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# Enlargement of the European Monetary Union

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*ABSTRACT*
**Enlargement of the European Monetary Union**
The paper that ensues from the own-initiative opinion elaborated for the European Economic and Social Committee deals with the planned enlargement of the euro area. It focuses on the following two issues: readiness of the euro area for its enlargement and readiness of the new EU Member States for adoption of the single currency. In the first part, authors record the EESC opinions on this topic. The second part focuses on benefits of introducing the euro, problems in the euro area, issues of single monetary policy and fiscal policy coordination. The third part evaluates readiness of the new EU Member States for euro area entry regarding their nominal, real and structural convergence. Conclusions include recommendations of authors to both candidate countries and the current Member States.

*KEYWORDS:* euro area, monetary policy, fiscal policy, Theory of Optimum Currency Areas (OCA), new Member States, Maastricht criteria, convergence

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# INTRODUCTION

*Following the enlargement of the EU on 1 May 2004 by the largest number of countries in the history of European integration, and what is more, countries with a relatively low economic level (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) and after EU integration of Bulgaria and Romania, Economic and Monetary Union (EMU) is also entering its next stage, in which it will have to face new challenges.*

*The currently applicable EU legislation does not contain provisions allowing Member States opt-outs from the third stage of EMU, such as are available to Denmark and the United Kingdom. In the accession treaties, the new Member States committed themselves to adopting the single currency and became EMU member states with a derogation regarding adoption of the euro,*[1] *retaining freedom to set their date of entry into the euro area once they have met the Maastricht criteria. At the same time, three members of the EU15 (Denmark, the United Kingdom and Sweden) still maintain their position of not introducing the single currency for now.*

*Particular attention should be given mainly to euro introduction in the transitive economies which have been experiencing significant structural changes. These countries could be divided into 3 groups: 1. EMU members (Slovenia), 2. ERM II members (Estonia, Lithuania, Latvia, Slovakia) and 3. non-ERM II members (Bulgaria, the Czech Republic, Hungary, Poland, Romania). Apart from the ambition of meeting the Maastricht criteria in a sustainable way, the aim of the macroeconomic policies in these countries is to increase their real convergence and improve their adaptive mechanisms. This is not only in the interest of their smooth accession, but also in the interest of the successful future operation of the euro area as a whole and in the interests of the stability of the euro as an important world currency.*

*On 1 January 2007, Slovenia as the first from the new Member States introduced the single currency and the number of EMU members increased to thirteen. The euro area is going to be enlarged by a further eleven, and perhaps up to fourteen, countries.*[2] *It will not only be a larger but also a qualitatively different monetary union, and much more diverse. Its successful operation, mainly implementation of the European Central Bank common monetary policy, coordination of national fiscal policies and coordination of the common monetary policy and fiscal policies will become more difficult.*

*This paper ensued from the own-initiative opinion* ***Enlargement of the European Monetary Union*** *that had been elaborated in the period from February 2005 till May 2006 within the Section for Economic and Monetary Union and Economic and Social Cohesion*

[1] Greece also had this derogation until 31 December 2000 and Sweden, which has not yet fulfilled the necessary criteria for introducing the single currency (the Swedish krona has still not entered ERM II), still has it.
[2] Including Bulgaria and Romania, as well as Denmark, the United Kingdom and Sweden as mentioned earlier.

*(ECO) of the European Economic and Social Committee (EESC – thereinafter only Committee).*[3] *Viliam Páleník as a member of the Committee was the rapporteur and Ivana Šikulová the expert of the opinion that took into consideration remarks discussed during the study group meetings. As the topic of euro area enlargement by the new EU Member States is very much discussed in these economies nowadays, the stated opinion was updated, adjusted and published as working paper.*

[3] EESC is an independent consultative body established by the Treaties of Rome in 1957. It consists of different economic and social interest groups' representatives of the organized civil society and its aim is to provide consultations to three main institutions – the European Parliament, the Council of the European Union and the European Commission. Consultation of the Committee by these institutions is mandatory in cases specified in the Treaties, or can be performed if considered appropriate. The Committee can be asked by some of the institutions to elaborate an exploratory opinion or can take its own initiative. On average, the Committee adopts annually about 150 opinions on various topics related to building and development of Europe. In this way, the Committee participates actively in the process of decision preparation and policy making at the Community level (for more information see http://www.eesc.europa.eu/).

## 1. SELECTED EESC DOCUMENTS ON THE EURO AREA AND THEIR CONCLUSIONS

The European Economic and Social Committee have already dealt with the issue of Economic and Monetary Union several times. As it is clear from the following two parts of the paper, a great deal of attention has been paid to the introduction of the single currency in the old EU Member States, as well as to the economic policy issues of the EMU. However, the issue of euro area enlargement by the new EU Member States has been discussed only in the opinions *The impact of enlargement on EMU* (2002) and *The new Member States and the broad economic policy guidelines* (2005). As the time draws nearer for more economies to join the monetary union, the Committee has decided to address this issue, which not only affects the acceding countries, but also places great demands on the euro area itself, in a separate own-initiative opinion *Enlargement of the European Monetary Union*, that has been the basis for elaborating this paper.

### 1.1 Opinions from the period 1997 – 2000

***The impact of the introduction of the euro on capital markets***
*(ECO/234, 1997, Commission referral, rappourteur Mr. Pelletier)*
This opinion was in response to a Commission document and contained technical recommendations concerning the redenomination of the bond, equity and derivative markets, as well as the conventions that should apply to the new euro capital market. It summarised the views on the degree of harmonisation needed to establish an efficient, transparent euro capital market. In most cases, the Committee opinion endorsed the line taken by the Commission.

***Practical aspects of the introduction of the euro***
*(ECO/239, 1997, Commission referral, Mr. Burani)*
The second opinion was also in response to a Commission communication and contained information on the practical preparations carried out in Member States and at the EU level in the period leading up to the adoption of the euro. It deals with such issues as accounting and reporting in euro, redenomination of existing debt, the design of euro coins, national communication campaigns, the effects of changing to the single currency on taxation, conversion charges, etc. It also set out the remaining decisions that had to be taken within the short period up to the end of 1997.

***External Aspects of Economic and Monetary Union***
*(ECO/233, 1998, Commission referral, Mr. Pelletier)*
In this opinion on the Commission paper, the Committee stressed the difference between the American and Japanese economies with their high level of homogeneity, on the one

hand, and the EU with marked differences between Member States, on the other. It also pointed out the need to examine the impact of monetary union on the financial markets.

***1999 Annual Economic Report, The EU economy at the arrival of the euro: promoting growth, employment and stability***

*(ECO/012, 1999, Commission referral, Mr. Cal)*

The opinion was the Committee's response to the 1999 Annual Economic Report, according to which the EU would have to put in place the right mix of economic policies along with structural measures in the markets for goods and services, capital and labour. The Committee took the view that those implementing fiscal policy (the Member States' governments), monetary policy (the ECB) and wage policy (social partners) would have to make a combined effort to put into practice a dynamic strategy to achieve economic growth and job creation. It also highlighted the role of economic growth in job creation.

***Impact of implementing EMU on economic and social cohesion***

*(ECO/019, 1999, own-initiative opinion, Mr. Dock)*

In this own-initiative opinion, the Committee stated that cohesion between regions had made no real progress, particularly as far as employment was concerned. This made it vital to have a successful implementation of the European Employment Pact, i.e. coordination of labour market policy measures (the Luxembourg strategy), reform of the market in goods, services and capital (the Cardiff strategy) and macroeconomic measures (the Cologne strategy). The Committee summarised the benefits and challenges of EMU for Member States and warned of the danger of asymmetric shocks appearing in some regions.

***An assessment of the introduction of the single currency***

*(ECO/022, 2000, own-initiative opinion, Mr. Sepi)*

In this own-initiative opinion, the Committee expressed its conviction that the introduction of the euro had a positive effect on the euro area's economy and had brought stability already in its first year. It stressed that the strength and stability of the single currency would depend not only on monetary policy measures but also on other policies to promote structural reforms, employment and social cohesion. These policy measures should equip the EMU to compete more effectively with the other world economic centres.

***Challenges posed by EMU to financial markets***

*(ECO/040, 2000, own-initiative opinion, Mr. Pelletier)*

The aim of this own-initiative opinion was to offer an overview of the tasks that the financial markets would face as a result of EMU. It observed that although the technical problems relating to the operation of these markets had been well studied, the economic impact of the creation of a large, unified euro market had been examined far less. Attention was drawn to the banking sector and its supervision, the institutional framework for regulation of the European stock, bond and currency markets, and the financing of companies, etc. The opinion stated that it was essential for Europe to rapidly establish a harmonised European framework for financial markets. The Committee warned that the conditions for the supply of capital and intermediation needed to be improved, and that demand for capital also needed to be stimulated.

## 1.2 Opinions from the period 2001 – 2006

***Coordination of economic policies as a consequence of EMU***
*(ECO/041, 2001, own-initiative opinion, Mr. Nyberg)*

This own-initiative opinion supplemented the earlier Committee's opinions and stressed the need for further coordination of macro-economic policies following the introduction of the single currency. It stated that differences in economic cycles and inflation rates in the various Member States were the main reason why EMU and the ECB common monetary policy could not work properly without coordination of economic policies. This would enable economies that deviated to meet the negative impact of a common monetary policy. Given the internal interdependence of the EU Member States, which contrasts with their external independence, it had to be realised that one country's economic policy has a significant impact on the economies of the other EU Member States.

***Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee, the Committee of the Regions and the European Central Bank: Practical aspects of the euro: state of play and tasks ahead***
*(ECO/053, 2001, Commission referral, Mr. Burani)*

As the introduction of the euro banknotes and coins approached, the Committee issued an opinion reacting to a Commission document of the same name. The opinion dealt with topics such as the situation in enterprises, acceptance of the euro by citizens/consumers, dual display of prices, the communication campaign, putting euro banknotes and coins into circulation, measures against counterfeiting and national cash changeover plans, and it gave its recommendations.

***Assessment of the state of preparedness for the introduction of the euro to highlight the main gaps and the necessary remedial action***
*(ECO/080, 2001, additional opinion, Mr. Burani)*

In this opinion, which supplemented the earlier opinion *Practical aspects of the euro: state of play and tasks ahead,* the Committee once again addressed the issues of communication, availability of euro banknotes and coins, rounding of prices, the financial system, businesses, logistical problems and the risks of fraud and counterfeiting.

***Proposal for a Regulation of the European Parliament and of the Council on cross-border payments in euro***
*(ECO/078, 2001, Parliament and Council referral, Mr. Burani)*

In this opinion, the Committee endorsed the aims presented in the Commission proposal. These involved reducing bank charges for cross-border payments in euro to the level of those applying at national level. The opinion raised the issue of how to avoid any rise in domestic charges, which some might seek to justify on the grounds of higher costs for international transactions.

***The impact of enlargement on EMU***
*(ECO/068, 2002, own-initiative opinion, Mr. Vever)*

The question of EU enlargement and its impact on EMU was considered by the Committee in this own-initiative opinion. It warned that, after enlargement, the 12 EU Member States in the euro area would have to coexist with 13 non-euro States (as opposed to only three before) and, as the new Member States entered the euro area, the EMU would become much more heterogeneous. It also pointed out that careful attention would need to be paid to the preparation of the candidate states for the adoption of the euro, as well as to the preparation of the EMU itself for enlargement. If nominal convergence (fulfilment of the Maastricht Criteria) of economies moving towards the euro area was to be sustainable, it had to be backed up by real convergence. In this opinion, the Committee drew attention to the fact that while new Member States should not rush through the various stages of the EMU accession process; they should also not put it off too long. It pointed out the need for institutional change in the euro area, particularly concerning ECB decision-making, and that the effective reform of the ECB management structure to make it ready for enlargement needed to be in place by the time the accession negotiations were completed. It also stated that, in the post-2006 period, the EU had to pay close attention to the question of transfers, budgetary resources and taxation in Europe.

***The economic policies of the euro area countries: convergences and divergences, results and lessons to be drawn***
*(ECO/079, 2002, own-initiative opinion, Mr. Nyberg)*

This opinion dealt with the various objectives of economic policy and stressed that the Lisbon objectives were not being given as much importance as the aims of price stability and balanced budgets. The proposal to add the goals of employment and higher growth to the Stability and Growth Pact was welcomed by the Committee, as a policy for higher growth rates was the best policy for debt reduction. The opinion also observed that tax systems had converged in both their structures and rates. The possibilities for tax evasion were reducing and there was a shift from income taxes to other taxes.

***The new Member States and the broad economic policy guidelines***

*(ECO/144, 2005, own-initiative opinion, Mr. Koulumies)*

This opinion set out that meeting the conditions for euro area entry would require implementation of disciplined and sustainable economic policies in the new Member States. The impacts of their ambitions to meet the Maastricht criteria (particularly inflation criterion and exchange rate criterion) on their economic performance were discussed. Economies joining ERM II too quickly would face the risk of exchange rates overestimation or underestimation. In addition, there would be a danger of speculative attacks on national currencies in ERM II. Faster productivity growth would go along with faster price increase in these countries and consequently, fulfilment of the inflation criterion would be endangered. The opinion also mentioned that the process of closing income gaps between the EU15 and the new Member States would probably take decades.

# 2. DEVELOPMENT IN THE EURO AREA AND ITS READINESS TO ACCEPT NEW MEMBERS

## 2.1 Benefits of introducing the euro

The overall assessment of euro area development to date and its prospects is ambiguous. On the one hand, it has brought notable achievements, but on the other hand there are problems with its operation. The introduction of the euro has had several positive effects so far:

- the euro has contributed to harmonisation and greater economic stability in the euro area, including the maintenance of price stability, the main ECB objective (this was not only achieved in those member countries whose inflation was low even before introduction of the euro, but also in those that had had higher rates of inflation);
- the euro's international role, which became the second world currency and the first real competitor to the dollar, is growing (seigniorage, the revenues from issuing the currency, is increasing) and its exchange rate stability has been maintained;
- it has reduced the transaction costs;
- it has eliminated exchange rate volatility between euro area countries;
- there has been progress in integration of the financial market which, through higher productivity and competitiveness and more effective allocation of capital, may lead to greater and sustainable growth;
- the euro has helped to reduce both short-term and long-term interest rates, which supports investment and consumption;
- there is greater price transparency, which stimulates the positive effect of competition on the markets for goods and services;
- there has been moderate growth in the level of mutual trade between euro area member states, which was already very high, and a rise in trade with the rest of the world.

## 2.2 Problems in the euro area

On the other hand, the euro area faces several problems, such as:

- a weak economic performance;
- a relatively high level of unemployment;
- the problems of some Member States in meeting the requirements of the Stability and Growth Pact (SGP).

For several successive years, the euro area as a whole has experienced very low economic growth (1.6 % on average for the period 2001 – 2006), which has prevented a substantial drop in unemployment rates.[4] On the other hand, the EU15 members who have not yet adopted the euro (Denmark, the UK and Sweden) are on average growing more quickly than the euro area (2.3 % for the period 2001 – 2006).[5] While the low growth cannot be ascribed solely to membership in the monetary union, it is a cause for serious reflection.

The drop in the growth of the euro area's economic output is the result of both external factors (increased oil prices, fall in prices of securities, slow-down in the growth of world trade) and the weakened contribution of domestic demand to economic growth. Other possible reasons include structural and other economic differences between members of the monetary union complicating the implementation of the common monetary policy, the rules in the SGP restricting fiscal policy, the effective absence of fiscal solidarity, an asymmetry preventing effective coordination of monetary and fiscal policy (implementation of a restrictive macro-economic mix),[6] lack of political will for structural reforms of the members' economies and difficulties in introducing them, insufficient flexibility of the labour markets (despite the improvement achieved) and their fragmentation in individual Member States, over-regulation of business, insufficient integration in the capital market, fundamental differences in Member States' taxation systems, unresolved problems in the Common Agricultural Policy, too much red-tape in the EU decision-making processes and the danger of negative asymmetric shocks (Iša, J., 2005a).

The euro area lags behind the USA (the main competitor of the euro area and the EU) not only in terms of the overall growth rate (1.6 % in the euro area, 2.6 % in the USA on average between 2001 and 2006) (OECD, 2007), but also in GDP per capita, which has remained at 70 % of the US level since the beginning of the 1980s. In growth of labour productivity and total factor productivity, too, the euro area as a whole is behind, the result in part, perhaps, of differences in production and the distribution of information and communication technologies. On the other hand, the USA has a higher public sector deficit and higher household debts than the euro area, as well as a large balance of payments current account deficit, in contrast with the slight surplus in the EMU.

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[4] This is mostly "thanks" to Germany, Italy, France and several smaller countries (Portugal, Netherlands, Belgium, and Austria).

[5] Some euro area countries (especially Ireland and Greece) have experienced a higher growth rate than the three non-members mentioned (ECB, 2007).

[6] The macro-economic mix in the euro area is not a relatively simple (and theoretically well-grounded) combination of the single monetary policy and a single fiscal policy, but a combination of a common monetary policy and (for the time being) thirteen national fiscal policies. The situation in the EU27 is even more complicated. In this case it is more a "mix of mixes", which on the one hand includes the ECB common monetary policy and the monetary policies of the 14 Member States that have not yet adopted the single currency and, on the other hand, the 27 national fiscal policies brought into line by the Stability and Growth Pact.

The level of unemployment in the euro area has long been higher than in the USA (8.3 % in the euro area in comparison with 5.3 % in the USA on average between 2001 and 2006) (OECD, 2007). Unemployment therefore belongs to the main economic problems and will become more of a burden after the new EU Member States join the euro area. However, there are economies, among both those using the euro and the new Member States, which have relatively low unemployment.[7] But it should also be said that in the three members of the EU15 who have not yet adopted the euro, this indicator is on average almost 3 % below the level in the euro area as a whole.

## 2.3 Conditions for optimal functioning of monetary union

There is no doubt that membership in the monetary union brings many benefits for countries taking part. However, the ECB monetary policy, carried out according to the "one size fits all" principle, does not necessarily suit all the member states at the same time in an economic area which is as diverse as the euro area (and will be even more diverse after enlargement). The common monetary policy will not be optimal for the economies of the new EU Member States, above all given the need for faster economic growth and price and wage rises in comparison with the current EMU member states.[8]

Entry into the euro area and the consequences of adopting the euro are usually evaluated using a cost/benefit analysis, which is largely based on the theory of optimum currency areas (OCA). The results should show whether monetary integration would be a net benefit to the acceding country and contribute to higher prosperity. The countries in the OCA apply fixed exchange rates, or a single currency, among themselves and flexible exchange rates towards the rest of the world and are tightly bound with mutual trade in goods and services, as well as having mobility of production factors. According to Mundell who began to be concerned with the OCA theory in the sixties of the last century, optimum currency areas have high mobility of production factors, especially labour. In the case that one of the regions faces asymmetric shocks and mobility of labour is inadequate, the currency area could expect different levels of inflation and unemployment. Other economists also developed OCA theory, emphasizing criteria such as the level of openness and size of the economies (R. I. McKinnon, 1963), volume of mutual trade, synchronisation of economic cycles, production diversification (P. B. Kenen, 1969), price and wage flexibility (M. Friedman, 1953), similar level of inflation (J. M. Fleming, 1971), financial integration (J. C. Ingram, 1973), fiscal integration (P. B. Kenen, 1969), and political integration (N. Mintz, 1970).

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[7] These are the Netherlands (3.9 % unemployment in 2006), Ireland (4.4 %), Luxembourg (4.7 %) and Austria (4.8 %) in the first group and above all Cyprus (4.7 %) and Lithuania (5.6 %) in the second (ECB, 2007).

[8] Problems resulting from the implementation of this policy can be seen even now in the current euro area. Some countries (Portugal, France, Italy) would benefit from lower interest rates to accelerate economic growth at the current time, whereas higher interest rates would be more suitable for other economies with higher growth rates (Ireland, Greece, Spain).

The adoption of the single currency is optimal for countries that are exposed to symmetric shocks or that have mechanisms to absorb asymmetric shocks.[9] Empirical studies show that the likelihood of asymmetric shocks is higher in Europe than in the USA. Naturally, the ECB's common monetary policy, whose main objective is price stability in the monetary union, cannot react to asymmetric shocks in individual euro area countries. For this reason, another sufficiently effective mechanism is needed to cope with these shocks.

The lower the mobility of production factors, openness of national economies, synchronisation of economic cycles and diversification of production; the weaker financial, fiscal and political integration, and the lower the volume of mutual trade, the more rigid the labour market and higher the inflation differentials between Member States' economies, the less suitable the ECB common monetary policy is for euro area members. The worse the adaptive mechanisms perform in alleviating the adverse effects of asymmetric shocks, the harder it will be for the country to deal with the loss of its own monetary policy.[10]

Current euro area members do not fulfil the OCA theory criteria. The situation will even worsen after its anticipated enlargement by the new EU Member States, because this will increase the heterogeneity of the monetary union as a whole and the achievement of an optimum currency area will be postponed until the distant future. A common monetary policy will therefore become even less appropriate for the Member States.

New papers are constantly appearing examining the monetary optimum for various regions of the world. However, the official, mandatory conditions for entry into the euro area are the Maastricht criteria of nominal convergence, fulfilment of which is not necessarily enough to ensure successful functioning of monetary union. The only OCA criterion included in the official criteria for adopting the euro is that of inflation. The creation of the euro area, then, was to some extent a political decision partly based on the assumption that use of a single currency would turn the monetary union into an optimum currency area.

Frankel and Rose claim that the adaptation of the structures of Member State economies for monetary union will probably bring with it greater integration (through trade and capital flows) leading to greater correlation of economic cycles (*hypothesis of endogeneity of*

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[9] Asymmetric shocks are shocks that impact several countries forming the monetary union simultaneously, although their effects in individual countries are different – in some cases positive, in others negative. Shocks that impact the Member States in the "same direction" (symmetric) but with different intensity also have an asymmetric character. This is in contrast to symmetric shocks, which affect all Member States in the same direction and with the same intensity. The question is, however, whether asymmetric shocks mainly result from insufficient economic policy coordination (in which case they would be less likely in the euro area) or whether they result from different trade and industry structures.

[10] The existence of the single currency in implementing different budget policies is often considered the reason for the lower economic growth in the euro area in comparison with the USA. From the point of view of OCA theory, greater labour market flexibility and particularly labour mobility in the USA also assists its favourable economic development. Some believe that even in the medium term, the lack of mobility on the labour market can be corrected through mobility on the capital market. But this, too, is not certain, as countries facing a negative asymmetric shock rarely attract capital through higher interest rates. In addition, when it comes to attracting foreign direct investment, other factors, such as labour costs, size and quality of the labour force, or the level of tax burden, play an important role and often lead to relocation of businesses.

*the OCA criteria*) and to reduced likelihood of asymmetric shocks. Countries that fail to meet the OCA criteria adequately ex ante, will meet them ex post (Frankel, J. A. – Rose, A., K., 1998). However, the endogeneity of the OCA criteria will not necessarily apply universally. In extreme cases, monetary integration could have the exact opposite effect. According to Krugman, the growth of mutual trade following entry into monetary union leads economies to specialise more in goods which give them a comparative advantage. This in turn may make the economy more vulnerable to sector-specific shocks and synchronisation of economic cycles may be reduced (*the specialisation hypothesis*, Krugman, P., 1993).[11]

## 2.4 The institutional aspect of decision-making in the ECB in the context of euro area enlargement

The current institutional arrangements for the euro area's decision-making process in the ESCB (European System of Central Banks) are also not one of its strong points, and may become a source of various conflicts in the future. The problem is that in the not so distant future a further 14 countries may adopt the euro, which would increase the membership of the Governing Council, the main decision-making body of the ECB, from the present 19 (13 governors of national banks and 6 members of the Executive Board) to 33 (27+6) members. Without reform of the voting system, the decision-making process could become very time-consuming and less effective, especially if the governors of the national banks protect their national interests.[12]

In an effort to ensure that the Governing Council could make the right decisions in a timely manner, the European Council unanimously adopted a decision on the voting system in the Governing Council, proposed by the ECB, on 21 March 2003. This happened despite the fact that the European Parliament, whose opinion is not binding, had rejected this proposal mainly because it believed that the rotation scheme proposed was too complicated and unfair. Following ratification by all the EU15 Member States, the European Council's decision came into force on 1 June 2004. It sets out the changes that will be made to voting rights in the

[11] The synchronisation of the economic cycles of individual euro area members has increased since monetary union was established, which confirms the endogeneity of OCA characteristics. It has to be said, however, that the convergence of the economic cycles of Spain, Portugal and Ireland is slower. The reason may lie in the low per capita GDP at EU entry and the catching up process accompanied by specific shocks or the shorter time they have had for developing mutual trade due to joining the EU at a later stage. For these reasons, it cannot be assumed that after the new Member States join the euro area there will be a rapid increase in the synchronisation of their economic cycle with the other Member States.

[12] In the FOMC (Federal Open Market Committee), the decision-making body of the USA's Fed, the balance of power between those representing the federation and those representing the regions is the reverse of that in the ECB Governing Council, as it contains 5 regional representatives from a total of 12 members. The 7 members of the Board of Governors therefore have a majority in the FOMC.

Governing Council as from a) the date on which the number of governors exceeds 15, until it reaches 22 and b) the date on which the number of governors reaches 22 (ECB, 2003).[13]

The adoption of the European Council's decision came just before the expected signing of the EU accession treaties by the new Member States, thus these countries were excluded from the acceptance procedure. Changes in the voting rights in the Governing Council are set out in Article 10(2) of the *Protocol on the Statute of the European System of Central Banks and of the ECB*, which is annexed to the *Treaty establishing a Constitution for Europe*. By ratifying the constitution, the individual Member States (now of the EU27) would thus also express their agreement with the changes in the voting system of the ECB Governing Council following enlargement of the euro area.[14]

The Committee proposes that at least twice a year a representative of the ECB Executive Board participate in a dialogue with the EESC during a plenary session. The Committee also thinks it is appropriate to consider publication of the voting results from ECB Governing Council meetings, in the interests of raising the accountability of the governors of national central banks in monetary union members. That would encourage them to make decisions on the basis of overall economic conditions in the euro area rather than developments in their national economies.

## 2.5 Coordination of national fiscal policies

While Fed monetary policy on the whole resembles ECB monetary policy, fundamental differences exist between the USA and the EMU in the implementation of fiscal policy. In the USA, a greater part of the fiscal system is centralised, and this system also contributes to the stabilisation of the regions more affected by asymmetric shock. Absence of fiscal federalism (i.e. a lower level of fiscal integration) as a potential adaptation mechanism for reducing the impacts of asymmetric shocks is an imperfection of the euro area. According to the opinions of several experts, without fiscal federalism, the monetary union can not be successful in the long term.[15] Mechanisms of fiscal transfers in Europe are far from the level of the American

[13] In the first case, governors will be allocated into two groups, according to a ranking of the size of their respective Member State's share of aggregate gross domestic product at market prices and of the total aggregated balance sheet of the financial institutions of the Member States which have adopted the euro; in the second case into three groups in the same manner, with voting rights to be rotated. The governors of national central banks will always have 15 voting rights and the 6 members of the Executive Board each retain a permanent voting right.

[14] However, following rejection in the referenda in France and the Netherlands, the Constitution's ratification by all the Member States is nowhere in sight.

[15] Fiscal federalism would consist in introducing a system of automatic transfer payments between states, i.e. in strengthening the role of the central fiscal authority and in abandoning the current confederate system of European public finance. However, this solution would be difficult to implement in Europe.

federal fiscal system. The centralised budget is low,[16] and so it does not function as an automatic stabiliser in the event of asynchronous cyclical deviations in individual countries. There is certain solidarity "mechanism" here in the form of the EU Structural Funds and Cohesion Fund, but these can not be considered sufficient substitute as they are much smaller and work over the medium to long term, i.e. they do not have anticyclical effects (Iša, J., 2002).

The euro area did not manage to use the higher economic growth during the first years of its existence to improve the fiscal situations in the Member States, i.e. for reforms and budget consolidations.[17] Implementation of the SGP has brought decidedly more success in achieving stability than it has with growth. At the same time, developments in the euro area confirm that even fiscal policy of the "one size fits all" type cannot meet the needs of all countries, because it does not take into account the diverse circumstances in individual economies and the differing impact of possible recession on them.

In autumn 2004, the Commission elaborated proposal of the Pact's reform and submitted it to the European Council. In March 2005, finance ministers from the EU Member States agreed in Brussels on a different version of the SGP rules reform, which was also approved by EU leaders at the spring summit (22 – 23 March 2005). According to the reformed Pact, the limits for public deficit ratio (3 % of GDP) and government debt ratio (60 % of GDP) remain crucial. However, the terms for deficit correction have been extended and the range of exceptions enhanced whereby the flexibility of the Pact has increased. In case the deficit exceeds the reference value temporary while remaining close to it, expenditures for the following purposes should be considered:[18]

- international solidarity (this can be understood as fulfilment of the requirement of France not to include expenditures for development aid and defence into the deficit);
- achieving European policy goals, notably the unification of Europe (understood as fulfilment of the requirement of Germany not to include the costs of country's unification into the deficit);
- achieving the Lisbon objectives (science, education, innovation), making public investments, reducing debt and improving public finances;
- implementation of pension reform, namely during five years after its introduction; reform costs are regarded degressively – it is possible to deduct from the deficit the full reform costs in the first year, 80, 60, 40 and 20 % of the costs in the following years (understood as a partial fulfilment of the requirement of the new Member States, particularly Slovakia, Poland and Hungary).

[16] Until 2006 it represented 1.24 % of GDP (besides which, almost half of this was allotted to the Common Agricultural Policy), and in 2007 – 2013 it will reach only 1.045 % GDP of the European Union.
[17] Although the state of public finances in the euro area has somewhat worsened, due particularly to Germany, France, Portugal, Greece and Italy, the situation is much better than in the USA.
[18] Council Regulation 1056/2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

Although the reformed Pact applies a more differentiated approach for individual countries, we assume that it still does not allow them to react flexibly enough to asymmetric shocks. More emphasis should be placed on the level of government debt, which would allow new Member States with low levels of debt to exceed the reference value temporarily in order to finance public investments, without endangering the sustainability of their public finances.

The Committee warns that increased pressure is needed to ensure the observance of all of SGP rules.[19] The Committee also wonders whether an independent body for fiscal policy should be created, which would be something of a counterweight to the ECB monetary authority. This would also create better conditions for coordination of monetary and fiscal policy in the euro area. The members of this body would be independent experts in business cycles and fiscal policy appointed by the EU heads of state or government on the basis of recommendations from the Council after it has consulted the European Parliament. These members would be voted in for an eight-year non-renewable term. The fiscal body would apply the SGP in the area of anticyclical policy and its sole role would be to set mandatory limits for maximum public deficit levels or minimum surplus levels as appropriate each year for every member state on the basis of its business cycle and in accordance with its medium term objectives for the budgetary position. It would, in effect, complement the roles of the Commission and the Council in fiscal matters.

## 2.6 Coordination of monetary and fiscal policy

Monetary union supposes a certain level of coordination of individual Member States' fiscal policies and a certain harmony of monetary and fiscal policy in the union as a whole. The USA is an example of a generally effective monetary union, with a single monetary authority (Fed) working alongside a single fiscal authority (the government). This basic symmetric structure allows resolution of not only strategic but also short-term (stabilisation) problems of economic coordination (Iša, J., 2005b).

The euro area has an asymmetric structure because of the relationship between the single monetary authority and the thirteen politically independent fiscal authorities, thirteen labour markets and thirteen different microeconomic policies. Given the asymmetric structure of the euro area system, the ECB is the only institution that has direct responsibility for stabilisation of the euro area economy from common shocks. „A properly functioning common monetary policy should not therefore only stabilise inflationary expectations, but also expectations for output growth, or other key aggregate economic indicators. The ECB does not, however, set itself such a task at all and cannot do so while there is a clear prioritisation of price stability not only in the medium term but also in the short term. This, understandably, weakens its stabilising role when not only asymmetric, but also symmetric shocks occur" (Iša, J., 2005b, p. 571).

[19] In the history of the SGP to date, none of the Member States have been forced to pay penalties for exceeding the public deficit limit, as Germany and France successfully evaded them in 2003.

In the USA, then, in contrast to the euro area, there is a certain “freedom in decision making” on monetary and fiscal policy, which is made possible in part by the existing institutional set-up and by the definition of monetary and fiscal policy objectives, which partially overlap. The Fed follows multiple objectives – maximum employment, stable prices and sufficiently low long-term interest rates.[20] Therefore, what is possible in the USA (i.e. a certain appropriate combination of monetary and fiscal policy) is a priori not possible in the euro area (Iša, J., 2005b).

[20] The Fed has never had and still does not have price stability as its only objective. The Federal Reserve Reform Act, 1977, made it responsible for movements in the employment rate. At the same time, the Federal Open Market Committee (FOMC) interprets the objective “support for maximum employment” as being equivalent to “support for long-term sustainable economic growth”. The ECB restricted its responsibility to achieving price stability, which is supposed to be the best method for achieving the other aims laid down in the Maastricht Treaty. Article 105 of the Treaty states more or less formally that the ESCB will support "the general economic policies in the Community", albeit "without prejudice to the objective of price stability".

# 3. POTENTIAL EURO AREA MEMBERS AND THE PERSPECTIVES OF THEIR MONETARY INTEGRATION

The second challenge connected with euro area enlargement is the ability of the acceding countries to fulfil the nominal Maastricht criteria, which is a necessary condition for their admission. Countries that are sooner or later likely to adopt the single currency may be divided into three groups:

- old EU Member States that for a variety of reasons have not joined the euro area (Denmark, the United Kingdom and Sweden);
- new Member States whose currencies have already joined the ERM II exchange rate mechanism (Cyprus, Estonia, Latvia, Lithuania, Malta and Slovakia);
- other new Member States (Bulgaria, the Czech Republic, Hungary, Poland and Romania).

According to the facts mentioned above, fourteen EU Member States have still not adopted the euro. With the exception of Denmark and the United Kingdom, who have opt-out status, all the others have committed themselves to doing so. In addition, in these two states and in Sweden, possible membership in the euro area must be agreed in a referendum.

Since the beginning of the third phase of EMU (1 January 1999), the Danish krone has been closely tied to the euro in the ERM II exchange rate mechanism (±2.25 %). Although the country fulfils all the convergence criteria and has strong trade links with monetary union members, it has the right under the EU Treaty to remain outside the euro area. Entry to the monetary union was rejected in a referendum, which took place in September 2000 (46.9 % in favour, 53.1 % against).

Due to the differences between the UK economy and the euro area economy, the British government has decided to make its membership in the monetary union dependent not only on fulfilment of the Maastricht criteria but also on fulfilment of five additional criteria, which take account of some aspects of the OCA theory. The last evaluation of the five tests, carried out in June 2003, on the basis of which the government would decide whether joining the euro area was in the national economic interest, were negative. Since 1998, support for adoption of the euro among the UK population has been only around 30 %, with roughly 60 % against.

The Swedish referendum on joining monetary union, which took place in September 2003, endorsed the 1997 parliamentary decision not to adopt the single currency for the time being. Only 41.8 % of the participants in the referendum were in favour of entry into the euro area, with 56.2 % against. Furthermore, Sweden does not fulfil one of the Maastricht criteria – its national currency has not been in the ERM II for the required two years.

The new Member States are obliged to attempt to fulfil all the convergence criteria. The Commission and the ECB evaluate, at least once every two years, the progress of the convergence of the EU Member States aiming to adopt the single currency in their convergence reports and submit them to the Council. After consultation with the European Parliament and discussions in the European Council, the Council will adopt, based on a proposal from the Commission, a decision on which Member States with a derogation fulfil the necessary criteria and which ones will have their derogation cancelled, i.e. it will decide whether or not to accept the respective country into the euro area, and if yes – on what date.

Integration of the new Member States into the monetary union has benefits for their economies as a whole, their enterprises and citizens. These include lower transaction costs, elimination of exchange rate risk vis-à-vis the euro, greater currency stability and financial market stability, better access to financial resources for small and medium enterprises, and greater price transparency. Lower interest rates, faster economic growth, subsequent higher employment and incomes, growth of mutual trade, growth of foreign direct investment and increased pressure for more rational implementation of budgetary policy are also expected.

On the other hand, the biggest disadvantage of membership in the euro area is considered to be the loss of independent monetary and exchange rate policy, i.e. the loss of exchange and interest rates as instruments with which to counter the effects of asymmetric supply and demand shocks on the national economy. Countries that enter the monetary union will no longer be able to change the value of their currency, nor determine the amount of money in circulation, which requires other adaptation mechanisms. Other drawbacks of euro area entry are restrictions in fiscal policy and the technical costs of transition to the single currency (Šiková, I., 2006).

## 3.1 Fulfilment of nominal criteria

The 2004 convergence reports produced by the ECB and the EC, which are individual documents, confirmed that none of the new EU Member States was ready for introduction of the single currency. They also evaluated Sweden, which fulfils all the criteria except for two years of membership in the ERM II.[21]

In May 2006, the ECB and the EC elaborated convergence reports on Lithuania and Slovenia based on their requests to be evaluated. The ECOFIN Council decided to cancel the derogation of Slovenia and allowed the country to adopt the euro on 1 January 2007, whereas the status of Lithuania as a country with derogation has not been changed on the ground of exceeding the inflation reference value (though only by 0.1 %). Within the regular two-year cycle, the ECB and the EC evaluated progress in convergence also in the other new Member States and in Sweden in December 2006.

According to the ECB *Convergence Report, December 2006*, inflation did not exceed the reference value only in four (the Czech Republic, Cyprus, Poland and Sweden) out of nine evaluated countries during the relevant twelve-month period since November 2005 till October

[21] As Denmark and the United Kingdom have a special status, convergence report is produced for them only if they request one.

2006.[22] In consequence of a high domestic and external demand growth, changes in regulated prices and excise duties, as well as in consequence of the catching up process, the inflation pressures are expected to continue. This could delay entry into monetary union in case of some economies. During the monitored period, only Hungary did not fulfil the criterion for long-term interest rates.

In 2005, only three countries evaluated recorded *public finance* surplus (Estonia, Latvia, Sweden) and six countries deficit – only two of them (Cyprus and Poland) under the 3 % GDP reference value. Only Cyprus, Malta and Hungary exceed the 60 % GDP reference value for *government debt*. Whereas the government debt/GDP ratio is expected to fall in the two Mediterranean countries, increase is likely in Hungary.

Within the group of the new Member States which have not entered the euro area, Estonia, Lithuania (since 28 June 2004), Cyprus, Latvia and Malta (since 2 May 2005) are the members of the exchange rate mechanism ERM II for a minimum of two years at the present time. Considering the fact they have not devalued their central parities, they fulfil *exchange rate stability* criterion. Slovakia joined ERM II on 28 November 2005 and currencies of four countries evaluated (the Czech Republic, Hungary, Poland and Sweden) do not participate in the exchange rate mechanism for the time being.[23]

Table 3.1
**Fulfilment of the Maastricht criteria in the new Member States in 2006**

| *Country* | *Inflation HICP (%)* | *Long-term interest rates (%)* | *Public finance balance (% GDP)* | *Government debt (% GDP)* | *ERM II membership* |
|---|---|---|---|---|---|
| Bulgaria | 7.4 | 4.4 | 3.3 | 22.8 | – |
| Cyprus | 2.3 | 4.1 | -1.5 | 65.3 | since 2.5.2005 |
| Czech Republic | 2.1 | 3.8 | -2.9 | 30.4 | – |
| Estonia | 4.5 | 4.3 | 3.8 | 4.1 | since 28.6.2004 |
| Hungary | 4.0 | 7.1 | -9.2 | 66.0 | – |
| Latvia | 6.6 | 4.1 | 0.4 | 10.0 | since 2.5.2005 |
| Lithuania | 3.8 | 4.1 | -0.3 | 18.2 | since 28.6.2004 |
| Malta | 2.6 | 4.3 | -2.6 | 66.5 | since 2.5.2005 |
| Poland | 1.3 | 5.2 | -3.9 | 47.8 | – |
| Romania | 6.6 | 7.3 | -1.9 | 12.4 | – |
| Slovakia | 4.3 | 4.4 | -3.4 | 30.7 | since 28.11.2005 |
| Slovenia | 2.5 | 3.9 | -1.4 | 27.8 | since 28.6.2004 |
| *Reference value* | *2.9* | *6.3* | *-3.0* | *60.0* | – |

*Source*: Eurostat, 2007, European Commission, 2007, own calculations.

Slovenia, which adopted the euro on 1 January 2007, met all official criteria for euro area entry as the first new EU Member State. On the contrary, Hungary, which does not fulfil any Maastricht criterion, has the worst position.

[22] Table 3.1 presents the fulfilment of the Maastricht criteria in 2006 in all new EU Member States including Slovenia, which is already member of the euro area, as well as Bulgaria and Romania, which became candidates for adoption of the single currency after their EU entry.
[23] Bulgaria and Romania, for which the ECB and the EC have not elaborated convergence reports so far, are also non-ERM II members.

The latest ECB and EC convergence reports from May 2007 evaluate progress of Malta and Cyprus towards convergence. These countries meet conditions for euro area entry. Ministers of Finance and Economy from the EU States definitely confirmed their monetary integration (1 January 2008) at their meeting at the beginning of July 2007, where also exchange rates of the Cypriot pound and the Maltese lira against the euro were set.

Two important questions arise in connection with the Maastricht criteria: Is there not a contradiction – in both current and future euro area member states – between fulfilling the Maastricht fiscal criteria (SGP requirements) and achieving the Lisbon objectives? Are the Maastricht criteria, which were drawn up in the early nineties, still appropriate for evaluating the readiness of countries to adopt the euro in today’s different macroeconomic and financial circumstances, where there is a much great capital mobility?

The need for the exchange rate stability criterion is particularly questionable. Membership in ERM II, which aims to ensure the “correct” exchange rate between the national currency and the euro on entry to the euro area, exposes the national currency to risk of speculative attacks, excessive exchange rate volatility and financial instability. The inflation criterion again does not take into account the need for higher price levels in the new Member States. In addition, it has been calculated from the average level of inflation in the three most successful EU countries rather than the euro area.

Entry into the monetary union and smooth operation within it require not only achievement of the given levels of nominal convergence based on the disputable Maastricht criteria, but also a certain level of real convergence and improvement of the adaptation mechanisms of the individual economies according to the OCA theory. Although these criteria, unlike those of the Maastricht Treaty, are not official criteria for adoption of the single currency, they play a fundamental role in assessing the readiness of countries to enter the monetary union and the cost/benefit evaluation of membership in it (Šikulová, I., 2006).

## 3.2 Real convergence

The main factors monitored when considering real convergence are the differences in GDP per capita in purchasing power parity (PPP)[24], in labour productivity and in price levels. Catching-up is conditional on the starting position of the country, the rate of growth, the disinflation strategy implemented, and the exchange rate regime. The process of real convergence is long-term in character and certainly will not be complete before the accession of the new EU Member States to the monetary union. It works through faster growth of real GDP in comparison with the EU, mainly as a result of growth in labour productivity and/or appreciation of the real exchange rate against the euro.

[24] PPP is both a currency convertor, between the national currency and the common currency, and a price deflator. Therefore, when GDP is calculated in the common currency measured in PPP, GDP will also be calculated in comparable prices and so enables the comparison of real GDP in different countries.

The new Member States, which apart from Cyprus and Malta have undergone a process of transition from centrally planned to market economies over the last sixteen years, are on average distinctly poorer than the EU15, and even in comparison with the so-called cohesion countries (Greece, Spain and Portugal). Their GDP per capita in PPP (including Bulgaria and Romania) was on average only 61.5 % of the EU25 average in 2006 (table 3.2) and even approximately half as low in real prices. The GDP per capita for Cyprus, Malta and Slovenia in real prices is relatively close to GDP per capita in PPP, but in other new Member States, the ratio between these two indicators is around 1:2. This difference between real prices and purchasing power parity is explained by the Balassa-Samuelson effect (B-S effect),[25] whose influence is relatively strong in most new Member States, as they are still in the process of catching-up. The countries analysed lag behind the EU average also in labour productivity per employee, which reached from 33 % of EU25 average in Bulgaria to 83 % in Malta and 62.7 % on average in the new Member States in 2006 (table 3.2).

Table 3.2
**GDP per capita in PPP, labour productivity, comparative price level and ERDI in the new EU Member States in 2006 (EU25=100)**

| *Country* | *GDP per capita in PPP* | *Labour productivity* | *Comparative price level* | *ERDI* |
|---|---|---|---|---|
| Bulgaria | 35.0 | 33.3 | 43.6 | 2.29 |
| Cyprus | 88.4 | 81.3 | 88.5 | 1.13 |
| Czech Republic | 75.9 | 67.9 | 60.1 | 1.66 |
| Estonia | 65.0 | 60.9 | 66.3 | 1.51 |
| Hungary | 63.4 | 72.5 | 59.3 | 1.69 |
| Latvia | 53.3 | 50.4 | 58.2 | 1.72 |
| Lithuania | 54.8 | 55.6 | 55.8 | 1.79 |
| Malta | 71.5 | 83.4 | 72.7 | 1.38 |
| Poland | 51.3 | 59.5 | 62.2 | 1.61 |
| Romania | 35.9 | 40.1 | 57.9 | 1.73 |
| Slovakia | 60.2 | 67.5 | 57.6 | 1.74 |
| Slovenia | 83.6 | 80.4 | 75.0 | 1.33 |
| *Average* | *61.5* | *62.7* | *63.1* | *1.58* |

*Source*: Eurostat, 2007, own calculations.

At the beginning of the transformation process, the exchange rates for these countries were distinctly undervalued, and in the last decade, they have continuously undergone real appreciation, which has manifested itself in a rise in the price level in comparison with the EU average (in the new Member States, the average level was 63.1 % of the EU25 average in 2006) and in a fall in the Exchange Rate Deviation Index (ERDI), i.e. the inverse of the com-

[25] The subject-matter of this effect is the different growth rates of labour productivity in tradable and non-tradable sectors. While this growth is faster in the tradable sector, wages have a tendency to rise in both sectors at almost the same rate. A gap is thus created in the non-tradable sector between growth in productivity and growth in wages. If growth in productivity in the tradable sector outstrips that in the non-tradable sector at home more than in other countries, this leads to faster growth of the domestic price level in comparison with abroad, i.e. a higher inflation rate differential.

parative price level. This fact shows the problematic relationship between nominal and real convergence.

The ERDI as a ratio of nominal exchange rate of the national currency to the euro/the PPP exchange rate was, at the time of euro area entry, 1.41 for Portugal (1999), 1.25 for Spain (1999) and 1.32 for Greece (2001). The price (and economic) level desired to provide a certain guarantee of a trouble-free integration process is considered to be 65 – 75 % of the average in the group of countries integrated, which is equivalent to an ERDI coefficient of around 1.3 to 1.5. However, with the exception of Cyprus, Slovenia, Malta and Estonia, price level did still not exceeded 65 % of the EU25 average for most new Member States in 2006. The lowest comparative price levels and so the worst ERDI values recorded – apart from the two newest EU Member States – Lithuania, Latvia and Slovakia (table 3.2).

The countries analysed should be given room to catch up both before entry to the ERM II and once they have joined. For this reason, a fluctuation band of ±15 % should be retained, which should allow sufficient room necessary for nominal appreciation of their national currencies against the euro. At the same time, the inflation channel should also be left to catch up over the whole of this period.

After entry into the euro area, these economies will only be able to achieve real appreciation through the inflation differential, which, however, will be capped by the ECB common monetary policy inflation target of "close to, but below, 2 per cent”. The ECB’s efforts to achieve price stability could thus lead to pressure to curb wage increases in the new Member States. But there is only a limited risk that the ECB common monetary policy, seeking to hold back inflation in the new Member States, will be too restrictive for the original members. That is to say, it is unlikely that euro area inflation would be significantly influenced, given the low weighting of the new Member States in the HICP (in which the weighting of individual countries depend on the relative size of their GDP). Inflation differentials that are too high could, however, hamper the implementation of the ECB common monetary policy.[26] Given the limited possibilities for real appreciation, after adoption of the single currency, the key role in the process of catching up will be played by high and long-term sustainable economic growth based on increase in productivity and in competitiveness.

[26] Here it is worth noting that the possible upwards adjustment of the definition of price stability for the euro area would create more room for the convergence of the new Member States, which have rapid real appreciation, i.e. a higher inflation rate, and at the same time would reduce what are even deflationary pressures on the current members. The fact is that a 2 % level of inflation is considered in the euro area as price stability. This is a rise of prices based on higher quality and production innovation, and is considered as phantom inflation. In the new Member States, phantom inflation is at even higher levels. On the other hand, it should be acknowledged that raising the ECB inflation objective could endanger the effort to establish the euro as a stable currency with a low level of inflation and therefore undermine its ability to compete with the US dollar for the role of world currency.

### 3.3 Constraints in optimal functioning of the new Member States in the euro area

From the viewpoint of OCA theory, Slovenia, Hungary, Poland, Estonia and the Czech Republic have the highest level of convergence among the new Member States.[27] The significantly lower economic level of the new EU Member States in comparison with the EU15 average, however, perpetuates the risk of asymmetric shocks. As a consequence, there is a need for adaptation mechanisms such as cross-border mobility of labour, wage and price flexibility, and fiscal transfers.

The existence of the single market as one of the forms of macroeconomic integration supposes the free movement of goods and services, as well as of capital and labour between individual member countries. However, these "four freedoms" of the single market have not yet been completely fulfilled in the EU, as there are obstacles to free movement of services and (since enlargement) to free movement of labour.[28]

According to the so-called 2+3+2 model, the EU15 Member States could restrict free movement of labour from the new Member States apart from Cyprus and Malta during the period of two years following EU entry (1 May 2004) with the possibility for this to be extended by a further three and then two years. During the first two-year period, Ireland was the only euro area country which did not use this possibility (and also Sweden and United Kingdom as EU15 countries). On 1 May 2006, Portugal, Spain, Greece and Finland also opened their labour markets for citizens from the new Member States. Italy did so later in 2006 and Netherlands in 2007.

Denmark simplified the procedures, and consecutive opening of its labour market is expected. Belgium and Luxemburg also simplified procedures, however, only in some sectors. France will release its labour market in successive steps, particularly in the sectors with shortage in the labour force. And at last, Germany and Austria will probably use the maximum length of the transition period, i.e. seven years, since regarding the geographical neighbourhood of the new Member States, they are afraid of inflow of cheap labour force from the East and Central European countries.[29]

Wage flexibility in the new Member States is somewhat higher than in the old Member States; this means that, in the case of regional shocks following EU entry, their labour markets will be able to fulfil the role of a compensatory mechanism better. However, the new

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[27] The majority of the new EU Member States have even better results than Ireland, Greece and Spain in meeting the OCA theory criteria.

[28] The creation of a single European market allowing completely free movement of goods and services, capital and labour by the end of 1992 was already envisaged in the Single European Act (1986). Article 3 of the consolidated version (1.11.2004) of The Treaty establishing the European Community also states that "…the Community's action includes… …an internal market characterized by the abolition, as between Member States of obstacles to the free movement of goods, persons, services and capital …"

[29] The new Member States were also entitled to introduce the restrictions for EU15 workers reciprocally, but only Hungary, Poland and Slovenia did so.

Member States need to improve competitiveness in the products market to achieve greater price flexibility.

And finally, the SGP, compliance with which causes problems not only for the new EU Member States but also for several euro area Member States (particularly Italy and Portugal), cuts down the room for implementation of fiscal policy, i.e. an important area of independent economic policy that the new Member States will retain even after adoption of the single currency. Efforts to reduce the public finance deficit below the reference value immediately after the EU entry – so that the euro can be adopted as quickly as possible – could namely conflict with the objective of increasing real convergence in these countries.

## 3.4 Entry into ERM II and the euro area

The optimum speed for the adoption of the single currency by the new Member States remains an open question. The advantage of a quick entry strategy is that instability caused by participation in the ERM II, by high capital mobility and by convergence games may be overcome in a relatively short time. The main disadvantage of this strategy is that it involves strenuous efforts to fulfil the Maastricht criteria and prepare for euro adoption. Rapid currency integration would also eliminate the possibility of using monetary policy to mitigate the macro-economic impacts of structural reforms. Keeping this opportunity is, on the other hand, the main advantage of the second strategy, given that the exchange rate may be regulated over a longer time.[30]

Countries that have already abandoned their use of monetary policy instruments in their own economy, will presumably find the rapid strategy more appropriate (Estonia, Lithuania). Some countries will, however, probably prefer the slower strategy and all the more so the greater the opportunities they see in the use of monetary instruments in their economic policy. During membership of the ERM II, which leaves the participating countries exposed to changing conditions on the global capital markets, the implementation of stabilising economic policies and the role of the monetary and fiscal authorities will be even more important.

On entry of the national currency into this exchange rate mechanism, it is important to determine an optimal central parity on which the currency's stability depends during the currency's two-year membership in the ERM II.[31] Credible and therefore stable entry parity

[30] The difficulties involved in the rapid entry strategy may, to a certain extent, be offset by the fact that the commitment to adopt the euro quickly and the confidence in the markets of this being accomplished may create a favourable environment for the implementation of economic policy, including fulfilment of the Maastricht criteria. The reverse may be true for the economies preferring the slow entry strategy, which risk delays in necessary reforms.

[31] The determination of the central parity (and width of the fluctuation band) will be the result of agreement between the ministers of the euro area, the ECB, and the minister and governor of the central bank of the country entering the ERM II, and changes to it are possible if consistent with macroeconomic fundamentals.

should be one as close as possible to the equilibrium value of the nominal exchange rate.[32] The estimate of an equilibrium real exchange rate for entry using, for example, the Balassa-Samuelson model, FEER (fundamental equilibrium exchange rate) methodology or BEER (behavioural equilibrium exchange rate) is therefore important.[33] The equilibrium nominal exchange rate with the euro can then be deduced from this.

Both overvaluation and undervaluation of the currency brings economic benefits and disadvantages. If the final nominal exchange rate (conversion rate) before adoption of the euro is too low, the country would enter the euro area with an overvalued real exchange rate, which would bring a fall in the domestic price level in comparison with other members of monetary union, a loss of competitiveness, reduction in growth and higher unemployment.[34] On the other hand, if the nominal exchange rate was set too high, the country would enter the euro area with an undervalued real exchange rate supporting exports and this would lead to faster growth of the price level.

Not long ago, the planned deadlines for adoption of the single currency in these countries were between 2007 for Estonia, Lithuania and Slovenia and 2010 for the Czech Republic and Hungary. However, on 1 January 2007, only Slovenia entered the euro area. Estonia and Lithuania did not meet the inflation criterion, Estonia did not even request for the evaluation of its progress in nominal convergence.

Many of the new Member States were forced to delay their entry into the monetary union (table 3.3). Their economic growth is high and can be considered sustainable in most cases, however, these countries face problems with macroeconomic imbalance in the areas relevant for qualification into the monetary union – inflation (Baltic countries) and public finances (most of the V4-countries).

Some of the new Member States have not set or reset (after the cancellation) the date for the euro adoption so far, however, they express interest to enter the monetary union quickly (Poland) or they have doubts an early monetary integration would be convenient for the economy (the Czech Republic). As far as the newest EU Member States are concerned, the aim of Bulgaria is to adopt the euro as soon as possible, whereas Romania will probably focus on increase in real convergence first.

[32] An undervalued central parity on entry to ERM II could jeopardise fulfilment of the Maastricht inflation criterion.

[33] The Balassa-Samuelson model, derived from a small open economy based on tradable and non-tradable sectors is the simplest of these approaches. However, only a part of real appreciation in transition economies is explained by the B-S effect. FEER is defined as the real exchange rate that makes it possible to have internal and external equilibrium at the same time. The basis of the behavioural method (BEER) is finding the long-term relationship between the real exchange rate and an appropriate selection of other economic indicators.

[34] These problems resulted from the incorrectly fixed conversion rate after the reunification of Germany in 1990.

Malta and Cyprus will become euro area Member States on 1 January 2008. Regarding their small economies, their integration into the monetary union will have only slight effect on the euro area economy. On the other hand, both states expect fostering tourism and increase in FDI after the euro introduction.

In view of the present situation and perspectives of fulfilling the Maastricht criteria, Slovakia will probably adopt the single currency according to the plan – on 1 January 2009. In that case, it would be the first V4 country in the euro area and also economy with the lowest level of real convergence at the time of euro adoption. Thus, great demand will be placed on the flexibility of the national economy.

Table 3.3
**Supposed timetable for adoption of the single currency in potential euro area Member States**

| Country | Year | Remarks |
|---|---|---|
| *Non-euro area members within EU15 countries* | | |
| Denmark | ? | |
| United Kingdom | ? | |
| Sweden | ? | |
| *The new Member States participating in ERM II* | | |
| Slovenia | 1.1.2007 | already euro area member |
| Cyprus | 1.1.2008 | originally 2007 |
| Malta | 1.1 2008 | |
| Slovakia | 1.1.2009 | originally 2008/2009 |
| Estonia | 1.1.2011 | originally 2007, entry delay (inflation) |
| Lithuania | ? | originally 2007, probably not before 2011 (inflation) |
| Latvia | ? | originally 2008, probably not before 2012 (inflation) |
| *Other new Member States* | | |
| Czech Republic | ? | originally 2010, probably not before 2012 (public finance deficit) |
| Poland | ? | probably not before 2012 (public finance deficit) |
| Hungary | ? | originally 2008, probably not before 2014 (does not fulfil any criterion) |
| Bulgaria | ? | originally 2009, probably not before 2011 (inflation) |
| Romania | ? | originally 2010 – 2012, probably not before 2014 (inflation) |

*Source*: Web pages of the central banks.

In the countries listed above, fiscal policy should play a crucial stabilising role both in the process of integrating into the monetary union and once the single currency has been adopted. It will have to support the catching-up process, deal with the pressures of implementing structural reforms, with harmonisation of the law with the *aquis* and with the need for heavy investment in infrastructure. In addition to the thorough consolidation of public finances, increasing flexibility in the labour market is also essential to reduce the need for the exchange rate as an adaptive instrument. The strengthening of the role and effectiveness of fiscal policy and of other policies will thus make it possible to meet the Maastricht criteria on a sustainable basis and create conditions for stable development of economies after their integration into the euro area, when the national monetary policies are replaced by the ECB common monetary policy.

## 4. CONCLUSIONS AND RECOMMENDATIONS

Despite undisputed successes in the existence of the euro area, it is already facing a number of problems. The introduction of the single currency did not bring the expected strengthening of the EU internal market, several structural reforms are behind schedule, many Member States have problems fulfilling the requirements of the SGP, the labour markets are still not flexible enough despite the reforms carried out in some Member States, unemployment is not falling and economic growth is still relatively low.

To help the EU become the most competitive economy in the world (albeit no longer by 2010), or at least to reduce the USA's lead, the EU and the euro area could look for inspiration to the way the American currency union operates. Although differing in important aspects from the euro area, it is also a good example of how flexible labour markets and labour mobility contribute to the effective operation of a currency union.

Timing of adoption of the single currency in the new Member States, whose economic level is still low in comparison with the euro area Member States, remains an open question. Even with sustainable fulfilment of the Maastricht criteria in these economies, the insufficient level of their real convergence and insufficient fulfilment of conditions for optimal functioning in the monetary union after enlargement of the euro area will produce more heterogeneity and greater risk of asymmetric shocks. This will reduce the efficacy of the common monetary policy for individual (old and new) Member States. Given the transitional periods for free movement of labour and the lack of fiscal solidarity, economies acceding to the monetary union will have no alternative adaptation mechanisms at their disposal after losing the exchange rate as a mechanism and this will increase the need for fiscal flexibility.

Taking all the above into account, the authors:

– draw attention to the need to strive to create better conditions for the optimal functioning of the monetary union, speed up structural reforms and complete the EU internal market, particularly by removing barriers to the free movement of labour and services, which would boost integration effects in the euro area as a whole as well as in the economies of individual Member States;
– suggest that greater account should be taken of the economic growth and employment objectives in implementation of ECB monetary policy;
– suggest that consideration should also be given to publishing the voting results from ECB Governing Council meetings;
– warn that the ECB Governing Council rotation voting scheme, which should come into effect following enlargement of the euro area, needs to be specified;
– suggest initiating a dialogue between a member of the ECB Executive Board and the EESC during its plenary session;

- consider it desirable to enable Member State economies to react better within the SGP to asymmetric shocks and ensure consistent compliance with all of the Pact's rules;
- wonder whether economic policy coordination, and hence the euro area's economic performance, would not be improved by an independent body for coordinating fiscal policy which would be an equal counterweight to the ECB;
- recommend the new Member States whose national currencies are not yet in the ERM II to thoroughly examine their economic situation, including their level of real convergence, before deciding when to enter the exchange rate mechanism;
- suggest that the old Member States should reconsider (if they have not done it so far) the length of transitional periods for free movement of labour, which may also have negative impacts on their own economies;
- warn that thorough consolidation of public finances, more flexibility in the labour and goods markets are required, and sound national plans for adopting the euro in the new Member States need to be drawn up;
- stress in particular that before the adoption of the single currency comprehensive information campaigns involving all of civil society are needed, which emphasise the benefits and, at the same time, warn of the risks of taking this step;
- advise Bulgaria and Romania, to ensure that their entry into the euro area is as smooth as possible and that they profit from membership of it, to pay particular attention in the period following their EU entry not only to sustainable fulfilment of the Maastricht criteria, but also to ensuring effective adaptation mechanisms and, in particular, to increasing real convergence.

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Such an important step in the process of European integration as euro area enlargement will bring not only benefits but also not insignificant costs, both for the accession countries joining it and for the current monetary union. There can be no doubt, therefore, that the readiness of both sides is a vital condition for a successful enlargement, i.e. effective operation of both the euro area as a whole and its individual members. For the new Member States this means sustainable fulfilment of the Maastricht criteria, as well as strengthening and increasing their level of real convergence and better fulfilling the conditions for optimal functioning in the monetary union. The readiness of the euro area, on the other hand, is mainly about implementing necessary structural reforms and also – to make decision-making processes more effective – institutional reforms.

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