# Exchange Rate Arrangements and EU Enlargement

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# 7. Exchange Rate Arrangements and EU Enlargement

**Jesper Jespersen**

## INTRODUCTION

The exchange rate has always been a highly sensitive political concern, because it is one of the country's windows abroad. In this sense, devaluations or depreciations are considered a defeat of economic policy and an erosion of national governments' credibility. Furthermore, when the exchange rate finally adjusts, the trading partners are, for good reasons, fearing that a 'beggar-your-neighbour' development will ensue. And even if a regime of fixed exchange rates is well designed, it may suffer in practice from a number of built-in weaknesses, which lead to these seemingly inevitable economic crises where high rates of interest and financial bankruptcies cause unemployment. The history of exchange rate arrangements is paved with such financial crises. The more recent and spectacular examples were the breakdowns of the European Monetary System in 1992–93, the South-East Asian crises in 1998, followed by the Russian, Brazilian, Turkish, and Argentinean crises. Indeed, the list seems endless.

One of the major conclusions of this chapter is that even within the European Union (EU), currency and financial crises remain a current threat. The economic performances of the 25 countries in the Union are dissonant, with balance-of-payments imbalances building up, rates of inflation rising, and unemployment rates diverging among member countries. Hence, in that perspective we will argue that it is difficult to imagine future financial crises being avoided, especially for the new member-countries (EU-10) that are still in transition from a planned economic system to a full-scale market economy. An additional disturbing matter is that these countries are undertaking this transition under the severe Stability and Growth Pact (SGP), which forces EU countries into a considerable fiscal and monetary straightjacket. Moreover, the ten new EU countries have been asked to make their macroeconomic development conform to the EMU convergence criteria of low inflation, and to prepare themselves for participation to the fixed exchange rate mechanism (ERM2), in which the euro is the anchor currency.

The overall objective of this chapter is to discuss the possible exchange rate regimes that the ten new EU countries (especially the former Eastern European countries) could choose for the future. Before beginning, however, we should keep in mind that these ten countries, except Poland, are all considered 'small and open economies' with respect to foreign trade. Even though the population of these countries reach 80 million citizens, their total GDP is only a little more than five per cent of the EU-15's total GDP. Moreover, the average income per capita in these countries is less than a third of the EU-15's. Hence, in terms of living standards and macroeconomic impact we are considering two separate worlds. If these two worlds should grow more equal, then the poorest countries could embark on an export-led growth path (as Ireland did in the early 1990s) without changing the economic development in the EU-15 in any significant way.

The structure of this chapter is as follows. The next section gives a brief overview of two distinct (and competing) macroeconomic theories: the new consensus economics (which is a merge of neoclassical and new-Keynesian equilibrium economics), and post-Keynesian macroeconomics.[1] In the third section we evaluate the different monetary and exchange rate arrangements and balance-of-payments constraints within the EU from a post-Keynesian point of view. In the fourth section we discuss how the exchange rate arrangements existing within the EU fit the overall growth strategy of the EU-10 countries. We conclude arguing that the new EU-10 countries should be allowed to follow an individually adapted exchange rate policy, which could mirror the differences among the countries and the fragile structures of the transitional economies.

## TWO DIFFERENT VIEWS ON GROWTH, EMPLOYMENT, AND ECONOMIC POLICY

Although the political sensitivity towards unemployment within the EU (new as well as old member-countries) has decreased, high unemployment is still a matter of concern. In this section we argue that, in countries with high unemployment, demand management and the exchange rate arrangement are important factors explaining the development of employment. Germany, as well as France, Poland, and Sweden are cases in point.

For instance, an unemployment rate close to 10 per cent is still a political liability in Germany in 2005. The government of Gerhard Schröder failed to improve on employment during its term in office. Of course, many reasons have been put forward for the disastrous employment record. Conventional

neoclassical equilibrium theory is blaming inflexible and sclerotic labour market structures. Post-Keynesian theorists, on the other hand, put more emphasis on the lack of effective demand for labour in countries where unemployment is substantial.

**New-Consensus Macroeconomics**

Within the neoclassical/new-Keynesian (today the so-called New Consensus) macroeconomics, sustained levels of high unemployment are caused by structural factors in the labour market and hardly, if at all, affected by demand factors. This strand of thought argues that unemployment is due to a lack of real wage flexibility, which is caused by exaggerated labour protective legislation, generous unemployment benefits, trade unions, and incentive-reducing wage and income taxes (for a textbook presentation, see Sørensen and Whitta-Jacobsen, 2004).

Saint-Paul (2004) goes one step further, and combines the new consensus macroeconomic theory with political theory. He gives a revealing example of this 'changed ideology' (to use his own expression) within the so-called New Consensus *political economy*. According to Saint-Paul (2004, p. 63), financial crises are necessary events that, by short-term hardship, prepare the public opinion for much needed labour market reforms. Hence, an external shock would rather have a (longer-term) beneficial effect by creating an increased *political* pressure for the, according to Saint-Paul (2004), *objectively* needed labour market flexibility and welfare reforms to improve employment.[2]

New Consensus political economists would further argue that a sustained public sector deficit is further evidence of an excessive fiscal policy and of labour market rigidities. If the labour market was made sufficiently flexible, and if politicians were made responsible for matching public expenses with current income, the structural budget will be self-balancing. Hence, within this theoretical perspective, a sustained public deficit is a sign of unsound public finances and/or labour market rigidities. In both cases a fiscal crisis unveils the needed labour market reforms and fiscal consolidation. A balanced budget is a remedy (together with labour market reforms), and solves the fiscal crisis and reduces involuntary unemployment as well.

This new political and economic consensus is the official theoretical argument underpinning current EU strategies for growth and employment. Hence, unemployment cannot be addressed by macroeconomic policies, but is a matter of labour market organization, together with national structural programmes and welfare reforms. In this theoretical setting, unemployment

has become a matter of national policies, where exchange rate arrangements are of a second-order concern.

Macroeconomic policies and exchange rate arrangements are mainly directed towards monetary stability. Price stability becomes the overarching macroeconomic goal. Hence, an inflation-target oriented monetary policy and irrevocably fixed exchange rates are considered suitable for this stability, which promotes the EU ambition of high economic growth.

## Post-Keynesian Considerations

If we consider the German case, the new-consensus macroeconomics fails to explain the development in employment. In fact, the number of jobs *expanded* by nearly 2 millions during the period 1998–2000 without any structural reforms.[3] This expansion was brought to a stop by the international downturn in 2001–03, when the German economy was hit by weak foreign (and domestic) demand. Then rising unemployment brought the German government's budget into conflict with the 3 per cent limit of the SGP, and the government was forced once again to tighten fiscal policy to avoid political and economic punishment from the other EU countries.

Furthermore, the employment prospects seemed to have deteriorated even in spite of the 2004–05 labour market reforms, which were mainly directed towards a reduction of social welfare for unemployed citizens. During the spring of 2005 the number of registered unemployed citizens breached the 5 million benchmark.

This development of expanding and contracting employment is fully consistent with post-Keynesian theory, where fluctuations in effective demand for goods and services are a main (but of course not the only) factor causing changes in growth rates and employment (see for instance Arestis and Sawyer, 2003).

In short, post-Keynesian macroeconomics stipulates that expanding effective demand is a necessary, but in many cases not a sufficient factor, to improve employment. Effective demand, it is argued, is affected by private sector behaviour toward consumption and real investment, economic policies and international competitiveness. In that theoretical perspective, the public, private, and foreign sectors are interrelated, and it is hardly meaningful to specify a target for the public sector budget independently of the development of the other two sectors.

With these fundamental theoretical divergences and political priorities in mind, we are better equipped to understand and to evaluate the challenges the EU-10 countries are confronted with when they have to choose a future

strategy for their exchange rate arrangement within the EU.

## MACROECONOMIC STABILITY AND EXCHANGE RATE ARRANGEMENTS IN A POST-KEYNESIAN PERSPECTIVE

In the post-Keynesian perspective, macroeconomic stability can be disrupted by a lack of effective demand. In this section we discuss how the balance of payments interferes with macroeconomic stability, and how the design of the exchange rate arrangement transmits effective demand through external relationships.

There are two major constraints on domestic growth emanating from the balance of payments: *a lack of foreign effective demand* (net exports and foreign direct investment), and *a lack of foreign reserves* (which holds back domestic expansion). These are explained in turn below.

The current account, together with the inflow of foreign direct investment, measures the foreign net effect on effective demand, which is crucial for growth and employment. By contrast, a purely domestic expansion may run into a lack of foreign reserves constraint as the current account deteriorates and foreign long-term capital inflows dry up.

The exchange rate is a macroeconomic price that has a major impact on international competitiveness. When one of the balance-of-payments constraints is binding, the exchange rate could be a useful instrument: in a freely floating exchange rate regime, the government has no formal exchange rate commitment. In this case, the 'lack of foreign reserves' constraint ceases to be binding, because the exchange rate is solely determined by the aggregate effect of private transactions in the current and capital accounts. Movements of the exchange rate have an impact on effective demand, as we mentioned above. Hence, the constraint of the foreign effective demand is also present in a floating exchange rate regime, and expected changes of the exchange rate play an important role as a borrowing cost on foreign loans.

### Foreign Effective Demand Constraint

In the post-Keynesian perspective, effective demand for goods and services is given highest priority when dealing with growth and unemployment. Of course, there is no one-to-one relationship between balance-of-payments transactions and effective demand. Nonetheless, there will be a rather close link between the transactions recorded in the current account and effective

demand. Exports of goods and services have an immediate effect on production and employment, whereas imports substitute domestic production, which reduces effective demand at home (and increases it abroad). When analyzing the impact of balance-of-payments transactions on effective demand, we should also add (at least a part of) foreign direct investment. Indeed, when such direct investments are made real, in the sense of setting up new factories, renovating old plants, or building houses, they increase effective demand like any other real investment, and should be analyzed as such. On the other hand, foreign direct investment consisting of buying shares in existing firms, with no explicit purpose of making real investment, are more like financial portfolio investment and do not add to effective demand.

As long as countries have separate currencies, they should keep in mind Thirlwall's theory of balance-of-payments constrained growth (McCombie, 2003), because in that case the domestic growth process could at any time be hindered or impeded by a lack of foreign effective demand or by a lack of foreign exchange causing indeed a financial crisis. Hence, the exchange rate arrangement plays a crucial role for countries that are in a vulnerable process of catching up with more mature economies, such as the EU-10 in respect of the EU-15.

**Foreign-Exchange-Reserves Constraint**

The growth process may also be constrained by a lack of foreign liquidity, when the stock of foreign reserves is low. In that case, a financial crisis can occur if the deficit in the foreign exchange market is not reduced through credible economic policies. In this sense, the foreign exchange market can be disrupted by speculative short-term financial flows. Foreign exchange reserves are a protection against this source of disturbance. Keynes as well as post-Keynesian economists (Davidson, 1997) favour a ban on speculative international transactions, which more often than not put the international financial system under stress (see also Rochon and Vernengo, 2000). The foreign-exchange-reserves constraint can be handled in a more orderly way in a system without financial flows generated by currency speculation. Unfortunately, in practice it is difficult to separate serious long-term capital movements from speculative financial transactions. In fact, the EU Treaty requires free cross-border capital flows, and does not distinguish between sound and unsound financial capital movements.

The most important institutional change within international finance over the last two decades has been the elimination of border controls on financial

capital movements within the OECD area. As a consequence, the citizens of the EU countries are free to borrow from any country abroad. Private banks and larger firms, therefore, cannot be liquidity constrained as long as they are able to pay the market rate of interest (and have the required creditworthiness). Those governments that have committed themselves to keep a fixed exchange rate, however, might become foreign reserve-constrained. Hence, in a fixed exchange rate regime there is always a risk that foreign reserves may be drained more quickly than the government is able to provide new and sufficient quantities of them. Paradoxically, free capital movements imply that governments have to stock an even larger foreign exchange reserve than within a system where capital controls prevail.

**Fixed Exchange Rate Regimes**

In a fixed exchange rate regime without international capital controls, the central bank has to sell or buy whatever amount of foreign exchange the private sector requires. The central bank needs to have sufficient foreign reserves (and credit lines) to satisfy existing demand. Substantial capital outflows reduce the privately held amount of central bank money (M0), which then puts some upward pressure on money market interest rates. If the day-to-day rate of interest goes beyond, say, 100 per cent (per annum), the politicians (and with them the public opinion) are prepared for a substantial devaluation of the exchange rate.

A fixed exchange rate regime is biased against the deficit country, because the surplus countries can just leave the rate of interest at a level that best fits their domestic economy. When the central bank of the deficit country experiences a foreign-reserves constraint, something has to give in. On the other hand, there is no mechanism, except for international political pressure, that can prevent a central bank of a surplus country from going on accumulating foreign reserves. In fact, a 'strong currency' is an undervalued currency, which generates a substantial surplus in the current account. A strong currency position leaves more room for directing monetary and fiscal policies towards domestic imbalances.

On the other hand, foreign reserves are somewhat costly to accumulate, because the central bank will only obtain a yield on its reserves equal to the interest rate on the anchor currency. Hence, any country – except for the anchor-currency country – that takes part in a fixed exchange rate system has to pay a participation fee, which amounts to the difference between the domestic and the foreign rate of interest times the average size of the foreign reserves. One could also call it a 'currency discount'. The mechanism is the

following: the larger the accumulated deficits of the current account (with a negative effect on effective demand), the larger the spread between the domestic and the foreign interest rate. As mentioned above, an *under*valued currency means in practice a *strong* currency with a smaller interest premium. Countries with the largest surplus on the structural account of the balance of payments (together with a reliable political system) have the lowest interest rate spread, which, in case of a substantial surplus, might even become negative.

The reason behind international capital controls in the years following the Second World War was to give countries participating in the Bretton Woods system the ability to pursue a more independent monetary policy.[4] This was, of course, of primary interest to those countries that were constrained by effective demand but had sufficient foreign exchange reserves. During the 1960s, it became increasingly difficult to prevent the private sector from circumventing international capital regulations. Hence, the beneficial effects of capital control were undermined, and participation in a fixed exchange rate system required an increasingly larger stock of foreign exchange reserves.

**Floating Exchange Rate Regimes**

Within a floating exchange rate regime, the central bank has no obligation to peg the exchange rate. The foreign payments undertaken by the private sector have to add up to zero. The exchange rate will adjust in such a way that realized demand and supply of foreign exchange equalize.

A floating exchange rate regime removes the foreign reserve constraint on macroeconomic policy. Hence, monetary policy can be directed also toward domestic imbalances.

Without international capital controls, pure financial transactions dominate the foreign exchange market and the exchange rate. Unfortunately, however, financial markets need an anchor so they do not go astray; but within a floating exchange rate regime there is no such anchor. Misguided expectations can make the exchange rate be adrift for years, which might then harm the foreign competing sectors considerably (see for instance Harvey, 1999).

If governments want to pursue a stabilization (full-employment) policy, then a domestic-oriented demand management policy may countervail the disturbances to effective demand caused by an over- or undervalued exchange rate within a floating exchange rate regime. In fact, recent research has shown that pre-announced exchange rate targets defined with reference to macroeconomic fundamentals, that is, a purchasing power index, may have a

stabilizing effect in a world of imperfect knowledge (Frydman and Goldberg, 2004). In that case, the central bank has to intervene in the foreign exchange market, not in order to defend a specific exchange rate, but rather to market a signalling effect that might give to market participants a kind of guidance with regard to fundamentals. The development of the euro–dollar exchange rate is an illustrative example, where limited interventions could have had an effect without the European Central Bank risking being foreign-reserves constrained.

Another more structural-oriented aspect related to a floating exchange rate regime is price stability. Economies in transition may need an external anchor for the domestic process of inflation. Speedy and far-reaching structural changes within the real economy might fuel an internal process of inflation, which needs some brakes. Depending on the transmission mechanism a floating exchange rate will reduce the impact of this external brake. As a consequence monetary policy in a floating exchange rate system, following the advice of the new-consensus theory, is directed towards a specific inflation target. But, in practice, the impact of monetary policy on price developments is uncertain. It has to pass through the formation of expectations in a world of imperfect knowledge. This is not the place to discuss inflation theory in a post-Keynesian perspective. One could only note that the balance of powers in the labour market, the welfare systems, and the level of unemployment are equally important factors (see Arestis, 1992).

**Summing Up**

There is no simple theoretical conclusion with regard to making a robust design of the exchange rate arrangement with reference to the EU-10 countries. In this section we identified four different systems, which are presented in Table 7.1. The right choice depends on the priorities of the overall macroeconomic stability, and even more importantly on the economic theory lying behind the evaluation. Furthermore, the best design depends on what kind of shocks are the most likely: internal or external; real or nominal.

Taking into consideration that the EU-10 countries are small economies, shocks are mainly expected to be caused by internal factors. (External shocks are expected to be rather symmetrically and handled at the EU level.)

*Table 7.1. Different exchange rate arrangements*

| | Macroeconomic target | |
|---|---|---|
| | Employment (demand management) | Inflation (foreign anchor) |
| Floating exchange rate | ++ | – |
| Fixed, but adjustable exchange rate[a] | +++ | + |
| Fixed exchange rate (ERM2) | + | ++ |
| Monetary union[b] | – | +++ |

*Notes:* the number of + indicates the ability of the exchange rate arrangement to cope with internal real (employment) or nominal (inflation) shocks; [a] adjustable with regard to securing a sustainable surplus in the current account; [b] with binding requirements on national fiscal policy.

One can sum up the arguments concerning macroeconomic stability in the following way. Employment is affected by effective demand (and structural policies). If effective demand is constrained, real stability is at risk. In addition, the internal process of inflation is difficult to manage through macroeconomic policies: it is often a consequence of structural imbalances and uncoordinated struggles over income shares running out of control. A fixed exchange rate regime may give a nominal guideline on price formation, but no guarantee that inflation is at bay.

Hence, in transition economies, a floating exchange rate arrangement may remove the 'foreign-reserve constraint', but at a price of forsaking the inflation anchor. Conversely, a fixed exchange rate arrangement *à la* ERM2 gives a kind of nominal anchor, but leaves the country vulnerable to effective demand shocks.

A well-designed (that is, fixed but adjustable) exchange rate regime could support full-employment policies, especially if adjustments were coordinated at a regional level to prevent beggar-your-neighbour policies. In that case capital control is not really an issue, because it does not make sense to speculate against a 'healthy' currency. Whereas, a badly-designed fixed exchange rate regime causes real uncertainty which, furthermore, can be reinforced by waves of speculative financial flows (Davidson, 2002b).

A monetary union removes the foreign reserve constraint definitely, and provides a nominal anchor (defined by the average inflation rate) for the

participating countries, but leaves especially small and open economies vulnerable to effective demand shocks and fiscal crises if they are out of tune with the major countries.

## DO THE EU-10 COUNTRIES FIT THE EUROPEAN MONETARY UNION?

This section evaluates the likely impact of the EU-10 countries embarking on the route to the EMU. Before we go into a more detailed analysis, from Table 7.2 it is obvious that there is a dividing line between the six smallest countries[5] (Cyprus, Estonia, Latvia, Lithuania, Malta, and Slovenia) and the somewhat larger countries (the Czech Republic, Hungary, Poland, and Slovakia) of the EU-10. The smaller countries seem to have a politically-defined goal of joining the EMU as quickly as possible, leaving the real macroeconomic considerations aside, whereas the larger countries have taken a more contemplative attitude, before they lock their currency up in the formal ERM2 arrangement.

*Table 7.2. Exchange rate arrangements of the EU-10 countries as of May 2005*

*Joined ERM2 in June 2004*
Estonia (unilaterally decided to maintain a currency board)
Lithuania (unilaterally decided to maintain a currency board)
Slovenia

*Joined ERM2 in May 2005*
Cyprus
Latvia (unilaterally reduced fluctuation band to ±1 per cent)
Malta

*Floating exchange rate arrangements*
Czech Republic
Hungary
Poland
Slovakia

*Sources*: European Central Bank (2004), *Convergence Report*; European Central Bank (2005), *Monthly Bulletin*, Frankfurt: European Central Bank.

According to the EU Treaty, new member countries are committed to pursue an economic policy that makes them qualified to a membership of the EMU without any unduly delays. The convergence criteria of the EMU consist of requirements related to low inflation, low rates of interest, a public budget deficit not exceeding 3 per cent of GDP, a public debt below 60 per cent of GDP, and participation in the ERM2 for at least two years without tensions within the band defined as ±15 per cent around the central exchange rate against the euro.

**Why a European Monetary Union?**

The EU had (and still has) the ambition of being an economic (and political) heavy weight on the world stage that could match the two – at that time – superpowers: the United States and the Soviet Union. For that purpose, a single European currency was considered important. Furthermore, it was argued that the economic counterpart of 'one Europe' would be 'one money', which could reduce costs of cross-border transactions (in goods, services, tourism) and increase transparency and competition.

On the other hand, obtaining macroeconomic benefits from the use of a single currency is less obvious. In that case, participating countries have to be economically well integrated and quite similar with respect to their vulnerability to internal and external shocks (as suggested by the theory of 'optimal currency areas', OCAs; see De Grauwe, 2005, for a textbook presentation of the costs and benefits of OCAs).

Plans for such a monetary union were put forward as far back as 1969 – the so-called Werner Plan. But it was not before the late 1980s that an elaborate and realistic plan leading to a European Monetary Union was designed. At that time, the overarching goal was political unification. For that purpose, a single currency was seen as a useful instrument. To give the euro a status as a strong international currency, it was considered necessary to keep inflation low in all participating countries. The design of the EMU was directed towards this goal by strengthening the nominal anchor. The main instrument was an independent central bank only responsible for price stability, and narrowly defined strings on the fiscal policy conducted by the member countries.

The deliberate political intention (and a requirement by the German government before giving up the Deutschmark) was to give the monetary union a deflationary bias to ensure that the nominal stability of the new currency was not put at risk. In practice, it has been showed that the EMU

has a strong deflationary bias (see Arestis and Sawyer, 1999). As a consequence of the substantial budget consolidations required during the 1990s, economic growth within the euro area was at its lowest since the Second World War, and unemployment at its highest.

After the spring of 1998, when the formal decision was taken regarding which countries would form the monetary union, there was a brief period of relief over fiscal policy. As a result, growth resumed, as in the German case. This expansion only lasted a few years. Then, the requirements of the SGP forced a number of countries, which found themselves in conflict with the 3 per cent rule (deficit to GDP ratio), to restrict their fiscal policy. Furthermore, the ECB was tough on monetary policy, because the rate of inflation was continuously above the self-declared target of 2 per cent. When the international boom ended in 2001, a number of EMU countries realized that they could not keep the budget deficit within the narrow limit of 3 per cent of GDP. The automatic stabilizers were much too strong, which initially prevented the recession from deepening too much. But the requirements of the SGP caused the EU countries to reduce their cyclically-adjusted budget deficits. Unless something unforeseeable happens in the international arena, the EMU-countries could remain for an extended period in this low growth trap, which, in fact, had destabilised the political process within the EU (Bini Smaghi, 2004, p. 173).[6]

For this very reason, three of the 'old' EU members (the United Kingdom, Sweden, and Denmark) have chosen to stay outside the EMU – although they all fulfil the formal convergence criteria. These countries do not need an external nominal anchor, and the restrictions on effective demand are considered much too narrow. It is remarkable that on the issue of joining the EMU, the popular vote was significantly different from the recommendation of the political leadership in Sweden and Denmark (and polls suggest that the same will happen in the United Kingdom if a referendum is called on substituting the pound with the euro). There are no simple explanations for this divide between the people and the politicians, but the divide seems to indicate that Danish and Swedish voters weighted macroeconomic stability with low rates of unemployment, an extended welfare state, and decentralized decision-making higher than to take part in a European currency area with the aim of matching the dollar in the global arena (Jespersen, 2004). The outcome of the referenda in France and The Netherlands may be interpreted in the same direction, that the population is more worried about securing the welfare systems than to go on improving economic efficiency at any costs.

These are the background considerations upon which the EU-10 countries have to decide their future exchange rate arrangements.

## The Road Ahead for the EU-10 Countries[7]

The EU was enlarged by 10 countries in May 2004.[8] These countries have 75 millions of inhabitants, which equals 20–25 per cent of the population of the EU-15. Economically, these Eastern and Central European member countries are miniscule. Together, they only account for 5 per cent of the EU-15's GDP (with Poland counting for approximately one third of the EU-10's GDP, see Table 7.3). This means that if measured at the actual exchange rates, the average level of income (per capita) is only around 30 per cent of the 'old' member countries (the EU-15). If measured in purchasing-power-adjusted exchange rates, however, the difference in income levels comes closer to 50 per cent (on average). In fact, the income level varies from 77 per cent of the EU-15 level in Cyprus to 40 per cent in the Baltic countries. Although growth rates have been quite impressive in recent years in a number of the new member countries of the EU, unemployment is still very high. Countries that are among the worst hit are Poland and Slovakia, which have close to 20 per cent registered unemployed. The Czech Republic and Hungary are doing better regarding unemployment, but have on the other hand huge current account deficits as well as substantial fiscal deficits[9](see Table 7.3).

*Table 7.3. Key statistics of the new EU member countries*

| | 1. % | 2. % | 3. % | 4. % | 5. %/GDP | 6. %/GDP |
|---|---|---|---|---|---|---|
| *Fixed exchange rate (ERM2) members* | | | | | | |
| Cyprus | 77.5 | 2.0 | 4.4 | 4.0 | –4.4 | –6.2 |
| Estonia | 41.2 | 4.8 | 10.0 | 1.4 | –13.7 | 2.4 |
| Latvia | 37.1 | 7.5 | 10.5 | 2.9 | –9.1 | –1.9 |
| Lithuania | 42.7 | 8.9 | 12.7 | –1.1 | –6.1 | –1.8 |
| Malta | 64.7 | 0.4 | 8.2 | 1.3 | –3.4 | –9.7 |
| Slovenia | 71.3 | 2.3 | 6.5 | 5.7 | 0.2 | –1.9 |
| *Floating exchange rate members* | | | | | | |
| Czech Republic | 63.8 | 4.1 | 8.3 | –0.1 | –4.8 | –13.0 |
| Hungary | 55.1 | 3.6 | 6.3 | 4.7 | –7.3 | –6.0 |
| Poland | 42.7 | 4.2 | 18.2 | 0.7 | –1.3 | –4.0 |
| Slovakia | 48.3 | 4.8 | 17.9 | 8.5 | –5.7 | –3.7 |
| EU-15 | 100.0 | 1.2 | 9.0 | 2.0 | 0.1 | –2.4 |

*Notes*: 1. national income (PPP) per capita compared to the EU-15 average; 2. real GDP growth rate; 3. unemployment rate; 4. inflation rate; 5. balance of payments, current account; 6. public sector budget deficit. The figures for the smaller countries refer to 2003, for the larger countries and the EU-15 are OECD projections for 2005 (except national income per capita).

*Sources:* Danmarks Nationalbank (2004), Table 1 and Figure 3 (based on 'European Commission spring economic forecast 2004-05'); Organisation for Economic Cooperation and Development (2004–5).

Although the EU-10 countries have chosen two different sorts of exchange rate arrangements, all of them are characterized by a substantial deficit on the current account and high unemployment (see Table 7.3). These macroeconomic imbalances indicate unambiguously that the exchange rates are overvalued – even in those countries with a free floating exchange rate. This is due in part to a strong inflow of foreign direct investment, but also to the fact that factors other than relative prices matter when currency traders form their expectations.

Poland has had an increasing rate of unemployment and a substantial balance-of-payments deficit for more than ten years. Until 2001, the deficit in the current account was around 5 per cent of GDP, then the exchange rate

was made free floating. This gave rise to a subsequent fall of more than 30 per cent in the real effective exchange rate (see Table 7.4) and an improvement of the current account.

Slovakia has also adopted a floating exchange rate, but employment is suffering from a highly overvalued currency. It needs a macroeconomic adjustment, probably an experience similar to Poland with a substantial drop in the exchange rate. This seems unavoidable, because the inflow of foreign direct investment has forced the local currency to appreciate much above a sustainable level. Then it is a matter of robustness in the financial sector to prevent this drop to expose a genuine financial crisis.

In fact, in the Slovakian case it is obvious that a fixed, but adjustable exchange rate regime would have been preferred from a stability point of view (see Table 7.1).

*Table 7.4. Development of the effective, real exchange rate*

| Country | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|
| Czech Republic | 90.4 | 98.4 | 100.0 | 106.9 | 104.7 | 114.4 |
| Hungary | 122.9 | 121.6 | 100.0 | 92.0 | 91.8 | 84.2 |
| Poland | 87.9 | 93.7 | 100.0 | 102.4 | 102.2 | 107.5 |
| Slovakia | 82.6 | 89.6 | 100.0 | 108.9 | 127.3 | 134.0 |
| EU | 101.0 | 97.5 | 100.0 | 100.8 | 91.0 | 93.8 |

| Country | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|
| Czech Republic | 116.9 | 115.0 | 117.8 | 125.1 | 122.4 | 117.6 |
| Hungary | 85.0 | 77.5 | 84.8 | 97.0 | 101.5 | 105.7 |
| Poland | 101.3 | 101.1 | 104.6 | 94.5 | 77.6 | 69.1 |
| Slovakia | 131.1 | 141.0 | 135.9 | 138.6 | 148.0 | 158.3 |
| EU | 92.8 | 84.0 | 85.2 | 89.9 | 101.1 | 106.0 |

*Source*: Organisation for Economic Cooperation and Development (2004), *Economic Outlook*, December, Table 44.

For the EU-10 countries the effective, real exchange rate is of special importance, because they are (except for Poland) highly dependent on foreign trade. Imports and exports account for a larger share of GDP in these countries than they do for the EU-15. Exports are determined by international

competitiveness and foreign effective demand. Unfortunately, the effective demand from the EU-15 is held back by low growth, caused by a restrictive fiscal policy (SGP) and a monetary policy directed towards price stability. The new member countries do not benefit from any kind of 'Marshall Aid' like the Western European countries did 50 years ago. They have to rely upon their competitive abilities and on access to the EU market (which has 450 million consumers).

The economic performance of the EU-10 countries is highly exposed to external imbalances. A successful growth path has to build on exchange rate arrangements, where they have gotten rid of external constraints imposed by balance-of-payments imbalances. Otherwise, their foreign debt will pile up, and make interest and dividend payments abroad become a millstone around their necks.

To be true, when the new EU members signed the EU Treaty, they accepted the political goals of the SGP and gave full membership in the EMU and the single European currency a high priority. This means that they are asked to conform to the convergence criteria. One of these criteria is to join the ERM2 and then not to devaluate the currency at any time in the future. To make these requirements successful, it is important that any country running a persistent deficit in the current account is allowed to make a pre-entry adjustment of the exchange rate to a sustainable level in a longer perspective.

A sustainable exchange rate should take account of:

- the needed structural adjustments,
- an unavoidable excess inflation as a part of the transition process,
- the correction of the actual balance-of-payments deficit,
- any over-valuation due to net inflow of foreign direct investment,
- slow growth of the EU-15.

Unfortunately, it is rather likely that the ECB will insist on fixing the ERM2 exchange rate at the existing level without considerations to future development. Using the actual exchange rate (which in fact was the case with the six smaller countries both in June 2004 and May 2005) means eliciting adjustment problems in the future. One could just look at the recent experiences within the EMU, where for instance Greece and Portugal are struggling with unemployment and balance-of-payments deficits. Hence, a strong competitive position within the EU is a necessary condition for these newly industrialised countries to keep growth rates high, especially when the increasing global competitive pressure is taken into consideration.

Ironically, there is a real risk that the earlier the EU-10 countries embark

on the road to EMU membership, the more likely it will happen at a long-term unsustainable exchange rate, which might damage the needed structural adjustments owing to increasing balance-of-payments constraints. Lack of effective demand is a recipe for economic and political crises. It is a matter of dispute to what extent the negative outcome of the referendum in France and the Netherlands (spring 2005) can be referred to the unsuccessful economic development during the EMU period.

One more complicating factor is that the slow economic growth of the EMU countries caused by the SGP has made the balance of payments of the new member countries deteriorate even further in 2004–05.

**Instability in a Period of Transition**

Within any fiat-money economic system, there is a risk of run-away inflation. When a government wants to reap a short-term benefit independently of the longer-term costs, borrowing from the banking system at a 'special' rate of interest is a temptation. Avoiding inflation requires a firm hand when the economy is in a process of political transition. The clearing of structural imbalances might be facilitated through changes in relative prices, with the risk of causing the overall price level to move upward more quickly than productivity gains.

In fact, transition economies have some structural similarities with a post-war economy. Relative prices have not adjusted for a long period of time; a number of traditional market institutions are missing – especially in the financial sector. There is a risk that inflation will emerge and build into the market system through a wage–price–wage spiral, fuelled by loose monetary and fiscal policies and not checked by foreign competition. This was the case in Latin America for quite a number of years. It could have been the case of Eastern and Central Europe. The prospect of becoming a member of the EU, however, gave support to the viewpoint that monetary stability should, at least temporarily, be given an overarching priority.

From a post-Keynesian perspective, it makes more sense to aim at balance in the labour market (full employment). Private real investments are instrumental in that respect, and could be supported by a low rate of interest. As we know from macroeconomic theory, a public sector balance cannot be analyzed in isolation. A specific target for the public sector budget has to be formulated with respect to the entire macroeconomic system. Otherwise, there is a risk of an inconsistent strategy, where the fulfilment of one specific target is a blockage to other important macroeconomic goals. In this coherent macroeconomic perspective, it becomes obvious why a specific target for the

public sector budget easily can be one more constraint on effective demand, and hence an obstruction to full employment.[10]

**Looking Ahead**

The future is politically and economically uncertain. For this reason, it is beyond any doubt that the smallest of the ten new EU countries want to be full member of any EU institution as quickly as possible, and is willing to adopt the single currency. This is mainly a consequence of the past. These countries search for political security, which is found in the core of the EU institutions. Furthermore, these small economies are so small that they cannot rock the EMU boat even if they go on with macroeconomic imbalances.

But the EU institutions were originally designed to fit a small number of rather homogenous countries. At the time of writing, there are 25 member countries, and within a foreseeable future another eight countries might become members of the EU. Although they are all rather poor and less developed economies, they could, within ten years (or even less), conform to the Copenhagen criteria making EU membership possible. In that case, the diversity within the EU will have increased even further. It would probably be more correct to speak, at least for a while, about disintegration rather than integration. This development would raise the question of an EU with several speeds of integration and in different dimensions. In practice, this debate about how fast and how far the euro area can be enlarged has already started.

In the previous section, we argued that macroeconomic stability of the transition economies requires that effective demand should grow in tandem with potential output. This can be supported by an active *national* policy making based on the following principles:

- Direct fiscal policy towards full employment, namely, matching the structural budget to the private sector's savings/real investment imbalance.
- Prevent the rate of interest (and share prices) to drift too far away from the fundamentals (high employment and low inflation); when needed, reintroduce international capital controls until macroeconomic balance is established through an active monetary policy.
- Ensure a current account balance (or surplus) by a fixed, adjustable, and slightly undervalued exchange rate *à la* Bretton Woods.

Now, as long as new-consensus macroeconomics is the 'mainstream' economics within the EU, macroeconomic stability is identified, as we mentioned above, with a balanced (so-called sound) budget, strict monetary

policy, and fixed exchange rates without any consideration to employment and balance-of-payments problems.

If the transition economies decide quite quickly to become members of the EMU, they run the risk of being caught in this 'mainstream economics' trap. They might initially gain from a lower real rate of interest and an unlimited access to foreign capital. This is a real temptation in the short run; but it represents a risk in the longer run, if the rate of inflation in these countries continues to stay above the EMU average. Some European countries have in varying degrees experienced such a development, where the difference in cost levels has accumulated to such an extent that the foreign competing sectors are hit hardly. There is no easy solution to this problem within the EMU. Without an extended EU budget and a much higher cross-border labour mobility, it is difficult to imagine that national differences can be equalized within the foreseeable future.

## CONCLUSION

Within the EU the arguments of new-consensus macroeconomics have hitherto dominated. In this respect, it is often argued that a monetary union with low inflation and balanced public budgets is a precondition for 'growth and stability'. Within the general equilibrium model it is easily shown that monetary control and a balanced budget are the best and most reliable instruments to secure growth, stability, and high employment.

The history of the EMU is somewhat different. Ever since it was designed in 1992 and implemented in 1999, economic growth has been unprecedentedly low and unemployment equally high in a number of countries. This development has, of course, questioned the relevance of the theoretical arguments behind the EMU. It is hardly an exaggeration to say that the predictions made by the new-consensus economists about the macroeconomic gains from the EMU have not yet materialized. A number of question marks with respect to the design of many European macroeconomic institutions have been set more and more frequently.

As an alternative, post-Keynesian macroeconomics emphasizes the constraints on effective demand as a major cause of this disappointing development. The design of the EMU process has a number of built-in deflationary biases. Furthermore, the new-consensus macroeconomics confuses macroeconomic targets with policy instruments. The public sector budget, the exchange rate, and the rate of interest are the instruments. Growth, inflation, and income distribution are the targets. To make an

instrument a target is counterproductive for economic policy making. As we have shown, the specific limit of the public sector budget became quickly an obstacle to macroeconomic stability. A fixed exchange rate can be useful as an instrument to break expectations of continued high inflation; but to make a monetary union a target of its own is an example of confusing aims with means to prosperity.

Further, to subdue the discretionary power of national fiscal policy by forcing all member states into a one-sized straightjacket of convergence criteria and fiscal control is one more example of misunderstood homogeneity. EU countries are rather different in structures and in political preferences. A common budget rule means in reality very different constraints on effective demand, which in the end might increase diversities within the EU and cause disintegration. This process will be enforced if the EU-10 countries prematurely join the EMU.

With regard to the EU-10 countries, a better macroeconomic policy would be to release them from the severe ERM2 requirement of a fixed exchange rate, recalling the history of the European Monetary System in the early 1990s. By contrast, an expansionary economic policy undertaken by the rich EMU countries, combined with substantial aid to the new members – like the 'Marshall Aid' – could much better facilitate the still needed structural adjustments. Such a 'helping-your-neighbour' policy would – as it did in the early 1950s – make effective demand higher and at the same time reduce the balance-of-payments constraint. Without doubt this extra foreign aid would increase economic growth in the EU-10 countries, which by itself could reduce public budget deficits, and makes the recipient countries spend more on imports, when the balance-of-payments constraint is relaxed.

In addition, it might be easier for the new EU member countries to reduce inflation rates, if they could participate at a later stage in the ERM2 at a *sustainable*, but still adjustable, exchange rate. For instance, the exchange rate arrangement could be quite similar to the Bretton Woods agreement, but with an expanded band of fluctuation, for instance ±15 per cent, where all countries (surplus as well as deficit countries) have the right and duty of adjusting the central rate whenever it is found necessary by some objective criteria.

Last, but not least, according to post-Keynesian macroeconomic theory the EU Treaty should be redrafted with regard to the role of the ECB. The macroeconomic reality does not conform to the abstract equilibrium model of new-consensus macroeconomics, which supports the construction behind the ECB. Post-Keynesian economists have shown empirically that there is no direct link between money supply (which is endogenously determined and

cannot be controlled) and inflation. In fact, monetary policy can affect effective demand, real investments, and further on growth and employment. To ask the governor of the central bank to secure price stability is a contradiction in terms, because he/she has no instrument to control inflation. In the real world, monetary policy (like fiscal and exchange rate policies) should be pursued as an integral part of a *national* economic policy of the individual EU country, which is undertaken in mutual respect of the other member countries and of the EU as a whole.

## NOTES

1. Davidson (2002a) gives a standard presentation of the post-Keynesian views on international economics.
2. The new consensus school considers its analytical framework of general equilibrium models based on microeconomic foundations and rational expectations as ideology-free. This is what it calls 'economics proper'. Therefore analytical deviations from this 'objective' model are caused by ideology or ignorance. This claim of ideology-free theory with regard to the construct of the EMU is challenged by a number of contributions in Moss (2004).
3. Employment in Germany increased from 37.2 million persons in 1997 to 38.9 million persons in 2001. See www.laborsta.ilo.org.
4. Davidson (2002b) elaborates on a proposal for a re-establishment of the Bretton Woods system in a modern design.
5. These countries have a population between 500,000 and 3 millions inhabitants.
6. In March 2005, the EU Finance Ministers decided to pursue a less strict interpretation of the SGP in the future. In practice, this implies that fiscal policy in the future will not have to be tightened as much as originally required by the European Commission; but the upper limit of 3 per cent is still unchanged.
7. De Grauwe and Schnabl (2003) put forward a balanced view on political and economic considerations.
8. According to the EU enlargement plan, Rumania and Bulgaria will become members in January 2007.
9. From a superficially point of view there are some similarities with the US economy; but the real difference is that the US is the largest economy and the strongest political power which in any event seem very attractive for foreign investors.
10. This misunderstanding is now so well established that for instance the weekly magazine *The Economist* uses the phrase 'instability and stagnation pact' as a characteristic of the Stability and Growth Pact.

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