STRATEGIES FOR EURO AREA MEMBERSHIP

Philippe Moutot§ and Anatoli Annenkov¶

Abstract: The purpose of this paper is to discuss the challenges facing present as well as future euro area member countries and to consider the appropriate strategies to overcome these challenges. To this end, this article gives a brief overview of the Economic and Monetary Union and the prospects of accession countries in joining this Union. The appropriate strategies for entering the euro area will be discussed with a focus on monetary and exchange rate policies. The paper stresses that participation in the EU and EMU is only an intermediate goal, with the ultimate goal being improvements in living standards within stable democracies. It is argued that EU and euro area membership are long-term commitments and therefore the policies adopted must be sustainable.

Introduction

As the date for the next EU enlargement approaches, the issue of appropriate economic policy strategies for joining the euro area is becoming increasingly important for the accession countries. Although some hurdles remain, it seems likely that enlargement will take place in Spring 2004. And once the accession countries have joined the EU, they can be expected to strive to join the euro area and fulfil the Maastricht convergence criteria.

The purpose of this paper is to present some thoughts on the challenges

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§ Philippe Moutot is Deputy Director-General (Economics) at the European Central Bank, Frankfurt am Main.

¶ Anatoli Annenkov is Senior Economist in the EU Countries Division of the European Central Bank.
facing future as well as current euro area member countries and to discuss appropriate strategies to overcome these challenges. To this end, this article starts by giving a brief overview of some of the challenges in establishing the Monetary Union. It proceeds to consider the case of accession countries and discusses appropriate strategies for entering the euro area, focusing on monetary and exchange rate policies. Finally the paper refers to challenges facing all countries in the Monetary Union.

It is important to stress from the outset that participation in the EU and Economic and Monetary Union (EMU) is only an intermediate goal, with the ultimate goal being improvements in living standards within stable democracies. EU and euro area membership offer great opportunities, but also bring responsibilities for the euro area as a whole. Therefore, it is necessary to underline that EU and euro area membership are long-term commitments and that the policies adopted must be sustainable.

**Establishing a Successful Monetary Union**

When discussing how a country should best prepare for membership of the euro area, it is useful to look at historical developments. The preparations for the introduction of the euro have taken a long time. Indeed, the creation of EMU marks a crowning moment in a historical process which proceeded in many dimensions after the Second World War. Over the years, the political desire to establish and safeguard peace was accompanied by the economic aspiration of enhancing trade integration as the driving force for further integration of citizens, institutions and markets.

The euro represents the result of both these driving forces; it guarantees exchange rate stability between member countries, which is beneficial to their trade, while also serving as a symbol of increased political integration. This duality has concrete consequences. Today, the euro area is a highly advanced institutional structure, combining both supranational and intergovernmental elements, which have taken more than half a century to achieve. Although this *acquis communautaire* has taken a long time to create, it offers a strong and transparent anchor for future members, as well as the possibility of a speedier integration into the euro area than experienced by most current members. However, it is impor-
tant for future success that the new members share the underlying principles, ideals and rules of these institutions, many of which may not have been in place for any appreciable period of time prior to membership.

The importance of the Maastricht convergence criteria should be stressed in this regard. These criteria have in fact been highly successful in promoting a culture of stability among the present euro area countries and EU Member States, a stability which is crucial for the credibility of the Monetary Union. They were designed to act as indicators of the ability of prospective member countries to sustain stability-oriented economic policies as market economies, open to trade and financial flows. The philosophy which dictated the selection of the macroeconomic criteria was that countries that are able to maintain stability-oriented policies over time, including in the face of adverse external shocks, are less likely to experience severe internal economic problems, which in a single currency area could have negative spillover effects on other member countries.

Naturally, country-specific economic problems, such as inflationary pressures leading to a loss of competitiveness, cannot be contained by monetary policy or nominal exchange rate adjustments in a monetary union. It is therefore important to understand the constraints on national economic policies within the monetary union.

The convergence criteria were formulated in a very clear way, supporting the credibility of the monetary integration process. As is well known, the criteria relate to price stability, public finances, exchange rate stability and long-term interest rates, while also taking into account other factors such as the results of market integration and legal convergence (see ECB, 2002a). They served well both as a target and as a disciplining device for economic policies in EU Member States throughout the 1990s. In fact, they resulted in a historically high degree of monetary and fiscal stability at the start of EMU, while also preparing countries for the realities of life in a single currency area. It is indeed difficult to imagine that the process of disinflation and fiscal consolidation in Europe in the 1990s would have been possible without the clarity of the convergence criteria or the prospects of the Monetary Union. Present fiscal challenges within the euro area show that these criteria were neither arbitrary nor irrelevant.
Taking a broader view of these main challenges, European integration should also be put into a global context. Throughout the world, there has been, since the Second World War, a focus on trade and financial liberalisation – a development that most countries have seen as beneficial to growth and employment. This implies that European integration is part of a global integration process based on the idea that the path to higher living standards lies firmly embedded in the adoption of open, market-oriented policies and integration into the international economy. So when considering the necessary strategies for accession to the EU and the euro area, it is crucial to keep in mind that much of what needs to be done, and much of what has been achieved already, would have been necessary in the context of globalisation even without the prospect of EU and euro area membership.

Challenges for Accession Countries

Following accession, the new EU members will be covered by the legal framework of the EU, but will have a derogation from the third stage of EMU. Full participation in EMU depends on the positive outcome of the convergence assessment as required by the EU treaties. Progress made with regard to the nominal convergence criteria will thus be crucial in the coming years until the current accession countries adopt the euro. However, the fact that these criteria focus on progress in “nominal” convergence should not be understood to mean that progress in real convergence is less important or that the two types of convergence stand in opposition to each other. By real convergence we normally mean issues related to per capita income levels, economic structures and integration of markets. Although different income levels as well as different economic structures are, in principle, compatible with membership of the euro area, advancing real convergence with the euro area is desirable in order to foster economic cohesion and reduce the risks and effects of asymmetric shocks.

There has been progress in real convergence over a number of years in most accession countries, but the sheer size of the income gap suggests that the process of income level convergence will extend well beyond the date of EU accession. Hence, it is all the more important that real convergence progresses in a sufficiently harmonious macroeconomic
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context. In fact, measures to promote real and nominal convergence can be mutually beneficial. In particular, it is important that the decrease in inflation is made consistent with a sustainable fiscal policy, which in turn is reflected in low long-term interest rates and finally appears consistent with stable exchange rates. This will provide the best conditions for high and sustainable economic growth and thus real convergence.

Similarly, advancing structural reform would improve the growth potential of the economy, implying faster output growth without inflationary pressures, which would support both real and nominal convergence. An impressive example of the possible symbiosis between real and nominal convergence is the economic development in Ireland between 1987 and 1999, in which GDP per capita moved from below 70% of the EU average to above the average. During the same period, inflation remained remarkably moderate and a significant government debt reduction took place. Inflation was only around 2.5% on average during this period while gross government debt declined from above 120% of GDP in 1987 to below 50% of GDP in 1999.

Strategies for a Sustainable Convergence Process

As regards the question of which strategies the accession countries should adopt in order to support a sustainable convergence process, it is firstly important that these countries push on with efforts aimed at narrowing the gap with the euro area in terms of living standards. Overall, there is still room in most of these countries to improve growth prospects and foster real convergence by enhancing market-oriented reform.

There remain three major areas of reform in accession countries. Continued effort in cutting subsidies and state aid to industries that are not competitive in the long term is necessary, although such measures may be painful in the short term. Similarly, restructuring of the public sector is necessary in order to modernise tax administration and, as the same time, expose a greater share of the economy to market forces and competition. Finally, further development and deepening of the financial sector is necessary (for an overview of financial sectors in accession countries see ECB, 2000b). Sound and well-functioning banking sectors, capital markets and payment systems are crucial for the monetary
transmission process and the effectiveness of monetary policy. They are also likely to promote further real convergence, as the availability and efficient allocation of capital could promote economic development and structural change, in particular for small and medium-sized companies. The most important reason for pursuing reform in these areas is that, if these issues are not addressed, pressures will sooner or later build up that could lead to additional fiscal expenditure or to pressures to adopt non market-oriented policies.

A second important component of a strategy for sustainable convergence is to choose the monetary and exchange rate strategies wisely, with the aim of promoting convergence while eliciting political support for the necessary changes. In recent years, the accession countries have made significant progress in reducing their inflation rates. Accession countries in central and eastern Europe which experienced high rates of inflation in the aftermath of the collapse of the communist system, were particularly successful in this regard. In most countries in this region, inflation was below 5% in 2002. This success is mainly associated with two factors: firstly, central banks have increasingly been granted independence from political influence, and secondly, monetary and exchange rate policies have been tuned to the needs of these countries. Let us address these issues in turn.

Experience shows that in order to achieve low inflation rates, it is of utmost importance to assign the primary objective of price stability to an independent central bank (see for example, Alesina and Summers, 1994). This is the main reason why EU membership requires that the legislation of central banks guarantees full institutional, personal, functional and financial independence. Obviously, it is not only the formal implementation of central bank independence which counts: it needs to be ensured that it is also practised in the central banks’ day-to-day operations. Concerning the choice of monetary and exchange rate strategies, a lesson that was learnt from the experience of some of the accession countries and some current EMU members is that exchange rate policy can be successfully employed in small open economies to anchor inflation expectations. In the early stage of the transition process, most accession countries managed to reduce their inflation rate mainly by pegging the exchange rate to a currency with a strong stability record. In this period, the Baltic States in particular experienced an extraordinarily strong real
appreciation of their currencies, which may have been partly related to inertia in inflation rates. Following this initial stabilisation period, the magnitude of the real appreciation no longer seems to be clearly related to the exchange rate regime.

In recent years, the spectrum of exchange rate regimes and monetary policy strategies has actually become relatively wide as several countries have gradually softened their pegs, while others have continued to rely on very strict links, such as currency boards. In particular, Poland, the Czech Republic, Slovakia and Hungary have moved towards more flexible exchange rate arrangements, partly in view of strong capital inflows, leaving room for monetary policy to target inflation more directly while giving the nominal exchange rate more leeway to adjust.

Consequently, there does not seem to be one single solution to the issue of stabilising inflation at a low level and no solution can be deemed perfect through time or across countries either. Each country needs to assess its possibilities, and these possibilities depend on the combination of the monetary, fiscal and structural policies chosen, as well as the institutional and structural features of the economy (see also Corker et al., 2000). In addition, broad public support for the necessary policies is crucial.

In the end, it is finding the appropriate balance between these various elements that will be essential for the achievement of sustainable convergence. It should be recalled that, in this context, countries aiming to join the euro area will have to participate in ERM II for a period of at least two years. While ERM II sets a central rate for the respective currency against the euro, the width of the standard fluctuation band offers a relatively high degree of flexibility. Ultimately, the market test of exchange rate stability will only be passed on a sustainable basis if it is properly backed up by credible monetary, fiscal and structural policies. This will be made apparent from the assessment of all the convergence criteria and whether they are fulfilled in a sustainable manner.

**Participation in ERM II**

This discussion leads directly to the issue of the timing of ERM II entry. Several countries have expressed a desire to participate in ERM II soon
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after joining the EU. With a rapid entry into ERM II, the accession countries may wish to reap the benefits of imported monetary policy credibility as soon as possible, whilst also seeking to fulfil of the exchange rate criterion. However, two issues should not be overlooked.

First of all, previous examples of immediate participation in the ERM after EU entry, such as that of Austria, involved particular underlying conditions. By joining the ERM, Austria mainly continued its existing policy of closely shadowing the Deutsche Mark, which it had successfully pursued for more than 15 years.

Accordingly, the Austrian schilling had already passed several market tests before entering the ERM. Secondly, the stability of the real exchange rate of the schilling against the Deutsche Mark suggested a high level of real convergence. By contrast, the patterns of most accession countries’ exchange rates suggest that the real convergence process for these countries may not yet be sufficiently advanced.

On the other hand, a long period in the EU before entering ERM II may not lead to a higher degree of preparedness, as the experience of Greece, which spent more than 17 years in the EU before joining the ERM, shows. It might be said that the years preceding the Greek entry into the ERM were characterised by insufficient macroeconomic stability, partly owing to growing capital flows related to the deregulation of the financial system, and that ERM entry was largely successful in stabilising expectations. Importantly, the determined pursuit of macroeconomic stabilisation was supported by fiscal and structural measures, such as reductions in public expenditure, cuts in state subsidies and the restructuring of public enterprises.

In any case, it is important to stress that attaining a reasonable level of structural convergence prior to entry and the pursuit of macroeconomic stabilisation will be helpful to reduce exposure to country-specific disturbances and limit risks to monetary and financial stability (Wagner, 2002).

Even when a high degree of sustainable convergence has been attained, other issues remain to be resolved. First of all, a decision on an appropriate exchange rate level for entry into ERM II needs to be taken. Although
the ERM II framework generally provides sufficient flexibility through wide fluctuation bands and the possibility of realignments, the agreed central parity should be sustainable in order to reduce the need for frequent realignments and interventions in foreign exchange markets. In order to fulfil the Treaty requirement, a Member State will need to respect the fluctuation margins without experiencing severe tensions and without devaluing its currency. Moreover, in the assessment of exchange rate developments by the ECB, the emphasis is placed on exchange rates being close to the ERM II central rates. From a conceptual perspective, the issue of an appropriate level of the central parity is closely related to the concept of “equilibrium exchange rates”. However, while estimating such equilibrium exchange rates is already a difficult task for major currencies, it is even more so for the current accession countries, due to their data limitations and the rapid real appreciation of their currencies in recent years – which to some extent may reflect the rapid structural change of these countries during the transition phase.

The relatively substantial real appreciation of the accession countries’ currencies experienced over the last decade can be attributed to several factors. First of all, many countries have gradually removed subsidies for non-traded goods. While energy prices, for instance, were still heavily subsidised in the early stage of transition, they have gradually converged towards more market-determined levels (Arratibel et al., 2002). Secondly, the transition from central planning to market-oriented economies prompted significant productivity gains, particularly in the early phase of the transition process. This justifies – via the well-known Balassa-Samuelson effect – a real appreciation of these currencies. However, most empirical studies indicate that the Balassa-Samuelson effect is relatively small.¹

Finally, some studies suggest that the real appreciation reflects an adjustment of these exchange rates from rather low levels at the beginning of the transition phase to levels which are more in line with those of other countries at a similar stage of economic development.

¹ The available estimates of the annual impact on inflation mostly range between 0 and 3 percentage points. See, for example, Arratibel et al. (2002), De Broeck et al. (2001), and Êgert (2002). However, there are several reasons why quantifications of the Balassa-Samuelson effect are difficult to make and may overestimate the extent of likely inflation differentials (Alberola, 2000; IMF, 2002).
To sum up, the accession countries have been following a variety of monetary and exchange rate strategies, and may do so also in the future. While each strategy has had its advantages and drawbacks, most of them have significantly contributed to macroeconomic stability and disinflation. What counts in the end is that this progress is sustainable. For each country, it will be a challenge to determine what will be the most appropriate time to enter ERM II and what this implies for a possible entry into the euro area. On the one hand, ERM II membership could offer increased credibility, reduced inflation expectations and a framework within which to achieve further real and nominal convergence.

On the other hand, a premature ERM II entry, before having reached a sufficiently high level of macroeconomic convergence, might risk tensions, which in turn could delay the process of entry into the euro area. In all cases, the fulfilment of all the convergence criteria on a sustainable basis will be crucial for an eventual euro area entry. This requires that one looks beyond a snapshot of the latest quantitative and static criteria when assessing the convergence process, gauging also the prospects for the durability of these advancements.

Another important, but often underestimated, challenge is the issue of statistics. In order to assess and monitor developments in all countries, a high quality and frequency of data are crucial. Moreover, data need to be comparable across countries. Therefore, it is useful if accession countries participate as much as possible in the efforts to upgrade and harmonise the statistical requirements right from the start.

**Conclusions**

Each country aiming to fulfil the convergence criteria for euro area membership will need to strike a balance between monetary, fiscal and structural policies, in addition to country-specific institutional and structural features, when deciding upon the appropriate strategy. Advancing real convergence appears particularly important in most countries and should be pursued in parallel with nominal convergence. The determined pursuit of macroeconomic stabilisation, supported by structural and fiscal measures to enhance market-oriented reform, is likely to lead to the best result in terms of both real and nominal convergence.
Fulfilling the convergence criteria is however only one part of the broader challenge, which faces all euro area countries. Firstly, the notion of “sustainable convergence” is crucial for the Monetary Union to function well. Hence, progress in convergence should be assessed over a number of years rather than a few years only. The better prepared a country is before joining the Monetary Union in terms of sustainability, the less likely it is to experience serious problems, which could also affect other countries in the euro area. Secondly, it is recognised that maintaining high growth and adjusting for disturbances without having a national monetary policy or the possibility of exchange rate adjustments poses challenges for other national economic policies. This raises the issue of improving the economy’s adaptability to changes in demand and supply. The combination of market integration, stability-oriented economic policies and structural reform aiming to increase flexibility should reduce the risks and effects of possible asymmetric shocks. Although these challenges are formidable, they are worth accepting, due to the gains arising from joining the euro area, in terms of increased trade, efficiency and stability.

Finally, it is important that the general public understands and supports the necessary adjustments and policies, which in any case may be necessary for countries set on maximising economic efficiency and prosperity in the context of globalisation. In this regard, accession countries face not only significant challenges on their way to full EMU membership, but also significant opportunities to build competitive and flexible economies right from the start of their integration into the EU. The adequate communication of these challenges and opportunities is, in itself, an important challenge for policymakers.

References


