SINGLE EUROPEAN CURRENCY EXPERIENCE OF NEW MEMBER STATES OF THE EUROPEAN UNION – PROBLEM OF NOMINAL AND REAL CONVERGENCE

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Abstract

The aim of the paper is to review the economic development of those countries that recently adopted the Euro and to point out possible consequences when nominal convergence is given higher priority than real convergence of an economy.

This paper primarily focuses on a comparison of real and nominal convergence within the accession process to the European monetary union. It stresses the unsuitable convergence process and underestimation of the importance of real convergence in the case of two new member states. Conclusion of this paper contains a decision, whether joining the euro area has been beneficial for these two countries. The two economies taken under review were Slovenia and Slovakia, which adopted single European currency at the beginning of 2007, resp. 2009.

The issue of real and nominal convergence is crucial for countries joining the euro area. But there is a problem by assigning level of importance to the individual types of convergence criteria. Successful joining this monetary area requires complete fulfillment of five nominal convergence criteria that combine both monetary and fiscal elements. These criteria should prevent from Euro adoption in those countries, whose fiscal or (and) monetary performance could negatively influence the working of the Euro-area. But the problem that might not be seen at first glance is that there isn’t any part of review process, which
would deal with the question of how the joining country has come to the fulfillment of these nominal criteria. The review process doesn’t contain both “if” and “how” questions, but only the “if” questions. The “how” questions should be dealt with within the review process of real convergence, but there isn’t any, because real convergence is only vaguely defined in the Euro-area access conditions. There is no exact determination to which extent should the economic cycles be synchronized, what level of GDP per capita should country achieve or what level of average wages and structural similarity of the economy should be achieved. But the most important “missing” condition within real convergence is the condition of economic “naturalness” of the whole convergence process, because that is one of the most important requirements for success of the whole monetary integration process. If country “naturally” (in economic terms) comes to the fulfillment of nominal convergence criteria, then it doesn’t have to worry much about possibly negative impact of joining of the euro area (especially loss of autonomous monetary policy). But if any country comes to the fulfillment in an economic “unnatural” way, or if any of reviewed economic indicators shows an unusual, but still tolerable development within the criteria, this situation may become a source of potential future problems after joining the EMU. This case is shown and described in the paper using recent development in two above mentioned countries, Slovenia and Slovakia.

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Introduction

The aim of this paper is to review economic development of two countries that recently adopted single European currency and to point out possible consequences of those situations, when nominal convergence is being given higher priority to than to the process of real convergence of an economy.

Thus, this paper primarily focuses on comparison of real and nominal convergence and their impacts on accessing process to the European monetary union, and stresses out possible unfavorable effects of convergence process and underestimation of the importance of real convergence in case of two new euro-area member states.

The two economies that were taken under review are Slovenia and Slovakia, which adopted single European currency at the beginning of 2007, resp. 2009. Under review, on the other hand, weren’t taken other two new EU member states that also joined euro area (Malta and Cyprus, both since 2008), because their economies are too small and different in structure from the other member states. In both these countries comes the biggest part of national GDP from tourism, which has been already using euro as the main currency for many years. Therefore, the adoption of euro was logical consequence for both these countries and didn’t represent any bigger economic change.

The issue of real and nominal convergence is crucial for countries joining the euro area. But there is a problem by assigning level of importance to the individual types of convergence forms and convergence criteria. Successful euro adoption requires complete fulfillment of five nominal convergence criteria that combine both monetary and fiscal elements. These criteria should prevent from euro adoption by those countries, whose fiscal or (and) monetary performance could negatively influence performance of the euro area. But the problem that might not be seen at first glance is that there isn’t any part of review process, which would deal with the question of how the joining country has come to the fulfillment of these nominal criteria. The review process doesn’t contain both “if” and “how” questions, but only the “if” questions. The “how” questions should be dealt with within the review process of real convergence, but there isn’t any, because real convergence is only vaguely defined in the euro area access conditions (exact wording is: country should try to accomplish the highest possible level of real convergence). Consequences of underestimation of real convergence process is described in the paper using recent development in two above mentioned countries, Slovenia and Slovakia. Theoretical background is being discussed in the second part of this paper.

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The case of Slovenia

Brief introduction

Slovenia joined the euro area at the beginning of 2007 and experienced directly in the first year of its euro area membership negative consequences arising from economic “unnatural” approach towards fulfillment of nominal convergence criteria in the recent past. Slovenia had been experiencing for the whole 1990’s and first years of the new millennium big problems with reducing relatively high inflation rate. Since inflation criterion is one of the five nominal convergence criteria, this situation constituted an obstacle in their fulfillment. The other four criteria had been fulfilled without any bigger problems. Therefore Slovenia had concentrated on lowering the inflation rate and at that time started the process of economic “unnaturalness”. In the end, it managed to lower the inflation rate to the needed level, but only by concluding an unwritten agreement between Slovenian government and labor unions in Slovenia on substantial lowering their wage claims for those years that were important for calculating inflation rate criterion value. Final outcome of this agreement appeared to be successful and Slovenia joined the EMU. But afterwards labor unions increased again their wage claims to compensate the low wage rise in the past years, which directly influenced price level in Slovenia. But since the economy abandoned its autonomous monetary policy (due to euro adoption), it hasn’t had any standard economic tool to react to this situation (e.g. can’t raise interest rates).

Detailed description and explanation of the situation

As it is shortly described above, Slovenia had been experiencing a relatively long period of higher inflation rate back in the 1990’s and at the beginning of the new millennium. One of the most important reasons of that development (apart from rising price level to balance its level in western market economies) was rapidly growing level of wage claims coming from all sectors of Slovenian economy. The reason was clear – people saw fast growing prices and wanted to retain their real income level. The whole process was speeded-up by labor unions, who are responsible for collective wage bargaining.

Problem was not that much rapidly growing level of labor productivity, which caused falling competitiveness.
Inflation rate reached its peak in 2001 by achieving nearly 10% rate\(^3\) (as can be seen from Graph 1). Slovenian central bank had to react to this unfavorable development by increasing the interest rates (main refinancing operations rate development is shown on the graph), which were in 2001 about 3.5 percentage points above the euro area rates. This raising of rates really helped start reducing the inflation rate (and thus inflation differential between Slovenia and the euro area), but interest rates differential still remained nearly the same.

Graph 1 – Comparison of euro area interest rates development with Slovenian central bank interest rates and Slovenian inflation rate development

Data source: Eurostat, Bank of Slovenia

In 2004 (May 1), Slovenia and other 9 countries joined the EU and some of these countries (including Slovenia) immediately started their euro adoption process. Slovenian officials and government knew that if they wanted to adopt euro in their country, they had to continue lowering the inflation rate (and also inflation

\(^3\) Graph depicts development of special form of inflation - 12-month average rate of change that reflects long-term inflationary development and is in a way a method for seasonal adjustment. This inflation rate is also used in calculations for inflation criterion within Maastricht convergence criteria. If we depicted standard form of inflation (annual rate of change – compares given month with the same month of previous year), inflation rates in 2001 would reach up to the mentioned 10%.
differential regarding euro area that had been still too high) and keep it down as long as possible.
Graph 2 – Development of inflation differential between the euro area and Slovenia

Data source: Eurostat; own calculations

But the officials did not want to raise interest rates too much in order not to threaten the growing economy. The only way was to convince Slovenian workers and labor unions to reduce their wage claims for a certain period of time (until successful euro area joining). In the end, they managed to do that and unofficial agreement between the government and labor unions came into effect.

The result was as intended. As it can be seen from Graph 3, wage increase rates fell dramatically during 2004 to 2006 (almost up to no increase). That was a reason for further lowering the inflation rate and its stabilizing since second half of 2005, which was important for passing the inflation criterion of Maastricht nominal criteria. The inflation differential between Slovenia and the euro area had been also decreasing and reached its minimum value (almost zero) in the first half of 2006.

In April and May 2006, when it came to preparing of Convergence report that was crucial regarding possible euro adoption, Slovenia managed to lower its inflation rate (based on 12-month average rate of change) to 2.3 %, which was slightly
under the computed value of this criterion (2.6 %)\(^4\). This meant that the most serious obstacle on a way to join euro area was relatively successfully tackled and solved. But the problems were about to come.

**Graph 3 – Nominal wages increase development in Slovenia**

Data source: Eurostat, Statistical Office of the Republic of Slovenia

The first problem was that Slovenia had to start adjusting its interest rates to the level of euro area. The aim was to minimize as much as possible the difference between interest rates in Slovenia and in euro area, because adopting euro also means adopting euro area interest rates. And the smaller the differences between these rates are, the smaller the possibility that a shock might occur is. The problem of Slovenia was that at the end of 2006, this difference was relatively high (about 1.5 percentage points) and there was a general trend in Europe of raising the rates\(^5\) by central banks (as illustrated by the example of euro area). But Slovenian central bank didn’t have much choice at that time. They knew about the inflation risk, but couldn’t raise the rates because of the above mentioned difference. If they had raised the rates, they would have risked a shock by adopting euro area rates that would have been much lower than the Slovenian

\(^4\) Source: 2006 Convergence report

\(^5\) Economies were doing well and there was a risk of their “overheating” and rising inflation rate.
ones. The officials decided to minimize the risk of this possible shock and they tried to make the level of rates converge, although they knew about the inflation risk.

Another problem was arising from the government deal with the labor unions. After successful euro area joining, there was no reason for them to keep their wage claims at a low rate. As it can be seen from Graph 3, at the beginning of 2007 the nominal wages started to rise again with pre-2004 rate again. This situation, together with the described interest rates adjusting process, influenced negatively the inflation development during 2007 and 2008. And there was no direct solution to this problem – by euro adoption gave up Slovenia also its autonomous monetary policy so it was no longer able to raise the interest rates (and lower the inflation rate). By looking at Graph 1 is it obvious that the euro area interest rates (implemented by common monetary policy) remained practically unchanged from the mid of 2007 until the third quarter of 2008, which didn’t constitute any positive environment for Slovenia. During that period they needed very much an interest rates raise to tackle the rising inflation. But common monetary policy is (and also has to be) based on preferring the interests of the whole area to the interest of single member economies. We can say that Slovenia (has) suffered from different development from other euro area member states.

It is important to state the main reason that caused this unfavorable development after euro adoption in Slovenia. I call this reason “economic unnaturalness” in convergence process. As it is going to be described later, Maastricht convergence criteria don’t evaluate the convergence process, they only determine whether the nominal criterion (in this case inflation criterion) has or hasn’t been fulfilled. And it is up to each country which way regarding criteria fulfillment it choose.

Slovenia went the wrong way. They didn’t care much about what they were doing, the only aim was to adopt euro as early as possible and whatever the costs could be. The officials knew about the inflation problem that represented the biggest obstacle. But it was clear that without some untraditional procedure would it be very difficult to pass the inflation criterion. We could say that if there hadn’t been the deal with labor unions, Slovenia couldn’t have adopted euro at the beginning of 2007 because of too high rate of inflation. Much more favorable situation would have been to let the inflation rate decrease approximately to euro area level (or slightly above it) as a natural economic process, without any one-time short-term intervention like the deal with labor union was. But in this case would this probably have lasted much longer\(^6\), but there would have been much less risk of unfavorable development in the future.

\(^6\) Current economic crisis caused lowering level of inflation in almost all countries.
The second possible risk that turned into a negative aspect was the development of central bank interest rates. When we look at their development during 2006, there was no sign of coherent development. Slovenian rates were above euro area rates, but they couldn’t be raised anymore in order not to increase the existing interest rates differential. On the other hand, Slovenia’s effort was to eliminate this differential as much as possible during 2006 to reduce the risk of possible shock after euro area interest rates adoption. But again, this has nothing to do with real economy convergence. During this period, Slovenia also needed to raise its interest rates to eliminate the risk of future inflation, but it decided not to, in order to eliminate the possibility of other shock connected with euro adoption. The right decision in this situation would be to postpone the adoption of single European currency until the interest rates don’t show higher level of compliance in terms of their development and height.

Economic cycles in all their form should be as much synchronized as possible. Unfortunately, it hasn’t happen in case of Slovenia.

The case of Slovakia

Slovakian case in brief

Slovakia also has had troubles resulting from underestimating of process of real convergence, maybe even with more serious long-term consequences. This problem includes other nominal convergence criterion than in case of Slovenia, the criterion of nominal exchange rate. It consists of two presumptions, whereas both have to be fulfilled. The first one refers to participation in the Exchange rate mechanism II (ERM II) for at least 2 years, the second one refers to stability of national currency against euro (national currency is pegged to euro in form of fixed rate and is allowed to move only in given fluctuation zone; country has to avoid any devaluation pressures – revaluation of central parity to euro is yet allowed). Slovakia had been fulfilling both presumptions of this criterion for the needed two years, but its currency had had to face strong revaluation pressures during the second year and in the end had to revaluate twice against the central parity to euro. And the mentioned rising strength of Slovak currency had (and has) caused the problem. At the time of conversion rate fixation against euro (July 8, 2008) reached Slovak currency its historical maximum - it had never been so strength before. But as it turned out, it was only a short-term market fluctuation of all Central-European currencies that all reached their peaks. After several weeks, all of them (except for Slovak currency that was already fixed against euro) began to depreciate against euro. It was a clear example of economic “unnaturalness”, because at the time of fixation wasn’t Slovak currency at its “natural” level (as can be seen comparing real and trend development in Slovakia on Graph 4). A
strong conversion rate against euro has been beneficial especially for people living in Slovakia because it has strengthened their purchasing power outside Slovakia, but it hasn’t been beneficial for almost all of the Slovak economy, because of its 80% orientation on export, especially to the euro area. This strong conversion rate disadvantages Slovak exporters (especially in comparison to exporters from other Central- and East-European countries, whose currencies depreciated strongly against euro in the second half of 2008 and at the beginning of 2009), which is even more negatively influenced by ongoing economic crisis.

Graph 4 depicts the development of two CEE-countries’ currencies, the Czech and the Slovak Koruna (same name in both countries). Both lines represent trend development for these currencies. We can see that their development around mid 2008 did not comply with the trends. Czech currency, after strong depreciation process, has stabilized approximately at the 2008 beginning value. But in case of the Slovak currency, there was no getting back at pre-appreciation value because of the mentioned fixation. Consequences of this differential development on two similar economies will be dealt with thereinafter. The whole illustration of the problem is to certain degree “enriched” by the ongoing economic crisis.

Graph 4 – CZK/EUR and SKK/EUR development

Data source: Czech statistical office, Statistical office of the Slovak Republic
Detailed description and explanation of the situation

This description and explanation is based on comparison of the development of the Czech and the Slovak economies. The Czech Republic (another CEE and neighboring country) was chosen because of its very high similarity to Slovakia\(^7\).

First of all, we will look at the development of external trade before and during the economic crisis. We can use the export index as an indicator of trend development\(^8\).

Graph 5 – Comparison of development of export indexes for the Czech Republic and Slovakia with CZK/EUR exchange rate development

![Graph showing comparison of export index development for Czech Republic and Slovakia](http://services.bepress.com/itfa/20th/art3)

Data source: Czech statistical office, Statistical office of the Slovak Republic

It is obvious when looking at Graph 5 that the value of export index for the Czech economy shows higher stability than in the case of the Slovak economy. This also applies to the period of the beginning of ongoing economic crisis. We can see that the value of the index dropped in case of Slovakia during 2008 almost to its two

\(^7\) Both countries have similar economy structure, are very open and export based. Both economic and cultural background is the nearly the same.

\(^8\) Import was not involved in the graphic illustration because of its very high degree of correlation (97 %) with export in both countries. Its involvement would make the graph less transparent.
thirds, whereas in case of the Czech economy the decrease amounted only to about 20%. During 2009 and first two months of 2010, as both economies have started to recover from their biggest downturn, values of this index tend to rise. First ten months of 2009 were more successful for the Czech economy, on the other hand last two months of 2009 and first two months of 2010 accounted for higher export index growth rate for Slovakia. But the explanation is not difficult – those higher rates of index are caused by low base value of previous year (2008/2009 turn).

But it is very important and interesting for this topic to follow up CZK/EUR exchange rate development. The value, at which was the Slovak Koruna pegged against euro, was too strong (i.e. that Koruna was overvalued). This might be a problem in those cases, when currencies of other competing countries depreciate against euro, which causes increase of price competitiveness of production from these countries with depreciating currencies. This situation occurred in Slovakia in the second half of 2008 and in the first half of 2009, when the Slovak Koruna was already pegged against euro (parity was stated at the value 30,126 SKK/EUR), but other CEE currencies started to depreciate strongly against euro, which, of course, made their products more price competitive when comparing to the Slovak ones. This may be one of the most important factors that caused steeper decrease in export of the Slovak economy compared to the Czech economy. This development in both countries also caused deeper downturn of the Slovak GDP compared to the Czech GDP.

We can get to similar conclusion when researching development of the Industry production index in both countries\(^9\), because its value depends primarily on demand coming from other countries (which by return influences level of export).

Also in this case, we could see higher values of this index (which means higher growth rate) in Slovak economy until second half of 2008. And again, the following downturn is more rapid in Slovakia than in the Czech Republic, which proves higher level of stability of the Czech industry.

As next, we can use the Industry new non-domestic orders index, which shows not only the impact of economic crisis, but also the degree of potential recovery of an economy. Its development is illustrated on the Graph 6.

\(^9\) Not shown graphically.
Analyzing this data, we come to a conclusion that is similar to the previous ones. New orders dropped more in Slovakia than in the Czech Republic at the end of 2008 and in the first half of 2009. Development of new industrial orders coming from euro area is also illustrated there in case of Slovakia. We can see that there was even bigger downturn regarding these orders compared to total non-domestic orders. One of the reasons was strong depreciation of other CEE-countries’ currencies (including CZK) that shifted away part of the demand to these countries with depreciating currencies. That’s why there is an illustration of CZK/EUR development. It is also interesting that since the end of 2008, the proportion of new industrial orders coming from euro area on total non-domestic orders has lowered from 77 % to 69 %\(^{10}\).

On the other hand, it should be pointed out that the value of nominal exchange rate is not the main variable of external trade. Export is a function of demand coming from country’s most important trade partners. Exchange rate has also

\(^{10}\) Values calculated by the author.
direct impact, but more likely in a form of a parameter, not a variable. If there is no demand, even maximum weak domestic currency can’t help. This can be illustrated on Graphs 7 and 8 regarding historical data for the Czech economy.

**Graph 7 – Comparison of the Czech export development with CZK/EUR development**

![Graph showing comparison of Czech exports and CZK/EUR development](image)

*Data source: Czech statistical office*
To conclude the recent development in Slovakia, it is important to say that exchange rate development is not the reason why Slovakian export has dropped since the second half of 2008 – the reason is decreased foreign demand arising from shrinking economies. But exchange rate development is the most likely reason why export from Slovakia has dropped considerably more than export from the Czech Republic.

As it was mentioned before, Slovakia fixed its currency against euro at bad time as all the currencies of CEE countries had been appreciating, but only for a very short-term. It was obvious that those exchange rates were out of their long-term development, partly caused by speculations on Slovak currency. It didn’t matter much by the other CEE countries, because they had the possibility to get back to their natural level, but this wasn’t possible for Slovakia any more. It could have

On the other hand, these countries suffered from relatively long period of huge exchange rate fluctuations.
waited several months to let the exchange rate stabilize and wouldn’t have experienced such a huge drop in export and GDP.

The same situation as in case of Slovenia happened during euro adoption process – another country that only headed towards Maastricht criteria fulfillment as if that was an economic area where no negative situation might occur. But it might occur based on uncontrolled nominal convergence process.

**What causes these negative situations in general and what could be the solution?**

The aim of the first part of this paper was to point out those negative situations that arise at country’s level and are determined by the decisions made by national authorities at national level. But this is not the most important reason. This development has to have some enabling factors staying outside national economies that only make use of them.

The most serious problem stays at EU level and concerns the way, how to measure the readiness of a euro area candidate country to adopt single European currency. The Maastricht (nominal) convergence criteria have been used so far. These criteria were formulated in the early 1990’s and became an essential part of primary EU legislation together with Maastricht treaty (as a part of it) since November 1993 and haven’t been reformulated since then.

Maastricht convergence criteria consist of five different views on economic convergence. Two criteria have fiscal and the rest monetary character. Their formulation is stated below.

1) **Price developments** - the criterion on price stability referred to in the first indent of Article 121(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that if, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.

2) **Fiscal developments** - the criterion on the government budgetary position referred to in the second indent of Article 121(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a

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12 Besides these five nominal criteria, there is also a central bank independency criterion.
13 Source: Convergence Report 2008, European central bank
14 Both fiscal criteria are involved.
Council decision under Article 104(6) of this Treaty that an excessive deficit exists”.

Article 104 sets out the excessive deficit procedure. According to Article 104(2) and (3), the European Commission prepares a report if a Member State does not fulfill the requirements for fiscal discipline, in particular if:

a. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:
   i. either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
   ii. the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value,

b. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

3) The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State.

4) The criterion on the convergence of interest rates referred to in the fourth indent of Article 121(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

As it was already mentioned before, the problem is how to measure truly economic readiness of a country to adopt euro. Many experts in Europe say that
Maastricht criteria are not sufficient, because of their focus only on nominal form of convergence process. Real convergence is completely missed out\textsuperscript{15}.

Involvement of real convergence into the process could be one of the solutions how to prevent occurrence of such situations that were described in the first part of this paper. It could be the right way to reveal possible future instability of the joining country. Real convergence criteria that could be used are stated below:

- **GDP per capita** (in power purchasing parity) – each country that wants to adopt euro should try to reach as highest level as possible. But it remains unclear, whether a minimum level should be set or not. And if so, what should be its value.

- **Comparative price level** of candidate countries – this issue is more important than the level of GDP. The explanation is quite simple – there are two price levels convergence channels, inflationary channel and exchange rate channel. Higher domestic inflation rate (than in euro area) means that national (or domestic) price level converge to euro area price level. The same happens if domestic currency (of a candidate country) appreciates against euro. And there is the point – if price level of a euro adopting country is not sufficiently close to the euro area one, the only chance that is left after euro adoption is to “suffer” from higher rate of inflation, because exchange rate appreciation is no more possible. That’s why countries should join the euro area only if they have sufficiently converged price levels in order to avoid increase in inflation rate in the future.

- **Synchronization of economic cycles** is another very important factor that should be definitely taken into consideration. The more the economic cycles are synchronized, the more the risk of possible asymmetric shock occurrence is eliminated. There is only one (common) monetary policy and if your economic development is to some extent opposite to the development of the other member countries, then there is a very high risk that the implemented monetary policy won’t fit your situation. All common policies of the EU (and especially common monetary policy of the euro area) are based on the principle “one size fits all”. That’s why synchronization of economic cycles is so important not only for the joining economy, but also for the whole monetary union, because its performance and success is logically based on performance and success of all its members.

\textsuperscript{15} There is only a short notice in the Treaty that country should try to accomplish the highest level of real convergence that is possible, which has absolutely no importance.
• Level of wages and labor productivity should be also as much similar as possible to the euro area, as well as structure of the economy.

• Also exchange rate volatility should be reduced to its minimum, but this factor is already partly incorporated in one nominal criterion and should also be applicable within the “naturalness” criterion.

• The last, but definitely not the least important factor would be already so many times mentioned naturalness in fulfillment of nominal convergence criteria. Considering this factor could have helped to prevent an unfavorable development in Slovenia or Slovak, as it was mentioned in the first part of this paper. Authorities of the EU, who are responsible for evaluation of fulfillment of nominal convergence criteria\textsuperscript{16}, would not be then within the evaluation process interested only in the final numbers (if a country fulfills those criteria), but would also have to consider, whether the achieved level of convergence could be long-term sustainable or not. If a country has have long-term problems with fulfillment of any of the nominal criteria, but then, in the year that is important for making the decision about possible euro area joining, this problematic criterion is fulfilled, then this development deserves a closer look in order to determine, what has caused such an improvement. If this process had been performed in case of Slovenia, it would not have probably adopted single European currency in 2007. Slovakian case should be viewed a little bit differently. There was also an unreasonable development of one economic variable that is important within nominal convergence (nominal exchange rate), but Slovakia itself had no direct impact on that development (in contrast to Slovenia, whose officials made the deal about wage increase). But Slovakian authorities should have said “let’s wait, what the exchange rate development within the few months will be”, because in the end, Slovakian economy gets primarily hurt. But they didn’t want to postpone the euro adoption, what they would have had to do in case of waiting for the future development of the exchange rate.

The fact that real convergence is not involved in the euro adoption review process is not the only problem of these nominal convergence criteria. There are many of them, more or less important.

Firstly, we could mention certain illogicality in the nominal convergence criteria calculation method. When looking back at the inflation and interest rates criteria, three EU member countries with lowest inflation rate are used for this calculation.

\textsuperscript{16} Mainly European Commission.
But there is a contradiction – why to involve all EU member states into criteria calculation and not only the euro area countries? It is important to adjust national inflation rate to the rate of the euro area, not the EU rate. This fact has had logically influence on the value of criteria since euro area enlargement and could influence the final decision about euro adoption in some country. On the below stated table, there is to see, which euro area non-members had been involved in the criteria calculations in Convergence reports from 2000 until 2008.

Table 1 – Euro area non-member countries involved in criteria calculations

<table>
<thead>
<tr>
<th>Convergence report</th>
<th>Involved euro area non-members</th>
</tr>
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<tbody>
<tr>
<td>2000 – May</td>
<td>Sweden</td>
</tr>
<tr>
<td>2002 – May</td>
<td>Great Britain</td>
</tr>
<tr>
<td>2004 – October</td>
<td>Denmark, Sweden</td>
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<tr>
<td>2006 – May</td>
<td>Sweden, Poland</td>
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<tr>
<td>2006 – December</td>
<td>Sweden, Poland</td>
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<tr>
<td>2007 – May</td>
<td>Sweden, Poland</td>
</tr>
<tr>
<td>2008 – May</td>
<td>Denmark</td>
</tr>
</tbody>
</table>

Data source: Convergence reports

It is obvious that all prepared Convergence reports were influenced by this illogicality and in one case, it had impact on decision about euro adoption in one candidate country, namely Lithuania.

The case of Lithuania

The aim of the Lithuanian government was to adopt single European currency in 2007, together with Slovenia. But its effort since the EU joining (in 2004) hadn’t been successful. Lithuania didn’t fulfill relative “closely” the inflation criterion – the reference value was calculated at 2.6 %, but the inflation rate for Lithuania amounted in the given period to 2.7 %. But if this inflation criterion had been calculated based only on euro area member countries, the result would have been different (see Table 2).
Table 2 – Two possible ways for inflation criterion calculation

<table>
<thead>
<tr>
<th>Countries involved (generally)</th>
<th>Countries involved in calculation (and their interest rate)</th>
<th>Reference value&lt;sup&gt;18&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>All EU member states</td>
<td>Sweden (0.9 %), Finland (1.0 %), Poland (1.5 %)</td>
<td>1.1 % + 1.5 p.p. = <strong>2.6 %</strong></td>
</tr>
<tr>
<td>Only euro area member states</td>
<td>Finland (1.0 %), the Netherlands (1.5 %), Austria (1.9 %)</td>
<td>1.47 % + 1.5 p.p. = <strong>2.97 %</strong></td>
</tr>
</tbody>
</table>

Data source: Convergence report - May 2006; Eurostat; own calculations

It is obvious that if the criteria had been formulated (and calculated) in the second way, Lithuania would have fulfilled this criterion.

Secondly, these criteria were formulated at the beginning of the 1990’s, when the economic situation and conditions were different, and also for different economies. Criteria were based on traditional German monetary discipline and aren’t much prepared for the situation of possible euro adoption by countries with significantly different level of real convergence (especially new member states from CEE region, but also southern member countries of the EU – see current situation in Greece).

Another disadvantage of nominal criteria is that they are applied in the same way to all candidate countries and don’t consider specifics of each country. “One size fits all” principle is not necessarily the best attitude.

The last disadvantage mentioned here concerns government deficit to GDP criterion. Total government deficit is being taken into consideration, but that doesn’t truly reflect the current situation regarding structure of government deficits. It would be more precise to involve only structural part of these deficits, because total deficits are either in a positive or negative way distorted by their cyclical parts.

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<sup>18</sup> The average inflation rate is calculated as arithmetic average.
Conclusion

At the beginning of the process of monetary integration within the European Communities (and later European Union), nominal convergence criteria had been chosen as a way how to decide about readiness of a country to adopt single European currency, and that has been influencing development of the euro area since its creation in the late 1990’s. But it has turned out recently that this kind of evaluation of euro adoption readiness is not the best way that could be used. Its disadvantages are too substantial. Nominal convergence criteria don’t take real convergence into consideration, do not truly reflect current economic situation, they don’t consider specifics of individual candidate countries and their reference values are being calculated based on all EU member states. This not so positive situation has been used by candidate countries to adopt single economic currency without being completely prepared for such an important economic change. As it was illustrated on two concrete examples (Slovenia and Slovakia) real convergence process should become much more important on both national and EU level. Especially requirement for long-term fulfillment of convergence criteria\(^\text{19}\) (or factor of naturalness in their fulfillment) seems to be of a great importance. Countries shouldn’t just focus on their one-time fulfillment when it is needed. Such a development leads to situations described above.

All countries that would like to adopt single European currency in a short or middle term should be aware that it is not any race, because in such a race, the winner would be also at the same time the long-term looser. Euro adoption can have positive impact on member economies, but only if they are ready to adopt. Otherwise it can turn into a long-term economic struggling with factors that no country can change.

References


\(^{19}\) And doesn’t matter how they are formulated.
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