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Article

The Euro at stake? The monetary Union in an enlarged Europe

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**Panel 4**

THE EURO AT STAKE? THE MONETARY UNION IN AN ENLARGED EUROPE

PAUL DE GRAUWE
University of Leuven

THE CHALLENGES AHEAD

The launch of the euro has been an extraordinarily successful operation. The most visible sign of this success is the fact that it took only a few weeks for the euro to become the single European currency used in daily transactions from Finland to Portugal and from Ireland to Greece. Until recently few people dreamt that this would be possible in their lifetimes.

The success of the launch of the euro is not only technical and economic, it is also and foremost political. The euro is now the most visible and practical symbol of the progress towards a political union in Europe.

And yet despite the magnitude of the success, the challenges ahead are formidable as well. The most important challenge comes from the fact that in the foreseeable future the euro area could consist of up to 27 members instead of the present 12. This enlargement of the euro area creates a number of problems that will have to be tackled. We will analyse two of these problems here. The first one has to do with the risks from the increased asymmetry of shocks that will exist in an enlarged euro area. The second problem relates to the institutional reform that will be needed to streamline the decision-making process in the Eurosystem.

The enlargement also creates challenges for the accession countries. In this paper we focus on the issue of convergence. We ask the question of whether the accession countries will be able to emulate the successful convergence of the EMU mem-

ber countries prior to the start of EMU. We also analyse the question of whether special convergence regimes (e.g. "euro-ization") are desirable.

The challenge of enlargement

The most important challenge facing the European monetary union is the enlargement with the accession countries (Central European countries, Cyprus and Malta). This enlargement creates two problems that have to be tackled. The first problem has to do with the effectiveness of monetary policies in the enlarged EMU; the second problem relates to the institutional reforms that will have to be introduced to make the system workable.

Is a Euro area of 27 countries an optimal currency area?

With a possibility of 27 members of EMU instead of the present 12 the challenge for the ECB to conduct monetary policy in an effective way will increase. The reason is that in such a large group the probability of occurrence of what economists call "asymmetric shocks" will increase significantly. Thus some countries may experience a boom and inflationary pressures while at the same time others experience deflationary forces. This possibility leads to the issue of whether the enlarged EMU will be an optimal currency area.

We look at two clusters of countries. The EU-12 (the present Euroland) is assumed not to be an optimal currency area as yet.¹ However, the dynamics of integration (which is stimulated by the monetary union itself) will move it toward the optimal currency area. In that area the costs for individual countries of being subjected to asymmetric shocks and not being able to use one's national monetary policies to deal with them is small compared to the benefits of the union. Thus, once in this area, the constraints imposed by a

¹ As will become clear this assumption does not diminish the power of the arguments we are making here.

monetary policy that must fit all sizes are not perceived to create unacceptably high costs.

Consider now what happens when other countries join Euroland. We deal with the full cluster of countries (of Euroland and newcomers) as EU-27. It is reasonable to assume that this cluster of countries is less well integrated than EU-12 and that it faces more asymmetric shocks than EU-12. One of the reasons why the EU-27 will face more asymmetries has to do with the Balassa-Samuleson effect, i.e. the accession countries experience faster productivity growth than the more developed present members. As a result, the former countries' rates of inflation will be structurally higher than the rates of inflation of the present EMU-members.

The important insight from this analysis is that the original members of Euroland (who are also part of EU-27) will now have to wait longer until they reach the optimal currency area.² Practically this means that since in the enlarged euro area the shocks are more asymmetric than in the original one, some of the original members will more often than today be outliers (in terms of inflation and output) compared to the average that the ECB will be focusing on. As a result, these members will perceive the policies of the ECB to be less receptive to shocks than before the enlargement. Some of the original members of the euro area may then find that the cost-benefit calculus about monetary union has become less favourable. While today most of the members of Euroland probably find that the interest rate decisions of the ECB are consistent with their national economic conditions most of the time, this may no longer be the case in an enlarged EMU. It will happen more frequently that some countries consider the monetary stance taken by the ECB to be inappropriate to deal with the economic situation of the moment. As a result, the perceived costs of the union will increase relative to the perceived benefits of the single currency. Such a situation is bound to produce tensions both inside the decision making process of the Eurosystem as outside the system when some countries feel that their economic interests are not served well by the ECB.

There is very little the ECB can do about this. By its very nature a monetary union implies that the

power to set interest rates is transferred to a common central bank which can only set one interest rate. Fine-tuning of the interest rate to cater for different national economic conditions is made impossible. This is the price the members of the union pay for the benefits they obtain from the existence of one currency.

The only way to deal with these issues is to make sure that individual member countries have the instruments to deal with these asymmetric developments. In this context progress towards reform of the labour markets aiming at making these more flexible is of great importance. Flexibility is probably the only instrument available that allow euro area countries to adjust to asymmetric shocks.

Enlargement and institutional reform

The enlargement is bound to have important implications for the decision-making process within the Eurosystem. The present system is characterised by equal representation of each member country in the Governing Council through the presidents (governors) of the national central banks. When, like today, the number of countries is limited to twelve such a system can work satisfactorily. In a future system where twenty seven countries could be sending a representative to the Governing Council the difficulties to achieve a consensus about the stance of monetary policy will be much greater than today.³ This is due not only to the larger numbers of persons involved in such a system, but also because, as we argued earlier, there will be more asymmetric developments in an enlarged euro area. These asymmetries will necessarily lead to different perceptions among the national governors about what the most appropriate course of action is for the euro area as a whole.

The problem can be summarised as follows. In the present set-up the ECB Board has a strategic position in the decision making process within the Eurosystem. This ensures that the interest rate decisions are made on the basis of the needs of Euroland as a whole. This is so even if the national governors are guided by the economic conditions that prevail in their own countries. Since the large countries (Germany, France, Italy) represent about

² If the EU-12 is in the OCA-zone at the moment of enlargement, its members are thrown out of this zone when the enlargement occurs.

³ See Baldwin, et al., (2001) for a detailed analysis of the decision-making problems in an enlarged European Union.

70% of the total, this decision making model also ensures that the large country's interests are relatively well served, despite the overrepresentation of the small countries in the Governing Council. Because of the strategic position of the ECB-Board a consensus can usually be reached easily around the interest rate proposals made by the Board. As a result, formal voting is usually not necessary.

In an enlarged Eurosystem this consensus model is likely to break down. The reason is that the ECB-Board will lose its strategic position. It will be confronted by the possibility that its interest rate proposals will be overruled by coalitions of small countries who experience different economic conditions than the average (which is dominated by the large countries). This will create the possibility that interest rate decisions will be made on the basis of economic conditions that prevail in a relatively small part of Euroland. This is bound to lead to grave conflicts within the Eurosystem.

The essence of the problem is that the small countries are over-represented in the Governing Council and that in an enlarged Eurosystem this will have the fatal effect that interest rate decisions may not always be made on the basis of the average economic conditions that prevail in the union. The solution to this problem must therefore consist in reducing the importance of small countries in the Governing Council, so that the strategic position of the Board can be maintained. This can be achieved in several ways. We discuss some possible formulas.

- *The US Fed formula:* this consists in allowing all governors to participate in the deliberations of the Governing Council but to restrict the voting rights to a limited number of governors (e.g. ten) on a rotating basis.
- *The IMF formula:* this consists in having small countries group together in constituencies and be represented by one governor.
- *The centralised formula:* this consists in restricting the decision making to the Executive Board of the ECB. Today the Board consists of six members. In this formula there is some scope for expanding the size of the Board.

The third formula is probably too drastic. The advantage of the first formula is political. By introducing a system of rotation in the voting, one does

not have to discriminate between small and large countries. The effect on the outcome will be broadly the same whether it is small or large countries, which are allowed to vote since this rotation system restores the strategic position of the ECB-Board. Large countries, however, may not like this solution. As a result, a combination of the first and second formula could be a reasonable compromise whereby groups of smaller countries delegate one of their governors on a rotating basis.⁴

The challenge of convergence of the accession countries

The conditions under which the accession countries will join the Eurosystem once they have entered into the European Union, are spelled out in the Maastricht Treaty. The general principles are, first, that all EU-members are expected to join the monetary union, and second, that entry into the Eurosystem is conditional on satisfying a number of convergence criteria. These two principles will apply to the accession countries in the same way as they applied to the EU-countries that are now members of the system.

How likely is it that the accession countries will satisfy the convergence criteria when they join the European Union? The question is important because if they satisfy these criteria upon their accession, their entry into the Eurosystem will be swift. This would also imply that the institutional reforms of the Eurosystem must be implemented in the near future.

In order to answer the question we analyse some of the macroeconomic variables that are supposed to converge as a condition for entry of the accession countries. We start with the budgetary convergence criteria. As is well known, a condition for entry is that the government budget deficits should not exceed 3% of GDP. We show the data of the accession countries for 2001 and compare these with the government budget deficits of the present Euro-members in the year 1994. We selected this year because this was five years prior to the start of EMU. The earliest moment the accession countries could join the Eurosystem is around 2006.⁵ Thus we com-

⁴ It is unclear, though, whether this solution is consistent with the Nice Treaty which says that the rebalancing of the votes should not introduce discriminations between countries.

⁵ See Baldwin, et al. (2001) on this issue of timing.

pare the budget situation of the accession countries with the budget situation of the successful Euro-members at a comparable time prior to entry.

The results are very striking. The accession countries' budgetary situation is significantly better than the budgetary situation of the successful Euro-members at a comparable time prior to their entry into the union.

A similar conclusion holds for the government debt levels. The Treaty stipulates that this should not exceed 60% of GDP. Again we find that the Accession countries are in a much better situation than the successful Euro-members at a comparable time prior to accession. In fact in the year 2000 all the accession countries satisfied this criterion, while in 1994 nine out of the twelve EU-countries had difficulties meeting the debt criterion.

Regarding the other criteria, inflation rates and long-term interest rates, we find that the accession countries score slightly worse than the successful Euro-members. The differences, however, are small. Except for the case of Romania, it appears that most of the accession countries should be able to reduce their inflation and interest rates to within the target ranges imposed by the convergence criteria.

Conclusion

The introduction of the euro has been spectacularly successful. This success should not make us complacent. The challenges ahead are formidable as well. The major challenge ahead will come from enlargement. The enlargement to a area of potentially twenty-five countries will affect EMU in two ways. First, it will lead to a change in the perception the present Euro-members have about the costs and benefits of the union. Second, it will affect the effectiveness of the ECB in maintaining monetary and financial stability within the euro area. The latter problem can be summarised as follows. Today the ECB Board has a strategic position in the decision making process within the Eurosystem. This ensures that the interest rate decisions are made on the basis of the needs of Euroland as a whole. Since the large countries (Germany, France, Italy) represent about 70% of the total, this decision making model also ensures that the large country's interests are relatively

well served, despite the overrepresentation of the small countries in the Governing Council. Because of the strategic position of the ECB-Board a consensus can usually be reached easily around the interest rate proposals made by the Board.

In an enlarged Eurosystem this consensus model is likely to break down. The reason is that the ECB-Board will lose its strategic position. It will be confronted by the possibility that its interest rate proposals will be overruled by coalitions of small countries who experience different economic conditions than the average. This will create the possibility that interest rate decisions will be made on the basis of economic conditions that prevail in a relatively small part of Euroland. This is bound to lead to grave conflicts within the Eurosystem.

The essence of the problem is that the small countries are over-represented in the Governing Council and that in an enlarged Eurosystem this will have the fatal effect that interest rate decisions may not always be made on the basis of the average economic conditions that prevail in the union. The solution to this problem must therefore consist in reducing the importance of small countries in the Governing Council, so that the strategic position of the Board can be maintained. We discussed some possible formulas that achieve this result.

Finally we analysed the convergence process of the Accession countries. We argued that the Accession countries should not experience more problems of convergence than the present Euro-members prior to their entry into the monetary union. As a result, there is no need for them to experiment with other monetary strategies (e.g. euro-ization) than those foreseen in the Maastricht Treaty.

The fact that the convergence process of the Accession countries is likely to be smooth and fast implies that these countries will join the Eurosystem pretty soon after accession in the EU. As a result, the need for institutional reform of the Eurosystem is a matter of urgency.

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JEAN-CLAUDE TRICHET,
Governor of the Banque de France

THE EUROPEAN MONETARY UNION AND EU ENLARGEMENT

Ladies and gentlemen, it is a great pleasure and an honour to be with you today, on the occasion of the Munich Economic Summit, in front of such a distinguished audience.

I would like to present briefly my views on the important and historical challenge of enlargement that the European Union and, at a later stage, the euro area, will have to cope with.

Twelve countries from central, eastern and southern Europe are currently negotiating accession to the EU. According to the calendar endorsed by the European Council, new accessions will take place as from 1 January 2004, that is to say in less than 19 months. This testifies again to the attractiveness of the European Union framework, which has provided us with economic prosperity and political stability for half a century.

The accession countries have accomplished remarkable progress in stabilising and strengthening their economies and institutions. Observing the accession countries, recent history shows the major improvements those countries have made, in hardly 10 years, on the road towards convergence with the EU. Let's keep in mind, with some humility, the sometimes rather slow pace the current Member States took, regarding for example, trade openness, price liberalisation, or macro economic discipline.

Nevertheless, there is also general agreement on the fact that the gap, in terms of average GDP per capita, between the accession countries and the euro area, although diminishing, remains still quite significant. On average, GDP per capita, in terms of purchasing power parity, might be around 44% of that of the euro area, while in terms of current exchange rates it is only around 22%. There are large differences between accession countries, since

a few of them are not that far from the EU standards. But, more generally speaking, the size of the gap, combined recently with a rather limited growth differential between the two groups of countries, suggests that the process of real convergence will be very gradual and will have to continue much beyond the tentative dates for EU accession.

Although differences in income levels are not incompatible with EU and even EMU membership, it is important for accession countries to increase real convergence. Indeed, real convergence is essential to create economic cohesion within EMU and promote integration between Members States, thereby helping to minimise the risk and the effects of asymmetric shocks, in the best interest of the accession countries themselves.

The Eurosystem and, in particular, Banque de France, follows with a great deal of attention the enlargement process. Within the framework of the Eurosystem, Banque de France contributes to the process through co-operation and twinning agreements with some central banks in accession countries, notably with the Bank of Poland, whose President is my colleague Leszek Balcerowicz, present here today, and Bank of Romania in particular.

Let me stress a few points of particular relevance for the Eurosystem and for the accession countries themselves, on the road towards achieving catching-up and convergence with the EU.

- Firstly, we should never forget that nominal convergence must be sustainable and therefore constitutes a medium-term objective, rather than a short-term priority. The strict compliance with the Maastricht criteria will be key for joining the euro area, but should not be seen only as an immediate requirement for joining the EU. Indeed, the EU Treaty calls, as a prerequisite for adopting the euro, for a high degree of sustainable convergence in the fields of price stability, government fiscal position, stability of the exchange rate, and long-term interest-rate levels. The sustainability of nominal convergence



itself presumes that sufficient preliminary progress has been made towards real and structural convergence (namely having set a fully-fledged market economy, catching-up in income and productivity levels, as well as economic and social infrastructures, upgrading of the legal system etc.). Conversely, a sustainable catching-up process requires macroeconomic stability. Therefore, nominal and real convergence should be pursued in parallel, and are not antagonistic.

- Secondly, I noted that many accession countries have already expressed their intention to join ERM II as soon as possible after EU entry. This intention is to be welcomed, although it should be clear that ERM II membership needs neither to happen immediately after EU accession in all cases, nor to be limited to only two years, which is the minimum for adoption of the euro. It would be misleading to consider ERM II as a mere “waiting room” before euro. On the very contrary, ERM II would allow countries to retain some limited exchange rate flexibility during the catching-up process. ERM II membership offers a meaningful, flexible but credible framework for increasing convergence with the euro area, for tackling the challenges faced by accession countries on the road towards the adoption of the euro, for contributing to macroeconomic and exchange rate stability, and for helping determine the appropriate level for the eventual irrevocable fixation of parities; and this, again, in the best interest of candidate countries themselves.
- Thirdly, a sound and efficient banking and financial system is key. Significant progress has been made over the past few years in rehabilitating the banking sector and encouraging foreign ownership. The latter has also contributed to greater integration into the EU financial system. The intermediation role of the banking sector remains fundamental for the efficient use of capital and sustained growth. Progress in corporate governance, the enhancement of the legal and supervisory frameworks that support the banking sector, and an efficient fight against money laundering, are also crucial. They are conducive to achieving the macroeconomic objectives of the accession countries.
- Fourth, central bank independence is of the essence. It is an integral part of the *acquis communautaire*, which is laid down not only in national legislation but above all in the Maastricht Treaty. The effective implementation of

the *acquis communautaire* is not only a legal prerequisite for accession to the EU. It also implies the effective transformation of accession countries’ economic framework, which should facilitate their integration into the EU and, later, the euro area. In this context, it should be ensured that there is no discrepancy between the central banks’ formal status in the legislation and the implementation of that legislation. The independence of the European Central Bank and national central banks is enshrined in the Treaty. When exercising their powers and carrying out their tasks and duties, neither the central banks of the Eurosystem nor any member of its decision making bodies shall seek or take instructions from Community institutions, from any government of a Member State or from any other body. Independence means institutional, operational and financial independence. We consider that comprehensive concept an essential contribution to the clarity and the credibility of the single monetary policy. It is of utmost importance that all present and future Member States respect this economic and institutional ground rule of the European framework.

- Fifth, and it will be my last point, let us not forget the present and future contribution of Central and Eastern European countries to the economic prosperity of Europe at large.

It seems that this contribution might be sometimes underestimated. In fact, transition economies, as a whole, are as important as the US in terms of external demand addressed to the euro area: they both enjoy the same share, i.e. 13% of our exports. And, during the last two years, transition economies contributed up to two thirds (namely 2.2% of a total of 3.3%) to the overall growth of our total external demand.

Central and Eastern European countries might represent today only a small fraction of the overall consolidated GDP of Europe. But they represent a major source of potential growth and therefore, in a medium to long-term perspective, a very important engine of growth to the benefit not only of their own economies but to the benefit of the European economy as a whole.

I thank you for your attention.

ERNST WELTEKE,
President of the Deutsche Bundesbank

THE MONETARY UNION IN AN ENLARGED EUROPE

Preconditions for EU accession

First proposition: the Copenhagen criteria have to be fulfilled prior to the Maastricht criteria

There is no contradiction between the Copenhagen criteria and the Maastricht criteria. The accession of candidate states to the EU is the first item on the agenda. EU accession is decided on the basis of the three criteria adopted at the Copenhagen European Council. Two aspects are important for monetary policy.

- Accession countries must be able to cope with competitive pressure and market forces in the EU (second Copenhagen criterion). Germany's experiences following reunification may serve as a guidepost for the considerable structural adjustment process that accession countries will be facing.
- Administrative structures must be remodelled at an early stage to make them compatible with the EU. Administrative structures in the accession countries should be capable of calling up Community funding and channelling it (third Copenhagen criterion). These funds can potentially help cushion the shock of opening up domestic markets.

Second proposition: For accession countries to join monetary union, they need to catch up by striving for real and nominal convergence

The past few years have already seen significant progress towards real and nominal convergence. However, each individual country's situation must be judged separately. Some countries already have a level of prosperity and convergence that is close to the EU average.

Cases in point are Cyprus and Slovenia. Per-capita GDP, expressed in purchasing power parities, is 85% of the EU average in Cyprus and 69% in Slovenia. That means those two countries generate a higher

per-capita GDP than some EU countries. (By comparison: Greece: 68%, Portugal: 74%, Spain: 82%.)

The remaining accession countries lag considerably further behind: Czech Republic: 59%, Hungary: 50%, Poland: 39%.

While looking at the averages, it must not be forgotten that in some cases there are overwhelming regional disparities within EU countries and accession countries.

Third proposition: In real economic terms, the accession of central and east European countries is already well advanced

Between 1993 and 2000 the percentage of accession countries' total exports which went to the EU rose from 55% to 67%. 60% of imports come from the EU (1993: around 55%). This reorientation of trade flows was mostly at the expense of trade with the Commonwealth of Independent States (CIS), especially Russia. Exceptions are Cyprus and Malta, whose trade is heavily tilted towards Asia/USA (Malta) and Russia, Syria and Lebanon (Cyprus) and whose trade flows with the EU are shrinking.

The integration of central and east European countries has been made easier by progress in capital market liberalisation. Positive macroeconomic data and the prospect of EU accession have been leading to large direct investment. Since 1999 direct investment has accounted for around 5% of all accession countries' GDP. Capital inflows are expected to maintain their level in 2002 as well. Including portfolio investment, capital inflows are expected to reach around 7% of accession countries' GDP in 2001.

Accession to monetary union

Fourth proposition: The Eurosystem has no preference for certain exchange-rate arrangements (eg corner solutions)



Whatever exchange-rate regimes are adopted should be constantly reexamined against macroeconomic reality and adjusted if necessary. See Annex for exchange-rate regimes of the accession countries.

Fifth proposition: In principle, all Maastricht criteria, including the exchange-rate criterion, must be met before a country can join the Eurosystem

Country-specific exceptions must not be allowed to set a precedent. At most, exchange-rate arrangements based on currency boards could potentially be considered equivalent to ERM II.

Monetary policy in an enlarged monetary union

Sixth proposition: The heterogeneous nature of monetary union will increase along with enlargement – labour and goods markets therefore need flexible adjustment mechanisms

The single monetary policy is a catalyst for reforms in other policy areas. The nation-states are in competition with one another to find the best solutions for economic, labour-market and fiscal policies. Deficits in individual countries are held up for review within the monetary union. Successful policy solutions set a benchmark for the less successful countries.

Reforming the ECB Council

The Governing Council has already begun considerations to reform the ECB Council. Proposals are being discussed internally; once a consensus has been reached, the ECB Governing Council will convey a proposal to the European Council.

First principle: The principle of “one member, one vote” set forth by the Maastricht Treaty will apply to the future organisation of the ECB Governing Council as well.

Second principle: Any change in the Governing Council's voting methods must be made with a view to achieving the broadest possible representation.

The demographic weight or national product could be used as criteria for the broadness of representa-

tion. Broad representation ensures widespread public acceptance of monetary policy.

Third principle: The Governing Council's decision-making procedures should be shaped with a view to making these procedures transparent

The Governing Council's decision-making process must not be characterised by complex and opaque voting procedures since that could cause the acceptance of monetary policy to suffer. The decision-making procedure must be comprehensible and easy to follow for outsiders.

Fourth principle: A reform of the ECB should be able to stand firm beyond the upcoming round of EU enlargement

Besides being in conformity with the EU treaties and the statute of the ESCB, a reform of the ECB should be designed to last over the medium term. Today's structures were designed for a 15-member monetary union. Reform should take account of the fact that in a few years the EU could comprise as many as 27 members. Reform must therefore be designed to take account not just of the current round of enlargement, in which up to ten nations will join the EU.

The euro area as an optimal currency area?

Seventh proposition: The EU-15 and EMU meet key criteria for being an optimal currency area

Within monetary union the capital mobility criterion has largely been met. Financial-market integration is at an advanced stage, and further harmonisation is being undertaken through initiatives by the EU Commission.

The current EU-15, like the Euro 12, is characterised by strong internal trade flows. The EU and EMU are less open to non-member countries than, for instance, the Federal Republic of Germany.

Inflation rates largely converged within EMU up until the introduction of the euro. Since then, increased disparity has been observable; however, it may be observed in other major currency areas as well.

Within EMU, fiscal discipline and fiscal policy coordination were improved by the Stability and Growth Pact (SGP) and the broad economic-policy guidelines. Criticism in some countries has not fundamentally called the consensus of coordination into question thus far.

Within the EU de facto integration has been achieved at the political level on the basis of the SGP and coordination of fiscal and economic policies.

Annex

Exchange-rate regimes in the accession countries

- Flexible exchange rates (Czech Republic, Poland, Rumania, Slovak Republic, Slovenia). In some countries (Czech Republic, Poland, Slovak Republic) the currencies appreciated in 2001 and early 2002.
- Real appreciation caused notably by nominal appreciation, whereas inflation differentials vis-à-vis the euro area fell.
- Productivity growth and capital inflows (especially in Poland and Czech Republic); in Czech Republic, direct investment resulting from privatisation was main reason behind capital inflows; in Poland, portfolio investment (visions of convergence).
- Increased volatility of exchange rates. Reasons: short-term capital inflows (Poland) and current account deficits (Czech Republic and Slovak Republic).
- Fixed-rate systems with bands (intermediate exchange-rate regimes: Cyprus and Hungary). Both countries converted to an exchange-rate regime analogous to ERM II with bands of $\pm 15\%$ (Cyprus: since August 2001, Hungary since October 2001).
- Hungary abandoned crawling peg. Result: appreciation. Cypriot pound stable since August 2001.
- Appreciation in Hungary caused by productivity gains, improved fundamentals and portfolio investment following the opening of capital markets.
- Potentially necessary to adjust the Hungarian exchange rate as a consequence of appreciation and falling inflation.
- Fixed exchange rates (Bulgaria, the Baltic countries, Malta).
- Bulgarian, Estonian and Lithuanian currencies pegged to the euro; Latvia's currency to IMF special drawing rights; Malta's to a basket containing the euro, dollar and pound.
- No loss of confidence or exchange-rate fluctuation caused by Argentinean crisis.
- Real appreciation thus far in sync with productivity growth.
- Current account deficits in Baltic countries (5% to 10% of GDP) require observation of exchange-rate movements
- Central bank independence
- Progress towards the rules set forth in the EU treaties and the Statute of the ESCB. Problem zone: personal independence of the central banks' board members.
- One accession country largely in compliance thus far (Malta); five other countries have envisaged amendments to their legislation (Cyprus and Estonia) or have already passed laws (Lithuania, Hungary, Slovenia) which largely conform to the requirements set forth in the EU treaties and the Statute of the ESCB.
- Six countries (Poland, Rumania, Bulgaria, Czech Republic, Slovak Republic, Latvia) still lag behind in implementing the requirements of the Maastricht Treaty.



LESZEK BALCEROWICZ,
President of the National Bank of Poland

THE WAY TO EMU FROM A CANDIDATE COUNTRY'S PERSPECTIVE

General remarks

Let me, at the outset, make some general remarks. Firstly, the points I am going to make represent my personal views – this is not an official position of the Polish Government. Secondly, the basic question is not whether Poland (and other accession countries) will adopt the euro, provided that they first enter the EU. Rather, it needs to be highlighted that enlargement of the EU also automatically means enlargement of EMU in the longer perspective. The present candidate countries are certain future participants in monetary union. There will be no more exceptions like the “opt-out clauses” offered to Britain and Denmark. So the issue under discussion is not “if”, but “when?” and “how?”. This is thus a crucial difference between Britain and, for example, Poland.

Another difference is that the idea of introducing the euro is very popular in Poland. According to a recent opinion poll, 64% of Polish citizens are in favour of quick introduction of the single currency into Poland, while only 22% are against such a substitution of the zloty. Interestingly, this result is much better than that from a recent poll concerning support for Polish membership of the EU as such (showing 55% in favour, 29% against). Nevertheless, when considering the optimal path to EMU, we must obviously focus beyond public opinion, on the financial and economic positions candidate countries have found themselves in. The countries concerned can basically be divided into two groups – those which have launched a euro-based currency board (like Estonia, Lithuania and Bulgaria), and those with flexible exchange-rate regimes (like Poland, the Czech Republic, Hungary, Slovakia, Slovenia and Romania). The task for the first group is much simpler. Their national currencies have already been fixed against

the euro, ensuring that the passage into the euro area will be a smooth one. Indeed, we could go as far as to say that they are “almost in it”. In consequence, it is the countries from the second group upon which I shall focus.

However, let me limit my remarks to what one may call the classical way to EMU. This is divided into three stages: the pre-accession period; the period after accession but prior to entry into ERM II; and the actual membership of ERM II (after at least two years, to allow for entry into EMU and the adoption of the euro).

I will discuss two possible strategies with respect to the targeted timing of the entry into EMU:

- targeting for the earliest possible entry,
- a “wait and see” policy.

I would argue that early entry into EMU is possible, and that it is preferable to a delayed entry. By an early entry I mean one that is close to the earliest possible date, i.e. 2006, provided that accession to the European Union takes place in 2004.

The first strategy is thus aimed at meeting all the necessary requirements and completing all the required reforms in the near future. In other circumstances, a targeting of the entry for 2006 would be an empty gesture. Overall, we know that adoption of the euro is dependent upon fulfilment of the Maastricht convergence criteria, which include:

- a high degree of price stability – something that will be apparent from a rate of inflation close to that of the three best performing member states in terms of price stability and does not exceed it by more than 1.5 percentage points;
- the convergence of long-term interest rates – which should not exceed that of the three best-performing member states by more than 2 percentage points in terms of price stability;
- sustainability of the government's financial position – meaning a figure of no more than 3% for the ratio between planned or actual govern-

- exchange rate stability – meaning compliance with the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without any devaluation against the currency of any other Member State;
- independence of the central bank (personal, financial and institutional).

Meeting the Maastricht criteria, especially the fiscal ones, requires structural reforms in public finances and in the enterprise sector. In addition, abolition of flexibility of the exchange rate calls for the deregulation of the labour market, if this is too rigid. All of these measures are conducive to long-term economic growth. Thus, preparation for early entry into EMU in fact means an early launching of reforms which will enhance the candidate countries' prospects for catching-up with the existing Member States.

The economic feasibility of rapid entry into EMU

Let us first approach this problem empirically, by checking the macroeconomic figures for Spain, Portugal and Greece in the four years before their entry into EMU, with the respective years being 1994 for Spain and Portugal and 1996 for Greece. Interestingly, a brief inspection of the data reveals that the macroeconomic stance of these countries was not better, but was rather worse than that of the leading accession countries in 2001, especially with regard to inflation rates, budget deficits and public debt.

As can be seen, the 1994 CPI inflation rates were 4.7% for Spain, and 5.2% for Portugal, while the

1996 figure for Greece was 8.2%. By contrast, the inflation rate recorded by Poland in 2001 was 3.6%. In turn, the 1994 budget deficit to GDP ratio in Spain was 6.1%, and that in Portugal 5.9%, while the figure for 1996 for Greece was of 7.5%. Compare this with the figure of 5.4% in Poland in 2001. Public debt in Spain and Portugal four years before entry into EMU exceeded 60%, while in Greece the rate was almost twice the specified Maastricht level. In Poland the corresponding figure remains below 43%.

So, put simply, if Spain, Portugal and Greece managed to meet the Maastricht criteria moving from worse macroeconomic positions than those of the present leading accession countries, why shouldn't the same be possible in the latter's case?

If we leave the empirical considerations aside, and employ more theoretical ones instead, we should basically concern ourselves most with the Maastricht inflation criterion, as it is the meeting of this that focuses most attention.

Let us note that Poland has already achieved a tremendous amount of disinflation. The rate in the country is 3.5% now (as of the end of February 2002), and similar figures will apply for the other leading candidate countries. In such a situation, the inflation rates in some of the EU countries are not seen to differ greatly.

Poland had managed to achieve this low level of inflation after extensive price liberalisation, so there would only seem to be limited scope for further corrective inflation.

Finally, there is the so-called Balassa-Samuelson effect, whereby rapid productivity growth in the tradable sector of the accession countries would lead – via accelerated wage dynamics – to higher inflation in the remaining sectors with a lower potential for productivity growth. However, what counts is the magnitude of this effect, and that has in fact been estimated to be rather modest. Empirical research in respect to Poland has, for example, shown that the impact of the Balassa-Samuelson effect upon the overall inflation rate to date has been in the 1.2%-1.5% range. As a matter of fact, the Balassa-

	Inflation	Budget deficit/GDP	Public debt/GDP
	%		
Spain (1994)	4.7	6.1	62.6
Portugal (1994)	5.2	5.9	63.8
Greece (1996)	8.2	7.5	111.6
Czech Rep. (2001)	4.1	9.4*	35.0*
Hungary (2001)	6.8	3.3*	52.3*
Poland (2001)	3.6	5.4	43.2*
* Preliminary.			

Source: European Commission for EU members and fiscal data; national central banks for accession countries.

Samuelson effect is also present in the Eurozone, in countries like Greece and Portugal.

Summing up, low inflation, the limited scope for future corrective inflation, and a manageable level of the Balassa-Samuelson effect combine to leave the Maastricht inflation criterion achievable. Furthermore, the meeting of the fiscal criteria is clearly in the interest of the countries concerned, as it would contribute to their economic growth.

Why targeting the earliest possible entry into EMU might be better than a “wait and see” policy

First and foremost, the setting of an early date of entry would mobilize candidate countries to complete their structural reforms so as to be able to meet the fiscal criteria and make their economies more flexible – as was the case in Spain, Portugal and Greece.

With respect to the fiscal criteria, it is reforms in the public sector that are of crucial importance. They should focus on the spending side, and on public enterprises. After enterprises are privatised, they become more efficient and profitable, start paying income taxes on their revenues, and do not require subsidies, as is often the case with state enterprises. All this improves the budgetary situation. In addition, privatisation revenues limit the government's borrowing requirements, thus constraining the growth of public debt and the related public debt service.

Another necessary reform in Poland is that of the labour market; and this is the main way to solve the painful social problem of high unemployment. Simulations made at the NBP have shown that, if a full reform of the labour market had been carried out in 1993, the unemployment rate in Poland last year would have stood at 7%, instead of 18%. Labour market reform, leading to higher employment and lower unemployment would also help to consolidate the public finances by increasing tax revenues and reducing expenditures on unemployment benefits.

The above reforms are necessary for rapid and sustained growth, and their linkage to early adoption of the euro would tend to make them more acceptable politically. Such a strategy obviously requires mission-oriented politicians. The strategy of “wait and see” might in contrast signal a lack of determi-

nation to carry out reforms which are necessary, not only for early entry into EMU, but also for a rapid and sustained catching-up.

Secondly, as was mentioned above, there is an interim period between the date of candidate countries' entry into the EU and their membership of monetary union (i.e. ERM II). A question as to the optimal length of this period then arises, and I would like to point out that, in what might be a rather turbulent time, especially for small and open economies of the kind the candidate countries possess, with large inflows and outflows of capital capable of causing significant exchange-rate volatility, it would be advisable to shorten this potentially turbulent period as far as is possible. A flexible exchange rate may be a mixed blessing under certain conditions.

Thirdly, the risks of giving up independent monetary policy and a flexible exchange rate need not be very large and, more importantly, are not reduced with the passage of time. Thus any delay of entry into EMU will bring little reduction in the costs of adopting the euro. Accession countries have achieved a high level of economic integration with the EU, as can be measured, for example, by the share of all exports going to the Union. In fact, the present volume recorded in Poland is actually higher than that noted in Greece, Portugal and Spain prior to their respective accessions to the EU and EMU. Currently about 71% of our exports are shipped to the EU, while 61% of our imports come from there. The corresponding respective figures for the above Member States in the 1980s were 48% and 41% (Greece), 50% and 37% (Spain), and 58% and 46% (Portugal). Poland has also achieved a high degree of cyclical convergence with the EU-15. Together, these two points combined suggest that asymmetric shocks would not present a serious danger to the present accession countries after their entry into EMU. For this reason, a single monetary policy for the whole euro area would not be hugely inappropriate for the present accession countries in comparison with their independent monetary policies, even if some new members might need a stricter monetary policy. This is one of the issues which requires further research.

With respect to the exchange rate, I have assumed that increased flexibility of the labour market would to some extent substitute for the lost exchange-rate flexibility.

Fourthly, a more rapid adoption of the euro would allow the present accession countries to reap the related benefits of an earlier date. What I have in mind here are such advantages as a strengthened framework for macroeconomic discipline, elimination of foreign exchange risks, a reduction of transaction costs, etc.

Finally, permit me to address fears among certain EU member states regarding a weakening of the euro following EMU entry on the part of Poland, Hungary, Slovakia or Latvia. To be honest, I do not find any rational argument supporting this view. Firstly, as I have pointed out, the earlier date of entry would mobilize the candidate countries to complete their structural reforms. Secondly, the candidate countries, taken together, account for only around 6% of GDP in the enlarged EU. Any negative impact on entry into EMU, which I personally consider unlikely, will in any case be highly subdued. Thirdly, I think the reasons behind the relative weakness of the euro do not lie in any structural problems of Greece or Portugal, but rather in those of the larger EMU member states. Finally, as there are currently differences in the rate of inflation, given the Balassa-Samuelson effect in the EMU countries, why should it be considered problematic for others, recording inflation only marginally different from the EU average, to join the euro area?

Conclusion

In conclusion, it should be stressed that real convergence is as important as nominal convergence, and it should not be assumed to be an unavoidable conflict between them. Firstly, the results of nominal convergence, especially low inflation, are among the foundation stones of long-term economic growth. Secondly, it is structural reforms that bring the real and nominal convergence into agreement. The more such reforms one has implemented, the less costly is disinflation, and the stronger the longer-term economic growth. In my view, the setting of an early date for adoption of the euro is a better way to accelerate these reforms than a strategy based on “wait and see”. I would like to finish with the following main point. The European Union should not discourage early entry of the candidate countries into EMU, but should rather encourage them to complete structural reforms. The cost of disinflation would be

lowered in this way, and long-term economic growth facilitated. This is a “win-win” strategy, as it assists the candidate countries, while at the same time convincing the existing EU member states of the economic stability and dynamism of the new entrants.