Hermann Remsperger: Enlargement of the European Union and European and Monetary Union: Maastricht meets Copenhagen

Speech by Prof Hermann Remsperger, Member of the Directorate of the Deutsche Bundesbank, at the annual meeting of ELEC, Frankfurt, 7 December 2001.

*   *   *

I. Introduction[1]

The accession of ten central and east European countries as well as Malta and Cyprus presents the European Union with one of the greatest challenges in its history.[2] In June 2001 the Gothenburg European Council clearly stated that the process of European enlargement is irreversible. It has already been foreseen that the first of the accession countries will participate in the European Parliament elections in 2004. What currently looks possible is that there will be a “Big Bang”, an initial major enlargement involving ten candidate countries. The new EU member states also commit themselves to adopt the euro at a later date. Contrary to the United Kingdom and Denmark there will be no “opt out” clause. This means that two to three years after enlargement of the European Union there could already be a far greater number of countries participating in European Monetary Union. In my opinion, however, it is actual progress in convergence rather than pressure to keep to a political date which should be the prime focus of the ongoing process of integration.

I would like to start today by describing some fundamental economic facts concerning EU enlargement. I then propose to outline the challenges for the candidate countries and the current EU member states in the enlargement process.

II. Economic background to EU enlargement

The accession of twelve candidate countries to the EU first of all means that the population of the EU is set to rise by more than 100 million, in other words by more than one-quarter. However, gross domestic product would not increase by anywhere near as much. The aggregate nominal GDP of the accession countries is currently less than 5% of GDP in the EU as a whole. In terms of purchasing power parities, the weight of the accession countries would be roughly twice as much. Even if this measurement method is used, however, there are considerable differences between them and the current member states.

The candidate countries also demonstrate *major structural differences* with the EU. The share of agriculture in the gross value added is on average more than twice as high as in the EU, where it is around 2%. Sectoral employment also points to the existence of structural discrepancies. In Poland, for example, agriculture contributes over 3% to the gross value added, whereas almost 19% of the workforce is employed in this sector. Increasing rapprochement with the EU is likely to result in a major reallocation of resources even if full structural harmonisation is not likely.

At this point I should add that the accession countries generally have large current account deficits. Although such deficits are thoroughly defensible for countries that are in the process of catching up, persistent current account deficits make the economy more vulnerable to internal and external disturbances, especially if these are relatively severe and are financed short term and in foreign currency.

When painting the external picture of the economy, it needs to be said that the average degree of openness in the candidate countries is significantly higher than in the EU. This is partly due to the fact that most of the candidate countries are fairly small. Nonetheless, the figures range from 29% in Poland to 109% in Malta.[3] Trade liberalisation and the prospect of EU accession, together with the geographical proximity of some of these countries to the present EU member states, have led to a

---

[1] I would like to thank Dr Sabine Herrmann for her assistance.

[2] Turkey is not included in these deliberations. Although it has applied for accession to the EU, negotiations have not yet begun.

[3] The degree of openness is defined as the average export and import of goods and services as a percentage of GDP.

considerable intensification of trade integration with the EU. Imports from and exports to the EU on average account for around two-thirds of the candidate countries' total imports and exports.

In addition to the differences with current EU member states, account also needs to be taken of the heterogeneity amongst the accession candidates. With a population of more than 38 million and around 40% of the total output, Poland is by far the largest accession economy. GDP in both the Czech Republic and Hungary, the second and third largest economies, is less than one-third that of Poland. Most of the other candidate countries are relatively small economies. As well as size and economic strength, the standard of living varies considerably. If purchasing power parity is taken as a basis, the figures range from 24% of the EU average in Bulgaria to 82% in Cyprus. Nine of the twelve candidate countries show less than 60% of the average EU income. It can therefore be assumed that real convergence will take some time.

The heterogeneity amongst the accession countries can also be seen from the fact that there are a number of different exchange rate regimes in operation. Most of the countries have seen their exchange rate regime change at least once, if not more often, during the transition process. This can be partly attributed to the fact that exchange rate policy has to fulfil different tasks in the various stages of development.[4]

The current exchange rate regimes can be roughly divided into three groups. At one end of the spectrum are Estonia, Lithuania, Bulgaria and, to some extent, also Latvia and Malta. These countries have reduced their monetary policy flexibility significantly by adopting a *currency board* arrangement or a relatively narrow currency peg. At the other end of the spectrum are the countries which allow their national currency to *float* on the foreign exchange markets and primarily pursue an inflation or monetary target. Poland, Slovakia and the Czech Republic fall into this category. The third group comprising Hungary, Cyprus, Slovenia and Romania[5] peg their exchange rates to the euro while at the same time allowing the external value of the currency to fluctuate somewhat.

III. Three-stage accession process

The increase in heterogeneity brought about by EU enlargement is frequently perceived as a risk for the single market and the single currency. It must be noted, however, that the candidates have to meet a whole range of requirements before they can accede to the EU or EMU. These go far beyond the nominal convergence criteria so often cited. For this reason, I think we need to take a closer look at the complex three-stage integration process. At the moment we are in the first phase, which will last until EU accession. Then comes the second stage, a period of transition characterised by two issues: entry into the exchange rate mechanism ERM II on the one hand and the convergence test for membership of EMU on the other. The third stage begins when the accession countries adopt the euro. The complicated issues involved with the third stage are not covered in this paper.

First Stage: Preparations and conditions for EU accession

In 1993, when the Copenhagen European Council decided that the European Union would be enlarged to include the twelve candidate countries, it also established the terms of their accession. The *Copenhagen criteria* require new member states to demonstrate a sufficient degree of political, institutional and economic stability, to comply with the obligations arising from membership and to identify fully with the goals of European integration. Of particular relevance to the Eurosystem are the *economic criterion* and the *criterion on the adoption of the acquis communautaire,* as the body of EU law is known.

The *economic criterion* established in Copenhagen requires new EU member states to have a functioning market economy that is able to cope with competitive pressure within the Union. This requires, among other things, functioning property rights, competition, free price formation and a well-developed financial sector. The European Commission's progress reports clearly show that so far only Malta and Cyprus fully meet the economic criterion. Although Estonia, Latvia, Lithuania, Poland, the Czech Republic, Hungary, Slovakia and Slovenia are functioning market economies, further efforts

4 See Wagner, H. (2001), "Pitfalls in the European Enlargement Process – Challenges for Monetary Policy", presented at the Bundesbank Conference on 26-27 October 2001.

5 Officially, Slovenia and Romania operate a strategy of monetary targeting, although the exchange rate is *implicitly* pegged relatively closely to the euro (managed floating).

are needed to differing degrees before these economies are able to cope with market forces. In Bulgaria and Romania the reform effort must be intensified considerably. While great progress has already been made in terms of liberalising trade and the foreign exchange market and in the privatisation of business enterprises, prime consideration must be given to economic competitiveness.

If a country is to be able to cope with international competition and if capital is to be channelled smoothly within a country, it is of paramount importance for the domestic banking and financial sector to be efficient. This requires a high degree of financial intermediation, liquid capital markets, the banks having a sufficient capital base, a functioning system of banking and securities supervision and sound payment systems.

The financial sector in the accession countries is in need of further development. All in all, the banks have a fairly low level of financial intermediation. This primarily reflects the relatively limited development position of former transition countries that are still undergoing a restructuring process. For instance, banking expertise is not yet developed enough in some areas and some banks remain insufficiently geared towards making a profit.

All this is also reflected in loans to the private sector. Here, the candidate countries display, on average, only around 30% of GDP or less than one-third of the figure for the EU. The occasionally very large spreads between loan and deposit rates – which are on average roughly twice as high as in the EU – point to a risk premium. Some observers interpret this spread as an indication that the banking system is not yet efficient enough.

On the whole, securities markets do not yet play a major role in the accession countries. Although the equity markets have grown steadily in importance since 1994, market capitalisation remains small by comparison with the EU. The bond markets are dominated by government bonds. Corporate bond markets scarcely exist. None of this is unusual for countries that are in the process of catching up. However, it does indicate problems with regard to the competitiveness of business enterprises.

If the major significance of the financial sector is taken into account when allocating resources, it becomes apparent that the accession countries need further structural reforms. The framework provided by the Copenhagen criteria is intended to ensure this *structural convergence*. It is a necessary precondition to accelerating the process of real convergence in the accession countries.

The *criterion on adopting the acquis communautaire* obliges the accession candidates to implement and enforce all the European legal acts and regulations. In terms of the later adoption of the single currency, this relates particularly to the central bank acts, movement of capital, the banking system and the stability of the financial system.

By virtue of their accession, the central banks of the new EU member states become part of the European System of Central Banks (ESCB). Central bank legislation must therefore be in line with the relevant provisions of the EC Treaty. The accession countries must accept the primary objective of maintaining price stability, ensure the institutional, personal and financial independence of their central banks and prohibit direct public sector financing by the central bank.

In addition, EU accession is conditional upon the liberalisation of capital movements. Nine of the twelve candidate countries have already been able to conclude provisionally the relevant chapters in the accession negotiations. However, there are still pronounced differences. Estonia, Latvia and Lithuania have removed all foreign exchange controls and are therefore fully liberalised in this respect, although there are still some restrictions to the purchase of property or land by foreigners. The Czech Republic and Bulgaria have also been able to fulfil the relevant capital account provisions of the *acquis* to a large extent. In Poland, Hungary, Slovakia and Slovenia there are restrictions on short-term movements of capital, in particular. There are still a considerable number of restrictions in Cyprus, Malta and Romania.

While the liberalisation of capital movements is essentially non-negotiable, the timing and the scheduling of the liberalisation steps should be dependent on the macroeconomic facts and the stability of the financial sector. Free movement of capital actually represents an additional challenge for the economies concerned. Particularly as their financial sector is not yet fully developed and reforms in banking supervision have still some way to go, it is best to adopt a step by step approach – especially if the accession countries are tying their exchange rate to the euro. It is not possible for monetary policy to be autonomous if the movement of capital is completely liberalised and if the exchange rate is targeted (impossible trinity[6]).

Second Stage: The transition period

The period of transition following EU accession is geared to enhancing the convergence needed for adoption of the single currency. The countries which accede to the EU commit themselves to adopting the euro at a later date. There is no “opting out”. The preparations for EU accession as laid down in the Copenhagen criteria establish basic rules for later adoption of the euro. Central bank independence constitutes the institutional basis for increasing harmonisation of exchange rate policy. Free movement of capital is essential to a meaningful monitoring of the exchange rate criterion. The reforms relating to the structure and stability of the financial markets speed up the process of real convergence. At the same time, the process of *catching-up* by the new EU member states will, of course, continue *after* accession.

When acceding to the EU the candidate countries commit themselves to regard *economic policy* as a matter of common concern and to submit to the EU mechanism for coordinating and monitoring economic policy. The objective is for all EU member states to have a stability-oriented economic policy that is geared to increasing convergence. The *Stability and Growth Pact* is especially geared to fiscal policy and establishes the medium-term objective of a balanced public-sector budget.

(a) Participation in the exchange rate mechanism ERM II

In the period of transition exchange rate policy is also a matter of common concern. In accordance with the Treaty, it is not possible to accede simultaneously to the EU and EMU. Rather, the convergence criteria require a country to have participated in ERM II for at least two years without severe tensions. Only then can it join EMU. Whether an even longer transition period would appear necessary or whether participation in ERM II can take place immediately after EU accession is dependent on the particular situation of the country in question or on its progress in the convergence process and in achieving macroeconomic stability.[7]

With regard to the question of what exchange rate regime would be appropriate, in my view particular attention must be paid to the following three aspects:

1. EU accession and liberalisation of capital movements could lead to capital flows becoming more volatile. It is therefore likely to be more difficult to maintain “rigid” exchange rate regimes.
2. As a result of the catching-up process, the accession countries will probably find their equilibrium real exchange rates increasing in the years ahead.
3. As inflation rates in some accession countries are still considerably different from those in the current EU countries, the exchange rate regime must also take account of the risk of higher current account deficits and of competitiveness.

In the transition period from EU accession to joining EMU, efforts must therefore focus on the consistency of exchange rate strategy and macroeconomic policy. Participation in the exchange rate mechanism is only appropriate if pegging the exchange rate more closely to the euro is in line with the general macroeconomic situation.

In my opinion, the European exchange rate mechanism is an adequate way of preparing for adoption of the single currency.[8] This mechanism can help to limit exchange rate fluctuations in a credible multilateral system, without preventing a certain degree of exchange rate flexibility.

However, it should be noted that there may be cases, in which even the broad bands of ERM II may not be wide enough to accomodate the necessary exchange rate adjustments during the integration process. This may be due, for example, to liberalisation measures or persistent changes in the relative

[6] See Frankel, J. (1999), “No Single Currency Regime is Right for All Countries or At All Times”, NBER Working Paper No. 7338, Cambridge.

[7] See Von Hagen et al. (2001), “Sustainable Regimes of Capital Movements in Accession Countries”, presented at the Bundesbank Conference held in Eltville on 26-27 October 2001.

[8] See Wolf, H. (2001), “Exchange Rate Regime Choice and Consequences”, presented at the Bundesbank Conference held in Eltville on 26-27 October 2001.

prices. It is therefore best to wait until the initial impact of EU accession is over before taking part in ERM II. This is the best way to avoid speculative attacks. This is particularly true of the present *free floating currencies*, whose proponents consciously stress exchange rate flexibility or the advantage of an autonomous monetary policy. Premature participation in the exchange rate mechanism could prompt the foreign exchange markets to "test" this mechanism.

In countries which have already maintained a fixed exchange rate peg to the euro for some time, it is argued that the current high degree of integration is "relaxed" by accession to ERM II, in other words by adopting an exchange rate band. This could lead to the risk of distortions. But in this context it should be taken into account that in certain circumstances exchange rate bands narrower than +/- 15 percentage points or even currency boards can also be sustained within the framework of ERM II. In the case of a currency board, however, this would merely involve a unilateral decision by the country concerned. The Eurosystem would not be under any obligation to intervene in order to support the currency board.

Other exchange rate systems, such as free floating, crawling pegs or currency boards using reference currencies other than the euro, are essentially incompatible with ERM II. Neither would the unilateral introduction of the euro as legal tender (euroisation) be in line with the way to participation in monetary union foreseen in the EC Treaty. The Treaty requires *all* candidate countries to adopt the *acquis communautaire* in its present form. This means that *all* candidates must comply with the stages leading to adoption of the euro provided for in the Treaty.

In any case, euroisation would probably be worth considering, if at all, for those accession countries that have already had a well functioning currency board or a fixed currency peg for some time. After euroisation, however, the countries in question could not count on the support of the Eurosystem. Consequently, they would renounce monetary sovereignty completely without benefiting from the confidence-building effect of participation in the Eurosystem.

In addition, it should be remembered that a decision to allow a country to participate in monetary union only makes sense if the economy concerned has proved able to cope with the pressures of the single market without contravening the convergence criteria of the EC Treaty. The credibility of the whole Eurosystem is ultimately dependent on the sustained convergence of all participants. The multi-stage integration process is intended to ensure that this convergence is indeed sustainable. Early adoption of the euro would simply undermine the integration process.

(b) High degree of lasting convergence before adoption of the euro

The long and carefully planned process of integration culminates in the adoption of the single currency. Accession to EMU is only possible if the accession countries can show *a high degree of lasting convergence*. Pursuant to Article 121 of the EC Treaty, a *high degree* of convergence has been attained if the Maastricht convergence criteria have been fulfilled. A clear benchmark is thus set for attainment of this target. S*ustainability* of convergence, however, is very difficult to assess. The criteria do not merely have to be met once at the time of the examination; they also have to be maintained after that time. Both aspects are important if monetary union is to function smoothly.

A high degree of convergence

The convergence criteria make considerable demands on the accession countries in terms of macroeconomic stability. The inflation criterion requires a *high degree of price stability* backed by market economic conditions. This is necessary to avoid longer and more persistent delays to the competitiveness within EMU and to allow the development to be as tension-free as possible within the framework of a single monetary policy. Stable prices create an atmosphere of accountability, increase transparency and allow resources to be allocated efficiently. They are thus a vital precondition for growth and employment.

Most candidates have made distinct progress in recent years in terms of macroeconomic stability. However, counter-developments, especially in prices, have been observed recently; in addition to internal influences, such as wage developments, these have been the result of external factors – such as oil prices and the exchange rate of the euro.[9] Great efforts are still needed to take the double-digit

9 See IMF(2000), "Exchange Rate Regimes in Transition Countries", Washington.

rates of inflation in Romania, Slovakia, Bulgaria and Poland back to an acceptable level. In 2000 only Lithuania and Malta had a rate of inflation which would have been in line with the inflation criterion.

If inflation expectations are to be kept as low as possible and the appropriate underlying conditions for a stability-oriented monetary policy secured, deficit and debt ratios need to be low. Sound public finances also ensure that national fiscal policy remains flexible even in times of cyclical downturns. This room for manoeuvre becomes even more important for the participants in a monetary union since they no longer have recourse to the instrument of exchange rate adjustments.

With regard to the criteria on the sustainability of public finances, the countries made improvements by and large up to last year. On average, in 2000 the accession candidates virtually attained the benchmark of 3% established by the Maastricht convergence criterion. Malta and the Czech Republic, in particular, still have very high public deficits. Especially against the background of an economic slowdown, however, some candidate countries are likely to experience a marked deterioration of their budgetary position in 2001. Moreover, it must be borne in mind that the deficits are based on definitions that are not always fully consistent with those of the EU. Government debt in all the countries – with the exception of Bulgaria – is around 60% or less.

The *interest rate criterion* requires an adjustment of the long-term nominal interest rates. In liberalised capital markets differences in the nominal interest rates primarily reflect expectations with regard to the development of the rate of inflation, public finances and exchange rate stability. Viewed in this way, the interest rate criterion provides an assessment, in line with market conditions, of whether the convergence progress can be sustained over the long term. However, in the run-up to monetary union it became apparent that interest rate differentials were declining sharply as confidence in accession grew (“convergence trade”).

Sustainable convergence

In terms of EMU accession, the Maastricht criteria are intended to ensure not only a *high degree* of convergence, but also its *sustainability*. Structural discrepancies and differences in the standard of living could, however, lead to the economies drifting apart again after accession. It is consequently important to ensure that convergence is sustainable. This is of particular importance for price performance, to which I shall return in a moment. First, though, it must be said that sustainability is also vital to fiscal policy. The Treaty states that *persistent* excessive deficits are to be avoided (Article 104). The Stability and Growth Pact gives concrete expression to the obligation to ensure a government budget that is in balance over the medium term. The stability programmes stipulate how and when the objective is to be achieved. The aim is to ensure that the stability orientation of European monetary policy is not undermined by a lack of fiscal discipline.

The Balassa-Samuelson effect,[10] as it is called, means that above-average growth rates in catching-up countries are accompanied by higher rates of inflation. This is the result of major increases in productivity in *traded goods*. In the case of the small open economies of the accession countries, the resultant improvement in return does not always lead to price reductions and may, instead, lead to calls for higher wages. The corresponding wage claims in the *non-tradable goods* sector, which does not generally show the same progress in terms of productivity, are accompanied by higher unit labour costs in this sector. The outcome is higher prices in the catching-up countries.

In this connection there have been frequent calls for the definition of price stability in the euro area to be increased.11 This is intended to prevent inflationary tendencies in the faster growing economies having to be counterbalanced by deflationary developments in other countries. Several aspects are problematic.

First, relaxing the objective of stability would undermine the credibility of the ECB in the early stages of its development. Second, the impact of the Balassa-Samuelson effect needs to be qualified. Estimates put it somewhere in the range of 1%-3% p.a.[12] Given the relatively small economic weight of the

10 See Balassa, B., (1964), „The Purchasing Power Doctrine: A Reappraisal“, Journal of Political Economy, Nr. 72, S. 585-596 and Samuelson, P., (1964), „Theoretical Notes on Trade Problems“, Review of Economics and Statistics, Nr. 46, S. 145-154.

11 As proposed, for example, by Sinn and Reutter (2001), “The Minimum Inflation Rate for Euroland”, NBER Working Paper, No. 8085, Cambridge.

12 See Broek/Slok (2001), “Interpreting Real Exchange Rate Movements”, IMF Working Paper, 01/56, Washington D.C.; Deutsche Bundesbank, Monthly Report, October 2001.

candidates, the effects on the European aggregate would therefore be fairly minor. For fundamental considerations major shortfalls in convergence should not be compensated by relaxing the stability objective. Fairly minor inflation differences, however, are completely normal in a monetary union and can be accommodated by the ECB's stability objective of up to almost 2%. They have so far not jeopardised monetary policy in Europe.

With regard to the enlargement of EMU, I would like to point out that efforts to increase the flexibility of the labour markets could take account of the sectoral and regional productivity differentials in the accession economies. Moreover, intensifying competition in the non-tradable sector and a restrained fiscal policy may be ways of avoiding higher rates of inflation. In any case, such efforts would seem to make a lot more sense than relaxing the European Central Bank's stability objective.

To ensure the sustainability of convergence, it is vital that not only nominal convergence but also an appropriate level of real convergence be achieved before accession to EMU. In this connection, attention should be drawn to the importance of the Copenhagen criteria and the concomitant structural reforms which lay the foundation for swifter real convergence *prior to EU accession*. Nominal and real convergence are two sides of one coin and should therefore be pursued simultaneously. To put it in a nutshell, Maastricht meets Copenhagen.

Nonetheless, the desire to achieve monetary stability is often seen to be at odds with the real process of catching up. It is argued that a monetary policy geared to the objective of stability puts an unnecessary brake on growth. This is, however, to overlook the fact that, if at all, this could happen in the short term; over the longer term a stable monetary environment is absolutely essential to price stability, a healthy investment climate and sustainable growth. This has also been borne out by numerous empirical studies. The IMF, for instance, shows that most progress is made by precisely those transition countries that are determined to push forward with monetary stabilisation.[13]

The criteria laid down in the EC Treaty represent a comprehensive set of rules for enlargement of the EU and European Monetary Union. If the rules are respected, it will be possible to sustain the degree of nominal and real convergence that is essential to ensure that European Monetary Union functions well. With regard to measuring convergence the EC Treaty therefore also refers to the need to take account of the results of the integration of markets, the situation and development of the balances on current account and the development of unit labour costs and other price indices (see Article 121 (1)). The EC Treaty subjects all members to the same criteria, thus avoiding the formation of a two-class monetary union. To sum up, neither the introduction of new hurdles nor the relaxing of existing criteria appear economically necessary or politically judicious.

IV. Conclusion

I would like to close by summarising my deliberations with five comments.

1. Accession of central and east European countries as well as Malta and Cyprus to the European Union represents an *unprecedented* integration process. Owing to the large number of candidates and their heterogeneity, not to mention the differences between new and existing member states, all those involved are faced with major challenges.

2. There is general consensus that the integration of the candidate countries represents both a political necessity and an economic opportunity. It is perfectly understandable that the candidates wish to benefit from the prosperity of this large economic area as quickly as possible. Particularly after the introduction of the single currency, an integration-related reduction in transaction costs, greater price transparency and a consolidation and expansion of the capital markets can be expected. In addition, the accession countries stand to benefit from the ECB's track record. A further decline in inflation rates, capital market rates that are tending to fall and improved investment terms can be expected.

3. If one considers the major significance of the financial sector for the allocation of resources, it becomes clear that further structural reforms are needed in the accession countries before they are ready to join the EU. The framework provided by the Copenhagen criteria is intended to ensure this *structural convergence*. It is a necessary precondition to advance the process of real convergence in the accession countries.

---

13 See Havrylyshyn et al. (1999), "Growth Experience in Transition Countries 1990-1998", IMF Occasional Paper No. 184, Washington D.C.; IMF, (2001), "A Decade of Transition: Achievements and Challenges", Washington D.C.

4. Accession to EMU *before* sustainable convergence has been achieved could prove to be disadvantageous both for the candidate countries concerned and for the Union as a whole. For example, forgoing the possibility of using the exchange rate as an adjustment instrument would be problematic if an insufficient degree of convergence has been attained. The competitiveness of the candidate countries could even be jeopardised. It is therefore vital that the Copenhagen and Maastricht criteria for enlargement are actually fulfilled. Before central and eastern European countries, Malta and Cyprus can participate in EMU, it really needs to be a case of Maastricht meeting Copenhagen.

5. The unilateral introduction of the euro as legal tender (euroisation) is out of keeping with the route to membership in monetary union foreseen in the EC Treaty. The Treaty requires *all* candidate countries to adopt the *acquis communautaire* in its present form. This means that *all* candidates must comply with the stages leading to adoption of the euro provided for in the Treaty.