Eastern Enlargement - Some Implications for the Monetary System

Diskussionspapier Nr. 71-W-98

Markus F. Hofreither

Juli 1998

wpr
Institut für Wirtschaft, Politik und Recht
Universität für Bodenkultur Wien

Die WPR-Diskussionspapiere sind ein Publikationsorgan des Instituts für Wirtschaft, Politik und Recht der Universität für Bodenkultur Wien. Der Inhalt der Diskussionspapiere unterliegt keinem Begutachtungsvorgang, weshalb allein die Autoren und nicht das Institut für WPR dafür verantwortlich zeichnen. Anregungen und Kritik seitens der Leser dieser Reihe sind ausdrücklich erwünscht.

Kennungen der WPR-Diskussionspapiere: W - Wirtschaft, P - Politik, R - Recht

WPR Discussionpapers are edited by the Department of Economics, Politics, and Law at the Universität für Bodenkultur Wien. The responsibility for the content lies solely with the author(s). Comments and critique by readers of this series are highly appreciated.

The acronyms stand for: W - economic, P - politics, R - law

Bestelladresse:

Institut für Wirtschaft, Politik und Recht
Universität für Bodenkultur Wien
Gregor Mendel-Str. 33
A – 1180 Wien
Tel: +43/1/47 654 – 3660
Fax: +43/1/47 654 – 3692
e-mail: h365t5@edv1.boku.ac.at

Internetadresse:

http://www.boku.ac.at/wpr/wprpage.html
http://www.boku.ac.at/wpr/papers/d_papers/dp_cont.html

Eastern Enlargement - Some Implications for the Monetary System

Markus F. Hofreither[*)]

Introduction

Currently, the dominating topics of European politics undoubtedly are, on the one hand, the realisation of the European Monetary Union and, on the other, the process of enlarging the community to the east. Although the number of detailed analyses dealing solely with one of these topics is extensive, the problem set emerging out of the combination of these two fundamental development processes has been analysed surprisingly rarely during the last years[1].

An explanation for this phenomenon may be provided by the fact that so far the European integration process predominantly dealt with markets, but not with policies. A look at the association treaties with Central and East European Countries (CEEC)[2] reveals, that no elements with respect to monetary policies are addressed explicitly. The same assertion holds for the structured dialogue between the EU and the CEECs. Only recently, a rising number of mostly informal discussions of monetary issues between EU and CEECs is to be observed at different levels. With individual countries it may be sub-committees or the committee level within the institutional framework of the Association Agreements, at the multilateral stage it can be observed e.g. in the form of casual conversations between ministers of finance during multilateral talks (Backé, 1997b, 31). The EU Monetary Committee has opened regular consultations with individual associated CEECs in October 1996 as well.

---

*) This Discussion Paper is an enlarged version of the background paper for a presentation at the conference “Agrimoney ‘98”, London, June 1998.

Markus F. Hofreither, Professor of Economics, Department of Economics, Politics, and Law, University of Bodenkultur Vienna, Gregor Mendel-Strasse 33, A-1180 Vienna; Tel. (++43) 1 47654 / 3671, FAX: (++43) 1 47654 / 3692, E-mail: HOFREITH@edv1.boku.ac.at.

1 Among the notable exemptions are Schmiedling (1992) or Frankel and Wyplosz (1995), suggesting the adoption of an ECU-based currency board managed by a central bank from an EU country or replacing the national currencies of the CEECs by the ECU. An opposite point of view was argued e.b. by Bofinger (1991) or Portes (1994) stressing that such steps could damage the quality of the EMS institutions and, in particular, may have an inflationary impact on EU currencies. Bofinger (1991) recommends the CEECs to choose a fixed exchange rate system with the ECU as an anchor currency.

2 Throughout this paper the abbreviation CEEC refers to the four Visegrad countries (Hungary, Poland, Czech Republic, Slovakia) plus Slovenia, the three Baltics (Estonia, Latvia, Lithuania) as well as Bulgaria and Romania. The five east European countries selected by the Union for the first wave of Eastern Enlargement are dubbed CEEC-5.

Admittedly, attempts to treat the topic of this paper seriously are severely hampered by the fact that the substantial uncertainties with respect to the process of Eastern Enlargement do occur in combination with the open questions regarding the performance of the EMU in practice. By assuming a smooth functioning of the EMU, a successful transition process of the CEECs and mastery of the necessary reforms within the EU-15 this topic can be analysed at the narrow institutional-technical level. At a broader macroeconomic level the fundamental economic questions regarding the functioning of the EMU and hence the broad range of monetary policy options, including also possible alternatives for eastern European applicants to the current criteria and the procedure of entering the EMU, would have to be taken into account.

Due to given limitations this paper addresses the problem set at the narrow institutional-technical level. At the outset, it provides a short overview of the general steps and consequences of Eastern Enlargement. Then it proceeds to a brief description of the current status of monetary economic reform in the CEEC-5, and, finally, draws some conclusions with respect to the implications for the monetary system of CEECs and EU.

Due to the given constraints, this paper mainly focuses on the first, narrow view of the problem set. Firstly, it tries to give a short overview of the general steps and consequences of Eastern Enlargement and the realisation of the EMU, then, secondly, proceeds to a brief description of the current status of economic reform in the CEEC-5 with a special emphasis on monetary aspects, and, finally, intends to draw some conclusions with respect to changes in the monetary system as well as monetary policy requirements. In order to make the inherent structure as well as the main problem set of this paper transparent, the following principal questions could act as a guideline:

1. What are the consequences of the realisation of the EMU for the CEECs?
2. What are the consequences of the accession of CEECs for the institutional setting as well as the performance of the EMU?
3. What activities have the CEECs to set in order to prepare for EMU membership in an optimal way?

This paper, however, does not raise more fundamental questions related to the adequacy of the way the EMU is realised by European policy-makers. Although this question is not a mere academic dispute but probably of significant policy relevance, we have to accept that the way the Maastricht Treaty forges this process is a political reality[3] today, and probably also in the coming years when the first CEECs will enter the Union. Nevertheless, in order to allow a comprehensive assessment of

---

[3] For interesting position about that topic refer e.g. to De Grauwe (1997)

the implicit risk structure of these politically unprecedented steps this problem set will be assessed briefly at the end of the paper.

Status and developments in the process of Eastern Enlargement

History of the accession process

After establishing bilateral trade and co-operation agreements combined with granting GSP-status, setting up the PHARE program etc. immediately after the political breakdown of communism as the leading political philosophy in the CEECs the decision of the council in Copenhagen (June 1993) provided an important stimulus in the process of Eastern Enlargement of the EU. The EU declared officially to integrate CEECs provided some preconditions are readily fulfilled. Among these conditions, first established at the Council Meeting in June 1993 in Copenhagen, not only the ability of the CEECs to meet the resulting requirements as well as to sustain the increased economic pressure was mentioned, but also the ability of the community itself to provide access without jeopardising the long term process of integration has been addressed explicitly. In this period the Commission also signed Association Treaties with all CEEC-10.

Between April 1994 and June 1996 all associated countries filed their accession applications. The following council meetings (e.g. Essen 1994, Madrid 1995) devoted a great deal of their activities in shaping the details of the (pre)accession process. In December 1995 the Madrid council obliged the commission to give its opinion on the filed accession applications, to provide a study dealing with the impact of Eastern Enlargement on particular common policies and to design a proposal for the financial constitution of the community after 1999. Last year the Commission announced its decision to start the first wave of integrating CEECs in 2002 with five countries: Hungary, Poland, Czech Republic, Slovenia, and Estonia. It is expected that 2002 is a somewhat too ambitious deadline, but at least by 2005 the first CEECs could be members of the EU. However, random political disputes like the current Cyprus problem could delay this process even further.

Economic integration effects for EU-15 and CEECs

Primarily, changes in three areas are to be expected: (i) trade liberalisation, (2) financial transfers, and (3) the institutional and legal framework. With respect to ***trade liberalisation*** the association agreements induced a substantial progress with respect to commodity markets, which even begins to embody “sensitive” products. Trade liberalisation so far has not led to the predicted drawbacks for EU-15, it is the CEECs which in specific areas experienced more problems than expected. EU accession of CEFTA-countries may indirectly reintroduce trade restrictions vis-a-vis the remaining association countries, as the CEFTA-agreement is more comprehensive, in e.g. also including agriculture (Horváth et al., 1997, 85).

Regarding ***financial transfers*** in connection with Eastern Enlargement the various assessments differ substantially, but nearly in all cases embody impressive figures. The main volume of these transfers is located in the domain of regional and structural as well as agricultural policies of EU-15 in their present form. It is a fact that the share of agriculture in the CEECs is substantially higher than in the EU and that the per capita income level is markedly lower in those countries. On the contrary, the ability of the Union to spend exorbitantly high additional amounts out of a more or less capped budget is obviously restricted. So attempts to avoid these financial transfers will require either to wait until these countries have achieved a comparable level of economic conditions or to alter the relevant policy mechanisms in a fundamental way. The current political strategy, formulated in the *Agenda 2000*, seems to rely essentially on the second alternative.

The third and sometimes underestimated dimension of Eastern Enlargement is the induced change in the ***legal and institutional setting*** of the CEECs (Bofinger, 1996), but to some degree also of the Union itself. At the microeconomic level all protectionist national instruments of trade policy are lost. Also providing specific subsidies to firms is subject to restrictive rules specified in Article 92 of the EU Treaty. Likewise, at the macro level, fiscal policy may be restrained through the ban of budgetary financing by the central bank or the "excessive deficit procedure" (Article 104 Treaty) under the policy co-ordination and surveillance provisions of the EC Treaty. These institutional restrictions of fiscal policy may be further exaggerated by the fact that under fully liberalised capital market conditions the government as a debtor has to compete globally with other emitting institutions. EU members joining EMU are facing even more severe losses of national authority at the macroeconomic level, as the possibility of a national monetary policy is eliminated. The required commitment to an anti-inflationary course of economic policy eliminates the possibility to reduce the burden of government debt via “surprise inflation”. So, the legal and institutional setting of a core member of the Union, being an EMU-*in*, differs a lot from the current status of most applicant countries. However, it has to be stressed that the preparation for these institutional changes at the same time may serve as an important ingredient for a successful transition process of CEECs.

Monetary Aspects of EU accession of CEECs

As already mentioned, neither the association agreements do contain any reference to monetary policy co-operation, nor does the structured dialogue. Although the declaration related to the European Council meeting in Copenhagen (June 1993) contains a passage requesting “...the candidate’s ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union” there is no official relationship between these two processes at all. So, there is no need for CEECs accessing the EU to fulfil the convergence criteria of the EMU nor to adopt the Euro as a currency. They only have “to share the aim of monetary union”, whatever this may intend. A useful interpretation of this wording could be that the convergence criteria may act as practical guidelines for long-term perspectives of policy making in the CEECs. In this respect, these criteria would complement the Copenhagen criteria in a useful way.

It is quite certain that the “first-wave” implementation process of the EMU will be finished at the time the first CEECs will join the Union. It will remain a matter of political judgement to what extent “adherence to the aims of economic and monetary union” obliges fully liberalised capital movements, complete financial sector reform with an independent central bank pursuing price stability as the primary objective, or even a satisfactory record of all convergence criteria.

The bottom line is that integrating the national currencies of CEECs into the EMS or the EMU respectively, will entail substantial changes in the monetary policy setting of the accession candidates. However, this integration of the CEECs into the EU will take place in stages, with the first stage being the integration of their economies through EU accession, the second stage the participation in the EMS II, and, ultimately, EMU membership with the Euro replacing their national currency. A very important preparatory step in the domain of the monetary system will be switching to or at least intensifying policy targeting on exchange rates.

Current status of economic conditions in the CEECs

Macroeconomic performance

As yet, the transition process has brought about positive results with respect to economic stability and growth. Real private expenditure exhibit quite a steady growth pattern since 1994, with a special emphasis on fixed investment. This development also has positive consequences for (official) unemployment rates, currently ranging more or less at the level of the average rate of EU-15. One of the main open questions is price stability, although, some progress is recognized in this domain. Inflation rates declined to one digit levels in Slovenia and the Czech Republic, but still reach or even exceed the 20% mark in the other CEECs. Curbing excessive inflation rates has been achieved mainly by applying tight monetary and fiscal policies. Wage increases above the productivity level may continue in order to compensate for a sharp decline during the initial stages of the transition process, but are restricted by the implied reduction of foreign competitiveness. The status of CEECs with respect to selected macroeconomic indicators in 1996 is illustrated in Table 1.

TABLE 1: Selected Macroeconomic Indicators in CEEC-5 (1996)

Country	**GDP**	**Unemploy-ment Rate**	**Inflation** (Consumer Price Index)	**Discount Rate**	**Governm. Deficit** (in % to GDP)
Czech Republic	4,4	3,5	8,8	10,5	-0,1
Estonia (1996)	4,0	4,3	23,1	*)	-1,6
Hungary	1,0	10,7	23,6	23,0	-2,0
Poland	6,1	13,2	19,9	22,0	-2,5
Slovenia	3,1	14,4	9,7	10,0	0,3

Source: *Focus on Transition,* 2/1997, Statistical Annex.
*) Due to currency board arrangements the Bank of Estonia does not lend to the government or enterprises and therefore, does not define and publish a discount rate.

Table 1 reveals that one of the main open questions remaining to be solved is price stability, although, some progress is to be confirmed in this domain. Inflation rates declined to one digit levels in Slovenia and the Czech Republic, but still reaches or even exceeds the 20% mark in the other CEECs. Curbing excessive inflation rates has been achieved mainly by applying tight monetary and fiscal policies (Wissels, 1996). There is some indication of wage pressure and the process of wage increases above the productivity level may continue as wage levels have been depressed during the initial stages of the transition process. However, this development is clearly restricted by the implied reduction of foreign competitiveness.

Due to the still low real exchange rates and an improvement of the quality of export products the balance of payments is improving in most countries. At times, strong inflows of foreign capital posed considerable problems for monetary policy.

Monetary policies in the CEECs

The ability to fulfil the obligations of a monetary union in the future requires the successful conclusion of the transformation process as well as structural reforms aiming at establishing market economies. A proper monetary policy plays a critical role in order to get inflation down and also to bring the national monetary systems in line with the EMS.

During the initial stages of the transition process various forms of capital controls prevailed. Since then, the progress in providing the basis for a solid monetary policy by reforming the banking system is notable. The current status of the monetary system in the CEEC-5 from the view of the Commission’s country reports (“Opinions”) is summarised in Table 2.

TABLE 2: Current Status of the Monetary System of the CEECs

Country	*Central Bank*	*Formal Objectives*	*Intermediate /operational Targets*	*Budget Deficit Financing*	*Exchange Rate Regime*	*Convertibility*	*Banking sector*
Czech Republic	Largely independent, but accountable to parliament	Stability of national currency	Fixed Exchange Rate and M2 / PRIBOR	Not fully prohibited	Managed float (since May '97)	Most forms of capital inflows liberalised	Highly concentrated, with small inefficient banks
Estonia	Highly independent	Stability of national currency	Exchange Rate	Prohibited by Central Bank Law	Kroon fixed against D-mark	Full with respect to current account (since 1992), also most capital movements	Most banks privatised, competition satisfactory
Hungary	Formally independent	Control of inflation (not officially in Central Bank law)	Exchange Rate and M2 / interest rate differential	Almost fully eliminated by the Central Bank law	Crawling peg	Full with respect to current account (since 1996), partly for capital account	Highly concentrated
Poland	Not formally independent from government *)	Strengthening the currency	Broad money and Exchange Rate	Not prohibited by Central Bank Law	Crawling peg (+/- 7%), deval. 1% p. month	Full with respect to current account (since 1995), partly for capital account	Segmented, state-dominated, low competition
Slovenia	Highly independent, but accountable to parliament	Stability of national currency	M1	Formally not fully prohibited	Managed float (since mid-92)	Full with respect to current account (since 1995), partly for capital account	Low competition, state-owned banks, interest rate agreement

Source: Pautola (1998, 45ff); Horváth et al. (1997, 69ff) ; Krzak and Schubert (1997, Annex).

*) In Poland a new Constitution was adopted by a referendum in May 1997, which enshrined an independent status of the central bank and also entailed fundamental changes in central bank legislation (Horváth et al, 1997, 76).

Table 2 illustrates that there is considerable progress in transforming the monetary system in a way that adequate monetary policy making becomes possible. All countries have introduced a two-tier banking system, distinguishing between central bank functions and commercial bank operations. However, concentration in the commercial bank sector of CEECs is still very high in many CEECs. This severely dampens competition in all countries with the exception of Estonia, where foreign bank branches are offered the same conditions as domestic banks.

Remaining country specific problems are e.g. indexation of interest rates and wages in Slovenia, but also the low volume of government bonds in this country, hampering the use of indirect instruments by the Slovenian central bank. In some countries also the problem of bad loans in the banking sheets is not resolved so far, as is the retreat of the state from bank ownership.

Despite the observable progress the Commission’s country reports spell out that a substantial deal of work is still lying ahead. Nevertheless, the policy changes realised so far positively helped to improve the overall macroeconomic performance in most CEECs. Exchange rate policies contributed substantially to this progress.

Exchange rate systems of CEECs

The choice of the exchange rate regime is one of the most important decisions in a transition economy. Generally speaking, a balance between external competitiveness and price stability has to be found. Two stylised facts have to be mentioned with respect to exchange rate systems in the CEEC-5: no exchange rate system so far has proven to be permanent, and there is no clear one way-development path as countries have switched forth and back between different exchange rate regimes (Koch, 1997). In this respect we observe changes between fixed exchange rate systems, pegging against currency baskets, floats with crawling bands, pre-announced crawling pegs, etc.

All CEEC-5 countries except Slovenia do apply forms of a basket-based pegging. The four countries discussed here opted in 1990/91 for baskets which contain EU currencies with a share of 50 % or more, the U.S. dollar making up most of the rest. Only Hungary also incorporated the ECU into its currency basket for limited periods (1991 to 1993 and 1994 to 1996 with a 50% and 70% share respectively). In 1990 Czechoslovakia formed a basket containing a share of 62 % EC currencies and the Austrian Schilling. Its successor states switched to a DEM-USD peg in 1993/94, with the DEM share roughly corresponding to the former share of all EU currencies and the Schilling. Poland switched from a USD peg in May 1991 to a basket, half of which consists of EU currencies with a predominance of the DEM (Backè, 1997a). Yet, in heading for EU accession the weight of the US-Dollar still seems too high in relation to European currencies.[4]

In choosing the (nominal) exchange rate as an intermediate target for monetary policy these countries had to accept that the money supply becomes endogenous, as only the domestic component remains under direct control of the central bank. Moreover, due to the inflation differential such a policy is vulnerable to real-term currency appreciation, causing sometimes severe trade deficits.

Some authors suggest that these countries should switch to a single currency peg, as such a step would be most favourable with respect to the credibility of the exchange rate system in face of quite a high vulnerability to inflationary processes (Hochreiter, 1995). Empirical evidence suggests that devaluation has a substantial impact on domestic price development (Koch, 1997, 25f.). However, with respect to real effective exchange rates the nominal devaluations since 1990 clearly improved the competitive position of countries like Poland, Hungary, or the Czech Republic.

By January 1996 all Visegrad countries as well as Slovenia have assumed Article VIII of the IMF's Articles of Agreement, rendering their currencies fully convertible for current account purposes, only leaving some restrictions on capital account transactions (Radzyner and Riesinger, 1996, 35). It is intended in all countries to remove the remaining barriers for capital movement within the next two years as well.

Eastern Enlargement and European Monetary Policy

CEECs and realisation of the EMU

The political process of Eastern Enlargement of the European Union is expected to lead to a first wave of accessions between 2002 and 2005. Before this event the EMU will be realised in its final stage with the introduction of the Euro as a currency. So the question, what consequences the realisation of the EMU for the monetary arrangement of the CEECs before their EU accession will entail, has to be raised first.

It has been demonstrated in this paper that the process of economic integration between the CEEC-5 and the EU has improved substantially during the last years. This also holds for the financial sphere. Nevertheless, the introduction of the Euro will induce perceptible changes in the setting of monetary and exchange rate policies for the CEEC-5:

1. Immediately, the four countries having pegged their exchange rates to currency baskets will have to replace the currencies of the EMU-member countries which will no more exist after

[4] Until recently the Hungarian currency basket contained 30 % US-$ and the Polish basket even 45 % (Horváth et al., 1997; 87).

2001. For Hungary and the Czech Republic, e.g., this implies to replace 70 % respectively 65 % DEM, Poland has to find a substitute for 35 % DEM and 5 % FRF.

2. This change may also provide an opportunity to increase the weight of the Euro which would make sense with respect to trade patterns particularly in the case of the Czech Republic. Such an adjustment would even make more sense if the Euro will take a role as a vehicle currency partly replacing the dollar.[5].
3. Although Slovenia due to its floating exchange rate system faces no immediate need for a change, the possible payoffs of a switch to a fixed regime with a prominent role for the Euro will have to be debated intensively.
4. In general, the management of the official reserves of all CEECs will be influenced by the introduction of the Euro.

The remaining space for monetary policy making will also be determined by the decision whether these countries will participate in the EMS II and the relevant ERM II from the beginning of their EU membership.

Situation of countries outside EMU

Stylised groups of countries

As already mentioned, the integration of the first CEECs into the EU between 2002 and 2005 will take place in three stages, being determined both by the degree of economic convergence and political preferences. An attempt to structure the likely outcome of the first wave of Eastern Enlargement three groups of countries can be distinguished: EU-members already being EMU-*ins*, EU-members (including the first CEEC entrants) remaining in a *pre-in* position with respect to the EMU[6], and CEE-countries situated in a *pre-in* position with respect to EU-membership.

The following Figure 1 tries to illustrate the likely situation after the first round of Eastern Enlargement.

---

5 On the contrary, decisions on currency baskets are also influenced by historic determinants, e. g. the size and the denomination of foreign debt or the composition of foreign investment stocks and flows (Backé, 1997a, 40).

6 The EU Treaty refers to these countries with the term “countries with a derogation”, in the discussions about these topic also the term “second-wave countries” is employed.

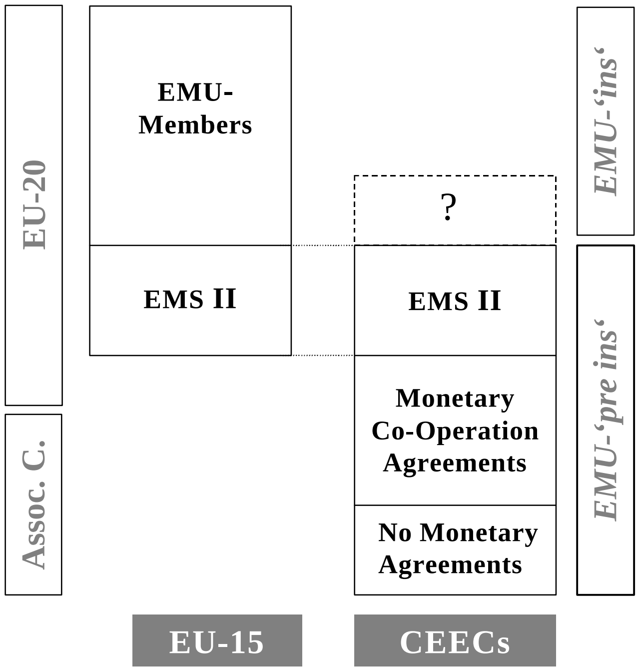

FIGURE 1: Situation after the first wave of CEEC-Accession

After the first round of Eastern Enlargement we will have an EU-20, with most likely five countries waiting for the second wave. From a monetary viewpoint we will have, at least, eleven EMU-*ins*, the remaining countries pending in a *pre-in* situation. The accession countries will either participate in EMS II or may be committed to some other monetary arrangements. For the remaining 5+n countries all three monetary options are at least a hypothetical possibility. The question mark indicates the theoretically interesting problem whether some of the newly accessing countries could at the same time become members of EMU, which will be addressed later in this paper.

EMS II and ERM II

The monetary policy setting for these countries remaining outside the EMU will be determined by EMS II, the successor of the EMS, which will replace the 1979 established EMS once the Euro is introduced (Backé/Lindner, 1996). One of the primary objectives of EMS II is to ensure a close monetary policy co-ordination between the Euro area and the "second-wave" countries. Basically, the EMS II is built upon five central principles:

(1) The anchor of the exchange rate mechanism is the Euro, with participating countries setting up bilateral central rates expressed in Euro with 15 % fluctuation bands resembling the current setting in the EMS (Pautola, 1998)

(2) In order to maintain price stability the ECB can interrupt exchange rate interventions if that is deemed necessary for securing the stability of the Euro.

(3) If significant exchange rate misalignments between the Euro and other countries are to be expected, realignments of the central rates are possible.

(4) The system has to be sufficiently flexible to accommodate different situations of the *pre-ins* with respect to economic convergence and monetary policy strategies.

(5) The exchange rate mechanism of EMS II allows equal treatment of all Member States with respect to the fulfilment of the convergence criteria.

„Pre in"-countries

The group of the five new accession countries[7] remaining in a *pre in* position with respect to monetary integration will conduct an independent monetary policy, but will already be committed to avoiding excessive deficits. The national banks of the five CEECs joining the EU will become members of the ESCB, with the governors being members of the General Council of the ECB, but not the Governing Council and the Executive Board (Backé/Lindner, 1996, 23).

By participating in the General Council of the ECB the central bank governors of the CEEC-5 will play a role in the process of co-ordinating the monetary policies between the EMU members and the non-EMU countries (Backé, 1997a, 41). One of the tasks of the General Council is to support the preparations of "second-wave" countries to enter Stage Three of the EMU. However, at the same time this new situation will restrict the individual range for monetary policy of the new entrants.

Yet, membership in EMS II and the Exchange Rate Mechanism (ERM II) is voluntary. However, it will be expected once the "second-wave" countries exhibit a satisfactory degree of economic convergence, enabling them to fulfil the relevant exchange rate criterion. Two reasons point in the direction of immediate participation:

(1) Stage III of the EMU supports as explicit goals the support of the convergence process of the *pre-ins* and the smooth functioning of the Internal Market. These objectives are equally binding for the remaining *"pre-ins"* of EU-15 and the new entrants (Horváth at al., 1997, 93). This, furthermore, will constrain the political possibilities to grant special flexibility exceeding the already quite flexible EMS II setting to the accession countries. By definition, in meeting the criteria for EU membership the new entrants should be in a position to cope with the not very restraining regulations of the ERM II[8].

---

7 This group consists of the four EU-15 remaining outside EMU and the CEEC-5 plus Cyprus.

8 Although having been widened recently in some countries, currently no currency margin of an CEEC-5 exceeds the bands of the ERM II.

(2) It may be in the economic self-interest of the CEEC-5 to participate in the EMS II from the very beginning of their membership, as the balance of rights and obligations within the EMS II looks more favourable than in the case of staying out (Backé, 1997a).

(3) The fluctuation bands of the four CEECs with a peg are narrower than those of ERM II.

Exchange rates are treated as a matter of "common interest" in the Union. The most important change for the CEEC-5 from participating in the ERM II will be the need to maintain parity rates as long as no common consent for a change has achieved. This requirement also holds for the initial setting of parity rates. With respect to intervention existing currency baskets will be replaced by a peg to the Euro. Both changes together imply e.g. for Hungary or Poland to give up their crawling pegs, which will force these countries to strengthen their performance with respect to price stability.

The actual conduct of European monetary policy after realisation of the EMU is still an open question. Many experts believe that it will be similar to that of the German *Bundesbank*, which would imply that interest rate determination is strongly influenced by deviations from the inflation target as well as potential output. Hence, inflation convergence will remain a dominating objective for the *pre-ins*. Nevertheless, one cannot exclude a priori that the monetary relations between the EMU members and the "second-wave" countries could become much more asymmetric than they are at present (Pautola, 1998). In this case the adequacy of the institutional and legal setting will be tested thoroughly.

EMU membership of newly accessing CEECs?

The likelihood that one or more of the accessing CEEC-5 will become an EMU member simultaneously with EU accession is seen to be rather low. Firstly, the chance of the CEEC-5 to meet all convergence criteria until 2002 is weak, particularly regarding inflation. Secondly, a legal problem emerges with respect to the exchange rate criterion requiring two years of formal participation in the ERM without any devaluation. Perhaps, this problem could be remedied by giving up the requirement of formal ERM membership. To circumvent this problem the participation of selected CEECs in the ERM II prior to EU membership has been proposed in the academic discussion (Bofinger, 1996; Nitsche, 1996). Thirdly, the possibility of simultaneously joining EU and EMU may simply be obstructed by technical requirements not being fulfilled by the banking system of such a country at the day of accession.

Monetary arrangements for "second wave" countries

Although currently EU membership is a precondition for joining ERM (Horváth et al., 1997, 92), the possibility and feasibility of participating in the ERM II by CEECs not joining the EU in the first enlargement round is yet a matter of debate (Nitsche, 1996). The consequences of such an arrangement of “second wave” countries would be, firstly, a dampening effect on short-term exchange rates between the Euro and their national currencies, but, secondly, also a loss of freedom with respect to monetary policy making, as the Euro would be the only anchor for these currencies. In the long run, such an arrangement would have positive effects regarding trade flows between EU and CEECs, as the Community would have a direct influence on the determination of central rates. Furthermore, such a setting would foster the process of economic convergence.

However, the feasibility of such an arrangement primarily depends on the inflation differential between the Euro zone and the relevant CEECs, influencing the necessity of exchange rate adjustments. If participation in ERM II is not considered to be feasible other forms of exchange rate co-operation agreements may be useful to restrain the risk of excessive exchange rate movements in face of increasingly liberalised capital markets. Forms of arrangements between the ECB, the central banks of the *"pre ins"* as well as the central banks of the association countries determining the criteria for interventions of the ESCB could be appropriate to avoid or restrain such exchange rate movements at low costs for all participants. Such arrangements, however, ought to be co-ordinated with activities of other international institutions engaged in this domain, e. g. the World Bank or the IMF.

EMU and CEECs: The broader perspective

In mainly discussing technical details it is frequently forgotten that the current process of realising a European Monetary Union is unprecedented, because never before in history so many countries have surrendered their national monies at a single stroke (Klein, 1998, 3). That this process is not without risk is even admitted by Wim Duisenberg, the elected first president of the ECB (Duisenberg, 1998). Realising this historic step in close connection with another process also without a historic precedent, the inclusion of selected CEECs, illustrates the tremendous dimension of the things to come.

With respect to EMU a risk which cannot be objectively assessed presently is whether a “one-size-fits-all” monetary policy for the selected eleven countries with substantial economic differences will be feasible. Important differences with respect to the often cited situation in the U.S. e.g. is the lack of substantial financial transfers between the members as well as the significantly lower labour mobility in Europe. With respect to the required flexibility of labour and product markets, which may be insufficient in many cases, Duisenberg (1998) emphasises the role of national policy making, admitting that “... it requires painful measures, the effects of which are not immediately perceptible“. However, the empirical validity of his statement, that “what is good for EMU is also necessary for the solution of the unemployment problem” may likely be questioned by other experts. However, if the performance of the EMU falls short of overall positive expectations, then quite a difficult situation with respect to economic policy making may occur, which may defer Eastern Enlargement for a long period.

The ability of the convergence criteria to safeguard the community against such a dilemma is clearly limited, as they primarily reflect political realities, but are widely arbitrary from an economic point of view. Furthermore, these criteria are only looking at macroeconomic factors, but do not refer to the equally important convergence at the microeconomic level[9].

A frequently addressed issue is the question whether unemployment currently is too high in Europe to dare the step into EMU, thereby relinquishing exchange rate variations as an important instrument. The frequently given answer, consistent with economic theory, is that monetary policy can influence growth and employment only in the short run, while its long term influence is on inflation rates only. However, having the choice between two sets of instruments may make a great difference in an exceptional economic situation, where the short-run is of relevance.

Looking at the EMU in combination with Eastern Enlargement from the viewpoint of the *Optimum Currency Area* literature a main question is the ability to cope with “asymmetric shocks”. As the exchange rate no longer is available as an instrument for equalising the competitive position, wages and prices themselves must react. If this does not work sufficiently, which can be presumed within the elaborated social setting of (western) Europe, fiscal policy has to step in. In requiring budgetary positions roughly to be in balance the “Stability and Growth Pact” intends to create a margin for such actions. Hence, the current 3%-criterion may have to be reduced in the near future in order to maintain this option.

A much broader and perhaps more theoretical discussion emerges from the question whether monetary policy really has to keep inflation rates low and uniform to foster economic convergence. Empirical studies illustrate that the distortion costs of a stable, anticipated inflation are not high, provided inflation is below 20 % annually. An advantage of inflation as a tax even is that it also hits e.g. black-market activities and money holdings of foreigners (Rebelo, 1994). For the CEECs it can reasonably be expected that substantial changes in the price levels may be essential to facilitate the completion of the transition process. This, however, may be at odds with the technocratic setting of convergence criteria. Particularly with respect to the accession of the CEECs it could be useful to step back and discuss again the basic options of forming a monetary union in a broader framework (e.g. DeGrauwe, 1997). This ranges from a thorough assessment of the feasibility of the conver-

---

[9] The literature on “Optimum Currency Areas”, originating in Mundell (1961), suggests, in general, four criteria for the feasibility of forming a currency union: (1) high mobility of factors of production; (2) high flexibility of prices and wages; (3) openness to trade; (4) diversity of production..

gence criteria to conceivable alternative monetary arrangements in order to introduce a common currency.

Summary and Conclusions

The political process of Eastern Enlargement of the European Union is in progress with negotiations with five CEECs having been launched early in this year. The EMU will enter its third stage by January 1, 1999, with eleven countries. By this time, all exchange rates between the “first-wave” countries will be irrevocably fixed. The Euro will be phased in during the next three years also as a hard currency. So, by July 1, 2002 at the latest, the EMU will exist in its ultimate state. At the same time this year is the official deadline for the first CEECs entering the EU. Main elements inducing direct or indirect changes of the monetary setting as a consequence of these two partly overlapping processes can be summarised as follows:

- Orientation toward fixed exchange rate systems of all CEECs will be necessary to prepare for full EU integration. The Euro will gain in importance and at least partly replace the US-dollar in the currency baskets of most CEECs or even serve as the only nominal anchor.
- The realisation of the EMU is of relevance for the CEEC-5 with respect to the functioning of the financial system. However, at the technical level dealt with in this paper there seem to be no severe conflicts between the internal deepening of the Union through the realisation of the EMU and the preparation for Eastern Enlargement.
- Although the Maastricht criteria are not official preconditions for EU membership of the CEECs a successful participation in the monetary arrangements within an EU-20 will require a strong movement towards these convergence indicators, which provide points of reference for a stability-oriented economic policy making within the EU too.
- Depending on the progress with respect to monetary stabilisation an important step for the new Eastern European Union members will be participation in ERS II. This step will further advance the convergence of economic fundamentals versus the EMU group.
- There will be no perceptible feed-back effects of CEEC-5 accession on the monetary system of the EU, particularly it is highly unlikely that accessing CEECs will at the same time be in a position to join the EMU.
- A successful performance of the EMU in the medium term is a crucial precondition for the continuation of the process of Eastern Enlargement, as severe problems of the European Monetary Union would put off this process for a long time.

References

Backé, P. (1997a): Interlinkages between European Monetary Union and a future EU Enlargement to Central and Eastern Europe, *Review of Economics in Transition*, 2/97, 27-45.

Backé, P. (1997b): Die Europäische Währungsunion und die Länder Mittel- und Osteuropas, *Österreichische Nationalbank, Berichte und Studien*, 1/1997, 77-85.

Backé, P. and Lindner, I. (1996): European Monetary Union: Prospects for EU Member States and Selected Candidate Countries from Central and Eastern Europe, *Focus on Transition*, Oesterreichische Nationalbank, 1(2), 46-66.

Bofinger, P. (1991): Options for payments and exchange-rate systems in Eastern Europe, *European Economy, Special Edition* No. 2, Brussels.

Bofinger, P. (1996). Vertiefung und Osterweiterung der Europäischen Union: Optionen für die Waehrungsunion der Zwanzig, *DIW Vierteljahresheft*, 65 (1), 75-81.

De Grauwe, P. (1997): The Economics of Monetary Integration, Third Revised Edition, Oxford.

Duisenberg, W. (1998): The Euro and the process of European Integration, Manuskript of a speech delivered in Rotterdam on March 5, 1998, http://www.ecb.int/.

Frankel, J., Wyplosz, C. (1995): A Proposal to Introduce the ECU First in the East, mimeo, June 1995.

Hochreiter, E. (1995): Central Banking in Economies in Transition, in: Th. Willett, R. Burdekin, R. Sweeney and C. Wihlborg, Establishing Monetary Stability in Emerging Market Economies (Westview Press).

Horváth, A., Dvorsky, S., Backé, P. and Radzyner, O. (1997): EU Opinions - The qualifying Round for Applicants, *Focus on Transition*, 2 (2), 69-101.

Klein, M. W. (1998): European Monetary Union, New England Economic Review, Federal Reserve Bank of Boston, March/April, 3-12.

Koch, E. B. (1997): Exchange Rates and Monetary Policy in Central Europe – A Survey of Some Issues, *Österreichische Nationalbank, Working Paper*, No. 24, 51 pp.

Krzak, M., Schubert, A. (1997): the Present State of Monetary Governance in Central and Eastern Europe, *Focus on Transition*, 2 (1), 28-56.

Mundell, R. (1961): A Theory of Optimum Currency Areas, American Economic Review, 60, September 1961.

Nitsche, W. (1996): WWU und EU-Osterweiterung, *Wirtschaftspolitische Blätter*, 5/96, 496-501.

Pautola, N. (1998): Optimal Currency Areas, EMU and the Outlook for Eastern Europe, *Review of Economics in Transition*, 1/98, 32-55.

Portes, R. (1994): Integrating the Central and East European countries into the International Monetary System, CEPR Occasional Paper, No. 14, London.

Radzyner, O., Riesinger, S. (1997): Central Bank Independence in Transition: Legislation and Reality in Central and Eastern Europe, *Focus on Transition*, 2 (1), 57-90.

Schmiedling, H. (1992): Lending Stability to Europe's Emerging Market Economies: On the Potential Importance of the EC and the ECU for Central and Eastern Europe, Tübingen.

Wissels, R. (1996): Pessimism Confounded? Economic Recovery in Eastern Europe, *Österreichische Nationalbank, Working Paper*, No. 22, 5-24.