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Friedrich Heinemann*

Central Europe and European Monetary Integration

A Strategy for Catching Up

The Maastricht Treaty has augmented the preconditions that have to be fulfilled by EU applicants from Central and Eastern Europe before a full membership can be achieved. Candidates have to prove that their participation in the European Monetary Union is a realistic possibility at least in the medium term. In this article, an early EMS membership – under certain conditions – is proposed as a monetary strategy for the reform countries.

The reform countries of Central and Eastern Europe have reason to regard the process of European integration with mixed feelings. While the increasing size and quality of the internal market makes it more desirable for them to join the EU, at the same time the obstacles to an early full membership are multiplied.

These obstacles do not result exclusively from the differences in economic and social structure between Western and Central Europe. On the contrary, at least as serious are the obstacles resulting from the inadequate institutional structure of the European Union. In its present shape, this structure is not appropriate for managing a community of 20 or more member states. The northern enlargement has increased the pressure for reforming the political institutions and decision mechanisms. In this regard reforms can be expected that will make an eastern enlargement easier.

In the budgetary field, the northern enlargement has not led to any reform pressure that could pave the way for Central Europe. Austria and the Scandinavian countries will pay more into the EU budget than they can expect to receive from agricultural and structural funds. So the enlargement has alleviated the budgetary problems of the EU rather than intensified the need for reforms. However, without serious reforms in the fields of structural and agricultural policy eastern enlargement seems to pose insurmountable budgetary difficulties.¹

Even if these budgetary problems could be overcome, the monetary ambitions of the EU have

added to the difficulties. With the Maastricht Treaty a new precondition for membership is the ability to jump onto the train towards a single currency. Under these circumstances, only those countries can be admitted to the EU for which membership in the monetary union is a realistic possibility within the foreseeable future. Because the introduction of a single currency is not without risks that probably increase with the size and diversity of the currency area, new applicants will be assessed very cautiously. Membership can only be realized if the West can be convinced there will be no negative effects on the quality of the single European currency. As a consequence, for a successful EU membership strategy today the monetary perspective must be taken into account much more seriously than before the Maastricht Treaty.

The convergence criteria of the treaty will be a central yardstick. How do the Visegrád countries perform today in the light of two central Maastricht criteria, i.e. deficit ratios and inflation rates? Tables 1 and 2 present some of the relevant data. In the light of the deficit criterium the Visegrád countries do not perform any worse than the West. In 1994 the average deficit ratio of the public sector in the EU-12 countries was 5.6 per cent.² On the contrary, in 1994 no EU country had such a favourable budgetary position as the Czech Republic.

In the monetary field the Visegrád countries still perform significantly worse than Western Europe. The

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¹ Friedrich Heinemann: EU-Osterweiterung und Kohäsionspolitik, Zentrum für Europäische Wirtschaftsforschung, 1995, Discussion Paper, No. 95-01.

² European Commission: European Economy, 1994, No. 58, Table 62.

Table 1
General Government Deficits
(Percentage of GDP)
Estimates and Forecasts

Country	1993	1994	1995	1996
Czech Republic	0.0	0.0	0.0	0.0
Hungary	6.0	6.5	6.0	5.0
Poland	2.9	4.0	3.5	2.5
Slovak Republic	6.8	5.0	4.0	3.0

Source: OECD: Economic Outlook, No. 56, Paris, December 1994.

Table 2
Inflation (Consumer Price Index)
(Percentage Change Over Previous Year)
Estimates and Forecasts

Country	1993	1994	1995	1996
Czech Republic	20.8	11	9	7
Hungary	22.5	20	17	12
Poland	35.3	30	23	18
Slovak Republic	23.2	16	12	8

Source: See Table 1

EU economies have proceeded far on the way towards inflationary convergence at a low level (average inflation (consumer price index) in the EU economies in 1994 was 3.3 per cent).³ The reform states are still clearly above this average inflation rate level.

Only with a further reduction in the coming years well into the single digit region, could the reform states be seen as serious candidates for European monetary integration. The fear is great that a high rate of inflation in the Central and Eastern European countries is a sign of underlying structural deficiencies, such as an inefficient tax system, excessive public expenditure or immature capital markets⁴ and that these deficiencies would lead to inflationary pressure in a European monetary union including these countries. The further process of inflation reduction will not be easy. An adequate monetary strategy should imply an approach to assist further inflation reduction.

Theory of Optimum Currency Areas

Although the Maastricht criteria have to be taken seriously because they will be central within the political qualification process, additional information can be sought from the theory of optimum currency areas and its empirical application.⁵ The theory's

methodology can be used to analyze whether, apart from the political arguments for EMU participation by the reform countries, there is also an economic case for it.

The basic concept of the theory of optimum currency areas is cost-benefit analysis. If a group of countries decides to give up the instrument of an adjustable nominal exchange rate this step helps save transaction costs. Resources which are used in the whole process of managing foreign exchange in the private and the business sector can be used otherwise. If previously there was excess volatility of the nominal exchange rate between the countries considering monetary union there is another benefit since this burden is wiped out for trade among those countries.

There are costs involved in giving up an adjustable exchange rate which could far exceed the moderate benefits from lower transaction costs. The exchange rate can be a helpful adjustment instrument between countries which are hit by asymmetric demand or supply shocks. An adjustable nominal exchange rate will be of particular importance if it can change international relative prices more rapidly than could be done by the reaction of prices and wages. Therefore, asymmetric shocks combined with wage and price rigidities strongly suggest the usefulness of an adjustable exchange rate in order to avoid internal (i.e. unemployment) and external (unsustainable current account deficits) disequilibria. However, there could be alternative adjustment instruments which offer a substitute for an adjustable exchange rate. In his seminal paper Mundell⁶ focuses in this context on labour mobility. Other alternative adjustment instruments have been discussed: Ingram⁷ discusses the importance of capital mobility. Kenen⁸ mentions the stabilizing function of fiscal integration: fiscal mechanisms of interregional distribution can help to alleviate the consequences of a shock with an asymmetric regional impact.

³ Ibid., Table 27.

⁴ CEPR: Monitoring European Integration 3: Is Bigger Better? The Economics of EC Enlargement, London 1992, p. 92.

⁵ The seminal paper is: Robert Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, 1961, pp. 509-516.

⁶ Ibid.

⁷ James C. Ingram: State and Regional Payments Mechanisms, in: Quarterly Journal of Economics, Vol. 73, 1959, pp. 619-632.

⁸ Peter B. Kenen: The Theory of Optimum Currency Areas: An Eclectic View, in: Robert A. Mundell and Alexander K. Swoboda (eds.): Monetary Problems of the International Economy, Chicago 1969, pp. 40-60.

Figure 1:
The Theoretical Concept of
Optimum Currency Areas

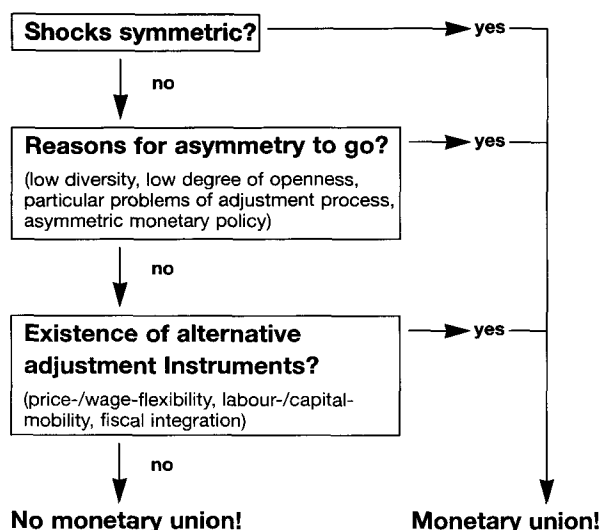


Figure 1 serves to summarize these ideas. If two countries are thinking of forming a currency union they should pose the following questions:

- ☐ First, are the shocks which hit both economies of a symmetric nature? If not there could be a problem in giving up an adjustable nominal exchange rate.
- ☐ Second, are the reasons for asymmetry expected to disappear? If the real integration of both economies is to progress, an increasing symmetry of disturbances can be expected.
- ☐ Third, are there alternative adjustment instruments which could do the job as well as or even better than an adjustable nominal exchange rate?

In the following, the empirical focus will be on question one, i.e. the degree of cyclical symmetry among European economies.

Data and Methodology

In a couple of studies the degree of cyclical symmetry in Western Europe has been analyzed.⁹ The CEPR study and the analysis by Bayoumi and Eichengreen both come to the conclusion that among Western European economies there is a core-periphery pattern. A core of countries show a high degree of cyclical correlation while there are economies on the periphery with an asynchronous business cycle relative to that core. It is interesting to regard the Visegrád countries within that context.

For that purpose, monthly data for the index of industrial production for the EU, EFTA (without Switzerland) and Visegrád countries are used. The source for the EU and EFTA economies are the IMF International Financial Statistics, the data are generally available from the beginning of 1972. For the Visegrád economies, monthly indexes of industrial production data were obtained from the OECD Short-Term Economic Indicators starting at the beginning of 1980 (except for Poland, where the data start in 1985). The OECD data base has the special advantage that it offers separate Czech and Slovak data. Therefore, in the analysis it was possible to treat the Czech and Slovak Republics as separate economies from the starting-point of the data in 1980.

The Visegrád data from the 1980s do not in every case conform to the conventions that can be relied upon when working with similar data for developed market economies.¹⁰ One problem of a volume indicator as it is used here is that in socialist times it was derived by dividing value data by possibly distorted price indices. For example, under-stated prices lead to an over-statement of volume. Ex post adjustment for such a mismeasurement is not possible because no quantification of the distortion is available. This quality limitation has to be kept in mind in the analysis of data from the period before the introduction of a market-oriented price system.

The methodological problem of a business cycle analysis is the decomposition of the relevant – seasonally adjusted – time series into a permanent and a cyclical component. In this study, the cyclical component is calculated as the deviation from a 36-months moving average. After calculating the cyclical component, correlation coefficients as a measure of cyclical closeness between European economies can be derived. In addition, it is interesting to compare the extent of cyclical fluctuations between Western and Central Europe as measured by the standard deviation of the cyclical component. Even if economies are hit by shocks at the same time, there is a problem if the size of the disturbance is different. In a monetary union there is one common monetary policy which might appropriately be used as an

⁹ CEPR, op.cit.; Daniel Cohen and Charles Wyplosz: The European Monetary Union: An Agnostic Evaluation, in: Ralph A. Bryant et al. (eds.): Macroeconomic Policies in an Interdependent World, Washington 1989, pp. 311-337; Tamin Bayoumi and Barry Eichengreen: Shocking Aspects of European Monetary Integration, NBER Working Paper, No. 3949, Cambridge.

¹⁰ OECD: Short-Term Economic Indicators Transition Economies, Sources and Definitions, Paris 1994.

Table 3
Cyclical Correlation with Germany: All Data

Rank	Country	Correlation Coefficient	Standard Deviation Relative to Germany
1	France	0.78	0.68
2	Austria	0.73	0.96
3	Belgium	0.69	0.95
4	Netherlands	0.67	0.78
5	Luxemburg	0.59	1.79
6	Denmark	0.57	1.65
7	Spain	0.54	0.83
8	Italy	0.51	1.26
9	United Kingdom	0.39	0.95
10	Norway	0.28	1.18
11	Slovak Republic	0.24	2.38
12	Greece	0.21	1.12
13	Czech Republic	0.15	2.61
14	Ireland	0.10	1.57
15	Sweden	0.06	1.11
16	Finland	0.04	1.10
17	Portugal	-0.04	1.98
18	Hungary	-0.21	1.86
19	Poland	-0.53	3.06

Table 5
Cyclical Correlation with Germany: The 1990s

Rank	Country	Correlation Coefficient	Standard Deviation Relative to Germany
1	Austria	0.89	0.90
2	France	0.85	0.45
3	Spain	0.76	0.70
4	Belgium	0.73	0.82
5	Italy	0.66	0.49
6	Netherlands	0.64	0.63
7	Luxemburg	0.53	0.77
8	Denmark	0.39	0.52
9	Slovak Republic	0.30	1.77
10	Czech Republic	0.15	1.74
11	Ireland	0.09	0.72
12	Portugal	0.08	1.02
13	Greece	-0.00	0.68
14	Sweden	-0.13	0.75
15	United Kingdom	-0.21	0.42
16	Finland	-0.34	0.90
17	Norway	-0.35	0.62
18	Hungary	-0.51	1.11
19	Poland	-0.90	1.95

Table 4
Cyclical Correlation with Germany: The 1980s

Rank	Country	Correlation Coefficient	Standard Deviation Relative to Germany
1	Austria	0.77	0.96
2	France	0.74	0.67
3	Denmark	0.73	2.10
4	Italy	0.68	1.38
5	Luxemburg	0.67	2.03
6	Belgium	0.66	1.07
7	Netherlands	0.65	0.98
8	Norway	0.62	1.84
9	Spain	0.62	0.90
10	Greece	0.56	1.23
11	United Kingdom	0.53	1.23
12	Sweden	0.53	1.07
13	Portugal	0.30	2.28
14	Finland	0.29	0.91
15	Ireland	0.28	2.17
16	Czech Republic	0.06	0.83
17	Slovak Republic	0.06	1.67
18	Hungary	-0.32	1.06
19	Poland	-0.54	2.00

instrument against homogenous disturbances that have similar effects everywhere. If the shock, although it is symmetric, leads to fluctuations in income of very differing sizes, a single monetary policy cannot be tailored according to national needs.¹¹

Incomplete Real Integration

For a successful European monetary union, it is helpful if potential members of the common currency area have a high degree of cyclical correlation. For the analysis it seems appropriate to take Germany as the reference economy.

Tables 3 to 5 present 19 European economies (EU members, Norway and the four Visegrád countries)

ranked according to their cyclical closeness to Germany as measured by the coefficient of correlation. The standard deviation of the cyclical component relative to the German standard deviation serves to compare the extent of fluctuations.

For Table 3 all the available data were included, i.e. starting for most EU and EFTA states in 1972 and for the Central European states in the 80s (see box). These results – not surprisingly – identify a core of economies around Germany: France, Austria, Belgium and the Netherlands, of which Austria and Belgium are not only cyclically close to Germany but have also a similar order of magnitude of cyclical fluctuation. From this analysis, these economies seem to be ideal candidates for forming a monetary union.

The EFTA economies together with the UK, Ireland, Greece and Portugal appear more distant from the core. The position of the Czech and Slovak Republics is within the EFTA field, while Hungary and Poland show a clearly negative correlation with the German cycle. All four Visegrád economies are characterized by a standard deviation of the cyclical component that is above the average of Western Europe.

In addition to regarding the whole period since the 1970s, subperiods are analysed. This seems of particular interest taking into account the structural break in Central Europe with the start of the transition process. It is important to see whether after the beginning of reforms and the opening of the Central

¹¹ CEPR, op.cit., p. 44.

European economies to the West their cyclical fluctuations become more related to the European core. Tables 4 and 5 present the results separately for the 80s and the 90s. The calculations for the 90s generally include data until about the end of 1993 (see box).

Comparing the 80s and the early 90s leads to the following conclusions for EU and EFTA states: the cyclical core is quite stable in both periods; particularly in the 90s, Italy and Spain seem to belong to that core; in the 90s, EFTA countries have a cycle negatively correlated to the core.

The bottom ranking of the Visegrád countries in the 80s reflects the isolation of Central Europe from Western Europe and the world economy in the socialist past. It is surprising that the standard deviation of the cyclical component in the old system is not significantly below Western European levels. Judging from the index of industrial production there seems to have been something similar to a business cycle in socialist times as well. In the years since 1990 Poland and Hungary have remained far removed from the Western cycle. This result is plausible since this period has been a time of adjustment with strongly falling incomes and production in the reform countries while Germany on the other hand experienced the "unification boom". Against this background the medium ranking of the Czech and Slovak Republics seems to be remarkable. Nevertheless, this analysis indicates that an early monetary union including the Visegrád countries would pose serious problems because of incomplete real integration. Even if a

country such as the Czech Republic managed to keep the exchange rate to European currencies relatively stable, the asynchronous cyclical performance indicates problems, at the latest when restrictions on the capital account are given up.

Early EMS-Membership?

The analysis identifies two problems that have to be overcome before the membership of Central European states in the European Monetary Union can be imagined. Firstly, a further reduction of the inflation rate is essential. Secondly, the degree of integration – as measured by the cyclical correlation – has to be increased. It can be expected that time will work for the solution of the second problem. Once the adjustment process has come to an end and the restructuring of the economies has been completed, the growing volume of trade will produce a closer relationship between Central and Western European cycles. However, in the meantime the existence of cyclical distance has to be taken into account when thinking about monetary strategy. Monetary strategy should therefore on the one hand be helpful in overcoming the inflation problem and on the other hand maintain the possibility of exchange rate changes as an adjustment instrument.

In Western Europe, the European Monetary System (EMS) has been an instrument for the participating economies to import monetary credibility from the German Bundesbank and for "tying one's hands".¹² Breaking inflationary expectations can lead to high costs such as mounting unemployment. These costs can be reduced if market participants are convinced that there has been a change in the monetary regime towards a more restrictive policy. In Western Europe, EMS membership has served that purpose for countries with a tradition of high inflation.

In the EMS, exchange-rate targets are defined in the form of central rates and a fluctuation margin around those rates. The system is formally constructed in a symmetric way, i.e. the central banks of both the strong and the weak currency countries have to intervene if their bilateral rate reaches the intervention point. Practically, it has worked in an asymmetric way and allowed the German Bundesbank to dominate the system. Countries unwilling or unable to follow German monetary policy had to devalue. This was often the case in the early stage of the EMS between

Origin and Availability of Data

Country	Data Availability	Source
Belgium	72.01 – 93.05	IMF-IFS
Denmark	76.01 – 93.10	IMF-IFS
France	72.01 – 93.10	IMF-IFS
Germany	72.01 – 93.11	IMF-IFS
Greece	72.01 – 92.12	IMF-IFS
Ireland	82.01 – 91.11	IMF-IFS
Italy	72.01 – 93.10	IMF-IFS
Luxembourg	72.01 – 92.12	IMF-IFS
Netherlands	72.01 – 93.09	IMF-IFS
Portugal	79.01 – 91.09	IMF-IFS
Spain	72.01 – 93.09	IMF-IFS
United Kingdom	72.01 – 93.09	IMF-IFS
Austria	79.01 – 93.06	IMF-IFS
Finland	72.01 – 93.10	IMF-IFS
Norway	72.01 – 93.11	IMF-IFS
Sweden	72.01 – 93.07	IMF-IFS
Czech Republic	80.01 – 94.01	OECD
Hungary	80.01 – 93.12	OECD
Poland	85.01 – 93.11	OECD
Slovak Republic	80.01 – 94.01	OECD

¹² Francesco Giavazzi and Marco Pagano: The Advantage of Tying One's Hand, in: European Economic Review, Vol. 32, 1988, pp. 1055-1082.

1979 and 1983 and again in the course of the EMS crisis of 1992/1993. Today, the success of anti-inflation policy in traditionally high inflation economies is explained by the credibility import through the EMS.

This experience indicates possible advantages of early EMS membership of the Central European reform countries, particularly for the further process of inflation reduction. Again, the EMS could export monetary credibility into economies that face the difficult task of breaking inflationary expectations. On the other hand, the EMS with its fluctuation bands and the possibility of realignments combines short-run stability with a degree of long-term flexibility that is necessary because of the still incomplete real integration of Central and Western European economies.

Risks

Several authors have discussed the issue of early EMS membership of the reform countries. Generally, it is feared that premature membership in the monetary institutions of the industrialized countries could damage the quality of these institutions.¹³ More specifically, in the context of the EMS there could be the danger that early membership could have an inflationary impact on the whole European currency area.¹⁴

This inflationary danger could result from the EMS intervention obligations. With full membership the Visegrád central banks would have access to unlimited credit from the "Very Short-term Financing Facility" of the EMS. This facility provides the weak currencies at the lower intervention point with central bank deposits denominated in the strong currency. It is feared that with limited credibility of the chosen central rate, the necessary massive interventions would have a liquidity impact on the hard currency monetary aggregate. In the worst case the central bank of the strong currency would lose its effective control over its monetary supply.

The Old and the New EMS

The EMS crisis of September 1992 to August 1993 changed the character of the EMS. The changes are highly relevant for the question of early EMS membership of the Visegrád countries.

Between 1987 and 1992 there were no realignments of central EMS parities. This success

was attributed to a growing degree of convergence in Europe. With the Maastricht Treaty that was signed in February 1992, EMS stability seemed to have gained a further base with the prospect of monetary union. More and more, the EMS was regarded as a de facto monetary union that would smoothly be replaced by a single currency. This view was expressed by the way in which the stability of EMS exchange rates was integrated into the Maastricht Treaty as one of the convergence criteria. This requirement increased the reluctance of all EMS members to agree to a realignment that would, through the devaluation of a country's currency, destroy the chances of that member state's belonging to the monetary union from the start.

In June 1992, Denmark voted against the Maastricht Treaty and confidence in the success of monetary integration was seriously shaken. The crisis impelled the Lira and the Pound to leave the Exchange Rate Mechanism and finally, in August 1993 after a series of realignments, the old fluctuation bands (± 2.25 per cent) were replaced by bands of ± 15 per cent.

The analysis of the EMS crisis has so far produced some insights into its causes.¹⁵ Ex post, the long period of exchange-rate stability seems to have been artificial from the point of view of economic fundamentals. In particular, German unification had caused adjustment pressure on real exchange rates. Because of the Bundesbank's unwillingness to accept real appreciation through an increase in German inflation, nominal appreciation was necessary.

The political reluctance to agree an early realignment led to a final eruption of speculation that put pressure even on currencies with a seemingly credible monetary policy. This overshooting speculation originated partially from the narrow ERM-fluctuation margins that created the chance of a "one-way bet": a speculator could expect that following a realignment the new upper intervention point of the weak currency would be below the old lower intervention point.

During the crisis it became clear that the German Bundesbank does not accept an unlimited

¹³ Richard Portes: Integrating the Central and East European Countries into the International Monetary System, CEPR Occasional Paper, No. 14, London 1994.

¹⁴ Peter Bofinger: Options for the Payments and Exchange Rate System in Eastern Europe, CEPR, Discussion Paper, No. 545, London 1991; CEPR, op.cit.; Hans-Peter Fröhlich: Währungspolitische Reformen in Osteuropa, Beiträge zur Wirtschafts- und Sozialpolitik der deutschen Wirtschaft, No. 197, Cologne 1992.

¹⁵ Hagen Lesch: Europa auf dem Weg zur Währungsunion: Ursachen und Lehren der EWS-Krise, Institut „Finanzen und Steuern“, Grüne Briefe, No. 326, Bonn 1994.

intervention obligation even if the ERM rules seem to stand for such an obligation. If the intervention leads to a conflict with the Bundesbank's priority of defending price stability it can effectively refuse to continue the intervention and count on the government to negotiate a realignment. Kenen¹⁶ cites the "Emminger letter" in which the former president of the Bundesbank reached that consensus with the German government. This consensus has been tested successfully.

The moment the EMS lost the character of a de facto monetary union the participating currencies were again assessed with respect to their internal strength so that shortcomings such as insufficient central bank autonomy or obvious conflicts between internal and external economic policy targets led to pressure on the parities.

The "new EMS" after the 92/93 turmoil differs from the old system by the following characteristics, that originate both from the 30 per cent fluctuation band and the experience from the crisis:

□ after the widening of the fluctuation margins to +/- 15 per cent the new EMS can be characterized as a system of unilateral exchange rate targeting.¹⁷ It

depends on the national economic authorities of each country to steer the exchange rate close to the central DM parity or to devalue;

□ both the Monetary Committee and the Committee of Central Bank Governors have in their reports drawn the conclusion that in order to avoid any future crisis it will be necessary to realign parities early as soon as there is fundamental divergence;¹⁸

□ in order to guarantee stable exchange rates the focus has shifted from the idea of importing credibility towards building up internal credibility by improving the central bank constitution and by overcoming conflicts of monetary policy with budgetary policy;¹⁹

□ the crisis has overcome the view that the EMS has the character of an early monetary union. The exchange-rate criterium has lost its meaning: it is imaginable that the new 30 per cent fluctuation band

¹⁶ Peter B. Kenen: Capital Controls, the EMS and EMU, in: The Economic Journal, Vol. 105, January 1995, pp. 181-192.

¹⁷ Manfred J.M. Neumann: Mehr Macht für die Notenbanken, in: Frankfurter Allgemeine Zeitung, No. 72, 26.3.1994, p. 13.

¹⁸ Peter B. Kenen: Capital Controls ..., op.cit.

¹⁹ Hagen Lesch, op.cit.

Helen Winter

Interdependenzen zwischen Industriepolitik und Handelspolitik der Europäischen Gemeinschaft

It is worth analyzing the various and often subtle connections between industrial policy and trade policy, because these policies are becoming more important and they are used as substitutes or as complements to one another.

After defining both policies and their relationships, the study examines the industrial and trade policy of the EC as a whole.

The key targets of industrial policy are to prevent or promote structural change and to improve international competitiveness. The various instruments of European industrial policy are designed to deal with international problems, but they also influence the trade relationships between other countries.

In addition to that, the EC uses trade policy instruments as some kind of industrial policy, or to protect industrial policy. This is sometimes cheaper as subsidies. But in some cases industrial policy substitutes trade policy because the application of traditional trade policy instruments is restricted by international agreements.

■ The book is published in German.

1994, 279 p., hardback, 89,- DM, 694,50 öS, 89,- sFr, ISBN 3-7890-3505-X
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will be regarded as "normal" in the sense of Art. 109j and that there will be no attempt to return to the old bands before the introduction of a single currency;²⁰

□ under the new rules the system is less vulnerable to speculation. This results from the fact that there is no longer an easy one-way bet.

Visegrád Currencies

The characteristics of the EMS after the crisis make the system more adequate for an early membership of the Visegrád countries. The fear that a weak currency could have a negative impact on price stability in the countries with a strong currency are no longer justified. The wide margins, the application of the "Emminger letter" and finally the willingness to realign more often are sufficient guarantees that there are no high risks resulting from Visegrád membership in the EMS. These characteristics also offer enough room for the exchange-rate adjustments that may be necessary because of the incomplete real integration between Central and Western Europe.

Nevertheless, the new EMS can be helpful for the currencies of the reform countries that want to preserve a certain degree of exchange-rate stability even after the introduction of complete currency convertibility. It can be doubted whether these currencies could successfully follow the Austrian example and target a DM parity on their own – i.e. without any intervention support – once unrestricted capital convertibility is introduced. Bofinger²¹ argues that the Austrian success can only be explained by the long-run investment by the Austrian authorities in monetary credibility and that the central banks in the reform countries do not yet possess comparable credibility. This assessment dating from 1991 is probably still correct today.

In comparison with a simple Austrian peg, the new EMS offers some helpful devices for a currency seeking stability. Interventions are possible and have regularly been used to limit the fluctuations within the band: intramarginal interventions can always be executed whenever there is an agreement among the central banks whose currencies are used in the operation. The German Bundesbank has approved the use of the DM for intramarginal interventions by EMS central banks up to a certain limit without the need of an agreement in every single case. For the intramarginal interventions the "Short-term Financing

Facility" can be mobilised. So there are flexible instruments to limit exchange-rate fluctuations even before the lower intervention point of any bilateral parity is reached.

While on the one hand currencies with serious credibility shortcomings cannot count on the EMS to protect them from devaluation, there are on the other hand instruments to smooth the fluctuations of currencies that appear sound, judging from their internal qualities. In that sense the EMS today combines the necessary disciplining elements with flexible possibilities of support. It seems to be the right place for a currency that has achieved certain medium targets of monetary reputation and that now has to stand the test of full convertibility.

Conditions for EMS Membership

In principle, the EMS in its present shape seems suitable for integrating Central European currencies and assisting them in their further attempts to reduce inflation rates and build up their reputation. Such an integration could be an element of a monetary strategy of catching up with the West – even long before the full membership of these countries in the EU can be realized. However, the preceding considerations indicate certain minimum requirements that should be fulfilled:

□ The EMS is presently a system that combines the currencies of EU member countries that have abolished all major restrictions to the free flow of capital. Even if the currencies of the reform countries were able to join the EMS years before full EU membership could be achieved these currencies would have to be fully convertible. The introduction of full convertibility could be parallel to EMS entry.

□ Most important, the central bank of a potential EMS member must be able to control the monetary aggregate. That means that the early stage of transition, in which soft budget constraints play a dominant role, must have been overcome. Apart from that, price liberalization and the phasing out of subsidies should be at an advanced stage. Only in that case does the attempt to build up further reputation within the EMS have a chance of being successful.

□ The central banks must be independent of politics. The point of reference should be the independence of the European Central Bank as defined in the Maastricht Treaty. Especially the prohibition of central bank credit to the government should have been enforced.

²⁰ Peter B. Kenen: Capital Controls ..., op.cit.

²¹ Peter Bofinger, op.cit.

□ Public deficits must be limited to a size that can be financed on capital markets in order to make central bank independence credible.

□ The inflation rate should be near the single digit region. A higher rate would make EMS membership pointless since regular devaluations of the high inflation currency would be unavoidable. An inflation rate requirement "near ten per cent" may seem lax from the Western point of view. However, the advantage of EMS membership is the idea of breaking inflationary expectations. There is no point in waiting until this has been achieved outside the EMS. Apart from that, high inflation rates were not unusual among the EMS members when the system came into existence in 1979 (Denmark, France, Italy and Ireland had inflation rates above ten per cent in 1979).

EMS Entry

If the preconditions are fulfilled, the reform countries should be allowed to enter the EMS at unanimously agreed central rates and wide fluctuation margins of ± 15 per cent. The case of a country that is not yet a member state of the EU entering the EMS is without precedent. It will be helpful not to confine the entry agreement to the narrow field of the EMS but also to include some elements of EU law as contained in the Maastricht Treaty.

In particular, the new EMS members should be subject to the most important common rules of the second stage towards Economic and Monetary Union. With the beginning of that stage in January 1994, the prohibition of central bank credit to the government was imposed. Since then the member states are also required to avoid excessive deficits. Finally, general economic policy has to be regarded as a field of common interest and is supervised by the Council. Because these rules are today legally binding elements of international law they contribute substantially to the monetary reputation of all EU member states. The EMS agreement with the reform countries should be used for the same purpose: by building up constraints through international law monetary reputation can be supported. Apart from these reputational considerations the inclusion of some EMU rules into the EMS agreement would be a significant step toward full economic integration.

After EMS entry under these conditions, it would lie within the responsibility of the governments of Central Europe to use EMS membership to reduce inflationary expectations. For that purpose, the governments would have to commit themselves to steering the exchange rate near to the central rate and

to sticking to a policy of "Crown Fort", "Zloty Fort" or "Forint Fort". A public commitment would raise the political costs of devaluation.

On political grounds, even a soft performance in the first phase of EMS membership (i.e. some devaluating realignments) might be better than remaining outside the EMS. The Central European Countries would have entered an important institution of the European Union. Western publics and politicians would get used to the idea of Central European membership in Western institutions.

The start of monetary union according to the Maastricht schedule would not pose any problems. Realistically, this new era is not to be expected before 1999. Only a part (a minority?) of the EU member states will qualify for a participation from the beginning. The EMS will have to be continued beside the area of a single currency. As such it will be the transition space for those currencies that still have to prove their qualification for monetary union. Probably, the Visegrád currencies would not be alone in that monetary space, at least for a couple of years.

Summary

Since the Maastricht Treaty was signed, the aims of European integration have included the introduction of a single European currency. Therefore, in an EU membership strategy the monetary perspective has gained importance. A country willing to qualify for EU membership has to prove its ability to participate in the monetary union at least after a transition period.

Obstacles to the monetary integration of Central Europe are presently the inflation rates, that are still significantly above Western European levels, and the incomplete real integration as measured by the degree of cyclical correlation. The incomplete real integration requires a minimum degree of exchange rate flexibility. Under these conditions, an early EMS membership is proposed to support the process of inflation reduction in the Visegrád countries. The EMS crisis of 1992/93 has improved the ability of the system to cope with the short-term entry of the Central European currencies. This is due to a less ambitious view of the EMS, that is no longer seen as a de facto monetary union.

The proposed strategy seems politically feasible, since the costs and risks for Western Europe are very limited. At the same time, the outlook for full membership of the Visegrád countries in the European Union under the Maastricht constitution would improve considerably.