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Lucjan T. Orłowski

Feasibility and timing of euro adoption by the new EU member states

1. The commitment to adopt the euro

The 10 new member states are now facing the challenge of framing and implementing policies for adopting the euro. They are all bound by the EU Treaty to replace their national currencies with the euro at some future time as they were admitted to the Union with a derogation to this effect. In order to prepare adequately for entry to the euro area, the candidates need to undergo fiscal and monetary convergence. In principle, they should refrain from lax fiscal policies that could skew the eurozone policy mix by forcing the European Central Bank (ECB) to tighten monetary policy. They should consistently reduce any public debt accumulation that could result in a banking crisis and subsequently put pressure on the ECB to monetize it. On purely technical grounds, to enter the European common currency system the euro candidates must satisfy the Maastricht fiscal and monetary convergence criteria. The original criteria are spelled out in the Treaty protocols dating back to 1991. Their viability and applicability to the new member states are currently subject to intense scrutiny, as they reflect the European Commission's apparent precept that the euro candidates should be treated as an isomorphic block, disregarding their structural and institutional differences (Kenen and Meade 2003).

2. Compliance with Maastricht

Despite the controversies surrounding the convergence criteria, they remain in place as strict requirements for euro adoption. At the present time, new member state compliance with the convergence criteria is diverse and, generally speaking, far from satisfactory, at least according to the European Central Bank in its recent Convergence Report (ECB 2004). The ECB concluded that satisfactory pursuit of the convergence process required that the candidates resolve their profound structural fiscal challenges and devise effective monetary policies aimed at securing price stability. The key convergence indicators are presented in Table 1.

A glimpse at the relevant country data reveals that new member states face a range of problems.¹ A comparison of data with the Maastricht benchmarks (reference values) suggests that the smaller new member states, particularly Estonia and Lithuania, appear to be ready for euro adoption, while the larger new member states have yet to achieve satisfactory fiscal and monetary stability. With the exception of Slovakia and the Baltic States, the new EU entrants do not fare well on *fiscal criteria*. General government deficits exceed the three-per cent limit stipulated by the EU Stability and Growth Pact (SGP), reflecting mainly large primary expenditures on social transfers, in particular substantial contingent fiscal liabilities in the form of guarantees and strong commitments to future pension obligations. Excessive fiscal deficits have clearly exacerbated the public debt to GDP ratios, which range from low levels in the Czech Republic and Slovakia, through borderline high in Slovenia, Poland and Hungary, to excessive in Cyprus and Malta. These countries are engaged in equally intense struggles in respect of achieving *price stability*. Inflation rates have been excessive in Slovenia, Hungary and, to some extent, Latvia and Slovakia. They have been on the edge of the reference rate in Poland and Malta, and successfully contained in the remaining four new member states. Nevertheless, headline inflation has increased, particularly in the aftermath of the May 2004 accession, although the recent price shock can be perceived as temporary, not threatening price stability in the long run. It stems mainly from EU accession-related increases in indirect taxes and administered prices, along with higher energy prices (ECB 2004). Some threats to price stability stem from renewed wage pressures that have contributed to rising unit labor costs. In light of these developments, policymakers in the euro candidate countries face the task of devising optimal convergence policies.

1 A detailed analysis of the individual countries' compliance with the official criteria is beyond the scope of this brief study, which is aimed solely at synthesising the main conjectures concerning optimal policies leading to euro adoption and not at examining the depth of the structural and systemic problems faced by the candidates.

Table 1: Fiscal and monetary convergence indicators for new member states
(excluding the exchange rate stability criterion)

	HICP inflation ^{a)}	Long-term interest rates ^{a)}	General government budget (share of GDP) ^{b)}	General government gross debt (share of GDP) ^{b)}	Percentage change in gross debt ratio from 2002 to 2004
Czech Rep.	1.8	4.7	-5.0	37.9	+9.1
Estonia	2.0	n.a.	+0.3	4.8	-0.5
Cyprus	2.1	5.2	-5.2	72.6	+5.2
Latvia	4.9	5.0	-2.0	14.7	+0.6
Lithuania	-0.2	4.7	-2.6	21.4	-1.0
Hungary	6.5	8.1	-5.5	59.9	+2.7
Malta	2.6	4.7	-5.2	73.8	+11.1
Poland	2.5	6.9	-5.6	47.2	+6.1
Slovakia	4.1	5.2	-2.3	30.8	+1.3
Slovenia	8.4	5.1	-3.9	44.5	+1.2
Reference values	2.4 %	6.4 %	-3.0 %	60.0 %	-

Notes: a) Average annual rates for September 2003–August 2004. b) European Commission projections for 2004.

Reference values for monetary convergence indicators are based on average annual inflation rates in Finland, Denmark and Sweden (three lowest inflation EU members) in September 2003–August 2004 plus 1.5 per cent; and their average long-term interest rates during the same period plus 2 per cent.

Indicators satisfying the Maastricht criteria are in bold.

Source: European Central Bank, 2004 Convergence Report.

However, it should be noted that finding a single comprehensive convergence policy and a uniform adjustment process for the 10 new member states may be an impossible task, considering their vast systemic differences. The Maastricht criteria are certainly insufficient to offer useful guidance to policymakers in this respect. Therefore, specific convergence policies need to be designed on a case-by-case basis and carefully tailored to national characteristics.

3. Monetary policies for convergence – no common prescription

Scepticism about “one-size-fits-all” policy prescriptions has emerged on the basis of a heated debate about optimal *monetary policies* for euro adoption. In essence, adoption of the euro will mean that the individual countries relinquish their monetary autonomy, which will entail certain short-run costs. These costs are likely to be minimized if adjustments to monetary policy regimes are properly designed and tailored to the individual country’s circumstances in the course of active preparations for euro adoption. There is now a consensus in the literature that the smaller candidate countries, such as the Baltic States, that rely on a currency board arrangement to guide their monetary policies will

be best served by maintaining their existing monetary regimes during their final passage toward the euro. This is because their financial markets are relatively less developed and thus susceptible to large, potentially destabilizing shocks. If greater monetary flexibility was adopted, it would precipitate financial volatility and so present investors with a higher country risk. A departure from the current hard peg would probably jeopardize direct investment and hamper economic growth in these countries. As a result, it would unnecessarily defer euro adoption by the smaller new member states.

In contrast to the smaller new member states, there is little consensus about effective monetary policies for euro adoption in relation to the larger new member states. The ongoing debate includes a variety of policy proposals, ranging from a leap to unilateral euroization to prolonged reliance on autonomous monetary regimes based on direct inflation targeting (DIT). Despite the controversies, there is a common belief that autonomous policies based on exclusive targeting of monetary growth or inflation would generate sub-optimal results. This qualm undoubtedly derives from the strict DIT policies currently being followed by the National Bank of Poland and the Czech National Bank.

The proponents of unilateral euro adoption, including Bratkowski and Rostowski (2001), Buiters and Grafe (2002) and Begg et al. (2003), have identified a number

of benefits that could result from such a bold move. Certainly, prompt entry into the euro area would entail considerably lower costs for both current and capital transactions. It would also bring about lower interest rates, although they would not be fully aligned with those in the eurozone as banking systems in the new member states are considerably less competitive (Nutti 2002). Nevertheless, lending rates in a prompt euro entrant would still carry a risk premium as long as institutional convergence of the financial systems remained incomplete. Perhaps the least questionable benefit of prompt euroization would be the elimination of exchange rate risk. As a consequence, exposure to speculative attacks on the currency would be lower. However, similar effects can be achieved by implementing fully autonomous, yet disciplined fiscal and monetary policies. Possible direct costs associated with a rush to euroization may entail the initial drainage of international reserves, a loss of seigniorage revenues to the government and surrender of the central bank's lender-of-last-resort function. However, these direct costs may prove to be rather insignificant as seigniorage revenues or central bank emergency lending activities are negligible in new member states at present. More qualified reservations about the leap to euroization attach to rising unit labor costs and the danger of losing the ability to respond adequately to asymmetric shocks. Such disadvantages may be particularly pronounced in a country whose monetary, real and institutional convergence efforts are far from completion. If the candidate country moves swiftly to euroization while its convergence is only partially complete, it may initially experience considerable financial disintermediation, as both depositary and lending activities shift abroad to more efficient financial centres. In addition, unit labor costs may increase as wage demands outpace productivity growth. As a result, rising production costs may curtail investment and economic growth, thus increasing unemployment. In any case, it will take some time for these short- and medium-term costs to dissipate. In essence, the timing of formal euro adoption should matter less than establishing a timeframe for successful completion of monetary, real and institutional convergence (Orlowski 2001; Nutti 2002). A few more years of monetary independence combined with disciplined fiscal policies to prepare adequately for euro entry may prove beneficial. This extra time would also allow for completion of the necessary institutional reforms.

Alternative proposals for more gradualist adjustments in monetary policy are based on extensions to the current rather strict DIT regimes, incorporating greater flexibility. In other words, they assign different weights to inflation and exchange rate stability targets.

Infusion of the exchange rate stability objective is believed to be critical for achieving successful monetary convergence with the euro. Despite the different policy prescriptions among the proposals, the gradualist approach recognizes the importance of having sufficient time for the successful pursuit if not the full completion of monetary, real and institutional convergence.

A rather extreme solution – a far-reaching departure from the current strict DIT policies – is proposed by Bofinger and Wollmershäuser (2001, 2002) who advocate adopting a monetary regime based on flexible exchange rate targeting during the final passage toward the euro. In their policy scenario, exchange rate stability becomes the key policy objective, while price stability plays a secondary role only, as it is presumed to be derived from less volatile exchange rates. However, if financial markets in new member states are institutionally unprepared and, therefore, not resilient to nominal shocks, efforts toward achieving exchange rate stability may entail frequent and costly interventions. In addition, it is highly uncertain whether a monetary regime focusing on exchange rate stability (even in a stricter form than the one allowed by ERM II) would in fact contribute to price stability. This is because the exchange rate channel of monetary policy transmission in the larger new member states is ambiguous and unstable (Orlowski 2003 and 2005; Golinelli and Rovelli 2004). Therefore, a smooth transmission of more stable exchange rates into low inflation cannot be guaranteed.

A more balanced weighting of inflation and exchange rate stability targets is advocated by Jonas (2004). His "dual-target and one-instrument" policy scenario is an extension of the present DIT regimes as it calls for assigning equal importance to inflation and exchange rate stability targets. However, the implementation of such a policy may pose serious difficulties as several plausible conflict areas between both targets can be identified. Among them is a possible combination of currency appreciation and high inflation in the presence of large capital inflows to new member states. A proper response to a stronger national currency would require lowering interest rates that could subsequently jeopardize the inflation target. On the contrary, raising interest rates by a central bank in response to higher inflation may lead to currency appreciation and exacerbate exchange rate volatility. Nevertheless, the conflicts between both targets become pronounced only in the presence of the so-called Balassa–Samuelson effects, which are believed to be prevalent in transition economies (Buiter and Grafe 2002; Begg et al. 2003; Mihaljek and Klau 2004; DeGrauwe and Schnabl 2004). According to the Balassa–Samuelson phenomenon, an increas-

ingly open, growing economy is likely to experience a productivity shock in the tradable goods sector that drives up wages in non-tradables, thus contributing to chronic inflation. If this is the case, early unilateral euroization would probably contain inflationary pressures from this source (Bratkowski and Rostowski 2001). However, there is compelling empirical evidence that the Balassa–Samuelson effect in new member states is rather insignificant (Égert et al. 2003), which may lead to the conclusion that the suggestion of potential conflicts between inflation and exchange rate stability targets has little merit, along with the arguments for early euroization derived from it.

Among the proponents of gradual policy adjustments, Orlowski (2004) assigns the highest priority to the inflation target. He proposes a policy framework based on targeting the differentials between the candidate country and the eurozone inflation forecasts. Such a forward-looking policy regime is viewed as conducive to euro adoption. In this monetary policy framework, the inflation forecast differential becomes the key operating target while exchange rate stability is treated only as a major indicator variable, and not as an auxiliary operating target. The proposed regime allows policymakers to focus exclusively on price stability as the main criterion of monetary convergence, so underpinning their strong commitment to price convergence prior to euro adoption. Moreover, the proposed policy regime would also underpin commitment to price stability when possible conflicts between disinflation and exchange rate stability arise. In essence, this forward-looking monetary policy regime advances the present DIT policies pursued by the Czech Republic, Poland and, to some extent, Hungary.

4. Fiscal consolidation – principal controversies

Equally intense controversies surround *fiscal policies* as fiscal discipline is believed to be particularly conducive to a successful final passage toward the euro, and necessary for aiding monetary adjustment efforts. There is a consensus in the literature that the three-per cent threshold prescribed by SGP as the maximum permitted government budget deficit in relation to GDP is rather demanding for new member states and that the European Commission should recast this benchmark (Szapáry 2000; Nuti 2002). The permitted deficit seems too narrow to enable governments to complete ongoing deep structural and institutional reforms. Moreover, the three-per cent limit applies to all countries equally, regardless of their public debt levels. This makes little

economic sense and the focus should be shifted instead to government efforts to achieve debt sustainability (Rostowski 2004). Briefly stated, highly indebted countries should be required to balance their budgets or to run surpluses in order to gradually relax the debt burden. By contrast, those new member states that have low debt-to-GDP ratios should be allowed to overrun the mechanical three-per cent limit in order to speed up the structural adjustments necessary to deepen their economic integration with “old” EU members.

Furthermore, there seems to be a consensus in the literature that SGP rigidity and its one-dimensional character are counterproductive as regards the quality of fiscal consolidation in new member states. This criticism holds true particularly when the government debt in relation to GDP becomes very high, prompting the authorities to cut expenditures while avoiding revenue-based consolidation (von Hagen, Hughes-Hallett and Strauch 2001). The expenditure cuts are likely to hamper economic growth more severely than the alternative tax increases. Moreover, SGP lacks a clear analytical foundation due to its simplicity. For instance, its calls for equal efforts to contain the budget deficit regardless of business cycle conditions are evidently oversimplified. In consequence, deficit reduction during economic slowdowns may exacerbate business cycle fluctuations; in other words, SGP-driven fiscal tightening becomes pro-cyclical during economic downturns. The final, frequently criticized shortcoming of SGP is that its inflexibility reduces the ability to respond to asymmetric, country-specific shocks. Therefore, SGP does not allow for the consideration of proper structural and institutional adjustment, something which may vary substantially among individual new member states.

Challenges to fiscal policies in the final passage to the euro also derive from a number of internal factors. Among them, the most burdensome to policymakers are the rigidities associated with social subsidies and formula-driven social transfers (Schadler 2004). These commitments are prevalent in all new member states due to population ageing which is expected to put substantial pressure on pension systems that in several countries are still based on the pay-as-you-go principle. Moreover, projected population ageing is likely to put additional pressures on public finances if further necessary reforms of pension systems are delayed. Social rigidities will be hard to overcome if labor market and pension system reforms are carried out.

More manageable challenges to fiscal stability are associated with temporary, one-off adjustments in tax rates. In particular, EU accession has necessitated increases in indirect taxation in all 10 new member states. These increases contributed to renewed inflationary

pressures in the second half of 2004. However, these effects are likely to dissipate in the near future and are not expected to jeopardize fiscal consolidation efforts and medium-term deficit-debt adjustments.

It can be further anticipated that fiscal policy will have to play an active role in restoring a proper balance between short-run accession costs and its more dynamic, long-run benefits. The immediate accession-related costs are likely to outweigh the benefits that will materialize only after some time. Consequently, the initial gap between large contributions to EU budgets and smaller EU transfers to new member states is likely to adversely affect public support for integration, including future euro adoption. An increase in domestic expenditures may be required to offset such temporary accession-related net costs.

Nevertheless, the ability to maintain fiscal discipline will be critical for successful convergence. More specifically, a disciplined fiscal policy is critical for lowering interest rates and achieving more stable exchange rates. In turn, lower interest rates and lower exchange rate risk premia will probably promote investment and income growth, and also allow more expansionary monetary policies. In contrast, a failure to maintain fiscal discipline will force central banks to apply a very restrictive monetary policy, which will hinder structural reforms and economic growth in new member states.

5. The road ahead – coping with ERM II

As argued above, the smaller new member states would be well served by maintaining their present currency board arrangements, while the larger ones that target inflation will have to modify their monetary policies in order to accommodate the objective of exchange rate stability. Regardless of the applied adjustment, the new member states can and should avail themselves of the exchange rate flexibility afforded by ERM II, providing that the “standard” plus-minus 15 per cent band of currency fluctuations holds rather than the “normal” band of 2.25 per cent prescribed by ERM I. Certainly, their participation in ERM II will necessitate a reorientation of their monetary regime in order to take account of possible exchange rate shocks. In essence, the standard band offers enough flexibility to accommodate these shocks, particularly in the absence of active interventions by central banks pursuing DIT policies.

This analysis clearly favors inflation-targeting policies as more conducive to effective monetary convergence with the euro than those based on exchange-rate targeting. Flexible inflation-targeting regimes offer attractive advantages over those based on currency stability

objectives, particularly the ones based on soft pegs. An exclusive focus on the exchange rate target does not necessarily forestall large currency shocks, especially if the country's financial system is inadequately prepared for their absorption. In addition, a currency peg, particularly one associated with the narrow 2.25 volatility margin, increases the risk attributable to misspecification of the reference rate. If the official reference rate is too weak – that is, set well below the dynamic equilibrium rate – it could inflate the domestic value of foreign currency debt and raise the default risk. If it is too strong, it could precipitate significant short-term capital inflows, exacerbating inflation. In any case, a wider tolerance band would create a cushion preventing such undesirable effects. Thus, the candidate countries face the challenge of a careful specification of the ERM II official reference rate that roughly corresponds to the dynamic equilibrium exchange rate.

Equally challenging are fiscal policy efforts aimed at maintaining a proper balance between the stringent objectives of fiscal convergence and those necessitated by structural reforms and social obligations.

In hindsight, the tasks of monetary and fiscal convergence to the euro are very complex; their framing and implementation pose major challenges to policymakers in new member states. Their search for appropriate policies and practices that are appropriate for the final passage toward the euro find some support in the literature, which, has not arrived at uniform optimal solutions. On practical grounds, however, the new member states' convergence with the euro is unprecedented, as there is almost no evidence on comparable reforms and experiences with monetary integration in the economies of the world.

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