8. **Exchange rate and capital movement issues in accession countries** (Begg et al.)

In 2002 in Copenhagen, accession to the European Union decided For a number of transition countries: Hungary, Poland, Czech republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania.

Perspective of adopting the Euro.

EU participation implies capital movement liberalization but not necessarily adoption of the Euro.

Once in the EU, accession countries (AC) will enter the ERM (exchange rate mechanism):

- Fixed exchange rate set jointly with ECB
- Band of +/- 15%.

Initially, most transition countries adopted a fixed peg to the Euro or to a basket of currencies.

Some countries have gone towards floating exchange rates:
Czech republic, Poland, Slovakia, Slovenia

Others have adopted a currency board: Bulgaria, Estonia, Lithuania.

Latvia has fixed peg, Hungary has fixed band, Romania, crawling band.

Main problem: Vulnerability to large capital flows before adoption of the Euro (similar problem for EU with 1992 crisis).

- Large inflows lead to real appreciation (currency appreciation under floating exchange rates and higher domestic inflation under fixed exchange rates) which reduce competitiveness, leading to current account imbalance but also lower growth and higher unemployment which can lead to …
- … large outflows and crisis.
- Increasing occurrences of crises under capital liberalization:
    - Mexico 1994
    - Europe, 1992
    - Asia 1997
    - Argentina

Countries with fixed peg are especially vulnerable. Speculation less risky and temptation for short term capital inflows to bridge deficit gap.

Some real appreciation is to be expected because of the Balassa-Samuelson effect.

The theory:

- Productivity growth in emerging market economy is in traded goods sector. => higher wages
- Wage equalization between traded and non-traded good sector.
- Non-traded good sector can only absorb higher wages via higher prices (absorbed by higher demand from higher incomes).
- Traded good price inflation given by world inflation.
- Higher productivity growth thus leads to higher non-traded good inflation and thus higher real appreciation.

Figure 1: Relative wages
(industry/total)

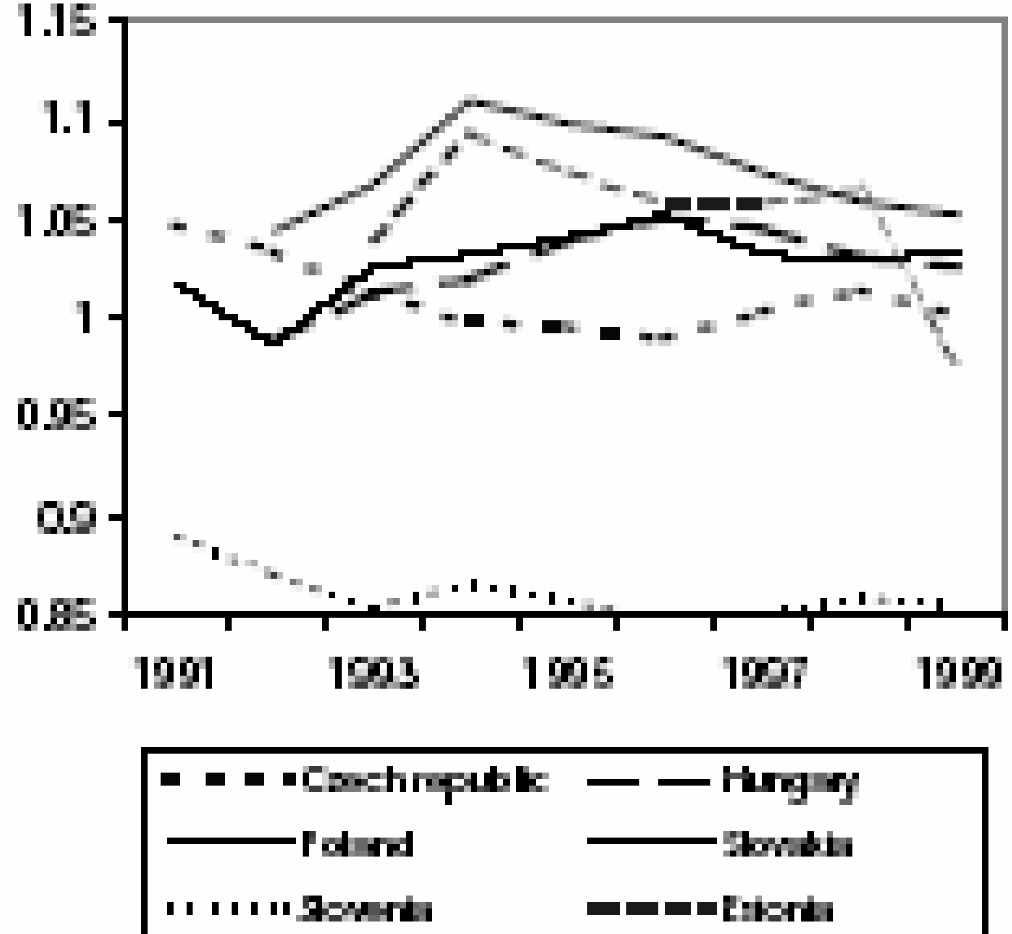
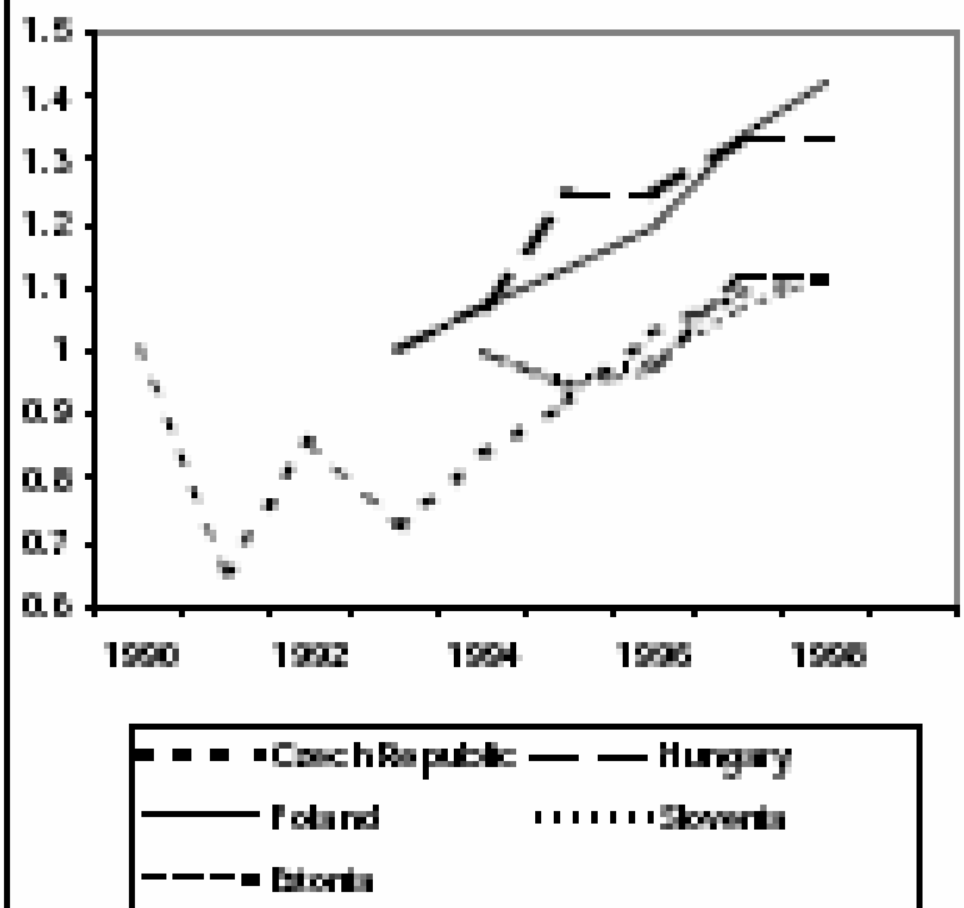
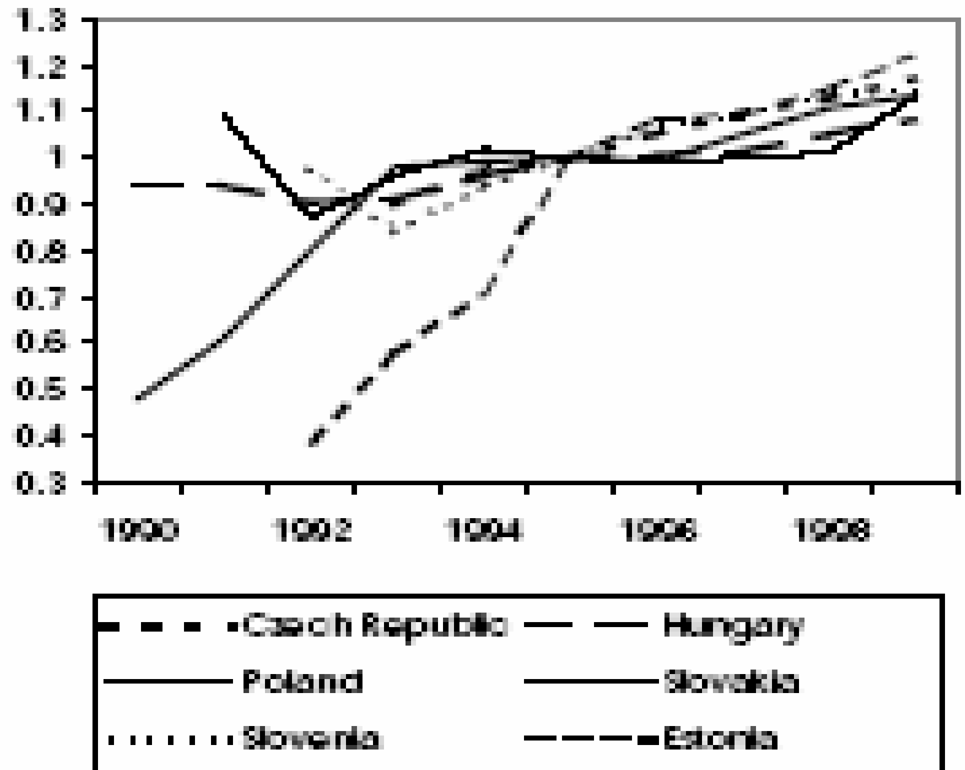


Figure 2. Relative Labor Productivity (Industry/Services)



Non-traded to traded price ratio

(Services to non-food CPI; 1995=1.0)



Accession countries have high potential for catch-up given their lower level of GDP per capita (around 50% of EU average against 65% for Greece, Spain, Portugal)

⇒Real appreciation will be observed for many more years.
⇒ Either nominal appreciation/reevaluation of higher inflation.

Exchange rate stability would be at the cost of inflation convergence.

With free capital mobility, real appreciation may be reinforced! And capital inflows can be followed by rapid outflows.

Exchange rate flexibility implies nominal trend appreciation.

Exchange rate stability implies accumulation of reserves, and therefore higher inflation, with danger of loss of competitiveness and unemployment.

Exchange rate flexibility seems preferrable.

When should countries join EMU?

Delay allows to complete macroeconomic stabilization under flexible enough exchange rates. Too early entry risks having inflationary effects. This may have negative effects on European financial system (and on inflation)

Delay risks danger of currency crisis if sudden capital outflows. Early entry shields from crisis.

ACs will prefer early entry, EU will prefer late entry.

Two basic options:

1) Euro-based currency board. Will require strong fiscal contraction.
2) Fully flexible exchange rate band with possible adjustments of central parity. Inflation target desirable coordinated with ECB. Announce conversion rate long in advance.