Brussels Workshop, 9 May 2003

Eurozone Enlargement - Exchange-rate Choices and Adjusting Markets

Minutes

I. Andrej Stuchlík (FU Berlin) Minutes: "Keynote Lecture"

The Keynote Lecture was delivered by Dr. Vít Bárta, scientific advisor to the Czech National Bank: **"Major challenges for accession countries on their way towards euro".**
The scientific advisor to the National Bank asked whether CEE countries tend to underestimate their possibilities with regard to EMU and strive too eagerly for the common currency. This however, should come as a surprise given the fact of UK's and Denmark's hesitation to join the club. Finally, the speed of accession displays the need to import political and economic stability. Nevertheless, some adjustment costs will arise and will possibly put the small open eastern European economies under pressure. (The full presentation as pdf-document: **Link)**
Among the major challenges are the choice of the most appropriate exchange-rate regime prior ERM II accession, the driving forces of real appreciation, the twin convergence processes, i.e. real vs. nominal, the impacts of capital flows, the speed of accession in general, the ERM II mechanism itself and finally the level of interest rates and the associated risk of overheating the economy.
As with regards the ERMII-mechanism, this fixed but adjustable instrument has its weaknesses. To prove this Dr. Bárta evoked the most current Hungarian experience. Watching the Forint crisis this January with its obvious conflict between different targets of monetary policy, he concluded that the crisis was due to a "too early fixing of the parity vis-à-vis euro". Quite provocatively he therefore stated: "if you do have inflation targeting, do not shadow ERM2; if you do shadow ERM2, keep your public budget under control; if you do not keep your public budget under control, do not be surprised by the results." Apart from that the often mentioned risk of overheating, for instance, should become manageable. Neither Ireland, nor Portugal suffered from a too low real interest rate due to its higher inflation within euroland. Instead this points to possible catching-up developments "which would not be otherwise conceivable".

II. Dominik Sobczak (Warsaw School of Economics) Minutes: Panel „Markets", Topic I "Goods, Services and Capital Markets"

1. Presentation of Prof. Dr. José Caetano, Ezoneplus, University of Évora

- Generally trade and FDI have global positive effects; however there may be some negative effects in transition countries.
- As far as the share of trade with the EU in the total volume of trade in accession countries is concerned, these countries are already integrated with the European Union.
- In the long term there is still some room for increasing the volume of trade between the European Union and Central and Eastern European Countries (CEEC).
- Generally the European Union countries have comparative advantages in human capital and RND intensive products. The changes in this are gradual in the European Union, but rapid advancement has been observed in the CEEC.
- Generally, as a result of the single market and the EMU, vertical specialisation of production is observed, which stipulates a new division of labour.

2. Presentation of Thomas Meyer, Ezoneplus, Freie Universität Berlin

- CEEC offer good investment opportunities; therefore they experience a high inflow of capital. This however raises questions whether it is beneficial for growth and if this inflow is sustainable. As the first one is concerned, some positive tendency is observed. As far as the latter, this can be sustainable if these countries continue to develop, however over-investment can be a problem when financial markets are underdeveloped.
- German banks loaned much more money to the CEEC than banks from other countries, but even if the German banking sector experienced serious problems this should not pose a problem, as it is very unlikely that German banks will withdraw their foreign investments.
- CEEC are not Asia or Argentina, they are in a totally different situation as far as the possibility of a financial crisis is concerned.

3. Discussion

- Jakub Borowski, National Bank of Poland
  - Case of Portugal – CEEC may be exposed to higher risks due to asymmetric shocks after the EMU accession – question to Prof. Caetano – What will happen in Portugal after the EMU enlargement?
  - Question to Prof. Dr. Jaakko Kiander (Ezoneplus, VATT, Helsinki) – Could you elaborate a little bit more on the processes behind the boom and bust pattern in the labour market after the accession of CEEC to the EMU?
- Prof. Caetano
  - Decrease of intra-industry trade is not a surprise. Over the last years Portugal's attractiveness for FDI decreased significantly because of Portugal's commitment to fulfil the Maastricht criteria in a short period. In addition, at the same time structural adjustments didn't take place. In effect, Portugal has considerable problems in complying with the provisions of the Stability and Growth Pact, and is threatened by negative growth.

- Prof. Dr. Jaakko Kiander
  - When labour conditions improve after the EU accession, trade unions may start to exert greater pressure on the increase of wages and employee protection.
  - Boom and bust – after the EMU accession there will be a short-term positive economic shock due to possible negative real interest rates. Therefore, according to the equilibrium model, there has to be a negative reaction.

III. Risto Vaitinnen (VATT) Minutes: Panel "Markets" Topic II: "Labour Markets"

J. Kiander emphasised in his introductory presentation the role of factor movements in the process of real income convergence between current and coming euro zone countries. The magnitude of factor movements and income transfers that are related to an enlargement of the euro zone area is significant for new member countries but small for the existing members. J. Kiander based his assessment on the results of CGE-model simulations that have been used in the project to evaluate the labour market consequences of the enlarged euro area. E-zone enlargement is expected to be beneficial for all countries involved if adjustment is smooth and convergence rapid. However, the likely positive shock that euro zone enlargement causes to capital inflow into the new member countries might cause real exchange rate overshooting. The adjustment to low inflation track implies slower growth and increasing unemployment for transitory period.

During the discussion J. Borowski (Head of Division “Macroeconomic and Structural Analysis Department”, National Bank of Poland) asked about the different mechanism that in the modelling framework causes the different impacts. He also asked whether the resent research of the trade creation role of currency union were taken into account in the model simulations. In his reply J. Kiander said that only the conventional trade policy effects of EU enlargement were part of the trade effects in the model simulations. The boom and bust aspect of the model simulation is an outcome of partial wage adjustment when wages react to errors in expectations.

IV. Christian Fahrholz (FU Berlin) Minutes: Panel “Exchange rates”

Prof. Dr. Renzo Orsi (Ezoneplus, University of Bologna) outlined the topic by giving a presentation on experiences and lessons from exchange-rate regimes in transition countries. Surveying the evolution of such regimes, a trend towards rather flexible regimes has been observable. This trend has come along with a convergence of inflation rates in these countries. Prof. Orsi also sketched the issue of costs and benefits of alternative exchange-rate regimes. In doing so, he inquired factors explaining respective country-specific choices.
J. Borowski commented on Prof. Orsi’s and Christian Fahrholz’ contribution to the Ezoneplus Summary Report “Eurozone Enlargement – Exchange-Rate Choice and Adjusting Markets”. Borowski criticised in particular the ‘threaten-thy-neighbour’-strategy by pointing at the lack of ambiguity of the ERM II provisions. According to his view, there will be no room for political manoeuvre. Maastricht criteria of the Treaty represent rather an adhesion contract for transition countries not giving any leeway at all.
During the subsequent discussion, Prof. Dr. Michael Bolle (Co-ordinator of Ezoneplus, Berlin) suggested that potential moral hazard might trigger speculative attacks deteriorating

the overall enlargement process. From the point of view of Ezoneplus, the enlargement process is basically exporting legal institutions to transition countries. In this regard, prosperity – at least macroeconomic stability – serves as a legitimisation of this institutional transfer, i.e. it ensures public support. This process takes place in a similar way as has happened to the political and economic recovery in Germany after WWII. However, differently to that time economic recovery will now rely on private capital financing instead of direct transfers as in case of the Marshall Plan funds. In this context, the role of alternative conversion rates, balancing the trade-off between exchange-rate regime sustainability and catching-up, has been discussed.

V. Andrej Stuchlík (FU Berlin) Minutes: "Roundtable Session – Risks"

Prof. Hanns-Dieter Jacobsen (Ezoneplus) started the discussion by claiming that most of the risks involved in the Euro enlargement are well known. However, what has been neglected so far is the interaction between different market segments such as labour with capital markets. Moreover, economic analysis tends to underestimate bargaining procedures in the course of EMU accession. Thus, in order to get a coherent picture of possible risks ahead, analysis must not encompass only economic effects but should focus also on political interaction mechanisms.

By the same token, Prof. Katarzyna Żukrowska (Warsaw School of Economics) stressed that most risks are well known by now, however as some of them showed up, they did so "but not where we were expecting them". According to her point of view, a hidden problem stems from liberalisation and globalisation leading to small open economies highly dependent on capital imports. To date the huge flow of capital has been beneficial but in course of EMU accession especially the low labour market flexibility may increase the "potential" reversal of those flows. To fight this possibility may lead to relatively high tax rates and may hinder growth. In the worst case, this could prompt institutional investors to opt for speculating against a CEE currency once they enter the somewhat flawed ERMII arrangement.

Another issue neglected so far to Prof. Żukrowska is the tendency of "decoupling" monetary and fiscal aspects of EMU accession. The respective Maastricht criteria should not be tackled separately since they are interdependent. Due to their size and dependency on foreign capital most economic roadmaps designed for industrial nation states are no longer applicable. Hence, often desirable aims are tried to be achieved via disputable ways.

"Not everyone will benefit the same way", Prof. Galego, (Ezoneplus, University of Évora) then emphasised herewith pointing at the general tendency in Euro-talk to neglect the huge variety across EMU-candidates. Moreover, benefits are not equally dispersed across Euroland either. In Portugal for instance, the textile industry will have to bear the heaviest burden. However, fears of FDI diversion in general appear to be rather unjustified, since this is about to happen anyway and independently of the enlargement of the common currency.

However, what about structural funds? Negotiations on the 2007-2013 budget showed how politically delicate a quarrel between 15 members may be. But what is going to happen with a size of 25?

The last risk Prof. Galego mentioned takes a country specific perspective: the question whether CEE applicants for the Euro might learn from the Portuguese experience? She argued that although the early accession has been a sound decision in political terms it might not from an economic perspective. With regard to Portugal's budgetary stance the adoption of the Euro came too early since not all structural reforms needed were properly executed at that time.

Then Dr. Lavrač (IER, Ljubljana) led the discussion towards open monetary and fiscal issues. Tackling the first both, for the CEEC as well as for the EU, the enlargement of the Eurozone involves some strategic reasoning. The applicants must keep in mind not to join the ERM II too early as well as not too late. Moreover, once they are in, staying too long should be avoided. Being somehow opaque regarding its requirements and day-by-day procedures, any participation within the ERM II should therefore be as short as possible. On the other hand, countries of the Eurozone strive to let new members in only if those may be ripe to do so. Current experience with the Stability and Growth Pact sheds some light on rather poor performances with respect to austerity politics. As has been done by Prof. Żukrowska he pleaded for a combined view on monetary and fiscal aspects and raised the question of fiscal sustainability in the light of demographic developments and the possibility of a somehow "adjusted" SGP for CEE countries. The EU could envisage leaving more room of manoeuvre to the applicants due to additional expenditures on infrastructure and institution building. Still, to him some open issues remain: such as the actual size and scope of adjustment costs for the CEE countries as well as the implicit bail-out by the European Union. Is it conceivable, he argued, that in case of a crisis the EU would remain silent and not assist?

The short presentations were followed by a lively discussion namely between Prof. Bolle, Dr Bárta and Mr Borowski. The Polish central banker first raised the issue of how to fix the idea of an equilibrium exchange rate? Should policy-makers watch out for the external or the internal value, how could such a bargaining situation as mentioned by the Ezoneplus team (see above) ever occur? Prof. Bolle took up again the role to explain why governments might feel tempted to behave strategically. From the EU perspective this implies that the biggest risk lies in possible "bad politics" the CEEC might conduct. How could the EU respond to such a risk and how could credible exchange-rate regimes be fostered? A primary conclusion to him would be primarily to help these countries to raise their savings rate, thus the governments would be able to "invest in investments" and make their economies more mature.

Finally, Dr. Bárta stepped into the discussion and urged researchers to focus more closely on tangible risks. Given the fact, that central bankers would have only marginal influence on policy outcomes he rather supported the Polish perspective in saying that an explicit overvalue strategy seems highly unlikely.

List of Participants

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Mr	Dr. Reinhard Boest	Vertretung des Landes Mecklenburg-Vorpommern bei der EU
Mr	Prof. Dr. Michael Bolle	Freie Universität Berlin
Mr	Jakub Borowski	National Bank Poland
Ms	Dr. Antje Brehmer	Vertretung des Landes Berlin bei der Europäischen Union
Mr	Paul Butzen	National Bank Belgium
Mr	Prof. Dr. José Caetano	Universidade de Évora, Portugal
Mr	Christian Fahrholz	Freie Universität Berlin
Mr	Dr. Peter Fisch	European Commission, DG Research
Ms	Kristina Frels	Bank für Sozialwirtschaft AG
Mrs	Prof. Dr. Aurora Galego	Universidade de Évora, Portugal
Mr	Hans Geeroms	National Bank Belgium
Mr	Fabrizio Iacone	London School of Economics
Mr	Stefaan Ide	National Bank Belgium
Mr	Prof. Dr. Hanns-D. Jacobsen	Ezoneplus Berlin
Mr	Axel Kampf	Vertretung des Saarlandes bei der Europäischen Union
Mr	Achim Kemmerling	Freie Universität Berlin
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Mr	Dr. Vladimir Lavrač	IER Ljubljana
Mr	Jaan Masso	University of Tartu
Mr	Thomas Meyer	Freie Universität Berlin

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