Are the New Member States on the fast track to the EMU?

An analysis of exchange rates misalignments in

Central European countries

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Non-technical summary

The paper aims at identifying determinants of the exchange rates in the New EU Member states, in order to state whether the deviations of actual exchange rates from its steady-state levels enable these currencies to join the ERM2 in the next years. This paper is partly motivated by the consequences of the subprime crisis for the behaviour of the exchange rates in the emerging markets. The floating exchange rates of domestic currencies vs. euro in the NMS are modeled by means of the panel VEC model.

The main findings of the research are:

- the Czech koruna, the Polish zloty and the Hungarian forint follow the same long-run relationship, in which the real exchange rates are explained by the real interest rates parities and the spreads of the sovereign credit default swaps
- due to differences in the economic setting (high inflation, lack of long-term inflation targeting), the common relationship is rejected for the Romanian leu
- the equilibrium exchange rates (EER’s) in the NMS evolve dissimilarly in general, but till the year 2005, there is an appreciatory trend for the EER’s in the Czech Republic, Hungary and Poland, which is due to the perspective of entering the EU. In case of Czech Republic and Poland there is a two year depreciatory trend from the middle of 2007, related to the financial crisis in the subsequent years and increments of the risk premiums. In case of Hungary, a shift in mean of the EER is observed at the beginning of 2006, which should be attributed to the deterioration of the Hungarian economy performance and the following austerity package. The EER of the Romanian currency exhibits a depreciatory trend in the whole sample, which is mostly due to high domestic inflation rate
- the disequilibriums in the other countries usually push EER’s outside their steady-states. Hence, the currency markets of the Czech Republic, Poland and Hungary are closely related in such a manner that appreciation/depreciation of one currency leads to similar movements in the other currencies of the NMS in the short-run

- the estimated misalignments exhibit some common patterns in terms of time spans and percentage values of under/overvaluation:
  - all currencies of the NMS are undervalued in the years 2003-2004, i.e. before the EU enlargement in the next year.
  - in the last years the exchange rates in Poland and Hungary remain close to its equilibrium levels, whereas the currencies of the Czech Republic and Romania are overvalued

- similar evolution of the exchange rates misalignments enables the NMS to jointly enter the EMU

- high values of the exchange rates misalignments make entering the EMU unlikely to happen in the next years

**Keywords:** equilibrium exchange rate, exchange rate misalignments, New Member States, EMU, panel VEC model