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Abstract

This study looks at the interplay between European Monetary Union (EMU) and a future EU enlargement to Central and Eastern Europe. The country focus is on the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The analysis concludes that EMU is improving the framework conditions for a future Eastern enlargement. Moreover, EMU in itself is becoming ever more relevant to the candidate countries from Central and Eastern Europe: The introduction of the euro and these countries' subsequent accession to the EU will alter their monetary and exchange rate policy frameworks. The EMU convergence criteria will not play a major role in the EU accession process. However, in the preaccession period, they should be viewed as medium- and longer-term points of reference for stability-oriented economic policymaking.

Keywords: EU, EMU, enlargement, Central and Eastern Europe

1 Introduction

Establishing a monetary union and preparing an enlargement of the EU to the East are at present the two main processes of European integration. The purpose of this study is to analyze the interplay of these two processes. Among the Central and East European countries (CEECs), the focus is on the Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEEC-5). The analysis starts with a review of the progress towards European Monetary Union (EMU) so far as well as the headway made towards a future accession of the CEECs to the European Union, followed by a brief stocktaking of monetary cooperation between the EU and the CEEC-5 to date (section 2). A scenario of the prospective main directions of further EMU- and enlargement-related developments is laid out in section 3. The study then turns to the question of what impact EMU has on the CEECs' EU accession prospects (section 4). Subsequently, in section 5, the main challenges for economic policymaking in the CEEC-5 resulting from EMU are scrutinized. The main conclusions of the study are summarized in section 6.

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2 Progress Towards EMU and Eastern Enlargement to Date

2.1 Preparing for European Monetary Union

At several instances during the course of its history, the European Community has "deepened" by reinforcing and intensifing its degree of integration and "widened" by including new members. The last (completed) deepening exercise was undertaken at the European Council summit in Maastricht in December 1991 when the *Treaty on European Union* was agreed upon. In the realm of economic integration, this treaty, which came into force in November 1993, foresees the establishment of a European Economic and Monetary Union. This union is to complement the cornerstone of the Community's economic integration hitherto, namely the Internal Market, which had come into being at the beginning of 1993.

European Monetary Union is to supersede the European Monetary System (EMS) installed in 1979, built on an Exchange Rate Mechanism (ERM), an intervention mechanism and a credit mechanism. For the creation of EMU, the Maastricht Treaty contains a three-phase timetable with January 1, 1999, as the latest date for the completion of monetary union. The first phase of EMU, which had already been approved by the Europan Council in June 1989, focused primarily on the liberalization of capital movements and an enhanced coordination of the economic, financial and monetary policies of the EU countries. The initial stage of EMU was overshadowed by crises of the EMS in 1992/93. After a period of exchange rate stability from 1987 onward, this time span was characterized by the leaving of the ERM by Italy and the UK,[2] subsequently by several realignments, and eventually by a widening of the 'normal' fluctuation margins from ± 2.25 % to ± 15 %. On January 1, 1994, the second stage of monetary union started with the establishment of the European Monetary Institute (EMI), the predecessor of the future European Central Bank (ECB) to be founded during the final phase of Stage Two. The EMI has the task to coordinate the monetary policies of the Member States and to make the necessary preparations for a single monetary policy and for the establishment of a European System of Central Banks (ESCB) consisting of the ECB and the national central banks. The introduction of a single currency and a common monetary policy conducted by the ESCB are at the heart of Stage Three of monetary union which will begin on January 1, 1999.[3]

Participation in Stage Three of EMU is conditional on the fulfilling by the EU Member States of the following economic convergence criteria: First, average inflation over a period of one year may not exceed that of the three best performing EU countries by more than 1.5 percentage points. Second, average interest rates for long-term government debt over a period of one year may not be more than 2 percentage points higher than in the three EU countries with the lowest inflation rates. Third, the public sector deficit may not exceed 3 % of GDP. Fourth, the public debt/GDP ratio shall not be higher than 60 %. The two latter convergence criteria are met if the ratios exhibit a clearly falling tendency towards the reference value or, in the case of the fiscal target, if the deviation is only exceptional, temporary and close to the reference value. Finally, the country must participate in the ERM of the EMS and has to observe the normal fluctuation margins of this mechanism without initiating a devaluation for two years.

EU countries which do not fulfill the conditions for Stage Three will have a derogation with respect to several provisions of economic and monetary union (listed in Article 109 k [3] EC Treaty) and are referred to in the EC Treaty as 'Member States with a derogation'. For these countries, there will be automatic convergence assessments every two years, which will allow them to join Stage Three of EMU if they fulfill the criteria at this later stage. In addition, any Member State with a derogation can request such conver-

[2] At the inception of the EMS, all EU states but the UK participated in the ERM. After the southern enlargements of the Union, Spain and Portugal joined in 1989 and 1992, while the UK entered the mechanism in 1990.

[3] The UK and Denmark both have an "opt-out clause", which confers upon their national parliaments the separate right to decide upon the introduction of the euro in their countries.

gence tests at any time.

Economic and monetary union, as agreed in Maastricht, has two additional dimensions. First, it embodies policy coordination and surveillance mechanisms geared towards fostering macroeconomic and, in particular, fiscal convergence. The most important mechanism is the "excessive deficit procedure", which is designed to ensure that the EU Member States live up to their commitment to avoid excessive public sector deficits and debt levels. Another instrument in this realm are convergence programs which the Member States have to submit on a regular basis.[4] Secondly, economic and monetary union embraces a set of legal convergence requirements, particularly in the fields of central bank independence and the prohibition of budgetary financing by central banks.

The European Council in Madrid in December 1995 confirmed January 1, 1999, as the starting date for Stage Three of EMU, decided to name the single currency "euro" and adopted a changeover scenario to the new currency. The decision on which countries will be the founding members of EMU will be taken by the European Council in early 1998, as soon as reliable data are available for 1997, the reference year for the fulfillment of the inflation, interest rate and fiscal criteria.

During the course of 1996, economic and monetary union was prepared by drawing up detailed regulations with respect to several aspects of the Maastricht Treaty's provisions and by elaborating complementary arrangements in order to further strengthen the EMU framework. At the European Council in Dublin in December 1996, the structure of a new exchange rate arrangement (EMS II) was agreed upon; it will govern exchange rate relations between the euro area and nonparticipating EU countries after the inception of Stage Three of monetary union. Furthermore, the legal framework for the use of the euro was endorsed, part of it for formal adoption in early 1997, and an agreement was reached on the principles and main elements of the Stability and Growth Pact. This pact is primarily about ensuring budgetary discipline in future euro zone countries, but it will also encompass provisions for a strengthened surveillance and coordination of budget positions and for a speedier and more clearly defined excessive deficit procedure pertaining to *all* EU Member States. In this context, the Commission will submit a legislative proposal on strengthening the format and the content of convergence programs, in order to foster Union-wide convergence more effectively. The intended expediting and clarifying of the excessive deficit procedure relates mainly to establishing clear definitions and setting deadlines for the various steps of the procedure.

On January 10, 1997, the EMI presented a framework report on the strategy and the instruments of the future single monetary policy to be applied by the ESCB. Another preparatory step for monetary union, on the agenda in 1997, relates to the elaboration of a scenario for EU states joining the euro area after January 1, 1999, an undertaking which is based on an Austrian initiative.

2.2 The EU and the Countries of Central and Eastern Europe

2.2.1 Preparing for an Eastern Enlargement of the European Union

The relations between the Community and the CEECs began to develop in the late 1980s, after a joint declaration between the EC and the CMEA (June 1988), and intensified significantly after the secular changes in Central and Eastern Europe at the end of 1989. Initially, the EC concluded trade and cooperation agreements with most CEECs, thereby removing import quotas specifically applying to centrally planned economies as well as a few nonspecific restrictions. In the fall of 1989, the technical assistance program PHARE was set up initially for Poland and Hungary and, shortly thereafter, extended to the other CEECs. In January 1990, the Community granted GSP status[5] to Hungary and Poland, one year later also to

[4] After the inception of Stage Three of EMU in 1999, euro zone countries will, according to the Stability and Growth Pact agreed upon at the European Council in December 1996 in Dublin (see below), regularly submit stability programs while the other EU countries will continue to prepare convergence programs.

[5] Under the GSP (General System of Preferences) of GATT, unilateral preferential tariffs are granted to third countries.

Czechoslovakia. Towards the end of 1990, the Community started association negotiations with these three countries, which were successfully concluded a year later.[6] The centerpiece of the Association Agreements is a full liberalization of trade over a ten-year period, except for agricultural products for which market access remains restricted. The freeing of trade with industrial goods has been asymmetric, with the EC opening up faster than the CEECs. Still, the Community has enjoyed fairly lengthy (though subsequently somewhat shortened) transition periods for several groups of sensitive products. Also, the EC has retained an array of instruments to control trade flows, in particular antidumping and safeguard procedures. In subsequent years, the EU concluded similar Association Agreements with Romania and Bulgaria, the three Baltic states and, most recently, in June 1996, with Slovenia.[7]

At the European Council meeting in Copenhagen in June 1993, the EC declared, for the first time, its readiness to accept the associated CEECs as new members, on condition that they meet a set of political and economic preconditions, namely "that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union... [and] the candidate's ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union." In addition the Council stated that "[t]he Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries."

Hungary and Poland handed in their formal EU membership applications in April 1994, shortly after their Association Agreements entered into force. All the other associated CEECs followed suit until mid-1996, the last one being Slovenia.

In December 1994, the European Council in Essen approved a preaccession strategy for associated countries from Central and Eastern Europe. The mainstays of this strategy are the Association Agreements, a structured relationship which provides a frame for a policy dialogue on a multilateral basis, the PHARE program in a modified form[8] and a White Paper on the Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union to be worked out by the European Commission. The White Paper was presented in May 1995 and endorsed by the European Council in Cannes in June 1995.

The European Council in Madrid in December 1995 stated that EU "[e]nlargement is both a political necessity and a historic opportunity for Europe. It will ensure the stability and security of the continent and will thus offer both the applicant States and the current members of the Union new prospects for economic growth and general well-being." The Council confirmed the Copenhagen accession criteria and referred to the need "to create the conditions for the gradual, harmonious integration of [the candidate countries], particularly through the development of the market economy, the adjustment of their administrative structures, and the creation of a stable economic and monetary environment."

In order to prepare the accession talks with the CEECs, the Madrid Council assigned four tasks to the European Commission, namely firstly to draw up the opinions on the membership applications of the CEECs, secondly to come forward with a composite paper covering the horizontal issues of enlargement, thirdly to prepare a study on the impact of enlargement on EU policies, in particular with regard to agricultural and structural policies, and fourthly to put together a Commission communication on the future financial framework of the Union for the period after 1999 (when the current framework expires), taking into account the prospect of enlargement. All these documents shall be ready as soon as possible after the end of

[6] After the breakup of Czechoslovakia at the end of 1992, new Association Agreements were negotiated and concluded with the Czech Republic and Slovakia in 1993.

[7] Slovenia had had an upgraded trade and cooperation agreement with the Community since 1993.

[8] From 1993 onward, PHARE has been adapted with a focus on medium-term (as opposed to the former one-year) programming, the inclusion of some financing for infrastructural projects and increased overall funding.

the current Intergovernmental Conference (IGC), which has the task to review the Maastricht Treaty and is scheduled to be concluded in mid-1997.

Finally, the Council expressed its "hope that the preliminary stage of [accession] negotiations [with countries from Central and Eastern Europe] will coincide with the start of the negotiations with Cyprus and Malta," which are to commence six months after the end of the IGC.[9]

In line with the calls of the Madrid summit, the European Commission has begun to prepare opinions of the membership applications of the associated CEECs. To this end, it put together a detailed questionnaire and handed it over to the ten associated CEECs in April 1996. The CEECs' answers were received in July and were subsequently sorted out and evaluated by the European Commission until the turn of the year. In early 1997, the European Commission will begin to draft the opinions, which it intends to have ready by the third quarter of 1997, together with the composite paper, the impact study and the financial framework communication.

2.2.2 Monetary Cooperation Between the EU and the CEECs to Date

Integration between the EU and the CEECs to date has been primarily a market rather than a policy integration.[10] This is particularly true for monetary policy: The Association Agreements do not contain any provisions on monetary policy cooperation. Nor does the structured relationship incorporate a continuous monetary policy dialogue. In July 1994, the European Commission proposed that the associated CEECs adopt macroeconomic surveillance procedures along the lines of the corresponding multilateral procedures within the EU (Article 103 EC Treaty) and that the Union participate in these mechanisms on a regular basis.[11] This initiative, which clearly would have had a monetary dimension, has apparently not gotten off the ground. More recently though, there has been a certain trend towards touching upon selected monetary (integration) matters at a few instances, although often in a broad context and fairly briefly. With individual countries, monetary issues have at times been raised at a sub-committee and, more recently, at a committee level within the institutional framework of the Association Agreements. In addition, the EU Monetary Committee has declared its readiness for opening regular consultations with individual associated CEECs (on the model of the Committee's periodic meetings with the Norwegian and Swiss authorities) and in fact started this dialogue in October 1996.[12] On a multilateral plane, the EU finance ministers and their colleagues from the CEECs have discussed matters with a monetary dimension, e.g. the issue of macroeconomic convergence, which was covered at a meeting in March 1996.

A more intense dialogue on monetary matters is bound to come about with the preparation of the European Commission's opinions on the membership requests of the associated CEECs. The questionnaires, which reportedly cover in considerable detail the EMU-related provisions of the EC Treaty and the detailed answers of the CEECs, constitute a starting point in this respect.

Against the backdrop of actual monetary cooperation so far between the EU and the associated CEECs, it is no wonder that academic proposals for establishing an institutionalized linkup between the EMS and the CEECs' national currencies or even an early EMS membership have not

[9] The perspectives of an accession of Malta and Cyprus to the EU have become fairly opaque though. In November 1996, Malta's newly inaugurated government publicly stated that the country is no longer interested in joining the EU (although it has not formally withdrawn its membership application). For Cyprus, progress into the direction of accession requires tangible headway towards a settlement of the constitutional and territorial problems that beset the island.

[10] See also Bofinger (1995).

[11] Kommission der Europäischen Gemeinschaften (1994)

[12] At that time, a first meeting of the Chairman and the Secretary of the Monetary Committee with high-ranking representatives from the Czech central bank and the finance ministry was held. At this meeting economic and monetary issues currently facing either side were discussed in some detail.

gained practical relevance.[13] It should be added that these suggestions have not found undivided approval among economists analyzing the transition process. The opponents have argued that such steps could damage the quality of the EMS institutions and, in particular, have an inflationary impact on EU currencies.[14]

It is interesting to note that even the issue of an ECU peg for CEECs has not had much impact on the exchange rate arrangements in Central and East European countries, although all countries under review, with the exception of Slovenia, have opted for basket-based pegging – and despite a fairly supportive discussion of the issue in the literature.[15] All four peg countries discussed here opted in 1990/91 for baskets which contain a share of EU currencies on the order of 50 % or more, while the U.S. dollar has made up all or most of the rest (30 to 50 %). However, Hungary has been the only one of the four countries – and in fact the sole transition economy – to incorporate the ECU into its currency basket, though only temporarily. The ECU had been a basket currency in the periods 1991 to 1993 and 1994 to 1996 with a 50 and 70 % share respectively, but as of January 1, 1997, it will be replaced by the Deutsche mark (as already in 1993).[16] Czechoslovakia opted in late 1990 for a basket containing a 62 % share of EC currencies and the schilling. Its successor states turned to a DEM–USD peg in 1993/94, with the DEM share roughly corresponding to the former share of all EU currencies and the schilling. Poland switched from a USD peg in May 1991 to a basket, half of which consists of EU currencies (predominantly DEM).[17]

[13] These far-reaching proposals went alongside even more radical suggestions like adopting an ECU-based currency board managed by a central bank from an EU country or replacing the national currencies of the CEECs by the ECU. See Schmiedling (1992), Frankel and Wyplosz (1995).

[14] See Bofinger (1991), Portes (1994).

[15] See e.g. Bofinger (1991), who advises the CEECs to choose a fixed exchange rate system and opt for the ECU as an anchor currency. He argues that an ECU peg would be appropriate, as the ECU is a good proxy for trade patterns and EU inflation has been fairly low and stable over time. See also Davenport (1992).

[16] In late 1991, the country switched from a trade-weighted multi-currency basket to a basket containing a 50 % ECU and a 50 % USD share. By this, Hungary wanted to underline its quest for full integration into the Community at the time it signed its Association Agreement. In the aftermath of the August 1993 crisis of the EMS, the ECU was replaced by the Deutsche mark. The ECU was dropped due to the "technical difficulties in following its movements", and the Deutsche mark was picked given the increasing role it played and currencies pegged to it in Hungary's international economic relations. In May 1994, the ECU was reintroduced into the basket with a 70 % share, while the U.S. dollar weight was reduced to 30 %. The reasons for returning to the ECU were economic and political. Due to the strength of the Deutsche mark, the 1993 basket had carried an unwanted tendency of appreciating the forint in real terms, and the ECU, meanwhile stabilized, had again become a viable alternative. The large weight given to the ECU reflected changing trade patterns. Politically, the ECU was again perceived to become capable of fulfilling the role of a future common European currency. In July 1996, Hungary decided to once more replace the ECU with the Deutsche mark as of January 1, 1997. According to the National Bank, the change is based on technical grounds, namely the cumbersome and time-consuming procedure of the ECU fixing, while the government argues that the new currency basket will be "more market-oriented" than the one in force since 1994.

[17] For the current composition of the baskets see Table 2. For details of the developments since the beginning of the transformation see Radzyner and Riesinger (1996).

3 A Scenario for Future Enlargement-Related Developments

Both processes – the move towards EMU and, even more so, progress towards Eastern enlargement – reach out into a more or less distant future. Therefore, any analysis of the interplay between the two processes must be based on assumptions about the likely developments in both areas. The following analysis is based on a scenario which is both optimistic and realistic. While acknowledging the future risks, it is assumed that decision-makers will be able to successfully cope with the challenges ahead. The main assumptions are:

First, **EMU** will be **implemented as envisaged**: Stage Three of monetary union will start in 1999 with a group of core countries and the **euro area** will be a **zone of monetary stability**. A start of monetary union as of January 1, 1999, seems a fair assumption, if one takes into account the political will, the advanced state of institutional and technical preparations and the substantial efforts so far at meeting the convergence criteria as well as firm intentions to make further progress in this field (in particular with respect to necessary additional fiscal consolidation). The improved economic outlook for this year may further facilitate the inception of Stage Three of monetary union on time. The euro can be expected to be a stable currency for two main reasons, namely the stability track record of the likely founding members of EMU and, secondly, the principal adequacy of the institutional and regulatory provisions of economic and monetary union (in particular the independent status of the ECB and its prime objective of ensuring price stability, the rigor of the convergence criteria, and the rules for future fiscal discipline, complemented by the Stability and Growth Pact).

Second, **reforms within the EU** in the coming years will be **sufficient** to make the Union ready **for enlargement**. In particular, the currently ongoing IGC will be concluded in time – or at least during the second half of this year – and it will achieve a critical mass of institutional reform in order to make sure that decision-making will be sufficiently efficient within a Community of 20-plus member countries. Also, the Union will agree in time upon a new financial arrangement for the years after 1999, based on a further reformed Common Agricultural Policy (CAP) and on an adjusted set of rules for structural policies, thereby making room to finance a first phase of Eastern enlargement. While the outlook of most analysts on institutional reform tends to be cautiously optimistic (despite the current slow pace of the IGC), the cost issue is often seen as an insurmountable stumbling block for enlargement in the foreseeable future. Recent estimates, however, indicate that the budgetary cost of an EU enlargement by the CEEC-5 will be substantially lower than suggested by earlier calculations, namely in the area of ECU 15 to 20 billion per year.[18] Notwithstanding the substantial uncertainties persisting with respect to quantifying the budgetary implications of enlargement, this order of magnitude seems to be manageable, especially against the backdrop of the size of the EU's GDP. Furthermore, it should not be overlooked that the budgetary cost issue is only one variable within a larger economic cost-benefit calculation which itself is only one component of the overall enlargement equation including also political considerations. It is therefore not purposeful to narrowly focus on budgetary costs when assessing enlargement prospects.

Third, the **CEEC-5** will **continue** their **stability- and reform-oriented policies**. This assumption is supported by the CEEC-5's overall performance so far and by the fact that commitment in general remains strong to continue sound macroeconomic policies and structural reforms. Still, not in all five countries are policy pledges always fully reflected in comprehensive structural reform programs and in a dynamic implementation process. Wherever this is the case, a deepening of reforms is indispensable. Here, it is assumed that the necessary policy actions will be taken in due course.

Fourth, Eastern **enlargement** will take place **in phases**, in line with political and economic merits of the candidate countries. A **first wave** is assumed to occur in **2002 or shortly thereafter**.

[18] See e.g. Breuss (1995) or, in a similar vein, Inotai (1995). Interestingly, Baldwin, who came out in 1994 with costs of approximately ECU 60 billion per year in the case of an EU accession of Hungary, Poland, the Czech Republic and Slovakia, has recently revised his cost estimate to ECU 20 billion per year.

This time horizon implies that the opinions of the European Commission on the membership applications from the CEECs will be ready, as intended, shortly after the end of the IGC and that the European Council will approve the start of accession talks in late 1997 or early 1998. It further implies a concentrated negotiation effort in subsequent years, a conclusion of the negotiations at the turn of the decade and a fairly short ratification period for the accession treaties. The daunting task of the negotiators could be significantly facilitated if the membership candidates developed comprehensive national strategies to prepare for membership. With respect to the approximation of laws, such strategies should have a specific focus on identifying and tackling problem areas with respect to taking over the obligations of the acquis communautaire. In the macroeconomic realm, these strategies should be geared to sustained fiscal and monetary discipline. On the EU side, it would be helpful if the preaccession strategy were further broadened in the fields of trade, infrastructural investment and agriculture. In trade, this could mean opening the EU market beyond the concessions already granted and renouncing the future application of instruments to control trade flows (especially antidumping and safeguard procedures), self-evidently in concurrence with the full acceptance of EU competition policy and state aid control standards by the membership candidates. Infrastructural investment in the candidate countries could be stepped up by turning PHARE into a structural-fund-type support instrument and by progress including the CEECs into Trans-European Network projects. Support for adjustment in agriculture could take the form of the proposed agricultural development fund for the CEECs[19] as a first step for subsequently phasing the CEECs in to the CAP.

The concentration of this study on the CEEC-5 does not necessarily imply that a first wave of Eastern enlargement will embrace all of these countries under any circumstances. Nor is it a priori excluded that other associated countries might qualify for an early EU accession. Still, from today's perspective, the five countries under review here undoubtedly belong to the most likely candidates for a first wave of Eastern enlar-gement.[20]

Finally, the **CEEC-5 will join EMU only some years after having acceded to the European Union**, which means that the countries under review will be "countries with a derogation" for a while. Also, the CEEC-5 will **not necessarily enter monetary union as a group**; different speeds of convergence are well conceivable.[21]

There are several reasons why an entry into EMU simultaneously with EU accession is unlikely. First, despite all prospective progress in the macroeconomic realm, it is questionable whether any of the CEEC-5 will meet all Maastricht convergence criteria for joining EMU in 2002, even though some of the CEEC-5 have apparently made it a top priority to meet these criteria. After all, this would imply that the year 2000 is the reference year for the fulfillment of the inflation, interest rate and fiscal criteria.

[19] Such a proposal was mooted by the EU Commissioner for Agriculture in August 1996.

[20] In this context, three points deserve attention. First, most of the other CEECs with Association Agreements are, by and large, in a less favorable position with respect to meeting all EU accession criteria than the CEEC-5. Second, an accession of all CEECs with Association Agreements as well as of other actual or potential candidate countries to the EU would mean that the Union would turn into a club of 25 or more Member States. In this case, the EU would clearly need a complete overhaul of its institutions and procedures in order to remain functional. It is not at all easy to see the political will for such a radical reform. Third, experience from earlier enlargements shows that both the Commission and the Council can only cope with a limited number of accession negotiations at a time. Clearly, the Union cannot negotiate in substance with twelve applicant countries simultaneously.

[21] It is still too early to thoroughly discuss most issues related to the timing and the implications of the CEEC-5 joining Stage Three of monetary union and therefore this paper refrains from dealing with these questions in detail. Nevertheless, from today's view, the perspective of acceding to the euro zone may well be attractive for the CEEC-5, as it would further improve credibility and rid them of monetary management problems (e.g. related to capital inflows). In addition, economic benefits could be disproportionately high in some respects, especially as regards transaction costs and the interest rate levels for foreign debt. See Bofinger (1996), Inotai and Palánkai (1994).

In addition, there is a legal problem with the convergence criteria relating to exchange rate stability, which requires two years of participation in the ERM (normal fluctuation margins) of the EMS without initiating a devaluation. Although the EC Treaty is clear in that this means formal membership in the Exchange Rate Mechanism (Article 109 j [1] indent 4 EC Treaty), some Member States (namely the UK and Sweden) hold the view that actual exchange rate stability is sufficient to fulfill this criterion. Still, one can expect that, according to the EC Treaty, formal ERM membership *will* be required. In the academic discussion, a participation of selected CEECs in the ERM of the EMS II *prior* to EU accession has been proposed.[22] However, it is questionable whether such a proposal is realistic. The EU has traditionally not been very open for formally including nonmembers – also EU candidate countries – into its exchange rate arrangements.[23] It remains to be seen whether the EU takes a different stance if the issue of an early ERM II membership for the candidate countries comes up.

Finally, practical and technical reasons may turn out to constitute additional obstacles to a simultaneous joining of the EU and EMU. National central banks will have to execute from day one of their countries' membership in EMU all monetary and exchange rate policy decisions of the ECB. This would imply that the CEEC-5 central banks would have to start the necessary comprehensive preparations very early in the process, namely in all likelihood even before the end of EU accession talks and thus presumably without clarity as regards their countries' EMU perspectives. In some cases, it may also be questionable whether the administrations and the financial sectors in these countries will be able to prepare and fully implement the introduction of the euro (in cash) within a timespan which will be at most three years and which will coincide with the initial phase of membership in the European Union and all the challenges resulting from it.

Based on these assumptions, I will address two main issues.

- Does EMU have a positive or negative impact on the EU accession prospects of the CEEC-5?
- What are the implications of EMU for the economic policies of the CEEC-5 and their preparations for EU membership in the coming years?

4 The Impact of EMU on the Accession Prospects of the CEEC-5

Looking at the impact of EMU on the accession prospects of the CEECs means posing the question of whether there is a conflict between a deepening of monetary integration within the EU and a future widening of the European Union to the East. In this context, technical, financial and adjustment issues have to be considered.

In analyzing **technical-procedural aspects**, one can ask whether the EMU implementation schedule will come into conflict with the enlargement timetable and thus lead to a slowdown of the enlargement process. Clearly, the European Union's agenda for the rest of the decade is a busy one. Nevertheless, a comparative look at the schedules for EMU and for enlargement shows that there should be no conflict between both processes in terms of timing. Accession talks will presumably be opened in early 1998 and will gain momentum in the second half of 1998. At this time, the preparations for Stage Three of monetary union will already be at a very advanced stage. After the beginning of Stage Three, EMU-related activities will most likely not preoccupy the EU machinery to an extent which could have a negative impact on the speed of accession talks with the CEEC-5. Moreover, it should not be overlooked that the main workload in the monetary sphere will be carried by the ESCB, while the brunt of accession negotiations will fall on the European Commission.

A second issue relates to the question of whether EMU will lead to additional **Community spending** and thus further complicate the task of finding solutions to the challenges of Eastern enlargement for the EU budget. A closer analysis

[22] Bofinger (1996).

[23] See e.g. Austrian initiatives for an associated EMS membership in the late 1980s and early 1990s, which did not bear fruit.

shows that the setting-up of EMU will in all likelihood not increase the pressure within the EU for additional intra-Community fiscal transfers and thereby narrow the Union's room for maneuver in the fiscal area. Additional transfers *within* the euro zone resulting from potential asymmetric shocks[24] should be as improbable as further spending due to an – unlikely – process of divergence setting in *between* euro zone countries *and* the other Member States of the EU after the creation of EMU.[25]

A third issue relates to the question of higher **adjustment** needs for accession candidates as a consequence of monetary union. Despite being a major step towards deepening the Community, EMU does not put any substantial additional hurdles in front of the CEEC-5. EU accession is in no way linked to entering Stage Three of monetary union (nor to fulfilling its macroeconomic conditions). Indeed, as already mentioned, the candidate countries will most probably join the euro zone only some years after their entry into the EU. In the legal area, economic and monetary union does necessitate some additional adjustment for *all* EU Member States and thus prospectively also for the CEEC-5 but, as will be argued in the subsequent section, the fulfillment of these requirements should not cause significant difficulties for the CEEC-5.

In sum, EMU does not and will not hamper the EU accession prospects of the CEEC-5. In fact, by keeping up the momentum of European integration, **EMU is creating a favorable climate for** a future Eastern **enlargement,** while an – unlikely – delay to complete monetary union or other implementation problems would substantially worsen the basic conditions for any widening of the Community.

[24] For a detailed analysis of the issue of asymmetric shocks see Pauer (1996).

[25] A divergence scenario is unlikely for a number of reasons. First, expected economic gains from monetary union are primarily of a dynamic nature and will thus unfold only in the medium to longer term. Second, gains from EMU will be moderated, if monetary union starts as expected with a relatively small number of countries. Third, in the initial phase, (net) gains will be reduced by the start-up costs of EMU.

5 Challenges for CEEC-5 Policymaking Against the Backdrop of EMU

Economic and monetary union is becoming ever more important for the CEEC-5 and their policies. Contrary to widespread perceptions, the **economic convergence criteria of EMU are *not* the main point of relevance** for the candidate countries **during** their EU **preaccession** period. In fact, these criteria have less direct importance in that phase than other aspects such as institutional and legal issues or the EMS II.

5.1 Economic Convergence

In recent years it has become popular for Central and East European policymakers to point out that their countries already meet some of the economic convergence criteria of the Maastricht Treaty. In most cases, these references have served as "evidence" of a perceived EU "maturity" of the Eastern membership candidates. Statements of this kind are understandable in the light of the fact that the preconditions for EU membership, as laid down in Copenhagen, remain vague about the necessary degree of monetary and fiscal convergence for joining the European Union. In their search for transparent and quantifiable benchmarks for membership, it apparently suggested itself to the CEEC-5 to use the economic convergence criteria as substitutes for transparently defined accession standards.

However, such references to the Maastricht convergence criteria may miss the point, given the fact that these criteria do not at all constitute benchmarks for EU accession. The convergence criteria are **not accession criteria.**[26] Candidate countries have to share the *aim* of monetary union, as laid down by the Copenhagen summit, but they do not necessarily have to be very close to – let

[26] Obviously as a response to the frequent statements from the CEECs related to the Maastricht convergence criteria, the EU took the opportunity of the structured-dialogue meeting between the EU finance ministers and their colleagues from the associated CEECs in March 1996 to underline this point.

alone fulfill – the Maastricht criteria at the time of EU accession or even before. The convergence criteria enshrine macroeconomic standards that are clearly stricter than those one can reasonably apply to measure a candidate country's readiness for membership in the fiscal and monetary realm. At the same time, the convergence criteria do not provide adequate benchmarks for all other dimensions of EU "maturity". Therefore, these criteria are both too strict and too narrow to be useful accession criteria. They may not be appropriate for countries set to catch up, and an excessive focus on these criteria may distract policymakers' attention from the daunting challenge to iron out underlying *structural* weaknesses.

Consequently, the **convergence criteria will not play a major role in the accession process**. The Union will not look so much at quantitative indicators, but primarily at qualitative improvements, i.e. the capacity of the CEEC-5 to correct macroeconomic distortions with policies and instruments that are compatible with the market mechanism in general and EU rules in particular.[27] This does not mean that the convergence criteria are of no significance whatsoever for the candidate countries. In fact, they should be viewed and indeed *are* increasingly being viewed as medium- and longer-term points of reference for stability-oriented economic policymaking.[28]

If one takes a look at the **actual state of** the CEEC-5's **convergence** with the Maastricht criteria, bearing all these qualifications in mind, a rather favorable picture emerges, by and large, with respect to fiscal convergence, while monetary convergence appears to be a significantly more remote perspective. Some tentative data on the CEEC-5's performance against the backdrop of the convergence criteria are contained in Tables 1 and 2. Substantial caveats have to be made as regards the interpretation of these figures. First, despite substantial progress in the statistical field in the CEEC-5, data are not always fully reliable and consistent. Second, in most cases calculation methods vary substantially from EU standards as well as among candidate countries. Thus, the figures presented below should be understood as rough indicators of a country's possible approximate stance with respect to the criteria, but they can by no means constitute a basis for judging whether a country actually "fulfills" one or the other criterion (which, just like comparisons between the CEEC-5, for the time being do not have much meaning anyway).

More interesting than the actual state are the **prospects** for macroeconomic convergence. Most recent economic forecasts (e.g. by the World Bank, the European Commission, the OECD or the WIIW) contain a positive short-term outlook with fairly high and robust growth, slowly falling inflation and further fiscal improvement. It is, however, too early to say what the dynamics of convergence will be in the medium or long run. What is clear is that a **series of problems** will have to be tackled on the road to further convergence, in particular with respect to government finances and to inflation.

As Table 1 shows, all five countries have made major progress in strengthening **government finances**, especially through tax reforms and cuts in expenditure, during the past few years. Fiscal accounts have been balanced or have shown only moderate deficits for several years, with the exception of Hungary, where the shortfall (excluding privatization revenues) is somewhat larger, but exposes a clear downward trend, and Slovakia, which made headway to a low budget deficit only in 1995. Still, in order to assure the *sustainability* of fiscal consolidation achieved so far, there is a need to tackle existing structural problems, especially in the social security system (but also in other sectors like education). Further challenges relate to substantial prospective revenue losses from customs duties (in the wake of the reduction of tariffs and, in some cases, the phasing-out of import surcharges) as well as to potentially higher expenditures due to badly needed infrastructural investment, the costs of legal harmonization and administrative preparation for EU membership as well as the need to do away with financial sector weaknesses. Finally, in the wake of EU accession, the CEEC-5 will have to set aside substantial budgetary means to meet the

[27] See also Pearce (1995).

[28] See e.g. Riecke (1996).

Table 1 **Macroeconomic Performance in the CEEC-5 in 1995 against the Backdrop of the Inflation, Interest Rate and Fiscal Convergence Criteria of European Monetary Union**

	Average inflation	Average interest rates for long-term government bonds	Public sector deficit/GDP[29]	Public debt/GDP
Reference value	2.7 %	9.7 %	3 %	60 %
Czech Republic	9.1 %	app. 9 %	0.6 % surplus	13 %
Hungary	28.2 %	app. 30 %	2.9 %[30]	87 %[31]
Poland	27.8 %	app. 22 %	2.6 %	58 %
Slovakia	9.9 %	app. 10 %	1.6 %	26 %
Slovenia	12.6 %	app. 12 %	0.0 %	31 %

Sources: WIIW, national sources, own calculations; for Slovenia: Lavrac and Lavrac (1996).

[29] These figures are based on central government deficits and are therefore only proxies for the overall public sector debt to GDP ratios. Also, in some cases fiscal balances include privatization receipts on the revenue side, which does not conform to EU regulations. This is an especially relevant factor with respect to Hungary.

[30] This figure includes extraordinarily high privatization revenues stemming primarily from the sell-off of substantial parts of Hungary's public utilities. The deficit without privatization revenues stood at 5.5 %. According to estimates, there was a clear downward trend to below 3 % of GDP (excluding privatization revenues) in 1996.

[31] In 1996, there was apparently a clear downward trend (estimated reduction by 5 to 10 percentage points).

Table 2 **Exchange Rate Regimes and Policies in the CEEC-5 in 1995/96 against the Backdrop of the Exchange Rate Criterion of European Monetary Union**

	XR regime	Basket	Fluctuation bands	XR stability	ERM membership
Requirements	ERM	---	"normal" fluctuation margins of the ERM (until August 1993 ± 2.25 %, since then ± 15 %)	currency has to remain within the "normal" fluctuation bands, no initiation of a devaluation for 2 years	yes, according to Article 109 j (1) indent 4 EC Treaty
Czech Republic	fixed peg	65 % DEM, 35 % USD	± 0.5 % until February 28, 1996, since then ± 7.5 %	stable against the basket	no
Hungary	adjustable peg until March 13, 1995, since then crawling peg	70 % ECU, 30 % USD (as of January 1, 1997: 70 % DEM, 30 % USD)	± 2.25 %	devaluations of 1.4 % on January 3, 1995, of 2 % on February 14, 1995, of 9 % on March 13, 1995; since then automatic monthly devaluation rate 1.9 % against the basket (until June 30, 1995), 1.3 % (until December 31, 1995), 1.2 % in 1996	no
Poland	crawling peg	45 % USD, 35 % DEM, 10 % GBP, 5 % FRF, 5 % CHF	± 0.5 % until March 1995, ± 2 % until May 16, 1995, since then ± 7 %	automatic monthly devaluation rate 1.4 % until Febuary 16, 1995, 1.2 % until January 8, 1996, 1 % since then; in addition, step-revaluation on December 22, 1995 by 6 % against the basket	no
Slovakia	fixed peg	60 % DEM, 40 % USD	± 1.5 % until December 31, 1995, ± 3 % until July 17, 1996, ±5 % until December 31, 1996 (since then ± 7 %)	stable against the basket	no
Slovenia	float	---	---	tolar depreciated against ECU by 11.8 % (in nominal terms) between January 1, 1995, and November 30, 1996	no

cofinancing requirements for EU transfers from the structural funds.

Inflation has been substantially reduced and has already reached or come close to single-digit levels in the Czech Republic, Slovakia and Slovenia (see Table 1). A significant further lowering of inflation will however be an arduous task, taking into account in particular deeply entrenched inflationary expectations, the persistence of several elements of cost-push inflation (e.g. such as the full adjustment of energy prices to cover costs and allow for adequate profit margins or with respect to nominal wage pressures) and the monetary management problems resulting from capital inflows. Moreover, inflation pressures may intensify if widening trade and current account deficits of one or the other country prove to be unsustainable. Finally, as a consequence of accession to the Community, the CEEC-5 will experience a substantial upward adjustment towards EU price levels for agricultural goods and food products (in case agricultural trade is fully liberalized at the time of joining).

A last aspect relating to the economic convergence criteria is the question of how these benchmarks will be adjusted against the backdrop of the creation of a euro zone in 1999. This issue is part and parcel of a comprehensive EMU **scenario for EU states joining the euro area after January 1, 1999**, which is currently under preparation. It is especially relevant with regard to the redefinition of the exchange rate criterion, which will relate to the participation in the Exchange Rate Mechanism of the EMS II, but also to the adaptation of the inflation and the interest rate criteria. The prospective reference value for the inflation criterion could be the euro-area-wide inflation rate plus 1.5 percentage points, the interest rate criterion could be revised analogously. The fiscal criteria will remain unchanged. The principle of equal treatment will ensure that, when the degree of convergence of Member States with a derogation is examined, the adjusted criteria will be applied in the same way as the original criteria to those countries participating in the euro area from the outset.

While the economic convergence criteria will become decisive parameters for the CEEC-5 only at the time they get ready to join monetary union, several aspects of EMU will become directly relevant in the more immediate future, and in some respects they are important already today. On the one hand, the introduction of the euro and the establishment of an EMS II will have substantial implications for the monetary and exchange rate policies of the CEEC-5. On the other hand, the membership candidates will have to adjust their frameworks for economic policymaking to the policy coordination and surveillance mechanisms and the institutional and legal provisions of economic and monetary union.

5.2 Monetary and Exchange Rate Policy Implications

The **introduction of the euro** in 1999 will create wholly new framework conditions for the CEEC-5's monetary and exchange rate policies, given their high degree of economic integration with the prospective euro zone countries. The four countries under review, which have pegged their exchange rates, will have to adjust the basket to which their currencies are pegged. This means replacing the Deutsche mark and, in the case of Poland, the French franc. Such adjustments could also offer an occasion for lowering the USD share in the baskets, which, in the light of trade patterns, is relatively high at least in the Czech Republic,[32]

[32] See Radzyner and Riesinger (1996). In order to make a judgment on the basket composition from a trade point of view, one would have to know the shares of the Deutsche mark and other currencies of the European stability zone as well as the USD share as regards the invoicing of foreign trade. (For example, the USD invoicing shares in the Czech Republic were 22.6 % for exports and 24.4 % for imports in 1995, while the USD share in the currency basket is 35 %. In contrast, the 1995 USD invoicing shares for Hungary's and Poland's foreign trade corresponded very closely to the USD share in the currency baskets of these two countries.) Prospectively, the composition of baskets will also depend on the question of whether the euro will take on a vehicle currency role, i.e. whether it will serve as an invoicing currency for the CEEC-5's trade with countries not only within but also outside the euro area. However, it should not be overlooked that decisions on basket compositions are not only based on trade patterns, but on a broad set of economic and political considerations. In the economic realm, also the size and the denomination of existing foreign debt, debt management deliberations and the composition of

or even for opting for an outright peg to the euro. In fact, the governor of the Czech National Bank stated in February 1996 that the dollar/mark basket would be kept for the time being, but the crown would be pegged solely to the euro, if the EU achieved Stage Three of monetary union.[33] For Slovenia and its (managed) floating exchange rate regime, there will be no direct need for changes as a consequence of the introduction of the euro. Nevertheless, the policymakers will have to tackle the basic issue of whether Slovenia should switch to a fixed exchange rate system in the context of preparing for EU membership or whether the float should be retained during the preaccession period. If the country opts for the former, questions of timing and regime designing will have to be answered. Apart from exchange rate considerations, the euro will influence the management of official reserves held by the Central and East European central banks as well as foreign debt management.

As a consequence of the CEEC-5's accession to the EU, their national banks will become members of the **ESCB**. The CEEC-5 will be formally included into the EU-wide monetary policy dialogue, most importantly via the participation of their central bank governors in the meetings of the General Council of the ECB, which will comprise – in contrast to the other ECB decision-making bodies – the Governors of the national banks of *all* EU countries (as well as the President and Vice-President of the ECB). It will be primarily through this body that monetary policies between euro and non-euro countries will be coordinated.

EU membership will limit the CEEC-5 central banks' and their governments' room for maneuver with respect to exchange rate policies, as this policy field is a matter of common interest within the Community (Article 109 m EC Treaty). The question here will be whether the CEEC-5 will formulate and implement their exchange rate policies within or outside the Community's revamped exchange rate arrangement. There are two main reasons why the countries under review may opt for a participation in **EMS II** and its Exchange Rate Mechanism (**ERM II**) from the outset of their EU membership. First, EU institutions and most Member States will strongly expect the CEEC-5 to join the EMS II and its Exchange Rate Mechanism. Second and even more important, taking part in EMS II and ERM II will be in the economic self-interest of the CEEC-5, as the balance of rights and obligations within the arrangement is more favorable than in the case of staying aside, even if intervention obligations are asymmetric. [34] If the CEEC-5 continue to pursue stability-oriented policies and reforms (as assumed here), they should have reached sufficient convergence to join EMS II and its Exchange Rate Mechanism, which will be fairly flexible, without major problems when entering the Union.

Participation in ERM II will bring several changes for the exchange rate regimes of the Central and East European countries. Changing parity rates will no longer be possible unilaterally, but will require common consent. The latter is also true for the setting of initial parity rates. Intervention constraints will change. Still existing baskets will be replaced by a peg to the euro and there will be no room for crawling pegs any more. (This means that Poland and Hungary will have to devise a schedule for reducing their automatic monthly devaluation rates in time alongside with further advances towards price stability, so that they will eventually shift to a fixed peg.) The width of the fluctuation margins should pose no problems, as the ERM II band will be larger than the widest presently existing margins in Central and Eastern Europe.[35] Slovenia will have to give up the floating exchange rate system when it joins ERM II at the latest.

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foreign direct and portfolio investment stocks and flows can play a role. As for political aspects, the quest for integration or other foreign policy considerations may be of relevance.

[33] See Reuters (February 28, 1996; December 24, 1996).

[34] The obligation of the ECB to intervene will be limited by its prime commitment to price stability.

[35] According to the conclusions of the European Council in Dublin, the standard ERM II band will be "relatively wide, as the current [ERM I band]". Concerning the extension of bands in Central and Eastern Europe see Radzyner and Riesinger (1996).

5.3 Legal Convergence

Economic and monetary union embodies a set of **institutional and legal provisions**, particularly in the fields of central bank independence and the prohibition of budgetary financing by central banks, pertaining in principle to all EU Member States no matter whether they are countries with or without a derogation.[36] A related issue is full convertibility, which constitutes not only a main element of Stage One of economic and monetary union, but is also a precondition for joining the EU internal market.

Central bank independence in the sense of the EC Treaty means that "neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body" (Article 107 EC Treaty). All EU Member States have to make their national legislation compatible with this provision at the latest at the date of the establishment of the ESCB (Article 108 EC Treaty).

The CEEC-5 have basically fulfilled this precondition.[37] However, the Polish situation is specific, as the country's central bank law has been in force since 1989 and is thus the only remaining central bank act of the countries under review dating from pretransformation times. This law does not contain a clear regulation with respect to central bank independence. The discussion of a new central bank law by Parliament, which has gone on for a while, has not yet led to resolving this issue fully. The main problem apparently lies in a clause of the draft law concerning the adoption of the monetary policy guidelines by the Sejm. This may, in the National Bank's view, amount to receiving instructions from parliament. Still, one can expect that the Polish norms on central bank autonomy will be brought in line with EU standards in a not too distant future.[38]

The **prohibition of budgetary financing by the central bank** (Article 104 EC Treaty) has been in force since the enactment of the Maastricht Treaty and will thus affect EU candidate countries from the outset of membership. In this area, the CEEC-5 have also made substantial progress. Lending to government is strictly limited in terms of amount and maturity[39], and it is the goal of the CEEC-5 to prohibit any such lending by law in the medium term. It should be noted that Article 104 also relates to debt outstanding. This means that dates for the eventual amortization of the debt stock will have to be set. The accepted practice in incumbent EU states is to find very-long-term solutions to the repayment of such debt. Hungary, where the outstanding debt of the state against the central bank is comparatively high for several reasons, has already begun to tackle this problem.[40]

In the area of **convertibility**, current account transactions have already been fully liberalized by all of the CEEC-5: The countries under review declared their currencies to be convertible according to Article VIII of the IMF's Articles of Agreement between June 1995 and January 1996. The Czech Republic, Hungary and Poland have made major progress liberalizing invisible transactions and capital movements in the context of their OECD accession in 1995/96. Slovakia and Slovenia can be expected to achieve a similar

[36] The only partial exception to these obligations relates to the UK. In case this country chooses to exercise its EMU opt-out clause, the UK will not be obliged to make the Bank of England independent.

[37] In fact, Hungary reinforced the independence of its National Bank by an amendment to the central bank law which entered force on January 1, 1997: The position of the Governor was strengthened by extending to him the right to nominate candidates for the Deputy Governor positions, and the term of office for the Deputy Governors was extended from formely three to now six years.

[38] See Hochreiter and Riesinger (1995). For Poland, see Reuters (April 22, May 30, June 12, July 3, 1996), PAP (September 30, October 2, 1996).

[39] See Hochreiter and Riesinger (1995).

[40] One reason for the size of the debt stock in Hungary is related to the fact that the National Bank has traditionally had the function of raising funds on the international capital markets. From this activity, the Bank has incured sizeable losses due to subsequent forint devaluations which have been recorded in the Bank's balance sheet as (zero-interest) claims against the state. All these losses were removed from the Bank's balance sheet and effectively taken over by the central budget as of January 2, 1997.

degree of currency exchangeability when they join this organization.[41] Full or almost full liberalization is envisaged in all CEEC-5 along broadly similar lines by the year 2000. The respective deregulation plans appear realistic and one may conclude that for most, if not all, CEEC-5 convertibility will not be a major problem in the context of a future EU accession.[42]

5.4 Policy Coordination and Surveillance

Finally, the **policy coordination and surveillance** provisions of the EC Treaty will affect the CEEC-5 after their accession to the European Union. Among these, the "excessive deficit procedure" (Article 104 c EC Treaty) is the most important. The CEEC-5, given their fairly good fiscal performance so far and their efforts to remedy structural weaknesses in their public sectors, should be able to comply with this procedure and to honor any EU recommendations under Article 104 c. Even if the array of sanctions under the excessive deficit procedure against EU countries with a derogation remains limited,[43] the liberalization of capital movements in the context of EU accession will in any case provide a strong incentive for fiscal prudence.[44]

In addition, the regular presentation of convergence programs will become relevant for the countries under review. What role these programs will actually play for the CEEC-5's policies will depend upon the result of the Union's endeavors to strengthen this mechanism. In any event, upgraded convergence programs could only be an advantage for the CEEC-5, as they could more effectively aid the preparations for an eventual joining of EMU than today's procedures.

6 Conclusions

This study has looked at the interplay between European Monetary Union and a future EU enlargement to Central and Eastern Europe. The country focus has been on the Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEEC-5). The basic assumptions of the analysis are: EMU will be implemented and completed as planned; a first wave of Eastern enlargement, including all or most of these countries will occur in 2002 or shortly thereafter; the CEEC-5 will join EMU only some years after becoming EU members. The main conclusions of the study are:

First, monetary cooperation between the European Union and the CEEC-5 has been fairly loose so far, but recently one can perceive a certain trend towards a more regular dialogue.

Second, there is not likely to be a conflict between a deepening of monetary integration within the EU and an enlargement of the Union to the East. In fact, by keeping up the momentum of European integration, EMU is creating a favorable climate for a future Eastern enlargement.

Third, EMU is becoming ever more relevant to the CEEC-5: The introduction of the euro will substantially alter the framework conditions for their monetary and exchange rate policies. A subsequent EU accession by the CEEC-5 will imply further changes, in particular the inclusion of their central banks into the ESCB and a participation in the EMS II and ERM II. The candidate countries will probably not have major difficulties in adjusting to the institutional, legal and procedural conditions of economic and monetary union. The EMU convergence criteria are not EU accession criteria and will therefore not play a major role in the EU accession process of the CEEC-5 but only at a later time when these countries get ready to join monetary union. From today's perspective, these criteria can serve as medium and longer-term points of reference for stability-oriented economic policymaking.

[41] In fact, on December 1, 1996, Slovakia enacted, as a preparatory move towards a later OECD accession, a set of measures to further liberalize some kinds of capital account transactions.

[42] For a detailed analysis see Backé (1996).

[43] If the respective country does not take effective action in response to these suggestions within a preset period of time, the Council has only one sanction it can inflict on excessive-deficit countries with a derogation, namely publishing its recommendations. This decision must be taken with a weighted two-thirds majority.

[44] See e.g. Backé (1996), Bofinger (1996).

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