RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS IN EU CANDIDATE COUNTRIES

In view of the advances made as regards accession prospects in a number of candidate countries, this article takes stock of recent economic and financial developments in these countries and outlines the challenges that remain ahead on the road to EU membership. While growth in candidate countries was generally robust prior to the global recession of 2009, this tended to be associated with increasing external and domestic imbalances, which proved unsustainable in the face of an external shock on the scale of the global financial crisis. The drying-up of external finance following Lehman Brothers' collapse also exposed other long-standing vulnerabilities in candidate countries which had not been addressed in the context of the rapid financial expansion seen prior to the crisis. Policy responses to the crisis were conditioned by the monetary policy frameworks and exchange rate regimes chosen by the respective authorities. The recent crisis, coupled with the ongoing turbulence in some parts of the euro area, serves as a reminder that lasting and sustainable convergence requires sustained policy efforts. In this regard, both membership of the EU and the eventual adoption of the euro should be seen as means to an end – namely real convergence, stability and prosperity – rather than as objectives in themselves.

1 INTRODUCTION

On 1 July 2013, Croatia is set to become the EU's 28th Member State. This will be the seventh enlargement in the EU's history and the first since 2007. A number of other countries are either on a formal path towards EU membership, subject to the successful fulfilment of relevant criteria (the "candidate countries", which are the primary focus of this article), or have at least been explicitly offered the prospect of EU membership (the "potential candidate countries", which are treated in a selective manner for the purposes of this article[1]).

In addition to Croatia's accession set to take place in 2013, over the past few years there have been a multitude of changes in terms of the institutional status of the various countries, with some countries being formally "upgraded" to candidate country status (having previously been regarded as potential candidate countries), other countries formally beginning accession negotiations a number of years after being granted candidate country status, and others moving from non-member status to the formal negotiation of accession within a relatively short period of time. At the same time, it is worth noting that some candidate countries were among the first casualties in the chain of events triggered by the global financial crisis, exhibiting some of the vulnerabilities that would subsequently afflict other parties elsewhere. These vulnerabilities included, to varying degrees, financial excesses, external and internal imbalances, fiscal fragility, limited scope for counter-cyclical fiscal policies and, in some cases, a need to resort to multilateral sources of external finance for balance of payment support. In light of these developments, this article reviews recent economic and financial developments in candidate countries and the challenges that lie ahead.

The remainder of this article is structured as follows. Section 2 documents the economic and institutional heterogeneity of countries on the road to EU membership. Section 3 describes economic and financial developments in candidate countries before, during and after the 2008-09 global financial crisis. Section 4 provides an overview of the monetary policy frameworks and exchange rate regimes in candidate countries. Section 5 outlines selected

1 The Treaty on European Union states that any European country may apply for membership if it respects the EU's democratic values and is committed to promoting them. A country can only join the EU if it meets all of the membership criteria articulated by the Copenhagen European Council of 1993 (and thus referred to as the "Copenhagen criteria"), namely: (i) it must have stable institutions guaranteeing democracy, the rule of law and human rights; (ii) it must have a functioning market economy and be able to cope with competitive pressures and market forces within the EU; and (iii) it must accept established EU law and practices, especially the major goals of political, economic and monetary union. Croatia is termed an "acceding country", having concluded accession negotiations and signed an act of accession. Five countries (Iceland, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey) have officially been granted "candidate country" status, and other countries in the western Balkans (Albania, Bosnia and Herzegovina, and Kosovo as defined under UNSCR 1244/99) are recognised as "potential candidate countries".

economic and financial challenges for candidate countries in the period ahead, with a focus on long-standing vulnerabilities that were not addressed in the context of the rapid financial expansion seen prior to the crisis. Section 6 concludes and draws some tentative policy lessons from the experiences of candidate countries in recent years.

2 THE ECONOMIC AND INSTITUTIONAL HETEROGENEITY OF COUNTRIES ON THE ROAD TO EU MEMBERSHIP

2.1 THE STATE OF THE EU ACCESSION PROCESS

The candidate countries are very diverse as regards their relative positions on the road to EU membership, as well as in economic terms. As regards the current state of accession negotiations, Croatia signed its accession treaty with the EU in December 2011 after around six years of negotiations and is now an acceding country.[2] It is set to become a full EU Member State in July 2013. Of the five countries that have officially been recognised as candidates to join the EU, three have begun accession negotiations: (i) Iceland, which applied for EU membership in July 2009 and began accession negotiations just one year later, as it already enjoyed a high degree of integration with the EU (as a member of the European Economic Area, the Schengen area and the European Free Trade Association); (ii) Montenegro, which applied for EU membership in 2008 and was granted candidate country status in 2010, before the opening of accession negotiations in June 2012; and (iii) Turkey, which applied to join what was then the European Economic Community in 1987, was declared eligible in 1997, and has been negotiating its accession since 2005.

The two other recognised candidate countries have yet to begin accession negotiations. The former Yugoslav Republic of Macedonia applied for EU membership in 2004 and was granted candidate country status in 2005, and Serbia applied for EU membership in 2009 and was granted candidate country status in March 2012. The three other western Balkan countries (i.e. Albania, Bosnia and Herzegovina, and Kosovo[3] as defined under UNSCR 1244/99) have been identified as potential candidates for EU membership in line with the conclusions of the Thessaloniki European Council of June 2003, which established the integration of this region as a priority for EU enlargement.

The ECB is involved in the accession process in its areas of competence, notably as regards monetary and exchange rate policies, financial stability and central bank statutes. The ECB closely monitors economic, financial and monetary developments in candidate and potential candidate countries. It also engages in regular exchanges of views with central banks from these countries (including an annual high-level policy dialogue with the central banks of candidate countries that have begun accession negotiations) and organises a number of other events at various levels aimed at establishing institutional relations and fostering dialogue. Finally, together with the NCBs of the Eurosystem and the European System of Central Banks, the ECB engages in technical cooperation with the central banks of candidate and potential candidate countries, with the aim of enhancing institutional capacity.[4]

2.2 DIFFERENCES IN ECONOMIC STRUCTURE

Candidate countries also vary significantly in terms of their underlying economic structures, ranging from Iceland's highly advanced economy to the transition countries of the

2 Despite being an acceding country, Croatia will be discussed together with the other candidate countries in this article.

3 This designation does not constitute a position on the status of this territory and is in line with UNSCR 1244/99 and the opinion issued by the International Court of Justice on Kosovo's declaration of independence.

4 The ECB and the NCBs provide technical cooperation both in response to ad hoc requests for short-term assistance and in the form of fully fledged longer-term programmes. Bilateral technical cooperation programmes have seen assistance provided to the central banks of Bosnia and Herzegovina (2007 and 2010-11), Serbia (2008-09 and 2011-13), Turkey (as of 2012) and the former Yugoslav Republic of Macedonia (2012-13), while a regional programme in 2010-12 has seen support for the central banks and banking supervisors of all candidate and potential candidate countries (with the exception of Iceland).

Table 1 Structural indicators for candidate and potential candidate countries

	Population (millions)	GDP per capita (US dollars, PPP terms)	Economic structure (percentages of GDP)			Exports (as a percentage of GDP)	Institutional indicators	
			Agriculture	Industry	Services		Transition progress[1]	Governance[2]
	2011	2011	2011	2011	2011	2011	2010	2011
Candidate countries								
Croatia	4.4	18,192	5.5	27.4	67.1	40.8	3.6	0.4
FYR Macedonia	2.1	10,367	11.3[3]	27.8[3]	60.9[3]	56.0	3.3	-0.1
Iceland	0.3	38,061	7.2[4]	25.2[4]	67.6[4]	58.4	...	1.4
Montenegro	0.6	11,545	10.1	20.0	69.9	39.5	2.9	0.1
Serbia	7.4	10,642	9.0	26.6	64.3	36.1	2.9	-0.1
Turkey	74.0	14,517	9.2	27.1	63.8	23.5	3.3	-0.1
Potential candidate countries								
Albania	3.2	7,741	20.0	19.4	60.6	33.6	3.1	-0.2
Bosnia and Herzegovina	3.9	8,133	8.7	26.2	65.1	41.1	2.8	-0.4
Kosovo	1.7	...	12.0	20.0	68.0	...	...	-0.5
Memorandum item								
EU10[5]	...	19,991	4.2[6]	29.6[6]	66.2[6]	70.8	3.7[7]	0.7

Sources: IMF, World Bank, EBRD and national sources.
1) The EBRD's transition indicator measures a country's progress from a rigid centrally planned economy (score of 1.0) to an industrialised market economy (score of 4.3). The figures shown in the table represent average scores across nine areas assessed by the EBRD.
2) The World Bank's governance indicator measures six aspects of governance, with scores ranging from -2.5 (worst) to +2.5 (best). The figures shown in the table represent unweighted averages across the six aspects assessed.
3) Data for 2010.
4) Data for 2009.
5) Unweighted average of Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.
6) Data for 2010; average excludes the Czech Republic and Estonia.
7) Average excludes the Czech Republic.

western Balkans, to G20 member Turkey. Table 1 provides summary indicators illustrating the differences between candidate countries as well as between potential candidate countries as regards economic structure and institutional development.

Iceland stands out in this respect, having by far the highest GDP per capita of all candidate countries (more than USD 38,000 in 2011), while displaying levels of governance akin to those of other industrialised economies. By contrast, the income per capita and institutional maturity of the remaining candidate countries generally fall short of the levels observed in the EU countries in central and eastern Europe (EU10)[5]. Performance in respect of institutional variables, such as progress with transition and the quality of governance, appears to be most advanced in those economies that have come the furthest as regards EU integration, with the country closest to becoming an EU Member State (i.e. Croatia) tending to rank highest, and candidate countries in the western Balkans tending to be less advanced. This is also the case for the three potential candidate countries in that region.

In spite of these differences, some similarities are worth noting. First, all candidate countries have service-oriented economies with more than 60% of GDP derived from this sector. Nevertheless, agriculture seems, overall, to play a more prominent role than in the EU10. Second, with the exception of Turkey, most candidate countries are relatively open to trade, although they remain a long way behind in relation to the export shares typically observed in the EU10. Third, candidate countries have significant trade links with the EU, which typically accounts for around two-thirds of their total exports and imports.

5 This article uses the term "EU10" to refer to Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia – i.e. the countries in central and eastern Europe that joined the EU in 2004 and 2007.

3 ECONOMIC AND FINANCIAL DEVELOPMENTS IN CANDIDATE COUNTRIES

3.1 DEVELOPMENTS PRIOR TO THE CRISIS

Notwithstanding their economic and institutional heterogeneity, candidate countries shared a number of characteristics in the years prior to the onset of the global financial crisis in 2008. First, the period between 2003 and 2008 was characterised by robust growth, with average annual increases in real GDP ranging between 4.3% (in Croatia) and 6.2% (in Montenegro) (see Table 2).

Second, this surge in output was accompanied by considerable financial expansion (see Chart 1), with the largest increases in domestic credit as a percentage of GDP in the period between 2003 and 2008 being observed in Montenegro (75 percentage points) and Iceland (55 percentage points). In the remaining countries, such increases ranged from 19 percentage points (in Croatia) to 25 percentage points (in the former Yugoslav Republic of Macedonia), more or less in line with trends witnessed in the EU10 (where an average increase of 27 percentage points was observed). A substantial percentage of domestic credit was supplied by foreign financial institutions, the majority of which were located in the EU. In fact, in a number of economies, real increases in the volume of local deposit money banks' liabilities vis-à-vis non-residents were broadly matched by the corresponding rise in credit to the private sector (see Chart 2).

Third, the provision of such significant amounts of finance fuelled a domestic demand boom, which in most instances could not be matched by the expansion of local productive capacity, leading to the emergence of sizeable external imbalances. By 2008, all candidate and potential candidate countries were recording significant current account deficits (ranging from around 10% of GDP to far higher levels), which in most cases represented a further deterioration relative to the sizeable shortfalls recorded in 2003. This was particularly true of Serbia, Iceland and Montenegro, where current account

Table 2 Economic indicators for candidate and potential candidate countries

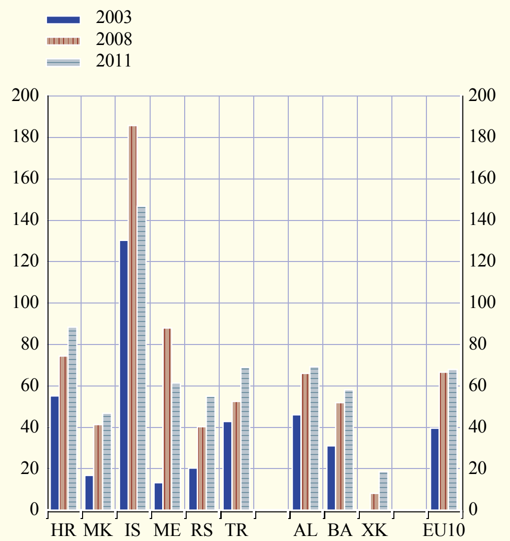
(annual averages; percentages; percentages of GDP)

	GDP growth			Inflation			Current account balance			General government balance[1]			General government gross debt		
	2003-2008	2009	2010-2011	2003-2008	2009	2010-2011	2003-2008	2009	2010-2011	2003-2008	2009	2010-2011	2003-2008	2009	2010-2011
Candidate countries															
Croatia	4.3	-6.0	-0.6	3.1	1.9	2.0	-6.7	-5.0	-0.1	-2.7	-4.1	-5.2	34.4	35.1	43.4
FYR Macedonia	4.7	-0.9	2.4	2.8	-1.7	2.9	-6.5	-6.8	-2.5	-0.1	-2.7	-2.5	30.5	23.8	26.5
Iceland	4.9	-6.8	-0.5	6.8	7.5	3.9	-17.7	-11.8	-7.4	2.4	-8.6	-5.5	40.0	88.2	96.1
Montenegro	6.2	-5.7	2.5	5.6[2]	1.8	1.7	-29.8	-29.6	-21.9	0.6	-5.7	-5.7	34.8	40.7	44.2
Serbia	5.0	-3.5	1.4	10.6	6.6	8.6	-14.1	-7.1	-8.3	-1.0	-3.7	-3.8	47.7	38.2	46.4
Turkey	5.8	-4.8	8.7	11.0	6.5	8.4	-5.1	-2.2	-8.2	-2.5	-5.6	-1.4	48.7	46.1	40.7
Potential candidate countries															
Albania	6.0	3.3	2.7	2.5	3.7	2.5	-8.6	-13.5	-12.5	-4.1	-7.4	-3.8	56.8	59.8	58.6
Bosnia and Herzegovina	5.3	-2.9	1.2	4.4[3]	0.0	2.9	-13.7	-6.3	-7.3	-0.4	-5.7	-3.8	27.8	36.1	40.1
Kosovo	4.7	2.9	4.4	1.5	0.1	5.1	-9.5	-15.4	-19.0	0.7	-0.6	-2.2	...	...	...
Memorandum item															
EU10[4]	5.8	-8.2	2.5	5.2	1.6	3.6	-9.4	-0.7	-0.9	-1.9	-5.9	-4.2	27.5	34.4	39.4

Sources: IMF and ECB calculations.
1) General government net lending/borrowing.
2) 2006-2008.
3) 2007-2008.
4) Unweighted average of data for Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Chart 1 Domestic credit

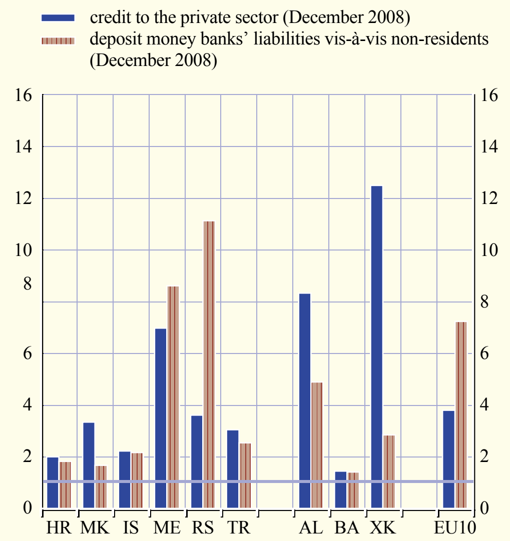
(as a percentage of GDP)



Sources: IMF and ECB calculations.
HR: Croatia; MK: the former Yugoslav Republic of Macedonia; IS: Iceland; ME: Montenegro; RS: Serbia; TR: Turkey; AL: Albania; BA: Bosnia and Herzegovina; XK: Kosovo.

Chart 2 Real growth in credit to the private sector and liabilities of deposit money banks vis-à-vis non-residents

(index: December 2002 = 1.0)



Sources: IMF and ECB calculations.
Notes: For reasons of data availability, figures for Montenegro and Bosnia and Herzegovina relate to December 2005 and December 2006, respectively.
HR: Croatia; MK: the former Yugoslav Republic of Macedonia; IS: Iceland; ME: Montenegro; RS: Serbia; TR: Turkey; AL: Albania; BA: Bosnia and Herzegovina; XK: Kosovo.

deficits in 2008 of 21.6%, 28.3% and 50.6% of GDP respectively were not sustainable from a medium-term perspective.

Fourth, consistent with these trends, in some candidate countries (notably Iceland, Montenegro, Serbia and Turkey) inflation was not generally in line with local targets of price stability (see Table 2 and Section 5.1).

3.2 THE CRISIS AND ITS AFTERMATH

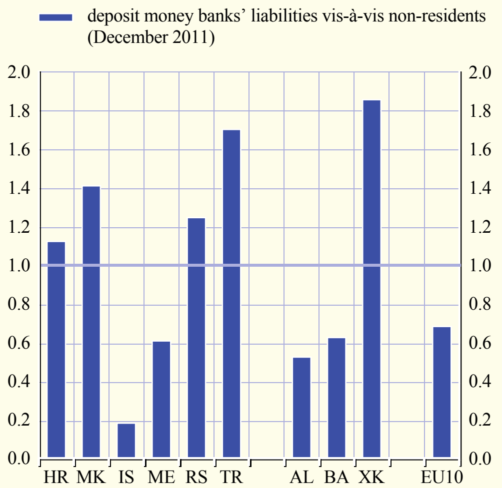
With the onset of the global financial crisis in autumn 2008 and the spillover from advanced to emerging and developing economies, candidate countries experienced a severe real economic contraction. Although this was associated primarily with the drying-up of external finance and downturns in key trading partners affected by the first wave of the crisis, other variables – such as countries' relative starting positions (e.g. as regards the pace of underlying credit expansion) and economic openness (with more open countries being more vulnerable) – were also important in determining the extent of the downturn in economic activity in candidate countries.

Thus, the domestic and external imbalances that had accumulated over the years unwound at a relatively rapid pace. The most heavily affected candidate countries saw real GDP contract by between 3.5% (in the case of Serbia) and 6.8% (in the case of Iceland) in 2009. The former Yugoslav Republic of Macedonia experienced a mild recession, with real growth contracting by 0.9%, while less financially exposed potential candidate countries in the western Balkans, such as Albania and Kosovo, had a soft economic landing and continued to post positive rates of real growth (see Table 2). Flows of finance from abroad – which had primarily taken the form of foreign direct investment and (debt-creating) other investment – tailed off. However, banks maintained their credit exposure to most candidate and potential candidate countries, partly as a result of policy action such as the "Vienna Initiative"[6], and those countries whose domestic banking systems were dependent on (now scarce) wholesale funding from abroad were put in a difficult predicament (see Chart 3). In some candidate countries (such as Montenegro) and in some potential candidate countries in the western Balkans, there was a marked contraction in foreign claims on domestic banking systems. Iceland is a special case in this respect on account of it defaulting on its external liabilities (see Box 2).

While candidate countries experienced similar economic and financial dynamics prior to the crisis, and the immediate contractionary effect seen in those countries as a result of Lehman Brothers' collapse was broadly comparable, there has been considerable heterogeneity in terms of those countries' economic performance since the 2009 recession. In 2010 and 2011 real activity in the former Yugoslav Republic of Macedonia, Montenegro and Serbia was relatively muted, Turkey recorded strong growth, and Croatia and Iceland continued to contract (see Table 2). These differences were also reflected in the changes observed in current account balances and inflation rates in the wake of the crisis. In Turkey, the current account deficit increased markedly following the 2009 recession and inflation rose. By contrast, there was persistent narrowing of external deficits in Croatia and Iceland, with price pressures remaining relatively limited.

Chart 3 Real growth in liabilities of deposit money banks vis-à-vis non-residents

(index: December 2008 = 1.0)



Sources: IMF and ECB calculations.
Note: HR: Croatia; MK: the former Yugoslav Republic of Macedonia; IS: Iceland; ME: Montenegro; RS: Serbia; TR: Turkey; AL: Albania; BA: Bosnia and Herzegovina; XK: Kosovo.

As regards countries' fiscal stances, the aftermath of the crisis has revealed that the broadly favourable picture observed in most countries prior to the crisis stemmed largely from the sizeable contribution that the dynamic (and, with hindsight, unsustainable) pace of economic activity made to public revenues. Average government budget balances in candidate countries ranged from -2.7% of GDP (in Croatia) to 2.4% of GDP (in Iceland) in the period 2003-08, but public deficits and indebtedness both rose sharply in 2009 (see Table 2). Following this deterioration, some of which was related to the operation of automatic stabilisers and shrinking revenue bases associated with the downturn in economic activity, budget balances have improved modestly in most candidate countries. However, fiscal positions have become more fragile relative to the pre-crisis period, limiting fiscal room for manoeuvre and making fiscal consolidation a significant challenge in many candidate countries.

4 MONETARY POLICY FRAMEWORKS AND CONDUCT IN CANDIDATE AND POTENTIAL CANDIDATE COUNTRIES

Monetary policy and exchange rate regimes in candidate countries encompass a broad spectrum of approaches, ranging from the

6 The European Bank Coordination Initiative (referred to as the "Vienna Initiative") was launched in January 2009 as a coordination platform for parent banks, home and host country authorities (i.e. central banks, supervisory authorities and ministries of finance), the IMF, the European Commission and the EBRD. Within this framework, parent banks signed (non-binding) letters pledging to maintain their exposure to countries with IMF/EU stabilisation programmes that were participating in the Vienna Initiative.

Table 3 Monetary policy and exchange rate regimes of candidate and potential candidate countries

	Currency	Monetary arrangement	Exchange rate structure	
			De jure	De facto
Candidate countries				
Croatia	Croatian kuna	exchange rate anchor vis-à-vis the euro	managed float	managed float
FYR Macedonia	Macedonian denar	exchange rate anchor vis-à-vis the euro	float	stabilised arrangement
Iceland	Icelandic króna	inflation-targeting with exchange rate stability as an interim target	float	float
Montenegro	euro	unilateral euroisation	no separate legal tender	no separate legal tender
Serbia	Serbian dinar	inflation-targeting	managed float	float
Turkey	Turkish lira	inflation-targeting	float	float
Potential candidate countries				
Albania	Albanian lek	inflation-targeting	float	float
Bosnia and Herzegovina	convertible mark	exchange rate anchor vis-à-vis the euro	currency board	currency board
Kosovo	euro	unilateral euroisation	no separate legal tender	no separate legal tender

Sources: IMF Annual Report on Exchange Arrangements and Exchange Restrictions and ECB compilation.

unilateral adoption of the euro in Montenegro to a tightly managed float in the former Yugoslav Republic of Macedonia, to inflation-targeting with a freely floating exchange rate in Serbia. Turkey and Iceland also operate inflation-targeting regimes with a number of idiosyncratic elements (discussed in detail in Boxes 1 and 2 respectively). Monetary policy and exchange rate regimes also vary widely across potential candidate countries, with unilateral euroisation in Kosovo, a currency board arrangement in Bosnia and Herzegovina, and an inflation-targeting regime with a freely floating exchange rate in Albania (see Table 3).

Box 1

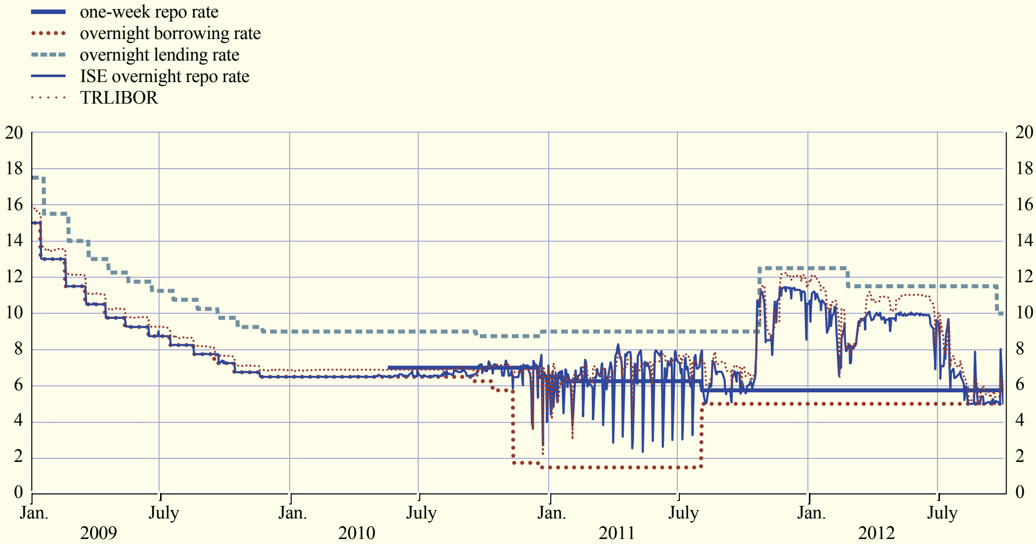
THE MONETARY POLICY OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

The monetary policy framework of the Central Bank of the Republic of Turkey has undergone some significant changes since autumn 2010, when the central bank introduced a monetary and macro-prudential policy mix. The central bank's primary objective is the achievement and maintenance of price stability in line with its inflation-targeting framework (which was established in its current, fully fledged form in 2006). However, in autumn 2010 the central bank began referring to financial stability goals when communicating strategy and policy decisions. In practice, in addition to targeting inflation, the monetary policy framework currently focuses on a number of variables (such as credit growth and the exchange rate) with a view to achieving multiple objectives, including financial stability, the rebalancing of economic growth and (given the large current account deficit) external stability.

The monetary policy tools used to achieve these multiple objectives include the more active use of the interest rate corridor and reserve requirement ratios in addition to the policy rate, with the resulting flexibility being the primary feature of this framework. In practice, this flexibility offers the possibility to adjust the primary focus of monetary policy and the way in which instruments

Money market and monetary policy rates in Turkey

(percentages per annum)



Source: Haver Analytics.
Note: ISE = Istanbul Stock Exchange; TRLIBOR = Turkish lira reference interest rate.

are applied in response to external and domestic financial conditions. Consequently, several distinct phases can be seen as regards the use of monetary policy (see the chart for details of interest rate developments as of 2009).

In the first phase, as of autumn 2010, the central bank focused, in an environment characterised by ample short-term external financing at low cost, on reducing macro-financial risks. In particular, it widened the interest rate corridor by reducing the overnight borrowing rate, and it also cut the policy rate (the one-week repo rate) in order to discourage short-term capital inflows. At the same time, it raised reserve requirement ratios – varying them by maturity, with lower ratios for longer maturities – to counter accelerating credit growth and encourage long-term (as opposed to short-term) lending.

The external environment then changed, with renewed increases in risk aversion in August 2011. The central bank reacted by narrowing the corridor between the overnight borrowing and lending rates, as well as applying liquidity measures and adopting a more accommodative stance by means of lower reserve requirements and a further reduction in the policy rate.

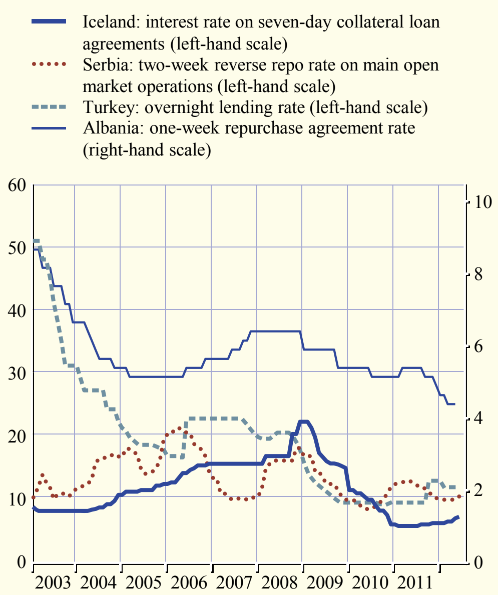
In October 2011, in order to counter rising inflationary pressures (partly due to the depreciation of the Turkish lira), the central bank widened the interest rate corridor, and coupled this with foreign exchange interventions. The central bank then allowed market rates to increase by rationing funding for banks in the repo market, thereby changing the average cost of the liquidity that it provided.

More recently, with inflation gradually becoming less of a concern, the central bank first allowed market rates to return to lower levels within the interest rate corridor, showing how it makes use of the flexibility provided for by the framework. Then, effective from 18 September 2012 onwards, it also reduced the top-end of the corridor by 150 basis points.

Looking at the monetary policy frameworks and exchange rate regimes in candidate countries helps to shed light on the various actions undertaken by domestic authorities in response to the fluctuations seen in the business cycle in recent years. Prior to the crisis, inflation-targeting central banks in candidate countries tended to tighten their monetary stances in a bid to prevent their economies from overheating and curb rising inflationary pressures in the context of rapid financial expansion (see Chart 4). Indeed, policy rates in Iceland increased by a total of 880 basis points between spring 2004 and autumn 2008. The National Bank of Serbia reduced interest rates between mid-2006 and mid-2007, but began tightening them again in autumn 2007, closely mirroring fluctuations in the dinar's exchange rate during this period (see Chart 5). Only one potential candidate country (namely Albania) has a monetary policy framework involving inflation-targeting, but developments there followed a similar pattern. Turkey was an exception among inflation-targeting candidate countries in the pre-crisis period. The Turkish central bank attempted to further reduce real interest rates in the face of continued disinflation in the economy, with inflation coming down from the high double-digit rates that were still common in the early 2000s. This policy was also facilitated by

Chart 4 Central bank policy rates

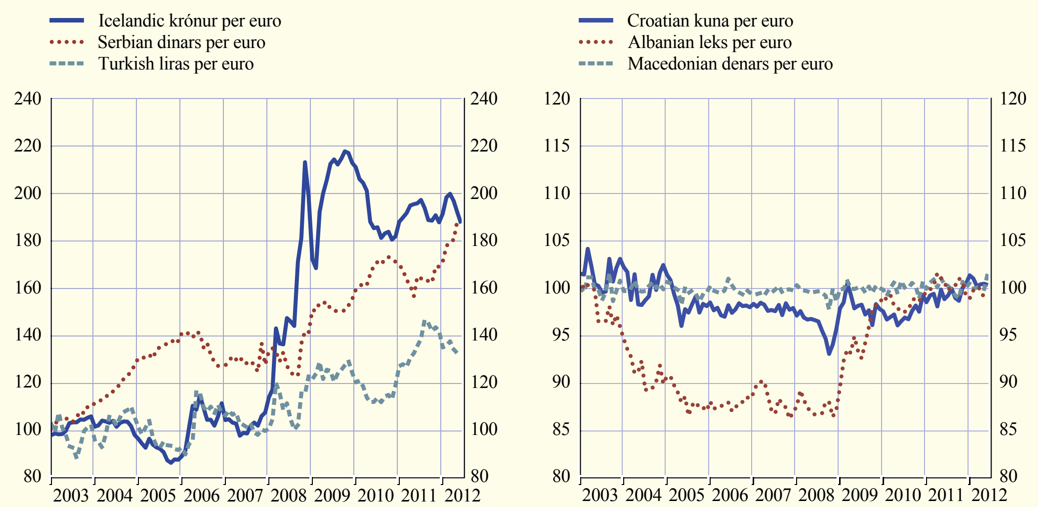
(percentages per annum)



Sources: IMF and national sources.

Chart 5 Exchange rates

(index: December 2002 = 100)



Sources: IMF and ECB calculations.
Note: An upward movement indicates a depreciation against the euro.

the relatively moderate pace of credit growth relative to other candidate countries.

Although use of the interest rate policy lever is a straightforward way of attempting to rein in credit growth for central banks with independent monetary policies, the side effects for small, open, and financially integrated economies can sometimes be significant, as Iceland's experience shows. There, increases in the central bank's policy rate also encouraged inflows of short-term "hot money" attracted by significant nominal interest rate differentials relative to the rest of the world (i.e. the potential for "carry trades"). This not only led to the strong appreciation of the króna and a worsening of the current account deficit, but it also failed to curb the expansion of the money supply to any significant extent.

By contrast, central banks in candidate and potential candidate countries that had more tightly managed exchange rates or did not have their own domestic currency approached the challenges of overly rapid credit growth, buoyant domestic demand and soaring inflation by introducing administrative or prudential measures to restrain foreign borrowing and domestic credit (e.g. higher reserve requirements, increased risk weights and provisioning obligations and quantitative restrictions on lending).[7] These measures were designed to compensate, in part, for the drawbacks of not having an independent monetary policy with the autonomy to gear interest rates to domestic objectives. Indeed, interest rate levels "imported" from anchor currencies were generally lower than those warranted by the economic circumstances in the candidate and potential candidate countries themselves, implying a pro-cyclical policy stance in the presence of financial expansion. Although the use – and effectiveness – of these administrative and prudential measures varied from country to country, it is clear that giving up control over a number of important policy levers severely restricts a country's room for manoeuvre when seeking to effectively smooth out fluctuations in the business cycle and maintain price stability.

Following the onset of the crisis, inflation-targeting central banks in candidate and potential candidate countries tended to swiftly reduce their policy rates. The accompanying declines in nominal exchange rates had mixed results. On the one hand, an "orderly" depreciation had the potential to make the dynamics of adjustment easier relative to countries that had tightly managed exchange rate regimes (or did not have their own domestic currency), as well as allowing a greater degree of freedom in terms of counter-cyclical policy responses. Turkey's experience was favourable in this regard, as was that of Albania. However, where (i) there was considerable downward pressure on the exchange rate; (ii) banks were highly dependent on foreign funding; and (iii) there was significant domestic lending in foreign currencies, the interaction between strongly depreciating currencies and high levels of private sector debt denominated in (or indexed to) foreign currencies created a host of new challenges for domestic authorities.

This often led to the pursuit of pro-cyclical policies as a result of conflicts between the objectives of macroeconomic stabilisation and financial stability (see also Section 5.2 on financial stability challenges related to foreign currency-denominated lending). This was the case in Serbia, and it was particularly true of Iceland, where the steep decline in the króna's exchange rate following the collapse of its banking system triggered a wave of defaults on foreign currency-denominated and inflation-indexed private sector liabilities, forcing the authorities to impose capital controls in order to regain control of the exchange rate and prevent further damage to balance sheets that were already considerably impaired (see Box 2).

7 For a more detailed overview of these measures, see Polgar, E.K. and Zdzienicka, A., *The Effectiveness of Policy Measures to Control Credit Growth in Emerging Europe*, mimeo., 2010.

Box 2

DEVELOPMENTS IN ICELAND DURING THE CRISIS AND THE AUTHORITIES' SUBSEQUENT POLICY RESPONSE

Although financial and economic developments in Iceland before and after the crisis were comparable to those seen in other candidate and potential candidate countries, the scale of the imbalances that accumulated prior to the crisis, the severity of the subsequent downturn and the policy reactions of the Icelandic authorities can be considered unique in many respects.

Following a credit-fuelled boom in consumption and investment, Iceland's private sector debt, which was largely indexed to inflation or the króna's exchange rate, reached around 500% of GDP in autumn 2008. At the same time, the strong growth seen in the international activities of Iceland's banks not only allowed the intermediation of this credit, but led to banks' – largely short-term – foreign liabilities increasing to almost 700% of GDP by August 2008. Glitnir, Iceland's third-largest bank, found it increasingly difficult to roll over obligations following the collapse of Lehman Brothers on 15 September 2008 and was nationalised on 29 September 2008. Just ten days later, Iceland's banking system disintegrated and defaulted on its external debt. These events were accompanied by a steep decline in the króna's exchange rate, with the currency depreciating against the euro by 15% between 15 September and 24 October 2008, when Iceland requested a stand-by arrangement (SBA) with the IMF. By 19 November 2008, when the SBA was formally approved, the króna had depreciated by a further 13%. The IMF also recommended the imposition of capital account restrictions to arrest the decline in the króna's exchange rate and prevent the further deterioration of households' and firms' balance sheets.

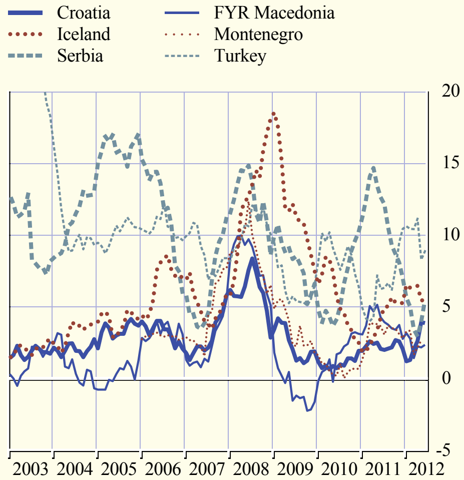
Indeed, limiting the convertibility of the króna swiftly halted the decline in its exchange rate (see also Chart 5) and enabled the central bank to take a domestic focus, resulting in a series of growth-supporting interest rate cuts (see also Chart 4) as inflationary pressures eased. Supported by the restructuring of the sizeable stock of non-performing assets, the re-establishment of a viable financial sector and efforts to put public finances back on a sustainable trajectory, Iceland's output registered its first quarterly increase in the third quarter of 2010 and has since continued to improve, leading to the successful completion of its SBA in August 2011.

When Iceland's policy response in the wake of the crisis is compared with that of other affected countries, there are two measures that stand out most. First, Iceland introduced capital controls to protect itself from the worst repercussions of the sudden reversal of capital flows that it faced at the end of 2008, a strategy that has possibly aided its subsequent recovery. However, as time goes by, evidence is mounting regarding the distortive and often detrimental effects that these restrictions are having on the decision-making of economic agents and the difficulties that Iceland's authorities face in decisively reducing the substantial stock of krónur that continues to be held offshore and returning to a fully liberalised capital account in the near future. Second, Iceland decided not to nationalise the debts of its oversized banking sector, instead opting to inflict losses on its financial institutions' creditors and foreign depositors. Although this saved the government from assuming liabilities that would potentially have been beyond its debt-servicing capacity, it also opened the door to a series of legal challenges (with final decisions still pending in some instances), thereby introducing a significant degree of uncertainty for authorities, businesses, foreign investors and the general public.

Candidate and potential candidate countries that had imposed administrative or prudential restrictions on the provision of credit in the boom years were in a position to relax some of these constraints, thereby cushioning the impact of the recession to some degree. While countries that had more tightly managed exchange rate regimes (or had no separate currency of their own) avoided the pernicious balance sheet effects associated with the currency mismatches described above, this came at a price, with those countries enduring, among other things, a slower unwinding of external imbalances (e.g. in Montenegro), the impairment of counter-cyclical policy responses in the face of fiscal constraints (e.g. in the former Yugoslav Republic of Macedonia), and a slower recovery in competitiveness relative to countries that experienced significant nominal depreciation (e.g. Croatia as compared with Serbia).

Chart 6 Inflation

(annual percentage changes)



Source: IMF.

5 SELECTED ECONOMIC AND FINANCIAL CHALLENGES FOR CANDIDATE COUNTRIES

Although the immediate trigger for the 2009 recession in candidate countries was an exogenous shock, the crisis exposed a number of long-standing vulnerabilities and challenges that had not been addressed in the context of the rapid financial expansion seen prior to the crisis. This section highlights challenges in three areas: monetary policy, financial stability and competitiveness.

5.1 MONETARY POLICY CHALLENGES

Price stability features prominently in the mandates of all monetary authorities in candidate and potential candidate countries. However, even inflation-targeting central banks have often failed to keep annual price rises within agreed thresholds, pointing to the difficulty of achieving and maintaining price stability. In this regard, Iceland, Serbia and Turkey have all had extended periods in which inflation has considerably exceeded their central banks' objectives (see Chart 6).

In Iceland, where the aim is for consumer prices to increase by 2.5% per year (+/- 1.5 percentage points), inflation has overshot the upper bound of this corridor in almost two-thirds of all months since January 2003. In particular, the significant pass-through of exchange rate developments to domestic prices complicates the conduct of monetary policy in Iceland and hinders the successful anchoring of inflation expectations. Thus, in the wake of the banking and currency crisis of 2008 and in light of the recent re-emergence of inflationary pressures, Iceland's authorities have initiated wide-ranging policy discussions with the aim of identifying a more appropriate monetary and exchange rate regime.

In Serbia, the inflation target is defined as a continuously declining value within a tolerance band, and the monetary policy objective for end-2012 is to reduce inflation to 4.0% (+/- 1.5 percentage points). The headline consumer price index remains highly volatile, with a significant peak seen in April 2011, and targets have generally been missed (with the exception of the first half of 2012). Core inflation, however, has generally moved within the tolerance band. Nonetheless, recent political pressure on the central bank may undermine the credibility of monetary policy, highlighting the importance of sound institutional frameworks for central banks in order to ensure their independence (as stipulated, moreover, by the EU *acquis communautaire*).

In Turkey, the inflation target was set at 4% in 2007 and 2008, with a tolerance band of +/- 2 percentage points, but the target was raised to 7.5% in 2009. In 2010 and 2011 it was reduced to 6.5% and 5.5% respectively, and for 2012 it is set at 5%, which is considered a medium-term target. Since 2006, when fully fledged inflation-targeting was introduced, end-of-year targets have generally been missed, with the exception of 2009 and 2010.

More generally, challenges associated with monetary policy and exchange rate regimes in candidate countries concern both the achievement and maintenance of price stability and the broader ramifications that the choice of a specific framework has for other policies. The fact that countries in the same area (e.g. the western Balkans) that are at similar stages of development have opted for very different monetary policy and exchange rate regimes suggests that there is no "one size fits all" approach. However, domestic policy-makers should be cognisant of the implicit choices that they are making for other areas as a result of choosing a specific monetary policy and exchange rate regime. Monetary authorities can face equally difficult policy dilemmas at either end of the policy spectrum, whether they have a freely floating exchange rate regime with inflation-targeting or a "hard" policy arrangement involving either a tightly managed exchange rate or the use of an external currency as legal tender. In addition, unilateral euroisation cannot become a way of circumventing the provisions of the Treaty on the Functioning of the European Union (hereinafter "the Treaty") that govern the adoption of the euro with the aim of ensuring lasting convergence (see Box 3).

The experiences during the crisis of candidate countries that have tightly managed exchange rate arrangements or do not have their own domestic currency suggest that such arrangements are more – rather than less – demanding for domestic policy-makers. This is because such arrangements not only restrict countries' room for manoeuvre as regards monetary policy itself, but also place greater onus on other policy areas. The conduct of fiscal policy, in particular, has to be especially prudent in such cases, as it needs to act as the primary stabilising device for the economy. In a similar vein, the fact that the exchange rate is unable to act as a shock absorber and facilitate adjustment in a downturn means, ceteris paribus, that labour and product markets need to be more flexible than those of countries with floating exchange rate regimes, so as to allow the nominal adjustment of wages and prices.

Moreover, a tightly managed exchange rate regime can help to encourage borrowing in foreign currencies to a far greater extent than other factors common to peers with more flexible exchange rate regimes (such as optimistic expectations regarding convergence). It is worth noting, in this regard, that two of the three candidate countries where foreign currency-denominated assets and liabilities account for the largest percentage of total assets and liabilities have tightly managed exchange rate regimes.

In turn, pervasive foreign currency-denominated lending limits room for manoeuvre as regards monetary policy, as a depreciation of the domestic currency would entail adverse balance sheet effects, resulting in financial stability challenges. Furthermore, significant use of foreign – as opposed to domestic – currencies complicates the transmission of central banks' policy decisions to domestic interest rates. Consequently, actively encouraging the use of domestic currencies may be a viable strategy with a view to giving monetary policy additional room for manoeuvre and addressing financial stability challenges (see Section 5.2).

Box 3

THE POSITION OF THE EU AND THE ECB ON UNILATERAL EUROISATION IN ACCESSION COUNTRIES

In November 2000 the ECOFIN Council adopted a position on unilateral euroisation as part of a policy stance on exchange rate-related aspects of EU enlargement. It stated that "Potential EU members wishing to join ERM II relatively swiftly after accession are already now expected to consider their policies with a view to their prospective membership in ERM II. In this context, it should be made clear that any unilateral adoption of the single currency by means of 'euroisation' would run counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the end point of a structured convergence process within a multilateral framework. Therefore, unilateral 'euroisation' would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro."[1]

In December 2003 the Governing Council of the ECB published a policy position on exchange rate issues relating to the acceding countries[2], indicating that any unilateral adoption of the single currency by means of euroisation outside the framework of the Treaty would run counter to the economic reasoning underlying EMU.

In addition, in 2007 the ECOFIN Council adopted a specific declaration on Montenegro[3] on the occasion of the signing of its stabilisation and association agreement. This declaration stresses: "Montenegro's present use of the euro, decided by the Montenegrin authorities in exceptional circumstances, is fully distinct from euro area membership." At the same time, the ECOFIN Council reiterated that "unilateral 'euroisation' is not compatible with the Treaty [...]. An EU Member State cannot adopt the euro and join the euro area without fulfilling all the criteria defined in the Treaty. These comprise the achievement of a high degree of sustainable convergence as defined in the Treaty". The ECOFIN Council concluded that "the implications of the Treaty framework for Montenegro's monetary regime will be detailed in due course, at the latest by the time of possible future negotiations for accession to the EU"[4].

1 Report by the ECOFIN Council to the European Council in Nice on exchange rate-related aspects of enlargement, Brussels, 8 November 2000, Council of the European Union press release No 13055/00.
2 Policy position of the Governing Council of the European Central Bank on exchange rate issues relating to the acceding countries, Frankfurt am Main, 18 December 2003.
3 Montenegro unilaterally introduced the euro as legal tender in January 2002.
4 Council Decision on the signing on behalf of the European Community of a Stabilisation and Association Agreement between the European Communities and their Member States, of the one part, and the Republic of Montenegro, of the other part, Brussels, 9 October 2007, Council of the European Union press release No 13484/07.

5.2 FINANCIAL STABILITY CHALLENGES

A long-standing challenge for most candidate countries in the area of financial stability is the preponderance of lending denominated in – or indexed to – foreign currencies.[8] Lending in foreign currencies (notably the euro) remains stubbornly high in countries such as Croatia, the former Yugoslav Republic of Macedonia and Serbia (see Table 4). Lending in foreign currencies entails several financial stability risks for borrowers and lenders. To the extent that borrowers (whether households or firms) do not hedge these loans, they are vulnerable to exchange rate risk. Banks granting such loans are indirectly exposed to exchange rate risk, which can materialise as credit risk where

8 See, for example, "Foreign currency lending in CESEE countries: evidence from the OeNB euro survey" and "Risks and costs associated with foreign currency lending", *The international role of the euro*, ECB, July 2011.

Table 4 Selected financial stability indicators for EU candidate countries

(percentages)

	Non-performing loans 1)	Capital adequacy ratio	Foreign currency lending ratio 2)	Ratio of liquid assets to total assets	Loan-to-deposit ratio 3)
Croatia	12.6	19.9	74.6	29.6	126.4
FYR Macedonia	9.9	17.5	58.3	26.5	86.4
Iceland	22.9	21.7	28.0	16.0	124.2
Montenegro	15.5	16.5	…	19.9	…
Turkey	2.7	16.6	26.9	51.1	94.9
Serbia	18.8	19.7	75.6	36.7	…

Sources: Haver Analytics, IMF and national sources.
Note: Data are for the first quarter of 2012, with the exception of Iceland (fourth quarter of 2011), Montenegro (fourth quarter of 2011) and Serbia (third quarter of 2011).
1) As a percentage of total loans.
2) Loans denominated in or indexed to foreign currencies as a percentage of total loans.
3) Data for the fourth quarter of 2011.

borrowers who do not hedge their foreign currency loans are unable to fully repay them on account of the depreciation of the local currency inflating the value of debt repayments in that currency. In addition, financial institutions granting foreign currency-denominated loans may be exposed to funding risk if they rely heavily on wholesale funding or financing provided by a parent bank, rather than on local deposits.[9] Furthermore, lending in foreign currencies can foster excessive credit growth, given that lower foreign interest rates may lead to increased demand for loans. This may, in turn, contribute to the build-up of asset price bubbles and – if foreign currency-denominated lending is financed by means of capital inflows (e.g. capital flows to local subsidiaries via parent banks) – to unsustainable external imbalances (see also Section 3).

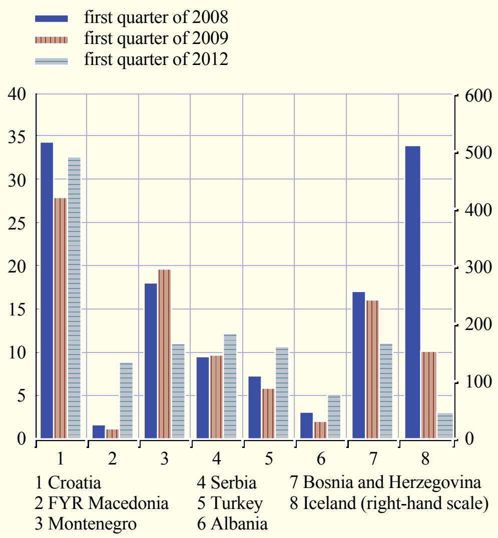
It is worth noting that the risks to financial stability arising from foreign currency-denominated lending to the non-financial private sector are not limited to candidate and potential candidate countries. Indeed, they also apply to some EU Member States in central and eastern Europe. For this reason, the European Systemic Risk Board (ESRB) has published a number of recommendations on this issue. While directed at EU Member States, these are also relevant for candidate and potential candidate countries.[10]

More recently, challenges in candidate countries have also been related to the management of credit and funding liquidity risks following the global financial crisis. As regards credit risk, while candidate countries' banking systems have relatively high capital adequacy ratios (see Table 4), some countries' non-performing

9 This is of particular concern given the strong presence of foreign institutions in the domestic banking systems of candidate countries, whether through subsidiaries or affiliates.
10 See the ESRB recommendations on lending in foreign currencies issued in October 2011 (www.esrb.europa.eu).

Chart 7 Stock of claims of BIS reporting banks on candidate and potential candidate countries

(as a percentage of GDP)



Source: BIS.
Note: Figures show claims on banking sector only.

loan ratios have tended to increase in recent years. Particularly in those countries where the economic outlook is expected to remain subdued, the potential for further deterioration in banks' loan portfolios is a matter of concern. With regard to funding liquidity risks, the main risk is disorderly deleveraging by foreign banks (many of which have headquarters in the EU), which has so far largely been averted[11] (see Chart 7).

The decline seen in recent years in BIS reporting banks' stock of claims on candidate countries' banking systems has been most pronounced in the case of Montenegro and, more particularly, Iceland (see also Box 2). Some deleveraging is unavoidable – and even warranted, to the extent that past excesses are unwound. Available evidence suggests that deleveraging by foreign banks – as measured by quarter-on-quarter changes in the external positions of BIS reporting banks – gained momentum in the second half of 2011, coinciding with strains in funding markets and efforts by regulators to improve capitalisation in foreign (or parent) institutions. However, the pace of deleveraging appears to have stabilised in the first quarter of 2012, coinciding with measures to improve bank funding and capital conditions in the EU and improvements in sentiment in certain financial market segments. Nevertheless, to the extent that strains in the banking sector persist, the risk of a further increase in deleveraging by parent banks in candidate countries (and elsewhere in the region) will probably remain. In order to counter this exposure in the long term, the establishment of a strong local deposit base and viable domestic financial markets are possible cornerstones of a policy strategy addressing vulnerabilities in this area.

5.3 COMPETITIVENESS CHALLENGES

By contrast with many other emerging market economies, where the key challenges concern the need to redirect those countries' development strategies, moving from reliance on export-led growth to a stronger focus on domestic demand, candidate countries generally face the task of shifting their focus from domestic to foreign drivers of growth. Indeed, policies emphasising the strengthening of the external sector would seem to be a prerequisite for the achievement of more dynamic economic activity, in particular if capital flows do not return to pre-crisis levels. This will also help to further unwind the external imbalances that accumulated in many candidate countries prior to the crisis.

As a consequence, issues relating to competitiveness are likely to gain in prominence, also in light of the strong competitive pressures that candidate countries will face in the single market when they join the EU (and eventually the euro area). Competitiveness issues in certain euro area countries are instructive in this regard.

In the years before the crisis, price and cost-related indicators of competitiveness gradually deteriorated in all candidate countries. Increases in unit labour costs were particularly pronounced in Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey (which is arguably part of the catching-up process). Available evidence for most candidate countries suggests that, in the last few years before the crisis, productivity failed to keep pace with increases in labour costs. Rising costs were associated with rising prices (e.g. in the non-tradable sector, to which capital inflows and credit were largely channelled), leading in turn to increases in real effective exchange rates, particularly in Serbia and Turkey. In spite of these developments, most candidate countries actually saw their shares of world export markets increase in the pre-crisis period, partly as countries opened up further to external trade.

By contrast, the onset of the crisis was generally associated with falling export market shares. These declines were particularly pronounced in Croatia and Iceland, which saw their export market shares fall below 2005 levels by end-2011 (see Table 5). In the aftermath of the crisis,

11 See also "EU bank deleveraging – driving forces and strategies", *Financial Stability Review*, ECB, June 2012.

Table 5 Developments in prices, costs and export market shares in candidate countries

(index: 2007=100)

	Real effective exchange rate		Unit labour costs		World export market share	
	2005	2011	2005	2011	2005	2011
Croatia	97.4	99.3	94.0	107.4	101.9	79.5
FYR Macedonia	100.1	102.2	90.9	121.0	82.0	104.6
Iceland	103.0	67.3	81.6	112.3	98.0	90.2
Montenegro	n/a	101.0	72.9	144.0 1)	83.5	91.0
Serbia	83.3	104.8	82.4	103.8	74.6	107.0
Turkey	85.5	112.0	86.0	104.8	98.0	99.0
EU12	92.6	104.1	89.2	110.5	88.2	101.7
EU15	98.9	95.9	96.6	108.9	102.0	86.4

Sources: BIS, European Commission, IMF, Haver Analytics, national statistics and ECB calculations.
Notes: The EU12 comprises Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia. The EU15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.
1) 2010 data.

candidate countries' real effective exchange rates have generally edged downwards or stabilised, but labour costs have not followed suit. Other factors potentially impinging on competitiveness relate to institutional quality. Developments in this area suggest that, while some marked improvements have been made in recent years, candidate countries continue to lag behind the central and eastern European countries that joined the EU in 2004 and 2007 (see Table 1).

6 CONCLUSIONS

Growth in candidate countries was generally robust prior to 2009, but tended to be associated with increasing external and domestic imbalances, which proved unsustainable in the face of an external shock on the scale of the global financial crisis. Subsequently, the drying-up of external finance following Lehman Brothers' collapse exposed other long-standing vulnerabilities in candidate countries that had not been addressed in the context of the rapid financial expansion seen prior to the crisis. While financial expansion is a normal part of the catching-up process, in some countries it led to unsustainable developments. Policy responses to the crisis were conditioned by the monetary policy frameworks and exchange rate regimes chosen by the authorities in the various countries.

The experience of the crisis, coupled with the ongoing financial tensions in parts of the euro area, should remind authorities in candidate countries that lasting and sustainable convergence requires sustained policy efforts. Against the background of a less favourable external environment, these countries are facing significant challenges in a number of areas. In the area of financial stability, critical tasks include addressing the vulnerabilities created by foreign currency-denominated lending and managing credit and funding risks. As regards monetary policy, achieving and maintaining price stability should be the first priority, which requires that central banks have a sound institutional framework ensuring their independence in line with the EU *acquis communautaire*. Another challenge will be to successfully handle the higher demands that tightly managed exchange rate regimes arguably impose on domestic policy-makers, as well as remaining vigilant regarding the links between monetary policy and financial stability under a given framework. Maintaining and improving competitiveness is also crucial for candidate countries. The key question for many of them is how to return to more dynamic economic growth. This requires the rebalancing of economic activity, with shifts from domestic to foreign drivers of growth, the assumption being that the ample capital inflows and credit which supported domestic demand prior to 2009 were not sustainable and will not be available to this extent in the future.

Overall, it should be borne in mind that both membership of the EU and the eventual adoption of the euro should be seen as means to an end – namely real convergence, stability and prosperity – rather than as objectives in themselves. The current tensions in parts of the euro area also serve as a reminder that adoption of the euro does not in itself guarantee continued convergence if the appropriate policies are not followed and the necessary reforms are not implemented.