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CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

## **TIGER Working Paper Series**

**No. 38**

# **Adopting the Euro in the Enlarged Union: An Obstacle Course**

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Warsaw, March 2003

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## **Adopting the Euro in the Enlarged Union: An Obstacle Course<sup>1</sup>**

### **Summary**

Joining the “Eurozone” – Economic and Monetary Union - is perceived as a very important step in the process of European integration. For the new members of the enlarged Union: Cyprus, Czech Republic, Estonia, Hungary, Malta, Latvia, Lithuania, Poland, Slovakia, Slovenia, participation in EMU is an integral part of their membership obligations (*acquis communautaire*). They cannot opt out, as it was in the case of the United Kingdom, Denmark and Sweden.

This paper discusses number of issues connected with joining the “Euro”, such as the Exchange Rate Mechanism, two years of speculation exposure, the Maastricht conditions, the fiscal shock of accession, and exchange rate real revaluation.

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<sup>1</sup> An earlier draft of this paper was presented at a workshop on “The impact of the accession criteria: economies and the internal market”, in the Session on “Adopting the Euro”, European Research Institute, University of Birmingham, 8 February 2003.

## 1. The obligation to join

For the new members of the enlarged Union participation in EMU is an integral part of their membership obligations (*acquis communautaire*). There is no opt-out clause like that of Great Britain and Denmark, nor the possibility of following Sweden and staying out of EMU by not joining the Exchange Rate Mechanism. Soon after EU membership (though not necessarily immediately) they must join ERM-II, at a central parity to be agreed with Union authorities; after at least two years of keeping their exchange rate within a +/- 15% band around the central parity, without changing it unilaterally, and if and when they satisfy all the other Maastricht criteria of fiscal and monetary convergence, they can join EMU at a final exchange rate with the euro (also to be agreed with Union authorities) at which the euro will then replace their domestic currencies.

The only way new members could stay out of the eurozone would be by deliberately failing to satisfy at least one of the Maastricht criteria, or by demanding a final conversion rate with the euro that undervalues their domestic currency so grossly as to be unacceptable to the Union (presumably they would not be so foolish as to deliberately choose a grossly overvalued rate). However, apart from the turbulence that unreasonable parity changes would create in financial markets, new members are actually keen not to avoid but to join the eurozone. Having experienced, directly or indirectly, the recessionary impact of economic and monetary dis-integration – of CMEA, of the USSR, of the CSFR, of the Yugoslav Federation – they do not need convincing of the potential advantages deriving from the European single currency: reduction of transaction costs, of exchange rate risk, of interest rates, and generally greater European integration of their trade and investment.

Membership of ERM-II is not automatic; new members will have to apply, and they have a minimum of latitude as to the timing of their application – months, not years. After application, the European Commission and the ECB will separately report on the applicant's convergence to the EU. Absurd as it may sound, exchange rate convergence is judged by both institutions with reference not to the +/- 15% range of variation allowed under ERM-II but to the original +/- 2.25% band of the Maastricht Treaty (see for instance the recent EC and ECB reports on Sweden's convergence, 2002). One would have thought that in the run up to EMU the allowed oscillation band for the exchange rate would have been narrowed rather than broadened, but since the achievement of a +/- 2.25% range of fluctuations is not a pre-condition of ERM-II membership, and is not the sole criterion for the assessment of convergence, this peculiarity is unlikely to matter.

## 2. The ERM-II entry rate

Negotiation of the central parity with the euro at which each member enters ERM-II is the next hurdle:

“Decisions on central rates and the standard fluctuation band shall be taken by mutual agreement of the ministers of the euro-area Member States, the ECB and the ministers and central bank governors of the non-euro area Member States participating in the new mechanism, following a common procedure involving the European Commission, and after consultation of the Economic and Financial Committee. The ministers and governors of the central banks of the Member States not participating in the exchange rate mechanism will take part but will not have the right to vote in the procedure” (art. 2.3, *Resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of economic and monetary union*; Amsterdam, 16 June 1997 (OJ C 236, 2.8 1997, p.5).

Here the wording is imprecise. The standard fluctuation band is not subject to mutual agreement but is fixed at plus or minus 15% around the central rate (art. 2.1). What is open to negotiation is the stipulation of a narrower band (as agreed in the case of the single current member of ERM-II, Denmark at +/- 2.25%), subject to the same procedure (art 2.4). It is not clear whether entry rates will be fixed as a result of a collective negotiation involving all the ERM-II candidates ready to join or of a one by one negotiation.

It is usually presumed that the new members will have an interest in entering ERM-II at a slightly undervalued rate to underpin their export competitiveness, while the present member states might object and welcome instead a slightly overvalued exchange rate for new members' entry. However, the matter is much more complicated than that, for the following reasons:

- 1) All east European accession candidates are running a current account deficit and, with the exception of the Czech Republic, are all running a trade deficit with the EU. Thus it would seem inappropriate for EU authorities to demand a nominal re-valuation of new members' currencies at their ERM-II entry.
- 2) The very prospect of greater European integration, open by EU and EMU membership, has been already been driving up the real and even the nominal exchange rate of accession candidates, due to increasing flow of FDI and above all financial capital inflows (on this point, see more below); the trend will continue after membership. Such a prospect reduces the incentive for existing members to seek an

overvalued exchange rate for new members. It also reduces the effectiveness of an undervalued rate otherwise attractive to new members.

- 3) An undervalued exchange rate enhances domestic competitiveness temporarily, but has the disadvantage of permanently raising the euro value of state and private liabilities incurred in domestic currency.

Ultimately both sides have a vested interest in a *sustainable* entry rate for new members, from the viewpoint of current account balance, without elements of either under- nor over-valuation. Therefore any simple or weighted average of recent trends – such as is often mentioned as a basic starting point – will not do. An element of subjective judgement and conjecture is involved in the negotiations about the entry rates. Otherwise the market will have to be used as guidance and as an instrument, because the ERM-II central parities will have to be validated by the market. Moreover, there is something profoundly contradictory in a process of market integration being guided by administrative decisions for exchange rates and only for exchange rates. If the ECB believes, say, that the Polish zloty is undervalued let them make massive purchases of zlotys in the market until they drive the rate to their desired level; let the Polish monetary and fiscal authorities make offsetting zloty sales if they want a weaker exchange rate.

The standard +/- 15% band is so broad that in practice it can easily accommodate any likely divergence of views between the authorities of the new member states and of the EU. But the entry central rate has, if nothing else, a psychological importance, and contributes to the formation of expectations about the final and irrevocable rate of conversion of the domestic currency with the euro at the end of the two years of successful ERM-II membership – if and when the other Maastricht parameters are met. And that final rate does not have to be validated by markets, representing simply the legal rate at which the euro is introduced as legal tender to free debtors of their obligations incurred in domestic currencies.

Entry in the ERM-II involves mutual support of exchange rate stability through central banks intervention – as long as their domestic targets are not jeopardised. No irrevocable commitment is entered as a result of joining ERM-II, and it is therefore in the interest of any new member to join it at the earliest opportunity, in order to acquire – for free – an option to join the Euro-zone as soon as the new member wishes to join after the two statutory years of membership.

### 3. Two years of speculation exposure

The ERM-II process, of possible jolts to market exchange rates both on entry and on exit and a wide range of allowed fluctuation in between, in the light of modern approaches to exchange rate policy is a recipe for potential disaster. Today in economic literature and policy recommendations there is a dominant view that exchange rate regimes should either be hyper-fixed, as in the case of a currency board or unilateral dollarisation or euroisation (i.e. total official replacement of the domestic currency), or float freely. Intermediate regimes of pegged but adjustable exchange rates often attract de-stabilising speculation, even when they are successful indeed especially if they are successful (because they attract financial capital inflows which cause non-sustainable real appreciation and can be easily reversed in panic). ERM-II, with its broad band of variation, the uncertain final rate of conversion and the possibility in any case of revising the central parity in case of difficulty, is precisely this kind of accident-prone exchange rate regime (ERM crisis of September 1992 crisis *docet*).

The initial and final jolts to the exchange rate, potentially involved by ERM-II membership, can encourage all kind of speculation, possibly based on self-fulfilling expectations of doom or boom, equally damaging in different ways. The administrative, bureaucratic, non-market and indeed anti-market nature of this process is evident and disturbing.

This problem is particularly serious for countries that have already adopted a hyper-fixed regime of currency board – Estonia, Latvia, Bulgaria – or a fixed exchange rate successfully maintained for several years. Their shift to a new fixed rate via a period of flexibility is equivalent to waking up a person who sleeps deeply only in order to give her a sleeping pill in noisy surrounds.

Two years of ERM-II participation is a long time, for possible de-stabilising pressures to develop. Could the period not be shortened for countries that have exhibited exchange rate stability in the past, or eliminated altogether for countries that have maintained a euro-linked currency board for at least two years? Brussels and Frankfurt bureaucrats stress the importance of the consultation and coordination processes that go on during ERM-II, considered as a ritual and an educational process in which all new members should take part. Yet there have been exceptions: Italy spent exactly two years in ERM before EMU entry, but only sixteen months before it was accepted as member; Finland also spent less than two years in ERM before acceptance. It is often suggested that if the UK joined the euro it might be allowed a shorter spell in ERM-II. Clearly there is room for a negotiated improvement.

#### **4. The Maastricht conditions: how hard to meet?**

Before joining the Euro, a new member must satisfy all the well known Maastricht conditions; beside two years in ERM-II within the bounds and without central parity changes, these are:

- 1) an average rate of inflation, in the year prior to the convergence examination for admission, not exceeding by more than 1.5% that of the three EU countries with the most stable prices;
- 2) a long term interest rate, as measured by the average yield on ten year government bonds in the year prior to the examination, no more than 2% above the corresponding interest rates in the three EU countries with the lowest rates of inflation;
- 3) an annual government budget deficit not exceeding 3% of GDP and
- 4) government debt not exceeding 60% of GDP – unless deficit and/or debt are close to the reference value and either have already declined substantially or exceed the reference value only temporarily

In addition, “account should also be taken” of the development in market integration, current account balances, unit labour costs and other price indices; central bank legislation will have to be compatible with the independence of the ECB and of the European System of Central Banks; capital movements will have to be completely liberalised; an adequate regulatory framework will have been established for sound banking system and financial markets.

Formally east-European accession candidates are remarkably close to satisfying the Maastricht conditions for EMU membership: some conditions are already satisfied, others are close enough with respect to the corresponding position of candidate countries in earlier rounds of enlargement, and with respect to the other two candidates in the current round, Malta, Cyprus, as well as the prospective future candidate Turkey.

Inflation has ceased to be the major economic problem in most accession countries, everywhere in single digits with the notable exception of Romania (30.3% in 2001, though lower than Turkey at 54.4%), expected to fall within the one digit range by 2005. In 2002 Poland and the Czech republic were below average inflation in the eurozone. Long term interest rates are on average higher than euro rates but rapidly converging; in the Czech Republic they are lower than the euro rate. Government deficits are above the 3% constraint in a number of countries (in 2001 in the Czech Republic, Hungary, Poland, Romania,

Slovakia) but below or just above 5%, well below Malta and Turkey (7% and 15.1% respectively). Government debt is everywhere below the threshold of 60% of GDP – only marginally exceeded by Bulgaria at 66.3% (2001; close to Malta with 65.3%; Turkey has a ratio of 122.8%, which is, however, comparable to the debt/GDP ratios of Belgium, Ireland and Italy at the time of their entry into EMU). In 2000-01 all accession candidates have maintained their exchange rates well within +/- 15% of their average rates over the period, suggesting that exchange rate volatility is not an obstacle to satisfying that particular condition.

Does that mean that the new members will easily satisfy the Maastricht criteria and slide smoothly and painlessly into EMU? Unfortunately there are also challenges ahead.

## **5. The fiscal shock of accession**

First, net transfers to the new members from the EU budget (smaller than originally expected but still positive and significant) in each country will accrue to the economy at large – including the private sector, local authorities, various extra-budgetary funds – and only in a very small part to the government budget which will contribute the costs of membership. Such costs are a share of VAT, a tax on GDP, loss of custom duties; contributions to EIB (while contributions to the ECB capital and reserves are the responsibility of the Central Bank) and to the European Development Fund, the Research Fund of Coal and Steel, a contribution to the British rebate (sic!). Charges will be paid in full from the start, while benefits will be introduced gradually and are in great part conditional on the new members' absorption capacity. The budget will also bear much of the cost of co-financing projects only partly funded by the EU conditionally on domestic support, and the burden of pre-financing transfers from structural funds. There will also be additional costs deriving from membership (meeting environmental standards, etc.), most of which are a charge on the budget.

Thus accession itself will involve a fiscal shock of the order of magnitude of 2-3 per cent of GDP, in a current situation of excess deficit. Moreover government budgets of transition economies exhibit public expenditure rigidities inherited from the past, due to extensive price indexation, cross-linking of incomes across sectors and groups (e.g. wages and pensions), fixed shares of specific expenditures (e.g. 2% of GDP on defence in Poland) and earmarking of some tax revenues wholly or partly to specific purposes. [In Poland, 14 state institutions simply decree their own budget every year; Parliament can cut them but usually shifts expenditure savings to other uses rather than to deficit reduction].



## 6. Exchange rate real revaluation

Second, the improved prospects of the new members' economies due to greater integration – as anticipated above – already now attract large scale flows of foreign direct investment and financial investment, and will increasingly do so in the near future. Foreign direct investment contributes to growth, also through associated managerial and technological injections; financial investment – in spite of the associated dangers of sudden reversals and volatility – helps funding domestic investment. But both also strengthen the domestic currency, leading to real revaluations and very often even nominal revaluations of the exchange rate, which help to reduce and contain inflationary pressure but have a deflationary impact on exports, employment and output.

Real revaluation has been a general exchange rate trend in transition economies. In 1990-92, on day one of stabilisation, the value of the dollar in domestic currency in Hungary was 4 times the exchange rate implicit in Purchasing Power Parities, 9 times in Bulgaria, 20 times in Poland, 132 times in Russia. In 2000 the ratio between Euro official exchange rates and PPP implicit rate was: Slovenia 1.59; Poland 2.00; Hungary 2.29; Czech Republic 2.46; Slovakia 2.78; for these 5 central-east European countries the average was 2.15. For the three Baltic countries the corresponding ratio was: Latvia 2.06; Estonia 2.25; Lithuania 2.26; their average was 2.20. For the eight east European accession candidates the average ratio was 2.17.

Therefore the distance between the current and PPP rates has been shortened over time but there is still room for improvement. Once the nominal exchange rate is permanently locked onto the euro, real revaluation can only take the form of a positive inflationary differential with respect to the rest of the eurozone (just as it happened in Holland at the time of a fixed rate of the guilder with the then DeutscheMark), with adverse impact on regional unemployment and distribution.

Exchange rate revaluation is often associated with the so-called Balassa-Samuelson effect: wages, rising in sectors producing non-tradables at the same rate as in tradables sectors where productivity growth is higher, cause inflation in non-tradables that raises the real exchange rate in terms of a consumption goods basket. Such an effect has probably been over-estimated as, in truth, it depends not just on a productivity growth differential between tradables and non tradables but on an *excess* of such differential in the country under consideration with respect to the rest of the world. Identical productivity differentials

between tradables and non tradables on a world-wide scale would not be a cause of real exchange rate changes other than through structural effects due to the relative share of the two sectors. The existence of such an excess differential in accession candidates remains to be proven; in some cases such excess differential might well turn out to be negative. [Moreover, tradables and non tradables are both substitutes and reciprocal inputs, thus making the classification somewhat dated].

Nevertheless real revaluation is a visible general phenomenon in all transition economies, and accession candidates are no exception. It is probably caused by other factors, such as the initial massive under-valuation when the monetary overhang of the previous system suddenly surfaced; subsequent reduction of political uncertainty as democracy took a firm hold and government alternation was shown not to reverse the transition; the abatement of inflationary expectations in the light of experience; and above all capital inflows, both foreign direct investment caused by high returns on productive investment and financial capital inflows caused by high local interest rates.

Instead of being rooted in dubious productivity differentials over and above those of other countries, currency real revaluation in transition economies appears to be a strain of the so-called “Dutch disease”. North Sea oil and gas strengthened the Dutch guilder (and the British sterling), through the trade surpluses they caused, destroying manufacturing industries unable to compete with imports funded by oil and gas exports; by the time oil and gas began to run out it was hard for those economies to recover from the earlier stagnation of non-oil output. Accession candidates are equally experiencing rapid real and often nominal revaluation of their currencies because of capital inflows instead of oil revenues, but the effect on their competitiveness is exactly the same.

Over the long run this is a self-regulating process, but in the short-medium run it has adverse effects and the eventual reversal may generate turbulences and crises. Ideally competitiveness should be preserved by raising domestic competition, reducing the cost of capital and containing wage growth within labour productivity, presumably through appropriate social pacts, which are difficult to both reach and to implement.

## **7. Co-ordination failures of monetary policy**

Third, in all accession candidate countries, co-ordination of fiscal policy with the monetary policy conducted by independent Central Banks, if any, is far from ideal; additional deflationary pressures derive from high interest rates, higher than justified by inflation and

exchange rate trends, stubbornly imposed out of single-minded, often exaggerated concern about inflationary trends. Such high interest rates attract financial investment and drive up the exchange rate but discourage productive investment (including FDI). Moreover Central Banks in transition economies have been modelled on the super-independent Bundesbank model, instead of other modern independent Central Banks like the Bank of England, the Central Bank of New Zealand or of Japan, characterised by greater built-in co-ordination with fiscal policy. Indeed they have often been given even greater independence from the government than the Bundesbank; at the same time they have sometimes taken on a political role of opposition to the government instead of being above political parties. Central Banks in transition economies also have a tendency to destroy resources through the high cost of sterilisation operations (i.e. borrowing back from the public money issued through reserve acquisition, at an interest rate greater than earned on their reserves). They also sometimes conceal resources in the folds of their balance sheets.

Lack of fiscal/monetary co-operation can be costly, as it is known to lead to higher interest rates, stronger exchange rates and higher government deficits than otherwise would be the case – a circumstance which makes harder the achievement of EU and EMU fiscal constraints in the run up to their membership. One of the main advantages of adopting the euro is precisely the enfranchisement of domestic governments from their own Central Banks.

## **8. The alternatives**

Dealing with these challenges – fiscal shock of accession, real exchange rate revaluation, co-ordination failures between monetary and fiscal policies – will require a combination of policies, such as:

- growth-enhancing policies,
- unpopular fiscal measures,
- the reform of public finance,
- relaxation or adaptation of EU rules,
- the diffusion of “creative” accounting practices such as securitisation of state assets and other manipulation of fiscal and quasi-fiscal assets and liabilities,
- greater policy co-ordination with Central Banks

or the postponement of their entry into EMU – unless the single currency is unilaterally introduced, against the current, unreasonable opposition of both ECB and the European Commission.