This chapter examines whether it is desirable for, and the ability of, the Central and Eastern European candidates for accession to the European Union (EU) to participate in the new exchange rate mechanism (ERM-2), and eventually in the economic and monetary union (EMU). For most of these countries the benefits of participating in EMU are likely to outweigh the costs. The key conditions for operating within ERM-2 include wage flexibility, a prudent fiscal and monetary stance, and a sound financial system. Once they have met these conditions the candidates will be able to shadow the euro prior to formal participation. The chapter concludes with a discussion of two policy dilemmas.

Introduction

Economic and monetary union (EMU) is of central importance for the countries of Central and Eastern Europe (CEE) that are aspiring to join the EU. Whereas participation in EMU is not a formal requirement for EU membership, by the time of accession these countries will be expected to be on the way to meeting the criteria for EMU participation. Indeed the new member states will have to adopt the *acquis communautaire* of stage 2 of EMU, including adherence to the relevant provisions of the Stability and Growth Pact. They will also be expected to have liberalized capital movements, achieved central bank independence, and will be required to participate in the new exchange rate mechanism (ERM-2).

Under the terms of the Stability and Growth Pact, non-participant (‘opt-out’ and ‘left-out’) EU members are required to submit medium-term convergence programmes for surveillance by the European Council. In addition, under ERM-2 they are required to maintain parity between their currency and the euro within a plus or minus 15 per cent margin for at least two years prior to qualifying for stage 3 of EMU. It can therefore be inferred...
that a basic – albeit implicit – prerequisite for EU accession is demonstration of the ability to operate within the ERM-2 regime and to eventually participate in EMU. Presumably there would also have to be credible convergence towards the EMU reference values for government deficit and debt, as well as for inflation and interest rates.

This chapter seeks to answer the following questions about the implications of EMU for the CEE EU-accession candidates. Based on the theory of optimum currency areas, is there a case for EMU participation by these countries? If so, are these countries equipped to join the ERM-2 regime, and more generally to embark on a hard currency strategy? Above all, what are the necessary conditions for these countries to enter and operate within ERM-2? The chapter concludes with a discussion of two policy dilemmas faced by the candidates when converging towards EMU. Although the chapter focuses on the initial leading accession countries (the Czech Republic, Estonia, Hungary, Poland and Slovenia), the main conclusions are also applicable to other candidates; moreover in some respects they are relevant for all transition economies in the region.

The case for participating in EMU

The economic case for joining the ERM-2 regime, and for eventually participating in EMU, rests primarily on the theory of optimum currency areas – assuming, of course, that EMU is an optimum currency area. The relevance of this theory for the accession countries transcends the familiar debate on fixed versus flexible exchange rates for economies in transition. The dominant view in that debate is that during the transition from central planning to a market economy, a fixed peg can serve as a policy anchor for macroeconomic stabilization while the necessary institutional framework, including market-based hard budget constraints, is being developed. An alternative view is that a flexible rate can be useful for maintaining external competitiveness and serve as a more immediate gauge for macroeconomic discipline without constraining the transformation of the economy. These arguments seem less germane to the leading candidates than to some other transition economies that still face strong destabilizing forces and have insufficiently developed institutions and macroeconomic policy instruments.

When assessing the applicability of the theory of optimum currency areas to the accession countries it is necessary to examine the benefits and costs that are likely to accrue to these countries upon entering the EMU currency area – which will, of course, be above and beyond the welfare effects of joining the EU as a customs union or a single market. As is well known, the benefits will primarily stem from the reduced cost of conducting economic transactions (trade, investment and services) with the existing currency area. Also, currency risk premia, including the risk of exchange rate depreciation, will lessen and ultimately vanish in those countries. The reduced transaction