THE EURO ZONE EASTERN ENLARGEMENT: CHALLENGES TO CURRENT MEMBERS AND THE ECB

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Abstract. *The eastward enlargement of the euro area entails significant implications both for acceding countries and for the current euro area member States or for the European Central Bank. The present analysis intends to assess the challenges up against the latter. The issue is analyzed from two points of view: firstly, relating to the risks caused by the group's drawing away from the status of optimum currency area, complemented by increasing development disputes and the difficulty of implementing a unique currency policy, and secondly – the issue of the voting mechanism within the ECB. When analyzing those two issues, we can easily notice that the difficulties for ECB and even for the actual euro zone member will increase. Since the extended euro zone will draw away from the status of optimum currency area, the costs of the monetary unification will increase for the new group as a whole (not only for the new members). Moreover, for the new euro zone, which is becoming more divergent, it will be very hard to find suitable monetary policy instruments for all. With reference to the second subject, the ECB will implement a new voting mechanism, but this will not solve the problem of having large economies with weak representation, and small economies that have strong representation in the Governing Council.*

Introduction

Even if tempted to analyze only the difficulties that new or upcoming members are likely to be up against, it would be erroneous to fail to analyze the challenges that enlargement poses to current euro zone members.

It is obvious that, should a new euro zone member accede without sufficient preparation, macroeconomic issues can emerge, and they automatically extend to the whole area, since there are tensions, disfunctionalities and difficulties that can endanger the euro credibility. Such problems can emerge both because nominal criteria get stretched and because there is a lack of structural or real convergence.

The present paper does not set out to analyze the issue from the point of view of a member state but from the viewpoint of the way in which the overall group is affected, including its central bank.

In this sense, there are two main aspects to be assessed with reference to the Economic and Currency Union enlargement. Firstly, a need to assess any eventual additional risks that might emerge in an enlarged currency union that draws away from the status of optimum currency area, and the more so since the degree if divergence and asymmetry is increasing, as well as the difficulties of a unique currency policy, suitable for all members. Secondly, the ECB voting mechanism is of interest, in the case of an enlarged euro zone.

Most studies show that there are issues as far as the structural and real

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convergence of new members to euro zone state is concerned. In this respect, we will proceed to see what ECB and euro zone member states might "fear" in the case of a much too early Eastern state accession.

The Optimum Currency Area and the Eastern extension of the euro zone

The Optimum Currency Area Theory is based on the seminal work of Robert Mundell (1961), but it was developed by some economists as Mc. Kinnon (1963), Kenen (1969), Frankel & Rose (1998) etc.[2]

The theory analyzes the costs and benefits of monetary unions (focusing on the cost component) ***and shows that the costs will be minimized if some conditions are accomplished***. For benefits side, a common currency reduces transaction costs and eliminates exchange rate volatility between union partners. Further, lower transaction costs and lower uncertainty encourage trade flows between members. For SEE countries, but not only for them, monetary union means credibility import and inflation expectation anchoring. This will bring stability and lower interest rates, as well as higher investment.

As about costs, the loss of monetary policy and exchange rate are the most important. Once in monetary union, a country has to comply with monetary policy decisions of the monetary union authority. As SEE countries are small countries it is clear that their interests will not weigh heavily in ECB's decision making. Without an autonomous monetary policy, the member countries' ability to respond to idiosyncratic shocks is reduced. Moreover, the fiscal constraints imposed by the Growth and Stability Pact restrict the ability to respond to asymmetric shocks.

Following this cost-benefits analysis, OCA theory shows the criteria that makes the monetary union successful. The theory is based on two types of criteria. The first one consists of **convergence and symmetry**: countries with the symmetric economic response will not experience high costs of monetary union. The second explains us that even with asymmetric response, countries still can benefit from monetary union if they have other mechanisms to adjust the economy **(the issue of flexibility)**.

The criteria that define Optimum Currency Area are listed below, by proposing a specific way of classification:

1. Criteria related to the possibility of asymmetric shocks (they can prove the existence of **structural convergence**):

a. The degree of economic openness
b. The similarity of production structure
c. Production and consumption diversification
d. Similarities of inflation rate

2. Criteria that prove the possibility of market adjust (market flexibility):

a. Labor mobility
b. Capital mobility
c. Price and wage flexibility
d. Financial integration

3. Criteria that show authorities the capability to intervene in the absence of the exchange rate mechanism:

a. Fiscal integration
b. Political union

4. "Meta" criteria; (the two criteria presented are more complex):

a. Similarity of demand shocks
b. Similarity of supply shocks

[2] For an interesting OCA theory analysis see Mongelli (2002)

Anyway, it is not easy to determine either if a group of countries represents an OCA or not. Most of the analysis[3] couldn't conclude that EU as a whole represents an OCA at the moment of the stage three of EMU. We can see instead, that there is a small group of member states that could form an OCA. Moreover we can follow Frankel and Rose analysis to find out that a group of countries can form a monetary union, even if is not an OCA[4]. From our point of view, that EU is a *"functional monetary area"*, an area that could have benefits from monetary integration even if it does not represent an OCA.

As regarding East European Countries, few of them seem to be ready for EMU from OCA theory point of view. If the euro area enlargement will imply only the countries that are ready from the structural convergence point of view, the specific pressures for the euro zone will not be high.

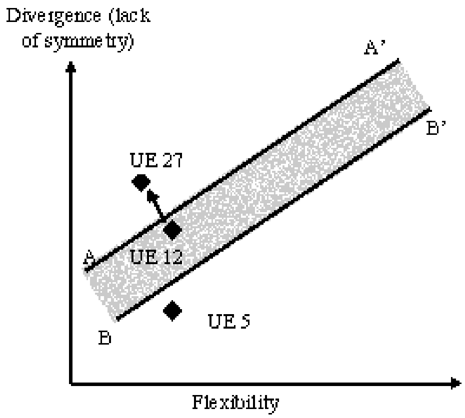
But if we consider an euro zone that comprises 25 (or even 27) members, we can say that this group is going far away from the OCA status, and there will be specific risks for the group as a whole, and not only for those members that are not prepared.

Graph 1 best represents the situation. Two concepts can be outlined in this case: the functional currency area and the optimum currency area. The AA line represents the outline of the functional currency area, in the sense that when a group of countries is above the line, then it lies outside the functional currency area, meaning that the risks entailed by making up a monetary union are high. The BB line separates the optimum from the functional areas, meaning in the case when a group of states are within this perimeter, they can make up a monetary union together, even if is not an optimum one.

In practice, the AABB rectangle hypothetically outlines the "grey" area of the monetary union costs and benefits, where it is not clear whether benefits are higher yet there are still premises for the monetary union to operate properly.

If for the 12 countries there are sufficient reasons to say that they could be in the grey area, a 27 member monetary union will be situated outside the gray area, and draw away from the status of an optimum currency area.

Even so, for the twelve countries there will remain premises for net benefits.



Graph 1 The monetary area optimum parameters related to the EMU eastern enlargement

What are we interested in, in fact? Euro is an EMU currency, comprising all members. Should this structure be jeopardized, **then all members are likely**

[3] Mc Morrow (1996), Bini-Smaghi & Vori (1993), Bayoumi & Eichengreen (1992) etc.

[4] See Frankel and Rose 1998, for endogeneity of OCA criteria. Those economists said that the criteria could be better fulfilled after unification, and countries should look after long term benefits.

to suffer, not only those whose economies do not evince OCA criteria. Therefore, drawing away from the optimum currency area is an element accounting for the qualms current members (and the ECB) have when it comes to an early accession of new members to the euro zone. They might want new member states to switch to euro after they come close to the structural convergence and flexibility requirements set up, so that the risks involved in enlarging the EMU should be mitigated.

An important element we should take into account is Great Britain's accession to the EMU, since its impact can be more significant than the one of the 12 new members or of the future EU members. And this is because of the EU member states, Great Britain's economy is the least correlated with the euro zone. Moreover, the British GDP is approximately 17% of the EU GDP, as opposed to the 5% of the 12 member states' GDP.

The necessity of real convergence: why does it matter for EMU?

Real convergence means the reduction or even elimination of per capita GDP gap between the EU countries and candidate countries. This challenge of real convergence needs economic growth for SEE countries greater than EU's, which implies the convergence of prices and wages. Eastern countries have a weak performance concerning per capita GDP.

Should real convergence be reached within the EMU, it is to be expected that poorer countries should have growth rates that are superior to the overall euro zone, until the levels of prices and productivity no longer substantially differ. This process will go on due to competitive markets, until the GDP per capita is the same all throughout the euro zone.

Before 1999, there used to be a trend stating that an enlarged monetary union including Portugal, Spain, Italy and Greece will pose difficulties to the ECB in implementing a restrictive monetary policy. Experience has shown that "poorer" countries register higher growth rates than the strongest, France and Germany. Moreover, the real convergence process involving "poorer" countries also entails higher prices hence higher inflation rates. Such countries would rather have a harsher monetary policy than the ECB's current one, addressing the overall interests of the euro zone.

Currently, even a fast convergence in the case of Portugal, Spain or Greece is not likely to pose problems for the Eurosystem to reach its inflation target. These countries are nonetheless close to the EU average, and their ratio in the harmonized commodity price index for the euro zone is and shall remain low.[5].

After EMU enlargement, things became more complicated because ECB will follow a monetary policy for the euro area interest, and it will not look at a specific country's inflation.

Anyway the Eastern countries will still have a low per capita GDP at the moment of EMU accession, when they will have voting rights in the Governing Council. This will complicate the voting process, in the context of more dynamic economies.

That means that an enlarged euro area will be more dynamic and will need higher interest rates. Are there

[5] Spain and Portugal's ratios are 1,8 respectively 9,1, meaning that even in the case of rampant 10% inflation in these countries, the zone target can be reached if it is under 1% in the other countries. Anyway this situation could have negative effects by affecting the competitiveness of these economies.

any chances for higher rates to be in the interest of the euro area as o whole? Which are the challenges for the Governing Council voting system? How important will be the inflation rate in Eastern countries for euro area inflation? We can see a few more challenges that EMU members as well as Eastern Countries have to meet.

From this standpoint, we can see that both the ECB and the euro zone states would have reasons to fear new members acceding to the EM, even the more so if we take Great Britain's accession into account.

Difficulties in the New ECB Decision-Making System

The necessity of a reform of the voting mechanism

The EMU institutional framework is characterized by centralizing decision and decentralizing implementation. The voting mechanism is extremely important since the participation of national representatives to decision-making is not to hold national interest into account. Even if the current mechanism is deemed adequate, the situation is likely to change following EMU enlargement by new members.

The prospect of EMU enlargement thus raises challenges for the ECB organizational structure, as well. Starting from the assumption that the euro zone will be enlarged by 15 new members, and lacking an ECB reform, we would have a Governing Council comprising 33 members. The ECB Council would become the body having the highest number of voters, as compared with other decision-making structures of other central banks, such as the FED. Many analysts have proved that it will be very difficult for such a body to make monetary policy decisions.

Another issue of the enlarged euro zone would be an overemphasized representation of national central banks in the decision-making mechanism (as compared with Bundesbank or the FED, where the Executive Board members dominate decision-making bodies). Moreover, taking into account the low ratio of the new members' economies, they would have a political representation that surpasses by far the size of their national economies[6].

In this respect, the voting mechanism of the ECB decision-making bodies will change. There were a series of proposals for change in publications in the field, among which: setting up a limited participation Monetary Policy Council that would operate under the Governing Council; introducing constituents, as in the case of the IMF; increasing the Executive Board's number of votes or adjusting the national governors' vote rights function of the economic size of every country.[7]

Consequently, the reform issue has been seriously taken into consideration. In December 2002, the ECB Governing Council has unanimously decided on the content of the voting mechanism reform proposal, which is absolutely necessary when contemplating the euro zone enlargement prospects.[8]

Once the Nice Treaty was in force on February 1st 2003, the ECB has formally adopted a recommendation regarding the change of the Governing

6 For a sound analysis, see Berger et alia (2003).

7 Also see De Grauwe (2003), Berger (2003), European Commission (2004).

8 The proposal was made based on the Nice Treaty provisions. European leaders have been unable to find a solution at the Nice meeting but they have inserted the empowerment clause, which has allowed the Council to change the voting system based on a proposal from the Commission or the ECB.

Council's voting mechanism. The ECB recommendation was passed on to the EU Council in February 2003. based on this recommendation and taking into account the opinions expressed by the Commission and the European Parliament, The EU Council, convened at the level of state or government heads, has unanimously decided[9] to change article 10.2 of the SBEC statute. The decision was ratified by the 15 member states in order to be in force[10].

What does the decision comprise? According to it, all the members of the Governing Council will continue to attend meetings. Yet the number of national central bank governors having a right to vote will not be larger than 15, the 15 votes being covered by rotation based on a pre-set rule, whereas the Executive Board members will preserve their vote rights. In order to cover the necessity that governors with a right to vote should at all times be from countries that would represent together the euro zone interests, they will have the right to vote with a certain frequency, based on groups of countries.

Governors will thus be part of different groups, function of their economies' ratios in the euro zone, resulting by calculating an index that will comprise, apart from the GDP, the size of financial markets. When the number of countries in the euro zone reaches between 16 and 21, the rotation system will operate based on two such groups, and when the zone is made up of 22 members, the system will be based on three groups. Governors in each group will hold the right to vote for equal periods of time.

Let us now exemplify its operation with 21 and 27 members. According to the above-presented data, the proposal stipulates that once the EMU reaches 16 members, the number of national central bank governors with a right to vote in the Governing Council should be restricted to 15, based on the rotation system. Thus, in the case when EMU comprises 21 members, the two group system will be used. Member states among the 5 large economies will have 4 votes, whereas the other 16 countries will hold 11 votes. In case the EMU is enlarged to 27 members, the three group system will operate, where the first 5 economies receive 4 votes, the following 14 have 8 votes, and the other 8 will have 3 votes.

To conclude, the new vote system is characterized by soundness, being designed to adapt to the euro zone enlargement up to 27 states (the current EU states, which Romania and Bulgaria will join).

Nonetheless, one can appreciate that in time, the rotation system might prove difficult even if sound, and ***that it is likely to lead to decision-making gaps when the euro area comprises a high number of members.***

Anyway, even in the event that reform does not fully do away with difficulties in the decision-making system, it nonetheless represents a step forward. We should not forget that Bundesbank or the Federal Reserve System (FED) have improved the operation of their bodies in time. It took years for these institutions to learn how to combine the benefits of a regional structure with the effectiveness of a centralized one[11].

[9] On 21.03.2003.

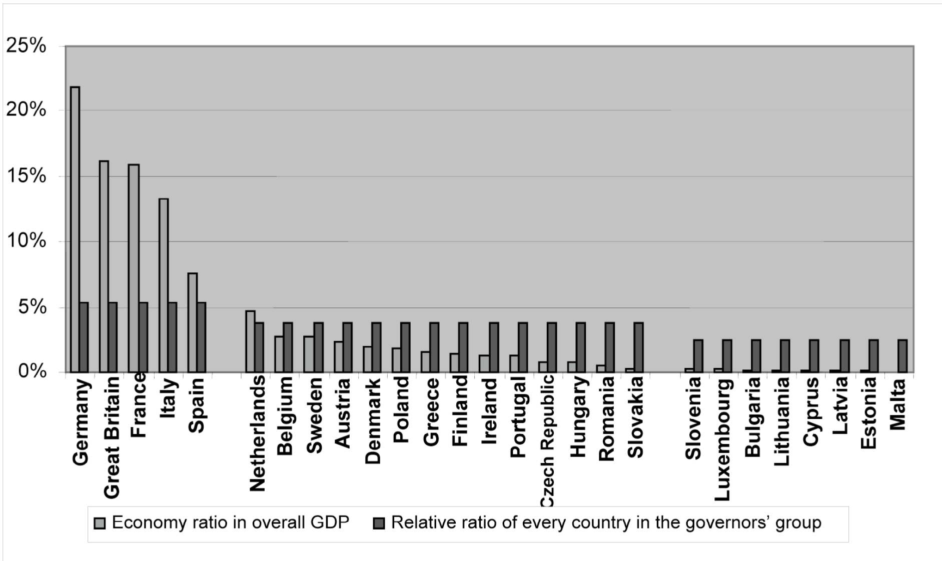
[10] European Commission (2004).

[11] See also Berger 2002.

Will the new voting mechanism eliminate the problems?

Thus, the reform of the ECB Governing Council's vote system is of special importance to eastern enlargement, which as we have shown, entails a limited number of 21 votes[12], regardless of the number of members the euro zone will comprise.

The proposed ECB reform will not fundamentally respond to enlargement challenges. Thus, with a total number of 21 members with a right to vote, the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.



Graph 2 Economic importance and each country's prevalence ratio in the governors' group

Source: according to the annex, own calculations[13]

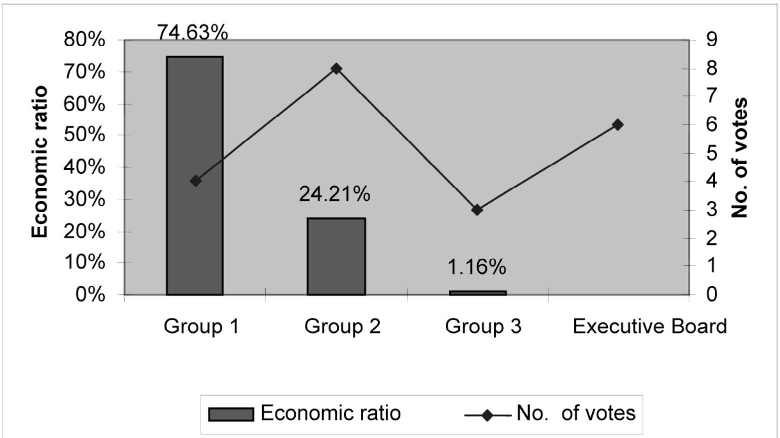
Moreover, reform will not do away with the issue of member state representation. Even in the case of the proposed reform, states such as Italy, France or Germany will be insufficiently represented, whereas states such as Malta, Latvia or Estonia will have a larger ratio than the size of their economies. There are fears that a "tyranny" of minority might emerge even with a reform.

Graph 2 proves the lack of symmetry between the economic importance of every country and the part they will play in an EMU enlarged to comprise 27 members.

The lack of correlation between economic importance and the role of national governors is even better outlined by graph 3, where one can see that the first group has a 74.63% economic participation and 4 votes, whereas the second group would have just a 24.21% GDP ratio and 8 votes!

[12] 15 of the Governors + 6 of the Executive Board

[13] See also Berger (2004).



Graph 3 Economic ratio and number of votes per group of countries
Source: calculations in the annex

If we are to refer to the last group as well, it will represent just 1.16% of the GDP yet it will hold 3 votes in the Governing Council. If in the case of the current euro zone composition, the Executive Board could vote for an average interest rate, in case of enlargement it is highly likely that the desired interest rate distribution should be asymmetrical. Therefore the voting process will be difficult, running the risk that certain countries with major economic importance should be dissatisfied with the interest rate voted by the Governing Council. In this sense, the ECB and large states' apprehension might be, again, grounded.

Consequently, even if prone to controversies, the reform is a step forward. One should not forget that it took years to the Bundesbank or the FED to perfect the operation of their bodies.

Conclusion

A process like the euro area enlargement has a lot of challenges: for the future euro area members, as they will give up national prerogatives; for current euro area members, because they have to accept economies that are not yet ready for euro; and for the ECB, because we can imagine how hard will be to implement a monetary policy for 25 or 27 members.

From the OCA theory point of view we can say that an Eastern enlargement of the euro area, could draw this group of states from the level of optimum they have in the present, and this will represent a problem not only for a specific state, but for the group. Moreover real convergence seems to be a problem. The difference between GDP per capita level in euro area and GDP per capita level in candidate countries is quite big and this is a major difficulty. It is obvious that the economic measures taken to catch up (to eliminate economic disparities), and different economic dynamics will create pressures for the single monetary policy, that needs to reach a measure that fits for all.

If we look at the ECB's voting mechanism, the proposed reform will not fundamentally respond to enlargement challenges: the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.

Moreover, reform will not solve the issue of member state representation. Even in the case of the proposed reform, larger economies such as Italy, France or Germany will be insufficiently represented, whereas smaller economies states such as Malta or Estonia will have a larger ratio than the size of their economies.

It is clear that the euro area Eastern enlargement launches major challenges also for the actual members and for the single monetary policy. Under these assumptions, the actual members of euro zone could be against a quickly enlargement to the East. But excepting Maastricht criteria, there are no other mechanisms to block EMU accession. It will not be a surprise if the European Commission and the ECB will be very exigent in evaluating the level of nominal convergence.

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Annex 1 The ratio/weight calculation in the case of ECB's voting mechanism reform

Table 1.1

Crt. No.	Country	Weight in overall GDP (2003)	Each country's relative ratio related to the overall number of governors' votes
	GROUP 1		
1	Germany	21.84%	5.33%
2	United Kingdom	16.08%	5.33%
3	France	15.83%	5.33%
4	Italy	13.30%	5.33%
5	Spain	7.58%	5.33%
	GROUP 2		
6	The Netherlands	4.63%	3.81%
7	Belgium	2.72%	3.81%
8	Sweden	2.71%	3.81%
9	Austria	2.28%	3.81%
10	Denmark	1.93%	3.81%
11	Poland	1.88%	3.81%
12	Greece	1.56%	3.81%
13	Finland	1.46%	3.81%
14	Ireland	1.36%	3.81%
15	Portugal	1.36%	3.81%
16	Czech Republic	0.76%	3.81%
17	Hungary	0.75%	3.81%
18	**Romania**	**0.50%**	**3.81%**
19	Slovakia	0.29%	3.81%
	GROUP 3		
20	Slovenia	0.25%	2.50%
21	Luxemburg	0.24%	2.50%
22	Bulgaria	0.18%	2.50%
23	Lithuania	0.16%	2.50%
24	Cyprus	0.12%	2.50%
25	Latvia	0.09%	2.50%
26	Estonia	0.08%	2.50%
27	Malta	0.04%	2.50%
Total		**100%**	**100%**

Table 1.2

	1	2	3	4	5	6
	No. of countries	Votes	Group frequency (2/1)	Country frequency	Group weight	The relative weight of each country
Group 1	5	4	80.00%	16.00%	26.67%	5.33%
Group 2	14	8	57.14%	4.08%	53.33%	3.81%
Group 3	8	3	37.50%	4.69%	20.00%	2.50%
	27	**15**			**100.00%**	

Notes:

1. The division per groups (table 1.1) is performed function of the GDP weight only;
2. In table 1.2, columns 1 and 2, groups and number of votes comply with the ECB proposal;
3. In column 5, the group weight in the overall governors' votes is calculated by dividing the number of votes (4, 8 or 3) to the whole number (15);
4. In column 6, every country's ratio/weight matches the group ratio to the number of countries in the group