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for Mr. Pedro SOLBES
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Exchange rate policies and EMU participation of accession countries

Ladies and gentlemen,

It is a great pleasure for me to be here tonight. I would like to thank the organisers of this seminar for giving me the opportunity to share with you some thoughts on the exchange rate strategies of accession countries on their road towards euro area participation.

One year ago, we successfully completed the introduction of euro notes and coins, the largest currency changeover operation ever undertaken. This was an outstanding achievement and a major milestone of European monetary integration.

A main challenge in the future will be to fully integrate the acceding countries in the EMU framework.

With the successful conclusion of accession negotiations at the Copenhagen Summit and the prospect of EU accession in about a year, acceding countries are increasingly focusing their attention on the next step in the integration process: their participation in Economic and Monetary Union (EMU), leading to the adoption of the euro. In this context, a key issue arises: which exchange rate strategies should these countries follow for a smooth and successful entry in the euro area?

At present, acceding countries rely on a wide range of exchange rate arrangements, covering the full spectrum from currency boards to free floats. This diversity reflects the different approaches chosen by the acceding countries to manage their transition process taking into consideration the economic conditions prevailing in each of them. It also reflects the fact that, from the EU side, there are no specific requirements on the exchange rate regime before accession to the Union. In general, the exchange rate arrangements of the acceding countries have served them well in the pursuit of macroeconomic stability and disinflation, as long as they were supported by an appropriate policy mix.

If the starting points differ between accession countries, they all share the ultimate goal of adopting the euro. No opt-out clauses, such as those accorded to Denmark and the UK in the Maastricht Treaty, have been agreed for any of these.

In my presentation tonight, I would like to discuss briefly three issues:

- first, the institutional framework for the adoption of the euro that should serve as the main reference of the acceding countries' strategies;
- second, the policy challenges ahead confronting these countries on the road to the adoption of the euro;
- and third, the approach of the acceding countries to monetary integration as reflected in their pre-accession economic programmes.

⇛ The economic case for adopting the euro

Before dealing with the institutional framework, let me say a few words on the economic arguments for the adoption of the euro by new Member States.

There is, of course, a strong a priori economic case for EMU participation for the acceding countries. They are relatively small economies, highly integrated with the EU and have liberalised their financial markets. The theory of optimum currency areas tells us that the more open an economy is the greater the potential benefits from monetary unification. This situation characterises many of the acceding countries. Therefore, the potential benefits from joining the euro area should in principle outweigh the cost of renouncing an independent monetary and exchange rate policy. The benefits would mainly stem from the elimination of the exchange rate risk, the reduction of transaction costs, lower interest rates due to imported credibility as well as from making their economies less vulnerable to external shocks. These conditions in turn will lead to an increase in trade, investment, employment and growth.

However, there are also significant risks associated with a premature EMU participation for these countries, as countries lose their exchange rate flexibility, while the process of structural change, catching up and fiscal consolidation is not yet finished. But I will return to these issues later. This is the reason why the EU Treaty foresees a sequential approach to EMU membership.

➲ The institutional path

The EU Treaty clearly defines the path for the full monetary integration of the acceding countries. These countries will not be able to adopt the euro immediately upon accession. They will first have to comply with the relevant Treaty requirements, including the exchange rate criterion, which foresees a minimum 2-year participation in ERM II. This institutional framework and its implications for the exchange rate strategies of candidate countries have been further clarified by the ECOFIN Council in its report of November 2000 to the Nice European Council.

- **Upon accession**, the new Member States will participate in EMU with the status of "Member States with a derogation" from adopting the euro. This is the same status that Greece had until 31 December 2000 and the status that Sweden still has now. This status will be confirmed in the Accession Treaty.

- **New Member States** will have to treat their exchange rate policy as a matter of common concern. This implies that they should avoid rates that are inconsistent with economic fundamentals, excessive exchange rate fluctuations and competitive devaluations. They are expected to join the exchange rate mechanism, ERM II, at some point after accession. Furthermore, new Member States will have to regard their economic policies as a matter of common concern and hence will be subject to the policy co-ordination and multilateral surveillance procedures.

- **For the next step**, which is the adoption of the euro, the Treaty requires that new Member States achieve a high degree of sustainable convergence. This achievement will be assessed against the convergence criteria laid down in the Treaty.

As you know, these convergence criteria have been the centre of much academic discussion. For example, it is sometimes argued that the inflation and exchange rate criteria should be adjusted to take into account the specific circumstances of accession countries and the potential trade-offs between nominal and real convergence they are likely to face.

Let me stress here that new Member States wishing to adopt the euro will have to comply with the same conditions set by the Treaty as the current euro area Members. The principle of equal treatment between the original and future participants in the euro area will thereby be fully honoured. The convergence criteria are meant to help assess whether a given country has achieved a high degree of sustainable convergence, that is whether its economy is sufficiently attuned with the rest of the euro area to adopt the common currency. In order to fulfil their purpose, these criteria need to be applied in a consistent way.

This institutional path excludes the possibility of either an adoption of the euro immediately upon accession or the unilateral adoption of the euro before accession, sometimes referred to as “euroisation”. The logic behind this is simply that when a Member States adopts the euro, it joins the euro area club with a ‘voice and vote’ and the decision obviously belongs also to the club, and has to be taken on the basis of the criteria set out in the Treaty.

As I have already mentioned, new Member States are expected to join ERM II some time after accession. This framework is sufficiently flexible to accommodate different exchange rate regimes in the run-up to the adoption of the euro. The only clear incompatibilities with ERM II identified so far are fully floating exchange rates, crawling pegs and pegs against anchors other than the euro. Countries with currency board arrangements have, in principle, the possibility to keep their euro-based currency board until the adoption of the euro.

Although currency board arrangements are not a substitute for participation in ERM II, they can constitute a unilateral commitment of the new Member State to a greater degree of fixity against the euro within ERM II. However, the new Member State wishing to keep the currency board will be subject to the common procedure established by the European Council Resolution of June 1997 on the establishment of ERM

II, which means that the central rate parity will have to be agreed multilaterally.

➲ Key policy challenges facing accession countries

In the run-up to full EMU membership, acceding countries will face several challenges which will have a bearing on their strategy for monetary integration. In my view, three principal policy challenges confront the acceding countries:

- First, in the run-up to accession these **countries must focus on preparing their economies for integration into the EU and pursue policies favouring real convergence**; structural reforms, in particular, will improve the flexibility of the economy and will lessen the impact of shocks to income and employment;

- second, given their present degree of real convergence and in a context of full capital account liberalisation, **it might be desirable for some of these countries to have some exchange rate flexibility**. In this respect, the ERM II mechanism could provide them with the required degree of flexibility, while providing a means to anchor market expectations;

- third, the acceding countries need to reform and **consolidate their public finances** and create the necessary margin for manoeuvre so that fiscal policy can serve as an adjustment instrument when the exchange rate instrument is no longer available.

- ***The Copenhagen economic criteria***

As I mentioned already, the priority of accession countries in the period before accession should be to prepare their economies for integration into the EU. In this period, they should focus on furthering the process of structural and economic reform in order to enhance their status as functioning market economies and be able to cope with competitive pressure and market forces within the Union. Acceding countries should not endeavour to meet the nominal convergence criteria prematurely. Prior to accession, progress towards real convergence should take precedence over nominal convergence, even though the two can be mutually supportive.

In a sense, the Copenhagen economic criteria could also be viewed as a measure of achieved real convergence. Of course, even once the Copenhagen economic criteria will be fulfilled, continued reforms in order to increase the flexibility of the economy will still be needed so as to further enhance both nominal and real convergence.

The Commission's Regular Reports review progress towards the fulfilment of the Copenhagen criteria every year. What do they tell us? The progress made by the accession countries in this respect has been impressive. The ten acceding countries are now considered functioning market economies and are expected to be sufficiently able to meet competitive pressures by the date of accession, provided they continue on their reform path.

However, progress in terms of real income convergence, the principal measure of real convergence, has only been modest. In 2001, GDP per capita measured in purchasing power terms reached around 45% of the EU average for the ten acceding countries, against around 41% in 1995. For most of them, closing the income gap with the current Member States will require reaching and sustaining growth rates well above the EU average over the coming years.

But what is also essential in view of EMU membership is the convergence of economic structures towards those of current Member States. Such structural convergence with the euro area is desirable before the adoption of the euro in order to reduce the adverse effects of asymmetric shocks and increase the degree of correlation of business cycles.

With regard to progress in the pursuit of real convergence, let me stress that a vigorous and determined implementation of the structural reform agenda is crucial. In particular, in most accession countries, further reforms of labour, product and financial markets are needed to strengthen the supply side of the economy and enhance their growth potential.

- ***Exchange rate regimes in accession countries and ERM II***

A wide variety of exchange rate regimes currently exists in accession countries. These regimes have evolved over time to adapt to macroeconomic and structural changes. In particular, in recent years, several accession countries have moved towards more flexible exchange rate arrangements, usually augmented by an inflation-targeting framework.

When considering moving toward greater fixity against the euro, three factors need to be taken into consideration.

- The first is the possible costs associated with asymmetric shocks. Small open economies with high import dependence benefit from stable or fixed exchange rates as the literature on optimal currency areas suggests. Yet, if markets are not sufficiently flexible, adjusting to an adverse shock through output and employment changes can be more costly and disruptive than if assisted by changes in the exchange rate.
- Second, the acceding countries ought to pay attention to their vulnerability to reversals in capital flows. Capital flows to accession countries might be strong and volatile especially in a context of rapid growth and full liberalisation of the capital account and, therefore, could make the defence of a pegged exchange rate difficult. This is particularly so if structural reforms are not pursued with vigour and the prospective productivity gains initially forecast do not materialise. Here, I cannot stress enough the importance of policy credibility for supporting stable capital flows in this context.
- Third, some upward pressures on prices are likely to result from the so-called Balassa-Samuelson effect and continued price liberalisation, resulting in a trend real exchange rate appreciation which could create challenges to the simultaneous pursuit of nominal exchange rate stability and low inflation. For instance, structural reforms leading to an increase in productivity growth are likely to cause an incipient appreciation of the real exchange rate. This can happen either through an appreciation of the nominal exchange rate or through increased inflation or a combination of both. Clearly, there will be circumstances where nominal exchange stability, low inflation and reforming the domestic economy will be more difficult to achieve simultaneously.

In view of these factors, I am convinced that the ERM II constitutes a useful framework for accession countries as it combines stability with flexibility and credibility. It provides a degree of exchange rate stability and an incentive for macroeconomic policy discipline while leaving the possibility of adjusting to shocks and market developments, even by changing the central rate. It provides an anchor to guide inflationary expectations, and its multilateral nature increases its credibility. It is also a framework for pursuing real and nominal convergence in parallel, provided that an appropriate policy mix exists.

In this context, the moment of entry and the length of ERM II participation should be determined according to what serves best the transition and macroeconomic needs of each individual country.

Fiscal policy and the transition to EMU

When designing their strategy for monetary integration, countries should also take into account the numerous goals that fiscal policy will need to pursue in the run-up to the adoption of the euro and beyond. This is an issue of crucial importance.

Fiscal policy will be called upon to play an enhanced role in stabilising the economy in an environment marked by continued current account deficits, the independence of monetary authorities and the progressive abandoning of the exchange rate instrument. It will need to support the catching-up efforts of the acceding countries. It will have to cope with substantial expenditure pressures stemming from the completion of transition reforms, compliance with the Community acquis and the need for extensive investments in transport and environmental infrastructure. Additional constraints will be placed on fiscal policy under the EMU's policy framework applying to "Member States with a derogation".

The burden put on fiscal policy will not only depend on the present situation of public finances but also on the degree of exchange rate flexibility in the respective countries. In the event of an early move towards fixed exchange rates combined with an unfavourable fiscal starting position, fiscal policy could become unduly restrictive while still having to bear the burden of any adjustment needed in case of external imbalances, external shocks or a reversal in capital inflows.

All this underscores the need for these countries to use the remaining years before EMU membership to consolidate public finances. Reaching sound public finances will require substantial efforts in some countries. In particular, they will need to implement reforms in order to reorient the structure of government expenditures and to cut the currently high levels of mandatory and quasi-mandatory expenditures.

➲ Pre-accession economic programmes

In order to prepare for future membership, acceding countries have engaged in a multilateral economic policy dialogue with the EU. In this context, they participate in a voluntary initiative called the Pre-accession Fiscal Surveillance Procedure. This includes the establishment of annual pre-accession economic programmes (PEPs). The programmes submitted to the Commission in 2002 give a good indication of the challenges ahead and the accession strategies pursued.

With regard to monetary and exchange rate policies, the PEPs envisage on the whole a continuation of the current monetary and exchange rate regimes up to accession. However, Malta and Romania indicate their intention to link their currencies closer to the euro. Malta has done so since then by increasing the share of the euro in its reference basket. Romania envisages switching to the euro as the reference currency in 2003-2004.

But the PEPs remain vague about the strategies and the timing for ERM II participation and the subsequent adoption of the euro, even though many acceding countries have already signalled their intention to join ERM II and to adopt the euro as soon as possible. The only exception is the Polish PEP that sets as an objective to comply with the convergence criteria by 2005. I welcome the fact that accession countries have opted not to be too specific at this stage in their strategies for monetary integration. The time will come to develop further these strategies and probably the next round of PEPs in this autumn will provide us with more information in this regard.

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Let me say a few words to conclude.

For any acceding country, the choice of exchange rate policy in the run-up to the adoption of the euro is a difficult exercise. Acceding countries must take into account a number of economic and institutional factors and choose a policy path that makes possible both a rise in the standards of living while respecting the relevant EU acquis. In view of these countries' different present exchange rate regimes and different degrees of convergence with the EU, there is a priori a case for a diversity of approaches. This applies as much to the choice of monetary and exchange rate policies as to the timing and length of ERM II membership and of the subsequent adoption of the euro.

The current Treaty framework provides the needed flexibility to accommodate these different approaches. In particular, I see no need to envisage an adaptation of the convergence criteria, as is sometimes suggested. However, what is required in most accession countries in the period up to the adoption of the euro is renewed efforts to implement structural reforms and consolidate public finances in order to further reduce the need for the exchange rate as an adjustment instrument. Provided that the right sequencing is followed, and as long as economic policies in accession countries are consistent with their exchange rate strategies, we will all benefit from the enlargement of the euro area.

Thank you.