An Appraisal on the Earlier Euro Adoption by the New Member States in the Frame of the Current Global Economic and Financial Crisis

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Abstract. The pathway of the new member states towards the euro area was stopped, but not modified by the current world economic crisis. Their inflation declined but the fiscal status suffered. On the verge of the financial crisis, the European Central Bank overruled the Central and Eastern European member states' intentions for an earlier adoption of the euro, requiring compliance with the Maastricht criteria. The objective of this paper is to analyze the main proposed solutions and to draw attention on the most suitable ones in keeping with the particular features of these countries. Our conclusion is that fast results on the euro adoption will definitely depend on the fiscal consolidation, the soundness of global economic rehabilitation, the capital availability, and the domestic policies. The nature of the approached problems and the authors' experience recommend this study, both for researchers and practitioners.

Keywords: convergence criteria; unilateral euro adoption; ERM II stage reduction

1 Introduction

On the background of this new economic crisis, it has been raised the issue of *relaxing the euro adoption convergence criteria*. The Hungarian Prime Minister Ferenc Gyurcsany asked for a shortening of the period in which a state must maintain its currency in the ERM II (exchange rate mechanism II) in order to join the euro area and the Polish Prime Minister Donald Tusk advocated for the same change.

Western leaders had different reactions in the discussions on this topic. Although heads like Angela Merkel[1] (German Chancellor, a country that is considered the most intransigent as regards the fullfilment of the euro adoption conditions) or Luxembourg Jean-Claude Juncker[2] considered that the measure of *reducing the period of euro area pre accession* can be reviewed, the criteria for entering into the euro area remained te same. The majority reject the possibility of making more flexible the strict membership criteria that limit the budget deficit, the public debt and the inflation. The president

[1] „The criteria must be met as they are set out in the Maastricht Treaty. We can not change the treaties."

[2] „There is no question of revising the accession criteria, since the stability of the euro currency and the euro area depend on them."

of France was the only one who expressed doubts regarding the pertinence of the budget deficit criterion. On behalf of the Czech presidency of the European Union, Mirek Topolanek said that there is broad consensus among the 27 EU members that it would be a "mistake to change the rules for now." Several leaders of EU countries were willing to accept an acceleration of euro adoption process in the Eastern European countries transition to the euro area, without taking into account a relaxation of the entry criteria or any exemptions from them.

The fulfillment of the nominal convergence criteria implies their sustainability, also. Lithuania's entry into the euro zone at January 1st 2007 was rejected because she did not meet the price stability criterion in the reference year, the inflation rate marginally exceeding the permissible limit (which is known only *post factum*, being a moving target) and it has been considered that the inflation sustainability at a low level is insufficient, being threatened by numerous risks.

2 Unilateral Adoption of the Euro

Unilateral adoption of the euro has been suggested by the International Monetary Fund (IMF) in March-April 2009, in a confidential report cited by *Financial Times*. IMF proposed a relaxation of euro zone joining criteria, so that the emerging states from Central and Eastern Europe should adopt the single currency without the representation right in the European Central Bank (ECB). According to the report, such an initiative would tackle the problems of external debt of these countries and would eliminate uncertainty in the region markets.

The European Commission has rejected the information, suggesting that the report is outdated and stated that the EU has taken already several steps to help Eastern Europe in overcoming the financial crisis.

The European Central Bank[1] believes also that EU emerging states should not adopt the euro unilaterally, because such a step would undermine global confidence in the euro. This option would widen euro area macroeconomic divergences and would contradict earlier imposed conditions.

An acceptable solution would be the acceleration of the emerging countries entry in ERM II, after the risks awareness posed by the participation at this phase. The ERM II entry means that countries take responsibility to keep the exchange rates stable for a specified period, and this situation is not without risks.

Politicians and economists suggest that Central and Eastern Europe is a region far from being homogeneous, but markets may address the issue differently. Contagion is an accepted phenomenon in the international banking system and regional economies have similar structures and are widely exposed to developments in western European economies. These factors shape the similar nature of these economies. What differentiates them is the exchange rate regime.

For the countries that target the exchange rate (Baltic countries and Bulgaria), the ideal solution is to join the euro zone as soon as possible, but they do not qualify yet for membership. At least for these four countries, the unilateral adoption of the euro may be a solution. These countries would not be formally accepted as members of the euro area, would not participate to the elaboration of the euro area monetary policy, could not access funds from the European Central Bank and would not affect

[1] Ewald Nowotny, a member of the European Central Bank Governing Council, cited by Reuters.

the statistics of the euro area, but they would eliminate the currency risk and would be members of a liquid euro market. Then, their main purpose would be to advance from the status of semi-membership to full membership of the eurozone. Unilateral adoption of the euro could undermine the rules of membership to a certain extent. In the end, these countries would adopt the euro assuming their own risks and should pay for them from foreign reserves. In some analysts' opinion, in this manner, the process of euro adoption would mean a general costs reduction across the EU itself.

The other four candidates countries to euro zone (Czech Republic, Poland, Romania, Hungary) are the largest economies in the region, and their size makes the sudden change of currency to be more risky, complex and less realistic. Their regimes of floating exchange rate make this change to be vulnerable to speculations. For this reason, the unilateral euro adoption, in these countries, can be a major strategic mistake: on the one hand, they "would taste" partially the benefits of the common monetary policy, but without the protection of the ECB and, on the other hand, they would not be able to issue currency and the useful exchange rate instrument, which often covered the loss of export competitiveness (when the exchange rate depreciated!) and even has softened the burden of external debt and its growth (when the exchange rate appreciated!), would be forever lost. Therefore, for these countries, and not only for them, the compliance with the "rules of the game" for EMU entry could be the key of success for a smooth single currency adoption. However, the adoption of euro by their smaller neighbour countries perhaps could advantage them, making these countries more stable.

The unilateral adoption of the euro would imply a defeat of the new member states in political terms: these countries are not members of the monetary union, but they recognize the euro supremacy and their dependency of the ECB's policy, they do not participate to the settlement of the common monetary policy and they do not have access to euro as their national banks can not issue euro, but they are under compulsion of nominal criteria fulfillment. The admission of the euro as an official currency can eliminate the current prime risk and can ease the access to liquidities in European currency, but the acceptance of the unilateral adoption of the euro represents a singular assumption of the responsibility for this decision.

Even if there were some advantages for a unilateral euro adoption for Romania (the elimination of the currency risk), as long as all convergence criteria are not yet met, there are risks arising from the macroeconomic situation, inappropriate for this step. The problem of the unilateral euro adoption was solved by itself, EU officials having announced that this was not possible.

The solution of unilateral euro adoption is not a new one. The biggest countries that have unilaterally adopted the euro are two parts of former Yugoslavia, Montenegro and Kosovo. In both cases, the changeover has been indirect: first the German mark was adopted unilaterally, and after that, by replacing the German mark with the euro, the changeover has been made.

Another independent country that uses the euro without an agreement with the European Central Bank is Andorra. The small principality used the currencies of the two big neighbours, France and Spain, with a dual display of the prices. The euro changeover in France and Spain has brought adjustments also in Andorra. Without any formal agreement with France or Spain, Andorra has not issued currency and did not enter into the calculations of the two central banks. The situation continues today, when Andorra uses the euro, but without the right to issue currency.

In Europe, the euro has been adopted unilaterally, also, in the British bases of Akrotiri and Dhekelia, located on the island of Cyprus or in the Caribbeans where there are two communities of France, Saint Barthelemy and Saint Martin, which use the euro, although they have not an agreement to that effect. French collectivities Saint Pierre and Miquelon (North America) and Mayotte (Africa) have agreements to use the euro. Not being independent states they can not issue their own currency, France being the one which is taking care of this aspect.

Three small European countries (Monaco, San Marino and Vatican) had agreements in this direction with the states whose currencies they used (France for Monaco and Italy for the other two), and the situation was prolonged also for the euro. Thus, these three countries may issue euro. Given their special situation, they can not issue banknotes with national series, but only currencies on whose reverse they may present a different image from that of the currency minted by France or Italy. These cases are not relevant since they are small economies, which were not in the EU accession process, at the moment of euro adoption.

3 Opinions on the Optimal Moment for Euro Adoption in Romania

Within the premises of the current crisis, there is an increasing number of opinions supporting the extension of the euro area. On the other hand, the euro adoption represents the final phase of a complex convergence process and not its beginning and it does not refute the necessity for macroeconomic rebalancement in the new member states.

In the March convergence report for Bruxelles, the Romanian government kept the euro adoption term for 2014, hoping to have sufficient time to implement the reforming measures. Even if in March the prime minister announced the acceleration of the euro adoption process we notice that the term is the same with the one mentioned in September last year. Romania has to maintain its schedule for euro adoption, but the state must enter the first stage of this process, which is MCS II. The adoption prior to 2014 is not possible due to the fact that Romania is not able to fulfill all the required conditions beforehand and it is hard to believe that they will be relaxed, taking into account the fact that many states had a hard to succeed this achievement.

Table 1 Arguments for early and late adoption of the euro in Romania

Arguments in the support of an early euro adoption	**Arguments for a late euro adoption**
• The more rapid occurrence of the benefits for currency risk elimination, favoring the sustainable economic growth. Presently, we have a high currency risk due to the increased indebtness in foreign currencies (the exchange rate may rather be a shock propeller than an adjustment tool). • The postponement may reduce the incentive for the implementation of structural reforms. • Keep the consistence of the set of macroecomic policies. • The commercial links with the euro area and the high level of euroisation of the economy would allow for a faster technical changeover.	• The delay for the implementation of structural reform measures may generate negative effects on the long term in the case of an early euro adoption. • Increased inflationary pressures – reduced potential for price convergence. • Reduced correlation of the economic cycle in Romania with the euro zone; the harmonization of the business cycle is a prerequisite for the diminishment of the asymmetric shocks. • Reduced sustainability of public finance – huge pressure on expenses and very low level of budgetary revenues. • Changing structure of the economy. • Low level of real convergence (GDP per

	capita). • Important constraints of the labor market. • Longer period for the monetary and exchange rate policies independence. • Deeper real and nominal convergence.

The adoption of the euro would eliminate the foreign exchange risk, which would reduce the trade expenses at the microeconomic level and, hence would increase the stability of the Romanian economy. The rate at which the changeover to euro will be implemented has important consequences. Thus, if a reduced value of the leu will be taken into account, then the prices will increase. On the other hand, salaries will not increase easily, and the National Bank of Romania will not be able to set the interest rates, as inflation will be harder to manage. The objective for euro adoption will remain a catalyst for future coherent policies.

4 The Effects of a Possible Reduction of the Two-Year Stage in MCS II

MCS II is the direct follower of the original MCS, which was set in close keeping with the ECU implementation in March 1992. Since then, MCS suffered many changes[1] to reach the current shape at 1st of January 1999, which was the starting point for the third stage of the European Monetary Union and the day of the launch of the euro. MCS II is a bilateral system in which the currencies of the participating countries are linked to euro in a fluctuating band. Each currency from MCS II has a fixed parity with the euro and a band around this central parity. In the cases in which pressures on the exchange rate exist, both the national bank of the euro member state as well as the European Central Bank will intervene to maintain the rate in the fluctuating band.

The convergence criterium for the exchange rate is a requirement for euro adoption. The achievement of this constraint necessitates the participation in MCS II and the preservation of the stability of the currency rate, which is closely related to the MCS II. Nevertheless, the two terms are not interchangeable, the participation to MCS II being possible, without the simultaneous achievement of the exchange rate stability criterium.

The floating band is in general ±15%, whitout excluding the possibility to have a narrower band. The intervention of the European Central Bank is automatic at the attainment of the floating edges, and not compulsory within the edges. The national and European central banks' interventions may be interrupted if the price stability is at risk. The reallingment of the central parity is achieved using a common procedure that can be initiated by both the European Central Bank and the member states.

There is thus a major difference between the functioning of the mechanism and the fulfillment of the exchange rate stability. The setting of the MCS II floating band is important for the functioning of the interventions of the central banks and the ECB.

The achievement of the exchange rate stability criteria requires taking part in MCS II for at least two years at the moment of the assessment without reducing the central parity during the examination

[1] Two main changes existed: one in August 1993 when the floating band was enlarged from ±2,25% to ±15% and the second one at the 1st of January 1999,when, through the introduction of the euro, the passing from a multilateral system to a bilateral one was in place.

period. An upward realignment of the central parity is all the times possible. The keeping of the currency rate in the floating band must be realized without severe tensions; the keeping of the rate at any costs, through excessive interventions or measures outside the market will not trigger the achievement of the exchange rate stability criterion. If the exchange rate exceeds the established edges, a distinction between the upper bound and the lower bound will be in place (exceeding the upper bound will be easily accepted). In case of such events the duration of the deviation, the reasons for this, the interest rate and the intervention policy will be analyzed.

The exchange rate is not an isolated economic variable but one that operates in a complex framework and in close connection with other economic variables, which characterize the domestic and foreign ecquilibrium. More than this, the currency regime is merely an element in a set of economic policies and has no exclusive or exceptional position. If an exchange rate regime is sustainable and plays a stabilizing role, it also depends on the dynamics of other variables and macroeconomic policies.

MCS II is a fixed currency regime, particular through the fact that one country may receive help from the European Central Bank in order to keep the currency within the floating band. As the usual case for other fixed currency regimes, MCS II focuses on the consistency and stability of the macroeconomic policies. Given prudential economic policies, a flexible economy and macroeconomic stability, the participation to MCS II with a floating band of ±15% may pass easily. The fulfillment of the convergence criteria in a narrower band of ±2.25% is not problems free.

Among the benefits of the participation to MCS II there is the stabilization of the exchange rate (through pegging exchange rate expectations) and of the economy as a whole, as well as the positive effect on the consistency of the macroeconomic policies. These benefits are visible when we examine the monetary development in most of the western European economies in the period of euro adoption. The question is weather, for the less developed European countries in an economic transformation process and experiencing increased volatility for the foreign capital inputs and outputs, the participation to MCS II is beneficial compared to the alternative monetary regimes possible to function before euro adoption.

The role of the MCS II in *stabilizing the exchange rate* is provided by the announcement of the central parity, which becomes a benchmark and, hence, reduces the volatility of the exchange rate. This situation should positively contribute to the convergence process of the respective country towards the level of more advanced states in the European Union. In practice, this stabilizing role may be limited by two factors: on the one hand there is the modification of the central parity, which could reduce the reliability and on the other hand there is its signalizing role, while the floating band of ±15% allows for an increased volatility, which makes its stabilizing role questionable. As a consequence, *the reduction of the compulsory two year stage would not significantly affect the stability of the exchange rate.*

The participation to MCS II requires consistent macroeconomic policies and it will determine a faster consolidation of the public finance and the related policies. On the other hand, it is preferred that the fiscal sustainability and the structural policies to precede the introduction of a fixed currency rate, while the restrictions on the currency floating should be a consequence of the implementation of these consistent policies and not a triggering factor.

Pursuing this rationing, if a country uses consistent economic policies, it is possible, at least at the theoretical level, that it takes into account *the adoption of the euro bypassing the intermediary stage of MCS II*. In a world in which the capital flows are high, to consider the MCS II as a test for the consistency and sustainability of the economic policies may have some costs as the financial market might “test” the vigilance of the authorities to maintain the exchange rate within the floating band. Thus, instead of expected stabilizing effects, a fixed currency rate with a floating band may drive to the unbalance of the capital flows.

The participation to MCS II is recommended also in the view of its beneficial effects on *inflation*. A fixed exchange rate will favour the price stability both directly through the interim of import prices and indirectly through stabilizing the expectations about the dynamics of inflation. Nevertheless, under the framework of a standard floating band of ±15%, which allows for significant fluctuations of the currency rate and for reassessment of the central parity, this stabilizing role is limited.

Some countries decided to adopt the inflation targeting strategy. Under this framework one could ask weather this strategy is compatible with the MCS II. A relative stability of the currency rate is essential for the price stability. Thus, within the inflation targeting strategy, an important attention is paid to changes in the currency rate. However, under the MCS II, the changes in the exchange rate are more clearly specified by explicit setting of quantitative bounds. If we had the simultaneous inflation targeting strategy and the participation to MCS II, there would have been two objectives for the monetary policy, which could deteriorate its efficiency and, hence the reliability of the central bank. This problem could be mitigated if the *period for the participation to MCS II was shorter*. In the case of a long participation to MCS II or the adoption of incompatible economic policies, the combination of inflation targeting strategy with the participation to MCS II may generate economic pressure.

The participation for a *long period of time to MCS II is not beneficial to macroeconomic stability*, and the simple participation to MCS II does not eliminate the currency turbulences. According to this conjecture we consider that the idea of reducing the compulsory two year stage in MCS II would be beneficial to the candidate countries, without deteriorating the economic stability in the euro zone.

5 Conclusions

In the Central and Eastern Europe, Bulgaria is the only state that wishes to enter into MCS II. Poland, the Czech Republic and Hungary postponed the adoption of the euro for unlimited time due to the current financial crisis, which destabilized their economies. Even if it initially wanted the adoption of MCS II in the first part of 2009, Poland recognized that the target was too optimistic and decided to postpone the moment until the country would be ready for this. The Czech Republic and Hungary, which were not in a hurry, announced that they will delay decision making in this respect until the global economic recession will reduce its intensity. Having entered the European Union in 2007, Bulgaria had to abandon the initial plans to enter the MCS II shortly after the integration due to the inflation acceleration and a huge current account deficit. Under the framework of the Greek economic crisis, the recent Bulgarian intentions to enter MCS II were postponed once again.

The recession will trouble the plans of the EU new Member States as far as the euro adoption is concerned. The speed with which the states in the Central and Eastern Europe will make efforts to start the procedures to adopt the euro will be determined by the fiscal consolidation, which will also depend on the soundness of the global economic recovery, capital availability as well as domestic policies.

We have to notice that the fulfillment of the nominal criteria at a certain point in time does not guarantee the success in the participation to the euro zone. The diversification of the domestic supply and the development of the external competitivity, as well as the flexibility of the labor market, should represent the first priority.

6 References

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