AICEI PROCEEDINGS

AICEI Proceedings, 2009, Volume 4, Issue1, DOI: 10.5281/zenodo.4514178

Ancuta Popa

Financial Crisis in the New Member States Jeopardizing the Euro-Zone Entry

Abstract

The paper aims to analyse the current financial crisis. After describing its causes and effects, the study focuses on the crisis' impact on the global economy, particularly on Central and Eastern European (CEE) economies, which hadn't yet adopted the euro currency. It also evaluates the measures undertaken by central banks in order to regain the confidence in the financial system and to prevent the repercussion of the crisis' negative effects; the coordinated actions of USA and the EU countries. I also put forward the crisis' macroeconomic impact on the CEE countries, especially concerning the fulfillment of Maastricht criteria. Because of the financial crisis some Maastricht criteria would be more difficult to fulfill in the short and medium term, which would make it hard for them to join the euro zone.

Keywords: *crises, financial, Eurozone, central and eastern Europe, central banks.*

The causes of financial crisis and holding events

Economic and financial crisis today seems to be unprecedented in the last half century. The economic recession extends in the U.S., Europe and Japan and it appears to be much more painful than the economic collapse of 1981-1982. A massive drop of confidence in both the business and consumer's level, both responding to restricted expenses is in full progress. The current financial crisis has its roots in the dramatically lowering cost of houses in the U.S. or in the fall of housing loan market. The main problems identified by many analysts (Cerna, 2008 Hardouvelis, 2008, Gere, 2008) in the United States are:

- the limits of U.S. growth model based on credit and consumers demand;
- strong deregulation of financial markets in the U.S.;
- innovation and strong financial market development of derivatives;
- high yields obtained by operators on the financial markets;
- excessive growth of the credit volume - in order to increase banks' profits or bonuses received by bankers;
- low level of interest rates charged by FED for the period 2001-2004 (1% -2.25%), which led to high rates of growth in the volume of credit and increasing rates of financial assets (assets' bubble);
- growth rate during 2001-2006 (from 1% to 5.25%) and the expiration of the periods for which the guarantees were granted, have led to explosive growth in volume of loans outstanding at maturity;
- correction of speculative growth houses price added to the mortgage market collapse;
- mortgage market crisis has turned into a crisis of the entire financial system (in the period June 2006 - June 2007, the increased mortgage outstanding was 34 billion dollars - from 6% to 9% in total - while U.S. financial system circulates funds of 57 billion dollars).

Isarescu (2009) considers that the financial crisis causes are deeper, both of macroeconomic and microeconomic nature. These two types of causes were interconnected in the production of the crisis. One of the main causes of the financial crisis was the abundant liquidity created by the major central banks around the world (FED, Bank of Japan) and the desire of the countries exporting oil and gas to limit currency appreciation. Also, there was a supersaturating with savings, driven by growing integration into the global economy of countries (China, Southeast Asia in general), with high accumulation, and redistribution of global wealth and income to the exporting countries (of goods like oil, gas, etc.). Abundant liquidity and supersaturating savings created available resources for investments, including sophisticated financial instruments, not easily understood by some investors.

Also, Daianu (2008) states that at the origin of the crisis was also the fact that the previous experience was not very well fructified in the last two decades: these crises were periods of euphoria, the massive price increase in assets (the so-called "bubbles"), the relaxation of prudential standards and greed without measure. Also it was not taken into account the severe warnings issued by prestigious names in the world of finance, such as Alexander Lamfalussy, Paul Vocker and others. This statement concerned, especially some types of financial innovation – on the background of securing the loans (i.e. their conversion into tradable bonds) - which have created enormous uncertainty and accentuated the systemic risks.

The consequences of abundant liquidity were the very low interest rates and their low volatility. Together, these consequences have led to increased appetite for assets with large gains. In addition, reduced volatility on the market created a tendency to underestimate risk and a real lack of vigilance of investors. On this background operated as aggravating, also series of microeconomic causes: securitization frenzy, cracks in the business model of rating agencies, outsourcing rational in the private but socially inefficient and, finally, increased international competition for deregulations.

Regarding the conduct of events, in 2006 we may find the first signs of the fall of housing market - a decrease in sales volume, number of new constructions slowed the accumulation of outstanding mortgages. Then appeared warning signals, in April 2007, New Century Financial, an American company that specializes in providing sub-loans, enter into bankruptcy and fired half of the staff, and in July 2007 the investment bank Bear Stearns announced that investors will receive less money than they invested in two funds managed by hedging bank. Turbulence intensifies; in August 2007, BNP Paris Bas announces the freeze of withdrawals of cash from two investment funds of the bank, when the French bank difficulties in properly assessing their assets and citing "credit market turbulence in the U.S.”. August 17, 2007, American Central Bank (FED) is to reduce interest on loans to commercial banks by 0.5% to 5.75% level. September 13, 2007, the press revealed that Northern Rock, a British mortgage lender, has provided an emergency loan from the Bank of England. The news produced panic among depositors who have withdrawn in just one day, 1 billion pounds of bank accounts, the bank is ultimately nationalized. Again, FED reduced monetary policy interest rate by 0.5% to 4.75%. In October, the Swiss bank USB announced losses worth U.S. $ 3.4 billion, caused by massive exposure on the sub, the president and executive director of the bank resign. Also, the head of the investment bank Merill Lynch resigns after the company announced an exposure of 7.9 billion USD in the sub-loans. Meanwhile, central banks injected billions of euro into the banking system, but interbank interest rate and risk premium increases significantly, and the aversion to risk affects some of the currencies of countries with emerging economy (eg, RON recorded a trend of depreciation) .

In early 2008, capital markets around the world suffer the most serious decline after the events of September 11, 2001. FED again reduced interest rate from 0.75% reference, to 3.5%, this being the most significant transaction of this kind in the past 25 years. Bear Stearns, the fifth large investment bank on Wall Street, crashes with bankruptcy; a major contribution had the rumors: cash worth 18 million USD evaporated in two days. Bank is bought by rival JPMorgan in a transaction worth 240 million USD, with only one year before the investment bank being worth of 18 billion USD. Bank of England reduced the interest of reference to the level of 5%. Thus, in April 2008, "rush money" begin:

- Royal Bank of Scotland announces a plan for raising cash from shareholders amounting to 12 billion pounds sterling, the Bank announced, also the reducing of asset accounting to 5.9 billion pounds;
- Swiss bank UBS launched a plan for raising cash in the amount of USD 15.5 billion, in an attempt to cover a loss of 37 billion USD;
- British Bank Barclays announces a plan to increase capital by 4.5 billion pounds.

In July the semipublic institutions of mortgage loan Fannie Mae and Freddie Mac are nationalized - with a share of 50% in the U.S. mortgage by 5200 billion USD.

There are voices saying that the financial difficulties are just at the beginning, which seems to confirm the months of September-October 2008. Thus, on September 10, Lehman Brothers Bank announces losses of 3.9 billion USD, and after the failure of several attempts to find a buyer, it enters into bankruptcy, becoming the largest bank collapse in U.S. Merill Lynch gives their agreement to be acquired by the Bank of America for 50 billion USD. Also, FED grant credit facilities (85 billion USD) to AIG insurance company; which is de facto nationalized by the U.S. Government (80% of the company's shares), worried about the global impact of bankruptcy of the company in question. On September 17, British Bank Loyds takes a significant share - 27.54% - from bank HBOS (the big UK mortgage lender), other banks are participating in the operation as TBS with 14.47% and Royal Bank of Scotland with 8.37%. Goldman Sachs and Morgan Stanley form a bank holding under the FED and the American billionaire Warren Buffett announced the investment of 5 billion USD in Glodman Sachs, for 9% participation rate of bank capital. Washington Mutual, the largest U.S. savings bank which had assets of 370 billion USD, is bought by JP Morgan Chase. On September 28, the banking and insurance Fortis (Netherlands) is partly nationalized by the payment of a sum of 11.2 billion euro from the governments of Belgium, Luxembourg and Germany for 49% participation rate of equity in subsidiaries in those countries. Meanwhile, in the United States, the members of the legislature agree on a plan to save the financial system, initiated by the Treasury of an amount of 700 billion USD. On September 29 in the UK, bank credit Bradford & Bingley Estate is partly nationalized, and the rest is bought by Spanish Bank Santander. Wachovia is bought by rival Citigroup. U.S. House of Representatives rejected the rescue plan Paulson financial banks worth 700 billion USD. This taking place in November raised concerns about banks' ability to overcome the crisis, Dow Jones index falls by 6.98% and the Nasdaq Composite by 9.14%. On September 30, the EU approved the French and Belgian investment worth USD 6.4 billion to save the Dextia.

Fighting with turmoil continues in October. On October 3, House of Representatives approved the revised version of the "Paulson Plan", which establishes tax of 150 billion USD and other aid to 700 billion USD to stabilize the financial system, the plan also provides an increase from 100.000 to 250.000 USD state guarantees for bank deposits. On October 7, Icelandic government takes control of Landsbanki, the second largest financial institution in the country, which has the branch Icesave in the UK. U.S. Bank Wells Fargo Bank buys rival Wachovia for 15.1 billion USD in shares, and the Dutch Government announces partial nationalization of Fortis Bank for the amount of USD 16.8 billion. On October 8, FED, ECB, Bank of England and central banks in Canada, Sweden and Switzerland reduced the reference interest rate by 0.5% in a concerted action. During 10-14 October, the IMF, finance ministers of the G7 group of countries and other officials from 15 EU countries decide to adopt a final plan to rescue the financial system, Germany, Great Britain, Spain, France and Italy adopt detailed plans for capital banks and government in Washington revealed details about an action through which injected 250 billion USD in multiple banks. On October 15, the countries of South Asia adopt a plan of several billion USD to support the banking system. On October 16, in Switzerland, UBS - the largest bank - the government receives an infusion of capital by 3.8 billion euro, also the central bank created a special fund where UBS will submit "toxic assets" worth up to 60 billion USD, while Credit Suisse Group, another big Swiss bank, collect 10 billion CHF (6.5 billion euro) from private investors (including fund and the government of Quatar) and announces loss for the third quarter.

Given the display of events, we can say that the world economy has entered in a severe recession as a result of the most dangerous shock that hit the mature financial markets after the year 1930 (Cerna, 2009). The main developed economies have already entered into recession. On December 1st, 2008, U.S. economic recession is officially declared by the National Bureau of Economic Research, and on January 23, 2009, Britain formally enter into recession, the statistics indicating a decrease in GDP by 1.5% in last quarter in 2008.

Policy-makers must choose between the stabilization of the financial conditions, on the one hand, and to bring their economies in a phase of coexistence of the recession with high inflation (stagflation), on the other. The economic world is faced with many cases of high public debt and large budget deficit - but also the need to pump significant money into the financial system. For example, in 2008, the U.S. public debt has reached 10.6 thousand billion USD (72% of GDP) and the budget deficit reached a record level of 455 billion USD (3.2% of GDP). The U.S. government bonds in the portfolio of foreign governments are 25% of the total. Non-residents hold about 44% of U.S. government debt, and about 60% of external debt is held by the U.S. central banks in other countries, in particular the central bank of Japan and China.

Actions undertaken in order to counteract the effects of the international financial crisis

After triggering the crisis, the central banks have conducted a series of actions destined to restore the loss confidence in the financial system and to prevent the reverberation of negative effects of the crisis on the real economy, which could include:

- FED has increased the volume of swap transactions made with other central banks - commercial banks have gained access to liquidity in U.S. dollars;
- FED has developed a facility for direct lending to the private sector and expanded the range of collateral accepted in operations like the open market;
- Central banks have reduced interest rate: on December 16, 2008, FED reduced the interest rate reference from 1% to a range between 0 and 0.25% - its lowest level ever recorded; on January 15, 2008, the ECB reduced interest rate reference to the level of 2%; on February 5, 2009, the Bank of England reduced the interest rate reference a fifth consecutive time by 1% - the lowest level of the 315 years of existence of the institution;
- Billions of USD and euro were injected into the banking system (examples are presented in the previous chapter).

It was reduced at very low interest rate in Japan as well - 0.3%, Hong Kong - 0.3%, Israel - 1% Swedish - 1% Czech Republic - 1.75%. In Romania, in early February, was decided first to reduce the interest rate in monetary policy by 0.25%, up to 10% after a year and a half of growth, and the meeting of 6 May 2009, the Governors of the central bank decided to reduce interest rate of monetary policy down to the level of 9.5% per year.

Coordinated actions of the U.S. government and EU countries have consisted of:

- Recapitalization of banks;
- Guaranteeing deposits - some countries established full guarantees of deposits and other types of claims;
- Guaranteeing interbank loans;
- TARP (Trouble Assets Relief Program) - State take toxic assets from banks (U.S. and some EU countries);
- Banks nationalization;
- Establishment of new regulation on the financial markets in full (including so-called parallel banking sector, and hedge-funds and private equity funds, the work of rating agencies, payment schemes that have fostered the assumption of risk at the expense of prudence required in the banking, a process of securitization of loans that has

become increasingly artificial and broken by what we call due diligence, etc.);
- EU envisages a centralized financial supervision;
- The officials require the application of risk management more effective and stringent;
- It is recognized the need to establish more robust measures with regard to the adequacy of capital;
- The practices of liquidity management are restrained;
- It is improved the prominence of risk and protection against them;
- It is opened a new global financial system (rebuilding institutional architecture).

There were funds allocated by governments of countries such as presented in the table below:

Table 1. Allocated funds

Country	**Guarantees**	**Recapitalisation**	**Total**
Great Britain	460 billion EUR	47 billion EUR	507 billion EUR
Germany	400 billion EUR	100 billion EUR	500 billion EUR
France	320 billion EUR	40 billion EUR	360 billion EUR
Denmark	200 billion EUR	-	200 billion EUR
Norway	-	55.4 billion EUR	55.4 billion EUR
Portugal	20 billion EUR	-	20 billion EUR
Greece	-	-	28 billion EUR
Austria	85 billion EUR	15 billion EUR	100 billion EUR
USA		250 billion USD	700 billion USD

*Preliminary Financial effort – 700 billion USD and 2 000 billion euro

Also, the countries of Central and Eastern Europe have committed to restoring stability by the economic incentives and bank intervention, such as Poland - 24 billion euro to support the economy, the Czech Republic - 2.5 billion euro to support the economy, Slovenia - 12 billion euro available to banks and 0.8 billion euro to support the economy, Bulgaria - 450 million euro investment projects and 250 million euro capital injection of capital into the bank specializing in SME. Other countries such as

Hungary, Latvia, Romania, called on support from international financial institutions.

Although such measures have been implemented after 17 months after the start of turmoil, the market remained non-transparent; this has boosted the financial crisis. Thus, there are direct and indirect effects of the crisis (Isarescu, 2008): direct effects come from exposure of the banks at the' toxic assets' and the indirect effects are caused by changes in the availability of capital and liquidity conditions, making the financing more difficult. The measures listed have proven to be inefficient which facilitated the passage of crisis in the real economy, first in the U.S. and then in other developed countries.

Isarescu (2009) believes that in the future the governments will be faced with many challenges. Thus, on the short term the main challenge is to find solutions to restore the confidence of investors and consumers. On the long term, the main challenge is to adjust the principles that guide the reform of international financial system, mainly related to transparency, to improve regulations on the security of accounts, ensuring proper regulation of markets, companies and financial products, ensuring the integrity of financial markets (on market manipulation and fraud), and strengthening cooperation between financial institutions in the world (the modernization of governance structures of the IMF and World Bank). Business ethics is not missing from this list of future challenges.

Statements of such threats to the financial stability would necessarily involve an effort of coordination between different financial institutions. Several European countries have turned to the financial support provided by international institutions, as follows: Hungary - 12 billion euro from the IMF, 6.5 billion euro from EU and 1 billion euro from the World Bank; Ukraine - 16 billion euro from the IMF, Latvia - 1.6 billion euro from the IMF, 3.1 billion euro from the EU, 400 million from the World Bank, 100 million from EBRD and 1.8 billion euro from Nordic countries; Iceland - 1.5 billion euro from the IMF; Romania - 12.9 billion euro from the IMF, 5 billion euro from the EU, 2 billion euro from the EBRD and the World Bank and a “loan arrangement” of 500 millions euro for Serbia.

It also should be established a coordination between EU countries, in the purpose of eliminating the differences between countries that are members of the euro area and those which are not. Most countries in Eastern Europe seem to reject the idea of a joint financial support for the region, preferring to seek aid separately. The EU rejected the proposal of Hungary developing a specific plan of 180 billion euro for the countries of the Eastern Europe, citing the idea that this measure would divide Europe between old members and new countries that joined it later. Wave of speculative attacks on currencies of Central and Eastern Europe (as in Poland, Hungary, Romania) and increasing threats to their financial stability determine governments to pursue an earlier entry in the euro area. Financial crisis puts these countries in a position to prefer a solution in one corner (Daianu, 2009), the meaning of their currencies were abandoned in favor of "shelter" offered by the euro. However, their attempt strikes a barrier: the Maastricht criteria, which are designed to ensure that all economies are subject to the same rules before adopting the euro. Central and Eastern Europe countries, which have not adopted the euro are faced with cacth-22 situation (Daianu, 2009) regarding the current financial crisis: if they remain outside the euro area have tendency to become more vulnerable (speculation attacks against their currencies are proof of it) if they fall too quickly, they may not face them, since they abandoned instruments as flexibility exchange rate and monetary policy. However, a decision must be made taking into account the costs and benefits involved for all parts.

The fulfillment of Maastricht criteria by the CEE countries

In present, within EU there are two categories of member states: members with full rights (within euro area) and members with derogation (outside the euro area). Before adopting the euro, accession countries to EMU (members with derogation) must participate in ERM II for at least 2 years. Concerning the countries that joining the European Union in 2004, Slovenia joined the single currency in 2007, Malta and Cyprus in January 2008, and Slovakia entered the EMU in January 2009. However, for the remaining CEE countries there is an increasing uncertainty regarding the timeline of joining the euro zone. Lithuania was refused the admission in the euro zone on January 1st, 2007, because it didn't fulfill the price stability criterion (it was appreciated that the inflation sustainability at a low level was insufficient, being threatened by numerous risks).

The international financial crisis determined a change of attitude concerning the euro adoption. "The financial crisis makes it evident that Denmark needs to join the euro", Prime Minister, October 2008. "Secure public finances and a quick adoption of the euro are the best way out of the crisis for Poland," Finance minister, February 2009. On Mars 2009 the Estonian government said it would aim for the country to adopt the euro on

January 1st, 2011, but they want to keep open the possibility of joining on July 1st, 2010. On January 2009 Czech prime minister announced that November 2009 will be the date when the government will determine a date for adopting the euro. Hungary's finance minister has said Hungary may start talks towards the end of 2009 about joining ERM II. Table 2 below displays the intention date of euro adoption by the CEE countries.

Table 2. Planned year of the euro adoption of the CEE countries

Country	EU Entry Year	ERM II Entry Year	Planned year of Euro Adoption
Estonia	2004	June 2, 2004	2010*
Latvia	2004	May 2, 2005	2011*
Lithuania	2004	June 2, 2005	2010*
Poland	2004	2009*	2012*
Czech Republic	2004	2008*	2011*
Hungary	2004	2009*	2014*
Romania	2007	2012	2014
Bulgaria	2007	-	-

* Forecasts – official date not set yet

A solution to avoid participating in ERM II, supported by some economists (Rostowski, 2000) is the euroisation before joining the EMU. EU authorities reject this type of shortcut to euro area, because adopting the single currency by candidate countries is the final moment of adjusted process that will ensure the nominal and real convergence process.

The eight CEE countries aiming to join the euro are bound to face more challenges in their process of entering the monetary union compared to their predecessors. This is because fulfilling the required conditions for nominal convergence is bound to take longer today, as uncertainty in global markets deepens and adverse shocks do not abate. Moreover, the EU and the ECB have grown more lukewarm towards the expansion of the EMU and insist that convergence conditions should be met. Most of the CEE countries are a long way from fulfilling the Maastricht criteria, and the current global macroeconomic environment of increasing inflation and reduction in GDP growth creates additional uncertainty.

Table 3. The fulfillment of Maastricht criteria by the CEE countries in 2008

Country	Inflation rate	Interest rate on long term	Budget deficit / surplus	Public debt	Exchange rate*
Limit	4.1%	6.24%	-3%	60%	+/-15%
Bulgaria	10.8	5.9	3.2	13.8	0/0
Czech Republic	6.3	4.6	-1.2	27.9	12.2/-12.6
Estonia	9.4	8.1	-2.0	4.3	0/0
Hungary	6.1	8.2	-3.3	71.9	22.0/-11.4
Latvia	14.1	7.9	-2.9	16.0	1/-1
Lithuania	10.8	8.1	-3.2	17.1	0/0
Poland	4.2	6.1	-2.5	45.5	30.7/-14.2
Romania	7.85	7.7	-5.4	13.6	19.6/-14.3

*Calculated as a maximum deviation of the exchange rate against euro in the period April 16, 2007 to April 15,2009
Note: source Eurostat

Inflation criterion represents the most difficult task to fulfill by candidate countries to EMU. All the CEE countries have rates bigger than the reference ones. For example, Latvia, Lithuania and Bulgaria have a double digit inflation rate. Even in a stable global macroeconomic environment, inflation in the CEE countries would be higher than that of the euro zone, and the current economic conditions create additional challenges for meeting the inflation criterion. Among the factors than make the disinflation process confront to a sustainability problem in the future, we mention the following: necessary convergence process in both prices and incomes to euro-area levels, the continuation of Balassa-Samuelson effect (empirical evidence estimated it between 1% and 4% per annum, Coudert, 2004), the increase of administrative prices, the application of communitarian acquis in fiscal and agricultural domains, the raise of nominal wages and the CEE countries would have no choice but to import inflation.

Figure 1. The price level (UE 15=100)

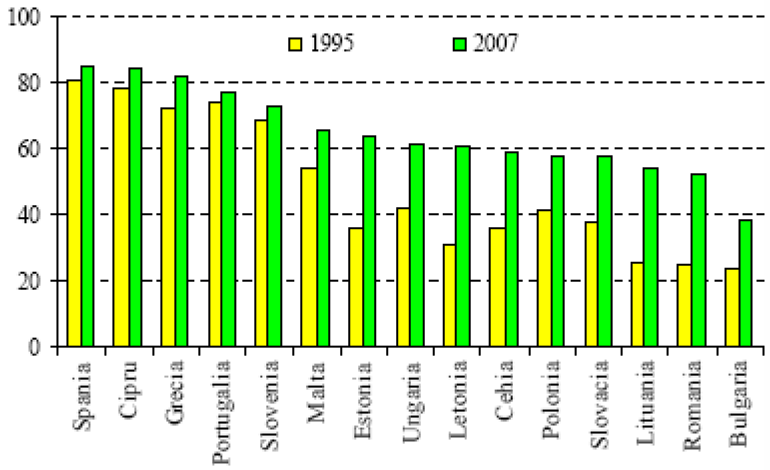
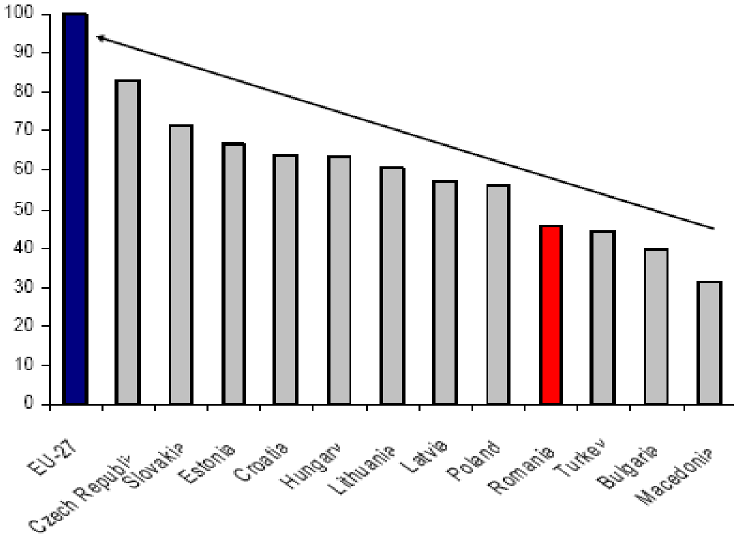


Figure 2. Real incomes convergeance in CEE counties (2008, GDP per capita, PPS-EU27 = 100)



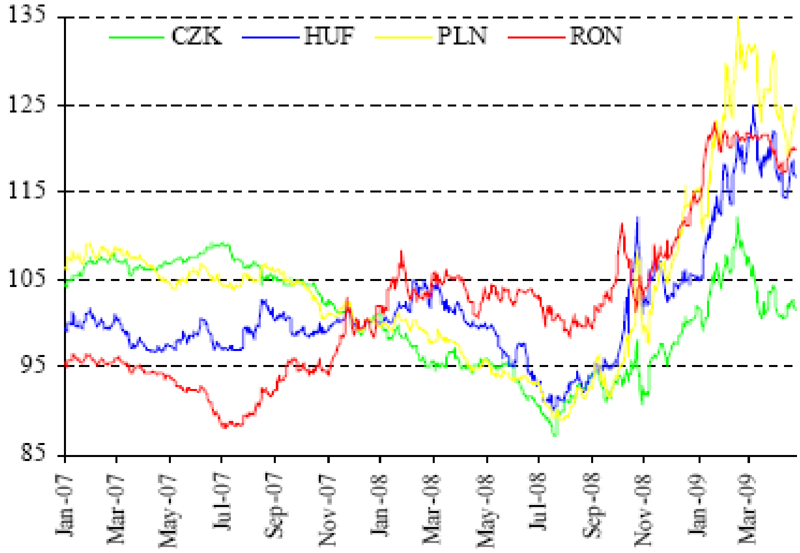
Long term interest rates converge to that of the euro zone as it approaches to the euro adoption. In 2008, there was a growth of long term interest rate in CEE countries, but only Czech Republic, Bulgaria and Poland met this criterion.

Public finance situation of candidate countries deteriorated in the last years, particularly in Romania and Hungary. The main problem is stabilizing, and then decreasing the budget deficit. These countries must cope with numerous challenges that rise doubts concerning their capacity to stabilize the financial situation. This is due to the fact that these countries are in deep financial needs following the joining the EU (connected to financing the modernization process of the administrative system and the infrastructure and national co-financing of the supporting programs of structural community funds) as well as due to continuing the prices alignment process and the reforms pursued in education, health and social insurance system. Or, a great part of these needs impose serious tasks for the budget. Consequently, the candidate countries should find sound and sustainable financial sources.

The public debt level which had an average level of 30% of GDP in 2007 is now increasingly, but it doesn't exceed the limit of 60% of GDP. The modest volume is explained by the fact that, at the beginning of transition, the former communist countries, excepting Poland and Hungary, didn't appeal to public loans in order to cover their budget deficit. This favorable situation risks changing due to the recent growth of the budget deficit.

The exchange rate arrangement plays a crucial role in a country's progress towards its EMU accession. Participation into the ERM-II requires a relative stability of domestic currencies vis-à-vis the euro for a period of two years (+/-15%). In late 2008, a number of countries in Eastern Europe, such as Poland, Hungary or Romania experienced increased speculation on their currencies. The wave of speculative attacks on currencies from CEE countries and the increasing threats to their financial stability prompts some governments to seek earlier entry into the euro zone.

Figure 3. Exchange rate against euro (December 2007 = 100)



But a major stumbling block for speedier euro accession is the Maastricht criteria – which look more difficult to fulfill in view of the ensuing global economic context. The Economic Community could, in theory, adopt a more permissive approach towards CEE countries willing to adopt the euro by relaxing/adapting the Maastricht criteria requirements. But not a few influential people in Frankfurt, Berlin, Paris, etc might say that, allowing economies with a rather more "fragile" position to join the euro zone would weaken the euro. On the other hand the ECB has both an operational and moral duty to assist central banks in CEE countries in case of need.

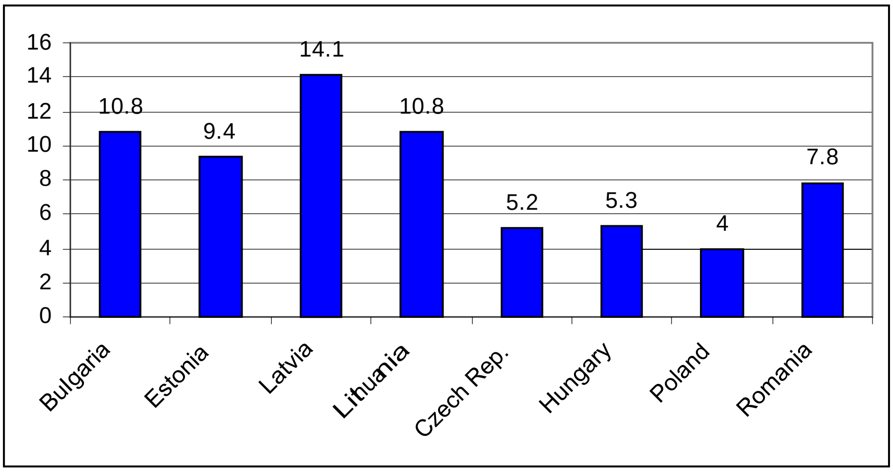
Challenges for the CEE countries

A difficult task of monetary and exchange rate strategies in CEE countries is to support the parallel pursuit of the real and nominal convergence to the euro area, i.e. to advance the disinflation process while allowing real income levels and the structures of the economies to catch-up with those in the euro area. Should the independence in monetary policy be maintained as long as possibly to cope with asymmetric shocks during their catch-up process? Or should they peg tightly to the euro and join the EMU quickly to reap the benefits of irrevocably fixed exchange rates?

From an economic point of view, the challenges facing the CEE countries are threefold (Daianu, 2009). The first set pertain to internal macroeconomic conditions: achieving sustainable inflation, reduced exchange rate volatility, prudent fiscal policy. The second set addresses the current global macroeconomic conditions, and the effects of the financial crisis. Third, a set of conditions relate to the institutional underpinnings of innovation and competitiveness –education being a paramount ingredient herein. Obviously, the three sets of challenges are interlinked and this is what makes it more difficult for the CEE countries to fulfill the Maastricht criteria.

Half of the CEE countries, the Baltic countries and Bulgaria, have a currency board arrangement. At first, this might be perceived as an advantage since it could smooth out their participation into the ERM-II. Moreover, currency boards also help bringing down inflationary expectations at a time when these are high. Nowadays, these countries are having the highest inflation rate within the EU, being the only four countries which had double digit inflation. In contrast, CEE countries with flexible exchange rates and inflation targeting regime fared much better – in spite of similar prevailing labor shortage conditions. Romania's inflation edged a little over 7.8% but inflation in the Czech Republic, Hungary and Poland were between 4-5.5%, a little higher that euro zone inflation.

Figure 4. Inflation rate (Feb. 2008/2009, %)

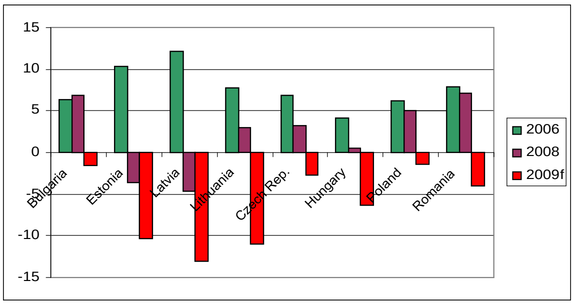


Several considerations made by the committee of CEE countries are worth taking into account when deciding which monetary regime is more suitable for their economies. First, it is important to ensure that the monetary regime will be consistent with the country's inflation objectives. This objective is part of the Maastricht criteria and achieving a low and sustainable level of inflation is possible only when structural economic adjustment has reached its final stages. Second, the financial deepening of the economies would raise additional issues regarding the transmission mechanism of the monetary policy.

Having a currency pegged to the euro – as Bulgaria and the Baltic states – seriously impair their central bank's response to current events, for instance. In the presence of potentially strong and variable capital inflows, which most of the CEE economies experience currently, the monetary authority has limited room for manoeuvre. Moreover, large swings in real exchange rate affect output and expectations. Allowing monetary policy to operate more flexibly seems to present a greater advantage in current circumstances. Moreover, an inflation targeting regime gives the central bank some discretion if unexpected economic circumstances materialize. And, it also allows a better coordination with fiscal authorities in designing and pursuing the appropriate economic policies. This said, however, a free floating of the exchange rate (which is implied by a hard inflation targeting regime) poses its own strong perils – especially under the extreme volatility conditions which have been brought about by the current financial crisis.

Analyzing the data, we can see that the economic growth in the last years has actually been somewhat higher in countries with fixed regime (average growth was around 9.2% in 2006) than in countries with flexible regimes (average growth 6.3% in 2006), Baltic States being on top. The financial crisis has an important impact on these economies, and we assist at a slowing down of the economic growth in CEE countries, the Baltic States being the most affected (a negative GDP real growth). The economic foresight is that the GDP decrease will run for a long time.

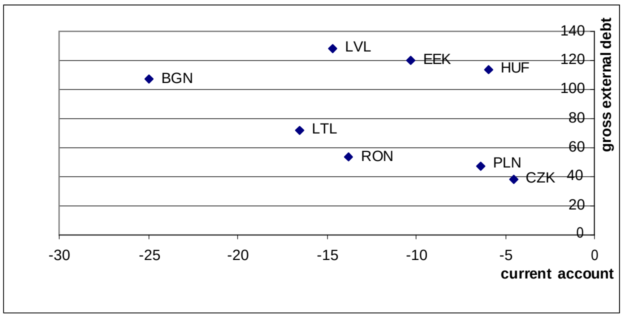
Figure 5. GDP real growth



* f - forecast

Maintaining external competitiveness is an important issue for accession countries, as there are small and open economies, in which exports and imports play an important role for their growth and investment developments. The more open an economy, the grater impact of exchange rate variation on domestic prices. Concerns about competitiveness would apply especially to countries with a fixed regime, if product and labor market flexibility were insufficient to adopt changes in international comparative advantages. The current account deficit was higher in the countries with fixed regimes than in countries with independent floating. This deficit must decrease through adequate political measures. The task of adjusting must be supported by the private and the public sector in the same time.

Figure 6. Current account deficit vs gross external debt in 2008 (% GDP)



Recent developments in financial markets in Europe have made the ECB to step in and guarantee support for some CEE countries. The ECB never acted as a potential lender of last resort for a non euro-zone country so far. The ECB's decision indicates how much the European financial landscape has changed since the creation of the Monetary Union. This crisis has brought about a quite paradoxical situation: it is not subsidiaries in CEE countries which cause the trouble in the main, but overall practices (such as over-leverage and involvement in the origination and distribution of securities) of banking groups headquartered in countries which belong to the euro zone. Ironically, the ECB is forced to step in because, not least, of poor practices in its principal geographic area of concern. From this point of view, the ECB's financial support which was extended to, for example, the National Bank of Hungary may be seen as a pre-emptive move attempting to maintain the existing financial stability in a wider euro-zone area. But this highlights also the vulnerability of financial systems in CEE countries, not necessarily of their own doing.

Also, all the governments of the ECE countries committed to rebuild the stability of the Central and Eastern Europe and engaged important sums to support their economies (Poland 24 billion euro, Czech Republic 2.5 billion euro, Bulgaria 450 billion euro). Some of them have even borrowed money from the international financial institutions, as follows: Hungary – 12 billion euro IMF, 6.5 billion euro EU and 1 billion euro World Bank; Latvia – 1.6 billion euro IMF, 3.1 billion euro EU, 400 million euro World Bank; Romania – 12.9 billions euro IMF, 5 billions euro EU, 2 billion euro EBRD and World Bank.

The Asian crisis of a decade ago made some to talk about a "two corner solution" for exchange rate arrangements in order to forestall financial misery. The current financial crisis has underlined the role of reserve currencies as "shelters" during periods of major distress; it is like we are going toward a "single corner solution" paradigm in exchange rate policy. CEE countries are, seemingly, in a catch-22 situation in view of the current financial crisis: if they stay outside the euro zone area they tend to become more vulnerable (speculative attacks against their currencies is a proof of this); if they get inside too quickly they risk not being able to cope with having renounced the flexibility of exchange rate and monetary policy tools. Nonetheless, a decision has to be made in view of the costs and benefits involve.

References

Cerna, S., (2008). Financial crisis: its impact on Romanian economy. *Conference AGER*, 2008.

Codert, V., Yanitch, J.P. (2002). Dix ans de transition des regimes de change des pays de l'Europe Centrale et Orientale candidats a l'Union Europeenne: bilan et perspectives. Bulletin de la Banque de France, No. 99.

Coudert, V. (2004). Comment evaluer l'effet Balassa-Samuelson dans les pays d'Europe centrale et orientale?. Bulletin de la Banque de France, No. 122.

Dăianu, D. (2008). De ce nu se învață, adesea din greşeli. *National Journal*, 17.09.2008.

Daianu, D. (2009). The Monetary Union: The Decade Ahead. The Case of Non-Member States. The William Davidson Institute, University of Michigan.

Gerea, N. (2008). Subprime Credit & Financial Crisis. *How is the World After the Financial Turmoil* Conference, *National Bank of Romania,* 2008.

Hardouvelis, A. (2008). International Financial Crisis and the Uncertain Economic Future. *How is the World After the Financial Turmoil* Conference, National Bank of Romania.

Isărescu, M. (2008). Romania in the Context of the Global Financial Crisis: an Overview. *How is the World After the Financial Turmoil* conference, National Bank of Romania, 2008.

Isărescu, M. (2009). International financial crisis and challenges for monetary policy of Romania. National Bank of Romania, 2009.

Rostowski, J. (2000). The Eastern Enlargement and the case for unilateral Euroization, Central European University, Budapest.