The European Union Enlargement and the EMU: departure situation and transition strategies

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Abstract

The aim of this paper is to analyze the economic stability departing situation of CEEC in order to discuss the type of transition that would be preferable for the Central and Eastern European Countries (CEEC) to access to the EMU. Recently, the EU has accelerated the negotiations for the enlargement of five CEEC in 2003 (Visegrad –4 and Estonia). During this ten last years this countries have afford an economic transition process to a market economy and a stabilization of its economic structures increasing integration towards the EU. Nevertheless despite the stabilization process real convergence towards EU is still unrealistic while the strategy adopted by the EC seem to be consistent . That is, a two step integration process should be the most possible and convenient strategy to lead a progressive but regular convergence of the CEEC into the EU-15. By the way, without supporting the Maastricht criteria as an adequate stability performance indicators for the CEEC its appliance permits to conclude that the actual enlargement strategy seem s to be efficient. By the way, other indicators of economic structure performance should be include, at the same time that a similar Maastricht criteria should be scheduled. The EMU in next future could be somehow a "optimum" currency area. However, by the inclusion the of any CEEC would imply an increase asymmetry and instability depending on the transitional process.

Key Words : economic stability, optimum currency areas , EU enlargement**.**

1. Introduction

1.1 General Comments[**]

One of the main lacks of the actual structure of the EU and Europe as a hole, has been the existence of a frontier between east and the west in Europe. Between 1994-1996 ten Central and East European Countries (CEEC) applied for EU membership, by signing European association agreements. The outcome was the European Commission decision (1997) to expand the EU to some selected eastern European countries (fifth EU enlargement) , initiating the debate about the effects throughout

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the actual economic integration phase. As a result, the eastern European Union enlargement becomes one of the most relevant policy issues for European union economist's[1]. Although, the political concerns are strongest that the economic explanations (Baldwin, 1995), the aggregate economic impact of the EU is something more than enlarging the European single market[2], because Europe after 1999 will become a monetary union (EMU) and therefore a stability performance strategy will be an unavoidable requirement.

Furthermore, the eastern enlargement is substantially different that other EU enlargements, specially if we analyze the basic economic structure of this countries (agriculture over GDP, income per capita, ect) compared with the average of the UE. Thus, analyzing the economic macroeconomic indicators of the four poor countries before its acceptance as a full member of the EU could be a relevant reference point of comparison. In this paper we will discuss the possible strategies for the CEEC to adopt the EU single currency in next future, by assuming the current economic performance situation.

The 1990 European Agreements were to improve integration of commodity markets within the EU, however the EU enlargement, provokes other relevant consequences, specially in the EU budget due to the new memberships will be recipients of the EU funds. In terms of costs and benefits, the major benefit for the EU is defined in terms of trade welfare gains and the prime cost is budgetary redistribution to this countries[3]. The benefits depend on the volume of trade and the exposure to the East trade while cost depend on the participation o the EU expenditure budget. According to recent studies, conclude that budgetary costs to offset efficiency gains (Gasiorek, 1994, Brown et al, 1997 ;Keuschenigg and Kohler, 1998). According to specific scenarios, Baldwin et al (1997) calculated a real income gain of 18 % - considering the 5 eastern countries considered so as Romania and Bulgaria – and a 0,2% for the EU-15. These are the issues that we addressed in this paper. We analyze the possible strategies to integrate in the next future a small amount of CEEC in the EMU, taking into account the Maastricht criteria, the optimum currency area theory criteria and finally comparing the initial take off situation with the convergence evolution or other currently integrated countries as Spain.

The economic conditions of the countries considered - CEEC - are significantly different . While in several countries , structural reform progress has been low in order to sustain high economic growth, in others the expansionary demand has lad to risked overheating, translated in terms of current account deterioration (see table 10). That is, currencies of the majority of CEEC -including Czech Republic and Slovenia – have been coming under pressures as a result of rising current account deficits (European Commission ,1997) . Therefore, we do consider three different blocs (Visegrad-5, Balcan -2 and Baltic 3) trying to homogenize different areas in order to analyze more specifically its economic performance (table 11) . The country risk indicators suggest

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[1] Probably, this will an historical challenge in geopolitical terms in order to face the effects of the globalization process. However, this paper will focus in the monetary economics aspects of the enlargement , specially in the long term ; and the possibilities and strategies of convergence and the integration in to a European monetary union (EMU).

[2] The EU enlargement will imply a reduction in a 16% of GDP per capita but an increase in the european market size.

[3] Breuss and Schebeck (1996) estimate a net fiscal cost of the Visegrad 5 enlargement of 13.125 MIO ECU (21% of EU-15 GDP).

that the Visegrad -5 are the countries with lower risk, while the picture of country risk has changed somewhat in 1996 (see table 10). Moreover, the social and political criteria have been taken into account. More concretely, some general conditions have decide the acceptance of the applicants –defined on the Copenhagen European Council (1993)- :

(i)   Existence and functioning of a market economy to cope competitive pressures and market forces
(ii)   Political stability : stability of institutions, democracy, rule of Law, human rights and respect for and protection of minorities
(iii)   Acceptance of the aims an obligations of the EU
(iv)   Improving Integration and economic stability

Due to the Amsterdam Treaty (1996) and the Luxembourg EU Council (December 1997) nearly all CEECs have been accepted as future EU members but in a two speed process. Initially, in a first step, five countries have been selected basically according to economic conditions -while political issue were also relevant - : Czech Republic, Hungary, Poland , Slovenia and Estonia were finally accepted as full membership in 2003. In a second step, another five countries have been selected : Romania, Bulgaria, Lithuania, Latvia and Slovakia. However, the strategy of acceptance has been global and inclusive , that is " a process in different steps but with every body implicated"[4] .

1.2 Objectives and methodology

 The aim of this paper is to answer the following questions: which is the rationality of the performance strategy to improve the European monetary integration situation of the CEEC in terms of stability parameters? , which would be the results of the application of the Maastrcht rules for the CEEC? and which are the basic differences in terms of macroeconomic stability conditions with the 1986 CE enlargement focusing on the Spanish economic situation during the first middle 80s**.**

A large number of macroeconomic indicators have been selected and calculated – price index tendencies, exchange rate volatility, annual variation of labor productivity and labor costs such as the country risk and economic performance indicators. The purpose is to denote there are specific economic reasons in order to enlarge the EU other than the political tools. The Maastritch criteria (MC) for the CEEC are evaluated and some the basic variables that according with the OCA literature are taken into account to evaluate the possibility in next future of a larger EMU. Finally, the application of the MC vs an alternative Optimum Currency Area Index (OCAI) - developed by Bayoumi and Eichengreen (1997) – has been computed to outline other implications of the enlargement of a monetary union rather than the MC. The basic data used is the European Bank of Reconstruction and Development Report , the OCDE Reports, the World Economic Outlook and the European Commission Report.

1.3 Orientation of CEECs to the EU

One of the consequences of the EU enlargement is the   increase in the size of integration with the EU, that is , the intensification of the economic relations between the ten regions and the EU. The EU constitutes nowadays a space of advanced

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[4] This were the words expressed by The British Prime Minister, Tony Blair during the EU presidency.

economic integration based on frequent and extended economic relations with CEEC, this is shown in (table 1), the share of the UE trade with respect total trade of the Visegrad-5 countries and Estonia is approximately 60%, for Romania is a 50% and a 40% for Bulgaria, Latvia and Lithuania. Thus, the EC (1997) selected countries are the more integrated in terms of share of EU trade.

The EU-CEEC trade has been growing rapidly during the 90s, nevertheless there has been a significant asymmetry terms of trade growth. Imports are growing faster than exports and therefore the trade balance is negative year by year. Probably the most important factor that explain the rapid growth is the trade liberalization. Thus, an increase growth trade implies the return to a more natural trade pattern following removal of the artificial distortions of the central planning system (Hamilton and Winters, 1991). However, the continuous orientation towards the EU, foresees that in 1998 and 1999 the economic development will continue due to the expected acceleration of EU economic activity[5].

Moreover, Keuschnigg and Kohler (1998) argue that there are great differences in terms of trade between CEEC and the UE. While the structure of tariff protection in the EU is 3% in the CEEC average import tariffs are 6,5 %. Another wide difference is in the structure of trade, the EU levis higher tariffs in agricultural goods, the CEEC is in industrial goods (Bladwin et al ,1997)Another significant difference is the magnitude of the trade balances, due to the growing imports explained by the expansion of domestic demand. The overall trade deficit for the CEEC has been a 9% of GDP in 1997 and this results do not seem to improve in a short run because of sustained import growth.

Trade effects of the EU Enlargement, are analyzed by Cadot and Melo (1995), they suggest that an increase imports from CEEC are likely to result in more unemployment, but it will be not very important in relative terms and not concentrated in a particular region. The new domestic private firm in CEEC are in a weak position, they still have to cope with building new capacities, new markets, management techniques and facing the task on developing technology sectors, and setting up adequate banking and financial sectors (Bonifer, 1995). By contrast, a large market create great opportunities for rising economic growth (Cecchini Report , 1989) because stimulate efficiency and enable the exploitation of the dynamic economies of scale. In order to understand if the CEEC integration will contribute to technical and economic efficiency , its used the indicator of the share of intra-industry trade within the EU[6] . The CEEC with higher share are the Visegrad-5 and the lower percentage is for the trade with the Baltic States. This is a clear explanation of a two stages transition[7].

Some authors argue that the EU enlargement strategy is to be a "concentric integration" indicating that countries geographically closer to the "European core" Europe will access preferably . However, the economic conditions do not indicate that countries geographically nearer are the best candidates to access (see for instance

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[5] Only two countries Slovakia and Poland a slowdown of growth is expected. In Poland – that represents a 40% of CEEC GDP- is expected to lead to a slower growth due to the fiscal expansion in 1997.

[6] Generally its an indicator of imperfect competition and is assumed to be explain by economies of scale and differential in products.

[7] Microeconomic restructuring entails privatization, reducing monopolization and price liberalization in all markets (trade, capital and labor and products) . Nevertheless, before achieving liberalization , the central planing distortions should be corrected in all countries, the fiscal system reformed –introducing or adding taxes – and a legal structure in order to protect property rights

Estonia). The current front –runners in the EU enlargement are the Visedrad-5 (Czech Republic, Hungary, Poland ; Slovenia and Slovakia). However, there are relevant differences from the EU-15[8] , for instance, the EU GDP per capita is two an a half on average than the Visegrad-5 -.Therefore its seem plausible to support a transitional strategy for the entrance of CEEC based on the latest enlargements. That is starting by an integration by association as a strategy for opening the European single market to CEEC. Nevertheless this kind of integration is limited by reaching only a high degree of liberalisation. Another possibility is to create an EFTA in a more integrated step process in order to implement a CECC Free Trade Area but the major benefits for the CECC would be reached by a higher degree of integration. Finally, the strategy adopted by the EU has been widening the "European area" [9].

1.4 Monetary Reform and Stability Conditions

After the CEEC currency convertibility has been guarantied due to the removal of the existing structural distortions[10], price stability has been one the main economic problems and therefore the disinflationary policy (nominal convergence) is understand as a key precondition to accelerate the transition to a market economy[11] despite within the CEEC, price stability conditions are extendedly heterogeneous . While Baltic countries and Poland still have reduced significantly their inflation rates, Romania and Bulgaria lead to an acceleration of inflation during 1997 and 1998 leading to exchange rate problems.

However, price stability leads to other purposes :

(i)   Assuring high growth taxes : due to the positive effect of stability in growth (Fisher, 1993). However, the co-ordination of monetary policy with other economic policy objectives such as unemployment is still unambiguous.
(ii)   Limiting the effects of inflation through competitiveness, that causes currency deprecations.
(iii)   Attracting FDI and expanding the private sector.
(iv)   Containing the effects on price instability on the indexation of commodities and other assets.

Table 3 shows the price tendencies in the different countries between 1991 to 1996. The general tendency is that the ten economies considered suffered a deep inflationary crises during 1991 and 1992. However, the size of the stability crises was

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[8] Therefore, the main differences accounted are the :

   (i)   State of Capital Stocks and Technology : this can be changed by the installation of new machines and the adoption of new technology.
   (ii)   Know How, Educational System and public sector functioning: this could take some decades, despite the rapid investment.

[9] Costs and benefits of the EU enlargement have been were studied by Baldwin et al (1997) arriving a an estimate net cost of 23 billion ECU for the Visegrad enlargement in 2000

[10] Thus the adjustment of relative prices toward international market conditions are determined from abroad price differentials in tradable goods

[11] Following Fisher (1993) , the macroeconomic framework can be described as stable when inflation is low and predictable, real interest rates are appropriate , fiscal policy is stable and sustainable, real exchange rate is competitive and predicable and the balance payments situation is perceived as viable.

higher in Romania, Bulgaria and Poland than in Czech Republic, Hungary and Slovakia. The different evolution reflects not only the economic coherence but also a different departure situation, due to Czech Republic and Hungary maintained a capped monetary supply . Table 3 shows the great progress of the stability process, despite inflation is one the expected problems within the transition of to a market economy departing from a planned economy[12]. Some authors consider inflation pressures in the CEEC to be defined as hyperinflations. However, an hyperinflation can be capped, by reducing the inflationary expectations and introducing a rigorous fiscal and monetary policy. By contrast, the economic price evolution in some CEEC can be defined as chronic inflation, that is caused by structural rigidities, and if the economic policy isn't able to reduce inflation then it's possible to cause hyperinflation**.**

One particular economic fact that appear analyzing the data is that higher inflation taxes reduce growth , so the reduction of inflation is one of the main objectives required to perform economic convergence with the EU. Between 1991 and 1996, the major production drops coincide with the higher inflation taxes, and the major growth levels coincide with the reduction of inflation. Therefore, the Keynesian dilemma doesn't applies for CEEC (table 3 and 4). The inflation rate is seen as an indicator of the overall ability to manage the economy (Fisher, 1993), due to high inflation associated with large budget and exchange rate distortions is associated with lower growth,. Inflation is a symptom of governmental out of control and as its shown in table those CEEC with higher inflation rates are improving less in terms of real convergence towards the EU.

Monetary policy in the CEEC is focused on controlling the money supply, thus a restrictive monetary policy should be then achieved. However, the size of the "restrictive" monetary policy is the main key issue . Thus, Janácova (1996) argues that the majority of CEEC try to control the money emission without controlling the system liquidity. The main explanations can be pointed out as :

(i)   The weak response of banks to the interest regulation due to inflation with abssence of leading a "new" private sector.
(ii)   The non existence of secondary markets in order to apply the open market instruments.
(iii)   The existence of many monetary transactions without compensation in a real output increase.
(iv)   Dependence on international capitals so as the range of the forms indebtedness.

The monetary policy , determines the currency policy, in the sense that a devaluation can be a strategy to offset a reduction of competitiveness, but the intensive use of devaluation can provoke a rise on inflation causing vicious circle . Although currency depreciation can be a useful instrument, in the most cases introduce inflationary pressures. One of the main policies that are used to control deprecations is to peg the exchange rate with a stable currency as the Euro could be, this argument could be supported by the recent conclusions of Wyplosz (1997) denoting that there's no apparent link between the evolution of nominal and real exchange rates in nine CEEC

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[12] The price liberalization in a context where its own structure do not reflect the real production costs and demand information it isn't available, there aren't mechanisms to break the price ascendant tendency**.** At the same time, there are other factors to explain the inflationary process, such as the monetary expansion and the undefined property right's

considered and because of the price flexibility the exchange rate is an independent variable (table 6 and 9).

 The experience after Bretton Woods denotes that countries   peg its currency need financial stability, otherwise they engage in frequent exchange rate adjustments. The decision of pegging a currency would depend on the factors mobility, the openness, degree of financial development , the divergence of inflation within countries, the presence of foreign and domestic nominal shocks and so on. Therefore,   without controlling inflation, developing financial markets and increasing factors mobility and openness a fixed exchange rate would cause problems. One of the usual arrangements adopted in a large number of countries are the currency board arrangements due to they enforce financial discipline and reinforce stability (Estonia, Lithuania and Bulgaria) Fixing the exchange rate could be for CEEC a package to break hyperinflation for some countries and to stabilize definitely its economies in order to access to the "EU stability area". Nevertheless, there's a trade off , the cost of pegging the currency are defined in terms of the need of international reserves, dependence on the monetary policy and problems on maintaining the current account equilibrium could arise. .

The most advanced regions could during the period 1990-1991 control the exchange rate volatility, however Bulgaria and Romania have suffered a continuous depreciation during this period that could be explained by the monetary policy control and the bad evolution of exports (see table 5). As its shows in table 5 and 6 , the most countries than could access in a first step into the EU are the one that control in an efficient way its exchange rate volatility, for instance Poland, Estonia and Latvia had during the period 1990-1996 30 times less money value loss - in terms of PPP- than Bulgaria. Nevertheless , the exchange rate variability depends more beside price stability on other factors that a CEEC government could had problems to react, such as on the market confidence . Other explanation is than CEEC are more sensible to changes in the international economic environment (such as an international currency crises) , and specially on the EU real   economic and financial cycle. In order to sterilize the exchange rate variability, the monetary policy plays the most important rule, that is if countries are able to contain inflation's by limiting the money supply expansion, then it could be possible to contain the market expectations that affect some currencies

The classical optimum currency area (OCA) literature suggests that asymmetric shock between countries might be bluffered by real exchange rate volatility, thus, lower volatility ceteris paribus would imply the absence of asymmetric shocks. That is , OCA advises that a higher level of trade between countries reduce the probability od asymmetric shocks. Nevertheless, there are other related linkages as monetary policy coordination and the volume of imports and exports. Table 6 denote that Poland, Latvia, Estonia, Slovakia and Czech Republic would be the best candidates to entry into the EMU.

1.5 A Model for Stability Convergence

The access to a monetary union requires as a basic aim two conditions a low inflation (price stability) and similar budget equilibrium's(fiscal equilibrium) of the currency area partners . Supposing a monetary union of n members , with similar price levels P (without inflationary bias) and similar preferences on the expected inflation P^*. We

suppose that **m** members would be interested on accessing with an inflation rate **P'**. Then an operazionalize a conditional criteria for the newcomers is to assure inflation and other variables related to be as low as the average of the monetary union countries . That is essentially fixing a criteria for inflation and for the fiscal imbalances.

a) The inflation criteria

Supposing a two period an according to Ozkan and Sibert (1997) we suppose that the impact of the cost reform depends on the expectation on the monetary policy selected by the **m** candidates, that is the expected inflation rate .In a first period there's a nominal convergence process while in a second period candidates apply for entry and they would be selected according its monetary policy (1).

$$\text{The exclusion criteria is :} \ \left\{ m \ would \ access \ \leftrightarrow \ P' \leq P* \right\} \tag{1}$$

During the transition period the candidates remain outside while the entry condition P* is set. The output of the **n** and **m** countries is given by the supply functions :

$$\text{The outside county output} : y_t = P' - P* - \varepsilon \tag{2}$$

$$\text{The monetary unoin output} : y*_t = P* - P**$$

Where **P**** is the expected inflation rate for the monetary union and ε is the output distortions, and therefore the monetary union has no output distortions . Assuming that policy makers can determine the monetary policy (**P**) the possible losses for the two in and out countries are defined by $\Gamma'(y,P')$ and $\Gamma*(y*,P*)$ respectively defined in terms of inflation and output distortions . Following Ozkan and Sibert (1997) and imposing rational expectations the equilibrium after the transition period is defined as the inflation convergence as follows :

$$P' = P* = P** = \theta\varepsilon \tag{3}$$

Therefore the inflationary bias is explained by the price stability and output distortions , while the monetary union has a lower inflationary bias than the entering candidates. Nevertheless, in (3) is showed that the newcomers increase inflation in a weighted measure of output deviations. Depending on the participation of the new member the inflationary bias would be high or not. The CEEC represent a significant increase in terms of population and GDP, and therefore an increase in inflation is an expected projection . This model seem to adapt to the actual situation.

b) The fiscal criteria

Containing debt and the budgetary deviations is a need to contain an inflationary bias due to differences in debt ratios between countries. If debt ratios are significantly different , then the preference to inflation may differ.

According to the models developed by Blanchard (1990) , we can depart from a budget constraint in relative ratios where **g** is the government ratio spending, **h** is the ratio of

public transfers, *t* is the average tax revenue, *r* is real interest rate and *y* is GDP growth :

$$\partial B / \partial t = g + h - s + (r - y)b = \vartheta \qquad (4)$$

$$b_t = b_0 + \int_t^o \vartheta dt$$

Thus, a high debt ratio (bo) would not permit nominal convergence except if the debt ratio is projected to decrease due to a budget deviation reduction. Therefore the fiscal criteria can be reduced as in terms of containing the budgetary deviation in a specific fixed amount in order to reduce the differences in the debt ratio across countries.

2. Nominal convergence process or an alternative strategy: The Maastrcht Criteria for CEEC

There are several approaches concerning on the kind of integration of the CEEC to the EMU. An economic and monetary integration of regions with significant economic and financial structure differences usually takes a long time and requires a gradual transition defined by the extension of a voluntary coordination in order to prepare the future access, a pre-established plan in order to support a gradual the creation of a common market and the gradual transfer of the monetary authority in the transition period. Therefore, in a transition period some problems can appear in the sharing authority between national central banks and the ECB. The exchange rate regime of CEEC in a transition period should be referred to the Euro despite the exchange rate changes would still be possible, and thus possible tensions in a "new EMS" - ERM-III- could escalate into exchange rate crises as denoted the EMS experience. However, despite the experience of the ERM denote some inconsistencies, the ERM has been successful for its ability to reveal the true preferences of monetary authorities with regards to the nominal convergence criteria.

The main question to answer here is when the CEEC will be prepared to establish a fixed exchange rates with the Euro, and which criteria will be established as indicators of economic performance and success in transition. One answer pointed out is that countries should have before a stabilization process of performance their underlying economic structure in order to accomplish MC – fiscal and price stability - . Other answers could be possible, for instance in the German unification there were no convergence criteria requirements. Table 8 summarizes the basic limitations for the current applicability of MC to the CEEC.

By contrast, establishing nominal criteria for the access to the EMU has a clear rationality additionally to improving credibility. The entry into a monetary union do not imply the abolishment of national currencies from the start, and thus regional inflation could occur and the free riding problem would arise. The Maastrciht strategy for moving towards a monetary union has been defined in terms of a gradual transition conditioned to the accomplishment of some specific criteria. Although, the MC are not indicators of macroeconomic performance, rely among developed market economies with microeconomic similarities, while the CEEC's are still countries that needs

microeconomic developments focused on structural reforms. For instance, one of the main elements of the transformation process is the creation of a social safety, that would lead to an important increase in government deficits such as the high share of budgetary redistribution in GDP (Palankai, 1996).

The MC are essentially, indicators of macroeconomic stability rather than real convergence indicators. Therefore, the success in nominal convergence of a determined number of countries is not an indicator of real convergence. Nevertheless, following Buiter (1997) real convergence is irrelevant for monetary union while economic integration according to affects positively growth Henkerekson et al (1997) . As a result, the performance on integrating the CEEC would have positive effects in terms of higher growth rates in a long run, while in a short run could imply larger costs. Despite, the Maastrcht criteria ere essentially nominal indicator, the selected CEEC - Visegra –5 and Estonia - are not as far as to satisfy some of the basic criteria and if we compare the results of Table 7 with the same criteria of a large number of EU countries in 1986 we would find large similarities.

In table 7, an EMU Indicator has been calculated following the methodology of Gros and Thygensen (1992). The results denote that Poland, Hungary and Slovenia are in terms of nominal convergence in a similar relative position as the EU average. This results, are however not very robust due to trade balance is in the most of countries negative while the EU is positive, and therefore the distance also in terms of nominal converge is nowadays sufficiently large to consider a transition period over at least the 10 years approximately that the EU lasted for a nominal convergence. Without, computing specific dynamic data, and due to the results from the comparison between the Visegrad- 5 and Spain in 1980-85 in table 12, there are grate similarities in the most of stability performance parameters, except in terms of the inflation rate, that is higher in the former countries (Table 12).

The experience of the stability convergence policy within EU has demonstrated that during the fulfilling period (1991-1998) , in the EU countries - despite achieving price stability- growth has been limited, unemployment has rise significantly . Therefore, if the integration strategy of CEEC is based for instance, on limiting public deficit in a similar values, then the debt burden and the necessities of the transformation process could impose a heavy social cost , especially if a social safety is needed .If the creation of a social safety is part of the transformation process this could lead to an increase in government deficits.

Obviously some of the priorities of CEEC could differ from the existing EU members , and therefore the stabilization programs induce to a underintegration, when solving the difficulties encountered in the transitional process. Therefore, the criteria to access EMU should include stability indicators such as particular indicators of economic structure(market economy, central bank independence, public sector size , progress in privatization ect) . However, Nello and Smith (1997) argue that even as nonparticipating countries the CEECs should therefore have to accept obligations with respect price stability, exchange rate stability and fiscal discipline. Moreover, the great differences between CEEC suggest that a different step integration process would be a the most plausible strategy, and the actual discussion is not so deep on selecting which countries than on determining the timing of the enlargement process.

According to the EMU experience (Maastrcht strategy) the strategy purposed in this paper would be outlined as :   Firstly, from table 6 , the Visegrad-5 should apply a disinflationary policy to reduce exchange rate volatility . Furthermore, central Bank independence would be a pre-requirement as Loungani and Sheets (1997) show that there's a negative correlation between central bank independence and inflation in transition economies. By the way, an CEEC- ERM should be introduce in order to guarantee the Euro implication of this countries by participating in the normal fluctuation margins of the EMS without the need of devaluation. That is , pegging the CEEC currencies to the Euro.   Secondly, the integration of markets should be taken into account, that is the situation and development of the balance of payments on current accounts and the developments of unit labor costs (Tygensen, 1993). Thirdly, the "excessive deficit" could be a general   access criteria due to the impact over inflation, probably this is the most conflictive criteria due to economic reforms induce to an expansive fiscal policy (see table 7). However, during a convergence period the magnitude could be higher than a 3% because if we comparative magnitude of the public debts of CECC with the UE countries there are significant differences, specially according to Italy and Belgium.

The "European model " of EMU supports that the sustainability of a monetary union requires fiscal and price stability, nevertheless the entrance conditions for the CEEC should depend on the moment on which the entrance to the EMU, that will depend on the macroeconomic stability of the EU after 2002. It can be supported an scenario were the full, 15 EU member access to the EMU, and Euro positioned as an international currency with a relatively similar degree of participation in the international trade and international financial transactions[13]. If the Euro constitutes a strong currency, and the CEEC integration accelerates its speed, then an artificial monetary union in terms of pegging the national currencies to the Euro could be risen with a   credible disinfaltionary policy.

However, are the whole CEEC potential candidates in a medium run? Probably, not. Despite the influence of political factors in the EC decision of a different step integration process of the CEECC there are relevant economic arguments behind. That is the credibility of the disinflationary policy (inflationary expectations) and the major nominal performance in converging the basic macroeconomic indicators.

3. The Optimum Currency Areas Theory and the CEECs

The literature of optimum currency areas (Mundell (1961), Mc Kinnon (1963) and Kenen (1969) establishes *that n countries can share the same currency if the use of nominal exchange rates do not affect significantly relative prices of the different economies involve*d[14] . The basic elements considered are the degree of openness -

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[13] The major benefits of the EMU are set as :
First , exchange rate stability that eliminates risks and transaction costs streaming from exchange rate operations inside currency union,. enhancing specialization and efficient allocation of capital .
Second, Avoiding negative externalities associated with beggar-thyneigbor type policies.
Third, Effectiveness of Monetary Policy as a result of a increase i money demand stability
[14] That is, for instance   the relative prices of imports and exports and the real wages of workers.

because prices then are being determined by the market[15]- , the degree of diversification - because reduce the need of use the nominal exchange rate to adjust a national specific shock - and the degree of mobility of factors -because then the relative factor prices are less dependent of regional shocks-.

The openness degree in the EU is about a 20% of GDP, supported in majority by the smallest countries (Whyplosz,1997). The degree of diversification is relatively high (Cohen and Wyplosz,1989) while the degree of labor mobility seem to be the main problems in order to consider the optimality of the EMU, specially considering regional distortions inside the countries (Decressin and Fatas, 1995) . After an enlargement, the EMU would be geographically bigger so as the differences between member countries – that is economic divergence in terms of economic growth- would increase , and therefore the more mobile labor must be if monetary union is to work[16]. Also the other criteria concerning to the degree of openness and diversification wont support a short term access of the CEEC in to the EMU.

Table 13

The monetary integration of the CEEC depends nowadays more on the monetary policy objectives and the macroeconomic performances applied. If we examine the exchange rate regimes we can identify four different situations, that may differ significantly between countries (table 7). The main differences can be explained by the capacity to contain inflation pressures. Those countries with a higher level of price stability are able to fixing or limiting its exchange rate variations, and in most cases adopting a Currency Board Regime.

The possibility of an integration of the CEEC countries to EMU is quite difficult in a short term, specially because of the stability conditions need to assure a former monetary integration. Probably one of the main short terms objectives would be the creation of a ERM for the CEEC in order to improve the nominal convergence (see table 8). The real convergence is today quite impossible, because it requires the modernization and harmonization of the economic and productive structures, and obviously this takes a long time. Therefore, the integration of CECC would eradicate the problems concerned on an Optimum Currency Area, that is the asymmetric shocks would arise with a higher frequency .

4. Conclusions

The economic perspectives of the CEEC are after the European Council Decision (1997) are encouraging due t the effort of some of this countries to stabilize its macroeconomic situation. In this paper it has been shown that price stability in the main political economy objective in order to access to the EMU. The data confirms the necessity of at least a two speed nominal convergence, due to the different evolution of inflation, exchange rate and growth between countries. Another conclusion is that an acceptable criteria for CEEC should include microeconomic performance indicators in

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[15] In an open economy exchange rate policy will mostly affect prices, so that the cost of giving it up and adopting a common currency is low.

[16] The OCA theory can be criticized by focusing on the past side and on the cost of the monetary union instead of the benefits, but the OCA test to be robust for selecting the potential participants in a EMU:

order to reduce possible shocks derives form economic structure differences. Although the economic integration with the EU in terms of trade is growing rapidly there are still enormous differences that make unrealistic an economic integration in a short run. By contrast, the stability parameters such as the EMU indicator , for the Visegrad-5 and Estonia denote that the EU enlargement strategy (1997) seem rational and economically efficient

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TABLES AND DATA

Table 1. Share of the UE Imports and Exports CEEC-UE (1996)

Country	% Y*	%M	%X	X-M**
Bulgaria	3	38,9	39,8	-4,6
Czech Republic	15	58,5	58,2	-4212,4
Hungary	14	62,8	59,8	-1179,7
Poland	40	63,9	66,5	-7582,2
Rumania	10	52,2	55,9	-849,6
Slovakia	6	36,9	41,3	-576,8
Slovenia	6	66,9	64,6	-1106,6
Estonia	1	64,5	51	-606,2
Latvia	2	49,1	44,1	8,6
Lithuania	3	42,6	33,4	-367,3

* Country Weights in total GDP 1997 aggregated using market exchange rates
**In Millions of ECUS.

(Souce: calculated from European Bank for Reconstruction and Development, Transition Report Update 1997)

Table 2. Exchange Rates Regimes of CEEC

EXCHANGE REGIME	COUNTRY
Currency Board	Bulgaria (DM) Estonia (DM) Lithuania(US$)
Currency Basket Reference	Hungary(DM-$) Latvia (DTS) Poland Slovakia (US $)
Administrated Floating (ad hoc interventions)	Czech Republic Slovenia
Free floating	Rumania

(Souce : FMI, Wold Economic Outlook)

Table 3. Inflation (Consumer price tendencies)

Country	1990	1991	1992	1993	1994	1995	1996	1997*	1998*	1999*
Bulgaria	50,6	338,5	79,4	56,1	87,1	62,1	129,7	-	35	15

Czech Republic	9,7	56,5	11,1	20,8	10	9,6	8,8	8,9	9,5	9,4
Hungary	28,9	35	23	22,5	18,8	28,5	23,4	18,2	14	12
Poland	585,8	70,3	43	35,3	32,2	28,1	19,5	15	16	12
Rumania	5,1	174,5	210,4	256,1	136,7	32,2	38,1	125	30	20
Slovakia	10,4	61,2	10	23,2	13,4	10	6,1	6,4	7,0	7,0
Slovenia	551,6	115	207,3	32,9	13,4	10	6,1	9,2	8,9	7,8
Estonia	23,1	202,0	1076,0	89,8	47,7	28,9	22,9	10,8	8,5	7,5
Latvia	10,5	172,2	951,2	109,2	35,9	25	17,2	8,5	7,0	6,1
Lithuania	9,1	216,4	1020,8	410,2	72,2	39,5	24,2	9,2	8,6	8,1

* calculated by using the private consumption deflactor.
(Souce: European Bank for Reconstruction and Development, Transition Report Update 1997 and European Commission Report)

Table 4. GDP real percentage change rate

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bulgaria	-9,1	-11,7	-7,3	-2,4	1,8	2,6	-10,9	-7,4	12	3,5
Czech Republic	-0,4	-14,3	-6,4	-0,9	2,6	4,8	4,1	1,2	2,6	3,6
Hungary	-3,5	-11,9	-3,1	-0,6	2,9	1,5	1,0	3,1	3,8	4,2
Poland	-11,6	-7	2,6	3,8	5,2	7	6,1	6,0	4,7	5,2
Rumania	-5,6	-12,9	-8,8	1,3	3,9	6,9	4,1	-3,0	2,2	4,4
Slovakia	-2,5	-14,6	-6,5	-3,7	4,9	7,4	6,9	5,3	4,5	3,6
Slovenia	-4,7	-8,1	-5,4	2,8	5,3	3,9	3,1	3,4	4,3	4,6
Estonia	-8,1	-7,9	-14,2	-8,5	-2,7	2,9	4,0	5,2	4,7	4,7
Latvia	2,9	-8,3	-35	-16	0,6	-1,6	2,8	3,5	4,1	4,2
Lithuania	-5,0	-13,4	-37,7	-24,2	1	3,1	3,6	5,0	5,4	5,7

(Souce: European Bank for Reconstruction and Development, Transition Report Update 1997 and European Commission Report)

Table 5. Exchange rates in terms of US dollars

Country	1990	1991	1992	1993	1994	1995	1996
Bulgaria	3,9	18,1	23,4	27,7	54,1	67,2	190,3
Czech Republic	18	29,5	28,3	29,2	28,8	26,6	27,1
Hungary	63,2	74,8	79,0	91,9	105,2	125,7	154,7
Poland	0,9	1,1	1,6	2,1	2,4	2,5	-
Rumania	22,4	76,3	308	760,1	1580	2037	3138
Slovakia	18	29,5	28,3	30,8	32,0	29,7	30,6
Slovenia	11,3	27,6	81,3	113,2	128,8	118,5	141,5
Estonia	-	-	12,9	13,2	13	11,5	12
Latvia	-	-	0,7	0,7	0,6	0,5	0,5
Lithuania	17	38,5	177,3	4,3	3,9	4,0	4,0

(Souce: European Bank for Reconstruction and Development, Transition Report Update 1997)

Table 6. Annual Exchange Rate Volatility (1990-1996)

	1990-1996
Bulgaria	23,6717553
Czech Republic	4,39893927
Hungary	22,7130506
Poland	0,67428975
Rumania	837,924188

Slovakia	5,08045274
Slovenia	49,8657966
Estonia	0,77674535
Latvia	0,09574271
Lithuania	68,1939489

(Souce: Own Elaborated and European Bank for Reconstruction and Development, Transition Report Update 1997)

Table 7. Maastricht Criteria for the CEEC (1996) and an overall convergence indicator

Country	Budg Def.	Prices	Int. R	PDebt	Debts Indicat *	Unemp	Trade Balan	EMU Indict. **
Bulgaria	13,4	116,9	575	111	3,7	12,5	2,6	607,2
Czech Republic	0,2	8,8	12,5	14,4	-5,98	3,5	-10,9	-0,68
Hungary	3,5	23,5	20	75	0,1	10,5	-6,1	28
Poland	3,1	20,2	20,3	54	-2	13,6	-6,3	28,7
Rumania	3,9	38,2	51,1	16	-5,8	7,8	-7,0	50
Slovakia	1,2	5,8	13,7	29	-4,5	11,1	-11,3	10,2
Slovenia	-0,3	9,7	23,7	32	-4,2	13,9	-4,6	28,5
Estonia	1,5	23,1	13,7	-		5,6	-24,4	-
Latvia	1,4	17,6-	16,3	-		7,2	-18,5	-
Lithuania	3,6	24,6	21	-		7,0	-15,15	-
EU-1997	2,8	1.9	4,5	74	0	10,7	10,55	28,5

*Debt indicator is calculated as the nbational debt/GDP ratio minues EF average divided by 10.
** The EMU indicator meaures the degree to become an EMU candidate using the methodologu of Gros and Thygensen (1992). The EMI indicator is calcultaed as adding up the budget deficit, , the interest rate, the unemployement rate and the trade balance. We've used for the CEEC countries the trade balance instead of the current account .
Souce: European Bank Reconstruction and Developement, De Grawve and Gros (1991) and Gros and Thygensen (1992)

Table 8.Limitations of The Maastricht Convergence Indicators

INDICATOR	OBJECTIVE	LIMITATIONS
PRICE STABILITY(I)	Inflation rates no more than 1,5% above average of the three countries with lowest inflation rate	Inflationary expectations due to price liberalisation, devaluation, wage indexation, servicing of public debt and public spending on infrastructure and unemployment benefits.
PRICE STABILITY(II)	Long-term interest rates should be no more that 2% above the average of the three lowest inflation countries	Underdeveloped long term capital markets, limitations on availability of data, pressures of high interest rates due to inflationary expectations.
PRICE STABILITY(III)	The exchange rate should remain with the normal band of EMS	The inflation pressures cause reductions in the competitiveness that are offset with deprecations.
FISCAL STABILITY (I)	The public debt must be less than 60% GDP	High debts service burden due to high interest used to combat inflation.
FISCAL STABILITY (II)	The national budget deficit must be less than 3% GDP	Budget situation of local and regional governments, the creation of social safety, the high social costs of

	limiting public expenditure.

Table 9. Index of Annual Variation of Labor Productivity and Labor cost

	1992		1993		1994		1995		1996	
Country	LP	ULC	LP	ULC	LP	ULC	LP	ULC	LP	ULC
Czech Republic	96,1	114,57	100,7	102,98	101,8	1105,8	102,1	105,48	102,7	105,16
Slovenia	101,3	95,95	105,1	122,65	107,2	83,77	104,2	91,84	102,3	96,38
Estonia	91,8	75,38	103,8	100,1	98,5	111,88	104,5	101,63	-	-
Poland	107,2	90,76	106,4	91,26	104,2	96,45	105,1	98,1	-	-
Slovakia	92,95	-	98,7	97,37	106	97,83	105,3	99,43	106,3	101,79
Hungary	106,8	89,89	104,7	93,31	105,3	100,09	103,4	85,78	101,1	92,28
EU- Gernamy	104,1	105	100,6	103,3	103,6	99,6	102,3	101,1	102,5	99,9

Souce : Economic Survey of Europe (1995-1997) and W. Andreff (1998)

Table 10. Country Risk in CEECs (comparision dates september 1993 to september 1996) and the reform index (average value 1989.1992)

CEECs	1993	1996	Ref. Index*
Czech Republic	43	35	0,45
Estonia	122	71	0,31
Hungary	46	44	0,61
Poland	72	55	0,62
Romania	75	61	0,26
Slovenia	61	34	-
Slovakia	63	49	-

* This index meausures the perfomance of the overal reform programe of every country taking into account (i) the extent of liberalization of domestic proces and the abolition of the state of trading monopolies, (ii) liberalization of the foreign trade regime and currency convertibility and the privatization of small-scale and large scale enterpises baking reform. The scale is from o to 1.
Souce : Euromoney 199 and Melo, Deniezer and Gelb (1996).

Table 11. Selected Economic Performance Indicators for the Visegrad –5 and Estonia

	GDP per capita 1996 in billons of dollars	Agricultural Participation in GDP 1996	Trade Balance as a % of GDP 1996	Inflation (private consuption deflactor)	Exchange rate anual average in dollars
Poland	3459	6,6	-8,2	19,9	2696
Slovenia	9279	4,3	-0,85	23,3	135,37
Slovakia	3525	5,2	-2,11	7,0	30,65
Hungary	4357	6,4	-2,6	23,3	152,6
Czech Republic	5340	5,1	-6,0	8,8	27,1
Average Visegrad-5	5192	5,52	-3,952	16,38	-
Estonia	3000	6,4	-1,058	23,1	12

(Souce : European Bank of Reconstruction and Developement, Selected Economic Indicators 1997 and European Comision Report autum 1997)

12. A Comparision between Spain 1980-86 and the Visegrad 1996

	Growth and real GDP per capita (in brakets)	Agricultural % GDP	Inflation	Trade balance as a % GDP
Visegrad-5 (1996)	4,24 (5192)	5,52	16,78	--3,952
Spain 1980-86	2,8	6	12,2	-5,3
EU 1996	1,7	2,9	2,5	10,13

(Souce : INE calculated as anual averages, Baldwin (1996), BERD Report Update 1997 and European Comison Report 1997 and World Economic Outlook)