ENLARGEMENT OF THE EUROZONE – CHALLENGES AND PERSPECTIVES

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Abstract: EU enlargement is not complete without the new member countries joining the eurozone. This paper makes an economic analysis of some theoretical and empirical aspects on which the success of the European Monetary Union enlargement will depend. Because the new EU member states are characterized by asymmetric shocks and low flexibility on the labor market, the new eurozone cannot be classified as an optimum currency area. Our study underlines the challenges of eurozone enlargement, considering that the monetary union can be undermine if the Eurosystem continues to apply the slow and incomplete reforms that are needed to revigorate the euro area economies.

Key words: eurozone, enlargement, challenges

The classical theory of **optimum currency areas** developed by Mundell (Mundell, R., 1961), McKinnon (McKinnon, R., 1963) and Kenen (Kenen, P., 1969) defines the optimum currency area as being a geographical region within which member states must use fixed rates of exchange on a single currency. Robert Mundell has identified a set of requirements that a country must meet in order to become part of an optimum currency area: symmetry of external shocks, mobility of the labor force, openness of the economy, the level of economic diversity. These criteria are still in use; for example, if a certain country is relatively open in terms of trade to another one or to a regional block, but its labor force mobility is insignificant, its economy is not very diversified and it has to face asymmetric shocks, a flexible rate of exchange is a good choice.

The explanation of the criteria of optimum currency area is that, generally, in an economy that has to face external shocks, real adjustment takes place if nominal rigidities are available. Thus, the only asymmetric shock would be the flexible rate of exchange. The shortage of capital mobility requires another method of adjustment. Even though Mundell has failed to unveil another benefit of the fixed exchange rate (lower transaction costs), he supposed that if adjustment costs are not very high (if the requirements of optimal currency area are met) the best choice is a fixed rate of exchange, which would stabilize the currency.

The criteria for optimum currency area are extremely important especially when a country is determined to peg its own currency to another one, defined as an anchor. In order to fight hyperinflation and constrain economic policy, the Argentine has chosen the currency board arrangement on the US dollar. Thus, the US dollar became a monetary anchor but, given the lack of a well-built fiscal policy and efficient institutions, this decision proved catastrophic. The result was deterioration of trade, increase in foreign debt, decrease in investments and slowdown in economic growth.

Recent specialized literature defines the concept of **impossible trinity** (the "Triangle of Impossibility"), namely the impossibility of having in the same time a fixed exchange rate, a free capital movement and an independent monetary policy (Frankel, J. A., 1999). Therefore, a flexible exchange rate, under greater free international capital mobility, enables the monetary authority to introduce an independent monetary policy. Nevertheless, if the monetary authority is not able to use the independence of the monetary policy appropriately the right choice is to give it up in order to import stability from other countries.

Most specialists have rightly concluded that European Union ***is not an optimum currency area***, because business cycles are not well synchronized, wage and price flexibility is low and fiscal transfers and labour migration is not welcome.

The enlargement of the European Monetary Union brings forth the costs and benefits it involves. We should find out the degree to which **"the new euro area"** will be an optimum monetary area. The traditional theory on the monetary area developed by Mundell (Mundell I) brings on a little skepticism. Because heterogeneity will increase in an enlarged euro area, the probability that asymmetric shocks should occur will increase as well. This is the reason why such enlargement is not recommended (De Grauwe, P., Schnabl. G., 2004).

There are still voices that recommend the adoption of the single currency after more than two years from the EU accession (De Grauwe, P., Lavrac, V., 1998). Their arguments are based on the fact that a country recently entered in the EU must cope with the competition existing on the single market and the challenges of the global capital markets. On the other hand, these countries are characterized by different levels of development, lower than those in the Union, and they have to obtain nominal and real convergence.

Nevertheless, three countries joined the euro area: Slovenia on January 1, 2007; Cyprus and Malta on January 1, 2008. It is no accident that the smaller countries are the first to join. For them the common currency is good protection against fickle financial markets. Their exposure to external trends is so much greater because of the relatively small size of the domestic economy.

The explanation should be found somewhere else the traditional framework of the optimum monetary area. As Mundell states in his work, in a world in which expectations are always changing, the fluctuations of the exchange rate do not work as stabilization tools used when facing asymmetric shocks. In this convention, called Mundell II, immediate entrance into the euro area could be the optimal solution.

The decision on the accession to the euro area depends on the assessment and perception of benefits and costs. The traditional theory of Mundell and McKinnon reveals three criteria that quantify the costs and benefits of participating in monetary union: asymmetry, flexibility, and openness (integration). Mundell does not recommend integration into a monetary union when a country faces strong asymmetric shocks and a lack of flexibility on the labor market. McKinnon introduces the openness degree, because eliminating the variability of the exchange rate reduces transaction costs and the volatility of internal prices.

While Denmark and Great Britain could negotiate in order to remain outside the eurozone, the new member countries have to accept the conditions stipulated in the Maastricht Treaty that is to prepare for the currency union and to adopt the single currency when they consider they are ready. On the other hand they meet the criteria of an optimum currency area to a lesser degree than the old EU members did. These countries are of small dimensions, have more or less developed trade relations with the EU and they expect benefits from the introduction of the euro.

De Grauwe and Melitz (2005) point out the fact that although the process of monetary integration in Europe has been regarded with skepticism, today’s success of the euro brings new valences for a possible constitution of some monetary unions in other regions, too. Focusing on the enlargement of the eurozone, they draw attention to its effects on the labor market reforms, on the empirical validation of the hypotheses regarding the endogenous character of the criteria for the optimum currency area and the process of monetary integration of Central and Eastern European countries.

Dabrowski and Rostowski (2006) consider and argue that the EU enlargement is not complete without the new member countries joining the eurozone, the failure of the monetary integration of these countries creating a two gear Europe and determining a fundamental change in the EU political and economic architecture, sharpening the already existing differences between the center and the periphery.

Smidkova (2004) explains the Czech Republic government's cautious position regarding adoption of the euro. The expectation of a quite late euro adoption date is predominantly due to persistent large fiscal disequilibria and the priority assigned to strengthening real convergence before adopting the euro. Csajbók and Csermely (2002) analyses the economic benefits and costs of introducing the euro in Hungary considering that have a permanent impact on Hungarian economic growth through numerous channels. Of the five Maastricht criteria, those relating to inflation and the budget deficit will require the greatest efforts in terms of economic policy. Meeting these two criteria automatically entails convergence of long-term interest rates. Polanski (2004) analyzes different scenarios for euro adoption in Poland. He notes that while Poland has already made significant progress in some convergence criteria (inflation and interest rates), it is seriously lagging behind meeting the budget deficit criterion. The author also links nominal convergence with real convergence and concludes that further nominal convergence is increasingly subject to real convergence. In the Polish case, he sees no contradiction between the two.

The convergence criteria imposed on prospective members for joining the monetary union have to do with what have been called “nominal convergence”. Low inflation and sustainable budgetary policies are desirable whether or not countries want to join a monetary union. The decisions of the ECB will systematically be felt by many member countries to be the wrong ones at the wrong time, leading to conflicts and tensions in the union.

Some euro-candidate countries will have higher inflation in the union because of the Balassa Samuelson effect. But there is nothing to be worried about. These countries will continue to have structurally higher inflation in the monetary union, without this creating problem of losses of competitiveness. Others may have lower inflation in the future, and yet be hit by an asymmetric development and a lack of flexibility that makes their membership very costly.

Countries that pass the budgetary convergence requirement have no guarantee at all that they will be successful members of the monetary union. But even if the budgetary numbers are a truthful they are irrelevant to predict if countries will experience more benefits than costs from their membership in the monetary union.

The eurozone enlargement will have extensive practical implications for the functioning of the eurozone. Asymmetric shocks will increase significantly: some countries may experience a boom and inflationary pressures while others experience deflationary forces. In this context, the ECB will not know whether to increase or to reduce the interest rates. As a result, member countries will often feel frustrated with the ECB policies that do not take into account the different economic conditions of the individual member countries. To minimize the potential risk of a future disintegration of the enlarged eurozone, an important measure that have to be taken should focus on making labour markets more flexible.

The strategy of the European Central Bank could represent a model, but this solution is not guaranteed because it was adopted considering the features of the euro area. The optimal monetary and exchange rate strategy for the transition period before joining the euro area should be selected according to the features of the country that aims at such an objective.

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