The“ legal wisdom ”and the“ economic rationality ”in the European Monetary Union

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The 2004 eastern enlargement of the European Union (EU) has been undoubtedly the most difficult one in the EU 45 year history. The enlargement has been not only the biggest one to date (ten countries are going to join at once) but also the disparities between the EU member countries and the new accession countries[1] (AC) as well as the disparities between the AC themselves have never been so pronounced as this time (each of them constitutes a tiny fraction of the EU economy, their income levels and economic conditions differ significantly and so on). Therefore the negotiations that preceded the enlargement were extremely complicated and time-consuming. It required enormous political and legal skills of Commissioner Guenther Verheugen to convince the public opinion in the AC that they should join the EU despite much less generous conditions than they expected to receive and, not less challenging, to convince the public in the wealthy current member-states that they needed their poorer neighbours to join the Union. The negotiations process and the accession treaties themselves represent therefore a masterpiece of legal and political work but often their “economic rationality” does not match their “legal wisdom”. The legal logic of the enlargement process calls for an equal treatment of all AC but, while failing at the same time to acknowledge serious differences between them, it has neglected potential dangers that may result from ignoring the logic of the economic agents participating in the enlargement process.

The road map for including the AC into the EU monetary integration framework was prepared together with other conditions of the *acquis* by the 1993 Copenhagen European Council. It was prepared more than a decade ago and its design was heavily influenced by the experience of the then members of the European Union struggling, at that time, to maintain their exchange rate regimes intact in the wake of the currency crisis that was going to undermine the fundamentals of the European Monetary System. During last fifteen years the world has changed however (including the successful launch of the EU common currency) and the group of accessing countries includes quite different members than the group of candidates ten years ago[2]. Logically, therefore, the road map should be adjusted too. But neither the acceding countries nor the Commission itself has shown any interest in reopening discussion about the once closed issue. However by do-

[1] The ten accession countries include Cyprus, Estonia, Latvia, Lithuania, Malta, Poland, Czech Republic, Slovakia, Hungary, and Slovenia.

[2] The first group of candidate countries included the Czech Republic, Hungary, Poland (the so called Visegrad Group without Slovakia), Estonia, and Slovenia. Later, the enlargement negotiations were opened with the remaining AC (including Bulgaria and Romania that failed to join the 2004 enlargement).

ing so, both sides undertake the risk of fuelling a considerable financial instability during the transition period.

There exists a bulk of research on what causes the currency crises and what are the requirements for a sustainable exchange rate regime. A turbulent financial history of the 1990 s provided a new impulse into the studies of international currency crises. The most general lessons drawn upon the rich experience of the 1990 s can be summarised as:

1. The regimes that aim at limiting the exchange rate movements to a specific fluctuation bands are likely to be sustainable only under extremely benign circumstances e.g. protected by capital movement restrictions.
2. Lack of restrictions on capital movement, limited exchange rate flexibility, high expected return on investment, and still unfinished disinflation process (resulting in high real interest rates) attract large capital inflows that put a powerful strain on domestic monetary policies. The large capital inflows figured in every currency crisis of the 1990 s.
3. The capital flows are channelled trough the economy by a country's banking system. A weak banking system greatly exacerbates the negative effects of capital flows.
4. Transparent, stability oriented policies and flexible labour and product markets are helpful in containing the results of a crisis but alone can not prevent it.
5. Although there is evidence that foreign direct investment is driven mainly by a standard set of economic fundamentals the flow of portfolio investment often seems to follow the positive (or negative) contagion pattern, i.e. a herd-like behaviour with little respect to economic fundamentals.

It can be argued that the construction of the ERM-II[3] went along the lines that disregard the experience of the 1990 s currency crises. First, the ERM-II is a fixed but adjustable exchange rate peg where each participating country's currency is unilaterally tied to the euro and the ECB makes no commitment to support the parities. In this respect, despite of its relatively wide fluctuation bands[4], the ERM-II is similar to the failed exchanges rate regimes of the 1990 s where the currencies were fixed to the US dollar. Consequently, each EU member country that does not use the euro will have to bear alone the burden of defending its parity while facing the consequences of the European Central Bank's monetary policy decisions on which it will have no influence. Combined with the obligation to maintain low inflation rate included in the Maastricht Treaty the exchange rate stability might be difficult to maintain.

The second important feature of the ERM-II is the fact that it operates under the full capital mobility. As required by the accession conditions the new accession countries have entered the EU (and therefore the ERM-II) with almost full liberalisation of their capital movements. Full capital mobility is known to be hardly compatible with a fixed exchange rate regime. In addition, as a low-cost part of the EU, the new accession countries are likely to continue attracting direct investment as investors seek higher profits. Given the large scale of catching-up with the

[3] The ERM-II is an exchange rate system for the EU member countries that do not use the Europe's common currency, the euro.

[4] As the experience teaches, authorities usually do not use the realignment option at the right time and, under such circumstances, even the wide bands of ±15% may not be sufficient. Furthermore, the ERM-II fluctuation bands may even be reduced to ±2.5% as suggested by Commissioner Pedro Solbes in Prague on May 19, 2003.

EU, the large direct investment flows are likely to contribute, through the productivity increases in industry, to Balassa-Samuelson effect and real exchange rate appreciation[5]. With their weak banking systems the accession countries may not be able to manage those capital flows. This may result in a reverse in capital flows. A loss of confidence in the AC policies (for instance due to the prolonged inability to meet the Maastricht criteria and adopt the euro) or resurgence in expected inflation may result in a standard, Krugman (1979) type, balance of payments crisis. Also lower expectations regarding a real exchange rate appreciation or real interest rates will make local assets less attractive and prompt a capital outflow. Hungary's experiment with unilateral shadowing the ERM-II confirms, in my opinion, the reservations about the framework[6].

In the light of the above considerations, it seems possible to argue that insisting on the ERM-II participation as a precondition for adopting the euro means a disregard to the experience of the 1990 s currency crises and makes the waiting period inside the ERM-II likely to become a self-defeating experiment. This, in turn, may have a serious influence on the behaviour of the market participants, including a widespread currency and asset substitution (in other words informal euroisation). This phenomenon is not only costly (needless to say, the wasted resources could be used for other convergence purposes), but also undermines the rationale for staying inside the ERM-II framework.

So far the issue of a monetary union enlargement has been dealt with on the basis of the earlier concluded legal agreements. While the agreements, calling for an equal treatment of all the EMU members, are based on strong legal logic, they violate the economic logic of the enlargement. Therefore, in order to prevent serious disturbances, the contradictions between the two logics should be corrected. Many solutions are technically possible. However, it requires a major assumption made by the EU authorities that, to paraphrase the title of the Frankel (1999) paper, there is "no single exchange rate regime that is good for all countries at all times". The accession countries should be allowed for varying monetary integration strategies. For the countries with currency boards, an immediate EMU membership is a natural step. For countries that successfully introduced floating exchange rate regimes it makes little sense to return to vagaries of a soft peg. Instead, they should be allowed to retain their current strategies, including inflation targeting, and to adopt the euro only when the degree of their real convergence becomes sufficient (the strategy the UK and Sweden have been allowed to adopt).

REFERENCES:

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[5] Price levels are lower in poor countries than in rich countries. When a country catches-up, usually through productivity gains, then its price level expressed in foreign currency rises. This happens either through nominal exchange rate appreciation or (and) increase in domestic price level.

[6] Short-term capital inflows of EUR 4-5 billion, equivalent to several percent of the country's GDP, entered the country within a few hours on January 15-16, 2003. This forced the central bank to reduce its interest rate, reintroduce restrictions on short-term deposits, and intervene heavily in the exchange rate market. Speculation was calmed, but as an outcome, inflation target for 2003 has been missed inducing a substantial loss of market confidence.