2004, a point of departure, more than arrival, with important choices and outright challenges. Entrance in the EU renews the debate on the trade-off between policies for a real convergence and policies for a nominal convergence. But, the two paths do not necessarily buck the trend and today all of the countries are in agreement on accelerating their entry in the EMU, with the single constraint of fiscal stabilisation. Instead, the debate remains open on the best exchange policy in the years immediately prior to the adoption of the Euro.

The convergence path? Thorny but passable

EUROPE UNDER CONSTRUCTION

by Carmelina Carluzzo and Debora Revoltella

In early May, after more than a decade of preparation, the first group of countries gained access to the Union, beginning to benefit fully from the single integrated market and participation in all community policies and decision-making processes. Then, in December, the European Council rewarded the efforts of the remaining candidates, confirming January 2007 as the date of access to the Union for Bulgaria and Romania and fixing 17 March and 3 October 2005, respectively, as target dates for the initiation of negotiations with Croatia and Turkey.

1. MAASTRICH PARAMETERS ON FISCAL SUSTAINABILITY, INFLATION AND RATES (2004A)

	Average Inflation	Interest Rates (Dec)	Debt/GDP	Deficit/GDP
Maastricht	**1.1** (+1.5)	**3.6** (+2.0)	**60**	**3.0**
Poland	**3.5**	**6.5**	48.7	**5.9**
Hungary	**6.8**	**7.6**	59.9	**5.3**
Czech Republic	**2.8**	4.6	40.0	**5.2**
Slovenia	**3.7**	4.3	28.3	1.7
Slovakia	**7.6**	4.9	43.7	**3.8**
Lithuania	1.0	4.5	22.8	2.8
Latvia	**6.1**	4.6	16.0	2.2
Estonia	**2.9**	4.15 Oct	5.4	-0.7
Bulgaria	**6.2**	5.4 10Y BGN	42.0	-0.3
Romania	**11.9**	**17.4** reference rate	21.5	1.7
Croatia	2.1	**6.7** 1W	44.9	**4.7**
Turkey	**11.1** WPI	**20.3** Tbill	**68.7**	**10.4**

Note: numbers in **bold** indicate non-satisfaction of the Maastricht criteria
Source: Eurostat, BCE, UniCredit – New Europe Research Network

Having attained (or at least being close to) membership of the EU, attention is now shifting to the process of convergence with the Monetary Union.
So, the debate on the trade-off between policies for real convergence and policies for nominal convergence has been renewed. On the one hand, lies the objective of adapting the population's standards of living, often measured in terms of GDP pro capita on par with acquisition power, which is the final goal of the regional integration process, destined to be achieved in the space of a few decades. On the other, lies the process of convergence with the Maastricht parameters, which requires policies, which are often restrictive, for the stabilisation of the macroeconomic situation, that can, in the short term, cause a slowdown in economic growth, although guaranteeing undoubted returns in the mid-long term. But, the two paths do not necessarily buck the trend.

The path toward the EMU

Table 1 shows the state of advancement of each country in terms of nominal convergence toward the European Monetary Union, presenting the level of fulfilment of the Maastricht criteria at the end of 2004 for the New European countries. We firstly linger on the parameters in terms of fiscal sustainability, inflation and interest rates, and then evaluate the strategies in terms of exchange policies.
For the new EU members, the constraint of

MAASTRICHT CRITERIA

- *Fiscal deficit/GDP not superior to 3%*
- *Public debt/GDP not superior to 60%*
- *Average annual inflation rate no more than 1.5% greater than the average of the three member States with the lowest inflation.*
- *Long term nominal interest rate not superior to 2% of the average of the interest rates of the three most virtuous countries as per price stability.*
- *Participation in the ERM II for at least two years, before joining the EMU: in this time period the exchange rate must not fluctuate more than 15% with respect to the parity set against the Euro*

fiscal sustainability is surely the most urgent, although with profound differences between the countries. The Baltic nations and Slovenia have already shown substantial alignment both in terms of their ratio of debt to GDP, and in terms of deficit to GDP. The situation is more difficult for Poland, Hungary, the Czech Republic and Slovakia. With the single exception of Hungary, which is able to satisfy the debt/GDP criteria marginally, at this time the parameter in terms of indebtedness seems to be basically in line with the target. It is to be noted, however, that in countries characterised by a strong necessity for investment in infrastructure and weak development of their financial markets, levels of indebtedness substantially inferior to those of more mature economies, such as the old EU members, would be desirable. Instead, we observe a trend in the region for growth in the public debt to GDP ratio. The problem of fiscal sustainability is even more evident when taking into consideration the ratio of deficit to GDP. None of the four countries, in fact, has reached the target as yet, despite the stabilisation policies enacted in recent years. The convergence plans indicate possible attainment of the target in 2007 for Slovakia and Poland, and 2008 for the Czech Republic. Despite the fact that all three countries have received notification from the European Council for excessive tax loss, their settlement plans seem credible at this time. The case of Hungary is different, as it now has a tax loss of 5.3% of its GDP and has presented a plan for gradual settlement that it not very credible.

Control of inflation remains a key objective in the monetary policy of many countries, with pressure tied to the process of true economic convergence and to the liberalisation of prices in act, in addition to phenomena pertaining to the economic situation, such as the impact of the oil shock in 2004. The parameters of interest rates in the long term indicate problems in convergence only for Poland and Hungary. Also to be pointed out is a trade-off between the necessity for foreign financing of countries with a greater need for investments in infrastructure and the level of real interest rates.

For the countries that are not yet EU members, nominal convergence, although it is not yet a priority, in any case represents an important target. The fiscal constraint of Bulgaria and Romania does not seem to be significant, while imbalances are recognisable both in terms of inflation and in the cost of money (long term rates). The need for complete macroeconomic stabilisation is also recognisable in terms of current deficit imbalances, although this is not one of the constraints for entry in the EMU. The situation in Croatia, on the other hand, seems to be closer to that of the Central European countries, with an imbalance in the public deficit representing the main obstacle for the EMU. Turkey is even farther from the EMU in terms of convergence in fiscal policy, inflation and rates.

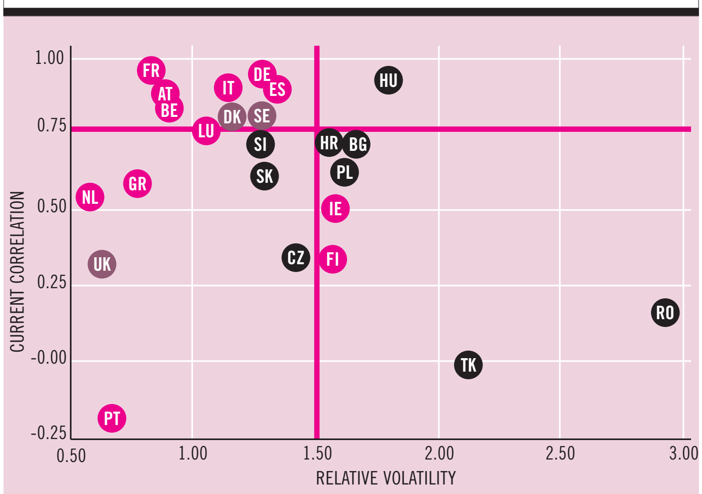
Thus far, we have concentrated on four of the five Maastricht parameters. A final element to take into consideration is linked to the exchange policy to be adopted in view of entry in the EMU, bearing in mind that, according to the Maastricht requirements, before entry the countries must participate for at least two years in the ERM II, without excessive imbalances.

The choice of the best exchange policy during the convergence phase has been at the centre of long debates. The ERM II, in fact, seems not to be a binding enough constraint, which renders the currency of the various countries more susceptible to speculative attacks or, in any case, to imbalances, without conferring the benefits of credible growth and risk reduction. With the Central European Bank having basically excluded the option of

unilateral adoption of the Euro, the choice for the new members is, then, between anticipated entry in the exchange agreement or minimisation of their stay in the scheme (and so, entry exactly two years prior to all the other parameters). The choice of the best strategy also depends on the level of integration and synchronisation of the economic cycle of each country with the economic cycle of the Euro zone. Against a strong integration, in fact, the cost in terms of volatility linked to entry in the ERM II tends to be reduced.
The Baltic countries and Slovenia requested and obtained[1] access to the European exchange system immediately after their entry in the EU. Basically aligned as concerns the other parameters, for these countries the two years in the ERM II represent the greatest time constraint for convergence with the EMU. The other countries, instead, are putting off access to the ERM II, with the objective of minimising their stay, entering only at an advanced stage of the nominal convergence process. The analysis of the economic cycles in different countries and their correlation with the EU cycle help in understanding the rationality of said choices.

1. Latvia is about to obtain it.

1. CORRELATION VS. RELATIVE VOLATILITY OF EACH COUNTRY'S ECONOMIC CYCLE AS COMPARED WITH THE MONETARY UNION CYCLE



EU 15: **FR** France, **DE** Germany, **IT** Italy, **ES** Spain, **AT** Austria, **BE** Belgium, **DK** Denmark, **SE** Sweden, **LU** Luxembourg, **GR** Greece, **NL** Holland, **IE** Ireland, **FI** Finland, **UK** United Kingdom, **PT** Portugal.
New Europe: **HU** Hungary, **HR** Croatia, **SI** Slovenia, **BG** Bulgaria, **PL** Poland, **SK** Slovakia, **CZ** Czech Republic, **RO** Romania, **TK** Turkey.
Source: UniCredit – New Europe Research Network

Economic integration between old and new member countries and exchange policies toward the EMU

Let's take into consideration two measures of the level of economic integration between old EU members and new or future members: the correlation between each country's economic cycle and that of the EMU and the volatility of a country's economic performance. Therefore, according to the Optimal Currency Area theory, more fully integrated countries, having a high correlation of their economic cycle and low volatility in performance, can enjoy the full benefits of monetary integration and minimise the risks of the anti-cyclical effects of policies.
In general (*Graph 1*), the countries of New Europe are on the average less synchronised with the Monetary Union than the old members of the Union and show greater cyclical fluctuations. Upon making distinctions between countries, however, important differences can be observed. Hungary, Poland, Slovakia and Slovenia (with a correlation greater than 0.6) have already reached a certain integration with the European economic cycle. Slovakia and Slovenia, additionally, show relative volatility of the cycle comparable to that of the core EMU members, showing themselves to be better able to contrast the pressures deriving from participation in the EU exchange agreement. Not by chance, Slovenia joined the ERM II immediately after its entry in the EU, while Slovakia is demonstrating a credible convergence plan, aimed at guaranteeing its entry in the ERM II in 2007 and in the EMU in 2009. Instead, Poland and Hungary show increased volatility in their economic cycles, which could result in high costs for prolonged participation in the ERM II. As they must still face the challenge of fiscal convergence, we can expect entry in the exchange agreement only starting from 2007 and 2010, respectively.
The Czech Republic seems to be an exception among the new members. Despite the fact that it has a similar level of development and is geographically and economically close to the Euro zone, the country shows low correlation with the Monetary Union (correlation = 0.35). Nonetheless, this is due to the fact that the Czech Republic suffered a serious economic and banking crisis in 1997-1999, compared to a moderate slowdown in the EMU. As regards the extent of its

fluctuations, the country demonstrates rather contained volatility and can be considered similar to Finland and Ireland. The political decision, expressed more than once, to minimise its stay in the ERM II would seem, therefore, to be economically correct.
Among the future candidates, the results concerning Bulgaria and Croatia are particularly interesting. In fact, the two countries show strong similarities to the dynamic of the Monetary Union, a consequence of the fact that both countries have already coupled their currencies to the Euro (Bulgaria through a Currency Board and Croatia through an informal peg to the Euro). The peg of the exchange rate, established during a period of economic crisis, caused a short-term loss in terms of monetary policy freedom, but favoured the quick realignment of economic growth. Both countries show a relative volatility in line with a few countries peripheral to the EMU. We expect, therefore, that immediately after entry in the EU, the two countries will follow the examples of Estonia and Slovenia, respectively. Bulgaria will continue to maintain the stability of its exchange rate through the Currency Board, annulling, in the ERM II regime, its fluctuation band around the central rate. Croatia, by means of a managed float system aimed at maintaining the fundamental stability of the exchange rate, allowing for seasonal fluctuations, will tend to stay close to the central rate.
Romania and Turkey show notable asymmetry as compared to the Euro zone, as they have been influenced in recent years by considerable idiosyncratic shocks. In particular, Romania was affected by the Russian crisis in 1998/1999, while Turkey was influenced by financial crises in both 1998/1999 and 2000/2001. In both countries, the stabilisation process continues and their cyclical fluctuations are affected by this and show a high level of volatility (more than twice that of the EMU). We do not believe that either Romania or Turkey could take advantage of a possible Currency Board, as Bulgaria and Croatia did previously. With the convergence process going ahead smoothly and without greater threats on the horizon, they would gain no advantage from the loss of a short term stabiliser (the exchange rate). It is reasonable to expect, instead, that their process of convergence with western European standards will proceed according to the positive trend already begun.

EU, ERM, EMU: the next steps

Table 2 presents our estimations of the convergence of the various countries to the EMU.
A first group of countries, which includes the Baltic countries and Slovenia, already EU members and in the ERM II, could have access to the EMU by 2007.
Poland, the Czech Republic, Slovakia and Hungary are still engaged in the process of convergence and fiscal realignment. Of these, the best performance is shown by Slovakia, which could realign itself with the standards as early as 2006/2007, for an entry in 2009 (with entry in the ERM in 2007). A similar path, although set back a year or two, is expected for Poland and the Czech Republic, while there are still uncertainties about Hungary, linked to the scarce credibility of the fiscal stabilisation plans it has presented so far.
Of the countries proposed, we can hypothesise a nominal accelerated convergence for Bulgaria and Croatia, which could even surpass the timeframes of countries that are already members. The macroeconomic stabilisation plans carried out in recent years in Romania and Turkey have led to important results. However, full nominal convergence is still far off.

2. THE CONVERGENCE DATES

	EU Entry	ERM II Entry	EMU Entry
Poland	may 2004	2007	2009/2010
Hungary	may 2004	2010	2012
Czech Rep.	may 2004	2008	2010
Slovakia	may 2004	2007	2009
Estonia	may 2004	june 2004	2007
Latvia	may 2004	2005 (expected)	2007
Lithuania	may 2004	june 2004	2007
Slovenia	may 2004	june 2004	2007
Bulgaria	january 2007	2007	2009/2010
Romania	january 2007		
Croatia	negotiations starting march 2005, entry in 2009	2009	2011/2012
Turkey	negotiations starting october 2005, entry around 2015		

Source: UniCredit – New Europe Research Network