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The Monetary Union and Brussels' strabismus

The connection between the marked increase in the public deficit and the postponement of entry in the Monetary Union is very close. The governments of the largest countries, from Hungary to Poland, from the Czech Republic to Slovakia, have, thus far, enjoyed surprising tolerance from the EU. Which has shown itself to be much more rigid, instead, on the issue of the Stability Pact.

After entry into the EU, the new member countries are involved in a sort of obstacle race to join the Monetary Union. As opposed to the older members, like Denmark and the United Kingdom, the new EU member countries (NMC) cannot remain indefinitely outside of the Euro zone. Even though there is not a pre-established entry date, sooner or later the NMCs must enter the European Monetary Union. On a formal-legal level, adoption of the Euro foresees participation in the New Exchange Rate Mechanism (the so-called ERM II) for a period of two years. At the beginning of this period, the countries must come to agreement with the ECB on a parity for the exchange rate, around which a fluctuation band of 15% is foreseen, both in the direction of increase and decrease. At the end of the two years, the parity can be maintained or re-evaluated. After these two years in "purgatory," adoption of the Euro is dependent on passing four tests, the so-called Maastricht criteria: (1) price stability for a period of one year before entry; stability implies that the inflation rate should not be greater than 1.5% of the average of the three most virtuous countries, i.e. with the lowest inflation rate; (2) exchange rate stability, which implies remaining within the ERM II fluctuation margins for two years without putting excessive pressure on the exchange; (3) compliance with fiscal constraints, with a limit of 3% for the public deficit-GDP ratio and 60% for the public debt-GDP ratio; (4) convergence of long-term interest rates, which can not deviate more than 2% from the average of the three EU countries with the lowest inflation rates. For the companies and banks of Old Europe that are interested in commercial activities or investments in the NMCs, it is particularly important to know when these countries will adopt the Euro. Contrary to the fears expressed by many, including the ECB, about the need to wait for the NMCs to reach a level of economic development and an economic structure similar to that of the older member countries before adopting the Euro, the most serious obstacle seems to be the NMCs fiscal imbalances. The NMCs can be separated into two distinct groups of countries. One contains three countries: Estonia, Lithuania and Slovenia, all of whom opted for immediate entry in the ERM II in June 2004. The other group includes the other countries who have declared their intention to adopt the Euro by 2010. The most significant and, in some ways, worrying fact is that the biggest countries, such as Poland, the Czech Republic, Hungary and Slovakia, have decided to postpone adopting the Euro. This is worrying because this decision coincides with a negative tendency in the public accounts of those countries, especially in Hungary and the Czech Republic. Looking at Table 1, we can note that the state of the public accounts are the main obstacle to adopting the Euro. Inflation and interest rates show a clear tendency toward convergence, with a few exceptions.

THE NEW MEMBER COUNTRIES FOUND THEMSELVES JOINING AN EU IN A PHASE OF CRISIS IN THE STABILITY PACT AND THE GREAT MAJORITY OF THEM HAVE BEEN IMMEDIATELY SUBJECT TO EARLY WARNING PROCEDURES. AN EMBLEMATIC CASE OF THE DIFFERENCE BETWEEN ARBITRARINESS AND FLEXIBILITY, A TERM WHICH HAS BEEN OVERUSED IN THE DEBATE ON THE STABILITY PACT

The connection between the marked increase in the public deficit and the postponement of entry into the Monetary Union is very close. The governments of the largest NMCs have taken full advantage of the weaknesses of the EU's system of fiscal rules, to rally electoral consensus through populist policies. The case of Hungary is the most glaring. What are the weak points and the responsibilities of both the European Commission and the older member countries? The first is not having made it clear to the NMCs that the excessive deficit procedures and, therefore, the public deficit constraints are applied to all EU member countries, not only to those in the Euro zone. It is true that the penalties for countries declared to be in a situation of excessive deficit are different for those who have adopted the Euro. In the specific case of the NMCs, however, the penalties foreseen, such as stopping the transfer of cohesion funds, represent a decidedly higher cost than that faced by a Euro zone member country.

The result has been that, upon entry into the EU, the great majority of NMCs, in particular the largest ones, have been immediately subject to early warning and excessive deficit procedures. This is where the responsibilities of the older member countries and the European Commission itself begin. The NMCs found themselves joining an EU in a phase of separation and crisis in the Stability Pact. The case of the NMCs is emblematic of the difference between arbitrariness and flexibility, a term which has been overused in the debate on the Stability Pact. The procedures followed for Hungary, the Czech Republic, Poland and Slovakia are, in fact, surprising. The Commission's recommendations speak of a reduction of the deficit in a sustainable manner to below 3% starting in 2007 for Poland, the Czech Republic and Slovakia and in 2008 for Hungary. On those dates, the deficit is foreseen as being only marginally under 3%. What is surprising is that before their entry into the EU, the Commission had never advised the candidate countries about the necessity to adjust their public accounts, with a completely benevolent interpretation of the deficits, according to which those deficits should, in large part, reflect the cost of the reforms and large public investment projects for the improvement of infrastructures. In the case of Hungary, its report of 22 December 2004, the Commission had to emphasise that the Hungarian government is not respecting the course for reduction of its deficit. The report, however, mentions that Hungary is not subject to pecuniary penalties since it has not adopted the Euro. There is no mention of the fact that the EU Treaties foresee the possibility to suspend the transfer of cohesion funds to a country declared to be in a state of excessive deficit. These decisions by the European Commission are characterised by a worrying dose of arbitrariness and a lack of transparency.

In general, the point of view that the high deficits of the NMCs are due to their special needs for public investment and financing of structural reforms does not come from a careful analysis of the public accounts in those countries, but from a political decision to tolerate their public deficits. An in-depth analysis is not possible within the limits of this essay. It is, however, useful to make a comparison between two NMCs, Estonia and Hungary. It should be noted that Estonia is a much poorer country than Hungary. Moreover, Estonia was part of the ex-Soviet Union and, therefore, had to dismantle institutions that were much more

CONVERGENCE TOWARD THE MAASTRICHT CRITERIA *

	Price stability	Public accounts	Exchange rate**	Interest rate
Czech Republic	yes	no	no	yes
Estonia	yes	yes	no	yes
Cyprus	yes	no	no	yes
Latvia	no	yes	no	yes
Lithuania	yes	yes	no	yes
Hungary	no	no	no	no
Malta	no	no	no	yes
Poland	no	no	no	no
Slovenia	no	yes	no	yes
Slovakia	no	no	no	yes

* Indicates that the indicators are in line with the Maastricht criteria

** The criteria of exchange rate stability is not applicable since two years have not passed since the entry of any of the NMCs into the ERM II

_The penalties for situations of excessive deficit, in the case of NMCs represent a decidedly higher cost than that faced by a member country (above, the European Economy Ministers) rigid than the Hungarian ones, which had undergone partial reforms as far back as the 1970s. In the period 2002-2004, Estonia had a surplus in the public budget equal on average to 1.7% of the GDP, while Hungary showed a deficit equal on average to 6.3% of the GDP. During the same period, public investments were equal to 4.1% in Hungary and to 4.7% in Estonia and, therefore, have nothing to do with the clearly worse performance of Hungary as compared to Estonia. The difference is that in Estonia the government behaved more responsibly. This responsibility was also imposed by the macroeconomic obligations linked to the choice of opting for a currency board, which eliminated the possibility of financing the public deficit through monetary emission.

THE FRAMEWORK THAT MANY NEW MEMBER COUNTRIES ARE EXPERIENCING CAN BE DEFINED AS THE NEW EUROPEAN UNION PATERNALISM. WHICH AT TIMES DISPLAYS TOLERANCE FOR FISCAL POLICIES THAT ARE IRRESPONSIBLE AND NEGATIVE FOR THE GROWTH OF THE NEW MEMBERS AND THEIR CONVERGENCE WITH THE OTHER EU COUNTRIES.

The result, beyond the rhetoric, is that a prudent fiscal policy has allowed Estonia to find space for resources to invest in the improvement of infrastructures and in social expenditures. Foreign investors have rewarded this strategy. Foreign investments represent Estonia's main engine for growth; macroeconomic stability ensured by a prudent and credible fiscal policy allows foreign and national investors to take a long-range view of their choices. The contrast with Hungary is jarring. The marked increase of the public deficit has led to an increase in the "country risk." With a national currency, the florin, that can oscillate in a band analogous to the one foreseen by the ERM II, there have been immediate pressures on the exchange rate. The response of the Central Bank has been to raise interest rates, which have reached 12% in the last year, that is more than 6% in real terms. The repercussions on investments and consumption have inevitably been very severe. Where, then, is the flexibility allowed by a "soft" interpretation of the EU's fiscal obligations, combined with an exchange rate which is also rather flexible?

The context that many NMCs are experiencing can be defined as a "new paternalism." We have passed from that which Kornai defined the paternalism of the planned regime, with the planner accommodating companies' insatiable drive for investment, to an EU paternalism, with its tolerance, justified by the rhetoric of the development of underdeveloped countries, of fiscal policies that are irresponsible and, above all, negative for the growth of the NMCs and their convergence with the other EU countries.

The debate on the reform of the Stability Pact should take into consideration the extremely negative effects loose fiscal obligations would have on the growth of the NMCs. The correction of a few evident defects in the Stability Pact should not lead to the disintegration of fiscal discipline and, above all, should not ratify arbitrariness in the application of the rules. This arbitrariness, disguised as the need for flexibility and support for development, would completely destroy the credibility of the fiscal rules and would undermine the very credibility of the European Commission as an institution which should guarantee the execution of the European Treaties.