The Introduction of the Euro: Implications for Central and Eastern Europe The Case of Hungary and Slovenia

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1 Introduction

This study deals with the implications the introduction of the euro has for Central and Eastern European countries (CEECs). At the current stage, it is particularly timely to look into this issue for two reasons. With the selection of the eleven EU countries which will take part in the euro zone from its onset on January 1, 1999, the preannouncement of bilateral conversion rates between the currencies of the participating countries and the designation of the members of the Executive Board of the European Central Bank (ECB) in early May 1998, the stage for the inception of Stage Three of EMU has been set. At the same time, preparations for a future enlargement of the EU to the East have entered a new phase this spring with the beginning of accession negotiations between the Union and five applicant countries from Central and Eastern Europe, notably the Czech Republic, Estonia, Hungary, Poland and Slovenia. The main focus of the analysis in this study is on two of these five countries, namely on Hungary and Slovenia. These two countries have been chosen because both of them are examples of the most advanced CEECs while, at the same time, having different historical experiences and traditions, distinct starting points in their transition to a market economy and partly divergent transition strategies, not least in the area of monetary and exchange rate policies.

The study starts out by examining the EMU-related aspects of EU Eastern enlargement (section 2). Subsequently, section 3 looks into the economic effects the introduction of the euro will have on the Central and Eastern European economies. The analysis then turns to the policy challenges EMU poses for the EU applicant countries and sketches some of the main policy responses of the authorities in the countries under review (section 4).[2]) The main conclusions of the study are summarized in section 5.

2 EMU-Related Aspects of Eastern Enlargement

According to the EU membership criteria for the CEECs set out by the European Council in Copenhagen in June 1993, applicant countries are, inter alia, required to establish a functioning market economy and to build up the capacity to cope with competitive pressures and market forces within the Union. Moreover, candidate countries have to be able to take on the obligations of membership (i.e. the *acquis communautaire),* including adherence to the aims of Economic and Monetary Union. These conditions clearly indicate: Applicant countries are under obligation to pursue *stability-oriented macroeconomic policies.* Yet, the Copenhagen conditions do not imply that the CEECs will have to meet the Maastricht convergence criteria at the time of their EU accession or even before. Fulfilling the Maastricht criteria is not a condition for joining the European Union. Macroeconomic policies should center, as the European Council in Madrid in December 1995 put it, around "the creation of a stable economic and monetary environment," as one of "the conditions for the gradual, harmonious integration" of the candidate countries into the EU. In this vein, attention should concentrate primarily on qualitative improvements (rather than quantitative indicators), i.e. on the capacity to correct macroeconomic distortions with policies and instruments that are compatible with market mechanisms in general and EU

rules in particular. Consequently, the convergence criteria should not be viewed as short-term "operational" policy targets. Rather, they are medium and longer-term points of reference for sound policymaking which must ultimately, but not necessarily upon EU accession, be fulfilled by new Member States on a sustainable basis.[3])

For economic and legal reasons, new Member States will, in all likelihood, *join the euro zone only after having acceded to the European Union.* On economic grounds, it is unlikely that newly acceding countries will be able to achieve a degree of structural adjustment by the time of their EU accession, which would put them in a position to fulfill the convergence criteria in a sustainable manner. In legal terms, acceding to the euro zone presupposes, inter alia, formal participation in the Exchange Rate Mechanism (ERM) of the EU for at least two years without devaluation.[4]) As EU membership is a precondition for joining the ERM, according to Community rules as they stand, a country cannot, on legal grounds, join Stage Three of EMU earlier than two years after having acceded to the European Union.[5])

Apart from a stability-oriented macroeconomic policy posture, applicant countries will have to meet two main prerequisites in order to participate in Stage Three of Economic and Monetary Union as non-euro area countries: first, the adoption of those parts/provisions and regulations of the EMU-specific *acquis communautaire* that pertain in principle to all EU Member States no matter whether they are euro zone countries or not and, second, the readiness to participate in institutionalized monetary and exchange rate policy cooperation within the European Union.

The *acquis dimension of EMU* relates to the Treaty provisions on the coordination of economic policies (including adherence to the regulations of the Stability and Growth Pact that are binding for all EU Member States), central bank independence, price stability as the prime objective of central bank policy, the prohibition of direct central bank financing of budget deficits, the ban of privileged access of public authorities to financial institutions and the liberalization of capital movements.

Monetary and exchange rate policy cooperation with the European Union has two main aspects. As part of their general incorporation into EU decision making, the newly acceding countries will be formally included into the EU-wide monetary policy dialogue, most importantly via the participation of their central bank Governors in the meetings of the General Council of the ECB, which will comprise – in contrast to the other ECB decision-making bodies – the Governors of the national banks of all EU countries (as well as the President and Vice-President of the ECB). It will be primarily through this body that monetary policies between euro and non-euro countries will be coordinated.[6]) A condition for meaningful participation in this concertation, and thus for EU membership, is that "monetary policy … be conducted with market-based instruments and … [that it] be 'efficient' in transmitting its impulses to the real economy."[7])

Second, upon joining the Union, the Central and Eastern European countries shall treat their exchange rate policies as a matter of common interest (Article 109 m EC Treaty). In more concrete terms, the newly

acceding countries are expected to participate in institutionalized exchange rate policy cooperation within the EU.[8]) Even though any formal decision on how to include the newly acceding CEECs into this cooperation is still some time away, it appears reasonable to expect, from today's perspective, that the institutional arrangement provided for by the ERM II will also be the basic framework for exchange rate cooperation pertinent to the countries of Central and Eastern Europe joining the European Union.[9])

3 The Economic Effects of the Introduction of the Euro on the Central and Eastern European Economies

The inception of Stage Three of Economic and Monetary Union will affect the Central and Eastern European economies through three main channels which are partly interrelated.[10]) First, the advent of the euro will impact on the CEECs through the growth effects it will have on participating countries. Second, euro interest and exchange rate developments will be critical determinants of the external economic framework conditions for Central and Eastern Europe. Third, the structural changes that Stage Three of EMU brings about or accelerates, in particular in the participating countries' financial sectors, will affect the CEECs.

Stage Three of Economic and Monetary Union will have positive medium-term growth effects for countries participating in the single currency area. Forecasts on the size of these effects have shown a considerable degree of divergence. The Austrian Institute of Economic Research has estimated that the implementation of Stage Three of EMU (if well managed) will allow the participating countries to move, in the medium term, to a growth path/trajectory which is 1 3/4 percentage points above a hypothetical scenario in which Stage Three of EMU would not be implemented.[11]) "Hard currency countries" will profit more (+2%) than "soft currency countries" (+1 1/2%).[12]) Through increased demand for imports from third countries, the positive growth effects of Stage Three of EMU will have a *beneficial impact on the CEECs' export and GDP performance.* What order of magnitude will these effects reach for the two countries under review here? Most of the demand for imports from Hungary and Slovenia to the prospective single currency area comes from "hard currency countries,"[13]) which reinforces Hungary's and Slovenia's trade gains induced by Stage Three of EMU. The additional import demand of euro zone countries from Hungary and Slovenia, resulting from EMU/Stage Three-induced real GDP effects as calculated by the Austrian Institute of Economic Research, will increase Hungarian exports by 2.7 percentage points and Slovenian exports by 2.2 percentage points in the medium run.[14]) Concomitantly, Hungary's GDP will rise by 0.9 percentage points and Slovenia's GDP by 1.3 percentage points.[15]) For other CEECs, these effects tend to be lower due to a generally smaller degree of trade integration with euro zone countries.

These positive effects will probably be weakened by two countervailing sets of factors. First, the implementation of Stage Three of EMU will intensify the trade of goods and services within the euro zone, as currency risks are done away with and transaction costs are reduced within the single

currency area. This would also imply that some trade of euro zone members with third countries is redirected towards intra-single-currency-area trade. According to estimates of the European Commission and the IMF, such *trade diversion* effects, however, will not be significant.[16])

Second, *prospective exchange rate developments of the euro* vis-à-vis other currencies and, in particular, vis-à-vis the U.S. dollar may affect the CEECs' trade with countries participating in the euro zone through changing real effective exchange rates.[17]) This is especially relevant for those CEECs whose currencies will be pegged or oriented towards one currency (usually the euro) rather than being linked to a basket that reflects trade invoicing shares. The Slovenian authorities have aimed at keeping the tolar's real exchange rate to the DEM fairly stable within the framework of a managed float regime. If Slovenia follows a euro orientation after the inception of Stage Three of EMU, the country's net exports will be affected by potential future exchange rate movements of the euro against the USD. The IMF staff estimates that a 10% appreciation of the euro (against the dollar) could lead to "a current account deterioration of 1 to 3 percent of GDP and could lower cumulative real GDP growth by roughly the same amount over a four-year period" for transition countries with a euro-oriented exchange rate policy.[18]) In 1997, roughly four fifths of Slovenia's exports and three fourths of its imports were invoiced in currencies which will be replaced by the euro, while USD shares were at 14% for exports and 19% for imports.[19]) Due to the prospective high share of euro-invoiced trade in Slovenia's overall foreign trade from 1999 onwards, the effects of potential exchange rate movements between the euro and the USD on Slovenia's current account can be expected to be at the lower end of the range mooted by the IMF.[20])

Hungary, in turn, has linked the forint to a currency basket consisting of the DEM (70%) and the USD (30%) under a crawling peg regime. Invoicing shares for Hungary's foreign trade correspond fairly closely to the composition of the basket to which the forint is linked.[21]) Thus, if Hungary sticks to the current basket, exchange rate movements of the euro against third currencies should only have negligible effects on Hungary's real effective exchange rate and thus on its net exports.

How will the introduction of the euro affect the *capital movements* of Central and Eastern European countries? The factors which will cause some trade diversion may also bring about a certain reorientation of *FDI flows,* as some foreign direct investment from euro zone countries may be (re)targeted to other euro zone members rather than to the CEECs. On the other hand, increased demand from the euro zone for imports from the CEECs will induce additional foreign direct investment in the transition countries. This will mitigate FDI diversion effects, and the net impact on foreign direct investment flows to the CEECs will presumably be small.

As to *portfolio investment flows,* the picture is more complex. Russo argues that the advent of the euro should stimulate portfolio capital inflows to the CEECs. In the wake of the convergence of yields between euro zone countries, investors – in a desire to maintain the yield/risk combinations underlying their portfolio diversifications – will turn increasingly to securities from the transition economies. The five CEECs which have started

accession negotiations with the EU "all of which offer assets with higher-yield/higher-but-moderate-risk combinations ... seem particularly well positioned to replace the southern EU countries in the portfolios of international investors." Other changes induced by Stage Three of EMU – the higher synchronization of business cycles within the euro zone, an accelerated securitization process in the euro area, and the reclassification as domestic-currency investments of assets held by institutional investors in currencies to be replaced by the euro – could intensify these portfolio shifts.[22]) Interest rate developments within the euro zone will either moderate or further reinforce the interest-sensitive parts of portfolio capital flows. If euro interest rates are low, the relative attractiveness of assets from advanced transition countries would rise further ceteris paribus. Conversely, higher euro interest rates would presumably moderate such a portfolio restructuring process.[23]) It goes without saying that factors unrelated to EMU, e.g. the Asian crisis or turbulences in the Russian financial market, could also generate portfolio capital flows into or out of Central and Eastern Europe – flows which could either add to or offset the additional non-FDI capital inflows to the CEECs induced by the advent of the euro.

Prospective developments of the euro interest and exchange rate not only affect trade and investment flows, but also the debt service burdens of Central and Eastern European countries. Changing euro interest rates would obviously alter the CEECs' interest payments, a factor which will be important for countries with sizeable foreign debt denominated in euros or in currencies to be replaced by the euro. Furthermore, debt service ratios may change due to exchange rate movements of the euro to third currencies, while the magnitude of the effect will hinge upon the size and the currency-denomination structure of foreign debt, the exchange rate regime and the extent to which such risks are hedged.

Last but not least, the inception of Stage Three of EMU will have a considerable impact on *financial sector developments* in the CEECs. The financial sectors of Central and Eastern European countries are experiencing substantial changes and, given the objective of integration into the EU's single market, the momentum of this process can be expected to remain strong in the next years. The integration and transformation of the financial sectors of countries participating in the single currency area induced by the inception of Stage Three of EMU will have spillover effects on Central and Eastern Europe, which will further accelerate the dynamics of change in the transition economies' financial sectors. Over the next few years, this additional impetus will be especially pronounced for those CEECs (like Hungary) whose financial markets are most open to foreign participation and activity and which have made most progress in bringing the regulatory environment into line with international (EU) standards.[24])

4 Policy Challenges for EU Applicant Countries

The preceding analysis suggests that the introduction of the euro poses or sharpens a number of policy challenges to the EU applicant countries from Central and Eastern Europe. Some of these issues will become directly relevant only in the medium to longer run while others will have to be tackled in the more immediate future, and in some respects already today. While most of the challenges are closely linked to the EU accession aspirations of the CEECs, a few will require action by the candidate countries irrespective of their future integration into the Union.

4.1 Policy Areas Affected by EMU

Against the backdrop of the deepening monetary integration within the European Union, what are the policy fields that will require the particular attention of the CEECs' authorities?

First, the advent of Stage Three of EMU further accentuates the need for sound and consistent macroeconomic policies in Central and Eastern Europe. Stability-oriented policies are not only a general prerequisite for accession to the European Union and, eventually, to the euro zone. Healthy macroeconomic policies will become ever more important in the years to come, as the CEECs will subsequently remove the remaining restrictions on capital movements,[25]) while, at the same time, they will presumably be exposed to an increase in (non-FDI) capital inflows induced by the implementation of Stage Three of EMU. While such flows have beneficial effects – they can raise the efficiency of capital allocation and may be used to finance additional investment, which, in turn, would enhance the growth perspectives of capital-importing countries – they also carry a number of risks: In particular, they increase the countries' exposure to sudden changes in capital flows, which can lead to serious macroeconomic turbulences and financial sector turbulences.[26]) In order to minimize these downside risks, lasting and solid macroeconomic consolidation, in particular in the *fiscal sector,* is a crucial necessity.[27])

Overall, Hungary and Slovenia have followed appropriate *macroeconomic policies* in recent years. Hungary has greatly reduced its twin deficits since 1995. Simultaneously, inflation has been brought down to levels clearly below 20%. Slovenia had a roughly balanced budget from 1994 to 1996 and recorded a modest deficit in 1997. Its external position is essentially sound. Inflation in Slovenia has been in the high single digits for the last two and a half years and has been slightly declining. In both countries, commitment in general remains strong to continue sound macroeconomic policies and structural reforms.[28])

In the fiscal field, tackling the existing structural problems will be instrumental in assuring and further reinforcing the sustainability of the consolidation achieved so far. The need for reforms is especially pronounced in the social security system, and Hungary, in particular, began to act on this front last year with the adoption of a comprehensive old-age pension reform program, while in Slovenia a major revamping of the old-age pension system is still in a preparatory phase. A lot remains to be done, i.a. on the disability pension system or in the area of health care, or in other sectors like education

or administrative reform. There is a need to further improve revenue collection, to reform local finances and to find adequate revenue sharing formulas and, in the case of Slovenia, to introduce a value-added tax (which is planned for next year). Some of these reforms – in particular in the pension, health and education systems – will require additional expenditures in the short to medium run, while leading to efficiency gains and cost reductions only in the longer term. At the same time, the fiscal authorities will be confronted with a number of further challenges: While customs duties, a relatively important revenue category, will go down, expenditures will be under increasing upward pressure due to public investment financing needs in infrastructure and environment, the costs of legal harmonization and administrative preparation for EU membership and perhaps also due to potential necessities to eliminate remaining or resurging financial sector weaknesses.

In the general macroeconomic picture, reducing inflation to low single-digit levels is the main challenge of economic policymaking in the advanced CEECs. A significant further lowering of inflation will be a demanding task, given the persistence of several elements of cost-push inflation, the deep entrenchment of inflationary expectations, the limited scope for further fiscal tightening and potential monetary management problems resulting from capital inflows. Important cost-push factors relate to the adjustment of the remaining regulated prices to full cost-recovery levels (a process that has essentially been completed only in Hungary so far)[29]) and to nominal wage pressures, in particular if wages rapidly adjust to past inflation as a consequence of rigid inflation expectations. Nominal devaluation/depreciation of the exchange rate may uphold or even increase inflationary pressures, both through cost and expectations channels.[30]) Imperfect competition and, generally, delays in specific areas of enterprise and financial sector reform may also hamper disinflation.

EMU will have a number of implications for the monetary and exchange rate policies of Central and Eastern European countries. Countries that peg their currencies to a currency or a basket of currencies to be replaced by the euro will have to adapt their exchange rate regimes with the inception of Stage Three of Economic and Monetary Union. For basket peggers, such technical adjustments could also offer an occasion for deliberations of a more strategic nature, namely to lower the USD share in the baskets or even to opt for an outright peg to the euro.[31]) These considerations are relevant for Hungary, which will have to replace the Deutsche mark in its basket. In fact, Hungary has already announced that the euro will substitute the DEM as of 1999. For the time being, however, Hungary will not change the weights of the basket currencies for reasons of export competitiveness. In the view of the Hungarian central bank, the euro may tend to appreciate against other currencies and, in particular, the U.S. dollar during the first phases of Stage Three of EMU, which could negatively affect Hungary's export-led growth strategy if the forint were to be pegged to the euro prematurely.[32])

In a similar vein, Slovenia will have to take a decision before the end of this year on how to replace the Deutsche mark as the de facto reference currency for its exchange rate policy as of 1999. Presumably, a euro-oriented exchange rate policy will supersede the DEM-oriented stance.

In a more forward-looking perspective, both countries will have to meet the EU standards on exchange rate policies and, in particular, get ready for participation in EU exchange rate cooperation. Provided that the ERM II arrangement will constitute the basic framework for exchange rate concertation between the euro zone and newly acceding Member States, Hungary would have to phase out the crawling peg regime it adopted in March 1995. Over the last three years, Hungary has already made some headway in this direction, reducing the automatic monthly devaluation rate step by step from 1.9% per month to 0.8% (see Table 3). The Finance Ministry and the National Bank have declared their intention to retain the crawl until single-digit inflation has been achieved. This would imply that the current regime would not be changed before 2000, when it is hoped that inflation will have been reduced to below 10%.[33])

Slovenia will have to tackle the basic issue of whether to switch to a fixed exchange rate system or to retain the float during the remainder of the preaccession period. If the country opts for the former, difficult questions of timing and regime design will have to be answered. Since 1996, there has indeed been some discussion on whether Slovenia should move to a peg regime. Still, there seems to be a broad consensus among policymakers for maintaining the currently pursued fairly successful exchange rate regime. Consequently, the policy objective for the next few years, stated in Slovenia's National Program for the Adoption of the Acquis communautaire (NPAA) adopted in March 1998, is to "stabilize the exchange rate of the tolar under the current administered floating exchange rate regime."[34]) In the view of the Bank of Slovenia, substantial further progress towards stability and consolidation will be required before pegging the tolar to the euro.[35]) This suggests that a regime change towards a formally fixed exchange rate system will probably occur rather towards the end of the preaccession period or in the context of EU accession.

The effects the introduction of the euro will have on capital flows to the CEECs may further accentuate the trend towards more flexibility which has been characteristic of the exchange rate policies of a number of the advanced CEECs over the past years, although less so for Hungary and Slovenia than for some other advanced transition countries (e.g. Poland, Czech Republic). EU accession aspirations and deepening economic integration may, however, work in the medium run against any policy moves which would greatly expand exchange rate flexibility. What is important for the CEECs in the runup to EU accession is to avoid any disruptive movements in nominal exchange rates and real misalignments that could (be perceived to) threaten their prospective inclusion into the EU single market.[36])

In the case of Hungary, a widening of the exchange rate band would be the primary step to make the exchange rate regime more flexible. Currently, Hungary's intervention band has a width of 2.25% on either side of the central rate. Unlike in other peg countries in Central and Eastern Europe, it has not been widened during recent years.[37]) Hungary has considered a widening of its intervention band to ±4.5% since last year. The central bank's 1998 Monetary Policy Guidelines state that a widening of the band during the course of this year could be conceivable, provided that

macroeconomic indicators develop as expected or better.[38]) During the first months of this year, the authorities have, at several instances, stated that a widening of the band is not on their immediate agenda.[39]) Most recently, in its comments on the outgoing government's guidelines for next year's budget, the National Bank of Hungary took a positive stance towards a widening of the band.[40])

In the first four months of 1998, non-FDI capital inflows to Hungary increased substantially. The country's financial account recorded a surplus of USD 1,938 million. Thereof, USD 1,759 million were net portfolio investment inflows; the net direct investment balance was at USD 395 million, and other investment recorded a net outflow of USD 215 million.[41]) Capital inflows appear to have subsided in the immediate aftermath of the May 1998 elections due to some uncertainty about future political developments in the country.[42]) As a consequence of the designation by Fidesz-MPP of respected candidates for the positions of Finance Minister and Minister of Economics and their first economic policy pronouncements (which signaled a broad continuity of macroeconomic policies), uncertainty has already been reduced tangibly. Remaining concerns would be further dispelled by the formation of a government with a program in line with recently voiced policy intentions, thereby removing the main factor behind the recent downturn in inflows.

At the current stage, it is perhaps too early to fully assess the underlying reasons for the capital inflow surge that occurred during the first four months of 1998 and to determine, in a conclusive manner, whether the underlying reasons for these flows are of a temporary or of a more permanent nature. Still, it is quite possible that a significant part of these inflows has been induced (as outlined in section 3) by the search of portfolio investors for alternative higher yield/moderate risk assets, after interest rates converged at low levels in the eleven euro zone countries. How will Hungary cope with these inflows if and when they continue after the current pause? Sterilization would be very costly, the room for (accelerated) interest rate reductions is probably small, and a tangible tightening of the fiscal stance cannot realistically be expected before next year. Thus, widening the intervention band may be the only short-term measure that could help contain these inflows by "throwing risk into the wheels" of interest-sensitive short-term capital movements. Still, it is not really clear whether such a policy measure would indeed be effective. If the current surge were only the beginning of a more substantive portfolio shift, the exchange rate would just move to the upper end of the (moderately) extended band without reducing capital inflows but possibly hampering, to some extent, export competitiveness.[43])

Despite the difference in exchange rate regimes, the case for more exchange rate flexibility appears to be similar for Slovenia too, as the tolar, due to regular central bank intervention, has displayed little (nominal) volatility against the DEM. At least for the near future, there is one main difference, though: Slovenia has had a more restrictive stance on non-FDI capital movements than Hungary,[44]) which has helped to contain inflows so far. In a more forward-looking perspective, when Slovenia moves further

ahead with freeing capital movements, the question of whether to extend exchange rate variability in practice (within the overall context of moving towards a peg regime in the medium run) in order to discourage capital inflows will arise in a similar manner as it has in Hungary.

Upon EU accession, the ERM II would appear to be the obvious frame for institutionalized exchange rate cooperation between the newly acceding Member States and the euro area. Participation in the ERM II would seem to be beneficial for the CEECs, as it could tangibly enhance the credibility of the CEECs' policies, thereby moderating exchange rate variations and facilitating nominal and real convergence with incumbent EU countries.

The Hungarian authorities have not taken a (publicly announced) position on how they envisage the country's participation in EU exchange rate cooperation upon EU accession, as this is not an issue which has to be settled in the near future. Nevertheless, there seems to be a clear inclination towards ERM II membership from the outset of Hungary's EU membership.[45]) Slovenia has, in principle, declared its intention to join the ERM II, with accession to the ERM II taking place at the same time as or shortly after entry into the European Union.[46])

What are the EMU-related challenges to monetary policy? As a condition for joining the EU, applicant countries have to effect monetary policy through market-based instruments. Hungary and Slovenia have based their monetary policy primarily on standard indirect policy instruments for several years already. Against the backdrop of EU accession, there are no substantive adjustment needs in this area, with one major exception: As Hungary and Slovenia are opening their banking sectors to the EU, mandatory reserve requirements, which are high in both countries,[47]) will have to be reduced in order to offer domestic banks a level playing field with foreign competitors. Even though full harmonization of instruments with the euro zone is not required before entry into Stage Three of EMU, it should still be commenced at a relatively early stage to match the sophistication of monetary policy instruments in place within the euro zone, and to eventually meet the need for all national central banks in the euro area to be ready to implement monetary policy decisions taken by the ECB fully and in the smoothest possible manner from day one of participation in the single currency area.

The conduct of monetary policy and, in particular, its room for maneuver will obviously be affected by the course on exchange rate policy. In this context, changing degrees of exchange rate flexibility over time are of special relevance. A specific challenge to monetary policy could emerge in transition economies in which multinational companies play an important role. These firms may wish to use the euro not only for cross-border transactions or accounting purposes but also for effecting domestic payments. If the latter is allowed or tolerated (and in fact, in a liberalized environment, it may not be easy to enforce restrictions in this field), monetary policymaking could be severely complicated.[48])

Another policy domain substantially affected by Economic and Monetary Union is *financial sector reform.* A properly regulated and skillfully supervised, sound and competitive financial sector is, in itself, a condition for entry into

the EU. From a more narrow EMU-oriented perspective, a well-functioning financial sector is important primarily for two partly interlinked reasons. First, healthy banks and functioning, sufficiently deep money and securities markets are preconditions for an effective transmission of monetary policy impulses to the real economy,[49]) which in turn is a prerequisite for effective participation in EU monetary policy cooperation. Second, alongside with fiscal consolidation, they are the key to limiting the risks associated with increasingly liberalized capital movements and increases in the magnitude of prospective flows related to the introduction of the euro.[50]) At the same time, the inception of Stage Three of Economic and Monetary Union itself will further speed up change in the financial sectors in Central and Eastern Europe.[51]) Increased competitive pressure from the euro zone financial market will also make it more demanding for the CEECs' domestic financial sectors to become sufficiently competitive for integration into the EU single market.

Table 1

The Financial Sector in Hungary and Slovenia

Some key indicators (1997)

	Hungary	Slovenia
Number of banks	40	28
Combined balance sheet of banks / GDP	71%	70%
Share of private ownership in the banking sector	79%	n. a.[1])
Share of foreign ownership in the banking sector	61%	12%
Average risk-weighted capital adequacy in the banking sector	17%	19%
Pre-tax profits / balance sheet in the banking sector	1.2%	1.0%
Market capitalization / GDP	35%	14%
Turnover at the stock exchange / GDP	80%	4%

[1]) *Due to the current process of companies' ownership transformation, this figure is not available for 1997.*

Financial reform has made substantial headway in Slovenia and, in particular, in Hungary. A number of weaknesses in the sector has been removed or mitigated, and the overall development of the financial systems in both countries has been positive in recent years. In the wake of being consolidated, most banks have increased their profitability, have strengthened their capital adequacy ratios and have tangibly reduced the share of bad loans. Bank privatization has been essentially completed in Hungary, while it is still at a relatively early stage in Slovenia. Foreign participation in the sector is very high in Hungary, while it has remained fairly low in Slovenia. Concentration in the sector has proceeded, competition has significantly increased (more so in Hungary than in Slovenia)[52]) and the diversity range of financial services has increased and their quality has improved. Money and securities markets have in general developed dynamically, and the role of the stock exchange has greatly expanded, in particular in Hungary. Prudential regulations have been strengthened, and supervision has been considerably tightened. Despite all these improvements, much remains to be done to further broaden and deepen the financial systems in Hungary and Slovenia (as well as in other advanced transition countries) to continue strengthening, in a transparent manner, the soundness of the financial sector in general and that of its weaker players in particular, to improve efficiency and sophistication, and to further open the domestic market to foreign financial institutions.

The advent of the euro accentuates the need to accelerate the reforms of the financial systems in the CEECs in order to continue to reduce fragility in the sector. Moving further ahead with the adoption, implementation and enforcement of the EU rules and standards on financial services will help facilitate the reform process.[53]) A further strengthening of supervision of financial institutions (and in particular the strict application of state-of-the-art prudential regulations) is of extraordinary importance in a context of rapid change. In fact, it is becoming ever more clear that this is and will, for the foreseeable future, remain one of the main challenges on the agenda for policymakers in Central and Eastern Europe.

The adoption of the EMU-specific *acquis communautaire* pertaining in principle to all EU Member States is another precondition for entry into the European Union. In this study, the focus is on two areas which stand out due to their particular bearing on the monetary realm: central bank independence (understood in a wide sense) and the liberalization of capital movements.

Hungary and Slovenia have made major progress over the last years in these two areas.[54]) Both countries have already come fairly close to the EU standards on central bank independence. The central bank laws of both countries concur broadly with the gist of the EU provisions on institutional and personal independence, although several specific provisions will still have to be brought fully in line with EU norms.[55]) Price stability has not been laid down unequivocally as the prime objective of central bank policy in Hungary's and Slovenia's central bank laws, although in practice it has been a very important or even the principal policy goal for both central banks. Hungary and Slovenia have strictly limited direct lending to the government by the central banks in terms of amount and maturity, but have not yet fully interdicted such lending. There is a general intention on the side of the policymakers to undertake the remaining necessary legal changes in the course of the next few years.

Slovenia completed the liberalization of current account transactions by declaring its national currency to be convertible according to Article VIII of the IMF's Articles of Agreement on September 1, 1995. Hungary did so four months later. Hungary has made major progress in freeing capital movements, primarily in the context of its accession to the OECD in 1996. Basically, most inward flows have been liberalized by now with the exception of short-term movements, while the deregulation of outward transactions has proceeded somewhat more slowly. The country aims at achieving full or close-to-full capital account liberalization by the year 2000 or shortly thereafter.[56]) Slovenia has achieved an intermediate state of capital account liberalization. Some capital controls which were (re)introduced on foreign nontrade-related loans in 1995 and on portfolio investments in early 1997 constitute a certain setback in the overall liberalization process. These restrictions will have to be phased out over the next few years, and the authorities have committed themselves to take actions to this end.[57]) In fact, Slovenia's declared intention is to move to full liberalization by 2001.[58])

The preceding analysis has clearly shown that legal harmonization in the area of capital account liberalization – just as adapting to the *acquis*

communautaire in a number of other fields – is not only a narrowly legalistic exercise. Rather, the example of freeing capital movements demonstrates very well that the development of a country's legal basis towards EU standards raises all sorts of both macro- and microeconomic issues. Against the backdrop of Slovenia's and Hungary's progress with macroeconomic stabilization and financial sector reform, it would seem that the gradual approach followed by the two countries has basically been appropriate (with a certain qualification for Slovenia as regards a few specific aspects of the capital controls put in place in 1995 and 1997). Moreover, plans of the two countries for further phased deregulation appear to be broadly appropriate.[59])

A major open question, in this context, is whether candidate countries should aim to achieve full and unconditional liberalization by the time of their EU accession or whether it would make sense to reach agreement with the Union on retaining, temporarily, a few precautionary restrictions on capital flows. More precisely, it is conceiveable that the CEECs keep, for some time after joining EU, well-defined safeguard provisions which would allow the reinstatement of strictly transient controls on short-term interest-sensitive capital inflows in emergency situations (including a concrete time schedule for their subsequent outphasing), after having reached an agreement with the other EU Member States and in consultation with the ECB and the European Commission. Provided these measures could be implemented with some reasonable short-run effectiveness, they would give the authorities in the CEECs some breathing space which could be used to put together a package of corrective measures. In fact, the EU regulations on short-term capital movements are the only part of the EMU-related *acquis communautaire* that is obligatory for all EU Member States in which the EU may be ready to accept transition periods.

Finally, the advent of the euro will affect the CEECs' management of their *foreign debt* and *foreign exchange reserves.* The former is more relevant for Hungary than for Slovenia: Despite a significant reduction over recent years, Hungary's foreign debt is still substantial/at a high intermediate level.[60]) In general, applicant countries "should try to gear their effective debt composition towards [the basket or the currency to which their national currencies are pegged or oriented]"[61]) in order to avoid major negative effects in the area of foreign debt management resulting from interest and exchange rate changes.

Expectations about prospective euro interest and exchange rate movements will influence the management of official reserves and, in particular, the prospective currency shares of foreign exchange reserves held by the central banks from Central and Eastern Europe. Here, the question of risk spreading will come in as well: With the introduction of the euro, the stock of foreign exchange reserves they hold will become much more uniform in terms of currency variation. The desire to maintain a given degree of diversification may also make reserve managers adapt the currency weights of their foreign assets or even take additional currencies into their reserve portfolios.

4.2 Prospects of Monetary Convergence

Against the backdrop of the unfolding implementation of EMU and improving macroeconomic performance in the advanced CEECs, the question arises of how speedily these countries should proceed further towards stability in general and towards the Maastricht convergence criteria in particular. Should the vanguard CEECs strive to fulfill these benchmarks as early as legally possible? In other words, should the target date for accession to the euro zone be two years after EU accession, which would imply that the reference year for the fulfillment of the fiscal and monetary Maastricht criteria would be year one of their EU membership? Or would the countries be better advised to envisage a longer preparatory period for full monetary integration?

Table 2

Macroeconomic Performance of Hungary and Slovenia in 1996/97

against the Backdrop of the Monetary and Fiscal Convergence Criteria of Stage Three of EMU

		Average inflation	Average interest rates for long-term government bonds (proxy)	Public sector balance/GDP	Public debt/GDP
		in %			
Reference value	1996	2.5	9.1	−3.0	60
	1997	2.7	8.0	−3.0	60
Hungary	1996	23.6	25	−3.3	74
	1997	18.3	16	−4.6	64
Slovenia	1996	9.9	24	+0.3	33
	1997	8.4	21	−1.5	32

Explanatory remarks: The figures presented in Table 2 can only be understood as *approximate orders of magnitude,* since the statistical methodologies have not yet been harmonized with EU standards. Long-term interest rates are especially difficult to measure in the CEECs. This results from the fact that none of the candidate countries has been in a position to issue 10-year fixed-interest government bonds, which are the benchmark for establishing yield figures. Applicability problems are even more pronounced with respect to the Maastricht *exchange rate* criterion (see Table 3), given that non-EU members do not participate in exchange rate arrangements within the Union. The data displayed in Table 2 are defined as follows: Reference values for inflation and interest rates relate to the unweighted average of the three best performing EU countries plus 1.5 percentage points (inflation) and 2 percentage points (interest rates) respectively. Inflation refers to the rise of the consumer price level (average annual rate). For long-term interest rates, the following proxies were used: for Hungary the yield of fixed-rate government bonds, primary market, weighted average (for 1996 three-year bonds, for 1997 five-year bonds); for Slovenia weighted annual average interest rates on tolar-denominated long-term loans extended by commercial banks for the financing of capital assets. It should be noted that this proxy yields very high rates for Slovenia, while the only available alternative indicator, namely the yield of ten-year DEM-denominated government bonds issued in 1990 listed at the Ljubljana stock exchange (but

very illiquid), would suggest an inconceivably low level of interest rates, namely 9% for 1996 and 8% for 1997. Slovenian experts guess that undistorted long-term interest rates for government bonds would have been in the rough order of 15% for 1996 and 1997 (see Lavrac 1998). The public sector deficit/GDP data are based on general government deficit figures as indicated by national sources. According to Russo (1998), actual general-government-balance/GDP figures are higher than indicated by the national source (especially in the case of Hungary), as some revenue items should indeed be classified as financing items. It should be noted that the rise in the Hungarian budget deficit from 1996 to 1997 is largely due to technical reasons; it results from a shift of public debt from the balance sheets of the central bank to the budget. Public debt/GDP data are based on consolidated general government debt figures. The 1997 figure for Slovenia is an estimate of the authors; its order of magnitude has been confirmed by the Finance Ministry of Slovenia.

Table 3

Exchange Rate Regimes and Policies in Hungary and Slovenia in 1996/97
against the Backdrop of the Exchange Rate Criterion of EMU

	Exchange rate regime	Basket	Fluctuation bands	Exchange rate stability	ERM membership
Requirements	ERM	–	"normal" fluctuation margins of the ERM (until August 1993 ±2.25%, since then ±15%)	currency has to remain within the "normal" fluctuation bands, no initiation of a devaluation for 2 years	yes, according to Article 109 j (1) indent 4 EC Treaty
Hungary	crawling peg	70% ECU, 30% USD until end-1996, 70% DEM, 30% USD since then	±2.25%	automatic monthly devaluation rate 1.2% since January 1, 1996, 1.1% since January 1, 1997, 1% since August 15, 1997 (0.9% since January 1, 1998, 0.8% since June 15, 1998)	no
Slovenia	managed float	–	–	tolar depreciated against DEM by 6.9% (in nominal terms) between January 1, 1996, and December 31, 1997	no

Basically, the target dates for an eventual accession to the euro zone throw light upon how long it will take for these two countries, in their own assessment, to lay the structural foundations which would allow them to meet the Maastricht benchmarks on a permanent basis. Hungary and Slovenia, like the other advanced transition countries, base their EMU strategies on a best-case scenario of their accession to the European Union, as they hope to join the Community around 2002. They wish to accede to the euro area as soon as possible. In Hungary, the central bank began to look into the issue already a few years ago.[62]) Since early 1997, a public debate has evolved on the matter and, more recently, the Hungarian Finance Ministry has also joined this discourse.[63]) Remarkably, the discussion has been characterized by a great degree of accord. The target dates the Hungarian authorities have communicated for joining the euro zone fall into the narrow range of 2005 to 2007. This implies that there is consensus on joining the single currency area several years after joining the EU.[64])

The Slovenian position has changed over time and is less uniform. Until last year, there was no explicitly adopted target date for joining the euro area, but the country's policymakers were confident that the Maastricht convergence criteria would be fulfilled by the year 2000 or 2001.[65]) Temporarily, Slovenia explored the idea of joining monetary union before accession to the EU[66]) but this notion was dropped fairly quickly, as the authorities realized that there would be no support at all within the Union for monetary integration to precede the other dimensions of EU integration and, above all, full integration into the internal market of the Community. In 1997, when drawing up Slovenia's strategy for EU integration, the authorities reviewed the country's stance on the issue and set the objective "to become an EMU member in 2005" (i.e. a few years after accession to the EU).[67]) This target date was reiterated in Slovenia's National Program for the Adoption of the Acquis communautaire, which is built on the country's EU integration strategy.[68]) However, subsequently, the Prime Minister declared the country's intention to join the European Union and the euro area simultaneously in 2002.[69]) Lately, though, he has been less explicit on the issue.[70]) The Council of the Bank of Slovenia, which discussed the country's EU and EMU strategies in mid-January 1998, came to the conclusion that it would be opportune for Slovenia to be admitted to the EU first and become a member of the euro zone only afterwards; the timing of Slovenia's integration into the single currency area would primarily depend on when the country will have achieved sustainable macroeconomic stability.[71]) Finally, the Minister for Economic Affairs stated that Slovenia would join the euro zone most probably around 2007 to 2008 and that the 2005 target date was based on an optimistic and not very likely perception of prospective future developments.[72]) Apparently, all these statements boil down to a main scenario setting out the year 2005 for accession to the euro zone. By retaining, simultaneously, alternative options in both directions, the authorities avoid any strong precommitment at this stage and preserve their full flexibility on the speed of the integration process, in case developments turn out to be either more favorable or less advantageous than expected from today's perspective.

Any judgment on the appropriate speed towards euro zone membership for the advanced transition countries should be guided by realism. Attaining sustainable nominal and, in particular, monetary convergence will be a longer-term process entailing deep structural change. More broadly, for these economies, it may take an extended period of time to gradually mitigate the downside risks associated with participation in a monetary union: Typically, even the vanguard transition countries are still fairly exposed to asymmetric real shocks, and the likelihood of such disturbances will presumably recede only gradually. At the same time, the adjustment capacity of these economies to asymmetric shocks may well be limited due to rigidities in the goods and labor markets as well as to a fairly narrow room for maneuver for fiscal policy.

In the advanced candidate countries, the assessment on this issue tends to be, in general, more positive.[73]) The argument here rests on the high dynamics of the unfolding transformation and the deepening of integration

with the EU, which will swiftly make applicant countries less prone to asymmetric real shocks. At the same time, analysts from candidate countries tend to argue that the ability to adjust to such disturbances is high due to the relatively pronounced flexibility of prices and (real) wages.

Still, this line of argumentation should probably not be taken too far for a number of reasons. First, even if transition continues to be fast and economic interaction between the Union and candidate countries retains its momentum, the CEECs' exposedness to shocks will abate only relatively slowly, as structural differences will not level out overnight. Second, price flexibility may be very much related to the speed and the comprehensiveness of change entailed by the transformation process; it may not be present to that extent in the longer run. Third, real wage flexibility has not been high generally in all transition countries and at all times. Rather, it has been pronounced only in specific instances (as in the early transformation phase or during particular episodes, e.g. in Hungary in 1995/96). Fourth, adjustment to a deep asymmetric shock in Stage Three of EMU (in a low-inflation environment) will require not only real but also downward nominal wage flexibility. Fifth, cross-border labor mobility will perhaps contribute only little to adjustment. The free movement of labor may be subjected to longer transition periods at the request of incumbent EU Member States, but even if it were not, it is questionable to what extent labor would move in practice in response to regional disturbances. Studies on migration show that the readiness to migrate is apparently not very pronounced in the advanced transition countries and that pull factors (i.e. the attractiveness of EU labor markets) are decisive for migration decisions, while push factors, in particular high or rising unemployment at home, do not play a tangible role for movements of labor from the advanced CEECs to Western Europe.[74])

Furthermore, potential overambition regarding the meeting of the convergence criteria may divert the focus from the number one policy goal of joining the European Union and the daunting tasks that are associated with all the preparations for EU membership. Furthermore, a premature attempt at meeting the Maastricht criteria could easily lead to inconsistencies in the policy mix and impair competitive positions, which could seriously hamper the catching-up process upon which the advanced CEECs have embarked. Clearly, during the next few years, catching up with Western Europe is a more immediate goal than meeting the Maastricht criteria, primarily because it facilitates EU accession and because it is a precondition for laying a sound basis for the ultimate accomplishment of a high degree of sustainable nominal convergence.

This is apparently also the main reason why Hungary has taken a long-term approach towards meeting the Maastricht benchmarks. Two statements may illustrate this. Halpern holds that "the convergence criteria can only become directly relevant for Hungary in the medium to longer run after EU accession. Adjustment to these benchmarks and the recurrent reference to them diverts the attention from the important (integration-related) questions of the present, and does not facilitate finding answers to them."[75]) Inotai states that Hungary has to keep on following "economic policies which focus on improving the country's competitiveness and thus has to be

decidedly export- and investment-oriented … Only such a strategy can ensure that Hungary will have become competitive in as many sectors as possible when entering the EU … This goal must not be put in danger by a forced and overhasty adjustment to the … Maastricht criteria superimposed from above onto the economy."[76])

5 Conclusions

This study has looked into the implications the introduction of the euro has for Central and Eastern Europe and, in particular, for Hungary and Slovenia. The main conclusions of the analysis are:

First, the EMU-specific aspects of EU enlargement to the East are basically threefold. They center around sound macroconomic policies, the adoption of those provisions and regulations of the EMU-specific *acquis communautaire* which in principle pertain to all EU Member States no matter whether they participate in the euro zone or not, and the readiness to participate in institutionalized monetary and exchange rate policy cooperation within European Union.

Second, Stage Three of EMU will affect the Central and Eastern European economies through three main channels which are partly interrelated. It will impact on the CEECs through the growth effects on participating countries, through euro interest and exchange rate developments and through the structural changes the introduction of the single currency will bring about or accelerate, in particular in the financial sectors of the participating countries. Stage Three of EMU will increase the import demand of euro zone countries from the CEECs and thereby spur growth in these two (and other) transition countries. The introduction of the euro will induce tangible additional (non-FDI) capital inflows to the advanced CEECs. Finally, the inception of Stage Three of EMU will accelerate change in the Central and Eastern European financial systems.

Third, the advent of the single currency poses or sharpens a number of policy challenges to the EU applicant countries from Central and Eastern Europe. The implementation of Stage Three of EMU accentuates the need for sound macroeconomic policies. Economic and Monetary Union raises a number of monetary and exchange rate policy issues for the CEECs, inter alia about the appropriate degree of exchange rate flexibility and euro orientation during the preaccession phase. Furthermore, it emphasizes the need for well-designed and probably speeded-up financial sector reforms. Finally, with the unfolding implementation of EMU, Central and East European policymakers will feel an increasing need to develop or further refine their strategies for eventual participation in the euro zone.

In the analysis, the examples of Hungary and Slovenia were used to illustrate the effects monetary integration has and will have for the Central and Eastern European countries. The main conclusions of the study are equally valid for and applicable to the other advanced transition economies that have applied for membership in the European Union.

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2 *In Hungary, the ruling coalition formed by the Socialists and the (leftist-)liberal Free Democrats lost its majority in the May 1998 elections. The strongest party in the newly elected Parliament is the center-right Federation of Young Democrats-Hungarian Civic Party (Fidesz-MPP). By June 16, the editorial close of this study, Fidesz-MPP had completed coalition talks with the Hungarian Democratic Forum, a small Parliamentary faction closely associated with Fidesz-MPP, and was in advanced coalition negotiations with the right-wing populist Smallholders, the third-largest party in Parliament. Against this backdrop, this study not only presents the policy actions taken and the announcements made by the outgoing government but also sketches the stated policy intentions of Fidesz-MPP and the Smallholders, its major prospective coalition partner, on selected issues pertaining to monetary integration matters. Postscript: After the completion of the study, the original candidate for the position of Finance Minister, László Urbán, withdraw and was replaced by Zsigmond Járai, whose first statements now that there is farreaching agreement in the area of macro-economic policymaking between both nominees. Thus the description and the assessment of Fidesz-MPP policy pronouncements covered in this study remain valid.*

3 *See European Commission (1997), Section 3.3 of the Opinions; Backé and Lindner (1996).*

4 *For the precise wording of the EC Treaty see Article 109 j (1) indents 3 and 4. The Treaty is clear in that it demands formal membership in the Exchange Rate Mechanism (see indent 4), and most Member States agree that actual exchange rate stability is not sufficient to qualify for euro zone participation. For EU countries joining the euro zone after 1999, the exchange rate criterion will relate to the revamped Exchange Rate Mechanism II (ERM II) which will govern the exchange rate relations between the euro area and nonparticipating EU countries from the inception of Stage Three of EMU. The principles, objectives and main features of this mechanism, laid down at the European Council meeting in Amsterdam in June 1997 are the following: Participation in the ERM II will be voluntary; nevertheless, non-euro area countries "can be expected to join the mechanism." The ERM II will be based on fixed but adjustable central parity rates of the participating currencies vis-à-vis the euro. There will be a standard fluctuation band of ±15% around the central rates of participating currencies, but formally agreed narrower bands will be possible. Intervention at the margins will in principle be automatic and unlimited, with very short-term financing available. However, the ECB and the central banks of the other participating countries can suspend intervention if it were to conflict with their prime objective of price stability. The flexible use of interest rates by the central banks of non-euro countries will be an important feature of the mechanism, and there will be the possibility of coordinated intramarginal intervention.*

5 *In order to remove this specific constraint, it has been proposed to change the Union's rules so as to render possible a participation of the most advanced transition economies in the ERM prior to EU accession (Bofinger 1996; see also De Grauwe and Lavrac 1998). Russo (1998) takes up this proposal, though with a different underlying reasoning: ERM II membership before EU accession could help to smooth the CEECs' exchange rate relations with the euro area. However, judging from past experience with European monetary integration, prospects for putting such a proposal into practice appear to be fairly low. So far, at least, formal EU membership has always been required as a precondition for participation in the European Monetary System and its Exchange Rate Mechanism.*

6 *Moreover, new Member States will participate in the EU Council's decision making on exchange rate policy matters, as laid down in Article 109 (e.g. by concluding exchange rate agreements with third countries or by adopting general orientations for exchange rate policy vis-à-vis third currencies, decisions which have to be taken in cooperation with the ECB, without any infringing or prejudice on its primary goal of price stability). In addition, the acceding CEECs will take part in Council decisions on certain other monetary matters that fall into the responsibility of the Council as laid down in Articles 105 (6), 105 a (2), 106 (5) and (6), 109 h, 109 i (2) and (3), 109 k (2), 109 l (5) of the EC Treaty. Furthermore, high-level representatives of the central banks and the Finance Ministries of the newly acceded countries will participate in the Economic and Financial Committee (which will replace the Monetary Committee as of January 1, 1999). The tasks of this committee include a continuous review of the economic and financial situation in the Member States and in the Community, contributing to the preparation of Council decisions on monetary matters and regular examinations of the situation regarding capital movements and payments (see Article 109 c).*

7 *European Commission (1997), Section B.3.3 of the Opinions. Full compatibility of monetary policy instruments with those in place in the euro zone has to be achieved only on entry into Stage Three of EMU.*

8 *See for example European Commission (1997), Volume 1, Chapter II.1.3: The newly acceding countries "are expected to participate in an exchange rate mechanism ..." See also European Commission (1997), Section B.3.3 of the Opinions.*

9 *For further arguments see Horváth et al. (1997); Backé (1998).*

10 *In writing this section, the authors have greatly profited from participation in a session on the opportunities and challenges of the euro for non-EU Member States held by the United Nation's Economic Commission on April 21, 1998. This section draws on the contributions to this meeting, in particular on Russo (1998).*

11 *See Breuss (1997). The authors of this study are well aware that there is a number of other well-founded projections about the effects of EMU on participating countries. Clearly, it would be equally legitimate to base an assessment about the effects on third countries on any of these other estimations.*

12 *Giving up the exchange rate instrument will make the latter group of countries undergo fairly significant adjustment processes which will have a perceptible negative growth impact for several years. See Breuss (1997).*

13 *In the case of Hungary, the share was approximately 85% in 1996 while, for Slovenia, it was somewhat below 80%. (In both instances, Italy takes the lion's share of exports to the group of "soft currency countries.")*

14 *These and subsequent calculations are based on 1996 figures. Figures on the income elasticity of import demand of the euro zone countries are taken from Russo (1998), Table 3.*

15 *It has also been argued that the introduction of the euro would reduce the exchange rate risks in the CEECs' trade with EMU countries. However, it remains to be seen whether the Central and Eastern European currencies will be more stable against the euro than against the currencies the euro will replace. What is clear is that the exchange rate risk in the CEECs' trade with euro area countries will become significantly less diverse through the introduction of the single currency.*

16 *See Dixon (1998); Russo (1998).*

17 *This factor/effect per se is not new: Up to now, exchange rate movements of the DEM vis-à-vis third currencies have affected the trade of these countries. Exchange rate developments also affect investment flows and debt service, two issues which are discussed in subsequent parts of section 3.*

18 *See Russo (1998).*

19 *In recent years, USD invoicing shares have been remarkably stable, while the weight of those currencies which will be replaced by the euro has increased at the expense of third currencies. The information on currency invoicing shares in Slovenia's foreign trade has been provided by the Bank of Slovenia.*

20 *The effects of potential exchange rate movements between the euro and the USD could become less relevant over time if the former gains additional weight as an invoicing currency at the expense of the latter.*

21 *Hungary's trade invoicing shares are compiled by Hungary's Central Statistical Office. They are also published in the annual report of the National Bank of Hungary. The figures for 1997 were released in April 1998 (see MTI-Econews, April 23, 1998).*

22 *See Russo (1998).*

23 *Several studies indicate that changes in the interest rate level in the United States have been a major external factor influencing the size and direction of portfolio capital flows from and to Latin America (see e.g. Calvo et al., 1993; Schadler et al., 1993). One may thus expect that variations in euro interest rates will have a similar impact on portfolio capital flows to and from the CEECs.*

24 *Russo (1998) points at securitization, concentration of wholesale banking and equity and derivative markets, and cross-border integration of payment systems as some of the main areas of this "structural contagion process." Increased competition in the financial sectors of the CEECs as a consequence of the inception of Stage Three of EMU is also expected by Dixon (1998).*

25 *Capital account liberalization issues and Hungary's and Slovenia's record in this area are discussed below in more detail.*

26 *Furthermore, capital inflows tend to impede disinflation and entail costly sterilization. Moreover, if not fully channeled into real investments, they may cause asset price bubbles. Besides, short-term capital flows exhibit, at times, erratic fluctuations. If these flows are used to finance long-term projects, shifts in flows will unveil these maturity mismatches and strain the balance sheets of companies (in case of direct financing from abroad) and/or the banking system (if flows have been channeled through the banks).*

27 *Fiscal consolidation is necessary for several reasons. First, strong public finances take the pressure off monetary policy to accommodate public sector deficits which could induce residents to move funds abroad in order to escape the inflation tax. Second, fiscal deficits can raise a country's debt stock over time (depending on their size as well as on real interest and growth rates); this could eventually lead to doubts about the country's creditworthiness, again triggering capital outflows. Third, a consolidated fiscal position can help narrow interest rate differentials if they result from upward pressure on domestic interest rates due to high public sector credit demand. It should be added that, while a sound fiscal position is indeed a precondition for capital account convertibility, progress on strengthening public finances may also intensify the problem of unsustainable capital inflows if confidence in economic policy grows strongly.*

28 *In Hungary, the electoral program of Fidesz/MPP calls for a major reduction of income tax and social security contributions on wages and salaries over the next four years. If fully implemented, this would entail a substantially higher fiscal deficit. Recently, the candidates designated for the position of Finance Minister and Minister of Economics have made clear that any reduction of income tax and social security contributions will have to fit into the overarching objective of maintaining a sound and disciplined overall fiscal stance (see Magyar Hírlap, June 4, 1998; Figyelô, June 11, 1998; HVG, June 13, 1998).*

29 *Hungary's formula for adjusting administered utility prices is based, inter alia, on past inflation, which adds a pro-inflationary bias to the indexation mechanism. The designated candidate for Finance Minister intends to change the adjustment method to expected future inflation in the course of 1999 (Figyelô, June 11, 1998).*

30 *As to inflationary expectations, this appears to be most clearly the case if exchange rate movements are preannounced, as in the crawling peg regime applied by Hungary (or Poland). Although such an exchange rate system is beneficial from a predictability point of view, the rate of crawl can easily become a floor for inflationary expectations, thus possibly contributing to the further entrenchment of such expectations.*

31 *See Radzyner and Riesinger (1996); Backé and Lindner (1996).*

32 *See statements of central bank Vice Governor Szapáry (MTI-Econews, February 17, 1998; Banklevél (8) 3; Magyar Hírlap, May 15, 1998; Figyelô, May 21, 1998).*

33 *For clear statements on this issue see Reuters, March 25 and 27, 1998; May 23, September 25 and November 27, 1997; November 4, 1996. Given the altered political setting after the May 1998 elections, the following overview on recent exchange-rate-policy-related pronouncements of Fidesz-MPP and the Smallholders appears to be in order. The Fidesz-MPP election program argues for a flexible exchange rate policy in order to support export-oriented growth. At the same time, the exchange rate policy of the last years is depicted as one of the "genuine reasons" for inflation in Hungary and, consequently, "lowering successively the speed of devaluation, in line with income developments and the impact on foreign trade developments" is to be one element of Fidesz-MPP's disinflation policy. Policy announcements in the preelection phase were decidedly critical about the crawling peg regime, which was said to have "outlived its usefulness" and which was termed pro-inflationary, since it entrenched inflation expectations (see statement of Fidesz-MPP vice chairman Varga, Reuters, March 25, 1998; Világgazdaság, March 26, 1998). After the election, this criticism was toned down considerably in an obvious attempt to calm the concerns of financial markets about possible policy changes perceived as inappropriate. Varga stated that the crawling peg system could be abolished only gradually depending i.a. on the inflation rate and the size of the budget deficit (see Reuters and Világgazdaság, May 27, 1998). This shift was reinforced subsequently when Fidesz-MPP chairman Orbán stated that the government to be formed would not even consider any change to the crawling peg mechanism until end-1998 (MTI-Econews, May 29, 1998). The designated candidate for the position of Finance Minister, László Urbán, has indicated that changes to the exchange rate system would be effected in close cooperation with the central bank and that a major regime shift would only occur as part of a comprehensive disinflation package which would have to include a forward-looking adjustment of regulated utility prices, a consensual moderation of wage increases and significant fiscal adjustment (Figyelô, June 11, 1998; HVG, June 13, 1998). Putting together such a package will take some time, which appears to imply that there will be no turnaround in Hungary's exchange rate policy in the near future. The Smallholders, in turn, argue in their election program for a scrapping of the crawling peg. The party intends to make it a policy priority to preserve the external and internal value of the forint. The advantages of the crawling peg are said to be minimal, its drawbacks, however, substantial. The continuous (nominal) devaluation under the current exchange rate regime is seen to have fueled inflation, to have stiffened production structures and to have caused a major rise in public debt (due to the exchange rate losses on foreign-currency-denominated debt). This stance has been underscored by a number of policy pronouncements (see e.g. Reuters, April 25, 1998). After the elections, the Smallholders declared that a managed float, which would allow the central bank "to strengthen the forint at any appropriate point in time," would serve Hungary's interests best in the future, while at the same time they stated that the party had never demanded the immediate scrapping of the present exchange rate regime (Pester Lloyd, June 10, 1998). László Urbán, in turn, has firmly stated that in the prospective coalition with the Smallholders, exchange rate policies would be shaped exclusively according to Fidesz-MPP concepts (Figyelô, June 11, 1998).*

34 *Government of Slovenia (1998).*

35 *This is one of the conclusions the Council of the Bank of Slovenia arrived at in mid-January 1998 when discussing the country's EU and EMU accession strategy (see STA, January 14, 1998).*

36 *See European Commission (1997), Volume 2.*

37 *The Hungarian band has been unchanged since December 1994. In contrast, Poland increased its band from ±0.5% to ±2% in March 1995 and to ±7% in May 1995; in February 1998, the band was further widened to ±10%. Slovakia extended its band in three steps from ±1.5% to ±7% during the course of*

1996. The Czech Republic increased its band of ±0.5% to ±7% in February 1996, the band being in force until May 1997, when the currency peg was abandoned altogether.

38 *National Bank of Hungary (1998).*

39 *MTI-Econews, February 10 and April 27, 1998; Reuters, April 28, 1998.*

40 *MTI-Econews, June 16, 1998. Neither Fidesz-MPP nor the Smallholders have taken any public stance on the specific issue of intervention bands under a pegged exchange rate regime.*

41 *This compares to a surplus of USD 398 million during the whole of 1997, which reflects a net inflow of direct investment of USD 1,653 million, a portfolio investment outflow of USD 1,047 million net and other investment flows of USD 208 million net. The steep increase in the financial account in the first months of 1998 is also reflected in bulging purchases of foreign currency by the National Bank of Hungary on the interbank foreign exchange market (see Magyar Hírlap, April 14, 1998).*

42 *To some extent, the temporary drop in inflows may have been reinforced by the most recent financial crisis in Russia.*

43 *For the Polish experience with the widening of the fluctuation band see Krzak (1998).*

44 *The restrictions on non-FDI capital inflows to Slovenia are described in some detail below.*

45 *See e.g. Székely (1997), Palánkai (1998), Inotai (Pester Lloyd, March 4, 1998).*

46 *Senjur (1998).*

47 *Hungary has a uniform requirement of 12% for forint- and foreign-exchange-denominated deposits irrespective of their maturity. In Slovenia, the level of the mandatory reserve differs depending on the denomination and the maturity of deposits as well as on whether the depositor is a resident or not. Mandatory reserves for tolar deposits are 12% for sight deposits and term deposits up to 30 days, 6% for term deposits between 1 and 3 months, 2% for deposits between 3 and 6 months and 1% for deposits of 6 to 12 months. In both countries, obligatory reserves are remunerated at below-market interest rates (currently 11% in Hungary and 1% in Slovenia). There are no reserve requirements on foreign currency deposits in Slovenia; instead, there are foreign exchange cover regulations, ranging from 100% on sight deposits of residents to 5% on deposits of over one year. A slightly different scale applies to the accounts of nonresidents. For more details see Bank of Slovenia (1997).*

48 *According to Palánkai (1998), such a development cannot be excluded in the case of Hungary.*

49 *This point was also highlighted by the European Commission (1997), section 3.3 of the Opinions.*

50 *There are a number of reasons why a well-working financial sector is a necessary precondition for liberalized capital movements. First, it enables the central bank to efficiently use indirect monetary policy instruments, thereby increasing its capability to react to disturbances without being forced to resort to the reintroduction of capital controls or other administrative measures. Domestic banks must be strong enough to withstand foreign competition. Eliminating financial sector imperfections in general is also important in order to narrow interest rate differentials which could induce capital inflows.*

51 *Hungarian central bank Vice Governor Szapáry expects that intensified competition after the introduction of the euro could trigger a massive wave of mergers and buyouts in the Hungarian banking sector (MTI-Econews, February 17, 1998).*

52 *In Slovenia, market forces are tangibly constrained by pervasive indexation of financial contracts, interest rate cartels and a fairly restrictive stance towards foreign participation and activity in the sector.*

53 *Hungary, in particular, has already come a long way in this respect. For an in-depth account on this issue, see Horváth and Zsámboki (1998). Slovenia's legal framework in the area of financial services, in turn, is less advanced. A comprehensive overhaul of the legal basis has been in preparation for a long time but has not been adopted yet.*

54 *For a detailed review on central bank independence see Radzyner and Riesinger (1997); for convertibility issues see Backé (1996). See also European Commission (1997) and Horváth et al. (1997).*

55 *This relates e.g. to some aspects of the rules on dismissal and on the terms of office of members of central-bank decision-making bodies and, similarly, to several specific features of the incompatibility provisions applying to central bank managers.*

56 *In their policy pronouncements, the coalition parties of the prospective new Hungarian government have not touched upon the specific issue of sequencing and timing further capital account liberalization in Hungary yet.*

57 *Indeed, the Bank of Slovenia has already started this process by easing the controls somewhat in June 1997. For details on the regulations see Bank of Slovenia (1998).*

58 *Republic of Slovenia (1998).*

59 *For a more detailed discussion of this issue see Backé (1996).*

60 *Accordingly, prospective changes in euro interest rates would have a tangible impact on Hungary's debt service burden (see statement of Hungarian central bank Vice Governor Szapáry, Reuters, December 24, 1996). This assessment is shared by Russo (1998).*

61 *Russo (1998).*

62 *See Tóth (1995), Riecke (1996), Surányi (1997), Szalai and Varró (1997) and Reuters, October 3, 1997.*

63 *See the statement of outgoing Finance Minister Medgyessy to Le Monde, April 17, 1998 and, earlier, an interview with the Finance Ministry's Director Tétényi (Reuters, February 27, 1998). For a somewhat less specific statement by Minister Medgyessy on Hungary's EMU perspectives see Reuters, September 25, 1997. See also Medgyessy (1998).*

64 *The outgoing Finance Minister and the central bank Governor have suggested that the fiscal convergence criteria could be within reach by 2002, while it would take a few more years to meet the monetary and the exchange rate criteria. In all likelihood, the change in government will not lead to significant alterations in Hungary's EMU strategy. The designated candidate for the position of Finance Minister, László Urbán, has recently stated that he "could conceive the year 2005 to be an approximate date" for Hungary's joining of the euro zone, the fiscal deficit/GDP ratio should approach the Maastricht threshold of 3% "within a few years" (Figyelô, June 11, 1998). The Smallholders have not made any public statements related to Hungary's EMU strategy.*

65 *See e.g. Reuters, April 11, 1995; October 18, 1996; May 7, 1997.*

66 *At the European Council meeting in Dublin in December 1996, Slovenia's Prime Minister Drnovsek said that "Slovenia will do its best to join monetary union as soon as possible, perhaps even before full EU membership" (Slovenia Weekly, January 11, 1997).*

67 *Government of Slovenia (1997).*

68 *Republic of Slovenia (1998).*

69 *See Reuters, December 13, 1997, and STA, December 15, 1997. Evidently, joining the EU and Stage Three of EMU at the same time would presuppose the European Union's readiness to change its policy stance on the exchange rate criterion outlined in footnote 3.*

70 *In a statement in March 1998, the Prime Minister continued to put a clear target date on EU accession (2002). He was less specific on the timing for joining the euro zone ("as soon as possible"). See Reuters, March 12, 1998.*

71 *STA, January 14 and 17, 1998.*

72 *Senjur (1998).*

73 *See for example Lavrac (1998) for the case of Slovenia.*

74 *See Fassmann and Hintermann (1997).*

75 *Halpern (1998), Deputy Head of the Economics Institute at the Hungarian Academy of Sciences and collaborator of the Centre for Economic Policy Research in London.*

76 *Inotai (1998), Chairman of Hungary's Strategic Task Force for European Integration and Director General of the Institute for World Economics at the Hungarian Academy of Sciences.p*