Some perspectives on currency relations between EMU and Central and East European EU accession countries


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Abstract: Central and East European prospective EU members are natural candidates for a subsequent admission to the European Monetary Union (EMU). This poses questions on (a) the optimal EMU accession time for Central European EU aspirants, and (b) the optimal exchange rate system in preparing for EMU accession. This paper discusses related issues and introduces four special issue papers on the subject.

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1. Exchange rate arrangements in CEECs

Ten Central and East European countries (CEECs) have applied for the Union’s eastern enlargement so far: the seven current CEFTA members (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia) and the three Baltic states (Estonia, Latvia, and Lithuania). These countries have maintained a wide diversity of exchange rate regimes over the past few years, from currency board arrangements (Estonia, Lithuania, and more recently Bulgaria), nominal pegs (e.g., Czech Republic until May 1997 and Slovakia until October 1998), crawling pegs (Hungary and Poland until this spring), to more or less controlled floating regimes (Slovenia, Poland since April 2000, the Czech Republic and Slovakia since mid-1997 and end of 1998, respectively). By joining the Union, new members may become part of ERM II still allowing for comparatively flexible exchange rate policies towards the euro. However, a common goal of these countries is to move on towards adopting the euro by full membership in the European Monetary Union. By the Maastricht criteria, this formally requires inflationary convergence with and exchange rate stability vis-à-vis EMU.¹

2. When to join EMU?

This question in fact relates to more than nominal convergence, in particular one would want to know whether CEECs and EMU may form an optimal currency area (Mundell, 1961). In a short-run interpretation of this concept, business cycles in the Czech Republic, Slovakia, Poland and Hungary have been shown to be already surprisingly highly correlated with European Union cycles. This might be taken to justify a common monetary policy [Boone and Maurel (1998); De Grauwe and Aksoy (1999)].

¹ Specifically, in the year before joining EMU a country’s rate of inflation should not exceed the average rate of inflation of the three lowest inflation EMU countries by more than 1.5 percentage points, while the central parity of its exchange rate towards the euro should not have changed during the last two ERM II years.
On the other hand, CEECs’ currencies experience a fundamentals-based trend towards real (i.e., CPI-deflated nominal) exchange rate appreciation [Halpern and Wyplosz (1997, 1998), Krajnyák and Zettelmeyer (1998)], which most probably will not have come to an end by the time of EU accession: In the medium run, accession countries still face relative price adjustments owing to ongoing structural reforms and liberalization, establishing rising relative prices in non-tradable service sectors such as telecommunications, energy, transportation, and health care. This implies a real exchange rate appreciation which might be understood as correcting the pre-transition disequilibrium allocation (Frensch, 2000; Szapary, 2001). Finally, during their long-run convergence to EU income levels CEECs are expected to feature a systematically higher productivity growth than the EU average, and especially so in the tradable goods sector: In line with the Balassa-Samuelson effect, the real exchange rates of the accession countries will appreciate during convergence. Although the empirical evidence on Balassa-Samuelson is rather mixed [Edwards and Savatano (1999), Cheung and Lai (2000)], it might – with fixed exchange rates – theoretically imply an inflation differential of several percentage points between accession countries and the EU average [Masson (1999), ECB (1999a)]. Expected medium and long-term real exchange rate developments thus suggest that, after EU membership, (most of the) accession countries may well be unable to meet both the nominal inflation and the exchange rate criterion of Maastricht, rather implying a trade-off between the two (Köhler and Wes, 1999; Masson, 1999; Mussa et al., 2000).

3. How best to prepare for EMU? Suggestions so far

In general, this question is reduced to which exchange rate arrangement to choose before joining EMU. Recognizing the trade-off between low inflation and exchange rate stability noted above, the exchange rate regime to choose (1) should not pose any barriers to equilibrium real exchange rate appreciation, as e.g. due to internal liberalization and the Balassa-Samuelson effect, (2) be compatible with moving towards meeting the Maastricht inflation criterion, and (3) ensure reasonable exchange rate
stability in the face of capital volatility (Szapary, 2001). Given these rather broad requirements, one should not be surprised to see quite a range of alternative suggestions:

Based on positive inflation and growth experiences in Estonia, Lithuania and Bulgaria, Gulde et al. (2000) suggest currency boards for accession countries, provided they are able to meet the necessary requirements, i.e. fiscal discipline, sound financial system and flexible labor markets. Bofinger and Wollmershäuser (2000), however, concentrate on the issue of exchange rate stability in the presence of capital volatility: When monetary conditions can be influenced by interest rates as well as exchange rate targets, and both are connected by interest rate parity cum risk premium, they demonstrate that only very small countries with very small inflation differentials to the EU should fix their currencies before joining EMU; others should follow flexible exchange rate targets.

Masson (1999) incorporates both points and formulates the accession countries’ fundamental conflict concerning their exchange rate policies before joining EMU: On one hand, capital market liberalization which must come no later than in ERM II [Temprano-Arroyo and Feldman (1999)] and a real appreciation trend do not make a fixed exchange rates system feasible for long. On the other hand, EU integration of trade and capital flows and the prospect of EMU membership seems to make a fixed system attractive. The trade-off between exchange rate stability and low inflation thus opens two alternative paths CEECs might take through the three stages of approaching EMU, i.e. EU accession, ERM II and finally EMU membership: (1) one might prepare for EMU by targeting low inflation rates combined with a flexible exchange rate system, (2) a ‘rather’ stable peg to the euro might be considered sufficient for EMU membership, even though the inflation criterion may be missed. According to this view, the EMU should acknowledge the existence of this trade-off by deciding on a hierarchy between the inflation and exchange rate criteria early on, in order to remove insurmountable barriers for CEECs’ entering EMU for a long time to come.

A very important, but so far unanswered, question in this respect is of course whether the main basis for the expected trade-off between low inflation and nominal exchange rate stability, i.e. the Balassa-Samuelson effect, is of the same importance for
all accession countries, or whether it might vary, as it does in other regions of the world as well for reasons not yet fully understood (see Ito et al., 1997; Devereux, 1999). Also, when discussing the choice of exchange rate arrangements, one should not ignore that the empirical literature is in fact far from yielding a clear-cut consensus on the \textit{ceteris paribus} effects of nominal exchange rate systems on inflation and output or growth (Edwards and Savatano, 1999). This is true also for accession economies: “For instance, Estonia has come close to achieving the EU inflation level with its currency board, as has the Czech Republic with its floating regime. Poland has followed approximately the same path of disinflation with a wide-band crawling peg, and Hungary with a narrow-band crawling peg” (Szapary, 2001, p. 26n). In accordance with this, Kopits (1999) stresses that in fact none of the current exchange rate systems of accession countries is incompatible with later joining EMU (see also ECB 1999b). Returning to the optimal currency area concept, it is rather the institutional and macroeconomic fundamentals and prerequisites for stability that matter for symmetry of shock absorbance within a currency area. In this respect, transition- and/or country-specific inflexibilities pose the greatest danger. These include labor market inflexibilities (such as backward wage indexation), high fiscal deficits, and fragile financial sectors, which are not necessarily connected with a particular exchange rate system and certainly cannot permanently be dealt with by a particular exchange rate system in a \textit{ceteris paribus} way.

The most important aspect of the choice of an exchange rate system therefore seems to be its credible combination with other macroeconomic policies and the institutional environment including a sufficient flexibility towards capital flows. This in turn implies that there need not be a unique solution for all CEECs. Rather, these countries which – due to their institutional environment and macroeconomic policies – feature only small inflation differentials to the EU average (even in the face of a real appreciation trend) may consider pegging to the euro earlier than others.
4. How do our special issue papers fit into the discussion?

Thinking about the two questions heading the previous sections in fact reveals a large number of subsets of related questions and issues to be resolved for particular countries at a particular time. Therefore, the seventeen papers originally submitted for this special issue competing for a 1000 euro “best paper” award deal with currency relations between CEECs and EMU from quite different perspectives. After a selective referee process, this special issue presents four of them. While most studies on the impact of EU integration have so far concentrated only on trade flows, our first contribution, by Claudia Buch and Daniel Piazolo, is an empirical enquiry into the determinants of both trade and capital flows in Central Eastern Europe and of the potential increments of these flows following the perspective admission into EU and EMU. The authors thus provide the basis for the exchange rate system discussion to follow. Based on gravity model estimates, the authors expect intensifying capital and trade flows with the approach of EU accession, in particular for the seven EU candidates besides the ‘leading transformers’, i.e. the Czech Republic, Hungary, and Poland, which have already come close to the expected values. In terms of differentiating between EU and EMU accession, the authors argue that adoption of the euro by the accession states should have two contradictory effects on cross-border financial asset holdings: First, it can be expected to stimulate capital flows within Europe as it eliminates exchange rate risks. On the other hand, as financial markets in Europe converge in terms of risks and return, incentives to hold more assets and liabilities outside the region are potentially enhanced. Due to a high correlation between EU and EMU membership so far, it turns out to be very difficult, however, to discriminate between the respective impacts of both institutional arrangements on capital flows empirically on the basis of the employed gravity approach.

With explicit or implicit reference to the trade-off between low inflation and exchange rate stability introduced in section 2 above, the rest of the papers are all concerned with the implied choice between inflation versus exchange rate targeting in the run-up to EMU membership. As already emphasized, accession countries have used quite different exchange rate regimes so far, and may have good reasons to continue to
do so when pursuing their common goal of EU and later EMU membership. Of course, these various arrangements go with different degrees of independence of monetary policy. Accordingly, Josef Brada and Ali Kutan find that so far transition economies’ convergence with EMU (proxied by the Bundesbank) monetary policies (in terms of base money development) has often been quite weak and especially so when compared to the behavior of the most recent members of the EU as well as those of Cyprus and Malta, two market economy candidates for EU membership. Motivated by this observation, Brada and Kutan conclude that EU membership should require a stable exchange rate regime between new members and the Euro-zone countries, where a necessary condition for the long-term viability of such a regime is that the new members will be able to follow the lead of the ECB in setting their monetary policy. Implicitly, this would be in line with the second route to EMU membership worked out in Masson (1999) and documented in section 3 above, i.e. a rather stable peg to the euro at the potential cost of higher inflation due to the Balassa-Samuelson effect. Given the limited knowledge on this effect already stressed in the previous section, the implied difficulties in its \textit{ex ante} measurement render inflation targeting quite impractical in the view of the authors.

To answer the question on exchange versus inflation targeting, Lucjan Orlowski introduces a time dimension. His main message is in favor of inflation rather than exchange rate targeting in order to build up monetary credibility during the early stages of approaching EMU membership. The author warns against a premature peg to the euro, which may imply real appreciation and large capital inflows to be costly sterilized due to lacking labor market flexibilities, as noted in section 3 above. Accordingly, the author recommends a gradual adjustment process that should begin with a relatively strict variant of inflation targeting, followed by flexible inflation targeting, to be ended with exchange rate targeting. The author’s examination of Czech and Polish examples suggests that both countries are making progress in terms of labor market flexibility, competition in the industrial sector and especially fiscal discipline, and may thus consider moving to a more flexible inflation targeting regime.

Peter Bofinger and Timo Wollmershäuser open the final contribution to this special issue by analyzing the two major constraints that a central bank of a small open
economy faces when it operates under free capital movements, i.e. the domestic (the appropriateness of the monetary conditions, independent of the exchange rate regime chosen) and the international constraint (uncovered interest rate parity cum risk premium). On this basis they challenge the mainstream view emphasizing the “two corner solution” with either completely fixed or independently floating exchange rates. They argue that, while the requirements for fixed rates are too restrictive to be successful, the advantage of an independent float is only valid for small open economies when exchange rate movements are closely related to fundamentals (a condition not to be assumed a priori). Alternatively, they suggest a “third way” strategy of flexible exchange rate targeting where central banks simultaneously manage interest rates and exchange rates so as to satisfy both the national and the international constraints, resulting in a time varying and flexible interest rate and exchange rate path.

In light of the wide range of questions related to timing of and preparation for EMU accession, it should come as no surprise that the members of the editorial board of this journal are about as equally split on these issues as seems the rest of the profession, including our authors. Correspondingly, editorial board members have decided to award the “best paper” prize for this special issue equally to Josef Brada and Ali Kutan’s monetary policy convergence paper and to Peter Bofinger and Timo Wollmershäuser’s suggestion of a third way to EMU.

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