The Bumpy Road to EMU: Similarities and Discrepancies in the Accession Countries

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1. Introduction

The aim of my paper is to compare the respective paths (exchange rate regimes) which were chosen by the accession countries during their preparation to the Economic and Monetary Union.

An important part of my project deals with the role of the European institutions (namely the European Central Bank, the European Commission, and the Ecofin) in the accession countries' preparation process for the Economic and Monetary Union. The most up-to-date issue in this field is the attitude of these institutions towards unilateral euroization. I would like to address the question of why *the response of these institutions to such suggestions has been so negative? What is the economic and political reasoning behind the officially outlined three-step approach?*

I will focus on the feasibility and appropriateness of the euroizaton project in the region, comparing the main benefits and costs claimed to be associated with this unilateral decision. Presumed benefits include lower interest rates, higher monetary stability in terms of low inflation, reduction of transaction costs and of exchange rate volatility and, finally, a catalyst role in structural reforms. On the other hand, outright costs (loss of seigniorage revenues, stabilisation costs in an inflationary environment etc.) and risks will be discussed.

The paper is organised as follows. Section 2 investigates the possible scheduling of the EMU enlargement, and argues that it is likely to happen sooner than usually expected. The next section deals with the actual situation concerning monetary issues in the candidate in the context of the standard accession path put forth by the European institutions and the global trend of bipolarisation of exchange rate regimes. Section 4 discusses the hotly debated unilateral euroization project, critically analysing the often-cited pros and cons of such a step. Section 5 concludes.

2. EMU enlargement: when and who?

It is a widely shared opinion that the Central and Eastern European (CEE) countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) will introduce the euro and participate in the EMU at some future point in time. If we consider the strong desire of these countries to join the EMU, it seems likely that the monetary union will expand soon after the enlargement of the EU. The basic argument here is that the admission decision is ultimately a political decision, and we should remember that many of the 12 current members were given exceptions from the famous Maastricht convergence criteria. Given this, it will be politically difficult to keep out the newcomers from the eurozone.

The Maastricht Treaty (Treaty on European Union, TEU) lays down a very specific procedure for joining, which demands meeting accurate targets over specific

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time periods (‘reporting periods’). Once a country has become the member of the EU, it can also join the modified European exchange rate mechanism, the ERM II. The first four criteria (i.e. debt, current deficit, long-term interest rates and inflation) must be satisfied on data from the year prior to the evaluation date. The reporting period for the fifth main criteria – ERM II membership without devaluation – is two years according to the TEU, thus the evaluation in this case cannot be made until a two-year track record exists. However, in May 1998 Italy’s and Finland’s formal ineligibility were overlooked by the European Commission and the European Monetary Institute (the precursor of the ECB), regarding the fact that Italy had been in the ERM for only 15 months before the evaluation and Finland for only 16 months. This, beyond doubt, set a precedent. Now it will be very difficult to impose this two-year waiting period for the CEE countries, especially for two Baltic states (namely Estonia and Lithuania), which have been already tied to the euro via their currency board systems.

Early unilateral euroization could also make the accession process faster. I will discuss this option in details later, but anyway, if it happens, it would mean no need for a changeover period, possibly no delay between the European Council’s approval and the introduction of the common currency. The implication of the above mentioned factors for the membership timeline is shown in Figure 1. I would like to stress here, that these are only legal and political possibilities, but it is important to bear in mind that a protracted transition period for the EMU membership should not taken for granted.

Figure 1. Timeline for the adoption of the euro with the earliest probable dates

Earliest probable date	Event
1 January 2004	EU accession
1 March 2005	Reporting period (15 months prior to examination for ERM criteria (Italian precedent), 1 year prior to all the other criteria)
1 May 2005	Data and report writing lag – ECB Convergence Report
1 May 2005	Data and report writing lag – Commission Convergence Report
1 June 2005	Ecofin votes by QMV on Commission proposal

1 June 2005	Changeover period: 0 months for euroised countries – full membership, voting rights in ECB Governing Council
1 January 2006	Changeover period: 6 months without earlier unilateral euroisaton - full membership, voting rights in ECB Governing Council

Source: Baldwin et al. [2001]

At this point, another question must be asked: will the CEE countries be able to fulfill the Maastricht convergence criteria in the near future? Let me start with the public finance conditions. *Gros* [2000] compared accession states with current euro member states at a similar point in time relative to their participation in the eurozone. The data shows clearly that the accession countries that are likely to join the EU in the first wave are closer to satisfying the criteria than the Southern member states were in the early 1990s.

Concerning the other two nominal criteria, the candidates are doing relatively well, with only a few notable exceptions (e.g. Romania and Hungary). Taking the first possible EMU enlargement date as June 2005, it is instructive to compare the current members at a comparable number of years before they entry. Figure 2 and Figure 3 show inflation and long-term interest rates for the EU states in 1994, and the same numbers for CEECs in 2001, respectively (both the data sets were collected roughly four years before joining the monetary union).

Figure 2. Inflation a long-term interest rates in Europe in 1994

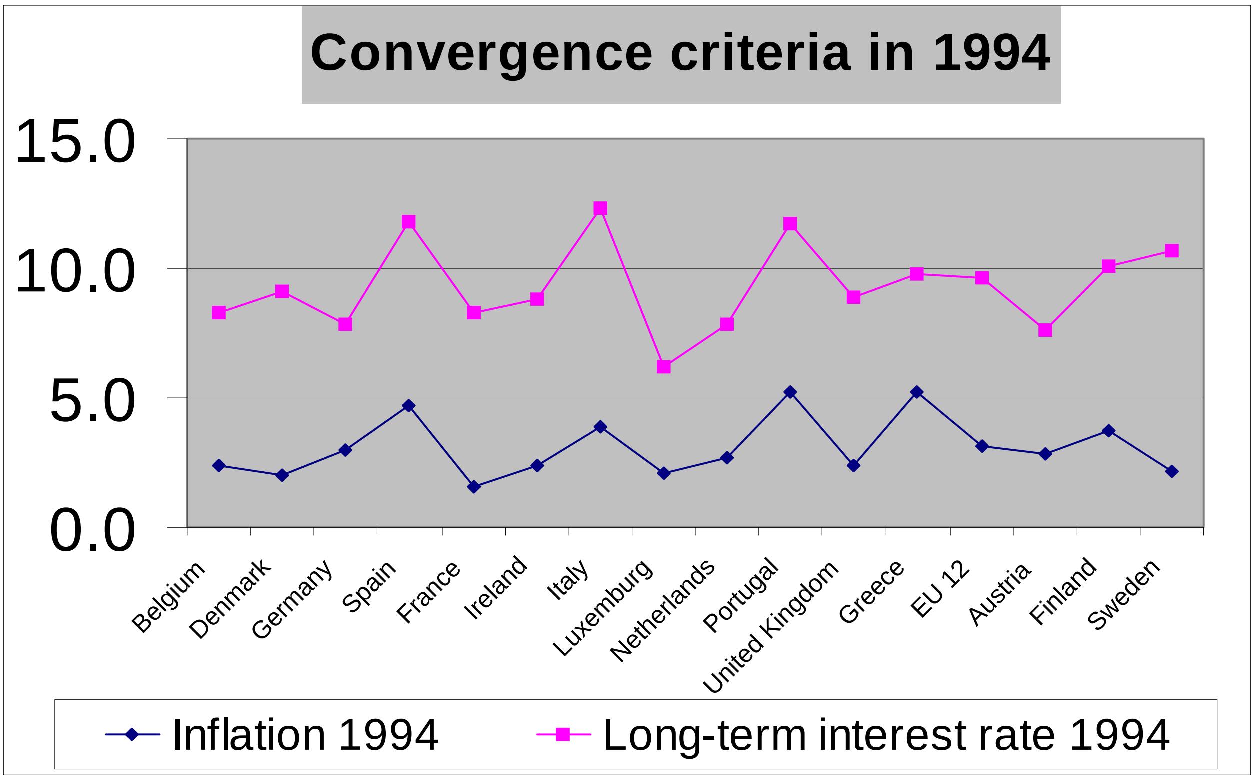

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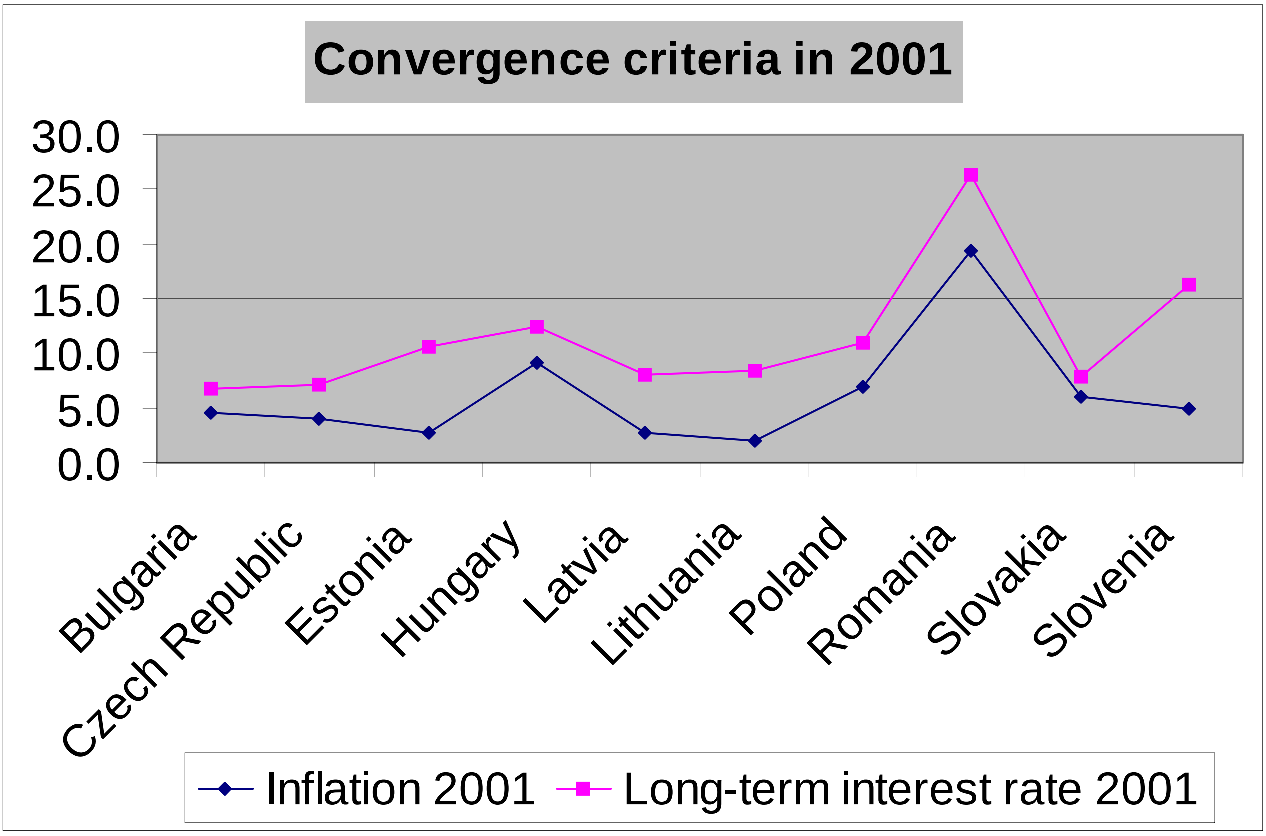
Figure 3. Inflation a long-term interest rates in Central Eastern Europe in 2001



Source: ECB Monthly Report, various issues

All in all, it appears that the candidates might have less difficulty in meeting the nominal macroeconomic criteria than the other usual requirements of EU membership (e.g. implementing the internal market measures, protecting the environment according to the European standard, or training public servants to become able to apply the new 'rules of the game'). And one should keep in mind the Italian and especially the Greek examples: inflation and budget deficits can be decreased substantially over a short period of time (let's say two or three years), using (or abusing?) the 'weighing in' possibility by a sufficiently determined government (*Szapáry* [2000a]).

Csaba [2002] pointed out that although the common currency has become effectively a new entry barrier for the CEECs, it should not be seen as an obstacle on the road towards full integration. Rather, it is an incentive for governments to make further fiscal adjustments, and to continue the disinflation process. In this context, the fulfilment of the strict macroeconomic criteria is possible in the coming years, and moreover, as the events of the last economic crises proved us, the required solid policies are in the self-interest of the accession countries.

On the other hand, participation in the euro area requires the fulfilment of all legal and institutional obligations that apply to EU countries either 'in' or 'out" of the eurozone. These requirements include, in particular, the granting of full independence to the national central banks, prohibiting the financing of government deficits, and liberalizing capital flows vis-à-vis third countries. During the last years virtually all the CEE countries met these obligations in the economic and monetary areas[2]. However, it should be noted that statutory central bank independence can substantially differ from the de facto independence of a central bank. Legal independence is only one, albeit very important factor that determines the situation of central banks. There are some other components, such as monetary policy traditions, the personality of central bank governors and, last but not least, how often the government or political parties use the remaining channels of influence. One quite popular approach to rank *actual* independence is to look at the 'rate of turnover of central bank governors', which can be interpreted as a measure of the average term of office of governors in each country[3]. Cukierman invented this concept at the

[2] See for example *Maliszewski* [2000].
[3] A higher turnover rate indicates a lower average term of office of the governor, and therefore a lower degree of actual independence.

beginning of the 1990s, and *Temprano-Arroyo and Feldman* [1999] applied it to measure de facto independence in transition economies. The study found a significantly higher rate for CEE countries than for the EU members and other industrialized countries, implying a relatively low degree of de facto independence. Although, in some cases this trend is due to one-off factors (e.g. Czech Republic), in general the data suggest that the legal status of central banks in CEECs overstates their actual autonomy.

3. Euro strategies in the accession countries: the bipolar view re-examined

During the preparation for the EMU, a central question is what type of exchange rates facilitates this process. In the last decade we have observed the bipolarization of exchange rate regimes, with the share of both hard pegs and floating gaining ground at the expense of soft pegs (‘hollowing out of the middle’, *Fisher* [2001]). The main reason for this change that softly pegged countries with liberalized capital movements proved to be severely crisis-prone. More and more countries adopted hard pegs (including dollarization, currency unions and currency boards), consequently less and less independent national currencies remained. These trends are not only true for well-developed economies, but also for emerging or converging markets.

Table 1. and Table 2. give an overview of the exchange rate regimes of the Central and Eastern European candidates since the early 1990s. They follow the classification of the IMF, which is based on official statements about exchange rate policies (self-evaluation of the countries).

Table 1. The exchange rate regimes in the first-round CEE countries 1990-2001

Country	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Czech Rep.	F	F	F	F	F	F	FB	MF	MF	MF	MF	MF
Estonia	n.a.	n.a.	CB	CB	CB	CB	CB	CB	CB	CB	CB	CB
Poland	F	CP	CP	CP	CP	CRB	CRB	CRB	CRB	CRB	CRB MF	MF
Hungary	F	F	F	F	F	CP	CP	CP	CP	CP	CP	CRB , FB
Slovenia	n.a.	n.a.	MF	MF	MF	MF	MF	MF	MF	MF	MF	MF

Table 2. The exchange rate regimes in the second-round CEE countries 1990-2001

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	F	FF	FF	FF	FF	FF	FF	CB	CB	CB	CB	CB
Latvia	n.a.	n.a.	FF	FF	F	F	F	F	F	F	F	F
Lithuania	n.a.	n.a.	FF	FF	CB	CB	CB	CB	CB	CB	CB	CB
Romania	F	MF	MF	MF	MF	MF	MF	MF	MF	MF	MF	MF
Slovak Rep.	F	F	F	F	F	F	CRB	CRB	FF	FF	FF	FF

Key to Table 1. and Table 2.

CP: Crawling pegs
CRB: Crawling Bands (larger bands)
F: Conventinal fixed pegs (with a band at most ±1%)
FB: Pegs with band larger than ±1%
MF: Managed floating with no preannounced exchange rate path
FF: Free floating
CB: Currency Board Arrangements

Source: Begg et al.[2001] with the author's own updates

As shown above, there has been a significant tendency in the region to move towards either flexible or very rigid exchange rate regimes[4]. The Czech Republic, Hungary, Poland and the Slovak Republic have all abandoned intermediate regimes of crawling pegs or crawling bands, and moved towards de facto managed floating. Romania and Slovenia introduced flexible regimes at an early stage of their transition process. In contrast, Bulgaria and the Baltic states adopted very rigid pegs. Bulgaria, Estonia and Lithuania operate currency board arrangements tied to the euro, while Latvia maintains a conventional peg to the SDR with a zero fluctuation band.

4 For a discussion about the CEECs ecxhange rate policies see *Kopits* [2000], *Szapáry* [2000b] and *Hochreiter – Wagner [2001].*

The exchange rate element of the convergence process is the ERM II, whose main parameters are designed to avoid the recurrence of the 1992-93 ERM crisis (*Horváth - Varró* [1997]). The system is compatible with a broad range of exchange rate arrangements; within the ERM II framework, countries can even set up currency boards to meet the exchange rate criteria. As argued above, there are practically two different paths for candidate countries to take: rigid pegs or some sort of a flexible system, the latter usually accompanied by an inflation targeting monetary strategy. There is a growing literature on whether inflation targeting is a better option for accession countries than a currency board, or not[5].

The official opinion of the European institutions tolerates a wide variety of regimes. "No common path should be prescribed to all 12 accession countries with regard to the orientation of their exchange rate policies prior to accession, the inclusion of their currencies in ERM II or the later adoption of the euro. Against the background of different starting-points for the economic reform process and the difficulty of ascertaining the lead-time for further headway towards nominal and real convergence, a plurality of approaches should be feasible without compromising equality of treatment" (ECB [1999]). This view was reiterated later with the following wording: „No common prescription is appropriate for monetary policy strategies and for exchange rate policies before EU accession. Different regimes are feasible, as long as they are supported by an appropriate and stability-oriented economic policy stance" (ECB [2000]). This debate is ongoing, and I will now turn to a topic, the question of unilateral euroization, that could rewrite all the scenarios and speculations about this issue.

4. A debate about unilateral euroization

First of all, I would like to clarify the terminology used in this paper. The term euroization is used only for those cases where the euro is introduced outside of the standard path to full participation in the EMU, thus it can be interpreted as a special version of dollarization.

The idea of an early euroization has been a subject of rather intense public discussion since 1999, especially in Poland and Estonia. The European institutions

[5] For more details see *Buiter - Grafe* [2001].

have taken a firm position on this issue, namely that such a step, without the prior consent of the EU, is not an appropriate way towards full monetary integration with the euro area. The main point in this context, is that the euroization "would run counter to the underlying economic reasoning of the EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework" (Ecofin [2000]). Besides this, a Note of the European Commission expressed outright opposition to such a possibility: "…the sequencing on the path towards the adoption of the euro provided for in the (Amsterdam) Treaty does not support euroization" (European Commission [2000]). The EU thus rejected the notion that an instant adoption of the common currency would be economically more advantageous for the candidates than the standard monetary path outlined by the Treaties. The European institutions seemingly based their disapproval to unilateral decisions on institutional and legal arguments. The next few paragraphs will briefly discuss the economing background of euroization.

The main potential benefits are lower interest rates, a reduction of transaction costs, positive trade effects emanating from the use of a single currency, and a stimulating role for macroeconomic discipline and structural reforms. However, if we take a closer look, these gains are not convincing enough.

The most cited advantage of unilateral euroization is a rapid reduction of interest rates, because the overall risk premium would be substantially diminished. It is likely to be true for short-term interest rates, but long-term interest rates will still be determined mainly by real factors, such as productivity of investments and by expectations about future developments and risks (e.g. default risk). As a consequence, if a domestic or foreign shock leads to serious economic imbalances, the default risk, and thus medium and long-term nominal and real interest rates will increase over time. In other words, the obvious elimination of exchange rate risk may be partly or even fully offset by a rise in the default risk at a later stage. This dynamic analysis showed, that this benefit might well be smaller that usually suggested by advocates of early euroization[6].

Another benefit of the euroization is the reduction of tranaction costs, which does exist, but empirical evidence suggest that this effect is small (*Backé and Wójcik* [2002]). In turn, the effects of a common currency on trade seem to be potentially

[6] For a detailed discussion of the interest rate effects see *Backé and Wójcik* [2002].

sizeable. However, it remains to be seen, how quickly these effects could materialize, it might take a long time before these gains could be harvested.

In addition, the prospective integration into the EU already represents a very important stimulus for structural reforms as well as fiscal prudence. It is highly questionable whether the euroization would add to the already existing powerful incentives for solid macroeconomic policies.

A further argument suggests that a fast unilateral euroization would speed up the monetary integration of the CEECs into the euro area (see *Bratkowski - Rostowski* [2000]). However, it will impose serious nominal rigidities on a dynamic cathing-up economy, so that to fulfill the Maastricht inflation criteria growth sacrifices must be incurred. Under a flexible exchange rate a substantial nominal appreciation could support bringing down inflation rates.

Not only the perceived benefits proved to be weak, or at least ambiguous under closer examination, the euroization implies outright costs and risks for the candidates. The loss of seigniorage revenues is the most tangible quantifiable cost, which would not occur without this unilateral action, hence the introduction of the single currency through the standard procedure would make those countries be eligible to participate in the sharing of such revenues (ECB [2001]). The loss of the lender-of-last-resort function also particularly problematic for those candidates, where the banking system is not stable and sound enough. In an euroized country, the monetary authorities cannot act as a lender of last resort, and this role probably would not be taken up by foreign and international financial institutions, which could lead to serious problems in case of banking sector crises.

Furthermore, the complete removal of monetary policy and exchange rate tools also carries potential costs. The autonomous exchange rate policy can be used as a policy instrument to correct substantial exchange rate misalignments, when the classical adjustment trough wages and prices would be much more painful in a distressed economy.

5. Conclusions

Having argued that EMU enlargement is not a distant prospect at all, this study moved on to explore the different paths towards the eurozone in the candidate countries. The European institutions have a large manoeuvring room to interpret some of the convergence criteria in a flexible way, for example, by applying existing precedents for the CEE countries. The global bipolar trend of exchange rate regimes is reaffirmed by the developments of the region, and is consistent with the viewpoint of the ‘official Europe’.

In addition, the paper investigates the political and economic consequences of an early unilateral euroization. It shows that for the accession countries the presumed benefits would probably not exceed the costs and risks implied by such a step. Given the sharp rejection of euroization from the side of European institutions, it is not worth adopting the single currency unilaterally, since the related benefits are ambiguous and vague, but the risks and costs are present and substantial.

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