

EMU Enlargement: Why Flexibility Matters

Inflation differentials can contribute to nominal and real adjustment, but may come with costs

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The European Monetary Union (EMU) continues to expand with Slovenia being its newest member since January 1, 2007 and several others in the waiting room. As exchange rates become irrevocably linked to the euro, regional inflation differentials become an important adjustment mechanism: for instance, when countries grow at different speeds, inflation differentials can emerge. Similarly, inflation differentials that emerge due to regions being hit by asymmetric shocks need not concern a central bank. A more difficult situation for a monetary policymaker occurs when persistent inflation differentials emerge because of inflexible labor and product markets. These could potentially lead to large adjustment costs, a loss of public support for the euro and a weakening of the external value of the euro. To avoid this, sufficient flexibility in labor and product markets is important to ensure smooth and sustainable nominal and real convergence of the New Member States (NMS).

The level of inflation dispersion in the EMU is close to levels observed in other monetary unions (see Figure). For the EU25 (all EU members except for the UK and Denmark), however, the average level of dispersion has been considerably high-

er. This is because the NMS are in a process of real and nominal economic convergence. Taking into account current nominal price levels and the recent speed of convergence, it is estimated that most NMS need several decades to achieve price level convergence (see Table). That is, if the NMS fixed their exchange rates to the euro tomorrow, they would have a higher average inflation rate than the current euro area member states for a sustained period of time.

Unable to Deliver Monetary Stability?

Arguably, monetary policy making by the ECB would be easier if most member states were located closely around the average rate of inflation. In contrast, a situation where two groups of countries persistently deviate from the union's average rate of inflation might expose the monetary union to tensions. As nominal and real convergence in the NMS is still far from being achieved, there is a risk that in an enlarged monetary union, two groups of countries will emerge that have a different rate of inflation, and hence different needs for monetary policy.

While the economic impact of the NMS accession to the EMU would be

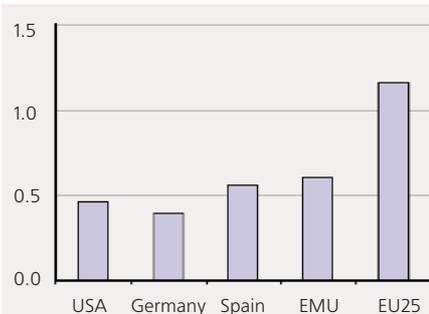
limited due to their relatively small economic weight, the NMS would represent a substantial political/social factor as they account for about 25% of an enlarged euro area's population. The ECB may not be able to deliver price stability for a considerable part of the population of an enlarged monetary union. Since 1999, the average share of total population that has an inflation rate within a ± 1 percentage point band around the GDP-weighted average inflation rate is about 80% for the current EMU and slightly more than half for a hypothetical monetary union of the EMU and NMS.

Conclusion

The EMU has extended monetary stability throughout Europe. Arguably, one of the factors contributing to the success of the EMU has been the high degree of convergence among its members when they formed the monetary union. To continue the success story, European policymakers should pay close attention to the economic circumstances of the candidate countries. Inflation differentials can contribute to nominal and real adjustment, but may come with costs: insufficient economic flexibility increases the risk of persistent regional inflation divergence, which could raise adjustment costs, complicate monetary policymaking and erode public support for the euro. Policymakers therefore need to be aware of the importance of economic flexibility to ensure smooth and sustainable convergence of the NMS to the euro area level.

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Inflation dispersion



Note: Unweighted coefficient of variation of regional inflation rates. Data for the USA (12 FED districts) is averaged over 1951-1999, for Germany (9 Bundeslander) 1951-1996, for Spain (50 provinces) 1961-1998 and for EMU (13 countries) 1999-2007.

Relative Price Index 2005, EU15=100

Country	GDP Deflator	Household Consumption
Czech Republic	54	56
Estonia	56	63
Latvia	48	55
Lithuania	47	53
Hungary	59	62
Poland	52	58
Slovakia	53	56
Bulgaria	35	42
Romania	43	52
Lowest 3 Eurozone		
Portugal	80	82
Greece	82	85
Spain	87	87

Source: Lewis (2007), Eurostat