

# The 1998 Reports of the European Commission on Progress by Candidate Countries from Central and Eastern Europe: The Second Qualifying Round

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## I Introduction

On November 4, 1998, the European Commission adopted and published, for the first time, “regular reports on progress towards accession by each of the candidate countries.”<sup>2)</sup> These reports constitute another important step in the enlargement process of the European Union. According to the conclusions of the European Council in Luxembourg in December 1997, these regular reports, which will be released yearly, are to review the developments in the ten applicant countries from Central and Eastern Europe (ACs) from the adoption of the Opinions in July 1997, with a focus on assessing these countries’ progress towards fulfilling the Copenhagen criteria for EU accession. While the Commission also prepared similar reports on Cyprus and Turkey, this study confines itself to the reports on the ten ACs as well as to the composite paper, which contains “a synthesis of the analysis in each of the regular reports as well as a series of recommendations.”<sup>3)</sup> At the time of writing, the regular reports were being discussed by the Council. Based on the results of this discussion, the European Council in Vienna in December 1998 will take a position on the regular reports in general and on the Commission’s recommendations in particular.

The main purpose of this study is to review and critically assess the 1998 regular reports from a central bank perspective.<sup>4)</sup> In doing so, we set out by examining the general structure and methodology of the reports (section 2). Subsequently, we look at some general macroeconomic issues (section 3). This is followed, in section 4, by an analysis of the Commission’s accounts on monetary and exchange rate policies as well as on the ACs’ (dis)inflation performance. Section 5 deals with Economic and Monetary Union issues. It sets out by discussing the integration path in this area and then moves on to scrutinizing the recent performance, with a specific focus on two areas, namely central bank independence and the liberalization of capital movements. After this in-depth discussion of specific issues of central bank interest, we broaden our focus and review the Commission’s overall assessments on the ten candidate countries in economic matters as well as its main recommendations (section 6). The main conclusions of the study are summarized in section 7.

In order to set the stage for our analysis, we first put the 1998 regular reports into a broader context by swiftly reviewing major recent developments in the enlargement process. Since the Luxembourg Summit, a number of steps have been taken which have kept up the momentum of this process, some of them sending mainly political signals, others contributing more

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2 *For simplification, these reports will in the following be referred to as the “regular reports” or the “reports.”*

3 *See European Commission (1998 a). Most of the quotes in this study relate either to the composite paper or to the 1998 regular reports on individual candidate countries from Central and Eastern Europe. Quotes the context clearly shows as belonging to the composite paper or the individual country reports will, of course, be identified as such in the remainder of this study, but in such cases the source will not be stated again in a footnote.*

4 *We thus intend to perform a similar exercise as last year’s exercise on the Opinions in Horváth et al. (1997).*

substantively to the overall development. Both countries that have held the EU presidency this year – the United Kingdom in the first half of 1998 and Austria in the second – have given particular attention to the issue of enlargement. In fact, one of the main objectives and priorities of Austria's first-ever EU presidency is “to ensure that the integration of new partners into the Union makes headway and that it achieves the best possible results for both parties.”<sup>1)</sup>

On March 30, 1998, the accession process was officially launched with all ten ACs and Cyprus by a meeting of the foreign ministers of the Member States and the candidate countries. Earlier on the same day, the Council adopted the individual Accession Partnerships<sup>2)</sup> (APs) for each of the ten candidate countries from Central and Eastern Europe. Complementing the APs, the candidate countries drew up National Programmes for the Adoption of the *Acquis* (NPAA) setting out a timetable for achieving the priorities and objectives laid down in the APs. On March 31, 1998, the Council held bilateral intergovernmental conferences with the “first wave” candidates selected at the Luxembourg Summit, namely the Czech Republic, Estonia, Hungary, Poland, Slovenia (and Cyprus) to begin accession negotiations. The next step was the analytical examination of the *acquis communautaire*, often referred to as the “*acquis* screening,” which was formally started with all the applicant countries from Central and Eastern Europe (and Cyprus) on April 3, 1998. This exercise is done differently for the two groups of candidates. Whereas the multilateral screening sessions for each chapter are rather short for the “first wave” countries and are immediately followed by bilateral sessions, the “second wave” countries (Bulgaria, Latvia, Lithuania, Romania and Slovakia) undergo a more comprehensive multilateral screening process, which will have to be concluded for all chapters before any bilateral *acquis* examination can be started. According to the composite paper, “the screening of 16 out of the total of 31 negotiating chapters was completed” for the “first wave” countries by the end of October, while the “second wave” countries will only start the bilateral screening process in the first quarter of 1999. On October 5, 1998, the Council decided to open substantive negotiations with the Czech Republic, Estonia, Hungary, Poland, Slovenia (and Cyprus) on the first seven chapters screened.<sup>3)</sup> On November 10, 1998, these negotiations were formally opened; this had, in fact, been one of the main operative goals of the Austrian EU presidency.

1 See EU Presidency homepage, <http://eu.presidency.gv.at>.

2 The Accession Partnerships are the main instrument of the preaccession strategy. They contain priorities for the adoption of the *acquis* and lay out the assistance of the EU in support of these priorities. See European Commission (1998 a).

3 These seven chapters comprise those areas of the *acquis communautaire* which are presumably the least controversial in the accession negotiations between the EU and the ACs, namely Science and Research; Telecommunications and Information Technology; Education and Training; Culture and Audio-Visual Policy; Industrial Policy; Small and Medium-Sized Enterprises and Common Foreign and Security Policy. The opening of substantive negotiations had become possible because all applicant countries had submitted their position papers in time in September 1998 so that the Commission could produce Draft Common Positions for each of these chapters, and for each of the applicants. These common negotiating positions were adopted by the Council on October 5, 1998.

## 2 General Remarks

The conclusions of the European Council in Luxembourg laid down that the regular reports will follow the same methodology as the Opinions, and this is restated in each of the regular reports as well as in the composite paper.<sup>1)</sup> In other words, the Commission assesses the candidate countries' progress towards accession in the light of the Copenhagen criteria. Consequently, the basic structure of the regular reports follows that of last year's Opinions. After an introduction (Part A), the core part of each regular report (Part B. Criteria for Membership) consists of four main sections, examining the political criteria (section B.1), the economic criteria (section B.2), the countries' ability to assume the obligations of membership (section B.3) and the administrative capacity to apply the *acquis* (section B.4). This is followed by the Conclusion (Part C) and by a Global Assessment of Implementation of the AP and the NPAA (Part D) which for obvious reasons does not have a matching counterpart in the Opinions. However, in contrast to the Opinions, the further breakdown of these chapters into subchapters is tangibly less deep in the regular reports, which in fact has a positive side effect: The problem of double coverage of certain issues and of occasional inconsistencies between certain subchapters, which was a weakness of the Opinions, is partly avoided in the regular reports.

In our view, the 1998 regular reports indeed follow, in principle, the same review and assessment method as the Opinions. However, one can also find certain differences. The Opinions basically embarked on a first stocktaking of the degree of fulfillment of the Copenhagen criteria by each applicant country. Consequently, the assessment and (implicit) ranking among the candidates was based on their preparedness to join the EU up to that point of time. The regular reports, in contrast, measure the progress achieved during the reference period, usually on the basis of the Opinions' assessments, and thus, for the first time, add a dynamic element to the analysis. As we will show in more detail in the review of central-bank relevant areas, the Commission's response to this altered setting is somewhat uneven. In some cases, the reports only give a final assessment of the progress achieved in the review period. In other cases, the reports also make an evaluation on the overall extent to which the candidates fulfill the conditions for membership at the time at which the reports were written. Finally, there are also some "intermediate" cases in which the reports use assessment formulations that are to indicate whether a country had already achieved a tangible degree of progress at the outset of the review period. In our view, it would be advantageous if future progress reports generally contained assessments both on the progress achieved in the review period and on the overall state of fulfillment of the Copenhagen criteria. Restricting assessments exclusively to recent developments would have drawbacks. Given the relative brevity of the review period, lauding applicants with a rapid pace of reforms and criticizing less ambitious candidates may distort perceptions if an assessment on the overall fulfillment of the membership criteria is lacking and the different starting

<sup>1</sup> See sections A.a) and B.2.1 of each of the ten regular reports as well as section I and section II.2 of the composite paper, respectively.

points are not taken into account.<sup>1)</sup> This seems to be true, in particular, of comparisons among applicant countries, and especially with regard to judgments on the criterion that relates to the “ability to assume the obligations of Membership.” Taking a more comprehensive approach to the assessment of meeting the Copenhagen criteria could also be justified on the grounds that the regular reports are an “update” of the Opinions,<sup>2)</sup> which of course contained a first evaluation of the overall fulfillment. It should also be noted that the conclusions of the European Council in Luxembourg in no way limit the Commission in this respect.

In the Composite Paper’s review of the Commission’s “definition of the Copenhagen criteria in the Opinions,” it is stated that “[t]here is also an important time dimension, and the issue of track record, which was one of the factors considered in the Agenda 2000. In this context track-record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.” In the actual country assessments of the 1998 regular reports, the briefness of the track record period plays a major role in the cases of Latvia and Lithuania.<sup>3)</sup> If one revisits last year’s Agenda 2000 on this matter,<sup>4)</sup> it turns out that sustained policy implementation and alignment with the *acquis* did play a tangible role for the judgments on the fulfillment of the criteria, but on the whole, the track record issue appears to have been somewhat less central to the assessments than in the 1998 regular reports. Moreover, the “track record” concept had been less precisely defined.

A further methodological issue is related to the exact review period of the 1998 regular reports. In the reports, it is indicated several times that the duration of the reference period is eighteen months,<sup>5)</sup> but when this timespan begins and, consequently, when it ends, remains open. On logical grounds, one would assume that the period starts June 1, 1997, i.e. the day after the cutoff date of last year’s Opinions, namely May 31, 1997,<sup>6)</sup> to avoid

1 This issue will become even more important from 1999 onwards, when the review period will be further reduced to twelve months. It should also be added that the shortness of the review period has other drawbacks as well. For example, a focus on just a short period makes it difficult to distinguish between temporary and more permanent slowdowns in the reform dynamics. While the former may be due to electoral cycles or unexpected, transient events, the latter may be associated with a general lack of political will to effect necessary changes.

2 See European Commission (1998 a and 1997 l).

3 See the following statements in the composite paper (European Commission, 1998 a): “[I]n a number of areas, the implementation of economic policy and reforms [in Latvia and Lithuania] are too recent to allow the Commission to conclude today that they can already be considered as functioning market economies.” On Latvia’s activities in the areas of legal alignment and strengthening of administrative structures, the following is said: “Because much of the legislation has been recently adopted, it is too early to assess the efficacy with which it will be applied in some fields.”

4 See Agenda 2000, Vol. 1, Part Two, Ch. I. (European Commission, 1997b) and the individual Opinions, sections B.2.2 (European Commission, 1997 d to 1997 m).

5 See e.g. section II.1 of the composite paper (European Commission, 1998 a): “... has been accomplished in the past eighteen months.” Or see section II.2 of the composite paper (European Commission, 1998 a): “This first review, however, takes into account a year and half of extra observations.”

6 See Agenda 2000, Vol. 1 (European Commission, 1997 b).

any break in the observation period and to ensure continuity. However, if one added 18 months, this would yield November 30, 1998, as the cutoff date, which obviously would not make any sense. In order to discern the implicit cutoff date, we looked for the most recent developments covered in those sections of the reports we scrutinize in this study, and it turned out that these relate to events in early to mid-October 1998.<sup>1)</sup> It would be helpful, for the sake of transparency and clarity, if future progress reports defined the respective review period explicitly.

### **3 Macroeconomic Developments: Selected Issues**

A short overview of the main lines of economic developments in the ACs during the review period is given in section II.2 of the composite paper. The individual country reports cover economic developments mainly in the respective sections B.2.2. These sections contain a record of macroeconomic developments since the Opinions, followed by a survey of the main achievements in the area of structural reforms by the applicants during the review period. This then constitutes the basis for the Commission's assessment on the economic criteria presented in section B.2.3 of each regular report.<sup>2)</sup>

According to the composite paper, economic growth in most candidate countries continued to be high and "has not been significantly affected by the worsening international environment and the turmoil in the international financial markets." The engine of growth has been domestic demand (and fixed investment in particular), while the contribution of net exports has been "marginally negative." Unlike in the other ACs, real GDP growth has been negative in Romania and the Czech Republic which, according to the Commission, is due primarily to internal factors. Foreign direct investment in the ACs "has continued to increase, even if it is still [relatively] low," with the size of inflows being positively related to advances in privatization and structural reforms.

The catching-up process, measured in GDP per capita (at purchasing power parity) compared to the EU average, has gained further momentum. Unemployment has fallen in some ACs, disinflation has continued in most candidate countries, and fiscal accounts have generally been favorable. Due to the economic revival, all ACs have recorded negative trade balances and "in some countries (Estonia, Latvia, even Lithuania, Czech Republic, Poland and Slovakia) this deficit may be too large. The current account is also strongly negative in Estonia, Slovakia and Lithuania."

*1 The most recent developments covered are the flotation of the Slovak crown (October 1, 1998), the abolition of the Slovak import surcharge (October 1, 1998), the submission of an amendment to the Gaming Act by the Czech government to Parliament (October 1, 1998), the failure of two small Estonian banks on October 2 and 7, 1998, the implementation of an earlier decision of the Romanian government to impose an import surcharge as of October 10, 1998, the proposal of the Monetary Policy Council of the National Bank of Poland for streamlining, in the light of the introduction of the euro, the currency basket to which the zloty is pegged (October 13, 1998), and last but not least the accession of Latvia to the WTO on October 14, 1998. Moreover, the tables in sections B.2.2 of the regular reports include data on economic key indicators up to September 1998, which were released up to October 14, 1998, in the case of Bulgaria up to October 20, 1998.*

*2 These assessments are reviewed in conjunction with the main recommendations of the 1998 regular reports in section 6 of this paper.*

The composite paper concludes the review of recent economic developments with the assertion that the economic impact of the Russian crisis on the ACs “can be expected to remain limited at this stage,” due to the successful trade reorientation towards the EU in recent years and, “more fundamental[ly due to] the [ACs’] perspective of EU accession,” which “has had a noticeably favourable effect on market sentiment.” Still, foreign financing has become more costly, especially for countries “that are perceived to have weak economic fundamentals.” The individual country reports also deal with this issue, with the exception of the report on the Czech Republic. The other nine reports scrutinize, in this respect, the ACs’ direct trade links with Russia and other CIS countries, “direct financial effects” (in particular the exposure of domestic banks to Russia) and implications for the ACs’ access to international financial markets.

A closer look at the most central points the individual country reports make in their review of economic developments since the Opinions yields the following picture.

Bulgaria is lauded for the “considerable progress” it has made on macro-economic stabilization, while structural reforms are found to have proceeded by and large at a satisfactory pace, but overall “[t]hey are still at a relatively early stage.” Building on these achievements and renewing reform efforts (especially trade and price liberalization, privatization and an overhaul of public administration) will be crucial for further progress.

The report on the Czech Republic takes note of the “difficult” macro-economic situation – in particular the fall in real GDP and the sharp rise of unemployment – and finds that prospects in this area “continue to look bleak.” The recent fall in inflation and the “considerable narrowing” of external deficits are acknowledged. There has been “some progress” on structural reform measures but much more has to be done, first and foremost in the financial sector, “[o]ne of the key weaknesses” of the economy, in particular “with a view to improving the framework for corporate governance and accelerating enterprise restructuring.”

The report on Estonia notes the country’s extraordinarily fast growth in the review period. The country is lauded for disinflation and fiscal consolidation as well as for “remarkably high productivity growth.” The authorities are commended for taking restrictive policy measures to contain risks associated with rapid financial sector development and continuously high external imbalances. On the 1997 current account, the report holds that “[m]ore than the level of the deficit,” the “sharply increased weight of debt-creating inflows and portfolio investments” in its financing “has been a cause of concern.” Structural reforms have continued. Future policies should concentrate on “further reducing external imbalances and inflation,” on proceeding with price liberalization, and on improving regulations and supervision of the non-bank financial sector.

Hungary’s economy “has performed better than envisaged in the reference macroeconomic framework outlined in the first ‘Joint Assessment of Hungary’s Medium-Term Economic Policy Priorities’” prepared by Hungary and the Commission in mid-1997, and “prospects have continued to improve.” Contrary to earlier economic upswings, accelerating growth has

not increased external imbalances, “largely due to substantial [FDI-driven] modernisation of some productive sectors.” Inflation has fallen substantially this year. Structural reforms have continued on many fronts, with the delayed tackling of the Postabank malaise and insufficient action in the health sector being the only greater points of criticism. In the future, the focus should be on improving “the implementation and enforcement of the legal framework” (especially in the areas of regulated monopolies and financial markets), on health reform and on a further strengthening of macroeconomic stability.

Latvia’s macroeconomic situation is found to have “improved considerably,” growth has accelerated, the fiscal position has been consolidated and disinflation has continued. “One point of concern ... is the size of the current account deficit” although it “is mostly covered by increased [FDI] inflows.” Economic reforms have made steady progress in many areas, “[h]owever many important reforms are in progress, or have only recently started to be implemented, which makes it difficult to give an overall assessment of the effectiveness of the reforms and of the institutions that have been created.” Priority should be given to “filling the remaining gaps in the regulatory and supervisory framework, especially in the financial sector,” to simplifying the legal environment for enterprises and to maintaining macroeconomic stability, including a reduction of external imbalances.

In Lithuania, macroeconomic stability has improved and structural reforms have advanced. The current account “is deteriorating,” but is increasingly being financed by FDI inflows, which are attracted by the country’s “enhanced economic environment.” Still, “the main risk on the macroeconomic side is that, at some point in the future, it may become difficult to finance the high and rising current account deficit.” The main future challenges are to complete the reform program, to implement and enforce the legislation properly (with particular attention to bankruptcy rules) and to preserve macroeconomic stability, “notably by ensuring the sustainability of the external accounts.”

Poland “has strengthened its macroeconomic stability.” Growth has remained buoyant, unemployment has been reduced, “export performance has improved to the extent that the widening of the trade and current account deficits could be curbed in the next few years,” inflation has fallen, and the budget deficit has been lowered. The country has “embarked upon a wide-ranging and broadly coherent set of further reforms.” Future policies should continue to focus on implementation of reforms, especially further privatization and sectoral reforms. Public finance implications of reforms should be monitored closely. In addition, further financial sector development and improved SME access to financial markets are perceived to be priorities.

Romania’s economic performance has “deteriorated” and the situation has become “very serious.” Economic activity has taken a sharp downturn. Macroeconomic policies have been tight but are increasingly undermined by the “paralysis” of most structural reforms. External accounts have deteriorated and are a cause of “serious concern.” The productive basis of the economy has shown a “fundamental weakness.” Financial discipline and corporate governance have continued to be low, pressures for state intervention are increasing, and the financial sector has become even more fragile. The Commission concludes that the authorities “must give absolute and urgent

priority to restoring macroeconomic stability” and implementing a comprehensive set of structural reforms in a coherent manner.

In Slovakia, the overall economic situation has worsened despite ongoing high growth, as the country’s fiscal position has “deteriorated significantly, external deficits [have] remained unsustainably high, and both inflation and unemployment [have] increased.” The report identifies two core economic policy problems, namely insufficient coordination between monetary and fiscal policies and too-slow economic restructuring. Privatization and enter-

Table

<b>Main Economic Indicators and Trends</b>							
		Real GDP growth rate	Inflation	Unemployment (ILO definition)	General government budget balance	Current account balance	Gross foreign debt
		<i>in percent</i>					
					<i>in percent of GDP</i>		
Bulgaria	1997	- 6.9	578	15.0	-2.6	4.1	96
	1998 latest	11.9 Jan.-June	Dec.-on-Dec. 5.5 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Czech Republic	1997	1.0	10.0	4.7	-2.2	- 6.1	41
	1998 latest	- 1.7 Jan.-June	Dec.-on-Dec. 8.8 Sept.-on-Sept.	5.9 March	n.a.	- 1.9 Jan.-June	n.a.
Estonia	1997	11.4	12.5	10.5	2.1	-12.0	44
	1998 latest	7.3 Jan.-June	Dec.-on-Dec. 8.9 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Hungary	1997	4.4	18.3	8.1	-4.6	- 2.2	n.a.
	1998 latest	“close to 5” Jan.-June	Dec.-on-Dec. 13.5 Aug.-on-Aug.	n.a.	n.a.	n.a.	n.a.
Latvia	1997	6.5	7.0	14.4	1.8	- 6.3	17
	1998 latest	6.4 Jan.-June	Dec.-on-Dec. 3.5 Sept.-on-Sept.	n.a.	n.a.	- 7.1 Jan.-June	n.a.
Lithuania	1997	5.7	8.4	14.1	-0.5	-10.3	15
	1998 latest	7.3 Jan.-June	Dec.-on-Dec. 3.6 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Poland	1997	6.9	13.2	11.2	-3.1	- 3.2	28
	1998 latest	5.9 Jan.-June	Dec.-on-Dec. 11.1 Aug.-on-Aug.	n.a.	n.a.	n.a.	n.a.
Romania	1997	- 6.6	151.4	6.0	-3.6	- 6.7	27
	1998 latest	- 5.2 Jan.-June	Dec.-on-Dec. 50.8 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Slovakia	1997	6.5	6.4	11.6	“N A”	- 6.9	51
	1998 latest	6.1 Jan.-June	Dec.-on-Dec. 5.9 Sept.-on-Sept.	12.1 Jan.-March	n.a.	-10.9 Jan.-June	n.a.
Slovenia	1997	3.8	8.8	7.1	-1.1	0.2	23
	1998 latest	4.8 Jan.-June	Dec.-on-Dec. 7.1 Sept.-Sept.	7.7 July	n.a.	n.a.	n.a.

Source: European Commission (1998b to k). The figures are taken from the tables on “Main economic trends” and “Main indicators of economic structure” contained in sections B.2.2 of the ten country reports, with one exception: The report on Hungary does not contain such tables, the data displayed above are therefore directly taken from the text of the report (section B.2.2) and from the statistical data annex of the report. The “Main economic trends” table in the report on Slovakia does not include general government deficit figures (“N A”), while the text itself indicates that the deficit is estimated to have reached about 5% of GDP in 1997, adding that it may have been even higher than that.

prise rehabilitation have often lacked transparency and, more generally, “the government still exerts considerable influence over the economy.” Problems in the financial sector are substantial and “are damaging overall economic efficiency.” The policy priorities that flow from this diagnosis are macro-economic stabilization, banking sector reform and enterprise restructuring, based on transparent and market-based measures.

In Slovenia, macroeconomic stabilization has remained “well established.” Growth has picked up, the fiscal stance “appears to be under control” despite a slight deterioration, and wage growth has slowed considerably. The implementation of reforms has often been “too slow,” as “[o]n the whole, the relatively favourable starting position of the Slovene economy has continued to hold back the sense of urgency for structural reforms.” Still, there has been some progress with privatization and “significant advances” on the liberalization and adjustment of administered prices. In the near future, the focus should be on “the determined and faster implementation” of planned reforms and on additional measures to improve the functioning of market mechanisms and to reduce state intervention, moreover on ensuring macroeconomic stability (in particular with regard to the evolution of the fiscal accounts).

In our view, the sections covering the macroeconomic developments since July 1997 are very well done. The accounts are thoughtfully and properly structured, perhaps with a single qualification. The sections on economic developments of nine of the ten country reports contain tables on “Main economic trends” and “Main indicators of economic structure” which give a concise overview of recent developments of the most relevant economic data. However, the English version of the report on Hungary does not contain such tables, which creates a certain unevenness.

The sections under review here provide a concise overview on key economic developments. Generally, all relevant policy measures and outcomes are covered; only in very few cases are bits of pertinent information missing (e.g. in the case of Hungary, the new venture capital law and the new Companies Act, both of which became effective in June 1998, could have been mentioned). In principle, factual developments are depicted correctly.<sup>1)</sup> The data quality is high, and the data presentation is largely consistent.<sup>2)</sup>

1 There are only very few and minor imprecisions, and they have no impact on the assessment. To give only a few examples, in the report on Bulgaria, the duration of the standby arrangement concluded with the IMF in the spring of 1997 is indicated inaccurately; furthermore, it is stated that “[i]n 1998, FDI inflows have slowed somewhat” while, in fact, in the first six months of 1998, according to balance-of-payments data, they were only a third of what they had been in the same period last year. In the report on Poland, it is stated that in the first nine months of 1998 real GDP continued “to grow at the same pace” as in 1997, while in fact growth slowed by more than a percentage point (both on the first three quarters of 1997 and on the whole of last year).

2 There are only a few slight incongruities between the data displayed in the tables and the references to the same indicators in the corresponding passages as well as some minor inconsistencies as regards the coverage of the most recent data. As to the former, the texts of the country reports refer, in several cases, to August 1998 figures while the tables contain September 1998 data on the same indicators; as for Polish unemployment, the text has the May 1998 rate, while the table exhibits the figure for August 1998. Sometimes, the text contains data on main economic indicators, which are however not displayed in the respective tables (e.g. Estonia’s budget and current account balances in the first half of 1998, measured in percent of GDP) or which do not fully correspond to the figures contained in the tables (e.g. Lithuania’s GDP growth in the first half of 1998). As regards the most recent data covered, the reports generally take into account figures released until mid-October; however, Hungary’s September inflation rate published on October 9, 1998, is missing.

The analysis undertaken in the reports is well-developed, and we generally share the essence of the Commission's assessments. Still, the sections merit a few remarks. First, on external accounts, the reports focus properly on the issue of how deficits are financed. However, it appears that there is no uniform underlying approach to judging whether the size of deficits is still within "tolerable" boundaries or whether they are already "too large." A case in point are the statements on the current account deficits in the reports on the Baltic countries, which do not take sufficiently into account, in their evaluations, that Latvia's deficit has been considerably smaller than that of the two other countries.<sup>1</sup>) Also, the summary assessment of the composite paper in this realm does not in all cases fully correspond to the results of the analysis in the individual country reports. A good example here is the judgment on the Polish trade balance, which is well analyzed and put into proper context in the report on Poland, while the composite paper simply states that it "may be too large," moreover without any differentiation with respect to ACs that have much higher deficits, while recording – at least in some cases – less advantageous macroeconomic and competitiveness-related developments.

Second, while banking sector and stock market developments are covered in an accurate and balanced manner in the ten country reports, this is not so true of some other segments of the financial sectors. The divergent accounts on developments in the insurance sectors are a case in point.

Third, on external framework conditions and their impact on economic developments in the candidate countries, we fully share the Commission's assessment that economic growth in the ACs was largely unaffected by the onset of "worsening international environment" in mid-1997. As to the Commission's analysis of the effects of the Russian crisis on the candidates, we have two basic observations. On the one hand, the Commission's overall judgment in the composite paper on the economic impact of the Russian crisis remains somewhat too general; moreover, it does not fully reflect some aspects of the assessments in the individual country reports, especially with regard to the Baltic countries. On the other hand, the assessment is not complete in two respects. Some effects of the Russian crisis on the ACs are not examined at all, or not fully examined, and the analysis itself is, in some instances, unbalanced among countries or, in the case of the Czech Republic, even missing. Going quickly through the list of actual or potential effects yields the following picture. We principally agree with the Commission that direct real economy effects on the ten ACs *as a group* will probably be limited because of the general reorientation of trade flows towards the West in recent years. Still, we would see the need for a certain differentiation among candidates, as *individual* countries' trade shares with Russia (and other CIS countries) differ substantially. In our view, the primary concern for the ACs relates to *indirect* real effects of the Russian crisis, i.e. the worsening of economic prospects in the candidates' main trading partner countries. However, the Commission does not deal with this key aspect of the Russian crisis either in the composite paper or in any of the country reports. We are aware that

<sup>1</sup> It should be noted that the composite paper does differentiate in this respect, as Latvia, contrary to Estonia and Lithuania, is not mentioned among the countries with a "strongly negative" current account.

these considerations relate primarily to the economic performance in the near future, but nevertheless this feature should probably not be completely neglected in the type of forward-looking overall assessment the Commission itself gives. Moreover, this aspect is also important for the formation of expectations and thus has an impact on current developments (e.g. investment decisions) as well.

Moving on to financial market effects, the composite paper does not deal with the repercussions of the Russian crisis on foreign exchange markets in the applicant countries. In the individual country reports, this issue is only covered for Hungary and Poland, where these effects were more pronounced than in other countries.<sup>1)</sup> Moreover, there have been considerable impacts on most candidate countries' stock exchanges. Although the leading stock indices in almost all ACs recorded considerable losses in the aftermath of the Russian crisis, the Commission deals with this particular angle only in the country reports on Hungary, Latvia and Slovakia.<sup>2)</sup> A related circumstance is the impact of the Russian crisis on the availability and the cost of foreign financing. On this, we conform with the Commission's analysis. The effect of the Russian crisis on the ACs' banking systems is not mentioned in the composite paper, but it is covered in many, though not in all, country reports. In fact, the issue of banking sector exposure vis-à-vis Russia is not tackled in the reports on the Czech Republic, Poland and Romania.

Fourth, while we do agree with the general assessment on economic developments in Slovakia, we would like to add a few qualifications on some specific issues. To begin with, while fiscal accounts undoubtedly worsened considerably from 1996 to 1997, the report on Slovakia somewhat overstates the dynamics of deterioration.<sup>3)</sup> Also, we fully share the Commission's concerns in the area of enterprise restructuring, but we think that the analysis of the respective legal framework should look not only at pure regulatory content, but should also extend to issues of implementation.<sup>4)</sup> Furthermore, the

1 *In both cases, the pressure was temporary. The zloty began to recover in September, as the report on Poland correctly states, and has in the meantime practically reached its former position in the band. The pressure on the forint abated in October. Since early November the Hungarian currency has traded around its central parity.*

2 *See sections B.2.2 of the regular reports on Hungary, Latvia and Slovakia, respectively. We fully agree with the Commission that "[b]ecause of the lack of foreign involvement, the [Slovak] stock exchange was largely unaffected by the Russian crisis." The more pronounced downturn that set in towards the end of September appears to be connected chiefly to domestic factors.*

3 *The regular report on Slovakia states that "the general government deficit is estimated to have surged from 1.3% of GDP in 1996 to about 5% in 1997. Members of the opposition at the time question the accuracy of the statistics claiming that the deficit was higher than reported." Detailed budget figures compiled by the OECD show that the general government deficit increased from 1.9% of GDP in 1996 to 4.7% in 1997. The worsening was thus 2.8 percentage points of GDP (rather than about 3.7 percentage points or perhaps even more, as the report on Slovakia suggests). Moreover, on an accruals basis, the deterioration was somewhat lower: Tax and social security payment arrears by enterprises grew considerably in 1997, partly due to the newly enacted Enterprise Rehabilitation Act (see below). The budget certainly embarked on a wrong track in 1997, and our argument is solely about the momentum of deterioration.*

4 *In more concrete terms, we fully agree that the Enterprise Revitalization Act, which provides a scheme for enterprise rehabilitation, is fraught with several unfortunate features; in particular, it has led to a worsening of the fiscal discipline of enterprises that hoped to qualify for rehabilitation. Still, it should be noted that the Act has remained largely unimplemented due to the lack of funds effectively available for debt restructuring and relief operations.*

report correctly points out the very high degree of nonperforming loans in the three biggest Slovak banks. It may have been useful, though, to put this fact into perspective by indicating that the banks have built up fairly high provisions and reserves against these bad debts. In general, the Commission is perfectly right in concluding that it is now time to take decisive action to correct macroeconomic imbalances and to tackle structural weaknesses. The underlying message of the country report apparently is that Slovakia should be in a position to catch up fairly soon in the overall accession process, if necessary moves to correct macroeconomic imbalances and to tackle structural weaknesses are taken "swiftly and in a transparent and market-based way." This would fully concur with our assessment.

Finally, when discussing macroeconomic developments and policymaking in the ACs in the accession context, one cannot do without commenting on a relatively new instrument, the Joint Assessment of Medium-Term Economic Policy Priorities. The main purpose of this exercise is to regularly review the medium-term economic and monetary policy strategies of each candidate with a focus on satisfying the Copenhagen criteria for membership in the Union and the *acquis* in the area of economic and monetary policy (coordination of economic policies, submission of convergence programs, avoidance of excessive deficits).<sup>1)</sup> The Joint Assessment is elaborated by the respective candidate country in close cooperation with the European Commission within the institutional framework of the Europe agreements.<sup>2)</sup> The progress achieved by the candidate countries so far in developing a medium-term economic strategy and in concluding the Joint Assessment exercise differs substantially from country to country and is briefly presented in chapter D.1 of each regular report, which covers the current state of implementation of the APs. According to the regular reports, only two applicants submitted a medium-term strategy and subsequently completed their first joint assessment with the Commission in the review period, namely Hungary and Slovenia.<sup>3)</sup> Sections B.2.3 of both country reports refer to the Joint Assessment, thus forming part of the Commission's overall assessment on the fulfillment of the economic Copenhagen criteria. Moreover, section B.2.3 of the report on Latvia states that the joint assessment was "in its final stages" at the time the reports were finished. Bulgaria, the Czech Republic, Estonia and Poland had finalized a medium-term economic strategy during the review period; the joint assessment, however, was only under preparation.<sup>4)</sup> For Romania, the Commission states that the country achieved some progress in preparing a medium-term economic strategy. The wording for Lithuania and Slovakia, who had not yet established a strategy, is slightly more negative.<sup>5)</sup>

1 See e.g. *Accession Partnership Hungary (1998)*.

2 *The practical work is done in the EU Association Sub-Committees on Economic and Monetary Issues.*

3 *In fact, the Joint Assessment with Slovenia has been completed recently; the one with Hungary, which was a pilot project for the new instrument, was finished in June 1997.*

4 *While this is also mentioned in section B.2.3 of the reports on Estonia and Poland as one of the elements relevant to the assessment, the respective sections in the reports on Bulgaria and Czech Republic do not contain a comparable reference. See sections D.1 of the regular reports on Bulgaria, the Czech Republic, Estonia and Poland, respectively.*

5 *See sections D.1. of the regular reports on Romania, Lithuania and Slovakia, respectively.*

In our view, by developing the Joint Assessment framework and by getting implementation going, the Commission has done very substantial work. The Joint Assessments can indeed become instrumental from three angles. First, they can facilitate a smooth fulfillment of the economic accession criteria. Second, they serve as a preparatory exercise for the applicant countries in the area of economic policy coordination within the European Union. Third, a Commission-approved medium-term economic strategy will foster the credibility of the ACs' policies and thereby improve framework conditions for investment and growth.<sup>1)</sup> In institutional terms, it was appropriate to place the instrument in the framework of the Europe Agreements. Here, we welcome the recently stated intention of the Commission to improve the involvement of Member States in the discussion process on the Joint Assessments which have been established between the Commission and the candidate countries. In a more forward-looking perspective, when drawing up Joint Assessments will have become a routine exercise, the Union will probably have to reflect on how to adapt and align institutional structures and procedures to further improve the usefulness of this instrument in preparing the applicants for actual participation in economic policy cooperation within the European Union.

#### **4 Monetary and Exchange Rate Policy and (Dis)inflation Performance**

This section reviews the main assessments of the regular reports on monetary and exchange rate policies as well as on the (dis)inflation performance of the ten candidate countries. In doing so, we concentrate on issues that are of general relevance for the economic policy posture of the ACs, while we leave the treatment of those monetary and exchange rate aspects which are specifically relevant from the perspective of the ACs' preparations for eventual integration into Economic and Monetary Union to later sections.

Much as in last year's Opinions, the area of monetary and exchange rate policy is not treated in a single chapter in each of the regular reports, but, due to the structure of the reports, it is dealt with in a number of different sub-chapters. Sections B.2.2 of all country reports contain, in their subsections on "Macroeconomic developments," one or two paragraphs on monetary policy issues which are generally of a rather descriptive nature. In some, but not all regular reports, the Commission's assessment of the country's monetary policy is to be found in sections B.2.3, which assess economic developments since the Opinions in terms of EU membership criteria.<sup>2)</sup> Moreover, a number of country reports contains an assessment of monetary and exchange rate policy in sections B.3.3, which discuss the ACs' ability to assume the obligations of membership with respect to Economic and Monetary Union.<sup>3)</sup>

1 This being so, it is somewhat unfortunate that the report on Hungary, in its analysis of economic developments in the review period, only states that actual performance has been better than foreseen in the country's 1997 Joint Assessment but does not elaborate on the main contents and the underlying structure of this benchmark.

2 See the regular reports on the Czech Republic, Estonia, Lithuania, Poland and Romania, sections B.2.3, respectively.

3 See the regular reports on Bulgaria, Estonia, Hungary, Lithuania, Poland, Romania, Slovakia and Slovenia, sections B.3.3, respectively.

The composite paper acknowledges that “inflation rates are diminishing and below the two digit level in Slovenia, Czech Republic, Slovakia, Latvia and Lithuania.” This is confirmed in the country reports which find that, during the review period, practically all candidate countries have successfully continued or returned to the disinflation process; only in Slovakia has inflation slightly increased since 1996, while still remaining well within the single-digit range. According to the country reports, monetary and exchange rate policies have played a significant role for the progress towards lower inflation in a number of ACs; in some country cases, the Commission identifies other reasons which have (also) fostered disinflation. The composite paper, in turn, does not deal with monetary and exchange rate policy developments in the ACs during the review period.

Against this background, what are the main statements of the individual country reports on the monetary and exchange rate policies and on disinflation performance? For Bulgaria, the Commission notes that the “core” of the country’s “successful stabilisation” has been “the operation of a fixed exchange rate under a currency board regime” since July 1, 1997. This monetary arrangement and the associated discontinuation of “inflationary financing of the budget deficit by the central bank” have been the “key element in the successful lowering of inflation” during the review period. In fact, already the credible prospect of the establishment of a currency board, supported by strong economic policies, reduced monthly inflation sharply in spring 1997. Moreover, “[t]he consolidation and further improvement of the macroeconomic stability will require a continued commitment to the currency board.” The currency board is also seen to have strengthened financial discipline; also, there has been a link between the board and the progress achieved in the banking sector since last year.

Similarly, the Commission commends the Czech National Bank’s “strict anti-inflationary” policy, which is identified as a main reason for the recent decline in inflation following a temporary acceleration of price increases after the flotation of the koruna in May 1997. Since August 1998, monetary policy has been eased in the light of improving inflation performance. The move from monetary to direct inflation targeting at the end of 1997 is termed “an important shift in the framework for monetary policy.” The exchange rate regime in place since May 1997 is “a managed float against the DM.” While this policy “is aimed at avoiding excessive volatility of the currency,” the Commission finds that “the value of the currency has fluctuated considerably” since May 1997. During 1998, the koruna has strengthened, but this has not hurt exports, which “have remained buoyant.”

On Estonia, the Commission states that “the limited scope for an autonomous monetary policy” in the context of the currency board arrangement, which has been in place since 1992, has “compound[ed] difficulties” in macroeconomic policy management caused by large capital inflows. Nevertheless, this limited room has been used well. The currency board arrangement and, in particular its automatic adjustment mechanism, “has functioned well despite serious strains on financial markets,” even though it has entailed “severe adjustment costs.” The report sees potential medium-term threats to the sustainability of the monetary framework, in case external accounts

and debt dynamics could not be controlled, but stresses that restrictive policy measures in 1997 and, in particular, in 1998 have “strengthened the credibility of the exchange rate commitment.” Against the backdrop of the currency board, the report very much welcomes the increasing share of foreign ownership in Estonian banks: “With the role of the central bank as lender of last resort strictly limited, easy access by banks to foreign funds (in particular via their parent company) improves confidence in the resilience of the financial system in case of a slow down of the economy or large capital outflows.” Disinflation was temporarily interrupted in the second half of 1997 and early 1998 due to higher adjustment of regulated prices, the depreciation of the DEM against the USD, and also partially to the strong growth in internal demand. Since this spring, inflation has begun to decelerate again.

The report on Hungary states that “[m]onetary policy has continued to operate within the framework imposed by [the] crawling peg exchange rate regime,” which the central bank “has maintained [in the review period] as one of its main instruments for reducing inflation.” Central bank interest rates and the rate of crawl have been gradually reduced “in an attempt to reduce inflationary expectations and moderate the growth of domestic demand,” while at the same time balance-of-payments considerations and “the pace of the recovery” have also played a role in these decisions and, in particular, their timing. The (fairly narrow) band has been left unchanged. In the wake of the Russian crisis, the exchange rate regime was put to a test, and the central bank had to intervene “to stop the forint from depreciating faster than the monthly rate of crawl and eventually was forced to raise interest rates.” Disinflation was moderate in 1997, due to the adjustment of energy prices, adverse seasonal trends in food prices and higher-than-planned nominal wage growth. This year, disinflation has accelerated “thanks to smaller increases in administered prices and consumption taxes as well as positive trends in the prices for food and imported raw materials” and despite higher wage growth than expected, which in turn is ascribed, *inter alia*, “to entrenched inflationary expectations.”

In Latvia, monetary policy “is mostly focussed on maintaining the fixed peg” to the SDR. Monetary policy has been “prudent” in recent years. Latvia has experienced substantial capital inflows, which have led to a rapid growth of money supply. This, however, “has not been a source of significant inflationary pressure,” as it has been accompanied by strong money demand growth. Furthermore, disinflation was helped by moderate wage dynamics, and in fact, “the main contribution to consumer price inflation has come from increases in administered prices.”

The Bank of Lithuania’s monetary policy, which “has been based [until now] on [a] currency board arrangement,” has been “prudent” over recent years. The currency board has also had an impact on the country’s fiscal policy, which has been geared towards “preserv[ing] the sustainability” of the monetary framework. The report takes note of the country’s gradual exit strategy from the currency board, which has been implemented “in a pragmatic and prudent manner.” In this vein, a wider set of monetary instruments has been introduced since last year “but in line with the Bank’s intention their use has been rather limited.” Disinflation has continued despite high wage

growth, increases in indirect taxes and administered prices; it has been supported “by the appreciation of the US dollar, to which the litas is pegged, and the decline in oil prices.”

The successful reduction of inflation in Poland is attributed to sound monetary policies and the better-than-expected fiscal performance, which has allowed for some relaxation of monetary policies (although real interest rates are still higher than two years ago) and thus for a more balanced macroeconomic policy mix. Relatively moderate wage growth has also supported disinflation. The central bank has “sign[aled] its willingness to fight inflation” by reducing the rate of the crawl under the crawling peg regime in operation in Poland several times. Also, it has widened the fluctuation band to  $\pm 10\%$ .

For Romania, the Commission finds that monetary policy has been tight and has operated in an improved framework, after special central bank credits to agriculture and enterprises had been discontinued. However, it is increasingly burdened by the failure to sustain structural reforms. Monetary policy has been “successful to some extent” in fighting inflation “through a strict control of the monetary base.” It has been supported by fairly restrictive fiscal policies and a gradual real appreciation of the leu under a managed float, which may, however, not be sustainable, given falling foreign exchange reserves and the ballooning current account.

Slovakia has suffered from a lack of coordination between monetary and fiscal policy. Monetary policy has been restrictive and this stance has been “necessary ... to counter excess domestic demand.” This policy also contributed to increasing the fragility of those banks “that depend on the interbank market for their financing.” The report notes that Slovakia was forced to give up its fixed exchange rate regime on October 1, 1998, because mounting devaluation pressures had generated losses of international reserves. Disinflation has come to a halt in the last two years, which is seen to be attributable mainly to high domestic demand, some adjustment of administered prices, indirect tax increases and the introduction of an import surcharge.

In the review period, Slovenia continued to operate a monetary policy framework that combines the control of monetary aggregates with a managed float for the exchange rate. It is commended for having been “successful for achieving stability and preserving competitiveness,” while its continued reliance on capital controls is criticized.<sup>1)</sup> The country has experienced some further disinflation in the review period, despite significant liberalization or adjustment of regulated prices (which in 1997 accounted for half of the rate of price increases). The report seems to suggest that disinflation has been helped by a considerable slowdown in wage dynamics.

In our view, the Commission’s accounts on monetary and exchange rate policy and, more broadly, on the (dis)inflation performance of the ACs cover key developments appropriately, perhaps with one exception, namely the immediate effects of the introduction of the euro on exchange rate pegs of candidate countries. The report on Poland deals with this issue, stating that the Monetary Policy Council of the National Bank of Poland has announced

1 We will return to this point in section 5.2.3 on the liberalization of capital movements.

its preference for redesigning, as of 1999, the current basket by reducing the number of currencies from presently five to only two, namely the euro and the dollar, while a final decision on the issue is still pending. The regular reports on Hungary and Latvia, the two other basket peggers among the candidate countries from Central and Eastern Europe, do not bring up this issue. In fact, the National Bank of Hungary announced already in spring that, as of 1999, the euro will substitute the Deutsche Mark in the DEM-USD basket to which the forint is pegged.<sup>1)</sup> Latvia, in turn, has not made any decision to change its peg to the SDR, but is contemplating a gradual move away from this basket currency, if currency shares in trade invoicing change after the introduction of the euro. In the same vein, the choice of the reference currency will have to be reconsidered by those countries which are presently pursuing a peg to the Deutsche Mark. The regular report on Bulgaria explicitly states that the existing DEM peg will be replaced by an equivalent peg to the euro as of January 1999. The country report on Estonia, in turn, does not touch upon this issue. In fact, as a consequence of the introduction of the single currency, the peg of the kroon to the Deutsche Mark will be technically changed into a euro peg. When exactly this modification will be effected is still open. At the latest, it will have to be done when the DEM loses its status as legal tender. Finally, for Lithuania, which operates a USD peg, the introduction of the euro per se will not require an immediate technical adjustment of its exchange rate regime; still, the country is pondering a move to a USD-EUR basket in one to two years.

The accounts also contain a certain dose of analytical examination of monetary and exchange rate developments and of (dis)inflation performance. However, the analysis is not developed to the same extent in all ten reports. A case in point are examinations of factors that drive the (dis)inflation process. For example, lower raw material and energy prices are likely to have helped disinflation in all ten countries, they are mentioned only in a few cases. For some countries, the impact of wage developments, changes in indirect taxes and exchange rate movements are well elaborated, while this is not the case for some other countries. Finally, inflation expectations, one of the major factors that have slowed disinflation in a number of applicant countries, is only put forward in the explanation of the Hungarian case but not for the other nine countries. A further example of a certain degree of unevenness in the analysis among applicants are the examinations of the effects monetary policy has had on banking sectors and the real economy in the candidate countries.

The depth of the analysis of exchange rate developments is not the same for all countries either. A case in point is the report on Slovakia, which, in general, touches only briefly on exchange rate issues and examines the flotation of the koruna, in particular, quite summarily, while other reports (e.g. the ones on Romania and the Czech Republic) undertake more detailed investigations into the field of exchange rates. Also, the question of the sustainability of exchange rate pegs does not always appear to be tackled in a fully balanced and thorough manner. Still on exchange rate issues, the

*1 A formal decision was taken at the end of October 1998.*

appraisal of crawling peg regimes is not fully even. While in the case of Hungary, this system as such is seen as “instrument[al] for reducing inflation,” the report on Poland only establishes a much more specific link between reductions of the crawl rate and the central bank’s “willingness to fight inflation.” In our view, preannounced crawling pegs typically demonstrate merits, compared to floating regimes, in terms of creating a transparent and predictable environment and of building credibility. Still, a crawling peg anchors inflation expectations both ways, as it establishes a ceiling as well as a floor for expectations, should not be ignored.

Furthermore, the underlying approach to the merits and benefits of currency board regimes does not seem to be wholly uniform. Clearly, the cost-benefit balance of monetary regimes can differ among countries and may shift over time, but this argument alone does not seem to be sufficient to explain why the reports on Bulgaria and, to a somewhat lesser extent, on Lithuania, focus on the advantages of a currency board while the report on Estonia is based on a much more differentiated approach.

This all leads us to conclude that the analytical depth in the regular reports may not always be fully sufficient to thoroughly assess one of the parameter for the EU membership criterion that relates to the “existence of a functioning market economy,” namely “macroeconomic stability ... including adequate price stability and sustainable public finances and external accounts.”<sup>1)</sup>

## **5 EMU Issues**

This chapter sets out to present and discuss general issues which are raised in the composite paper and relate to the integration of the applicant countries from Central and Eastern Europe into Economic and Monetary Union. Subsequently, the developments in the ten countries in the review period and the respective assessments of the Commission are treated.

### **5.1 Integrating Central and Eastern Europe into EMU: General Issues**

The composite paper’s section on Economic and Monetary Union starts with some introductory remarks on the legally proper use of some parts of EMU-specific terminology. In particular, the Commission draws “a clear distinction ... between participation in EMU – compulsory for all Member States – and adoption of the euro as a single currency.” In fact, from January 1, 1999, onwards, “the EU will be in the EMU, even though some Member States will have a derogation. The legal requirements relating to the 2<sup>nd</sup> and 3<sup>rd</sup> stage and the capacity to take on the obligations of EMU will become the EMU *acquis*.” This is why with the inception of Stage Three of EMU, “[i]t will no longer be accurate to refer to EMU as being in its 3rd stage.”

The Commission then lays out a path for the integration of candidate countries into Economic and Monetary Union. In their preparations for the eventual introduction of the euro, EU applicants will have to go through “three distinct preparatory phases,” namely the preaccession phase, the

*1* *Agenda 2000, Vol. 1 (European Commission, 1997b), restated in section II.2 of this year’s composite paper (European Commission, 1998a).*

accession phase and the final euro phase, and to meet the obligations that pertain to each of these phases.

In the *preaccession* phase, applicant countries are supposed to fulfill the criteria for EU membership. Meeting the economic criteria for EU membership “will ensure that the general economic framework – including institutions and policies – are broadly compatible with EMU,” while in this phase, there is “no institutional requirement to assess progress made on convergence criteria.” Moreover, candidate countries will have to fulfill EMU-specific legal obligations which are in principle binding for all EU Member States.

In the *accession phase*, i.e. between entry into EU and the joining of the euro zone, Member States, inter alia, have to observe “treatment of exchange rate policy as a matter of common interest and, later, participation in the exchange rate mechanism.” Also, each country has to “further adapt” its “national central bank’s statutes with a view to integration in the European System of Central Banks.” Finally, they have to make progress towards fulfilling the Maastricht convergence criteria.

The *final euro* phase will begin if and when a country complies “with the necessary conditions for the adoption of the single currency, following the examination of the achievement of a high degree of sustainable convergence.”

In our assessment, the section in the composite paper that deals with the integration of EU applicant countries from Central and Eastern Europe into EMU is well structured and raises the relevant issues.

The Commission’s plea for using the proper language and terminology is absolutely in order. In particular, it is useful to differentiate between participation in EMU on the one hand and being part of the euro zone on the other: A uniform use of terms and concepts would facilitate the debate, even if it does not change its substance. While the distinction the composite paper highlights has been adhered to in the Council Regulations on the introduction of the euro and in the legal acts of the ECB, this has not always been the case for other official EU documents and even much less so for the public discussion on EMU issues.<sup>1)</sup> On one specific point, though, the line of argumentation of the composite paper appears to be somewhat too punctilious. We do not consider it legally problematic to term the – open-ended – phase that will begin on January 1, 1999, as “Stage Three of EMU,” even after it has already begun.<sup>2)</sup>

The Commission identifies “three distinct preparatory phases” (of which in fact only the first two are indeed “preparatory”). This is, to a certain degree, a departure from the Agenda 2000 documents in which the Commission did not principally exclude a two-phase scenario in which a country would join the EU and introduce the euro simultaneously, although such a scenario was dubbed “unlikely.”<sup>3)</sup> As we have argued elsewhere, it

1 To give only one example, the *Stability and Growth Pact*, inter alia, states that “[t]his... pact in no way changes the requirements for participation in stage three of EMU, either in the first group or at a later date.”

2 This is so for the simple fact that there are a number of Treaty and ESCB Statute provisions referring to “Stage Three” which will remain effective even after January 1, 1999.

3 See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m) and Agenda 2000, Volume I, section II.1.3 (European Commission, 1997b).

may practically be ruled out, for both economic and legal reasons, that the ACs will introduce the euro simultaneously with their accession to the European Union.<sup>1)</sup> Therefore, we welcome the position the composite paper takes on this issue.

Also, the 1998 composite paper treats exchange rate issues during the phase between EU accession and the introduction of the euro somewhat differently than Agenda 2000 did. On this, Agenda 2000 stated that “all Member states shall ... be in a position to stabilise their exchange rates in a mechanism yet to be decided” and, respectively, that the newly acceding countries “are expected to participate in an exchange rate mechanism.”<sup>2)</sup> Juxtaposing the statements in the two documents, brings to light three salient points. First, the remarks in Agenda 2000 on institutionalized exchange rate cooperation concern a period that begins with EU accession, while the 1998 composite paper relates to a “later” period of the accession phase. Second, Agenda 2000 spells out what the future entrants “should” be able to achieve or “are expected” to do, while the composite paper focuses on the “obligations” of new Member States during the accession period. Third, in the 1998 composite paper, the institutional reference point for the “later” period of the accession phase is the exchange rate mechanism (apparently the ERM2), while Agenda 2000, for the period beginning with accession, refers in very general terms to an exchange rate mechanism without further specifying the design of such an arrangement.

The composite paper does not explain the reasoning behind its deliberations, nor does it lay out the causes for the shift in stress compared to Agenda 2000. While we do not intend to conjecture about the Commission’s underlying considerations, two points should not go unnoted. First, even if the 1998 composite paper does not touch upon the issue of institutionalized exchange rate cooperation in the period immediately following EU accession, the Commission continues to reflect on this issue.<sup>3)</sup> Second, the wording on exchange rate coordination in the composite paper may be open to different interpretations. In our understanding, the composite paper does not principally exclude a scenario in which new Member States would enter the exchange rate mechanism simultaneously with their accession to the European Union. The sequence the composite paper establishes between EU accession and participation in the exchange rate mechanism *solely* relates to the *obligations* new EU entrants will face, in the Commission’s view, in the *specific context* of their eventual *full integration into the euro zone*. On this, it should be noted that it is not yet fully clear whether formal membership

1 See Backé and Lindner (1996), Horváth et al. (1997), Backé and Radzyner (1998).

2 See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m) and Agenda 2000, Volume 1, section II.1.3 (European Commission, 1997b).

3 See de Silguy (1998), who holds that the exchange rate regime of the Central and Eastern European applicants is, “en général, celui du ‘crawling peg’: il se caractérise par des fluctuations de change limitées de la monnaie nationale et son rattachement à une monnaie forte (dollar et/ou deutsche mark). En conséquence, au moment de leur adhésion à l’Union, un mécanisme, des relations particulières ou un système ad hoc devront être imaginés pour les pays candidats qui ont adopté le régime de ‘crawling peg.’ Ces mécanismes s’appliqueront avant qu’ils ne soient en mesure de participer au S[ystème] M[onétaire] E[uropéen] bis.”

in ERM2 will indeed be a genuine prerequisite for an eventual advancing to the final euro phase.<sup>1)</sup>

A further remark on the Commission's catalogue of obligations pertaining to the intermediate period between EU accession and entry into the euro zone concerns the "further adaptation of the national central bank's statutes with a view to integration in the European System of Central Banks." In our interpretation, this relates primarily to the need to fully harmonize regulations in the area of monetary policy instruments. The requirement for EU membership in this respect is that all instruments be market based,<sup>2)</sup> but obviously this qualitative criterion leaves ample room for designing instruments and procedures. Even though the full harmonization of instruments is not obligatory before entry into the euro zone, candidate countries may find it useful, as we have argued elsewhere, to commence the very complex and time-consuming process of an ever closer orientation of monetary policy instruments to ECB standards even before EU accession.<sup>3)</sup>

## 5.2 The Review Period: Developments and Assessments

In presenting and discussing the developments in the review period and the Commission's assessments of those developments, we first take a comprehensive look at the main matters involved. We are deliberately leaving out of account two specific issues, namely central bank independence and the liberalization of capital movements, from the discussion in substance for the time being and keeping them for a subsequent in-depth analysis in separate subsections.

### 5.2.1 The Broad Issues

The individual country reports survey and assess EMU-related developments during the review period in sections B.3.3 (subsections on "Economic and Monetary Union"). Moreover, the EMU section of the composite paper ends with a comparative summary assessment of the overall progress made by the ten ACs in this area. It is convenient to begin our presentation of the

1 Participation in ERM2 per se is "voluntary," although all EU Member States are "expected" to join the mechanism (see European Council Amsterdam, 1997). Whether the EU Member States that do not take part in the euro zone from its outset will have to join the exchange rate mechanism in order to qualify for entering the single currency area is not absolutely clear from a legal perspective. Those who argue that such an obligation exists base this claim on the principle of equal treatment, which is to ensure that the criteria for joining the single currency area will be applied in the same way for countries that enter the euro zone after 1999, as they have been interpreted for those countries which participate in the euro area from the beginning. As the latter countries had to participate formally in the exchange rate mechanism in order to qualify, it is argued that this should also be the case for the others, with formal participation in ERM2 being the benchmark. Those who doubt this line of reasoning point to the circumstance that, in a formal sense, ERM2 may not be the legal successor of ERM1; furthermore, they refer to the fact that at least some features of the exchange rate criterion were interpreted extensively (as regards the width of fluctuation bands and the period of participation) when the Member States which will participate in the euro zone from 1999 onwards were selected. In this latter view, actual exchange rate stability would suffice and, in order to ensure equal treatment, ERM2 would be the prime reference point for assessing exchange rate stability. So far, most EU countries have supported the position that argues for formal participation, but no political decision has been taken on this issue yet.

2 European Commission (1997b).

3 See Backé and Radzyner (1998).

Commission's views with the basic statements the composite paper contains and to introduce the more detailed accounts of the country reports subsequently.

The *composite paper* begins its country-specific remarks by reviewing the assessment made in the Opinions on whether individual applicant countries will be able to "participat[e] ... in EMU as [a] non-participant in the euro area" in the medium term.

For seven of the ten countries, the composite paper "confirm[s]" the assessment made in the Opinions, while the other three – Latvia, Lithuania and Bulgaria – are "upgraded" due to their "recent progress." According to the Commission, only in the case of Romania could participation in EMU in the medium term as a noneuro country pose "serious problems." Bulgaria's entry "can now be envisaged if it continues along th[e current] reform path," and the participation of the eight other countries is said to pose "few problems," provided that reform continues and existing weaknesses are properly addressed. Furthermore, the composite paper reaffirms the conclusion in the Opinions "that it [is] still premature to judge when [the applicant countries] will be ready to adopt the euro."

The EMU sections in the *individual country reports* start out with a statement on the degree of progress achieved since the Opinions. Poland is seen to have made "good progress," Bulgaria, Latvia and Romania "some progress," Estonia "some additional progress" and the other five countries "little additional progress."

Bulgaria's advances are linked to headway made in macroeconomic stabilization, central bank independence<sup>1</sup>) and the enhanced stability of the banking system, while there is a distinct need to accelerate and deepen financial sector reforms.

The Czech report notes the change in the monetary framework to direct inflation targeting, while "[s]ignificant problems still remain in the financial sector" and central bank legislation has not been changed in the review period.

Estonia is credited for the good functioning of its currency board "despite serious strains on financial markets," for the proper use of "the limited number of monetary policy instruments" and on central-bank-independence grounds.

The Hungary report focuses on exchange rate issues and the effects of the Russian crisis on the Hungarian foreign exchange market; it also refers briefly to issues of legal and actual central bank independence.

On Latvia, the remainder of the EMU section restricts itself to mentioning a limited change of the central bank law.

The EMU section in the report on Lithuania states that the central bank "has been implementing in a pragmatic and prudent manner a strategy foreseeing the eventual exit from the currency board arrangement." It concludes by stressing the need for further realignment of central bank legislation "[i]n the course of this process."

<sup>1</sup> In line with the structure of our study, this section restricts itself to stating whether the Commission refers to changes in central bank regulations or provisions on capital movements. The substance of these regulatory changes and other related issues will be discussed in more detail later in two separate sections.

The Polish report starts out with reviewing changes in the exchange rate regime since the Opinion. It then turns to the transmission of monetary policy decisions to the banking sector, which is said to be “slow.” Furthermore, recent rapid credit expansion may pose additional challenges to banking supervision. The report concludes by presenting changes in central bank legislation.

The report on Romania notes the good functioning of the foreign exchange market, an increasing pressure on the leu, the very slow banking privatization and the “very weak” state of the financial sector. It concludes by reviewing recent changes in central bank legislation.

The Slovak EMU section sets out with a critical remark on the limited restructuring of the banking sector. It then notes that “[t]he former government tried unsuccessfully to reduce the independence of the Central Bank.” It ends by referring to the recent flotation of the Slovak koruna, after “[m]ounting devaluation pressures had generated losses of international reserves.”

Finally, the report on Slovenia commences by reviewing the country’s monetary policy framework, which has “achiev[ed] stability and preserv[ed] competitiveness, but has relied on extensive capital controls.”<sup>1)</sup> The banking sector “is not sufficiently open to competitive pressures;” the still existing interest rate cartel will expire soon. The section ends on issues of central bank independence.

In our analysis, we first focus on structure and on factual contents. Subsequently, we will discuss the Commission’s assessments.

Our observations on *structure* relate to the ten country reports. The EMU sections in the individual reports are relatively homogeneous in terms of their structure and in the fields they cover. They all start with an assessment of the degree of progress achieved since the Opinions that uses the same language – a fact which facilitates the comparison across countries. For six countries, the sections review developments in three areas, namely the monetary and exchange rate framework, the financial sector and central bank legislation. In three cases, the sections cover only monetary issues and central bank independence. In the case of Latvia, only one matter is covered, namely the central bank law, while in the case of Slovenia, limitations to capital movements are a fourth topic touched upon.

The *contents* of the sections are factually correct and accurately presented; there are only a few cases of minor imprecisions which have no real impact on the assessment.<sup>2)</sup> In some instances, the sections could have profited from a more detailed presentation of the facts covered.<sup>3)</sup>

Our remarks on the *Commission’s assessments* are twofold. First, we observe that the assessments in the Opinions are summarized somewhat inaccurately

1 The summaries in this section on the main points the Commission makes on EMU issues in the individual country reports restrict themselves to stating whether the Commission refers to the issue of capital controls. The substance of these limitations will be discussed later in a separate section.

2 As an example one could mention that, in the case of Bulgaria, direct budgetary financing by the central bank was “effectively” stopped in early 1997 and not only with the introduction of the currency board arrangement from July 1997.

3 For example, it could have been useful to state that Lithuania has not taken any further measures to effect the exit from its currency board in the last few months.

in the 1998 composite paper. According to the Opinions, the participation of the Czech Republic, Hungary, Poland and Slovakia in EMU as noneuro countries will pose “no problems” in the medium term, while that of Estonia will pose “few problems.” On Slovenia, the detailed EMU-related review in the Opinion (section B.3.3) concluded that the country’s participation would cause “no problems,” provided that it addressed some weaknesses, while in the Opinion’s Summary and Conclusions (Part C), it was stated that “some difficulties” “could” be involved.<sup>1)</sup> Against this background, it is not clear how the composite paper can conclude that the 1997 Opinions stated that the participation of the Czech Republic, Estonia, Hungary, Poland, Slovenia and Slovakia in EMU could pose “few problems in the medium term.” Proper comprehension is complicated by the fact that the composite paper, based on the progress achieved in the review period, “confirms” the assessment of the Opinion for all these countries and by the fact that the individual country reports find that more or less pronounced progress in the area of EMU during the review period can be witnessed in all ten country cases. Moreover, neither the composite paper nor the report on Slovenia sort out the assessment inconsistency the Opinion on Slovenia displayed on EMU matters.

Second, we essentially share the assessments in the individual country reports on the progress achieved in EMU matters during the review period. As regards the assessment approaches and methods, we would plead in favor of a more explicit analytical treatment of EMU-specific issues in the future. Against the backdrop of the obligations a candidate country has to fulfill in the area of EMU before its accession to the European Union, it would seem useful to address two questions as a basis for arriving at an assessment on the degree of progress achieved in the review period: First, have applicant countries made headway to “conduct[ing] ... monetary policy with market-based instruments” by removing the remaining weaknesses the Opinions pointed out?<sup>2)</sup> Second, has financial sector reform in the ten applicant countries made monetary policy more “efficient” in transmitting its impulses to the real economy?<sup>3)</sup> These issues are only rarely touched upon in the 1998 regular reports, while they were given fairly comprehensive coverage in last year’s Opinions;<sup>4)</sup> in fact, there is one reference to monetary policy instruments (in the report on Estonia) and another one on the transmission mechanism (in the report on Poland). Likewise, it may be useful to put exchange rate developments into the specific context of EMU-related obligations,

1 See Horváth et al. (1997).

2 See Opinions, sections B.3.3 (European Commission, 1997d to 1997m).

3 See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m). It should be noted that the financial sector is of threefold importance for assessing progress towards accession. First, it is significant for the assessment to what extent an AC fulfills the economic conditions for EU membership: Applicant countries have to ensure that “the financial sector is sufficiently well developed to channel savings towards productive investment” in order to be regarded as functioning market economies. Second, it is important for a country’s ability to assume the obligations of EU membership in the area of Economic and Monetary Union. Third, it has an *acquis* dimension which relates to EU directives that pertain to financial services. In this analysis, we only cover the second aspect, looking at financial sector issues purely from an EMU angle. A broader approach to financial sector issues would go beyond the scope of this study. A number of aspects that relate to the *acquis* dimension are covered by Würz and Müller (1998).

4 For a short review see Horváth et al. (1997).

rather than to merely report them. The yardstick here would be to scrutinize whether the reforms applicant countries have undertaken improve the outlook for a “stabilization of] their economies in the long-run, as well as [for] avoid[ing] disruptive movements in nominal exchange rates and misalignments.”<sup>1)</sup> To be sure, this is *not* to say that sections B.3.3 should revisit issues like monetary policy or financial sector reform in general. Rather, the point is that, based on the general review and assessment of economic developments the reports undertake in their chapters B.2, sections B.3.3 would probably benefit from some further elaboration of those issues which are particularly pertinent in the specific EMU context.

Apart from this, it remains somewhat open whether the assessments the EMU sections arrive at are solely based on the developments which these sections explicitly review - or whether developments which are inspected in other sections of the reports but are also relevant in the EMU context are also taken into account in the assessments. This question becomes relevant for some countries with regard to financial sector issues, and for all but one country with respect to the freedom of capital movements.

### **5.2.2 Central Bank Independence**

Much as in the case of last year's Opinions, the regular reports only briefly discuss the issue of central bank independence (CBI). While CBI is treated for all countries in section B.3.3, which examines the candidates' ability to join the European Monetary Union, the reports on the Czech Republic, Poland and Romania also refer to this issue explicitly in section B.2.3, where the fulfillment of the Copenhagen economic criteria is analyzed. Moreover, the composite paper contains a general reference to CBI as one obligation “to be adopted to be in place for EU accession.”

This year's regular reports concentrate mainly on the legal dimension of CBI and briefly examine whether any changes in central bank legislation were adopted since the Opinions. The regular reports rightly find that no legislative changes took place in the Czech Republic, Estonia, Hungary, Lithuania, Slovakia and Slovenia during the review period. Moreover, the Commission correctly depicts the introduction of a new central bank law alongside with the currency board arrangement in Bulgaria as well as recent changes in the central bank legislation of Latvia, Poland and Romania. Whereas in Poland and Romania entirely new central bank laws went into force at the beginning of January and July 1998, respectively, Latvia prohibited the central bank from granting short-term credits to government in an amendment to the existing law. In line with its methodology, the Commission does not undertake a specific assessment to rate the degree of progress achieved in the area of CBI. Rather, it performs a more general assessment on the candidates' ability to join Economic and Monetary Union. Only in the case of Poland is it explicitly stated that the country has made “significant progress” in the CBI realm during the review period, an assessment which contributes substantially to the Commission's broader judgment that the country has made “good progress” on all EMU-specific aspects.

<sup>1</sup> *European Commission (1997c).*

In our view, the regular reports' accounts on central bank independence constitute a good case in point for the potential drawbacks that are associated with an approach that examines the progress achieved during the review period, but does not judge the overall state of fulfilling the conditions for EU membership; in particular it is a good example that such an approach can convey a skewed picture of the overall preparedness of ACs in specific areas to those who are not fully aware of the contents of last year's Opinions.

A country-specific remark on aspects of legal CBI relates to Poland: While the Commission provides a comprehensive picture of the changes in the country's central bank law, it does not mention that Poland's new Constitution, which was endorsed by referendum in May 1997, contains a number of stipulations related to the independent status of the central bank – provisions which had not been covered either in last year's Opinion.<sup>1)</sup> In our view, the stipulation of CBI even through constitutional regulations significantly increases the degree of protection against potential attacks on legislated CBI, and should therefore not be neglected.

Four of the regular reports briefly touch upon issues of actual CBI. As a case in point, the regular reports on the Czech Republic and Slovakia mention briefly that there had been calls or even outright attempts to reduce the degree of CBI during the reference period in both countries, which, however, remained fruitless. This in itself provides some recent evidence of the importance of a high degree of legal protection of CBI even through constitutional stipulations. In the same context, the Czech National Bank is lauded by the Commission for having “demonstrated that it is able and willing to take unpopular decisions if the need arises.” Another reference to actual CBI can be found in the regular report on Poland, where the Commission acknowledges that the newly created Monetary Policy Council “... in the brief period of its existence ... has established its authority.” Furthermore, the regular report on Hungary remarks that “contrary to what has happened following previous general elections, the Governor of the N[ational] B[ank of] H[ungary] was not replaced following the May 1998 elections.” This may be understood to suggest that Hungary's turnover rate of governors as one indicator of the degree of actual CBI was particularly high in recent years.<sup>2)</sup> However, our comparative analysis of turnover rates of governors in six of the applicant countries does not confirm this assumption, with Hungary scoring better results than Poland and Estonia.<sup>3)</sup> Generally, we find it hard to fully reconstruct why selected aspects of actual CBI are examined for some applicant countries and left out of account for the others. In order to ensure a fully balanced treatment of all the ten applicant countries, it would have been more appropriate to examine major aspects of actual CBI for all candidates in a more uniform and comparable manner.

1 *The Polish constitution endows the central bank with the sole right to determine and implement monetary policy and to issue money. Moreover, it contains provisions on the bodies of the central bank, introduces a Monetary Policy Council, and stipulates appointment procedures, terms of office as well as incompatibility clauses for the Governor. Most importantly, the Polish constitution explicitly prohibits the central bank from financing the state budget deficit. See Radzyner and Riesinger (1997).*

2 *See Radzyner and Riesinger (1997).*

3 *See Dvorsky and Radzyner (1998).*

A more specific point concerns the question of whether a currency board arrangement constitutes a principal obstacle to fulfilling all the requirements the Treaty on European Union lays down in the area of CBI. On this issue, the Opinions on the three currency board countries in the region – Bulgaria, Estonia and Lithuania – did not take a fully uniform view.<sup>1)</sup> We welcome the elimination of this ambiguity in the 1998 regular reports, which apparently presume that a currency board which is operated by (and embedded in) an independent central bank can be brought fully in line with the EU's legal standards on CBI.

### 5.2.3 The Liberalization of Capital Movements

The 1998 regular reports deal with the liberalization of capital movements primarily in sections B.3.1 (The Four Freedoms, Free Movement of Capital). In some instances, the Commission touches upon the issue in other sections as well. What are the main contents of the 1998 regular reports on capital account liberalization?

According to the Commission, Bulgaria has achieved limited liberalization so far. In the review period, it has improved framework conditions for FDI through a new law, in particular by reinforcing the national treatment principle and by allowing partly and wholly foreign-owned companies to buy land.

The Czech Republic has further extended the “very substantial degree” of capital account liberalization it had already achieved at the time of the Opinion, particularly by the adoption by government of changes to the Foreign Exchange Act “which should enter into force in 1999” and will further liberalize “credits and guarantees, issuing of foreign securities on the Czech market, operations in money market instruments and derivatives and purchase abroad of currency by residents.” In a specific area, though, there was a setback, which also meant a violation of the country's Europe agreement: Companies with foreign participation were banned from operating lotteries “and similar games.”

Estonia “has been progressing” since the Opinion on doing away with “residual restrictions,” namely on the issuance of mining licenses to nonresidents, while limitations on the purchase of real estate remain.

Hungary had achieved “substantial” progress by the time the Opinion was written, and has advanced further by removing most of the remaining restrictions on medium- and long-term transactions as well as a few limitations on short-term operations. Explicitly, the report mentions permitting cross-border branching, raising the limits on the physical export of currency and granting the “full right” to “authorised resident foreign exchange banks” to “operate on non-resident accounts.” At the current stage, short-term transactions and real estate transactions remain tangibly restricted,<sup>2)</sup> but Hungary plans to lift all remaining limitations by the year 2000.

1 See the statements on this issue in the Opinions on Bulgaria, Lithuania and Estonia (European Commission, 1997d, 1997f, 1997i). See also Pautola and Backé (1998) for a more detailed discussion of what the Opinions said on this particular matter.

2 The exact wording on investment in real estate in the report is the following: “In addition, restrictions on the acquisition of real estate by non-residents remain, albeit limited to arable land, as well as purchases of real estate abroad by residents.”

On Latvia, the Commission states that the country “continues to have a liberal regime for capital movements” and fulfills the respective provisions of its Europe Agreement, except for limits on foreign investment inflows in some sectors.

Lithuania is said to have “reached already a high degree of liberalisation of capital movements” and “[t]here are no restrictions on the inflow or expatriation of capital by investment companies [sic].”

Poland had already achieved “considerable success” in liberalizing capital movements at the time of the Opinion, despite some remaining shortcomings. Since then, according to the Commission, it has taken a number of further steps, in particular the “[e]ntry into force of the new Foreign Exchange Law which will fully free current transactions and a substantial portion of capital transactions” as well as other new laws on banking, on the central bank, on public trading and on investment funds. The purchase of real estate by nonresidents is singled out as an area in which “significant limitations” persist. Still, all remaining restrictions on capital movements “should be lifted before the end of 1999, as indicated in the Polish OECD liberalisation timetable”; incidentally, this is one of four references to this international organization in the capital account liberalization section of the Polish progress report. In contrast to the other country reports, the issue of capital account liberalization is again touched upon in the conclusion of B.3.1, which states that “Poland continues to make a phased liberalisation of capital movements but the timetable for future liberalisation remains to be clarified.” Moreover, the matter of capital account liberalization is taken up again in Part D (Accession Partnership and NPAA), as further liberalization of capital movements is one of the short-term priorities laid down in Poland’s AP. In its summary of Poland’s progress in meeting these short term priorities, the Commission states that “[s]ignificant legislative steps are required in the field ... [of] liberalisation of capital movements.” Finally, in its discussion of the Polish NPAA, the Commission remarks that the program does not “clearly refer” to “some important issues ... such as ... restrictions on Acquisition of Property by Foreigners in Capital Movement.”

The report on Romania mentions the country’s adherence to the obligations of Article VIII of the IMF’s Articles of Agreement in March 1998, a point that is repeated in section B.3.8 on External policies, Trade and international economic relations<sup>1</sup>). “In the field of the liberalisation of capital movements, restrictions on outflow[s] of foreign direct investment, profits and dividends have been removed and Romania has liberalised the T-bill market for non-residents” while numerous other restrictions remain in place. The capital account liberalization section of the progress report on Romania ends by discussing the issue of financial supervision.

On Slovakia, an amendment to the Foreign Exchange Act is said to have introduced “further relaxation” since the Opinion in the areas of issuing and trading foreign securities on the domestic capital market, investment by res-

<sup>1</sup> Romania’s achievement of full current account convertibility is also reported in section B.2.2 of the country report, however without reference to Article VIII of the IMF’s Articles of Agreement.

idents in foreign securities, and the abolishment of the foreign exchange surrender requirement for residents.

Finally, on Slovenia, the Commission starts out by criticizing that the country did not take up the main recommendations of the Opinion. Consequently, "little" progress has been made, and the "[l]iberalisation of capital movements is still very slow." Capital controls introduced earlier on continue to be an obstacle to an alignment of legislation. "Nevertheless, some actions have been taken in 1998: in the field of portfolio investments (obligatory custody accounts) and external credits and loans (obligatory interest-free tolar deposits) restrictive measures [by] the Bank of Slovenia have been partially eased." This is not the only reference in the report to Slovenia's capital account restrictions. On the contrary, in section B.2.3 (Assessment in terms of the Copenhagen criteria, The existence of a functioning market economy) the Commission states that the capital account has to be liberalized further to improve the functioning of market mechanisms – a point which is highlighted again in the subsequent general evaluation section B.2.4. In section B.3.3 (Economic and fiscal affairs, Economic and Monetary Union), Slovenia's approach towards regulating capital transactions is criticized again: "Slovenia has resorted to capital controls which are an impediment to FDI flows. Restrictions on inflows are still used extensively, even though a number of ad hoc measures ... in February 1997 were subsequently relaxed in July of the same year." As in the case of Poland, further capital account liberalization is among the short-term priorities of Slovenia's AP and thus is also tackled in Part D of the report, with the Commission giving the following assessment on the progress achieved: "[A]lignment is still hindered by the restrictive measures imposed by the Bank of Slovenia, although some restrictions were partially eased in 1998."

The composite paper refers to the issue of freeing capital transactions only *en passant*, namely in its EMU section, where the "[c]ompletion of the orderly liberalisation of capital movements" is mentioned as one of the EMU-specific parts of the *acquis* that "need to be adopted to be in place for [EU] accession."

For a critical assessment of the Commission's account on the liberalization of capital movements, it is expedient to reflect first on the structure of the statements, subsequently on the factual content and finally on the Commission's evaluation. In doing this, the main focus is, for obvious reasons, on the reports' sections on "The Free Movement of Capital," while occasional references will be made to other parts of the reports dealing with capital account liberalization.

The sections on capital account liberalization are characterized by a tangible lack of uniformity in *structure*. Most, though not all, country reports contain a short introductory statement that summarizes the overall progress achieved in the realm of capital account liberalization. In some cases, this statement relates to the current status quo, while in others it refers to the situation at the time of the Opinions. Many, though not all, reports also contain an explicit statement on the degree of progress that has been achieved since the Opinions. Subsequently, the individual country sections list measures which were taken in the review period.

Another structural incongruity concerns the conclusions of the Internal Market subchapter. In the report on Poland, these conclusions take up the issue of capital account liberalization, while this is not the case in the other nine reports; there is no discernible reason for this differentiated approach.

Moving on to the *factual content* of the reports, one notices that the reports differ in the scope of facts that are covered. While most country sections are “to the point” and deal with the core matters of capital account liberalization, a few – in particular the ones on Poland and on Romania – touch upon issues which are not or only very loosely related to the heart of the matter. These differences, together with the structural disparities, are reflected in large divergences regarding length and depth of the individual examinations.

Another general observation pertains to the fact that, in some instances, there is a full enumeration of all liberalization steps (as e.g. in the report on Slovakia) while in other cases the enumeration is selective (as e.g. in the report on Hungary), but this differentiated approach is not made explicit in the individual country accounts. Some country reports also touch upon the remaining gaps in freeing capital movements, however again without fully clarifying whether gaps are listed comprehensively or selectively. Nor is it clear whether certain shortcomings which are found for several countries – like restrictions on the purchase of real estate – indeed relate solely to those countries where they are explicitly mentioned or possibly to others as well.

Do the reports expose factual developments in a correct manner? Moreover, do the reports cover all measures that are important for an assessment on progress since the Opinions? Do they also comprise all steps that deserve mentioning for reasons of presenting the ten country cases in a balanced manner? On these issues, one can conclude that, in most instances, liberalization measures are depicted correctly and without substantive omissions. Nevertheless, several imperfections can be noted.

For example, the statement in the report on Hungary that “restrictions ... remain ... [on] purchases of real estate abroad by residents” is inaccurate: As of January 1998, a foreign exchange permit is no longer required for buying or building real estate abroad by residents. Again on Hungary, the Commission states that “from 15 May 1998 ... authorised resident foreign exchange banks have received the full right to operate on non-resident accounts.” In fact, this step was already taken years ago. The measure Hungary did implement during the review period in the area of extending the scope of operations on deposit accounts by residents abroad – a measure which is not mentioned in the report – relates to liberalizing the opening of commodity exchange and stock exchange depository accounts as well as of margin accounts connected to hedging operations; this measure, though, became effective on January 1, 1998, and not in mid-May.

As regards Poland, the new act on the central bank is clearly a significant step forward towards a state-of-the-art regulatory framework, as discussed above, but, as for capital movements, the provision of article 46 should not go unnoticed, which allows the central bank to resort to a specific form of capital controls “should the implementation of monetary policy be jeopardized”:

In this case, the Bank can introduce the holding of non-interest-bearing deposits at the central bank against foreign funds utilized by banks and domestic businesses. The former central bank law did not contain such a provision.

In the case of Poland and Hungary the reports include the countries' target dates for the full liberalization of capital movements.<sup>1)</sup> For other countries, like the Czech Republic or Slovenia, which have adopted similar target dates, this is not the case.<sup>2)</sup> Indicating the target dates of all rather than only some of the countries that have adopted such dates would have been appropriate for a balanced overall presentation.

The Commission reports Romania's adherence to Article VIII of the IMF's Articles of Agreement during the review period. Although this does not fall into the narrow area of capital movements, there is a good case for mentioning it in this section, given the close connection between current and capital transactions. However, the report on Bulgaria should have mentioned that this country, too, removed the remaining restrictions on current payments and adhered to by the provisions of Article VIII in September 1998. Such a reference would seem to be justified not only for reasons of a balanced account, but also because it is a relevant piece of information for the overall assessment (beyond the evaluation on capital account matters). Again on current payments, the Polish report's reference to the new Foreign Exchange Bill contains the potentially misleading statement that this bill "will fully free current transactions." In fact, current transactions were already fully liberalized back in 1995; the new piece of legislation solely reconfirms this state of affairs.<sup>3)</sup>

Also, there are a few factual inconsistencies *within* individual reports. For example, on Slovenia two different dates ("July 1997" and "1998") are given as the time at which the restrictions on some capital movements were par-

1 *The report on Poland clearly links the country's target date to its binding obligations vis-à-vis the OECD, while no mention is made of Poland's National Programme of Preparation for Membership in the European Union, which states that the full liberalization of capital movements "should be completed in the year 2000" (Committee for European Integration, 1998). In the report on Hungary, it is left open to what commitment or intentions the given target date relates. As the report repeats, in a somewhat rephrased manner, the Opinion on this issue, the stated target date might relate to the liberalization plans Hungary had communicated to the Commission in its answers to the 1996 Questionnaire. Compared to Poland, Hungary has engaged in a legally nonbinding commitment vis-à-vis the OECD to fully liberalize capital movements by the end of the year 2000. The country's NPAA is somewhat less explicit on the timing (see Ministry of Foreign Affairs, Hungary, 1998).*

2 *In the OECD framework, the Czech Republic has declared its preparedness to finalize capital account liberalization by the end of 2001; in the National Programme for the Preparation of the Czech Republic for Membership in the European Union, the respective passage is comparatively soft: "Currently, the completion of capital movement liberalization is being contemplated for or around the year 2000" (Government of the Czech Republic, 1998). Slovenia's NPAA foresees a full liberalization of capital movements until 2001 (Republic of Slovenia, 1998), in line with the country's EU Accession Strategy (Institute of Macroeconomic Analysis and Development, 1998). Slovenia applied for OECD membership in 1996; the organization has not yet examined the country's regime of capital movements.*

3 *Moreover, in the report on Romania, it is stated that "[i]n the field of the liberalisation of capital movements, restrictions on [the] outflow ... of profits and dividends have been removed." In the standard terminology, these transactions are, in fact, cases of current rather than capital transactions. However, in the practice of the EU, it seems to be quite common to treat such transactions under the heading of capital movements (see for example Slovenia's Europe Agreement).*

tially relaxed, while the correct date is June 1997. In the case of Poland, the two statements on the timetable for further liberalization are not fully congruent, at least not on the target date for full liberalization.

Last but not least, we turn to a critical evaluation of the Commission's assessments, starting out with comments on the general issues of appraising progress and then moving on to the individual country judgments.

A fundamental issue pertains to the Commission's approach to assessing any measure that removes restrictions on capital movements wholesale as evidence of progress towards EU accession, no matter how its timing, scope and sequencing fit into the overall reform process. This appears to be too formalistic and schematic – and it does not ensure that the liberalization of capital movements proceeds in an “orderly” fashion, as is called for in the composite paper.

To genuinely gauge the progress towards EU accession in this field, a more thorough analysis would appear to be appropriate. Such an examination would be concerned with the proper timing and sequencing of liberalization measures crucial to minimizing the potentially considerable risks associated with liberalizing capital movements, while reaping its undisputed benefits. In other words, the focus should be much more on ensuring the sustainability of the opening-up of the capital account that has already been achieved and (at least in cases where the Commission analysis itself takes a forward-looking perspective) also of the steps envisaged to further deregulate capital movements.

Whereas FDI and other long- as well as medium-term flows should be liberalized early on, planning the further liberalization of capital movements needs to be carefully considered against the backdrop of the overall macroeconomic performance and the record on structural, institutional and legal reforms. In this context, the most crucial factors are a sustainable in-depth consolidation of the fiscal sector, as well as a well-functioning, resilient and effectively supervised domestic banking and finance sector.

Two examples may suffice to make this point more comprehensible. First, in the light of the overall macroeconomic situation and the state of structural reforms in Romania, one may question critically whether the timing of liberalizing its Treasury bill market for nonresidents was indeed fully appropriate. Second, if the reports present the target dates of individual applicant countries for the complete liberalization of capital movements – as some of them do – it would make good sense to put these dates into perspective by raising the awareness about the implications these targets have for overall policymaking.

A second point concerns the relevance of capital account liberalization for the assessment on the fulfillment of the economic criteria for EU accession. More precisely, can limitations or slow progress in freeing capital movements have a bearing on the record of an applicant country in meeting the criterion of “the existence of a functioning market economy,” as the 1998 report on Slovenia appears to suggest? While the issue of capital account liberalization clearly is important for a judgment in the Internal Market and the EMU areas, this is much less cogent for the functioning-market-economy criterion. The existence of a functioning market economy requires, according

to the Commission's own interpretation, that prices, as well as trade, be liberalized; however, this does not extend to capital flows.<sup>1)</sup> In line with this interpretation, none of the other 1998 reports contain a comparable criticism in the sections evaluating the performance on the market economy criterion, nor do any of the 1997 Opinions, although there are certainly cases in which liberalization is less advanced than in Slovenia. This is not to say that capital account convertibility issues should not be considered in the macro-economic and structural context. On the contrary, the lack of a more comprehensive approach that links capital account liberalization to these issues is one of the main shortcomings of the Commission's overall analysis, as we have argued. However, given the established assessment and operationalization methods, it seems problematic to use arguments related to capital account liberalization in assessing the extent to which applicants conform to the economic criteria for membership.

A third point relates to the references to commitments undertaken in the OECD framework. The OECD has undoubtedly done substantive work in the field and it is therefore useful indeed to refer to the commitments some EU applicant countries have made vis-à-vis the OECD. Still, in a report that assesses progress towards EU accession, such statements should probably be qualified or refined in order to take properly into account that the OECD Codes of Liberalisation and the EU rules on the free movement of capital are benchmarks which differ in a number of respects regardless of all common features. Moreover, such references to commitments vis-à-vis the OECD should be made for all OECD Member States from Central and Eastern Europe (and not only for Poland, as is the case in the 1998 regular reports).

The Commission's assessments on the progress individual countries have made, in legal terms, *since the Opinion* can be shared in most cases, although evaluating the Commission's assessments is complicated somewhat by the fact that not all reports contain an explicit statement on the degree of progress achieved since the Opinions. The Commission's implicit assessments are not easy to infer in all cases.<sup>2)</sup> As regards the extent of *overall* progress to date, it is not possible to fully compare all ten countries for the same reason. Apart from these general observations, the sections on the liberalization of capital movements in the reports on Poland and on Slovenia merit special discussion.

The case of Poland is one of those in which the section on liberalizing capital movements does not contain an explicit statement on the degree of progress achieved since the Opinions. In our view, the overall tone of the section and the enumeration of a number of individual measures creates a somewhat too positive impression about the progress made in legal alignment, which is in the focus of the Commission's assessment. This is so for three reasons. First, an evaluation should not fully disregard the safeguard

1 See *Agenda 2000, Vol. 1* (European Commission, 1997b), restated in section II.2 of this year's composite paper (European Commission, 1998a).

2 Moreover, the 1998 regular reports use a less homogeneous language on the gradation of progress than the Opinions, which also makes comparing exercises more difficult.

clause put into the new central bank law. Second and much more fundamentally, the new Foreign Exchange Act which is mentioned as Poland's central advance was still being discussed in Parliament when the Commission adopted and released the 1998 regular reports.<sup>1)</sup> According to the Commission's own method of basing its evaluation on "measures which have been adopted rather than those which are being prepared or are in the course of adoption,"<sup>2)</sup> this bill should not be taken into account when measuring Poland's progress.<sup>3)</sup> Third, the other steps mentioned in the Commission's account appear to improve framework conditions and do not necessarily liberalize capital movements *per se*.

On Slovenia, the assessment that little progress was achieved in the review period is principally correct. While it is clear that Slovenia has to phase out its capital controls subsequently, we would argue that the overall picture the country report conveys in the field of capital account liberalization is probably somewhat too negative. This is due to a number of facts. First, the very same issue of restrictions on capital movements is raised in five different sections of the report, with the references in sections B.2.3 and B.2.4 not really justified, as we have argued. Second, the report includes only a short and fairly general reference to the steps Slovenia has actually taken in the review period while the other country reports often present the concrete content of liberalization measures.<sup>4)</sup> Third, the report does not mention Slovenia's target date for full capital account liberalization, while the reports on Hungary and Poland do include this information. Fourth, the report does not contain a reference to the binding commitments Slovenia had undertaken in its Europe Agreement, which was signed in June 1996 and is expected to become effective on January 1, 1999, after a very

- 1 Unlike in the section on capital account liberalization, there appears to be an awareness of this issue in Part D of the Polish report on the implementation of the short-term priorities of the NPAA. Otherwise, it would presumably not arrive at the conclusion that significant legislative steps are still required in the area of freeing capital movements.
- 2 As the Commission correctly states, "[t]his method is the only one which allows for comparison and measurement, on a objective basis, of the progress really achieved on the way to accession" (European Commission, 1998a).
- 3 The case was different for the liberalization measures adopted in May 1998 by the Czech government – a fact that cannot be clearly discerned from the information the Commission gives in its account. In fact, according to the Czech Foreign Exchange Act, taking these recent steps fell into the government's competence and was effected through a decree which did not have to be approved by Parliament. The decree determines that the measures come into force on January 1, 1999; therefore, a precise date of enactment is determined (which again is not discernible from the report on the Czech Republic).
- 4 The relaxations on portfolio investments enacted in June 1997 relate to earlier measures that restricted operations in this field in February 1997 when the Bank of Slovenia obliged nonresidents to conduct portfolio investment operations through custody accounts. The custodian bank is obliged to treat such an investment as a foreign exchange exposure and must hold equivalent foreign exchange reserves against it. As a consequence, charges on these accounts are substantial. This measure was already covered in the Opinion on Slovenia. In June 1997, portfolio investment operations in shares acquired by nonresidents who undertake not to sell, assign or otherwise dispose of these securities in the subsequent seven years, except to other nonresidents who must make the same commitment for seven years, were exempted from these provisions (see Bank of Slovenia, 1998). – Finally, as regards steps undertaken to relax limitations on capital movements in the review period, we, unlike the Commission, are not aware of any actions by Slovenia in the field of "external credits and loans (obligatory interest-free tolar deposits)" that would have "partially eased" earlier measures.

protracted ratification process on the EU side.<sup>1)</sup> While it is clearly up to Slovenia to take the appropriate measures, the Union itself could have promoted liberalization by speeding up the ratification process. Moreover, the report links Slovenia's capital account restrictions closely to the design of its monetary framework. While this link clearly exists, a full analysis would also have to consider whether there are also structural and institutional impediments, especially in the financial sector, that may hinder a faster and lasting removal of capital controls.

## **6 The Commission's Assessments and Recommendations**

After this discussion of specific issues of central bank interest, we would like to broaden our focus by reviewing the Commission's overall assessments on the ten candidate countries in economic matters and, subsequently, the Commission's recommendations.

In the economic realm, applicant countries have to be functioning market economies and, moreover, they have to be able to withstand competitive pressure and market forces within the Union to meet the requirements for EU membership. To qualify for accession negotiations in economic terms, candidates have to fulfill the first criterion and should be able to satisfy the second criterion in the medium term.

In Chapter II, the Commission summarizes the assessments it has arrived at in the composite paper. The Commission regards the Czech Republic, Estonia, Hungary, Poland and Slovenia as functioning market economies. All these countries are seen to have made further progress since the Opinions, although weaknesses still remain. Slovakia is perceived to "come very close in terms of legislation and systemic features." Latvia and Lithuania have, according to the Commission, made substantial progress in becoming market economies; both countries, in particular Latvia, "are approaching the situation of Estonia in 1997," which was considered a functioning market economy in last year's Opinion. Bulgaria "cannot be regarded as a functioning market economy" despite "substantial progress," while Romania has not made any progress towards the criterion under review. Looking at the overall developments in the ten countries, the Commission registers "considerable progress ..., although ... economic conditions continue to vary considerably, because of different starting positions."

On the second criterion, Hungary and Poland "have continued to improve their ability to meet competitive pressures and should be well able to satisfy [this] criterion in the medium-term, provided that current efforts are maintained." Slovenia "should also be able" to do so, provided it speeds up the implementation of reforms. The Czech Republic "can also still be

*1 In the agreement, Slovenia committed to remove vis-à-vis the European Union sectoral and enterprise-type-specific restrictions on foreign direct investment inflows, on cross-border branching, on commercial and financial credits, on portfolio investment and on the acquisition of real estate. While these provisions will be phased in during a period of up to four years, some will become effective by the time the agreement enters into force. For example, in the area of financial credits, Slovenia will have to instantly eliminate the non-interest-bearing deposit instrument.*

considered to be able to meet [this] criterion, even though it lost some ground compared with last year." Slovakia's prospects to meet this benchmark in the medium term are rated as being "good, provided the government takes urgent steps to establish a fully functioning market economy." Estonia "is in a very similar situation, but its important external deficits continue to pose problems for lasting development, despite recent improvements." Latvia and Lithuania have made "great strides" towards being in a position to meet the criterion in the medium run. Bulgaria is perceived to also have made progress recently, while "Romania's situation has deteriorated." Thus, Hungary, Poland, the Czech Republic, Estonia, Slovenia and Slovakia should be able to meet the criterion in the medium term. For doing so, however, the Czech Republic, Estonia and Slovakia will have to put a particular stress on doing away with country-specific weaknesses. On condition of a sustained implementation of reforms, "Latvia, and to a lesser extent also Lithuania, should be able to make the progress necessary" to live up to the criterion in the medium term.<sup>1)</sup>

The Commission's recommendations can be found in Chapter VII of the composite paper. The Commission "does not feel it necessary, on the basis of the [individual country] reports . . . , to make new recommendations 'on the conduct or extension of the negotiations.'" Subsequently, the Commission focuses on seven of the ten countries reviewed in this study. It sets out by "highlight[ing] the particular progress made by Latvia. If the momentum of change is maintained, it should be possible to confirm next year that Latvia meets the Copenhagen economic criteria and, before the end of 1999, to propose the opening of negotiations." Lithuania is said to have made "[c]onsiderable progress," but additional measures and, in some areas, a longer track record are needed before the Commission can consider proposing the opening of negotiations. On Slovakia, the Commission states that "[t]he new situation . . . following the [parliamentary] elections [in September 1998] also allows for the prospect of opening negotiations," provided that the political criteria are met, "measures to correct the economic situation are undertaken" and "transparency in its operation" is enhanced. Bulgaria is lauded for "considerable progress" in the economic realm, while Romania has not made further progress on the economic front since the Opinions. Slovenia and the Czech Republic are criticized for "a worrying slow down in the rhythm of transposition and application of the *acquis* . . . . If this stagnation continued, it would create a problem for the capacity of these countries to meet their obligations as future Member States in the medium term." The composite paper then returns to a broader focus again and states that "it seems that with regard to the adoption of the *acquis communautaire* . . . the difference between the 'ins' and 'pre-ins' is not very important," which is perceived "to underline the global and inclusive character of the accession process." The Commission concludes by stating that

<sup>1</sup> *In this study, we neither present nor discuss the general assessments of the Commission on the ACs' ability to assume the obligations of EU membership and their administrative capacity to apply the acquis, as this would go beyond the core theme of our analysis. The same is true, a fortiori, of a presentation of the reports' evaluations on the political criteria.*

“whatever the place of the candidate countries in the accession process and in the negotiations, the major lesson of the reports transmitted to the European Council is that the rhythm of preparation for accession must accelerate if deadlines are to be met.” In the run-up to accession it will remain “necessary to guarantee the most objective possible measurement of the progress of each candidate for membership. This is why the Commission intends to submit further progress reports to the Council at the end of next year to allow it, if appropriate, to take decisions on the conduct or extension of the negotiations.”

In our view, the wording of the assessments in the economic realm is clear and does not leave any crucial point untouched. In particular, we welcome the revised diction of the Commission’s evaluation on Slovakia’s ability to withstand competitive pressures and market forces within the EU in the medium term. The new wording takes into account that the existence of a functioning market economy is, according to the Commission’s own interpretation of the Copenhagen criteria, a precondition for the capability to withstand competitive pressures, while the judgment in last year’s Opinion on Slovakia did not fully correspond to this basic exposition.<sup>1)</sup>

The recommendations are also formulated in a lucid manner, perhaps with one slight exception. The portions on Latvia and Lithuania may create the false impression that a country has “to meet the Copenhagen economic criteria” in order to qualify for the opening of accession negotiations. This is, of course, only true of the market-economy criterion, but not of the criterion that relates to the capacity of a country to withstand competitive pressure and market forces within the Union. In line with the overall methodology, a more exact formulation could have been, for example, “to meet the criterion of a functioning market economy and to be able to cope with competitive pressures and market forces in the medium term.”

Due to the specific focus of our study on central-bank relevant issues, we are not in a position to assess, in substance, the Commission’s overall country assessments and the recommendations that flow from these evaluations. This is so because “it is the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, that are pertinent” for the overall judgments, as the composite paper states very appropriately. A closer look at the selected areas we have scrutinized shows that the current situation in Latvia, Lithuania and Slovakia – the three countries which have, according to the Commission, a prospect of launching negotiations – corresponds, in many respects, favorably to the benchmark established in 1997.

In an overall perspective, we welcome the dynamic element in the Commission’s recommendations which ensues from its apt approach to single out “second wave” candidates by indicating that these countries are seen to have a prospect for accession negotiations and to differentiate further on how concrete this prospect is from today’s perspective. Likewise, it is appropriate to indicate important slippages which could, if they persist, threaten a country’s “first wave” status.

1 See for example Horváth et al. (1997).

Indicating the prospect for accession negotiations for some “second wave” countries, in particular, may also help to alleviate some of the concerns about potential negative effects of last year’s decision to open negotiations only with a subgroup of Central and East European applicants, mainly relating to a possible redirection of foreign investment from these countries.<sup>1)</sup> The 1998 composite paper takes up this point and emphasizes that there has not been any FDI reorientation away from the “second wave” countries. In our view, cross-border investment flows are driven by a number of factors, and it is very difficult to isolate the effects associated with the differentiated treatment of applicant countries as regards the launching of negotiations. In other words, it may well have been the case that FDI and other flows would have developed even more favorably had an alternative approach been chosen.<sup>2)</sup> In a forward-looking perspective, it will remain very important to protect the inclusive nature of the accession process. If the reform course remains on track in Latvia and Lithuania and if Slovakia takes advantage of the new situation by implementing the necessary political, macroeconomic and structural measures, it will become ever more important to ensure that Bulgaria and Romania do not fall behind too much in this process.

Overall, the reactions from the applicant countries to the 1998 regular reports has been constructive and positive. There has been little criticism and, in most respects, the Commission’s assessments and recommendations have been welcomed or at least accepted. This is also true of a number of shortcomings identified by the Commission, like for example slippages on the “*acquis* criterion.” In most of their responses to the Commission’s assessments and recommendations, the authorities of “second wave” countries underlined the need to further preparations for EU membership and, thereby, to shorten the period until the eventual opening of negotiations. Slovakia’s reaction is noteworthy, as it first asked the Commission to delay its regular report on the country for a few weeks in order to allow for some extra time to make additional progress. In the meantime, this position has been modified in that Slovakia has requested the Council to ask the Commission to prepare a supplement to its 1998 report for the European Council meeting in June 1999. This raises a basic question: Should the Council give preference to handling the assessment process in a very flexible manner in order to be in a position to react to special situations or, alternatively, should it stick to the agreed procedures, mainly with a view to preserving the credibility of the overall process through steady, continuous implementation? For Slovakia, the prospect of an extraordinary evaluation could constitute a strong impetus to accelerate reforms. However, while in principle the country would appear to have a good chance to take all the necessary measures specified in the 1998 progress report quickly, it may be questionable whether

1 See for example Horváth et al. (1997).

2 If one takes a closer look at some of the “second wave” countries, one can find good reasons for the presumption that internal factors were the main forces driving FDI dynamics in the review period. In the case of Bulgaria and Romania, political change and a fresh impetus to stabilization and reform (which unfortunately was only temporary in Romania) appear to dominate. Slovakia recorded a decrease in FDI inflows during the review period. Here, one could argue that the unfavorable domestic developments in Slovakia were aggravated by the negative signal associated with the decision not to open accession negotiations.

a time span of six months would indeed be perceived as sufficient for demonstrating sustained implementation. Finally, we welcome the Commission's concluding reference to the 1999 regular reports. Given that three applicant countries now have the prospect of joining the "first wave" in the not-too-distant future, the stakes are high indeed for next year's reports.

## **7 Conclusions**

This study has reviewed the European Commission's 1998 regular reports on the progress of the ten candidate countries from Central and Eastern Europe towards EU accession. The focus has been on those issues which are of particular interest from a central bank viewpoint. Therefore, the study has examined the reports' accounts and assessments on monetary and exchange rate policies, (dis)inflation performance and preparations for integration into Economic and Monetary Union, with a specific focus on central bank independence and the liberalization of capital movements. This has been complemented by a presentation and analysis of some selected general issues related to methodology, the broad macroeconomic picture, the Commission's overall assessments in the economic realm and its main recommendations.

In general, we conclude that the European Commission has done very valuable work drawing up those parts of the 1998 regular reports that we have reviewed in this study. Overall, these sections are well structured, properly focused, and based on accurately presented factual evidence. We also share most of the specific assessments the reports contain in the fields of monetary and exchange rate policies, (dis)inflation performance and EMU-related issues. In the detailed analysis, we highlight several features of the reports which we find particularly useful, while pointing critically to a few other points where we see room for further improvement in future regular reports.

On methodology-related issues, we argue for giving preference to comprehensive assessments which do not restrict themselves to simply measuring the progress achieved during the review period, but also judge the overall extent to which the applicants fulfill the conditions for membership. We also note a somewhat greater stress on track record issues as compared to last year's Opinions, and the fact that the review period is not clearly delineated. In the general macroeconomic realm, we essentially agree with the Commission's analysis; as for framework conditions, we maintain that the reports do not in all instances fully cover the impact of the Russian crisis on the ACs; furthermore, we underline the substantive work the Commission has done by establishing the Joint Assessment of Medium-Term Economic Policy Priorities. Monetary and exchange rate policies and (dis)inflation performance are reasonably well presented in the reports, a deepening of the analysis in some respects could contribute to further solidifying the basis for the assessments in this area. In our view, it is most appropriate that the Commission lays out a path for the integration of candidate countries into EMU. This excellent exposé has only one potential drawback: The statements on exchange rate cooperation in the period between EU accession and joining the euro zone are not fully tied in to the Agenda 2000 statements on the same issue, which makes full comprehension somewhat difficult. The sections that

evaluate the progress of candidates in the field of Economic and Monetary Union are well done. They could be further improved if some of the monetary and exchange rate issues of special relevance in the particular EMU context were analyzed more deeply. The specific portions on central bank independence are good; there is probably room for a more analytical approach to issues of actual central bank independence. Our assessment of the sections on the liberalization of capital movements is somewhat more mixed, as they contain several inaccuracies and rely on an assessment approach which appears to be too formalistic.

Due to the specific focus of our study, we are not in a position to make an assessment, in substance, on the Commission's overall country evaluations and the recommendations that flow from these judgments. Nevertheless, we have analyzed the principal approach the Commission has taken in drawing up its recommendations and welcome the dynamic element which ensues from singling out some "second wave" candidates by indicating that these countries have a prospect for the opening of accession negotiations in the not-too-distant future. Against this backdrop, the stakes are high indeed for the Commission's next series of reports on progress by applicants towards EU accession which are due in the fall of 1999.

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