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Economics Revision Focus: 2004

A2 Economics

Enlargement Countries and the Euro

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Revision Focus on Enlargement Countries and the Euro

A2 Syllabus Requirements:

European Union Enlargement – widening of European integration

The performance of existing members of the EU compared with applicants. The economic consequences of admitting new members

The European Single Currency

The euro: technical considerations, e.g. conversion costs; entry qualifications (convergence criteria) and their effects; single market considerations, e.g. price transparency, effects on competition.

Accession Countries and the Euro

On 1 May 2004, ten countries joined the EU: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Malta and Cyprus. These countries will not automatically adopt the Euro, although a large number of them have expressed a desire to join the euro zone as quickly as is economically feasible. One of the quirkier consequences of EU enlargement is that overnight, there are more EU members outside the Euro Zone than inside! There are currently 12 members of the Euro Zone and 15 countries outside of the single currency!

Convergence rules

To achieve membership of the Euro, these countries must first fulfil the **convergence criteria** laid down in the **Maastricht Treaty**. This Treaty stipulates for example that a country should spend at least **two years in the ERM following EU accession**. This would mean the earliest an acceding country could enter the euro area is 2006 – the likelihood is that some accession countries will seek to join the Euro in 2007 or 2008. It will be a gradual process – with perhaps three or four countries joining in the first instance and then progressively more over the next five or six years.

Switching to semi-fixed exchange rates

The current front-runners among the new EU members appear to be **Cyprus, Estonia, Lithuania and Slovenia** who have all indicated they could join the **Exchange Rate Mechanism 2** - the "waiting room for the single currency" – later in 2004. That means they would have to **fix their currency against the euro** within a **fluctuation band** of 15 per cent. In effect they are joining a **semi-fixed exchange rate system** where the value of the currency finds its own market determined level from day to day, but where the central banks stand ready to **intervene with official buying and selling** of currency and changes in **short-term interest rates** if the currency comes under pressure.

Hungary is planning to join the euro in 2008, with **Poland** and the **Czech Republic** a year later.

Many of the accession countries have experience in handling semi-fixed exchange rates during their years of transition from the eastern bloc. For example, **Estonia** has had a fixed currency regime since 1992, longer than France or the Netherlands. Latvia, Lithuania, Cyprus and Malta have all had **currency pegs** for many years. And under the terms of Exchange Rate Mechanism 2, the European Central Bank would stand ready to defend a currency in the FOREX markets should it come under speculative attack.

This was not the case during the UK's short-lived membership of the ERM from October 1990 – September 16th 1992, when Bank of England currency reserves proved woefully inadequate to protect sterling from wave after wave of speculative selling.

All of the new member states are bound by the EU's **fiscal stability and growth pact**, but are being given extra time to comply with its 3 per cent of GDP **budget deficit ceiling**.
Criteria to join the euro zone pose hurdle

In order to adopt the common currency, the new EU member states have to fulfil the criteria set up in the **Maastricht treaty**:

1. The rate of inflation cannot exceed that of the euro zone's three most stable countries by more than 1.5 percentage points.
2. Long-term interest rates can only be 2 percentage points higher than in those countries.
3. No exchange rate realignment for at least two years.
4. A government budget deficit of no more than 3 percent of gross domestic product
5. National debt cannot be higher than 60 percent of gross domestic product

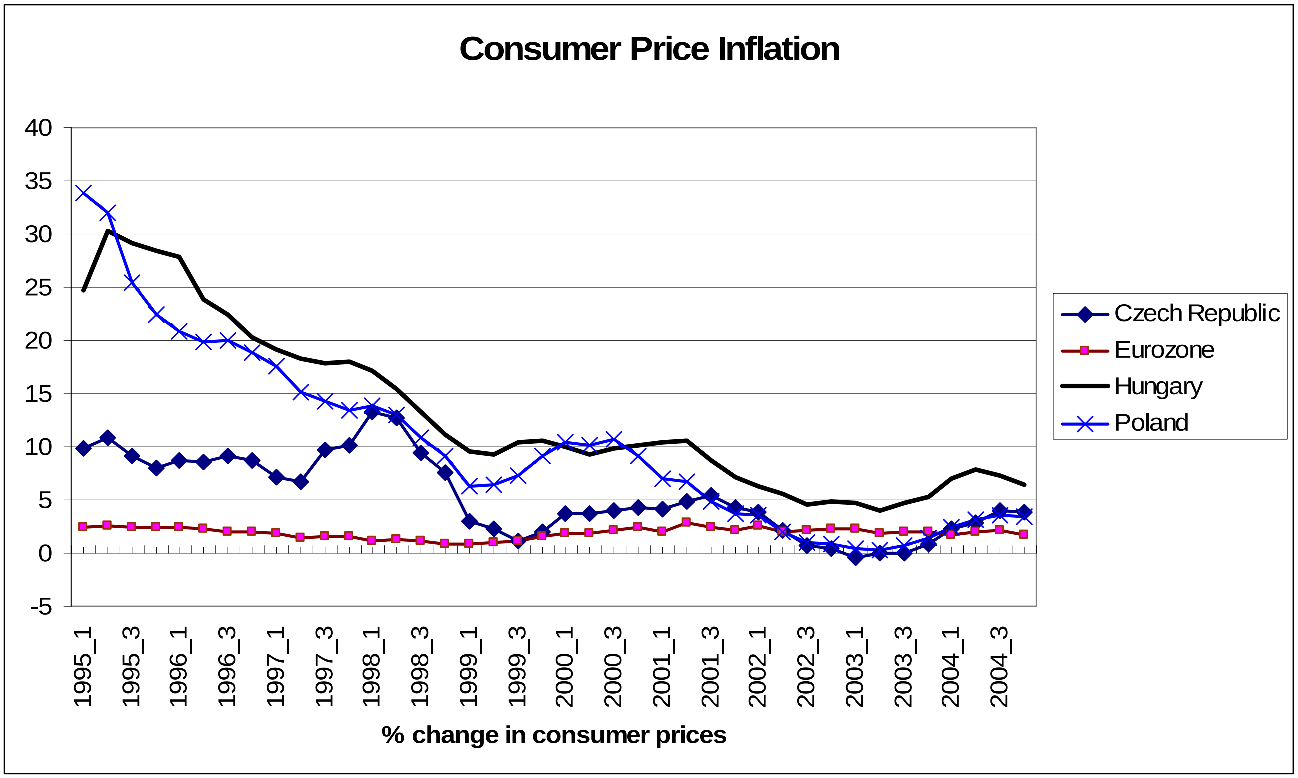
Why are these convergence criteria thought to be important?

1. **Living with the ECB's rate of interest:** Economic convergence is needed for member states within the Euro to be able to live permanently with a single rate of interest – the "one size fits all" idea where countries must accept the short term rate of interest determined by the European Central Bank
2. **Consolidating macroeconomic stability:** A single currency area comes under pressure if member nations have wildly different rates of inflation, government borrowing and government debt. Remember that there is no exchange rate adjustment process *within* the Euro Zone, so a country that has relatively high inflation can quickly lose price and cost competitiveness against fellow members (with consequences for growth and unemployment) unless they take action to bring inflation under control
3. **Providing a platform for the single market:** Economic theory suggests that currency unions work best in promoting growth, trade, investment and general macroeconomic stability when there is a degree of **real** as well as **cyclical convergence** between member countries. One of the issues here is whether a common currency encompassing twenty or more nations takes the Euro Zone well beyond the size consistent with an **optimal currency zone**!

How have accession countries fared in terms of bringing their macroeconomic performance closer into line with the well established members of the Euro Zone? We now consider some of the evidence for a selection of accession countries.

Inflation

Significant progress has been made by accession countries in achieving lower and more stable rates of consumer price inflation compared to the Euro Zone average. Indeed, in 2003 three of the new EU member states (Lithuania, Poland and the Czech Republic) had the lowest inflation rates of any country now in the EU.



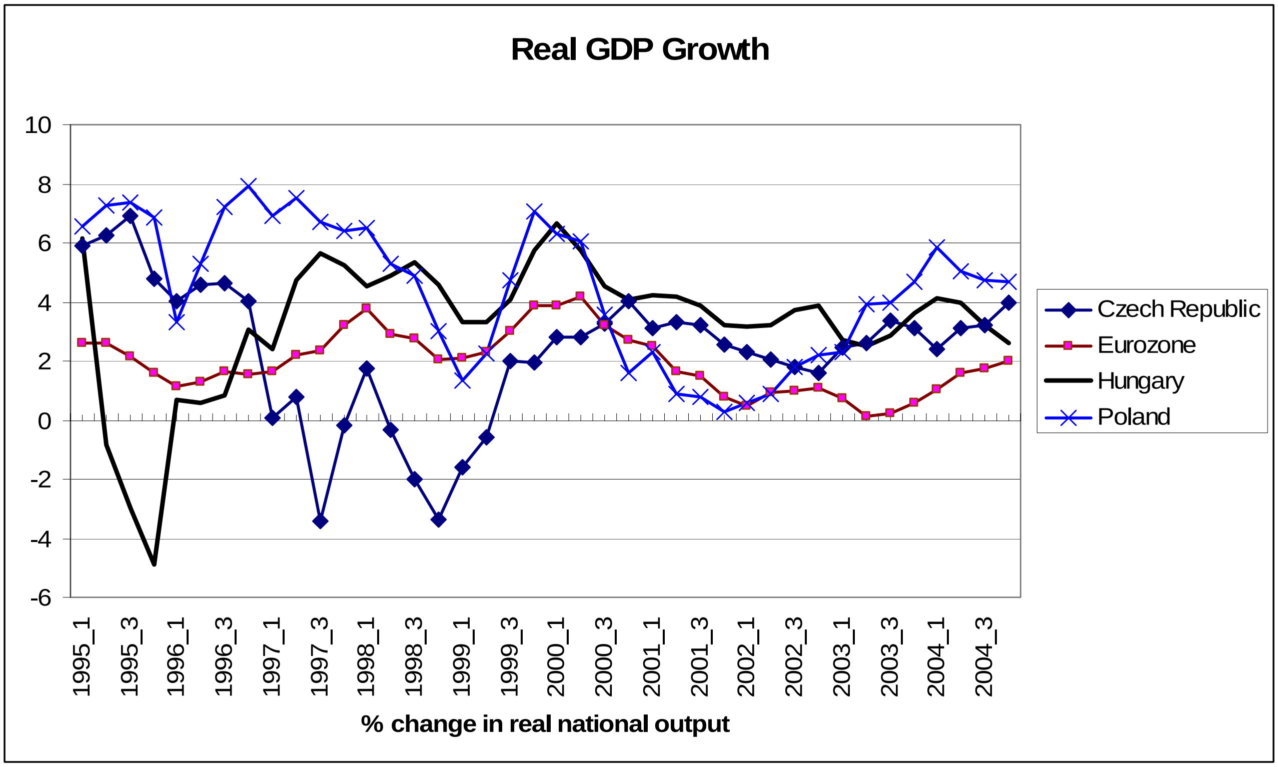
Consumer Price Inflation in EU Countries

Annual & change in consumer prices

	1997	1998	1999	2000	2001	2002	2003	Average
Hungary	18.5	14.2	10	10	9.1	5.2	4.7	8.9
Slovakia	6	6.7	10.4	12.2	7.2	3.5	8.5	7.8
Slovenia	8.3	7.9	6.1	8.9	8.6	7.5	5.7	7.6
Poland	15	11.8	7.2	10.1	5.3	1.9	0.7	7.4
Estonia	9.3	8.8	3.1	3.9	5.6	3.6	1.4	5.1
Czech Republic	8	9.7	1.8	3.9	4.5	1.4	-0.1	4.2
Greece	5.4	4.5	2.1	2.9	3.7	3.9	3.4	3.7
Latvia	8.1	4.3	2.1	2.6	2.5	2	2.9	3.5
Ireland	1.2	2.1	2.5	5.3	4	4.7	4	3.4
Malta	3.9	3.7	2.3	3	2.5	3.1	2.6	3.0
Portugal	1.9	2.2	2.2	2.8	4.4	3.7	3.3	2.9
Cyprus	3.3	2.3	1.1	4.9	2	2.8	4	2.9
Netherlands	1.9	1.8	2	2.3	5.1	3.9	2.2	2.7
Spain	1.9	1.8	2.2	3.5	2.8	3.6	3.1	2.7
Lithuania	8.8	5	0.7	0.9	1.3	0.4	-1.1	2.3
Italy	1.9	2	1.7	2.6	2.3	2.6	2.8	2.3
Denmark	1.9	1.3	2.1	2.7	2.3	2.4	2	2.1
Luxembourg	1.4	1	1	3.8	2.4	2.1	2.5	2.0
Finland	1.2	1.4	1.3	3	2.7	2	1.3	1.8
Euro-zone	**1.6**	**1.1**	**1.1**	**2.1**	**2.3**	**2.3**	**2.1**	**1.8**
Belgium	1.5	0.9	1.1	2.7	2.4	1.6	1.5	1.7
Sweden	1.8	1	0.6	1.3	2.7	2	2.3	1.7
France	1.3	0.7	0.6	1.8	1.8	1.9	2.2	1.5
Austria	1.2	0.8	0.5	2	2.3	1.7	1.3	1.4
United Kingdom	**1.8**	**1.6**	**1.3**	**0.8**	**1.2**	**1.3**	**1.4**	**1.3**
Germany	1.5	0.6	0.6	1.4	1.9	1.3	1	1.2

Many of the accession countries have tended to have higher average rates of inflation that existing EU members over the period 1997-2004, but that significant progress has been made. Indeed during this period four of the accession countries have out-performed Greece on inflation and Lithuania has had lower inflation than four of the first wave of 12 countries inside the Euro Zone.

Economic Growth



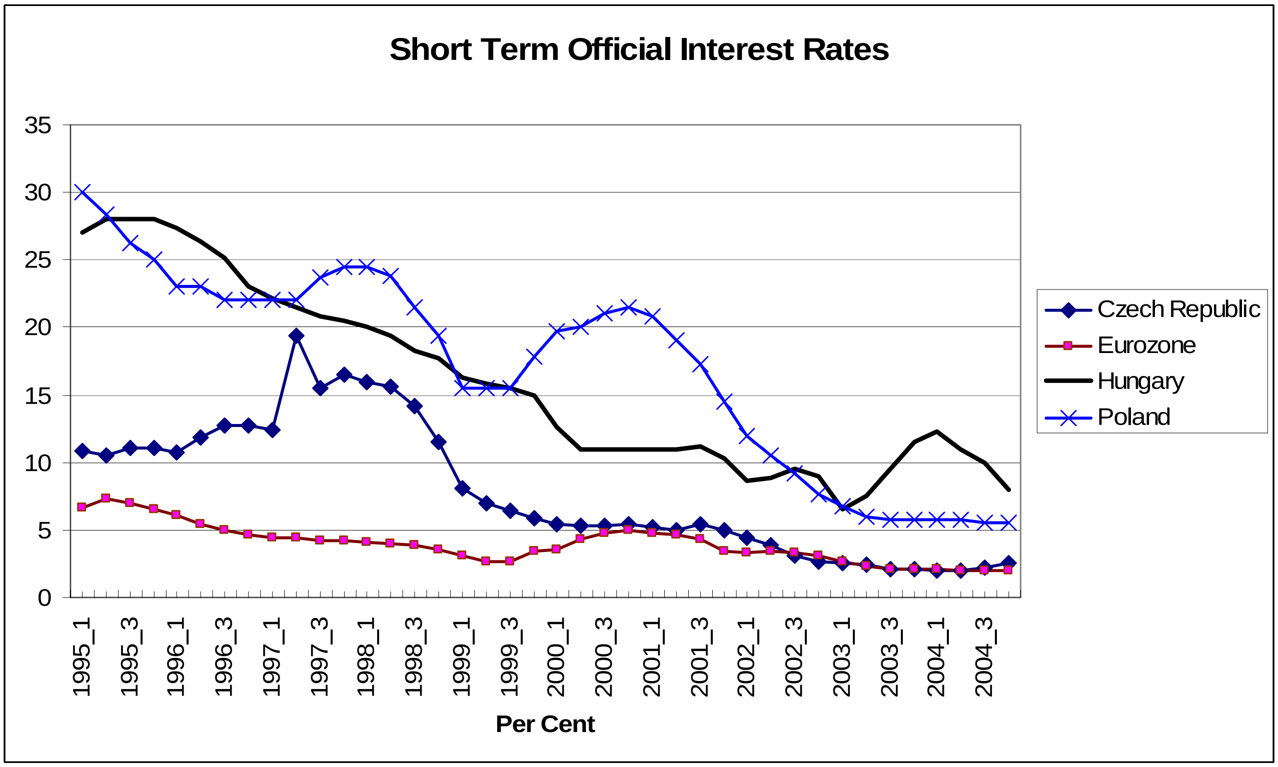
Annual % change in real national output

	2000	2001	2002	2003	2004	Average 2000-04
Latvia	6.8	7.9	6.1	7.4	6.2	7.05
Lithuania	3.9	6.4	6.8	9	6.9	6.6
Estonia	7.3	6.5	6	4.7	5.4	5.98
Ireland	10.1	6.2	6.9	1.4	3.7	5.66
Greece	4.4	4	3.9	4.3	4	4.12
Hungary	5.2	3.8	3.5	2.9	3.2	3.85
Slovakia	2	3.8	4.4	4.2	4	3.68
Luxembourg	9	1.3	1.7	2.1	2.4	3.3
Cyprus	5	4	2	2	3.4	3.28
Slovenia	3.9	2.7	3.4	2.3	3.2	3.1
Poland	4	1	1.4	3.7	4.6	2.94
Czech Republic	3.3	3.1	2	2.9	2.9	2.84
Spain	4.2	2.8	2	2.4	2.8	2.84
Finland	5.1	1.1	2.3	1.9	2.6	2.6
United Kingdom	**3.8**	**2.1**	**1.6**	**2.2**	**3**	**2.54**
Sweden	4.3	0.9	2.1	1.6	2.3	2.24
France	3.8	2.1	1.2	0.2	1.7	1.8
Malta	6.4	-1.2	1.7	0.4	1.4	1.74
Belgium	3.8	0.6	0.7	1.1	2	1.64

Euro-zone	**3.5**	**1.6**	**0.9**	**0.4**	**1.7**	**1.62**
Austria	3.4	0.8	1.4	0.7	1.8	1.62
Denmark	2.8	1.6	1	0.4	2.1	1.58
Italy	3	1.8	0.4	0.3	1.2	1.34
Germany	2.9	0.8	0.2	-0.1	1.5	1.06
Netherlands	3.5	1.2	0.2	-0.7	1	1.04
Portugal	3.4	1.7	0.4	-1.3	0.8	1

Source: Eurostat

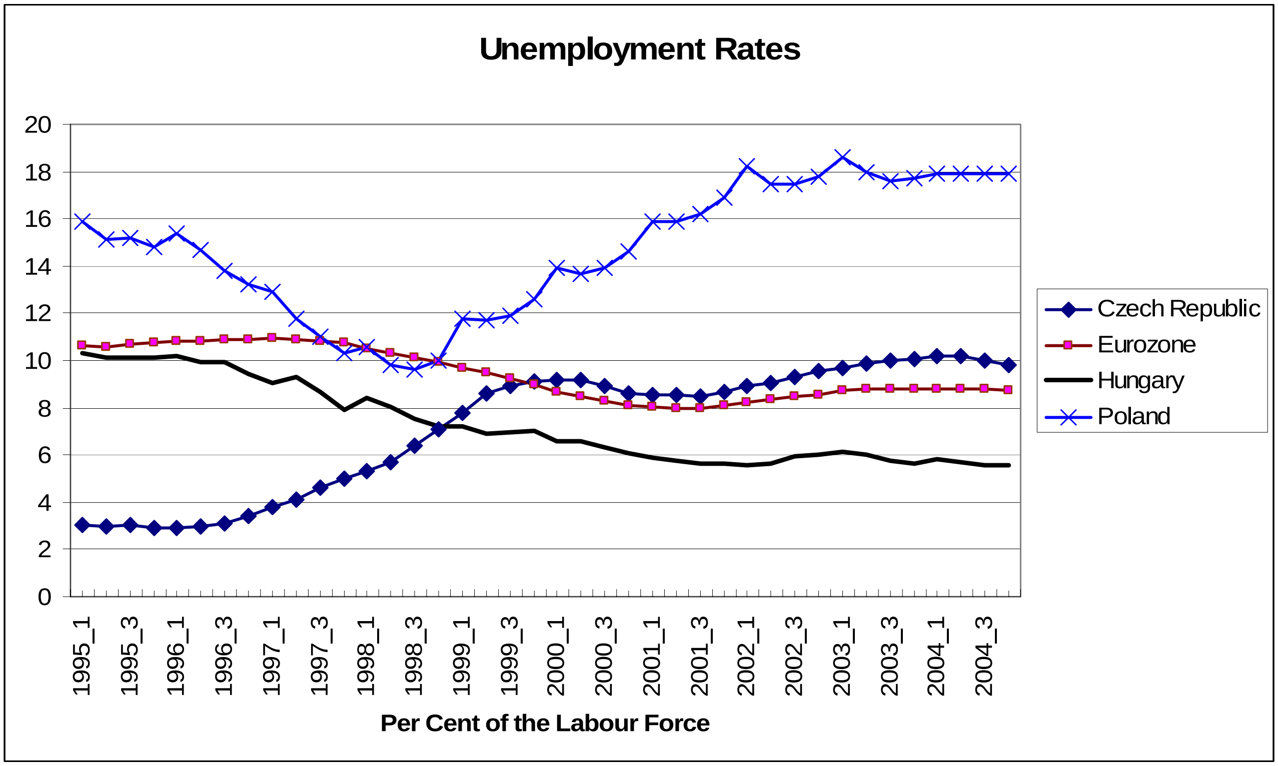
Interest Rates



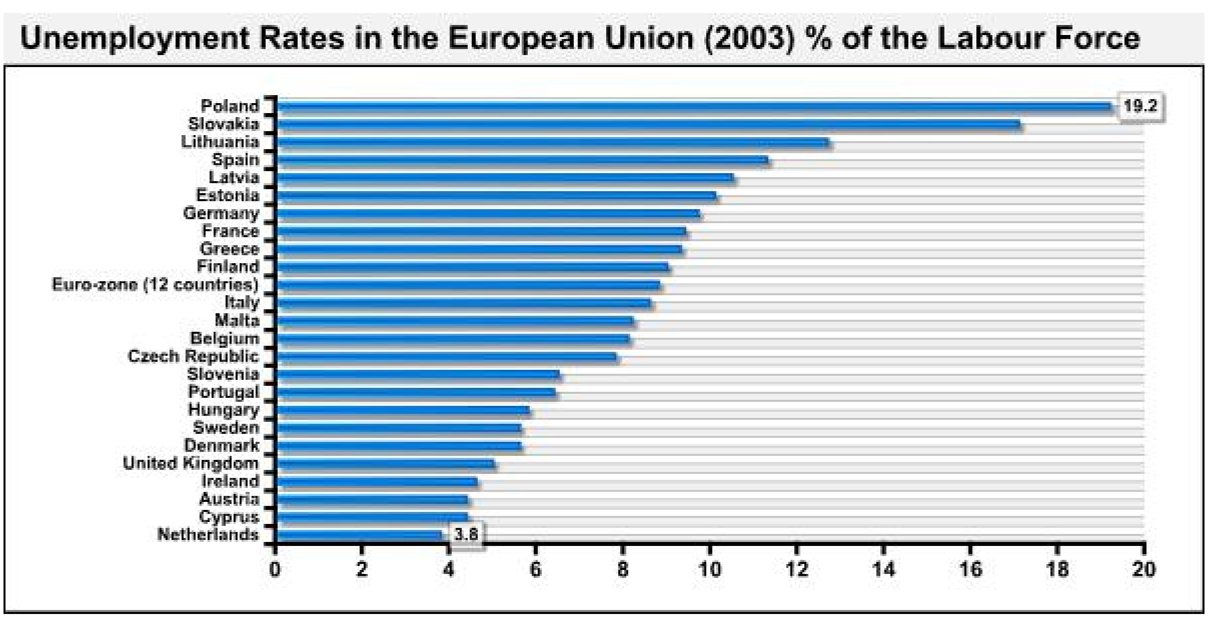
- There has been some convergence in short term interest rates for those accession countries shown in the chart above. Of course, success in achieving lower rates of consumer price inflation allow interest rates to head lower as well
- The Czech Republic looks like it could comfortably assume an ECB set interest rate immediately! Whereas in Hungary, short term interest rates remain 3 or 4 per cent higher – and moving into the Euro now would create economic risks. A sharp drop in interest rates to the Euro Zone level would risk creating an unsustainable boom in the Hungarian economy with the threat of a recession and higher inflation
- In general, most access countries still have much to do to bring their inflation rates and interest rates consistently in touch with the Euro Zone average – and to keep them there ahead of possible Euro entry in a few years time

Long term interest rates

Unemployment



There remain large differences in unemployment rates across the European Union as shown in the charts above and below. This might be taken as evidence that the accession countries are a long way off real economic convergence with single currency countries. Would joining a fixed exchange rate system and then a common currency make the unemployment problem worse in a nation like Poland? Or would it provide a stimulus to trade, competition and investment and a catalyst for further structural economic reforms that, in the medium term, will boost employment rates?

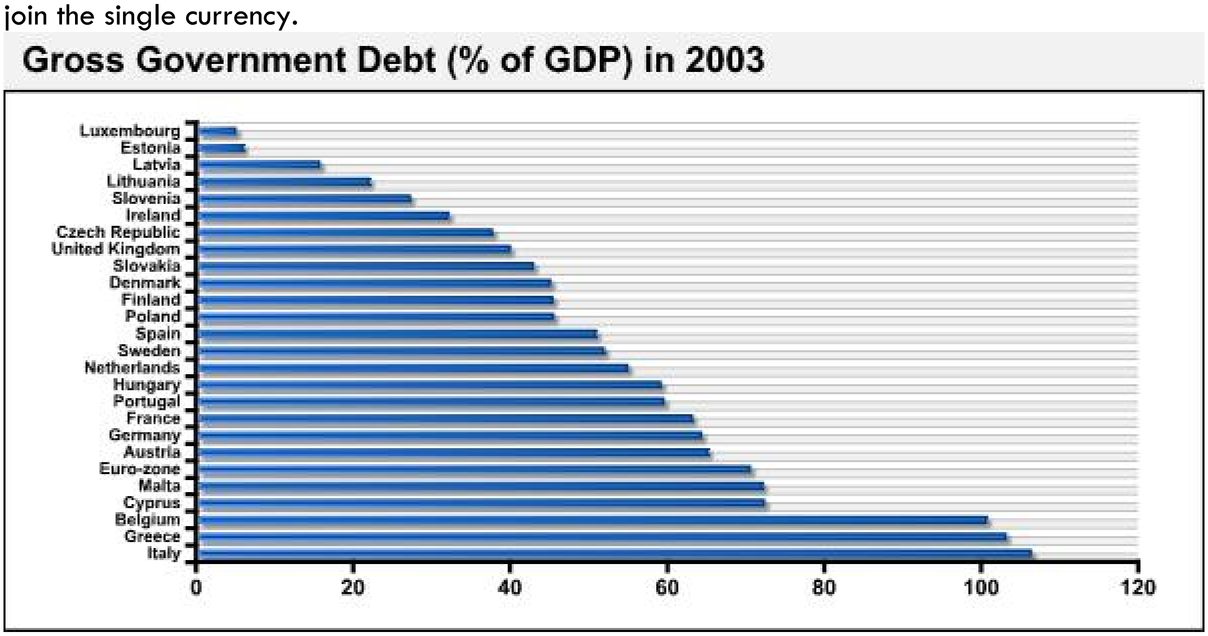


Government Budget Balances

The amount that a government borrows is another of the Maastricht Treat convergence criteria and it is also part of the terms and conditions of the EU Fiscal Stability Pact. The table below indicates that the government budget deficits of the Czech Republic, Hungary, Poland and Slovakia were all in excess of 4 per cent in 2003; indeed, the Czech deficit was way above the 3 per cent Maastricht maximum! – Almost off the radar in fact.

Budget balance as a % of GDP	2003	(-ve shows a budget deficit)	2003
Estonia	2.6	Netherlands	-3.0
Finland	2.3	Greece	-3.2
Denmark	1.5	United Kingdom	-3.2
Sweden	0.7	Slovakia	-3.6
Spain	0.3	Germany	-3.9
Belgium	0.2	France	-4.1
Ireland	0.2	Poland	-4.1
Austria	-1.1	United States	-4.9
Lithuania	-1.7	Hungary	-5.9
Latvia	-1.8	Cyprus	-6.3
Slovenia	-1.8	Japan	-7.4
Italy	-2.4	Malta	-9.7
Euro-zone	-2.7	Czech Republic	-12.9
Portugal	-2.8		

Reducing a fiscal deficit can often be a painful process. It may require cut backs in government spending programmes or an increase in the overall burden of tax – both of which are politically unpopular. So the governments of accession countries may opt to hold off from joining the single currency until they have better control of their fiscal deficits. There are certainly big pressures on them to spend more in order to improve the environment and build up the economic infrastructure needed for their economies to be competitive inside the single market. At the moment, the political opposition to government spending cuts and/or higher taxes may prove to be a large barrier to accession countries announcing a firm intention to join the single currency.



GDP per capita *PPS adjusted*	**1994**	**1999**	**2004**
Luxembourg	164.8	189.2	186.5
Ireland	84.1	111.2	118.2
Denmark	112.6	115.8	110.5
United Kingdom	99.4	103	109.8
Austria	115.2	113.7	108.5
Netherlands	108.2	109.7	106.1
Belgium	108.5	105.3	104.3
Sweden	105.4	107.7	102.2
France	104.9	103.9	101.8
Finland	94.6	101.5	99.2
Euro-zone	100.9	100.2	97.8
Euro-zone (12 countries)	**99.7**	**98.9**	**97.8**
Germany	108.5	103.1	96.8
Italy	103.5	101.9	95.7
Spain	78.6	83.5	86.3
Cyprus	77	74.5	76.1
Greece	66.5	65.3	73.7
Slovenia	62.5	67.2	70.3
Malta		70.5	66.8
Portugal	64.9	70.2	66.5
Czech Republic			63.1
Hungary	46.3	47.8	55
Slovakia	45.4	42.9	47.6
Lithuania	27.8	34.9	45.3
Estonia	30.8	35.2	44.7
Poland		41.8	42.6
Latvia	26.6	30.1	37.7

The advantages of joining the Euro

1. **Reductions in currency risk** – this will enhance trade and investment flows between accession countries and the rest of the Euro Zone
2. **Reduction of transaction costs** and increased price and cost transparency in markets
3. **Lower interest rates** – which will boost capital investment and promote long-term growth
4. **Higher investment and trade** will help to speed up the process of real economic convergence
5. **Politically important symbol** of their commitment to Europe

Disadvantages of joining the Euro

It is important for the accession countries to enter the single currency with **strong economic fundamentals** – some economists argue that a **period of consolidation** is required for most of these countries before they become better prepared for irrevocable Euro entry.

1. **ERM constraint**: Having to spend two years inside the ERM II may prove to have a de-stabilising effect on the accession countries – particularly due to the high rate of capital inflows (putting upward pressure on their currencies)
2. **Retaining monetary policy freedom:** As they settle into the Single Market – it makes sense for them to retain some monetary policy autonomy e.g. in setting interest rates and retaining the option of exchange rate adjustments
3. **Budget deficits:** Many of the accession countries have high budget deficits – they might come under pressure to reduce these fiscal deficits by cutting government spending / raising taxes – which will be politically unpopular and which will hit short term economic growth
4. **Concentrate first on the supply-side:** In the near term, the accession countries might be better suited focusing on supply-side economic reforms designed at raising productivity and promoting entrepreneurship rather than becoming too obsessed with joining the Euro. This will improve the flexibility of their economies and will strengthen the ability to cope with shocks to economic activity and employment.
5. **Harder for the ECB to set rates:** The arrival of the 10 newcomers to the Euro, with their generally higher rates of growth than in Western Europe, will also complicate the work of the European Central Bank when they join the eurozone. The ECB is responsible for setting the single official interest rate for the euro, no easy task considering the different level of economic development

already inside the bloc. A single currency area of twenty nations, possibly more is far removed from the concept of an optimal currency zone