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The Accession Economies' Rocky Road to the Euro

by

Barry Eichengreen

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Abstract

Now that the decision has been taken to admit to the European Union eight of what were once called the transition economies, attention has naturally turned to whether these countries should also join Europe's monetary union. But where is a consensus that joining the EU, while posing certain difficulties, will be a source of net benefits, there is no such consensus about the adoption of the euro. In part this uncertainty reflects the unusual difficulty that monetary economists have in translating theory into policy. We specialists, in other words, cannot even agree amongst ourselves.

In this lecture I suggest that this uncertainty is unwarranted. Adopting the euro is clearly superior to the other monetary options available to the new EU members. These countries are right to be committed to joining Euroland as soon as possible. And the incumbent members of the euro area should be happy to have them. To be sure, enlarging the monetary union will pose difficulties for both the incumbents and the new members. But these are minor compared to the difficulties that will arise under other scenarios. From this point of view, it is regrettable that the incumbents appear to be placing unnecessary obstacles in the path of the aspirants.

Barry Eichengreen, George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at UC Berkeley

The Accession Economies' Rocky Road to the Euro¹

**Barry Eichengreen
University of California, Berkeley
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In this lecture I want to suggest that this uncertainty is unwarranted. Adopting the euro is clearly superior to the other monetary options available to the new EU members. These countries are right to be committed to joining Euroland as soon as possible. And the incumbent members of the euro area should be happy to have them. To be sure, enlarging the monetary union will pose difficulties for both the incumbents and the new members. But these are minor compared to the difficulties that will arise under other scenarios. From this point of view, it is regrettable that the incumbents appear to be placing unnecessary obstacles in the path of the aspirants.

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1. Options

Consider the alternatives available to the new EU member states. They can run a currency board, like Estonia, or euroize unilaterally if the EU does not subject them to harsh penalties for doing so. For countries inclined in this direction, joining the euro zone is clearly their first-best alternative. Monetary policy is identical either way, and if they are members of the ECB they will have a voice in its formulation.

Another option for new member states is to float, but they cannot float freely. In contrast to the UK and Sweden, much of their debt is denominated in foreign currency.² Hence, when the exchange rate moves, they are hammered by balance-sheet effects. This means that their floating exchange rates must be heavily managed. I don't want to overstate the point; absent monetary union, floating is still the best option going. But there are limits on how freely the exchange rate can float. There are also limits on the utility of monetary policy as a stabilization device.

²Why is not hard to see. Their domestic financial markets are less well developed, limiting the market among residents for domestic-currency-denominated debt. They are only now developing the strong policies and institutions needed to create a market in local-currency debt among nonresidents. And their small size, compared to the UK or even Sweden, makes it unattractive for most foreign investors to sink the costs of managing exposures in their currencies. These are the classic preconditions for the problem of "original sin" (the inability to borrow abroad in one's own currency) analyzed by Eichengreen, Hausmann and Panizza (2003). The Czech Republic and Poland are something of an exception, for reasons detailed there.

Closer to where I live, Brazil exemplifies these dilemmas. Some 40 per cent of its debt is dollar denominated or linked. Hence, when the exchange rate weakens, the central bank is forced to hike interest rates to limit the extent of the depreciation. Not infrequently, the source of that depreciation is a decline in domestic demand. A weaker exchange rate is the market's way of crowding in export demand and keeping production from falling as sharply as domestic sales. And the *real* was permitted to fall in the recent slowdown, by as much as 30 per cent. But beyond that it was not permitted to go for fear of damaging balance-sheet effects. And the interest rate increases needed to limit those balance-sheet effects are precisely the wrong policy from the point of view of stabilizing domestic demand. This has meant, for much of the recent period, that monetary policy has been procyclical. It has amplified rather than diminishing macroeconomic fluctuations. The problem is not that Brazilian policy makers are inept; to the contrary, the central bank is admired for its technical expertise. But it faces an unavoidable dilemma. Luis Felipe Céspedes and coauthors describe this nicely in a recent NBER working paper entitled "IS-LM-BP in the Pampas."³ In their model, there may be no way to shift the IS, LM and BP curves so that they intersect at a happy equilibrium. Central Europe may be very far from the Pampas, but its dilemma is the same.

³Céspedes, Chang and Velasco (2002).

This leaves the option of limiting the currency's movement to a narrow fluctuation band. If you are a believer in bands – if you are John Williamson, for example – then there may be relatively little that I can do to convert you. But as a long-standing skeptic, I am convinced that prescribing bands for the new EU members for an extended period is the worst form of macroeconomic malpractice. Bands are fragile and difficult to manage. Their fragility is clear from Europe's own experience in 1992. A fine illustration of the difficulties of managing them was inadvertently provided by Hungary earlier this year.⁴ And the costs when they collapse can be enormous.⁵

Theorists can construct models of well-behaved exchange rate bands. Members of this audience will be familiar with Paul Krugman and Lars Svensson's models of target zones that reconcile

⁴The country devalued the forint by 2.3 per cent on June 4th, partly with an eye, one presumes, toward obtaining a more favorable ERM-II parity. The authorities having failed to prepare the markets, investors were taken aback; the currency immediately fell by another 6 per cent, forcing the central bank to raise interest rates sharply in order to defend it – none of which enhanced credibility or the fiscal position.

⁵This is the conclusion of the first systematic study of the subject, Eichengreen and Masson et al. (1998). An extension and update of their analysis can be found in Duttagupta and Otker-Robe (2003).

limited exchange rate flexibility with significant monetary autonomy.⁶ But exchange rates will be stabilized only if the commitment to the band is credible. If there are suspicions that the authorities may change their minds, then the band can become a destabilizing force.⁷ And if depreciation within the band raises debt-servicing costs, then the resulting monetary autonomy will be of little value.

⁶See Krugman (1991) and Svensson (1994).

⁷This is shown analytically in an unjustly neglected article by Bertola and Caballero (1992).

Consigning the new EU members to a narrow-band ERM II as a half-way house on the road to the euro area sets them up for precisely the kind of crisis the ERM suffered in 1992. Hopes that they will successfully navigate the transition to monetary union and its lower interest rates have already stimulated convergence play flows. Indeed, Central and Eastern Europe is the only emerging region forecast to receive significant net debt flows in 2003.⁸ But both domestic political disruptions and statements emanating from Brussels and Frankfurt could abruptly end this happy state of affairs. Those flows would then turn around, bringing the whole house of cards crashing down.

Through process of elimination, I therefore conclude that joining the euro zone is the best option going. The new EU members already enjoy little monetary autonomy. They display little exchange rate flexibility anyway. Joining the euro area will render their monetary policies more predictable and their finances less fragile. It will give them at least some say over a monetary policy that they would otherwise have to import from Euroland as a *fait accompli*.⁹

Why then are the incumbents reluctant to have them join? So long as they are catching up with the West, the new economies will experience relatively fast Balassa-Samuelson inflation, creating fears

⁸The most recent Institute of International Finance estimates forecast net debt flows into the region of \$17 billion in 2003, compared to \$3.5 billion for the Asia-Pacific region, \$2.7 billion for Latin America, and \$0.7 billion for Africa and the Middle East (Institute of International Finance 2003).

⁹To be sure, they would be even better off if their labor markets were more flexible (they may still be more flexible than those of Western Europe, but in recent quarters wages have shown a distressing tendency to only be flexible in the upward direction). Similarly, they would find monetary union more comfortable if labor mobility between Eastern and Western Europe was higher (if it was not restricted by the incumbent EU members for a transitional period of six or seven years). The point, though, is that more flexible labor markets are equally important whether or not the new EU members join the monetary union, so long as they enjoy relatively little monetary autonomy in the event that they stay out.

that the ECB will feel compelled to maintain a tight monetary stance inappropriate for slow growing countries like Germany. But on a GDP-weighted basis (which is the basis on which central banks conduct monetary policy), the new members will be too small to dominate the stance of ECB policy for a long time – until, that is, they are considerably richer and the Balassa-Samuelson effect has largely disappeared.

Another explanation for the incumbents' reluctance is the fear that these countries could have financial problems that will compel the ECB to intervene, compromising its anti-inflationary resolve. While there is no question that the new EU members have fiscal work to do – I will return to this shortly – the danger they pose to the financial stability of Euroland and the threat they pose to the anti-inflationary credibility of the ECB are in fact considerably less than in the case of the incumbent members. Their debts are still low. Their banking systems are not at risk since these are largely foreign owned. Without getting into the debate over the Stability Pact, suffice it to say that the logic of the argument connecting fiscal policy to central bank credibility is disputable.¹⁰

A final reason why the incumbents may be reluctant to admit ten new members is that doing so will render the ECB board unwieldy, forcing the institution to move finally to a rotation system under which even the large countries will periodically have no vote. I share their dislike for rotation, although the basis for my dislike is different: I fear that it will reintroduce nationality into the deliberations of the board without doing much to streamline decision making. Better would be to delegate monetary policy decisions to the executive board. But this is still viewed as unacceptably radical. The upshot is that

¹⁰We in the United States have no trouble reconciling irresponsible fiscal policy with sound central banking, although that is hardly a recommendation!

significant enlargement of the ECB would force the incumbents to rotate off the board from time to time. If this is what is fueling their reluctance to accept new members, it is short-sighted.

2. The Transition

It is against this background that Pedro Solbes' statement last May that the new EU members will be expected to adhere to the narrow bands of the ERM-II for two years as a precondition for qualifying for monetary union is particularly disturbing. The new members have enough financial problems; they do not need this additional burden. As we learned in 1992, a strict interpretation of the convergence criteria that makes holding currencies within the ERM's narrow plus-or-minus 2 1/4 per cent bands for two years without involuntary realignment is a recipe for disaster. The new EU members will want to follow policies consistent with early admission to the monetary union, but they will also have to attend to the domestic economic situation, and in particular to its implications for the government's reelection prospects. If doubts develop for whatever reason and capital begins to flow out, they will have to raise interest rates to attract it back. They will have to raise rates even more sharply than mandated by existing balance-sheet effects.

Higher interest rates are not helpful, of course, for the employment situation. Thus, the authorities are in the unenviable position of having to choose between raising interest rates to hold open the promise of admission to the monetary union later, or not raising them to avoid aggravating the unemployment problem now. Politicians not being exactly famous for their willingness to delay gratification, there is the danger that a loss of confidence, even if unwarranted, could tip the balance. Forced to pay an even higher price now for the promise of monetary union later, the loss of confidence

may lead them to abandon a peg that they would have otherwise happily maintained. This is an instance of multiple equilibria. It is a classic example of a self-fulfilling balance of payments crisis.¹¹

This risk is greater with narrow bands than broad ones, as the EU learned after moving from the former to the latter in 1993. If a successful attack leads the government to abandon hope for early admission to the monetary union, causing it to shift to a more accommodating policy, the attack will precipitate a sharp drop in the exchange rate, conferring significant gains on currency speculators. If the attack is unsuccessful, on the other hand, the exchange rate will barely move, confined as it is to narrow bands, and currency speculators will lose nothing. But under wide bands, there is a two way bet; speculators are confronted with the possibility of losses as well as gains. As the early birds develop doubts about future prospects, the currency can weaken considerably within the band before the central bank is forced to take action. But when other investors decide whether or not to pile on, they must

¹¹The particular model I describe is due to Ozkan and Sutherland (1994). Even skeptics of multiple equilibria like the late Rudi Dornbusch recognize this incarnation of the problem. To quote Dornbusch (1998), “But if interest rates cannot be raised to defend exchange rates, then the slightest piece of bad news means capital outflows, those capital outflows quickly become punitive. If there isn’t a lot of reserves in the central bank, then everybody knows that this is going to end with a currency crisis, and that currency crisis is sure because the government isn’t making it expensive for the speculators to bet against they currency, they can’t afford to, so it’s only a question of time. Anything that is only a question of time is certain to happen, and anytime that rumor spreads, of course, all the sharks will come: the big ones, and all the little ones along.”

recognize that if the currency eventually recovers to its initial position within the band (a reasonable expectation on the assumption that nothing else changes) they will suffer serious capital losses. This helps to limit herding and the force of the purely speculative pressures with which the central bank is forced to cope.

And the problem is likely to be even greater with the ERM-II than with the old ERM, insofar as the European Central Bank will feel only limited obligation to intervene on behalf of the accession economies or to provide them with short-term financing. While the difference should not be exaggerated, the original ERM was all for one and one for all. A crisis that jeopardized one country's participation might jeopardize the entire system, as Europe learned in 1993. While there were limits on how far the strong-currency countries would go to support their weak-currency counterparts, there was still a clear perception of shared interest in the system. Now, in contrast, the euro will not have ERM bands; if a country exits the ERM-II or the system collapses, this will not much affect the value of the euro or exchange-rate stability within (most of) the single market. This makes it more likely that the provisions that allow the ECB to withhold intervention until a currency has reached the edge of its fluctuation band and then to halt such it if it fears that price stability is threatened will be invoked. And currency speculators know it.¹²

If this were not enough, there is also the possibility that the narrow bands of the ERM-II will be

¹²This difficulty is of course reinforced by the absence of capital controls like those that were so important to the operation of the original ERM over its first decade, which will be gone as soon as the new members join the EU.

incompatible with the other convergence criteria.¹³ The Maastricht criteria, as interpreted by the Commission, require both stable exchange rates and low inflation. Fast-growing economies catching up with the leaders necessarily have appreciating real exchange rates. By definition, then, either the exchange rate criterion or the inflation criterion will have to give.

¹³A point first made, to my knowledge, by Halpern and Wyplosz (1999).

Assume that the differential rate of productivity growth between the traded and nontraded goods sectors in the new and old EU member states is running at 3 per cent a year. This is not unrealistic: between 1973 and 1991, this differential was 2.8 per cent per annum higher in Italy than in Germany, and 2.3 per cent higher in Spain than in Italy.¹⁴ Without getting into details, suffice it to say that comparable figures for the accession economies in the 1990s were significantly higher.¹⁵

If the share of nontraded goods in consumption is a half, then consumer price inflation in the new economies will run 1 1/2 per cent per year above the euro area average, assuming that the law of one price holds for traded goods and labor is perfectly mobile between sectors.¹⁶ Since there will be some dispersion of inflation rates within Euroland, it follows that inflation in the new economies will inevitably exceed the rate of inflation in the three best-performing euro-area economies, which remains one of the other convergence criteria. If we think that yearly inflation in the three best-performing euro-area economies will be a percentage point below the euro-area average (which was the actual situation in June 2003), which is not out of line with historical norms, then the new countries need only half a

¹⁴Canzoneri, Cumby Diba and and Eudy (2002), Table 1.

¹⁵Thus, estimates in Rother (2000) imply a traded-goods productivity differential in Slovakia of 5 per cent in the period 1993-98. Those in Sinn and Reutter (2001) imply differentials ranging from 5 to more than 10 per cent in the Czech Republic, Slovenia, Estonia, Poland and Hungary, with most national values clustered in the neighborhood of 5-6. To obtain the contribution to CPI inflation, one must first subtract Euroland values – say, one per cent – and divide the remainder by two (assuming that nontraded goods account for half of consumption – see below). Comparable numbers for the current decade may be lower insofar as the catch-up process in Central and Eastern Europe is now well underway; on the other hand, they may be higher if EU membership accelerates convergence, as intended.

¹⁶I am tempted to assert that this is precisely the mean estimate of Balassa-Samuelson inflation, estimates of which are evenly distributed between 1 and 2 per cent.

percentage point of Balassa-Samuelson inflation a year before they encounter this problem. It is not implausible, in other words, that this constraint will bind.

To make my point simple, consider the case where inflation in the three best-performing EU economies is a percentage point below the euro-area average of 2 per cent, and the differential rate of increase of traded versus nontraded goods prices is 3 per cent higher in the new member states, making their overall inflation rates 3 ½ per cent. The inflation differential between the new member states and the three best performers is then 2 ½ per cent per annum. The exchange rate then has to be pushed up by a full percentage point in the year prior to the evaluation in order to avoid violating the inflation limit of 1 ½ per cent above the three best-performing incumbents. But doing so comes within a hair of breaching the limit on the range of permissible exchange rate fluctuations assuming that the exchange rate began the year at its central parity. If the exchange rate was stronger than this, which will almost certainly be the case if expectations of a favorable outcome are running high and capital is flowing in, then either the exchange rate or the inflation criteria will be violated.

Now, one can imagine various ways around this problem. Maybe there will be a fortuitous anti-inflationary shift in the terms of trade in favor of the accession economies.¹⁷ Maybe the EU will recognize that the provision focusing on inflation not in the euro area as a whole but in its three lowest-inflation countries is archaic now that the monetary union actually exists.¹⁸ Maybe it will adopt a flexible interpretation of the precondition requiring members of the ERM-II to maintain narrow 2 1/4 bands

¹⁷Lee and Tang (2003) show that such fluctuations can be quite important, although they are equally likely to move against the accession economies as to move in their favor.

¹⁸As argued by Kenen and Meade (2003).

without involuntary realignments, classifying all revaluations as voluntary. In effect, this would amount to narrow bands on the downside and wide bands on the upside.

But by making qualification sensitive to events and interpretation, this process will also make the financial situation fragile and the new member states crisis prone. The Commission has not shown an ability in recent months to articulate a clear and consistent party line. If the initial expectation is that it will adopt a permissive interpretation, capital will flow in, strengthening the exchange rate and fueling inflation (and therefore creating a conflict between the two convergence criteria if a strict interpretation of the rules is enforced). To prevent the exchange rate from more than modestly exceeding the top of its band, the authorities will have to cut interest rates (fiscal policy being hard to manipulate in the short run), adding to the inflationary pressure. If there is then a suggestion that the Commission will require a strict interpretation, capital flows will turn around. The potentially self-fulfilling speculative dynamics that I described earlier will then come into play.

For all these reasons, I fear that the narrow bands of the ERM-II would be a recipe for disaster. My point estimate of the probability that a country like Hungary could stay in its narrow 2 1/4 per cent bands for 3 1/2 years, from mid-2004 when it enters the EU to early 2008, when it adopts the euro, is zero. Wide bands would be better, but no bands would be best. In the days before Stage III approached, it was possible to make a case for bands, namely, that EU member states needed to be prevented from engaging in exchange rate manipulation that might be corrosive of cohesion and even threaten the single market. But now the monetary union exists, and the new member states want in. If they are allowed a reasonable transition path, most of them will enter quickly, rendering any intervening exchange rate fluctuations transitory and therefore of only ephemeral impact on the single market. This

suggests focusing on the inflation and budgetary criteria to determine whether they are capable of running sound and stable policies. If they fail to do so, they will not be allowed to enter the monetary union. But then they will not be able to operate narrow bands either. There is no case for the ERM-II either way.

3. Fiscal Policy

The major challenge for the new members, from this point of view, will be fiscal adjustment. To be more precise, this is the major challenge for the large accession economies: the Czech Republic, Hungary, Poland and Slovakia. There is a striking divergence between the budget deficits of the Big Four, which have exploded, and those of the smaller accession economies, which remain firmly under control. Estimates for 2003 deficits are all over the map, making me reluctant to cite any of them. Suffice it to say that the investment banks are forecasting deficits on the order of 5 to 7 per cent of GDP for the Czech Republic, Hungary, Poland, and Slovakia. This is in contrast to the situation in the four small accession economies, whose deficits are either very close to 3 per cent (in the cases of Latvia and Lithuania) or well below that threshold (in Estonia and Slovenia).

Thus, in order to understand the prospects for fiscal consolidation and therefore early euro adoption by the Big Four, it may be illuminating to ask why the fiscal positions of the large and small countries diverged in the first place.¹⁹ One factor is surely the different value that large and small

¹⁹Here it may also be tempting to argue by analogy with Western Europe, where there also seems to be a divergence in fiscal stance between the large and small countries, with France and Germany currently being most likely to breach the Stability Pact's limits, to the aggravation of the smaller EU members, most of which have significantly stronger budgets. But the situation in the west is different. There, France and Germany essentially think that they are too large and politically important to ultimately become the subject of EU sanctions and fines (we shall see). In the east, countries like

countries place on monetary union itself. The small ones benefit more from the convenience of the common currency; this is a standard argument from the theory of optimum currency areas. For them, the threat that a failure of fiscal discipline will mean delay in entering the monetary union is an effective deterrent. The large countries are less impressed by this threat. Poland, with 40 million residents, may feel the same ambivalence as, say, the United Kingdom. Thus, the pressure to rein in deficit spending is correspondingly less.

But, as I have argued, any benefits that the large countries may currently perceive from staying out of the euro are likely to prove illusory. They are not going to have an easy ride either in or out of the ERM-II. Unlike the UK, many of their foreign liabilities are euro-denominated, limiting their monetary autonomy. This suggests that they too will come to appreciate the advantages of adopting the euro, but they may learn this the hard way, after a period of macroeconomic and financial turbulence and a delay in fiscal consolidation.

A second difference between the Big Four and the Baltics is their style of regulation and the structure of their welfare states. The big Central European countries are becoming “westernized,” complete with structured labor markets, regulated product markets, and generous welfare states, at a rapid rate. Welfare-state-related transfers account for a large share of the increase in their public expenditure and are notoriously difficult to cut. The Baltics remain more market oriented and have

Hungary and Poland recognize that they are not too important to be sanctioned, and that if their budgets remain outside the Maastricht limits they will not be admitted to the monetary union. Thus, the political underpinnings of deficits in the large countries of the two parts of Europe are very different.

smaller welfare states. Welfare-state-related transfers are notoriously difficult to cut; they can therefore encourage the growth of public spending and deficits.

Third, political business cycles may operate less powerfully in small countries.²⁰ Pump priming through deficit spending is less effective because the leakages through imports are greater. In addition, manipulation of the economy in the run-up to elections may be more transparent and thus less effective.

Fourth, the small countries have more efficient budgetary institutions that are less prone to free riding and faster to adjust to shocks. Here I rely on the work on Holger Gleich, who has constructed indices of the efficiency of budget institutions for all ten accession economies (see Gleich 2003). Gleich assigns higher rankings to countries whose institutions are conducive to coordination and cooperation in decision making and that should thus promote fiscal discipline.²¹ Ranked one to ten (where ten is best), the four small countries have an average score of 8, while the four large ones have an average score of only 5. Estonia, Latvia and Slovenia have the three best scores in terms of the efficiency of budgetary institutions, while Hungary and Poland have two of the worst.

²⁰There is considerable evidence of political business cycles in the accession economies: see Clark and Hallerberg (2000) and Hallerberg and Souza (2002).

²¹The relevant coordination mechanisms include the delegation of budgetary power to a strong finance minister or prime minister, and mechanisms for facilitating communication among competing interest groups leading to binding decisions.

Finally, fiscal control may simply be harder in larger, more decentralized economies. Where there are more regional governments and spending ministries, there is more pronounced common pool problem – a greater temptation for each to spend more now and ask for a transfer from the central government later. Where there is more ethnic and economic heterogeneity, there may similarly be a greater tendency for each group to demand more spending on its particular need, to the neglect of the aggregate consequences.²² Institutional reform making the budgeting process more centralized can address this problem, but there are obvious pressures against centralization in large, diverse economies. And delegating agenda setting power to a strong finance minister tends only to be effective when there is a strong one-party government, which is not the norm in this part of the world.

None of this means that fiscal consolidation is impossible in the larger accession economies, only that it faces hurdles not also present in the smaller countries.²³ It also raises questions about the feasibility of some countries' consolidation strategies. Hungary, for example, now proposes to embark on an ambitious three year deficit reduction plan, culminating in an evaluation of its readiness for monetary union in 2006. Unfortunately, this will collide with the next round of general elections, which creates the worry that the authorities' fiscal goals may end up being sacrificed on the alter of electoral politics. The structure of the country's fiscal institutions does not suggest that this problem will be easily addressed.

The pressure to abandon consolidation will depend, of course, on whether initial efforts at belt-

²²This is the central finding of Alesina, Baqir and Easterly (1999).

²³Tightening fiscal policy is also the right response to the capital-inflows problem that these countries are likely to experience following accession. See Begg et al. (2003).

tightening aggravate macroeconomic problems or help to solve them. This question brings us, inevitably, to the issue of expansionary fiscal consolidation. Do the large accession economies meet the preconditions for this exceptional case where deficit reduction stimulates growth and reduces unemployment?

I must admit to not being very optimistic. Fiscal consolidation does least to aggravate unemployment when the exchange rate is flexible, so that the decline in domestic absorption can crowd in exports via a weaker currency. But this mechanism will not be operative in countries that immediately enter the ERM-II.²⁴ It will only benefit the others to a limited extent, given that the euroization of their liabilities will prevent them from allowing their currencies to depreciate too far.

In addition, to the extent that the fiscal imbalance stems from a public sector that is too large or growing too quickly, fiscal consolidation will only be sustainable if it addresses this core problem, which means limiting the growth of spending rather than raising taxes. That this is the medium-term strategy (meaning starting in 2005 or 2006) in all the large accession economies is somewhat reassuring.²⁵

But the truth is that most of these countries display little appetite for cutting spending now. Hungary is relying mainly on tax increases to address its immediate fiscal problem, reflecting the fact that the vast majority of expenditure takes the form of transfer payments and other programs that are

²⁴This leaves me more optimistic about the Czech Republic than Hungary. While the authorities in the latter have indicated the intention to enter the ERM-II as quickly as possible, those in the latter have indicated a desire to hold off until fiscal consolidation is complete.

²⁵See European Commission (2003), Table I..25. The intention to cut the number of public-sector employees, announced last September, holds out some hope for spending reductions, but whether it can be implemented over union objections remains to be seen.

politically difficult to cut. Thus, the government's 2004 budget proposal foresees no reduction in the expenditure/GDP ratio, which will remain at 48 per cent of GDP.²⁶ Reductions in the public expenditure/GDP ratio will only kick in later. In Poland there will be no decline in the government expenditure/GDP ratio between 2003 and 2004, according to the 2003 Pre-Accession Program; to the contrary, it will rise further, to 48 per cent of GDP. Expenditure reductions are scheduled to kick in only later, starting in 2005.

²⁶Spending by local governments included. Instead, the authorities anticipate reducing the deficit ratio by 1 per cent of GDP by limiting personal income tax and VAT rate cuts.

Again, why is not hard to see: social transfers account for a substantial share of general government expenditure, and this component of the budget is notoriously difficult to cut. The same Pre-accession Planning Programs that project eventual declines in the share of general government expenditure foresee no decline in social transfers as a share of GDP (aside from a limited decline in Poland).²⁷ Some of my colleagues have argued that we shouldn't worry about large deficits in these countries, because there is still ample scope for productive public investment. They argue similarly that one shouldn't be alarmed by the absence of more rapid public expenditure reduction, since the new EU members need to match their receipts from the Cohesion Funds. When one sees the large share of national income absorbed by public spending and how much of this takes the form of transfer payments, I continue to believe that what is needed is expenditure reduction, not more deficits.

Finally, in most of these countries, medium-term fiscal scenarios seem to be based on overly optimistic growth forecasts. In other words, governments are projecting declines in the deficit by making exceedingly optimistic assumptions about revenues. They see public spending as a share of GNP declining not as a result of slower growth in the numerator but faster growth in the denominator. Households, firms and financial markets are likely to see this rosy scenario for what it is. Their awareness that the authorities have taken only half measures means that consumer and investor

²⁷European Commission (2003), Table I.26. Pension reform that more closely links benefits to contributions (and raises the retirement age or limits the indexation of benefits, where doing so is needed to put the scheme on a sustainable footing) is an important signal that pension systems will not be allowed to remain a major drain on the general government budget. But, according to the latest information I have, only two of the four large accession economies have taken major steps in this direction. In the other two, these reforms are still only in the planning stage. European Commission (2003) reports that Hungary and Poland have introduced a mandatory funded pillar, but the Czech and Slovak Republics still have not.

confidence will be less than otherwise. And this in turn means that consolidation is less likely to be expansionary.

Let me be clear. I am not questioning that fiscal consolidation is needed in the large accession economies. I am not questioning that it will happen. But I am challenging the assumption that it will be painless. Hence, there are likely to be reversals along the way. The process may take several additional years to complete.²⁸

All this may mean a few additional years before the large accession economies are accepted into the euro area. They will find it easiest to complete their preparations if they are not at the same time required to participate in a narrow-band ERM-II. But neither will life be pleasant outside the ERM-II – even one with 15 per cent bands – it too will almost certainly be a rough ride. This will further drive home the advantages of belonging to Europe's monetary union. Requiring the new EU members to participate in the ERM-II would of course have the same effect, but perversely make it more difficult for them to complete their preparations. If the incumbent members have the common sense to abandon

²⁸Given all this, what would be sensible preconditions for admission to the euro area? Inflation rates within 1 ½ per cent of the euro area average (not the three lowest-inflation members of the euro zone). Debts below 60 per cent of GDP. The same deficit criteria that applies to the incumbent members. In saying this I am assuming that the Stability Pact is going to be sensibly reformed in the direction of greater flexibility. Beyond that, the new EU members should receive no special concessions. Granting them exemptions for public investment will only encourage manipulation of public-sector accounts. And where deficits are truly excessive, public investment is not the explanation.

their perverse ERM-II requirement, I see no reason why the large accession economies cannot join a euro area that already includes Estonia, Latvia, Lithuania, and Slovenia by the end of the decade.

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