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20th MEETING OF THE ASSOCIATES
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**ITEM 6 OF THE AGENDA: ENLARGEMENT OF THE EURO ZONE: CHALLENGES
AHEAD**

At the Meeting the subject will be introduced by Mr. Elmars Kronbergs, Adviser at the FBE. After the presentation a round table discussion on the main challenges and lessons learned will take place.

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On 1 May 2004 the European Union (EU) welcomed ten new members: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. In contrast to what is widely assumed, these ten countries will not adopt the euro as their new currency immediately because they first have to show that their economies have converged with the economy of the euro zone. Once they have achieved economic and budgetary results which prove that their economies have converged, they will join the single currency in accordance with the procedures laid down in the Treaty.

During the accession negotiations, which were wound up in Copenhagen in December 2002, none of the countries asked for a derogation and no opt-outs were granted along the lines of those secured by Denmark and the United Kingdom . This means that the new Member States will be obliged to adopt the euro once they meet the convergence criteria.

➤ A BIT OF HISTORY

Economic and monetary union (EMU) comprises various stages. The main objective of Stage One, which began in 1990, was the complete liberalization of capital movements under Article 56 of the EC Treaty.

In Stage Two, which began on 1 January 1994, the Member States implemented measures enabling them to achieve the convergence targets necessary in order to enter Stage Three of EMU and guaranteed the independence of their central banks. The process of coordinating economic policies and ensuring multilateral surveillance of progress with convergence began in the course of Stage Two. The Member States were called on to do all they could to avoid excessive public deficits.

In Stage Two the Member States had to take measures to free their central banks of political interference. Central banks were now responsible for monetary policy and, as such, determined interest rates in the euro zone. They were also prohibited from financing a budget deficit affecting the European institutions, the governments of the Member States or other authorities, be they regional or local, and from granting loans to state-owned companies.

Stage Three of EMU began on 1 January 1999 with the launch of the euro on financial markets. Under the accession treaty, the new Member States went straight into Stage Three of EMU on 1 May 2004. They have the status of "Member State with a derogation" within the meaning of Article 122 EC.

Article 122 (3) EC indicates the provisions of the Treaty which do not apply to the Member States with a derogation:

- Articles 104(9) and (11) on the procedure for giving a Member State formal notice to reduce its budget deficit and the possibility for the Council to impose financial and other penalties on Member States which persistently fail to comply;
- certain monetary policy provisions, which remain the responsibility of Member States with a derogation;
- certain articles concerning the European System of Central Banks (ESCB) and the European Central Bank (ECB);
- rights and obligations under the ESCB as set out in its Statute (Article 43 ESCB).

The voting rights of Member States with a derogation are suspended as regards the Council decisions referred to in the articles indicated in Article 122(3).

However, Articles 119 and 120, which concern difficulties with a Member State's balance of payments, also apply to Member States with a derogation.

With a view to achieving the necessary budgetary discipline to join the euro zone, the new Member States' budgetary policies will be subject to supervision. They are required to develop multiannual stability and convergence programmes which include objectives concerning their progress towards adopting the euro, particularly as regards price stability and healthy public finances. The Council evaluates these reports on the basis of an assessment carried out by the Commission.

➤ CONVERGENCE CRITERIA

Every two years, or on the request of a Member State, the Commission and the ECB draw up separate reports on progress with convergence (convergence reports) and evaluate the situation with reference to the convergence criteria. Convergence with the euro zone is required for four criteria indicated in Article 121(1) EC:

- **price stability**, measured according to the rate of inflation in the three best performing Member States;
- **long-term interest rates** close to the rates in the countries with the best inflation results;
- an annual **budget deficit** which does not exceed 3% of gross domestic product (GDP) and **total government debt** which does not exceed 60% of GDP or which is falling steadily towards that figure;
- **stability in the exchange rate** of the national currency on exchange markets. The exchange-rate mechanism of the European Monetary System requires this stability to be demonstrated and sustained for two years.

The reports also examine whether the Member States' legislation, in particular on the national central bank, is compatible with Articles 108 and 109 EC and with the ESCB's Statute. They also consider other relevant economic issues.

The timing of the adoption of the euro in new Member States will mainly depend on how fast the new Member States reach a sufficient degree of sustainable nominal convergence. The sustainability of nominal convergence will be examined by means of the above-mentioned Maastricht convergence criteria. The Maastricht criteria are based on the consensus view in Europe that stability oriented policies provide the best environment for promoting growth and employment creation.

➤ ACCESSION PROCEDURE

The Council, meeting at Head of State and Government level, reaches a decision after examining the convergence reports submitted by the Commission and the ECB and consulting the European Parliament. It decides, on a qualified-majority basis and on a proposal from the Commission, which Member States with a derogation meet the necessary conditions to adopt the single currency on the basis of the criteria laid down in Article 121 and terminates the derogation of the Member States in question.

Once this decision has been taken, the Council sets the irrevocable conversion rate between the national currency in question and the euro. This decision is taken unanimously by those Member States which have adopted the euro and the Member State in question.

Specific measures then have to be taken to introduce the euro: minting of euro notes and coins, arrangements for the switchover and actions to introduce banks, businesses and the general public to the new currency. So it is possible that a certain amount of time elapses between the Council decision and the actual introduction of euro notes and coins. However, as of the date set by the Council, the euro will be the official currency of the

Member State concerned and will be used, for instance, in interbank transfers, as during the transitional period from 1 January 1999 to 31 December 2001.

The same procedure will apply to Denmark and the United Kingdom should they decide to waive their opt-out, and to Sweden once it meets all the criteria.

➤ **BRIDGING THE ECONOMIC DIVIDE**

Most of the new Member States have completed the transition from a planned economy to a market economy. They have made remarkable progress in the area of nominal convergence, particularly as regards inflation. But progress has been slower as regards real convergence of per capita GDP with the European average. In any event, convergence will be a long-term process. It should speed up after accession.

One of the main issues prior to joining the euro zone is the exchange rate. For the time being there is a wide range of exchange-rate systems, such as fixed exchange rates, the currency board arrangement and relatively free floating exchange rates. As preparations for entry into the euro zone are completed, the new Member States will join the exchange-rate mechanism before adopting the euro.

Inflation in the new Member States is still generally higher than in most euro zone countries. This may be linked to an economic phenomenon known as the "Balassa-Samuelson" effect, whereby countries with higher growth generally have higher inflation. It is difficult to assess the scale of this effect. However, it has an undeniable impact on inflation during the catch-up process. The "Balassa-Samuelson" effect calls for a degree of flexibility to be maintained in exchange rates in the post-accession period. Flexibility in the exchange rate and the real interest rate, depending on the requirements of the country in question could, for example, limit the risks of economic overheating.

The advantages of adopting the euro include eliminating the transaction costs associated with keeping a national currency, cutting interest rates and reducing the exchange-rate risk for businesses. This should help to attract additional investment and stimulate real convergence of economies.

In conclusion, a decision on rapid entry into the euro zone should be taken in the light of each country's specific situation. However, a new Member State which meets all the convergence criteria and has achieved a high degree of economic convergence with the euro zone could join the new exchange-rate mechanism after accession and then, after the two-year test phase, introduce the euro in 2007-2008.

➤ **FUTURE ENLARGEMENT OF THE EURO AREA**

Introduction of the euro requires careful practical preparation. The European Commission regularly reports on the state of preparations for introducing the euro. These reports are issued for information purposes only and have no legal value; they should not be confused with the convergence reports.

Plans for adopting the euro from 2007 onwards

In order to be able to adopt the euro, a Member State must have observed the normal fluctuation margins provided for by the European exchange-rate mechanism (ERM-II) for

at least two years without devaluing its currency. Three Member States (Estonia, Lithuania and Slovenia) joined ERM-II on 28 June 2004 and wish to adopt the euro as soon as possible. A Member State joining ERM-II in 2004 cannot meet the exchange-rate criterion until 2006; this means that the new Member States cannot adopt the euro before 2007.

In accordance with the EC Treaty, the Council decides, on a proposal from the Commission, which Member States fulfill the necessary conditions for adopting the euro and fixes the date on which they will join the euro area. On the date of adoption of the euro, the conversion rate becomes effective, the national currency ceases to exist and responsibility for monetary policy is transferred to the European Central Bank (ECB).

➤ MAIN CHALLENGES

Preparing for introduction of the euro

Introduction of the euro needs to be prepared well in advance. For practical and logistical reasons, the first wave of euro-area countries opted for a three-year transitional period between adopting the euro as a currency and putting euro banknotes and coins into circulation. But a "big bang" scenario in which entry into the euro area coincides with the introduction of euro notes and coins could also have its advantages, among other things because the new Member States are already familiar with the euro. Official plans and intentions are taking shape in all the new Member States, such as competitions for the designs of euro coins.

Policy challenges

The challenges for monetary policy are strongly influenced by a well-defined institutional framework for the monetary integration of new Member States. Two main principles of this process:

- First, there is no single monetary and exchange rate policy strategy which can be considered appropriate for all new Member States.
- Second, the principle of equal treatment is key in applying the institutional framework. Comparable situations and cases will be treated in a comparable manner throughout the monetary integration process.

The monetary integration of the new Member States is taking place in distinct phases. The first phase can be characterized as the period before joining the ERM II exchange rate mechanism. The second phase is the period between joining ERM II and the adoption of the euro. Three new Member States: Estonia, Lithuania and Slovenia are already in this stage.

In the period before ERM II membership, monetary and exchange rate policy remains a responsibility and prerogative of the country concerned. However, the rules of the game are already different from the time before acceding to the EU, because a number of Treaty obligations apply already at this stage. In the new EU Member States, in the same way as for the old ones, price stability has to be the main objective of monetary policy. Moreover, exchange rate policy is to be treated as a matter of common interest.

Within this common institutional framework, the new Member States have been pursuing a variety of monetary and exchange rate policy strategies. Some countries, such as the

Czech Republic, Hungary, Poland and Slovakia pursue variants of inflation targeting. Others, such as Cyprus, Latvia and Malta follow an exchange rate targeting strategy.

Although both the new Member States and the monetary policy strategies they follow are heterogeneous, a number of key guidelines can be identified for a successful conduct of monetary policy in these countries. In an environment of increasing inflation pressures, it will be crucial to contain inflation expectations in order to avoid (or at least minimize) second-round effects of temporary price increases and thus to achieve and/or to maintain price stability. In those new EU countries where inflation still has to be brought down, the key challenge is how to break inflationary expectations, with as little output and employment sacrifice as possible. The credibility of monetary policy is in this context a key condition of success.

The orientation of other economic policies is crucial to establishing an overall economic environment conducive to price stability. Sound fiscal policies play a key role in this respect. In addition, the implementation of structural reforms aimed at raising potential growth and enhancing the flexibility of labor and product markets will help to achieve higher growth without experiencing additional inflationary stimulus on the demand side. It is also vital that wages are set in line with labor productivity developments. During the past few years, in some new EU Member States, wage increases have exceeded labor productivity growth substantially. The key reasons for the excessive wage growth were minimum wage rises and public sector wage hikes.

A key point in the recent public debate about the necessary course of wage policy as a response to EU enlargement is that the relation of labor and capital has substantially changed following the enlargement of the EU with countries at considerably lower level of wages and capital endowments than in the old Member States. For the EU as a whole, in relative terms, labor became more abundant and capital became scarcer. This implies that an adjustment has to take place in one way or the other. To reap the benefits of enlargement, higher labor market flexibility is the best way to adjust both in the new and the old member states. Improving the flexibility of labor markets could help to improve domestic adjustment mechanisms to external shocks, increase competitiveness, decrease persistently high unemployment in a number of countries and enhance the conditions for price stability.

Lessons drawn from the previous changeover

The first changeover to the euro was a success, although there is room for improvement in several respects. Early, thorough preparation is therefore necessary in order to ensure a speedy changeover and public acceptance of the new currency. The transitional period of three years was too long and that euro notes and coins would have to be introduced swiftly, for the benefit of all parties involved. It would be preferable for the period of dual circulation to be short.

The national authorities must take steps to avoid any impact on prices, for example as a result of incorrect conversion of prices by shopkeepers and retailers. Active involvement of consumer organizations would be preferable. The authorities could require retailers to publicly display their commitment to making an exact price conversion in order to ensure credibility and enable consumers to bring pressure to bear.

The enlargement of the euro area towards Eastern Europe will occur in several successive waves, but without the collective momentum of the first wave. The transition from the national currency to the euro could be much faster in the new Member States, not least

because many countries are considering a "big bang" approach whereby the date of entry into the euro area coincides with the date of official introduction of euro cash.

➤ **KEY FIGURES**

The enclosed tables (enclosure 1) show figures for the annual inflation, deficit and government debt of the new Member States and the applicant countries. Figures for the fifteen and twenty-five Member States and the euro zone are also included for comparison purposes. The figures are taken from the Commission's spring 2005 economic forecasts.

➤ **QUESTIONS TO CONSIDER FOR THE ROUND TABLE DISCUSSION:**

For the existing Member States of the Euro-zone:

- 1) What were the main challenges in the process of adoption of the Euro in your country?
- 2) What were the main lessons learned from that process? What kind of advice, suggestions would you like to give to the Member States which are going to join the Euro zone soon? Were there mistakes the new Member States could/should avoid?
- 3) Any information on the impact the adoption of the Euro has had on a country's economy and on the lives of its citizens? What is the perception of ordinary citizens themselves?

For the potential entrants to the Euro Zone:

- 1) When is your country planning to join the Euro zone?
- 2) What are the main difficulties/problems your country may face during the EMU adhesion and the adoption of the Euro? (Economic: meeting convergence criteria; political; others)
- 3) Questions to existing Euro zone Member States on solutions/experiences in dealing with one or other particular situation during the adoption of the Euro.

➤ **SOME SUPPLEMENTARY DOCUMENTS:**

- 1) European Central Bank: Policy position on exchange rate issues relating to the acceding countries (Dec 2003):
<http://www.ecb.int/pub/pdf/other/policyaccexchangerateen.pdf>
- 2) The European Commission's spring 2005 economic forecasts:
http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/ee205en.pdf
- 3) *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank: First report on the practical preparations for the future enlargement of the euro area [COM(2004) 748 final - Not published in the Official Journal].*

http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=2004&nu_doc=748

- 4) Enlargement of the euro area: adjustment of voting arrangements in the Governing Council of the ECB
<http://europa.eu.int/scadplus/leg/en/lvb/l25065.htm>
- 5) The enlargement of the EU and the euro zone
Speech by Otmar Issing, Member of the Executive Board of the ECB, at the Spring 2005 World Economic Outlook Conference, Frankfurt am Main, 27 April 2005
<http://www.ecb.int/press/key/date/2005/html/sp050427.en.html>

Enclosure: 1

KEY FIGURES

These tables show figures for the annual inflation, deficit and government debt of the new Member States and the applicant countries. Figures for the fifteen and twenty-five Member States and the euro zone are also included for comparison purposes. The figures are taken from the Commission's Spring 2005 economic forecasts.

Table 1.a: New Member States: inflation

New members	2000	2001	2002	2003	2004 (E)	2005 (F)
Cyprus	4.9	2.0	2.8	4.0	1.9	2.3
Estonia	3.9	5.6	3.6	1.4	3.0	3.3
Hungary	10.0	9.1	5.2	4.7	6.8	3.8
Latvia	2.6	2.5	2.0	2.9	6.2	5.0
Lithuania	0.9	1.3	0.4	-1.1	1.1	2.9
Malta	3.0	2.5	2.6	1.9	2.7	2.4
Poland	10.5	5.3	1.9	0.7	3.6	2.1
Czech Republic	3.9	4.5	1.4	-0.1	2.6	1.9
Slovakia	12.2	7.2	3.5	8.5	7.4	3.7
Slovenia	8.9	8.6	7.5	5.7	3.6	2.6
EU15	1.9	2.2	2.1	2.0	2.0	1.8
EU25	2.4	2.5	2.1	1.9	2.1	1.9
Euro zone	2.1	2.4	2.3	2.1	2.1	1.9

Table 1.b: Applicant countries: inflation

Applicant countries	2000	2001	2002	2003	2004	2005 (F)
Bulgaria		7.4	5.8	2.3	6.2	4.0
Croatia				1.8	2.1	2.7
Romania				15.3	11.9	8.2
Turkey				25.3	10.6	8.7

Table 2.a: New Member States: budget deficit

New members	2000	2001	2002	2003	2004 (E)	2005 (F)
Cyprus	-2.4	-2.3	-4.5	-6.3	-4.2	-2.9
Estonia	-0.6	0.3	1.4	3.1	1.8	0.9
Hungary	-2.4	-3.7	-8.5	-6.2	-4.5	-3.9
Latvia	-2.8	-2.1	-2.7	-1.5	-0.8	-1.6
Lithuania	-2.5	-2.0	-1.5	-1.9	-2.5	-2.4
Malta	-6.3	-6.4	-5.9	-10.5	-5.2	-3.9
Poland	-1.6	-3.9	-3.6	-4.5	-4.8	-4.4
Czech Republic	-3.7	-5.9	-6.8	-11.7	-3.0	-4.5
Slovakia	-12.3	-6.0	-5.7	-3.7	-3.3	-3.8
Slovenia	-3.5	-2.8	-2.4	-2.0	-1.9	-2.2
EU15	1.0*	-1.1	-2.2	-2.8	-2.6	-2.5
EU25	0.8*	-1.2	-2.3	-2.9	-2.6	-2.6
Euro zone	0.1*	-1.7	-2.4	-2.8	-2.7	-2.6

* these figures include UMTS proceeds, which had a significant impact on the annual deficit of certain Member States.

Table 2.b: Applicant countries: budget deficit

Applicant countries	2000	2001	2002	2003	2004	2005 (F)
Bulgaria	-0.5	1.2	-0.1	0.6	1.4	-0.5
Croatia				-6.3	-5.0	-4.4
Romania	-4.4	-3.5	-2.0	-2.0	-1.4	-2.4
Turkey	-6.1	-29.8	-12.3	-9.7	-3.9	-3.9

Table 3.a: New Member States: government debt

New members	2000	2001	2002	2003	2004	2005 (F)
Cyprus	59.9	61.9	65.2	69.8	71.9	69.9
Estonia	4.7	4.4	5.3	5.3	4.9	4.3
Hungary	55.4	52.2	55.5	56.9	57.6	57.8
Latvia	12.9	14.9	14.1	14.4	14.4	14.0
Lithuania	23.8	22.9	22.4	21.4	19.7	21.2
Malta	57.0	62.4	62.7	71.8	75.0	76.4
Poland	36.8	36.7	41.2	45.4	43.6	46.8
Czech Republic	18.2	27.2	30.7	38.3	37.4	36.4
Slovakia	49.9	48.7	43.3	42.6	43.6	44.2
Slovenia	27.4	28.1	29.5	29.4	29.4	30.2
EU15	64.1	63.3	62.7	64.3	64.7	65.0
EU25	62.9	62.2	61.7	63.3	63.8	64.1
Euro zone	70.4	69.6	69.5	70.8	71.3	71.7

Table 3.b: Applicant countries: government debt

Applicant countries	2000	2001	2002	2003	2004	2005 (F)
Bulgaria	73.6	66.2	54.0	46.3	38.5	32.5
Croatia				51.6	53.8	53.2
Romania	23.9	23.2	23.3	21.3	18.5	19.1
Turkey	57.4	105.2	94.3	87.2	80.8	75.9

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