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Eijffinger, S.C.W.

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The new EU member states: trading off exchange rate stability and price stability

The purpose of this Briefing Paper (1) is to discuss the implications of the upcoming enlargement of Economic and Monetary Union (EMU) in Europe.(2) The current euro area countries will be joined soon by a number of new EMU entrants that have a substantially lower income per capita.

As of May 2004 the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia have joined the European Union (EU).

These new EU Member States will be members of EMU with a so-called derogation. After a two-year waiting period, their convergence will be evaluated based on the Maastricht Treaty convergence criteria. It is likely that EMU will be enlarged within two years time. The majority of the new EU Member States - Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia - have adopted already ERM (Exchange Rate Mechanism) II in June 2004 and will join EMU probably after a two-year period, as they do not have an opt-out clause. We will mainly focus on this problem of trading off both and the role of the European Central Bank (ECB).

First, we will assess the Maastricht Treaty convergence criteria and how consistent they are for the heterogeneous set of new EU countries. Then, we analyse the implications for the new EU countries of entering of the waiting room of ERM II. Furthermore, we evaluate the potential inflation differentials (Balassa-Samuelson effect) between the new EU countries and the euro area and its consequences for the ECB’s decision-making process. Finally, we discuss the effectiveness of monetary policy in defending exchange rates during speculative attacks and the ECB’s commitment to intervening within ERM II.

The convergence criteria: is there a trade off between exchange rate stability and price stability?

EU membership does not imply immediate membership of EMU. However, the new EU Member States have no formal derogation from EMU membership as obtained earlier by the UK and Denmark. In other words, the new EU members have an obligation to join EMU. Before they can enter EMU, the new members have to fulfill the criteria as stipulated in the Maastricht Treaty.

However, whether and when the accession countries satisfy the Maastricht criteria will be to a significant extent at their discretion. After all, Sweden has thus far evaded the obligation to join EMU by not satisfying the exchange rate criterion. (Buiter and Grafe, 2002).

1 Briefing Paper for the Monetary Dialogue of September 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank
The Maastricht Treaty contains four convergence criteria:

1. price stability: an average inflation rate (measured on the basis of the consumer price index) that does not exceed by more than 1.5 percentage-points that of, at most, the three best performing member countries.

2. sustainable fiscal position, meaning that there is no excessive deficit. An excessive deficit exists if:
   - the budget deficit is higher than 3 per cent of GDP, unless, either the ratio has declined substantially and continuously and has reached a level that comes close to 3 per cent, or the excess over the 3 per cent reference value is only exceptional and temporary and the deficit remains close to 3 per cent;
   - the ratio of gross government debt to GDP exceeds 60 per cent, unless the ratio has declined substantially and continuously and has reached a level that comes close to 60 per cent, or the excess over the 60 per cent reference value is only exceptional and temporary and the debt remains close to 60 per cent;
   - the ratio of the debt to GDP exceeds 60 per cent, unless, either the ratio has declined substantially and continuously and has reached a level that comes close to 60 per cent, or the excess over the 60 per cent reference value is only exceptional and temporary and the debt remains close to 60 per cent;

3. exchange rate stability, meaning that the currency has respected the ‘normal’ fluctuation margins of the Exchange Rate Mechanism (ERM), without severe tensions for at least two years (especially no devaluation on the initiative of the member country concerned).

4. low interest rate, meaning that the average long-term interest rate should not exceed by more than 2 percentage-points the interest rates in, at most, the three best performing countries in terms of price stability.

Although these criteria have been criticized for their lack of theoretical foundation (see e.g. Eijffinger and De Haan, 2000), the old EU countries have made it very clear that the new EU countries have to stick to this part of what is called the ‘acquis communautaire’. In this paper we will focus primarily on the convergence criteria of price stability (1) and exchange rate stability (3) and whether or not they are compatible with each other.

Many studies have addressed the question of the proper exchange rate regime for the new Member States in the period between entering the EU and becoming a (full) member of the EMU. The exchange rate regime is a key determinant of a country’s macroeconomic stability, which affects the investment climate. Apart from the perspective of future EMU membership, the choice of exchange rate regime is therefore of great relevance for the accession countries. Table 1 shows the exchange rate regimes of the (potential) new EU members at this moment.

### TABLE 1. EXCHANGE RATE REGIMES OF (POTENTIAL) NEW EU MEMBER STATES

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange rate regime:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>Fixed peg to euro (currency board)</td>
</tr>
<tr>
<td>Cyprus</td>
<td>Exchange Rate Mechanism II</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>Managed float to euro (inflation targeting)</td>
</tr>
<tr>
<td>Estonia</td>
<td>Exchange Rate Mechanism II</td>
</tr>
<tr>
<td>Hungary</td>
<td>Crawling peg to euro with band +/- 15% (implicit inflation targeting)</td>
</tr>
<tr>
<td>Latvia</td>
<td>Exchange Rate Mechanism II</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Exchange Rate Mechanism II</td>
</tr>
<tr>
<td>Malta</td>
<td>Exchange Rate Mechanism II</td>
</tr>
<tr>
<td>Poland</td>
<td>Full float (inflation targeting)</td>
</tr>
<tr>
<td>Romania</td>
<td>Managed float (monetary aggregates targeting)</td>
</tr>
<tr>
<td>Slovakia</td>
<td>Managed float (monetary aggregates targeting)</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Exchange Rate Mechanism II</td>
</tr>
</tbody>
</table>

Source: Adapted from De Haan, Eijffinger and Waller (2005).
An important (political) issue that will influence the timing of EMU membership is the interpretation of the exchange rate criterion as provided for in the Maastricht Treaty. A strict interpretation is that the new EU Member States should be a formal member of ERM II for two or more years following EU accession.1

However, Buiter and Grafe (2002) argue that the exchange rate criterion can be satisfied without the candidate country being an ERM II member. Italy and Finland (and later Greece) joined EMU right from the start, even though they had not spent two years in the ERM when they were admitted. More substantive, is the question of the proper exchange rate regime from an economic perspective. An important consideration in choosing an exchange rate regime is that the accession countries have to liberalize international capital flows as part of the ‘acquis communautaire’, making them more vulnerable to speculative attacks.

As follows from Table 1, the relatively smaller, new EU Member States – like Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia – have adopted ERM II and the relatively larger ones – the Czech Republic, Hungary, Poland and Slovakia – have chosen for (implicit) inflation targeting or monetary aggregates targeting. From the candidate EU-countries e.g. Bulgaria has opted for a currency board and Romania for monetary aggregates targeting. The Baltic states have waived the scope for fluctuation of their currencies within ERM II on their own initiative by retaining their previously existing currency board arrangements. These voluntary and unilateral commitments, however, do not place any additional obligations on the ECB. By contrast, Slovenia had previously allowed the exchange rate of its currency to fluctuate within a specific band around a depreciation path as part of a crawling peg system.2

A currency board can be considered as the most credible form of a fixed exchange rate regime as the own currency is convertible against a fixed exchange rate with some other currency(ies), which is codified, be it in a law or otherwise. The anchor currency is generally chosen for its expected stability and international acceptability. There is, as a rule, no independent monetary policy as the monetary base is backed by foreign reserves. A currency board is a strong, ‘doublebarrelled’ commitment device (Buiter and Grafe, 2002). Through the currency peg it represents a commitment to price stability. Through the ‘no domestic credit expansion’ constraint, it represents a commitment to budgetary restraint. The value of these commitments depends either on the currency board arrangement being perceived as credible and permanent, or on the belief that, if it is abandoned, it will be replaced by something representing a comparable commitment to price stability and budgetary responsibility as a credible currency board, like the EMU.

At the other extreme, a country may choose a floating exchange rate regime with an independent central bank with some kind of an inflation targeting strategy. Berger, De Haan and Eijffinger (2001) show that a currency board becomes, ceteris paribus, more attractive under the following conditions:

- the imported foreign monetary policy is in the hands of an independent and conservative (i.e. inflation-averse) foreign central bank.
- the home country’s central bank is relatively dependent and output-oriented compared to the foreign central bank.
- the correlation between the home and foreign country’s output shocks is high.

Compared to a full-fledged central bank, a currency board is a cheap way of managing monetary policy. As pointed out by Buiter and Grafe (2002), all that is needed is a sufficient number of modestly skilled bank clerks who exchange, at a fixed rate, domestic currency for the foreign currency in terms of which the peg is defined. As a currency board implies that the central bank cannot (fully) act as lender of last resort, no country should consider a currency board unless it can afford to do without a lender of last resort. As this safety net for the financial sector is missing, a prerequisite for a currency board is a reasonably healthy financial system. Likewise, no country should consider a currency board unless it has a sound fiscal framework that will not require discretionary access to central bank financing by the general government.

A currency board runs the risk of a real misalignment. If a country’s inflation remains higher than that of the pegging country, the currency can become overvalued (Pautola and Backé, 1998). While fixing

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1 At its meeting in Amsterdam in June 1997, the European Council decided to replace the ‘old’ Exchange Rate Mechanism of the EMS (ERM I) by the ‘new’ Exchange Rate Mechanism Mark II (ERM II). The ERM II offers the opportunity to stabilize exchange rates of EU members, which participate in EMU (the ‘ins’) and of those, which do not (the ‘outs’). According to the Maastricht Treaty, each member state that is not yet allowed to participate in the euro area shall treat its exchange rate policy as ‘a matter of common interest’. In principle, this should also apply to the countries with an opting-out clause, i.e. Denmark and the UK. Nonetheless, membership of ERM II is voluntary for all ‘outs’. The operating procedures for ERM II have been laid down in an agreement between the ECB and the national central banks in the non-euro area. ERM II is designed as an asymmetrical, euro-centered exchange rate system. The main feature of ERM II is the wide fluctuation of ±15 per cent between the euro and the currency of the country participating in the mechanism.

2 From the launch of the euro at the beginning of 1999 up to Slovenia’s entry into ERM II, its currency lost totally 21 % of its value against the euro. The success of Slovenia’s ERM II membership will depend on whether the depreciation trend of its currency vis-à-vis the euro can be broken in a credible way.
the exchange rate is a fast way to disinflate an economy starting with a higher inflation rate, pegging the exchange rate will not necessarily reduce the inflation rate instantaneously to that of the pegging country.

There are several reasons why inflation will not fall right away (Roubini, 1999).
First, purchasing power parity does not hold exactly in the short run since domestic and foreign goods are not perfectly substitutable and the mix of goods and services in the countries concerned may differ.
Second, non-tradable goods prices do not feel the same competitive pressures as tradable goods prices, thus inflation in the non-traded sector may fall only slowly.
Third, as there is significant inertia in nominal wage growth, wage inflation might not fall right away. Often wage contracts are backward looking and the adjustment of wages will occur slowly.
Finally, differing productivity growth rates may be reflected in differences in price increases (Balassa-Samuelson effect). If domestic inflation does not converge to the level of the pegging country, a real appreciation will occur over time.

As Roubini (1999) points out, such a real exchange rate appreciation may cause a loss of competitiveness and a structural worsening of the trade balance, which makes the current account deficit less sustainable.

It follows from the preceding analysis that a currency board with a peg to the euro may be the proper exchange rate regime for accession countries on their road to full EMU membership. Apart from the (related) risk of misalignment, there may, however, be a serious problem. Together, the exchange rate and the inflation criterion restrict the scope for changes in the real exchange rate of the accession countries vis-à-vis the euro.

Due to the Balassa-Samuelson effect, the accession countries may experience higher inflation than the euro area in case of a nominal fixed exchange rate. This even leads Szapary (2000) to argue that the inflation criterion of the Maastricht Treaty should be relaxed or reinterpreted. To examine whether this conclusion is justified, we will now first discuss the literature on the Balassa-Samuelson effect in the transition countries.

The implications of EMU enlargement: how large will the inflation differentials be?

It is often argued that due to the Balassa-Samuelson effect, transition countries have experienced a real appreciation of their real exchange rates. As a consequence of economic restructuring, many transition countries have experienced rapid productivity growth in their industrial sectors. As productivity growth in the traded goods sector exceeds that in the non-traded goods sector, non-traded goods prices increase due to the wage equalization process between both sectors.

When productivity growth in the transition countries exceeds productivity growth in the countries in the euro area, the transition countries will have a higher inflation rate. According to Eurostat (2001), average productivity in manufacturing in transition countries was only about 40 percent of the EU average in 1998.

Therefore, we can expect further high productivity growth. This restructuring will, however, take some time. During this period, these countries will probably experience higher inflation than the current EMU countries.

This raises two questions. First, how big are these inflation differentials between current and potential future EMU members? Second, what are the policy implications? 1

There is clearly no consensus in the literature on the magnitude of the Balassa-Samuelson effect in the transition countries. Table 2 provides a summary of various recent studies. Estimates vary widely.

Whereas Rogers (2001), for instance, estimates that the Balassa-Samuelson effect is likely to imply two additional percentage points of annual inflation in the accession economies, Égert (2002a,b) finds little evidence of a higher inflation rate due to the Balassa-Samuelson effect in the Czech Republic and Slovakia. The extremely high inflation differentials implied by sectoral productivity developments and labor shares for Hungary and Poland as reported by Backé, Fidrmuc, Reiniger and Schardax (2002) attract attention. According to these authors, their figures reflect mainly the massive gains in productivity in the tradable-goods sector that have been achieved during the 1990s in these two countries.

They argue, however, that past figures are probably not a good guide for the future as convergence implies that productivity increases will tend to decelerate as higher productivity levels are reached.

These diverging outcomes are partly the result of differences in method. An important factor is that not all studies summarized in Table 2 are restricted to estimates of the Balassa-Samuelson effect. The literature has pointed out various other channels than can give rise to inflation differentials. Some of the studies take these into account.

For instance, Halpern and Wyplosz (2001) have estimated the Balassa-Samuelson effect for a panel of nine transition countries also including demand factors. The same is true for Coricelli and Jazbec (2001), who, in addition, add a variable capturing...
Next, they regress the relative consumer price levels of 29 OECD countries on the GDP-based comparative price levels of these countries (i.e. on ratios of the GDP measured in PPP and at current exchange rates). The coefficients of the independent variables in both equations are negative and highly significant. In a third step, Pelkmans et al. (2000) calculate the relative consumer price levels of the ten Central and Eastern European accession countries, based on their comparative price levels and the coefficient estimated for the OECD countries in the second equation. Finally, the authors use the coefficient estimated in the first equation for the euro area countries to compute the accession countries’ inflation differentials form the average euro area, which are implied by their relative consumer price levels. Their results show on average an inflation differential of 3.8 percentage points between the accession countries and the euro area average due to estimated differences in the price levels.

As to the policy implications, the evidence reviewed suggests that accession countries...
with a fixed exchange rate regime may have problems in meeting the inflation criterion of the Maastricht Treaty. Countries with a somewhat more flexible exchange rate regime are unlikely to have problems to meet the Maastricht criteria for Balassa-Samuelson reasons. The Balassa-Samuelson effect is unlikely to exhaust the 15 per cent bands of the ERM II in two years. Some observers have argued that the convergence criteria should be modified (see e.g. Coricelli and Jazbec, 2001). One could, for instance, compare the inflation rates of the accession countries with those in the least developed EMU countries or allow for a higher than the 1.5 percentage-point differential. These suggestions have met little support from the current EMU countries. Admitting countries with relatively higher inflation rates could increase the HICP inflation in the euro area. However, this argument should not be overstressed as the weight of inflation in the accession countries in the total euro area inflation rate is quite low. For instance, a 3 per cent difference in inflation rates between the 1998 Accession group and the rest of the euro area would only imply a 0.1% increase in the euro area’s GDP-weighted inflation (Égert, 2002a).

Buiter (2004) warned very recently that forcing the new EU Member States to enter the ERM II waiting room for the euro is even “pointless and potentially dangerous”. He thinks that creative reinterpretation is essential, if unnecessary risk to the financial stability of the EMU candidates is to be avoided. According to Buiter no monetary authority should be asked to pursue more than one nominal target. The simultaneous pursuit of three nominal targets (nominal exchange rate, inflation target and nominal interest rate target) greatly enhances the likelihood that a “major financial accident” will happen. He stated that EMU candidates should be allowed to have a free floating exchange rate between the time their date and rate for joining the euro are announced and the time their currency is locked into the euro.

Buiter urged euro membership as soon as possible in the national interest of the new EU countries, noting that even the biggest country – i.e. Poland – is too small, too open and too financially vulnerable to run its own currency. Therefore, he concludes that without new rules for euro membership there are risks that the accession of a country being not ready for the euro could result in harm to other old and new EMU members.

Equally important is that the increase in the dispersion of inflation rates in the euro area may increase the risks implied by the decentralized set-up of the ECB. As the catch-up process of the new EU countries will continue after they have joined EMU, the enlargement of the monetary union implies more inflation divergence.

If national considerations play a role in the behavior of national central bank governors in the Governing Council of the ECB, it may become more likely that the focus on euro-area-wide developments will be undermined. From this perspective, the future enlargement of EMU only underscores the need for reform of the ECB in the sense of strengthening the Executive Board at Frankfurt-am-Main vis-à-vis the presidents and governors of the National Central Banks (NCBs) within the Governing Council (see Eijffinger, 2003).

The effectiveness of monetary policy in defending exchange rates during speculative attacks: theory and evidence

The theoretical literature on the effectiveness of monetary policy in supporting a currency during episodes of severe speculative pressure can be distinguished into two groups, the ‘traditional’ view and the ‘revisionist’ view. The traditional view argues that the monetary authority can support the exchange rate by raising interest rates. Higher interest rates discourage capital outflows and appreciate the exchange rate. The revisionist view argues that when speculative attacks are accompanied by balance-sheet problems in the financial and corporate sectors, monetary tightening may have a depreciating effect on the exchange rate.

We start with summarizing the traditional view on the effectiveness of monetary policy in case of speculative attacks. Furman and Stiglitz (1998) raise two important concerns regarding the traditional effect of monetary policy. As the interest rate increase is likely to be temporary, the support of the exchange rate is also temporary.

Moreover, a 1% expected nominal depreciation of the following day would require according to Furman and Stiglitz no less than a 3678% annualized interest rate increase. In response to these doubts, the proponents of the traditional view argue that increases in interest rates might be able to strengthen the exchange rate permanently, through their effect on the expected future exchange rate. Three possible channels of this effect can be distinguished. First, the Dornbusch (1976) ‘overshooting’ model of the exchange rate argues that an interest rate increase will lower inflation and will lead to a stronger expected future nominal exchange rate. Second, Backus and Drifill (1985) and Drazen (2000 and 2003) explain how raising the interest rate could signal the willingness or ability of the monetary authorities to defend the exchange rate. When the interest rate returns to its initial level, the change in expectations persists, causing a permanently stronger exchange rate. Finally, Furman and Stiglitz (1998) mention that a temporary interest rate defense provides policymakers with time to implement reforms that strengthen the exchange rate permanently.

4 Under that assumption of purchasing power parity (PPP) applies in the long run.
5 According to Drazen, the opposite could also hold where raising interest rates signals the lack of other means to defend the exchange rate, for example because of a low level of reserves.
The revisionist view, however, argues that tighter monetary policy affects the probability of bankruptcy and uncertainty about the future. Firms and banks will face higher costs of borrowing, which will decrease investments and profits. If they are negatively exposed to higher interest rates, their net worth will drop as well. Consequently, the probability of default in the corporate and banking sector goes up and this adverse effect may more than offset the traditional effects and cause the nominal exchange rate to depreciate instead of appreciate.

Empirical evidence on the effectiveness of monetary policy is mixed. Two approaches can be distinguished. The first approach assesses the time-series relationship between interest rates and exchange rates in one or more countries. Goldfajn and Baig (2002), using daily data, find little impact of interest rates on exchange rates or vice versa in the 1997/1998 Asian crisis countries.

Dekle, Hsiao, and Wang (2002), based on weekly data, show a small supportive effect of interest rates on nominal exchange rates during the crises in Korea, Malaysia, and Thailand. Gould and Kamin (2001) also use weekly data and find that monetary policy did not significantly affect exchange rates in Thailand, Indonesia, Korea, Malaysia, Philippines, and Mexico.

The second approach looks at a large cross-section of currency crises or speculative attack episodes and determines whether raising interest rates had a supportive effect on the exchange rates in those periods. Furman and Stiglitz (1998) look at nine developing countries in the nineties and assess whether episodes of sustained high interest rates were followed by an appreciation of the domestic currency.

Using daily data, they find a significant depreciating impact of interest rates on exchange rates in low-inflation countries. Goldfajn and Gupta (1999) ask whether a tightening of monetary policy made it more likely that the post-crisis real appreciation would take place through nominal appreciation rather than through higher inflation. Looking at crises episodes in 80 countries, they find that monetary tightening appreciates the nominal exchange rate, but only in countries with strong banking sectors.

Kraay (2003) identifies episodes of severe speculative pressure preceded by relatively fixed exchange rates in 54 developed and developing countries. He asks whether high interest rates defend currencies during speculative attacks. Using monthly data, Kraay finds no impact of interest rates on the outcome of speculative attacks.

The empirical assessment of monetary policy effectiveness is likely to suffer from endogeneity. Regressing the exchange rate, as a dependent variable, on the interest rate, as an independent variable, might cause problems, as the interest rate (monetary policy stance) is likely to depend on third factors, some of which also affect the exchange rate. Kraay (2003) instruments for monetary policy but still finds no significant impact of monetary policy on the exchange rate. So, the empirical evidence of both time-series and cross-section approaches to the effectiveness of monetary policy in defending exchange rates during speculative attacks is mixed and non-conclusive.

The operating procedures for ERM II: should the ECB and the non-euro area NCBs intervene intramarginally?

The operating procedures for ERM II, which have been laid down in an agreement between the ECB and the non-euro area NCBs, are quite crucial for defending the currencies participating in ERM II against speculative attacks. For each of these currencies a central rate vis-à-vis the euro and a standard fluctuation band of + 15 % are defined, in principle supported by automatic unlimited intervention at the margins, with very short-term financing available. However, the ECB and the participating NCBs could suspend automatic intervention, if this were to conflict with their primary objective of maintaining price stability. Exchange rate policy cooperation may be further strengthened, for example by allowing closer exchange rate links between the euro and the other currencies in ERM II where, and to the extent that, these are appropriate in the light of progress towards convergence (European Central Bank, 2004). So, it is up to the ECB to decide whether it has a hard or soft commitment to exchange rate intervention within the fluctuation band of + 15 % and on the basis of which conditions with respect to the country’s fiscal and monetary policy.

These intramarginal interventions will play, just like they did during ERM I, a crucial role in deterring speculative attacks against the ERM II currencies. A soft commitment of the ECB to intramarginal intervention may provoke speculative attacks in case the financial markets have serious doubts regarding the real and nominal convergence process of the country involved. On the contrary, a hard commitment to intervening within ERM II from the part of the ECB is only realistic when it is combined with conditionality in terms of fiscal and monetary policy. The question is, of course, whether or not (constructive or creative) ambiguity in intervention policy will be beneficial to the exchange rate stability of the ERM II currencies. I think that ambiguity - creative or not - will not be beneficial for exchange rate stability. Therefore, it is essential that the ECB will clarify how strong its commitment will be to intervening within ERM II to reduce the probability of these speculative attacks and how it will interpret the convergence criteria of price stability and exchange rate stability in formulating its advice to the European Council on euro adoption by the new EU countries.
The importance of central bank independence in the new EU Member States: does legal independence of non-euro area NCBs also imply actual independence?

Finally, the role of central bank independence in the new EU Member States should not be underestimated. The fifth implicit convergence criterion is the independence of the NCBs of these countries. They have to comply with the legal independence of their central banks in order to make the position of the central bank in accordance with the Maastricht Treaty and the Statute of the European (System of) Central Bank(s). What matters is, however, the actual independence of the central bank.

Only the actual practice of central bank independence determines the effectiveness of monetary policy to assure price stability. Legal independence is a necessary but not sufficient condition for a truly independent central bank and can be seen as a fundamental basis for building the institutional climate needed for actual independence.

The translation from legal independence into actual independence is primarily determined by the compliance with the law or the rule of law in a country. Eijffinger and Stadhouders (2003) have investigated empirically the impact of the rule of law on the rate of inflation. Several Institutional Quality Indicators (IQIs) are integrated in their empirical test between the rate of inflation and the rate of inflation in a country. The individual IQIs are each significantly and negatively related to the rate of inflation for 44 developed and developing countries during the period 1980-1989. This result becomes stronger when two or three institutional quality indicators are combined.

Although the IQIs are highly correlated to each other, a combination of IQIs may give a more complete picture of the qualitative institutional environment in a country. Therefore, the rule of law is quite essential for strengthening the actual independence of NCBs in the new Member States. Central bankers in these countries have to learn to behave independently and politicians have to learn to accept this independent behaviour of central bankers. This learning process will take time, perhaps a generation, and should be fully supported by the ECB.

Conclusions

It is likely that EMU will be enlarged in two years time. Some of the new EU Member States - e.g. Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia - will join EMU probably after a two-year period, as they do not have an opt-out clause. The new EU countries face a difficult decision in trading off exchange rate stability and price stability depending on their inflation differentials with the current euro area countries. This implies that the Maastricht Treaty convergence criteria for price stability and exchange rate stability are in their present form incompatible. This may lead to speculative attacks against some currencies of the new EU countries. The empirical evidence of both time-series and cross-section approaches to the effectiveness of monetary policy in defending exchange rates during speculative attacks is mixed and non-conclusive. So, it is up to the ECB to decide whether it has a hard or soft commitment to exchange rate intervention within the fluctuation band of + 15 % and on the basis of which conditions with respect to the country’s fiscal and monetary policy. A soft commitment of the ECB to intramarginal intervention may provoke speculative attacks in case the financial markets have serious doubts regarding the real and nominal convergence process of the country involved. On the contrary, a hard commitment to intervening within ERM II from the part of the ECB is only realistic when it is combined with conditionality in terms of fiscal and monetary policy. Ambiguity in intervention policy will not be beneficial to the exchange rate stability of the ERM II currencies. The ECB should clarify its commitment to intervening within ERM II to reduce these speculative attacks and its interpretation of the convergence criteria in formulating its advice to the European Council on euro adoption.

Finally, the role of law is quite essential.
for strengthening the actual independence of NCBs in the new Member States. Central bankers in these countries have to learn to behave independently and politicians have to learn to accept this independent behaviour of central bankers. This learning process will take time, perhaps a generation, and should be fully supported by the ECB.

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