

THE NARROW ROAD TO EMU ENLARGEMENT

The accession of ten new members to the European Union on the 1 May 2004 is not the end of the enlargement process: joining the euro area will be the next step for these countries. To do this, they will have to fulfil the criteria set out in the Maastricht Treaty, in particular the membership of the ERM II for at least two years. This requirement, however, leads to uncertainties, as economic convergence is not consistent with exchange rate stability for all countries. The success of ERM membership will also depend on the central parities chosen, the sustainability of current account financing and on containing the uncertainties which could affect the stability of expectations. Monetary enlargement may therefore be very progressive, concerning the "small countries" first, which presently have fixed exchange rates, and only later affecting the "large" new Member States.

Since 1 May 2004, the European Union has 25 members. The 10 new Member States are all known candidates for monetary union. In contrast to the United Kingdom and Denmark, they have not negotiated "opt out" clauses: when negotiating their membership of the EU, they all intended to join EMU rapidly. Now, however, divergences are appearing between the "small" candidates, which have confirmed their haste to adopt the euro, and the "large" countries that are tending to put off entry into EMU.

The forthcoming monetary enlargement may thus go ahead in stages, subject to the trade-offs these countries will make between the demands of nominal convergence needed to join the euro and their more general need to catch up economically.

1999-2004: the Principle of Equal Treatment

The principle of equal treatment implies that the candidates will be admitted into monetary union on the basis of the same criteria to those applied in 1999. The enlargement of the monetary union will therefore be conditional to the fulfilment of the Maastricht criteria: the convergence of inflation rates and long term interest rates, the control of public spending and exchange rate stability.

These criteria already led to heated debate during the 1990s, especially with respect to two points that are still relevant to future members. On the one hand, the Maastricht criteria only deal with nominal convergence: they do not include convergence of economic structures nor macroeconomic trends, though these are deemed to be essential in judging the optimality of a monetary zone¹ (Table 1). On the other hand, the criteria are strongly interdependent²: if one is not respected it could lead to others being breached too.

Table 1 – Real convergence indicators of the new Member States, 2003

	Macroeconomic equilibria			Convergence
	Growth (%)	Unemployment (%)	Current account balance (as % of GDP)	PPP GDP per capita as a % of the EMU average
Estonia	4.4	5.3	-12.2*	43.3
Hungary	2.9	5.9	-4.0	56.6
Latvia	6.0	8.6	-8.6*	35.8
Lithuania	6.6	10.2	-5.3*	34.0
Poland	3.3	18.0	-3.5	39.1
Czech Republic	2.2	9.9	-6.5	61.3
Slovakia	3.8	15.1	-8.2	49.0
Slovenia	2.1	11.2	1.7	78.2

* 2002.

Sources: European Commission, national sources and the CEPII-CHELEM database.

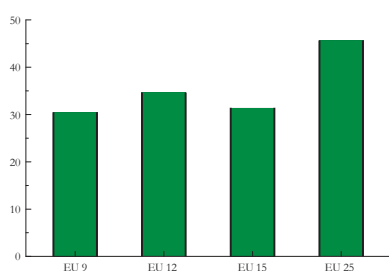
The debate has not changed since 1999, but the arrival of the new members has increased the income disparities within the

1. The Maastricht Treaty does include complementary criteria, such as the current account balance. But in practice, these have not been used.

2. Thus, a rise in inflation and in inflationary expectations –the first criterion– leads to a rise in long term interest rates –the second criterion– which may induce expectations of a depreciation and exchange rate instability –the third criterion– and even a worsening of budget balances, leading to excessive public debts.

enlarged European Union, much more than was the case of previous enlargements: the enlargements of the 1980s did increase the heterogeneity of the EU, but the 1995 enlargement was rather neutral. In contrast, the heterogeneity of the zone should increase greatly with the latest enlargement. On the basis of disparities observed in 2002, the coefficient of variation of GDP per capita at PPP should rise from 30% to more than 45% (Graph 1).

Graph 1 – The dispersion of income per capita levels (in PPP) in 2002, for the various configurations of the EU (variation coefficient, in %)



Source: World Bank, *World Development Report*.

At the end of the 1990s, the development gap between the new and existing members of the EU was reflected in quite strong disparities regarding the fulfilment of the Maastricht criteria. Generally speaking, public finances were under control (apart from in Hungary and Slovakia), whereas inflation and long term interest rates were significantly higher than those within EMU. Today, this situation has been reversed: inflation has fallen strongly and interest rates have converged, but the public finances of the CEECS³ have deteriorated (Table 2). To be sure, the EUs structural funds will help finance some projects, but their fiscal impact could be limited by the costs of the EU participation (applying European rules and regulations, contributing to the EU budget), to such an extent that consolidating public finances may well be a difficult task⁴.

Table 2 – The Maastricht criteria and the candidate countries for the euro

	Inflation %	Fiscal balance	Public debt	Long term interest rate	Official exchange rate regime	Exchange rate volatility ^a
	2003	as % of GDP		oct. 2003		
Estonia	3.5	0.0*	5.8	3.9 ^b	Currency board/euro	[-0.3 ; +0.4]
Hungary	5.0	-9.2	56.8	7.11	Fixed rate/euro ± 15 %	[-5.7 ; +9.9]
Latvia	2.5	-2.4*	14.6	3.8 ^b	Fixe rate DTS	[-9.7 ; +10.5]
Lithuania	1.0	-2.9*	27.0	4.6 ^b	Currency board/euro	[-0.3 ; +0.0]
Poland	1.1	-3.8	46.0	6.75	Free floating rate	[-15.8 ; +14.7]
Czech Rep.	3.5	-6.7	19.5	4.64	Managed floating	[-7.7 ; +5.3]
Slovakia	8.8	-7.2	38.2	5.15	Managed floating	[-3.7 ; +6.7]
Slovenia	6.0	-2.4	28.0	4.1 ^b	Managed floating	[-6.2 ; +3.2]
EMU	1.2**	-2.6	70.1	4.35	--	--

* forecasts for 2004; ** average of the three countries with the lowest inflation rates.

a. Maximum spreads since January 2002, compared to the average of 2002-2003, in %; a negative figure indicates an appreciation. b. 8 February 2003.

Source: DREE, *Revue d'élargissement*, various issues; OENB, *Focus on Transition*; Merrill Lynch.

However, the main uncertainty lies in the behaviour of the exchange rate. Indeed, under the terms of the Maastricht Treaty, entry into EMU is conditional on membership for two years of the ERM II (with fluctuation margins of ± 15% around the central parity), together with nominal exchange rate stability. This latter constraint is more ambiguous as acceptable volatility is not specifically defined.

The Constraints of the ERM II

The prerequisite of exchange rate stability is meant to strengthen the nominal convergence process and ensure convergence in expectations.

But the new members are in different situations with regard to the requirements for participating in ERM. First, pegging the nominal exchange rate will not be equally constraining for all of them. The Baltic States have already adopted fixed exchange rates against the euro: for Estonia such an exchange rate seems appropriate, given that it is a small, highly open country, with very little real exchange rate flexibility⁵. In the larger countries, for which the exchange rate plays a more marked role in macroeconomic adjustment, pegging the nominal exchange rate is less obviously “the” best strategy to adopt. Besides, these countries had to scrap their currency pegs in the early 1990s, as their pegs became unsustainable due to massive capital inflows.

In both cases, however, the constraint of participating in the ERM II may be considered as unwelcome. Countries with a fixed exchange rate have little understanding for the fact that after years of having had currency board arrangements, they will still be required to ensure exchange rate stability against the single currency. Larger countries, in contrast, are wary about the well-known difficulties associated with managing fixed exchange rate regimes in a context of capital mobility: for the exchange rate to be stable, under such conditions, real exchange rate equilibrium, current account sustainability and a convergence of market expectations must all be reached.

Real Exchange Rate Equilibrium

In theory, the exchange rate cannot stray durably from its fundamental equilibrium level. The choice of the central parity is therefore crucial to the predicted stability of the ERM II: a central parity which is too different from the rate which ensures the equilibrium of relative prices increases the risks of crises. From this point of view, the new members are very heterogeneous: the Slovenian tolar and the Hungarian forint fluctuate around their equilibrium values,

3. Balanced budgets are a constitutional constraint in the Baltic countries.

4. See, in particular, the estimations made by J. von Hagen & J. Zhou (2003), “Exchange Rate Policies on the Last Stretch”, *mimeo*, and the CESifo report “Report on the European Economy 2004”, IFO Institute for Economic Research, Munich.

5. A depreciation of the nominal exchange is, in fact, very quickly offset by a rise in imported inflation, to such an extent that the real exchange rate is hardly flexible.

but the Polish zloty is very volatile, while the Slovak, Czech and Estonia currencies tend to be structurally over-valued (Table 3).

Table 3 – Real exchange rate misalignments of CEEC currencies against the euro (a positive number indicates over-valuation, a negative one under-valuation) in %

	(1) CEPII mid-2001	(2) BOFIT early 2002	(3) Situation early 2004
Slovakia	10	-	14
Czech Republic	11	14	11
Estonia	-	11	10
Slovenia	2	5	0
Hungary	2	6	-2
Poland	15	15	-12

(1) Source: B. Egert & A. Lahrière-Révil (2003), "Estimating the equilibrium exchange rate of the central and Eastern European acceding countries: the challenge of euro adoption", *Review of the world economics*, vol. 139 No4, pp 683-708. (2) Average of the two estimations in J. Rahn (2003), "Bilateral equilibrium exchange rates of EU accession countries against the euro", Bank of Finland Institute for Economics in transition (BOFIT), *Discussion paper* No11. (3) = Exchange rate distortion (2) + change 2004/2002 in the nominal exchange rate.

Entering the ERM II with an over-valued exchange rate risks slowing down economic growth and generating exchange rate pressures via worsening current account balances. In contrast, an under-valued central parity risks feeding price increases through greater imported inflation. In both cases, entry into EMU may be called into question. Even if $\pm 15\%$ fluctuation margins of the new ERM are relatively large, adjustments in emerging countries may be significant. For instance, since 2002, the zloty has depreciated by 30% against the euro (equal to the entire fluctuation margin of the ERM II).

The Sustainability of Current Accounts

The exchange rate also reacts to the net financing requirements of the economy. In the new members –apart from Slovenia and more recently Poland– current account deficits exceed 5% of GDP. This is normal for countries undergoing rapid catch-up, because of higher growth and strong investment needs, and is generally considered as sustainable as long as such deficits are financed by stable capital inflows, in other words foreign direct investment (FDI). For

the new members, FDI has over-financed deficits for quite some time (Graph 2). But such massive capital inflows are not guaranteed to last forever. A large share of these flows arose from the wave of privatisations which is now coming to an end. Furthermore, the stocks of accumulated foreign investments are already substantial (much greater, on average, relative to GDP than in the euro area –see Table 4). Consequently, there are strong doubts about the capacity of the new member states to attract continued, massive FDI inflows. In as far as current account financing problems may lead to balance of payments crises, and so to exchange rate crises, the ERM II may become unstable.

Table 4 – Stock of FDI in % of GDP

	1990	1995	2000	2002
EU	11	13	29	31
Developing countries	15	17	31	36
South-East Asia	21	21	37	38
Estonia	...	14	52	66
Hungary	2	27	13	38
Latvia	...	13	29	32
Lithuania	...	6	21	31
Poland	0	6	22	24
Czech Republic	4	14	42	55
Slovakia	1	4	24	43
Slovenia	4	9	16	23

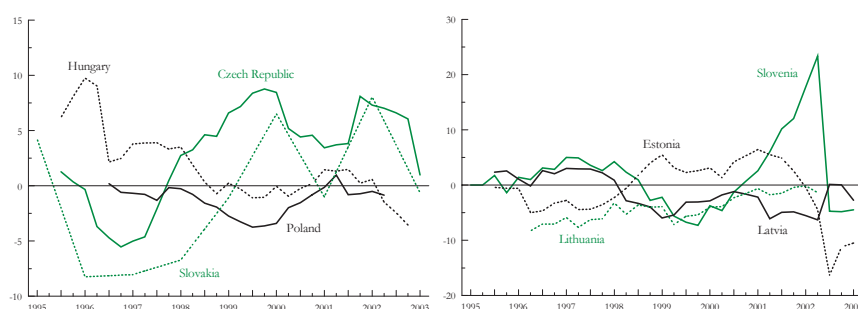
Source: UNCTAD, *World Investment Report* 2003. For information: Greece: 9% in 1980, followed by an annual average of 10%. Spain: 2% in 1980, and 5 to 33% between 1985 and 2002. Portugal: 12% in 1980, followed by 19 to 36% thereafter.

The Convergence of Expectations

Fixed exchange rate regimes with perfect capital mobility are known for their weakness in the face of speculative attacks. For the ERM II, such intrinsic weakness may be worsened by possible "convergence plays". Such plays arise when agents, anticipating economic growth in a country with a fixed exchange rate regime, invest massively in the economy, being attracted by high rates of return. But when such investments are short term, any turnaround in expectations may reverse the play and trigger a currency depreciation.

The ERM II may also be weakened by the uncertainty surrounding the acceptable level of volatility during the two years before EMU entry. The official volatility for the ERM II is indeed $\pm 15\%$. However, applying the principle of equal treatment could lead the EMU countries to integrate more stable currencies or slightly appreciating currencies more easily, which would imply volatility less than $\pm 15\%$. ECB support (which in principle is unlimited under the ERM II) should only apply when exchange rates approach the wide fluctuation margins: intra-margin intervention will thus be the responsibility of the national central

Graph 2 – The over-financing of current account balances through net FDI inflows (current balance + net FDI inflows, moving average over 5 quarters) in % of GDP



Source: IMF, *Direction of Trade Statistics*.

banks. Therefore, the ERM will *de facto* be asymmetrical, as national central banks will be more involved in stabilising exchange rates than the ECB. This will be all the more so given that the ECB will only intervene in the markets if its primary objective of price stability is not undermined. As a result, a series of uncertainties surround the exact conditions for evaluating the criterion of exchange rate stability, and this could *a priori* make the two-year ERM period perilous.

■ Risk Asymmetries

Monetary enlargement will definitely affect the institutions of the Union strongly (it has therefore been necessary to reform the functioning of the ECB). But this will ultimately have little economic impact on the present members of EMU, due to the strong asymmetries between the size of the present euro area and the new EU members. To be sure, the economic catch-up of the new members could be an independent source of inflation (the Balassa-Samuelson effect). But it is unlikely to influence the harmonised price index (given the weight these countries will have in the index), and it is little likely that it will lead to excessively restrictive monetary policy on the part of the ECB.

The new members will therefore bear the main adjustment costs, with consequences that could be important to the dynamics of growth. If the Baltic States seem able to reconcile strong disinflation and strong growth, the same cannot be said for those CEECs in which slowing inflation over the last three years has been accompanied by a slowdown in growth. There is a risk of over-valuation when countries enter the ERM and then EMU, and this would be important as any over-valuation could then only be reversed through disinflation, leading once again to a slowdown in growth and hence catch-up.

From this point of view, what strategy could the new members adopt? This question is all the more complex as membership of the Union is highly symbolic, resulting from

strong public aspirations, as reflected in the successful referendums on membership.

It will probably be difficult to refuse EMU membership to small countries wishing to join quickly, provided that they meet the criteria. Unless they then readjust their parities in a concerted way prior to adopting the euro, which is improbable, they run the risk of over-valuation. They will then have to adjust their economies alone, especially as their small size will give them little influence in the monetary policy decisions of the ECB. But apart from Slovenia, these are among the poorest new members, requiring the greatest amount of real adjustment. The risks of income disparities persisting durably within an enlarged monetary union should not therefore be ignored.

The larger countries have chosen (or been constrained in the case of Hungary) to adopt a wait-and-see strategy, with EMU membership being put off until the end of the decade. Poland's recent experience has shown that exchange rate flexibility allows for macroeconomic adjustments to be made, in a relatively simple way: the depreciation of the zloty has been accompanied by a non-inflationary correction of the current account and a return to growth⁷. Giving up monetary sovereignty can therefore lead to significant costs for these countries. The question of how long these countries should wait to enter the euro area remains open. For the "Southern" European countries, which joined the EEC in 1981 and 1986, more than ten years lapsed before they entered EMU (1991). Their entry into the euro area was still accompanied by some turbulence, though without any major crises. Patience can therefore be beneficial.

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6. See B. Egert, T. Gruber & T. Reininger (2003), "Challenges for EU acceding countries' exchange rate strategies after EU accession and asymmetric application of the exchange rate criterion", *Focus on Transition*, 2, pp. 152-175.

7. Poland's high level of unemployment continues to be a problem.

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