Monetary aspects of the enlargement of the EU

The accession of up to 13 candidates for membership, predominantly from central and eastern Europe, constitutes one of the greatest challenges the European Union has faced in its history. The negotiations that are currently in progress with twelve of those candidates have meanwhile progressed so far that it is likely that the first enlargement round will be completed by the middle of the present decade.

The integration of the new EU member states in the monetary policy of the euro area will take place in stages, with the design of the various integration steps and the pace of their implementation being closely coordinated with the overall economic policy strategies of the countries concerned. In the light of the ultimate goal of their participation in monetary union, particular account must be taken of the requirement of sustainable convergence, as stipulated in Article 121 of the EC Treaty. This essay is intended to provide an overview of the present state and future progress of the enlargement process. Attention is focused mainly on the monetary aspects, and on the prerequisites for a sustainable integration of the future EU member states.

The state of the accession process

New strategy to expedite the accession negotiations

The EU enlargement process, which began in Luxembourg in December 1997, was given a major boost by the meetings of the EU Heads of State and Government in Nice in December 2000 and in Gothenburg in June 2001. The European Council (EC), convening in Nice from December 7 to 9, 2000, approved a new strategy, suggested by the Commission, for expediting the accession negotiations. The "timetable" drawn up thereafter, covering a period of 18 months, mapped out the frame of reference within which the Union defines in concrete terms its attitude to the problems encountered, including the applications for transitional periods. At the same time, the "timetable" forms a flexible framework for the accession preparations of the candidate countries – a framework that can be adjusted to the progress made by the individual states.

Launch of a dialogue on macroeconomic and financial stability

Another major outcome of the EC meeting in Nice was the launch of an economic policy dialogue with the candidate countries on the topic of macroeconomic and financial stability. The EC approved a corresponding statement by the ECOFIN Council. That dialogue, and the efforts to achieve macroeconomic and financial stability, are designed to foster sustainable economic convergence. This new instrument is intended to prepare the candidate countries for their future economic and monetary policy cooperation in the EU, after their accession. At the same time, major foundation stones are laid for their subsequent participation in European Monetary Union (EMU).[1]

Institutional reforms fall short of expectations

In particular, the Intergovernmental Conference (IGC) beginning in February 2000 served to prepare the Community for enlargement; it was wound up by the Heads of State and Government of the EU following the Nice meeting of the EC. The primary aim of those deliberations was to amend the Community treaties, so as to ensure the EU's ability to take action in a Union enlarged to up to 27 countries and, at the same time, to safeguard the due representation of all current and future member states in the Community institutions. However, the agreed institutional reforms, viewed as a whole, fell short of expectations. That applies especially to the decision-making procedure in the Council, and to the size and composition of the Commission. With regard to ensuring the Eurosystem's ability to take action and its efficiency, an enabling clause was added to the Treaty of Nice incorporating a simplified amendment of the voting procedure in the ECB Governing Council.[2] According to the presidency conclusions of the Nice EC meeting, the Treaty of Nice paved the way for enlargement. In view of the unsatisfactory results of the Nice conference, institutional reforms will continue to play a key role in the already-agreed "post-Nice process".

Time frame for the completion of enlargement

On the basis of the progress made to date by the candidate countries and the continuation of the ratification procedure for the Treaty of Nice, the EC agreed in Gothenburg on

1 For further comments on the dialogue on macroeconomic and financial stability, see: Deutsche Bundesbank, The outlook for the enlargement of the EU following the Nice European Council, Monthly Report, March 2001, pp. 15–18.
2 For a detailed account of the results of the IGC, see: Deutsche Bundesbank, loc. cit., pp. 17 f.

The Copenhagen criteria

The Copenhagen criteria demand, as a prerequisite for membership:

- the stability of institutions guaranteeing democracy, the rule of law, human rights, respect for and protection of minorities (political criteria);
- the existence of a functioning market economy as well as the capacity to with stand competitive pressure and market forces within the Union (economic criteria);
- the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union (criterion of adopting the *acquis communautaire).*

Deutsche Bundesbank

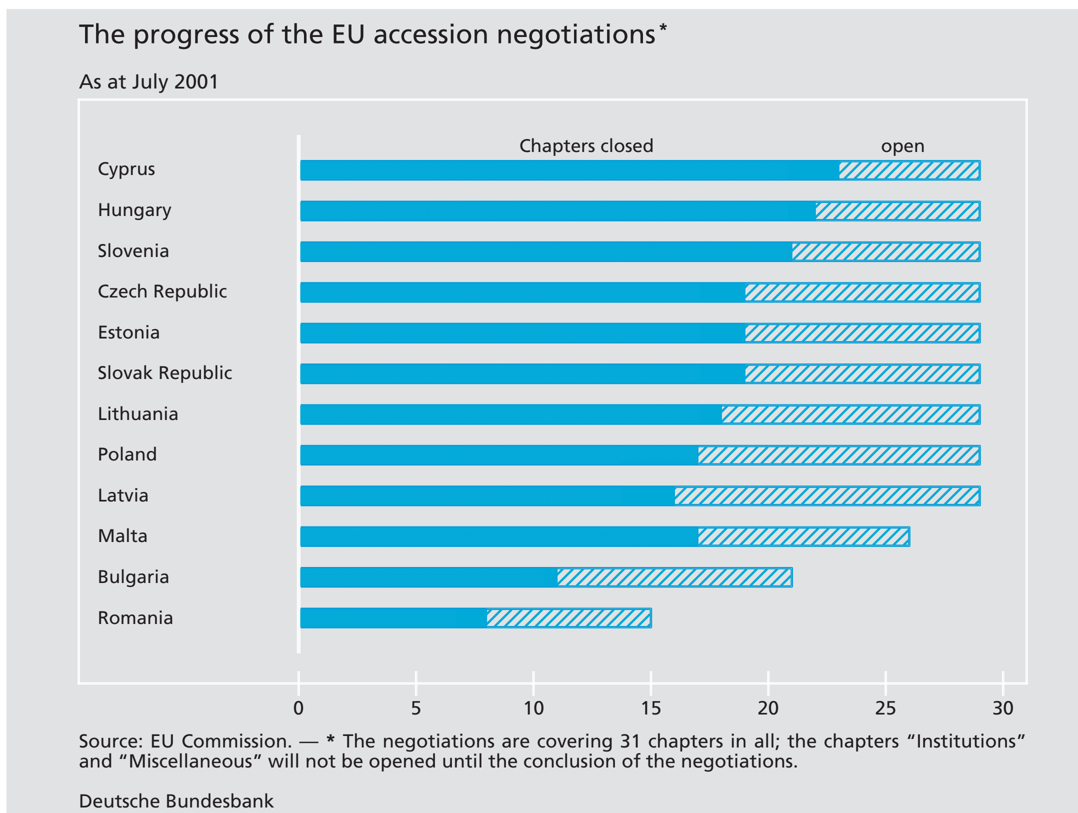
June 15–16, 2001 on a time frame for the completion of enlargement. The EC thinks it feasible to complete the negotiations for those countries which are adequately prepared for accession by the end of 2002, provided that the progress made by the candidate countries towards meeting the accession criteria is maintained. The intention is that those countries should be able to participate, as members, in the elections for the European Parliament held in 2004. But the crucial factor governing the further course of events and the completion of the accession negotiations is the actual headway made by the various candidate countries.

Progress in the accession negotiations, but some major issues still outstanding

Accession to the EU is conditional upon compliance with the political and economic criteria laid down by the EC in Copenhagen in 1993, as well as upon the adoption and implementation of Community law (the so-called *"acquis communautaire"*). At the present moment, all the countries with which negotiations are being conducted[3] satisfy the political criteria, but only Malta and Cyprus meet the economic criteria.

The negotiations on the adoption of the *acquis communautaire,* which have been subdivided into 31 chapters, have made good progress of late; in the process, the second

3 At present, negotiations are under way with the following candidate countries:
– first group (since March 1998): Cyprus, Czech Republic, Estonia, Hungary, Poland and Slovenia.
– second group (since February 2000): Bulgaria, Latvia, Lithuania, Malta, Romania and Slovak Republic.
Turkey has the status of a candidate country, but does not meet the conditions for entering into accession negotiations.



Source: EU Commission. — * The negotiations are covering 31 chapters in all; the chapters "Institutions" and "Miscellaneous" will not be opened until the conclusion of the negotiations.

Deutsche Bundesbank

group of candidates has largely caught up with the first one. Among the countries that have made the most headway, more than two-thirds of the chapters have already been tentatively closed.

Despite the progress made to date, however, it must be borne in mind that the negotiation of the most difficult chapters – especially EU financing, agricultural policy and structural policy – is still pending. In those areas, the Community, too, still has to define its position. Moreover, numerous calls for transitional periods, which the Community intends to accept only in justified exceptional cases, are hampering the negotiations. Another source of great controversy is the transitional arrangement sought by the EU with regard to the free movement of persons.

Intensification of economic and monetary cooperation in the pre-accession phase

The monetary integration of the candidate countries will take place in stages. The pre-accession phase will be followed by the post-accession period, which will be completed by the introduction of the euro. As early as the pre-accession phase, ever-closer cooperation will occur between the EU and the candidate countries in the fields of economic, fiscal and monetary policy. On the basis of the European Treaties, the Community supports the policies of the candidate countries to foster macroeconomic stability, as well as real and nominal convergence. By means of partnerships with individual candidate countries, a procedure to monitor budget policies has been introduced. The pre-accession economic programmes to be drawn up every year by the candidate countries under that scheme, and their budget statements, are the subject

of the newly introduced dialogue on macroeconomic and financial stability, in which high-level representatives of the governments and central banks of member states and candidate countries participate; the first dialogue meeting took place in Stockholm on June 27, 2001. At a second such meeting towards the end of this year, the macroeconomic stability of the candidate countries and the stability of their financial sectors, including their progress towards structural reforms, are to be assessed on the basis of a report by the Commission. In future, both meetings are to be held at annual intervals. Once a year, the dialogue will take place at ministerial level. The Commission will notify the Council about the conclusions reached at the high-level meetings and, every year, about the appraisals of budget statements and of the pre-accession economic programmes. By virtue of this newly introduced macroeconomic and financial dialogue, the ECOFIN Council will play a more and more important role in the final phase of the accession process.

Sustainable convergence requirements

Achievement of a high degree of sustainable convergence prior to participation in EMU

After joining the EU – which presupposes compliance with the accession conditions and the completion of the accession negotiations, including ratification, in all the countries concerned – the candidate countries will participate in Stage Three of EMU as "member states with a derogation" (Article 122, subsection 1, EC Treaty); that is to say, they will not immediately be member states of EMU. During that period, the candidate countries will have to make greater efforts to achieve a high degree of sustainable economic convergence.

Convergence criteria

As a yardstick, the Treaty of Maastricht lists the four so-called "convergence criteria", and defines them in an accompanying protocol. In its report to the EC in Nice on the exchange-rate aspects of enlargement, the ECOFIN Council confirmed that the same criteria as for the present euro-area countries are to be applied to the candidate countries' full participation in EMU by the introduction of the euro. Specifically, the requirements are that

– the inflation rate is to be not more than one and a half percentage points above the average inflation rate of the three best-performing member states of the Eurosystem;

– long-term interest rates are to be not more than two percentage points above the corresponding level in those three countries;

– the public sector deficit is to be equivalent to not more than 3 %, and the level of public debt to not more than 60 %, of the gross domestic product;

– the country must have participated for not less than two years in the European Exchange-Rate Mechanism (ERM II) within the normal margins of fluctuation, without any devaluation being required.

Besides these quantified convergence criteria in the narrower sense, according to the provi-

sions of Article 121, EC Treaty, "... the results of the integration of markets, the situation and development of the balance of payments on current account, and ... the development of unit labour costs and other price indices" are to be taken into account in the assessment of the sustainability of the convergence achieved. Moreover, the candidate countries have to bring their statutory provisions into line with the EMU regulations of the Treaty. Such legislative convergence, which is called for by Article 109, EC Treaty, is to be achieved before accession to the EU, with the amendment of the central banking laws and statutes – especially with respect to the independence of the central bank – playing an important role.

All the convergence criteria specified are designed to forestall inflationary tendencies within the monetary union and to avoid the tensions which may arise if the unified and common monetary policy fails to meet the needs of all member states.

To that end, a strengthening of real convergence is required, especially by means of structural adjustments and reforms. Progress in that area may be measured to a certain extent by the movement of per capita GDP relative to the EU average.

Differing degrees of progress towards convergence

To date, developments in the candidate countries have shown a mixed picture. As regards nominal convergence, a number of countries have made substantial headway in recent years. However, there have also been some contrary trends and setbacks of late. In particular, inflation is proving to be more intractable than was expected. That is due, firstly, to rises in oil prices; furthermore, the price pressure has been reinforced by the low external value of the euro, since most of the candidate countries gear their exchange-rate policies to the euro. Secondly, in a number of countries, domestic cost pressures have been pushed up on the wage side. For instance, certain countries, including Poland, recorded double-digit inflation rates again in the year 2000. But since the above-mentioned external factors have dwindled in significance of late, the price pressures have been tending to slacken somewhat most recently. On the other hand, the increase in the prices of non-tradables (such as services), which is typical of an economic catching-up process, persists, implying that inflation rates above the Community level are likely in the medium term.

In the field of reducing public sector budget deficits, more progress was generally made in the year 2000. In Slovenia and the Czech Republic, by contrast, a significant deterioration in budgetary positions was registered. In Poland, the current year has witnessed a dangerous imbalance in public finances. In view of the global slowdown in economic growth, though, rising budget deficits are to be expected in other countries as well. But the level-of-debt criterion is currently being met by all the candidate countries except Bulgaria.

Lengthy catching-up process with respect to real convergence

As far as real convergence is concerned, a lengthy catching-up process by the candidate countries is to be expected. Measured in terms of purchasing-power standards, per capita GDP, taking the average of all candi-

The economic data of the candidate countries for the year 2000

Country	GDP at current market prices, € billion	Per capita GDP 1, % of the EU average	Real growth of GDP, year-on-year change in %	Public sector financial balance, % of GDP	Rise in consumer prices, annual average in %	Balance on current account, % of GDP
Bulgaria	13.0	24	5.8	– 1.0	10.4	– 5.8
Estonia	5.5	38	6.9	– 0.7	4.0	– 6.4
Latvia	7.7	29	6.6	– 3.0	2.6	– 6.8
Lithuania	12.2	29	3.3	– 3.3	1.0	– 6.0
Malta	3.9	53	5.0	– 7.1	2.4	– 14.5
Poland	171.0	39	4.0	– 3.0	10.1	– 6.3
Romania	40.0	27	1.6	– 3.7	45.7	– 3.9
Slovak Republic	20.9	48	2.2	– 3.5	12.0	– 3.7
Slovenia	19.5	71	4.6	– 1.3	8.9	– 3.2
Czech Republic	55.0	60	2.9	– 4.9	4.0	– 4.6
Hungary	49.5	52	5.2	– 3.3	8.2	– 3.6
Cyprus	9.5	82	4.8	– 2.7	4.1	– 5.0
Turkey 2	217.4	29	7.2	– 11.3	54.9	– 4.9
Candidate countries, total	625.2	35	5.2	– 6.0	24.3	– 5.1
Candidate countries, other than Turkey	407.8	44	4.1	– 3.2	12.9	– 5.3
Compare: EU-15	8,510.0	100	3.3	1.2	2.1	– 0.2

Source: Eurostat, IMF (World Economic Outlook), EBRD (Transition Report), national data and Bundesbank calculations — **1** In purchasing-power standards (PPS). — **2** Turkey has the status of a candidate country, but is not participating in the accession negotitations.

Deutsche Bundesbank

date countries, stands at just over one-third of the Community level. Only Cyprus and Slovenia have reached a degree of prosperity matching, or slightly exceeding, that of the economically weaker Community member states; the great majority of the candidate countries are still distinctly below that level. What is needed in the long run in those regions is a significantly higher rate of real growth, relative to the Community, in order to narrow the gap sufficiently to ensure that no undue tensions arise among the participating countries.

Macro-economic ...

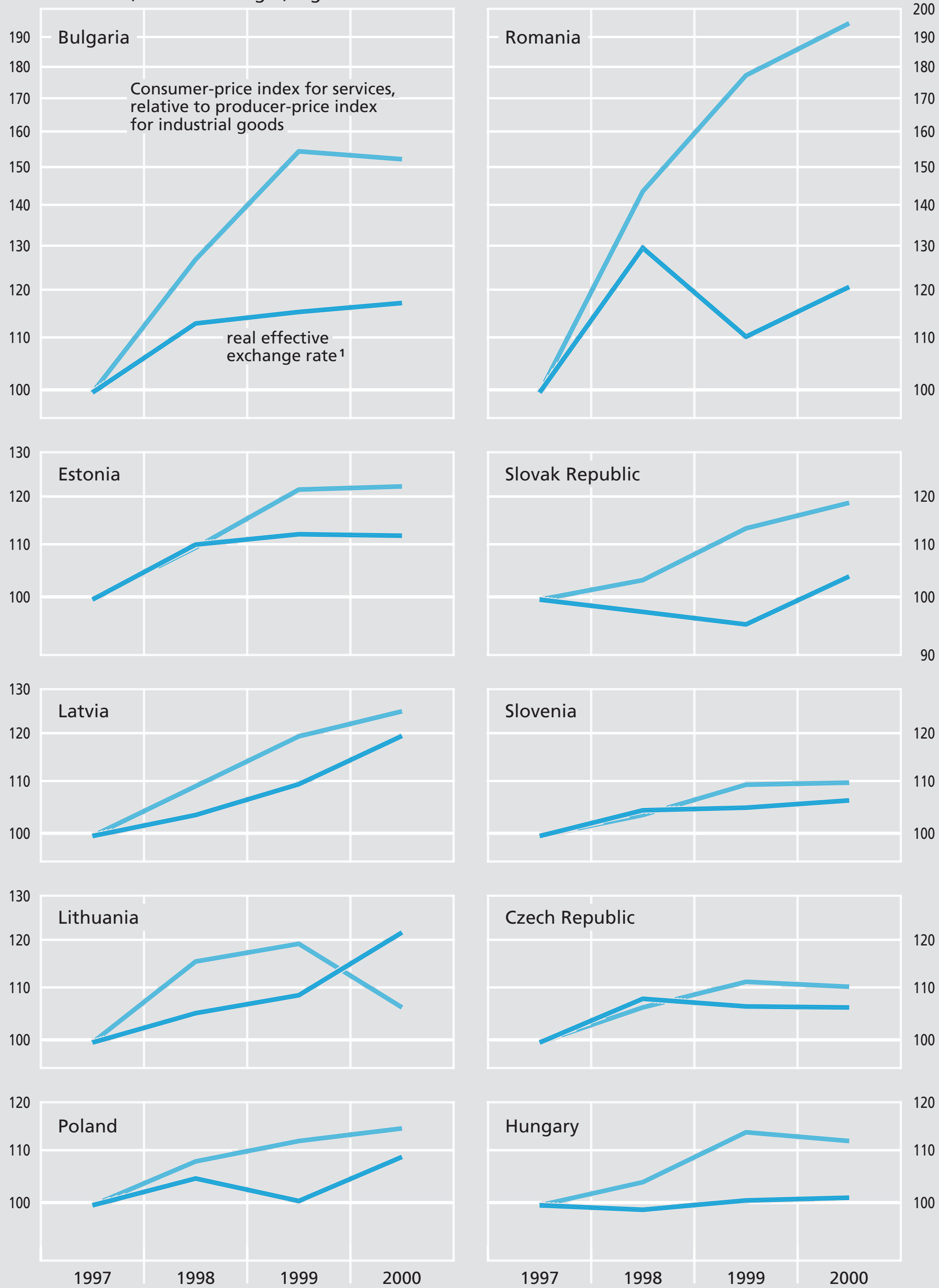
The persistent inflation in the candidate countries owes something not only to external constraints, such as the rise in oil prices and the strength of the US dollar, but also to unwelcome macroeconomic developments. Such developments result from the interplay of the competing demands of consumers, investors and the government on potential output, which, despite expanding strongly, is still rather limited in level. As suggested above, increased cost pressure owing to excessive wage rises has likewise been felt in a number of countries. Wage-indexation clauses and the extrapolation into the future of the high rates of inflation observed in the past have also contributed to such developments.

... and structural causes of inflation in central and eastern Europe

More recently, besides these familiar causes of inflation, attention has likewise been focused on more structural factors which engender a certain degree of inflation in the candidate countries. A commonly mentioned factor of this type is what is known as the "Balassa-Samuelson effect", which arises be-

Changes in domestic price relationships and real appreciation in central and eastern Europe

1997 = 100, annual averages, log. scale



1 Bilateral exchange rates against the currencies of major trading partners, weighted with foreign trade values and deflated by consumer-price indices.

Deutsche Bundesbank

cause, in the economic catching-up process, productivity in the manufacturing sector of the candidate countries goes up disproportionately fast, and gradually approaches the level prevailing in industrialised countries. But the resultant upturn in earnings is often not reflected in corresponding cuts in the prices of the industrial products concerned. This is because the candidate countries, without exception, are small open economies whose prices are oriented to the world-market prices of the respective industrial goods. That affords leeway for wage increases in the industry in question, which give rise to matching wage demands in other sectors of the economy, whose productivity has not improved so much. Since productivity gains in the services sector, for instance, are typically lower than in the field of industrial production, wage rises there result in higher prices. On balance, therefore, the general price level in those countries goes up faster than in the more developed economies, and the upshot is a real appreciation. According to Bundesbank estimations, taking the average of the past few years, this effect seems to have run at a magnitude of two to two and a half percentage points a year. Other computations come to similar conclusions (see the box on page 25). This is equivalent to roughly one-half of the average real appreciation against the EU recorded by the candidate countries in recent years.

Other causes of structural inflation

In addition, a number of other factors are responsible for real appreciation in the transition countries. First among these are shifts in the structure of (product) demand, in favour of the tertiary sector. At the beginning of the transition process, that sector often accounted for only a small share of aggregate demand. It gained greater significance only in the wake of economic liberalisation. One of the reasons for that is the agricultural and industrial bias of production structures, which goes back in part to the days of centralised economic planning in those countries. Moreover, on past experience, the demand for services rises disproportionately fast as incomes grow. Both phenomena result in price relationships shifting; specifically, services become more expensive relative to industrial goods, which, given the often manifest downward price rigidities, reinforces inflationary pressures, and is ultimately reflected in a real appreciation.

Capital inflows from abroad likewise tend to cause the domestic currency to appreciate in real terms. That goes particularly for foreign direct investment, which is of considerable importance in many transition economies. Insofar as it is mainly the relatively capital-intensive industrialised sectors that benefit from the enhanced supply of capital, as is often supposed, the improved capital flow fosters the productivity gain, and thus reinforces the above-mentioned Balassa-Samuelson effect.

The task of stabilisation

The implications for monetary policy

The task of stabilisation makes heavy demands on candidate countries' monetary policy. Ultimately, what is needed is to devise a convincing strategy, with the aim of lowering inflation rates in a reasonably predictable

fashion to the level of those in the euro area, thereby simultaneously reducing adjustment frictions, in the form of employment and growth losses, to an unavoidable minimum. This presupposes that the authorities are successful in shifting the inflation expectations of all those concerned in the desired direction, while not only avoiding disappointments and unwelcome evasive reactions in the process but also providing a sustainable basis for strong and tension-free growth by ensuring sufficient predictability and dependability on the monetary side.

Those aims are sometimes contrasted with a scenario focusing on the short-term trade-off between the wish for a swiftly-moving catching-up process and the objective of monetary stabilisation. In this context, monetary discipline is often seen as an unnecessary "constraint on growth". Correspondingly, a monetary policy strictly oriented towards the objective of stability is viewed as hostile to growth and employment. However, this is to disregard the fact that, judging by past experience, attempts at monetary stimulation at best generate short-lived successes; over the somewhat longer term, the expansionary stimulus fizzles out in a further acceleration of inflation, with the implication that the task of stabilisation will subsequently be even harder to perform – often, in fact, only at the price of profound and sustained stabilisation crises, with heavy losses of growth and prosperity in real terms. At any rate, empirical economic research has found distinct evidence that insufficient stability gives rise to real growth losses in the longer run. Price stability is an essential precondition for sustainable growth. As a matter of fact, empirical studies by the IMF substantiate the finding that precisely those transition economies that have pressed ahead most energetically with monetary stabilisation[4] have made the greatest progress.

Structural price shifts as a particular challenge to monetary policy ...

A problem which has attracted greater attention more recently is that of the implications of the above-mentioned structural price shifts and their potential impact on inflation for the efforts at convergence. In principle, effects on inflation can be neutralised by a correspondingly restrictive stance on the part of monetary policy. On the external flank, the competitive advantages deriving, other things being equal, from stronger productivity gains in the industrial sector would be offset over the longer term by a (nominal) revaluation (or reduced devaluation) of the national currency. In other words, sufficiently flexible exchange rates would facilitate the catching-up process, in conformity with stability. They safeguard the requisite monetary room for manoeuvre. The unavoidable real appreciation would then come about through an adjustment of the nominal exchange rate – rather than through inflation differentials vis-à-vis the more developed countries.

...and in implementing reforms

But a particular problem would be posed by the emergence of structural inflation differentials if their impact on macroeconomic inflation rates were suppressed only temporarily by a restrictive monetary policy, in order for-

4 See, for instance: O. Havrylyshyn et al. (1999), Growth Experience in Transition Countries, 1990–98, IMF Occasional Paper No. 184, Washington D.C., or IMF (2001), A Decade of Transition: Achievements and Challenges, Washington D.C.

The scale of the Balassa-Samuelson effect in central and eastern Europe

In the debate on the accession of future EU member states to the Eurosystem, the likely scale of future inflation differentials is a crucial factor. Among the possible causes of structural inflation in developing countries and emerging economies, most attention is paid to the Balassa-Samuelson effect. However, empirical studies measuring the contribution of productivity increases to real appreciation in the candidate countries of central and eastern Europe are of only limited value for predictive purposes. Since membership of the EU may have a major impact on the future movement of the real exchange rate, historical contexts yield, at best, no more than initial indications of the likely magnitude. The table below provides an overview of current studies of the Balassa-Samuelson effect in the candidate countries.

The results vary according to the observation period and the choice of country group, but a magnitude of one to three percentage points appears to be plausible. In the period from 1997 to 1999, the currencies of the ten central and eastern European candidate countries, on an (unweighted) average, appreciated in real terms by just under 4 % a year. Excluding Bulgaria and Romania, that rate came to approx. 3.3 %. Hence the Balassa-Samuelson effect is responsible for roughly one-half of the average real appreciation rate in central and eastern Europe.

Real appreciation rates in central and eastern Europe (CEE) due to productivity gains

	IMF (2001) 1	UNO (2001) 2	Coricelli/Jazbec (2001) 3	Bundesbank (2001) 4
Estimation	CEE-10 5 1991–1998	CEE-10 (excl. Bulgaria and Slovak Rep.) 1991–1999	CEE-19 6 1990–1998	CEE-10 1994–1999
Real appreciation due to productivity gains against EU-15 (percentage points p.a.) 7	1.4–2.0	2.0–2.2	0.7–1.2	1.9–2.6

1 M. de Broeck and T. Sløk (2001), Interpreting Real Exchange-Rate Movements in Transition Countries, IMF Working Paper 01/56, Washington D.C. — 2 UNO, Economic Commission for Europe (2001), Economic Survey of Europe 2001, Chapter 6, New York and Geneva. — 3 F. Coricelli and B. Jazbec (2001), Real Exchange-Rate Dynamics in Transition Economies, CEPR Discussion Paper No. 2869, London. — 4 Provisional result of an internal study due to appear shortly as a Discussion Paper of the Research Centre of the Deutsche Bundesbank. — 5 CEE-10 denotes the ten central and eastern European EU candidate countries. — 6 CEE-10 plus Armenia, Azerbaijan, Belarus, Croatia, Kazakhstan, Kyrgyzstan, Russia, Ukraine and Uzbekistan. In the respective countries, the observation period begins with the start of the transition process. The observation period stated therefore applies only to Estonia, Hungary and Poland. — 7 The studies cited do not explicitly state the estimated real appreciation, defined as the nominal appreciation adjusted for the inflation differential. The figures listed in the table are based on computations by the Bundesbank, using estimated coefficients.

Deutsche Bundesbank

mally to satisfy the inflation criterion set by the EC Treaty. In the extreme case, it would even be conceivable for economic reforms that might temporarily entail price rises, but would exercise a stabilising effect in the long run, to be deferred, so as not to imperil accession to monetary union. In this connection, the decontrol of administered prices or a lowering of income tax financed by raising indirect taxes might be contemplated. At any rate, after its hypothetical accession to the Eurosystem, the country concerned would no longer have a free hand to keep the second-round effects of such moves towards liberalisation, or other structural tendencies towards price increases, under monetary control. A progressive loss of competitiveness would be the inevitable consequence.

Support from a moderate wage-rate policy

Essential prerequisites of tension-free price stabilisation are, however, a moderate and sophisticated wage-rate policy and sufficiently flexible prices. Failing this, combating inflation will succeed only via the "costly" route of temporary employment losses. In particular, decentralised wage bargaining, which from the outset takes account of differences in productivity between the various industries and sectors, counteracts any price rises in the services sector. Moreover, it may help to reduce the social cost of adjustment arising from the fact that productivity gains within the industrial sector by no means occur uniformly, but may be enforced only by the shedding of labour or by factory closures.

Stabilisation strategies and exchange-rate policy

Divergent stabilisation strategies

In the quest for a convincing stabilisation strategy which gives the necessary guidance to market players' expectations and curbs the leeway for price rises on the monetary side without impairing longer-term growth potential, there are, however, no "patent remedies". Monetary policy strategies with which a central bank has enjoyed success need not be readily transferable to conditions in another country. For instance, the monetary targeting strategies practised by the Bundesbank for over 25 years presuppose stable structural relations between changes in the money stock and price movements, and such relations cannot be taken for granted in most transition countries. Moreover, the strategy of "inflation targeting" employed today by a number of central banks calls for a minimum of structural stability between monetary policy instruments and price movements that does not always obtain. For that reason, the majority of candidate countries made use, especially in the early stages of the adjustment process, of some anchoring of their national currencies to one or more stable key currencies. The degree of linkage ranges from a strict Currency Board via pre-announced exchange-rate target zones and "crawling pegs" to rather informal and highly flexible arrangements. The anchor currencies used are likewise by no means uniform, even though, on account of the growing economic and financial integration with western Europe, the role of the euro is prominent, and tending to increase.

Exchange-rate changes as a valve for safeguarding competitiveness

Judging by past experience, exchange-rate orientation proved its worth, especially during the nineties, as a major element in the stabilisation policy of most transition countries. However, they were not able to dispense altogether with exchange-rate adjustments to offset the cumulative loss of competitiveness resulting from inflation differentials, especially vis-à-vis the west European industrialised nations, which, although they have contracted, still continue to exist. Only small open economies, such as – notably – Estonia, constitute an exception to this rule; it has consistently abided by the anchoring of the Estonian kroon to the Deutsche Mark and the euro under the Currency Board.

Increasing exchange-rate stability with progressive convergence

For a number of candidate countries, a certain degree of exchange-rate flexibility seems to remain necessary. Although the associated currency risks must not be disregarded, they are at the same time an effective protection against speculative attacks – and one that is quite compatible with market conditions. That applies particularly if limited exchange-rate flexibility is accompanied by a steady strengthening of the domestic purchasing power of the national currencies concerned. The dilemma existing between exchange-rate flexibility and exchange-rate stability (which characterises periods of relatively high inflation) resolves itself, so to speak, as convergence progresses: the growing internal stability of the respective national currencies substantiates the greater stability of exchange rates. It is then, at the latest, that it seems to be obvious why the candidate countries in question are adjusting their exchange-rate regimes to the requirements of participating in ERM II. This is particularly true in the case of completely flexible rates or of "crawling pegs".

Ideas of the Community on the exchange-rate policies of the candidate countries ...

According to the ideas of the Community, which were approved by the EC most recently in Nice, the selection of the exchange-rate regime during the pre-accession phase is at the discretion of each candidate country. In the process, care must be taken to ensure that the regime is consistent with the country's economic policy strategy, which, in particular, should serve macroeconomic stability and foster lasting convergence. With their accession to the EU, the new member states are required, under Article 124, EC Treaty, to treat their exchange-rate policy as a matter of common interest. That means, among other things, that the exchange-rate links with currencies other than the euro cannot be retained in the long run. In any case, participation in ERM II is expected in due course. Currency Board arrangements, buttressed by the euro as the anchor currency, and imposing corresponding commitments unilaterally on the member state in question, are not necessarily at variance with that.

...and on ERM II participation

Incidentally, the candidate countries, by their future participation in ERM II, are not merely fulfilling a formal condition, without which, under the terms of the Treaty, subsequent accession to the Eurosystem will not be possible. Instead, such participation provides the appropriate monetary policy framework for the phase of increasing convergence, in both nominal and real terms. On the one hand, that mechanism certainly permits continued exchange-rate adjustments, either by exploit-

ing the margins of fluctuation (which, at ± 15 %, are decidedly wide) or by means of formal realignments. On the other hand, for the currencies concerned, participation affords a certain protection against overly pronounced swings in short-term rates.

Unilateral introduction of the euro unwelcome

By contrast, any premature unilateral introduction of the euro ("euroisation") would be unwelcome in the eyes of the Community. It would run counter to accession to the Eurosystem under the Treaty, which envisages the introduction of the euro at the end of a structured convergence process, and also presupposes a mutual agreement on the appropriate exchange rates. Hence, after such a unilateral step, the countries concerned could not count on the support of the Eurosystem. They would therefore run the risk of relinquishing monetary policy sovereignty without being able to rely on the confidence-enhancing implications of participation in the Eurosystem.

Alternative strategy of early accession to the Eurosystem ...

From time to time, as an alternative strategy, early accession to monetary union is proposed – earlier, that is, than is possible if the conditions set under the Treaty are complied with strictly. That – it is alleged – might greatly expedite the convergence process. The stabilizing anchoring in the Eurosystem would – it is claimed – effectively protect the young financial systems from monetary crises; it would facilitate the deepening of economic and financial relations with other countries and would assist the transition countries in combating inflation all round. Structurally-induced price rises in the catching-up process due to productivity gains in the tradable-goods-producing sector pose, in the opinion of the advocates of this strategy, no risk to the countries themselves, since they do not affect the international competitiveness of the economy concerned. As regards price stability in the euro area, they are negligible anyway, given the limited scale of the Balassa-Samuelson effect and the low economic weight of the candidate countries. From various quarters, it has therefore even been suggested that the road to monetary union should be "facilitated" by easing the requirements for convergence under the Treaty.

... poses risks to international competitiveness

Quite apart from the fact that inflation is noxious even if it has no direct effects on international competitiveness, this line of argument is correct only in part. It is true that rises in the prices of non-tradables do not directly impair the international competitiveness of the country concerned. But, as the tertiary sector supplies intermediate inputs for industrial production, such rises play a role that must not be underrated in international competition between locations. Hence there are no grounds for being indifferent to price rises, even if the underlying reasons are traced back to sectoral productivity gains, which are characteristic of the real convergence process. For the rest, it should be borne in mind that inflation differentials between catching-up economies and highly developed economies cannot be ascribed to the aforementioned Balassa-Samuelson effect alone.

Only lasting progress towards convergence ....

By a careful review of the sustainability of the progress made towards convergence, the candidate countries must therefore be prevented from "paying for" premature acces-

sion to monetary union by means of lasting competitive disadvantages. This implies, *inter alia*, that price adjustments which may result from essential reforms should have been completed by the time of accession to monetary union.[5] In particular, care should be taken to ensure that any transitional arrangements expire in good time, or are reviewed carefully in the light of their potential implications for price stability.

... affords protection against conflicts of interest ...

Furthermore, if the convergence were insufficiently sustainable, it would be difficult, or even impossible, for a single monetary policy to do justice, at the same time, to the interests of both the more mature economies and the transition countries. This might engender tensions in the monetary policy decision-making process. That might well hamper a single interest-rate policy oriented towards the needs of the entire monetary area.

... and speculative attacks

It is also questionable whether premature accession to monetary union could really afford the hoped-for protection from speculative attacks on the financial markets (not all of which are fully developed) in some of the candidate countries. Participation in the larger currency area of the Eurosystem would, by definition, avert the risk of crises for an individual national currency, as well as the associated monetary risks. But the corresponding risk premiums would be reflected in the interest-rate level, and possibly also in financing difficulties besetting the candidate country in question, rather than in the exchange rate.

Moreover, support and aid measures would be possible at national level only on a very limited scale. And, if the European authorities felt obliged to counteract crisis-like developments in one of the participating countries by means of appropriate liquidity assistance, a loss of reputation by the entire monetary area, and therefore by the euro as well, could hardly be avoided. Within a monetary union, in particular, the risk of the contagion of regionally engendered financial market crises appears especially great. Consequently, the ability of individual member states to cope with the demands of the single monetary policy becomes a matter of common concern. The convergence criteria of the Maastricht Treaty take specific account of this conflict potential, and thereby strengthen not only cohesion in the monetary union but also investors' confidence in the common currency. This is why the Eurosystem makes particular demands on the competitiveness and functionality of member states' banking systems.

Summary

Being predominantly small open economies, which already conduct more than half of their foreign trade with the European Union, the candidates for accession have a strong interest in the stabilisation of their nominal exchange rates against the euro. However, exchange-rate stability that is to prove sustainable must be based on domestic stability. Premature accession to the Eurosystem that was not backed by adequate convergence

5 See: F. Coricelli and B. Jazbec (2001) loc. cit.

might pose substantial risks to all those concerned. It is essential, for the sake of all those involved, to prevent such consequent potential tensions.

The application of the existing treaties – without any further amendments – not only seems advisable on grounds of equity prior to the selection of future members, it also makes economic sense. The Treaty provides for clearly-defined steps towards integration, which build on one another, and for the implementation of which specific conditions must be fulfilled. For instance, the so-called Copenhagen criteria regulate accession to the EU, but at the same time they must be viewed against the backdrop of subsequent participation in the joint monetary union. The nominal convergence criteria, as conditions for participating in monetary union, supplement the political and real economic criteria of the EU accession process, which must be met beforehand.

Real and nominal convergence must go hand in hand in order to ensure, as far as possible, the tension-free functioning of the single monetary policy in an enlarged EMU. That is expressly confirmed by the Treaty. Article 121 of the EC Treaty not only lists the four often-specified nominal convergence criteria but also covers the results of the integration of markets, the situation and development of the balances of payments on current account, and the development of unit labour costs and other price indices. Thus, the criterion of sufficient real convergence does not constitute an additional obstacle to accession. In the final analysis, it is a matter of ensuring the sustainability of the convergence achieved, under the conditions of a unified monetary policy. The road to monetary union is mapped out clearly in the Treaty: just like the successful steps towards integration taken hitherto, the next steps, too, should be geared to the same objectives.