

The euro and the new EU members

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European Central Bank

Main objective: price stability safeguarding the value of the euro.

Executive Board, Governing Council and General Council

Executive Board: President + Vice-P. + four members (appointed by common accord by euro countries)

- implement monetary policy and manage the day-to-day ECB
- prepare Governing Council (GC) meetings and exercise delegated powers from the GC

Governing Council: Executive Board + Governors of NCB of euro countries

- formulate monetary policy for the euro area (targets & indicators)
- guidelines and decisions about the Eurosystem

Two meetings per month

European Central Bank

General Council: President and Vice-P. of ECB + governors of the 25 EU members (transitional body)

- tasks for Stage Three of Economic and Monetary Union
- many tasks about advisory and collection of information
- preparations for irrevocably fixing the exchange rates to adopt the euro
- characteristic: high degree of **integration of candidates countries** in the tasks of the ESCB

European Central Bank

Independence of ECB

- Financial and management
- Political
- Operational (not goals)

Transparency (from the point of view of ECB)

Credibility (and predictable policy measures)

Accountability (the Annual Report has to be addressed to the EP, EU Council and EC)

Stage Three for New Countries

The New Member States went straight into **Stage Three of EMU** on 1st May 2004: member States with a derogation.
(Stage Three began on 1st January 1999)

They will adopt the euro respecting the **convergence conditions**:

- high degree of price stability
- sound fiscal situation
- stable exchange rates
- converged long-term interest rates

Crucial role of **Convergence Reports of ECB**.

Price Stability and Fiscal Consolidation

Price stability

- Sustainable evolution of prices
- Average annual rate of inflation (HICP) not exceeding 1.5 percentage points + the average of the 3 best

Fiscal situation

- Non existence of a excessive deficit problem
- Reference values for the excessive deficit
 - 3% of GDP deficit
 - 60% of GDP government debt

... and Exchange Rate Stabilisation

More at the level of fiscal situation:

- if the deficit exceeds government investment expenditures ...
- medium-term economic and budgetary projections
- report of ECB about fiscal developments (deficit and debt)

Exchange rate developments

- (1993: $\pm 2.25\%$ (derogation 6%) $\rightarrow 15\%$ (...))
- no severe tensions for at least two years (short-term interest rate differentials)
- no devaluation against the euro

Long Term Interest Rate

Development of long term interest rate

- LT i. r. as a consequence of convergence ...
- nominal LT i.r. not exceeding 2 p.p. + average of LT i.r. of 3 best on inflation (i.r.: government bonds, one year and average 12 months)

Evolution of **short term interest rate differentials** for the analysis of exchange rate sustainability.

Decision

The **Council** by **qualified majority** decides which members meet the necessary convergence conditions for the euro and sets the irrevocable conversion rate.

... *the Economic Process of Convergence*

- The **path for the euro** can be apparently a motorway.
- **Nominal convergence** is not a end but a way to obtain a grater level of welfare.
- The new member states are (now) **market economies**. But with greater problems in terms of the “rule of law” essential for “the market” than some of the older members.
- **Wide range of exchange rate systems**: fixed e. r., currency board and relatively free floating.
- **Balassa-Samuelson** effect: higher growth then higher inflation → higher flexibility at interest rates and exchange rates

... *the Economic Process of Convergence*

- **Rebelo-Vegh** (1995): real exchange rate evaluation is more efficient to achieve inflation stability on short term than monetary (and fiscal) policy. But in the (medium) long run this kind of policy has higher costs in terms of employment and production. So, short living governments or urgent results, and exchange rates stabilisation policies are politician friendly.
- Trade-off between “economic institutions” and “trust on politicians” is biased in favour of “economic institutions” - see in this case the “euro” -. Voters make an inversion of means and aims: **with the euro governments are forced to maintain macroeconomic stability**. What we normally ignore is the amount of costs of this decision - the above bias.

National Statistical Data

Countries	Yr_{03}	U_{May04}	$DevGDP_{PPP03}$	GDP_{USD}
Czech R	2.9	8.4	-31.3	Lithuania + Cyprus
Estonia	5.1	9.1	-51.2	Latvia + Estonia
Cyprus	2.0	4.2	-16.7	+ Malta =
Latvia	7.5	10.6	-54.7	2xLuxembourg
Lithuania	9.0	11.5	-54.1	Hungary + Slovakia
Hungary	2.9	5.9 <i>June</i>	-39.2	+ Slovenia =
Malta	1.7 ₀₂	8.9	-22.5	Portugal
Poland	1.3 ₀₂	18.9	-53.8	Czech R =
Slovenia	2.3	6.4	-23.0	1/2 Finland
Slovakia	4.2	16.4	-48.9	Poland =
EU ₂₅	0.8	9.0		1/2(Austria+Finland)
euro	0.5	9.0		

Convergence Data

Countries	$HCPI_{May04}$	def_{05}	D_{05}	$r_{April04}^{LT}$	CA_{05}
Czech R	2.6	5.1	42.4+	4.60	-6.6
Estonia	3.7	0.0	5.3	4.63	-9.1
Cyprus	1.2	4.1	76.9+	5.17	-3.5
Latvia	6.1	2.0	16.1	4.89	-10.9
Lithuania	1.0	2.6	23.2	4.55	-5.9
Hungary	7.8	4.3	58.0	7.89	-5.8
Malta	3.0	4.5	75.9+	4.65	-3.9
Poland	3.5	4.5	50.3+	7.02	-3.6
Slovenia	3.9	1.8	28.2	4.83	-0.6
Slovakia	8.2	3.9	46.1	5.06	-4.0
EU ₂₅	2.3 (1.2)	2.5	63.4	(4.11)	0.8
euro	2.5	2.6	70.9		1.4

Convergence Data for Applicant Countries

Countries	<i>deficit</i> ₀₃	<i>deficit</i> ₀₅	<i>D</i> ₀₃	<i>D</i> ₀₅
Bulgaria	0.1	1.0	46.2	43.2
Romania	3.0	3.0	21.8	23.5
Turkey	7.1	6.0	87.4	77.5

Applicant Countries: Bulgaria and Romania

Bulgaria:

- The process to a market economy began rather late and the political support was not always clear
- Russian financial crisis and the war in Kosovo had negative impact
- After a erratic but negative growth trend in 1999 production recorded real growth
- Inflation had an erratic downward trend but in 1996 the e.r. collapse led to hyperinflation
- The introduction of currency board system (1997) stabilised the e.r. but the CB is still not politically fully independent.

Applicant Countries: *Bulgaria and Romania*

Romania:

- Until 2002 Romania had made limited progress in adopting the EMU acquis
- The process for a market economy began only after the end of 1996. And is still now too much incomplete
- From 1997 to 2002 the average growth of real product was negative (-1%) → no real convergence!
- The public deficit stabilised. Inflation fell from 177.5% (June 1997) to 23% (July 2002)
- The exchange rate (floating freely, officially) has been used to curb inflation
- Informal economy is still important (\pm 30-40%)
- The CB and the financial markets would be independent from public authorities only at the end of 2004