Postponing Euro–Area Expectations?

While honoring the Treaty, the interpretation of the inflation criterion could be given a fresh look

Tanel Ross

For a number of the New Member States, including Estonia, adoption of the euro is the key priority. This short article discusses some political and economic issues of the enlargement and provides a brief update on Estonia's position.

The starting point for the adoption of the euro is rather straightforward. Eliminating exchange rate risk and promoting real exchange rate stability boosts both intra-EU trade and GDP growth. Adopting the euro would foster financial diversification and investment flows. The enlargement of the eurozone so far has provided substantial benefits for the new and old member states alike.

If the cost-benefit analysis is so straightforward, why do doubts about the pace and breadth of the eurozone enlargement linger? In general, two lines of argument caution against a speedy enlargement. First, an economic line of skepticism notes the eurozone and most of the NMS are at different stages of the economic cycle (or medium to long term development). Second, a political line of skepticism focuses on eurozone governance and, indeed, on EU governance in general.

Economic Skepticism

The economic line of skepticism notes that the New Member States are in a fundamentally different cyclical position compared to the old ones. Economic convergence leads to higher GDP and productivity growth rates, a somewhat higher CPI inflation, and often to current account deficits, as well. Nominal exchange rate flexibility, in this skeptical view, is needed at some point to adjust to a slower growth path. Premature entry to the eurozone would make that adjustment too painful.

These arguments, however, omit the single most important feature of the EMU — its members' economies should be agile enough to make use of the opportunities a stable monetary framework provides. To this end, economic flexibility is needed in all eurozone member states. On some occasions, the Balassa-Samuelsson effect will push an equilibrium inflation rate above the eurozone average. Yet on other occasions shocks to retail trade or telecom services that cannot be easily traded across the single market, would result in real exchange rate depreciation and lower inflation. In either instance, divergence of inflation rates is a result of normal and manageable economic adjustment, and is not a sign of weakness.

Clearly, eurozone members will continue to specialize in the single market and face asymmetric shocks. The divergence of inflation rates and external positions is thus expected to continue irrespective of the enlargement. The corresponding adjustment path of real exchange rates depends predominantly on the flexibility of economic structures. Therefore, the suggestion that the NMS should postpone joining the eurozone simply because of rapid output growth or current account deficits is not entirely correct. Potential eurozone entrants are likely to be flexible enough to adjust in the currency union without recourse to nominal exchange rates.

Estonia's costs of delayed eurozone entry could amount to 10 percentage points of a cumulative loss in GDP growth over five years

Political Skepticism

Political arguments that caution against too rapid enlargement can be divided into two broad categories, even leaving aside general enlargement fatigue.

One of these arguments points to the assumption that the enlargement of the eurozone will be difficult without further political integration. This implies that the credibility of the euro would suffer without closer coordination among fiscal and structural policies, or among other policies.

The existing toolbox for policy coordination within the EU, however, is already impressive. The renewed Stability and Growth Pact and the new Lisbon strategy for growth and jobs together provide a full framework for coordinating policy and applying peer pressure. The fulfillment of commitments by individual member states would suffice for the efficient functioning of the monetary union for years to come. Enlargement of the eurozone would not hinder the proper functioning of any of these mechanisms.

Nor would the views of representatives of new entrants likely disrupt monetary management. Central bank governors from the NMS, according to some, are somehow more accustomed to inflation rates exceeding 2%. Ironically, it could be also argued that governors from the NMS would be too hawkish, as higher interest rates would be preferable in their home countries.

It should be underlined that the members of the Governing Council do not represent their central banks, but the entire eurozone. This applies equally to the present and future members of the eurosystem. Nevertheless, local economic conditions may still count in the voting pattern on the board. It is interesting to note that in the Federal Open Market Committee (FOMC), regional conditions may have a stronger impact on board members in Washington, DC than on FOMC members from the regional banks.

Estonia will Stay on Course

Estonia, by adhering to a fixed exchange rate and the currency board framework, has been a *de facto* member of the common currency area since June 1992. With complete liberalization of capital movement and full integration of the financial system with the European markets, Estonia has been as close to currency union as an independent country can possibly be. Hence, early adoption of the euro is the only realistic policy goal. Estonia has met all the Maastricht criteria with ease — except for the current interpretation of the inflation criterion.

Continued on p. 7

flows, we find that that behind-the-border factors will lead to the increase of import and especially export volumes. For example, the greatest absolute trade gains — US$49 billion and US$62 billion respectively — could be expected if port efficiency and IT infrastructure of the studied countries reach half the average level of the EU, and 70% of trade gains are associated with export expansion.

Improvements in behind-the-border factors by half of the EU-15 average also result in large relative trade gains of around 11%. For instance, Lithuania's trade volume would rise more than 25% if its IT infrastructure level reaches 50% of the EU level.

Trading Partners Also Benefit

Trade facilitation improvements benefit not only the countries that implement them, but also their trading partners. The more intense trade relations are between countries, the greater the potential benefit partner countries will enjoy. Given the importance of intra-regional trade between the EU-15 and the EU-8 and the candidate countries, the expected total trade gains to all of them may amount to almost US$10 billion if all four dimensions of trade facilitation improve by up to a half of the EU-15 level. Of these, 74% accrue to the EU-15 countries.

Almost 40% of the total estimated trade gains for the EU-8 and candidate countries come from improvements in IT infrastructure (see Figure). The second largest potential gains for EU-8 — almost 30% — come from port efficiency. These two dimensions should be therefore given a higher priority for improvement. Bulgaria, Romania, and Turkey receive more widely dispersed gains with investments in port efficiency, customs regimes and regulatory policy at around 20% of the total trade gains.

Improvements in trade facilitation in the New Member States and Turkey will also bring sizable benefits to EU15

In relative terms, the EU-8 and the candidate countries will benefit more than the "old" members, thanks to the existing relatively intense trade relationships. In particular, their relative trade gains are quite large should the largest economies among them — the Czech Republic, Hungary, and Poland — improve trade facilitation. For example, if Poland increases its IT infrastructure to half of the EU-15 average, the other seven new member countries will enjoy a trade gain of 0.8%; Bulgaria, Romania, and Turkey will gain 0.25%, and the EU-15 — 0.29%.

Concluding Remarks

As our analysis has shown, improvement in IT infrastructure could lead to the largest gains for the new members and the candidate countries. If clearance procedures could be streamlined, the attendant time could be shortened and costs saved.

In general, improvements in port facilities and IT infrastructure may be more costly than the administrative reforms at the center of customs regimes and regulatory policy — but they could have correspondingly high payoffs. The eligibility for additional EU financing with accession should provide more scope for improvements in these areas.

John Wilson is at Development Research Group, Xubei Luo is at Europe and Central Asia Region, and Harry Broadman is at Africa Region, the World Bank, Washington, DC. Full text of the authors' paper "Entering the Union: European Accession and Capacity Building Priorities" is available at: http://econ.worldbank.org (World Bank Policy Research Working Paper No. 3832). The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent. The findings and conclusions here do not necessarily represent the views of U.K. government or the U.K. Department for International Development, which has provided support for the project. BT

Continued from p. 5

Against this backdrop, a few suggestions for future work could be made.

All the Treaty provisions should, of course, be honored. Within this framework, however, taking a fresh look at the interpretation of the inflation criterion is possible. The three countries with the lowest inflation rates are not necessarily the three best performers of the EU-25. Indeed, it has been almost customary in recent convergence reports that two out of the three reference countries were ones with floating exchange rates that might not serve as the most suitable benchmark for joining the currency union. Thus, new ways should be explored, for instance, by taking into account the european Central Bank's explicit numerical target for calculating the reference value of the price stability criterion, or only looking at the inflation rates of eurozone members.

The new interpretation of the criterion would not set an unwelcome precedent for any future enlargements. It would demonstrate that the adoption of the euro would be assessed only by economic policy merits. Indeed, it is not entirely clear why a combination of low inflation and a fluctuating nominal exchange rate would be preferred to a strictly fixed rate when deliberating over eurozone membership.

It has been customary to ask what will happen if entry to the eurozone is indefinitely postponed. The Bank of Estonia's calculations put the economic costs of delay in terms of a cumulative loss in GDP growth at 10 percentage points over five years compared to the baseline. Of course, strong policies can reduce the impact of the postponement or even render it negligible. In any case, the fixed rate of exchange remains the sole anchor for Estonia's monetary policy. Over the medium term the inflation rate is expected to move closer to the eurozone average thus providing an opportunity to adopt the euro in the not so distant future.

Tanel Ross is Director of International and External Relations Department of the Bank of Estonia. He has contributed this article to BT. The views expressed here are the author's and do not necessarily reflect those of the Bank of Estonia. BT