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Exchange rate regime alternatives before EMU enlargement



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TABLE OF CONTENTS

KEY POINTS	2
1. INTRODUCTION	2
2. CURRENT EXCHANGE RATE ARRANGEMENTS IN THE ACCESSION STATES (GENERAL TENDENCIES)	3
3. FACTORS TO BE CONSIDERED WHEN CHOOSING THE OPTIMAL EXCHANGE RATE REGIME	4
3.1. FORMAL CONSTRAINTS ON EXCHANGE RATE REGIMES ARISING FROM EU MEMBERSHIP	4
3.2. THE PROBLEM OF VOLATILE CAPITAL FLOWS	4
3.3. THE NEED FOR CONVERGENCE TO THE EU	6
4. PROS AND CONS OF MAJOR EXCHANGE RATE REGIME CHOICES IN THE TRANSITION PERIOD TO EMU	7
4.1. UNILATERAL EUROISATION	7
4.2. CURRENCY BOARD	8
4.3. MANAGED FLOAT / INDEPENDENT FLOAT	10
5. CONCLUSION	13
APPENDIX: A SUMMARY OF PROS AND CONS OF EXCHANGE RATE REGIME CHOICES BEFORE EU ENLARGEMENT	15

Exchange rate regime alternatives before EMU enlargement

KEY POINTS

- There is no ‘one size fits all’ exchange rate regime for all accession states in the interim period after joining the EU and before introducing the Euro.
- Corner solutions (the most rigid or most flexible) exchange rate regimes are advisable for the accession states, with the condition of liberalised capital flows, which is a key requirement for EU membership. These exchange rate regimes are less vulnerable to speculative capital flows than intermediate options, such as fixed but adjustable peg and crawling peg regimes.
- Among the corner solutions there are three major options for the accession states:
 - a) **Unilateral Euroisation**, which means the adoption of Euro as legal tender before joining EU is **not a feasible option**, mainly because it is not compatible with the current views of the EU.
 - b) **Currency board (CB) arrangement**, which is a highly rigid exchange rate arrangement that limits the Central Bank's money creation to the size of international reserves, **can be a suitable option for some of the smallest, most open accession states, such as the Baltic states**, assuming there is no exchange rate misalignment, banking supervision and financial regulations have a high standard, and wages and prices are sufficiently flexible to absorb external shocks.
 - c) **Managed float**, which is a form of flexible arrangements, where the exchange rate is allowed to be determined by the markets, but the authorities intervene at their discretion to influence the rate, **seems to be the most suitable option for the Central European countries**. Its key advantage is the opportunity to pursue an active monetary policy. In addition, the chance of exchange rate misalignment is smaller in the medium term than in the case of fixed regimes. Although higher exchange rate volatility in managed float regimes is a burden for trade, it positively influences the structure of capital flows by discouraging speculative capital with higher exchange rate risk. When choosing this option it is a key condition for success to maintain a healthy mix of a tightening fiscal and an easing interest rate policy. This can help to avoid an excessive inflow of interest sensitive speculative capital, that could generate currency overvaluation and disruptive exchange rate volatility.

1. Introduction

Before the end of this decade, most Central European countries are likely to become members of the European Monetary Union. After achieving EU membership the accession states are expected to join ERM-2, the exchange rate coordination mechanism for the currencies of some EU members that have not introduced the Euro yet. Although, the CE-5 countries (Czech Republic, Hungary, Poland, Slovakia and Slovenia) are not very far from achieving the criteria, convergence of inflation rates and interest rates may require significant efforts. The experience of Southern European countries in the run up to EMU membership in the early 90s showed that the convergence process to EMU is not necessarily smooth. The years before EMU membership will possibly be accompanied by volatile capital flows and sharp exchange rate movements. The crisis of ERM (the European Exchange Rate Mechanism before EMU) in 1992 provided an example of the possible difficulties that can emerge before joining EMU. The sharp fall of the Italian, and Spanish currencies during the ERM crisis showed the consequence of maintaining a highly vulnerable fixed but adjustable exchange rate regime, while experiencing a large inflow of volatile capital during the convergence process towards EMU.

The choice of an appropriate exchange rate regime can be a crucial ingredient of a policy mix to avoid such unnecessary disturbances. This paper analyses the possible challenges for the Central European and Baltic economies, and the pros and cons and feasibility of possible exchange rate regime choices before EMU. The paper only focuses on those accession countries that were named in the last enlargement progress report of the EU Commission, as the ones having a chance to complete negotiations in 2002 and join the EU in 2004. These are the CE-5 and the three Baltic states (Estonia, Latvia, Lithuania). These countries have a good chance to introduce the Euro in the medium term, while for Romania and Bulgaria it is only a longer-term option.

2. Current exchange rate arrangements in the accession states (general tendencies)

Exchange rate systems in the accession countries have shown a wild plurality since the beginning of the transition. The exchange rate regime choices of the accession states can not be described by two simple terms: fixed or flexible. Between the extremes of fully flexible and irrevocably fixed regimes, a wide range of exchange rate regimes exist at different degrees of flexibility. An IMF classification identified 8 types of exchange rate regimes, numbering them from the least flexible regime (See Table 1.)

In the accession countries almost all types of exchange rate regimes existed. However, since the start of the transition significant changes happened in the occurrence of various regime types. In CE-5 the most important tendency was the gradual increase of exchange rate flexibility. In 1990 conventional fixed pegs were in place in all Central European countries. After the early 90s a plurality of fixed, crawling peg type intermediate and managed floating type flexible regimes characterised Central Europe.

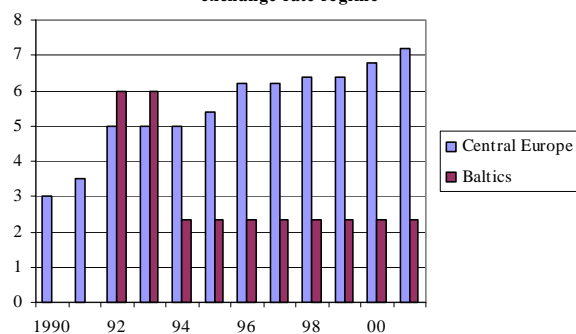
Table 1. Exchange rate regime classification of the IMF

Exchange Rate Regime	Description
1. Dollarisation (or Euroisation)	No separate legal tender
2. Currency Board	Currency fully backed by foreign exchange reserves
3. Conventional Fixed Pegs	Peg to another currency or currency basket with a band of at most +/- 1 %
4. Horizontal Bands	Pegs with bands larger than +/- 1%
5. Crawling Pegs	Pegs with central parity periodically adjusted in fixed amounts at a pre-announced rate or in response to changes in quantitative indicators
6. Crawling Bands	Crawling pegs, combined with bands more than +/- 1%
7. Managed float with no pre-announced exchange rate peg	Active intervention without commitment to a pre-announced target or path for exchange rate
8. Independent Float	Market-determined exchange rate and monetary policy independent of exchange rate policy

Source: IMF

In 2001, the most flexible types of exchange rate regimes, namely managed float, and in the case of Poland independent float dominated CE-5.

Chart 1. Average degree of the flexibility of the exchange rate regime



Source: IMF

of exchange rate regime flexibility

1990s, when a series of emerging market crises demonstrated the vulnerability of intermediate exchange rate regimes (fixed but adjustable pegs) in the world of high capital mobility (e.g. Czech, Mexican, South-East Asian, Russian, Brazilian, Turkish crises).

This was in sharp contrast with the tendency of the Baltic States to move towards very rigid exchange rate regimes. After free float in 1992-93 Latvia and Lithuania introduced conventional fixed peg and currency board regimes, respectively. Estonia had already established a currency board regime in 1992 and managed to sustain this very tight regime since then. Chart 1. illustrates the opposing tendencies in Central Europe and the Baltic states by calculating the average numbers of the degree of exchange rate flexibility, based on the IMF classification.

The changes to exchange rate regimes in the accession countries fit very well into the world-wide tendency for the polarisation of exchange rate regime choices. The reason for the move towards extremes lies in the experience of the late

Table 2. Exchange rate regime choices in the CEE accession states in 2001

	Exchange rate regime choice	Anchor currency
Czech R.	Managed Float	Euro
Hungary	Managed Float	Euro
Poland	Independent Float	-
Slovakia	Managed Float	Euro
Slovenia	Managed Float	Euro
Estonia	Currency Board	Euro
Latvia	Conventional Fixed Peg	Euro
Lithuania	Currency Board	Euro*
Bulgaria	Currency Board	Euro
Romania	Managed Float	Euro

*Lithuania switched to Euro from its previous anchor currency Dollar in 2nd, February 2002

3. Factors to be considered when choosing the optimal exchange rate regime

3.1. Formal constraints on exchange rate regimes arising from EU membership

Before accession to the EU, no specific obligations exist concerning the exchange rate regime of candidate countries. However, in 2000, the ECOFIN Council of the EU (the part of the EU council responsible for Economic and Financial Affairs) gave some guidance regarding the acceptable exchange rate regimes after joining the EU, but before joining EMU. The countries joining EU in 2-3 years time will be required to fulfil, among other criteria, the exchange rate criterion of the Maastricht Treaty, that requires exchange rate stability for at least two years before introducing the Euro. To achieve exchange rate stability, the new member states will be required to join ERM-II, the EU's pre-EMU exchange rate mechanism. The exchange rates of the new member states in ERM-II should be tied to the Euro, and allowed to fluctuate in a +/- 15 % band.

According to the Council, the only types of exchange rate regimes that are not compatible with ERM-II, are the following: any regime without a mutually agreed central rate to the Euro, crawling pegs, and pegs to currencies other than the Euro. Therefore, for instance, independent float is not acceptable because of a lack of central parity with the Euro.

3.2. The problem of volatile capital flows

A key criterion for an optimal exchange rate regime is the provision of help for the management of capital flows in a sustainable way. The problem of volatile capital flows is an especially relevant factor for the prospective Central European EU members. The accession states of Central Europe have already experienced very strong capital flows in the 1990s. There are many reasons to believe that the EU accession of the Central European countries will be followed by an even stronger inflow of both FDI and portfolio capital.

The chances of high capital inflow in the years following accession are related to the integration of the region into the EU, and their convergence process to EMU.

- The requirement for EU membership contains conditions for the accession states to liberalise their capital markets and abolish all significant restrictions to capital movements as stipulated in the Maastricht Treaty. The accession countries have been already harmonised with these requirements to large extent.
- Most economic forecasts suggest that the accession states' growth rate will most likely remain at least 2 percentage points higher than the EU average. Higher growth rates imply higher rates of return on capital, thus facilitating the inflow of capital.
- Long term interest rates in the accession countries are relatively high, as they were in the Southern European countries in the early 90s. Expectations towards the decrease of these interest rates and the increase of asset prices are likely to generate capital inflows. Furthermore, the efforts of central banks to meet the Maastricht criteria are likely to require the sustaining of an interest rate level that is higher than the uncovered interest rate parity. This can encourage fixed income investments, such as investments in government securities.

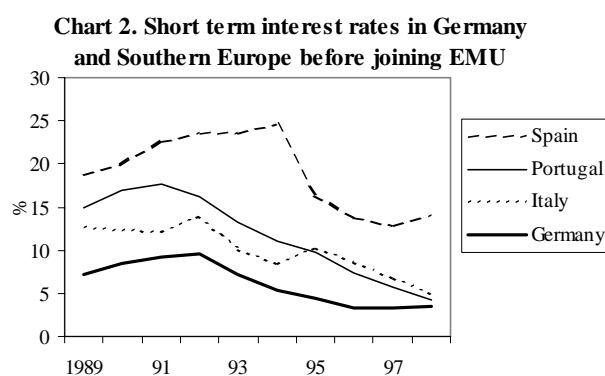
- The improvement of macroeconomic fundamentals can also intensify capital inflows, as the accession states will make efforts to improve their fiscal position and decrease their inflation rate in the convergence process to the EMU.

On the one hand, stronger capital inflows into the region are highly desirable. Domestic savings are not yet sufficient in the candidate countries to cover the investment needs of their economies in the process of large scale industrial restructuring. Moreover, capital inflows from Western Europe, the US and Japan can continue to play a key role in transferring new technologies, and can help to create more efficient financial systems. These factors can facilitate higher growth.

On the other hand, stronger capital inflows can be a source of various policy dilemmas.

The experience of Italy and Spain during the ERM (Exchange Rate Mechanism) crisis demonstrated the difficulties of sustaining a fixed but adjustable regime during the convergence play to EMU, while facing large and volatile capital flows. In the ERM mechanism, the currencies of the member states were tied to the anchor currency (at that time the DM) with a tight $\pm 2.5\%$ fluctuation band. This arrangement limited exchange rate volatility effectively, however large capital flows tested the system and led to a collapse of it in 1992. The strong inflow of capital started with the removal of capital controls in the EU between 1987 and 1992, due to the requirements of the Single European Act.

In the Southern European countries, where interest rates were far higher than in other member states at the time (see Chart 2), there were high expectations of interest rate convergence due to the effort of these countries to be in the first group to join EMU. The expected decrease of interest rates was naturally associated with an increase of asset values.



Source: Eurostat

This factor, together with the relative exchange rate stability under the tight bands of the ERM mechanism served as a magnet for the capital of institutional investors. However, the stability of the interest rate convergence was linked to expectations that the end of the process would be the EMU membership of these countries. When the Danish referendum said no to EMU in 1992, it was sufficient to undermine investor confidence, and caused a sharp reversal of short-term capital flows and the massive fall of currencies in question.

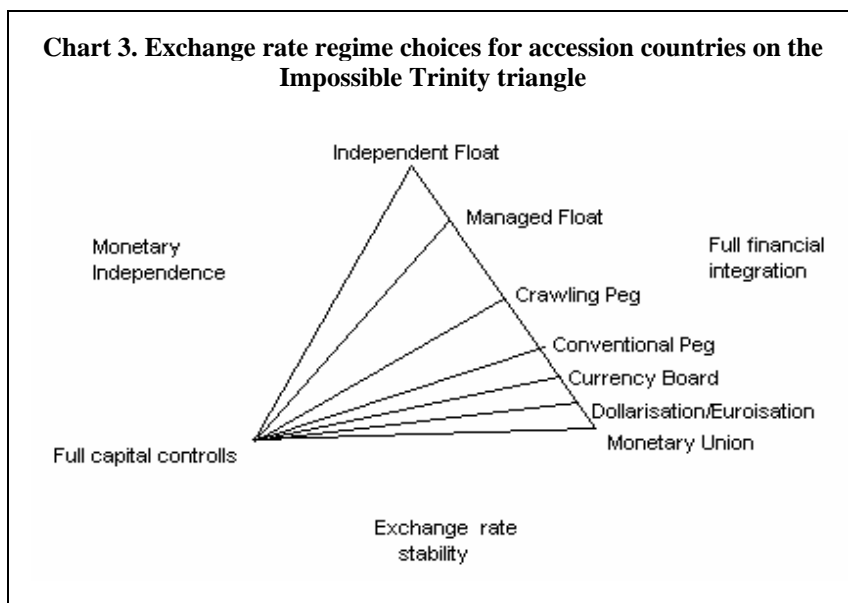
Besides the problem of speculative attacks, another key problem is associated with the difficulties of pursuing an independent monetary policy, while fixing the exchange rate in the world of high capital mobility. Various economic studies demonstrate that the CE-5 countries would greatly benefit by fixing their currencies to the Euro. These benefits are associated with their gains from exchange rate stability due to their strong trade links and economic integration with the economies of Euro zone¹. However, in the period before introducing the Euro, fixing the national currency can result in a problem, characterised as “impossible trinity²”.

The key problem is that a country cannot achieve at the same time all three objectives of independent monetary policy, openness of the capital account and exchange rate stability.

¹ See more in Heinz (2002)

² See more in Habib (2001)

Chart 3. Exchange rate regime choices for accession countries on the Impossible Trinity triangle



In the case of opting for capital account liberalisation (this is the case relevant to the accession states due to EU requirements) the accession country in question faces two choices:

A) Fixing the currency inevitably leads to giving up monetary independence, because keeping the exchange rate in a narrow, pre-determined band requires an interest rate policy that accommodates capital inflows.

B) Opting for monetary independence is only possible under free mobility of capital, if the free movement of the exchange rate accommodates capital

inflows instead of the movements of the interest rate.

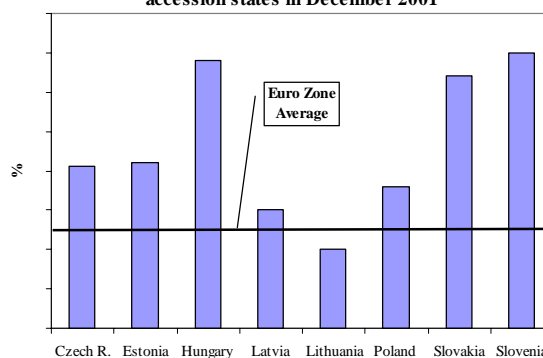
Chart 3. illustrates some exchange rate regime options for the accession countries in the case of full financial integration (no capital controls case) in the impossible trinity triangle. The various choices between Monetary Union and independent float represent an increasing level of monetary independence and a decreasing degree of exchange rate stability.

3.3. The need for convergence to the EU

An important criterion for exchange rate regimes before EMU membership is to provide effective support to the nominal convergence (e.g. fiscal consolidation and decrease of inflation). The convergence of inflation rates will not necessarily be an easy task (see Chart 4) and will require credible policies and a suitable exchange rate regime. One problem is that there are a lot of factors that justify higher inflation rates in the accession countries than in the current EU member states. For instance, in some sectors of the economy, prices are still significantly lower than in the EU (e.g. real estate sector, energy sector). The liberalisation of these sectors and the abolishment of the last pockets of regulated prices, can accelerate the convergence of price levels to the EU level. This inevitably means higher inflation rate than in the EU.

At the same time, the exchange rate regime should not hamper the convergence of the real economy either. On the contrary, it should support the structural convergence of the accession countries and the catching up of productivity and per capita income levels to the EU. When it comes to real convergence, the main risk factor is the development of exchange rate misalignments that can lead to an overvaluation of the currency and severe competitiveness problems of the real economy. The consequence of an inappropriate exchange rate regime with excessive real appreciation of the currency can be the build up of unsustainable current account deficit. This can cause a forced devaluation of the currency and restrictive policies that attempt to eliminate the external imbalance, while hampering growth for several years. We have seen examples of this sort of painful adjustment in almost all CE-5 economies as well (Czech Republic, Hungary, Poland, Slovakia).

Chart 4. Consumer price inflation in the first wave accession states in December 2001



Source: EIU, Eurostat

4. Pros and cons of major exchange rate regime choices in the transition period to EMU

The purpose of this section is to give an account of the pros and cons of three exchange rate options for the accession states. All exchange rate options to be discussed here are from the realm of corner solutions that have proved to be more suited to cope with the consequences of intensive capital flows. The three major options are Unilateral Euroisation, currency board, and managed float arrangements (Table 2. provides a brief account of the pros and cons of these regimes).

Among these options, Unilateral Euroisation (the introduction of the Euro before EU enlargement) and currency board are very similar alternatives on the most rigid side of exchange rate regime choices. Unilateral Euroisation (introducing Euro even before EU membership) and currency boards also have very similar advantages and disadvantages for the accession states. The main difference between the two options is that Euroisation could be a more credible and less reversible option for a country that chooses a rigid exchange rate solution.

4.1. Unilateral Euroisation

One of the most hotly debated exchange rate regime proposals for the accession countries is the idea of Euroisation. Debate about this unique option is especially lively in Poland and Estonia. Euroisation is one of the so-called hard peg solutions. The essence of the idea is that the candidate country should adopt the Euro as a legal tender unilaterally, even before EU membership. This would mean that the accession country surrenders its monetary authority to the ECB, already before joining EU.

Advantages

No speculative attacks on the currency

The main advantage and key motivation behind the Euroisation proposal is that it could provide an alternative for the accession countries against joining ERM-2 and facing the problems, discussed above of volatile capital flows, because in the absence of an own currency, speculative attacks would be impossible.

Decrease of interest rates may facilitate growth

The proponents of Euroisation also emphasise its role to facilitate real convergence through its growth enhancing effects. Among these effects the most important is the supposed decrease of interest rates. The abolishment of exchange rate risk could lead to a fall of risk premium, facilitating a decrease of real interest rates. However, in practice it is not necessarily the case. The risk premium on a certain country's government bonds consists of two major components: foreign exchange risk premium, and default risk premium. While the foreign exchange risk would disappear undoubtedly with the introduction of Euro, it is uncertain what would happen with the default risk of the country in question. The key question is, whether the system would function smoothly. In case the accession state would introduce Euro at an overvalued or undervalued rate, or asymmetric shocks arise that the economy cannot overcome easily without an independent monetary and exchange rate policy, it could actually increase default risk. Hence, in the case of an inappropriate timing and conversion rate, the beneficial effect of the fall of foreign exchange risk on interest rates can be offset completely by the increase of default risk.

Problems

Not compatible with the EU's views

The major problem with the idea of Euroisation is that it is not compatible with the views of the ECB. The reason for the negative view of the EU about Euroisation is that the EU would like the candidates to fulfil the same criteria as the founding members of the EMU. Of course, Unilateral Euroisation would be possible even against the will of EU, but it would almost surely undermine the chances of the applicant country in question from achieving EU membership. However, even if we assume that the views of the ECB may soften in the future (e.g. due to recognition of the arguments of the proponents of Euroisation), there are various other problems to cope with in the Euroisation proposal.

Danger of conversion at a wrong exchange rate

In some circumstances Euroisation could also hamper the catching up of the economy or the success of anti-inflation policy. There is a risk of exchange rates being converted at a non-equilibrium level. Since after introducing the Euro there will be no longer any way to alter the conversion rate, conversion at overvalued or undervalued exchange rate can cause problems. An overvalued currency can cause problems with competitiveness, while an undervalued currency can cause difficulties in decreasing inflation. Unfortunately, identifying the equilibrium level of an exchange rate in the accession countries is still a very difficult task, mainly due to the ongoing fast structural changes of these economies.

4.2. Currency board

Since Euroisation is not a feasible option for the accession countries, as it does not harmonise with the current EU requirements, for those countries that would prefer higher exchange rate stability as opposed to larger monetary independence, a currency board arrangement seems to be a more feasible option. According to the EU's statements, currency boards are acceptable in certain circumstances. The main condition is that the CB regime should function smoothly, without large external or internal imbalances for a sufficiently long period.

The experiences of CB regimes in the three accession countries that have introduced it (Estonia, Lithuania and Bulgaria) have been quite favourable so far. Inflation was squeezed down from hyperinflation to single digit levels. In addition, the two Baltic States achieved solid economic growth rates since the introduction of CBs. It is a debatable question, however, whether these countries should sustain their currency board system until joining the Euro Zone.

A currency board (CB) system is another form of hard pegs. It is considered to be a more rigid form of exchange rate regime than a conventional fixed peg. The most essential elements of a CB regime are the following:

1. *The central bank limits the amount of money creation to the size of international reserves.*
2. *The exchange rate is irrevocably fixed.*
3. *The domestic credit expansion of the central bank is prohibited.*

Advantages

Enhances monetary policy credibility

The CB arrangements are greatly enhancing the credibility of the monetary policy regime. Therefore, they serve as a very powerful means of anti inflation policy in those countries where the main reason for high inflation is the lack of policy credibility. CBs are the most credible version of fixed exchange rate regimes. The major source of credibility is that the exchange rate is irrevocably fixed, and the money printing of the central bank, consequently the monetary financing of fiscal deficit is prohibited. The consequence of higher credibility is that the central bank may achieve its objective to diminish inflation with much lower output cost (slow down of growth) than in a fixed but adjustable regime.

Contributes to growth and anti-inflation

According to the proponents CB regimes are both effective to decrease inflation and support the catching up of the economy at the same time. They claim that the credibility enhancing properties of CB regimes helped the countries that introduced CBs to achieve lower inflation and higher growth rates than the countries with other exchange rate regimes. Therefore, CB regimes are supposed to help both nominal and real convergence to the EU. However, the empirical tests are possibly misleading. The CB regimes in most countries, were usually introduced after a deep economic crisis, and existed for a limited period (except Hong Kong and a few other cases) afterwards. Therefore, the apparent good growth performance of the CB regimes may only signal the rebound effect (accelerated growth after the years of a crisis,) instead of growth enhancing effect of CB regimes.

A CB regime is more suitable for smaller and more open economies. These economies have very limited opportunities to pursue independent monetary policy, because interest rate changes induce very quickly powerful responses of capital inflow and outflow. Furthermore, in the case of an asymmetric shock, the devaluation of the

currency is inefficient to enhance export competitiveness even temporarily. The devaluation of the currency pushes up import prices, and the rising import prices cause an upward pressure on the domestic inflation rate much quicker than in larger, less open economies. Therefore, the choice of a CB regime in Estonia and Latvia is more reasonable than it would be in the case of Poland, the largest economy among the accession states.

Problems

Defending CB's against speculative attacks can be costly

It seems that CB is better suited to alleviate the problems caused by volatile capital flows, than conventional fixed peg, due to its stronger credibility. However, the credibility of a currency board can be shaken as well. Unlike in the case of Euroisation, the devaluation of the national currency is still possible. This implies that if the credibility of the commitment to defend the fixed parity comes into question, this can sharply increase the costs of defending the CB. For example, in 1995 Argentina had to increase interest rates to a very high level, to stop a massive outflow of capital and had to face a short but severe recession, with GDP declining by 5 percent.

Low level of public debt and lack of sufficient instruments to speculate with are key to success

Some economists argue that in the case of the Baltic States the stability of their exchange rate regimes were to a large extent related to the lack of sufficient financial instruments to speculate with. The size of these countries is very small even compared to the Central European economies. More importantly, they had a very low level of public debts even though in some cases it was increasing in the most recent years. In 1998-99 the currency board of Estonia went through a severe test. The Russian crisis in 1998 affected Estonia very strongly, due to its strong trade links with Russia at the time. The collapse of the Russian markets caused a deep recession of the Estonian economy, and the emergence of a large trade deficit, but the currency board remained solid.

In the case of an asymmetric shock the whole adjustment of the economy should take place in wages and prices

Another potential danger of CB regimes is strongly linked to their positive properties. On the one hand, the lack of independent monetary policy encourages fiscal discipline and structural reforms. On the other hand, the lack of opportunity to respond to asymmetric shocks by using exchange rate or monetary policy can be very costly. The lack of these major macroeconomic tools to influence the economy implies that in the case of an external shock the whole adjustment should take place in wages and prices. For instance, in case an external shock (such as a sharp increase of energy costs due to changes of oil and gas prices) hits the economy, the temporary downward adjustment of real wages can be helpful to overcome the hard times, by decreasing production costs. In the case of significant labour market rigidities, this adjustment can not take place. This can significantly increase the costs of the external shock in terms of lost jobs and output. It is a good sign that so far the labour markets of the Baltic countries proved to be fairly flexible, at least in comparison with current EU members.

The Central Bank has a limited opportunity to support fragile banks in the case of a financial shock

A key risk factor of CB regimes is that the central bank has a very limited opportunity to give credit to the banking sector, therefore it is unable to fill its role as a lender of last resort. It can be a fatal mistake to introduce a CB regime in a country with a fragile banking system, and poor regulations. The most important task during the establishment of a currency board regime is the strengthening of prudential regulations and supervision. From CE-5 and the Baltic States, Hungary, Poland, Slovenia and Estonia have good quality financial regulations (see Table 3).

Table 3. The quality of financial regulations and institutions in 2001

	Financial Regulations		Financial Institutions	
	Extensiveness	Effectiveness	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions
Hungary	4-	4-	4	4-
Slovenia	4	4-	3+	3-
Estonia	4	3+	4-	3
Poland	4	3	3+	4-
Lithuania	3+	4-	3	3
Czech R.	3+	3	4-	3
Latvia	3	3	3+	2+
Slovakia	3	3	3+	2+

Source: EBRD

Note: The scale ranges from 1 to 4+, 4+ represents full compliance with the current international standards in the developed countries.

Regarding the feasibility of the regime in the ERM-2, during the years prior to joining EMU one should separate those countries that already have a CB regime (Estonia, Lithuania), from those that have a different exchange rate regime. Those countries that managed successfully a CB regime for several years prior to joining ERM-2 have a good chance to maintain the CB regime in the interim period before EMU membership. Even though, in the case of exchange rate overvaluation, the depreciation of the exchange rate is not possible in the CB regimes, mounting external imbalances and weak growth performance would signal if the regime were not sustainable over a long enough time. Furthermore, giving up an existing CB arrangement, and choosing a flexible arrangement would have significant costs for the economies that currently have a CB. One problem would be the loss of the hardly earned credibility, and the risk of speculative attacks, as many investors would possibly interpret the regime shift as a confession of some hidden problems in the fundamentals of the economy. In the Baltic countries, it is also questionable whether they could pursue successfully an independent monetary policy without any previous experience in this field.

Similarly, adopting a CB arrangement just before entering ERM-2 can be a risky move as well. It can be highly dangerous to introduce a CB regime and irrevocably fix parities, right before joining ERM-2, with lacking of a sufficient period to test the sustainability of the CB regime.

4.3. Managed float / independent float

Managed float and independent float are on the flexible end of the IMF's classification of exchange rate regimes. The difference between a managed float and an independent float is that in an independent float regime there is no central parity for the exchange rate. Therefore in theory market forces play a dominant role in the determination of the exchange rate. In a managed float, there is a central rate and the central bank tends to play a more active role in the management of the exchange rate, limiting an unwanted degree of volatility.

Currently, the option of managed float (MF) is undoubtedly the most popular option among the Central European economies. Slovenia opted for a managed float regime in the beginning of the transition, and maintained this regime with an active intervention policy of the central bank, successfully avoiding the over-appreciation of the currency for many years. No doubt, sustaining tighter control on short-term capital movements than other CE-5 economies played an important role in this success.

In the Czech Republic (from 1997) and in Hungary (from July 2001), the managed float regime was combined with an inflation targeting system of monetary policy, similar to the one pursued by the Bank of England since 1997. In Poland the central rate of the Zloty was abolished in the beginning of 2000, and an independent float regime was introduced, which, was coupled by an inflation targeting system, which was similar to the two other major CE-5 economies.

Independent float regimes are not acceptable for the EU in the interim period before EMU. However, managed float regimes are perfectly compatible with ERM-2, if the currency is tied to Euro, and the range of fluctuation is within the +/- 15 % range.

Advantages

Better suited to handle capital flows

The flexible exchange rate regimes, and managed float regimes in particular are better suited to handle the problem of capital flows, than a fixed but adjustable regime. In theory, there is no need to pursue an accommodating interest rate policy (lowering interest rates to avoid intensifying capital flows driving out the exchange rate from a narrow band). In a flexible arrangement the movements of the exchange rate absorb capital inflows and outflows, giving a degree of freedom for interest rate policy.

Managed float regimes with a wide fluctuation band may also influence positively the structure of capital flows. Larger exchange rate volatility is a natural characteristic of the flexible regimes. If the exchange rate is allowed to fluctuate in a wider band (e.g. +/- 15 %), there is a larger scope for market forces to determine the movements of the exchange rate. Larger exchange rate volatility tends to increase the foreign exchange risk awareness of international investors. The greater awareness of potentially high losses due to exchange rate fluctuation tends to decrease the amount of speculative capital inflow.

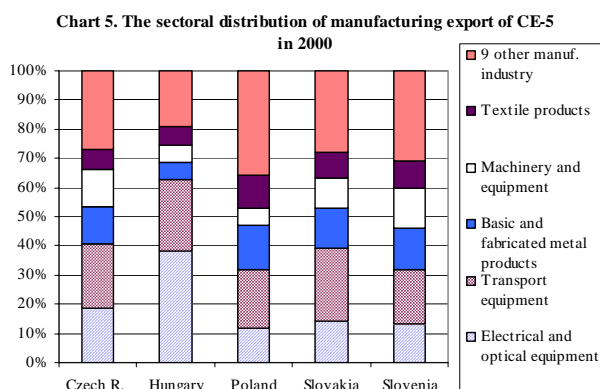
Makes independent monetary policy possible

The opportunity to pursue an independent monetary policy is one of the main attractions of the flexible option. In practice, this opportunity means three functions of a central bank's policies:

1. *The independent use of interest rate policy.*
2. *The possibility to use the nominal appreciation of the currency as a tool to squeeze down inflation.*
3. *The option to use exchange rate adjustments to overcome external shocks.*

In Central Europe, the opportunity to use exchange rate policy can be especially valuable. Decreasing inflation from a moderate (7-10%) to low (2-3%) level is a major challenge for the central banks in the region. The nominal appreciation of the currency can be a powerful tool to fight back inflation, in most CE-5 countries, where interest rate changes have a smaller effect on inflation, due to the low depth of financial markets. In more developed countries, the impact of the central bank's interest rate decision on mortgage rates is a key channel of monetary policy. In CE-5 this channel is very weak, given the infancy of mortgage markets. On the contrary, the exchange rate channel tends to be the most powerful channel of monetary transmission. The appreciation of the currency has a strong effect on inflation via the decreasing import prices measured in the domestic currency.

At the same time, these countries tend to be more vulnerable to external shocks than most current EU members partly because of their less liquid capital markets and stronger sectoral (see Chart 5) and geographical concentration of trade. Therefore, the opportunity to use exchange rate and monetary policy can be highly valuable for counter-cyclical stabilisation purposes.



Source: WiiW

Lower chance of exchange rate misalignment in the medium term

In MF regimes, and even more so in independent float regimes, according to its believers, there is a lower chance of exchange rate misalignment in the medium term. It can be an especially advantageous property in the period before fixing the currency irrevocably, when the equilibrium level of the exchange rate should be determined. Unfortunately, experience shows that market forces do not necessarily ensure an equilibrium exchange rate at any time. In the short term, exchange rate misalignments are highly possible.

Have a disciplining effect on fiscal policy

Even though, disciplining effect on fiscal policies is normally associated with CBs, in a managed float or an independent float regime, there is also a mechanism for disciplining fiscal policy. The fall of the exchange rate can serve as a prompt signal in the case of the emergence of concerns in the markets about fiscal overspending.

Problems

Larger exchange rate volatility is a burden for trade

Unfortunately, larger exchange rate volatility tends to be a mixed blessing. An excessive degree of volatility can be a burden for most exporting companies that tend to sign contracts in Euro. This shortcoming of the managed float regime can be mitigated by improvements in the liquidity of the derivative markets, helping exporting companies to hedge better against the foreign exchange risk of their operations. A key element of a liquidity enhancing policy is the liberalisation of derivative transactions, allowing foreigners to participate in the market on equal terms with the domestic players.

Capital inflows may lead to currency overvaluation

Even though the opportunity to pursue an independent monetary policy can be a highly welcomed property of a flexible arrangement, in the face of high capital mobility, this independence can be strongly limited even in a flexible regime. The key problem is that in a country where the central bank pursue an ambitious anti-inflation policy, the interest rates tend to be high for a relatively long period, offering high returns for investors in the fixed income (mostly government bond) markets. It is especially true in the Central and Eastern European accession states, where due to several reasons (among other things due to their higher productivity growth than the average in the EU), inflation rates tend to be higher than in the current EU member states. A sufficiently high level of real interest rates tend to attract short term interest sensitive capital even in the face of higher exchange rate volatility in a floating regime. This together with the significant amount of FDI flowing to the accession states, put a strong upward pressure on the exchange rate. At the end of the day this can lead to a strong overvaluation of the currency.

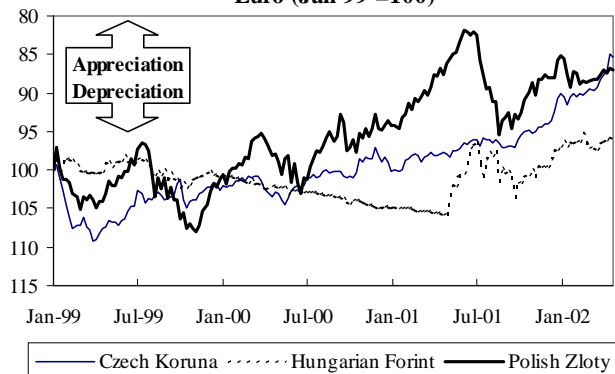
The results can be a deterioration of international competitiveness, external imbalances, and at the end of the day a large corrective depreciation of the currency. The large depreciation can cause a setback of inflation, decreasing the monetary policy credibility, and lengthening the time of convergence towards EMU.

The development of the Polish economy in 2000 and 2001 shows a clear example of this challenge. In April 2000, Poland abolished the central rate of the Zloty with the Euro and opted for an independent float regime, after pursuing a crawling peg policy for several years. After floating the Zloty the Polish central bank's policy was to avoid intervention and let the market forces determine the interest rate. In the first six months the Zloty followed closely the movements of the Euro. However, after November 2000 the Zloty/Euro exchange rate started to appreciate rapidly. An extraordinarily high level of interest rates was one of the key reasons behind the fast appreciation. The high interest rate policy of the central bank can be only partly explained by catching up related inflationary factors, such as the inflationary impacts of fast productivity growth. The key reason was the mismatch between fiscal and monetary policy. While fiscal spending was not kept on the level necessary to achieve the inflation target of the central bank, the National Bank of Poland (NBP) decided to use a "heavy handed" high interest rate policy to achieve the target, and enforce a fiscal adjustment.

The period of speedy appreciation was stopped by the contagion effect of the instabilities in Argentina in July 2001, together with the effect of adverse news about the unexpected depth of budgetary problems in Poland. Although the Polish currency went through the sharpest fall among the currencies of Central and Eastern Europe,

fortunately the devaluation did not have any devastating effect. Poland avoided larger disturbances in her financial markets –partly due to her relatively sound and well regulated banking system.

Chart 6. CE-3 currencies' exchange rate against Euro (Jan-99 =100)



Source: Datastream

However, the long period of strong appreciation (see Chart 6.) of the currency together with the high real interest rates, strangled domestic demand and squeezed down GDP growth to a dramatically low level in 2001.

The fact that the decrease of inflation continued after the devaluation reflected the strongly suppressed state of domestic demand.

There are three lessons to be learnt from the story:

First, the policy of the central bank to facilitate the convergence of the inflation rate to the level determined by the EU, should be accompanied by a sufficient degree of fiscal consolidation. This can help to avoid excessive speculative capital flows, and to enhance the stability of the managed float regime in the convergence period.

Second, even in the case of an inflation-targeting framework, when the main focus of the central bank is to achieve a pre-announced inflation target, the appropriateness of the exchange rate should be monitored. If it is necessary, the central bank should intervene to avoid excessive exchange rate volatility.

Third, the Maastricht criteria on inflation, and exchange rate stability can be conflicting in the period of convergence, due to the strong appreciating effect of intensive capital inflows on the exchange rate. Enforced convergence to the Maastricht level of inflation rate can weaken the stability of the exchange rate regime of an accession country, while decreasing interest rates discouraging an excessive inflow of capital can undermine ambitious inflation targets. A possible solution of this problem is in the hands of the EU. While, higher inflation due to fiscal imbalances should not be an acceptable reason to deviate from the inflation path required by the EU, it should be recognised by the EU that inflation rate in the accession states tend to be higher than in the EU due to structural reasons. Unfortunately, modifying the Maastricht inflation criterion seems highly improbable, because watering down the Maastricht criteria, even if for a good reason, does not appear to be a politically feasible option in the current member states. Instead of that, the CE-5 countries should continue fiscal consolidation to decrease inflationary pressures from the fiscal side that can give more scope for the central bank to decrease interest rates faster without endangering the inflation targets.

5. Conclusion

Corner solutions (flexible regimes or hard pegs) seem to be better choices than the fixed but adjustable regimes that tend to be highly vulnerable to speculative attacks, as demonstrated by the ERM crisis in 1992.

Unilateral Euroisation and currency boards have very similar advantages and disadvantages for the accession states. However, while a currency board is an acceptable arrangement for the ECB (at least in certain cases), Unilateral Euroisation is not at the moment. Therefore, from the most rigid exchange rate regimes, only CB can be a suitable option for some accession states.

The Baltic countries have a chance to manage successfully their currency board regimes before joining EMU. However, the sustainability of the regime should be monitored carefully in the following years, focusing on macroeconomic variables, such as current account deficit and economic growth. For the smooth functioning of the system in the case of external shocks, it is also important to strengthen prudential regulations and banking

supervision. Moreover, enhancing the flexibility of wages and prices can improve the ability of the economy to overcome external shocks in the absence of an independent exchange rate and monetary policy.

Flexible alternatives, such as managed floating are more suitable for the CE-5 economies. A key advantage of a flexible arrangement is the opportunity to pursue an independent monetary policy. This is highly valuable for the CE-5 countries that need a large degree of discretion for interest rate policy in responding to external shocks during the convergence process, while driving inflation further down.

However, in practice the independence of monetary policy can be strongly limited, even in case a flexible exchange rate solution, because excessive capital inflows can drive the exchange rate to unsustainable levels. This may force the central bank to decrease the interest rates to a lower level than would be necessary to decrease inflation to the required level. One way to minimise this danger is to give a strong priority to fiscal consolidation in the convergence period. Tighter fiscal policy allows the central bank to decrease interest rates faster. This can limit the inflow of interest sensitive capital, which is a key factor of currency appreciation.

Another beneficial property of managed float regimes is that despite the possibility of temporary exchange rate overshooting, exchange rate misalignment in the medium term is less likely than in fixed exchange rate regimes. It is very important for the Central-European catching up economies, where sustaining high growth, while avoiding external imbalances is a key objective of economic policy.

Appendix: A Summary of pros and cons of exchange rate regime choices before EU enlargement

	Analytical criteria	Advantages	Problems
Euroisation	EU requirement on exchange rates	–	<ul style="list-style-type: none"> • Not compatible with the EU's views.
	Problem of capital flows	<ul style="list-style-type: none"> • No danger of speculative attacks. 	
	Impact on EU Convergence	<ul style="list-style-type: none"> • No exchange rate volatility facilitates trade with the EU. • Immediate decrease of interest rates due to strong decrease of foreign exchange risk. 	<ul style="list-style-type: none"> • Danger of conversion to Euro at an over or undervalued exchange rate. • Limited opportunity to react to asymmetric shocks. • If the system does not function smoothly the increase of interest rates due to higher default risk.
Currency board	EU requirement on exchange rates	<ul style="list-style-type: none"> • Compatible with the EU if it managed successfully over a long time. 	–
	Problem of capital flows	<ul style="list-style-type: none"> • Danger of speculative attacks is lower than in a conventional fixed peg, but credibility can be shaken, because devaluation is still possible. 	
	Impact on EU Convergence	<ul style="list-style-type: none"> • Enhances policy credibility that helps to achieve lower inflation and higher growth at the same time. • Encourages fiscal discipline and structural reforms. 	<ul style="list-style-type: none"> • The central bank has very limited lender of last resort function. This can increase financial stability risk. • On the medium term the lack of active monetary policy can hamper anti-inflation policy • Stronger interest rate volatility may hampers economic activities.
Managed float	EU requirement on exchange rates	<ul style="list-style-type: none"> • Compatible with the EU if the range of fluctuation is within +/- 15 % 	–
	Problem of capital flows	<ul style="list-style-type: none"> • Better suited to handle large capital flows via the adjustments of the exchange rate. • Larger exchange rate risk discourages speculative capital inflow 	<ul style="list-style-type: none"> • There is the danger of an overvaluation of the exchange rate due to excessive capital inflows.
	Impact on EU Convergence	<ul style="list-style-type: none"> • The prompt changes of the exchange rate can signal quickly policy problems. (e.g. sharp depreciation can signal fiscal overspending) • Lower chance of exchange rate misalignment in the medium term. • Active monetary policy can help to cope with external shocks • Active monetary policy and the opportunity to use nominal appreciation can be a powerful instrument against inflation 	<ul style="list-style-type: none"> • Stronger exchange rate volatility is a burden for internationally active firms. • Possible overvaluation can cause competitiveness problems.

We believe the data used in compiling this report is reliable, but we cannot guarantee its accuracy or completeness. The contents of this report merely indicate our present judgements. The purpose of this report is to provide information to customers, and it not to be construed as an offer or solicitation to buy or sell investments. Customers are asked to use their own judgement in applying this information.

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