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Exchange rate regimes and shocks asymmetry: the case of the accession countries

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This paper reviews the pros and cons of an early EU enlargement that includes the Central and Eastern European countries (CEECs). The analysis of Maastricht criteria and real convergence enables us to distinguish the subset of transition countries that have succeeded in stabilizing and restoring economic growth from a second subset that failed to do so. For the former group, business cycles symmetry is an important issue. Using the Kalman filter, we compute the time varying correlation of demand and supply shocks in Ireland, Portugal, Spain and eight CEECs, namely the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Our results emphasize an ongoing process of convergence of demand shocks, but divergence of supply shocks. *Journal of Comparative Economics* **32** (2) (2004) 212–229. Czech National Bank, Prague 11503, Czech Republic; CNRS-ROSES, Université de Paris 1, Maison des Sciences Économiques, Paris 75647, France; CERGE-EI, Charles University, Prague 11121, Czech Republic; OECD, Paris 75775, France; CEPR, London, EC1V 7RR, United Kingdom; WDI, Ann Arbor, MI 48109-1234, USA.

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1. Introduction

EU enlargement towards the East is unprecedented. The situation of the Central and Eastern European Countries (CEECs thereafter) is dramatically different from that of the previous entrants into the EU, e.g., Spain, Portugal, and Greece. First, the institutional environment in the CEECs must be improved. According to Berglöf and Roland (1998) and Sgard (1995), finance and banking institutions are underdeveloped, although progress has been made to reduce the gap between the CEECs and the EU countries. Second, if the CEECs enter the EU in 2004, the delay between formal candidacy and actual admission would be exceptionally short. More generally, the wide range of possible macro-economic situations, both in terms of growth and inflation, may raise questions regarding the possibility of a common policy mix.

For this unprecedented enlargement, different conditions might seem, at first glance, contradictory. Maastricht criteria are not compatible with catching-up objectives because nominal exchange rate stability implies relatively high inflation for accessing countries with growth rates higher than the European average. Catching-up is measured not only in terms of macro-economic aggregates but it also has an institutional dimension that, although harder to evaluate, is essential. Nevertheless, our purpose is not to review the necessary conditions for the enlargement to be successful but rather to focus on a subset of macro-economic criteria. When joining the EU, the CEECs will have to adopt the *acquis communautaire*, including eventually the EMU, if not the Euro itself.[1] Although this does not mean that the Maastricht criteria must be satisfied before joining the EMU, it does imply convergence and stability along these lines.[2] Moreover, nominal convergence is a necessary, although not sufficient, condition for real convergence so that similarity in terms of GDP per capita and GDP volatility can serve as an additional criterion to evaluate whether joining the same economic area is in each country's interest. Finally, sharing the same monetary policy does not depend only on GDP levels but also on the similarity of business cycles. If two countries have the same business cycle around a different trend, they can share the same monetary policy. The real exchange rate can adjust to changing economic circumstances and shocks through changes in wages and prices rather than through changes in the nominal exchange rate.

This paper examines the pros and cons of the CEECs joining the EMU. Section 2 discusses how the CEECs perform with respect to the traditional Maastricht criteria. Although these criteria are not required for candidate countries, they allow us to distinguish between two groups of countries. Countries having a sound macro-economic environment and in which the process of catching up is progressing are contrasted with those who still experience large imbalances and hyperinflation, so that the convergence process is

[1] See Agenda 2000, Strategy for Enlargement Document, Report on the progress made by every candidate country on their way to accession, European Union Bulletin, Supplement 3/2000, p. 28: "The Economic and Monetary Union (EMU) is an essential part of the "acquis." It is however convenient to distinguish clearly between participation in EMU—compulsory for all member states—and participation in the Euro."

[2] This is similar to the requirement that non-EMU countries, e.g., UK, Denmark and Sweden, present a convergence program in line with the EMU countries' Growth and Stability Pact.