

**MONETARY, FISCAL AND EXCHANGE RATE POLICIES FROM  
THE VIEWPOINT OF THE ENLARGEMENT OF THE EUROZONE:  
SURVEY OF THE LITERATURE**

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## ABSTRACT

The paper surveys recent academic literature in monetary policy, fiscal policy and exchange rate policy from the viewpoint of the eastward enlargement of the eurozone. It starts by overviewing some currently most debated issues in the area of monetary policy, first in general, then from the point of the ECB (European Central Bank) and finally from the point of view of CEEC (Central and Eastern European EU candidate countries) in their run up to the EU and to the eurozone. The paper also overviews some fiscal policy and exchange rate policy dilemmas of CEEC related to their monetary policies and finally touches upon the issue of optimal dynamics of the entry of CEEC in the eurozone.

***Key words:***

*economic and monetary union*

*eurozone,*

*euro,*

*monetary policy,*

*fiscal policy,*

*exchange rate policy*

## **INTRODUCTION**

It is expected that Central and Eastern European EU candidate countries (CEEC) will join the EMU (European Monetary Union) in a couple of years after their accession in the EU. The eastward enlargement of the eurozone will bring new challenges to both EU countries and CEEC. This paper surveys recent academic literature and identifies some open questions in monetary, fiscal and exchange rate policy, seen from the viewpoint of the eastward enlargement of the eurozone. The focus of the paper is on monetary policy issues. Monetary integration in general, and monetary union as its highest stage in particular, is about giving up national monetary policy autonomy in favour of the single currency and single monetary policy. However, this survey should not confine itself solely to monetary questions, as both fiscal policies and exchange rate policies have a direct impact on the conduct of monetary policies and can be crucial for the success of the European single monetary policy.

The paper is organised in three separate, although related parts. The first part overviews monetary policy issues, the second discusses fiscal policy issues and the third part surveys exchange rate policies of CEEC on their way to the EMU. The last part draws some overall conclusions.

## **I. MONETARY POLICY**

Research on eastward enlargement of the eurozone involves monetary policy issues both in the EU member countries and in CEEC. In this survey we will first shortly focus on some more general monetary policy issues dealt with in recent academic literature, and then concentrate on some more specific problems of monetary policy, first from the point of view of the European central bank and then from the point of view of CEEC.

Recent academic literature on monetary policy issues covers a very wide spectrum of topics within the central theme of what central bankers do or should be doing (for a survey, see Clarida, 1999, King, 2000, Herrero, 2001). In this survey we can have only a very limited ambition to discuss some of the issues which may have a particular relevance for

the topic of the eastward enlargement of the eurozone. In this context, we limit ourselves to two general issues: a) the ultimate goal of monetary policy, which involves discussion on price stability and on specifics of monetary policy in low inflation environment, and b) the intermediate target of monetary policy, which involves discussion on alternative monetary strategies and on inflation targeting in particular.

Considering the ultimate goal of the monetary policy and the primary responsibility of a central bank the literature now widely agrees that the final goal of monetary policy should be (only) price stability. This final goal is being increasingly incorporated in the statutes of national central banks, including the ECB and those of the candidate countries. The question remains whether this should be the sole ultimate goal of monetary policy or there is room for any other additional goals which central banks should try to achieve with their monetary policies? There is a common understanding that price stability should have a definite and explicit primacy over any alternative final goals, such as output or employment stabilisation (Feldstein, 1999, Smets, 2000, Oesterreichische nationalbank 1999, ECB 2001). Such alternative goals should be clearly subordinated to the goal of price stability and pursued only to the extent where they are not in conflict with the primary goal. However, it is recognised that in practice, central banks in the actual conduct of their monetary policies sometimes follow some simple rules, such as Taylor rule or Taylor-type rules, where in setting the interest rate they take account of both inflation and output gaps (Clarida, 1998, McCallum, 1997, Taylor, 1999a and b).

A related question is what is actually meant by price stability, how it should be determined and measured. In particular, does it mean zero inflation rate, or is perhaps some low level inflation rate consistent with the idea of price stability? As the result of experience of past decades price stability is now widely accepted as a value per se, which led to its unquestioned position as an ultimate goal of monetary policy. Inflation is detrimental for long term growth. Phillips curve is considered to be vertical, which means there is no trade-off between inflation and unemployment. By higher inflation a country does not get more growth and/or employment but just ends up with more inflation. Inflation has serious negative economic effects, as it impairs the functions of money, distorts price signals, causes additional costs (such as shoe-leather costs, having to do with activities devoted to

economising on money held, and such as menu costs, having to do with frequent pricing changes) and leads to socially undesirable redistributions. The effects of inflation of course depend on how far an economy is indexed, whether there is some money illusion and possibility for surprise inflation and which rigidities, nominal or real, prevail in the economy.

However, recent monetary literature emphasizes specifics of low inflation (Akerlof, 1996, Svensson, 2000, Herrero, 2001). According to these views, Phillips curve may at low inflation level be sloped, and there may be some gains from low inflation, particularly if nominal rigidities prevail over real rigidities in the economy. Low inflation can have some beneficial effects, like allowing for an easier adjustment of relative prices (the so-called grease in the wheels effect). Other authors, however, find evidence of opposite effect, particularly when real rigidities prevail. According to them, even low inflation is harmful (the so called sand in the wheels effect).

Conduct of monetary policy in an environment of low inflation gave rise to a discussion on some specific issues in the academic literature, such as zero-bound problem and the problem of measurement (overstatement) of inflation (Svensson, 1999a, Herrero, 2001, Akerlof, 1996). According to the first, with very low inflation there is a natural limit to lowering of the interest rate, when it approaches the zero value, as it can not become negative in nominal terms. According to zero-bound view in this case monetary policy loses its most important instrument and can become ineffective. Opponents argue that there are other mechanisms of transmission and instruments which can be activated so that monetary policy remains effective. The second problem is related to the measurement of inflation, particularly to possible overstatement of inflation. This may have as a consequence that at a low level of inflation deflationary pressures are in fact present, which give rise to different problems and tasks for the monetary policy. Both these concerns combine to the belief that some low level inflation can be more desirable than setting the price stability goal of the monetary policy actually at zero inflation rate.

The second issue on which we concentrate in this survey is the choice of the monetary strategy among alternative available monetary frameworks such as monetary targeting,

inflation targeting and exchange rate targeting (Mahadeva, 2000). In recent academic literature particular emphasis is being given to inflation targeting as a relatively new and still evolving monetary strategy (Mishkin, 1999 and 2000, Svensson, 1997, Bernake, 2000, Haldane, 1995). Adopting inflation targeting as a monetary framework is a fashionable trend also in practice, since an increasing number of countries are actually adopting this monetary strategy while others are still considering to switch to it. Inflation targeters are to be found in all groups of countries, including the transition economies. In comparison with other alternative monetary strategies, inflation targeters perform better (Mishkin, 2001).

Inflation targeting in fact can mean quite different arrangements with differing technical solutions, which share the common principle – to anchor inflationary expectations by giving clear and transparent commitment to the public by the monetary authorities. Some open questions (Smets, 2000, Svensson, 1999b, Mishkin, 2000) remain the following: a) What should be targeted, inflation rate or price level? b) Point inflation rate or inflation band? c) Band with the middle point or without it? d) Closed band or one-sided open band? e) Length of the targeted horizon? f) Use of escape clauses in case of missing the target? g) What price index to use? h) Core or headline inflation? One specific question dealt in the literature is the role of asset prices in inflation targeting (Bernake, 2000, Mishkin, 2001). Should asset prices such as housing prices, stock prices and exchange rates be included in price indices and thus targeted? The prevailing view is that asset prices should be helpful in preparing inflation forecasts, but that the central banks should not try to control such overall price indices and target asset prices directly, mostly because of the problem of identifying the bubbles in asset prices.

Next we move from these more general issues of monetary policy dealt with in the academic literature to those more directly relevant for the theme of the paper, first to those having to do with the ECB and the conduct of the single European monetary policy since the move to EMU in 1999 (Begg, 1998, Favero, 2000, Buiter, 1999, ECB, 1999 and 2001, Gaspar, 2001, Gerlach, 1999 and 2000, Issing, 2000). The issues which were discussed rather critically in the literature can be grouped under these main headings: a) ultimate goal of the ECB (price stability), its concrete definition (inflation rate of 0-2 per cent in the medium term) and the results in achieving it, b) monetary strategy of the ECB (two pillars

strategy, which many authors find an unclear and inconsistent mix of monetary targeting and inflation targeting), c) exchange rate policy of the ECB (benign neglect concept, with discrete interventions as opposed to the rules, such as target zones), including the weakness of the euro, d) issues of independence, accountability and transparency of the ECB, including the communication of its monetary policy decisions to the public, e) problems of leading the single European monetary policy compared to national monetary policies (with issues such as lack of track record and inherited credibility, stability of money demand in new circumstances, differences in transmission mechanisms among member countries, and how to accommodate national specific cycles into “average” economic conditions in the eurozone which a single monetary policy should be addressing).

However, from the point of view of the Eastward enlargement of the eurozone, the most important question concerning the ECB is the following: Is there a danger for the single European monetary policy from letting CEEC join the eurozone, and in particular, from letting them join the eurozone too early? The assumption here is that the first theoretically possible date for CEEC for joining the eurozone is 2006. This is based on the assumption of their joining the EU and the ERM 2 in 2004 and their joining the eurozone two years later, in 2006. The more realistic scenarios which add legal, technical and economic reason for delaying somewhat this process, do not define this time frame precisely, but have in mind postponing the entry of CEEC in the eurozone for a couple of years.

Can the inclusion of CEEC supposedly weaker currencies in the euro area lead to additional problems of the European single monetary policy and to the less stable euro? In particular, can it corrupt the decision-making process in the ECB when formulating its monetary policy, leading to lower credibility of the ECB and to easing of the single European monetary policy? For various reasons we think that these potential dangers should not materialise: a) by that time, after all the adjustments having been made and the Maastricht convergence criteria fulfilled, the currencies of CEEC need not be less stable, b) being small countries (with some exception of Poland) their combined weight in the euro is negligible, so they can not have an effect on the euro that would be worth mentioning, c) decision making process on the single European monetary policy in the ECB is based on stability culture, and not on weighing and averaging individual nationally

determined interests regarding monetary policy, d) with the inclusion of CEEC in the eurosystem, the rules and procedures of decision making on the single monetary policy in the ECB may change, so as to accommodate the larger number of countries in the governing board of the ECB without making the decision making process on single monetary policy too complicated and inefficient.

We not turn to monetary policies of CEEC with particular view on how the process of their EU and EMU accession as well as their transition-specific characteristics will shape their monetary policies in the period before their joining the eurozone. It should be noted that monetary and exchange rate matters are particularly for these economies heavily interrelated, so – to avoid repeating and overlapping - some of the monetary policy issues that are directly related to their exchange rate policies are covered in the chapter on exchange rates in this state-of- the art report.

CEEC at the moment experience very different monetary arrangements and policies (Begg, 1996 and 1999, Cottareli, 1999), but in the process of their EU, ERM2 and EMU accession they will have to adjust their monetary arrangements in not so distant future to the requirements of the single monetary European policy. In other words, they will have to prepare to make their monetary policies more and more compatible with the single European monetary policy.

This is also the result of legal requirements in the process of accession negotiations and adoption of the *aquis communautaire* in the field of EMU, which put additional constraints on monetary policies of CEEC. They have to make their central banks independent, completely open themselves to capital flows, prohibit direct financing of the government by the central bank and prevent any privileged access of the government to financial institutions, by the time of their EU accession. Finally, before joining the EMU and adopting the euro, CEEC will have to meet the Maastricht convergence criteria on a sustainable and healthy basis. These include, alongside with the two fiscal criteria, three monetary criteria, which clearly define the mandate of their monetary policies in the period before their inclusion in the eurozone. The Maastricht convergence criterion on inflation implies they have to focus on disinflation in this interim period. In the specific

circumstances of these countries, to which we turn in more detail later, disinflation from present levels of inflation to the Maastricht reference value may be a demanding challenge. However, the role of the monetary policy should not be seen in isolation and overemphasised. Monetary policy should be consistent with and supported by other macroeconomic policies, particularly by prudent fiscal and income policies. Overburdening the monetary policy otherwise can result in too strict monetary policies, which may lead to unnecessary losses in output and employment, which can run against their needed catching-up process and real convergence with the EU.

At the moment, before their EU accession, CEEC have their full monetary sovereignty, both from the formal and from the factual point of view. Formally, they will retain their monetary sovereignty until they adopt the euro and join the single European monetary policy. Factually, their monetary policy independence is becoming more and more limited, the more they come closer to fixing the exchange rate and to liberalising their capital flows. With the entry in the EU and ERM 2, their exchange rate policies (and for that matter, their economic policies in general) become the matter of common concern, which means subject to coordination and surveillance. Those CEEC, which already completely liberalised their capital flows and completely fixed their exchange rates (currency board regimes) or are planning to do so in the near future (unilateral euroisation) are giving up their factual (if not yet formal) monetary sovereignty. In this respect they are already in a (unilateral) monetary union, as their monetary policies are completely tied to the single European monetary policy.

From the point of view of CEEC, their monetary policies should be focused on devising credible disinflation strategies, preparing themselves for the soft landing in the eurozone. Their monetary policies should be framed in the context of the process of their accession to the EU, ERM 2 and EMU, and considering their transition-specific circumstances, such as the following:

- a) The need for building up institutions (independence of central banks, supervision of the banking sector, development of money and capital markets) and to speed up structural reforms in the real and financial sector;

- b) Special importance of the exchange rate (as small and open economies) and exposure to capital flows, particularly before their EU entry, but perhaps also in the ERM 2 period before their accession to the eurozone;
- c) The need for real convergence and catching up, leading to their exposure to transition - specific price dynamics (Ballassa-Samuelson effect – trend appreciation of the real exchange rate).

## **II. FISCAL POLICY**

The eastward enlargement of the eurozone concerns fiscal policies in both EU countries and in CEEC. Fiscal policies in CEEC are affected by fiscal policies in the EU countries and are constrained by the fact that their fiscal position should shortly adjust to the EU fiscal requirements. They are already involved in fiscal surveillance procedures. After their EU accession their economic policies, including fiscal policies, become the matter of common concern and subject to coordination and supervision procedures. And finally, CEEC will have to comply with the fiscal rules of the EU, in particular with excessive deficit rules and Stability and growth pact requirements. On the way to the eurozone, before adopting the euro they will have to meet the two Maastricht fiscal criteria (on fiscal deficit and public debt). After joining the EU and before entering the eurozone they will be subject to some of the provision of the Stability and growth pact and will have to prepare convergence reports on the fulfilment of the Maastricht convergence (including fiscal) criteria. After joining the euro area, CEEC will have to comply with all Stability and growth pact requirements and will have to prepare stability reports, with the aim to report on the sustainability of their fiscal position in the monetary union. All these processes and requirements from their joining the EU and eurozone will call for considerable effort and adjustments in their current fiscal policies and positions. On the other hand, fiscal policies of the EU countries themselves are being affected by the prospect of eastern enlargement of the eurozone, as the eastern enlargement will be a burden for the EU budget, although actual costs are still undetermined and subject to negotiations on the last, most difficult and financially most demanding chapters in the negotiations on the EU accession of CEEC.

Literature of fiscal policy issues, particularly in Europe, is concentrated on the role of the fiscal policy itself (and in relation to monetary policy) in the framework of EMU. Along with more traditional issues such as fiscal discipline (Von Hagen, 1996, Canzonieri, 1996

and 1998, Kopits, 1998), sustainability of fiscal position (Perotti, 1997, Bayoumi, 1995a, Alesina, 1997 and 1998, De Bandt, 2000), optimal macroeconomic policy mix (Begg, 2000), the emphasis is on the constraints on national and EU-wide fiscal policies which derive from the single monetary policy in the EMU (Mongeli, 1999, Fatas, 2000, Masson 1996 and 2000). As regards the EU-wide policy, literature focuses on issues related to fiscal federalism (Hewitt, 1992, Kletzer, 2000, Ter-Minassian, 1997, Von Hagen, 1996, Mihaljek, 1998). The debate touches first the question of distribution of fiscal powers among different levels of government (supranational, national, regional, local) and next, related to this, should the EU aim for a EU-wide fiscal policy, modelled on the fiscal system of the federal states (Von Hagen, 1993, Sala-i-Martin, 1992, Bayoumi, 1995, Persson, 1996). Of course, contrary to monetary policy, there is no such thing as a single fiscal policy, so even in the EMU fiscal policy remains decentralised and in the hands of individual member countries. The question is primarily about the size of the EU budget, which is compared to national federal states extremely small and furthermore inflexible, i.e. earmarked for specific purposes, mostly for agriculture (CAP). However, in the literature the question is raised whether with the move to the EMU there is a need to substantially increase fiscal powers at the EU-wide level. For political reasons, it seems very unlikely that any substantial change in the size of the EU budget will be possible, at least in the short-term.

The idea for a EU-wide fiscal policy derives from the roles of the national fiscal policies, which through their allocative, stabilising and redistributive effects can affect economic situation in individual regions within the state. Through automatic stabilisers or even with active fiscal policy the state can redistribute income in the direction of those regions which have suffered negative asymmetric shocks and thereby help to stabilise their income. In the EMU, member countries adopted the single currency, gave up their own monetary and exchange rate policies and became from a monetary point of view similar to regions within the states. In case of negative asymmetric shocks, which lead to decrease in their output and/or employment, they would need additional or alternative macroeconomic policies, common fiscal policy in the first place, which could substitute for the loss of the monetary and exchange rate instruments of adjustment in the monetary union in order to help them neutralize negative shocks (Obstfeld, 1998). Based on the above argument, current literature deals with the issue of whether it is possible and advisable to build an EU-wide common fiscal policy (Melitz, 1991, Belke, 1998, Fatas, 1998).

Another research topic considers the role of the national fiscal policies in the EMU, where two opposing views can be detected. According to the first, because of the EMU, member

countries should have more flexibility in the conduct of their national fiscal policies, while according to the second (which prevailed in the EU), national fiscal policies should be constrained by the fiscal rules of the EU.

The first view starts from the belief that the burden of macroeconomic stabilisation in a member country of a monetary union should to a larger extent now fall on their national fiscal policies, since their monetary policies are lost. In case of a negative asymmetric shock, a country should depend on its fiscal policy, by letting automatic stabilisers, if not by its active fiscal policy, counteract recessionary impact of the negative shock. According to this view the fact that a country joins a monetary union calls for a greater role of its national fiscal policy, therefore the EU fiscal rules should allow for autonomy and flexibility of national fiscal policies.

The second view starts from the belief that national fiscal policies in a monetary union have strong spill-over effects which can cause negative externalities for other member countries or for the EMU as a whole. Fiscal rules of the EMU should therefore limit the flexibility of national fiscal policies. A country which would use its fiscal policy to counteract a negative asymmetric shock, risks that its fiscal position becomes unsustainable, if unfavourable public debt dynamics develops. Negative external effects for other member countries come in the form of higher interest rates, which spill-over the entire EMU, and/or pressures on the ECB to lead a more accommodating monetary policy (if we leave aside the bailing-out problem, which, however, according to the literature may or may not exist). To prevent free-riding and spill-over effects, the EU rules seriously constrain national fiscal policies of member countries. This is the reason for adopting excessive deficit rules in the Treaty on EU, for the fiscal Maastricht convergence criteria as a precondition to joining the EMU, and for the Stability and growth pact for the period after joining the EMU. In particular, the rules of the Stability and growth pact raised some controversies in the literature (Buti, 1998, Eichengreen, 1998). First issue is their enforceability, since the sanctions require a 2/3 majority of votes, which may be hard to achieve, and second issue is that sanctions have negative economic impact on countries which are already in troubles. Third issue finally is that currently some member countries are close to upper limits of their fiscal deficits according to the Stability and growth pact provisions, which limits their room for leading flexible fiscal policies in case of an early recession, which according to recent developments seems to be a realistic danger. In concluding it can be said that research still needs to answer the question where to draw the right line between centralisation and national competencies of fiscal policies in the EMU.

These issues seem to some extent forward-looking from the current viewpoint of CEEC, but they show the direction of fiscal adjustments which they will have to undertake in not so distant future (Ministry of Finance, 2000). For the moment they have to concentrate on the right mix of macroeconomic policies and on overcoming some burdens of transition-related fiscal situation (Tanzi, 1992) and in particular to move from fiscal dominance to monetary dominance, which is a precondition for the soft landing of these countries in the eurozone.

### **III. EXCHANGE RATE POLICY**

Research on optimal or appropriate exchange rate regimes of CEEC should from the viewpoint of eastward enlargement of the eurozone be seen in the light of future accession of these countries to the EU and to the EMU (or euro area, to be more precise). Relevant academic literature conventionally starts from the description of alternative exchange rate arrangements actually used in these countries and goes on to compare their relative advantages and disadvantages. (Edwards and Sevastano, 1999, European parliament, 1999, Calvo and Reinhart, 2000, Feldman, 1998).

CEEC actually opted for very different arrangements, from the very rigid to almost completely flexible exchange rate regimes. Economic analysis concentrates on determinants of this choice, which can be found in structural characteristics of individual countries, or in the main focus of their macroeconomic policies, i.e., the nature of the problem which the exchange rate policy is primarily concerned with (nominal anchoring, disinflation, external competitiveness, capital inflow problem etc.). (Begg, Halpern and Wyplosz, 1999, Kopits, 1999, Masson, 1999). Main conclusions from the research on exchange rate regimes of CEE countries in the recent literature are the following: First, no exchange rate regime is a priori superior to others, choice of the exchange rate arrangement should be tailored to specific circumstances of a country. (Frenkel, 1999). Therefore, in this phase, before the EU accession, all exchange rate regimes in use are acceptable for CEEC on their way to the EU and to the eurozone. (ECB, 2000, EU Commission, 2000). Second, interim solutions, such as fixed but adjustable pegs, are found to be particularly problematic, since in the circumstances of increased capital mobility they are particularly exposed to possible speculative attacks and are therefore inherently vulnerable. (Begg, 1998). Third, in the last two years there were quite a few shifts in the exchange rate arrangements of CEEC in the direction of the so-called corner or bipolar solutions. This

means that interim regimes of the fixed but adjustable type were abandoned in favor of either very rigid arrangements (such as currency boards) or very flexible arrangements (such as almost free floating). (Backe, 2000). An alternative explanation would be that there was a general move towards increased flexibility of the exchange rate regimes of CEEC, while currency board arrangements should be seen as a result of very specific circumstances (serious lack of credibility). (Bulde, 2000). Fourth, it is important that countries design timely exit strategies in order to prepare for smooth shifts to the new exchange rate arrangements. (Eichengreen, 1998 and 1999).

After their EU accession, exchange rates of CEEC become the matter of common concern and their currencies are expected to join the ERM 2 (Exchange rate mechanism 2). Due to the limited experience of this mechanism (only two currencies participating, only less than three years of functioning), literature on this exchange rate arrangements is only starting to emerge. However, some issues, such as its design, rules and procedures, its performance etc. deserve additional research, particularly since the ERM 2 is - through its role in the Maastricht exchange rate criterion - crucial for determining the dynamics of joining the euro area for CEEC. Open questions which are particularly relevant for CEEC are the following: First, is this exchange rate mechanism flexible enough for these countries to prepare their currencies for a soft landing in the eurozone? Second, does ERM 2 as a specific form of adjustable peg expose CEEC to particular exchange rate vulnerability? Third, how should exit strategies from present arrangements be designed, particularly in the light of recent evolution of the very basic concept of the ERM 2? If ERM 2 is being understood as a broader framework (EU commission, 2000, ECB, 2000), which can include most individual exchange rate arrangements, except for those which are clearly incompatible with its requirements, this problem should be largely overcome.

The largest part of the academic literature dealing directly or indirectly with the exchange rate regimes of CEEC is in fact forward looking, in the sense that the issue is analysed in the framework of future inclusion of these countries in the monetary union. This body of literature is based on optimum currency area theory (Mundell, 1961). It starts from analysing the exposure to symmetric vs. asymmetric shocks in a monetary union and from discussing the availability and flexibility of alternative mechanisms of adjustment (such as fiscal policy, labor mobility, flexibility of wages) which come into play once a country joins a monetary union and gives up its exchange rate as an instrument of adjustment. This is the basis for the assessment of expected costs and benefits from joining the monetary union. (Fidermuc and Schardax, 2000, DeGrauwe and Lavrač, 1999, Boone and Maurel, 1999). However, as the membership in the European monetary union is mandatory for the

new EU countries, the issue of costs and benefits, although analytically relevant, is irrelevant from a decision-making perspective. Research should perhaps be directed more to the dynamics of expected costs and benefits of joining the monetary union, which should give some additional insight into the debate on too early vs. too late accession of CEEC to the euro area.

Another recent trend in the literature is the debate on nominal vs. real convergence (Bjorkstein, 2000). While nominal convergence, embodied in the Maastricht convergence criteria has to do with macroeconomic stability, real convergence has to do with catching-up in the GDP per capita level and related to this with structural reforms and finishing the transition process for CEEC. Within this framework, recently fashionable topic is the Balassa Samuelson (B-S) effect for CEEC (Pelkmans, 2000, Coricelli and Jazbec, 2001). According to this theory, there is a trend appreciation of the real exchange rate in transition economies, which originates from differential growth of productivity in the tradable vs. non-tradable sector in the catching-up economies. (Clark and MacDonald, 1998, Halpern and Wyplosz, 1997). The implication is that transition economies due to B-S effect should experience somewhat higher inflation rates. Some authors therefore suggest that the Maastricht convergence criterion on inflation should be adjusted for the case of CEEC to take account of the transition-inherent inflation dynamics in their catching-up process. (Pelkmans, 2000, Szapary, 2000).

According to the EU official views, nominal and real convergence should run in parallel. In other words, CEEC should for the moment not concentrate too early and too intensively on meeting the Maastricht nominal convergence criteria, at the expense of neglecting structural reforms leading to their real convergence. The central issue in this debate is the following: Is monetary integration possible among countries at the different level of economic development? Experience of historical monetary unions, of EMU itself and of some federal states which can be seen as functioning “monetary unions”, demonstrates that it is possible, although perhaps more demanding. This issue is very relevant for the debate on the dynamics of the inclusion of CEEC in the eurozone. Further research should be devoted to costs and benefits of a too early vs. a too late admission of CEEC to the eurozone, to explore the risks for both sides - the eurosystem itself and for CEEC.

Finally, as a shortcut to the membership in the European monetary union, suggestions for an unilateral adoption of the euro emerged in the academic literature in CEEC. (Rostowski, 2000, Nuti, 2000, Coricelli, 2000). Inspired by earlier experience and debate on dollarisation, (Berg and Borenstein, 2000) particularly in Latin America, the idea is to

abandon domestic currency and to adopt the euro, thereby unilaterally and informally joining the European monetary union. The costs and benefits of this solution are well established, but the overall evidence is not conclusive. (Wojcik, 2000). Anyway, the EU is opposing this idea, which runs counter to its concept of the phased process of successive steps in joining the euro area for CEEC.

In concluding it could be said that the research on appropriate exchange rate regimes of CEEC on their way to the eurozone will intensify in the next few years and will find new challenges as their ERM 2 and eurozone membership comes closer.

## **CONCLUSIONS**

The paper starts with discussing some currently most debated issues in the area of monetary policy, first in general, then from the point of view of the ECB and finally from the point of view of CEEC in their run up to the EU and to the eurozone. With respect to the eastward enlargement of the eurozone, the main questions from the point of view of the ECB seems to be the following: Will the participation of CEEC, supposedly financially weaker and in terms of policies less responsible countries, mean a danger for the stability of the euro? Will it corrupt the decision-making process in the ECB? Will it worsen the quality of the European single monetary policy and its credibility, particularly in the case of an early entry of CEEC in the eurozone? The paper offers some arguments why this may not be the case.

The paper attempts to identify the adjustments, both of legalistic and economic nature, which CEEC will have to undertake in the area of monetary policy in order to prepare themselves for their soft landing in the eurozone. In the phased process of their monetary integration they will have to go through specific interim institutional arrangements, such as the ERM 2, before they fulfill the Maastricht convergence criteria and finally adopt the euro. In their run up to the eurozone they are under the constraints of their transition-specific structural characteristics, such as the need to build up adequate institutions, speeding up their structural reforms and catching up with the EU GDP per capita level. Additional challenges for their monetary policies come from their exposure to high and

potentially volatile capital flows and from their transition-specific price dynamics (Balassa-Samuelson effect).

The paper finally discusses some fiscal and exchange rate dilemmas of CEEC, related to their monetary policies. In the fiscal area, the paper focuses on the scope and constraints of the national fiscal policy in a monetary union in the context of the debate on fiscal federalism within the EMU. For CEEC, the main task remains the conduct of responsible fiscal policies and sustainability of their fiscal position once in the EMU. As far as their exchange rate policies are concerned, CEEC are at the moment, before joining the EU, free to choose their exchange rate arrangements according to their individual preferences. After their EU accession, their exchange rate policies become the matter of common concern and they are expected to join the ERM 2. Finally, the paper touches upon the issue of dynamics of the entry of CEEC in the eurozone, which has to do with the concept of real convergence. Possible opportunities and risks to both sides, EU and CEEC, related to either early or late inclusion of CEEC in the eurozone, deserve additional research before a final conclusion on the optimal timing of the adoption of the euro for CEEC can be reached.

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