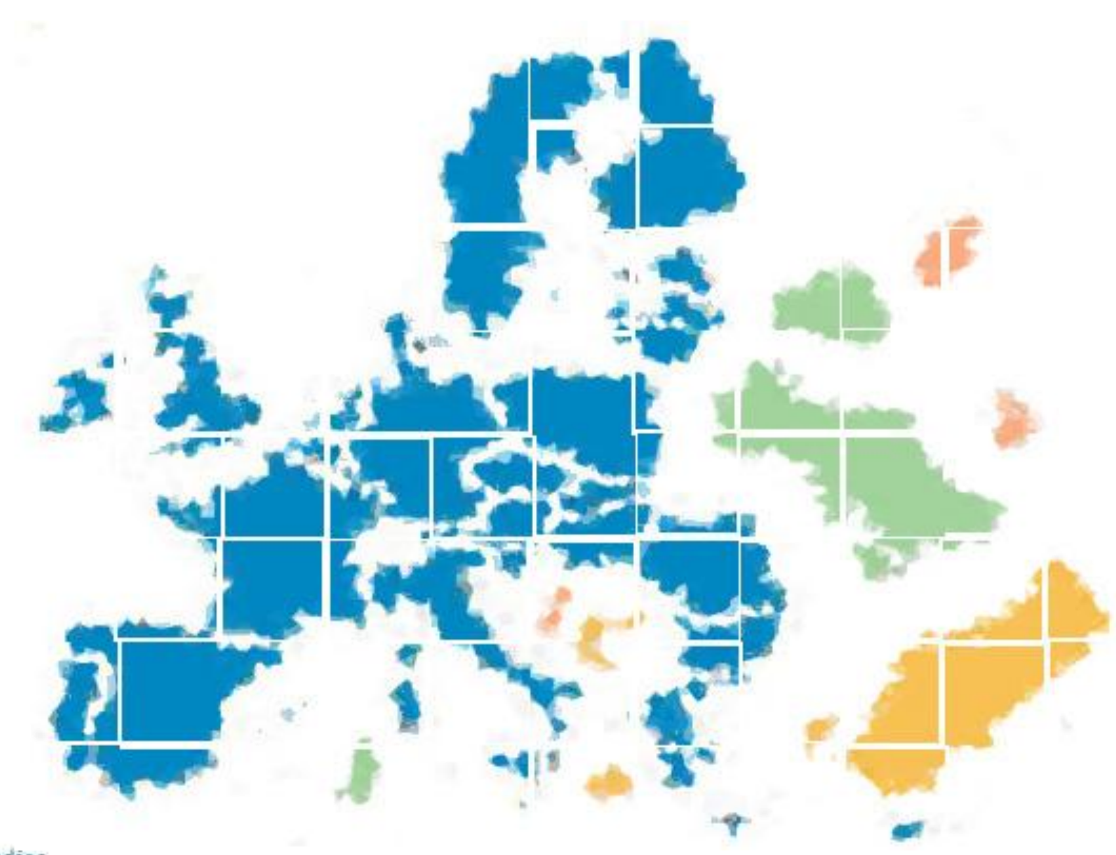
EU Frontiers

Policy Brief

Visegrad countries in the eurozone: Process of convergence or divergence towards the euro?

Antonia Molnarova



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EU Frontiers

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Antonia Molnarova joined CENS in November 2010 as a research assistant responsible for the region of the Visegrad countries. After finishing her master degree in International Trade at the University of Economics in Prague (2007), she was awarded a one-year scholarship of the German Academic Exchange Service and gained a Master of European Studies from the University of Hamburg (2008). Fascinated by international and European affairs, she enrolled in the traineeship programme of the United Nations Industrial Development Organization in Vienna (2009) and European Commission, DG Communication (2009-2010). Besides Slovak and Hungarian (bilingual), she is fluent in English and German.

Introduction

After the EU accession in 2004 and 2007, all Central and Eastern European countries are required to adopt the euro as soon as they fulfill the Maastricht convergence criteria[1]. Despite similar historical situation and facing similar challenges, Hungary, the Czech Republic, Poland and Slovakia, also called the Visegrad countries, take a very different stance as regards the best timeline for euro adoption. Slovakia is the only country in the Visegrad region which adopted euro as a national currency in January 2009. Due to imbalances caused by the economic crisis and consequent problems with fulfilling the convergence criteria, the rest of the group is increasingly hesitant about adopting euro and postponed their plans for entering the eurozone.

This paper is focusing on how the global economic and financial crisis affected the economic performance and national currencies of the Visegrad countries and how the prospects of joining the eurozone of these countries look like. It tries to give answers to the following questions: Did the early euro adoption in Slovakia serve to the benefit of the country? Did the Hungarian forint, Czech koruna and Polish zloty weaken or strengthen during the economic crisis and by how much? What were the main events that had the biggest influence on the development of these currencies? When will the next expansion of the eurozone by the Visegrad countries take place?

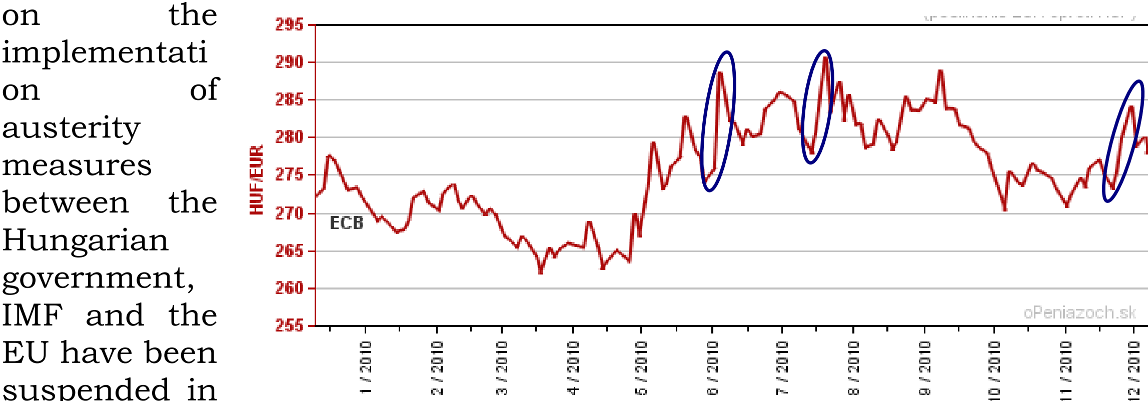
[1] The Maastricht criteria were laid down in the Maastricht Treaty – hence their name – in an effort to secure the long-term sustainability of the common monetary policy and they include: price stability (the inflation rate should be no more than 1,5 percentage points above the rate for the three EU countries with the lowest inflation over the previous year); interest rates (the long-term rate should be no more than two percentage points above the rate in the three EU countries with the lowest inflation over the previous year); budget deficit (below 3% of GDP); national debt (below 60% of GDP, but a country with a higher level of debt can still adopt the euro provided its debt level is falling steadily); exchange rate stability (participation in ERM II for a period of two years).

Hungary

Hungary has suffered the worst consequences of the global economic and financial crisis among all Central European countries. In autumn 2008, it experienced a severe downturn and there have been significant decreases in the value of the national currency. The scale of the financial crisis in Hungary is much bigger than in other countries in the region mainly due to the huge foreign debt (which deepens the country's dependence on the situation on markets worldwide) and a crisis in public finances. In November 2008 in exchange for an economic rescue package of $ 25,1 billion granted by the IMF, the EU and World Bank, Hungary had committed to conduct deep structural reforms.

The exchange rate of the Hungarian forint against the euro has shown a high degree of volatility. The forint depreciated strongly between mid-2008 and March 2009, then partially recovered due to the received financial assistance and recorded a period of relative stability from mid-2009.

A series of communication mistakes of the new government in early June 2010 concerning Hungary's commitment to meet the 3,8% of GDP deficit target in 2010 caused a rapid weakening of the forint. Additionally, talks on the implementation of austerity measures between the Hungarian government, IMF and the EU have been suspended in July 2010 due to disagreements concerning the manner of achieving the set budget goals. The financial institutions were demanding Hungary to impose greater budget discipline and perform a more intensive cost cutting process. The dispute with the IMF had a detrimental effect on the opinion among investors and markets about the Hungarian economy and caused depreciation of the forint. Consequently, according to the statistics of the ECB, forint reached its maximum in the year of 2010 on 20 July at the level of 290,57 HUF/EUR (the minimum was 261,92 HUF/EUR on 18 March). The average value of the forint in 2010 was 275,28 HUF/EUR. **Between 8 December 2009** (when one euro was



worth 273,42 HUF) **and 8 December 2010** (when one euro was worth 278,85 HUF), **forint depreciated by 2,0% (+5,43)** [2].

The IMF was trying to convince Budapest to further reduce costs and to restructure unprofitable state-controlled companies. In turn, the Fidesz government, winning 2/3 parliamentary majority in general elections in April 2010, wants to cover the budget gap with higher incomes by such means as imposing an additional tax on the financial sector. The IMF opposes the latter solution, arguing that the measures are of temporary nature and the burdens imposed on banks will cause a slowdown in new loans and, consequently, a decrease in economic growth. The government has also decided to suspend private pension funds and use their savings. This new source of revenue, which in fact means spending wealth saved over 12 years, will allow the country to meet its deficit target without further holding back public demand. However, the longer term effects of this policy make growth and public spending a heated topic. This move of the government has even led to the downgrade of Hungary's credit rating by two steps to just above junk category by Moody's early December 2010, bringing it into line with that of Standard & Poor's. Consequently, the forint fell against the euro.

Loans in Swiss francs lured Eastern European consumers as a means to escape high domestic rates. As a result, many Hungarian home buyers borrowed in francs and then converted the cash into forints, keeping the benefits of low Swiss rates. The forint's depreciation against the franc and the following increase of interest costs on Swiss franc-denominated mortgages have massive implications both on households and the banking sector.

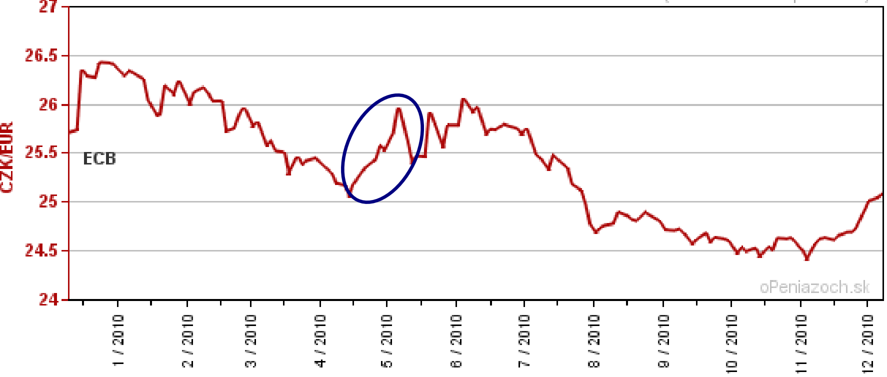
With regards to Hungary's euro adoption prospects, the country will probably not be able to join the eurozone before 2015 and taking into account the country's economic situation, the single currency is not a prior concern at the moment.

[2] Data were taken from the webpage of the European Central Bank, where foreign exchange reference rates are based on a regular daily concertation procedure between central banks across Europe and worldwide.

Czech Republic

The global financial crisis has hit the Czech economy less forcefully in comparison with other countries in the region. Nevertheless, it has caused a fall in the main economic indices and deterioration in the country's financial condition. The factor which has had the worst effect on the Czech economy was the slump in demand in Germany, causing a general reduction in Czech exports in 2009. Despite of that, the Czech Republic is viewed as one of the lowest-risk countries in the EU. Both Standard & Poor's and Fitch Ratings have boosted the country's credit rating in recent months, reflecting the continued profitability of its banking system throughout the global economic crisis.

Between mid-2008 and February 2009, the Czech koruna depreciated strongly against the euro, and then it partially recovered, recording a period of more stability from mid-2009. The banking system has remained solid, as the foreign-currency loans that were popular in Hungary and in Poland were negligible in a conservative country where interest rates have historically been below those set by the ECB. The currency depreciated in April 2010 because of concerns that the Greek debt crisis may spread. In addition, analysts became increasingly worried about a possible new government being formed by the Social Democrats who have pledged to increase welfare spending. However, after the unforeseen victory of the centre–right in the parliamentary elections in May 2010, the Czech koruna reacted dramatically and strengthened against the euro. According to the statistics of the ECB, the Czech koruna reached its minimum in the year of 2010 on 4 November at the level of 24,408 CZK/EUR. The average value of the koruna in 2010 was 25,346 CZK/EUR. **Between 8 December 2009** (when one euro was worth 25,757 CZK) **and 8 December 2010** (when one euro was worth 25,090 CZK), **the Czech koruna appreciated by 2,6% (-0,667)**.



In June 2010 Czech President Václav Klaus named Miroslav Singer as the new president of the Czech National Bank (ČNB). Taking on of the role of the president of the ČNB by a person who shares the economic views of the country's Euroskeptic President will mean a continuation of the current ČNB policy, namely the unwillingness of the Czech Republic

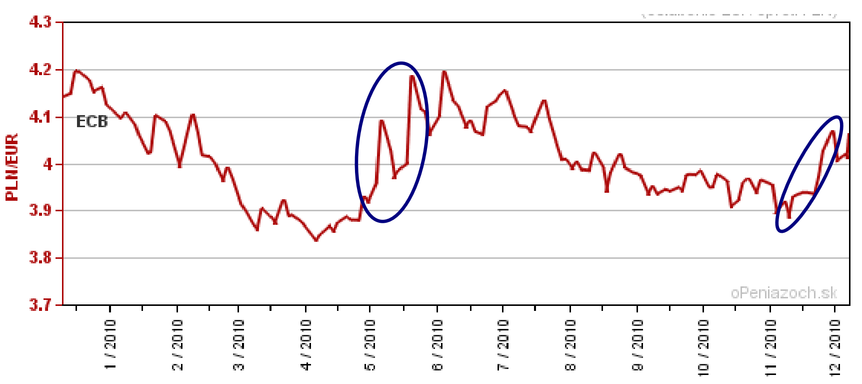
to enter the eurozone. Together with the lack of agreement among government parties regarding the strategy for joining the eurozone, the perspectives for the Czech Republic signing up are being postponed. With the euro struggling and eurozone countries faltering, Czechs have even started a whisper campaign to get a permanent exemption from the mandatory euro adoption rule. President Klaus has been cited in local media as saying they would like to negotiate an opt-out from having to adopt the euro. The Czechs are convinced that their own currency and monetary policy was, is and will remain central to navigating through the modern era of turbulent financial markets, panicky investors and rising cost of debt. PM Petr Nečas reacted to the President's demand saying the Czech Republic would find it hard to negotiate a change in the Accession Treaty approved by all the 27 EU Member States. The government was also reserved as regards taking part in the rescue plan for eurozone countries and recently ruled out joining the permanent aid mechanism.

However, Czech politicians know the time will come when they will not be able to say the country does not qualify or that surrendering the koruna is not on the agenda. The most likely outcome is that the government will attempt to gradually fulfill the convergence criteria, delaying setting a date for joining the eurozone.

Poland

Poland was the only country in the EU to survive the 2009 crisis without falling into recession. However, approaching the end of the year 2010, it seems now that the country avoided the recession in 2009 only temporarily. The European Commission forecasts that Poland will run the sixth highest deficit in EU27 next year. While strong economic growth helped to mask the deterioration of fiscal structural deficit and fiscal loosening supported growth during the global economic downturn, now having one of the highest deficits poses a relatively big risk to future Polish growth.

The Polish zloty was subject to sharp depreciation pressures between mid-2008 and February 2009, before recovering thereafter against the backdrop of decreasing risk aversion in the financial markets. In May 2009 the IMF approved a one-year precautionary arrangement under the Flexible Credit Line[3], which was introduced in March 2009 for countries with pre-specified qualification criteria and might have contributed to reducing the risk of exchange rate pressures. In April 2010, the Polish President Lech Kaczynski, Governor of the National Bank of Poland and dozens of the country’s top political and military leaders died in a plane crash in western Russia. Since the government under PM Donald Tusk was continuing to perform its function, financial markets displayed resilience and no major negative impact on the zloty was experienced. However, the zloty weakened in May 2010 because fears that Greece’s bailout may have to be extended to other indebted nations drove investors from riskier assets in emerging markets like the Polish, with a high budget deficit and a relatively low GDP per capita. The zloty strengthened after Bronislaw Komorowski won the presidential elections in July 2010, spurring the hopes that his victory would help to reduce the nation’s budget deficit and to adopt the euro in 2015. In his recent public declarations, Jacek Rostowski, Poland’s Minister of Finance, has



[3] The IMF introduced the system of Flexible Credit Lines (FCL) in 2009 for countries with robust policy frameworks and very strong track records in economic performance in order to be able to access short term funds and reassure financial markets and investors during the economic crisis. To date, three countries, Poland, Mexico and Colombia, have accessed the FCL. Partly due to the favourable market reaction, all three countries have so far not drawn FCL resources.

been stressing that his country's debt and deficit situation are a serious, but not critical issue. The markets are not listening. In November 2010, renewed concerns about the European sovereign debt and about the ability of Poland to fight the budget deficit caused a slump of the Polish zloty against the euro, dollar and the Swiss franc, the currency in which many Poles have their mortgages denominated. In 2010, the average value of the zloty was 4,0058 PLN/EUR. **Between 8 December 2009** (when one euro was worth 4,107 PLN) **and 8 December 2010** (when one euro was worth 4,0633 PLN), **the Polish zloty appreciated by 1,1% (-0,0437)**.

Mr. Rostowski is correct that Poland's fiscal problems pale in significance compared to the travails being experienced by peripheral eurozone countries like Greece and Portugal, and look better than the situation in core countries like Spain and Italy. In an article written for a Polish newspaper[4], Mr. Rostowski said that Poland does have a medium term fiscal problem, but that the government, which has pledged to drive the deficit below 3% of GDP by 2013, is taking appropriate steps. However, with markets so jumpy about increased risk in light of the crisis in Ireland and worsening perspectives for Portugal and Spain, any country that looks at all troubled is vulnerable - despite protests from the finance minister.

Since aggressive speculations against the Polish currency from the last year have taught Poland a lesson, according to PM Tusk, "Poland will enter the eurozone, when it is ready for it". Also President Komorowski said that adopting the common currency should remain Polish priority, but when it happens is not the matter of prior concern at the moment. Analysts agree that the safe accession date is 2015. Now, the key challenge for Poland is to create a plausible strategy for decreasing public finances deficit under 3%.

[4] Gazeta Wyborcza, 29 November 2010

Slovakia

Slovakia is the only country in the Visegrad region which adopted euro as a national currency on 1 January 2009. It is difficult to evaluate the pros and cons involved in the adoption of the single currency because too little time has passed since its adoption and full statistical data for 2010 are still unavailable. In 2009, Slovakia's first year in the eurozone, the country was affected severely by the global crisis. Since the Slovak koruna was included in the Exchange Rate Mechanism II (ERM II)[5] in 2005 and it had a fixed exchange rate against the euro since July 2008, the euro partially sheltered the Slovak economy against consequences of the deepening economic crisis. Furthermore, entering the eurozone facilitated access to capital as interest rates were lower than in the neighbouring countries which are outside the eurozone. This has enabled Bratislava to significantly reduce its debt service costs. Low interest rates and the availability of capital have made loans to both firms and citizens more accessible. Moreover, the introduction of the euro had a beneficial effect on the investment climate and foreign investments in Slovakia fell less than in the other countries during the crisis.

On the other hand weak currencies strengthened exporters of non-euro zone countries and Slovakia had to face consequences of "shopping tourism" for its retail sector. Especially during the first half of 2009 Poland, the Czech Republic and also Hungary experienced huge waves of Slovaks seeking much cheaper goods in shops and supermarkets abroad. The global economic crisis and the too high conversion rate of the Slovak koruna to euro set in July 2008 at 30,126 SKK/EUR resulted in lower demand for Slovak goods. The latter has also made Slovak exports less competitive than those of the other countries in the region which benefited from the decrease in the values of their national currencies. Nevertheless, most economists share the opinion that the negative consequences of adopting the euro (primarily the lower export profitability) are temporary and that the adoption of the European currency will have a positive effect on Slovakia's economy in the longer term.

Helping to solve debt problems is the responsibility of eurozone countries. Thus Slovakia was obliged to participate in the Greek aid package and it was also in Slovak interest to help to stabilize the euro. The government gave a green light to unlock the mechanism of bilateral

[5] A currency in ERM II is allowed to float within a range of ±15% with respect to a central rate against the euro, acting as the anchor currency. This is also known as a semi-pegged system. When currency values threaten to fluctuate outside the set margin, financial steps are taken to correct the fluctuation, including intervening in the currency market or offering loans.

loans aimed at helping Greece to handle its debts. However, the Slovak loan of € 816 million came under fire of media and right wing opposition parties rejected it. Since Slovakia does not have such funds immediately available to contribute to the Greek rescue deal, the country itself would have had to take on more debt. This became a major campaign issue in the general elections in June 2010. Outgoing PM Robert Fico said in May that he was backing the emergency program out of European solidarity, but said he had no mandate to sign the deal without the approval of the incoming government. A series of accusations over who should sign began, creating something of a blockade to the approval of the EU bailout program. In August 2010, the new PM Iveta Radičová's month-old center-right coalition rejected the nation's participation in the bailout of the Greek economy, saying poor countries should not pay for the profligacy of richer peers.

Nevertheless, the new Parliament signed the so-called Framework Agreement on the European Financial Stability Facility (EFSF), the € 750 billion eurozone support mechanism, with a share of € 4,5 billion worth of loan guarantees. When Ireland requested help from the EFSF, Slovak Minister of Finance Ivan Mikloš announced at a news conference that Slovakia will contribute with almost € 180 million to the EU bailout. However, he also said in a speech that the bailout of Greece was "essentially a mistake" and governments in Europe were now "hostage" to financial markets.

Conclusion

The success of the euro adoption depends both on economic performance and on the political will to do so. The main reason why the Czech Republic is declining to join the eurozone is to keep its monetary independence and to set the monetary policy that suits its own economic conditions. This, coupled with a market-friendly program of the Czech government, budget discipline and upward moving growth forecasts support the stability of the Czech koruna which appreciated by 2,6% (-0,667) in 2010. The Polish government shares a similar view that rushing into the adoption of the single currency is not a prior concern at the moment. Even though Poland has avoided falling into recession so far, worsening of the fiscal deficit could cause a risk to the Polish growth. The timing of euro adoption will then depend on economic steps taken to drive the deficit below 3% rather than on political consensus. As regards the national currency, the Polish zloty appreciated by 1,1% (-0,0437) in 2010. Considering Hungary's economic situation, joining the eurozone is not a prior issue at the moment. The forint has shown a high degree of volatility against euro throughout the year 2010 and depreciated by 2,0% (+5,43).

Only two years have passed since Slovakia, as the only country from the Visegrad Group, adopted the euro. It partially sheltered the Slovak economy against consequences of the deepening economic crisis but also made Slovak exports less competitive compared to non-eurozone countries in the region which benefited from the decrease in the values of their national currencies. It seems that Hungary, Poland and the Czech Republic, either for lack of political consensus or economic problems, will not be ready to follow Slovakia and adopt the euro before 2015. Also countries within the eurozone, facing their own financial difficulties, do not want to agree to soften the criteria for admission or to shorten the transition period in ERM II system. Therefore, the prospects of a new expansion of the eurozone by a Visegrad country are quite distant.

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