

# **EU Enlargement and the Adoption of the Euro**



**April 2004**

**AIB Global Treasury  
Economic Research Unit**

# Enlargement: The Accession Countries

- The following 10 countries are due to join the European Union on May 1st, 2004.

**Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia**

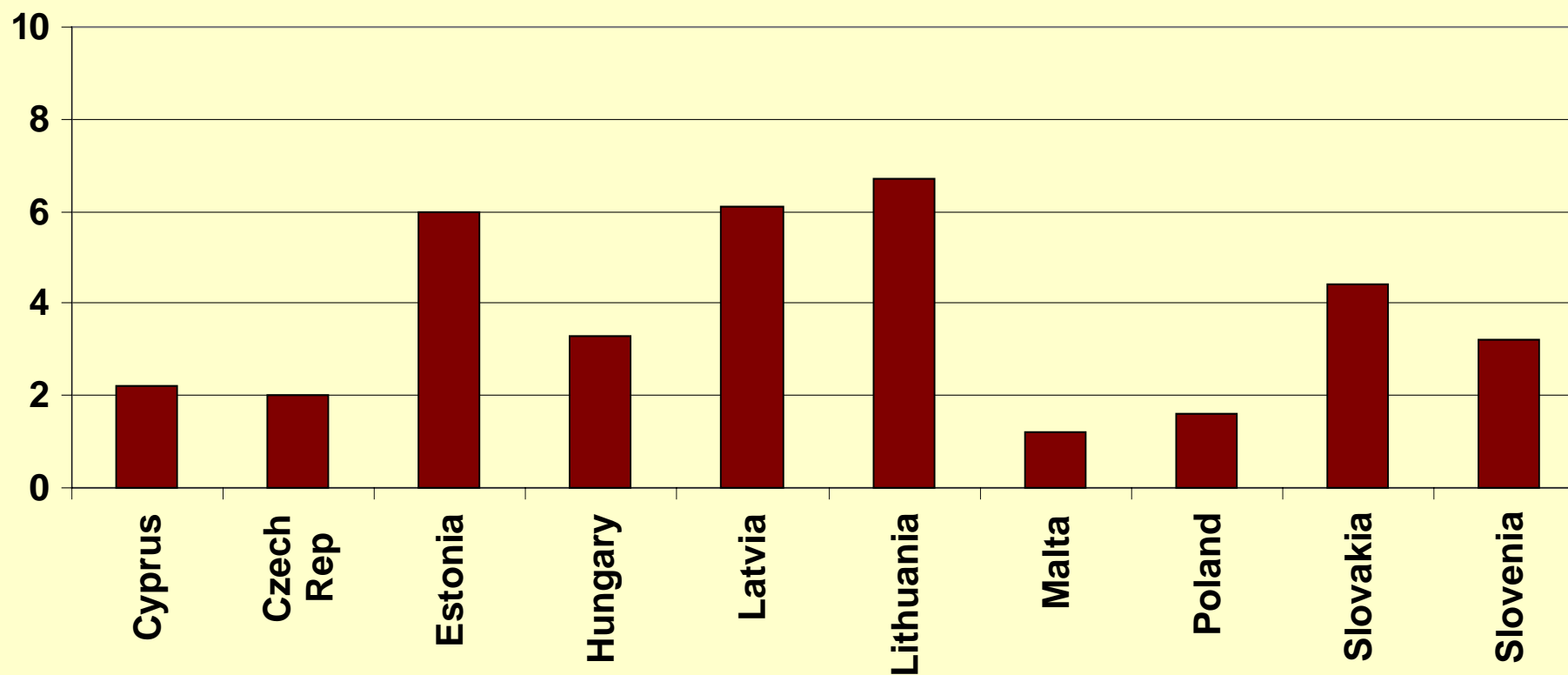
- This is the most ambitious enlargement in the history of the EU
- To put this in context, the combined GDP and population of the ten new countries accounts for just 4.5% of total GDP and 16.5% of the total population of an enlarged EU (EU-25)
- On enlargement, the EU will be larger on a population basis but poorer on per capita basis.
- It will also be more reliant on agriculture

# Accession Countries: Results of Vote to Join EU

<b>2003 Referendum Details</b>				
Country	Date	% 'Yes'	% 'No'	% Turnout
MALTA	Mar-08	53.6	46.4	91
SLOVENIA	Mar-23	89.6	10.4	60.3
HUNGARY	Apr-12	83.8	16.2	45.6
LITHUANIA	May 10-11	91.1	8.9	63.4
SLOVAKIA	May 16-17	92.5	6.2	52.2
POLAND	June 7-8	77.45	22.55	58.85
CZECH REP	June 13-14	77.3	22.7	55.2
ESTONIA	Sep-14	66.9	33.1	63
LATVIA	Sep-20	67	32.3	72.5

# Accession Countries: GDP

GDP Growth (Y-on-Y % Change)

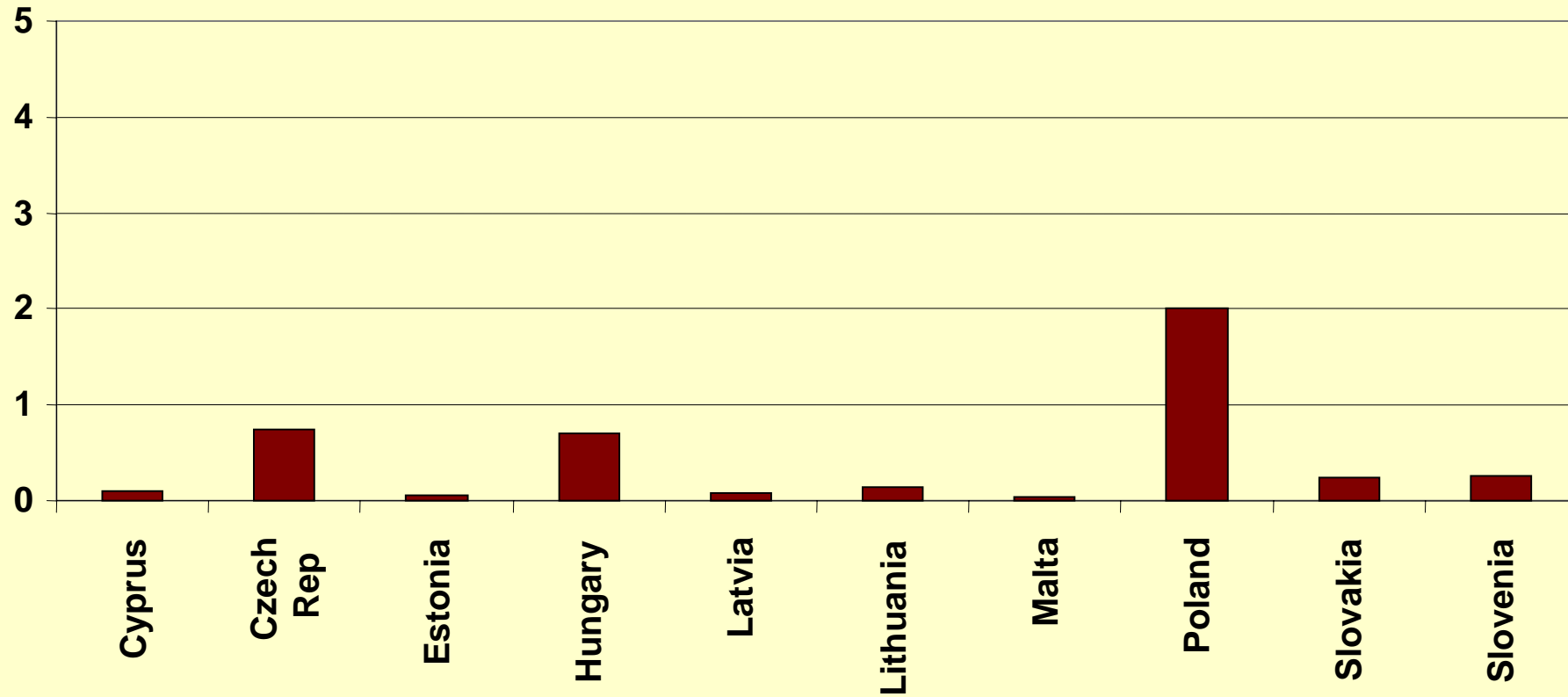


Source: Eurostat, 2002

# Accession Countries: GDP



Accession Country GDP as % of Total EU-25

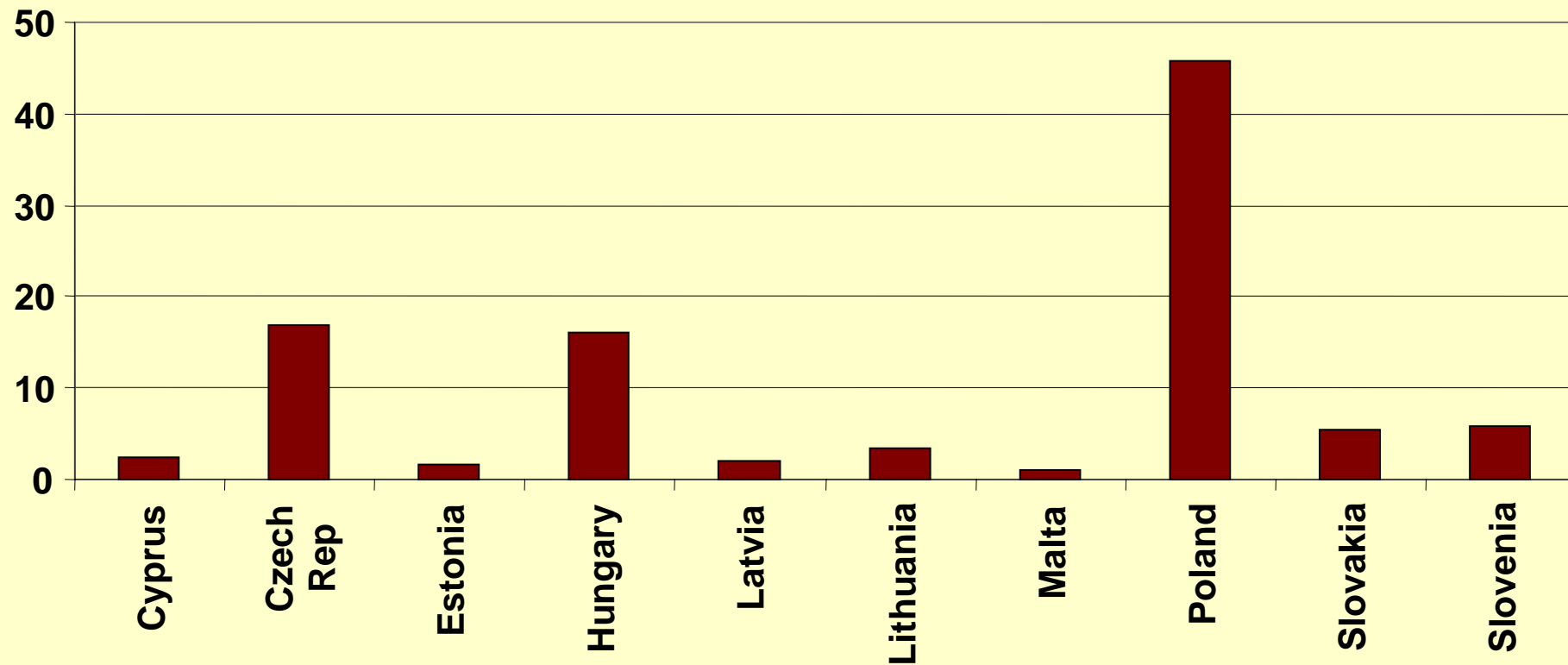


Source: Eurostat

# Accession Countries: GDP



Accession Country GDP as % of Total Accession Group

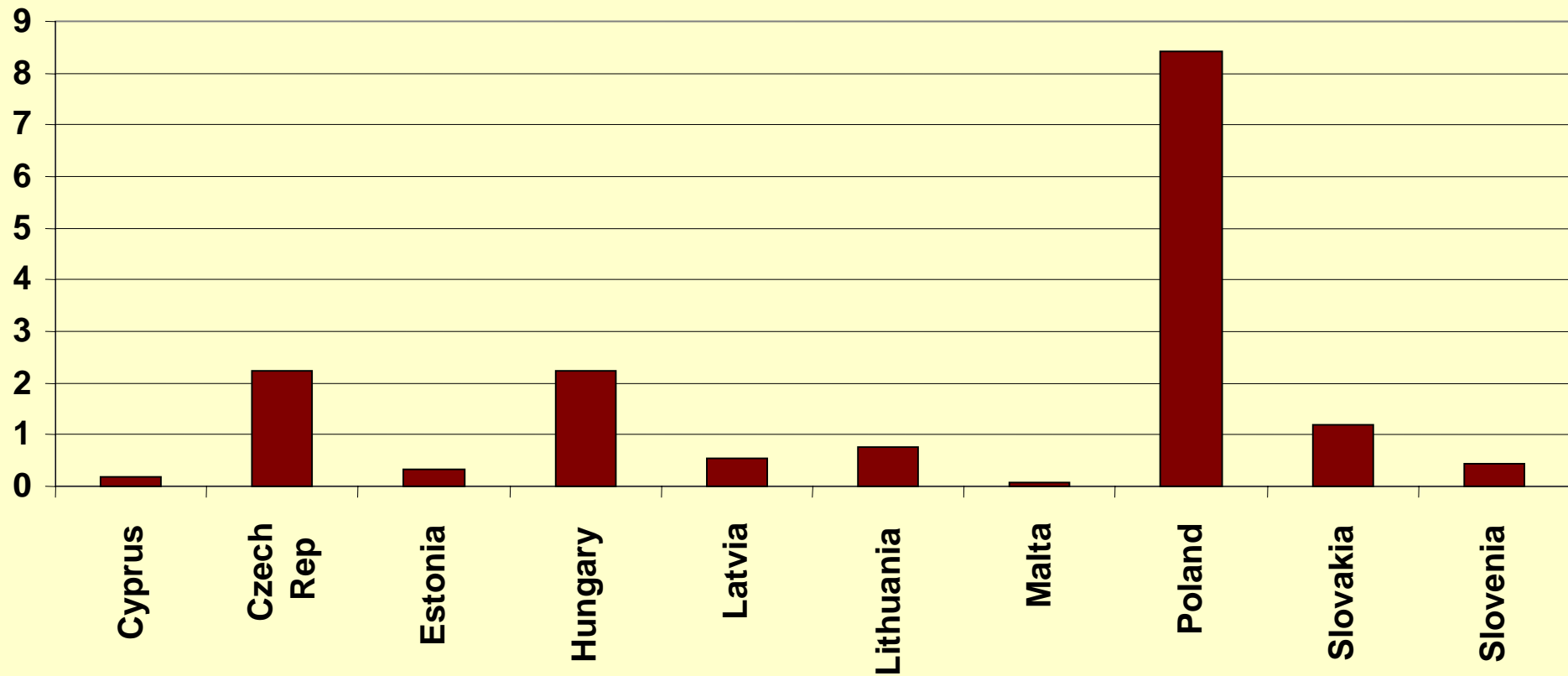


Source: Eurostat

# Accession Countries: Population



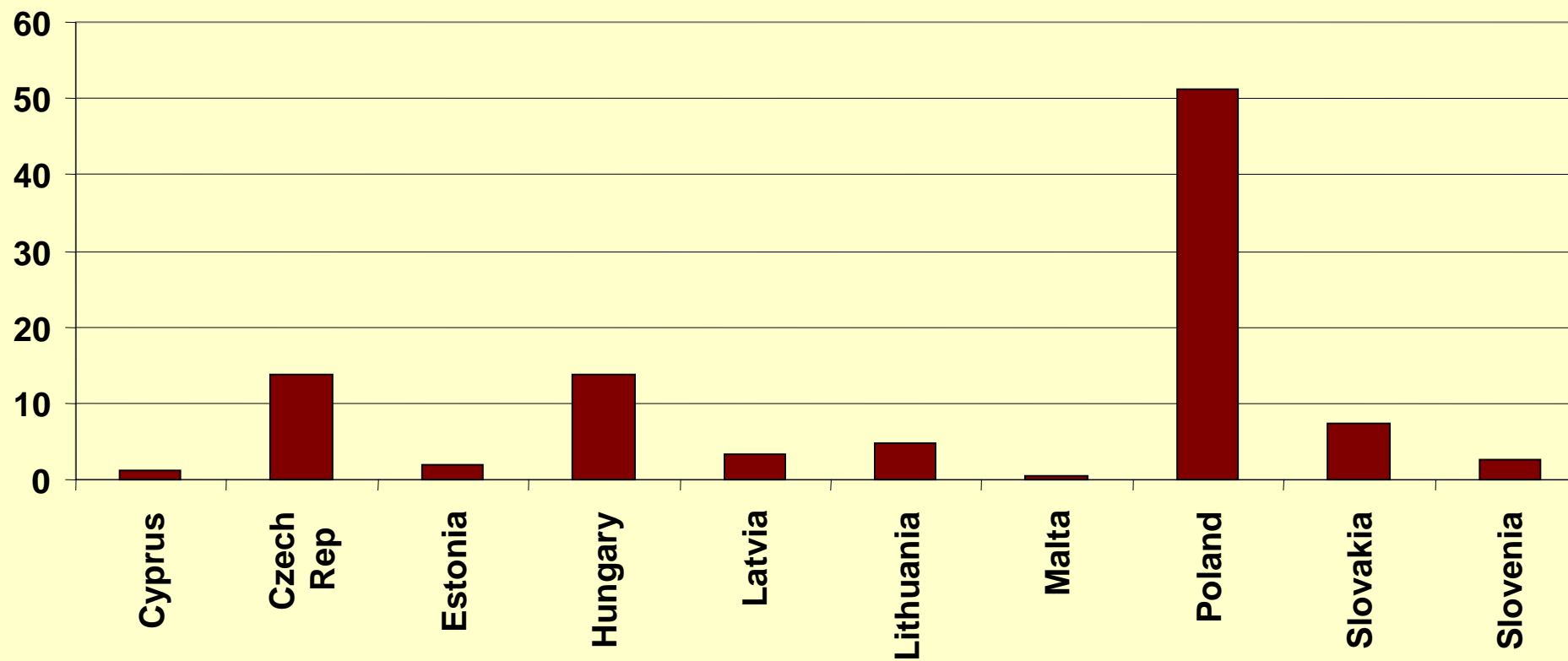
Accession Country Population as % of Total EU-25 Group



Source: Eurostat

# Accession Countries: Population

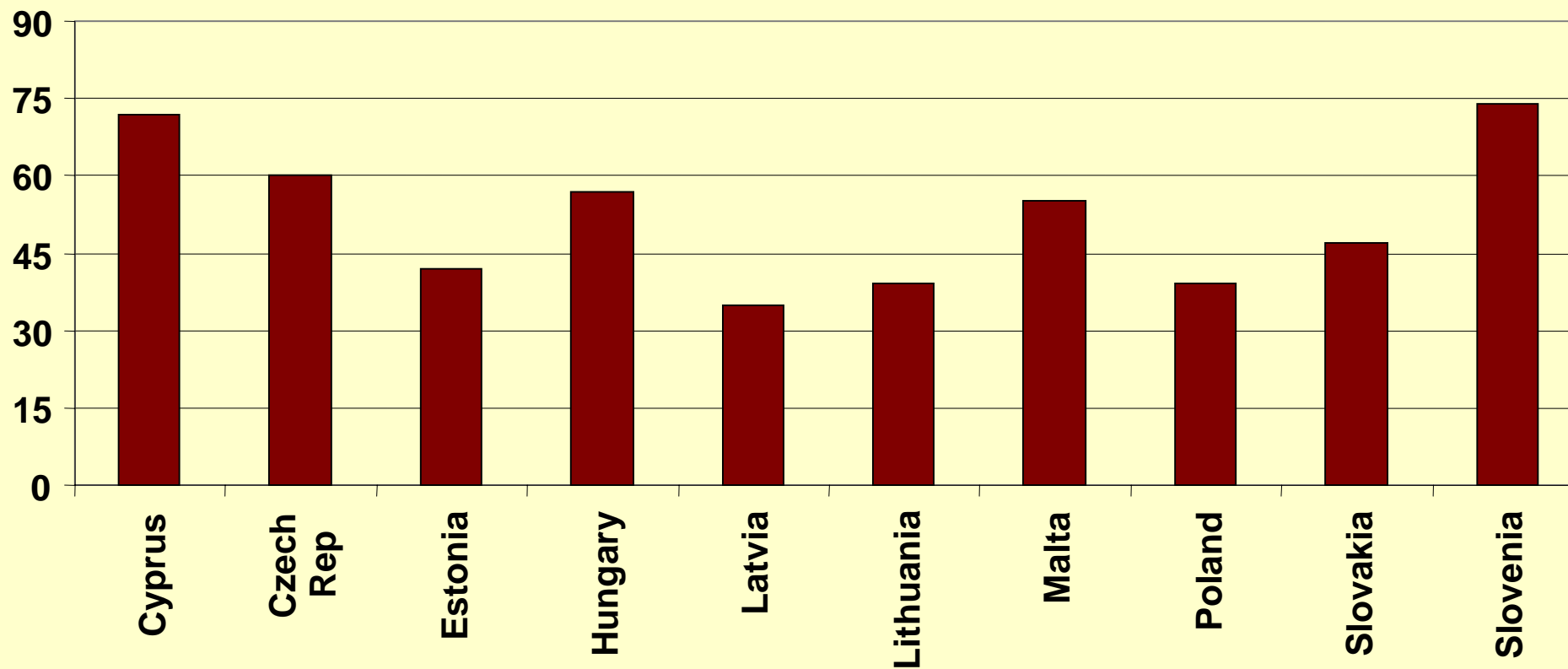
Accession Country Population as % of Total Accession Group



Source: Eurostat

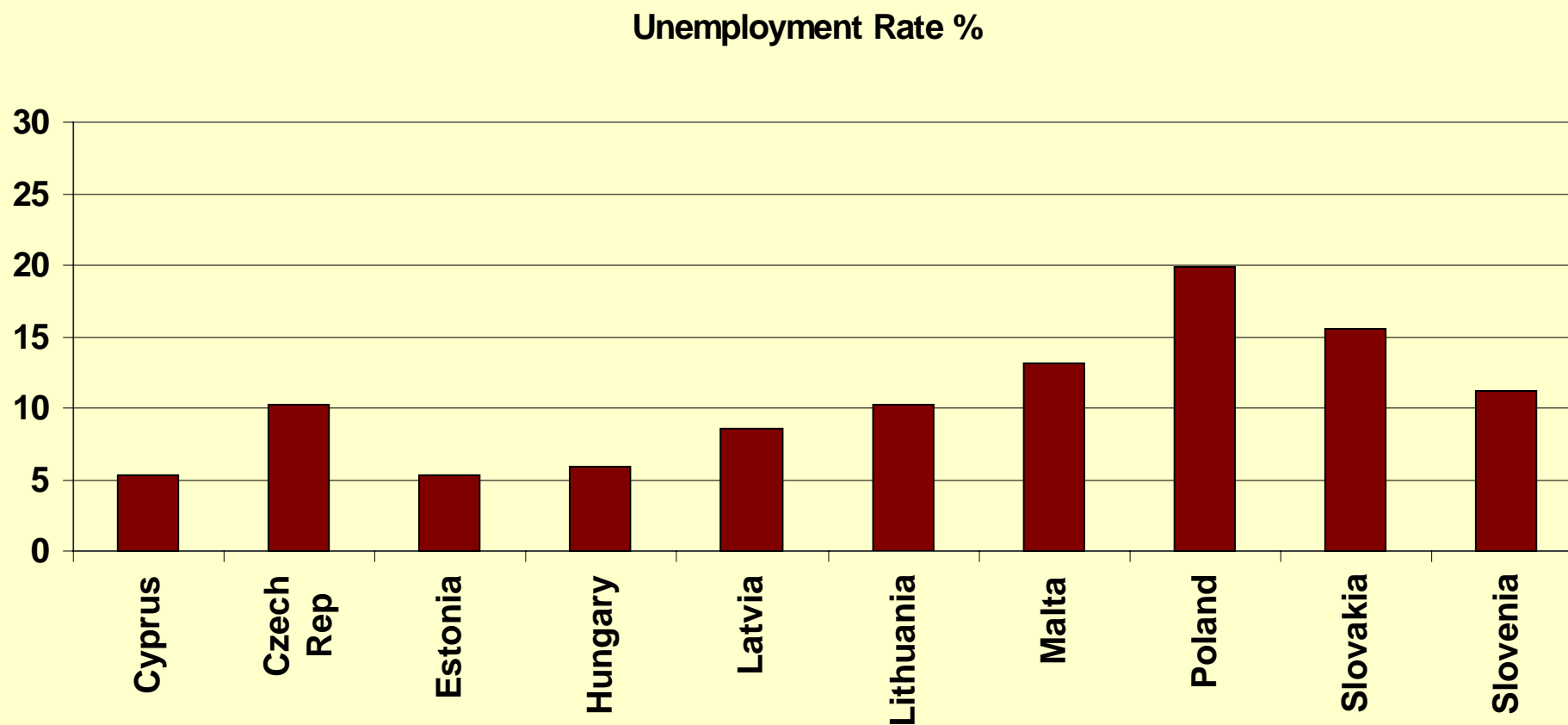
# Accession Countries: GDP per Capita

Accession Country GDP per Capita as % of EU Average



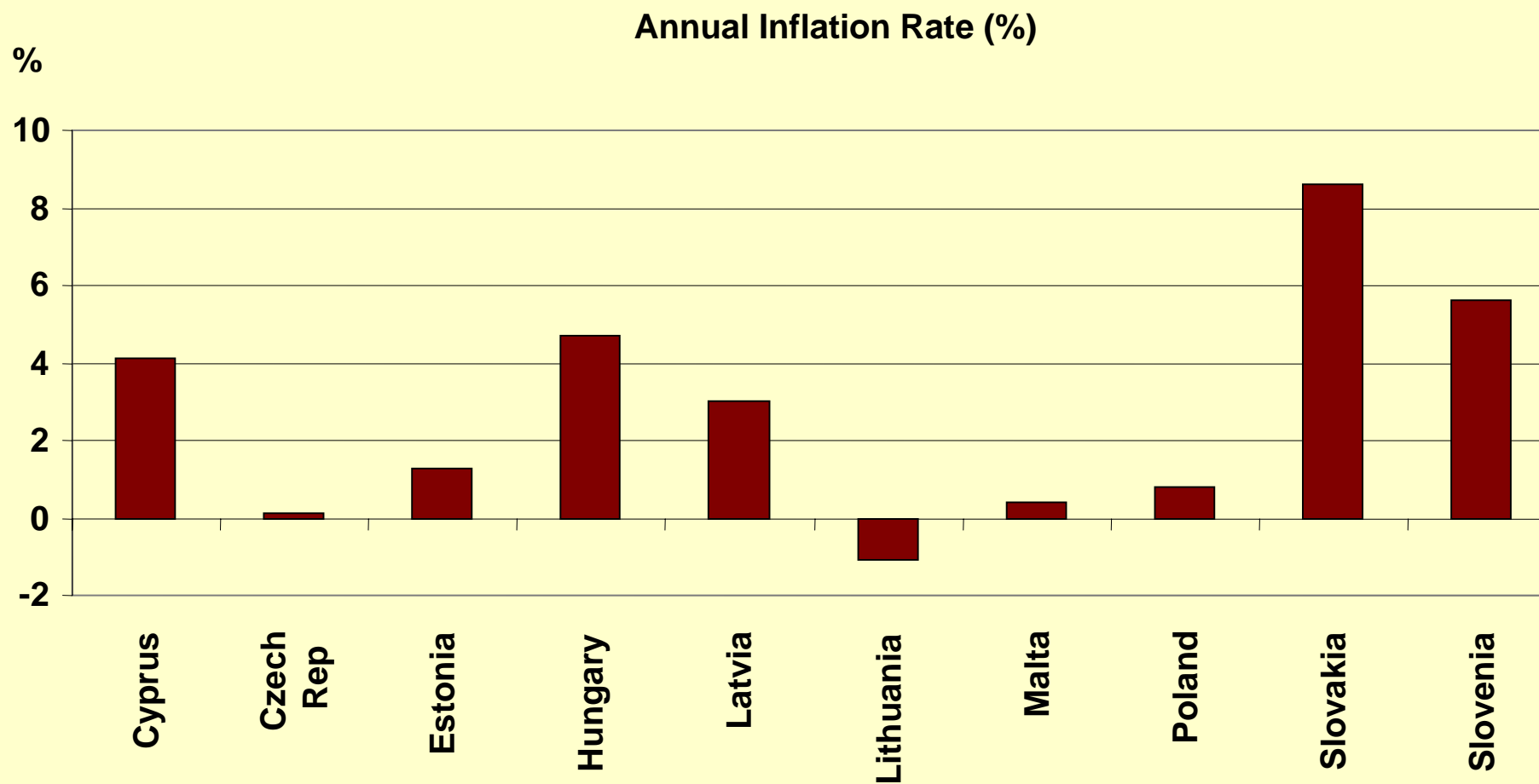
Source: Eurostat

# The Accession Countries: Unemployment



Source: Eurostat, 2003 except for Cyprus and Malta

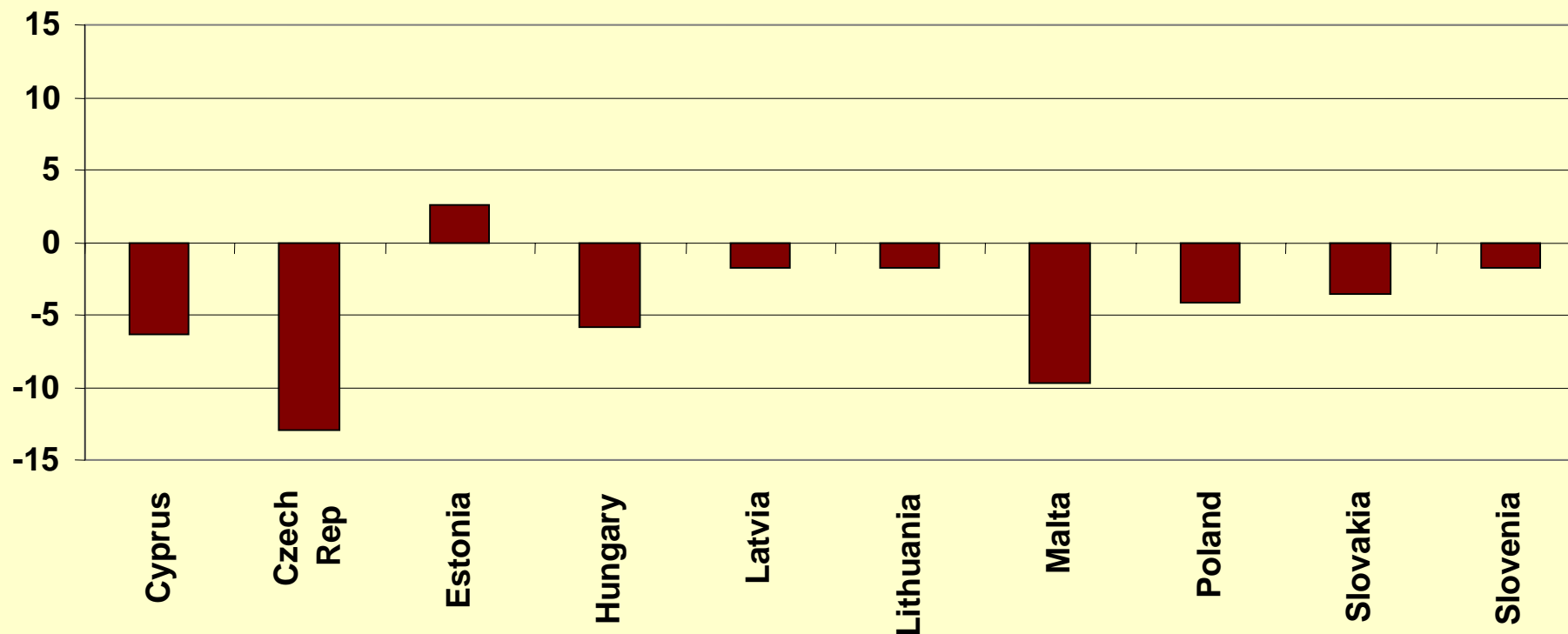
# The Accession Countries: Inflation



Source: Eurostat, 2003 except for Malta

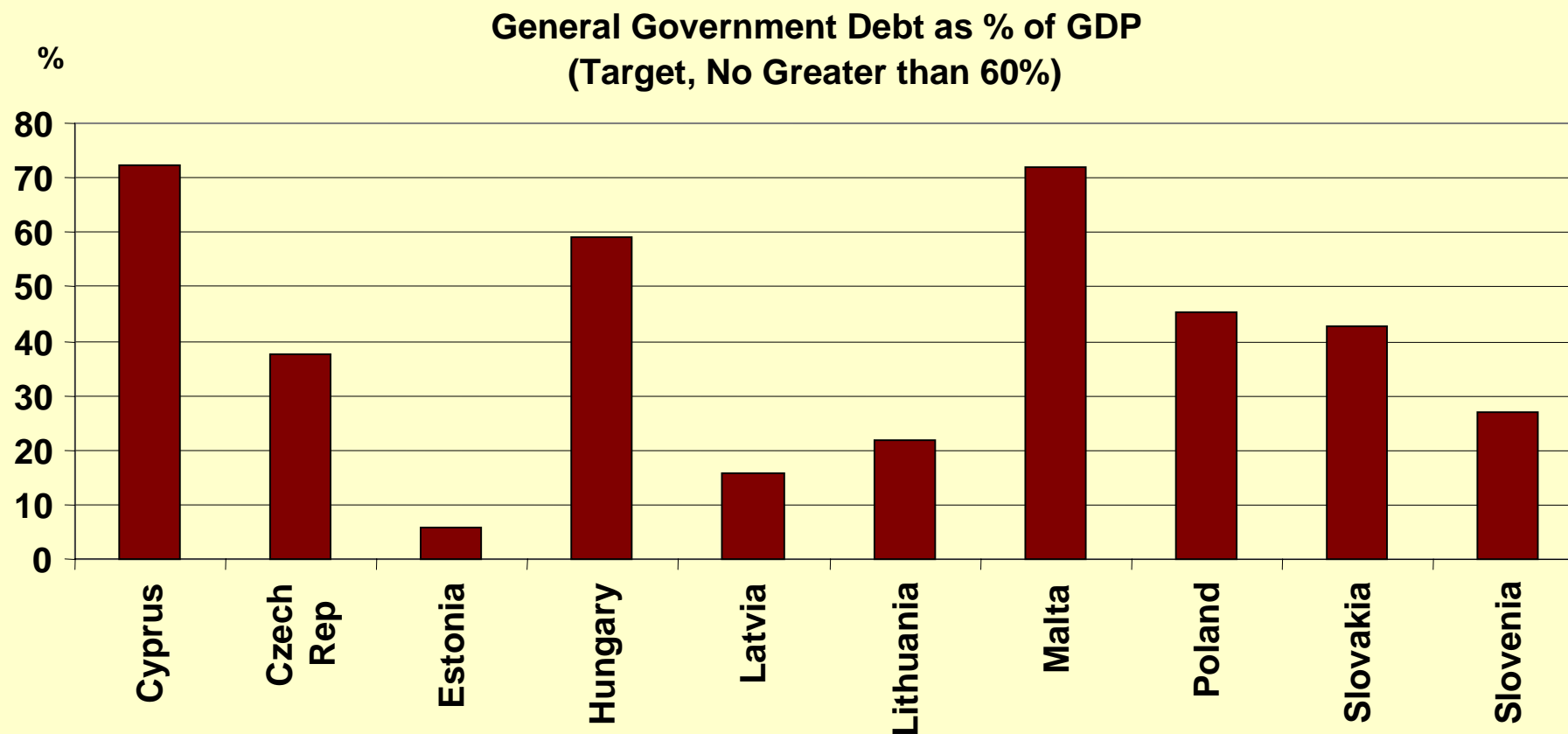
# The Accession Countries: Budget Balance

Budget Balance as % of GDP  
(Target, Deficit of No Greater Than -3%)



Source: Eurostat, 2003

# The Accession Countries: Government Debt



Source: Eurostat, 2003

# The Accession Countries & the Euro



- All ten EU accession countries have made a commitment to join EMU but will be required to meet the necessary membership criteria (Maastricht Treaty). To recap, these criteria are as follows:
  - **Inflation** can be no higher than 1.5% above the average inflation rate of the three eurozone countries with the lowest inflation rate
  - **Long-term interest rates** can be no more than 2% above the average interest rate of the three eurozone countries with the lowest inflation rate
  - **Budget Deficits** should be no more than 3% of GDP unless it has been declining substantially and continuously and is close to the reference rate
  - **Government Debt** should be no more than 60% of GDP unless it has been declining at a satisfactory rate
  - **Exchange Rate** relative to the euro should be within normal membership bands of ERM II ( $\pm 15\%$  of its agreed fixed parity rate with the euro) for at least two years. The parity rate and timing of ERM entry are decided by the ECB, candidate central banks, EU Finance Ministers and the European Commission

# The Accession Countries & the Euro

- Thus, the first step towards membership will be to join the ERM II mechanism
- While a number of countries want to apply for membership as soon as possible do not assume that this will happen in May 2004
- Most accession countries are some distance away from meeting all of the necessary membership criteria
- Furthermore, given the scale of structural development still needed in many of the countries, and thus the need for flexibility on fiscal and monetary policy, there are significant risks associated with premature membership
- Indeed, a number of the countries have expressed the view that they are in no great hurry to join the single currency.
- Both the European Commission and the ECB have also warned of the need to maintain flexibility
- Against this background, while many will shadow the euro, none of the accession country currencies are expected to join the euro before 2007 at the earliest
- Czech Republic, Hungary, Poland and Slovakia are seen as the “main players” in terms of joining the euro
- ***Note: The parity rates chosen at the time of joining ERM II are likely to be the eventual euro membership rates***



# Existing Exchange Rate Regimes

Cyprus	Pegged to the euro at a central rate of 0.585 with +/- 15% fluctuation margins that have been in place since January 1st 2001. Widened from +/- 2.25% bands that were introduced in January 1st 1999
Czech Republic	Crown is free floating after it failed to stay in a +/-7% band against the DEM/USD in 1997. Main reference now is the euro. A “managed float” as the CB has repeatedly intervened to fight currency depreciation.
Estonia	Currency board arrangement in place since June 1992. Pegged to the euro at 15.64 kroons in early 1999
Hungary	Introduced ERM-2 type band (+/- 15%) in May 2001, forint central parity rate currently at 282.36 in a 240.01-324.71 band
Latvia	Lat is pegged at 0.7997 to the IMF’s SDR world currency basket (includes USD/EUR/YEN/STG) since 1994. CB intervenes when lat breaks through 2% band limit versus SDR

# Existing Exchange Rate Regimes

Lithuania	Lita pegged to the euro at LTL3.4528 to 1 Euro since 1 February 2002. Prior to that was pegged to the USD. CB has said rate unlikely to change before euro membership
Malta	Maltese pound is pegged to a basket of currencies, which is made up of 70% euro, 20% sterling and 10% US\$. Central bank is in favour of an early adoption of the euro but as yet has given no indication of its preferred central rate.
Poland	Zloty has been fully floated since April 2000, when central parity and trading bands were eliminated. Both the central bank and the government are responsible for exchange rate policy.
Slovakia	Crown has been free floating since October 1998 after it failed to stay in a +/-7% band against the DEM/USD. Main reference now is the euro. Again CB has repeatedly intervened to fight currency depreciation.
Slovenia	“Managed float”. The CB has repeatedly intervened to fight currency depreciation against the euro, its main reference rate.

# Estimated Euro Entry Date and Rate



(Expressed as national currency : 1 EUR)

	Estimated Entry Date	Estimated Entry Rate
Cyprus (Pound - CYP)	2007	0.58
Czech Republic (Crown - CZK)	2009-2010	32.0
Estonia (Kroons - EEK)	2007	15.64
Hungary (Forint - HUF)	2009-2010	280.0
Latvia (Lat - LVL)	2008	N/A
Lithuania (Lita - LTL)	2007	3.45
Malta (Lira - MTL)	2007-2008	N/A
Poland (Zloty - PLN)	2008-2009	4.50
Slovakia (Crown - SKK)	2009	40.0
Slovenia (Tolar - SIT)	2008	N/A

# **Exchange Rate Trends Versus Euro**

# Cypriot Pound Versus Euro

CYP



Source: DATASTREAM

# Czech Crown Versus Euro

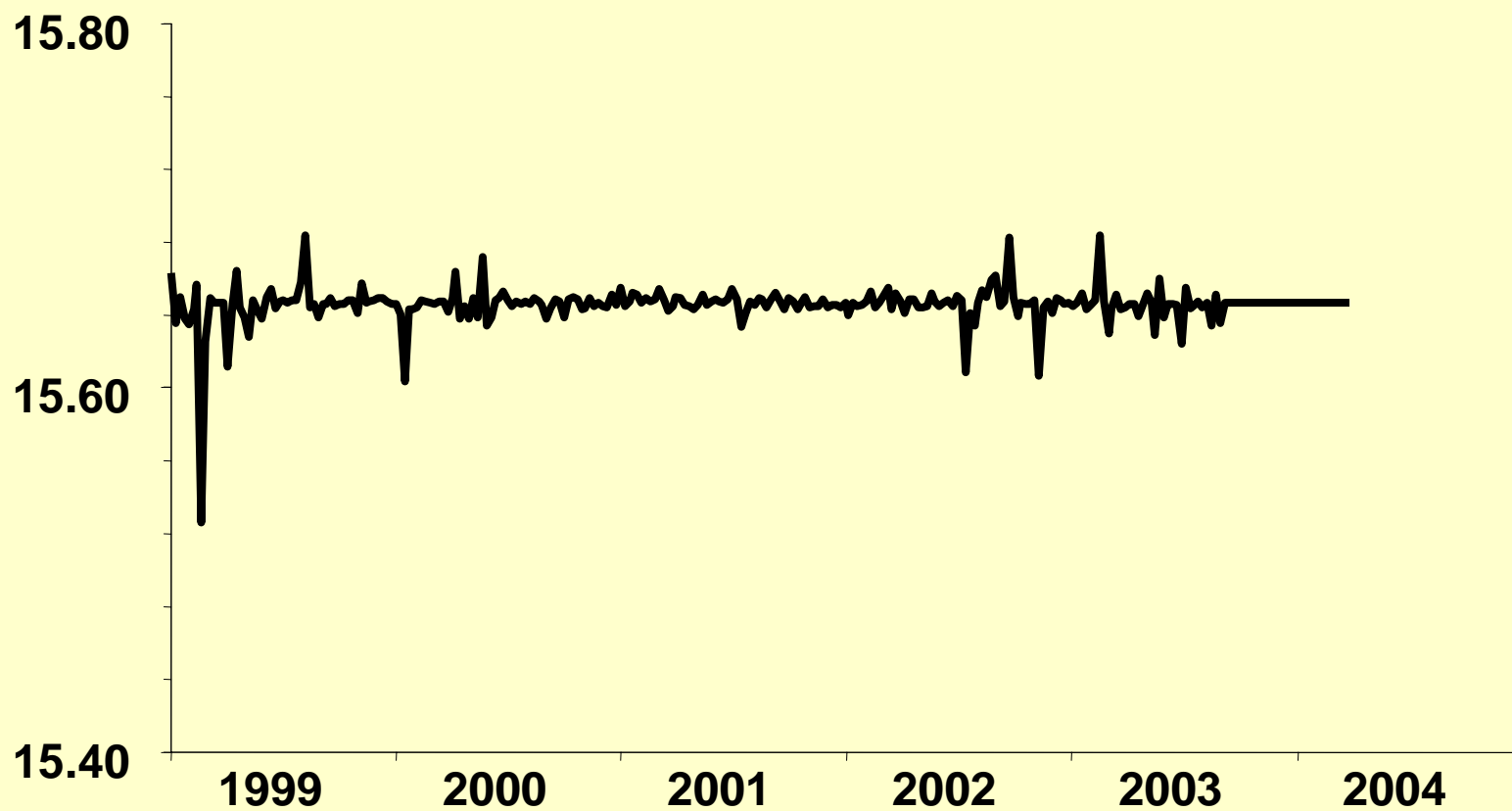
CZK



Source: DATASTREAM

# Estonian Kroon Versus Euro

EEK



Source: DATASTREAM

# Hungarian Forint Versus Euro



Source: DATASTREAM

# Latvian Lat Versus Euro

LVL



Source: DATASTREAM

# Lithuanian Lita Versus Euro

LTL



Source: DATASTREAM

# Maltese Lira Versus Euro



Source: DATASTREAM

# Polish Zloty Versus Euro



Source: DATASTREAM

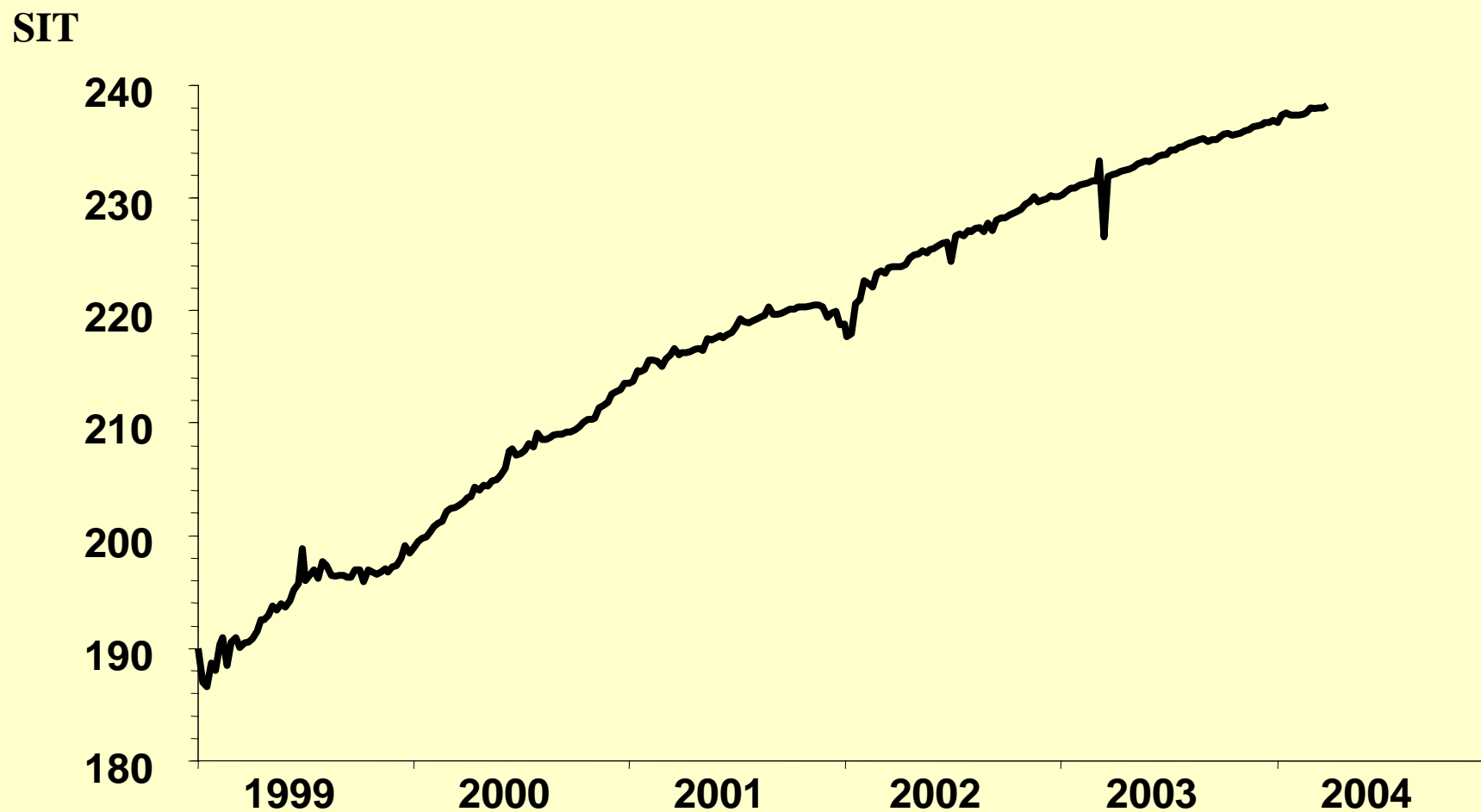
# Slovakian Crown Versus Euro

SKK



Source: DATASTREAM

# Slovenia Tolar Versus Euro



Source: DATASTREAM

# Meeting the Criteria, How the Countries Measure Up

- With the exception of Slovakia and Slovenia, national inflation rates are favourable
- With the exception of Hungary, interest rate trends are also supportive
- However, countries still face considerable hurdles to ensure that they are in a position to join EMU
- Many of these concerns relate to big budget deficits
- Political wrangling has hindered fiscal reform, pushing back likely ERM entry dates, particularly for the larger candidates like Poland, Hungary, the Czech Republic and Slovakia

# Conclusions

- **10 new countries will join the European Union on 1 May 2004**
- **The combined GDP and population of the ten countries accounts for just 4.5% of the total GDP and 16.5% of the total population of an enlarged EU (EU-25)**
- **All accession countries wish to join EMU**
- **However, there is no set time for convergence and the majority of countries have some way to go before meeting the necessary convergence criteria**
- **Thus, the earliest EMU entry date seen is for Estonia in 2007, with the majority of new EU members states not expected to join the single currency until 2008-2009**



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