The Euro Goes East

Brigita Schmögnerová

Thank you. This is actually quite a unique opportunity for me to sit among central bankers. Before we started this panel the President of the ECB told me that, there is not necessarily a tension between finance ministers and central bankers and that the central banker is usually a supporter of the finance minister in the cabinet, and I have to say that he is right. But we also have sometimes different views, but this is life. I would also like to take the benefit from the fact that I am the last speaker and if you allow me I would like to make just a few comments to all of what has been said.

The first one was about meeting the criteria, that we should meet them without sacrificing growth. I think that this is really extremely important and it does not matter whether income convergence is measured only by growth convergence or not. I think growth is still one of the most important criteria for catching up. As Commissioner Verheugen said a few hours ago, the European Commission recently released the progress reports, i.e. the regular reports on progress of the applicant countries towards accession. The progress reports evaluate each country on the basis of a list of criteria, including political, as well as economic criteria. Not only the “Maastricht criteria” which is, as everybody knows, not a precondition to EU accession. But in any case I think that it is important to understand that one of the most important case tests is really growth convergence or income convergence. This is I think important also from the political point of view, because if you really want to acquire the support from your electorate you must make some promises and you must also deliver the promises. And the most important promise is that you will improve your standard of living. You have to work hard, you have to go through all the reforms of which we had an opportunity to speak and the compensation for that will be the increase of your incomes, the improvement of your standard of living.

On the other side it's really true that if you want at the same time to increase GDP growth and to deliver results in meeting the Maastricht criteria, you sometimes come into difficulties. The second statement could be that meeting criteria is a very complex and complicated process and I would like to stress that in all circumstances this is a process that could be considered as a very straight process and a process which in all cases has to be sustainable.

If you look at the situation of different candidate states it is really true that there is a huge differentiation among the countries. I would like to consider only the group of Central European applicant countries: Czech Republic, Hungary, Poland, and Slovakia. The experts say that providing that nominal per capita GDP levels grow between 5 % and 6 % in euro terms in the poorest EU countries up to 2020, the applicant countries in this area should grow on an annual basis by 11.7 % in nominal terms for Slovakia, 10.1 % for Czech Republic, 11.2 % for Poland, 10.4 % for Hungary. This really requires enormous efforts to succeed in achieving such a high growth rate and at the same time you can achieve that by high price increases, high inflation. But actually this is not the case, if we really want to preserve a good investment climate and if we really want to reach another target which is the Euro zone, i. e. entering EMU. Needless to say that central bankers concentrate on price convergence and I do agree with what was said about disinflation tendencies. Although I have to say that even in pre-accession stage there are some exceptions that are just contrary to disinflation tendencies and I have to say that many of the countries had to make some corrections with administrative prices, including Slovakia. Which means that core inflation really goes down, but if you look at the headline figure it temporarily could go rapidly up and I would like to emphasize that the policy of catching up can generate high prices. Additionally, having troubles with current account deficits there is sometimes a necessity for depreciation of the currency, which again has a negative impact on inflation.

You spoke about price increases after accession and I think, indeed, that there is some evidence among the former new member states that the entry into EU did have some negative effect on price increases but anyway, in the longer-term, what we can conclude is that over time prices will converge and new member states definitely will come to the situation that prices will be much lower than is the case at present.

As a final point I just would like to draw your attention to the next convergence criteria which are extremely important and that is fiscal convergence. I would like to say that the accession, the pre-accession process is extremely costly and it really raises a lot of fiscal constraints. First, we all speak about the necessity of structural reforms. I would like to emphasize that these reforms, or most of them, are very expensive. All or most of the candidate countries have already gone through the restructuring of their banking sector and the former central bank governor of the

Czech Republic, Mr. Tošovský, just a few minutes ago just tried to draw your attention to the cost of this process. In Slovakia 11 % of GPD represents just the principal of the cost of restructuring and I have to add debt service which is quite high as well. Also, the population in the applicant countries is ageing as well and there is a necessity for pension reforms which is of course also costly in these countries and I could mention other reforms which are quite expensive.

Many applicant countries want to make the business environment more friendly. There is a real necessity for attracting FDI and the general belief in applicant countries is that the best way is to reduce taxes. But on the other side this does have negative implications on the fiscal situation – at least in the short term. There are as I said some real and significant risks to fiscal performance with the preparation for EU accession, with the adoption of the acquis communautaire, with the compliance of many EU standards, especially environmental standards, with the improvement of transport infrastructure, with building of new institutions etc. etc.

I would like to add that the list is probably not complete. And once the applicant country becomes a new member state there is another fiscal burden, an important one which is the contribution to the EU budget. That is the reason why many applicant countries would like to negotiate some, let's say, transitory conditions. I have to say that there is not a positive response from the side of the European Commission up to now although in all accessions, if you look to the 80s or 90s, all of the new member states were granted transitional arrangements. And again the problem of catching up is very often in contradiction to fiscal convergence although we do have very positive examples of euro zone countries in the mid-90s when they achieved at the same time relatively high growth and also good price development and a good fiscal performance as well.

The next point is exchange rate stability. Mr. Duisenberg spoke about the necessity of the future EU member states to be a member of the ERM for at least two years, which indicates that no new EU state will become a member of the euro zone before 2006. It's simply not possible, as we suppose that the first enlargement will be in 2004 and there is a necessity for at least two years to be a member of ERM. The problem could be – as we spoke about some temporary deterioration of inflation – that high inflation could necessitate to adjust exchange rates. I spoke also about some deterioration of the current account which could be the implication of a transitory recession but also of a synchronisation of a recession of the applicant countries with the EU countries. So currency depreciation might be required for the maintenance of the current account deficit and this could have some negative implications for meeting the criteria for an application to ERM.

We spoke about different exchange rate regimes in the different applicant countries. Most of the countries will simply have to go from the existing regime to a new one, which to some countries will be a totally new one. So if they were used to a fixed exchange rate regime they may have to change to managed floating and then probably go back again to a fixed exchange rate. I do not think that there will be any risk to keep within the fluctuation band and I think that with the exceptions which I indicated, I don't think that this will be a great problem.

I think Mr. Balcerowicz was very positive about the necessity of early accession to the EMU. Let me just enumerate some of the benefits of early accession, but on the other side I would like to mention also some negative implications of early accession, just trying to be as objective as possible. It is quite clear that especially for small economies, early entry to EMU could help to eliminate exchange rate risk which is quite huge irrespective of what are your fundamentals. Due to the fact that we succeeded in bringing down current account deficit, fiscal deficit, etc. we really from time to time can observe and are challenged with some fluctuations of the currencies. In this case there is a necessity of some improvement from the side of the central bank, for some intervention. I think that we also look forward to benefit from all the risk premiums. It is quite clear that EMU countries benefited from lower spreads that narrowed in a very speedy way from above 300 basis points to less than 30 basis points. We also expect that we will have an opportunity to benefit from a wider financial market. And I think that it is always good, even for finance ministers, if there is pressure, external pressure, on fiscal consolidation. And I think that we will not have any more problems with the proper fiscal/monetary policy mix. I know that usually central bankers blame ministers of finance that they are responsible for not making a proper combination of fiscal and monetary policy. I am not going to quarrel about that. I suppose that sometimes even central bankers are responsible for an inappropriate policy mix. But as a matter of fact, once we become a member of EMU this problem will be not a national problem, it will be just shifted to somebody else and I think national governments will benefit from that to some extent.

I think that we will benefit definitely on government debt service. There will be an easier access to a larger investor base. As I said yield curves will converge across the founding members of the EMU within a relatively short period. I suppose there could be room for closer cooperation between the government debt offices and I think that definitely this will be one of the unique opportunities. Maybe investment bankers and institutional investors will not be that happy but this is the way how to make the debt service even cheaper. There will be an opportunity for syndicated placements instead of traditional auctions etc.

Finally I just would like to say just a few words about potential disadvantages of early EMU accession. As I said the transition period will not allow to use exchange rate policy for decreasing some risks. The first one is current account deficit risks. And the applicant countries from time to time, even after the accession, will probably have to face this. Another issue is that the interest rate policy of the ECB can be, and sometimes we are a witness of that, in contrast to the policy of catching up.
I think that the debate between the finance ministers of the euro zone and the ECB is very well known and this could expand to the new member states as well. And as I said earlier, in some phases the policy of catching up could generate higher prices and probably could jeopardize price convergence targets.

And here I come to the last question which was put by the chairman of this panel: if the strictness in the handling of the criteria is not going to be relaxed to some extent. This is a question especially for the President of the ECB and I just would like to ask a very concrete question. Yesterday there was a quite interesting article in the Financial Times about the possible relaxation of budget targets, of the fiscal policy. And the question is if this could be confirmed. As this was an unofficial suggestion from those people who are connected with the ECB, could you confirm this or is it just a rumour which newspaper men like very much and they like to write quite a lot about that. Thank you for your attention.