Reports from the Economic Research Centre

The Economic Research Centre holds regular conferences. In future, there will be a new section in the Monthly Report dedicated to reporting on these conferences. The first article in this new section concerns a conference on the EU's enlargement to the east. This new part of the Monthly Report will also contain a compilation of selected discussion papers written at the Research Centre. The main purpose of this is to introduce papers which do not already feature in other Monthly Report articles but which are expected to meet with quite broad public interest. These papers reflect the personal opinions of the authors and do not necessarily represent the views of the Bundesbank.

How to pave the road to E(M)U: the monetary side of the enlargement process (and its fiscal support)

A year ago the European Council decided to launch a dialogue between the European Union and the accession countries. This exchange of opinions is intended to achieve greater clarity as to how the parties involved view the road to the EU and the euro. With this in mind, the Bundesbank's Economic Research Centre, the National Bank of Hungary and the Center for Financial Studies at the University of Frankfurt co-hosted a conference in late October. This meeting was, above all, dedicated to addressing issues in connection with the monetary environment of the accession process. The conference was attended by academics, economists and decision-makers from the countries involved.

Focal topics of the conference

The conference programme had four focal topics (see the overview on page 81):

– Which exchange-rate regime seems best equipped to promote the convergence process in the accession countries over the coming years?

– Which monetary policy strategy should those countries choose?

– How have financial systems developed in the accession countries and what is the future outlook?

– What challenges will fiscal policymakers in the accession countries be facing in the years to come?

This conference revealed that, for a whole raft of issues, there are no great differences of opinion. Generally speaking, the major advances made in the transformation process were emphasised. There was also little apparent divergence of opinion about the significance of some key elements of the transformation process, such as the liberalisation and privatisation of the economy and, especially, of the financial markets. In other areas, though, there is evidently still a considerable need for debate, particularly about how quickly these countries should aim to join the new exchange-rate mechanism (ERM II) and at what time the euro can then be introduced in those countries.

In search of the right exchange-rate regime

Over the past decade, the transformation countries have chosen a variety of exchange-rate regimes, ranging from flexible exchange rates to systems in which exchange rates fluctuate within a band to currency boards. Many countries have also changed their exchange-rate regimes during this period. Despite this variety, the macroeconomic results have been relatively similar, especially the overall success in reining in the very high rates of inflation of the early nineties. This makes it clear that the microeconomic reform of institutions and markets was a priority over the past decade. Now that the structures have been more closely aligned with those of Western-style market economies, however, it may be expected that macro policy, including the choice of exchange-rate regime, will receive greater attention in future.

There was no consensus among the conference participants as to the best way of handling the convergence process in terms of exchange rates. At one end of the spectrum was a school of thought in favour of at least some central and east European countries joining ERM II as soon as possible and then keeping this stage as short as possible prior to entry into monetary union. The opposite view was that these countries should maintain the flexibility of their exchange rates for a number of years, using the freedom thus gained mainly to press ahead with the process of real convergence. The time spent in ERM II should also be used in that manner, it was said. Some researchers favoured a solution in which accession countries would unilaterally – and prior to monetary union – make the euro legal tender in their countries. That pro-

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Programme for the conference on 26 and 27 October 2001

Introductory Remarks by Ernst Welteke and Zsigmond Járai

The Transition Process after 10 Years: Achievements and Challenges Ahead
Jean Lemierre (EBRD)

Sustainable Regimes of Capital Movements in Accession Countries
David Begg (Birkbeck College), Barry Eichengreen (University of California), László Halpern (Hungarian Academy of Sciences), Jürgen von Hagen (University of Bonn), Charles Wyplosz (GIIS, Geneva)
Discussant: Beatrice Weder (University of Mainz)

Exchange Rate Regime Choice and Consequences
Holger Wolf (George Washington University)
Discussant: Roland Vaubel (University of Mannheim)

The Repercussions of EU-Enlargement for the Equilibrium Value of the Euro
Jerome Stein (Brown University)
Discussant: Palle Andersen (BIS)

Finance for Growth: Policy Choices in a Volatile World
Thorsten Beck (World Bank)
Discussant: Charles Wyplosz (GIIS, Geneva)

On Booms and Crashes: Financial Liberalization and Stock Market Cycles
Graciela Kaminsky (George Washington University), Sergio Schmukler (World Bank)
Discussant: Joseph Bisignano (BIS)

The Financial System in the Czech Republic, Hungary and Poland after the first Decade of Transition
Thomas Reininger, Franz Schardax, Martin Summer (Oesterreichische Nationalbank)
Discussant: György Szapáry (National Bank of Hungary)

Short Term Capital, Economic Transformation and EU Accession
Claudia Buch (University of Kiel), Lusine Lusinyan (European University Institute)
Discussant: Marko Skreb (IMF Advisor, Bank of Albania)

Central Banking and the Choice of Currency Regime in Accession Countries
Willem Buiter, Clemens Grafe (EBRD)
Discussant: Richard Portes (London Business School, CEPR)

Pitfalls in the European Enlargement Process – Challenges for Monetary Policy
Helmut Wagner (University of Hagen)
Discussant: Gerhard Illing (University of Munich)

Monetary Convergence of the EU Candidates to the Euro: Theoretical Framework and Policy Implications
Lucjan T. Orlowski (Sacred Heart University)
Discussant: Willy Friedmann (Deutsche Bundesbank)

Fiscal Challenges and Macroeconomic Stability in the Accession Countries
C. Maxwell Watson (IMF)
Discussant: André Sapir (European Commission, Université Libre de Bruxelles)

Fiscal Foundations of Convergence to European Union in Pre-Accession Transition Countries
László Halpern (Hungarian Academy of Sciences, CEPR)
Judit Neményi (Financial Research Ltd.)
Discussant: José Marin (European Central Bank)

Panel discussion: What are the Open Questions and What Did We Learn from the Conference?
Participants: Mitja Gaspari (The Bank of Slovenia)
Zsigmond Járai (National Bank of Hungary)
Klaus Regling (European Commission)
Jürgen Stark (Deutsche Bundesbank)
Zdenek Tuma (Czech National Bank)

Deutsche Bundesbank

posal encountered opposition, though. The differences of opinion are due to a range of differing assessments. For one thing, there was no consensus on the issue of whether it is only "extreme" exchange-rate regimes – freely floating exchange rates or rigid, institutionally fixed rates – that can be stable or whether in-between solutions are also possible. There were also varying assessments as to whether accession countries would be capable of forming an optimal currency area together with the euro-zone countries in the very near future, which would make fixed exchange rates seem prudent, or whether, say, asymmetrical shocks present a real danger, which would require flexible exchange rates.

In this debate, the issue of whether and to what extent short-term capital inflows and outflows can be expected to render an exchange-rate strategy more difficult in the years to come has gained a fair amount of importance. At the conference, empirical findings were presented which indicate that short-term capital flows into the accession countries are expected to increase strongly in future, but that such flows could reverse themselves just as quickly if conditions change. At any rate, experience has shown that capital flows are more important in developed economies with modern financial systems than would still appear to be the case in eastern Europe at present. Such a scenario indicates potential problems for which economic policymakers in those countries, in particular, have to be prepared.

In the debate, attention was also devoted to the Balassa-Samuelson effect. This postulates that countries in the catch-up process will tend to experience relatively sharp price increases in the non-traded goods sector, which, on balance, cause their currencies to appreciate in real terms. However, it is not clear how much of a factor this effect will be in future. What is more, it only shows up under certain conditions, and economic policymakers do have ways of counteracting it. Even so, there was a discussion on whether such an effect would justify modifying the Maastricht convergence criteria or whether these considerations would rule out rapid accession to monetary union.

Although the conference was principally dedicated to the potential challenges facing the accession countries, accession naturally also has many diverse implications for the economies already in monetary union. The Maastricht convergence criteria are a case in point; they were intended to protect stability policy from being undermined as a result of enlargement. Enlargement could well mean the equilibrium rate of the euro against non-euro-area countries will be different from that of the present euro zone. The NATREX model for describing equilibrium real exchange rates, which was presented at the conference, provides a framework for such analyses. For instance, it states that long-term exchange-rate effects will be influenced by whether accession leads to increased growth in Europe (which would favour a trend towards appreciation), or whether the need for investment in the enlarged Europe can only be met by the increased use of savings from non-euro-area countries (which would tend to have an adverse impact on the exchange rate).

Monetary policy strategy

The choice of exchange-rate regime is also a fundamentally important element of monetary policy in the economies in question. As long as countries permit at least a certain degree of flexibility in their exchange rates, central banks will have to decide on an independent monetary policy strategy. Many of those economies are relatively small, with exports and imports being a major factor. Such countries will therefore always need to pay attention to developments in their currencies' exchange rates and the consequences thereof.

The type of monetary policy strategy in which the exchange-rate regime should be embedded is open to debate. During the conference, the possibilities of a strategy of a medium-term inflation forecasting management were discussed in particular detail. However, it is evident that any forward-looking monetary policy strategy will encounter problems owing to limited past experience and the rapidity of change in those countries.

Significance of financial systems in eastern Europe

For the future road to enlargement of the EU and EMU, the financial systems of the accession countries are of crucial importance for a variety of reasons. International experience has shown that a well-functioning financial system is needed to complement a well-developing economy. Such a financial system can also make an important contribution to an economy's ability to withstand shocks at the lowest possible cost. In the final analysis, an efficient monetary policy is also dependent on being able to exert an impact on the economy through developed financial markets and financial institutions. During the conference, features which characterise internationally tried and tested systems were discussed. Experience has shown that competitive and liberal financial systems – albeit with clearly defined legal frameworks and effective supervisory structures – constitute a good basis for a prosperous economy. Whether a system is more bank-based or more financial-market-based is a secondary issue. What is more important is that market forces are given a chance to act. State-owned banks have often found it difficult to promote economic development, for example.

To some degree, the liberalisation of financial systems is either being put on hold or being undertaken only very cautiously out of fears of increased vulnerability to crises. An empirical study of liberalisation, investigating a large number of industrial and developing countries, concluded that, although stock-market volatility may increase immediately after government controls have been dismantled, liberalised stock markets are not inherently more prone to crises but actually more stable.

With that in mind, the financial systems in Poland, Hungary and the Czech Republic were analysed in depth. Despite differences of detail, major progress has been observed in all three countries over the past decade. Privatisation and foreign credit institutions' involvement in those countries have both had a positive impact. However, a number of indicators show that the standards of Western industrialised economies have not yet been achieved. That is true of the significance of bank loans and even more so of capital-market-based corporate financing. In that connection, however, attention should be drawn to the particular structures that exist in those countries. Specifically, many major direct investment projects are financed through foreign banks. Also, the efficiency of accession countries' financial institutions still appears to be below par in many cases. Lastly, a lack of legal certainty may present a barrier to the intensification of financial relationships. Although the legal foundations are mostly in place, there are also signs that the enforcement of legal claims is not always regulated in a satisfactory manner.

Fiscal policy facing major challenges

Over the next few years, fiscal policymakers in the central and east European countries will be facing a major challenge. It is true that the figures for government deficits and levels of debt are often more favourable than they were for some of today's euro-zone members during the preparatory phase prior to monetary union. However, some warning flags were raised during the conference. One point to ponder is that in many cases burdens from ancillary budgets still exist which have not yet been included in the official figures on public finances. That is a consequence of the need to restructure credit institutions with problem loans, for instance. However, it seems more important to note that these countries need to make up a lot of ground in terms of infrastructure investment, thus making it important to get their priorities right. And for that to happen, suitable political decision-making structures are necessary. When taking decisions on government revenue and expenditure, the first concern should be to ensure that the forces of growth are strengthened. For that reason, too, those countries have to set themselves particularly high efficiency and fiscal prudence standards since they are to a large extent dependent on other countries' confidence and willingness to invest.

The conference is likely to have contributed to raising awareness of the problems that lie ahead in the accession process. It has also promoted the ongoing dialogue between university academics and representatives of the institutions involved, as well as between the participants from eastern Europe and western Europe. The conference clearly showed how important it is for this exchange of opinions to be continued in the years to come.