Flash Comment

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Lars Christensen, Senior Analyst, + 45 45 12 85 30 (direct), + 45 40 74 49 51 (mobile), larch@danskebank.dk

New Europe: Does the ECB dislike the CEE currency boards?

The increasing and clear signs of overheating in a number of Central and Eastern European countries – especially the Baltic States and South East Europe – are drawing attention not only from the financial markets, but also from international institutions. Recently the IMF has warned of the dangers of overheating in the CEE and the World Bank has on numerous occasions raised the same concerns. Now the ECB is also stepping up the rhetoric. At a conference earlier this week ECB officials expressed their concern about the increasing imbalances in the Central and Eastern European economies.

In fact, it seems that the ECB is suggesting what would have been unthinkable a year ago – that is it time to change the exchange rate policies in the CEE countries with exchange rate pegs – i.e. the Baltic countries and Bulgaria. It seems that at this week's conference ECB board members Jürgen Stark and Lorenzo Bini Smaghi have been indicating that the fixed exchange policies in the Baltics and Bulgaria contribute to increasing imbalances in these economies.

Most strikingly Bini Smaghi said: "the requirements for the budgetary and structural policies associated with an exchange rate linked to the euro might just be too demanding to counteract the pro-cyclical effects of very low real interest rates. This might lead to boom and bust cycles, with potentially very severe adjustments costs that may delay real convergence."

Is this the ECB's way of telling the Baltic countries and Bulgaria to give up their exchange rate pegs? We cannot be sure but Bini Smaghi's comments can hardly be interpreted as an endorsement of the fixed exchange rate regimes that are in place in the Baltics and Bulgaria.

On the back of Bini Smaghi's comments one could also raise the question whether the ECB would help the national central banks to defend the present pegs if they were to come under pressure.

Obviously, as the Baltic countries (but not Bulgaria) are ERM2 members the ECB at least to some extent has an "obligation" to defend the +/- 15% fluctuation band around the central parity for the Baltic exchange rate, but the ECB is not committed in anyway to defend a tighter band - like the +/- 1% fluctuation band that is in place in Latvia.

Therefore, we think that the Baltic and Bulgarian central banks will not get any help from the ECB in defending the currency pegs – not before the currencies get close to the weak end of the 15% fluctuation band. The ECB might even be unwilling to defend the currencies at these levels. First, Bulgaria is not an ERM2 member and the ECB does not have any formal obligation to defend Bulgaria's currency board. Second, when the Baltic States joined ERM2 the countries committed themselves to reducing imbalances in their economies. The developments in inflation and the current account in the Baltic countries show that they have failed to do this. The ECB might use that as an "excuse" not to even defend the 15% fluctuation band in the event that the Baltic currencies were to come under pressure.

We believe this issue is of extreme importance for the Central and Eastern European markets. To us it is quite clear that urgent policy action is needed to bring down the imbalances, especially in the Baltic States and South East Europe. These countries will not get any help from the ECB in defending their currency pegs unless action is taken very soon.

Finally, we also note that the EU Commission is probably in line with the ECB on this issue. We feel that the EU Commission is unsatisfied with the speed of reforms in most of the new EU member states and therefore is likely to play hardball if some of them were to get into economic problems due to the New Europe boom turning into a bust.