UDK

When Should the New EU Member States from Central Europe Join the Eurozone?

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The eight new EU members from Central and Eastern Europe (the CEE8) should all aim to join the Eurozone as soon as possible. Even the largest among them, Poland, is too small, to open and too vulnerable to destabilising capital flows to be an optimal currency area. With unrestricted labour mobility with the EU15 no later than 2011, the CEE meet all the conventional Optimal Currency Area criteria for membership in the Eurozone.
In some of the larger CEE8 countries, especially Hungary, Poland, the Czech Republic and Slovakia, fiscal sustainability is not yet soundly established. It is in the self-interest of countries with question marks behind their fiscal-financial sustainability to defer Eurozone membership until that issue has been resolved.

The inflation criterion for EMU membership – a candidate country should have a rate of inflation not more than 1.5 % above the average of the 3 EU members that are best performing in terms of price stability is (a) stupid because it is based on the inflation performance of the 25 EU members rather than on that of the 12 member Eurozone; (b) stupid because it ignores Balassa-Samuelson equilibrium inflation differentials, and (c) in violation of both the spirit and the letter of the Treaty because the ECB and the European Commission use a definition of 'best performing in terms of price stability' for candidate EMU members that amounts to 'the three member states with the lowest inflation rates (barring anomalies)' that is different from and tougher than the definition used for the Eurozone itself, which would be 'the three member states whose inflation rates are closest to but below 2 percent'. With the in-house definition of price stability, Lithuania would have been able to join the Eurozone in January 2007. Now it is condemned to spend yet more time in the pointless purgatory of ERM2.

On 1 May 2004, eight Central European former communist states, together with Cyprus and Malta, joined the 15-member European Union. Estonia, Lithuania and Slovenia joined the Exchange Rate Mechanism (ERM) of the Economic and Monetary Union (EMU) in June 2004 and hoped to become members of the Euro area by 1 January 2007.[1] Latvia joined the ERM in May 2005 and targets full membership of the EMU in 2008. Slovakia also joined

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[1]The European Monetary Union has 12 members. The UK, Sweden and Denmark, as well as the 10 new EU members that joined the EU on 1 May 2004, are not members of the Eurozone.

ERM in 2005 and hopes to join the Eurozone in 2009. The Czech Republic, Hungary and Poland have not yet joined the ERM. In May 2006, only Slovenia was recommended, by the ECB and the European Commission, for Eurozone membership on 1 January 2007. Estonia had been bullied into dropping its request for membership on January 1, 2007 and Lithuania was judged not to be ready. In this article we consider whether or not the new member states would benefit from joining the Eurozone and any potential economic grounds for excluding them.

SHOULD THE NEW MEMBERS JOIN THE EUROZONE?

The benefits to the new members from Central Europe of membership

From the point of view of the economic fundamentals emphasized by optimal currency area theory, it is in the interest of all eight new Central European members (the CE8) to join the Eurozone as soon as possible. They are all too small, too open and too vulnerable to speculative attacks against their national currencies to be optimal currency areas. For the smallest ones among them, it is indeed doubtful whether a national currency is a viable option in the medium to long run.

In terms of economic size, as measured by their percentage share of world GDP, the new member states are tiny, as seen in Figure 1.[2] Several of the countries are about the size of Luxembourg (0.05 percent) and collectively B at 1.93 percent B the eight countries are about the same size as Mexico (1.76 percent) or Canada (1.84 percent).

As shown in Figure 2, the CE8 are relatively dependent on trade.[3]

Their share of trade in GDP, calculated as the percentage of the sum of imports and exports to GDP ranges from about 70 percent for Poland to nearly 140 percent for the Slovak Republic. This contrasts with the United States, where the share of trade in GDP is about 24 percent and with France, where it is about 56 percent. Moreover, openness is increasing in the new member states and should become significantly higher. These countries still trade significantly less than would be expected, given their size, per capita income, distance from trading partners and man-made barriers to trade.[4] The latter impediment is primarily the legacy of misdirected central planning which has still not been completely overcome.

While openness to trade is high, financial openness is nearly complete. As part of the acquis= the body of EU laws, regulations and directives that the new EU members have to adopt to qualify for EU membership B virtually all fiscal, administrative and other institutional barriers to financial capital mobility have been lifted. The only exceptions are some remaining restrictions on foreign ownership of land and real estate that are not of macroeconomic significance.

An open financial account has many advantages: it permits nations, such as the new member states, with high economic potential to draw on foreign savings to augment their domestic capital stocks. It permits foreign direct investment, which brings financial resources and transfers skills, knowledge and technology. It increases the efficiency of financial intermediation and permits cross-border risk sharing. However, it exposes countries to whims of international financial markets. Average *daily* global turnover in the global foreign exchange market is roughly $2 trillion and a single large hedge fund may have more financial resources at its disposal than the monetary authorities of most of the new member states.

Their size and openness imply that for the CE8, a national currency is a liability. If they attempt to peg their exchange rate, then sooner or later they will almost certainly undergo a sudden and costly disruption to their financial sectors. The disastrous experiences of East Asia, Russia and

Fig 1: Percentage Share of World GDP

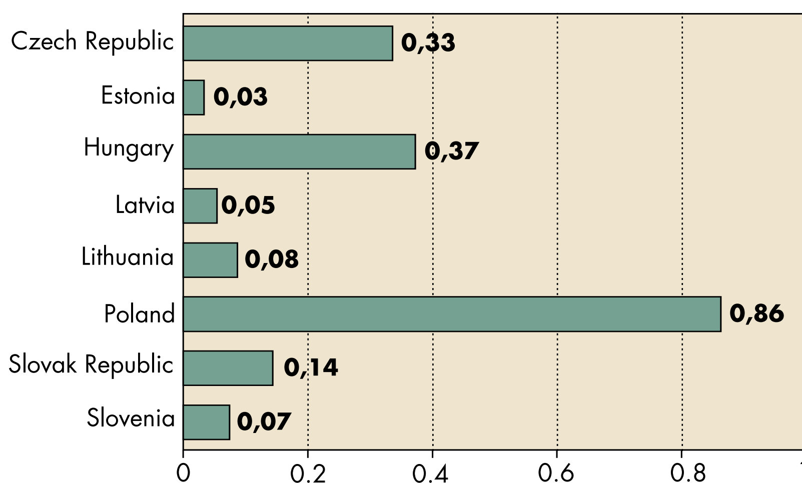
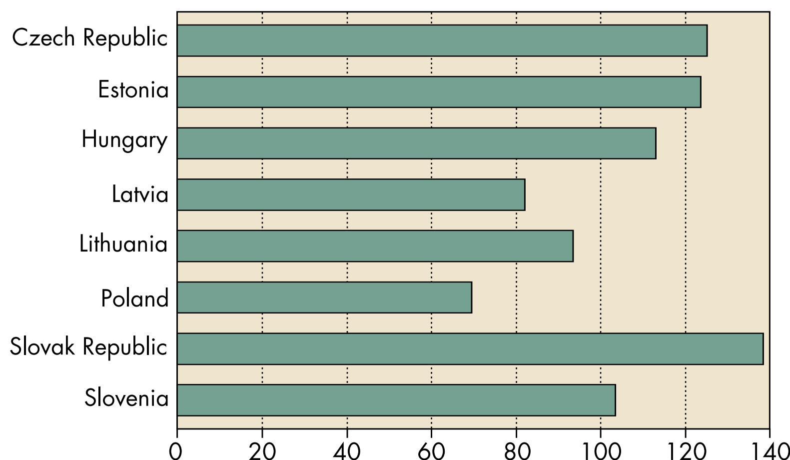


Fig. 2: Share of Trade in GDP

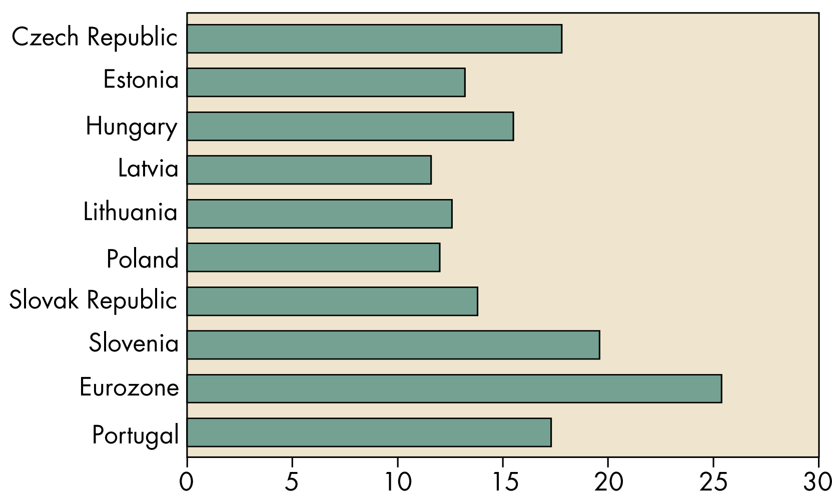


[2] GDP based on PPP share of world total, source: IMF World Economic Outlook and EconStats 2006.

[3] Source: World Bank Development Indicators, 2004.

[4] This can be demonstrated empirically using Agravity models@, which relate trade intensity to such variables as real GDP per capita and distance from trading partners, see e.g. *Transition Report 2003*, European Bank for Reconstruction and Development, London 2003.

Fig. 3: Per Capita GDP in Thousands of Euros



Latin America in the late 1990s and 2002 serve as a warning that, for small open economies with mobile financial capital, pegged exchange rates lead to turmoil and output loss. The current situation of Iceland and New Zealand illustrates the problem with the alternative floating exchange rate regime. Swings in capital flows brought about by external events can force central banks to have to choose between cutting off growth with high interest rats or allowing precipitous declines in the value of their currency.

Writing in the *Financial Times*, Wolfgang Munchau argues that Estonia and Lithuania are too poor to join the eurozone.[5] Indeed, as shown in Figure 3, Estonia and Lithuania are poor relative to most of the new members states and the new member states are poor relative to the Eurozone.[6]

But, the gap is narrowing and two new member states (the Czech Republic and Slovenia) are wealthier than the Eurozone member Portugal. However, if poverty implies sharing a common currency with wealthier neighbours is undesirable, perhaps Tower Hamlets should leave the sterling area.[7] The smallness and openness of the member states implies that the exchange rate is not an effective instrument or buffer that would allow them to achieve the necessary changes in international relative costs and prices with small transitional costs of excessive inflation and unemployment. Instead, the foreign exchange market itself is a source of excess volatility, instability and, at times, persistent misalignment.

The obvious cost to the member countries of joining the euro area is the loss of an independent monetary policy. One consequence of this is that monetary policy cannot be used to stabilise country-specific shocks. However, there is debate about whether monetary policy makers are good at stabilising the economy, beyond what would be achieved as a by-product of inflation targeting. It can be argued that monetary policy should attach only limited weight to the stabilisation of the real economy. One reason is that an *inflation bias* may result when the monetary policy maker actively pursues the stabilisation of output or employment. Another reason is that stabilization is difficult: shocks are hard to identify and quantify and monetary policy is subject to lags which are long, variable and highly random.

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A factor which might mitigate any cost associated with losing a stabilisation role for the central bank is the surprisingly high degree of cross-country labour mobility between the CE8 and the few earlier EU member countries that did not invoke the option to restrict (for a transitional period of up to 7 years) labour immigration from the new member states after 1 May 2004. Labour mobility can serve as a substitute for conventional stabilisation policy in coping with country-specific shocks.

It should also be noted that the cost of a common monetary policy to countries such as Estonia and Lithuania would not necessarily be greater than the cost to the existing Eurozone members. In the fourteen years since their independence Estonia and Latvia have been remarkably successful in transforming themselves into flexible and resilient market economies. The World Bank publishes an index measuring the ease of doing business in different countries. The index depends on such factors as business regulations, property rights and labour market rigidities. On this index, Lithuania and Estonia rank 15th and 16th in the world, respectively, not far behind the best EU25 performer (Denmark in 9th place) and ahead of Germany (19th place) and France (44th place).[8]

Another potential cost to losing an independent monetary policy arises from public finance considerations. Due to different abilities to collect taxes and differences in the size of the informal sector, different countries may have different optimal inflation rates. If a government is relatively poor at collecting taxes and if its (frequently cash-intensive) informal sector is relatively large – so that non-inflation taxes are distortionary – then a country may find it optimal to collect a significant inflation tax, either through seigniorage (revenues from base money issued by the central bank) or an erosion of the real value of domestic-currency fi-

[5] "Monetary union is not for the poor", 30 Jan 2006.

[6] Source: Eurostat.

[7] Tower Hamlets is a London (UK) borough, just east of the City of London. It contains the heart of the old London docklands and is among the poorest boroughs of London, although it contains Canary Wharf, London's new financial centre.

[8] World Bank, *Doing Business in 2006*, overview. The first three countries are New Zealand, Singapore and the United States, respectively.

xed interest debt at a rate of inflation higher than was anticipated when the debt was issued. Thus, the inflation rate which is optimal for one Eurozone member may not be optimal for another. Furthermore, as different member countries have different consumption baskets, there can be significant differences in inflation rates across countries even with a common monetary policy. Thus, even if all member countries had the same optimal rate of inflation and this rate were achieved on average across countries, inflation could still be too high or too low in individual member countries. For the CE8 however, this cost is likely to be small compared to the benefits of Eurozone membership.

The Cost to the Eurozone of the new members from Central Europe becoming members

An inability or unwillingness of new member states to commit themselves to a sustainable fiscal policy is viewed as a potential cost of their membership in the Eurozone to the existing member states. It is frequently believed that a country's actual or threatened insolvency might jeopardise the entire Eurozone financial system or destabilise the common currency by forcing the European Central Bank into a bail out. While it is not entirely clear that this fear is reasonable, this is one reason why the current Eurozone members might have grounds for objecting to the entry of some new member states.

Establishing whether or not a country is following a sustainable fiscal policy is not a straightforward matter. The *economic* concept of sustainability should not be confused with whatever numerical benchmarks or criteria may feature in a set of legal documents or administrative procedures, be it the two fiscal Maastricht criteria for EMU membership or the fiscal criteria of the Excessive Deficits Procedure for existing EMU members. Unsustainable public debt, implying the prospect of government insolvency and debt default, is a threat whenever the outstanding stock of debt is high relative to the ability and willingness of present and future governments to generate primary budget surpluses, that is surpluses before interest payments.

Fig. 5: Government Deficit as a Percent of GDP

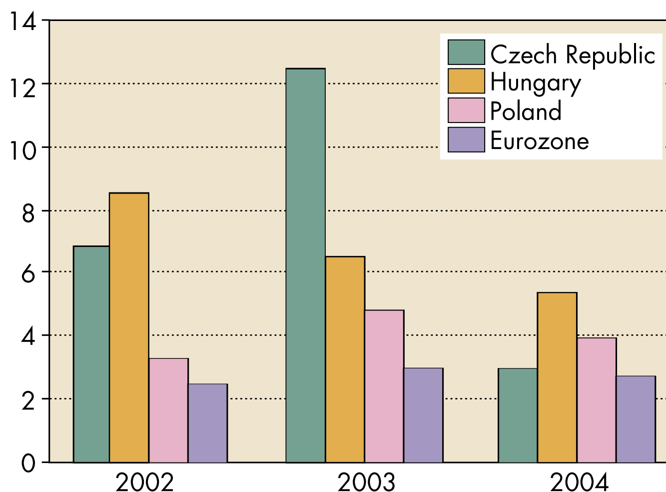


Fig. 6: Government Surplus as a Percent of GDP

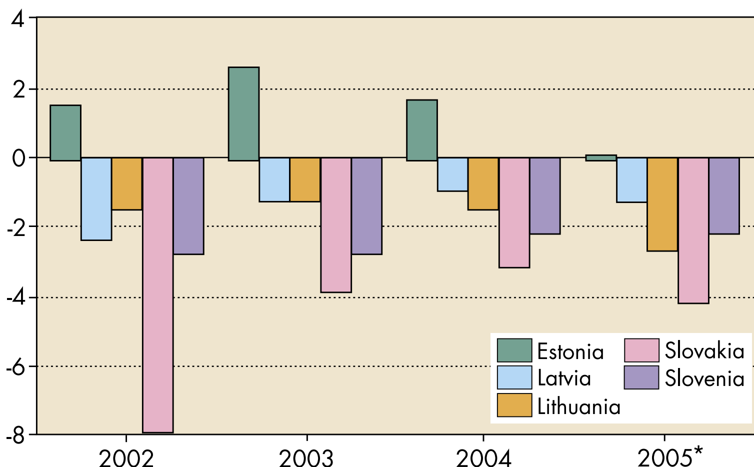
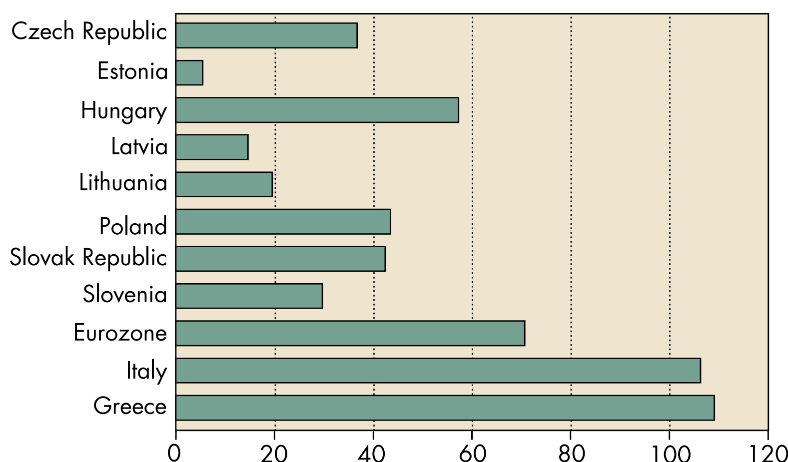


Fig. 4: Government Debt as a Percent of GDP



It is clear from Figure 4 that the existing debt-to-GDP ratios of all of the new member countries from Central Europe are well below the average of the Eurozone and much lower than the stratospheric levels of Greece and Italy.[9]

Poland, Hungary and the Czech Republic are, however, as shown in Figure 5, running large and persistent conventional budget deficits.[10]

They certainly show no evidence of being capable and willing to generate primary surpluses. For this reason it may be justifiable to claim that at

[9] Source: Eurostat, OECD.

[10] Source: Eurostat.

present Poland, Hungary and the Czech Republic are not ready for Eurozone membership.

As regards fiscal sustainability, the three Baltic countries and Slovenia, and possibly even Slovakia, are ready for Eurozone membership now (see Figure 6). Indeed, they were ready on 1 May 2004 and are clearly far more »ready« than Italy, Greece, and quite possibly also France and Germany, none of which can be confidently stated to have sustainable fiscal programmes.

WHAT ARE THE PROSPECTS FOR ESTONIA, LITHUANIA, LATVIA, SLOVAKIA AND SLOVENIA TO SATISFY THE MAATSTRICHT CONVERGENCE CRITERIA?

There are four Maastricht criteria for full membership in EMU. The first is a pair of fiscal conditions that constrain gross general government debt to be less than sixty percent of (annual) GDP. The second is an interest rate criterion: long-term (ten-year) nominal interest rates on central government debt are to be within two percent of the average in the three EU member countries with the best (lowest) inflation record. The third is an inflation criterion that specifies that the annual inflation rate cannot exceed the average of the three best performing EU member countries by more than 1.5 percent? Percentage points during the year prior to the formal assessment of whether a candidate has met the EMU membership criteria. Finally, there is an exchange rate criterion: the exchange rate has to remain within the normal fluctuation margins provided for by the ERM of the European Monetary System without severe tensions for at least the last two years before the formal assessment. In particular, the candidate must not devalue its currency on its own initiative during the period. The »normal fluctuation margins« have been interpreted by the ECB and the European Commission to be plus or minus 15 percent around a fixed central parity against euro. In addition, there is a requirement that central bank of the candidate country must be independent. Only the fiscal criteria have any hope of being rationalisable in terms of optimal currency area considerations, and even there the connection is weak: the two Maastricht fiscal criteria are neither necessary nor sufficient for fiscal sustainability.

By being fiscally profligate and by not joining the ERM, Poland, Hungary and the Czech Republic are out of the running for Eurozone membership this decade. However, Estonia, Lithuania and Slovenia aspire to adopt the euro on 1 January 2007, Latvia sometime in 2008 and Slovakia during 2009. Slovenia is likely to be successful in meeting the Maastricht criteria; Estonia is unlikely to be and it is uncertain whether or not Lithuania will comply.

As was seen in Figure 4, no CE8 country is in danger of exceeding the upward bound on government debt. The general government surplus (deficit, if negative) is depicted in Figure 6 and it can be seen that the of the five candidate countries, only Slovakia is in danger of exceeding the three percent limit.[11] Estonia has been running surpluses and Slovenia and Lithuania are running small deficits. The Slovenian central bank projects that its deficits will continue to decline and to reach one percent in 2008. The same fiscal austerity has not characterised Euro-member countries; in 2004 the Euro area as a whole had a 2.7 percent deficit-to-GDP ratio and the three-percent limit was exceeded by Germany, Greece, France and Italy.

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The five candidate countries should easily meet the long-term interest rate criterion; bond yields within the Eurozone have converged and the average of the three lowest inflation countries' interest rates is close to the Eurozone average. In December 2005, the ten-year interest rates on public debt in Latvia, Lithuania, Slovakia and Slovenia were 3.59, 3.79, 3.62 and 3.69 percent, respectively. The Euro area average was 3.41 percent, making the target rate well over five percent. Estonia has lacked an instrument for comparison (that is, at least a five-year bond), but based on its low public-sector kroon interest rates and sound budgetary position, it should not face difficulties meeting this criterion.

Estonia, Lithuania and Slovenia joined ERM on 28 June 2004. Estonia and Lithuania maintain currency board arrangements and assumed a unilateral commitment to peg their currencies to the euro; the kroon and litas have traded at their central parity rate since Estonia and Lithuania joined the ERM. Slovenia's monetary policy is aimed at stabilising its exchange rate and the tolar has traded close to its fixed central euro parity rate since entry. Latvia joined the ERM on 2 May 2005 and the lats has remained well within Latvia's target zone of plus or minus one percent around the central parity. Since Slovakia entered the ERM on 28 Nov 2005, the Slovak Koruna initially appreciated, but has since stabilised between one and two percent above the central rate.

Inflation, measured as the change from the same month of the previous year, for the twelve months of 2005 and January 2006 for the five candidate countries is shown in Fig. 7 below.[12] Average inflation in the three lowest-inflation countries of the EU was a little over one percent in January 2006. The Benchmark or target inflation rate, calculated as the average of the three lowest inflation rates in the EU plus 1.5 percent? percentage points, is shown in Chart 1. The benchmark in May 2006 was therefore 2.6 % inflation. This Chart also shows the behaviour of an alternative benchmark (not, unfortunately, part of the Treaty-based Maastricht criteria), labelled >Eurozone= and given by the average *Eurozone* inflation rate plus 1.5 percent. With the benchmark rate at 2.6 percent early in 2006, only Slovenia met the inflation criterion. It is

[11] *Monthly Bulletin* Feb. 2006. The 2005 estimates are from the EBRD *Transition Report* 2005 and the European Commission.

[12] Source: Eurostat

Fig. 7: Inflation

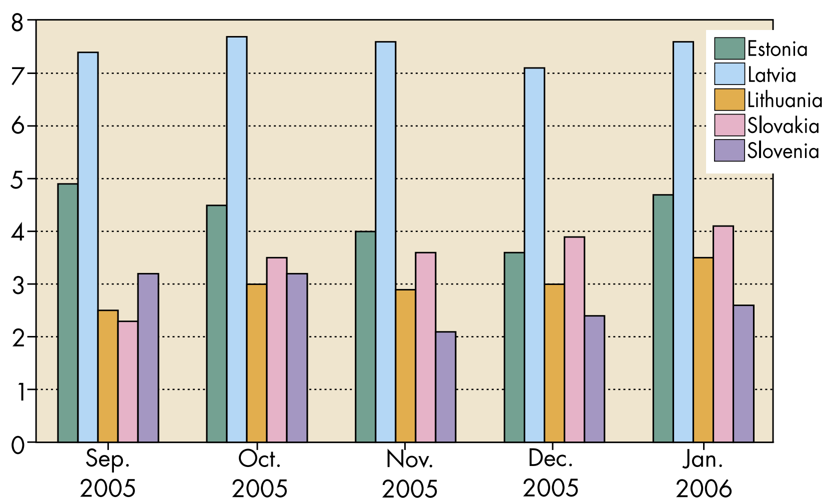
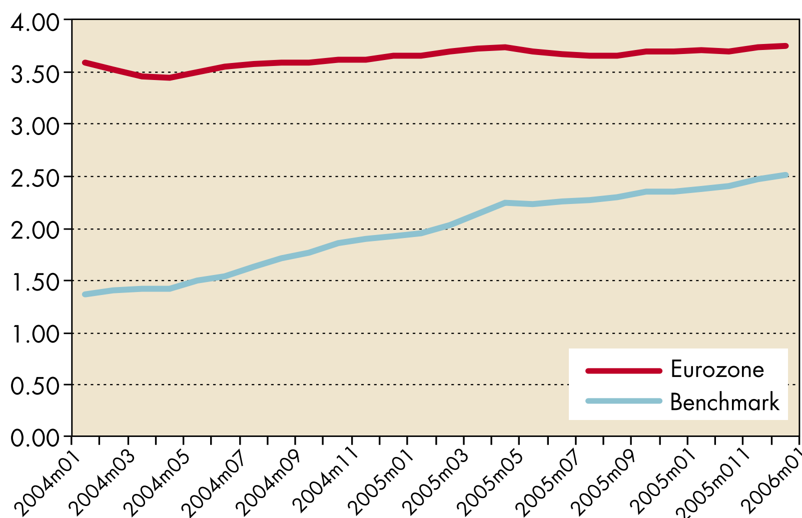


Chart 1: Benchmark InflationRates



clear that Latvia is far from being able to satisfy the inflation target, that Lithuania misses it by a whisker and that Estonia, Slovakia miss it by a wider margin. With the more sensible Eurozone inflation-based benchmark now running above 3.5 percent per annum, Lithuania would pass the test and Estonia would come quite close. Finally, with a criterion based on the inflation rates of the three countries whose inflation rate is closest to but below 2.0 % (the ECB's own price stability criterion!) Lithuania would easily pass the test.

Given their success in maintaining their exchange rates against the euro, the inflation rates in Figure 7 are no surprise. In the face of external shocks, either a small open economy's exchange rate fluctuates or its inflation rate varies. It is not possible achieve both an inflation target and an exchange rate target simultaneously, except by chance. The legislated goal of the Estonian central bank is to achieve price stability and to that end Estonia has operated a remarkably successful currency board since 1992. Since June 2004 Estonia has maintained an unchanged exchange rate in the ERM. However, mainly as a result of oil price rises, its inflation rose to 4.1 percent in 2004. As a consequence, Estonia will not meet the Maastricht inflation criterion by June 2006; it is unlikely to meet it in 2007.

Even without an energy price shock, the Balassa-Samuelson effect implies that as the accession countries' productivity levels catch up with Euro area countries their real exchange rates will appreciate. For currency-board countries such as Estonia and Lithuania with a fixed nominal exchange rate this implies that their inflation will be higher than in the Eurozone. Short data sets and cyclical factors make it hard to estimate the size of the inflation increase due to the Balassa-Samuelson effect on the accession countries, but current estimates are in the range of 1.5 percent to 2.5 percent per year.[13] As the Maastricht Treaty only allows for inflation to be 1.5 percent above the *best*-performing members of the EU, this creates a serious problem for Estonia and Lithuania.

Estonia and Lithuania may simultaneously satisfy the inflation and the exchange rate criteria by luck. Economic theory suggests that the only other macroeconomic policy options are either to abandon their highly successful currency boards and adopt a more flexible exchange rate system: the fifteen percent exchange rate bands may permit more leeway than the 1.5 percent band in the inflation target. Or, they can use fiscal policy to drive down their domestic demand to the point where both criteria can be met. Neither choice seems particularly appealing.

Slovenia's better inflation performance may reflect Slovenia's greater convergence towards Euro area levels, seen in Fig. 3. Per capita income in Slovenia is already about three quarters of the average of current area members and, thus, Slovenia is likely to be experiencing less of a Balassa-Samuelson catch-up effect. In addition, it is possible that Slovenia is more able than are Estonia and Lithuania to influence inflation through its control of administered and regulated prices and more willing to put up with the resulting distortions.[14]

The most unusual and unfortunate feature of the Maastricht inflation criterion is that its benchmark is based on the 3 lowest inflation rates among the 25 *EU* members, and not just on the inflation performance of the 12 member *Eurozone*. Indeed, in recent months, two of the three lowest inflation rates were for countries that are in the EU but not in EMU – Poland and Sweden. It would make as much

[13]A discussion of this is found in Willem Buiter, »To Purgatory and Beyond: When and How should the Accession Countries from Central Europe Become Full Members of the EMU,« 2004.

[14]The European Bank for Reconstruction and Development ranks countries on their degree of price liberalisation from 1 (a rigid centrally planned economy) to 4+ (an industrialised market economy). Estonia and Lithuania scored 4+; Slovenia scored a 4. Some other countries scoring a 4 were Azerbaijan, Kazakhstan and Ukraine.

economic sense to base the decision on admitting the candidate Eurozone members on the inflation performance of Sub-Saharan Africa as on that of EU members that are not in the Eurozone. Indeed even the inflation performance of the 12 *individual* Eurozone members is irrelevant for prior nominal convergence by the candidate members. This prior nominal convergence requirement (which is not implied by optimal currency area considerations) would require convergence on the Eurozone average rate of inflation (shown as Eurozone in Chart 1) or on the target rate of inflation of the Eurozone – close to but below 2 percent per year. For a small country joining a large common currency area, prior inflation convergence (up to the differential warranted by the Balassa-Samuelson effect) is helpful but not essential. Membership in the common currency is a swift and efficient way of achieving the right degree of inflation convergence.

A good case can be made that the inflation criterion used by the European Commission and the ECB for Eurozone membership – the *three lowest inflation rates* among the 25 EU members, except for anomalies, is inconsistent with both the letter and the spirit of the Treaty.[15] The Treaty refers to the *three best performing countries in terms of price stability*. The ECB has, as part of the operationalisation of its price stability target, defined price stability as close to but below 2 percent. This means that the tree best performing countries in terms of price stability are not the three countries with the lowest rate of inflation but the three countries whose inflations rates are closest two but below 2 percent. The average of the three countries whose inflations rates are closest to and below 2.0 percent was 1.9 percent in May 2006. Adding 1.5 % gives a benchmark of 3.4 %, something easily met by Lithuania.

Conclusion: what to do when »the law is a ass"?«

Of the five candidate Eurozone members, Estonia, Latvia, Lithuania, Slovakia and Slovenia, only Slovakia is not yet a convincing candidate for immediate Eurozone membership. All that stands between the four countries and a Eurozone membership that would benefit both them and the existing EU members is the likelihood of the rigid application of an arbitrary inflation criterion, and one which probably violates even the letter of the Treaty, because it is based on the three lowest inflation rates rather than on the inflation rates of the three countries that are best performing in terms of price stability.

It is clear that Lithuania has good grounds for contesting in the European Court of Justice the decision to exclude it from Eurozone membership. Estonia and Latvia are unlikely to have any legal recourse at this stage: the decision to exclude them makes no sense, but is 'legal'. This raises the problem of what to do when Athe law is a ass@.[16] Failure to enforce a law, or a Treaty-based rule like the application of the Maastricht criterion, weakens the rule of a law and the respect for rule-bound behaviour. Enforcing a law or a rule that makes no sense and inflicts unnecessary harm also weakens respect for the rule of law and for rule-bound behaviour and thus undermines them. In the case of the Maastricht criteria, this dilemma has already be resolved by the fact that, for better or worse, the criteria have been violated both in spirit and in the letter so frequently, that little or no further damage will be done by a flexible interpretation of the inflation criterion. Italy, Greece and Germany joined EMU despite not meeting the debt criterion at the time of entry. Finland, Italy and Greece also did not satisfy the exchange rate criterion.

Furthermore, the ECB has, in its Convergence Report 2004, explicitly opened the door to a flexible interpretation and calculation of the reference value for inflation. It contains the statement: *»The price developments in Lithuania over the reference period, which resulted in a 12-month average rate of -0.2 % due to the accumulation of specific factors, have been judged to be an outlier and were consequently excluded from the calculation of the reference value.«*[17]. The ECB then further underlines the scope for flexibility and discretion by making the following point: *»It should be noted that the concept of 'outlier' was already referred to in earlier convergence reports. It does not imply any mechanical approach to the exclusion of certain inflation rates but was introduced in the 1998 EMI Convergence Report to appropriately deal with potential significant distortions in individual countries' inflation developments.«*[18]

Finally, there is some further hope that Estonia and Lithuania will join Slovenia on January 1, 2007 as Eurozone members, because that decision will be taken by the European Council – the ministers of finance. The ECB and the European Commission have a merely advisory role in this matter. The very creation of EMU has been a triumph of political will over technocratic timidity. It could happen again here.

[15] The ECB does not give a definition of what an anomaly is. In the 2004 Convergence Report, Lithuania was left out of the calculation of the benchmark with an inflation rate of -0.2 percent. This could indicate that negative inflation rates are anomalous.

[16] »If the law supposes that,« said Mr. Bumble,Y Y »the law is a ass - a idiot. If that's the eye of the law, the law is a bachelor; and the worst I wish the law is that his eye may be opened by experience - by experience.« From Charles Dickens, *Oliver Twist,* chapter 51, p. 489 (1970). First published serially 1837B1839.

[17] European Central Bank, *Convergence Report 2004*, Frankfurt am Main, p.16.

[18] European Central Bank, *Convergence Report 2004*, Frankfurt am Main, Box 1, p. 8.

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