BRIEFING PAPER

New EU Member States and the Euro

by

Gustav A. Horn

Institut für Makroökonomie
und Konjunkturforschung

Duesseldorf
February 2006

Executive Summary

The paper outlines the criteria that should be followed when deciding upon new members of the currency union. It is argued that basically those of the Maastricht treaty should be applied. But some changes are necessary since the currency union now is already existing in contrast to the situation 1997.

It is argued that the inflation criterion of the treaty should be changed and replaced by the ECB target rate. The same reasoning applies to the interest rate criterion. As the relevant exchange rate for assessing currency market stability only the Euro is of relevance. Only the debt ratio and not the actual deficit should be considered when the debt siutaiton is analysed. Finally in addition to the criteria mentioned in the treaty the unemployment situation should taken not consideration.

Applying these criteria on the present candidates for an entry show that only two countries, the Czech Republic and Slovenia fulfil them all.

1. Introduction

In contrast to the United Kingdom, Denmark and Sweden the new EU member countries do not have an opting out clause with respect to the Euro currency area. That means they are obliged to enter a convergence path to the monetary union and should be part of the Euro currency area in due time. The question is when this should be the case. During the past years some governments of the new member countries seem to indicate that they venture a very fast track to accession. Some even wanted to join as early as 2007. Some members cautioned a fast entrance given the still huge differences in wealth and institutional frameworks between the “old” members of the currency union and the potential new ones.

The decisive question is which criteria should guide the decision when these countries should join or rather wait. There is a formal and an economic answer to that question. The treaty of Maastricht provides the formal answer. The convergence criteria were laid down in Article 122 (2) of the Treaty establishing the European Community.[1] There is a deficit criterion saying the state deficit must not exceed 3 % of GDP and the debt burden must be below 60 % of GDP. There is an inflation criterion that states, inflation rate must not exceed the average of the three lowest inflation rates of member countries by more than 1.5 percentage points. The same applies in principle to long term interest rates but the allowed difference is 2 percentage points to account for potential minor risk premiums. Furthermore the exchange rate must show two years of stability in advance of the planned entry into the currency union. These formal criteria were decisive at the set up of the currency union although they were liberally interpreted at times. So they should be also applied in the case of new member states as they were e.g. in the case of Greece that joined the currency union not in the first round, too.

However, one should keep in mind that the economic importance of above criteria is not the same for each criterion. So when taking a decision one should consider this and be liberal when economically minor targets are not met whereas one should be strict when important economic preconditions are not fulfilled. In the following section it will be outlined what important economic targets should be met in countries before joining the currency union. In the third part it will be analysed whether the necessary

[1] See Annex.

preconditions are fulfilled for single countries. In the final part recommendations will be outlined.

2. On Monetary Convergence

The most important criterion for a successful monetary convergence is a sustainable inflation rate that is compatible with inflation targets of the currency union. If a country's inflation rate would deviate significantly and resiliently from this target severe regional imbalances would be the consequence. If the inflation rates are higher than the target, firms would loose their competitiveness on the joint currency market at least in the long run. Lower exports and higher imports would deteriorate external balances. If the inflation rates are lower, the country would always gain in competitiveness and trade surpluses here would lead to trade deficits in other member countries. Imbalances would occur in a symmetric manner. This argument means that "structural" changes of real exchange rates should be avoided. If there is a need for a significant adjustment of real exchange rates this should be done before such a country joins the currency union. That implies e.g. that inflation processes resulting from high wage increase or even indexed wage settlements have to be abolished in advance. This is part of the monetary convergence. This argument also implies that fundamental differences in the macroeconomic price level should have been overcome before a country joins the currency union. Otherwise inflation differences would be unavoidable.

These considerations are the more important the bigger a joining country is. The impact of small countries is negligible whereas those of larger countries may be very significant. Furthermore these considerations are the more important the longer regional deviations from the inflations targets last. A negative example in this respect presently is Germany where the inflation rate is well below EMU average since the beginning of the currency union. As a result Germany acquired a high surplus in the trade balance, whereas other countries dived deep in the red. In the long run these imbalances require an adjustment process. Either prices in Germany start to rise stronger than in the rest of the EMU inciting the danger of inflation or prices in the other EMU countries also follow the Germany path taking EMU at the brink of deflation. In order to avoid these potentially painful adjustments right from the beginning countries should show an inflation rate close to the target of the ECB.

The benchmark outlined in the treaty and mentioned in the introduction is that the average inflation rate of those EU countries with lowest inflation rate plus 1.5 percentage points should not be exceeded. This may have been a useful concept before the currency union started in order to avoid too heterogeneous inflation rates. But since the currency union now is set up, the ECB target seems to be the only sensible yardstick. If the average plus 1.5 percentage point rate is higher or lower than the target the accession of these countries influence the Euro area inflation rate in a way that the ECB target is missed and that makes monetary policy more difficult. In addition to that the outlined imbalances would occur. Presently (latest figures from 2005) the three EU-countries with the lowest inflation were Sweden (0.8 %), Finland (0.8 %) and the Netherlands (1.5 %) yielding an average of 1.03 %. Thus new member countries would be allowed an inflation rate of about 2.5 % according to the treaty criterion. With these rates the new members of EMU would not only drive the aggregate inflation rate upwards, they also would face severe competitive problems in the medium run. So the criterion should presently be even more strict than outlined in the treaty and the 2 % target rate of the ECB should be applied. It makes anyway not much sense to consider inflation rates from outside the currency union (Sweden) although the treaty states it differently.

A very important aspect of the assessment is the sustainability of the actual inflation rate, because it is of no use if a compliance with the criteria is only reached for a short period of time and missed as soon as the country has joined the currency union. The treaty tries to capture the sustainability by applying a capital market criterion of long term interest rates differences. If capital market investors would not believe in a measured inflation convergence because they think inflation rates will rise well above the target as soon as the country has joined. Interest rates differences would show this disbelief and one should consider this when deciding upon the entry. In deviation from the way the criterion is phrased in the treaty and similar as in the case of inflation rates one should take now the average of comparable long term government bond of the present members of the currency union plus the risk premium of 0.5 percentage points implied by the treaty. Presently the appropriate rate would be in case of long term government bond yield (10years) about 4 %. This would replace average of the three countries with lowest inflation rates plus 2 percentage points. Given the fact that the currency union now exists this criterion makes as in the case of inflation rates no longer sense.

To have a look on interest rates is one sensible way to assess the sustainability. Another related criterion is the exchange rate stability. If capital markets trust the credibility of the monetary convergence, there should be no excessive movements of the exchange rate. However whether this is a stable situation should also be assessed by looking on the current balance. If there are high surpluses or deficits and exchange correction may be appropriate before joining the currency union. Otherwise this has to be achieved by respective inflation movements not necessarily following the stability target of the ECB.

The interest rate criterion and the exchange rate criterion are phrased in an asymmetric way in the treaty. Interest rates are not allowed exceed the benchmark. They are allowed to be lower. Exchange rates are not allowed to show a tendency for depreciation above some limits against the currencies of the member states, now to be replaced by the single currency Euro. They are allowed to appreciate according to the treaty. Thus the treaty does not reflect the now prevailing symmetrical nature of the ECB target but follows the asymmetrical reasoning with respect to inflation the ECB also showed during the first years of its existence.

But next to these capital market criteria one should not neglect real economy developments. If a target compatible inflation is accompanied by an unemployment rate that is well above the EMU average there is the danger that with decreasing unemployment the target is no longer met. Lower unemployment may lead to increased wage settlements driving inflation upwards. The same reasoning applies for the symmetric case. If the target is accompanied by an unemployment rate well below the average then there exists the danger that with rising unemployment the inflation will be well below the target. Hence sustainability should be judged according to capital market criteria as well as by real economic developments.

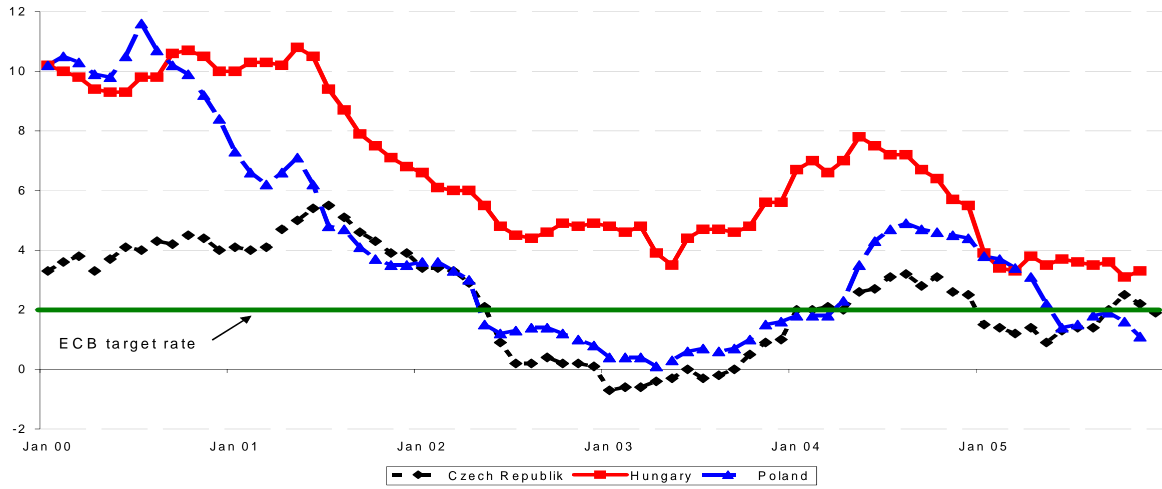
If both above mentioned criteria are fulfilled there should be no serious problem when new members join the currency union. From economic point of view the debt criterion is of minor importance for monetary convergence. In presence of an independent central bank the danger of debt financing monetary policy is low risking severe hyper inflation processes is low. This particularly applies with respect the ECB where one government is simply not in a position put enough pressure on the ECB council to follow such a policy. There is only one risk that needs to be considered. An excessive debt burden may in the very long run effect the banking sector in one country. In the

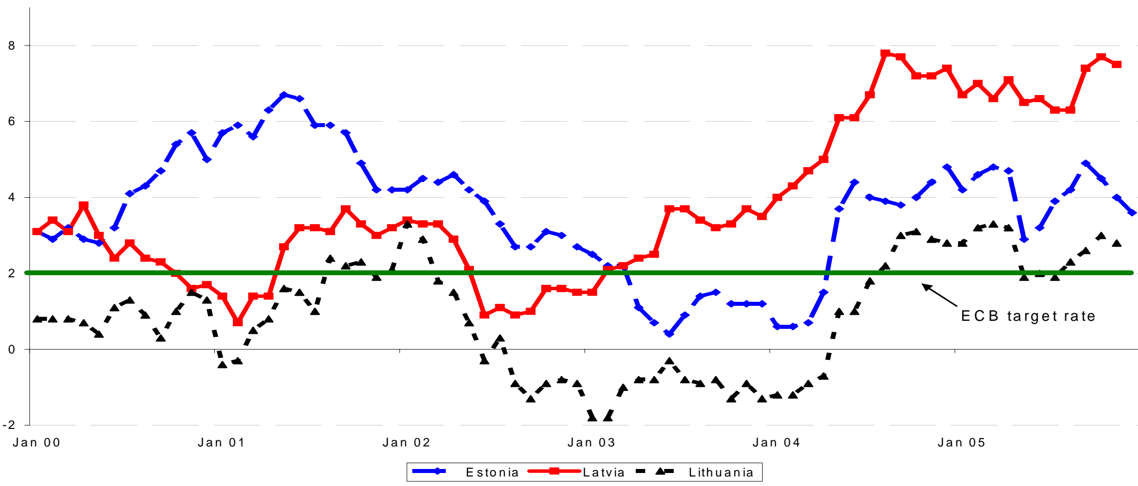
end the ECB has to guarantee the stability of this sector. These kinds of pathological processes have occurred in recent times only in not fully developed countries. Therefore there is only a very remote reason to have a look on the debt burden. This is the more so since it is also in the national interest to avoid such a situation since every government would loose any financial leeway in a situation with an excessive debt burden.

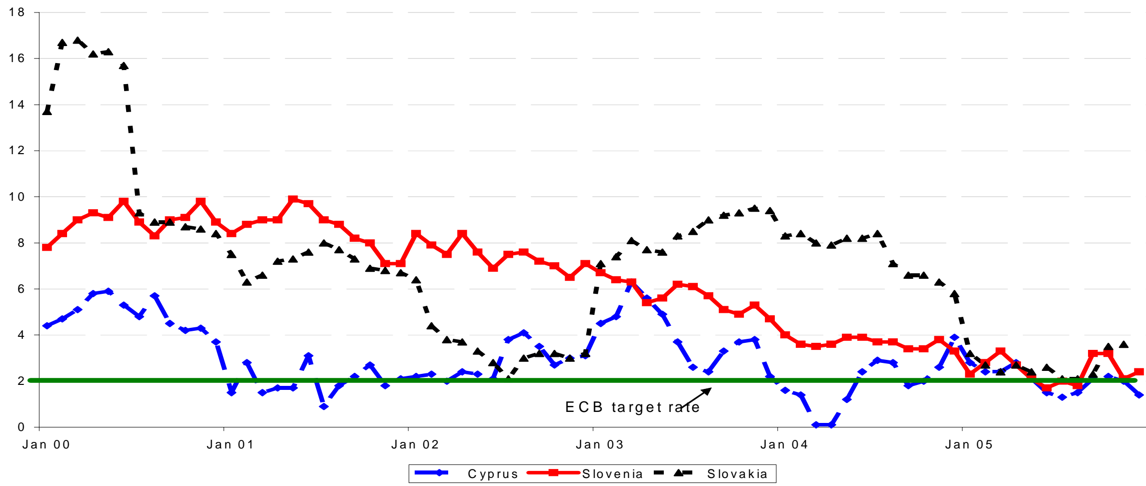
When considering the debt situation it is not the actual deficit that should be decisive but rather the debt ratio. Here for conventional reasons the benchmark of the treaty, 60 % of GDP, should be applied. A country with a low debt burden can afford a high deficit without endangering monetary stability. And as the past shown even a high debt burden like in Italy or Belgium can go well along with low inflation rates. Thus one should be very lenient when assessing the debt situation of candidate countries. When the decision on the first member countries was taken in 1997 the debt burden criterion was as the cases of Italy and Belgium show also not handled very strictly. This has not affected price stability during the consecutive years.

3. The Performance of the Candidate Countries

The inflation criterion is fulfilled only by some of the candidate countries. As many western European countries at forefront of the currency union that showed even double digit inflation rates, countries like Poland, the Czech Republic, Slovenia, Cyprus and with some doubts also Lithuania and Slovakia have reduced inflation rates from similar high values down to about 2 %. This certainly is a great success.

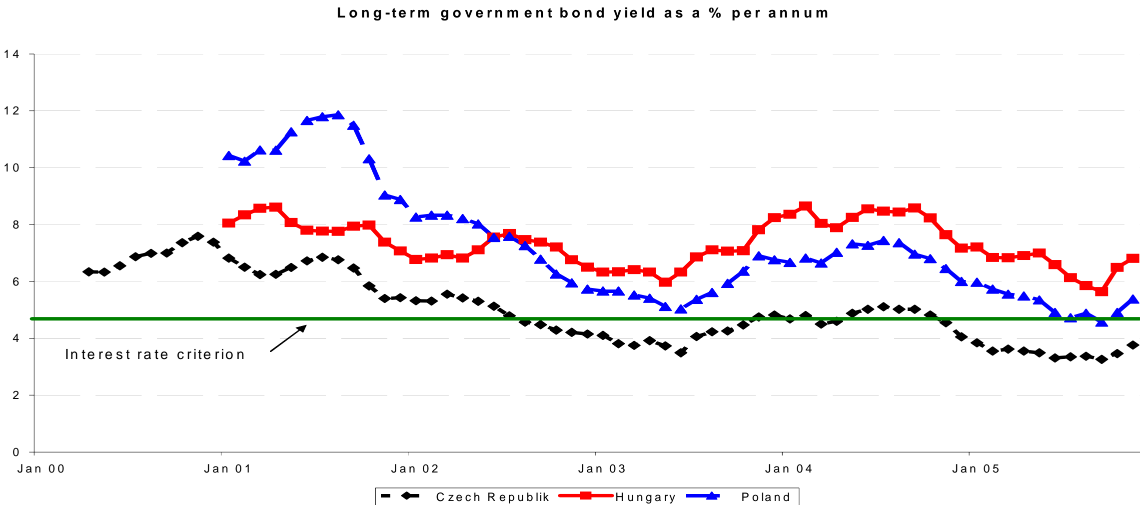

Inflation Rate - New member Countries
12
10
8
6
4
2
0
-2
ECB target rate
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Czech Republik
Hungary
Poland

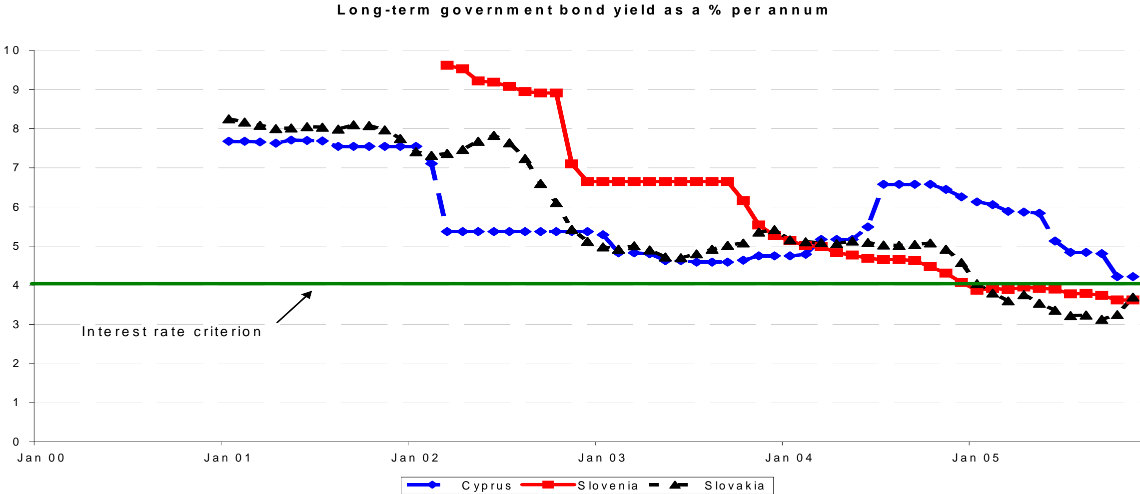

Inflation Rate - New member Countries
8
6
4
2
0
-2
ECB target rate
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Estonia
Latvia
Lithuania

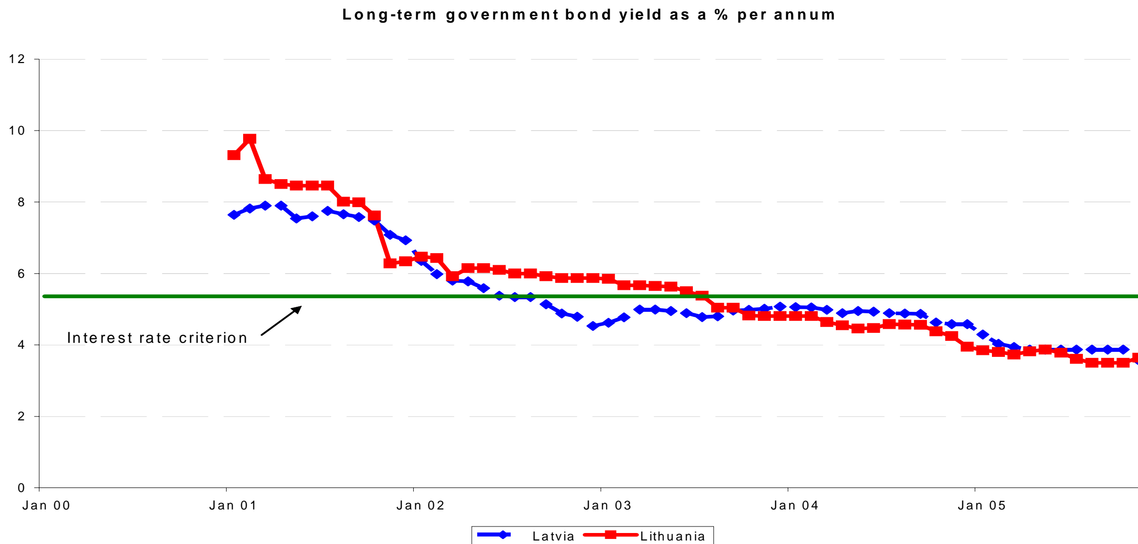

Inflation Rate - New member Countries
18
16
14
12
10
8
6
4
2
0
ECB target rate
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Cyprus
Slovenia
Slovakia

On the other hand it is fairly obvious that inflation in Hungary, Latvia and Estonia is still or again, in the case of Estonia, well above the ECB target rate. These countries presently do not fulfil the most important criterion.

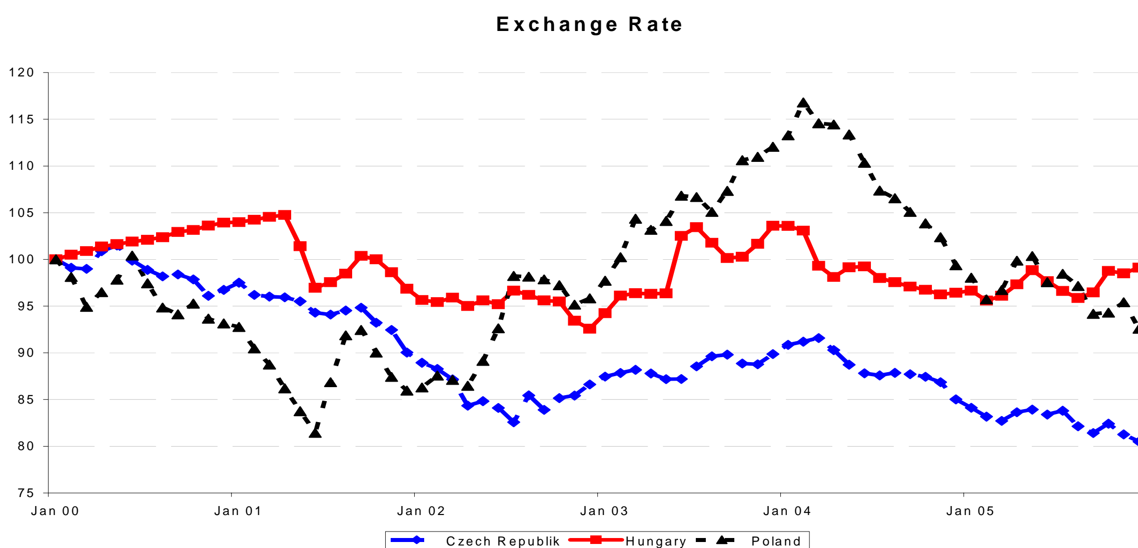
The sustainability of the inflation rates shall be judged according to the capital market performance the exchange rate movements and the unemployment rate.

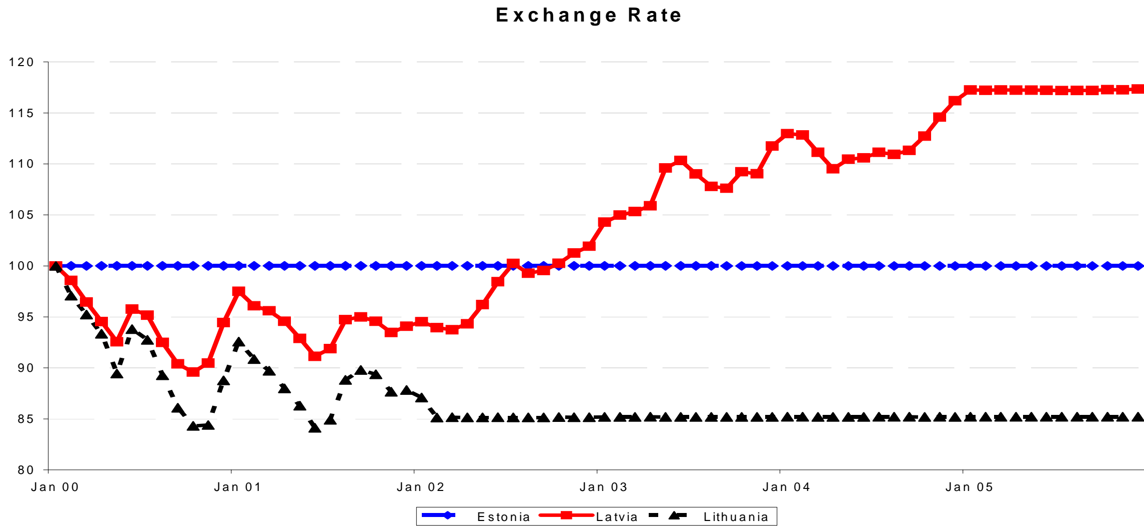


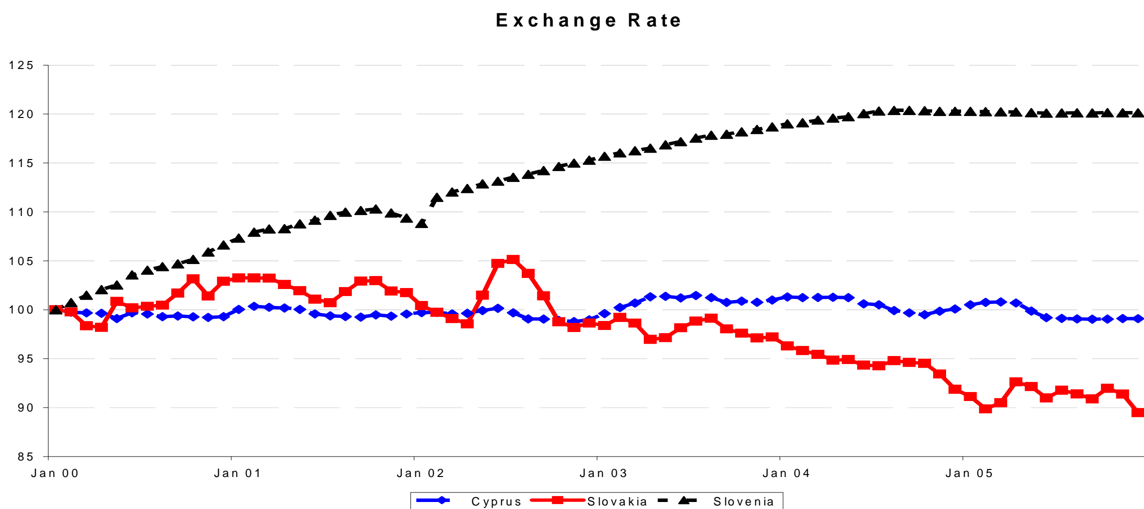




For Estonia no appropriate rates are available. From the rest of the countries only Hungary and Poland significantly do not fulfil the interest rate criterion applied here. This is not surprising in the case of Hungary where inflation is relatively high too. In the case of Poland there can be some distrust of capital markets as far as a sustainable low inflation rate is concerned. But there is also a major influence of relative restrictive monetary policy that keeps short term rates relatively high. Thus there seems to be some distrust of the Polish central bank with respect to the low inflation rates. For those countries that do no meet the inflation criterion but where interest rates are nevertheless relatively low capital markets expect this inflation process to be of temporary nature.

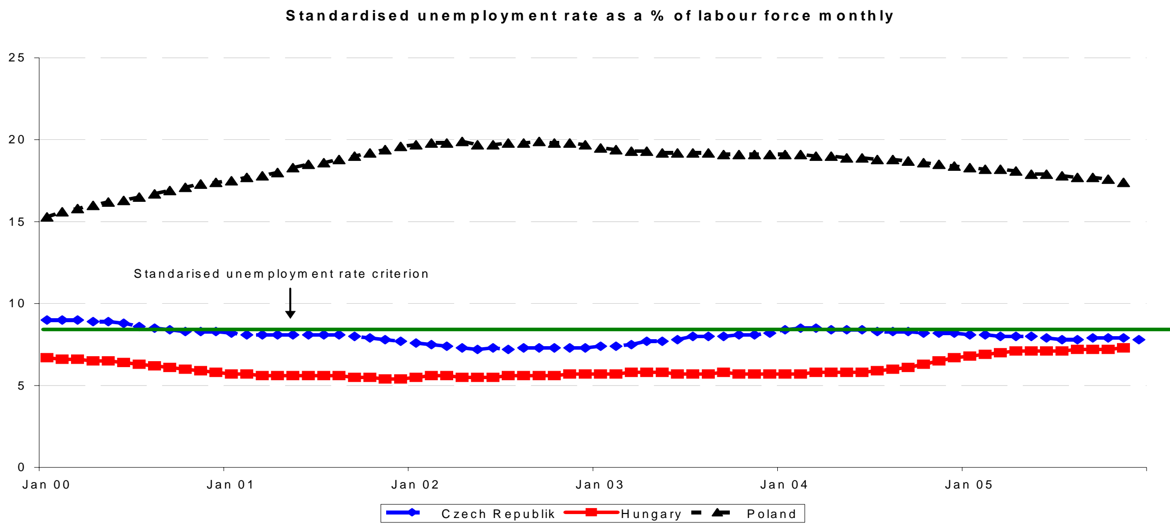


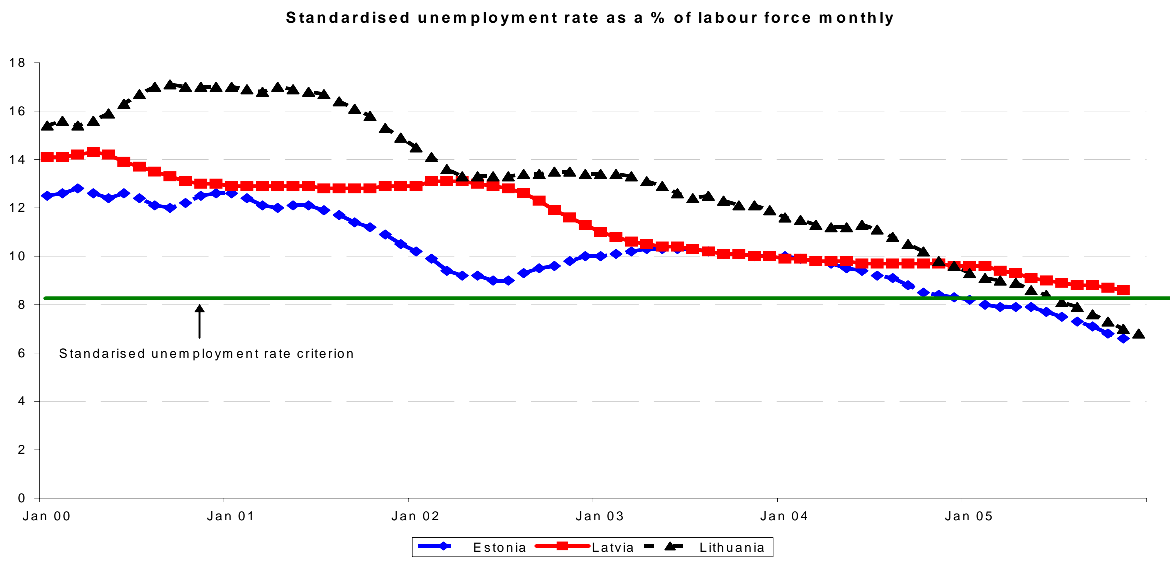


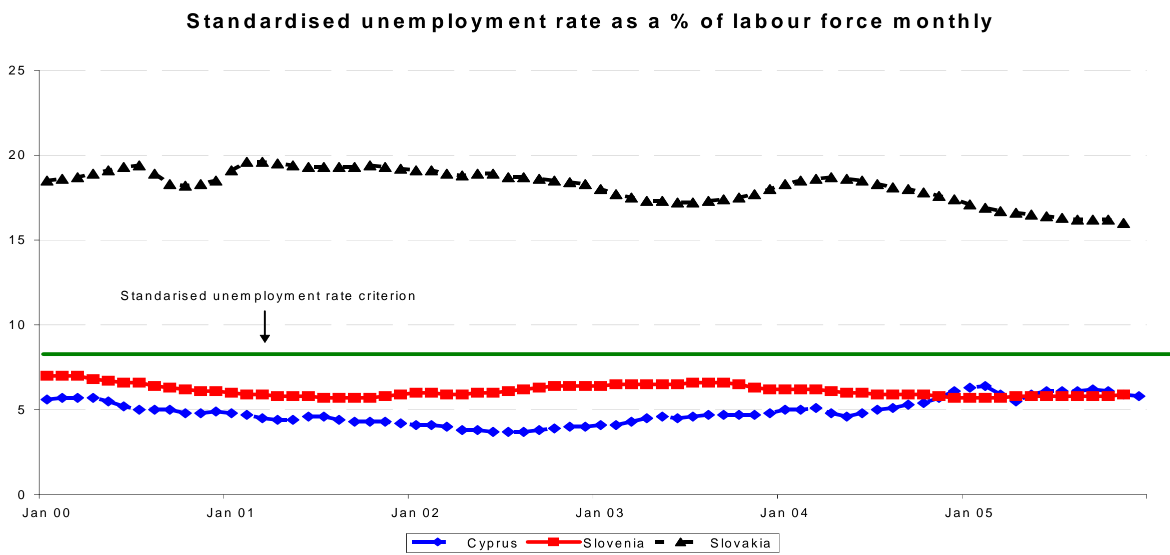


Looking at the development of exchange rates one can realize a high degree of stability. All countries fulfil the criterion if one allows for maximal depreciation of 15 % for the past two years. In fact only Latvia had this depreciation but meanwhile follows pegged rate strategy. However some caveats are necessary. Since many candidate countries have pegged their exchange rate to the Euro and done so credibly one should expect significant movements. The current balances of all member countries show partly very high deficits. So al lot speaks in favour of a depreciation of many currencies before joining the currency union. This in turn may temporarily lead to higher inflation rates.

The last aspect to judge the credibility of ECB target compatible inflation rates was a look on unemployment.

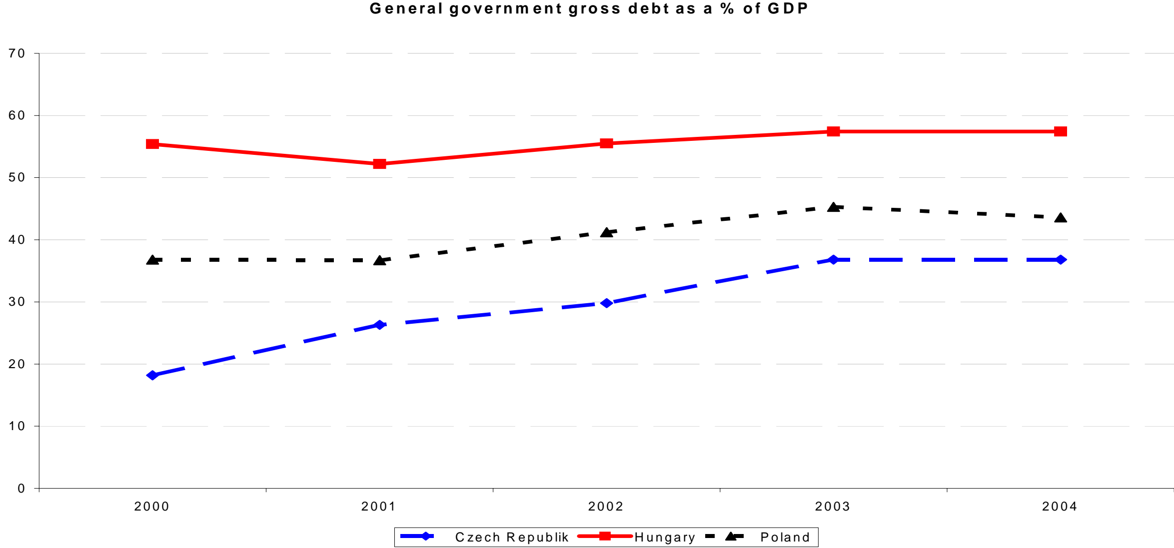

Standardised unemployment rate as a % of labour force monthly
25
20
15
10
5
0
Standarised unemployment rate criterion
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Czech Republik
Hungary
Poland

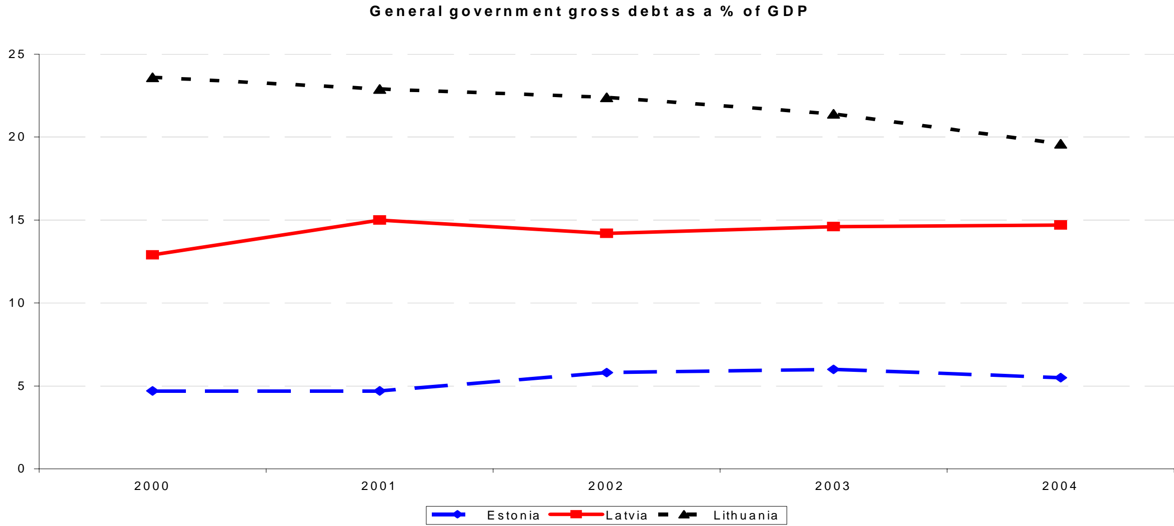

Standardised unemployment rate as a % of labour force monthly
18
16
14
12
10
8
6
4
2
0
Standarised unemployment rate criterion
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Estonia
Latvia
Lithuania

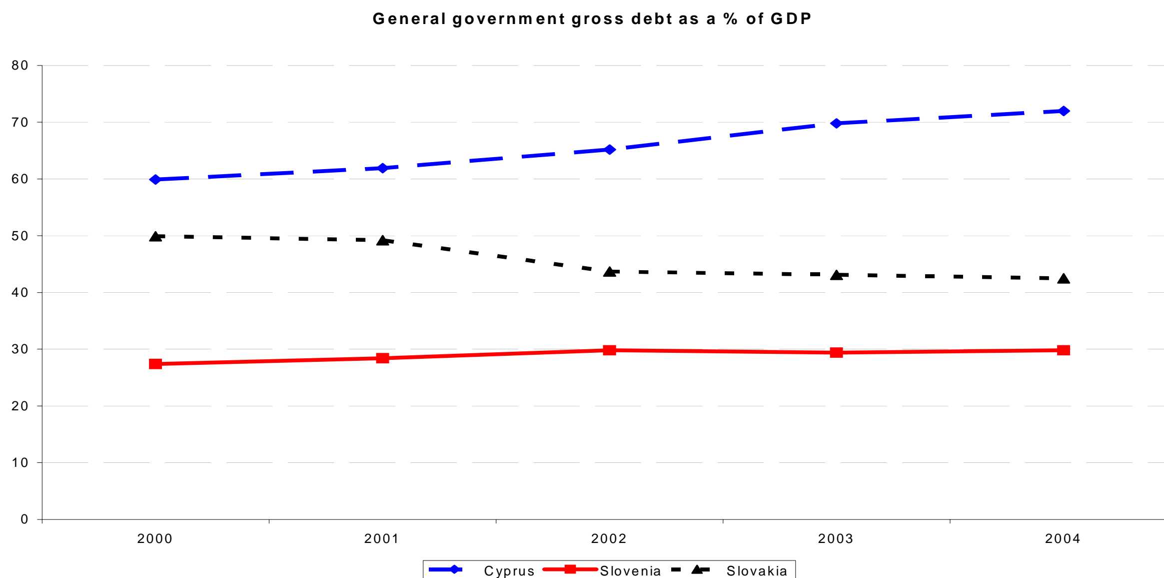

Standardised unemployment rate as a % of labour force monthly
25
20
15
10
5
0
Standarised unemployment rate criterion
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Cyprus
Slovenia
Slovakia

Except Slowakia and Poland all other countries are close to EMU average or even slightly below. That sheds some doubt on their inflation performance. If unemployment is reduced in these countries inflation may rise and trespass the target So credibility is an issue with respect to Poland and Slovakia.

The final criterion state in the last section was the debt burden.







All countries except Cyprus are well below that margin. The Baltic states especially Estonia have hardly any public debt burden to carry. The case of Cyprus is a bit critical since the debt burden is not just above 60 % but also rising. Here a turn in around in fiscal policy is necessary in due time.

4. Conclusion

The assessment of the candidate countries shows that more or less all the countries in question are on the track to monetary convergence with the currency union. But one should be careful to avoid premature entry into the union. The cost in terms of growth loss of joining later than possible are much lower than those of joining too early. In the former case interest rates may be a bit higher outside the currency union than inside. The difference will incite some growth loss. But given the fact that everyone may expect an entry in the near future, this should be minor. If on the contrary the entry is too early and e.g. inflation is still too high a loss of competitiveness and thus growth is inevitable. Since inflationary processes are hard to break when a national monetary policy is no longer in charge, a lengthy process of low export growth maybe the consequence.

Performance of the Candidate Countries					
	Inflation	Interest Rate	Exchange Rate	Unemployment	Debt Burden
Cyprus	+	+	+	+	-
Czech Republik	+	+	+	+	+
Estonia	-	n.a.	+	+	+
Hungary	-	-	+	+	+
Latvia	-	+	+	+	+
Lithuania	+/-	+	+	+	+
Poland	+	-	+	-	+
Slovenia	+	+	+	+	+
Slovakia	+/-	+	+	-	+

+ Criterion fulfilled
- Criterion not fulfilled
+/- undecided
n.a. not available

Given this the survey of the respective shows in the table shows that only countries out of the 9 analysed here should join the currency union under present circumstance. Beyond doubt only the Czech Republic and Slovenia fulfil all the criteria mentioned. For all the other countries there remain doubts whether the inflation rate is credibly close enough to the ECB target to ensure a stable further development within the currency union.

Annex :

Convergence Criteria of the Treaty establishing the European Union

PRICE DEVELOPMENTS

Article 121 (1), first indent, of the Treaty requires: “the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”.

Article 1 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that: “the criterion on price stability referred to in the first indent of Article 121 (1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.”

FISCAL DEVELOPMENTS

Article 121 (1), second indent, of the Treaty requires: “the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104 (6)”. Article 2 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that this criterion “shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104 (6) of this Treaty that an excessive deficit exists”.

Article 104 sets out the excessive deficit procedure. According to Article 104 (2) and (3), the Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

(a) the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:
– either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
– the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission’s report. Finally, in accordance with Article 104 (6), the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and following an overall assessment, whether an excessive deficit exists in a Member State.

EXCHANGE RATE DEVELOPMENTS

Article 121 (1), third indent, of the Treaty requires: “the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”.
Article 3 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that: “the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121 (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two

years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

LONG-TERM INTEREST RATE DEVELOPMENTS

Article 121 (1), fourth indent, of the Treaty requires: "the durability of convergence achieved by the Member State and of its participation in the exchange_rate mechanism of the European Monetary System being reflected in the long-term interest_rate levels". Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty
stipulates that: "the criterion on the convergence of interest rates referred to in the fourth indent of Article 121 (1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long_term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."

Source: ECB Convergence Report 2004.