The Road to Eurozone. Comparative Analysis of the Maastricht Criteria Fulfillment by the CEE Countries

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Abstract: *As some of the CEE countries are not yet participating as full members of the Economic and Monetary Union they are still obliged to enter the Euro area at some time in the future. Issue with raising importance tends to be the fulfillment of the convergence criteria and the problems relating to it in the context of the global financial crisis. This paper is focusing on the comparative analysis of the Maastricht criteria fulfillment by some of the CEE countries and the related criticism regarding their proper settlement.*

Key words: *CEE countries, Maastricht criteria, Eurozone, critique.*

JEL codes: *F02*

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1. Introduction:

The road to Eurozone goes through obligation to fulfill some criteria for nominal convergence, namely the Maastricht criteria for inflation, long-term interest rates, debt, deficit and exchange rate. In a pure economic and monetary union it is important for the countries to success such level of integration which makes it possible for them to realize low trade cost and similar business cycles for maintaining sustainable growth and economic stability.

This paper investigates comparatively the fulfillment of the convergence criteria by some CEE countries and the problems relating to it in the context of the global financial crisis. Special attention is paid to the criticism regarding their proper settlement.

Next sections are organized as follows: Chapter 2 presents the methodological explanation of the abovementioned analysis. Chapter 3 comprises of the comparative analysis itself. Chapter 4 represents the guidelines for further analysis and literature review regarding the critics to the Maastricht criteria is presented in Chapter 5. The last Chapter 6 is the conclusion.

2. Methodology:

For the purpose of our analysis the *comparative analysis method* is used. The examined countries are presented in three groups*:*

- *the Baltic countries: Lithuania, Latvia and Estonia;*[1]
- *the New member states: Bulgaria and Romania;*[2]
- *Central European member states: Czech Republic, Hungary, Poland, Slovak Republic and Slovenia.*[3]

All of them are small and open economies, which have a large share of their foreign trade within the EU. Some of the countries are already euro zone members but the focus of the investigation is on their way to euro zone as regards of their monetary and fiscal policies.

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[1] Members of EU since 2004. Estonia has entered the Euro zone in 2011, Latvia – in 2014, and Lithuania – in 2015.

[2] Members of EU since 2007. Still not members of the Euro zone.

[3] Members of the EU since 2004. Slovenia is euro zone member since 2007, the Slovak Republic – since 2009. The Czech Republic, Poland and Hungary aren't still members of the Eurozone.

The investigation period is the time frame between the entering in the EU until the present, i.e. 2004 – 2016, though the new member states are EU members since 2007.

Because of the different timing of the available data it is presented in two time frames, namely:

- GDP growth, debt and deficit levels – annual data;
- Inflation and long-term interest rates – monthly data.

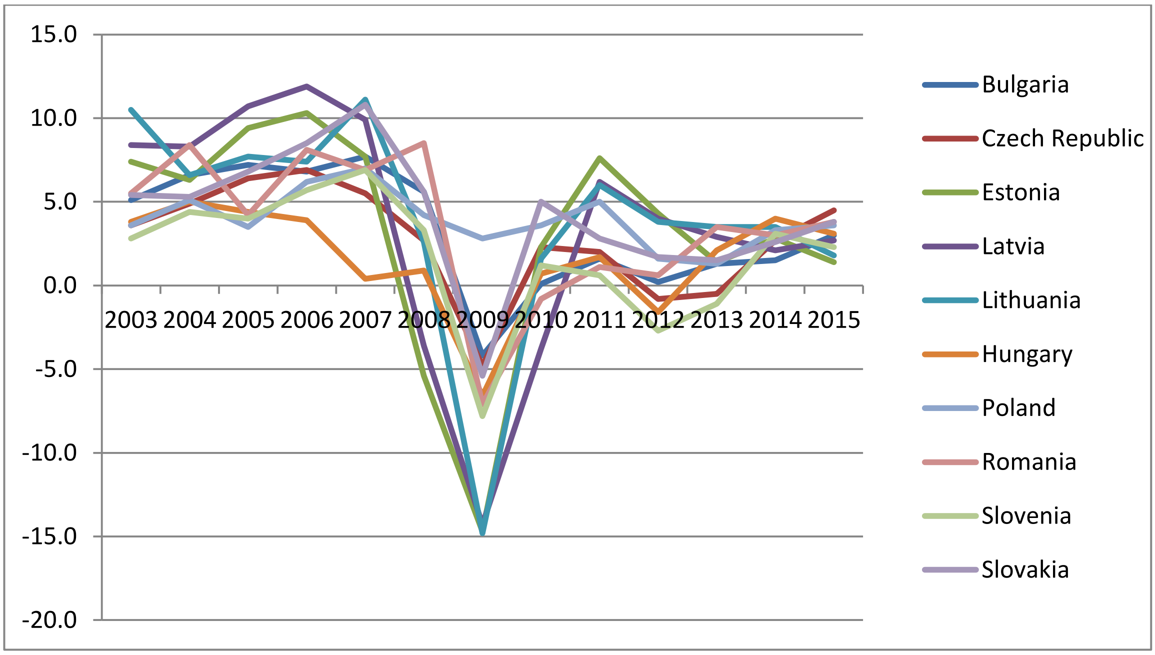
All abovementioned data is extracted from Eurostat.

3. Comparative analysis

➢ GDP Growth

In regard to the Maastricht Criteria fulfillment, it is not presented in detail, but rather in a comparative view and particularly attention is brought to the countries with the most deviating parameters. These criteria are very well known, but first the *GDP growth* of each country is addressed. The data is annual, presented as chain linked volumes, percentage change over previous period, the period – between 2003 and 2015.

Graph. 1 GDP growth. Annual data 2003 – 2015



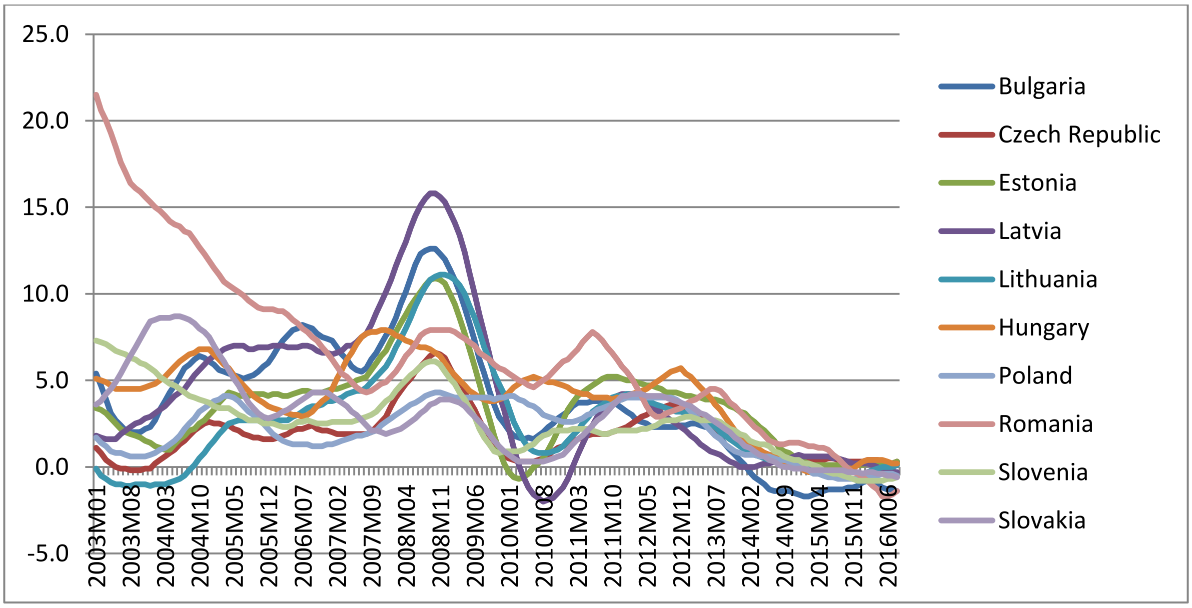
Source: Eurostat

At a first sight there is a large downturn in the period of the world economic and financial crisis between 2008 and 2010. These three countries are the Baltics. At the same time there is also very high growth before the crisis and again these are the Baltics. If we think about this large difference we can consider the book of Mr. Chobanov (2012) where he explains this with the huge imbalances, accumulated before the crisis, which allowed the very high GDP growth and then this growth turned into a severe recession. As regards the new member states Bulgaria and Romania, there is very similar dynamics as in the Baltic countries but not in the same large extent.

- **Inflation**

To proceed to the price developments, represented as the Harmonized Index of Consumer Prices dynamics, we use monthly data, presented as moving 12-months average rate of change, the period – between 2003M1 and 2016M8.

Graph. 2 HICP. Monthly data 2003M1 – 2016M8



Source: Eurostat

Here the contrast is made by more countries. Romania has very high values of inflation in the beginning of the period but later this problem is already solved. The so called BELL countries[4] had also problems with the inflation.

[4] Bulgaria, Lithuania, Latvia and Estonia.

All of the three Baltic countries have seriously high inflation levels, which are observed also in the period of the global financial and economic crisis. Actually the inflation is following the strong internal demand combined with the very high level of GDP growth, which shows the economy overheating. In the meantime these economies are narrowly catching up with the prices in the euro area. Also the international prices of oil and food have significant impact.

In the case of the New Member states a dynamic activity is observed. The two countries are under the influence of the global prices of oil and food and the increasing of the internal administrative prices related to it.

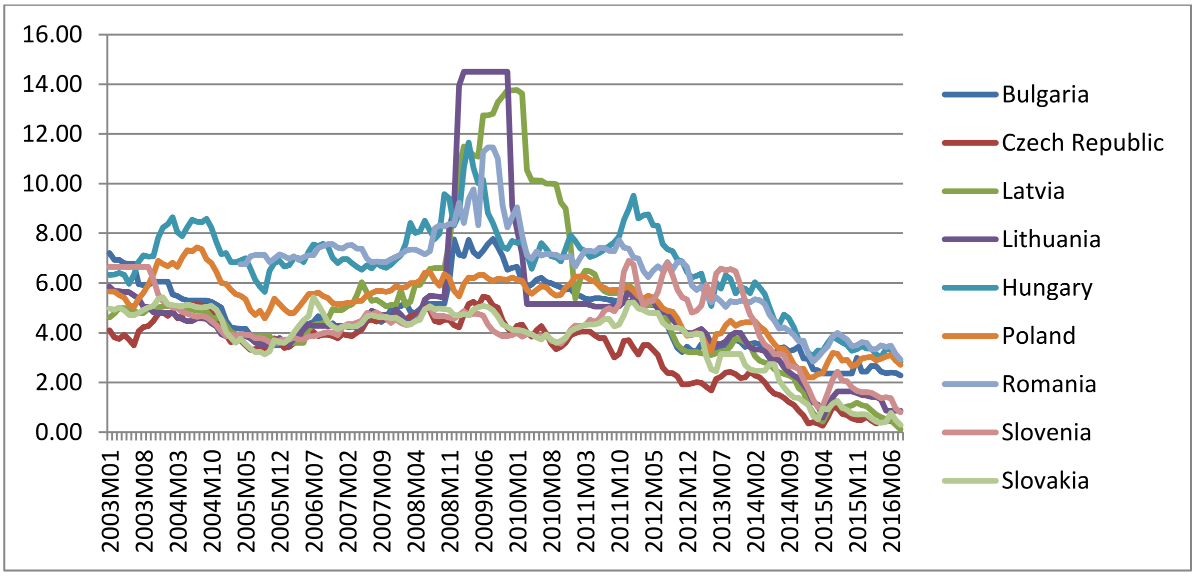
Romania has problems with the inflationary expectations but after the financial aid from international financial institutions the confidence is again regained and the inflation went down to normal values.

A big part of the inflationary pressures in Bulgaria, particularly in the period of the global crisis, could be explained with the fact that the food has a large share in the consumer expenses and the economy uses a lot of energy in the production processes. So when the international prices of food and oil rise, it immediately influences the Bulgarian inflation.

- **Long-term interest rates**

The long-term interest rates' data is again monthly, representing the period between 2003M1 and 2016M8.

Graph. 3 Long-term Interest Rates. Monthly data 2003M1 – 2016M8



Source: Eurostat

Here the exceptionally high values are again in the Baltics. May be it is interesting to be noted that Estonia is not in this graph. The reason is that this country has not got benchmark for the long-term interest rates due to the fact that the bond market in the country is not developed and the government has not issued government securities with long maturities. Instead for the purposes of the convergence assessment a broad analysis of the financial sector is used and it should be concluded that the country has no problems with the fulfillment of this requirement.

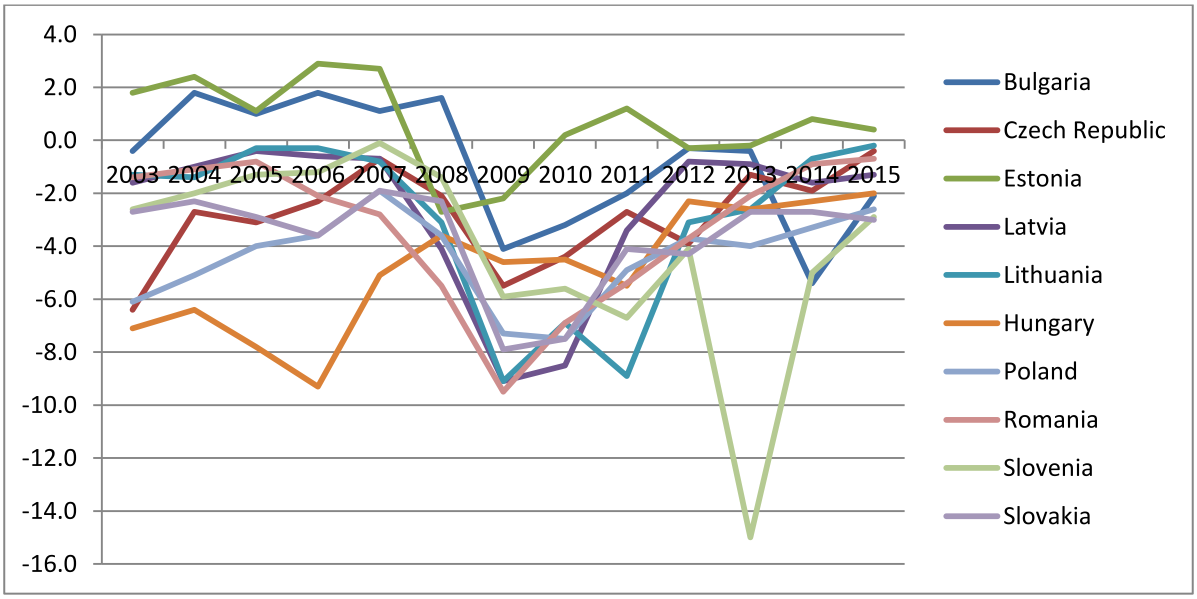
The other two Baltic countries have some problems in the period of the global crises but then the long-term interest rates are on historically low levels.

Romania has also very high values of the long-term interest rates, which could be explained with the severe global recession, the very limited opportunity for financing from the international capital markets and the high instability also in the country.

- **Budget balance**

The budget balance is the criteria with the most problematic fulfillment. It is represented as a percentage of the gross domestic product at the end of every year for the period between 2003 and 2015.

Graph. 4 Budget balance. Annual data 2003 – 2015



Source: Eurostat

Almost all of the countries have been subject of the excessive deficit procedure. The only exception is Estonia. The country has also very good performance as compared to the other two Baltics. Latvia even had a need for financial assistance, which was provided by a team of international financial institutions and neighbor countries.

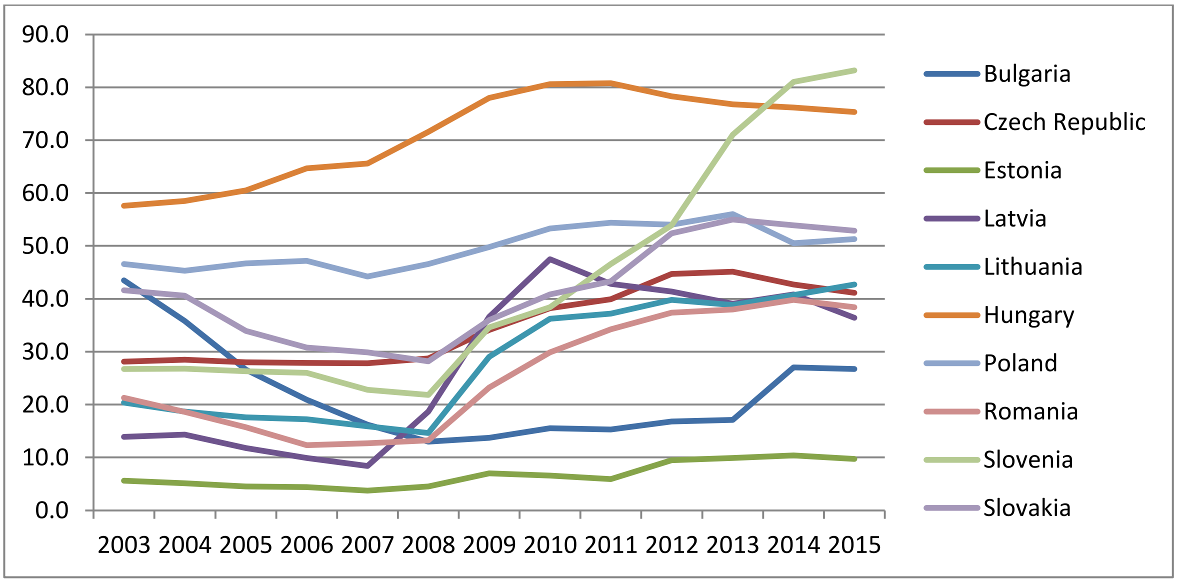
The most severe downturn and really high deficit has Slovenia and it should be mentioned that this happened not in the period of the Great recession but after it, when the debt crisis is already in action. This has rational explanation. In the year 2012 the government has implemented bank recapitalization, which raised the deficit with almost 10% of GDP.

In regard of the New Member states it is obviously that Bulgaria has better performance than Romania and is subject of the excessive deficit procedure for a very short period. Actually Bulgaria has deficit level above the reference value for a second time after the global crisis in 2014. The European Commission has agreed that this is caused by exceptional economic conditions in the face of the local banking crisis due to the bankruptcy of the local bank CCB[5] and the need for financing the National Deposit Guarantee Fund.

- **Debt**

The debt dynamics, similarly to the budget balance, is represented as a percentage of the GDP. The data is annual for the period between 2003 and 2015.

Graph. 5 Debt Dynamics, Annual data 2003 – 2015



Source: Eurostat

[5] Corporate Commercial Bank.

Almost all of the countries have debt levels which are well below the reference value of 60% of GDP. Hungary comes under notice because in the whole period the debt levels of the country are well above the reference value. This situation is determined by the low GDP growth, the very high yield of the government securities due to the European debt crisis from 2012 and the high budget deficits. Even the financial and technical assistance of the international financial institutions is not of great help.

In contrary, Estonia could be named “the best performer” among all countries. Bulgaria also is much disciplined.

The situation of the debt dynamics in the Baltics is the same as it is with the budget deficit. Although not subject of the corrective arm of the Stability and Growth Pact, Latvia and Lithuania has a large increase in their general government debt levels. In contrast, in Estonia only slight increase is observed.

The New Member States have no significant problems with the share of the government debt in the GDP. Even though the debt levels in Romania have been on a historically high path, they are well below the reference value.

In contrast, Bulgaria has very high debt levels in the beginning of the period in consideration and even at the time of the global crisis and after it the debt dynamics is far below the values before the crisis.

As a whole it is obvious that the debt levels are well increasing right after the outbreak of the global financial and economic crisis.

4. Guidelines for further analysis

For the narrower analysis possible classification of these 10 countries could be regarding their monetary policy and also their exchange rate. This is illustrated in the table below where the countries are allocated considering the two factors mentioned.

Monetary Regime / Exchange Rate	**Pegged Exchange Rate**	**Floating Exchange Rate**
Currency Board	Bulgaria	
	Estonia	
	Lithuania	
Inflation Targeting	Hungary	Romania
		Slovak Republic
		Poland
		Czech Republic
Active Monetary Policy	Latvia	Slovenia

The countries in italic and grey color are already members of the euro zone but before entering the euro area these were their characteristics. It is useful to follow up their way of entering the Eurozone and draw some conclusions of good practices and well managed policies.

5. Critique of the Maastricht criteria. Literature Review:

Since the appearance of the European Union the issues regarding the European integration are broadly concerned and discussed. In recent times, although very criticized each and together, the convergence criteria of Maastricht are in the field of view of economists, politicians and researchers.

Malović, Đukić and Redžepagić (2011) even stated that these criteria are settled without fundamental base and most of the countries didn't fulfill them or did this for a very small time period. Baldwin and Wyplosz (2009) actually noticed that the fiscal criteria of Maastricht are choosen in regard of the German economy circumstances and could not be applied to all European countries.

Claessens, Mody and Vallėe (2012) expressed the fear that this is the cause of the instability in the newly established monetary union and that is why there are so many mechanisms and funds created to address the lack of common fiscal buffer in the eurozone in times of economic crisis and other negative external shocks.

As was mentioned above, the criteria in the fiscal area are the most problematic. Questions arose even at the far beginning of their settlement, the most fundamental of them: Why are there actually fiscal requirements for entering the Eurozone?[6] The Eurozone is a monetary union and all countries conduct common monetary policies, but in the fiscal area they implement particularly individual policy measures. In fact it is really difficult for the countries to fulfill this requirement in the context of different budget needs and economic conditions.

Moreover in a monetary union the fiscal policy tends to be the resource for addressing the external and internal shocks for the normal functioning of the economy, so these Maastricht requirements are restricting the power of the parliaments to be flexible and sustained to the world and regional crisis.

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[6] Frankel (1992)

Most recent investigations actually reveals again the Keynes' idea, named "the new view of fiscal policy"[7] that the government expenses are a big power for the growth of the economy and that they are not the cause for the crowding-out effect of the private investments, but could also help to boost their activity. Here is also obvious the limiting effect of the Maastricht fiscal criteria.

This critique is only the base for further analysis of the need and if there is a need, of the optimal and sustainable value of the fiscal requirements in a monetary union with different level of economic development countries in the CEE region.

6. Conclusion

The review of the Maastricht criteria fulfilment by the CEE countries is a good opportunity to realize a situation where there is some kind of inconsistency and internal conflict between monetary and fiscal indicators. One could inevitably ask the question why are these criteria designed like that. There are a lot of possible explanations but the most important issue appears to be whether it is necessary and as it looks like in a monetary union it should exist fiscal coherence to some extent, which are then the optimal requirements as regards to countries under different local economic circumstances.

[7] Furman (2016)

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