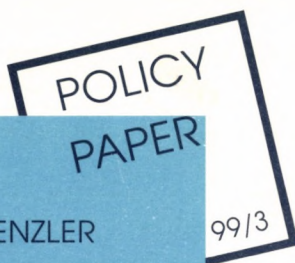




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Implications of the Euro  
for Enlargement

*Rapporteur*  
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## Policy Paper

99/3

WP 320  
EUR



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## **Implications of the Euro for Enlargement\***

### **Report of the Working Group on the Eastern Enlargement of the European Union**

**Chairman:** Horst Günter KRENZLER

**Rapporteur:** Susan SENIOR NELLO

\* This report is based on two background papers written for the Working Group on Eastern Enlargement by Joly Dixon, and Andrzej Stepniak. The report does not necessarily reflect the individual views of participants within the Working Group. Responsibility for the publication of this report lies with Horst Günter Krenzler.

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Printed in Italy in May 1999  
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**Working Group on the Eastern Enlargement of the European Union**  
(Meeting in Brussels, October 22-23, 1998)

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## 1. Introduction

In the last few months the EU has undergone profound changes: the third stage of Economic and Monetary (EMU) began on January 1 1999, while in 1998 accession negotiations started with five Central and Eastern European countries (CEECs) and Cyprus.<sup>1</sup> To date, both in academic analysis and in policy-making, the processes of deepening and widening of the EU have generally been treated separately. The aim here is to examine the links between these two integration processes, and, in particular, to assess the likely impact of the euro on enlargement.

The introduction of the euro will have important implications for third countries, and, in particular, for countries like the CEECs which have tight economic and financial links with the EU. In preparing to join the EU, and (eventually) EMU, these countries will have to make fundamental choices with regard to the appropriate macroeconomic and exchange rates to adopt. The CEECs will also have to introduce far-reaching legal and institutional changes in order to meet the requirements for EU membership and participation in EMU.

The Working Group on Eastern Enlargement of the European Union met in Brussels in October 1998 to discuss these questions and to indicate, where possible, appropriate routes and strategies both for the applicant countries, and for the EU in preparing for EMU in an enlarged EU.

The following Section sets out the conditions the CEECs must meet for EU membership, concentrating on the requirements relating to EMU. Fulfilling the Maastricht criteria is not a condition for joining the EU, but the question of how far the applicant countries should adopt the criteria as an objective is also considered here. Section 3 sets out the legal and institutional obligations of the CEECs when they join the EU, even if they do not participate fully in Stage 3 of EMU. Section 4 discusses the economic implications of EMU for the CEECs, while Section 5 considers the question of appropriate choices with regard to fiscal, monetary and exchange rate policies. Section 6 deals with changes to be made in institutional arrangements in preparing to join EMU. Section 7 indicates possible tensions between deepening and widening in the integration process, before drawing conclusions and indicating policy implications in the final section.

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<sup>1</sup>Ten Central and East European countries (CEECs) applied for EU membership: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. At the December 1997 European Council in Luxembourg the decision was taken to open membership negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

## 2. The Preaccession Period: The Maastricht Criteria as a Medium-to-Long Term Objective

The 1993 Copenhagen Summit of the European Council set out the conditions which the application countries have to fulfill in order to join the EU. These conditions entail that the applicant countries have functioning market economies; are capable of dealing with competitive pressures and market forces in an enlarged Single European Union; that they can ensure stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, and that they must be able to take on the obligations of membership, *including adherence to the aims of economic and monetary, and political union* (emphasis in italics added).

At the Copenhagen Summit it was also stipulated that enlargement is subject to the condition that the EU is able to absorb new members and maintain the momentum of integration.

The requirement that the applicant countries are able to take on the "*obligations of membership*" is generally taken to mean their ability to adopt the *acquis communautaire*,<sup>2</sup> including the *acquis* relating to EMU. The applicant countries are also required to ensure effective implementation of the *acquis* and this will entail substantial changes in their administrative and judicial capacities.

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<sup>2</sup>The *acquis communautaire* is the body of EU legislation, practices, principles, and objectives accepted by the member states. It is composed of the Treaties (and, most importantly, the Treaties of Rome, the Single European Act, the Maastricht Treaty and, following ratification, the Amsterdam Treaty); legislation enacted at the EU level and judgements of the European Court of Justice; Justice and Home Affairs; Foreign and Security Policy and Treaties of the EU with third countries. The *acquis* has been accumulating over the years and now amounts to some 12,000 legislative acts.

<sup>3</sup>In Agenda 2000 (p.45) the Commission outlined a three-stage framework for the adoption of the *acquis* on the part of the applicant countries:

- implementation of the Europe Agreements (or Association Agreements) which the 10 CEECs which have applied for EU membership have signed with the EU, in particular with regard to trade, national establishment, intellectual property and public procurement;
- progress in transposition and effective implementation of the measures set out in the 1995 White Paper and, in particular, those relating to key aspects of the Single Market such as banking, public procurement and taxation, and
- ability to take on other aspects of the *acquis*. Areas singled out for attention include the environment, agriculture, energy, industry, telecommunications, transport, social affairs, customs administration and Justice and Home Affairs.

The Commission has also referred to the need to go "beyond the *acquis*" in certain areas such as nuclear safety and the fight against crime.

The Madrid Summit of 1995 called for the "*creation of a stable economic and monetary environment*" as one of the conditions for "*gradual and harmonious integration of the candidate countries into the EU.*"

From the decisions of the Copenhagen and Madrid Summits two important considerations emerge:

1) Preparing for EMU has to be analysed in the wider framework of getting ready for accession, which entails progress in meeting the Copenhagen criteria and taking on the *acquis*. In other words, progress in microeconomic restructuring, privatisation and institutional change also have to be taken into account because of their implications for the macroeconomic performance of the applicant countries.

2) Specifically with regard to preparing for EMU, what is important is ensuring the overall stability of macroeconomic performance. This entails choosing appropriate macroeconomic policies, and developing the ability to correct macroeconomic distortions with policies compatible with market mechanisms.

It is important to stress that although the applicant countries have to adhere to the aim of EMU, and develop their capacity to correct macroeconomic distortions with market-based instruments, they are not obliged to meet the Maastricht criteria at the time of their accession.<sup>4</sup> The Working Group agreed that the Maastricht criteria should not be regarded as a short-run objective, but rather a goal for the medium to long run. The present concern with meeting the convergence criteria in certain CEECs would seem premature, and may distract from the more important objective of preparing to join the EU. As Backé and Radzyner (1998, p.17) argue:

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<sup>4</sup> The Maastricht Treaty spelt out five criteria:

- i) Successful candidates must have inflation rates no more than 1.5% above the average of the three countries with the lowest inflation rate in the Community.
- ii) Long-term interest rates should be no more than 2% above the average of that of the three lowest inflation countries. This is to ensure that inflation convergence is lasting, because otherwise higher expected future inflation in a country would be reflected in higher long-term interest rates.
- iii) The exchange rate of the country should remain within the "normal" band of the exchange rate mechanism (ERM) without tension and without initiating depreciation for two years. At the time of the Maastricht Treaty the "normal" band referred to the margins of  $\pm 2.25\%$ , but since August 1993, in some circles it is now taken to refer to  $\pm 15\%$ .
- iv) The public debt of the country must be less than 60% of GDP.
- v) The national budget deficit must be less than 3% of GDP.

The last two on the list (iv and v) are referred to as the "fiscal" criteria and are subject to an escape clause. A country may be granted a waiver if the gap between the actual and reference situation is "exceptional and temporary" or if the excess in public deficit or debt is declining "continuously and substantially".

*".....a premature attempt at meeting the Maastricht criteria could easily lead to inconsistencies in the policy mix and impair competitive positions, which could severely hamper the catching-up process upon which the advanced CEECs have embarked. Clearly, during the next few years catching up with Western Europe is a more immediate goal than meeting the Maastricht criteria, primarily because it facilitates EU accession and because it is a precondition for laying a sound basis for the ultimate accomplishment of a high degree of sustainable nominal convergence. "*

However, although fulfilment of the convergence criteria is not a precondition for EU membership, as Agenda 2000 points out,<sup>5</sup> they should *"remain key points of reference for stability-oriented macroeconomic policies and must in time be fulfilled by the member states on a permanent basis"*.

A further difficulty arising for the Maastricht criteria in the CEEC context is that their application in transition economies is not always appropriate. For example, the benchmark used for the interest rate criterion is usually the interest on 10-year government bonds, or comparable securities, and the fledgling nature of capital markets in the CEECs means that generally such bonds are not issued by the applicant countries. The problem of applicability also arises with regard to the exchange rate criterion as so far the CEECs have not participated in any EU exchange rate mechanism, and participation in such an arrangement for at least two years is a condition for adopting the euro. The concept of public deficit in the Maastricht Treaty refers to central, regional and local government as well as social security funds, and, as Daviddi and Ilzkovitz (1996) point out, the budget situation of local and regional governments is often difficult to assess in the CEECs. Moreover, in defining public deficits in the CEECs differences arise, for example, in the treatment of funds from privatisation and in payments to bail out banks and other financial institutions. One result of the application of the convergence criteria in the EU has been a process of standardizing definitions, though this is far from complete.

Tables 1-3 in the Appendix set out data for the CEECs with regard to the Maastricht criteria and other macroeconomic indicators, though it is important to recall that in some cases statistical harmonisation with Eurostat data is incomplete. Data on exchange rates has not been included here, given the problem of applicability of this criterion to the transition economies, but Table 4 indicates the various exchange rate arrangements used by the CEECs.

As can be seen from Table 1, inflation is particularly resilient in the CEECs. Economic transformation may contribute to inflationary pressures in a number of ways: through price liberalisation and the ending of the CMEA trading system (with the consequent increase in energy prices), devaluation and

<sup>5</sup> Section 3.3 of the Opinions.

increased public spending on infrastructure and unemployment benefits, wage indexation, and, in some countries, servicing of the public debt. As a result there may be increased inflationary expectations and these could prove self-fulfilling.

When the formerly closed and inefficient centrally planned economies were opened up to market forces a process of catching up with rapid gains in productivity occurred. If the productivity gains are faster in the traded than in the non-traded sector, this could also generate inflation.<sup>6</sup>

### 3. With Accession: Adopting the Acquis with Regard to EMU

The EU has decided that there will be no more opt-out clauses from EMU (such as those granted to the UK and Denmark) for new countries joining the EU. After accession, even as countries not participating fully in the third stage of EMU (i.e. with a temporary derogation),<sup>7</sup> the countries joining the EU are therefore required to take on the *acquis communautaire*. As Joly Dixon (1998) describes, the main elements of the *acquis* in the area of EMU are:

- adherence to the objective of EMU;
- respect of the Stability and Growth Pact<sup>8</sup> including regular submission of convergence programmes in the context of EU surveillance (Art 99 § 2-5)<sup>9</sup>;
- the prohibition of direct public sector financing by the Central Bank and the ending of privileged access to that bank (Art .101);

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<sup>6</sup> This phenomenon is called the Balassa-Samuelson effect. When a small economy opens to international trade its export prices are set at the world level. If the country is on its production possibility frontier, increased productivity in traded goods leads to increased wages in the traded-goods sector. However, if wages are equalised between the traded and non-traded goods sectors, and the non-traded goods sector has lower productivity, inflation will increase. Grafe and Wyplosz (1997) stand this argument on its head, arguing that in transition economies the real appreciation determines real wages and hence the pace at which workers will leave the state sector, and join the new traded and non-traded sectors.

<sup>7</sup> Until they meet the Maastricht criteria new EU members would not be able to join the euro area.

<sup>8</sup> The Stability and Growth Pact was agreed at the Dublin Council of 1996 and confirmed at Amsterdam in 1997. According to the Pact, budget deficits would be limited to 3% of GDP, except if the country experienced a fall in GDP of over 2%. If a country exceeds the ceiling of 3%, it would have to make a non-interest-bearing deposit of 0.2% of GDP plus 0.1% for each point of the excess deficit, up to a maximum deficit of 6% of GDP. The deposit would be returned when the deficit falls below 3% of GDP, but if the excess deficit lasts for over two years the deposit could become a fine.

<sup>9</sup> The references are to the relevant Articles in the Amsterdam Treaty on European Union.

- treatment of the exchange rate and of other economic policies as a matter of "common concern" (Art 99 and Art. 124) to be coordinated within the Council (Art. 99 §1);
- the orderly liberalisation of capital movements not only *vis-à-vis* other EU members, but also third countries (Art 56), and
- independence of the central bank (Art. 108) and its adherence to price stability as the primary objective (Art 105).

According to the Amsterdam Treaty (Art. 111), when the CEECs join the EU they will have to participate in some form of exchange rate arrangement with euro area countries, and most EU Member States argue that exchange rate stability alone is insufficient to qualify for joining the euro zone (Backé and Radzyner, 1998).

The 1997 Amsterdam European Council set out the main features of ERM 2 (exchange rate mechanism) which will govern exchange rate relations between the EU (11) and Member States not participating fully in Stage 3 of EMU from 1999:<sup>10</sup>

- participation in ERM 2 will be voluntary, though "expected";
- ERM 2 will be based on fixed, but adjustable parity rates of participating currencies with regard to the euro. The standard fluctuation band will be  $\pm 15\%$  against the euro, though narrower bands may be agreed;<sup>11</sup>
- intervention at the margin will be automatic and unlimited, and short-term financing will be available. The ECB and Central Banks of participating countries can suspend intervention if it conflicts with the primary objective of price stability;
- coordinated intramarginal intervention will be possible, and the flexible use of interest rates by non-euro countries will play an important role.

Even if the CEECs do not participate fully in Stage 3 of EMU when they join the EU their central banks will take part in the European System of Central Banks (ESCB), but they will be allowed to conduct their own monetary policy and will keep their own official foreign exchange reserves. The Governors of the Central Banks of the CEECs will be members of the General Council of the ECB, and so will be able to follow monetary developments in the euro area closely. The General Council will also be responsible for monetary cooperation between the euro area and countries in the ERM 2.

<sup>10</sup> ERM 2 was conceived essentially for EU currencies, but the possibility of extending it to the CEECs prior to accession has been proposed, see Section 5 below.

<sup>11</sup> However, the narrower bands have to be approved of by a procedure involving the European Commission, the Economic and Financial Committee, the ECB, the Ministers of Finance of the euro area and the country concerned.

On joining the EU, even with derogations from Stage 3, CEEC Ministers will take part in the decision-making of Ecofin (the Council of Economic and Finance Ministers) on exchange rate policies and other monetary matters falling under the competence of the Council. Ecofin is responsible for defining the exchange rate regime and the negotiation of international monetary agreements after consultation with the ECB and the European Parliament. The Council, acting either on a qualified majority or on a recommendation from the Commission and after consulting the ECB, or on a recommendation from the ECB, may also formulate the orientation of exchange rate policy towards third countries, though it must ensure that the primary objective of price stability is not prejudiced.<sup>12</sup> CEEC representatives will also participate in Economic and Financial Committee which carries out regular reviews of the economic and financial situation of the EU and its member states, helps to prepare Ecofin decisions on monetary matters, and carries out a regular examination of the situation of capital movements and payments.

#### 4. The Economic Effects of EMU on the CEECs

The Working Group generally agreed that the introduction of the euro would have a positive impact on growth<sup>13</sup> and trade<sup>14</sup> in the euro area. The introduction of the euro would entail completion of the Single Market, increased price transparency and competition, and would remove exchange rate uncertainty and foreign exchange transaction costs between euro area countries. The allocation of resources is also likely to improve, with firms being able to locate where their unit costs are lowest and where they can best exploit economies of scale.<sup>15</sup>

The positive effect on growth in the euro area is likely to be reflected in increased demand for imports from third countries, in particular, from countries like the CEECs, which have tight economic and trade links with the EU. Although increased trade and investment within the euro area could lead to

<sup>12</sup> Article 111 of the Amsterdam Treaty.

<sup>13</sup> Backé and Radzyner (1998) report that the Austrian Institute of Economic Research estimated that (if well managed) implementation of Stage Three of EMU would allow the participating countries to move to a growth path 1.75% higher than a hypothetical scenario in which the euro was not introduced. However, introduction of the euro is occurring at a time when real contagion from the East Asian crisis is causing growth forecasts in the EU to be revised downwards.

<sup>14</sup> See, for instance, De Grauwe (1988) for empirical evidence of how exchange rate stability under the EMS contributed to intra-EC trade in the 1980s.

<sup>15</sup> In theory forward exchange markets should provide hedging services against foreign exchange risks, but in practice such hedging involves a cost, and forward markets rarely cover a period of more than a year which is too short for most investment decisions (Zis, 1995).

some trade and investment diversion from third countries, on balance the net impact on trade and growth in the applicant countries is likely to be positive, as a recent IMF study confirms.<sup>16</sup> According to the IMF study, for each 1% growth in the GDP of the euro area, the CEECs<sup>17</sup> could expect to benefit from a 0.6% increase in GDP and a 1.5% increase in exports.

The EU(11) has a population of about 290 million, and in 1997 had a combined GDP of \$6.5 trillion, compared with \$8.7 trillion of the US. The euro area accounted for 19% of world trade in 1997, which again is roughly comparable to the US share of 17%.<sup>18</sup> However, the role of the dollar in international trade and finance is far greater than its share of world trade and output might suggest. According to the Bank for International Settlements (BIS), the dollar features on at least one side of 83% of all foreign exchange transactions, the D-mark in 30% and other EU(11) countries in 24%.<sup>19</sup> As will be shown below, the dollar remains the single most important currency in the invoicing of trade, in the reserves of central banks, and in the denomination of international private assets.

Given the economic weight of the EU, and the likely impact of the euro in further deepening and widening EU financial markets, it seems probable that the euro will play a growing international role.<sup>20</sup> Portes and Rey (1998) describe a circular mechanism by which this may come about. As euro markets for money and securities become more integrated and liquid, transaction costs will fall, rendering euro-denominated assets more attractive. This in turn will make it more likely that the euro becomes a vehicle currency. Increased holdings of euro-denominated assets and use of the euro as a vehicle currency make the EU financial market deeper, broader and more liquid, and so on.<sup>21</sup>

<sup>16</sup> East/Central Europe: Benefits to be Reaped from Monetary Union. Study directed by Roger Nord as indicated in the press release of the IMF, Washington DC, October 1998

<sup>17</sup> CEEC (13) including the 10 applicant countries, Albania, Croatia and Macedonia. The conclusions are based on the assumption of continued transition in the CEECs, and that the EU manages to avoid "reform fatigue" i.e. failure to introduce structural reform, lax fiscal discipline and higher unemployment.

<sup>18</sup> These statistics are taken from *The Economist* of 14/11/98.

<sup>19</sup> As reported in *The Economist* of 14/11/98.

<sup>20</sup> Some authors (Bergsten, 1997a, and McCauley and White, 1997) warn that an integrated market might take some time to emerge, given the present decentralisation of EU financial markets, and the absence of a central government borrower like the US Treasury which could act as a fulcrum for the market.

<sup>21</sup> This reciprocal effect creates scope for multiple equilibria and hysteresis.

However, the extent to which the euro can challenge the dollar as an international currency will depend on how far the money and securities markets of the EU(11) become effectively integrated, and on confidence in the euro as a stable currency. A stable currency implies a low inflation/low depreciation risk and this in turn will depend on the anti-inflationary credibility of the ECB, and the extent to which stable macroeconomic policies are implemented under the Growth and Stability Pact. As Portes and Rey (1998) argue, the ability to reduce transaction costs in EU financial markets will also depend on the number of full participants in Stage 3 of EMU, and, in particular, on when and whether the UK joins, given the importance of the City as a financial centre.

In 1998 it was estimated that roughly half of total world export invoicing in the world was in dollars, while one third was in the major EU currencies (IMF, 1998). It seems probable that the euro will be used more than the currencies which it replaces, since not only is trade in the euro area trade likely to be invoiced in euro,<sup>22</sup> but economies of scale will also encourage firms in countries which trade mainly with the EU(11) to start invoicing in euro. Given the rapid redirection of CEEC trade towards to EU in recent years (see Table 5), it seems likely that many CEEC firms will invoice in euro both in trade with the EU(11) and with other CEECs. In some CEECs multinational enterprises play an important role, and these may increasingly adopt the euro for cross-border transactions, and accounting. None the less widespread use of the dollar in invoicing is likely to continue, in particular in oil and commodity markets.

In 1997 57% of all official foreign exchange reserves were held in dollars, with a further 20% being held in EU currencies and the ECU, and about 4.9% in yen (IMF, 1998). Next to the dollar, the D-mark was the most widely-held currency in official reserves (12.8%), and it seems likely that the euro will take over this task from the D-mark and other major EU (11) national currencies.

Bergsten (1997b, p.90) has estimated that official reserve shifts into euro could range between \$100 billion and \$300 billion, but argues that the time horizon over which such shift might occur is extremely uncertain. Inertia is an important force, and, for example, the pound sterling continued to play an important role as a reserve currency long after Britain's decline as a hegemonic power.<sup>23</sup>

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<sup>22</sup> However, intra-EU(11) trade will be considered "domestic" and so will not appear in calculations of the share of world trade invoiced in euros.

<sup>23</sup> See Kindleberger (1984), and Eichengreen (1994).

Two reasons can be advanced to explain why the share of official reserve holdings in euro might increase at the expense of the dollar. First, there may be economies of scale in holding international reserves so that the ECB will need to hold fewer foreign currency reserves than did the Central Banks of the EU(11) prior to introduction of the euro. Secondly, it seems likely central banks in third countries, including the CEECs, will decide to increase the share of euros in their official reserves.

Countries pegging their exchange rate to the euro such as Poland or Hungary have a strong incentive to hold euros for intervention in foreign exchange markets. The holding of reserves will also reflect the importance of the euro in balance of payments transactions. The management of official reserves, and, in particular, the shares of different foreign currency held, will also be influenced by expectations about exchange rates and interest rates, and there may be some diversification of reserve portfolios in order to spread risks.

Future developments in the euro exchange rate and interest rates will also have implications for the debt servicing burdens of the CEECs, and to limit possible negative consequences, these countries might be advised to gear the composition of their debt to the basket or currency to which their currency is pegged or oriented.

Official reserves of currencies are relatively small compared with private holdings of international financial assets. Excluding intra-EU portfolios, in 1996 global holdings of international financial assets, including bank deposits and bonds, amounted to some \$3.5 trillion.<sup>24</sup> Roughly 50% of these were in dollars, and only 10% in EU(11) currencies, so that, according to Bergsten (1997b, p.90), a balancing of portfolios would require a shift of \$700 billion.

From 1999 governments of the EU(11) will issue debt in euros, and will begin to re-denominate existing securities in euros so that by 2002 all debt and other securities will be denominated in euros. However, despite the wide range of instruments issued by countries and companies, it seems likely that introduction of the euro will render the yield on portfolio investment in the EU(11) more uniform. Insofar as the CEECs are able to provide an alternative which combines higher yields with moderate risk, they may be able to attract increased portfolio investment. Clearly, much will depend on what happens to interest rates in the euro area, since *ceteris paribus* lower EU(11) interest rates increase the relative attractiveness of portfolio investments in the CEECs. The ability of the CEECs to develop broad and deep financial markets is also important in this context.

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<sup>24</sup> Bergsten (1997b, p. 90).

One of the concerns expressed by the Working Group was that shifts in official reserves and private portfolios into euro could increase the value of the euro against the dollar. An appreciation of the euro against the dollar could lead to a current account deterioration in CEECs having a euro-oriented exchange rate policy,<sup>25</sup> though this effect would be mitigated by the large share of trade with the euro area.

A related issue was with the possibility of short-term volatility of the euro against other currencies such as the dollar and the yen. External trade of the EU(11) accounted for only about 10% of GDP in 1997,<sup>26</sup> and the ECB is committed by the EU Treaty to price stability as its main priority. As a result there might be a risk of an inward-looking EU characterised by "benign neglect" with regard to movements of the euro against third currencies. On this point the Working Group was relatively optimistic about the possibilities for international cooperation, and argued that the introduction of the euro might render the EU more aware of its international responsibilities.

## 5. The Implications for Policy in the CEECs

In preparing for EMU, policy-makers in the CEECs have to make choices in three main (though interconnected) areas: fiscal policy, monetary policy and exchange rate policy, including the question of whether to introduce capital controls.

### Fiscal Policy

As can be seen from Table 2, in general the ratio of public debt to GDP in the CEECs is relatively low. The large public debt in countries such as Bulgaria, Hungary, and (to a lesser extent) Poland is chiefly the result of foreign debt inherited from the previous regime, rather than reflecting present fiscal imbalances.

In 1997, as Table 2 shows, only Hungary (partly because of the heavy burden of serving the foreign debt), Slovakia and Romania failed to meet the Maastricht criterion with regard to fiscal deficit. However, the Working Group

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<sup>25</sup> Movement of the euro against other third currencies is likely to have less effect on the current account of a country such as Hungary, where the composition of the currency basket to which the forint is linked roughly corresponds to the invoicing shares of foreign trade (Backé and Radzyner, 1998). However, this result will change when Hungary moves to a euro-only based peg from 2000, and is based on the assumption that there will not be substantial changes in invoicing in Hungarian foreign trade.

<sup>26</sup> Eurostat data.

considered that sustainability of fiscal consolidation in the transition countries was likely to encounter a number of difficulties, both on the spending and revenue sides.

Although external discipline can play a useful role in CEECs where fiscal deficits are too high, excessive concern for budgetary constraint may hinder transition.<sup>27</sup> The applicant countries face pressure for additional government spending from a number of sources. Improvements in infrastructure are urgently required in all these countries, and in many cases bad debts remain a problem. The task of taking on the *acquis* also calls for budgetary expenditure, in particular, in areas such as the environment, the modernisation of administration and improvement in judicial capacity. The CEECs are also engaged in fundamental reform of their pension systems, health care, and education.

Transition entails reform of the fiscal system by introducing taxes on income and value added in place of turnover taxes, and by widening the tax base. Improvement in tax collection is urgently required in all these countries, in particular as the growth of a new, green field private sector<sup>28</sup> was accompanied by widescale tax evasion.

### Monetary Policy

One of the conditions for joining the EU is that applicant countries are able to implement monetary policy with market-based instruments. Although complete harmonisation of monetary instruments with those of the euro zone is not required before full participation in Stage 3 of EMU, it is important that the accession countries begin preparing now, so that they are able to implement the decisions of the ECB when they eventually adopt the euro.<sup>29</sup>

The financial sectors of the applicant countries are already undergoing a process of fundamental change as the CEECs bring their regulation in line with EU standards as part of the process of adopting the *acquis*. It seems likely that the introduction of the euro will have a positive spillover effects in encouraging further financial restructuring in the CEECs. Insofar as introduction of the euro renders financial markets in the euro area broader, more liquid and more tightly integrated, competitive pressure to stimulate reform of the financial sectors in the CEECs could increase.

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<sup>27</sup> See also Tanzi (1993) for a discussion of these issues.

<sup>28</sup> Also referred to as "organic" privatisation.

<sup>29</sup> As Temprano-Arroyo and Feldman (1998) describe, even after the irrevocable fixing of exchange rates, the practical arrangements for changeover to a single currency can take up to three and a half years.

The Working Group agreed on the need to develop sound, competitive, well-regulated and adequately supervised financial sectors in the CEECs, a lesson whose importance the East Asian crisis again underlined. The markets for money and securities must be developed to enable the effective operation of monetary policy instruments. It is necessary to resolve the problem of bad debts; improve the functioning of capital adequacy rates; complete the process of bank privatisation; develop well-functioning systems of payments, and ensure adequate competition in the financial sector. It was agreed that foreign ownership of banks may play a positive role where the new owners have a tradition of effective supervision, as, for instance, occurred in Hungary.

### **Exchange rate policy**

As can be seen from Table 4, the CEECs opted for a wide range of exchange rate regimes, reflecting diverging views among economists and policy-makers with regard to which was the most "appropriate" exchange rate regime to adopt, but also the differing macroeconomic conditions at the start of transition (Gaspar, 1995). The choice of exchange rate regime in the CEECs may change over time, and is likely to be influenced by factors such as the historical legacy,<sup>30</sup> progress in transition, the degree of development of financial markets, considerations of credibility, and the size and openness of the economy. The availability of reserves is also an important factor, and was a major reason behind the initial decision of Bulgaria and Romania to float.

Table 4 also indicates the changes in the CEEC exchange rate regimes which are likely to result from introduction of the euro.<sup>31</sup> Countries which peg their exchange rate to a currency, or basket of currencies to be partially or totally replaced by the euro will have to alter their regime, and this could offer an opportunity for strategic choices, for example, by reducing the share of the US dollar in the basket.

With regard to exchange rate policy, there was general agreement in the Working Group that there should not be a single path in preparing for euro membership. What is important is that the choice of exchange rate regime is consistent with the overall macroeconomic policy mix. The CEECs should decide on an appropriate economic policy framework, and then ensure that the choice of exchange rate regime is consistent with that framework. However, in discussing possible alternatives, considerable differences of opinion arose. Four

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<sup>30</sup> For instance, when the country has opted for a currency board, or managed floating, this will influence subsequent choices.

<sup>31</sup> Other countries will also have to adjust, such as the 14 francophone African countries which use the Communauté Financière Africaine (CFA) franc pegged to the French franc.

possible paths were discussed: currency boards, managed floating, a unilateral peg, or introduction of some form of ERM 2 prior to accession.

Currency Boards have operated in Estonia since 1992, Lithuania since 1994 and Bulgaria since 1997. Lithuania began an exit programme at the beginning of 1997, but this is presently on hold for an undetermined amount of time, partly because of the unstable situation in Russia. A currency board entails that the outstanding liabilities of the central bank are backed at least 100% by its foreign currency reserves. In the strictest form of currency board, any change in currency reserves translates immediately into a change in monetary base. In practice less strict versions of monetary boards are usually adopted, which allow some discretion over the monetary base.<sup>32</sup> The currency board also entails freedom of capital flows, and prohibits lending by the central bank to the public sector. The introduction of a monetary board therefore means sacrifice of monetary autonomy.

Currency boards may act as a means of gaining confidence in a new currency and may perform a useful role in extreme situations when inflation is high. However, the Working Group argued that they were a less attractive option when inflation was low, and applicant countries were trying to introduce fiscal and monetary instruments appropriate to a market-oriented economy. It was considered doubtful that a country would be allowed to pass directly from a currency board to full participation in Stage 3 of EMU.<sup>33</sup> What seems more

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<sup>32</sup> For instance, this was the case in Estonia where the central bank has maintained some discretion concerning how far capital inflows are allowed to boost the monetary base, as well as maintaining minimum reserve requirements for commercial banks. In general the Bank of Estonia has kept reserve coverage at about 110% (Korhonen, 1998).

<sup>33</sup> On this point Backé and Pautola (1998) argue:

"In general there is no obvious reason why a central bank which runs a currency board should not be in a position to fulfill all the requirements the Treaty on European Union lays down in the area of central bank independence. As regards to price stability as a primary objective of central bank policy, a currency board has no policy tools at its disposal to directly fight inflation. However, empirical evidence has shown that a currency board tends to deliver low inflation or even price stability. Monetary policy cooperation among the EU countries is based on the existence of market-based monetary policy instruments, and on their effective use, if the need arises. Under a pure currency board regime, there is no (active) monetary policy. Furthermore, a currency board country cannot fully participate in an institutionalised exchange rate cooperation of a standard EU type, which requires flexible use of interest rates. Since a currency board does not allow for any direct control of price level and interest rate developments, meeting the monetary convergence criteria can also become more complicated. So far, Lithuania is the only East European currency board country that has officially announced an exit programme. Technically, exit would mean moving away from the strict concept of a currency board and loosening the backing rule, thereby building up more room to act as a lender of last resort in any future crisis. However, the main problem related to exit is

likely is a gradual relaxing of the currency board with the introduction of monetary policy instruments in the applicant countries.<sup>34</sup>

One of the main arguments advanced against floating rates was the cost of volatility, in particular, in small, open economies (though it was also pointed out that, as the East Asian crisis demonstrates, the cost of a foreign exchange crisis coupled with a debt crisis may be even higher). In discussing the option of managed floating, attention was drawn to what was described as the "rather successful" experience of Slovenia. The Slovenian tolar has displayed relatively little nominal volatility against the D-mark, partly as a result of regular intervention by the Central Bank, but also because of the relatively restrictive stance adopted with regard to capital movements (see below).<sup>35</sup>

As set out at the Amsterdam European Council, ERM 2 was conceived for EU currencies. Although an exchange rate arrangement with non-EU countries is not at present envisaged by the EU and is not required by the Europe Agreements, it is *"likely to remain high on the policy agenda in the coming years"* Berrigan and Carré (1997, p.123).

According to the Maastricht criteria, a country has to participate in the ERM within the normal bands for at least two years before admission to the euro area. If the accession countries cannot participate in the ERM 2 before they join the EU, they would have to wait for two years after accession until they meet this criterion formally. In the past the Council has demonstrated a certain flexibility in interpreting this criterion, and, for example both Finland and Italy were accepted, even though they had been in the ERM less than two years. However, some members of the Working Group were in favour of admission of the applicant countries to ERM 2 before EU accession, and advanced various arguments for this option:

- membership of ERM 2 would lend credibility to the CEECs, and increase the likelihood of nominal and real convergence with the euro area;

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that of credibility. A lot will depend on how well the monetary authorities deal with their new monetary freedom."

<sup>34</sup> For instance, in 1997 Lithuania announced that its currency board would be abandoned, and that a peg to the euro, or a basket including the euro would be introduced.

<sup>35</sup> Slovenia completed liberalisation of current account transactions in 1995, and though there was some liberalisation of capital account transactions, capital controls were reintroduced in 1995 and 1997.

Most CEECs liberalised current account transactions and capital flows associated with FDI (foreign direct investment) fairly early. The Baltic States opted for a relatively high degree of openness with regard to capital flows, while the Czech Republic, Hungary and Poland have been easing restrictions on capital movements also with an eye to their commitments as OECD members.

- with its wide bands, and calls for timely realignments, ERM 2 would prove flexible and this might help to avoid real misalignment, and disruptive movements in nominal exchange rates;
- ERM 2 would thereby obtain some meaning and critical mass, since otherwise ERM would be a rather "lonely" arrangement. At the time of its conception, it was widely believed that the ERM 2 would include more (possibly five or six) countries;
- an early inclusion of the CEECs in ERM 2 would furnish additional experience of cooperation in an EU context, helping them to see exchange rates and economic policies as a matter of common concern, and assisting the preparation for eventual full inclusion in EMU.

Against this, other members of the Working Group expressed doubts about the effectiveness of ERM 2 in the event of a speculative attack, in particular, if the bands of fluctuation remained as wide as  $\pm 15\%$ . Even wide bands are likely to prove ineffective in the face of prolonged capital movements. For example, if capital inflows continue, the exchange rate simply moves to the upper end of the band, limiting competitiveness, but not arresting the capital flows.

ERM 2 envisages marginal and intramarginal intervention, using a modified form of the Very Short Financing Facility. It is, however, subject to the condition that the ECB's primary objective of price stability is not jeopardised, which implies a certain asymmetry with regard to obligations. The commitment of the ECB to intervene on behalf of a non-euro currencies is therefore limited, and some members of the Working Group argued that it was probable that the ECB would prove reluctant to take on obligations with regard to the pre-ins.

Some members of the Working Group argued in favour of pegged exchange rates on ground of credibility and the usefulness of the exchange rate as an anchor in countries with a history of fiscal and monetary mismanagement. Some were in favour of a crawling peg, though others argued that these may be subject to destabilising expectations.

The main criticisms made by members of the Working Group who opposed arrangements such as a unilateral peg, or joining some form of ERM 2 prior to accession was that they would not allow enough flexibility to meet the problems arising from real appreciation of the exchange rate, capital inflows, and possible asymmetric shocks in the accession countries. Moreover, if the applicant country has not achieved an adequate degree of structural

convergence, relative prices will not have adjusted fully, which renders the level of equilibrium exchange rate difficult to assess.<sup>36</sup>

Various studies<sup>37</sup> confirm that transition economies have generally followed a pattern of significant initial undervaluation of the exchange rate followed by real appreciation.<sup>38</sup> This real appreciation can be explained by the productivity gains associated with the catching-up process and the inflationary pressures intrinsic to transition. As Halpern and Wyplosz (1997) argue, real appreciation is the "*equilibrium outcome of successful transition*." If a country pegs its exchange rate and its productivity growth is higher than that of the euro area, then its inflation will be higher than in the euro area as real appreciation cannot take place through changes in the nominal rate. As a result, the country may have difficulty in meeting the Maastricht criterion on inflation. Inflation can be brought down to low levels only if the nominal exchange rate is allowed to appreciate.

Most of the CEECs furthest advanced in economic transition (such as the Czech Republic, Poland and Hungary) have, on occasion, experienced difficulties as a result of large-scale capital inflows.<sup>39</sup> These were encouraged by the relatively high interest rates implied by the macroeconomic stabilisation

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<sup>36</sup> According to Berrigan and Carré (1997), without adequate understanding of equilibrium conditions, agreeing on a central parity for the CEECs against the euro would be a "hit and miss" affair. They therefore advocate a cautious approach to adopting a hard peg.

<sup>37</sup> See for instance Halpern and Wyplosz (1997) or Nuti (1996).

<sup>38</sup> The Czech case proves a good example of the difficulty of attempting to peg the nominal exchange rate in a transition economy. A currency basket peg was first introduced in 1991. The composition of the basket was changed in 1992, and again in 1993 when the koruna's exchange rate was based on a basket made up of the dollar (35%) and D-mark (65%). Full convertibility of the koruna was implemented from October 1, 1995. The fluctuation band of  $\pm 0.5\%$  was increased to  $\pm 7.5\%$  in February 1996. Initially (as was also the case in Poland) the magnitude of the devaluation prevented the exchange rate from acting as an effective anchor. Subsequently, nominal currency stability and a higher rate of inflation than in OECD countries undermined the cushion which an undervalued exchange rate provided in the early years of transition. The real appreciation of the exchange rate was not matched by increases in productivity, and Czech firms began to lose competitiveness. Strong speculative pressure emerged and the Czech Central Bank attempted to fight the speculative attacks using foreign exchange intervention and an increase of interest rates. It is estimated that some \$2 billion in reserves was spent in an attempt to maintain the fixed exchange rate system, (*Financial Times*, 1/12/1997). However, in May 1997 it was forced to switch to a managed float based on a target rate of 17-19.5 koruna per D-Mark.

<sup>39</sup> As Gabrisch (1997, p.577-580) explains, the difficulties experienced by certain CEECs as a result of capital inflows could be repeated after enlargement as a consequence of transfers to these countries from the Common Agricultural Policy and Structural Funds.

programmes in transition economies, at a time when interest rates in Western Europe and the US were relatively low.

Capital inflows may create difficulties for the recipient country in a number of ways.<sup>40</sup> Sudden surges in capital inflows may lead to rapid monetary expansion, inflationary pressures, real exchange rate appreciation, and widening current account deficits. The inflow of foreign capital may also lead to speculative bubbles, with sharp increases in prices of property, and on the stock exchange. A major fear is that, given the volatility of international capital movements, substantial capital inflows may be followed capital flight.

As sterilisation may be difficult to implement and costly in transition economies, some members of the Working Group were in favour of controls on capital movements.<sup>41</sup> They pointed to the East Asian experience which provided further evidence for the risks of overhasty liberalisation of capital movements when it is combined with lax enforcement of prudential rules, weak regulation and poor supervision of the financial sector.

Although freedom of intra-EC capital flows was required as part of the Single Market *acquis* (Directive 88/361/EEC), transitional periods were granted to Spain, Greece, Portugal and Ireland. Several members of the group suggested that when the CEECs join the EU, there might be a case for them maintaining some precautionary restrictions on capital movements temporarily and for allowing the possible reinstatement of transient controls in emergency situations, provided there is adequate prior consultation with the ECB.

Other members of the Working Group were opposed to capital controls arguing that a major difficulty is ensuring their effectiveness, as capital flows may be re-routed through other channels (such as current account transactions, and intra-firm transfers of transnational enterprises). Moreover, it was pointed out that capital controls may worsen the international allocation of resources, preventing countries from achieving a better international diversification of their portfolios, and reducing the necessary funds for investment in the country concerned. They may also insulate the country from competitive pressures, thereby reducing the incentives to introduce necessary reforms. Capital controls (and even more so, exchange controls) also entail administrative costs and may permit a certain degree of bureaucratic discretion. However, there seemed general agreement that where capital liberalisation occurred, it should take

<sup>40</sup> As Calvo et al (1996) explain for the case of developing countries.

<sup>41</sup> A distinction may be made between capital controls, which refer movements on capital account, while exchange controls (such as the proposed "Tobin tax") extend also to current account transactions of the balance of payments.

place in a gradual and orderly way and should be paralleled by improvements in regulation and supervision of the financial sector.

The role of the exchange rate mechanism is to act as a shock absorber in the event of asymmetric shocks.<sup>42</sup> The question which arises is whether between the EU and CEECs the likelihood of asymmetric shocks will be greater or less in an enlarged EU. It seems likely that transition countries with an insufficient level of structural adjustment, and low economic and financial convergence with the EU will be more liable to asymmetric shocks with regard to the euro area. As integration proceeds, it will probably be accompanied by some convergence of consumer tastes and preferences. If this is the case, on the demand side the shocks would be more likely to affect all the partners, reducing the role for a shock-absorber such as adjustment of exchange rates.

The implications for the production side are less clear. If integration leads to specialisation according to a Ricardian concept of comparative advantage, the economies of an enlarged EU will become less similar and more vulnerable to asymmetric shocks. Against this, a growing share of trade between the EU states and the CEECs is intra-industry.<sup>43</sup> This could be taken to imply that the economic structures of the potential members of an enlarged EU are becoming more similar and so are less likely to be affected by asymmetric shocks.<sup>44</sup>

The cost of forgoing the exchange rate instrument will also be less if it can be replaced by alternative mechanisms. Such mechanisms could include wage-price flexibility and factor mobility,<sup>45</sup> and EU or national measures such

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<sup>42</sup> These are disturbances which affect the countries involved in different ways.

<sup>43</sup> For instance, according to Eurostat data (Eurostat Statistics in Focus, External Trade), in 1995 the share of intra-industry trade in trade with the EU was 68% for Slovenia, 65% for the Czech Republic, 60% for Hungary, 48% for Poland and 34% for Estonia.

<sup>44</sup> However, even here the issue is far from being clear-cut, since what appears as intra-industry trade may in fact disguise huge differences in quality. The concept of intra-industry trade has been challenged as being merely a statistical phenomenon since, in general, the measured level of intra-industry trade decreases as the level of disaggregation of data increases. What is needed in this context is further research into the distinction between vertical intra-industry trade (involving quality differences) and horizontal intra-industry trade (which is trade in genuinely similar products).

<sup>45</sup> Wage-price flexibility implies that in the case of a permanent adverse asymmetric shock the real wages and relative prices in that country or region (if the production is concentrated in a particular area) will fall. There will be a strong incentive for workers to move to other regions or countries where real wages are higher. Similarly, if there is sufficient capital mobility, capital will be attracted to other regions where the remuneration of investment is higher. If factors of production were sufficiently mobile, this process would continue until differences in the remuneration of factors between regions were eliminated.

as regional or budgetary policy which could be used to compensate regions or countries which have been adversely affected.

Although in some cases the transition economies have displayed a relatively high degree of real wage and price flexibility, as Backé and Radzyner (1998) argue, this has not always been the case, and moreover may be a transitional feature associated with the transformation process.

The Single Market Programme has led to a high level of capital mobility in the EU, but this is much less the case for labour. Freedom of labour movement is also one of the most sensitive aspects of enlargement, given the widespread fear in existing EU member states that removal of the barriers could lead to large-scale migration to the West.<sup>46</sup> For this reason there has been much debate about whether to introduce a transition period before allowing full mobility of labour after Eastward enlargement, even though this runs counter to one of the fundamental tenets of the Internal Market Programme.<sup>47</sup>

In the case of a single country if the demand for a good whose production is concentrated in a particular region falls, transfers from the government budget may be used to compensate producers in that region for the loss of income. However, the task of fiscal consolidation in the CEECs is likely to limit the funds available for this purpose. At least in theory EU regional or budgetary policies could be used in a similar way to offset the repercussions of asymmetric shocks between the member states. However, both the size of the EC Budget (with a ceiling of 1.27% of EU GDP) and the limit of 4% of GDP on transfers through the Structural Funds proposed by Agenda 2000 severely restrict the ability of the Community to carry out this role in an enlarged EU. A way round this difficulty would be to rely on stabilisation rather than compensation, and establish an EU stabilisation fund for this purpose, but at present such a measure is not on the agenda, and does not seem to have much political support (Polak, 1997, p. 509).

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<sup>46</sup> However, much of the recent literature suggests that migration in an enlarged EU will be on a manageable scale. This conclusion emerges either from a comparison with labour flows from South to North Europe over the 1950-1970 period (CEPR, 1992) or from an analysis of the factors underlying the decision to migrate (Faini, 1995, and Faini and Venturini, 1994). Individuals have a preference for living in their own country for social, cultural and linguistic reasons, so an individual will only undertake migration when the wage differential is large enough to offset the non-monetary costs of migration.

<sup>47</sup> The so-called "four freedoms" of movement of goods, services, labour and capital.

## 6. Procedures for Dialogue, Cooperation and Coordination

As part of the pre-accession strategy, the CEECs participate in the activities of Ecofin, and of various working groups, and sub-committees on economic issues. They cooperate in technical areas such as the preparation of statistics and macroeconomic forecasting. The Accession Partnerships also entailed annual Joint Assessment of medium-term economic policy priorities. However, there is still scope for including the CEECs more effectively in EU mechanisms of coordination of economic policies.<sup>48</sup>

When the applicant countries join the EU, even without participating fully in Stage 3 of EMU, they are obliged to treat their economic policies as a matter of common interest and coordinate them in the Council. This involves participation in the procedures to monitor economic performance in the EU and its member states, as well as the coordination of economic policies through national convergence programmes, broad guidelines and multilateral surveillance to assess the consistency of the policies of the EU and its member states with the broad policy guidelines (Art.99§2-5 of the Amsterdam Treaty). They would also participate in the excessive deficit procedure as reinforced by the Growth and Stability Pact. The President of the Council represents the member states in inter-institutional relations so helping to organise the coordination of economic and monetary policy. In this way the new Member States would be involved in the consultations between the Council and ECB, and they would participate in the Economic and Financial Committee.

The consultation procedures in the EU are already at an advanced stage and there would seem a strong case for including the applicant countries in these as early and as far as is possible in order to familiarise CEEC policy-makers with the practical workings of EMU.

Some members of the Working Group agreed with the proposal of Bergsten (1997a) that EMU should lead to the replacement of the Group of 7/Group of 10 countries by a Group of Three. However, the issues of responsibility for international economic policy and representation of the EU at the international level emerge from the Maastricht Treaty in a blurred manner. The ECB is responsible for monetary policy, while formal exchange rate agreements, and the orientation of exchange rate policy fall under the competence of the Council. Fiscal policy remains in the hands of the Member States, though subject to the constraints of the Growth and Stability Pact. It is therefore difficult to see how the ECB could represent the EU on issues relating to fiscal and exchange rate policies.

<sup>48</sup> For further discussion of these issues see Davididi and Ilzkovitz (1996) Temprano-Arroyo and Feldman (1998) and Dixon (1998).

The Vienna European Council of December 1998 endorsed a report of the Council on external representation of the Community which foresees that the President of the Ecofin Council (or if the President is from a non-euro area Member State, the President of the Euro-11 assisted by the Commission) shall participate in meetings of the G7. The ECB as the Community body responsible for monetary policy should be granted observer status at the IMF Board. The views of the EU on other issues relating to EMU would be presented at the IMF Board by an official from the Member State holding the Presidency assisted by a representative of the Commission.<sup>49</sup>

The issue of whether regional organisations such as the EU should play a more active role in international surveillance was raised in the context of a more general discussion concerning "new international financial architecture." Aside from the problem of representation, the introduction of EMU raises complex questions concerning future institutional relations between the IMF and EU. New techniques and procedures will have to be developed in order to enable the IMF to continue its surveillance of monetary and exchange rate policies in the EU, and it was felt that this IMF surveillance could provide a useful complement to internal EU procedures.

With regard to the CEECs, some members of the Working Group argued in favour of two-tier supervision, with national supervision being backed up by the reinforced role for the EU. The EU has a relatively well-developed system of financial supervision, and this experience could be used to the benefit of the CEECs. This could be achieved by giving greater priority to the question of supervision in the PHARE Programme. Against this, other members of the Working Group argued that this would encounter considerable principal-agent problems, and raised delicate questions of national sovereignty. There seemed widespread support for the idea that the IMF could play a more active role in ensuring that supervisory standards were better implemented in the CEECs.

## **7. The Impact of the Introduction of the Euro and Enlargement on the Integration Process**

The question was raised of whether deepening of the integration process would imply an additional hurdle for widening. This might arise because EMU adds to the *acquis* which has to be taken on by the applicant countries, or because the time and energy devoted to EMU means less for enlargement.

Against this it was argued that an EU strengthened by EMU would be in a better position to take decisions on enlargement. Padoa Schioppa (1988) refers

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<sup>49</sup> Conclusions of the Vienna European Council, 11-12 December 1998.

to the "contradictory quartet" which no international monetary arrangement has been able to reconcile simultaneously, namely:

- liberalised trade
- free capital movements
- fixed exchange rates
- autonomy of monetary policy<sup>50</sup>

The way forward entailed by introduction of the euro is to combine the first three elements of Padoa Schioppa's list with a common monetary policy. Introduction of the euro would remove certain fundamental consistencies in the present situation, so facilitating the enlargement process.

According to Eurobarometer surveys, public opinion in the CEECs remains very positive towards market reforms, and towards the European Union in general, although it has been falling in recent years (and, according to some members of the Working Group, expectations have becoming more realistic). It is perhaps telling that to date Eurobarometer has carried out no surveys of attitudes towards EMU in the CEECs.

## Conclusions

Despite heated discussions on various issues such as the relative advantages of different exchange rate regimes for economies in transition, or the usefulness or effectiveness of capital controls, a number of conclusions emerged from the discussions of the Working Group:

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<sup>50</sup> During the first period of the EMS (1979-83) participating countries maintained controls on capital movements and there were frequent realignments of exchange rates. After 1983 Italy and France managed to acquire exchange rate stability but only through losing autonomy for monetary policy and recourse to capital controls. Britain realised free capital movements and trade during the 1980s but only at the cost of exchange rate stability.

The 1998-92 period of the EMS was characterised by great stability, if not rigidity of exchange rates. The only realignments which took place were considered "technical", as for instance when Italy entered the narrow  $\pm 2.25$  band of fluctuation in 1990. The introduction of the Single Market entailed a commitment to free trade and capital movements. This system could survive only as long as the other ERM countries were prepared to sacrifice monetary autonomy and accept German policy leadership. In 1992 other EMS members were reluctant to raise their interest rates to the high levels applied in Germany after re-unification. They decided to regain a certain degree of monetary autonomy but this was only achieved by sacrificing fixed exchange rates, first with the currency fluctuations of 1992/3 and then from August 1993 when the bands of fluctuation of the ERM were widened to  $\pm 15\%$ .

- Preparing for EMU has to be analysed in the wider framework of getting ready for accession, which entails progress in meeting the Copenhagen criteria and taking on the *acquis*.
- The Maastricht criteria should not be regarded as a short-run objective for the CEECs, but rather a goal for the medium-to-long run.
- Introduction of the euro is likely to have a positive effect on trade and growth in the euro area, and this will probably be reflected in increased demand for imports from third countries, in particular, from countries like the CEECs, which have tight economic and trade links with the EU.
- It seems probable that the CEECs will use the euro to a greater extent than the currencies it replaces in the invoicing of trade, in the reserves of their central banks, and in the denomination of international private assets
- The sustainability of fiscal consolidation in the transition countries is likely to encounter a number of difficulties, in particular, because additionally government spending is necessary on infrastructure, pension systems, health care, education, and for the task of taking on the *acquis communautaire*.
- The CEECs urgently need to develop sound, competitive, well-regulated and adequately supervised financial sectors in order to implement monetary policy with market-oriented instruments, and as a means of avoiding the negative implications of volatile international capital movements.
- With regard to exchange rate policy, there should not be a single path in preparing for euro membership. What is important is that the choice of exchange rate regime is consistent with the overall macroeconomic policy mix. The CEECs should decide on an appropriate economic policy framework, and then ensure that the choice of exchange rate regime is consistent with that framework.
- Capital liberalisation should take place in a gradual and orderly way, and should be paralleled by improvements in regulation and supervision of the financial sector. When the CEECs join the EU, several members of the Working Group suggested that there might be a case for applicant countries maintaining some precautionary restrictions on capital movements temporarily and allowing the possible reinstatement of transient controls in emergency situations, provided there is adequate prior consultation with the ECB.
- The consultation procedures in the EU are already at an advanced stage and there would seem a strong case for including the applicant countries in these

as early and as far as is possible in order to familiarise CEEC policy-makers with the practical workings of EMU.

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**Table 1: Inflation and Long-term Interest Rates in the CEECs**

	Inflation (average annual increase in CPI)			Long-term interest rates*	
	1995	1996	1997	1996	1997
Bulgaria	62.0	123.0	1084.7	330.1	209.9
Czech Republic	9.1	8.8	8.4	12.5	13.2
Estonia	29.0	23.1	11.2	12.3	11.4
Hungary	28.2	23.6	18.3	28.2	23.1
Latvia	25.1	17.7	8.7	26.2	14.1
Lithuania	39.6	24.6	8.8	24.1	13.0
Poland	27.8	19.9	15.0	19.6	23.9
Romania	32.3	38.8	154.8	71.5	107.9
Slovakia	9.9	5.8	6.1	13.5	20.9
Slovenia	13.5	9.9	8.4	23.7	21.3

The Maastricht Criterion refers to 10-year government bonds (or the nearest maturities). As these are not available for most CEECs, the interest rates are generally for bank lending rates.

Source: Temprano-Arroyo and Feldman (1998)

**Table 2: The Fiscal Criteria in the CEECs**

	General gov. debt as % GDP 1997	Government surplus/deficit as % GDP		
		1995	1996	1997
Bulgaria	105.2	-6.4%	-13.4	-2.6
Czech Republic	10.9	-1.3	-1.8	-2.2
Estonia	5.6	-1.2	-1.5	2.1
Hungary	68.0	-6.8	-3.1	-4.8
Latvia	10.8	-3.4	-1.1	1.8
Lithuania	22.2	-1.8	-2.7	-0.5
Poland	48.2	-2.4	-2.5	-3.1
Romania	31.3	-2.6	-4.0	-3.6
Slovakia	26.7	-2.2	n.a	-4.8
Slovenia	24.1	0.0	0.3	-1.1

Source: Eurostat, Dixon (1998), and Temprano-Arroyo and Feldman (1998)

**Table 3: Growth and Unemployment in the CEECs**

	Growth of GDP Real percentage change			Unemployment %, ILO definition		
	1995	1996	1997	1995	1996	1997
Bulgaria	2.1	-10.8	-6.9	14.7	13.7	15.0
Czech Republic	6.4	3.9	1.0	4.1	3.5	4.7
Estonia	4.3	4.0	11.4	9.7	10.0	10.5
Hungary	1.5	1.3	4.4	9.5	9.2	8.1
Latvia	-0.8	3.3	6.5	18.9	18.3	14.4
Lithuania	3.3	4.7	5.7	17.1	16.4	14.1
Poland	7.0	6.1	6.9	13.3	12.3	11.2
Romania	7.1	3.9	-6.6	8.0	6.7	6.0
Slovakia	6.9	6.6	6.5	13.2	11.1	11.6
Slovenia	3.9	3.1	3.8	7.4	7.3	7.1

Source: Dixon (1998)

**Table 4: The Likely Impact of Introduction of the Euro on Exchange Rate Regimes in the CEECs**

Currency	Current Regime	Likely future Arrangements
Bulgarian lev	Peg to D-Mark	Peg to euro
Croatian kuna	Managed float, shadows DM	Managed float, shadow euro
Czech koruna	Managed float, shadows DM	Managed float, shadow euro
Estonian kroon	Currency board	Switch to euro peg
Hungarian forint	Crawling peg; basket 70% DM, 30% US\$	Jan 1 1999 euro replaced DM in peg basket; Jan 1 2000 switch to euro only peg
Latvian lat	Informal peg to SDR	Switch to euro peg not before 2000
Lithuanian litas	Currency board	Switch to 50:50 \$/euro fixed rate, probably in 1999
Polish zloty	Basket: 45% US \$, 35% DM, 20% others, crawling peg	Jan 1 1999, include euro in new basket; slower crawling peg. Eventually switch to euro-only basket
Romanian leu	Managed float	Managed float
Slovakian koruna	Managed float, shadows DM	Switch to euro shadow
Slovenian tolar	Managed float	Eventually fix rate to euro

Source: *Financial Times*, 8 December 1998

**Table 5: The increase in the EU share of the total trade of selected CEECs over the 1989-95 period**

	% total exports 1989	% total exports 1997	% total imports 1989	% total imports 1997
Czech Republic and Slovakia	18.2% (EC) 4.6% (Austria) 6.6% (GDR)	58.2%* (Cz Rep.) 45.0% (Slovakia)	17.8% (EC) 5.5% (Austria) 7.8% (GDR)	62.4% (Cz Rep.) 39.5% (Slovakia)
Hungary	24.8% (EC) 6.4% (Austria) 5.4% (GDR)	71.2%	29% (EC) 8.6% (Austria) 6.2% (GDR)	62.6%
Poland	31.8% (EC) 0.5 (EFTA)	64.0%	34.2% (EC) 0.7% (EFTA)	63.8%
Bulgaria	5.5% (EC) 1.5% (EFTA)	43.3%	10.3% (EC) 3.9% (EFTA)	37.3%
Romania#	28.5% (EC) 3.2% (EFTA)	56.5%	13.8% (EC) 1.3% (EFTA)	52.5%

\* 1996

# Earlier data is for 1988

Unless otherwise stated the statistics are for EC 12 in 1989 and EU 15 in 1997.

Source: Economist Intelligence Unit, own calculations on the basis of PlanEcon and EC Commission, 1994b, (Romania and Bulgaria), and own calculations on the basis of Rocznik Statystyczny (Poland).





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