WRR

WORKING DOCUMENTS   **W 131**

CEE CANDIDATE COUNTRIES ON THE WAY TO EUROZONE

Alexandr Hobza

The Hague, October 2002

2

PREFACE

One of the principal economic policy challenges of the larger European Union of 25 or 28 Member States is the "passage to the euro" by the acceding countries. Although it is an obligation for the candidate countries, there is no calendar. Few if any guidelines, other than ultimately complying with the Maastricht entry criteria, have been formulated by the EU thus far. This has led to an intense policy debate about the optimal time path and preparatory action for the candidates as well as, at times, calls for revising the Maastricht criteria or for entirely different entry tests. In any event it is crucial for the new Member States and their sustained catch-up growth that the passage to the euro is smooth. Internal stop-and-go policies as well as external exchange rate instability ought to be avoided. The option value of waiting can therefore be high. On the other hand, being a member of the eurozone carries substantial gains such as low long term interest rates (surely, lower than when staying out) almost certainly a further boost to inflows of direct investment.

The present study analyses systematically the policy aspects and options for the passage to the euro for the Central European candidate countries. It is supported by considerable empirical work. It assesses in some detail whether or not the Maastricht criteria might not induce undesirable economic effects and whether an alternative test, based on the optimal currency area theory, could be preferable. It surveys a range of other issues such as the significance of the Balassa-Samuelson effect, the robustness, scope and efficiency of financial services in Central Europe and the performance of the candidates with respect to direct investment inflows. Finally, it provides an overview of the somewhat confused policy debate on the issue in the candidate countries themselves.

This study has been written for the project Effective policies in the Pan-European Union which the WRR (the Netherlands Scientific Council for Government Policy) recently completed. Mr. Hobza 's contribution has helped the WRR to identify what the critical options are for the passage to the euro for countries in a stage of development, and with a history of transition , which raise difficult policy dilemma's. It is a crucial example of how greater diversity in the larger Union invites new thinking and possibly more flexible and differentiated responses by EU policy makers.

Alexandr Hobza is research fellow at CEPS, the Centre for European Policy Studies in Brussels. The author thanks Daniel Gros, Research Director of CEPS, for support and constructive comments.

Prof. mr. M. Scheltema
Chairman WRR

3

CONTENTS

5

1   INTRODUCTION

Over the last decade, the Central and Eastern European (CEE) transition countries[1] have gone a long way. At last, it seems that the prospect of the EU membership is, for most of them, within a reach. The possible timing of entry in the European Union was first specified by the June 2001 Goeteborg European Council summit stating the objective that the candidate countries should partici-pate in the European Parliament elections of 2004 as members. To meet this date the candidate countries should conclude the accession negotiations by the end of 2002. And the December 2001 Laeken European Council meeting made it clear which candidate countries have a chance to comply with this deadline. Therefore, 'if the present rate of progress of the negotiations and reforms in the candidate States is maintained, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, the Czech Republic and Slovenia could be ready.'[2]

This means that 10 out of the current 13 candidate countries might become EU members at the beginning or in the course of 2004. Romania and Bulgaria are clearly lagging behind and still have much homework to do in order to fulfil the Copenhagen criteria. The accession negotiations with the last candidate – Turkey – have not been launched yet.

In terms of economic integration EU membership is not the last stop and the can-didate countries also aim at becoming members of the Eurozone. This, however, will not happen at the same moment. The adoption of the euro is conditioned by compliance with the Maastricht convergence criteria, and one of them requires a member country to be a member of the European Exchange Rate Mechanism (ERM II) for at least two years. Thus, even if the candidate countries became members of the ERM II upon their entry in the EU, they would have to wait, in the case everything goes smoothly, for those two years before they could start dis-tributing euro notes and coins to their citizens.

The Economic and Monetary Union(EMU) is an integral part of the *acquis communautaire* and the candidate countries have accepted it as a political com-mitment with all its implications. This means they will be bound to become members of the Eurozone one day. Until then they will be EMU members with a derogation for the introduction of the single currency. From a legal point of view they would be in the same category as Sweden. The EU institutions stated expli-citly that no opt-out as in the case of Great Britain and Denmark would be grant-ed. Fair enough, the candidates do not seem to be calling for any.

However, they still have to make a number of crucial decisions concerning their way towards the euro. What would be the right moment to join the ERM II in order to achieve the optimum balance between the costs and benefits of intro-duction of the single currency? How to make sure that the way is a smooth one?

Answers to these questions are far from unambiguous since the opinions on these issues vary immensely.

Thus, the case of EMU, compared to the EU one, is much less clear cut. There has been a large number of voices from all possible directions raising numerous fears concerning the premature adoption of the euro. The group of the 'early-euro' sceptics includes such prominent EU players such as the European Central Bank and the European Commission. Also the banking sectors of both the incumbent and prospective member countries raise their concerns and academics are split on this issue. This goes somewhat against the intentions of some of the candidates to become part of the Eurozone in the shortest possible time.

This report will try to address the prospects of the candidate countries' membership in the Eurozone and identify potential pitfalls on their way. It is organised as follows: Section 1 provides an overview of the latest economic developments in the candidate countries. Section 2 turns to the assessment of the progress in real convergence of the candidate economies. Section 3 then considers issues of external stability of the candidate countries that might become highly relevant during the transition to the Euro Area. Section 4 explores the level and prospects of nominal convergence as defined by the Maastricht Treaty. The structural issues with predominant attention to the financial markets in the candidate countries are dealt with in Section 6. Section 7 summarises the attitudes of the various actors in the 'euro enlargement game'.

NOTES

¹   This paper deals only with the CEE countries which are candidates for the accession to the EU.

²   Presidency Conclusions of Laeken European Council, December 2001.

2   LATEST MACROECONOMIC DEVELOPMENTS AND PROSPECTS IN THE CEE CANDIDATES

After fast growth in 2000 and relatively good results in the first half of 2001, growth in most of the CEE candidate countries slowed down significantly towards the end of 2001. The deterioration of the international environment has contributed most to the lower economic performance. Thus the average growth for the
CEE-10 is estimated at 3.1 percent in 2001 compared to 3.7 percent for 2000. The largest trade partner of the candidate countries – the EU – failed to take over the role of global economic engine from the US. Revised estimates report growth of GDP of only 1.7 percent with the German economy almost stagnating at 0.7 percent. According to the estimates of the European Commission, growth will only resume in 2003. However, the candidate economies so far seem to be rather resistant to the adverse external developments and thus they might retain moderate but stable growth rates. It appears that especially economies which went through cyclical slowdown in late 90s – the Czech Republic and the Baltic states – will be able to withstand the global slowdown rather well. In the case of the latter it is also strong growth in Russia and increased oil transit that underpin these relatively good prospects. Economic growth has been, and also will be, driven by strong domestic demand in the forthcoming period, with a notable exception of Poland which is currently undergoing the strongest economic crisis since the beginning of the transformation. The Polish domestic demand has been withering due to very high interest rates which are the result of bad policy mix in the preceding years.

Inflation rates have reported a favourable development in the CEE candidate countries as the average inflation rate declined from 12.3 percent in 2000 to 9.2 percent in 2001. Producer price indices in many countries reported almost zero growth due to reductions in world commodity prices dominated above all by the drop in the price of crude oil. Among the candidates, especially the Baltic states achieved a considerable degree of price stability, closely followed by the Central European (CE) countries. Prospects for reduction in inflation have considerably increased in Hungary after the introduction of more flexible exchange rate arrangement which was followed by strong appreciation of the Hungarian Forint. Among the most advanced candidate countries it is Slovenia which has failed to achieve a more pronounced improvement. Still rather high average inflation in the candidate countries is to a large extent influenced by Romania which has not yet managed to get its inflation under control. According to the Economist Intelligence Unit (EIU) forecasts, Romania will be able to push down inflation to single digit levels only after 2006. After excluding the two candidates that are lagging behind – Romania and Bulgaria – the average inflation rate would be slightly under 6.5 percent. The countries that have already achieved a moderate level of inflation rates might find it difficult to reach more pronounced improvements due to relative price changes induced by the process of catching-up (for more see below).

The reduction of inflation has been further strengthened by the high unemployment rates in the region. Unemployment exceeded 13 percent in 2001 which is one percentage point rise compared to the preceding year. This, however, documents not only the impact of unfavourable development in the world markets but also longer-term effects of structural changes in the candidate economies. The countries with largest expected increases in unemployment were those where the absolute level is among the highest, namely Bulgaria, Poland and Lithuania. The labour markets of candidate countries suffer from a high degree of structural rigidities which will, together with continuing restructuralisation, put a lower limit on reductions in the unemployment rates. The situation in the individual countries is, of course, highly differentiated with Hungary and Slovenia at the lower bound and Slovakia, Poland and Bulgaria at the upper one with rates exceeding 18 percent.

The whole transformation period has been characterised by considerable current account deficits. In 2001, the average deficit was slightly below 5 percent of GDP and seems to be sustainable due to strong capital inflows. The overall level of capital account imbalances is not expected to deteriorate in the coming period, despite the negative effect of global slowdown on exports of the candidate countries, due to the lower prices of imported commodities and especially oil. Also the contraction of domestic demand in Poland and subsequent drop in imports will contribute to the sustained level of the overall current account deficit. A rapid development of exports of services, especially tourism, is another factor working towards reducing the current account imbalances. However, current account deficits still remain at a high level in a number of candidate countries, which might prove troublesome in the case of a sharp decline in capital inflows.

Table 2.1   Basic indicators of the candidate countries (2000)

	Population	GDP per head		Inflation	Unemploy-ment	Gross capital formation	FDI	
	Millions	Curr. prices	PPS	%	%	% of GDP	Stock per capita	Net inflow % of GDP
EU15	378.4	22520	22400	2.1	8.2			
Bulgaria	8.2	1600	5400	10.0	16.4	16.2	239	7.1
CR	10.3	5400	13500	3.9	8.8	28.3	2213	9.0
Estonia	1.4	3800	8500	4.0	13.7	23.4	1980	8.0
Hungary	10.0	5000	11700	9.8	6.4	22.9	1790	2.9
Latvia	2.4	3300	6600	2.6	8.0	24.6	934	5.7
Lithuania	3.7	3300	6600	1.0	15.4	18.7	683	3.4
Poland	38.6	4400	8700	10.1	15.0	25.3	671	5.3
Romania	22.4	1800	6000	45.7	10.8	18.5	317	2.8
Slovakia	5.4	3900	10800	12.0	18.6	30.0	1000	10.8
Slovenia	2.0	9800	16100	8.9	7.0	27.8	1348	1.0
Average CEE						24.5		

Table 2.1   continuation

	Trade				Share of industry	Share of agriculture	
	Exp to EU (% of total)	Imp from EU (% of total)	Trade balance as % of GDP	CA deficit (% of GDP)	% of gross value added	% of gross value added	% employ-ment
EU15							
Bulgaria	51.2	44.1	-9.9	-5.9	25.1	14.5	Na
CR	68.6	61.9	-6.2	-4.8	36.0	3.9	5.1
Estonia	76.5	62.2	-15.8	-6.8	14.6	6.3	7.4
Hungary	75.1	58.4	-4.4	-3.9	26.9	4.8	6.5
Latvia	64.6	52.4	-14.9	-6.8	16.3	4.5	13.5
Lithuania	47.9	43.3	-9.8	-6.0	22.8	7.6	19.6
Poland	69.9	61.2	-7.8	-6.3	29.0	3.3	18.8
Romania	63.8	56.6	-4.6	-3.7	27.6	12.6	42.8
Slovakia	59.1	48.9	-4.7	-3.7	25.8	4.5	6.7
Slovenia	63.8	67.8	-6.2	-3.3	27.7	3.2	9.9
Average CEE			-7	-5			

Source: European Commission, EBRD (Share of Industry)

3   REAL CONVERGENCE

In this section progress of the candidate countries on the way from centrally planned to market-based economies will be assessed with a view to the integration to EMU. Real convergence will be looked upon from both a broader and a more specific point of view. Broader real convergence is perceived as a process of gradual upgrading of the general social, political and economic structures towards those of the EU countries. The narrower concept of convergence is understood as decreasing the differences in the economic development measured by real output, productivity, standards of living etc. The broader concept, on which the Copenhagen criteria are based, may provide us with information on the stage of transition in wich the candidate countries find themselves. We need to go beyond the general wording of the Copenhagen criteria, which are interpreted only in the yes/no way and which are currently fulfilled by a large majority of the CEE candidates on this basis. Further differentiation is needed to find possible weak spots in the economies of the EMU candidates that would be capable of sparking economic crisis during their quest for the single currency. Real convergence in the strictly economic sense is not a precondition for successful functioning of the monetary union as the experience of the current member states amply demonstrates, but it is certain that achieving a higher level of output levels accompanied by convergence of economic structures would further strengthen its functioning.

15

3.1   REAL CONVERGENCE: BROAD CONCEPT

It is obvious that despite the huge progress achieved by most of the CEE candidate countries, a lot still remains to be done. For a first overview, one can have a look at the EBRD Transition indicators presented in Table 3.1. For a better overview, the fields are shaded in such a way that darker ones signify larger deficiencies compared to the level of developed countries. It is immediately apparent that the transition countries have largely succeeded in liberalising their trade and privatising their state sector. Price liberalisation has not been finished yet in any of the countries, but the reasons for the sluggish progress are predominantly social and one can expect that this process will be accomplished by the entry into the EU/EMU. Large backlogs can be, not surprisingly, identified in the infrastructure sector. However, these are not crucial for the process of the monetary integration and membership in the Eurozone. Moreover, liberalisation of many network industries is in progress in many of the candidate countries, and is sometimes even faster than it is in the current EU states. More relevant are still sizeable shortcomings in governance, sound legislative framework and financial markets structure and functioning. Various aspects of governance and legal framework are touched upon in the following section. The situation in the financial markets is analysed below in the part dealing with structural issues.

Table 3.1   EBRD Transition indicators 2001

	Markets and trade			Enterprises			Markets
	Private sector (% of GDP)	Price liberali- sation	Trade and foreign exchange system	Small- scale - privati- sation	Large- scale privati sation	Governance and enter- prises restruc- turing	Compe- tition
Bulgaria	70	3	4+	4-	4-	2+	2+
Czech Republic	80	3	4+	4+	4	3+	3
Estonia	75	3	4+	4+	4	3+	3-
Hungary	80	3+	4+	4+	4	3+	3
Latvia	65	3	4+	4+	3	3-	2+
Lithuania	70	3	4+	4+	3+	3-	3
Poland	75	3+	4+	4+	3+	3+	3
Romania	65	3+	4	4-	3+	2	2+
Slovakia	80	3	4+	4+	4	3	3
Slovenia	65	3+	4+	4+	3	3-	3-

	Infrastructure					Financial institutions	
	Telecoms	Electric power	Railways	Roads	Water and water waste	Banking reform and interest rate libera- lisation	Securities markets and non- bank financial institutions
Bulgaria	3	3+	3	2+	3	3	2
Czech Republic	4	3	2+	2+	4	4-	3
Estonia	4	4	4	2+	4	4-	3
Hungary	4	4	3+	3+	4	4	4-
Latvia	3	3	3+	2+	3+	3+	2+
Lithuania	3+	3	2+	2+	3+	3	3
Poland	4	3	4	3+	4	3+	4-
Romania	3	3	4	3	3	3-	2
Slovakia	2+	3	2+	2+	2+	3+	2+
Slovenia	3	3	3+	3	4	3+	3-

Source: EBRD (2001)

3.1.1   GOVERNANCE

The candidates are clearly lagging behind the current member countries in terms of governance. This is documented by innumerable indicators published by many institutions and assessing various aspects of governance. In order to gain an overall impression six composite indicators constructed by Kaufman et al. (1999 a,b) are presented in Table 3.2.[1] It is obvious that the candidate countries on average achieve worse results than their EU counterparts and usually even the best performing CEE country is below the EU average.

Table 3.2   Estimates of the six governance indicators

	Voice and Accountability	Political Instability and Violence	Government Effectiveness	Regulatory Burden	Rule of Law	Graft	GDP per capita (USD 1998)
CEE best	1.20	1.25	0.67	0.85	0.83	1.02	14400
CEE worst	0.41	0.02	-0.81	0.09	-0.15	-0.56	4683
EU average	1.44	1.11	1.37	0.91	1.31	1.48	19991
EU best	1.63	1.51	2.03	1.21	1.81	2.13	23855
EU worst	1.07	0.21	0.56	0.59	0.50	0.67	13994
Czech R.	1.20	0.81	0.59	0.57	0.54	0.38	12197
Estonia	0.79	0.79	0.26	0.74	0.51	0.59	7563
Hungary	1.20	1.25	0.61	0.85	0.71	0.61	9832
Latvia	0.62	0.46	0.07	0.51	0.15	-0.26	5777
Lithuania	0.77	0.35	0.13	0.09	0.18	0.03	6283
Poland	1.07	0.84	0.67	0.56	0.54	0.49	7543
Slovakia	0.74	0.65	-0.03	0.17	0.13	0.03	9624
Slovenia	1.07	1.09	0.57	0.53	0.83	1.02	14400
Bulgaria	0.60	0.43	-0.81	0.52	-0.15	-0.56	4683
Romania	0.41	0.02	-0.57	0.20	-0.09	-0.46	5572

* EU average without Luxembourg, higher=better, range=(-2.5,2.5)

Source: Kaufman et al. (1999 a,b)

However, Gros and Suhrke (2000) note that the weakness of the institutional infrastructure should be looked at from a relative point of view. It may be true that in most cases the candidate countries are lagging behind in their performance compared to the EU members but this weakness might be just a consequence of their low level of per capita income. This can be clearly seen in Figures 3.1 to 3.4. The correlation between the governance indicators and the level of economic development is rather high. In the case of the indicator assessing the regulatory burden it is 71 percent. In all other cases it exceeds 80 percent (government effectiveness – 85 percent, rule of law – 88 percent, and graft 85 percent). Thus the level of governance and institutional framework seems to be appropriate given the level of development of the candidate countries.

Gros and Suhrcke (2000) proceed by saying that the more advanced candidate countries in Central Europe have institutional frameworks that are judged by foreign investors, and in surveys, as being 'normal' for their level of development (or even slightly better than one would expect). There is little reason to believe that progress will not continue as the overall catch-up process proceeds. Moreover, the accession process itself exerts an important pressure on the candidates to upgrade their institutional frameworks. The progress reports of the Commission acknowledge substantial improvements in this field. And thus, one can expect that at the time of accession the institutional framework in the candidate countries will be at a level compatible with troubleless functioning of the EU. Certainly, the candidate countries (at least those less developed) will not be able to get to EU levels in a relatively short time as the establishment of effective institutions, governance structures and sound practises requires decades rather than

years. Hence, these issues will remain on the top of the reform agenda even after the EU entry. But their potential to initiate a crisis should be rather limited as they are actually seen by investors as appropriate. Moreover, Gibson and Tsakalotos (2001) find that despite the fact that microeconomic inefficiencies can very often be identified as playing a role in financial and currency crises ex post, they rarely act as a detonator.

Figure 3.1   EU and Candidates: Regulatory Burden and GDP per capita
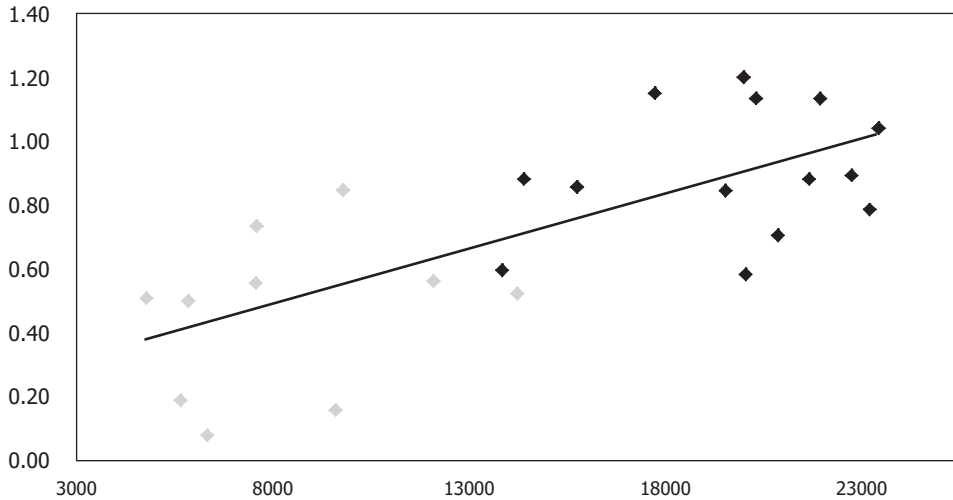
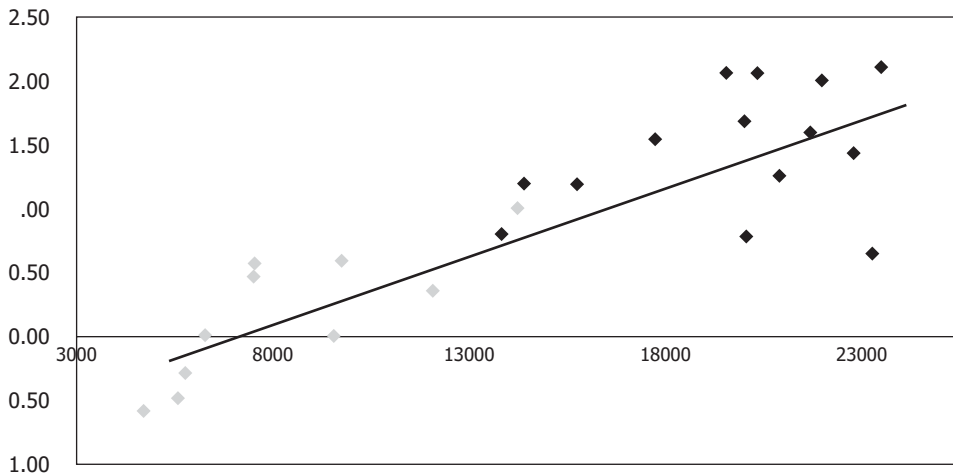**Figure 3.2   EU and Candidates: Graft and GDP per capita**

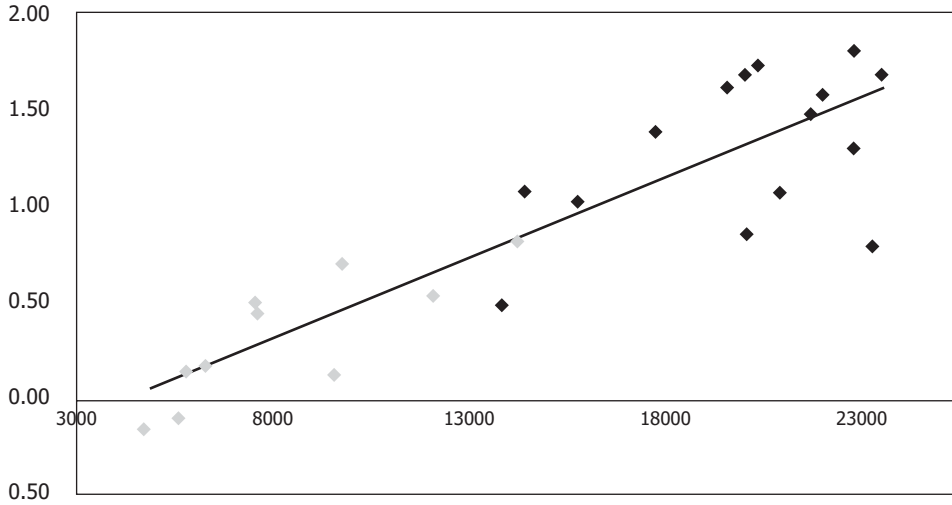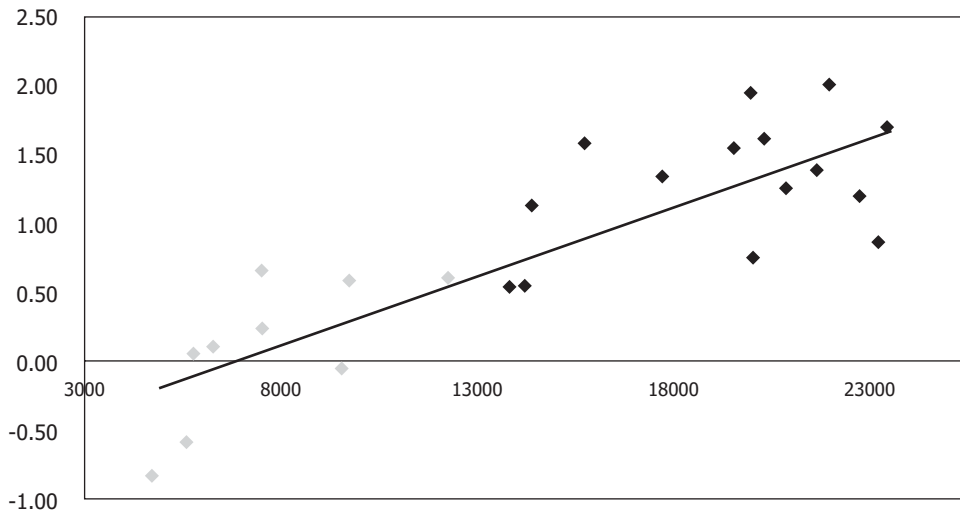**Figure 3.3** **EU and Candidates: Rule of Law and GDP per capita**

Figure 3.4 **EU and Candidates: Govt Effectiveness and GDP per capita**

3.2 REAL CONVERGENCE: NARROW CONCEPT

One of the major objectives of the EU which is deeply imbedded in the Treaties, is the achievement of real convergence between its members. The forthcoming enlargement is going to pose a serious challenge to the successful fulfilment of this objective. The countries that are aspiring for membership are on a substantially lower level of economic development than a vast majority of the current members. According to the neo-classical growth theory, the candidate countries that are characterised by lower income levels and capital to labour ratios are

expected to grow at a faster rate than the current, more developed, EU member countries. This is encouraging. But the real developments in the candidate countries indicate that it might not be that easy. First, it has to be stressed that catching up is not a fast process. The weighted average per capita GDP expressed in PPP reached 40.5 percent of the EU average, and in 2000 it was 43 percent. This means only 2.5 percentage points improvement. After excluding Romania and Bulgaria, the increase was 3.5 percentage points (from 42.5 percent to 46 percent). Also the pattern of convergence was rather uneven among the candidate countries. The largest increases were experienced by Slovenia, Estonia, Hungary, Poland and Latvia. For some other EU candidates, the recent transition experience is not very encouraging. The Czech Republic, Romania and Bulgaria even experienced real divergence.

Table 3.3   **GDP per capita as percentage of EU average**

	BL	CR	EE	HU	LI	LA	PO	RO	SI	SL
1995	32.5	62.4	32.6	46	31.4	25.1	34.4	27.9	62.9	44.1
2000	28	58.8	38.5	51.1	33.3	30	39.4	23.3	69.4	47.9

Source: Own computation on the basis of AMECO data

The candidate countries usually report higher growth rates of GDP than the incumbent EU members and it is often expected that they will retain higher growth during the forthcoming period. Is this enough to achieve higher real convergence? Figure 3.5 suggests that this is the case. The countries with higher real GDP growth have achieved higher convergence in terms of per capita GDP levels expressed in purchasing power parities. The countries that reported negative average growth in the period between 1995 and 2000 – Bulgaria, Romania and the Czech Republic – indeed experienced an increase in the differences between levels of economic development.

In general, the relationship between the relative real GDP growth and the level of development defined as per capita GDP in PPP (as a percentage of the EU average) does not have to be that straightforward. The changes in the relative levels of economic development can thus be caused not only by the real growth but also by the changes in international relative prices and exchange rates. The European Commission (2001) suggests that the changes in international relative prices favoured all of the CEE candidate countries with the exception of Slovakia. Hence, they caught up more (or diverged less) than would have been the case if only the growth rates were taken into account.

Figure 3.5   Candidate countries: real convergence and growth

Average growth minus EU average (1996-2000)
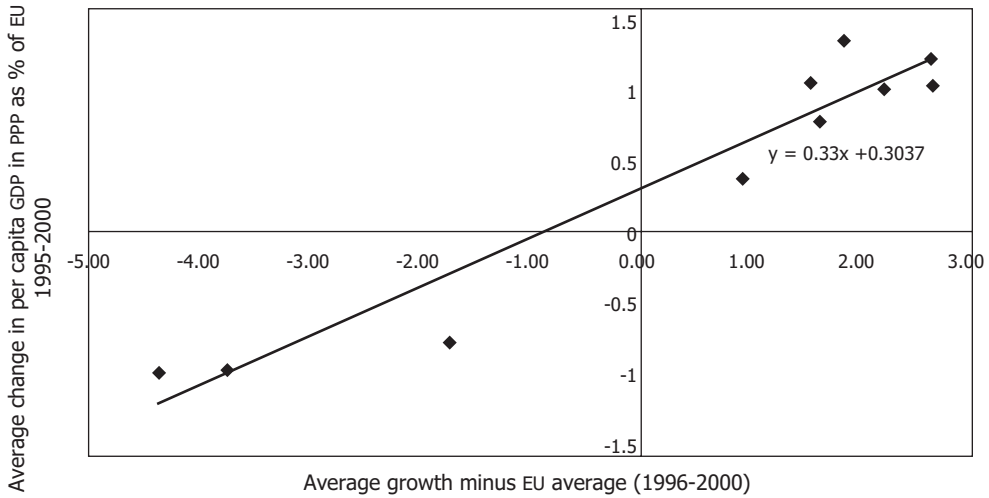
As already mentioned, real convergence is a long-run task. According to the computations of the Commission (EC, 2001), based on the estimated future growth rates from the pre-accession economic programmes, it might take some of the candidate countries decades to achieve the GDP level of 75 percent of the EU average (Table 3.4). Thus, Bulgaria, Latvia, Lithuania, Poland and Romania would need about three decades to reach this level of 75 percent. Even if one computes the length of the catching-up relative to the enlarged EU, the difference would be almost negligible for those most lagging behind. Despite the fact that, originally, the EU average will be reduced by more than 20 percent once the candidate countries join, their growth will be more dynamic, thus increasing the average at a higher rate. It is necessary to stress however, that these estimates are only indicative as they are based on a very simplified extrapolation of the current trends.

Table 3.4   GDP per capita in PPP (years needed to reach 75% of EU average)

	BL	CR	EE	HU	LI	LA	PO	RO	SI	SL
EU15	31	15	19	11	31	27	33	34	1	20
EU27*	31	6	16	7	30	25	33	33	-	16

* CEE candidates + Malta and Cyprus

Source: EC (2001)

Lately, most of the discussions concerning the future membership of the candidate countries in EMU are dominated by fears that the gap in economic development between the prospective and current EU members would pose a threat to the euro. Therefore, some observers call for introduction of additional criteria (more on this below). However, the data provided clearly show that the expected catch-up by far exceeds the conceivable time framework for the EU and also for EMU enlargement. Introducing any additional convergence criteria based on the narrow concept of real convergence would thus technically mean imposing a

stand-still to the Eurozone enlargement with all its negative consequences. Moreover, as Gros (2001) argues it is 'health not wealth' that counts in the process of (monetary) enlargement. This may be further demonstrated by the experience of the current poorest members of the Eurozone. It appears that neither Greece or Portugal nor the Eurozone as a whole suffer due to their membership.

A further concept that is often referred to when assessing the 'real' side of a country's preparedness to join a monetary union is the optimum currency area theory. Therefore, some evidence based on this approach is provided in the next section.

3.3 STANDARD OPTIMUM CURRENCY AREA INDICATORS

The costs and benefits of establishment of a monetary union are often judged using the optimum currency area theory (OCA). Unfortunately, the quantification of the OCA criteria is rather contentious. Therefore, it is not certain that such an approach can provide an unambiguous indication of whether a country is 'ripe' to give up its currency and join a monetary union, but as it is the most widely used methodology, some evidence for the case of the candidate countries is provided. Although the OCA-based conclusions are at best indicative and subject to a number of reservations, they might provide some useful insights into the core issues.

The following standard six indicators from the optimum-currency-area approach are used:

1 *Trade structure similarity*: The more similar trade structure is the lower should be the likelihood that trade is affected by asymmetric shocks. The measure used here is the correlation coefficient between the shares of about 100 pro-ducts (at the 2-digit CN-level) in overall intra-European exports and in the exports of each EU member to other EU members (2000 data).

2 *Intra-industry trade*: An indicator of the extent to which two countries exchange similar goods. The higher this indicator, the lower should be the likelihood that trade is affected by asymmetric shocks. Technically we use the Grubel-Lloyd index on the basis of the 2-digit CN-level of trade structures. This index is calculated as one minus the sum of the absolute value of net exports of each CN 2-digit sector over the sum of total exports and imports (2000 data).

3 *Real GDP growth correlation*: Correlation coefficient between real GDP growth in EU12 and the respective country from 1993/4-2000.

4 *Industrial growth correlation*: Same method as above.

5 *Unemployment rate (changes) correlation*: Correlation coefficient between the unemployment rate of EU12 and candidate countries, 1994-2001.

6 *Exports to EU15* as a percentage of GDP (2000).

The first two indicators capture the differences in economic structures that are supposed to measure the potential for asymmetric shocks. Indicators 3 to 5 measure the extent to which the economies of individual countries have tended to move together with the EU average over the observed period. The last indicator measures the importance of trade with the rest of the EU and is thus a measure of the expected benefits from the EMU.

In Table 3.5, the values of the indicators for the CEE candidate countries and for some of the current EU members, both 'euro' and 'non-euro' ones, are provided.[2] It is important to stress that the absolute value of the indicators should not be taken at their face value in order to determine whether a country is suitable for joining a monetary union, as it is difficult to say what magnitudes are still acceptable. One should rather look at the relative ranking of the countries. Moreover, the start of the transition process in the late 80s and early 90s was marked by substantial 'transitional recession' which was caused by the switch from a centrally planned economic system to a market-based one.[3]

Table 3.5   The traditional OCA indicators

	Trade structure similarity	Intra-industry trade	Real GDP growth correlation	Industrial growth correlation	Unemploy-ment rate correlation	Exports to EU15
CR	74	92	7	30	-20	39
Estonia	56	51	14	44	-19	58
Hungary	76	91	89	75	-30	43
Poland	59	84	16	16	-58	13
Slovenia	72	86	39	82	40	32
Bulgaria	40	23	43	43	-49	23
Romania	42	29	-20	-38	-25	19
Latvia	22	10	30	29	28	24
Lithuania	36	27	-4	-12	-61	18
SR	68	88	14	72	-30	33
Average	54.5	58.1	22.8	34.1	-22.4	30.2
GER	95	77	68	90	85	14
GRE	22	26	64	56	64	5

Source: own calculations based on AMECO data

The OCA indicators provide a rather mixed evidence. The value of the structural variables is on average quite high. Also the value of exports to the EU countries as a percentage of the GDP is high, pointing to the fact that the candidate countries are strongly tied to the EU market and thus would significantly benefit from joining the Euro Area. On the other hand, the indicators of business cycle co-movement score rather poorly and in the case of changes in unemployment rate the correlation is even slightly negative. Therefore, one could prematurely conclude that the candidate countries hardly form an optimum currency area, at least in the traditional sense. However, several caveats have to be made.

The overall picture hides huge differences between the candidate countries themselves. As for the structure of trade, the most advanced countries can be

easily compared to the EU economies. The Baltic states (perhaps with an exception of Estonia) and the South Eastern candidates still have a very different composition of trade compared to the EU, both in terms of its general structure and the share of intra-industry trade. In the case of the Baltic States it might be their small size that contributes to the extremely low values of indicators of intra-industry trade and trade similarity. They have no choice but to specialise in a limited number of industries. The structure of export industries thus does not provide a very comforting picture. Wood industry and textiles account for almost 50 percent of Latvian exports. Lithuanian exports are dominated by mineral products, textiles and machinery. Estonia seems to be less vulnerable to industry specific shocks as its economy is more diversified with machinery as a major export article. However, the high degree of openness makes the Baltic States interested in joining a large currency area. The advantage they will derive from EMU membership will also depend on the EMU's size when these countries join. For instance, the current exports of Lithuania to the EU countries account only for 48 percent of its GDP. If the Euro Area also comprised Poland and Lithuania's Baltic neighbours, the share would rise to roughly 70 percent.

The data on business cycle developments show that, with a notable exception of Hungary, the CEE cycle is clearly out of sync with the Eurozone one. This may be to a large extent caused by the unsettled economic features of the candidate economies and a series of country specific crises. The Czech Republic went through a recession in 1997 and 1998. Economic growth in the country resumed only recently and continues even despite the sharp slowdown in the EU. Baltic states suffered strongly as a consequence of the Russian crisis at the end of 90s. Also Bulgaria witnessed a severe crisis in 1997.

The relatively unfavourable values of the indicators that are supposed to embody the costs of adoption of a common currency do not necessarily lead to the conclusion that the CEE countries are not suitable candidates for EMU membership. As Frankel and Rose (1996) note, some of the OCA indicators are endogenous and are bound to change once the countries join the monetary union.[4] It is thus possible that the indicators of co-movement in macroeconomic variables such as GDP growth, industrial growth and unemployment rates will adapt and get more synchronised with the EU average. Therefore, we can argue along these lines that countries like the CEE candidates would not satisfy the OCA criterion of a high correlation with the core countries as long as they stayed outside, but that they would satisfy this criterion once they had been inside the EMU for some time. Moreover, the business cycle indicators have been heavily influenced by the fact that the candidates have undergone a process of transition.

Obviously, this point concerns the relative development of business cycles which can to a certain extent be considered as policy-induced, but the trade structures would not likely be much affected by EMU membership as they depend on structural characteristics that change only very slowly over time.

3.4   CORRELATION OF BUSINESS CYCLES: A CAVEAT

What can one conclude from the observation that over a certain period in the recent past the correlation between real GDP growth rates has been positive?

Is it unambiguously better considering joining the EMU if the correlation of shocks has been positive? An example should be enough to illustrate a conceptual problem that is almost always neglected. Assume that (domestic) demand shocks have positive spillover effects in the EMU so that a positive shock to demand in the Euro Area would increase demand also in the country in question (and vice versa, but this is less important in this context). It can be shown that in this case it might well be better for the candidate for EMU if the correlation between the demand shocks (at home and in the Euro Area) is negative.

To see this, just consider what happens if the correlation is positive (say, at the limit equal to 1). In this case, the foreign (=Euro Area) demand shocks will tend to come at the same time as domestic ones. As the spillover effects were assumed to be positive, it follows that domestic booms (and busts) will be reinforced by the spillover effects of the Euro Area booms and busts. It could thus be better for a country that considers joining the EMU if the correlation between the demand shocks was negative (under the hypothesis that the spillover effects are positive). Berger, Jensen and Schielderup (2001) use a standard model to analyse the ramification of this idea. They seem to have been the first to draw attention to this line of reasoning.

25

The standard reasoning would be different. It would emphasise that the common monetary policy of the euro area will not be appropriate for the candidate country if the correlation is negative. Consider the case of a strong negative correlation between domestic and foreign demand shocks. In this case the ECB is likely to tighten when the home country is experiencing negative shocks. This is clearly not appropriate from the point of view of the home country, but how important is it? The negative correlation implies that a negative shock in the home country is likely to happen when there is a positive shock in the Euro Area. As long as the spillover effects are positive, this implies that a negative demand shock at home will usually be mitigated by the stronger demand coming from the Euro Area so that negative domestic demand shocks will not lead to severe downturns. Hence, it might not matter that much that the common monetary policy is not entirely appropriate for the country in question.

Another factor that influences whether a negative correlation of shocks is an indicator of potential problems with joining the euro is the effectiveness of monetary policy. If monetary policy does have a very strong influence on output (compared to the spillover effects resulting from foreign shocks discussed above), the monetary policy stance could become decisive in determining output in the home country. In this case the home country might suffer from a common

monetary policy that is based on the Euro Area developments if the correlation of the shocks is negative.

These considerations imply that one should be careful in jumping to the conclusion that countries for which the correlation coefficient (between national and Euro Area data) of GDP growth (or other business cycle indicators) is positive, are automatically better qualified for the EMU than countries for which the correlation coefficient is negative. Moreover, it would also seem inappropriate to conclude that a higher correlation coefficient is necessarily better.

The discussion so far has identified two key factors: the sign and size of spillover effects and the effectiveness of monetary policy in stabilising output. There is very little one can say about systematic cross-country variations of the latter, as very little is known what factors in reality influence the monetary transmission channel. Only little more is known about the size and sign of the spillover effects of demand shocks. But there is a general presumption that they are positive and sizeable. Gros and Hobza (2001) show that this might not be the case for the larger EU countries. However, one would presume that for the very small and open economies of the smaller candidate countries (e.g. Estonia, Slovenia) the spillover effects from an expansion of Euro Area demand could be positive and sizeable; or, at least, larger than for the larger candidates, like Poland. This implies that one should evaluate the traditional OCA indicators somewhat differently for the smaller candidate countries.

3.5 IDENTIFICATION OF DEMAND AND SUPPLY SHOCKS THROUGH VAR

The correlation coefficients of the GDP and industrial growth may not be considered as the most appropriate measure of co-movement of business cycles[5] and thus the likelihood of occurrence of asymmetric shocks. A more refined method might be required. Therefore, Fidrmuc and Korhonen (2001) estimated the correlation of the supply and demand shocks between the candidate countries and the Euro area using a structural VAR model. Supply and demand shocks were recovered with help of the decomposition developed by Blanchard and Quah (1989).[6] Their findings once again underline the heterogeneity of the group of EU candidates. Especially, Hungary and Estonia are characterised by a relatively high degree of correlation of both supply and demand shocks with the Euro Area.[7] The other candidates, including the most advanced, Slovenia and the Czech Republic, show little correlation of shocks. Some of them have even negative correlation of the demand shocks. An interesting case is Lithuania which reported a negative value also in the case of correlation of the supply shocks. This might be caused by the highly specific structure of its economy.

Fidrmuc and Korhonen also updated the analysis of Bayoumi and Eichengreen (1993) and found that, interestingly, some of the countries which were by the latter marked as peripheral, have converged significantly. Thus Italy, Spain and also

Portugal achieved a rather high correlation with the Euro Area shocks. This seems to support the hypothesis of the endogeneity of the OCA criteria. Therefore, it appears that during the period of preparation for the EMU and its early years the increased interaction between the economies has led to a synchronisation of their business cycles. This would be good news for the candidate countries.

Boone, Maurel and Babetski (2002), also using a VAR model, found that the level of demand and supply shock symmetry in the CEE candidate countries is approximately at the same level as the symmetry of shocks of countries such as Spain and Portugal at the time of their accession to the EMU, meaning not very high. Further, they discovered some evidence on demand shock convergence with the EU/Germany.[8] According to their evidence, supply shocks have hardly converged during the first decade of transition however, which might be due to the Balassa-Samuelson effect. Unlike Fidrmuc and Korhonen, they do not report any convergence of the economic shocks in the EMU 'periphery'.

3.6 LABOUR MARKET FLEXIBILITY

The threat of diverging economic developments in the candidate economies which would pose a challenge to the formulation of economic policies on both the Eurozone and national level can be mitigated if the labour markets are flexible enough to act as an efficient adjustment mechanism. Labour markets of most of the current EU members are usually considered to be too rigid and calls for greater flexibility often appear. Where do the candidates stand in this respect?

Riboud et. al (2002) attempted to assess the flexibility of the labour market institution in six CEE candidate countries (the Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia). In order to allow for a comparison with the developed economies they made use of the OECD methodology (1994 and 1999). According to their findings, these countries fall somewhere in the middle of the flexibility scale compared to the OECD economies. Though they do not reach the level of flexibility of the UK, Ireland and Denmark, they still exhibit much greater flexibility than the Club Med countries, France and Germany (see table 3.6 and figure 3.6).[9] As regards, unemployment insurance systems, the CEECs seem to be less generous that the OECD or EU countries. They also spend less on both passive and active employment policies. Also in terms of the role of the unions in the wage negotiation process, the candidates fall somewhere in the middle of the range of the OECD countries. However, they have extremely high payroll and also other taxes which even exceed the highest levels in the EU.

Table 3.6   Labour market flexibility in the CEECs

	Employment protection legislation***				Unemployment insurance		Taxes	
	Regular empl.	Temporary empl.	Collective dismissals	EPL Strict-ness ****	Benefit replace-ment	Benefit duration (months)	Payroll tax rate (%)	Total tax rate (%)
Czech Republic	2.8	0.5	4.3	2.1	50	6	47.5	73.4
Estonia	3.1	1.4	4.1	2.6	10	3-6	33.0	63.3
Hungary	2.1	0.6	3.4	1.7	64	12	44.0	81.5
Poland	2.2	1	3.9	2	40	12-24	48.2	80.0
Slovakia	2.6	1.4	4.4	2.4	60	6-12	50.0	81.0
Slovenia*	3.4 (2.9)	2.4 (0.6)	4.8 (4.9)	3.5 (2.3)	63	3-24	38.0	69.1
CEEC average	2.7	1.2	4.1	2.4	48		43.4	74.7
EU average**	2.4	2.1	3.2	2.4	60		23.5	53.0
OECD average	2.0	1.7	2.9	2.0	58		19.5	45.4

* Numbers in brackets refer to the new labour code if approved.
** EU average without Luxembourg and Greece
*** 1: minimum protection, 6: maximum protection
**** Weighted average of the first three columns

Table 3.6   continuation

|	Passive policies		Active policies		Unions			
	% of GDP	Spending per unempl.	% of GDP	Spending per unempl.	Union density (%)*	Union coverage index**	Coord. unions	Coord. employers
Czech Republic	0.31	0.04	0.19	0.02	42.8	2	1	1
Estonia	0.08	0.01	0.08	0.01	36.1	2	2	1
Hungary	0.56	0.06	0.40	0.04	60.0	3	1	2
Poland	1.71	0.12	0.49	0.03	33.8	3	2	1
Slovakia	0.54	0.05	0.56	0.05	61.7	3	2	2
Slovenia	0.89	0.11	0.83	0.11	60.0	3	3	3
CEEC average	0.68	0.06	0.42	0.04	49.0			
EU average	1.73	0.26	1.16	0.16	44.4			
OECD average	1.43	0.23	0.92	0.14	39.6			

* Percentage of salaried workers that belong to a union.
** 1: less than 25 percent of salaried workers are covered by collective agreements, 2: between 26 and 69 percent are covered, 3: 70 percent or more are covered.

Source: Riboud et al. (2002)

However, the labour market institutions are usually found to have played a limited role in the transition economies (Boeri and Terrell, 2002, Riboud, 2002). As these countries have undergone a fundamental systematic change, the evolution of the labour markets was largely shaped by general approaches to transition such as the macroeconomic stabilisation or structural reforms. At the beginning of transition, candidate countries suffered a large drop in their economic output. This was (with an exception of the Czech Republic) followed by a rapid increase in the unemployment rate and a decline in labour market participation (which was unusually high for some population groups during the communist regime). Interestingly, the high unemployment rates have stayed at these high levels until now (the Czech one rose after the recession in 1998), though the GDP has recovered substantially. Labour market institutions might have somewhat contributed to this persistence (Riboud, 2002).

Figure 3.6   Flexibility of employment protecting legislation
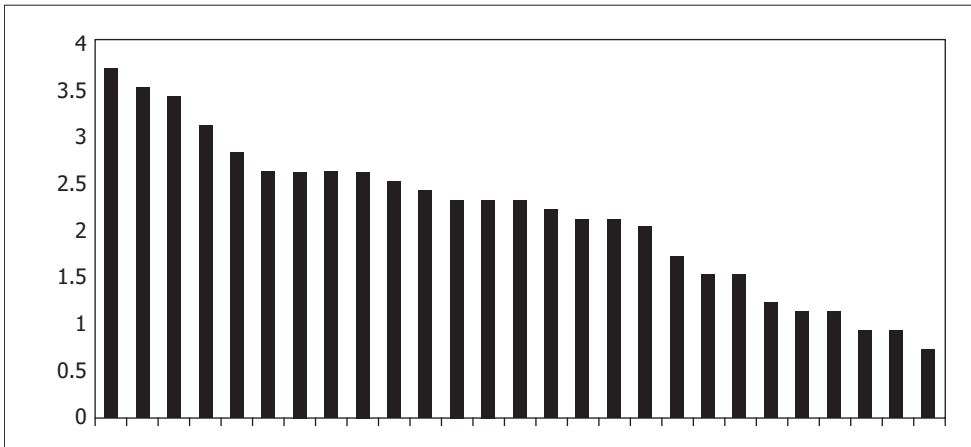
* Slovenia after new labour code is approved

Source: Riboud et al. (2002)

The CEE candidate countries thus generally opted for labour market institutions common in the Western Europe, which might be due to cultural and geographical proximity. This is further supported by the fact that they are required, prior to their entry into the EU, to align their legislation with the acquis communautaire which includes a number of provisions regarding labour market regulations. Thus, the candidate countries have introduced similar rigidities as the ones that are troubling the EU countries (Riboud et. al., 2002). Though this might not pose many problems in the current phase of transition it may come to the fore once the process of structural reform is completed.

NOTES

[1]   The authors collected over 300 measures of governance from different sources cover-
ing a large number of countries and constructed six aggregate indicators of gover-
nance using an unobserved components model. The model expresses the observed
data as a linear function of unobserved governance plus a disturbance term capturing
perception errors and/or sampling variation in each indicator. Then, point estimates
of the indicators for individual countries and their variances (as a mean and variance
of conditional distribution of an indicator given the observed data for an individual
country) can be computed from the model. The range of indicators vary from
approximately –2.5 to 2.5. However, the authors note that the governance indicators
are not very precisely estimated given the relatively large standard deviations com-
pared to the units in which they are measured.

[2]   Fidrmuc and Korhonen (2001) also present correlation coefficients of GDP growth
based on quarterly data and arrived at approximately same results.

[3]   For this reason the analyses is restricted to the period from 1993/4 to 2000.

[4]   Frankel and Rose apply the Lucas critique argument by saying that the establishment
of a monetary union (in our case accession of the candidate countries to the EMU) is
bound to change significantly the nature of the business cycles in the member coun-
tries through the increase in intra-EMU trade and the impact of common monetary
policy. They put stress on the role of trade flows which will according to their evi-
dence lead to greater synchronisation of the business cycles. 'Thus cyclic correlation
is endogenous with respect to trade integration.' However, note that for example
Eichengreen (1992), Kenen (1969), and Krugman (1993) believe that the trade integra-
tion will result in greater specialisation of the economies and thus the correlation of
business cycles could actually decline if supply shocks were to prevail.

[5]   At least because high values of the coefficient only show that the GDP (or other indi-
cators) move in the same direction but fail to provide information on the actual mag-
nitude of the movements. Further, it is not possible to distinguish the impact of sup-
ply and demand (permanent/temporary) shocks.

[6]   The decomposition of the reduced form error terms to supply and demand shocks is
the main point of criticism of this approach. The identification of the reduced form
VAR model is based on the assumption that demand shocks do not have permanent
effects on output, whereas supply shocks do. As Minford (1993) notes this is doubt-
ful. The temporary shocks could, for example, reflect temporary supply shocks, tem-
porary effects of monetary and fiscal policies and effects of the exchange rates.
Similarly, the permanent shocks reflect not only the supply factors but also the per-
manent responses to them (both fiscal and monetary). It is thus difficult to distin-
guish the nature of the shocks which then reduces the validity of conclusions. If the
exchange rates are found to be effective in dealing with a certain type of shocks it
would be useful to be able to isolate these shocks. But then, it would be desirable to

distinguish between shocks and responses to them which the VAR methodology does not allow either.

7   The correlation of the demand shocks was in general lower than that of the supply shocks. This might be a result of different economic policies followed by the national governments and as such could be expected.

8   By using a time-varying estimation (Kalman filter) they computed 'time-varying correlation coefficients' of the development of shocks.

9   However, in terms of employment protection legislation, Slovenia ranks among the countries with the highest degree of inflexibility. This could somewhat change if the new proposed labour code, which introduces much more flexible provisions for both permanent and temporary contracts, is approved.

4 ASSESSING THE STABILITY OF THE CANDIDATE COUNTRIES

4.1 CURRENT ACCOUNTS

Current account deficits are usually presented as a percentage of GDP, which is useful if one wants to focus on the capacity of a government to service foreign debt. However, if one wants to have an idea of the exchange rate adjustment required to re-establish current account equilibrium, one should relate the deficit to overall export receipts (goods and services). Under certain reasonable conditions, one could actually argue that the deficit as a percentage of export receipts gives directly the percent depreciation required to eliminate the deficit without a contraction in domestic demand, i.e. a deficit equivalent to 20 percent of exports would require a devaluation of about the same magnitude.[1]

Table 4.1   CA as percent of export receipts

	1996	1997	1998	1999	2000	2001
Bulgaria	0.2	7.1	-3.3	-16.1	-10.1	-10.5
Czech Republic	-13.0	-11.5	-4.1	-4.7	-6.5	-6.6
Estonia	-13.7	-15.6	-11.5	-6.1	-6.7	-6.8
Hungary	-9.7	-4.6	-9.5	-8.3	-5.2	-5.0
Latvia	-10.7	-12.0	-20.7	-22.0	-15.1	Na
Lithuania	-17.2	-18.8	-25.6	-28.2	-13.2	-7.8
Poland	-4.7	-14.5	-14.8	-21.1	-19.2	-15.8
Romania	-26.8	-21.7	-31.3	-14.4	-10.8	-16.6
Slovakia	-18.2	-15.5	-15.2	-8.1	-5.0	-9.9
Slovenia	0.2	0.1	-1.3	-7.5	-5.5	-2.6
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Portugal	-0.8	-3.3	-0.8	1.0	-8.6	-0.4
Spain	-21.5	-22.2	-21.6	-6.2	-6.4	0.4

On this account, the data diverge relatively modestly between the CEE candidate countries. Most of them seem to have been able to stabilise their current accounts. Out of the first wave of countries, Poland experienced the highest current account deficit as it amounted to more than 15 percent of export receipts. However, Poland managed to decrease the ratio from above 20 percent and thus get under the values experienced by Spain during the early 1990s. (Portugal had only negligible deficits during this period). This ratio has been much lower in Slovenia, the Czech Republic, Estonia, Lithuania and Hungary. The two latter countries succeeded in achieving significant reductions in the current deficits in the last years. Bulgaria whose deficit stays at levels of about 10 percent was joined by Slovakia which experienced a sharp deterioration of the current account balance. The problems of external balance appear to be largest in Romania with very little hope for early stabilisation.

These data imply that a country such as Poland would require a very large depreciation, over 15 percent, should it ever need to achieve a balanced current account

quickly. It is usually argued, however, that there will be no need for this because the deficit is financed by stable flows of foreign direct investment. This argument was also frequently used prior to 1992 in the case of Spain and Portugal. In comparison, countries such as Hungary and the Czech Republic are in a much more stable monetary environment, as their need for devaluation would be much smaller.

4.2   FOREIGN DIRECT INVESTMENT

Table 4.2 below shows that Portugal and Spain also had rather large inflows of FDI, again measured as a percentage of export receipts. For Spain, FDI flows averaged over 10 percent of exports during the pre-crisis period, and for Portugal they were only somewhat smaller.

For example, for Poland today, FDI flows in relation to export receipts are nearly twice as important. During 2000 they amounted to over 15 percent of exports, financing most of the current account deficit. In all the other candidate countries, the current account deficit is to a larger or lesser extent covered by FDI flows too.

Table 4.2   **FDI flows (balance of payments data) as percent of export receipts**

	1996	1997	1998	1999	2000
Bulgaria	2.8	10.3	12.2	17.0	12.2
Czech Republic	4.8	0.6	11.2	19.1	12.7
Estonia	5.0	7.4	13.9	7.5	8.4
Hungary	10.3	8.7	5.9	65.1	4.7
Latvia	14.6	18.2	11.4	11.5	12.5
Lithuania	3.7	7.0	17.5	12.2	7.4
Poland	12.9	13.4	14.3	17.9	16.9
Romania	3.2	11.8	20.7	10.2	8.2
Slovakia	3.3	1.9	5.2	3.2	14.7
Slovenia	1.8	3.6	2.2	1.7	1.7
	1991	1992	1993	1994	1995
Portugal	9.2	5.0	6.1	3.9	0.0
Spain	9.0	11.1	5.9	5.1	1.9

Source: Own computations on the basis of AMECO data

Table 4.2a   FDI flows (balance of payments data) as percent of GDP

	1996	**1997**	**1998**	**1999**	**2000**
Bulgaria	1.8	6.4	5.5	7.5	7.1
Czech Republic	2.5	0.3	6.6	11.6	9.0
Estonia	3.4	5.8	11.1	5.8	8.0
Hungary	4.0	4.0	3.0	34.5	2.9
Latvia	7.4	9.3	5.8	5.1	5.7
Lithuania	2.0	3.8	8.3	4.8	3.3
Poland	3.1	3.4	4.0	4.7	5.3
Romania	0.9	3.5	4.9	3.0	2.8
Slovakia	1.8	1.1	3.2	2.0	10.8
Slovenia	1.0	2.1	1.3	0.9	1.0

Source: Own computations on the basis of AMECO data

In the Czech Republic, FDI flows represent double the current account. The key question is thus for how long the candidate countries can count on inflows of this magnitude. Over the last years, the CEE countries have experienced rather stable flows, which have on average increased year after year. But can this go on forever? The experience of Spain and Portugal is again instructive in this respect. FDI flows to Spain halved in the year after the first attack (1993) and have then considerably fallen again after the second major attack (1995). By 1997, Spain became a net exporter of FDI, and later Portugal as well. With swings in external flows of this size it is not surprising that a large adjustment in the real exchange rate of the peseta was needed.

35

Figure 4.1   Foreign direct investment as a percentage of exports in Portugal and Spain
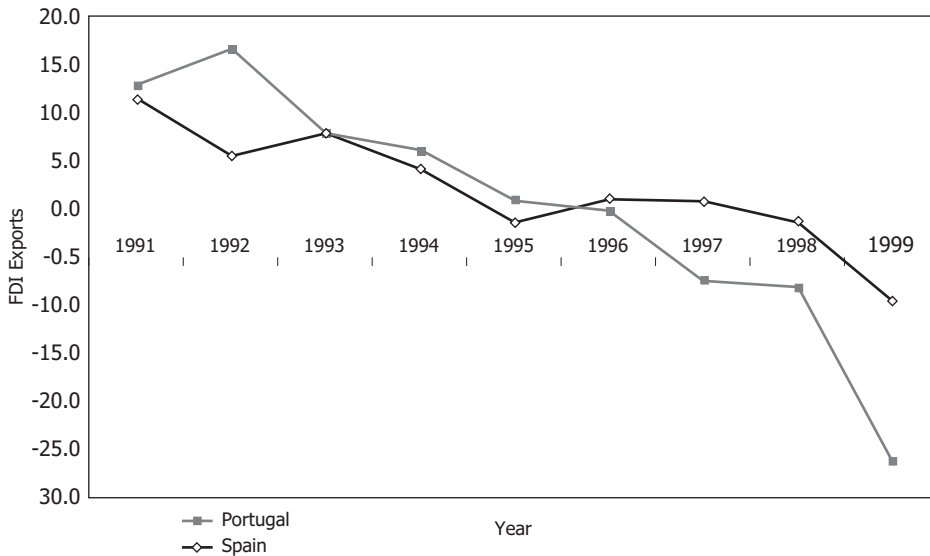
4.3 SAVINGS AND INVESTMENT: CAPITAL MOBILITY IN THE CANDIDATE COUNTRIES

Large current account deficits could be justified if they finance the build up of a strong capital stock, whose returns can later finance debt service. Unfortunately this mechanism does not seem to be the main driving force for current accounts in Central and Eastern Europe. This evaluation might appear to be surprising in a view of the importance of the flows of foreign direct investment into CEE candidate countries. Indeed, for most countries FDI flows are large enough to cover the current account deficits. But the key question is whether FDI is in addition to domestic investment. Here the evidence is not conclusive. Across countries there is only a rather weak tendency for countries with higher FDI to have also higher investment rates. Moreover, the countries with the largest current account deficits are not the ones with the highest investment ratios.

Another way to evaluate the driving forces behind the capital flows into the CEEC is to look at the relationship between the changes in current accounts and investment ratios across countries as depicted in Figure 4.2. It is apparent that countries which recorded large increases in the current account current accounts (as percent of GDP) were also mostly the ones with the highest increase in investment to GDP ratios. If one applies the Feldstein-Horioka criterion, this suggests that capital mobility is already rather high in Central and Eastern Europe.

Figure 4.2   Relationship between Changes in Investment and the Current account between 1995 and 2000 (as a percentage of GDP)
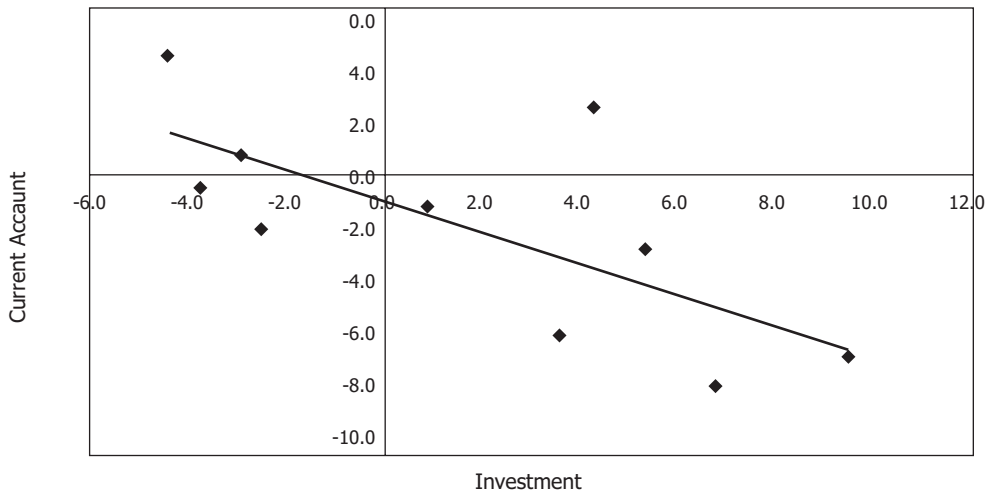
How should one evaluate this apparent contradiction? It seems that capital is mobile at the margin (for the CEECs) but enormous differences exist among these countries as to their overall propensity to save. The poorer countries (e.g. Bulgaria and Rumania) seem to have the lowest national savings rates (they have

low investment rates, but still sizeable current account deficits). The large current account deficits make sense in an inter-temporal context, if one assumes that they help the country to accumulate capital faster than it could if it did rely on national savings alone. But unfortunately the poorer countries do not seem to be the ones that grow faster, which is not surprising in the light of their lower investment ratios. This points again to a risk: namely that some countries accumulate large foreign debts that finance an unsustainable rate of consumption. A protracted crisis is likely to result when capital markets discover that the country has difficulties servicing its debt because not enough capital (physical and human) was invested in the tradables sector. Hungary has been in this situation for most of the past decade. It emerged from the over-indebtedness trap only after a long period of belt-tightening which was politically and economically very painful (Poland extricated itself from a similar situation at the end of the 1980s thanks to a combination of large scale debt forgiveness and rapid growth). At present it appears that the CE candidates, are no longer in this situation, but the danger remains for the laggards, i.e. Bulgaria and Romania.

4.4 REAL APPRECIATION AND COMPETITIVENESS

During the early 1990s, there was a lively discussion whether the 'Club Med' currencies (of Portugal, Spain, Italy, and Greece) were overvalued. There was no general agreement, because the judgement depended, as usual, on the indicator and the base period used. The two indicators most often used to measure competitiveness are (and were then) the real exchange rate deflated by the CPI and by Unit Labour Costs (ULC). These two usually give different indications. Now, and then (see Table 4.3).

Table 4.3 Appreciating real exchange rates (percent appreciation relative to the indicated base period)

	2001 relative to 1996		2001 relative to 1999	
	CPI	**ULC**	**CPI**	**ULC**
Czech Republic	22	22	12	10
Estonia	21	20	5	-3
Hungary	24	9	13	9
Latvia	39	34	12	7
Lithuania	53	84	16	9
Poland	37	40	27	27
Romania	60	-13	17	-43
	End-1991 relative to 1980		**End-1991 relative to 1987**	
	CPI	**ULC**	**CPI**	**ULC**
Italy	31	-1	11	9
Spain	24	2	26	28

Sources: Gros and Thygesen (1998) p. 216 for Club Med relative to Germany. For candidate countries: own calculations on the basis of AMECO data, CPI relative to EU12, ULC total economy.

In the case of Spain, it was argued that there was no need for a large exchange rate adjustment because there was no real overvaluation – but only if one used

ULC as the competitiveness indicator and 1980 as the base period. Not surprisingly, this was the position taken by the authorities. A similar argument was used in the case of Italy, where there was also a large discrepancy between the ULC– and the CPI–based measures.

The candidate countries today present a very similar picture. Depending on the base period and the indicator chosen, it can be argued that their currencies are overvalued by a very small margin or, on the contrary, by a very large one. In the case of the Czech Republic, Hungary and Estonia is the potential overvaluation relatively small across most indicators and base periods. Poland and Lithuania report much higher level of real appreciation. In Romania, the CPI deflated exchange rate indicates a considerable overvaluation, whereas the ULC based one points to an undervaluation. In the future, a further trend of real appreciation of the candidate countries' is expected. Strong appreciations have occurred especially in the Czech Republic (from December 2001 to April 2002 by more than 10 percent), Poland and also in Hungary (after the country widened the Forint fluctuation band). The argument that the CEE currencies cannot be overvalued because exports of most of the candidate countries keep growing fast was also used in the case of Spain, where exports had actually doubled in dollar terms in the five years prior to the attack of 1992. This is typical of countries that have recently opened up to trade, such as the transition countries today or Spain in 1992, when it dismantled its last tariffs within the, then, EC. In such cases both exports and imports tend to grow strongly, whatever the exchange rate, more and more sectors are exposed to international competition.[2]

These data suggest that sooner or later an exchange rate adjustment might be needed.[3] What does this imply for the exchange rate policies pursued by these countries?

For example, Poland and the Czech Republic officially follow a floating exchange rate, accompanied by domestic inflation targets. They are thus in a different situation than Spain and Italy in the early 1990s, which were members of a fixed exchange rate adjustment, the ERM. In theory, an exchange rate adjustment could thus come about gradually and without disruption.

However, experience has shown that large exchange rate adjustments almost always lead to some disruption in financial markets. This was the case even for Spain, which in 1992 had actually a rather large room for manoeuvre under the ERM (Spain had margins of +/- 6 percent). A sudden large depreciation usually forces the central bank to increase interest rates to limit the domestic inflationary pressures that would otherwise worsen inflation. Moreover, the terms of trade shock (deriving from the depreciation) in combination with higher interest rates might initially lead to a contraction in demand (as in Italy and Spain). This in turn puts pressure on the budget, leading to higher deficits; which then might undermine confidence and thus aggravate the depreciation.

Such a negative spiral does not need to develop. The case of Greece shows that a smooth 'glide path' to EMU is possible. But it could be potentially dangerous for the candidate countries operating flexible exchange rate regimes to enter into an ERM-type arrangement that would tie their currencies to the euro before they have a clearer view of whether the current exchange rate levels are sustainable in the long run. The case of Greece, which engineered successfully a one-step surprise devaluation is instructive in this regard.

However, the real appreciation which is a natural consequence of the transition and catching-up process does not necessarily have to be damaging for the candidate countries. If it comes through the Balassa-Samuelson effect it does not imply any loss of international competitiveness. Moreover, real appreciation may also reflect further trade integration and elimination of non-quality related price differences. And last, it may generate pressure on the exporters to increase their productivity and improve performance and thus eventually lead to an increase in competitiveness. Figure 4.3 demonstrates that despite the considerable real appreciation, competitiveness (measured by real labour units costs) has even increased in some of the candidate countries relative to the EU.

Figuur 4.3   Real labour unit costs (1996 = 100)
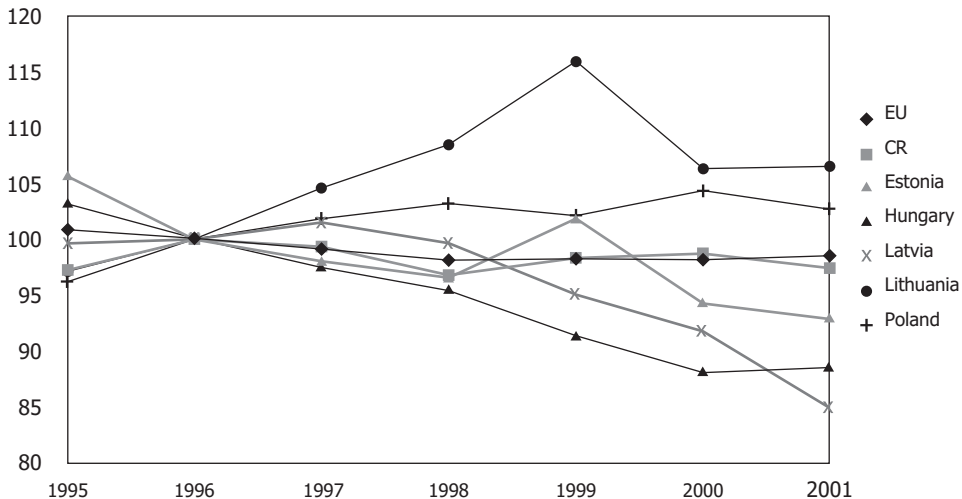
NOTES

[1]   The conditions are that imports are relatively price inelastic and that the demand curve for exports has an elasticity of one, which is not far from typical estimates in the empirical literature.

[2]   For an analysis of the experience of transitions countries see De Broeck and Slek (2001).

[3]   For further discussion of the potential for real appreciation in the transition economies see Halpern and Wyplosz (2001).

5   NOMINAL CONVERGENCE A LA MAASTRICHT

The ultimate condition for the membership in EMU is to achieve a certain degree of nominal convergence with the other members as stipulated by the Maastricht criteria. The EU institutions have so far made it clear that the criteria will have to be fully adhered to by the candidate countries in their run up to the monetary union.

The motivation behind the formulation of the Maastricht convergence test was threefold. First, the EU countries wanted to create a stable low-inflationary growth-friendly environment and hence the stress put on the level of inflation and interest rates. Second, the founders of EMU wanted to eliminate the risk of free-riding behaviour and thus they introduced the conditions limiting the size of budget deficits and the government debt. And eventually, the condition regarding the exchange rates was intended to test the stability of currency in question and appropriateness of the level of exchange rate vis-à-vis the other ERM countries.

Despite the fact that the Maastricht criteria had been heavily criticised they proved, at least in terms of the stabilisation of the public finances, rather successful. Indeed the EU countries managed in the run-up to EMU to bring the public deficits under control and those with a substantial government debt succeeded in bringing it down to more acceptable levels. At least because of this, it can be expected that the current eurozone countries together with the ECB and the European Commission will insist on 'stringent'[1] adherence to the original wording of the criteria. But many economists in this context call for some tailoring of the criteria so that they were more suited for the candidates' specific situation (Pelkmans et al. , 2000, Halpern and Wyplosz, 2001, Buiter and Grafe, 2001, Rostowski, 2002). They voice concerns that attempts to comply with the criteria in a relatively short time might prove to be destabilising for the CEECs and could potentially lead to a real divergence instead of catching up.[2]

41

Maastricht criteria

Article 121 (ex. Article 109j) lists the criteria according to which the degree of sustainable convergence necessary for EMU entry is assessed:
- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government's financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;

- the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels.

A protocol to the Treaty specifies the criteria by stating that a Member State has a to achieve price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Further, over a period of one year before the examination, a Member State has to have an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. In terms of stability of public finances, the general government deficit of a Member State may not exceed 3 percent of GDP, or should be falling substantially or only be temporarily above though still close to this level, and the gross government debt may not exceed 60 percent of GDP at market prices, or must at least show a sufficiently diminishing rate and approaching the reference value at a satisfactory rate. And finally, a member state has to respect the normal fluctuation margins (in the case of erm II +/-15 percent) provided for by the exchange-rate mechanism on the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

Let us first examine where the candidate countries stand now in terms of the values of the Maastricht indicators. The evidence is apparently mixed. The candidate counties are doing quite well regarding the volume of general government debt. It is only Bulgaria which highly exceeds the stipulated threshold. Also Hungary is uncomfortably close to the limit but it has a promising record of having been able to push down the ratio from about 90 percent in the beginning of the 90s to the current 57 percent. In 2001, only half of the candidate countries managed to keep their budget deficits under 3 percent of GDP. These were the Baltic States, Slovenia and also Bulgaria. In terms of monetary indicators, the performance of the CEE candidate countries is lagging behind. Inflation criterion was, despite a good progress towards achieving price stability by the vast majority of the candidate countries, fulfilled only by Lithuania. The (unweighted) average of 8.9 percent highly exceeded the threshold value which stood at 3.3 percent in 2001. Even if Romania and Bulgaria were excluded from the sample, the resulting 5.8 percent inflation is still substantially higher. The interest rate criterion is bound to be violated too.[3]

However, the candidate countries are not entering the Eurozone today and thus it rather makes sense to assess their preparedness in a more forward-looking manner. Hence one can compare the performance of the current EU/EMU candidates with that of the 'weakest' EU countries aspiring for adoption of the euro in the late 90s – the so called Club Med (Portugal, Spain, Italy and Greece). As already mentioned, the earliest possible date for the current candidate countries to join the Eurozone seems to be 2006. In such a case, the final decision on

accession would be made in 2005 on the basis of 2004/5 data. Hence, in order to assess where the candidates stand today in comparison to the Club Med countries at approximately the same time before EMU entry one should use the data for Spain and Portugal from 1993 and for Greece from 1995 as it joined EMU two years later. Table 5.1 presents results of such a comparison.

Table 5.1   Maastricht criteria – candidate countries and club Med

	Budget deficit end 2001)	Debt (end 2001)	Inflation (2001)	LT interest rates (2001)
Bulgaria	-1.5	100.0	7.9	5
Czech Republic	-4.5	29.1	4.8	5.4
Estonia	-1.0	5.9	5.9	6.8
Hungary	-3.7	56.7	9.6	6.6
Latvia	-1.4	9.2	3.1	10.2
Lithuania	-1.5	26.1	1.2	6.3
Poland	-5.1	48.4	6.0	8.4
Romania	-3.5	34.1	34.4	49.2
Slovakia	-5.2	45.0	7.5	7.7
Slovenia	-1.2	25.0	8.5	n.a.
Average	-2.9	38.0	8.9	11.7
Average-B,R	-2.9	30.7	5.8	7.3
Maastricht thresholds	-3.0	60.0	3.3	???
1993/5 data				
Portugal	-5.9	61.1	6.9	9.5
Spain	-6.7	58.7	5.3	10.1
Italy	-9.4	118.2	5.5	11.1
Greece	-10.5	108.7	8.9	Na
Average	-8.125	86.675	6.65	10.23333

In this context, it immediately appears that the candidate countries are in a much better shape than were the Club-Med countries 5 years before their entry to the Eurozone. Thus, the candidates will not necessarily encounter problems in fulfilling the qualification criteria for becoming fully-fledged EMU members. However, it might also be worthwhile to analyse where the CEE candidates see themselves in the mid-term horizon and whether they share this optimism concerning the fulfilment of the convergence criteria. Their intentions are included in the pre-accession economic programmes submitted to the European Commission in 2001.[4]

As the figures 5.1 to 5.3 show, the ambitions of the candidate countries are not very high in this respect. The figures depict the values of the convergence criteria achieved in 2001 in comparison to the projections of the candidate countries for 2004.[5] The 2001 values are depicted on the horizontal axis and the 2004 values on the vertical one. Therefore a position to the right (in the case of budget deficits to the left) of the dividing line indicates an improvement towards fulfil-

ling the criteria. Figure 5.1 clearly shows that the largest reductions in inflation rates are expected by the countries who are still fighting hard to get their price level increases under control. Despite the fact that the value of the inflation criteria is not firmly set but depends on the actual values of inflation in the three best performing countries in the EU, we can use a very benevolent approximation of 2 percent (target for price stability set by the ECB) plus the allowance of 1.5 percent. Even this high threshold would be met only by Lithuania and perhaps Latvia. Figure 5.2 reports in general a substantial improvement in budgetary balances. However, the Czech Republic and Poland would fail to get under the 3 percent threshold, and Slovakia and Romania would be quite close. In terms of public debt as a percentage of GDP, most candidate countries do not expect considerable improvement. It is not necessary however, due to the already achieved low levels. The countries that suffer from high indebtedness – Bulgaria and Hungary – are planning large improvements and thus would qualify quite comfortably, compared to some of the current EMU members.
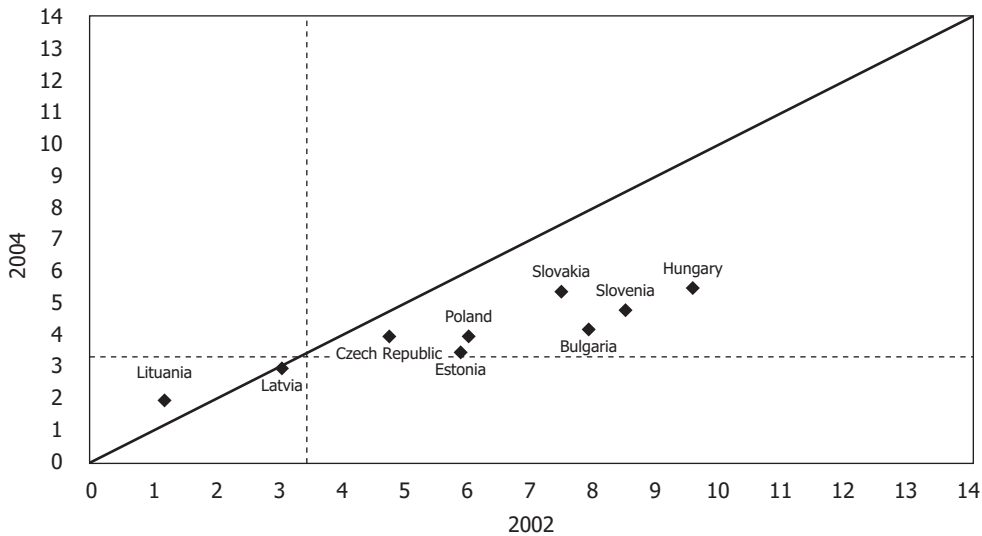
Figure 5.1   Inflation (2002 vs 2004)
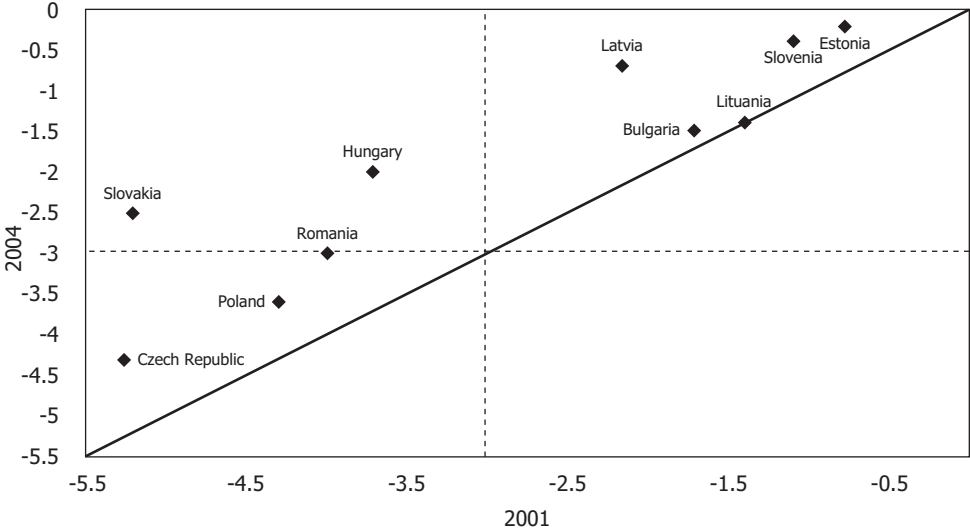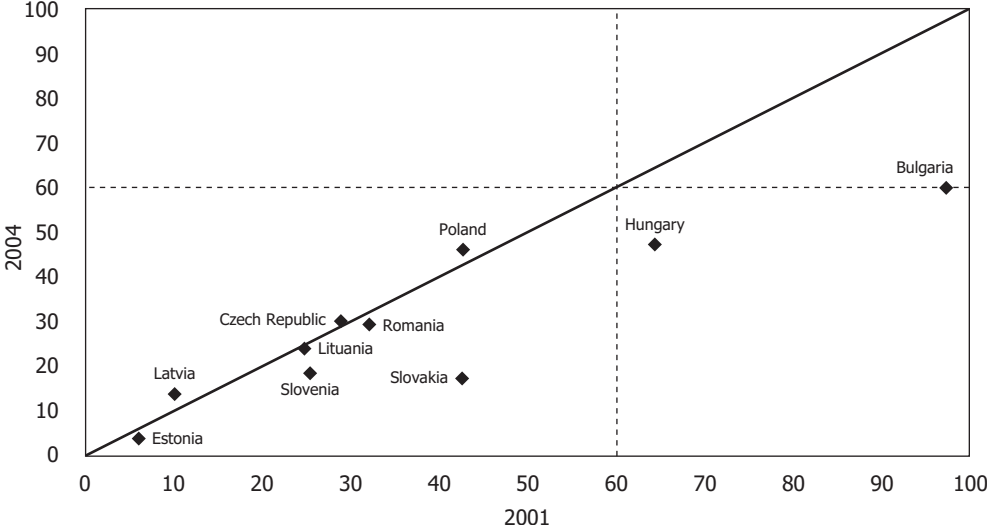
Figure 5.2   Budget deficits (2001 vs 2004)

Figure 5.3   Public debt (2001 vs 2004)

Despite the potential to meet the Maastricht criteria in the middle-run demonstrated by the comparison with the Club Med countries, the EIU forecasts for 2006 indicate that the CE countries could still, despite numerous self-confident statements of the countries' representatives, find it difficult to comply with the convergence criteria. Table 5.2 shows that none of the Visegrad 4 countries would qualify for the participation in the Eurozone as of 2007. The Czech Republic and Poland would violate the budget threshold and all of them, the Czech Republic perhaps marginally, would exceed the required level of inflation. On the other hand, the forecast does not take into account the determination of some of the candidate countries to enter the Eurozone which would induce them to make an effort to bring their economic indicators in line with the Maastricht requirements.

Table 5.2   Forecast for 2006

	Czech Republic	**Hungary**	**Poland**	**Slovakia**
Inflation (average)	2.9	3.9	4	3.7
Budget balance (of GDP)	-3.9	-1.9	-4.7	-2.1

Source: EIU

This brings us again to the fact that an early fulfilment of the convergence criteria might, not be easy. Does it mean that the candidate countries should rather wait, or is there anything wrong with the criteria? Are they really suitable in their present form to generate the desired stability and favourable economic environment for real convergence in the candidate economies? And indeed, many argued that the criteria are not appropriate for the candidate economies. There are some inherent features of the candidate economies that make it difficult for them, if not impossible, to comply with the criteria in the short- to middle-term, but at the same time do not pose a risk to their overall stability and thus do not contradict their membership in the Eurozone. An attempt to fulfil the criteria in a relatively short time might undermine the process of real convergence and potentially lead to a divergence. Thus an early entry in the Eurozone, which most of the CEE candidates wish to achieve, would be endangered and the following economic disruptions might have an adverse impact on the incumbent member states themselves.

Most objections and warnings are directed to the criteria concerning price stability, budget balance and exchange rate stability. Let us deal with them in turn.

5.1   INFLATION: BALASSA-SAMUELSON

The candidate countries have in most cases a rather impressive record in bringing down the inflation rates. Now, all of the countries except Romania managed to achieve one-digit inflation rates and forecasts indicate that in the following years the stabilisation of price level growth will continue. However, as is also apparent from the forecasts, inflation is expected to decline only modestly and stay at

higher levels than those common in the EU and also the Eurozone. This might have potentially important implications regarding the timing and strategy of the accession of the candidate countries to the EMU.

When looking for causes of such an inflation inertia, one has to resort to the theoretical framework of the Balassa-Samuelson effect explaining trend appreciation of the real exchange rates in terms of productivity differentials in the tradable and non-tradable sectors of an economy.

The catching-up process in the candidate countries can be characterised by trend appreciation of their real exchange rates. Why is that so? Labour productivity in the candidate countries rises in most cases at a higher pace compared to the EU economies, and the large gap in price and productivity levels between the CEE candidates and the EU countries coupled with strong FDI inflows indicate that the faster productivity growth might be preserved in the future as well. However, the high degree of trade integration implies that most of the increases are experienced in the tradable sector. The non-tradable sector benefits from increases in productivity only to the extent that the non-traded goods and services enter the production of the traded goods as intermediate inputs facing thus indirect competition. As the marginal product of labour in the tradable sector increases and prices, due to the international competition are kept at the world level, wages in this sector also tend to rise.

The basic assumption of the model is that wages in the economy tend to be equalised. First, there exists, though in reality somewhat limited, labour mobility between the sectors and thus the workers would move to better paid jobs in the tradable sector thus generating pressure towards equalisation. And further, trade unions also tend to make sure that the wage developments in the whole economy are more or less synchronised (Halpern and Wyplosz, 2001).

Thus, the increase in wages in the tradable sector results in equivalent increases in the non-tradable sector. However, the profitability of the non-traded sector facing rising wages and limited productivity increases cannot be retained without upward adjustment of prices of the non-traded goods and services. Hence inflation in the non-traded sector tends to overtake inflation in the traded sector.[8]

Thus, the evolution of the real exchange rate due to the Balassa-Samuelson effect can easily be depicted by several equations. The real exchange rate can be written as:

$$s_r = \varepsilon + \pi^* - \pi$$

where ε is the rate of expected depreciation of the nominal exchange rate, π and π^* are the inflation rates (based on the CPI index) in the transition country and Eurozone, respectively. The overall inflation rate can be decomposed to inflation rate in the traded sector and inflation rate in the non-traded sector, πT and πN, respectively. Also in this case the asterisk will denote the Eurozone. α will be the

share of the tradables in the CPI index and its composition is assumed to be the same in the transition country and the Eurozone. Thus,

$$\pi = \alpha\pi^T + (1\text{-}\alpha)\ \pi^N \text{ and } \pi^* = \alpha\pi^{T*} + (1\text{-}\alpha)\ \pi^{N*}.$$

From this follows that

$$s_r = \varepsilon + \alpha\pi^{T*} + (1\text{-}\alpha)\ \pi^{N*} - \alpha\pi^T = + (1\text{-}\alpha)\ \pi^N.$$

Due to the international arbitrage it must hold that the inflation rate of domestic tradable goods is equal to the inflation of the Eurozone tradable goods plus expected rate of depreciation. Therefore,

$$\pi^T = \pi^{T*} + \varepsilon$$

Then we can find that

$$s_r = (1\text{-}\alpha) \lfloor (\pi^N - \pi^T) - (\pi^{N*} - \pi^T) \rfloor.$$

From this follows that the real exchange rate will appreciate if the difference between the excess inflation in the domestic non-tradable sector over the tradable sector is larger than that in the Eurozone. And the higher differences in productivity levels in the transition countries compared to the eurozone indicate that it will probably be the case. The gap between the GDP per capita levels in the candidate countries and their EU partners is very wide. Thus there is a large potential for catching-up and productivity increases.

At this point it is important to stress that the Balassa-Samuelson (B-S) effect is an equilibrium phenomenon which naturally occurs when an economy experiences economic growth. Through an adjustment in relative prices in the economy, an appreciation of the real exchange rate is achieved. Therefore, higher inflation generated by this process is in no way a threat to monetary stability of a country or its international competitiveness and thus there is no need to counteract it by economic policies.

It is of course important to know what the magnitude of the effect might be, or whether it occurs at all. The ECB (1999) claims that a number of recent papers found evidence in favour of the Balassa-Samuelson hypothesis. Pelkmans et al. (2000) estimate that the inflation differential generated by the B-S might amount to between 3.5 percent and 4 percent. Halpern and Wyplosz (2001) arrived at a similar estimate of about 3.5 percent. Sinn and Reutter (2001) also report high levels of inflation which might be compatible with the Balassa-Samuelson effect. According to their estimates the candidate countries might have inflation rates that are higher by between 3 percent to 7 percent than those in Germany, a country with the lowest difference between productivity in tradables and non-tradables sectors. Coricelli and Jazbec (2001) estimated the possible size of the effect for 19 transition countries and arrived at a conclusion that

under the assumption of a yearly rate of real convergence between the transition countries and the EU of 2 percent, the B-S effect will result in a real exchange rate appreciation of about 1 percent. The estimates of the UNO (2001) vary between 2 percent and 2.2 percent. The Bundesbank (2001) arrived at estimates of 1.9 percent to 2.6 percent.

These numbers show large differences which are due to different methods applied, various sizes of the samples and periods covered. Many are subject to various reservations regarding the very short time periods used in estimations which in addition were characterised by large transformation structural changes. Also the division between the tradable and non-tradable sectors is hard to determine in practice. As a result, studies use various techniques which make the results incomparable. Moreover, the estimates of the impact of the B-S effect on CPI inflation might be further distorted as most of the studies are using a GDP value added distinction which can be considerably different (Durajsz, 2001). Moreover, some assumptions on which the estimates are based, such as full labour mobility and resulting wage equalisation can, in reality, lead to an overestimation of the overall impact of the B-S effect.

Even when taking into account these reservations, it is obvious that the B-S effect plays an important role. The estimated values in most cases exceed the 1.5 percent limit given by the Maastricht inflation criteria. From this point of view, insisting on a strict adherence to the criteria seems to be capable of generating economic crises rather than achieving the desired stabilisation of the candidate countries. If a candidate country wishes to adopt the euro in the shortest possible time, as many of them already proclaimed, it will be forced to suppress inflation under the stipulated limit. This could mean generating recession. Of course, it can be argued that the effect will decrease over time, but given the large differences in economic levels between the CEE candidates and the EU and thus also productivity, it seems improbable that the gap would close sufficiently during the desired four years time to reach '€-day'.

The inflation problem could certainly be solved, at least temporarily, with help of flexible exchange rates. The 'undesired' inflation differential in the light of the Maastricht criteria could be compensated for by proportional nominal appreciation of the exchange rate. This might however be in breach with the criteria concerning the stability of exchange rates within ERM II. The relatively wide +/-15 percent band could soon appear uncomfortably tight and an adjustment might be needed. (Wyplosz and Halpern, 2001) However, it is noteworthy that this would be an upward adjustment whereas the inflation criterion only speaks of unilaterally decided devaluation. The reasoning behind the Balassa-Samuelson logic would thus advocate for more flexibility regarding the upward adjustments. This would only be a temporary solution and after the entry into the Eurozone the change in relative prices would be needed anyway. As a result inflation differentials will persist.

49

Moreover, some of the candidates have deprived themselves of this possibility by fixing their exchange rates in a form of conventional pegs or currency boards. Therefore, the appreciation of their real exchange rate can solely be achieved through changes in relative prices. These countries then have little possibilities to limit the overall inflation without resorting to price controls and generating recession at least in some sectors of their economies. From this point of view, an adjustment in the Maastricht criteria would be desirable without running the risk of damaging their commitment to price stability in the Eurozone (Buiter and Grafe, 2001). The EU and member countries' officials have so far been opposed to such proposals, arguing by equal approach to all countries. However, it is worth noting that no official intervention into the wording of the Treaty would be necessary as the quantification of the criteria is done in a separate protocol. (Pelkmans et al., 2000).

What will the reduction of inflation under the Maastricht threshold cost?
(Gros, 2002)

It is important to find an answer to the one key question that is likely to arise in reality rather soon: by how much will growth have to be squeezed in the short run in order to allow a country with a strong B-S effect to reduce its inflation differential to the 1.5 percent allowed for by the Maastricht criteria.

In order to get a rough idea about possible magnitudes one can perform a somewhat simplistic econometric analysis with data from the Euro Area (1999-2001) which should rather be taken as indicative than a precise estimate of the size of the effects in question. In this analysis the difference between national inflation rates and the euro area average was explained by two variables: the relative price level and the cyclical position of the country. The result of a simple ols regression was rather good in that the two explanatory variables had a strong and clearly identifiable impact on inflation differentials. The point estimate on the relative price level variable (defined as the ratio of per capita GDP at current prices to per capita GDP at PPP) allows one to make a prediction for the B-S effect for the candidates. For example, for Poland per capita GDP evaluated at PPP is around 36 percent of the EU average, but evaluated at current prices without purchasing power adjustment it is only 18 percent of the EU average, implying a relative price level factor of 0.5. Given the estimated point coefficient of around (minus) 3.6 this implies that inflation in Poland should be 1.8 percent higher than the Eurozone average. The B-S estimates for other candidate countries vary between 1.3 percent in Slovenia to 2.6 percent in Bulgaria.

One reason why the estimate of the B-S effect is lower than that in most of the previous studies might be that they just related inflation differentials to relative prices for the early years of the Eurozone. But during these years it so happened that the poorer countries also were in particularly strong cyclical positions (basically because their growth was still being fuelled by the huge interest rate reductions which had taken place just beforehand). This means that the relative price variable picked up also the effect of the cyclical position, and was thus biased upwards. The introduction of the variable of the cyclical position controls for this effect.

Moreover, the estimates presented here also show that it will be rather costly in terms of foregone growth to squeeze the economy for a while, just in order to qualify for EMU. The point estimate on the cyclical position proxy is around 0.3. This implies that one would have to reduce growth by 3.3 percent in order to reduce the inflation differential by one full percentage point.

From the above, it is obvious that the B-S effect is not only a transition specific phenomenon. SVR (2002) looked for the sources of relative price changes (tradables/ non-tradables) in the Euro Area, whereas Fagan (2001) looks directly at inflation differentials as a function, inter alia, of price level differences. Both identify the B-S effect as an important factor, which could contribute to divergences in inflation rates.

Fagan (see box below), found that the price level differences are not the only or even the main factor in explaining inflation in the EMU countries. Indeed, the estimated coefficient is so low that differences in price levels contribute to inflation differentials only modestly. Hence, also other factors have to be sought that would explain the actual and also expected differentials. In other words, the fact that the candidate countries are poor today does not automatically mean that they will have much higher inflation in the Eurozone. Some fear that the accession of the applicant countries to the Eurozone would endanger price stability. Ignoring the fact that the weight of these countries is negligible and so is their influence on the Eurozone aggregates, it is important to realise that the higher inflation rates are a natural phenomenon which concerns the current member countries as well.

Fagan (2001) panel estimate of HICP inflation (1999-2001) in Euro Area

$\pi_{i,t}$	- HICP inflation rate in country i in period t	(1 to 10%)
$y_{i,t}$	- Output gap (for EU: OECD estimate)	(-2,5 to 2.5%*)
$rp_{i,t-1}$	- Relative consumer price level	(0.4 to 0.5)
$\varepsilon_{i,t}$	- Indirect tax variable	
$dprod_{i,t}$	- Relative productivity growth (traded/non-traded)	(5% to 10%)
	R2=0.82	N=33

Note: Numbers in brackets are typical numbers for candidate countries
* for candidate countries computed as the difference between actual growth and average
  for 1995-2000

The general conclusion one can draw from this partial survey is that the B-S effect exists. Therefore, if the inflation criterion remains without changes, the candidate countries that want an early membership at a fixed exchange rate will have to accept a period of reduced growth in order to reduce inflation temporarily. This might not be needed if they engineer the appropriate appreciation just before joining. But at any rate they will have to accept higher inflation later if the catch up continues. The key question is how much. The earlier estimates were quite high in this respect. However, the new evidence trying to disentangle the

51

relative importance of various factors on the inflation differentials is somewhat more modest as far as the absolute values of the expected B-S effect are concerned.

Anyway, if the candidate countries decide not to push too much and wait with the introduction of the euro, one good year might help them to get under the magical limit and they would be in (Szapary, 2000, Pelkmans et al. 2000). This could, however, take somewhat longer than they would wish and could also bring along all the negative aspects of unfulfilled expectations including financial market volatility, reverse capital flows and increased pressure on the currency. On the other hand, such an approach would require longer-term sound fiscal and monetary policies which would generally support the overall stability.

5.2   FISCAL CHALLENGE

Most of the candidate countries do not have any particular problems with fulfilling the debt criterion. In this respect the performance of the Baltic states is also striking with a public debt amounting to only 6 percent and 9 percent of GDP for Estonia and Latvia respectively. Bulgaria, which so far highly exceeds the stipulated framework, is planning substantial reductions of the debt. Also Hungary which is now approximately at the level required by the Maastricht criteria is expecting a considerable consolidation of its debt position until 2004. What might be worrying is the dynamics of the public debt in some other candidate countries. It is especially the case of the Czech Republic, Slovakia and to some extent also Poland. The major reason is the necessary cleansing of their banking sectors which were troubled by several crisis during the last couple of years. The data on bad loans in the economies (see below) indicate that a large part of this problem has already been solved and thus no further large increases in the level of government debt should be expected. However, in the short- to medium-term the debt-to-GDP ratios might still increase, but the process will presumably be over before EU accession. Further pressure on public finances from this side should thus be limited. Moreover, in most of the candidate countries strong growth combined with relatively low deficits should lead to rather strong downward pressures on the debt-to-GDP ratio so that some debt assumption could take place without putting in jeopardy the debt criterion.

A much greater problem seems to be the fulfilment of the deficit criterion. This is especially the case of the majority of the CE candidate countries. In 2001, the Czech Republic, Slovakia, Poland, Hungary and also Romania highly exceeded the 3 percent threshold for budget deficit. It is worrying, however, that no significant improvements are envisaged by some of them. The impact of expansionary fiscal policies could be to a certain extent limited by the fact that the higher deficits still reflect the costs of banking sector restructuralisation.

Achieving a fiscal deficit below 3 percent is essentially a question of political will. But the will seems to be rather withering in some of these countries. In the

short-term they have often a very limited scope for reductions in deficits as a large part of the budgets is composed of mandatory expenditures. Moreover, the tax collection is sometimes relatively inefficient contributing thus to an increase in tax arrears and exerting further pressure on the balance of public revenues and expenditures. Therefore, substantial fiscal reforms are needed in order to provide the desired fiscal discretion. And it takes some time to phase in such reforms. The conflict of political proclamations and lack of will or perhaps ability to take appropriate measures is especially apparent in Poland which wants to adopt the euro as early as possible yet failing to come up with a programme for the necessary reduction in budget deficits. The need for fiscal reforms is in the candidate countries generally acknowledged. However, their execution is very sensitive from a political point of view. Suhrke (2001) found that people in the transition economies exhibit a clear preference for more income equality compared to their West European counterparts. This 'egalitarian' spirit might effectively prevent any attempts for larger reforms of public expenditure as they would most probably entail reductions in social transfers. Such an effect is likely to be much stronger in the wake of elections. On the other hand, the objective to join EMU is positively accepted by the public in most of the candidate countries, and is a precondition for healthy fiscal policies. This could act as a catalyst for reforms.

In this context one can also ask whether it is only the structure of public expenditures which is not suitable for the transition economies. It might also be that the size of the government is too big given their level of economic development. This would further support the argument for radical fiscal reforms. Figure 5.4, relating per capita GDP measured in PPP and size of the government for 88 countries, attempts to provide at least a partial answer to this question. And indeed, it seems that all of the candidate countries lie above the regression line which would mean that they, at their level of development, cannot afford to have so extensive a public sector. However, several caveats have to be made. The fit of the regression is rather loose. And further, if only the EU and CEE countries are taken into account there seems to be hardly any relationship between the size of the government and per capita output.

A crucial question for the future shape of fiscal policies in the candidate countries is: Are there any longer-term (probably transition related) factors that would urge the candidate countries to continue running large budget deficits? It is often argued that such pressure might arise from the need to build a modern infrastructure in the candidate economies, plus the pressure on their underdeveloped social system. Thus according to Wagner (2001), an effort to comply prematurely with the budget deficit criteria might lead to real divergence. He argues that there is a trade-off between real and nominal convergence stemming from the need for the candidate countries to support their catching-up process by building an appropriate infrastructure. He goes even further by saying that some of the transition countries might 'lag behind more and more, so that the other EU countries will politically be forced to bail these countries out. As soon as the financial markets assign a high enough probability to this scenario, this may result in a significant EU-wide increase in interest rates and thus, at the worst,

Figure 5.4   Size of government and economic development
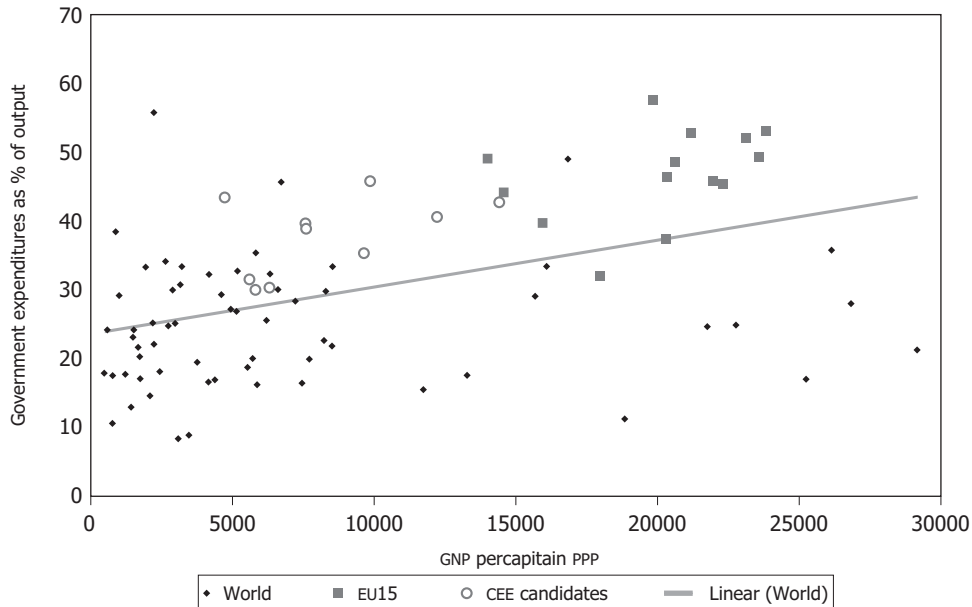
lead to an anticipatory recession.' (Wagner, 2001, p.31) However, these concerns seem grossly overestimated as the reliance on the government investment as a prerequisite for economic growth is clearly doubtful.

Moreover, one also needs to answer the question to what extent are the candidate countries lagging behind the EU in terms of infrastructure. The public infrastructure of the candidates is certainly less developed than that of current EU members. The candidates have fewer motorways and paved roads per inhabitant and square kilometre, fewer fixed telephone lines, etc., but this does not immediately imply that they therefore need more investment in this area. What they have might actually be adequate for their level of development. Poland for example has actually a larger stock of infrastructure than one would expect given its income per capita. It is thus difficult to argue that public infrastructure is the main impediment to growth. Moreover, once the CEE candidate countries join the EU they will be eligible for support under the regional policy of the EU, which is designed to finance this type of expenditure.

In the EU it is also often argued that the candidate countries have an underdeveloped social security system. It is true that pension expenditures figure prominently in the current debate over the budget crisis in Poland. But the same could be said of most EU countries as well. Indeed, most of the indicators that should signal pressure for spending in the social sphere show little difference between the EU and the CEECs.

For example, there is no significant difference in the age profiles between populations of the EU and of most of the candidates. The ageing problem is thus not worse for the new members. Poland actually has somewhat less of a greying

problem than the EU. In terms of public spending on health and education (as a percentage of GNP), there is also little difference between the candidates (around 5 percent) and the EU average (below 6 percent).

On the other hand, there will be considerable costs of complying with EU standards (especially environmental). Further 'burden' on the candidate countries' budgets will be the requirement to provide a part of the funding of projects under the EU structural and cohesion programmes (Eichengreen and Ghironi, 2001). This could either prevent the candidate countries from making maximum use of the available funds or from seeking savings in other areas which could be efficiency decreasing. Thus in a recession the candidates could be deprived of EU sources of financing as they would not be able to provide their required part. Therefore, Eichengreen and Ghironi advocate for increasing the 3 percent limit on budget deficits given by the Growth and Stability Pact. An alternative solution would be a change in the rules concerning the provision of the financing from the EU Structural Funds.

Fiscal policy will undoubtedly be one of the crucial factors for the candidate countries's way to the Eurozone. If managed properly it can smoothen the way to the Eurozone, if not the way can become quite bumpy. All in all, it appears that the pressure on budgets should be manageable over the medium run in all the CEE candidate countries, allowing them to achieve the required remaining reductions in deficits. This, however, requires some efforts and in the case of some candidate countries even more profound fiscal reforms.

55

5.3 EXCHANGE RATE REGIMES

The candidate countries have a whole range of exchange rates regimes in place with differing degrees of flexibility. On the one hand, Bulgaria, Estonia and Lithuania operate currency boards and on the other Slovakia, Slovenia, Romania, the Czech Republic, and Poland introduced managed floating or freely floating exchange rates. The present situation is a result of a longer term development during which the candidates adapted their exchange rate regimes according to the needs of monetary policy management or, at times, as a consequence of currency crises. Some (Begg et al., 2001, Buiter Grafe, 2001, Tullio, 1999) put forward an idea of hollowing out of the middle ground of the exchange rate regimes. It is based on the observation that, whereas at the beginning of their transformation most of the post-communist countries operated exchange rate regimes with reduced flexibility (mostly pegs), they later shifted to either fixed regimes or rather to flexible regimes. Such a tendency has been found also in the case of other emerging economies in general (Fischer, 1999). The underlying reason is the increasing role of capital flows in the international economy. Consequently, small open economies which have dismantled the barriers to free movement of capital find it increasingly difficult, if not impossible, to operate exchange rate regimes with an intermediate degree of flexibility.

Before the candidate countries make it to the monetary union they will have to pass three stages (EC, 2000):

1 The pre-accession stage;
2 The accession phase, covering the period from the date of accession to adoption of the single currency (this stage can be subdivided into the period before adopting the ERM II regime and membership in the mechanism);
3 The final phase of the adoption of the euro.

In the current, pre-accession, stage the choice of the exchange rate regime is left fully to the discretion of the candidate countries. After numerous pledges of both representatives of the candidate countries and the EU member states, the accession negotiations were concluded at the end of 2002. Thus the target set at the Gothenburg European Council aiming for 2004 as the date of entry of the most advanced candidates into the EU can reasonably be achieved. Furthermore, the so-called big-bang scenario has become ever more probable after ten out of the current twelve candidates (leaving behind Bulgaria and Romania) were marked as capable of concluding the negotiations by the set term at the Laeken European Council summit. Thus it seems that the pre-accession period might soon be over for the majority of the CEE candidates.

The second stage, starting at the moment of the EU membership, will not change much. It has been several times confirmed by the representatives of the EU that the new member states cannot hope for an opt-out from the participation in the single currency as received by Great Britain and Denmark. They will become members of the EMU with a derogation for introducing of the euro. The new members will be able to keep their current exchange rate arrangements. The only limitation will be that, according to the article 124 of the Treaty, they will have to consider their exchange rate policies as a matter of common interest. The ECOFIN Council further specified this by stating that the smooth functioning of the single market must not be distorted by competitive devaluations.

According the Maastricht criteria, a country has to prove the stability of its exchange rate before it can adopt the euro. In practice it means that a country has to become a member of the EMR II and comply with its rules for at least two years (see the Box on ERM II below). Thus the ERM II membership will be the ultimate stage before the entry into the Eurozone. However, according to many economists it will also be the most critical one. The candidate countries are not in any way bound as to the timing of ERM II entry. Those who are willing to adopt the euro in the shortest possible time will aim at introducing the ERM II upon their entry into the EU. Those who stick to the more cautious approach can follow the example of Sweden and postpone it for quite some time. However, most of the candidate countries do not seem very excited by the prospect of operating fixed exchange rates, though with a rather wide fluctuation band, as this can very likely generate exchange rate risk. It is thus to be expected that the countries will adopt this regime for only the required two years – if everything goes well.

In terms of the exact form of the exchange rate the ERM II is rather benevolent. According to the European Commission (2000) the only exchange rate regimes that are incompatible with the ERM II are regimes without a mutually agreed central rate to the euro, crawling pegs, and pegs to currencies other than the euro. This means that a large number of the candidate countries will have to, at this point, adapt their exchange rate regime to make it compatible with the ERM II (for an overview of the current exchange rate arrangement see Table 5.3). It is especially the case of the countries operating floating exchange rates and of Latvia, which has kept the peg of its currency to SDR. In practice, the switch from floating to ERM II does not have to be that profound a change in some of the countries as they manage their exchange rates quite heavily and the exchange rate is in general quite stable (e.g. Slovenia). Latvia will have to adjust its peg and attach the lat to the euro. However, the central bank is willing to do this only once the country enters the EU. Despite the fact that Latvian trade has reoriented towards the EU significantly, only 36 percent of the value of the transactions is paid in euros. Also the private sector in Latvia is quite resistant to using the euro. Only 10 percent of foreign currency deposits are denominated in euros. The rest is dominated by dollars (Repse, 2001). Lithuania has successfully repegged the litas from the dollar to the euro on 2 February 2002. Hungary, willing to give a further boost to disinflation, increased the fluctuation bands of the forint to +/- 15 percent in May 2001. This can also be seen as a preparation for the entry into the ERM II.

Until recently, the countries with currency boards were concerned about possible implications of participation in the ERM II. They were afraid that after having operated very fixed exchange rates for a couple of years they would have to abandon the firm peg and introduce some degree of flexibility in the form of an ERM II fluctuation band. However, the Commission and the ECOFIN Council acknowledged that such a solution would not bring the desired stability and voiced their opinion that currency boards were compatible with the ERM II regime as long as the ECB and the respective country agreed on the central parity. The EU has even resolutely refused any attempts at unilateral euroisation as it would reportedly run counter the logic of demonstrating the sustainable convergence as stipulated by the Treaty (EC, 2000 and Noyer 2001).

Table 5.3   Exchange rate (ER) and plans for participation in ERM II/EMU

Country	Current ER regime	MP framework	PEP (EMU target date)	Plans for EMU entry	ERM II
Bulgaria	CB (euro) from 1997		Want to achieve nominal convergence at the time of EU? Accession	Yes (national accession strategy)	Keep CB
Czech Republic	Managed Floating	Inflation Targeting	No	N	+-15%
Estonia	CB (euro) from 1992	IMF supported	No	Target date not set till 2003	Keep CB
Hungary	Crawling bands (+-15%)	Inflation targeting	ASAP	Y (mon. policy aimed at EMU in 2006-7)	2 years (possibly narrower bands)
Latvia	Fixed peg to SDR	IMF supported	No	Y (national accession strategy)	
Lithuania	CB (in Feb switched from USD to euro)	IMF supported	No	Join ERM II	Keep CB
Poland	Independent Floating	Inflation Targeting	No	Yes (2006)	After accession,
Romania	Managed* floating	IMF supported	No	Meet Maastr in MT	Switch to euro as a reference currency
Slovakia	Managed floating	No specific anchor (monitors various indicators)	ASAP taking into account real convergence		
Slovenia	Managed floating	Monetary aggregate target	No	Yes (Central Bank – 2006)	ASAP after accession

* The de facto exchange rate regime of Romania differs from the de jure one. In reality the exchange-rate regime is an informal crawling peg to the us dollar, linked to inflation.

Source: IMF, EC (2002b), 'Plans for EMU': Lorenzen (2001)

Exchange Rate Mechanism II

The Exchange Rate Mechanism II replaced the European Monetary System after the EMU was established as of 1 January 1999. The rules of the ERM II were set in two legal Acts:

– The resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of economic and monetary union (16 June 1997).
The Agreement between the European Central bank and the national central banks of the

– Member states outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union (1 September 1998 and amended on 14 September 2000).

According to these documents the exchange rates between the Euro Area and the non-Euro Area EU countries are governed by the following principles:

The non-Euro Area countries are required to treat their exchange rate policy as a matter of common interest. The functioning of the single market should not be endangered by real exchange rate misalignments or excessive exchange rate fluctuations, which would disrupt trade flows between Member States.

The ERM II should not endanger the primary objective of the ECB to maintain price stability. Thus, any adjustment should be made in a timely fashion in order to avoid fundamental misalignments.

The EU countries participate in the ERM II on a voluntary basis. However, a country with a derogation for the introduction of the euro is expected to join the mechanism.

The ERM II is based on central rates of the national currencies against the euro. Decision on the rates will be taken by a mutual agreement of the ministers of the Euro-Area Member States, the ECB and the ministers and central bank governors of the non-Euro Area Member States participating in the ERM II. The procedure also involves the European Commission and the Economic and Financial Committee. The ministers and governors of the central banks of the Member States not participating in the ERM II will take part but will not have the right to vote in the procedure. All parties to the mutual agreement, including the ECB, will have the right to initiate a confidential procedure aimed at reconsidering central rates. The central rates will, however, remain the focus for the non-Eurozone countries participating in the ERM II through the implementation of stability-oriented economic and monetary policies.

The standard fluctuation band around the central parity will be +/-15 percent. Interventions at the margins will in principle be automatic and unlimited, with a very short-term financing available (up to 3 months). The ECB and participating central banks can suspend the interventions only if the primary objective of price stability is endangered. After a mutual agreement between the ECB and the respective central bank of a non-Eurozone country, an intramarginal intervention can be undertaken.

A narrower fluctuation band than the standard one can be agreed upon request of the non-Eurozone member state concerned. Such a negotiated fluctuation band would in principle be backed by automatic intervention and financing. The decision on the fluctuation band would follow the same procedure as in the case of central rates.

Despite the immense progress which most of the candidate economies achieved, they are still considered as being transition economies. As such they are more vulnerable to various shocks and crises. Therefore, the choice of the exchange

rate regime can potentially play an important role in the process of joining the EMU. Many economists devoted a great attention to the question what exchange rate regime the candidate countries should adopt during the transition period before the full EMU membership to be able to cope with the troubles that the candidate countries might encounter on the way. This research is useful for identifying potential sources of instability, however, the original question about the optimal choice of exchange rate regime seems to be of a limited practical use as most of the candidate countries seem to be satisfied with their current arrangements and are planning to retain them until the entry into the ERM II or even the Eurozone. Any substantial changes in exchange rate regimes which might be undertaken will, therefore, most probably be a consequence of an actual crisis, not a precaution against one.

NOTES

[1]   Stringent in a sense that no formal changes to the criteria will be allowed. The inter-
       pretation of the criteria in the case of the incumbent EMU members was however a
       different story, as a rather flexible approach was adopted. From this point of view one
       could also expect a relatively benevolent approach towards the present candidates (or
       at least the candidate countries can use this fact in negotiations on entry). However,
       one also needs to bear in mind that this time the situation will be to a certain extent
       different. It can be assumed that the EMU membership of the current candidate
       countries will not be such a politically predominated issue as was the launch of the
       EMU in 1999 and therefore more attention to the economic aspects will likely be
       devoted. This is also indicated by the rather cautious, if not discouraging, stance of
       the ECB in terms of timing of the entry into the Eurozone.

[2]   Note that the EU uses the same line of reasoning but arrives at completely different
       conclusions: the enlargement of the Eurozone to the East should be postponed.

[3]   Moreover, interest rate convergence will result from a stable exchange rate.
       Therefore, the exchange rate stability criterion can also be viewed together with the
       criterion on interest rates.

[4]   The pre-accession economic programmes (PEPs) are part of the so-called Pre-
       Accession Fiscal Surveilance Procedure which is designed to prepare the candidates
       to participate in the multilateral surveillance and economic policy coordination pro-
       cedures in the EU. They include the medium-term policy framework of the candidate
       countries and their structural policy priorities. The PEPs were submitted in 2001 for
       the first time.

[5]   Which were in some cases described by the European Commission as slightly over-
       optimistic.

[6]   A question arises how realistic are the plans, especially in the case of Bulgaria.

[7]   Another reason might be the still considerably high share of goods and services in
       the consumer basket whose prices are not fully determined by free market forces (in
       Poland the share is estimated at almost 15 percent (Durjasz, 2001). This might be due
       to direct regulation or structural weaknesses. The case of regulated prices will not be
       further dealt with as it is reasonable to expect that the prices will have been deregu-
       lated by the time the candidate countries enter the EU/EMU.

[8]   The magnitude of the effect also depends on the demand side effects. Rising
       increased productivity leads through increasing income and wealth to increases in
       consumption. If the demand for non-traded goods and services, as it is usually
       assumed because of their 'superior' character, rises at a higher speed than the demand
       for non-traded good, the price increases might be even further reinforced.

61

[9]   Typically, these studies have used econometric techniques to detect the existence of long-run relationships (co-integration) between relative price levels and relative productivity. In this framework, the direction of the applied studies has been twofold. A first class of studies focuses on the relationship between long-run changes in relative prices and productivity differentials across countries, while others analyse the link between the productivity differentials and inflation differentials across sectors within countries. The general conclusion of the first approach is that there is evidence of a relationship between the evolution of the relative price levels across countries and that of productivity differentials. Following the second approach, a clear causality between productivity growth in the traded goods sector and inflation in the non-traded goods sector has been identified. Indeed, recent studies show that, while some of the more restrictive assumptions of the hypothesis are not supported by the data, there is still clear evidence that the B-S effect has been at work within the Euro Area.

[10] This is after all not that surprising as the EU institutions do not even take into account the impact of the B-S effect on the interest rates differentials in the Eurozone, see Sinn and Reutter (2001).

[11] See Pelkmans et al. (2000) for more details.

[12] See Gros and Suhrcke (2000).

[13] There are more reasons to doubt the need for large public infrastructure spending. Within the EU one actually does not find any link between public investment and growth in GDP. Ireland, by far the fastest growing economy of the EU over the last decades, has a somewhat below-average ratio of public investment to GDP. Moreover, given the changes in financial markets that have taken place over the last decade, it is now generally recognised that most infrastructure projects could also be financed and sometimes even operated with substantial private sector involvement. Major projects, such as motorways, are already being undertaken on a mainly private sector basis in the candidates.

[14] They further argue in favour of increasing the limit on budget deficits by saying that the new Member states will be able to grow considerably faster than the current members did in 1990s when the criteria were designed. The candidate countries are also likely to experience 'larger shocks, either of the business cycle variety or one-off disturbances like a banking problem.'

[15] This means that all EMU related legislation would have to be implemented already before the EU entry. The envisaged measures include complete liberalisation of the capital movements (Art. 56); prohibition of any direct public sector financing by the central bank (Art. 101) and of privileged access of the public sector to financial institutions (Art. 102); alignment of the national central bank statutes with the Treaty, including the independence of the monetary authorities (Art. 108 and 109) (ECOFIN Council, 2000).

6   SPECIFIC STRUCTURAL ISSUES

The candidate countries still have a very long reform agenda. This can be seen for example from Table 6.1 which summarises the objectives of the candidate countries in the field of structural policies (for a more extensive and elaborate summary of structural issues based on the regular reports of the Commission see appendix). Despite vast differences among the candidate countries the most pressing issues are very similar. Most of the candidate countries wish to finalise the privatisation and liberalisation process (there are usually backlogs in privatising large enterprises, especially telecoms and utilities). Furthermore, new legislation on competition and bankruptcy usually needs to be introduced and implemented. Tackling all these issues will be crucial for future development towards a stable and healthy economic climate which will be indispensable for a troubleless transition to the euro. However, as these issues are of general interest and do not pose any immediate implications for the process of monetary integration, they will not be treated explicitly. Instead, attention will be directed towards an area which will be of utmost importance for a smooth way to the euro – financial markets, their structure, vulnerability to crises and their legislative framework.

Table 6.1   Structural agenda according to the PEPs

Czech Republic Privatise large enterprises, banks New rules on competition New law on bankruptcy FDI promotion	**Hungary** Strengthen SMEs Liberalise telecom and utilities Support R&D Develop tourism sector
Poland Continue privatisation Restructure several industries, including coal and steel Strengthen SMEs Revise bankruptcy law	**Slovakia** Complete privatisation Liberalise and restructure utilities Strengthen SMEs New law on bankruptcy
Slovenia Complete privatisation and restructuring Promote entrepreneurship and competitiveness Liberalise telecom and utilities	**Estonia** Privatise energy sector New rules on competition
Latvia Privatise large companies, land Liberalise and enhance regulation of telecom and utilities New competition rules New bankruptcy law Export promotion	**Lithuania** Continue privatisation Implement new bankruptcy law Liberalisation and restructuring of energy sector
Bulgaria Privatise and restructure utilities and transport sector	**Romania** Accelerate privatisation and restructuring Revise bankruptcy law Strengthen SMEs Improve competition policy

Source: European Commission

6.1 BANKING SYSTEM AND FINANCIAL MARKETS

An important, and far from easy, role in the Eurozone enlargement process will be reserved for the financial sectors of the candidate economies. Given all the risks inherent in the process there will be a need for stable and healthy banking sectors and capital markets. They should be able to cope with challenges brought about by expected large capital inflows or contagion effects of financial crises in the world markets – the financial markets of the candidate countries are after all still considered as emerging markets. Furthermore, the financial markets are essential for attaining a higher level of real convergence as necessary restructuring and dynamic development of the enterprise sector can hardly be possible without sources of financing. Therefore, stable institutions intermediating domestic savings to investment are needed. Also, achieving nominal convergence can largely depend on the level of development of the financial sector. If the financial markets are underdeveloped, stabilisation efforts of the monetary authorities are limited due to weak functioning of channels of monetary transition. High interest rates further increase the burden on public finances, thus hampering any efforts for fiscal consolidation. Bailing-out of troubled banks can also become, as transition experience amply illustrated, a heavy burden on government budgets.

Banking systems and capital markets could also become a cause of crises themselves. If, for example, the banking system proved to exhibit substantial deficiencies in terms of the level of regulations or their application, alternatively if the bad loan problem got out of hands without authorities intervening in time, investor confidence could be shattered and a crisis could potentially follow. The latest empirical research suggests a strong link between currency crises and banking crises (i.e. Kaminski, 1999). Currency crises are often preceded by, or come together with banking crises. Therefore, it is essential for the candidate countries to have sound banking systems in order to be able to cope with large capital inflows that are in some cases already occurring and that are expected to further strengthen due to the so-called 'convergence play' in the run-up to the Eurozone accession. In this respect, Demirguc-Kunt and Detragiache (1998) find that the probability of a currency crisis depends negatively on the number of foreign banks operating in the country which ultimately points at the importance of the integration to the international financial markets for the candidate countries (see some evidence below).

Therefore, this section will attempt to provide an assessment of the financial systems in the candidate countries and their potential implications for the EMU enlargement process with a special attention to their vulnerability to crises.

The market based financial sectors were virtually non-existent in the current CEE candidate countries at the beginning of the transformation process. Therefore, the mono-bank system had to be replaced by the genuine two-tier banking system and equity and debt markets had to be created. Most of the countries adopted a universal banking system at the beginning of the transition.

In such a system individuals keep most of their savings in banks which then become the main source of external financing of the private sector. Banks are also the major investors in the equity and debt markets.

Establishing the bank dominated (vs. capital market dominated) financial sector was probably the only alternative for the transition countries as banks, although not operating according to market principles, were already existing whereas the capital markets had to be established and financial instruments introduced. Banks further played an important role in the overall economic development of the countries and also significantly contributed to the capital markets establishment. However, the current structure of the financial systems varies immensely among the current candidate countries, which reflects a diverging mix of macro- and microeconomic policies they adopted in the course of transition. One of the major factors was the method of privatisation which prevailed in the respective country. Hence, securities markets are more developed in countries that preferred privatisation through voucher schemes and investment funds. On the contrary, countries that chose privatisation through other methods such as management buy-outs, auctions or negotiated sales necessarily supported the development of the banking segment of their financial systems.

It could be argued that the developed domestic banking sector is not indispensable for financing of the private sector in the time of a very high capital mobility. Investment can be covered through FDI inflows or by raising capital in the foreign financial markets. And indeed, both of these options have played an important role in most of the candidate countries. On the other hand, it appears that a high level of economic growth can hardly be achieved without efficient intermediation of domestic savings into investment by the domestic financial sector. Deutsche bank (2001) shows that the candidate countries with best access to external financing also reached the highest level of development of domestic financial markets.

Economic growth also seems to be an important factor for the development of banking sectors in the candidate countries. Figure 6.1 shows that the fastest growing candidate countries in the second half of 90s also experienced the highest surge in credit to the private sector. It is of course difficult to establish the causality in this case as one can say that increased lending to companies and individuals contributed to high growth of the economies. However, this further underlines the importance of the domestic financial sector as it apparently goes hand in hand with fast economic development. The figure depicts the sharp differences between the candidates in the first and second wave of enlargement. Also in this case, the Czech Republic constitutes a group in itself with a moderate average growth but a sharp decline in banking sector lending activity due to the late 90s currency and banking crisis and following credit crunch.

65

Figure 6.1   **Percentage change in domestic credit and average growth rate (1995 – 2000)**
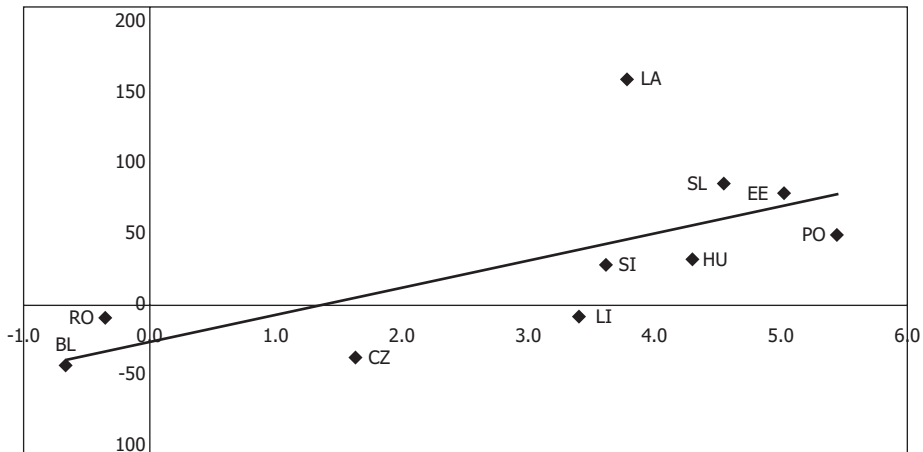
Banking systems of the candidate countries are underdeveloped compared to their EU counterparts. As a measure of banking system development and its ability to intermediate savings into investment one can use the share of domestic credit to the private sector as a percentage of GDP (Table 6.1). The comparison unveils an immense difference between the candidate countries and developed economies. Whereas the share stands at roughly 120 percent in the latter group, the best performing candidates, the Czech Republic, Slovakia and Slovenia, find their values at about 40 percent. In Estonia, Hungary, Poland and Latvia, the domestic credit as a percentage of GDP is roughly 20 percent. The last group of countries with very low values slightly exceeding 10 percent comprises Lithuania, Bulgaria and Romania.

Not only is the domestic credit very low in the candidate countries but its development in time is hardly encouraging as it exhibits very little progress and significant instability. Very few countries experienced a substantial rise in the indicator throughout the transition process. Thus only Slovakia has made a considerable progress. Positive developments can also be observed in the case of Estonia, Slovenia and to a certain extent Poland. All the other countries more or less stagnated or even experienced sharp reversals that usually coincide with periods in which the countries were hit by economic crises. As a consequence, the domestic credit in the Czech Republic has declined from its peak of about 60 percent in 1995 to slightly over 40 percent at the end of the decade.

The poor performance in terms of lending activity of the candidate countries' banking sectors points to structural problems with channelling private savings to private investment. The gross saving rates of the candidate economies is on average only a fraction lower than that in the EU – 21 percent compared to 22 percent. However, per capita bank deposits in PPP terms reach only 18 percent of the EU average. As the major part of savings in the candidate countries is deposited with banks, the part that is invested in the securities markets can hardly explain the huge discrepancy. A possible reason might be the low banking tra-

dition and unwillingness of people to save. Also the trust in the banking sectors is still on a low level due to a number of crises and bankruptcies. Thus, it seems that a significant proportion of individual savings is still kept 'under the mattress' instead of being available for efficient investment opportunities.

Table 6.1   Domestic credit to the private sector as % of GDP

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Bul	7.2	5.8	3.7	3.8	21.1	35.6	12.6	12.7	14.6	12.5
Cz			50.8	59.5	59.4	57.4	54.7	48	43.8	38.2*
Est	18	7.5	10.9	13.8	14.8	18	25.5	25.2	25.9	25.9
H		23.4	20.7	21.4	18.6	18.7	20.4	20	20.7	23.6
Lat			17.3	16.4	7.8	7.2	10.7	15.2	16	19.6
Lith			13.8	17.6	15.2	10.7	9.6	10	10.7	14
Pl	11.1	11.4	12.2	12	12.8	15.9	18.1	17.6	18.8	18.8
Ro					na	11.5	13.7	16.6	10.5	na
Slk				26.9	20.7	24.9	42.1	43.9	40.5	37.6
Slv			22.1	23	27.4	28.7	28.6	32.8	35.8	na
GER	156.7	152.1	160.5	158.8	166.7	175.9	186.4			
F	92.8	93.1	91.3	86.2	85.1	80.8	79.9			
UK	105.4	104.2	101.6	99.8	102.8	105.5	106.7			
US	127.1	123.6	122	121.9	124.9	126.2	127.7			

* Provisional figure for December

Source: EBRD

Table 6.2   Banking sector indicators

2000	Risk-weighted capital asset ratio (in %)	Non-performing loans (% of total)	Asset share of state-owned banks	Number of banks	Of which foreign-owned
Bul		10.9	19.8	35	25
Cz	14.9	19.3	28.2*	40	26
Est		1.5	0	7	4
H	13.5	3.1	8.6	38	30
Lat		8.3	2.9	21	12
Lith		10.8	38.9	13	6
Pl	12.4	15.9	24	74	47
Ro		3.8	50	33	21
Slk	12.5	26.2	49	23	13
Slv	13.5	8.5	42.2**	28	6
GER			52	3392	
F			31	570	
I			36	911	

Note: Non-performing loans − excludes loans transferred to a rehabilitation agency or consolidation bank
* After the sale of Komercni Banka is included the share drops to roughly 14 percent.
** Sale of Vseobecna Uverova Banka in 2001 brought the share down to roughly 29 percent.

Source: EBRD

The relative underdevelopment of the banking systems of the candidate coun-
tries in terms of their size would not be such a great problem if the sectors were
healthy. However, they are in most cases troubled by a high volume of bad loans.
On average the current level of bad loans is still estimated at about 15 percent.
Banks partly inherited bad loans from the past as a result of soft budget con-
strains for the state enterprises and the absence of risk management approach.
Thus, the first tasks of the transition countries were rehabilitation and recapitali-
sation of the banks. Most of the debts were transferred to national consolidation
agencies or banks and then covered by issues of government bonds. However,
the bad loan problem persisted and in some countries even strengthened leading
to several banking crises. Insufficient level of banking regulation and supervi-
sion, low accounting standards, lax licensing requirements, lack of risk assess-
ment experience or simply criminal activities were the primary reasons for the
continued troubles. In some cases political pressure on banks to increase their
lending activities either to insolvent state-owned enterprises or to the enterprise
sector in general had an important impact on the increase in the volume of non-
performing loans too.

The overall data on bad loans hide an uneven pattern. Most troubled seem to be
the Central European candidate countries (with an exception of Hungary and
partly Slovenia). On the other side, Estonia performs best. However, some cau-
tion is necessary when looking at the data as it does not include bad loans that
have been transferred to national consolidation agencies or consolidation banks.
Thus, for instance, the Romanian figure declined sharply from its peak of almost
60 percent in 1998 to roughly 4 percent two years later. In the Czech Republic
the considerable losses of the consolidation agency due to clearing of the banking
sector prior to its privatisation are included into the expenditure side of the go-
vernment budget, thus significantly increasing the resulting deficits. This indicates
that the price for stabilisation of the banking system which has to be borne by
the public sector can be substantial (f.e. in Hungary the costs of recapitalisation
and rehabilitation are estimated at 10 percent of GDP (Wagner and Iakova, 2001),
the latest estimates show that the costs could be as high as 20 percent in the
Czech Republic (EC, 2002a). Bad loans are thus becoming a problem of public
finances and do not burden the banking sector any more.

However, the vulnerability of the banking system might not be that severe as
usually perceived. During the 90s, the candidate countries proceeded with pri-
vatisation of the banks, though with differing speed. According to the European
Commission (2001), the bank privatisation has been completed in Estonia,
Hungary, Latvia and the Czech Republic. Progress has been achieved by
Lithuania, Romania, Poland and Slovakia, whereas the progress is lagging behind
in Slovenia. The process of privatisation and consolidation of the banking sector
has resulted in a strong foreign ownership of domestic banks. This is a beneficial
process for the candidate countries as strong strategic partners provide the
domestic banks with their banking know-how and also strengthen their capital
positions.

A large majority of the new owners come from the EU countries, which contributes to greater integration of the banking systems of the EU and the future members. Thus, in the Baltic countries, characterised by a high degree of consolidation, the banking systems have become largely integrated and connected to the Nordic members of the EU. For example, in Estonia the two largest banks with assets accounting for almost 85 percent of the total assets of the sector – Hansbank and Uhisbank – are controlled by two Swedish banks – Swedbank and SEB respectively. Furthermore, Swedbank then plays, through Hansbank, an important role in the banking systems of the two remaining Baltic countries. SEB also controls crucial shares in Latvian and Lithuanian banks. The banking sectors of the other candidate countries are fragmented to a much larger degree (especially in Poland) but important stakes are held by Western banks (see Table 6.3 for an overview of foreign ownership development of banking sector assets in the candidate countries and, for comparison, the EU ones).

Table 6.3 **Share of majority foreign-owned banks in total assets (in percent)**
Panel a): The CEECs

	1998	1999	2000	2001
BL		74,4		
CZ	25,7	28,1	65,5	90,1
EE	5,1	90	93	97,5
HU	58,9	61,8	62,9	65,5
LA	78,7	78,2	77,2	62,6
LI	51,8	38,3	57	83,9
PO	16,6	47,2	69,6	68,4
RO	20	47,5	50,9	55
SLK		28,2	42,7	81
SLV	20	47,5	50,9	55

Source: European Commission (2002)

Panel b) The EU

Ireland	53.8	Netherlands	7.7
UK	52.1	Finland	7.1
Belgium	36.3	Italy	6.8
Greece	21.9	Germany	4.3
Spain	11.7	Austria	3.3
Portugal	10.5	Sweden	1.6
France	9.8 (1996)	Denmark	n.a.

Source: European Central Bank (1999)

Banking sectors in the candidate countries have gone through a pronounced process of consolidation. The number of banks operating in these countries has dropped substantially since the beginning of transformation. Many of these were not able to survive the tightening of the regulatory framework and high competition in the sector. Lack of experience, insufficient capital strength and high administrative costs drove many of the banks to bankruptcy or forced them to merge. Thus, for example, the number of banks was reduced by 30 percent in

Bulgaria after its 1997 banking crisis. Increased competition was the driving force behind the recent consolidation in the Hungarian and Slovenian banking sectors. However, the sectors in these two countries are still considered to be 'over-banked' (DB, 2001).

The consolidation wave was further strengthened by the high merger and acquisition activity in the world-wide banking sector. Thus, naturally, also the CEE branches of the merging foreign banks joined together. This was also the case of Estonia where the externally driven consolidation process was extremely strong. As a result, the number of banks operating in Estonia has fallen from about 40 at the beginning of the 90s to 6 at the present.

Preparation for the EU membership has become another important factor contributing to further consolidation and concentration of banking activities in the candidate countries, especially through adopting and applying the stricter EU legislation concerning regulation and supervision of the financial markets. Thus, banks can comply with increased capital requirements by merging with other banking institutions.

As these factors will continue to play a role, the consolidation of the banking sectors of candidate countries is expected to continue. Especially smaller and middle-sized banks will hardly be able to operate as universal banks and unless they succeed in specialising on a specific market segment they will be forced to secure their future through a merger. Thus, over time the banking sectors are likely to reach a higher efficiency and an optimal size.

The positive impact of the increased competition and rising efficiency of the banking institutions together with relatively stable and favourable macro-

Figure 6.2   Interest rate spreads (CE countries)
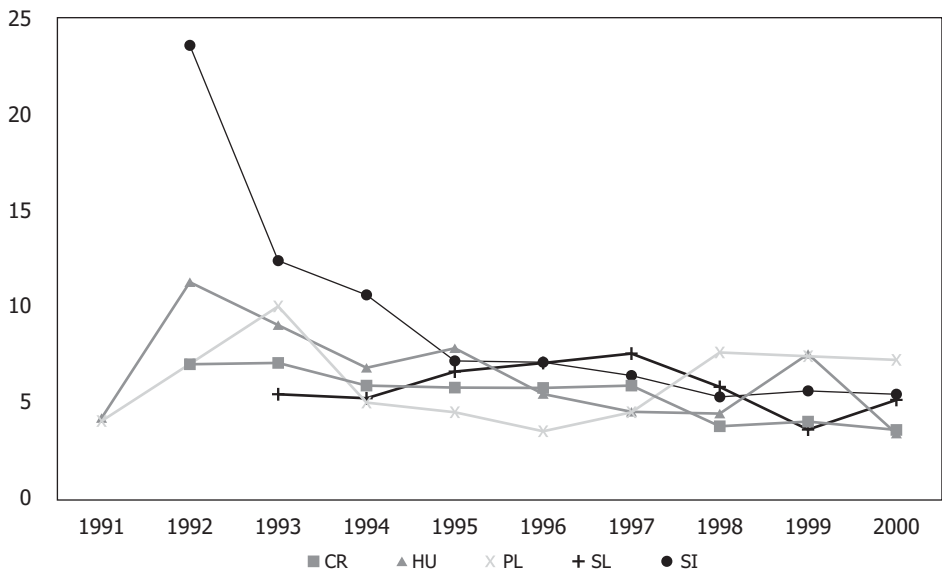
economic environments can be seen from the rapidly declining interest spreads (lending rate minus deposit rate) in most of the candidate countries (Figures 6.2 and 6.3). The most advanced countries are approaching the EU levels. The remaining differences are to a large extent due to higher risk premia in the non-EU countries. Bulgaria has also achieved a substantial success as the interest spread dropped to under 10 percent after hitting levels far above 200 percent

Figure 6.3   Interest rate spreads (Baltics)

71
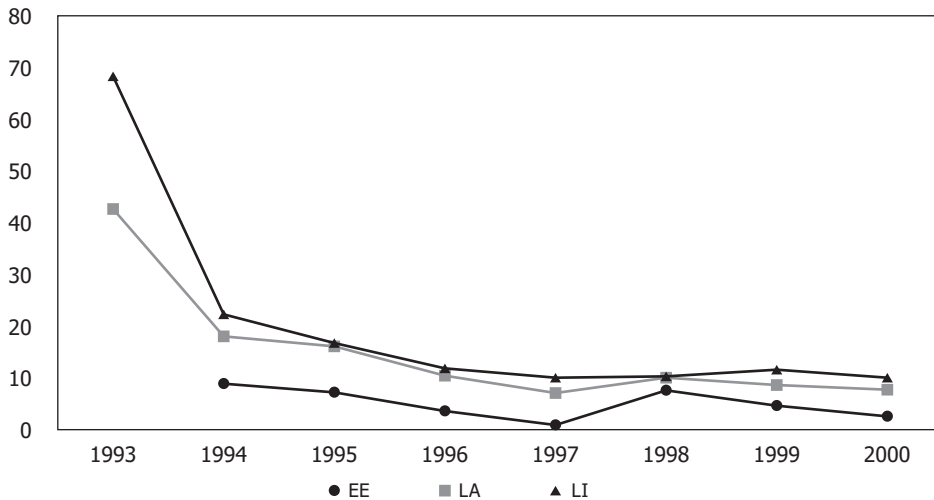
during the 1997 crises. Romania remains far back with an interest spread exceeding 20 percent. From the above, it is obvious that the banking sectors of the candidate countries are still underdeveloped in comparison with the EU. At the same moment, it is clear that the banking sectors will play an important role in the process of monetary integration of the current EU applicants as they will have to secure stable financial environment and be able to accommodate the anticipated large capital inflows. If one was drawing conclusions on the basis of the past developments, there would be little reasons for optimism. The banking sectors of the candidate countries have been troubled by structural deficiencies and suffered from numerous crises which often had an impact on the whole economy. However, it appears that during the last couple of years the situation has improved considerably and the banking sectors have undergone a process of privatisation, restructuralisation and rehabilitation. A strong foreign ownership of local banks has become a rule rather than an exception after most of the candidate countries cast away the protectionist policies and granted foreign investors full access to their banking institutions. Though still somewhat weak, the banking sectors in most of the candidate countries seem to be structurally healthy. According to the Deutsche Bank (2001) Estonia and Hungary have relatively well developed stable banking systems and Poland and the Czech republic are expected to catch up soon. Also Slovenia could join the group soon after it makes an effort and completes the privatisation of its banks. On the other hand, Bulgaria and Romania are lagging behind.

Therefore, the factors that troubled the banking sectors of the candidate coun-
tries in the past such as the non-performing loans, macroeconomic instability
and state interventions are losing importance. However, there are other potential
risks which could potentially generate crises. Deutsche Bank identified the fol-
lowing risks with high relevance for the candidate countries: expansionary mon-
etary and fiscal policies, large scale of private capital flows, real exchange rate
appreciation, occurrence of lending booms, lack of deep bond and derivative
markets and weaknesses in the accounting, disclosure and legal framework. This
indicates that the attention should be no longer focused on the fundamental
structural issues but rather on general improvements in the regulatory frame-
work and its implementation (see below). Good regulation, healthy macroeco-
nomic policies and strategic foreign participation in the domestic banking sectors
will be essential to cope with large capital inflows and potential volatility which
are likely to characterise the transition period before the full EMU membership.

Gros and Suhrcke (2000) also show that the more advanced candidates have
actually financial sectors that are appropriate for their level of development. In
this area it appears that the transition is over. This does not mean that troubles
cannot arise. The problems that erupted in the Czech banking sector over the last
years serve as a reminder that serious corporate governance problems might per-
sist even in systems that were regarded as rather strong. But a number of EU
countries faced rather similar problems not so long ago.

The small size of the banking sectors and almost non-existent securities markets
are definitely a disadvantage for the candidate countries and there is a need, and
also potential, for improvement. On the other hand, small size limits the sys-
temic impact of a bankruptcy on the whole economy. The following shock can
thus be more quickly isolated.

6.1.1   FINANCIAL MARKETS

Securities markets in the candidate countries clearly exhibit a low level of devel-
opment. The logic of the transition process led to the establishment of the bank-
ing dominated financial sector. Even in the countries such as the Czech Republic
and Slovakia that opted for privatisation through vouchers which has lead to a
relatively faster development of the securities markets, the banking sector is by
far the most dominant source of private credit. A significant role in financing the
enterprise sector is also played by the foreign investment in the form of either
privatisation or corporate loans. Banking sector assets in the Central European
Candidates make up roughly 85 percent to 95 percent of the overall financial sec-
tor assets (IMF, 2001).

The lower development of securities markets compared to the banking sector is
also apparent from the EBRD development indicators presented in Table 6.4. In
all candidate countries, apart from Poland, the development of securities markets
was given a lower mark than the banking sector. The securities markets in Poland

and also Hungary are, according to EBRD, approaching the international standards whereas the markets in Bulgaria, Romania and to a lesser extent in Latvia and Slovakia are still in the phase of formation of securities exchanges, market makers and brokers. Only a 'rudimentary legal and regulatory framework for trading and issuance of securities' is in place in these countries (EBRD, 2001).

The development of the securities markets is usually measured by market capitalisation and turnover. Market capitalisation as a percentage of GDP provides information on the size of the securities markets and their ability to finance the needs of the economy. Turnover as a percentage of capitalisation then gives an intuition of the market liquidity. However, one may first have a look at the capitalisation and turnover indicators in their absolute values. Then it is immediately apparent that in some of the candidate countries we can hardly speak of any securities markets at all. Especially Bulgaria and Romania are characteristic by extremely low values of the two indicators. The Baltic States are only somewhat better in this respect. Even if one takes into account the size of these economies and the immense gap in economic development, and thus much lower needs for financing, the picture does not get much brighter. Capitalisation as a percentage of GDP in all candidate countries is much lower than the respective values in the EU economies. Also this relative indicator confirms the 'non-existence' of capital markets in Romania and Bulgaria. It can also be seen that the largest securities markets in the region are also the most liquid, and thus the most attractive ones.

Table 6.4	Securities markets indicators					
	Capitalisation (EUR bn)			Turnover (EUR bn)		
	Securities market – total	Equity market	Debt market	Securities market – total	Equity market	Debt market
Czech Republic	20.6	12.6	8	34.4	7.4	27
Hungary	26.2	12.8	13.1	32.6	26.1	6.4
Poland	72.9	33.9	39.1	62.9	42.4	20.4
Slovakia	5.9	3.4	2.6	10.7	9.5	1.2
Estonia	2.0	1.9	0	0.3	0.3	0.2
Latvia	1.9	0.6	0.8	1.0	0.3	0.7
Lithuania	3.8	3.4	0.4	0.5	0.2	0.3
Bulgaria	0.7	na	na	0.1	0.1	0
Romania	1.3	na	na	0.3	0.3	0
Slovenia	4.7	3.5	1.3	1.0	0.7	0.3
CEEC	140.1		65.2	143.6	87.4	
Germany	3618.0	1352.9	2265.1	6072.3		
Czech Republic	36	22	14	167	58	338
Hungary	51	25	26	124	204	49
Poland	42	20	23	86	125	52
Slovakia	28	16	12	180	283	46
Estonia	37	36	1	14	17	553
Latvia	25	8	10	51*	26	89
Lithuania	31	26	3	12	6	60

Table 6.4   Continuation

	Capitalisation (EUR bn)			Turnover (EUR bn)		
	Securities market – total	Equity market	Debt market	Securities market – total	Equity market	Debt market
Bulgaria	5	na	na	11	10	Na
Romania	3	na	na	21	21	Na
Slovenia	38	26	10	21	20	22
CEEC	35		16	103	117	
Germany	178	67	111	168		

* Turnover for Latvia is distorted due to take-over activities

Source: DB Enlargement monitor, 2000

The equity markets in the candidate countries fulfil their role as a source of equity finance only marginally. For instance, in the Czech stock exchange only one IPO (initial public offering) issue has been completed successfully since it started its operation. The only other attempt in 2001 has been postponed because of the low interest of investors. Many of the equity markets in the candidate countries were principally set up in order to enable mandatory listing of shares during the privatisation of state-owned enterprises. Thus, in the Czech stock exchange over 1,000 companies were listed in 1994 after the voucher privatisation was completed. However, the number dropped to about 150 in 2000. On the other hand, the Budapest exchange recorded a continuous increase in the number of listed companies from 40 in 1994 to 65 in 2000. The low development of equity markets was largely caused by an insufficient level of regulations and consequent lack of confidence of domestic and international investors.

The debt markets in the candidate countries have experienced a fast growth in the last years. However, most of the expansion was due to government bonds. Corporate bond issues are used rarely and only by the largest companies. In the EMU accession process it is important for the candidate countries to establish a benchmark for the comparison of their long-term interest rates with the EMU ones. So far, Poland, Hungary, the Czech Republic and Slovenia have issued 10-year government bonds (DB, 2001).

The future development of the candidate countries' securities markets is hard to predict. The short-term capital controls and unfavourable business and legal environment which were the main hurdles for a dynamic development of the securities markets are now largely removed and the entry into the EU will mean their complete elimination. Thus, there is a potential for fast expansion of these markets. However, the process of convergence to the EU and growing internalisation of the financial markets will have an ambiguous effect. It is likely that the approaching membership in the Eurozone will intensify trading on interest-rate convergence to the EMU levels and will thus lead to an increase in interest in the local debt markets. On the other hand, the convergence will mean that the debt

instruments in the candidate countries will move to the investment grade cate-gory and will not be considered as high-yield 'emerging market' products any more. The focus of investors that are interested into such products will therefore shift to other countries. The development of local debt and equity markets could get a further boost once the needed pension reforms are introduced and strong pension funds are established.

It is not sure whether the local equity market will manage to reach the 'critical mass' necessary for their successful development. The big companies have usual-ly few incentives to raise the needed funding in the domestic exchanges as they can get capital either from the banks or international capital markets at a lower price. Therefore, it is probable that also the capital market sector will be charac-terised by a strong tendency towards concentration and mergers. An example of this trend are the Baltic States where a wide cooperation exists. Moreover, the Tallinn exchange was bought by Finnish HEX-Group. Thus, only the most devel-oped exchanges such as those in Prague, Budapest and Warsaw seem to have potential for fast development and increasing volumes of trading.

The small size and underdevelopment of the securities markets do not pose many risks on the way to the Eurozone. The limited role of the markets as a source of financing for the domestic companies would effectively reduce the impact of any disturbances in these markets.

75

6.1.2 REGULATIONS

One of the crucial steps that the candidate countries had to take was the estab-lishment of an appropriate regulatory framework for the functioning of the financial markets. The transition experience shows that it has been a lengthy and gradual process with a number of failures and omissions. However, introducing legal acts and regulations is certainly not enough as efficient enforcement of the rules and supervision are necessary. And efficient application of the legal and regulatory framework has remained the Achilles heel of many candidate coun-tries. For a quick overview, one can resort to the EBRD Legal Transition indica-tors regarding the financial markets. They distinguish between extensiveness which assesses whether the legal rules conform with minimum international standards and effectiveness which measures to what extent the rules are clear, accessible and adequately implemented. It is apparent that all the candidate countries have to make a larger or smaller effort to reach the international stan-dards usual in the financial markets of developed economies. It is also noticeable that the scores for effectiveness are in most cases somewhat lower than those obtained for extensiveness (with the exception of Lithuania). And surprisingly, the scores of many countries have actually declined compared to last year. According to the EBRD (2001) the decline is entirely due to the drop in banking sector scores, whereas the capital markets experienced improvement during the observed period. Unfavourable assessment of the banking sector might be due to

'a growing sense that banking supervision and regulation have not been conduct-
ed in an effective manner'. However, one should also note that the score '3'
already provides a certainty that the legislation 'is perceived as reasonably com-
prehensive, but could benefit from further refinement in some areas.'

Table 6.5   Legal Transition indicators: financial regulation

	2001			2000		
	Overall	**Extensiveness**	**Effectiveness**	**Overall**	**Extensiveness**	**Effectiveness**
Bulgaria	3	3	3	3-	3	2+
Czech Republic	3	3+	3	3+	4	3-
Estonia	4-	4	3+	3+	4	3-
Hungary	4-	4-	4-	4	4	4
Latvia	3	3	3	3	3	3
Lithuania	3+	3+	4-	4-	4	4-
Poland	3+	4	3	4	4	4
Romania	3+	4	3	3+	4	3
Slovakia	3	3	3	3	3	3-
Slovenia	4-	4	4-	4	4	4

Source: EBRD

Since the beginning of the transition the candidate countries have made a signifi-
cant progress in establishing an institutional and also legal framework for the
functioning of financial markets regulation and supervision. However, much still
remains to be done. In 1995, the European Commission published a White Book
which provides detailed overview of the measures that the candidate countries
have to adopt in order to become members of the EU. This is a benchmark
according to which the Commission assesses the degree of legislative approxima-
tion of the candidates. It gives an overview of the minimum measures that have
to be adopted in order to allow for an undistorted functioning of the single mar-
ket. The measures are supposed to be phased gradually in two stages according
to their relative importance. Thus, the fundamental, stage I measures, are
required to be introduced as soon as possible as their effective application
requires a certain time period. Stage II measures are more specific and can be
introduced later though before the accession to the EU.

Measures that are relevant for the financial markets include:
1   Free movement of capital (in the Stage I controls on medium- and long-term
    capital flows should have been removed and in the Stage II the restrictions on
    short-term capital flows should follow)
2   Free provision of financial services
3   Creation of institutions capable of insuring stability of prices and financial
    markets

Concrete measures that the candidate countries are supposed to adopt in the field
of the banking sector and capital markets are further specified in the Box on
'Legal approximation of the financial sector regulations'.

As the candidate countries developed bank dominated financial markets they also had to adopt an appropriate form of regulation and supervision. The banking sector requires tight rules and credible supervision which should ensure confidence and thus prevent financial instability and runs on banks. The transition experience has shown that in plenty of cases such credible regulations and supervisory institutions had not been put in place or supervision failed to act properly and banking crises followed. Nevertheless, it is obvious that the establishment of well-functioning securities markets is also not possible without a clear and enforceable regulatory and supervision framework. Due to the dominance of the banking sector securities markets received less attention at the beginning of the transformation also in terms of introducing a confidence enhancing framework. This was also the case of the Czech Republic and Slovakia where a much higher degree of regulation and supervision would be desirable because of the role that the equity markets played in the process of privatisation. However, this was largely neglected and lead to further instability and allowed for quasi-legal transactions leading to 'tunneling' of the investment companies and funds and their eventual bankruptcies.

The institutional set up of banking supervision in most cases relies on central banks. Only Hungary and Poland opted for independent supervisory institution. In Poland, it is the Commission for Banking Supervision (an autonomous body within the central bank) that is responsible for the prudential supervision of banks. In Hungary, the role is divided between the Banking and Capital Market Supervision Agency and the National Bank. The name of the Hungarian supervisory institution already indicates that it is in charge of not only the banking sector but also the capital markets. Thus, Hungary has followed the example of some developed countries and introduced a single regulatory body for the whole financial system. This is usually viewed as an appropriate response to the increasing complexity of the financial markets and proliferating links between their segments. From the other candidate countries it is only Estonia that is considering an introduction of the single supervision body. Others prefer specialised supervisors as they currently seem to be a better solution in order to build up the so much needed confidence and reputation (Lannoo, 2001).

The Stage I measures in the banking sector have been largely adopted in all of the candidate countries. But there still remains much to be done in introducing the Stage II measures. However, the development goes very fast and the commitment of the accession countries to put these regulations in place before the EU entry, with exception of some transitional periods, makes the issue largely irrelevant for the post accession period.

Moreover, it can be argued that the relative underdevelopment of the financial systems in the candidate countries implies a lower need for such a sophisticated system of regulation as is implemented in the current member states. Lannoo (2001) concludes that the financial markets of the candidate countries might benefit more by introducing tailor made regulatory packages than fully adopting

the whole lot of EU regulations designed for mature European markets. It then can easily happen that the financial markets of the candidates will end up over-regulated. Despite the validity of the argument it is becoming largely irrelevant as the candidates are clearly heading towards the EU standards. However, some issues still deserve attention. There have been discussions concerning the level of deposit protection. While a very important tool to attain confidence in markets, it is capable of creating moral hazard and higher risk-taking by the financial institutions if its level is set too high. The levels of deposit insurance common in the accession countries fall well below the EU level of 20,000 euro. In 2001, the deposit guarantee directive was fully adopted only in Slovenia. For sound development of the financial markets it is necessary to promote risk awareness which then makes the market agents follow reasonable strategies and minimises the potential for instability.

What nevertheless remains is the problem with effective application of the rules. As already mentioned, the EBRD indicators report a persistent gap in enforcement of the regulations and executing supervision. The gap is larger in the case of the equity and debt markets. In this field, the improvement can be enhanced by the participation of the foreign financial institutions in the domestic markets of the candidates. For example the Czech branch of the GE Bank achieved capital adequacy ratio of more than 41 percent in 2001 (compared to the required 8 percent level).

Legal approximation of the financial sector regulations
The legal measures that the candidate countries have to adopt in order to make their regulatory framework compatible with the eu one are laid down in the White Paper for banking and securities markets.

BANKING

Stage I measures:

   First Banking Directive (77/780/EEC)

   Own Funds Directive (89/299/EEC)

   Solvency Ratio Directive (89/647/EEC)

   Deposit Guarantee Directive (94/19/EC)

Stage II measures:

   Second Banking Directive (89/646/EEC)

   Annual and Consolidated Accounts Directive(86/646/EEC)

   Capital Adequacy Directive (CAD I) (93/6/EEC) and amendment Value at Risk Amendments

   (CAD II) (98/31/EC)

   Large Exposures Directive (92/121/EEC)

   Consolidated Supervision Directive (92/30/EEC)

   Money Laundering Directive (91/308/EEC)

   Further directives adopted after the White Book:

   BCCI follow-up Directive (95/26/EC)

   Netting Directive (96/10/EC)

Securities markets

Stage I measures:

Prospectus for public offerings of securities: Council Directive 89/298 coordinating the requirements for the drawing up, scrutiny and distribution for the prospectus to be published when securities are offered to the public

Stock exchange admission: Council Directive 79/279/EEC coordinating the conditions for the admission of securities to official stock exchange listing

Publication of information on major holdings: Council Directive 88/627 on the information to be published when a major holding in a listed company is acquired or disposed of

Regulation of insider trading: Council Directive 89/592

Collective investment undertakings (Ucits): Council Directive 85/611 on the coordination of laws relating to undertakings for collective investment in transferable securities

Stage II measures:

Investment services (ISD): Council Directive 93/6

CAD I and CAD II Directives (see Banking sector)

Further directive adopted after the White Book:

Investor compensation schemes: Directive 97/7/EC of the Council and the European Parliament on investor compensation schemes

---

Source: Lannoo (2001).

NOTES

[1]   Which consists of a central bank and a number of commercial banks.

[2]   Though, it is often argued that the candidate countries should strive to achieve sub-stantially higher levels of savings if they want to catch up successfully with their EU counterparts. But also in this case the data hide a highly differentiated picture. Whereas the Czech Republic and Hungary save 31 percent of their GDP Bulgaria's saving rate is only 7 percent.

[3]   A considerable part of the loss was incurred by the bail-out of the already privatised IPB Bank which collapsed in June 2000. This case also points to the importance of creating appropriate incentive schemes for strategic investors. The IPB Bank had been sold to the investment bank Nomura Europe in 1998. However, the new owner failed to undertake the necessary restructuring which led to a deterioration of the bank's balance during the recession in 1998 and 1999 and ended in a collapse.

[4]   In the EU countries, there is a growing tendency to transfer the supervisory function to an independent body. In this way a conflict of interest which could arise when the central bank is responsible for both price stability and supervision of the banking sec-tor can be circumvented. Thus, less than half of the central bank in the EU is respon-sible for the supervision of the banking sector.

[5]   Czech News Agency, 26 March 2002.

7 OPINIONS ON THE INTRODUCTION OF THE EURO IN CANDIDATE COUNTRIES

The introduction of the euro notes and coins seems to have sparked public discussion in a majority of the candidate countries regarding their future entry into the Eurozone. Now, the situation is bound to be even more complicated than in the debate concerning the EU membership in which it has usually been the case that most of the elites were in favour of the accession to the EU but the public opinion was rather split, at times with the negative stance prevailing. In the discussion regarding the EMU it appears that not only the public but also the policy-makers and academics are divided.

The latest public opinion polls done in some of the candidate countries indicate huge differences in the opinions towards the introduction of the euro. The Central European countries seem to be pro-euro oriented as over 60 percent of Polish and Czech citizens support the adoption of the single currency. On the other hand, roughly two thirds of the Latvians are opposed to the idea of changing their national currency for the euro.

Whereas public opinion might be largely influenced by short-term events such as the introduction of euro notes and coins in the euroland countries, and can rather easily swing in any direction, the positions of the policy-makers and academics should reflect longer term considerations based on thorough cost-benefit analysis and risk assessment. Therefore, in the following sections the positions and the underlying arguments of the major players in the enlargement euro-game will be analysed. These will be crucial for the decisions on the precise timing and strategy of the Eurozone entry and eventual success or failure of the process.

At the end of the day it will be the candidate countries that will initiate all the steps necessary for the EMU entry and therefore the most attention will be paid to their respective positions. Of course, the consent of the European Council and the ECB will be required, and opinions of the European Commission and European Parliament will be of some importance. A third group of players, with a rather indirect influence, that will be explored are the academic observers and independent institutions who may, to some extent, have some bearing on the decision making by presenting their authoritative views on the issue.

7.1 EU INSTITUTIONS, MEMBER STATES AND INDEPENDENT OBSERVERS

The European institutions have so far played a limited role in the debates concerning the introduction of the euro in the candidate countries. In general, their official position is quite conservative and they often call for a moderate approach in the candidate countries. According to them, the candidates should take full advantage of the fact that the EU membership does not automatically imply the

adoption of the euro and should wait until the real convergence reaches higher levels. In 1999, the European Parliament published a report which stressed the importance of real convergence in the process of the candidate countries' accession to the monetary union. The report recommended to pursue nominal convergence only after real convergence is achieved as it could have damaging consequences for the candidates. It also expressed concern that the stability of the euro could be endangered if the Euro area was enlarged prematurely. Since then, the position of the EU institutions has broadly followed the same line concerning the need for real convergence as a precondition for monetary integration.

In September 2000, the representatives of the Bundesbank, the governor Ernest Welteke and member of the board Hans Reckers, went even further by requiring that the convergence criteria for the candidate countries should be tightened (probably by introducing a certain threshold of GDP per capita for entry into the EMU). They also argued that early participation of the new countries in the EMU would further weaken the euro. This is however opposed by many independent observers (see for example DB, 2001).

In October 2001, the vice-president of the ECB Christian Noyer urged the candidate states to catch up economically with the current EU countries before they join the eurozone. He, however, acknowledged that the EMU is fully compatible with various levels of income but stressed that greater real convergence would be desirable as it is likely to bring about a higher synchronisation of economic developments and a lower risk of asymmetric shocks after the candidates join the EMU.

The director of the IMF's European department Susan Schedler said that the candidate countries were expected to enter the ERM II two years after the EU membership at the earliest and thus they could adopt the euro only in 2008.

European Banking Federation (2002) in its analysis also called a slower approach to the Eurozone. The EBF underlined the importance of macroeconomic stability and strong banking systems. It dismissed the argument that the difference in income levels of the member countries would threaten the functioning of the EMU. However, also according to them, early compliance with the Maastricht criteria could be at the expense of real convergence. They also argue that the candidate countries might still be in the need of flexible exchange rates. They conclude that the candidate countries should stay in the ERM II for longer than the required two years, which should provide them with the desired stability while retaining a degree of exchange rate flexibility.

7.2   THE CANDIDATES

The following section attempting to summarise the positions of the candidate countries largely draws on public statements of representatives of the central

banks and governments and other policy makers. Despite the fact that these are certainly informative, clear official positions would be preferable. However, a large number of the candidate countries have not issued such positions yet. The reason might be that the monetary integration is starting to receive greater attention only now that the EU membership is getting its final shape and thus also participation in the EMU, though without the euro, is approaching. Some of the countries still have not decided what path they should follow and are currently in the process of forming their opinions. Also, some of them may simply want to keep some discretion in terms of final timing for the time being to be able to react flexibly to changing circumstances. In such cases they usually make political commitments towards the early adoption of the euro but are reluctant to present a specific time frame.

7.3 CENTRAL EUROPE

The Czech Republic seems to be the most reserved candidate in this respect. Neither the Czech government nor the Central Bank have issued a clear statement on the timing of adoption of the euro. The central bank is expected to produce its position paper in the course of 2002. However, the governor of the CNB Zdenek Tuma is inclined to a more cautious approach which he also confirmed in his statements for press. On the other hand, another member of the CNB board, vice-governor Oldrich Dedek is well known for his support of fast accession to the Eurozone. However, it seems that the slower track approach might prevail. The CNB would thus propose to retain the exchange rate flexibility for a period of one or two years after the entry into the ERM II, which is perceived as a necessary, but not a too dangerous obstacle on the way to the Eurozone. Therefore, the Czech Republic intends to stay in the ERM II only for the required minimum period of time. If this approach indeed prevailed, the Czech Republic might target the year 2007/8 for its planned entry into the EMU.

The government, despite its pro-EU stance, is even more reserved in terms of the EMU entry. The deputy prime minister Vladimir Spidla recently said that the Czech Republic would be ready for the introduction of the euro six or seven years after EU accession, which would indicate the year 2010/2011. His statement is probably based on a report prepared by the government 'Social and economic impact of the CR membership in the EU'. The government is above all concerned with the prevailing gap in real output and the difference between the price levels in the EU and the Czech Republic. The loss of monetary policy as an adjustment mechanism before the economy converges to a greater extent to the EU level is seen as detrimental. The report also considers exchange rate appreciation as an important channel of price level convergence. Furthermore, the state of public finances with the expected impact of price increases due to price deregulations and price convergence in both tradable and non-tradable sectors seem to make fulfilment of the Maastricht criteria problematic in the horizon foreseen for the earliest possible enlargement of the Euro-area.

Slovakia prefers an early entry into the Eurozone. The Slovak national bank has published an analysis of the issues concerning the country's membership in the EMU recently named 'Open questions of monetary integration'. In the material, the central bank refused any option of unilateral adoption of the euro. The conclusions regarding the timing of the accession to the eurozone are rather vague, but it seems that the NBS expects the benefits of the early entry to outweigh the costs. Furthermore, at several occasions, the NBS vice-governor Elena Kohutikova expressed an intention of the central bank to proceed to the monetary union rather quickly. This view was shared by the Minister of Finance Schmoeglerova, who stated that Slovakia should be ready to join the monetary union two years after joining the EU. However, she was forced to resign.

There is no official position on the EMU entry in Poland. However, the governor of the central bank Leszek Balcerowicz and the Prime minister Leszek Miller have made numerous statements indicating that Poland should join the Eurozone as soon as possible, preferably around 2007. In terms of the political and also public support, the case for the euro appears extremely strong. The NBP is currently working on a document concerning the future membership of the EMU. According to polls, there is even a larger share of citizens who would support adoption of the euro than those who would support entry in the EU. The reason might be that people are willing to replace the historically not very stable zloty for a stable and strong currency.

Two influential economists, Andrzej Bratkowski, vice-governor of the central bank and Jacek Rostowski proposed in 2000 that Poland should adopt the euro unilaterally in the shortest possible time in order to avoid economic instability which could arise during a prolonged accession process. Despite the fact that such an option is fiercely opposed by the ECB and other EU bodies, this proposal has become a topic of intensive domestic disputes.

However, verbal support might not be enough for successful accession to the Eurozone. For example, the recent government document of Economic Strategy (Enterpreneurship, Development, Labour) expects the budget deficit to be around 3 percent in 2006, which is on the edge of the Maastricht criterion. This might prove problematic since the inflation, as mentioned above, is estimated at roughly 4 percent, which would almost certainly violate the Maastricht criteria. Therefore, a coordinated approach is required. If Poland intends to qualify for an early membership of EMU, which would mean to fulfil the Maastricht convergence criteria in 2006 or 2007 in order to enter in the following year, it will have to transform its determination into something more practical such a better coordinated fiscal-monetary mix which would allow it to push down inflation and keep a stable exchange rate. For this a budget deficit of (much) less than 3 percent might be required.

Hungary clearly aims for the earliest possible accession to the EMU. The Central bank has accepted an ERM II like system in June 2001 and it is striving to reduce

inflation to the required levels by 2005. The objective of the Hungarian central bank to become a member of the Eurozone in the shortest possible time – the year 2006 – has been confirmed by a number of statements of its top representatives. For instance, the vice-governor of the NBH Werner Riecke stated that he saw no economic reasons for any delay in the full EMU membership. According to the central bank's estimates, the membership in the Euro Area will increase the growth potential of the economy by 0.3 to 0.9 percentage points per year through the reduction in transaction costs, increased trade integration and reduction in interest rates. Therefore, according to him there is no reason for Hungary to wait until a higher degree of real convergence is achieved. The Hungarian government also supports the EMU membership and is willing to adjust its fiscal policy accordingly. Hence the medium-term budget outlook envisages a reduction of the deficit to 2.5 percent of GDP in 2004.

Slovenia is determined to become an EMU member as soon as possible. Numerous statements have been made by its leading politicians that Slovenia should adopt the euro in the shortest possible time. Under the current circumstances this indicates the year 2006. The accession to the EMU is extensively dealt with in the official central bank's 'Medium-term monetary policy framework'. The Slovenian central bank sets itself an objective to 'gain access to the EMU as soon as possible'. In order to achieve this, the central banks divided the implementation of this strategy into three parts: 1) to enter the EU as soon as possible; 2) to enter the ERM II upon the accession to the EU; 3) to stay in the ERM II the shortest possible time and then enter the EMU. According to this optimistic scenario, the entry date for Slovenia would be 2006. The Slovenian central bank set an inflation target of 3 percent to 4 percent which should be achieved by the end of 2005.

7.3.1 BALTICS

All the Baltic countries operate very rigid exchange rate regimes. Estonia and Lithuania introduced currency boards and Latvia has put into place a firm peg. All of the countries wish to keep their current arrangements until the entry into the EMU. Full membership in the Euro Area is clearly a superior option to the current one and thus it is reasonable to expect the Baltic States to aim at an early early accession into the monetary union.

Estonia is the most advanced country of the region as far as the progress in reforms and also determination to proceed to the EU and also EMU is concerned. In 2000, the former Prime Minister Mart Laar even proposed that Estonia could adopt the euro unilaterally before the EU entry itself. He set up a working group that was supposed to examine the issue in 2000. The working group recommended that Estonia adopt the euro at a regular pace though. Only if the EU accession was delayed Estonian authorities should resort to an early adoption of the euro on the basis of an international agreement. Such a move is however

strongly opposed by the central bank representatives. This is further underlined by the position of the EU which practically precludes any consensual way of introducing the euro without following the path laid down in the Maastricht Treaty. The governor of the Central Bank Vahur Kraft repeatedly refused any attempts at early euroisation, especially without the blessing of the EU, and stated that Estonia should proceed towards the full EMU membership in the way specified by the Treaty. The objective of the central bank would be to enter the ERM II at the time of EU accession while maintaining the currency board arrangement. The EMU membership should follow as soon as possible.

The orientation of Lithuania towards the Eurozone membership was demonstrated by a smooth repegging from the US dollar to the euro at the same parity on 2 February 2002. The currency board retained its credibility and no financial strains appeared. Both the central bank and the Ministry for Finance see the early EMU membership as their objective. However, no details on the timing are available in the documents of the Lithuanian institutions. The governor of the central bank expressed his opinion that the litas might be replaced with the euro in 2007 or 2008 referring to the uncertainty related to the EU entry and also membership in the ERM II.

Latvia is operating a fixed peg exchange rate regime which would at first sight speak for a fast entry into the Eurozone. However, the lat is not fixed to the euro, which is seen as incompatible with the ERM II system, but to SDR. Latvia intends to retain the current exchange rate regime until the country's entry into the EU. Therefore, it is not that surprising that the switch to the euro peg and then entry into the Euro area is not on the top of the political agenda. Moreover, a public opinion poll done in January 2002 found that 51.8 percent of the population is against introducing the euro in Latvia. In favour of the euro were only 36.3 percent of the respondents. However, after the lat is repegged to the euro there is no reason to stay outside the Euroarea and the country will most likely aim at the earliest possible date, together with its Baltic neighbours. The somewhat reserved position of Latvia regarding the ERM II and thus also EMU entry might be apparent from its pre-accession economic programme as Latvia stated that it is planning to join the ERM II as of accession into the EU or later.

7.3.2 LATECOMERS

Bulgaria had a floating exchange rate regime for the first six years of the transition. The deep economic crises in 1997 which resulted in hyperinflation forced the country to seek a different solution which materialised in adoption of the currency board arrangement. Since then the exchange rate anchor helped to stabilise the economy and bring down inflation to acceptable levels. Both the government and the central bank support further functioning of the currency board. According to their statements the currency board arrangement should be preserved until the country's entry into the EMU. The Argentinean crisis, how-

ever, aroused much discussion concerning the sustainability and desirability of the fixed exchange rate regime for Bulgaria. Some economists argue that Bulgaria should exit the currency board unless it wants to face problems with external balance. They stress that currency boards are only a crisis arrangement and as such should be abandoned after the desired stabilisation has been achieved. The official bodies strictly refuse any options involving exit from the currency board however. The way to the EMU should be as short as possible, but no concrete data has been set so far.

Romania still has not achieved the necessary level of macroeconomic stabilisation. The pre-accession economic programme expects the stabilisation to occur until 2005. Currently, Romania officially operates a managed float with dollar as a main reference but in practise the exchange rate system rather resembles a crawling peg. According to the PEP, as of 2003 a change in the monetary and exchange rate regime may become possible. The Commission (2001) assumes that 'depending upon the actual conditions at the time, the authorities may shift to either an inflation targeting framework or a "more predictable" exchange rate regime (presumably a pre-announced crawling peg). Romanian authorities usually express their willingness to proceed to the EMU but do not indicate any specific date. This is quite understandable due to the reform and stabilisation agenda that still lie ahead of them.

7.3.3 SO WHEN?

In general, the candidate countries wish to become members of the 'euro-family' as soon as possible. The determinacy of many of them seems to be lower than usually assumed, however. Out of the CE countries, which are best prepared for the entry into the EU and also the EMU, only Slovenia and Hungary have officially expressed their wish to join the monetary union as soon as possible so far. Public statements of the representatives of the governments and central banks are largely supportive of fast Eurozone entry. Of course, some differentiation in the opinions can be noticed. It is especially the Czech Republic which openly voices reservations concerning an early membership in the Eurozone. Slovakia supports the fast-track approach but the public statements often leave some space for doubts when stressing the uncertainties inherent to the process. Hungary, Slovenia and Poland have so far firmly retained positions supporting the early membership. The political commitment in these countries seems rather strong and thus it is improbable that abrupt shifts should occur.

However, implications for the timing of the Eurozone enlargement are not that clear-cut. A commitment to an early membership might have different interpretations in different countries. And also the Czech preference for a slower approach might not in reality mean any substantial delay compared to the other candidates. It seems that the majority view in the Czech National Bank supports a period of full exchange rate flexibility after the EU entry (and before ERM II

membership) in order to secure a degree of freedom to cope with a potential asymmetric shock initiated by the accession. According to some central bank officials, the Czech Republic could then adopt the ERM II compatible exchange rate regime approximately a year after joining the Union. By following this 'cautious' approach, the country might join the Eurozone in 2007 or 2008. It is noteworthy that this is roughly the same date proposed by the Polish proponents of the fast-track option. So it seems that, ignoring the underlying rethorics, the countries aim at approximately the same date.

A question remains whether all these countries will be able to support their verbal commitments by practical measures ensuring the fulfilment of the Maastricht criteria in the envisaged short period of time. In this sense, a close cooperation of fiscal and monetary policies will be required. This will raise great pressure, especially on the state of public finances requiring the countries to reduce substantially their budget deficits. According to their own forecasts for 2004, some of them will experience problems to get under the threshold set by the convergence criteria. Moreover, as mentioned before, even a budget deficit of 3 percent GDP might not be enough to support the monetary policy in fulfilling the criteria on inflation, interest rates and exchange rate stability.

Estonia and Lithuania are, quite naturally, in favour of a fast Eurozone membership as they have fixed their exchange rates vis-à-vis the euro already and any prolongation of the EMU pre-accession stage does not make sense for them. For similar reasons also Bulgaria supports a quick way to the eurozone. Latvia is expected to change its peg to the euro upon the accession to the EU and then follow the standard way to the EMU. Only Romania does not seem to be preoccupied with the adoption of the euro yet. Possibly because of its large reform agenda that has to be dealt with before (EC, 2002b).

Despite the inherently economic content of the discussion concerning the Eurozone accession, the final decision on the timing of the entry will be predominantly political. Ideally, it will be based on a wide consensus of the government, the central bank and major political parties. The candidate countries do not intend to hold referenda on the Eurozone membership. Therefore, the current statements concerning the EMU membership can hardly be considered as precise and binding. Parliament elections are expected soon in a number of candidate countries and the results are not easy to predict. Thus government positions can change overnight with the victory of the opposition party/ies. Central banks in general seem more resistant to such abrupt switches in positions. However, the case of the Czech Republic where the fast-entry approach of central bank governor Tosovsky was replaced with the appointment of the new governor Tuma by a more cautious one.

A further question that remains is the trade-off between the temporary loss of growth and (temporary) reduction in inflation before the EMU entry. For instance, the experience of the Czech Republic which went through an abrupt

recession at the end of the 90s has made the authorities more sensitive in terms of sustaining a high rate of growth. Thus the current position, though not final yet, indicates that, if faced with a choice between the retained GDP growth and early Eurozone membership, the authorities would opt for the former. Poland is currently experiencing the deepest economic crises since the beginning of its transformation and it can happen that once the recession is overcome the determination of the government and the central bank to proceed quickly towards the Eurozone will very much weaken if the price had to be high (see above the box on the costs of bringing inflation to the Maastricht levels).

Then what is the probable timing of the Eurozone entry of the candidate countries? The following analysis will concern only the best prepared ones as the case of those lagging behind is troubled by many more uncertainties, including the EU entry itself.
As a basic assumption, the candidate countries are expected to become EU members at the beginning or in the course of 2004.

Further, based on the current state of discussions it is assumed that the Maastricht criteria will not be eased. So far all the calls for adjustment in the inflation criteria have been met with frowning or just silence. Slovenia tried, in the course of the accession negotiations, to propose the Commission that the exchange rate criterion be removed arguing that the exchange rate of the Slovenian tolar had in fact exhibited the required stability. (Lavrač, 2001) The countries operating currency boards could use the same argument with even more persuasiveness. However, the Slovenian proposal was turned down and thus the ERM II seems to be the only feasible way to the Eurozone. Nor there appears to be any willingness to take into account inherently higher rates of inflation due to the B-S effect. On the other hand, the EU has recently introduced the notion of real convergence as a precondition for successful monetary integration which is by some observers (Lavrač, 2001, Slovenian NB) viewed as a possible way to delay the EMU enlargement. Following this line of argument, proposals for strengthening of the Maastricht criteria for the candidate countries appeared. However, there are not any signals that the Commission would consider tightening of the current criteria or even introducing any new, real convergence based ones. The EU seems to have tied hands in this respect as it usually argues by the good of the candidate countries themselves. It can hardly argue that it knows better what the candidates need. The appeal of the ECB's vice-president Noayer (see above) to the candidate countries not to sacrifice economic growth for fast compliance with the convergence criteria was swiftly followed by a Polish demand to renegotiate the Maastricht Treaty in order prevent such a lose-lose situation.

Moreover, it seems that the real reason behind the calls for prudence could rather be EU's fear that accession countries, with still somewhat different preferences concerning the balance of growth and inflation than those of the 'core' eurozone countries, could soon acquire a substantial part of votes on the ECB's board and effectively alter its monetary policy.

89

Once the candidate countries become EU members, it will be virtually impossible for a proposal to introduce further criteria to be approved by the Council of Ministers. Similar arguments might be used when looking for an answer to the question as to what the EU institutions would do if the new member states managed to qualify for the euro unexpectedly quickly. The Treaty requires the prospective EMU members to fulfil the convergence criteria on a healthy and sustainable basis. As we have seen, the nature of the process of catching-up makes it, at least in the case of inflation, virtually impossible. And the experience of the current EMU members amply demonstrates this fact. Thus, the EU can hardly use this argument in order to prevent the 'pre-mature' Eurozone enlargement. Moreover, it will be the Council consisting of the old and also new members which will have a decisive word in this issue. Thus, the new members could, if need be, threaten to block decisions on other issues if the older members were reluctant to let them in.

Hence, the major factors that will have an impact on the final date of the Eurozone enlargement into Central and Eastern Europe will be the determination of the candidate countries, not only the verbal one but also in the form of concrete policies, and exogenous economic factors (e.g. the relative position of the economic cycles in the EU and candidate countries, the size of capital flows).

The following scenarios are possible for the candidate countries on their way to the Eurozone:

Scenario 1: Quick and smooth
After the successful entry in the EU at the beginning of 2004, the new member countries immediately adopt the ERM II regime and operate it for the following two years. The period in ERM II could in fact be even shorter as it was the case of Greece before it entered the EMU. However, as the current position of the EU does not favour the fast approach, it is reasonable to assume that the full two years will be required. Then, in 2006, they would enter the Eurozone, where they will live happily ever after.

Scenario 2: Let's be realistic
The candidate countries enter the EU in 2004 (rather in the course than at the beginning of the year). After some preparatory period, they enter the ERM II where they will stay for about two years. The EU side can delay the negotiations on the ERM II enlargement until the candidates' entry into the Union. Then, the new members can initiate the procedure themselves. This would lead to some delay in introducing the exchange rate mechanism but not a substantial one. Alternatively, the candidate countries could willingly postpone the phasing in of the ERM II if they felt they might have problems with fulfilling the convergence criteria in two years' time, and in such a way avoid staying unnecessarily long in the more vulnerable semi-fixed exchange rate regime. Then, the Eurozone membership would follow in about 2008. This scenario as well as the 'Quick and Smooth' one expects that no troubles occur during the stay in the ERM II.

Scenario 3: Do not scare us!

The uncertain nature of the accession process coupled with still ongoing structural changes and persisting deficiencies may lead to economic crises. It may be a currency crisis generated by unstable capital flows into the CEE countries, a banking crisis arising from insufficient supervision or a crisis resulting from bad macroeconomic policies. It is probable that one type of crisis would quickly initiate others as well. Usually, such crises spread around the whole economy and have an impact on the currency and also on the real economy. Then, the country would almost certainly violate the criterium of exchange rate stability, which means that two or probably even more years would have to pass before it would have a chance to qualify.

Scenario 4: Improbable, but …

It could also happen that some of the candidate countries would experience a crisis in the period before the entry into the EU. Than the EU side might acknowledge the dangers associated with the lengthy stay in the ERM II waiting room, as the candidates see it, and adapt its approach dropping the requirement for the two years of participation in the exchange rate mechanism. This would open a way to much earlier enlargement of the Euro area to the east. Alternatively, if Sweden or Great Britain decided to join the Euro area it is probable that they would try to avoid the stay in ERM II. The EU willing to take advantage of their change in attitude could agree creating thus a precedent. It is highly probable that the candidate countries would try to make use of it.

91

Due to all the uncertainties outlined above it is difficult to assign probabilities to these scenarios. Moreover, it is probable that not all the countries will follow the same path. Nevertheless, it can be expected that countries will move in groups and thus the most determined ones such as Slovenia, Hungary and Estonia might pull in other countries as well. This mechanism might also work the other way round as an economic crisis in one candidate country could also affect the others preventing them from fulfilling the convergence criteria. Despite the fact that the candidate countries proved to be rather resistant to the Asian or Russian crisis it is not certain what the contagion effect within the region would be. The Czech crisis in 1998 or the Polish one of 2002 do not seem to have affected the others very much. However, in the run-up to the Eurozone membership, which will probably be characterised by increased volatility, it can be very different and a currency crisis in one country can be followed by attacks on other regional currencies, as was amply demonstrated by the 1992 crisis of the EMS.

NOTES

[1]   Which consists of a central bank and a number of commercial banks.

[2]   Though, it is often argued that the candidate countries should strive to achieve substantially higher levels of savings if they want to catch up successfully with their EU counterparts. But also in this case the data hide a highly differentiated picture. Whereas the Czech Republic and Hungary save 31 percent of their GDP, Bulgaria's saving rate is only 7 percent.

[3]   A considerable part of the loss was incurred by the bail-out of the already privatised IPB Bank which collapsed in June 2000. This case also points to the importance of creating appropriate incentive schemes for strategic investors. The IPB Bank had been sold to the investment bank Nomura Europe in 1998. However, the new owner failed to undertake the necessary restructuring which led to a deterioration of the bank's balance during the recession in 1998 and 1999 and ended in a collapse.

[4]   In the EU countries, there is a growing tendency to transfer the supervisory function to an independent body. In this way a conflict of interest which could arise when the central bank is responsible for both price stability and supervision of the banking sector can be circumvented. Thus, less than half of the central bank, in the EU are responsible for the supervision of the banking sector.

92

[5]   Czech News Agency, 26 March 2002.

8   CONCLUSIONS

Ten of the thirteen candidate countries are proceeding quickly towards EU membership which formally also implies membership of EMU. However, these new EU members will initially have a derogation for the introduction of the euro. When can and should this derogation be lifted, i.e. when should the euro be introduced in these countries? And how can one ensure that the transition period to the euro is smooth? These are the key issues underlying the analysis presented in this paper.

The time frame is now quite clear: The earliest possible date of entry into the Eurozone is the year 2006 (if the EU enlarges in the course of 2004). A large number of the candidate countries have indeed expressed a willingness to proceed to the Eurozone as quickly as possible. It is thus possible that by 2006 the membership of the eurozone rises considerably. A brief comparison with the Club Med countries (whose qualification for EMU was also long in doubt) indicates that most of the candidate countries could be able to satisfy the conditions in the medium-term and introduce the euro relatively quickly.

But many officials in the EU, especially in financial circles, are not very excited about this prospect and call for prudence and a slower-track approach. The objections are usually concerned with a need to reach a higher level of real convergence. Though it is acknowledged that a monetary union is fully compatible with income differences among its members, too fast a compliance with the nominal convergence criteria is often conceived as a threat to real convergence.

The analysis of this paper suggests that fulfilment of the fiscal criteria should not represent a problem for the candidates and cannot be said to retard real convergence. However, this is not necessarily the case for the inflation criterion (if viewed together with the exchange rate stability criterion). The catching up process can be expected to lead to substantially higher inflation rates in the candidates if they fix their exchange rate to the euro. Our analysis of this so-called Balassa-Samuelson effect suggests that the magnitude of the problem might be smaller than often feared, but the problem exists and puts the candidate before a difficult alternative: either implement restrictive policies to squeeze inflation during the qualification period for EMU, or accept a delay in being able to join the euro.

In this limited sense one can argue that the Maastricht criteria do not take into account the specific situation of the candidate economies. As a result, the candidate countries willing to fulfil the inflation criterion might be forced to follow sub-optimal economic policies. Therefore, there is a strong economic case for a reappraisal of the setting of at least one criterion.

It is a generally accepted proposition that the most dangerous exchange rate system combines capital mobility and 'fixed but adjustable' exchange rates. This is

93

exactly the position the candidates will be in for at least two years, when they have to qualify for the EMU. What then should the EU do to smoothen the way to the Eurozone?

The EU could contribute to a smooth transition by a somewhat more flexible approach towards the convergence criteria as some tailoring to the needs of the candidate economies would be highly desirable without endangering the stability of the incumbent EMU countries. The EU could also reassess its, so far extremely negative, position towards the unilateral euroisation. This would help to eliminate some of the risks pertaining to the traditional Maastricht way to the Eurozone.

NOTES

[1]   It is important to stress the heterogeneity among the candidate countries. Clearly, Bulgaria and Romania are lagging behind and EU/EMU membership is a longer-term issue for them. But also the more advanced candidates show a high degree of difference.

BIBLIOGRAPHY

Balassa, B. (1964) 'The purchasing power parity doctrine: a reappraisal', *Journal of Political Economy*, December.

Begg, Eichengreen, Halpern, von Hagen, Wyplosz (2001) Sustainable Regimes of Capital Movements in Accession Countries, CEPR, mimeo

Berger, Helge, Henrik Jensen and Guttor, Schjelderup (2001) 'To Peg or not to Peg? A Simple Model of Exchange Rate Regime Choice in Small Economies', *Economic Letters*, 73 (2001).

Boeri, Tito and Katherine Terrell (2002), Institutional Determinants of Labour Reallocation in Transition, *Journal of Economic Perspectives,* Vol. 16, No. 1

Bofinger, Peter and Timo Wollmershauser (2001), 'Is there a third way to EMU for the EU accession countries?', *Economic Systems* 25, 253-274

Bratkowski A., Rostowski J. (2001), Why Unilateral Euroization Makes Sense For (Some) Applicant Countries? NBP Conference 'Polish Way To the Euro', Warsaw.

Buiter and Grafe (2001) Central Banking and the Choice of Currency Regime in Accession Countries, *SUERF studie*s no 11

Bundesbank (2001), Monetary Aspects of the Enlargement of the EU, *Monthly Report*, October

Coricelli, F. and B. Jazbec (2001), Real Exchange-Rate Dynamics in Transition Economies, *CEPR Discussion Paper* No. 2869, London

Demirguc-Kunt, Asli, and Enrica Detragiache (1998), 'The Determinants of Banking Crises in Developing and Developed Countries', *IMF Staff Papers* 45, 81-109

De Broeck, Mark and Torsten Slek (2001), Interpreting real exchange rate movements is transition countries, Bank of Finland, Institute for Economies in Transition (BOFIT), Discussion Paper No. 7.

Deutsche Bank (2001), *EU Enlargement Monitor*, August

Durajsz, Pavel (2001), 'How to balance real and nominal convergence? The case of Poland', unpublished manuscript.

EBRD (2001), *Transition Report*, London: *EBRD*.

European Commission (2000) Exchange Rate Strategies for EU Candidate Countries, Brussels, ECFIN/521/2000-EN.

European Commission (2001a), Autumn 2001 Forecast, Economic Reform Monitor, Issue 2001/4, November, DG Ecfin.

European Commission (2001b): Real Convergence in Candidate Countries – Past Performance and Scenarios in the Pre-Accession Economic programmes, ECFIN/708/01-EN.

European Commission (2001c) 'Progress towards meeting economic criteria for accession: the assessment from the 2001 Regular Report', DG Ecfin, *Enlargement Papers*, No. 6.

European Commission (2002a), Report on macroeconomic and financial sector stability developments in candidate countries, *Enlargement Papers*, DG Ecfin.

European Commission (2002b) 'Evaluation of the 2001 pre-accession economic programmes of candidate countries', DG Ecfin, *Enlargement Papers* No. 7.

Eichengreen, Barry (1992), 'Should the Maastricht Treaty Be Saved?' *Princeton Studies in International Finance*, No. 74, International Finance Section, Princeton Univ, December.

Eichengreen, B. and F. Ghironi (2001), 'EMU and Enlargement', mimeo.

European Banking Federation (2002): EU and EMU enlargement, *FBE Letter*, February.

Fischer, Stanley (1999) 'Reforming the International Financial System', *Economic Journal* 109, 557-576

Fischer, Stanley (2001), Exchange rate regimes: is the bipolar view correct?, mimeo, IMF, January.

Fagan, Gabriel (2001) *Sources of Inflation Divergences across Euro Area Countries,* mimeo.

Gibson, Heather D. and Euclid Tsakalotos (2001), The Euro, EU Enlargement and ERM II, CES ifo conference 'Managing EU enlargement'.

Gomulka S. (2001), Poland's Road to the Euro: A Review of Options. NBP Conference 'Polish Way to the Euro', Warsaw.

Gros, Daniel and Niels Thygesen (1998), *European Monetary Integration from EMS to EMU*, London: Addison-Wesley Longman.

Gros, Daniel and Marc Suhrcke (2000), Ten Years After: What is special about transition countries?, *CEPS Working Document* No. 143, Centre for European Policy Studies, Brussels, May.

Gros, Daniel and Alexandr Hobza (2001), Fiscal Policy Spillovers in the Euro Area: Where are They?, *CEPS Working Paper* No. 176

Gros, Daniel (2002), Comments to on 'The Eastern Enlargement of the EU and the Case for Unilateral Euroization' by Jacek Rostowski, CASE conference Beyond Transition, 12-13 April.

Halpern, Laszlo and Charles Wyplosz (2001), Economic Transformation and the Real Exchange Rates in the 2000s: The Balassa-Samuelson Connection, Economic Survey of Europe, UNECE 2001/1 Chapter 6 pp 227-239.

Kaminski, Graciela (1999), Currency and Banking Crises: The Early Warnings of Distress', *IMF Working Paper* 99/178.

Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobaton (1999a). "Aggregating Governance Indicators', *World Bank Policy Research Department Working Paper* No. 2195.

Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobaton (1999b). "Governance Matters". *World Bank Policy Research Department Working Paper* No. 2196.

Kenen Peter, 1969, 'The Theory of Optimum Currency Areas: An Eclectic View,' in R. Mundell and A. Swoboda eds., *Monetary Problems in the International Economy*, Chicago: University of Chicago Press.

Koenig R. (2001), Should the Maastricht Criteria Be Modified? NBP Conference 'Polish Way to the Euro', Warsaw.

Krkoska, Libor (2000), 'Assessing macroeconomic Vulnerability in Central Europe', *EBRD Working Paper* 52, June.

Krugman Paul, 1993, 'Lessons of Massachusetts for EMU,' in F. Giavazzi and F. Torres, eds., *The Transition to Economic and Monetary Union in Europe*, Cambridge University Press, New York 241-261.

Lannoo, Karel and Tanja Salem (2001), 'The Emerging Regulatory Framework for Banking and Securities Markets in the CEECs' in Michael Schroeder (ed.), *The New Capital Markets in Central and Eastern Europe*, Springer-Verlag, Berlin.

Lavrač, Vladimir (2001), *Exchange Rate Regimes of Central and Eastern European EU Candidate countries on their Way to EMU*, ACE project 'Alternative exchange rate regimes in transition economies'.

Lipschitz L., Lane T., Mourmouras A. (2001), 'Capital Flows to Transition Economies: Master or Servant.' In: *Integration into the EU and EMU: Challenges of Nominal and Real Convergence.* Czech National Bank, Prague.

Lorenzen, Hans Peter (2001), Alternative Exchange Rate Strategies for Accession to - EMU, Dissertation at LSE, London.

Mundel, Robert (1961), 'A theory of optimum currency areas', American Economic Review 51, September: 657-65.

NBP (1998) *Medium-Term Strategy of Monetary Policy (1999-2003)*, Warsaw, September.

Repse, Einars (2001), The euro goes east: a view from Latvia, Speech at the European Banking Congress, Frankfurt, November.

Riboud, Michelle, Carolina Sánchez-Páramo and Carlos Silva-Jáuregui (2002), 'Does Eurosclerosis Matter? Institutional Reform and Labour Market Performance in Central and Eastern European Countries in the 1990s, *World Bank Social Protection Discussion Paper* No. 0202.

Rostowski Jacek (2002), 'The Eastern Enlargement of the EU and the Case for Unilateral Euroization', Paper for CASE conference Beyond Transition, 12-13 April

Samuelson, Paul (1964), Theoretical Notes on Trade Problems', *Review of Economics and Statistics*, May.

Schardax F. (2001), Real Convergence, Real Exchange Rates and Inflation in the CEECs. NBP Conference 'Polish Way To the Euro', Warsaw.

Sinn, Hans-Werner and Michael Reuter (2001), The Minimum Inflation Rate for Euroland, *NBER Working Paper* No. 8085.

Suhrke, Mark (2001) 'Preferences for Inequality: East vs. West', *Innocenti Working Paper* No.89, October.

SVR (2001) 'Inflation differentials in the Euro area', Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Wiesbaden.

Szapary, G. (2000), 'Maastricht and the choice of exchange rate regime in transition countries during the run-up to EMU', *NHB Working paper* No. 7

Tullio, G (1999) Exchange rate policy of Central European countries in the Transition to European Monetary Union', in P. de Grauwe (ed.) *Inclusion of Central European Countries in the European Monetary Union*, Boston, Kluver, 63-104.

UNO, Economic Commission for Europe (2001), *Economic Survey of Europe 2001*, Chapter 6, New York and Geneva.

Wagner, Helmut (2001) Pitfalls in the European Enlargement Process – Challenges for Monetary Policy, conference 'How to pave the road to E(M)U: The monetary side of the enlargement process (and its fiscal support), Eltville, 26/27 October.

Wagner, Nancy and Dora Iakova (2001), Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth, *IMF Working Paper* 01/141.

ANNEX :   *REMAINING PROBLEMS IN THE PROGRESS TOWARDS ACCESSION BY THE CANDIDATE COUNTRIES, 2000-2001*

	Estonia	Slovenia	Hungary	Czech R	Slovakia	Latvia	Lithuania	Poland	Bulgaria	Romania	Turkey
Chapters [1]	20	22	23	22	20	21	21	19	13	9	-
Function./ competit. [2]	3 in near term	3 in near term	3 in near term	3 in near term	3 in near term	3 in near term	3 in near term	3 in near term	close in med. term	not yet no	no partly
Market economy	- current account deficit - segmented labor market - oil-shale industry restructuring	- inflation - labour market - restruct/ privatisation in banking & insurance - FDI - state's influence	- expansionary fiscal policy - non-transparent fiscal practices - pension reform - health care reform	- current account deficit - public finances - prudential regulations - SOEs privatisat - steel industry restruct.	- current account deficit - unempl. - financial supervision - privatisat. - labour market reform	- fiscal discipline - land privatisation - land market - unempl.	- unempl. - energy market - low financ. intermediat. - pension reform; - domestic & FDI;	- policy mix budget deficit - public finances - unempl. - privatisat. - restructur. - infrastruct. - state aids schemes & monitoring	- inflation - land market; - private & public investment - regulatory framework - financial intermediat.	- current account deficit - external account - inflation - privatisat. - restructur. - private sector	- two financial crises - restructure banking, agri-cult, SOE - investment in education, health, social cervices, infrastruct.
CPI / Rank [3]	5.6 28	5.2 34	5.3 31	3.9 47	3.7 51	3 59	4.8 38	4.1 44	3.9 47	2.8 69	3.6 54
Rule of Law	- court decisions quality and enforcement - institut. transparency - administr. coordination - local level implement.	- police behaviour - no Civil Servants and Public Agencies Laws	- Supreme Court overload - police behaviour - new Status Law	- no public contracts tenders - no Civil Service Act - economic crime, e.g. 'tunnelling'	- implement. of policy and intern. obliga-tions - judicial impartiality and political neutrality - Roma discriminat.	- legal set up and civil serv-ice develop-ment - pay reform	- adm. cor-rupt. - administr. transparency - no Law on Courts - strategy on corruption - court system financing & management	- civil service - judicial immunity - abuse of custody - corruption strategy - police, border guards, civil servants corruption	- judicial system - Roma discriminat. - child welfare - corruption prevention - public administr. transparenc & accountability	- corruption largely unresolved - childcare institutions - minority discriminat. - police accountability	- fundam. rights restrictions - death penalty - no real cultural rights - judiciary independ. - transparency - poverty in South East
Status / Progress [4]	3 +	3 ++	2 +	2 ++	2 +	1 ++	1 ++	1 +	0 +	0 -	0 -
Administrative capacity	- piracy and counterfeit goods - institution transparency - operational capacity	- structural funds man-agement - independ. supervisory agency - EC funds management	- fiscal state aids control - audio-visual - market surveillance - transport - agriculture - EC funds management	- central bank independ. - agriculture - regional policy - environm. - border controls - EC funds management	- company law - competit. - transport - social policy - fin. control - agriculture - EC funds management	- public procurement - agriculture - transport - energy - telecoms	administr. reorganisat. - internal financial control - EC funds management	- secondary lgislation - standards & certificat. - control system & border inspection	- modernisat. of judiciary - EC funds management - sustained effort - resources	- major constrain in preparation - internal mkt - competition - agriculture - environm. - social policy - public funds	- needs major reform at all levels - create new structures - major discrepancies with acquis - state aids - reg. policy - agriculture

NOTES

[1]   Chapters of the acquis closed (temporarily) as of November 2001.

[2]   Copenhagen economic criteria consisting of two sub-criteria: a) existence of a functioning market economy and b) capacity to withstand competitive pressure and market forces within the Union.

[3]   Corruption Perception Indicator (CPI), 2001 by Transparency International:
   • 91 countries surveyed on the perceptions of the degree of corruption as seen by business people, academics and risk analysts;
   • it ranges between 10 – highly clean (e.g. highest in Finland, 9.9 (1)) and 0 – highly corrupt (e.g. lowest in Bangladesh, 0.4 (91));
   • (www.transparency.org/documents/cpi/2001).

[4]   Legal, institutional & regulatory set up: 0-unadequate; 1-partially in place; 2- key institutions in place, 3-largely in place; progress since 2000: (+) further, positive; (++) substantial, (-) limited or no progress.