EMU ENLARGEMENT: A PROGRESS REPORT

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The date of the formal EU accession did not mean the end of the integration effort of new member states to fully participate in the Single European Market, when taken in its broader sense, including the EU common currency.[1] Apart from joining the Economic and Monetary Union (EMU), new members are still waiting to join the Schengen zone and have full access to labor markets of certain old member states (OMS). There are also specific transitory provisions in many other chapters of the *acquis* related to agriculture, environment, infrastructure, free capital movement, taxes, etc.

The purpose of this paper is to focus on EMU enlargement, which – from an economic point of view – seems to be the most important part of the unfinished integration agenda, and is also raising the biggest controversies.[2] The advocates of rapid EMU enlargement stressed the high level of trade and business cycle integration of the New Member States (NMS) with the eurozone, and the potential benefits for the NMS in terms of decreasing transaction costs and exchange rate risk. Opponents pointed out the costs of meeting the Maastricht criteria and giving up the supposed shock-absorbing role of the exchange rate. There were also some political and economic concerns in the Old Member States (OMS). The former came down to retaining a carrot which could be granted or withheld from the NMS depending on their good behavior, and some understandable concerns about how responsibly they were likely to behave after EU accession. Economic fears were mostly related to the controversial hypothesis that the accession of rapidly-growing countries would increase the inflationary pressure and interest rates in the eurozone, which would have an additional contractionary impact on the slower-growing economies of some OMS (see Rostowski 2006; Zoubanov 2006).

Only after the EU accession of the first ten NMS had been formally completed could the EMU enlargement process finally begin and could various earlier arguments and hypotheses related to this process be empirically tested. At the end of 2006, two and half years after the first wave of EU Eastern Enlargement and the first ERM-2 accession decisions, it seems that a good moment has come to reconsider old arguments and concerns.

This paper can be seen as a progress report that focuses on the following key issues: a short overview of candidates' situation with respect to EMU accession, the formal Treaty obligation to join EMU vs. the actual freedom of choice of the entry date, revisiting the pros and cons of adopting a common currency, the relevance of the Maastricht criteria and fears regarding the ERM-2 mechanism and the political economy and politics of EMU enlargement. The final part provides a summary and policy conclusions.

A progress report

The EMU accession process of the NMS could only formally begin after the NMS had officially joined the EU, i.e. after May 1, 2004.[3] Joining the new Exchange Rate Mechanism (ERM-2) was the first institutional step on this road. So far, seven NMS have joined this mechanism, thus demonstrating their desire to follow a fast-track accession to EMU. These have been: Estonia, Lithuania and Slovenia (all three joined in June 2004), Cyprus, Latvia and Malta (May 2005) and Slovakia (November 2005). On the other hand, the three biggest NMS – Czech Republic, Hungary and Poland – do not have binding and credible plans to join the Eurozone yet. Hungary has officially declared its interest to introduce the euro at the beginning of the next decade but a serious fiscal crisis, suffered by this country recently, makes any predictions in this respect very uncertain. Fiscal imbalances (although less severe than in the Hungarian case) and political reluctance to address them right away can be considered the main obstacles to the Czech Republic's and Poland's EMU accession. In addition, some leading politicians and political parties currently in power in these two countries run on a somewhat euro-skeptical ideological platform, part of which is a desire to postpone euro adoption.

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[1] Formally, the concept of a Single European Market refers to four basic freedoms, i.e. free movement of goods, services, capital and people. It does not include a common currency (which is the key element of the Economic and Monetary Union, another institutional block of the EU). However, as the decrease in transaction costs has been the main rationale behind introducing the euro, our interpretation, which considers a common currency as the important part of a common market, seems to be economically justified.

[2] The author of this paper and the institute, which he represents (CASE) actively contributed to this debate.

[3] January 1, 2007 in case of Bulgaria and Romania.

While prospects for a relatively fast EMU enlargement looked pretty good (at least with respect to the smaller NMS) in the second half of 2005, they became gloomier in 2006, mostly as a result of a rigid interpretation of the Maastricht inflation criterion. Among the first three countries that joined ERM-2 in June 2004 and that had originally planned to introduce the euro on January 1, 2007, Estonia was effectively discouraged from applying for EMU membership on the grounds that its actual inflation rate well exceeded the reference value. Lithuania, where HICP breached the criterion by 0.1 percentage points only, asked the Commission to prepare the convergence report, which came to a negative decision on its EMU entry (CR 2006, 9). The Commission's negative verdict was approved by ECOFIN. Only Slovenia received a "green light" to enter the Eurozone in January 2007.

Lithuania's case had a negative influence on the follow-up debate on prospects and the timetable of EMU accession both in the EU as the whole and in the NMS, discouraging some of them from undertaking more radical adjustment policies, particularly in the fiscal sphere. The timetable of EMU enlargement has become uncertain and has lost political momentum.

Is EMU accession mandatory?

At first glance, the question seems to be wrong as the NMS do not formally have an opt-out option like Denmark and UK. They are legally obliged to join EMU at some point. However, according to Article 4 of the Treaty of Accession (signed in April 2003 in Athens) the NMS obtained the status of "Member States with derogation" regarding EMU membership (CR 2004, 2) and the derogation period has not been determined. Moreover, joining EMU requires an active effort by each candidate to meet the nominal convergence and legal criteria of the Treaty.

This can take many years if a country is not interested in joining quickly. It is enough to continue a floating exchange rate regime, which excludes both ERM-2 and EMU membership. Thus the NMS possess *de facto* a great room for maneuver as to when they will adopt the common currency. In extreme cases, it would be possible to postpone EMU membership almost indefinitely. The case of Sweden, which has not joined EMU or even the ERM-2 yet (in spite of not having the opt-out option), can serve as an example, which perhaps some euro-skeptical NMS will follow.

In addition, present EMU members, which must grant an approval to each candidate country to join both ERM-2 and EMU (by qualified majority voting or in unanimous voting – in the case of determining the conversion exchange rate), possess great discretionary power to determine the speed of EMU enlargement. So far most of them as well as the Commission and the ECB are following a very cautious approach, discouraging NMS from rapid EMU entry ("don't rush" advice) and trying to use all formal opportunities to delay this process.

Net benefits of EMU enlargement

If the NMS are not effectively obliged by the Treaty to join EMU soon and the political attitude of EMU incumbents to fast-track Eurozone enlargement is not necessarily encouraging, what are the economic arguments for joining EMU? Answering this question requires coming back to the well-known discussion on the costs and benefits of joining a common currency area, i.e. to the seminal papers of Mundell (1961) and McKinnon (1963). However, the limited size of this paper allows only for summarizing the main findings[4]:

1. Most of the NMS represent a very high share of trade with other EU countries (70 to 80 percent or even more). The share of trade with the Eurozone is smaller (due to trade relations with non-EMU members of the EU) but still ranges from 40 to 60 percent of total trade (with only Latvia and Lithuania representing lower figures). However, when all the NMS will have joined EMU, this share will increase significantly (through absorption of substantial intra-NMS trade). Generally, the level of trade and investment integration of the NMS with the EU and EMU is not, on average, worse than in the case of incumbent EMU members, implying potential benefits from decreasing transaction costs and decreasing risk of asymmetric shocks.
2. The NMS exhibit an increasing co-movement of their business cycles with those of EMU countries, although the speed of convergence varies

[4] For more detail analysis see, among others, Dabrowski, Rostowski et al. (2006); EFN (2006 Spring).

among countries. This implies a gradually decreasing risk of asymmetric shocks.

3. According to the endogeneity hypothesis (see Frankel and Rose 1998), enlarging the euro area will create additional trade (see Maliszewska 2006) and investment flows and speed up the convergence of business cycles. These effects can be particularly strong in countries now running flexible exchange rate regimes.
4. In the world of increasing financial integration, room for sovereign monetary policies in small open economies is gradually diminishing: their central banks cannot risk "leaning against the wind" (see Dabrowski 2004) and must follow, in one way or another, the monetary policy decisions of the monetary authorities of the biggest monetary areas (ECB in case of NMS). This puts in question the main argument in favor of postponing EMU entry, i.e. retaining an instrument of monetary/exchange rate accommodation to asymmetric shocks.
5. Joining the Eurozone also means eliminating the risk of currency crises for NMS. While the last few years did not see any spectacular financial turbulences in emerging markets, this does not mean that NMS are totally immune from this risk. The end of this unique period of extremely low interest rates may bring about a new wave of speculative attacks against emerging-market currencies.
6. Rapid EMU entry can also bring substantial fiscal benefits, especially for countries (such as Hungary and Poland), which have a high public debt burden, high primary deficits and must offer higher yields to purchasers of their debt instruments (all three factors are closely interrelated). For these countries, the strategic policy decision of early EMU accession would mean starting fiscal adjustment sooner and enjoying lower interest rates earlier which would both result in lower nominal debt, other things being equal (see Dabrowski, Antczak and Gorzelak 2006).

The limited economic potential of the NMS compared to the EMU-12[5] means that the latter will gain less, in terms of transaction costs and potential trade and investment creation, than the former. However, for the same reason, economic risks for the OMS will also be negligible. This includes the afore-mentioned concern that the rapidly growing economies of the NMS could increase the inflation pressure in the enlarged Eurozone and lead to an overly restrictive monetary policy.

Re-examination of the Maastricht criteria

The four criteria of nominal convergence (as preconditions for joining EMU) were formulated in the beginning of the 1990s in the Maastricht Treaty. The purpose was not merely to enlarge the EU territory and number of member countries, but to create a monetary union (as well as a new currency) among countries, whose inflation rates and long-term interest rates varied greatly (in some EU countries inflation well exceeded 10 percent). Besides, the global macroeconomic and financial environment was quite different at that time. Some of the EU-12 members still had capital controls. Global financial markets were less developed and sophisticated. Therefore the room for a sovereign monetary policy was larger, even in countries which belonged to EMS.

It is fair to say that from the very beginning the mutual consistency of these criteria raised some doubts and was, in fact, only possible under some additional assumptions. The two requirements of the fiscal criterion represent the best example here (see Gros, Mayer and Ubide 2004). The deficit ceiling of 3 percent of GDP is consistent with the debt ceiling of 60 percent of GDP only under the assumption of a 5 percent growth rate of nominal GDP. If average nominal growth is lower (which has been the case for EMU as a whole and for most of its members for a number of years) the deficit must be correspondingly lower.

An even more serious inconsistency affects both, exchange rate stability and the inflation criteria. Fixing the exchange rate makes the inflation rate mostly exogenous for the monetary authorities, particularly in a world of free capital movements. And inflation differences exceeding what is tolerable under the inflation criterion can result from various sources, such as differences in productivity growth (the Harrod-Balassa-Samuelson effect), changes in the demand structure (in favor of non-tradable services), or initial differences in purchasing power parity (PPP) of individual currencies. The NMS, growing faster than the OMS and starting with lower levels of development, can experience all these sources of higher inflationary pressure and

[5] In 2004, the total GDP of 10 NMS amounted to only 5.6 percent of the total GDP of the future EMU-22 (twelve current members and ten candidates). The total share of the five smallest NMS (Baltics, Cyprus and Malta) amounted to only 0.7 percent (see EFN, 2006 Spring, Table 3.2).

thus face the risk of breaching the inflation criterion, which is what really happened in the case of the Baltic countries.

An additional difficulty can result from the fact that the reference value for the inflation criterion is calculated on the basis of a simple arithmetic average of the three best-performing EU members, which do not have to be EMU members. With substantial differentiation of inflation rates inside the EU, it is possible that the three best performers, representing a very small share of overall EU GDP, can set the reference value well below the average inflation rate of the entire EU (and indeed EMU) and the actual rate of most of their members. Lithuania's failure to meet the inflation criterion by a very narrow margin in the spring of 2006, when the reference value was set by two non-EMU countries, Poland and Sweden, demonstrates the high probability of the above scenario. Obviously, such an outcome does not say too much about a candidate's nominal convergence with the current EMU.[6] And what are the effective policy tools to bring inflation down in countries like Estonia or Lithuania that have run currency boards for many years and have balanced or surplus budgets?

A similar inconsistency may also relate to the ERM mechanism itself, which was originally designed as a narrow fluctuation band around a central parity, but was formally widened to a ± 15 percent range after the 1992 EMS crisis. This is a kind of hybrid monetary regime under which the central bank tries to simultaneously manage the exchange rate and interest rates (liquidity). Historical experience shows that such a regime is prone to speculative attacks, as was experienced by many current EMU members in 1992 to 1993 (Wyplosz 2004).

So far, the central banks of the ERM-2 participants have not experienced problems with keeping the exchange rates of their currencies close to the declared parity, except for the National Bank of Slovakia, which had to defend the koruna when it came under market pressure after a general election on June 17, 2006. However, there are two important caveats here. First, five out of seven ERM-2 members have had currency boards or fixed pegs for many years, so they do not, in fact, run sovereign monetary policies. Second, the last few years have been characterized by calm on emerging markets.

Political economy and the politics of EMU enlargement

The policy conditionally attached to EMU accession may serve as a powerful incentive for fiscal adjustment and associated reforms, mostly in the social policy sphere, as has been demonstrated by the experiences of many current EMU members in the second half of 1990s. However, this kind of incentive mechanism can only work if the candidate knows that the reward (EMU membership) is truly available and welcomed by the other members.

I am not suggesting any softening of those entry criteria, which: (i) are very important for the collective economic safetyor EMU (avoiding free riding under the umbrella of the monetary union); and (ii) remain under the control of each candidate. This relates, in the first instance, to fiscal criteria, which should be closely observed and executed without any waiver, perhaps even with some additional safety margin, taking into account the fact that the NMS are enjoying a unique period of post-enlargement catch-up growth and that they will face serious long-term fiscal problems as a result of population aging (even more than in Western Europe). This means that the NMS should run balanced or surplus budgets (like Estonia).[7] On the other hand, the competent examination of candidates' performance must take into account that some of the macroeconomic variables remain under limited control of national economic policy, such as the inflation rate under a fixed exchange rate regime.

Punishing the best macro- and microeconomic performers such as Estonia and Lithuania for missing an inflation criterion that they are unable to control, issues the wrong political signal. It not only discourages good performers, but also those countries that are facing a complex fiscal adjustment agenda on their road to the euro. This leads euro-skeptical and opportunistic politicians in countries suffering fiscal problems to ask, "If the reward is problematic and the NMS are not very welcomed in the Eurozone yet, then why should we risk making unpopular decisions?"

[6] Lithuania's twelve-month HICP in March 2006 (2.7 percent) was higher by only 0.4 percentage points than the average inflation of the Eurozone.

[7] And this condition is, in fact, required by the Stability and Growth Pact.

This skepticism is further fuelled by the demands of real convergence (meaning closing the income per capita gap between the EMU candidates and the Eurozone) or criticism of the NMS' persistent current account deficits (see Bundesbank 2006) caused by large FDI inflows. Both arguments are based on economic misconceptions and do not have a formal ground in the Treaty.

The attempt to slow down EMU enlargement can be considered part of a wider phenomenon: public opinion and politicians in some OMS have become reluctant not only to continue the EU enlargement process (with respect to Turkey and Western Balkan countries) but also to complete the 2004 and 2007 enlargement agenda. Apart from EMU enlargement, the Schengen zone enlargement and the opening of OMS labor markets to the NMS labor force are also going to be delayed. This may signal a political intention to have, at least temporarily, two categories of EU members, with the "core" built around the current EMU. It is hard to believe, however, that this two-tier membership will benefit the EU and help solve its fundamental economic and political problems, such as finding a compromise on the proposed constitution that was frozen by the negative results of the French and Dutch referenda in 2005.

Summary and conclusions

Until now, the EMU enlargement process has developed slowly. This results not only from "post-enlargement fatigue" and euro-skepticism in some of the NMS (demonstrated by the inability of certain countries i.e. Czech Republic, Hungary and Poland to address fiscal problems), but also from resistance to admitting the NMS to the euro area from the "incumbent" side. The negative assessments of Lithuania and Estonia's eligibility are the best examples of this phenomenon. Ironically, this has affected the two best economic performers and *de facto* long-time members of the Eurozone (they run euro-denominated currency boards).

Continuation of the "don't rush" policy will have negative economic and political consequences for both, the NMS and the European Union as a whole. First, it will discourage the NMS from carrying out fiscal adjustment and from continuing reforms in politically sensitive areas such as social welfare. Secondly, as the potential benefits of joining the euro area outweigh their costs, delaying EMU enlargement results in net welfare losses for the NMS and delays hopes of their income catching up with that of the OMS. It will also limit the net benefits of those NMS that joined EMU first because some of their important trading partners will remain outside the common currency area. Thirdly, financial markets have until now assumed a scenario of relatively quick EMU enlargement. This explains the relatively low NMS risk premiums. However, when investors realize that this process will be postponed for good, the risk premiums will probably increase, thus weakening growth perspectives and adding to fiscal problems. Any adverse shock such as political problems in any single country or financial turbulences on other emerging markets may trigger a financial crisis in the periphery of the enlarged EU. Fourth, applying 'second-rate' status to most NMS will negatively influence the Union's ability to meet key economic and political challenges in the near future.

The "don't rush" policy should be abandoned in favor of clear incentives to speed up the fiscal adjustment of the EMU candidates as a precondition of their membership in the common currency area, even with the additional safety margin comparing to the Maastricht criteria. On the other hand, the inflation performance should be interpreted more flexibly, at least reflecting its partly exogenous character under fixed exchange rate regimes. This flexibility may go in two directions:

1. The inflation criterion should be applied to assess macroeconomic (mostly monetary) policies in the period preceding the adoption of the ERM-2 central parity and should subsequently be abandoned. It should be completely abandoned in the case of EMU candidates running well-established euro-denominated currency boards.
2. In addition, the reference value should relate to the average inflation rate in the Eurozone instead of the average of the three best performing EU members.

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