FROM ACCESSION TO ADOPTING THE EURO

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1. **INTRODUCTION**

In a few months’ time, on 1st of May next year, the European Union will welcome ten new Member States.

This is in itself a landmark achievement of greatest political dimension. But, and more to the point of today’s conference, the imminent enlargement of the EU is also witness to a historically unprecedented transition of former socialist countries to competitive market economies. Indeed, economic transition has been a precondition for accession. The EU is a community of well functioning and highly efficient market economies. Any new Member State - and that was clear from the outset of considering accession of Central and Eastern European countries - had to show similar economic features, in order to benefit economically from accession.

2. **COPENHAGEN ECONOMIC CRITERIA**

*Background*

This view was formally endorsed by the Heads of State and Government of the EU more of a decade ago, at the Copenhagen European Council of June 1993. This summit marked an important goalpost in this historical process of enlargement. Allow me to cite its conclusions:

“Membership requires that the candidate country has achieve stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate’s ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.”

In other words, the Council established the well-known so-called Copenhagen accession criteria.

Two of these are of economic nature namely (a) to be a functioning market economy and (b) the capacity to cope with competitive pressure and market forces within the Union. Hence, the European
Council set minimum requirements for EU membership as regards the economic performance of the respective candidate country.

The reason behind this has of course been the fact that in 1993 most candidate countries were still in the early days of transformation from being centrally planned economies. More generally, there has been the conviction that only with a sufficiently market-oriented and competitive economy a country would, in economic terms, be able to benefit from membership to the EU. Why? Because the EU is representing a market-based, very efficient and tested integrated economy. That is why these criteria have been applied to all candidate countries thereafter, and not only to transition economies.

Application

These criteria have since then been applied by the Commission in a consistent and rigorous way in its opinions on membership application and subsequent Regular Reports on progress with preparations for all candidate countries. For this purpose, subcriteria were defined and applied, in order to ensure utmost objectivity of these assessments. Subcriteria are for example: macroeconomic stability (sustainable public finances and current account), development of financial sector, degree of trade integration, availability of human and physical capital, proportion of small firms.

I think the Commission has done quite a good job over the years in applying these economic criteria. Overall, the assessments and their conclusions have been widely accepted as a proper description and evaluation in the country concerned and, equally importantly, as an agenda and catalyst for further stabilisation and reform efforts in the countries concerned.

Present situation

Where do we stand in the accession process as regards the compliance with the economic criteria?

Obviously, the ten acceding countries have passed this hurdle. The Commission Regular Reports of last year and the Copenhagen European Council last December have confirmed that the countries have fulfilled the accession criteria, or will have done so by the date of accession on 1 May.

The three remaining candidate countries are not there yet. Bulgaria has been recognised as a functioning market economy last year, Romania could be one fairly soon if the good progress made in this
country continues, and also Turkey has made much progress. Yet all of them will still have much to do before they can fully meet both economic criteria.

3. CHALLENGES IN TERMS OF REAL/NOMINAL CONVERGENCE

Challenges in real convergence

I just mentioned one of the characters of the Copenhagen Accession criteria, namely that these represent minimum standards only. Or to put it differently: accession is reached by the ten acceding countries, and in sight for other candidate countries, but the economic policies of these countries will continue to face major challenges. The overarching goal must be a further real convergence of these economies with the EU economy. The present picture is mixed: on the one hand, trade integration is already quite high: already close to 70% of all exports of acceding countries go the current Member States. Furthermore, 80% of foreign direct investment towards the acceding countries comes from the EU. And business cycles have been increasingly synchronised with EU cycles. Yet, on the other hand, income levels are still well below those enjoyed by current Member States. For the average of the ten acceding countries, GDP amounted, in terms of purchasing power standards, to just 47% of the EU average in 2002 (compared to 42% in 1995). Catching up in this regard remains the key challenge for further real convergence. And, in the light of the presently low starting levels, it will remain such a challenge for many years in most countries.

Key factors for a successful and sustainable catching up are well known and partly overlapping with the Copenhagen economic criteria, let me just mention a few of them here: a good business environment with functioning market entry and exit, sufficient investment in physical infrastructure and human capital, a well working financial sector and macroeconomic stability. EU membership will reinforce the framework for further real convergence at many different levels, as it will

- enhance further economic integration with other countries,
- pave the way for further deregulation, allowing for a level playing field across Europe,
- strengthen macroeconomic stability by the EU budgetary surveillance and economic policy coordination mechanisms, and
- reinforce investment in public infrastructure conducive to efficiency gains in the economies of new Member States.
**Challenges in nominal convergence**

This leads me to some remarks I would like to make on another form of convergence: i.e. the “nominal convergence”. Sufficient progress on a sustainable basis in this respect is a precondition for adopting the euro. Looking at present levels of inflation or interest rates in future Member States, or at government debt levels, acceding countries have already quite well advanced, and certainly more so than many Member States in the early nineties, when the path towards the single currency was laid.

**Relationship between real and nominal convergence**

Sometimes the concern is voiced that the present levels of nominal convergence are not sustainable, as further catching up, accession-related challenges and mounting capital flow volatility might threaten these achievements. Hence, the fear is that there could be a trade-off between nominal and real convergence. But, at the same time, most would agree that such developments are not avoidable, in particular when economic policy is sufficiently oriented towards flexibility of product and capital markets and macroeconomic stability. Fiscal policy plays a key role in this context. And here challenges are of a larger scale:

4. **BUDGETARY CHALLENGES**

Budgetary challenges can be regrouped under 2 headings. The first challenge is specific for the acceding countries and stems from the possibility of conflict between real and nominal convergence. The second challenge, which I will only briefly mention as it is not typical for the acceding countries, is related to the ageing of the population.

**Real versus nominal convergence**

In the short-term, budgetary policy could be caught between real and nominal convergence. Fiscal policy will be called upon to play an enhanced role in stabilising the economy, in particular, in an environment marked by continued or high current account deficits. Furthermore, the independent central bank is expected to have price stability as its prime objective. Finally, on the way to the euro, the use of the exchange rate instrument is progressively abandoned. Additional constraints will be placed on fiscal policy under the EMU policy framework applying to "Member States with a derogation".

On the other hand, fiscal policy will have to cope with substantial expenditure pressures stemming from the completion of transition
reforms, compliance with the Community acquis and the need for extensive investments in transport and environmental infrastructure in order to foster real convergence.

The budgetary situation varies from country to country. According to the Commission Forecasts released on 29 October, the average general government deficit in the acceding countries is estimated to be 5% of GDP in 2003, and only Estonia, Latvia, Lithuania and Slovenia are expected to remain below the threshold of 3% of GDP. In most acceding countries the deficit in 2003 is expected to fall short of the targets that governments fixed for this year in the Pre-Accession Economic Programmes submitted in August 2003, as growth disappointed and the fiscal stance was loosened. However, with the improvement of the economic situation and a tightening of fiscal policy in some countries, the average general government deficit is expected to decline (to about 4.1% in 2005). Only in Poland a sharp deterioration of the deficit from 4.3% of GDP in 2003 to 5.9% of GDP in 2004 is expected in the Commission Forecasts, before easing to 4.9% of GDP in 2005.

**Ageing**

In the medium-term, the challenge is the sustainability of public finances in the light of the ageing of the population, which will lead to pressures on the pension and health-care systems. Facing these problems, the majority of the acceding countries have introduced a 3-pillar pension system, including a state-managed, pay-as-you-go pillar and two fully funded pillars (one obligatory and one voluntary). The primary objective is to link pension benefits closer to pension contributions and to bring the unfunded public scheme closer to actuarial balance. This will contain government deficits and debts in the medium-term, although in the short-term the set-up of funded pension schemes outside the general government sector may entail some pressures on public finances.

**Surveillance**

These challenges are closely monitored, already before accession. Based on procedures which exist for the Member States, the acceding countries were invited to submit Fiscal Notifications and Pre-Accession Economic Programmes, which the Commission evaluated in a multilateral setting. After accession, surveillance will be reinforced: Convergence Programmes should be presented and the Excessive Deficit Procedure will be of application. In this context,
it is also important to present the budgetary statistics on a harmonised ESA 95 basis.

5. POLICY MESSAGE ON SPEED TOWARDS ERM/EURO PARTICIPATION

Let me now turn to the issue of the acceding countries' timing for ERM II entry and euro adoption. Most acceding countries have already announced their target dates for joining the euro area, and some of them have recently tabled concrete strategies towards full monetary integration. In this context, a key question arises: what is the optimal timing for a smooth and successful entry in the euro area from the perspective of both each individual country and the euro area as a whole?

Here I would like to discuss briefly two aspects:
- the institutional path, and;
- the acceding countries' plans

The institutional path

The Treaty clearly defines the institutional path towards the full monetary integration of new members. Before adopting the euro, new Member States will first have to achieve a high degree of sustainable convergence, which will be assessed against the convergence criteria laid down in the Treaty. These include the exchange rate criterion, which foresees a minimum two-year participation in the exchange rate mechanism, ERM II.

Let me stress here that new Member States wishing to adopt the euro will have to comply with the same Treaty conditions as current euro-area Members. The Commission will uphold the principle of equal treatment.

The new Member States will, upon accession, participate in EMU with the status of "Member States with a derogation" from adopting the euro. This status implies, inter alia, that new Member States will have to treat their exchange rate policy as a matter of common concern, and that they are expected to join ERM II at some point after accession.

This institutional framework is sufficiently flexible to accommodate different exchange rate regimes in the run-up to the adoption of the euro. The only clear incompatibilities with ERM II identified so far are fully floating exchange rates, crawling pegs and pegs against
anchors other than the euro. For instance, Poland will have to abandon its free floating exchange rate regime when it joins ERM II.

The acceding countries' plans

The 2003 Pre-Accession Economic Programmes provide indications on the acceding countries' plans for future monetary integration. Estonia and Cyprus aim at introducing the euro early, in 2006 or 2007. The other acceding countries favour a later adoption of the euro. Hungary, Latvia, Poland and Slovakia mention 2008 or 2009 as target years for joining the euro area, while the Czech Republic targets euro adoption by 2009-2010.

The acceding countries' plans might evolve and will have to be elaborated further. Clearly, these plans have to be in line with the institutional framework I have sketched out. Also, the timing of ERM II entry and euro adoption has to be set carefully in the light of the key policy challenges faced in the run-up to the euro. I have already outlined these challenges:

- First, new members need to pursue policies favouring nominal and real convergence. Structural reforms, in particular, will improve the flexibility of the economy and will strengthen its capacity to cope with shocks to income and employment;
- Second, the acceding countries need to consolidate and reform their public finances so that fiscal policy can serve as an adjustment instrument when the exchange rate instrument is no longer available.

In this context, it might be appropriate for some Member States to consider joining ERM II only after a certain degree of convergence and significant progress in fiscal consolidation have been achieved. Indeed, joining a mechanism that serves an exchange rate objective implies constraints on other policies. These processes can reinforce each other, but participation in the ERM should not be seen as a free lunch. All in all, the moment of entry and length of ERM II membership, and the timing of euro adoption should be determined according to what best serves the transition and macroeconomic needs of each individual country.