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**Ezoneplus: Research project, European Commission, Fifth Framework Programme, 2001-2004**

## Editor's Note

Welcome to the July issue of the Ezoneplus newsletter. This time you will learn about the results of the Ezoneplus Brussels workshop, held on May 9<sup>th</sup>. Moreover, the research consortium published a variety of new working papers providing regional input on monetary and fiscal issues of EMU-enlargement and Christian Fahrholz' contribution develops a model of strategic exchange-rate policy, thus opening the floor for possible political bargaining struggles.

At last you may find helpful the table of contents of a recent publication distilled from the Ezoneplus Conference on Trade and FDI, held in Cracow, Poland last November.

**EZONEPLUS Partners:  
Estonia, Finland,  
Germany, Italy,  
Poland, Portugal, and  
Slovenia**

## Review of Brussels workshop, May 9th

### **“Eurozone Enlargement: Exchange-rate Choices and Adjusting Markets”, Brussels, Goethe-Institut/Inter Nationes**

On May 9<sup>th</sup>, the Ezoneplus Consortium organised an academic workshop for representatives of the European Commission and academia in Brussels. The aim of **Eurozone Enlargement: Exchange-rate Choices and Adjusting Markets** was to present research and outcomes of the first year of Ezoneplus (conference minutes are available at [www.ezoneplus.org](http://www.ezoneplus.org)). Divided into a keynote lecture and three topical key issues, the workshop covered capital & labour markets, trade & FDI, as well as exchange-rate policies.

The keynote lecture was delivered by Dr. Vít Bárta from the Czech National Bank: **Major challenges for accession countries on their way towards euro**. The scientific advisor to the National Bank asked whether CEE countries tend to underestimate their possibilities with regard to EMU and strive too eagerly for the common currency? This however, should come as a surprise given the fact of UK's and Denmark's hesitation to join the club. Finally, the speed of accession displays the need to import political and economic stability. Nevertheless, some adjustment costs will arise and will possibly put the small open eastern European economies under pressure. (The full presentation as pdf-document: [Link](#))

According to **Dr. Vladimír Lavrač** from IER in Ljubljana, the applicants must keep in mind not to join the ERM II too early as well as not too late. Moreover, once they are in, staying too long should be avoided. Being somehow opaque regarding its requirements and day-by-day proce-

**Brussels workshop –  
May 9, 2003**

**Keynote lecture by:  
Vít Bárta, Czech Na-  
tional Bank**

dures, any participation within the so-called ERM II should therefore be as short as possible.

On the other hand, countries of the Eurozone strive to let new members in only if those may be ripe to do so. Current experience with the Stability and Growth Pact sheds some light on rather poor performances with respect to austerity politics. Similarly to **Prof. Katarzyna Żukrowska** from the Warsaw School of Economics he pleaded for a combined view on monetary and fiscal aspects and raised the question of fiscal sustainability in the light of demographic developments and the possibility of a somehow “adjusted” SGP for CEE countries.

A “hot topic” has been the issue of how to determine the equilibrium exchange rate and the possibility of strategic bargaining. The Ezoneplus Berlin team argued that CEE countries might be tempted to pursue a strategy of entering the ERM II with an over-valued exchange rate, in order to coerce the Union into financial assistance.

**Jakub Borowski**, National Bank of Poland, rejected this instrumental logic, but during the subsequent discussion, **Prof. Dr. Michael Bolle** (Co-ordinator of Ezoneplus, Berlin) suggested that potential moral hazard might trigger speculative attacks deteriorating the overall enlargement process. From the point of view of Ezoneplus the enlargement process is basically exporting legal institutions to transition countries. In this regard, prosperity – at least macroeconomic stability – serves as a legitimisation of this institutional transfer, i.e. it ensures public support.

## New Ezoneplus Working Papers

### **(1) Ezoneplus Working Paper No. 14, April 2003**

Fahrholz, Christian: “Strategic Exchange-Rate Policy of Accession Countries in ERM II”

Exchange-rate policies of Central Eastern European Countries (CEEC) have often been a subject matter. Yet, some new insights in terms of political economy considerations upon exchange-rate policy are provided. It is pointed out that it is more appropriate to analyse exchange-rate policy in course of Exchange Rate Mechanism II (ERM II) with regard to a changing incentive structure. In doing so, considerable moral hazard problems become apparent.

ERM II shall provide for an adequate level of convergence between prospective and current members of European Monetary Union (EMU). However, this institutional arrangement and, particularly, its impact on the incentives for exchange-rate policy making might enable CEEC to load considerable costs of convergence onto current members. Accordingly, the phase of ERM II is considered to be a bargaining on the distribution of costs of convergence between prospective and current members of EMU. In return, accession countries would offer to maintain public support for European integration. The CEEC’ leverage in this bargaining rests on brinkmanship, i.e. putting exchange-rate regimes at risk, thus possibly undermining the according public support.

This paper delineates the basic assumptions and conditions for successful brinkmanship, points out the specific transmission mechanisms, and characterises this kind of exchange-rate policy as ‘threaten-thy-neighbour’. Overall analysis results in a cautious outlook on probable effects of such strategic exchange-rate policies on European institutional and economic matters. [Link to the paper](#)

**Brinkmanship or what?  
CEEC and incentives to behave strategically during the accession procedure**

### **(2) Ezoneplus Working Paper No. 15, June 2003 – Regional Input**

Lavrač, Vladimir; Žumer, Tina: “Exchange-rate regimes of CEE countries on the way to the EMU: nominal convergence, real convergence, and optimum currency area criteria”

**The effects of real vs. nominal convergence on the entry strategies towards ERM II**

The paper starts from the description of alternative exchange rate regimes currently in use in Central and Eastern European EU candidate countries. Their present exchange rate arrangements differ substantially, as they cover the whole spectrum of possible solutions, from currency boards to floating exchange rate regimes. By now it is known that these countries will first enter the EU and the ERM 2 (exchange rate mechanism, devised for the so-called pre-in countries, as a preparatory stage before their EMU membership), and only a few years later join the EMU and adopt the euro. The paper therefore tries to evaluate present arrangements of the candidate countries from the point of view of how compatible these arrangements are with the future ERM II and EMU requirements.

The paper addresses some issues which are still open in the process of inclusion of CEE countries in the EMU. First, what are the interests of both parties involved (CEE countries and the EU side) regarding the dynamics of the accession of CEE countries to the EMU, and related to this, what is its likely scenario (early or late inclusion in the EMU), taking into account the balance of powers between the two sides. Second, the paper discusses the criteria for measuring readiness of individual CEE countries for joining the EMU.

As an illustration, the paper attempts to measure some of the optimum currency area indicators for the case of Slovenia, and finds out that Slovenia is relatively quite suitable for joining monetary integration and relatively well prepared for joining the euro area. In particular, Slovenia is not expected to be exposed to serious asymmetric shocks, once it joins the EMU. [Link to the paper](#)

**Slovenia: a test case for optimum currency area theory?**

### **(3) Ezoneplus Working Paper No. 16, 2003 – forthcoming**

Orsi, Renzo: “Exchange-rate Regimes, Final Report”

This report aims to conclude our research on different exchange-rate regimes. Nevertheless, this issue will figure prominently within upcoming publications.

### **(4) Ezoneplus Working Paper No. 17, 2003 – forthcoming**

Lavrač, Vladimir ed.: “Monetary and Fiscal Policies, Final Report”

### **(5) Ezoneplus Working Paper No. 17A, May 2003 – Regional Input**

Lättemäe, Raoul: “EMU accession issues in Baltic countries”

After joining EU, the accession countries are expected to join the EMU and the euroarea. This cannot take place immediately after EU enlargement, as prior joining euroarea the accession countries should apply to the European Commission for entering EMU stage three and fulfil Maastricht’s convergence criteria. There is no deadline, when accession countries should make the decision to join the euro-area.

However, there is no opt-out clause for accession countries either, like there was for Denmark and UK in 1999. All accession countries are expected to join the monetary union in some stage. This paper analyses briefly the EMU accession issues in Baltic countries. In addition, a formal inspection of the OCA criteria in Baltic countries is carried out, using the structural VAR methodology. The results of Baltic countries are compared with the results of other accession countries and EU countries. [Link to the paper](#)

### **(6) Ezoneplus Working Paper No. 17B, May 2003 – Regional Input**

Kiander, Jaakko: “Macroeconomic Policy and Performance in the Nordic Countries in the 1990s”

This paper reviews the macroeconomic policies and performance of the three Nordic EU countries. The experiences of Denmark, Finland and

**Performance of the Nordic States and the effects of the Stability and Growth Pact**

Sweden from the turbulent economic developments of the 1990s and from adjusting their public sectors to fiscal consolidation are illustrating, not least for the discussion of the future challenges of. The economic crises and structural changes of the 1990s as well as the choices done in monetary and fiscal policies can be viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. In this paper the monetary and fiscal policies of the three Nordic EU countries is compared to the averages of EU15. The economic performance of these countries is assessed in terms of growth and employment. The main conclusions of the paper are: (i) the fixed (but adjustable) exchange rate regimes may be costly in terms of output and employment if they are not fully credible; and (ii) large economic fluctuations create easily equally large changes in fiscal balances, which may exceed the limits of the Stability and Growth Pact. [Link to the paper](#)

**(7) Ezoneplus Working Paper No. 17C, July 2003 – Regional Input**

Fahrholz, Christian; Mohl, Philipp: “Fiscal and Monetary Policy in Belgium, France, Germany, Luxembourg and the Netherlands”

This regional input analyses recent developments and future prospects of fiscal policy (part I) and monetary policy (part II) of Benelux, France and Germany (EMU-5) covering the period of 1997-2004. The fiscal policy part concentrates on budgetary effects of the eastward enlargement. Besides, socio-economic developments are considered, as well. In context of monetary policy affairs, the heterogeneity of EMU-5 members is surveyed. The brief analysis of two main aspects of the monetary union – the GDP growth rates and the inflation rates – indicates that diversity among the surveyed countries still prevails. [Link to the paper](#)

**The euro and fiscal and monetary developments:  
How do Benelux, France, and Germany differ?**

**(8) Ezoneplus Working Paper No. 17D, May 2003 – Regional Input**

Marzo, Massimiliano: “Challenges for Monetary Policy and the Enlarged Euroland”

The recent outset of European Monetary Integration with the introduction of a unique currency and a full centralization of monetary policy together with the increasing integration of global capital markets stimulated a large body of research on monetary policy rules. Since Lucas’ critique, the need to find rules which are at the same time simple and accountable has been a first goal for researchers and policy makers. In fact, policy can be effective only if it is credible. Credibility is enhanced through the adoption of simple, accountable monetary policy rules. However, the big question is: what kind of rules?

This paper tries to address the critical aspects in monetary policy modeling with a special emphasis to Euro-Enlargement. [Link to the paper](#)

**(9) Ezoneplus Working Paper No. 17E, 2003 – forthcoming**

Zukrowska, Katarzyna et. al.: “Monetary and Fiscal Policies, Regional Input on Poland and the Czech Republic”

**(10) Ezoneplus Working Paper No. 17F, March 2003 – Regional Input**

Vieira, Carlos; Vieira, Isabel; Costa, Sofia: “Monetary and Fiscal Policies in EMU: some relevant issues”

The common monetary policy, announced at the end of the 90s, is based on a two per cent target for inflation. Such a restrictive policy stance, which is believed to be a way of assuring monetary stability in the integrated area, may in fact lead EU economies to deflation, with all the negative consequences that the situation involves.

The monetary union was implemented in a space not completely homogeneous in economic terms, where a number of disparities are still evident. The improvements in terms of economic integration and the previous completion of the single market program did not fully abolish the gap between the rich core and the poor peripheral countries. Furthermore, the EU is also a heterogeneous space in social, cultural and political terms and such heterogeneity will be enhanced by the imminent Eastern enlargement. As a result, the probability of asymmetric disturbances has not diminished, as previously expected following an intensification of economic integration, and is still high, especially in the periphery of EMU.

However, the coexistence in EMU of one common monetary policy and several domestic fiscal policies raises a number of problems of both academic and political interest. First, there are reasons to assess a hypothetical need to also centralise fiscal policies in such circumstances, according to what prevails in federal states. Second, given that this hypothesis has not reached consensus in the EU, nor is it expected to do so in the near future, the issue of how to co-ordinate monetary and fiscal policies, in order to achieve the desired outcomes in both global and individual terms, arises. Third, the fact that policy spill-overs are enhanced in the EMU, the need to avoid free riding behaviour on the part of member states and the apparent non-reliance on financial markets to discipline sovereign debtors led to the option of restricting the autonomy of domestic fiscal policies by setting up constraints upon the relative levels of deficits and debts. [Link to the paper](#)

**(11) Ezoneplus Working Paper No. 17G, May 2003 – Regional Input**  
Capriolo, Gonzalo; Lavrač, Vladimir: “Monetary and Exchange-rate Policy in Slovenia”

The paper is divided into three sections presenting some stylized facts concerning monetary and exchange rate policy framework in Slovenia. Three periods are covered: Money-based Stabilization Policy (1991-1995), Price and Real Exchange Rate Stability Dual Targeting Policy (1996-2001), and Exchange Rate Based Stabilization Policy and Accession to ERM2 (2001-). [Link to the paper](#)

**(12) Ezoneplus Working Paper No. 18, June 2003**

Lavrač, Vladimir: “Institutional Aspects of Dynamics of Inclusion of Accession Countries in the EMU”

The main topic of the paper is optimal dynamics, i.e., timing of entry of the accession countries in the ERM II and EMU. Some of the main questions addressed in the paper are the following: a) Should accession countries aim at an early or a delayed entry in the EMU? b) What are economic and other arguments for an early or late inclusion in the EMU? c) What are the institutional external constraints which may prevent an early inclusion of accession countries in the EMU?

Institutional rules of the phased process of monetary integration for the accession countries are not quite transparent and leave much room for discretion to the EU side. In such circumstances it is difficult for the accession countries to devise clear and consistent strategies with respect to the timing of entry in the ERM II as an interim institutional mechanism in the run-up to the EMU.

This is precisely a dilemma which the accession countries are facing at the moment. Should they try to join the ERM II as soon as possible, i.e. immediately after the EU accession, or somewhat later? There are reasons to believe that the ERM II mechanism is potentially dangerous, so it would be wise to stay in this mechanism for as short time as possible (for a period of prescribed minimum two years). Staying for too long in this mechanism may cause problems in meeting the Maastricht convergence criteria and may lead to delaying the entry in the EMU into indefinite future.

**The Maastricht exchange-rate criterion: unintended dynamics?**

**What implies ERM II for the entry-strategy of CEEC?**

ERM II is potentially dangerous and an unstable exchange rate mechanism, since it is a system of a soft peg, which may become vulnerable to financial crises, particularly in case of free capital mobility and expected large capital flows before the EU and EMU entry (convergence play).

The paper also contributes to the debate on nominal versus real convergence as a precondition for joining the EMU, seen in the light of the discussion on optimal dynamics of inclusion of accession countries in the EMU. One of the conclusions of the paper is that there is room for improvement of the institutional set up in the run up of accession countries to the EMU. In particular, there should be more transparency, equal rules treatment, and less discretion in the hands of the EU institutions.

[Link to the paper](#)

## Book on Ezoneplus Cracow Conference out now

### **(\*) The Eastward Enlargement of the Eurozone**

An academic conference was held in Cracow on November 21-24 last year. The results are now published: (you may find the complete document at [www.ezoneplus.org](http://www.ezoneplus.org))

Zukrowska, Katarzyna; Sobczak, Dominik, ed. 2003. "Eastward Enlargement of the Eurozone. Impact on Trade, FDI and Capital Markets", Warsaw School of Economics, Warsaw.

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