I. INTRODUCTION

The European Union stands on the verge of an enlargement wave, which is without any historical precedent. Currently, negotiations are taking place with ten Central and Eastern European countries, Malta and Cyprus. These countries will have to incorporate the vast body of EU rules and laws (the so-called Acquis Communautaire) that regulate the free movement of goods, services, capital and labour in the Internal Market. Moreover, they will have to foster the ability to function within this common market and withstand competitive pressures by developing full-fledged market economies and strong economic structures. This should form the basis for a successful economic integration into Europe. After EU accession, the final step in this integration process, as prescribed by the Treaty, would be the adoption of the single currency: the euro.

Clearly, the accession process poses major challenges, in particular for the candidates in Central and Eastern Europe. As former communist plan economies, these countries focus on completing transition and making the necessary structural adjustments in their economies. Of course, these processes of transition and accession largely work in parallel. The purpose of this paper is to analyse the economic policy challenges involved and, in particular, to assess appropriate exchange rate regimes both before and after EU accession. As new Member States will be expected to eventually join monetary union, a key question is whether an early fixed peg to the euro in these strategies would be appropriate.

The first part of this paper focuses on EU accession. An overview is given of the relative economic and structural position of Central and Eastern European candidates on the basis of the formal conditions for accession (the so-called Copenhagen criteria). Following from this assessment, major economic policy challenges in the process of catching-up are identified and set against actual exchange rate policies in candidate member states. The second part deals with the prospects for joining Economic and Monetary Union. It evaluates the readiness for euro adoption on the basis of legal requirements (the Maastricht criteria) and economic preconditions as prescribed by the optimum currency area theory. Subsequently, appropriate exchange rate regimes towards EMU are discussed, paying specific attention to the pros and cons of early euro adoption.

II. PREPARING FOR EU ACCESSION

1.1 Introduction

In general, Central and Eastern European candidates can be characterised as relatively small and open economies. However, candidates are by no means homogeneous, as there are major differences in structural and economic performance. Indeed, the timing of EU entry will be

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1 The ten Central and Eastern European countries have a joint GDP of 5% of EU GDP (comparable to the Netherlands). External trade amounts to 45% of GDP on average, with strong trading ties with the EU.
determined solely on the basis of individual achievements and not depend on enlargement in groups. Assessments take place on the basis of the so-called Copenhagen criteria, which, apart from political requirements, prescribe that a well-functioning market economy is achieved before accession and economic sectors can compete in the common market (see box). The latest assessments of the Copenhagen criteria by the European Commission conclude that Estonia, Hungary and Poland appear to have functioning market economies, and should be able to withstand competitive pressures within the internal market in the near term. The Czech Republic and Slovenia follow closely behind with relatively more work to be done on the functioning of the market economy. Slovakia, Latvia and Lithuania are expected to be able to cope with competitive pressures in the medium term, while Bulgaria and Rumania are somewhat further behind, not meeting either criterion.

The formal economic requirements for EU entry reflect a need for convergence both in terms of structural and institutional development as well of (real) economic progress. The remainder of this section deals specifically with these concepts of convergence, which are then translated in specific policy challenges.

1.2 Assessing structural convergence

The development of institutional strength and administrative capacity is central to completing transition. It provides the foundation for implementing sound economic policies and creating an economic environment that attracts foreign direct investment and fosters entrepreneurship. However, in practice the assessment of intangible institutional aspects such as the quality of supervision, corporate governance and law enforcement is difficult. In this light, it is not surprising that the Copenhagen criteria offer room for interpretation and therefore lack transparency. The European Commission concludes in its latest assessments for instance that the Czech Republic and Slovenia show limited progress in reforming the public administration. In addition, Slovenia faces an underdeveloped private banking sector while the Czech authorities have to pursue the improvement of corporate governance, and the restructuring and privatisation of the financial sector with more vigour. For Poland, privatisation of heavy industries and restructuring of the agricultural sector have priority, whereas Slovakia lacks institutional strength and needs more progress in restructuring state owned banks. Undoubtedly, these are all sound and

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2 As the box indicates, candidates are expected to show the ability to fulfil all the rights and obligations of EU-membership, including EMU. In other words, ‘opt-out’ clauses such as current EU-members UK and Denmark have with regard to euro adoption will not be possible.

3 See the Regular Reports on Progress towards Accession, published by the Commission on 8 November 2000 (http://europa.eu.int/comm/enlargement/report_11_00/)
necessary policy objectives, but they give little indication of the extent of structural convergence towards EU levels, or the relative position among candidates.

A widely-used source for measuring transition and structural convergence are the EBRD transition reports. Despite problems of interpreting these indicators, they can be useful for cross-country comparisons and for analysing structural progress. The indicators tend to reflect the general ranking of countries by the European Commission. The indicators for all candidates show, however, relatively limited progress in areas of institution building (e.g. competition policy, corporate governance and financial market development) compared to straightforward market liberalisation and privatisation (see Figure 1 and Table 1). Again, some caution on interpreting these data is in place here. An alternative institutional indicator developed by the IMF for instance shows a better relative score for Slovenia than for Estonia, while this is the other way around for the composite EBRD indicator for institutional performance.

Finally, growth performance or relative income levels as depicted in figures 2 and 3 might be used as a proxy for structural convergence. Undoubtedly, there is a high correlation between growth/welfare and structural development, but it seems that lower income levels do not reflect per se a weaker structural position (see table 1). Good examples are Estonia and Poland, which score high on the EBRD institutional index, but have relatively low income levels.

4 Yuti (2000) finds that EBRD-indicators tend to overstate the extent of institutional and structural progress. Moreover, it is unclear how the benchmark of “functioning market economy” would relate to the average position of the EU.

5 The Bundesbank has argued that for adopting the euro new Member States should also pass an income test, without specifying the exact level of GDP per capita that should be reached.
Table 1 Structural indicators of accession countries

<table>
<thead>
<tr>
<th></th>
<th>Poland</th>
<th>Czech R.</th>
<th>Hungary</th>
<th>Slovenia</th>
<th>Slovak R.</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
<th>Romania</th>
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<tbody>
<tr>
<td>Real GDP-growth (average 1995-2000)</td>
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<td>1.6</td>
<td>3.8</td>
<td>4.3</td>
<td>4.5</td>
<td>4.6</td>
<td>3.3</td>
<td>3.1</td>
<td>-0.4</td>
<td>-1.0</td>
<td>2.5</td>
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<tr>
<td>CPI-inflation (2000, average)</td>
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<td>3.9</td>
<td>9.5</td>
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<td>11.9</td>
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<td>2.9</td>
<td>1.0</td>
<td>45.0</td>
<td>7.0</td>
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**Size of economy**

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<tbody>
<tr>
<td>GDP per capita (% EU)</td>
<td>37</td>
<td>59</td>
<td>51</td>
<td>71</td>
<td>49</td>
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<td>27</td>
<td>29</td>
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<tr>
<td>Population (% EU)</td>
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<td>2.7</td>
<td>2.7</td>
<td>0.5</td>
<td>1.4</td>
<td>0.4</td>
<td>0.6</td>
<td>1.0</td>
<td>6.0</td>
<td>2.2</td>
<td>100</td>
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<tr>
<td>GDP (% EU)</td>
<td>1.8</td>
<td>0.6</td>
<td>0.6</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>0.1</td>
<td>0.1</td>
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</table>

**Financial intermediation**

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<tbody>
<tr>
<td>Domestic credit to private sector as % of GDP</td>
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<td>44</td>
<td>21</td>
<td>36</td>
<td>38</td>
<td>26</td>
<td>17</td>
<td>10</td>
<td>11</td>
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<td>Broad money (M3) as % GDP</td>
<td>43</td>
<td>75</td>
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<td>53</td>
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<td>43</td>
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<td>21</td>
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<tr>
<td>Bad loans in banking sector as % GDP</td>
<td>14.5</td>
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<td>40</td>
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<td>11.9</td>
<td>36.6</td>
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**Institutional strength**

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</thead>
<tbody>
<tr>
<td>EBRD indicator of institutional performance</td>
<td>3.3</td>
<td>3.2</td>
<td>3.5</td>
<td>2.8</td>
<td>2.8</td>
<td>3.1</td>
<td>2.6</td>
<td>2.8</td>
<td>2.3</td>
<td>2.4</td>
<td>4.3</td>
</tr>
<tr>
<td>Index of institutional quality</td>
<td>7</td>
<td>6.8</td>
<td>8.7</td>
<td>8.5</td>
<td>2.8</td>
<td>6.1</td>
<td>2.6</td>
<td>2.6</td>
<td>-0.8</td>
<td>0.1</td>
<td>12.6</td>
</tr>
</tbody>
</table>

1. For the Baltic States M2 is used. EU average is 69% with 41% as minimum and 96% as maximum.
2. Simple average of EBRD-2000 transition indicators for the banking sector, non-banking financial institutions, competition policy and enterprise reform and corporate governance.
3. Index developed by Beatrice Weder and used in the IMF WEO 2000. Includes voice and accountability, political stability, government effectiveness, regulatory burden, rule of law, and corruption. The average value for advanced economies is 12.6
One particular element of structural convergence that has yet attracted limited attention in the Copenhagen test is the development of financial markets and institutions. This concept of financial convergence refers on the one hand to – for example – the position of central banks and the quality and enforcement of supervisory standards, and, on the other hand, to the composition and depth of the financial market. General indicators point to relatively underdeveloped financial markets in accession countries (items banking reform and non-bank financial market in Figure 1). Broad money and private credit as a percentage of GDP are generally substantially lower than in the EU (Table 1), or coincide with substantial bad debts (Czech and Slovak republics). Moreover, liquidity in intrabank and government bond markets will have to develop further. Generally financial intermediation has trailed behind economic development in transition countries.

A further deepening of financial markets would enhance the catching up process and would be a necessary pre-condition for further convergence with the EU. Nevertheless, given the relative institutional weakness in regulation and supervision, fast track financial development could pose a risk to stability. With capital liberalisation progressing and a changing composition of capital inflows (see below), there have been calls for even stricter supervisory rules than applied in the EU (Talley e.a, 1998).

### 1.3 Economic progress

All accession countries have made major efforts in enforcing painful economic adjustments and transition despite the consequences in terms of high structural unemployment and lower income levels. The last decade has shown that overcoming this initial transition shock has generally proved to be more difficult than expected. As shown in Figure 2, the Central European countries and Slovenia have only recently managed to match or outperform their pre-1990 GDP levels. On the other hand, the Baltic and Balkan countries suffered a much sharper downturn, and have not recovered, the downward trend only reversing around 1994.

These results on growth performance appear to mirror the latest outcome of the Copenhagen test. Outliers are Estonia and Slovakia. For Estonia the initial trade dependency on Russia and
sensitivity to the Russian crisis have played a role here, while slower progress of institutional reforms might explain the lower ranking for Slovakia. Interestingly, in terms of actual catching up, only Poland has shown an accumulated GDP-growth outperforming the euro area.

Figure 3 shows welfare and price levels of accession countries relative to the EU average. Slovenia stands out, having an income level, both on a nominal exchange rate and PPP basis, that nears the low-income countries that currently participate in EMU. Convergence of price levels is still somewhat further behind. Poland and Estonia show relatively low GDP per capita levels of around 20% of the EU average, which compares to 30% for Portugal at the time of EU entry (1986) and 50% when it joined the euro area (1999). These levels give an indication of the need to catch-up in the future. An annual growth of 6.5% for Slovenia, 10-11% for the Czech Republic and Poland, and 17% for Bulgaria would be needed during a 20 year period to catch up with the average income level of the three poorest EU-members Portugal, Greece and Spain.

1.4 Policy challenges in completing transition and accession

Real appreciation

A successful process of catching up and bridging the price and income differentials with the EU not only calls for a strong growth performance, but also points to the eventual need for substantial appreciation of the real exchange rate in accession countries. The difference between relative welfare and income levels (i.e. the average purchasing power of a Czech in his home country and in the EU) gives an indication of the level of price convergence that will need to occur. For the Czech Republic GDP per capita at current prices is 25% of the EU average, whereas the same figure corrected for purchasing power parity is 59%. Although part of this real appreciation can

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6 The price level of 55% of the EU-average compares to the relative price level of Portugal in the early 1990s
7 See for further analysis: ING Barings, EU enlargement and convergence (March 2000)
proceed through nominal appreciation of the exchange rate, it is likely to coincide with higher inflation levels.

This is in line with the Balassa Samuelson (BS-) effect. In the catching-up process, productivity gains in the open tradables sector of the economy exceed increases in the non-tradables sector. However, with nominal wages increasing at similar pace in both sectors, the increase in unit labour costs is likely to be higher in the non-tradables sector, thus pushing up inflation. Therefore, catching up economies may face a structurally higher inflation rate than mature economies. The exact impact of the BS-effect on inflation in countries is subject to debate. Estimates range from 1.9% to 2.5% annually in the case of Slovenia (IMF, 2000) and Hungary (Simon and Kovacz, 2000) respectively, to 3% for the group of most advanced candidate countries as a whole (BoE, 2000). However, these estimates are based on backward looking data and do not take into account a possible acceleration of real appreciation in the face of the remaining, substantial differential of price levels. A forward-looking approach shows that the effect for accession countries as a whole could be closer to 3.5-4% annually (Pelkmans, Gros, Nunez-Ferrer, 2000). As in comparison, the IMF has calculated the BS-effect to have contributed 1.5-2 percentage points to inflation annually over the last decade in below average GDP per capita EU member states as Portugal and Spain.

All accession countries have shown strong real appreciation since the GDP-dip of 1993-94 (Figure 4). Real appreciation based on producer prices has been less pronounced than that based on CPI, reflecting the BS-effect and the impact of the liberalisation of administrative prices. Fixed regimes have resulted in real appreciation rates in the Baltics reaching three times the average of the rest of the group. At the same time inflationary pressures in these countries have diminished over the last few years in contrast to countries like Hungary and Slovenia, which used a nominal depreciation trend to keep the real exchange rate virtually constant (see Figure 4 and Table 1).

As real appreciation and the BS-effect are part of a natural process of convergence of income, prices (tradables and non-tradables) and productivity levels, they are in essence not harmful to the overall economic performance. Nevertheless, the central bank needs to scrutinise this process closely in order to avoid further wage pressures through second round effects, which would lead to a deterioration of the competitive position. Further challenges for monetary policy result from price liberalisation in areas such as housing, energy and transport, which imply relative price adjustments feeding into inflationary pressures on an ad hoc basis.

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9 According to the ECB, on average some 20% of the CPI-basket consist of administrative prices. Further price liberalisation will of course have a direct effect on inflation, but can also cause second round effects in other areas.
Figure 4: Real exchange rate and current account developments in candidate Member States
Capital inflows and current account deficits

Improved investment opportunities in maturing transition economies typically attract capital, particularly when coinciding with capital liberalisation. While capital inflows support the catching up process, they can complicate exchange rate policy, particularly in cases where doubts about the sustainability of large current account deficits can lead to sudden speculative reversals in capital flows. As Figure 4 shows all accession countries have been facing current account deficits to different degrees. With some exceptions these have generally been sustainable, with net capital inflows remaining fairly constant, amounting to $23bn or some 6% of GDP per annum on average since 1995 (BoE, 2000). Apparently, these countries have not faced the substantial withdrawals of capital by banks in other emerging economies in the face of the recent Asia and Russia financial crises. This is largely explained by the composition of capital flows, consisting mostly of foreign direct investment and being of non-bank nature.

FDI flows have tended to be highly correlated with privatisation. With investment opportunities drying up in this field, other capital inflows such as greenfield and portfolio investments will have to finance the current account deficit. The elimination of (short-term) capital controls and further deepening of financial markets will enhance such flows.10 Moreover, the experience of previously accessioning countries such as Portugal and Spain indicates that the prospect of EU accession is likely to enhance further strong capital inflows. This might nevertheless increase vulnerability for sudden changes in sentiment. In that respect, it has to be kept in mind that candidates will not be allowed to (re-)introduce short-term capital restrictions after accession, unlike Portugal and Spain, which in their early years of EU membership were granted transition periods.

Asymmetric shocks

Given structural and institutional divergences, fast track transition economies can be vulnerable to asymmetric shocks, either of a domestic or external nature. Shocks might be triggered by overexposure of certain sectors or a high dependency on foreign capital inflows. Indeed, for some accession countries, membership of the EU itself may imply a shock through strong direct effects on competitiveness and demands on policy-making.11 When asymmetric shocks occur, painful adjustments will have to be made in the domestic economy. This will require the adjustment of relative price levels that in turn depends on the availability of flexible labour markets and an elastic wage setting process. Exchange rate adjustment can absorb part of the shock effect. Recent examples of asymmetric shocks in Central and Eastern Europe include the Russian crisis, particularly affecting the Baltics, and the Czech banking crisis.

10 Most accession countries have already substantially liberalized the capital account; the Baltic countries have virtually completed the process, while OECD members Poland, the Czech Republic and Hungary have some restrictions remaining on short-term movements and real estate investments
11 For example, adherence to technical standards and codes regarding the free movement of goods, services and labour will pose a major challenge (consumer protection, on the job health & safety standards, environmental regulations).
1.4.1 Exchange rate regime shifts in the light of transition challenges

Figure 5 shows that at the start of the transition process most Central and Eastern European countries opted for an external exchange rate anchor in order to secure macro economic stability and disinflation. The U-turn from a relatively free float to a currency board arrangement in Bulgaria should also be interpreted in this light. However, where the small and relatively flexible Baltic economies have continued their fixed regimes, Estonia and Lithuania both operating a currency board, other more advanced transition economies introduced regime shifts at a later stage in the transition process. The Czech Republic (January 1998) and Poland (April 2000) discontinued their conventional pegs to introduce more flexible exchange rate regimes in combination with an inflation targeting strategy. Hungary (1995) switched to more limited exchange rate flexibility, maintaining a crawling peg with a monthly depreciation of 0.3% vis-à-vis the euro within narrow bands (about 2.25%).

These regime shifts were a reaction to the challenges as described above. In the case of Poland and Hungary shifts were effected in response to high current account deficits and exchange rate pressures, whereas in the case of the Czech republic the regime shift was forced upon the authorities because of large-scale speculative attacks. Interestingly, the Hungarian central bank has found it difficult to maintain its current regime in the face of upward pressures on the exchange rate and strong inflationary tendencies in the domestic market. Supported by the IMF and OECD, it has requested the government to broaden the crawling band in order to allow for higher interest rates and cushion part of the process of real appreciation through the nominal exchange rate. However, the (short-term) fear for loss of competitiveness has made the government reluctant to act.

For some countries, the choice of the exchange regime is influenced by the prospect of EU participation. The regime shift in Poland was partly motivated by eventual ERM / euro
participation, as to gradually find a market-determined equilibrium exchange rate. Similarly, Hungary intends to move in due course to a fixed central rate against the euro while widening the fluctuation bands. Generally, with the accession process and EU trade relations progressing, virtually all accession countries have adopted the euro as the central reference or anchor currency by now.\footnote{Lithuania has planned to replace the dollar with the euro in its currency board regime by 2001, while Latvia is set to change its SDR-peg to a euro-peg.}

1.5 Preliminary conclusions
Although EU accession countries have made substantial progress towards becoming fully-fledged market economies, the completion of transition has turned out to be difficult. In order to make EU–participation a success, further progress in institutional, structural and economic development is needed. Major challenges lie ahead particularly for financial market and monetary policies, in terms of dealing with real appreciation, capital inflows and potential shocks. Real appreciation and developments in unit labour costs have to be closely watched, in order to be able to compete within the internal market. Shifts in exchange rate regimes may facilitate the catching-up process.

Nevertheless, as the assessments of the Copenhagen criteria have shown, accession is foremost a political process determined by time constraints. As such, there is no doubt that after an overall positive judgement, further necessary structural and economic convergence will continue within the EU, after accession. Part II deals with the question how this would relate to the readiness and ability to set the final step of integration, i.e. participation in EMU.
II. THE ROAD TO EMU

2.1 Introduction
This part evaluates the ability of accession countries to eventually participate in EMU. First, the economic rationale of joining monetary union is tested by means of the optimum currency area theory. In addition, the accession countries are being assessed on the basis of the formal conditions for adopting the euro, as prescribed by the Maastricht Treaty. Finally, while keeping in mind the findings of part I, the appropriate road towards EMU is discussed, paying specific attention to the pros and cons of early euro adoption.

2.2 Optimum currency area theory
A standard approach to assessing a country’s readiness for monetary union is the conventional theory of the optimum currency area (Mundell, 1961). Potential members should essentially show convergence in economic structures, in order to minimise the risk of asymmetric shocks. In absence of the exchange rate instrument, a high degree of price and wage flexibility as well as capital and labour mobility is needed to avoid excessive structural unemployment resulting from such a shock. The cost for giving up exchange rate flexibility would in general be more limited for small, open economies, as these would have more to gain from exchange rate stability. In short, this means that the assessment focuses on (1) the benefits derived from trade relations, (2) the costs derived from diverging economic structures, (3) the ability to cushion these costs through market flexibility.

In an analysis of common and asymmetric sources of shocks in output and employment, findings of De Grauwe and Aksoy (1997) point to considerable co-movement between Germany and at least some of the accession countries (particularly Slovenia). Similarly, Boone and Maurel (1999) indicate that, to a large extent, German shocks can explain business cycle fluctuations in accession countries. However, other studies (Buch and Dopke, 1999) find only limited evidence for cyclical convergence between the EU and accession countries. In any case, most studies stress that backward looking data shortage causes considerable uncertainty, not in the least because the process of transition has not been completed. To avoid this problem, one could argue that trade relations and the risk of asymmetric shock are interrelated, in as far as strong trade relations are correlated with similar economic activity and suggest an integration of economic structures and convergence of business cycles (Frankel and Rose, 1996/1997).

Table 2 shows that in fact all accession countries apart from Poland and Romania are more open, as measured by external trade as a percentage of GDP, than the average EU country. Whereas in

\[13\] In their static model, accession countries actually come closer to forming part of an optimum currency areas with the core countries than the present Nordic EU-countries (Denmark, Finland and Sweden).

\[14\] In contrast, some authors (Krugman) argue that greater trade integration enhances regional specialisation which could actually increase the probability of asymmetric shock.
Table 2  OCA indicators for accession countries

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<th>Poland</th>
<th>Czech R.</th>
<th>Hungary</th>
<th>Slovenia</th>
<th>Slovak R.</th>
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<td>Import / export (percentage of GDP)</td>
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<td>Exports to CEECs (percentage of total)</td>
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<td>Imports from CEECs (percentage of total)</td>
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<td>FDI-stock per capita (in €, end of 1998 / 1999)</td>
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<td>729</td>
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**Sectoral structure**

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<th>Services</th>
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<td>62</td>
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<tr>
<td>Czech R.</td>
<td>4</td>
<td>39</td>
<td>57</td>
</tr>
<tr>
<td>Hungary</td>
<td>6</td>
<td>34</td>
<td>60</td>
</tr>
<tr>
<td>Slovenia</td>
<td>4</td>
<td>39</td>
<td>57</td>
</tr>
<tr>
<td>Slovak R.</td>
<td>4</td>
<td>32</td>
<td>64</td>
</tr>
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<td>57</td>
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<td>16</td>
<td>40</td>
<td>43</td>
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<td>Bulgaria</td>
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<td>26</td>
<td>56</td>
</tr>
<tr>
<td>EU</td>
<td>2</td>
<td>40</td>
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</table>

**Percentage share of total employment in:**

<table>
<thead>
<tr>
<th>Poland</th>
<th>Agriculture</th>
<th>Industry</th>
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<tbody>
<tr>
<td>Czech R.</td>
<td>5</td>
<td>27</td>
</tr>
<tr>
<td>Hungary</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Slovenia</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Slovak R.</td>
<td>6</td>
<td>27</td>
</tr>
<tr>
<td>Estonia</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Latvia</td>
<td>7</td>
<td>24</td>
</tr>
<tr>
<td>Lithuania</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Romania</td>
<td>9</td>
<td>22</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10</td>
<td>24</td>
</tr>
</tbody>
</table>

**Labour market flexibility**

<table>
<thead>
<tr>
<th>Poland</th>
<th>Flexibility in labour protection</th>
<th>Trade union membership</th>
<th>Level of wage determination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech R.</td>
<td>4.0</td>
<td>61</td>
<td>S</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.6</td>
<td>35</td>
<td>C</td>
</tr>
<tr>
<td>Slovenia</td>
<td>6.6</td>
<td>40</td>
<td>N</td>
</tr>
<tr>
<td>Slovak R.</td>
<td>2.8</td>
<td>42</td>
<td>C</td>
</tr>
<tr>
<td>Estonia</td>
<td>-</td>
<td>32</td>
<td>N/S/C</td>
</tr>
<tr>
<td>Latvia</td>
<td>-</td>
<td>13</td>
<td>C</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-</td>
<td>28</td>
<td>N</td>
</tr>
<tr>
<td>Romania</td>
<td>-</td>
<td>10</td>
<td>C</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-</td>
<td>50</td>
<td>C/S/C</td>
</tr>
<tr>
<td>EU</td>
<td>4.1</td>
<td>--</td>
<td>--</td>
</tr>
</tbody>
</table>

1. Flexibility in labour protection on a scale of 1 - too restrictive - to 8 ample flexibility (Hong Kong). Source: World Competitiveness Yearbook 2000
2. National (N), Sectoral (S) or Company (C). Source EBRD Transition report 2000
the late 1980s only one third of trade took place outside the Eastern bloc, these countries have now established strong trading ties with the EU, ranging from 50% of total exports for Lithuania to 76% in the case of Hungary. With the exception of Poland and Slovenia, all countries saw their share in EU imports increase strongly since 1995, driven by the Europe Agreements and WTO-membership.\textsuperscript{15} When intra Central and Eastern European trade is included, the combined trade share generally far exceeds the EU member states in terms of their average intra-EU plus extra EU-trade shares with accession countries. Clearly, historic ties and free trade arrangements among accession countries have enhanced bilateral trade.\textsuperscript{16} Finally, although hard evidence is difficult to obtain, FDI seems to play a role in enhancing trade links (and vice versa). Countries with high FDI per capita levels, in particular Hungary and Estonia, typically show a strong increase of value-added, technically advanced products exported to the EU.

The relationship between openness and convergence of economic structures has been analysed further by Fidrmuc and Schardax (2000) on the basis of intra-industrial trade data. They show that an increasing share of manufacturing trade is of an intra-industrial character, reaching levels for Hungary, Slovenia and the Czech Republic similar to Italy and Sweden. Slovakia has a level similar to that of Portugal, followed in order of decreasing levels by Poland, Estonia, Bulgaria and Romania. Finally, Latvia and Lithuania have a relatively low share of intra-industrial trade, similar to that of Greece and Turkey. These data are, however, difficult to interpret given possible high differences in quality of intra-industrial traded goods and the possibility that intra-industrial trade within the EU is concentrated in other industries.

A more straightforward reflection of structural differences may be provided by the share of sectors in the economy. Table 2 indicates that the agricultural sector in the Baltic and South Eastern European accession countries is relatively important. Moreover, Poland stands out with a substantial share of employment in agriculture despite the limited share of this sector in GDP. With over two million small Polish farmers, there seems to be a substantial hidden unemployment in this sector. The relatively large size of the agricultural sector in these countries can be interpreted as a sign that sectoral adjustment in the transition process has not been completed. Sectors that are a highly dependent on FDI may be particularly vulnerable to shocks. For example, given the importance of Finnish investments in the Estonian mobile phone industry, an international downturn in the telecom sector could easily result in an asymmetric shock for Estonia.

\textsuperscript{15} The Europe Agreements have to a great extent assured free movement of industrial products between the EU and accession countries, while at the same time allowing the accession countries to reduce tariff barriers at a slower pace than the EU. However, trade in agricultural products and services have remained more constrained, suggesting that further trade integration is likely to take place after accession.

\textsuperscript{16} The Czech and Slovak Republics, Poland, Hungary (since 1993), Slovenia and Romania (1996-97) are members of the Central European Free Trade Area. The Baltic States have their own free trade area. However, because of lack of data, the latter is not subject to further analysis here. The accession countries compose the third most important trading region for the EU (after US and Asia) with 10-11% of total extra-EU exports and imports.
As far as domestic market flexibility is concerned, remnants of the plan economy still negatively influence the functioning of labour and product markets. Generally, labour markets in accession countries are relatively flexible compared to the EU (see Table 2) and are characterised by a relatively high participation rates. Minimum wages are low in comparison and the role of the ‘old’ trade unions in ‘new’ fast-growing sectors appears to be limited. In addition, wage bargaining tends to take place on a decentralised level, indicating a potential to absorb sector-related shocks. On the downside, the limited comparable data available point to hidden unemployment and malfunctioning social security institutions in Poland, relatively high statutory social security contributions for employers in Hungary and the Czech Republic (close to 40% GDP) and low flexibility of labour protection and social security systems in Slovenia (OECD). In addition, Heller & Keller (2000) and Boeri (2000) point to a general lack of labour mobility, caused by underdeveloped and inefficient social welfare systems, house market rigidities and inappropriate skill structures. In many cases, these problems reflect institutional weaknesses.17

Optimal currency area theory and EMU

What do the above assessments say about the ability to function within a single currency area? On the one hand, countries like Hungary, the Czech Republic and Slovenia seem to pass the optimal currency area test, although the data are somewhat difficult to interpret. Moreover, in the last decade these countries have been vulnerable to shocks, have suffered long periods of recession and some have applied exchange regime shifts. On the other hand, the assessment of the broader concept of structural convergence in part I indicates a relative institutional underperformance. Some argue that an ex ante assessment of accession countries in this respect would be unnecessary, as the mere fact of euro adoption would guarantee convergence of economic structures ex post.18

In contrast, others pose the fundamental question whether further structural convergence after EU accession would be needed before adoption of the euro. Participation in EMU requires a high level of institutional quality, inter alia with respect to economic policy co-ordination, centralised monetary policy-making and prudential supervision. The concept of financial convergence (dealt with in sections 1.2 and 2.3) is also of direct relevance to a smooth functioning within the framework of EMU, as the monetary transmission mechanism will be affected and the monetary instruments must be effective. More generally, financial and political instability in these countries will have an effect on the functioning of EMU as a whole, regardless of the limited economic weight that these countries represent. A gloom scenario would be if the combination of structural

17 Rebuilding social security and pension systems could offer great opportunities, making them more effective and efficient than those of the old welfare states of Western Europe. In this respect, the effect of EU-accession itself is somewhat unclear. The social Acquis will have to be adopted (contractual rights, working time, social dialogue, non-discrimination), but social policy as such will remain a national responsibility.
18 Coricelli (2000) waters down the importance of structural convergence in evaluating the desirability of euro adoption, pointing to regional disparities and low labour mobility that are already apparent in the EU itself.
and welfare disparities would lead to political tensions in the EMU policy framework in times of asymmetric shocks. Indeed, the accession countries would jointly represent a substantial political weight with 30% of EU population.  

2.3 Formal requirements for euro adoption

To qualify for euro adoption, all countries have to meet the conditions as set out in the Treaty of Maastricht. These criteria are meant to secure sustainable convergence within Economic and Monetary Union (see Box 1).

<table>
<thead>
<tr>
<th>Box 1: Maastricht criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflation</strong></td>
</tr>
<tr>
<td><strong>Interest rate</strong></td>
</tr>
<tr>
<td><strong>Sound government finances</strong></td>
</tr>
<tr>
<td><strong>Legal convergence</strong></td>
</tr>
<tr>
<td><strong>Exchange rate stability</strong></td>
</tr>
</tbody>
</table>

Nominal convergence

Table 3 gives a forward-looking overview of nominal convergence for accession countries, based on European Commission predictions. On the fiscal criteria, many countries already meet the requirements, and regarding the debt criterion they perform much better than the average participant in the euro area. Concerning inflation and interest rate convergence, the picture looks different. More advanced transition economies such as Hungary and Poland tend to score worse on these data. Clearly, real appreciation and the BS-effect – as discussed in part I – would explain inflation levels consistently above the Maastricht reference value. In this respect, some caution should be exercised in interpreting the nominal criteria, as an accession country might at this stage not be able to pursue price and exchange rate stability in parallel. Similarly, although budgetary discipline is important, the transition process in a number of countries may still exert substantial fiscal pressures for recapitalisation, pension and social security reforms, sector restructuring and EU accession, particularly in case privatisation revenues dry up. As regular EU

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19 Basically, one could think of tensions in the monetary policy framework (ECB-Council) in case of strongly diverging inflation levels (see also Björksten, 2000), or pressures for fiscal transfers in the face of low labour mobility.
transfers will only cover part of these costs, an early, strict focus on the Maastricht deficit criterion might not be sustainable.\(^\text{20}\)

### Table 3 Nominal convergence in candidate countries

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</tr>
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<tbody>
<tr>
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<td>5.7</td>
<td>-1.8</td>
<td>-1.2</td>
<td>95.5</td>
<td>97.5</td>
<td>5.0</td>
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<td>4.3</td>
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<td>-4.8</td>
<td>29.0</td>
<td>28.5</td>
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</tr>
<tr>
<td>Estonia</td>
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<td>-0.7</td>
<td>0.7</td>
<td>11.1</td>
<td>11.8</td>
<td>6.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.1</td>
<td>8.4</td>
<td>-3.3</td>
<td>-3.0</td>
<td>70.0</td>
<td>63.8</td>
<td>8.4</td>
</tr>
<tr>
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<td>3.4</td>
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<td>-2.8</td>
<td>26.4</td>
<td>26.7</td>
<td>10.0</td>
</tr>
<tr>
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<td>-3.4</td>
<td>-2.5</td>
<td>10.6</td>
<td>10.4</td>
<td>11.1</td>
</tr>
<tr>
<td>Poland</td>
<td>10.1</td>
<td>7.5</td>
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<td>-2.8</td>
<td>43.9</td>
<td>43.7</td>
<td>12.3</td>
</tr>
<tr>
<td>Romania</td>
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<td>30.0</td>
<td>-3.8</td>
<td>-4.1</td>
<td>31.1</td>
<td>30.4</td>
<td>45.0</td>
</tr>
<tr>
<td>Slovak R.</td>
<td>12.1</td>
<td>6.0</td>
<td>-5.2</td>
<td>-5.5</td>
<td>28.5</td>
<td>29.0</td>
<td>-</td>
</tr>
<tr>
<td>Slovenia</td>
<td>8.3</td>
<td>5.0</td>
<td>-1.1</td>
<td>-1.3</td>
<td>25.0</td>
<td>25.5</td>
<td>7.7</td>
</tr>
</tbody>
</table>

**Benchmark** 2.8 3.0 60.0 7.34

Source: European Commission (Autumn Forecast 2000) and Deutsche Bank.

*Not in line with Maastricht definitions and excluding extra-budgetary expenditures, e.g. social security, bad debt restructuring. Not comparable across countries and as close as possible to general government net lending.

**Partly estimates. Bulgaria, Lithuania, Slovak R. and Latvia have no 10-year benchmark.

Given these possible tensions between nominal convergence and catching up, some observers suggest adapting the nominal Maastricht criteria. Szarpary (2000) and Coricelli (2000) argue that the inflation criterion should take into account the BS-effect by taking average euro area inflation or the average of the three highest inflation countries of the euro area as a benchmark (for 2000: Ireland, Portugal and Spain which arguably are in a catching-up process as well). In this respect, earlier interpretations of the Maastricht Treaty did set a precedent, with some window dressing in order to fulfil the budget criterion (Italy, Spain, France), and a failure to meet the debt criterion (Belgium, Italy exceeding 120% GDP) or the exchange rate criterion (Italy and Finland just missed the minimum two-year ERM membership requirement).

Nevertheless, regardless of possible pros and cons of early euro adoption, with the euro in place, an ad hoc adaptation of the criteria to the specific circumstances in accession countries will create serious credibility problems. As such, the inflation criterion might actually be an adequate nominal measure in the Maastricht test that could give some reflection of the underlying structural improvement of the economy. The challenge of completing transition would then be similar to reaching sustainable convergence, as prescribed by the Treaty.

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\(^\text{20}\) For example, off-budget expenditures on social security in Poland and bank restructuring in the Slovak and Czech Republics pose substantial budgetary challenges. Thus, the Czech government announced in February 2001 that capitalisation of banks for privatisation would push up the public sector deficit to 4.9% for 2000 and 9.4% for 2001. Generally, ING estimates the total costs of restructuring banking, enterprise and pension and health care systems for accession countries at some 2% of GDP on average for the next 6 years. The costs involved in EU accession in some cases could reach an annual level as high as 11% of total GDP for the next decade. See EBRD Transition Report 2000, pp 55-56, for an analysis of fiscal challenges.
Legal criterion and nominal convergence

The transformation from a mono to a two-tier banking system in transition countries has led to the new phenomenon of independent central banks. Given short track records, central banks have to ‘earn’ independence by winning public credibility through accountable and transparent policies. High inflation expectations and the challenge of completing transition do not make this an easy task. Thus, in some countries the informal relationship with politics has remained a source of potential friction despite the fact that most central bank laws already prescribe full (instrumental) independence. Another problem in applying the legal criterion is that currency boards, while independent by definition, are not managed by fully-fledged central banks and have limited scope in applying monetary instruments (‘operational convergence’).

Given the challenges of completing transition, the question is how central banks can develop independent and credible policies towards meeting the nominal criteria of Maastricht in a sustainable way. In some countries sophisticated monetary techniques have already been introduced as well as indirect market instruments (e.g. repo-transactions, lending rates). However, given generally low levels of financial intermediation, their effectiveness is highly dependent on developments in the transmission mechanism of monetary policy.

For more advanced candidate countries, direct inflation strategies, as already introduced in Poland and the Czech Republic, may be appropriate. Such strategy adds to the institutional advancement of monetary policy setting, as internal inflation forecasts and modelling techniques are developed. Keeping in mind structural changes (e.g. price liberalisation), a path of disinflation towards low levels of price stability in the long run could be established. Multi-year targets provide the necessary flexibility to offset potentially destabilising exchange rate developments without jeopardising the inflation target, particularly given the likelihood of changes in the monetary transmission mechanism. The transparency of the target could increase central bank credibility and lower inflation expectations. Eventually, an exchange rate peg to the euro through ERM membership can be contemplated, in which the inflation target would become conditional on a stable exchange rate. Overall, such an approach would seem to be in conformity with the sustainable convergence requirement of Maastricht.

Exchange rate stability

Applying the exchange rate criterion of Maastricht is less straightforward. Figure 4 shows that Estonia and to a lesser extent the Czech Republic have maintained a reasonable stable nominal exchange rate. For example, the Czech parliament has adopted a new central bank law, giving it the right to approve part of the budget and appoint board members, and putting an obligation on the central bank to discuss important monetary policy decisions with the government. These measures seem to contradict Treaty of Maastricht requirements on central bank independence.

In this respect, in as far as monetary policy can only serve but one objective (Tinbergen rule), the exchange rate would clearly remain an important factor in price stability strategies. For more reading on this subject, see Orlowski (2000).
exchange rate against the euro. However, the criterion prescribes that countries have participated during two years in the European exchange rate mechanism (ERM). As ERM membership is not open to non-EU member states, this requirement can only be met after accession. In this respect, ERM membership is also meant as a market test, to determine the equilibrium exchange rate and assess the authorities’ capacity and discipline to maintain a stable exchange rate. However, for countries like Estonia that run a currency board regime, such a ‘forced’ regime shift could create severe market tensions and credibility problems. It could be argued that the ability to sustain a currency board over a longer period should give an indication of the competence and market flexibility needed for joining the euro area. As such, a unilateral commitment to a fix against the euro after EU accession could be judged compatible with ERM participation. It is up to the EU member states to assess whether the central parity would be viable on the basis of the currency board track record. Such an assessment will include the soundness of macro-economic policies, the banking sector, wage-price flexibility, external competitiveness, and current and capital account developments.

2.4 Appropriate exchange rate regimes towards EMU

In view of the tensions between meeting the Maastricht criteria (and reaching sustainable convergence) and dealing with the remaining policy challenges before and after EU accession two major avenues to EMU participation stand out: a fast track adoption of the euro or a more gradual approach, involving distinct steps.

Fast track euro adoption

A number of accession countries have expressed their preference for an early adoption of the euro. Indeed, some countries (Slovenia, Lithuania) have hinted at adopting the euro unilaterally before EU accession, using official reserves to replace the monetary base M1 with euros after these have been physically introduced in 2002 (or with one of the national euro area currencies (deutsche mark) before that date). Of course, with euroisation, seigniorage income would be lost, while the country concerned will not take part in EMU decision-making, and specifically, euro area monetary policy decisions. In economic terms, however, the effects of euroisation and a formal adoption of the euro seem virtually the same, although being outside the EMU framework could increase relative market risks of default, putting upward pressure on long-term interest rates (Wojcik, 2000).24

In principle the motivation for adopting the euro – either through the formal procedure or unilaterally – would be the same as for the current euro participants. Given strong trade relations, accession countries would benefit from the elimination of transaction costs of converting national

24 To a large extent, this analysis also applies to currency boards. Euroisation would effectively be the same as replacing the national currency in a currency board framework. Of course, given the possibility of exit, the potential advantages of formal euro adoption only partly reflects those of a currency boards, while in contrast to euroisation, seigniorage is maintained.
currencies, while exchange rate risks will be eliminated, and price transparency and competition will be enhanced. Moreover, joining an area of low inflation and high central bank credibility could lower interest rates by decreasing risk premiums. Some even argue that early euro adoption could make accession countries less vulnerable to financial crises and contagion, as potential exchange rate volatility and sudden capital flow reversals would be eliminated and responsibility for bailing-out might shift from the national to the euro area level.

Finally, in political terms, there might also be a strong push to formally join the euro area early, particularly if the group of euro countries would become the heart of further integration within the EU. As accession countries have much to gain from EU membership, particularly in terms of political stability and financial support, it might be in their interest to join such a ‘core group’ as soon as possible.  

Similarly, having a say in ECB monetary policy setting could be attractive for those countries that already maintain a unilateral fixed regime.

The cons of early euro adoption or euroisation are closely related to the policy challenges. Thus, there is no reason to believe that the real appreciation process would come to a halt in the coming years, particularly given the fact that in most cases catching up with the EU is only just taking off. Clearly, this will also remain a major challenge for currency board regimes in the Baltic States. As with euroisation, the instrument of nominal appreciation to smooth the real appreciation process and subdue inflation is not be available. More importantly, monetary policy cannot react to a possible interaction of real appreciation (and the BS-effect) and cyclical inflationary pressures, and thus lower inflation expectations. Indeed, a high growth and inflation environment can result in strong wage pressures and erode competitiveness, particularly if after EU accession welfare levels are expected to converge quickly. These problems would also occur with an early, formal adoption of the euro. Given the relatively limited economic weight, the monetary stance of the euro area as a whole could become seriously out of line with the needs of these economies.

A worst case scenario would be if negative real interest rates led to boom-bust cycles and asset bubbles in the light of relatively underdeveloped financial markets (and the increased likelihood of bail-out). The latter is, of course, closely related to the challenge of dealing with short-term capital inflows and current account imbalances. Here, some exchange rate flexibility could limit the speculative nature of such flows. Similarly, although the risk of an asymmetric shock is difficult to assess, a fully fixed regime would exclude the possibility of exchange rate

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25 The recent Treaty of Nice (December 2000) offers a minimum number of eight EU-Member States the possibility to progress further in the integration process by forming so-called core groups in specific areas such as defence, foreign policy, justice and home-affairs. Some political leaders of euro-countries have indicated that the single currency could work as a catalyst in this respect.
depreciation, implying that a high degree of domestic market flexibility would be needed to cushion such a shock.\textsuperscript{26}

\begin{center}
\textbf{Box 2: Experiences of Portugal and Spain*}
\end{center}

There is a remarkable resemblance between the worries raised at the current enlargement process and the discussions about accession of Portugal and Spain to the EU in the 1986. As these countries share important characteristics with the current EU-candidates – having relatively low welfare levels and carrying the inheritance of dictatorship (large state sector and rigid markets) – some lessons might be drawn from their experiences.

Both countries faced strong capital inflows at the time of EU accession attracted by interest rate differentials, reduced risk premiums and investment opportunities. As a relatively fixed exchange rate regime was maintained, the large inflows resulted in strong inflationary pressures, undermining the price stability anchor of the peg. To allow for adjustment, both countries switched to more flexible regimes and maintained a relatively tight fiscal policy. In addition, Portugal and Spain generally used short-term capital controls, albeit with limited long-term success, to prevent inflows from undermining strict monetary policy (Gros, 1993).

As a further anchor in the process of catching up, Portugal and Spain became a member of ERM in 1992. They lifted all remaining capital flow restrictions. Driven by substantial interest rate differentials and policy credibility gains, (short-term) capital inflow continued. However, in the following years, Spain (4) and Portugal (2) went through a number of realignments and widened the bands from 6% to 15% in order to overcome the ERM crisis and higher sensitivity to the European recession.\textsuperscript{**}

Finally, at the end of the 90s with euro participation in sight both countries faced strong convergence play related financial inflows.

Generally, what follows from the analysis is that convergence takes time and can continue within the EU. Clearly, in terms of liberalisation or even structural reform some accession countries may have progressed further than Portugal and Spain at the time of their accession. However, the fact that after ten years of negotiations these countries entered the EU with substantial transitional periods\textsuperscript{***} also gives a reflection of the challenges that lie ahead. Not only have the complexity of the Acquis and the demands on institutional capacity increased, but the room for transitional periods might well be limited. Thus, it is likely that after accession, any short-term capital controls, such as Slovenia reintroduced in the mid-90s when reacting on strong inflows, will not be available. Moreover, in terms of real convergence, Portugal and Spain were relatively further progressed than most of the current candidates. As such, it is relevant to note that within EMU Portugal is currently facing a sizeable current account deficit, and – judged by the upward trend of the real exchange rate – inflationary pressures / loss of competitiveness.

Overall, it took Portugal 6 years to enter ERM in 1992 and fully liberalise capital flows, and another 7 years to enter EMU, while GDP per capita grew from 30% to 50% (or 75% in PPP terms) of the EU-average. The question is whether a relatively early entry in the euro area of new Member States and the resulting loss of exchange rate flexibility, as depicted in the simplified figure below, would be the appropriate road to take.

\begin{center}
\textbf{Simplified, hypothetical reflection of the accession process vis-à-vis Portugal}
\end{center}

\begin{center}
\begin{tabular}{c|c|c|c}
Portugal & rigid market economy & pre accession period & EU \& ERM \& EMU \\
\end{tabular}
\end{center}

\begin{center}
\begin{tabular}{c|c|c|c}
First entrants & plan economy & pre accession period & EU \& ERM \& EMU \\
1990 & 2004/5 & 2006/7
\end{tabular}
\end{center}


** According to Brage de Macedo, Nunes and Covas (1999) it was the ERM code of conduct (multilaterally surveyed by the EU) that eventually acquired Portugal the necessary credibility and financial reputation to gradually close the interest rate differential with Germany, while keeping the Escudo close to the central rate.

*** In the field of agriculture and trade (7-10 years transitional period for capital and tariffs on industrial and agricultural products), and free movement of labour and entrepreneurs (e.g. 5-year transitional period for restrictions on setting up credit institutions by foreigners)

\textsuperscript{26} Last but not least, as discussed in 2.3, the urge to meet the Maastricht criteria could seriously hamper the catching-up process, as price and exchange rate stability have to be pursued simultaneously.
The gradual road to EMU

The alternative of a gradual approach towards EMU is illustrated by the accession experiences of the Iberian EU members (see Box 2). In short, these countries faced similar policy challenges and managed to secure a successful convergence path, partly by avoiding a premature lock-in of the exchange rate. Such approach is also favoured by the European Commission and the EU Council of Ministers. Their formal position on the accession process is that countries first should focus on EU membership by fulfilling the Copenhagen criteria, while adopting a suitable exchange rate regime. Secondly, after accession, exchange rate policies will be treated as matters of common concern, implying that acceded countries will have a free choice of regime, but will probably not be allowed competitive devaluation. At or some time after accession, membership of the exchange rate mechanism (ERM) can follow. However, within ERM crawling pegs, free-floating and pegging to other currencies than the euro are not allowed. Thirdly, when the Maastricht criteria are met, these countries will adopt the euro.

An important aspect of this gradual approach is the role of the ERM. As discussed in section 2.3, the Maastricht criteria prescribe a minimum two-year membership as a way of testing the viability of parity. However, following past experience, the ERM should not be regarded as a necessary hurdle towards euro adoption, but as a regime that can offer the necessary stability and flexibility over a longer period. If needed, a broader fluctuation band (up to 15%) or the possibility of adjusting parities can be considered. In offering this flexibility to accession countries that plan to enter ERM early, it is of crucial importance that markets are convinced of this longer-term role. Following the lessons of the 1992 and 1993 ERM crises, an initially wider band could limit the risks of convergence play and speculative attacks. It would allow for realignments to take place within the band, whereas the potential capital loss of speculators would be much bigger if the exchange rate would return back to the central rate in a broader band.

2.5 Preliminary conclusions

The optimum currency area theory seems inconclusive as to whether accession countries are ready for adoption of the euro, although the relatively flexible and open accession economies have already established tight trading ties with the EU and, in this respect, could gain from joining the single currency area. On the other hand, completing transition in terms of reducing structural and institutional divergences seems a crucial precondition that is not fully captured by this theory. Moreover, an early lock-in of the exchange rate and monetary policy instruments might neither be desirable nor sustainable, as it would preclude meeting the challenges in the catching-up process. This reflects the paradox of pursuing the inflation and exchange rate criteria of Maastricht in parallel. In this light, more advanced candidates might prefer a gradual approach to EMU, allowing time for monetary practices and exchange rate policies to converge.

27 Conclusions of the EU Council of Ministers (Ecofin), 7 November 2000.
III. CONCLUSION
Over the last decade, accession countries have made great efforts in completing the process of transition. Yet, these countries – including the most advanced – still face substantial policy challenges in securing further structural convergence and catching up with the EU member states. In the light of these challenges, there is no doubt that the processes of completing transition, EU accession and euro adoption are interdependent. Whereas the Copenhagen criteria in theory presuppose a fully-fledged, competitive market economy, in practice, assessment problems and time constraints suggest that further structural convergence (defined broadly) would have to take place after accession. As accession and transition can be mutually re-enforcing, this need not create major problems. However, with regard to EMU, a proper sequencing of integration should be respected, as to safeguard economic progress of accession countries as well as the functioning of EMU itself. This implies a gradual approach, in which monetary practices and exchange rate policies are allowed time to deliver sustainable convergence, as prescribed by the Maastricht Treaty.

In this light, the appropriateness of exchange rate regimes over time should be considered. Generally, the experience of accession countries shows that they have been capable of maintaining the fine balance between price stability – where significant uncovered interest rate differential may attract speculative capital – and confidence in their currency, adapting the exchange rate regime if needed. As such, the trade-off between fixed and flexible regimes lies both in the changing challenges of a maturing transition economy and the structural strength and flexibility of the domestic market. Neither regime can be a panacea in itself, but to exclude the option of exchange rate adjustment prematurely could be a mistake.

These concepts of policy flexibility and a gradual road towards EMU are reflected in the three-step approach that is currently set into place by the EU. Here, ERM participation would play an important role both in enhancing further convergence and catching up, and as a test for institutional capacity and the sustainability of the exchange rate parity. In this light, possible currency board regimes within the ERM-framework would need to show a good track record and have to be assessed on a broad range of economic, financial and structural indicators. Moreover, the logic of the three-step approach also supports the official EU line that euroisation by candidate Member States would run counter to the economic rationale of the Treaty. In any case, the EU will have to make clear that membership of ERM should not (necessarily) be regarded as an obligatory, minimum two-year step towards euro adoption.

Finally, regarding general guidance in progressing towards EMU, the specific policy challenges in the areas of catching up and institutional and financial convergence could become part of the regular framework of multilateral surveillance that exists within the EU. Indeed, on these issues
the accession countries are already preparing so-called Pre-Accession Economic Programmes, which will be discussed in a high level forum with representatives of EU member states. In addition, the European Commission is to report on macro-financial stability in candidate countries. Clearly, these initiatives provide the basis for further monitoring by means of the convergence programmes that have to be produced after accession. Such a framework could enhance mutual understanding and transparency between new member states and through the familiar process of benchmarking, peer pressure and best practice ensure a smooth integration into the EU and a safe route to the euro.
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