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EXCHANGE RATE POLICY IN THE RUN-UP TO EMU – THE AUSTRIAN EXPERIENCE*

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Current state of play

The fifth round of EU enlargement is well under way. Accession negotiations with ten countries from central and eastern Europe¹ are approaching the final stages for those countries that are most advanced in the transition. They will be ready to accede to the EU once they have fulfilled the so called Copenhagen criteria, named after the EU Copenhagen summit of 1993. These criteria define the preconditions for EU membership: (i) the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for the protection of minorities, (ii) the existence of a functioning market economy and the capacity to cope with the market forces within the Union and (iii), the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

Based on these criteria the European Commission annually assesses the progress the accession countries make in meeting these conditions. In its latest report it concludes (EC 2000) that Cyprus and Malta already fulfill them, while most of the accession countries from central and eastern Europe with the notable exception of Bulgaria and Romania have made significant progress and may soon be regarded market economies.

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¹ Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia as well as Cyprus and Malta (the "accession countries"). Since December 1999 Turkey has also been a candidate for EU accession. Negotiations have not yet started because the conditions for their commencement are not yet met.

According to the current schedule, a first wave of accession countries can be expected to enter the EU around 2005. The new entrants will, at the time of EU entry, also accede to Economic and Monetary Union (EMU). This is so because phase 3 of EMU commenced on 1 January, 1999, and an opt-out clause like the one granted to the UK and Denmark will not be available. The new members will join EMU with a derogation until they comply with the Maastricht convergence criteria.

In the specific context of the accession countries of central and eastern Europe, each of these criteria poses specific challenges. The inflation criterion is defined as an inflation rate of not more than 1½% over the three best performing EU countries during the latest 12 months. For an assessment regarding the new Member States the following questions arise: What is the precise meaning of "three countries with the lowest inflation rate" in the context of the Eurozone? What if it were the case that one or more of the three countries were those which currently remain outside the Eurozone (Denmark, the UK and Sweden)? Would or should an "inflation premium" resulting from fast real growth in the catching-up process (due to the Balassa-Samuelson effect) be accounted for in some way? Currently there are no answers, just statements noting that the Treaty has to be applied literally.

If the inflation criterion is satisfied and sustained stability-oriented policies are secured, it should be feasible to satisfy the interest rate criterion at the same time. Recall that this criterion requires an average nominal long-term interest rate that does not exceed by more than 2% percentage points, at most, the three best performing member states in terms of price stability.

The challenge to satisfy the fiscal criteria in a sustainable way should not be underestimated. Substantial demands on the public budgets of the new entrants are due to the completion of the transition and to additional outlays generated by EU accession, e.g., in the agricultural sector, badly



Each of the Copenhagen criteria poses specific challenges

needed infrastructure investment, investment in education, etc.

Finally, the new entrants are expected to participate at one stage in the Exchange Rate Mechanism 2 (ERM2) after joining the EU. In this context there are the issues of timing and of pursuing an exchange rate arrangement that satisfies the conditions to enter ERM2.

Upon fulfillment of these criteria the new Member States are committed to adopt the euro. The shortest possible period from EU membership to the adoption of the euro under Treaty provisions is two years. Consequently, counted from today (2001), the new Member States could replace their currencies with the euro in some six years from now, i.e., around 2007/2008, at the very earliest. Judged from the "real" (catching-up) angle, six years seem to be quite a short period of time in view of the real economic adjustments that are still necessary. Yet, as seen from the angle of financial markets, six years are a very long time that can be beset by vulnerabilities and risks.

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The monetary dimension of the accession process

The formal path to the adoption of the euro foresees three phases: First, in the current pre-EU accession phase, a variety of exchange rate regimes are feasible. This phase ends with EU and EMU accession. Second, in the post-EU accession (intermediate) phase, the new members are expected to participate in ERM2, where the national currency is pegged to the euro with a horizontal band. Entry into ERM2 will (most likely) not coincide with EU entry. Third, at the beginning of the final phase, the euro will be adopted once the Maastricht criteria will have been met.

Furthermore, the EU Treaty stipulates that capital movements be liberalised *before* EU accession, as liberalised capital flows constitute an integral part of the EU Single market. Consequently, all applicant countries (with the exception of Estonia) will have to complete the liberalisation process in a relatively short span of time and in an "orderly" way unless they request and are granted a transitional arrangement. So far, no one has done so.

Finally, the statutes of the national central banks have to be adapted in a way that guarantees their

independence as is enshrined in the Maastricht Treaty, and all provisions granting direct public sector financing must be discontinued prior to EU membership.

Some economic challenges that lie ahead

In the following I will sketch just three important economic challenges which will have to be addressed before the euro can be adopted.

Which exchange-rate arrangements in the transition to the euro?

Assessing the evolution of the exchange-rate arrangements in the accession countries since the opening-up, a clear trend to either fixed or flexible options has taken place. At the same time this movement has been asymmetric. More flexible arrangements have become – relatively speaking – more popular than fixed hard pegs. While Bulgaria and Lithuania moved from flexible arrangements to a currency board and Estonia (currency board) and Slovenia (managed float) have maintained their exchange-rate regimes throughout the transition period up to now, the other six accession countries from central and eastern Europe moved, mostly gradually, to more flexible arrangements. Yet, in reality, a high degree of flexibility might be quite elusive. Especially smaller countries typically show a "fear of floating". The majority of this type of country manage the exchange rate quite heavily, as is the case in Slovenia.

Regardless of the current exchange-rate arrangement, the accession countries have already decided that they want to replace their own currency with the euro. Note that today the euro already constitutes at least an indirect nominal anchor for all accession countries with the exception of Lithuania, which – at the time of writing – continues to tie its currency to the USD but plans to switch its peg to the euro by 2002 and Latvia, which still pegs the lat to the SDR. The dominance of the euro as an anchor is not surprising given the countries' close trade relationships with the Eurozone and their political aspirations.

Accession countries that currently implement free floating regimes, crawling pegs and conventional pegs against currencies other than the euro, will, at some point before the adoption of the euro, have

to change their current arrangements. This means that at least Latvia, Lithuania and Hungary (crawling peg, as of May 2001 with a broad band) will sooner or later, in any case before entering ERM2, have to have an intermediate regime switch. Which avenue should they take?

Regarding the impending decision of whether to move to a more or less flexible intermediate arrangement, the following fundamental economic point comes to mind: The issue of how and when to adjust the exchange rate regime is closely related to the speed of the catching-up process, the institutional structure of the country concerned, its internal policy mix and the degree of price and wage flexibility. A country that is confident it can equilibrate the sizeable external as well as domestic structural shocks and internal imbalances with internal policy measures might opt for a fixed arrangement, others might conclude that they still need the exchange rate as an adjustment mechanism and might opt for a more flexible one which is, at the same time, compatible with ERM2. Having this in mind, the Czech Republic and Poland opted for a more flexible intermediate exchange-rate arrangement while Estonia considers its economy to be flexible enough to retain the currency board arrangement until the kroon is replaced by the euro.

How to deal with real and nominal convergence?

In our context real convergence is defined as a rate of economic growth that is high enough to allow a convergence of the standard of living between the new entrants and (the average of) the existing ones. In the process price levels also converge. Hence nominal and real convergence are interrelated. I will not deal with the equally important convergence of economic structures nor with legal and institutional convergence.

Given the vast differences in real per capita GDP and plausible assumptions about sustainable growth differentials, it is clear that the real catching-up process will take at least a generation. Proposals to link the adoption of the euro to some minimum per capita GDP benchmark thus amount to the request of a sizeable postponement of its adoption. It seems that more recently the discussion has moved away from such regressive propositions. Nominal and real convergence are at least

dealt with on an equal footing as is, for example, the position of the Eurosystem.

Real convergence requires faster productivity growth than in the current EU. Considering that productivity advances are higher in the tradable sector of the economy than in the sheltered domestic sector, "catching-up" countries will experience higher inflation rates than countries growing less swiftly. This is the so called Balassa-Samuelson effect. Empirical evidence indicates that this effect could be anywhere between 1 and 4% for fast growing accession countries undergoing massive structural change. Therefore, the (equilibrium) real exchange rate will appreciate.

Under these conditions countries that pursue a fixed rate strategy in the run-up to the introduction of the euro might encounter difficulties fulfilling the inflation convergence criterion. Thus, there have been a number of suggestions to take these effects into account when assessing the adherence to the inflation criterion. One of them proposes to compare the inflation rate of tradables. It appears, however, that such proposals will not be acceptable.

How to phase in the remaining capital account liberalisation?

In contrast to the widely differing exchange rate arrangements, the accession countries have moved swiftly and quite uniformly (despite remaining differences) to liberalise capital account transactions. As is discussed elsewhere (Hochreiter 2000) this is in sharp contrast to the policies followed in western European countries after the second World War, whose capital account liberalisation was not completed until 1991.

There is a clear link between the state of development of financial markets, the financial health and competitiveness of the banking system and the efficiency of supervisory authorities on the one hand and the risks and vulnerabilities associated with liberalisation on the other. It is no coincidence that the informal ECOFIN of April 2001 in Malmö singled out the currently still weak and underdeveloped financial sector in most of the accession countries as a serious concern and as a major obstacle for adopting the euro. Thus, ridding financial intermediaries of bad debt and securing recap-

The Balassa-Samuelson effect leads to a real appreciation of the exchange rate

italisation, and strengthening their competitiveness should take precedence over the final liberalisation steps. Moreover, their precise sequencing is important in order to prevent capital inflow surges and capital flights. In this context the Austrian experience might give some guidance.

The Austrian experience – Is it relevant?

The last section discussed a number of challenges the accession countries will have to meet: continued substantial structural adjustment, (hopefully) rapid real growth connected with Balassa-Samuelson effects, entering ERM2, and coping with the completion of capital account liberalisation before joining the EU.

It is obvious that the international and domestic environment that Austria faced in the post-war period before its EU accession and the adoption of the euro differed vastly over most of the (pre-accession) period. Yet, I maintain that a number of the challenges that Austria faced were at least similar in economic terms. In particular, Austria coped with sizeable asymmetric shocks, massive structural change and rising capital mobility while maintaining a fixed peg to the DEM for two decades. It had to deal with a trend appreciation of the real exchange rate due to Balassa-Samuelson effects while preventing damaging spill-over effects to the economy as a whole and, at the same time, managed to liberalise capital transactions in a way that prevented speculative attacks. I feel – with all caveats – that Austria's experience could be of some interest to accession countries.

First, Austria's success in sustaining the fixed peg was determined by a flexible, adaptable economy, in particular wage flexibility, that helped to equilibrate a number of quite sizeable asymmetric shocks relative to Germany. The design and implementation of consistent and stability-oriented economic policies fostering economic growth were supported by specific institutional features, like the social partnership. Nonetheless, I argue that Austria is no "special case" but exemplifies the steadfast application of "good economics".

Second, Austria's economic performance in the last three to four decades can be characterised by a high degree of price stability, low unemployment, and stronger real growth than Germany. On aver-

age, Austria's growth rate was 0.3 percentage points p.a. higher than Germany's over the past four decades. Austria has thus been in a "catching-up phase" against Germany at least since 1960 and has overtaken Germany in the 1990s, also as a result of the effects of unification on German per capita income. It has to be added, however, that Austria's per capita GDP was approx. 80% of that of Germany's in 1960 and thus substantially above the current level of all accession countries with the exception of Slovenia. (Glück and Hochreiter, 2001).

The catching-up process implied a structural inflation gap (as measured by the CPI) of around one percentage point per annum, at least until German unification. Such a prolonged positive inflation gap would have made the currency peg unsustainable had there not been a secular increase in price competitiveness in the exposed sector (as measured by ULC in industry) and the absence of spill-over effects from the exposed to the sheltered sector.

As far as the EU candidate countries are concerned, such a combination of faster productivity growth than in the reference country and a fixed exchange rate could be at variance with the requirement of the Maastricht inflation criterion. In addition, there is a danger of spillovers to the sheltered sector, a threat that should not be underestimated as the Austrian experience of the 1970s demonstrated. But if a (hard) pegging strategy is chosen, central banks should signal their determination to stick to the peg in the face of real appreciation under the conditions described above.

Third, Austria followed a very cautious step-by-step approach to liberalising international capital transactions ever since the end of the Second World War. The formal pace of liberalisation (current transactions were liberalised in 1962) was rather slow and, as a rule, long-term capital inflows were liberalised prior to outflows and financial institutions and firms were privileged over private citizens. In general, existing regulations were first applied more and more liberally. Only much later was the regulation itself changed. For example, major banks had already been granted licenses for foreign transactions in the early 1960s. Hence, banks were, at the time of formal liberalisation, already well integrated into the international financial market. Thus, formal liberalisation did not cause further shocks for financial

Austria had to cope with similar problems

institutions and monetary policy and therefore had only minor effects on the behaviour of economic agents.

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