EMU: Experiences to Date and Challenges for the Future

Have the first two years of European Monetary Union fulfilled the expectations of its supporters? Or have the fears of the critics been confirmed? What challenges will EMU have to face in the years ahead?

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Europe’s Contribution to the Stability of Financial Markets

The European Union (EU) plays an important role in global financial markets, for two main reasons. First, its size in the global economy is roughly similar to that of the United States. Second, the financial markets of the EU are liberalised and therefore open to global investors and borrowers.

The process of Economic and Monetary Union (EMU) in Europe influences the stability of financial markets in several ways. On the one hand, EMU brings sizeable benefits related to a more efficient allocation of financial resources amongst borrowers and investors, both within the euro area and beyond. On the other hand, there are financial stability issues associated with deeper financial market integration. These issues arise mainly from the possibility of a wider and more rapid propagation of shocks across a highly integrated area.

In my remarks, I should like to examine the implications of EMU, including – in particular – the introduction of the euro, for financial stability in the euro area and at the global level.

Efficiency Benefits from EMU

Available evidence indicates that the benefits the efficiency of the financial markets reaps from EMU have five main sources.

First, since the Maastricht Treaty assigned to the ECB the primary objective of maintaining price stability, in the years preceding the introduction of the euro, inflation expectations in the euro area progressively declined to levels in line with price stability. A monetary policy firmly pursuing the objective of price stability contributes to a stable macroeconomic environment, which is, in turn, conducive to the stability of financial markets. In particular, a clear anchor for inflation expectations contributes to the efficiency of the price formation mechanism in the financial markets. Monetary policy can also contribute to financial stability by reducing, to the extent possible, the occurrence of surprises related to monetary policy decisions, thus avoiding any unnecessary volatility in long-term interest rates. Conversely, the conduct of monetary policy is greatly facilitated in an environment of financial stability.

Second, in the context of EMU, the governments of the EU Member States committed themselves to establishing and maintaining sound public finances. Sound public finances contribute to economic stability and thereby to the stability of financial markets. In general, the best contribution that economic policies can make to the stability of financial markets is to retain a stability orientation and to be conducted prudently and in a forward-looking manner. This should make it possible to avoid the sanctions of abrupt adjustments which market forces can impose on unsound or erratic policies. In addition, the process of reducing government deficits and debt has created some room for private borrowers in the markets for debt securities, thereby contributing to the development of the private capital markets in the euro area.

Third, following the introduction of the euro, the private capital markets of the euro area have also benefited from the abolition of intra-area currency

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risks and from the removal of a number of constraints which used to be imposed on institutional and other investors. The development of strong private capital markets can alleviate the problems of access to credit which may arise from banking problems. At the same time, banks continue to play a key role in the European financial system, on account of their activities in underwriting and asset management, for instance. They constitute the main source of liquidity for other financial and non-financial firms in times of financial market stress. Strong banking systems can help to overcome a standstill in capital markets, such as that which occurred during the episode of financial market turbulence in the autumn of 1998.

Fourth, with EMU, financial markets have become more integrated within the euro area. They have become more open towards non-resident borrowers and investors. The integration of financial markets, both within the euro area and at the global level, increases the range of borrowing and investment possibilities available to economic agents, thus contributing to the allocation of savings to the most productive investments. In addition, the removal of obstacles to the integration of financial markets can contribute to the spreading of technological advances and financial innovation. More generally, it can enhance financial performance, both within the euro area and at the global level. Although great progress has been made in the integration of financial markets within the euro area, the process of integration is not yet complete, in particular with respect to retail banking, for instance.

Fifth, with inflation expectations stabilising at low levels, the inflation risk premium has become relatively less important as a determinant of financial prices within the euro area. This creates room for other factors such as credit risk to play a more important role in the price formation mechanism. This contributes to what I have once called the development of a "credit risk culture" in the euro area, which helps investors to focus more on the underlying soundness of borrowers.

The establishment of a clear anchor for inflation expectations, the integration of financial markets and the development of capital markets for private borrowers all have benefits in terms of the efficiency of financial markets. This would tend to reduce the likelihood of abrupt adjustments in financial portfolios and financial prices which, in less well-functioning financial markets, correct inefficient financial resource allocations from time to time. More efficient financial markets should be less conducive to the development of bubbles, whereby financial prices diverge from the values implied by fundamental determinants for prolonged periods of time.

Special Issues for Financial Market Stability

Despite their benefits, the structural changes under way in the euro area also highlight some special issues for financial stability.

A first issue relates to the fact that progress in integration leads to changes in the nature of risks faced by borrowers, investors and financial intermediaries. In particular, the expansion in cross-border transactions between financial intermediaries can lead to an increase in the exposure of financial intermediaries to developments occurring in other countries of the euro area. The increase in financial transactions going beyond national boundaries within the euro area is a development which is welcome, since it provides an opportunity for a better diversification of the risks faced by financial intermediaries. However, at least in the initial stages of the existence of the euro, financial transactions going beyond national boundaries within the euro area may be affected by sizeable information asymmetry and information verification problems. This could complicate the assessment of risks inherent in these transactions. As a result, some financial intermediaries may fail to establish and maintain adequate cushions in order to cover the risks incurred in cross-border transactions. In the presence of such excessive risk-taking on the part of financial intermediaries, there is a possibility that problems faced by financial intermediaries in one region of the euro area could spread rapidly to financial intermediaries located in other regions of the euro area. In such circumstances, there could be an increase in financial market volatility at an area-wide level as well as in the frequency of occurrences of financial distress at the company level. This could hamper the mechanism of allocation of financial resources and impose large costs on the economy.

Obviously, a remedy to the occurrence of such problems is the maintenance of adequate capital cushions by financial intermediaries, which enable them to cover potential losses. Prudential supervision has an important role to play in ensuring that financial intermediaries comply with capital adequacy requirements and maintain sound internal risk management practices, particularly when their businesses evolve in relation to the changes occurring in EMU. In this regard, a peculiarity of EMU is that prudential super-
vision is under the responsibility of national authorities. Its field of jurisdiction is therefore not the same as that of monetary policy, which is exercised at the level of the euro area. Under the so-called “home country” principle, each financial institution in the European Union is unequivocally under the jurisdiction of a single national supervisor. This framework for prudential supervision has the advantage that it imposes a light regulatory burden on financial institutions and facilitates access to local information.

However, while the existing institutional arrangements can provide an adequate and flexible basis for safeguarding financial stability, we need to strengthen co-operation and the exchange of information between supervisors and central banks in Europe. This was also seen as vital in the recent report on financial stability prepared by the Economic and Financial Committee. If problems at a major financial institution were to have effects in other countries, information should be effectively distributed and common solutions should be sought when needed. As for the regulatory regime, one current drawback is that the adaptation of regulatory requirements, which is necessitated from time to time, can be a lengthy process requiring amendments to Community legislation.

A general remedy to the problem of potentially excessive risk-taking by financial institutions is the improvement of disclosure practices, whereby financial institutions inform the public about their risk profiles. Disclosure reduces information asymmetries between financial institutions, on the one hand, and borrowers and investors, on the other. As clients of financial institutions become better informed about the risk profiles of financial institutions, they are better able to compare the prices of services offered by various financial institutions, thereby allowing the forces of competition to discriminate against financial institutions with excessive risk exposures relative to their capital cushions.

A second issue for financial stability arises from the fact that, in the course of the process of structural change under way in the financial markets of the euro area, new infrastructures are being developed, such as new payment systems or new trading systems. These new infrastructures often use more advanced telecommunications and computing systems than their predecessors and bring together a larger number of market participants. This permits the achievement of more rapid and secure processes as well as lower transaction costs. In addition, some of the new infrastructures permit a concentration of activity on single harmonised platforms instead of fragmented ones. This can also contribute to a reduction in total costs. However, the new infrastructures need to be able to withstand conditions of high financial market volatility or high trading activity, as well as the failure of some market participants to fulfil their obligations. Appropriate mechanisms need to be in place to ensure a smooth functioning under such conditions, in order to avoid the risk of gridlock, which could be damaging for financial markets. Such a risk would be particularly acute when infrastructures have become very concentrated, as the consequences of failure would affect a large number of users. It is therefore important that safety standards are rigorously applied in the newly developed infrastructures for euro area financial markets. As regards payment and settlement systems in particular, in accordance with its tasks assigned by the Maastricht Treaty the ECB seeks to promote the setting up of safe, sound and efficient payment and settlement systems, for both wholesale and retail payments, including electronic money.

Conclusion

Evidence available thus far suggests that the benefits brought by EMU and, in particular, the introduction of the euro to the stability of financial markets are sizeable. They concern both the residents of the euro area and the rest of the world. These benefits derive mainly from the establishment of a clear anchor for inflation expectations, the integration of financial markets and the development of capital markets for private borrowers. However, the integration of financial markets and the development of capital markets for private borrowers should be seen as ongoing processes. In some areas, such as retail banking, financial markets in the euro area are still segmented. In addition, the process of structural change which is currently under way in Europe highlights some special issues for financial stability. Both prudential supervision and payment and settlement system oversight have key roles to play in this regard. If the challenges posed by the process of structural change in European financial markets are appropriately addressed, and if economic policies are pursued with a stability orientation, prudently and in a forward-looking manner, I am confident that Europe’s contribution to the stability of financial markets will be very positive.

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2 ECB: Role of the Eurosystem in the field of payment system oversight, June 2000.
Views on EMU have never been unequivocal. While European governments embarked rather enthusiastically on this venture, the general public, at least in the German case, has always been basically reluctant. Euro-sceptics forcefully made the case that Euroland was an artificial construct, sporting deep-seated flaws—substantial discrepancies in regional per capita incomes, rigid labor and product markets and, in particular, conflicting views about the remit of economic policy and, consequently, the design of institutions of policy-building—that would make for a fragile edifice and possibly even an eventual unraveling.

After two years, a preliminary, if partial, assessment seems possible. Looking at conventional indicators and judged against its own performance over the last decade, Euroland's constituent regions have evolved rather well (see Table 1). Growth picked up, accelerating towards double the pace that we were used to over the 1990s. To be sure, the German and Italian economies took quite a while to gather steam. Nonetheless, as regards for example Germany, last year's output growth at some 3 percent was substantially above the lackluster outcomes since the end of the unification boom and, fortunately, above the employment threshold. As a result, unemployment receded and employment increased—since 1997 and with unfamiliar rates. Performance was even more impressive at the—so to speak—periphery and with the small-open economies like Ireland, the Netherlands, Finland, or Portugal. This growth has been within the limits of potential output, leaving Euroland's current account roughly in balance. Finally, and this being the fourth of the traditional objectives of economic policy, inflation has been well-behaved. While there was, to be sure, a pick-up in the price-level over the course of last year, exceeding the ECB's medium-run target, this was mainly the upshot of the sharp hike in oil prices—and the real-effective devaluation of the euro (to which we come presently). However, the increase in the price-level appears to be a mechanical once-and-for-all without inducing additional second-round effects. This being a judgment in which markets invest as well—as inflation expectations embedded in French index-linked bonds show. Remarkably, this stands in stark contrast to the oil-price shocks of the early and late 1970s when wage claims did not account for the redistribution of income towards oil producers and hence squeezed corporate sector profits and, as a result, capital expenditures with further negative knock-on effects on growth and employment.

To be sure, alleging that all of this was but preordained by the euro's introduction would invite, correctly at that, substantial doubt. Nonetheless and sideling some queries, economic policy in Euroland was conducted in a way compatible with an, on balance, healthy performance. Still, in the German case the prevailing public judgment on the EMU experience seems to be sceptical. The main reason being the euro's trajectory over the last two years. In particular, pundits who had confessed their dislike of the whole venture early on feel amply confirmed. For the wrong reasons, as is argued below, where the euro's recent course is put into historical and conceptual relief. Nevertheless, as will be briefly and selectively enumerated, EMU faces substantial challenges which have to be dealt with constructively over the coming years. By way of wrapping up, a suggestion on venues to explore in coping with these challenges will be offered.

The Euro's Course—Confirming EMU-Sceptics?

Since its launching on January 1, 1999, the euro almost constantly lost in value against the US-$ until bottoming out in the fall of 2000 at some 83 cents to the dollar (see Figure 1). Looking at contemporaneous market indicators as well as consensus forecasts, this was a largely unexpected evolution. And, as an aside, even the most ferocious Eurosceptics, who tell us that they had always told us so, apparently haven't put their money where their mouth always was—i.e., in put positions on the euro. Sadly though, since, with

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1 See for a rather similar evaluation Stefan Collignon: Two years into the Euro: the next step for Europe, mimeo, London School of Economics 2001.
hindsight, this obviously would have amounted to a money-making machine. But why is it that sceptics claim erroneously the depreciation of the euro for their position?

The rational, unexpected part. As a matter of fact, the engaged spectators on international financial markets consistently underrated the prospective performance of the US economy while, at the same time, being slightly too positive on Euroland's perspectives. Indeed, during the euro's second year of existence, the US economy, very late in an indeed long-lasting cycle, once more accelerated towards a year over year output growth of some 5 percent. This happened against major imbalances as seen from a conventional perspective, namely: a current-account surplus which was clearly on an unsustainable path. And, even more palpably, developments on the stock markets and here, in particular, in the so-called hightech sectors. There, price-earnings-ratios were, until March 2000, at simply unprecedented heights. Stock prices implied an abundance of investment opportunities as well as a corresponding profitability simply stretching credulity. Indeed, to justify existing market valuations one had to plug in franchise values – that is a wedge between the return on equity and the weighted average cost of capital – 2½ times above their historical average. Moreover, whereas standard theory tells us that return on equity should, at the end of the day, shrink towards cost of capital, the representative investor, by buying and holding shares, confessed her belief that this wedge would be permanent. As an up-shot, all sorts of claims, inconsistent with conventional ideas, were in the air. Ray Fair, for example, by applying the Gordon-growth formula, calculated that with the earnings growth implied in market valuations in early 2000 (some 14 percent over the next ten years), the ratio of after-tax profits to nominal GDP (assumed to grow by 6 percent on a nominal basis) should, with almost 12 percent, be double as high as the historical ratio. Moreover, returns on equity were boosted by substantial debt-financed share buyback programs, i.e. substituting debt for equity. Clearly, since economic profitability could not match return on equity demanded by shareholders, this increased leverage set the stage for a less resilient corporate sector when faced with an economic downturn.

Admittedly, there would be more to address here like, for example, the wealth effect and its impact on private consumption. Be that as it may, in the meantime we have experienced that no amount of new economy reasoning could prevent markets from falling prey to the laws of (economic) gravity.

Anyhow, a very instructive graph (Figure 2), which I borrow from the BIS Annual Report of 2000, palpably makes us aware of how market participants were surprised by actual developments in the USA. Even the most optimistic Wall-Street economist fell well short of the outlier which reality turned out to be in this case. In other words, after the fact the direction as...
well as some of the way the euro-dollar exchange rate took is understandable with the most basic of economic models one uses, i.e. the Mundell-Fleming approach. Again, this lasting relative growth differential – as well as US interest rates therefore being constantly above Euroland levels and thus attracting capital quite naturally – came as a surprise. On the other hand, I am not aware that any of those who claim to have had the prescience on where the euro were to go, were making better predictions about the relative growth performance between the USA and Euroland, i.e. a proximate, underlying reason for the euro’s performance.

The boundedly rational, overshooting part. To be sure, as regards exchange rates one is well-advised to beware of “one-reasoners”. Evidently, there is more to the plot than the open economy version of the IS-LM-approach allows us to grasp. And most probably, markets have overdone it again. This, alas, is not unusual on expectation-driven asset exchanges. Indeed, a frequently used substitute for the MF-framework, the Dornbusch sticky-price model teaches us that with diverging speeds of adjustment between goods and asset markets, exchange rates should, as an equilibrium reaction, overshoot. Unfortunately, foreign exchange markets – like other asset markets as well – are at times inclined to go beyond even these limits.

A graphical confirmation of this observation can be gleaned from Figure 3, which, for a recap, portrays the DM-US- exchange rate over the floating-rate period. Incidentally, against this background arguments about the structural, inherent weakness of the euro as compared with the DM simply fall apart. Indeed, over the sample period the DM was valued, on average, at 2.04 to the US-$; and two-thirds of the dispersion was within a 43 pfennigs band about that mean. There are, moreover, two obvious examples of significant overshooting. Beginning with the summer of 1984, the US-$ decoupled from anything that might have served, even ex post, as a fundamental explanation. Then, in late February 1985, the Bundesbank intervened unilaterally and succeeded single-handedly in triggering a change in the US-$’s course. The episode ushered in a period of explicit coordination (the Plaza and Louvre accords) and possibly an implicit target-zone. The other period which immediately falls to mind is the winter and spring season of 1995, when the US-$ bottomed-out, on a daily basis, in mid-March at 1.36 to the DM. At that time, again, intervention has seemed to correct the course of events launching the dollar on a lasting upward trend.

Be that as it may, as evaluated from the vantage point of conventional wisdom, financial markets generate numerous anomalies, indeed so many, that standard finance texts devote at least one chapter for example to end-of-week, end-of-year, or excess-risk premia effects – among others. And foreign exchange markets are not above this. Indeed, Paul de Grauwe diligently gathered – in our eyes convincing – evidence of an instance of negative bubble-building with regard to the euro as well. While positive news on the Euroland economy, which should buoy on the euro (a variable endogenous to fundamental events) was usually left unaccounted for, the same held true for negative views concerning the USA. As a result, markets “systematically disregarded the observable

More precisely, the growth gap narrowed over the course of 1999 in order to open again during 2000. A further qualifier is called for: there was a constant outflow of long-term capital from Euroland towards the USA reflecting long-term relative return expectations which will be difficult to honor.

fact that relative to Euroland's economy the news about the US economy was less favorable. Since, moreover, equilibrium values for exchange rates come with an uncomfortably large error margin – band of agnosticism as de Grauwe calls it – exchange rates can move quite substantially without being perceived as evidently out of kilter. Then, as de Grauwe argues, to rationalize current, if misaligned, levels analysts start a search for fitting news while at the same time carefully discounting evidence which does not confirm accepted beliefs. Of course, this is the cognitive dissonance reasoning which was suggested two decades ago by George Akerlof and William Dickens to explain various behavioral puzzles.

Such a diagnosis, to make it clear, is not about disparaging market participants – which mainly behave compatibly with existing incentives or, so to speak, the logic of the situation. It is, however, about acknowledging how financial markets – aggregating over all the individual behavior – process and, in particular, select information. Moreover, against a background scenario of unevenly distributed knowledge about data and substantial economies of scale in passing judgment on them, simply following other traders might become rational. Indeed, this behavior of others is an essential part of the information set of individual investors. Finally, if the canonical assumption held true according to which asset prices fully reflect all the possibly relevant information then, as Grossman and Stiglitz argued long ago, any individual incentive to gather as well as decipher data would disappear. Thus, with investors refining their calculations up to the point where marginal costs equal expected gross yields, again at the margin, prices might become essentially informationless.

All told, financial markets are prone to – rational – herding. Hence, asset prices can deviate significantly from what functionally efficient markets – appropriately reflecting underlying fundamentals (about which we are uncertain) – would call for. As an upshot, significant consequences for the objectives people really care about – income, employment, prices – might result.

Anchoring devices: PPP, FEERs and BEERs. Therefore, whereas in academia a position of agnosticism is very much acceptable, in more mundane practical circles some pretense of knowledge about a roughly fitting value of the exchange rate is inevitable. It is here where purchasing power parity – belonging to the most cherished propositions of applied economics (identical goods must fetch an identical price) – comes in. While being almost buried until the mid 1980s, recent developments in econometrics fortunately gave it a further lease of life. Alas, however, movements towards PPP-levels are literally protracted, or, to use Kenneth Rogoffs appropriate metaphor, glacial. From the empirical literature it emerges that it takes 3 to 5 years before half of a deviation from PPP is corrected for. Rather obviously, this is way – indeed: orders of magnitude – beyond the (apparently ever shrinking) time-horizon of those trading in (or commenting in public on) these markets.

As a consequence, when searching for criteria to evaluate the appropriateness of exchange-rate levels, 

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2 See George Akerlof: An Economic Theorist's Book of Tales, Cambridge 1984, pp. 123-44, CUP.


one has to look for other devices. In a first approach, as pioneered by John Williamson, figured out which exchange rate would be compatible with a sustainable position on the balance of payments account over the medium run. There were basically two ways explored to get at this fundamentally equilibrating rate, corresponding to internal as well as external balance. Either a structural model was solved, and thus the result was contingent on the model’s spelling out how the world works, or more boldly, a medium-run tolerable position had to be posited normatively.

The second approach, to which Ronald MacDonald has been a decisive contributor, involves looking again for a position on the current account which is consistent over time, and lets the data speak. And the gap between actual and data-suggested exchange rates is perceived as misalignment. Again, these equilibrium values come with substantial margins of error.

However, at the end of the day, both approaches came to the conclusion that the euro was beyond – more precisely: below – bounds which could be reconciled with conventional arguments. Hence, inasmuch as this impacts on the final targets of economic policy, this was a situation which called for corrective action. As Michael Mussa, the IMF’s departing chief economist said ahead of the ECB’s interventions in the f/x markets: When, if not now?

Challenges To Be Solved Constructively

Some have seen EMU as a – too risky – gamble. Others, in a more positive vein, conceive it as a challenge – to be met with constructive answers. Within the binding space limits given to me, I just want to touch upon three – all of them with a bearing on monetary policy and all of them dealing with externalities and hence coordination problems.

Underwriting financial market stability. The German Finance Ministry recently suggested a fundamental reorganization of financial market supervision. Starting from the observation that financial markets in the future will be dominated by institutions of the bancassurance variety – a view which can definitely claim to be original since it is neither shared by international institutions nor the bulk of the academic literature – it suggests creating an encompassing supervisory authority dealing with the universal banks – which, viewed from a US perspective, epitomize financial conglomerates – and securities markets, as well as the insurance industry.

Here is not the place to go into any detail. Still, what careful research has unearthed is that central banks, as a result of confidential knowledge, are relatively better capable of evaluating the quite opaque positions of banks than markets or rating agencies. In addition, such knowledge generated while conducting hands-on supervision is conducive to the macro-duty of central banks, i.e. monetary policy: it allows for better forecasts of inflation as well as unemployment. Likewise, since EMU implies the effective expansion of the market arena, thereby creating deep and liquid markets, this will emphasize the marchéisation of external funding as opposed to the bancarisation. In such an environment, however, to counteract financial fragility, the provision of good money – the lender of last resort function – becomes ever more important. Rather obviously, monetary policy is deeply implied.

Moreover, and again a subject barely scratched at here, within the Basle deliberations on bank regulation, Euroland, without a blueprint of its own, is mainly reacting defensively to US proposals – on capital adequacy, on the supervisory review process or on market discipline. The patent holes in, for example, the models to control the trading book of banks need urgent attendance. Therefore, discharging central banks from conceptual obligations – as opposed to operational duties – appears to me to be highly debatable. Finally, the dominating partners in international rule-setting come from a finance or central bank inspired background. Hence, inasmuch as the new approach of the German Finance Ministry (leaving too much to desire) is apt to provide an example for our partners, the debate...
merits to be conducted in a Euroland context. Hence, what is lacking in Europe is a constructive discourse on this subject of common interest.

**Intra-Euroland price-level differentials.** Starting with quite substantial differences in per capita income, Euroland was, to begin with, prone to sport diverging price-level developments. And in fact, regional inflation rates have been moving apart again of late. At the start of EMU national headline rates of inflation were between 0.25 and 3 percent, while core rates stayed between 1 and 2.75 percent. At the end of last year the inflation rate as measured by the HCPI was between 2.25 and 7 percent while the underlying rates were between 1 and 5 percent. Such discrepancies, if continued, could generate significant problems. After all, within a currency union a continuous loss of regional/national price-competitiveness implies quite naturally negative effects on employment and growth.

To begin with, it is important to assess where price-level pressures emanate from. Economies, having embarked on a catching-up process, are usually characterized by significant changes in relative prices between tradable and non-tradable goods (in particular, services). This, being an upshot of differential productivity developments together with a mobility of labor existing within but not between regions of a currency union, is, so to speak, an indicator of the catching-up process – an equilibrium response, hence negligible for monetary policy. On the other hand, however, if inflation differentials result from diverging developments of prices in the exposed sector, then, inevitably, a damper on price competitiveness would result.

For a unitary monetary policy this entails potentially nagging problems since in regions with higher inflation rates real interest rates are commensurately lower, possibly feeding local asset market bubbles (a point often made by Charles Goodhart during the debate about the costs and benefits of EMU). Here, again, we are confronted with a failure of capital markets, namely, that differentials between nominal interest-rate yields are substantially below regional inflation differentials – for which there is ample evidence. However, as has been frequently pointed out, the burden of adjustment falls on either relative prices, labor mobility or national fiscal policy. Moreover, inasmuch as the Euroland price index rises, on average, more rapidly than in the low-inflation regions of Euroland, this amounts to more ambitious inflation targets for the low-inflation regions, as Hans-Werner Sinn and Michael Reutter have pointed out. Here, the US experience might serve as an appropriate counterfactual. As Stephen Cecchetti has shown, relative price levels between cities – i.e. intranational real exchange rates – show a substantial divergence. And what is even more puzzling, they are characterized by strong persistence, that is mean-revert only very protractedly – with a half-life of convergence of some nine years, thus roughly double the time we typically find for international real exchange rates.

**Macropolicy coordination.** Euroland enhances the interaction of economic policy-formulating institutions, being autonomous and at the same time interdependent. What finally matters, the overall stance of macro-economic policy, will be the upshot of a three-level game between a Europeanized monetary policy, twelve national fiscal policies, coordinated via the Stability Pact, and a pretty heterogenous setup of wage- and price-setting behavior. Whatever its goals, monetary policy can realize them only by affecting aggregate demand – being, however, influenced by fiscal policies and wage policies as well. In other words, goal-achievement is inextricably linked to policies pursued by other actors in the plot.

In such a situation of strategic interaction with the attending externality problems, questions of coordination are at issue. However, evaluations are still rather far apart. Whereas, at one end of the spectrum, for the German Council of Economic Experts the debate about macropolicy seems to be of no avail, having been conclusively dealt with in the Maastricht Treaty of 1991, this is apparently not a view shared by, for example, the French Conseil d'Analyse Économique. In other words, differences about the adequate policy mix and, in particular, how to accomplish it – by default or in a controlled fashion – are still looming quite large. And here a major bone of contention has been the means and ways of instituting
tionalizing, if at all, fiscal policy coordination. In fact, proposals to develop the Euro Group towards a collective executive body, organizing the mutual exchange of information as well as being capable of defining and implementing common positions, are compelling in my eyes. Moreover, as suggested recently by Commissioner Solbes, the EU Commission here might serve in a supporting and coordinating capacity.

24 This is a position argued in the paper by Pierre Jacquet and Jean Pisani-Ferry, op. cit., as well as in Jürgen von Hagen: Co-ordination of Economic Policies and Employment, in: Alexandre Lamfalussy et al. (eds.): The Euro-Zone: A New Economic Entity, Brussels 1999, Bruylant.

25 See on this Paul de Grauwe: The Economics of Monetary Union, Oxford 1996, OUP.


Concluding Remarks

With micro-benefits and macro-costs having always been embarrassingly balanced, the economics of EMU has never been clinching. Hence, the decisive (and normative) arguments in favor of EMU have always been political. At the same time, most of the queries reside here as well: a most urgent question thus is, how Euroland conceives of dealing with its structurally enhanced interdependence.

While being critical of some aspects of suggestions by Pierre Jacquet and Jean Pisani-Ferry (for example on the ECB’s two-pillared strategy or the external representation of Euroland), I largely sympathize with the bulk of their analysis, in particular that a debate about an economic policy charter – outlining principles and rules of the conduct of economic policy – should be launched. To arrive at a common position will be no mean feat. As a prerequisite, the respective positions should be acknowledged in a non-caricatural form. Of course, institutionalizing fiscal coordination must not impinge on the ECB’s independence – as has, moreover, explicitly never been intended in the above-mentioned proposals. Indeed, according to the professed intentions, by creating a Euroland-level institution of fiscal policy and thus rectifying in the apt wording of Tommaso Padoa-Schioppa to some degree the “institutional solitude of the ECB at the Euroland level”, criticism otherwise aimed directly at the ECB might be deflected.

All of this entails that we probably have to discard the convenient idea according to which the institutional setup as well as the guiding philosophy have been written in stone in Maastricht. Stating this is, indeed, ending on a positive note. Since it acknowledges that Euroland is capable of reacting to new challenges – as they come up. EMU is very much an open arrangement.

Pedro Solbes*

The European Union, EMU and Enlargement

Looking back over the last few years, we have seen historical changes. The fall of the Iron Curtain, German unification and democracy in central and eastern Europe have changed the political landscape of our continent.

To exploit the new opportunities and to repeat the success of western European integration with our eastern and some new Mediterranean neighbours we need to strengthen European integration.

We should not forget that even an enlarged European Union has to stand the test of international competition and to guarantee economic growth and employment. Our companies must adapt to a new knowledge-based economy, to globalisation and world-wide financial markets and to increased structural changes.

We have to be able to defend our common interest in international trade negotiations and to safeguard the basic values of a European model of society, which is based on competitiveness and solidarity.

To meet the challenges of the world economy successfully, Europe needs an integrated well-functioning home market.

With the internal market programme, the European Union has successfully abolished national barriers to trade in goods and services, has started to set common standards and has helped to build a more

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competitive European economy. But we still have to
make further progress to exploit all our economic
potential. To give you only one example: multinational
companies. Amongst the twenty biggest companies
in the world measured by sales, you will find nine
American, six Japanese and only four European
companies. If you look at the stock market value of
the big companies, the picture is even more striking.
Amongst the ten most valuable companies, you will
find eight American, one Japanese and one European
company.

I know very well that economic performance cannot
be measured by the size of the companies. Flexible
small and medium sized companies are an important
asset for the European economy, but it is evident that
Europe needs further market integration. This brings
me to the most ambitious European project of the last
years: Monetary Union.

The introduction of the euro was the logical conse-
quence of the internal market programme.

**European Monetary Integration**

Monetary integration has always been a centre-
piece of European integration. Let me remind you that
this started already more than three decades ago.
Even at the time of the launch of the European
Monetary System in 1979, the process of monetary
integration was not uncontroversial. Fixing the
exchange rate limits the room for independent
national economic policies. This is obvious for
monetary policies but implications for other policy
areas e.g. fiscal policy and wage developments are
evident, too.

Therefore, it was not a surprise that different policy
responses to economic developments led to a
temporary set-back in the monetary integration
process. Nevertheless, in the 1980s monetary
integration got a further impulse from the domestic
and external liberalisation of capital movements
which enhanced the need for stability oriented and
co-ordinated economic policies.

I am fully aware that, among economists, the intro-
duction of a single currency, while leaving other policy
areas in the responsibility of national authorities, is not
uncontroversial.

When assessing developments in EMU, the pro and
con arguments have to be seriously considered. But
our assessment today has to start from the fact that
EMU has been a reality for about two years and the
euro is in place, though not yet in the form of coins
and notes.

It is unfortunate that so much attention has been
paid to short-term developments in the euro
exchange rate. Naturally, I am convinced that a strong
euro reflecting the economic fundamentals is in our
interest, but the stability of a currency has to be
assessed in terms of both its internal and external
performance. In Germany too, internal stability – as
measured by a lasting low inflation rate – has always
been given priority over external stability. For
example, the dramatic rise in the dollar against the
Deutsche Mark in the 1980s was not seen as calling
into question the Bundesbank's anti-inflationary credi-
bility. Therefore, what really matters for the strength
of the euro in the long term is the underlying inflation
performance of the euro area. In this respect, the
record of the euro has been highly encouraging.

The euro area has enjoyed very low inflation by
historical standards. For most of 1999, the euro area
inflation rate remained close to 1% – a performance
not achieved in the previous thirty years.

The recent acceleration of headline inflation, almost
totally due to higher import prices, has not spilled
over to higher inflation expectations as can be
observed in stable long term interest rates. It will be
crucial to contain wage settlements so that higher oil
price induced inflation will not generate domestic
inflation pressures.

**Unification of European Financial Markets**

The smooth change-over to the euro has paved the
way for the development of truly European financial
markets. While the single market has fostered real
economic integration, the euro is acting as a powerful
force to unify financial markets. Up to now, the
situation in Europe has contrasted sharply with the
highly integrated financial markets of the United
States and Japan. This is now changing: let me give
you three examples as evidence:

- the rapid development of the euro-denominated
corporate bond market,
- the acceleration in the pace of consolidation of the
banking sector, and
- the proposed links and alliances among national
stock exchanges.

Given these favourable achievements, I think that
the developments of the euro exchange rate have
received an over-proportionate degree of attention in
public. One way to respond could be to remind
people of the huge swings that have been observed in
the mark-dollar exchange rate in the eighties and
nineties. We also do not know what kind of exchange
rate turmoil would have resulted in response to the oil price shock if EMU had not been established.

Until last summer, the depreciation of the euro was mainly attributable to relatively weak cyclical conditions in the euro area economy. Indeed, the US economy continually surprised – at this time – markets with ever more positive news. However, an appreciation of the euro was expected to coincide with evidence of a recovery in the euro area economy. Therefore, the euro’s failure already to respond in the year 2000 to the improved economic outlook for the euro area had shifted attention to other possible explanations. In particular, structural factors have been mentioned as being important to the euro exchange rate because of market perceptions of the euro area economy as inflexible. The euro area may be seen by markets as a relatively less attractive location for investment. I believe that this is a misperception and underestimates the nature and extent of the ongoing structural change in Europe.

Reduction in Public Sector Deficits

Let me add some comments on fiscal policy coordination achievements. The EMU framework requires that the combination of fiscal and monetary policy is the appropriate one for non-inflationary growth.

This is the motivation behind the Stability and Growth Pact. The Pact requires Member States to adhere to strict fiscal discipline, while allowing them to respond – without inflationary risk – to cyclical developments in their national economies. All of the Member States have made significant progress in reducing their public sector deficits.

For the euro area as a whole, the public sector deficit was about 1½% of GDP in 1999 and in the meantime it fell further well below 1% of GDP. A number of countries have achieved the medium-term objective of a budget surplus or near-balance. Most of the other countries need to pursue fiscal consolidation efforts but should be in a position to reach this objective at the latest in 2002. Given the historical experience of divergence in terms of budgetary performances, the consensus about the role of fiscal policy and the optimal policy mix in EMU is a major achievement.

All in all, the experience with EMU is reassuring, and the euro has found its place in the financial market and in the business community. The introduction of notes and coins at the beginning of 2002 will complete the most ambitious single project of European integration. This will still need a lot of information and preparation by the Member States, the ECB and the Commission. Over time, I am convinced that the euro will develop into a milestone of European identity.

Many people living outside the EU are looking forward to becoming part of the EU and finally adopting the euro as legal tender, a clear sign of the attraction of the European Union. This brings me back to enlargement.

Widening the Euro Zone

Indeed, enlargement of the EU will also imply, at some later stage, a widening of the euro zone. A euro area of initially 11 and now 12 countries is only a first step in the process.

What kind of scenario should be envisaged to get from here to the ultimate monetary integration of the candidate countries in the euro area? What is the appropriate sequencing?

I firmly believe that in the transition countries, the reform agenda relating to accession to the EU must have priority over policy moves inspired by EMU participation such as meeting convergence criteria. In the run-up to accession, the candidates should concentrate primarily on furthering the process of structural and economic reform with an appropriate administrative capacity. The adoption of the single currency can only be the final step in what has been, and will remain, a lengthy process of economic integration with the EU.

The European Commission is closely monitoring the progress of all the candidate countries. In November 2000, the Commission finalised the third set of Regular Reports in which we assessed, inter alia, the economic progress made in terms of the Copenhagen accession criteria, and the extent to which the candidate countries are ready for membership. This annual exercise is crucial for the credibility of the overall enlargement strategy.

This year’s conclusions pointed at the economic progress and pick-up of growth in the great majority of the candidate countries. This can of course be attributed to a large degree to the good economic performance of the EU. We also noticed a tendency for inflation to rise in a number of candidate countries, mainly on the back of the increase in oil and food prices, but without any great danger of things spiralling out of control.

As to the fulfilment of the economic criteria, it is clear that progress has been observed for a number
of consecutive years and negotiations are advancing at a steady pace.

Beyond the measurement of progress, however, how can we build a process of economic policy cooperation with the candidate countries to contribute to this successful, progressive integration into the EU and, ultimately, into the euro area? For its part, the Commission will be conducting with the candidate countries a pre-accession fiscal surveillance, which includes the establishment of economic programmes by the pre-accession countries.

Regarding future monetary integration, I believe the Treaty provides a relatively straightforward scenario for the progressive integration of the candidate countries into the EU and the euro area. In addition, I am convinced that this institutional framework provides sufficient flexibility to accommodate different regimes and different "paths" towards the adoption of the euro.

Unambiguously, the EU Treaty provides for a clear and unique institutional path towards the adoption of the single currency for the candidate countries. Upon accession, the new Member States will enter the EU and participate in EMU with the status of Member States with a derogation from adopting the euro. This status will be granted in the Accession Treaties. New Member States will have to treat their exchange rate policies as a matter of common concern and are expected to join the ERM2 at some point after accession. Then, for the adoption of the euro, the Treaty requires that new Member States reach a high degree of sustainable nominal convergence. This is the equal treatment principle, and it will be applied in full to the candidate countries.

The Treaty framework should provide sufficient flexibility to allow different exchange rate strategies. This is certainly the case now, in the pre-accession phase where there are no institutional obligations in this area, and where exchange rate policies should be essentially aimed at supporting other policies in furthering the transition and preparing for accession.

What is the scenario after accession, and the framework for exchange rate relations between new Member States and the euro area?

After accession, the ERM2 will provide enough flexibility to accommodate different regimes, provided that the countries' commitments and objectives are credible and in line with those of the mechanism. The only clear incompatibilities vis-à-vis the ERM2 that can be identified already at this stage are fully floating exchange rates, crawling pegs and pegs against anchors other than the euro.

In principle, the option of maintaining a euro-based currency board until the adoption of the euro is available on a case-by-case basis, as an additional unilateral commitment to a greater degree of fixity against the euro, within an ERM2 participation. However, when a country with a currency board wants to join the ERM2, the request would have to be examined in the context of the common procedure set out in the ERM2 Resolution, and the central parity/conversion rate will have to be agreed multilaterally. This implies that some of the countries that would prove able to successfully operate a currency board to the euro with a sustained track record would not necessarily have to go through a "double regime change" (moving away to some flexibility before going back again to a harder peg and subsequently the irrevocable locking of the exchange rate).

Increased exchange rate fixity in the run-up to accession need not, however, be the preferred solution, and rather more the exception than the norm. Generally speaking, the candidate countries will, in the run-up to accession and participation in the ERM2, have to reconcile their ambitions for exchange rate stability and inflation reduction.

Concluding Remarks

To conclude let me come back to our starting point.

Europe has to deepen economic integration and has at the same time to develop a credible strategy for enlargement. The progressive widening of the euro area is such a realistic concept. I am convinced that the Treaty spells out a scenario for the next five to ten years in this area which is based on equal treatment and makes sense in terms of economic policy challenges. Therefore, I see no reason to envisage a different approach to future monetary integration and the adoption of the euro by future EU Member States. No need, for example, to "reinforce" the convergence criteria, as is sometimes suggested.

What is necessary is a common effort to explain this policy and its advantages to the public inside the Member States of the European Union and also to the candidate countries.

People in general are afraid of changes but the European Union has to change. It is our common responsibility on the national and European levels to assure people that the changes will be for the benefit of all and not only a bargain for the few.
The fifth enlargement of the European Union (EU) is an irreversible event. It may occur in stages or it may become a "fait accompli" due to external factors or be delayed by them. The process of negotiations has advanced significantly and the horizontal aspects of enlargement have all been dealt with. They all amount to a single issue: that a serious restructuring and adjustment be undertaken by the applicant countries but the cost associated with such a transformation be shared by both the EU and the countries concerned. As the catching-up process will be especially difficult for the eastern and central European countries the following analysis will concentrate on them despite the fact that the present negotiations also include Cyprus and Malta.

Very rightly the European Parliament voted in favour of enlargement's taking place before the next European elections in 2004. In principle the European Council of Nice in December 2000 followed this timetable. But it is crystal clear that countries can only become members of the EU if they fulfil the criteria laid down in the Treaty. This also applies to membership of Economic and Monetary Union (EMU). The European Parliament and the European Commission included in the Copenhagen criteria not only that of functioning market economies and the capacity to withstand competitive pressure and market forces in the Union, but also that of being able to take on the obligations of membership, including adherence to the aims of political, economic and monetary Union (Copenhagen European Council). It is interesting to note that the catching-up process is in full swing especially with regard to price stability and budget consolidation. But this does not imply that the investment-led economic growth needed is achievable and that unemployment and problems of social exclusion can and will be solved. All balance sheets on the economic preparedness of the candidate countries hide the serious problem of the sustainability of the catching-up process. Even the problem of implementing economic legislation, of building up the institutions, administration and courts necessary for the good functioning of a market economy is unsolved, as is the question of the framework for carrying out the obligations concerning free and fair competition and state aid. Therefore the economic convergence called for as a condition of entry and later accession to EMU is of crucial importance for all countries. This should not, however, be viewed solely in terms of formal compliance with the EMU convergence criteria when judging the state of readiness of the applicant countries. The EMU convergence criteria concentrate on the nominal convergence criteria which brought a large number of constraints to the new EMU members during the second stage of EMU. They will also affect employment and the social situation in the accession countries. It is therefore crucial to prepare for entry and to support the accession countries in their preparations.

EMU is an integral part of the acquis communautaire. Participation in EMU is a compulsory goal for all new member states, but joining the euro zone means meeting the convergence criteria. The accession countries must first undergo structural and economic reforms and develop institutional, administrative and judicial capacities. EMU membership can only be the final step towards full integration with the EU. There is no rebate for the fulfilment of the convergence criteria. It is the Treaty that counts – nothing more and nothing less. But it has to be remembered that with EU membership the new members must be able and willing to participate in EMU in the foreseeable future.1 At the moment, several candidate countries have problems with inflation rates, long-term interest rates and exchange-rate stability. Only after becoming members of the EU can the accession countries become candidates for EMU and apply for EMU membership, by proving that their stability policies comply with the stability policy of the euro zone. So the earliest possibility of becoming an EMU member

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1 President of the Economic and Monetary Affairs Committee of the European Parliament.

1 European Council in Copenhagen, 21-22 June 1993, Conclusions of the Presidency (No 7 A ii).
is two years after having become a member of the EU. Then, only on the basis of the convergence reports of both the European Central Bank and the European Commission, and after consultation of the European Parliament, will the European Council decide if and when the applicant’s entry into EMU is justified.

Monetary Union is not merely a monetary area, just as the EU is not merely a free trade area. In addition to economic considerations, the Community integration process is based on a model for society, with all the implications this has for welfare policies in particular. In this connection, most of the applicant countries fall even further short of the Community average in terms of per capita gross domestic product (GDP) than Ireland and Portugal did when they acceded to the Union in 1973 and 1986 (58% and 60% respectively of the Community average at the time). EMU is an irreversible mechanism which implies conscious public support for transfers of sovereignty in various areas, transfers which must be fully accepted and explained by political leaders and the two sides of industry in the countries concerned. Any prospect of granting the applicant countries derogations from the EMU criteria was rightly ruled out from the start by the Council and the ECB. Prior to joining the euro, these countries will retain their own monetary policy and their participation in the European System of Central Banks will be restricted as stipulated in the Treaty in respect of the countries granted a derogation. The new member countries will have the status of “Member States with a derogation”. They have no possibility of an opt-out like those granted to the United Kingdom or Denmark. They have to pursue policies which demonstrate their will to participate and look at matters from the perspective of the common interest.

Convergence is Needed

The accession countries will have to organise convergence and stability. This will continue to mean a major shock because of the necessary changes which will affect their financial, economic and social structures. The first step is convergence with the economic criteria of the 1993 Copenhagen European Council, which means a functioning market economy, macroeconomic stability and structural reforms, a stable legal framework for the economy, the reform of business law, of state aid and a stable banking and financial system.

The long-term goal is to catch up with the performance of the EU economy. Real convergence might be a desirable aim, but real convergence is neither a criterion for accession nor for the membership of EMU. Many countries have been successful in reducing inflation and anchoring exchange rates, and growth perspectives are promising. Average real growth in these countries is often higher than the EU average, and the standard of living of the population has increased. There is nevertheless a further need for pragmatic approaches in the field of structural reforms to ensure the reforms are carried out in a sustainable way and will be accepted by the population. In order to avoid rejection on either side, the transitional arrangements which will be necessary should serve as flexible and appropriate instruments to cope with the convergence process, especially in view of the free movement of workers and services or the environment as was the case at the accession of Spain, Portugal and Greece.

The candidate countries will have to cope with competitive pressure and market forces within the Union. This pre-condition for membership requires not only the introduction of legislation in areas relating to the single market but, especially, the guaranteeing of their implementation by guaranteeing the rule of law, as well as the setting up of efficient institutions for the functioning of a market economy.

Progress has also to be made in the organising of competitiveness and social and economic cohesion by speeding up the adjustment of industrial structures, encouraging the development of SME’s, by improving and simplifying the legal framework and by establishing a stable macroeconomic environment, a viable social protection system and active labour market policies.

Accession to the Euro

The accession countries will have to plan three stages in order to join the euro zone: the pre-accession phase with the completion of the market economies and the achieving of sustainable macroeconomic stability, the second phase between accession and the adoption of the euro with full membership in the Single Market and, finally, the third stage with participation in the euro zone according to the procedure provided for in Article 121 of the EC treaty. As already stressed, membership of the European Union does not automatically imply membership of EMU.

This is very rightly so because EMU is an irreversible project, a community which cannot accept divorce or annulment, but calls for an everlasting act
of solidarity. That is why the convergence criteria are so essential and have to be met with a serious commitment. EMU implies conscious public support for transfers of sovereignty in various areas, transfers which must be fully accepted. Therefore derogations from the EMU criteria have been ruled out from the beginning of the negotiations. Thus, the accession countries have to prepare first for the accession and after accession for the nominal convergence as stipulated by the EU treaty. They are required to cope with the convergence criteria and start by fighting inflation, striving for stable exchange-rate relations to the euro and changing to an independent central bank. Here the case of the Czech Central Bank is a disappointing case. Sound public finances also have to be guaranteed in order to support the objective of price stability. In order to prepare for EMU accession, countries submit information on government debt, fiscal deficits and related data and also prepare an economic programme with a medium-term policy framework. The countries can thus prove their state of preparedness concerning structural reforms, public finances and technical, statistical and institutional capacities which will enable them not only to fulfil the economic criteria for accession but also later to achieve membership of EMU. This includes being able to cope with the ESA 95 accounting standards. The first annual notification will take place on April 1st, 2001 and will be evaluated by the Commission. The pre-accession economic programme (PEP) is designed to support EU accession by developing the institutional and analytical capacity necessary to participate in EMU.

The first pre-accession fiscal surveillance procedure will take place in 2001 and will be an important step towards letting accession countries participate in policy co-ordination by establishing medium-term economic policy priorities, and in this way facilitate their integration into the policy co-ordination procedures of the EU. After accession all new Member States will have a derogation for the adoption of the euro but they have the right and an obligation to adopt it. This means that they can and must apply, or the procedure set out in the Treaty will take place. This is nothing new and special for the new countries. It is in accordance with the EMU context as applied to the existing member countries.

**Enlargement and EMU – Risks and Challenges**

The positive macroeconomic effects of enlargement will certainly outweigh any negative consequences. However this does not rule out the possibility that some risks and challenges may arise before the positive effects of enlargement are felt, so that people might react in a negative way to EU and EMU membership. Already now the opinion polls show neither in eastern European nor EU countries any enthusiasm about eastern enlargement. More people are against it than are in favour. This is not unexpected because the initial years following accession will mean a major shock for the economies of the new member states. There will be constraints because of the necessary structural reforms to be taken. But the beneficial effects of policies reducing inflation and anchoring exchange rates should not be ignored. Therefore pragmatic adjustments, a smooth transition and a sustainable path to budgetary discipline and exchange-rate policy, as well as close cooperation between ministries and central banks, are needed.

**Financial Stability is Needed**

Macroeconomic stability does not go without financial stability. European and international cooperation is not only needed in order to increase foreign direct investment (FDI) in the accession countries. There is still a need to strengthen banking and financial systems and to improve the reliability of banking supervision, for example through credit information centres, which could check the risks at a central level and contribute to better access to finance for small and medium-sized enterprises. Also the dependence of eastern European banks on FDI from the banking sector of specific countries can contribute to financial instability if the legal certainty of all aspects is not guaranteed. Financial instability in eastern European countries can also affect EU member countries.

Financial stability has to be improved by common market legislation. It may also be that the accession countries should be granted a transitional period for introducing the liberalisation of capital movements, especially short-term capital movements, in order to establish a fully functioning banking system and financial market with legal certainty so that risks for opening up markets are reduced. Participation in the EU and the euro will only be successful if the stability of financial systems is guaranteed by an efficient and competent banking sector and a functioning financial sector. Here progress has to be made in all countries.

As to Foreign Direct Investment (FDI), one should be careful. The surge of EU FDI in the applicant countries has been significant. EU FDI stocks held in the economies of the applicant countries reached 658,570 million euro at the end of 1997. This statistic
is important as it accounts for about 11% of total EU FDI, and all this occurred in a span of ten years. However, this significant statistic has been due to the drive of CEECs to transform their state-planning economies into market economies, coupled with large-scale privatisation.

It is equally true that all previous enlargements were associated with an increase in FDI originating either in EU countries or in other OECD countries. Spain emerged as a major host country for FDI after joining the EU in 1986. Ireland experienced a similar trend in inward FDI in 1974 and in the post-1992 European Single Market period. However, FDI theory and experience show that market-seeking FDI depends on two factors: access to a previously closed market and the economic prospects and expected profits in a host country. But market access and expected profits largely depend on the existence and functioning of capital markets and on complementary factors such as legislation, a trained labour force, management experience and political stability. Yet these basic requirements and factors influencing inward FDI differ from one region to another and thus complicate the exercise of examining the likely inward FDI to applicant countries at the expense of other regions such as NAFTA, ASEAN or China.

The development of capital markets must not simply be accompanied by the development of banking systems and practices, but must be preceded by it, in the interests of the real economy. Measures to forestall the risk of banking crises and the contraction of credit supply cannot be based solely on the application of international prudential standards, jointly drawn up by the supervisory authorities of the leading industrialised countries in the Basle Committee within the Bank for International Settlements. Neither can they be based on the internationalisation of activity which goes hand in hand with the increasing role played by foreign banks, nor, above all, on premature moves to offer businesses access to the financial markets.

Greater control of the risks inherent in traditional lending activities is a prerequisite, not least in order to ensure that small and medium-sized firms do not suffer any disadvantage in terms of access to funding because they are not assessed by credit-rating agencies. A variety of tools can be developed by the authorities to assist banks, such as loan inventories (files containing details of the sums lent to each borrower) or balance sheet inventories.

Priority must of course be given to strengthening banking supervision at a national level, since it is at that level that this task is still carried out within EMU. Co-operation in the sphere of payment and clearing systems is also important, a matter which concerns both the ECB and the national central banks.

The free movement of capital is a fundamental principle of the EU, like the free movement of goods, persons and services. This is why, in legal terms, all restrictions on the full convertibility of currencies have to have been removed by the date on which a country joins the EU, irrespective of the preparations for its entry into the euro area. Most of the applicant countries, who themselves have put forward the arrangements and timetable for this liberalisation process, have already made substantial progress towards this objective. The only requests for transitional periods made at this stage concern property assets with a view to restricting sales of real estate to nationals of the other Member States. However, it seems appropriate to consider the principle of transitional periods in respect of this aspect of the acquis communautaire, since the dangers of instability linked to financial globalisation are much greater today than they were in the 1980s when some of the current Member States were granted transitional periods. The objective would be to encourage direct and long-term investment and prevent a situation arising in which short-term speculative capital movements made it necessary to restore as a matter of urgency restrictions which have previously been abolished. Moves to prevent disruption and safeguard the continuity of this process are essential to the credibility of these currencies. The risks of a premature increase in capital movements when set against the development of the banking and financial institutions and the real economy must be taken into account.

**Exchange-rate Regimes – Do They Matter for EMU Accession?**

There has to be consistency in the exchange-rate systems which correspond to the economic situation and policies. What is good for Estonia may not be good for Poland.

What is needed is exchange-rate stability in order to cope with problems related to price adjustments, capital inflows and outflows and exchange-rate appreciation and depreciation policies. So it is quite understandable that different accession countries also differ widely in their exchange-rate regimes, which range from free-floating exchange rates to pegging systems with currency boards. For example, Malta and Latvia are pegged to baskets of currencies, Cyprus to the euro and Hungary and Poland have a
crawling peg system. Similar systems are observed in Slovakia, Slovenia and Romania. They differ even further from the rigid arrangements of Estonia, Lithuania and Bulgaria. There is no common view on a specific exchange-rate mechanism for the pre-accession period.

Certainly exchange-rate strategies should contribute to macroeconomic stability but of course the path of structural reforms is more important than the exchange-rate system. Therefore it would be advisable not to strive to introduce the euro as a parallel currency but to join the ERM2 which is flexible enough for the new members.

There is freedom of choice. But it is desirable that candidate countries do not prefer systems of free floating, crawling pegs and pegs to reference currencies other than the euro.

The transition from 15 to 27 Member States raises the problem of the size of the various institutions and of the balance among the various Member States. Among the decisions taken at the recent Inter-governmental Conference, the reform of the composition of the Commission will serve as a useful precedent with a view to the inevitable revision of the Statute of the ESCB. As soon as the new Member States join the EU, therefore, their central bank governors will sit on the ECB’s General Council, the enlargement of which raises no particular problems.

However, the prospect of a Governing Council comprising up to 33 members (15 current Member States + 12 new Member States + 6 members of the Executive Board) raises, in addition to considerations of effectiveness, concerns regarding: the numerical balance between the Executive Board and the representatives of the national central banks, the balance between the old and new Member States, and the supranational image of a college whose members sit in a personal capacity, and are supposed to consider only the interests of the euro area and are at pains not to defend the interests of their country of origin.

Legislation has to be put in place that ensures the full independence of central banks, which has not been achieved in all countries. Concerning monetary policy, many countries will have to bring down inflation rates, but it is also a fact that monetary policy strategies are more and more similar to those of the European Central Bank.

The cornerstone solutions are currency boards, flexible exchange-rate systems, but also the “euroisation” of the whole system. This means the introduction of the euro as a parallel currency. This is not a solution favoured by the European Union because it may give the illusion of already having joined the euro zone without having fulfilled the convergence criteria. This might also affect the external value of the euro.

A more realistic approach would consist in creating a European exchange rate mechanism (ERM) with the euro or granting the new members membership in the ERM II. This would be of advantage to the new members. Most of their trade is with the European Union so that by joining the ERM II most of their trade would not be affected by exchange-rate turbulence or volatility. Despite the teething troubles of the euro during its first years, it is on its way to becoming a world reserve currency, but also a trade and billing currency, the euro as an international currency is even more attractive to those countries and therefore adopting one of the formalised and institutionalised linkages with the euro is also attractive. ERM II also offers the opportunity to differentiate between the countries. The broad range of fluctuation of a maximum +/- 15% can be reduced so that more advanced countries can be more closely linked to the euro than others. There is of course the obligation of the ECB to intervene in favour of those currencies. But there are limits: the ECB shall only intervene if price stability in the EMU member countries is not affected.

On the other hand, the new members of the EU during this stage are also obliged to adapt the parities if necessary. The most difficult task in choosing this model of ERM II participation is fixing the central exchange rate at the right level. There will be a conflict of interest because no partner will accept an exchange rate which will be harmful to its trading position. The accession countries actually still have undervalued currencies and use this situation to favour their trade balance, especially the bigger countries like Poland, the Czech Republic and Hungary.

Concluding Remarks

Eastern enlargement is both a challenge and an opportunity for peace, stability and enhanced regional cooperation in a part of the world characterised by conflicts and wars. The new agenda ends the Yalta world order but does not end the necessity of solidarity. Thus, enlargement calls for preparation and solid cooperation on both sides. The Nice Treaty does not cope with this aim. An enhanced programme has to be organised in the post-Nice process as foreseen by the conclusions of Nice in order to make the Union decision-making process more efficient, transparent and democratic.