Charting a Course Toward Successful Euro Adoption

Newest EU entrants should reap net gains from joining the euro area

Susan Schadler

THE FIRST WAVE of transition countries to join the European Union (EU) are turning their attention to the next step in their integration with Europe—replacing their national currencies with the euro. Upon joining the EU, these countries also became members of the Economic and Monetary Union (EMU) with a derogation on adopting the euro. This means that each will be committed to taking the step but can choose when to do so.

Joining the euro area will involve major economic changes for these countries. On the benefit side, they will gain in growth and efficiency from closer integration with the euro area; they will also leave behind emerging market risk. The potential cost of monetary union stems from the susceptibility of member countries to asymmetric shocks—economic shocks that affect one or more members differently from the rest of the currency area. Economies linked by a monetary union have a common monetary policy, which may not be the optimal one for a country facing an asymmetric shock. Relinquishing the ability to conduct a national monetary policy could, therefore, result in greater economic volatility unless other macroeconomic policies or behavior—primarily fiscal policy and wage and price flexibility—is effective in smoothing the effects of asymmetric shocks.

Current conditions in the new member states present challenges for the approach to euro adoption. Real convergence—narrowing the gap in real per capita income—is markedly behind that of even the poorest euro area members. While nominal convergence—the narrowing of gaps in inflation—is rather advanced, policy convergence—particularly aligning fiscal deficits—is at least as much of a hurdle in most of the new member states as it was for the most difficult pre-EMU cases. These initial conditions raise questions about the balance of benefits and costs, the

policies that must be put in place for a successful experience in the monetary union, and the challenges of meeting the entry tests—the EU Maastricht convergence criteria. This article examines these questions with a focus on the Central European countries and the kinds of considerations that should guide IMF surveillance in these countries.

Since each new member state is committed to adopting the euro, the critical issues are when and how to do so. The considerations are complex but broadly reflect three distinct questions:

NEWEST EU ENTRANTS

CURRENT EURO AREA
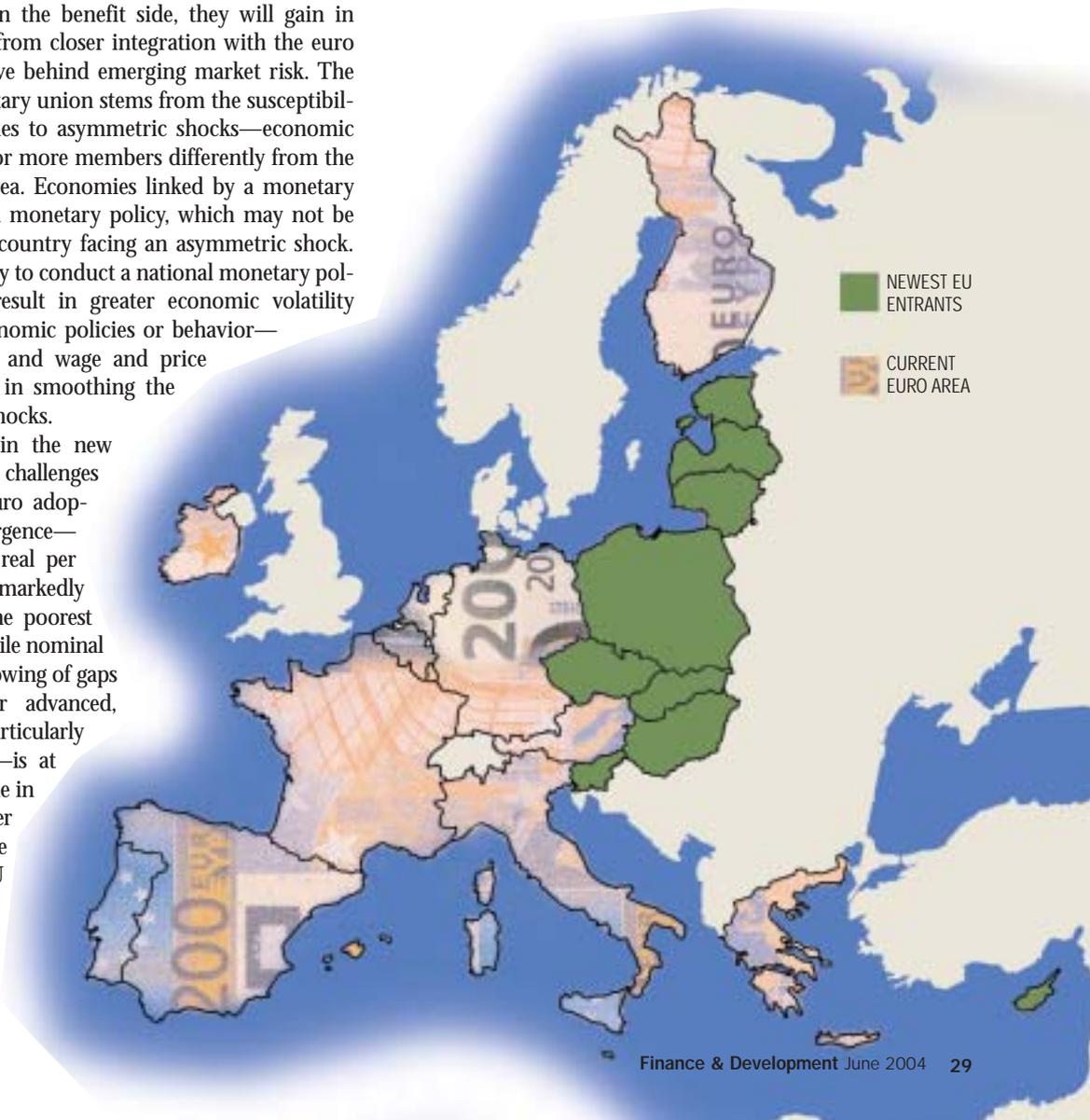
● *Do the long-term benefits of being in the euro area out-weigh the costs?* If the gains from increased trade, growth, and policy discipline are expected to be larger than the costs of relinquishing monetary policy as an instrument for economic stabilization, countries should move ahead quickly to put in place policies necessary for euro adoption. If benefits and costs are balanced and net gains are likely to rise over time, a slower approach to euro adoption might be preferable.

● *What policy or institutional changes are required to ensure a successful experience in the euro area?* Broadly, these involve enhancing both synchronization with the euro area economies and economic mechanisms—such as wage and price flexibility and fiscal policy—for absorbing asymmetric shocks.

● *How long will it take to credibly and efficiently put needed policies in place and to meet the Maastricht criteria?* Any policy regime change carries risks of macroeconomic volatility, and a strategy for managing such risks is essential.

> ## "The Maastricht criteria coincide with goals—low inflation and a conservative fiscal position—that any country should have before joining a low-inflation currency union."

Identifying costs involved in meeting the Maastricht criteria, ways of minimizing these costs, and the optimal time for bearing them is important.

Pros and cons of currency union

Recent research on the benefits of currency unions for trade and income suggests that gains over 20–30 years can be large. For example, a 2003 study by Andrew Rose (University of California at Berkeley), concludes that a currency union can increase trade between members by amounts ranging from 10 to 100 percent—almost entirely through trade creation rather than trade diversion. Together with estimates of the impact of greater trade on income, euro adoption could raise GDP by up to 10 percent over 20 years in Poland and by up to 20–25 percent in most of the other Central European countries. Recent work on the actual experience of EMU in its first four years finds that, even during its short life, it has had positive effects on trade and growth for the existing members that—if continued—could be consistent with large long-term effects.

One unresolved puzzle, however, is what causes increased trade in a currency union. The elimination of foreign exchange risk seems to be an obvious channel. However, studies looking at how exchange rate volatility affects trade in a wide cross section of countries within and outside Europe do not unambiguously point to significant gains from its elimination. And most models of the benefits of currency union membership control for free trade arrangements, so the removal of trade barriers is not the explanation either. This

suggests that other effects of a currency union—notably, lower transaction costs and greater competition and transparency of prices—must play a role. Euro adoption should also produce some other, less well researched benefits, including lower risk premiums on interest rates in member countries and a stronger framework for policy discipline.

These gains must, however, be viewed against the costs of giving up an independent monetary policy as a tool for stabilizing the economy. A key point to bear in mind here is that economies linked by a monetary union are obliged to follow the same monetary policy, whether or not it is appropriate, while economic shocks may differ across countries. The optimum currency area literature, pioneered by Robert Mundell in 1961, assesses the scope for costs associated with the loss of national monetary sovereignty with two aims. The first is to determine a country's susceptibility to real shocks that are asymmetric to those in the broader currency union and that therefore would ideally be met by a country-specific monetary policy. The more weakly synchronized a country's business cycles with those in the broader currency union, the lower its intraindustry trade with the currency union, and the more a country's sectoral composition of output differs from that of the currency union, the more susceptible it is to asymmetric shocks. The second aim is to assess the ability of countries to adapt—mainly through wage and price flexibility but also through the use of countercyclical fiscal policy—to these shocks in the absence of monetary policy.

Generally, the new member states display optimum currency area properties that are as strong as those in the Southern European members of EMU or stronger. Moreover, Jeffrey Frankel and Andrew Rose, among others, argue that entering a currency union can launch processes that change members' economic structures to make them less susceptible and more adaptable to asymmetric shocks.

Two other questions are important in evaluating the costs of relinquishing monetary policy. First, in small open economies such as those in Central Europe, how effective is monetary policy as a shock absorber? Borghijs and Kuijs (2004) suggest that the largest share of recent macroeconomic shocks to Central European economies may have been financial shocks that, in their view, are best countered by fluctua-

Box 1
What is the Balassa-Samuelson effect?

The Central European economies' catch-up to euro area income levels will be driven at least partly by productivity gains from increases in capital-labor ratios and total factor productivity. Generally, these gains are faster for tradable goods—which face foreign competition and tend to attract the larger share of technology-intensive foreign direct investment—than nontradables. As wages in the tradables sector rise with productivity, they also bid up wages in the nontradables sector. To maintain profit margins, prices of nontradables must increase relative to those of tradables. This process is called the Balassa-Samuelson effect.

tions in money supplies rather than by exchange rates. In this case, irrevocably fixing exchange rates may not end up being much of a loss in the arsenal of macroeconomic policy tools. Second, do countries have fiscal, wage, and structural policies that not only help absorb shocks but do not themselves create shocks? Ensuring this—the aim of nominal convergence embodied in the Maastricht criteria—is critical for successful currency union membership.

Whether the gains for trade and growth are likely to exceed the costs from possible macroeconomic volatility is ultimately a matter of judgment. Models that integrate both effects and draw inferences in terms of a single metric—such as net effects on welfare—do not exist. Some observers see the risks of increased volatility in Central European countries that adopt the euro before achieving greater real convergence—and, by extension, they argue, synchronization of shocks—as outweighing the benefits. Others argue that the potential benefits for growth are large; better-disciplined macroeconomic policies might reduce volatility; and susceptibility to asymmetric shocks is, anyway, unrelated to real convergence. After a qualitative weighing of the evidence, an IMF staff study concludes that, on balance, provided countries adopt structural and fiscal policies that minimize economic volatility, euro adoption can be expected to hasten real convergence at the risk of a modest increase in volatility.

Preparing for EMU

The Central European countries approach euro adoption with certain basic macroeconomic characteristics that distinguish them from existing euro area members yet create risks that need careful management. Five specific characteristics stand out:

• These countries should continue to attract *large and possibly volatile net capital inflows.* Reflecting capital-labor ratios, which are a fraction of those in Western Europe, and therefore relatively high rates of return on investment, recent net inflows have been about twice the size relative to GDP as those in the pre-EMU Southern European countries. The predominance of foreign direct investment, typically small derivative markets, and fundamentally high rates of return offer some protection from sudden reversals. But the size of the inflows coupled with the risk of contagion and changing expectations make capital account volatility a vulnerability.

• Productivity growth is likely to be strongest among traded goods, where technology transfers are apt to be largest. Increased productivity should give rise to *real exchange rate appreciations* owing to the so-called Balassa-Samuelson effect (see Box 1). Once nominal exchange rates are indelibly fixed (or movements are constrained), this real appreciation will have to occur through slightly higher inflation in the Central European countries compared with the euro area average.

• *Inflation* in some of these countries is above the optimal rate and, even in those where it is lower (Czech Republic and Poland), it remains unclear whether low inflation will be sustained through the cycle (see chart).

• With bank credit to the private sector in these countries less than half the euro area average, *bank credit booms* are likely.

Banks remain reluctant to lend to enterprises but are already stepping up lending to households. Rapid credit growth could create risks of asset price bubbles and overheating.

• Except in Slovenia, *general government deficits* are large (see table), reflecting moderate revenue ratios but high current primary expenditures, especially on social transfers, relative to per capita GDP. Debt ratios, however, range from low (in the Czech Republic and Slovenia) to borderline high (in Hungary and Poland).

These characteristics mean that the requirements for a successful experience in the euro area—and, perhaps to an even greater extent, for navigating the path to euro adoption—are demanding. Beyond synchronizing economic activity and wage and price flexibility, three elements are of central importance.

Prices coming down
Inflation in the Central European economies has been on an overall trend of convergence with the euro area average.[1]
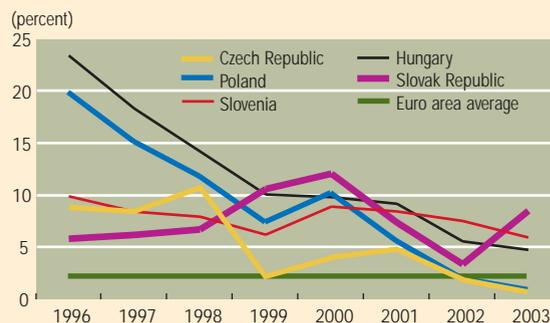
Sources: IMF, *International Financial Statistics*; and IMF staff estimates.
[1]Consumer price index (CPI) inflation for 1996–2003 for the Central European economies and average CPI inflation for 2000–03 for the euro area.

Mixed bag
How the newest entrants fare on fiscal criteria.
(percent of GDP, 2003)

	Fiscal deficit		Debt	
	Government Financial Statistics	European System of Accounts 95	Government Financial Statistics	European System of Accounts 95
Czech Republic	–6.9	–7.6	30.4	30.5
Poland[1]	–6.3	–4.3	50.0	46.2
Poland[2]	...[3]	5.7	...[3]	50.0
Slovak Republic	–5.4	–4.8	44.9	44.9
Hungary	–5.2	–5.2	57.2	57.2
Slovenia	–1.6	–2.0	27.8	27.8
Euro area	...[3]	–3.0	...[3]	70.4

Sources: National authorities; and IMF staff estimates.
Country notes: For the Czech Republic, the Government Financial Statistics (GFS) deficit excludes transfers to the Česká konsolidační agentura (CKA—Czech bank consolidation agency). GFS debt includes debt of the CKA (equivalent to around 6.4 percent of GDP). Including second-pillar pension funds in the general government balance would decrease Hungary's European System of Accounts 95 deficit by around 0.7 percent of GDP. Poland's GFS deficit excludes compensation payments (equivalent to around 0.4 percent of GDP) that will not have to be made after 2004.
[1]Including second-pillar pension funds in the general government.
[2]Excluding second-pillar pension funds from the general government.
[3]Data not available.

What is the ERM2?

The ERM2 is an arrangement that links currencies of prospective euro area members to the euro by establishing a band for exchange rate fluctuations of 15 percent above and below an agreed central parity. The Maastricht exchange rate criterion is not necessarily assessed with respect to this wide band, however. Precedents and official statements suggest that exchange rates would be deemed stable if they remained within a very narrow band (for example, ±2¼ percent). But scope seems to exist for very short term movements below this range and more prolonged movements—though still within 15 percent of parity—above it.

First, fiscal deficits and rigidities from subsidies and formula-driven social transfers must be low. With output and demand growth likely to remain volatile in the Central European countries, prudent debt levels—levels that could be serviced without undue strain on the economy even in slack periods—would be no more than 40–50 percent of GDP. Countries should also have overall fiscal deficits well below the EU's Stability and Growth Pact (SGP) limit of 3 percent of GDP to allow automatic fiscal stabilizers to operate. At the same time, fiscal policy will need to be able to respond nimbly to restrain demand in the event of credit booms.

Second, financial market supervision must be strong. Rapid growth of bank credit to the private sector is almost inevitable, regardless of the timing of euro adoption, as bank intermediation approaches Western European levels. Effective bank supervision, alongside fiscal restraint, will be key to containing any risks of asset price bubbles and overheating—particularly since countries will no longer be able to conduct an independent monetary policy. The large presence of foreign banks in these countries makes coordination of supervision with euro area countries important.

Third, competitiveness must be robust. This principle should guide the choice of the central parity rate for ERM2—the transitional exchange rate mechanism (ERM) that countries have to join at least two years before adopting the euro (see Box 2)—and, later, the euro conversion rate. Downward price and wage rigidities in the new EU members would make adjustment to an overvalued parity costly in terms of employment and forgone growth. An important adjunct to proper conversion rates will be securing low inflation so as to ensure that competitiveness remains strong.

Strategies for the approach to euro adoption

Beyond these basic preparations for strong performance in EMU, each country must elaborate a strategy to meet the Maastricht criteria. These nominal convergence criteria consist of four conditions to be met during a single assessment year: annual average inflation not exceeding by more than 1½ percentage points that of the "three best-performing Member States in terms of price stability"; annual average nominal interest rate on the 10-year benchmark government bond no more than 2 percentage points above the average in the same three countries; a fiscal deficit below 3 percent of GDP, and public debt less than 60 percent of GDP; and the value at which the currency trades against the euro held within the "normal fluctuation margins" of ERM2 without severe tensions for at least two years.

In broad terms, the Maastricht criteria coincide with goals—low inflation and a conservative fiscal position—that any country should have before joining a low-inflation currency union. The new member states are no exception. But charting a course to meet the Maastricht criteria, as well as the basic conditions each country sets for itself, will require strategies that pull together several macroeconomic policy strands.

Fiscal adjustment will be the bellwether of the seriousness of each country's commitment to adopting the euro. Framing and meeting medium-term targets will be essential. Typically, these targets will need to go beyond the Maastricht fiscal criteria to ensure that debt ratios stay within safe ranges and deficits stay within the SGP limits after euro adoption. The short-term effects of this adjustment will be depressing. But in a setting likely to include rapid credit expansion and strong export growth, this process may be appropriate even from a strictly demand management viewpoint. Most important, thoughtful structuring of the adjustment—trimming bloated social transfers and subsidies while fully utilizing EU transfers for infrastructure and other spending—will produce longer-term supply-side benefits. Contrary to concerns in some circles that deficit targets at or below the Maastricht fiscal limits are too restrictive for the Central European countries with still sizable development needs, the IMF staff study views these targets as providing an appropriate medium-term anchor for fiscal policy.

Getting central parities right will be another key part of the strategy. The 1992–93 ERM crisis underscores the importance of avoiding unrealistic parities and responding quickly when signs of misalignment arise. Estimating equilibrium exchange rates will, at best, produce fairly wide ranges: deciding where within the range to set the parity will be part of risk management strategies. In general, the adverse effects of getting parities too low (inflation and overheating) are likely to be less disruptive than those of getting the rate too high (low growth, high unemployment, and the need for downward price and wage adjustments). Attention to minimizing the risks of the latter is thus key.

Low inflation will be essential to preserving competitiveness. The evidence on the Balassa-Samuelson effects suggests that sustainable inflation in these countries will likely be 1–2 percent above that in the euro area once exchange rates are fixed. Countries will need to keep inflation at this level through wage and fiscal restraint. This would put inflation at rates similar to those in the other "catching up" member states—Greece, Ireland, Portugal, and Spain—where the average has been 3.4 percent since the beginning of the common monetary policy. Whether the Maastricht inflation criterion will force the Central European countries to go beyond this during the assessment year remains to be

seen. Interpreting the "three best-performing Member States in terms of price stability" as those closest to the European Central Bank's inflation objective (close to but below 2 percent) would appropriately render a ceiling of about 3–3½ percent. Interpreting them as the three lowest-inflation countries would put the ceiling below 3 percent—lower than rates that should be sustainable in the Central European countries.

Choosing robust monetary policy frameworks will also be critical. Until entry into ERM2, existing, generally well-functioning frameworks—in most cases, inflation targeting with flexible exchange rates—should be continued: these have protected the countries from disruptive effects of capital account volatility by discouraging any presumption of implicit exchange rate guarantees. After ERM2 entry, frameworks will need to be adapted to enhance the stabilizing effects of the central parity, maximize the chances of meet-

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ing the exchange rate stability and inflation criteria, and manage risks of capital flow volatility. The challenge will be to avoid "intermediate exchange rate regimes" between the time-proven safety of a hard peg and a broadly free float. These could invite disruptive market tests of the authorities' resolve to defend a narrow exchange rate band and discourage appropriate risk-hedging investor behavior. Two options are apparent:

● a loose form of exchange rate targeting that would have interest rate policy (together with fiscal policy) aimed at stabilizing the exchange rate over time around the central parity. This would involve no explicit or implicit commitment to a band interior to the ERM2's exchange rate band of 15 percent on either side of parity, nor any role for intervention that could trap the authorities on one side of speculative pressures; or

● a hard peg—akin to a currency board in terms of both its operation and the rigor of supporting fiscal and wage policies.

Ideally, these two frameworks would produce similar outcomes: conservative macroeconomic policies supporting stable exchange market conditions. The choice between them, however, signals to markets how the exchange rate will respond to exogenous disturbances. Under a hard peg, interest rates would bear the immediate brunt of any disturbance; under exchange rate targeting, the exchange rate would. The absence of such clarity—and with it the incentives for investors to cover themselves against risks in open foreign exchange positions—makes the continuum of frameworks between the two (including narrow bands) risky alternatives for these countries.

A final question concerns the time horizon for ERM2. One view is that ERM2 should be used as a testing ground over an indefinite period. That is, managing the exchange rate within a ±15 percent band and gradually narrowing the band to a small margin around the central parity would test policy consistency and the appropriateness of the central parity for final conversion. In this perspective, the exchange rate is an indicator of market sentiment rather than an instrument for managing emerging market risks. An alternative view—favored by IMF staff—is that countries should enter ERM2 only when they are well prepared to adopt the euro upon completion of the two-year mandatory stay. According to this view, entering ERM2 before policies suitable for euro adoption are in place could, by removing the urgency of a clear target date for euro adoption, slow the mobilization of political support for needed policy changes. And, without adequate supporting policies, even a wide band could invite speculative attacks.

Conclusion

With proper supporting policies, euro adoption is likely to bestow substantial net gains on the new member states over the long term and make them stronger, more self-reliant members of the EU. But the policy requirements to make their experience in the euro area successful are rigorous. Even before they enter ERM2, the Central European countries, in particular, will need to embrace fiscal adjustment with determination, secure low inflation, and ensure considerable wage and price flexibility. With this degree of commitment, the economic effects of this major regime change should be manageable and, indeed, prosperity-enhancing. ∎

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