EMU entry for the new EU states, the convergence criteria and the stability pact

Main items

- **A comparison of the arguments for quick EMU entry between the new member states and Sweden**
- **Consequences of the present turmoil regarding the stability pact for EMU entry**
- **The EU fiscal rules and the new member states**

Consequences of Swedish entry

- Mundell-type optimal currency area analysis
- Efficiency gains of a common currency
  - lower transaction costs
  - reduced exchange-rate risk
  - stronger competition
- Stabilisation policy cost
  - domestic monetary policy no longer available as domestic policy tool to counter country-specific (asymmetric) macroeconomic shocks in goods and labour markets

High stabilisation policy cost in 1996

1. **Unusually high unemployment after the deep recession of the early 1990s**
2. **Fiscal policy was not available as an alternative stabilisation tool because of large government budget deficits and high government debt**

Changes in Sweden since the mid-1990s

- **Unemployment has come down**
- **Fiscal consolidation has freed fiscal policy for use as a stabilisation instrument**
- **Judgements of much larger efficiency gains**

  - much larger trade effects

  - trade increases of 5-30 percent between countries that have both adopted the euro

  - fair chance that adoption of the euro gives substantial long-run increases of GDP per capita (order of magnitude of 5 %)

Table 6.1

The evolution of exchange rate regimes in acceding countries

	1990	1995	2000	2003
Cyprus				Peg to the euro (±15% band, de facto ±1-2% band)
Czech Republic	Peg	Peg	Managed float	Free float, inflation targeting
Estonia		Currency board	Currency board	Currency board with peg to the euro
Latvia		Peg	Peg	Peg to SDR (euro weight is 29%; ±1% band)
Lituania	Peg	Currency board	Currency board	Currency board with peg to the euro
Hungary	Peg	Crawling bands	Crawling bands	Peg to the euro (±15% band), inflation targeting
Malta				Peg to currency basket (±0.25% band)
Poland	Peg	Crawling bands	Crawling bands	Free float, inflation targeting
Slovakia	Peg	Peg	Managed float	Managed float
Slovenia		Managed float	Managed float	Managed float

Note: IT stands for inflation targeting

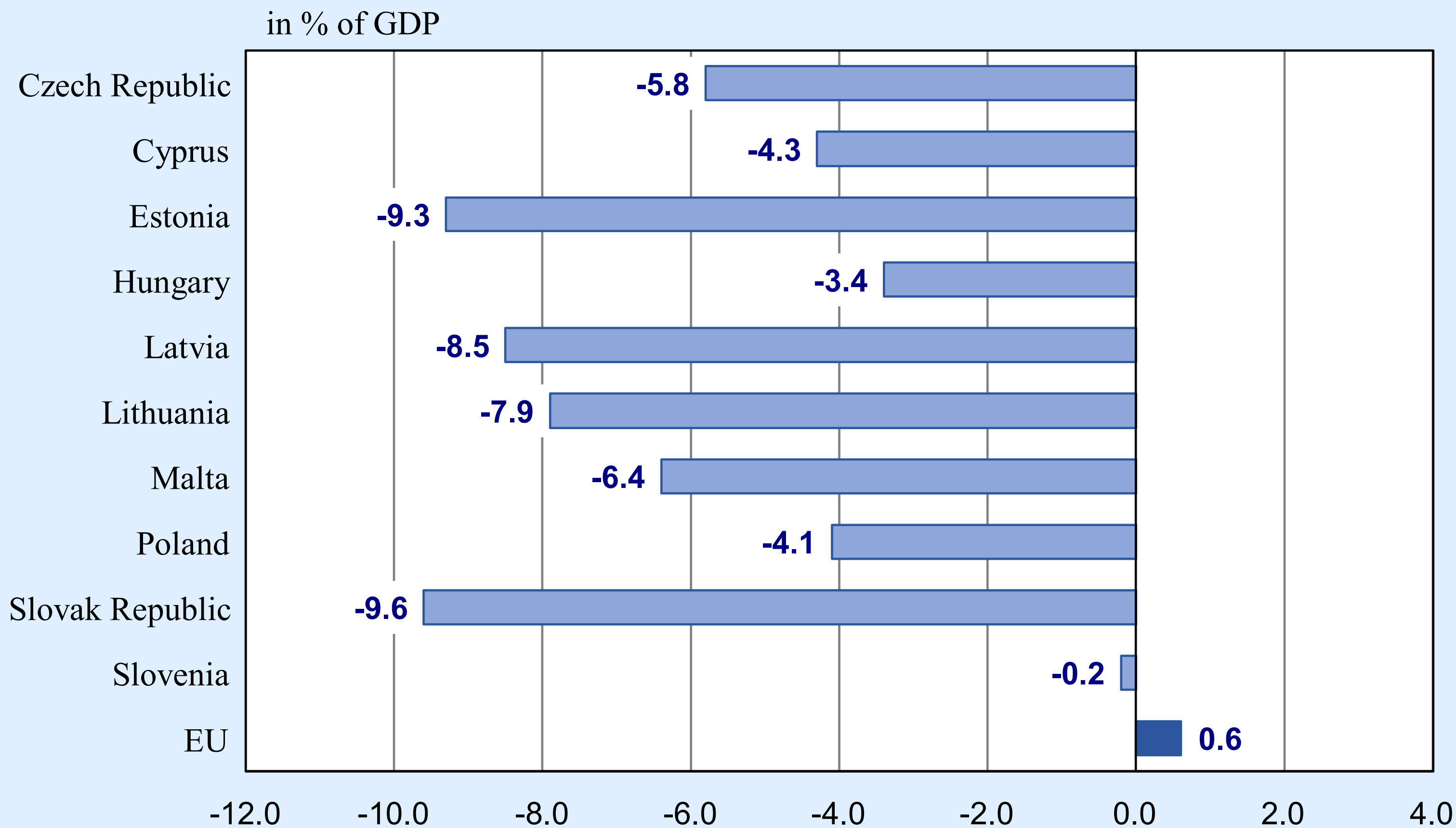
Source: Von Hagen and Zhou (2002); Begg et al. (2003).

Much stronger arguments for quick EMU entry for the new EU states

- Reasonable to attach much larger relative weight to the efficiency/growth arguments
- Smaller stabilisation gain of monetary policy autonomy
  - more nominal wage flexibility: higher trend growth of nominal wages and weaker trade unions
  - steady migration flow which can vary
  - little autonomy if already strong currency peg
- Exchange rate variability is more likely to be a source of shocks rather than a shock absorber
  - emerging markets problem: large capital inflows fuel domestic credit expansion, excessive risk taking and overheating
  - vulnerability to capital flow reversals
  - the domestic value of debt denominated in foreign currency increases if the currency depreciates: risks of widespread insolvencies and bankruptcies

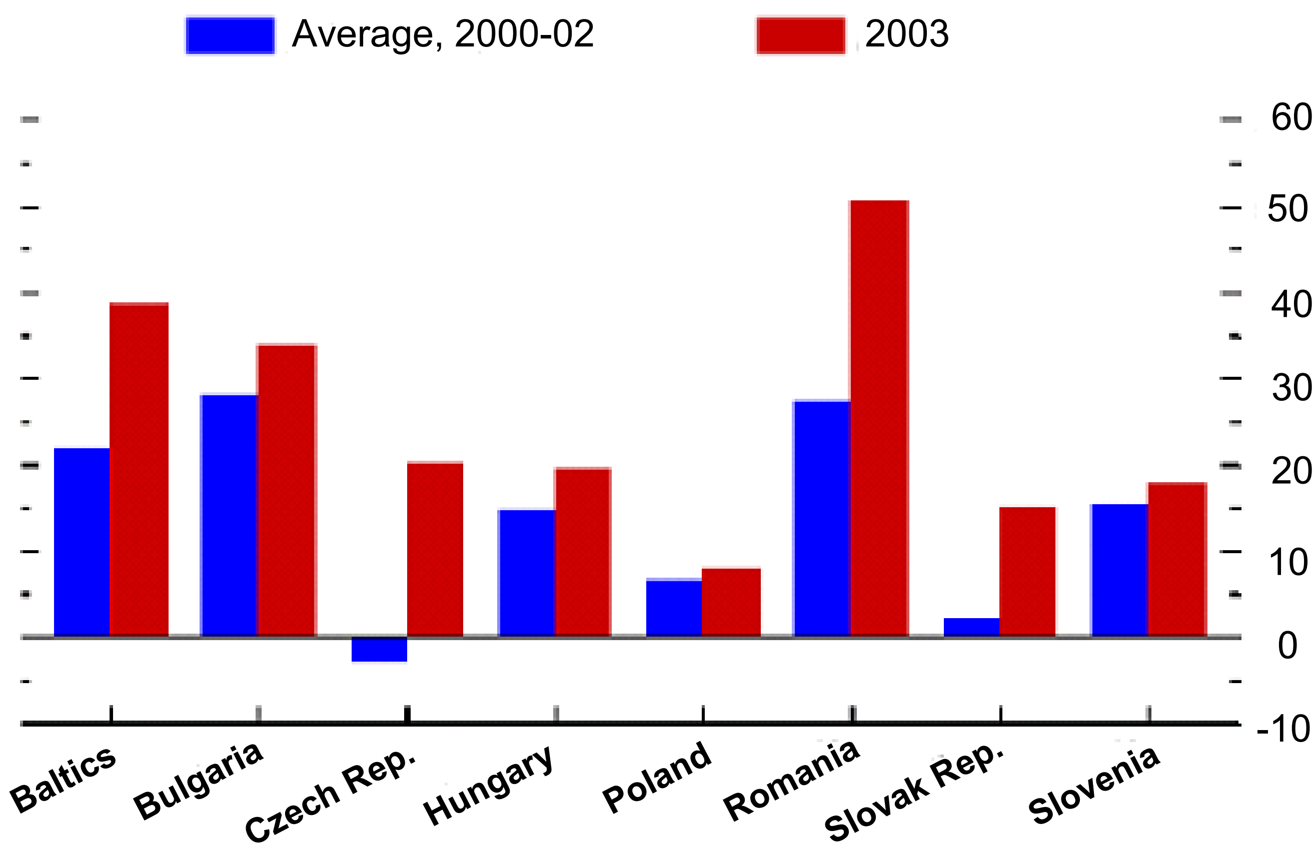
Fig. 5.5

CURRENT ACCOUNT BALANCE IN ACCESSION COUNTRIES
(average for the period 1997 – 2003)



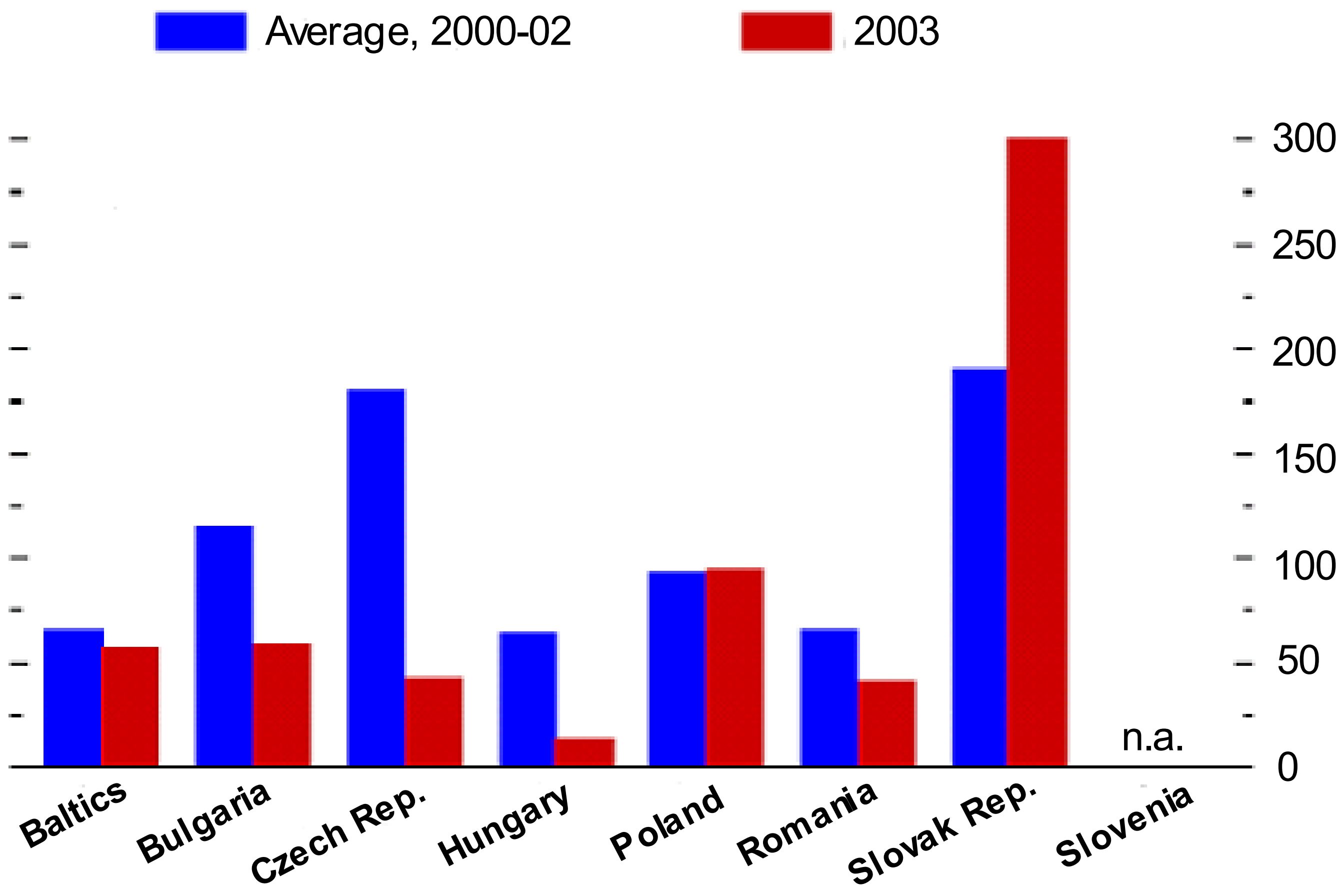
Sources: EBRD Transition Report 2003; European Commission, European Economy Autumn 2003; own calculations.

Credit growth (percent)



Source: Haver Analytics: IMF, International Financial Statistics; and IMF staff calculations.

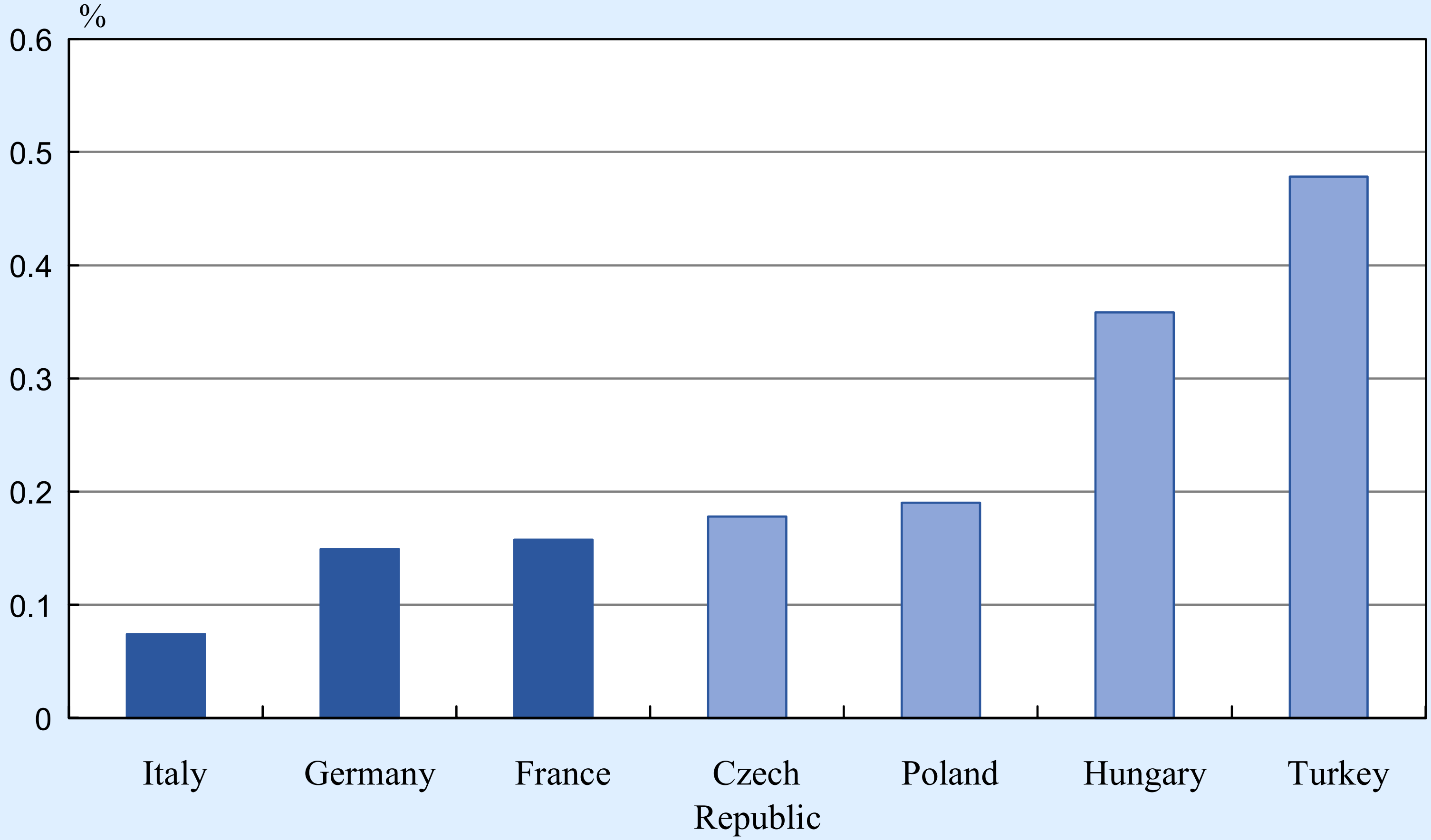
FDI coverage (percent of current account deficit)



Source: Haver Analytics: IMF, International Financial Statistics; and IMF staff calculations.

Fig. 6.3

Share of Foreign Currency Liabilities in the Banking System in 1999



Source: OECD, Database on Bank profitability, financial statements of banks, 1999.

The stabilisation argument against early EMU entry is weak for the new EU countries

- Large FDIs may not shield against capital flow reversals
- Nor may foreign ownership of banks
- The emerging-markets argument rather provides a stabilisation argument for as early an EMU entry as possible
- ERM membership should be as short as possible
- Also potential credibility gains for low-inflation policies
  - possible parallel to the Southern European countries
  - political instability?

The crisis in the stability pact

- Risk of reverting to earlier situation of excessive rises in government debt
- 7 out of 15 old EU states have actual or forecast deficits in excess of the 3-%-limit
- 6 out of 10 the new member states are in the same situation
- In all 13 out of 25 member states are in this situation
- 3 out of 15 old EU states also violate the rule that the government debt ratio must not increase if it is above 60 %
- 2 out of 10 new EU states violate the same rule
- Fiscal discipline is even less in the US

Net lending old member states (percent of GDP)

	2003	**2004**	**2005**
Austria	-1,1	-1,1	-1,9
Belgium	0,2	-0,5	0,7
Finland	2,3	2,0	2,1
France	**-4,1**	**-3,7**	**-3,6**
Germany	**-3,9**	**-3,6**	-2,8
Greece	-3,0	**-3,2**	-2,8
Ireland	0,2	-0,8	-0,1
Italy	-2,4	**-3,2**	**-4,0**
Luxembourg	-0,1	-2,0	-2,3
Netherlands	**-3,2**	**-3,5**	**-3,3**
Portugal	-2,8	**-3,4**	**-3,8**
Spain	0,3	0,4	0,6
Euro area	-2,7	-2,7	-2,6
Denmark	1,5	1,1	1,5
Sweden	0,7	0,2	0,7
UK	**-3,2**	-2,8	-2,6
EU-15	-2,6	-2,6	-2,4

Source: European Commission (2004)

<u>**Net lending new member states (percent of GDP)**</u>

	2003	**2004**	**2005**
Cyprus	**-6,3**	**-4,6**	**-4,1**
Czech Republic	**-12,9**	**-5,9**	**-5,1**
Estonia	2,6	0,7	0,0
Hungary	**-5,9**	**-4,9**	**-4,3**
Latvia	-1,8	-2,2	-2,0
Lithuania	-1,7	-2,8	-2,6
Malta	**-9,7**	**-5,9**	**-4,5**
Poland	**-4,1**	**-6,0**	**-4,5**
Slovakia	**-3,6**	**-4,1**	**-3,9**
Slovenia	-1,8	-1,7	-1,8
EU-10	**-5,7**	**-5,0**	**-4,2**

Source: European Commission (2004)

Government debt old member states (percent of GDP)

	2003	**2004**	**2005**
Austria	65,0	65,5	65,3
Belgium	100,5	97,4	94,3
Finland	45,3	44,5	44,3
France	**63,0**	**64,6**	**65,6**
Germany	**64,2**	**65,6**	**66,1**
Greece	103,0	102,8	101,7
Ireland	32,0	32,4	32,6
Italy	106,2	106,0	106,0
Luxembourg	4,9	4,5	3,8
Netherlands	54,8	56,3	58,6
Portugal	**59,4**	**60,7**	**62,0**
Spain	50,8	48,0	45,1
Euro area	**70,4**	**70,9**	**70,9**
Denmark	45,0	42,3	40,0
Sweden	51,9	51,8	50,5
UK	39,9	40,1	40,6
EU-15	**64,0**	**64,2**	**64,2**

Source: European Commission (2004)

Government debt new member states (percent of GDP)

	2003	**2004**	**2005**
Cyprus	**72,2**	**74,6**	**76,9**
Czech Republic	37,6	40,6	42,4
Estonia	5,8	5,4	5,3
Hungary	59,0	58,7	58,0
Latvia	15,6	16,0	16,1
Lithuania	21,9	22,8	23,2
Malta	**72,0**	**73,9**	**75,9**
Poland	45,4	49,1	50,3
Slovakia	42,8	45,1	46,1
Slovenia	27,1	28,3	28,2
EU-10	42,2	44,4	45,2
Euro area	**70,4**	**70,9**	70,9
EU-15	**64,0**	**64,2**	64,2
EU-25	**63,1**	**63,4**	63,4

Source: European Commission (2004)

Cyclically adjusted net lending (percent of GDP)

	2003	**2004**	**2005**
Austria	-0.9	-0.9	-1.8
Belgium	0.7	0.0	-0.5
Finland	2.3	2.1	2.2
France	**-3.8**	**-3.3**	**-3.3**
Germany	**-3.2**	**-3.0**	**-2.5**
Greece	**-3.3**	**-3.7**	**-3.3**
Ireland	0.1	-0.3	-0.2
Italy	**-1.9**	**-2.6**	**-3.6**
Luxembourg	0.0	-1.3	-1.6
Netherlands	-1.7	-1.4	-0.9
Portugal	-1.7	-2.0	-2.4
Spain	0.4	0.6	0.7
Euro area	-2.2	-2.2	-2.2
Denmark	2.0	1.3	1.4
Sweden	0.7	0.2	0.7
UK	-2.8	-2.5	-2.3
EU-15	-2.1	-2.1	-2.1

Source: European Commission (2004)

Consequences for new member states

- **You are joining another club than the one that seemed to exist a few years ago**
  - **weaker incentives for fiscal restraint**
  - **possible adverse consequences in terms of interest rate and exchange rate developments for new entrants of lax fiscal discipline**
- **How will the convergence criteria be interpreted?**
  - **lax interpretation in line with the lax interpretation for the old member countries in the EMU**
  - **but the rules were applied as entry criteria for the old EU countries**
  - **incentives for a very strict interpretation**
  - **the enforcement of the rules is credible as long as the rules are entry conditions but not after EMU entry**

Can the EU fiscal policy rules be enforced?

- The root of the problem is the political decision-making in the Ecofin Council
  - strategic incentives to be forgiving
- The application of the rules must be depoliticised
  - give the Commission alone the right to issue early warnings
  - sanction proposals from the Commission that can be voted down only unanimously in the Council
  - sanction decisions at the judicial level of the European Court of Justice instead of at the political level of the Council

EU fiscal policy rules may not be working

- Fiscal discipline may have to be achieved at the national level
- It may not be enough to rely on a "culture" of fiscal discipline
- Need for building institutions promoting discipline
- Transparent policy framework with clearly defined budgetary and stabilisation objectives
- Independent Fiscal Policy Council to oversee that government policies are in line with set objectives
  - regular consultation by the government
  - preparation of calculations to base the budget on
  - policy recommendations how to achieve the basic objectives
  - deviations of government policies must be publicly motivated
  - basic idea: increase the reputational costs for policy makers of deviating from set objectives
- UK Treasury: open letter from government to the parliament if large output gaps or budgetary objectives are violated

Can the EU fiscal rules be improved?

- On-going discussion
- Are better rules more enforceable rules?
- How well adapted are the rules to the situation of the new EU members?

Arguments against a golden rule

- **Many government investments do not give future revenues**
- **Increased risks for *creative accounting***
- **Where should one draw the line?**
  - **tax cuts stimulating private investment**
  - **tax cuts stimulating employment**
  - **military spending**
  - **human capital investment**
  - **everything?**
- **Demographic development speaks against general loosening of budgetary objectives**

Government investment as share of GDP

	2003	2004	2005
Cyprus	0.0	0.0	0.0
Czech Republic	4.4	4.4	4.4
Estonia	4.7	4.5	4.3
Hungary	3.2	4.5	4.6
Latvia	2.4	2.3	2.2
Lithuania	2.9	3.2	3.2
Malta	5.1	5.1	4.9
Poland	3.5	3.5	3.7
Slovakia	3.0	2.7	2.5
Slovenia	0.0	0.0	0.0
EU-10	3.0	3.1	3.1
EU-15	2.4	2.4	2.5

Source: European Commission (2004)

The new member states

- **Need for investing in public infrastructure**
- **Larger government investment than in the old member states**
- **Possible *golden-rule exception* during *transition period***
- **Higher deficit ceiling and medium-term target per-mitting deficit over the cycle if government investment above threshold (2-2.5 % of GDP) and GDP per capita below certain level (80 % of EU average?)**
- **Risk for demands from old EU states**
- **But rules that are not adapted to new situations are considered less legitimate**

Focus on the stock of government debt rather than the flow budget concept

- Higher growth of nominal GDP in new EU states mean faster reduction of government debt ratio
  - change in debt-to-GDP ratio = deficit-to-GDP ratio minus nominal GDP growth x debt-to-GDP ratio
  - catching-up effect and Balassa-Samuelson effect
- Focus on current budget outcomes rather than on debt because of smaller possibilities of manipulating the data
- Let the deficit ceiling depend on the debt ratio
- Low debt ratio should give larger room for manoeuvre in terms of government investment and stabilisation policy
- Stronger incentives for fiscal restraint in upswing by providing politicians with a more visible prize in terms of possible movements to a higher category

A possible way of letting the deficit ceiling depend on the debt ratio

Debt ratio (% of GDP)	Deficit ceiling (% of GDP)	Countries in the range (debt ratio in parenthesis)
<25	5.0	Luxembourg (4.5), **Estonia (5.4)**, **Latvia (16.0)**, **Lithuania (22.8)**
25-35	4.5	**Slovenia (28.3),** Ireland (32.4)
35-45	4.0	Denmark (40.0), UK (40.6), **Czech Republic (40.6),** Finland (44.5)
45-55	3.5	**Slovakia (45.1),** Spain (48.0), **Poland (49.1),** Sweden (51.8), Netherlands (56.3)
>55	3.0	**Hungary (58.7),** Portugal (60.7), France (64.6), Austria (65.5), Germany (65.5), **Malta (73.9)**, **Cyprus (74.6),** Belgium (97.4), Greece (102.8), Italy (106.0)

Note: New EU states in italics. All data are are Commission forecasts for 2004.