Eurozone Enlargement
—
Exchange-Rate Choices and Adjusting Markets

EZONEPLUS Summary Report

Michael Bolle (Ed.)

Bolle, Michael (Ed.). *Eurozone Enlargement – Exchang-Rate Choices and Adjusting Markets*. Berlin: Berliner Wissenschaftsverlag, 2002. (ISBN - 3-8305-0350-4)
www.ezoneplus.org

Editor’s note

Accession to the European Monetary Union (EMU) will call for much greater adjustment efforts than does the "simple" enlargement of the European Union (EU). It can be expected that the inclusion of formerly communist Central and Eastern European Countries (CEEC) into the EMU, starting as early as 2006, will accelerate deep changes within existing European institutions and in the new member countries as well.

This Summary Report reflects the first results of the research project "The Eastward Enlargement of the Eurozone (Ezoneplus)" that has analysed the implications of such a move on markets, particularly on labour and capital markets as well as on trade and foreign direct investment (FDI). Our research shows that exchange-rate policies – the regime chosen as well as the rates themselves – are of decisive importance. Fierce bargaining can be expected over the issue of how to distribute the adjustment costs between the old and the new member states.

The research consortium, supported by the EU's 5th Framework Programme, consists of leading economic and political research institutions from Estonia, Finland, Italy, Poland, Portugal, and Slovenia, coordinated by the Freie Universität Berlin's Jean Monnet Centre of Excellence. Under the direction of Hanns – D. Jacobsen, Christian Fahrholz and Andrej Stuchlík have compiled this report by developing a set of focal questions and by extracting some conclusions that should provoke further discussion. Additional thanks go to Achim Kemmerling, Thomas Meyer, and Katarzyna Żukrowska who provided expert help and our students, Oliver Pamp and Algara Stenzel, who prepared the print version.

December 2002

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Introduction

1. Coping with Reshaped Markets – Purpose of this Report

Eight Central and Eastern European countries (CEEC) are about to join the European Union (EU), most of them possibly as early as 2004.[1] Shortly after – and perhaps only two years – after joining the EU, these countries will (and have to) surrender monetary sovereignty and adopt the euro as legal tender, thus, becoming full members of the eurozone, or European Monetary Union (EMU) – including voting rights with regard to the conducting of monetary policy by the European Central Bank (ECB). This step, or, to be more precise, series of steps, has already been taken by the current twelve members of EMU[2], and they are still struggling with the economic and political adjustment processes.

In fact, the third step of European monetary unification in 1999, which fixed the exchange rates between the EMU members irrevocably, has provoked much academic discussion on the pros and cons of a joint currency, usually starting from optimum currency area arguments. A trade-off is assumed between the advantages of economic integration on the one hand – i.e., enhanced and more efficient cross-border allocation of resources – and the loss of political flexibility in terms of monetary autonomy and exchange-rate variations on the other. If the benefits of integration are low, a high probability of asymmetric shocks increases the need for economic discretion. If other means of flexibility, e.g. rapid price adjustments, migration, or fiscal transfers, are lacking, the verdict is returned against a common currency.

Thus, considerations on whether, and how, to benefit from integration and the eastward enlargement of the eurozone turn out to be dependent on the scope of transition in terms of real convergence already achieved. In a dynamic view, EMU and the introduction of the euro can even be expected to deliberately constrain economic policy, though flexibility might be needed. Since the markets are not yet providing such flexibility, they might – or have to – change. Markets themselves adapt and reshape when confronted with changing constraints requiring sufficient institutional arrangements and functional legal infrastructure. Thus in turn, market rationale might coerce public authorities to accommodate this process of reshaping.

As a consequence, public authorities in CEE face a dilemma because they have to respond to cost – bearing market adjustment processes in a way that does not hurt their chances to stay in power. In a nutshell, the question is: How can the adjustment burden be shouldered? Who is going to pay? Conventional wisdom in the EU implies that this kind of question usually leads to extensive bargaining between all parties involved. However, what means do CEEC have at their disposal to successfully induce, or force, the EU or the ECB to step in? Can the latter afford, politically and economically, to

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[1] They include the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and the Slovak Republic, as well as Romania and Bulgaria. The latter two are generally considered as not yet ready for accession. Cyprus and Malta also participate in the current accession process.

[2] The current EMU members are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, The Netherlands, Portugal, and Spain.

leave the main load of the adjustment burden to the CEEC alone and run the risk of jeopardizing the accession schedule? On the basis of comprehensive analyses of capital, labour, and goods markets, and existing exchange-rate regimes, this Summary Report will offer some conclusions on the bargaining processes that are to be expected.

2. Issues Areas Addressed

The Summary Report presents the first major findings of the international three – year research project Ezoneplus, reflecting challenges for CEE as well as for EMU countries posed by the eastward enlargement of the eurozone. Ezoneplus profits from the participation of scholars representing the disciplines of political science and economics coming from seven research groups in Estonia, Germany, Finland, Italy, Poland, Portugal, and Slovenia. The project aims at a comprehensive assessment of the diverse implications of transition on the process of EMU enlargement.

Four chapters will present the first year's research outcomes in the areas of capital and labour markets, trade & FDI, and offer some initial ideas regarding the conduct of exchange-rate policies. Each part sketches the dominant research issues, presents major results, and indicates the main problems still to be tackled. Common to all chapters is the aim to identify the key effects on efficiency, stability, and the distribution of costs and benefits.

Efficiency and stability are important criteria in assessing the effects of enlarging the Eurozone. To talk about the distributive effects, in turn, is also necessary since the EMU is a politically negotiated institution, in which enlargement may be expected to lead to political quarrels about the distribution of costs and benefits.

We want to emphasize that in the Ezoneplus project exchange rates perform a pivotal role for reasons of efficiency, stability, and distribution alike, despite the fact that countries in transformation apply several different strategies in this specific area, achieving differentiated results in return. Exchange rates imply the largest benefits of enlargement, the hugest risks of destabilising financial flows, and the fiercest political debates about who has to pay for the costs of mutual adjustment. It is for this reason that we start our overview with the foreign exchange market: How do exchange-rate regimes affect the issue areas concerned?

3. Exchange Rates and Exchange-rate Regimes

First, exchange-rate issues are addressed because they are the nexus of the overall economic activity: The exchange rate reflects the performance of all reshaping markets and affects them in turn as well.

To date, research has focussed on exchange-rate regimes as a means of disinflation, shock absorbing and improving international competitiveness, taking into account the advantages and disadvantages of different arrangements. Optimal exchange rates and exchange-rate regimes have been investigated as well as the CEEC' "timing" dimension, i.e. the question as to when to join ERM II[3] and, eventually, the eurozone.

[3] ERM II is a revised version of the former exchange-rate mechanism, a system in which EU currencies rates are given a band of plus or minus 15% within which to fluctuate against one another. Membership of ERM is a precursor to joining EMU. Once the first wave countries are 'in', the ERM will be updated to ERM II, allowing for the fact that by then, the euro will be a book currency and the participating currencies will be irrevocably fixed against it. The main parameters of ERM II will be: (1) central rates

How best, it has to be asked, to smooth the transition process towards EMU, i.e. to prevent the worst–case scenario, an emerging markets currency crisis?

Considering the operation of exchange-rate regimes in CEEC it can be observed that despite the abundance of such regimes during the first half of the 1990s, a common attitude of those rather fixed regimes has been to focus on exchange-rate targeting. During recent years, in fact, some CEEC such as Poland have turned towards more flexibility. Nevertheless, they will have to switch again to fixed but adjustable pegs on account of ERM II. Apart from the original peg with a +/– 15% band, in principle, only tighter bands and hard pegs are permissible. It is important to notice that such regimes are particularly vulnerable to speculative attacks.

With regard to exchange-rate policies, two different stances can be distinguished. First, a government can conduct exchange-rate policy as a subordinated feature of a comprehensive monetary policy in terms of a disinflation strategy, in order to qualify as soon as possible for the adoption of the euro. Second, exchange-rate policy might be conducted in terms of what could be called a "threaten-thy-neighbour"-policy: Provided ERM II membership is granted, couldn't it be beneficial for CEEC governments to loosen their grip on economic and fiscal policy in order to force others step in? Could not such a consideration even provoke a CEEC government to blackmail current members of EMU? In fact, governments could seek to transfer adjustment costs of EMU membership to current and other prospective members of the eurozone. Since CEEC and the EU may have conflicting interests, the question of choosing a particular exchange-rate regime and conversion rate is of particular importance: In essence, the answer determines the distribution of costs and risks between the two sides; not to mention opportunity and exit costs in case of a failure in integrating CEEC into the EU. The legal provisions of 'Copenhagen' and 'Maastricht' largely determine the constraints. Independent of the actual regime adopted, the run-up period will force CEE policy-makers to combine low inflation, financial stability, and continuing structural change in increasingly opening economies – and, thus, to maintain a tight fiscal policy stance. However, the political incentives generated by pegged rates often fail to provide sufficient fiscal restraints to help governments avoid possible currency crises. It goes without saying current members of EMU run such risks as well, but current analyses suggest that CEEC are tempted to exploit those risks to increase their political leverage in financial matters with current members of EMU.

Based on these considerations which indicate a variety of trade-offs as a result of different preferences and restrictions, both the CEEC and the EU have to take into account a still-to-be-determined set of transmission mechanisms affecting the markets in question.

4. Impacts on Labour Markets

One of the major links between foreign exchange and labour markets works through currency crisis. If, e.g., unemployment soars in transition economies with a fixed exchange rate, then speculative attacks are a likely consequence. But exchange-rate

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for currencies will be related to the euro and will be determined on a basis of common agreement, including the European Central Bank; (2) central rates will be able to be adjusted to avoid tensions, with ECB involvement; (3) wide fluctuation bands will exist, but there will be an option for narrow bands if the currency(ies) are more closely converged.

regimes also produce important qualitative and quantitative consequences for the labour market itself.

An inclusion of CEEC into the EU, and finally EMU, is likely to cause labour movements and may speed up economic convergence between the less and more advanced economies of the union. In a nutshell, a common currency makes the CEEC, and the EU for that matter, more transparent and may create enhanced flexibility and mobility in EMU labour markets (stronger incentives for labour movements).

Two effects have to be looked at, labour mobility and labour market flexibility. Labour market flexibility depends to a large extent on wage flexibility and institutional flexibility. The institutional flexibility characterizes to what extent state institutions and trade unions are involved in the regulation of labour markets. This kind of flexibility so far has been, at best, mixed because in most CEEC the socialist legacy and the state-oriented mentality of many voters restrict the political decision-makers' room for manoeuvring and limit the success of appropriate, even necessary, initiatives. At this point one could add that CEEC membership in the EU can be considered as a stimulus for more flexible labour markets in EU members-states. Placing stronger emphasis on active labour market programmes – e.g. education and training, including development of lifelong learning, which is now an established priority throughout the EU – is only a long-term perspective and not likely to produce results over the next several years.

Wage flexibility denotes how responsive wages are to market fluctuations. It is safe to conclude that, in general terms, in almost all CEEC wages are quite flexible, although differences across countries and economic sectors exist. After all, the labour market policy is under-capitalised, unemployment remains high, and minimum wages and unemployment benefits are low.

Western European labour markets, and, in particular, those of the countries neighbouring the CEEC, are still highly rigid in terms of institutional and wage flexibility. Since the consequence is unemployment, this has also delimitating effects for the cross-border movement of people.

With regard to labour mobility, or migration to the EU, it is expected that – once the current regime will be replaced with the right of free movement of labour – the long-run migration potential from the accession countries to the current EU members will not be that significant: roughly 1 per cent of the EU population, less than 4mn people. Unlimited movement of labour will even cause quite serious pressure on the labour markets of the CEEC due to possible movement of better-qualified and more flexible members of labour force (brain drain). Movers will be mainly people with good qualification who do not find appropriate jobs at home.

From these results of the labour markets analyses one can draw the conclusion that neither migration nor labour market flexibility are strong enough to reduce the inevitable adjustment burden of most of the accession countries once they join EMU. They have to look for other means, e.g. for fiscal and labour market policies, to fill the upcoming adjustment gap. But in this respect their flexibility will be limited as well, thanks to the Maastricht criteria and the Stability and Growth Pact. Therefore, it is to be expected that the search for a favourable exchange-rate and an appropriate exchange-rate regime will dominate the candidate countries' accession strategy.

5. Impacts on Capital Markets

The elimination, or enhancement, of exchange-rate risk is probably the key transmission mechanism regarding the eastward enlargement of capital markets. In fact, capital markets involve the most prominent part of the economic system that is strongly affected by monetary integration. Capital markets comprise more than financial systems and foreign direct investments because they include all productive resources that are not labour, but are priced and traded in an organised way.

The institutional framework plays an important role, in particular with regard to ensuring property rights and enforcing the rules of the game. Financial development and economic growth are increasingly perceived to be complementary. Financial institutions provide a number of important services such as trading, hedging, allocation of capital, screening, and monitoring. Financial development may even enhance the domestic savings rate.

With the enlargement of EMU, costs of cross-border transactions diminish as currency risk, vis-à-vis the euro, vanishes, and other *de jure* and *de facto* barriers to international mobility of financial flows are eliminated. Capital markets have undergone massive changes in the past decade in Western Europe, but of course more fundamentally in the CEEC. To ensure the success of EMU an active and open market stance is required. The euro increases the cost of failure and, thus, provides a strong incentive for countries to comply. Repercussions to current members will be stronger; hence, they will not allow any substantial deviation from the consensus economic policy.

A common currency fosters capital market integration, i.e. liberalisation, deregulation, and consolidation of financial services throughout the currency area. More efficient financial markets improve the allocation of capital and thus contribute to long-term growth and prosperity. The main vehicle is more and better investments.

However, in the short run it will be important to avoid imbalances, which might destabilise the candidate states. Country risks might diminish and capital inflows to the CEEC, that are expected to contribute to economic convergence with the EU, might unexpectedly overshoot a sustainable level and be channelled into unprofitable investments. Eventually this money may be suddenly withdrawn, undershooting the long-term level and depriving the applicant states of financial resources and leading to crisis.

A prudent treatment of these flows requires a developed capital market, something the CEEC are only about to acquire. Hence, applicant states should use foreign capital flows especially to promote capital market development – e.g., facilitating entry of foreign banks. The adoption of the *acquis communautaire* and the Stability and Growth Pact provides a tested institutional framework and macroeconomic stability. At the same time, however, this framework delimits macroeconomic flexibility. Again, the exchange rates and the exchange-rate regime chosen before entering ERM II and EMU are of utmost importance for stabilising capital flows and, ultimately, the successful mastering of the fragile and risky transition period towards full EMU membership.

6. Impacts on Trade and Foreign Direct Investment

Regarding trade and FDI it can be expected that EU enlargement entails positive effects on the welfare of all countries involved, due to the reallocation of resources and the restructuring of production and trade. Unrestricted movement of goods, services, and

capital creates a division of labour and provides opportunities for the exploitation of comparative advantages as well as economies of scale. However, in spite of the expected trade creation effects within the enlarged EU (and, in fact, trade diversion outside), it must be acknowledged that during the transition period difficulties may arise in those regions, sectors, and firms that are confronted most directly with the new competitive challenges.

It is true that trade relations between the CEEC and the EU have been considerably reinforced over the last decade. In addition, the CEEC' sectoral composition of relative comparative advantages underwent profound changes, reflecting a gradual shift towards more advanced, even tech-intensive, exports where wages are relatively high. There exists, however, a strong heterogeneity at the country level, suggesting that geographic proximity to the EU and income convergence stimulate product differentiation and trade of R&D and capital intensive goods. The trade expansion of intermediate products and the emergence of vertical specialisation confirm a progressive and quick entrance of the CEEC into the international division of productive processes. The nature of CEEC-EU trade, however, still reflects a strong factor complementarity between the two groups or the absence of intra-industry trade.

Conventional wisdom and simple economic reasoning confirm the insight that an undervalued currency raises export-generated income contributing to the economic performance of a country. The German post-war *Wirtschaftswunder* may be an appropriate example of this. The German Economic and Monetary Union of 1990 provides an example of the opposite strategy. During the process of German unification and the adoption of the West-German Mark, the East German currency was suddenly appreciated by more than one hundred per cent. Again, exchange rates and exchange-rate regimes matter. To the CEEC they appear to be of extreme importance as far as export earnings, competitiveness, and economic growth are concerned.

International direct investment is mainly determined by host country characteristics such as dimension, potential demand, openness to world trade, and lower relative labour compensation levels. Thus, FDI flows play an important role in the process of transformation of trade structures in CEEC. The most important ones include:

- First, a high volume of FDI contributes to the transformation of these countries' specialisation patterns, leading to the gradual consolidation of export structures based upon products that are intensive in technology and in qualified labour.
- Second, in almost all CEEC changes in trade composition were consolidated by an increased share of intra-industry trade in total trade.
- Third, it helps to introduce organisational changes on the micro level.
- Fourth, it brings in advanced technologies and know-how.

All in all, such consequences contribute to CEEC' international competitiveness. In fact, it has turned out that those CEEC that adopted more radical liberalising reforms and applied more extensive privatisation and macroeconomic stabilisation programmes have attracted higher amounts of FDI and have progressed more in economic terms. Improving export performance and growing attractiveness to direct investment from abroad have played a mutually reinforcing role.

7. The Upcoming Bargaining Processes

Our initial verdict was that exchange rates and exchange-rate regimes matter before the Central and East European Countries join ERM II and, finally, EMU. The accession-

induced reshaping process in the European Union reinforces itself by driving the CEEC into an uncomfortable position. The market reports have indicated that the perspective of joining the eurozone leaves few political and economic alternatives to the CEEC but to play and to bargain extensively on the basis of varying and adjustable exchange rates, even to opt for a hard peg or, if need be, to unilaterally introduce the euro before joining ERM II. After all, once these countries are members of EMU, the ECB is unlikely to extensively assist them any longer with regard to monetary and fiscal policy. The Maastricht criteria and the Stability and Growth Pact limit the extent to which the ECB will be able to meet their particular demands.

From this perspective, it is quite likely that the CEEC will try to use their bargaining power for as long as they retain any. To determine the respective rooms for manoeuvring a variety of additional economic and political questions have to be answered, including:

- What will be the consequences of exploiting exchange-rates and exchange-rate regimes for national economic purposes?
- Which are the restrictions both the CEEC and the ECB have to take into account regarding fiscal and monetary policies?
- Which are the primary economic channels that allow for the transmission of politico-economic influence by the CEEC?
- What will be the likely range in the division of adjustment costs once the bargaining process starts?
- Which CEEC will follow what kind of exchange-rate regime?