

Dilemmas of Pre-Accession Policy*

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* Presented at the 41st IBIMA International Conference, 26-27 June 2023, Granada, Spain

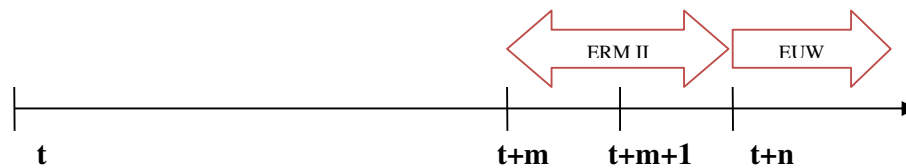
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Summary

The functioning of the Bretton Woods System (BWS) and the European Monetary System (EMS) turned out to be a type of lesson for the architects of the European Monetary Union (EMU). In consequence, some changes were introduced to the new European system in order to make it more flexible. The nature of these changes was defined in the Maastricht Treaty (MT). These regulations were to ensure greater stability of the EMU, as the convergence of economic parameters in member states should have a positive impact on the perception of their common currency.

Introduction

The EMU architects drew conclusions from the functioning as well as from the causes behind the destabilisation of both the BWS and the EMS. It had already been decided that Europe's single-currency area was meant to eliminate speculative attacks and the asymmetric position of the centre within the system. At the same time, countries which aspired to join the euro area were required to meet nominal convergence criteria, such as particular levels of budget deficit, public debt, inflation and long-term interest rates. Limit values for these parameters were established in the MT. In addition, before joining the EMU, the exchange rate of national currencies must be pegged to the euro within a permissible fluctuation band (within ERM II) for two years. The above changes are meant to ensure the stability of the EMU, because the convergence of economic parameters in member states should have a positive impact on the perception of the common currency. On the other hand, the meeting of the discussed criteria may require changes in current economic policies, primarily in the fiscal and monetary spheres, in this way, determining the framework of pre-accession policy determinants [Chmielewski 2003]. The main purpose of the study is to indicate some fundamental problems and choices facing Europe's economic policy when the meeting of convergence criteria is required. We can ask the following question: what assumptions and limitations should be adopted in order to meet the convergence criteria in terms of the European economic policy?



where:

t : present time,

$t+m$: accession to ERM II,

$t+n$: verification of the convergence criteria and accession to the EMU,

$t+m \rightarrow t+n$: two-year exchange rate reference period,

$t+m+1 \rightarrow t+n$: one-year reference period for the other criteria

Source: Own

Fig. 1. Time steps on the road to the EMU

It is assumed that the conscious involvement of public authorities spread over at least several years makes it possible to achieve structural economic convergence in the countries joining the Euro zone in relation to the countries that have already been using the common currency in the absence of economic or military crises in the abovementioned research entities.

Implementational variants of the convergence criteria

A reasonable assumption can be made that the accession of a given country to the EMU will take place over a period of several years, e.g. in the period $t+n$, where t is the present time (Figure 1). This means that in order to meet the convergence criteria, appropriate adjustments in the fiscal, monetary and exchange rate spheres must be made within n years.

Two variants were analysed due to the consequences of their implementation for the real economy and exchange rate stability in ERM II. Option I consists in meeting convergence criteria before entering ERM II. Option II does not meet these criteria due to non-existent adjustments in fiscal and monetary policies.

The analysed variants focus on two economic parameters, i.e. deficit in the public finance sector and inflation. In the case of countries applying for accession to the EMU and at the same time exceeding the permissible level of public deficit¹, a tightening of fiscal policy is required. The scale of restrictions depends on the degree of the excess in the indicated limit value. One of the features of the modern fiscal policy-making process is a high proportion of fixed government expenditure. However, reducing public deficit merely by reducing state expenditure may be an ineffective measure. It may be necessary to adjust the income side of the budget by increasing the average tax rate. It should be clearly emphasised that in variant I the required fiscal restriction would be extended over time, generating lower social costs.

Also, the detrimental effects of actions performed by monetary authorities, which are required to lower inflation², could be less painful for the real economy if they were spread over the period $t, t+m$. In such a situation, the central

¹ Directly before the accession of a given country to the EMU, no excessive deficit decision may be taken with respect to it. Such a deficit occurs when the public deficit in relation to GDP exceeds three percentage points or the ratio of public debt to GDP exceeds 60 percentage points.

² The level of inflation of a given country during the year preceding accession to the EMU may not exceed 1.5 percentage points of the inflation of three EU countries with the most stable price level. This inflation is measured

bank can reduce inflation rates by appropriately shaping inflation expectations, thus avoiding excessive increase in interest rates, all the more so as monetary measures are supported by fiscal restrictions (Figure 2).

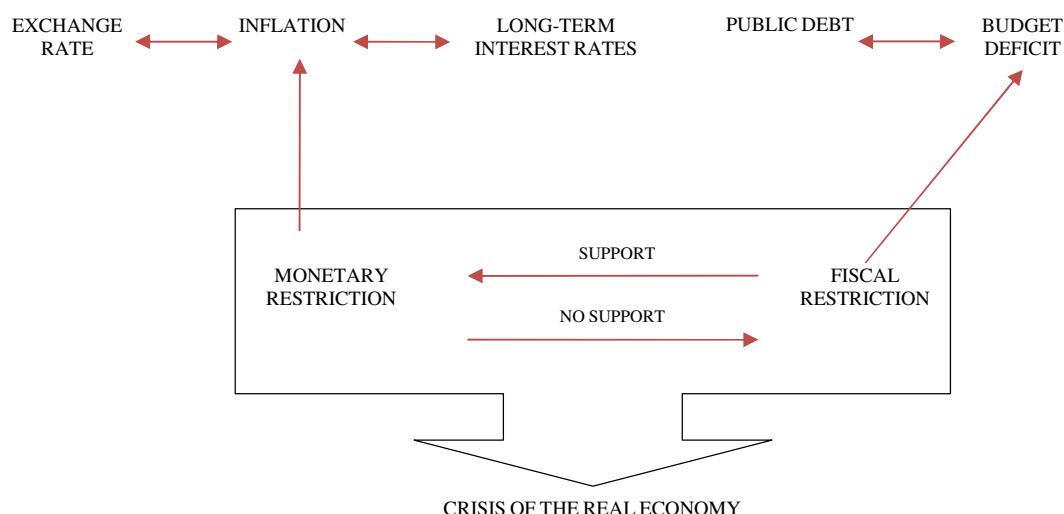


Fig. 2. Basic relationships in meeting the convergence criteria

Source: Own

The implementation of variant I results in a temporary slowdown in the GDP growth rate and employment problems. However, it was mentioned earlier that disturbances in the real world can be less painful because they are spread over time. One should be aware that the implementation of the convergence criteria before accession to the EMU forces incurring macroeconomic costs affecting the real economy. Therefore, the quality of the pre-accession policy constitutes an important factor, which takes an appropriate time perspective into account. This applies in particular to those countries that are characterised by significant imbalances in the labour market.

When analysing exchange rate stability under ERM II, attention to two related phenomena should be paid. The first one relates to the Balassa-Samuelson (B-S) effect. It applies primarily to those countries where there is a relatively high rate of growth in the efficiency of production of tradable goods. The dilemma between inflation and nominal appreciation of the exchange rate is a consequence of the B-S effect, the second phenomenon being speculative capital flows resulting from the disparity of interest rates. The complementarity of both phenomena consists in the fact that the central bank will be forced to raise interest rates in order to avoid inflationary pressure resulting from the B-S effect [Konopczak 2013]. Monetary restriction increases the likelihood of speculative movements, as well as of appreciation of the currency, which is detrimental to export production. Leaving interest rates unchanged at the expense of price increases would be an alternative solution. There is also an intermediate solution possible, i.e. recognition of the exchange rate and inflation as equal goals of the monetary policy. The question is how effective it would prove. It follows that the interchangeability between inflation and the nominal appreciation of the exchange rate may pose a significant threat to the convergence process and hinder the selection of the value of economic tools.

by the HICP (Harmonized Index of Consumer Prices), not the CPI (Consumer Price Index). HICP is calculated according to a unified methodology of the European Union by the member states. One main difference between the HICP and the CPI is that the harmonised index shows how current consumption costs have changed compared to consumption costs (with a different structure) a year prior, while the CPI shows how much was spent on today's basket of goods and services in relation to the expenses that would have been incurred to purchase the same basket in the previous year.

However, a positive consequence of the implementation of variant I may be a relatively high stability of the currency in ERM II. It will result from a smaller scale of the necessary adjustments in monetary and fiscal instruments in the period $t+m$, $t+n$, due to their successive adaptation in the period t , $t+m$, as well as from the breakdown in time of the convertibility between inflation and nominal appreciation. It should be noted that upon entering the ERM II, the exchange rate of a given currency may be overestimated, thus, negatively affecting the real economy. This threat also highlights the importance of the quality of the pre-accession policy for the monetary integration process in Europe. It is stated that even before ERM II accession, economic politicians should strive to eliminate or at least weaken factors leading to excessive appreciation of their currencies. These factors, in addition to the B-S effect, include e.g. interest rate disparity and privatisation transactions. Elimination of the above phenomena will postpone accession into the euro zone. On the other hand, it may prove a conscious and responsible pre-accession policy.

Variant II assumes that the convergence criteria will not be met before the introduction of a given currency to ERM II. This means that they must be completed in the first year of participation in the exchange rate mechanism, i.e. in the period $t+m$, $t+m+1$. This is due to the discrepancy between the two-year reference period for the exchange rate and the one-year reference period for the other criteria. The application of option II is associated with a strong and cumulative fiscal and monetary restriction over time. The consequence of such actions would be a shock to the real economy. Moreover, actions under this option would have destabilising effects on the exchange rate of a given currency in ERM II. The extent of destabilisation would depend on the scale of the B-S effect and speculative capital flows. Given the impact of both phenomena, simultaneous reduction of inflation and control of the exchange rate would be difficult to reconcile. Therefore, the actual implementation of variant II seems unlikely, especially in the case of a large internal imbalance in a given economy.

The fiscal variant and the monetary variant in relation to the convergence criteria

The previous subchapter presents variants of meeting the nominal convergence criteria, taking into account the time perspective and assuming adjustments in both fiscal and monetary policies. Two separate economic policy scenarios are analysed here, i.e. the fiscal variant and the monetary variant. To simplify the analysis, it was assumed that the activities performed by public authorities or the central bank would only aim at meeting the inflation criterion.

In the fiscal variant, the reduction of the inflation rate to at least the limit value requires reductions in government spending and/or increases in the average tax rate. Fiscal restriction not only reduces domestic demand, but also reduces inflation expectations. The reaction of aggregate demand to this restriction occurs very quickly due to the short external lag of fiscal policy. This contributes to the reduction in inflation and, as a result, appreciates the exchange rate. However, the reduction of the budget deficit reduces the borrowing needs of the budget, and thus the scale of inflowing capital, which eases the appreciation pressure [*Report on the benefits and costs of Poland's*

Table 1. Inflation reduction vs. fiscal and monetary impulse

Advantages and disadvantages

Fiscal Impulse (Fiscal Restriction)	Prompt response to aggregate demand
Smaller scale of exchange rate tensions	Limitations resulting from the realities of modern democracy
Probability of a large reduction in domestic demand	
Monetary Impulse (Money Restriction)	No parliamentary control over the monetary transmission mechanism
Reduced scale of recessionary tensions. Slower response to aggregate demand	
Strong currency appreciation tensions	

Source: Own.

accession to the euro zone 2004). This effect may, to some extent, disrupt the meeting of the inflation criterion and require an additional tightening of fiscal policy.

In the monetary variant, lowering the inflation rate requires an increase in interest rates. The monetary impulse runs with a longer lag than the fiscal impulse due to the length of the monetary policy external lag. However, an increase in the interest rate contributes to the appreciation of currency, which weakens the inflationary pressure and at the

same time shortens the period of required economic restrictions. On the other hand, there is a greater probability of exchange rate tensions in the monetary variant. Table 1 shows the strengths and weaknesses of the fiscal and monetary options.

Table 1 attests that transparency of channels transmitting fiscal policy impulses to the real economy as well as greater stability of the exchange rate provide arguments in favour of the fiscal option. This suggests that the discussed variant is safer from the point of view of individual countries' participation in ERM II. On the other hand, the level of fiscal austerity necessary to reduce inflation may not gain the required political acceptance in view of the electoral cycle theory.

The choice of the monetary variant is supported by much greater freedom on the part of monetary authorities (in relation to fiscal authorities) in determining the scope of restrictive measures. In addition, appreciation of currency resulting from the increase in interest rates weakens the inflationary pressure and thus a smaller scale of domestic demand reduction is possible than in the fiscal variant. The advantages and shortcomings of the discussed variants suggest that cooperation between public authorities and the central bank aimed at tightening the fiscal policy and (moderately) tightening the monetary policy would be the best solution. This type of policy-mix should be considered a manifestation of a conscious pre-accession policy which takes into account the time perspective of implementing such a policy.

Controversies around convergence criteria

It was pointed out earlier that confidence in the common currency to a large extent depends on the convergence of individual economic planes. An economic policy aimed at meeting the convergence criteria specified in the Maastricht Treaty should be a factor consolidating the stability of the EMU. However, the construction of nominal convergence criteria causes some controversy. On the one hand, it is postulated to ensure the principle of equal treatment, i.e. the same rules should be applied both to the current EMU members and to the newly acceding states. On the other hand, the dynamics of economic phenomena is noticeable, as certain events, such as deflationary tendencies, characteristic of the current European economy, did not occur with such intensity at the time of establishing the euro zone. It is argued that this should constitute an argument for updating the convergence criteria. Supporters of such a view pay special attention to the inflation criterion.

Increasingly frequent deflationary pressures in contemporary Europe lead to the lowering of the inflation reference value (IRV). Against this background, a question arises whether for inflation criterion to be rationally constructed countries with a negative price growth rate should be taken into account when calculating the value. This question is all the more justified as the indicated deflation phenomena may be successively repeated in the future, resulting in a drastic reduction of IRV, even to negative values. The potential negative IRV forces deflationary policy in countries aspiring to join the EMU, and thus generates high costs for the real economy. These costs are revealed at the level of implementing deflationary policy, as well as at the level of deflation itself. The former concern the issue of the rationality of the monetary policy. A very low IRV forces the central bank of a country aspiring to join the EMU to set not only an unadvisable, but also an inappropriate inflation target. In such a case, private entities will have to revise their views on the degree of credibility of the central bank, which will result in further disturbances in the real economy. The previously mentioned B-S effect, which strengthens the structural inflation trends, would additionally hinder the process of disinflation, and then the process of introducing the economy into deflation.

The second type of costs is related to economic consequences arising in deflationary conditions. Firstly, with the existence of a lower limit on the nominal interest rate, the monetary authority loses the ability to stimulate the economy through a negative real rate. Secondly, the higher the deflation, the higher the real interest rate, which in turn hinders private investment. Moreover, a decrease in the general level of prices may lead to a temporary slowdown in private consumption due to the conviction that the real money stock will increase. Thirdly, after accession to the EMU, individual countries may seek to quickly neutralise the deflationary environment and to some extent disturb the price stability of the euro area.

In view of the admission of new members to the EMU, the question of reformulating the discussed criterion should therefore be considered. Some solutions can be proposed here. The first would be to replace negative HICP values with zero. This solution eliminates the possibility of a negative IRV, but its minimum level of 1.5 percent still seems too restrictive. Another solution would be to adopt lower IRV limits at the level of 3 percent, while maintaining the existing methodology for calculating the discussed indicator. This value is supported by a view

commonly found in the economic literature that the optimal inflation rate is 2-3 percent and by the fact that in recent years, central banks of developed economies have most often set their inflation target at this level.

Other convergence criteria are less controversial. Generally, the reasonableness of interest rate convergence in the single-currency area is not questioned. After the introduction of the common currency, the exchange rate risk premium disappears and nominal interest rates should undergo autonomous convergence. However, within the EMU, some differences in the level of these rates are possible due to market expectations regarding inflation or public finance discipline. According to many observers, this fact justifies the convergence of interest rates³ before accession to the euro area, as it may be a factor weakening the expectations of entities to their differentiation in the future. On the other hand, many argue that individual countries are characterised by different sensitivity of demand and prices to interest rate levels. In such a situation, a more favourable solution would be to set less restrictive rules regarding the discussed criterion, especially in the face of the aforementioned elimination of exchange rate risk in the post-accession period [Suardi 2001].

The exchange rate criterion⁴ is the last of the monetary criteria specified in the Maastricht Treaty. One of the main advantages of the common currency is the elimination of fluctuations in nominal exchange rates. ERM II eliminates this volatility to some extent even before joining the EMU. It was previously indicated that the most advantageous solution would be to meet the convergence criteria before joining the ERM II. Structural reforms are required in some countries. Their implementation would make sense before accession to the euro area, when the exchange rate may still be subject to correction. At the same time, a certain imperfection of the construction of the discussed criterion is emphasised. Merely keeping the currency within the standard fluctuation band (+/- 15%) without parity devaluation/appreciation is not tantamount to obtaining a positive assessment of exchange rate stability. An additional condition is the absence of the so-called serious tensions in the foreign exchange market during the two-year participation in ERM II. However, objective measures of exchange rate stability have not been specified, which reduces the transparency of this criterion.

Interpretations of the European Commission and the European Central bank remain a certain determinant in this regard. The assessments of these institutions indicate that the exchange rate should be close to parity and emphasise greater tolerance for appreciation than depreciation against parity. The position of the EC and the ECB fails to precisely explain several issues, such as: what level of the exchange rate is considered to be close to parity, what the consequences of a temporary deviation of the exchange rate from the lower or the upper limit of the fluctuation band will be, and what justifies the specific asymmetry of the ERM II system consisting in greater acceptance of currency appreciation than its depreciation [Naszodi 2008].

In the case of fiscal criteria, it is indicated that stable state finances, measured by a low level of deficit and public debt, are necessary to ensure sustainable economic growth. Countries applying for accession to the EMU should shape their finances in such a way that they can be subject to cyclical fluctuations after the introduction of the common currency without losing control over public spending. At the same time, some economists and observers of the euro zone point out that maintaining rigid threshold values for fiscal criteria in relation to member states is not an optimal solution. Given the fact that the area for discretionary economic policy is clearly narrowed down in the EMU, they propose, in strictly defined cases, to allow for the possibility of periodic stimulation of the economy by increasing the public deficit above the limit value specified in the Maastricht Treaty⁵.

In the discussion on the rationality of the nominal convergence criteria, the issue of the extent of real convergence is also emphasised. Regardless of the controversies surrounding the previously discussed criteria, the stability of the single-currency area is more difficult to achieve without legitimising an appropriate level of convergence of the real economy [Kusideł 2013]. The Maastricht Treaty does not explicitly specify the criteria for convergence of the real sphere, which would have to be met obligatorily before joining the euro area. It was noted earlier that the main determinants of this convergence include the structure of production and demand, economic growth and the intensity of mutual trade links. It can be reasonably assumed that economic growth is a significant stimulant of the situation on the labour market and, at the same time, of the unemployment rate. The latter parameter is a measurable value and could constitute an independent convergence criterion. It is difficult to unequivocally determine the legitimacy of such a condition. On the one hand, setting the unemployment rate criterion would force a fundamental

³ In the year preceding the examination of the macroeconomic position of a country joining the EMU, the nominal long-term interest rate must not exceed the average interest rate in the three most price-stable EU countries by more than 2 percentage points. Ten-year treasury bonds are taken into account in the assessment.

⁴ Before joining the EMU, a prospective member state must respect the fluctuation band of its currency against the euro within ERM II without its depreciation/appreciation over a period of at least two years.

⁵ These defined cases basically correspond to the previously specified conditions (rules) concerning exceeding the permissible value of the public deficit.

change in the directions of the pre-accession policy, as both nominal and real values would have to be taken into account. This would require stronger structural adjustments in particular countries and would further unify their economic structures. This fact would be a factor bringing the EMU closer to the optimal conditions of a single-currency area.

On the other hand, setting a limit value for the unemployment rate could delay the process of monetary integration in Europe. It seems that this was the main argument against explicit discernment of real criteria in the Maastricht Treaty. It was assumed that the national governments (of the EMU founding countries and future accession countries) would be aware of the need to develop the greatest possible economic convergence on both nominal and real grounds.

Conclusion

It is emphasised that the stability of the single-currency area in Europe is largely determined by the way the economic policy is determined before accession to this area, referred to as pre-accession policy. For some observers, this is a key factor in the sustainability of the EMU. Pre-accession policy should therefore have its own status, the main determinant of which would be the awareness of national public authorities about the need to achieve the greatest possible economic convergence with countries already belonging to the EMU. The process of economic convergence should cover both the nominal and the real sphere of the economy. This can generate problems related to frequent lack of correlation between these spheres. Reducing the imbalance in the labour market requires expanding the expansiveness of the economic policy, which is usually associated with an increase in the budget deficit and/or an increase in inflation. It follows that the aim of the pre-accession policy is to strive to achieve structural economic convergence in countries joining the euro area in relation to countries already using the common currency. This is one of the prerequisites for the stability of the EMU. However, it also requires conscious involvement of public authorities spread over at least several years.

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