Eastward Enlargement of the Eurozone – Impact on Trade, FDI and Capital Markets

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Introduction

The book is structured into three parts, which reflect the three panels that took place during the conference in Cracow in November 2002, within the Eurozone plus Program, financed from V Framework EU Program and Committee of Scientific Research (Poland). The first part entitled Challenges related to adoption of euro, second Transfer of FDI, third dealing with Capital markets and exchange rates in the process of integration with the EMU.

The Cracow conference has created an opportunity for scholars from different centers to exchange their views on current matters that build the road for countries in transformation to the EU and further on to EMU. It shows differences in opinions among scholars, countries, societies which try to achieve same goal in a different way. Reading the texts as there are presented a thorough reader can see that the divisions in opinions and further in attitude to the discussed programs derive from the fact that most of us trust authorities well known, quoted and endeavored by majority of researchers. Others represent wise conscious thinking, which helps them to draw conclusions from facts, where their knowledge is actively used to evaluate events not being captured nor imprisoned by fame of theories nor theoreticians.

In first part there are five texts written chronologically as they were presented in the conference by Vít Bárta from Czech National Bank gives an overview of preparation of Czech economy for introduction of euro, Karel Zeman from Czech Republic – discusses the same problem but from different angle and coming out with different findings as far as the policy guidance should be shaped. Marcin Żogała from National Bank of Poland discusses the Maastricht criteria, their role in economy and perspectives of fulfillment, while Artur Nowak Far from Warsaw School of Economics shows harmonization of the Polish law with the acquis in the field of preparation to monetary union. Stanisław Swadźba, from Economic Academy in Katowice, shows direct social context of the democratic decision taking procedure which is the attitude of the voters towards joining the EU and generally integration.

The second part consists of four texts in which I, representing Warsaw School of Economics, discuss impact of exchange rate regime on directions of flow of capital. This text tackles the problem of differences in strategies applied in the front-running economies of Central and Eastern Europe and indicates differences in the achieved results, measured by catching up with the level of development. Ingeborg Nìmcová, from Czech Republic, gives an overview of the Czech bibliography on FDI flows. Ewa Latoszek, Warsaw School of Economics, shows the changing pattern of FDI impact on Polish economy in the period of transformation. The last paper in this part is also written by me

and in it I try to find out what is the influence of level of interest rate on the FDI flows.

The final third part consists of five papers. The first text written by Thomas Mayer indicates all the fears that are associated with Eastern enlargement of Eurozone, Dominik Sobczak shows the ongoing quick changes on the stock market in Europe after introduction of EMU, indicating consolidation of the markets. Piotr Bańbuła discusses the influence of EMU on Central and Eastern European bond markets. Rafał Wiełądek comments on interdependence between exchange rate regime and capital flows, illustrating his findings by case studies from Czech Republic, Poland and Estonia. The final text is again written by me and it throws some light on a new phenomenon of changing competitiveness of exports in the light of main partner currency appreciation. It is important to combine effects of introduction of euro on intensiveness of competition, consolidation of capital markets and the crowding out effect on capital releasing it to flow to economies that plan their accession in May 2004 and further the remaining candidates in 2007.

All in all, presented set of papers shows current problems that are faced by accessing economies in their preparation to EU membership and, after that step, to EMU, which are viewed from different perspectives and indicate individual attitudes of the researchers. They produce insights revealing some aspects of new economy (although the notion is not used by the authors) characterized by several characteristic features: globalization, liberalization, certain universalization of systems, institutions, law, etc… They indicate some possibilities that are created by a dual currency financial world system, which can create growth simply by flows of capital, which become healthy in comparison with the former multi-currency system overwhelmed by one of the currencies. It seems that the processes shown by authors of papers in this volume are only at their beginning and should be considered as basis for new framework of international division of labor encompassing more and more regions, ending with all continents. Use of experiences of the European integration as well as systemic transformation of Central and Eastern Europe can give an impulse for catching up in the developing economies. Applied methods are simple and effective as shots taken in Czech Republic, Poland or Estonia indicate, understanding simplicity of the mechanism others can follow…

Katarzyna Żukrowska

Acknowledgements

The book contains a collection of texts, which were presented during the international conference organized in November 2002 in Cracow. The conference was organized by International Security Department of Warsaw School of Economics and Association of Student Scientific Societies with great support of Institute for Strategic Studies of International Center for Democratic Development (responsible for logistic). My best gratitude should be expressed to Chairmen of the Center, Bohdan Klich, Director of the Institute, Andrzej Sokołowski, and all Institute's staff members who have offered their helpful hand to us.

This scientific meeting was one of in series of meetings conducted within the EZONEPLUS program which is financed from the 5th Framework Program establishing opportunity for scholars from Estonia, Germany, Italy, Poland, Portugal, Finland and Slovenia to exchange views on current events which take place within primary phases of introduction of EMU and preparation of member-states for enlargement what includes Eurozone enlargement.

Papers presented in the volume are not representative for the whole set of scholars that work in the Program. It created an opportunity to bring together scholars from Czech Central Bank and the National Bank of Poland as well as scientists from the two countries. It was attended by representatives of EUROZONE plus chief-coordinators from Free University of Berlin. I would like to thank professor Hans-Dieter Jacobsen, who inspired the Cracow meeting, being its *vivendus movens*.

I am grateful to dean Joachim Osiński for being supportive to all our initiatives of international cooperation as well as domestic activities in which we include students from Program for European Studies run together with Sciences Po from Paris. I would also like to say how grateful I am to Rector Marcin Nowakowski for his support to our activities whenever this was needed.

Conference was organized by Małgosia Grącik from our department and attended by Ania Pochylczuk (also International Security Department) temporary on a scholarship at Warwick University (UK). It is impossible to mention all names to whom we owe gratitude for smoothly running the conference, good atmosphere and interesting accompanying events like our food breaks in excellent Cracow restaurants and pubs. All has given us an opportunity to know each other closer and to expand the opportunities to persuade our opponents by supporting our visions with better arguments than those used in the time of presentation. The list of those we should mention by name is long. I would like to express my gratitude to: Małgosia Grącik (for

collecting the papers from the authors), Dominik Sobczak (for preparing this volume for publication), Anna Pochylczuk and all others…

I would like to say that I am very proud of the team of young scholars with whom I cooperate from the Department and outside it, who demonstrated highest ethics of scientific work participating in the meeting, taking part in the vivid and very professional discussion during which different and often opposing views were expressed, what can be easily spotted in this publication.

Finally I would like to express my gratitude to Ms Zofia Jurewicz, who, not being personally with us in Cracow, was following all our moves, coordinating from Warsaw hectic behavior of "absent minded scholars" who always should be guided by hand otherwise they would be lost somewhere in the middle of their way without a chance to reach the point of destination. We felt her sympathetic presence and helpful guidance and we are grateful for her engagement in all we do and her support to all our ideas. I think that in this particular matter I am expressing not only my views but also the views of my younger colleges from the Department.

I would also like to underline great help which we received from Ms Iwona Bukat in servicing the conference financially and from Ms Małgorzata Zysińska in coordinating our cooperation with universities abroad.

The meeting was inspiring, what you can see from the excellent level of the papers presented. And we do hope that such meetings in friendly and scientific atmosphere will continue, if not in Warsaw, Cracow or other Polish city, than in other countries.

Katarzyna Żukrowska

Part 1:

Challenges related to the adoption of euro

Vít Bárta*

Czech National Bank and euro: major options and issues

Introduction

The adoption of euro has been discussed in the Czech National Bank (CNB) for almost two years now. Although the internal discussion has been rather intensive, there is no recent no official CNB strategy on the adoption of euro published at the time of this workshop.[1] While there was no obvious consensus about the strategy reached within the Bank still about a year ago, nowadays most bank board members prefer the fast track approach to euro rather than the slow track. In spite of the fact that support to the fast track prevails among top bank officials, some skepticism on fast track persists at lower level of the bank staff. According to some analysts, the risks related to the adoption of euro are quite high while benefits are questionable or even doubtful. As a result of internal discussions, the first draft of the Strategy has been outlined in September 2002 and dispatched to the Ministry of Finance in order to initiate the discussion with the government. The draft provides the framework for the assessment of readiness of the Czech Republic to adopt euro. In this paper we will show what are the major issues and bottlenecks currently discussed within the CNB on the future adoption of euro and what are the major options available for the Czech Republic at the current stage of development. The analysis of different aspects should be considered as preliminary and tentative.

1. Core of the euro debate

In the euro accession process, only one fundamental parameter remains open to the discretion of policy-makers: the timing of the adoption of euro. Related to the issue of timing is the "choice" of the euro-locking exchange rate. Supporters of the fast adoption of euro suggest that the single currency is essential for reaching high level of macroeconomic stability especially when a

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* The author is an Advisor to the Bank Board Member in Czech National Bank. Although the paper draws heavily from the analytical work of CNB, the views and conclusions are those of the author and not those of the CNB. All errors and omissions are exclusively the author's responsibility.

[1] The document *"The Czech Republic and the Euro – Draft Accession Strategy"* was published on 27 December 2002 on the CNB website.

given economy is small and open. They claim that the volatility of the exchange rate is uncomfortably high and sometimes damaging which implies high volatility of inflation and unnecessarily high costs of its stabilization. They generally believe that available adjustment mechanisms could work efficiently in dealing with shocks and remaining policy instruments after "loss" of monetary policy will be capable enough to stabilize the economy. On the other hand, supporters of the "slow track" to euro do admit that the adoption of euro would stabilize the economy but are afraid that:

- an essential instrument of stabilization policy (relatively independent monetary policy) will be lost and will not be substituted enough by remaining instruments,
- the currency could be fixed at the wrong parity,
- irrevocable fixing of currency could have adverse impacts on growth if the chosen parity proves to be misaligned with equilibrium exchange rate and if available adjustment mechanisms prove to be insufficient in coping with macroeconomic instability.

As a consequence of these doubts they suggest to follow wait-and-see policy towards euro. The public debate on this topic started only recently and no country-wide consensus has been reached yet.

2. Outline of the CNB Draft Strategy for adoption of euro

The CNB Draft Accession Strategy contains the following major conclusions:

- Unilateral euroization is not an option.[2]
- Advantages of single currency speak in favor of an early adoption of euro. If the accession to the EU comes true in 2004, earliest possible time of adoption of common currency is 2007.
- Risks associated with the adoption of euro are as follows:
  - imperfect synchronization of domestic cycle with business cycle abroad,
  - in-built tendency towards budget deficits that implies urgent need of fundamental consolidation of public finance,
  - inflexible labor market.
- Inflation targeting regime is not inconsistent with ERM2, if ERM2 is understood as a necessary condition for the EMU entry. Consequently, participation in ERM2 should not be longer than 2 years. The reasons behind this suggestion are that participation in ERM2 basically does not

[2] Unlike for example Poland, there are hardly any supporters of the unilateral euroization in the Czech Republic. Since the very beginning of discussions about adoption of euro, Czech policymakers strived for a compliance with the official ECB procedure.

protect the economy from monetary turbulence and that implementation of inflation targeting within the framework of ERM2 could imply both systemic and policy dilemmas.

- CNB suggests to organize together with the Ministry of Finance a regular yearly assessment of the progress in main areas. The results of the assessment would be available each May.

3. Area to be watched: basic framework

CNB Draft Accession Strategy defines several areas within which the "economic readiness" of the country to adopt euro will be studied. Those areas refer to:

- Cyclical and structural correlation with Eurozone,
- Flexibility of adjustment mechanisms (fiscal policy, labor market),
- Other factors that can influence the timing of EMU accession (maturity of financial sector, equilibrium exchange rate, etc). Below we briefly deal with each of these areas and present preliminary findings and tentative conclusions.

3.1. Cyclical and structural correlation with Eurozone

Chart 1. Cyclical correlation

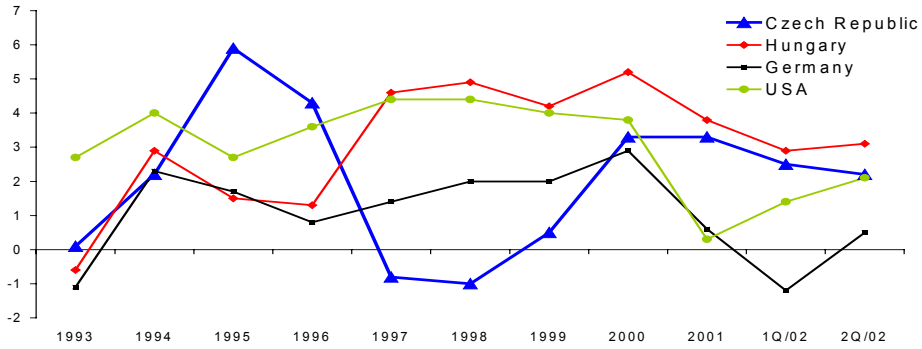


Chart 1. shows the evolution of business cycle of the Czech economy as compared to Hungary, Germany and USA. A closer look at the data indicates that during the recession 1997-1999 the Czech cycle was highly uncorrelated with that in Germany. Even in 2002 the cyclical correlation was far from being perfect, although correlation has increased in the meantime. However, it can be assumed, that due to intensifying ties to the German economy the level of cyclical correlation will increase in the medium- and long-run. The pattern that

is likely to emerge will be that cyclical swing of German and Czech economy will be similar but the Czech economy will display generally a higher rate of growth in the future.

Chart 2. Structural similarity vis-a-vis Germany

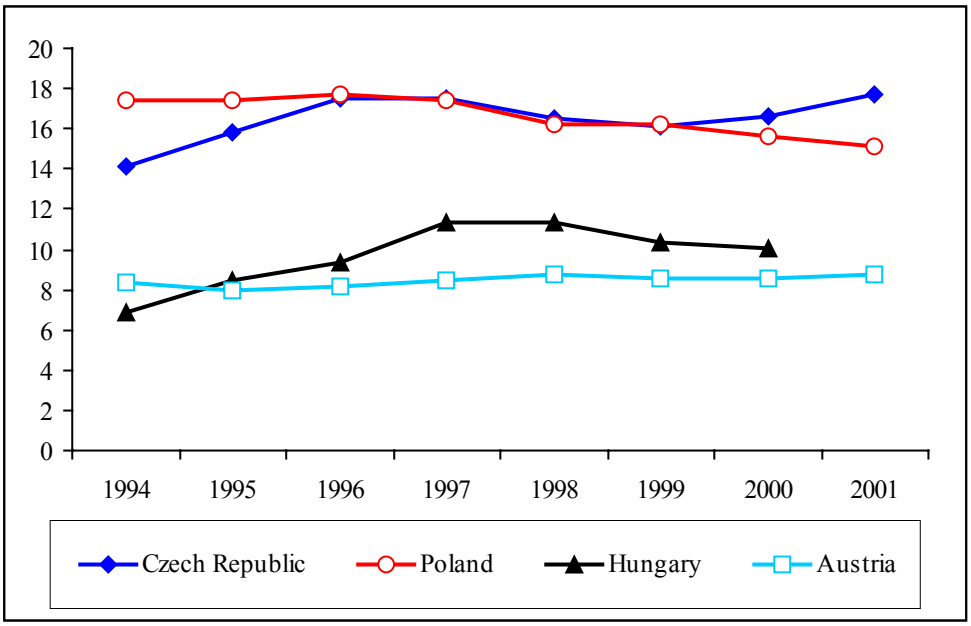


Chart 2. portrays the structural similarity of the Czech economy vi-a-vis German economy while using the Landesmann structural index defined as the share of value added in individual sectors in total value added (zero value stays for absolute similarity). The analysis implies that structural similarity of the Czech economy (and Poland) vis-a-vis Germany is smaller than that of Hungary and even further diverged in 2001. This finding is in contrast with other evidence that indicates a strengthening of intra-industry trade between both countries.

While the upper panel of Chart 3. shows the share of exports to Eurozone in total exports of a given country, the lower panel shows the same for imports. The tentative conclusion from the evidence is that since 1993 trade flows with Eurozone have intensified in given countries except Poland. Also, the share of exports to Eurozone in total exports and the corresponding share of imports reach high levels and are comparable with other small open "peripheral" EU countries such as Portugal, Ireland, Greece and Belgium.

Chart 3. Exports to Eurozone and imports from Eurozone

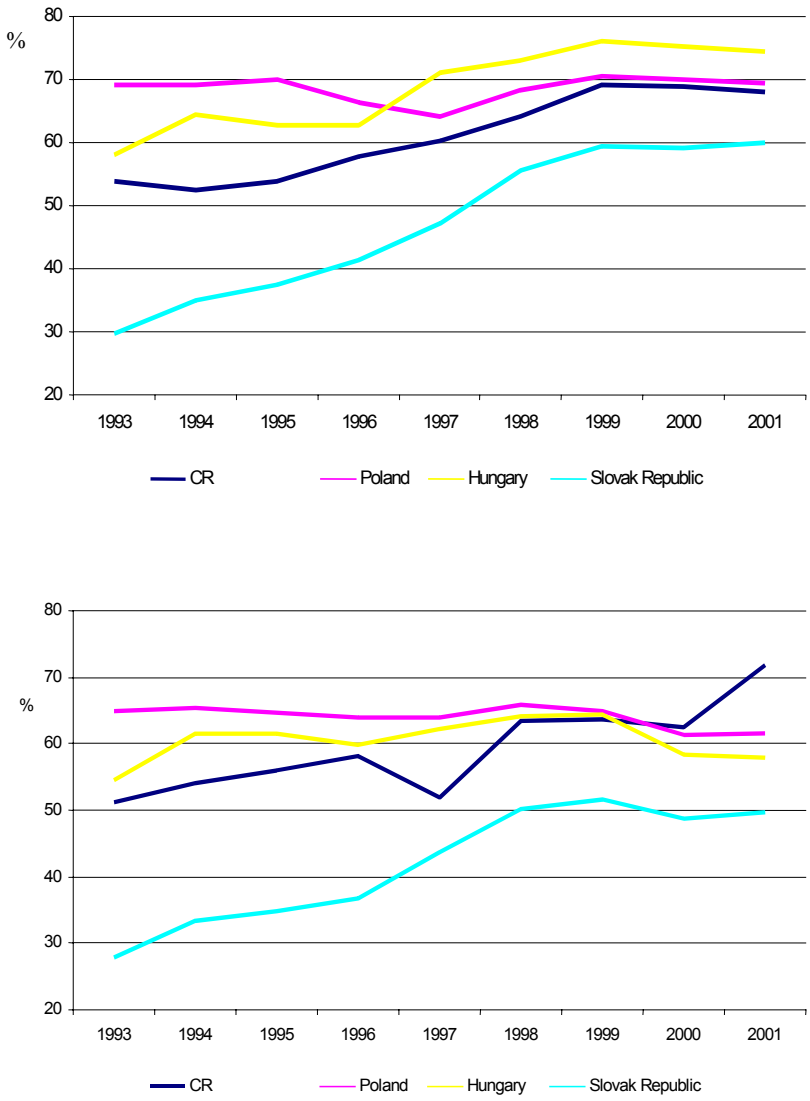
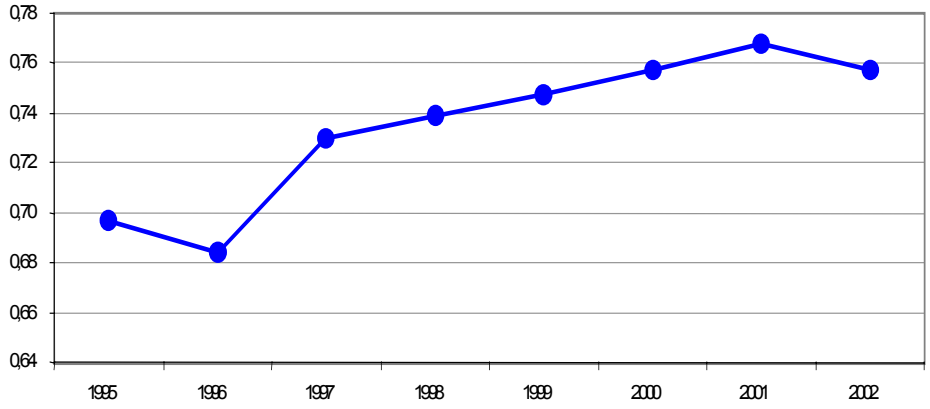


Chart 4. shows the evolution of intra-industry trade of the Czech Republic with the use of Grubel-Lloyd index (defined as the share of intra-industry trade in total trade). We can conclude that the share of intra-industry trade reaches rather high level, higher even than the level of some EU member countries. Considering the existing level, another increase of the index comparable with the pace observed in recent years does not seem to be likely.

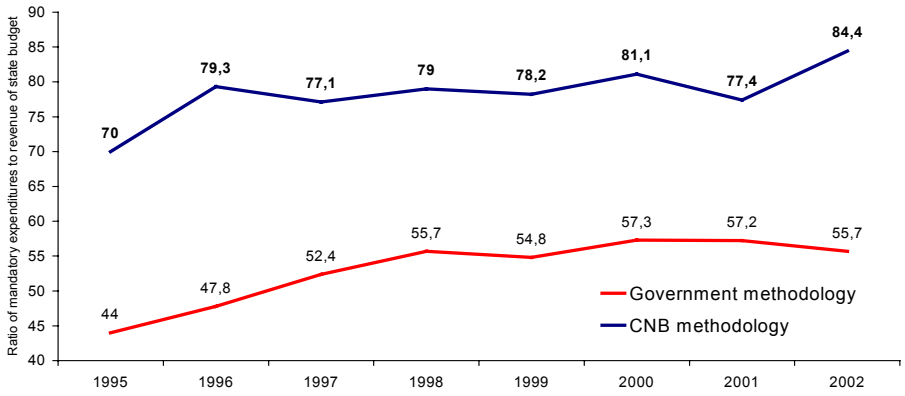
Chart 4. Intra-industry trade



3.2. Flexibility of adjustment mechanisms

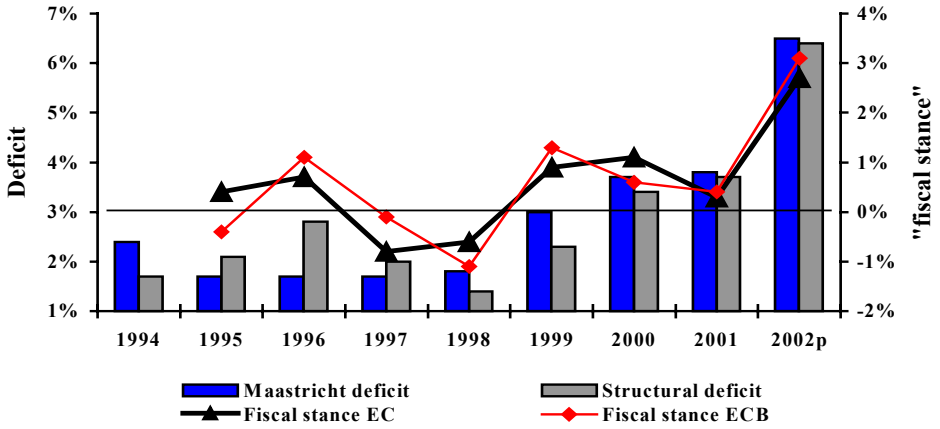
In the absence of monetary policy, the burden of macroeconomic adjustment shifts onto another mechanisms. Chart 5. shows one of the approaches to the assessment of stabilization capacity of public budgets.

Chart 5. Ratio of mandatory expenditures to revenue of state budget



The ratio of mandatory expenditures to revenue of state budget since 1995 has increased by 14 percentage points according to both computation methodologies. It implies that rather high ratio substantially limits the space for implementation of anti-cyclical stabilization policy by budgetary means. A bit different perspective is provided by Graph 6 that presents public budget and fiscal stance.

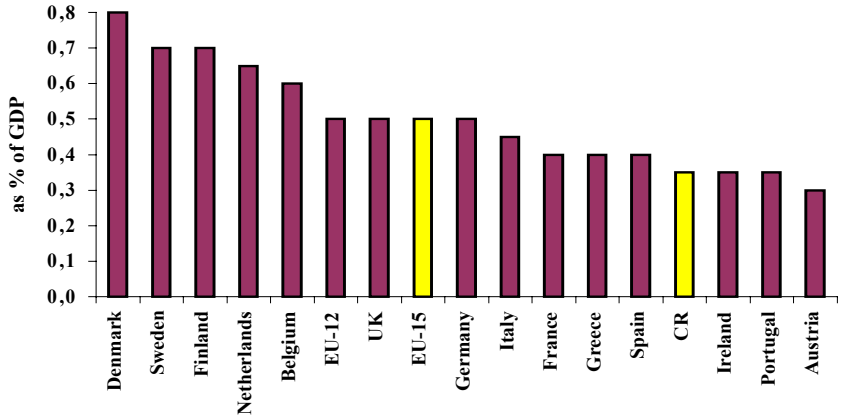
Chart 6. Public budget and fiscal stance



It is obvious from the evidence that since 1998 there has been an outspoken tendency towards increasing deficits in public finance driven predominantly by an increase of structural deficits.

Fiscal policy has been mostly expansionary (except for 1997-98) and its impact was mostly pro-cyclical (except for 1999). Nowadays, the fiscal performance is far from complying with a given Maastricht criterion and is going to further diverge from it in a foreseeable future. The situation in public finance thus seems to be much worse than in other accession countries.

Chart 7. Size of automatic fiscal stabilizers



The responsiveness of fiscal balance to business cycle is reflected by the size of automatic fiscal stabilizers. Chart 7. compares its size for the Czech Republic in comparison with several other European countries. The comparison suggests that the size of Czech stabilizers is somewhat lower than the EU average (partly because of the fact that the responsiveness of expenditures to business cycle is taken as zero; normally it is about 20 % of the size of responsiveness of budget revenue).We could infer that the very size of automatic fiscal stabilizers in the Czech economy should not cause any substantial problem for the functioning of the economy within the framework of Stability and Growth Pact.

The way how the Czech fiscal stabilizers could work in reality is simulated in Table 1. The table basically quantifies the available space for fiscal discretion for several European countries.

Table 1. Space for fiscal discretion

As % of GDP	**Cyclical "safety reserve"** **(1)**	**Maximum structural deficit** **(2)**	**Current public deficit** **(3)**	**Space for discretion** **(4)**	**Adjusted space for discretion** **(5)**
Germany	-1,4	-1,6	-2,8	-1,2	-0,5
Greece	-1,3	-1,7	0,3	2,0	1,6
France	-1,3	-1,7	-2,0	-0,3	-0,2
Netherlands	-2,3	-0,7	0,0	0,7	0,9
Portugal	-1,8	-1,2	-2,6	-1,4	-1,6
Sweden	-2,2	-0,8	1,7	2,5	2,6
CR	**-1,1**	**-1,9**	**-6,5**	**-4,6**	**-4,5**

Notes:
(1) equals "normal" output gap * size of automatic fiscal stabilizer
(2) equals –3% (as Maastricht limit) *minus* (1)
(4) equals (3) *minus* (2)
(5) space for discretion adjusted to current output gap
(-) indicates the necessity for fiscal adjustment
(+) indicates the space for fiscal discretion

The table implies rather unfavorable situation of the Czech fiscal policy. Should the Czech Republic fulfill the Maastricht criterion and comply with the Stability and Growth Pact now, the fiscal correction of the scope between 4-5% of GDP would be required. Fiscal adjustment of such a scope, if implemented quickly, would have large negative impact on growth at least in the short run. Czech Republic is in much worse situation than all EU member and also possibly than most of other accession countries. The ageing of population will further sharpen the fiscal tension unless the issue of pension system reforms is addressed decisively.

The analysis of the labor market carried out by CNB is less advanced than that of fiscal policy. While Chart 8. shows the variation coefficient of unemployment rate, Chart 9. portrays the long run unemployment rate.

Chart 8. Variation coefficient of unemployment rate

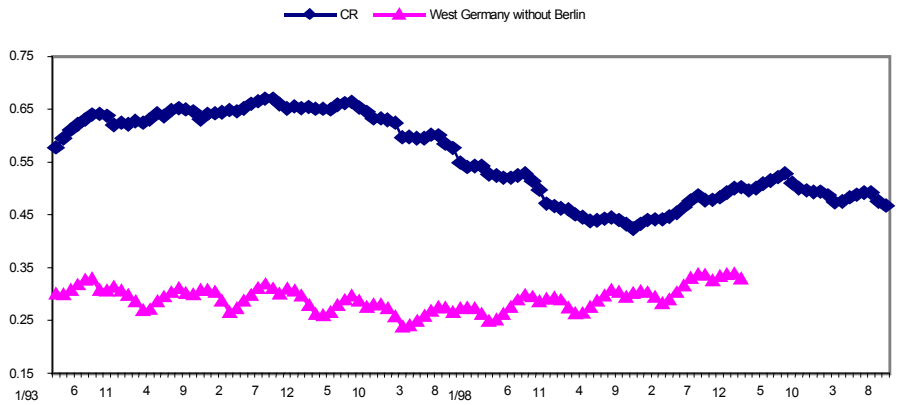
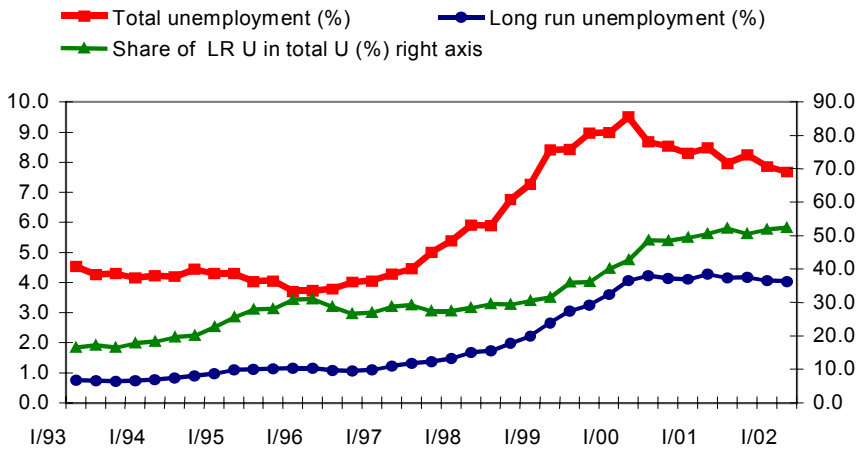


Chart 9. Long run rate of unemployment



The evidence suggests a limited flexibility of the Czech labor market. There are several reasons for this conclusion. The mobility of labor is low partly due to still not very flexible housing market. People are not very willing to change jobs although a progress has been witnessed in recent years. As indicated by Chart 8., variation coefficient is still higher than in Germany in

spite of significant improvements after 1997. Also, Czech wages are inflexible downwards. All in all, inflexible labor market could increase the risk stemming from an early adoption of euro. The risks could be further enhanced by restrictions imposed by the EU Commission on migration between accession countries and EU incumbents.

3.3. Other factors that can influence the timing of EMU accession

There is a wide range of economic factors that might influence the timing of the adoption of euro. These refer to the assessment of the fundamental real exchange rate, inflation differentials, interest rate differentials, state of the convergence play, similarity of yield curves, etc. Some indicators show that nominal convergence in the Czech Republic is quite well advanced. Inflation is currently even lower than in the EU, policy interest rates of the CNB are on the same level as those of ECB and the yield curves practically identical. These "achievements" seem to justify a relatively early adoption of euro. Another good news from CNB point of view is that the exchange rate bubble which plagued the economy in the first half of 2002 deflated in the second half as a consequence of coordinated action between the central bank and government. Acute appreciation pressures have thus been mitigated, at least temporarily, which should contribute to a stabilization of inflation expectations.

4. Current risks

As was mentioned above, the most significant medium term risk factor is the unconsolidated public finance. Lack of courage of current government to address this problem decisively could have destabilizing impacts on macroeconomic equilibrium. There is a concern that any unnecessary hesitation to put fiscal house in order could be ruthlessly penalized by financial markets. As a consequence, an ongoing convergence play could be interrupted and adoption of euro postponed. In addition, lack of fiscal prudence may require a monetary tightening in the long run with negative implications for economic growth and real convergence. There is even the risk that mounting government debt could pass the threshold of Maastricht limit of 60% at the end of this decade thus effectively preventing from adoption of euro. Chart 10. and 11 below sum up the outlook for fiscal development. The data for the period 2003-2006 are forecasts by Ministry of Finance based on the assumption that no consolidation is implemented (i.e. no policy change scenario).

Chart 10. Public deficit 1994-2006

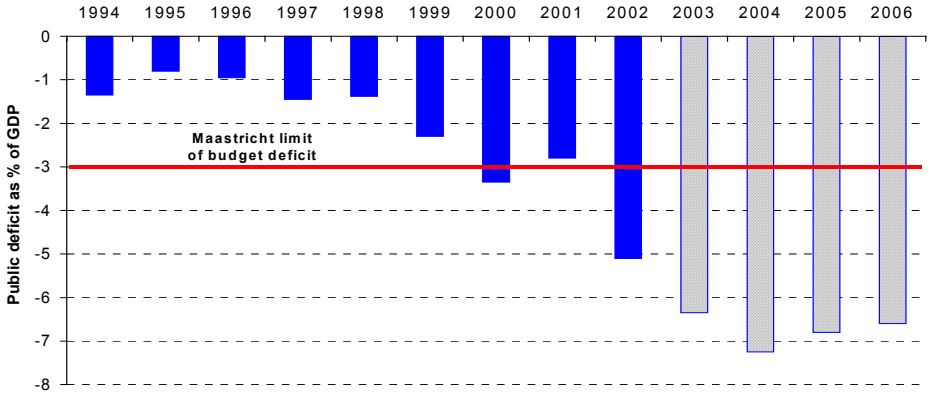
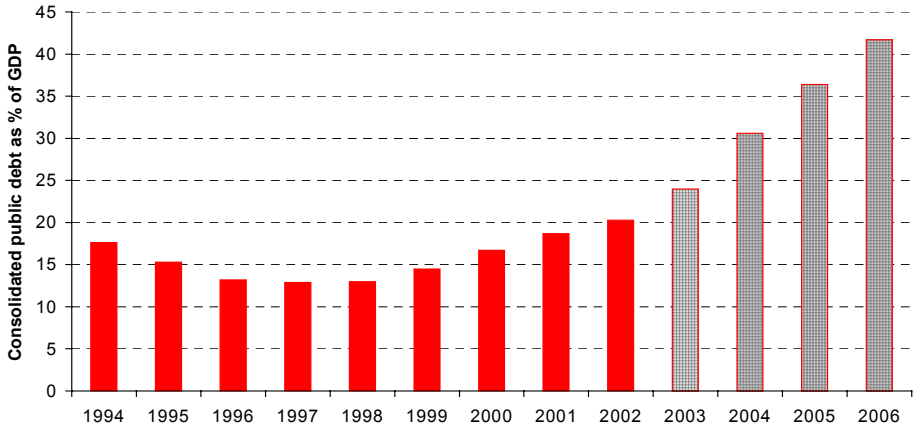


Chart 11. Public debt 1994-2006



5. Arguments against fast adoption of euro

Although CNB already revealed its preference for the fast track to euro, some arguments against fast adoption should not be ignored. In this paper we presented some evidence implying that adjustment mechanisms may not be ready to cope with shocks appropriately. This refers to very limited ability of fiscal policy to stabilize the economy mainly due to an increasing ratio of mandatory expenditures to total revenue and narrowing space for fiscal maneuver over the business cycle. Also, the lack of flexibility of labor market may impose unnecessary costs on real adjustment instead of price adjustment that could lead to an undesirable slow down in real convergence. Rather painful

aspect is that both fiscal consolidation and labor market reform are time consuming and require a social and political consensus. When we consider that domestic political scene has been characterized by minority governments in recent years the overall political and social setting does not seem to be very conducive to required changes.

Some doubt could also emerge with respect of the pace of recent real appreciation. Should the real appreciation be attributed predominantly to the Balassa-Samuelson (B-S) effect (which is in full conformity with mainstream economic reasoning), then the pace of real appreciation observed since 1993 may not have been an equilibrium process. Some recent studies focused on the quantification on B-S effect have found a little evidence that the productivity growth differential should account for the real appreciation by more than 1 percentage point a year. Should this be the case, a larger part of real appreciation during most of 1990s thus remains unexplained. This inescapably introduces an uncertainty into the estimation of the equilibrium exchange rate. The lesson for policymaking would be to give the economy enough chance (time) to "find" its equilibrium exchange rate level in order to minimize the adjustment problems if the irrevocable pegging the currency to euro occurs with a noticeable misalignment. Such a requirement just implies to let the economy work several years in the circumstances when all transformation restructuring is basically finished and big state stakes in major enterprises sold.

Summary

To summarize, current fiscal policy and especially the lack of strong commitment to consolidate public finance decisively emerge as major bottlenecks for adoption of euro by the Czech Republic in this decade. It could even be the case, that by the time when policymakers manage to put public deficits under control, currently observed lack of flexibility of remaining adjustment mechanisms basically disappear. As a consequence, the dilemma between the fast and slow track may be already solved in favor of the latter.

Karel Zeman*

The basic features of the proceeding discussion about the Czech Republic preparation for joining the Eurozone

Abstract

The paper summarizes the current stage of the Czech Republic preparation for accession to EU and its adherence to the aims of EMU with accent on basic features of:

- macroeconomic policy orientation,
- adoption and implementation of the EMU related *acquis communautaire*,
- assessment of the Copenhagen criteria fulfillment,
- possible period for adoption of the euro.

Meeting the Copenhagen convergence criteria constitute a prerequisite for the Czech Republic accession to EU (in year 2004). But the fulfillment of the Copenhagen criteria (real convergence) support the ability to adhere to the aims of EMU at the time of the Czech Republic accession to EU. As is mentioned in the literature[3], there exists the strong elements of complementarity between the processes of real (Copenhagen criteria) and nominal convergence (Maastricht criteria). This view has been adopted by the European Central Bank (ECB).[4]

The fulfillment of the "Maastricht convergence criteria" (including price stability, the sustainability of public finance, exchange rate stability in the framework of participation in the Exchange Rate Mechanism and the convergence of interest rates) is not mandatory for the Czech Republic accession to EU. However, creating the macroeconomic conditions for their realization is an important part of economic strategy and policy for the accession to EU[5] and in particular of the adoption and the implementation of

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[3] *Social and Economic Consequences of the Czech Republic´s Integration into the European Union (Economic Convergence, Competitiveness and Social Cohesion)*, Summary, Czech Government Council for Social and Economic Strategy, Prague, May 2002; Dědek, O., *The Czech Economy and the Euro (In Czech)*, Politická ekonomie 2002, No.3; Dědek, O., *Managing Economic Convergence and Financial Stability in the Czech Republic*, Prague Economic Papers, 2002, No. 2.

[4] *The Eurosystem and EU Enlargement Process, European Central Bank*, Monthly Bulletin, 2000, No.2 (February).

[5] *Economic strategy of the Accession to the European Union: Growth-Competitiveness-Employment- Solidarity*, Approved by the Government of the Czech Republic on May 17th,

the EMU-related *acquis communautaire* which will provide the necessary background to pursue stability-oriented policies in preparation period for the final adoption of the euro in the Czech Republic (during the period 2006-2010).

1. Macroeconomic policy orientation towards meeting the Maastricht convergence criteria

The **primary objective of economy policy** is to meet the Copenhagen criteria, whilst closing the gap in income levels between the Czech Republic and the EU[6]. In this context the Czech economic strategy is oriented to the improvements of competitiveness in the broadest sense in medium-term. The integration of the Czech economy into EU single market environment (and later into EMU environment) is a crucial step in coping with the challenge of globalization.

The medium-term framework of Czech macroeconomic policy is based on co-ordination of national monetary and fiscal policies.[7]

The main objective of the Czech National Bank (CNB) **monetary policy** is price stability. Monetary policies are conducted under **inflation targeting** on the basis of the CNB´s long-term monetary strategy. Inflation target for the next four-year period has been announced in the form of range for year-on-year growth of headline consumer price index, descending evenly from the level of 3-5 per cent in January 2002 to the level of 2-4 per cent in December 2005. Favorable inflationary development, economic growth without any visible imbalance tendencies and halting of interest rate cuts abroad are the main factors influencing CNB´s monetary policy regime in the forthcoming period.

The main objective of **fiscal policy** in the medium run is to consolidate public finance and to create a room for maneuver so that fiscal policy can make use of its stabilizing properties. The public finance consolidation will be focused on the medium-term consolidation of the tax quota and a gradual reduction in the expenditures quota in order to mitigate and subsequently eliminate public finance's deficit tendencies without negatively affecting the performance of the Czech economy and its real convergence. A gradual reduction in structural deficits will require adaptation of the expenditure and revenue side of the general government budgets. This primarily involves a revision and revaluation of the volume and structure of mandatory expenditures

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1999, Prague; *The Eurosystem and EU Enlargement Process, European Central Bank*, Monthly Bulletin, 2000, No.2 (February).

[6] *Joint Assessment*, op. cit.

[7] *National Programme for the Preparation of the Czech Republic for Membership in the European Union*, Ministry of Foreign Affairs of the Czech Republic, Prague, June 2001.

and improving budgetary allocation. This task is essential for preparing the Czech Republic for EU accession as well as for becoming a full-pledge member of the EMU in the future.

Main medium-term economic challenges for the Czech Republic are **public finances.** The sources of **fiscal risk** (or challenges) are identified as:

- the implicit indirect government liabilities that developed at institutions managing non-performing assets,
- the indirect government liabilities stemming from state guarantees,
- future expenditure for pensions and healthcare stemming from changes in demographic developments.

In 1999, the CNB announced the **Long-term Monetary Strategy**, with the approval of the Government. The CNB set the target to approximate price growth to the EU and to create conditions for reaching the long-term objective of price stability defined in the Long-term Monetary Strategy anticipated for around 2005. In April 2001, there was a shift to a continuously targeted band for total year-on-year inflation that will steadily fall from 3-5 per cent in January 2002 to 2-4 per cent in December 2005. This target was set on the basis of an agreement with the Government. If inflation is affected by excessive unbalanced tendencies in regulated prices or the unexpected administrative measures, the institution of exceptions shall be applied to reach the inflation target.

A new quality of a dialogue between the Central Bank and the Government has **improved the conditions for forming a desirable mix of monetary and fiscal policy**. Consensus of the Government, the Central Bank and other entities, including trade unions, increases the credibility of announced inflation targets. This also has a favorable effect on inflation expectations and reduces the costs of anti-inflationary policy.

The task of fiscal policy in the medium run is to consolidate public finances and to create a room for maneuver so that fiscal policy will limit the danger of the pro-inflationary risk.

The consensus of the government and CNB on the medium-term tasks of both monetary and fiscal policy should pursue both goals in co-operation, i.e. the goals of price stability and balancing the economic cycle.

Important measure for increasing sustainability of the fiscal stance of the Czech economy in medium-term is **the conception of increasing the efficiency of public finances** prepared by Ministry of Finance of CR. It is composed of **five principles forming the basis of budgetary reform** needed for the future meeting of the nominal (Maastricht) convergence criteria as a prerequisite for joining EMU:

- **Principles of transparency**: the direction for continuing strengthening of fiscal transparency is based on prior analyses and the identified sources of

fiscal risk as well as international codes and recommendations for fiscal transparency related to:
- clearly defining the Government sector based on the principles of the integrity of the budget and its financing,
- the accessibility of reliable, systematic, complete, timely and comparable information for budgetary participants and the general public,
- the openness of budgetary preparations and implementation, strengthening of the system of financial controls over all the procedural levels of public finance including verification by an independent entity.

- **Principles of budgetary stability**: this mainly concerns improving the management of budgetary expenditures by a complex system of preparation and establishing medium-term expenditure targets according to Government priorities and integrating them into the medium-term expenditure framework:
  - efficiency from the standpoint of operations as well as allocation by introducing Government expenditure budgeting on the basis of performance and results,
  - decentralizing budgetary authorities and responsibilities to strengthen the subsidiary principles, while integrating the functions of financial management (implementation of the budget, budget and debt financing, accounting, bookkeeping and financial statistics and financial planning).

2. Adoption and implementation of the EMU-related *acquis communautaire*

According to the opinion of the ECB[8] the adoption and the implementation of the EMU-related acquis provide the candidates for accession to EU with the necessary background to pursue stability-oriented policies. From the perspective of the Eurosystem, for establishing the appropriate conditions for stability-oriented monetary policies, sound banking systems and smoothly functioning market economies are important. In particular this refers to legislation:
- on central banks,
- on capital movements,
- related to the creation of conditions for sound banking systems and financial stability.

[8] *The Eurosystem and EU Enlargement Process*, op. cit.

According to 2002 Regular Report[9] "the Czech Republic has made significant progress in the adoption of EMU-related *acquis*".

In March 2002, Parliament amended **the Law on the Czech National Bank (CNB)** with a view to align it fully with the *acquis*. The amendment entered into force on 1 May 2002.

As regards the independence of the CNB, the amendment to the bill on the CNB has ensured compatibility with the *acquis* with changes in the area of financial, personal and institutional independence. Additionally, an amendment to the Constitution of the Czech Republic has ensured that the primary objective of the CNB is defined as price stability.

In the field of **capital movements**, liberalization in line with the *acquis* is almost completed. In the field of capital movements and payments, an amendment to the Foreign Exchange Act has been adopted. As of January 2002 it abolishes restriction on acquisition of real estate by branches and agencies established in the Czech Republic.

In terms of **payment system**, the amendment to the Act on Banks, which entered into force on 1 May 2002, has abolished the CNB´s monopoly for clearing domestic inter-bank currency payments. It has also aligned Czech legislation with the *acquis* concerning the single license for institutions authorized to issue electronic payment instruments.

As regards **money laundering**, the amendment to the Act on Banks prohibits any new deposits or payments of interest on existing anonymous account from 1 January 2003.

In the field of financial services, transposition of **banking sector *acquis*** has been largely completed. The harmonization amendment to the Act on Banks (dealing with regulation and banking supervision) entered into force in May 2002. This act with the new Act on Payments has helped to ensure a comprehensive transposition of the relevant *acquis*.

According to overall assessment of those aspects of the Economic and Monetary Union *acquis*, which candidate countries should implement before accession, **the Czech Republic have completed the process of legislative alignment with the EMU *acquis*.**

The Czech republic will participate in EMU upon accession with the status of a country with a derogation under article 122 of the EC Treaty, and it will need to implement the necessary changes to its institutional bank and legal framework by the date of accession.

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[9] *2002 Regular Report on Czech Republic's Progress Towards Accession*, CEC, Brussels, 9.10.2002, SEC (2002) 1402, pg. 78.

3. Assessment of the Copenhagen criteria (with adherence to EMU) fulfillment

There is the mutual relationship between real and nominal convergence in the process of the Czech Republic preparation for accession to EU and consequently to EMU. In particular, price stability has a positive impact on real economic performance and sufficient fulfillment of the Copenhagen criterion related to the ability to adhere to the aims of EMU already in the period of preparation for accession to EU.

In its 2002 Regular Report[10], the Commission concluded that **the Czech Republic is a functioning market economy.** The continuation of its current reform path should enable the Czech Republic to cope with competitive pressure and market forces within the Union. Against a challenging international economic environment, economic performance has improved. Macroeconomic stability has been achieved, reforms have deepened while the Czech authorities' commitment to the economic requirements of EU accession has been sustained.

The Czech Economy has returned to solid **growth rates** following a recession in 1997 and 1998 and macroeconomic stability has been regained (see figure in Table 1). But the progress in terms of real income convergence is slow. In 2001 the average per capita GDP in purchasing power standards (PPP) amounted to 57% of the EU-15 average[11].

The economy as a whole has achieved a satisfactory level of competitiveness. Gains in **labor productivity** over the last five years have enhanced the external competitiveness of the Czech [12]economy.

Table 1. Main trends of basic real convergence indicators in the Czech Republic

	1997	**1998**	**1999**	**2000**	**2001**
Real GDP growth rate, per cent[a)]	-0.8	-1.0	0.5	3.3	3.3
Labor productivity growth, per cent [b)]	0.1	0.4	2.6	4.0	2.9
GDP per capita in ECU/euro PPP	12100	12200	12500	12600	13300
Gross value added structure, in per cent [c)]					

[10] ibidem.
[11] ibidem.
[12] K. Zeman, *The Strategy for Accelerating the Catching-up Process in the Czech Republic Preparation for Accession to EU*, Paper for International Conference "EU Eastern Enlargement Coming Soon, Strategy for Membership", Gdansk University, April 18-24, 2002

Agriculture and forestry	4.4	4.6	4.2	4.3	4.2
Industry	34.1	32.5	31.8	32.3	32.9
Construction	8.0	7.2	7.2	7.1	7.2
Services	53.4	55.7	56.8	56.3	55.8
As % of GDP [c)]					
Gross fixed capital formation	30.6	29.1	27.8	28.3	28.3
Exports of goods and services	56.5	58.8	60.6	69.8	71.3
Imports of goods and services	62.5	60.0	61.9	73.2	74.1
Share of EU-15 as % of total external trade					
Exports	59.8	64.0	69.2	68.6	68.9
Imports	61.8	63.5	64.2	62.0	61.8
As % of population					
Economic activity (15-64)	71.7	71.7	71.8	71.2	70.7
Employment rate					
(15-64)	68.6	67.5	65.6	64.9	65.0
Average employment structure, in per cent					
Agriculture and forestry	5.8	5.6	5.3	5.2	4.6
Industry	32.0	31.5	31.1	31.0	31.4
Construction	9.6	10.0	9.4	9.4	9.1
Services	52.6	52.9	54.1	54.8	54.6
Unemployment rate as % of labor force, total	4.3	5.9	8.5	8.8	8.0
Lon-term unemployment share, as % of all unemployed	32.3	31.5	36.7	50.0	52.9

a) In constant prices.
b) GDP in constant prices per employed person.
c) In current prices.

Source: *2002 Regular Report on Czech Republic's Progress Towards Accession*, CEC, Brussels, 9.10.2002, SEC (2002) 1402.

The sectoral structure of the economy, which is characterized by a relatively large manufacturing sector, has altered only marginally. The share of the manufacturing sector in the economy has altered with the economic cycle. Its decline, both in terms of gross value added and of employment, came to a halt in 1999, and it has been rising again since then. In 2001, industry (without construction) produced 34% of gross value added, the same share as in 1997. The development of the services sector in terms of GDP shows just the reverse trend, though its share in total employment has been on the rise over the whole period. In particular, financial intermediation and the tourist sector posted gains. The gross value added of construction fell from 8% in 1997 to 7% in 2001 with a smaller drop in the share of total employment. The agricultural sector has never posed a severe challenge in terms of structural adjustment because of its small size.

High level of **gross fixed capital formation** have significantly improved the supply side of the economy. Over last five years, fixed investment has averaged 28,8% of GDP. Private investment has reached 23,5% of GDP on average, thus leaving about 5% for public investment which compares favorably to the EU average. This strong investment performance has helped to replace the old capital stock and has upgraded production capacities. As a result productivity increases of about 3,2% on average over the last three years pushed up output growth and improved competitiveness. Physical infrastructure as a prerequisite for smooth economic development has got closer to international standards.

Employment policy is focused on fighting unemployment and on fostering flexibility. Progress in this policy area has been rather limited, though there seems to be a policy consensus on the most pressing deficiencies on the labor market: increasing regional disparities in unemployment, rising unemployment levels within what are considered high-risk groups and a declining employment rate in the older age groups. Labor force mobility will remain limited as long as adequate housing cannot be provided due to the highly regulated rent market. Active employment policy measures need to be focused on target groups with a clear linkage to market requirements.

The **well-skilled labor force has been an asset for coping with economic restructuring and making the Czech economy more competitive**. The high quality of professional education and the short time required to obtain qualification together with relatively low wage costs have been an advantage in competition for foreign investments. While the majority of the labor force have completed secondary education (about 66%), the percentage of the people with tertiary education has remained at a level of about 12%. Considering the trend towards increasingly advanced production technologies, a more sophisticated services sector and deeper integration into the world economy, education must be able and willing to meet higher demands. The education system faced the

challenge of expanding tertiary education and providing the workforce with tools to adapt to life-long learning in order to continuously meet labor market requirement.

Unemployment remains high due to restructuring and structural mismatches on the labor market.

The unemployment rate (labor force survey data) has more than doubled, from 4.3% in 1997 to 8.8% in 2000. Its decrease to 8% in 2001 appears to be in particular the result of an amendment to the Labor Code limiting overtime work. The unemployment rate reflects the impact of the 1997 crisis and subsequently economic restructuring which only starts at late stage in the transition process. Employment fell in each year between 1997 and 2000, amounting to a cumulative loss of employment of 3.0% registered. Though the adjustment process has been accompanied by accelerating investments and new employment opportunities, these have not been able to compensate for the job losses. The composition of unemployment reveals the structural shortcomings in the labor markets. Workers in sectors undergoing restructuring find it difficult to move to the other sectors or regions with a higher growth potential since flexibility and mobility are hampered by deficiencies in re-qualification and the scarcity of affordable housing in more prosperous regions. In certain circumstances, the social benefit system may work as an disincentive to take up work. Hence, while some regions and sectors suffer from high and even increasing unemployment, others are reporting the first signs of shortage in the skilled labor force.

The Czech economy is very open and **trade integration with the EU has reached high levels.** While in 1997 exports and imports of goods and services amounted to 119% of GDP, this ratio rose to more than 145% in 2001. Exports to the EU also showed a clear upward trend, from roughly 60% of total exports in 1997 to about 69% in 2001. Imports from the EU as a percentage share of the total, by contrast, have hovered around the five-year average of 62%. In general, trade with developed market economies has intensified, but trade relations with other transitional economies have been extended as well. External trade is concentrated to a very high degree on technology and capital-intensive manufactured goods, with an emphasis, on the export side, on road vehicles and electrical machinery[13].

The Czech economy has emerged as an **attractive market for foreign investments.** From 1997 to 2000, inflows of foreign direct investment (FDI) reached an average of 7,8% of GDP, peaking at 11,6% in 1999 and then decreasing to 8,7% in 2001. In the first quarter of 2002, FDI reached EUR 3,1

[13] K. Zeman, *Competitiveness of the Czech Manufacturing during the Period of Preparation for Accession to EU (In Czech)*, Study of Institute of Integration of the Czech Republic into the European and World Economy, Prague, November 2002.

billion. FDI inflows originated mainly from the EU and other OECD countries and were concentrated in the machinery and equipment sector and in the financial services sector. Privatization-related FDI has accounted for a large share of total FDI, but greenfield and brownfield investment has gained increasing importance. This development has been supported by offering attractive incentive packages to foreign investors. The Czech Investment Incentive Act provides a large number of investment incentives hat can be combined. The Office for Protection of Economic Competition ensures the compliance of the investment grants with the *acquis*.

Good progress in real convergence has been influenced by **the macroeconomic policy mix** (which has been broadly adequate) and also by the process of privatization. **The private sector** is firmly established and accounts for the overwhelming part of the Czech economy. Private ownership has become the dominant form of ownership. In 2001, 79,8% of GDP was produced in private companies, in contrast to 74,7% of GDP in 1997. The land market has been liberalized and land registers, broadly speaking, work properly. The supply of industrial and commercial land has continued to exceed demand, although the market in economically booming regions like Prague is tighter. Overall, the state still owns a significant share of land.

The conclusion from real convergence of the Czech economy development during last five years has supported the opinion that it created conditions for relatively quicker admission into the Eurozone where the single currency – the euro – is used.

4. Possible period for adoption of the euro

Assessment in terms of main trends of the basic nominal convergence indicators in the period of last five years support the faster adoption of the euro in the Czech economy (see figures in Table 2.).

Inflation remained at relatively low levels. After peaking at 9,7% in 1998, the inflation rate dropped to a very low 1,8% in following year. However, since the beginning of the economic pick-up, as price deregulation measures have also been taken up again and pushed by the increase in international commodity prices, the inflation rate edged up to 3,9% in 2000 and 4,5% in 2001. Throughout the first half of 2002, inflationary pressures were subdued. Slackening economic activity, low international commodity prices but also the strong Czech crown has contributed to this development. In the first half of 2002, consumer price inflation was 3% higher than in the corresponding period of the previous year.

The current monetary and exchange rate policy framework of direct inflation targeting and a managed exchange rate float have served the economy

well. Inflation targeting was introduced in 1998, with net inflation serving as the reference until 2001. In the first years, the inflation targets of the CNB were undershot. With its "Setting of the Inflation Target for the Period 2002 to 2005", the CNB has embarked upon headline inflation targeting which helps ensure that the public accepts the targets. The inflation target is set as a band which should fall continuously from 3% to 5% in January 2002 to 2% to 4% in December 2005.

Monetary policy has been accommodating since 1998. Policy rates been cut back several times, recently reaching 3% for the main **interest rate**, the two-week repo rate. The real short-term interest rate (day-to-day money market rate, corrected for by consumer price inflation) has equally been falling from around 11% in 1997 to 0,5% in 2001. Monetary conditions reflect the low inflationary environment and the strong exchange rate of the Czech currency.

Table 2. Main trends of basic nominal convergence indicators in the Czech Republic

	1997	**1998**	**1999**	**2000**	**2001**
Inflation rate, Consumer price index[a)]	8,0	9,7	1,8	3,9	4,5
Average interest rates, % per annum					
Long-term[b)]	10,5	12,1	7,6	6,8	6,0
Credit rate	13,2	12,9	8,7	7,2	7,0
Deposit rate	7,7	8,1	4,5	3,4	3,0
Public finance, as % of GDP					
General Government deficit surplus	-2,7	-4,5	-3,2	-3,3	-5,1
General government debt of the whole economy [c)]	44,6	39,5	43,2	41,2	36,5
Gross foreign debt of the whole economy as % of exports [c)]	42,5	45,2	46,8	38,1	
FDI (net) inflow, in Mio ECU/ euro	1 148	3 303	5 932	5 405	5 489
FDI (net) inflow, per cent of GDP	2,5	6,6	11,6	9,8	8,7
Current account balance, percent of GDP	-6,1	-2,3	-2,7	-5,3	-4,6

a) Annual average
b) 5 year government bonds yield to mat.
c) In CZK

Source: *2002 Regular Report*, op. cit.; *Czech Republic Macroeconomic Forecast*, Ministry of Finance CR, Prague, October 2002.

Reluctance to undertake comprehensive expenditure reforms has led to **a deterioration in public finances**. The previous government pursued only modest fiscal consolidation, but the fiscal program of the newly-elected government is not very ambitious in this respect, either. On the basis of harmonized EU standards (ESA 95), the **general government deficit** has averaged 3,8% of GDP from 1997 to 2001. In 2001, the deficit reached 5,5% of GDP and it is anticipated that it will surge to 6,6% of GDP in 2002. Public budgets have to swallow the costs resulting from the delayed implementation of structural reforms, in particular the clean-up of the banking sector and the restructuring of the corporate sector.

General government debt has been moderate but this does not completely reflect government's financial exposure. General government debt reached 23,6% of GDP at the end of 2001, up from 13,7% in 1998. Past and current levels of government debt do not fully reflect the actual picture of indebtedness as they include only part of the debt of the transformation institutions and guarantees of the government and the National Property Fund. The government has started to gradually internalize these liabilities in the general government debt. That adds substantially to the statistically reported stock of government debt over time.

The **current account deficit** averaged 4,1% of GDP between 1997-2001. Since 1998, the deficits have been financed by **high inflows of foreign direct investment**. In 1996/1997, the economy was confronted with unsustainable current deficits due to soaring deficits in foreign trade. The implementation of the austerity measures in 1997 led to a temporary sharp deceleration of imports. With the economy recovering since 1999, the trade and current account deficits have widened again. However, the trade deficits have been dominated by investment goods imports and there is no indication so far that consumer goods imports are getting out of hand. In 2001, the trade balance recorded a deficit of 5,5% of GDP and the current account surplus. In the first quarter of 2002, the trade balance posted an estimated deficit of 4,6% of GDP and current account deficit reached 4,2% of GDP.

In discussions on the **possible time the Czech Republic should adopt the euro**, there are two flows of opinion. The first is "the sooner the better"[14], and the second is "be careful, no need to hurry"[15]. Going by the Regular Reports of recent years, the European Commission is more inclined to the latter view. The outcome of this debate necessarily entails a detailed examination of the other theoretical observations and an evaluation of the practical experience of countries (e.g. Ireland, Portugal and Spain)[16] when the exchange rate

[14] O. Dědek, *The Czech Economy*, op. cit.
[15] *Social and Economic Consequences*, op. cit.
[16] O. Dědek, *The Czech Economy*, op. cit.

mechanism disintegrated in 1993, or the recent experience of Argentina. Some of the Czech Republic's basic macroeconomic parameters (economic level and comparative price level) will not come close to the standards enjoyed by the least economically developed countries (Greece and Portugal, when they entered the Eurozone) until 2008-2010. Therefore their results could play a key role in future decision.

According to the results of study prepared for the Czech government[17] **the benefits of joining the Eurozone** rest primarily in the **elimination of the risk of currency crises**. World-wide experience of repeated financial and currency crises, which can be sparked or augmented also by the "international infection" effect, is a powerful argument in favor of the fast adoption of the euro. Another clear-cut advantage, particularly apparent in the case of the open Czech economy, is the **reduction in transaction costs**, i.e. the cost of converting currency. Another plus is the anticipated **cut in interest rates**, even though this change would only affect the Czech Republic to a lesser extent (considering the low interest rate differential).

The volatility of the **exchange rate will also fall and exchange rate fluctuations would be eliminated completely** in relations with the Czech Republic's main trading partners – members of the Eurozone. **The absence of the exchange rate is undoubtedly a factor simplifying real convergence**. However, the exchange rate is also a significant factor of the economy allowing for adaptation to changes in the economic situation. Experience has confirmed that where the exchange rate fails to adapt, the external imbalance tends to be corrected by a slowdown or decline of economic growth.

The risk relate to loss of the adaptation mechanisms of the economy, which is at a much lower economic level than the economies of other Eurozone members. Differences in economic level lead to major divergences in structural characteristics and in resistance of economies to external shocks, as well as in the inflation rate which is optimal for their economic growth.

There are general and specific risks. As yet, there is no synchronization between the Czech economic cycle and the Eurozone cycle, nor can we assume that the impacts of economic shocks on the Czech economy and on the other members of the Monetary Union will be symmetrical. Substitute adaptation mechanism could be high price and wage flexibility (up or down) and high cross-border mobility of the workforce and of business activities (in both directions). However, these mechanisms are still weak. It is well known that European Union is working in the interest of current Member States to slap administrative restriction on the free movement of the workforce and business activities (especially services) for a long period of time. Fiscal policy, as another adaptation instrument, will also be limited by the fiscal stability pact.

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[17] *Social and Economic Consequences*, op. cit.

Specific risks are attached to transition economies. The process of real convergence will give rise, in the Czech economy, to the tendency of real appreciation of the currency, which will be expressed after Eurozone accession as a real appreciation of domestic assets, resulting in an increase on general price levels. This is set to be a long-term process. Real appreciation will on the one hand bring the danger of loss of competitiveness, and on the other hand the problem will emerge as to whether the economy will be able to achieve optimum growth at an inflation rate low enough not to interfere with the European Central Bank's monetary goals.

An anti-inflation policy that is too tight could slow down the necessary correction of relative prices, which must be a lot deeper in the Czech economy than stabilized Member States because of the persistent price deformations. Price levels in the Czech Republic are among the lowest in Central-Eastern European (CEE) countries, and therefore we can expect them to balance out at a much more forceful pace. A very important long-term source of real appreciation will be the tradable and non-tradable sectors of the economy, in a situation where there is "wage contagion". There will be several reasons for real appreciation – as wee catch up technically and economically, price growth will be faster, which will be reflected in part as "fictitious inflation", because product innovation and enhanced quality will be registered statistically as a price rise.

ECB efforts to maintain a low inflation rate in the Eurozone as a whole could check the economic growth of new members and reduce their inflation under the level required for the smooth progress of swift real convergence. If the ECB were to put its inflation targets up, this would interrupt efforts to establish the euro world-wide as a strong currency with a low inflation rate which will be able to compete with the dollar in the future as the world's main transaction and reserve currency. Recent experience in transition economies (e.g. the abrupt halt of economic growth in Poland due to attempts at implementing rapid disinflation) are steering the European Central Bank towards a policy of greater prudence, and its opinions are generally being **channeled into recommendations that candidate countries do not hurry along their entry to the Eurozone at an unnecessarily fast pace.**

Once the Czech Republic becomes a member of the European Union, we can expect several years of numerous changes in relative prices and faster movements in prices levels towards the average EU level. This faster progression will continue until the integration impacts of the new environment the Czech Republic will find itself in as an EU Member state have been absorbed. The higher inflation rate this will entail should be incorporated in advance into the Czech National Bank's inflation targets for the post-accession period. It will be essential for the central bank to take objective price impacts into account. It would be inexpedient to combat a temporary rise in the inflation

rate with monetary policy because this could artificially induce a recession in the economy.

After absorbing initial integration influences, the economy should be given a certain time to adapt, during which there would be no point in attempting premature approximation of the inflation rate with the Maastricht Criteria. A key element will be support for a **rise in productivity and the preservation of competitiveness**. When a consensus is reached between the Czech Republic and Eurozone countries that the Czech Republic is ready for admission to the Eurozone, it will be necessary to make a decisive cut in inflation, the public deficit, and the state debt to the level required under the Maastricht Criteria. This should not be a major problem in the case of state debt, as, in relation to GD, this is still one of the lowest among EU Member candidate countries and even Member States (second to Luxembourg). However, another reduction in inflation and achieving a 3% public finance deficit could endanger economic growth in the medium term.

At least two years prior to the estimated adoption of the euro, the Czech Republic will have to join ERM 2. If it manages to enter with an appropriate initial exchange rate, then the two-year abidance to the fluctuation band of ± 15% set for ERM 2 should not pose a great problem.

Although large-scale exchange-rate fluctuations cannot be ruled out, the koruna has reported a remarkable degree of short-term and long-term stability against European currencies right from the beginning of transformation. The Czech economy, unlike Poland and Hungary, for example, is not accustomed to using the exchange rate as a permanent instrument to support competitiveness for years on end. Therefore it will not take long in ERM 2 to find out whether the Czech economy is able to function without permanent competitive devaluation. Nevertheless, throughout the time the Czech Republic remains an ERM2 member, a considerable amount of attention will have to be devoted to financial markets, which could exploit a fixed fluctuation band for speculation against the Czech currency. Therefore this is a risk period and ERM 2 membership should be kept to the minimum possible period (preferably the prerequisite two years).

Concluding remarks

Comparison of forecasted trends of basic real and nominal convergence indicators (according to the macroeconomic forecast prepared by the Ministry of Finance CR, October 2002) for the period 2002-2005 (see: Table 3.), together with expected combination of needed legal framework fasten up the attributes of functioning market economy and with conclusion of the adoption and the implementation of the EMU-related *acquis*, create the condition for the adoption of the euro in near future in the Czech Republic.

Table 3. Forecasted trends of basic real and nominal convergence indicators in the Czech Republic

	2002[a)]	**2003**[a)]	**2004**[b)]	**2005**[b)]	**2002 – 2005**[c)]	**1997 – 2001**[d)]
Real convergence indicators						
Real GDP growth rate, per cent	2,7	3,3	3,8	4,2	3,5	1,1
Labor productivity growth, per cent [e)]	2,3	3,2	3,8	3,8	3,3	2,0
As % of GDP [f)]						
Gross fixed capital formation	27,8	27,7	27,6	27,4	27,6	28,8
Exports of goods and services	65,7	64,1	65,0	66,7	65,2	63,3
Imports of goods and services	66,7	65,1	65,3	66,3	65,8	66,3
Unemployment rate as % of labor forces (average)	9,2	9,9	9,9		9,7	7,1
Nominal convergence indicators						
Average inflation rate, per cent	2,0	2,0	3,2		2,4	5,6
Average interest rate, percent per annum						
Credit rate	6,3	6,3	6,7		6,4	9,8
Deposit rate	2,3	2,4	2,7		2,5	5,3
Public Finance, as % of GDP						
General Government deficit/surplus [g)]	-9,0	-7,8			-8,4	-3,8
General Government debt	20,3	24,0			22,2	15,3
Current account balance, per cent of GDP	-4,2	-4,1			-4,1	-4,3
Gross foreign debts	29,0	28,0			28,5	41,0

a) Forecast.
b) Outlook.
c) Average of forecasted figures.
d) Average of real development figures.
e) GDP of constant prices per employed person.
f) In current prices.
g) Excluding net lending.

Source: *2002 Regular Report*, op. cit.; *Czech Republic Macroeconomic Forecast*, op. cit.

In conclusion it is interesting to mention the discussion remark of Mr. Zdeněk Tůma, CNB Governor, that the Czech Republic will not be able to fulfill the Maastricht Criteria before 2006. According to his opinion, the Czech Republic will adopt the euro around the year 2008[18].

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Marcin Żogała*

The Maastricht exchange rate criterion: what do we know, what do we need to know?

Introduction

The strategy of building a monetary union in the European Economic Community, proposed in the Dutch city of Maastricht, was based on the idea "first convergence then common currency". Key features of the strategy came to be known as "convergence criteria". These are five requirements that must be fulfilled by an EU member who wishes to join the single currency area. The convergence criteria concern inflation, interest rates, budget deficit, public debt and exchange rate.

In order to be able to fulfill the criteria it is important to understand how they are interpreted and evaluated. This paper concentrates on the exchange rate criterion. First, the requirements of the criterion, as contained in the Treaty, are thoroughly explored. Two consecutive sections examine the interpretation and evaluation given on that criterion by the European Commission and EMI/ECB: section 3 analyses the issue of fluctuation bands and section 4 researches into a minimum period of the ERM participation. Finally, section 5 offers a scenario of a "fast path" to EMU, and makes a reference to the situation in Poland. The last section offers concluding remarks.

1. Requirements of the Treaty

The so-called "convergence criteria" are contained in the article 121 (1) of the Treaty Establishing the European Community. In order to be allowed to introduce the common currency, a country needs to achieve a high degree of sustainable convergence. The level of convergence is measured, according to the Treaty, on the basis of four criteria[19]:

- the achievement of a high degree of price stability,
- the sustainability of the government financial position,
- the exchange rate criterion,

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[19] The public finance criterion consists of requirements concerning budget deficit and public debt, which are sometimes referred to as two separate criteria.

- the long-term interest-rate level.

The exchange rate criterion reads: "the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State."

The four criteria outlined in the article 121 are further developed in Protocol annexed to the Treaty. On the exchange rate criterion the Protocol adds just few more details: "The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

Upon the wording of the Treaty and the Protocol one can distinguish four fairly precise requirements related to the criterion:

- the observance of normal fluctuation margins,
- no devaluation,
- no severe tension,
- the observance of time-frame (at least two years).

The European Commission and the European Central Bank (the European Monetary Institute before June 1998) are obliged to prepare reports, so called "Convergence Reports", in which they assess which countries have fulfilled the convergence criteria. These two reports are then presented to the Council, which, on the basis of the reports and opinion of the Parliament, decides whether a Member State is allowed to introduce the common currency.

The first twin-reports were published in 1996. The purpose of those reports was to investigate whether the majority of EU members fulfilled the criteria and whether it was feasible to initiate the stage three of the EMU. The 1996 reports concluded that only one country – Luxembourg – fulfilled all the criteria and hence the stage three could not commence. The second edition of the Convergence Reports was prepared in 1998. The Treaty sets the deadline for the start of the last stage of EMU at 1 January 1999. The 1998 reports were produced only to justify which countries were eligible to form single currency area.

Not all EU members joined the euro area in 1999: Greece and Sweden were not allowed; Denmark and Great Britain opted-out. The Treaty stipulates that the Commission and ECB should continue to study the situation in the Member States with a derogation (except Denmark and Great Britain, which will be examined after they decide to join) and present their reports evaluating

the state of economic convergence. The reports should be prepared at least every two years or at the request of a Member State with a derogation. Consequently, next Convergence Reports were published in 2000. The conclusion of the reports was that Greece fulfilled the criteria and could be eligible to become the twelfth member of the euro-club. Sweden did not fulfill the exchange rate criterion. In 2002 the only country subject to Convergence Reports was Sweden, which still continued not to comply with the exchange rate criterion.

2. Fluctuation margins

At the time the Treaty was drafted "normal fluctuation margins" were ±2,25%. That narrow margin provided a basis of European exchange rate co-operation not only since the start of the EMS in 1979, but right back to the launch of its predecessor, the "snake" in 1972. Thus ±2,25% margins had all the right to be seen as "normal". As an exception to the rule, ±6% fluctuation was allowed for some currencies: Italian lira till 1990, British pound, Spanish peseta and Portuguese escudo.

At the time of drafting up the Treaty no one could predict the dramatic events of 1992 and 1993 when huge speculative attacks emerged. In the efforts to defend the bands, some of the central banks lost large portions of their foreign reserves. In August 1993, in order to put an end to speculation the band was widened. The new band allowed for 15% fluctuation above and below the parity. This situation caused problems with interpretation of the term "normal fluctuation margin". In the Convergence Report 1996 (titled "Progress Towards Convergence"), the European Monetary Institute wrote: "*The EMI does not at this stage consider it appropriate to give a precise ex ante operational content to the measurement of exchange rate stability (...), which could also mechanically be applied to forthcoming periods*", (EMI 1996). At that time, however, it was already known, that the third stage of EMU would begin in 1999, not earlier.

The problem returned in 1998 when the European Commission and the EMI prepared the Convergence Reports, which were to indicate which countries would be allowed to enter the Eurozone. The major contradiction concerning the exchange rate criterion appeared between "the spirit" and the letter of the Treaty. The spirit of the criterion was to prove that stable exchange rate could be maintained. The letter of the criterion, however, allowed the exchange rate to fluctuate within 30%-wide band, which is difficult to identify with exchange rate stability. Moreover, the widening of the band in 1993 was meant to be a temporary measure with the expectation of returning to the narrow margins, which eventually was not the case. Since there was no formal

commitment to observe the original ±2,25% margins, it was also inappropriate to assess the criterion on the basis of the former framework.

As a solution to this dilemma the Commission proposed the system based on so-called "median currency". Median currency was defined as a currency with a median deviation from its central parity against ECU. Each day, the currencies were ranked according to the percentage deviation of their ECU exchange rate from their ECU central parity. The median currency was selected as the mid-point currency in this ranking. This was than a currency at the center of the mechanism. The deviation of other currencies was calculated in relation to the median currency, not central parity. Such a framework was very convenient for currencies that were moving together in the center of the mechanism. In the median currency approach the ERM currencies were allowed to fluctuate 15% above and below its central parity against other EU Member States, but the stability of exchange rates was assessed in the context of fluctuation margins of ±2,25% around the median currency.

The Commission used the narrow band as an indicator. The breach of the ±2,25% margins was recognized as a possible "severe tension". However, it was not applied automatically. In assessing whether a breach of the margins corresponded to a severe tension, a range of elements was taken into account:

- the duration and amplitude of the deviation,
- the nature and extent of any policy response with particular reference to foreign exchange interventions or changes in short term interest rates,
- and whether the pressure had been towards appreciation or depreciation of the currency.

Given the emphasis the Treaty places on devaluation, it was reasonable to exclude movement above the 2,25% margin (i.e. appreciation) as a possible cause for non-fulfillment of the criterion.

EMI applied more descriptive way of evaluation than the Commission did but the two approaches have much in common. EMI noted that the widening of the band made the interpretation of the exchange rate criterion less straightforward and proposed its own framework for interpretation. As far as the fluctuation margins are concerned the emphasis was placed on exchange rates being close to the central rates without indicating any explicit band. The same applies to the interpretation of "severe tensions": main indicator for EMI was the deviation of exchange rate from central parity but no reference value is set. A range of indicators was also used: exchange rate volatility against the Deutsche Mark and its trend, short-term interest rate differentials vis-à-vis the group of countries with the lowest money market rates and their evolution.

Both reports – the one of EMI/ECB and of the Commission – are legally equal: they are presented to the Council in parallel, and the Council should take both of them into consideration when taking the decision on admission of a

Member State to the single currency area. There is however difference between the role both institutions play in the Community, which could have an influence on the role of the reports. This is the Commission who recommends to the Council a certain decision – the right that was not given to ECB. The Council cannot act on its own but on a recommendation from the Commission. Consequently, there is a slight difference between the reports. In its Convergence Reports the Commission describes the situation in EU Member States under investigation and concludes whether the requirements of the Treaty are met or not. One cannot find such a conclusion in the Convergence Reports of EMI/ECB, which conclude with description of the situation.

On 1 January 1999 the European Monetary System (EMS) ceased to exist and was replaced by the Exchange Rate Mechanism 2, as stipulated by the European Council Resolution of 16 June 1997. The standard fluctuation margin in ERM 2 has been set at ±15%. Hence in the new system there is no interpretation problem which margin is to be used as the "normal" one. Nonetheless, in the Convergence Reports of the years 2000 and 2002, the Commission still applies the narrow band as an indicator of severe tensions. The difference is that the ERM 2 is based on the euro, not on bilateral exchange rates, as was the case in EMS, and hence median currency approach is no longer applied. All fluctuations of the participating currencies are thus measured in relation to their parities against the euro.

The interpretation of the criterion applied by the Commission makes ERM 2 band asymmetric: the upper margin equals 15% and the lower one 2,25%. The difference is that the upper margin is defended by automatic and unlimited coordinated interventions. The lower one, however, is not. There is a possibility of coordinated intramarginal intervention in ERM 2 but a prior agreement has to be reached between a national central bank and ECB. The fact is that the currencies of current accession countries are prone to appreciation rather than depreciation. Consequently, the situation when the lower 2,25% margin is endangered is less likely, yet on the appreciating side there is enough room for maneuver. However, given the unpredictability of foreign exchange market in the short run, the appreciating trend does not rule out events of downward speculation. The possibility of such an event rises if the nature and role of the lower margin is not clear. If the commitment of the authorities to defend the lower margin is not precise, this could encourage markets to test it. Consequently, the lack of precision in formulating the criterion and the procedure of evaluation could lead itself to non-compliance.

3. Duration of the ERM membership

After the events of the years 1992-1993 – the widening of the band and withdrawal of the lira and the pound from ERM – the discussion emerged whether ERM membership is an independent requirement or is it just to help to maintain exchange rate stability[20]. Consequently, the question was whether a formal participation in ERM is required along with actual exchange rate stability. Similar discussion split the views of EMI Council in 1996 and 1998. A strong majority, however, took the position that the requirement of the ERM membership applies. The Commission shared that opinion.

By November 1996, when the first Convergence Reports were published, 4 currencies did not participate in ERM: the Greek drachma, the Italian lira (joined at the end of November 1996), the Swedish krona and the British pound. The Austrian schilling joined the system at the beginning of 1995 and the Finnish markka in mid-October 1996 hence both currencies participated less than the required two-year period. In the opinion of the Commission none of the above countries fulfilled the exchange rate criterion. The remaining EU members participated in ERM for well over two years. It is worth mentioning that the Treaty stipulates that the two-year membership in ERM should be calculated up to "examination", not till the euro zone entry. That means that a Member State should participate in the Exchange Rate Mechanism for at least two years before the Commission and the ECB prepare convergence reports.

In March 1998, when the second set of Convergence Reports was published, three currencies did not participate in the ERM: the Greek drachma, the Swedish krona and the British pound. Ten currencies complied strictly with the criterion (the Belgian franc, the Danish krone, the German mark, the Spanish peseta, the French franc, the Irish pound, the Luxembourg franc, the Dutch guilder, the Austrian schilling and the Portuguese escudo). Two cases were dubious: the one of the Finnish markka and the Italian lira. Convergence Reports 1998 were prepared in March so the two-year period under examination covered March 1996 to February 1998. The Italian lira rejoined ERM on 25 November 1996 what gives about 15 months of participation by end-February. The Finish markka joined the system on 14 October 1996 and by end-February had been participating in ERM for about 16 month. It is true that after joining the system, both currencies respected the lower 2,25% margin. In the Convergence Reports of the Commission and EMI, however, the period prior to ERM entry was taken into account as well. At the beginning of the two-year examination period both lira and markka were under depreciating pressures. In March 1996 the downward deviation of the lira reached the

[20] P.B. Kenen (ed.), *Making EMU happen. Problems and proposals: a symposium*, Essays in International Finance No. 199, Princeton University, 1996.

maximum of 7,6% below its future central rate. In the case of the Finnish markka, its maximum downward deviation below its future central rate reached 6,5% in April 1996. Nevertheless, the conclusion of the Commission was that both Italy and Finland fulfilled exchange rate criterion.

Two years later, in the Convergence Report 2000 the situation in Greece and Sweden was examined. At that time the situation was much clearer. The Greek drachma participated in the ERM and ERM 2 for more than two years. Its exchange rate during the whole period was above the parity. The case of Sweden was also clear-cut. Sweden did not participate in the ERM and hence did not fulfill the criterion.

However, in the same report the Commission stated that during examination of exchange rate criterion it takes into account the following conditions:

- participation in ERM 2 at the time of the assessment is mandatory,
- participation in ERM 2 for at least two years is expected,
- exchange rate stability before entering ERM 2 can be taken into account.

Although not plainly expressed, this is indeed the framework that the Commission used in 1998. It was not applied explicitly, but the outcome of the examination shows that such criteria must have been used. It is not a secret that in 1998 examination, a little bit of politics was involved. The political costs of keeping some countries out would have been much higher than economic cost of modest relaxation of the criteria. Thus I have the impression that the evaluation framework of Convergence Report 2000 is just *ex post* formulation of the rules that were implicitly applied two years earlier.

The same framework of examination was repeated in the Convergence Report 2002. There could be at least two reasons why the Commission formulated and used such a framework in the last two reports. The first reason is "the principle of equal treatment". This principle says that all EU Member States, no matter when, should join EMU under the same requirements. The case of Italy and Finland in 1998 could be referred to later on by future entrants.

The second reason could be that this lax interpretation of the criterion is a kind of "incentive" for the current Member States with a derogation which do not participate in ERM 2, especially Great Britain. The support for the euro across the Channel is still low both among politicians and the citizens. If one makes the British wait two years, they may never decide to get in.

Can the current candidate countries expect that the same mode of assessment will be applied in future examinations? In the Convergence Reports 2000 and 2002, when the Commission explained the framework for the examination, it clarified that this was the framework used in the *current* examination. This could mean that the rules could change during next assessments. The principle of equal treatment, however, requires that the rules

are kept unchanged. This would be in line with expectations of some accession countries, which have already announced their will to join EMU at the earliest possible date[21]. These countries include Cyprus, Hungary, Poland, Slovenia, Slovakia, and the Czech Republic, whose approach has been recently changing from a distrustful towards more favorable one. The position of the Eurosystem is, however, that there is nothing to rush about[22]. The officials of ECB and the Commission continue to emphasize the need and importance of the sustainable real convergence. They warn against treating ERM 2 only as a waiting room without making any effort to foster the convergence of the real side of the economy. Hence this is doubtful whether current candidate countries will be accepted after shorter participation in ERM 2.

4. The path to EMU: a scenario

Although this is not reasonable to expect that for current candidate countries shorter participation in ERM 2 will be accepted, a number of these countries are willing to make the ERM 2 participation at least not longer than formally required. Poland is one of them. Polish authorities believe that early participation in the Eurozone will be beneficial for sustainable economic growth and will itself contribute to real convergence. The National Bank of Poland, together with Ministry of Finance, has already started to work on the strategy of joining the Economic and Monetary Union.

In order to set conditions the principles of Poland's accession to the Eurozone the Interdepartmental Work Group was established in July 2002. The Group consists of representatives of the National Bank of Poland and Ministry of Finance. The principles of the Polish strategy, agreed so far are as follows:

- the convergence criteria should be met in 2005,
- Poland should join EMU as soon as possible and should take into consideration the macroeconomic conditions, including the impact on the economic development,
- participation in ERM 2 will take place within the broad band ±15%,
- the central rate of the Polish zloty against the euro, will be set in agreement with the EU representatives, including the European Central Bank. While setting the central rate, the market exchange rate in the selected reference period will be taken into account.

The accession negotiations for ten candidate countries have been finalized and the date of the EU enlargement has been set. Having the key dates and the

[21] *Evaluation of the 2002 pre-accession economic programs of candidate countries*, European Economy. Enlargement Papers No. 14, European Commission 2002.
[22] *The Eurosystem and the Accession Process*, European Central Bank 2002.

principles of the strategy agreed, it is useful to sketch a scenario of Poland's joining EMU. It could be a reference scenario for any country opting for a "fast path" to EMU.

At the European Council meeting in Brussels in October 2002, it has been agreed, that the enlargement will take place on 1 May 2004. The earliest possible date of the ERM 2 entry will than be 3 May (Monday). In such a case the decision of the ECOFIN Council on participation in the ERM 2 should be taken during the weekend 1-2 May 2004. This is very unlikely, however, because of enlargement ceremonies. The next possible date is the following Monday – 10 May[23]. Such timing is possible but requires earlier consultations with ECB, the Commission and the Council, concerning mainly the central rate of the currency in the system.

If the entry to ERM 2 takes place on 10 May 2004, the two-year period required by the Treaty ends on 9 May 2006. The year 2006 is just the year when the Convergence Reports should be published, according to the Treaty. Last Convergence Reports published in 2002, were prepared in May and examined the period up to end April 2002. If the same timing is applied to the convergence report 2006, a new Member State will miss just several days to the full two-year duration of the ERM 2 participation. If the participation in the system proceeds smoothly there should be no reason to deny the fulfillment of the criterion. There is however the issue of "severe tensions" – if they occur, the fulfillment of the criterion is uncertain.

Assuming that the participation in ERM 2 proceeds smoothly, the inflation and interest rates criteria are fulfilled in April at the latest, and budgetary criteria are fulfilled by the end of 2005, the Commission and ECB should conclude in their Convergence Reports that a Member State fulfils the requirements of the Treaty. Both reports will then be submitted to the Council. Next the European Commission will prepare a proposal for those Member States whose derogation is to be abrogated. The European Parliament will be consulted and then the Council (of Heads of States or Governments) will discuss the issues.

The last step of the procedure is the meeting of the ECOFIN Council. The Council, acting by a qualified majority will decide, which Member States with a derogation fulfill the necessary conditions and whose derogation is to be abrogated. The Council will also decide on the date of the EMU entry and the conversion rate. The ECOFIN Council will probably take the decision before the June European Council meeting[24]. This would be "politically correct" and will give the European Council the possibility to officially "welcome the decision of the Council". Nevertheless, when everything is agreed before, there

[23] The day of entry to ERM (2) has so far always been Monday.
[24] This was the case when Greece joined EMU.

will be no reason to wait any longer. The entry date has been so far always 1 January – it was the date of the start of stage III in 1999 and the date of Greece's entry in 2001. This is not a rule however, and the Council could set another date, if it considers it appropriate. A Member State with a derogation applying for the EMU membership will take the decision along with other Council members and if it forces earlier date of entry, the Council might agree. The fundamental issue in choosing a date of entry should be the state of preparation to introduction of the euro, concerning legal, technical and logistic matters, in the public as well as private sector. If preparations are well advanced the entry could take place earlier, if not, the E-day should be postponed. It is also important what the market exchange rate of the national currency will be in relation to the agreed conversion rate. If the market exchange rate is much higher (this is the only possible case, since the level of allowed depreciation is limited), the shorter period before the EMU entry, the faster the pace of required depreciation. The conversion rate has always been equal to the central parity, although there were cases that the parity was revalued during the two-year examination period.

In short, the reference scenario could look like this:

- 1 May 2004 – accession to EU,
- 10 May 2004 – accession to ERM 2,
- end of 2005 – compliance with budgetary criteria,
- April 2006 – compliance with inflation, interest rate and exchange rate criteria,
- June 2006 – the Council's decision on accession to EMU,
- 1 January 2007 – entry into euro area.

Conclusions

This paper discussed issues related to evaluation of the Maastricht exchange rate criterion. The way the criterion has been formulated in the Treaty is itself not precise. The crisis in EMS and its effects – withdrawal of some currencies and widening of the fluctuation band – made the interpretation of the criterion even more difficult. The European Commission and ECB tried to find a framework of evaluation, which would be a compromise between the intention of the Treaty and developments in the foreign exchange market. A strong political will to admit some countries to EMU, which did not fully comply with the rules, added to the vagueness of the criterion.

The way the Commission interprets the term "severe tension" makes the fluctuation band in ERM 2 asymmetric. Given the well-known problems associated with participation in fixed exchange rate systems, adding additional

restrictions to the movements of exchange rates could make participation in ERM 2 even more difficult. At worst, lack of precision in the formulation of the criterion could lead to a failure in meeting the requirements.

Consequently, at least some candidate countries would prefer a shorter period of the ERM 2 participation prior to the introduction of the euro, which would not be an unprecedented situation. Moreover, the specification of the Commission's evaluation framework in Convergence Reports 2000 and 2002 shows that the Commission does not require the full two-year participation. The question, however, arises whether the same framework will be applied in case of current candidate countries. The representatives of the Commission as well as ECB continue to stress the unfeasibility of early adoption of the euro by new Member States. Thus taking into account the formally required two-year participation in ERM 2, the earliest possible date of EMU entry is the beginning of 2007.

The way the exchange rate criterion will be interpreted in the future is of utmost importance for the current candidate countries. Neither ECB, nor the Commission, however, has so far revealed future modes of assessment. This situation does not contribute to successful preparations to the ERM 2 membership and should be rectified as early as possible. The European Commission and the European Central Bank should finally announce the framework for evaluation of the criterion, which will be applied in the future, not just explaining the rules that were used in the past. This is extremely difficult to comply with rules that are set when the evaluation has already been concluded.

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Economic and Monetary Union *acquis* and Polish law

1. Economic and Monetary Union *acquis* as an element of the accession negotiations between European Union and Poland

Any country's participation in the Economic and Monetary Union (EMU) is a natural and, in fact, determined by the Treaty establishing European Community (TEC) ramification of that country membership in the European Union. This determination has a predominantly legal character. It arises from Art. 4 TEC. It also is evidently implied in Art. 121 TEC (in connection with Art. 122(2)), which charged the European Commission and the European Monetary Institute (i.e. the predecessor of the European Central Bank) with the obligation to submit to the Council reports on the progress made in "the fulfillment by the Member States of their obligations regarding the achievement of economic and monetary union". In these reports, these authorities had to include an assessment of EU countries performance with regard to convergence criteria. The inevitability of participation in the Economic and Monetary Union is also expressed in these provisions of art. 122 which apply to countries with the derogation, i.e. a special legal arrangement which, under specific conditions, excludes them (presently Denmark, Sweden and the UK) from single monetary policy and, therefore, makes the euro unattainable to them as their legal tender. The mentioned art. 122, gives the European Commission and the European Central Bank the task to periodically report to the Council on progress each Member State with the derogation makes in fulfilling convergence criteria. These reports have to be submitted at least biannually, or in any time, at the request of a Member State interested in having abrogation proceedings (i.e. the procedure of lifting the derogation so far applicable to it) initiated.

From the very beginning of the membership negotiations between Poland and the European Union, the question of complete (i.e. not constrained by any type of derogation) participation of this acceding state in the fully-feathered EMU have been considered a medium-term objective connected with so called economic Copenhagen criteria specifying preconditions on which countries of Central and Eastern Europe could enter the EU. Neither the Copenhagen criteria, nor the ultimate objective of entering the EU has ever been challenged by subsequent governments. Nor has it become a matter of conflict between Poland and the EU. It does not mean that the Polish negotiation position was

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given an ideal form by national negotiators. In my opinion, it stated in too imperative and unconditional terms that Poland is to partake in the Exchange Rate Mechanism 2 (ERM2) irrespective of a possible after the Treaty of Amsterdam, interpretation of Art. 121 TEC[25].

Generally speaking, Polish negotiation position regarding the EMU expresses a will to fulfill all the obligations arising from the Economic and Monetary Union *acquis*, irrespective of whether they have primary or secondary character. This means that Poland is willing to meet criteria of legal convergence (laid down in Art. 108-109 TEC) and economic convergence criteria covering requirements of fiscal discipline (specified in Art. 121 TEC in conjuncture with Art. 104 TEC and provisions of Protocols No. 4 and 5 annexed to the Treaty of Maastricht). Poland is also to partake in the co-ordination of national economic policies on the grounds of Art. 99 TEC (being a form of the, so called, open method of co-ordination), and in the co-operation in the field of monetary policy (in this area Art. 105 TEC is most instrumental) and foreign exchange policy (by virtue of Art. 124 TEC).

2. EMU acquis stimuli and their national legal anticipation

If the EMU *acquis* influence on national laws of non-Member States is considered, it will appear that at least partially, some of this influence can be attributed to anticipatory legislative behavior. This means that the acceding countries (with Poland being no exception) have already introduced *acquis*-induced or inspired modifications to their legal systems. They have done it in order to approximate their laws with EU legal standards in areas where this was required (mostly by virtue of European Agreements and in the course of accession negotiations) or desirable and possible (being an ultimate objective to be achieved after the entry, but already made effective in view of anticipated membership). In part, this impact of the EMU *acquis* was of implicit character. This means that national legislators adjusted legal systems within their jurisdiction not being prompted by the EC *acquis* or international (explicit or implicit) obligations, but rather using *acquis* as an excuse for bringing national standards up to those applicable in the EU.

The impact that the EMU *acquis* exerts on national legal systems cannot be analyzed without any reference to practice of its implementation and

[25] At present, neither the Council Resolution of 5th of December 1978 on the European Monetary System, nor the reflective of it central banks agreement of 13th of March 1979 to which Art. 121 TEC implicitly refers, are binding to anyone. As a result, the relevant provision of Art. 121 TEC originally concerning the participation in the EMS should now be construed as requiring adequate foreign exchange rate stability. See: A. Nowak-Far, *Unia Gospodarcza i Walutowa w Europie*, C. H. Beck, Warszawa 2001, pp. 167-168.

enforcement in a given country, also in areas of discretion allowed on the grounds of each nation's constitution and laws. When we look at the EMU *acquis* from this vista, we conclude that this *acquis* consists of two groups of legal norms:

- *instrumental* ones, i.e. containing legally enforceable obligation to apply specific arrangements in order to achieve defined in law or at least implied by it objectives), and
- *autotelic* ones, i.e. the norms which function independently from possible arrangements leading to the achievement of ultimate objectives of the application of these norms and having their reasoning deeply rooted in economic theory; this means that autotelic legal norms define binding objectives (e.g. stability of prices) leaving competent authorities of macroeconomic policy with the liberty to apply whatever means of legal and non-legal nature to achieve these objectives[26].

The ultimate Poland's goal to accede to the European Union, and in consequence, to all aspects of the Economic and Monetary Union, determined that Poland had undertook various preparations to her participation in the EMU, especially in different institutional forms of economic and monetary co-operation provided for in the EMU *acquis*. As a result, Poland introduced a vast variety of modifications to its legal system. They concerned both purely legal (formal) and real (economic) framework within which individuals, companies, and public administration make their decisions. It is worth mentioning that some of them were caused by developments in the very Economic and Monetary Union – in particular by the transition to the third stage of the EMU on the 1st of January 1999 r. (marked by the introduction of the euro as a parallel, yet non-cash, legal tender in 11 and later on 12 Member States and finally, by the introduction of the euro banknotes and coins in these states completed with the withdrawal of old, national legal tender in 2002). In both legal and real areas, the impact of the EMU *acquis* on Polish legal system was most distinctively marked by:

- strengthening of independence of the Polish central bank, the National Bank of Poland (NBP), coincided with some modification of the scope of its responsibility and accountability with regard to monetary and foreign exchange rate policies,
- introduction of numerous legal provisions which together create a *sui generis* mechanism preventing excessive budget deficits (which bring Polish system closer to that applicable in the EU).

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[26] The concept originally presented in: A. Nowak-Far, *Unia Gospodarcza i Walutowa w Europie*, op. cit., s. 414-416. The division between instrumental and autotelic legal norms should be distinguished from another distinction of EC norms between these directly applicable and these not having direct applicability.

With regard to significant to Polish individuals and companies an issue of the euro introduction in the EU Member States partaking in the third stage of the Economic and Monetary Union, important legal arrangement was introduced in the form of Parliamentary Law which adjusted Polish legal system to make it better reflect on this extraorbital fact having significant effects on legal relationships governed by Polish law, irrespective of whether they emerged in or out of Poland.

It is worth noting that in a more distant than the mere entry to the EU perspective, EMU-related implications of Poland's EU membership can be considered on the grounds of specific legal institutions solutions of the EC law concerning the participation of EU Member States in the following key arrangements:

- multilateral surveillance procedure (MSP), within the framework provided for by the Council, and covering the obligation to provide the Commission with information concerning significant measures adopted in the field of macroeconomic policies as the Member States "deem necessary" – all laid down in Art. 99 TEC, as well as in one of EC regulations, namely the Council Regulation No. 1466/97 of July 1997 being a part of Stability and Growth Pact[27],
- excessive deficit avoidance procedure (EDP), based on Art. 104 TEC (with some more specific provisions set forth in Protocol No. 5 attached to the Treaty of Maastricht and in some other provisions of secondary law),
- limited forms of co-operation within the General Council of the ECB, particularly with regard to national foreign exchange policy, that – generally speaking – has to be conducted in accordance with Art. 124 TEC – which means „treated as a matter of common interest", and with due, albeit, applied "by analogy" regard to the "experience acquired in co-operation within the framework of the European Monetary System and in developing of the ECU".

In the period immediately following Poland's entry into the EU, the country will have the status of the Member States with the derogation (governed by art. 121 TEC). Poland will retain this status until the moment of the successfully ended application of abrogating procedure of art. 122 TEC in conjunction with art. 121. The Polish derogation will obviously be of conventional character (i.e. will be governed by the relevant provisions of the Treaty) as contrasted with the protocolar (i.e. granted by virtue of specific protocols attached to the Treaty of Maastricht) derogations of Denmark and the United Kingdom. The derogation based on the Treaty generally means that:

[27] Council Regulation 1466/97/EC of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ, L 209/1).

- up to abrogation, Poland will not partake in all aspects of the EDP – in particular, the Council will not have power to apply to Poland corrective measures with the aim to alter her fiscal policies, nor will it be in capacity to give Poland a notice to take within a specified time-limit, measures for the deficit reduction, nor will it be able to apply sanctions to Poland specified in the Council regulation No. 1467/97/EC[28],
- Poland will not directly participate in monetary and exchange rate policy formulation (and implementation) within the European System of Central Banks which means that it will not be bound (unless by its own express consent) by any measures taken within this framework with regard to exchange rate and monetary policies,
- Poland will not be legitimated to propose her candidate for any posts in the EBC Executive Board, nor will the President of the National Bank of Poland participate in meetings of the ECB Governing Council.

The period of derogation, i.e. the time from the *de iure* accession to the European Union to the entering the third stage of the Economic and Monetary Union marked by the adoption of the euro will have a significant impact on overall Poland's performance within the EU. In this transitory period, Poland will be legally bound to thrive to fulfill convergence criteria (which means that we are dealing here with the obligation to perform duly and in good faith and not with the obligation to achieve a result in a specific period of time) within the convergence programs drafted according to provisions of Section 3 of the Council Regulation No. 1466/97 (which would be a continuation of the practice commenced in the pre-accession years when Poland agreed to submit so called Pre-Accession Economic Programs reflecting on her fiscal and economic policies).

In further perspective, after the adoption of the euro, Poland's preparations to the EMU will concern rectification of its participation in the ECB Governing and Executive Councils, the so called eurogroup (whether in its already existing informal format or proposed by the Convention a more formal setting), and – if yet another Convention proposal has been accepted, the Euro-ECOFIN Council.

[28] Council Regulation 1467/97/WE of 7 July 1997 r. on speeding up and clarifying the implementation of the excessive deficit procedure (OJ, L 209/6).

3. Independence of the Polish Central Bank

In the EC acquis, independence of national central banks within the European System of Central Banks is governed by Art. 108-109 TEC. These two provisions concern so called criteria of legal convergence. The former provision stipulates *inter alia* that national central banks of the EU Member States or members of their decision-making bodies are prohibited to take instructions „from Community institutions or bodies, from any government of a Member State or from any other body" in performing their statutory tasks and duties conferred to them by the Treaty and the Statue of the ESCB (the latter being a part of the TEC as a Protocol No. 3 annexed to the Treaty of Maastricht). Simultaneously, this Treaty provision prohibits the said institutions, bodies and authorities to seek influence on national central banks in the performance of their tasks arising from the Treaty or statutory delegation. The well-rooted practice, having its basis in the *de facto* binding interpretation of Art. 108 given by the European Monetary Institute in 1996, specifies that national central bank independence, as it is set forth in Art. 108 TEC, has four dovetailing aspects: personal (i.e. independence of members of decision-making body of a national central from influence of the government or any other authority), institutional (i.e. independence in decision-making within the area of monetary policy and other areas of ESCB competence), functional (i.e. legal guaranty of formal and material compliance of national legislation concerning the tasks and objectives of national central banks with the tasks and objectives set forth in the EC legislation for the ESCB), and financial (i.e. ensuring that central banks can avail themselves resources appropriate and commensurate to competences invested in them with regard to their participation in the ESCB). So formulated the scope of independence of national central banks is destined to prompt the acceding countries to bring their central banking regulations up to EU standards in this area. Their efforts to modify their legal systems to make them compliant with Art. 108 TEC indicate that they treated the legal norms expressed in this provision as having both anticipatory and instrumental character. Anticipatory nature of the said Treaty stipulation arises from a rather obvious fact that central bank independence is not only a purely legal issue – its *de facto* complete implementation depends not only on the mere legal regulations, but even more so on the „culture of independence" reflected in respecting by all stakeholders somewhat peculiar position of a central bank in a country legal and political system. Such a culture requires that rules of political game be gauged by the standards set forth in Art. 108 TEC and be observed by the very central bank on one hand, and the executive and legislative branches of government on the other. Instrumental character of Art. 108 TEC arises from a well-rooted and having long tradition reasoning that independence of central bank from current political agenda together with its sometimes undesirable

expressions (e.g. political cycles, log-rolling in fiscal policy-making) is instrumental to defining optimal and effective monetary policy with regard to its instruments, at least in the situation where, as it is the case with the EU, the ultimate objective of this policy is clearly defined (in Art. 105 TEC, which actually does not mean that the goal of price stability set forth in this provision is accepted by everybody and is not a subject of any economic and political discussion). The present legal arrangement prevents governments from charging their national central banks with tasks which might, at least in unfavorable circumstances, be incompatible with sound economic policy principles – but might fulfill otherwise unwarranted macroeconomic expectations of the latter – with their economic and political by the very central banks.

EMU *acquis* undoubtedly was the major stimulus for strengthening the National Bank of Poland's independence in all its aspects. The new 1997 Constitution invested with the National Bank of Poland responsibility for protecting "the value of the national currency". Moreover, being fully aware that the membership in the EMU is a natural consequence of the EU membership, the drafters of the Polish law adjusted its provisions accordingly. This approximation resulted in providing the NBP with a broad scope of independence in both choosing and implementing monetary policy goals and measures. The NBP Act was passed by the Polish Parliament (Sejm) on August 29, 1997 and entered into force on January 1, 1998.

The new law took into account most of the patterns of central bank independence derived from the Treaty of Maastricht. Art. 3(1) of the Act on the NBP stipulates that stability of prices shall be the principal objective of the Polish central bank monetary policy. It also sets forth a rule according to which, without prejudice to the primary goal of price stability, the NBP support the general economic policy of the government. This legal arrangement reflects the EC law standard (Art. 105(1) TEC) according to which "the primary objective of the ESCB shall be to maintain price stability" but without prejudice to this objective, the ESCB shall also support the general economic policies of the Community. This, however, does not mean that all Polish political parties and fractions treat this prioritization of tasks as a framework of legal maneuver beyond which there is an area of incompatibility with EC law. With some frequency drafts of legal acts emerge which, if not rejected by the parliament (Sejm) at some stage of legislative procedure, would have given primacy to the task of supporting by the NBP general economic policy of the government, or – in yet another scenario – subjected the NBP monetary policy to far-going parliamentary scrutiny (which especially under majority government would make the NBP *de facto* dependent from the government).

The new law gave the NBP a broad range of prerogatives pertaining to the selection of monetary instruments (Chapter 6) and to the establishment of basic

reference rates (e.g. discount rate (Art. 45)). Moreover, the Polish central bank, is to a considerable degree, insulated from pressures for financing public debt. Instrumental in achieving this objective are the provisions of the new 1997 Constitution, which prohibit the government from financing budget deficit through the NBP and art. 42 of the Act on the NBP which set forth "no-automatism" rule in providing refinancing to commercial banks.

Chapter III of the NBP Act contains basic provisions regarding the relationship between the Polish central bank and the government. One of the articles contained in this Chapter, Art. 21, stipulates that the Polish central bank should cooperate with relevant governmental authorities in formulating and implementing the country's economic policy while simultaneously making certain that the basic goals of its monetary policy (i.e. price stability) can also be achieved. The cooperation provided for in Art. 21 included provision of information on monetary policy to other governmental bodies (e.g. specifically Art. 23(1)(2)), cooperation with the Minister of Finance in the formulation of the country's financial plans, issuing opinions pertaining to drafts of various regulations originating by other governmental bodies but pertaining to economic policy or having any impact on the banking sector, and last but not least, presentation of the NBP monetary policy goals to the Sejm (Art. 12). Art. 24 of the NBP Act provides that the NBP shall implement foreign exchange policy formulated by the government, in agreement with the NBP. Interestingly, the Act does not contain any provision which would specifically prohibit the NBP from seeking and taking advice or instruction from other governmental bodies or institutions pertaining to the monetary policy.[29]

In the personal realm, the Act on the NBP fully complies with the ESCB's standards. According to Art. 9(1) of the new law, the Governor of the NBP is nominated by the Sejm after a recommendation made by the President of the Republic. The term of office is 6 years (compared to 5 years required for the governors of the ESCB's members).

The main decision-making body of the NBP is the Monetary Policy Council (*Rada Polityki Pieniężnej, RPP*) consisting of the NBP Governor (acting as Chairman) and 9 members nominated evenly by the President of the Republic, Sejm and Senate (the higher house of the Parliament). RPP members' terms of office are also 6 years. The NBP's Governor or the RPP members can be removed from their offices only on reasonably justified grounds: e.g. if convicted of a criminal offence in an enforceable court judgment.

The RPP is responsible for making decisions concerning strategic goals of monetary policy and selection of its instruments in a given economic context. Another body, namely the NBP's Management Board, is in charge of the

[29] For example, section 12 of the Deutsche Bundesbank Act contains a provision that "*the Budesbank shall be independent of the instructions from the Federal Cabinet*".

operational execution of so specifically defined monetary policy. This Board consists of 6-8 members nominated by the President of the Republic on recommendation of the NBP Governor.

It is essential to recognize that none of the RPP members formally represents the interests of the government. However, Art. 15 of the NBP Act provides that a governmental representative can participate in the Council meetings. This person does not have any voting rights but can submit motions for the RPP consideration. In recent months, art. 15 has not been fully used by the government. Namely, its representative has not showed up during the RPP consecutive meetings.

4. Legal regulation concerning public deficit and public debt

A somewhat striking impact of the EMU *acquis* on Polish law took place in the realm of legal regulation of public debt, and indirectly, of public deficit. In the former area, the most fundamental is Art. 216(4) of 1997 Constitution, which prohibits raising public debt or granting guarantees or establishing a collateral which would result in such an increase of public debt that it exceeded a threshold of 3/5 (i.e. 60%) of gross national product. This provision also stipulates that the methodology of calculation of GNP and governmental public debt shall be laid down in detail in a separate law. Another Constitution provision, namely Art. 220(1), is also of relevance for governmental public financing in Poland. It provides that „an increase in expenditure or contraction of revenue planned by the Council of Ministers shall not result in deciding upon a budget deficit higher than that provided for in the preliminary draft budgetary law" (i.e. the document which in Polish constitutional order, is submitted to the Parliament by the very government). Another 1997 Constitution provision, namely Art. 220(2), prohibits financing of governmental deficits through overdraft or any similar arrangement in the national central bank.

All the said provisions have a more or less general character. As such, they formulate a general framework for sound, and lest we forget, compatible with EC *acquis,* public finance management. Problems of compatibility of Polish and EC laws pertaining to public deficits, if any, do not arise from the Constitution, but rather in lower rank regulations. Some irregularities arise also in the practice of financial law interpretation. Art. 220(1) of 1997 Constitution provides an interesting example of this problem. The rationale behind this provision draws on the idea of constraining legislative action that might increase public spending without consent of the government (solely responsible for execution of the budget). Irrespective of this rationale, it is now interpreted in a way which gives Polish Parliament free hand in its law-making power, as if

no such rationale ever existed.[30] Fortunately, this undesirable situation will soon cede to exist. With Poland's entry into the EU the present interpretation of Art. 220(1) of 1997 Constitution is bound to change first of all because, pursuant to Art. 87 of the Constitution, after the ratification of the Accession Treaty, EC law (including the rules concerning public deficits) becomes applicable to Poland – together with its legitimate interpretation.

There is yet another piece of legislation induced by EC law and fundamental for governmental deficit and its management, namely the Law of 26th of October 1998 on public finance[31]. Although the Law is not yet completely in line with EC standards, applicable to a vast variety of issues concerning public expenditure and revenue (e.g. definition of deficits), it contains provisions which are essential for avoiding excessive public debt. From this point of view, the most important are stipulations of Art. 45 to 47 of the Law which contain so called prudential and corrective rules applicable (in escalating order) when the debt exceeds, respectively, 50%, 55% and 60% GNP. The measure of the last resort applicable when public debt exceeds the constitutional threshold of 60% is the prohibition to provide for any public budget deficit in the year following the year when such an excess took place.

5. Polish law and the introduction of the euro

In January 1999 the euro was introduced for non-cash transactions. Later on, in January 2002, euro coins and banknotes were brought into circulation and subsequently replaced national currencies of 12 participating EU countries. Polish law had to adequately reflect on these developments in order to prevent distortions in contractual relationships arising within Poland and/or with Polish law applicable. That reflection was the Parliamentary Law on consequences of the introduction of the single currency – the euro in some Member States of the European Union[32] adopted in May 2001. Generally speaking, the new act made a worthwhile attempt to redefine the position of Poland as a third country *vis-à-vis* the euro area.

In more specific terms, the new law provided in its Art. 1 that its objective was to determine consequences resulting from the introduction of the euro in the EU with regard to the Polish legal system. Specifically, it made reference to such important issues as the exchange of banknotes and coins denominated in currencies of these Member States which introduced the euro as their single currency and put into circulation euro-denominated legal tender.

[30] A. Nowak-Far, *Unia Gospodarcza i Walutowa w Europie*, *op. cit.*, pp. 434-435.
[31] Journal of Laws, No 155, item 1014.
[32] Journal of Laws No. 63, item 640.

The main provisions of the Law concerned contractual obligations and formulate some general rules, of which allowed payments originally agreed in national currencies of the EU countries now adopting the euro was the most essential.

In addition, the Law provided that all deposits maintained by Polish banks (including organizational units of the National Bank of Poland) had to be converted into the euro according to the specified conversion rates[33] (with the permissible rounding up or down to the two nearest eurocent[34]). In its art. 6, the Law formulated a specific rule according to which neither the introduction of the euro in majority of the EU Member States, nor any of its own provisions could constitute a basis for the termination of a contract concluded before January 1, 2002. Neither could it "excuse any performance arising from it, or its cancellation, or alteration any of its term". The prohibition set forth in this article specifically referred to the change in interest rate applicable to contracts. Art. 7 of the Law provided that Polish citizens had the right to exchange banknotes and coins denominated in currencies of the EU Member States which adopted the euro as their currency into the single European currency. The exchange was to be done either by the National Bank of Poland (and its regional branches) or commercial banks at a small charge specified later on by the NBP[35].

Conclusions

Approaching entry into the European Union has given rise to strong legislative activities in Poland. This conclusion applies also to the area of financial and monetary regulation. The process of legal adjustment (either reflective on developments which have already taken place or anticipating developments to happen) is not constrained only to law-making, but also has important aspects in the application and interpretation of law. When it is viewed in a broad context, the legal system being already under significant EC *acquis* influence has already contributed (albeit not without a great deal of anxiety in

[33] They are equivalent to the conversion rates specified in the Council regulation 2866/98/EC of 3 May 1998 on the conversion rates between the euro and the currencies of the Member States adopting the euro (OJ L 359/1) as amended in the Council regulation 1478/2000 of 19 June 2000 2866/98 (OJ L 167/1).

[34] This provision with regard to the euro is consistent with the rule set forth in art. 5 of the Council regulation No 1103/97/EC of 17 June 1997 on certain provisions relating to the introduction of the euro (OJ L 162/1).

[35] For a more thorough analysis of this regulation see: A. Nowak-Far, *Poland and the Economic and Monetary Union in Europe*, in: W. Czapliński (ed.), *Poland's Way to the European Union: Legal Aspects*, Scholar, Warsaw 2002, pp. 205-230.

the political realm and with some spectacular failures especially when it comes to public deficit) to fiscal policy discipline. The resulting legal arrangements caused some controversies between the National Bank of Poland, the government, and the Parliament – all boiling down to the omnipresent and ubiquitous in macroeconomic theory problem of assignment of roles responsibility and accountability. It is, however, significant, that forthcoming EU membership brought this controversy to a higher intellectual level (the last conclusion being not applicable to some more exotic parliamentary fractions of the Polish Parliament).

The mere expectation of membership in the EU greatly supported axiological reasoning of these pieces of Polish law which are reflective of *acquis* often being a legislative pattern for national regulations concerning budgetary policy. This conclusion applies to a particular provision of Art. 220(1) of Polish Constitution which, even now, has a rather unstable interpretation.

The coming EU membership considerably contributed to the increase in the National Bank of Poland's independence. It also has some important real ramifications, since it has supported the present NBP's monetary policy, which is based on direct targeting.

There are some significant tasks ahead of Poland. Since after its entry into the EU, Poland will have a status of a country with the derogation, it will have to formulate a concept of its participation in limited forms of co-operation within the EMU institutional framework. Especially, Poland will have to improve its national co-ordination of EU and EMU-related domestic affairs and set new standards for domestic decision-making with regard to macroeconomic and monetary policies decided upon in various EU fora (including ECB Governing Council, the eurogroup, and perhaps, euro-ECOFIN Council). An effective (i.e. properly coordinated participation in these fora would require, as a prerequisite, an improvement of co-ordination between the NBP, Ministry of Finance and other ministries somehow involved in macroeconomic policy formulation and implementation.

Stanisław Swadźba*

Social support for the integration of Poland with the European Union and acceptance of democracy and market economy

Introduction

Since 1989 Poland has been undergoing considerable socio-economic changes. Poland gave up its system of a centrally planned economy (socialism) and chose a system of a market economy. Systemic transformation was initiated and it is based on the idea of transition from the old system to the new one. Therefore, Poland has to adjust its economy to the requirements of a market mechanism.

Simultaneously, Poland relatively quickly (after the change of the system, collapse of the Council for Mutual Economic Assistance – CMEA and the Warsaw Pact) expressed its will to integrate with the Western Europe. It was already in 1991 when Poland concluded the Association Agreement with the European Union (EU). The agreement came into force in 1994. In 1997 Poland was invited to discuss conditions of its EU accession. Negotiations started a year later. It is likely that this year (2002) the negotiations will be finished, and next year the EU accession referendum will be held, followed by the ratification of the related documents. In 2004 Poland will become a member of the European Union. Hence, a systemic transformation of our economy is not only based on its adjustment to the requirements of a market economy. There is some other form of transformation, i.e. adjustment of Polish economy to the EU requirements (so-called dualism of Polish transformation).

It is already thirteen years since a systemic transformation of Polish economy was initiated. In these years Poland has witnessed considerable changes of a systemic character. First of all economic activities were liberated, prices were liberated as well, money convertibility was introduced, several new institutions including stock market, antimonopoly office together with a real and authentic central bank were established, and in the relatively short period of time a large part of state-owned companies were privatized. These were surely revolutionary changes that led to the emergence of a new economic system – a system of a market economy. It has already become well established enough to prevent a reversal of a centrally planned economy. A detailed analysis of our economy shows how far the previous system was left behind as far as ownership structure, functioning of production and redistribution (social

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provision), labor market, financial system and an approach to environmental protection are concerned.[36]

Analyzing a system as a set of interdependent institutions – taking newly set up market institutions into consideration – it is possible to conclude that Poland is fully anchored in the market economy system (though there are still existing relics of the old system, real socialism enclaves in market economy). On the other hand, an economic system is also an established, systematically repetitive behavior of economic life actors. This behavior is rational, market driven and profit oriented. If such understanding of a system is adopted, current economic system of Poland is neither fully market oriented nor capitalistic. The evidence is provided by Polish farming. Such non-market behavior refers to many other business entities that are also dominated by claiming attitudes so characteristic for the previous system. Mining serves as a good example.

Polish citizens' views on the changes of the economic system are also worth analyzing. To what extent is a new system – democratic market economy – accepted? Is it supported and identified with by society? Do Polish attitudes towards numerous particular issues comply with all provisions that determine a democratic system and market economy? These views do influence an assessment of an economic system in a given country.

1. Polish society's opinion on the economic system in Poland

According to the results of research carried out by CBOS (Public Opinion Research Center) in March 2002[37] majority of Poles believe that a challenge to reconstruct the system in Poland was worth undertaking. However, this percentage amounts only to 58%. One out of four Polish people (27%) questions the sense of transformation.

Nevertheless, the results presented above cannot be directly interpreted as acceptance of transformation directions i.e. construction of a capitalist market economy. Taking this criterion into consideration the situation is even worse as reflected in some other CBOS polls.[38] A question whether you agree or disagree with a statement that capitalist economy based on free and private entrepreneurship is the best economic system for your country has been

[36] These issues were undertaken in the research carried out by the Economic Systems Unit at the Karol Adamiecki University of Economics in Katowice. See: S. Swadźba (ed.), *System gospodarczy Unii Europejskiej a docelowy model polskiej gospodarki*, Akademia Ekonomiczna w Katowicach, Katowice 2000.

[37] *Akceptacja demokracji i zasięg postaw antydemokratycznych w Polsce*, http://www.cbos.pl/SPISKOM.POL/2002/KOM063/KOM063.HTM

[38] *Polacy o gospodarce wolnorynkowej, socjalizmie i zmianach gospodarczych ostatniego dziesięciolecia,* http://www.cbos.pl/SPISKOM.POL/2000/KOM071/KOM071.HTM

positively answered by only 41%. As far as 29% do not share this opinion and therefore – as one may conclude – believe that some other economic system than a capitalist one would be better. Others (30%) have no opinion on the subject.

Public opinion polls concerning numerous particular issues are also symptomatic. They reflect acceptance of our new economic system. In research carried out by Pentor in February 2002[39] there was a question whether Poland should maintain shares in enterprises and influence appointing of management or whether it should complete privatization. As far as 61% of responders answered that the State should maintain shares and only 26% were in favor of complete privatization. Besides, as far as 40% think that ousting people associated with the previous government from State Treasury corporations and replacing them with people who enjoy trust of Leszek Miller's government is justifiable. Even if such opinions do not manifest support to centrally planned economy, they definitely encourage state capitalism, political parties' excessive involvement in economy and politicizing of business activity that all do not help a successful economic development of a country and do not comply with tendencies of the world economy.

In other research carried out by Pentor in October 2002[40] a question whether it is necessary to keep subsidizing unprofitable companies, was answered "yes" by 49% of Poles. Only 32 % do not agree. That is also some acceptance for practices of old economic system.

In Poland there are many supporters of recovering the state's property. CBOS's research carried out in June 2002[41] when Szczecin Shipyard's problems were revealed showed that 52% of Poles are more or less for the idea of re-nationalization of collapsing privatized companies (25% – decisively yes, 27% – rather yes). Only 30% were against (including 15% – rather not, 10% – no and only 5% – decisively no). Although the question includes information that re-nationalization costs are borne by all taxpayers it does not weaken support for the involved State's interventionism (56%). It only increases a number of opponents among all respondents (22%). According to related poll by TNS OBOP there are more and more supporters of re-nationalization. The question of more suggestive nature ("Some of already privatized companies face serious problems e.g. FSO in Żerań or Szczecin Shipyard. Should the State re-acquire such companies or not?") has generated 69% of positive answers and 18% of negative ones. 13% of respondents have had no opinion.[42]

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[39] „Wprost", 24 February 2002.
[40] „Wprost", 27 October 2002.
[41] *Czy państwo powinno ratować upadające sprywatyzowane zakłady?*, CBOS, Warszawa, June 2002, BS102/2002.
[42] „Gazeta Wyborcza", 5 June 2002.

Such views on rationalization should not be surprising if Poles' opinions on privatization are taken into consideration. According to the TNS OBOP poll three quarters of Poles are – diplomatically speaking – disillusioned with privatization. For 41% privatization is associated with a robbery and 33% believe it is a sale-off. Only for 18% of Poles privatization means sale. Apart from it, 78% of Poles think that the State has sold too many factories, banks and other companies (7% – enough, 3% – too few). Simultaneously, the question concerning benefits of privatization for economy has generated the following answers: 87% – no benefits and only 7% have indicated benefits.[43]

Market economy is – in conditions of Western European civilization – a democratic economy. Market and democracy are strongly interdependent. That is why, it is worth presenting what kind of attitudes towards democracy Poles represent. For nearly 10 years a stable part of Poles have been accepting superiority of a democratic system over all other forms of government. This opinion met acceptance of 66% of Poles (14% did not agree) in March 2002. However, the question whether undemocratic governments may ever prove more necessary than democratic ones was answered yes by 43% of Poles and only 33% said no. Moreover, half of Poles (49%) admit that they do not care whether governments are democratic or not (for 40% it is important). In this poll respondents were asked a few more questions. Answers provided enable to divide respondents into three groups i.e. "democrats" (40%), "moderate anti-democrats" (51%) and "extreme anti-democrats". Hence, only 40% of citizens question alternative (undemocratic) ways of governing.[44]

Of course such opinions on democracy and market economy may also be met in many highly developed capitalist countries including members of the European Union. However, it is necessary to stress that share of those, who oppose or criticize systems of their countries is much lower. This situation is illustrated by, inter alia, polls conducted in Poland and Germany.

Polls that were organized in these countries in 2000[45] conclude that only 53% of Poles think that democracy is the best method of governing. In Germany this percentage amounts to 84% including 88% in western lands and 69% in eastern ones. Besides, a smaller group of respondents associate democracy with economic issues. In Poland there are fewer people who are satisfied with functioning of a free market economy than in Germany. When asked a question whether emergence of a market economy that is not much controlled by the State is beneficial or detrimental to the future of the State 38% of Poles answered: beneficial and 40%: detrimental. In Germany 75%:

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[43] Ibidem.

[44] *Akceptacja demokracji i zasięg postaw antydemokratycznych w Polsce*..., op.cit.

[45] *Postawy wobec wolnego rynku i demokracji w Polsce i w Niemczech* http://www.cbos.pl/SPISKOM.POL/2001/KOM044/KOM044.HTM

beneficial (79% – western lands, 55% – eastern ones) and 14%: detrimental (10% – western lands, 27% – eastern ones). Results concerning economic order that is a key indicator of an economic system are also very interesting. Poles and Germans were asked who should manage industrial companies and they were suggested a selection of possible answers. 26% of Poles (Germans – 37%) stated that companies should be managed by their owners or managers appointed by the owners. 11% of Poles (Germans – 3%) believed that the State should own companies and appoint management. However, government's suggested scope of responsibilities for regulating of economy and realizing of social policy is similar both in Poland and Germany. Polish and German attitudes differ but if these two nations are to be compared Eastern Germans are more similar to Poles than to Western Germans. Hence, on the basis of the conducted research it is possible to conclude that Polish and German attitudes are still influenced by experiences of the previous systems. Citizens miss the State and do not trust the market.

2. Poles' opinions on the accession of Poland to the European Union and the Euro Zone

Results of polls concerning support for Polish integration with the European Union and introduction of Euro in Poland are going to be quoted here. Next, some opinions on the economic system will be referred to. Finally, conclusions will be made.

According to CBOS polls of September 2002[46] 59% of citizens will surely take part in the referendum (13% – rather yes, 4% – rather no, 11% – surely yes, 13% – do not know). 70% would support Polish accession and 19% would say no (answers of people who declare their intent of participation in the referendum). Such percentage has been on the same level for some years. Total number people who were questioned include 59% of supporters, 22% of opponents and 18% of the undecided. The more educated people, the more they earn and the more satisfied they are, the more supportive towards the integration issues they prove. The highest support is manifested by managerial class and highly educated people. The lowest one is found among farmers. The highest support is represented within PO (Civic Platform) and SLD (Democratic Left Alliance) and the lowest one among members and supporters of Samoobrona (Self-defense) and LPR (League of Polish Families).

Poles also support introduction of Euro in their economy. In 2002 there were 35% of Polish people who were pretty sure they would agree to replace

[46] *Społeczne poparcie Polski dla integracji z Unią Europejską*, Komunikat z badań. CBOS, Warszawa, September 2002, BS157/2002.

Polish zloty with euro – a new and common for all the EU members currency (29% – rather yes, 19% – rather no, 9% – definitely no). So, almost two thirds of respondents (64%) accept the idea (29% of them are against). Besides, as much as 18% of respondents would like to change currency before entering the EU (it is known that Poland does not fulfill all criteria and it is not possible).[47] According to the latest polls (July 2002) as far as 32% of respondents would like to introduce euro in Poland right now (12% – definitely, 20% – rather yes).[48] On the other hand, the latest TNS OBOP polls ordered by the National Bank of Poland show that over two thirds of Poles (67,6%) want euro instead of zloty. What is the most interesting in the results of these polls? As far as 47% of the Polish EU membership opponents are for introducing euro in Poland.[49]

It is visible that there are much more supporters of the Union and a new currency than supporters of democratic and market system. There is some inconsistency here since a political criterion (democratic system), market economy and its competitiveness (ability to face the EU competitiveness) are prerequisites of entrance to the EU. Although the European Commission states, in its last report of October 2002 assessing progress of all candidate countries while preparing to their membership, that Poland is ready for its membership it is known that there is still much to do in many areas. In his interview given to D. Zagrodzka, Günter Verheugen, the Commissioner responsible for the European Enlargement presents the EU expectations for Poland. First of all they include further privatization, preventing companies from getting involved in politics, anti-corruption measures, economic restructuring with special emphasis on farming, proper regional policy and improvement of education.[50] Actions taken in these fields have been criticized by the EU for a long time. Apparently there is a social consent to them in Poland.

Conclusions

On the basis of polls conducted by public opinion research centers it is possible to conclude that Polish social support for a new economic system – democratic market economy – is not very high. Lack of social acceptance of the system means that this system is still not stable and rooted. Taking awareness of our society into consideration Poland is still not in the democratic system of a

[47] *Czy Polacy chcą Euro?* http://www.cbos.pl/SPISKOM.POL/2002/KOM020/KOM020.HTM
[48] *Polacy o Euro, kursie walutowym i planowanych zmianach w Radzie Polityki Pieniężnej*, CBOS, Warszawa, July 2002, BS/129/2002.
[49] „Wprost", 3 November 2002.
[50] „Gazeta Wyborcza", 15 November 2002.

market economy. Such Poland is not and will not be a strong element of the world market economy or the EU economy.

There might be a question what should be done to change a situation in order to increase acceptance of a new economic order (as in the case of present EU member countries).

This question is indirectly answered by the polls discussed above. Higher acceptance of democracy and market economy is always enjoyed by better-educated societies that are satisfied with their material situation (as in the case of acceptance of Polish entrance to the European Union and the Eurozone). Therefore, it is possible to say that only increase in education and real income per capita may result in the increase in support of a new economic system – democratic market economy.

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8. *Postawy wobec wolnego rynku i demokracji w Polsce i w Niemczech,* http://www.cbos.pl/SPISKOM.POL/2001/KOM044/KOM044.HTM
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Part 2:

Transfer of FDI

Katarzyna Żukrowska*

Exchange rate regime and FDI Flows

Introduction

International capital flows occurred in the past as a form of exploitation of richer economies by poorer ones. This was possible when economies were national and protective but policies conducted in different groups of countries enabled asymmetric protection, i.e. developed economies were protective, while economies turned into their colonies were less protective. With time passing protection became asymmetric in the opposite manner: developed economies became less protective, finding interests in liberalization, while developing economies started to protect their economies in a more hermetic manner.

Most of the theories at that time, which was not far ago embracing 1970's and still in the 1980's, were supporting such approach, giving priority to the idea that only countries representing same level of development can cooperate closer and integrate. This turned to be wrong and pushed developing countries – in most cases – into further peripheries. Nevertheless, there were examples of success stories, illustrating that development and catch-up is possible under certain conditions. International Monetary Fund – engaged in process of development alongside with World Bank – gave similar number of positive examples as negative ones. India was a negative example, same as Brazil and some other catching up economies, while Korea, earlier Japan or recently Mexico and Chile were encouraging ones.

Nevertheless, all those countries encountered problems, especially in last decade, when intensive move of production factors started. Those difficulties, which occurred in this period have numerous and rather complex background, exchange rate regime is one of them but does not exhaust fully the topic. The paper concentrates on mutual dependencies between capital flows and type of exchange rate regime used in the economy. The best illustration of exchange rate regimes and prospect they create for capital flows can be found in transforming post-communist economies and comparisons of different solutions applied by individual states. Exchange rate policy is part of the strategy to open the economy and intensify competition so it has a double fold role: as a financial safeguard and as tool to protect or open the economy.

This paper is aimed at pointing that fears of financial crises can be eliminated by sound transformation of exchange rate regime, what in turn is used as an argument showing that such policy stimulates engagement of stable,

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long-term investments in the economy, eliminating short term flows, pointed at speculation and considered to be the most dangerous for the financial stability of a catching-up economy.

1. Historic background of today's changes

Economy is a process what is a paraphrase of Latin *panta rei* formulated by Heracle. With closed, protected, national economies economic policy was pointed at supporting national potential of production and stimulating its utilization. This was accompanied by increasing tax burdens, which helped to collect money for support of the national producers, who have occupation to national labor force and in turn stimulated demand. The idea was simple but costly. Each of the developed countries has build high walls of protection around their national economies of tariff and non-tariff instruments, enabling this procedure but at the same time stimulating costs and limiting by high prices the size of demand.

Such a policy was increasing the rift between developed and developing, no matter how much money was pumped into the economies of the Third World. Aid money send to Third World in form of credits or aid turned quickly into consumption and debts as those countries were not able to use the credits properly building up their own production potential as their economists were naturally following the protective philosophy of economic policy, what in natural way eliminated competition the most effective tool stimulating progress, innovativeness and economic stabilization.

Today capital accumulated in a developed economy can bring more profits to its owners by being exported abroad, to a country where productivity is in rise and labor cheaper. Is it profitable for the exporter of the capital? Is it profitable for the importer of capital? Both are afraid of risk that some perturbations of the economy can diminish the amount of invested capital in case of the exporter or cause panic of departure of the capital from unstable economy in case of the importer what can result in further deterioration of the economy in spite of restructuring, growth and catch-up. Are such apprehensions justified or not? They are well funded in the experiences from the past but in changing world economy decisions about FDI can bring profits for both investors and recipients but this is not achieved unconditionally. What conditions guarantee profitability to investors and recipient economies? They are simple: external and internal liberalization enabling introduction of flexible exchange rate, which adjusts to demand and supply automatically, without need of political decisions to do so. This eliminates most dangers of speculation that were present in case of fixed exchange rates. Speculations are limited to a group of surfers who profit on short-term fluctuation, resembling floats on surfing

board on sea waves. The other group of short-term speculators comes attracted by profits offered by state's obligations, issued to finance budget debt and budget borrowing. Both type of transactions have limited impact on states financial standing what is linked on the one hand with the flexible rate regime, while on the other with the safeguards in financial derivatives, commonly used in international capital turnover. Nevertheless, how complicated safeguards capital market will introduce the most important role can be ascribed to flexible exchange rate regime, enabling the capital market to return to equilibrium by interest rate adjustment.

In other words speculators with the old knowledge how to earn money on international capital markets are not able to gain, or perhaps more precisely their play-grounds are shrinking and the game for them brings about more risks than profits as economies which they can use for their revenues are less and less reliable and their number is diminishing with departure from fixed exchange regime to a flexible one. The process of departure from fixed to flexible exchange rate regime was accelerated by a number of crises on financial markets at the end of 1990's, i.e.: Russian ruble crises, Asian domino crises of the 1997, consecutive Brazilian crises or small turbulences on financial markets of Hungary and Czech Republic. Nevertheless, in most cases, the capital flow was not prohibited nor limited. Economists new that economy is not able to develop without free flow of capital, what up to the end is not yet transferred to remaining production factors but this will come in the future as continuation of the until now observed trends in the world economy, stimulated by globalization, which enforces liberalization introduced in the economy in internal and external relations.

Does it mean that speculation was totally curbed by current changes in the economy? The answer to this question is negative. There are always some sources, which bring opportunities for speculators but they change quickly and need specific knowledge and quick adjustments, what increases risks. For instance new opportunities will be created in case of transforming economies, when they will fixed their exchange rates, preparing for EMU and entering into ERM-2. The second opportunity is formulated by work of the dual monetary system, created by US$ and euro (€). The third by individual decisions of countries changing their exchange rate regimes, although in most cases safeguards are introduced by utilization of external peg (currency board or some other solution that deprive politicians of their power over the exchange rate policy), limiting internal political decisions in this field.

Nevertheless, all situations that can be foreseen by speculators, are at the same time taken into account by the policy-makers, who naturally introduce new type of protective guards along with their decisions, minimalizing if not eliminating totally the possible dangers that occur with new conditions on capital market. Moreover, the group of those who follow and understand the

current capital market which recently is in permanent flux, what is at the same time accompanied by massive and misleading information is rather limited. This also is one of the new safeguards, which punishes the greed of old-liners and awards those who try to keep the path with changing capital market.

The best illustration of this can be found in the size of international capital flows. Intensification of FDI was always accompanied by intensification of flows of speculative capital. After 2000 both types of such flows were curbed down[51]. World FDI inflows and outflows in 2001 amounted to $735 billion and $621 billion respectively. In comparison to 2000 the inflows dropped by 51%, while outflows by 55%. Since 1991 this was a first fall of flows and deepest in last three decades. Nevertheless, countries with low interest rates invest abroad and the direction of flows is clearly defined. Increase of flows can be observed from developed to developing economies, while at the same time flows between developed economies are in decline, although their scale is still bigger than flows to catching-up and developing economies. Such tendency has to be considered as natural. Small in size economies (what is measured by size of their GDP) require smaller injections of capital to start-up growth and restructuring, than big economies.

2. Exchange rate regimes exemplified by selected transforming economies

Convertibility was one of the preconditions of liberalizing trade and capital flows to transforming economies. It was also one of the prerequisites of decentralization and departure from monopolistic trade regime that predominated in centrally planned and distributive economies before 1989. Freedom to set the exchange rates was at the beginning of transformation closely constrained by low levels of international currency reserves[52]. All transforming economies needed to win credibility indicating correctness of the direction of conducted economic policy despite some negative occurrences in their economies. At the beginning of transformation it was desired to introduce a fixed exchange rate regime as it helped to use the exchange rate as an anchor that has stabilized domestic prices. This was considered to be one of the tools that reduced inflationary expectations and thus inflation itself[53].

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[51] *World Investment Report 2002. Transnational Corporations and Export Competitiveness*, United Nations, New York-Geneve 2002, p. 3.
[52] *Economic Survey of Europe, 2000*, No. 2/3, United Nations, New York-Geneve 2000. p. 76.
[53] M. Blaszkiewicz, J. Konieczny, A. Myslińska, A. Radziwiłł, P. Wozniak, *Some benefits of reducing inflation in transitions economies*, BOFIT, Discussion Paper No16/2002.

Economic and fiscal policy in transforming economies were firmly funded on three pillars, which have been prepared in cooperation with EU Commission:

1) broad economic policy guidelines,
2) convergence programs,
3) excessive deficit procedure (including the stability programs[54]).

It must be clearly stated that before the accession to the EU transforming economies are not obliged to meet the Maastricht criteria of convergence. This is clear from Copenhagen criteria, which only state that the candidates should "adhere to the aims" of economic and monetary union. In the Accession Partnerships it has been agreed that candidates start to make their headways, however, towards convergence with the sound economic conditions prevailing in the Euro area. Exchange rate policy applied in all transforming economies is subordinated to meet the stabilization of exchange rate requirement at the point when joining ERM-2. This is achieved gradually, following the guidelines of macro stabilization recommendations, what is supported by marketization of the exchange rate policy.

All economies in which fixed exchange rate regime was introduced faced a strong drive towards deep devaluation, what was considered as a precondition of competitive exchange rate, helping to stimulate exports and protecting against adhesive imports[55]. Such a solution was made as a countermeasure towards prospects of falling foreign currencies reserves if contrary decisions were undertaken. Deep devaluations have opened wide gaps between foreign and domestic prices, what had a negative effect on rate of inflation. For instance in Russia and other CIS economies foreign reserves were low, what was accompanied by too lax monetary and fiscal policies to contemplate nominal exchange rate pegging. A floating exchange rate regime was adopted after period of tensions on the capital market. Nevertheless, requirement to increase the foreign currency reserves was univocal with the fact that Russia and other floaters were not able to adopt full float. With growing reserves resulted by the applied exchange rate policy the support for full float increases.

One can generalize that in an early stabilization stage of systemic transformation a concern with disinflation favored nominal exchange rate pegging, while with advancement of the systemic reforms, when inflation was under control, need to limit destabilizing effects of capital inflow were in favor of more flexible exchange rate regimes. Floating exchange rate was in the

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available range of solutions considered to be an extreme option. Stabilization was accompanied by "welfare effects" that followed disinflation[56].

Between the two extreme stages of fixed and floating exchange rates the size of reserves was moderate, what decided that in most transforming economies adoption of the exchange rate regime had to find a solution balancing between two goals: keeping competitiveness; keeping stability[57]. This required flexibility in nominal terms and stability in real terms. In most cases the regimes were changed from one to another in a gradual manner by adopting the crawling band with preannounced rate of crawl, which was linked to level of anticipated inflation. The rate was therefore declining as inflation was curbed down, while at the same time the band was widened alongside with the pattern applied in ERM, where it started with narrow values of ±2,5% of fluctuation and ended with ±15%. Need of introduction of some protective measures against external shocks, required utilization of an external peg for the exchange rate of national currency, usually composed of a basket of currencies, which reflected proportions of currencies used in foreign trade transactions[58]. In some cases single currencies were used as pegs but this was a rather rare solution in the group of countries applying for the EU membership.

Exchange rate regimes in most countries with some exceptions (i.e. Poland, Hungary) followed a similar pattern in their exchange rate policies[59]. At the beginning all went through deep depreciation, what was followed by appreciation. Applied solution cannot be considered as a surprise. It was well funded in practical realities, that embraced low level of foreign currency reserves at the starting point of transformation, big risks linked with systemic changes, limited knowledge of the decision-makers, etc…[60]

In course of 2001 and 2002 in most economies in transformation serious changes were introduced in their monetary policy. In some countries like Poland those changes have taken place earlier, still in 2000. Those changes embraced widening of the exchange arte band from ±2,5 to ±15%. This was a step preparing the exchange rate to float, what happened at the end. Such changes were introduced in case of Hungarian forint and Czech crone, both tied

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to euro. The resultant euro peg with 15% fluctuation band in effect is equivalent to a unilateral commitment to adhere to a monetary regime, which is fully compatible with the EU's ERM-2. On 1 February 2002 the Lithuanian lit was repegged from the dollar to the euro. This was done with any further ramification for the country currency board arrangements. Those changes were announced in advance. In January 2002 the National Bank of Romania, following the policy of managed float, switched from targeting the dollar to targeting 50:50 dollar-euro basket. This was subordinated to the strategy aimed at reducing the impact of dollars appreciation on the country's exports.

Furthermore, several transforming countries have changed their regulations concerning the size of minimum reserves requirements. The Central Banks in Czech Republic, Hungary, Poland and Slovakia reduced the required reserves ratios in line with their strategies of gradual harmonization of these regulations towards the regulations binding the EU – member states. In addition, The Czech National Bank started paying interest on the mandatory reserves of commercial banks, while the National Bank of Hungary increased the interest rate on these deposits.

The general low level of inflation, reached much faster that anticipated, followed by appreciation of exchange rates of national currencies, caused by inflow of capital in the most advanced economies in transformation, i.e. Czech Republic, Hungary and Poland forced their Central Banks to lower their interest rates. Nevertheless, policies applied here were not similar and often a bit hectic. Generally the interest rates were following the tendency of the central interest rate. Most stabilized policy in this field was observed in Poland, where central interest rate was lowered steeply a number of times what was followed by reduction of the banking interest rates but their level was still highest in the group of three countries considered to be the leaders in transformation. In short such clear picture was distorted by unexpected adjustments. In Czech Republic the exchange rate is low and this is followed by the banking rates. At the same time strong pressure on increase of the budget deficit is observed. Similar situation has been taking place in Hungary, what has forced the monetary policymakers to increase back steeply the interest rate to a level higher than in Poland.

Generally speaking the moves towards reduction of the central interest rates and monetary relaxation did not result in cheaper credits in real terms, on the contrary, in four of five East Central European economies (with Slovenia being exception) real lending rated rose on average. This specific effect was resulted by unexpectedly quick process of disinflation. High interest rates with low inflation and availability of skilled labor force followed by expectations of productivity growth are considered to be the main factors attracting inflow of FDI. Investors understanding specifics of the current stage of transformation used the opportunities to invest and this has resulted in an increase of volume of

credits going to non-government sector in Hungary, Slovenia, Estonia, Latvia and also Croatia and Poland (in case of the latter it was only corporate credit). By contrast the credits to non-government sector continued to shrink as a share of GDP in Czech Republic and Slovakia.

In sum, real lending rates in transforming economies remain relatively high, what implies that the policy-makers try to control demand, which otherwise could result in quick increase of current account deficit, which slowly indicates that the gap between imports and exports shows a narrowing tendency. At the same time the real deposit rates in number of economies were negative, what can be considered as discouragement for private and corporate savings, what is an incentive to encourage consumption to a certain degree. Large disparities between real lending and real deposit rates reflect first of all that the consumer price index (CPI) grows generally faster than the producer prices index (PPI). The first index (CPI) is used to discount the deposit rates, while the second to discount the lending rates (PPI). This tendency is resulting from adjustment of relative prices, where prices of services are an important component of CPI and they grow faster than prices of goods. They also reflect what is known as Balassa-Samuelson effect, what implies in most fast growing and catching-up economies prices of non-tradable goods (with large weight of CPI) tend to grow faster than the prices of tradable goods (correlated with PPI)[61].

As far as the exchange rate regimes in transforming economies are concerned one can say that the situation was relatively stable. All changes were introduced without tensions and turbulences. No excessive volatility was observed on currency markets. Real effective exchange rates in ECE followed similar trends, what can be interpreted as realignment with main world currencies as well as parallelism in strategies applied in transforming economies. In most cases real exchange rates appreciated.

3. Convertibility of zloty and liberalization of capital flows in Poland after 1989

Zloty was not convertible since 1936, what changed in 1990[62]. Transformation strategy of the economic system posed a question: whether convertibility of the Polish currency should be immediate or gradual? With the

[61] Economic transformation and real exchange rates in the 2000s: the Balassa-Samuelson connection, Economic Survey of Europe, 2000, No.: 1 chapter 6, pp. 227-239.

[62] E. Pietrzak, Międzynarodowy Fundusz Walutowy akceptuje polska deklarację. Zloty oficjalnie wymienialny! Nowa Europa 1995, No.: 182 (8.08.1995). (IMF accepts the Polish declaration on convertibility. Zloty convertible).

choice of shock therapy it became clear that convertibility of zloty should be one of the main instruments of economic transformation, which was launched on the 1 January 1989. The concept of internal convertibility, used in the program, was based on experiences of the return to convertibility, in the post-war period of western democracies. It was anticipated that such a solution would diminish the risk of such step, limiting external players from putting pressure on the exchange rate in the preliminary phase of its introduction[63].

There were six principles, forming the rules of zloty convertibility[64]:

- Polish exporters had free access to foreign currencies, which they needed in most of the current transactions. Moreover, uniform exchange rate was used for purchasing foreign currencies,
- There were no restrictions on current transactions concluded by non-residents,
- Enterprises were obliged to sell to the state the foreign currency received in foreign transaction,
- External capital transactions were limited,
- Polish zloty could not be used in foreign transactions and payments,
- Resident-individuals were not covered by the obligation to surrender foreign currencies to the state. They continued to have foreign currencies on the market, according the exchange rate shaped my market forces. This exchange rate was shaped closely to the rate paid by banks. The non-resident individuals had the right to sell foreign currencies.

With time passing the conditions of functioning of rules of the convertibility of the Polish zloty were modified. Those modifications embraced:

- Free access to foreign currencies by residents in their transactions which dominated in their activities.: i.e. trade transactions and three types of services (transport, shipping, insurance). Polish enterprises were allowed to grant their foreign partners short-term commercial loans. Restrictions still covered a narrow group of transactions, mainly services others than those mentioned;
- Restrictions for non-residents on current foreign exchange were eliminated gradually. The most important decision in this respect was the right to transfer abroad the total profits (including the dividends), earned on investments made in Poland. This solution entered into force in June 1991. More or less two years latter a similar freedom embraced incomes on securities bought in Poland as well on the interests;

[63] Same solution was introduced nearly simultaneously in the former Yugoslavia. (18 December 1989). It took some years when other countries have taken advantage from this experience.
[64] E. Pietrzak, Polski zloty. Od wymienialności wewnętrznej do standardu

- Exceptions were introduced to the ban on foreign currency accounts held by the Polish companies. Those exceptions included the right to hold such accounts by Polish authorized banks;
- Opening of the market for capital transactions was asymmetric. Import of capital was mostly liberalized[65], while export of capital was nearly totally prohibited.

The law was successfully liberalized by introduced amendments to the Foreign Exchange Act[66] and the General Exchange Permit[67]. Non-residents obtained free access to portfolio investments, embracing equities and Treasury bonds and Treasury bills (zloty denominated instruments). The access of foreign investors to the Treasury bill market, a tool used in reduction of servicing the domestic public debt, opened the market for short-term capital flow, known as speculative capital. This was considered as an additional instrument crediting the economy.

Gradual liberalization of the capital market led Poland to convertibility according to the IMF standard. This decision came into force on 1 June 1995, when Poland declared readiness to accept the requirement of article VIII of the Agreement on IMF. The decision did not change much in practice of the Polish exchange rate mechanism and openness of the Polish capital market. It has changed the status of zloty, accepting officially the earlier attained state[68]. Most of the decisions on opening of the Polish market to inflow of foreign capital were prepared within the framework of negotiating membership in the OECD. The additional requirements on convertibility are formulated by in article VIII of IMF Agreement, section 2,3,4, which says that:

- Restrictions on making payments and transfers in current international transactions should be avoided without distinction either they concern residents or non-residents,
- Same exchange rate should be applied and discriminatory practices avoided,
- Country is obliged to buy-back own currency from another IMF member.

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[65] Capital import in form of FDI and portfolio was restricted only to a small extent, except real estate acquisition. The latter was limited by restrictive regulations dated 24 March 1920 (Act on Real Estate Acquisition by Foreigners). Liberalization of FDI, enacted mainly by Act on Companies with foreign participation, dated 14 June 1991 (Journal of Law 1991, no 60, item 253).

[66] Journal of Law 1991, No. 35, item 155.

[67] Polish Monitor 1993, No. 32, item 331.

[68] Act on Foreign Exchange, 1 January 1995; Ordinance of Minister of Finances, dated 27 March 1995 on General Exchange Permits, Polish Monitor 1995, No 16, item 197.

Article XXX (d) of the IMF Agreement adds some specific conditions, stating that liberalization embraces all types of payments, which are not the purpose of capital transfer, what embraces[69]:

- Payments linked with the foreign trade and other business, including services and short term banking facilities,
- Transfers of interest on loans and net income from other types of investments,
- Amortization of loans or depreciation of direct investments,
- Remittances for family living expenses.

After acceptance of zloty convertibility according to the IMF standards, the Polish exchange legislation was further liberalized. There were three reasons behind decisions in this field. Firstly, Poland was experiencing an increase in foreign exchange reserves, which undermined the exchange rate policy. Secondly, Poland was obliged to change the regulations concerning openness of the capital market in view of OECD membership. Thirdly, Poland was bind by close perspective of joining the EU with its single internal market, which have introduced four liberties: in trade, services, labor and capital movements.

The requirements formulated by Organization for Economic Cooperation and Development are far reaching. They are formulated within the Code of Liberalization of Capital Movements and some other instruments. Recently a Multilateral Agreement on Investments is discussed among the OECD member states. Nevertheless, progress here is small. There is chance that Doha WTO Round, which started in November 2001, will reach the goal earlier than the OECD. Negotiations on capital transfers liberalization were included in the last GATT Uruguay Round.

A country can liberalize its capital flows autonomously, regionally or globally. The higher the level of decisions the smaller scale of liberalization is achieved. Poland has joined OECD as a third post-communist country after Czech Republic and Hungary and was the 28th member of the organizations. Polish legislation required additional changes as a result of OECD membership, what was achieved in 1996 (signed on 11th July, ratified in September). Other East Central European countries will liberalize their market for capital inflow within GATT/WTO. An agreement on this issue was signed in December 1997. Nevertheless it is limited in scope in comparison with the decisions on market opening which are discussed within MAI agreement of OECD.

Requirements and obligations within OECD membership have been mainly altering the export of capital from Poland, while import of capital was liberalized earlier.

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[69] W. Małecki, *Polish zloty. Foreign exchange market*, Working papers, Instytut Finansów, No. 52/1997.

This has influenced:

- Capital exports from Poland, what embraced FDI made by companies and individuals. Since 1 April 1996 it was possible to invest in OECD countries. Firstly, this enabled purchase of equities or shares in companies in OECD countries, in quantities assuring at least 10% of voting power. Secondly, it created conditions to buy or establish branches or enterprises in OECD countries. Thirdly, it made possible to acquire real estate in OECD. There were no limits imposed on the capital exports, while in case of non-OECD countries a 1 million ECU limit was imposed in case of their investments in OECD member-states. Other forms of capital were liberalized to a smaller extent as strict limits were imposed. In case of portfolio investments, Polish companies can buy Treasury securities and bonds in other OECD countries, under the condition that their maturity is not shorter than one year and the amount of investments does no exceed 1 million ECU in each company engaged in investment. Both financial and commercial loans, granted by residents to foreign entities for up to one year, no longer require a permit. Foreign companies can sell shares and trust funds or equities in companies residing in OECD or other countries with which Poland concluded agreements on mutual protection of investments. This can be done within ECU 200 million limit in yearly terms, what includes loans contracted by foreign companies in Polish market through issuing bonds that are mature longer than one year. Such a condition was set-up by Securities Commission.
- Capital imports to Poland went through far reaching liberalization before the OECD membership. Important change was to allow enterprises to draw long-term loans abroad. This embraces financial loans and bond issuing on foreign markets. Liberalization embraced also commercial credits, guarantees, warranties granted by foreign companies to the Polish partners. At the end of 1999 the Polish capital market has been fully liberalized for flows of long-, medium and short-term capital. Since 1 January 1999 foreign banks and insurance companies were allowed to operate freely on the Polish market. At the end of 1999 short-term capital flows and full term convertibility of zloty was attained.

In sum, liberalization of the Polish capital market both in case of exports and imports was achieved gradually, leading to full market standards, accepted by the IMF. This process leads to opening of the market for OECD partners, what includes all the EU members. Liberalization of capital transfers within GATT/WTO, OECD, IMF and in lesser extent the Europe Agreement prepares the country to join the internal market of the EU in the field of freedom of capital movements.

4. Marketization of exchange rate value setting: from fixed to floating regime – the Polish case

Exchange rate arrangements in Poland since 1990 can be divided into four phases, which are following:

- Between 1 January 1990 and 14 October 1991 – administratively fixed peg,
- Between 14 October 1991 and 16 May 1995 – administratively pre-announced crawling peg,
- Between 16 May 1995 and 16 May till 12 April 2000 – exchange rate set by Central Bank within a crawling band,
- Since 12 April 2000 – flexible (floating) exchange rate.

Poland has applied a model of transformation in which the exchange rate played an important if not crucial role. It was one of the anchors of the stabilization strategy. On the one hand it was supposed to act against the inflationary expectations, curbing the inflation, while on the other one, it was one of the instruments opening the economy, stimulating competition and enforcing cost reductions also stimulating stabilization in long run.

In 1989 zloty was overvalued what enforced devaluation at the start of the reform. Poland has devalued zloty deeper than it was needed, if its real value was considered. Nevertheless, this decision was dictated by the strategy to hold the value after devaluation as long as possible on the same level, not introducing new shocks to the economy. Before setting the new value of zloty – specialists had to answer several questions:

- How deep the devaluation should be?
- To which currency the exchange rate should be fixed?
- For how long the fixed rate should be kept?

Answers to all the questions were difficult as they concerned short and long-term consequences for the economy. From the distance it seems that the implied decisions were wise. This attitude can be supported by measuring the effectiveness of the Polish model of transformation, which brought about at least three things[70]:

- Quickest departure from transformation depression,
- The highest rates of growth,
- The unique example of a post-communist country which has reached the level of industrial production from 1989.

The answer to first question was to devalue zloty deeper than its current real value was at that time. Such overshooting could have an impact on

[70] Poland has reached the level of production of 1989 in 1995. Since that time this level was surpassed by ca 32%. Until now Poland was followed only by four other countries, i.e.: Czech Republic (101% in 2002), Hungary (108%), Slovak Republic (106%), Slovenia (118%). Quoted after Transition Report update 2002, EBRD, London 2002, p. 17.

prolonging the initial period of fixed rate, what played an important role in the economy. The exchange rate was additionally used as a tool opening the economy and stimulating competition. This in turn forced enterprises to cut their costs of production and look for savings. It also helped to supply the market, which was characterized by demand exceeding supply, reflected in the forced savings. Moreover, improvement of supply reached in specific transformation conditions was an instrument in which liberalized prices have found their new equilibrium on a lower level in comparison with a situation when the economy would be closed.

The second question was answered by pegging zloty at the beginning to the US$. The exchange rate was fixed at 9500 zł/US$. The third question was not answered from the start. It was assumed that the fixed rate should be kept as long as possible. It was assumed that the period of fixed rate would last several months. In reality it was kept for one year and a half, what had a healthy impact on stabilization of the economy. Such a long period of fixed rate of exchange was possible thanks to the initial depth of devaluation and decline of the dollar value against other currencies in the 1990, which reduced the pressure for further devaluation. At the beginning zloty was undervalued, with time passing the fixed exchange rate has reached the equilibrium with the real market value of zloty expressed by the currencies in the basket. Further on the fixed rate was hiding the appreciation of zloty. Undervalued zloty was protecting the Polish economy against imports and in specific period was the main tool used in trade policy of the country as most of the custom duties were lifted. With appreciation the fixed exchange rate was used as a tool opening the market for imports with its rather well known consequences in intensified competition. This lasted till 17 May 1991, when zloty was devalued by 14,4% against the dollar. Since that date the dollar peg was replaced by a combination of currency basket to which zloty was pegged till 1 January 1999. This basket was composed of following currencies:

- US dollar 45%,
- British Pound Sterling – 10%,
- German Mark – 35%,
- French Frank 5%,
- Swiss Frank – 5%.

Share of individual currencies represented their weight in foreign trade transactions concluded by Poland. Such composition stabilized additionally the exchange rate of zloty as it reflected different trends in which the exchange rates of currencies in the basket were changing their values. This was also the case afterwards, when two currencies of the group were preparing to fix their exchange rate with euro, joining EMU. It was the case of Germany and France.

Devaluation of zloty and change of currency peg influenced the fluctuation range of bilateral exchange rates. Reduction of inflation forced a new approach to the exchange rate binding. A fixed rate in such conditions would mean continues hidden appreciation. Effects of such policy on the trade balance, which reflected limited competitiveness of the export offer became evident. Exchange rate of zloty was still used as an instrument to fight inflation. In such conditions it could:

- Continue the policy of fixed exchange rate, pegged to the currency basket,
- Continue the policy of fixed rate with periodic adjustments,
- introduce a crawling peg with crawling pace adjusted periodically in accordance to difference between inflation rates on Polish markets and abroad,
- Application of crawling peg by a pre-announced fixed rate.

The last method was applied in the Polish practice. The decision entered into force on 14 October 1991. Since that date the Polish zloty was devalued in a monthly devaluation by 1,8%. This method of fixing new level of exchange rate reflected the state of economy in that period. It also reflected the intention of the economic policy to act against inflation and secure the real exchange rate. The scale of planned devaluation was lower than assumed inflation. This has enforced additional discrete devaluations:

- By 10,7% on 26 February 1992,
- By 7,4% on 27 August 1993.

Decisions about additional devaluations were intended to introduce corrections into the growing gap between actual scale of crawling devaluation and scale that was necessary for stabilization of the real exchange rate. Decreasing inflation rate and inflow of foreign capital as well as non-registered trade, increasing currency reserves has influenced the decision narrowing crawling devaluation rate from 1,8% to 1,6%. In 1994 the trade balance has improved. All those circumstances had an effect on exchange rate policy. Despite the fact that main pillars of the exchange rate policy were still in force, the scale of crawling devaluation was reduced three times: to 1,5%, to 1,4% and finally to 1,2%. this was done in accordance to officially announced rules. Between announced new levels of exchange rate – the rate was fixed.

Stabilization of the Polish currency led to a new solution in the exchange rate policy, which was introduced on 16 May 1995. Changes were complex but based on similar elements, which were introduced in the former phase (i.e. peg to a currency basket and estimation of its value by the Polish Central Bank in accordance to monthly devaluation of 1,0%, replaced by 1,2% from 8 January 1996). The role of exchange rate at that time was to set limits of the range of admissible fluctuations of the zloty exchange rate in internal bank market. The band of fluctuation of the exchange rate was widened from +2% to +7%. The

Polish Central Bank intervened in the foreign exchange market, keeping the exchange rate within the defined band of fluctuations.

The institution of fixing rates has been introduced, what concerned two currencies: German Mark and US$. The fixing was obtained by bids and offers for the two currencies collected by Polish Central Bank everyday between 2.00 and 2.30 PM. This was done according to specific technical rules. Nevertheless, those rules were not fully defined, giving margin of freedom to the Polish Central Bank. The commercial banks are free to set their exchange rates in their transactions with customers. On 22 December 1995 the exchange rate of zloty was revalued by 6%.

With introduction of euro in 11 EU member-states on 1 January 1999 the basket of five currencies was replaced by a basket of two currencies: 45% share of US$ and 55% of euro. Czech Republic and Hungary have at that moment replaced DM, which was used as peg in case of their currencies by euro. Finally on 12 April 2000 the floating exchange rate system was introduced. This step was undertaken a day after announcement of the size of trade deficit for 1999, which climbed from 12 billion in 1998 to 18 billion in 1999. This move has resulted in a quick adjustment of exchange rate of zloty, which has found a new equilibrium on a lower level, returning back to previous level after strong intervention of the Polish Central Bank on the capital market.

In sum, properly set stabilization policy, conducted within the transformation strategy can lead to close convergence of the economic systems. This is true even in case of an economy like the Polish one, which at the starting point was deeply destabilized, more than Czech's or Hungarian economies.

5. Capital flows

Exchange rate regime reflects advancement of the systemic reforms, being at the same time an indicator of stabilization of the economy. With progress of the reforms and departure from the fixed exchange rates regime the flows of capital to the region are in rise. Polish economy started to grow in May 1992, relatively quickly after introduction of the "Balcerowicz Plan", the rates of growth in Poland for a while were the highest in the region, what resulted in the fact that Poland in the whole period of transformation since 1989 achieved an average highest rate of growth. Moreover, Poland in the whole period after 1989 was the only country in the group of economies in transformation that exceeded the average rate of growth of the EU market. This was so despite falling rates of growth and serious slow down in 2001 and 2002. The results here can be indicated by data shown in the Table 1., presented below.

Table 1. Dynamics of economic growth in transforming economies in 1989-2001

Country	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Czech Republic	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	5.0	4.5
Estonia	8.1	-6.5	-13.6	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.7	-1.1	6.4	4.5
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.3	5.1	-4.2	2.9	3.4
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	4.0
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	4.1	3.5
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.6	2.5
Slovakia	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.0
Slovenia	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.8	5.0	4.7	4.0
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.5	5.2	4.5
Average	**1.3**	**-4.7**	**-10.8**	**-10,0**	**-4.5**	**1.5**	**4.1**	**2.7**	**3.5**	**2.7**	**1.0**	**4.2**	**3.7**

Source: Transition Update 2001. EBRD, London 2002. p. 15.

The Polish transformation depression was concentrated in two years 1990 and 1991, while in remaining economies the production continued to fall still in 1992 and 1993. Except two last years indicated in the table, the average rate of growth in Poland according to EBRD sources was higher than the average achieved by all economies in transformation from east Central Europe. In 2000 and 2001 the rate of growth in Poland, according to EBRD data, was a bit below the average of ECE economies. In reality the disparity here was bigger as the economy in Poland was growing with a rate lower than 1%. Nevertheless, the results of rate of growth, which can be considered as an effective tool measuring the success of transformation strategy applied in Poland were still highest in the region.

After becoming a member of the EU – Poland will be placed on the 10 position among all EU members, according to criterion of size of the GDP. Calculations indicate in period 1989-2001 Poland was the only economy that achieved positive differences between its rate of growth and the average achieved in the EU. This remark requires additional explanation stating that the economy of EU has seriously slowed down in last decade, what is ascribed to strong deregulation moves linked with changes in the economy resulting from introduction of convergence criteria, introduction of common currency and globalization. Most of the occurrences require certain adjustments in the policy but their correctness or failure is proved after a certain period, with a delay,

after which corrections to applied strategy can be introduced. Nevertheless, none of the remaining catching-up economies was developing with a faster rate than the one achieved by the EU.

Table 2. Level of GDP of candidate economies, average dynamics of growth in 1989-2001, difference of this dynamic towards EU dynamics, position of the EU according to criterion of size of the GDP

Economies in trans-formation	**Average dynamics of growth in 1989-2001**	**General level of GDP growth in compari-son to 1989**	**Place of the EU after obtaining membership according to criterion of GDP size (in brackets size of GDP in billion euro)**	**Average dynamics of GDP growth in EU in 1989-2001**	**Difference between dynamics of a country with dynamics of EU in 1989-2001**
Czech Republic	0,44	98	16 (**62**)	X	-1,19
Bulgaria	-2,66	70	22 (**14**)	X	-4,29
Estonia	0,30	82	25 (**6**)	X	-1,33
Lithuania	-2,60	64	23 (**13**)	X	-4,23
Latvia	-7,70	64	24 (**8**)	X	-9,30
Poland	2.29	127	10 **(202)**	X	0,66
Romania	-2.01	77	18 (**42**)	X	-3,64
Slovakia	0,72	103	20 (**22**)	X	-0,91
Slovenia	1,30	114	21 (**21**)	X	-0,33
Hungary	0,85	105	17 (**57**)	X	-0,78
Average	**0,91**	**90,4**	**X**	**1,63**	**-2,38**

Source: Own calculations based on Transition Report Update 2001, EBRD, London 2002.

After a period of slow down Polish economy is recovering, what can be ascribed mainly to appreciation of euro, what makes Polish exports to the EU market more competitive. This phenomenon has a same effect as depreciation of own currency and opposite to depreciation of the currency used in transactions of the importers. Appreciation of euro is mainly achieved by changes of the direction of capital moves from the US economy to Europe after changes of the level of interest rates. Before 11 September 2001 the interest rates in the US higher than in the EU were causing appreciation of the US$, now the situation is different. The simple mechanism used here shows that dual currency system can accelerate the growth by creating favorite conditions for capital flows, what appreciates the euro, increasing competitiveness of imports into euro-market and thus an import sucking effect, stimulating the economies which are trade-dependent on that market. In case of those economies (with Poland in that number) appreciation of euro increases competitiveness of exports addressed to the EU market, worsening competitiveness of exports

offered by the EU, this is one of the measures that improves the current account equilibrium in transforming economies. Such a situation also improves climate for capital inflows into those economies, helping them to reform, restructure and build competitive production potential. The interest rates in transforming economies are naturally higher as they are – in most cases – resulted by high inflation rates that reflect process of stabilizing the economy in its transition from deficit to equilibrium state, during which the proportions between demand and supply are being adjusted first by increase of prices, secondly by increase of supply, thirdly by price adjustments towards reduced costs of production and increased supply (imports and home production).

Flows of capital to transforming economies are being attracted by higher interest rates if they are higher in real terms (corrected by rates of inflation and exchange rate tendencies); prospects of labor productivity rises; increasing demand; attractive labor costs, lower than in advanced economies; prospects of further expansion to the remaining transforming economies when offered with lower, more competitive prices, enabled by lower productions costs; market liberalization, leading to increase of its size, measured internally and externally; low taxes. From the perspective of capital exporting economies the process of desindustrialization is also important, what is accompanied by the fact that most of the investing companies have easier access to competitive capital, advanced technologies, know-how, organization, marketing and selling as well as servicing infrastructure. In such circumstances flows of capital diminished to developed economies but kept high rates of growth to all types of catching up economies i.e.: transforming, newly developed or developing[71].

Table 3. Inflows and outflows of FDI to countries in transformation

Contents	Inflows				Outflows			
	1989-2001 cumulative	1989-2001 per capita	2001	2002[a]	1990-1995 annual average	1996	2000	2001
ECE	98 297	1 365	16 933	21 318	275	1 292	4 012	3 518
Poland	34 426	890	6 502	7 000	19	53	17	14
Hungary	21 869	2 177	2 204	1 502	26	-3	555	337
Czech Republic	26 493	2 570	4 820	7 000	67	153	43	96

[a] estimates

Source: Outflows given after World Investment Reports 2002, p. 309.
Inflows given after Transition Report Update 2002, p. 24.

[71] World Investment Report. Transnational Corporations and Export Competitiveness. 2002. UN, New York, Geneva 2002, p. 3.

In 2001 and 2002 FDI flows in and from East Central Europe remained at the levels comparable to those of the previous year. In fact, while global FDI inflows declined by more than 40% - and this slow-down affected all regions except Africa – flows into East Central Europe rose. The increase was 2% in year terms[72].

East Central European economies are small when a criterion of size of GDP is used. This means that they require smaller capital inflows sufficient to restructure their economy. Liberalization of inflows and outflows in this group of economies can be used as evidence of possibilities which can be created by liberalization of factor movements between developed and developing economies. In the group of ECE economies in transformation the Polish example has a specific position as this is the only economy that in the whole period of systemic changes experienced higher rates of growth than the economies of EU member-states. This proves that external and internal liberalization are important factors of a catching-up strategy.

Conclusions

The exchange rate regime in a transforming economy has an important role to play in macrostabilization strategy as well as in the process of opening of the economy. Choice of peg, composition of the currency basket and the type of exchange rate policy adjustments are important in the policy mix applied in this field. It is not neutral what is happening with the currency towards which the national currency of transforming economy is pegged. The choice of exchange rate policy is closely linked with the interest policy. Recent events on the international capital market indicate that interplay between two main currencies can be used as a stimulating incentive for economies, which are closely economically linked with one of the markets, where one of the currencies is used. This was the case with a dollar peg at the beginning of Polish transformation, and this is the case now, when exchange rate of euro appreciates and exchange rate of dollar relatively looses value.

[72] Ibidem, p. 68.

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Ingeborg Nìmcová*

The Czech view

Overview of the Czech bibliography concerning the topics of FDI and Czech participation in the EMU

The leading idea for this short contribution was to bring a short review of a Czech approach to one part of the topics of this workshop – "FDI and Czech accession to the EMU". I have covered main part of the published monographs and articles that have been published by the Czech authors. Surprisingly, the topic has not appeared as a main at all. Only few remarks could be found as a side effect of researching other topics.

Let me classified the covered literature just to bring a more systematic picture. Let us divide the resources into two groups. First is formed with studies and documents published and approved by the Czech government. Here we find mostly strategic approach[73]. Let me name the two most relevant publications.

"Social and Economic Effects of Integration of the CR into the EU – New challenges, possible risks" from June 2001. There the approach was focused on competitiveness of the Czech economy, on convergence scenarios and price level adjustment in the relevant part of the material.

The report "Social and Economic Coherence of Integration of the CR into the EU – Economic Convergence, Competitiveness and Social Cohesion" published in May 2002, contains a chapter on pros and cons of a fast acceptance of euro. This seems to be first larger analyses and probably the first "giving names" to the potential problems.

In the second – larger group – there are the remaining studies and articles published by very different authors – from researches of the CNB and academicians, to analytics from businesses. Three main groups can be detected here:

- Publications and articles on FDI,
- Publications and articles on macroeconomic analyses of the CR convergence,
- Publications and articles on the Czech accession to the EMU.

Certainly we will also find few combined articles there.

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[73] Majority of the documents is available in English at http://www.vlada.cz

"FDI group" is focused mostly on the actual problems of FDI in the CR – incentives, effects on growth and restructuring, unemployment, spillovers etc. In relation to integration, only analysis of the recent development is available.

"Convergence group" is connected mostly with analyses, while scenarios of the future development are quite rare.

"Czech accession to EMU group" deals with future monetary scenarios, trying to find optimal schedule. FDI aspect has not been examined. The closest related finding concerns the expectations of the level of interest rate.

Generally, we can repeat, that in this larger part of Czech publications FDI and CR accession/participation in EMU has not been investigated, and only rare and occasional remarks can be found.

Evident question must be following: "Why this topic is in the Czech economic research missing?" We can see two main reasons:

- recent development of FDI inflow into the CR (since 1998),
- historical experience with CR-SR monetary union in 1993.

There have been some milestones in the development of the FDI inflow. Step by step building of credibility after the break of former Czechoslovakia was accompanied by the sell of a minor share in telecommunications in 1995. Contraction in following years reflected problems with balance of payments and slight monetary crisis around 1997. Following years were influenced by growing package of investment incentives. The first introduction of investment incentives occurred in Spring 1998 and, in fact, it presented totally different governmental approach to the FDI and generally a new philosophy of the Czech restructuring and development. The growing package of these incentives strengthened activities of Czechinvest – a governmental agency recruiting mostly foreign investors. Great influence on total volume had also the privatization program of the Czech government. Therefore, the share of selling of the state property should be distinguished from capital for greenfield investments.

There are many questions and problems concerning accommodation of the FDI in the Czech economy but there are not any questions concerning the size of the FDI volume.

Following table and charts show the FDI Inflow into the CR 1993-2002 and forming of the FDI stock in the Czech economy.

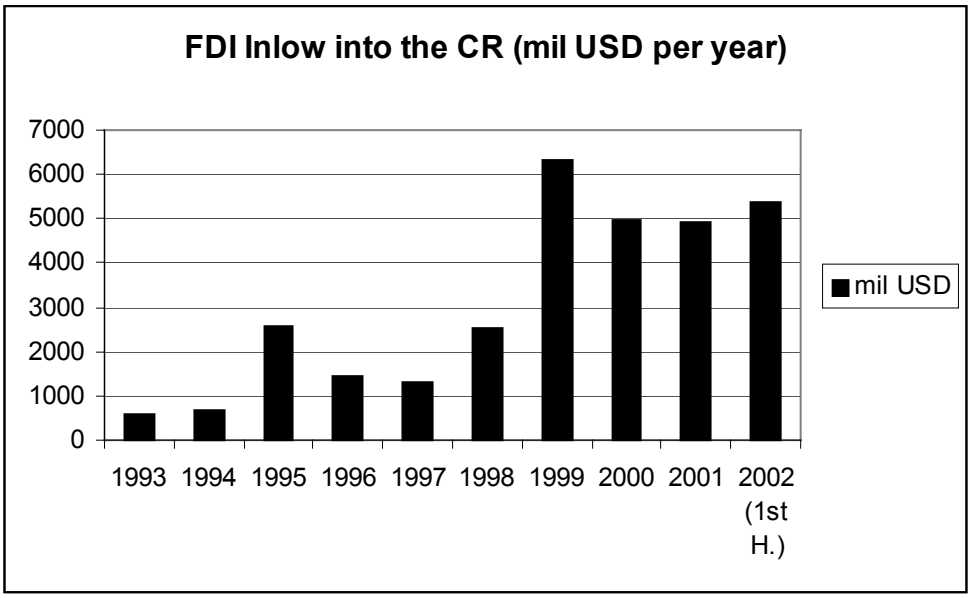
The size of the volume and the size of stock of the FDI may not lead to discussions to how to support the inflow including growth of credibility through a fast participation in the EMU. Simply the Czechs seem not to need discussion like this since the problem is not urgent.

Table 1. FDI Inflow into the CR 1993-2002

Year	mil US$	Year	mil US$
1993	568	1998	2540
1994	682	1999	6324
1995	2558	2000	4986
1996	1428	2001	4916
1997	1300	2002 (1st H.)	5385

Source: CNB, EIU.

Chart 1. Inflow of FDI into the Czech Republic

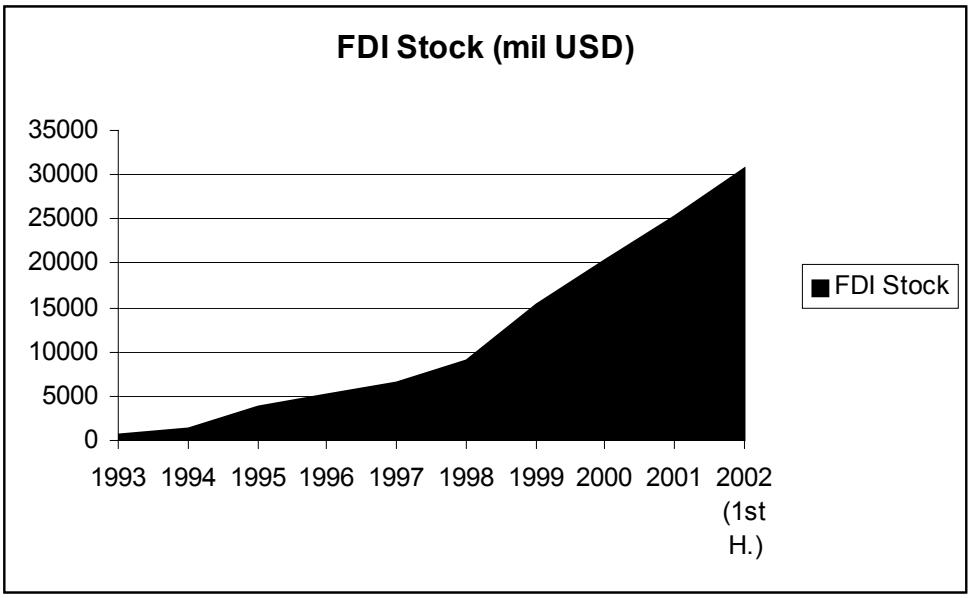


Second reason – historical experience of a monetary union with Slovakia in 1993 is – according to my opinion – also relevant. Split of former Czechoslovakia was accompanied by discussions on transfers between the republics. There was a certain will to put a brake into the des-integration process, which drastically affected mutual trade. But this will was not big enough to stay in monetary union. There was no "Pact of Stability" and from the very beginning the Czech side decided to separate the Czech crown as soon as possible. The monetary union lasted exactly 1 month and 8 days.

A result of this experience is more understanding to the position of economically stronger present members of Eurozone and certain fear of „covered" redistribution. This understanding might be observed especially among politicians, economists, bankers and experts who personally participated

in the events of 1993. The younger generation seems to be more focused on quick Czech accession to the EMU, as it has been observed in recent discussions.

Chart 2. FDI stock in Czech Republic



Although this explanation of missing topic might be rather subjective and additional reasons might be brought to attention, more careful investigation of convergence process and role of the FDI in it could expected soon.

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Ewa Latoszek*

Influence of FDI on the Polish Economy

1. Overall FDI inflows in Poland during the transition period

In Poland, the legal act regulating terms of operation of companies with foreign shareholding took effect much later than in the Czech Republic and Hungary, delaying inclusion of these entities in the privatization process. Although, especially in the early 90s, foreign direct investments flew to Poland in lower volumes than to our neighbors. With time passing, Poland managed to surpass them in terms of cumulated value of FDI (compare: Figure 1). Eleven years after introduction of economic reforms, Poland was the Central European leader in total value of FDI[74]. It is worth adding that untill 2000, Poland has attracted more than US$ 45 billion, while by the year 1998 this value amounted to US$ 30.7 billion, i.e. 1,5 times more than in Hungary and almost 3 times more than in the Czech Republic. Moreover, it is worth mentioning that in terms of cumulated value of FDI, Poland outstripped the Czech economy in 1993, lagging behind Hungary for the next four years (compare: Chart 1.).

What's more, out of the countries compared, Poland is the only one to show positive growth rates of FDI in the whole period before 1998, while the Czech Republic experienced a decline in the years: 1993, 1996 and 1997. In case of Hungary, the negative FDI ratios were registered respectively in 1994, 1996 and 1998.

According to available data, the positive growth of FDI flows to Poland was reversed in 2000. The reasons for such a breakdown were of various nature, although the major responsibility was borne by external determinants (the crisis in Russia), reduced re-investments of foreign companies, limited absorptive ability of the Polish market (because of the implementation of 4 socio-economic reforms), and finally a slowdown of economic growth in Poland[75].

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[74] According to PAIZ's statistics, the value of foreign capital invested in Poland has exceeded US$ 52 billion so far, more than in any other country of the CEE region.

[75] There is a connection between the growth rate and the volume of FDI flows. According to estimations made, a 1% growth of GDP complies with a 3-4% increase in FDI flows, although in Poland this phenomenon has more indirect influence, compare: D. Milaszewska, *Wybrane aspekty wpływu zagranicznych inwestycji bezpośrednich na polską gospodarkę*, Uniwersytet Szczeciński, 2000.

Chart 1. Cumulative value of FDI in Poland, Hungary and the Czech Republic in 1991-1998

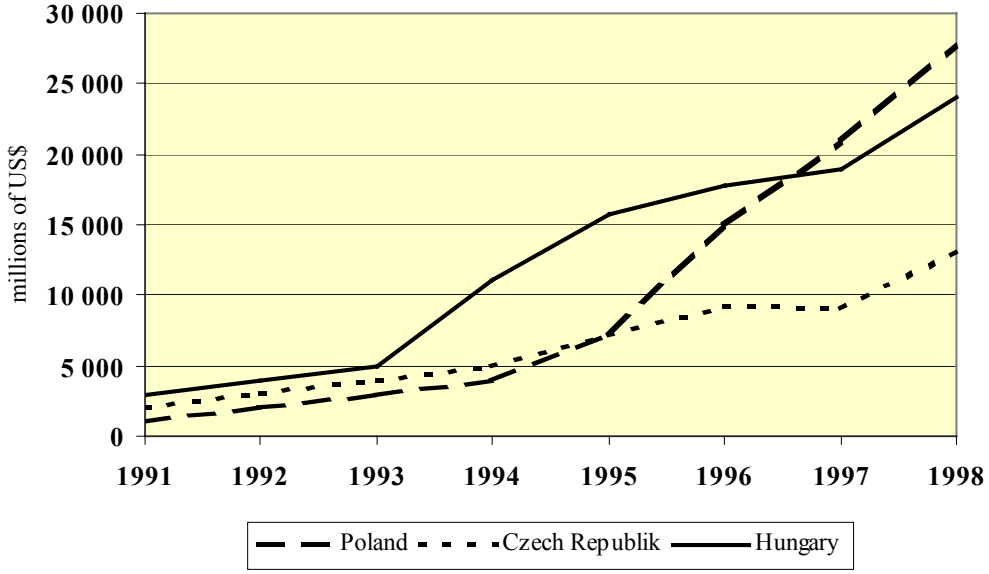


Table 1. FDI inflows to Poland in 1991-2000 (millions of US$)

Measure	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Cumulated FDI	369	1 605	3 224	4 926	7 788	14 028	20 587	30 651	35 171**	45 161**
Cumulated FDI per capita (US$)	10	42	84	128	202	363	533	794	675	1 007
Cumulated FDI (% GDP)	0,47	1,90	3,75	5,32	6,54	10,42	15,17	19,66	n/a	n/a
FDI inflows	291	924	1 300	1 600	2 500	6 200	6 600	10 100	8 300*	10 600*
FDI inflows (% GDP)	0,38	1,09	1,48	1,72	2,10	4,63	4,85	6,92	n/a	n/a

* Data for 1999,2000 are rounded up/down, from "Newsweek Polska", No 4/2002, 27 January 2002.

** According to PAIZ, FDI exceeding US$ 1 million.

Source: *World Investment Report 2001: Promoting Linkages*, United Nations Conference on Trade and Development, UN, NY and Geneva, 2001, *Transition Report 2000*, EBRD 2000.

By the year 1998, the cumulative FDI stock in CEE reached the level of US$ 93 billion, out of which Poland, Hungary and the Czech Republic absorbed 33,1%, 24,2% and 9,7% respectively[76]. Such approach shows a strong position

[76] Comparing the data with statistics concerning the year 2000 published by Nowe Życie Gospodarcze, the share of Poland, the Czech Republic and Hungary in cumulative stock of FDI to CEE accounted for 36%, 21%, and 20% respectively, compare: G. Garlińska, *Umieć się*

of Poland, however, in terms of per capita value it is the Czech Republic and Hungary[77] which have an invariable advantage: US$ 1 447 and US$ 1 764 respectively, against US$ 675 in Poland[78]. According to the statistics, the per capita value of FDI in Poland was calculated at US$ 1007 in 2000. It does not change the order of classification, locating Poland after both Hungary (US$ 1 900) and the Czech Republic (US$ 1 752), although a considerable improvement can be noticed.

Growing inflows of FDI in Poland were driven by many determinants but the following are assumed to be major: political and economic stabilization, improved overall business climate, size of the market and perspectives for its development. Owing to the positive influence of these factors on the perception of Poland as a potential investment location, the share of FDI (both stock and flows) in GDP was gradually increasing, what reflects a growing role of the investments in the Polish economy. In 1998, inflows of FDI to Poland accounted for 7% of GDP (the highest out of the countries considered), while in 1991 – for merely 0,38%. The share of FDI stock in GDP increased over the same period from 0,47% to 19,66%, remaining lower than in Hungary (42,2%) and the Czech Republic (20,0%). Table 2. presents a synthetic illustration of Poland's position against the countries compared in terms of various measures of FDI in 1998[79].

Table 2. Ranking of Poland, the Czech Republic and Hungary, various breakdown, 1998

Criterion	Position in the analyzed group, 1998		
	First	Second	Third
Cumulated FDI	Poland (30 651)	Hungary (19 700)	Czech Rep. (10 901)
Cumulated FDI per capita (US$)	Hungary (1 950)	Czech Rep. (1 058)	Poland (794)
Cumulated FDI (% GDP)	Hungary (42,2)	Czech Rep. (20,2)	Poland (19,66)
FDI inflows	Poland (10 100)	Czech Rep. (2 540)	Hungary (1 900)
FDI inflows (% GDP)	Poland (6,92)	Czech Rep. (4,69)	Hungary (4,07)

pokazać, Nowe Życie Gospodarcze, No 20/ 312, 21 November 2001 and *World Investment Report 2001*, UNCTAD.

[77] With relatively lower demographic potential.

[78] The data concern 1999, order of classification remained the same in 1998.

[79] The most current and comparable (coherent sources) data have been collected for the year 1998 for all three compared countries.

In defiance to some predictions, the year 2000 turned out to be record-breaking in terms of the FDI inflows, which were registered at the level of US$ 10,6 billion. Taking under consideration that they grew by US$ 8,3 billion the year before, it is apparent that the two years of significant inflows additionally strengthened Poland's leading position in CEE in this respect. It is worth emphasizing that the amazing result of 2000 was achieved, among all, thanks to privatization of large companies, such as Telekomunikacja Polska S.A.[80] Similarly to the Czech Republic and Hungary, there is however a justified ground for concern since the completion of privatization in Poland might cause a decline in FDI inflows[81]. Unfortunately, the year 2001[82] with approximately US$ 7 billion of new FDI appeared to be the initiation of a gradual slowdown in investment activities of new foreign companies. This, in turn, implicates the necessity of identifying possible reasons for the reduced interest in Poland as a potential investment target. The following aspects can be indicated in that respect:

- worldwide tendency towards reduction of transnational capital flows under growing uncertainty and deteriorated economic climate,
- forthcoming completion of privatization process and in consequence, lower attractiveness of privatization offers left,
- decline in GDP and unfavorable changes in regulations concerning Special Economic Zones (SEZ).

2. FDI in Poland – breakdown by countries of origin

According to the PAIZ's data, foreign companies have invested more than US$ 49,4 billion over the last 10 years (including the estimated value of FDI lower than US$ 1 million). Taking into consideration the inward stock of the investments made over the last decade, the club of major foreign investors consists of: the French, the Americans, the Germans and the Dutch, whose investments totaled at the end of 2000: US$ 7,9 billion, US$ 7,3 billion, US$ 5,9 billion and US$ 4,2 billion respectively. Furthermore, the highest number of investors operating in Poland come from the same countries: 209 companies from Germany, 130 from the US, 70 from France and 66 from the Netherlands. The subsequent positions in terms of total investments made

[80] It was the most expensive privatization transaction in Poland: France Telecom paid US$ 3,2 billion for Telekomunikacja Polska S.A.

[81] According to „Transition Report 2000. Employment, skills and transition", EBRD, the degree of privatizing Polish economy is estimated at 70%, while in case of the Czech Republic and Hungary at 80%.

[82] Data have been cited from the article: J. Brzozowski, *Zagraniczny kapitał napływa gdzie chce*, BOSS Gospodarka, No 3 (418), 19 January 2002.

belong accordingly to Italian capital (US$ 3,4 billion) and international organizations (US$ 3 billion). Investors from Great Britain, Sweden, Korea and Russia complete the top ten ranking.

Moreover, the analysis of the data included in Table 3., allows to draw several conclusions, namely:

- FDI inflows are comparatively diverse in terms of origin of capital but investors from the OECD have a 91,0% share in cumulative value of FDI located in Poland, which corresponds to more than US$ 41,8 billion[83],
- the majority of foreign investments is invariably made by the capital from the EU: approximately 67% of the total stock corresponding to US$ 30,7 billion,
- North American investors channeled 16,5% of the FDI stock to Poland what equals US$ 7,5 billion, while the investments made by the Asian countries constituted 5,1% of the value,
- the top of the most active foreign investors in Poland have not experienced any serious changes over the analyzed period (1991-2000), following only slight reshuffles in positions of the classification,
- it has been observed that FDI in Poland are strongly correlated with privatization; changes in Table 3 take place each year as a consequence of privatization transactions[84].

Table 3. Foreign investors in Poland according to inward stock in 2000, volume and % structure of FDI in 1998

Country of origin	2000		1998		
	Position according to total investment stock	Cumulated value of FDI	Cumulated value of FDI	Position according to total investment stock	Structure %
France	1	7 901,0	2 398,9	3	8,8
USA	2	7 350,3	4 911,2	2	18,0
Germany	3	5 903,7	5 117,3	1	18,8
Holland	4	4 224,9	1 878,9	6	6,9
Italy	5	3 417,6	2 037,6	4	7,5
International organizations	6	2 296,7	1 813,1	7	6,6
Great Britain	7	2 181,1	1 929,5	5	7,1
Sweden	8	2 027,9	691,5	11	2,5

[83] http://www.paiz.gov.pl and *Zagraniczne inwestycje w Polsce w 2000 roku*, Biuletyn Departamentu Statystyki, National Bank of Poland, Warsaw 2001.

[84] According to the PAIZ's data, about 35,5% of all foreign investments in 2000 resulted from privatization of Polish enterprises.

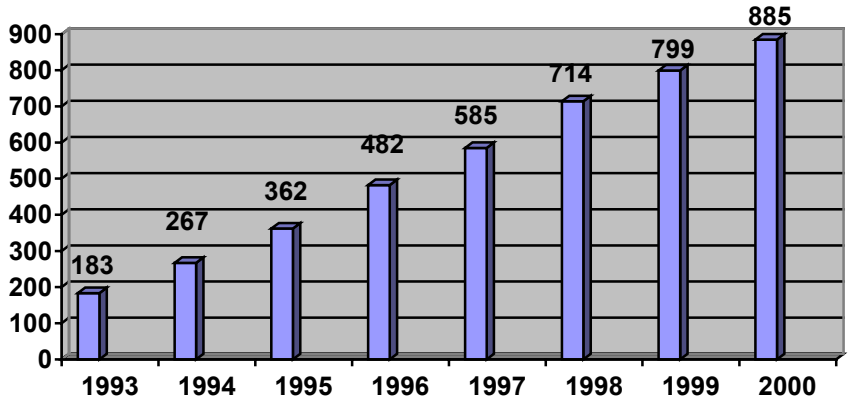
Korea	9	1 617,4	1 412,4	8	5,2
Russia	10	1 286,4	958,0	9	3,5
Austria	11	1 172,1	758,3	10	2,8
Ireland	12	1 025,0	226,1	16	0,8
Switzerland	13	757,5	666,2	12	2,4
Denmark	14	741,2	558,4	13	2,0
Belgium	15	587,5	156,8	19	0,6
Greece	16	501,5	3,6	33	0,01
Norway	17	491,7	455,8	14	1,7
Japan	18	476,0	198,3	17	0,7
Spain	19	377,9	62,3	24	0,23
Portugal	20	338,7	147,2	20	0,5
Finland	21	256,0	191,2	18	0,7
Canada	22	209,2	235,6	15	0,9
Croatia	23	173,0	138,0	21	0,5
Turkey	24	100,0	48,0	25	0,18
Israel	25	83,4	5,4	33	0,02
Australia	26	70,0	98,1	22	0,4
Czech Rep.	27	51,2	68,4	23	0,3
China	28	45,0	25,0	27	0,09
RSA	29	35,0	25,0	28	0,09
Liechtenstein	30	31,9	29,5	26	0,11
Luxembourg	31	17,2	2.3	34	0,01
Slovenia	32	10,0	6,0	30	0,02
Cyprus	33	7,2	Unclassified		
Taiwan	34	5,7	5,7	31	0,02
Malta	35	1,0	Unclassified		
Hong Kong	Unclassified		20,0	29	0,07
Total investments exceeding US$ 1 million		45 772,0	27 279,6		
Estimated investments below US$ 1 million		3 620,5	3 371,6		
Total		49 392,5	30 651,2		

Source: PAIZ's Research Department; K. Przybylska, *Determinanty zagranicznych inwestycji bezpośrednich w EŚW*..., op. cit., pp. 42.

3. Major foreign investors in Poland

The list of major foreign investors (covering only investments exceeding US$ 1 million) published by the PAIZ in 2001 consists of 885 companies (including 127 new ones) from 35 countries, against 799 from 35 countries at the end of 1999, 714 from 34 countries in 1998 and 585 from 30 countries a year earlier. It is noticeable that the number of investing corporations fallows a systematic growth. Growing attractiveness of Poland is reflected in a much more forcible way by comparison of current number of foreign investors with only 192 entities operating in Poland in the first year of the PAIZ's publication.

Chart 2. Number of foreign investors operating in Poland, 1993-2000



Source: Polish Agency for Foreign Investments, www.paiz.gov.pl

While analyzing the database of major individual foreign investors[85] in a period 1998-2000/2001, significant changes in the classification registered every year are visible. From the comparison of the top ten investors in 1999 and 1998, it can be noticed that four new companies joined the group, namely:

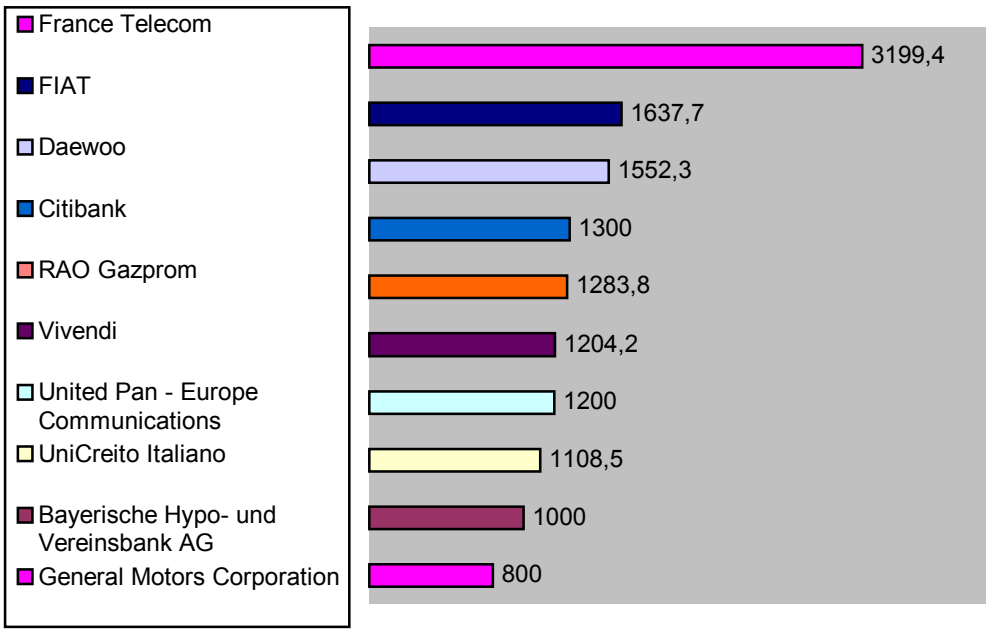
- French Vivendi: got possession of shares of Electrim Telekomunikacja,
- Dutch United Pan-Europe Communications: purchased a stock in digital platform Wizja TV and the Polish Cable TV,
- Irish Allied Bank Plc: owner of shares of Bank Zachodni and Wielkopolski Bank Kredytowy,
- International Corporation Eureco B.V.

It is worth adding that over the analyzed period, Daewoo Corporation took the leading position, surpassing the previous leader – FIAT, currently ranked 2nd. In the year 2000 (Chart 3.), France Telecom was classified 1st

[85] Using the criterion of cumulated value of FDI.

thanks to its investment of more than US$ 3 billion in privatization of Telekomunikacja Polska S.A. FIAT managed to hold the second position by expanding own capital involvement to US$ 1,6 billion and channeling investments to banking and insurance sectors, apart from automotive industry. The third, in turn, appeared to be Daewoo Corporation, which did not enlarge own investments (at US$ 1,5 billion), wrestling with financial difficulties. As compared with 1999, Citibank, which invested US$ 1,3 billion and became a major shareholder of Bank Handlowy S.A, expanded the leaders' club. The subsequent positions belonged to: Russian GAZPROM, Vivendi and United Pan-Europe Communications to be supplemented by investments of Unicredito Italiano, Bayerische Hypo- und Vereinsbank AG and General Motors.

Chart 3. Major foreign investors in Poland, section according to FDI stock, 30 June 2001 (millions of US$)



Source: PAIZ and "Businessweek" No 1(118), January 2002.

On the whole, out of the total number of 885 companies with foreign shareholding, 481 entities made investments of US$ 1-9 million, 252 channeled from US$ 10-49 million, while 65 exceeded the level of US$ 50 million. It should be also pointed out that the larger scale of investments – exceeding US$ 100 million, refers to 60 enterprises, out of which only 9 invested more than US$ 1 billion (compare: Chart 3.). Therefore, it can be concluded that a significant degree of concentration of foreign investor's financial sources in relatively few Polish enterprises seems to be characteristic for FDI in Poland.

4. Influence of FDI on Polish economy – broad effects

The measure of macroeconomic effects resulting from the involvement of FDI in Polish economy is a share of the investments in creation of GDP. It can be observed that since 1990, both the FDI inflows and stock have been gradually increasing in relation to GDP (compare: Table 1.), what forcibly points at a growing position of foreign long-term capital in a development of Polish economy. It is worth underlying that GDP goes up accordingly to an increase in FDI flows, however, provided that foreign capital does not squeeze out local competitors[86]. It should be also taken into account that although FDI have a long-term character, it does not mean that the capital invested does not make sudden decisions about a radical withdrawal from a host market. The relevance of FDI in Polish economy was an object of the report prepared by the IKiCHZ. According to the estimations made[87], the share of companies with foreign shareholding reached the level of 33% in 1999, against 29% in 1998, 23% in 1997, 19% in 1996 and 13% in 1994. In the year 2000, the share amounted to 37-38% thanks to record-breaking inflows of FDI. Along with a growing share of foreign companies, the scale of their economic influences on Polish economy increases as well.

Naturally, the influence of FDI goes far beyond the benefits resulting from sales of privatized enterprises or benefits from the exports of locally made products. In the opinion of scientists from the Institute for Research on Market Economy, there are four principal characteristics of a direct influence of FDI on a host country, namely: higher level of investments, production, demand and economic effectiveness, with indirect effects such as: improvement of credibility of a country at international arena, increase in national income and budget revenues or significant upgrade of infrastructure.

5. Financial indicators achieved by companies with foreign capital share

Constantly increasing share of foreign companies in total revenues of all entities proves a growing relevance of these companies in Polish economy. In 1999, the revenues generated from an entirety of operation of companies with foreign shareholding accounted for 31,6% of total revenues registered by the entities, which prepared their statistical reports. Let us compare this with the

[86] GDP is a measure of production generated by production factors localized on the territory of a certain country, regardless of investors' origin.

[87] The following categories were analyzed: number of operating foreign entities, scale of employment generated by them, their revenues from overall activities and exports, investment outlays, fixed assets and circulating capital, own and external capitals.

data concerning preceding years: 26,8% in 1998, 20% in 1997 and 12,4% in 1994. It is worth emphasizing that the main source of these revenues has been irreversibly the sales of goods and services on the local market.

While analyzing the list of the biggest 500 companies operating in Poland ('List of 500[88], 2001), it can be observed that the total revenues of foreign companies included in the classification are almost equal to the revenues generated by companies with an exclusive Polish ownership. Authors of the report also point at a 19% increase of the revenues of wholly foreign companies in comparison to 2000 and the fact that their gross profitability[89] went up by more than half (from 1,8% to 2,8%). The analysis of data included in Table 4. allows for the following conclusion: any degree of foreign capital participation in enterprises covered by the report has a positive influence on the scale of revenues, gross profitability and the volume of investments made.

Table 4. Influence of the kind of ownership on operation and economic results of the companies from the *List 500*, 2001

Ownership	Average value of revenues per one company		Gross profitability (%)	Relation of investments to revenues (%)
	In millions of PLN	Change against 2000 (%)		
Wholly state-owned	1 595	6,9	0,5	5,7
With a state controlling share	2 535	6,4	2,3	4,9
With Polish private capital exclusively	549	10,1	2,1	4,7
With a controlling share of Polish private capital	718	-3,7	3,3	9,7
With foreign capital exclusively	745	18,9	2,8	13,3
With a foreign majority shareholding	1 532	4,4	3,0	14,8

Source: *List of 500. The biggest companies in Poland*, supplement to "Rzeczpospolita", 8 May 2002.

As far as net profitability is concerned, there is a visible advantage of companies with foreign shareholding again: in 1999, the index for all the entities was registered at 0,1%, while in case of foreign companies it achieved the level of 0,7%.

[88] *List of 500. The biggest companies in Poland*- classification according to sales revenues, supplement to "Rzeczpospolita", 8 May 2002.

[89] Gross profitability – relation of gross profits to sales revenues, it is not affected by differentiated tax influence of individual companies, as it is the case of net profitability.

It is also worth noticing that over the period of 1994-1998, there was a significant growth of foreign companies' share in the profits achieved from a strictly production operation in Poland. In 1994, the share amounted to merely 2,4% to achieve the level of 66,0% four years later[90].

Table 5. Economic indicators of companies with foreign controlling share from the *List of 500* – classification according to gross profitability, 2001

No	Position on the "List of 500"	Enterprise	Gross profitability index (%)*	Income tax (in thousands of PLN)
1.	421.	BNP Paribas Bank Polka S.A., Warsaw	23,68	17 440,0
2.	249.	Wrigley Poland Sp.z o.o., Poznan	22,38	34 904,0
3.	42.	Kompania piwowarska S.A., Poznan	21,36	161 799,0
4.	137.	AIG Amplico Life S.A., Warsaw	19,45	69 487,0
5.	7.	Bank Pekao S.A., Warsaw	18.76	499 384,0
6.	71.	International Paper - Kwidzyn S.A., Kwidzyn	18,30	0,0
7.	222.	Avon Cosmetics Polska Sp. z o.o., Warsaw	19,16	3 614,4
8.	426.	Pilkington Sandoglass Sp. z o.o., Sandomierz	17,30	1 098,1
9.	300.	ABN Amro Bank (Polska) S.A., Warsaw	16,69	215 408,7
10.	463.	PTE Commercial Union S.A., Warsaw	16,04	0,0

* Gross profitability index from the *List of 500* in 1992-2000: max: 41,57% (PERN Przyjaźń - the monopolist), min: -39,96%, average: 2,08%.
Source: *List of 500*…, op. cit.

In 1999, the percentage of enterprises revealing their net profits was still lower among companies with foreign shareholding (55%) than in companies with an exclusive Polish ownership (68%). However, in the opinion of B. Durka[91] there has been an absolute and relative improvement of financial indicators in companies with foreign shareholding, what, in defiance to the general opinions, implicates an increase in funds collected by the budget from taxes[92]. Breakdown of the most profitable companies with foreign controlling

[90] The Vienna Institute for International Economic Studies (WHW) Research Reports, No. 268, 2000 in: T. Pakulska, M. Poniatowska – Jaksch, *Bezpośrednie inwestycje zagraniczne w krajach EŚW*, Instytut Funkcjonowania Gospodarki Narodowej, Warsaw School of Economics, Warsaw 2001, pp. 51.
[91] Director of IKiCHZ.
[92] The literature indicates that unfavorable phenomenon of profit transfers was especially intensive in the beginnings of operation of foreign entities in Poland, while it has been reduced

share from the *List of 500*, (Table 5.) does not confirm the opinion about a mass transfer of profits made by the companies. If foreign companies were to follow such practices on a large scale, it would be impossible for them to be in the lead in terms of gross profitability. If, however, they do transfer profits and despite of that they still generate the highest profitably, it is the symptom of their higher effectiveness in allocation and utilization of resources, which is definitely to the advantage of the Polish economy.

It must be emphasized that the above data concern only the companies with a majority foreign shareholding from the *List of 500*, what prevents from generalization and treating the problems of profit transfers and manipulations with transfer prices as nonexistent. The data prove, however, that such practices do not have a mass character, as it is often described by some press publications. It is worth emphasizing that Poland has not completely worked out the mechanisms enabling better control over the companies suspected of transferring profits. The assessment of this phenomenon remains difficult, since the capital linkages are precisely organized and make it difficult to call the transfers into question.

6. Investment activity of companies with foreign shareholding in Poland

In the early phase of economic and structural reshaping in Poland, access to external capital markets was significantly limited and highly difficult in practice. In addition to the funds made available by foreign creditors and international financial institutions, foreign direct investments played an important role in financing development of market mechanisms, although their flows and dynamics remained unsatisfactory.

In 1990, the participation of foreign capital in total investment outlays amounted only to 2,2% (small investors excluded) to rise in 1993 to 3,3%, in 1994 to the level of 8,5% and account for almost 13% a year later.

As Table 6. shows, the growing share of FDI in total investment expenditures is more noticeable in subsequent years of the analysis. Despite the dominant approach of satisfying mainly the local demand, which is in any case dependent from the government's policy towards foreign investors, it is impossible not to appreciate the growing activity of foreign capital in Poland.

Relation of investment outlays to the fixed assets of companies with foreign shareholding amounted to 29,0%[93] in 1999 (in sectors: processing industry and financial intermediaries) with almost the third part channeled for

recently: long operation in the market with constant looses revealed raises suspicions of fiscal authorities, although on the initiation of operation it could have been justified.

[93] Exceeding significantly the average of 8,6%.

brand new buildings, including greenfield investments of 24%[94]. Higher propensity to undertake investments characterizes companies with various level of foreign shareholding from the *List of 500*, which is also presented in Table 4.

Table 6. Investment activity of companies with foreign shareholding in 1990-1998

Category	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Share of FDI in total investment outlays (%)	2,2	2,8	3,1	3,3	8,5	12,9	20,4	19,4	25,1	n/d	n/d
Rate of changes of investment outlays in Polish economy (constant prices, previous year =1)*	-10,1	-4,1	0,4	2,3	8,1	17,1	19,2	22,2	15,3	5,9	2,2

* "Nowe Życie Gospodarcze", No 8/300, 22 April 2001.
Source: own calculations based on Central Statistical Office and PAIZ.

Investment activity of foreign capital is regarded as an important stimulus for growth and economic development of a host country, constituting serious replenishment of domestic investment funds. Entrance of foreign investor into sectors or enterprises crucial to economy or region, activates a multiplier mechanism (in simplification) by creation of new jobs, new volume of incomes and an increase in demand.

It is worth pointing out here that regardless of the current situation of the Polish economy, low level of domestic investments remains its main long-term problem. Nowadays, about 24% of GDP is invested in Poland, which does not constitute the level sufficient for quick development of production potential in order to assist the growth of GDP at the desirable level of 5-6%, all the more, that the scale of domestic savings remains close to 20% of GDP[95].

Such a dynamic investment activity of foreign capital is a natural consequence of establishment of new companies and a replacement of production machinery in enterprises taken-over. Therefore, foreign investments play a considerable role in technological reshaping and modernization of Polish economy.

Growing propensity of companies with foreign shareholding to undertake investments in Poland leads to strengthening their role in economic

[94] P. Glikman, *Kontrowersje wokół kapitału zagranicznego w Polsce*, Gospodarka Narodowa, No. 11 - 12/ 2000, Year XI, SGH, June 2001, pp. 65.
[95] W. Orłowski, *Nie lekarstwo, ale kuracja*, "Rzeczpospolita" No 9 (6086), 11 January 2002, pp. A8.

development of the country, as well as in the adopted restructuring processes. It should be taken into account that the condition and structure of fixed assets are one of the basic factors determining productivity and the level of unit labor costs, which influences also the degree of modernity and competitiveness of the Polish economy. Therefore, the increase of FDI in the base of fixed assets from the level of 8,9% in 1994 to 28,7% in 1999 should be perceived as positive. It is worth adding that at the end of 1999 the value of fixed assets in companies with foreign shareholding reached PLN 125,3 billion, including PLN 62,4 billion in industry.

7. Entities with foreign capital share and Polish foreign trade

Competitive position of economy refers mainly to its participation in international exchange, while any reshuffling of this position follows the changes in the role and terms of this country's share in the exchange. Foreign direct investments have an important influence on balance of trade and financial equilibrium of a host country.

Influence of FDI on the balance of trade can manifest itself in:

- the burden put on balance of trade owing to an increased supplying imports and imports of capital goods,
- creation of exports, which may balance the increased imports,
- substitution of imports, which may positively influence the balance of trade.

Foreign companies, especially transnational corporations, are characterized by a generally higher share in exports and imports than in the total value of a host country's production. It results from the concentration of these entities on trade intensive sectors and from their higher propensity to foreign trade than this of domestic companies[96]. It is also a natural consequence of the TNCs' advantage in access to information and their broader experience in operating globally, as well as their specialization in intra-trade of semi-processed goods among the headquarters and subsidiaries.

In Poland, companies with foreign shareholding present a significant involvement in foreign trade, revealing higher propensity to both exports and imports than Polish enterprises. In the year 2000, in comparison to 1995, companies with foreign shareholding strengthened their position in Polish exports, which can be confirmed by an increase in their share in the total exports from 24,4% to 56,2% respectively (in the earlier period the share had

[96] J.H. Dunning, *Multinational enterprises and the global economy*, Adison Wesley Publ. Comp., 1995, s. 386.

grown from 10,0% in 1992 to 17,7% in 1994)[97]. As far as the import of these companies is concerned, it can be observed that its share in total imports decreased from 55,8% in 1999 to 54,2% in 2000[98], although in comparison with 1995 and 1996, when the share amounted to 42,4% and 47,7% a considerable increase can be observed[99]. It is worth emphasizing here that the dynamics of foreign companies' exports was almost eight times higher than of their imports, which was partially caused by a declining dynamics of internal demand.

Undoubtedly, the faster growth of exports of companies with foreign shareholding in comparison with the growth of their imports contributed to reduction of their adverse impact on the balance of trade from US$ 478,9 million in 1999 to US$ 8 737,8 million in 2000. At the same time, the share of the deficit in a total negative balance of Polish foreign trade declined from 62,0% to 50,5% respectively. There is, however, the question if such tendency (of faster growth of exports) can be kept in the near future. In the opinion voiced by the authors of the report from IKiCHZ[100], the analysis of a mid-term correlation between the structure of FDI and the structure of sold production of industry, exports and imports do not provide any grounds for such expectations. As it has been already mentioned, the study over the influence of FDI on foreign trade flows and the balance of current payments conducted by IKiCHZ reveals that FDI in Poland are much more oriented towards domestic market and have a pro-import character.

It is additionally confirmed by the analysis of sources of foreign companies' revenues that they are prevailingly generated by goods and services sold on domestic market. The share of exports in total revenues of these companies amounted to 13,2% in 1999 with a downward tendency registered since 1994, when it had reached a 15,6% share (1995: 15,3%). According to B. Durka, the average propensity to exports of companies with foreign shareholding exceeded twofold the one of Polish companies in 1999, while in the period 1995-96 it had been higher by 60%. Such a significant improvement of this relation, however, resulted partially from the faster decline in the share of exports in total revenues of Polish companies from 9,5% in 1995 to 6,4% in 1999.

Considering the future perspectives for economic development of a host country, one should be aware of a considerable influence of the structure of foreign trade realized by foreign companies (Table 7.).

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[97] J. Chojna, *Miejsce podmiotów z udziałem kapitału zagranicznego w gospodarce narodowej Polski*, in: *Inwestycje zagraniczne w Polsce*, IKiCHZ, Warszawa 1997, s. 54.

[98] with an increased share of Polish companies.

[99] B. Durka, J. Chojna, *Udział podmiotów z kapitałem zagranicznym w polskim handlu zagranicznym*, in: *Inwestycje zagraniczne w Polsce*, op. cit., pp. 67.

[100] Instytut Koniunktur i Cen Handlu Zagranicznego (Foreign Trade Institute).

Table 7. Share of companies with foreign shareholding and with exclusively Polish ownership in Polish foreign trade

Categories	1995	1996	1995	1996
	Companies with foreign shareholding %		Companies with exclusive Polish ownership %	
Share of imports in total value of Polish imports	42,4	47,7	57,6	52,3
Structure (purpose of use):				
- supplying imports	65,1	63,6	70,8	70,2
- investment imports	13,1	14,4	13,0	13,7
- consumer imports	21,5	21,7	15,1	15,5

Source: B. Durka, J. Chojna, *Udział podmiotów z kapitałem zagranicznym*…,op. cit., pp. 67.

In terms of the purpose of use, the structure of imports of foreign and Polish companies included in Table 7. was convergent only in case of investment imports, which in 1996 amounted to 14,4% and 13,7% respectively. Consumer imports appeared to be much higher in case of foreign entities (21,7% against 15,5%), while supplying imports of domestic companies surpassed the one of foreign enterprises (70,2% against 63,6%). The basic part of a negative balance of trade of foreign companies fell on exchange of machinery and equipment, electrical and electronic apparatus (exports totaled US$ 1,7 billion against US$ 5,3 billion worth of imports), which could bring positive pro-development effects in a longer perspective. Anyway, high share of consumer imports remains disturbing.

Surpluses were created in exports of some agricultural products, groceries, clothing, furniture, wood and wooden products, thus in labor- or resource-intensive products, which confirms the long-lasting economic gap between Polish foreign trade and this of developed countries (mainly the EU Members).

Contrary to the influence on the balance of trade exerted by FDI, which could be either positive or negative for a host country, the FDI impact on the balance of payments is in general positive. FDI contribute to the reduction of problems with financial payments, provided, however, that the capital for the payments is not collected from domestic market but transferred from abroad. Foreign financial obligations resulting from FDI are not charged to the receiver country's account, while the transfer of profits to the country of investor's origin depends on economic results generated from these investments. Moreover, financial benefits associated with the inflows of FDI, apart from the transfers of the capital itself, refer also to the exports of foreign companies and the phenomenon of substitution of the exports.

8. Influence of FDI on Polish labor market

The capital brought by foreign companies into Poland has a broad impact on domestic labor market as well, which has a tremendous relevance in the situation of current unemployment rate registered at about 18,5%. Percentage share of the people employed in companies with foreign shareholding in a total number of the employed has been systematically increasing for the last several years. According to the Central Statistical Office (CSO), in 1993, 7 935 companies with foreign shareholding employed 310 810 people. In 1996 the number of foreign companies increased to reach 12 377 entities with 682 763 employees (more than a double increase since 1993), accounting for 5,4% of the total employment in Poland (excluding the sector of agriculture). Employment in the companies continued to grow to exceed 923 000 people at the end of 1999, (accounting for 13% of total employment in non-agricultural sectors of economy) with an increase in the number of the companies to 13 400. It is apparent that the number of the employed in foreign companies grew much faster than the number of these entities, what points at the gradual expansion of human resources in these corporations.

Table 8. Influence of companies with foreign shareholding on employment in Poland in 1990-1999

Categories	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Employment in companies with foreign shareholding (thousands of people)	168,2	117,6	230,0	310,2	370,0	500,0	626,0	682,8	840,9	923,5	n/d
Share in total employment in non-agricultural sectors of economy (%)	1,0	1,3	2,0	2,8	3,3	4,5	5,4	5,9	7,3	13*	n/d

*Nowe Życie Gospodarcze, No 8/300, 22 April 2001.
Source: own calculations based on CSO and PAIZ.

Nevertheless, it should be emphasized that the role of these entities in creation of new jobs is visibly below their general position in Polish economy resulting from the number of the companies, their production potential, scale of their revenues or their exports. The studies conducted in 1996 by the Research Institute for Democracy and Private Enterprise revealed that there is no direct inter-dependency between the growth of FDI and the increase in

employment[101]. Partial responsibility for that could be put on the fact that foreign investors obliged themselves to temporarily hold an excessive employment or, in other words, to postpone necessary redundancies in time. However, according to the authors of the report from IKiCHZ[102], it is prevailingly associated with a much more efficient allocation and management of the labor force employed in the companies in comparison to Polish enterprises. Efficiency of labor force in foreign companies, measured per one employee appears to be almost twofold higher than in the wholly state-owned enterprises[103]. Confirmation of the fact can be found in the data included in Table 9., concerning the companies from the latest *List of 500*.

Bearing in mind that certain number of current jobs in companies with foreign shareholding existed before the entrance of foreign investors, it is difficult to estimate unambiguously the degree into which foreign companies contributed in creation of employment and into which they only held the jobs existing.

Table 9. Efficiency of labor force and remuneration in the companies from the *List of 500* – section according to the type of ownership

Ownership	Average employment per one company	Average annual remuneration in thousands of PLN	Efficiency of the employees (revenues in thousands of PLN per one employee)
Wholly state-owned	5 629	42,5	298,6
With a state controlling share	4 410	53,0	596,5
With Polish private capital exclusively	6 64	28,1	783,2
With a controlling share of Polish private capital	1 325	43,0	546,2
With foreign capital exclusively	1 495	45,1	688,5
With a foreign majority shareholding	3 179	47,4	530,8

Source: *List of 500*…, op. cit.

[101] M. Poniatowska - Jaksch, *Atrakcyjność inwestycyjna przestrzeni gospodarczej Polski dla firm europejskich*, in: M. K. Nowakowski (ed.), *Na progu UE. Szanse dla polskich przedsiębiorstw*, Monographs and Studies No 450, Instytut Funkcjonowania Gospodarki Narodowej, Warsaw School of Economics, Warsaw 1998, pp. 121-143.
[102] B. Durka (ed.), *Inwestycje zagraniczne w Polsce*, IKiCHZ, Warsaw 2000.
[103] In 1995 efficiency of labor force in companies with foreign shareholding (measured by revenues per one person employed) was higher than the average efficiency in domestic economy by 65%.

Nevertheless, along with investments undertaken by foreign corporations, the sphere of their influence, especially on regional labor markets, becomes tremendous and not limited exclusively to the creation of own jobs. Activity of foreign companies provides a stimulus for expansion of employment at cooperating entities and local subcontractors as well. The best illustration of this influence can be the loss of more than 6 000 potential jobs because of a fiasco of two large investment projects[104], which were expected to provide additional employment for several thousand of people at cooperating companies. It is worth adding that according to estimations, one job generated because of FDI, creates on average 4 new ones[105].

Operation of foreign companies on the Polish market demonstrates itself also in a higher level of professional qualifications revealed by employees. Although foreign investors rate the skills of Polish staff highly, almost 88% of all the companies with foreign shareholding organized active professional trainings in 1996. It is worth mentioning that out of the total number of the trainings, an employee took part in at least 3 of them in case of 21% of companies, in 2 trainings in 29% of companies and in 1 training in 38% of foreign enterprises[106]. As such, the companies with foreign shareholding have contributed enormously to changes on the Polish labor market by creation of new opportunities and constantly pressurizing for expansion of skills and education.

Radical changes are also introduced in the sphere of human resource management – the especially backward domain in Polish enterprises, which lag behind their foreign competitors in that respect. This problem refers, first of all, to the aspects such as: professional selection systems (in 76% of the companies with foreign shareholding pooled)[107], motivation systems (84%) and transparency of organizational structures (76%) or delegating competencies (70%).

Higher skills of employees in foreign companies transfer themselves onto adequate raise in salaries and increase in domestic savings, proceeding along with a growth of incomes. The researches conducted[108], as well as more current analysis of remunerations in companies with foreign shareholding from the

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[104] The projects mentioned concern the investment of Philips and a joint-investment of PSA Peugeot, Citroen and Toyota.

[105] PAIZ's press communiqué dated 8 April 2002, at 14.00, www.paiz.gov.pl

[106] The research was conducted by a poll covering 196 companies with foreign shareholding of at least 22 employees. Respondents: the people with previous work experience in domestic companies; compare: M. Bak, P. Kulawczuk, *Analiza wpływu inwestycji zagranicznych na polską gospodarkę*, - results of researches commissioned by PAIZ, Warsaw 1996, pp. 54-68.

[107] ibidem, pp. 55.

[108] A. Bendi, Z. Cieślik, *Formy działalności inwestycji zagranicznych a dyfuzja kapitału intelektualnego w polskim przemyśle*, Ekonomista, No 4/1999, pp. 419-438.

previously cited *List of 500* (Table 9.), suggest that people employed in the sectors of industrial production with a majority share of foreign companies receive on average higher wages. It is the confirmation of a general opinion that foreign companies provide indirect (immaterial) production inputs, contributing to a growth of labor productivity of a host country's industry. As such, foreign investors stimulate the diffusion of knowledge and higher productivity in the sectors of their own operation in a host economy.

Another important aspect associated with activity of foreign companies in the Polish economic reality is an increasing position of medium-size enterprises (with employment of 50-250 persons)[109]. In the early stage of transformation, an absolute domination of industrial giants was a sensation in the world of real socialism, being a rare phenomenon in the world at that time. Nowadays, the share of the employed in medium enterprises, in the whole economy and industry, has become more alike in the EU Members (20-21%)[110], which is also owed to foreign capital.

9. FDI and modernization of Polish economy

In the modern world economy, competitiveness of an individual country is a product of complex quality factors, including new, revolutionary technologies. Foreign direct investments constitute an effective transferring channel of these technologies, generating a spin-off effect and even a catching-up process. As results from the researches conducted by a marketing company – Indicator[111], 62,8% of companies with foreign shareholding apply 1-year-old technologies, while the numerous modern technological solutions (not older than 1 year) have been implemented by the companies with Canadian, British, Austrian and American shareholding. It is also observed, that the latest technologies have been introduced by investors in sectors such as computing (94,1%), publishing and printing, hotels or production of machinery and apparatus (73,5%)[112].

It is the choice of the sector of the FDI allocation and the level of technologies implemented which influence the changes of industrial structure. Initially, transnational corporations investing in Poland adopted so-called

[109] The share of these entities in Polish economy accounted for 12% in 1989, while in the OECD countries for approximately 20-30%; medium size industrial companies employed 5,5% of the total working population.
[110] *The European Observatory for SMEs*, Zoe termeer, Holland 1997 in: P. Glikman, *Kontrowersje wokół kapitału zagranicznego*..., op. cit., pp. 66.
[111] Compare: *Foreign investors in Poland*, PAIZ's report, Warsaw 1996.
[112] *Nowe technologie i wzrost inwestycji*, "Rzeczpospolita" No 61, 12 March 1996.

market seeking[113] strategy and produced consumer goods designed for domestic market, which did not require neither latest technologies nor changes in their products. Transition towards industrial production aimed at exports (*export-oriented manufacture*), resulted in an increase in innovative technologies and improvement of quality of the products[114]. Nevertheless, the data cited above do not appear to deny the hypothesis that the technology imported to Poland is obsolete or typical for matured or declining products. Bearing in mind the low level of domestic technologies, the superiority of foreign technological solutions might hold, despite the fact that they do not belong to the most modern ones.

The above considerations implicate also the question about the scale of foreign capital outlays invested in the R&D operation. Unfortunately, according to the 1997 data, 5,3% of the foreign companies[115] pooled, allocated less than 1% of their turnovers on R&D within the previous 3 years, while 20% of the companies expended l-2% of the turnovers on this activity. Simultaneously, as many as 76,9% of the companies declared that they sub-contracted analysis and researches from Polish research and consulting institutions, spending less than 1% of their turnovers on that. At the same time, 15,4% of foreign companies relied on external provision in the R&D sphere, channeling from 1-3% of own turnovers onto these services. The figures assume the headquarters to be the main source of R&D activities, (53,8% of the outlays in the area were borne by the mother-companies). It is worth adding that such phenomenon remains consistent with the theoretical indications of successive stages of TNCs' internationalization and confirms the necessity of reshuffling the Government's policy towards assisting private R&D researches (both Polish or foreign ones) with financial support from the state.

10. Other forms of the FDI influence

One of the principal aims of the systemic transformation is a creation of a desirable structure of ownership, development of market institutions and building widespread business-like behavior with an emphasis on private initiative and entrepreneurial attitude. Foreign direct investments also contribute to the achievement of this aim, although their role in the process is difficult to quantify. On the one hand, the entrance of foreign investors to the

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[113] J. H. Dunning, *Re-evaluating the Benefits of Foreign Direct Investment*, "Transnational Corporations", Vol. 3, No. 1, February 1994, pp. 35-36.

[114] Compare: B. Liberska, *Rola bezpośrednich inwestycji zagranicznych w rozwoju gospodarczym i transformacji systemowej w Polsce*, in: M. Belka, W. Trzeciakowski, (ed.), *Dynamika transformacji polskiej gospodarki*, INE PAN, POLTEXT, Warsaw 1997, pp. 247.

[115] The research was conducted on the poll of 250 foreign companies from the PAIZ's list.

Polish market resulted in expansion of private sector and led to improvements of economic efficiency. On the other hand, however, investors taking part in the privatization process, contributed to a quality progress in the management of the companies privatized.

To cut in short, foreign capital in the form of FDI breaks internal limitations in competitiveness of Polish enterprises. Foreign investors bring financial support, technologies, qualifications and modern methods of management and organization, distribution or marketing into Polish business reality. Furthermore, many of them make their own distribution networks available to Polish producers. This overall influence triggers improvement in competitiveness of the enterprises with foreign shareholding and, indirectly, stimulates the raise in competitiveness of selected sectors and the whole economy. The positive effect of the FDI activity in Polish economy is not, however, limited to foreign companies exclusively. It is worth underlining that FDI influence Polish companies also through the effects of diffusion (or of imitation). The necessity to withstand the growing competition triggers positive changes in Polish enterprises, stimulating introduction of new technologies, strategies and managerial concepts. Observations of experiences gained by the Irish market[116] prove that domestic industry learns fast through adopting patterns of foreign[117] companies' style of operation.

11. Negative aspects of FDI

Negative aspects of FDI influence on Polish economy have been already discussed in the profile of FDI in Poland, which was included in Point 3. Among others, it was pointed out that Poland has not been able to successfully deal with certain essential internal economic problems, such as: discrepancies in regional development or inefficient, obsolete structure of the economy. Although these issues appear to be independent from FDI, the investments deepen them additionally. It is possible to indicate the following negative consequences of an adverse influence of FDI on Polish economy:

- foreign investors additionally enlarge considerable disproportions in economic development of individual voivodships by concentrating their operation in the biggest urban areas of the country,

[116] More detailed information in: B. Liberska, *Doświadczenia Irlandii w wykorzystaniu zagranicznych inwestycji bezpośrednich w rozwoju nowoczesnego przemysłu*, in: Z. Sadowski (ed.), *Kapitał zagraniczny w Polsce*..., op. cit., pp. 46-50.

[117] The effect of fast learning of new technologies in domestic countries is described in: S. Dax, *Externalities and Technology Transfer Through Multinational Corporations. A Theoretical Analysis*, Journal of International Economics, 1987, No I/2, pp. 171-182.

- companies with foreign shareholding have been interested mainly in setting up of their production in traditional industrial sectors of labor intensive nature; as such, they strengthen the backward economic structure of Poland,
- although the share of foreign capital in development of the Polish sector of services is significant and prevailing in comparison with Polish capital, its dominant position in the banking sector for instance raises the question about the scale of safe involvement and control of foreign capitals over such a crucial sector of economy,
- unfortunately, Poland attracts FDI of the highest level of technological advancement only in a limited degree, which raises concerns that Poland may become the source of cheap labor force and an absorptive market for products sold by foreign corporations; these presumptions are confirmed by the analysis of foreign companies' investment motivations in Poland,
- foreign companies take advantage of the R&D potential of domestic institutions insufficiently; they are not interested in co-operation with local sub-contractors of components,
- the analyzed structure of imports of foreign companies signalizes that such a large scale of supplying and consumer imports of foreign entities negatively affects Poland's balance of trade,
- although the Decree of the Ministry of Finance, regulating the principles of calculation of taxpayer's income through estimation of transfer prices, the phenomenon of dishonest internal pricing remains significant, especially in case of the initial stage of foreign investment.

The analyses and studies[118] conducted, point out that the lack of positive effects of FDI might take place only in the early stage of TNCs' operation in a host country. Many developing countries or those undergoing systemic transformation might presumably experience negative consequences of operation of these entities associated with technological change reducing the demand for labor. However, the question if the host country manages to leave this stage and realize the benefits resulting from capital inflows and the diffusion of knowledge, depends largely on the policy of government towards foreign investors. The fear for excessive involvement of foreign capital, partial liberalization and the lack of credibility in the world, in addition to rigidity of Polish labor market may lead to the consequences opposite to those intended.

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[118] A. Cieślik, *Makroekonomiczne konsekwencje napływu bezpośrednich inwestycji zagranicznych dla gospodarki kraju goszczącego. Analiza teoretyczna*, EKONOMIA No 5/ 2002, Kwartalnik Wydziału Nauk Ekonomicznych Uniwersytetu Warszawskiego, Warsaw 2002, pp. 94 – 115.

12. FDI in Poland prior to accession to the EU – perspectives and potential impact

Influence of European economic integration on the FDI flows are object of a broad discussion in the literature and all the conclusions made confirm that international integration is an important determinant of scale and directions of FDI flows in the world economy. It has been proved by the intensified flows of FDI which were triggered off as a response to such integration attempts as: NAFTA, APEC, ASEAN or the EU market[119]. The influence of FDI with reference to CEE seems to be positive, in the light of both theoretical analyses and the empirical researches conducted. As the integration processes between the EU and CEE reach more advanced levels, foreign direct investment motivated by such factors as: search for new markets and resources or the platform for exports are expected to increase. Experiences of the EU Members authorize such conclusion as well. There is only one question left: what would be the effect of Poland's accession to the EU on the long-term investments channeled into the country?

According to the theory of internationalization, the achievement of full liberalization first, in the trade of goods and then, gradually in exchange of production inputs, is a logical sequence of the stages of liberalization. Full liberalization of capital flows constitutes the completion of these processes.

Undoubtedly, the association agreement signed between Poland and the European Communities is an element additionally strengthening stability of political and legal frames for the FDI inflows. However, the agreement itself does not constitute any guarantee of increased FDI inflows to Poland. It is because a minimization of political risk affecting investments has been supported by a simultaneous reduction of economic risk, which is in turn a derivative of internal economic policy of Poland.

Bearing in mind the theory of integration, it can be concluded that it is the situation in the trade exchange[120] to determine the balance of opportunities and threats resulting from integration aspirations and the approaching accession of Poland into the community structures. Complementarity of trade and foreign direct investments is a well-known phenomenon. At the same time, however, it is observed that FDI are not undertaken unless certain levels of trade linkages are established. Difficulties in access to the EU market might be an element restraining propensity to investment in Poland in case of export oriented FDI. However, it should also be taken into consideration that FDI allocated in Poland

[119] The leading importer and exporter of FDI, as it has been already illustrated in chapter 1 of the thesis.

[120] In this situation the selective protective periods imposed on the trade exchange appear to be problematic.

are much more focused on satisfying the local market than to export production, as it is the case of the Czech Republic and Hungary.

In the long-term perspective, the favorable influence changing the pattern of comparative advantages of Polish exports is quite probable. It may take place thanks to the exposure of Polish producers to fierce competition, higher quality and technical standards.

Certain resolutions of the association agreement, as well as some chapters of the pre-accession negotiations already closed, might adversely affect foreign investors' perception of Poland's location determinants. The motivations of foreign investors undertaking FDI in Poland can be of double nature. Firstly, the investments can be initiated by the companies operating inside the integration grouping in order to find an optimal location. Secondly, they may be also undertaken by the companies from the third countries, encouraged by the possibilities to avoid customs tariffs. External tariffs, currently in force in the EU, may be a motivator of tariff-jumping FDI, being another way to hold the market share previously serviced through exports at the same time, (many TNCs face the necessity of redesigning their strategy of servicing the EU market).

Undoubtedly, perspectives and expectations of an increase in the Polish exports to the EU are not dependent from the value of foreign investments, but mainly from their character. The nature of FDI will be determined by the degree of openness and accessibility of Polish market, which is, in turn, conditioned on obligations and agreements reached.

According to some opinions voiced[121], expectations that Polish membership in the EU will tremendously increase FDI in the sphere of R&D might never come true, since Poland has not developed any sector requiring exceptionally intensive investment activity of this kind (assembling lines appear to be the most technologically advanced investments in Poland, the Czech Republic and Hungary[122]). Much more probable, however, seems to be the benefits gained from the external technological effects than the inflow of high technologies themselves.

Out of the potential threats connected to the association agreement, the following two are often indicated[123], namely: undermining market position of domestic companies and limiting their possibilities to generate own ownership advantages owing to an increased penetration of the EU Member States in the Polish market. However, the analysis of geographical structure of FDI in

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[121] J. Witkowska, *Bezpośrednie inwestycje zagraniczne*..., op. cit., pp. 201.

[122] They rely on the innovative concepts worked out in technological centers of the headquarters and do not require any R&D operation close to the factories in the countries mentioned.

[123] J. Witkowska, *Przepływy bezpośrednich inwestycji zagranicznych w gospodarce światowej a procesy integracji gospodarczej ze szczególnym uwzględnieniem Unii Europejskiej i Polski*, European Studies, No I/ 1997, pp. 73-103.

Poland enables to observe that, if the share of the EU investments in the FDI stock is predominant (about 60%), the initiation of economic integration (1994 – Polish motion for the accession to the EU was put forward) did not raise the attractiveness of Poland in the eyes of European capital. At the end of 1994, the EU investors had a 36% share in the total initial capital (FDI) in Poland, surpassing only slightly the American capital with a 34% share. It is worth comparing these figures to the data in 1991, when approximately 60% of foreign capital invested in Poland came from the EU Members with American share at a merely 10% level.

The fact that the Association Agreement was signed and the motion for Polish membership in the EU was accepted, initiated the creation of stable political frames in relations between Poland and the EU. Undoubtedly, this should have a positive impact on reduction of investment risk in Poland and in consequence, on improvement in investment climate in the eyes of foreign investors. Future membership in the EU imposes the necessity of intensifying adjustment processes and speeding up the restructuring of many sectors of Polish economy. In practice, however, the approaching accession of Poland is only one of complex factors determining the FDI inflows to Polish economy.

The question of FDI flows in Poland is subject to regulations of the Association Agreement with the EU, which, on both parties, imposes obligations to assure unrestricted FDI flows provided the companies are set up in accordance with legal regulations of a host country, including institutions associated with formation of companies by the citizens on basis of self-employment. It is justified to assume that targeting the accession to the EU will extract pro-liberal tendency in the policy towards foreign capital, including FDI. Although, stabilization of operational environment is of high relevance, the lack of it does not seem to be indicated as the most problematic barrier faced by foreign investors in Poland.

These aspects are very important because the assessment of the advancement of preparations to the integrated EU system is based on a variety of elements, while adjustments to legal regulation and conditions of competition are only some of them. Convergence of Poland has been taking place in at least similar extend through real economic linkages, including trade connections, cooperation between economic entities and institutions or capital transfers. The exceptionally important position of FDI in the convergence of Poland to the EU Members should point at the necessity of undertaking active steps towards improvement of investment determinants of Poland, all the more that they appear to be moderately competitive in comparison with the Czech Republic and Hungary – our major rivals of pro-integration aspiration as well.

It is worth emphasizing that the expectations of increasing FDI inflows in Poland may turn out to be unjustified unless radical reforms are introduced. This scenario seems to be highly probable bearing in mind that the privatization

process is approaching twilight. The example of Spain (where the annual FDI flow in the pre-accession period had increased to US$ 10 billion on average) shows that the admission of Poland to the EU structures may trigger much higher flows of investments. However, it cannot be forgotten that Poland is not the sole member of the group of potential candidates. Both the Czech Republic and Hungary have been changing their policy towards foreign capital, which brings them visible economic benefits and many winning investment offers, which the Polish party often loses. For these reasons, the prognosis of the former Director of PAIZ – A. Pawłowicz, based on the experience of Spain and assuming a dynamic increase of FDI in Poland in a longer term of 5-7 years, is not convincing.

It is also worth to pay attention to the lack of agreement in pre-accession negotiation concerning the Special Economic Zones (SEZ). Until recently, SEZ constituted a significant encouragement for foreign investors not only in Poland but also in the Czech Republic.

However, the protection privileges in the SEZs have been gradually reduced in Poland because the perspective of the EU membership extracts abolition of this kind of incentives.

Katarzyna Żukrowska

Level of interest rate and FDI flows

There are different groups of factors, which decide about capital flows and attractiveness of a market for foreign investors. One of them is level of interest rate. It can effectively stimulate inflows and cause changes of the economy. The level of interest rate decides where the credits are draw and where they are invested indicating the direction of capital flows.

1. Groups of factors determining flows of capital and their changing role

Capital flows embrace FDI and portfolio investments. The first are divided into investments engaged in buying existing production potential (i.e. privatization, mergers) or investing in newly established ventures (i.e. grass-root investments), while the second is buying different type of securities (issued by the state to finance their budget or issued by enterprises seeking money for investments)[124].

In case of economies in transformation the biggest capital that was attracted into their economies was engaged in privatization. Too lesser extent it was engaged in portfolio investments as capital market in most ECE economies is underdeveloped. Nevertheless, part of the capital investments from abroad is engaged in securities. The stream of capital engaged in such investments is stimulated by the level of interest rate, which has to exceed the level of interest rate in the country, which exports capital. It is not the only condition as the level of interest rate has to be higher in real terms i.e. with the correction, that takes into account the level of inflation rate.

The role of level of interest rate and trade stimulation can be analyzed not only in relation to ECE economies but recently the best illustration of stimulation of the interest rate can be seen in case of capital flows between EU and US. The events of 11th September 2001 and slowing down of the American economy has resulted in quicker than anticipated before reduction of the exchange rate. Before 11th September the exchange rate in US was higher than in EU what stimulated capital flows from the EU to US, what in turn resulted in increase of mutual trade between the two.

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[124] A. Buckley, *International Investment Value Creation and Appraisal. A Real Options Approach*, Copenhagen Business School, 1998.

After 11 September 2001 the interest rates in US were lowered bellow the level of the EU, what has turned the direction of capital flows from EU to US in the opposite direction. US started to export capital to the EU market. The same can be observed in case of Japan. Generally it was assumed that credits are drawn and invested in the same economies but within developed economies, being members of OECD, where the capital can flow freely, it is rather clear that differences in level of interest rates stimulate flows capital according to the following direction: from economies with low interest to economies with higher interests; from economies with high taxes to economies with lower taxes; from economies where productivity is growing slowly to economies, where the productivity is in a rise; from economies with high earnings to economies with low earnings; from economies with higher inflation to those with lower level of price increases.

Table 1. Levels of interest rates in EU and US

	3-month money market interest		**corpo-rate bonds**	**10-year gov't bonds**		**3-month money market interest**		**corpo-rate bonds**	**10-year gov't bonds**	
	5 May 2001	5 May 2000	5 May 2001	5 May 2001	5 May 2000	15 Feb. 2003	15 Feb. 2002	15 Feb. 2003	15 Feb. 2003	15 Feb. 2002
US	4,17	6,57	7,50	5,29	6,39	1,28	1,77	6,04	3,91	5,04
EMU	4,78	4,58	4,50	4,95	5,34	2,73	3,36	4,38	3,91	4,92

Source: The Economist 15-21 February 2003, 5-11 May 2001.

Interesting observations that can be made from the presented data:

- 10 year government bonds have the same value in EU and US,
- Corporate bonds have higher prices in US than in EU,
- 3-month market interests are higher in EU than in US.

This means that capital still continues to flow in both directions although different segments of the economy are supplied by those flows. Data about flows in those periods is not available but appreciation of euro indicates the direction of net flows. In medium run dollar will also appreciate and the two markets will follow a same policy of increased intensiveness of competition indicating what type of production is profitable and what should be moved to economies with lower costs of labor. This will result in crowding out low profit investments, leading towards replacement of them by higher profit investments. Low profit investments will be moved to less developed economies increasing their profitability even in conditions of lower prices resulting from lower costs of production (mainly lower labor costs). This in turn will stimulate further

increase of foreign trade and capital flows, what in turn will have a positive impact on employment and economic growth.

The observed occurrence is leading towards equalization of interest rates internationally in long run, accelerating desindustrialization of developed economies and industrializing those less developed, dragging the latter into the main stream of economy and resulting in new shape of international division of labor. This requires not only application of mechanisms stimulating growth by capital inflows between EU and US or Japan but also liberalization of capital flows and trade in developing economies. Liberalization towards developed economies cannot be considered as sufficient here as also regional liberalization is important as it decides about the size of market in new conditions, not limiting the size to national borders.

The indicated regularities are part of the process of deregulation forcing desindustrialization of the economy paving way for servilization with higher incomes and salaries. This is also one of the conditions in favor of systemic changes in economies going through transformation.

The role of interest rates level plays a different role in development strategy for each individual group of economies. The paper will indicate the regularities observed here as well as it will illustrate advantages and disadvantages occurring in those countries.

2. Role of interest rate in a developed economy

Traditionally interest rates were considered to be in monetary policy a tool, which either stimulates demand or freezes it. Generally low interest rates were considered to be supportive for economy acceleration, while increasing interest rates were putting the growth under control. With liberalization of capital flows those rules still are at work but at the same time credits are drawn and money is exported abroad by businesses, which want to move to economies with higher increases of rate growth, productivity, etc. i.e. catching up economies.

In such circumstances low interest rates stimulate the economy of capital exporter indirectly by increasing imports to a third country and they are source of additional income if exporter of capital brings some profits and they are transferred to the economy, which is engaged in exporting capital.

This gives growth impulses as well as improves wealth in country exporting capital. In case of catching up economies also positive effects can be observed. Nevertheless, profits are not achieved unconditionally. Their occurrence require macrostabilization, liberalization external and internal, introduction of convertibility and flexible labor market.

Are such solutions also beneficial for capital importer or they serve uniquely interests of capital exporter? The argument here is that such relations are beneficial for both partners engaged in the transaction.

3. Role of interest rate in a transforming economy

In a transforming economy the interest rate plays an important role in the policy of macrostabilization; a tool opening the economy; as well as a mean helping to increase competitiveness in initial stages of transformation, etc. In such circumstance it is not neutral what type of currency peg was used in macrostabilization policy; similarly as composition of the basket of currencies used or which currency is used for that purpose if one currency has to play the role of peg; how deep is the initial devaluation; and finally how adjustments of exchange rates (nominal and real are adjusted temporary).

Correct choices introduced here bring stabilization impulse so important in an economy which departs from its past. If volatility of exchange rates occurs it becomes clear that applied exchange rate policy was based on false assumptions[125]. When directions of changes are less hectic and indicate a clear line of changes (i.e. from devaluation or depreciation to appreciation) than one can say that applied policy mix in this field is a correct one.

Why tendency of currency appreciation occurs in economies, which try to catch up those who are more developed? Answer to this question is easy and rather simple. One indicator is the size of reserves in those countries, which keep growing. This is resulted by privatization, which attracts most of the capital inflows to economies in transformation. Second reason can be ascribed to relatively higher interest rates, which if they want to be real, covering high inflation rates, are traditionally higher in transforming economies than in economies of developed market democracies. Third can be ascribed to structure of savings, which often are held in convertible currency despite high returns offered by government bonds.

The mechanism put in motion here is simple. The flows of capital stimulated by conditions characterizing economy in transformation usually, after a period of privatization fascination, are attracted by governments bonds, which as a rule have higher returns than other investments in securities. In such conditions it is very important to conduct sound and predictable monetary policy, which helps to keep the inflowing capital longer than the issuing date of the bonds. Otherwise all future transactions will create problems for this particular market. In other words sound policy helps to keep the short-term inflows of capital for a longer period. Such capital is also considered as source

[125] G. Gandolfo, *International Finance and Open-Economy Macro-economics*, Springer 2002.

that can be used for investments. Nevertheless, higher interest rate play a prohibitive role in this respect. But inflows create conditions for pressure to lower the interest rates in other to achieve more or less similar conditions on different markets, pushing the level of interest rates in longer run to new lower equilibrium.

As far as the attempt to answer the question about the level of interest rate – how high it should be in case of a transforming economy? – the answer is rather simple – it cannot be too low as interest rate indicates the availability of capital on the market and all transforming economies consider capital as a deficit good. In such conditions on the one hand the level of interest rate has to reflect the size of supply of the capital, in other words the availability of capital or on the other hand it has to reflect the price of capital in real terms i.e. taking into account the rates of inflation (interests have to be higher than inflation rate). Lowering rapidly the interest to the level of EU economies can bring in short terms a demand shock, stimulating price increases, inflation and in turn slow down of consumption and production, pushing the economy towards recession.

Higher interest rates stimulate inflows of capital increasing thus its availability and creating conditions to lower down the interest as a result.

4. The role of interest rate in a catching-up economy

Liberalization of capital inflows (regional, global or subregional) can be considered as a tool, which helps to reduce disparities in development between economies. Dispersion of ownership exclude exploitation and creates prospects for national investors to use their savings (or draw credits to invest) at home market which according to the stated rules of capital flows will be profitable.

World economy is characterized by deep disproportions concerning development, supply in production factors, wealth, access to technology and savings. Division of world economy into poor and rich, those who have capital, technologies and industrial potential to produce and those who are poor, are badly supplied in capital, technology, do not posses production potential but have good demographic record, missing in the group of advanced and catching-up democracies – creates interdependencies of a new type in global perspective. Those interdependencies are considered to be a new method of omitting open conflicts as they create mutual interests. Disparities not only similarities can be used in such relations as safeguards. Moreover, this paper is aimed at pointing out that those disparities used in specific conditions can stabilize world economy, limit the number of open conflicts, increase security, release military expenditures and help finding a field, which can takeover their role (military buildup) in stimulating economy.

World economy is in a process of deep changes according to the philosophy of replacing state intervention understood in broad manner, i.e.: subsidies, protection, aid, etc… by liberalization and deregulation, what in turn will help to allocate better sources and factors, enforcing higher effectiveness of possessed capital. This is all done in the process of globalization, which approves development differences between groups of countries and is aimed at including those excluded by poverty and underdevelopment into the main stream of the world economy, following the pattern that was used successfully by post-communist states in their transformation strategies[126]. This is leading towards new international arrangement of economic (and political) relations. In turn this has to be followed by changes in international organizations.

This new approach is subordinated to an attempt of enabling consumption in case of 89% of the world population. There is no doubt that developing countries are potential markets but until now they could consume under the condition of external borrowing or other forms of crediting, what included also foreign aid. World is divided into 11% of population that is engaged in production of 82% of world's GDP and remaining 89% of the population that is engaged in production of 18% of world's GDP[127]. Such disparities draw a simple scenario for the past, which has to be formulated with use of the experience of EEC economies, transforming economies as well as Latin American economies and their relations with US and Canada and recently with EU (Mercosur and its association with EU).

Development economics, applied in the past, stimulated temporary consumption by aid making at the same time those economies more dependent on developed economies in technology, imports of consumption goods, aid or credit transfers and increasing external debt. This effect in long run was negative for both developing economies, as well as for the developed ones. The explanation of negative effects of such development policy was double fold. In case of developing economies this had lead the countries into high indebtedness trap, pushing away their economies into further peripheries. In case of developed economies: money transferred was giving a short term relief increasing employment, that was stimulated by imports from developing economies – recipient of aid money, what was financed in economies of the donors by increasing budget deficit. Transfers of aid money were proceeded either directly by a country or by a financial organization like IMF or World Bank, EU – where all countries had their state deposits, financed also from their state budgets. Moreover, a developing country was protecting its economy,

[126] P. Dicker, *Global shift. Transforming the world economy*, Third edition, P.Chapman Publishing ltd. 1999. p. 60.
[127] E. Haliżak, R. Kuźniar, *Stosunki międzynarodowe. Geneza. Struktura. Dynamika*, WUW 2000, s. 168.

applying custom duties, which were used to finance the state expenditures, what included internal intervention and support to uncompetitive production and services, able to function only in specific conditions of protected economy. It was a typical illustration of a vicious circle, resulting in expanding distance between advanced and developing economies. This was so no matter how much money was pumped from abroad into the developing economies[128]. Those who changed their status successfully based their catch up strategy on external liberalization. If they run into trouble after a period of high rates growth this was resulted by some reminisces from the past system in politics or economics, or in both of the systems. Often the reasons of noted perturbations could be spotted in anti-democratic structures in political life, or outdated, protective and politicized exchange rate policy, or inefficient banking system, etc...

Developed countries were experiencing different methods of growth stimulation in their own economies. For a while, economists considered that integration is possible and brings positive effects only in case of economies (states) representing similar level of development. Against that rule EU included by enlargement more and more members representing lower level of development in comparison with the core of integration. Inclusion of less developed economies was stimulated by deepening of integration, i.e.: inclusion of new fields into liberalized areas. Looking at European integration we can recall that while forming the EEC or even earlier SCEC - Italy was the country that represented lower level of development. Enumerating other examples one has to mention also: Ireland, Spain and Portugal as well Greece. All of them were less developed and after membership were able to catch-up with their development. Exception was made by the three EFTAn's, who represented higher level of development than average in the EU (measured by per capita incomes). None of the countries lost, all have gained. Expansion by deepening and widening made the countries in closest vicinity sensitive to the process and encouraged them step by step to come closer or simply join.

In parallel there were additional experiences carried out, proving that liberalization works. This was done in different continents and different configurations. Enough to mention departure from golden standard by American dollar in 1972, followed by 1973 energy crises, what has stimulated international flows of capital on a large scale from developed to developing economies, namely so called Asian Tigers or Latin American economies. Those transfers worked for catching up in more neglected regions, indicating at the same time that those economies require some deep reforms and capital flows and activation of the markets can not solve the emerging problems on its own. Transfers of capital stimulated growth and further capital transfers as growth created conditions of high investment returns. In most of those cases transfers

[128] A. Hirschman, *The fall and rise of development economics*, krugman/www/dishpan.html

led to financial crises, which stimulated politically undesired reforms, limiting power of politicians and increasing share of democratic solutions in political systems of those regions, i.e.: departure from fixed exchange rate policy, deregulation of capital markets, increase of flexibility of labor market, etc. The experience gained in Asian tigers, mainly analysis what worked and what did not, were used in case of post-communist states when they were preparing their strategies to change systems from command and distributive ones to market economies. Nevertheless, not all states in transformation used the same dose of liberalization, what was followed by differences in achieved results.

The next experience was made by integration of Mexico within NAFTA (together with Canada and the US). Before this was done most economists believed that such integration will move working places from developed to less developed economies, what will be mostly demonstrated on the borders of Mexico and USA. This did not happen, moreover both economies received positive impulses, resulting in their rates of growth. Liberalization of trade within NAFTA was not followed by financial support conducted within aid policy of the US. Transfers of money were accomplished by IMF and within the frames of flows of FDI.

In case of post-communist states the more liberalized the economy was – the better results it obtained in transformation. A specific case was ascribed to the process of reunification of the two German economies, what was strongly supported with the old type of tools available within the West German budget as well as structural funds and CAP money available in the EC. The results were interesting. On the one hand, inflation did not occur on such a scale as it did with other liberalization decisions. On the other hand, unemployment has increased in some regions to 38% and production went rapidly down. Big economy (West Germany with EC) was able to counterbalance the impact of opening of small economy. In case of other economies either the opening was not so wide, what was also accompanied by cushioning of state expenditures (Hungary, Czech Republic, Slovenia, or even in a higher extent in case of Bulgaria and Romania), or the in limited number of cases opening was wider and cushioning smaller (Poland, Estonia). There was also another option, which from political point was the most difficult. At the beginning opening was limited, followed by strong cushioning, what with time passing was replaced by wide scope of opening and elimination of cushioning (Lithuania and Latvia). The stimulus that was used hear can be ascribed to a specific strategy applied by the EC, which has well coordinated the queue of those willing to join, helping to undertake politically difficult decisions as it seemed to be easier to adjust and join then to stay left behind and suffer.

Looking at the listed examples one can draw interesting conclusions. Integration among unequals is possible and gives positive impulses for both

types of economies: catching up and those, which are ascribed as developed ones.

Conclusions

Level of interest rates is important for capital flows. It creates chain reactions stimulating development and restructuring but this can be achieved under the condition of capital flows liberalization; sound macro-economic policies and predictable tendencies in exchange rate policy. Composition of the segments of capital market in advanced economies creates opportunities for capital flows between advanced economies. Last events of 2002 and beginning of 2003 indicate that European market and US market can be considered as one of the stimulus of capital flows as remaining markets do not have today such abilities, what results from their size measured by value of their GDP.

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Part 3:

Capital markets and exchange rates in the process of integration with the EMU

Thomas Meyer

The eastward enlargement of the Eurozone – shaping of capital markets

Introduction

Ten countries are about to join the European Union (EU), perhaps as early as 2004, including Malta (if public support can be restored), Cyprus (if the political/geographical problem can be tackled) and some eight central and eastern European countries (CEEC) which are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, Slovak Republic but not Romania and Bulgaria – in general both are considered not to be ripe for accession.

Shortly after, and perhaps just two years after joining the EU, these countries will adopt the euro as legal tender and will become part of the European System of Central Bank—which includes voting rights with the monetary policy of the European Central Bank. European Monetary Unification (EMU) as of 1999 has provoked a lot of academic (and not so academic) discussion on the pros and cons of a joint currency, usually starting with Mundell's optimum currency area arguments (Mundell 1961)—which eventually awarded him the Nobel Prize in the very same year. The trade-off is seen between the advantages of economic integration – i.e. enhanced cross-border allocation of resources, which should lead to more efficiency – and the loss of flexibility in economic policy in terms of monetary autonomy and exchange rate variations. When the benefits of integration are low; a high probability of asymmetric shocks renders the need for economic discretion very valuable, and other means of flexibility, mainly in the form of fast price adjustments, migration, or fiscal transfers, are missing, the verdict is returned against a common currency.

Apart from that rather static point of view, the notion has been pronounced that EMU itself might change some of those issues. Given that economic policy is constrained, and that flexibility might be needed, which markets are not yet providing, than that latter fact might change. Economic actors might realize, for instance, that currency devaluation, expansive monetary policy, or substantial fiscal stimulus will not become available and react by creating more flexibility themselves. Markets reshape when confronted with changing constraints. Market forces might coerce public authorities to accommodate this process (cf. Bolle and Neugart 2000).

Capital markets are a prominent part of the economic system and obviously strongly affected by monetary integration. Costs of cross-border transactions dwarf as currency risk (vis-à-vis the euro) vanishes and other *de jure* and *de facto* barriers to international mobility of financial flows will be eliminated. Previously segmented markets become more integrated, exposing less efficient usages of funds and starting a reallocation. The resulting process of restructuring includes a considerable amount of *creative* destruction and will leave winners and losers in both, the applicant states as well as in the current Eurozone. Prospective losers might lobby against restructuring, and part of the success of enlargement will depend on how will be dealt with potential losers – i.e., whether they will be ignored, compensated, or allowed to block a process that otherwise might yield economic advantages for a majority. In that sense eastward enlargement is not Pareto-efficient, however, given that prosperity will grow, resources will be created that might suffice to compensate legitimate claims of potentially disadvantaged.

Capital markets comprise more than financial systems and foreign direct investments. They include all productive resources that are not labor, but are priced and traded in an organized way. The financial system is a key element in that respect because here pricing and trading takes place in market institutions which are explicitly set up—such as stock exchanges—or at least follow an institutionalized pattern, for instance bank financing. Evidently, the institutional framework plays an important role, in particular with regard to ensuring property rights and enforcing the rules of the game. Financial development and economic growth are increasingly perceived to be complementary (Levine, 1997). Financial institutions provide a number of important services such as trading, hedging, allocation of capital, screening, and monitoring. Financial development may even enhance the domestic savings rate (Pagano, 1993). Indeed, a strong correlation of financial and economic development has been found in influential studies such as King and Levine (1993).

This paper aims to analyze most likely effects of an eastward enlargement of the Eurozone on capital markets in the CEE applicants, and to a lesser degree in the current Eurozone. It is part of an international research project, Ezoneplus, which is supported by the European Commission in the 5th framework program. Other reports focus on trade and foreign direct investments, labor markets, and exchange-rate regimes, so that corresponding issues are omitted here. The division is of course delicate and overlaps might be inevitable. Moreover, previous work has explored theoretical arguments (Meyer 2001) and provided an empirical background (Meyer 2002, Vieira and Vieira

2002, Lavrac 2002, Kiander 2002, Marzo 2002). Hence, this paper sums up both strands and draws some preliminary conclusions.*

1. Agenda ahead

1.1. EU and EMU

In Gothenburg the current members of the European Union envisaged to include the CEE applicants by 2004—albeit no binding commitment has been made. However, the most likely scenario seems to be an accession of ten applicants, including Malta and Cyprus but without Bulgaria and Romania, somewhat around 2004 or shortly after. Though it might be favorable to include only a smaller number of the most advanced countries in a first round (cf. Eichengreen and Ghironi 2001), the political cost of disappointing those who remain outside seem to be too high.

In contrast to the current EU members there will be no opt-out clause for EMU granted to future participants—i.e., those who join the EU are expected to join EMU as well, as soon as the Maastricht criteria are fulfilled. One condition laid down in the Maastricht treaty requires participation in the successor of the European Exchange-Rate Mechanism (ERM), now dubbed ERM2, for a minimum period of two years without realignment. Consequently, most prospective members plan the adoption of the euro within two years after joining the EU (European Commission 2001). By then, future EMU members will not only have adopted the acquis communautaire and have fulfilled the Amsterdam conditions, both necessary to join the EU, but will also have complied to the Maastricht criteria and will be subject to the regulation of the Stability Pact.

The Maastricht criteria require convergence of a number of nominal variables to EU levels, such as, inflation, exchange rates, and long-term interest rates, as well as the two notorious fiscal criteria which set an upper limit for budget deficits of 3% of GDP and a maximum of 60% of GDP to total indebtedness. The Stability Pact extends the 3% constraint into the future and includes levies in case of non-compliance, subject to the approval of the council of EU-ministers. The acquis communautaire represents the sum of EU legislation and includes such juicy pieces as the common agricultural policy. With regard to financial markets and banking it includes a wealth of regulation

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ranging from capital account liberalization (Capital Liberalization Directive) to deposit insurance of at least €20k per customer (deposit protection). In many respects, these joint standards create a level playing field for financial transactions in a then enlarged Eurozone which will improve market efficiency. However, the transition may prove to be painful for some CEE financial institutions, in particular the many banking directives which increase European competition and may put a strain on very small banks (cf. Wagner and Iakova 2001).

Accessions to the EU and to the Eurozone share a lot of commonalities. But joining the euro will add a new quality to the process of European integration for the CEE applicants, just as it did for the current members. The reason lies with the growing dependencies in the economic development of participants. Sharing a currency means sharing the inflation rate – at least to some extent. The European Central Bank (ECB) determines a common interest rate which might be too high for some countries and too low for others, given differences in the financial systems and business cycles. CEE applicants are economically small and should have only a minor impact on European inflation – in normal circumstances. A financial crisis in CEE might lead to the expectation of an ECB bailout, moreover the national branches of the ECB may act independently as a lender of last resort and increase money supply. The accession countries will also get their say in the ECB board of directors and participate in the decision-making process and probably opt for a more convenient – i.e. expansionary – monetary policy. Whether or not they will get away with it seems rather unclear. Anyhow, the worse economic conditions become in CEE the more explicit and implicit pressure will current members and the ECB feel to assist – for instance because standard tools such as exchange rate realignments or sovereign monetary policy ceased to exist. The cost of economic distress in the CEEC can be partly exported to the present Eurozone, which increases the incentive on both sides to prevent it in the first place.

The current euro-members have a vested interest in the stability and prosperity of the joining countries in CEE. The cost of economic failure would be magnified by the euro and part of it would be transferred to the present Eurozone. In order to rule out failure, the Eurozone will insist on a sound macroeconomic policy and the enforcement of the acquis. The detection of non-compliance, however, is a tricky task burdened with political considerations. But given the linkage created by the euro, the rigor with which acquis and macroeconomic austerity will be enforced (coerced) should be much stronger. For instance, chances should become slim that deviations from the acquis – in particular in the day-to-day application – would be tolerated for political reasons.

The commitment of the EU towards its prospective members becomes more credible with the euro and hence shapes market sentiment toward an expectation of stable and growing CEE applicants. This credibility lowers the real cost of stabilization. A caveat might be that the current EU values stability in the CEEC higher than prosperity, relative to the applicant's preferences – i.e., the EU is more risk-averse, because it might share the cost of failure rather than the fruits of strong growth. However, given the high cost of buying macroeconomic credibility without a strong anchor and the tremendous advantages of a sound institutional framework, the price of staying too prudent seems rather modest.

1.2. Financial development and EMU

Since 1999, the time when the first countries joined the EMU, capital markets in the Eurozone have undergone massive changes. Though it is to acknowledge that capital markets are changing anyway—due to advances in research and technology, transforming investment patterns, corporate restructuring, just to mention a few—it can be argued that the euro is strengthening and precipitating this process.

Economies of scale render integrated capital markets more efficient by two respects. First, price volatility will sink because more supply meets more demand, regional imbalances are mitigated on the European level. Reduced price volatility means less liquidity risk and thus lower cost of capital. Moreover, an integrated financial market sets a level playing field with regard to regulation and institutions, for instance in the form of the acquis communautaire, which lowers transaction costs. The potentially biggest advantage stems from increased competition for funds on a European level. Capital market integration, by definition, means the removal of market segmentation. The latter sometimes provides a cozy resort for less profitable investments only because outside options were missing. In a bigger market lenders may eventually find a more lucrative asset; borrowers a cheaper source of financing. Less lucrative investments and expensive financing will be driven out of the market.

Studies, such as Danthine et al. (2000), and Galati and Tsatsaronis (2001), have shown that EMU spurs the trends toward a unified capital market with the beneficiary effects described above: While market size increases, the euro-market is bigger than the sum of the previously separated national capital markets, liquidity and fundamental risk is reduced. Hardouvelis et al. (1999) estimate a reduction of 2% in the cost of capital due to the process of European integration 1992-1998. Moreover, the standardized expression of prices in euro and the creation of a euro-wide yield curve as a benchmark improves market efficiency (Danthine et al. 2000). Thanks to the bigger European market, the average size of bond issues has increased. With the euro's introduction average

corporate bonds issue value $400m, up from just $200m the year before. Government issues now seem to exceed a minimum of €5bn-€20bn if they aim for a benchmark issue (cf. Santillán et al. 2000).

The removal of segmentation can be exemplified with European equity markets where movements in price indices have become more and more in line. For instance the correlation of the main German index, the DAX, and the main French one, the CAC 40, has increased from .63 (1993-1996) to .83 (1997-2000). Table 2.2.1 shows the correlations for the two periods for most European stock exchanges.

Table 1. Correlation coefficients between weekly variations of stock exchange indices

1993-1996

	PSI20	*MADX*	*FTSE100*	*CAC40*	*DAX*	*MIB30*	*Stoxx50*
PSI20, Portugal	1,00						
MADX, Spain	0,34	1,00					
FTSE100, UK	0,20	0,51	1,00				
CAC40, France	0,25	0,59	0,62	1,00			
DAX, Germany	0,26	0,52	0,59	0,63	1,00		
MIB30, Italy	0.10	0,43	0,39	0,49	0,45	1,00	
DJ Euro Stoxx 50, EU	0,30	0,70	0,74	0,86	0,85	0,63	1,00

1997-2000

	PSI20	*MADX*	*FTSE100*	*CAC40*	*DAX*	*MIB30*	*Stoxx50*
PSI20, Portugal	1,00						
MADX, Spain	0,71	1,00					
FTSE100, UK	0,55	0,68	1,00				
CAC40, France	0,65	0,76	0,74	1,00			
DAX, Germany	0,64	0,75	0,71	0,83	1,00		
MIB30, Italy	0,62	0,76	0,62	0,75	0,72	1,00	
DJ Euro Stoxx 50, EU	0,68	0,84	0,79	0,93	0,92	0,81	1,00

Source: Banco de Portugal, Relatório do Conselho de Administração 2001.

Table 1. shows increased correlations for the movements of all major European stock exchanges. The removal of market segmentation gave capital markets throughout the Eurozone more clout. Financing slowly turns from a traditional bank-based system at least to some extent toward a more open-market approach. Banks still increased their business (see Table 2.) but changes are visible. Germany's banking system has experienced much pressure which initialized some restructuring, in particular the disentangling of banks and firms. Though convenient for many business-leaders, this structure has proved to be an obstacle in international competition and an integrating capital market

makes such disadvantages more apparent. Creation of shareholder value has become more prominent since more people own stocks and exit options – within and outside Europe – have become cheaper (cf. Meyer 2002).

Table 2. Domestic credit provided by banking sector (%GDP)

	Belgium	*France*	*Germany*	*Netherlands*	*USA*
1990	70,3	104,4	105,4	103,0	110,9
1999	147,3	102,2	145,2	126,8	164,2

Source: World Development Indicators 2001.

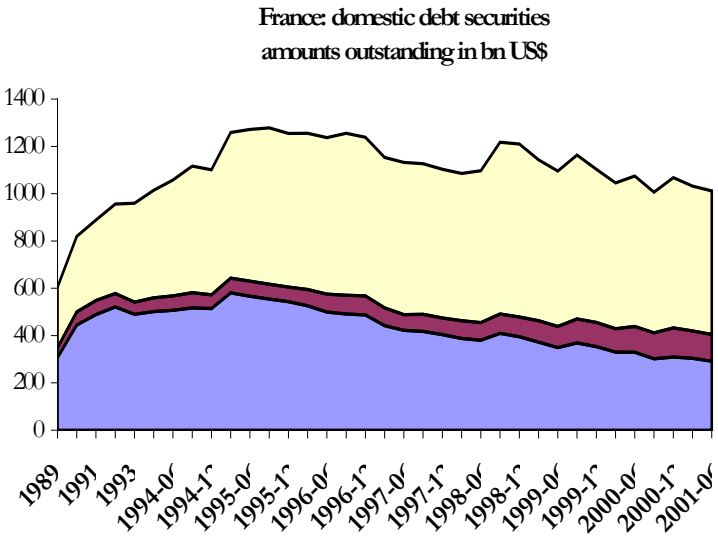
Fixed incomes have been the biggest success in the still young euro-history. Bonds emissions have soared with the introduction of the joint currency (Charts 1, 2 and 3.), though some technical considerations played a role. The subsequent decline in US$-terms has to take into account the considerable depreciation of the euro vis-à-vis the greenback. More interesting than the amounts is the composition of the bonds markets: Corporate bonds are on the rise; in Germany their share multiplied by nearly twenty, albeit from a very small level. Corporate bonds are of particular importance because they are an alternative to bank lending, and indicate the functioning of the financial system, because bonds-holders can enforce their property rights only in a stable and reliable institutional setting (cf. Meyer 2002).

The euro increases international mobility of capital by:

- lowering the cost of international transactions,
- reducing *de facto* barriers to international operations, and
- helping to enforce the *de jure* liberalization of the capital account – i.e. mainly the enforcement of the acquis communautaire.

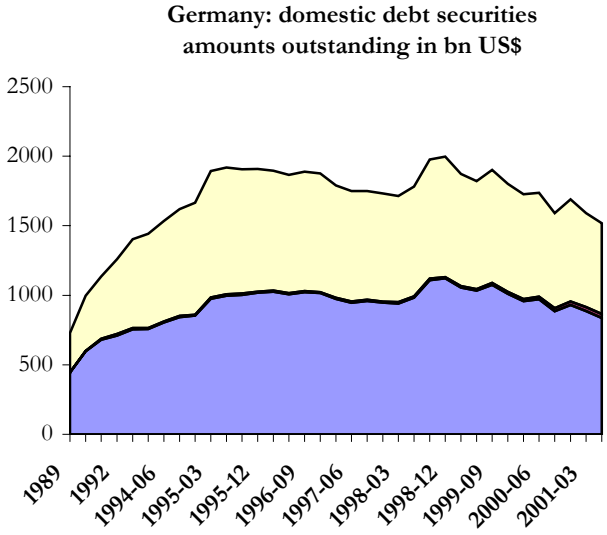
An integrated European financial market increases the efficiency of capital allocation, which strengthens an ongoing process of restructuring in corporate and public Europe. International mergers and acquisitions are eased as financing them has become more and more possible at lower cost. Tremendous amounts of money – such as for the expensive G3 telecom-licenses – could be raised on European capital markets. Institutions and legislation is following market pressure: European stock-exchanges, though still very much a matter of national pride, are increasingly collaborating in order to realize the economies of scale so much needed in financial markets. And there is still much to make up in comparison to the biggest and most liquid trading floors in the US (see Table 3.). The latest sign of increased competition is the intrusion of Nasdaq into the European market with the foundation of Nasdaq Germany jointly with the stock exchanges of Berlin and Bremen – both very small regional exchanges struggling for survival.

Chart 1.



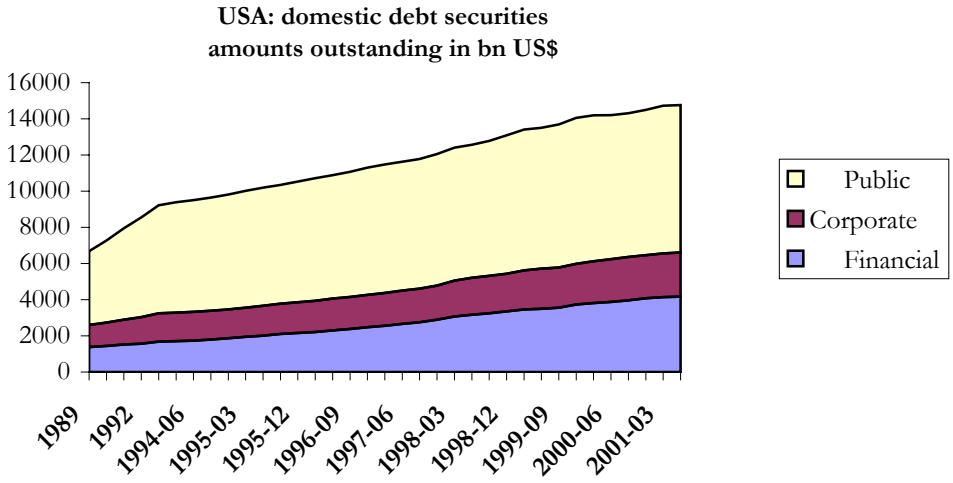
Source: Bank for International Settlement, 2002.

Chart 2.



Source: Bank for International Settlement, 2002.

Chart 3.



Source: Bank for International Settlement, 2002.

Differences in regulation are an often-quoted impediment to capital market integration in Europe. Standards, practices, and law deviate from each other within the Eurozone – and with regard to other financial centers, mainly London and the US. Particularities in domestic regulation can become a problem because they increase information costs of investors, which have to know and assess the differences, and may be rewarded by a discount on domestic asset. Hence, the current trend toward a unified regulation, respectively the attempts to explain the benefits of some particularities ("comply or explain"). The quality of institutions is an important determinant of investment decisions. Members of the Eurozone have felt the increasing pressure to modernize their financial regulation. In Germany, a new code on corporate governance has just (February 2002) been published, which is a good example. Though not a formal law, and thus no formal sanction in case of non-compliance, German firms may face a discount on the capital market if they deviate from this standard without an appropriate explanation. Hence, enforcement is given to the capital market, which may be more efficient than a public authority. Note, however, that it needed some public impulse to create the code in the first place.

Table 3. Stock markets – Key indicators 1999, 1998

Country	Market capitalization (% GDP)	Turnover ratio (value % capitalization)	Number of listed domestic Companies	Trading costs (basis points) 1998		
				Explicit	Market impact	Total
France	103,0	62,4	968	22,76	7,10	29,85
Germany	67,8	107,5	933	24,45	14,59	39,04
USA*	181,8	123,5	7 651	13,36	17,53	30,89

*Trading costs refer to NYSE.
Source: World Development Indicators, 2001; Domowitz et al. 1999.

2. The bright and dark side of euro

Transformation includes acquiring living standards of the Western models. The arrival of market forces in the formerly planned economies revealed the low value of the then existing capital stock. Thus the accumulation of capital in productive investments is a necessary condition to increase productivity, incomes, and prosperity. Hence, quantity and quality do matter. Capital is supplied by domestic savings – i.e., waiving of consumption – and by net imports of foreign resources. Given the low capital endowment in most CEEC, investment opportunities should be aplenty – i.e., the demand for capital or the real interest rates investors are willing to pay should be quite high. However, the interest rate may be not a sufficient tool to allocate funds to the most profitable investment, because very risky projects, even with a negative net present value, might be able to pay higher interest rates, but only pay in favorable conditions – if not they go bust with little or no payment to lenders. Less risky projects are more likely to have a positive net present value, but might even in good states of nature not be able to afford rocketing interest rates. Thus a prudent and sophisticated financial system is needed to distinguish between risky and less risky projects. Without such a system lenders ration credit and tightening financial condition might stall economic growth.

Financial markets in CEE share some disadvantages: they are very small, indeed; even the biggest markets in Poland, Hungary, and the Czech Republic come only close to half of the German size in terms of stock market capitalization and provided credit. And that is in relation to GDP (see Table 4.). In absolute terms – which are arguably more important – these markets are minuscule which points to some severe difficulties in acquiring and channeling funds efficiently as – again – economies of scale play a crucial role. Moreover, the institutional framework has not yet leveled with mature economies, in particular with regard to the enforcement of legal and business norms.

Table 4. Overview – financial markets in CEE

2000	**Bulgaria**	**Czech Republic**	**Hungary**	**Latvia**	**Lithuania**	**Poland**
Domestic credit provided by banking sector (% of GDP)	18,29	57,28	53,95	24,22	14,44	37,83
Financing from abroad (% of GDP)	-1,69	0,04	1,53	-0,26	1,93	0,04
Foreign direct investment, net inflows (% of gross capital formation)	50,44	30,42	12,12	21,02	16,17	22,35
Inflation, consumer prices (annual %)	10,32	3,9	9,79	2,65	1,01	10,13
Interest rate spread (lending rate minus deposit rate)	8,42	3,74	2,97	7,49	8,29	5,83
Market capitalization of listed companies (% of GDP)	5,15	21,67	26,34	7,88	14,03	19,83
Short-term debt (% of total external debt)	4,21	42,34	14,12	37,58	22,95	11,18
Stocks traded, total value (% of GDP)	0,48	12,96	26,63	3,19	1,79	9,28

2000	**Romania**	**Estonia**	**Slovak Republic**	**Slovenia**	**Germany**	**United States**
Domestic credit provided by banking sector (% of GDP)	14,13	40,01	59,85	47,12	147,54	161,72
Financing from abroad (% of GDP)	------	-0,06	3,17	1,73	------	0,52
Foreign direct investment, net inflows (% of gross capital formation)	14,36	30,21	35,67	3,48	44,55	------
Inflation, consumer prices (annual %)	45,67	4,03	12,04	10,85	1,95	3,38
Interest rate spread (lending rate minus deposit rate)	------	3,86	6,44	5,72	6,23	------
Market capitalization of listed companies (% of GDP)	2,91	37,15	3,88	14,05	67,82	153,54
Short-term debt (% of total external debt)	3,53	28,78	12,24	------	------	------
Stocks traded, total value (% of GDP)	0,64	6,57	4,68	2,56	57,08	323,89

Source: World Development Indicators 2002.

The ability of the financial system to tell good from bad investments is less developed which increases the chances of imbalances and asset-price bubbles. Foreign financial institutions consequently take over a majority of the CEE market but have to experience some resistance in terms of political and public opposition.

Countries in CEE want to gain prosperity and maintain economic and social stability at the same time. Transition may create a trade-off between these goals. A consequent open-market approach would improve long-term economic growth, however, short-term destabilization and a strain on social cohesion might be a side effect. With regard to capital market this dilemma can be exemplified with the rigor of capital account liberalization. The removal of barriers to capital mobility increases in general quantity (see Table 5.) and quality of investments, as net capital inflows are combined with a transfer of know-how, technology and management skills. The restructuring process from a planned economy toward markets will be fostered. However, restructuring may be painful, because production factors might not be easily transferable to new usages. This affects sunk costs in old industries – i.e., now redundant machines and property – but in particular employees in these sectors, who have to burden the cost of adapting to new jobs and might lobby in favor of policies to reduce this burden. Moreover, the restructuring might reduce economic activity and increase volatility in the short-term.

The success of the eastward enlargement of the Eurozone depends on the developments on several levels of the capital market. Capital account liberalization and the prospect of monetary stability lure considerable amounts of money into the applicant states. The sustainability of these flows depends on the quality of investments chosen, which in turns depends on the allocation abilities of the financial system. Apart from the intrusion of foreign intermediaries, institutions play a crucial role, especially the guarantee of long-term property rights, including sufficient corporate governance. Deficits on one of these levels might cause instability, which eventually might lead to a sudden reversal of foreign money out of CEE. Hence, the following three sections cover the development on these levels.

2.1. Capital flows vs. destabilization

All transforming countries, except Bulgaria, in Central and Eastern Europe, which have applied for EU membership run investment quotas higher than in most mature economies. And all of them import considerable amounts of foreign capital.

Table 5. Key figures 1998/1999

	Investment rate	***Current account deficit***
	As % of GDP	
Bulgaria	16,4	5,5
Czech Republic	32,6	3,5
Estonia	25,4	6,9
Hungary	23,2	3,4
Latvia	20,1	9,9
Lithuania	22,5	6,0
Poland	25,3	7,1
Romania	20,2	4,9
Slovenia	26,9	2,6
Slovak Republic	40,8	3,3

Source: EBRD, 2000.

In principle this is a benign situation: Considerable investments quotas, most of them higher than the usual 20% prevalent in Western Europe, can be financed without sacrificing private consumption. However, what happens if for whatever reason these flows do not sustain? A sudden reversal of capital flows may trigger financial and currency crises as seen in Mexico 1994, East Asia 1997, or Argentine 2002 for that matter.

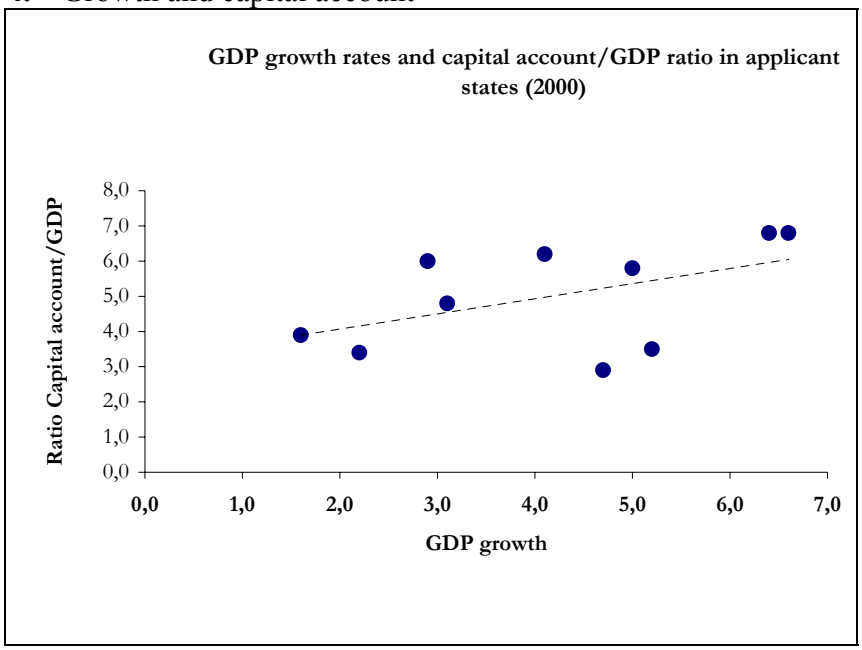
A wealth of literature has described the detrimental effects of a sudden outflow of capital. The financial system, and in particular the banking industry, is the vulnerable part. A common argument goes like this: The loss of foreign capital deprives local banks of financial resources and exposes their currency and maturity mismatch. Banks react by reducing credit, thereby worsening the financial conditions of the private sector. A credit crunch translates into shrinking profits and rising numbers of company failures, which in turn worsen banks' assets again. Either by depreciating loan values (non performing loans) or collapsing values of private sector investments such as shareholdings. The mechanism reinforces itself and may lead to a vicious cycle and to financial crisis (cf. Mishkin 1998).

The magnitude of this threat is determined by the probability of a turnaround of flows as well as by the associated costs. A reversal of capital flows shares some commonalities with a bank run; in both cases a lack of collective action may magnify an in the first place minor cause of concern. For instance a temporary liquidity problem of a bank can lead to a bank run that deprives remaining resources and threatens the solvency (the seminal model is Diamond and Dybvig 1984, cf. Radelet and Sachs 1998). However, whole

economies cannot be directly compared with banks. But international investors may be as capricious as banks' depositors, in particular when the costs of repatriating their money are low and the overall economic conditions become at least unclear. A typical problem is the build-up of bubbles – i.e. overinvestments in certain assets that are mainly reasoned by the expectation of strong investment into this specific asset in the future. The asset itself is rather arbitrary, be it Dutch tulips or Malaysian real estate. When the bubble bursts, asset prices may not only return to the whatever fair value, but undershoot this level considerably, because investors flee the market. Without sustained funding even profitable project in the first place will eventually go bust. Hence, overreactions in both directions harm the economy. The better a financial market is developed the less likely will be an asset price bubble – though the dotcom-bubble shows that even the presumably highest developed markets are not immune. Now, overinvestment must not necessarily lead to an asset-price bubble, but anyhow it distorts the allocation abilities of the capital market and increases the probability of a sudden removal of funds.

Growth attracts foreign money – i.e., those CEEC with higher growth rates experienced higher capital imports – or is it the other way round? Growth creates investment opportunities which can be used by funds from abroad. Increased investments may translate into higher growth.

Chart 4. Growth and capital account



Source: EBRD, 2001.

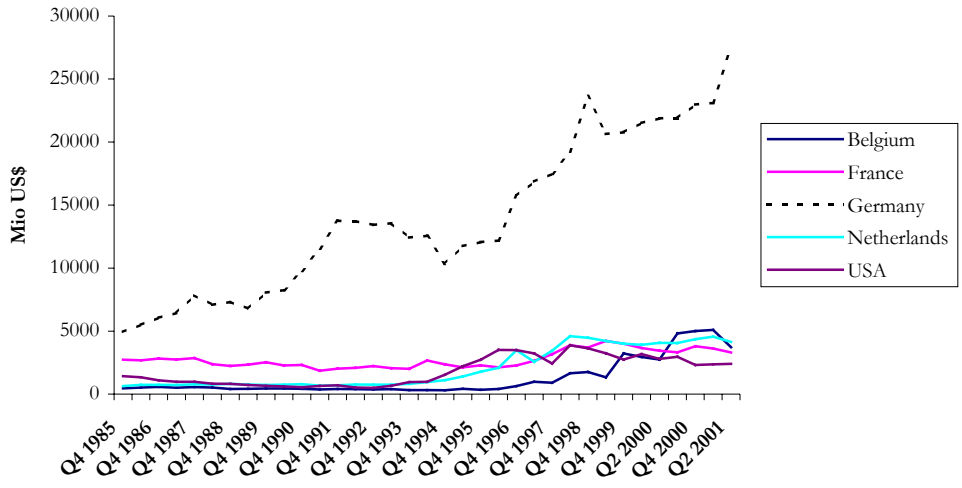
Chart 4. illustrates the point: growth is associated with higher rates of capital import. That may create an argument for pro-cyclical capital flows – i.e., growth is complemented and pushed further by foreign investment (and vice versa), whereas the other way round, a loss of either growth or foreign capital might be aggravated by an additional loss of the other.

The literature on capital account comes up with a positive outlook as long as the institutional setting is sufficiently developed and macroeconomic stability is sustained (for a survey cf. IMF 2001). There is a good chance that this will be the case in CEE, because liberalization is embedded in a process of European integration, which provides the institutional framework to attach – the *acquis* – as well as macroeconomic austerity – for instance, in the form of the Stability Pact.

However, the problem must not necessarily be with the CEE applicants. Chart 5. shows that the amounts of foreign loans provided by the banking system is rather unevenly distributed—for instance German banks lend more than $27bn, much more than French or US banks. A German credit crunch could thus easily translate into tightening financing conditions for the CEEC initiating the process described above.

Chart 5.

Consolidated International Claims of Reporting Banks to CEEC
(by nationality of reporting banks)



Source: BIS 2002.

Capital inflows are an inevitable source for domestic investment – barring any substantial capital controls more than already in place to discourage a too

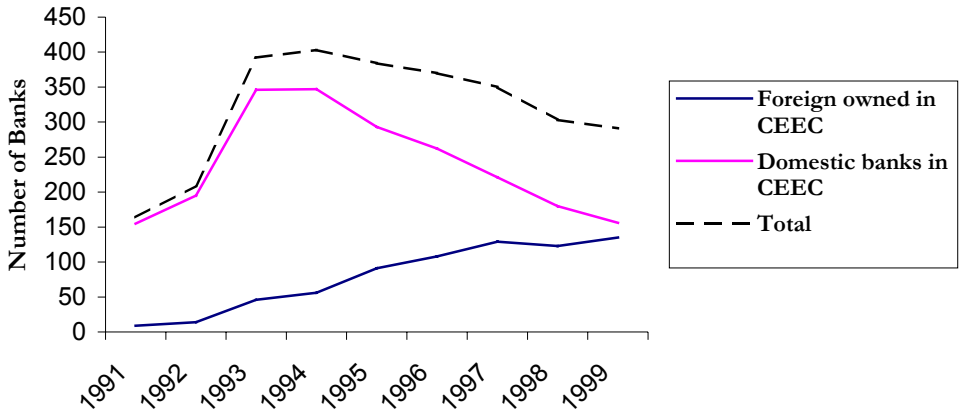
strong short-term bias. To make the best out of them, the CEEC should seek to improve the allocation abilities of their financial markets. The less money is channeled into unsustainable investments the less likely (or necessary) will be financial distress or crisis. CEE applicants should welcome foreign expertise in telling apart those from profitable ones – i.e., allow foreign entry (see next section). And they should be particularly careful not to create room for bubbles themselves – for instance in the form of public guarantees which might induce moral hazard.

2.2. Foreign entry vs. lending discrimination

The previous part suggested that the success of the eastward enlargement of the Eurozone depends strongly on the financial system's ability to cope with increasing but volatile capital imports. The financial system itself is shaped by the stream of foreign money if only because part of it is used to acquire stakes in CEE financial institutions – i.e., mainly banks.

Chart 6.

Development of Banks in CEEC



Source: EBRD, 2001.

In the early 90s the total number of banks exploded in most CEEC. Planned economies have been traditionally under-banked, hence this surge may be a sign of catching-up with mature economies' levels of financial services. However, the number of new banks might have overshot and exceeded demand, which may explain the shrinking numbers starting in 1995. On the other hand, financial sectors in most countries have consolidated as international competition grew and the realization of economies of scale has become more

and more important to guarantee survival, hence declining numbers of banks may indicate an increasing integration into an international capital market.

Foreign ownership is on the rise. Soon, every second bank in CEE will be foreign owned. However, national differences persist: Some of the CEEC showed more enthusiasm toward foreign owners, whereas others have been rather reluctant—for instance in Slovenia, one of the advanced applicant states, only 5 out of 31 banks have foreign owners (numbers for 1999, EBRD 2000).

Foreign banks that enter emerging markets generally have lower interest rate margins and overhead expenses but higher profits than domestic banks, indicating their superior competitiveness. This improves the functioning of capital market and is supposed to have positive welfare effects, at least in the long run (Claessens et al., 2001b). Foreign banks improve quality and availability of financial services by increasing bank competition and enabling greater application of modern banking skills and technology, serve to stimulate the development of bank supervisory and legal framework, and enhance a country's access to international capital (Levine, 1996). These beneficiary effects are supported by a number of studies, such as Levine (1996), Walter and Gray (1983), Goldberg and Saunders (1981), and Gelb and Sagari (1990).

If it is true that foreign financial institutions improve market efficiency then there are nevertheless a couple of associated risks to consider. First, foreigners may lack public acceptance, which might prevent governments to sell financial institutions abroad. This feeling is not limited to Eastern Europe but can be found throughout the world—for instance, French authorities did not allow to let ailing Crédit Lyonnais fall into hands of Deutsche, Germany's biggest bank (The Economist 1999). Banks and financial institutions are an important feature of the economic cycle, losing control over it is seen as losing national sovereignty in that respect. Moreover, having such an integral part of the economy being taken-over by foreigners may seem as disqualifying domestic talents and capabilities which might be hard and unpleasant to accept. A similar fear can be observed with regard to the tradability of land. Real estate is a non-negligible asset as investment and arguably even more important as collateral for credit. Limiting the purchase of land is a strong impediment for investors, and all CEEC, except Estonia and Lithuania, have restriction on tradability of land for foreigners in place, either *de jure* or *de facto* (EBRD 2000). Land is burdened with emotion like banks are: Slovenians cherish their small Adria coastline (Lavrac 2002), and do not want to forgo it into foreign hands. Poles are more precise and especially dislike the vision of Germans buying considerable parts of the countryside.

However, there are some reasons behind these arguments than just sentiment, and many flaws. The EMU of 1999 has created a European capital market, enhanced competition, and improved efficiency. Now, financial institutions play on a European level, which leads to considerable changes and

consolidation (for a more detailed description see the background paper on Benelux, France, and Germany). The Western European financial industry has in many points advantages over their CEE counterparts, mainly their superior financial technologies and access to capital. Their disadvantage is that they are less informed about regional particularities, with regard to governments, institutions, firms, and customers. If a very big part of the financial system is replaced by foreign players, this specific knowledge might get lost. Small and medium sized firms (SME) seem to be mostly affected. Bank loans are usually the only access to external capital, except for private investors, but most other means such as shares and bonds are not cost efficient. Moreover, SME financing is traditionally risky, has small margins, and hence, promises only little profit. Assessing the economic and financial condition of SME requires detailed knowledge about the business environment and the firm itself; something that is often acquired only in a long-term relation between bank and customer: A relation often dubbed as arm's length lending. SME may suffer in two ways: Either domestically owned banks disappear, or competition with foreign competitors forces them out of any low profit business, which SME lending often is (cf. Agénor 2001, or Stiglitz 1993). But this must not necessarily be so. International competition might render SME lending the only remaining resort for domestic banks; new banking skills and technologies might improve the profitability of SME lending and let foreign banks enter this business; by the same token, improved access to capital might turn SME lending more attractive, and so forth. Hence, some recent evidence suggests that lending conditions for SME even improve under foreign entry (cf. Clarke et al. 2001a,b).

Financial markets in CEE are rather small compared to EU standards. European consolidation will create fewer but bigger financial institutions, and most of them will come from mature economies, given their superior market (and marketing) power. However, even a medium-sized player on a European level will be big enough to dominate a national market in an applicant state. If integration into a European capital market falls short of the creation of a dominant financial actor, than the result may be de facto a monopoly with the usual adverse concomitants (cf. Agénor 2001). Moreover, in times of distress, foreign banks might "cut and run" – i.e., retreat from the problematic market, leaving the country with an incomplete financial industry (again cf. Agénor 2001). Hence, the reluctance of many CEE politicians to allow foreign banks to acquire controlling stakes in domestic financial institutions. But banks and financial markets are also often used as policy-instruments; again a phenomenon not limited to CEEC. Politicians try to keep as much control as possible—for instance in order to pursue development objectives. A domestic bank may be asked to lend to ailing firms, albeit economic sense tells otherwise, in order to safe jobs or to guarantee support for the next election

campaign. International firms seem less dependent, and thus, less subject to a comparable hold-up. The distrust of foreign banks extends consequently to a distrust of private ownership of banks at all: In many CEEC state-owned banks still have an asset share of more than 20 to 40% (EBRD 2000), albeit these shares are not too scary, given that for instance half the German banking sector is public-owned. However, the track record of governmental intervention is rather mixed, to say the least. For instance, La Porta et al. (2002) show that countries with higher government ownership in banks usually suffer from lower growth rates. With regard to the CEEC this relation is not self-evident. Slovenia, one of the most successful applicants has an asset share of state-owned banks of more than 40%, but so have rather less fortunate Romania and Bulgaria (EBRD 2000).

Since the mid-90s foreign banks have gained more and more importance in the applicant states. Whatever the associated resentments, financial markets have improved during that period. Domestic credit to enterprises (in % GDP) has increased or has been stable with figures from 10 to more than 40%. Only the Czech Republic observed a considerable decline from 48 to 44% after the 1997 currency crisis, albeit it still has the highest level (EBRD 2000). But the Czech Republic also has a high share of non-performing loans in relation to total loans with more than 30%, again rising after 1997, only surpassed by Romania (37%) and the Slovak Republic (40%). But the general picture is rather positive. The same holds for other indicators such as the EBRD index of banking sector reform and the EBRD index of reform of non-banking financial institutions. Foreign entry has improved market efficiency and further progress can be expected.

The question whether or not foreign ownership is welcome will not be posed, because the acquis communautaire does not allow any restrictions that violate the internal market, in particular the freedom of capital. Hence, it will be important to manage the financial integration and consolidation. The most important lesson might be to ensure diversity – i.e., to prevent being dominated by few major players. The most viable way to do so, seems to pursue the integration into the European capital market, where huge domestic financial institution (foreign owned or not) shrink to one of many fish in a bowl.

2.3. Institutional development

Institutions do matter. Markets develop their full potential only when in place are appropriate rules which hinder or limit detrimental behavior of market participants. Transaction costs rise when rules and framing institutions are missing, making especially those transaction unprofitable that require high institutional standards. Ordinary spot transactions, such as buying a standardized good, can be easily monitored and enforced and thus require only few institutional prerequisites. The more monitoring and enforcement become

problematic, for instance because the transaction comprises deals now and in the future, the higher standards are needed or the higher transaction costs rise respectively.

Financial transactions are among the most demanding contracts. Even common credit and loan relations have several distinct points of execution, such as the initial transfer to the debtor and the following interest and repayments. More advanced contracts do not specify the due amount but have some residual claims like stocks, where dividends are paid as a share of profit less interest. Any investment now relies on the expectation that the counter-party is willing and able to fulfill its commitment in the future. Trust is needed, and trust grows the stronger and reliable institutions are.

Capital markets basically suffer from three variants of contract problems:

- ex ante, the price might not reflect the fair value of the asset – for instance, the interest rate charged might not sufficiently reflect default risk. Moreover, a raising interest rate may drive good risks out of the market and hence worsen the pool of remaining risks with a loss in total return (cf. Akerlof 1970, Stiglitz and Weiss 1981),
- ex post, contract-parties may change their behavior – e.g., the manager of a firm which has firstly issued stocks, might turn away from value-maximization in favor of perquisite consumption and asset stripping. The loss in firm value is often dubbed as agency cost (cf. Berle and Means 1932, Fama 1980),
- again ex post, contract-parties may renegotiate the terms of the deal and may get away with it, given that the other party has little outside options – i.e. the deal has a high degree of specificity (cf. Williamson 1985, Blanchard and Kremer 1997).

Institutions have evolved to reduce the potential of these. There are laws and regulation that require to report truthfully and to comply with contract terms; norms and values structure behavior that is not subject to legal action, and contract-parties may find it to be in their own interest to behave honest and trustworthy, if only to gain reputation and other favorable signals for future business (cf. Williamson 2000).

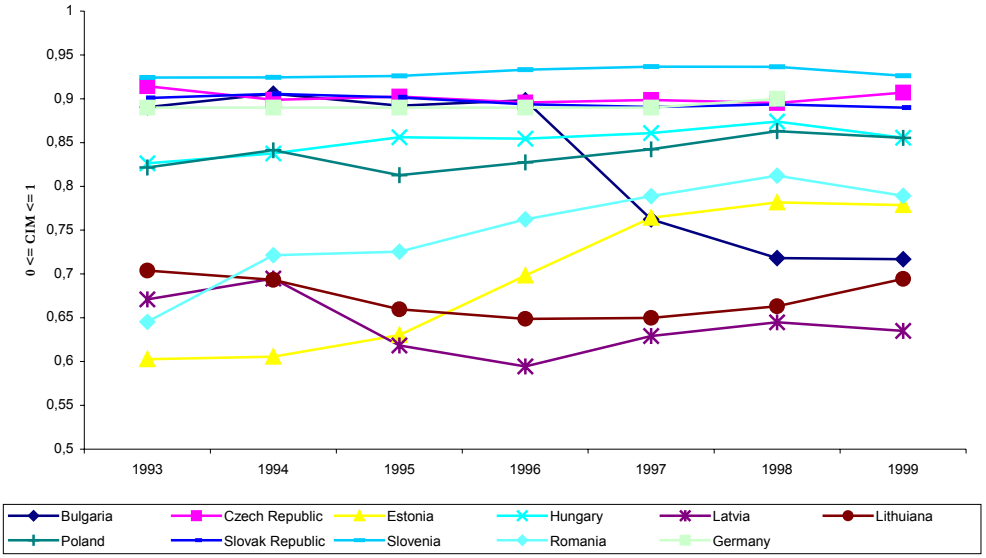
Most CEEC have by now adopted commercial law and regulation quite similar to that of mature economies. In fact, some just transferred the respective codes to new grounds. But there is still a significant discrepancy between law on the books and its effectiveness. A glance at the EBRD's transition indicators may be illuminating. It may be true that financial transition indicators may be high in general, though, with regard to securities markets and non-bank financial institutions – i.e., the more advanced parts of a financial system – these indicators are lower, on average two notches (EBRD, 2000). Moreover, with regard to the legal framework – i.e., commercial law and financial

regulation—it is important to note that there is still a difference between extensiveness and effectiveness according to the respective indicators, extensiveness being ranked usually 0 to 3 notches higher than effectiveness (EBRD, 2000). Enforcement of rules seems to be the crucial ingredient of capital market development.

A glance on the institutional development is allowed by the calculation of the CIM indicator (contract-intensive money) as proposed by Clague et al (1999). Chart 7. displays the CIM for the 10 CEEC plus Germany as a reference.

Chart 7.

Contract-intensive money in the CEEC



Source: International Monetary Fund 2001, own calculations.

Joining EMU affects the institutional framework in multiple ways. The acquis includes a wealth of laws and regulation that has to be adopted by the prospective members. The European Commission will monitor if these are only adopted on the book or put effectively into practice. By the same token will financial markets monitor these efforts and will reward success by lower real interest rates. Failure to improve the institutional framework would mean constant perhaps even higher real interest rates which might lead to a violation of the Maastricht convergence condition on long term interest rates. Thus, the incentive to enforce an appropriate institutional framework is strengthened.

Whenever institutions are discussed the role of the state in providing these is often emphasized. With regard to features such as laws, regulation, supervision, and legal system this pronounced position is evident. Why then is the enforcement of certain institutions still a problem? The usual responses include arguments that highlight the legal tradition, respectively that it takes time for

The CIM calculates the ratio between contract-intensive forms of money – i.e., non-currency money – and total money supply. Non-currency money is estimated with a broad M2 definition and total money as currency held outside banks. The CIM is used as a proxy for institutional quality, because longer-term commitment, such as savings deposits, are only accepted when people feel that their property rights are respected. Without trust, they would hold only very short-term assets or cash, including foreign currency. Hence, the higher the CIM the more contract-intensive forms of money are used in relation to total money supply, and hence, the more confidence in the financial system and its institutions can be seen. The average CIM for the CEEC (not weighted) amounts to 0,8 as opposed to 0.9 in Germany. However, the regional dispersion is quite interesting, albeit data comparability and quality is certainly a caveat. The Baltic States score lowest; only Estonia shows a remarkable increase starting in 1995. Bulgaria exhibits the sharpest fall, whereas Romania managed a considerable increase, though from a low level. Slovenia and the Czech Republic have similar and above values than Germany (see Chart 7.).

Joining EMU affects the institutional framework in multiple ways: the acquis includes a wealth of law and regulations that has to be adopted by the prospective members. The European Commission will monitor if these are only adopted on the book or put effectively into practice. By the same token, financial markets will monitor these efforts and will reward success by lower real interest rates. Failure to improve the institutional framework would mean constant, perhaps even higher, real interest rates, which might lead to a violation of the Maastricht convergence condition on long term interest rates. Thus, the incentive to enforce an appropriate institutional framework is strengthened.

Whenever institutions are discussed the role of the state in providing these is often emphasized. With regard to features such as law, regulations, supervision, and legal system this pronounced position is evident. Why then is the enforcement of certain institutions still a problem? The usual responses include arguments that highlight the legal tradition, respectively that it takes time for new institutions to evolve, or argue that it might not be in the interest of politicians to change the status quo because private benefits more than compensate for the loss in welfare. True as they are, these answers seem not entirely convincing. The involvement of the private sector may be the missing link.

The state is not the only one to put institutions into practice. An appropriate law might be in place as well as trained judges and lawyers; however, it still requires a plaintiff. If trails are cumbersome and time and money consuming, private parties might abstain from suing even if chances to win are high. Moreover, they might abstain from business that might require the enforcement of claims via the courts. But in particular with respect to rather vague institutions such as norms, values, and ethical behavior, private enforcement is crucial. Cheating during a deal might not be legally traceable – or the costs of doing so are prohibitively high – but impairs future business.

With the promise of the euro in the applicant states, foreign investors are attracted by monetary stability and profitable investment opportunities. They may also change the way institutions are enforced. Foreign investors have presumably less possibilities for private benefits – i.e., they require fair and honest transactions more than domestic investors do. Note, we all are only in it for the money, but the average foreign investor, given the lack of a domestic network, might maximize its profit under developed financial and legal institutions. Moreover, big international and institutional investors might take legal actions even if they do not pay off as a stand-alone project. But their size and time horizon allows them to internalize the positive external effect in the form of an improved legal (enforcement) system.

EMU will integrate the applicants in CEE into a European capital market where a certain set of formal and informal rules apply. The acquis requires the fulfillment of the formal side, whereas market participants enforce formal and informal rules. Of course, international investors will try to exploit institutional deficiencies in the same way as locals, but they might have less scope to do so compared to domestic incumbents, with their established connections and networks. It will be important to keep pace with this development in order to ensure that internationals work to support the institutional setting instead of exploiting it.

Conclusions – don't fight it

Capital markets in Europe are changing toward a more open-market approach, and so are the capital markets in the CEE applicant states, albeit they are still in process of transformation. An open market solution is generally regarded as a more efficient solution in terms of allocation and corporate governance, but might also increase financial volatility. Institutional quality, such as the guarantee of property rights, sufficient competition, and so forth, plus macroeconomic stability, are necessary to mitigate volatility.

Eastward enlargement of the European Union includes the CEE applicants to this development. The adoption of euro promises monetary

stability, the accompanying mandatory conditions require fiscal austerity and an institutional upgrade to western European levels. In that sense will the arrival of euro strengthen the process toward markets and accommodate it by providing institutional quality and macroeconomic stability.

The downside might be that any deviations from this train would become more costly. A very early reliance on markets and deregulated banking might not suit the transforming economies, which, due to their volatile economic development, might prefer a more interventionist stance. Exuberances and downward spiral is sometimes part of financial market. Apparently small causes might trigger destabilizing capital flows, which increase economic volatility. CEE applicants are in particular exposed to foreign funds, and it will be important that potential triggers from the financial system or corporate sector will be suppressed.

A financial crisis would hurt the CEEC anyway, but euro somehow increases the bets: euro raises expectations in the form of macroeconomic, monetary, and institutional stability, which fuel optimism and capital inflows. This enthusiasm might easily overshoot. However, if the high hopes would be disappointed or adjusted to reality, enthusiasm might turn sour and capital flows might even undershoot a long-term level and cutting the CEE applicants of financial resources. The euro improves access to international capital at lower cost and facilitates integration into the European financial market, however, failure to keep pace with this development might also incur much higher cost, which is the very logic of this process.

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Dominik Sobczak*

Impact of establishing the Economic and Monetary Union on stock markets in Europe

Introduction

Economic integration within the European Union (EU) takes place on different levels and in various spheres of activity, among them in financial sector. However, tightening the co-operation of financial institutions over the borders of particular Member States was not happening with significant speed until the process of establishing the Economic and Monetary Union (EMU) began. One of the key reasons for monetary integration in the EU was the need to ensure free movement of capital, therefore, not surprisingly, this was a true turning point in the development and integration of all sectors of financial markets in the whole Europe, and, among these, the stock markets.

The core aspect of monetary integration in the European Union was, naturally, the introduction of a single currency – euro. Nevertheless, in order to ensure proper and stable operation of the EMU, certain economic adjustments preceding the withdrawal of national currencies in Euroland, as countries belonging to EMU are sometimes called, needed to be carried out. The necessary convergence applied both, to monetary and fiscal policies in EMU future members, influencing, in effect, and changing the whole environment in which financial markets were operating.

In this work, however, attention will be paid only to one sector of financial markets – the stock markets. Within this, several aspects will be discussed, starting with the state of art before the single currency was introduced. Nevertheless, the core of the essay will be dedicated to the influence which establishing of EMU had on stock markets in Euroland, but also in EU Member States remaining outside EMU, mainly due to the position of London as a major European financial center. In the final part, the situation on stock markets in accession countries, with concentration on Poland, will be presented, together with prospects for these markets in the view of future membership in the EMU.

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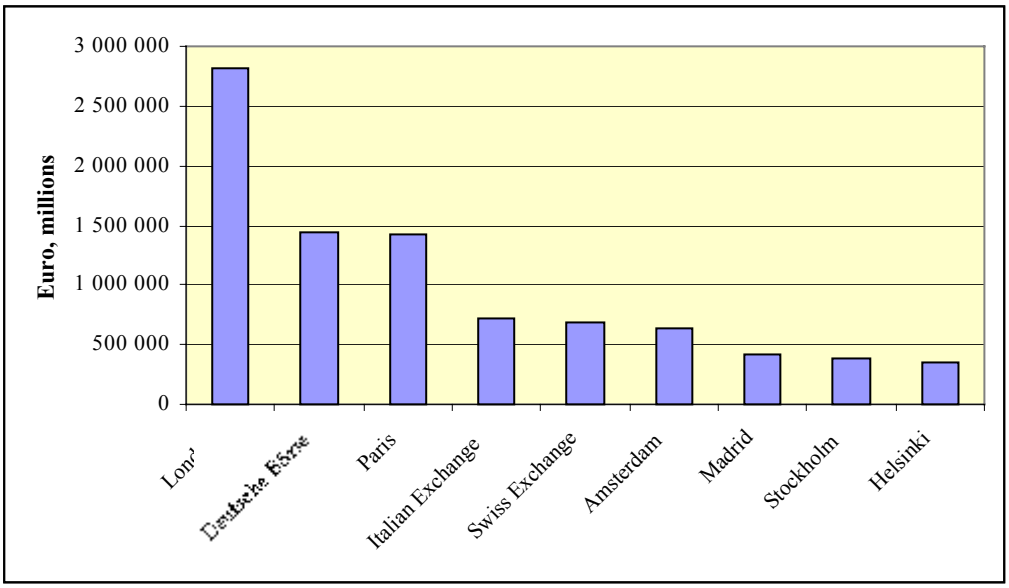
1. Overview of stock markets in Europe before establishing EMU

Legal framework for the EMU was created by the Treaty on the European Union, signed in Maastricht on 7th February 1992, which stipulated three stages of establishing the EMU[129]. However, although already the realization of the second stage had certain influence on stock markets in the EU, monetary integration was completed in the final stage, which started with the beginning of 1999. Therefore, as the starting point for discussion on the impact of EMU, the situation on stock markets in the second half of the 1990s will be presented.

1.1. Major stock exchanges in Europe in the second half of the 1990s

In the second half of the 1990s there were three major stock exchanges in Europe, situated in three top financial centers (Chart 1.).

Chart 1. Market capitalization of major European stock exchanges in January 2000



Source: *European Stock Exchange Statistics, January 2000*, Federation of European Stock Exchanges, www.fese.be

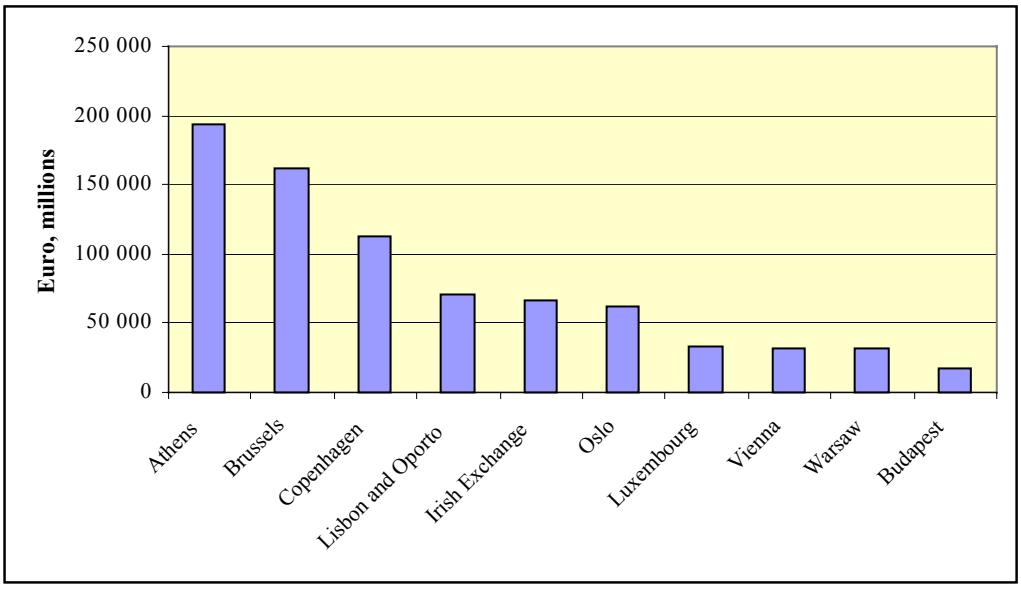
Definitely the biggest one was the London Stock Exchange (LSE), which was the first choice of most companies wanting to list on a foreign market. In

[129] Treaty on the European Union, also called Treaty of Maastricht entered into force on 1st November 1993. For details concerning the three stages of monetary integration see R. Woreta, J. Zombirt *Unia Gospodarcza i Walutowa* in: E. Kawecka-Wyrzykowska, E. Synowiec (ed.), *Unia Europejska. Przygotowania Polski do Członkostwa,* Instytut Koniunktur i Cen Handlu Zagranicznego, Warsaw 2001, p. 419-420.

London there was also a large derivatives exchange called the London International Financial Futures and Options Exchange (LIFFE). Another important financial center was Frankfurt am Mein with the largest bourse for trading shares in continental Europe – the Deutsche Börse, which also controlled German Options and Futures Exchange (Deutsche Terminbörse). The third largest financial center was Paris with the stock exchange Bourse de Paris and derivatives exchange Marché à Terme International de France – MATIF.

In Europe there were also several stock exchanges of secondary importance located in other major European cities, such as Bolsa de Madrid, Borsa Italiana in Milan, the Stockholm Stock Exchange, the Swiss Stock Exchange, Helsinki Stock Exchange, Amsterdam Stock Exchange and Brussels Stock Exchange. Additionally, a few minor, but already developed stock exchanges were located in Copenhagen, Oslo, Athens, Dublin and Vienna. After the economic transformation in Central and Eastern Europe in the beginning of the 1990s, also in these countries stock exchanges were opened as a symbol of market economy. However, in the second half of the 1990s these markets were still fledgling.

Chart 2. Market capitalization of minor European stock exchanges in January 2000



Source: *European Stock Exchange Statistics, January 2000*, Federation of European Stock Exchanges, www.fese.be

In the second half of the 1990s also another trend could be observed in Europe as three markets were created specially for trading stocks of fast

growing small and medium size enterprises, operating mainly in new technologies. All three of them started trading in 1997. Easdaq was created in Brussels as a pan European market basing on the structure and trading system of Nasdaq. Euro Neuer Markt is an alliance of small traditional exchanges for high-tech enterprises comprising the German Neuer Markt, French Nouveau Marché and similar markets in Milan, Amsterdam and Brussels. The third of them is AIM.[130]

1.2. Barriers of internationalization of stock markets before establishing EMU

Before the establishing of the EMU internationalization of stock markets in Europe, as well as cooperation between stock exchanges and supervisory authorities was on a very low level. Such situation was a result of a number of barriers which discouraged investments in foreign stocks[131]. Due to this, investors, as well as companies which acquired capital by going public, concentrated on domestic markets.

One of the major hindrances of internationalization of trading stocks in Europe was the significance of country-specific risk, which was considerable due to different domestic currencies and different monetary and fiscal policies which were pursued in each country. Different currencies created exchange rate risk, a very important component of country-specific risk, as, due to fluctuations of exchange rates, the returns on capital invested in foreign stocks were much more uncertain and difficult to evaluate than domestic investments. To limit this risk, investors needed to hedge, thus increasing their costs, which led to decreased profitability of foreign transactions. Moreover, different currencies and fluctuating exchange rates created problems with comparability of prices between markets, which seriously limited the development of arbitrage transactions. Country-specific risk was also increased by different phases of business cycle in individual countries, which partly was a result of national monetary and fiscal policies. From the investors' point of view such situation required more work in order to decide on acquiring foreign stocks, as monetary and fiscal policies had to be analyzed separately in each country, where investing was considered. Monitoring economic situation and development prospects also required more work after the investment had been made. This additional work meant additional costs, thus domestic markets were far more attractive in that respect. Moreover, certain problems with assessing

[130] W. Aspadarec, *Tendencje konsolidacyjne i wyzwania przed polskim rynkiem kapitałowym w perspektywie integracji z rynkiem europejskim,* Bank i Kredyt 01/2002, National Bank of Poland, January 2002, p. 46.
[131] M. Dusza, *Rynek kapitałowy w Polsce: narodziny, pierwsze dziesięciolecie, perspektywy,* Biblioteka Menedżera i Bankowca, Warsaw 1999, p. 145-146.

the economic condition of individual companies also appeared due to differences in accounting and reporting rules and standards. Some barriers to internationalization of investing in stocks were also created by national legal regulations, as pension funds and insurance companies could allocate only a small share of their capital on foreign markets.

To a very large extent the above-discussed barriers were abolished by the introduction of the common currency, which will be discussed further.

2. Implications of the EMU for development of stock markets in the European Union

The establishment of the Economic and Monetary Union is expected to have a significant influence on the development of European stock markets, as it considerably changed the whole financial environment in the European Union, as well as conditions in which stock exchanges operate and investors make decisions. In fact, the discussed impact can be presented in three separate groups of implications, determined by three stages of establishing the EMU.[132]

The first stage began in 1990 and stipulated completing the introduction of free movement of capital, embarking on the process of building the common financial market and increasing cooperation of central banks in order to enhance coordination of monetary policies.

The remaining two stages had a much more significant influence on the development of stock markets in the European Union. The key features of the second stage entailed the obligation of countries eager to join the EMU to implement fiscal and monetary discipline in order to fulfill the convergence criteria agreed by the European Council in Maastricht. This process had very considerable implications for the stock markets, thus below its more detailed analysis will be given. Another crucial step towards the creation of EMU taken during the second stage was the establishing of European System of Central Banks, which took over the competences of national central banks in shaping monetary policy in EMU.

On January 1st 1999, at the beginning of the third stage, which culminated the process, the core of the Economic and Monetary Union was introduced, namely the single currency – the euro. It was introduced in two phases. In the first one, which lasted until the end of 2001, the single currency existed only in electronic transfers of capital among financial institutions, companies, etc. The introduction of the euro was completed when the currency appeared in material form on January 1st 2002, and national currencies were withdrawn within the following three months. From the stock markets point of view, embarking on

[132] E. Kawecka-Wyrzykowska, E. Synowiec (ed.), *Unia Europejska…*, op. cit., p. 419-420.

the first phase was crucial, as stock trading is carried out exclusively in dematerialized form. Due to the importance of the common currency for stock markets in Europe, its impact will be discussed in details below.

At the end of this part a hitherto observed influence of establishing the EMU on the situation on stock markets in the EU will be presented.

2.1. Consequences of the implementation of convergence criteria

Due to monetary and fiscal character of convergence criteria, their implementation did not, to a large extent, influence the institutional framework of stock markets in the European Union, but it created conditions for investors to increase their interest in trading stocks. The influence of each criterion was different, thus they will be discussed separately.

There are two fiscal criteria which are fixed. The first one states that, both planned and actual, budget deficit, measured in market prices, must not exceed 3% of the country's GDP. Moreover, the total public debt of a country must not be higher than 60% of GDP in the year preceding the qualification for entering EMU.[133] The latter criterion was eventually treated flexibly.[134] In the 1990s most countries of the EU experienced at least some problems with fiscal discipline, therefore, the discussed criteria implied often the need of reforming the structure of budgetary expenditures. Due to this, a serious limitation of treasury bonds and treasury bills supply in future EMU members was experienced, and investors were stripped of a significant proportion of their possibilities to allocate funds. In result, institutional investors, with large portfolios at their disposal, needed to find different investment possibilities, which created conditions for growth in other sectors of capital markets, among these, stock markets. Moreover, as fiscal policy remained after the creation of EMU in competence of national governments, the Stability and Growth Pact was agreed during the Summit of the European Council in Amsterdam in June 1997. This document obliges all EMU members to pursue the policy of balanced budget, and even to attempt to achieve a budgetary surplus in order to guarantee proper functioning of the EMU.[135] Provisions of the Stability and Growth Pact are the continuation of Maastricht fiscal criteria, guaranteeing their long-term effects on stock markets.

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[133] ibidem, pg. 423.

[134] In fact, in 1997, which was the reference year for fulfilling the convergence criteria, out of eleven countries qualified, only in France, Finland and Luxembourg the public debt stayed under 60% of GDP. In most others it varied between 60% and 75% of GDP. However, due to invitation of Belgium and Italy, whose public debt was over 120% of GDP, some specialist were saying that politics won with economics. For further details see: L. Oręziak, *Euro: nowy pieniądz,* Wydawnictwo Naukowe PWN, Warsaw 1999, p. 44.

[135] About Stability and Growth Pact read further in: L. Oręziak, *Euro*..., op. cit., p. 65-67.

The following two criteria concentrate on the monetary aspects of economy, as they refer to the stability of prices and the level of nominal interest rates. Their level is relative and defined depending on the best performing countries. The first criterion states that average inflation, measured in reference to consumer price index, in the year preceding the qualification for EMU must not be higher than 1,5 percentage point over the average value for three best countries in this respect. The second monetary target stipulated low long-term interest rates, represented by long-term treasury bonds, which should not exceed 2 percentage points over interest rates in three countries with the lowest inflation.[136] The impact of monetary criteria on development of capital markets is tremendous, as low inflation significantly contributes to increased stabilization of the economy, thus limiting the country risk, which was a crucial factor in investors' decisions on allocating a part of their portfolio on a foreign market. Low interest rates are also of prime importance for development of capital markets, as they mean mediocre returns on low-risk and no-risk fund allocation possibilities such as bank deposits, treasury bonds and treasury bills. In result, investors are more eager to take up risk in order to increase profitability of their capital, thus expressing greater interest in stock markets, among others.

The last condition for entering the EMU refers to stabilization of domestic currency, which should participate in the exchange rate mechanism of the European Monetary System for at least two years. During this period a currency may fluctuate in the +/- 15% band without any devaluations.[137] This criterion is also important for an institution considering making an investment on a foreign stock market, because it seriously reduces exchange rate risk, which plays an important role in judging a country-specific risk. Such conditions make any foreign investments safer, and returns better predictable.

It is also important to note that the general aim of imposing the fulfillment of convergence criteria on EMU Member States was to achieve and maintain economic convergence and stability in the whole Eurozone. Therefore, the establishment of the EMU was a significant incentive to boost internationalization of stock markets in this area.

2.2. Consequences of the introduction of the common currency

Introduction of the single currency in EMU countries had a wide range of consequences on the functioning of stock markets in the European Union, and, to some extent, also in the remaining European countries. The main area in which the impact of the euro can be observed is the evolution of importance of country-specific risk in investment decisions.

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[136] ibidem, p. 423.
[137] ibidem.

As it was presented above, the existence and significance of country-specific risk was one of the most important barriers of internationalization of capital markets in the European Union. In fact, the introduction of the euro to a large extent removed this type of risk. Why was it able to do so? The answer to this question is relatively simple: because existence of country-specific risk is closely connected with the existence of exchange rates, which are the consequence of different national currencies. Therefore, when the euro took over the functions of national currencies, all aspects of country-specific risk connected with exchange rates were removed.[138] Another source of country-specific risk is connected with differences in national monetary policies. As, concurrently with the introduction of the single currency, shaping the monetary policy in the whole Eurozone was ceded to a single institution – the European Central Bank (ECB), this source of country-specific risk also disappeared. The effects of differences in phases of business cycles were also weakened due to the fact that, as research results show, countries with aligned monetary policies experience stronger business cycle co-movements.[139] However, the synchronization of interest rates in the EMU eliminated also an important source of cross-country variations in stock returns. The effect of this factor on internationalization of stock markets within the EMU is difficult to assess. On the one hand, shrinking differences between countries lower country-specific risk, thus contributing to internationalization. However, on the other hand, looking for higher returns on capital is one of important reasons for investing abroad, therefore foreign markets become less attractive, and investors may tend to prefer, better known, domestic markets.

Establishing the EMU, however, did not entirely eliminate country-specific risk, as there are also other factors contributing to it. To this group belong specific regulations which were left in competence of national authorities. Primarily, this is, although unified to some extent by convergence criteria, fiscal policy within which the biggest importance is attached to taxation systems, which vary significantly among EMU countries. Within the Euroland there are also discrepancies in approach towards social policy, which result in different social security measures, pension systems and labor market regulations. From the investors' point of view one more factor is important – slightly varying accounting rules and standards. All the above aspects of economic environment contributed to preservation of country-specific risk, though in a limited scope. However, there is also one factor connected with the introduction of the euro which in fact increases country-specific risk. Monetary

[138] L. Oręziak, *Euro…,* op. cit., p. 121.
[139] I. M. Arnold, *Country and Industry Effects in Euroland's Equity Markets* in: J. J. Choi (ed.), *European Monetary Union and Capital Markets,* Elsevier Science, United Kingdom 2001, p. 138.

policy is now the same for all Euroland countries, but some regional differences in monetary transmission mechanisms remained. Due to this, economies of different countries may react slightly differently to the same monetary instruments, which may result in monetary policy shocks in individual EMU members.[140]

Nevertheless, the introduction of the single currency and common monetary policy made the EMU much more attractive for institutions investing on a global scale, because the whole area received the rating of AAA, which means that the EMU as a whole is rated as an area of no country-specific risk, therefore it is maximally safe.[141] This fact should considerably contribute to development of stock trading in the EMU in the long run, as investors should express greater interest in allocating capital in this area.

Due to the fact that country-specific risk played an important role in investors' decisions, with its considerable reduction resulting from monetary integration, the significance of that type of risk was expected to decrease. Empirical research, together with queries among investors, confirmed these forecasts. In the beginning of the 1990s, country effects were much more important for investors than industry risk. However, with the approach of euro-launch the gap was consistently narrowing, and already in the first year of the operation of EMU industry effects surpassed country effects as far as investment risk is concerned, which is naturally a very positive stimulus for increasing internationalization of capital markets within the Eurozone. However, in this respect, one threat arises. EMU may lead to higher geographical specialization among participating countries, which in effect may become less diversified, thus increasing the exposure to industry risk.[142]

The creation of EMU, in the long run, should also have a positive influence on the development of stock markets due to more general factors. They are mainly connected with expected increased profitability of enterprises due to higher incomes from the sales of goods and services in the whole Eurozone, together with elimination of costs related to currency exchange and hedging transactions. Moreover, lower financing costs are also expected due to increased competition among financial institutions and lower interest rates resulting from budgetary discipline.

2.3. Situation on stock markets in the European Union since the introduction of euro

At the threshold of the euro-launch, it was expected that in the first few years the introduction of the common currency will not stimulate the

[140] ibidem, p. 138.
[141] M. Dusza, *Rynek kapitałowy w Polsce...,* op. cit., p. 146.
[142] I. M. Arnold, *Country and Industry Effects…*, op. cit., p. 147.

development of stock markets to a large extent. These expectations proved generally correct. There are two main reasons for this. First of all, companies tend to look for capital on the best-known markets, as this guarantees the biggest liquidity. Therefore they concentrate on their domestic markets, only occasionally selling their shares abroad, and the elimination of currency risk is not likely to change this tendency soon. On the other hand, investors' activeness is more tightly connected with macroeconomic situation and global tendencies than with currency in which securities are denominated.

Nevertheless, although the situation on European stock markets remained in line with tendencies observed in the United States and Japan, the approach towards managing portfolios changed considerably. Due to elimination of currency risk, investors started to pay more attention to industry risk, thus concentrating on sectoral analysis of stocks and turnover on individual markets. Moreover, sectoral analysis is more and more often carried out in a pan European perspective. Such attitude is currently declared by over 75% of institutions involved in trading stocks.[143]

The spell of time during which positive conditions created by the introduction of euro will be transferred into development of capital markets in the EMU, demonstrated by significant increase of market capitalization, volume of trading and number of IPOs (Initial Public Offerings), will depend on the speed of creating a true unified economic area. It must be kept in mind, however, that differences in taxation systems, production costs and competitiveness of enterprises will be difficult to eliminate in a short period of time.[144]

3. Consolidation tendencies within stock exchanges in the European Union

As it is described above, the introduction of euro, as of yet, has not had any direct impact on increasing the capitalization and volume of trade on stock markets in the European Union. This does not mean, however, that creation of EMU had little impact on stock markets as a whole, as it acted as a crucial stimulus of institutional changes. It was not a reason for these changes, but it was a key condition which enabled them, and sped them up, because all stock exchanges in the EMU started to carry out all transactions in the same currency.

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[143] J. Zombirt, *Wpływ euro na rynki kapitałowe,* Bank i Kredyt 06/2002, National Bank of Poland, June 2002, p. 16.

[144] L. Oręziak, *Euro…,* op. cit., p. 122.

3.1. Reasons and conditions of consolidation among European stock exchanges

The changes in the institutional framework of European Stock markets mainly refer to increased cooperation of stock exchanges operating in different countries, which led to mergers, acquisitions and alliances. There were several reasons for which various stock exchanges in Europe decided to give up a considerable portion of sovereignty in order to find partners abroad. In globalising financial markets the biggest stock exchanges fight for domination, therefore European stock exchanges experience a very strong competitive pressure from American exchanges. This means that they constantly need to adjust their trading systems and legal regulations to create the best possible conditions for investors, which means liquidity, wide range of shares and low commissions. This requires considerable outlays. The stock exchanges, however, were unable to raise adequate funds for that purpose and for creating new ownership relations without additional sources of financing, which, since the year 2000 brought up a wave of privatizations among stock exchanges in Europe.[145] The first to privatize was the Stockholm Stock Exchange. The other major stock exchanges went public in 2001, among them: London Stock Exchange, Deutsche Börse, Euronext, Borsa Italiana, LIFFE and several smaller. The shares of most exchanges are quoted on their own markets, while the trade of some stocks, like London Stock Exchange, is carried out on a separately established, specialized market organized by some brokerage house.[146]

As the largest exchanges fight for the world supremacy, smaller ones strive for survival, thus they look for strong partners. To understand the process, which has been going on in Europe within the last few years, it is also crucial to realize, that the more shares are traded on an exchange, the more its revenues rise and the greater its bargaining power when it comes to defending or instigating a merger or takeover. Therefore all, small, medium, and the biggest exchanges are interested in consolidation. However, this requires stock exchanges to become regular enterprises, which operate in a very competitive environment and concentrate on profits, thus they must cut costs and boost revenues.[147]

Nevertheless, though the single currency was introduced and the exchanges acquired capital necessary to participate in the consolidation process, one important barrier, which hampers the creation of a pan European market, still remains – different clearing and settlement systems which are used by

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[145] W. Aspadarec, *Tendencje konsolidacyjne...*, op. cit., p. 46.
[146] *Stan przygotowań polskiego rynku kapitałowego do integracji z Unią Europejską*, Komisja Papierów Wartościowych i Giełd, October 2002, p. 30-31.
[147] W. Aspadarec, *Tendencje konsolidacyjne...*, op. cit., p. 44-45.

major European stock exchanges, because transaction and settlement costs between different systems are even ten times higher than within the same system. There are four major systems[148]:

- NSC – used by stock exchanges aligned in Euronext; stocks are traded in this system also on Chicago Mercantile Exchange, BOVESPA in Sao Paulo – the biggest exchange of South America, Toronto Stock Exchange and Warsaw Stock Exchange,
- Xetra – used by the Deutsche Börse,
- SETS – used by the London Stock Exchange since 1997,
- Saxess – used by OM Group on the Stockholm Stock Exchange.

However, although since 1999 the consolidation process of European stock exchanges accelerated significantly, the creation of a pan European stock market still remains a dim perspective, although in the year 2000 the probability of its fast creation seemed high. Apart from some institutional barriers, which are described above, its main cause still lies in aversion of major bourses management to partially give up sovereignty, which is necessary for the consolidation process. Nevertheless, the continuation of consolidation seems inevitable, because there are far too many stock exchanges in Europe, which makes them cost-ineffective and results in low liquidity. In fact, various European specialists on capital markets believe that within a few years only 3 to 5 bourses will remain in Western Europe.[149]

3.2. Cooperation of stock exchanges in the European Union since the introduction of euro

As the consolidation process among European stock exchanges accelerated since the establishment of EMU, the picture of the institutional framework of European stock markets changed considerably. The most important event on this scene took place on 22nd September 2000, when Paris, Amsterdam and Brussels stock exchanges agreed on the establishment of a holding company Euronext N.V. on the basis of a strategic alliance, which also entailed derivatives markets of these three financial centers. Since than, Euronext has been a very active player on the European scene. In January 2002 Euronext completed the takeover of a major derivatives exchange based in London – LIFFE, and in February of that year an alliance with BVLP – the Portuguese Stock Exchange was finalized. Currently, the exchange is also conducting advanced alliance talks with the Helsinki Stock Exchange. When

[148] *Stan przygotowań polskiego rynku kapitałowego...*, op. cit., p. 30.

[149] In fact, Jean-François Théodore, chairman of Euronext, estimates that the number of bourses in Western Europe will be reduced to 3-4, while Peter Lewis of Société General predicts 4-5 stock exchanges to survive. For further details see: T. J. Kim, *European capital markets : integration towards the core*, Euromoney Books, London 2001, p. 21-23.

the already initiated unification process of Euronext members is completed, there will be a single trading platform for all trading members using the NSC system for equities and LIFFE-CONNECT for derivatives. The settlement system will also be unified, while there will be a single clearing house acting as central counterparty, and thus guaranteeing payments and delivery for all market transactions. Finally, there will be a single order book for all markets for each security or financial product, making for greater transparency and liquidity. These improvements will generally make trading within Euronext more efficient and less expensive.[150] Dr Jacek Socha, Chairman of the Polish Securities and Stock Exchanges Commission, is of the opinion, that Euronext may become a true pan European market, but it needs to enter into alliance with Bolsa de Madrid and Borsa Italiana in Milan. However, to attract these exchanges, Euronext must cease to be identified as the French proposal for Europe, and must gain the image of a transnational stock exchange.[151]

The Deutsche Börse is the second major European stock exchange which participates in the consolidation process. There are two main international projects which were launched with cooperation of the bourse from Frankfurt – Eurex and Newex. Eurex was originally created in December 1996 as a joint venture project between the Deutsche Börse AG and the Swiss Stock Exchange, Schweizer Börse, but it was formally established in 1998 after the merger of DTB Deutsche Terminbörse (German Options and Futures Exchange) and SOFFEX (Swiss Options and Financial Futures Exchange). The object of this merger was the development and realization of a joint platform for the two options exchanges as well as the harmonization of their services and product ranges. Eurex offers a truly international market and is the only fully computerized trading and clearing platform for derivatives which offers a wide range of standardized, innovative products with worldwide access. It is not only a top derivatives market in Europe, but in 1999 it became also the largest in the world.[152] Newex was created as a joint venture with the Austrian Exchange in Vienna with the aim of building a platform for trading equities of Central and Eastern European (CEE) companies. In this way Newex proposed an alternative for domestic capital markets and London Stock Exchange. The bourse was situated in Vienna and started with listing 90 companies from Russia, Hungary, Czech Republic, Austria, Poland, Slovakia and former Soviet Republics. By mid 2001, however, the average turnover achieved less than 1 million US$, and the market remained stagnant. Hitherto, Newex was unable to attract attention of CEE companies, which preferred domestic markets, and those wanting to list

[150] *Euronext: organisation and procedures*, Euronext 2002, p. 4, http://www.euronext.com/extra/pdf/euronext_organisation_12_2002_en.pdf
[151] *Co powie Londyn*, Gazeta Wyborcza 31.10 – 01.11 2002, p. 30.
[152] *Eurex*, Deutsche Börse AG, January 2002, http://deutsche-boerse.com/ir

abroad turned to markets giving bigger prestige, like London or New York. However, some CEE stock exchanges accused Newex of stealing listings due to its aggressive practice of quoting companies without their agreement. Altogether, the initiative is not very successful, and last year it was moved to Frankfurt with the hope, that this renowned financial center will add prestige to the Newex stock exchange.[153]The London Stock Exchange remains the only leading European Stock Exchange, which hasn't yet embarked on consolidation process. An attempt, however, has been made to merge with the Deutsche Börse, but, due to high ambitions of each exchange, there were problems with agreement on the terms of merger, mainly concerning the selection of instruments which would be traded on each bourse. However, the collapse of the project, which would create by far the biggest stock market in Europe, does not seem to discourage both bourses, as currently there are rumors that the negotiations were taken up again.[154]

In Europe there is also one more, important alliance of stock exchanges, which is gathered around the Stockholm Stock Exchange. Formal agreement which established the Nordic Exchanges NOREX was signed on 21st January 1998 by the Stockholm Stock Exchange and Copenhagen Stock Exchange. The alliance was expanded onto the Icelandic Market in June 2000 and Oslo Börs in October 2000. In may 2001 Norex also embarked on cooperation with Baltic stock exchanges in Riga, Tallinn and Vilnius. Since June 1999, the only trading system used by Norex members is Saxess, which was developed by the Stockholm Exchange. In spite of the common trading system, Norex exchanges also operate under the common regulatory framework. It is also important that Norex exchanges work in line with the principle of single point of liquidity, which means that each company is quoted on only one Nordic exchange.[155]

Some movement could also be observed among markets for high-tech companies, as in June 2001, as a result of the purchase of 58% stake in Easdaq by the American exchange Nasdaq, Nasdaq Europe was established with premises in Brussels. Following the creation of Nasdaq Japan, with this deal Nasdaq continues to build a global stock trading market, which could operate 24 hours a day, moving from one continent to the other. This new stock exchange may prove a strong competition for the biggest European exchanges, as several major financial institutions from Western Europe and United States are involved in the project, and already 75% of all shares traded on Nasdaq Europe are also listed on Nasdaq.[156]

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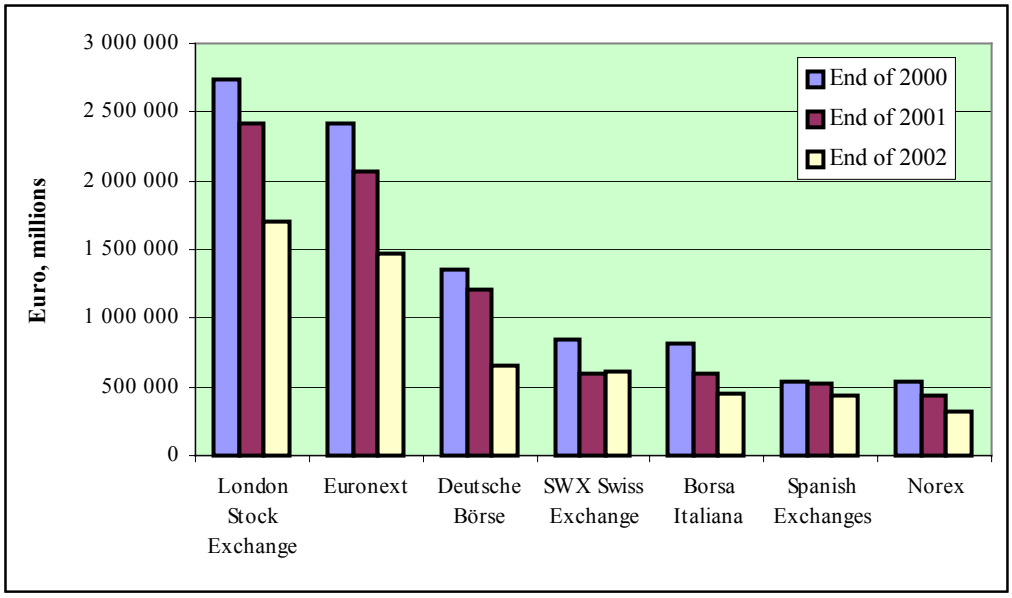
[153] T. J. Kim, *European capital markets*..., op. cit., p. 24.
[154] M. P. Garapich, *Powstanie największy rynek w Europie?*, Parkiet, 18-20 January 2003, p. 10.
[155] *Key dates* and *Norex vision*, Norex 2002, www.norex.com
[156] W. Aspadarec, *Tendencje konsolidacyjne*..., op. cit., p. 46.

3.3. Comparison of major stock exchanges in Europe

The size of stock exchanges can be compared using different figures. In this work three categories will be presented and discussed: market capitalization, total value of equity trading, and the number of listed companies.

As far as market capitalization is concerned, two stock exchanges definitely dominate on the European scene: London Stock Exchange and Euronext. Although, in the period 2000-2002 the capitalization of bourses in Europe significantly decreased, these two still remained on top. The gap between them also only slightly narrowed. Basing on Chart 3. an interesting observation can be made about Deutsche Börse, whose capitalization dropped the most, and about Swiss Exchange and Spanish Exchanges, whose capitalization decreased relatively less.

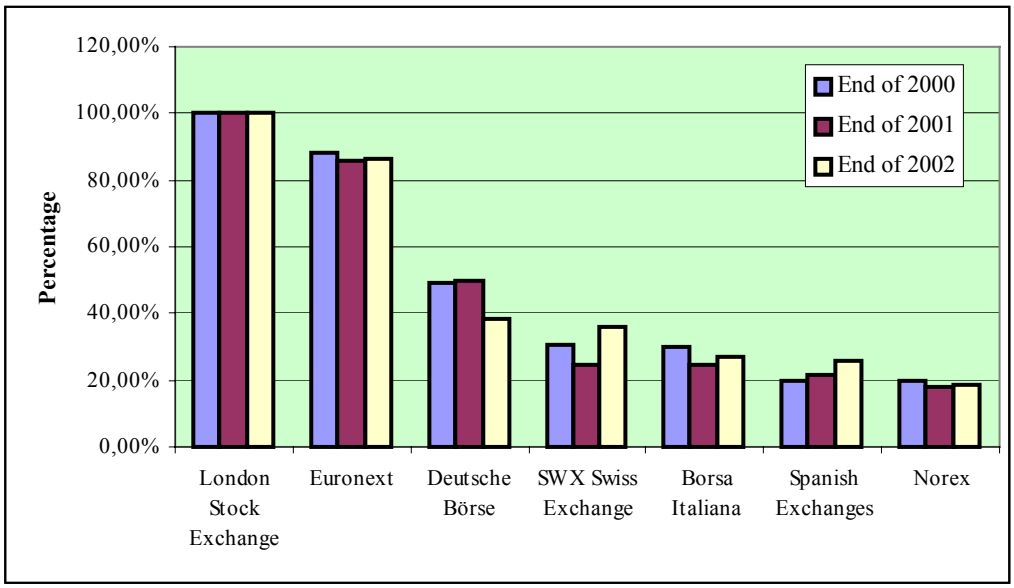
Chart 3. Market capitalization of major European stock exchanges 2000-2002



* Data for Norex capitalization for 2001 are taken from the November bulletin.
Source: *European Stock Exchange Statistics, December 2000-2002*, Federation of European Stock Exchanges, www.fese.be

The above observation is confirmed on Chart 4., as the share of capitalization of Deutsche Börse against the London Stock exchange dropped significantly, while the figures for the Swiss Exchange and Spanish Exchanges went up. The situation on the Swiss Exchange is particularly interesting from this work's point of view, as it remains outside the European Union.

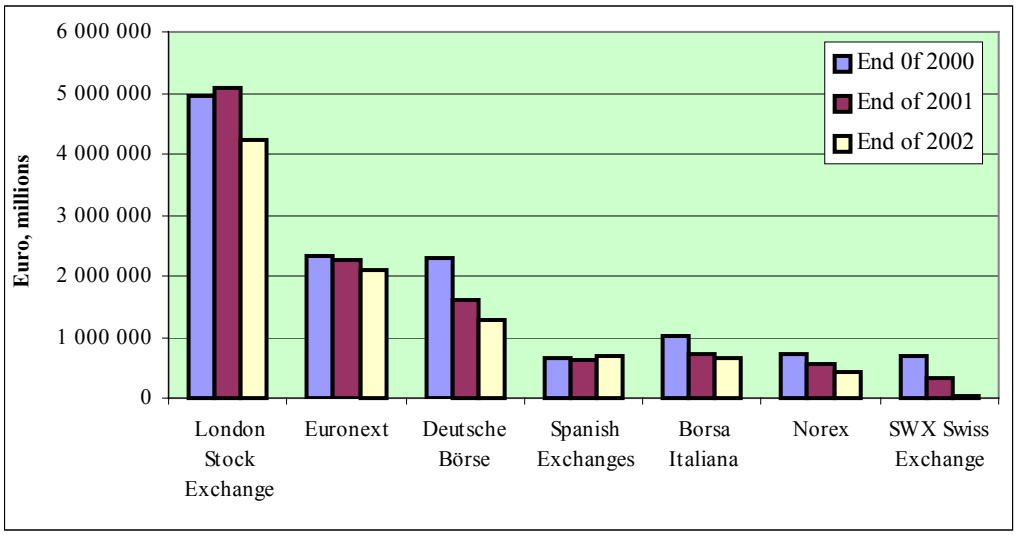
Chart 4. Market capitalization of major European stock exchanges as a percentage of market capitalization of the London Stock Exchange in 2000-2002



* Data for Norex capitalization for 2001 are taken from November.
Source: *European Stock Exchange Statistics, December 2000-2002*, Federation of European Stock Exchanges, www.fese.be

Data presented in Chart 5. are very interesting in relation to the introduction of euro, as certain conclusions can be drawn about the changes in the interest, which investors demonstrated towards particular stock markets. A few aspects require some comment here. First of all, it is evident, that some trading from London, but especially from Frankfurt shifted to Euronext, as in generally deteriorating value of trade, the latter lost only about 10% of its turnover, while London about 15% and Frankfurt over 44%. On the other hand, the Spanish Exchanges proved strong, and gained almost 4,5%. This confirms the conclusions from Charts 3 and 4. However, the situation on the Swiss Exchange is a true wonder, as within these two years its value of trade went down to just over 6% of the turnover in 2000. Keeping in mind that its capitalization dropped only by a little bit more than 25%, this is an extremely interesting observation, because this means that about 650 million euro worth of trade moved from Switzerland to the EU countries, and probably mostly to Euronext, as its position was the strongest of top three European exchanges.

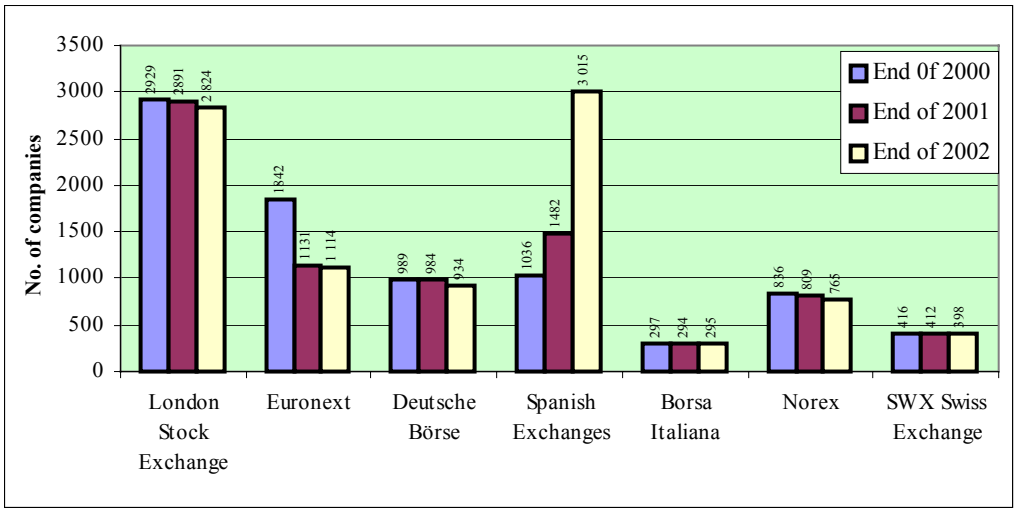
Chart 5. Total value of equity trading on major European stock exchanges in 2000-2002 (single counted)



Source: *European Stock Exchange Statistics, 2000-2002*, Federation of European Stock Exchanges, www.fese.be

In the comparison of stock markets it is also important to take into consideration the number of companies which are listed on each exchange. This has been done in Charts 6 and 7.

Chart 6. Total number of listed companies on major European stock exchanges in 2000-2002

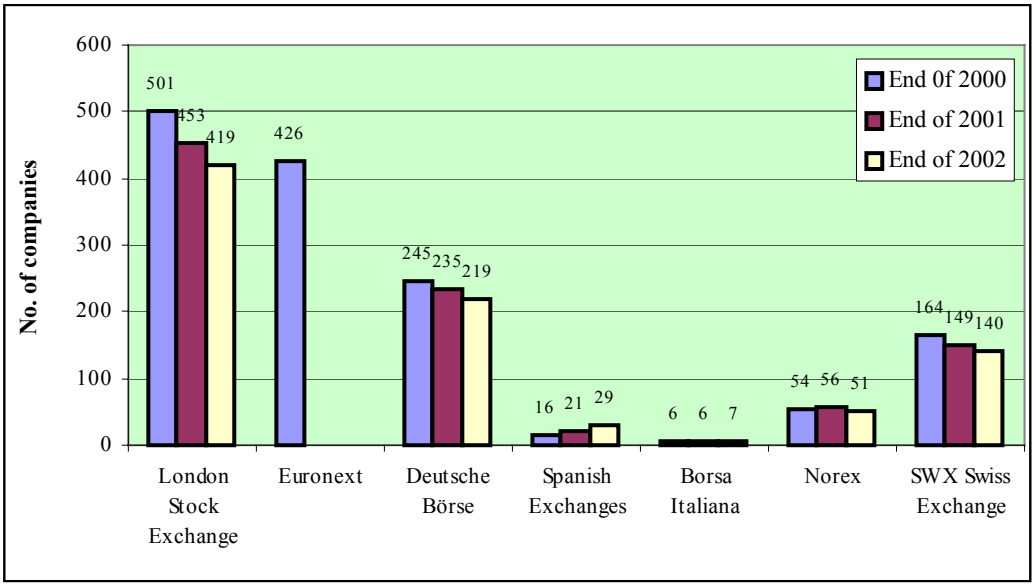


* Figures for Euronext for the years 2001 and 2002 include only the number of domestic companies, as data concerning foreign companies are unavailable.

Source: *European Stock Exchange Statistics, 2000-2002*, Federation of European Stock Exchanges, www.fese.be

Generally, the number of listed companies remained stable, with a slight downward trend, on most stock exchanges. Unfortunately, data for Euronext are incomparable, as only data for both, domestic and foreign companies, were available only for the year 2000. For the years 2001 and 2002, only the number of domestic companies is quoted. Once more, a surprising observation can be made about the Spanish Exchanges, where the number of listed companies nearly tripled within the analyzed two years. This information explains the conclusions from the above charts concerning the growing importance of this exchange on the European scene.

Chart 7. Number of foreign companies listed on major European stock exchanges in 2000-2002



* Data for Euronext for 2001 and 2002 are unavailable.
Source: *European Stock Exchange Statistics, 2000-2002*, Federation of European Stock Exchanges, www.fese.be

However, data presented in Chart 7. prove, that the increasing potential of the Spanish Exchanges come mainly from the domestic market, as only several foreign companies are listed there. The general trend within these two years implies that there was a decreasing interest of companies in foreign stock markets, as their number on each of the key bourses dropped between 10% and 17%. Surprisingly, despite the most considerably deteriorating situation, the Deutsche Börse noted the lowest decrease, which may provide evidence that the interest of companies shifted slightly towards the Eurozone. This conclusion could have found support in information from Euronext, but unfortunately, as it was already mentioned, there are no data in this respect.

As of yet, the situation in Italy and on Norex has not been elaborated, but it generally developed in accordance with the general trend in Europe.

4. Approach of bourses in Central and Eastern Europe towards consolidation

The three biggest bourses of the region are situated in Warsaw, Prague and Budapest. As it was pictured on charts in previous chapters, in comparison with top Western European bourses, the size of stock exchanges in Central and Eastern Europe, represented by market capitalization, average turnover and number of listed companies, is marginal. In fact, the capitalization of the Warsaw Stock Exchange (WSE), which is the biggest of the three accounts for about 1,3% of the figure for the London Stock Exchange (see Charts 1 and 2). In result, due to the prestige and far greater opportunities of acquiring capital, many domestic blue chips list their GDRs in New York and London, often giving domestic investors far less attention. In this situation, with the ongoing process of integrating financial markets in Europe, and near membership of these countries in the European Union, it will be extremely difficult for these small exchanges to retain sovereignty. Therefore, the only possibility to create viable equity market in the region seems to be some form of consolidation of several stock exchanges. Such bourse would be able to, to some extent, compete with bigger bourses from the EU, and would be a relatively equal partner in negotiating strategic alliances and mergers. Warsaw, Prague and Budapest stock exchanges seem to have varied opinions towards such idea. As Maria Dunavolgyi, the CEO of Budapest Stock Exchange (BSE), disclosed, they treat consolidation as a rather mid-term plan. She declared, that currently BSE is concentrating on increasing its attractiveness by tax incentives and introducing stocks in euro denominated accounts[157]. On the other hand, Jan Sykora, chairman of the Prague Stock Exchange, said that they tried to initiate talks with bourses in Warsaw, Budapest and Vienna, but their Boards of Directors were not eager to give up sovereignty.[158]

In fact, most institutional investors believe, that bourses in Central and Eastern Europe are fighting a rather losing battle to retain independence, and that they should seek to integrate into EU markets rather sooner than later. The directors of the Warsaw Stock Exchange seem to share this point of view. Actually, dr Jacek Socha, Chairman of the Polish Securities and Stock Exchanges Commission, said that attempts to create a CEE bourse are banned for failure, because Western direction is much more attractive for domestic

[157] T. J. Kim, *European capital markets*..., op. cit., p. 23.
[158] ibidem, p. 27.

markets due to prestige and possibilities to obtain capital. However, Warsaw Stock Exchange should not fear losing the blue chips to bigger bourses, as 70% of the total turnover belongs to domestic investors and it is unlikely that blue chips would be willing to lose such an investor base. [159]

Currently, the Warsaw Stock Exchange is considering privatization in order to prepare for consolidation with some bigger stock exchange from the Western Europe. In fact, negotiations about an alliance with Euronext are quite advanced at the moment, as the plan was already approved by the WSE Board. It is also likely that concurrently a separate agreement will be signed with the Lithuania's market, which would enable WSE to serve additionally as a bridge between western markets and Lithuania. An important stimulus to this deal is the same clearing and settlement systems in Euronext, WSE and the Lithuania's exchange, based on French NSC system. Another advantage lies in the fact that Euronext operates on a basis of an alliance, therefore stock exchanges retain a considerable proportion of autonomy. It is also worth mentioning, that, though WSE is the biggest market in the region, the offer from Euronext is the only one so far coming from the leading markets.[160] The deal with Euronext, however, is still uncertain, as apart from considerable advantages, the are also disadvantages of such a solution. First of all, consolidation with the London Stock Exchange would give much more prestige and possibility to obtain capital, and secondly, no Polish company is listed on Euronext, while several are quoted on LSE, therefore, even when the alliance with Euronext will come into force, some companies will still prefer to look for capital on LSE.[161]

Conclusions

The establishment of the Economic and Monetary Union considerably changed the conditions in which stock markets operate. Since the introduction of the common currency, the effects of these changes were limited in respect to gains in the value of trade and market capitalization. This was generally in line with expectations of specialists, as stock markets are more vulnerable to general macroeconomic factors, than political solutions. Nevertheless, it is expected in the long-term that the single currency and common monetary policy should act as strong stimuli for development of stock markets in the Eurozone. First signs of this could be already observed in the span of last two years, as stock markets

[159] *Co powie Londyn*..., op. cit., p. 30.
[160] Recently, an offer of alliance also came from the Helsinki Stock Exchange. The offer is currently profoundly analysed, and will be seriously considered by the WSE authorities. See: *Co powie Londyn*..., op. cit., p. 30.
[161] ibidem, p. 30.

of the EMU proved noticeably stronger, apart from Frankfurt, than the markets remaining outside the Eurozone. The best example for this was provided by the Swiss Stock Exchange, which lost most of its turnover within the period 2000-2002, as, not being part of the EU, it could not take advantage of certain facilitation of capital flows, clearing and settlements, which are available for London and Norex.

Nevertheless, the EMU already stimulated vivid movement towards consolidation among the European bourses as they tally to stand up to investors' expectations and competition from American stock exchanges. Considering the differences in clearing and settlement systems operating on the biggest European exchanges, the single currency considerably facilitated the process.

As far as the future of Central and Eastern European stock markets facing near accession to the EU and later to the EMU is concerned, the conclusion is similar to that for the current Eurozone members. These markets should continue their development, but in the short term, the impact of euro will not be strongly visible. However, as these markets are very small in comparison to the western counterparts, it will be very difficult for these exchanges to retain sovereignty, therefore in order to prepare well for the integration with the EU, they should quickly join the consolidation process taking place in Western Europe at the moment.

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Piotr Bańbuła*

EMU and CEE countries bond markets

Introduction

This work is divided into two parts. The first part analyses the effects of launching the euro on capital markets in the European Monetary Union, with a closer look at corporate and government bond market. The second part is contributed to present situation on capital markets in Central and Eastern European Countries and its prospects after implementing the common currency.

1. Euro as a part of European Integration

The new currency is a milestone in European integration and apparently has far-reaching consequences for Europe itself and for the rest of the world as well. Its importance is unprecedented in the world's history, as no other union has gone that far in the process of integration. Since its birth in 1999 the euro has managed to become an international currency, willing to take an American challenge. The dominant role of the dollar as an international currency and it's importance in bond markets provides the U.S. government with several advantages, such as "liquidity discount" and possibility of financing current account deficits in its own currency[162]. The EMU aims to obtain similar benefits from the euro as well. However, due to dynamic nature of the processes, it's true impact on world's economy may only be verified by time. Even now though, it is indisputable that the common currency will significantly alter economic environment of Europe, both in micro and macro scale.

First of all, the introduction of the euro is a vital part in creating big, pan-European market of goods, services, labor force and capitals. It enhances the deregulation process brought upon by the EMU, as it eliminates transaction costs and currency risk. In a nutshell, one market, with stable common currency, promises many benefits - transparent pricing, better allocation and lower cost of acquiring capital, increased competitiveness and efficiency, lower transaction costs, deeper and more liquid capital market. While the whole process is not cost-free, the most important task that awaits EMU countries is to satisfy all the requirements of the optimum currency area (OCA). The flexibility of wages and

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[162] J. Jay Choi, J. M. Wrase, *European monetary union and capital markets,* 2001, International Finance Review.

prices is still to be improved. The mobility of the workforce is also a major problem, as lack of going-after-job lifestyle and language barrier leave Europe far behind the USA in this field[163]. Furthermore, common monetary policy, with still existing differences in boom and bust cycles among the member states, may prove to be too liberal for some and too restrictive for others. Thus, deeper integration of the member countries seems to be the only option left.

2. Euro and capital markets

New, pan-European capital market created with the birth of the euro, is considerably deeper and more liquid than any of these in member countries. Firstly, stable internal price of the common currency and greater resilience to external shocks of the EMU as a whole, lead to reducing risk premium of the Eurozone, thus lowering the cost of capital in the area. Secondly, it provides its participants with longer-term horizons for their investment plans. The disappearance of national currencies has eliminated an important obstacle to capital flows, which will inevitably result in better allocation of funds and higher competitiveness.

It is already the case in intermediation sector. Due to the ease in price comparison, the costs of intermediation have fallen, generating earnings on the part of borrowers and smaller profit margins on the part of banks. Moreover, banks no longer obtain profits usually connected with the transaction costs. Integrated capital market slowly alters the way funds are raised in the Eurozone, with clear emergence of the corporate bond market. While continental Europe has been known for the dominant role of the banks as a lending institution many companies shift towards increasingly cheaper and more liquid capital market.

The introduction of the common currency has improved the allocation of funds, as large, institutional investors are no longer obliged to have the major part of their portfolio denominated in national currency, but in the euro instead. It is also possible for them to sell big blocks of bonds without exchange rate being moved. The factors that are important in their decisions have also changed. Credit spreads tend to play a dominant role, while such factors like currency movements and interest curves have ceased to be relevant[164].

Euro-driven effects are not easy to distinguish from other factors that shape the new face of the European capital market. Institutionalization in management of savings, introduction of common financial standards, profound and very rapid changes in telecommunications and information technology, which allow to

[163] L. Oręziak, *Euro. Nowy Pieniądz,* Warsaw 1999, Wydawnictwo Naukowe PWN, p. 37-39.
[164] T. J. Kim, *European capital markets: Integration towards the core,* London 2001, Euromoney Books, p. 31-32.

process and send data more quickly, strongly contribute towards improved risk management, efficiency and faster respond to constantly changing environment[165]; also play a key role in changes one may observe nowadays. The birth of common currency has also enhanced and amplified some of the tendencies visible in recent years, such as wave of M&A and consolidation in banking sector. The former derives from the process of corporate restructuring, as companies try to improve their competitive position in the market. Banks, especially smaller ones, also seek ways of screening themselves against new competitors. Such pressure also influences investment banks. Some of them (ING Barrings, Commerzbank) have already closed these parts of their activities, as they face severe problems with withstanding competition on the part of large, European banks and American giants, such as Merrill Lynch and Goldman Sachs, who have amplified their activity in Europe[166].

It is worth underlining that while the launching of the euro has proven to have significant impact on bond market, such strong effect is not visible in stock markets. It can be primarily contributed to recent worldwide problems concerning these markets, such as the events of September 2001, undermined trust on the part of investors due to creative accounting and the fact that stock markets are by definition mostly affected by macroeconomic changes and global events. The situation on stocks in the USA is the trigger and propeller of changes elsewhere, thus the decline in their markets cannot stay without a response from European stocks. The fact that EMU had only minor effect in this field is well shown by changes observed in capitalization of shares on European Stock Exchanges. While the annual growth in the Eurozone amounted to 43% in years 1997-99, Greece enjoyed annual growth rate of 153%[167]. However, euro may prove to be a good incentive for further integration of stock markets in Europe. On the other hand, the introduction of the common currency has imprinted its presence in derivative markets, which have recorded significant contraction in their activities, resulting from the disappearance of foreign exchange and interest rate contracts[168].

2.1. European government bond markets

The creation of one, large capital market in Europe stays apparently not without consequences for the governments in the Eurozone. While they benefit from lower cost of capital, more liquid market, which allows them to place larger volumes of bonds, EMU has proven to be a double-edged sword for them.

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[165] E. Peree, A. Steinherr, *The euro and capital markets: A new era,* EIB Report 2001/03, p. 4-5.
[166] J. Zombirt, *Wpływ euro na rynki kapitałowe,* „Bank i Kredyt" nr 6, NBP 2002, p. 6-7.
[167] E. K. Gatzonas, *The impact of the Euro on Primary Equity Markets,* in: *European Monetary Union and Capital Markets* J. Jay Choi, J. M. Wrase (ed.), International Financial Review, 2001, p. 103.
[168] D. Gros, K. Lannoo, *The Euro Capital Market,* John Wiley & Sons, 2000, p. xv.

Firstly, treasuries are restrained in their activities by the Maastricht Treaty and Stability and Growth Pact. Thus, public debt of a country within Eurozone should not exceed 60% in relation to GDP and budget deficit is to be kept under 3% margin. Bearing this in mind, it is not a surprise that the introduction of the common currency has not created value added in this segment, only leading towards adding up of national markets. However, this combined worth of government bonds issued in EMU has amounted to US$ 2 800 billion, which is now comparable with the value of American bonds, reaching the value of US$ 3 000 billion[169]. Thus, the size of this segment of the market and growing importance of the euro as a international currency may grant EMU governments several benefits, including the "liquidity discount".

Secondly, governments have found themselves in a more competitive environment, which has forced them to increase attractiveness of their bonds. In order to achieve this, smaller countries may arrange a common date for their issues, which allows them to increase liquidity in the segment.

The constraints imposed by the Maastricht Treaty and Growth and Stability Pact are clearly visible when one compares the dynamics of issuance activities of governments and corporations (see Table 1.). Government debt is sustained at similar level in recent years, while corporate bonds enjoy a significant increase.

Table 1. Issuance of euro-denominated bonds in years 1999-2000

	Year 1999		**Year 2000**		**Year 2001**	
	EUR mln	*% of total*	*EUR mln*	*% of total*	*EUR mln*	*% of total*
Governments (+other sovereign, and agencies)	691 030	**49,34**	669 910	**51,64**	733 127	**50,00**
Corporations	136 438	**9,74**	136 522	**10,52**	209 157	**14,26**
Total	1 400 453	100	1 297 087	100	1 466 006	100

Source: European Commission.

Thus, euro seems to have created a new quality, rather than new quantity in the government bond market. This segment has become significantly more transparent, as well as competitive. Lower cost of acquiring capital is of vital importance for governments, especially, when one takes into account the need to keep the debt under control. Ease in yield comparison and growing unison of issuing procedures in the whole Eurozone have resulted in better consumer position.

[169] J. Zombirt, op. cit., p. 3.

While the birth of the euro strongly contributed towards creating single bond market, it has not eliminated several differences that pose an obstacle to true integration. The European Commission has created an expert group in 1996, called Giovannini Group after its chairman, who was supposed to identify the impact of the euro on capital markets, likely problems and challenges. The Group stressed the necessity for eliminating existing differences in infrastructure, market practices, legal and fiscal regulations. It also recommended implementation of Actual/Actual day counts for bond markets and semi – annual coupons. Moreover, although different benchmarks can coexist and in the absence of federal issuer the market will choose it, Eurozone–wide indicators are desirable. This should provide greater transparency and clarity[170].

Nowadays, due to persisting discrepancies, even countries sharing the same rating do not share the same benchmark. Should Eurozone become a truly united market, these differences are to be reduced or eliminated.

2.2. European corporate bond market

While the birth of the euro has done little to increase the value of government bond market, it has strongly influenced the corporate market in this field. Annual growth rate of new corporate bond issues rises constantly, reaching market share of 14,36% at the end of 2001 (see Table 1.). This upward trend is more than simply considerable, since the issuance of corporate euro-denominated bonds increased by almost 40% within only one year. There has been no such movement in dollar-denominated bond market[171]. Emergence of big and significantly more liquid capital market in the Eurozone brought upon by the common currency has also created other phenomena that amplify the influence of the euro itself.

An increase in corporate bonds market share was only possible due to an increasingly diversified in offer and demand for such securities. To indicate indispensable growth of interest on the demand side, one must remember that the large institutional investors, such as insurance companies, pension funds, mutual funds, investment banks, had to find alternative instruments for their portfolios that would substitute highly rated and secure euro-denominated government bonds. The Growth and Stability Pact has severely restrained EMU countries from expanding their public debt and budget deficits. Furthermore, the growing role of institutionalized management of savings, primarily attributed to pension funds activity, has created strong a need for low-profit but secure instruments. Moreover, deregulation of capital flows and elimination of currency risk exposure in EMU have made it possible to act on pan-European level. While the

[170] Source: European Commission http//europa.eu.int
[171] E. Peree, A. Steinherr, op. cit., p. 11.

development of public sector was kept in check by Growth and Stability Pact, these investors have turned to highly rated corporate bonds.

An increase on the offer side of the market derives from several factors, such as wave of mergers and acquisitions, relatively low interest rates, poorer performance on the part of the companies and not favorable situation on equity markets[172].

The large number and volume of mergers and acquisitions in recent years have created a demand for funds to finance leveraged buy-outs. The wave of M&A is strongly related to restructuring process in the Eurozone's corporate sector. The liquidity of the new market has allowed to raise much more money in a single issue. In fact, the number of billion-plus euro-denominated issues amounted to seven in 2000, while in 1998 there were only three[173]. This trend for jumbo issues was started by Olivetti, which along with other telecommunication companies seek new ways of defending against breakdown in this sector, primarily through M&A. However, these companies do not fall into highly rated category of issuers. Their offer has been met by the demand on the part of institutional investors; who, in order to achieve better-than-average performance in constantly more competitive market, seek high-profit bonds.

The situation on equity markets was rather discouraging and placing shares through Initial Public Offerings (IPO) might lead to both, lower than expected value of funds gathered and loss of corporate control. Furthermore, low interest rates have made raising funds through bond issuance cheaper, which encouraged companies to use this means of financing.

While "flourishing" of corporate bond market in the Eurozone is perhaps an exaggeration, the dynamic development in this field is a fact.

3. Capital markets in Central and Eastern European Countries (CEEC)

Not more than fifteen years ago CEE countries were ruled by communists and market economy did not exist. The transformation period in this region was a very difficult time as societies and governments had to learn how to act in a completely new environment. Not even one generation has passed since that time and the memory of it is still fresh. However, these countries have made a huge leap from centrally-planned economy to market-oriented one. The change covered all aspects of life, bringing freedom and new opportunities but also challenges and frustration. In many countries social problems grow stronger, as people cannot find their place in completely new environment.

[172] J. Zombirt, op. cit., p. 12.
[173] T. J. Kim, op. cit., p. 30-31.

New political order created after the Second World War has left CEEC far behind their western neighbors, especially in terms of economic development. Nowadays, they are trying to catch up and diminish the differences. One of the most important steps successfully taken is the near accession to the European Union. Should these countries had not done huge work on their own, it would not have been possible. However, meeting today's living standard enjoyed by even the poorest countries in the EU will probably last for one generation or more.

The short time that has passed since the beginning of 1990's is not without consequences for capital markets. There are two aspects that should be mentioned.

The first is the legislation framework, privatization and emergence of institutions well known in developed countries that simply did not exist in communist ones. The financial landscape has gone through dramatic revolution in order to meet the requirements of market economy. Almost everything had to be changed or created from scratch. In many cases the frequently changing law is far from being perfect which only increases uncertainty.

The second is mentality, education and practical experience. This aspect is often neglected or forgotten, yet it plays a vital role. While every single year brings a lot of improvement in this field, habits inherited from the past and lack of market experience of the society as a whole do impede the transformation. Thus, technological, instrumental and institutional background is not always used to its fullest potential.

Bearing this in mind, it comes as no surprise that capital markets in CEEC are rather undeveloped. Relatively short lifespan of private institutions and companies is especially apparent in stock markets and corporate bond market. Stock exchanges have shorter history than the market economy in these countries and may be described as one treated with "suspicion". The gap existing between CEEC and EU countries is striking when one takes into consideration the capitalization of European stock markets.

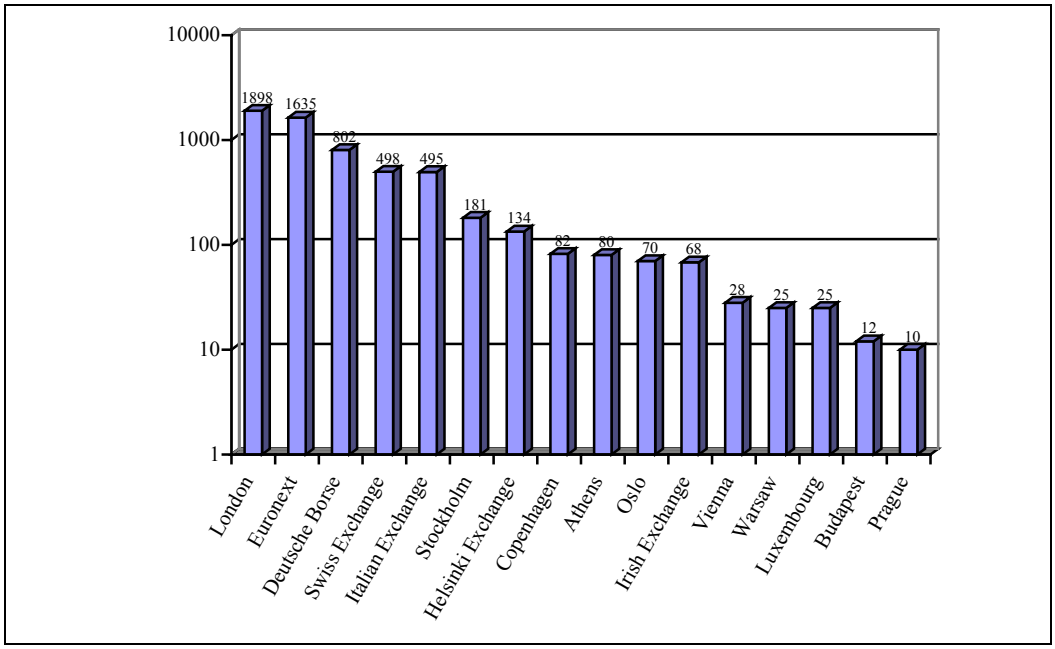
Only the Warsaw Stock Exchange (WSE) is comparable in this field with the smallest stocks in Western Europe, whereas the combined worth of exchanges in Budapest and Prague is still lower. Moreover, the number of companies listed on GPW was quite significant, reaching the level of 211 in August 2002, which places it among medium European stocks in this field. The same indicator for Budapest and Prague amounts to 51 and 45 respectively[174]. The data prove that equity financing was significantly more successful and important in Poland than in any other CEEC.

While capitalization of stocks is a good illustration of persisting differences between these regions (in Western and Eastern Europe), the role of exchanges as an intermediary for privatization process was significant. Governments have used domestic exchanges to sell public companies through IPOs (Initial Public Offer)

[174] Source: Polish Securities and Exchanges Commission (KPWiG).

or SPOs (Secondary Public Offer). While the scale of the process varies among CEEC amounting to 65% (0,9% of GDP) of total revenues from privatization in Poland and 85% (3,4% of GDP) in Hungary in years 1997-98[175].

Chart 1. Capitalization of European stock markets (August 2002) in billions of euro



* logarithmic scale.
Source: Polish Securities and Exchanges Commission (KPWiG) 2002.

3.1. Government bond market

All the given countries under review were and still are going through a profound restructuring process. This means high government spending. The issuance of government debt securities proved to be a comfortable way of financing budget deficits. Ongoing process of restructuring, enforced by market necessity and approaching accession to the EU will probably sustain these tendencies. Acquiring funds, needed for covering the budget deficit, in this way may become cheaper after the accession.

Even in the negotiation period these countries observed constantly growing interest on the part of foreign investors. The accession will surely improve credibility of new member countries and their ratings will increase. Increased demand and lower risk will surely lead to decreased cost of capital for the

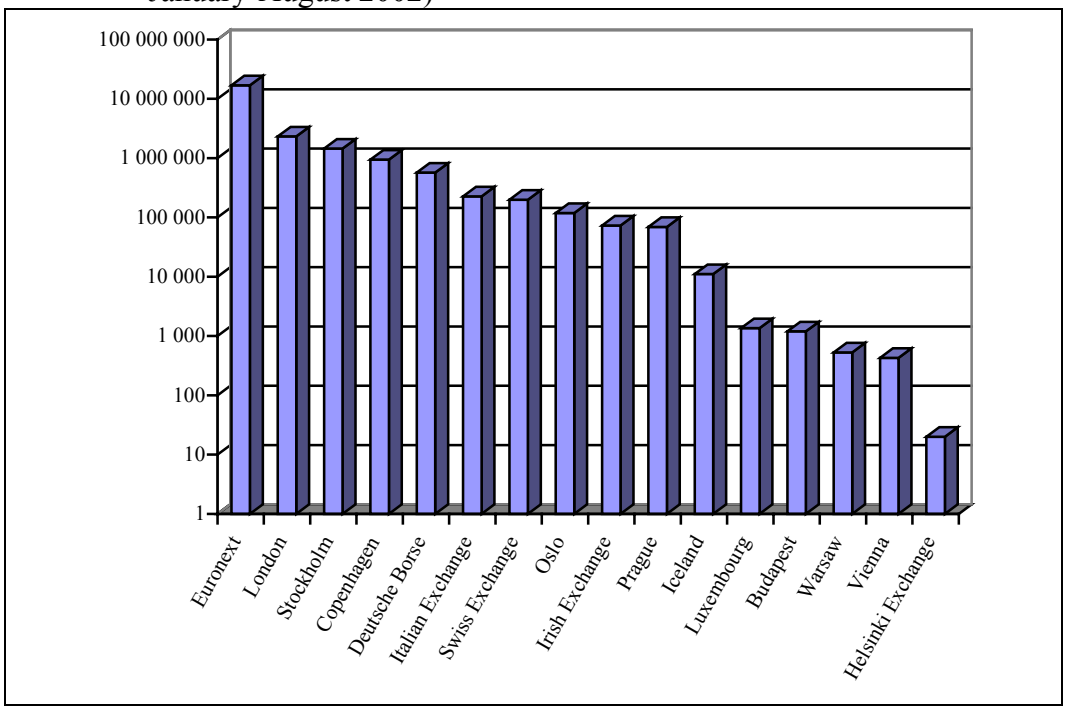
[175] M. Schroder, *The new capital markets in Central and Eastern Europe,* Center for European Economic Research (ZEW), Manheim 2001, p. 457-458.

treasuries. However, there is also the other side of the coin. Inflow of foreign capital strengthens CEEC currencies, thus worsening their position as an exporter.

The domestic demand for such low-risk securities is also enhanced by pension system reforms, which resulted in a growing number of big institutional investors. One may expect that CEEC will follow the global suit for institutional management of savings. In the period when those entities are legally prevented from running currency risk exposure, they will have to turn to domestic securities.

Thus, the role of households is not very likely to increase. Should the low level of savings rise, people will probably prefer to turn to professional asset managers. In these terms, along with growing wealth of society, the role of households will increase but rather in an indirect way. The small investor's retrieval from the market was clearly visible on the Warsaw Stock Exchange. In the early and in the mid 90's, individual investors strongly prevailed over institutional ones, and the market share in this field was like two to one. In the late 90's this picture changed drastically and big investors became a dominant force. This shift resulted from rather discouraging situation on stock markets, which was only amplified by the global events at the beginning of the new millennium.

Chart 2. Bond turnovers on public markets in millions of euro (double counted: January-August 2002)



* logarithmic scale.
Source: Polish Securities and Exchanges Commission (KPWiG).

As for trade, regulated markets have proven to be important only in the Czech Republic (see Chart 2.). In other cases over the counter (OTC) market has been a prime way of trading. Poor performance in case of Poland results from minor role of the Warsaw Stock Exchange as a place for trading, which amounts only to few percent of total trading. The major part takes place on interbank market[176]. While reliable data for this part of the market are extremely hard to acquire, the significance of OTC market in CEEC was confirmed by Deutsche Bank Research (2001)[177].

Further process of European integration will also affect this market. All of the new EU member countries will strive to join the European Monetary Union as well. While the date for the EU accession is set in most of the cases, there is no such clear information for the introduction of the euro in these countries. All of the new member countries will have to comply with the Maastricht criteria, but government's opinion about the exact accession time differs. Some will try to enter at the first possible moment, which means 2006 (two years of participation in ERM II) in most of the cases. Poland is one of such countries, but while the National Bank of Poland (NBP) and the government have set the year 2005 as a year in which Poland will comply with all the criteria, this information is regarded with caution by the market. Due to budget deficit problems, high unemployment rate, which may cause some political hesitation on the part of EMU, the possible accession date is more likely to be set for 2007 or 2008. At the same time other countries, like the Czech Republic) are somehow reluctant to enter the Eurozone quickly. Czechs intend to enter the EMU at the end of the first decade of this century (2009), as they want to stabilize the situation in their budget and set appropriate exchange rate for the korona before joining the ERM II.

Being a member of the EMU will probably lead to similar tendencies to those observed in West European countries. Newly admitted countries will enjoy direct access to deeper and more liquid capital market. Country risk for new members will also fall, as the pan-European market is definitely more resilient to external shocks and disruptions than any of the national markets. Moreover, as the LCY-denominated (local currency) bonds will be issued in euro, investors from other countries might shift their interest to them. Firstly, the purchase of such securities would no longer be connected with currency exposure, which considerably increases their attractiveness. Secondly, institutional investors may be tempted by higher profit promised by these bonds, especially in the period when the 60% GDP barrier is not near.

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[176] KPWiG, *Stan przygotowań polskiego rynku kapitałowego do integracji z Unią Europejską*, Warsaw 2002.

[177] J. Koke, M. Schroder, *The future of Eastern European capital market*, in: *The financial integration of an enlarged EU: Banking and capital markets,* Cahiers Papers Volume 7 No 1/2002, EIB Papers, 2002, p. 121.

On the other hand, new members will have to act in more competitive environment and the referential figures (especially public debt) will grow closer. The transparency of the new market is going to enforce the need for attractiveness as well as compliance with pan-European standards. The prospect of large block issues is not very promising and attractive in this case. Being a third-league player in the field of volume, new members are likely to arrange common dates of issues, in order to obtain liquidity in the segment.

Nowadays all of the CEEC have managed to keep their public debt at a level below 60% of GDP. Sustaining it at a desired level in long-term (for example, while in the EMU itself) may prove to be difficult, but the constraints imposed by the Growth and Stability Pact will probably keep it in check with the referential value. Along with the time passing all new members are sure to encounter a clash between fiscal restrains and the need for investment and restructuring.

3.2. Corporate bond market

Corporate bond market in CEE countries is significantly less developed than its public counterpart. It primarily results from short time that has passed since the transition. While the governments can significantly more easily build their position in the market it takes much longer for the companies.

The minor role of corporate bonds in the debt securities market is well reflected by their role as a source of financing. Michael Schroder in his work[178] clearly shows that the internal sources of financing were the most important ones in CEEC in the late 90's. Among the external sources of lending, domestic banks proved to be the most important means. Along with the economic development and aperture, the cross-border lending by non-resident banks significantly grew in value (especially in the case of the Czech Republic and Estonia). Intercompany loans were of the same importance as non-resident bank credits in Poland and Hungary. His researched also showed, that corporate bond's share in total debt financing was almost negligible.

The infancy of corporate bonds in CEEC may prove to be a good foundation for their development in the years to come. Taking into account pan-European trends, companies may find this means of financing increasingly cheaper, thus attractive. The possibility of financing via debt securities will mostly depend on their credibility, position on the market and interest rates. In the time before the EMU accession, their bonds may be purchased by domestic institutional investors, who will like to diversify their portfolios. Many company owners may also find bond issuance more comfortable than share issuance. It would allow them to maintain the corporate control and increase financial leverage.

The pre-EMU time may also bring some changes. Should the economic policy of the governments participating in ERM II be credible and their fiscal

[178] M. Schroder, op. cit., p. 455-456.

policy sound, the volatility of the exchange rate between national currency and euro will probably stay low. In this case euro-denominated bonds are expected to be attractive to both, companies and foreign investors. Companies gain access to more liquid market and currency risk is reduced. As stated before, much will depend on macroeconomic policy of the country. The accession to EMU itself will open new, incomparably more liquid and transparent market for all the CEE companies. The securities issued by them will generally fall into high profit-and-risk category, which may be attractive to some investors, looking for higher-than-average income. Moreover, these bonds will be free of currency risk for the entities from the Eurozone. Large companies will be able to find demand for large block issues and concentration levels will cease to be that important.

On the other hand EMU area is much more competitive environment than any of CEEC markets. Many of the companies will have difficulties with withstanding this pressure, which was the case of even the renowned Western companies (see chapter 2. Euro and capital markets). It is more than likely that many of these entities are going to be a target of takeovers, while in other cases stiff competition may result in bankruptcy. However, the overall result will certainly bring efficiency and improvement.

Conclusions

Pan-European capital market, created along with the launching of the euro, is significantly more liquid and deeper than any of the former national markets. Transparent pricing and elimination of currency risk result in better allocation of funds, increased competitiveness and efficiency. Greater resilience of large market, stable and low inflation, lead to reducing the risk premium for the area, which lowers the cost of capital.

Integrated capital market slowly alters the ways funds are raised in the EMU. While the Continental Europe has been known for the dominant role of banks as lending institutions, nowadays the dynamic development of corporate bond market is a fact. An increase in this sector was also amplified by the wave of M&As, as many companies are going through profound restructuring process in order to withstand the competitive pressure. On the other hand, due to restraints put on treasuries by the Maastricht criteria and Growth and Stability Pact, government bond market has not observed increase in volume of issues. However, the added value of all national markets of the Eurozone provide investors with one of the most liquid markets in the world.

Capital markets in CEEC are still poorly developed and of negligible value when compared with their western counterparts. However, the ongoing process of restructuring, enforced by market necessity and approaching accession to the EU creates strong need for funds and till now bond issues have proven to be the most

favored way of financing budget deficits. Although, the treasuries will surely benefit from lower cost of capital in the Eurozone and better ratings, the referential values of Maastricht criteria will inevitably grow closer, creating a clash between investment needs and restraints included in Growth and Stability Pact.

The corporate bond market is significantly less developed than its public counterpart. This may be a good base for future growth, especially when institutional investors will aim at higher profit bonds. Large companies will surely benefit from lower cost of capital and demand for their big block issues, while weaker may easily become targets of takeovers or end as bankrupts.

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Author has also used some of the materials published by the Bank for International Settlements (http://www.bis.org), the European Commission (http://europa.ec.int), the National Bank of Czech Republic (http://www.cnb.cz), the National Bank of Hungary (http://www.mnb.hu) and the National Bank of Poland (http://www.nbp.pl).

Rafał Wielądek*

The exchange rates and capital flows. The case of Central European countries in transition

At the age of the globalization, the escalating movement of capital, commodities and services between regions and states play an important role in the contemporary global economy. These occurrences are also faced by Central European economies, which are subject to systemic change that covers a transition from the planned economy to the market one. The transition, which in general is focused on the processes of liberalization, deregulation and external opening, adds a new dimension to the problem of capital flows in the region and generates specific policy challenges, among which is the policy of the exchange rate. Furthermore, this problem gains a new relevance in terms of accession of those countries to the European Union, and then eventually to the Economic and Monetary Union (EMU).

The aim of this paper is to examine the development of exchange rate policies confronted with escalating capital flows in three Central European countries in transformation: the Czech Republic, Hungary and Poland. The analysis is also extended to Estonia, which formally is not located in the Central Europe, but presents an interesting policy alternative to prior states. The paper is organized as follows. First part briefly discusses the role of exchange rate policies in the transforming economies and capital flows being experienced during the systemic transformation. The next is dedicated to specific cases of Central European states. The final part deals with the context of the problem within future accession of analyzed states to the EMU.

1. The exchange rates and capital flows at the process of the economic transformation in Central Europe

One of the aspects of the systemic change performed by the Central European Countries (CECs) was the opening of their economies to the external trade and financial relations creating conditions for their integration into a globalized supply chain and worldwide specialization of production. However, this goal forced creation of completely new institutional framework and tools of economic policy, which were unfamiliar to the socialist economic regime. These were, besides other market economy institutions, an establishment of

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exchange rate systems and, *inter alia*, central banks responsible for this part of economic policy.

For all CECs the implementation of exchange rate policies played a crucial role in the transformation process. However, depending on transformation strategy chosen (Żukrowska 1995) and the advance at the path of the systemic change, there was no common optimal exchange rate regime to be applied by all the CECs. Moreover, the systemic changes on their own were advancing in several stages with different, stage-specific features. In each country, the environment for the exchange rate and the requirements addressed to its role has changed. During the early stages of transformation nearly all the CECs subordinated their exchange rate policies to:

- the role of a nominal anchor being set at fighting inflation; this issue was very relevant for transition economies, since price liberalization at the beginning of transition resulted in a powerful outburst of inflation. In certain economies, it started a wage- and price-rooted inflationary spiral, which furthermore was stretched within the time due to the fact that not all regulated prices were liberalized at the same time. Although the extent of the problem of inflation burst was different in different countries, the choice of the exchange rate as a nominal anchor was mostly determined by the fact that this tool stood for a highly visible, easily verifiable target (for control of the relative prices adjustment), while monitoring the developments of money supply was quite complicated at the time (Klyuev 2001), and
- the role of a tool determining the international competitiveness of home industries; the collapse of political order in this region of Europe was accompanied by vanishing of the economic interdependence being established by this order. The dissolution of the COMECON made the CECs redirect trade flows and thus remodel the industrial output structure of their economies. In this case, the exchange rate was to promote exports as an effective incentive of shifting the productivity factor resources towards more efficient and externally competitive industries (Alexander 2000). Nevertheless, it raised a fundamental contradiction in the relation to the previously discussed role of the exchange rate policy. In fact, relatively high inflation rates at the CECs were fairly persistent for a variety of reasons, and pushed above their trading partners' levels. As a result, there occurred a real appreciation of CECs' domestic currencies, which constantly hampered the competitiveness of the CECs economies' exports and encouraged imports, thus causing the trade balance and the current account balance to deteriorate. In a long run, such developments raised the serious problem of sustainability of the stabilization acquired and forced, *inter alia*, series of discretionary devaluations (Klyuev 2001).

While in an earlier stage, only stabilization goal and current account fundamentals mattered, because of the underdeveloped domestic financial infrastructure and only partial liberalization of capital movement, in the follow-up stage, capital flows and capital account fundamentals became no less important for exchange rate policies. Hence, having reduced inflation to acceptably moderate levels, a number of countries in the region (e.g. Czech Republic, Hungary, Poland) moved towards more flexible exchange rate arrangements as to take under consideration the influence of escalating capital flows.

The question of capital flows in the region is inseparably connected with the very issue of economic transformation. The task of systemic change demanded providing sources of financing of technological progress and change of the industrial structure of economies. Moreover, the social dimension of transformation shock generated a pressure upon development of mechanisms of financial amortization via public spending. Due to usual shortage of domestic savings, the above two internal factors had a decisive influence on emergence of a need of external financing of the systemic change within the CECs, which generated a phenomenon of capital flows in the region. In general, capital movements that derived during the transformation processes in the Central Europe may be divided into two composing elements:

- inward (foreign) direct investments (FDIs) – this sort of capital flows adopted different forms from greenfield investments, via direct or voucher privatizations, to enterprises' share purchases. Direct investments of long-run character were the most desirable form of incoming external capital by nearly all of the CECs and were subject to relatively quick and far-reaching liberalization at the early stages of transformation. However, it was not available for all of the CECs at the equal basis. The availability of FDIs for each Central European country was first of all conditioned by its creditworthiness and institutional competitiveness. These include macroeconomic stability gained, the ratio of the external indebtedness, the level of economic reforms, extent of trade liberalization, natural resource endowments, the privatization method, direct administrative barriers and a size of government bureaucracy reflecting obstacles to investment and entrepreneurship in general (Garibaldi et al 2002). Nevertheless, CECs enjoying substantial inflow of FDIs had to face a additional pressure upon further appreciation of national currencies, which forced adopting certain changes within exchange rate mechanisms that provided for discretionary or announced devaluations in order to counteract its negative impact on export competitiveness,
- portfolio investments – in contrast, this sort of capital faced more selective approach by CECs. On the one hand, because of immaturity and

underdevelopment of domestic capital markets the attraction of portfolio investments was one of the fundamental issues for financing national budget deficits. On the other hand, due to the character of mobility of this kind of capital, financial authorities of CECs decided to implement a number of restrictions on currency convertibility and introduced a system of capital flows control (especially on those of short-term character) in order to prevent economies from destabilizing influence of portfolio capital flows. The effectiveness of the control mechanisms differs among countries of the region and depended on a level of development of financial infrastructure, quality and transparency of governance (i.e. financial supervision and regulation) (Lipschitz et al 2002). Nevertheless, the inflow of portfolio capital forced CECs to counteract persistent appreciation of domestic currencies which included an element of investment risk by installing and successive widening of the fluctuations bands within exchange rate mechanisms preventing possible capital flight. This policy choice was especially relevant in the case of countries experiencing relatively high inflation rates, when capital inflows were targeted at taking advantage of interest rate differential.

2. The case studies

2.1. The case of Czech Republic

At the very beginning of the transition, the Czech and Slovak Federal Republic (CSFR) used to be perceived as relatively (in comparison to other states of the region) balanced economy, with no inner inflationary overhang or signs of tensions within the balance of payment. The country enjoyed balanced budget, controlled level of wages and prices. It was also free from expanded inflationary expectations and enjoyed fairly low external indebtedness (around 6 bln US$, only about 115% of exports in convertible currencies). Furthermore, the country's economy was strongly integrated with COMECOM markets (Lutkowski 1999).

Despite fairly good initial conditions, the start of transformation path turned out to be a strong shock. First of all, it was due to dissolution of Council for Mutual Economic Assistance (COMECON) and common conversion of its settlements into convertible currencies on basis of world prices. Secondly, the shock was magnified by series of minor devaluations of CSFR koruna (in sum by 95%), which took place prior to the implementations of the IMF-supported actual stabilization program. Although the latter was strictly aimed at creating of a specific back up for introduction of internal convertibility of koruna and buffer against possible shock of opening of economy, it resulted in strong pressure upon rise of prices. As a consequence, in the first quarter of 1991 the

CPI increased by 50% and afterwards got stabilized at level above 10% (Patterson 1999).

CSFR's stabilization program provided for introduction of policy of exchange rate stability that was targeted to anchor the stabilization process after the sweeping price and foreign exchange liberalization in January 1991. Thus, the koruna was pegged to a basked composed of DM (68%) and US$ (32%) and was to fluctuate in a very narrow +/- 0,5% band. However, no binding commitment was publicly made to keep the introduced type of fixed exchange rate regime and the given exchange rate level unchanged, neither indefinitely nor for any pre-announced period (Hrncír 1996).

This system survived the CSFR partition of February 8, 1993 without disturbances. Nevertheless, the dissolution of monetary union with the Slovak Republic led to the creation of the Czech koruna (CZK) as the legal tender of the Czech Republic and emergence of separate capital market, which was a subject to accelerated liberalization that constituted very characteristic feature of Czech way of transformation. Czech financial authorities decided to largely liberalize restrictions on capital flows, including portfolio ones. The other feature was that Czech stabilization program paid special attention towards quick and radical limiting of the public sector share within the economy, as well as conducting possibly quick privatization (Lutkowski 1999).

These two incentives had a key influence on the development of Czech capital markets. First of all, facing the difficulties in access to the internal financing (the result of restrictive policy mix) the domestic enterprises and local authorities sought source of capital via placing koruna-denominated eurobonds on international markets. Because of low level of external indebtedness of Czech republic (and thus relatively high level of country's creditworthiness), these securities enjoyed considerable interest by foreign inventors, even when issued without government guarantees. Secondly, Czechs introduced mass privatization, which was based on voucher distribution among citizens who were free to sell/purchase them on secondary capital market. These solutions considerably facilitated further development of Czech capital market, but unfortunately in an expense of insufficient and inadequate supervision system and control mechanisms.

As a result, during the first years of transformation the inflow of foreign capital (which, beside FDIs, included substantial share of portfolio investments) was one of the biggest in the region (approx. twice as much as in Poland). The development of Czech domestic financial market was significant, as domestic banks offered modern financial products. This included operations on the futures market, which were not available on other transition economies' markets at the time. Since 1994, borrowing in foreign currency by Czech enterprises increased, including short-term borrowing by banks, encouraged by

interest rate differentials and expectations of further currency appreciation (Morales 2001).

Concerns about speculative capital flows started in August 1995, when a limit on net short-term borrowing by banks was set. Nonetheless, capital flows (reaching 17,4 % of Czech GDP between 1993 and 1995) and persistent exchange rate appreciation pressures continued, as increased speculative trading related to koruna-denominated securities issued took place, attracted by the domestic-foreign interest rate differential of 8,5 %. Real exchange rate appreciation and the accompanying loss of competitiveness led to an increasing current account deficit, which amounted to roughly 8% GDP in 1996. These macroeconomic indicators greatly provoked later speculative attack of May 1997.

The scope of capital flow liberalization and the applied exchange rate regime produced fundamental divergence within the economic policy leading directly to currency crisis. The direct reason for system breakdown came from the forecasts on Czech export volume published in the first quarter of 1997. The news made foreign investors sell koruna-denominated securities, as to minimize exchange rate risk losses. Meanwhile, domestic enterprises and individuals started mass run on foreign exchange purchase. A pressure on depreciation of koruna became a fact.

The first attack on the fixed exchange rate of the koruna, which at the time had been allowed to fluctuate in a +/- 7.5 % wide band, came on 15th May, 1997. During the two weeks of crisis, the Czech National Bank (CNB) responded by several interest rate hikes (by raising the official rates as much as 75%) and by administrative measures for non-residents, which, *inter alia*, stood for prohibiting domestic commercial banks to lend in domestic currency to foreigners. Unfortunately, the actions undertaken did not bring awaited relief to Czech monetary system and on 26th May, 1997 the CNB (after 10 unsustainable interventions) gave up the peg and introduced managed floating regime. It was accompanied by koruna devaluation by 12% against DM and 10% against US$ and eventual replacement of the basket by DM alone. As the Czech anti-inflationary policy had been based on the maintenance of the fixed exchange rate, the system change resulted in emitting strong inflationary impulse into the economy. This forced CNB to rearrange the monetary policy's philosophy into Direct Inflation Targeting (DIT). The reforms following the crisis were painful. In 1998 the economy entered a recession and suffered economic growth slowdown, the unemployment rate rocketed and fiscal stability deteriorated, resulting in political crisis (Arvai-Vincze 2000).

Czech republic was the very first country in the Central Europe that suffered full-scale currency crisis.

2.2. The case of Hungary

In the beginning of the economic transformation, the Hungarian economy was perceived as one of most liberalized economies out of all the CECs. The liberalization was, *inter alia*, targeted at attracting foreign investments. In effect, in 1980s Hungary absorbed nearly as much as half of the FDIs volume in the Central and Eastern Europe. Moreover, the two-tier banking system was established as early as in 1987 and in 1988 Hungary introduced widespread tax reform, regarding introduction of Value Added Tax. Besides, the very first roots of capital market dealing initially with Treasury and enterprises bonds were laid. Nevertheless, in late 1980s the country suffered a burden of considerable external debt (around U$ 20 bln) and considerable inflationary expectations resulting in recurrent tensions upon prices and wages (Lutkowski 1999).

The stabilization program of transformation was mainly aimed at achievement of a macroeconomic stabilization and further opening of the economy. Thus, the Hungarian currency – forint – had been devalued and pegged against a basket of 11 convertible currencies, which provided for creation of nominal anchor for prices and foreign trade liberalization. Furthermore, the internal convertibility of the forint has been introduced but the capital account transactions were still severely restricted, excluding FDIs' net revenues transfers.

The results of implementation of the program, alike the case of the Czech Republic and Poland, were different than anticipated. Hungary suffered deep fall in industrial output (totaling above 17%) and, despite the fact that the country did not bear any considerable inflationary overhang and enjoyed prices' structure close to the world level, the price index rose by 35% within the first quarter of 1990. Such developments had a decisive influence upon preserving the inflationary expectations that resulted in persisting high inflation rates amounting to 20% average annually in the mid-1990s. Besides, as a consequence, a strong demand pressure occurred, adding considerably to the existence of persistent current account deficit.

Furthermore, in 1992-1994, the Hungarian banking sector experienced full-scale crisis, which was actually resolved through consolidation program, but, as a matter of fact, it generated serious side effects. One of them was a rapid rise of external debt, repayment of which reached up to 20% of budget deficit in 1994, which considerably boosted budget deficits in following years (Lutkowski 1999).

The above issues of the first phase of Hungarian economic transition confronted with statutory aims of National Bank of Hungary (NBH) – i.e. safeguarding the internal and external purchasing power of the currency – implied a serious problem for the national monetary policy, namely too many goals at a time: inflation control or external balance. In practice, in 1991-1994, the policy of NBH turned inconsistent and its emphasis shifted from one goal to

another. As a result, within this period the forint's basket changed four times (being finally composed of 30% of US$ and 70% of ECU) and the currency itself was a subject of 20 discretionary devaluations. Additionally, the swinging policy was compounded by a postponement of fiscal adjustment aimed at limiting high budget deficits.

In 1994-1995 Hungary lifted long-term and several mid-term capital controls due to OECD membership commitments. These actions were in fact contemporaneous with discretionary devaluations undertaken and the emergence of exceptionally high fiscal deficit of 9% of GDP. As a result, recurrent attacks on the forint in a not-fully-liberalized environment took place, whose effects were strengthened by general fall in FDIs inflow (Avrai, Vincze 2000).

To counteract further negative developments, the stabilization package was introduced in March 1995. It contained important structural reforms targeted mainly at fiscal stabilization via limiting public spending. In terms of monetary policy, the package included devaluation of the forint by 9% and, what is more important, introduction of the new exchange rate regime. Since this time, the forint has been assigned a pre-announced crawling band of initial width of +/- 2,25% and of a monthly devaluation coefficient of 1,9%. The change within the monetary policy also regarded a change within the NBH's priorities to the price stability principle.

The reform program proved successful as it generated a substantial improvement in fundamentals, making the adoption of comparatively rigid crawling band arrangement feasible. After 1995 no serious crisis occurred, though the exchange rate came under pressure because of the Russian crisis. In 1995 the stock market was too insignificant to suffer, but the Asian and especially the Russian crisis led to a decline in the stock market prices and certain turmoil on the foreign currency market, but the whole economy strived those crises rather easily. For the most of the second half of 1990s the exchange rate was under a reverse, appreciating pressure that involved substantial intervention and increases in official reserves (Avrai, Vincze 2000).

The Hungarian pre-announced crawling peg was aimed at stemming inflation expectations, taking into consideration productivity gains and underpinning disinflation. Such long sustainability of this regime depended on the maintenance of fiscal balance and on reasonable wage policy. Both goals were gradually achieved within the Hungarian transformation of the second half of 1990s, which facilitated further liberalization of the exchange rate regime. The devaluation coefficient had been gradually reduced and it was finally abandoned in October 2001. The band of permitted fluctuations had been gradually widened up to +/- 15%. Taking under consideration the fact, that the forint's currency basket had been replaced with the 100% peg against the euro in January 2000, the perspective of incorporation of the forint into the ERM II

will probably not require any revolutionary change within the Hungarian exchange rate policy.

2.3. The case of Poland

Alike the Czech Republic, the exchange rate policy in Poland was an important instrument of attaining the country's economic stabilization within the economic transformation.

Poland entered the 1990s with the exchange rate mechanism that was a major part of the stabilization program – the Balcerowicz Plan. The fixed rate of the zloty against the US dollar in conjunction with introducing its internal convertibility was one of the 'nominal anchors' of the Plan aimed at reassuring the inflationary expectations of the Polish society at relatively low level under circumstances of the price liberalization. Moreover, the deep devaluation hidden within the fixed rate was a tool of promoting the development of domestic entrepreneurship. Similarly to the case of the Czech Republic, within the Plan realization it quickly turned out that the inflation level was much higher than that anticipated and the exchange rate 'nominal anchor' had initially a pro-inflationary character. (Lutkowski 1999)

Thus, there finally emerged a need for changing the exchange rate mechanism. Firstly, the substantial differences between the Poland's and its main trade partner states' inflation rate resulted in the real appreciation of the zloty. Secondly, the need of adjusting the exchange rate policy was intensified by the breakdown of the COMECON markets and by the necessity of the Polish exports reorientation towards West European markets. Due to the above factors, on 17th May 1991, zloty was devalued by 16,8% against the US dollar and thereafter the zloty's dollar parity was replaced with the currency basket.

It was evident that in terms of the Polish economic situation it was not possible to conduct frequent, discrete devaluations due to the fact that such operations would result in a strong, pro-inflationary pressure. On 14th October 1991 the Polish monetary authority decided on replacing the fixed peg mechanism with the *crawling peg* one. However, the initial devaluation coefficient, which was set at 1,8%, proved to be insufficient regarding the inflation rate, which in practice extorted two further discrete devaluations: on 26th February 1992 by 10,7% and on 27th August 1993 by 7,4%. Moreover, these devaluations were, besides stimulating the exports and supporting its effectiveness, targeted at laying the ground for further reduction of the monthly devaluation coefficient within the strategy of limiting the pro-inflationary influence of the exchange rate mechanism. This intention was executed through the progressive reduction of the devaluation coefficient form 1,6% on 27th August 1993 to 1,2% on 16th February 1995. This operation was facilitated by gradual fall of the inflation rate, and foreign exchange reserves growth

caused by increased flow of the FDI and non-registered trade surplus (Żukrowska 1998).

The progressive process of both the capital flow liberalization and opening of the economy, in conjunction with Polish authorities' intention to extend the scope of convertibility of the Polish zloty, added a new context to the exchange rate policy. Since then, the exchange rate policy had to complement the liberalization of the capital flow to create favorable conditions for adequate exchange rate marketization, which was to reveal the actual purchasing power of the Polish currency. On the other hand the policy had to counteract the possibly destabilizing results of the capital inflows, in particular those of the speculative character. All those circumstances effected the decision on changing the exchange rate mechanism on 16th May 1995, when NBP in consultation with Polish government introduced the band (+/- 7%) and kept the rule of the 'crawling' devaluation within the regime.

The rapid inflow of foreign capital that took place in 1995 proved the exchange rate mechanism solution established correct. During this year, the capital inflow concerned mainly the FDI, which were propelled by the restoration of Poland's credibility at the international financial markets due to the Paris and London Clubs agreements on the Polish external debt reduction. The FDI however were followed to the allowable extent by portfolio investments being attracted by relatively higher interest rates – a side effect of the anti-inflationary policy conducted in Poland at the time. Despite the obvious advantages, the inflow of the foreign capital bore negative consequences as well, which was materialized by the constant appreciation of the zloty's real exchange rate that, in return, attracted the capital of strictly speculative character awaiting further its strengthening. To ease the pressure of the appreciation speculation the National Bank of Poland, in consultation with the Ministry of Finance, decided to revalue the exchange rate of zloty by 6% in December 1995. Since spring 1996 the NBP had started to intervene sporadically as to maintaining more frequent, smaller and unpredictable, exchange rate fluctuations.

In January 1996 the monthly devaluation coefficient was reduced to 1% and it also was being maintained during all the 1997 to diminish threat of escalating deficit of current account. At the time, persisting, rapid inflow of foreign capital (including portfolio one) was continually influencing the further zloty's appreciation. Such developments made the NBP repeatedly conduct discrete interventions, which played a special role in May and July 1997 when the financial turmoil in the Czech Republic and on the Far East financial markets made portfolio investors rapidly sell out Polish Treasury securities.

In 1998 the exchange rate policy experienced a fundamental change that was entailed by the institutional reform of the National Bank of Poland (NBP) followed by the establishment of the Monetary Policy Council (MPC).

Although the exchange rate regime itself did not change, since February 1998 the exchange rate policy's priorities have been shifted towards creating the comfortable conditions for newly defined monetary policy being aimed at the price stability (the DIT strategy). Therefore the Council, intending to reassure the inflationary expectations, decided on subsequent limiting of the 'crawling' devaluation rate in 1998 from 0,8% to 0,5% on 10th September. Moreover, the MPC resolved to increase an extent of exchange rate mechanism flexibility, which, according to the Council's intention, was to facilitate the more autonomous monetary policy. By this reason, the hitherto existing band of allowable fluctuations was extended to +/- 10% on 26th February and then to +/- 12,5% on 28th October 1998.

The exchange rate's greater flexibility played a particularly beneficial role during the Russian financial crisis outbreak in the beginning of August 1998, which in Poland resulted in symptoms of retreating of the portfolio investors form the Treasury securities market. Eventually, the scale of capital outflow was relatively small at the time, which was also due to the fact, that NBP totally ceased currency interventions, thus greatly increasing the unpredictability of the exchange rate fluctuations. Moreover, still increasing inflow of FDI during 1998 finally made up for the temporary short-term capital outflow, which also counteracted the zloty's accidental depreciation.

The MPC announced further 'crawling' devaluation reduction as well as its absolute suppression and, what is more, gradual widening of the scope of permissible fluctuations till total liberalization of the zloty's exchange rate.

The above declarations were put into action as early as 1 January 1999 when the zloty's basket was rearranged. Thereafter, on 24th March 1999 the devaluation rate was limited to 0,3%, the band of exchange rate fluctuations was expanded to +/- 15% and, consistently, on 7th June 1999 the *fixing* institution was liquidated. The above actions were strictly targeted at gradual preparation of the suitable ground for total exchange rate liberalization, which actually took place on 12 April 2000. Moreover, due to the new Act on Foreign Exchange of 1999, the controls on short-term capital flows were severely lifted in the beginning of October 2002.

In comparison to the previously discussed cases, Poland decided to introduce liberalization of the exchange rate and capital flows gradually in harmonized sequences, which led Poland avoid currency crisis to date.

2.4. The case of Estonia

In comparison to the previously discussed Central European states, Estonia presents a different way of coping with exchange rates and capital flows liberalization. As a small country, it decided to undertake a revolutionary systemic change.

In 1991, as a former Soviet republic Estonia experienced heavy loss of industrial output and serious deterioration of terms of trade due to conversion of energy trade settlements with Russia to world prices. This rendered the fall of GDP by as much as 10-15% and annual inflation exceeding 200%. (Lutkowski 1999)

Facing those conditions Estonia's policy makers decided to implement a radical option for economic reform in 1992, which in general favored possibly quick incorporating of the Estonian economy into world one. In terms of exchange rate policy this meant introduction of a new national currency – the kroon – that was fixed against German mark (1 mark to 8 kroons) within the currency board arrangement (CBA). As far as capital flow liberalization is concerned, all restrictions on capital movement were fully lifted already by 1993. The first solution was to provide the new national currency with stability and international credibility, while the second intended to create friendly and attractive conditions for foreign investment helpful in structural transformation of the economy.

After the implementation of the opening strategy the actual economic conditions even worsened (which can be illustrated by the fact, that the total fall of GDP within 1991-1993 amounted to nearly 40% and inflation rates reached 80% per month) and the banking sector suffered severe crisis in 1993-1994 (loosing as much as 30% of its net assets). Nevertheless, during the second half of 1990s the Estonia economy entered a path of quick growth and stabilization. The CBA was successful in providing a predictable economic environment although the gradual decline of inflation rate made the kroon appreciate substantially in real terms against the currencies of major trading partners (i.e. the European Union basically). The above phenomenon also contributed an emergence of serious current account deficit reaching about 10% at the end of 1990s. However, the deficit has been financed by increasing capital flows, especially FDI, which gave Estonia the second highest FDI per capita in the region after Hungary.(Lutkowski 1999)

Under the full capital movement liberalization, the crises of 1997 and 1998 had a limited impact on the Estonian CBA. There was some pressure on the Estonian kroon at the time of Czech crisis of May 1997, but it did not last long as interest rates rose automatically due to the CBA. However, during the Russian crisis of August 1998 the Estonian stock market was seriously hit by the loss of confidence of foreign investors in emerging markets in general. The immediate rise of interest rates took place again, but capital flight was not substantial as Estonia's economic link with Russia is not that deep as it used to be before the systemic change. Nevertheless, the impact of interest rates hikes was rather of significant importance to the dynamics of Estonian GDP growth, which may be well illustrated by the fact that in 1997 reached an outstanding 10,6% while in 1999 decreased by 1,3%. Furthermore, the kroon was a subject

to further real appreciation, which may stand for a problematic issue in terms of international competitiveness of the Estonian economy in the future. (Avrai, Vincze 2000)

In January 1999 the Estonian kroon was fixed against the euro at the same conversion of the German mark in the common currency, which makes the country formally the most advanced one on the path to the euro adoption among the states discussed above.

3. The context of the EMU accession

CECs aspiration towards the European Union membership implies the fact, that the countries will have to satisfy the 'Copenhagen criteria', among which is the ability to take on the obligations of the Economic and Monetary Union membership. From the exchange rate policy point of view, this means that they will have to accomplish the redefined exchange rate convergence criterion. This stands for an obligation to participate in the Exchange Rate Mechanism II (ERM II) of the European Monetary System designed for the states remaining out of the EMU.

The possibility of not participating in the EMU by some of the member states was already provided by Art. 109k of the Treaty on European Union. According to the Art. 109k(1) such states are described as a '*member state with a derogation'*, which in the virtue of Art. 109k(3) implies that in relation to the '*outs*' the provisions on the ESCB functioning are not applied (Art. 105(1-3,5), 105a, 108a, 109, 109a(2b), chapter IX of the ESCB Statutes), which also refers to the adoption of certain procedures regarding the budget deficit and public debt limits compliance (Art. 104c(9,11)). Moreover, by the terms of the Art. 109k(4) the states with derogation are devoid of the voting power within the above domains, which mainly was due to the necessity of making them unable to influence the decision-making process of the ESCB and thus potentially harming the monetary policy conducted by this body. However, the '*outs*' are formally left a possibility of smooth entry to the EMU, which is stipulated by the Art. 109k(2). According to it, *'At least once every two years, or at the request of a member state with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 109j(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which member states with a derogation fulfill the necessary conditions on the basis of the criteria set out in Article 1109j(1), and abrogate the derogations of the member states concerned*'. This record means that the convergence criteria are still in force within the EMU membership

qualification process, although because of the EMU project advancement they had to be modified.

As far as the exchange rate criterion is concerned, the modification is far-reaching. This is due to the fact that since the EMU project entered the stage III the hitherto existing European Monetary System has been liquidated which considerably influenced the substance of the Treaty provisions on the necessity of stabilizing the member states domestic currencies within the EMS. Similarly to the previous version of the EMS, the participation in this one is voluntary and it shall be constituted on the basis of the bilateral agreements between the accessing states' central banks and the ECB. The main elements of the new System are as follows (Gross & Thygesen 1998):

- the Exchange Rate Mechanism mark II, within which there are to be established central rates of the *pre-ins* states currencies against the euro, instead of a grid of parities like the old ERM (so-called the '*hub-and-spokes*' system). There are to be provided 'relatively wide' (at present +/- 15%) bands of fluctuation around the central euro-related rates, but individual *ad hoc* arrangements to limit the fluctuation margins are possible for countries of a good convergence (so called '*convergence performance'*) with the Eurozone, in particular in terms of the price stability,
- automatic and unlimited currency interventions aimed at maintenance of the participating currencies within the band of fluctuations conducted by both the national central banks and the ECB. However, it is essential to note down, that the latter body is entitled to condition the scale of intervention on the 'convergence performance' of the accessing country. Moreover, the interventions mechanism provides for possibility of conducting intra-marginal interventions (with the 80% threshold) to be supported by the Very Short-Term Financing Facility (VSTF) being organized after the one of the old EMS[179]. A specific *novum* in relation to the previous system, is the option that both sides (in practice the ECB) can refrain from intervening if this threatened price stability rule. In case of chronic troubles the adjustment of the central rates should be considered in a timely fashion. Both sides, including the ECB, will have a right to initiate a confidential procedure to do so.

Beside the ERM II, the attainment of the exchange rates convergence shall be facilitated by the terms of the Art. 109m(2), which stipulates that each member state shall treat its exchange rate policy as a matter of common interest.

The above findings confronted with the fact, that all the CEC candidate states will have to lift any existing restrictions on capital movements into and

[179] Within the ERM II the financial support system will be limited to the short-term facilities only. As the EMS experience shows, parity rate realignment is more feasible solution than drawing the medium-term facility.

from EU (and third states as well) have a serious bearing on CECs' exchange rate policy prior to the EMU membership.

First of all, all of the CEC are experiencing so-called Balassa-Samuelson effect, which, in short, results in inflationary pressure on consumer prices (for further analysis see: Kovacs 2002). In consequence, in the middle run, the real exchange rates of the accessing countries will appreciate during the convergence process. This, under the relatively narrow band of fluctuations of ERM II, may provide enough of certainty for the markets to engage in speculation for a convergence of interest rates and persistent anticipated appreciation of the exchange rates of candidate states. The risk of currency crisis in the verge of EMU membership is especially evident prior to the eventual fixing of the candidate's state currency against the euro. Therefore, a country willing to enter the Eurozone should back up its exchange rate policy by adequate supportive policies, particularly the fiscal and income ones, which would ensure internal and external macroeconomic stability. (Szapary 2000)

Naturally, the strategy of joining the ERM II will be different for different countries as their exchange rate regimes and scope of capital movement liberalization derive from their path of economic transformation and experiences gained during this process. For Poland and Czech Republic, which have relatively large and liquid capital markets, the experience of (managed) floats seems fairly good solution before accessing the ERM II. This regime with sufficiently large and liquid currency markets is most likely to help in determining an appropriate rate of a nominal exchange rate of those states' currencies prior to EMU membership. As far as Hungary is considered, the best policy choice seems to be to keep the present regime providing that the country enjoys sound fundamentals – including fiscal balance – that will prevent from tensions in the exchange rate causing potential capital flight. In case of Estonia, maintenance of CBA seems to be a natural solution before formally accessing the EMU. Although in terms of Maastricht Treaty provisions the very formality of participating at the ERM II raises some controversies in this case, the only Estonia's problematic issue might be a question of irrevocable fixing rate against the euro. This operation will have to be undertaken with consideration of substantial real appreciation of Estonian currency that might hamper future competitiveness of the country (Freytag 2002).

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Katarzyna Żukrowska

Exchange rate policy and intensiveness of competition

All economies in transformation follow same pattern of changes in their exchange rate policy: phase of devaluation is followed by a phase of depreciation according to the well known from the theory Balassa-Samuelson effect. Those two unequal phases of determining the value of exchange rate have to be taken into account in shaping the overall economic policy, mainly trade policy but also privatization, FDI flows, as well as depth of devaluation at the starting point, when convertibility is introduced. Wrong assumptions and mistakes in consecutive moves linked to this matter bring additional constraints to the transforming economy in form of prolonged period of high inflation (or returns to accelerate inflation), conditions putting pressure on the value of the currency, in extreme conditions leading to financial crises.

Traditionally all economists are aware of the fact that devaluation of national currency can be used as a short term tool stimulating exports as this improves competitiveness of the export offer. This economic rule can be used *a rebour*, i.e. using opposite dependencies appreciation and its impact on intensiveness of competition. This paper is presenting mechanisms of that, reasons and foreseen effects.

1. Depreciation and competitiveness

Exchange rate policy was always considered as one of the important tools of trade policy, i.e. politicians engaged in the economics approaching problems in their balance of payments or more precisely in current account often used manipulation with exchange rate as a remedy. Devaluation stimulates in short term competitiveness of the export offer of a country, which devalues its currency, at the same time it makes imports more expensive in comparison to the previous level of exchange rate before devaluation. Devaluation gives an immediate effect stimulating exports and cutting imports, what helps to improve the results of the current account if not obtain a surplus departing from a deficit. This decision has a positive effect on labor market: increasing employment, what immediately changes the size of budget deficit, increasing tax revenues and decreasing expenditures (if other conditions are constant). This is achieved as a result of simple dependency: devaluation increases the prices of foreign currencies in the devalued currency, and it decreases the price of devalued currency in foreign currencies. Despite some simple positive

effects devaluation has also some costs. First of all, in short all prices adjust to that movement, what means similar moves of other currencies and prices, what reduces the positive effect in the devaluing country. Secondly, devaluation is considered to be one of the strong incentives stimulating inflation. In such circumstances it was natural that decisions were made to "depoliticize" exchange rate policy taking the decision about its level from the hands of politicians. Depolitization of exchange rate policy in practice was univocal with introduction of float in exchange rate policy, what means flexible adjustments to interplay between demand and supply for the currency[180].

In other words exchange rate policy can be considered as a tool, which is used to regulate access to a market. This means that the exchange rate policy decides on state of openness of the economy. In such circumstances it is not surprising that specific decisions were taken in the EU in the field of exchange rate policy in order to limit and finally eliminate the role of this tool in national trade policies of the member-states. This was achieved gradually by limiting the margin of exchange rate fluctuations, although this solution turned to bring some unexpected dangers into the financial market as each currency coming close with its exchange rate to the introduced margins required intervention. For observers coming closer to the point of intervention created a good opportunity for speculation. Those points were easy to define same as countermeasures taken by National Central Bank. This was costly and in longer run ineffective. With time passing margins of the fluctuation were widened. This was a step leading to more flexible solutions and finally elimination of exchange rate within EMU. The margins of ERM were gradually expanded from $\pm$1,5% through $\pm$2,5% (in some cases $\pm$6,5%) until $\pm$15% (after Amsterdam)[181]. The decision to expand the fluctuation of exchange rate margins were undertaken as a result of difficulties faced by several currencies within ERM after decision to reunify the two German states and introduce conversion of DDR mark 1:1 towards the DM. H. Kohl has made that decision, what was commonly considered as political decision to gain support of the electorate and be elected again for the chancellor position. German Bundesbank was against, and this was so especially in conditions when several currencies used German Mark as a peg for their currencies. The reaction was two-folded: internal and external. BUBA (Bundesbank) has increased quickly interest rates, what was helping the financial market to return in short to a new equilibrium[182]. In the external context one should mention that several currencies were not able to keep the

[180] R. N. Cooper, *Exchange rate choices,* Harvard Institute of Economic Research in Series: Harvard Institute of Economic Research Working Papers No. 1877, 1999, p. 33, edirc.repe.org/data/reharvus.html

[181] S. George, I. Bache, *Politics in The European Union*, Oxford University Press 2001, p. 130-131.

[182] M. Gartner, *A Primer in European Macroeconomics*, 1997, p. 222-223.

path of their exchange rates controlled by the margins given by ERM. Important to say that Italian lira and British pound were forced to leave the mechanism of exchange rate stabilization set within ERM. This stabilization was a type of institutionalized tool helping to control exchange rate policy of the EU member-states. Widening the margins of fluctuations had a double role to play. On the one hand it was limiting possibilities of speculative attacks, as they occurred only in points were exchange rates were close to margins of fluctuation. On the other hand, wide margins of ERM helped countries facing difficulties on their financial markets to keep the exchange rate target in their way to EMU.

Depreciation was quite frequently used method to stimulate growth, especially in less developed economies i.e. Italy, Greece, Spain, Portugal, Ireland. Nevertheless, as was said, utilization of this tool had its costs and as the whole history of European integration was based on opening the economies of member states mutually one to another one than such a tool had to be eliminated in order to be effective in integrating the member states together in a process of forming internal single market of 1986/1987.

Effects of depreciation on current account can be easily seen in the Polish experience after 1989, when for a long period zloty was loosing value not as said in the Balassa-Samuelson effect. Appreciation came in advanced stage of transformation. What are the reasons of depreciation?

All transforming economies faced current account deficits as in process of opening their economies they have exposed their markets to competition. Their production was not competitive as economies of ECE were developing autarchically before 1989. All economies in transformation had to introduce convertibility and fix rates of their currencies. The method applied here, as was mentioned in other papers, was different. All economies of ECE countries had used fixed exchange rates in their path to achieve full convertibility. This was certainly their common denominator. At the same time some differences occurred. What was different in their practices? Individual countries used different currency pegs and gradually were changing them differently, moreover, they had applied different strategies of adjustment of their real exchange rate to the nominal one. Periods in which the currencies were departing from their nominal values and had to be adjusted were different. Period in which fixed exchange rate was used were different. Depth of devaluation at the starting point also differed. Finally, the scope of opening of the economies in transformation was different, what also had an impact on the tendency in shaping of exchange rate policy.

Reasons of depreciation were simple: inherited uncompetitive economy from the past; scope of opening of the economy; used pegs and tendencies characterizing the value of currency used as a peg; finally depth of devaluation when entering the phase of fixed exchange rate. The deeper devaluation at the

starting point the longer the currency could stay unadjusted. In other words who has overshot his currency more could keep the exchange rate fixed longer. When a currency used as a peg was depreciating – same effect was possible for the pegged currency. In other words when the currency used as a peg was loosing value, the currency pegged to it was also loosing value not requiring additional adjustments, which were advisable as with time passing the trade deficit was growing weakening naturally the value of pegged currency. Making the long story short, one can say that depreciation of currency used as a peg was helping to keep unchanged level of exchange rate pegged to it for a longer time, helping to stabilize the economy. This was the case with Poland as it used US$ as a peg in the first stage of introducing convertibility. US$ at that time was loosing value what was univocal for zloty with "an invisible devaluation". Czech crown and Hungarian forint were pegged to DM, what was replaced by euro[183]. German Mark was appreciating at that time, giving a different effect in case to pegged to it currencies. At the same time the two currencies did not need adjustments of their currencies value as the current account deficit was balanced to a certain degree by flows of capital, which did not occur on such a big scale in Poland in the first stage of transformation. Poland suppressed its economy by a shock therapy, resulting in deep fall of production, increase of inflation and unemployment. This was discouraging for foreign investors. The applied policy in case of Poland embraced of customs duties suspension (in case of most goods) and protection of the market only by overshot devalued zloty.

Statistics presented below, indicating the value of exchange rates in Czech Republic, Hungary in Poland between 1994 and 2002 illustrates that appreciation occurred in Czech Republic in 1995, while in three analyzed economies in 2001. Different pattern of behavior of the exchange rate in Czech Republic can be ascribed to size of the capital inflows to the Czech economy, which from the beginning of transformation was creating impression of the most stabilized economy in the region (measured by inflation indicators, size of transformation depression, as well as size of current account deficit and unemployment rate) – in longer run this country turned to be lagging in transformation. False stabilization has attracted the biggest inflows of capital in the region. Appreciation in 2001 is a natural effect of increased competitiveness of the economies, causing improvement between the proportions of exports and imports, streams of capital inflows and controlled inflation. It also reflect the changes in interest rate, considered to be one of the tools, which is still in hands of the Central Bank, enabling control of the exchange rate value.

[183] M. Jarvinen, *Exchange rate regimes and nominal convergence in the CEECs*, Bank of Finland, Institute for Economics in Transition, , No. 4, 2002.

Table 1. Value of exchange rate in Czech Republic, Hungary and Poland in 1994-2002

Exchange rate	1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Republic									
End of year	28,2	26,7	27,3	34,7	30,0	35,7	38,8	36,5	n.a.
Annual average	28,8	26,5	27,1	31,7	32,3	34,6	38,6	38,0	n.a.
Hungary									
End of year	110,7	139,5	164,9	203,5	219,0	252,5	284,7	279,0	n.a.
Annual average	105,1	125,7	152,6	186,8	214,5	237,3	283,7	287,1	n.a.
Poland									
End of year	2,4	2,5	2,9	3,5	3,5	4,2	4,3	4,0	n.a.
Annual average	2,3	2,4	2,7	3,3	3,5	4,0	4,3	4,1	n.a.

Source: *Transition Report Update*. EBRD 2002 p. 53 ,63, 75. London 2002.

If the exchange rate fluctuates appreciating and depreciating afterwards – such changes bring inflationary impulses to the economy, what cannot be considered as best strategy within macrostabilization policy. Defined direction of changes helps to undertake decisions in other fields of economic policies.

Statistics presented below show divergence in effects of the applied economic (trade) policies in three analyzed economies of ECE. In Hungary and Czech Republic the current account from the beginning was mounting till 1996. In 1997 it diminished in both economies. This improvement was followed by increase and fall in Hungary and increase of current account deficit in Czech Republic except period between 1997-1998. In 2002 both economies experienced a decrease in the size of deficit. Again such mixed effects of foreign trade were not giving clear impulses for the macrostabilization effects. In case of Poland the situation was different. At the beginning it was the only example of economy with surplus of the current account in the region. This was replaced by time passing by a deficit, which was growing till 1999 and started to fall down after that year. Both examples indicate that in both cases the policies applied differed and their effects were not same as a result.

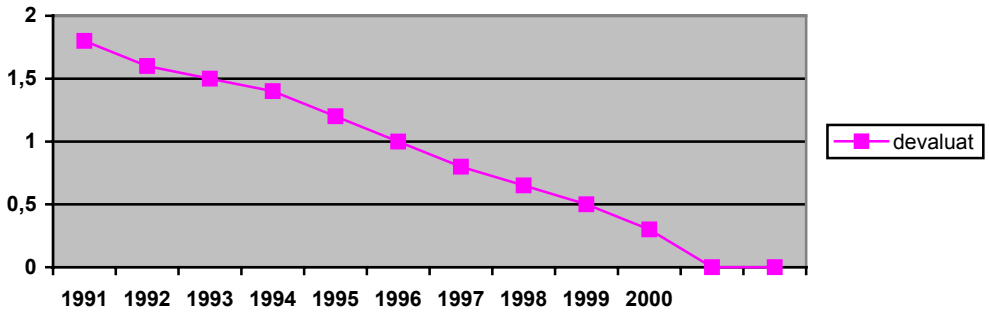
Table 2. Current account in Czech Republic, Hungary and Poland

Current Account	1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Republic									
Current account	-787	-1 369	-4 292	-3 211	-1 336	-1 567	-2 273	-2 654	-3 000
As % of GDP	-1,9	-2,6	-7,4	-6,1	-2,3	-2,9	-4,5	-4,7	-4,5
Hungary									
Current account	-3 912	-2 480	-1 678	-981	-2 298	-2 081	-1 346	-1 171	-1 041
As % of GDP	-9,4	-5,6	-3,7	-2,1	-4,9	-4,3	-2,9	-2,3	-1,7
Poland									
Current account	677	5 310	-1 371	-4 312	-6 858	-11 569	-9 946	-7 040	-7010
As % of GDP	0,7	4,5	-1,0	-3,2	-4,4	-7,5	-6,3	-3,9	-3,7

Source: *Transition Report Update*. EBRD 2002 p. 53 ,63, 75. London 2002.

Scale of devaluation in yearly terms was diminishing with time passing, what enabled introduction of the float in April 2000. Poland was first in the group of ECE introducing floating exchange rate. Czech Republic and Hungary have introduced that solution in the course of 2001 and 2002.

Chart 1. Exchange rate adjustments in Poland



Source: A. Słojewska, *Upłynnienie coraz bliżej*, Rzeczpospolita 7 January 2000.

Free float of zloty was introduced after a period in which the exchange rate regimes were changed in adjustment to scale of devaluation forces by general

macroeconomic conditions. When the economy stabilized requiring smaller adjustments in level of exchange rate the float was introduced.

2. Appreciation and competitiveness

Since 12 April 2000 exchange rate of zloty floats. Looking at is value one can observe that it temporary looses value and than gains it again, floating between 4,8 zloty/US$ (lowest value June 2001) to 3,6 zloty/US$ (highest value reached in February 2003). The average between the two extreme values between November 1999 till November 2002 is 4,20 zloty/US$. This was also the most frequent value that zloty was obtaining within its floating adjustments reflecting the changing supply and demand. This indicates that danger of financial crises was eliminated, what seemed to be the main goal of conducted exchange rate policy. Exchange rate fluctuations result in changing values and proportions of exports and imports. However, recently appreciation of zloty is not accompanied by worsening of the current account situation as interest rate is still relatively high (despite gradual decisions to reduce it in 2002 by the Monetary Policy Council), what helps to control consumption and thus pressure to increase imports. Moreover, appreciation of euro is increasing the dues from earlier drawn credits.

Mentioned moves are showing that the monetary policy is sound despite some problems with monetary policy as the budget deficit is in increase, although it is resulted according to EC Regular Progress Report of October 2002, by costly reforms. The budget deficit after a period in which it was bellow the requirements of the convergence criteria set for budget deficit in Protocol 2 of Maastricht Treaty, demanding from EMU candidates to keep the deficit bellow 3%, reached the level of 6%. According to the same source the budget deficit of Hungary reached the same level of 6%, while Czechs was higher than that by 2%, reaching 8%. It is worth mentioning that Czechs budget was the most stabilized in the region since the beginning of transformation. Commission comments this in following manner: Poland run into a high budget deficit financing costly reforms which can bring recovery in short for the economy, while comments concerning Hungarian and Czechs economy are different. Here the Commission states: both countries financed by the budget deficit measures, which were supposed to stimulate growth. Measures undertaken by those countries were not supported by the Commission and their positive impact on the economy is questionable, can occur in longer period.

Appreciating currency stimulates further inflows of capital and increase intensiveness of competition on the market, making imports cheaper and exports more expensive. This in turn – with other conditions unchanged – have an impact on the balance of payments, worsening the current account.

3. Depreciation of external currency used as a peg

Currency used as a peg can appreciate or depreciate, it can also keep more or less same value. Keeping the same value of the pegged currency means that when divergence between nominal and real exchange rate value occurs – the institution responsible for adjustments of the rate has to take the decision in this field. The adjustments should be conducted in a sound manner eliminating rapid changes, which supply additional shocks for the economy and create conditions for inflationary pressure. The use of currency peg is not neutral for the whole policy. A basket of different currencies, reflecting appreciation and depreciation of its components gives a more neutral effect in comparison to use of one currency, which can either appreciate or depreciate. Currencies used in such a basket should reflect the utilization of currencies in foreign transactions of the country in question.

As was observed before the exchange rate in transforming economies as a rule go trough a process of depreciation, what is followed by appreciation. Tendencies characterizing the value of currency used as a peg is not without meaning for the economy in transformation. In the period of fixed exchange rate a depreciation of currency used as a peg helps to keep the fixed exchange rate for a longer period in comparison with the opposite situation. If a currency appreciates in the period when the currency pegged is depreciating, than adjustments have to be deeper reflecting the two tendencies, going into two opposite directions. This in turn has an effect on inflation and exchange rate. Such a finding decides that it is more advisable to use a basket of currencies than one currency as a peg. Moreover, different tendencies of the first two currencies used as a peg help to stimulate exports at least on one of the markets. Illustrating this one can recall the situation when Poland was using basket of two currencies US$ (45%) and euro (55%) – euro at that time was loosing value, while dollar was gaining. This has resulted in a surplus of current account with the US and markets, where trade transactions were concluded in US$ and increase of deficit in markets, where the currency was depreciating.

4. Tendencies in value setting of currencies used in a basket of currencies serving as a peg

Value of currency used as a peg can be set by decision of the Central Bank of a country or the European Central Bank, or it can be set by the play of supply and demand within the floating system. The first method is considered to be a type of fixed exchange rate system, while the second as flexible (floating) exchange rate system. The way in which the value of currency used as a peg is set is not neutral for the value of exchange rate of a country using it

as a peg. It requires specific adjustments of internal policy concerning exchange rate, trade, interest and budgetary policy. By changing the level of interest rate one can have an impact on the exchange rate. Moreover, fiscal and monetary policies in different manner are adjustable to the regime setting the value of exchange rate. According to textbooks on macroeconomics one can say that fiscal policy reacts to impulses produced by the economy when the exchange rate regime is fixed, while monetary policy adjusts with certain difficulties. And the opposite can be observed with a floating regime. With floating exchange rate regime the fiscal policies lose power, while monetary policies gain. This can be presented in a form of a diagram.

Chart 2. Fixed and floating exchange rates and effectiveness of monetary and fiscal policies

	Fixed exchange rate	Floating regime
Monetary policy	No	Yes
Fiscal policy	Yes	No

Source: own arrangement.

Moreover, we can state that the dynamics of fiscal policy is dependent on the applied budgetary policy, in other ways on this if the government runs a primary deficit or a surplus, and whether growth exceeds or falls behind of real exchange rate. This yields four different cases that can occur in practice.

Chart 3. Debt dynamics: 4 scenarios

	g>t	g<t
r>y	Case A	Case B
r<y	Case C	Case D

r – interest rate
y – rate of growth
g –government expenditures
t – revenues from taxes

Case A – government runs a primary deficit, and real income growth exceeds the real interest rate. Macroeconomic scenario is stable. The interest rate determines how fast the debt grows due to interest payments alone, if these are being financed by issuing new debt. The income growth rate determines how quickly the income grows. With balanced primary budget and income growth that exceeds the interest rate, the debt ratio converges to 0. Convergence also obtains with primary budget deficit. But then equilibrium obtains at debt level at which the reduction of debt ratio due to income growth exceed the interest rate is exactly balanced by what primary deficit adds to the debt ratio.
Case B – economy experiences primary budget surplus. This makes the government a creditor in equilibrium. Due to y>r this equilibrium is still stable.
Case C – as in case A government runs a deficit but income falls short of real interest rate. There are two consequences of that. The government must be a creditor for debt ratio to be in equilibrium. Second, the equilibrium is fragile. Any displacements trigger endogenous processes that make debt ratio explode in either direction. Stabilization is only possible by appropriate adjustments of primary deficit ratio.
Case D – debt ration instable as in case C. Government runs a surplus, equilibrium requires the government to be in debt.

Source: M. Gartner, *A Primer in European Macroeconomics*, Prentice Hall, London, New York, Toronto, Sydney, Tokyo, Singapore, Madrid, Mexico City, Munich, Paris 1997, p. 277.

Those simple dependencies can indicate that use of a peg for currency can bring some impact on the value of currency of a country and thus on inflation. This fact decides that economies in transformation are moving towards flexible regime of currency value setting. Nevertheless, the dependencies shown in two charts are still true for the internal situation of a country and can define the results of fiscal policy.

Policies pointed at reducing the deficit of the budget have a side effect on reducing expenditures from the budget what is univocal with reduction of state intervention increasing competitiveness of goods, which formerly were subsidized. Thus convergence policy stabilizing the economy and reducing inflation is decreasing presence of a state, which formerly was increasing competitiveness of the goods produced in national economy. In other words new solutions are pointed at achieving real competitiveness, what can be one of the conditions that moves the economy towards new division of labor. It forces deregulation, restructuring and real competitiveness (as opposite to artificial

level achieved with all subsidies and other financial support that was applied in other to foster exports.

5. Appreciation of external currency of the main export/import market

Appreciation of the currency used in the market, which turns to be the main export market for a country in transformation has a same effect like own devaluation but without side costs in form of inflationary impulses. At the beginning of 1990's the tendencies in case of value of different European currencies were important for transforming economies to a certain degree depending either the currency was used as a peg or as a component in the currency basket, and if so what was it share in that basket or transactions concluded. Since 1999, when euro was introduced it was important what was happening with the exchange rate of euro as in most case European market attracted more than 60% of exports of all economies in transformation. Depreciation of the currency was univocal with increase of protection, decreasing in effect exports of ECE to EU, while appreciation was stimulating imports of that markets. Appreciation of euro in the period heading accession stimulates growth in economies joining the EU, what makes those markets attractive for FDI location, what in turn can be considered as a stimulus for the EU market. This rule can be effective when the share of total exports from EU to ECE will increase in global share of exports, otherwise the effect for EU economy will be limited. Big asymmetry in mutual trade between ECE and EU lead to a conclusion that such an effect will be rather limited. Nevertheless, this share can be increased if rule of symmetric liberalization among economies in transformation would be introduced. Such a move could stimulate flows of capital from EU economies to the accessing economies and stimulate exports to the economies of former Soviet Republics. Huge potential market of the CIS (Commonwealth of Independent States) economies requires opening as a tool helping to stabilize and reshape their economies. With production accomplished in economies with higher salaries the exports to economies with lower PPP (purchasing power parity) will be limited. When the production is moved to economies with lower PPP prospects of exports to those markets will automatically increase. This will also help to create a potential that will be able to produce goods for exports which, with time passing, will help to cover the costs of imports. Again this finding is relatively simple and experience (failures and success stories) of transformation show that such an approach can be beneficial for EU, ECE and CIS.

Conclusions

Tendencies occurring in value setting of external currencies play different roles on different stages of transformation. Generally speaking three main possibilities can be found in the practice of mutual relations between ECE and EU economies in this specific respect.

Appreciation and depreciation of the currency plays an important role in different stages of transformation of the ECE economies either stimulating trade or competition on national markets. It is also important what happens with the currencies applied as pegs for currencies, which are heading towards convertibility according to art. VIII of IMF. Finally, when economies of ECE states come to stage of floating regime, which fixes their value of exchange rate according to the rules of market, following the supply and demand for national money, tendencies occurring in value of currencies of main export markets of ECE are important. Appreciation of such currency can be considered as a stimulus for exports, while depreciation as a tool halting imports.

The found dependency can be used as a stimulus of growth in EU economies under the condition that share of exports to ECE economies increases in the overall exports of the EU. With limited capacities to increase imports to economies, which are generally small, measured by their GDP, requires trade liberalization with remaining economies in transformation on equal terms (symmetric).

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