Exchange-rate policy in eastern Europe and EU integration *

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In the not-too-distant future the European Union[1] (EU) will include some economies in transition[2] (EiTs). Once accession occurs, these countries will be confronted with new opportunities and constraints. Two in particular stand out: 1) macroeconomic policies become subject to surveillance and guidance by especially the European Commission and the Council of Ministers of economics and finance (ECOFIN); and 2) EiTs need to continue with vigorous economic restructuring to foster catch-up for their own sake, but also to ensure successful accession in the spirit of EU 'cohesion'.

From the moment accession was mooted, most observers assumed that a new member upon entry would have to join the Exchange-Rate Mechanism associated with preparing for monetary union (ERM II). As per recent decisions of ECOFIN (EC 2000 and 2001), however, this is no longer so. But the EiTs most advanced with their accession negotiations desire to move into the euro zone at the earliest opportunity, suggesting that they hope to join ERM II upon entry. This may well not be the wisest policy choice when seen against the broader backdrop of what should prospectively motivate macroeconomic policy in some EiTs.

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[1] For the sake of simplicity, this denotes postwar economic cooperation in western Europe.

[2] I deal here only with the ten EU candidates (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

This paper deals with potential conflicts between rapid EU integration and pursuing catch-up by focusing on exchange-rate (ER) policies. It is primarily conceptual rather than empirical, if only because a lot of the latter literature on EiTs in particular inadequately reflects the ER issues touched upon here.[3] By combining real and nominal convergence issues with institutional change following upon EU accession, I draw a novel perspective on the desirable post-accession transition regime for EiTs. The remit of the debate has so far centered too narrowly on derogations from the *acquis communautaire et politique* (henceforth *acquis*) at the expense of pondering the prerequisites of catch-up modernization in EiTs. Perhaps this has been motivated by the presumption that the EU's cohesion policies are adequate to handle the tasks associated with new accessions.[4] Since this Panglossian view is unlikely to reflect reality, I inquire into how best to improve compatibility between catch-up modernization and early EU membership for EiTs, focusing on ER policies.

The paper is structured as follows. After justifying the proposed inquiry, I summarize recent statements on ER policies that candidates are expected to pursue in the run-up to their membership and upon accession. Thereafter I briefly recount recent debates on ER regimes. Next I examine the requirements for functioning appropriately within the EU context, which suggests that the EiTs must modernize and reconcile this obligation with EU membership, in spite of the EU's cohesion experience. From this follows the desirability of innovating a novel EU post-accession cohesion strategy with a fairly active ER policy. Conclusions with core components of such a strategy follow.

1. A rationale for inquiring into goal compatibility

There can be little controversy about the fact that successful EU entry is predicated on the new entrant being able to play a constructive

[3] It is very difficult to properly specify appropriate empirical exercises for EiTs for a number of reasons, only some of which I can touch upon here. For useful overviews of what is required, see Begum (2000), de Broeck and Sløk (2001), Canzoneri *et al.* (1998), MacDonald (1998).

[4] As Ems (1999, p. 91) from the Commission put it, "economic obligations for EU membership are sufficiently flexible to allow for a sustainable catching-up". Solbes (2001, p. 71), EMU Commissioner, affirms this.

role in the single European market (SEM). That depends on its ability to compete along established rules for a market share of advanced specialization in fairly sophisticated manufactures and their associated services. This in turn is a function of the entrant's industrial and technological sophistication. If an economy does not yet possess that level of maturity, it will have to acquire it rapidly. By any reasonable gauge, none of the EiTs will have progressed sufficiently to average EU standards by the time accession will be consummated – perhaps 2004 for the best placed (see Section 5). As such, as the EU reports on candidates note (see Section 3), the EiTs need vigorously to pursue catch-up. This can be reconciled with early integration only if some mechanism can be innovated to foster such compatibility. Inasmuch as major derogations from the *acquis* are precluded, temporary exemptions must, as it were, become part of the *acquis*, that is, of the cohesion agenda and its institutional, budgetary and policy supports.

Catch-up in acceding EiTs is needed for several reasons. One derives from the promises of the transition, certainly in central Europe, to emulate levels of productivity and income, and in time wealth, of western Europe. Another is that the EU must ensure through its cohesion and regional policies that divergences within the union, just like in individual member countries, do not exceed the tolerable. But it has had mixed results with such policies for the late-entering EU members (notably Greece, Portugal and Spain) as well as with the earlier regional policies (including notably for Ireland and southern Italy). Finally, none of the EiTs has thus far reached a self-sustainable growth path (see Section 5).

The EiTs upon entry will have to participate in Economic and Monetary Union (EMU) *with a derogation*. This means that the entrants must observe the rules of economic union and of the monetary union applicable to EU members outside the euro zone. These encompass, among others,[5] the broad economic-policy guidelines, the convergence programs and the excessive deficit procedures reinforced with the rules of the Stability and Growth Pact. These confine the national room for policy maneuver.

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[5] Ilzkovitz (1996, pp. 242ff.) and Temprano-Arroyo and Feldman (1998, pp. 28ff.) give useful overviews of EMU requirements for entrants with a derogation.

Having one's policy constrained in this manner may pose a dilemma: joining ERM II or preparing for monetary union requires that ERs should not move much. If nominal ERs (NERs), defined as units of local per reference currency, cannot be adjusted, real ERs (RERs) should on the whole stay put too. This can hold only under two broad conditions. One is when there is sufficient flexibility in product and factor markets so that, upon a shock, internal and external equilibrium can be quickly restored. Since with close monetary union interest rates are linked, the flexibility refers in particular to prices of traded (PT) and nontraded goods[6] (PN) as well as wages. In spite of considerable internal and external liberalization, none of the EiTs possesses adequate flexibility in product and factor markets to cope easily with ER pressures, which will show up at least in RER movements. Only reducing domestic absorption below potential to redress external balance and/or to compress inflation, until domestic product and factor prices yield a new equilibrium, would offset this. That in itself would, however, delay catch-up modernization, entailing possibly high output and employment losses.

In economies that are reasonably stable and possess compatible economic structures, the optimal currency area paradigm posits that there are unlikely to be asymmetric shocks. If these countries were to lock their ERs or adopt a single currency, symmetric shocks can be taken care of without altering ERs. This paradigm is hardly applicable to EiTs, however. Stability in the policy environment of these countries has perhaps recently been emerging. But there is no guarantee that this will continue. Second, although many product prices have been freed, not all are subject to demand and supply. In some EiTs, furthermore, wages are sticky downward. Third, the EiTs have been undergoing, and will need to continue to foster, incisive structural change. This necessarily impacts differently on various product categories, hence some ER.

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[6] The literature mostly ignores that some nontradables enter into tradables. This has a bearing on the RER and its link to PN/PT (see Kakkar and Ogaki 1999, UNECE 2001). It should be especially important for the distribution sector (MacDonald and Ricci 2001), but I ignore this complication here.

2. RERs in transition

The kinds of transformation the EiTs have been passing through since 1989 have affected the relationship between their NER and RER, not to mention the purported equilibrium ER (Halpern and Wyplosz 1997). Following the initial NER devaluation, the RER began to appreciate because of 'corrective inflation' as well as longer-term trend appreciation (Begg, Halpern and Wyplosz 1999; Liargovas 1999), but by far not consistently (as standardized effective RERs in Table 1 suggest). This stems from circumstances partly rooted in the legacies of administrative planning, but also from the course of structural transformation. Both necessarily vary among countries and over time. Whereas it is hazardous to generalize, when considering ER pressures it is useful to distinguish several changes with widely differing impacts on relative prices, hence on RERs, and the country's competitive position (Banerji and Gelos 2000). These are not solely the conventional supply-side factors underlying the Balassa-Samuelson (BS) effect. There are also demand developments as equilibrium is restored and consumer choice with growing incomes takes hold (UNECE 2001, p. 232).[7]

Since so much of the debate on RERs in EiTs revolves around the BS effect, it is appropriate to recall its definition as well as the rather restrictive bases upon which it is predicated. Balassa (1964) and Samuelson (1964) independently modeled the implications of differential productivity gains and their effects on RERs. Simply put, the BS hypothesis posits that productivity gains in the tradable sector (T) allow real wages to increase commensurably. Since wages are assumed to be equalized throughout the economy, including the nontradable sector (N), where productivity gains are smaller, N wages and prices will also increase. This in turn will lead to a rise in the general price level, resulting in RER appreciation.

Note that the BS effect is defined within the standard two-country, two-product and two-factor framework. It assumes, among other things (de Broeck and Sløk 2001, p. 8), full competition with instantaneous adjustment, mobile capital, PTs are at purchasing power

[7] For empirical sources of RER movements in Hungary and Poland, see Dibooglu and Kutan (2001).

TABLE 1

REAL EFFECTIVE EXCHANGE RATES, PERIOD AVERAGES (1995 = 100)

	1990	1991	1992	1993	1994	1996	1997	1998	1999	2000
Bulgaria	n.a.	n.a.	63.6	97.8	89.0	85.8	102.6	116.4	118.8	120.7
Czech Rep.	81.9	75.7	79.2	92.1	96.7	106.7	107.5	116.3	114.8	114.5
Estonia	n.a.	n.a.	n.a.	76.4	84.7	109.7	113.3	125.1	134.2	129.1
Hungary	80.6	89.0	96.8	105.3	104.2	102.8	108.1	107.3	109.0	109.6
Latvia	n.a.	n.a.	n.a.	87.6	106.5	107.3	113.9	142.8	149.5	156.9
Lithuania	n.a.	n.a.	n.a.	n.a.	94.3	106.3	120.8	139.6	160.2	169.8
Poland	51.3	80.3	85.4	91.6	92.4	108.8	111.4	117.0	112.3	121.6
Romania	119.2	111.0	68.6	95.1	102.2	90.4	105.3	137.0	116.6	127.7
Slovakia	92.4	89.8	91.3	96.3	97.2	99.7	104.6	102.3	100.0	109.1
Slovenia	n.a.	n.a.	n.a.	91.5	94.2	102.9	102.2	98.2	99.0	101.1

Sources: The IMF's IFS CD-rom database, except for the following. Data for the Baltic countries and Slovakia are from national banks, usually CPI based with trade weights of major western partners, but Latvia's are only end of period, rebased to December 1995 from the official index, for ten major currencies, first calculated for December 1993. Slovenian data are from various issues of *Slovenian Economic Mirror*.

parity, N and T are independent, equilibrium is maintained throughout the economy notably in wage setting, and the law of one price holds so that inferences for NERs can be drawn from RER movements. In other words, it is an equilibrium supply phenomenon and can be counteracted through policy actions only by distortionary price controls. These and other assumptions are unlikely to hold for EiTs over a protracted period of time during which various demand *and* supply shifts due to transformation occur. It is therefore important to be aware of various past and likely future product and factor price movements for as long as the transformation lasts. I do so here with the specific purpose of drawing policy suggestions for ER regimes in moving into ERM II and eventually the euro regime.

First, all EiTs started in disequilibrium as domestic and trade prices were not directly linked and external transactions were administratively restrained. Also, domestic prices were distorted. Necessary consumer goods, such as foodstuffs and utilities, tended to be priced low. By contrast, durable consumer goods tended to be priced high. Services in general were undersupplied, but those on offer tended to be priced low. Furthermore, wages in manufacturing (M), especially

in heavy industry, were high, whereas those in service sectors (S) were low. Demand and supply did, of course, affect prices in the nonstate sector, including the unofficial one. External liberalization led, then, to a major price realignment, with PT tending toward world prices (P*) times the NER. Domestic price liberalization itself gives rise to various relative price movements. Since some prices, such as wages, cannot be lowered, inflation is inevitable, leading to RER appreciation as measured by consumer or producer price indices, but not necessarily unit labor costs (ULCs).[8]

Second, external liberalization with a realistic, if undervalued, NER linked external and domestic PTs, allowing for tariffs and transportation and handling costs. Because under administrative planning there was an excess supply of some manufactures (largely heavy industry) as compared to an undersupply of more consumer-related manufactures (largely light industry), marked shifts in relative prices among product categories are inevitable, due to external competition and, once the private sector gets under way, to domestic competition as well. The effect on the RER can go either way, but appreciation is the more likely outcome.

Third, because of the pent-up S demand, upon internal liberalization, S prices, which are largely PN, may be expected to rise more rapidly than PT, resulting in RER appreciation.[9] This applies to both S on offer as well as those denied, and indeed those newly required with the emerging market economy, even if in depression but more so once household incomes rebound, and no longer needed as the administered economy fades. For one thing there is the endemic S shortage. But also the room for major and more rapid improvements in the quality of available S than M will accelerate PN faster than PT, exerting upward pressure on the RER. Similarly, prices of necessities will tend to rise due to shortages and the cessation of administrative allocation. For some S such as housing, electricity, gas and private transportation, prices will continue to be administered for some time,

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[8] Note that RERs are defined variously and, depending on the deflator and weights utilized, they may strikingly vary (Zanello and Desruelle 1997). For an application to Latvia, see Havrylyshyn *et al.* (1999). All this calls for caution in setting up empirical analyses of RERs and the policy inferences drawn from them.

[9] The standard assumption is that manufacturing and perhaps agriculture are T, whereas the rest of GDP consists of N. With many S activities having become tradable as transportation, information and communication costs have dwindled, that assumption is no longer robust, if it ever was.

if only because of the social impact of large upward price revisions. They will hence tend to rise more slowly than justified by market relations.

These price shifts will make it difficult to preserve relative wages inherited from administrative planning, especially in the newly invigorated sectors. Rising wages there will attract resources out of the more traditional sectors into new, competitive M and especially S activities. Product and factor prices in traditional activities temporarily decline in terms of PN until modernization through restructuring or new production facilities begins to transform T. Unless resources can be shed quickly from traditional activities, S wages will rise more rapidly, owing to excess demand. The resulting appreciation of the RER will exert pressure to improve productivity in traditional activities or close them down.[10]

Fourth, following domestic liberalization N productivity may initially rise sharply as prices adjust upward; in some countries foreign direct investment (FDI) first enters S activities (Jakab and Kovács 2000; UNECE 2001, p. 236), and productivity catch-up toward international levels is initially probably easier and larger in S than elsewhere, making room for paying higher wages in N than in T.[11] This too is a sort of reverse BS effect. The RER tends to appreciate on a CPI basis, but not necessarily on a ULC basis because not all productivity gains will initially be reflected in wages, given substantial unemployment in EiTs.

Fifth, not only were pre-transition prices set erratically, firms had little incentive to move from output to profit maximization through organizational modifications, changes in production methods and adaptation of output structures. With new incentives, firms can reap sizable one-off technical efficiency gains. Also allocative and adaptive efficiency gains are in the offing, though over a more protracted period. This release of resources from M should flow into S. It

[10] Grafe and Wyplosz (1997) present a three-sector model: 1) an old, inefficient, but subsidized T; 2) a new T that expands through self-financing, thus slowly; and 3) N that grows vigorously once the transition gets under way. They not only get the reverse BS effect. Also wage increases in N jeopardize the survivability of the old T, thus forcing factor relocation, hence an upward movement in PN/PT until modernization will take root.

[11] Note that for upward pressure on RERs may exist without T and N wages being fully equal (Strauss 1997).

should moderate the wage drift in the newly invigorated S, but only after some friction.

Sixth, once the imbalances between traditional production and services have been eliminated, productivity gains in the former are likely to exceed those in the latter. With external liberalization, competition will bring PT in line with P*. As a result, they compress the upward drift in prices that, at a given NER, can be accommodated. By fostering competition in T, the EiTs experience productivity gains in tradables that surpass those feasible in N, once the above gains have been booked. This sets the stage for the gradual working of the conventional BS effect as resources are attracted out of N into T to accommodate higher wages. With the restoration of equilibrium in the economy, the latter effect should increasingly come to prevail.

Seventh, whereas most PT get freed up early on, core PN even in the most liberal EiT remain under control for a protracted period of time. When these prices are gradually aligned with production costs, the RER appreciates. In spite of liberalization, product and factor prices in EiTs are not sufficiently flexible to accommodate such adjustments without ER changes. With downward rigidity in prices and productivity growth in T exceeding N's, once the initial one-off gains booked, inflation in EiTs during most of catch-up modernization should continue to exceed the EU's. Stabilization with a fixed NER and limited permissible inflation would require excessive downward adjustment in economic activity, yielding larger than desirable unemployment while slowing down catch-up.

Eighth, the inherited fiscal structure cannot be maintained. Yet demand for government funding, such as for the social safety net, remains high. As especially the structure of fiscal revenues undergoes change, relative prices in the economy will be perturbed. The exact effect on the RER is ambiguous. Nonmonetary financing of public deficits is likely to lead to real appreciation via higher real interest rates, however.

Ninth, the EiTs are likely to see their terms of trade improve as the quality of their output of goods and services, hence the productivity of that sector, rises. If quality on balance surges faster for S than for T, there will be RER depreciation. Otherwise, the effect will be RER appreciation.

Finally, raising adequate volumes of capital in EiTs is problematic because of low incomes, destroyed financial wealth and poor do-

mestic financial intermediation. Once these economies regain a measure of stability during the transformation, it may well prove difficult to channel FDI right away into productive activities, leading to inflationary pressures, hence RER appreciation.[12]

3. ER policy and EU membership

Whereas some of the above-cited differential NER and RER movements are likely to be reduced as the transformational turbulence passes, they will not disappear for as long as major structural transformations need to be completed. If the EiT were to be forced or overly eager to join ERM II, the conflict between nominal and real convergence might be exacerbated.

Will the EiTs upon accession be formally compelled to pursue the standard nominal convergence process? The EiTs most advanced with their structural transformation have left no doubt about their desire to participate in ERM II soonest upon accession, so that in due course – after the mandatory minimum two years' wait – they will be able to join the euro zone. This may be good public relations. Setting such a step prematurely is not good economics, however, given the priority of modernization through incisive structural change and the ensuing further substantial adjustments in relative product and factor prices, including the ER.

For some time after entertaining accession of EiTs, the European Commission waffled on this issue, no doubt because the member states had been less than forthcoming.[13] Until recently, EU policy pronouncements seemed to suggest, though never unambiguously,

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[12] For the empirical impact of FDI on RER movements in the case of Mexico, see Dabós and Juan-Ramón (2000).

[13] Ilzkovitz (1996), who at the time headed the relevant unit in Brussels, gives an ambiguous position (compare pp. 248 and 255). Her then colleague (Maurer 1999, p. 102), however, leaves no doubt. Some IMF staff (Corker *et al.* 2000) are somewhat more circumspect, but endorse "soon after membership". Temprano-Arroyo and Feldman (1998, pp. 29ff.) leave no doubt about the obligation upon accession, invoking the European Council decision discussed in the next paragraph. Kopits (1999) too holds this view.

that upon accession the newcomer would have to join ERM II. The Amsterdam Council in June 1997 decided that:

> "Participation in the [ERM] will be voluntary for [members] outside the euro area. Nevertheless, [members] with a derogation can be expected to join the mechanism. A [member] which does not participate from the outset in the [ERM] may participate at a later date" (EC 1997, p. 7).

One can read this in two ways: new members are expected to join, while those with an earlier opt-out status, it is hoped, will do so in the future; or new members, as the earlier opt-outs, can choose not to join immediately, but will enter "soon after accession".

In its most recent views on these matters, the European Commission, relying on ECOFIN decisions of November 2000, took a more nuanced position. Its formulation is delicate, however: "After accession, although not necessarily immediately, accession countries are expected to join the ERM II" (EC 2001, p. 2). In its 2000 reports on the accession status, presumably invoking the ECOFIN decision about to be issued, the Commission emphasized that the priority for the candidates should not be euro-zone participation, as distinct from submitting to the rules of EMU with a derogation. Rather,

> "the candidates should concentrate primarily on furthering the process of structural, and economic reform while developing the administrative capacity. Participation in the euro zone can only be the final step in what has been, and will remain, a lengthy and successful process of economic integration with the EU" (EC 2000, p. 27).

Unacceptable ER regimes upon EiT entry are "free floating (or managed floats without a mutually agreed central ER), crawling pegs, and pegs against anchors other than the euro" (EC 2001, p. 2). Also, competitive devaluations will not be acceptable since, as per article 124 of the Treaty on European Union (TEU), a new member is required to treat its ER as a matter of common concern. This is particularly important for safeguarding the SEM's smooth functioning. While ER flexibility may be desirable to dampen inflation in members that are likely to experience productivity gains over and above those typical of the EU, this is not likely to suffice in pursuing a policy conducive to real convergence as defined.

These official statements suggest that, upon entry, the EiTs will not necessarily have to join ERM II right away. Rather, accession will be followed by an

> "intermediate phase between accession and the adoption of the euro, where full participation in the [SEM] is taking place together with progressive monetary integration toward the euro zone and through participation, at some point, in [ERM II]" (EC 2000, p. 28).

Greater emphasis is now being placed on ensuring consistency in macroeconomic policies and instruments, on the one hand, and forging ahead with real convergence or catch-up modernization, on the other hand (EC 2001, p. 2). The Commission even intimates that this is a prerequisite for achieving "sustainable nominal convergence" (EC 2001, p. 1), which is code for meeting the Maastricht criteria and joining monetary union.

If this is a correct reading of the latest EU stance, the authorities have apparently finally become aware of a potentially serious conflict between holding the acceding EiT to the standard EMU rules with a derogation and fostering catch-up, which itself should in time facilitate adherence to EMU rules. They implicitly now face a moderate derogation whose scope will have to be compressed over time in a manageable format. In other words, there should be room for conceptualizing a catch-up strategy as an integral part of the transition regime upon accession for the EiTs – a special cohesion policy, whose basic contours I sketch in Section 7.

4. ER regimes and modernization policies

Since the transition's inception, the EiTs have experimented with several ER regimes, none proving consistently superior to the other (Corker *et al.* 2000). Indeed, at present one finds the entire range of ER regimes, save replacement of a national currency with some international one – dollarization or euroization for short – though Estonia in 2000 toyed for a while with euroization.[14] This is testi-

[14] Bosnia and Herzegovina and Montenegro, and to some degree Kosovo too, have simply adopted the Deutsche Mark, implicitly the euro. But they are not (yet?) EU candidates.

mony to two facts that need to be borne in mind. First, the ER is necessarily a policy instrument. In and of itself, ER stability is useful only if it furthers reaching a more encompassing policy objective at lesser cost than by varying the NER. Second, experience demonstrates that other policies matter more than the NER (Backé 1999, Darvas and Szapáry 2000, Masson 1999, Szapáry 2000 and 2001, Williamson 2000). One should add here that the 'institutions' of the market, especially the robustness of financial systems with adequate supervision and prudential regulations, as the EU rarely fails to stress, are critical for good macroeconomic policy in a fairly open economy.

Second, as a result of the turmoil in foreign-exchange markets since the mid-1990s, a consensus seems to have arisen around the notion that, in an increasingly integrated world economy, countries can select only extreme regimes (Fischer 2001): a credible fixed rate, such as through a currency board or dollarization/euroization, would be more appropriate for countries likely to experience monetary shocks; or a fully flexible ER for an economy more likely to be exposed to real shocks (Rogers 1999, p. 269). It is argued that intermediate ER regimes are intrinsically unstable: no matter the fundamentals, disruptive speculative attacks on a country's currency once the credibility of the peg is undermined will inevitably trigger ER crises.

There is sufficient logical and factual evidence that, as a general proposition, this position leaves a lot to be desired (Williamson 2000 and 2001). Credible corner regimes have some advantages. But the latter's advocates have blown these purported benefits out of proportion. At the very least, the risks, drawbacks and dangers of such an instrumentation are frequently underrated. The probability of banking and debt crises, as well as of serious ER misalignments with dysfunctional fluctuations over time does not drop to zero. Not only that, constructive macroeconomic policies that lend credibility to an intermediate solution are underplayed, as if there were no room for measured policy in any but industrial countries (Dornbusch 1996).

The choice of ER regime should be based on multiple considerations, including the source and nature of economic shocks; the institutional features of the economy; the prevailing economic structure; and longer-term policy ambitions, including functioning well within the SEM. Rather than the ER regime *per se*, it is the consistency of the country's entire policy package – fiscal policy, institutional capabilities and structural reforms – that matters most for macroeconomic

performance. Basic conditions for ER stability are wage flexibility, fiscal and monetary discipline, and sound financial sectors. But I look here only at one such danger: premature NER fixing, say, through euroization (Wójcik 2000), may delay the so needed modernization once EiTs enter the EU or decide for themselves, possibly for public-relations reasons, to shadow ERM II in the interim. Inflation and interest rates in the EiTs *may* on the whole be too high relative to EU magnitudes, including on account of productivity growth differentials, to comply with the EU's guidelines, even with full exploitation of the bands around parity in ERM II. Recent inflation experiences, both levels and changes over time as indicated in Table 2, are perhaps indicative.

TABLE 2

CONSUMER PRICE INFLATION (ANNUAL PERCENTAGE CHANGE) *

	1993	1994	1995	1996	1997	1998	1999	2000
EU	3.5	2.9	2.8	2.3	2.0	1.5	1.2	2.3
Bulgaria	72.9	96.2	62.1	123.1	1082.6	22.2	0.4	10.4
Czech Rep.	20.8	10.0	9.1	8.9	8.4	10.6	2.1	3.9
Estonia	89.6	47.9	28.9	23.1	11.1	10.6	3.5	4.0
Hungary	22.6	19.1	28.5	23.6	18.4	14.2	10.1	9.8
Latvia	109.1	35.7	25.0	17.7	8.5	4.7	2.4	2.6
Lithuania	410.1	72.0	39.5	24.7	8.8	5.1	0.8	1.4
Poland	36.9	33.2	28.1	19.8	15.1	11.7	7.4	10.1
Romania	256.2	137.1	32.2	38.8	154.9	59.3	45.9	45.6
Slovakia	23.1	13.4	10.0	6.1	6.1	6.7	10.5	12.0
Slovenia	31.7	21.0	13.5	9.9	8.4	8.1	6.3	8.9

* Retail prices for Slovenia. Data for 2000 are preliminary.
Source: WESS (2001, statistical annex, Table A.9).

Upward pressure on the ER due to real convergence complicates the relationship between EiTs and EU (see Section 5). There is likely to be significant appreciation due to the productivity bias for which the scope for revaluation within the ERM II may be too narrow. Also, the EiTs have open capital markets. They therefore experience

induced capital inflows for which controls are not particularly welcome. FDI and nondebt-creating capital flows are appropriate for supporting market-oriented transformation. Decontrol of debt-creating capital movements, especially short-term inflows, should not proceed faster than domestic financial liberalization with adequate prudential regulations and banking supervision (Kopits 1999). Yet, EU membership requires open capital markets as per articles 56-60 of the TEU. There is apparently no derogation from that prescription in the offing (Randzio-Plath 2001).

If inflation in EiTs were to be attuned to EU levels at a time of substantial but volatile capital inflows, real values of the domestic currency would appreciate, real interest rates might fall, and upward pressure on current-account deficits could be substantial. The choice of the ER regime, which cannot prevent real appreciation and large current-account deficits, must be guided by making inflows orderly, predictable, and as consistent with underlying investment opportunities as possible (Corker *et al.* 2000, pp. 15-16). Slowing down structural reform for the sake of ER and price stability, however desirable those features may be in the medium run, is counterproductive: it simply staves off relative price adjustments and exacerbates demand pressures, eventually leading to an unsustainable external imbalance (Kopits 1999, p. 36). The strategy should therefore allow for either periodic revaluation or higher inflation or interest rates.

Sizable changes in relative and absolute domestic product and factor prices will need to be accommodated through higher inflation than 'normal' in the EU.[15] Note that such price adjustments would necessarily vary among sectors, not just T and N, depending on where and at what speed the EiTs will be relocating their competitive strengths. Sizable FDI inflows will necessarily differentiate productivity gains among various T and N. Absent NER adjustment, the implied real appreciation will jeopardize the competitive position of a country on a catch-up modernization path. Curbing domestic absorption may help to restore external balance, necessarily at the cost of below-potential economic activity, which is not desirable for catch-up. It may be easier to exploit the NER to offset RER appreciation that undermines competitiveness than managing drift in domestic product

[15] The Maastricht criterion specifies at most 1.5 percentage point over the three best inflation performers.

and factor prices. After all, the adjustment of PN/PT is a normal feature of modernization that moves the NER/RER ratio toward unity. This seems to be the dominant force driving RER appreciation in EiTs that have embarked on reforms, including the EU candidates (de Broeck and Sløk 2001). To the extent that such adjustment can be traced to BS productivity growth differentials with wage pressure, the appreciation in the (internal) RER can be regarded as an equilibrium phenomenon. It does not imply a loss in competitiveness (Banerji and Gelos 2000);[16] there is hence no need to devalue the NER.

5. Requirements for successful entry by EiTs

Successful entry of EiTs into the EU should be adjudicated for newcomers, the present EU members and nonmembers with a special status in the EU.[17] For newcomers, enlargement should enhance, and be an integral component of, delivering upon the 1989 aspirations of countries: the further solidification of genuine, robust political pluralism and of a functioning market economy as rapidly as possible. Integral to such a successful 'return to Europe' should be effective competition in the SEM, while the incoming EiT progresses credibly with its longer-term modernization aims. For the present EU members to benefit from enlargement, individually and collectively, the SEM's remit should be effectively widened. One dimension is the geographical remit, of course. But the SEM should become more encompassing also in terms of enhancing competition and augmenting income and wealth. It should also minimize friction over budgetary redistribution, over the drawbacks – real and feared – of (temporary) derogations from the *acquis*, and over low-wage competition. Finally, enlargement should only minimally encroach on the benefits that many countries derive from preferential arrangements with the EU. These preferences are bound to be diluted (van Brabant 1999, pp. 193ff.). To the extent this shift does not accord with the EU's foreign-

[16] There is considerable muddle on this issue (see UNECE 2001). I shall return to this in Section 7.

[17] The effects on global welfare also matter. I eschew this issue since EiT accession has become a 'political obligation'.

policy interests, adverse consequences should be avoided or compensated. But even otherwise, the negative impacts on the neediest countries deserve to be minimized for equity reasons.

To maximize the cited benefits for newcomers as well as present EU members, the two groups should be 'similar' in a number of respects. That is to say, newcomers should be reasonably modern developed European market economies, allowing for fair competition in the SEM, and possess functioning pluralistic political systems, enabling them to participate fully in the EU's governance mechanisms. The latter requires not only robust parliamentary systems, but also a vibrant civil society, a modernized civil service, and a functioning judiciary. Otherwise newcomers will find it hard to observe EU rules and to advance their interests in the EU's governing bodies.

Will the EiTs soon be reasonably modernized? If not, what could go awry in an expanded EU? Recall that the Commission, since the 1999 reports (EC 1999), has adjudicated the EiTs to meet the political criteria for membership, a stance subsequently endorsed by the Council and Parliament. That should not, of course, be equated with the notion that these countries now fulfill all political parameters of modernization. Even in the carefully worded Commission reports, these countries are admonished to book further progress notably in the protection of human rights and minorities, the rule of law, transparency, adequate public administration, social provisioning and so on.

Two economic criteria in particular matter. First, a functioning market economy requires (see EC 2000, p. 23)

> "that prices, as well as trade, are liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy".

Second, newcomers need to be able to cope with competitive pressures and market forces within the EU. This

> "depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to make decisions in a climate of predictability. It also requires a sufficient amount of human and physical capital, including infrastructure. State-owned enterprises need to be restructured and all firms need to invest to improve their efficiency" (*ivi*).

Furthermore,

> "the more access enterprises have to outside finance and the more successful they are at restructuring and innovating, the greater will be their capacity to adapt. Overall, an economy will be better able to take on the obligations of membership the higher the degree of economic integration it achieves with the Union prior to accession. Both the volume and range of products traded with EU Member States provide evidence of this" (*ivi*).

As regards meeting the economic criteria for membership, the 2000 reports (EC 2000, pp. 23-24) classify the EiTs as follows (van Brabant 2001b): Estonia, Hungary and Poland meet the first criterion and are expected soon to meet the second; the Czech Republic and Slovenia are regarded as functioning market economies and should be able to meet the second criterion in the near term, upon completion of remaining reforms; Latvia, Lithuania and Slovakia are similarly regarded as functioning market economies and should be able to meet the second criterion in the medium term, provided they implement current structural-reform programs and undertake further modifications as necessary; Bulgaria meets neither criterion but is deemed to have made further progress since 1998; Romania has made too little progress toward meeting the criteria.

In short, as of late 2000 none of the EiT candidates met the minimal requirements for a modernized society capable of constructive participation in the EU, as per the latter's assessments. If entry were to occur by mid-2004, the EiTs will undoubtedly have booked further progress. But it would defy credibility to assume that they will have become sufficiently modern to function constructively in the EU with only minimal cohesion support.

It is therefore useful to take another look at what is required. Before doing so it is instructive to reflect briefly upon the contribution of the EU to modernizing newcomers, specifically in view of the macroeconomic-policy constraints that arise with accession. In every previous enlargement, the EU put in place derogations from its established policies by either innovating a special mechanism to tackle the specific problems of entrants or modifying existing policies. The objective has invariably been easing time and space inconsistency between the advantages and drawbacks of EU integration for all concerned, thus accelerating effective merger of newcomers into the SEM. Such modifications were especially prominent with the second

(Greece) and the third (Portugal and Spain) expansions, as well as retrospectively for Ireland, given its less than stellar integration since the early 1970s until the early 1990s. These led to the adoption of the so-called cohesion agenda.[18] While these countries, upon entry, were not really all that much advanced as compared to the EiTs when they are expected to enter, this gauge is not particularly pertinent. Rather, the relevant criterion is twofold. On the one hand, the degree to which new entrants lag behind incumbents at the time of accession, taking full account of the progress achieved by the previous newcomers as well as the founders, matters. On the other hand, given the history of planning under monoparty control, various aspects of why EiTs upon early entry cannot yet function fully constructively within the EU need to be borne in mind.

For cohesion to prevail, differentials between income and productivity *per capita* in one country or region cannot exceed some margin, and these differentials need to be narrowed over the medium to long run. *Per capita* incomes in EiTs are substantially below the EU's average, even when measured in purchasing power parities (Table 3). Hungary, Slovakia and Slovenia, as per EU measurements, have undoubtedly booked some progress since the early 1990s. Bulgaria, the Czech Republic and Romania have hardly moved at all; some have retrenched markedly, so that the gap among the EiTs has actually widened over time: whereas the span in 1994 was 23.6% for Latvia and 60.1% for Slovenia, in 2000 that was 24% for Bulgaria and 72% for Slovenia. Only three countries (the Czech Republic, Hungary and Slovenia) in 2000 reached at best half the EU's average.

Of course, cohesion needs to be seen in a broader context than just *per capita* incomes. Indicators of the sectoral composition of output and productivity levels of these countries, for example, would further buttress the assessment painted above. Also their administrative and parliamentary infrastructures, not to invoke other institutions essential to smoothly functioning markets, such as the financial infrastructure, trail minimal EU standards. These features need to be reinforced in tandem. There can, then, be little doubt about the need for further catch-up, both on a country and even more on a regional ba-

[18] The Common Agricultural Policy itself could be viewed as a cohesion policy, except that it forms part and parcel of the bargain at the origin of the European Economic Community.

sis, for the sake of these countries; it is also imperative for the SEM's proper functioning.

TABLE 3

PER CAPITA INCOMES RELATIVE TO EU AVERAGE (IN PERCENTAGES) *

	1993	1994	1995	1996	1997	1998	1999	2000
Bulgaria	26.0	26.4	27.7	24.9	22.6	22.4	22.5	24
Czech Rep.	n.a.	57.8	62.4	65.1	63.7	60.3	59.1	58
Estonia	30.2	29.2	31.8	33.2	36.6	37.2	36.4	37
Hungary	42.0	43.8	46.1	46.6	48.3	49.0	50.7	52
Latvia	23.7	23.6	24.3	25.2	27.3	27.7	27.4	29
Lithuania	n.a.	25.8	27.6	28.7	30.5	31.0	29.2	29
Poland	31.3	31.4	32.1	33.7	35.6	36.1	36.9	39
Romania	28.4	29.2	32.0	33.1	30.8	28.2	26.9	27
Slovakia	37.8	37.6	43.9	46.2	48.4	48.7	48.6	48
Slovenia	58.5	60.1	64.3	66.1	68.4	68.9	70.8	72

* EU average from 1995 on is based on total EU. Before, the data for Denmark, Greece, Luxemburg, the Netherlands and Portugal are missing.

Sources: 1993 from the European Commission's EiT reports for 1998; 1994, *ibid.* for 1999; 1995-1999, *ibid.* for 2000. Data for 2000 are from Eurostat as quoted in *Russian & Baltic Economies' – The Week in Review*, no. 29, 20 July 2001, p. 2. The various sources do not always yield comparable data, however.

Given the lost last decade under administrative planning and the destruction and disarray wrought by the transition, the tasks incumbent on ensuring effective cohesion policies for EiTs is unlike what confronted the EU in the earlier four enlargements. The EU needs to shape a different cohesion approach to secure orderly modernization in EiTs. Its central focus should be on ensuring that the post-entry transition phase not impede strong and sustainable growth over a prolonged period of time. It should also facilitate high and varying productivity growth among sectors and regions, implying in turn RER movements in the medium to long term (see Section 3). Furthermore, it needs to foster high investment in infrastructure. In addition, it should encourage a steady supply of foreign capital, preferably of the nondebt variety, and mobilize domestic capital without the EiT becoming overly exposed to external investors and falling victim to en-

dogenous crises and contagion. Finally, that phase ought to impart high credibility for the process both abroad and at home (Ems 1999), including by strengthening the institutions of the market economy and political democracy within an orderly state.

6. Transformation as catch-up modernization

I cannot elaborate at length here on the kind of catch-up modernization required in EiTs, both to satisfy the expectations of the electorates in these countries and to facilitate successful entry into the EU (Andorka 1996; van Brabant 1998, pp. 474ff., and 2001a). It should be clear, however, that such cannot be confined to raising productivity, technological sophistication, industrialization, openness to trade and finance, and gains in *per capita* incomes. True, these are important for enhancing policy credibility, sustaining sociopolitical support, and minimizing potential conflicts with EU members. Yet, modernization encompasses other elements. In the case of most EiTs, as stressed in just about any official EU statement on enlargement, the notion embeds also democratization of society, cultural diversity, tolerance, a vibrant middle class around a full array of small and medium-size enterprises, a competent and honest civil service, and so on.

As shown in Table 3, the hoped-for rapid growth in productivity and *per capita* incomes in EiTs at the transformation's inception has not so far materialized. Yet the potential for rapid gains at the transition's inception was considerable. For one thing, as a legacy of state planning these economies found themselves in multiple disequilibria. With internal and external liberalization, resource reallocation in response to emerging incentives should have led to sizable efficiency gains from reorganization and resource redeployment. Emulating more productive and well-understood production and organizational technologies would in time also yield adaptive efficiency.

It is perhaps paradoxical that, with few exceptions, there has been little catch-up to best-practice in EiTs, all the more as considerable restructuring at the firm level, regardless of ownership form, and substantial reallocation of resources among firms and sectors have occurred (Carlin, Haskel and Seabright 2001, pp. 76ff.). Even in the bet-

ter-performing EiTs rapid catch-up to productivity levels of typical western European market economies[19] has not yet occurred. The precise reasons for this disappointing outcome are only slowly emerging in view of the paucity of comparable and comprehensive firm-level data. The temptation to attribute the less than stellar performance with productivity to 'disruption' caused by the transformation (Blanchard and Kremer 1997) and to the poor institutional infrastructure for building a vibrant market economy (Carlin *et al.* 2001, pp. 79ff.) is irresistible.

The reason why commentators, pundits, advisers and policy makers a decade ago wrongly trumpeted rapid catch-up with proper policies within the framework of the Washington Consensus is complex. At the very least they ignored a whole range of crucial prerequisites for economic agents to reap the benefits of competition while minimizing the associated disorganization. They include the governance of firms, financial institutions and nonstate agencies; missing or slowly emerging or poorly functioning product and factor markets; the essential role of the state in establishing, maintaining, correcting and augmenting the legal and regulatory structures of markets; the effort to compress taxation and poor collection systems, while demands for fiscal outlays soared; the inadequate legal environment, both laws and the judiciary, for the effective protection and enforcement of property rights, which themselves first need to be disentangled; considerable personal and other insecurity for all actors; the absence, slow emergence, and at times dysfunctional role of civil society, especially where it matters for the smooth coordination of economic decisions; poorly conceived social-protection policies; and so on (van Brabant 1998, pp. 249ff.).

Though many EiTs have made considerable progress since 1989 with correcting the cited shortcomings, they still fall short, albeit to varying degrees, of being efficient market economies. Also their wealth-generating capacity remains unstable. Even in resolving core societal conflicts, many EiTs in addition remain democratic more in

[19] From the convergence literature it is clear that full catch-up in 'convergence circles' cannot be secured on the basis of borrowing or emulating existing technology. The plausible upper bound is around 75 to 80% of best-practice. At that point, domestic innovation and adaptation will be required to forge further ahead. For simplicity's sake, I take that marker as best-practice levels that, in 1989-91, EiTs were expected to be able to achieve easily.

the procedural than the substantive sense. Furthermore, a vibrant and empowered middle class has only slowly been crystallizing. Moreover, looking at economic features, many EiTs have comparatively high and unstable inflation (Table 2), large current-account deficits, high unemployment, widening income and wealth inequalities, weak domestic savings, inadequate financial intermediation and legal protection, pervasive personal uncertainty, considerable poverty and crime; substantial debts, fiscal deficits and unstable currencies in some; reduced social security, deteriorating education and science, exodus of artists and scientists, and falling health standards. These are indicative of how far the EiTs lag 'modern EU society'. Dahrendorf (1990, pp. 99-100) early on, unlike many observers, estimated that it would take sixty years for the civic culture and society to evolve toward a stable democracy and a functioning market economy. I do not know whether this is a reasonable conjecture. There can be no doubt, however, that more time will be required to catch up to average EU levels.

7. Toward a strategy for catch-up modernization with accession

If the first accessions occur around 2004, the entering EiTs will probably not yet be sufficiently restructured to take full advantage of the SEM and participate fully in the EU's governance structures to the benefit of all. Because effective participation in the EU's common policies *may* benefit modernization, policy makers need to shape the accession transition to ensure this outcome. Cobbling together a mechanism, as part of the EU's arsenal of common policies, that enhances catch-up in the newcomers, in spite of narrowing the room for policy flexibility under EMU's rules, is appropriate and in the present EU's interest.

Any post-accession strategy to accelerate structural change in the EiTs requires careful scrutiny of where each candidate stands as regards the major dimensions of modernization, what can be expected from further economic liberalization, and where remedial measures could usefully be envisaged especially to bolster positive incentives to private investment into and in these countries. It should trace the

negative and positive aspects of EU entry along a realistic time trajectory and, where feasible, quantify them under alternative policy scenarios, possibly with an evolving institutional setting. In this paper, I can only amplify briefly on the ER regime and its modulation over time so that it enhances structural change, institutional adaptation and catch-up modernization.

Recalling the myriad origins of relative price shifts in an EiT (see Section 2) and the further structural change required (see Section 5), the variance in the distribution of inflation rates by product category in EiTs is likely to exceed that of an economy adjusting along an equilibrium path. In other words, rapid catch-up in EiTs *must* be accompanied by differentiated relative price adjustments, not just PN/PT, even if general upward price drift can be avoided through appropriate macro policy stances. Overall inflation results are likely to mask a systematic relationship between changes in the variance of inflation rates by product groups and shifts in some price index, especially if prices are downward sticky. Similarly, whether such inflation on balance warrants an adjustment in NERs depends on whether the inflation occurs largely in N rather than T. Given the amplitude and size of future relative price shifts in EiTs, owing to inherited imbalances, these adjustments are likely to be skewed; they are not random effects but sustained relative price changes with a pattern as the transformation encompasses the entire economy (Coorey, Mecagni and Offerdal 1998).

Given that productivity growth differentials can be expected to be in favor of newcomers, provided they continue to catch up, room has to be created for mitigating the upward pressure on inflation and RER appreciation by allowing controlled NER adjustments when warranted by loss in competitive positions. This is particularly important given the external dependence and the weakness of domestic demand as stimulus for sustainable growth in virtually all EiTs. Various modalities could be enacted. In the more advanced EiTs, the price drift is prospectively likely to stem chiefly from the conventional BS circumstances. That is to say, productivity gains for T, including on account of FDI, are likely to exceed those in N. Inasmuch as wage gains in T justified by productivity increments will exert upward pressure on wages in N, inflation in newcomers is likely to exceed the EU's (Szapáry 2000).

Nobody knows the precise size of the BS effect. Tentative computations suggest that for each percentage growth in GDP over and above the EU's average, the EiTs gain some 0.4 percentage point in productivity (de Broeck and Sløk 2001, pp. 10ff.; WEO 2000, p. 169). Presumably EU statisticians could construct plausible estimates to guide policy makers. These could then be factored into the policy stances of ECOFIN to allow higher inflation in newcomers than can be condoned as per the Maastricht criterion, whatever its economic rationale (Canzoneri *et al.* 1998). Whether these also warrant controlled NER devaluations at discrete intervals depends on the actual or expected erosion in competitive positions, which is an empirical matter.

The permissible range of NER fluctuations in ERM II is 15% either side of parity. Inasmuch as the above suggests that the underlying trend will be for RER appreciation, that leaves, in fact, only the above-parity range of 15%. Even if EiTs were to be able to remain within this range for two years and otherwise meet the criteria for euro entry, the constraints on permissible inflation as per EMU rules may well be onerous, unlike what EU insiders uphold (Randzio-Plath 2001, p. 76), to accommodate the price flexibility needed to absorb productivity growth differentials over the medium to longer run. This would *prima facie* suggest that the EiTs should not prematurely join ERM II and *a fortiori* the euro zone.

On the other hand, being in an ERM mechanism may be beneficial. It lends credibility to EiT policies, which is critical to mobilize capital, including from abroad. Participation could also make it easier for the EU to involve EiTs more fully into its macroeconomic policies with perhaps more frequent joint fine-tuning, until EiT restructuring efforts settle onto an equilibrium path. At that point, ERM II as a lead-in to the euro zone would be appropriate, especially on the expectation that it would be a two-year wait at best. Finally, there is symbolic value to ERM participation, given the stances of many EiT policy makers on joining soonest the euro regime.

A plausible case can, then, be made for designing a more flexible ERM, all the more since the only EU member that is presently following ERM II, within narrow margins, is Denmark; Sweden and the United Kingdom are not likely to join any time soon. Would it, under those conditions, not be advantageous to design an ERM III with

wider bands and looser intervention constraints,[20] but allowing members to set progressively narrower bands, including those of ERM II, and have close involvement of the EU's macroeconomic surveillance in EiT policies? Having stayed within the 15% bands for two years could remain one of the five Maastricht criteria (aside from low long-term interest rates; low inflation, which itself may well not be suitable; an upper limit to long-term debt relative to GDP; and a ceiling on fiscal deficits in terms of GDP) for adjudicating suitability for joining in time the euro regime. Those EiTs, such as Hungary and Slovenia, that in all likelihood can already operate within these bands should be allowed to adhere to the present ERM criteria as embedded in the proposed ERM III. Their higher inflation rate justified by productivity growth differentials should not inhibit euro-zone participation.

Conclusions

The number of candidates, the diversity of their development level, their combined population, the role of agriculture, their comparatively low levels of development, and so on make configuring constructive enlargement into a daunting policy task. Something ought to be innovated by flexibly confronting the unprecedented cohesion challenges to ensure reasonable success for the impending enlargements. There will undoubtedly be a transition period following entry of EiTs. That will accommodate, among others, temporary derogations from components of the *acquis* for which EiTs lag (such as labor norms, health prescriptions and environmental regulations). Restrictions in labor movements and access to real estate will also be included. I have argued in this paper that other measures deserve to be contemplated to reconcile the need for catch-up modernization with the desire to adhere as much as possible to the

[20] I also advocate that full capital-account liberalization may well not be conducive to rapid catch-up. At least the potential application of controls on hot money flows should be a useful EMU derogation. And these countries deserve as much leeway as some of the latecomers to the EU, Portugal and Spain in particular, enjoyed. For an advocacy in the right direction, but on the wrong terms, by a key member of the European Parliament, see Randzio-Plath (2001, pp. 74-75).

acquis. Among the latter, the policy constraints due to EMU with a derogation may inhibit smooth catch-up. The EU's cohesion agenda, including with respect to participation in ERM II, therefore needs to be refined.

EU decision makers have apparently only slowly come to realize the potential conflicts between comparative NER stability with low inflation and catch-up through productivity and growth differentials in favor of EiTs. As a result, entering EiTs are no longer required or urged to join ERM II immediately. Instead, the priority of real convergence in newcomers is now emphasized. Allowing newcomers not to join ERM II upon entry, while a useful modification, ignores the desire of entering EiTs to be closely associated with EU mechanisms, if only to gain anchored credibility for engaged policies.

As far as the ER is concerned, I have proposed a more intrusive and adaptive surveillance of a dynamic ERM with hardening intervention points, narrowing effective bands as modernization takes hold, for EiTs. This would accommodate modernization ambitions without disadvantaging present members. It would also obviate the need to invent additional convergence criteria, as advocated by Siebert (2001). Revamping the ERM into a well thought-out ERM III that permits greater NER flexibility and does not presume staying within the present margins around parity, but gradually narrows the room for policy maneuver under joint surveillance to ERM II conditionality, whence entry into the euro zone may be constructively contemplated, would be preferable to keeping the newcomers altogether outside the EU's mechanisms until they will have all but completed real convergence on their own strengths.

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