EMU Entry for the New EU States, the Convergence Criteria and the Stability Pact

by

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The title of my speech is *EMU entry for the new member states, the convergence criteria and the stability pact*. I have over the years been doing quite a lot of thinking on the EMU, but I am certainly no expert on the new EU member states and even less of an expert on Estonia. Still, I thought it could be interesting to make a number of reflections on EMU entry for the new member states in general, and for Estonia in particular, from a more principal point of view.

More specifically, I will focus on the following items:

1. A comparison of the arguments for and against a quick EMU entry between Sweden and the new member countries, including then Estonia. I read somewhere that the Swedish decision not to join caused a lot of surprise in Estonia, so this could be a good reason for making this comparison.
2. The consequences for EMU entry of the new member states of the present turmoil regarding the stability pact.
3. The issue of how well the existing EU fiscal rules – if they still exist – are adapted to the situation of the new EU countries.

Let me first turn then to what I do know very well, the Swedish deliberations with respect to EMU membership. In 1995-96 I chaired a Swedish government commission, which had been given the task of analysing the pros and cons of entering the EMU at the start in 1999 as a preparation for the decision of the Parliament. In some respects the Swedish situation vis-á-vis EMU then is similar to the current situation of the new EU countries, so it might be interesting to compare the pros and cons.

The analysis we made then was very much of a *traditional Mundell optimal-currency-area one*, where we tried to trade off the efficiency gains of adopting the common currency (lower transaction costs, reduced exchange-rate risk, and stronger competition if price comparisons are made easier) against the stabilisation policy cost of losing monetary policy as a domestic policy tool in the case of country-specific macroeconomic disturbances in goods and labour markets.

The recommendation of the government commission in 1996 was that Sweden was not yet ready for the monetary union. We judged then the stabilisation policy cost to be very large. There were two main reasons for this:

(1) At the time *unemployment* was still unusually high in Sweden after the deep recession in the early 1990s (with 8 % open unemployment at the maximum and 13 % total unemployment if we add up open unemployment and participation in labour market programmes against earlier usually around 2 % open unemployment and, say, 4 % total unemployment) : for this reason we put a very large weight on the risk of unemployment rising even more if the economy was exposed to additional asymmetric shocks that in the case of EMU membership could not be met through monetary policy.

(2) *Fiscal policy* was not then available as an alternative stabilisation tool because of the large government budget deficits and the high and rising government debt, which meant that the overriding fiscal policy priority was to consolidate the government fiscal position independently of cyclical developments. This would have left no room for expansionary fiscal policy in the EMU if we were to be exposed to an additional recessionary asymmetric shock.

I believe that the arguments for Swedish entry have over time gradually become stronger. For this reason I voted in favour of entering EMU in the referendum last year, a view which was not, as you know, shared by a majority of the voters.

In terms of the economic arguments, I think two three major changes have occured relative to the 1990s:

(1) Unemployment has come down considerably (today in a recession around 5.5 % open unemployment; 7.5 % if we add up open unemployment and participation in labour market programmes). This reduces the risk that we could end up with extremely high unemployment levels if we were to be exposed to asymmetric macroeconomic shocks that cannot be countered in the EMU.

(2) Fiscal policy consolidation has freed fiscal policy for use as a stabilisation policy instrument, which makes it easier to counter asymmetric macroeconomic shocks. Today Sweden is one of relatively few EU countries with a budget surplus in the present downturn.

(3) One must make another judgement of the efficiency gains of a common currency today than earlier. As you know, there has emerged a large research

literature pointing to very large trade effects, which did not exist earlier. Part of this literature is controversial and estimated long-run effects incredibly large (doubling or trebling of trade). But it is difficult not to be impressed by those studies that look at how trade developments have differed between country pairs in the EMU and country pairs outside the EMU, which usually find trade increases from EMU membership somewhere in the 5-30 % range. If one links these studies with other studies that try to measure the impact of more trade on long-run GDP per capita, one has to come up with the conclusion that there is a fair chance that adoption of the euro alone could result in substantial long-run increases in GDP per capita (say somewhere around 5 %).

OK, let me now leave Sweden and move over to the case for EMU entry for the new member states, including Estonia. For these countries I think the balance of arguments is very different. The case for a quick adoption of the euro appears to be much stronger. I see several reasons for this.

A first reason concerns the balance between the *efficiency/growth* and the *stabilisation* arguments. I would find it reasonable to attach a much larger weight to growth considerations relative to stabilisation considerations in the new EU countries than in the old member countries: with the low-per capita income levels one should expect income growth to be the overriding priority and the objective of stabilisation of smaller importance.

But also the stabilisation argument must be evaluated rather differently for the new EU states.

First, I would expect there to be much *more flexibility* in many of the new member states, not least in the Baltic ones, than in Sweden. This could substitute for the loss of domestic monetary policy as a stabilisation tool in the EMU.

1. Higher trend productivity growth means that the trend rate on nominal wage growth will be much higher than in the old EU states. This means larger possibilities to reduce relative wage costs vis-á-vis other countries in a country-specific recession via reductions in the growth of nominal wages, but without nominal wage cuts which are always much more difficult to achieve.

2. Also, the prospects for nominal wage reductions are probably larger because trade unions are weak.
3. Migration flows might be more of a shock absorber than for a country like Sweden. Income differentials are likely to trigger a steady flow of migration, the size of which is likely to vary depending on the relative cyclical position.

The evaluation, of course, also depends on the current exchange rate regime, which differs a lot among the new EU member countries. If one already has a currency peg – and especially a very strong one as in Estonia – monetary policy autonomy has already been given up and EMU entry does not involve any further stabilisation policy loss, except getting rid of the ultimate ”escape clause” that the peg could be abandoned in an extreme situation. This strengthens considerably the argument for joining the EMU as quickly as possible. In parenthesis, a similar argument applies for Denmark, but that was obviously not enough to convince the Danish voters. The argument is not there, however, for the new EU member states with flexible exchange rates: the Czech republic, Hungary, and Poland.

But the greatest difference in my view concerns in my view the nature of potential macroeconomic shocks. The risk that exchange rate variability could itself be a major source of shocks rather than a shock absorber must be judged much greater for the new EU member states than for the old. For the typical OECD country, one usually finds that pure exchange rate shocks are not very important for variability in output and inflation. But in ”emerging markets” – which one should consider the new EU countries to be – there is a very large risk that exchange rate fluctuations can exacerbate rather than dampen macroeconomic disturbances. There are many examples of this: Mexico, the Asian crisis, Russia, Argentina, Turkey and so on.

As you all know, the risk is that large capital inflows fuel rapid domestic credit expansion that can contribute to excessive risk taking and overheating of the economy. But this also makes the capital importing countries very vulnerable to reversals of capital flows, which can be triggered very suddenly when macroeconomic problems arise. If this happens, exchange rate depreciation may in the end be impossible to withstand, which will then exacerbate the crisis to the extent that the domestic value of debt denominated in foreign currency increases, which can cause insolvency and bankruptcies.

I am in no position to judge how serious a problem this might be for individual countries, but it is certainly something that both macro economists in general and portfolio managers are very well aware of. For instance, the IMF has pointed to the large current account deficits in the new EU countries, the high rates of credit expansion, and that the share of more stable FDIs in capital imports have recently gone down. In the recent report of the European Economic Advisory Group at the CESifo Institute in Munich, where I am a member, we also pointed to the currency mismatches existing with large foreign currency liabilities in the banking sector in some of the new EU countries. We were also sceptical that large FDIs would be enough to shield capital importing countries against capital flow reversals, as foreign FDI investors have a strong incentive to hedge against capital losses on their illiquid investments due to currency depreciation by taking a short position in the currency. And we were sceptical that foreign ownership of banks would automatically guarantee liquidity provisions and capital injections in such situations.

All this means that the stabilisation argument against EMU membership is much weaker for the new EU member countries than for old ones like Sweden and the UK. Rather the ”emerging-market argument” is a stabilisation argument for as early entry as possible, as it would seem to say that there are stabilisation benefits of EMU entry that are larger the less ”mature” the entering countries are. The argument is also an argument that the qualification period of ERM membership should be made as short as possible for those new EU states having flexible exchange rates, since the risks associated with capital flow reversals are considerably larger in fixed exchange than in flexible exchange rate regimes, where capital inflows and overheating tendencies can be dampened through contractionary monetary policy.

What about other arguments? In the Swedish debate in the mid 1990s one argument in favour of EMU entry was that there might be a credibility gain for low-inflation policies. This was in my view a quite weak argument for us, and we also proved quite successful in building credibility ourselves by adopting consistent low-inflation policies and making the central bank independent, but for the Southern European countries such credibility gains were certainly important. They could also be important, I guess, for some of the new EU member states: I might have a prejudiced view, but I would believe that political instability in some of the countries could always represent a potential risk for the credibility of low-inflation policies outside the EMU.

Let me then move over to my next point: the consequences for the new member states of the present turmoil as regards the *EU´s fiscal policy rules* and the *stability pact.* What does this imply for the new member states?

Let me first say that I do believe there is a cause for serious worry. This is not because the deviations from the 3 % deficit ceiling in themselves are very serious: they certainly are not in the short term. The worrying thing is instead that the earlier consensus that the rules must be taken seriously to avoid reverting to the earlier situation of the 1980s and early 1990s with rapidly rising government debt is disappearing. I believe the EU in this respect is finding itself on a sliding plane where anything could happen.

Most of the discussion in the EU has concerned France and Germany, but in fact now seven of the old EU members (also Greece, Italy, the Netherlands, Portugal, and the UK) have actual or forecast deficits above the limit and six of the new members (Cyprus, the Czech Republic, Hungary, Malta, Poland, and Slovakia). In all, that is 13 of the 25 member states, not a situation anyone could imagine a few years ago. To some extent this reflects the cyclical situation, but the picture is also worrying in terms of structural deficits. Three of the old member states (France, Germany, and Portugal) and two of the new ones (Cyprus and Malta) are also violating the rule that the government debt ratio must not increase when it is above 60 %. This occurs at the same time as fiscal discipline has waned even more in the US, which is often taken as an excuse for what is happening in Europe.

How does this affect your and other member states´ entry into the EMU? Well, one obvious conclusion is that you may be entering a club that works very differently from what you and everyone else thought. I think you must very seriously contemplate the risk that the other members of the EMU will not in the future exert the fiscal discipline we earlier thought. This could lead to higher interest rates and exchange rate developments that have adverse consequences for you. This could also in the long run weaken the incentives for fiscal restraint in the new member countries. So, what has been happening on the fiscal front clearly makes EMU less attractive to join.

Another question is how the present uncertainty regarding the stability pact will affect the prospects for EMU entry. It might appear logical that looser rules for the EMU countries should lead to a more flexible interpretation of the convergence criteria for entry for the new member states. One could at least expect some of the new member states with large deficits to argue this way. But in my view a looser interpretation of the entry conditions is not very likely, as the rules were in fact applied quite stringently as convergence criteria at the EMU start: Italy, Portugal, Spain and Greece were all forced to make quite substantial sacrifices to qualify for membership.

I would rather believe the opposite, that the present problems of enforcing the stability pact for the current euro countries will give them strong incentives for a very strict interpretation. The simple argument is then that the rules work only as long as they are entry conditions: it is a credible threat not to be admitted into the EMU if deficits are too large. But sanctions – deposits and fines – have been shown not to be credible once a country is in the EMU. For this reason, it may be perceived by the current EMU members to be even more important than before to apply the fiscal rules as convergence criteria for EMU entry, so that new EMU members at least have a sound fiscal position at the time of entry.

Another – but related issue – is what could be done to make the stability pact rules enforceable, an issue where also the new member states have to take a stand. My view is that the root of the problem is the *political decision-making* in the Ecofin Council on the application of the rules. I believe this can never work: since any finance minister knows that he/she might in the future end up in a situation with excessive deficits, there will always be a very strong strategic incentive to be forgiving against colleagues with current problems in order to invest in a nice treatment for oneself if one needs it in the future. (We have just seen this happen. Italy a few weeks ago did not get the early warning it should have had: this clearly was a pay-back from France and Germany for Italy’s support last autumn for breaking off the excessive deficit procedure for these countries).

For this reason I believe that if the rules are to be enforceable, then the application of the rules must be *depoliticised* in some way. This could be done in several ways. The Commission could itself get the right to issue early warnings. The Commission could also be allowed to make a proposal to the Ecofin Council to impose sanctions on a country (instead of as now only to make a recommendation, which would imply that the Commission's view would prevail unless the Council votes unanimously against it). A third possibility, which was proposed by the European Economic Advisory Group, is that decisions on sanctions in the Excessive Deficit Procedure should be moved from the political level of the Ecofin Council to the European Court of Justice (which is something different than as now to let the Court rule *ex post* on the legality of the Council's decisions).

I am not very optimistic regarding the possibilities to restore credibility and enforceability for the fiscal rules at the EU level (except as convergence criteria for EMU entry). I believe the probable development is one where there is more stress on the multilateral surveillance *ex ante*. The sanctions will not be used; instead there will be a lot of talk of "peer pressure" and more qualified judgements taking more factors into account (long-term sustainability, demographic pressures, the cyclical situation etc.). But in effect this will be just a masking of a dismantling of the common fiscal rules. If so once a country has become a member of the EMU, it cannot expect much help from the EU rules to uphold fiscal discipline. This will make it all the more important to design fiscal policy institutions at the national level that promote fiscal discipline.

Here I know far too little about the situation in Estonia. Judging from outside you seem to have established a culture of fiscal discipline and balanced budgets. My only point is that we thought we had done that in Sweden to through government expenditure ceilings and a target of 2-%-of-GDP budget surpluses over the cycle. But – although the fiscal situation in Sweden is far better than in most of the other EU countries – it appears that budget discipline is gradually slipping (the more so, the further we get away in time from the huge deficit problems in the early 1990s).

The conclusion of some economists has been that it is not enough to rely on a political consensus, but there is also a need for strong national institutions promoting discipline. One proposal that has been made is to formulate very clear and transparent objectives for fiscal policy and then institute an independent expert Fiscal Policy Council to survey that government policies are in line with the set objectives. The council would have to be consulted on a regular basis by the government in the budget process. The council could, for example, prepare the calculations that the budget would rely on and it should formulate policy recommendations on how to achieve the fundamental fiscal policy objectives determined by the parliament. The government would of course be free to deviate from the recommendations, but would then have to explicitly motivate why.

The idea is thus to increase the reputational cost at the national level for a government that does not adhere to the long-run objectives it has set. I need not say that this proposal is politically very unrealistic – in fact politicians in Sweden dislike it very much. But if my pessimism about the future developments of fiscal policy is correct, I do believe that we will in the future get a debate on quite radical changes of the national decision-making processes for fiscal policy. (We already have it among economists. The discussion was taken very seriously by, for example, the UK Treasury in its evaluation last year of the pros and cons of UK entry into the EMU: the evaluation raised the idea of requiring the government to write an *open letter* to the Parliament if large output gaps or budget deficits would arise: a procedure modelled on a similar procedure for the Bank of England in the case of significant deviations from its inflation target.)

However, let me move back now again to the EU fiscal policy rules and take them seriously again, as we should at least with their use as convergence criteria. There is also an ongoing discussion, as you know, on possibilities of improving them. The hope then is that better rules should be more legitimate rules and increase the possibilities that the rules can be enforced also as rules for the countries that are already EMU members. One important issue is then how well adapted the rules are for the new member states.

I believe that the first thing one comes to think about then is the discussion about *the golden rule*: that budget deficits should be allowed in the medium term to the extent that they arise from government investment (which give future revenue) and that government investment should be deducted from the deficit when evaluating the 3 % deficit limit. The worry is then that required tax financing of government investment will reduce the level of investment.

I believe there are a number of arguments against such a golden rule:

- All government investment do not give future government revenues
- The risks for creative accounting are increased: that is that current expenditures are counted as investment
- It becomes difficult to draw the line: if government investment is deducted from budget deficits, why should one not do this also with tax cuts stimulating private investment (which increase the future tax base) or with tax cuts increasing employment and so on.
- Why should one not – as the French have proposed – be allowed to deduct military expenditures: they can also be perceived as a kind of investment in maintaining the productive capacity of a country?
- Why should one not deduct costs for education – investment in human capital – which we know is a key factor behind growth?
- Why shouldn't one be allowed to deduct everything?

These arguments imply to me that a golden rule in general is not a very good idea. Introducing it as a general rule would open up for a development further undermining fiscal discipline. This would be a very wrong signal to give in a situation where future demographic developments in most EU countries instead require a reduction in government debt and interest payments in order to give room for future expenditures.

But I can also see a problem for the new EU countries, where there is a need to invest in public infrastructure. Returns to investment are higher both in the private and the public sector. Government investment is also about half a percentage point higher as a share of GDP than in the old EU member states. It would be unfortunate if the EU rules restricted these investments.

I believe one thing that one could contemplate is whether one could take the special situation of the new EU member countries into account. One did not in all likelihood have in mind the membership of countries with so much lower incomes and higher growth when formulating the original rules. Could one think of an *exception* for the new EU states during a transition period? Could one allow a higher deficit ceiling than 3 % of GDP (and a medium-term target permitting a deficit over the cycle) if government investment is higher than a certain threshold (2 or 2.5 per cent of GDP? For example, as long as GDP per capita remains below a certain percentage of the EU average (say 80 %).

There could be an argument for such an exception to the current rules. But there are, of course, complications. Once one begins to introduce exceptions, there will be demands for other revisions also from the old EU states. On the other hand, if one does not show a certain flexibility in order to adapt the rules to new situations, the rules will be perceived as less legitimate.

Another aspect of the fiscal rules relating to the new member countries is that *ceteris paribus* the government debt ratio tends to fall more rapidly there than in the old member states because nominal GDP growth is faster. Since the change (increase) in the debt-to-GDP ratio is equal to the deficit-to-GDP ratio plus the nominal growth rate of GDP times the debt-to-GDP ratio, the debt-to-GDP ratio will develop more favourably in a fast-growing country than in a slow-growing country for a given current budget outcome. Nominal GDP growth in the new member countries will increase faster than in the old both because real GDP growth is faster and because of the Balassa-Samuelson effect implies higher inflation. This does not make much difference for Estonia, since you have so low public debt, but it does for the average new member country: if nominal GDP growth is 7 per cent and the debt ratio 45 %, the automatic reduction in the debt ratio due to nominal growth is 3.15 percentage points, so this could also be an argument for letting a golden rule allow some more fiscal leeway during a transition period.

My point of departure is then that it is the debt ratio and not the current budget situation that is the key variable of relevance when judging the fiscal situation. The main reason for the present focus on the flow budget variable rather than the debt stock was the pragmatic one that debt criteria are more subject to manipulation through privatisations and restructuring of government debt and assets than the current deficit (or rather that it would become too complex to keep track of the ”true” cumulated debt stock value if the reported figures are purged of various bookkeeping transactions in a cumulative fashion, but much easier only to make adjustments of the current balance).

But if one wants to have more of a focus on the debt level one possibility could be to let the deficit ceiling depend on the debt ratio. The argument is then that one of the points of having low government debt ought to be that one gets more room of manoeuvre for fiscal policy, both when it comes to government investment and the freedom of action to run budget deficits in recessions in order to stabilise the business cycle. The European Economic Advisory Group last year proposed a scale, where the deficit ceiling would gradually increase over 3 % when the debt ratio fell below 55 %: according to the proposal the deficit ceiling would be 3.5 % if the debt ratio is 45-55 % (which applies to Sweden) and 5 % if the ratio is below 25 % (which applies to Estonia).

An additional motive for the proposal was to enhance the incentives for fiscal restraint in upswings by providing governments that reduced their debt levels with a more visible prize: this would be the case if they could point to the fact that they had moved the country up a rung (to a more prestigious) category among EU countries.

In our proposal we chose the limit for allowing larger maximum deficits to 55 % in order to avoid relaxing the fiscal rules for Germany and France (and Portugal), which have been the worst sinners. But we also had an eye on the new member states, which would get a larger room for manoeuvre in fiscal policy because of their lower debt ratios than in the old EU members. This would of course apply especially to the Baltic States, and not least to Estonia.

I am approaching the end of my speech. I will not try to sum it. Let me just end by looking at EMU entry from the other point of view, that is from the point of view of the euro countries and the functioning of the EMU. From that point of view it is, of course, an advantage if more countries enter that have opted for stability-oriented monetary and fiscal policies. From that point of view I think that entry both of Estonia and the other Baltic states as well of Sweden and the UK would strengthen the euro area. As far as I can judge it would strengthen the forces working for fiscal discipline.

One could also reflect on what an early entry into the EMU for the Baltic states would have for public opinion in Sweden. One should not exaggerate, but in a somewhat longer time perspective, I think it would have quite some impact on Swedish opinion, making it more positive towards the euro.