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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Randzio-Plath, Christa (2001) : Eastern enlargement and monetary union, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 36, Iss. 2, pp. 72-76

This Version is available at:

<https://hdl.handle.net/10419/44404>

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## Eastern Enlargement and Monetary Union

The fifth enlargement of the European Union (EU) is an irreversible event. It may occur in stages or it may become a "fait accompli" due to external factors or be delayed by them. The process of negotiations has advanced significantly and the horizontal aspects of enlargement have all been dealt with. They all amount to a single issue: that a serious restructuring and adjustment be undertaken by the applicant countries but the cost associated with such a transformation be shared by both the EU and the countries concerned. As the catching-up process will be especially difficult for the eastern and central European countries the following analysis will concentrate on them despite the fact that the present negotiations also include Cyprus and Malta.

Very rightly the European Parliament voted in favour of enlargement's taking place before the next European elections in 2004. In principle the European Council of Nice in December 2000 followed this timetable. But it is crystal clear that countries can only become members of the EU if they fulfil the criteria laid down in the Treaty. This also applies to membership of Economic and Monetary Union (EMU). The European Parliament and the European Commission included in the Copenhagen criteria not only that of functioning market economies and the capacity to withstand competitive pressure and market forces in the Union, but also that of being able to take on the obligations of membership, including adherence to the aims of political, economic and monetary Union (Copenhagen European Council). It is interesting to note that the catching-up process is in full swing especially with regard to price stability and budget consolidation. But this does not imply that the investment-led economic growth needed is achievable and that unemployment and problems of social exclusion can and will be solved. All balance sheets on the economic preparedness of the candidate countries hide the serious problem of the sustainability of the catching-up process. Even the problem

of implementing economic legislation, of building up the institutions, administration and courts necessary for the good functioning of a market economy is unsolved, as is the question of the framework for carrying out the obligations concerning free and fair competition and state aid. Therefore the economic convergence called for as a condition of entry and later accession to EMU is of crucial importance for all countries. This should not, however, be viewed solely in terms of formal compliance with the EMU convergence criteria when judging the state of readiness of the applicant countries. The EMU convergence criteria concentrate on the nominal convergence criteria which brought a large number of constraints to the new EMU members during the second stage of EMU. They will also affect employment and the social situation in the accession countries. It is therefore crucial to prepare for entry and to support the accession countries in their preparations.

EMU is an integral part of the *acquis communautaire*. Participation in EMU is a compulsory goal for all new member states, but joining the euro zone means meeting the convergence criteria. The accession countries must first undergo structural and economic reforms and develop institutional, administrative and judicial capacities. EMU membership can only be the final step towards full integration with the EU. There is no rebate for the fulfilment of the convergence criteria. It is the Treaty that counts – nothing more and nothing less. But it has to be remembered that with EU membership the new members must be able and willing to participate in EMU in the foreseeable future.<sup>1</sup> At the moment, several candidate countries have problems with inflation rates, long-term interest rates and exchange-rate stability. Only after becoming members of the EU can the accession countries become candidates for EMU and apply for EMU membership, by proving that their stability policies comply with the stability policy of the euro zone. So the earliest possibility of becoming an EMU member

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<sup>1</sup> European Council in Copenhagen, 21-22 June 1993, Conclusions of the Presidency (No 7 A iii).

is two years after having become a member of the EU. Then, only on the basis of the convergence reports of both the European Central Bank and the European Commission, and after consultation of the European Parliament, will the European Council decide if and when the applicant's entry into EMU is justified.

Monetary Union is not merely a monetary area, just as the EU is not merely a free trade area. In addition to economic considerations, the Community integration process is based on a model for society, with all the implications this has for welfare policies in particular. In this connection, most of the applicant countries fall even further short of the Community average in terms of per capita gross domestic product (GDP) than Ireland and Portugal did when they acceded to the Union in 1973 and 1986 (58% and 60% respectively of the Community average at the time). EMU is an irreversible mechanism which implies conscious public support for transfers of sovereignty in various areas, transfers which must be fully accepted and explained by political leaders and the two sides of industry in the countries concerned. Any prospect of granting the applicant countries derogations from the EMU criteria was rightly ruled out from the start by the Council and the ECB. Prior to joining the euro, these countries will retain their own monetary policy and their participation in the European System of Central Banks will be restricted as stipulated in the Treaty in respect of the countries granted a derogation. The new member countries will have the status of "Member States with a derogation". They have no possibility of an opt-out like those granted to the United Kingdom or Denmark. They have to pursue policies which demonstrate their will to participate and look at matters from the perspective of the common interest.

### **Convergence is Needed**

The accession countries will have to organise convergence and stability. This will continue to mean a major shock because of the necessary changes which will affect their financial, economic and social structures. The first step is convergence with the economic criteria of the 1993 Copenhagen European Council, which means a functioning market economy, macroeconomic stability and structural reforms, a stable legal framework for the economy, the reform of business law, of state aid and a stable banking and financial system.

The long-term goal is to catch up with the performance of the EU economy. Real convergence might be

a desirable aim, but real convergence is neither a criterion for accession nor for the membership of EMU. Many countries have been successful in reducing inflation and anchoring exchange rates, and growth perspectives are promising. Average real growth in these countries is often higher than the EU average, and the standard of living of the population has increased. There is nevertheless a further need for pragmatic approaches in the field of structural reforms to ensure the reforms are carried out in a sustainable way and will be accepted by the population. In order to avoid rejection on either side, the transitional arrangements which will be necessary should serve as flexible and appropriate instruments to cope with the convergence process, especially in view of the free movement of workers and services or the environment as was the case at the accession of Spain, Portugal and Greece.

The candidate countries will have to cope with competitive pressure and market forces within the Union. This pre-condition for membership requires not only the introduction of legislation in areas relating to the single market but, especially, the guaranteeing of their implementation by guaranteeing the rule of law, as well as the setting up of efficient institutions for the functioning of a market economy.

Progress has also to be made in the organising of competitiveness and social and economic cohesion by speeding up the adjustment of industrial structures, encouraging the development of SME's, by improving and simplifying the legal framework and by establishing a stable macroeconomic environment, a viable social protection system and active labour market policies.

### **Accession to the Euro**

The accession countries will have to plan three stages in order to join the euro zone: the pre-accession phase with the completion of the market economies and the achieving of sustainable macroeconomic stability, the second phase between accession and the adoption of the euro with full membership in the Single Market and, finally, the third stage with participation in the euro zone according to the procedure provided for in Article 121 of the EC treaty. As already stressed, membership of the European Union does not automatically imply membership of EMU.

This is very rightly so because EMU is an irreversible project, a community which cannot accept divorce or annulment, but calls for an everlasting act

of solidarity. That is why the convergence criteria are so essential and have to be met with a serious commitment. EMU implies conscious public support for transfers of sovereignty in various areas, transfers which must be fully accepted. Therefore derogations from the EMU criteria have been ruled out from the beginning of the negotiations. Thus, the accession countries have to prepare first for the accession and after accession for the nominal convergence as stipulated by the EU treaty. They are required to cope with the convergence criteria and start by fighting inflation, striving for stable exchange-rate relations to the euro and changing to an independent central bank. Here the case of the Czech Central Bank is a disappointing case. Sound public finances also have to be guaranteed in order to support the objective of price stability. In order to prepare for EMU accession, countries submit information on government debt, fiscal deficits and related data and also prepare an economic programme with a medium-term policy framework. The countries can thus prove their state of preparedness concerning structural reforms, public finances and technical, statistical and institutional capacities which will enable them not only to fulfil the economic criteria for accession but also later to achieve membership of EMU. This includes being able to cope with the ESA 95 accounting standards. The first annual notification will take place on April 1<sup>st</sup>, 2001 and will be evaluated by the Commission. The pre-accession economic programme (PEP) is designed to support EU accession by developing the institutional and analytical capacity necessary to participate in EMU.

The first pre-accession fiscal surveillance procedure will take place in 2001 and will be an important step towards letting accession countries participate in policy co-ordination by establishing medium-term economic policy priorities, and in this way facilitate their integration into the policy coordination procedures of the EU. After accession all new Member States will have a derogation for the adoption of the euro but they have the right and an obligation to adopt it. This means that they can and must apply, or the procedure set out in the Treaty will take place. This is nothing new and special for the new countries. It is in accordance with the EMU context as applied to the existing member countries.

### **Enlargement and EMU – Risks and Challenges**

The positive macroeconomic effects of enlargement will certainly outweigh any negative consequences. However this does not rule out the possi-

bility that some risks and challenges may arise before the positive effects of enlargement are felt, so that people might react in a negative way to EU and EMU membership. Already now the opinion polls show neither in eastern European nor EU countries any enthusiasm about eastern enlargement. More people are against it than are in favour. This is not unexpected because the initial years following accession will mean a major shock for the economies of the new member states. There will be constraints because of the necessary structural reforms to be taken. But the beneficial effects of policies reducing inflation and anchoring exchange rates should not be ignored. Therefore pragmatic adjustments, a smooth transition and a sustainable path to budgetary discipline and exchange-rate policy, as well as close cooperation between ministries and central banks, are needed.

### **Financial Stability is Needed**

Macroeconomic stability does not go without financial stability. European and international cooperation is not only needed in order to increase foreign direct investment (FDI) in the accession countries. There is still a need to strengthen banking and financial systems and to improve the reliability of banking supervision, for example through credit information centres, which could check the risks at a central level and contribute to better access to finance for small and medium-sized enterprises. Also the dependence of eastern European banks on FDI from the banking sector of specific countries can contribute to financial instability if the legal certainty of all aspects is not guaranteed. Financial instability in eastern European countries can also affect EU member countries.

Financial stability has to be improved by common market legislation. It may also be that the accession countries should be granted a transitional period for introducing the liberalisation of capital movements, especially short-term capital movements, in order to establish a fully functioning banking system and financial market with legal certainty so that risks for opening up markets are reduced. Participation in the EU and the euro will only be successful if the stability of financial systems is guaranteed by an efficient and competent banking sector and a functioning financial sector. Here progress has to be made in all countries.

As to *Foreign Direct Investment* (FDI), one should be careful. The surge of EU FDI in the applicant countries has been significant. EU FDI stocks held in the economies of the applicant countries reached 658,570 million euro at the end of 1997. This statistic

is important as it accounts for about 11% of total EU FDI, and all this occurred in a span of ten years. However, this significant statistic has been due to the drive of CEECs to transform their state-planning economies into market economies, coupled with large-scale privatisation.

It is equally true that all previous enlargements were associated with an increase in FDI originating either in EU countries or in other OECD countries. Spain emerged as a major host country for FDI after joining the EU in 1986. Ireland experienced a similar trend in inward FDI in 1974 and in the post-1992 European Single Market period. However, FDI theory and experience show that market-seeking FDI depends on two factors: access to a previously closed market and the economic prospects and expected profits in a host country. But market access and expected profits largely depend on the existence and functioning of capital markets and on complementary factors such as legislation, a trained labour force, management experience and political stability. Yet these basic requirements and factors influencing inward FDI differ from one region to another and thus complicate the exercise of examining the likely inward FDI to applicant countries at the expense of other regions such as NAFTA, ASEAN or China.

The development of capital markets must not simply be accompanied by the development of banking systems and practices, but must be preceded by it, in the interests of the real economy. Measures to forestall the risk of banking crises and the contraction of credit supply cannot be based solely on the application of international prudential standards, jointly drawn up by the supervisory authorities of the leading industrialised countries in the Basle Committee within the Bank for International Settlements. Neither can they be based on the internationalisation of activity which goes hand in hand with the increasing role played by foreign banks, nor, above all, on premature moves to offer businesses access to the financial markets.

Greater control of the risks inherent in traditional lending activities is a prerequisite, not least in order to ensure that small and medium-sized firms do not suffer any disadvantage in terms of access to funding because they are not assessed by credit-rating agencies. A variety of tools can be developed by the authorities to assist banks, such as loan inventories (files containing details of the sums lent to each borrower) or balance sheet inventories.

Priority must of course be given to strengthening banking supervision at a national level, since it is at

that level that this task is still carried out within EMU. Co-operation in the sphere of payment and clearing systems is also important, a matter which concerns both the ECB and the national central banks.

The free movement of capital is a fundamental principle of the EU, like the free movement of goods, persons and services. This is why, in legal terms, all restrictions on the full convertibility of currencies have to have been removed by the date on which a country joins the EU, irrespective of the preparations for its entry into the euro area. Most of the applicant countries, who themselves have put forward the arrangements and timetable for this liberalisation process, have already made substantial progress towards this objective. The only requests for transitional periods made at this stage concern property assets with a view to restricting sales of real estate to nationals of the other Member States. However, it seems appropriate to consider the principle of transitional periods in respect of this aspect of the *acquis communautaire*, since the dangers of instability linked to financial globalisation are much greater today than they were in the 1980s when some of the current Member States were granted transitional periods. The objective would be to encourage direct and long-term investment and prevent a situation arising in which short-term speculative capital movements made it necessary to restore as a matter of urgency restrictions which have previously been abolished. Moves to prevent disruption and safeguard the continuity of this process are essential to the credibility of these currencies. The risks of a premature increase in capital movements when set against the development of the banking and financial institutions and the real economy must be taken into account.

### **Exchange-rate Regimes – Do They Matter for EMU Accession?**

There has to be consistency in the exchange-rate systems which correspond to the economic situation and policies. What is good for Estonia may not be good for Poland.

What is needed is exchange-rate stability in order to cope with problems related to price adjustments, capital inflows and outflows and exchange-rate appreciation and depreciation policies. So it is quite understandable that different accession countries also differ widely in their exchange-rate regimes, which range from free-floating exchange rates to pegging systems with currency boards. For example, Malta and Latvia are pegged to baskets of currencies, Cyprus to the euro and Hungary and Poland have a

crawling peg system. Similar systems are observed in Slovakia, Slovenia and Romania. They differ even further from the rigid arrangements of Estonia, Lithuania and Bulgaria. There is no common view on a specific exchange-rate mechanism for the pre-accession period.

Certainly exchange-rate strategies should contribute to macroeconomic stability but of course the path of structural reforms is more important than the exchange-rate system. Therefore it would be advisable not to strive to introduce the euro as a parallel currency but to join the ERM2 which is flexible enough for the new members.

There is freedom of choice. But it is desirable that candidate countries do not prefer systems of free floating, crawling pegs and pegs to reference currencies other than the euro.

The transition from 15 to 27 Member States raises the problem of the size of the various institutions and of the balance among the various Member States. Among the decisions taken at the recent Intergovernmental Conference, the reform of the composition of the Commission will serve as a useful precedent with a view to the inevitable revision of the Statute of the ESCB. As soon as the new Member States join the EU, therefore, their central bank governors will sit on the ECB's General Council, the enlargement of which raises no particular problems.

However, the prospect of a Governing Council comprising up to 33 members (15 current Member States + 12 new Member States + 6 members of the Executive Board) raises, in addition to considerations of effectiveness, concerns regarding: the numerical balance between the Executive Board and the representatives of the national central banks, the balance between the old and new Member States, and the supranational image of a college whose members sit in a personal capacity, and are supposed to consider only the interests of the euro area and are at pains not to defend the interests of their country of origin.

Legislation has to be put in place that ensures the full independence of central banks, which has not been achieved in all countries. Concerning monetary policy, many countries will have to bring down inflation rates, but it is also a fact that monetary policy strategies are more and more similar to those of the European Central Bank.

The cornerstone solutions are currency boards, flexible exchange-rate systems, but also the "euroisation" of the whole system. This means the intro-

duction of the euro as a parallel currency. This is not a solution favoured by the European Union because it may give the illusion of already having joined the euro zone without having fulfilled the convergence criteria. This might also affect the external value of the euro.

A more realistic approach would consist in creating a European exchange rate mechanism (ERM) with the euro or granting the new members membership in the ERM II. This would be of advantage to the new members. Most of their trade is with the European Union so that by joining the ERM II most of their trade would not be affected by exchange-rate turbulence or volatility. Despite the teething troubles of the euro during its first years, it is on its way to becoming a world reserve currency, but also a trade and billing currency, the euro as an international currency is even more attractive to those countries and therefore adopting one of the formalised and institutionalised linkages with the euro is also attractive. ERM II also offers the opportunity to differentiate between the countries. The broad range of fluctuation of a maximum  $\pm 15\%$  can be reduced so that more advanced countries can be more closely linked to the euro than others. There is of course the obligation of the ECB to intervene in favour of those currencies. But there are limits: the ECB shall only intervene if price stability in the EMU member countries is not affected. On the other hand, the new members of the EU during this stage are also obliged to adapt the parities if necessary. The most difficult task in choosing this model of ERM II participation is fixing the central exchange rate at the right level. There will be a conflict of interest because no partner will accept an exchange rate which will be harmful to its trading position. The accession countries actually still have undervalued currencies and use this situation to favour their trade balance, especially the bigger countries like Poland, the Czech Republic and Hungary.

### Concluding Remarks

Eastern enlargement is both a challenge and an opportunity for peace, stability and enhanced regional cooperation in a part of the world characterised by conflicts and wars. The new agenda ends the Yalta world order but does not end the necessity of solidarity. Thus, enlargement calls for preparation and solid cooperation on both sides. The Nice Treaty does not cope with this aim. An enhanced programme has to be organised in the post-Nice process as foreseen by the conclusions of Nice in order to make the Union decision-making process more efficient, transparent and democratic.