International Center for Economic Growth
European Center

WORKING PAPERS

NR. 7.

MACROECONOMIC STUDIES

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Exchange rate regimes of Central and Eastern European EU candidate countries on their way to EMU

JANUARY 2002

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ACE project "Alternative exchange rate regimes in transition economies", workshop, Vienna, 21 September 2001

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1. INTRODUCTION

The paper starts from the description of alternative exchange rate regimes currently in use in Central and Eastern European EU candidate countries. Their present exchange rate arrangements differ substantially, as they cover the whole spectrum of possible solutions, from currency boards to floating exchange rate regimes. By now it is known that these countries will first enter the EU and the ERM 2 (exchange rate mechanism, devised for the so-called pre-in countries, as a preparatory stage before their EMU membership), and only a few years later join the EMU and adopt the euro. The paper therefore tries to evaluate present arrangements of the candidate countries from the point of view of how compatible these arrangements are with the future ERM 2 and EMU requirements.

On the basis of available information, both from the EU side (including the European central bank) and from the candidate countries themselves, the paper tries to identify the most likely timing of the entry of the best prepared candidate countries in the eurozone, but also considers alternative (optimistic and pessimistic) scenarios, which may lead to a too early or to a delayed entry of these countries in the eurozone. Related to this, the paper analyses some costs and risks involved in the case if one of these extreme scenarios in fact materialised, both from the point of view of the candidate countries and from the point of view of the EU side.

Finally, the paper touches upon the issue of nominal versus real convergence as a precondition for joining the eurozone for the candidate countries. For these countries, nominal convergence, embodied in the famous Maastricht convergence criteria, is being supplemented by real convergence, which means speeding or terminating the processes of transition, catching up and structural reform. The paper critically examines the concept of real convergence as a precondition for the entry of the candidate countries in the eurozone and warns against the misuse of this concept, which may result in unnecessary delay in joining the eurozone for these countries.

2. EXCHANGE RATE REGIMES OF CENTRAL AND EASTERN EUROPEAN EU CANDIDATE COUNTRIES

Discussions on optimal dynamics of the inclusion of CEE (Central and Eastern European EU candidate countries) in the eurozone conventionally start from the analysis of exchange rate regimes of these countries. In the process of joining the EU and the euro area their present exchange rate arrangements will at some point in time have to go through some changes before their final adoption of the euro. The sequence and timing of adaptations of their exchange rate regimes shed some light on the issue of optimal as well as on realistic dynamics of inclusion of CEE in the eurozone.

CEE presently use very different exchange rate regimes, covering practically the whole spectrum from rigidly fixed to free floating exchange rate arrangements. Very rigidly fixed exchange rate regimes in the form of currency boards are used in Bulgaria, Estonia, and Lithuania. Conventional fixed peg regime is used in Latvia. Hungary uses a more flexible

exchange rate arrangement in the form of a crawling peg. Slovenia and Romania use managed floating exchange rate regimes, while the Czech Republic, Slovakia and Poland use relatively free floating exchange rate regimes. These diverging views among the CEE on the optimality of the exchange rate arrangements are not a new development. Even at the outset of their transition process in early nineties they opted for different exchange rate regimes. In line with conventional wisdome at that time, which emphasised the role of the fixed exchange rate as a nominal anchor for macroeconomic stabilisation, majority of CEE decided for some form of a fixed exchange rate regime. Others, like Slovenia, against conventional wisdome, opted for more flexible solutions, even for a managed floating exchange rate regime. As all exchange rate arrangements basically performed well and fulfilled their main task of stabilising the economy and bringing down inflation rate of the CEE to the range of single digit figures, one can conclude that no single optimal exchange rate regime exists for CEE and that their choice of an appropriate exchange rate regime should be tailored according to their specific characteristics and priorities. Their choice of the exchange rate regime therefore reflects the main alternative focuses of their exchange rate policies - bringing down inflation, sustaining balance of payments equilibrium, dealing with large and volatile capital flows, stabilising the real exchange rate etc. Anyway, the view that the optimality of the exchange rate arrangements for the CEE can not be generalised mirrors in the position of the EU on the current exchange rate arrangements of the CEE. Until they join the EU, there are no restrictions on the choice of the exchange rate regime for the CEE.

In the period since the beginning of transition, most of CEE (except Baltic countries and Slovenia) experienced some shifts in their exchange rate regimes. Changes in the exchange rate regimes intensified particularly after currency crises in Asia and Russia. In turned out that some interim solutions, particularly fixed but adjustable exchange rate regimes, are specially vulnerable to speculative attacks related to currency crises. There seemed to be a tendency to move away from interim solutions in the direction of the so-called corner solutions, either in the form of rigidly fixed exchange rate regimes, such as currency boards, or in the form of more flexible exchange rate arrangements, such as managed or even free floating exchange rate regimes. A closer inspection of the exchange rate regime shifts, however, reveals that except for the case of Bulgaria, which moved from a floating exchange rate regime to a currency board as a result of specific circumstances (financial crush and the need to restore confidence), all other regime shifts were in fact in the direction towards more flexible solutions. In particular, The Czech Republic, Slovakia and Poland adopted flexible exchange rate regimes, which are close to free floating. This points to a certain contradiction. The move towards more flexible exchange rate arrangements appears to be in contrast with the supposed move towards more fixed exchange rate arrangements which monetary integration with the EU implies, as ultimately the inclusion of CEE in the euro area calls for an irrevocable fixing of the exchange rate and giving up the exchange rate altogether, when they adopt the euro. The question then is how and when this trend towards increased flexibility will turn around towards increased fixity of the exchange rate regimes and will this shift be the result of changes in underlying economic developments, or merely the result of external institutional constraint (formal requirements regarding exchange rate regimes of CEE in the process of their joining the EU and the eurozone).

3. EU EXCHANGE RATE STRATEGY FOR CENTRA AND EASTERN EUROPEAN EU CANDIDATE COUNTRIES

Until recently, EU strategy towards inclusion of CEE countries in the eurozone was rather vague or undefined, as the discussions on the issue seemed premature. Even simultaneous inclusion in the EU and in the euro area for CEE was not completely excluded, although signal were sent to CEE that this would not be a desirable option. In the last two years, EU institutions (European commission, ECOFIN, European central bank) defined their position, coordinated their views and presented rather elaborated strategies towards exchange rate regimes of CEE in their run-up to the EU and to the euro area.[1]

EU side (in this text we use this term as a shortcut expression, which combines the position of the above mentioned EU institutions) sees the inclusion of CEE in the eurozone as the final phase of their process of economic and monetary integration in the EU. This process is devided in three distinct phases. The first phase – preaccession phase - which lasts till the accession of CEE in the EU, gives CEE free hands in the choice of their exchange rate regimes. In this phase, their retain their monetary sovereignty, but have to adopt acquis communautaire in the field of EMU (completely liberalise capital flows, make their central banks independent, prohibit direct financing of the government by the central bank and prohibit privileged access of the government to financial institutions).

The second phase - accession phase - starts with the inclusion of CEE in the EU and ends with their inclusion in the eurozone. In this phase, CEE lose to a considerable degree (but not yet fully) their monetary sovereignty. As this is by far the most relevant phase for the topic of the paper, we will look at it more closely in the following.

The third phase - euro phase - starts when CEE meet the required criteria for the inclusion in the eurozone, adopt the euro and give up their own national currencies. From there on, CEE have equal rights and obligations in the conduct of the single European monetary policy as any other EU members of the eurozone.

In the second, accession phase, exchange rates of the CEE become the matter of the common concern. In particular, excessive exchange rate fluctuations or misalignments of their exchange rates would be considered inconsistent with the proper functioning of the single market, i.e. potentially harmful to other EU members. In this context it should be mentioned that with their accession, economic policies of CEE also become a matter of common concern and become subject to coordination and common surveillance procedures. Finally, as EU members, CEE have to share the aims of economic and monetary union. In other words, contrary to some incumbent members of the EU, new entrants will not be given the possibility to opt-out of joining the euro area. As a part of their EU package CEE will at some point - when they are assessed as ready - finally have to adopt the euro even if they

[1] Strategy of the EU side towards CEE exchange rate regimes on their way to eurozone can be discerned from European commission (2000), ECOFIN council (2001) and European central bank (2000). For the IMF view on exchange rate regimes of the CEE on their way to EMU, see IMF (2000).

opposed it. However, this is not a very relevant concern, since most CEE expressed their ambition to join the euro area as soon as possible, perhaps even at the time of their EU accession.

By now it is clear that the EU position on this issue is very firm: When joining the EU, CEE can not simultaneously join the euro area, even if they had that ambition, for both economic and administrative reasons. Among economic arguments, EU emphasises the following ones: even when joining the EU, CEE will not be completely normally functioning economies similar to the incumbent EU members; single market which they will join at the time of EU accession can only be a starting point for assessing their readiness for monetary integration with the EU, which means they are not directly comparable or on the same level playing field; even with all their pre-accession adjustments and adoption of the acquis communautaire, joining the EU will in itself be a big shock which will require additional adjustment; they need to converge in real terms in parallel or before concentrating their efforts on meeting nominal convergence criteria; because of the inherent transitional and catching-up price dynamics they have to retain some flexibility in their nominal exchange rates. Some of these economic arguments reappear later in the discussion on real vs. nominal convergence.

The administrative reasons, which prevent CEE from simultaneously entering the EU and the euro zone, are the following: In order to meet the Maastricht convergence criterion of exchange rate stability, as one of the preconditions for joining the eurozone, CEE will have to participate for at least two years in the ERM 2 (Exchange rate mechanism 2), a specific system of a fixed, but adjustable exchange rates. ERM 2, as a successor of ERM, which ceased to exist with the introduction of EMU in 1999, is designed for the so called pre-ins, EU member countries which are not yet ready for joining the euro area. According to present rules, CEE can not join ERM 2 before their EU accession, which means that for administrative reasons only - even if they fulfilled all other Maastricht convergence criteria and were able to demonstrate their readiness to adopt the euro - they would have to wait for at least two years before being admitted to euro the area.

4. ERM 2 AND CENTRAL AND EASTERN EUROPEAN EU CANDIDATE COUNTRIES

Participation in the ERM 2 is formally voluntary, but CEE are expected to join this mechanism at the time of their accession to the EU or somewhat later. However, if we combine the fact that on the one hand joining the euro area is ultimately an obligation for CEE, and that on the other hand participation in the ERM 2 is mandatory for candidate countries, who want to join the euro area, it turns out that the ERM 2 is in fact mandatory for CEE. Are there any degrees of freedom for CEE in deciding at least on the timing of their ERM 2 membership?

First let us review the main characteristics of the ERM 2. Basically, it is a system of a fixed, but adjustable exchange rate. Contrary to former ERM, which was a multilateral system of exchange rates among each pair of member countries' currencies, ERM 2 is a bilateral relation between a member currency and the euro. Central rate in euro is determined jointly

with the ECB (European central bank), and so is the band of permissible fluctuations of the market exchange rate around the central rate. CEE will use a wider band of +/- 15% around the central rate, although narrower band of +/-2,25% is in principle also possible, if CEE performances justified it and ECB agreed to it. Intervention at the margins of the fluctuation bands is mandatory and unlimited, except for the fact that ECB can refrain from supporting the exchange rate of a currency in the ERM 2, if it was considered to be against the goal of price stability in the euro area as a whole. Realignment of the central rate is possible by agreement with the ECB, if the central rate was seriously misaligned. In principle, realignment of the central rate is possible in both directions, but as the Maastricht criterion on exchange rate stability requires that a currency is kept for two years between normal fluctuation margins without devaluation of the currency at the country's own initiative, the possibility for realignment is in fact asymmetric. Devaluation of the currency would postpone the entry in the eurozone of the country in question for a certain period, since it would have to demonstrate exchange rate stability for additional two years, starting from the moment of devaluation. Obviously, characteristics of ERM 2 make it a flexible enough mechanism to give room for required flexibility of the exchange rates of CEE in the interim period, while preparing them for their later participation in the euro area.

CEE will probably not be able to by-pass the ERM 2. Slovenia tried in the process of negotiations with the EU to ask for an exemption, which would enable it to by-pass the ERM 2 and open the possibility for an early inclusion in the euro area, perhaps even at the time of Slovenian accession in the EU, by insisting that factual stability of the exchange rate before the EU entry should satisfy the Maastricht exchange rate criterion. As the EU responded negatively to this initiative, which was considered incompatible with the acquis on EMU, Slovenia withdrew its proposal from its negotiating position. There is still some possibility for by-passing the ERM 2 for the CEE countries, but the chances are slim and exogenous from their point of view. Namely, Great Britain and Sweden oppose to ERM 2 being a mandatory interim mechanism, which they will first have to go through, when and if they at last decided to join the euro area. These countries claim that ERM 2 is not funded in the Treaty on European union, but that it is an intergovernmental agreement, which is less binding and easier to change, if circumstances called for such a change. Additionally, some arguments against the strict interpretation of the participation in the ERM 2 as a criterion of exchange rate stability can be found in the case of Italy and Finland, which at the time of the formal assessment of their readiness for joining the euro area (fulfilment of the Maastricht convergence criteria) had not been participating in the ERM for two years yet.

Regardless of these considerations, CEE are expected to join the ERM 2 at some point in time, possibly at the time of their EU accession or somewhat later. ERM 2 is currently not open to non-members of the EU, so according to present rules CEE can not join it earlier than when becoming full EU members. They can apply for the membership in the ERM 2 at any time after their EU accession, but the criteria for the membership in the ERM 2 are not very transparent. The decision to accept a new member is the result of a multilateral procedure involving many countries, ad hoc criteria and discretion, so ex ante it is difficult to assess the outcome. The message is that CEE can not a priory expect an early membership in the ERM 2 immediately after EU accession, as the procedure allows the EU side some discretion and room for delaying, if it was in their interest to do so. However, CEE membership in the ERM

2 relatively soon after their EU accession seems most likely, perhaps after allowing for technicalities of the procedure for accepting new members to take a couple of months. Question remains, what would happen if CEE themselves delayed the entry in the ERM 2 like Sweden does. Although this does not seem to be a realistic option, it would be interesting to see whether the EU side in that case would rush and pressure these countries to join the ERM 2, taking into account that their ultimate membership in the euro area is mandatory.

Scenario of the monetary integration of the CEE according to presently available information is therefore the following. At the time of their EU accession or (shortly) afterwards, CEE will join the ERM 2, but will have a derogation with regard to the euro. They will have to participate in the ERM 2 for at least two years or more, depending on their fulfilment of the Maastricht convergence criteria on a sustainable and healthy basis. They can be assessed for their readiness to adopt the euro anytime at their request or at least every two years. The rules for the new candidates for the euro area are the same as they were in the case of the present euro area members. It is very likely that CEE will not be given some discounts regarding their meeting of the fiscal Maastricht convergence criteria, as was the case for some EU incumbent members. Recently, some claims emerged in academic literature for adjusting the Maastricht convergence criteria, particularly the inflation rate criterion, to the new circumstances, to take account of the transition-specific price dynamics of the CEE.[2]

Until recently, ERM 2 was considered to be a specific homogenous mechanism, whose main characteristics and rules treat all its members in the same way. However, EU side lately changed its attitude somewhat, and interpret the ERM 2 as a broader framework, which can accommodate different exchange rate regimes of individual CEE countries. The idea is to enable those countries, whose exchange rate regimes are compatible with the ERM 2, to avoid double switch in their exchange rate regimes. In the case of a currency board, a country does not have to exit from the currency board to enter the ERM 2, but can enter the ERM 2 with the currency board. In a sense, although participating in the ERM 2, a country can thus directly switch to the euro from the currency board, without unnecessary shifts in the exchange rate regime. Of course, the EU side reserved some discretion as regards the assessment if a concrete exchange rate regime is in fact compatible with the ERM 2 requirements, and as regards ECB assuming any additional obligations from such more binding unilateral commitments beyond its regular ERM 2 obligations. Most of the current exchange rate regimes of the CEE seen in this light seem compatible with the ERM 2. Exemptions are floating exchange rate regimes, crawling pegs and fixed exchange rates, pegged to another (non-euro) currency. Before entering the ERM 2 these three exchange rate regimes will have to be adjusted, since they either do not have a central rate, or adjust it automatically, or are pegged against the wrong currency or basket of currencies. The position of the EU side against the recently fashionable proposals from the CEE for unilateral euroisation is for the moment less defined.[3] In principle, euroisation is considered to be contrary to the concept and rules of monetary integration of the CEE, which the EU side sees

[2] Suggestions to change the Maastricht convergence criteria in the case of CEE are given in Pelkmans et al (2000) and Szapary (2000).

[3] Some arguments for unilateral euroisation of CEE are given in Rostovski (2000) and Nuti (2000).

as a multilateral, successive and phased process. The fact that some of the exchange rate regimes, which CEE use currently, are more compatible with the ERM 2 requirements than some others, does not necessarily mean that those countries are better prepared to join the euro area. Which criteria should be used when assessing relative readiness of individual CEE for joining the euro area is left for the discussion in the final part of the paper.

5. Dynamics of Inclusion of Central and Eastern European EU Candidate Countries in the Eurozone

Taking into account recently elaborated EU strategies towards CEE exchange rate regimes and particularly the role of the ERM 2 in their run-up to the eurozone, which were discussed in previous parts of the paper, what can be said about the timing of entry of CEE in the eurozone? First, it is obvious that not all ten CEE are equally ready for monetary integration. We will concentrate on the timing of the entry in the eurozone for those best prepared, while others are expected to follow in the next couple of years. Second, we start from the assumption that the best prepared CEE are willing to join the euro area as soon as possible and that they are successful in meeting required preconditions (real and nominal convergence) in time. Third, any discussion on the timing of the entry of CEE in the eurozone can only be speculative, since there are three uncertainties involved in their the euro dynamics: Uncertainty about the timing of their EU accession, about the timing of their ERM 2 entry and about the timing of their joining the eurozone. Each of these three phases has its own uncertain dynamics, which can combine to quite a large error in the estimated timing of the entry of the best prepared CEE in the euro area.

What are the interests of both involved parties, EU side and CEE, concerning the dynamics of inclusion of CEE in the eurozone? Generally speaking, CEE, particularly the best prepared ones, are in favour of an early accession to the eurozone. Their strategies reflect their ambition to join the euro area as soon as possible.[4] On the other hand, EU side warns against premature entry of CEE in the eurozone and seems to prefer a delayed "wait and see" approach. In fact, according to the EU side, CEE should join the euro area when they are ready (fulfil the Maastricht convergence criteria on a healthy and sustainable basis), but added to this are some pessimistic economic assumptions, demanding preconditions and administrative barriers, which altogether require a long process of adjustment and preparations of CEE. EU institutions also seem to favour as much discretion as possible in this matter, just to be on the safe side.

Since the attitudes of CEE and of the EU side concerning the timinig of CEE entry in the eurozone are obviously diverging, the outcome will be the result of the balance of powers between the two sides. As CEE are "joining the club", the balance of powers is asymmetric, which means that the timing of their eurozone entry will be from the point of view of CEE more or less exogenous, i.e. externally determined.

[4] Strategy of CEE regarding the timing of their EMU accession can be discerned from European Parliament (1999).

What are the risks from a premature inclusion of CEE in the eurozone for the EU side and for the CEE? As far as the EU side is concerned, the risks which call for their overcautious approach to the timing of the entry of CEE in the eurozone are the following: Inclusion of supposedly weaker currencies of CEE could endanger stability and credibility of the euro, could require financial assistance to help CEE deal with asymmetric shocks in the monetary union, could lead to a bias in the decision making process in the ECB, leading perhaps to looser or more accommodative single European monetary policy. This arguments can be opposed on the ground that the share of CEE (in terms of GDP or monetary aggregates) in the eurozone and in the Eurosystem will be almost negligible, and that it can not be assumed that CEE are a priori inclined to less stable financial policies, particularly after many years of adjustment which they went through or still have to go through.

Risks from joining the eurozone for CEE countries undoubtedly exist, but they are in principle similar to those of the EU countries. They will lose their monetary policy and exchange rate instruments, but it has to be said that in the process of joining the EU and particularly the ERM 2 they will lose much of their monetary sovereignty anyway, so joining the eurozone will imply only residual loss of their monetary autonomy. The risks CEE will be exposed to in the euro area are conditional. If they will suffer specific asymmetric shocks, and if alternative adjustment mechanisms (such as wage flexibility in the first place) do not work, they could suffer some decline in growth and employment. This risks need not be too pronounced or specific for them, at least from an ex ante perspective and taking into account that they still have a number of years ahead to undertake needed adjustment and to prepare themselves for participation in the monetary union. Even if these risks in the worse case scenario materialised, their position would still not be much different from that of the regions within federal states, which suffer an asymmetric shock within the "monetary union", which in a sense a federal state represents from a monetary point of view. However, in the regional adjustment process in federal "monetary unions" some additional instruments of adjustment (common fiscal policy, migration of labour) can be activated more easily than in international monetary unions which lack a strong supranational state. These risks should be in the first place concern and responsibility of CEE themselves. In the period of preparations they should work on eliminating the causes of domestic asymmetric shocks, and on making their adjustment mechanisms (labour and product markets) more flexible.

On the other hand, there are also obvious benefits for CEE from their early inclusion in the eurozone. The benefits of joining the euro area for CEE are similar to those of the EU countries. There are microeconomic advantages (elimination of exchange rate fluctuations, risks and costs, elimination of currency conversion costs, transparency of prices) and macroeconomic advantages (lowering of the inflation rate and of the interest rate), which CEE can start collecting as soon as they join the eurozone. If it turns out that CEE can expect net benefits (higher benefits than costs) from the inclusion in the eurozone, which seems to be the case, they should aim at joining the eurozone as soon as possible in order to collect these net benefits as soon as possible.

Another argument for an early inclusion of CEE in the eurozone can be found in the fact that in the process of their EU approximation these countries had to liberalise their capital flows almost completely. Before their membership in the EU and in the eurozone they are

particularly exposed to potentially volatile speculative capital flows, but have no instruments to protect themselves against them and no support from the EU side, which EU and eurozone members have at their disposal. Once they join the eurozone, their exchange rates can no longer be subject to speculative attacks and they can count on balance of payments support in case of serious asymmetric shocks.

Finally, there are also some political or prestigious reasons for an early membership in the eurozone from the point of view of individual CEE, which has to do with their rivalry and ambition to be in the first group of new countries to adopt the euro.

Three alternative scenarios with respect to the timing of CEE entry in the eurozone reflect opposing views of the EU side and CEE and balance of powers between them. From the point of vies of possibilities for an early inclusion of CEE in the eurozone the following scenarios can be suggested:

1. Optimistic scenario: EU entry in 2003-2004, entry in the ERM 2 at the same time, entry in the eurozone two years later, in 2006. This is the first theoretical date for the adoption of the euro for the best prepared CEE. Optimistic scenario seems very unlikely from the present perspective, as it would require good results in structural reforms and successful fulfilment of the convergence criteria in CEE, technical efficiency in the assessment the readiness of CEE for joining the ERM 2 and the eurozone, and some change in the so far conservative attitude of the EU side towards monetary integration of CEE.

2. Pessimistic scenario: EU entry in 2005-2006, entry in the ERM 2 a year later, entry in the eurozone four to five years later, which gives a range between 2010 and 2012 for CEE to adopt the euro. Realisation of a pessimistic scenario would require exactly opposite assumptions than in the case of an optimistic scenario. Taking into account the attitudes of the EU side and balance of powers to support it, pessimistic scenario from today's perspective seems more likely than the optimistic one.

3. Realistic scenario: EU entry in 2004-2005, entry in the ERM 2 half a year later and entry in the eurozone two and a half to three years later, which gives a range between 2007 and mid 2008 for CEE to adopt the euro. Realistic scenario still gives the group of say 2-3 best prepared CEE countries around seven years to undertake necessary adjustment and preparations, which is much, considering the adjustment effort they had to undertake in the past ten years of their transition and EU approximation. Other less prepared CEE could follow in some 2-3 years, and most problematic probably in some 5 years.

6. NOMINAL VERSUS REAL CONVERGENCE ISSUE

The EU side emphasises that criteria for the admission of new members to the eurozone will be the same as criteria that were used for the selection of the present members of the euro area. This means that meeting the Maastricht convergence criteria on a healthy and sustainable basis should be for CEE a necessary and sufficient precondition for their accession in the eurozone. However, starting from their transition-specific characteristics, for

CEE an additional precondition, labelled as real convergence, was introduced lately. Their real convergence should take place in parallel to their nominal convergence or in fact before it, since the idea is that CEE can not be properly assessed for nominal convergence until they converge enough in real terms. Real convergence is understood as catching-up in the level of their GDP per capita towards the average in the EU, implementation of necessary structural reforms and termination of their process of transition. The concept of real convergence is rather vague, and no specific indicators which could be assessed in quantitative terms are suggested as real convergence criteria, although it can not be excluded that such formal criteria may emerge in time.

It can be argued that the concept of real convergence was introduced for the CEE because of the fear that after joining the EU, CEE would be able to fulfil the nominal convergence criteria relatively quickly, so that it would be difficult for the EU side to find arguments and instruments to keep them out of the eurozone, if it considered their membership in the euro area as premature. It is to be reminded that the Maastricht convergence criteria failed in keeping out the Southern, supposedly financially more problematic EU members out of the eurozone. This can explain why the concept of real convergence was introduced - to allow some discretion of the EU side for keeping CEE out of the eurozone for a while, if necessary. The concept of real convergence can be dangerous since because of its discretionary nature it can be misused to postpone the entry of CEE in the eurozone into indefinite future. When will CEE converge enough in real terms? Catching-up, even if not interrupted, is a lengthy process, transition in a sense that CEE are still different from EU countries will hardly ever end, structural reforms can also last forever.

The main question in the nominal versus real convergence debate is probably the following one: Is monetary integration among countries at the different level of economic development possible? The answer should be yes. Historical monetary unions, existing monetary unions, and even European monetary union itself, which includes member countries with considerably different GDP per capital levels, demonstrate this. Perhaps it would be easier to run a monetary union with member countries at the same level of economic development, but in reality this never happens. What matters most is the readiness of member countries to conduct responsible monetary and fiscal policies, if the monetary union is to survive. Another argument in support of the case can be found in federal states, which are conditionally speaking “monetary unions”, normally consisting of regions at the different levels of economic development (take as an example Italy with its developed northern and underdeveloped southern regions). However, as was mentioned before, monetary unions at the international level are more demanding than those at the national level, since a country can use additional mechanisms of adjustment to deal with regional asymmetric shocks in a “monetary union”.

Finally, it is evident that not all CEE are equally suitable and prepared for monetary integration. A convoy approach to the accession of CEE in the eurozone would not be appropriate. Best prepared candidates should not wait for the others, but go ahead, join the eurozone and themselves set an example that CEE can be successful members of the euro area. Given the problems with interpreting and measuring nominal and real convergence, discussed earlier in the paper, it is evidently difficult to assess even relative readiness of

individual accession countries for their joining the process of monetary integration. Maastricht convergence criteria alone, at least in this stage, may be misleading, due to conceptional, interpretational and methodological problems of applying them to CEE. Additional help can come from comparisons based on their real convergence. Finally, some optimum currency area indicators can shed some light on realitive suitability of individual CEE for joining the euro area.

In concluding, according to optimum currency area criteria Slovenia seems to be a country suitable for joining monetary integration.[5] It is a small, open and diversified economy, with its trade and financial links geographically concentrated towards the EU. First empirical investigations show that Slovenia is cyclically rather synchronised with the EU, and that its trade structure is similar to the trade structure of the EU countries, so Slovenia should not expect serious asymmetric shocks, which would cause problems for its economy once in the eurozone.[6] How much other alternative mechanisms of adjustment (such as flexibility of the labour market) will be flexible at the time of Slovenian accession in the eurozone is at this stage hard to predict. According to fulfilment of the nominal convergence criteria, Slovenia can be grouped among best prepared countries, as it meets both fiscal Maastrich convergence criteria, while the three monetary criteria which at the moment are not meet, will be at the focus of economic policy in the next few years before Slovenia's EU and eurozone accession. Finally, Slovenia compares well in terms of real convergence, as its GDP per capita is by far the highest within the group of CEE. It is already rather close to the EU average and catching-up with the lowest per capita income countries of the eurozone.

7. Conclusions

The paper started from discussing alternative exchange rate regimes of CEE with an ambition to assess their relative compatibility with the EU-determined exchange rate strategy for CEE in their run-up to the eurozone. A special emphasis was given to the analysis of the ERM 2 as an interim exchange rate mechanisms, which CEE will have to participate in for a certain period, before being admitted to the euro area.

In order to shed some light on the dynamics of the inclusion of CEE in the eurozone, the paper tried to identify the interests of CEE and of the EU side with respect to the timing of CEE entry in the eurozone, and found these interests to be diverging. Taking into account the balance of powers between both sides and after elaborating some arguments for and against an early compared to a delayed entry of these countries in the euro area, an attempt was made to present three scenarios (optimistic, pessimistic and realistic) with respect to the timing of CEE entry in the eurozone.

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[5] For more details on Slovenian exchange rate regime on the way to EMU, see Lavrač (1999). Some more details on Slovenian compatibility with nominal convergence criteria and optimum currency area criteria are given in Lavrač (2000).

[6] For some preliminary emiprical research on optimum currency area criteria for CEE, see De Grauwe and Lavrač (1999).

Next, the paper touched upon the debate of nominal versus real convergence and its relevance for the dynamics of inclusion of CEE in the euro area. The conclusion is that the concept of real convergence can be dangerous if misused, since it gives the EU side too much discretion and the possibility to delay the adoption of the euro even for the best prepared CEE into indefinite future, against the ambitions of the CEE. Finally, it is argued that CEE should not be treated as a homogenous group (convoy approach), but that the best prepared candidates should go forward and themselves set an example. It is difficult to assess relative readiness and suitability of individual CEE for monetary integration, but some combination of nominal and real convergence criteria, as well as of optimum currency area criteria should be helpful, particularly if all of these indicators pointed to the same direction.

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