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CHOSEN PROBLEMS OF THE EURO ZONE ENLARGEMENT*

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Abstract

An article investigates a problem of the euro introduction by new members of the European Union. It presents some potential benefits and costs of entry to European Monetary Union in the context of its present and future functioning. Then it discusses some advantages and disadvantages of postponing joining the euro-zone. Besides, potential meaning and consequences of giving a target date of introduction of the euro by a country and possible scenarios that can be taken at this way are presented in the paper.

Since the 1st January 2007 Euroland comprises 13 countries. The finance ministers of EU member states have approved of Slovenia's admission to the euro area. The application of Lithuania was rejected – European Commission and European Central Bank have judged that it has not fulfilled the inflation convergence criterion. With regard to this event, the article touches an issue of the need for reconsidering the Maastricht criteria which presently seem to be a source of many content-related and interpretation doubts. It also investigates the requirement for adjusting the convergence criteria to the fact that the euro-zone has already been in existence.

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WYBRANE PROBLEMY ROZSZERZENIA STREFY EURO

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Słowa kluczowe: Unia Europejska, Unia Gospodarczo-Walutowa, kryteria konwergencji, nowe państwa członkowskie.

Abstrakt

Artykuł podejmuje problem wprowadzenia euro przez nowe państwa członkowskie Unii Europejskiej. Jest próbą odpowiedzi na pytanie, czy nowi członkowie Unii są gotowi na przyjęcie wspólnej waluty zarówno pod względem gospodarczym, jak i społeczno-politycznym. Przedstawia także potencjalne korzyści i koszty przystąpienia do Unii Gospodarczo-Walutowej w kontekście jej dotychczasowego i przyszłego funkcjonowania oraz wady i zalety spowolnionego dochodzenia do euro przez kraje pozostające poza Unią Walutową.

Od 1 stycznia 2007 roku strefę euro tworzy 13 krajów, gdyż ministrowie finansów państw UE zatwierdzili przystąpienie do tego grona Słowenii. Wniosek aplikacyjny Litwy został odrzucony – Komisja Europejska i Europejski Bank Centralny uznały, że nie spełnia ona inflacyjnego kryterium konwergencji. W nawiązaniu do tego wydarzenia referat podnosi kwestię potrzeby ponownego przeanalizowania budzących wątpliwości merytoryczne i interpretacyjne kryteriów z Maastricht i dostosowania ich do faktu, że obszar euro już istnieje. Artykuł prezentuje także znaczenie i konsekwencje, jakie może spełniać podanie przez dany kraj konkretnego terminu wejścia do strefy euro oraz możliwe scenariusze tego wydarzenia.

Introduction

1st January 2002 was a great day for a political and economical integration of Europe. That was the first day of a physical existence of the euro currency which would be an important factor helping to renew an economic position of EU in a global competition of XXI century. That was the point of view of euro enthusiasts. On the other hand the skeptics saw it more as a political endeavor than economical one[1]. Even though the euro had existed in bank and financial accounting since 1st January 1999, the euro area was still far away from fulfilling the conditions of optimum currency area (OCA)[2]. Consequently in

[1] Before the beginning of stage three of EMU creation M. Obstfeld argued that European institutions were not ready for a single currency. A good preparation for EMU would have meant much deeper economical and political unification (see OBSTFELD 1998, pp. 1-32].

spite of the fact that it has been almost seven years since the birth of the euro, the discussion concerning its effectiveness and future is still under way.

However, Polish decision-makers cannot ask whether Poland should become a part of the Euroland. When Poland joined the EU, it had also agreed to implement single European currency[3]. As a result keeping its national currency is politically impossible. On the other hand the EU countries make more than 70% of Polish international trade. This means that staying out of European Monetary Union (EMU) is economically irrational in the long run. The situation seems obvious: Poland has no other possibility than becoming part of the euro-zone. However, Polish decision-makers can ask other question: when should Poland adopt the euro? This paper is a voice in the discussion that results from this last question.

The paper consists of a succinct presentation of advantages and disadvantages of joining EMU. Then the potential meaning of giving a target date of introduction of the euro by a country and its functions are presented. The third part of the paper deals with the consequences of postponing adaptation of the euro. In the end the article touches the problem of controversies concerning the Maastricht criteria that have risen recently.

Advantages and disadvantages of entering the EMU

Thousands of pages have been already written about potential benefits and costs of creating a single European currency. In this article this issue will be presented succinctly mainly from the point of view of the new member countries.

The first and the most obvious benefit of the euro is a possibility of using it in every day international transactions. This is especially important for enterprises that do not have to bear costs of currency exchange in foreign trade and for citizens who travel a lot[4]. On the other hand this makes serious costs

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[2] According to the theory of optimal currency areas (OCA) a country that joins the monetary union should be the part of OCA. It is characterized by wage and price flexibility, high labor mobility or possibility of broad budget reallocation of resources. Otherwise the country can bear very high costs in case of asymmetric shocks as it cannot utilize devaluation as an asymmetric shock absorber in order to improve its international competitiveness (MUNDELL 1961, pp. 657-665Ą. However, there are some skeptics of this theory who argue that a country can usually fulfill the criteria only after some period in monetary union. Beside, losing a possibility of devaluation is not a big lost from the perspective of a long run growth as the availability of this tool creates a greater temptation for moral hazard behavior. It can result in postponing painful reforms that are necessary to improve an international competitiveness of a country. Latin America was an example of this (ORĘZIAK 2004, p. 24).

[3] It also applies to other new member countries that joined the EU in May 2004.

[4] This savings are matching up to 0,5% GDP in case of the European Union countries that have already adopted euro (ORĘZIAK 2004, p. 47).

for financial sector as banks and some other financial institutions lose an important source of revenue. From the macroeconomic perspective the new EU member countries can become real part of a big common European market. Adopting the euro enables to lower transaction costs of international cooperation. The disappearance of exchange currency costs makes foreign trade cheaper and it enables easier comparison of price levels between new and old countries of the EU. This may be especially advantageous for enterprises from Central Europe as they still often have to use price competition to obtain a place on the EU market. In the long run these factors will increase the competitive intensity and make an incentive for faster restructuring of the economy.

The second crucial factor that can seriously improve the position of Poland on the common European market is the disappearance of currency exchange rate risk. This makes an economical calculation much more appropriate as it is difficult to estimate profitability of international contracts with volatile exchange rates. The exchange rates risk increases the transaction costs of foreign trade and can make it artificially less competitive (ORĘZIAK 2004, p. 47). These factors are especially important for small and medium sized enterprises from Central Europe. They usually do not have the financial resources or knowledge to reduce the exchange risk through transactions on the market of derivatives that are usually available for even relatively small companies in EMU countries.

In spite of a great inflow of foreign direct investments Central European countries still suffer from lack of capital and relative underdevelopment of financial markets. Adopting the euro will remove one of the last barriers to big integrated and liquid financial markets of the EU (see JAKUBISZYN 2003, pp. 12-16, MARSKI 2003, p. 51). Currently the access to the EU financial markets is mainly used by the biggest enterprises from Poland. Implementing the euro will probably give this possibility for much smaller companies. Firstly it will reduce the transaction costs. It is also expected that it will create knowledge spillover effects and improves the process of learning to take advantage form international financial markets. Low costs of access to relatively big European financial market will be also very important for insurance companies and especially pension funds form Central Europe. These financial institutions need many investment possibilities that cannot be provided on local financial markets. This is especially important as Central European societies have started the process of getting older.

The skeptics of EMU are mostly reluctant to giving away the control over national's monetary policy. Most of all they are not in favor of losing the possibility of devaluation in case of asymmetric shock[5]. Even though the last few years have proved that these concerns were a little exaggerated in case of present members of EMU, the skeptics often argue that the loss of that tool can be more disadvantageous in case of less developed countries with less matured economies that are usually more vulnerable to asymmetric shocks.

On the other hand EMU enthusiast argue that the disappearance of control over national monetary policy reduces the possibility of short term discretional actions that lead to political biasness cycles which usually reduces the long term growth potential. This is especially important in case of Central Europe that can be still characterized by significant underdevelopment of civil society in combination with a low quality of general economic education and underdevelopment of social institutions that are essential for stable monetary policy. However, it is worth remembering that even the existence of common monetary policy conducted by the European Central Bank (ECB) is not able to ensure the full political independence of monetary policy. It can move the political influence from national to the international level[6]. The full independence of the ECB in isolation from institutional background can also lead to a situation when the euro, instead of the lack of necessary and painful reforms, is publicly pointed as the main cause for economic stagnation. This has already happened on political markets of Italy and – paradoxically – Germany (*Italy's Northern.* 2005, *The European Union...* 2005).

The new members of the EU have recently become concerned about possible taking over of common monetary policy by the biggest economies of EMU[7]. When these countries lose the national control over monetary policy, they can be afraid that the short-term interests of the dominant EMU participants will mostly influence the decisions of the ECB. That would result in monetary policy commensurate with political interests of the biggest countries that can threaten the long-term stability of whole monetary union[8].

[5] The argument is shortly presented in footnote no 3.

[6] It could be already seen when the first president of the ECB was appointed. French president was opting for his candidate Jean-Claude'a Trichet, whereas the remaining countries preferred Wim Duisenberg. That resulted in a serious political crisis. In the end a peculiar consensus was reached – the Dutch candidate of majority was appointed the president of the EBC but only on half of his tenure. After four years he was supposed to resign and the French candidate was going to take over his position.

[7] In order to reduce this risk when the ECB was created, the smaller countries of EMU were granted an excessive weight in the system. Austria, Belgium, Finland, Ireland, Luxemburg, Netherlands and Portugal were controlling 9 of 17 voices in the Governing Council of the ECB when the Germany had only 2 voices. However, the GDP of single Germany was twice as big as the GDP of all these seven countries.

[8] The first signal that would suggest this threat was an augmentation of Theo Waigel's proposal of Stability Pact that was done under the pressure of France. According to the original proposition a country that broke the rules of financial responsibility would be automatically punished with a financial penalty. In the final Stability and Growth Pact this penalty is optional. The next strong impulse to increase these concerns, especially among the new members of the EU, was the way these rules were applied to Germany, France and Greece (see *The death of.* 2003, *Replacing the defunet.* 2003). Even though the rules were broken notoriously by these states, the financial punishment was

Consequences of setting the target date

Setting the target date for the introduction of the euro fulfils at least two functions. Firstly it constitutes the factor that creates, mobilises and justifies the economic policy. It promises stable macroeconomic policy and structural reforms and therefore it is the important signal for financial markets. Secondly it can be considered as an indicator concerning the place that a given state wants to take up in the European integration. Nowadays belonging to the euro-zone means willingness to participate fully and affect the decision making process in the EU whereas remaining outside the Euroland indicates the caution and anxiety about further integration, which is regarded among other things as a loss of national sovereignty for the sake of carrying out monetary policy deprivation. If, as seems probable the members of the euro area come to the conclusion that for both political and economic reasons the better functioning of the single European currency requires a further pooling of their national independence then it can mean the marginalisation of other members remaining outside the "core" (*Flexibility and the Future of the European Union* 2005).

Considering the situation of member countries that are obliged to join the euro-zone there are three possible scenarios of giving the tentative target deadline for the adoption of the single European currency: setting the nearest possible date, setting the distant date and having no official target date. While the first scenario evidences the single-minded determination to get on with economic reforms, the second and the third ones diminish credibility of such declaration. They both introduce uncertainty concerning the reorganisation of public sector finance and the reforms aiming to increase competitiveness, decrease the differences in development levels and solve the demographic problems. Consequently, even if their objective is solely painstaking preparation for fulfilment of convergence criteria, in the extreme cases they can code the coming true prognosis of unstable and inconsistent economic policy. Furthermore, if the reason of the last scenario is merely dislike and fear of undertaking the commitments, it must be said that it is the excessive caution as the target date can be postponed without any legal-international consequences for the sake of difficulties in achievement a high degree of durable convergence. The loss of reputation connected with this kind of event should not bring about greater damages than the continuous uncertainty in regard to economic policy of a given country.

not applied to them. It was mainly a result of their political interests, not a reliable economic analysis and caring about long term stability of the euro-zone.

Consequences of postponing adaptation of the Euro in case of Poland

The decision of postponing adaptation of the euro means that a country cannot fully utilize the benefits described in the first part of this paper. Additionally staying out of EMU can lead to higher interest rates, which increases the costs of capital. For example, it is estimated that Denmark has to keep interest rates 0,4 percentage point higher than the ones that would be obtained if it was a member of EMU (ORĘZIAK 2004, p. 48). However, in case of Central European countries this number may be higher in the long run, which means higher costs of financing, thus losing some international competitive advantages of Central European enterprises.

The postponing adaptation of the euro is not a factor that is conducive to macroeconomic credibility of a country on the international financial markets. The necessity of obtaining convergence criteria helps to stabilize the inflation expectations, which is necessary for keeping inflation on a reasonable level. Thus it is a condition of reducing interest rates which is crucial for lowering the cost of public debt (see SOKOŁOWSKA 2005, p. 6). In case of Poland it can be especially significant as the financial market has been accustomed to the idea of fast adaptation of the euro.

The skeptics of the euro implementation argue that when the new EU members postpone its implementation, their economies can have more time for structural changes that make them part of the euro optimal currency area. In their opinion it is too early to lose the possibility of devaluation in case of asymmetric shocks[9]. However, the optimists point that there are at least three important weaknesses of this argument.

Firstly in case of Europe most asymmetric shocks have not only national level. They usually influence group of countries. In that case devaluation is not effective (SOKOŁOWSKA 2005, p. 7). In some cases it can even bring the results similar to a currency exchange rate war which is usually disastrous for an international trade in the long run[10].

Secondly Poland has been an active participant in European trade and financial markets for last few years. It has contributed to a serious restriction of independent national monetary policy. Nowadays Poland cannot afford

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[9] See footnote no 3.

[10] There were many examples for this in XX century. The last one happened in the years 1992-1995 when French franc was appreciating 9% in relation to 25 main currencies of the world and German mark about 10%. In the same time Italian, Spanish and British currencies were depreciating by 25%, 16%, 11% respectably. As a result many branches in Germany and France suffered a serious recession, even though the global demand for their products in whole Europe was growing 15% every year. It was the background for growing pressure of German and French societies on reestablishing trade barriers that had been already removed many years ago (ORĘZIAK 2004, p. 47).

a short term monetary policy that would result in higher inflationary pressure and loss of credibility on the financial markets[11]. Thus Poland has not utilized the possibility of currency exchange rate manipulation for last few years (ORĘZIAK 2004, p. 153). As a result it made a strong incentive for Polish companies to implement a demanding restructuring process which helped to build a real foundation of their international competitiveness. The results of research conducted by J. Crespo-Cauresma and C. Wójcik show that Polish economy is quite well integrated with EU from the perspective of monetary policy. There is a significant correlation between real interest rates in Poland and Germany, which is the dominant EMU economy (CRESPO-CUARESMA, WOJCIK 2004, pp. 4-13).

Last but not least Poland has to conduct all the necessary reforms that lead to obtaining convergence criteria and are necessary for adopting the euro, regardless of whether it joins EMU or not. Sound macroeconomic policy, healthy public finances are the basic condition of keeping international competitiveness' especially in case of a relatively small open economy (see SOKOŁOWSKA 2005, p. 7).

Controversial convergence criteria

Since the 1st January 2007 Euroland comprises 13 countries as the finance ministers of the EU Member States have approved of Slovenia's admission to the euro area. The application of Lithuania was rejected – European Commission and the ECB concluded that there should not be any change in the status of this country as a Member State with derogation. This unfavourable appraisal has brought about a political crisis in Vilnius and triggered off a lively discussion about the convergence criteria.

Lithuania has met all Maastricht criteria except one. Lithuanian budget deficit in 2005 amounted to 0.5% of GDP, well below the reference ratio of 3%. The ratio of government debt to GDP was equal to 18.7%, far below the 60% reference value. Average level of long-term interest rates of 3.7% was well below the reference value of 5.9% (*Raport o konwergencji.* 2006, pp. 7-8). As far as the exchange rate criterion is considered Lithuania has also fulfilled it as the country joined ERM II with its existing currency board regime (see TYMOCZKO 2004, pp. 91-93) and since that the Lithuanian litas has remained at its central parity. The only criterion that has not been met was the one on price stability as a 12-month average rate of HICP inflation of 2.7% was just above the reference value of 2.63% (*Raport o konwergencji.* 2006, p. 7).

[11] The abuse of devaluation policy can seriously increase that risk.

The comparison of the approach to Lithuania, that was refused access to the euro-zone on the grounds that it missed the inflation criterion only by 0.07 percentage point, and to the Old Member States leads to the suspicion that different standards are applied to different countries. As a matter of fact majority of the Member States qualified for the single European currency adoption in 1999 had not fulfilled at least one convergence condition. It is worth mentioning that in Italy the debt-to-GDP ratio in 1997 was 121.6% and in Belgium it was even higher and amounted to 122.2%. Moreover the periods of membership in ERM for the Finnish markka and the Italian lira were shorter than the requisite 2 years (*European Monetary Institute* 1998, pp. 5-10). It can be assumed that making exceptions in case of some economies on the stage of creating the common currency caused a bigger danger for its stability than Lithuania's minimal exceeding of the inflation criterion.

The suspicion of adopting double standards can be also justified by the experiences of the euro-zone. Namely France, Germany and Greece have broken the 3% deficit ceiling repeatedly and no sanctions have been applied against them[12]. In turn Greece, Ireland and Spain time after time exceeded the reference value of inflation rate. Then if the Maastricht treaty is to be obeyed rigidly, there should be no doubts that equal standards are applied to all Member States.

Besides above-mentioned allegations there are also interpretative problems concerning the definition of price stability and the calculation of the reference value. The European Parliament holds an opinion that the reference value based on the arithmetic average of inflation rates from three EU countries with the lowest rates seems unfounded in the light of the relevant provisions of the treaty. Instead, it should be rather calculated as an average inflation rate in the three best performing Member States in terms of price stability which is defined as an inflation rate that is below but close to 2%[13] (*European Parliament resolution on the.* 2006). Assuming the second interpretation the reference value would be equal to 3.4% and Lithuania would fulfil it easily. In turn European Commission takes the stand that concept of "price stability" appears in Maastricht treaty in two different contexts and each one reflects a particular and precise aim. In one case the point is the inflation performance

[12] See footnote no 9.

[13] Maastricht treaty does not state that the reference value should be calculated as the average rate from the countries with the lowest inflation rates. Article 121 (I) of the treaty requires of the candidate countries to achieve a "high degree of price stability" defined as "the rate of inflation which is close to that of, at most, the three best performing member states in terms of price stability". An identical formulation exists in the protocol on the nominal convergence criteria attached to the Maastricht treaty. Article 105a (I) states that "the primary objective of the European System of Central Banks shall be to maintain price stability" and ECB has defined "price stability" since May 2003 as an inflation rate that is "below, but close to, 2%".

of the euro-zone while in the second the focus is on the assessment of the candidate country's preparations for the euro introduction. Convergence inflation reference value based on "an inflation rate close to but below 2%" would mean significant loosening of the criteria and imply unequal treatment of Member States. In commissioners' opinion such a change would be indeed disadvantageous from the economic point of view (*Inflation criterian there.* 2006). This contradiction between European Commission and European Parliament has to be clarified as the transparent and uncontroversial application of the Maastricht treaty provisions by EU institutions is required.

As far as the convergence criterion on price stability is considered there is also another concern if it is reasonable and proper to calculate the reference value allowing for countries remaining outside the euro area[14]. From the economic point of view there is no reason of such proceedings (*Report from the Commission.* 2000, p. 53). On the other hand the question can be asked if it is sensible to take into account only the states that belong to the Euroland as they do not carry out their own independent monetary policy any more and the differences in their inflation rates reflect structural factors rather than varied macro-economic policy. Besides, according to the European Parliament the so-called Balassa – Samuelson effect[15] should be taken into consideration in case of new Member States (*European Parliament resolution on the.* 2006). All these doubts show that the Maastricht criteria need reconsidering and adjusting to the fact that the euro-zone has already been in existence.

Conclusions

The enlargement of the euro-zone can bring a lot of benefits to new EMU participants and the whole European economy as well. Though, there are still a few questions concerning this process that are worth a serious discussion. In case of Central European countries it seems that the economical advantages of fast adaptation of the euro will exceed the potential costs. However, some profound empirical studies of this matter are still needed. Furthermore when a country wants to become a part of EMU it is better to set a near tentative target date of the euro adaptation. Lately the new the EU member states have been exposed to a serious suspicion concerning the double standards of convergence criteria application: separate for old member countries and the new ones which is politically, economically and socially unacceptable.

[14] For instance during the last assessment among the reference states were Sweden, Finland and Poland with the inflation rates 0.9%, 1.0% and 1.5% respectively.

[15] The hypothesis that growing productivity in tradable sector leads to higher relative non-traded goods' prices and an increase of country's inflation rate (see ORŁOWSKI 2001, pp. 2-4).

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