

INFLUENCE OF NON-PRIORITIZED ECONOMIC AND SOCIAL ELEMENTS ON EXCHANGE RATE REGIMES

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ABSTRACT

The entrance into the EMU implies, for any country, a tremendous effort because of the strict economic objectives it imposes. Target levels of inflation, public deficit, government debt and long-term interest rates. Consequently, a country's economic policy start to focus only in achieving these targets ignoring other effects on the whole society.

However, social transformations take place as a consequence of the new conditions under which country's economic agents start to operate. The role of private investment, joint-ventures, labour demands both in salaries and working conditions, the need of industrial competitiveness, productivity levels, the demand for value-added services, the behaviour of internal savings and consumption levels, the internal and external demand for travel and touristic activities, are only examples of some economic, social and industrial elements which can change in a country during the pre-accession period.

This paper analyzes these non-prioritized economic and social factors, paying attention to how they can influence exchange rate regimes and be affected by them. The overall purpose is to see if there is some sort of interaction between these elements and the regimes.

Social, industrial and economic elements are examined separately. For each of them, its behaviour respect to different exchange rate regimes is reviewed. The list of economic and social elements being analyzed is not an exhaustive one. The criteria applied for their selection has intended more to show how different aspects of the whole society can affect and be affected by an exchange rate regime than to rank them according to their importance.

INTRODUCTION

This paper analyzes the influence of non-prioritized economic and social elements on exchange rate regimes.

Recent literature on exchange rate regimes have mainly focused on evaluating the importance of inflation targeting¹, defining the right strategies for managing financial crisis², analysing common currency³ areas and proposing policies for European monetary integration⁴.

The enlargement of the European Union to include ten new countries by the year 2004, two more, probably in 2007 and a last one, in a current unknown date, poses the challenge of how to manage successfully, the incorporation of all these economies into a common currency area already working.

Exchange rate regimes are having in accession economies a very noticeable role. These countries are using them as another mechanism of economic policy aimed to give response to potential disadjustments. One of the most interesting facts observed when reviewing transition economies events over the last decade, is the great number of changes in the exchange rate regimes⁵ applied and the shift from fixed systems to more flexible ones.

The subject analyzed in this paper, which has been defined with the expression of non-prioritized social and economic elements, makes reference to different aspects in the social and economic areas that become very relevant for a country undergoing a process of change. The subjects analyzed are divided in three groups: economic, industrial and social elements.

Economic elements is referred to macroeconomic variables that may be affected during a transformation process like the one that the entrance into the European Union represents. Industrial elements are concepts closely related to the productive base of the country. Finally, social elements include variables and ideas linked to the social dimension of individuals.

The economic elements being analyzed are private investments and joint-ventures, internal consumption and domestic savings. The industrial aspects reviewed are competitiveness, productivity and value-added services. The social elements are salaries, working conditions and tourism.

The reason behind the selection of these issues is double. On one hand, to acknowledge that joining the European Union is a process which surpasses the economic scope for affecting citizens' life. The second one is to see if it is possible for a country to have some influence on these elements through exchange rate regimes.

1¹ See Eichengreen, 200

2² See Mishkin, 1998 and Williamson, 199

3³ See McKinnon, 200

4⁴ See Coricelli, 2002 and Nuti, 200

5⁵ See Hagen and Zhou, 200

A major risk accession economies face, is to focus exclusively on big macroeconomic figures, relevant for the purposes of the negotiating process such as inflation, long-term interest rates, government debt and government deficit. To do that would imply to think of enlargement as a race where different stages have to be reached prior to join the ERMII⁶ which is the pursued goal. From these perspective, in the meantime, all other issues become non-relevant.

In the paper, the analysis is performed from a global perspective, not focusing on any specific country. However, approach to the different elements is done taking into account the reality of accession economies. In this sense, concrete references to some of these countries are done in different epigraphs.

One of the great difficulties it was necessary to overcome, was the fact of having to deal with the economic reality of thirteen different countries, each of them with its own problems. Several criteria was intended to apply in order to classify the information of so many countries. Inflation and effective exchange rate values were some of them. At the end, the chosen criteria was based on the exchange rate regime applied in the country. Several groups were identified. *Currency boards* which includes Bulgaria, Estonia and Lithuania, *Managed float* which comprises Romania, Eslovenia, Czech Republic and Slovakia, *Peg to basket* which includes Malta and Latvia, *Leaving crawling peg to enter into free float* which comprises Poland and Turkey and, finally, a *Fluctuation bands* group which includes Cyprus and Hungary.

This classification only intends to make more manageable the information analyzed. Hungary was included with Cyprus despite the fact of being a leaver of a crawling peg system since mid-2001, because these are the only two countries, currently using fluctuation bands. Latvia applies a fixed peg to the SDR⁷. As this is a combination of different currencies, it has been included with Malta which has a peg to a basket of currencies⁸.

As it can be seen, the analysis does not differentiate the countries which will join the European Union⁹ in 2004 from the ones¹⁰ which is expected will do so by 2007 and from Turkey¹¹. This classification is used in the tables which accompany this paper.

It is reasonable to expect that in the medium term, all these countries will join¹² the ERMII and, consequently, adopt the euro as their local currency. However, this issue is not addressed in this paper as it is not also the option to euroization¹³.

⁶ Since the beginning of 1999, the ERMII has replaced the ERM to which it was referred the Maastricht Treaty

⁷ Special Drawing Rights include the euro, british pound, US dollar and yen

⁸ The currencies included in this reference basket are euro, british pound and US dollar

⁹ These are ten countries: Cyprus, Malta, Hungary, Poland, Czech Republic, Slovakia, Slovenia, Lithuania, Estonia and Latvia

¹⁰ These countries are Romania and Bulgari

¹¹ It is unknown when it will join the European Unio

¹² Joining the ERMII stipulates for two years to keep exchange rates within fluctuation bands of +/- 15% around a fixed parity which can be revalued, but not devalued. Moreover, during one year before entering the EMU, they have to fulfill the economic criteria of the Maastricht Treaty which controls the levels of certain macroeconomic variables such as inflation not exceeding the average of the three best performing members by more than 1,5 percentage points, average nominal long-term interest rate on govt. bonds not exceeding by more than 2 percentage points the average of the threebest performing membersin terms of price stability, government deficit of at most 3% of GDP and a government debt of maximum 60% of GDP

¹³ Not accepted by EU authoritie

The definition of exchange rate used in this paper is units of domestic currency per unit of foreign currency.

The paper is organized in four sections. Section one is dedicated to economic elements. Epigraph one analyzes the role of private investments. An special chapter is dedicated to joint-ventures. Epigraphs two and three review the behaviour of domestic consumption and savings levels. In the second section, the analysis focuses on industrial elements. Epigraph one of this second section evaluates the need of competitiveness. Epigraph two is dedicated to productivity levels and epigraph three reviews the demand for value-added services. In the third section, social elements are analyzed. Epigraph one focuses on salaries. Epigraph two is dedicated to working conditions demands. Epigraph three examines the demand for travel and tourism. Section four, which is the last one, contains the conclusions. References and tables are included at the end.

SECTION I: ANALYSIS OF ECONOMIC ELEMENTS

I.1.- PRIVATE INVESTMENT

Privatisation has been a recent phenomenon in accession countries. However, in opposition to similar processes taking place in other European nations, were not the desire to quickly obtain financial resources for the public sector or sindical arguments the major driving forces pursuing a change in company's ownership¹⁴. This paper will assume the current situation as given without entering to analyze the convenience of a faster process¹⁵ or the weaknesses observed .

From a macroeconomic standpoint, privatisation has promoted in accession countries two major socio-economic changes. First, a higher share of the private sector in the whole economy. Secondly, an increasing trend of foreign direct investment (FDI) inflows.

The increase in the role played by the private sector in the economy has been partly motivated by the significant presence of international organizations which set as a requirement to provide financial aid and technical assistance to these countries, their transformation into open economies¹⁶.

One of the peculiarities of the privatisation process in accession economies have been the different modes applied for privatising. This has led to end with two different investors' bases, the domestic and the foreign ones.

Privatisation supporters have always argued that this is the only way to achieve higher levels of efficiency. Other approach to the same issue considers that this lack of efficiency is originated by the agency problems existing in the private and the public sector¹⁷. This view based on the agency theory is relevant for the purposes of this paper, not as a way to evaluate the convenience of the privatisation process, but for analyzing the different scheme of incentives that the two private investors' bases may have for the choice of a certain exchange rate regime.

Tables 1a) and 1b) below, summarize the implications of different types of exchange regimes on certain economic aspects which may affect the investment climate. The analysis is done separately for domestic investors and foreign ones. It is assumed a normal working of the exchange rate systems. Therefore, speculative attacks are not taken into consideration. The selected variables are uncertainty, available financing, effect on inputs costs and entrance into new markets.

Uncertainty makes reference to the level of predictability of the economy. That is to say, if economic agents can reasonably advance the economic environment they will be facing in the short-term. The possibilities are *Low*, *Medium* and *High*. *Low* means in this case highly predictable.

14¹⁴ See Costas, 199

15¹⁵ See Hare and Richet, 199

16¹⁶ See Andreff, 199

17¹⁷ See González-Páramo, 199

Available financing is referred to the amount of domestic credit available in the economy. The possibilities are *Affected* and *Not affected*. *Affected* means that some sort of variations on the domestic credit can happen. These may be the consequence of the existence of limits to their amount or the result in changes in the levels of interest rates which will affect companies' recourse to this source of funding.

Effect on inputs costs makes reference to how these costs may change as a consequence of the applicability of a certain exchange rate regime. The possibilities considered are *Affected* and *Not affected*. *Affected* means an increase or decrease in the price of domestic inputs.

Entrance into new markets is referred to the effect that the applicability of a certain exchange rate regime may have for the attractiveness of company's products in foreign markets solely on a price basis. It is assumed that both groups of investors use domestic production facilities. Intra-industry and intra-firm trade are not considered. The possibilities are *Affected* and *Not affected*. *Affected* means that there could be some sort of advantages or disadvantages. *Not affected* means that there is no effect.

The exchange regimes being considered are currency board, peg to a basket, peg using as nominal anchor the euro, fluctuating peg with a narrow band of +/- 5% and a wide one of +/- 15%, crawling peg having inflation as a target, the same regime using a constant exchange rate as a reference, narrow and wide crawling bands for the two same references, managed float and free float. These regimes reflect all the spectrum of possibilities.

Table 1.a.- Domestic private investors

Exch. rate regime	Uncertainty	Avail. financing	Inputs costs	New markets
Currency Board	High	Affected.Potential limits	Not affected	Affected negatively
Peg to basket	Low	Affected.Increase int. rates	Affected.Potent.increase	Affected negatively
Peg to €	Low	Affected.Increase int. rates	Affected.Potent.increase	Affected negatively
Peg with +/- 5%	Low	Affected if in band limits	Not affected	Affected posit. upper
Peg with +/- 15%	Medium	Not affected	Not affected	Affected posit. upper
Crawling peg Inflation	High	Not affected	Not affected	Affected negatively
Craw.peg Const. exc.r.	High	Affected.Increase int. rates	Affected.Potent.increase	Affected negatively
Cr. inflation +/- 5%	Medium	Affected	Affected.Potent.increase	Affected posit. upper
Cr. inflation +/- 15%	High	Affected	Affected.Potent.increase	Affected posit. upper
Cr. const.exc. +/- 5%	Medium	Affected Increase int. rates	Affected.Potent.increase	Affected posit. upper
Cr. const.exc. +/- 15%	Medium	Not Affected	Not Affected	Affected posit. upper
Managed float	High	Affected	Affected.Potent.increase	Affected posit. or neg
Free float	High	Affected	Affected.Potent.increase	Affected posit. or neg

Table 1.b.- Foreign private investors

Exch. rate regime	Uncertainty	Avail. financing	Inputs costs	New markets
Currency Board	Low	Affected.Potential limits	Not affected	Not Affected
Peg to basket	Low	Affected.Increase int. rates	Affected.Potent.increase	Not Affected
Peg to €	Low	Affected.Increase int. rates	Affected.Potent.increase	Not Affected
Peg with +/- 5%	Medium	Affected if in band limits	Not affected	Affected posit. upper
Peg with +/- 15%	High	Not affected	Not affected	Affected posit. upper
Crawling peg Inflation	High	Not affected	Not affected	Not Affected
Craw.peg Const. exc.r.	Low	Affected.Increase int. rates	Affected.Potent.increase	Not Affected
Cr. inflation +/- 5%	High	Affected	Affected.Potent.increase	Affected posit. upper
Cr. inflation +/- 15%	High	Affected	Affected.Potent.increase	Affected posit. upper
Cr. const.exc. +/- 5%	Medium	Affected Increase int. rates	Affected.Potent.increase	Affected posit. upper
Cr. const.exc. +/- 15%	High	Not Affected	Not Affected	Affected posit. upper
Managed float	High	Affected	Affected.Potent.increase	Affected posit.or neg
Free float	High	Affected	Affected.Potent.increase	Affected posit.or neg

The differences between the two group of investors lie on their evaluation of the uncertainty of the exchange rate regime and on the indirect effects on the entrance into new markets. In this sense, it is interesting to keep in mind that foreign investors are in a better position than domestic ones, not only because they can easier surpass potential financing difficulties by recurring to their traditional foreign sources of funding, but also because when dealing with other markets they can benefit from an international commercialization network.

Among domestic private investors, small and medium sized companies (SMEs) and individual firms are in the worse situation. They lack, not only the resources, but the product to compete in foreign markets. Their scope of action is their own country. Difficulties in financing and higher levels of interest rates will have a direct impact on their production scheme increasing their operating costs. Bigger domestic firms may also be affected to the extent that they will not have access to international financial markets. However, their size will always provide them with more possibilities for selling their products abroad.

Floating regimes can open the room for great levels of exchange rate increases (depreciation) or decreases (appreciation). In the first case, domestic private investors can see an increase in the sales of their products as they become more appealing to foreign customers. In the second one, they are in a bad position because, as they do not employ foreign outputs, they could not make the gains derived from a situation like this.

The existence of these two groups of private investors with differentiated sets of interests can have an impact on economic growth stability over the long-run. Foreign investors will always invest as long as they can get enough returns for their investments. Domestic ones will do so as long as their welfare will increase. Foreign investors will reinvest part of their earnings and, most probably, will benefit from tax advantages. Domestic ones may benefit from tax allowances too but, at their income level, they will be net contributors.

This does not mean that foreign investors will be bad investors. FDI inflows are a traditional source of development for all international economies¹⁸. According to the Investment Development Path, IDP, accession economies will be in the second and third stage, characterized by net FDI inflows and investments in mature industries (manufacturing, chemicals) and more advanced ones (automotive, electronics). FDI focuses on benefitting from local competitive advantages, mainly low labour costs, while promoting the surge of a complementary domestic industry around foreign firms.

Table 2 shows the total volume of FDI inflows in the accession countries for the period 1997-2001 and the percentages they represent respect to each year's GDP. It can be easily seen from it, its great significance as source of financing for accession economies. This importance becomes, even more relevant, when it is taken into account the fact that FDI is currently financing the current account deficits of many accession countries.

Table 3 combines information from FDI amounts with currencies' exchange rates respect to the euro. It seems from it that FDI flows respond more to a country's competitive advantages such as location or existence of low-cost skilled labour force, than to exchange rate movements.

¹⁸ Dunning's model of Investment Development Path, IDP, distinguishes five stages of development according to the level of FDI and the industries in which it invests. See Durán , 200

I.1.1.- SPECIAL CASE: JOINT-VENTURES

The joint-ventures to be analyzed in this paper will be those ones in which one of the partners is a foreign company. An association between local companies is regarded, for the purposes of this paper, as a domestic one and therefore, potential advantages derived from having to work with different exchange rates will not exist.

A joint-venture is a type of investment which on many occasions is seen as having more advantages for the local partner than for the foreign one. It is certain the fact that the latter is prone to this form of association when external local conditions are unknown¹⁹. Otherwise, it would result unattractive for companies financially healthy to assume the risks derived from sharing production facilities with smaller local entities.

The uneven association which a joint-venture represents, is however, highly regarded by the local country because of all the indirect benefits it brings to the community. To evaluate the success of a joint-venture cannot only be done on the basis of annual turnover, profits or created employment, but on terms of their great social impact.

Cooperation with universities, more amount of resources allocated to R&D activities or demand of highly skilled local workers are only some examples of foreign investors' contribution to increase the level of competitiveness of the domestic economy. Relevant are also the possible transfers of knowledge which may take place directly, between the foreign and the local partner, or indirectly, allowing the local firm to benefit from international networks and contacts.

From a macroeconomic standpoint, international joint-ventures can be characterized as stable foreign investments. The degree of commitment of the foreign partner with the local economy is perceived as a positive sign by the business community. This will be much appreciated by local authorities the higher is their country risk .

Overall, this form of association is perceived as a win-to-win situation. Even in the case of failure, losses will be lower and the local partner will retain, at least, all the management practices it has learned developing the company, such as logistics, controlling, marketing or personnel techniques. These are assets of tremendous importance for accession countries because they open the door to a modernization process which will lead to increases in the productivity levels, benefitting the whole society.

However, it would be unfair to think that partners undertake a joint-venture only to show a good image and in order to improve the overall welfare of the society. In fact, they are a useful alternative to better cope with some of the problems derived from the applicability of certain exchange rate regimes.

In situations of financing constraints such as in a currency board, foreign partners can assume a more preeminent role in the company recurring to their traditional foreign sources of funding to bypass these problems. This recourse abroad can also be helpful for entering into new markets from the home base in situations of high domestic inflation rates. Depending on the size of the foreign partner, a multinational or a foreign national firm, it may have subsidiaries or distribution agreements in other countries. This will amplify the effects of the domestic

19¹⁹ See Agarwal and Ramaswami, 199

economic policy decisions, widening the number of countries involved while attracting them also towards investing in the local economy.

Exchange rate policies aimed to preserve a real value will pose upon the local producers' exports a great burden because it would oblige them to base their strategy only on control of inputs' costs.

A joint-venture is not a non-valuable alternative for foreign investors. The uncertainty of a possible currency crisis as a consequence of narrow fluctuation bands can be diminished on the foreign partner side allowing the domestic one to assume a high share of ownership. In the same way, higher levels of appreciation or depreciation of a currency operating under a floating regime can be better managed if there is a local partner interested in reinvesting profits in order to improve technical facilities, upgrading joint-venture's capabilities. In this sense, it should be kept in mind that in order to move forward in the investment development path²⁰ towards the fourth and fifth stages, it is necessary that the local company will develop some sort of competitive advantage.

²⁰ See Durán, 200

I.2.- INTERNAL CONSUMPTION

This paper will analyze domestic final consumption from a relative perspective. This means that the approach to follow is to see how the levels of the different consumption components are evolving through time and the effect this is having on accession economies. This view is justified by the increasing importance domestic consumption is acquiring in accession countries as major, if not only, growth driving force of their economic development.

From a domestic consumption perspective, accession economies can be characterized by two features. The first one is the great contribution of final consumption to total GDP. The second one is the great share of private consumption, significantly higher than for EU members. Public consumption can be regarded as being in line with the levels in EU countries.

This high share of private consumption could be seen as the logical consequence of accession countries' economic development which has led domestic households to increase their amount of expenditures. The level of money illusion originated in this process with higher openness of the economy and bigger trade flows, may have woken up the consuming side of the population. But this should just be a transitory fact. The concerns arise when gross fixed capital formation figures are analyzed and a decreasing trend in their total annual amounts can be observed for almost all the accession countries with the exception of Latvia and Bulgaria. It would pose a great risk on the future economic development of accession economies to believe that a lower level of domestic private consumption could act as destabilizing factor. A less preminent role in the total GDP in favour of other items will provide these economies with more balanced roots.

Exports levels in these economies are highly sensitive to international crisis. It should not be forgotten that these countries regardless of the achieved level of privatisation are very specialized economies. The problem is not that their excess of exportables²¹ over exports is small, but the fact that their volume of importables is significantly very low. Therefore, the challenge they face is to broaden their domestic production base with the derived consequences of this on country's competitiveness and productivity.

Disposable income, both in real and in nominal terms, affects the levels of domestic private consumption. From their current behaviour, it is reasonable to infer that accession countries' citizens seem not to fear the instability that the coming catch-up process could bring to their economies. They may be convinced that in case of existence of any difficulties, the European Union will find some sort of alternative way to help them to get over these problems. Otherwise, their current high spending levels would be unexplainable. To aggravate the problem, many countries have chosen to increase their exports seeking appreciations²² of their real exchange rates. This fact has not made consumers aware of the negative impact of inflation. They may be perfectly thinking of it as the price to pay in order to compete in international markets.

From a consumers' standpoint, not all the exchange rate regimes behave equally. Fixed pegs have the disadvantage that their references may well be far above the real economy of the pegged country, imposing a dynamics of adjustments through interest rates unsustainable over the long-run. In a situation like this, individuals will be incentivated to spend all their disposable

21²¹ See McKinnon, 196

22²² Appreciation means in this case that the real exchange rate is a lower value than the nominal rate

income at the present time as its expected nominal value in the future will be far below their current real levels. In this case, wide fluctuation bands become a necessary mechanism, not for relaxing the economic monetary discipline, but as a way to allow room for the coexistence of two economies advancing at different paces. In this sense, crawling regimes to the extent they can use as references different terms such as balance of payments items or a constant exchange rate can facilitate the adjustment process. Floating systems will never have this problem as they resemble real economy.

An element which conditionates the levels of consumption in the economy regardless of the amounts of disposable income is money supply, M1. This becomes an extremely relevant issue with currency boards regimes and with strict peg systems. Consumers will not be able to manage over restrictions of this type and will have to adjust their spending levels not to their expectations but to the liquid funds available in the economy.

As economies are becoming more globalized, consumers may be concerned by the impact on their countries of foreign shocks, both external supply shocks and nominal ones. In any case, it is reasonable to expect a reduction in consumption levels which will disappear gradually as economies recover their growth levels. There is no exchange rate regime which can avoid the impact of these shocks although the flexible ones allow for a less painful adjustment.

I.3.- INTERNAL SAVINGS

Domestic savings is a macroeconomic variable closely linked to a country's economic development. This fact together with the traditional association of high levels of savings to rich economies might lead to think that this is an issue that accession economies can postpone to more prosperous future times. In this sense, it should be pointed out that the concerns expressed when analyzing domestic consumption, referred to an observed decreasing trend in gross fixed capital formation should not be understood as a rejection of the importance of high levels of domestic savings.

Savings role as stabilizing factor acquires a tremendous significance for accession economies as it is one of the best transmission mechanisms of an advanced country's economic institutions well-functioning and citizens' confidence in their own economy.

Not less relevant is its dimension as financing source for the economy. The great challenge accession economies are starting to face is the need to consolidate current levels of investments without falling in the time-inconsistency²³ problem. The high levels of current FDI inflows are hiding the need to broaden the financial resources base of the economy. It is necessary for these countries to dissipate the potential negative effects that money illusion may have as a consequence of the enlargement process. In this sense, the fact that the number of small countries involved is very large is defining a behaviour which could be considered as an extreme of the theory of optimum currency areas²⁴.

It would be a mistake to postpone the consolidation of these transition economies on the basis that current reference values of exchange rates with the euro are overvalued and the entrance into the ERMII should be done on different parities. In this sense, the period of two years with wide fluctuation bands of +/- 15% prior to joining the euro, may lose its adapting character to become a hard adjustment process. Following this argument, the current high volumes of FDI would act as representatives of consumers' savings signalling their weak belief in the exchange rate systems²⁵.

All these facts makes urgent the implementation in all these countries of pension reforms and financial markets developments to allow savers to assume their role in the economy. The increasing globalization trend observed with the merge of international financial markets does not help to broadly set up these institutions among country's companies and individuals.

Accepting as a working hypothesis, individuals' desire to increase their level of savings, the challenge, from an exchange rate systems' perspective, may lie in aspects such as the safety of the exchange regimes and the incidence of economic policy decisions on the amounts of real income.

The concept of safety of a certain exchange regime makes reference to the fact that savers do not like surprises. Individuals invest part of their income, among other reasons, to assure against the uncertainty of the future or potential unfavourable events. Money accessibility and a sufficient

²³ Time-inconsistency problem arises because there are incentives for a policymaker to pursue discretionary policy to achieve short-run objectives, such as higher growth and employment, even though the result is a poor long-run outcome, high inflation. See Mishkin, 199

²⁴ See Mundell, 196

²⁵ See McKinnon, 196

return are key aspects for savers. In this sense, the credibility of nominal anchors should be regarded positively. However, the analysis of the situation cannot pass over the fact that as emerging countries economies are increasingly opening their markets allowing for higher levels of international capital mobility, pegged regimes are becoming more difficult to sustain²⁶. On the other hand, floating regimes can adversely impact the amounts of real income, difficulting the development of a savings' culture. The need of it, is essential, overall for these countries which will have to manage over the long-run a catch-up process with EU economies. In this sense, the increasing presence of the private sector in the economy contributes to create a demand for investment resources which, if financial institutions are able to handle properly, should fit their liabilities' deposits.

The risk of currency crisis in accession economies and its possible influence discouraging savers' behaviour has been relatively limited until now. It should be kept in mind that all these economies are just going through a capital liberalization process which until recently have limited the possibility of investing in foreign assets.

26²⁶ See Eichengreen, 200

SECTION II: ANALYSIS OF INDUSTRIAL ELEMENTS

II.1.- THE NEED OF COMPETITIVENESS

A country's competitiveness²⁷ is closely related to its performance in international markets. Competing with other producers helps to put a country's economy into perspective. It does not imply necessarily, negative domestic consequences because it may act as a boosting factor pushing forward the economy while opening it to new techniques or innovation processes. To the extent this last effects will show up, a country's competitive position will become more stable. This will provide the whole country with significant benefits such as a decrease in the price elasticity of exports, domestic investment inflows and easier entrance into new markets. Even aspects such as increases in wages could be better managed.

To be competitive implies not only to be a great exporter but also to allocate resources to domestic investments in order to implement infrastructures such as telecoms and transport ones, develop R&D activities or improve workers' skills.

Accession economies have reached their competitive levels through two different ways. The first one would correspond to those countries which have exploited their competitive advantages, mainly location and low labour costs. This will be the case of the Czech Republic, Slovakia, Hungary and Poland which have experimented significant increases in their volumes of intra-industry and intra-firm trade²⁸. The second path would consist of benefitting from real exchange rate appreciations with the consequent impact on the total amount of exports. Baltic countries²⁹ such as Estonia and Lithuania would be within this group.

Many are the possible variables to be analyzed when evaluating competitiveness. Table 4 shows the values of the national infrastructure index for the accession countries. Table 5 contains the data corresponding to the external openness index, an indicator of a country's total volume of trade flows. The positions accession countries would occupy in an hypothetical ranking based on the values in the year 2001 of each of these indicators, will vary significantly due to the fact that the national infrastructure index gives more importance to the first way, while the external openness index takes into account trade flows which are highly sensitive to real exchange rate movements.

The level of investments of a country serves to characterize the stability of its competitiveness and its adequacy as supporting tool of an economic policy oriented towards economic growth. Although a direct impact on dual productivity should not be expected, it is certain that to the extent competitiveness is acting as economy's driving factor, it can originate new investments and activities' development in the non-tradables sector.

From an exchange rate perspective, the path a country follows to become more competitive is crucial. To rely exclusively on exchange rate movements imply to reject disciplined regimes which will not allow for parity movements. The level of real exchange rate appreciation the

²⁷ OECD defines competitiveness as the degree in which, under conditions of free market, a country can produce goods and services that pass the test of the international competition and that, simultaneously, allow to maintain the sustainable growth of the national income

²⁸ Manufacturing intra-industry trade as percentage of total manufacturing trade accounted in the period 1996-2000 for 77,4% in Czech Republic, 76% in Slovakia, 72,1% in Hungary and 62,6 % in Poland (Source: OECD Statistics)

²⁹ See Bank of Estonia, 200

country would need in order to significantly increase its volume of exports would determine its degree of tolerance respect to wide fluctuation bands.

On the other hand, if a country is choosing to benefit from certain competitive advantages it should apply an exchange rate regime which will allow it to preserve them.

Alternatively, the choice of a certain exchange rate regime may conditionate the competitive level of an economy. The limits imposed on available financing by currency board regimes where the volume of internal credit becomes a variable endogenously determined and their strict convertibility rule, leave as only option to remain competitive, to attract foreign investments which will push the economy forward. This would be similar to the way followed when pegged systems are in place. In general terms when a country's selection is a fixed system, it is postponing the issue of competitiveness to a further moment in time, when structural disadjustments would have been already solved. This is in clear opposition with floating regimes which allow for an immediate cash in on country's real economy's weaknesses.

Competitiveness should not be a short-term goal. The key aspect that economic authorities should take into consideration when dealing with it, is the degree of commitment they are willing to assume in order to make a country more competitive in the long-run. In this sense, the fact of not changing very often of exchange rate regime can be seen as a positive sign that those ruling the economy know where to go.

A major drawback competitiveness has, is the lack of a simple measure able to capture in a unique way, the overall competitive situation of the economy. If this could be surpassed, it may be not out of context, the definition of some sort of economic target in its terms.

II.2.- PRODUCTIVITY LEVELS

Increasing productivity is a goal in all economic policies. The achievement of higher production levels per unit of input is not only the result of an increase in the use of factors, but the consequence of the technological progress. Increasingly, this abstract concept, formerly associated with stochastic processes, is adopting the form of elements such as innovation, technological catch-up and inputs reallocation.

Traditional analysis of productivity focuses on analyzing its relationship with other macroeconomic variables, mainly inflation³⁰. This leads to explain changes in real exchange rates³¹. As a consequence, productivity levels will determine real exchange rates.

This paper aims to look at productivity from a completely different perspective.

Productivity is defined as output per unit of input³². However the first difficulty arising when dealing with this topic is to find a clear and universally-accepted measure of it. Some authors use gross domestic product as proxy for levels of output while others prefer gross value added or even industrial production indexes. When analyzing the labour productivity, it seems there is a consensus because occupation rates is an indicator widely monitored in each country's statistics. More problems present the determination of multifactor productivity due to the fact that intermediate indexes may be taken into account instead of raw data.

All of this is a good proof of the relative character of this concept. Productivity makes sense in relationship with something else. When dealing with a country's productivity, the interesting point is to see if it is higher or lower than trading partners' or competitors' one or, even, the economic policy reference country's one. This is done both in global terms and across sectors. The international trade between two or more different countries act as a positive productivity boosting factor, promoting the more efficient use of inputs. This explains why tradables³³ and non-tradables³⁴ sector follow a different evolution pattern.

This importance of the foreign trade as a major driving force pushing productivity forward introduces the exchange rate as a key element in the relationship between inputs and output. Therefore, the challenge is to find an efficient exchange rate regime.

From the productivity perspective, an efficient exchange rate system should be effective in allowing an increase in the level of the internal demand domestically satisfied. This last aspect is extremely important. Accession countries show over the recent years an increased trend in their levels of imports which are causing them significant current account déficits.

³⁰³⁰ The Balassa-Samuelson effect deals with this relationship. It differentiates two sectors in the economy, tradables and non-tradables whose productivity is growing at different levels. Wages in the tradables sector determines wages in the non-tradables sector and, consequently, relative prices in the non-tradables. This leads to an appreciation of real exchange rate. This model concludes that the difference between the changes in prices in tradables and non-tradables depends on the difference in the growth productivity rates in both sectors, known as dual productivity. When dealing with two countries, the difference between relative prices at home and abroad is determined by the difference in the dual productivity levels at home and abroad. For a more detailed explanation, see Égert, 2002

³¹³¹ See Égert, 2002. This paper analyzes the Balassa-Samuelson effect in the Czech Republic, Hungary, Poland, Slovakia and Slovenia

³²³² See Webb, 1998

³³³³ Tradable goods are those which could enter into foreign trade because transportation is feasible. See McKinnon, 196

³⁴³⁴ Non-tradable goods are those which could not enter into foreign trade because transportation is not feasible. See McKinnon, 196

The problem should not be analyzed from the perspective of traditional optimum currency area theory³⁵ where disequilibrium leads to the country in the weakest position to accept increases in the level of unemployment. The approach suggested by this paper is in terms of composition mix of domestic demand.

Accession countries have increased, by different rates, their nominal amount of total exports. This has been the consequence of new investments, sometimes driven by advantageous geographical locations or by the existence of former productive structures and restructuring processes. This has crystallized in an increasing importance in their economies of certain manufacturing industries, intra-industry trade and intra-firm trade. This has brought as a consequence for these countries an increase in the proportion that exportable goods represents respect to total exports. On the imports side, the ratio of importable goods to imports is very low. If domestic demand of exportables increases as a consequence of the higher levels of disposable income, the country moves towards a situation in which there is an increase in its total production of exports. As this happens, internal resources which could be allocated to the production of importables are kept away from this, leading to an overall situation of disequilibrium. To correct this, investments on the production of importables will be needed. These investments will take place to the extent economic agents will have an incentive to do so and these will exist if market forces allow a win-to-win situation. The assumptions are that no restrictions on availability and use of technical processes exist and that country's legislation on proprietary risks is in line with internationally accepted rules.

As production of importables increases, total volume of tradable goods go up too, leading to increases in the levels of domestic employment. As a consequence of the fact that domestic prices are below exports' ones, overall tradables sector productivity would slightly decline reducing the gap with the non-tradables' one. Inflationary pressures on importables' domestic prices would push them up to similar levels to exportables' ones. This increase will be done upon the condition that real economy will back it. In the worst case that during this adjustment price's period, investments in non-tradables had not taken up leaving their productivity levels unchanged, at the end the country will be better off because at least, their demand for imports would have decreased.

In order for the adjustment price's process to take place, the exchange rate regime being in place should not impose limits neither on the volume of money supply in the economy nor on the available internal credit levels. Monetary discipline should not be so strict as to force increases in the levels of interest rates.

Accession economies with the highest levels of productivity are not good examples of what has been mentioned here because they are the countries which have been more closely related to Western economies and have a significant presence of the non-tradable sector in their economies. This is the case of Malta, Cyprus and Slovenia. From an exchange rate systems perspective, these countries represent a wide array of regime's possibilities which go, respectively, from conventional peg to peg with bands and to managed float.

35³⁵ See Mundell, 196

II.3.- THE DEMAND FOR VALUE ADDED SERVICES

Value-added activities are becoming an increasing factor of competitiveness, globally for each individual country and, particularly, for each company. In the context of this paper, the analysis of this issue will pay attention to its demand side. Two different types of demand for these services will be considered. Both of them take place at each firm's level. The first one represents the external supply side of these activities while the second provides the internal dimension of it.

Many value-added services performed by firms such as advertising agencies, consulting and auditing firms, professional and management training, market research companies, etc., are carried out by parties not directly involved in the production process of the agents who demand them. On the other hand, value-added activities also take place within each company's boundaries. Project planning, marketing, programming, R&D, logistics and quality management are some examples of this.

From a macroeconomic standpoint, it is more relevant the existence of a demand for this type of services than its internal or external character. Value-added activities increase the value of the final product, improve the efficiency levels of a company's management, set-up a long term view aiming to consolidate a company's position in the market while contributing to differentiate each economic agent offer to potential buyers. The results for each individual company can be measured in terms of increases in market share, development of proprietary techniques, higher volume of sales and margins' improvements. For the whole economy the expected consequences are a greater volume of exports, higher rates of economic growth, increases in the level of employment and a consolidation of a country's economy in the world through the reinforcement of its competitive position. Additionally, accession countries would see a further shift of their traditional structure of production from a heavy weight of the industry sector towards an increasing presence of the services one.

Table 6 shows figures of value added per employee for different industries, both in some accession countries and EU members. Table 7 reflects the differences in these value added amounts between certain accession countries and the average of the figures corresponding to EU members. It can be seen from them how important is for accession economies to develop a demand for this type of services as a first step towards increasing the value added of their products and services.

Factors like production and export diversification and trade integration have already been considered as relevant aspects for the choice of an exchange rate regime³⁶. From the perspective of this paper, it is important to highlight some of the characteristics of the demand for these type of services. Its domestic component plays a major role because companies have to assume a leading attitude towards incorporating these services into their production. Foreign customers will buy the resulting products with higher value-added only to the extent they will exist in the market.

This requires from domestic economic agents to take the decision to allocate financial resources to these activities. The level of company profits and, more importantly, its stability will act as demand driving factors. Companies will be willing to spend money on these activities only to the extent they will have enough extra funds. These services are not regarded as productive

36³⁶ See Eichengreen, 200

elements. This implies that company's managers will not compromise other investments, mainly in fixed assets, to dedicate resources to investments whose return is unknown. The argument of a need to create demand for new products and to differentiate the existing ones, in order to consolidate company's position in the market and to ensure its long-term viability is not enough.

From a global country's economy perspective, the advantages derived from an increasing level of value-added products are the possibility to originate an exports stream not based on real exchange rate appreciations and to boost the development of the non-tradable sector with the consequent effect of decreasing domestic dual productivity³⁷.

Elasticity of the foreign demand will be positive and higher than one. This will not increase the risk that the domestic economy will be exposed to higher impacts of international nominal shocks. The importance of small and medium sized companies as suppliers of these type of services set a requirement on the economy of high levels of liquidity, avoiding credit restrictions.

Table 8, below analyzes more in detail the possible influence of different exchange rate regimes on the two demand driving factors identified above.

The level of company's profits makes reference to the potential increase in exports revenues as a consequence of the normal functioning of the exchange rate regime, excluded any speculative attacks. No changes in domestic demand are assumed and no additional entry costs are considered.

The stability in the level of company's profits is referred to the non-existence of significant yearly oscillations in the amount of company's benefits.

The exchange rate regimes analyzed are the same that were considered in the epigraph one of section one, dedicated to private investment.

³⁷Dual productivity is a concept which makes reference to the difference in productivity levels between the tradables and non-tradables sector. See Égert, 200

Table 8.- Relationship between exchange rate regimes and demand driving factors

Exch. rate regime		Level of company's profits	Stability of company's profits
Currency board		Operationally affected. Motivated to increase exports to avoid reliance on domestic demand	Low
Traditional peg	To a basket	Not affected. Protected from strong appr./depr. in any of the basket currencies	High
	To €	Not affected if this is the currency of trading partners	High
Peg with bands	+/- 5%	Affected. Slightly increase in the upper band	Fairly stable
	+/- 15%	Affected. Increase in the upper band	Fairly stable
Crawling peg	Level of infl	Not affected	High
	Constant Exc. rate	Affected. Potential risk of decrease	Low
Crawling band	Level of infl. +/- 5%	Affected. Increase in upper band.	Fairly stable
	Level of infl. +/- 15%	Affected. Increase in upper band	Fairly stable
	Const. exch. +/- 5%	Affected. Increase in upper band	Low
	Const. exch. rate +/- 15%	Affected. Significant increase in upper band	Low
Managed float		Affected	Low
Free float		Affected	Low

SECTION III: ANALYSIS OF SOCIAL ELEMENTS

III.1.- SALARIES

Labour costs represent for accession countries a significant competitive advantage which, up to now, has had a major influence attracting foreign investments. The differences in their levels with EU members are significant and may represent in some cases up to four times. This fact complemented with an educated labour force may lead to think that accession economies should not be concerned with the future evolution of demands in this field.

The key question which immediately arises when analyzing wages and total labour costs' differences between the two geographic European areas is to what extent this situation would hold in the long run. Accession economies should not be built upon wage levels as an entry barrier because of the negative impact this would have on their own economic future development. Productivity gains should be based on output levels increases, not on inputs costs decreases. It is certain that long-term projections do not appeal a change in the current transition economies' attitude to the extent that it is argued that with the new framework of all countries operating with the same currency, materials inputs costs will be the same for all producers and the need of low labour costs to stay in the market will turn crucial. Until now, accession economies are benefitting from exchange rate movements which amplify the positive competitive advantage of their reduced salaries. In the long-term the room for variation will be narrower.

The wage formation process in the accession economies is undergoing a radical transformation. The grounds for tripartite negotiations at central level and bipartite ones at sectorial and company's levels have just been set up and results should start to come out over the next years. This should have implications on the overall economy³⁸ and, particularly, on the non-tradables sector. The share of these products in the economy should go up to compensate the effects of low imported inflation levels.

The two countries among the accession group, with higher wage levels, Cyprus and Slovenia, continue to apply a wage indexation system that for the last one has just shifted from backward to forward looking. From an optimum currency area's theory³⁹ perspective this practice would just confirm the lack of incentives to change inputs costs' strategy mentioned previously.

Accession economies are seeing how their exporting destinations are switching from the former Soviet Union influence area towards EU members. This implies a change in the foreign price reference used in the wage setting process. The pressure this puts on real wages would simply add more difficulties to keep this competitive advantage in the long-term.

From an exchange rate regimes' standpoint, several aspects related to wages should be taken into consideration. The first and, probably, most important one, is the need of a country's conviction that to rely exclusively on low labour costs as a way to remain competitive is not enough. Accession economies should diversify their production in order to isolate them from potential negative impacts derived from business cycles and as a way to give answer to internal social pressures.

³⁸ Linskog considers that "the export sector can be considered as the engine of growth and wage formation together with exchange rate policy can be described as the engine of inflation". See Linskog, 198

³⁹ See Mundell, 196

Economic growth is strictly linked to real exchange rate movements as recent studies have empirically demonstrated⁴⁰. This poses a great constraint on these economies as this has been the strategy widely applied until now. A transitory solution may be to take advantage of exchange rate fluctuations reinvesting domestically a great proportion of profits in new activities. One of the issues accession economies have to deal with is an increasing level of imports both in response to production needs and in order to satisfy internal final demand.

This leads to a second question exchange rate systems should take into consideration that is the mix of exportables and importables in the economy. Until now, accession economies' approach has consisted of making profits concentrating on the exportables group. It is also true that the specialized economic facilities they had, did not give them many other alternatives. To increase the proportion of importables as a way to contain imports' increases and achieve reductions in trade deficits levels has different implications for each country's economic authorities depending on the exchange rate regime being applied. Currency boards will be seriously concerned with a decrease in the number of foreign transactions undertaken by economic agents as a consequence of its negative impact on country's reserves. For pegged regimes the threat would come from the potential distortion of domestic real economy that this might introduce and its consequent risk of a currency crisis. Lagged adjustments would make sense if combined with the attendance of the first aspect mentioned above. It is unknown to what extent floating systems' realignments would offset the potential reductions in trade deficits.

The third aspect exchange rate regimes should take into consideration will be affected by the decisions adopted respect to the two previous ones. It makes reference to the share of non-tradable goods in the economy.

All of these elements would have an impact on the overall level of salaries. Increases in the amount of importables in the economy will push down average tradables' wages shortening differences with non-tradable goods' employees. This theoretical scheme faces the problem that unions and workers will be incentivated to pursue a different policy as exportable products deliver higher quantifiable immediate benefits to the economy. The potential pressures this may add on the production base will take place in several years' horizon and can be perfectly managed through the factor mobility required by a single currency area. The evolution in an even much further time horizon as a consequence of differences between salaries' levels of domestic population working abroad and the one working in the home country are not being considered as it is assumed that the foreigners will reinvest part of their income in the home country contributing to its economic development. The disequilibrium this would bring pushing wages upward is simply considered to be out of the timeframe of the problem.

Only in situations of social instability as a consequence of inflationary pressures or high levels of unemployment, exchange rate policy will be subordinated to labour costs' objectives.

40⁴⁰ See Stockman, 199

III.2.- WORKING CONDITIONS DEMANDS

The recent history in Eastern European accession countries have been characterized by the great importance of the social dimension of work. Employees have benefitted from social advantages provided by their employers that were unknown in EU members. Housing, health, food subsidies, education,..., were a significant part of a workers' compensation. Western concept of social welfare, although aimed to provide a great level of social coverage, operates under a different scheme where the working relationship does not play such an important role.

The Copenhagen criteria⁴¹ that accession members have to fulfill in order to be accepted as members of the European Union gives a first hint of the complexity of an enlargement process like this one and the wide array of issues involved. Protection of minorities, fight against long-term unemployment, facilitating young people and women entrance into the labour market or development of specialized professional skills are only some goals of EU's policy.

For the purposes of this paper, it is important to mention that the demand of certain working conditions will come from two different sources. On one hand, the European Union which has clear rules that companies have to fulfill related to aspects such as environment, transport or hygienics. On the other hand, economic agents, both workers and employers, who as a consequence of the increase in trade flows will start to adopt practices from their counterparts such as, for example, number of working hours or social security coverage levels for employers.

All these demands will have an effect on country's economic growth and labour force, increasing the difficulties of the technological catch-up process. On the other hand, and to the extent economic agents will be unable to satisfy these demands, the last responsibility will fall upon the governments which will see aggravated their existing problems for managing accession countries current account deficits.

A rapid join of the ERMII which due to its own dynamics with fluctuation bands of +/- 15% would have to be done at accession currencies' lowest parity levels⁴² with respect to the euro, would imply for the governments and increase in the burden share they have to support in this process. The situation will improve to the extent that companies will invest or allocate part of their profits to satisfy these demands. However, domestic producers would not be encouraged to do that because they would not longer benefit from real exchange rate appreciations and would be forced to compete on the basis of production costs and product differentiation. In this scenario it would be difficult for them to attend social working demands. The overall result may be an increase in the level of interest rates with the consequent dissuasive effect this would have on the country's economy.

Although accession countries have characterized for applying a wide spectrum of exchange rate regimes, it is fair to say that none of them have revealed as the more appropriate to manage current social problems such as the high level of long-term unemployment. Table 9 shows that with the exception of Cyprus and Turkey, in the rest of the countries this type of unemployment affects roughly to half of the total unemployed people. One positive and striking fact observed

41⁴¹ The Copenhagen criteria establish as requirements that accession countries have to fulfill in order to join the European Union the following ones: to be a stable pluralist democracy and be committed to the rule of law, to the respect of human rights and to the protection of minorities; to be established as market economies; to be able to cope with competitive forces and market pressures within the Union and to be able to assume the obligations of membership, in particular, as far as the "acquis communautaire" is concerned

42⁴² Lowest parity level means the highest number of domestic currency units per unit of euro

in accession countries is their low levels of severity rates. The existence of a non-conflict culture can help to manage the attendance of social working demands. Table 10 includes data for some accession countries and EU members referred to number of days worked per thousand workers over the period 1991-2000.

The change in the working conditions has positive effects such as the extension in the range of social welfare benefits, the improvement of a country's standards of living and indirectly, better quality products.

From the perspective of an exchange rate regime, demands on working conditions will pose all its pressure on non-deterioration of a country's social standards of living. This will imply the non-existence of economic restrictions to imports, the maintenance of the purchase power parity and the availability of company's funding at reasonably affordable levels. All of this depicts a picture where interest rates should be kept under control, not becoming the recurring tool of the monetary policy and where real economy should be in line with exchange rates. The importance of fluctuation bands as softening instruments of immediate or gradual hard adjustments originated by the required discipline of pegged regimes seems to be crucial for the attendance of these demands. An alternative strategy of letting companies to benefit as much as possible from real exchange rate appreciations should be also considered to the extent this will not leave companies out of the market.

III.3.- DEMAND FOR TRAVEL AND TOURISM

The tourism⁴³ sector in the accession countries plays a very significant role, as it is derived from its important contribution to these countries GDP. Table 11 includes the values of these percentages for the period 1997-2000. Although the relative contribution of these activities to their country's domestic production significantly varies among them, there is little doubt on their importance.

From a social standpoint, touristic activities contribute to consolidate the openness of the economy, act as a pressing element pushing upward the quality level of the delivered services and become a source of employment. Table 12 shows the structure of these countries' visitors by region of origin. It differentiates visitors from other accession countries and from the current EU members. The pressure these last ones can make for spreading the use of an existing currency such as the euro, can be a helpful element in order to shorten and ease the introductory phase of this currency in these countries.

From a macroeconomic standpoint, the significance of this sector for the accession countries is unparalleled. Their net positive contribution to the balance of payments is used for counterbalancing trade deficits. It is still a pending issue to see how accession economies will undertake the consolidation of this industry, moving it from its current stage of single services offers to complete the whole cycle of the touristic activity. It is uncertain if the high level of investments this will require could be totally financed by the generated tourism revenues.

However, it is not the focus of this paper the supply side of this sector but its demand one and its interaction with exchange rate regimes.

It is interesting to see that the highest contributions to GDP occur in countries with some sort of peg system, such as Malta and Cyprus, and currency board regimes such as Bulgaria and Estonia. For the first ones, one may argue that their geographical location is what really matters when analyzing the touristic industry and exchange rates are something unrelated. However, the increasing presence of this activity in other differentiated locations which, one of the things that have in common with the former ones is a well-definite exchange rate regime, may lead to assume that this industry dislikes float regimes, either free float or managed ones. This striking fact is explained because most of the foreign visits are originated as package trips that customers buy in their home countries not benefitting from currencies' movements.

It is not a coincidence the high contribution of touristic activities to currency board economies. Most of the tourism revenues come in the form of foreign reserves. Both Bulgaria and Estonia have a significant number of visitors from EU members. The third country applying a currency board regime in the EU-accession group is Lithuania which splits almost equally its number of visitors between accession countries and other Europeans non-EU members. It should be remembered that until its replacement by the euro in January 2002, the reference reserve currency in Lithuania was the US dollar. The payment methods used in touristic activities⁴⁴ are mainly liquid ones which help central banks in these countries to increase their volume of

⁴³ Tourism includes here, travel and touristic activities. Travel is different from transportation

⁴⁴ See García Cid, 2002. This study analyzes tourism revenues in Spain in the year 2000, according to payment methods employed. It is showed that notes represented 30,4% of total revenues, while bank transfers accounted for 34,8% and credit cards for 12,9%. Tourism sector represented 5,5% of total Spanish GDP in 1999

reserves while expanding the domestic money supply. This has undoubtedly, indirect benefits for the whole economy which sees in this way how financing gets easier. The good behaviour of inflation levels in these countries may well be a consequence of this sector's performance.

The decision by the ECOFIN⁴⁵ of deciding on a case-by-case basis if currency boards will be accepted during the enlargement process acknowledges the important stabilizing factor played by these regimes in some Eastern European economies. However, the long period these regimes have been in place⁴⁶ poses the need of having to face successful exit strategies⁴⁷ to ensure country's economic institutions are not severely damaged for the future. Time-inconsistency problem may be aggravated by weak sustainability of this economic development model in the long-run without assuming for the touristic sector, a higher level of investments in infrastructures and installations.

It will be interesting to see the future evolution of this sector in countries like Hungary and Cyprus which have wide fluctuation bands of +/- 15%. In this way it would be possible to evaluate if the assumption made about pegged systems holds also for target zones, inferring, consequently, the relevance for this industry of the imported credibility approach.

The characteristics of this industry: high investments in fixed assets, long-term recovery, low returns, high levels of working-capital, define a business model which has to negotiate, months in advance, the activities to be performed in order to diminish the uncertainty on its expected revenues. This aspect although different from the credibility one, affects this industry in a similar way conditioning the choice of the exchange rate regime as it does not allow to benefit from the automatic adjustment between spot and forward rates embedded in the floating mechanisms⁴⁸. This implies, as a consequence, that tourism dislikes currency speculative movements that although sometimes could mean unexpected benefits, it is found they are not enough to offset the risks this attitude could pose on a company's operations.

The level of disposable income, purchase power parities and exchange rate values are key elements for defining the domestic and foreign demand of touristic activities. In this sense, it is important to keep in mind that foreign visitors would be more willing to travel abroad if its currency exchange rate has appreciated⁴⁹. In the same situation, domestic tourists will be reluctant to travel abroad although their domestic touristic activities should not be affected.

In the case of countries with a relatively high level of stability in their exchange rates, purchase power parities will have a determinant influence as people will find appealing to visit certain countries where the purchasing capacity of the foreign currency is high.

⁴⁵ The ECOFIN Council in a meeting in the year 2000, expressed that all exchange rate regimes except a free float, a crawling peg and a peg to a currency other than the euro were, in principle, compatible with the EMU. Currency board arrangements will be analyzed on a case-by-case basis

⁴⁶ In Estonia since 1992, in Lithuania since 1994 and in Bulgaria since 1997

⁴⁷ See Mishkin, 199

⁴⁸ See Williamson, 199

⁴⁹ Appreciation in this case means that the number of domestic currency units per unit of foreign currency has increased

SECTION IV.- CONCLUSIONS

The analysis done in the different sections of the paper shows the existence of a relationship among exchange rate regimes and the reviewed economic, industrial and social elements. It is possible to find some way of influencing these elements through the exchange rate system in place. The opposite interaction which would consist of deciding on which exchange rate system is more adequate in order to satisfy certain objectives set up with respect to the analyzed elements can also be inferred from the arguments contained in the paper.

The analysis of the economic elements starts with the review of the importance of the role that private investment has in accession countries. Two are the different investors' bases which have resulted as a consequence of the privatisation process, domestic and foreign ones. Each of these groups have distinct sets of interests which crystallizes in the different evaluation they made of aspects of the investment climate under the assumption of the application of different exchange rate regimes. It is argued that the predictability of the economy under the different systems differs between the two groups as it also happens with the potential advantages for entrance in new markets, derived from each type of exchange regime. The economic significance of the foreign group comes not only as a consequence of the high volume of FDI inflows, but also from its contribution to the economic development of these countries.

A special analysis is done of the joint-ventures, linked to the results obtained in the review of private investment, showing how it is an adequate method to bypass some of the observed difficulties each investor's group has for operating under certain exchange rate regimes.

Accession countries are seeing how final domestic consumption is pushing their economies forward. The share of private consumption is significantly higher than in EU members. Reasons of money illusion, confidence in the near future and the strategies applied by many countries allowing for appreciations of their real exchange rates are given as possible explanations of this consumist behaviour. Key factors affecting these levels such as real and nominal disposable income, money supply M1 and the impact of foreign shocks are reviewed paying attention to how different exchange rate regimes affect them.

Arguments are given supporting the importance for these economies of increasing their levels of domestic savings. It is pointed out the concern which could arise if these low amounts of savings were the consequence of a citizens' lack of confidence in the economy. Development of more advanced financial markets and institutional investors' base should help to dissipate any arising doubt on these economies. Aspects such as the safety of different exchange rate regimes and the future potential risk of currency crisis are analyzed in their relationship with different exchange rate systems.

The second part of the paper focuses on some industrial elements. Two paths for increasing a country's competitiveness are identified. One is based on local competitive advantages while the second one pursues to modify real exchange rate values. Depending on the way followed the purposes of the exchange rate policy will differ. Reasons are given of how the choice of a certain exchange rate system may conditionate the competitive level of the economy.

Productivity levels is the second industrial element analyzed. The paper presents a different approach which would take into account a change in the mix of tradable goods, increasing the amount of importables. Some features that an exchange rate regime should have in order to contribute to this goal, are suggested.

Demand for value-added services is analyzed both for the case when the supplier is a third company and when the own company performs these services. The level of a company's profits and their stability over the years are regarded as the two key elements driving this demand. They are analyzed separately for different types of exchange rate regimes.

The last part of the paper is dedicated to social elements. The first one to be considered is salaries. Low labour costs is one of the competitive advantages of accession economies. Doubts are expressed on their sustainability in the long-run, although it is also pointed out that the fact that the two countries with higher levels of salaries, would continue to apply wage indexation mechanisms may be understood as a confirmation that currency area will be developed on the basis of low salaries. Three aspects linked to wages should be taken into consideration when deciding on an exchange rate system. They are the rejection to rely exclusively on low salaries as a means to be competitive, the mix of exportables and importables in the economy and the share of non-tradables goods in the economy.

Demands aimed to improve working conditions are a logical consequence of the enlargement process. To the extent that economic agents will fail to give response to them, all the pressure will shift towards the government with the consequent aggravating effect on current account deficits. Exchange rate regimes should contribute to manage this situation non-deteriorating country's standard of living.

Tourism has a very significant share in accession countries' GDP. From some facts observed in accession economies it is argued that this type of activity prefers pegged systems as a way to reduce uncertainty. Levels of disposable income, purchase power parities and exchange rate values are key elements which affect the evolution of this industry and are highly dependant on exchange rate regimes.

The paper does not undertake any empirical research to test the proposed arguments. Lack of enough series of data is the main reason for that and it should be the next step to go through. The positive result is that exchange rate regimes and all these wide array of different elements which seems to have nothing in common among them, are interrelated and it is possible to influence them through exchange rate systems. There is no doubt, however, that further research in these areas is needed. The immediate consequence for accession economies is that it is possible to move upward from these elements to key macroeconomic variables.

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