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Postscript to Henk Brouwer, Ralph de Haas and Bas Kiviet

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In December 2002, the European Council in Copenhagen concluded that ten candidate countries would be able to accede to the EU in 2004. In the history of the EU enlargement process, this is undoubtedly a unique step. The decision has intensified the debate on how quickly these countries should join the EMU after their accession to the EU. To be able to join the EMU, countries must comply with the (nominal) convergence criteria for inflation, public finances, long-term interest rates and the exchange rate, as laid down in the Treaty of Maastricht. The latter criterion stipulates that a country should observe the normal fluctuation bands within the European Exchange Rate Mechanism (the so-called ERM-II) for at least two years without devaluing against the currency of any other member state. In the ERM-II, the exchange rates of the currencies of the accession countries are pegged to the euro, with a standard fluctuation band of +/- 15 percent and with the possibility of realignments of this central rate. This minimum period of two years implies that the ten candidate countries would be able to join the EMU at the end of 2006, or early 2007, at the earliest. With this formal timeframe in mind, the authorities of most candidate countries, supported by several academics, seem to be in favour of entering the EMU as quickly as possible. On the other hand, the eurosystem authorities have been especially reticent to the idea of rapid EMU accession.

From: Financial Stability and Growth in Emerging Economies
FONDAD, September 2003, www.fondad.org

The Road to EMU: Short Cut or Detour?

The proponents of rapid EMU accession generally base their view on three arguments. A first argument is that most candidate countries are already highly integrated with the euro area in terms of financial and trade flows, and as a consequence have more or less similar business cycles as compared to the euro area. As such, the common monetary policy of the eurosystem would not be inappropriate for the candidate countries. A second argument is that the prospect of rapid accession to the EMU would stimulate governments of the candidate countries to implement necessary, but painful reforms. Also, with EMU accession ahead, such reforms would likely be more acceptable to parliaments and the public at large. A third argument relates to the general antipathy towards the ERM-II. This mechanism is considered to be a mere waiting room before the adoption of the euro, while at the same time creating possible risks to financial stability. In fact, some academics even refer to the ERM-II as purgatory! One important reason for this view is that trying to maintain a fixed, but adjustable exchange rate in the context of large and volatile capital inflows, would unavoidably lead to speculative attacks on the new EU members' currencies. While fighting off such attacks is costly, giving in to them might be even more costly in terms of financial instability. Therefore, the quick adoption of the euro will eliminate exchange rate risk and, as such limit financial stability risks. Moreover, no exchange rate risk means lower risk premiums. This would of course be beneficial for trade and investment, which in turn would enhance the growth potential of the accession countries. All together, although acknowledging the formal requirement of the ERM-II participation after EU accession, most accession countries are likely to limit their stay in ERM-II to the shortest period possible. As they aim for rapid EMU accession, they might well consider the central parity chosen in the ERM-II to be the conversion rate for euro adoption.

The arguments against (too) rapid EMU accession are basically two-fold. First, rapid EMU accession would require the new EU member states to comply with the nominal convergence criteria at rather short notice. One could question the feasibility of such a steep adjustment path, especially with regard to the criterion for public finances. Currently, the budget deficits, particularly in the Central and Eastern European accession countries, are still significant.

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Moreover, substantial budgetary risks may emerge in the near future. For instance, the completion of the transition process and of the accession to the EU will entail significant government outlays. In the three Baltic countries, for example, annual public expenditures due to complying with the environmental requirements stemming from the EU *acquis communautaire*, are estimated to reach 2 percent of GDP. Although most of the current accession countries have made remarkable progress in inflation reduction, major risks in this area still lie ahead. In addition to the well-known Balassa-Samuelson effect, inflationary pressures might also arise from EU accession itself. For instance, regulated prices in the accession countries still constitute around 20 percent of the consumer price index on average. As most of these regulated prices are set below cost-recovery level, the process of price liberalisation as required by EU accession, will have an upward effect on price dynamics in the accession countries. Besides the question of feasibility, one could wonder whether a very ambitious nominal convergence path is desirable. In some countries, this adjustment path is only possible with very tight budgetary and monetary policies, which could slow down their already limited progress in real convergence towards the euro area.

A second argument against rapid adoption of the euro is that maintaining their currencies through participation in the ERM-II could be beneficial for the new EU member states. The ERM-II provides both stability and flexibility, and as such can foster the combination of nominal and real convergence. The exchange rate peg vis-à-vis the euro offers the new EU member states an anchor for macroeconomic stability in general, and for containing inflation in particular, as in a number of these countries with relatively limited financial markets, the exchange rate channel is the most effective monetary transmission channel. At the same time, the ERM-II offers flexibility through the relatively large bandwidth and the possibility of realignments, which could be advantageous for the new member states. After all, most of these countries are small open economies, which are still in the process of rapid structural transformation and catching-up. In this environment, nominal exchange rate flexibility could serve as a useful instrument to accommodate economic shocks or an appreciation of the real exchange rate. As such, *ex ante* guarantees about the euro conversion rate are impossible to give, even more so as last minutes revaluations are still possible – see, for instance, Ireland and Greece. If used in this way, the ERM-II could both foster economic stability as well as provide an anchor for nominal stability.

To conclude, it is clear there is more than one ground for arguing both in favour and against rapid EMU accession by the new EU member states. It is important to note that the ERM-II is a multilateral arrangement with responsibilities for the authorities of both the participating country and the euro area. Therefore, in advance of accession of the new EU member states to the ERM-II, intensive discussions between these parties on the modalities of operating in this exchange rate mechanism seem warranted. Obviously, once participation in the ERM-II becomes a fact, both parties should carefully monitor the sustainability of the central rates.