Catch-up, the transition to full participation in EMU and financial stability

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Since the resolution of the Russian financial stability crisis of 1998, an event that had pronounced repercussions for several neighbouring countries, the growth rates of the recently acceded Member States of central and eastern Europe (RAMs)¹ that joined the EU in 2004 have comfortably outpaced those of most of the EU-15. After the adverse shock of the early transition period when every country endured falling output and high inflation, most countries saw a bounce back in activity. This return of rapid growth in all the RAMs since the late 1990s (when, in addition to the Russian crisis, other asymmetric shocks of varying kinds had slowed growth) has resulted in an impressive degree of real convergence in GDP in recent years. Indeed, among the EU-15, only Greece and Ireland have had growth rates comparable with the RAMs since 2000 and, as table 1 shows, the fastest growing RAMs have grown at four to five times the rate of the euro area as a whole. The convergence is consistent with what would be expected from the many studies triggered by the work of Barro and Sala (1992). However, as can be seen from table 1, although the gap in GDP per head has narrowed, it remains substantial and bridging it will remain a challenge.

Table 1 about here

All the new members are expected to become full members of EMU which will require them to fulfil the nominal convergence criteria. For some, current values for the relevant indicators suggest that there will be few problems in this regard, but for others a more extensive adjustment will need to occur. Nevertheless, for all the RAMs, the extent of the nominal adjustment they face to be eligible to move to stage 3 of EMU is not only manageable, but is also less than that which confronted some of the current members of the euro area in the mid-1990s.

A successful transition to euro area membership will, though, entail far more than meeting the Maastricht criteria. A change of monetary regime, especially one as far-reaching as adoption of the euro, will have profound effects on the real economy and will also affect financial markets in ways that could imperil financial stability. Moreover, there are potential tensions between the catch-up process (real convergence) and the achievement of the nominal convergence criteria that could affect the political economy of how and when to seek full participation in EMU.

Financial stability² has been recognised as a crucial factor in promoting long-term growth and is, therefore, bound to be an issue in both catch-up and euro accession. Its importance has been underlined by the ECB (2005a) and is also evident in the increasing attention paid by the relevant authorities. That the RAMs are alert to the challenges of financial stability is evident from the increased emphasis it receives in the priorities of the respective national central banks. The Czech National Bank, for example, highlights on its web-site the fact that it 'commenced financial stability analysis in earnest when it defined the priorities of its economic research for the period 2003–04 and published the *Banking Sector Stability Report for 2003*' and now publishes an annual financial stability report. Major causes for concern are the quality of prudential supervision, the potential for a rapid increase in consumer debt and

¹ Because of their different background and economic characteristics, this paper does not discuss Cyprus and Malta which acceded to the EU at the same time.

² Not an easy concept to define, other perhaps than as an absence of financial crisis [discussion with Charles Goodhart].

how it might compromise macroeconomic stability, and the relatively under-developed banking sectors in the RAMs.

The next section of the paper examines the challenges associated with acceding to stage 3 of EMU and in striking a balance between the long-term gains from EMU and the short-term risks to real convergence, highlighting the salience of financial stability. Sections 2 and 3 look at what is entailed in adjusting to EMU prior to accession (stage 2 adjustment) and once fully integrated (stage 3 adjustment), then section 4 appraises the links between real convergence and financial stability in the EMU context. Concluding comments complete the paper.

1 The challenges of acceding to stage 3 of EMU

Strictly, the RAMs are in the same position as Sweden in having no opt-out from full participation in EMU. They did not do so on joining the EU in 2004 only because the standard Maastricht conditions have to be fulfilled before they are eligible, a condition which, in practice, means a minimum two year participation in ERM II. Sweden, though, has already demonstrated that there is no real obstacle to staying out and it looks as though some countries, notably the Czech Republic, intend to exploit this flexibility. Others, such as Estonia and Lithuania, want to accede at the earliest opportunity, while there are signs that countries which were previously quite enthusiastic (Hungary for instance) are now minded to proceed more cautiously.

Behind these positions lies a debate about the costs and benefits of early euro area accession, focusing especially on its implications for real convergence. The question is whether switching prematurely to the euro would endanger real growth, even if it is regarded as axiomatic that euro area membership confers longer-term benefits. This question goes beyond the simple approach of asking whether the new members are suited to join the euro area on the basis of conventional optimum currency area criteria by the intrusion of the element of timing. Orlowski (2005) describes how during the 1990s, macroeconomic imbalances became quite severe in many of the central and eastern European countries in the wake of real exchange rate movement and currency crises of various sorts and how severe action was taken to stabilise their economies in the aftermath of the initial shocks of transition. The approach to euro accession will inevitably involve a sequence of further steps in monetary policy and other policy areas. Orlowski spells out some of the challenges of optimal sequencing of shifts in the monetary policy regime in moving towards full participation in EMU. In advocating a form of direct inflation targeting as the appropriate regime for many countries, but with the expectation that once price stability is entrenched, a greater focus can be put on exchange rate stability, Orlowski (2005: 223) notes that 'financial markets ought to be institutionally advanced in order to facilitate such a complex policy'.

As an analytic device for understanding the likely effects of acceding to, then participating fully in, monetary union, a useful concept is the 'j-curve'³, the essence of which is that there are short term costs of a change that produce a dip in performance (however measured), followed by an up-turn. Figure 1 illustrates it, showing that there is an expected trajectory for the economy in the absence of full adoption of the euro. Acceding to the euro area initially causes a worsening of performance (GDP is the most obvious 'performance' variable, but not necessarily the only one), but then induces a superior performance. The crucial issues, especially from a political economy standpoint, are the depth of the dip in the 'j' and the time it takes for performance to revert to an upward trend (shown on the horizontal axis as the gap from point A to point B), then to return the economy to where it would have been in the absence of the shift to the euro (from point A to point C). A wide range of factors will influence these two transitions and thus how they bear on the decision, but it is also important to note that the relevant parameters will not be fixed at the outset and may, instead, vary quite substantially depending on specific policy choices or behavioural adaptations.

³ Conventionally used to assess the sequence of effects of a currency realignment

Figure 1 about here.

It is also important to recognise the extent of change taking place within the RAM economies as they continue to integrate and to consolidate their transition. The pace of these changes means that many of the attributes of these economies that might be appraised in determining whether they are a good 'fit' with EMU, are themselves subject to change. Consequently, it will be especially difficult to establish whether, for example, optimum currency area (OCA) criteria assessed at any point in time can shed much light on the question of how rapidly to seek euro accession. Some recent literature has focused on the endogenous fulfilment of OCA criteria (for a summary, see De Grauwe and Mongelli, 2005), with countries adapting as a result of joining the currency union. De Grauwe and Mongelli (2005) identify four areas in which endogeneities might follow from adhesion to a currency area, all of which contribute to the upward movement (from B-C in figure 1) in the j-curve:

- Effects attributable to the impact on economic integration, notably by accelerated price convergence and more intense trade with partner countries
- The stimulation of financial integration and the resulting scope for financial flows to provide a form of automatic stabilization
- Convergence in susceptibility to shocks that lessen the probability of asymmetric shocks
- Encouragement of product and labour market flexibility

De Grauwe and Mongelli (2005) posit three dimensions of optimality which they believe bear on the case for membership: the degree of economic integration among candidates for union, the flexibility of economies and the correlation (or symmetry) of incomes. They suggest that in the absence of closely correlated incomes, either strong integration or pronounced flexibility can be substitutes that still allow the microeconomic benefits of monetary integration to be realised, implying that the one can be traded-off against either of the other two. They also point out that endogenous movements in the direction of OCA in the variables underlying any of the three dimensions will tend to improve the trade-off between any pair of variables, so that endogeneity becomes self-reinforcing.

However, it can be argued that because of their specific circumstances, the cost-benefit calculus of early euro accession for the RAMs will depend crucially on how much of this 'endogeneity' can be achieved in advance of euro accession. Hence the issue is what might be called *anticipatory OCA endogeneity*, which can be defined as transformations of an economy that arise because of, but prior to, monetary integration. In one sense, the convergence trajectory embodied in the Maastricht convergence criteria presaged just such a process by stipulating the adaptation of nominal variables (and the influences on them), but the range of endogenous variables goes much further, and embraces variables that will shape the capacity to adjust within the monetary union and to 'live' successfully with it. Consequently, in appraising the conditions of the RAMs it is important to consider what is distinctive about them from an OCA perspective.

The new members as optimum currency area candidates

Much of the analysis of OCAs is predicated on the assumption that the countries that form the monetary union will all shape the resulting union, such that its characteristics represent some averaging of the individual economies. Clearly, if two countries are close to identical, their union will result in broadly the same configurations of relevant indicators and will have little need to adapt. Identifying such pairs using OCA criteria is, indeed, aimed at minimising this adaptation distance (see, for example, Bayoumi and Eichengreen, 1997). At the outset, however, EMU did have to bring together economies with more disparate characteristics and the outcome is a mix that, at least for the largest economies, reflects some of their preferences, notably in institutional arrangements. Some of the euro area members, however, seemed to have used the common currency as a means of achieving a rapid paradigm shift, the most obvious cases being the conversion of the southern Member States from high- to low-inflation economies.

In time, the various pressures towards endogeneity should mean that all the members of the euro area should tend towards common attributes. Korhonen and Fidrmuc (2001) show that there were substantial changes over time among the current euro area members in the degree to which they can be considered convergent with Germany on OCA criteria. They also find that only Hungary and Estonia seemed at the time they were writing to be convergent with the euro area. In later work, these same two authors find, however, that the slowdown in EU-15 in the period 2000-02 led to increased heterogeneity in business cycles (Fidrmuc and Korhonen, 2004), so that there may be a cause for concern if current differences in growth rates between the RAMs and the core countries of the euro area persist.

For the RAMs, accession to the euro area will be on rather different terms from the current members, as they will be joining a monetary union in which all the common characteristics and institutional arrangements are settled. In other words, it is a 'take it or leave it' package, not one that will change to reflect their arrival other than in pretty marginal ways⁴. Moreover, because they are all, in GDP weight, small economies (even Poland would account for barely 3% of an enlarged euro area GDP and in aggregate the eight new members add around 7% to euro area GDP), the RAMs will make very little difference to the setting of monetary policy variables. Assuming the choice of interest rate is, approximately, the GDP-weighted average of the interest rates that would otherwise be set for individual Member States, for the needs of the RAMs to move the ECB repo rate by a quarter point (the smallest change that seems to occur), would imply that the rate required for the RAMs in aggregate should, in fact be a full four percentage points above or below the rate that would be set.⁵

There is, moreover, a catch-22 at the heart of this argument. If the economic conditions in the RAMs are sufficiently divergent to sway the interest rate decision, the gap would be so big as to be alarming, yet it would only be accommodated by an interest rate decision that goes a tiny way towards the needs of the RAMs. In other words, if monetary policy is to be about right for the RAMs it will only because they have engineered conditions that make it so, not because the ECB sets rates for their conditions.

One of the aspects of endogenous OCAs highlighted in the literature is that trade tends to expand because the common currency eliminates one source of uncertainty surrounding transactions with other countries. For small firms, especially, a threshold may be overcome and since the RAMs inevitably contain a preponderance of small firms, the effect may be especially pronounced for them. Yet Aglietta et al. (2003) note that the RAMs have successfully re-orientated their productive structures towards global markets without a common currency and that a key factor in doing so has been the balance struck between maintaining export competitiveness and containing inflation. They also argue that attempting to accede too rapidly to the euro could, by tipping the scales too far towards nominal convergence, upset this delicate balancing act and have an adverse effect on real convergence.

The contrary view has been well expressed by Leszek Balcerowicz, the Governor of the National Bank of Poland, who stated in a speech to the 11th European Banking Congress in Frankfurt, 23 November 2001, that early 'entry of the candidate countries into EMU would allow them to start reaping the related advantages (more price transparency, reduced transformation costs, stronger macroeconomic framework)' as quickly as possible and would help to consolidate the momentum towards structural reforms. The arguments about the optimal timing for full participation in EMU are, thus, in some respects, more difficult to pin down than conventional OCA assessments.

⁴ Decision-making in the ECB Governing Council will evolve to become a rotation system, and it may be that explicit voting, rather than the present approach of consensus will be implemented, but it is doubtful whether this would actually alter the decisions taken.

⁵ Plainly, this is back-of-the-envelope arithmetic and the actual judgement would be a more refined calculation, but it is nevertheless pretty telling.

The salience of financial stability

The risk that financial instability will have a damaging effect on the level and rate of growth of output is well-known, and is by no means confined to under-developed countries. According to an ECB (2005a) study, the crises in Argentina (2001-2), Turkey (1999-2001) and Indonesia (1998) resulted in losses of 12-15% of GDP, while Eichengreen (2004) cites evidence from the past 120 years that suggests that financial crises have 'cost' on average 9% of GDP⁶. Moreover, the history of transition in the fifteen years since the demise of central planning in the economies of the RAMs has also seen various episodes of monetary and financial crises. Nor is the problem confined to less developed countries: major episodes of financial instability arose in the Nordic countries in the early 1990s. Jonung and Hagberg (2005) estimate that between the onset of the crisis in Finland in 1990 and the return to trend growth in 1994, there was a cumulative loss of real income of 26.4 percentage points. In the parallel crisis in Sweden, they estimate the cumulative loss to have been 13 percentage points. In both cases the financial dimension of the crisis was central.

Several issues arise in assessing the relationships between financial stability, full participation in EMU and the outlook for real convergence and on the extent of the likely dip in the j-curve (from A to B in figure 1).

- As Issing (2005: 196) observes, 'monetary integration is more than just adopting a common currency; it also implies financial market integration'. Hence, the degree to which the financial markets of candidates for stage 3 of EMU are equipped to cope with the demands of integration will matter.
- Consumer debt as a proportion of national income in the RAMs is well below the median for the EU-15 and would be expected to expand as they become more integrated into the EU (Tùma, 2004). This is likely to have effects on asset markets and on the structures of bank balance sheets that could increase the risk of financial crises.
- The experience of the RAMs in regulatory oversight and prudential supervision of financial intermediaries has been chequered, with a number of problems arising during the 1990s. Even if the framework now in place is regarded as sound, implementation also has to be taken into account and there will be a need for a phase of learning by doing, during which vulnerabilities may increase.
- Ownership of major banks in most RAMs is now substantially in foreign hands. While this may be beneficial for risk spreading, there is also a danger that it will lead to lending policies that could exacerbate volatility in GDP if the parent banks make decisions not on the basis of circumstances in the host country, but on the basis of their overall markets⁷.
- The intra-country dimension of real convergence also warrants attention, particularly in relation to asset markets. A characteristic of all the RAMs has been relatively more rapid growth and faster economic development in a small number of regions, usually the capital.

⁶ Eichengreen also notes that the loss of output in Argentina and Indonesia exceeded that in the US during the Great Depression, triggering massive economic and social changes. As he puts it (Eichengreen, 2004: 10) 'the social impact of financial crises can be enormous'.

⁷ Heid et al (2004) show that the response of German banks to the 1998 Russian crisis was to scale back their lending to emerging markets. In contrast, during the Asian crises, banks re-weighted their portfolios toward the emerging markets with the better macroeconomic prospects, without altering their overall lending. Heid et al. (2004: 15) also warn that 'banks should also be aware of the fact that a country's creditworthiness can deteriorate very fast when investors suddenly change their perceptions towards emerging markets altogether in the face of problems in one of the emerging market countries'.

A central influence on the outlook for financial stability will be the choice of monetary regime. Golinelli and Ravelli (2005: 198) identify a range of conditions for sound monetary policy (see table 2). They claim that their 'findings provide strong support for the feasibility of an inflation targeting (IT) strategy in transition economies. This strategy may be adopted, in our view, as soon as the process of disinflation has been completed. In this perspective, IT emerges as the natural follower to a strategy of crawling band (as in Hungary and Poland), as well as to a strategy of exchange rate peg (as in the Czech Republic)'.

Table 2 about here

And what about real convergence?

Research on convergence has been far from conclusive and there are conflicting views on the degree to which economic cycles are, or will be, synchronised. Caselli and Tenreyro (2005) suggest four channels through which real convergence might occur:

- Solow-type growth reliant on their lack of capital and the consequent high marginal productivity of capital
- Technological catch-up
- Gains from trade in previously relatively closed economies
- Induced structural change in which there is a switch of resources from low to high productivity activities.

The competitive effects of the single market, arguably reinforced by monetary union constitute a fifth mechanism not quoted by these authors which will also bear on structural adaptation. Together these effects can make a considerable difference to productive structures. Average productivity per worker in Spain was only 60% of that in France in 1950, but had converged to 90% by 1970 (Caselli and Tenreyro, 2005). Polish agricultural workers appear to achieve just 9% of the productivity of their French counterparts compared with 40% for manufacturing and 56% for services. This suggests considerable scope for both between-sector resource reallocation and within-industry catch-up, though also that it will be a drawnout process. The RAMs start with one advantage compared with their southern European counterparts of yesteryear, namely a relatively high level of human capital, though there may be a risk that the legacy from centrally planned days of a good education will erode and may be less suited to the contemporary knowledge-intensive economy.

Productivity growth and its links to labour costs are generally encouraging for the RAMs the evidence is that nominal labour costs remain low, as can be seen from table 3. EU accession can be expected to put upward pressure on nominal wage rates, but the data show that there remains considerable room for manoeuvre. Moreover, so long as productivity growth remains robust, it will offset nominal wage increases and some new members have an enviable record in this regard. Such higher productivity growth may reflect the lower starting point, especially of the Baltic States and also the fact that their transition started later. Even bearing this in mind the productivity growth has been exceptional.

Table 3 about here

The findings of Brada et al. (2005) that the real output of the five new members they investigate is not very well co-integrated with France and Germany prompts them to advocate caution in moving to full participation in stage 3 of EMU. They conclude that these 'economies would be well advised to retain some measure of policy autonomy to deal with productivity shocks whose magnitude and timing may continue to differ significantly from the shocks affecting the EU core. This is far from surprising given the extent of the transformations taking place and the very different phases in the macroeconomic performance of the new members. A data period that comprises an initial transformation recession, a phase of stabilisation and phases of growth interrupted by supply or currency shocks is hardly a viable basis for estimation.

A further issue is how economic activity evolves within a Member State. There is a tendency across the EU for economic activity and dynamism to be most concentrated in capital regions, leading to possible spatial imbalances that, in turn, can give rise to macroeconomic imbalances. Although there are data lags that mean the most recent data relate only to the period before accession, the evidence nevertheless suggests that regional disparities are growing in the four larger new Member States The remaining four (Slovenia and the three Baltic countries) are small, very open economies and although there is also some evidence of disparities, it is a qualitatively different setting. In j-curve terms, spatial imbalance could result is a steeper initial dip and a slower recovery.

Paving the way: prior adjustment in stage 2 of EMU

It is easily forgotten that the current members of the euro area went through an extended apprenticeship before the start of stage 3 in 1999. Formally, the aim was to achieve a sufficient degree of nominal convergence such that prospective participants in stage 3 would not exhibit differences that would put undue strain on policy choices at the level of the euro area. Nominal convergence, however, was only part of the story, not least because it says little about the likely impact on the real economy, nor was it the only pathway to membership. In the debate around joining EMU at the time of the negotiation and ratification of the Maastricht treaty, two schools of thought emerged about how to proceed. One, often referred to as the *economists'* perspective, favoured prior convergence by ensuring that the participants in the monetary union had similar inflation rates and other nominal indicators (Wyplosz, 1997), an irony of this labelling being that it was most heartily endorsed by central bankers and little supported by academic economists.

The other school of thought – again with some irony - came to be known as the *monetarist* approach, in spite of being the one mainly espoused by academic economists of diverse persuasions. Its main thesis was that once countries entered a monetary union, economic agents would rapidly adapt their behaviour, a corollary of which is that their history would have only a marginal bearing on how they conducted themselves under EMU. The logic of this position was that a 'big bang' move to EMU would be the most attractive route, partly because it would avoid the potential damage to the real economy from an extended period of restraint aimed at achieving the required limits for the nominal indicators. In principle, this would mean a flatter j-curve with a smaller loss from the transition to EMU.

As note above, for the RAMs, the question is no longer the same. The rules are set and they have to conform, and the institutional structure of EMU is established. Consequently, being able to live with the EMU regime is now largely about timing of different sorts of development. When the assessments of the current euro area members were done in 1998, the position was that all the contenders bar Greece comfortably passed the inflation and long-term interest rate tests, but for several an element of discretion had, in effect, to be used to enable them to pass the fiscal tests.⁸

A crucial question for the new members is the extent to which they are likely to be subject to the Balassa-Samuelson (BS) effect. This arises when high productivity growth in the traded sector leads to wage inflation in sheltered sectors because workers seek to maintain differentials, even if there is no corresponding productivity increase in the latter. For catching-up economies, the scope for productivity gains is substantial, especially if inward investment brings in substantial new capital. The outcome tends to be an appreciation in the real exchange rate. The magnitude and extent of such effects has been contested, with sharply varying estimates, although an authoritative study by Schadler et al. (2005) suggests that the effect will add in the range of 1-2 percentage points to consumer price inflation in the recently acceded state of central and eastern Europe. The implication is that, to offset this effect, they

⁸ Some of the strains that have since arisen in fiscal discipline can probably be traced to this fudging of the criteria.

will have to attain an underlying inflation rate in the traded sectors that is as low as the best performing euro area members in order to meet the Maastricht price inflation criterion⁹.

Price levels in the recently acceded Member States remain generally far below those of the euro area countries, though there has been notable convergence. According to the latest data in the Eurostat Structural Indicators database, prices in the euro area in 2003 were 103% of the EU-25 average, while those in the new Member States ranged from a low of 49.8% in Slovakia to 77.1% in Slovenia. In the three years from 2000 to 2003, the rate of price convergence was highest in Hungary (up from 48.4% to 58%) and the Czech Republic (47.3% to 55.2%). In the other NMS, the rate of convergence was lower, while in Poland and Latvia, the relative price gap widened vis-à-vis the EU average. Asset prices, bearing in mind the experience of some of the current members of the euro area (notably Portugal and Ireland) may be a specific problem. Housing is the obvious concern, especially with the rapid growth in so many countries of housing loans, but share prices have gone up substantially in the RAMs, according to OECD data. Table 4 shows the rates of increase for selected countries up to July 2005.

Table 4 about here

Turning to budgetary ratios, six of the new members were found to have excessive deficits immediately following EU accession and Hungary was castigated again in the spring of 2005 for being slow to abate the deficit. Reform fatigue may also be a factor complicating adjustment, especially with EU accession being sold as an economic opportunity. EU membership may, in addition, lead to some short-term fiscal problems, even though the sizeable allocations expected from the cohesion budget will result in net fiscal transfers to the new members. In particular, co-financing rules may oblige the new members to devote more public spending to public investment. Provided the investment in question is productive, it should underpin growth and thus generate greater fiscal resources in the medium-term, but here again a short-term cost arises. The need to conform to environmental quality standards will potentially put pressure on public finances in the new Member States, although Hallett (2004) concludes that these fears have been exaggerated and that on balance EU accession will ease their fiscal positions.

Fiscal adjustment also contains a sting in the tail for the new members. The Maastricht ratios of 3 per cent deficit and 60 per cent debt were selected largely to ensure that a steady state could be maintained in the convergence process, assuming a 5 per cent trend growth in nominal GDP, values that were around the (then) EU-12 average at the time the criteria were set. Nominal growth at that rate would, in turn, be approximately 2.5 per cent real growth with 2 per cent inflation, or a similar combination of the two components.¹⁰ A country growing at that rate with an initial debt of 60 per cent could sustain a 3 per cent deficit without increasing the debt ratio; if the deficit were held below 3 per cent, debt would decline. For the RAMs, however, the initial arithmetic is different. Real growth in recent years is well above the benchmark 2.5% rate, as is inflation, while for several countries the debt ratio is well below 60 per cent. As a result, their deficits could remain some way above 3 per cent, without imperilling fiscal sustainability (as measured by indebtedness). Consequently, there is a risk that some countries will be obliged to rein in their deficits in a manner that would reduce aggregate demand and compromise public investment, yet not be necessary to contain public debt. Treaty change in this respect cannot be expected to happen, but it is evident that rapid fiscal consolidation could be damaging to real convergence.

⁹ Because the benchmark is the three best, rather than the euro area HICP inflation rate, it is conceivable that the RAMs would have to achieve a rate below the euro area average, especially if larger members have higher rates. It could, thus, be a demanding test.

¹⁰ The calculation is multiplicative rather additive.

The question of whether the new members would do well to retain the exchange rate as an instrument of adjustment in the early years of EU membership depends on the likely form of shocks. In essence, if shocks are financial or monetary, an independent exchange rate will be damaging, whereas if shocks mainly affect demand, then a relative price movement brought about by an exchange rate movement may be beneficial. A study by Borghijs and Kuijs (2003) surveys the evidence on the experience of the CEECs in this regard and suggests that although the exchange rate may have been useful in dealing with real economy shocks in larger countries, in smaller economies it has not. They explore how useful exchange rates have been in resolving shocks in five CEE countries and conclude that exchange rate variability has probably been unhelpful or even counter-productive.

There is also a significant risk of greater macroeconomic volatility from early membership of ERM II, a system that requires a fair degree of nominal convergence to be generally beneficial for its participants, but could prove to be damaging if exchange rates tend to diverge. At issue here is what is currently in place, as it could be argued that moving from a currency board to ERM carries little risk, whereas a country such as the Czech Republic which has an inflation-targeting monetary policy would be more vulnerable. A possible 'capital inflow stop' (Rostowski, 2003) could trigger macroeconomic instability and thus a risk of currency depreciation, a solution to which would be to move rapidly to adopt the euro. The effect may be to damage the prospects for real convergence leading to an adverse outcome, especially if pressures for easy monetary policy create unsustainable short-term booms or at least tend to be pro-cyclical.

In addition, as Cihak and Holub point out, price convergence may be accelerated for reasons other than the conventional BS effect. If so, one of two problems for eligibility for stage 3 will arise, depending on the exchange rate regime in operation. For new members that operate currency boards, the real appreciation will have to be accommodated by higher inflation, which could threaten achievement of the Maastricht inflation criterion during the period when convergence is being assessed. Where there is nominal exchange rate flexibility, on the other hand, it will be the stability of the exchange rate that is threatened. A crucial issue, therefore, will be whether the 15% ERM band or a much narrower band is applied in assessing the Maastricht exchange rate criterion.

Three approaches can be envisaged, all of which have differing implications for the conjunction of real convergence, financial stability and EMU accession and thus the shape of the j-curve:

- A big bang approach aimed at acceding to full EMU at the earliest opportunity, perhaps occasioning a short, sharp fall in the j-curve then rapid recovery
- A longer period of acclimatisation inside ERM II, but with the focus on a stable exchange rate, with less of a loss, but a slower upturn
- A sequencing approach in which the initial emphasis is on price stabilisation (via inflation targeting) followed by a switch to the minimum period inside ERM II. Ideally managed, this could offer the most promising j-curve.

Links from financial stability to real convergence

The links between financial stability and real convergence likely to affect the RAMs operate through a variety of channels (see, for instance, Brouwer et al., 2002; Rostowski, 2003). They include the stability of key macroeconomic variables and shifts in the policy frameworks affecting monetary policy and the exchange rate, the determinants of major financial flows, the character of the financial system and how it is evolving, and the regulatory environment for financial services. Macroeconomic mismanagement has long been recognised as a source of financial crises, in which inattention to price stability or imbalances in components of demand can lead to volatility in financial markets that precipitate problems.

Jiménez and Saurina (2005) note that there is a long history of banks succumbing to lending fervour in periods of relatively rapid economic growth and point out that mistakes are more likely during upturns than in periods of slower growth when banks exercise more caution. However, they also point out that the empirical support for the contention that rapid growth in lending is associated with higher credit risk is limited. They try to remedy this gap by investigating the relationship and find that there is a positive relationship between an increase in lending and future non-performing loans – an intuitively probable finding – but only with a fairly substantial lag. Their empirical work also demonstrates that it is the riskier loans extended in economic upturns that account for this phenomenon: as they put it (Jiménez and Saurina, 2005: 23) 'credit risk increases in boom periods although it only pops up as loan losses during bad times'. The current strong growth in the RAMs could, on this evidence, be a source of future problems.

Eichengreen (2004) makes the obvious, if telling, point that financial crises do not erupt in countries with rudimentary financial markets, and he suggests that the biggest problems are likely to be in emerging markets or transition economies. But Eichengreen also emphasises the important links between financial development and productivity growth, and thus highlights an important trade-off that policy-makers have to optimise. Modernisation of the financial sector is a necessary condition for real convergence, but it carries the risk that there will be a disruptive bout of financial instability. Eichengreen et al. (2003) point to three risks that tend to characterise emerging market economies:

- Currency mismatch, which is characterised by short-term liabilities in an external currency while the assets and/or cash flow to service the debt is in the national currency
- Debt intolerance, which is an inability to manage the levels of debt that more de veloped countries can sustain
- What they call original sin, the inability to borrow abroad the country's own currency, with the result that any external borrowing carries a currency risk.

Drawing the various influences together, box 1 shows the range of possible effects of EMU accession on the banking sector.

Box 1 about here

Living with full EMU: stage 3 adjustment

Once fully in EMU, a country plainly has to adapt to the new regime and this, in turn means rethinking the policy mix - in the broadest sense - because EMU changes the scope for using different policy instruments in adjusting the economy. Conventional demand management instruments operate in a very different manner and tend to be more constrained than for a single country¹¹, so that more of the burden of any adjustment necessarily falls on supply-side polices, notably those that bear on the labour market. The high degree of trade integration between the new members and the euro area, as well as their relatively more flexible labour markets, mean that they may find it easier to 'live' with the euro than several of the current members. An inference is that stage 3 adjustment, part of which is the degree to which optimum currency area criteria are satisfied endogenously, will be more critical than stage 2 adjustment.

The stage 3 challenges are, in part, about accommodation to the new policy environment, but also concern the dynamic effects of participation. In a Lucasian sense, EMU is a significant regime change that must be expected to transform a wide range of economic relationships. The implication is that past economic trends may not be a good indicator of how countries will fare once inside the euro area. In this regard, the record of the early years of the euro contain a number of surprises and, with eight years of observations now available (hard data

¹¹ Though less so for the smaller, open economies.

for 1999-2004 and forecasts for 2005-06), some lessons can be drawn. The travails of Germany, Portugal and Italy contrast with the apparent success of Spain, Finland and Ireland and, while it would be disingenuous to attribute these trends only to the single currency, can offer some insights.

Three overlapping, but distinct dimensions of adaptation are relevant. The first is macroeconomic acclimatisation, which comprises a range of processes:

- Re-balancing of the policy mix, given the switch to a firm monetary policy orientated to price stability, with fiscal policy expected to assume more of the burden of dealing with demand shocks. The macroeconomic re-balancing also includes learning to live with more constraints on fiscal flexibility.
- Changes in the signals that guide the relationships between monetary and fiscal policy, and in how demand management interacts with the labour market.
- Effects on nominal interest rates and thus on the burden of debt service that lead to a rebalancing of tax and spending, and may have distributive consequences by shifting demand from lenders to borrowers, a change that may also have be regional in its incidence. Such shifts may, in turn, have an effect on the banking industry, though whether it affects the risk of financial crises is hard to predict.

Second, there will be a shift in the dynamics of the labour market and how its different attributes affect the capacity for supply-side adjustment. An economy with a rigid labour market will find it more difficult to alter its competitiveness, because labour-market adaptation occurs only slowly, and (as Germany has found since entering EMU) to be highly contested. On the whole, however, the RAMs start from a more propitious position in that the extensive transformations that they have already undergone during transition have resulted in relatively freer labour markets than in many current euro area members.

Third, closer integration through monetary union induces longer-term effects. These include structural changes in the geography of economic activity caused by polarising and agglomerating forces (see Neary, 2001; and, for a perspective on policy issues, Baldwin et al., 2003). There will also be EMU-specific trends, such as a possible spatial concentration of financial services. One of the effects of EMU that was, arguably, under-anticipated has been the relatively rapid growth of intra-euro area trade, even though Rose (2004), especially, had pointed to it as a probable effect. Trade data show that the new members are generally more open economies than most EU-15 Member States, and also that their trade is now very largely with EU partners. This sort of trade pattern implies little need for adjustment.

A particular source of instability is capital inflows, which are likely to remain substantial in the new member states, even though the major waves of privatization are now passed. The experience of Ireland and Portugal also suggests that asset bubbles that could impinge on macroeconomic stability need to be anticipated and that dealing with a public investment boom (especially with a gearing-up of transfers from the EU Structural Funds) may be an issue.

Much has been written about the high level of employment in agriculture, notably in countries such as Poland. However, it is the share of primary activity (agriculture and fishing) in GDP that is, arguably, more revealing. In the euro area, the average in 2004, according to Eurostat data reported in the August 2005 issue of the ECB *Statistics Pocketbook* was 2.2 per cent, with a range from 6.4 per cent in Greece to 1.1 per cent in Germany and just 0.5 per cent in Luxembourg. In the new Member States, the Baltic States have the highest ratios, peaking in Lithuania with 5.7 per cent, while most other countries are clustered around the 3 per cent mark (including Poland at 2.9 per cent). In general, manufacturing in the new member states accounts for a higher proportion of GDP than in the euro area: the highest share in 2004 was in the Czech Republic at 32 per cent and Slovenia at 30.2 per cent, with the median around 25 per cent compared with 20.8 per cent in the euro area. However, the Irish manufacturing share

is marginally higher than the Czech one, and Germany, Slovakia, Poland and Hungary have similar values around the 25-26 per cent mark.

In construction, the data suggest that it is the EU-15 'cohesion countries' that have the highest GDP shares, implying that receipts from the Structural Funds may have played a part. Most of the new members have a construction share close to the euro area average of 5.9 per cent, but higher than the three largest economies. The one area of economic activity where the new members are most distant from the euro area is finance and business, which accounted for 27.8 per cent of economic activity in 2004 in the euro area, but a spread from 12.1 per cent in Lithuania and 16.4 per cent in Poland to just over 21 per cent in Slovakia and Hungary.

These admittedly crude indicators suggest that, in terms of the broad structure of economic activity, the RAMs are not that different from the euro area. While the dependence on agriculture as a source of (plainly, low-quality) employment is much greater in the new member states, it would not take many years of relatively higher growth for the structures to converge with the euro area, at least at this highly aggregated level. Indeed, in the various broad sectors, the range among the twelve current members of the euro area is such that, with the exception of finance and business, the RAMs would not appear to be out of place. More highly disaggregated data might tell a subtler story. However, to the extent that monetary policy tends to focus on the impact of interest-rate changes on broad sectors, and on the distinctive transmission channels that bear on different sectors, there is no immediate cause for concern.

The value of the exchange rate on entry into EMU will also affect the shape of the j-curve by affecting competitiveness, influencing the trajectory of the economy in the short- to mediumrun. Arguably, one of the problems confronting the Italian economy today is that its competitiveness declined progressively after acceding to the euro because of the twin effects of low productivity growth and rising real wage costs. Consequently, for the new members, 'getting the parity right will be another key part of the strategy', as Schadler et al (2005: 9) note. Bulir and Smidkova (2005) present potentially worrying evidence the nominal exchange rates of some new members risk being overvalued, even within ERM II. They find that the Czech, Hungarian and Polish currencies were overvalued in 2003. Their simulation work suggests that, in contrast to the Slovenian Tolar, all three currencies would struggle to stay within the constraints of ERM II over the period 2004-10, based on their end–2004 exchange rates. Bulir and Smidkova also suggest that the competitiveness of these three economies could be harmed if they try to meet the Maastricht criteria too soon, while Slovenia may be better off revaluing before entering stage 3.

Several members of the euro area have struggled to conform to the fiscal rules and have found themselves in breach of the Stability and Growth Pact. It is, however, on the supply-side of the euro area economies that problems have been most evident, although whether these can be attributed directly to EMU is doubtful. Labour market mismatch has been a feature in several countries, productivity growth has slowed and investment in R&D has been disappointing. These shortcomings have been extensively documented (see, for example, the Sapir report, 2004 and the Kok report, 2004) and the 2005 re-launch of the Lisbon strategy is intended to offer a remedy. One sense in which these problems can be linked to EMU is that as fiscal consolidation has proceeded, Member States have – as is so often the case – found it easier to cut public investment than consumption. Yet it also has to be pointed out that as nominal interest rates have declined, there ought to have been greater incentives for the private sector to invest more.

A second sense in which supply-side difficulties may have had been affected by the shift to EMU is that the extended period of slow growth associated with the transition to the euro may have inhibited structural reforms. Such reforms are typically easier to push through when the economy is booming and the social and political costs of change can more easily be accommodated, whereas stagnation often entrenches defensive attitudes. For the RAMs, this diagnosis has a silver lining in that the extent of reform has already been considerable, with

the result that some of the problems that characterise 'old' Europe – notably inflexible labour markets – have already been confronted, implying a lesser dip in the j-curve.

What mechanisms are in place to assure stabilisation?

Within the euro area, as with any currency zone, the central bank has to rely on the financial system for the transmission of monetary policy (Issing, 2005). But if the financial system is underdeveloped there may be vulnerabilities that compromise its capacity to fulfil these functions. For similar reasons, any monetary policy decision (which, by definition, will be taken for the euro area as a whole) may lead to differentiated effects on the real economy of an RAMs compared with the current members.

The ECB (2005a) notes the importance in the event of a financial crisis of private flows in resolving the problem. While official flows can play a useful catalytic role, especially where the country facing a crisis is classified as intermediate in credit ratings, they are shown not to be a reliable answer. The study also notes the obvious point that the involvement of domestic private sector creditors in dealing with a financial crisis has direct implications for the real economy which may aggravate the costs of the crisis. It follows that a robust system that minimises the risks of such crises is a highly desirable attribute of an economy. A linked issue is the extent to which external rather than domestic private creditors are involved.

Brada et al. (2005: 253) stress that even if monetary variables, such as the growth of base money or the interest rate display convergence towards the euro area, the transmission mechanism to the real economy depends on the character of the financial system. They observe that 'even if the transition economies were to follow the monetary policies of the Bundesbank or, now, the European Central Bank (ECB), major changes in their financial systems could transform such policy into quite different results in terms of the growth of broader measures of the money supply, interest rates or inflation'.

The financial sector in the RAMs

The financial legacy of transition, as well as current trends in the financial sector, will bear on the costs and benefits of euro area accession and on the prospects for adjustment, with both macroeconomic and microeconomic effects. Countries which have an overhang of external debt – Poland was one, although the reliefs granted by the Paris club eased the burden - face both a debt service and repayment outflows, whereas those (such as the Baltic States) which had the slate wiped clean at the start of the transition have an obvious advantage.

The extent of domestic credit is an important factor and one likely trend is that the indebtedness of consumers and the corporate sector will increase. Zdeněk Tùma, the Governor of the Czech National Bank noted that: 'in the acceding countries, bank credit to the domestic private sector typically has a ratio of 30 to 40 per cent of GDP, while the EU average is around 100 per cent of GDP. This difference is to a large extent natural, reflecting the lower GDP levels of the acceding countries, their history, and the recent weaknesses in their legal and institutional environments' (Tùma, 2004: 2) He goes on to make the point that higher debt is likely to be associated with greater risk of financial crises. Risk of financial crisis consequent on this scale and speed of change further complicate the negotiation of fit.

Although the bank credit to GDP ratio has risen substantially in nearly all the countries of central and eastern Europe, the rate of increase has not been unreasonable, given the low starting-point. Indeed, actual stocks of lending are, in many cases, below what might be expected from the level of development of the country (Cottarelli et al., 2005). Three major shift occurred during the 1990s: the need to write off the loans extended to state enterprises; privatisation (mostly to foreign investors); and the building up of bank lending to the private business sector. Bank lending continues to dominate business finance (ECB, 2005b). In 2003, the average lending to the private sector was around 35% of GDP, compared with some 117% in EU-15. An ECB (2005b) study attributes this low ratio to three factors:

- Above all, the fact that private sector credit was largely absent under central planning, with the result that there was neither a developed banking system, nor experience among consumers or business in demanding credit
- Second, an uncertain legal environment that could have compromised debt enforcement
- The fact that foreign-owned enterprises often relied on external sources of finance

The ECB study also finds that the RAMs are – in keeping with experience elsewhere – progressively seeing an increase in the extent of financial intermediation. Although, by 2003, the average rose by six percentage points from 29% of GDP in 1995, the increase in private credit in some of the RAMs has been much more rapid and if the EU-15 average is seen as a benchmark towards which the new members will converge, the scope for a surge in credit is evident. This prospect raises a number of issues germane to financial stability. First, it implies that both lenders and borrowers will have to adapt their behaviour.

The latest data highlight the potential problems. Bank lending to the private sector in the RAMs has been growing rapidly in recent years, with growth of as much as 55% in Lithuania in the year 2003 and by 80% in 2004. Lending to households grew more rapidly than to companies in seven of the eight RAMs (Slovenia is the odd one out), with growth in excess of 60% during 2003 in Lithuania, Latvia and Hungary (ECB, 2004). Figure 2 shows the trend for three of the RAMs for which comparable data are available. Much of this lending to households appears to have been for housing finance raising the spectre of an unsustainable house price boom. In Hungary, for example, lending for house purchase rose more than sixfold in nominal terms between the beginning of 2002 and July 2005, while total lending to households 'only' quadrupled.¹² In Poland, the latest financial stability report (for the first half of 2004) noted the sharp rise in lending to households, and the surge in housing loans associated with EU accession. Figure 3 shows the extent of the surge in house-related lending for the Czech Republic, Estonia and Hungary.

Figures 2 and 3 about here

A second concern, as credit increases, a change that may have repercussions for the monetary transmission mechanism, the risk of credit induced effects on macroeconomic stability will also be increased. The speed with which credit expands – that is, slowly over many years, or rapidly as modern financial products are rolled-out – will influence how this effect unfolds, as well as the trajectory towards stage 3 of EMU.

A third likely effect is that as credit expands, the probability of defaults and bank failure will rise. The solution is not hard to state, namely to implement appropriate regulatory measures, notably assurance of capital adequacy, and to prevent trouble by well-designed prudential supervision. But it also has to be recognised that there is a learning process in developing such measures. Particular attention will need to be paid to how the financial system evolves and the degree to which the dominance of traditional banking is replaced by an increase in other forms of intermediation. Off-balance sheet risks have manifestly been a source of problems in EU-15 and represent one potential threat to financial stability in a rapidly changing financial environment.

The ECB study also shows that stock market capitalisation, at just under 20% of GDP, is substantially below the EU-15 level (68%), reinforcing the image of an under-developed financial sector. As part of the transition from central planning, most banks were privatised and there are now hardly any state owned banks. Indeed, a large proportion of the banking system is now foreign-owned, a fact that may help risk sharing in a way that is supportive of financial stability, but which also poses potential threats from asymmetries that are discussed

¹² Data from the Magyar Nemzeti Bank, *Monetary balance sheet statistics* available online at

<http://english.mnb.hu/engine.aspx?page=mnben_statisztikai_idosorok>

below. Only in Latvia and Slovenia is the foreign share of bank assets under 50%, while in three countries (Czech Republic, Slovakia and Estonia) it is close to 100%. The ECB study shows that most of this foreign ownership takes the form of RAM banks being subsidiaries of foreign credit institutions.

More encouragingly, the ECB study shows that on various indicators of solvency, the banking system in the RAMs is in reasonably good shape. Loans amounted to 49% of assets in the RAMs in 2003, compared with 51% in EU-15, while liquid assets were also sizeable. The robustness of these and other indicators does, though, have to be viewed with caution given the likely increase expected in financial intermediation in general and lending to households in particular. How banks themselves change as organisations will also be an issue. For example, there are unrealised economies of scale among the smaller banks in the RAMs (Fries and Taci, 2005), implying scope for efficiency gains through consolidation.

All of these trends point to the probability of an increased sensitivity of the economy to possible interest rate shocks and, potentially, to an intensified risk of financial instability. Issing (2003: 22) maintains that 'a system definition of financial stability practically excludes a trade-off between monetary and financial stability', though he concedes that a short-term conflict may arise. But for economies in transition, it might be expected that the conflict could be more acute, especially if Balassa-Samuelson influences or measurement problems complicate the issue.

Concluding comments

Full participation in EMU promises to entrench macroeconomic stability, to accelerate the integration of financial markets and help to assure financial stability, and to raise the volume of trade by eliminating currency risk as a form of barrier. The trouble is, though, that to attain these prizes, an economy has to be in a position to exploit the opportunities afforded by accession to the euro area. Any doubts concern whether, having come through the process of transition during the 1990s, EMU imposes constraints on macroeconomic policy and would restrict flexibility by eliminating the exchange rate as a potential instrument of adjustment and shock absorber. These constraints could slow real convergence.

The question is not whether the stable macroeconomic policy that EMU assures is in the interests of economies in search of a long-term economic development strategy, but whether they are yet able to cope with it. In some respects, the Maastricht nominal convergence route to monetary union may be more demanding in the short-term for the new members. They face greater pressures for public investment and may also have to confront demands for an 'EU membership dividend' in social spending. Dealing with the consequences of real convergence in the form of a Balassa-Samuelson effect on the price level may also be challenging, since it could engender a conflict between price stability and exchange rate stability.

This paper has emphasised that the challenges are about the speed with which different facets of economic change occur, and the ease with which behaviour and structures consistent with the single currency can be engendered. There cannot be an all-encompassing answer and a range of trajectories along the j-curve can be envisaged. For the small open economies, the balance of costs and benefits will tend to favour entering stage 3 as quickly as possible. The Baltic economies exemplify this, since their record shows that despite entering transition in 1992 in an inauspicious position they have been able not only to adapt their macroeconomic variables rapidly, but also to shake up the supply-side of the economy successfully. Ireland's experience may have some resonance for them.

Poland is a rather different story for which Spain, a country that has been through a successful transition - albeit from a different form of totaliatarianism - may offer a parallel. Like Poland, Spain saw a rapid rise in unemployment and had to contend with a sharply declining rural economy. The time span was longer and the distance that had to be travelled lesser, but the fact that Spain, as seen in 1991/2, let alone 1986 or 1975, has gone from being a marginal candidate for full participation in EMU to one of the more successful economies ought to be a

source of encouragement for countries like Poland. Even so, von Hagen and Traistaru (2005: 166) suggest that Poland and the Czech Republic 'are the only two new member states for which a late entry makes sense, given that they have demonstrated the potential for an autonomous, stability-oriented monetary policy based on inflation targets.' Having analysed the congruence of shocks, Frenkel and Nickel (2002: 23) also conclude that their results 'support an entry into EMU for more advanced east central European states at the earliest possible date'.

In keeping with the overall themes of this conference, an important question is how financial stability bears on the decision, recognising that it affects both the transition and how comfortable the RAMs find living with EMU. Some of the risks commonly associated with episodes of financial crisis can be played down. Macroeconomic policy, notably, seems unlikely to be a trigger for financial instability, notwithstanding the trend in some of the RAMs for fiscal deterioration. As table 5 shows, all the EMU candidates meet or are within touching distance of the nominal convergence criteria, so that unless a maverick government comes to power and squanders these advantages in what would be a very cavalier manner, it is hard to see a breakdown of discipline. Central Bank independence and its corollary, a commitment to price stability, would, in any case, be likely to inhibit any such trajectory.

Table 5 about here

Of potentially more concern is the impact of financial flows. Here, a variety of flows come into play. The RAMs will, in all probability, continue to be attractive destinations for foreign investment, even though the big waves of inward investment associated with privatisation are over. Flows of up to 4% of GDP will also come from EU cohesion policy beyond 2006, so that the consolidation of EU membership will provide a net stimulus that may, in addition, be targeted at a narrow range of sectors (especially construction and training). Together, these flows will warrant quite substantial deficits on other components of the current account of the balance of payments. With high current account deficits in many of the RAMs in recent years, the risks of imbalance could be intensifying. A related issue is whether there are currency mismatches. Thus, a crucial question will be how stable capital flows can be and whether a vulnerability to withdrawal of the more mobile forms of capital might exist. In particular, the switch – when it occurs - from inflation targeting to exchange rate stability in the two years of ERM membership will require careful handling.

The whole gamut of regulatory considerations as they affect the financial sector are also likely to be a potential source of concern as the sector itself evolves. An anticipated shift towards securities' markets, and the interplay between foreign ownership and the structure of balance sheets is one aspect, but so too is the growth of consumer credit. While, in most cases, the fundamentals (such as capital adequacy) of the banking sector in the RAMs look pretty sound, the possibility of an asset bubble and lack of experience in regulating securities markets could be a challenge if change occurs rapidly. A first question in this regard is whether institutional capacity is able to keep pace, while a second is whether financial liberalisation needs to be tempered. Policy implications include improving the underpinnings of the financial system such as the efficiency of the payment systems or the application of accounting standards, and ensuring that the regulatory machinery takes sufficient account of the need for stability. It is also clear that the relationship between the central bank and the supervisory authority is key.

It is far from obvious that retaining control of monetary policy aids stabilisation, especially if time inconsistency considerations apply. Instead, the very fact of an external constraint can facilitate the pursuit of policies that have the better long-term pay-off. In the short-term, though, pressures on governments to favour real over nominal convergence and thus to avoid policies that have an immediate cost will be strong. A first political economy challenge, therefore, is to flatten and shorten the dip in the j-curve by a careful mix of policies. Second, the RAMs need to learn from the founding members of the euro area that stage 3 adjustment matters and to prepare accordingly. Third, living with EMU means that endogenous change

has to take place, and that it is not enough to meet the nominal criteria. Especially where the risks of financial stability are most pronounced, some caution may be warranted about rapid euro area accession, though for many the reverse may be true, namely that euro membership will provide an effective safeguard against financial crises.

Overall, a reasonably sanguine view can be taken of the prospects for the RAMs to move successfully to full participation in EMU without compromising real convergence or risking financial instability.

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