FINANCIAL CRISIS 2008 AND THE STABILITY PERFORMANCE OF EASTERN EUROPEAN EU MEMBERS AND GREECE: CHALLENGES FOR THE STABILITY OF THE EURO

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ABSTRACT

The financial crisis of 2008 is unprecedented and has led to a completely new situation in the monetary and financial integration of the EU. Some member states of the EU are threatened by bankruptcy which could also risk the achievements of monetary integration and the strong stability performance of the Euro from the last ten years. The exchange rate of the Euro came under stress because the markets are nervously observing how the "Greek tragedy" can be solved without damaging the credibility of the Euro.

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Keywords: Financial Crisis, Stability, Exchange Rate

THE AFTERMATH OF THE FINANCIAL CRISIS 2008: INTRODUCTORY REMARKS

Since the financial crisis of 2008, the convergence analysis of the Eastern European EU members has to be regarded from a different perspective. The surprising success of Slovenia and Slovakia who have achieved to gain membership in the Euro zone through a strong and credible stability policy is not likely to happen again with the other Eastern European EU members. But also the existing "old" members of the Euro zone are under enormous pressure: Next year, a deficit procedure will be started against all 16 Euro states. And Greece and Italy might face a serious test of their ability to regain financial stability. The financial markets surely mistrust the ability of Greece to succeed on this matter which can be easily seen in the high interest rates for Greek long term government bonds that are almost twice as high as the interest rates for German bonds (see *Beck* and *Wentzel* 2010).

Nevertheless, the financial crisis has not stopped the existence or changed the wording of the European Treaties. Even though the financial and economic situation of 2010 is completely different from 1999 when the first round of Euro states were selected, the new EU members in the East are obliged to adopt the Euro. So the efforts to achieve the financial preconditions to introduce the Euro cannot be interrupted. The "opting out clause", which held for Britain, Sweden, and Denmark, is not available for the new members. This is surely a double-standard, but the matter of the fact is that the Eastern European governments have signed voluntarily their commitment to the *acquis communautaire* and therefore to the introduction of the Euro. From an economic perspective, a very interesting *dilemma* occurs: All member states have to adopt the Euro in order to fulfill their legal obligations, but they are only accepted in "the Club" if they match the criteria. Therefore the strategic exit option for a country who might not want to adopt the Euro is failing on the criteria on purpose. This is the strategy of Poland and the Czech Republic right now who refuse to participate in the European Monetary System II.

The research question of this paper is if any of the new members is ready to follow Slovenia and Slovakia, who were the first of the new members to introduce the Euro. Nevertheless, the final judgment if a country is performing strong enough or not is never easy: The intensive debate in May 2008 between the European Commission and the European Central Bank regarding Slovakia joining the *Euro* zone is a clear expression of this controversial. The European Commission was strongly supporting Slovakia – mainly for political reasons, while the ECB was expressing serious concerns about the sustainability of the Slovakian stability path. The final result of this debate is obvious.

Experts with the best empirical data and knowledge available come to completely different conclusions concerning the stability performance. Nevertheless, there are more and more concerns about the quality of empirical data since the case of Greece has demonstrated that some countries even work with faked data to convince the European institutions about their stability performance. Recently, rumors occurred that also Bulgaria did not provide accurate date. But which European or international institution could force Euro zone members to fulfill their obligations and provide realistic and fair data? When the Western Europeans started their way towards the Euro in the early 90^{th}, there was a credible threat that non-performing countries were not accepted. This resulted in a lot of pressure on national governments to cut spending and to achieve more solid and balanced budgets. However, with the introduction of the Euro, this political sanction had disappeared and the *Stability and Growth Pact* has never gained any credible authority that violations of the treaties would be punished (see *Wentzel* 2005).

In this paper, the efforts of the new member states on their way to fulfill the obligations from the European Treaty will be analyzed. In addition to that, this paper will also analyze the case of Greece who might be the first country to be expelled from the Euro zone after continuous and deliberate violations of the financial rules. The presented analysis deals with the empirical facts, but considers also additional factors from the political and institutional environment. Therefore is follows a two pillar strategy of analysis, combining both empirical and institutional arguments.

1. PERFORMANCE OF ESTONIA

1.1. Convergence criteria

With regards to the government budgetary position Estonia enjoyed a surplus of 1.1 percent per year since 2000, which has been used to reduce the public debt (*European Commission* 2006: 15). Elder forecasts underlined a rising surplus of the revenues to 1.3 percent of GDP, which strengthens the confidence in the Estonian budget balance (*Eeste Pank*, *Bank of Estonia* 2008: 8). However, the strong impact of the financial crisis has turned the annual balance from a surplus into a deficit in 2008 and will turn back into a surplus at the earliest in 2011: The official statistics from Estonia predict a surplus of 0,1% in 2011. In contrast to the Estonian published data, the European commission forecast assume a deficit by 3,9% in 2010 instead of 1,0 % (*European Commission* 2009: 209), which would exceed the criterion on annual deficit.

Figure 1: Budgetary developments 2005-2011, Estonia (% of GDP).

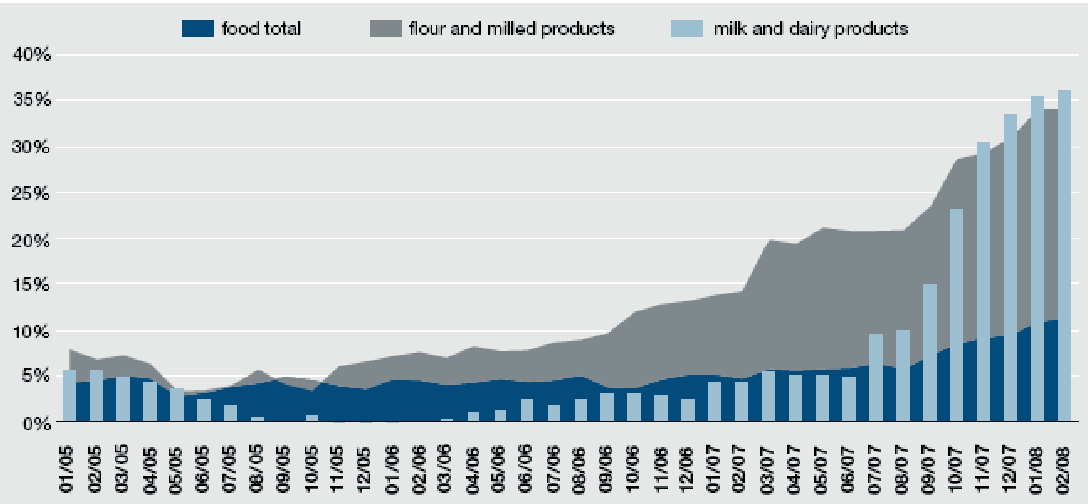
	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	-2,3	- 3,4	- 2,7	1,9	1,7	1,0	-0,1
Gross government debt to GDP	4,4	4,2	3,5	3,7	3,7	3,5	3,0

Source: European Commission 2007: 228; European Commission 2009: 210.

The exchange rate stability has performed well: Before the assessment to ERM II, the *Estonian Kroon* had been anchored to the *Deutsche Mark* (DM). The *Estonian Kroon* started transition from a socialist currency of the Soviet era in 1990, at that time a very challenging institutional arrangement (see *Wentzel* 1995). Since June 2004, the *Estonian Kroon* is part of European Exchange Rate Mechanism and could maintain a constant currency board within the mechanism with direct transmissions of monetary impulses coming from the Euro area (*European Commission* 2006: 64). Recently, the *Estonian Kroon* appreciated by 3 percent, which "was mainly facilitated by the stronger growth of consumer prices compared to that in the partner countries, which is why growth in the real exchange rate of the *Kroon* accelerated to 4–5% in the second half-year" (*Eeste Pank*, *Bank of Estonia* 2008: 8). Estonia has high foreign exchange reserves covering 115 percent of monetary base and short-term interest rates fulfill the convergence criteria too (*European Commission* 2006: 64). There are no pressures on the exchange rate right now. "As a result of Estonia's low level of government indebtedness no benchmark long-term government bond or comparable security is available to assess the durability of convergence as reflected in long-term interest rates" (*European Commission* 2006: 16). The indicator is predicated on key figures from bank loans and non-financial businesses (*European Commission* 2006: 16). Recent developments, especially since 2004 fulfill convergence criteria of long-term interest rates and there is no indication of any worsening.

As a result of initially external price shocks, higher indirect taxes, increasing wage costs and a strong demand growth from 2004 to 2007, Estonia suffered relatively high inflation rates, which remain above the reference value. The Estonian CPI increased approximately up to 10 percent in December 2007. However due to the strong reforms Estonia needed to run to cope the financial crisis and the lack of FDIs, higher unemployment rate and lower public spending the inflation rate dropped strongly and turned in 2009 for some months into a deflation. Over 2009 it remained round about 1,6%, which fulfills criterion on price stability and currently there is no sign of a soon strong increase since Estonia still suffers a hard recession.

Figure 2: Rise in food prices in Estonia compared to the corresponding month of the previous year



Source: *Eeste Pank*, *Bank of Estonia* 2008: 11

Source: http://www.ecb.int/stats/prices/hicp/html/inflation.en.html

1.2 Current economic situation and recent structure reforms

In terms of the economic structure Estonia is relatively well performed: The average hours of work per week are with 40,7 above the EU average (Statistisches Bundesamt 2009: 37.), effective age of retirement is by 65 years (Eurostat 2007: 3), which is both above the legal age and the EU average with 59,5 years. However the ancillary labour costs are with 37% too high (Statistisches Bundesamt 2009: 37.) and Estonia suffers still corruption, even if its position in the corruption perceptions index is with 27 the lowest among the new members (Transparency International 2009: 6.). The public spending on health care and pensions are below the EU average

1.3 Additional factors

Domestic investments and the productivity growth are based on increased foreign savings in Estonia. The *Euro* is already accepted as investment currency and the integration of the Estonian economy with the EU is remarkable strong (*European Commission* 2006: 16). However, the Estonian economy will have to satisfy large financial needs due to a decline in private savings since 2002 and the large external deficit (*Financial Times* 2008), which widened from -5,6 in 2001 up to -13,1 in 2006 (*European Commission* 2006: 15). The external deficit is financed by FDI inflows and intra-group bank lending. However, that will not be sufficient to prevent future financing problems of the external balance (*European Commission* 2006: 69). "With the external debt stock having grown […] to above 80% in Estonia in 2005, debt service – let alone the redemption of debt – it might take a considerable toll on future consumption and investment. For a vigorous convergence scenario it will be essential to ensure that the high current account deficit reflects sound private investment rather than conspicuous consumption" (*Deutsche Bank Research* 2006: 1). In 2007, the trade balance deficit decreased slightly: "The underlying reason for this was the increased outflow of investment income, calculated on an accrual basis. Income on investment in Estonia was about 45% larger than in 2006 also in the last months of 2007" (*Eeste Pank*, *Bank of Estonia* 2008: 7).

Moreover according to a survey from the European commission, Estonia is among the best prepared countries for the future demographic change, which will have positive impacts on public debt (Tagesanzeiger: 14.10.2009).

1.4 Conclusion

To sum up, Estonia currently fulfills all required convergence criteria. "The common feature in recent economic forecasts has been that the adjustment of domestic demand growth will be smooth and that current account deficit is not expected to decline rapidly once economic growth slows" (*Eeste Pank*, *Bank of Estonia* 2008: 18). The inflation rates will remain low, however there is the danger of a rising external deficit. The prospect does not indicate changing. However, public deficit is a prerequisite to join the *Euro* zone that is definitely not negotiable (see *Wentzel* 2005). This leads to the conclusion that Estonia will not fulfill criteria in the short term and is therefore not yet qualified to join to *Euro* area. Cutting down deficit will be the central challenge for Estonia on their way into the monetary union. However, Estonia remains one of the best performing countries among the Eastern European member states and will be one of the first to join the Euro area considering the empirical and institutional basis.

2 PERFORMANCE OF LATVIA

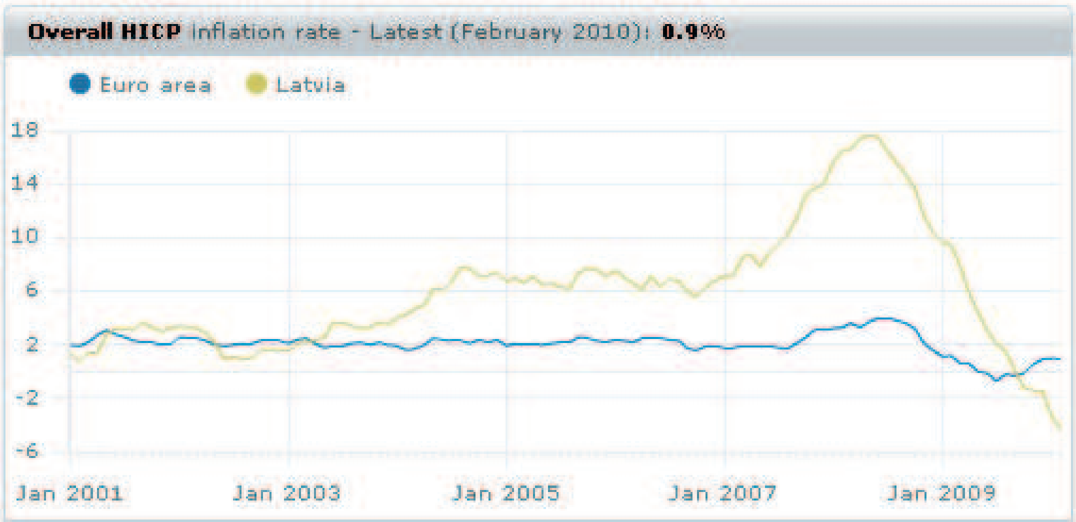
2.1 Convergence criteria

By 2006 the general government balance of Latvia realized a surplus of 0.2 percent of GDP due to higher tax revenues than expected in previous government's drafts. Forecasts of the European Commission predicted smaller but positive balances of annual government deficit, which has happened just until 2007 – before the crisis impacted the Latvian economy. The status of Latvian's gross government debt fulfilled required criteria during the recent years by 12 percent in 2005 and will be reduced up to 10 percent in 2008 (*European Commission* 2006: 19). However this did not happen: The gross debt to GDP was by 19,4% in 2008 and 32,4% in 2009. The financial crisis hit Latvia very strongly and caused both higher public deficit and debt. Therefore, Latvia does not fulfill anymore convergence criterion concerning deficit and in the future on debt as well, if the Latvian economy will not recovery.

After a moderately depreciation against the Euro, Latvian *Lats* became part of ERM II in May 2005 and has successfully maintained its currency within the corridor of one percent around the Euro central rate (*European Commission* 2006: 89). The lack of severe tensions and the satisfying developments in short-term interest rates and foreign exchange reserves, lead to a fulfilment of criteria on the required exchange rate stability (*European Commission* 2006: 90). The *Lats* is "growing into the system". The long-term interest rate (LTIR) within Latvian economy has been around 3.9 percent and did never approach to the upper bound of 6.2 percent of the required convergence criteria (*European Commission* 2006: 90), so the average LTIR has always remained below the reference value. Furthermore, Latvia enjoys confidence from investors reflected by the moderate spreads to the Euro area (*European Commission* 2006: 91).

Inflation is continually high with 6.7 percent in 2006 and is also expected to remain high (*European Commission* 2006: 19). The sudden rise from 2.9 percent in 2003 up to 6.2 percent in 2004 and the persistence of high inflation rates reflected initially external price shocks, higher administered prices, indirect taxes and increasing capacity constraints (*European Commission* 2006: 84). However Latvia enjoyed a strong drop of inflation rates in 2009 as consequence of the hard structural reforms Latvia has taken, e.g. salary reduction by 15% for employees in public sector and the VAT was increased from 5% to 21%, forced by the IMF (International Tax Review: 2008). In average the inflation rate still exceeds the criterion on price stability with 3,3% in 2009.

Figure 4: ECB: Inflation and the euro



Source: http://www.ecb.int/stats/prices/hicp/html/inflation.en.htm

In the past there have been more demand-side factors and upwards pressures stemming from labor costs (*European Commission* 2006: 18). Moreover, excise taxes and pro-cyclical fiscal policies lead to the conclusion that the inflation was not considered as a primary problem by Latvian government. However the current unemployment rate of 23%, which is also caused due to lay offs on the public sector (*Auswärtiges Amt*. Lettland - Wirtschaft: 2010), will lower pressure on inflation rate in the future.

The prices are still decreasing and Latvia will suffer a deflation in 2010 if the economy will not recovery. Both the strong volatility of the prices and the dependency of FDIs, which determine the power of the economy and the way of inflation, lead to the conclusion that Latvia is not yet qualified to fulfill the criterion on price stability.

2.2 Current economic situation and recent structure reforms

In terms of the economic structure also Latvia is relatively well performed due to strong reforms in 2009: The average hours of work per week are with 40,6 above the EU average (Statistisches Bundesamt 2009: 37.), effective age of retirement is by 61,6 years (Eurostat 2007: 3), which is both above the legal age and the EU average with 59,5 years, and the ancillary labour costs are with 28% pretty low (Statistisches Bundesamt 2009: 37.) . However Latvia suffers still corruption: its position in the corruption perceptions index is with 56 in the middle among the new members (Transparency International 2009: 6.). The public spending on health care and pensions are below the EU average

2.3 Additional factors

The integration of Latvian economy with the EU is strong and the Euro is currently used as an investment currency which would relieve the adoption of this currency. Foreign savings, especially from Euro area countries, intensified investments and productivity growth (*European Commission* 2006: 91). However, Latvia suffers a large external deficit (*Financial Times* 2008), which has widened from -7.6 in 2001 to -16.4 in 2006 (*European Commission* 2006: 95) and is mainly financed by FDI inflows and intra-group bank lending (*European Commission* 2006: 94).

2.4 Conclusion

Latvia does not fulfill all required convergence criteria. The inflation rate is definitely too high and due to the strong dependency with foreign trade the inflation will turn into deflation in 2010. Monetary stability is the main precondition for the membership in the Euro area and definitely not negotiable. The budgetary aspects are also inappropriate. Both the large deficit, as well as the prospective strong financing needs exclude Latvia from participating in the Euro area in the near future.

However, the Euro is becoming a parallel currency in Latvia in regular life which leaves the country – like its Baltic neighbors – in a difficult situation. Even though the *Euro* cannot be adopted officially in the near future, it is part of the Latvian economy in many ways. It can be concluded that the role of the *Euro* as a parallel currency in the Baltic states is another example of *Greshams's* law (see *Wentzel* 1995). There might be a crowding out of the *Lats* by the *Euro*, which will be a real challenge for the monetary policy of the national central bank and, later on, also for the ECB.

Latvia may be able to introduce the Euro in the midterm in case the economy will recover and support the strong institutional reforms and also if Latvia will be able to take their inflation rates under control. Latvia enjoys high credibility among foreign investors since it started hard reforms early and was able to realize them quickly.

3 LITHUANIA

3.1 Convergence criteria

The performance of Lithuania regarding the government deficit and debt is quite positive (*European Commission* 2007: 251). "Lithuania's general government deficit will hover around 1.4% of GDP from 2008 onwards. The government's longer-term target of a cyclically balanced budget seems reachable in the light of the envisaged improvement in tax collection and the proven political ability to restrain expenditure" (*Deutsche Bank Research* 2006: 4). The gross government debt is currently by around 18 percent and is expected to decrease in 2011. However forecasts from the European commission predict annual deficits by 8% and a gross debt by 32% in 2011 (*European Commission* 2009: 231). The forecasts are based on different expectations regarding GDP growth and social spending.

Figure 5: Budgetary developments 2005-2011, Lithuania (% of GDP).

	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	0,5	0,5	1,2	2,9	2,1	1,0	0,00
Gross government debt to GDP	18,6	18,2	17,0	15,3	16,9	18,1	17,1

Source: *European Commission* 2007: 228; European Commission 2009: 210.

The budget for 2007, approved in December 2006, did not contain significant tax changes and confirmed the confidence external observer have gained in the budget policy of Lithuanian government (*European Commission* 2007: 251). Government target was to balance budget in 2009. However, social expenditures were increasing, but among it, the planned higher subsidies to farmers are co-financed by the European Union, so does not burden government balance in full (*European Commission* 2007: 251). However the financial crisis hit the Lithuanian economy very strongly and the country was close to be bankrupt. The GDP was sinking by 18% in 2009 (Auswärtiges Amt. Lithauen - Wirtschaft: 2010.) The hard reforms taken in 2009, e.g. increasing the VAT from 19 to 21% (Worldwide Tax 2009) and further necessary fiscal consolidation and structural reforms who are intended to be implemented (New Europe 2009), supported and will support the economy and it is expected to find the way back to recovery in 2010 or 2011.

Lithuania fulfills criteria concerning exchange rate stability, but has to be monitored in next years. Lithuanian *Litas* has participated in ERM II since 28 June 2004 and ever since the *Litas* has remained stable (*European Central Bank* 2006: 23). Lithuania has got a large deficit in balance of payment, which is covered only half by net inflows of FDI (*European Central Bank* 2006: 23). However, Lithuania is one of the emerging countries which normally realize such kind of development: "In fast-growing catching-up countries like Estonia and Lithuania a current account deficit is considered to be normal, reflecting the fact that domestic savings are too small to finance investments" (*Deutsche Bank Research* 2006: 9).

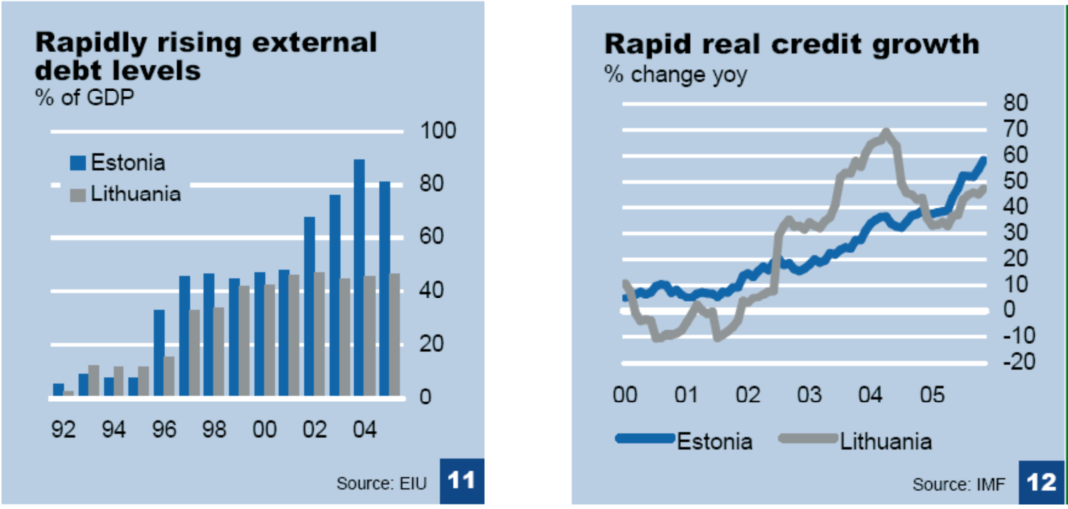


Figure 6: External debt in % to GDP and Real credit growth 2000 to 2005 (Source: Deutsche Bank Research. Estonia, Lithuania, Slovenia: Poised to adopt the euro (2005): 9)

The performance of long-term interest rates reflects the credibility of Lithuania's convergence process: The spread of long-term government bond yields declined from 55 basis points to 25 and the average LTIR is at 3.7 percent, below the reference value of 5.9 percent (*European Central Bank* (2006): 24). The long-term interest rates declined since 2001 and the spread between Lithuanian LTIR and euro area LTIR narrows, which is indicative of "market confidence in general economic and fiscal developments in Lithuania" (*European Central Bank* 2006: 24).

Year	2003	2004	2005	2006	2007	2008	2009
HICP	-1,1	1,2	2,7	3,8	5,8	7,4	-0,6

Figure 7: Measures of inflation and related indicators. (Source: Eurostat - Tables, Graphs and Maps Interface (TGM) table 2010.)

The inflation rate has been volatile and increased until 2008. In contrast to the value reference of 2.6 percent in 2006, the Lithuanian inflation is higher than the average of the countries (*European Central Bank* 2006: 20) that adopted the *Euro* and there remained several risks for inflation; especially higher fuel prices for transport and increased prices for food in general (*European Central Bank* 2006: 21). Moreover, European Commission forecasts predict perspective risk factors for inflation in the longer term as a result of strong domestic demand, energy price increases and increases in indirect taxes (*European Central Bank* 2006: 21). Since the Lithuanian economy was hit by the economic crisis and suffered a large downturn in their GDP and several salary cuts, layoffs and tax increases, the danger for high inflation rates has lost its basis and in fact in 2009 Lithuania has experienced a deflation. However along with its Baltic neighbor Estonia, Lithuanian economy is too dependent on foreign trade and FDIs and take the risk that the inflation rate will increase sharply once the economy recover.

3.2 Current economic situation and recent structure reforms

After the strong reforms taken in 2009 the economic structure is better than in many other Eastern European countries: The average hours of work per week are with 40,3 above the EU average (Statistisches Bundesamt 2009: 37.), effective age of retirement is by 63,4 years (Eurostat 2007: 3), which is both above the legal age and the EU average with 59,5 years. Just the ancillary labour costs are with 41% high (Statistisches Bundesamt 2009: 37.) . Lithuania has to cope the problem with corruption, where the country has the position 52 in the corruption perceptions index in the middle among the new members (Transparency International 2009: 6.). The public spending on health care and pensions are below the EU average.

3.3 Additional factors

Lithuania underlines the willingness to adopt *Euro* by ensuring a tight fiscal policy which supports fiscal consolidation and the credibility of the currency board arrangement (*European Central Bank* 2006: 24). In addition to this, Lithuania enjoys market confidence in general economic and fiscal developments (*Convergence report* 2006: 24). However, the large deficit in balance of payment (*Financial Times* 2008) is covered only half by net inflows of FDI which indicates weaknesses regarding Lithuania's price competitiveness (*European Central Bank* 2006: 24). The medium and long-term convergence to the *Euro* is threatened by the high current account deficits.

3.4 Conclusion

With regards to the discussion in and about Greece, Lithuania pointed out that it is possible to realize strong reforms in a little time to prevent serious problems. Government debt increases in 2007 and 2008, but will maintain below the required limit of 60%. Exchange rate is stable since Lithuania is part of ERM II and long-term interest rates declined as a result of a market confidence in economic and fiscal developments. Even the inflation rate is below the required reference value and due to several downward pressures it is expected to further remain stabile in future. Lithuania is in some areas well performing with a strong commitment of its government to reach objectives of convergence criteria, but is yet not able to adopt *Euro*. However, if the country achieves to reduce public deficit and the GDP growth will increase, it might get into an entry position soon.

Furthermore, it has to be mentioned that Lithuania is in a similar situation to the Baltic neighbors. The *Euro* is already part of the economic daily life and the gap between the official currency and the unofficial exchange is getting smaller. Credibility from the Lithuanian economy comes mainly from a solid budget policy over several years and from successful privatization. The challenge, as in the case of Estonia, is the reduction of the new deficit. However, that should be a manageable task.

4 POLAND

4.1 Background

Poland was the "top student" at the beginning of the transition in 1990 (see *Wentzel* 1995; *Weber* 1995). The legendary reforms of *Leszek Balcerowic* (the so-called "shock-therapy") converted the country quickly from a centrally planned and administered system into a market economy and became a milestone of economic policy in general. Poland and the other "Visegrad contries" (Czech Republic, Slovakia, Hungary) tried everything to become members of the European Union as soon as possible and finally achieved full membership in 2004.

Nevertheless, since the access to the EU in 2004, the Polish enthusiasm to intensify the European integration has disappeared. In 2006, Poland fulfilles only two of the four required convergence criteria, namely the price stability and the long-term-interest rates. Moreover, the Polish government under *Lech Kacinski,* questioned the European Central bank's independence (*OCDE* 2006: 4) and asked for a more "democratic approach" in monetary policy, which means nothing else than giving the government control over money supply. The recent developments in deficit and debt, as well as the exchange rate performance are far away from the value references agreed in the convergence criteria.

However, the new Polish Prime Minister *Donald Tusk*, elected in 2007, has implemented a change concerning the attitude of the Polish government to public debt, independence of the national Central Bank, political relations to other EU-members, and EU institutions in Brussels. Poland now accepts its obligations from the *acquis communautaire* and the contract with the EU that clearly states that the country is obliged to adopt the *Euro* and therefore has to work hard to fulfill the convergence criteria as soon as possible.

4.2 Convergence criteria

Up to 2008 Poland fulfilled the criterion concerning price stability, but this can't be taken for granted and has to be observed strictly in future. The inflation rate in 2009 was by 3.4%, which exceeded the requirements on price stability. After high inflation rates in the early 1990s, Polish inflation decreased sharply, but so far has been volatile (*European Commission* 2006: 24). Fluctuations in prices after EU accession, as well as a lack of willingness on the part of the previous Polish governments, both the post-communist party *Sojusz Lewicy Demokratycznej* (*SLD)* that governed up to 2005 and the national-conservative *Prawo i Sprawiedliwość (PIS)*, to stabilize the prices lead to this volatile development of Polish inflation. The new Prime Minister *Donald Tusk* announced changes in public expenditures: In particular he is committed to limit social spending. However, there is evidence of a slight pick-up in inflation in 2007 and 2008 attributed to improved economic conditions and higher indirect taxes, drafted by the Polish government (*European Commission* 2006: 127). "The first half of 2007 saw an acceleration of economic activity driven by booming domestic demand. Growing labor shortages have fuelled strong wage increases. The pick-up in unit labor costs and record-high capacity utilization rates has darkened the inflation outlook" (*OECD* 2007d: 1). To sum up, part of the inflationary pressure is "home made", whilst another part (energy prices, food) stem from the development of the world economy. Poland was the only country with a slight plus in GDP growth and therefore didn't experience a sharp fall of inflation rates as the other Eastern European countries did.

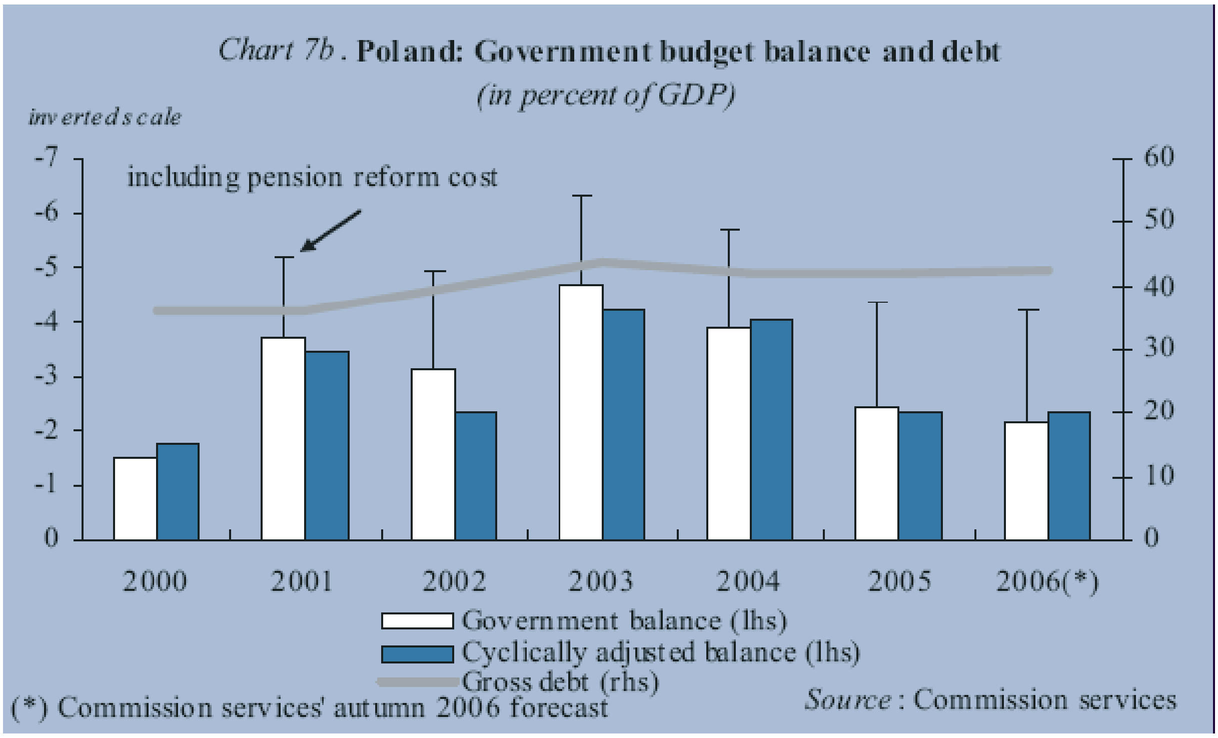


Figure 8: Poland: Government budget balance and debt. (Source: European Commission 2006: 24)

	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	4,3	3,8	2,0	2,7	2,5	2,3	-1,9
Gross government debt to GDP	47,1	47,6	44.9	45,9	45,8	45,5	44,8

Figure 9: Budgetary developments 2005-2011, Poland (% of GDP). (Source: European Commission 2007: 228; European Commission 2009: 243.).

Poland is not part of ERM II. "The *Zloty* exchange rate has fluctuated widely over the past few years" (*European Commission* 2006: 25). However, the 3-month-spread narrowed since 2004. Moreover, Polish currency seems to be undervalued: "A large majority of factors suggest continued undervaluation of the CEE-4 currencies. This was confirmed by numerous sensitivity tests. Even though the productivity gap between the EU-15 and the new members is large, it is apparently not as large as implied by the current exchange rates. The CEE currencies' initial undervaluation is more persistent than assumed by many people" (*Deutsche Bank Research* 2005: 6). Nonetheless, to fulfill criterion on exchange rate stability, Poland have to be part of ERM II for at least two years. Poland does not fulfil this required criterion.

Since 2005, the long-term interest rates did never exceed the reference value of 6.5 percent and the long-term spreads narrowed, which both accomplish required criteria. LTIR fluctuated due to shifts in the inflation forecasts and the ambiguous attitude regarding its monetary policy, but it did not impact its good performance (*European Commission* 2006: 25).

4.2 Current economic situation and recent structure reforms

Poland enjoys a very good position in terms of its economic structure with regards to other EU members: The average hours of work per week are with 40,4 above the EU average (Statistisches Bundesamt 2009: 37.), effective age of retirement is by 61,4 years (Eurostat 2007: 3), which is both above the legal age and the EU average with 59,5 years. Just the ancillary labour costs are with 25% high (Statistisches Bundesamt 2009: 37.) . Corruption is still a big problem, where Poland has the position 49 in the corruption perceptions index, which is also in the middle among the new members (Transparency International 2009: 6.). The public spending on health care are below the EU average, however the spending for pensions is with 11,4% above and needs to be changed.

4.3 Additional factors

The integration of Polish economy with the EU is strong, with increasing exports, rising trade and FDI relations especially with its neighbouring countries (*European Commission* 2006: 125). Political uncertainties, caused by the previous government, did not influence negatively the volume of capital inflows. Planned restrictions of Central Bank's independence, as announced by the former *Kacinski* administration, don't seem to be pursued any longer by the new government. However the new Prime Minister *Donald Tusk* is charged to dispel all doubts concerning political uncertainties which clouded the investment climate and monetary framework in the past. Moreover, the new government has to cope with the dependence of FDI on ensuring a favorable investment climate and the decreasing net inward foreign direct investments since late 1990s (*European Commission* 2006: 25).

A survey from the European commission made in 2009 revealed that Poland is among the second best prepared countries for the future demographic change, which will have positive impacts on public debt (Tagesanzeiger: 14.10.2009), however contains also space for structural reforms.

4.4 Conclusion

Poland does not fulfill the required convergence criteria. The deficit is rising so that the short and medium term expectations are pessimistic. The fluctuation of the *Zloty* as well as the persisting political uncertainties does not lead to a change on Poland's status as a "Member State with derogation" (*European Commission* 2006: 25). Poland is yet not able to participate on the Euro area and it will probably take quite a while until the country can improve its performance.

The credibility test "par excellence" is the budget and the general attitude of the administration towards cooperation on the European level. If the highest representatives of the country are suggesting printing money to solve budgetary problems like the former administration did, inflationary expectations will remain high. In addition, since Poland is a large country, the ECB and the European Commission won't accept and should not accept any compromises for new members.

5 THE CZECH REPUBLIC

5.1 Convergence criteria

Czech inflation is volatile but however remained under the reference value in 2009 (*European Commission* 2006: 46). Previously, the weak labor market demand prevented an increase in wage inflation. Recently, the Czech economy observed a moderate increase of inflation rates due to the EU accession, higher administered prices (*European Commission* 2006: 46) and "as in other countries, developments in food and oil markets have also been increasing consumer prices" (*OECD* 2008: 3). Czech inflation rate has picked-up modestly in 2007 and 2008, which was primarily based on improved economic conditions and higher purchase taxes. Future developments of Czech exchange rate as well as the Czech tax policy was supposed to determine inflation rate in the medium term (*European Commission* 2006: 13), because "exchange rate movements strongly influence Czech consumer prices" (*OECD* 2008: 3). However, the financial crisis caused a huge drop to 0,36% in 2009 and is expected to remain low. The Czech Republic currently fulfills the criterion on price stability.

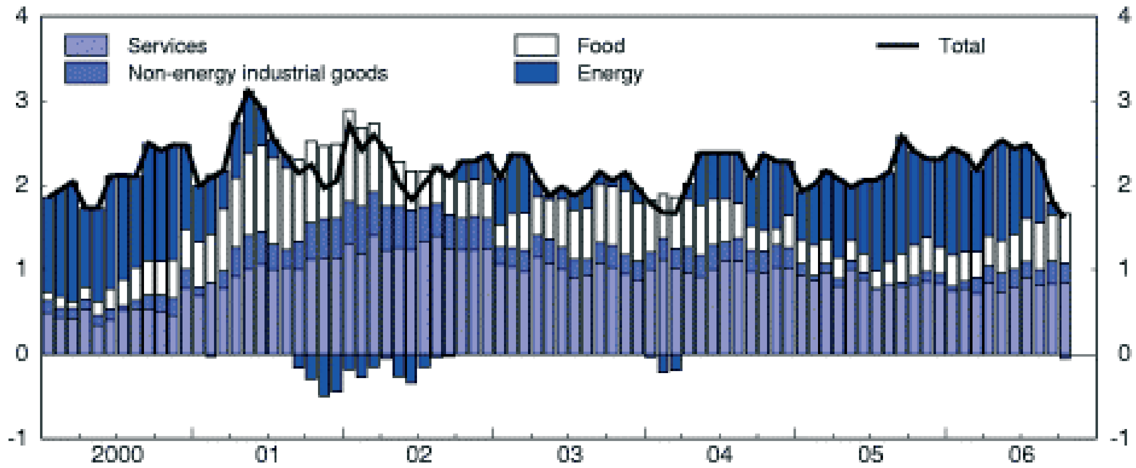


Figure 10: Contributions to inflation. Year-on-year percentage change (Source: OECD (2007a)).

Concerning public deficit and debt the Czech Republic is under the reference value of annual government deficit to GDP by 3.0 percent in 2009, and within the frame permitted by convergence criteria on gross government debt to GDP by 27,9 percent in 2009 (*European Commission* 2007: 220). The Czech government increased social expenditures after 2000 which were not backed up with additional tax revenues: This gap has led to higher annual deficits. Only the stronger economic growth in recent years has prevented severe fiscal problems. However, the medium-term prospect does not indicate improvements. Additional social and educational expenditures have been drafted in budget for 2007 (*European Commission* 2006: 50). Moreover the additional spending in social measures will increase the deficit up to 4,9% and the gross debt to 37,9% according to a forecast from the European Commission. The forecasts for both made by the Czech Republic assume lower values based on higher GDP growth rates for 2010 and 2011.

	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	3,5	2,7	1,0	1,2	1,6	1,5	1,2
Gross government debt to GDP	30,4	29,4	28,9	28,8	27,9	26,8	25,5

Figure 11: Budgetary developments 2005-2011, Czech Republik (% of GDP). (Source: European Commission 2007: 228; European Commission 2009: 203.).

The Czech Republic does not fulfill the exchange rate criterion therefore did yet not join ERM II (*European Commission* 2006: 14). Constant upward revaluation of the *Czech Koruna* and low inflation of recent years both have been reflected in the development of short-term interest rates (*European Commission* 2006: 52). However, the average long-term interest rate did never exceed the reference value since accession to the EU, which underlines successful disinflation. The Czech Republic fulfils convergence criterion on long-term interest rates (*European Commission* 2006: 52).

5.2 Current economic situation and recent structure reforms

The Czech Republic shows a differentiated picture in terms of the economic structure: On the one side the average hours of work per week are with 41,2 hours above the EU average (Statistisches Bundesamt 2009: 37.), effective age of retirement is by 62 years (Eurostat 2007: 3), which is both above the legal age and the EU average with 59,5 years, and the spending in health care is in the middle among the EU countries. However the ancillary labour costs are with 38% high (Statistisches Bundesamt 2009: 37.). Corruption is still a big problem, where the Czech Republic has the position 52 in the corruption perceptions index (Transparency International 2009: 6.) and the public spending for pensions is relatively high with 7,3%.

5.3 Additional factors

“The improved economic performance is being driven by export oriented manufacturing reflecting further deepening of the economy’s involvement in international production chains” (*OECD* 2008: 3). The Czech economy enjoys a high degree of their foreign ownership of financial intermediaries and realizes large trade and FDI relations with other EU members. The higher inflow of net FDI leads to positive financial account of 8 percent (*European Commission* 2006: 14). However, portfolio investments flows remained volatile (*European Commission* 2006: 56) and due to the delay of privatization proceedings in the 1990s, the Czech Republic has a “less developed financial sector in comparison with EU-15” (*European Commission* 2006: 53). The intensity of financial intermediation is smaller than those of other similar EU countries (*European Commission* 2006: 53). The equity market is comparatively small with only 39 listed shares on the Prague Stock Exchange (*European Commission* 2006: 53).

5.4 Conclusion

By 2010 the Czech Republic fulfilled three of the four required convergence criteria, but not the exchange rate stability. The budget deficit is still a major concern and will worsen, if the economy will not find back to the way of recovery. The Czech Republic suffers under the consequences of the delay in privatization proceedings in the 1990s, the financial sector is small and was also hit strongly by the Financial crisis. Considering the performance of the economy, the Czech Republic has made good progress and with regards to the good empirical data and the remaining problem with the exchange rate there is the assumption that a soon accession is politically not desired.

6 HUNGARY

6.1 Convergence criteria

Hungary was always a special case even during the time of Soviet occupation and the centrally administered economy. At the beginning of transition in 1990, experts expected the country to be the fastest and most successful on their way to become a competitive market economy. Nevertheless, the development of Hungary, especially the stability performance, has been unsatisfactory and disappointing for many specialists.

The Hungarian inflation rate has been, and still remains, volatile: Originally from a high level it declined to 4 percent in 2003, then has picked-up since 2004 attributed to higher prices in energy and food. It declined and has picked-up again in 2006 as a result of higher indirect taxes (*European Commission* 2006: 97). Several measures implemented in 2006, such as higher administered prices and indirect taxes, as well as health and education reforms has increased inflation rate in 2007 (*European Commission* 2006: 20). A smooth conversion to a low rate is not likely right now. Even after the strong impact of the financial crisis the inflation rate remained high with 5,6% in 2009.

Year	2003	2004	2005	2006	2007	2008	2009
HICP	4,7	6,8	3,5	4,0	7,9	7,5	5,6

Figure 12: Measures of inflation and related indicators. (Source: Eurostat - Tables, Graphs and Maps Interface (TGM) table 2010.)

With a gross government debt to GDP by 72,5 percent in 2009 Hungary is far away from the references value and there is no sign for substantive change (*European Commission* 2007: 255). "The 2006 deficit, at 9.2% of GDP, indeed marked another peak in Hungary's strong electoral spending cycle. The government's goals imply breaking out of this" (*OECD* 2007c: 3). Since 2001, the Hungarian government pursuit year after year an expansive fiscal policy which leads to large increases in public expenditures, especially public wages and social transfers (*European Commission* 2006: 20), in contrast to investors' expectations, that the objective to adopt the single European Currency would commit Hungarian government to satisfy convergence criteria (*Národná Banka Slovenska* 2005: 9). These expenditures should have been reduced corresponding to tax cuts, but did not (*European Commission* 2006: 21). In spite of an immense privatization, the Hungarian government did not prevent debt and deficit increases (*European Commission* 2006: 102). However the emergency credit given by the IMF and the structural reforms Hungary has started until the election of the new conservative government in 2010, Hungary could lower the annual deficit under 3,0 % and seems to be on a good way to recovery. Further reforms are still needed, since European Commission forecasts predict a gross debt by 82,9% of the GDP in 2011.

With regards to exchange rate stability, *Hungarian Forint* is not participating on ERM II, which automatically excludes Hungary from being part of the *Euro* area for at least next two years (*European Commission* 2006: 21). Likewise, the long-term interest rates have never been under 6.2 percent, quite the contrary the average LTIR is at 7.1 percent (*European Commission* 2006: 104). Moreover, yield spreads vis-a-vis *Euro* widened since 2006 and investors do increasingly avoid Hungary due to extended fiscal adjustments (*European Commission* 2006: 21).

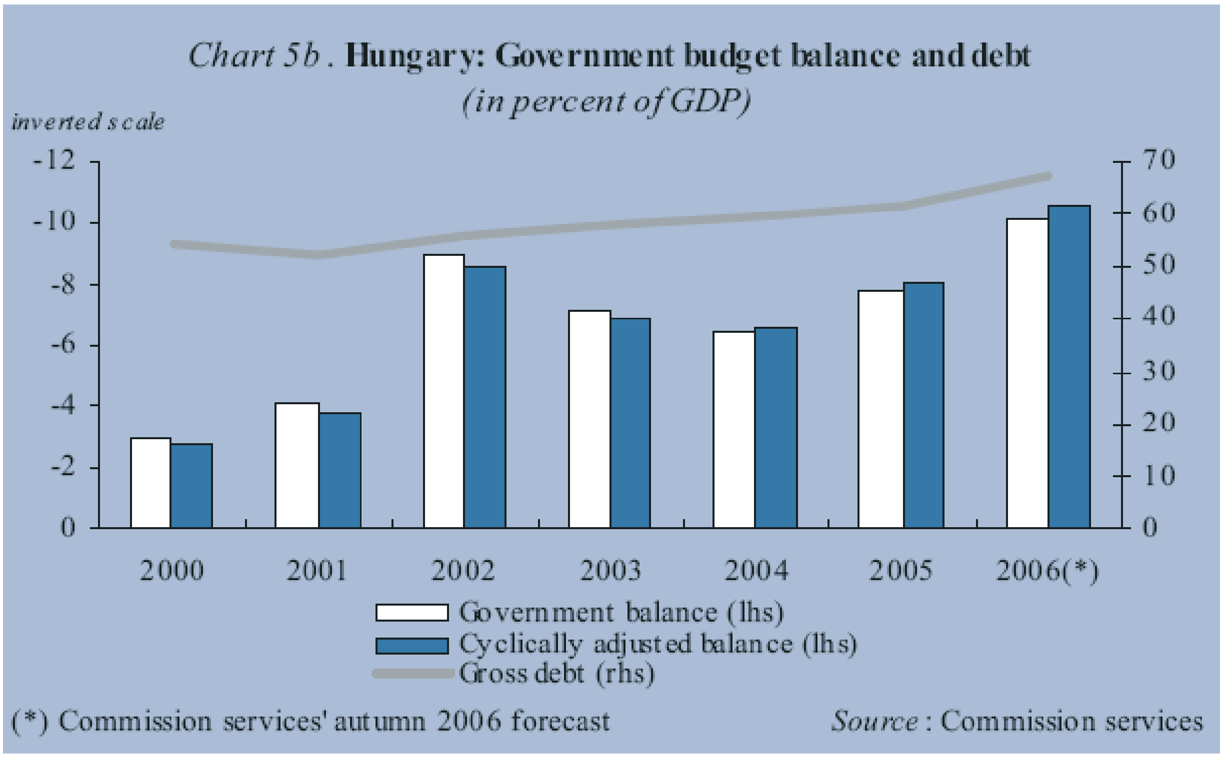


Figure 13: Hungary: Government budget balance and debt. (Source: European Commission 2006: 21)

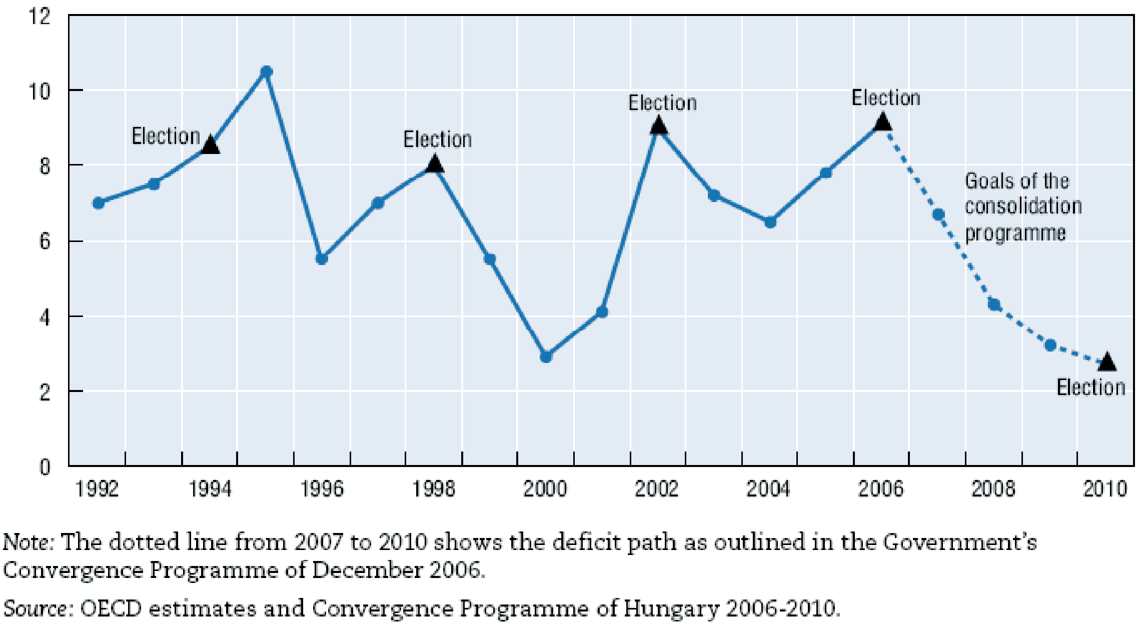


Figure 14: Hungary: General government deficit, History and Goals in % of GDP (Source: OECD 2007c: 3).

6.2 Current economic situation and recent structure reforms

Hungary suffers large structural problems due to a lack of needed reforms. Hungarian population wants to enjoy Western European lifestyle which is not backed up with an according productivity. On the one side the average hours of work per week are with 40,5 hours above the EU average (Statistisches Bundesamt 2009: 37.). However the effective age of retirement is by 58 years (Eurostat 2007: 3), and therefore under both the legal age and the EU average with 59,5 years. The spending in health care is in relatively high. The ancillary labour costs are with 42% above the EU average of 36% (Statistisches Bundesamt 2009: 37.) . Corruption is still a big problem (Transparency International 2009: 6.) and the public spending for pensions is relatively high with 8,5%. In the last year Hungary has increased their VAT from 20% to 25%, cancelled the subsidies for public transport, energy cost and health care and reduced both the number of employees and the salary in the public sector.

6.3 Additional factors

The integration of Hungarian economy with the EU is remarkable, with a high degree of foreign ownership of financial intermediaries (*European Commission* 2006: 21). Hungarian's account deficit decreased due to smaller deficits in goods and services. However, the development of the Hungarian economy in recent years remains disappointing. Hungary suffers a large deficit in public savings, less portfolio inflows and receives negative publicity regarding the foreign investor's assessment of Hungarian economic fundamentals (*European Commission* 2006: 108).

A survey from the European commission made in 2009 revealed that Hungary is along with Poland among the second best prepared countries for the future demographic change, which will have positive impacts on public debt (Tagesanzeiger: 14.10.2009), however contains also space for structural reforms.

6.4 Conclusion

"The biggest test of the consolidation program will be from 2009 onwards, when structural reform is supposed to deliver more of the deficit reduction, but when also pressures for new spending measures are likely to mount due to elections in 2010" (*OECD* 2007c: 3). By 2007 Hungary was not in a position to claim fulfillment of the convergence criteria. The inflation rate is too high to accomplish required criteria and remains volatile. Both government deficit and debt are excessive, and Hungary is not participating in ERM II and the long-term interest rates moved above reference value. Not even the medium-term prospective does reveal any signs for a soon accession of Hungary to Euro area. The biggest problem is the fundamental lack of long term commitment of the Hungarian government to reach the objectives of convergence criteria.

7 BULGARIA

7.1 Convergence criteria

The inflation rates keep increasing since 2004 but dropped strongly in 2009 to 1,7%. However the inflation is very volatile and can pick up every time again. Currently Bulgaria fulfills criterion on price stability, however the data from the past reveals that Bulgaria is strongly dependent on foreign investments and good economical circumstances. The danger is that the inflation rates will re-pick up after the economy has recovered and threaten the price stability.

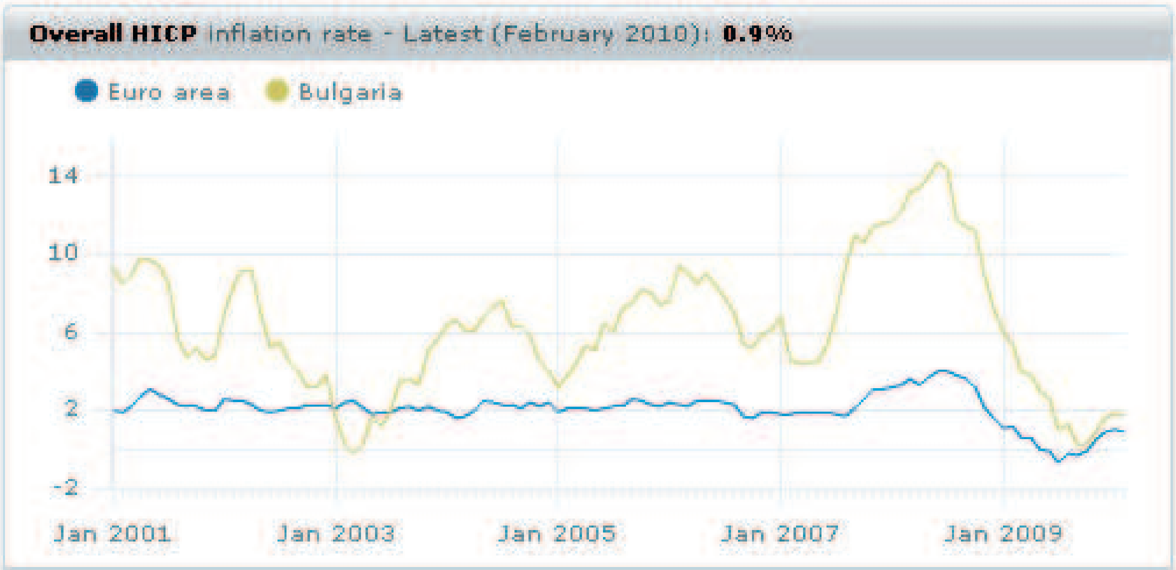


Figure 15: Measures of inflation and related indicators. (Source: Eurostat - Tables, Graphs and Maps Interface (TGM) table 2010.)

The annual surplus remains stabile by 3,0% and the gross debt is low by 15,2%. However just with regards to the last 3 years' data the exact fulfillment leads to the suspicion, that the figures are well-calculated to fulfill the criterion on public deficit. Recently there are incidents that official data are wrong and lower than in reality – a situation as Greece has experienced (FAZ, 13 April 2010, page 18 „Mogelnder Musterschüler").

	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	-1,9	-3,0	-0,1	-3,0	-3,0	-3,0	-3,0
Gross government debt to GDP	29,2	22,7	18,2	15,4	15,4	15,3	15,2

Figure 16: Measures of inflation and related indicators. (Source: Eurostat - Tables, Graphs and Maps Interface (TGM) table 2010.)

In terms of the exchange rate stability Bulgaria does not participate on ERM II and therefore does not fulfill the required criterion. The long term interest rate is below the reference value and fulfills criterion.

7.2 Current economic situation and recent structure reforms

Bulgaria's economic structure can compete with neighbor countries: The average hours of work per week are with 41,7 hours above the EU average (Statistisches Bundesamt 2009: 37.). The effective age of retirement is by 62,4 years (Eurostat 2007: 3), and therefore over both the legal age and the EU average with 59,5 years. The spending in health care is in relatively low with 4,3% and the ancillary labour costs are with 25% under the EU average of 36% (Statistisches Bundesamt 2009: 37.) . However corruption is still a big problem (Transparency International 2009: 6.): Bulgaria has the position 71 and is on top along with Romania and Greece among the EU members. The public spending for pensions is relatively high with 9%. In 2008 Bulgaria introduced a flat tax by 10% (SLC Europe: 2008). Anti crisis package consists generally of higher public expenditures (higher pensions, higher subsidies etc) (Auswärtiges Amt. Bulgarien - Wirtschaft: 2010.).

7.3 Additional factors

The integration of Bulgarian economy with the EU has progressed and the stability performance is not bad. Bulgaria is economically catching up very fast, however institutional reforms are still weak and the central bank independence not fully achieved.

Moreover according to a survey from the European commission, Bulgaria is among the best prepared countries for the future demographic change, which will have positive impacts on public debt (Tagesanzeiger: 14.10.2009).

7.4 Conclusion

Deficit and debt are very low, the inflation low, but volatile. Bulgaria lacks of stronger structural reforms and the higher social spending can increase deficit. An accession to the Euro area will be at the earliest in 5-8 years.

8 ROMANIA

8.1 Convergence criteria

The original high inflation declined to 4% in 2007. However in spite of the impact of the financial crisis the inflation rate remains high and along with Hungary now one of the countries with the highest inflation rate.

Figure: 17. ECB: Inflation and the euro. Source: http://www.ecb.int/stats/prices/hicp/html/inflation.en.htm

The annual deficit continuously exceeded the required criteria. The 2011 forecast with a deficit by -2,9% seems to be too optimistic. The forecast from the European Commission predict an annual deficit by -5,6% in 2011. However the gross debt is with 22% far away from the convergence limit of 60% and therefore fulfills that criterion.

	2005	2006	2007	2008	2009	2010	2011 Forecast*
Annual government deficit to GDP	1,4	2,2	2,5	5,4	5,1	4,1	-2,9
Gross government debt to GDP	15,8	12,4	12,7	13,6	18,0	20,8	22,0

Figure 18: Measures of inflation and related indicators. (Source: Eurostat - Tables, Graphs and Maps Interface (TGM) table 2010.)

In terms of the exchange rate stability Romania does not participate on ERM II and therefore does not fulfill the required criterion. Concerning long-term interest the value of Romania was in the last three years always around 7,1 % and therefore above the reference value. Romania does not fulfil the long-term interest criterion

8.2 Current economic situation and recent structure reforms

Along with Bulgaria the economy of Romania can compete with its neighbor countries: The average hours of work per week are with 41,7 hours above the EU average (Statistisches Bundesamt 2009: 37.). The effective age of retirement is by 64,7 years (Eurostat 2007: 3), and therefore over both the legal age and the EU average with 59,5 years. The spending in health care is in relatively low with 3,9%, spending in pension with 6% as well and the ancillary labour costs are with 34% under the EU average of 36% (Statistisches Bundesamt 2009: 37).

However corruption is still a big problem (Transparency International 2009: 6.): Romania has the position 71 and is on top along with Bulgaria and Greece among the EU members. Romania has a low pressure on public finances with regards to high retirement age and working hours and comparatively low spending on pensions and healthcare. The IMF gave Romania a credit over 13 billion Euro, related to macroeconomic conditions, such as reduction of salaries for employees in public services, which are supposed to be realized in 2010.

8.3 Additional factors

The European „enthusiasm“ in Romania is extraordinary and the economic catch-up process is very strong. Until the year 2008 the private consumption was very strong, however decreased with the financial crisis. On the other side the fiscal consolidation is still a major concern for Romania and institutional reforms and anti-corruption measures are a real challenge.

8.4 Conclusion

Almost on all levels Romania needs to improve. Stronger structural reforms are pending. However the first will be realized in 2010 and the European enthusiasm will help to introduce stronger reforms. Accession to Euro seems to be possible at the earliest in the long-term (8 years).

9 Greece

9.1 Convergence criteria

Greece suffered under continuously high inflation since accession to the Euro area. A strong decrease happened in 2009 due to recession, but picked up again at the end of 2009. The inflation is currently by 3.9% (March 2010). However the inflation increased again due to higher taxes. The impact of the sharp recession and the consequences of the reform program in order to get support from the EU are hard to predict.

Year	2003	2004	2005	2006	2007	2008	2009
HICP	4,1	2,7	2,9	3,3	2,6	4,4	1,3

Figure 19: Measures of inflation and related indicators. (Source: Eurostat – Tables, Graphs and Maps Interface (TGM) table 2010.)

Figure 20: ECB: Inflation and the euro. Source: http://www.ecb.int/stats/prices/hicp/html/inflation.en.htm

Greece admitted in November 2009 to have hided public debt over years: Real debt by 113% of GDP in 2009 and deficit for 2009 was revised (from 3.7%) to 12.5% of GDP (*European Commission*, 2010: 3). Greece needs to refinance debt in 2010 – interest rates went up to 7,5% in April 2010. Up to now, it remains unclear which institution might organize and supervise the help for Greece and their reform efforts. The analysis clearly shows that Greece does not fulfill the criterion on gross debt and public deficit.

Concerning long-term interest the value of Greece is currently by 6.24% (March 2010), from 5.87 in March 2009 and 4.42 in March 2008 (ECB: Long-term interest rate statistics for EU Member States, 2010.). With regards to the current situation it is expected to increase, so that Greece does not fulfill the long-term interest criterion.

9.2 Current economic situation and recent structure reforms

Greece suffers large structural problems and is worst than almost all Eastern Europe countries who want to join the Euro area: The average hours of work per week are with 39,9 hours under the EU average (*Statistisches Bundesamt* 2009: 37.). The effective age of retirement is by 62.4 years (*Eurostat* 2007: 3), and therefore over both the legal age and the EU average with 59.5 years. The spending in health care is in the middle of all countries with 5,1%, however the spending in pension with 11,5% as well as the ancillary labor costs with 36% (*Statistisches Bundesamt* 2009: 37.) really needs reforms and to be lowered. The payment reduction in pensions is one of the goals of the current government to cope fiscal the problems. Corruption is still a big problem (*Transparency International* 2009: 6.): Greece has the position 71 and is on top along with Bulgaria and Romania among the EU members.

The VAT has been increased to 21% (since 15th Mar 2010), tax as well for higher incomes and even for the Greek church, cancellation of tax reduction for certain sectors have been done (taxi drivers, layers, doctors, sportsmen) and stronger controls of tax declarations will be effectuated (*Der Standard*: 14. April 2010.). The Greek government plans to reduce debt on GDP from currently 12,7% to 8,7% (*European Commission* 2010: 3).Still this year the government planned to increase the age of retirement, salary cuts for employees in public sector, reduce pensions, layoffs in public sector and further measures

9.3 Additional factors

The Greek economy is highly integrated with the EU, the trade and FDI relations with other EU are extensive and Greece has a high degree of foreign ownership of financial intermediaries. Moreover strong shipping and tourism can help Greek economy to balance negative effects.

However Greece suffers inelastic public spending: The Greek economy based largely on the public sector (40% of GDP) (*European Commission*, 2010: 3).and a sudden increase in taxes and cuts in salaries will affect economy very hard.

9.4 Conclusion

Greece proves to be the most problematic case of all EU members. They got access to the EU on the basis on faked data, they maintained that unfavorable practice and right now they are on the edge of bankruptcy. The fact that they are already member of the Euro area makes things even more difficult. In the case of bankruptcy, the prolongation of Euro membership would surely not be a good solution. But neither favorable is the option to reintroduce the old currency *Drachme* because it is hard to imagine how the Greek central bank could avoid the total collapse of the exchange rate against the Euro.

Financial markets clearly demonstrate the main problem of Greece: the lack of credibility and the enormous structural problems. Economically it should not be part of Euro zone and needs to run reforms. The next six to twelve months will decide about Greece‘s future in Euro the zone.

10 GENERAL CONCLUSIONS

Analyzing the data from current research and the official European institutions, it seems clear that a fast integration of the Eastern European members into the common currency area is not likely and not recommendable. But it is also not convincing at all to keep Greece in the Euro zone since they perform much worse compared to other Eastern European members, like the Baltic States, e.g. These states, despite all their differences, might be eligible in the near future because they perform quite well in the most important area of testing; the attitude towards public debt. They have developed some kind of a “stability culture” and they are cooperating very well with their European neighbors and the European institutions.

Eastern European member states are economically very differently prepared for the future and can be divided into three groups: The first group consists of the Baltic countries Estonia, Latvia and Lithuania who have been hit stronger than the other countries by the financial crisis, but also who organized and implemented credible institutional reforms and have a better basis for the next years once the world economy recovers again. These countries have a strong commitment to the Euro, which is mainly based on their experience in the Soviet Union and their deep wish to be more integrated with Western Europe. Moreover, they have recognized and enjoyed in the past years the advantages of liberalizations in the economy. Both facts have led to the situation that their governments were able to suggest hard reforms within one year to face the crisis and are better prepared for the future than anybody else in Europe.

The second group consists of Poland and the Czech Republic. They have a longer tradition of reforms but were not able to run all necessary changes due to political obstacles. The economies are in fact currently best prepared to adopt the Euro, however with regards to some missing reforms there are threats for the midterm. In both countries the advantages of Western Europe are recognized, however they see both also the advantages of an own currency and also have a modest critical position to be subordinated under an EU regime. Liberty and national pride is very important and in fact the commitment towards the United States of America seemed in past stronger than to Western Europe after the long history and suffering in the socialist block. Since their gross debt is not yet too high, they have no clear advantage of adopting the Euro to lower their interest rates and maybe devaluate their currencies in case it is favorable.

The members of the third group are Hungary, Romania and Bulgaria. Romania and Bulgaria have a totally different level of economical prosperity with regards to Hungary, however they share one common challenge: They all still need to run deep structural reforms and are not able to adopt the Euro even in the midterm. Hungary will have the chance to start reforms this year with a new government. Romania and Bulgaria have got warnings from the European Union to face their problems with corruption. The commitment to adopt the Euro is very high in both Romania and Bulgaria, however in Hungary there are strong powers who have a very critical position towards the European Union and are willing to blame the EU for internal economical problems. Just deep reforms with a soon recovery of their economies will be able to overcome that obstacle.

Ironically, the financial crisis has led the countries somehow towards a better position to adopt the Euro: The crisis hit many countries so strong that a simple "business as usual" wasn't able to continue. Baltic tigers passed all other countries in terms of realized reforms so that they will be best prepared in the midterm. Poland and the Czech Republic will need to establish reforms and they can hold the financial crisis responsible for that instead of always blaming the convergence criteria for home-made problems. This will help to find support in the population, since the adoption of the Euro and the corresponding regulatory framework is a free choice, however the financial crisis and their consequences are not free to choose.

Hungary was running strong reforms in the last 12 months and the crisis gave the last political shot to a government which already lost confidence after scandals back in 2006. The strong political swing could help the country to easily introduce further reforms, but the right-wing parties have a very critical position towards the EU which raises new concerns. Romania and Bulgaria already have a strong commitment, but they need to further intensify their efforts in the more difficult economical environment.

Furthermore, it has to be acknowledged that the Euro became a parallel currency in all these countries and it will be quite interesting to observe if *Gresham*'s law will also hold for these countries, and the stronger currency will push the national currencies aside without an official acceptance of the Euro. In Romania or Bulgaria, for example, the Euro is already some kind of official currency and used (and preferred) all over the country, even though these countries are far away from starting official negotiations about an access to the Euro area.

The ECB might run into a very interesting application of *Gresham's* law in the near future: They have to admit that the *Visegrad* states might not be strong enough to adopt the Euro – but at the same time the Euro is spontaneously taken over by the economy.

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Abbreviations:

CEE-4	Central and Eastern European EU members: Poland, Hungary, Slovakia and the Czech Republic
CZK	Czech koruna
EUR	euro
EEK	Estonian kroon
ERM II	European Exchange Rate Mechanism II
FDI	Foreign direct investment
Forint	Hungarian currency
GDP	Gross domestic product
HUR	Hungarian forint
LTIR	Long-term interest rates
LVL	Latvian lats
PLN	Polish zloty
SKK	Slovak koruna

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