Possible Entry into the Euro Zone of New Member States in January 2007

Anne Sibert[1]

I. *Summary*

Estonia, Lithuania and Slovenia joined the ERM in June 2004 and hope to become members of the Euro area by 1 January 2007. Each of them satisfies four of the five Maasctricht criteria for full membership in EMU: the two fiscal criteria, the exchange rate criterion and the interest rate criterion. Unfortunately, while Slovenia is likely to satisfy the fifth criterion, the inflation criterion, Estonia is unlikely to satisfy it in either 2006 or 2007 and it is uncertain whether Lithuania will be able to comply by 2007. In this note I detail the progress each of these countries has made toward satisfying the Maastrict criteria and their performance in this regard relative to the Euro area as a whole. In addition to considering the likelihood of these countries satisfying the Maastricht criteria in the short run, I assess their longer-run prospects for economic convergence.

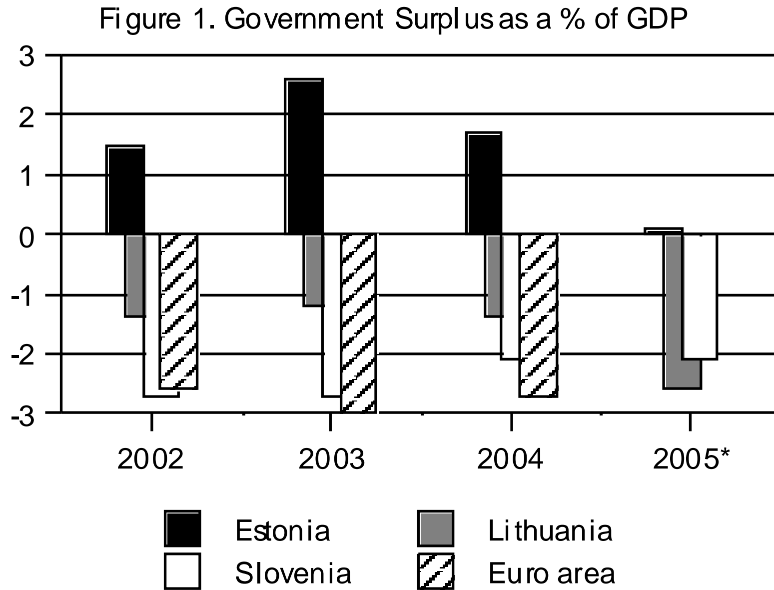
II. *What are the prospects for Estonia, Lithuania and Slovenia to satisfy the convergence criteria?*

Estonia, Lithuania and Slovenia aspire to adopt the Euro on 1 January 2007. Slovenia is likely to be successful in meeting the Maastricht criteria; Estonia is unlikely to be and it is uncertain whether or not Lithuania will comply.

The Maastricht Treaty requires that potential Euro area members have a sustainable fiscal position. This is measured by a pair of criteria: countries are to have a general-government-deficit-to-GDP ratio of less than three percent and a gross-general-government-debt-to-annual-GDP ratio of less than sixty percent. The general government surplus (deficit, if negative) is depicted in Figure 1 and it can be seen that the three candidate countries are in little danger of exceeding the three percent limit. Estonia has been running surpluses and Slovenia and Lithuania are running small deficits. Slovenia is running the largest deficits, but the Slovenian central bank projects that its deficits will continue to decline and to reach one percent in 2008. The same fiscal austerity has not characterised Euro-member countries; in 2004 the Euro area as a whole had a 2.7 percent deficit-to-GDP ratio and the three-percent limit was exceeded by Germany, Greece, France and Italy.

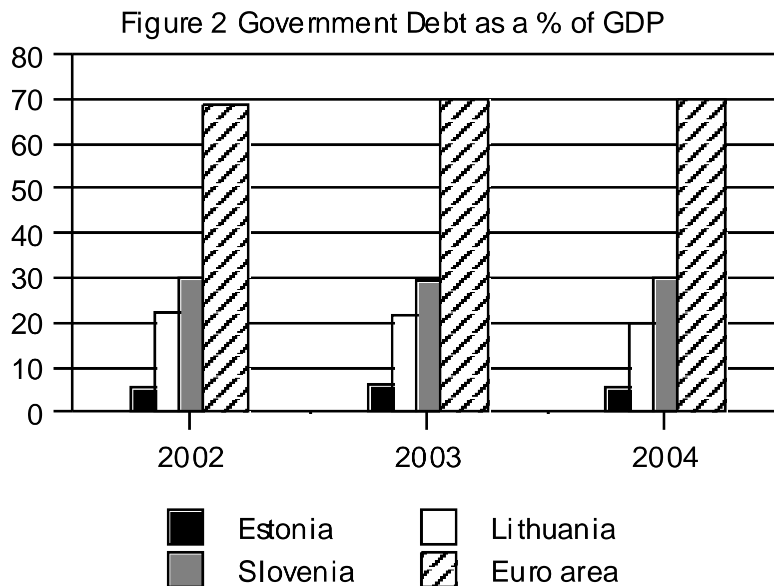
---

[1] Briefing paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament for the quarterly dialogue with the President of the European Central Bank.



Source: For years 2002 - 2004, *ECB Monthly Bulletin* Feb. 2006. The 2005 estimates are from the EBRD *Transition Report* 2005.

General government gross debt as a share of GDP is depicted in Figure 2 below. As is seen -- unlike the Euro area as a whole -- the three candidate countries are well below the sixty percent upper bound. The Estonian debt-to-GDP ratio hovers at about five percent, lower even than Luxembourg's. The debt-to-GDP ratio is about twenty percent in Lithuania and thirty percent in Slovenia, well below the debt-to-GDP ratio in most of the current member states.

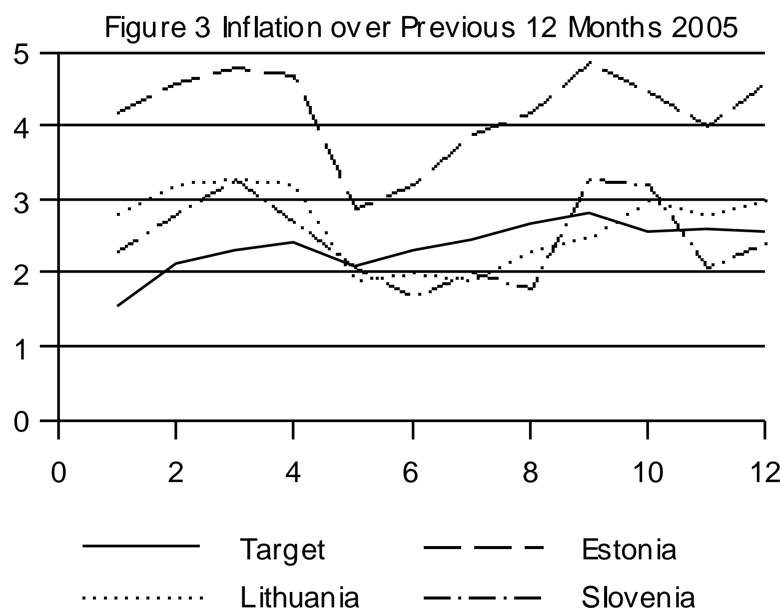


Source: *ECB Monthly Bulletin* Feb. 2006.

Aspiring member countries must join the exchange rate mechanism (ERM) of the European Monetary System. They are required to maintain the value of their currency within ± 15 percent bands around a fixed central parity with the euro for two years prior to joining the Euro area. Estonia, Lithuania and Slovenia joined ERM II on 28 June 2004. Estonia and Lithuania maintain currency board arrangements and assumed a unilateral commitment to peg their currencies to the euro; the kroon and litas have traded at their central parity rate since Estonia and Lithuania joined the ERM. Slovenia's monetary policy is aimed at stabilising its exchange rate and the tolar has traded close to its fixed central parity rate since entry.

Potential entrant countries must satisfy an interest rate criterion: Long-term (ten-year) nominal interest rates on their public debt must be on average within two percent of the average of interest rates on the government debt of the three countries in the wider EU25 with the lowest inflation rates for one year prior to examination. This criterion should be easily met; bond yields within the Euro area have converged and the average of the three lowest inflation countries' interest rates is close to the Euro area average. In December 2005, the ten-year interest rates on public debt in Lithuania and Slovenia were 3.79 and 3.69 percent, respectively. The Euro area average was 3.41 percent, making the target rate well over five percent. Estonia has lacked an instrument for comparison (that is, at least a five-year bond), but based on its low public-sector kroon interest rates and sound budgetary position, it should not face difficulties meeting this criterion.

The criterion that is likely to provide grounds for excluding Estonia and perhaps Lithuania is the inflation criterion: the annual inflation rate cannot exceed the average of the three best performing countries in the wider EU25 by more than 1.5 percent for one year prior to the examination. Inflation over the previous twelve months for the three candidate countries is shown in Figure 3 below. Target inflation is monthly inflation over the previous twelve months in the three lowest inflation countries plus 1.5 percentage points.



Source: Eurostat.

Estonia provides a good example of the difficulties inherent in trying to satisfy both the exchange rate and inflation criteria. The legislated primary objective of the Estonian central bank is to ensure price stability and Estonia has operated a remarkably successful currency board since 1992 and, since 28 Jun 2004, Estonia has been part of ERM II with an unchanged exchange rate. As a small open economy with a fixed exchange rate its inflation is primarily determined by external events and – mainly as a result of oil price rises – its inflation rose to 4.1 percent in 2004. As a consequence, Estonia will not meet the Maastricht inflation criterion by Jun 2006; it is unlikely to meet it in 2007.

Even without an energy price shock, the Balassa-Samuelson effect implies that as the accession countries catch up with Euro area countries their real exchange rates will appreciate. For currency-board countries such as Estonia and Lithuania with a fixed nominal exchange rate this implies that their inflation will be higher than in Euro area countries. Short data sets and cyclical factors make it difficult to assess the size of the inflation increase due to the Balassa-Samuelson effect on the accession countries, but current estimates are in the range of 1.5 percent to 2.5 percent.[2] As the Maastricht Treaty only allows for inflation to be 1.5 percent above the *best*-performing members of the EU, this creates a serious problem for Estonia and Lithuania

As a consequence, Estonia and Lithuania may simultaneously satisfy the inflation and the exchange rate criteria by luck. The only policy options are either to abandon their highly successful currency boards and adopt a more flexible exchange rate system: the fifteen percent bands in ERM II permit more leeway than the 1.5 percent band in the inflation target. Or, they can use fiscal policy to drive down domestic demand to the point where both criteria can be met. Neither choice seems particularly appealing.

Recent inflation performance has been better in Slovenia than in Estonia and Lithuania. Partly this may reflect Slovenia's greater convergence towards Euro area levels. Per capital income in Slovenia is already 70 percent of the average of current area members and, thus, Slovenia is likely to be experiencing less of a Balassa-Samuelson catch-up effect. In addition, it is possible that Slovenia is more able and willing than are Estonia and Lithuania to influence inflation through its control of administered and regulated prices.[3]

III. *Medium-term prospects for Estonia and Lithuania*

As very small open economies, a fixed exchange rate system is unlikely to be viable for Estonia and Lithuania in the long run. If they fail to enter the Euro area, they face the

---

[2]A discussion of this is found in Willem Buiter, "To Purgatory and Beyond: When and How should the Accession Countries from Central Europe Become Full Members of the EMU," 2004.

[3]The European Bank for Reconstruction and Development ranks countries on their degree of price liberalisation from 1 (a rigid centrally planned economy) to 4+ (an industrialised market economy). Estonia and Lithuania scored 4+; Slovenia scored a 4. Some other countries scoring a 4 were Azerbaijan, Kazakhstan and Ukraine.

eventual possibility of a financial crisis followed by a currency crisis. In the medium term, however, this risk is not substantial. Both Estonia and Lithuania have a reputation for being committed to their currency boards and their primarily foreign-owned banking sectors are healthy.

IV. *Longer-term prospects for Estonia and Lithuania*

Both Estonia and Lithuania have experienced rapid growth in recent years. Real GDP growth in Estonia and Lithuania was an estimated 7.9 and 7.3 percent, respectively, in 2005. It is projected to be 6.5 percent Estonia and 6.25-6.50 percent in Lithuania in 2006.[4] Although it is still low relative to other new EU members, income per capita in both Estonia and Lithuania has been converging toward EU levels.

Estonia and Latvia have been remarkably successful in transforming themselves into market economies. The World Bank publishes an index measuring the ease of doing business in different countries. The index depends on such factors as business regulations, property rights and labour market rigidities. On this index, Lithuania and Estonia rank 15th and 16th in the world, respectively, not far behind the best EU25 performer (Denmark in 9th place) and ahead of Germany (19th place) and France (44th place).[5] Lithuania and Estonia's placing so high is a remarkable achievement; all of the reforms have taken place in only fourteen years since independence. The Heritage Foundation ranked Estonia fourth in its 2005 Index of Economic Freedom.

Estonia and Lithuania face some challenges, however. First, Estonia's persistent external imbalances are cause for some concern. Estonian growth has been achieved, in part, by borrowing from abroad. In recent years Estonia has run large current plus (new definition) capital account deficits.[6] These grew to 12.7 percent in 2004, but have declined to 10.4 percent in the first half of 2005. As a consequence, Estonian external indebtedness rose to over 80 percent of GDP in 2004 and is estimated to have risen to over 90 percent in 2005.[7] In Lithuania, current account deficits were 6.4 percent of GDP in 2004 and the IMF predicts that deficits will remain in the range of 7-1/4 - 8 percent of GDP in the next few years. Estonia's recent external imbalances smooth consumption and are not necessarily undesirable for a rapidly developing economy; Lithuania's smaller imbalances are certainly reasonable for a country in its stage of development. However, neither country can sustain its current

---

[4]International Monetary Fund.

[5]World Bank, *Doing Business in 2006*, overview. The first three countries are New Zealand, Singapore and the United States, respectively.

[6]The old definition capital account is now called the financial account. The new definition capital account comprises some former current account transactions: capital transactions and the acquisition and disposal of non-produced non-financial assets.

[7]Much of this is owed to the foreign parents of Estonian subsidiaries.

external imbalances in the long run. A challenge for both countries will be to mobilise domestic savings: at 19 and 14 percent of GDP, respectively, Estonia's and Lithuania's savings are among the lowest of new EU countries.

Second, output appears to be close to potential in Estonia and above potential in Lithuania and there is a danger of overheating. The policy options are limited; fiscal policy and supervision of the banking system are the obvious tools. Fiscal policy could be tightened, although Estonia ran a small surplus in 2005. Regulatory measures may help protect both economies from some of the effects of large-scale credit expansion.

Third, some structural rigidities persist in Estonian and Lithuanian labour markets. It costs 33 weeks salary for a firm to fire a worker in both countries; this contrasts with no cost in the United States and 66.7 weeks salary for Germany. As do many European countries, Estonia has rules regulating working hours. The World Bank measures these rigidities; on a scale from zero (best) to 100 (worst), Estonia scores an 80 and Lithuania scores a 60. This compares with zero for the United States and 80 for Germany. This lack of flexibility reduces firms' incentives to respond to increased demand by hiring new workers.

V. *Longer-term prospects for Slovenia*

Slovenia is the wealthiest and mostly likely of the three candidate countries to gain full EMU membership in 2007. Real GDP growth was 4.2 percent in 2004. While fiscal policy satisfies the Maastricht criteria, longer-run sustainability requires tightening. The banking system is healthy.

Slovenia's problems are structural: in many ways it has converged less toward countries in the Euro area than have Estonia and Lithuania. Recent policy appears to have been aimed more at ensuring an early entry into the Euro area than at promoting the long-run health of the Slovenian economy. Slovenia faces significant rigidities, standing in 63rd place in the World Bank's ranking of the ease of doing business. It costs firms in Slovenia 43 weeks of salary to fire a worker. Increased labour market flexibility would enable Slovenia to better absorb asymmetric shocks in a monetary union, but there are indications that matters have worsened rather than improved in recent years.[8] It takes 60 days to complete the procedures necessary for starting a new business in Slovenia, compared to 26 days in Lithuania, 8 days in France and 2 days in Australia.[9] Improving matters would promote increased direct investment.

---

[8]Respondents too the 2005 EBRD/World Bank Business Environment and Enterprice Survey, cited in the EBRD *Transition Report 2005.*

[9] Krueger, *Ibid.*