Strategic Exchange-Rate Policy of Accession Countries in ERM II

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Exchange-rate policies of Central Eastern European Countries (CEEC) have often been a subject matter. Yet, some new insights in terms of political economy considerations upon exchange-rate policy are provided. It is pointed out that it is more appropriate to analyse exchange-rate policy in course of Exchange Rate Mechanism II (ERM II) with regard to a changing incentive structure. In doing so, considerable moral hazard problems become apparent.

ERM II shall provide for an adequate level of convergence between prospective and current members of European Monetary Union (EMU). However, this institutional arrangement and, particularly, its impact on the incentives for exchange-rate policy making might enable CEEC to load considerable costs of convergence onto current members. Accordingly, the phase of ERM II is considered to be a bargaining on the distribution of costs of convergence between prospective and current members of EMU. In return, accession countries would offer to maintain public support for European integration. The CEEC' leverage in this bargaining rests on brinkmanship, i.e. putting exchange-rate regimes at risk, thus possibly undermining the according public support.

This paper delineates the basic assumptions and conditions for successful brinkmanship, points out the specific transmission mechanisms, and characterises this kind of exchange-rate policy as 'threaten-thy-neighbour'. Overall analysis results in a cautious outlook on probable effects of such strategic exchange-rate policies on European institutional and economic matters.

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Section 1

This paper studies the exchange-rate policies of Central Eastern European Countries (CEEC), particularly regarding their performance in Exchange-Rate Mechanism II (ERM II), i.e. the period before their admittance to the European Monetary Union (EMU). The decisions taken at the Copenhagen summit in December 2002 cleared the way for the accession countries[1] to join the European Union (EU) in May 2004. At that time, CEEC are provided to enter ERM II: According to the schedule—as there is no opting-out for the prospective EU-members—they are supposed to join EMU two years later in 2006.

Analysis indicates that ERM II is not just one of several Maastricht criteria for qualifying for EMU-membership, but might provide other political incentives than its founders have initially imagined. Basically, ERM II and other Maastricht criteria are to ensure an adequate level of convergence between prospective and current members of EMU. Regarding a smooth functioning of EMU, it seems to be economically desirable, to require approximately the same level of convergence in an enlarged eurozone.

Whereas Maastricht addresses rather nominal convergence, real convergence is here of particular interest. The latter means that standards of living between current and prospective members of EMU are getting closer. This is usually defined by a narrowing gap of GDP per capita.

Prospective members have actually to bear the burden of those costs of convergence entirely by themselves. According to the rationale of the Maastricht criteria: If they will not be able to persevere the transition process of convergence, they would not attain access to EMU. Regarding ERM II, however, this institutional arrangement and its implications for the incentives of policy-making bodies—particularly with regard to exchange-rate policy—might enable accession countries to load considerable costs of convergence onto current members. CEEC might probably put their exchange-rate regimes deliberately at risk. In that manner— i.e., in case of a default, thus undermining public support for EMU-membership—they would possibly impair the entire European integration process.

Because of that effect, the period of ERM II can be considered as a bargaining[2], i.e. a challenge of distributing the costs of convergence between prospective and current members

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[1] Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. When analysing CEEC (hereafter synonymous to 'accession countries'), Cyprus and Malta are not concerned. These countries do not fit into the here-developed argumentation.

[2] NB: A corresponding formal game theoretic analysis will not be presented, but the possibility of brinkmanship in ERM II is—hopefully—thoroughly demonstrated.

of EMU in exchange for public support for European integration in accession countries.[3] The paper indicates that ERM II can give CEEC some leeway in the according bargaining. In this respect, accession countries exert exchange-rate policy strategically. Accession countries can potentially force current members of EMU to provide somewhat pecuniary assistance. A policy of gradual escalation, i.e. brinkmanship, could eventually result in an exchange-rate crisis. Though a successful brinkmanship implies that the crisis scenario will not occur. Whether such brinkmanship is actually effective, will depend on whether it fulfils specific conditions. In particular, a successful brinkmanship has to meet two conditions in terms of effectiveness and acceptability. That is to say, that CEEC really must be able to coerce current members of EMU into providing assistance, thus, averting an exchange-rate crisis and a consequential drop of public support for European integration in accession countries. In this regard, the effectiveness condition would be fulfilled. Likewise, the acceptability condition holds as long as CEEC do not perceive themselves to be too close to the brink. If these conditions are valid, then brinkmanship represents a credible threat.

Such a strategy necessarily requires that current members of EMU are basically willing to pay for CEEC' admittance to, firstly, EU and later on EMU. In this context, former allowances for CEEC by the EU and—just recently—the decisions taken at the Copenhagen summit point slightly at the current members' willingness to pay for the prospective members. In Copenhagen, they agreed on a financial package for the accession countries amounting to 40,8 bill. € for the years 2004-2006 in order to smooth the transition process. The upshot of this is that an almost apparent willingness to pay entails moral hazard, i.e. inviting CEEC for brinkmanship.

The remainder of the paper is structured as follows. In section 2 basic assumptions for moral hazard behaviour in terms of brinkmanship are discussed. In particular, reasons why the EU is willing to pay for CEEC' accession to the monetary union are stressed. After that, general patterns of exchange-rate policies in CEEC are surveyed. Section 3 starts with a review of and the institutional design of ERM II. Then, particular features of economic policy formation in applicant countries are analysed. In doing so, the details of the brinkmanship strategy are elaborated. Potential countermeasures of current members of EMU are also discussed in that context. It is pointed out how ERM II gives CEEC some specific leeway in a subsequent

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[3] Basically, EMU is succeeding the EU-integration process. However, it can be presumed that current members of EMU would draw on other so-called 'members states with a derogation'—simple members of the EU, so to say—to bear the respective burden, as well. Thus, the terms EU and 'current members of EMU' are used synonymous except when otherwise expressively stated.

bargaining on the costs of convergence. At the heart of this bargaining is a brinkmanship strategy. To put it bluntly, it is shown that the bargaining between prospective and current members of EMU consists of an exchange of sustaining public support for European integration in CEEC for some kind of financial assistance by current members of EMU. Section 4 concludes and provides an outlook on alternative solutions to such a brinkmanship.

Section 2

At first, the basic position for an analysis in the light of brinkmanship of CEEC is briefly inquired. Second, the performances of accession countries' exchange-rate policies are reviewed. This contributes to an understanding of qualitative differences in exchange-rate policy stances, which enables to grasp characteristics of exchange-rate policy as a brinkmanship strategy.

The crux and core of the eastward enlargement

The core

When analysing the enlargement process of the European Union (EU), it is assumed that it has been driven, essentially, by political rationale: Both parties—current as well as prospective members of EU—agreed on the need to stabilise the region of CEE in view of their specific geopolitical concerns and security policy interests.

At the beginning of the 1990s after the fall of the iron curtain their regime eventually collapsed and political systems in CEEC changed fundamentally. Thus, they entered a rather uncertain phase. At that time, western European countries suggested an enlargement of the EU. In doing so, they were offering to export an established institutional system to CEEC.[4] From the point of view of the accession countries, this option has been especially lucrative because of the incorporated economic benefits. Whereas the same does not necessarily hold true for current EU-members, since the accession countries' economic size is rather small and the considerable difference in living standards suggest rather few, if any, long-term economic gains.[5] This points up to the political gains for current members of the EU, i.e. reducing the

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[4] The same is valid for the southern enlargement process of the EU such as in case of Greece, which acceded to the EU in 1981. This country had been considered as a young democracy requiring economic and political support (Friebel, et al. 1999:2).

[5] Baldwin et al. (1997) consider different scenarios of budget costs of the EU-enlargement. They estimate the net budget costs of EU-enlargement at max. 8 bn. ECU, i.e. 0.01% of the EU-15's GDP.

uncertainty of state-interaction and stabilising CEEC politically (cf. Baldwin, et al. 1997:168). Correspondingly, the costs of convergence according to the Maastricht criteria reflect CEEC' maximum willingness to pay for prospective economic and political benefits from European integration.

Certainly, it could be argued that CEEC are already institutionally embedded into a somewhat European design of political systems. This is indeed true. However, retracting concession would jeopardize all CEEC' efforts of preparing for EU-membership, i.e. fulfilling the Copenhagen criteria and adopting the acquis communautaire. In that case, their integration into 'western societies' would probably be stopped or even reversed. Either way, these options are politically riskier than the current stance of integrating CEEC into the EU. (Thus, the willingness of the EU to pay for CEEC' membership in EMU is derived from this argumentation.)

In this respect, there is a considerable difference to the former process of creating EMU. In the run-up to EMU, the EU-members have established Maastricht criteria in terms of a tying-hands strategy in order to force themselves to ensure monetary and fiscal stability in the joint currency area and to ensure an appropriate operation of the euro (Willett 2000:388, cf. Hallerberg and Vinhas de Souza 2000:7). In case of the most divergent southern EU-members the Maastricht criteria have been a quite effective disciplining: Greece, once again, did actually not qualify for being a founding member of EMU in 1999, but joined in 2001.

However, neither the present EMU, nor a fortiori an enlarged EMU does represent an 'Optimum Currency Area'. Albeit, the eurozone might be shaped in that way (De Grauwe 1997; Frankel and Rose 1996). Correspondingly, the basic idea of the Maastricht criteria with regard to CEEC is that an applicant state pursuing economic policies in accordance with the "ins'" economic formation is capable of adapting to a single monetary policy. The criteria on interest rate differentials and the government debt/GDP ratio are of minor interest, besides the exchange-rate criterion the criteria for inflation and fiscal deficit are hereafter of specific interest. According to the Treaty the fiscal deficit must not be higher than 3 per cent of GDP, whereas inflation must be no more that 1.5 percentage points higher than the average of the three lowest inflation rates in current member countries of EMU.

At present, after having set-up the 'euro-club', the incumbents want some outsiders to join them. However, if insiders are really willing to provide these outsiders access to their club, than this enlargement process will shape prospective insiders' incentive structure differently. This time the moral hazard problem will be much more severe than in case of the former

Maastricht process.[6] Convergence could probably be much less enforced and, thus, Maastricht criteria would become probably less effective constraints.

The crux

The basic difference to the time of 1995-1997 is that Maastricht criteria do not provide a sophisticated tying-hands strategy, but a plain external constraint for prospective members of EMU: When founding the club, the primary objective has been to construct a sustainable EMU. However, that is obviously not the present object. While Greece as a potential founding member failed to qualify for EMU for the time being, the political stability of that country has not been at stake. At that moment, Greece might have been considered as an adequately consolidated democracy not requiring more European economic and political support. However, quite the contrary can be assumed in respect to CEEC. The political process and its outcomes are more uncertain when compared with the corresponding present formation in current EMU-member countries.[7] Thus, political stability and public support for European integration seems to be less consolidated in CEEC. This might probably become evident if they entered ERM II at the same time with their admittance to the EU and would experience immediately thereafter a currency crisis. Such exchange-rate crisis, then, is most likely to undermine the CEEC' aspiration to EMU-membership and European integration in general.[8] Accordingly, it is presumed that CEEC are allowed to join EU—and finally EMU—basically for political reasons. Therefore, there might be considerable scope for moral hazard behaviour when passing through the Maastricht qualification process including ERM II.

This moral hazard behaviour might trigger speculative attacks on CEEC' fixed exchange-rate regimes in ERM II. The preceding performance of fixed exchange-rate arrangements, for instance, during the former crises in 1992/93 of the European Monetary System (EMS) and in course of the Asian crisis in the late 1990s, indicates their vulnerability. Although, some countries' economic policy formation was considered to be consistent with their particular exchange-rate regime, market sentiments turned abruptly against them. Speculative attacks tested governments' credibility of a given promise to maintain a once determined fixed exchange rate (here, the standard references are Obstfeld 1994, 1995).

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[6] Certainly, there has been some scope for moral hazard, particularly for countries, which might have been considered as rather indispensable for constructing EMU such as, for instance, Italy.

[7] The apparently high level of electoral volatility in CEEC can serve as an indicator of political uncertainty. There is a vast literature of studies on the volatility of the electorate in selected CEEC. See Birch (2001:5-7) for brief survey on that issue.

Although currency crises in CEEC would not appear automatically—for instance, on account of sizable interventions by the ECB—, the then rising need to raise interest rates would eventually trigger an abandonment of the exchange-rate regime. This holds especially if higher interest rates will bring about the risk of provoking a banking crisis.[9] The latter is crucial for CEEC, because of the eminent importance to stabilise (net-) capital inflows (recently, Begg, et al. 2003; Corker, et al. 2000:1). A reversal of such capital flows could deteriorate overall economic activity, which may cause a devaluation of a CEEC' exchange rate for this reason (Foreest and de Vries 2002:24). Moreover, one country's fall might trigger further speculative attacks. Such a contagion effect usually spreads among countries with similar economic fundamentals and political features, as is the case in CEEC. Such a spreading currency crisis would confront current members of EMU with economic and in particular political problems.

Exchange rate crises are defined when there is to spot a change in parity, a relinquishment of an exchange-rate regime or an international bail-out (cf. Bordo, et al. 2001:55).[10] Generally, such crises come along with a considerable loss in terms of output and employment. In this regard, it is presumed that rising unemployment rates would undermine the public support for European integration and herby induce high political costs for incumbent governments. Thus, in course of an exchange rate crisis economic and, most notably, political integration of a specific CEEC into the EU might probably fail. However, this is an incidence—in accordance to the above-mentioned rationale of European integration—which the EU really wants to avoid. Thus, knowing that the incumbents are willing to pay for their accession, CEEC could make use of the implicit risk of loosing public support for European integration by putting the exchange-rate regime deliberately at risk. In doing so, they might probably dispose of an effective brinkmanship strategy, i.e. a credible threat enabling to elicit the EU's willingness to pay.

Overall, integration of CEEC into the eurozone can be regarded as a multilateral and deliberately arranged process. This process is divided into three distinct phases: The first lasts

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[8] See IMF (2000:173) for the importance of public support for integration in CEEC.
[9] Normally, banking crises emerge at the onset of a recession. This holds in particular, if the recession follows a preceding economic activity that was fuelled by credits, capital inflows, and accompanied by an overvalued exchange rate (cf. Bordo, et al. 2001:69-72). See Kaminski and Reinhart (1998) for a detailed survey of transmission mechanisms of currency and banking crises.
[10] The authors also employ another index of exchange market pressure acting as an indicator for currency crises (ibid.).

until CEEC admittance to the EU – this pre-accession phase ends most likely in April 2004. Second, when CEEC have become members of EU they have to pass through the presumably two-year lasting period for qualifying for EMU-membership. Here they have to comply with the requirements of ERM II and other Maastricht criteria. From the onset of this ultimate 'accession phase' CEEC lose to a considerable degree their monetary sovereignty and exchange rate issues become a matter of common concern according to Article 124 (ex 109m) of the Treaty. Third, CEEC are provided to be—because there is no opting-out—affiliated EMU-members. Exchange-rate policy issues are of particular interest during the second phase. In the following, the performances of exchange-rate policies in CEEC are surveyed in order to distinguish specific types of such policies, so that the characteristics of the respective policies in ERM II can be classified.

Stances of exchange-rate polices in CEEC

Exchange-rate policy, on the one hand, is considered as comprising the choice of a specific regime and—given a fixed regime—the reference currency, central rate and (where applicable) fluctuation band; on the other hand, it has to make allowance for the underlying fiscal and monetary policy mix. Fiscal and monetary policy, when focusing on national policy objectives, have to take into account the interdependencies between the different policy areas and the reactions by rational private actors, particularly in case of free movement of capital. Accordingly, when talking about exchange-rate policy, not only the choice of exchange-rate regime, conversion rate etc. is meant, but also the respective fiscal and monetary policies.

Ideally, exchange-rate policy corresponds and fits into an optimal policy mix, which would achieve simultaneously internal and external balance. However, inflation and output or external competitiveness are conflicting objectives according to the typically assumed short-run trade-off expressed in the Philipps-curve. Obviously, exchange-rate regimes are not chosen once and for all, but are a corollary of certain economic conditions at a specific time. Exchange-rate regimes reflect main alternative focuses of exchange-rate policies: coping with exogenous shocks and transnational policy spill-overs, bringing down inflation, stabilising real exchange rates, sustaining the balance of payments equilibrium, dealing with large and volatile capital flows etc.

Principally, two ideal types of exchange-rate policy regarding fixed exchange-rate regimes and with reference to the above-mentioned trade-off can be distinguished.[11] First, exchange-rate policy can be conducted in terms of a 'beggar-thy-neighbour'-policy, i.e. by competitive devaluations. Thus, an improvement of external competitiveness would be achieved at the expense of others in terms of exporting unemployment. Second, a government can perform exchange-rate policy, particularly in determining the external value of a currency, as a subordinated feature of a comprehensive monetary policy in terms of a disinflation strategy. These two ideal types constitute a continuum of alternative exchange-rate policies.

Despite sharing a number of common economic features and the common target of becoming a member of the EU, exchange-rate regimes in the CEEC exhibit a remarkable diversity since the beginning of the transition process (see Table 1). This reflects not only specific national economic policy objectives, but also different stages of transition.

Table 1: Exchange-rate Regimes in CEEC

Country	Period	Exchange-rate Regime	Reference Currencies	Band
Czech Republic	12/90 – 05/97	Peg	DM (65%), USD (35%)	
	Current	Managed Float		
Estonia	Since 06/92	Currency Board	DM/Euro	+/-3%
Hungary	03/95 – 12/98	Crawling Peg	DM/Euro (70%), USD(30%)	+/-2,25%
	Current	Peg	Euro	+/-15%
Latvia	Since 02/94	Peg	SDR	+/-1 %
Lithuania	10/92 – 03/94	Independent Float		
	04/94 – ½	Currency Board	USD	
	Current	Currency Board	Euro	
Poland	05/95 – 01/99	Crawling Peg	USD (45%), DM(35%) BP(10%), FF(5%), SWF(5%)	+/-7%
	Current	Independent Float		
Slovak Republic	07/95 – 12/98	Peg	DM (60%), USD (40%)	+/-7%
	Current	Managed Float		
Slovenia		Managed Float	Money Supply Target: Euro is reference value, informal	

Source: Shoors (2001), ECB (2002)

At the outset of transition with its sudden opening of CEEC' economies, there has principally been a choice between two different types of exchange-rate policy depending on particular preferences. They could have selected a range of alternative exchange-rate policies that lie in

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[11] When exchange-rate policies are considered hereafter, it is referred to fixed exchange-rate regimes. References to floats are made explicit. A discussion of the political economy of floating exchange-rate regimes is omitted in this paper.

between the two ideal types of a 'beggar-thy-neighbour'-policy and an exchange-rate policy subordinated to a comprehensive monetary policy, i.e. stabilising the price level.

A specific problem of economies in CEEC at the end of the Cold War and after the breakdown of the Council for Mutual Economic Assistance (COMECON) was the complete restructuring of aggregate demand, i.e. demand was highly non-elastic: No one was prepared to buy goods and services produced in CEEC anymore. Accordingly, there has actually not been an option for enhancing external competitiveness in terms of a 'beggar-thy-neighbour'-policy. Moreover, a relative low central parity would have hampered the transition in terms of reconstructing the capital stock (McKinnon 1991:102-3).

The opening to the world market and the initial price liberalisation has had the effect of bringing an adjustment of relative prices. When these countries under transition opened themselves to international trade, there had been an opportunity to import a price structure similar to foreign commercial partners, if local producers were forced to face a tight budget constraint. By fixing the exchange rate, in fact, the internal inflation cannot rise too much without loosing competitiveness with respect to foreign producers. The local enterprises react to this pressure partly by reducing inflation, and partly by reducing the output – possibly as less productive units are pushed out of the market.

Moreover, at the onset of transition it has been necessary to get rid of the inherited glut of money. An applicable disinflation strategy can generally be based on either an exchange-rate targeting or an explicit inflation targeting. However, the former comes especially into consideration when both monetary institutions are lacking credibility and the economy is strongly integrated into the world market. At the beginning of the 1990s, monetary institutions in CEEC were actually lacking credibility. Therefore, an exchange-rate targeting in terms of a fixed exchange-rate regime for importing monetary credibility, thus providing a nominal anchor for domestic prices, has been appropriate (e.g. Fratianni and Hagen 1992; Giavazzi and Giovannini 1991). Such a disinflation strategy requires specific institutional arrangements (central bank independence, accountability of price stability, transparency etc.) for being effective (Mishkin 2000). The more such 'signals' have performed in the past, the easier to reduce inflation (Golinelli and Rovelli 2002). Another inflationary impact stems from particular features of CEEC' catching-up. Due to international liberalisation, prices of non-tradable goods have risen more rapidly than prices of traded goods. This Balassa-Samuelson (BS-) effect arises basically from a more rapid productivity growth in the traded goods sector relative to non-traded goods sector. Though, the respective adjustment of wages tends to

cope with the productivity growth in the traded goods sector, it exceeds the less enhanced productivity in the non-traded one. This can result in higher inflation rates.[12]

At a later stage of the transition process after the initial liberalisation of prices, CEEC switched in their disinflation strategy from an exchange rate to an explicit inflation targeting.[13] This has provided an alternative signal to the local economy, showing that the stabilisation effort is not over, but is made more explicit and similar to the one of mature economies, i.e. current members of the eurozone. Additionally, Iacone and Orsi (2002) point out that a switch may have been due to the lift of capital control as required in course of the transition process.

Despite that, CEEC still have to cope with inflationary pressures, stemming not at least from the catching-up process. This process is linked up with equilibrating relative prices. As a consequence, real exchange rates of CEEC tend to appreciate (ECB 1999:42).

The main challenge for CEEC has been and still is to make the strategy of entering the EU compatible with the catching-up process. These two objectives might turn out to be contradictory with respect to the Maastricht criteria. Overall, the required policy mix to meet theses criteria for EMU-membership, is likely to slow down economic growth. The required compliance with Maastricht criteria might be challenged in course of CEEC' passing through of ERM II.

Section 3

Emphasizing strategic aspects of exchange-rate policies in accession countries, first, the institutional design of ERM II is briefly scrutinised. In this context, related academic literature often starts from a description of alternative exchange-rate regimes comparing advantages and disadvantages for CEEC in the run-up to EMU (see, for instance, Schweickert 2001:4-22). However, the focus here is on the incentive structure of alternative exchange rate regimes with respect to policy decision-making. Then, those regimes are elaborated which are most

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[12] Note, that transition economies have a higher potential for quality improvements than mature markets. Corresponding higher prices are hard to tell apart from nominal increases. Thus the measured average inflation rates may be higher for statistical reasons (Filer and Hanousek 2000). Golinelli and Rovelli (2002) point out that the connected competitive loss is far less relevant when producer prices indices (PPI) rather that consumer prices indices (CPI) are compared.
[13] In this context, Iacone and Orsi (2002) have analysed the exchange rate performances of the Czech Republic, Poland and Hungary.

capable of exposing the political economy concerns of exchange-rate policy in ERM II, i.e. soft pegs and unilateral euroization.[14] In doing so, strategic aspects of exchange-rate regime choice with regard to ERM II can be derived.[15] In this context, possible countermeasures of current members of EMU are also addressed. In addition, the respective discussion can be tightened up by previously determining relevant marginal conditions for exchange-rate policy-making in CEEC. Thus, the important role of trend real appreciation and of capital inflows for the stability of fixed exchange-rate regimes in accession countries are stressed.

The design of ERM II

ERM II differs only slightly from its preceding Exchange Rate Mechanism (ERM) in the European Monetary System (EMS). The basics of its institutional design are shortly delineated in the following.

The most striking difference is the 'hubs and spokes'-system: Central parities are only defined against the euro and not between all other participating countries. Hence, their currencies can fluctuate considerably more against each other making interventions probably less frequent.[16] Interventions on the margins are binding. However, the Resolution (EU 1997) posts the price stability objective of central banks explicitly superior to the obligations on intervention. There is also the possibility of intra-marginal interventions on the basis of mutual agreement.

The standard fluctuation band is +/– 15% around the central rate alike the EMS. According to the Resolution, decisions on central parities and the band are taken by mutual accord of the ministers of the eurozone, the ECB and the minister and central bank governor of a respective accession country intending to participate in ERM II – the European Commission and Economic and Financial Committee are only consulted. On request of an accession country, the above mentioned parties could agree on narrower fluctuations bands than the standard one alike Denmark with its present fluctuation band of +/– 2,25% margins. Interestingly and in contrast to the provisions of the former EMS, all parties have the right to

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[14] Coricelli (2002), for example, investigates the case of unilateral euroization. In respect to soft pegs only fixed, but adjustable exchange rates (with or without bands) are meant. A discussion of crawling bands or pegs and (to a large extent) currency boards is omitted, as these arrangements are not relevant in the context of ERM II. Furthermore, when practising the 'Swedish variant'—i.e., infringing the Maastricht provisions deliberately— CEEC might opt for staying outside of ERM II. Then, they might possibly turn to a beggar-thy-neighbour policy pursuing competitive devaluations. However, the focus here is that CEEC are really aspiring EMU-membership. Accordingly, this strand of discussion is not tracked hereafter anymore.

[15] Fölsz (2003) and Fidrmuc (2002) are recent examples in literature taking into account such strategic aspects.

[16] Theoretically, the currencies of two accession countries might fluctuate up to 60% against each other around

initiate a confidential procedure if central rates are deemed to need realignment. Ideally, this procedure enables to reconsider central rates before they deviate too much from real equilibrium exchange rates and currency crises become inevitable. Though realignments in terms of devaluation would infringe the provisions of the Treaty, revaluations of central parities are compatible with ERM II (Article 121, ex 109j).

Despite the present diversity of exchange-rate regimes in CEEC (see Table 1), these countries will have to switch ultimately to fixed but adjustable pegs in order to comply with the requirements of ERM II. The legal provisions of ERM II allow for the time being only a few alternative exchange-rate regimes. Apart from the original peg with a +/− 15% oscillation band, only conventional soft pegs are permissible. The ECB does actually not accept currency boards to be a substitute for participation in ERM II (ECB 2002:59-60).[17] Currency boards would offer accession countries an opportunity to draw on the ECB credit facilities quite directly. Such mechanism might probably impair the ECB price stability objective, thus infringe the provisions of ERM II. Moreover, the ECB refuses unilateral euroization as an eligible exchange-rate regime regarding the passing through of ERM II. Due to ambiguous institutional changes within the decision-making process in the ECB, the price stability of the euro might once again deteriorate. This holds when market sentiments expect the ECB to be too much attached with CEEC' concerns and to accept higher inflation in the periphery (cf. Baldwin, et al. 2000). Besides, an early accession and thus too much heterogeneity inside EMU could complicate controlling in terms of monetary policy (Duisenberg 2001). Additionally, the Council of Ministers would have no influence to determine the conversion rate at which the accession countries enter the eurozone, in case of unilateral euroization (Buiter and Grafe 2002:5-6). Therefore, current members object in particular unilateral euroization in CEEC during their transition to EMU, since CEEC would as a result load considerable economic risks onto current members.

Though exchange-rate policy is dealt with as a matter of common interest in, it is very useful to analyse the incentive structure of alternative exchange-rate regimes for policy making.

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their originally determined central parities to the euro.

[17] However, accession countries that are currently operating with a currency board (e.g. Estonia, Lithuania) might not necessarily be required to, firstly, float their currency within ERM II before they, secondly, re-peg it to the euro later (ibid.).

Trend real appreciation and capital inflows

The issue of overvalued real exchange rates in CEEC has been already addressed in context of the BS-effect (see above). However, with respect to the financing of catching-up and the rebuilding of the capital stock a general trend towards real exchange-rate appreciations seems unavoidable as well as desirable. The ongoing process of real convergence and building-up of the capital stock requires corresponding capital inflows. Corresponding current account deficits would balance the capital inflows. Higher real interest rates reflect that expected rates of return in CEEC are higher than, for instance, in countries of current EMU-member. Thus, capital flows ensue. In this context, Lipschitz et al. (2001:12-14) discern a policy-dilemma: On the one hand, interest rates reflecting the real capital scarcity in accession countries, would be relative higher than in mature economies. On the other hand, considerable lower real interest rates would cause an imbalance between domestic saving and investment, thus a current account deficit and thereby capital inflows would occur. As it can be expected that risk premia in CEEC rather decline in course of their continuing integration into EU and the considerable level of free capital movement, capital flows to CEEC will probably be alleviated.

In this respect, the composition of capital inflows regarding their maturity structure is of specific interest. Whereas FDI-inflows—dependent on relatively higher productivity of capital—are rather long-term capital inflows, portfolio investments are much more volatile. The persisting current account deficits will most likely exert considerable pressure on fixed exchange rates in CEEC as long as these deficits are not backed by corresponding FDI-inflows. In general, capital inflows might have a positive impact on the institutional building of financial markets in CEEC. At the same time, however, applicant countries are going to be more exposed to sudden large shifts in capital flows deteriorating the exchange-rate regime. Provided an overvalued exchange rate does not slow down overall economic activity, further capital inflows increase the risk of exchange-rate distress. Such problems might be aggravated in the case of an institutional lag vis-à-vis western financial markets, as shortcomings in efficiency standards might lead to the creation of bubbles.

This trend real appreciation is in particular a real phenomenon akin to the BS-effect, however, not a mere monetary issue. Thus, the corresponding overvaluation is considered to be independent of the exchange-rate regime question: Whether there is a peg or a floating exchange-rate regime, it cannot prevent such a real exchange-rate appreciation, endemic to

the process of convergence (Lipschitz, et al. 2001:14). On the contrary, especially fixed exchange rates—like in case of ERM II—might provoke a moral hazard problem when private sector takes successively ever more substantial open positions (Foreest and de Vries 2002:24; Eichengreen and Hausmann 1999).The progressive liberalisation of capital flows in context of the acquis communautaire does not necessarily stop the trend real appreciation, but makes those specific exchange-rate policy arrangements rather shaky (IMF 2000:156-7; Mishkin 1999:22).

A further problem in this context is that current account deficits in course of real exchange rate appreciations might be considered as an indicator of an impending currency crisis. However, a large trade deficit can also be the result of increasing confidence in economic policy formation (Mendoza and Uribe 1999:33). This might hold similarly true in respect to trend real appreciation for distinguishing it as a real economy phenomenon or just a monetary phenomenon indicating a loss of competitiveness. For private agents such effects might be hard to distinguish in particular cases.

Political economy of exchange-rate policy

Exchange-rate regimes in course of ERM II have to cope with this trend real appreciation and corresponding capital inflows. These factors might amplify CEEC' leverage in the subsequent bargaining. As regards the political economy of exchange-rate policy, it has to be presumed that policy-makers are generally vote maximising. Thus, governments seek to exploit possible capacities in economic policy making in order to correspond to voters' preferences. It can be assumed that policy-makers are risk-averse actors who greatly discount prospective future costs due to short time horizons. Furthermore, with respect to CEEC it is plausible to take for granted that voters in CEEC mostly favour less unemployment (see above).

Fixed exchange rates such as pegs have been processed as a nominal anchor in CEEC, i.e. as a part of a comprehensive disinflation strategy (see above).[18] However, there is a need for

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[18] The following may challenge some insights of academic literature, for instance, on the functioning of exchange-rate pegs as a nominal anchor. Though that view is far from being wrong it might be more appropriate to resort analytically to such an endogenous policy view, i.e. taking into account the shaping of the incentive structure of relevant actors (Willet 2001:4). In a similar manner, already Eichengreen et al. pointed out that it is helpful to provide exit strategies for exchange-rate regimes originally designed to import monetary credibility (1998:10-12). In this context, Bofinger indicates that it is generally observable, that after having introduced a respective fixed exchange-rate regime, the risk premium of the specific currency declines from an initial high

conducting a prudent, rather restrictive fiscal policy. According to a simple Mundell-Fleming model it is especially fiscal policy that can affect output and the current account under fixed exchange rates and high capital mobility. Correspondingly, exchange-rate policy can be a tightrope act during a soft peg. Deviations from an appropriate fiscal policy stance can result in exchange-rate distress. A speculative attack would be triggered as soon as agents expect the peg to be relinquished when policy makers would probably monetise the deficit (Wolf 2001; cf. Watson 2001). With regard to CEEC, the most striking example in this context is the Czech currency crisis in May 1997 (Begg 1998).

From the point of view of political economy, it is difficult for governments—in case of fixed exchange rates alike the soft and adjustable pegs considered here—to implement and/or to keep up tight monetary and fiscal policies (Hallerberg and Vinhas de Souza 2000:4-5). This is due to the fact that exchange-rate pegging gives front loaded benefits and delayed costs: If there is an output gap and a corresponding level of unemployment in CEEC, then—given downward inflexibility of prices, particularly of wages—there might be a demand for more (public) expenditure. In particular, the political incentives generated by pegged rates often fail to provide sufficient fiscal restraints to avoid possible currency crises. That is to say, because fiscal laxity would undermine a peg only after some time, forcing a discrete devaluation in the future, while, for instance, under a float budget deficits lead to an immediate depreciation. Thus, assuming that the time horizon of politicians is sufficiently short, a government may be tempted to conduct fiscal laxity (Klyuev 2001:4).

Moreover, it is generally high capital mobility, which fuels the consequential moral hazard even more. In providing lower cost for financing, it might amplify the incentives to loosen fiscal policy, thus, reducing short-run discipline (Andrews and Willett 1997:490; Willett 2001).[19] As a consequence, necessary austerity policies in order to strengthen the stability of a fixed exchange-rate regime might be delayed for too long. In course of a possible monetization of government deficits such fiscal laxity would amplify trend real appreciation. A future devaluation would become more likely.

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level down to almost zero just to rise afterwards again (1999:15).

[19] Hallerberg and Vinhas de Souza (2000) have searched for political business cycles in CEEC from 1990 to 1999. They also empirically prove that the combination of capital mobility and fixed exchange rates even renders an institutional arrangement such as an independent central bank designed to deter governments from generating a political business cycle redundant.

In this context, Marini and Piersanti (2001) present an interesting formalised currency-crisis model. They neither bothered with CEEC, nor with the concerned literature in place here. However, their model inquires the turmoil of currency crises in Latin America and Asia at the end of the 1990s. According to their analysis, particularly a

Unilateral euroisation, however, is a regime, which is generally most effective in avoiding exchange-rate distress.[20] This might be the overall objective with respect to a smooth transition of CEEC to EMU, since a currency crisis might heavily disrupt the integration process. Therefore, unilateral euroisation might be, at first glance, the best choice of an exchange-rate regime with regard to the elimination of exchange rate risks. There might be several more microeconomic advantages, for instance, the lowering of transaction costs and transparency of prices. These would foster economic integration, both through increased trade and FDI. Besides, inflation- and interest-rates can be expected to decline, particularly, in case of euroisation. These advantages, however, are not foregone conclusions.

Potential disadvantages have to be reckoned: Apart from the above-mentioned problem of pre-selection, euroisation implies, first, a loss in terms of seigniorage. Second, the loss of a lender of last resort might entail some additional difficulties in terms of financial fragility. The third problem of unilateral euroisation is that this arrangement would immediately put considerable pressure on alternative adjustment mechanisms, i.e. labour flexibility and mobility. This might be particularly relevant in case of a high sensitivity to specific asymmetric shocks contributing to rising unemployment. If adjustment mechanisms do not function properly because of persisting (nominal) rigidities, an increase in a countries default risk will emerge and interest rates be (re-)raised (Wójcik 2000:72-3). It is an empirical question, whether exchange-rate regimes like unilateral euroisation are economically favourable for CEEC. Some argue, that rather those fixed exchange-rate arrangements are advisable for very small open economies where trade is a considerable share of national income like the case of Estonia, since relative erratic exchange-rate performance would hamper stabilisation efforts (Eichengreen and Masson 1998:3; Bofinger 1999:24).

Above all, the most striking difference to soft pegs in respect of policy-makers' incentive structures is that unilateral euroisation can be very unpleasant to national voters. This is precisely not valid for soft pegs. For that reason, policy makers with a sufficiently short time-horizon will most probably favour soft pegs instead of euroization.

This might particularly hold true with regard to ERM II when taking into account the EU' willingness to pay for economic and especially political stability in CEEC. Thus, eligible exchange-rate regimes in the context of ERM II on the one hand and the quasi-insurance of a

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rise in current and expected future budget deficits results in real exchange rate appreciations, current account deficits and, ultimately, in an exhaustion of foreign reserves.

[20] This has been thought about currency boards, as well. Though the fall of Argentina's Peso in December 2001 indicates that also currency board arrangements can be doomed to fail.

likely bail-out by current members of EMU on the other hand might possibly invite governments in CEEC to excessive moral hazard. Consequently, the respective brinkmanship can possibly give CEEC a leeway in a subsequent bargaining on costs of convergence. Before tracing the brinkmanship strategy, the interests of both current and prospective members of EMU are reconsidered.

All parties' interests are self-evident: gaining political stability and (more or less) economic benefits – at best as a free lunch. There is obviously no free lunch and the accession process implies a costly convergence in course of the required compliance with the Maastricht criteria.[21] As CEEC are adjusting towards EMU, it seems natural to presume that they bear such costs. Most notably, ERM II might be considered as a two-year lasting device for loading the costs of convergence entirely onto the accession countries themselves. Current EMU-members' reluctance to allow for immediate admittance to EMU might also be reasonable because, for instance, the transmission mechanisms of monetary policy and the functioning of automatic stabilisers in CEEC are still unclear. Thus they might associate the risks of a premature inclusion of CEEC with a fear that stability and credibility of the euro might be harmed. In this context, ERM II can also be regarded as a measure to continue testing the operation of automatic stabilisers and channels of monetary policy.

Now prospective members of EMU might force euroland to provide some kind of extra-funding or the like in order to prevent currency crises because they would most probably weaken the enlargement process effectively. Certainly, if an exchange-rate crisis became actually apparent, then that would also imply costs for CEEC. Both current and prospective members of EMU would be worse off by raising economic costs in a currency crisis' aftermath and undermining the public support for the European integration process. However, employing a 'quasi-adventuresome' strategy of brinkmanship making exchange-rate policy a particular tightrope act might force current members of EMU to act as CEEC would like them to. The effectiveness of such brinkmanship rests on the extent of CEEC' default: The more current members of EMU would be affected in respective political and/or economic terms, the more credible is the CEEC' threat. That is to say, that the probability of a currency crisis incidence is subject to a critical threshold. If the respective probability were too small, the EU would not be coerced to provide assistance. However, the credibility of the

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[21] Besides, there are considerable costs, for instance, on account for implementing the acquis communautaire. Though these costs are not explicitly considered, because the focus here is on costs in terms of output and employment in course of the demanded compliance with the Maastricht criteria.

brinkmanship is also dependent on whether it is acceptable to the CEEC in the first place. If the probability of currency crisis were too high, CEEC would abstain from a hazardous exchange-rate policy.

Overall, there is apparently room for political manoeuvre, i.e. CEEC practising brinkmanship. Accordingly, ERM II will most probably enable CEEC to load considerable costs of convergence onto current members of EMU. However, potential European incumbents' precautions have to be considered, as well. These might possibly represent a hook in CEEC' brinkmanship strategies. In this respect, once again the issue of credible external constraints as well as the subject of conversion rates are addressed.

Incumbents' countermeasures

It could be argued that Maastricht criteria provide a constraint to CEEC' brinkmanship strategy. However, such external constraints might not be effective because it becomes less credible when the party imposing the constraints actually wants the other to join them (see above). That is valid for the indebtedness- as well as for the inflation-criterion. Considering the latter, CEEC would have to pursue rather restrictive monetary policies in ERM II. However, this kind of adjustment would probably come along with a recession. In this context, Natalucci and Ravenna (2002:28-9) indicate that such a welfare-inferior policy would probably not be implemented when CEEC' eventual accession could not be credibly foreclosed by the incumbents. It is worth-noting in this context, that in the literature it is feared that CEEC might resort to artificial inflation reducing measures such as, for instance, transitory indirect tax reductions prior to their participation in ERM II. After attaining access, those might be suspended. According to Szapáry (2001) such phenomenon is denoted as a 'weighing-in syndrome' (see also Deutsche Bundesbank 2001:26).

Furthermore, the efficacy of economic surveillance is doubtful. There is already surveillance in terms of regular Notification and Pre-accession reports in place. Though, surveillance may help detect early moral hazard behaviour. However, it is unlikely to curb the corresponding incentives of soft pegs in ERM II.

To the extent that the preceding measures might not represent effective external constraints, this might possibly hold for the choice of conversion rates at the outset of ERM II. Evidently, from the angle of current members of EMU undervalued conversion rates are

most favourable (Bofinger 1999:29). These might provide a precautionary measure against trend real appreciation, for instance, in course of exogenous shocks, i.e. positive supply shocks (Keefer and Stasavage 2001:13; see Babetski, et al. 2003:21). In particular, undervalued conversion rates would undermine an overvaluation scenario and the corresponding brinkmanship strategy. Just to mention the CEEC' position in this regard: They would rather opt for overvalued central parities in order to exacerbate their exposure to currency crises. Generally, from an economic point of view, equilibrium exchange rates would be most favourable. They would neither distort purchasing powers, competitiveness, nor contribute to a redistribution of wealth, i.e. no effects on stocks of debts and claims.[22]

The determination of the 'true' equilibrium exchange rate is a particular problem, though. Ideally, markets determine such 'balanced' conversion rate. The determination of the conversion rate is, however, basically a political decision. Hence, even if floating would be allowed days before the actual conversion rate would be chosen at the dawn of ERM II, then rational agents will anticipate the conflict of interest in bargaining upon the appropriate choice of the conversion rate and no 'true' equilibrium exchange rate will emerge.

Even if political implications are neglected, it is possible that accession countries enter ERM II with an overvalued central parity such as, for instance, Italy and Spain did in the former EMS.[23] Alike in case of the latter, exchange-rate regimes in CEEC could turn out to be a recipe for distress.

With respect to incumbents' countermeasures, CEEC should not be allowed to opt for narrower oscillation bands than +/− 15% around the conversion rate in order to make allowance for the trend real appreciation.[24] Although exchange-rate policy is a matter of

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[22] Here, we do not step into a detailed discussion of the distributional effects of alternative conversion rates on stocks of debts etc. as their impact on continuous economic policy might be of minor relevant. Yet to be added, it can be said that undervalued conversion rates favour agents accounting for debts denominated in domestic currency, but makes agents having obligations denominated in foreign currency worse off. The opposite holds for the case of overvalued conversion rates (cf. Crombrugghe 2001:4).

[23] Spain, for example, had joined the EMS with an overvalued exchange rate in 1989. It experienced a recession and failed to fight inflation effectively, thus, it devalued in 1992, and anew in 1993 and 1995. During the years of 1989-92 Spain experienced considerable capital inflows. These were due to, first, expected higher rates of return, second, financial liberalization and, third, a restrictive monetary policy and expansionary fiscal policy, which meant high interest rates. A corresponding real exchange rate appreciation was also observable which is also imputed to a BS-effect. Most meaningful in this context seems to be the specific role of wages: During the two years prior to Spain's participation in the former ERM, real wages increased moderately and did not developed significantly different to other European countries. However, after the Spanish accession both real and nominal wages rose sharply (Bacchetta 1994:25-7), which points in some respects to the above-mentioned 'weighing-in syndrome'.

[24] Even such broad bands might be not sufficient to prevent speculative attacks. In January 2003 speculators attempted to drive the Hungarian Forint (soft peg with a +/− 15% band) above its upper limit and thus to trigger a revaluation of its central parity. Although revaluation do not really contradict the provisions of ERM II and the speculative attack was stalled, the occurrence of an attack points to the fragility of even such broad bands.

common concern already prior to ERM II, CEEC would probably introduce smaller bands – as some of these countries have already done (see Table 1). A subsequent widening of the fluctuation bands, though, might signal that both parties cannot agree on the 'true' conversion rate. Accordingly, market sentiments might shift and cause a destabilising process (for a more detailed discussion, see Bofinger 1999).

To sum up, soft pegs can exhibit some charming incentives for policy-makers. From the point of view of political economy, policy-makers are most notably seeking to maximise votes. Soft pegs are really great in this respect as governments can comfort voters possibly even by some more additional budget spending respectively a less rigorous austerity. This might work as long as voters and policy-makers are not bothered with a probable future breakdown of the exchange-rate regime. Unilateral euroisation, however, runs counter to the (short-term) objective of maximising votes. If the exchange-rate policy affects private citizens welfare and accordingly their level of support for the government, the latter will favour soft pegs allowing for enlarged budget spending (in the short run) instead of the (politically) stony road of unilateral euroisation.

Within ERM II, precisely those soft pegs are eligible which are also basically prone to speculative attacks. Trend real appreciation and the progressive full liberalisation of capital flows in a non-mature financial surrounding might even exacerbate possible exchange rate crises. Multiple equilibria regarding the credibility of fixed exchange rate are likely on account for difficulties in perceiving actually bad economic policy formation. Moreover, this gives rise to contagion effects spreading among CEEC.

Most notably, the political economy dimension of the enlargement process shapes the political incentive structure in CEEC significantly. Respective politicians with a sufficiently short time horizon will not only make use of those comfortable incentive, but practice even more moral hazard due to the existing EU' willingness to pay CEEC. The according brinkmanship may allow CEEC to elicit the EU' willingness to pay.

Current members of EMU do apparently not dispose of effective countermeasures as soon as CEEC are inside ERM II: Neither economic surveillance by current members of EMU, nor deliberately undervalued conversion rates and not a pointing at the small print, i.e. Maastricht criteria, will actually take effect. Thus, CEEC might most probably not be prevented from making use of the risk of exchange-rate crises. In this respect, ERM II will open up opportunities for CEEC to load considerable costs of convergence onto current members of

EMU. The following section summarizes and touches consequential prospects of the institutional adjustment in course of the eastward enlargement of the eurozone.

Section 4

The focus of the preceding analysis has been on the particularities of CEEC' exchange-rate policies within ERM II and generally in course of their integration into EMU. In doing so, it has become apparent that the shaping of political incentives for exchange-rate policy making might have 'perverse' effects. This might result in excessive moral hazard due to an existing EU' willingness to pay for CEEC' admittance to EMU. The according brinkmanship makes allowance for the subsequent bargaining on costs of convergence.

Analysis has started with the critical assumption that the enlargement decision was basically a political decision aiming at a regional stabilisation of CEE. Accordingly, we arrived at the conclusion that the EU has a considerable willingness to pay for CEEC' integration. Overall, this decision accounts for a momentous free-riding process.

Moral hazard is really not a novel phenomenon in context of European economic policy coordination. However, there is a particular difference of the convergence play in course of the enlargement process to the preceding Maastricht process in the run-up to EMU. In case of the latter, Maastricht criteria had been a tying-hand strategy for the founding members of EMU. Now these provide just an external constraint, whose credibility is less effective because of the particular political dimension of the enlargement process. Although, the political stability in CEEC is substantially more fragile than in case of consolidated western European democracies, this does not inevitably entails that the EU reveals their willingness to pay. It is in principle conceivable that the accession countries pass through the qualification process adhered to Maastricht criteria including ERM II as long as they need to comply with its provisions. What really enables CEEC to elicit the EU's willingness to pay for their accession is to create a scenario, which would credibly threaten to undermine their political stability. Such a credible threat can be attained by brinkmanship transmitted by exchange-rate policy.

The characteristics of respective transmission mechanisms and relevant conditions for a successful brinkmanship have been delineated in this paper. Basically, a policy mix that may be considered as unsustainable with the soft peg in some circumstances brings the

transmission mechanisms forward in particular. In this regard, such fixed exchange-rate regimes, provided for by ERM II, can feature 'perverse' incentives for exchange-rate policy making. This applies particularly when Maastricht criteria are not considered as a sufficient external constraint. In this respect, CEEC might not take those rigorous steps in fiscal and monetary policies required for keeping up the fixed exchange-rate regime. Moreover, accession countries' stability of exchange-rate regimes might be particularly at stake when economic conveniences are taken into account such as trend real appreciation and the decisive role of capital flows. Eventually, slacken the reins in terms of exchange-rate policy might put the exchange-rate regimes of CEEC in ERM II at risk, i.e. a currency crisis may evolve.

Albeit, there is a deviation from the original term 'beggar-thy-neighbour', this brinkmanship bears some resemblance to it. In this regard, the overview of exchange-rate policy formation in CEEC during the 1990s is suitable for an accordant classification. The survey indicates that the accession countries pursued exchange-rate policy in terms of disinflation at the outset of transition. Then, they turned more to implicit exchange-rate targeting, though, still aiming at price stability. However, exchange-rate policy will probably be exploited for output and employment concerns. Indeed, such policy stance does not aim at competitive devaluations for improving external competitiveness. Yet, it might enable CEEC to ripe benefits at the expense of current members of the eurozone, i.e., by receiving some kind of extra-funding. In respect of the analysis, this particular kind of exchange-rate policy can be characterised as a *'threaten-thy-neighbour'*-policy.

It is important to notice that successful brinkmanship will by no means entail a currency crisis – in that case such strategy would have failed. Furthermore, we will possibly not even observe that current members provide CEEC with extra-funding in monetary terms. The EU' willingness to pay might, for instance, rather result in an allowance for additional indebtedness and higher inflation rates. Thus, CEEC' specific costs of convergence in the light of Maastricht criteria would be lowered. However, possibly solely the exclusion of soft pegs in ERM II might prevent CEEC effectively from being prone to exchange-rate crises. As a consequence ERM II would have to be radically modified and only floats to be allowed. However, betting on a revision of the Treaty is rather inappropriate.

It has been shown that current members of EMU do not dispose of effective countermeasures when CEEC are already participating in ERM II. But, a quick introduction of the euro as legal tender in CEEC could be a feasible option for current members of EMU. Alternatively and in contrast to the ECB' present attitude towards an early introduction of the

euro, CEEC could be encouraged unilateral euroisation. In doing so, current members of EMU would forestall that CEEC squeeze out their willingness to pay. However, as an early introduction of the euro would probably affect the price stability of the euro itself, this option is to inflict a worst or a next-worst outcome on current members. Therefore, the EU is rather exposed to a 'Catch-22'-situation.

With regard to the overall analysis, the political economy perspective indicates that Maastricht criteria, in particular ERM II shapes the enlargement differently than originally foreseen. In contrast to the former Maastricht process of convergence 1995-1997, this time applicant states will probably get paid for their admittance. That is to say, that current EMU-members will likely undertake to pay for CEEC' costs of convergence. This will either result in higher charges or in a modified institutional setting for economic policy coordination within an enlarging eurozone, i.e. adjustment matters. According to the analysis, it is rather unlikely that institutional arrangements, for instance, such as the Stability Pact will still prevail in an enlarged eurozone. Certainly, this would also affect the price stability of the euro. As long as the emergence of currency crises and, correspondingly, strategic exchange-rate policies of CEEC, i.e. brinkmanship, cannot be excluded it seems almost inevitable that the price stability of the euro will get harmed. However, regarding public support for European integration in CEEC and overall political stability in an enlarging EU you may consider this deal worth the money.

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