Euroizing the New Europe\textsuperscript{1}

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Economists will never agree on the success or failure of Europe’s common currency (Dean, 2002a). In the mid-1990s, Milton Friedman famously declared, “I know of no good economist anywhere in the world who advocates the euro for Europe”, thereby impugning most European economists and many non-Europeans, including Robert Mundell. (Mundell’s history as a thorn in Friedman’s side dates back to the 1960s at the University of Chicago when Bob famously asked in a seminar “And Milton, do tell us why you think money is so important”, and runs right up to 2003 when they debated dollarization and the euro in the National Post, a Canadian national newspaper.)

Martin Feldstein, a sober and responsible Professor at Harvard and Director of the National Bureau for Economic Research, even predicted that the euro would lead to war. It is important to understand that the impetus for the euro was not economic: it was political. The euro was to be the jewel in the crown of European union. We all understand that the motivation for European economic union was political, but we tend to forget that currency union came as the culmination of the long journey that began in the early 1950s when the French civil servant Jean Monnet and the French foreign minister Robert Schuman inspired institutionalized economic cooperation between France and Germany in order to intertwine their interests so inextricably that they would never again go to war. In 1951 France, Germany and the Benelux countries

\textsuperscript{1} This talk draws in part from Dean (2004).
pooled their coal and steel resources, and in 1957 they formed the common market that has now evolved into the European Union.

Western Europe has, indeed, been at peace now for the longest period in its history, 60 years. Some would argue that this had more to do with U.S. troops on European soil. But undoubtedly peace has had a lot to do with cross-border trade and investment. Still, an open question is whether trade and investment could have been pursued just as effectively, or perhaps more effectively, under the multilateral aegis of the GATT and its successor, the WTO. In fact the European Union itself is now under unprecedented strain, with ten new members as of May 1, 2004, with a constitution that may or may not be ratified by national referenda, and last but not least, with a set of Maastricht-like criteria for adoption of the euro that are increasingly irksome to the EU’s four largest new members in Central Europe.

Before dwelling on the euro for New Europe, consider for what they’re worth two mega-facts. Superficially at least, they seem to belie the conventional wisdom that the EU and the euro have promoted prosperity. The first mega-fact is that the two major Western European countries that never joined the EU – Norway and Switzerland – enjoy per capita incomes and other macroeconomic indicators dramatically better than the EU average. The second mega-fact is that the three EU countries that opted out of the common currency – Denmark, Sweden and the United Kingdom – are also much more prosperous than the EU average: in fact they are in the top half-dozen among fifteen countries in the “old” EU.

In short, neither members of the “old” European Union, nor members of the European Monetary Union, are necessarily the most prosperous countries in Western Europe. The fact that Britain, Denmark, Sweden have all prospered without the euro does not surprise most economists. Britain’s terms of trade and business cycles do not coincide with continental Europe’s. Denmark and Sweden’s are closer - moreover they stand to benefit more from integration with the euro-zone’s capital markets – but they have already achieved this by pegging their currencies. Of course a decisive reason for Britain’s opt-out was its brief but disastrous flirtation with fixing to the then-European Currency Unit in 1989, a flirtation that ended in 1992 with George Soros winning a billion dollars from the Bank of England in a bet against the pound
sterling, and was soon followed by an economic upswing relative to the euroized Europe that continues to this day.

A good part of what motivated all three countries to turn down the euro had been simply national pride and hubris. All three countries worry about sacrificing even more sovereignty to Brussels: though ironically while Brits worry about the imposition of regulations that could strangle incentives and efficiency, Swedes worry about the opposite – that Brussels will demand they dismantle their welfare state.

The ultimate irony is that the euro has almost certainly impeded prosperity in Germany, which along with France was its most powerful proponent. To compound the irony, Germany was the prime proponent of the now-infamous Growth and Stability Pact that straightjackets fiscal policy, never mind that the common currency has already straightjacketed monetary policy. This double straightjacketing has strangled aggregate national spending in Germany, where real growth has stagnated and unemployment has stuck at 10%.

Meanwhile, the three largest economies that joined the euro on May 1st, 2004 – the so-called “Visegrad” countries, Poland, Hungary and the Czech Republic – will record average real GDP growth above 4% in 2004. Projected growth for the eurozone in 2004 is only 1.5%. Productivity growth for the Visegrad three is running at an astounding 9.5%, versus 2.8% for the eurozone. Of course this does not mean that they should stay out of the euro: in fact a condition of joining the EU is that they’re not allowed to stay out of the euro. But those same conditions allow lots of room for indecision and delay. The new members of the EU can delay joining so-called “ERM 2” (the Exchange Rate Mechanism that is prerequisite for adopting the euro), and then cannot exit ERM 2 until they meet a list of macroeconomic conditions over at least two years.

A recent study by Deutsche Bank developed a cost/benefit index for joining the euro, and for all three Visegrad countries, the index was well below one. The reason is that ERM 2 conditions are seen to be too costly in the near term, relative to somewhat ephemeral benefits from the euro in the long term. In fact for more than a year now, all three countries have been stating publicly that they are unlikely to adopt the euro much before the end of this decade, if then (Box 1).
**Conditions for adopting the euro**

These conditions, the ones that the larger four of the ten new EU countries find so onerous, are what Brussels and Frankfurt demand for exit from ERM 2 and entry to the euro. They are direct descendants of the conditions that the EU set down for itself at under the Maastricht treaty of 1991:

- To join the EU, accession countries had to meet many economic criteria, the most basic of which was to create market economies. Before adopting the euro they must join ERM II and commit to maintaining exchange rates within +/- 15% (de jure) or +/- 2.25% (de facto) bands around a parity peg to the euro for at least two years. In addition, they must have met the following “Maastricht criteria” during the year before they want to adopt the euro (i.e., at the earliest, during the second year of their period in ERM II):

  - Inflation and long term interest rates within 1.5% and 2% respectively of the three EU countries\(^2\) with the lowest inflation rates
  - Public debt at or below 60% of GDP, and budget deficits at or below 3% of GDP

**Serial Small Fixers**

Now the six smaller new EU countries – the three Baltic states of Estonia, Lithuania and Latvia, the two island states of Cyprus and Malta, and Slovenia - have little or no problem with these criteria. Estonia has had a hard, currency-board fix to the euro since 1992, Lithuania adopted a similar currency board fix to the dollar in 1994 and then re-fixed to the euro in February of 2002. Latvia has long been pegged to the SDR within a very narrow ,+/- 1% band. Cyprus has a peg to the euro that is de jure +/- 15% but de facto much narrower. Malta pegs to a basket that is 70% euro and the rest dollar and pound sterling. Slovenia runs a heavily-managed crawling band with pragmatic monetary, real, external and financial indicators. See Box 2.

\(^2\) Note that in this context “EU countries” means all 25 existing members, including all 10 new members as well as the 3 old members that have not adopted the euro.
In short, the six smaller of new EU countries, with the exception of Slovenia, could be characterized as “serial small peggers”. Both their inflation and interest rates are already low, and they will easily meet those two criteria for adopting the euro. Their deficit-to-GDP ratios are also comfortably low. Slovenia has relatively high inflation but can and will work that down by managing its exchange rate. Slovenia fundamentally runs a tight ship and has the highest per capita GDP among the ten new members of the EU. It is small and open and ideally suited for a common currency. Slovenia and the five “serial small peggers” have all declared their intentions to adopt the euro by 2007 – in Estonia’s case, by 2006.

Four Flakey Floaters

This leaves the four “flakey large floaters”: Poland, Hungary, Czech Republic and Slovakia. These countries began the 1990s by pegging their currencies in order to stabilize their out-of-control macro-economies: before privatization, soft budget constraints prevailed. Central banks were too weak to resist printing money without the external anchor of a currency peg. As inflation came under control, they gradually softened their pegs. Poland now runs a completely free float with inflation targeting. Hungary nominally pegs to the euro but within a wide, +/- 15% band, and targets inflation but less ambitiously than the Poles. Czech Republic also has a managed float with inflation targeting. Slovakia runs a managed float with hybrid targets and implicit inflation targeting.

Currency regimes in the four flakey floaters have not always run smoothly. Poland saw its zloty rise rapidly due to rapid capital inflows, and had to choose between currency stabilization and inflation targeting (Dean, 2002b). It chose the latter but is now coping with high interest rates and high unemployment. Hungary’s florint has been on a roller-coaster ride; recently it has spiked but with no relief in sight for inflation or interest rates. Czech Republic experienced a currency crisis in 1997, and then rapid appreciation until about 2002.

The fundamental challenge facing these transition countries is that their productivity growth is much higher than Western Europe’s. As already mentioned, productivity growth in the three Visegrad countries is
forecast at 9.5% for 2004, versus just 2.8% for the euro-zone. Belassa-Samuelson tells us that under plausible assumptions, the real exchange rate must rise in countries with productivity growth in tradeables that is higher than that of their trading partners. This means that either their inflation rates must be above their trading partners’, or their nominal exchange rates must rise, or some combination of the two. Hence it is not surprising that the flakey four floaters are all struggling with inflation, rising exchange rates, or both.

But why, you might ask, haven’t rising real exchange rates proved a problem for the six serial small peggers? Part of the answer is that, in the Baltics in particular, low inflation was endogenized early, even in the non-tradeables sector, as the result of their early and unambiguous currency boards. This has also been true of Bulgaria, which adopted a currency board in 1997 and has experienced remarkable low inflation in non-tradeables. Whether the experience of the small early-fixers can be taken as lesson for larger countries is debatable and beyond my scope in this short talk.

In any case, the Visegrad countries are having trouble meeting the inflation and interest conditions for joining the euro, and some of them are having trouble floating even within the wide +/- 15% band. This has been the de jure band for ERM 2 to allow the Italians and Spaniards to get back on the euro-accession wagon after their crises of 1992/93. But in mid-2003 Pedro Solbes, the EU Monetary Affairs Commissioner, startled putative accession countries by proclaiming that de facto the band expected within ERM II will be much narrower, presumably the +/- 2.25% that was required before 1992. Hence the question of the band has become contentious and controversial

States of controversy

Indeed, several aspects of the route to adoption of the euro are currently controversial in Warsaw, Prague, Budapest, Bratislava, Ljubljana etc., and even, soto voce, in Brussels and Frankfurt. Here are six of the most controversial:

• Should the three best EU countries or the over-all EU average dictate inflation reference levels for inflation and long term
interest rates? If the latter, reference levels would, of course, be higher.

- Should +/- 2.25% or +/- 15% be allowable as a band for exchange rate fluctuations?

- More generally, should ERM II relax its inflation ceilings and/or relax nominal exchange stabilization to allow real exchange rates to appreciate as productivity catches up to the EU?

- Does the European Central Bank ever contemplate acting as a centralized lender of last resort? If so, might it not also want to centralize banking supervision?

- Bad bank debt is particularly problematic in the Czech Republic, in Slovakia and in Poland. Is it manageable at country levels?

- Should the new member states with currency boards abandon them before joining ERM II? This would seem pointless unless realignment of parity with the euro is contemplated. But how rapidly should the countries that currently float “tighten up”, and then at what parity rate should they lock in to the euro?

**Tradeoffs, dilemmas and challenges**

In summary, the euro-accession countries, particularly the four “flakey large floaters”, face tradeoffs, dilemmas and challenges.

*How much flexibility?* As already suggested, among the large floaters a continued history of volatility against the euro implies that transitional restructuring and/or volatile capital flows may necessitate continued flexibility for several years.

*What central parity, and when?* The central parity consistent with current account balance may be higher in, say, 2007, than now, especially if new member states are constrained by the Maastricht criteria to inflation rates no higher than the lowest three EMU countries. The EU Commissioner’s declaration last year of preference
for a narrow ERM II exchange rate band could force countries to make a premature choice of parity.

An additional consideration in the choice between fixing parity now or later is that secular growth in capital inflows can cause real exchange rate appreciation, again via inflation or via nominal appreciation. This can also delay the date for fixing parity.

In both cases (catch-up productivity growth and rapid capital flows), the parity rate consistent with current account balance is a moving target. A final complication is that the medium term parity rate is not necessarily one that is consistent with current account balance. On the contrary, continuing current account deficits are appropriate as long as productivity growth and returns on capital are above EMU and world averages.

In any case, to put the parity dilemma in a nutshell, premature exchange rate stability may cause excessive current account deficits (in case of undervaluation), or excessive inflation (in case of overvaluation).

Fiscal challenges

I have not yet mentioned fiscal deficits. The brutal reality is that even were they to resolve their inflation, interest rate and exchange rate stability problems, the big four floaters could not the euro in the near future without severe and politically painful fiscal retrenchment. In recent years fiscal deficits have actually widened in Czech Republic, Hungary, Poland and Slovakia and are typically over 5%. Even in Cyprus and Malta, deficits are above 3% of GDP. These deficits may prove more intransigent than in Western Europe, given long socialist traditions and the consequent likelihood of continued pressure for government spending on both infrastructure and transfer payments. Moreover, Balassa/Samuelson effects cause the relative price of non-tradeables to rise, which operates to make government services more expensive.

And not only may these deficits prove intransigent in the long run, they may be inflexible in the short run. Given a reluctance to cut spending, the scope for contractionary counter-cyclical fiscal policy may be more
limited in the Central and Eastern European Countries than in Western European countries like Ireland. In the opposite direction, the scope for stimulatory fiscal policy will be limited if the Growth and Stability Pact’s 3% deficit ceiling is imposed on these countries, and enforced.

Next to adopt the euro?

Finally, a few words about who might next adopt the euro, beyond just the ten new members of the EU.

Bulgaria and Romania hope to join the EU in 2007. Croatia has just applied, and Macedonia is also on track. All four could, in principle, adopt the euro by 2010, although Croatia and Macedonia will accede to both the EU later than Bulgaria and Romania. Turkey has had official EU-candidate status since 1999, but is not expected to be admitted until at least 2015.

Several countries could unofficially euroize: that is, withdraw their domestic currency and adopt the euro without permission from Brussels or Frankfurt. Kosovo and Montenegro have already done so. Bosnia and Serbia could be next, especially if they hold out no hope to join the EU in the foreseeable future and therefore have no particular incentive to jump through hoops devised by Brussels and Frankfurt. And what about countries that may never need to please Brussels, countries like Armenia, Georgia, or Kazakhstan?

It is not, however, crystal clear that abandonment of local currencies is typically in the cards. Although many if not most countries in Eastern Europe and Central Asia already use the euro or the dollar informally for transactions and/or store of value purposes (Feige & Dean, 2004), the number of national currencies in the region has multiplied over the last decade with the creation of new nation states (Pomfret, 2003), and for many of them – Ukraine for example – their currency is a symbol of the national independence they were so long denied. It is not clear that widespread formal dollarization, euroization, or currency union is likely in the near future except in countries that accede to the EU.

BOX 1
Self-declared Intentions to Join European Monetary Union

- Czech Republic: “as soon as plausible economic conditions have been created” (PEP 2003) [More concrete statements by CZ point to 2009 – 2010]
- Estonia: “as soon as 2006” (PEP 2003)
- Lithuania: “Realistically … start of 2007” (Governor Sarkinas, March 2003)
- Malta: “second half of 2007 or Jan 2008 latest” (Governor Bonello, Feb 2004)
- Poland: “only when macro conditions make it possible … [given projected gov’t deficits] … 2008 or 2009” (PEP 2003)
- Slovakia “earliest realistic target 2008” (Strategy of the Slovak Republic for adoption of the euro, June 2003)
- Slovenia “Both the Bank and the Government … judge … it will be possible at the beginning of 2007” (Joint programme of the Slovenian Government and Bank of Slovenia for ERM II entry and adoption of the euro, November 2003)

- In short, declarations of the new member states range from 2006 (Estonia) to Jan 2010 (Czech Rep.)
- Most optimistic (2007 or earlier) are Cyprus, Estonia, Lithuania, Malta, and Slovenia
- Least optimistic (2008 or later) are Czech Republic, Hungary, Latvia, Poland and Slovakia


BOX 2

- Cyprus: De jure: Peg to euro with +/- 15% band. De facto: Narrow range of fluctuation
- Czech Republic: Managed float; 2 – 4% inflation target by end 2005
- Estonia: CBA fix to euro since 1992
• Hungary: Peg to euro with +/- 15% band; inflation target of 3 – 5% by end 2005
• Latvia: Peg to SDR with +/- 1% band
• Lithuania: CBA fix to dollar in 1994, then to euro in February 2002.
• Malta: Peg to basket of 70% euro, 30% dollar and pound sterling
• Poland: Free float with inflation target of 1.5 – 3.5%
• Slovakia: Managed float: hybrid strategy; implicit infl. targeting
• Slovenia: Crawling band with monetary, real, external and financial indicators


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