# The Race for the Euro

**BY JÜRGEN STARK**

*The central and eastern Europeans eagerly seek club membership. Here are the hurdles.*

The European Council in Copenhagen in 2002 was a historic milestone on the way to the enlargement of the European Union: Accession negotiations were concluded with ten new member states, most of which are from central and eastern Europe—Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. The successful conclusion of negotiations with these ten candidate countries also lends new dynamism to the accession of Bulgaria and Romania, which were offered the prospect of becoming members of the EU in 2007. It is envisaged that—once the Accession Treaty has been signed and the national ratification procedures completed—the ten new members will join the EU on May 1, 2004. This would allow them to participate in the 2004 European parliamentary elections.

Upon accession, the ten countries will join the European Economic and Monetary Union (EMU) as "member states with a derogation"; their central banks will become part of the European System of Central Banks. The new "member states with a derogation" will have to conduct exchange rate policy as a matter of common interest, which will exclude, for example, competitive devaluation. However, the hurdles of strengthening real and nominal convergence still have to be overcome before a country can adopt the euro and participate in the Eurosystem.

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The EU enlargement negotiations began back in December 1997. Since that time the candidate countries have made considerable progress in the race to adopt the euro. The process involves several integrative steps which build on one another. Most of the accession countries were formerly communist states and have had to go through a deep process of transition in order to fulfill the criteria laid down by the 1993 European Council in Copenhagen. While the Copenhagen criteria regulate accession to the EU, they are also important for participation in the EMU. Furthermore, a high degree of sustainable convergence—a condition for the adoption of the euro—complements the political criteria relating to the integration process.

### AMENDING CENTRAL BANK LEGISLATION

The Copenhagen criteria imply the existence of a functioning democracy guaranteeing human and minority rights (political criteria), the existence of a functioning market economy able to cope with competitive pressure and market forces in the internal EU market (economic criteria) and the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union (criterion of adopting the acquis communautaire). As far as monetary integration is concerned, aligning central bank legislation with the provisions of the EC Treaty is a major challenge. The accession countries need to amend their central banking laws and statutes in order to incorporate price stability as the primary objective and to guarantee central bank independence.

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### INTRODUCTION OF THE EURO AS A RESULT OF A MULTILATERAL PROCESS

Most accession countries wish to adopt the euro as soon as possible. However, they will become members of the euro area and their central banks will become part of the Eurosystem only after a high degree of sustainable economic convergence has been achieved. They should not introduce the euro unilaterally; in the Eurosystem's view, that would not be in line with the spirit of the Treaty. The introduction of the euro will be the result of a multilateral process with the check of real and nominal economic convergence. The convergence criteria aim at fostering stability within the monetary union and the accession countries. The Maastricht Treaty lists four convergence criteria; these were applied to the present euro-area countries and will also be applied to the acceding countries. The "Maastricht criteria"—which must be applied strictly—are as follows.

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- The inflation rate is to be not more than 1.5 percentage points above the average inflation rate of the three best-performing member states of the Eurosystem;
- Long-term interest rates are to be not more than 2 percentage points above the corresponding level in those three countries;
- The public sector deficit must not exceed 3 percent of GDP and the level of public debt must not be above 60 percent of GDP; and
- The country must have participated for at least two years in the European Exchange Rate Mechanism (ERM II) within the normal fluctuation margins, without any devaluation being required.

*The progress of disinflation in the accession countries was remarkable in the last decade.*

In order to assess the sustainability of the convergence achieved, the "results of the integration of markets, the situation and development of the balance of payments on current account, and […] the unit labor costs and other price indices" must—according to the EC Treaty—be taken into account.

### REMARKABLE PROGRESS OF DISINFLATION

The progress of disinflation in the accession countries was remarkable in the last decade. Inflation has come down from double-digit rates to relatively low levels. Nonetheless, further lowering of inflation rates remains a challenge. The ongoing price liberalization and deregulation and the Balassa-Samuelson effect will contribute to inflation differentials between the current euro-area member states and the acceding countries.[1]

### FISCAL POLICY WILL FACE SUBSTANTIAL CHALLENGES

Fiscal policy has undergone profound changes in the acceding countries during the transition process and will need to face up to substantial challenges in the years to come. The medium-term sustainability of fiscal policies is already a source of concern in many acceding countries. On the one hand, acceding countries will need to invest huge amounts in human and physical capital and in enhancing living standards and social welfare. On the other hand, they will need to reduce their deficits in order to fulfill the deficit criterion. The level-of-debt criterion is currently being met by almost all acceding countries.

### IMPORTANT TO ENTER ERM II WITH STRONG FUNDAMENTALS

The exchange rate mechanism criterion requires participation in ERM II within the normal fluctuation bands for two years. It is up to each new EU member to decide when it wants to join the exchange rate mechanism. Most acceding countries wish to join ERM II soon after their accession and adopt the euro after the required minimum period of two years. However, the greater flexibility of the exchange rate before ERM II entry could be an advantage for the acceding countries, as flexible rates offer a certain protection from speculative capital inflows. Some countries may need to depreciate in order to cope better with external balances; others might need an appreciation to accommodate productivity gains without triggering inflation. There is a trade-off between greater sovereignty in economic policy under flexible exchange rates and "tying one's hand" in monetary, fiscal, and wage policy by adhering to fixed rates. It is important for the acceding countries to enter ERM II with strong fundamentals, thus minimizing risks of sustained pressure on the exchange rate.

The acceding countries should therefore give careful consideration to the timing of their ERM II participation. ERM II should be regarded neither as a fast track to the euro nor as a mere waiting room. In contrast: ERM II is a meaningful policy framework in its own right and should be seen as a convergence instrument. It is in these countries' own interest to focus first on stabilizing and adapting their economies before participating in ERM II.

### PERSISTENT CURRENT ACCOUNT DEFICITS

In order to assess the sustainability of the convergence achieved, the EC Treaty calls for consideration of, *inter alia,* the "situation and development of the

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balance of payments on current account." Most accession countries have had large current account deficits since the mid-1990s. This has been an important feature of the transition process, as sizable investment needs combined with low domestic savings had led to a significant dependence on foreign savings. Despite substantial progress in the transition process, current account deficits continue to persist in several acceding countries. This raises concerns about the medium-term sustainability of this position. In the past, foreign direct investment was the main financing source of current account deficits in most accession countries and the foreign direct investment inflows were related to privatization. Now that privatization is already well advanced in most countries, a smaller amount of foreign direct investment may be expected in the future. Thus, it will be even more important for the acceding countries to ensure a favorable environment for investment. In addition, alternatives to foreign direct investment, such as financing through internal savings, should increase in importance in the coming years in order to make the current accounts more sustainable.

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### LENGTHY CATCHING-UP PROCESS OF REAL CONVERGENCE

In parallel with nominal convergence, accession countries need to comply with real convergence. This is necessary to deepen integration among members and to lessen the likelihood and impact of asymmetric shocks. In terms of purchasing power parity, a lengthy catching-up process can be expected. The per capita income in the acceding countries stands at around 40 percent of the Community level on average.

In general, economic growth did not slow down in the acceding countries in 2001 and in 2002 as it did in the present euro-area member states. Nevertheless, the growth rates were not high enough to bring about a significant narrowing of the income gap between the acceding states and the current member states. There is an ongoing process of real convergence in the acceding countries, but experience so far suggests that it will be a fairly long process, setbacks included.

The degree of real convergence may be underestimated if only real income levels are taken into account. Other structural factors, such as further progress in corporate, financial, and labor market reform, institutional and legislative reform, infrastructure, and trade integration, have to complement the catching-up of income levels and will raise the growth potential in the acceding countries.

It should be emphasized that by subjecting economic policies, including monetary and exchange rate policies, to the objective of a fast introduction of the euro, there is a risk that policy incentives may become distorted in favor of nominal convergence—at the expense of real convergence. In an extreme case, economic reforms that would entail price rises, but would have a stabilizing effect in the long run, might be postponed so as not to endanger accession to Monetary Union. A somewhat less ambitious target regarding early ERM II and Eurosystem membership might offer candidate countries greater leeway for achieving a proper balance between nominal and real convergence. Parallel progress in nominal and real convergence does not come automatically, but only is achieved as a result of economic policies which place equal emphasis on both objectives. In situations in which nominal and real convergence would not be compatible, the question arises as to whether policies should not focus more on real convergence than on too fast an introduction of the euro.

Acceding countries must make progress in both real and nominal convergence in order to ensure the tension-free functioning of a single monetary policy in an enlarged euro area. Premature accession not backed by adequate convergence might pose substantial risks to the acceding states and the overall EMU framework. Every acceding country should endeavor to deepen its integration in the monetary framework of the Eurosystem in a manner consistent with its individual circumstances. ◆

1. The Balassa-Samuelson effect reflects the rise in the relative price of non-tradables because of lower labor productivity gains in this sector compared with the tradable sector.