

**BRIEFING NOTES TO THE
COMMITTEE FOR ECONOMIC AND MONETARY AFFAIRS
OF THE EUROPEAN PARLIAMENT**

Charles Wyplosz
Graduate Institute of International Studies, Geneva and CEPR

Third Quarter 2005

STATE OF CONVERGENCE OF NEW ERM II MEMBERS

Executive Summary

The ten new EU members differ in a number of respects from the current Euro area members. They are poorer, their labour is cheaper and they have relatively large agricultural and industrial sectors. As they integrate themselves into the EU, they will continue to undergo deep changes. This is what EU membership is all about, and it has little bearing on euro adoption.

Still, two aspects matter for euro adoption. First, as their standards of living rise, so do their wages and prices. Consequently, if they peg their exchange rates and, later on, adopt the euro, they will undergo higher inflation rates than the current Euro area members. There is nothing wrong with this, but it must be accepted and not held against them as they apply to euro adoption. Secondly, their financial systems are still in development. As a result, the EU10 countries are less able to withstand adverse shocks and their financial systems are more fragile.

The three first countries that joined ERM2 in June 2004 seem to have a good chance of fulfilling the Maastricht conditions. Those that joined in May 2005 are in a less secure position but most, if not all, have a good chance of admission after two years in ERM2. The four countries that have not yet joined ERM2 do not fulfil one or more of the remaining Maastricht condition.

The equal treatment principle amounts to applying to the EU10 countries that were designed long ago for a group of different countries. The emergence of the real convergence debate acknowledges these important differences but draws inappropriate policy conclusions. Rather than using the lack of convergence to delay Euro area membership, it would have been wise to re-thing the Maastricht nominal criteria. This occasion has been missed but it remains possible to take into account the E10 country specificities – fast growth, vulnerability to ERM2 membership, higher inflation trend, massive needs for public investment – when assessing whether the entry conditions are fulfilled.

1. Convergence: Real and Nominal

The ten new EU members (EU10) do not have an exemption, they must join the euro area as soon as they are ready. Readiness is defined by the five Maastricht convergence criteria. These criteria were designed in 1991 at the time of the Maastricht Treaty to ensure that all euro area countries had adopted a “culture of [price] stability”.

The reasoning behind the criteria was straightforward. Given the central role of the Deutschemerk, the euro area would have to include Germany. Germany would not give up the DM unless it received strong reassurance that the new common currency would be as strong as the DM, meaning permanently low inflation. Low inflation, in turn, required that the new common central bank be given a clear price stability mandate and be supported in this endeavour by all member states. Member states would only support price stability if they had already achieved it.

The five Maastricht criteria aim at establishing demonstrated evidence that price stability has been achieved (this what the low inflation low interest rate and ERM membership with a stable exchange rate criteria seek to do) and that there would be no incentive to re-inflate (hence the budget deficit and public debt criteria).¹ In the end, as is well-known, all the initial candidate countries managed to pass the five tests, with the exception of Greece that did so two years later. All countries did meet the first three criteria, but most failed a rigorous interpretation of the budgetary criteria. Figure 1 shows the situation of all EU countries in 1998, on the year when the criteria were assessed. The 3% budget deficit limit was satisfied by all countries, sometimes barely and sometimes as the result of ‘creative accounting gimmicks’. Many countries had failed to bring their public debts below the 60% threshold; they could claim, however, that their debts were declining towards the threshold, a clause introduced in Maastricht at Belgium’s request.

These five criteria are called ‘nominal’ because their justification is that they contribute to low inflation. They say nothing about the real side of the economy (growth, income per capita, employment, etc.). This is interesting because standard economic analysis – the optimum currency area theory – does not concern itself with the nominal criteria and focuses instead on some real criteria.

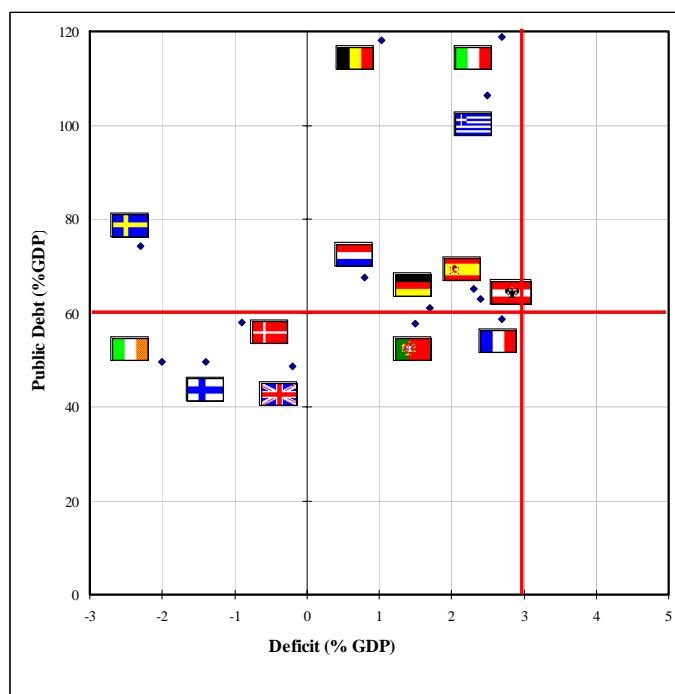
The reason why nominal criteria are not part of standard economic analysis is that it is understood that once a common central bank is given the sole authority of conducting monetary policy, national inflation rates are entirely driven by the common monetary policy. It is further believed – and supported by much empirical evidence – that inflation rates promptly adjust when the monetary policy regime is changed. Why did Europe depart from accepted wisdom? One reason was the belief that inflation is ‘inertial’, that it changes slowly; as noted, this belief is not consistent with the evidence.² Another reason was concern with political conditions, the fear that many

¹ The budget and debt criteria are justified in view of the fact that most inflationary episodes occur when a near-bankrupt government presses its central bank to finance the deficit and/or monetize – i.e., buy back – the public debt.

² One of the most famous pieces of evidence is Germany abrupt end of hyperinflation in 1923 upon the creation of a new central bank, the Rentenbank.

potential member countries were not *really* committed to price stability and would push for a relaxation of the price stability objective. This view is undoubtedly correct.

Figure 1. The Budget and Debt Criteria (1998)



Source: Baldwin and Wyplosz, *The Economics of European Integration*, McGraw Hill, 2003.

Standard economic analysis, in contrast with the Maastricht conditions’ focus on entry, is concerned about the working of a monetary union. The optimum currency area emphasizes the need for some degree of labour market flexibility and the importance of openness to trade as well as diversified exports. Many current discussions about the suitability of the new EU member countries raise the issue of real convergence, often appropriately called ‘catch-up’, although not quite in the same way as the optimum currency area does. There remains, therefore, a gap between the views of policymakers and those of economists, and it affects the way to evaluate Euro area enlargement.

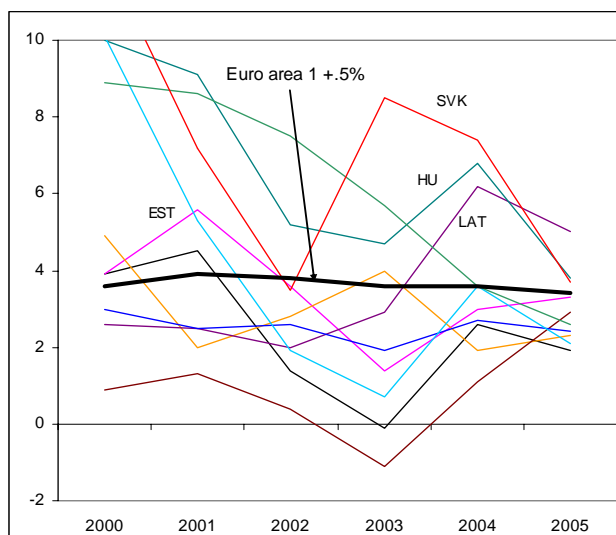
2. Nominal Convergence

Six of EU10 countries have joined the ERM2; three (Estonia, Lithuania and Slovenia) did so in May 2004 and three (Cyprus, Malta and Latvia) a year later in June 2005. Two year of membership without a forced devaluation is one of the five Maastricht criteria. This means that the first group can join the euro area in 2006 and the second group in 2007, assuming of course that they meet the other criteria.

Figure 2 shows the evolution of inflation rates in the ten new member countries since 2000. One of the Maastricht criteria is that inflation – measured by HICP as in the

figure – should not exceed the Euro area’s own rate by more than 1.5%. There is a clear pattern of convergence towards the Maastricht criterion.

Figure 2. Inflation rates in the ten new member countries (2000-2005)



Source: EU Commission

According to the Commission’s forecasts shown in Table 1, only three countries fail this criterion in 2005, two of which (Hungary and Slovakia) marginally so; since these two countries have not joined the ERM, they have time to fully converge. If Latvia is to join the euro area by end 2006, it has little precious time to lower inflation. The other ERM members only need to maintain their position vis a vis the euro area (which is expected by the Commission to have an inflation rate of 1.9% in 2005).

Table 1. Inflation rates in 2005

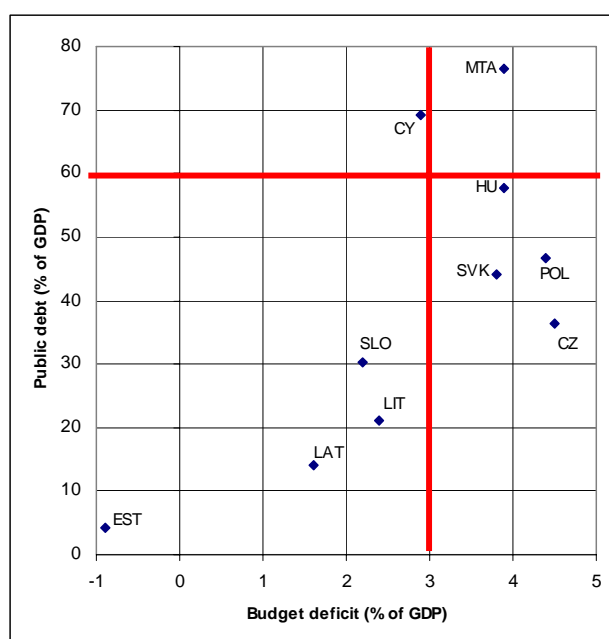
Czech Rep.	Estonia	Cyprus	Latvia	Lithuania
1.9	3.3	2.3	5	2.9
Hungary	Malta	Poland	Slovenia	Slovakia
3.8	2.4	2.1	2.6	3.7

Source: EU Commission

As was the case with the original euro area members, the budgetary criteria are likely to be the most difficult to fulfil. Figure 3 shows the situation in 2005, as forecasted by

the Commission.³ Four of the six ERM members (Slovenia and the three Baltic states) meet both the deficit and debt criteria. Cyprus satisfies the deficit criterion but not the debt one, and Malta satisfies none. With a debt of 76% of GDP and rapidly rising since 2000 (when it was 57% of GDP), Malta cannot easily invoke the 'Belgian clause'. Cyprus's debt, on the other hand, seems to have peaked in 2004 after a steep climb since 2000 (when it stood at 59.9 % of GDP); provided it makes further progress on its deficit in 2006-7, it could be declared as fulfilling both criteria.

Figure 3- The Budget and Debt Criteria (2005)



Source: EU Commission

Overall,⁴ barring unexpected disturbances, Estonia, Lithuania and Slovenia are well poised to join the euro area by late 2006, probably January 2007. None of the three countries that will have spent two years in the ERM are one year later is yet sure to qualify for entry in late 2007, although Cyprus and Latvia still have a fair chance. Malta will have to quickly reduce its deficit.

It is not surprising that four countries have not yet become members of the ERM. All of them have deficits in excess of 3% and inflation rates are in the danger zone in Hungary and Slovakia. The strategy, actually followed as well by five of the six ERM

³ In contrast with Figure 1, countries with high deficits also tend to have high debts. Thus the fiscally-undisciplined countries of 2005 have been fiscally-undisciplined for a while.

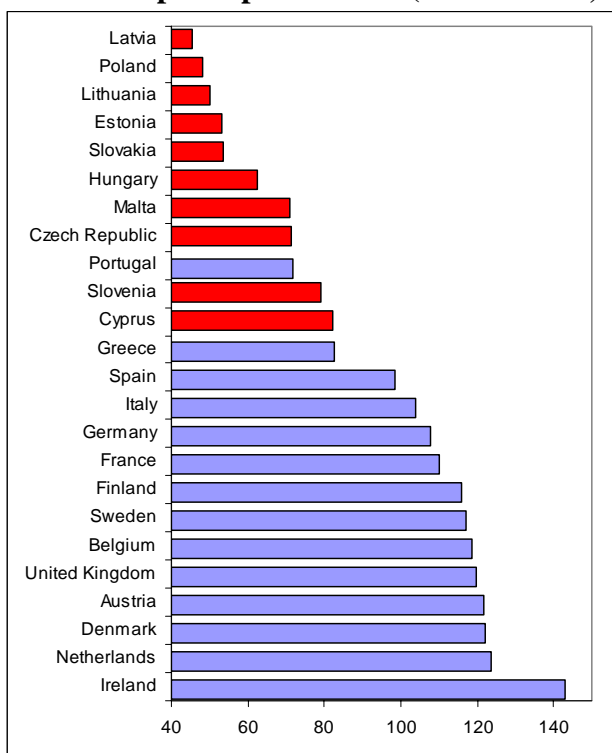
⁴ The interest rate criterion – long term rates must not exceed the euro area rate by more than 2% - is not discussed because it depends mostly of market expectations that the country will join the euro area. Presumably, if all four other criteria are fulfilled, if they conclude that the country will be admitted, they will drive the interest rate close to the euro area level.

members, is to first tackle the inflation and budgetary criteria and then enter ERM. Only Malta seems to have jumped prematurely.

3. Real Convergence

While there has been little discussion of real convergence when the Single Currency was under consideration, the issue is now often mentioned. The reason, of course, is that standards of living and the degree of economic development differ between the EU10 and the 15 older EU members (EU15). Figure 4 shows that standards of living in the EU10 countries are generally lower than among the EU15 countries, the differences being particularly strong in the Baltic States, Poland and Slovakia where income per capita is less than half of Germany's.

Figure 4. GDP per capita in 2005 (EU-25 = 100, PPS)⁵



Source: Eurostat

Table 2 provides some evidence on specialization. The EU10 countries are more agricultural and industrial than the EU15 countries, but the differences are not huge. Adjustments are needed, but they do not require major disruptions in the EU10 countries. As for the EU15 countries, the expected effects can easily be exaggerated. An important point made by Table 2 is that the EU10 countries are economically small, individually and collectively. Their combined GDP is less than 5% of the EU.

⁵ Luxembourg is not shown because its GDP per capita is much higher (225% of EU-25).

Table 2. Structural differences

	GDP, 2002 (€bn)	Sectoral breakdown, 2002 (%)		
		Agriculture	Industry	Services
EU25	9 613	2.1	27.2	70.7
EU15	9 169	2.0	27.0	71.0
Czech Republic	78	3.2	37.3	59.5
Estonia	7	5.4	29.3	65.3
Cyprus	11	4.1	20.3	75.6
Latvia	9	4.7	24.7	70.6
Lithuania	15	7.1	30.5	62.4
Hungary	69	3.7	30.7	65.6
Malta	4	2.8	28.1	69.1
Poland	202	3.1	30.0	66.9
Slovenia	23	3.0	35.2	61.8
Slovakia	26	4.4	31.1	64.5

Source: Eurostat

Why does it matter and for whom? Economic integration between rich and poorer countries triggers important adjustments. The poorer countries take advantage of low production costs to develop labour-intensive industries that displace activities in the richer countries. Table 3 confirms that labour costs in the EU10 countries are significantly lower than in EU15. Of course, productivity is lower too but, as the third column indicates, unit labour costs some 40% lower in the EU10 countries. While, in the long run, this process benefit all countries, rich and poor alike, transition costs can be significant while the poorer countries catch up. In addition, when unemployment is high – a symptom of badly functioning labour markets – the costs may be very long lasting in both rich and poor country. All of this, however, is first and foremost a consequence of goods market integration and comes as the result of EU accession. Monetary union membership is expected to deepen goods market integration, but it is a second-order effect in comparison to EU accession. No matter how important and sensitive it is, this issue does not really belong to the question of euro adoption.

Yet, these differences matter in two respects. First, catch-up means fast growth and rising standards of living. A manifestation of this process is that wages and prices of goods and services that are not open to trade (retail, construction, most services) and therefore cheaper rise relatively to those in the richer countries. This relative increase can take the form of higher inflation, continuous exchange rate appreciation, or both. Monetary union membership closes down the exchange rate appreciation option so it is expected that the poorer euro area will undergo a higher inflation rate than the richer ones. Estimates of this effect – called the Balassa-Samuelson effect – vary between 0.5% and 2% per year. It is important that this is not ‘bad’ inflation, the consequence of monetary profligacy. This is ‘catch-up inflation’, a by-product of an economic success story.

Table 3. Labour costs and productivity

	Hourly labour costs, 2000 (€)	Labour productivity, 2002 (€000)	Unit labour costs EU15=100
EU15	22.2	57.6	100.0
Czech Republic	3.9	16.9	59.8
Estonia	3.0	12.0	65.5
Cyprus	10.7		
Latvia	2.4	12.0	52.3
Lithuania	2.7	10.7	65.7
Hungary	3.8	17.0	58.4
Poland	4.5	16.9	68.7
Slovenia	9.0	25.4	91.7
Slovakia	3.1	13.3	59.7

Source: Eurostat

Second, the poorer countries are characterized by less well developed financial markets. One relevant role of financial markets is that they help cushion disturbances by allowing adversely hit firms and households to borrow their way out. Less well developed markets offer fewer opportunities and are also more unstable. Monetary union matters because exchange rate adjustments play an important role in dealing with adverse shocks. The fear is that if a poorer country is hit by an adverse shock, which it cannot mitigate through depreciation, its firms and citizens will bear a heavy burden and its financial markets may be seriously shaken. A financial crisis in the midst of the euro area is not a welcome occurrence.

4. Maastricht and the New Member Countries

Early on, it has been decided to apply 'equal treatment' across the board to the whole process of EU membership, and this concerns monetary union as well. While perfectly understandable from a legal viewpoint, the equal treatment principle raises some difficulties in the case of the formerly centrally planned economies. This point has been recognized by the ECB, but the own policy implications that it draws are debatable:

'To determine their optimal strategy regarding ERM II and later euro adoption, new Member States will have to consider the specific circumstances of their country, including their overall monetary integration strategy, monetary and exchange rate policy framework and fiscal position. In addition, they will need to consider to what extent the transition process and progress in the catching-up of real incomes could have a bearing on the desired degree of adjustability of their exchange rates. Given the risks implied by premature rigidity of the exchange rate, it might be appropriate for some new Member States to only consider applying for ERM II membership after a further degree of convergence has been achieved. This is particularly advisable when an early rigidity of the exchange rate could precipitate disorderly realignments with

potentially disruptive economic consequences, including for the credibility of the mechanism as a whole.’

Policy position of the Governing Council of the European Central Bank on exchange rate issues relating to the acceding countries, 18 December 2003.

The ECB’s view is that ERM membership should be seen as the last step before Euro area membership and that both should be delayed until real convergence has been reduced. Implicitly real convergence is added to nominal convergence as a prerequisite, albeit an informal one. The stated justification is the existence of risks to the EU10 countries as well as to ‘the mechanism as a whole’. While the risks are not explicitly stated, they echo the arguments presented in Section 3 above.

What is missing in the ECB view is the alternative to rapid euro adoption. If exchange rate fixity is seen as premature, it means that the exchange rates should be floating. This runs against the whole post-war history of Europe. On the Continent at least, preventing European currencies from fluctuating widely against each other has been an overriding concern of policy makers since the early 1950s. The European Snake in the 1970s, the ERM and the Single Currency attest to this preoccupation, driven by the conviction that stable exchange rates provide the level-playing field needed to underpin the Common Market.

Is this approach outdated? One answer is that the mere existence of the euro provides the anchor that European countries have been missing since the end of the Bretton Woods system. Another answer is that exchange rate pegging has been made possible by capital controls, which were only dismantled at the end of the 1980s. As EU members, the EU10 countries have been required to eliminate their capital controls and do not have now the possibility of pegging their exchange rates for very long. The 1992-3 ERM crisis is a powerful reminder that pegged exchange rates and full capital mobility constitute an explosive mix.

This is all true. It remains that floating exchange rates have a tendency to be quite volatile; the EU10 countries are justifiably concerned by this volatility. The deal offered by EU membership combines the interdiction of retaining capital controls and the door to Euro area membership. Unable to adopt a pegged regime such as the ERM for long because capital is now fully mobile, their own interest is to move to euro adoption as soon as they are allowed to. Yet, they are told to go slow. This what the ECB policy recommendations imply.

The explicit imposition of the nominal convergence Maastricht criteria is legalistic; the suggestion that real convergence should also be acknowledged is disingenuous. It is an echo of the Maastricht debate on the need for each country to establish ‘a culture of price stability’ prior to adopting the euro. Section 1 argues that there is little economic justification for this view and one good political reason, the need to ensure that the ECB is wed to price stability. Extreme prudence was, perhaps, justified before the launch of the euro. Back then, the Eurosystem had no track record and needed to establish its reputation. Six years on, the Eurosystem has acquired a solid reputation and the collective economic weight of the EU10 countries is negligible (see Table 2). Why, then, does the Eurosystem seem to lack self-confidence? One possible, untold reason is decision-making in the Eurosystem’s Governing Council. With the one

central bank-one voting rule, it is conceivable that ten new members could tilt the majority of a divided Council. Officially, however, the Council easily makes consensus decisions. This argument is puzzling.⁶

In addition, while legally important, the equal treatment principle is logically flawed. If, as the prominence of the real convergence issue suggests, the new Euro area candidates are different from the previous ones, applying rules designed 15 years ago for other countries and before the euro existed is not justified. Indeed:

- The inflation criterion ignores the Balassa-Samuelson effect, which did not apply to the EU15.
- The ERM membership criterion ignores the volatility of the ERM2 in the absence of capital controls, which were underpinning ERM1.⁷
- The budgetary criteria ignore the massive needs for public investment in the formerly planned economy countries.⁸

5. Conclusion

It is, of course, too late to review the Maastricht criteria. The only remaining degree of discretion concerns the evaluation of the candidate countries when they apply for Euro area membership. The first batch (Estonia, Lithuania, Slovenia) is likely to sail through the process. The situation will be more delicate for the second batch (Cyprus, Malta and Latvia).

The remaining countries, the largest ones among the EU10, have been led to adopt a wait-and-see strategy. This is a matter of concern. If their exchange rates significantly fluctuate, especially in the depreciation direction, pressure will mount to lock them in the ERM. Insistence that they rigorously fulfil the Maastricht criteria would then open up a period of fragility inside ERM, the result of exchange pegging under conditions of full capital mobility.

⁶ The issue of decision making in the Eurosystem is important and has unfortunately not received the attention that it deserves. I discuss it in my Briefing Notes to the ECON Committee of 2003, First Quarter.

⁷ One response is that the ERM2 allows for wide bands of fluctuations. Yet, the ECB December 2003 statement quoted above also mentions that ‘the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate’, which calls for reduced margins. This is unhelpful.

⁸ This need is indirectly recognized in the new Stability and Growth Pact, which is meant to solidify the two Maastricht budgetary entry criteria. Why should it not be applied to the entry conditions? Equal treatment seems to be the answer.