Euros in the wallets of the Slovaks, but who will be next?

08.05.2008

The CEE preference for early Euro adoption change when politicians look at the related economic trade-offs & political costs.

Shortly after 10 new member states joined the European Union in 2004, the Baltic countries, Hungary and Slovenia expressed their interest in joining the Eurozone as soon as possible. Some of them, which had a fixed exchange rate regime, even questioned whether it was necessary to spend an additional two years in ERM-II before the assessment.

For many countries the Euro adoption became a political agenda without a deeper understanding of economic trade-off or political costs. The CEE preference for early Euro adoption have changed a little though, since politicians have started to be confront the reality – in terms of the economic trade-off and political costs related to early adoption.

Timetable – Euro Adoption expectation

	Market consensus**	Erste Group Research*
Lithuania	2012	-
Estonia	2012	-
Poland	2013	2013
Latvia	2013	-
Romania	2015	2014
Hungary	2014	nicht vor 2014
Bulgaria	2014	-
Czech Republic	2013	nicht vor 2015

Source: ErsteGroup Research (* without Baltics and Bulgaria) , **Reuters Poll (April 2008)

Hungary
The highest political costs related to fiscal consolidation occurred in Hungary, where the government had to cut the fiscal deficit during an economic slump, which always hurts. Now it seems that Hungary will not be able to meet its Medium Term Objective plan to cut structural deficit to below 1% before 2012, because of the high political costs related to reforms in Hungary. Orsolya Nyeste, macro analyst at Erste Bank Hungary: “Hungary does not have any official Euro adoption target date, but implemented a fiscal adjustment program in 2006, resulted in a budget deficit reduction to a more sustainable level. In addition, the abolition of the forint exchange rate band announced this February could create a basis for a market-determined ERM II entry rate, as a preliminary stage for EMU entry. However, 2014 seems to be the earliest possible date for Hungary to join the monetary union.”

Czech Republic
Much better positioned for early Euro adoption is the Czech Republic, but single currency is currently not at the top of political agenda. This is mainly because the country want to make structural reforms first, in order to increase flexibility and competitiveness of the economy. Positive public perception of CZK appreciation, which is a benefit of sovereign monetary policy and a more convenient way to achieve price convergence, is another reason why the Czech Republic is not in a hurry to adopt the single currency. Therefore, we do not expect that Czech Republic to join the Eurozone before 2015. Martin Lobotka, macro analyst at Ceská sporitelna: “The Czech Republic does not have any strictly set date for Euro adoption - a strategy approved in 2007 now only says that "Euro adoption date will depend on strengthening of the Czech economy's flexibility and on solving problems associated with public finance reform”. All in all, largely unreformed systems and a lukewarm reaction from a substantial part of the elite towards speedy Euro adoption lead us to forecast Euro adoption no sooner than in 2015.”

Poland
Poland, contrary to the Czech Republic, might benefit from strong governmental support of early Euro adoption and adopt the single currency by 2013. Lubos Mokras, macro analyst at Ceská sporitelna: “Poland currently does not have an officially agreed national target date for Euro adoption. We expect that the most likely entry year will be 2013, so the country would enter ERM-II not later than in 2010. The current climate of higher inflation, which has both domestic and international sources, is in our view only temporary and the determined monetary policy of NBP will ensure inflationary stability.”

Romania
Romania needs much more time to advance its structural reforms ahead of Euro adoption. But it is interesting that Romania is not in EDP and the ratio of public debt to GDP is one of the lowest of new EU members. The price level is not so far from Hungary’s (57% vs. 60% of EU27), so Romania is much better positioned to fulfill the Maastricht criteria

in the medium term than Hungary. Romania can apply for Euro adoption by 2013 and join the Eurozone in 2014. Before that, financial markets will have to regain confidence in the Romanian currency and enable smooth entry to ERMII in 2011. It seems that this is still not properly priced in long-term yields to actually provide the most interesting “convergence play” opportunity.

Dumitru Dulgheru, macro analyst at Banca Comerciala Romana: “Although Romania made good progress in terms of convergence in the last few years, there is still a long way to go. At the end of 2007, 2 out of 5 nominal convergence indicators were not consistent with Maastricht Criteria, such as inflation and long term interest rates. We expect that rising inflation and significant external imbalance only have a temporary nature. Thus we still see the adoption of the European single currency in 2014 as a real possibility. This will of course strongly depend on the continuation of the economic reforms and restructuring of the economy - and the next three years will be crucial from this point of view.”

The Baltics

While for the above-mentioned countries the biggest obstacle in Euro adoption is fiscal consolidation, the Baltic States face a completely different challenge – how to meet the inflation criteria. Their pegged currencies do not support the disinflation effort, compared to CEE countries with floating regimes where currency appreciation takes away part of the inflationary price convergence . It will take at least two years for the recently elevated inflation to settle down. Baltic countries have been in ERMII for longer than the required two years and they are not in EDP. So they can apply for single currency in any year they fulfill the inflation criteria. However, sustainability will be always questioned and that remains the main risk.

Croatia

Alen Kovac, Macro analyst at Erste & Steiermärkische bank Croatia: „”At this point, prior to EU entry, it might be too early to speculate around Croatia’s entry to the Eurozone. According to the present timeline Croatia should become an EU member in 2011, meaning that Eurozone entry would be scheduled no earlier than 2014. Croatia would not be likely to wait long to apply for ERM II, and become a Eurozone candidate, since the proportion of ‘Euroization’ in the economy is already high and the loss of monetary sovereignty would therefore not be substantial. So, from the current picture, fulfillment of the Maastricht criteria should be well within the reach - nevertheless with such a long timescale some risks may arise along the way.”

Slovakia in Eurozone – Who will be next? [ppt; 218,5 KB]

ERSTE GROUP

Press conference

May 8, 2008, Vienna

Slovakia in Eurozone – Who will be next?

Juraj Kotian, Co-Head CEE Macro and Fixed Income Research, Erste Group

Positive assessment of Slovakia is good news for whole CEE region

ERSTE GROUP

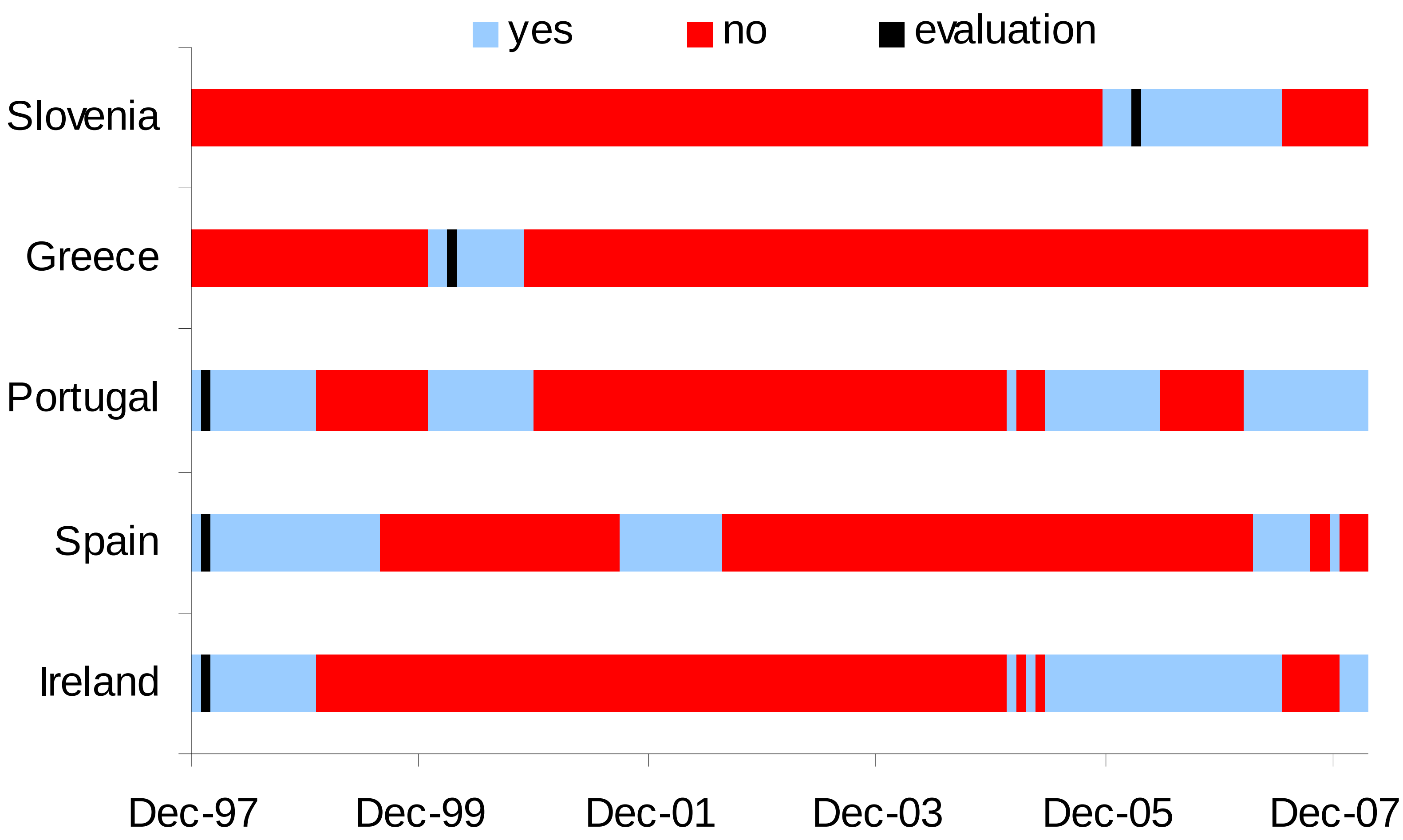
European institutions were more cautious during the assessment, due to the following:

- **the spiked inflation in Slovenia, the first new EU member state to join the Eurozone**
- **Slovakia will enter the Eurozone as the country with the lowest price level**
- **a country with a flexible exchange rate will serve as a benchmark for the assessment of Poland, Hungary, the Czech Republic and Romania**

Inflation criterion not easy, even for some EU countries

ERSTE GROUP

Fulfillment of inflation criterion

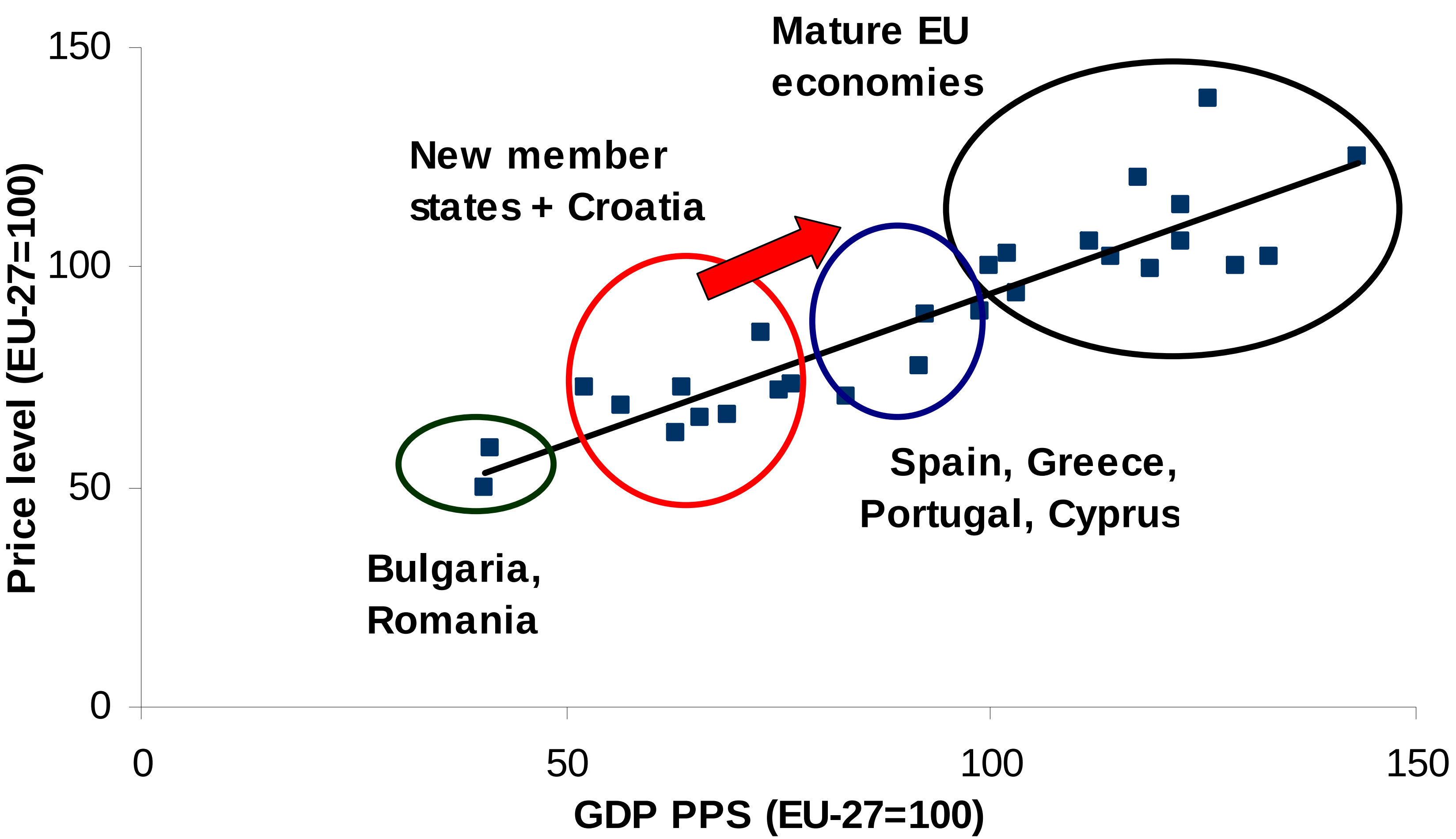


Source: Eurostat, Erste Group Research

Inflation in CEE is likely to be higher as income convergence induces price convergence

ERSTE GROUP

Income vs. price convergence



Source: European Commission, Eurostat, Erste Group Research

Currency appreciation has played significant role in disinflation process

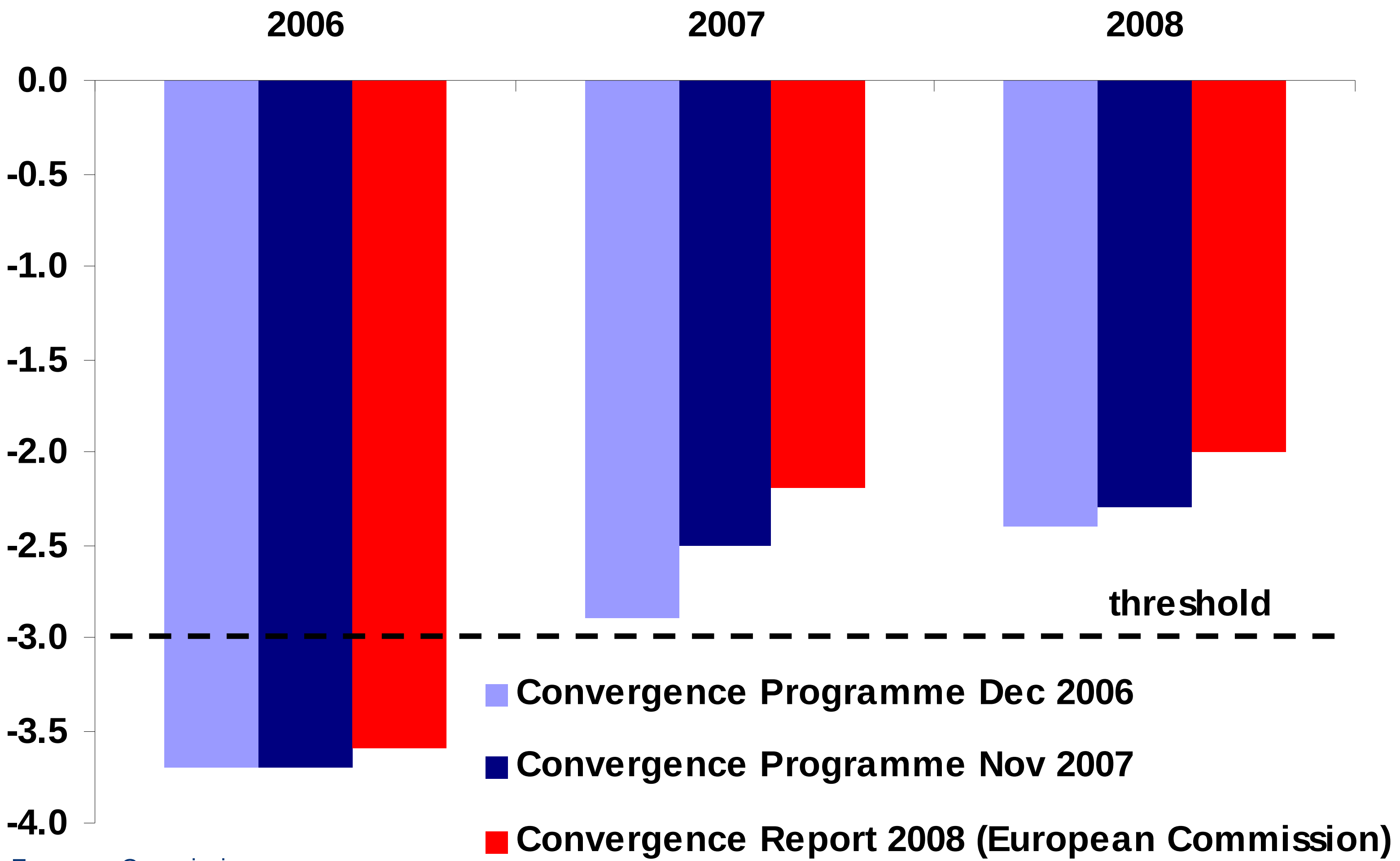
ERSTE GROUP

- **Countries with flexible exchange rates have greater chances to meet inflation criterion**
- **Sustainability is measured in 2Y horizon**
- **It is difficult to reject country because of “concerns” – hard data/evidence is needed to do so (as with Lithuania)**
- **Inflation criterion is outdated, revision will be demanded by next candidates**

Following recommendation of EC in fiscal area was cornerstone of successful euro adoption process

ERSTE GROUP

Fiscal balance (% of GDP) – Slovak Republic



Source: European Commission

Timing depends heavily on political support for early adoption and ability of governments to advance in terms of structural reforms and fiscal consolidation

ERSTE GROUP

Fiscal deficit and sustainability of public finances is an issue for

- Hungary (public debt above 60% of GDP)
- Poland
- Czech Republic (should be excluded from Excessive Deficit Procedure soon)

Countries with pegged currencies – difficulties meeting inflation criteria

- Estonia
- Latvia
- Lithuania
- Bulgaria

Weak political support

- Czech Republic (do reforms first, CZK appreciation – convenient manner of price convergence)

We should see pretty long pause lasting at least three years until next CEE country qualifies for Eurozone

ERSTE GROUP

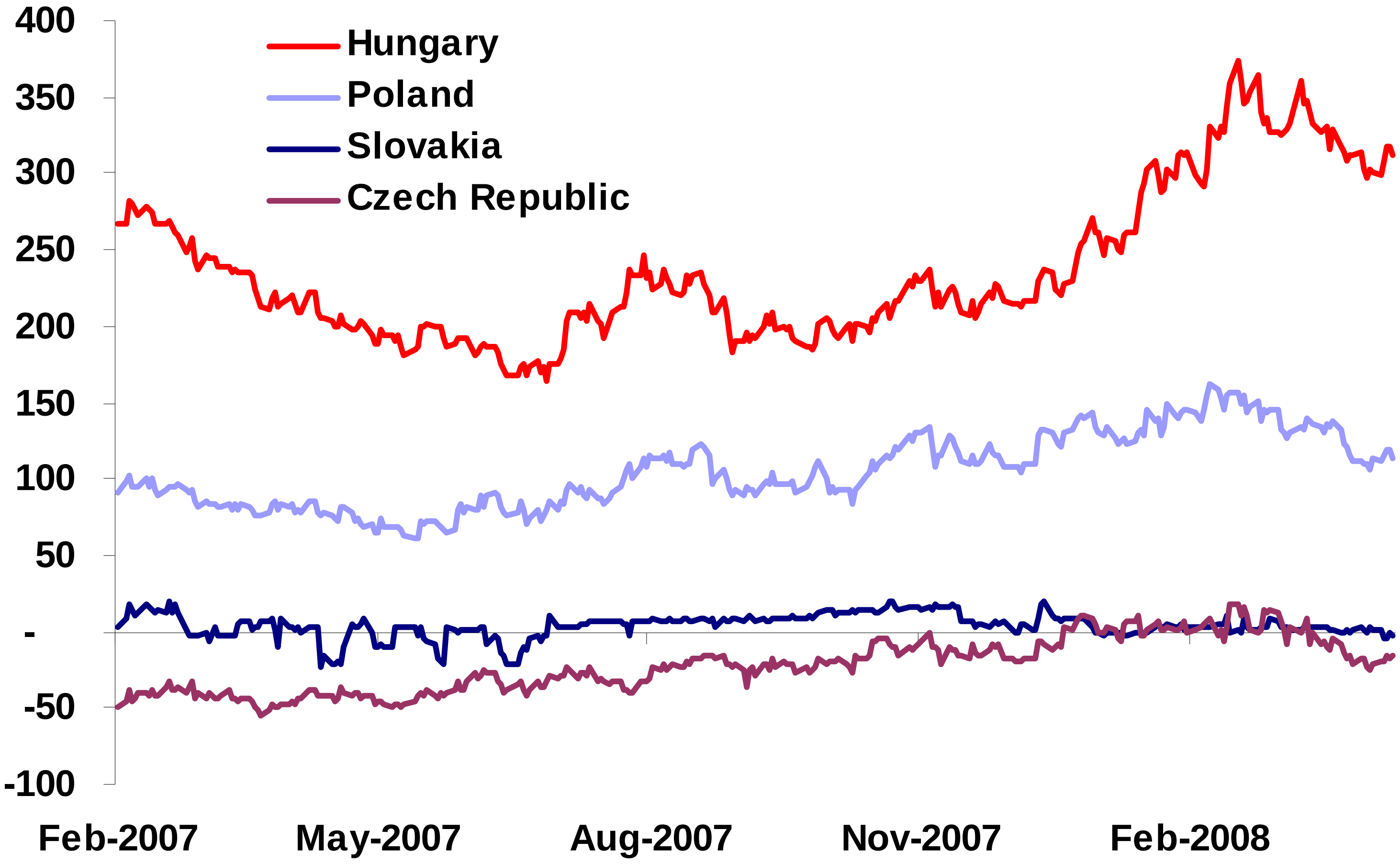
	Erste Group Research*	Market consensus**
Lithuania	—	2012
Estonia	—	2012
Poland	2013	2013
Latvia	—	2013
Romania	2014	2015
Hungary	not before 2014	2014
Bulgaria	—	2014
Czech Republic	not before 2015	2013

Source: Erste Group Research (* without Baltics and Bulgaria) , **Reuters Poll (April 2008)

Credible euro objective should ensure quick convergence of long-term swap rates to EMU levels

ERSTE GROUP

Spreads against EUR on 10Y Interest Rate Swaps



Source: Reuters, Erste Group Research

Conclusion

ERSTE GROUP

Slovak euro adoption process brought number of precedents for financial markets and other euro hopefuls:

- **stronger currency appreciation tolerated in ERM II**
- **disinflation achieved via currency appreciation is accepted**
- **hard to reject country on concerns on sustainability**
- **much more emphasis is devoted to fiscal consolidation**
- **tightened monetary conditions ahead of euro adoption generate extra yields for institutional investors**

Further EMU enlargement:

- **countries with flexible exchange rates have advantage**
- **ability of governments to advance in terms of structural reforms and fiscal consolidation is crucial**

Contacts

ERSTE GROUP

Thank you for your attention!

Visit our webpage www.erstebank.at
and download the most recent research
or sign up for automatic delivery via email

Erste Group Research (Vienna)

CEE Macro and Fixed Income Research

Juraj Kotian
co-Head of CEE Macro and Fixed Income Research
+43 5 0100 17357
juraj.kotian@erstebak.at

Rainer Singer
co-Head of CEE Macro and Fixed Income Research
+43 5 0100 11185
rainer.singer@erstebank.at

Local research offices (Macro and Fixed Income)

Bratislava
Slovenska sporitelna
Head: Juraj Barta
+421 (2) 59574166
barta.juraj@slsp.sk
Coverage: Slovakia, (Ukraine)

Budapest
Erste Bank Hungary
Analyst: Orsolya Nyeste
+36 (1) 3732830
Orsolya.Nyeste@erstebank.hu
Coverage: Hungary

Bucharest
BCR
Head: Lucian Anghel
+40 (21) 3126773
Lucian.Anghel@bcr.ro
Coverage: Romania

Kyiv
Erste Bank Ukraine
Analyst: Viktor Stefanyshyn
+38 (044) 593 17 84
Viktor.Stefanyshyn@erstebank.ua
Coverage: Ukraine

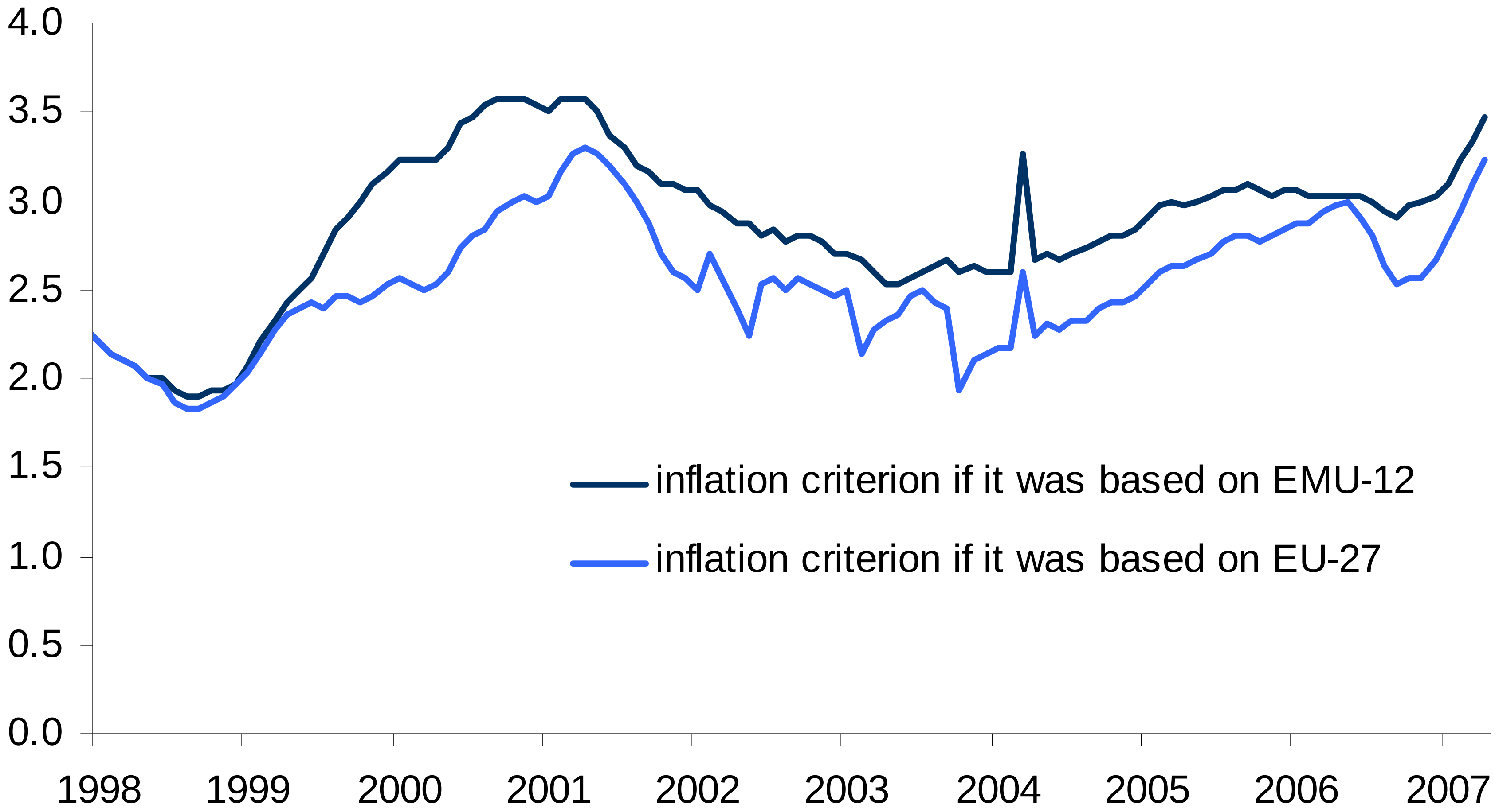
Prague
Ceska sporitelna
Head: David Navratil
+420 (2) 24995439
dnavratil@csas.cz
Coverage: Czech Republic, Poland

Zagreb
Erste Bank
Analyst: Alen Kovac
+385 (62) 371383
akovac2@erstebank.com
Coverage: Croatia, Serbia

ERSTE GROUP

Back-up slides

EU enlargement and the wrong definition has made inflation criterion tougher



Source: Eurostat, Erste Group Research

Income convergence induces price convergence

ERSTE GROUP

Income vs. price convergence (1997-2006)