland and 3% rate in the Czech Republic and Hungary. These targets, slightly above those commonly found in advanced economies, are intended to accommodate the Balassa-Samuelson effect of further productivity gains in the tradable sector.

Interactions with fiscal policy

The foremost policy challenge facing some large new EU members in their quest for the euro lies in the public finances. In contrast to fiscal discipline in the Baltics and Slovenia, since the second half of the nineties the Czech Republic, Hungary, Poland, and until a few years ago Slovakia, have been characterized by a loose and procyclical fiscal policy.²⁵ Fiscal profligacy was on the rise in the Central European accession countries well ahead of EU membership, apparently explained by perceptions of a stronger bargaining position in these countries than in the smaller candidates (Chart 6).²⁶

Upon entering the Union, all four Central European members were subject to the excess deficit procedure under the Stability and Growth Pact, and have been required to periodically submit convergence programs, intended to narrow the deficits (at least to below the reference value of 3% of GDP) and eventually achieve balance or surplus, as stipulated in the Pact. The record of compliance so far has been uneven,²⁷ and for a while, fiscal stress has been exacerbated by membership-related effects on the budget and by the accumulation of contingent liabilities.²⁸

²⁴ Poland already operates with a continuous inflation target of 2.5% since January 2004. These reference values are currently set at a small margin above the three best performers in the euro area.

²⁵ See Kopits and Székely (2003). For evidence of a procyclical stance in these countries, see for example Coricelli and Ercolani (2004).

²⁶ See the game theoretic explanation and supporting empirical evidence in Berger and others (2004).

²⁷ Both Hungary and Poland have availed themselves of a derogation (valid until 2007) permitting inclusion of government-sponsored private pension funds in the recorded general government balance. Despite this practice, Hungary has systematically exceeded all budget deficit forecasts since 2001 and more recently the deficit limits set in the convergence program; see National Bank of Hungary (2005).

²⁸ Estimates of direct net budgetary costs range from 3 to 4 ½ % of GDP yearly; see Kopits and Székely (2003). Major types of contingent liabilities consist of extrabudgetary operations, public-private partnership projects, public pension schemes and health-care benefits.

Lack of sufficient progress in structural reforms, including in civil service, public pensions, health care, off-budget operations, and taxation, pending from the transition period,²⁹ contribute to a looming medium- to long-term sustainability problem. With the exception of recent reforms—introduction of a flat tax at a moderate uniform rate on value added, personal and corporate income, and pruning of social benefits—in Slovakia, continued failure of some Central European members to cope—aside from occasional one-off measures and creative accounting practices—with sizable public sector imbalances (Chart 7) is likely to lead to a marked rise in indebtedness in the future (Chart 8).³⁰

Among the inflation targeting members, Romania has so far maintained near balance in its public accounts. In addition, though various corrective measures, Slovenia, the Czech Republic and Slovakia have complied with convergence programs and are no longer subject to the excess deficit criterion. Poland has been less successful in this endeavor, while Hungary remains the worst fiscal performer in the Union.

Fiscal laxity poses a major burden for the conduct of monetary policy in the new member states. Apart from the demand pressure stemming from the primary deficit, to be captured by inflation forecasts, recurrent excesses above projected deficit limits and the ensuing buildup in the ratio of public debt to GDP tend to have repercussions on the risk premium. Furthermore, in members with a relatively low propensity to save in the private sector, as in Hungary and the Czech Republic, large government deficits are accompanied by a significant external current account imbalance (Chart 2).

As suggested above, monetary authorities in these new members face a daunting task in comparison to their counterparts in the advanced economies.³¹ Under the inflation-targeting framework, besides monitoring and reacting to inflation forecasts, they need to gauge a significant and volatile risk premium that reflects market perceptions of fiscal sustainability and of the government's apparent appetite for correction. As a crude proxy, the forward spread on long-term government bonds indicates a rising risk premium in Hungary and Poland in 2003, followed by considerable decline in Poland.³² Meanwhile, spreads have

²⁹ For an inventory of pending reform tasks, see Kopits (2005).

³⁰ The public debt projections shown in Chart 8, taken from Deroose and others (2005), are significantly understated for the larger Central European members as they exclude some off-budget and quasi-fiscal liabilities, as well as a range of contingent liabilities arising from recent policy decisions. Moreover, they ignore considerable fiscal risks over the projection horizon, such as those estimated with a Value-at-Risk approach in Barnhill and Kopits (2004).

³¹ Mervyn King's remark that "central bankers are often accused of being obsessed with inflation, but if they are obsessed with anything it is fiscal policy" has particular relevance for monetary policymaking in the Central European member states.

³² This interpretation of bond spreads of course does not preclude, in addition, its usual role as an indicator of long-term inflation expectations.

remained rather narrow in the Czech Republic and Slovakia, presumably in anticipation of a more likely convergence to the Maastricht criteria (Chart 13).³³

In the absence of a fiscal reform-cum-adjustment program, successful disinflation in the high-deficit high-debt countries has been relatively costly. Notably in Poland and Hungary, the base interest rate has been set at a higher rate than would have been necessary if fiscal policy had been disciplined (Chart 14). This occurred over a period when in fact monetary policy has had to gain credibility in financial markets, resulting in relatively high real interest rates: 2000-02 in Poland and 2003-04 in Hungary (Chart 15).

In Hungary, the fiscal adjustment launched in mid-2006 has been a mixed blessing for monetary policy. On the one hand, the expected withdrawal of demand should contribute to some disinflation. On the other, although in principle an upfront VAT rate increase and a series of administered price increments do not influence inflation, in practice such increases need to be met with tightened monetary conditions in order to preempt a possible passthrough into inflation expectations. The task is made more difficult by external price shocks from wage pressures and commodity price increases abroad.

From a political economy perspective, it can be argued that credible monetary policy may not have contributed to fiscal discipline after all. Apparently, fiscal policy in the larger new members has been shaped by a moral hazard game. Under the perceived shield of prudent monetary policy, in combination with the EU membership, these member governments seem unabashed in running high fiscal deficits.³⁴ Of course these deficits must be financed by maintaining interest rates high enough to lure investors in search of profit opportunities in the carry-trade of high-yield government paper. Underlying this implicit collusive behavior between, on the one hand, political leaders eager to win elections (or to stay in power) by cutting taxes and boosting pork-barrel spending and social transfers, and on the other, rent-seeking investors disposing of ample liquidity, is the belief that EU membership and a cautious monetary stance will offer sufficient protection against a sudden capital outflow.

Monetary transmission mechanism

³³ It is worth noting that, despite the much worse long-term debt projection for the Czech Republic (Chart 8), the spread on Czech bonds is considerably lower than for the neighboring new members suggesting that for “convergence” investors what really matters is the trajectory of the public debt ratio until the expected adoption of euro. Typically, such investors hold local currency-denominated long-term government paper with a view to realizing capital gains in terms of an appreciation of the bond price and/or the exchange rate upon adoption of the euro.

³⁴ Earlier declarations by government leaders in Poland and in Hungary (mainly during electoral campaigns) on the budget proposals and the convergence programs submitted to the European Commission, can be viewed as evidence of moral hazard. In each case, the pronouncements presented a contrived choice between, on one hand, spending needs (social programs, infrastructure, R and D, etc.) or tax cuts, and on the other, observance of deficit limits under the convergence program—with little apparent fear of adverse market reactions.

There are two questions that are often raised with regard to emerging market economies, and particularly, the new EU members, that operate with an inflation-targeting framework. First, how effective is monetary policy, including with the prospect of credit booms? Second, is there evidence of “fear of floating” in these countries? The answers, which may have a bearing on the convergence to the euro, require some discussion of the monetary transmission mechanism.

Typically, the principal channels of transmission from changes in the base interest rate to consumer price inflation are the credit channel, the market interest rate channel, and the exchange rate channel. The effectiveness of these channels depends of course on a variety of elements, including wage flexibility, openness of the economy, depth of the financial system, and of course, credibility of the inflation-targeting framework. Given differences in these conditions, the relative strength of the channels is different in emerging market economies and in advanced economies.

In emerging market economies, with openness and shallow domestic financial intermediation, the exchange rate channel is far more powerful than the credit or interest rate channels. As discussed earlier, these conditions prevail in the new EU members as well. However, in the foreseeable future, as domestic financial markets deepen in these countries so will strengthen the credit channel. Some observers have voiced concern about the prospects of credit booms in these economies, which could in turn strain the financial system and possibly even lead to a garden-variety banking crisis.³⁵ In the new EU members, these concerns can be allayed by the soundness of the banking system. As long as prudential regulations are enforced and banking supervision is effective, including with cautious valuation of collateral, the progressive deepening of financial intermediation should continue to proceed apace.

More immediately, some new members are experiencing a significant currency substitution in domestic bank credit. Under a hard peg and with euro entry within reach, the sharp rise of euro-denominated bank loans can be seen as a natural development, in anticipation of the inexorable replacement of the euro for the local currency. In Central Europe, however, with an inflation-targeting framework and uncertain timing of euro adoption, the accumulation of foreign currency denominated liabilities (Charts 16 and 17) by households, small- and medium-sized enterprises, and even by the government,³⁶ can be problematic. Besides

³⁵ See Schaedler and others (2004).

³⁶ This phenomenon is reminiscent of the so-called original sin, promoted by Eichengreen and Hausmann (1999). However, whereas commercial banks in the Central European members cover their foreign-exchange positions, borrowers assume a currency risk on these credits (denominated not only in euros, but also in Swiss francs and Japanese yen), which can be significant on short- and medium-term maturities, especially with slippages in the date of euro adoption. Also, short-term foreign currency-denominated debt of the public sector is modest compared to the experience of a number of countries in Asia and Latin America in the nineties.

burdening these borrowers with a potentially significant currency risk, this process tends to erode the effectiveness of monetary policy, by weakening further the credit channel, and indirectly, the exchange rate channel.³⁷ Besides the obvious leakage from the credit channel, due to declining local currency denominated borrowing, the increased internal borrowing denominated in foreign currency may ease some exchange rate appreciation that would have taken place otherwise.

Currency substitution in bank liabilities, earlier in Poland and more recently in Hungary, can be ascribed to periods of tight monetary conditions, adopted largely in reaction to loose fiscal policy.³⁸ In these circumstances, because of the weaker transmission channels, central banks may need to administer ever higher dosages of interest rate hikes to contain inflationary pressures. A small piece of good news is that some currency substitution can be reversed with monetary easing, as experienced in Poland in 2004. This reversal is, however, dampened by a ratchet effect operating on market interest rates. With insufficient competition, bank and nonbank financial intermediaries are far less eager to lower lending rates to their clients following a decline in the base interest than in raising them after an increase.

A rudimentary exploration of the policy reaction function in the Czech Republic, Hungary and Poland, during the inflation-targeting regime (see Appendix), reveals considerable variation in the base interest rate and the reserve position, but less pronounced volatility in exchange rates. Such circumstantial evidence, as well as some correlation among these variables, implies an apparent “fear of floating” in these countries,³⁹ with Poland being the mildest case. In the case of Hungary, a stronger correlation can be explained by the attempt at simultaneously targeting the inflation rate and the exchange rate through 2003; subsequently this condition may have prevailed on very rare occasions when the exchange rate drifted close to the hard edge of the band and it became de facto a fixed rate.⁴⁰ A more comprehensive probe into the determination of the base interest rate suggests that the key explanatory variables in the policy reaction function for the new members are, besides the exchange rate, the headline inflation for Poland and the Czech Republic, and the core

³⁷ These implications of the shift to foreign currency credits have been ignored in the existing studies of the monetary mechanism in these countries. See for example Coricelli and others (2005) and the papers presented at the 3rd Macroeconomic Research Workshop of the National Bank of Hungary, October 29-30, 2004 (<http://www.mnb.hu>)

³⁸ In Slovakia, the data shown covers the stock of credit to all corporations, not only of nonfinancial corporations.

³⁹ See Calvo and Reinhart (2002) on statistical evidence of “fear of floating” over a wide range of emerging market economies.

⁴⁰ On Hungary’s experience with smoothing exchange rate fluctuations, see Karadi (2005).

inflation for Hungary.⁴¹ In addition, the reaction function exhibits a strong smoothing behavior in all countries, and in some, a significant effect of the risk premium proxied with the spread on sovereign paper.

These preliminary results—albeit observationally equivalent to “fear of floating”—can be interpreted as evidence that the base interest rate has been set bearing in mind that the exchange rate channel is the main vehicle of transmission and that, in practice, inflation forecasts are conditional on unchanged nominal interest and exchange rates over the forecast horizon. Moreover, the typical reason for “fear of floating,” namely, the adverse balance-sheet effect of depreciation (due to a high proportion of foreign currency denominated debt), is absent in these countries.

Outlook for adopting the euro

The criteria for entering the euro area are well known. The candidate member state, with the consent of the ECB, must formally operate within the ERM-2 regime, which serves as the anteroom for the euro, over a minimum two-year period.⁴² This exchange rate regime prescribes a wide 15% +/- band around a declared parity; under an alternative interpretation, a narrow 2 ¼ % band must be observed.⁴³ In the year prior to adoption of the euro, the candidate must meet reference values for the inflation rate and long-term government bond rate, set respectively at 1½% and 2 % and points above the average rates of the three best performing EU members. In addition, the candidate must keep the general government deficit below the reference value of 3% of GDP and its debt must be declining to below 60% of GDP.

In principle, any one of the monetary/exchange rate frameworks being followed by the new members is compatible with these criteria. In practice, however, the actual policy stance and its sustainability, especially as regards the fiscal and inflation criteria, are the key to qualifying for the euro. At the very outset of EU membership, the Baltics (Latvia a year later) and Slovenia, and subsequently Slovakia joined the ERM-2 regime. Among them, only Slovenia succeeded in entering the euro area. By contrast, the large Central European members have yet to qualify or to apply for the ERM-2. Indeed, they all suspended the

⁴¹ Spreads on local currency long-term government paper as a proxy for the risk premium seem to be a determinant in some countries, whereas industrial output is not—perhaps pointing to an absence of the Taylor rule.

⁴² Buiter and Grafe (2002) provide an eloquent criticism of the rationale for ERM-2 and for the two-year waiting period requirement for small EU members which already meet the fiscal criteria.

⁴³ Interestingly, none of the new members had opted for unilateral euroization prior to EU accession; for an assessment of the potential costs and benefits of this approach, see Salvatore (2004).

initially declared euro adoption dates: Czech Republic and Hungary in 2009 and 2010, respectively, while Poland intended to set a date only after a referendum scheduled for 2009.

Although the Baltics had met, in substance, all the criteria, and their entry in the euro area could have been a mere formality, they were disqualified because the recorded inflation rate exceeds the inflation criterion by a slight margin. Arguably, such a strict interpretation of the criterion was unreasonable on economic grounds and ran counter to the spirit of Maastricht insofar as this outcome was beyond the control of the authorities and was partly attributable to equilibrium real appreciation. The solution to this anomaly would be simply a step nominal appreciation prior to adopting the euro (a precedent from a couple of old members when adopting the euro),⁴⁴ or alternatively, a modification (or waiver) of the criterion, given the likelihood of further above-average inflation rates after entry (as experienced in several high-growth members in the euro area).⁴⁵ On the other hand, Slovakia seems to have met the criteria, above all given the durability of recent fiscal adjustment and reforms.

Future prospects for the larger Central European members hinge largely on fiscal behavior and convergence to the deficit reference value. Given continuation of a credible inflation-targeting framework, the inflation reference value should be relatively easy to meet. Also, it should be possible to accommodate the upward pressure on the equilibrium exchange rate over a two-year period within the wide band (though not necessarily within the narrow band) of the ERM-2 mechanism.⁴⁶ Observance of the long-term interest rate criterion would follow almost automatically from successful inflation targeting and from credible reduction of the fiscal imbalance.

As suggested above, convergence to the fiscal reference values for deficit and debt boils down, in essence, to a political economy problem. The recent experience of Slovakia demonstrates that in Central Europe the sure path to euro consists of an upfront fiscal correction-cum-reform strategy. Barring an unanticipated reversal, Slovakia not only is well placed to adopt the euro as scheduled, but more important, is enjoying narrow interest spreads and higher growth than the rest of Central Europe.

The more perilous muddling-through approach, currently followed in the other central European members, particularly Hungary and Poland, involves continuation of a series of one-off steps to contain the budget deficit just barely enough to meet the yearly targets of the convergence program formulated under the excess deficit procedure, while relying on a

⁴⁴ See for example Kopits (2004a).

⁴⁵ Buitier (2004) is not only critical of the inflation criterion, but questions the rationale for inflation targeting in these countries in view of anticipated abandonment of the target upon entry in the euro area. The

⁴⁶ However, model-based simulations suggest that, under current policies, real appreciation of the Czech, Hungarian and Polish currencies would prevent compliance even with the wide ERM-2 band. See the calculations in Bulir and Smidkova (2005).

credible monetary policy. At best, this approach will result in relatively high and volatile interest rates and lackluster growth, along with likely overruns of budget projections stipulated in convergence programs and thus slippages in the adoption of euro beyond the end of the decade.

A worst-case outcome, that cannot be ruled out, stems from the vulnerability associated with fiscal sustainability problems and a high external imbalance in some of these countries, along with a market perception of political unwillingness to deal with the disequilibrium situation.⁴⁷ In other words, these countries may remain exposed to a sudden stop in external financing triggered by a decline in risk appetite in the current financial turbulence. A very recent—albeit brief—episode of an adverse shift in investor sentiment was recorded in a marked jump in CDS spreads on sovereign paper for some Baltic economies, Hungary and Poland.

Summary and conclusion

The post-socialist new EU members have declared their intention to adopt the euro within this decade. In their quest for this goal, and partly for historical reasons, they follow two alternative policy approaches.⁴⁸ The Baltic members and Bulgaria (Slovenia until euro adoption), operate within a fixed exchange rate-based framework, supported by balanced public accounts. Until recently, this strategy has served them well. They have attained record growth rates in the Union while inflation has decelerated, though reaccelerating in recent years partly for reasons beyond policy control.

By contrast, the new Central European members have adopted an inflation-targeting framework which has been instrumental in achieving a marked disinflation. However, in some cases, this framework has been accompanied by weak fundamentals, especially excessive government deficits, and in some cases, a looming debt sustainability problem. As an exception, Slovakia embarked on a fiscal reform program in combination with a promising consolidation. Similarly, Romania so far has managed to remain close to fiscal balance. This action apparently sustains an above average growth rate, while the other Central European members have been operating at most around capacity output.

⁴⁷ See Goldstein and Wong (2005) for an application of a wide range of indicators for assessing the likelihood of a forthcoming currency crisis.

⁴⁸ In some respects, the contrast between the two approaches is similar to the strategies followed by Austria and Greece prior to the last stage of EMU, discussed in Hochreiter and Tavlas (2004). Indeed, Austria's strategy is comparable to the Baltics' hard peg. However, Greece followed far looser and nontransparent macroeconomic policies than any new EU member. Although misreported at the time, government deficits significantly exceeded the Maastricht reference value and, until shortly before euro adoption, were accommodated by the monetary authorities. Thus, Greece in fact did not qualify for entry in the euro area

Building on an impressive performance, the Baltics and Slovakia have joined the ERM-2 regime, in preparation for euro. With fulfillment of all Maastricht requirements, so far only Slovenia was bale to enter the euro area. For the major new Central European members (Czech Republic, Hungary and Poland), successful monetary policy should set the basis for meeting the inflation and interest rate criteria for euro entry. Sizable public sector imbalances, however, constitute a major impediment to compliance with the deficit criterion, possibly derailing the euro until after the decade.

In many respects, the ten post-socialist new EU member states belong to the universe of emerging market economies. They face macroeconomic and financial volatility, shallow domestic financial markets, and collateral-constrained access to financing. In addition, they have been experiencing an equilibrium real exchange rate appreciation associated with strong productivity gains in the tradable sector. Nevertheless, differences with other emerging market economies derived from EU membership. The new members have imported an institutional armory that *inter alia* ensures a sound banking system. More generally, EU membership has contributed to a sharp reduction in country risk, and for some new members, has alleviated currency risk.

The privileged status conferred by membership has been internalized by the new members in differing ways. For the Baltics, Bulgaria, Romania, Slovakia and Slovenia, EU accession, and the prospects of euro adoption, has acted as an external anchor which to a large extent has defined policymaking and institution-building. For larger Central European members, it may have contributed to some moral hazard embodied in a rather indulgent fiscal policy already prior to accession. With the evolution of a credible monetary policy, moral hazard has increased among some government leaders as well as foreign investors. Attracted by high interest yields, carry-trade investors are far more tolerant of weak fundamentals in these countries than in comparable non-EU emerging market economies, under the belief that the combination of prudent monetary policy and EU membership provides some sort of a protective umbrella. Nurtured by this shared belief, government leaders may have been too willing to incur continued public sector deficits and rising indebtedness.

A number of major challenges lie ahead for monetary policy in the new member states on the road to euro. These challenges can be grouped under five headings: credit boom in the private sector; laxity in the public finances; inflationary pressures from abroad; capital inflows attracted by monetary tightening; and repercussions from the international financial turbulence. Although some of these challenges are shared in various degrees with other emerging market economies, others are fairly specific to the new EU member countries.

First, Bulgaria and the Baltic members face a major credit boom, fueled largely with capital inflows and intermediated by foreign-owned domestic banks. Growth in mostly euro-denominated domestic credit has been extended for housing investment and personal consumption. Excess demand has spilled into an unsustainable current account imbalances (in excess of 10 % of GDP) and high inflation (at double-digit rates) in half of these members. Absent monetary policy instruments and constrained in the application of administrative measures to contain the domestic imbalance, the authorities are left with two

options. One is to generate unrealistically high public savings, above and beyond the present balance or surplus position—accompanied by near zero public indebtedness. The other is to tighten the application of prudential rules on bank lending (including margin requirements, collateral valuation, etc.), to raise capital and liquidity obligations, or to impose old-fashioned credit ceilings—some of these measures subject EU approval. Whereas the former may well lead to a sharp economic downturn, the latter may have well-known adverse allocative consequences, with limited lasting impact on reigning in the sources of the boom.

Second, over the past year or so, Central European members began correcting earlier fiscal indulgence—though lagging behind the adjustment undertaken in Romania and Slovakia. In fact, the larger members are broadly in complinace with the convergence programs submitted under the excess deficit procedure pursuant the Growth and Stability Pact. However, the question remains open as to whether these programs will be brought to completion, as scheduled, and whether the adjustment will be sustained beyond the present programs, which presuppose a critical mass of reform measures in the public sector. In fact, the latter are indispensable for underpinning the inflation targeting framework, and thus for strengthening the credibility of the central bank, and ultimately, for maintaining price stability.

Third, as elsewhere, monetary policy faces a major challenge in managing price pressures stemming from the surge in the prices of oil, foodstuffs, and other commodities abroad. While, in principle, central banks need not react to external price shocks, they must contain second-round domestic inflation by convincingly anchoring inflation expectations. The latter is particularly challenging in emerging market economies, including the new EU members, where the credibility of central banks has yet to be fully established. In the event, preemptive interest-rate hikes may be necessary to avert the effect of such price shocks.

Fourth, given the openness of the economy, monetary tightening in these countries inevitably stimulates capital inflows, especially from carry-trade investors. In the event, the central bank faces a dilemma between strict inflation targeting on the one hand, and dampening financial investment on the other. Regrettably, it has at its disposal few of the tools to alleviate this trade-off, which may be available in emerging market economies outside the EU. Introduction of capital controls, selective subsidies, sectoral credit limits, or various administrative tools, experimented with for example in Latin America, are beyond the scope of the new members. At most, they may resort to occasional foreign exchange intervention, with questionable effectiveness beyond the short term.

Fifth, though so far emerging markets have been spared from potentially devastating effects of ongoing financial turbulence, they are not at all immune from possible contagion due to diminished worldwide tolerance for risk or from the eventual fall in export demand. Sudden drying up in government bond markets and sharp rise in default risk premium on sovereign paper, experienced last month, was a worrisome episode for highly indebted emerging market economies, including some of the new members. Besides heightened vigilance by the monetary authorities, this episode should be viewed by these governments as a wake-up call for speeding up the fiscal adjustment-cum-reform process.