

## **The EU attitude to Unilateral Euroization: misunderstandings, real concerns and ill-designed admission criteria.**

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### **1. Introduction.**

We have analysed the difficulties faced by the more advanced transition applicant countries (TACs) in achieving macroeconomic stability in the run-up to EU and EMU membership [Rostowski 2000], and have presented the case for unilateral euroization (UE) as a solution to these problems elsewhere [Bratkowski and Rostowski, 2000]. It has been a surprise to us that the European Commission has responded very negatively to such suggestions, treating them as being against the interests of current EMU members [European Commission, August 2000]. It is not the purpose of this paper to restate the arguments in favour of euroization (in terms of the interests of the transition countries). Rather, our aim is to try to understand and to analyse the arguments against euroization (in terms of the interests of current EMU members) which have been put forward by the Commission and by other EU sources. We divide the argument into four sections. Section 2 deals with arguments that are based largely on misunderstandings - mainly a confusion between the implications of unilateral introduction of the euro and entry into the Economic and Monetary Union (EMU) of the European Union (EU). Section 3 addresses arguments which have some merit, and which a unilaterally euroizing country would do well to meet by adopting suitable policies. In Section 4 we argue that EU opposition to unilateral euroization is misguided, given that the EU's key legitimate concern during euro zone expansion is keeping countries that have not yet developed a "culture of price stability" out of EMU decision-making bodies. In Section 5 we set out our view that the present Maastricht convergence criteria are unsuitable for TACs, and our proposals for their adjustment, in the interests both of current EMU Member States as well as of the TACs. This adjustment would take the form of a loosening of the inflation criterion and a tightening of the fiscal one. Our conclusion is that entry into EMU *via* prior UE and satisfying the (possibly adjusted) Maastricht criteria is likely to give more certainty as to TACs' commitment to price stability within EMU, than if they entered *via* ERM2 and satisfied the present criteria. Appendix I discusses some of the legal aspects of the UE problem, while Appendix II looks at some more abstract issues, which we speculate may underlie some of the EU's objections.

A briefing Note of the European Commission to the Economics and Finance Committee of the Euro 11 group of countries [European Commission, August 2000], expresses outright opposition to unilateral euroization. The most important argument put forward is the legal one that UE is not envisaged by the Amsterdam Treaty, and that since applicant countries commit themselves to accepting EU law as it is upon joining, they cannot introduce UE even before they become members. After a careful reading of the text of the Treaty, we do not accept that there is any insurmountable

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legal problem with unilateral euroization, and we deal with the legal aspects further in Appendix II. However, it would be far better if UE - were it to be adopted by an applicant country - should be so with the good will of the EU side. For there to be such goodwill, the EU side has to be convinced that UE is not against its interests, and exploring to what extent this is the case is the purpose of this paper.

## 2. Misunderstandings.

### *Unilateral Euroization vs. admission to EMU.*

Most of the arguments against UE in the Note rest on a, certainly verbal and possibly intellectual, confusion between a country's "adoption of the euro" and its "joining the EMU". Joining EMU includes obtaining a seat on the Council of the ECB by the country's national central bank (NCB), the NCB concerned joining the European System of Central Banks (ESCB), and a number of other rights and obligations. Among the latter is the possibility of the Member State being subjected to fines if it records excessive fiscal deficits (under what used to be known as the Stability and Growth Pact, and is now part of the Amsterdam Treaty).<sup>2</sup> Clearly countries cannot unilaterally adhere to EMU, no more than the Governor of the Bank of Latvia can force his way into a meeting of the ECB Council. Membership of the EMU (which is now in its third stage, in which the euro exists as a single currency for 12 countries), can only happen after the treaty provisions, and in particular the Maastricht convergence criteria, are satisfied.<sup>3</sup> On the other hand, anyone should be able to use a fully convertible currency in their transactions, if they and their counter-party so wish.

In the same vein the Commission's Note continues: "Candidate countries cannot adopt unilaterally the currency of another currency area." As a positive statement this is nonsense.<sup>4</sup> However, a justification for this ban *is* attempted, as the Note continues: "For this reason (presumably a mis-translation of the original "this is because") the credibility of the euro rests on the economic fundamentals of the Member States belonging to the euro zone, which participate fully in the institutions defining the monetary policy and the co-ordination of the economic policies of its members."<sup>5</sup> This statement is entirely correct, and it explains precisely why, unlike EMU accession, UE by any number of countries cannot negatively affect the credibility of the euro. Unilaterally euroizing countries will not, and should not, participate in the institutions defining the macroeconomic policy of the eurozone, and therefore they cannot "spoil the euro" for the existing members. This fear of new members "spoiling the euro" can again be seen in the passage which states: "The treaty sequencing ... aims to ensure that new Member States adopting the euro have as equally sound and sustainable fundamentals as those already in the euro...". This certainly makes sense as a requirement for countries joining EMU and its institutions, but not for those that merely wish to euroize unilaterally. Indeed, UE requires the countries undertaking it to convert almost all of their reserves into euro, which will

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<sup>2</sup> Thus, the Note states that: "the sequencing on the path towards the adoption of the euro provided for in the treaty do not support euroization...the adoption of the euro will take place without meeting the treaty provisions".

<sup>3</sup> Although we believe that the inflation criterion should be adjusted so as to make it more appropriate for the new applicant countries of central, eastern and southern Europe (of which more in Section 5), such a change is not essential for UE to be beneficial for TACs.

<sup>4</sup> Unless the original text was softened in translation (from the German?) to "cannot" from "must not"!

<sup>5</sup> The ECB and the Eurogroup of Ecofin (Ecofin X).

*increase* demand for the euro and thus its credibility. Furthermore, the desire of third countries to adopt the euro is a vote of confidence in the currency.

Unilateral use of the euro by countries that wish to do so should be seen as equivalent to the spreading use of the euro in international trade and finance, which was one of the aims of its founders (in particular the French). Would the EU object if Microsoft corp. decided to do all of its invoicing and paying of salaries in euro, as well as holding all its cash in the single currency? Surely not, yet such a move might have a greater impact on demand for the euro than the unilateral adoption of the currency by Hungary.<sup>6</sup> Ecofin X has recently (September 2000) expressed concern about the value of the euro on the international exchanges. It is hard to understand how in such a situation it can be seriously contemplating restrictions on the convertibility of the currency, and yet an attempt to forbid UE by third parties amounts to no less than this.

The Commission's Note also claims that in the case of UE "[t]he principle of equal treatment between present and future, as among future Member States will be violated." This is again the result of confusion between joining EMU and "introducing the euro". Convergence criteria (possibly adjusted to take account of the fast growth of transition applicant countries (TACs) – see Section 5 below) have to be met before any member state can join EMU. This means that the principle of equal treatment *will* be maintained, both as between current and future Member States, and between future ones.

A slightly different point is made when the Note states: "Sustainable nominal convergence could not be judged before the economies of candidate country (*sic!*) have demonstrated their capacity to successfully operate within the single market combined with the economic discipline and conditions that adopting the euro [i.e. joining the EMU – A.B. and J.R.] requires".<sup>7</sup> Can sustainable nominal convergence be *demonstrated* if UE has already occurred? Certainly it can. Member States can just not be admitted to EMU and its institutions until they had completed the single market and fulfilled all of the Maastricht convergence criteria. The exchange rate stability criterion would be automatically fulfilled since the country would already be using the euro, so abrogation of the EMU derogation would depend on satisfaction of the public finance, interest rate and the - possibly adjusted - inflation criteria. As we have argued elsewhere [Bratkowski and Rostowski 2000], UE would lead to a sharp reduction in interest rates which would make meeting the long-term interest rate criterion easier. In countries with high public debt this would reduce government expenditure, and make meeting the fiscal and public debt criteria easier. The only problem might be the inflation criterion, which we discuss in Section 5.

#### *Real convergence.*

Prominent ESCB officials have argued that not just nominal but also "real" convergence should be required of TACs before they join EMU. Thus Hans Reckers, a Bundesbank Board member, has argued that TACs should not be allowed to join

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<sup>6</sup> Certainly no objection was heard from EMU Member States when recently Rover (then owned by BMW) insisted on invoicing all of its UK suppliers in euro.

<sup>7</sup> Let us be quite unambiguous: we believe that countries unilaterally adopting the euro should not be allowed to join EMU until they have demonstrated sustainable nominal convergence with the Member States within EMU, and have demonstrated their capacity to successfully operate within the single market.

EMU before they had achieved GDP per capita levels equivalent to 70% of the EU average [Financial Times, 26 Sept. 2000]. In fact, the value or stability of a currency has nothing to do with the income of the people who use it. Were this the case, West European currencies would have been much more stable in the 1970s than in the 1870s, whereas the opposite was the case. It may be the case that a certain minimum level of income is required for a society to be able to support various sophisticated institutions, such as advanced forms of banking supervision, which may be helpful in protecting the political system from demands for inflationary finance (e.g. so as to devalue the burden of bad bank or corporate debts). In fact, the more advanced TACs already have such institutions in place. More important, however, is that this can only be an argument against TACs joining EMU, not against their adopting UE. Indeed, if one believes - as the Member States of the EMU claim to - that monetary union is essential for the proper functioning of the single market, and if one also believes with Herr Reckers that the TACs are not sufficiently mature to be admitted as fully fledged members to EMU, then maybe they should actually be *required* by the EU to adopt the euro as their currency without admission to EMU policy making institutions, i.e. to adopt UE (see Section 4).

*Implicit “lender of last resort” guarantees.*

One often expressed anxiety, particularly in Bundesbank circles, is that UE will mean that the ECB would *in practice* be obliged to provide lender of last resort liquidity (LOLR) to the unilaterally euroizing country in the event of a banking crisis. Clearly, from a legal point of view no such obligation would exist on the ECB, but the fear is that in practice it would be unable to avoid such action, as the alternative would, for some unspecified reason, be even more costly. This need not be a serious problem for a number of reasons.

- We have recommended [Bratkowski and Rostowski, 2000] that countries should only embark on UE if they have sufficient international reserves (IR) to establish a banking sector liquidity fund (BSLF) which would cover any reasonable LOLR needs. Thus, for example, Poland has sufficient IR to cover 25% of all bank deposits and 90% of sight deposits. Those governments, which do not have sufficient reserves should either borrow them in advance of UE, or enter into contingent loan contracts with eurozone commercial banks to supply such reserves when the need arises. A UE agreed with the EU could, therefore, include an undertaking by the unilaterally euroizing country to maintain a BSLF of a certain size (relative to deposits).
- As the above example shows, LOLR is in fact a fiscal, not a monetary function. As long as the national treasury’s credit is good, it can lend Treasury Bonds to a troubled bank, and the latter can borrow against them on the market. A BSLF can therefore consist simply of government bonds of the country concerned, and can be established without a stock of IR.<sup>8</sup>
- Banking systems are generally foreign owned, and in particular EU owned, in the most advanced TACs.<sup>9</sup> Thus, foreign owners of TAC banks will be

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<sup>8</sup> A BSLF of this kind could be accepted by the EU as long as the quality of the UE country’s debt was known to be high. This could be judged prior to UE by the spread on such paper over EMU Member States’ paper. If this spread exceeded a certain reference value, then the UE country would be required to supply IR to the BSLF up to a given level.

<sup>9</sup> The Czech Republic and Slovenia are exceptions. The Czech Republic is in the process of privatising its banks to foreigners, while Slovenia is tiny.

very likely to provide liquidity should the need arise (because they know that their subsidiaries are solvent, or to maintain their reputation). This will be so whether the countries concerned have their own currency or have euroized unilaterally.<sup>10</sup>

A similar fear can be detected in comments that suggest that UE with an overvalued exchange rate would cause a serious recession, and that the only way to protect the candidates against this is to forbid UE. Our view is that any agreements between the unilaterally euroizing country and the EU should be aimed exclusively at satisfying any legitimate EU concerns there might be (see Appendix II), rather than attempting to ensure that the unilaterally euroizing country does not harm itself. Agreements that attempted the latter might indeed be taken to imply a degree of responsibility by the Member States of the EMU. Countries undertaking UE have to be clear that they are doing so entirely at their own risk.

### **3. Real concerns.**

#### *The stock of broad euro money.*

The ECB may be concerned that after UE by a country, it will not know what the “euro M3” stock of money is. The simple response is that the NCB of a country that euroizes unilaterally in agreement with the EU, should undertake to keep the ECB informed of the level of euro bank deposits on its national territory. The ECB will also know the total stock of outstanding notes and how many were bought by the euroizing country at the moment of UE, though not how many of them are on the territory of a euroized country at a later date. However, given that the ECB targets broad money and the small size of the countries concerned this should not be a major problem, particularly as the ECB will in any case not know what proportion of euro notes are held outside the EMU.

A variant of this concern is the fear that if one country is permitted UE, then a large number will follow suit, and as a result the ECB will not know the demand for “euro M3”, the so-called “snowball effect”. This is largely as misunderstanding. All that need concern the ECB are: (1) The demand for euro notes generated by the NCBs of the euroizing countries converting the euro denominated government bonds in which they held their international reserves into cash. (2) The increased forex demand for euro, as IR are switched out of other currencies (as discussed in the previous Section). The first is information that any NCB will willingly provide to the ECB, the second looks from today’s perspective highly desirable. The re-denomination of bank deposits into euros, which will constitute the bulk of the increase in “euro M3” resulting from UE, should not affect ECB policies or operating procedures at all. If UE results in an additional increase in the demand for money in the euroizing country (because of the greater credibility of the euro than of the national currency that preceded it), then the residents will have to obtain euro from EMU Member State

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<sup>10</sup> Finally, like the Bundesbank, the ECB has no uncollateralised LOLR capability, only being allowed to lend to EMU-resident banks against (rather widely defined) collateral. Since the liabilities of non-EMU governments or firms do not figure on the ECB’s list of acceptable collateral, how then *could* it lend to non-EMU banks, even if could overcome the question of their residence status? The only possibility, as we see it would be for it to lend against EMU government securities, which even if it happened would not be a disaster.

residents. They can do this either by borrowing from member State banks, or by running a current account surplus with the rest of the world and converting the proceeds into euro. In either case “euro M3” will increase (at given interest rates), and should be allowed to do so.

*Up-front competitive devaluation.*

The Commission’s Note points out, correctly, that according to the treaties exchange rate policy is an issue of common concern within the EU. Whether this is sensible is a different problem, the treaties are quite clear on the matter. But, again, UE does not violate this principle. It is true that the unilaterally euroizing country chooses the exchange rate at which it will convert its domestic currency into euro unilaterally *ex definitione* (on the pure legality of this see Appendix I). However, it is the Council of Ministers of the EU that will decide whether a country is ready to join EMU or not. The most likely scenario is that a country converts its national currency into euro at a somewhat undervalued rate. It will then have the benefit of temporarily augmented competitiveness (assuming upwardly sticky prices in the tradeable goods sector), but at the cost of higher inflation on its traded goods. EMU Member States can then delay the country’s admission to EMU until this inflation has eliminated the country’s competitive advantage.<sup>11</sup> A country embarking on UE then has to trade off the advantage of an undervalued conversion rate for its competitiveness against the disadvantages in terms of higher inflation and later accession to EMU. As the “second movers” in this game, the current Member States have all the advantages. (We discuss a number of other possible objections to UE in Appendix II).

*However, “small is beautiful”.*

The small size of the TAC economies is very important. Whereas, the non-German Member States of the EMU accounted for three-quarters of EMU GDP, all the TACs together account for only 6% of EMU GDP. Because of this, *any* negative impact on existing EMU Member States of either UE or EMU accession by TACs, even in the absence of nominal convergence, will be very small. It will probably be less than one fifteenth of the impact of the average founder member joining EMU with the same degree of nominal divergence.<sup>12</sup> Thus, individual TACs can probably join the eurozone (either into EMU or through UE) with nominal divergence about 15 times as great as that of individual founder members, and still have the same effect on other members. In fact, no such effect was noted at the time of passing to Stage 3 of EMU. The above does not lead us to argue for the abolition of the Maastricht criteria for EMU accession for TACs, merely that real disruption to other members should not be the grounds for retaining them.

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<sup>11</sup> In purely legal terms this could be done by the Council of Ministers having the right to grant a derogation from the reference value of the Maastricht inflation criterion when deciding on the abrogation of a Member State’s derogation, if it is convinced that any excess inflation in that Member State is due exclusively to the movement of non-traded goods prices.

<sup>12</sup> Total GDP of all ten central and east European applicants is about \$290 bn, compared with EMU GDP of over \$6 trillion (with 12 members). The largest TAC, Poland, has an economy which is one tenth the French or Italian.

#### 4. The “stability culture problem”, EMU admission and unilateral euroization.

One reason for the Maastricht criteria for EMU accession is that EMU membership gives a country voting rights in the ECB and the Ecofin X, and *one would not want countries that have not demonstrated a commitment to low inflation to have such a vote*.<sup>13</sup> This is especially important as, although the ECB is supposed to make policy for the EMU as a whole, and therefore small economies should have a small weight in its considerations, each ESCB member NCB has one vote, and there are at least 12 potential new members from central, eastern and southern Europe, most of which have recent histories of far higher inflation than Western Europe. We call this the “price-stability culture problem”. Of course, this worry should not apply to UE, which does not give the country concerned any influence over euro zone monetary policy. Indeed, as we mention above, it would be better, given the “price-stability culture problem”, for the EU to encourage UE among candidates. UE is a regime which imposes all the rigours of “living with the euro” while excluding countries from EMU decision making. However, unlike the traditional path to EMU *via* ERM2 and satisfaction of the Maastricht inflation criterion, it does *not* set an entrance exam which is harder than the rigours of membership subsequent upon it [Rostowski 2000].

Thus EU opposition to UE is largely the wrong answer to the wrong question. UE is not an *easier* way of getting into EMU, as the Commission seems to think. Rather, it is a *better* way of dealing with the macroeconomic problems of the “pre-admission” period in the case of some TACs. Better from the point of view of the TAC [Bratkowski and Rostowski, 2000], and better we believe from the point of view of today’s Member States, because it allows a better solution to the “stability culture problem”. Not only are applicants subjected to the rigors of living with the euro without participating in EMU decision making, but the criteria for their admission to EMU can be made *more suitable* than they are at present for the purpose of resolving the “stability culture problem” (see next Section).

#### 5. The design of the Maastricht Criteria and the “stability culture problem”.

If it were not for the positive feedback from expectations, the long-run interest rate criterion would be sufficient on its own as a test of nominal convergence. Expectations of higher than average inflation, devaluation or of significantly higher public debt would all translate into nominal interest rates which would fail to satisfy this criterion. However, if investors expect a country to join EMU, then this will lead to its long-term interest rates converging on those of the Union plus a mark-up for expected depreciation in the period before admission.

If the market exchange rate is close to the equilibrium rate then, for a normal country unaffected by the Harrod-Balassa-Samuelson effect(see below) it is the case that:

$$i = i^* + \pi^e + z = i^* + \rho^e + z \quad (1)$$

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<sup>13</sup> Another reason the achievement of nominal convergence, which as we discuss below in Section 5, was very important when the EMU was being established, but is less so for the admission of new members to an existing EMU. The EU usually assumes that the achievement of nominal convergence is sufficient evidence of commitment to price stability for the indefinite future. Of course, this is not in fact the case.

where:  $i$  is the interest rate on government debt,  $i^*$  is the average interest rate on government debt in the EMU,  $\pi^e$  is the expected inflation differential for the country concerned *vis-à-vis* the EMU,  $z$  is a country specific risk premium on government debt and  $\rho^e$  is the expected rate of depreciation relative to the euro.

However, expectations of accession bring forward the date at which  $\rho^e = 0$ , and therefore result in  $i$  converging on  $(i^* + z)$ . This positive feedback mechanism means that, if the only admission criterion were the long-term interest rate criterion, multiple equilibria might exist, unless the decision on admission to EMU was anchored in some other criterion.<sup>14</sup> The presence of multiple equilibria means that the mere announcement by both sides that a country will join EMU at a given exchange rate at a given date, should be enough to determine long-term interest rates. This is why the EMU side refuses to commit itself to applicants' exchange rates.

The needed anchor is provided by the two criteria which are directed more at short-term conditions: the inflation and exchange rate criteria. Differential inflation will move in the same direction as the international value of the national currency *vis-à-vis* the euro, so in principle either the exchange rate criterion or the inflation criterion should be adequate to provide the needed anchor. The inclusion of both in the Maastricht Treaty probably originally resulted from German anxiety that each indicator on its own could be distorted. Thus, inflation can be affected in the short term by price controls, while the exchange rate can be sustained by forex intervention. The latter would reduce national currency  $M$  if it were unsterilized, as it would need to be to succeed. This would raise short-term interest rates, but long-term rates would rise only slightly as long as admission to EMU continued to be expected. Rigging both criteria, however, was assumed to be harder than rigging just one.<sup>15</sup>

The debt criterion, on the other hand, is directed at “ $z$ ” in eq.(1), the country specific public debt premium. The fear is that if countries with very high public debt join EMU, they may exert pressure for the ECB to pursue an inflationary policy, so as to reduce their public debt/GDP ratio. Such a policy is particularly attractive if debt is held in long-maturity instruments, so that higher interest payments on rolled-over debt are not large. Like the long-term interest rate criterion, the public debt criterion is, therefore, directed more at future, post-admission, inflation, while the inflation and exchange rate criteria are directed at present inflation. However, there seems to be less possibility for rigging the long-term interest rate criterion. The need for the public debt criterion, as a second criterion relating to future inflation, is therefore less convincing than the need for a second short-term criterion (i.e. inflation as well as the exchange rate). This is particularly so as the debt criterion has so far been interpreted rather liberally. What of the fiscal deficit criterion? On the one hand it helps to support the public debt criterion (see below), on the other hand it has helped to restrict demand in the short term in the founder Member States of EMU, since most started Stage 2 of EMU with deficits well in excess of the reference value of 3% of GDP.

Thus, we have two sets of criteria for EMU admission. The short-term ones (inflation, the exchange rate and to a degree the fiscal deficit), which are supposed to

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<sup>14</sup> Expectations of admission by themselves lead to interest rates converging on EMU rates, which leads to admission. On the other hand, expectations of non-admission can lead to interest rates remaining different from EMU rates (in the absence of policy measures to bring about their convergence), which leads to non-admission.

<sup>15</sup> The fact that exchange rates are more volatile than prices led to the abandonment of the 2.5% ERM band for a 15% band in 1993 – another important example of the malleability of the convergence criteria in the face of economic reality.

demonstrate a country's commitment to low inflation *before* it is admitted to EMU, and two long-term criteria. The long-term interest rate criterion demonstrates the markets' belief that a country will join EMU and that its fiscal position will remain sustainable in a low inflation environment *after* admission, while the public debt criterion is supposed to exclude governments which are likely to be tempted by the inflationary option also *after* admission.

As has been discussed elsewhere [Rostowski, 2000], the Harrod-Balassa-Samuelson (H-B-S) effect means that countries with fast growing labour productivity in the tradeable goods sector face higher inflation in their non-tradeable sector than their trade partners. As a result, even if they have a fully fixed exchange rate, a currency board or indeed a common currency with their trade partners, they will experience higher overall inflation. Since this is more a rise in the *relative price* of non-tradeables, rather than a general increase in the price level, such an inflation differential due to the H-B-S effect has no implications for the competitiveness of the country's tradeable goods sector. It therefore has no implications for the international value of the single currency. Moreover, since such a differential affects only non-tradeables it cannot be exported to other countries within a common currency area. For these reasons there is no reason why it should be resisted by policy makers, either in the country in question or in the wider currency area. *Inflation of this kind should not be thought of as evidence of the absence of nominal convergence, and this is why we believe that the Maastricht inflation criterion should be altered for the TACs.*

Therefore, our suggestion is that the inflation criterion alone should be altered, by allowing the European Council to ignore the inflation criterion in the case of a Member State which has adopted UE, if the Council is convinced that any inflation differential in that State relative to the (three best performing members of) EMU is a result of movements in non-tradeable goods prices alone.<sup>16</sup> This would allow fast growing TACs to accede to EMU without having to engineer a nominal appreciation that would unnecessarily reduce (temporarily) the competitiveness of their tradeable goods sector.<sup>17</sup> We see little disadvantage in this to existing the Member States of EMU. In fact UE makes it harder for a country to join EMU with temporarily suppressed non-H-B-S inflationary pressures because of the unavailability of nominal appreciation, which is present under ERM2. Thus, Ireland has failed to satisfy the inflation criterion since the creation of the euro.<sup>18</sup> As described in the previous Section, we see the main legitimate purpose of the inflation criterion being that it demonstrates a country's commitment to low inflation *before* it is admitted to the EMU. However, UE provides the same demonstration because, at the time it adopts the euro unilaterally a country does not know *when* it will be admitted to EMU, and thus when it will begin to participate in ECB decisions.

Furthermore, the deficit criterion - which we think should not on any account be liberalised - will have a much greater effect on the public debt/GDP ratio in fast growing TACs than it did in the slow growing founder members of EMU. The reference value for the fiscal deficit of 3% of GDP is consistent with the reference value of 60% for the public debt/GDP criterion, when countries' nominal GDP grows at 5% per annum. This has been the case for the EMU's founder members, both in the

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<sup>16</sup> In principle such an adjustment in the Maastricht criteria is possible without the country unilaterally euroizing. However, in such a case, it would be harder for the Council to be sure that the inflation differential was due only to H-B-S inflation.

<sup>17</sup> "Temporarily" because the countries are fast growing.

<sup>18</sup> Since then, Irish inflation has been well above the reference value. So much for the *sustained* nominal convergence, which the Commission in its Note says the criteria ensure!

early nineties when the criteria were established (real growth was typically about 2% p.a. and inflation about 3% p.a.), and in the late nineties when real growth was somewhat higher and inflation lower. If the maximum permitted public debt is:

$$D/(PY) = 0.6$$

Where D is the public debt expressed in nominal terms, P is the GDP deflator and Y is the real level of GDP, and it is the case that:

$$\Delta(PY)/PY = \Delta Y/Y + \Delta P/P = 0.02 + 0.03 = 0.03 + 0.02 = 0.05$$

Then the maximum permitted fiscal deficit ( $\Delta D$ ) must be the one that satisfies the constraint:

$$\Delta D/(PY) = [\Delta(PY)/(PY)] * D/(PY) = 0.05 * 0.6 = 0.03$$

This is because the increase in public debt (the fiscal deficit) at which public debt is constant, is the one that ensures that the increase in nominal public debt and in nominal GDP are the same. We see this if we divide both sides of the expression above by  $\Delta(PY)/(PY)$  and get:

$$[\Delta D/(PY)]/[\Delta(PY)/(PY)] = D/(PY) = \Delta D/\Delta(PY)$$

The stylised facts for the founder members of EMU give:

$$\Delta D/\Delta(PY) = 0.03/0.05 = 0.6$$

Which means that if the deficit criterion is adhered to over a longer period of time, but the public debt/GDP ratio is higher than 0.6, then the public debt ratio will decline until it reaches 0.6, because the marginal public debt/GDP ratio  $\Delta D/\Delta(PY)$ , which is limited to 0.6, will be lower than the average ratio.

For TACs which can expect nominal GDP growth of maybe 10% per annum (5% real GDP growth and 5% inflation, mostly due to the H-B-S effect), the fiscal deficit criterion gives  $\Delta D/\Delta(PY) = 0.03/0.10 = 0.3$ . This is far lower than the public debt criterion, and if the fiscal deficit criterion were sustained under such circumstances it would mean that the public debt/GDP ratio would converge on about 0.3.<sup>19</sup> This is in fact roughly the level in Poland. The Czech ratio is still lower, while the Hungarian one is significantly higher.

However, because we accept the importance of countries demonstrating their commitment to low inflation before they are admitted to EMU, we are prepared to go further. Unilaterally euroizing countries could be required to submit to the fiscal provisions of the Stability and Growth Pact before they join EMU. These require fiscal accounts to be balanced over the business cycle, which in the presence of nominal GDP growth, implies net public debts approaching zero in the long run. For most fast growing TACs it would imply sharp reductions in net debt. Thus Poland, which has a gross public debt/GDP ratio of about 35%, would find this reduced to 13.5% within 10 years. On the other hand Germany, with gross debt of about 60% of

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<sup>19</sup> We are grateful for the above point to Stanislaw Gomulka.

GDP and lower nominal growth, will still have a gross debt/GDP ratio of 37% in ten years.<sup>20</sup>

## 6. Conclusions.

European Union opposition to unilateral euroization mainly stems from an intellectual confusion between UE and admission to EMU. Underlying this confusion is justified concern about admitting countries to EMU before they have developed a “stability culture” to a sufficient degree. The EU reasoning seems to be that since the traditional route to EMU membership *via* the ERM and the present convergence criteria was designed as a test for the presence of a “stability culture”, it follows that any proposals for a change in this route must be designed to circumvent this test. We believe that UE provides a *better* test of a country’s commitment to price stability than the traditional route does, partly because it makes it harder for a country to temporarily repress inflation through nominal appreciation. So much is this the case, that we believe that it would be safe to soften the Maastricht inflation criterion for countries adopting UE, particularly if they satisfied a hardened fiscal deficit criterion. Of course, UE not only has the advantage to the EU of being a better test of a country’s commitment to price stability, it is also less costly and less risky for the TACs [Rostowski 2000].

Ensuring nominal convergence before admission to EMU was also a purpose of the traditional route. UE does not make it harder to ensure nominal convergence before a country is admitted to EMU, since the (possibly adjusted) Maastricht criteria would - and should - remain in force as conditions of EMU admission. Nevertheless, it is worth noting that given the small size of the TACs’ economies, nominal convergence by new applicants is far less important to the members of EMU today than it was to the founding members when the 3<sup>rd</sup> Stage of EMU was established. Nor does the possibility of a significant up-front devaluation at the moment of conversion, constitute a valid reason for rejection of UE. Although the unilaterally euroizing country does have such a possibility, and should probably use it (in moderation) so as to build up a “cushion” of competitiveness, this will temporarily increase inflation in the country concerned, something which the EU has every right to consider in deciding the date of a country’s admission to EMU. Possible ECB concerns about information regarding the size of the euro broad money stock can - and should - be met (by the unilaterally euroizing country undertaking to keep the ECB informed of the size of euro deposits in its banking system).

Furthermore, as we have seen, the Commission’s fears that UE would mean that there would be inequality of treatment between present and future and between future members of EMU is groundless, as the Maastricht criteria would still have to be satisfied. So is the fear of some in the Bundesbank that UE would involve an additional implicit lender of last resort commitment by the ECB to banks in the unilaterally euroizing country. Also, as we discuss in Appendix II, UE does not necessarily fit better with a “functionalist” rather than a “union building” approach to European integration. Furthermore, fears that the euro might lose some of any supposed “hard currency premium” it benefits from at present (discussed in Appendix II) are also misplaced. First, unilaterally euroizing countries would have to buy euro

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<sup>20</sup> On the assumption of a constant gross/net public debt ratio.

with their international reserves, which would increase the international value of the euro, and second, the TAC economies are very small compared to the EMU economy.

Finally, although it is true that UE allows countries to benefit from the existence of a single European currency without having participated in its creation, they do not do as free riders, since they have to pay for the notes they use (i.e. they pay seignorage to EMU members). Indeed, proposals for UE coming from TACs show that the EU's ambition that the euro should become a global currency can be realised. However, the EU's opposition to UE, which is in fact an attempt to limit the convertibility of the euro, suggests that the foreign exchange markets may not be wrong in their suspicion that the EU may not yet have fully matured to the role of supplier of a global currency.

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## APPENDIX I

### **The Legal Aspects of Unilateral Euroization.**

In the European Commission's Note [August 2000], it is claimed that the sequencing of steps to the adoption of the euro is set out in the Treaty of Amsterdam, that this sequencing is therefore part of the *acquis communautaire*, and that it must therefore

be accepted by EU applicant countries as it stands. What is more, since unilateral euroization (UE) does not conform to this sequencing UE cannot be adopted by applicant countries. If this were indeed the case, then we would favour the adoption of currency boards (CBs) by those countries for which we have recommended UE. Currency boards are now accepted by the EU as a suitable path to EMU. The same arguments advanced for UE hold for a CB, only the benefits are slightly smaller in the case of a CB. Interest rates will be slightly higher under a CB than under UE, and speculation is more likely against a CB since it is easier to abandon. However, speculation against a CB has as yet not succeeded anywhere, and with a CB less seignorage is foregone than with UE.

Nevertheless, it is our view that the Amsterdam Treaty does *not* set out a sequence of steps which have to be undertaken before a country adopts the euro, and that therefore such a sequence is *not* part of the *acquis*. Applicants will be admitted to the EU as Member States with a derogation from stage 3 of the EMU. This derogation is defined (art. 122(3) of the Treaty) as the country not being subject to articles 104(9) and (11), 105(1), (2), (3) and (5), 106, 110, and 112(2)b of the Treaty, as well as Chapter IX of the Statute of the ESCB. These articles relate to a country's membership of the ECB, the ESCB, its liability to sanctions should it break the fiscal deficit requirements of the Treaty<sup>21</sup>, its right to vote in the European Council on exchange regime agreements between EMU and non-Community countries and on the EMU's exchange rate policy, as well as being subject to the *requirement* that *only* euro notes be legal tender on its territory.

None of these things will happen as a result of UE. The candidate will evidently not accede to EMU institutions, nor will it have the right to vote on EMU exchange rate policy. It will not be subject to sanctions for failure to abide by the fiscal deficit limits of the Treaty, nor will it be *required* to make euro notes the only legal tender on its territory. If it *decides* to make euro notes the only legal tender on its territory, this will be a free choice, not because of the requirement of the Treaty. An applicant which unilaterally euroizes therefore fully meets the Treaty's definition of a Member State with derogation from EMU. Thus UE does *not* fail to conform to the *acquis*.

From our point of view, the biggest problem is presented by art.123(5). This states that if it is decided to abrogate a member State's derogation from EMU (i.e. to admit it to EMU on the basis of it having fulfilled the Maastricht convergence criteria set out in art.121(1)), then the Council shall in agreement with the Member State<sup>22</sup> concerned "adopt the rate at which the euro shall be substituted for the currency of the Member State...". Clearly if a national currency does not exist then "the rate at which the euro shall be substituted" for it cannot be adopted, either by the Council or anyone else! However, it is fairly clear that this paragraph applies only to those countries which actually have a national currency upon entering the EU, and cannot apply to those which do not have such a currency.

One final point needs to be mentioned. Art.123(5) states that at the abrogation of the derogation, apart from adopting the rate at which the euro shall be substituted for the national currency of the Member State concerned, the Council will also "take the other measures necessary for the introduction of the euro as the single currency in the member State concerned." We believe that this does not rule out UE, because UE means adopting the euro as a country's national currency. We only have the

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<sup>21</sup> Previously the "Pact for Stability and Growth", which is now part of the Treaty.

<sup>22</sup> The Council acts with the unanimity of the member States, on a proposal of the Commission and after consulting the ECB.

“introduction of the euro as the *single currency* [our italics] in the Member State concerned” when that State comes to participate in the common institutions which determine the EMU’s monetary and exchange rate policies. This of course will not happen upon UE, but only once the derogation is abrogated.

## APPENDIX II

### *Dilution of the presumed “hard currency premium”.*

We now come to a number of rather more speculative points, which may or may not play a role in EU opposition to UE. The first is the fear that allowing other countries to use the euro can somehow reduce the “hard currency premium” the single currency is believed to benefit from. This may be based upon the suspicion of some in Germany that it joined the EMU at a significantly overvalued conversion rate. Until the creation of the euro, the Deutsche Mark was the anchor currency of the ERM, and a safe haven against higher inflation in other European countries as well as against currency re-alignments [Dornbusch 1991]. This may have resulted in a small flow of additional demand for DM each year. Over time this may have generated an appreciable premium on the DM. Such a possibility is indicated by the fact that German labour productivity is about the same as the French, while labour costs are about 30% higher [Wolf 1999]. When the euro was created, the additional capital flows into Germany ceased and indeed, may have reversed as investors tried to improve returns now that the “safe haven” factor no longer worked in Germany’s favour. Would this effect – assuming that it ever occurred – be repeated as a result of UE? First, one should note that *even if* such an effect occurred upon creation of the EMU, its size would be much smaller upon the admission of the TACs, because of the smallness of the TAC economies compared to that of the EMU, and because TACs, being fast growing countries, attract significant amounts of foreign investment. Second, although it might occur as a result of the admission of TACs to EMU, the effect will *not* occur as a result of UE. This is because on impact UE results in an increase in demand for the euro, since unilaterally euroizing countries have to change most of their IR into euro.

### *Free riding on European integration.*

Those EU Member States that are at the head of the drive for greater integration (Germany, France) may fear that UE is an *easier* path to EMU than the traditional one through the exchange rate mechanism (ERM) of the European Monetary System. The concern here would be that, if late joiners benefit from joining late in the building of new European institutions, then a free rider problem may arise, so that few will wish to be among the founding members of new forms of co-operation. We do not deny that UE is an easier path for TACs to join EMU. That is why we believe it is better than the ERM – involving smaller costs it improves welfare. We do not, however, think that it will create a serious free rider problem in the future in other areas of integration. This is because money is special: on the one hand its use involves large positive network externalities, on the other hand one stable money is much like another. This means that there are large benefits from joining an existing monetary union, and relatively small costs in not having been in at the beginning, when the institutional details were agreed among the founder members. The only exceptions to this are the rules for the division of seignorage and for voting in the ECB and Ecofin

X. Yet in EMU these are already generous to small and poor countries.<sup>23</sup> Moreover, as we discussed, it was vital for the founder members to achieve a high degree of nominal convergence, as the larger ones were of roughly equal size, and a high degree of nominal divergence meant a real risk of the union splitting up. This is no longer true of potential new members. Even the UK accounts for only 16% of the GDP of a now nominally largely uniform EMU, while Poland accounts for 2%. However, these special factors are unlikely to be present in any other field of European integration. All of these - technical standards, financial regulation, transport and telecoms networks, environmental protection, tax harmonisation, even defence and foreign policy co-operation - involve huge benefits to members of the “initiating group” who write the new rules which late comers have to accept because of the principle of the sanctity of the “*acquis communautaire*”. Late comers do benefit in the process of creating a single currency, but this is by its very nature the only case in which they do, so no general free rider problem, which would inhibit further integration, is unleashed by allowing them to do so.

*Union-building vs. functionalism.*

Our second point also relates to the future of the integration process in Europe. Among the many approaches to the process of European integration, two concern us here. On the one hand there is the “union building” or “incremental political” approach, particularly favoured by France, in which each step in integration becomes the basis for the next. Indeed, it is often argued that previous steps make the next one essential, because without it they cannot be made to operate effectively - the so-called “ratchet effect”.<sup>24</sup> On the other hand is the “functionalist” approach, which identifies areas in which common European institutions can increase the freedom and welfare of European citizens, and proceeds to establish them, without necessarily assuming “forward links” to further stages of integration. The functionalist approach fits well with the creation of de-politicised institutions such as the ECB, or an independent anti-monopoly office, such as has recently been proposed. Since such institutions are apolitical, they are by definition isolated from the influence of other, political, European institutions. They are therefore not necessarily useful in pushing forward the “union building” agenda. Although such institutions may open up new opportunities for functional integration, they may also reduce the need for political integration. Germany, with its tradition of *ordnungsliberalismus* (liberalism through constitution building) has some natural affinity for this approach.<sup>25</sup> The tussles over an “economic government” for the EMU (between France and Germany) and over tax harmonisation (between France and the UK) are expressions of this tension between the two approaches. UE appears at first sight to fit better into the “functionalist” approach. The euro is seen merely as stable money, which anyone should be able to use, rather than as reward received by countries which “participate fully in the institutions defining...the co-ordination of the economic policies of its [the EMU’s] members” [European Commission August, 2000]. On the other hand, UE allows the

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<sup>23</sup> Seignorage is divided according to a formula in which a country’s share in the EMU’s GDP and its population are given equal weight, which is generous to poor countries. Each Member State gets one vote on the ECB council irrespective of size.

<sup>24</sup> The conclusion is not often drawn that this “need for the next step” should, maybe, have been made clear before the previous steps were taken.

<sup>25</sup> Although Germany is the most federalist large Member State, because of its fear of trying to use national power. This is a fear of both the domestic and the foreign reactions such an attempt might evoke.

single market to be completed with a single currency, without giving a large number of small and poor countries a vote in the ECB or in Ecofin X, before they have demonstrated their commitment to price stability, so it is also consistent with the “union-building” approach.

Finally, we suspect that there may also be a political dimension to Herr Reckers’ proposal to require “real convergence” of TACs before they are admitted to EMU, and its extension in private discussion to UE by some EU officials. German voters were assured that the euro would be “as strong as the Deutsche Mark”. The international strength of DM has been a point of pride among Germans. It has been seen as a reward for hard work, thrift and economic virtue, and is associated in their minds with their high real income levels. Admitting poor countries in the East to use of the euro, while Denmark and Sweden hold aloof, may be thought *by voters* to be likely to diminish its value. This is particularly so as, in the continued absence of euro notes, all that voters see of the euro is its current slide on the international exchanges! Our belief is that this problem will dissipate once euro notes are in circulation, and voters see that from year to year these buy much the same goods.

#### *Risks to candidate countries.*

A number of other arguments have been put forward by EU sources, advancing the supposed economic risks to a unilaterally euroizing TAC as the main objections. The first of these points out that it might be a mistake for a country with a high level of trade protection and considerable restrictions on capital movements to euroize unilaterally. This is because it will have to abolish such restrictions upon joining the EU, and its equilibrium exchange rate might then prove to be well below the rate at which it converted its national currency to euro. It could then face the prospect of prolonged recession, without the option of devaluation. This argument does not apply to the more advanced central European and Baltic applicants, which already have low levels of protection *vis-à-vis* the EU, high levels of capital mobility, and in most cases rapid rates of productivity growth. Rapid productivity growth means that even an initial over-valuation will be quite rapidly compensated if it is modest, whereas we propose that countries should euroize at a rate that is initially slightly under-valued. Nevertheless, it seems reasonable that the more closed the economy contemplating UE, the larger the initial under-valuation it needs as a margin of safety, and the harder it is to estimate how large such a margin needs to be. Such considerations may be relevant to some of the Balkan TACs or pre-TACs (Bosnia, Kosovo, Montenegro), although there is also evidence that currency board economies display faster growth, lower inflation and lower interest rates than ordinary fixed pegs, and that the “harder” the type of CB arrangement, the better the performance [Atanassova 1999]. In any event, we do not argue that UE is the best path to EMU for all TACs, only that is for some.

It has also been claimed that UE will cause a very undesirable business cycle in advanced TACs. All the benefits that we claim flow from UE are admitted: elimination of exchange rate risk, elimination of the “expectations based” element of inflation and reduction in transactions costs in trade with the EMU. These things lead to a large increase in capital inflows, which drives a sharp reduction in nominal interest rates and an improvement in the fiscal position (another of the benefits of UE). The reduction in interest rates and the increase in capital inflows cause an investment (and consumption) boom, which it is claimed will at some time bust. This bust may be less serious thanks to the absence of a national currency, so that geographical proximity alone will cause spill-over effects between firms within the

country (they will no longer be subject to a common currency risk). However, it may still be significant. Furthermore, since much of the capital inflow will be channelled through the banking system, this creates a risk of reckless lending, and the basis for a mountain of bad bank debts being laid. We have pointed out this latter risk ourselves [Rostowski, Financial Times, 9 August 1999].

On the narrower question of banking system solvency, our answer is threefold. First, present very high domestic interest rates, which are needed to constrain demand in rapidly growing TACs, are already causing bad debts to grow.<sup>26</sup> Second, firms and banks are already borrowing abroad on a large scale so as to avoid high domestic interest rates.<sup>27</sup> The difference is that at present they are also exposed to currency risk. Third, a “capital surge” of this kind is in any case likely when the TAC concerned joins the EMU, and it needs to prepare its banking supervisory authority to cope. UE merely brings this need forward by a few years. However, we do not deny that adequate banking supervision capability should be a pre-requisite to UE as far as the TAC involved is concerned.

The wider business cycle question is harder to pronounce on, as our knowledge of the evolution and timing of cycles is so poor. Following the traditional path to EMU via ERM2, a fast growing TAC would be subject to two offsetting forces on aggregate demand. On the one hand the need to reduce inflation to the Maastricht reference value in spite of the H-B-S effect implies nominal appreciation, which will reduce demand for the country’s tradeables. On the other hand the convergence of interest rates on EMU levels should increase overall demand. In Italy the overall effect of preparation for EMU entry was to reduce the rate of growth of GDP, whereas in Ireland, Portugal and Spain growth increased.<sup>28</sup> After EMU accession the effects of low interest rates will continue, while those of nominal appreciation will no longer operate. One may therefore expect a recovery (acceleration) of growth after accession, leading to a bust several years down the line.<sup>29</sup> In the case of UE the initial pre-accession growth should be faster, because there is no offsetting depressive effect from nominal appreciation, but on the other hand there will be no post-accession (to EMU) acceleration. The boom would be brought forward and so would the bust, so that it might occur sooner after EMU accession than otherwise (or even possibly before EMU accession if the period between UE and EMU accession were sufficiently long). Even if we had any real confidence in the above reasoning, it is very unclear what conclusions to draw from it. Is an earlier boom and bust worse (or better) than a later one, either for the TAC concerned or for Member States which are already in EMU?

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<sup>26</sup> In Poland the share of bad loans in corporate liabilities to Polish banks increased from 11% at the end of 1998 to 15% in the summer of 2000.

<sup>27</sup> Thus, in Poland in the second quarter of 2000, private sector debt (bank and corporate) increased by 20% compared to the second quarter of the year before. The *increase* was equivalent to about 4% of GDP.

<sup>28</sup> Fiscal tightening to meet the Maastricht criterion played a role in Italy.

<sup>29</sup> We assume that, as with Ireland, Spain and Portugal, the ECB should not take the circumstances of small central and east European economies (CEEs) much into account when setting interest rates, even once they are members of EMU.