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The EMU: A Challenging Goal for the "New" Member States of the European Union?

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1. *Introduction*.- Currently, thirteen of the European Union's 27 Member States form the euro area. Therefore, Denmark and the United Kingdom have a special "opt-out" status and Sweden does not fulfil all the required criteria. For the 2004 and 2007 entrants, joining the Economic and Monetary Union (EMU) is an ambitious objective. So far only Slovenia achieved this goal, on the 1st of January 2007.

Following their accession to EU, the remaining eleven countries – "Member States with a derogation"[2] – are expected to adopt the euro once the necessary conditions (i.e. the so called Maastricht criteria) are fulfilled.

Official positions of European Commission and European Central Bank indicate that the new EU members, next to the fulfilment of the Maastricht criteria, should go through the Exchange Rate Mechanism II (ERM II) before the adoption of the euro. This would imply two years in a fixed exchange rate system with periodic reviews of Maastricht indicators.

Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia already entered this "waiting room" for the EMU while the three largest new member States – Czech Republic, Hungary and Poland – remained outside the ERM II. Bulgaria and Romania, which joined the EU in 2007, are expected to join ERM II and, eventually, the EMU as soon as possible.

It is worth to notice that the enlargement process is continuing. The EU is currently engaged in membership negotiations with Croatia and Turkey, while Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia are all waiting in the queue. It is also very likely that the future EU members will join, at the end of the convergence process, also the EMU.

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[2] The ten countries which joined the European Union on 1 May 2004 are Member States with a derogation by virtue of Article 4 of the Accession Treaty. Sweden became a Member State with a derogation in May 1998.

This paper intends to provide an analysis of the current state and the prospects of the “enlargement” of the euro zone and to discuss some of the issues related.

The paper is organised as follows. In the first paragraph a short review of costs and benefits of a currency area is provided, the second and the third paragraphs present the euro (declared) entry strategies of the new EU members and the current status of convergence criteria, some considerations follow.

2. *Benefits and costs of a single currency*.- That the euro brought both benefits and costs, in economics terms, to the countries that adopt the single currency is straightforward to understand. A much more demanding exercise is to draw a balance between them.

Table 1 Benefits and Costs of joining the EMU

Benefits	Enhanced competition: easier price comparison foster competition and hence leads to lower prices in the short to medium run. Consumers, wholesalers and traders can buy from the cheapest source, thus putting pressure on companies trying to charge a higher price.
	Elimination of transaction costs related to the exchange and/or the management of different currencies due to elimination of exchange rate fluctuation.
	Increased macroeconomics stability due to convergence criteria.
	Elimination of exchange rate fluctuations: this provides a more stable environment for trade within the euro area by reducing risks and uncertainties for both importers and exporters.
	More attractive opportunities for foreign investors: a large single market with a single currency means that investors can do business throughout the euro area with minimal disruption and can also take advantage of a more stable economic environment.
	Price transparency: consumers and businesses can compare prices of goods and services more easily when always expressed in the same currency.
Costs	Loss of independent monetary policy; including the loss of controlling the exchange rate.

Economists have broadly analyzed the costs and benefits derived from the adoption of the single currency (see table 1). The major benefit of a common currency that has been emphasized is that it facilitates trade and investment among the countries of the Union by reducing transaction costs in cross-border business, and removing exchange rates volatility.

In an environment of different currencies, transaction costs, including the costs of obtaining information about prices, would be higher. This would be a disincentive to trade, consumption and investment.

The main disadvantage of joining the EMU is the "*one-size-fits-all*" monetary policy, including the exchange rate policy, applied to a set of still heterogeneous economies. Therefore, a single currency means for participants a single monetary policy[3] and no opportunity to change their exchange rate. This can be a big problem if a country or region is likely to suffer from asymmetric shocks that affect it differently from the rest of the single-currency area. Currency area members are no longer able to offset shocks by loosening their national monetary policy or devaluing their currency.

Giving up national monetary policy, including the exchange rate, as an instrument for adjustment, has serious consequences for other national economic policy instruments too. Fiscal policy can no longer confine itself to pursuing medium-term, redistributive goals, but would also have to compensate for a "rigid" monetary policy situation at the national level. Furthermore, the "one-size-fits-all" problem of monetary policy is more serious for the applicant countries than for the current members of EMU. However, the cost associated with the loss of monetary independence depends upon how well the individual countries were conducting monetary policy prior to joining the currency Union.

The problem of the single monetary policy is strictly connected with the issue of "not optimality" of the EU as currency area. Therefore, in an optimal currency area workers are able and willing to move freely to other countries; wages and prices are flexible and can adjust to the shocks; and fiscal policy can shift resources to areas hurt by a shock from areas that are not hurt. Actually does not seem to us that the EMU satisfies all this features.

In the specific case of some of the new EU members – most of which are transition economies – maintaining a certain exchange rate flexibility temporary after EU accession may be important from a cyclical stabilisation viewpoint. In such countries, retaining exchange rate flexibility can contribute to smoothening output volatility,

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[3] In accordance with the EC Treaty, the Council decides, on a proposal from the Commission, which Member States fulfill the necessary conditions for adopting the euro and fixes the date on which they will join the euro area. On the date of adoption of the euro, the conversion rate becomes effective, the national currency ceases to exist and responsibility for monetary policy is transferred to the European Central Bank (ECB) .

especially if GDP developments display substantial fluctuations, as it is often the case for countries on a catching-up process.

A more gradual approach towards ERM II and EMU participation could be preferable to countries that are still facing high fiscal imbalances. In these cases, achieving fiscal consolidation should precede ERM II and EMU entry in order to promote a smooth participation in the mechanism. Indeed, a fast adoption of a single currency – in particular in a post-transition and EU accession context – may not be fully consistent with an optimal path of fiscal consolidation[4].

3. *Strategies for euro adoption*.- All the countries that joined the EU on May 2004 initially declared their intention to adopt the euro as soon as possible[5]. In terms of the announced monetary strategies of the countries it can be seen that for some of them the declared strategy to join the ERM II and the EMU[6] soon does not suffer from substantial objections.

In the case of Estonia, Latvia, Lithuania and Slovenia, the announced strategy to join the ERM II immediately after the accession and to adopt the euro after a short stay in ERM II did not run counter to substantial objections. In fact, these countries had already renounced to an autonomous monetary policy and they managed to accommodate their catching up process without using the exchange rate as an adjustment tool.

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[4] In general, monetary integration is facilitated in countries where fiscal deficits and public debt are limited, stability-oriented policies are fully maintained and further structural policies are implemented appropriately in order to support the specific economic setting. Labour market flexibility also remains crucial to adjust to possible differences in economic conditions.

[5] Following the procedures laid down in the Treaty of the Union, their aim is to introduce the euro at the beginning of 2007, subsequent to a two year mandatory period within ERM II. ECB, (2003), An analytical review of the acceding countries strategies towards the adoption of the euro and the ERM II, Internal Staff paper, March.

[6] The ERM II is a pegged but adjustable system in which central parities are defined against the euro and not between all other participating countries. Hence this bilateral nature is expected to reduce the frequency and the scope of interventions. Central rates and fluctuation bands are set by common agreement involving the ministers of euro zone, the SECB governors of the AC. The standard fluctuation band is +-15% while not excluding the possibility of setting a narrower band. Intervention support of the ECB to NCB is automatic at the margins of the band (marginal interventions), any interventions within the band (intra-marginal intervention) need not to be (but may be) supported by the ECB. Finally realignments of central parity are made by the common procedure, which both the ECB and the member States have the right to initiate.

Table 2 Exchange rate regimes of new EU member States (2007)

Czech Rep.	Managed floating with no pre-determined path for the exchange rate
Estonia	ERM II (currency board with fixed peg to euro)
Cyprus	ERMII (pegged exchange rate with +/- 15% fluctuation band)
Latvia	ERM II (fixed peg to euro)
Lithuania	ERM II (currency board with fixed peg to euro)
Hungary	Pegged exchange rate with +/- 15% fluctuation band
Malta	ERM II (fixed peg to euro)
Poland	Free float with inflation target
Slovenia	Member of the EMU since the 1st of January
Slovakia	ERMII (pegged exchange rate with +/- 15% fluctuation band)

Source: ECB Convergence report (2006)

However, for Czech Republic and Poland, it may be preferable to still maintain their current floating exchange rate regime for some time after EU entry, as inflationary targeting in these countries has proved a well-functioning framework for monetary policy and has reached the goal of lowering inflation.

Estonia, Lithuania and Slovenia aspired to adopt the euro on 1 January 2007, less than three years after they joined the European Union on 1 May 2004. All three countries joined ERM-II on 28 June 2004. However, last year, Lithuania's application for euro membership was turned down and Estonia was advised not to apply because of concerns about inflation. Only Slovenia achieved the goal being admitted in as Euro area member on 1 January 2007.

Cyprus, Latvia and Malta intend to join the euro area on 1 January 2008. They entered ERM-II on 2 May 2005. Slovakia aims to adopt the euro on 1 January 2009. The Czech Republic and

Hungary aspire to join the euro area in 2010 while Poland has no target date for the time being.

Tab 3 Timing of ERM II and Euro adoption

	2004	**2005**	**2006**	**2007**	**2008**	**2009-10**
Czech Republic						EMU
Estonia*	ERM II				EMU	
Hungary						EMU
Lithuania*	ERM II				EMU	
Latvia		ERM II			EMU	
Poland						
Slovenia	**ERM II***			**EMU***		
Slovak Republic		ERM II				EMU
Cyprus		ERM II			EMU	
Malta		ERM II			EMU	

*1 January 2007
Source: *Deutsche Bank Research, ECB*

4. *Maastricht criteria: How to Join the EMU*.- All the EU 2004 members have undertaken to introduce the euro as soon as they are "ready". The readiness of the countries will be decided in accordance with the Maastricht criteria, which determine the minimum requirements for inflation, long-term interest rates, budget deficits, government debt, and exchange rate stability[7].

Among these criteria, according to us the inflation one is the requirement that is harder to meet for 2004 members than for more mature economies. Therefore, transition countries catch up with the more developed nations, they post higher productivity gains in the traded goods sector, owing to the greater competitive pressure, than in the non-tradable goods sector. Wages in the tradable goods sector rise along with the productivity gains and so, because both sectors are competing with each other on the same employment market, wage levels in the domestic sector also increase, which drives up prices

[7] The deficit of the general government must be below 3% of GDP. Gross debt of the general government must be below 60% of GDP or declining toward 60% of GDP at a satisfactory rate. Inflation must not exceed the average rate of inflation in the three EU countries with the lowest inflation rate by more than 1.5 percentage points. The long-term interest rate must not exceed the average rate in the three EU countries with the lowest interest rate by more than two percentage points. Two years of participation in the Exchange Rate Mechanism II (ERM II) without major tensions in the foreign exchange market are required.

because productivity gains in that sector are not keeping pace. This phenomenon is known in Economics as the "*Balassa-Samuelson effect*".

In the Maastricht criteria, the inflation criterion is set by adding 1.5 percentage points to the average inflation rate of the three countries which experimented the lowest rates over the last 12 months. However, all EU members are considered relevant in this assessment method, regardless of whether they belong to the EMU or not. However, it does not seem to us appropriate to include all EU members in the assessment, since the scope is the economic convergence with the EMU members and not with the EU ones[8].

Tab.4 Criteria for EMU entry- current situation (October 2006)

	Deficit /GDP (%)	Debt/GDP (%)	Inflation*	Interest rate**
Czech Republic	-3.5	30.9	2.5	3.8
Estonia*	2.5	4.0	4.4	4.2
Cyprus	-1.9	64.8	2.4	4.2
Latvia	-1	11.1	6.7	4
Lithuania*	-1	18.9	3.5	4.1
Hungary	-10.1	67.6	3.9	7.3
Malta	-2.9	69.6	3	4.3
Poland	-2.2	42.4	1.4	5.3
Slovenia	-1.6	28.4	2.5	3.9
Slovak Republic	-3.4	33	4.5	4.5
EMU criterion	-3	60	3.1	5.8

* Harmonised index of consumer price, ** Long term interest rate
Source: European Commission

This point was crucial in May last year when the requests of entry in the EMU of Slovenia and Lithuania were under review. If only members of the currency union had been included, the reference rate for inflation would have been 3.0% rather than 2.6% and Lithuania would already have been able to introduce the euro in 2007 instead of missing the inflation criteria.

In 2006, only five out of the ten Member States examined (Czech Republic, Cyprus, Malta, Slovenia and Poland) had average inflation rates below the reference value. Inflation in the other five countries was above the reference value, with the largest deviations being observed in Latvia, Slovakia and Estonia (see table 4).

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[8] Enlarging the number of representative countries increases the probability of finding ones with lower inflation, so the inflation criterion always tends to be set at a lower rate.

With regard to the budgetary performance in 2006, Estonia recorded a fiscal surplus, three out of the ten countries recording fiscal deficits had deficit ratios above the 3% reference value specified in the Treaty (the Czech Republic, Hungary and Slovakia).

As for the government debt, three countries exhibited debt ratios above the 60% of GDP reference value in 2006 (Hungary, Malta and Cyprus). Looking back at the period from 1996 to 2005, debt-to-GDP ratios increased substantially in the Czech Republic, Cyprus and Malta. Large primary deficits and substantial deficit-debt adjustments were the main reasons for the rise in debt ratios. In recent years, debt ratios seems to have stabilised or declined in most countries, mainly reflecting lower primary deficits

The agreements on participation in ERM II have been based on a number of policy commitments pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing structural reforms. ERM II entry was also linked in some cases with unilateral commitments on the part of the countries concerned regarding the maintenance of narrower fluctuation bands (Estonia, Latvia, Lithuania e Malta)

Within ERM II, none of the central rates of the currencies examined in this report have been devalued in the past year. Indeed, most currencies remained at or close to their respective central rates with the exception of Slovakia that in March 2007 re-valued the central parity of its currency versus the euro[9].

Long-term interest rates are still pretty heterogeneous among the 2004 members but all the countries are on a declining path. Using 2006 data, the EMU criterion is approximately 5.8 percent. Only Hungary fails this since its rate in 2006 was 7.3% mainly due to its fiscal problems.

5. *Open questions: if and when?*- This paper has briefly reviewed the exchange rate strategies announced by new EU members for the period after EU entry, with a special focus on their paths towards the adoption of the ERM II and the euro. The paper presents also a description of the current status of the convergence process as defined

[9] The 16th of March 2007, the central rate of the Slovak koruna has been revalued by 8 ½ percent, The revaluation of the central rate of the Slovak koruna was justified by underlying fundamentals. It will support the authorities in maintaining macroeconomic stability. The revaluation is based on a firm commitment by the authorities to pursue appropriate supportive policies, aimed in particular at achieving price stability in a sustainable manner and underpinning external competitiveness and economic resilience.

by the Maastricht criteria. To conclude we intend to point out some observations.

First of all it is worth to underline that the 2004 members, former planned economies, have still significant differences with respect to EMU members in terms of a range of nominal, real and structural conditions. This particularly concerns labour market features, policy interest rates, external positions and fiscal performances. Since the so called Maastricht criteria were designed for “core” Europe nations at a time when the “EU enlargement” was just an idea, there is some concern that a strict interpretation of the Maastricht criteria, could keep the new EU members out of the EMU.

In particular, the inflation criterion seems to us the requirement that is hardest to meet for the new members. Not only the definition of the inflation criterion fails in recognizing the peculiar condition of transition countries, but also its interpretation to assess countries convergence seems to us very strict.

Secondly, inflation in the new Member States is still generally higher than in most euro zone countries. This is partly linked to an economic phenomenon known as the “Balassa-Samuelson” effect. The “Balassa-Samuelson” effect calls for a degree of flexibility to be maintained in exchange rates in the post-accession period. Flexibility in the exchange rate and the real interest rate, depending on the requirements of the country in question could in same extent, limit the risks of economic overheating. From this point of view seems to us that a decision on rapid entry into the euro zone could suffer from some objections.

Thirdly, it is worth to notice that the new members have committed themselves at government level to adopting the euro, however, the timing of the introduction is completely at the discretion of the single countries. It is important to take into consideration that the provisions of the Treaty can actually be also used to delay introduction (as in the case of Sweden).

Thus, as well as the Maastricht criteria, and especially the inflation criterion, which is proving problematic for the half of the accession States, also “political” risks could constitute a large obstacle in process of the enlargement of the euro area. In some 2004 member States acceptance rates for the euro among the populations often run at less than 50%, and also political elites have become more euro-sceptical.

Notwithstanding there are some risks that in many countries the possible entry dates are being put back, the trend towards the euro is continuing. From the today perspective it is likely that Malta and Cyprus will enter the EMU in 2008, and that Slovakia will follow in 2009. The Baltic States, Poland, the Czech Republic and Hungary, as well as the newest EU members Bulgaria and Romania, will probably not join in this decade.

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