Central and Eastern Europe: New Member States (NMS) Policy Forum, 2014,
Staff Report on Cluster Consultations—Common Policy Frameworks and
Challenges

CENTRAL AND EASTERN EUROPE: NEW MEMBER STATES (NMS) POLICY FORUM, 2014

April 2015

STAFF REPORT ON CLUSTER CONSULTATIONS— COMMON POLICY FRAMEWORKS AND CHALLENGES

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- The **Staff Report** prepared by IMF staff and completed on February 26, 2015.

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CENTRAL AND EASTERN EUROPE: NEW MEMBER STATES (NMS) POLICY FORUM, 2014

February 26, 2015

STAFF REPORT ON CLUSTER CONSULTATIONS— COMMON POLICY FRAMEWORKS AND CHALLENGES

KEY ISSUES

2014 marked the tenth anniversary of accession to the EU of the first group of Central and Eastern European (CEE) countries. The first NMS Policy Forum was launched in the fall of 2014 as a platform for discussing policy frameworks and issues relevant for non-euro area NMS. It brought together representatives of the six CEE countries that are EU members but are not yet in the euro area - Bulgaria, Croatia, Czech Republic, Hungary, Poland, and Romania (NMS-6), as well as the ECB, the European Commission and the IMF. Discussions focused on four themes:

Euro adoption: A once sizeable country risk premium associated with joining the euro area has mostly vanished, as the euro crisis has exposed flaws in the euro area's institutional framework. Further, the crisis has illustrated both risks and benefits from adoption: monetary autonomy has proven helpful for absorbing shocks, while foreign currency mismatches—that can be much reduced with euro adoption—have shown to be a key vulnerability. Flexible labor markets, fiscal and macro-prudential policy space, and income convergence are prerequisites for successful adoption.

Opting into the Banking Union (BU) before euro adoption: The lack of equal (or fully equivalent) treatment of the BU members and non-euro area opt-ins—regarding their role in the Single Supervisory Mechanism (SSM), as well as access to common liquidity and fiscal backstops—makes opting into the BU before euro adoption less attractive. Countries that would benefit most from early opt-in are those that see the BU as a way to enhance the quality and credibility of bank supervision or to gain access to larger industry-funded common backstops.

The EU's fiscal framework and pension reform: In the wake of the crisis, many NMS abolished second pillar pension funds. Further reforms to the EU's fiscal framework are warranted to remove disincentives for setting up and maintaining second pension pillars and, more generally, for structural reforms.

Making the most of the EU single market and EU Services Directive: Structural reforms to strengthen human capital, skills match, labor market efficiency, and foreign investment environment will help NMS to reap full benefits from EU integration. Further liberalization of trade in services will likely benefit the NMS-6 more than other EU members.

Approved By
Aasim M. Husain
(EUR) and
Mark Flanagan (SPR)

Bilateral discussions took place during November 5-17 in Brussels, Frankfurt, and in the capitals of the NMS-6. The NMS Policy Forum took place on December 12 in Warsaw. Mission members included A. Ilyina, J. Rahman, and J. Wiegand (heads), G. Everaert, P. Iossifov, J. Podpiera, A. Stepanyan, and Y. Sun (all EUR). J. Roaf, R. Sierhej, G. Tolosa (Resident Representative Offices) and H. Schoelermann (IMF Office in Europe) supported the mission teams. Messrs. M. Snel and D. Radziwill (OED) and A. M. Husain (EUR) attended the forum on December 12. Support from headquarters was provided by J. Bluedorn, N. Geng, J. Ralyea, J. Yang, J. Yoo, and L. Zeng (all EUR). G. Ordonez-Baric assisted with the preparation of the document.

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INTRODUCTION

1. The New Member States (NMS)¹ have made significant progress on EU integration and income convergence since mid-1990s. With the first group of Central and Eastern European countries joining the EU in 2004, the EU accession process provided strong impetus for reforms that boosted NMS export performance, deepened integration into the EU market and supported income convergence (see charts). That said, the pace of convergence varied and there are still significant differences across NMS in their level of real and financial integration with the EU and the euro area. Furthermore, most NMS experienced credit booms that led to a build-up of macroeconomic imbalances. Following the global financial crisis of 2008/09, most NMS went through deep recessions, bringing convergence to a halt. The crisis also exposed weaknesses in the EU and euro area architecture that are now being addressed through major institutional reforms. As a result, the issues related to the monetary, financial and trade integration of the NMS-6 with the rest of the EU and the euro area have come to the forefront.

Sources: World Input-Output Database; and IMF staff calculations.
Notes: The seven bars are for 1995, 2000, 2005, 2008, 2009, 2010 and 2011, respectively. Red indicates post-EU accession years; light red, euro area crisis years (2010, 2011)

Sources: Penn World Tables; and IMF staff calculations. Notes: The eight bars are for 1995, 2000, 2005, 2008, 2009, 2010 and 2011, respectively. Red indicates post-EU accession years; light red, euro area crisis years (2010, 2011)

2. Presently, NMS face the challenge of safeguarding recovery and restarting convergence. Despite gaining some pace, recovery in NMS is still fragile amid sluggish euro area growth. In some NMS, growth is being held back by lingering private sector balance-sheet weaknesses, including high debt burdens (see chart). Disinflation – driven by falling global food and energy prices, as well as disinflationary spillovers from the euro area – may exacerbate

¹ NMS includes both NMS-6 and NMS-EA. NMS-6 comprises Bulgaria, Croatia, Czech Republic, Hungary, Poland, and Romania. NMS-EA comprises Estonia, Latvia, Lithuania, Slovakia and Slovenia.

difficulties faced by overleveraged firms and households. Unless crisis legacies are fully addressed, restarting convergence will be difficult.

3. The policy space in NMS-6 —already constrained in the aftermath of the crisis—is being re-shaped by the ongoing institutional reforms in the EU and the euro area. Few NMS-6 have full *monetary policy* flexibility, either because of the lack of monetary autonomy, or because of significant currency mismatches. *Fiscal space* is also limited, reflecting in part burdens from the crisis. Adjustment is needed in all NMS to meet their medium-term objectives under the EU fiscal rules (see chart). Furthermore, the scope for using *prudential policies* is being re-defined by ongoing reforms of the European financial architecture. It is, therefore, important to understand how the NMS-6' policy frameworks interact with evolving EU institutions and what the NMS-6 should do to ensure that their eventual euro adoption is a success.

Private Sector Indebtedness, 2013 (Percent of GDP)

Sources: EUROSTAT Sector Accounts; and IMF staff calculations.
Notes: The debt stock includes the unconsolidated outstanding amounts of loans and debt securities, excluding financial derivatives. Data for Bulgaria is for 2012.

Fiscal Deficit and Medium-Term Objective (Percent)

Source: European Commission; and IMF, WEO database. Notes: Croatia does not have an MTO, but is currently under the Excessive Deficit Procedure (EDP).

4. The 2014 NMS Policy Forum focused on policy challenges related to the monetary, financial and trade integration of the NMS-6 with the EU and the euro area. This report reflects staff's analysis and discussions with the NMS-6 authorities, the European Commission and the ECB during November-December 2014 and covers four broad policy issues:

- **Euro adoption:** Has the calculus of euro adoption changed for the NMS-6 in light of the recent crisis experience and evolving European financial architecture?
- **Opting into the Banking Union prior to euro adoption:** What are pros and cons of joining the Banking Union before euro adoption?
- **The EU's fiscal framework and pension reform:** Are the EU fiscal rules providing the "right" incentives for the NMS to carry out structural reforms? This question is discussed with a specific focus on pension reform, where many NMS-6 saw reform reversals in recent years.
- **Making the most of the EU single market:** How can the NMS-6 take full advantage of being part of the EU single market? What are the structural reform priorities? Could services exports play a larger role given the recently implemented EU Services Directive?

EURO ADOPTION

5. Since 2004—when the first group of Central and Eastern European countries joined the EU—five NMS have adopted the euro: Slovenia, the Slovak Republic, and the Baltics.

While in the Baltics euro adoption followed many years of unilateral hard pegs to the euro, Slovenia and the Slovak Republic maintained monetary autonomy until shortly before euro adoption.

6. The rest of NMS—that have not yet adopted the euro— maintain very different monetary regimes. *Bulgaria and Croatia* have tied their currencies to the euro—the Bulgarian lev by means of a currency board, the Croatian kuna in the form of a tightly managed quasi-peg. Thus, both regimes mimic many features of euro adoption already. By contrast, the *Czech Republic, Hungary, Poland, and Romania* target inflation and, correspondingly, generally allow exchange rates to float.

7. What does euro adoption entail? Following major institutional reforms triggered by the recent crisis, euro adoption now means joining not only the common currency area, but also the common regulatory area (Banking Union). Thus, after joining the euro, the monetary policy functions shift to the ECB, while bank supervision and resolution, at least for systemic institutions, come under the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM), respectively.

Policy areas	Policy responsibilities	
	<i>in EU, outside euro area</i>	<i>after joining euro area</i>
Monetary policy	Local (+ some coordination with ECB)	Centralized (Eurosysteem)
Fiscal policy	Local (+ EU fiscal rules)	Local (+stricter enforcement of EU fiscal rules)
Macroprudential policy	Local (+ European Systemic Risk Board (ESRB) monitoring)	Mainly local (+ESRB monitoring and greater role of the ECB)
Microprudential supervision	Local	Mainly centralized (Banking Union)

8. What are the key considerations for NMS regarding euro adoption?² Countries need to consider the impact of euro adoption on: (i) growth prospects and competitiveness; (ii) the likelihood, nature and impact of shocks (common with the euro area or idiosyncratic); and (iii) the policy space required to manage economic cycles and respond to shocks. Countries that are expected to function successfully within a common currency area should have sufficient degree of similarity (business cycle synchronization, financial integration, real income levels) and economic flexibility (labor and product market flexibility). This is because such economies would be less likely to face asymmetric shocks and also be able to better cope with them. It also means

² See background paper on “Euro adoption: Macroeconomic Benefits and Challenges” for detailed analysis.

that ceding monetary autonomy would be less costly and there would be less need to use other policy instruments for fine-tuning local monetary and financial conditions to the economies' needs.

9. How was the calculus of euro adoption viewed a decade ago? The last time Fund staff analyzed this issue in a multilateral setting was in 2004 (published as [Schadler et al., 2005](#)). Broadly speaking, the key trade-off was viewed as follows:

- In favor of euro adoption, the 2004 study identified (i) trade generation that could translate into higher growth, and (ii) enhanced perception of policy credibility from deeper integration with the euro area (with the Eurosystem replacing local central bank in the conduct of monetary policy) that could, inter alia, lead to lower financing costs.
- Among possible risks from euro adoption, the study noted that coping with asymmetric demand shocks would become more difficult without an independent monetary policy. As other potential risks, the study identified large and volatile capital inflows and lending booms, as well as higher inflation due to the Balassa/Samuelson effect. However, these risks were viewed as manageable assuming continued low growth volatility and further synchronization of business cycles with the euro area – provided that countries would have sufficient fiscal space and wage flexibility, supported by structural reforms to boost competitiveness, as well as strong financial supervision.

10. The past 10 years of experience of the euro area and NMS-6 have shed new light on several aspects of euro adoption, emphasizing additional benefits but also risks:

- *Trade and growth generation* has remained far below original expectations. Recent estimates for additional GDP growth triggered by euro adoption range from nil ([Havranek, 2010](#)) to 2-3 percent of GDP ([Baldwin, 2006](#)), compared to previously anticipated real GDP gains of 10 to 25 percent over 20 years (based on estimates from e.g., [Frankel and Rose, 1998](#) and [Rose et al., 2000](#)). Increased trade is now thought to be associated more with EU membership, and less with euro adoption and the corresponding reductions in transaction cost and exchange rate risk.
- *Euro premium* – the euro area crisis has cast doubt on the degree to which euro adoption increases an economy's resilience, thus the reputational boost a country receives from adopting the euro is no longer the same (see chart).
- *FX mismatches* have been shown to carry large risks in times of financial strain. Hence, the elimination of FX mismatches through euro adoption can bring significant benefits.
- *Demand shocks* have been much larger in the past decade than expected in 2004 implying that *monetary autonomy* has been more valuable than had previously been anticipated.

The last three issues are discussed in some detail below.

11. Staff's analysis suggests that the euro premium has diminished in the wake of the euro crisis—defined as the impact of euro membership on a country's perceived credit risk.

Countries that adopted the euro in the 2000s—such as Slovenia (2007) and Slovakia (2009)—could, at the time, expect to benefit from a reputational boost equivalent to as much as two sovereign debt ratings notches, or about 9 points with the survey-based Institutional Investor Rating (IIR) (see chart). The euro premium likely reflected a combination of increased credibility of the monetary policy framework, as well as reduced vulnerabilities due to the elimination of exchange rate risk and access to lender-of-last resort facilities in a global reserve currency. In the wake of the euro crisis, this euro premium has mostly vanished. It is possible that a positive premium may return, however, especially if ongoing institutional reforms in the euro area are successful.

International Investor Ratings Premium for Euro Membership (Rating points)

Source: International Investor Ratings; and IMF Staff calculations.

12. At the same time, euro adoption would still help eliminate risks stemming from currency mismatches. While in Poland and the Czech Republic, only a modest share of loans to the private sector is denominated in or linked to the euro, liability euroization is high in the other NMS-6, and hedging and macro-prudential policies have not fully eliminated this risk. The

Balance Sheet Euroization

(FX loans to the private sector as share in total)

Euro Premium and Balance Sheet Euroization

(Fixed effects, 2006-12)

Sources: EBRD; International Investor Ratings; Standard and Poors; and IMF Staff calculations. Note: CZE is end-2013 instead of November 2014. Hungarian data preceded the conversion of Swiss Franc mortgages into domestic currency.

experience of the Baltic countries suggests that for highly euroized economies, eliminating currency mismatches through euro adoption can enhance perceived creditworthiness by almost two ratings notches, or 10 IIR ratings points (see charts).³

13. Furthermore, the record of the past decade suggests that monetary autonomy has been valuable for absorbing shocks and containing macroeconomic imbalances:

- *Managing convergence.* In 2003–07, when the NMS-6' average income gap per capita (PPP) against the EU15 closed by about 10 percent, nominal exchange rate appreciation aided in tightening monetary conditions, in particular in the Czech Republic and Poland and, to a lesser degree, Hungary. Tighter conditions, in turn, helped dampen domestic demand, and contain inflation and credit growth.
- *Limiting the impact of the crisis.* During the downturn of 2008/09, monetary easing and exchange rate depreciation helped prevent excessive contractions in domestic demand, especially in Poland and Romania, although there is considerable heterogeneity within both groups (floaters and peggers) (see charts).

Real Monetary Conditions and Domestic Demand Growth

Sources: Haver Analytics; and IMF Staff calculations.

³ Some FX mismatches would remain also after euro adoption, notably for loans denominated in Swiss Francs. The share of Swiss Franc loans is sizeable only in Poland and Croatia, however (about 10 percent of total loans, concentrated in mortgages). Hungary converted most Swiss Franc loans into domestic currency in November 2014.

- *Combating deflation spillovers.* More recently, inflation-targeting central banks have had some success in containing the pass-through of disinflationary pressures from the euro area into core inflation, by offsetting spillovers with their monetary policy stance.⁴

14. Monetary autonomy would be difficult to replace fully with other instruments, at least in the face of shocks of the magnitude seen over the past decade:

- *High labor market flexibility* could facilitate adjustment through wages in lieu of the exchange rate. In this context, it is worth noting that integration of the NMS-6—especially Hungary, the Czech Republic, and Poland—with the euro area is not necessarily lower than integration within the euro area, and that the NMS-6 score better than the euro area on many economic flexibility indicators (see Table 1 and Box I).
- Yet, for all NMS-6, the *real income gap* vis-à-vis the euro area is still substantial and *risk-sharing* through cross-border asset holdings is much lower compared to the euro area average (see Table 1 and Box I). Further, the experience of the Baltic countries suggests that even for the most flexible economies, longer and more intense fluctuations in economic activity would still have to be expected when giving up monetary autonomy.
- Among the NMS-6, Bulgaria and Croatia have had some success in dampening pre-crisis demand growth through *macro-prudential measures* (Croatia) and in using *fiscal buffers* to mitigate the downturn (Bulgaria). Still, given the size of the past decade's shocks, these policies have not been able to fully substitute for monetary autonomy. Whether shocks of this magnitude will happen again is an open question.

Headline Inflation Variance Decomposition
(Contributions in percent; 2008-14)

Sources: Haver Analytics; and IMF Staff calculations.

15. In practice, both the NMS-6 and EU institutions have considerable leeway over initiating the euro adoption process. In their accession treaties to the EU, the NMS-6 committed to adopting the euro “once the necessary conditions are fulfilled.” The process is also subject to discretion from the side of the euro area institutions, notably with regard to accession to ERM2, for which there are no clear-cut criteria. According to the latest convergence reports by the EC and the ECB, no NMS-6 fulfills all adoption criteria at this juncture, mainly because of the lack of legal harmonization or the prerequisite participation in ERM2 (see Table 2).

⁴ The ECB’s recently announced QE program can help combat disinflation not only in the euro area but also in the NMS-6. QE also illustrates, however, that ECB decisions can have large spillovers to the NMS-6, and that own instruments to align the monetary conditions with domestic needs can be helpful.

Table 1. Real and Financial Integration of NMS with the Euro Area – Selected Indicators

	Bulgaria	Czech Republic	Croatia	Hungary	Poland	Romania
Real convergence						
Income gap (relative to euro area)	-	-	-	-	-	-
Business cycle synchronization with euro area	+	+	-	+	+	-
Trade openness to euro area	+	+	-	+	+	+
Participation in pan european value chains	-	+	...	+	+	-
Economic flexibility						
Labor market regulations	+	+	-	+	+	+
Business regulations	-	-	-	-	-	-
Financial integration						
Foreign-owned bank assets	+	+	+	+	+	+
External bank liabilities	+	-	+	+	+	+
Total foreign financial assets	-	-	-	-	-	-
Total foreign financial liabilities	-	-	-	-	-	-

Source: see Box 1 for explanations.

Note: "+" if above euro area average and "-" if below euro area average.

Table 2. EC Convergence Report 2014 - Fulfillment of Euro Adoption Criteria

	Bulgaria	Czech Republic	Croatia	Hungary	Poland	Romania
Legal	-	-	+	-	-	-
Price stability	+	+	+	+	+	-
Exrate (ERM2)	-	-	-	-	-	-
Fiscal (no EDP)	+	(+) ^{1/}	-	+	-	+
Interest rates	+	+	+	+	+	+
Other	Macro imb		Macro imb	Macro imb		

Source: European Commission

1/ The Czech Republic left the Excessive Deficit Procedure in 2014.

Note: The criteria are as follows: 1/ *Legal* = includes the statutes of the national central bank; 2/ *Fiscal* = a government budgetary position without a deficit and debt level that are determined excessive; 3/ *Price stability* = a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability; 4/ *Exchange rate stability* = the observance of the normal fluctuation margins provided for the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro; and 5/ *Interest rate stability* = observed over a period of one year before examination, a Member state has had an average nominal long-term interest rate that does not exceed by more than 2ppt that of, at most, the three best-performing Member States in terms of price stability.

Staff's Position

16. The timing of euro adoption is ultimately an issue of preferences that can differ across countries. While the analysis above illustrates both economic benefits and drawbacks, the decision on adoption goes beyond purely economic aspects and includes political economy and broader political considerations that are beyond the scope of this analysis.

17. That said, there are consequences for countries' macroeconomic policy frameworks when they adopt the euro:

- for *economies that have monetary autonomy* (Czech Republic, Hungary, Poland and Romania), euro adoption would constrain macro-policy options, especially for economies with large income gaps and less synchronized business cycles vis-à-vis the euro area. Thus, a large burden would be placed on other policy instruments to safeguard balanced growth, notably counter-cyclical fiscal policy—which, in turn, requires fiscal space—and macro-prudential policies. Structural reforms to boost growth potential and facilitate internal adjustment would also be key. The ongoing EU fiscal and financial governance reforms aim not only at strengthening the euro area's institutional framework, but they will also affect countries' policy space in the euro area.
- for *economies that use the euro as monetary anchor* (Bulgaria and Croatia) the trade-off presents itself somewhat differently, as they have already ceded monetary autonomy and exchange rate flexibility to benefit from the euro as monetary anchor. In their case, a key issue is to what extent the ongoing reforms will constrain the use of macro-prudential instruments.
- as for the *euro adoption process*, specific and—to the extent possible and suitable—measurable criteria for ERM2 accession could render the process more structured for the involved parties. Such criteria would usefully emphasize real income convergence and structural preparedness – notably adaptable labor markets—as prerequisites for adoption.

Authorities' Views

18. Country authorities and representatives of the European institutions concurred with most elements of staff's analysis, but offered varying perspectives often specific to a country's situation.

- Countries with currencies pegged to the euro and/or some highly euroized NMS generally continued to see merits in euro adoption. Countries with pegged currencies argued that the lack of monetary autonomy could be—and had been—compensated by the use of other instruments, notably fiscal policy and regulatory measures. Similarly, the EC emphasized that countries' overall policy mix mattered more than the exchange rate regime. Some NMS—notably Romania—viewed euro adoption as a reform anchor.

- Most countries with floating currencies continued to see much value in monetary autonomy and exchange rate flexibility for absorbing shocks and supporting real convergence. The European institutions pointed out, however, that Hungary and Romania—both countries with flexible exchange rate regimes—had requested international financial assistance during the 2008/09 crisis. Further, the ECB noted that there were limits to monetary autonomy also for non-euro area EU members, as the treaty on the functioning of the EU specified that each Member State shall treat its exchange rate policy as a matter of common concern.
- Several authorities noted that a large, positive “euro premium” could be a double-edged sword, as it could provoke over-confidence in the benefits of euro adoption, as had been the case prior to the euro crisis. Thus, the current situation may provide a more sober environment to realistically assess implications, benefits and challenges of adoption than the pre-crisis period up to 2009.
- Most NMS-6 authorities viewed real convergence in income levels and/or structural features of NMS economies as more important than nominal convergence—in contrast to the euro adoption criteria that are formulated in nominal terms. The EC underscored that the level of economic integration and business cycle synchronization with the euro area varied considerably across countries, which required a differentiated view. The European Institutions and some country authorities emphasized that even in cases where adoption was not envisaged in the short term, countries should prepare for eventual adoption through structural reforms as well.
- Common concerns centered on whether ongoing reforms are sufficient to fix the euro area architecture—noting in particular slow progress on fiscal union, and insufficient common backstops—and whether the euro area’s institutional framework grants sufficient fiscal and macro-prudential policy space to manage convergence and asymmetric shocks (see Box 3 for details on the NMS-6 survey).

OPTING INTO THE BANKING UNION BEFORE EURO ADOPTION

19. In the aftermath of the crisis, the EU and the euro area embarked on ambitious financial sector reforms aimed at harmonizing the regulatory and supervisory regimes for all participants in the EU single market for financial services. The European System of Financial Supervision⁵ was set up in 2011, followed by the development of the Single Rulebook.⁶ The euro

⁵ Comprising the European Banking Authority (EBA), European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA), the Joint Committee of the European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB) and national supervisory agencies.

⁶ Including the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) adopted in mid-2013, and the Bank Recovery and Resolution Directive (BRRD) adopted in mid-2014.

area countries further agreed to centralize their bank supervision and resolution regimes by establishing a Banking Union (BU), which is also open to non-euro area EU countries.

20. The main motivation for establishing the BU was to reverse financial fragmentation that impeded monetary transmission within the common currency area in the wake of the recent crisis. By design, the BU should raise the credibility and quality of banking supervision and eliminate the distinction between home and host supervisors (via the Single Supervisory Mechanism (SSM)), as well as sever the links between banks and sovereigns by unifying the bank resolution and restructuring framework (via the Single Resolution Mechanism (SRM)) and providing a common, industry-funded backstop. This should in turn lead to lower bank compliance costs, the removal of any barriers to cross-border banking activity (which may be in place to protect national interests), lower resolution and restructuring costs, and ultimately lower bank funding costs.⁷

21. The full benefits of the BU will be realized once all its elements are in place, which is not yet the case. While the SSM and SRM are now operational, an effective common fiscal backstop is still needed to break the sovereign-bank links (the ESM is currently acting as *de facto* common fiscal backstop for euro area banks). Other key elements include allowing the Single Resolution Fund (SRF) (which will be fully funded and mutualized only by 2024)⁸ to borrow against future industry levies, and working towards a pan-European deposit guarantee scheme (DGS).

22. What does “opting into the BU” entail?⁹ BU membership refers to participation in both the SSM and in the SRM. For non-euro area economies, “opting into the BU” would mean entering into a close cooperation with the ECB and amending national legislation to enable national authorities to work with the ECB and the Single Resolution Board (SRB) under their supranational frameworks for supervision and resolution, respectively. Whereas the outcome of the application is not conditional on the results from the comprehensive assessment, the ECB can use its powers to request further information and carry out its own comprehensive assessment to steer the process. For those NMS-6 that have already announced a target date for euro adoption (Romania), joining the BU prior to euro adoption effectively amounts to phasing in the necessary

⁷ See [IMF’s Staff Discussion Note on “A Banking Union for the Euro Area” \(IMF, 2013\)](#) for a comprehensive discussion of the BU design and benefits.

⁸ The SRF will start out with national compartments which build up over time and are gradually mutualized building to 100 percent after 8 years, in 2024.

⁹ See background paper on “Opting into the Banking Union before Euro Adoption” for detailed analysis.

institutional and operational adjustments. Upon joining, the NMS-6 would generally be expected to enjoy the same benefits as other BU members, with some caveats (see below).

23. Importantly, upon opting into the BU, non-euro area members would not be treated in the same way as the euro-area members:

(i) *role in the SSM*: non-euro countries are not members of the ECB's Governing Council that is charged with adopting decisions drafted by the Supervisory Board (SB);¹⁰ (ii) *fiscal backstop*: non-euro area opt-ins are not eligible for direct bank recapitalization from the ESM (acting as *de facto* common fiscal backstop); and (iii) *liquidity support*: non-euro area opt-ins would not automatically have access to the ECB liquidity facilities.¹¹

That said, there are some safeguards for non-euro area opt-ins, such as the reasoned disagreement procedure and the exit clause. The latter means that unlike euro-area members, non-euro area countries can terminate their participation in the BU (though the ECB can take such decision as well).

Modalities of BU participation for opt-ins

Role in SSM governance on par with euro area members	X
Access to ECB liquidity support	X
Possibility of direct bank recap by ESM	X

24. Certain features of their banking systems make the NMS-6 particularly sensitive to the lack of equal treatment of non-euro area countries in the BU (discussed above):

- *Ability to influence decisions related to parent banks is critical for the NMS-6* because most of their banking systems are dominated by the euro area bank subsidiaries, which tend to be more important for local economies than for the parent banking groups (see charts). If under the BU most *barriers to cross-border transfers* of capital and liquidity are removed, this could reduce the required capital and liquidity buffers at the subsidiary level, but it would also take away some of the local authorities' ability to ring-fence (see Box 4). Having less control over intra-group cross-border flows could be partly offset, however, by the benefits that come with direct participation in the SSM, which would allow opt-ins to vote in the SB on issues that are currently beyond the purview of local supervisors. It also remains to be seen how the SSM will balance prudential considerations of host and home countries, and address potential concerns that considerations related to larger financial systems/institutions, which have a greater bearing on the financial stability of the BU as a whole, would be viewed as more important.

¹⁰ The ECB Governing Council cannot change draft supervisory decisions, but can object and refer them back to SSB for redrafting, or to a mediation panel to resolve differences among national competent authorities.

¹¹ At present, any liquidity provision by the ECB to non-euro area members via repo or swap lines is evaluated on a country-by-country basis and subjugated to monetary policy considerations.

Three largest banks by assets, 2013
(Percent of GDP)

Sources: Bankscope; and IMF staff estimates.

Note: Top 3 banks would be expected to come under SSM.

Assets of largest foreign-owned banks in NMS-6
(Individual bank assets)

Sources: Bankscope; and IMF staff estimates.

Note: In some cases, the source data are consolidated for the financial group, in which the bank is part of.

- *Access to common liquidity and fiscal backstops is important for the NMS-6, because (i) they still have large external liabilities (see Box 1), though many NMS subsidiaries are now less reliant on foreign parent bank funding than before the crisis (see Box 2); (ii) banks in NMS-6 typically hold less bail-inable funds (other than uninsured deposits) than eurozone banking groups operating in the region. The NMS-6 are, therefore, more likely to benefit from the risk-sharing aspect of the SRF or other common backstop (see chart).*

Bank Funding Structures, 2013

(Billions of US dollars; percent of total; based on largest 10 banks in each country for NMS and select parent banks)

Sources: Bankscope; and IMF staff estimates.

25. Apart from the BU design, the calculus of the BU opt-in is influenced by country characteristics, policy preferences and BU's operational modalities. Box 4 aims to provide a simple taxonomy. Some of the key considerations are:

- *The NMS risk-sharing preferences* depend on country-specific characteristics that affect the types of shocks they are likely to face (e.g., economies that are less integrated with the euro area and hence, more likely to face asymmetric shocks, may derive greater benefits from having access to common backstop).
- *The NMS policy preferences* may influence the desired stringency of prudential standards. While lower incidence of financial instability is growth-enhancing, at any given time, policy makers may have to weigh different considerations when deciding on the "right" level of stringency required to contain systemic risks (e.g., tighter standards reduce the risk and cost of financial instability, but also dampen credit growth and lower bank profitability). The NMS would be more inclined to opt in if they perceive the SSM's preferences to be similar to their own.
- *The policy space configuration* of the BU opt-ins is yet to be fully defined. In particular, NMS need to consider that joining the BU may pose new challenges for their macroprudential and monetary policies. Under the BU rules, there is an asymmetry in the direction of macroprudential policies that can be taken by the ECB and national authorities. They both can tighten standards beyond the level set by the other regulator, but, apart from reversing their own decisions, cannot compel loosening. That said, some macroprudential tools will remain under full control of the national authorities (see figure).

To the extent that joining the BU would *limit the ability of local policymakers to react to negative shocks* (unless fully offset by lower likelihood of shocks or additional support from the euro area institutions), this would be yet another consideration in the opt-in decision.¹²

26. Finally, the extent to which both indirect and direct benefits from the BU will materialize for the NMS-6 will depend on how supervision and financial systems evolve over time. As host countries of euro area banks, the NMS-6 would benefit from greater financial stability in the euro area and simpler home-host interactions with the euro area single supervisor. Also, *funding costs* for the NMS banks could be reduced either because parent banks would be providing more or cheaper funding to their subsidiaries or because the NMS banks would be able to borrow directly in the wholesale markets at lower cost. But the extent to which the NMS banks will be able to take advantage of lower cost of non-deposit funding will depend on supervisory preferences and evolving bank funding models. The lack of clarity on the implementation of structural measures at the EU and national levels adds another layer of uncertainty about the future cross-border banking model in Europe.¹³

Staff's Position

27. Since the BU is still evolving, the opt-in decision problem has many moving parts. Much like the euro adoption calculus, the BU opt-in decision would have to take into account the NMS-6 country characteristics and policy preferences, as well as evolving modalities of the BU (some trade-offs are highlighted in Box 4).

28. When would opting into the BU make sense? Staff's analysis offers some observations:

- *BU design:* the lack of equal (or fully equivalent) treatment of euro area and non-euro area members of the BU tilts the decision against early BU opt-in and in favor of waiting until euro adoption. Addressing the issues related to SSM governance, liquidity support and fiscal backstop would make the BU opt-in before euro adoption more attractive.

¹² For example, during the crisis, some European countries used prudential measures to enhance credit supply, including a reduction in risk weights for SME loans when calculating banks' capital adequacy ratios, forbearance of nonperforming loans, and countercyclical macroprudential regulations (e.g., GFSR (2013)). While it is generally recognized that containing systemic risks should remain the primary objective in setting/modifying macroprudential measures (while taking into account their impact on broader economy), in practice, there may be differences in views between supranational and local authorities on the acceptable heterogeneity in macroprudential standards across BU members, given the ECB's objective of ensuring the level playing field and preventing regulatory arbitrage.

¹³ Based on the CRR, national authorities can implement structural measures to restrict cross-border banking activities, subject to a green-light procedure involving the member state, EBA, EC and Council. This means that removal of all barriers to cross-border transfers of capital and liquidity in general cannot be taken for granted. The implementation of more restrictive structural measures could in turn lead to further changes in the cross-border banking model (e.g., it could increase incentives to convert subsidiaries into branches), which will affect the BU opt-in calculus as well.

- *BU modalities*: lack of clarity and experience with BU operational modalities is another factor in favor of waiting. This, in particular, applies to coordination between SSM and local supervisors, as well as to coordination between prudential policies at the national and BU-levels and national monetary policies. The modalities would also affect the macroprudential and possibly monetary policy space at the local level.
- *Some may still opt in* because for them the BU participation may be a way to address specific challenges which outweigh other factors, including the BU shortcomings. For example, some NMS may see BU as a way to enhance the quality and credibility of bank supervision or to gain access to larger industry-funded common backstops. There may be other factors, including political economy considerations (such as the desire to distance supervision from local vested interests) or concerns about being “left behind” if other NMS-6 join first.¹⁴

Authorities’ Views

29. While acknowledging that once fully established the Banking Union would significantly increase the resilience of the European financial system, the NMS-6 had a number of common concerns related to opting in before euro adoption:

- *protection of NMS interests vis-à-vis euro area parent banks*: most NMS-6 were concerned that they would not have sufficient influence on the SSM decisions regarding parent banks. Notably, most NMS-6 were concerned that after joining the BU, local supervisors would lose the power to set liquidity requirements for local subsidiaries; the worry about losing the ability to ring-fence local liquidity tops the list of concerns in the NMS-6 survey (see Box 5). Furthermore, the option of exiting the BU was not viewed as providing sufficient safeguard as it was seen as unlikely to be ever used in practice due to negative reputational effects.
- *misalignment between decision powers and burden-sharing*: while decisions on liquidity provision and bank resolution of significant banks would be taken at the BU-level, for now and in the near future, the cost would be largely borne by individual member states. The NMS-6 were interested in exploring ways in which the euro area institutions could extend their support to opt-ins (on par with other BU members) in the event of financial instability.
- *lack of clarity on and experience with operational modalities of the BU* meant that most NMS-6 found it difficult to assess the balance of potential benefits (which were seen as likely to materialize in the future) and drawbacks (which are more immediate).
- *policy space and policy coordination*: it is not yet fully known how being part of the BU would affect the ability of non-euro area NMS to conduct monetary and macro-prudential policies.

¹⁴ See background paper for discussion of these issues.

- *uncertainty about how the European financial system will evolve under the BU* and how the decision of one or more NMS-6 to opt in might affect those that choose to stay out. In particular, it is not yet clear whether supervisors, parent banks and investors would view those NMS countries that opt in and those that stay out differently.

30. The ECB and EC emphasized the advantages of the BU opt-in before euro adoption:

- They highlighted the benefits for the NMS-6 of having a seat at the table in the SSM and access to common industry-funded backstop, while also emphasizing that the decision to seek close co-operation was up to member states and that such a step required thorough preparation.
- While acknowledging that non-euro area countries could not be treated in exactly the same way as euro area countries, they argued that the BU design was a balanced solution in light of the Treaty framework. They also noted that safeguards for non-euro area opt-ins (e.g., a reasoned disagreement procedure and exit clause) were in place and that discussions on the common fiscal backstop are ongoing with the view to achieving a better symmetry between euro area and non-euro area BU members.
- They also noted that early opt-in would allow the NMS-6 to participate in shaping the BU operational modalities.

THE EU FISCAL FRAMEWORK AND PENSION REFORM

31. In the past few years, the EU's fiscal framework has undergone several changes to enhance its traction and better align fiscal incentives with cyclical and country-specific circumstances, often in reaction to shortcomings exposed in the wake of the global financial crisis. Accommodating pension reform is one aspect of the changes to the framework—others include stronger enforcement mechanisms, and the formulation of fiscal targets in structurally adjusted terms, so as to avoid pro-cyclical fiscal policies—and it is key for most NMS. It is also the area where the EU's framework specifies most clearly exemptions from the standard fiscal criteria, with a view to rewarding structural reforms.

32. The NMS were among the earliest pension reformers in Europe.

- Parametric reforms legislated in the late 1990s and early 2000s rendered most *PAYG pension systems* in the region technically sustainable, although at the expense of very low future benefit replacement ratios—often as low as 20 percent (compared to an average of about 40 percent today). This sharp decline leaves room for doubt as to whether legislated public pension reforms are socially—and therefore politically—sustainable.

- In parallel with the reforms to the PAYG system, most NMS introduced a *second, mandatory, funded pension pillar*, to supplement pension incomes. Hungary (1998) and Poland (1999) led reform efforts in the region, followed by Bulgaria, Croatia (both 2002), and Romania (2007). The exception among the NMS-6 is the Czech Republic that, instead of introducing a mandatory second pillar, strengthened tax incentives for accumulating savings in the voluntary third pillar. Staff's background analysis finds that the NMS's record with second pillars has been mixed, typically characterized by modest returns—although the assessment is complicated by sharp investment losses during the global financial crisis—little diversification of pillar II pension assets, and relatively high (albeit falling) administrative costs.

PAYG Pension Cost and Replacement Rate, 2060

(For selected EE countries)

Sources: EU 2012 Aging Report, World Bank.

33. Many second pillar reforms were reversed following the 2008/09 financial crisis, although the degree and permanence of these reversals has differed. In Hungary, Poland, Slovakia, and in all Baltic countries, some contributions were redirected to the first pillar, while Romania delayed the built-up of its second pillar. However, the Baltic states are in the process of restoring or have already fully restored pillar II systems, while Poland and Slovakia reversed pillar II reforms partially, and Hungary in full.

34. Staff's analysis suggests that the EU's fiscal framework contributed to pressures that led to pillar II pension reversals.

- *Transition cost.* The treatment of second pillars was a marginal issue in the EU prior to 2004, when NMS with large funded pillars began to join to the EU. In fact, only in 2004 Eurostat reclassified pillar II schemes from belonging to the public to the private sector. From that point, contributions diverted from the PAYG system to the second pillar counted no longer as government revenue, while the government's PAYG pension obligations remained unchanged. In the absence of compensating tightening measures, this raises the reported headline deficit and thus triggers the accumulation of additional government debt, while the assets accumulated in the Pillar II fund are recorded outside the public sector. This effect—often called “transition cost” of establishing a second pension pillar—will persist until PAYG pension obligations diminish and are replaced with pillar II pensions.
- *The framework.* Until 2005, the EU's fiscal framework was formulated almost exclusively in terms of the headline fiscal balance, with no possibility to offset the transition costs from establishing a second pension pillar—thus biasing member states' incentives against setting up an maintaining second pension pillars. A reform in 2005 granted very limited exemptions in the context of the Excessive Deficit Procedure (EDP), allowing limited adjustment of the deficit as long as it remains “close to the reference value” and for a maximum of five years

(on a digressive linear scale). The exemption captured neither the full transition cost—more than 1 percent of GDP a year in countries with large second pillars (Poland, Hungary, Slovakia)—nor the entire transition period (40–50 years).

- *Patterns of reversal.* When the crisis put pressure on fiscal balances, reversing pillar II reforms became a means for reducing headline deficits and thus staying within (or returning to) the EDP deficit limits. In line with these policy incentives, countries with the largest second pillars enacted the largest pillar II reversals, while countries with smaller pillar II schemes were generally able to maintain them. By contrast, staff finds no link between reform reversals and other factors often cited as reasons for abandoning the second pillar, such as low returns on pillar II assets or high management fees (if anything, the more profitable second pillar funds were dissolved).

35. Recent changes to the EU's fiscal framework reduce the anti-pillar II bias, but they do not eliminate it.

- *MTO's.* A portion of the costs from systemic pension reform can—but does not need to—be recognized when defining a country's medium-term fiscal objective (MTO) and the prescribed adjustment path to the MTO. In practice, there appears little link between a country's MTO and the existence and size of a second pension pillar.
- *Excessive Deficit Procedure.* The five-year restriction during which pension reform can be taken into account has been eliminated, but this applies only to the deficit and not to the debt criterion.¹⁵ The EDP exemption remains limited in size, however, thus penalizing disproportionately countries with large second pillars. Further, with changes to the EU's fiscal

Pillar II. Contribution Rates and Reform Reversals

Pillar II. Asset Returns and Reform Reversals

Sources: WB (2014); and IMF staff calculations.

¹⁵ Public debt accumulates to the extent that the pension contributions diverted from the PAYG system to the second pillar are not offset by fiscal tightening. The counterpart to higher public debt are the Pillar II fund assets.

accounting framework that came into effect in 2014 (ESA 2010), the transfer of second pillar abolish Pillar II funds in the context of the EDP.¹⁶

- Overall, *the rules and exemptions are complex and nontransparent*, and leave the European Commission much discretion in their application.

36. The gap between the EU's fiscal framework and fiscally neutral treatment of a country's pension regime remains sizeable. This is illustrated by a comparison between Poland and Germany, using the concept of the pension-adjusted balance developed by FAD (2012). While Germany's headline balance is 4 percentage points of GDP stronger than Poland's, Poland had a stronger pension-adjusted balance in 2013.¹⁷

Staff's Position

37. Securing fiscally and socially sustainable pension systems remains a challenge. With currently legislated parameters, most NMS-6 PAYG pension systems will pay much lower pensions in future, creating a risk of old-age poverty and potential for social conflict.

Such an outcome can be avoided by accepting higher fiscal burdens in future, or by increasing savings ahead of time in order to generate additional income out of which pensions could be paid.

38. Pillar II reforms are one, but not the only, way of generating higher savings.

Countries that have maintained pillar II should strengthen them in ways that reduce the offset between higher private and lower public savings. Countries that have abolished second pillars need to cope with the cost of ageing in other ways, including strengthening the fiscal stance and limiting debt accumulation to generate fiscal space for when PAYG pension obligations fall due, and strengthening incentives for participation in the third, voluntary pillar.

39. The EU's fiscal framework should be more neutral toward a country's choice of pension regime. While recent reforms have moved the framework some way in this direction, further steps in this direction would be helpful.

Poland vs. Germany: Headline vs. Pension Adjusted Fiscal Balance (PAFB) (Percent of GDP)

¹⁶ It does not eliminate the incentive entirely, as (i) the resulting future increase in social security contributions still counts toward the fiscal deficit, (ii) pillar II asset transfers continue to reduce recorded government debt and, relatedly, (iii) interest savings as a result of debt reduction continue to lower the recorded overall deficit.

¹⁷ The deterioration of Germany's PABF in 2013 reflects in part the reversal of parametric reforms to Germany's PAYG pension system (notably reductions in the retirement age for some groups).

Authorities' Views**40. For most NMS-6, dealing with the cost of ageing without excessively constraining future fiscal space remains a major challenge.**

- Several NMS-6 authorities were of the view, however, that recent and planned reforms were addressing the issue, singling out increases in the effective retirement age as a policy that could enhance fiscal sustainability without cutting back excessively the size of pensions. European Commission staff broadly agreed with this assessment.
- As regards the EU fiscal framework, European Commission staff was of the view that recent reforms to the framework had largely eliminated incentives to abolish second Pillar pension funds and that the framework adequately highlights challenges relating to implicit liabilities in the pension area. Views of country authorities differed, with some arguing that more flexibility was needed to render the corrective arm of the SGP neutral to the choice of the pension regime, and others advocating a stronger consideration of ageing-related fiscal costs under the preventive arm.
- More generally, views differed on whether implicit and explicit fiscal liabilities should be treated differently (by policy makers and by markets). The Polish authorities suggested that expenditure ceilings rather than deficit rules could address many shortcomings of the EU fiscal framework, without rendering the framework overly complicated.

MAKING THE MOST OF THE EU SINGLE MARKET

41. Being part of the EU allows new member states (NMS) access to a larger market for their products and serves as a catalyst for growth and convergence. The EU single market provides opportunities for firms to grow, and, at the same time, subjects them to stronger competition raising incentives to improve productivity. The open trade and investment regime in turn also acts as a conduit for technology transfer that over time improves the quality of export products. Higher quality and quantity of exports creates a virtuous cycle of growth and convergence.

42. Structural reforms that improve human capital, work incentives and foreign investment environment are key to improving export performance. Staff's analysis based on the experience of 10 NMS during the post-accession years shows that a significant share of the explained variation in value added exports to the EU comes from differences in the levels of higher education, continuous participation in vocational training and skills upgrade, incentives to

work and hire, and restrictions on foreign investment and ownership.¹⁸ In terms of relative importance of structural factors, vocational training and skills upgrade have the strongest impact followed by incentives to work (inactivity trap), foreign investment and ownership environment, higher education, and relative minimum wage (see chart, LHS). Integration with supply chains, which also captures the impact of other institutional factors that facilitate trade, shows a strong positive impact on exports, larger than most structural variables.

43. Staff's analysis, based on the experience of 10 NMS both within and outside the euro area during 2003–11, points to some country-specific structural reform priorities for increasing exports to the EU and the rest of the world.

Relative Importance of Structural Factors in Explaining Value Added Exports to EU

Note: This chart illustrates the increase in value added exports to EU that would be brought about by a one-standard-deviation improvement in each structural factor, based on staff's regression analysis.

- The above average performance in the *Czech Republic* is mostly explained by the higher level of continuous participation of its labor force in vocational training and skills upgrade, a lower degree of restriction on foreign investment and ownership and strong integration with regional supply chains.
- For *Hungary*, wage competitiveness, strong links with supply chains and foreign investment environment have all contributed to the above average performance, although the contribution from foreign investment environment has declined markedly in recent years.
- For *Poland*, there is room for improvement in integration with supply chains and foreign investment environment to help increase exports to the EU single market.
- For *Bulgaria* and *Romania*, the below average performance has been persistent over time indicating room for broad-based structural reforms, particularly with respect to higher education and foreign investment environment. Bulgaria also seems to have lost some of the positive contributions from its relatively low minimum wage over time, an indication of waning wage competitiveness at the low-skill segment.

¹⁸ See background paper "The New Member States (NMS): Making the Most of the EU Single Market" for detailed analysis. The regression analysis excludes Croatia due to lack of data for value added exports and many of the structural variables.

**Structural Reform Priorities in NMS-6:
Contributions to Deviations from Average NMS Export Performance in EU, 2011**

Source: Staff calculations using regression results and data from Eurostat, World Input Output Database, European Commission (LAF database), and Economic Freedom of the World 2013 Annual Report. The "Export integration gap" refers to value added exports of goods and services to the EU relative to the NMS-10 average. Human capital includes contributions from higher education and continuous participation in vocational training; labor market efficiency and competitiveness includes contributions from inactivity trap, relative minimum wage and unit labor cost based real effective exchange rate.

44. Most NMS-6 countries have considerable room for quality improvement in their current export products. Staff's analysis of export quality based on indices developed by [Henn, Papageorgiou and Spatafora](#) (2013) and [Vandenbussche](#) (2014) shows room for quality improvement in all countries, particularly in the EU market.¹⁹ Romania and Bulgaria demonstrate the largest room for improvement among NMS-6 with about 40 percent of exports to the EU falling in the bottom quartile of quality. In contrast, exports from the Czech Republic and Hungary to the EU market are concentrated in the two middle quality quartiles.

45. Structural reforms are critical for further quality improvement. A survey of the literature shows that some of the structural reforms that explain differences in export performance in staff's regression analysis are also the ones that tend to explain differences in export quality: human capital, institutional quality, and foreign investment (see for example [Zhu et al](#), 2009, Henn et al, 2013, and [Weldemicael](#), 2012). Not surprisingly, there is a strong positive

¹⁹ Henn, Papageorgiou and Spatafora (2013), which was used for quality analysis for exports to the world market, constructs a quality index based on an estimated relationship between export quality, unit value, production cost and distance from importers. Vandenbussche (2014), which was used for quality analysis for exports to the EU market, constructs a quality index using firm-level cost data in a mark-up model.

relationship between exports value and quality for the NMS, both in the world and the EU markets. Hence, pursuing structural reforms that increase exports also helps with quality improvement over time.

46. Reform priorities depend on initial conditions. For countries exporting relatively low quality products, accessing technology through foreign investment and higher links with supply chains are more important than other reforms (see [EBRD 2014](#)). For countries with lesser room for quality improvement, further progression in the quality ladder requires significant scaling up of higher education, skills match and R&D. For example, for the Czech Republic and Hungary, which are highly integrated with the EU and stand taller than others in the quality ladder, continued success of export-led growth would require catching up with some of the most competitive economies in the world. For these countries, diversification of exports including through new product lines or partners would be helpful particularly in light of persistent weaknesses in the post-crisis euro area.

Services Share in Gross Exports to EU, 2013
(Percent of GDP)

Sources: Eurostat; and IMF staff calculations.

47. Better market access is also important for enhancing exports from NMS-6. When it comes to services exports, the EU single market does not work as well as it does for goods. Countries face numerous export restrictions. To improve access for services exports, the EU introduced the Services Directive (SD) in 2006. Most services exports (70 percent) from the region belong to sectors covered under the SD. The implementation of the SD has reduced overall import restrictions on services by about 30 percent relative to the pre-SD levels, with considerable variation across countries and products (see Box VI). However, progress has fallen short of expectations as many EU member states have opted to only partially reduce or even keep some restrictions.

48. Staff's analysis shows that further liberalization of the services sector would boost the NMS-6' exports to the EU. An

analysis of Revealed Comparative Advantage (RCA) using exports to the EU shows that the NMS-6 have a comparative advantage in various services products that fall under the SD, including in professional services (Czech Republic, Hungary, Poland and Romania) which remain most protected (see table).²⁰ Further dismantling of restrictions by EU members, both advanced and emerging market economies, will help boost services exports to the EU.

Revealed Comparative Advantage (RCA) in Professional and Technical Services

	RCA	% of services exports under SD
Bulgaria	0.6	15.9
Croatia	0.4	8.1
Czech Republic	1.1	29.6
Hungary	1.1	31.3
Poland	1.1	35.7
Romania	1.1	39.6
Estonia	0.8	26.5
Latvia	0.7	30.8
Lithuania	0.4	22.7
Slovak Republic	0.8	20.4
Slovenia	0.5	16.4

Sources: IMF Staff calculations using Eurostat data. Notes: The sectors under professional and technical services include legal, accounting, management, public relations services, advertising, market research and other technical consultancy. RCA is relative to total services gross exports.

Staff's Position

49. Structural reforms are important for strengthening export integration with the EU and improving export quality. The main policy priorities to enhance exports to the EU include improving higher education, vocational training and skills, incentives to work and hire, foreign investment environment and also reforms to increase links with supply chain. For countries that are already highly integrated with the EU market, such as the Czech Republic and Hungary, diversification outside the EU would be beneficial. For quality improvement, structural reforms need to be mindful of a country's existing quality level. For countries producing products at the lower end of quality spectrum, accessing technology through an improved foreign investment environment and greater links with supply chains are key. Countries that are at the medium-level of quality spectrum would benefit from improving skills and higher education, and innovation through higher R&D spending.

50. Further liberalization of trade in sectors covered by the Services Directive (SD) will be particularly beneficial for the NMS-6. These sectors constitute a significant part of services exports from NMS-6 and many show comparative advantage in these products. Success in this regard will strongly depend on actions by EU trading partners.

²⁰ RCA in services products is the ratio of a service product's share in a country's total exports and the same product's share in EU total exports. A value greater than 1 indicates presence of RCA. These calculations were done using value added exports data. For professional and technical services, the RCA was computed with respect to services exports to EU data from Eurostat.

Authorities' Views

51. NMS-6 view the EU single market as key to strengthening export growth and convergence. They agreed that reforms to improve the foreign investment environment, higher education, labor market flexibility and links with supply chains are needed to maximize benefits from the single market for the NMS-6, especially given that low wages are unlikely to remain a source of comparative advantage going forward.

52. Authorities viewed progress in reduction of barriers under the EU Services Directive as modest so far. They saw significant room for growth in services exports from further liberalization, including by NMS themselves. Authorities acknowledged that exports outside the EU have been an important source of growth since the crisis and going forward looking outside the EU will help boost the export performance of NMS.

53. The EU and ECB representatives agreed with staff's findings on country-specific structural reform priorities and the importance of a well-functioning single market. ECB staff noted that the latter were particularly important as a means to tackle the apparent deceleration in the convergence process in some of the NMS-6. While acknowledging the generally positive role of cross-border supply chain participation in supporting economic activity and technology spillovers, ECB staff also highlighted the potential risks, notably that of a lock-in into low value-added activities, as well as skill mismatches that could result when participation was not sufficiently diversified across sectors.

STAFF APPRAISAL

54. The recent crisis and ongoing institutional reforms in the EU and the euro area have brought policy issues related to the integration of the NMS-6 with the rest of the EU to the fore. To gain full benefits from EU integration and ensure that eventual euro adoption is a success, the NMS-6 should strive to enhance their competitiveness and economic flexibility through structural reforms, while at the same time boost their fiscal and macroprudential policy space.

55. Euro adoption. There are both economic advantages and drawbacks associated with adoption. A once sizeable country risk premium associated with adoption has vanished with the euro crisis. Further, joining the euro area implies giving up monetary autonomy, which has proven valuable for absorbing shocks and containing macroeconomic imbalances. That said, euro adoption continues to hold advantages for highly euroized countries, as it would help eliminate currency mismatches. For the NMS-6 with flexible exchange rate regimes, a key consideration would be the extent to which monetary autonomy can be replaced by other policy instruments and support from the euro area institutions. For the NMS-6 peggers, an issue is to what extent they can continue to use macroprudential tools after adopting the euro. Progress with real convergence and structural preparedness are key prerequisites for making eventual euro adoption a success.

55. Opting into the BU. For those NMS-6 that have set a target date for euro adoption (Romania), early opt-in is a way to phase-in some of the necessary institutional changes. For others, the BU opt-in decision requires careful consideration of country characteristics, policy preferences and BU's modalities. Two factors – the lack of equal (or fully equivalent) treatment of euro area and non-euro area BU members and the lack of clarity on and experience with the BU operational modalities – tilt the decision against early BU opt-in at this stage. For some NMS-6, these factors may not dominate other considerations. Notwithstanding the BU shortcomings, some NMS-6 may still see net benefits from the BU participation due to enhanced quality and credibility of bank supervision, distancing local supervision from local vested interests or gaining access to common industry-funded backstops.

56. EU fiscal framework and pension reform. The EU's fiscal framework arguably contributed to pressures triggering the unwinding of many second pension pillars in the wake of the 2008/09 crisis. While recent reforms render the framework more flexible, it continues to fall short of neutrality toward a country's choice of pension regime. That said, Pillar II reforms are one, but not the only, way to strengthen pension systems. Countries that have maintained a second pillar should reduce the offset between higher private and lower public savings. Countries that have abolished second pillars should generate additional fiscal space and consider strengthening incentives for participation in the third, voluntary pillar.

57. EU single market and EU Services Directive. The main policy priorities to enhance trade integration with the rest of the EU include improving higher education, vocational training and skills, incentives to work and hire, foreign investment environment and also reforms to increase links with EU supply chains. For countries that are already highly integrated with the EU market, diversification outside the EU would be beneficial. For quality improvement, structural reforms need to be mindful of a country's current position in the export quality ladder. Further liberalization of trade in sectors covered by the EU Services Directive will be particularly beneficial for the NMS-6, given that many have comparative advantage in specific services.

58. The EU and euro area institutions can support further integration of the NMS-6 by ensuring that the ongoing governance reforms are mindful of their impact on the NMS-6 economies and policy frameworks. To that end, it is important to:

- define more specific criteria for admission to ERM2 to help guide the reform agenda in the NMS-6, and in this context, emphasize the importance of *institutional, structural, and real convergence*;
- ensure that the *interests of non-euro area members of the BU* are adequately protected. In particular, it would be important for the SSM to establish a strong track record and to clarify the operational modalities as early as possible; in addition to ongoing discussions on the common fiscal backstop with the view to achieving a better symmetry between euro area and non-euro area BU members, the ECB could, similarly, consider extending liquidity support to the BU opt-ins in the event of financial stress;
- establish *mechanisms for effective policy coordination* between local central banks, the ECB, the SSM/SRM and the EC to address potential tensions that might arise between different (prudential, growth and price stability) policy objectives at the national and supranational levels;
- ensure that the EU framework (e.g., fiscal rules) does not create *disincentives for structural reforms* that the NMS-6 need to carry out in order to increase economic flexibility and growth potential;
- consider further efforts to lift intra-EU restrictions on *services trade*, building on the experience with the EU Services Directive.

Box 1. Real and Financial Integration of NMS with the Euro Area

While there is significant heterogeneity across NMS, including within the NMS-6 and NMS-EA groups, for all NMS-6, the real income gap is still substantial and risk sharing from cross-border asset holdings is still lower, compared to the euro area average.

Real convergence: For Hungary and the Czech Republic, synchronization with the euro area is notably higher than for the other NMS-6 (see charts); and also higher compared to Greece and Portugal (see background paper for details). This can be explained by both countries being closely integrated in pan-European supply chains and with their strong trade links with the euro area (see charts). That said, the real income gap (relative to the euro area) is still substantial for most NMS.

Economic flexibility: labor markets in the NMS-6 are more flexible than in the euro area, on average, with lower statutory minimum wages, union density rates and more decentralized wage bargaining structure than in the euro area. However, NMS tend to fall short in the area of liberalization of business regulation.

Gross Domestic Product per Capita, 2013
(Thousands, purchasing power standard)

Sources: Eurostat; and Haver Analytics.

Business Cycle Synchronization with Euro Area, 1998-2013
(Contemporaneous correlation of output gaps)

Source: IMF staff calculations. Notes: Output gaps are extracted with the Baxter-King bandpass filter. Euro area average is an unweighted average correlation for the 12 initial members (Kappler, M. and A. Sachs, 2013)

Trade Openness to Euro Area, 2013
(Percent of trading partner's GDP)

Trade openness = (exports to euro area + imports from euro area)/GDP

Source: IMF, Direction of Trade database.

Importance of Participation in Pan European Value Chains for National Economy, 2011 (Percent of GDP)

Sources: IMF, WEO database; World Input-Output Database; and IMF staff calculations. Note: Sum of (1) Domestic value-added intermediate exports to EU importers used to produce goods and services for export to third countries and (2) Imports from EU trade partners used in production of export products in percent of GDP.

Box 1. Real and Financial Integration of NMS with the Euro Area (concluded)

Labor Market Regulations, 2011

(Index, 10 = least restrictive)

Source: Economic Freedom of the World.

Business Regulations, 2011

(Index, 10 = least restrictive)

Source: Economic Freedom of the World.

Financial integration: In all NMS-6, most banking sector assets are under foreign ownership, mainly of banks domiciled in the euro area, with the Czech Republic, Romania, and Croatia exhibiting the highest degree of foreign bank ownership. Furthermore, Romanian, Croatian and Hungarian banks tend to rely on external liabilities more than their peers. However, cross-border asset holdings tend to be one-directional: FDI and portfolio investment from euro area residents in NMS is much larger than vice versa. As a result, domestic investment in the NMS is more sensitive to domestic saving than in EU15.

Foreign-owned Bank Assets, 2013

(in percent of total banking system assets)

Source: ECB.

External Bank Liabilities, May 2014

(in percent of total banking system liabilities)

Source: ECB.

Financial Assets, 2013

(Percent of GDP)

Source: IMF, IIP database.

Note: Total financial assets exclude FDI assets.

Financial Liabilities, 2013

(Percent of GDP)

Source: IMF, IIP database.

Note: Total financial liabilities exclude FDI liabilities.

Box 2. NMS Banks' Links to the Euro Area

In all NMS-6 countries, most banking sector assets are under foreign ownership. Foreign banks played a key role in both the pre-crisis credit boom and post-crisis bust, and continue to scale back their external positions vis-à-vis most NMS, but with some differentiation based on local banking system fundamentals.

The pre-crisis domestic demand booms across much of the region were mainly financed by euro area banks via funding of their local subsidiaries or via direct cross-border lending (see chart). On the demand side, credit expansion was driven by robust economic growth and falling nominal interest rates. The cost of foreign borrowing was brought down by a narrowing of the country risk premia and low opportunity cost of funds for foreign parent banks through the third quarter of 2007.

The post-2008 reversal turned the pre-crisis credit booms into busts. Euro area banks reacted by reducing their exposure to the region, while differentiating across NMS countries according to their risk profiles. Among the NMS-6, banking systems with relatively higher quality of loan portfolios and profitability and relatively lower share of foreign funding at the height of the boom, such as Poland and the Czech Republic, managed to attract additional foreign funding. Countries with higher FX-currency mismatches, NPLs and lower profitability, such as Hungary, Romania, Bulgaria experienced the largest outflows (see chart and Figure 1). As a result, the reliance on foreign funding has fallen across the region, while remaining above the euro area-average (see Box 1), with loan-to-deposit ratios in most NMS-6 now below the euro area-average (Figure 1).

External Position of BIS-reporting Banks vis-à-vis NMS Countries

(Billions of US dollars, exchange-rate adjusted, vis-à-vis all sectors)

Sources: BIS; and IMF staff calculations.

(Change, percent of 2013 GDP, vis-à-vis banks)

Sources: BIS; and IMF staff calculations.

Figure 1. NMS Banking Systems: Selected Indicators**Return on Assets, 2014 or Latest**
(Percent)

Source: BIS and IMF staff calculations.

Capital Ratio, 2014 or Latest
(Percent, bank regulatory capital to risk-weighted assets)

Source: IMF FSI tables.

Non-Performing Loans, 2014 or Latest
(Percent of total loans)

Source: IMF FSI tables.

Coverage Ratio, 2014 or Latest
(Percent, provisions to NPLs)

Source: ECB.

Share of FX and FX-Linked Loans in Private Sector Loans, November 2014 (Percent)

Sources: EBRD, IMF and IMF staff calculations.

Loan-to-Deposit, November 2014 (Percent)

Sources: IMF and ECB.

Box 3. How Do NMS-6 See Potential Benefits and Drawbacks of Euro Adoption?

This Box summarizes the results of a Fund staff survey of the views of the NMS-6' central banks and ministries of finance on euro adoption.

Benefits: the NMS-6 authorities value most the access to euro liquidity facilities, enhanced country reputation as a result of membership that could give rise, inter alia, to lower risk spreads, and the reduction of FX mismatches. There is considerable heterogeneity between responses, however. Other benefits, such as euro-adoption-driven trade and growth effects as well as a boost to inward direct investment, are viewed as less important. Euro adoption is generally not expected to increase countries' business cycle synchronization with the euro area.

Concerns: Authorities' concerns relate primarily to the euro area's unfinished reform agenda and, relatedly, to the extent to which the euro area governance framework will reduce fiscal and macro-prudential policy space. In addition, many respondents felt that it would be important to reach sufficient income convergence with the euro area prior to adoption euro.

Box 4. Benefits and Costs of Joining Banking Union for Non-Euro Area Countries

This Box describes a simplified taxonomy of country characteristics (top row in Table 3) and policy objectives (financial stability and growth, first column in Table 3) and whether joining the BU could help or hinder the achievement of these objectives (column showing potential benefits and costs). The cells in the matrix indicate which of the country characteristics are likely to be associated with relative benefits or costs.

Country characteristics:

The country characteristics in Table 1 are the ones that appear most relevant for the decision to join the common currency area or the common regulatory area based on the literature:

- The degree of *real or financial integration* with the euro area (columns 1 and 3) determines the relative likelihood of common versus asymmetric shocks and hence, risk-sharing preferences;
- The degree of *economic flexibility* (column 2) reflects the ability of the economy to absorb shocks; less flexibility makes it more likely that negative shocks could trigger financial instability.
- The *share of local bank assets owned by euro area banks* (column 4) indicates the importance of intra-group cross-border flows of euro area banks for domestic financial stability.
- The *supervisory standards* (column 5) refer to the stringency of rules and quality of supervisory processes at the local level.
- *Local backstops* for the financial system include local deposit guarantee schemes (DGS) (column 6) and *fiscal policy space* (column 8) refers to national capacity to absorb shocks. Their adequacy is inversely related to countries' potential exposure to contingent liabilities, as measured by the ratio of insured deposits to GDP, and the size of public debt relative to GDP.
- *Policy space indicates* the availability and effectiveness of monetary and fiscal policies (columns 7 and 8), as tools for demand management. Fiscal policy space can be proxied by the ratio of public debt to GDP, whereas the availability of monetary policies depends on the nominal anchor (exchange rate versus inflation) chosen by the central bank.

Examples of trade-offs:

- Economies that are less integrated with the euro area and hence more likely to find themselves facing different cyclical conditions than the rest of the BU (e.g., Bulgaria, Croatia) face a trade-off between gaining access to a large industry funded common backstop (SRF)¹ and giving up some flexibility to deal with country specific shocks.²
- Economies where local banking systems are dominated by euro area banks (e.g., Czech Republic, Croatia) face a trade-off between gaining more information and involvement in discussions and decisions concerning euro area parent banks versus ceding full control over intra-group cross-border capital and liquidity flows (ability to ring-fence).³

¹ That, in practice, will only be mutualized gradually over time.

² Due to possible constraints on macroprudential policies discussed in the main text.

³ If all/most negative externalities stemming from the activities of the euro area cross-border banks are indeed effectively eliminated under the BU, then the value of having control over intra-group cross-border flows would be significantly reduced. One example of such negative externalities is the failure of home supervisors of banks with subsidiaries in Central and Eastern Europe (CEE) to rein in credit expansion in the region, which fueled unsustainable domestic demand booms prior to 2008. Host supervisors' efforts to limit rapid credit growth were easily circumvented by redirecting borrowers from local subsidiaries to parent banks' headquarters. After the onset of the crisis, a coordinated effort was undertaken, including under the Vienna Initiative, to mitigate financial stability risks in the CEE countries stemming from synchronized large scale deleveraging by parent banks.

Table 3. A Simplified Taxonomy of Benefits and Costs of Joining Banking Union for Non-Euro Area Countries

Policy objective	Benefit or Cost of Joining the Banking Union	Real Sector				Financial Sector				Supervision/Backstops				Policy Space			
		(1) Degree of real convergence/integration with the euro area		(2) Degree of labor & product markets flexibility		(3) Degree of financial integration with the euro area		(4) Banking system structure (share of banks owned by euro area banks)		(5) Supervisory standards		(6) Industry-funded backstops (DGS)		(7) Monetary		(8) Fiscal	
		High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Financial stability	1. Improve the overall quality of supervision										+		+				+
	2. Limit negative externalities from euro area banks					+		+		+		+					+
	3. Increased access to info and improved home-host coordination through SSM					+		+									
	4. Reduce ability to mitigate country specific shocks		-		-		-		-	-							
	5. Constrain ability to control cross-border intra-group flows					-		-		-							
	6. Increase efficiency and lower cost of cross-border bank resolution							+									
	7. Provide access to common, industry-funded backstop (SRF)		+		+		+						+				+
	8. Loss of some local control over resolution process in the absence of fiscal backstops							-		-			-				-
	9. Reduce ability to smooth credit cycles through prudential measures		-		-		-		-	-					-		
<p>Note: The table presents a simplified taxonomy of country characteristics (top row) and policy objectives (first column) and whether joining the BU could help or hinder the achievement of these objectives (rows showing potential benefits and costs). The cells in the matrix indicate whether country's ranking on a given country characteristic has a material impact on the benefits or costs of joining (e.g., the degree of real or financial integration with the euro area (columns 1 and 3) affects the relative likelihood of common versus asymmetric shocks, with lower integration = higher likelihood of asymmetric shocks and hence costs of giving up local policy space to respond to them). Types: for each characteristic listed in the top row, a country can be of two types: "High" – at or above the average across BU members; and "Low" –below the average across BU members. Payoffs: "-" (extra loss); "+" (added benefit with diagonal stripes indicating only partial benefit during transition to full SRF mutualization); and "blank" (particular benefit or cost of joining does not depend directly on country ranks on a particular economic characteristic).</p>																	

Box 5. How Do NMS-6 See Potential Benefits and Drawbacks of Early Opt-in the BU?

This Box summarizes the results of a Fund staff survey of the attitudes of the NMS-6' central banks and ministries of finance regarding possible participation in the Banking Union prior to euro adoption.

The survey revealed greater concern about potential downsides of early opt-in the BU than appreciation of potential upsides. The areas of greatest concern are the anticipated loss of control over cross-border intra-group liquidity flows, the inadequate role of NMS-6 in the SSM and SRM governance, loss of control over bank resolution, and the absence of provisions for access to ECB liquidity. At the same time, the main attractions of BU membership are the access to common industry-funded backstop in case of bank resolution, the better access to information about foreign parent banks, as well as the expected improvement in market perception of quality of supervision and in coordination between home and host supervisors. However, NMS-6 policymakers see limited scope for increasing the quality of supervision under the SSM via stricter prudential norms and distancing from vested local interests. On the upside, the operational costs of the centralization of bank resolution are not considered an obstacle to opting-in.

NMS-6 Survey Results*

(*) 4 – High Importance; 2 – Moderate; 0 – Negligible Importance; bars show the balance of opinion from five responses from CBs and four from MoFs.

1 Loss of control over cross-border intra-group flows	1 Access to (larger) common backstop (SRF)
2 Inadequate representation in the SSM	2 Greater access to information related to parent banks
3 Inadequate role in the SRM decisions	3 Increased market perception of quality of supervision
4 Loss of control over bank resolution	4 Improving home-host coordination
5 Lack of access to the ECB liquidity facilities	5 Higher quality of supervision via more consistent enforcement of prudential norms
6 Under the SSM, bank supervision may not be sufficiently strict for country circumstances	6 Greater role in shaping euro area financial architecture
7 Lack of access to common fiscal backstop	7 Reducing bank compliance costs
8 Excessively complicated procedures for bank resolution under SRM rules	8 Increasing influence over supervisory decisions related to parent banks
9 Challenges in coordinating monetary and prudential policies	9 Increasing efficiency and reducing cost of bank resolution
10 SRF is not yet fully mutualized	10 Reducing bank funding costs
11 Under the SSM, bank supervision may be too strict than called for by country circumstances	11 Distance supervision from vested local interests
12 SRF contributions are too high given expected benefits	12 Higher quality of supervision via stricter prudential norms

Box 6. EU Services Directive: Reduction in Barriers

The EU services Directive (SD) was adopted in 2006 in order to promote competition and trade in services. The intended implementation period was 2006—2009, during which member countries were to review their respective regulatory framework for services in order to identify restrictions that could be removed. However, countries were given considerable leeway as pre-existing restrictions could be maintained if they were deemed necessary to protect public interest as long as they were non-discriminatory, necessary and proportionate. Countries worked in clusters of 5 members each for mutual evaluation of abolition/amendment of restrictions. Regulations targeted by the SD mostly include prior authorizations, licenses, specific authorizations, economic needs tests, prohibition on having an establishment in more than one member state, quantitative or territorial restrictions, and restrictions on multidisciplinary activities.

The EC assessed the economic impact of the Services Directive (SD) in 2012 (Monteagudo et al., 2012). The focus of the assessment was on the quantification of changes in barriers since the implementation of the SD. The study found that barriers across member states and services sectors have significantly decreased since the implementation of the SD – about 30 percent reduction across the EU. But the reduction varies across member states as well as sectors – from very low barrier reductions in Austria and United Kingdom to more than 50 percent reductions in Spain and Sweden; also from a 14 percent barrier reduction for Tax Advisers to a 50 percent reduction for Travel Agencies, highlighting significant room for further decrease.

Number of Barriers across Countries

Number of Barriers across Sectors

Source: Monteagudo et al. (2012). Note: Number of barriers reflects the sum of barriers across EU-27 and across selected 15 sectors. A value of 0, 0.8, and 1 are assigned to barriers that are eliminated, partially eliminated, and unchanged.