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Qualification for Euro tougher than before: inflation criteria "more challenging" while sustainability under question too

Convergence process inevitable: generally higher inflation expected in Slovakia compared to the Eurozone over the next 10-20 years

Slovak case creates precedent: unless central banks manage expectations, markets likely to push up the course of remaining Euro hopefuls with floating currencies

On May 7th 2008 the European Commission's Convergence Report will recommend that Slovakia join the Eurozone in January 2009; the conversion rate will be announced at the beginning of July.

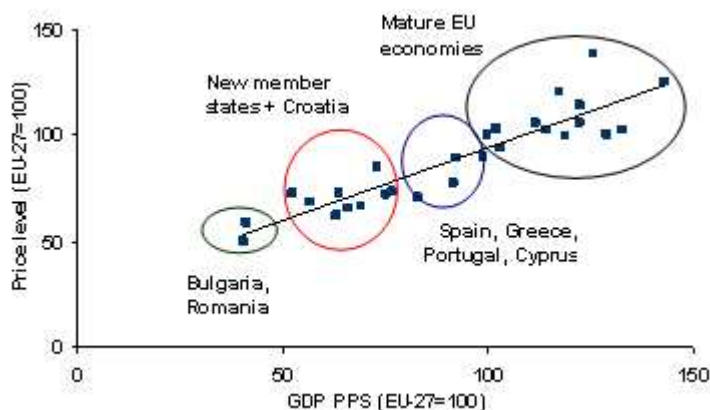
Erste Bank analysts say European institutions were more cautious during the assessment because of two reasons. The first one is the lesson learnt from Slovenia, the first new EU member state, which has joined the Eurozone and where inflation has spiked tremendously. The second reason was that Slovakia will serve as a benchmark for assessment of other candidates from CEE with flexible exchange rate regime and relatively low price level.

Is qualification for Euro tougher than before?

"During the Euro adoption process we could see that qualification was not an easy task. Inflation criteria has become "more challenging" after the number of EU countries has been increased", says Juraj Kotian, Co-Head of CEE Macro/Fixed income research at Erste Bank. "Stronger emphasis on sustainability has been another challenge, as it has not been defined anywhere", he continues.

Evaluation of sustainability was definitely the biggest risk for Slovakia in the whole Euro adoption process. Slovakia will enter the Eurozone as the member with the lowest price level, implying further price convergence as a side effect of growth of incomes. The ECB has been aware of the slim possibility of fulfilling the inflation criteria over the longer period of time and expressed "a serious concern" about sustainability in its draft version of the Convergence report. At the end of the day, the inflation outlook is evaluated only for the current and next year and the wording has been changed to be less hawkish.

Price sustainability - convergence is inevitable



Luxembourg is outside the chart. Calculation of 2008 price levels based on EC forecasts, 2008 GDP PPS are Eurostat forecasts. Source: Eurostat, Erste Bank Group Research

The Slovak price level is still only about two thirds of the EU average and further price convergence is inevitable. Thus far, koruna appreciation played a significant role in the process. Once the exchange rate is fixed, the only way to narrow the existing price differences is through higher price growth at home than abroad. "As a consequence, we expect generally higher inflation in Slovakia compared to the Eurozone in the next 10-20 years. In terms of price convergence, this would offset the missing impact of currency appreciation", says Kotian.

Overall, by stressing the importance of long-term price sustainability but not using it against Slovakia at the end, European authorities provided themselves with a good deal of flexibility for the future when other countries will be assessed. The way Slovakia is dealt with allows Eurozone officials to rule either way in the future, thinks Kotian.

Slovakia: what have markets learned?

Slovakia's example shows that currency appreciation does not pose a problem for European authorities. While in the

ERM II exchange rate band, the Slovak koruna strengthened by 16% by early May, even though ERM II conditions only allow 15% to any side. "Appreciation was made possible due to revaluation of the central parity, while another one is probably still to come before the conversion rate is set", says Juraj Kotian. While currency depreciation would probably not be viewed in a positive light, tolerance of European authorities towards a stronger exchange rate might have stemmed from the fear of competitiveness loss on the side of old EU governments. At the same time, the ECB could have favoured a stronger conversion rate due to the dampening impact on inflation in the initial post-Euro period, explains Kotian.

The clear preference of the market was for as strong an exchange rate as possible. Foreign investors bought significant volumes of the koruna, particularly during the central bank's massive interventions in late 2006 and early 2007 (worth almost 7% of GDP). One of the few (but important) factors that prevented a more significant appreciation was the fear that the central bank might intervene against the koruna or that it might set the conversion rate at a weaker level than the market.

Market behaviour, however, posed a dilemma to the central bank. It could have either accepted the market movement or set the conversion rate away from the spot exchange rate. However, even though some of central bank officials argued in favour of a weaker conversion rate, by setting it at an off-market level it would cause a one-off non-market impact on the value of investors' portfolios, not a desirable outcome either. Also, setting the exchange rate weaker could be politically sensitive, as the general public tends to favour stronger conversion rate.

Conclusion

Positive assessment of Slovakia by the European Commission has increased hope that the single currency project will not be stopped. However, a rather long pause of at least 3 years is expected until the next CEE country qualifies for the Eurozone.

Countries with flexible exchange rate regimes are in a much better position to fulfil the inflation criteria. None of these countries have already entered ERM-II and some of them face serious challenges in the fiscal area (especially Hungary), which lowers their chances of early Euro adoption. The timing depends heavily on local political support for early adoption (the lowest in Czech Republic, relatively high in Poland now) and the ability of governments to advance in structural reforms and fiscal consolidation.

"The adoption process also provides a good investment opportunity for fixed income investors. In order to compress inflation, tightened monetary policy is in place that generates an additional yield through a mix of positive interest rate differentials and currency appreciation", concludes Juraj Kotian.

[Euro adoption in CEE \[pdf; 101,2 KB\]](#)

Special Report

Euro adoption in CEE

- Slovakia in Eurozone – Who will be next?
- The stronger emphasis on sustainability
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- Currency appreciation does not pose a problem for the European authorities
- Why are other CEE countries not in such hurry?

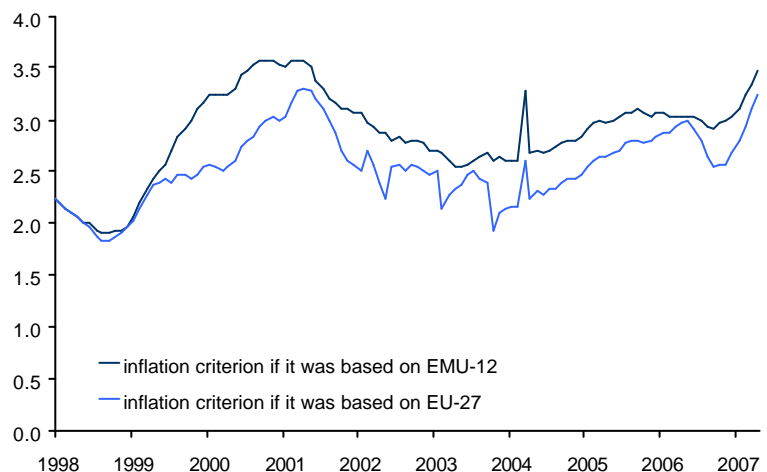
Slovakia in Eurozone - Who will be next?

On May 7, the European Commission recommended in its Convergence Report that Slovakia join the Eurozone as of January 2009. Membership has to be formally approved by the finance ministers of the EU, after consultations with the European Parliament and the European Council; the conversion rate will be announced at the beginning of July. The long-awaited green light was not seen as granted even a couple of weeks before the official announcement. Even though it has been obvious since the beginning of the year that Slovakia would fulfill all of the explicit Maastricht criteria, never-ending disputes about sustainability of fulfillment continued to the very end of the process. European institutions were more cautious during the assessment for two reasons. The first is the lesson learnt from Slovenia, the first new EU member state, which joined the Eurozone and saw inflation spike tremendously. The second reason was that Slovakia will serve as a benchmark (or set a precedent?) for the assessment of other CEE candidates with a flexible exchange rate regime and relatively low price level.

Is qualification for euro tougher than before?

During the euro adoption process, we could see that qualification was not an easy task. The inflation criterion has become "more challenging" since the number of EU countries has increased. One crucial aspect has been an economically wrong definition of the criteria - the inflation threshold is calculated from the pool of all EU countries, instead of just Eurozone members. While this wrong definition had only a limited effect when only three EU countries were outside the Eurozone, the disproportion increased after ten and later two further countries joined the EU without becoming Eurozone members. The wrong base for the calculation of inflation criteria and lack of political will to fix the definition thus compressed the threshold for inflation. For comparison, the average reference limit since 1998 would have been 0.3pp higher if it was based on the EMU-12 and not on the EU-27¹.

New EU entrants make inflation criterion tougher



The chart is illustrative. Maastricht criterion is based on actual number of EU countries. Source: Eurostat, Erste Group Research

The stronger emphasis on sustainability has been another challenge, as it has not been defined anywhere. Thus, the view on sustainability can be subjective, with a bias in either direction. The evaluation of sustainability was definitely the biggest risk

¹ It would have been 2.8% on average if the narrow case of the EMU-12 was used and 2.5% if the EU-27 was used. In reality, the EU-15 was used for the first wave of euro countries; later, the EU-25; it is the EU-27 at the moment.

for Slovakia in the whole euro adoption process. Slovakia will enter the Eurozone as the member with the lowest price level, implying further price convergence as a side effect of income growth. The ECB has been aware of the low chances to fulfill the inflation criteria over a longer period of time and reportedly expressed "a serious concern" over sustainability in its draft version of the Convergence Report. At the end of the day, the inflation outlook is evaluated only for the current and next year and the wording has been changed to be less hawkish.

Why? The European Commission has been a decisive counterparty during the whole process and its primary focus has been on fiscal consolidation. In this area, Slovakia has delivered much more than was originally required. Slovakia has also committed to speeding up fiscal consolidation in order to mitigate potential inflation risks. On the other hand, the ECB has not provided enough striking evidence that Slovakia would breach the threshold already in the first year after euro adoption. The likelihood is high², but not high enough to reject the hypothesis that Slovakia might keep inflation below the threshold in the first year.

Price sustainability - convergence is inevitable

Despite the significant margin with which Slovakia fulfilled the nominal inflation criterion³, European assessors wanted to make sure that the criterion was not met due only to random chance events or administrative measures, but rather on a more long-term basis. Media coverage of the post-euro acceleration of Slovenian inflation (although it was significantly affected by factors unrelated to the euro) even reinforced calls for thorough scrutiny of past and anticipated price developments.

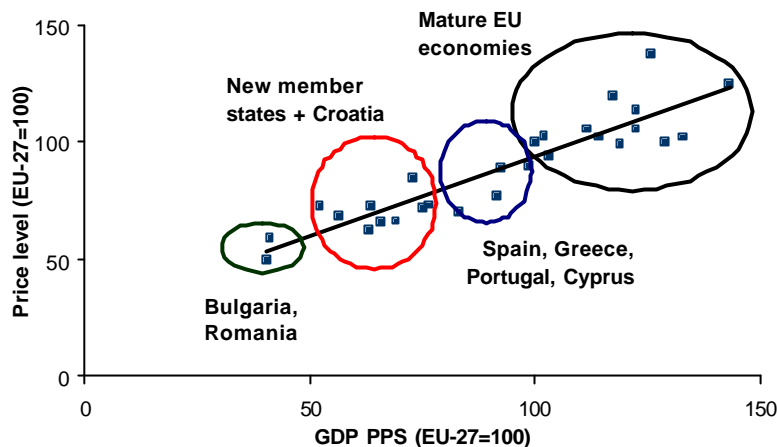
Not that the arguments against the sustainability of a low-inflation environment in Slovakia are groundless. Indeed, the Slovak price level is still only about two thirds of the EU average and further price convergence is inevitable. The European Commission explicitly wrote a small paragraph in the report for every assessed CEE country stating that the country "has a potential for further price level convergence in the long-term, as income levels rise towards the EU average." Thus far, koruna appreciation has played a significant role in the process⁴. Once the exchange rate is fixed, the only way to narrow existing price differences is through higher price growth at home than abroad. As a consequence, we expect generally higher inflation in Slovakia compared to the Eurozone in the next 10-20 years. In terms of price convergence, this would offset the missing impact of currency appreciation.

² The anecdotal evidence is that none of the Eurozone countries that entered the Eurozone with price levels below 90% of the EU27 (Portugal, Spain, Greece, Slovenia) were able to fulfill the inflation criterion at the end of the first year of membership in the Eurozone. We do not have evidence about Malta and Cyprus, which have been in the Eurozone for less than one year. Slovakia adopts the euro with the price level estimated at near two thirds of the EU27.

³ At the time of assessment, the average 12M inflation was 2.2%, below the 3.2% reference limit.

⁴ Strengthening of the domestic currency makes a country more expensive relative to foreign partners; price levels converge.

Convergence in incomes triggers convergence of prices



Luxembourg is outside the chart. Calculation of 2008 price levels based on EC forecasts, 2008 GDP PPS are Eurostat forecasts. Source: European Commission, Eurostat, Erste Bank Group Research

Low inflation difficult without currency appreciation

Estimates of exchange rate pass-through to inflation ranged wildly in Slovakia. On the low side, the Slovak central bank estimates the exchange rate impact on consumer prices at some 10-20%⁵. On the high side, some researchers suggest 35-40% pass-through.⁶ Our estimate of exchange rate pass-through is in between, at around 25-30%. That is, koruna appreciation of 1% decreases prices by 0.25-0.30%. However, the speed of impact varies considerably, depending on inventory levels and pricing policy in a given sector⁷.

Another unrelated aspect is administrative measures by the government orchestrated so that the Maastricht criterion is met. In Slovakia, the government pressured energy distributors to keep prices under control, but the extent of this impact is difficult to estimate. While this poses some inflation risk in the future, the primary reason was not the euro, but rather pre-election promises; Slovakia would meet the inflation criterion even without the government pressure, albeit possibly with a slightly smaller margin.

Not every euro country sets good example

While achieving low inflation in the long term is a problem present mostly in new EU countries, some old EU members also had trouble fulfilling the Maastricht criterion. The most glaring example is Greece, which met inflation criterion shortly before its 2000 euro assessment and several months afterwards only to stay above the reference value for more than seven years now. Portugal and Spain have also been above the inflation criterion more often than not since their admission to the Eurozone. What these three countries have in common with the new EU member states is that their price level is below the EU average⁸. A specific example is Ireland,

⁵ Among others, Peter Sevcovic, (2007), *Influence of the Exchange Rate on Inflation - Introductory Words*, Biatic 11/2007, NBS, http://www.nbs.sk/BIATEC/BIA11_07/11_07AN.HTM

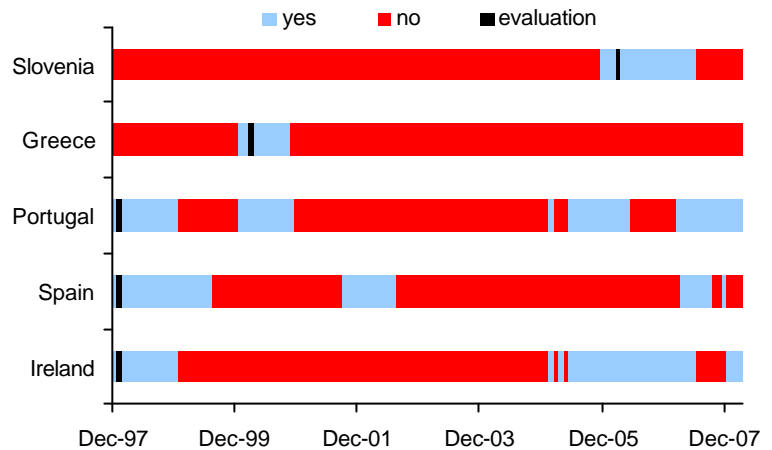
⁶ E.g. Fabrizio Coricelli & Balázs Égert & Ronald MacDonald (2006). *Monetary Transmission Mechanism in Central & Eastern Europe: Gliding on a Wind of Change*, William Davidson Institute Working Papers Series wp850, William Davidson Institute at the University of Michigan Stephen M. Ross Business School

⁷ One of the quickest categories to be affected is probably fuels, while regulated energy prices (such as gas) are usually reset only once a year; hence, transmission of exchange rate into prices is much slower.

⁸ The difference is smaller, as the price levels of Greece, Portugal and Spain were within 85-93% of the EU average in 2006. All remaining old EU members have above-average price levels.

which is more expensive than the EU average, but its high-growth environment makes it unique within the old EU members and, in this respect, more similar to new EU members. This high Irish economic growth was accompanied by inflation, which was mostly outside Maastricht bounds.

Inflation criterion not easy, even for some EU countries



Source: Eurostat, Erste Bank Group Research

New member states share both features that make them prone to above-average inflation and meeting the price criterion when needed will be far from certain. Specifically, their price levels have still not caught up to the Eurozone level, while their economic growth exceeds that of old Europe. This should be even more visible in countries with fixed exchange rate regimes (whether or not they are entering the Eurozone), where inflation could not be curbed thanks to currency appreciation.

Enough flexibility for future assessments

If Slovakia were ruled out of the Eurozone due to sustainability, despite a hefty cushion below the reference inflation limit, this would have significant consequences for other new EU member states as well. Since all of these countries lag in the price level, this would be a message that, even if they meet the criteria, the argument of sustainability could be used against them at any time. Also, even though it was mentioned in the past in the case of Lithuania, sustainability was never used as a basis for a country's rejection (apart from the negative outlook, Lithuania also narrowly missed the nominal inflation criterion) and using this argument now could have ignited accusations of double standards⁹.

Overall, by stressing the importance of long-term price sustainability, but not using it against Slovakia in the end, the European authorities provided themselves with a good deal of flexibility in the future when other countries are assessed. The treatment of Slovakia allows Eurozone officials to rule either way in the future (if the difference between the 12M inflation average and the reference rate is smaller).

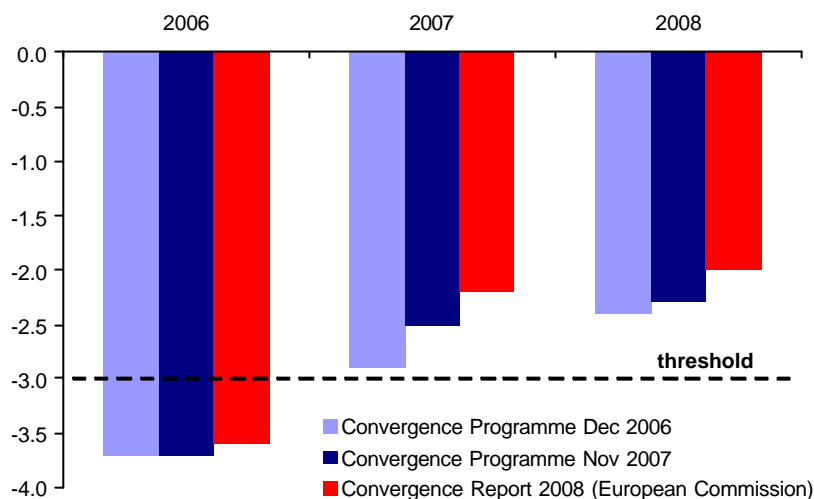
Fiscal consolidation - additional effort matters

When the new government came into power in 2006, financial markets and European institutions had doubts about the continuity of fiscal consolidation, due to the strong pre-election promises from the ruling Social Democrats. The Convergence Program originally planned fulfillment of the Maastricht criteria by a tiny margin, meaning that

⁹ Indeed, the Latvian central bank was reported to have raised this argument in discussions about Slovakia.

the positive development could easily be reversed if consolidation was not strong enough. It became clear very soon that European institutions would demand a "sufficient safety margin" against breaching the 3% of GDP deficit threshold. Thanks to the strong economic growth, better than projected tax revenues and responsible control of expenditures, the government finally delivered much better results than originally planned. We believe that following the recommendation of the European Commission in the fiscal area was the cornerstone of the successful euro adoption process.

Projected general government balance (% of GDP, Slovakia)



Source: Eurostat, Erste Bank Group Research

Who will be next?

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 fixed exchange rate regimes¹⁰, even questioned whether it was necessary to spend an additional two years in ERM-II before the assessment. For many countries, euro adoption became a political agenda without a deeper understanding of the economic trade-offs or political costs.

What was reason for ASAP approach in Slovakia?

Slovakia is one of the most open economies in the EU-27 in terms of the share foreign trade in GDP and almost half of the trade is done with Eurozone countries. Economic benefits have been strongly communicated, mainly by the central bank. Also, the Ministry of Finance has been pushing the whole process strongly ahead, as a fixed timeframe was supportive in its consolidation effort. The argument "because we want to adopt the euro in 2009" was efficiently used against any fiscal expansion attempts. Without having an explicit goal to adopt the euro in 2009, the government would not have delivered such strong fiscal consolidation.

Why are other CEE countries not in such hurry?

Preferences for early euro adoption in CEE changed somewhat when politicians started to be confronted with reality - in terms of economic trade-offs and political costs related to early adoption.

¹⁰ Hungary even imitated ERMII by having a +/-15% fluctuation band.

Fulfillment of the Maastricht criteria requires tightening of monetary and fiscal policy. Both reduce economic growth in the short run. The Czech Republic, Poland and Hungary are in Excessive Deficit Procedure (EDP), which strictly monitors their corrective measures in the fiscal area, which should help them to achieve their Medium Term Objective (MTO) plans in an agreed timeframe. MTO goes far beyond a minimum threshold of 3% for the fiscal deficit to GDP and requires that the structural deficit is within a safety margin below 3% and converge to below 1% of GDP or even lower in the future¹¹.

The highest political costs related to fiscal consolidation occurred in Hungary, where the government had to cut the fiscal deficit during the economic slump, which always hurts. Now, it seems that Hungary will not be able to meet its Medium Term Objective plan to cut its structural deficit to below 1% before 2012, because of the high political costs related to reforms in Hungary.

Much better positioned for early euro adoption is the Czech Republic, but the single currency is currently not at the top of the political agenda. The main reason is that the country wants to carry out structural reforms first, in order to increase the flexibility and competitiveness of the economy. Such actions are also recommended by the EC before a country joins the Eurozone¹². The positive public perception of the CZK appreciation, which is a benefit of sovereign monetary policy and a more convenient manner of price convergence, is another reason why the Czech Republic is not in such a hurry to adopt the single currency. That is why we do not expect the Czech Republic to join the Eurozone before 2015.

Poland, contrary to the Czech Republic, might benefit from strong government support of early euro adoption and adopt the single currency by 2013. The government had aimed to adopt the euro by 2012, but, given the political clash between the president and government, fiscal consolidation might take more time than originally planned.

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 criterion. Their pegged currencies are not supportive of disinflation efforts compared to CEE countries with floating regimes, where currency appreciation took away part of the price convergence from inflation. It will take at least two years until the recently elevated inflation settles down. The Baltic countries have been in ERMII for longer than the required two years and they are not in EDP. So, they can apply for the single currency in any year that they fulfill the inflation criterion. In any case, sustainability will always be questioned. That remains the main risk.

¹¹ *The structural deficit is the cyclically-adjusted fiscal deficit adjusted for one-off items. The safety margin is interpreted as a structural deficit close to 2% of GDP. According to EC forecasts, Slovakia has not been fulfilling this requirement, but Slovakia has objected to the methodology for calculating the structural deficit based on the output gap. The EC-used model was calibrated on EU15 economies and used the constant output elasticity of capital in the Cobb-Douglas production function for all countries (see http://ec.europa.eu/economy_finance/publications/publication746_en.pdf). The Ministry of Finance argued that application of country-specific elasticity would significantly reduce the magnitude of the output gap and the cyclical influence of GDP growth on the fiscal balance.*

¹² *"Implementation of structural reform measures notably in the field of pensions and health care aimed at containing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances" is written in the Council Opinion on the convergence report from March 2008.*

Timetable – Euro Adoption expectation

	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)

Romania will need much more time to advance in structural reforms ahead of euro adoption. However, it is interesting that Romania is not in EDP and that the ratio of public debt to GDP is one of the lowest of New EU members. The price level is not far from the price level in Hungary (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 have to regain confidence in the Romanian currency and enable a smooth entry to ERMII in 2011. It seems that this is still not properly priced-in to Romanian long-term yields, which actually provide the most interesting "convergence play" opportunity in the region.

Slovakia: What have markets learned?

The Slovak euro adoption process brought a number of precedents for financial markets and other euro hopefuls. Regarding the exchange rate, these include the tolerance among the European authorities of significant currency appreciation (even though the final decision about the conversion rate is yet to come). While perfectly reasonable, the koruna's behavior within the ERM II framework was somewhat non-standard. As the euro adoption date approaches, the markets have become less sensitive to anything but news related to Slovakia's euro adoption and the level of the conversion rate. The same holds for long-term yields.

No objections to currency appreciation

Slovakia's example shows that currency appreciation does not pose a problem for the European authorities. While in the ERM II exchange rate band, the Slovak koruna strengthened by 16% by early May, even though ERM II conditions only allow 15% to any side. Appreciation was made possible due to revaluation of the central parity, while another one is probably still to come before the conversion rate is set.

The authorities ruled that Slovakia met the exchange rate criterion even though it states that the currency should move 'without severe tensions'. Additionally, the exchange rate should be 'close to ERM II central rates'. While currency depreciation would probably not be viewed in a positive light, the tolerance among European authorities towards a stronger exchange rate might have stemmed from the fear of a competitiveness loss on the side of old EU governments¹³. At the same time, the ECB could have favored a stronger conversion rate, due to the dampening impact on inflation in the initial post-euro period. Among the decision makers, the only words against the koruna appreciation were spoken by (part of) the Slovak central bank.

¹³ A stronger exchange rate would make Slovak labor costs more expensive and possibly less attractive for companies from the old EU.

Markets can play on appreciation

Markets did not pay too much attention to the level of the ERM II central parity, betting that the conversion rate would be stronger than the parity figure. The initial ERM II entry in November 2005, when the central parity was set at the then-spot exchange rate 38.455 SKK/EUR, triggered immediate koruna strengthening of 2%. The parity revaluation in March 2007 to the off-market value 35.4424 SKK/EUR made the koruna appreciate by 3.5% (from 33.9 SKK/EUR to 32.7 SKK/EUR), as the new central parity at a weaker than market level was not perceived as a probable conversion rate. Instead, the move opened more space for koruna appreciation beyond 15% of the original ERM II band. The appreciation only stopped when the central bank intervened against the currency.

Were it not for euro adoption, the koruna would likely be much weaker at present. The clear preference of the market was for as strong an exchange rate as possible. Foreign investors bought significant volumes of the koruna, particularly during the central bank's massive interventions in late 2006 and early 2007 (worth almost 7% of GDP). Under normal conditions, selling these holdings would trigger currency depreciation and incur costs to investors. However, instead of selling, some investors chose to wait until the euro is adopted, so that they can convert korunas back to the euro at a fixed exchange rate¹⁴. Moreover, as they believed that the spot exchange rate would be important during discussions about the final exchange rate to the euro, investors drove the koruna appreciation, as the conversion rate impacts not only the newly bought koruna assets, but also the existing ones. One of the few (but important) factors that prevented a more significant appreciation was the fear that the central bank might intervene against the koruna or that it might set the conversion rate at a weaker level than the market. In response, crucial market drivers were news affecting Slovakia's chances to adopt the euro and those that were related to the conversion rate, since these were the only relevant factors determining profits of investors. At the same time, most economic data lost importance¹⁵.

¹⁴ An investor buying a currency would cause its appreciation. Still, she is not able to take economic profit, as, *ceteris paribus*, the sale of the same volume would trigger the same movement in the opposite direction (i.e. depreciation). However, let us say that the country is going to announce a fixed exchange rate in the near future and the investor assumes it will be set at the future spot exchange rate. As in the previous case, purchases of the koruna would trigger currency appreciation. However, if the investor waits with the sale until the exchange rate is fixed, 'selling' will be done automatically and will not trigger any backward movement. The investor is thus able to book profit. This impact is even heightened if she had other assets in the same currency, since these would also gain value.

¹⁵ Normally, economic data influences the exchange rate, as it determines future demand and supply of the currency coming from the real economy. Capital investors anticipate these flows and buy or sell the currency in advance. However, in a country adopting the euro, future real-economy demand and supply will not affect the exchange rate (as it will be fixed). The only real questions for profitability are if the exchange rate is fixed and where the conversion rate is set, which are more political decisions.

Development of Slovak koruna in ERMII



Source: Reuters, Erste Group Research

Central bank's dilemma

Market behavior posed a dilemma for the central bank. It could have either accepted the market movement or set the conversion rate away from the spot exchange rate. However, even though some central bank officials argued in favor of a weaker conversion rate, by setting it at an off-market level, it would cause a one-off non-market impact on the value of investors' portfolios - also not a desirable outcome. Moreover, setting the exchange rate at a weaker level could be politically sensitive, as the general public tends to favor a stronger conversion rate.

For remaining euro hopefuls with floating currencies, this creates a precedent. Unless the central bank provides a credible anchor for expectations, markets are likely to push other currencies stronger in the euro run-up, too¹⁶. If the central bank has a strong opinion on the conversion rate, it can only achieve it by clear communication of its views and showing determination to pursue it (e.g. via interventions or threat to set an off-market conversion rate). Unfortunately for the central bank, communication about the exchange rate is restricted within ERM II. An important factor affecting the strength of the process is the share of foreign investors that are long in the euro hopeful's currency. The higher it is, the stronger the appreciation pressure.

Long-term rates converge early

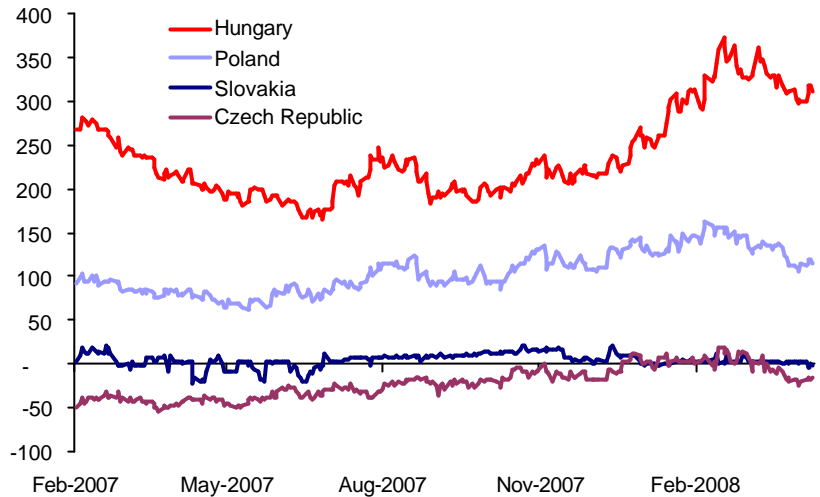
The difference between Slovak and Eurozone long-term yields compressed early, as 10Y swap spreads went down to 20-30bp even before ERM II entry was announced. However, after the 2006 elections, which brought a new government with an initially ambiguous stance on adopting the European currency, spreads widened significantly (up to 145bp on 10Y swaps), demonstrating how sensitive the market was to the euro issue¹⁷. Within the EMU, Slovak short-term rates and swap yields would be identical with the Eurozone, while the no-euro scenario would likely bring higher short-term and long-term rates. Once the new government announced it would stick to the 2009 euro plan and made steps to prove it (such as the 2007 budget), spreads returned to pre-election levels. During 2007 and so far in 2008, when euro adoption has looked

¹⁶ For countries with fixed exchange rates or narrow fluctuation margins, the central rate is likely to serve as the conversion rate and the 'currency game' does not pay off.

¹⁷ This came alongside pressures for depreciation of the koruna, which was defended by the central bank.

increasingly probable, Slovak swap yields have been practically identical with the Eurozone. As for bond spreads, they will stay positive after euro adoption, due to different creditworthiness and lower liquidity; however, they also converged and yield movements of Slovak T-bonds have been linked to the development in the EMU.

Spreads against EUR on 10Y Interest Rates Swaps



Source: Reuters, Erste Group Research

For countries not yet converged in terms of spreads, following a credible euro objective should ensure quick convergence of long-term swap rates to EMU levels, as these will be identical in the Eurozone. The process should be accompanied by the compression of bond spreads until the conversion rate is set and a slight pick-up of spreads afterwards, once investors are deprived of profits from currency appreciation¹⁸. Obviously, the potential for convergence gains on bonds is greater for countries like Romania or Hungary that are perceived to have higher rates without the euro than in the Eurozone, as is the sensitivity of yields to any derailments from the euro adoption path¹⁹.

¹⁸ This is not valid in the ERM II, when the currency might still be strengthening.

¹⁹ In Slovakia, both short-term and long-term interest rates would likely be higher without the euro.

Conclusion

The positive assessment of Slovakia by the European Commission has increased the hope that the single currency project will not be stopped. However, we should see a pretty long pause (lasting at least three years) until the next CEE country qualifies for the Eurozone. The Baltic countries will always face difficulties meeting the inflation criteria, unless a higher level of price convergence is achieved. Even if inflation declines, sustainability can be questioned. Countries with flexible exchange rate regimes are in a much better position to fulfill the inflation criterion. The assessment of Slovakia confirmed that nominal appreciation is tolerated within the ERM II and disinflation achieved partially thanks to currency appreciation is accepted as well. This significantly increases the chances of other adepts with relatively low price levels and flexible exchange rates (Poland, the Czech Republic, Hungary and Romania) to fulfill the inflation criterion in the mid-term outlook. None of these countries has entered ERM II and some face serious challenges in the fiscal area (especially Hungary), which delays their chances of early adoption. The timing depends heavily on political support of early adoption (with the lowest in Czech Republic, relatively high in Poland now) and the ability of governments to advance in terms of structural reforms and fiscal consolidation.

The adoption process also provides a good investment opportunity for fixed income investors. In order to compress inflation, tightened monetary policy needs to be in place, which generates additional yield through a mix of positive interest rate differential and currency appreciation. In those countries where bond yields are not aligned with the Eurozone at the beginning of the process, euro adoption without any derailment generates income from spread convergence.

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Quotes of analysts from Erste Bank Group

Czech Republic (Martin Lobotka, analyst at Ceska sporitelna): "The Czech Republic does not have any strictly set date for euro adoption - the original strategy from 2003 forecast euro adoption in 2009/2010. As it became apparent that this would not be achievable, a cautious approach prevailed and the updated strategy (approved in 2007) now only says that the 'euro adoption date will depend on the strengthening of the Czech economy's flexibility and on solving problems associated with public finance reform.' These two areas - limitations on fiscal policy to act in a timely fashion to counteract adverse shocks and the rigidity of Czech labor markets - are also highlighted by the CNB as major obstacles to speedy euro adoption in their Analysis of Convergence. We would add that a long-term risk is posed by the lack of substantial reform (e.g. the pension system, healthcare) so far. Also, the public discourse in the Czech Republic seems more wary of the potential risks associated with premature euro adoption and more opinions seem to be voiced that are against the adoption of the euro at all costs (i.e., discarding monetary policy prematurely might be risky). All in all, the largely unreformed systems and tepidity of a substantial part of the elite towards speedy euro adoption lead us to forecast euro adoption no sooner than in 2015."

Poland (Lubos Mokras, analyst at Ceska sporitelna): "Poland currently does not have an official national target date for euro adoption. The current government is stating that Poland will be prepared for euro adoption in 2012. However, it will be a political decision. Thus, it is not certain that the euro will be adopted in 2012. The current government has been inclined more toward early euro adoption, but the political parties that comprised the former government and current President Lech Kaczynski have been rather euro-skeptical, so there could be some political problems in the process of euro adoption. The central bank is positive on euro adoption. We see the most likely entry year as 2013, so the country would enter ERM II no later than in 2010. Besides possible political obstruction from the current opposition parties and the president, inflation development could be the biggest obstacle to euro adoption. We expect the current episode of higher inflation, which has both domestic and international sources, to be only temporary and that a determined monetary policy by the NBP will ensure inflation stability. As for the budget criterion, we expect a disciplined approach from the current government, despite the demise of Deputy Finance Minister S. Gomulka."

Hungary (Orsolya Nyeste, analyst at Erste Bank Hungary): "Since the central bank published a comprehensive cost-benefit analysis relating to the introduction of the euro in 2002 concluding that the country would benefit from early euro adoption, policy makers have been verbally supporting the earliest possible adoption of the single currency, which means as soon as the country meets the nominal convergence criteria. In the last six years, however, the country has proven unsuccessful in approaching the Maastricht targets. Based on the continuous fiscal problems, Hungary had to abandon both target dates of 2008 and 2010 for euro adoption. Hungary does not have an official euro adoption target date, but implemented a fiscal adjustment program in 2006, resulting in a budget deficit reduction to a more sustainable level. In addition, the abolition of the forint exchange rate band announced this February can also be seen as a commitment to the EMU, as freeing the exchange could create a basis for a market-determined ERM II entry rate, as a preliminary stage for EMU entry. However, as much stronger fiscal consolidation, the implementation of structural reforms and a higher level of real convergence are essential to tame future inflation risks when the country joins the Eurozone, 2014 seems to be the earliest possible date for Hungary to join the monetary union."

Romania (Dumitru Dulgheru, analyst at BCR): "Although Romania has made good progress in terms of convergence in the last years, there is still a long way ahead. The recently increased volatility of the currency and elevated inflation have reduced the central bank's optimism regarding the planned euro adoption in 2014. At the end of 2007, only two out of five nominal convergence indicators were not consistent with Maastricht Criteria such as inflation and long-term interest rates. We expect that rising inflation and the significant external imbalance are of only a temporary nature. Thus, we still see the adoption of the European single currency in 2014 as possible. This will of course strongly depend on carrying out economic reforms and restructuring of the economy; the next three years will be crucial from this point of view."

Croatia (Alen Kovac, analyst at Erste Bank Croatia): "At this point, prior to EU entry, it might be too early to speculate about Croatia's entry to the Eurozone. According to the present timeline, Croatia should become a member in 2011, meaning that Eurozone entry would be scheduled no earlier than for 2014. Croatia would not likely wait long to apply for ERM II and become a Eurozone candidate, as already the proportion of euroization in the economy is high and the loss of monetary sovereignty would therefore not be substantial. Fulfillment of the Maastricht criteria according to the current picture should be within reach. Nevertheless, as the time horizon is rather long, some risks may arise along the way."

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