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Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Relations

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Abstract

Economic and Monetary Union (EMU) has a number of institutional implications for the transition countries of Central and Eastern Europe and selected Mediterranean countries that aspire to join the European Union (EU). After describing the current institutional framework for their relations with the EU, the paper examines two basic categories of institutional effects: those stemming from the need to satisfy the Maastricht convergence criteria before joining the euro area, and those stemming from the need to adopt the EU's institutional and legal provisions in the area of EMU.

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SUMMARY

This paper examines the institutional channels through which Economic and Monetary Union (EMU) in the European Union (EU) can affect countries that aspire to join the EU. It focuses on the transition countries of Central and Eastern Europe and selected Mediterranean countries (Cyprus, Malta, and Turkey), as they all may want to become members of the EU in the future. The institutional implications are of most immediate concern for those countries that expect to participate in the next round of EU enlargement, but may also influence policies in the other countries.

After describing the current institutional framework for relations between the EU and these countries, the paper examines two basic types of institutional implications of EMU.

The first stems from the need to satisfy the Maastricht convergence criteria before joining the euro area. The launching of EMU will increase pressure on countries aspiring to EU membership to design their macroeconomic policies in a way that will facilitate convergence toward the Maastricht targets. None of the countries reviewed currently meets all the Maastricht criteria. While a majority appear to satisfy the fiscal criteria, very few meet the inflation or interest criteria and further convergence on these two fronts is expected to be slow and difficult for some.

The second stems from the need to adopt the EU's institutional and legal provisions in the area of EMU applicable to EU countries remaining outside the euro area. These requirements include the need to establish fully independent central banks, the prohibition of central bank and other privileged financing of the government, the participation in the European System of Central Banks, the need to coordinate macroeconomic policies (and, in particular, exchange rate policy), and the complete liberalization of capital flows. The paper examines where the countries under review stand in terms of some of these requirements.

I. Introduction

This paper delves into a number of institutional channels through which Economic and Monetary Union (EMU) in the European Union (EU) can affect the transition countries of Central and Eastern Europe (CEECs) and selected Mediterranean countries. Such institutional implications of EMU are of most immediate concern for those countries that expect to participate in the next round of EU enlargement. They are also important for countries with more distant or uncertain EU membership prospects. Indeed, in formulating their policies, some countries in this latter group are already keeping an eye on the various institutional requirements associated with EMU that are discussed in this paper. Thus, in a more general way, the paper aims to provide the reader with a broad understanding of the institutional implications of EMU for a wider range of countries than just those with early EU membership prospects.

The paper is organized in the following way. Section II describes the current institutional framework for relations between the EU and the CEECs and discusses their prospects for EU membership.[2] The analysis focuses on those CEECs that have signed association agreements with the EU (hereafter referred to as "associated CEECs"). These countries must demonstrate their ability to adhere to the aims of economic and monetary union under the so-called Copenhagen criteria for EU accession. The institutional set-up for relations between the EU and the selected Mediterranean countries—namely, Cyprus, Malta, and Turkey—is discussed in Section III. Section IV then examines the institutional implications of EMU for countries with EU membership prospects, distinguishing between the Maastricht convergence criteria and the need to adopt the EU's institutional and legal provisions (i.e., the *acquis communautaire*) in the area of EMU. With reference to the *acquis communautaire*, Section IV includes a discussion of: participation in the future exchange rate mechanism of the EU; central bank independence; central bank and other privileged financing of the government; participation in the European System of Central Banks; the liberalization of capital flows; the need for an efficient, market-oriented financial sector; and the payments systems. Finally, Section V offers concluding remarks.

II. Relations with the EU: CEECs

A. Background

As countries dominated by state trading, CEECs faced considerable trade barriers in the EU during the socialist period, including various quantitative restrictions and import authorizations, and relatively high tariffs. Only the former Socialist Federal Republic of

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[2]The CEECs covered in this paper are Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, the Former Yugoslav Republic (FYR) of Macedonia, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia, and the Federal Republic (FR) of Yugoslavia.

Yugoslavia (SFRY) and Romania, by virtue of their neutral or non-aligned status, were granted favorable treatment under the Generalized System of Preferences (GSP).[3] In addition, the former SFRY concluded trade agreements with the EU in 1970 and 1975, resulting in the most favored nation (MFN) clause being applied to that country. A Trade and Cooperation Agreement (TCA) was also signed in 1980 that allowed preferential entry of Yugoslav industrial goods into the EU.

EU trade policy responded to the historical changes in the CEECs that followed the fall of the Berlin Wall. TCAs were concluded with Hungary, Poland, Czechoslovakia, Bulgaria and Romania in 1988-90, granting them MFN status and providing for the phase-out, over a 10-year period, of the selective (discriminatory) quantitative restrictions that the EU applied to these countries (see Table 1). In 1990, the EU abolished these selective quantitative restrictions ahead of schedule (except in sensitive sectors), and suspended the application of nonselective quantitative restrictions to Czechoslovakia, Hungary, and Poland. It also extended GSP treatment to all the CEECs. The preferential treatment accorded to exports from CEECs was enhanced with the signing in the first half of the 1990s of Association Agreements, also known as Europe Agreements (EAs). These replaced the TCAs and represented an important step toward closer economic and political integration of the CEECs into the EU. Ten countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia) have now signed EAs.[4, 5]

Following the outbreak of the war in the former SFRY, the EU denounced the 1980 TCA with that country in November 1991, but continued to apply unilaterally its commercial terms to the successor republics through the so-called autonomous preferential trade regimes, which are renewed annually. The relevant import quotas set by the EU were not distributed among the successor states (they apply on a first-come-first-served basis), although they were reduced in proportion to Slovenia's exports as this country was granted more favorable treatment under the TCA and, later, under the EA. The FYR of Macedonia signed a second-generation TCA with the EU in April 1997; it entered into force in January 1998. In December 1997, the EU decided on political grounds not to renew in 1998 the autonomous trade preferences to the FR of Yugoslavia. With the autonomous preferential trade regimes no

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[3]This treatment was granted to the former SFRY in 1971 (when the GSP was created) and to Romania in 1974.

[4]These ten countries accounted in 1996 for about 94 percent of total EU imports from the CEECs.

[5]Albania signed its first trade agreement, a TCA, with the EU in 1992. The Baltic countries also signed TCAs with the EU in 1992. The latter agreements were converted into free trade agreements in 1994, and then into full EAs in 1995. The Slovenian EA was also preceded by a second-generation TCA, signed in 1993.

Table 1. Trade and Association Agreements Between the EU and CEECs

	Trade and Cooperation Agreements			Europe Agreements 1/			Interim Europe Agreement 2/		
	Signed	In force		Signed	In force		Signed	In force	
Albania	11-May-92	1-Dec-92		...	...		...	...	
Bosnia-Herzegovina 3/	...	...		...	...		...	...	
Bulgaria	8-May-90	1-Nov-90		8-Mar-93	1-Feb-95		8-Mar-93	31-Dec-93	
Croatia 3/	...	...		...	...		...	...	
Czech Republic	...	...		4-Oct-93	1-Feb-95	4/	16-Dec-91	1-Mar-92	4/
Former Czechoslovakia	7-May-90	1-Nov-90		16-Dec-91	...	4/	16-Dec-91	1-Mar-92	4/
Estonia	11-May-92	1-Mar-93	5/	12-Jun-95	Feb-98		...	...	6/
Hungary	26-Sep-88	1-Dec-88		16-Dec-91	1-Feb-94		16-Dec-91	1-Mar-92	
Latvia	11-May-92	1-Feb-93	5/	12-Jun-95	1-Feb-98		...	...	6/
Lithuania	11-May-92	1-Feb-93	5/	12-Jun-95	1-Feb-98		...	...	6/
FYR of Macedonia 3/	29-Apr-97	1-Jan-98		...	...		...	...	
Poland	19-Sep-89	1-Dec-89		16-Dec-91	1-Feb-94		16-Dec-91	1-Mar-92	
Romania	22-Oct-90	1-May-91		1-Feb-93	1-Feb-95		1-Feb-93	1-May-93	
Slovak Republic	...	...		4-Oct-93	1-Feb-95	4/	16-Dec-91	1-Mar-92	4/
Slovenia 3/	5-Apr-93	1-Sep-93		10-Jun-96	Not yet	7/	11-Nov-96	1-Jan-97	
FR of Yugoslavia 3/	...	...		...	...		...	...	
Former SFRY 3/	2-Apr-80	1-Apr-83	8/	...	...		...	...	

Source: European Commission.

1/ The Europe Agreements (EAs) replaced the Trade and Cooperation Agreements (TCAs).

2/ Provide for an early implementation of the trade aspects of the EAs.

3/ After the break-up of the former SFRY, the EU denounced the TCA of 1980, but continued to apply unilaterally its commercial terms to the successor republics. This is done through the so-called autonomous preferential trade regimes, which are renewed annually. These autonomous regimes stopped applying to Slovenia and FRY of Macedonia with the entry into force of their TCAs. In December 1997, the EU decided not to renew in 1998 the autonomous regime to FR of Yugoslavia.

4/ Following the dissolution of the former Czechoslovakia, separate EAs and supplementary protocols to the Interim Agreements were signed with each of the two successor republics.

5/ Free trade agreements with each of the Baltic countries were signed on July 18, 1994. They entered into force on January 1, 1995, replacing the trade aspects of the 1992 TCAs.

6/ Since the Baltic countries had already signed free trade agreements with the EU in 1994, there was no need for Interim Agreements. Such agreements were therefore never signed.

7/ Still in the process of ratification.

8/ The former SFRY had previously signed two non-preferential trade agreements with the EU, in March 1970 and June 1973, respectively. An Interim Agreement, implementing the trade provisions of the TCAs of 1980, entered into force in April 1980.

longer applying to the FYR of Macedonia and the FR of Yugoslavia, the import quotas applied to Bosnia-Herzegovina and Croatia under these regimes were again reduced.

The EU has so far accepted the principle of an eastern enlargement only for those CEECs that have signed EAs. All of them submitted formal membership applications between 1994 and 1996 (see Table 2); some could join the EU as early as in 2002. A number of non-associated CEECs have expressed a desire to be part of the EU at some stage. None of them have submitted a formal application and their membership prospects seem more distant, though their policies are also being influenced in some cases by the institutional implications of joining the EU someday.

B. The Associated CEECs and the Europe Agreements

In order to enter fully into force, each EA has to be ratified by the Parliaments of the EU member states as well as by the Parliament of the associated country in question. Of the ten countries having signed EAs, only the Slovenian agreement has yet to be ratified. Pending ratification of the Slovenian EA, an Interim Agreement implementing its trade and trade-related provisions is in force. Table 1 reports the relevant dates for the various country agreements.

The EAs are more ambitious than the Association Agreements the EU had previously concluded with other countries. In addition to the trade liberalization component, the EAs cover political dialogue, mutual right of establishment of firms, supply of services, liberalization of capital flows, movement of workers, and various forms of economic, financial, and technical cooperation. Consistent with their recognition of the associated countries' ultimate objective of joining the EU, the EAs also foresee the approximation of these countries' laws with those of the EU, particularly in trade-related areas such as competition, state subsidies, customs, product standards, and intellectual property rights.

Trade

The trade part of most EAs foresees the establishment of a free trade area for industrial products between the EU and each associated CEEC within 10 years of the entry into force of each agreement. The provisions of the EAs are asymmetric in the sense that the period for the phase-out of import restrictions is much shorter for the EU than for the CEECs. The EAs obliged the EU to abolish within one year of their entry into force quantitative restrictions on all industrial imports from the associated CEECs except for textiles and coal, and tariffs on most of the EU's industrial imports. For a number of "sensitive products," including coal, iron, steel, some chemicals, leather goods, footwear, glass, clothing, and textiles, tariffs were to be abolished over a period of two to five years (six years in the case of the products

Table 2. EU Membership Applications, European Commission Opinions, and Membership Prospects

	Official application for EU memberhip	European Commission opinion Date issued	Result 1/	Accession negotiations initiated in: 2/	Tentative date of membership
CEECs:					
Albania	...	...	...	...	...
Bosnia-Herzegovina	...	...	...	...	...
Bulgaria	Dec-95	Jul-97	Negative 3/	...	...
Croatia	...	...	...	...	...
Czech Republic	Jan-96	Jul-97	Positive 3/	Mar-98	2002
Estonia	Nov-95	Jul-97	Positive 3/	Mar-98	2002
Hungary	Mar-94	Jul-97	Positive 3/	Mar-98	2002
Latvia	Oct-95	Jul-97	Negative 3/	...	...
Lithuania	Dec-95	Jul-97	Negative 3/	...	...
FYR of Macedonia	...	...	...	...	...
Poland	Apr-94	Jul-97	Positive 3/	Mar-98	2002
Romania	Jun-95	Jul-97	Negative 3/	...	...
Slovak Republic	Jun-95	Jul-97	Negative 3/	...	...
Slovenia	Jun-96	Jul-97	Positive 3/	Mar-98	2002
FR of Yugoslavia	...	...	...	...	...
Mediterranean countries:					
Cyprus	Jul-90	Jul-93	Positive 4/	Mar-98	2002
Malta	Jul-90 5/	Jun-93	Positive	...	...
Turkey	Apr-87	Dec-89	Negative 4/	...	...

Source: European Commission

1/ Negative opinions imply an assessment that the country in question is not ready to start accession negotiations in the near term.

2/ Refers to the start of formal negotiations on the accession treaties.

3/ Opinions issued in the context of the European Commission's Agenda 2000 documents and endorsed by the Luxembourg European Council of December 1997. The degree of preparedness for membership of the countries that did not receive a positive opinion is to be reevaluated regularly (probably on an annual basis).

4/ Opinion reiterated in the Agenda 2000 and the Luxembourg European Council of December 1997.

5/ The Maltese government formed following the October 1996 election decided to freeze Malta's membership application indefinitely.

included in the Multifiber Agreements).[6] These sensitive products, however, account for about 50 percent of the associated CEECs' exports to EU, and arguably include some products in which the CEECs would seem to have a comparative advantage over EU countries. Trade in agricultural products is in principle excluded from the proposed free trade area. Nevertheless, the EAs foresee reduced tariffs for a number of agricultural products, generally within a given quota, with either the tariff or the quota becoming less restrictive over a five-year period.[7]

At the European Council meeting of Copenhagen in June 1993, the EU decided to accelerate substantially the pace of liberalization for sensitive industrial products and to advance by six months a reduction in duties and an increase in quotas for agricultural products compared with what had been envisaged in the EAs. Also, the European Council of Essen in December 1994 agreed to align the liberalization timetable for custom duties and tariff quotas for Bulgaria and Romania with that for the Visegrad countries as from January 1, 1995.[8] As a result, all statutory tariffs on industrial imports from the associated CEECs, except certain textiles, were eliminated by January 1996. Tariffs on products from the Visegrad countries, Bulgaria, and Romania that were covered by the Multifiber Agreements were abolished in January 1997, ahead of the dates set in the Uruguay Round agreements. Those on textile imports from Slovenia, Latvia, and Lithuania were eliminated in January 1998. Thus, since that date, all industrial imports from the 10 associated CEECs into the EU have been free of duties. However, this duty-free treatment of industrial imports from the associated CEECs cannot really be considered preferential, given that about 80 percent of the EU's industrial imports from all countries are free of tariffs.

In terms of possible contingent protection, the EAs include standstill clauses that prohibit the introduction of any new duties or quantitative restrictions from the date of entry into force of the agreements, safeguard clauses, anti-dumping provisions, and rules of origin.[9] The CEECs,

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[6]In the case of the Baltic countries, however, all industrial exports to the EU except textiles from Latvia and Lithuania were fully liberalized as of the date of entry into force of their free trade agreements with the EU (January 1995).

[7]The average tariff applied by CEECs on agricultural goods is lower than EU rates on these goods. Thus, as noted by Baldwin et al. (1997), EU enlargement and the requirement of adopting the EU's common external tariff is likely to lead to an important increase in CEEC agricultural protection against third-country suppliers.

[8]The Visegrad countries comprise the Czech Republic, Hungary, Poland, and the Slovak Republic.

[9]The EAs include six safeguard clauses referring to specific products or groups of activity and one general safeguard clause. Rules of origin specify how custom officials should determine the origin of goods when they have been processed in, or transported through, different

(continued...)

however, are allowed to derogate under exceptional circumstances the standstill clause in order to protect infant industries and sectors under restructuring. The contingent protection embodied in the anti-dumping and general safeguard clauses, and the use the EU has made of them in several instances, have been criticized for being one of the most restrictive aspects of the EAs.[10] The anti-dumping provision may seem unnecessarily restrictive, given that CEECs are obliged under the EAs to introduce the EU competition rules, which also prohibit dumping, within three years. As for the general safeguard clause, it has sometimes been noted that its drafting is laxer and more open to abuses than that of the comparable Article XIX of GATT.[11] It should also be indicated that the EU has negotiated in recent years Voluntary Export Restraints (VERs) for certain categories of steel exports from associated CEECs.

It has been argued that the pursuit by the EU of separate EAs with each CEEC, as opposed to a multilateral preferential trade zone with all of them, could divert foreign direct investment (FDI) from CEECs to the EU and reduce intra-CEEC trade.[12] For example, a company may decide to supply the associated CEEC markets from an EU location, despite the lower production and transportation costs of alternative CEEC locations, because of the existence of relatively high tariffs on intra-CEEC trade flows or simply because of uncertainty about the continuity of intra-CEEC trade agreements. The "hub-and-spoke" nature of the EAs therefore may tend to marginalize the "spoke" economies (the associated CEECs) to the benefit of the "hub" (the EU).

These undesirable "hub-and-spoke" effects of the EAs were until recently exacerbated by their relatively strict rules of origin. The original protocols on rules of origin attached to the EAs set relatively demanding requirements (in terms of changes in tariff headings or value added produced locally) for classifying goods as produced in the associated CEECs. This tended to deter investment in these countries.[13] For example, a Western firm interested in setting up an assembly plant in a CEEC with relatively cheap unskilled labor to produce low value-added goods and export them to the EU markets did not qualify for EU trade preferences if it used too many inputs from countries outside the EU and the country in question. This led some

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[9](...continued)
countries, in order to know which tariffs to apply.

[10]See, for example, Faini and Portes (1995, p.3) and EBRD (1994, p. 118). For a different view and a detailed description of the EAs' contingent protection rules, see European Commission (1994c).

[11]See EBRD (1994, p.118).

[12]See Baldwin (1994, pp.130-39).

[13]The rules of origin initially contained under the EAs and their possible implications are discussed in European Commission (1994c and 1994d) and Messerlin (1992).

Western firms to build their factories in EU countries despite their higher labor costs. So-called cumulation provisions can limit these negative effects to the extent that they allow the value added in other countries with similar preferential trade agreements to count as local content. Unfortunately, while the EAs permitted bilateral cumulation (between the CEEC concerned and the EU) of local content, as well as diagonal cumulation among Visegrad countries (e.g., between the Slovak Republic, Poland, and the EU), they did not provide for cumulation between the Visegrad countries, Bulgaria and Romania.

Recognizing the shortcomings of the rules of origin initially contained in the EAs, the European Council of Essen agreed to take the necessary steps to extend the diagonal cumulation provisions to Bulgaria, Romania and, eventually, to all new associated CEECs (in particular, the Baltic countries and Slovenia). It also proposed to introduce this diagonal cumulation of content between the countries of the European Free Trade Association (EFTA) and the associated CEECs.[14] This so-called *pan-European cumulation* initiative materialized in the amendment of the protocols on rules of origin of all the EAs during the first half of 1997. Since July 1997, 31 countries, including the 15 member states of the EU, the 10 associated CEECs, the four EFTA countries, Andorra, and San Marino, benefit from this pan-European multilateral cumulation of content; Turkey is expected to join the system in January 1999.[15]

The EU has also encouraged the associated CEECs to liberalize trade among themselves partly on the grounds that it will limit the diversion effects of the EAs. Two major intra-regional CEECs trade arrangements have been concluded: the Central European Free Trade Association (CEFTA), currently comprising the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia; and the Baltic Free Trade Agreement, among Estonia, Latvia, and Lithuania. The associated CEECs have also concluded free trade agreements with the countries of the EFTA as a whole, shadowing the EAs.

Current account convertibility and capital flows

Regarding current account convertibility, the contracting parties must ensure the full convertibility of their currencies for all current transactions liberalized under the EAs. Since all the associated CEECs had already introduced a high degree of current account convertibility at the beginning of the transition, this obligation was not particularly constraining. All the associated CEECs except Bulgaria have subsequently accepted the obligations under Article VIII of the IMF's Articles of Agreement, and Bulgaria is expected to take this decision reasonably soon. With effect from their entry into force, the EAs also obliged the contracting

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[14]Following the integration of some EFTA countries into the EU in 1995, membership of EFTA has been reduced to Iceland, Norway, Switzerland, and Liechtenstein.

[15]The rational and main principles of the pan-European cumulation system are explained in European Commission (1994d).

parties to liberalize FDI flows between themselves, as well as the repatriation of these investments and of any profits stemming from them.[16]

In addition, the parties commit themselves to taking measures during the first five years of application of the EAs to facilitate the application of EU rules on the free movement of capital. At the end of this five-year period, the Association Council, the highest bilateral consultative body created by the EAs, is to examine ways to apply those rules in full. Since the Maastricht Treaty has extended the obligation to fully liberalize capital movements to transactions vis-à-vis third countries, this part of the EAs amounts in practice to the acceptance by CEECs of the medium-term objective (but without committing themselves to a concrete timetable) of fully opening their capital accounts vis-à-vis all countries. The EAs also incorporate a standstill clause prohibiting—as from the date of entry into force of the EAs for the EU countries, and as from the end of the fifth year of applicability of the EA for the CEECs—the introduction of any new foreign exchange restriction on capital flows or current payments between residents of the two contracting parties.

Movement of workers

The EAs basically only oblige each contracting party to prevent discrimination, based on nationality, of legally employed workers from the other party and to ensure access to the labor market of the legally resident spouse or children of a legally employed worker from the other party. The EAs therefore do not ease in any significant way the relatively restrictive immigration rules of EU countries vis-à-vis the CEECs. There is only a vague commitment on the part of EU member states to try to preserve or improve, subject to the situation in their labor markets, these immigration rules: the Association Council will examine within five years of the entry into force of the EA ways in which the mobility of workers between the two parties could be enhanced.

Political dialogue

Finally, the EAs introduce an institutional framework to promote a bilateral political dialogue. An Association Council meeting once a year at the ministerial level, an Association Committee meeting twice a year at the senior official level, and a number of specialized subcommittees, have been created.[17] The EAs also foresee regular contacts at the parliamentary level. At the meetings of the Association Council and Committee, all EU member states are represented along with the CEEC concerned and the European Commission.

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[16]However, free movement need only be ensured by the end of the fifth year after the entry into force of the EAs in the case of FDI flows related to the establishment of physical persons as self-employed.

[17]Under each EA, a "Subcommittee on Economic Issues" has been created to discuss broad macroeconomic and structural reform issues at twice-a-year meetings.

C. Prospects for EU Membership: Where We Stand

The principle of an EU enlargement to the associated CEECs was first announced at the European Council of Copenhagen in June 1993, the same Council meeting where the EU decided to shorten the trade liberalization schedules initially fixed under the EAs.[18] The Conclusions of the Presidency issued after this meeting commit the EU to admitting all associated CEECs, provided they meet certain economic and political conditions (known since then as the "Copenhagen criteria" for accession), namely: i) the existence of stable institutions guaranteeing democracy, the rule of law, human rights, and respect for the protection of minorities; ii) the existence of a functioning market economy and the capacity to cope with competitive pressures and market forces within the EU; and iii) the ability to take on the obligations of membership, including adherence to the aims of political, *economic, and monetary union* (emphasis in italics added).

The Conclusions noted as a further condition the EU's capacity to absorb new members without slowing the pace of European integration.[19] This last condition can be important, since the enlargement to the CEECs, most of which are relatively poor, populous, and agrarian, is expected to imply a significant cost for the EU budget, notably by increasing Common Agricultural Policy (CAP) expenditures and transfers from the Structural and Cohesion Funds, and to complicate the decision-making process within the EU as the number of countries increases. However, recent estimates of the budgetary cost of an Eastern enlargement of the EU are substantially lower than earlier calculations had suggested.[20]

Since the Copenhagen Council, a pre-accession strategy for the associated CEECs has progressively taken shape (see Table 3).[21] In Copenhagen, the Council launched the so-called structured dialogue with associated CEECs. The idea, which was further developed at the European Council of Essen in December 1994, was to provide a multilateral framework through which associated countries could discuss at the ministerial level issues of common concern. Since 1995, joint meetings of the ministers responsible for each of the main policy

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[18]This commitment on the part of the EU is not contained in the EAs, which only acknowledge the associated countries' desire to eventually join the EU.

[19]For a further discussion on the interpretation and implications of the Copenhagen criteria, see European Commission (1997a) and Daviddi and Ilzkovitz (1997).

[20]For example, Baldwin, the author of one of the most quoted earlier estimates (Baldwin, 1994), has recently revised (Baldwin et al., 1997) his estimate of the net cost in the year 2000 of an enlargement to the four Visegrad countries from about ECU 60 billion to about ECU 20 billion. See also European Commission (1997a) for more details on the implications of an Eastern enlargement for the EU.

[21]See European Commission (1994a and 1994b) and European Council (1994).

Table 3. Milestones in the Relations Between the EU and CEECs

Date	Event
1970	The EU signs the first nonpreferential trade agreement with the former Yugoslavia.
1971	The Generalized System of Preferences (GSP) is created and the former Yugoslavia is granted GSP treatment
1975	The EU signs a second nonpreferential trade agreement with former Yugoslavia. Romania is granted GSP treatment.
1988-90	The EU signs Trade and Cooperation Agreements (TCAs) with Hungary (1988), Poland (1989), and the former Czechoslovakia, Bulgaria and Romania (1990), and extends GSP treatment to all of them. In 1989, the EU launches the PHARE program, initially limited to Hungary and Poland but subsequently extended to other CEECs. The EU grants its first balance of payments support loan to a CEEC (Hungary), in the context of the G-24 initiative.
1991	The EU signs Europe Agreements (EAs) with the former Czechoslovakia, Hungary, and Poland.
1992	Interim Agreements implementing trade aspects of EAs with Czechoslovakia, Hungary, and Poland enter into force. The EU signs TCAs with each of the Baltic countries and Albania.
1993	The EU signs EAs with Bulgaria and Romania. Interim Agreements with these two countries enter into force. The EU signs TCA with Slovenia. The European Council of Copenhagen accepts the principle of, and lays down the general criteria for, EU membership of the CEECs. It also accelerates the trade liberalization calendars envisaged in the EAs.
1994	EAs with Hungary and Poland enter into force. The EU signs free trade agreements with the Baltic countries. European Council of Essen launches "pre-accession strategy" for CEECs, including the "structured dialogue", and asks the Commission to prepare White Paper on the harmonization of legislations in CEECs with those of the EU. Hungary applies for EU membership.
1995	EAs with Bulgaria, the Czech Republic, Romania, and the Slovak Republic enter into force. EAs with Baltic countries signed. European Commission presents White Paper. Bulgaria, Romania, the Slovak Republic, and the Baltic countries apply for EU membership. The European Council of Madrid asks the European Commission to submit opinions on membership applications soon after the end of the 1997 Intergovernmental Conference (IGC), and announces that accession negotiations with countries receiving positive opinions will start six months after the end of the IGC.
1996	Slovenia signs EA and applies for EU membership.
1997	Following the proposals made by the European Commission in the Agenda 2000, the European Council of Luxembourg agrees to start accession negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia in the spring of 1998. The pre-accession strategy for all applicant CEECs is reinforced by the decisions to establish "accession partnerships" and increase pre-accession financial assistance.
1998	EAs with Baltic countries enter into force. Accession negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia start.

Source: European Commission

areas (e.g., foreign affairs, agriculture, transport, and finance) have been taking place once or twice a year between the 15 EU countries and all the associated CEECs.[22] In addition, the Heads of State and Government of the EU and the associated CEECs have been holding joint meetings on the sidelines of the European Council meetings.

The Essen summit also requested the European Commission to prepare a White Paper indicating the key measures that the associated CEECs should take in order to align their legislation with that of the EU internal market, thus preparing themselves for the eventual acceptance of the whole *acquis communautaire* when they join the EU. This White Paper was presented by the Commission in May 1995, following consultations with the associated countries.[23] The PHARE program has also been adapted to focus increasingly on the legal and institutional changes needed for EU membership and to shift emphasis partly from technical assistance to the financing of investment (including that on trans-European infrastructures).

In December 1995, the European Council of Madrid called on the Commission to submit as soon as possible after the end of the Intergovernmental Conference (IGC) of 1997 its opinions on the applications for EU membership from the associated CEECs, and to prepare a study on the impact of the enlargement on the EU, including a medium-term financial framework. More importantly, the Madrid summit announced that negotiations with those CEECs receiving a favorable opinion on their accession request could begin six months after the end of the IGC. The IGC, which had started in early 1997, finished at the European Council of Amsterdam in June 1997 (Treaty of Amsterdam). A month later, the Commission presented its opinions on membership, as well as the other studies requested by the Council, in the so-called Agenda 2000.[24]

In its Agenda 2000, the Commission proposed to start membership negotiations with five associated CEECs: the Czech Republic, Estonia, Hungary, Poland, and Slovenia. The proposal reflected the Commission's assessment of the degree to which the different candidate countries satisfied the economic and political criteria laid down at the Copenhagen summit.[25] When the Agenda 2000 was endorsed by the European Council meeting of Luxembourg in December 1997, the Council confirmed that accession negotiations with these countries would start in the spring of 1998. These negotiations were formally launched in March 1998 and are

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[22]Thus, for example, the Ministers of Finance of the EU member states and the associated CEECs have been holding two joint meetings a year (so-called Joint ECOFINs), one devoted to macroeconomic matters and the other to structural reform issues.

[23]See European Commission (1995a).

[24]European Commission (1997a).

[25]Three of these countries (the Czech Republic, Hungary, and Poland) are already members of the OECD and have been accepted into NATO.

expected to last at least two years.[26] The accession treaties must then be ratified by the Parliaments of the incumbent EU members and of the new members, a process that can easily take another year and a half. Furthermore, a new IGC has yet to resolve the issue of the institutional reforms required by the new enlargement of the EU, a thorny issue that was left pending at the 1997 IGC. For all these reasons, the integration of these four CEECs into the EU is unlikely to take place before 2002. And, as noted in the conclusions of the Luxembourg Council, these CEECs might not all join the EU at the same time, the actual timing depending on the difficulty of negotiating and ratifying each individual accession treaty.

The Luxembourg summit also decided to reinforce the pre-accession strategy for all applicant CEECs (including those that were not to start negotiating accession treaties in 1998) through the creation of a new instrument called "accession partnerships" and an increase in pre-accession aid. It was also decided at that summit to launch in March 1998 an intensified pre-accession dialogue (as opposed to formal accession negotiations) with the associated CEECs that have not yet received a positive opinion on their membership applications. The accession partnerships, which were approved by the Commission in March 1998, centralize for each applicant country all forms of EU financial and technical assistance, and identify a number of economic or political measures each country should take to prepare for membership, including a basic timetable for the adoption of the *acquis communautaire* in certain priority areas. Pre-accession aid is to be strengthened by further focusing the PHARE program on accession priorities and, as from the year 2000, by providing financial support for the development and adaptation to the CAP of the agricultural sectors of associated CEECs and by establishing a structural adjustment instrument similar to the Cohesion Fund. This financial assistance is to be linked to the applicant countries' progress in adopting the *acquis communautaire.*

The Commission will report on a regular (probably annual) basis to the Council on the fulfillment of the targets contained in each accession partnership. On the basis of these reports, the Commission will decide whether to recommend to the Council that accession negotiations start with other applicant countries. Some other CEECs may therefore receive a favorable opinion on their accession requests over the next few years; and it is not inconceivable that, if their membership negotiations were to proceed very smoothly, they could join the EU at the same time as some of the countries selected in Agenda 2000.

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[26]Accession negotiations with the EFTA countries that joined the EU in 1995 lasted only one year. These countries, however, were to provide net contributions to the EU budget, and had already introduced much of the *acquis communautaire* in the context of the European Economic Area agreement with the EU. Furthermore, since CEECs are still transition economies and will be joining a more deeply integrated EU than existed when the EFTA countries joined, they will have to make a comparatively greater effort of harmonization of legislation. The negotiations with Portugal and Spain, two countries that were less advanced than the EFTA countries and were to become net recipients of EU transfers, lasted several years.

Finally, the Luxembourg Council decided to organize a "European Conference" that will bring together EU incumbent countries and all countries aspiring to join the EU. Initially, only the associated CEECs, Cyprus, and Turkey have been invited to take part in the conference, but it seems that other CEECs could eventually participate provided they meet certain political requirements. The conference is intended to provide a multilateral forum for political consultation, and contribute to deepen cooperation in economic matters, foreign and security policy, and justice and home affairs. It will meet once a year at the level of Heads of State or Government and, where necessary, at the ministerial level; its first meeting took place in March 1998.

III. Relations with the EU: Selected Mediterranean Countries

The integration into the EU of Greece, Spain, and Portugal, and the EAs with CEECs, have increased the degree of competition faced in the EU market by the countries of the Southern Mediterranean Rim. Partly in response to this, the EU launched a new Mediterranean strategy in 1995, the basic principles of which were stated in the Barcelona Declaration of November of that year. This strategy, which is normally implemented through the signing of so-called Euro-Mediterranean Association Agreements (EMAs), aims at strengthening political ties and creating a free-trade area for industrial goods comprising the EU, 11 Mediterranean countries, and the territory under the Palestinian Authority over 12 years.[27] On agricultural products, the EMAs only envisage the reciprocal extension of preferential access at a later stage. Like the EAs concluded with CEECs, the EMAs include liberalization measures in the areas of the supply of services, right of establishment, capital movements, and harmonization of trade-related legislation. In contrast with the EU's policy toward associated CEECs, however, its new Mediterranean policy does not in general contemplate the eventual accession of the Mediterranean countries to the EU. The new Mediterranean policy also implies a substantial increase in financial and technical assistance from the EU in support of the liberalization and structural reform efforts of Mediterranean countries.[28]

Cyprus, Malta, and Turkey signed the Barcelona declaration and are eligible for the type of trade concessions and financial support envisaged under the EU's new Mediterranean policy. All these countries, however, are considered by the EU to be special cases, requiring a non-standard approach. Turkey, Cyprus, and Malta had all signed in the 1960s and 1970s first-generation Association Agreements (AAs) with the EU, foreseeing the gradual establishment of customs unions (CUs) with the EU, a more ambitious integration objective than the free

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[27]The 11 Mediterranean countries are Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Syria, Tunisia, and Turkey. The EU has signed EMAs with Israel, Morocco, Tunisia, and Jordan, and an Interim Agreement with the Palestinian Authorities. Similar agreements are currently being negotiated with Lebanon, Algeria, Egypt, and Syria.

[28]A more detailed description of this strategy and the EMAs is contained in Nsouli et al. (1996) and Alonso-Gamo et al. (1997).

trade areas contemplated in the EU's new Mediterranean policy (see Table 4). While in the case of Cyprus and Malta the provisions of the AAs aimed at creating a CU were not developed as planned, a Customs Union Agreement (CUA) with Turkey entered into force at the end of 1995. Moreover, in the case of Cyprus and Malta, the AAs were seen as a stepping stone toward full EU membership. This possibility (although still remote) is also open for Turkey, as recognized in Article 88 of its AA with the EU.

A. Cyprus and Malta

Cyprus and Malta, both small Mediterranean islands with close economic and political ties with the United Kingdom, signed similar AAs with the EU in 1972 and 1970, respectively (see Table 4). The signing of these AAs was partly prompted by the need to limit trade diversion effects from the expected entrance of the United Kingdom into the EU (effective in 1973). Both AAs foresaw the gradual establishment of a CU. In a first stage (lasting five years for Malta and four for Cyprus), both parties undertook a significant but asymmetric reduction of tariffs on industrial products, with tariff protection declining more substantially in the EU. At the end of a second, vaguely defined stage, a CU was to be created. While in the case of Malta, the EU made no concessions on agricultural products, Cyprus agreed with the EU on certain mutual concessions in this area, affecting a considerable share of Cyprus' agricultural exports to the EU. The timetables for the establishment of the CUs, however, were not respected. Cyprus and the EU signed in 1987 a Supplementary Protocol laying down the procedures for the creation by the year 2001 or 2002 of the CU envisaged in the AA.[29] In the case of Malta, the second stage of the AA has not got underway.

Both Cyprus and Malta submitted formal applications for EU membership in 1990, with the European Commission delivering favorable opinions on both applications in 1993. The Commission's opinion on Cyprus however noted the difficulties created by the continued division of the island, and the EU Council decided to postpone the beginning of the accession negotiations, hoping that the negotiations undertaken by the two parts of the island under the auspices of the United Nations would come to a satisfactory conclusion. In the event, these talks finished with disappointing results.

The agreement on a CU with Turkey created a more propitious context in which to consider the accession of Cyprus. In March 1995, the EU Council approved the CUA with Turkey and simultaneously announced that accession negotiations with Cyprus would begin six months after the end of the 1997 IGC, implying that negotiations with the internationally recognized, Greek-Cypriot government could start before a political settlement on the future of the island is reached. This timing was confirmed in the Commission's Agenda 2000. The idea, which is

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[29]The Protocol foresees the establishment of the CU in two phases. During the first, lasting 10 years, trade in agricultural products and certain industrial products will remain subject to restrictions. Passage to the second phase is not automatic; it requires a further decision by the two parties.

Table 4. Trade and Association Agreements Between the EU and Selected Mediterranean Countries

	Association Agreements		**Customs Union Agreements**	
	Signed	In force	Signed	In force
Cyprus	10-Dec-72	1-Jun-73	21-Dec-87 1/	2/
Malta	5-Dec-70	1-Apr-71	...	...
Turkey	12-Aug-63	1-Nov-64	22-Dec-95	31-Dec-95

Source: European Commission

1/ Date of signing of a Supplementary Protocol defining the conditions and procedures for the implementation of the customs union envisaged in the Association Agreement.

2/ The Protocol foresees the establishment of a customs union between Cyprus and the EU by the year 2001 or 2002.

shared by the United Nations, is that "the decision to open negotiations should be seen as a positive development which could promote the search for a political settlement."[30]

The Luxembourg summit of December 1997 announced that accession negotiations with Cyprus would begin in the spring of 1998 and called for the participation of representatives from the Turkish Cypriot community in the negotiating delegation. Accession negotiations began in March 1998, but have been complicated by the difficulties in the relations between Turkey and the EU that have followed the EU's decision to exclude Turkey from its present enlargement plans (see below).[31]

In April 1995, the Council announced that membership negotiations with Malta would start six months after the conclusion of the IGC. However, the government of the "anti-EU" Maltese Labor Party, formed following the October 1996 general election, decided in November of that year to freeze Malta's membership application. While the membership application has not been formally withdrawn, which should facilitate its rapid reactivation should Malta wish so in the future, this has put Malta's prospects of EU membership on the back burner for the time being. Malta's government has nonetheless indicated to the EU its interest in creating a free trade area with the EU for industrial products and cooperating on certain other issues. The Commission's Agenda 2000 does not contain any reference to Malta.

B. Turkey

The Association Agreement of Ankara of 1963 recognized the objective of a gradual establishment of a CU between Turkey and the EU, with a view to the possible accession of Turkey into the EU at a later stage.[32] An additional protocol defining a concrete timetable with measures aimed at the creation over a 22-year period of a CU was signed in 1970 and became effective in 1973. Following several delays, the agreement implementing the final phase of the CU was signed on December 22, 1995 and entered into force on December 31, 1995.

Under the CUA, customs duties on industrial and processed agricultural goods have been eliminated by both parties. The CUA however does not cover traditional, nonprocessed agricultural products, nor trade in services. The elimination of tariffs on imports of industrial

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[30]European Commission (1997a).

[31]Partly in reaction to the Luxembourg decisions, the Turkish-Cypriot government has so far refused to participate in the EU accession negotiations, having declined an offer in this respect made by the Greek-Cypriot government. It has also threatened to boycott any resumption of the UN-sponsored talks with the Greek-Cypriot community.

[32]This was the second AA ever signed by the EU. The first one had been signed with Greece in 1961.

and processed agricultural goods from the EU, together with the adoption by Turkey of the (on average lower) EU's Common External Tariff, has resulted in a substantial reduction in Turkey's average protection rates.[33] However, Turkey retains a number of exemptions to the EU's Common External Tariff, with full harmonization slated to occur only in 2001. Turkey was also given a five-year period to align itself with the preferential trade agreements between the EU and third countries. In addition to the tariff reductions, Turkey is in the process of harmonizing its legal system with that of the EU in trade-related areas (mainly competition policy, state aids, customs regulations, and intellectual property).

Turkey submitted an application for membership to the EU in 1987. In its 1989 opinion on Turkey's application, the Commission noted that Turkey was not prepared to join the EU, although it reaffirmed the country's eligibility for membership. The Agenda 2000 acknowledged that "the CU has demonstrated the Turkish economy's ability to cope with the competitive challenge of free trade in manufactured goods," but continued to argue—on both economic (macroeconomic instability and structural weaknesses) and political grounds (development of democracy, human rights, protection of minorities, relations with Greece, and the problem of Cyprus)—that Turkey is still not ready for membership. The European Council of Luxembourg reiterated Turkey's eligibility for membership, confirmed that Turkey will be judged by the same objective criteria and standards as other applicants, and, as noted, invited Turkey to participate in the European Conference. However, it excluded Turkey from any concrete pre-accession talks or strategy, and implicitly linked Turkey's participation in the European Conference to the country meeting certain political conditions such as a commitment to refer its territorial disputes with Greece to the International Court of Justice.[34]

At the request of the EU Council, the Commission issued a communication to the Council in July 1997 proposing ways, other than EU membership, to deepen the EU's relations with Turkey.[35] The Commission's proposals include a further liberalization of agricultural trade, the liberalization of trade in services, Turkey's participation in certain EU programs, and increased cooperation in areas such as the environment, trans-European networks, justice and home affairs. The Commission also supports the conclusion by Turkey of trade agreements with the CEECs and other Mediterranean countries.

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[33]See IMF (1997c, p. 36).

[34]In reaction to these decisions, the Turkish government has frozen the political dialogue with the EU, and decided not to attend the first meeting of the European Conference.

[35]European Commission (1997b).

IV. Institutional Implications of EMU for Countries with EU Membership Prospects

EMU is part of the *acquis communautaire* and the EU has decided that no more opt-out-from-EMU clauses—such as those granted to the United Kingdom and Denmark by the Maastricht Treaty—will be accorded to new countries entering the EU. CEECs and Mediterranean countries joining the EU in the future will therefore have to prepare themselves and ultimately join the euro area.

As part of their respective accession treaties, some newcomers could get a "transitory period" for the monetary part of the *acquis communautaire*, just as they could in principle get transitory periods for certain aspects of, say, the CAP or the EU's environmental legislation. There are however several reasons why such formal transitory periods are unlikely. First, there seems to be a consensus within the EU that transitory periods for newcomers should be limited in number, scope, and duration.[36] Second, most candidate countries for EU membership seem keen to participate in EMU as soon as this becomes possible. Third, those newcomers that, for macroeconomic reasons, will not be ready to participate in EMU should not need a formal transitory period since, in any case, they will be unlikely to comply with the Maastricht convergence criteria required for joining the euro area.

It cannot be ruled out that some EMU incumbent countries could show reluctance to accept newcomers into the euro area even if they met all the Maastricht criteria. Incumbent countries might argue that while those countries may have achieved nominal macroeconomic convergence, they still show an excessive degree of real and structural divergence, which could make their participation in the euro area problematic for both newcomers and incumbents. For example, for a CEEC that meets all Maastricht criteria but is still undergoing rapid systemic change, it may be particularly difficult to assess upon entry into the euro area the level and trend of its equilibrium real exchange rate. The level at which its exchange rate is fixed irrevocably when it adopts the euro, therefore, could soon prove inadequate. Also, a newcomer with an insufficient degree of structural convergence and economic and financial integration with the EU will be more likely to suffer asymmetric shocks with respect to the EMU area.[37]

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[36]In its Agenda 2000, the Commission proposes to avoid derogations and keep transitory periods to a minimum in the new accession treaties to be negotiated.

[37]The possible reluctance of incumbent euro-area countries to accept structurally weak newcomers in their monetary area would, however, be unlikely to lead the former to ask for transitory periods at the time of the EU membership negotiations with latter. Rather, it would surface at the time the EU Council had to vote on whether the countries in question were ready to adopt the single currency.

It should also be noted in this context that, for practical and technical reasons, it seems difficult for the countries under analysis to join the EU and EMU simultaneously. As discussed in the reports on the matter prepared by the European Monetary Institute (EMI) and the European Commission in 1995, it can take up to three and a half years from the time the exchange rates are fixed irrevocably among participant currencies to make all the practical arrangements needed for the changeover to the single currency.[38] Although this is a maximum period and new entrants will benefit from the changeover experience of the original members of the euro area, institutional weaknesses in the banking system, government, and enterprises are likely to create extra difficulties for the non-EU countries under discussion. Applicant countries would therefore have to start the technical preparations well before becoming EU members, even though their prospects of joining the euro area might remain uncertain at that juncture. Furthermore, these technical preparations would impose a significant additional burden on the private and public sectors of these countries at a time when they would already be making a great effort to adapt to other areas of the *acquis communautaire*.

For countries aiming at EU membership and, by implication, eventual participation in the euro area, EMU has two types of institutional or policy implications. The first and most obvious stems from the fact that these countries will need to satisfy the macroeconomic convergence criteria laid down by the Maastricht Treaty before they can join the euro area. This will increase pressure on candidate countries to design their fiscal, monetary and exchange policies in a way that facilitates the convergence toward those Maastricht guideposts. Many of these countries are already keeping a eye on these convergence criteria when formulating their economic policies.[39] Secondly, unless they obtain transitory periods, countries joining the EU will have to fulfill from their date of membership all the legal and institutional requirements that apply to EU countries remaining outside the euro area ("member states with a derogation," in the terminology of the EU).[40] These requirements include, in particular, granting full independence to their central banks, prohibiting the monetary financing of government deficits, and fully liberalizing capital flows, including vis-à-vis third countries. Preparing for the adoption as of their dates of EU membership of this *acquis communautaire* in the area of EMU may well pose a more immediate challenge for candidate countries than adjusting their macroeconomic situation for acceding to the euro area.

The remainder of this paper discusses each of the two institutional impacts of EU membership and EMU in turn.

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[38]See EMI (1995) and European Commission (1995b).

[39]This may seem premature, at least for some countries with distant EU membership prospects.

[40]Except in the case of the United Kingdom and Denmark, these "derogations" are temporary, thus being an hybrid between a real (permanent) derogation and a transitory period.

A. Satisfying the Maastricht Convergence Criteria

As noted earlier, "the ability of CEECs to adhere to the aims of EMU" was explicitly mentioned by the Copenhagen European Council as one of the criteria for EU membership. Policy makers in CEECs have sometimes interpreted this as meaning that their countries should meet the Maastricht criteria on inflation, government deficit, public debt, long-term interest rates, and exchange rate stability as a precondition for joining the EU.[41] ***As the European Commission and the Council have stressed on several occasions, however, the Maastricht convergence criteria are not accession criteria.*** The Copenhagen criteria refer to the ability of applicant countries to adhere to the aims of EMU rather than their ability to actually join the euro area.

Table 5 shows how the countries covered by this paper fared in 1996-1997 in terms of all the convergence criteria except the exchange rate criterion.[42] Since medium- and long-term securities markets in most of the countries under review remain underdeveloped, it was generally not possible to obtain data on 10-year government bonds or on other representative bonds of similar maturities. Instead, information on average bank lending rates or treasury bill yields was used for most countries.

Table 5 indicates that none of the countries examined complied in 1997 with all four of the reported convergence criteria, but that a majority of them satisfied at least two of them. Among the best-positioned countries were FYR of Macedonia, Cyprus, and Malta. FYR of Macedonia was the only country to satisfy the inflation criterion and the only one to meet three of the criteria, but it missed by a wide margin the interest criterion. Cyprus was the only country where interest rates were below the Maastricht reference value; it also met the debt criterion and was within reach of the reference value for inflation, but its government deficit increased significantly in 1997, moving further away from the Maastricht ceiling. Malta met or was very close to meeting all the criteria except the deficit criterion.

Other countries that were comparatively close to the Maastricht targets were Croatia, the Czech Republic, Estonia, the Slovak Republic, Slovenia, and the Baltic countries, all of which comfortably met the two fiscal criteria (Estonia and Latvia even ran budget surpluses),

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[41]The exact definition of these criteria is summarized in the initial footnote to Table 5.

[42]The exchange rate criterion is, strictly speaking, not applicable for the countries under analysis since they do not share an exchange rate arrangement with the EU. Judged on the basis of no realignment for two years, however, only Croatia, Cyprus, Estonia, Malta, the Slovak Republic, and Slovenia would appear to meet the criterion. In recent years, these six countries have maintained their exchange rates within narrow bands against the deutsche mark, the ECU, or a basket dominated by one of these two currencies. Lithuania, in the context of its currency board arrangement (CBA), and Latvia have also maintained stable pegs in recent years, although vis-à-vis the U.S. dollar and the SDR, respectively.

Table 5. Maastricht Convergence Indicators, 1996-97
(In percent)

	Consumer Price Inflation 1/		**General Government Balance/GDP 2/**		**Gross Government Debt/GDP 3/**		**Long-Term Interest Rates 4/**	
	1996	1997	1996	1997	1996	1997	1996	1997
CEECs:								
Albania	12.7	32.1	-12.1	-13.6	30.8	37.0	17.7	32.5
Bulgaria	123.0	1082.2	-13.4	-4.4	105.8	105.2	300.1	209.9
Croatia	3.5	3.6	-1.6	-2.6	38.0	35.7	18.5	14.2
Czech Republic	8.8	8.4	-1.2	-2.1	10.2	10.9	12.5	13.2
Estonia	16.7	11.3	-1.5	2.0	6.9	5.6	12.3	11.4
Hungary	23.6	18.0	-5.1	-5.7	74.1	68.0	28.2	23.1
Latvia	17.6	8.4	-1.3	1.3	13.8	10.8	26.2	14.4
Lithuania	24.7	8.8	-4.6	-1.9	23.7	22.2	24.1	13.0
FYR Macedonia	2.5	1.7	-0.4	-0.4	53.5	59.0	22.4	21.2
Poland	19.9	15.1	-3.3	-3.6	49.2	48.2	19.6	23.9
Romania	38.8	155.0	-3.9	-3.5	23.4	31.3	71.5	107.0
Slovak Republic	5.8	6.1	-1.3	-4.8	24.5	26.7	13.5	20.9
Slovenia	9.7	9.1	-0.1	-1.8	23.5	24.1	23.7	21.3
Mediterranean countries:								
Cyprus	3.0	3.5	-3.4	-5.1	54.3	53.4	7	6.5
Malta	3.0	3.0	-8.6	-8.0	42.1	47.0	7.7	7.9
Turkey	82.3	85.7	-11.5	-9.1	37.8	36.0	132.4	105.2
Memorandum items:								
All EU 5/	2.5	1.9	-4.3	-2.6	73.2	72.7	...	5.5
Reference value 6/	**2.5**	**2.6**	**-3**	**-3**	**60**	**60**	...	**7.2**

Sources: National sources; and IMF staff estimates.

Note: The table shows IMF staff estimates of the convergence criteria mentioned in the Maastricht Treaty, except for the exchange rate. The convergence criteria are: (1) annual consumer price inflation must not exceed that of the three best performing countries by more than 1.5 percentage points; (2) interest rates on long-term government securities must not be more than 2 percentage points higher than those in the three member states with the lowest inflation; and (3) the government deficit should not be excessive. In this context, a country will be considered to have an excessive deficit if either the general government deficit exceeds 3 percent of GDP (unless this ratio has been declining substantially and continually and is close to the reference value, or the excess over the reference value is exceptioinal and temporary), or if its public debt exceeds 60 percent of GDP (unless this ratio is sufficiently declining and approaching that reference value at a satisfactory rate). The exchange criterion is that the currency must have been traded without severe tensions within the normal fluctuation bands for at least two years, in particular without a devaluation at the initiative of the member state in question.

1/ Consumer price inflation data are based on national statistics and may not be consistent with the harmonized consumer prices constructed by EUROSTAT, which are those that will be used in applying the Maastricht criteria. The data shown in the table are average inflation rates.

2/ May not correspond to EUROSTAT definitions and coverage. Excludes privatization revenues. For Croatia and Cyprus, balance of the consolidated central government. For Hungary, balance adjusted for some items (mostly sales of assets) that should be treated as financing items. For the Baltic countries, data includes net lending as expenditure. For Turkey, public sector borrowing requirement (with a negative sign reflecting a borrowing need).

3/ Data on public debt may not be consistent with the definition agreed in Maastricht. Data for Albania only includes domestic public debt. For Estonia, public and publicly guaranteed foreign debt.

4/ The Maastricht criterion refers to yields on government bonds of 10-year (or nearest) maturities. Owing to the lack of long-term bonds with market-based yields, the interest rates shown for most CEECs and Malta are bank lending rates. For Albania, rate on 90-day treasury bills. For Poland, rate on 52-week treasury bills. For Turkey, average yield on T-bills across maturities ranging from 3 months to 1 year. Data are average rates for the year. For the Slovak Republic, end-of-period rates.

5/ Average weighted by GDP shares, based on purchasing-power parity valuation of countries' GDP levels. For interest rates, January 1998 data.

6/ For inflation and interest rates, based on simple average of the three EU countries with the lowest inflation. For interest rates, January 1998 data.

showed (except Estonia) one-digit inflation rates (3½ percent in the case of Croatia), and had interest mostly in the 10-20 percent range. Poland and Hungary were in an intermediate position. Poland met the debt criterion and exceeded the reference value for the government deficit only by a small margin, but showed somewhat higher interest rates than the group of four countries just mentioned and a significantly higher, though also more rapidly declining, inflation rate. Lagging somewhat behind Poland was Hungary, which did not meet any of the criteria, although it achieved significant declines in inflation and the debt ratio in 1997. Among the worst-situated countries were Bulgaria (which was far from meeting any of the criteria), and Albania, Turkey, and Romania (all of which met the debt criterion but missed the other three criteria by wide margins).[43]

Three main conclusions emerge from Table 5. First, a majority of countries appeared to satisfy, or to be close to satisfying, the two fiscal criteria: all countries except Bulgaria and Hungary seemed to comply with the public debt criterion, while 9 countries seemed to satisfy or (in the case of Poland and Romania) be close to satisfying the government balance criterion. The data on government balances and debt shown in Table 5, however, are not always consistent with the Maastricht definitions, and they may tend to give a more favorable picture of these countries' compliance with the Maastricht criteria than warranted. In particular, while the government balances shown in Table 5 have been adjusted when necessary to show privatization revenues below-the-line, as required by the EUROSTAT definitions, they normally do not capture quasi-fiscal operations, which are sizeable in a number of countries.[44] Second, the inflation and interest criteria remain elusive for most countries and future convergence in these two areas is expected to be slow and difficult. Third, there does not seem to be a strong correlation between performance in terms of the Maastricht criteria, on the one hand, and progress made with structural reform and levels of economic development, on the other. In fact, some relatively advanced countries such as Hungary or Poland scored relatively poorly in terms of these nominal convergence criteria, while some countries with less developed market economies and institutions such as the FYR of Macedonia or Croatia fared relatively well on these criteria.[45]

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[43]In the case of Bulgaria, however, the data on average 1997 inflation and interest rates shown in Table 5 provide an overly negative picture. Since Bulgaria introduced a CBA in July 1997, its inflation and interest rates have declined dramatically: annualized CPI inflation during the first four months of 1998 was 11.6 percent and average bank lending rates stood at 14.4 percent in April 1998.

[44]In Romania, for example, the deficit on quasi-fiscal operations by the national bank, which is not included in the data shown in Table 5, is estimated at 2 ½ percent of GDP for 1996.

[45]For an analysis of compliance with the Maastricht criteria in CEECs in a broader context that also looks at indicators of structural and per capita income convergence to the EU, see Fischer et al. (1998).

B. The *Acquis Communautaire* in the Area of EMU

This section discusses the main obligations (and rights) in the economic and monetary areas that the Maastricht Treaty and secondary legislation adopted subsequently imply for EU countries with a derogation. Some of the obligations already apply since the start of Stage II of EMU; others will only become effective (for all EU member states) once Stage III of EMU begins.[46] Compliance with these obligations does not constitute per se a criterion for EU membership, though progress toward fulfilling them has influenced, and is likely to influence in the future, the Commission's opinions on EU membership applications. A summary of the rules in the area of EMU that are applicable to countries with a derogation in Stage III of EMU, including where appropriate the exclusions, is provided in Table 6.

Participation in ERM II

At its meeting of Amsterdam of June 1997, the European Council defined the main principles and elements of a new Exchange Rate Mechanism (ERM II) that will replace the current one in Stage III of EMU.[47] ERM II has been conceived only for EU currencies. No exchange rate arrangement is being envisaged for the time being between the euro and the currencies of neighboring non-EU countries. The AAs signed between the EU and CEECs or Mediterranean countries do not foresee any form of exchange rate cooperation. European Commission officials have nonetheless indicated that an exchange rate arrangement involving the euro for at least some of the associated CEECs is likely to be high on the EU's political agenda in the coming years, although any such arrangement should not threaten the price stability objective of the European Central Bank (ECB).[48] The possibility of exchange rate arrangements with non-EU currencies is also contemplated in Declaration No. 5 annexed to the Maastricht Treaty, which states that "the Community shall be prepared to cooperate [on monetary and exchange rate matters] with other European countries and with those non-European countries with which the Community has close economic ties."

Looking ahead, once the countries under analysis join the EU, they will be confronted with the decision on when to join ERM II. As in the case of the current ERM, membership of ERM II

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[46]The Maastricht Treaty conceives EMU as a three-stage evolutionary process. Stage II began on January 1, 1994 with the creation of the EMI and the entry into effect of the obligations to fully liberalize capital flows and to avoid any privileged financing of governments (including direct central bank credits). Stage III will start for all EU countries (including those with a derogation) on January 1, 1999, when the 11 EU countries selected at the Brussels summit of May 1998 (all the EU countries except Denmark, Greece, Sweden, and the United Kingdom) will fix irrevocably their exchange rates and start pursuing a common monetary policy.

[47]See European Council (1997a). See also European Council (1996).

[48]See Berrigan and Carré (1997).

Table 6. Rules in the Area of EMU Applicable to Countries With A Derogation, in Stage III of EMU

Rights and obligations	Relevant Legislation 1/	Exclusions	Relevant Legislation 1/
Exchange rate policy			
* Obligation to treat exchange rate policy as a matter of common interest	Art. 103 and 109m of Treaty	* Participation in single exchange rate policy vis-a-vis third countries	Art. 109 of Treaty and 43 of Protocol
* Participation in ERM II	Art. 109j; European Council meetings of Dublin (Dec.'96) and Amsterdam (Jun.'97), Conclusions of the Presidency		
Financing of the government			
* Prohibition of central bank direct financing	Art. 104 of Treaty; Council Reg. EC/3603/93		
* Prohibition of privileged financing	Art. 104a of Treaty; Council Reg. EC/3604/93		
* No bail-out provision	Art. 104b of Treaty		
Central bank independence, goals, and participation in the ESCB			
* Independence from government 2/	Art. 107 of Treaty and 7 of Protocol	* Participation in single monetary policy	Art. 43 of Protocol
* Price stability as primary goal	Art. 102 of Treaty and 2 of Protocol	* Participation in Governing Council and Executive Board of ECB	Art. 109a Treaty and 43 of Protocol
* Governor's term of no less than 5 years	Art. 14 of Protocol		
* Restrictions on capacity to dismiss the Governor	Art. 14 of Protocol	* Nomination of Executive Board of ECB	Art. 43 of Protocol
		* Pooling of foreign exchange reserves	Art. 30 and 43 of Prot.
* Participation in ESCB	Art. 106 of Treaty and 14 of Protocol	* Sharing of ECB's seignorage income and transferring of net profits to ECB	Art. 32, 33 and 43 of Protocol
* Participation in General Council of ECB	Art. 45 of Protocol		
Liberalization of capital flows			
* Liberalization vis-a-vis EU countries	Art. 67, 69 and 71 of Treaty and Directive 88/361/EEC		
* Liberalization vis-a-vis third countries	Art 73b of Treaty		
Financial assistance			
* Emergency financial assistance	Art. 103a of Treaty		
* Balance of payments loans	Art. 109 h of Treaty		
Policy coordination and surveillance			
* Obligation to treat economic policy as a matter of common interest	Art. 103 of Treaty		
* Broad economic policy guidelines	Art. 103 of Treaty		
* Participation in Economic and Financial Committee	Art. 109c of Treaty		
* Convergence programs	European Council Resolution on Stability and Growth Pact (June 17, 1997); Council Regulation EC/1466/97	* Stability programs	Council Regulation EC/1466/97
* Excessive deficit procedure 3/	Art. 104c and Protocol No 5 of Treaty; European Council Resolution on Stability and Growth Pact (June 17, 1997); Council Regulations EC/1466/97 and EC/1467/97	* Sanctions in case of excessive deficits	Art. 104c and 109k of the Treaty

Sources: Treaty of the European Community and other legislation.

1/ Treaty refers to the Treaty of the European Economic Community, as modified by the Treaty on European Union signed in Maastricht on February 7, 1992. Unless otherwise indicated, Protocol refers to Protocol No. 3 on the Statutes of the European System of Central Banks and of the European Central Bank, annexed to the Treaty.

2/ The United Kingdom is not required to have an independent central bank if it chooses not to participate in EMU (Art. 5 of Protocol No. 11 annexed to the Treaty).

3/ The United Kingdom does not have a legally binding obligation to avoid excessive deficits in Stage III of EMU (Art. 5 of Protocol No. 11 annexed to the Treaty).

will be voluntary, but EU countries with a derogation "can be expected to join the mechanism."[49] Participation in the ERM under the normal fluctuation bands for at least two years remains a criterion for admission to the euro area, although the admission of Finland and Italy (both of which had been in the ERM for less than two years) suggests that the EU Council is not interpreting this criterion strictly.[50]

ERM II, as currently envisaged, will be based on standard fluctuation bands of ±15 percent defined vis-à-vis the euro, which will be the anchor currency. This implies bilateral fluctuation bands twice as large among non-euro participant currencies. Both marginal and intra-marginal interventions supported by a slightly modified version of the current Very Short Term Financing Facility will be possible, provided they do not impinge on the ECB's primary objective of price stability. The commitment of the ECB to intervene in the foreign exchange markets to support a particular non-euro currency is therefore limited. Timely realignments of central parities will be encouraged. Countries having reached a sufficient degree of convergence with the euro area may enter, if they so wish, into closer exchange rate links involving (publicly announced or secret) narrower fluctuation bands vis-à-vis the euro. These forms of closer exchange rate cooperation, however, must be approved by a procedure involving the European Commission, the Economic and Financial Committee (the body replacing the Monetary Committee at the start of Stage III of EMU), the ECB, and the ministers of finance of the euro-area countries, in addition to the country requesting it.

Its voluntary nature, the wide bands, calls for timely realignments, and the possibility of closer exchange rate links for certain countries make ERM II a flexible system, which would seem to accommodate the varying circumstances of the associated CEECs and other candidate countries for EU membership. Some of these countries may require a significant degree of exchange rate flexibility for a certain period after joining the EU for several reasons: their inflation differentials with the euro area may remain significant; they will be more exposed to asymmetric shocks; and their rapid pace of structural transformation is likely to affect their equilibrium real exchange rate. This is acknowledged by representatives of the European Commission. Referring to the CEECs entering the EU, Berrigan and Carré (1997, p. 125) note that the flexibility of ERM II "allows one to conceive of a broad spectrum of exchange rate arrangements within the new mechanism, ranging from very loose pegs to progressively tighter arrangements, including a currency board."

Table 7 summarizes the current exchange rate regimes of the countries under analysis. A majority of these countries currently peg (de jure or de facto) their currencies to the deutsche

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[49]European Council (1997a, Annex II, p. 16)

[50]In justifying its decision, the Council noted that the Italian and Finnish currencies had appreciated or remained stable against the ERM currencies since March 1996. See European Council (1998).

Table 7: Exchange Rate Regimes, May 1998

	Exchange Rate Regime	Basket/Target	Fluctuation Band	Remarks
CEECs:				
Albania	Independent float			
Bosnia-Herzegovina	Currency board	DM	0%	Currency board was formally introduced on June 20, 1997.
Bulgaria	Currency board	DM	0%	Currency board introduced on July 1, 1997. Its Law foresees the substitution of the DM by the euro as currency of peg upon launching of EMU.
Croatia	Managed float	De facto narrow target band vis-a-vis DM		The kuna has remained within narrow band against the DM since devaluation of October 1993
Czech Republic	Managed float			On May 27, 1997, the central bank was forced to abandon ±7.5% fluctuation band against a basket including the DM (65%) and the US$ (35%)
Estonia	Currency board	DM	±3%	Currency board was introduced in June 1992.
Hungary	Crawling peg	Basket: DM (70%), US$ (30%)	±2.25%	Mid-point of the band is devalued monthly by 0.9% against the basket
Latvia	Fixed peg	SDR		The exchange rate has been pegged to the SDR since February 1994.
Lithuania	Currency board	US$	0%	Currency board was introduced in April 1994.
FYR Macedonia	Managed float	De facto peg to DM		Denar devalued by 14.2% on July 9, 1997, after having been stable against DM since early 1994
Poland	Crawling peg	Basket: US$ (45%), DM (35%), £ (10%), F (5%), SWF (5%)	±7%	Mid-point of the band is devalued monthly by 1% against the basket
Romania	Independent float			
Slovak Republic	Fixed peg	Basket: DM (60%), US$ (40%)	±7%	Crown has remained stable against reference baskets since 10% devaluation in July 1995
Slovenia	Managed float	De facto shadowing of DM, combined with real exchange rate rule		
FR Yugoslavia	Fixed peg	DM		The dinar was devalued by 70% in November 1995 and by 45% in March 1998.
Mediterranean countries:				
Cyprus	Fixed peg	ECU	±2.25%	
Malta	Fixed peg	Basket: ECU (67%), US$ (21%), £ (12%)	±0.25%	
Turkey	Managed float	Real exchange rate rule		

Sources: *Annual Report on Exchange Arrangements and Restrictions, 1997,* IMF; and IMF staff reports.

mark, the ECU, or a basket dominated by one of these two currencies.[51] In addition, Poland uses a basket where the deutsche mark and the French franc have a combined weight of 40 percent. Upon the launching of Stage III of EMU, these countries will have to either replace these currencies with the euro or change the nature of their exchange arrangements.[52] As more CEECs gear their exchange rate policies toward the euro, the advantages for other CEECs (in terms of the stabilization of the nominal effective exchange rate) of pegging to the euro will tend to increase. This, in conjunction with the prospect of EU accession, may lead other countries to also adopt the euro as a reference currency, or to increase the weight of this currency in their currency baskets. Indeed, the three-stage plan to exit the CBA announced by Lithuania last year explicitly foresees the eventual pegging of the litas to the euro or a basket including the euro in the third stage (scheduled to take place not earlier than 1999).[53]

As some of the countries under analysis join the EU, they may need to further adjust their exchange rate arrangements if they wish to participate in ERM II. Countries with CBAs or other (formal or de facto) fixed pegs could continue with similar arrangements within ERM II, with the associated advantages in terms of intervention and financing facilities. Countries with pre-announced crawling pegs (such as Hungary or Poland) or floating exchange rates (such as Albania, Romania, and Turkey), however, would have to substantially modify their exchange rate regimes to join ERM II. All countries, including those that will decide to stay out of ERM II after joining EU, will be subject to the obligation to treat their exchange rate policy as a matter of common interest (Art. 109m of the Treaty).[54]

Central bank independence

All EU member states should ensure, at the latest at the time of establishment of the European System of Central Banks (ESCB), that their national legislation (including the central bank statutes) is compatible with the Treaty and the Statutes of the ESCB (Art. 108 and 14 of

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[51]This includes Hungary's crawling peg. Croatia, the Czech Republic, FYR of Macedonia, and Slovenia can be included in this group, because, although they formally have managed floats, in practice they "shadow", or try to stabilize their currencies against, the deutsche mark.

[52]Cyprus has recently announced its intention to shift the exchange rate peg in January 1999 from the ECU to the euro. Also, the Bulgarian CBA law (Art. 29) foresees the substitution of the deutsche mark by the euro at the start of Stage III of EMU. In the Bulgarian case, since the law stipulates that the substitution will take place at the same exchange rate used by euro-area countries to convert the deutsche mark into the euro, the possibility of taking advantage of this conversion to adjust the level of the exchange rate of the lev is legally precluded.

[53]See Bank of Lithuania (1997).

[54]All references to articles hereafter refer to the Treaty of the European Economic Community as modified by the Treaty on European Union signed in Maastricht on February 7, 1992.

Protocol No. 3).[55] This implies in particular: i) that their central bank governors should be elected for terms of no less than five years and should only be dismissed under circumstances of serious misconduct or inability to perform their duties (Art. 14 of Protocol No.3); ii) that their central banks should not take any instructions from the government (Articles 107 and 7 of Protocol No. 3); and iii) that they should have as primary objective the maintenance of price stability (Articles 105 and 2 of Protocol No.3).[56] Since the ESCB is to be established in June 1998, new countries joining the EU will have to fulfill these requirements as of their dates of accession to the EU. In addition, iv) national legislation should prohibit any form of direct credit from the central bank to the government as of the beginning of Stage II of EMU.

These four provisions in the Maastricht Treaty are all aimed at ensuring the independence of the central banks from the public authorities. They deal with each of the four legal characteristics used by Cukierman to construct a measure of statutory central bank independence.[57] These characteristics refer to: i) the rules on the appointment, dismissal, and term of office of the chief executive of the central bank (usually the governor); ii) the capacity of the central bank to formulate monetary and exchange rate policy without government interference; iii) the stated ultimate objectives of the central bank; and iv) the limitations on the central bank's ability to lend to the public sector. Table 8 describes the current status of the countries under analysis regarding the first three of these legal characteristics. The situation concerning the fourth characteristic is discussed in the next section.

When two-tier banking systems were established at the beginning of the transition process, many CEECs endowed their newly created central banks with a relatively high degree of independence (Estonia in the context of a CBA). The new central bank laws often mirrored existing Western central bank laws, in particular the Bundesbank law. Subsequently, many countries enacted new legislation increasing central bank independence (including the introduction by Lithuania of a CBA in 1994). This process has gathered momentum recently with the amendment of the law on the National Bank of Hungary of December 1996, the adoption of CBAs in Bulgaria and Bosnia-Herzegovina in July and June 1997, respectively, the adoption of a new Constitution and central bank law in Poland in mid-1997 that enshrine the principle of an independent central bank, and the passing of new central bank laws in

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[55]The United Kingdom, however, is exempt from this obligation if it decides not to participate in the euro area.

[56]While Article 14 of the Protocol only refers to the terms of the Governors, the EMI is of the opinion that these minimum term requirements should also apply to other members of the decision-making bodies of the EU national central banks. The EMI also calls for incompatibility clauses for such members, which the Maastricht Treaty only stipulates explicitly for the members of the ECB's Executive Board (Art. 11.1 of Protocol No.3). See EMI (1996).

[57]See Cukierman (1992) and Cukierman et al. (1992).

Table 8. Indicators of Statutory Central Bank Independence
(Situation as of end-January 1998)

	Composition, appointment and dismissal of Boards	Objective(s) of the central bank	Policy formulation
Albania	Board of 9 members, all appointed by Parliament on government proposal. The President of the Republic appoints Governor, and the Board appoints 2 Deputy Governors. All members have 7-year terms renewed on a rotating basis. They can be reappointed. Dismissal only possible for well-specified reasons not related to policy.	Main goal: price stability. Other objectives (development of financial and foreign exchange markets, ensuring orderly monetary conditions conducive to balanced economic growth) are subordinated to primary goal in case of conflict.	Independence from government is explicitly stated in the CB law. MoF has right to attend Board meetings but is not entitled to vote. Exchange rate and monetary policies are formulated by CB alone.
Bosnia-Herzegovina	During first 6 years of existence of CB, the Board will consist of a Governor, appointed by IMF after consultation with the Presidency of Bosnia-Herzegovina, and 3 other members appointed by that Presidency. 1/ After these 6 years, Board will be composed of 5 members appointed by Presidency. Board will appoint Governor from among its members. All members will have 6-year renewable terms. They may only be dismissed under well-specified reasons not related to policy.	Only objective: price stability	Independence from other public authorities explicitly stated in CB law. CB alone formulates monetary policy. Exchange rate constrained by legal obligation, under the currency board, to peg the domestic currency to the deutsche mark.
Bulgaria	Board of 7 members: a Governor appointed by Parliament, 3 Deputy Go-Governors proposed by the Governor and appointed by Parliament, and 3 other members appointed by President of Republic. All members have 6-year terms renewed on a rotating basis. CB law lists reasons for dismissal of members but does not exclude dismissal on other grounds.	Main objectives: stability of national currency and development of an efficient payments mechanism.	Independence from government bodies explicitly stated in CB law. Exchange rate policy is constrained by currency board arrangement.
Croatia	Board composed of Governor, Deputy Governor, 2 or more Vice-Governors and up to 8 other members, all appointed by Parliament for 6-year terms. Deputy and Vice Governors appointed upon recommendation of Governor. Regarding the dismissal of Board members, the CB law only notes that this is to be decided by the Parliament.	Primary goals: stability of national currency, and maintainance of liquidity in domestic and international payments. Other objectives: support economic policies of government provided this does not endanger primary goals.	CB law states that the CB will formulate independently monetary and exchange rate policies.

Table 8 (continued). Indicators of Statutory Central Bank Independence
(Situation as of end-January 1998)

	Composition, appointment, and dismissal of Boards	Objective(s) of the central bank	Policy formulation
Czech Republic	Board of 7 members: the Governor, 2 Vice-Governors, and 4 other members, all appointed by the President of Republic for 6-year terms. They can only be dismissed in limited number of cases defined by CB law.	Primary goal: price stability.	CB formulates exchange and monetary policy independently from government. Government may attend Board meetings in advisory capacity.
Estonia	Board consists of Chairman and 8 other members (including Governor). All appointed by Parliament for 5 years, the Chairman upon nomination of President of Republic, the other members upon nomination of Chairman. Law does not limit reasons for dismissal of Board members.	Main goal: ensure stability of the currency. CB will also support economic policies of government provided this does not conflict with primary objective.	Law states that the CB shall be independent from government, and will pursue monetary and banking policy independently. Exchange rate policy is constrained by currency board arrangement. MoF attends Board meetings without voting rights.
Hungary	Board consists of President, up to 5 Vice-Presidents, and other members in a number equal to the number of Vice-Presidents plus 1. All members appointed by President of Republic (Vice-Presidents upon CB President nomination, and President and other members upon Prime Minister nomination). President and Vice-President have 6-year terms. Other members have 3-year terms. Law lists reasons for dismissal but does not exclude dismissal on other grounds.	Main goal: to safeguard the domestic and external purchasing power of the national currency. The CB law, however, also indicates that the CB will support the economic policy program of the government.	The CB law states that the CB will formulate and implement monetary policy independently, without being subject to instructions from the government. Exchange rate policy, however, is approved by the government in agreement with the CB. The government is represented at CB Board by a Minister.
Latvia	Board consists of Governor, Deputy Governor, and 6 other members, all appointed for 6-year terms. Governor nominated and appointed by Parliament. Other members appointed by Parliament upon recommendation of Governor. Law lists reasons for dismissal but does not exclude dismissal on other grounds.	Main goal: maintainance of price stability. Other objectives: facilitate free and efficient allocation of financial resources, and ensure the stability of the financial system.	The CB law states that the CB shall not be subject to instructions from the government. It shall formulate monetary and exchange rate policy, and banking supervision independently. MoF may attend board meetings without voting rights.
Lithuania	Board consists of Chairman, 3 Deputy Chairmen, and 10 other members. Chairman appointed for 5-year term by Parliament upon recommendation of President of Republic. Other members appointed for 9 years by President of Republic upon recommendation of Board Chairman. Board members may only be removed for health, criminal, or incompatibility reasons.	Main goal: price stability. Other objectives: ensure proper operation of foreign exchange market and payments system, and support government's economic policy provided this does not conflict with main goal.	The CB law states that the CB shall be independent from government. Exchange rate policy is contrained by currency board arrangement.

Table 8 (continued). Indicators of Statutory Central Bank Independence
(Situation as of end-January 1998)

	Composition, appointment, and dismissal of Boards	Objective(s) of the central bank	Policy formulation
FYR of Macedonia	Board consists of Governor and 8 other members appointed by Parlia-Parliament for 7 years. The Governor is nominated and recalled by President of Republic and can be reappointed. A Deputy Governor (for 7-year term) and one or more Vice-Governors (for 4-year terms) are appointed among Board members, at Governor's proposal, with the possibility of one reappointment. CB law does not limit reasons for dismissal.	Primary objectives: stability of the currency and the liquidity of domestic and international payments.	CB law states that the CB will act independently.
Poland	Board of 10 members: the President, appointed by lower house of Parliament upon recommendation from President of Republic, and 9 other members appointed in equal numbers by Lower House, Senate, and President of Republic. All members serve 6-year terms and may only be removed for health or criminal reasons.	Primary goal: price stability. In addition, CB will support government policies provided this does not conflict with primary objective.	The Constitution and the CB law enshrine the principle of full independence of the CB from the government. CB formulates monetary policy, and implements the exchange rate policy defined by government in agreement with the CB Council.
Romania	Board consists of Governor, Vice-Governor, 2 Assistant Governors, and 5 other members, all appointed by Parliament at Prime Minister proposal for 5-year renewable terms. CB law lists limited number of reasons for dismissal and forbids removal on other grounds.	Primary goal: currency and price stability. Other objectives: development of financial markets and normal operation of banking system.	Law does not recognize independence from government but assigns to CB full responsibility for exchange rate and monetary policy. Board meetings may be attended by MoF without voting rights.
Slovak Republic	Board consists of Governor, 2 Vice-Governors, 2 Executive Directors and three other members. Governor and Vice-Governor appointed by President of Republic upon government recommendation, with consent of Parliament. Other members appointed by government upon recommendation of Governor. Terms: 6 years for Governor, Vice-Governors and Executive Directors; 4 years for other members. Law lists 3 reasons for dismissal of Board members but does not exclude dismissal on other grounds.	Primary goal: stability of the currency. Within the limits defined by the CB law, the CB will also support the economic policy of the government.	The CB law states that the CB shall fulfill its tasks independently of instructions given by the government. Deliberations of the CB Board may be attended by a member of the government in an advisory role. Exchange rate and monetary policies are formulated by the CB alone.

Table 8 (concluded). Indicators of Statutory Central Bank Independence
(Situation as of end-January 1998)

	Composition, appointment, and dismissal of Boards	Objective(s) of the central bank	Policy formulation
Slovenia	Board consists of Governor, Deputy Governor, 3 Vice-Governors and 6 independent experts. Governor and experts appointed by Parliament upon proposal of President of Republic. Other members appointed by Parliament upon proposal of Governor. All members serve 6-year terms. CB law does not restrict possible reasons for dismissal of Board members.	Primary goals: the stability of the currency and the liquidity of domestic and international payments.	CB law states that CB shall act independently in carrying out its assignments.
Cyprus	Board consists of Governor and Deputy Governor, appointed jointly by President and Vice-President of Republic for at most 5 years, and 5 Directors appointed by government for 5-year terms. All members can be reappointed. Terms are renewed on a rotating basis. CB law lists a number of reasons for dismissal but does not exclude dismissals on other grounds.	Main goal: to foster monetary stability and credit and balance of payments conditions conducive to the orderly development of the economy. In so doing, the CB must have due regard to the economic conditions prevailing in the country.	Independence from government is not stated in CB law. A representative of MoF can attend CB Board meetings, propose subjects to include in agenda, express views without voting rights, convene meetings under certain conditions, and temporarily suspend a Board decision if deemed incompatible with CB law or contrary to public interest.
Malta	Board consists of Governor and Deputy Governor, appointed by the President on advice of the Prime Minister for 5-year renewable terms, and three other members, appointed by Prime Minister for 3-year renewable terms. CB law lists some reasons for dismissal but does not exclude others.	Goals: safeguard international value of the currency, promote orderly and balanced economic development, rising level of employment and income consistent with price and currency stability, and foster development of capital markets.	Independence is not recognized by CB law. The MoF may, if thought necessary in the national interest, and after consultation with the Governor, give written instructions to the CB and the CB must comply with them.
Turkey	Board consists of Governor and 6 other members. Governor is appointed by government for 5 years upon Board proposal. Other members are appointed for 3 years by the CB's General Assembly of Shareholders (Treasury is majority shareholder). All members can be reappointed. Governor can only be dismissed for the reasons listed in the CB law.	Main goals: to conduct money and credit policy in conformity with Government Development and Annual Programs; and to take, jointly with government, measures to guarantee internal and external stability of the currency	Independence is not recognized by CB law. Monetary policy is formulated jointly with government, in consideration of the latter's economic policies. Exchange rate policy is formulated within the guidelines defined by the government.

Sources: Central Bank laws and amendments, and other national legislation.

Note: CB = Central Bank. MoF = Minister of Finance

1/ The Central Bank of Bosnia-Herzegovina was established on June 20, 1997 under a currency board arrangement.

Albania and Romania in January 1998.[58] Some of these recent changes in central bank laws (in particular, those in Hungary and Poland), as well as some of the amendments being planned in other countries, explicitly aim at better aligning these laws to the EU standards and, in that respect, EMU is already having an institutional impact on these countries.

Following this recent wave of changes in legislation, many CEECs satisfy or are close to satisfying the first three central bank statutory requirements laid down by the Maastricht Treaty. Albania, Bosnia-Herzegovina, the Czech Republic, Lithuania, and Poland already fully comply with such requirements. All the CEECs appoint their governors for tenures of at least five years, as stipulated in the Maastricht Treaty (see Table 8). In fact, in all these countries except Estonia, Romania, and Lithuania, the Governor is elected for six or seven years, implying a term considerably longer than their electoral cycles. In a few of them (Hungary, FYR of Macedonia, and the Slovak Republic), however, some of the other members of the Board have terms of less than five years, which, as noted, would not be consistent with the stricter interpretation of the EU rules made by the EMI. In addition, some countries do not restrict by law the possible reasons for removal of Board members (Bulgaria, Croatia, Estonia, Hungary, Latvia, the Slovak Republic, and Slovenia).[59]

With respect to the statutory objectives, practically all the CEECs have price or currency stability (or both) as their sole or primary goals, to which they subordinate any other stated objectives. To the extent that "currency stability" is associated with price stability, stating the main objective in this way would seem consistent with the Maastricht treaty. As emphasized by some authors, however, currency stability (or the stability of the external purchasing power of the currency, as stated in the National Bank of Hungary's law) may in some cases be in conflict with price stability.[60] Regarding policy formulation, the central bank laws of all CEECs except Romania explicitly enshrine the principle of independence from the government, which extends to both monetary and exchange rate policy in all of them except Hungary (where exchange rate policy is approved by the government, although in agreement with the central bank). Finally, in line with the EMI's interpretation of the Maastricht Treaty requirements, the central bank acts of many CEECs contain incompatibility clauses for high central bank officials, aimed at preventing potential conflicts of interest.

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[58]The new law on the Bank of Albania, drafted with IMF support, aims at reducing government interference following two politically motivated changes of Governor in less than six months in 1997.

[59]The central bank laws of Bulgaria, Hungary, Latvia, and the Slovak Republic list a limited number of reasons for dismissal, all consistent with the cases foreseen by the Maastricht Treaty, but do not explicitly exclude removal on other grounds.

[60]See Radzyner and Riesinger (1997, p. 63), who also provide a comprehensive analysis of statutory and de facto measures of central bank independence in the Visegrad countries and Slovenia.

The relatively high degree of statutory central bank independence in the CEECs contrasts with the situation prevailing in the three Mediterranean countries examined here (see Table 8). While Cyprus, Malta, and Turkey all meet the Maastricht requirement that governors be appointed for terms of at least five years, the length of the term (five years in the three countries) is lower than that seen in most CEECs, and, except for Turkey, none of these three countries restricts the reasons for the dismissal of Board members. Central bank goals include, without clear subordination to a price stability objective, the orderly development of the economy (Cyprus and Malta), promoting a rising level of income and employment (Malta), and supporting the government's economic policy (Turkey). The independence of the central bank from the government is not recognized in any of these three countries. In Malta and Cyprus, a government representative has some important prerogatives in the Board of the central bank, and in Turkey the government plays a key role in the formulation of exchange rate and (jointly with the central bank) monetary policy. These three countries will therefore need to undertake substantial changes in their central bank laws to adapt them to the Maastricht requirements.

While the extent to which countries satisfy the Maastricht rules under discussion provides a good measure of their degree of statutory central bank independence, legal independence is only one of the factors that determine the actual degree of independence. The latter depends also on elements such as tradition, the personality of central bank managers, and how actively the government uses its possible channels of influence. One approach to measuring actual (as opposed to statutory) independence, popularized by Cukierman, is to look at the rate of "turnover" of central bank governors.[61] Table 9 provides data on the average rate of turnover of governors for seven of the countries under analysis, which can also be interpreted as a measure of the average term of office of governors in each country. Table 9 also shows average turnover data for industrial and developing countries.

The main conclusion that emerges is that all the countries for which turnover data were available experienced high turnover rates, implying a relatively low degree of de facto independence. Turnover rates were particularly high for Poland, Hungary, and Turkey, but they significantly exceeded in all seven countries the average turnover rate seen in industrial countries in 1980-89.[62] While the recent amendments of central bank legislation in Hungary and Poland are not reflected in these ratios, the data suggest that the legal status of central banks in CEECs overstates their actual independence.

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[61]See Cukierman (1992) and Cukierman et al. (1992).

[62]In the Czech Republic, the Slovak Republic, Slovenia, and Malta in the period 1980-89, however, turnover rates were below the average in developing countries. Average turnover rates for 1950-89 in the 72 industrial and developing countries analyzed by Cukierman ranged from a minimum of 0.034 (implying one change in governor every 29 years) to a maximum of 0.93 (an average tenure of only about 13 months).

Table 9. Turnover Rate of Central Bank Governors in Selected Countries

	Period of observation	Turnover rate 1/
CEECs:		
Czech Republic	1992-97	0.23
Hungary	1991-97	0.38
Poland	1989-97	0.49
Slovak Republic	1992-97	0.23
Slovenia	1991-97	0.17
Mediterranean countries:		
Malta	1972-79	0.38
	1980-89	0.20
Turkey	1972-79	0.38
	1980-89	0.40
Memorandum items:		
Average of 21 industrial countries	1980-89	0.13
Average of 51 developing countries	1980-89	0.29

Sources: Radzyner and Riesinger (1997) for the CEECs; and Cukierman et al. (1992) for the Mediterranean countries and industrial and developing countries averages.

1/ Calculated as the number of governors divided by the length (in years or fractions of years) of the period of observation. A higher turnover rate, therefore, indicates a lower average term of office of the governor and, therefore, a lower degree of actual central bank independence. Because in all countries the electoral cycle is of at least four years, central bank independence is normally expected to decline seriously for turnover rates above 0.25.

Looking at turnover ratios seems relevant in the case of the countries under review insofar as there seems to be a negative correlation between the frequency of the change of governor and inflation, at least in developing countries.[63] Empirical evidence also suggests that there is a negative correlation between statutory independence and inflation, but this correlation does not seem to hold for developing countries.[64] With the central banks of CEECs having been established at most nine years ago and their laws having been amended frequently, there is not a sufficiently long track record to produce robust econometric relations between central bank independence and inflation, and few studies have attempted this. There is, however, some evidence that transition countries with more (statutorily) independent central banks had lower inflation than their counterparts, even after controlling for different initial conditions, fiscal performance, and the quality of structural reforms.[65]

Monetary and other privileged financing of the government

As noted above, the Maastricht Treaty requires all countries to renounce any form of direct central bank financing of government deficits from the beginning of Stage II of EMU (Art. 104). This applies to overdraft facilities, advances, and the purchase directly from public institutions by the central bank of government securities (including purchases in the primary market). Only indirect credit through the purchase of government securities from a third party (as in the case of open market operations or the refinancing of banks against government paper as collateral) is allowed. A Council Regulation of December 13, 1993 (Regulation EC/3603/93) has clarified the exact application of the prohibitions of Article 104. Regarding the possibility of overdrafts or short-term advances, it allows intraday credits on the grounds that they may be necessary to guarantee a smooth operation of the payments systems.[66]

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[63]See Cukierman et al. (1992).

[64]Also see Cukierman et al. (1992). Another important finding of the empirical literature on central bank independence is that "goal independence" (the central bank's capacity to choose freely the ultimate objectives of monetary policy) does not play a significant role in generating the negative correlation between independence and inflation observed for industrial countries. Rather, what seems to matter for inflation performance is "instrument independence" (the central bank's power to pursue it goals in the manner it deems most appropriate). See Debelle and Fischer (1994). Evidence on the relationship between central bank independence and inflation is discussed in IMF (1996b, Box 11, pp. 128-29).

[65]See Loungani and Sheets (1997). This study used a sample of 12 transition countries including Albania, Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Poland, and Romania, and is based on regressions of inflation on two alternative indices of statutory independence.

[66]For a discussion of the Maastricht rules on central bank financing of the government,

(continued...)

Privileged access by public authorities to financial institutions (such as through the placement among banks of public debt at below-market rates) has also been prohibited since the beginning of Stage II of EMU (Art. 104a). However, this limitation excludes privileged financing based on prudential considerations, which seems to cover the possibility of reserve requirements remunerated at below-market rates. In addition, the Maastricht Treaty introduced a "no bail-out" provision (Art. 104b), which prohibits the assumption of liabilities of an EU member country by another EU country or the EU budget, a provision that became effective with the Treaty.[67] All the obligations contained in Articles 104, 104a, and 104b will therefore apply to countries joining the EU as of their dates of membership.

Current regulations on central bank financing of the government in the countries under review are shown in Table 10. Only Bulgaria, Bosnia-Herzegovina, Estonia, and Lithuania comply in full with the Maastricht requirements in this area. The CBAs of these four countries prohibit any type of credit from the central bank to the government, including (except in the case of Lithuania) indirect credit via open market operations. Bulgaria and Bosnia-Herzegovina also prohibit central bank credits to banks collateralized with government securities, although the Bulgarian central bank may extend credits to banks against government collateral in the case of a liquidity crisis. These tight rules are part of the usual and more general prohibition under CBAs of any domestic credit from the central bank to either the public or the private sector.[68] Poland will also satisfy the Maastricht limits on central bank financing of the government as of October 17, 1998, when the full prohibition of any direct credit enshrined in the Constitution of 1997 will come into effect. In the meantime, the National Bank of Poland will still be allowed to purchase, within certain limits, treasury bills in the primary market. The National Bank of Hungary (NBH) is also almost in full compliance with the Maastricht rules, following the amendments to its law introduced in January 1997.[69] The Hungarian government's

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[66](...continued)
including their rational, see Cottarelli (1993).

[67]The Treaty foresees, however, the possibility of EU financial assistance to a member state suffering from exceptional circumstances such as natural disasters (Art. 103 a, 2) or from serious balance of payments problems (Art. 109 h and I).

[68]In this respect, the possibility the Lithuanian central bank has of conducting open market operations with government securities, and the possibility the Estonian and Lithuanian central banks have of extending credit to banks against government securities, are rare among countries with CBAs.

[69]These amendments prohibited any direct credits from the NBH to the government except a very short-term overdraft facility. This, in conjunction with the 1997 Budget Act, did away in particular with the NBH's obligation to grant loans to the government to cover foreign exchange rate losses on the state's foreign borrowing.

Table 10. Rules on Central Bank Financing of the Government
(Situation as of end-January 1998)

	Overdrafts and advances 1/	Securitized lending
Albania	Not allowed.	The CB may grant to the government loans of up to 6-month maturities provided they are collateralized by government securities, bear market interest rates, and do not exceed 5% of ordinary government revenues of the previous year. Under exceptional circumstances, this limit may be temporarily increased to 8% of ordinary revenues. 2/ The CB may engage in OMO with government securities but the securities obtained in this way are subject to the above-mentioned limits unless the OMO are justified on monetary policy grounds. It may also rediscount government securities held by banks and maturing within 3 years from the date of discount.
Bosnia-Herzegovina	Not allowed. The currency board law forbids the extension of any credit to the government.	The CB may not purchase government securities in the primary market, nor engage in any OMO. It may not extend to banks credit collateralized with government securities.
Bulgaria	Not allowed. The currency board law forbids the extension of any credit to the government (with the exception of credits related to the purchase of SDRs from the IMF).	The CB may not purchase government securities in the primary market, nor engage in any OMO. It may grant to banks loans of up to 3 months collateralized with government securities in the case of liquidity risk threatening the stability of the banking system.
Croatia	Short-term loans to bridge liquidity gaps are allowed but should not exceed 5 percent of the current year's budget and must be repaid by the end of the current year.	CB may grant credits to banks against government securities and may engage in OMO. The CB law does not explicitly foresee CB purchases of government securities (T-bills) in the primary market, and these have never taken place.
Czech Republic	Not allowed.	The CB may grant direct short-term credit to the government through the purchase of T-bills maturing within 3 months from the day of purchase, provided the total amount does not exceed 6% of current year's budgeted expenditures. It can also buy and sell from banks government securities and hold them for up to one year, and can grant to banks credits for up to 3 months guaranteed with government securities.
Estonia	Not allowed.	The CB may not purchase government securities in the primary market, nor engage in any OMO. It may however extend to banks credit collateralized with government securities.

Table 10 (continued). Rules on Central Bank Financing of the Government
(Situation as of end-January 1998)

	Overdrafts and advances 1/	Securitized lending
Hungary	An overdraft facility, limited to 2% of planned revenues for the current year, is available to the government. Overdrafts may not exist continuously for more than 15 days and must be eliminated by year-end.	All direct financing from the government other than the overdraft facility is explicitly prohibited. In particular, the CB may not purchase government securities in the primary market. OMO in government securities are allowed but only for monetary policy purposes.
Latvia	CB may grant short-term credits to the government up to 1/12 of budgeted current revenues.	The CB may grant short-term loans to banks collateralized with government securities. It may also perform lombard operations against government securities.
Lithuania	Not allowed.	The CB may conduct OMO with government securities. It may also grant, withing certain limits, credits to banks collateralized with government securities.
FYR of Macedonia	CB may grant loans up to 5% of the current year's budget provided that they do not conflict with the CB's monetary policy objectives.	CB may grant to banks loans of up to 3 months guaranteed with government securities.
Poland	Not allowed. The Constitution of 1997 explicitly prohibits any form of direct credit to the government from October 17, 1998.	Until October 17, 1998, the CB may purchase in the primary market T-bills up to 2% of current year's planned budgetary expenditures. From that date on, purchases of government securities in the primary market will be forbidden. CB may conduct OMO with government securities.
Romania	The CB may grant short-term advances but they must be repaid withing 180 days, bear market interest rates, and may not exceed 7% of the previous year's budget revenues, nor the double of the CB's capital and reserves.	CB may grant to banks loans of up to 90 days against government securities maturing within one month from the date of acquisition.
Slovak Republic	Not allowed.	The CB may grant direct short-term credit to the government through the purchase of T-bills maturing within 3 months from the day of purchase, provided the total amount does not exceed 5% of the budgetary revenues of the previous year. It can also buy and sell from banks government securities and hold them for up to one year, and can grant to banks credits for up to 3 months guaranteed with government securities.

Table 10 (concluded). Rules on Central Bank Financing of the Government
(Situation as of end-January 1998)

	Overdrafts and advances 1/	Securitized lending
Slovenia	CB may grant short-term advances to the government to bridge over temporary liquidity gaps but they may not exceed 5% of the current year's budget, nor 0.5% of the anticipated budget deficit, and must by fully repaid by the end of the fiscal year.	The CB may engage in OMO in government securities.
Cyprus	The CB may make direct advances to the government up to 10 % of the ordinary revenue estimated for the current fiscal year. These advances must be repaid not later than 3 months after the end of the current fiscal year. The CB will receive no interest unless otherwise agreed.	CB may purchase T-bills maturing within 12 months from the date of aquisition, and provide advances to banks against this same type of government securities provided that the total amount of T-bills obtained in this way does not exceed 10% of estimated government revenue for the current fiscal year. The CB may also conduct, under certain limits, OMO with other government securities.
Malta	The CB may grant advances to the government to cover temporary liquidity gaps up to 15 % of ordinary revenue estimated for the current fiscal year. These advances must be repaid as soon as possible and, in any case, by the end of the current fiscal year. The rate of interest applied is to be agreed between CB and MoF. 3/	CB may purchase in primary market T-bills maturing within 93 days. 4/ It can also grant to banks loans of up to 3 months guaranteed with government securities maturing within 20 years, and conduct OMO in government securities with maturities of up to 20 years, provided that the securities obtained in these two ways do not exceed 20% of the sight deposits at the CB. In addition, the CB may purchase bonds or shares issued by public companies for the purpose of financing government development plans under certain limits specified by the CB law.
Turkey	CB may extend short-term advances to the government up to 15% of current year's general budget. The rate of interest applied is to be agreed between CB and MoF. A protocol signed between CB and Treasury in 1997, however, foresees the end of the Treasury's recourse to short-term advances from the CB.	CB may discount or grant advances against bills, or Treasury-guaranteed bills, with maturities of up to 9 months, issued by state enterprises and administrations to cover seasonal liquidity needs connected with purchases of raw materials or crops. OMO in bonds issued by the state or public agencies are allowed but only for monetary policy purposes and with bonds with maturities up to 12 months. The total amount of OMO (with both public and private securities) may not exceed five times the total of the CB's capital and reserve funds.

Sources: Central Bank laws and amendments, and other national legislation.

Note: CB = Central Bank. MoF = Ministry of Finance. OMO = Open Market Operations.

1/ Overdrafts (on the current account of the government at the central bank) refer to any line of credit granted by the latter to the former without specified maturity. Short-term advances refer to any nonsecuritized credit with fixed (normally short-term) maturity.

2/ For 1998, these limits have been set at a higher level (10 percent and 15 percent of ordinary revenues, respectively).

3/ A 1994 amendment to the Central Bank of Malta Act provides for the eventual removal of this facility; the amendment has not entered into force but the government has voluntarily refrained from seeking access to this facility since the end of 1996.

4/ The Central Bank of Malta disengaged from the primary market after March 1996.

capacity to run overdrafts in its current account at the NBH for up to 15 days, however, is still incompatible with EU rules which, as noted, only permit intraday credits.

At the other extreme, Cyprus, Malta, and Turkey have the laxest rules on central bank financing of the government among the countries under review. They all allow advances of 10-15 percent of government revenues (or budget appropriations), without imposing short deadlines for their repayments and leaving freedom to the central bank and government to agree on the interest rate applied. In addition, they permit direct purchases of government securities either in the primary market (Cyprus and Malta) or from the public administration and certain state enterprises (Turkey). Although Malta and Turkey have recently taken a number of steps to reduce the de facto access of their treasuries to central bank financing (see Table 10), these three countries still need to reform substantially their rules on the matter to comply with EU standards.

The rest of the countries (all of them CEECs) have relatively restrictive rules (though not as restrictive as required by the Maastricht Treaty) and can be classified into two groups. The first group consists of the Czech Republic, the Slovak Republic, and Albania (under the new central bank law passed in early 1998), all of which prohibit overdrafts or unsecuritized advances from the central bank to the government, but permit direct securitized credits under relatively strict limits (via the acquisition of treasury bills in the case of the Czech and the Slovak Republics, and in the form of loans to the government collateralized with government securities in the case of Albania). The second group includes the rest of the countries shown in Table 10, and is characterized by permitting overdrafts or unsecuritized advances under relatively strict conditions but not allowing (or at least not explicitly foreseeing in the law) the purchase by the central bank of securities directly from the government.

Participation in the European System of Central Banks

Even if the countries under analysis stay out of the euro area for a number of years after joining the EU, their central banks will be part of the ESCB on a restricted basis (Art. 1 of the Protocol). In particular, their central bank governors will be members of the General Council of the ECB, which comprises the President and Vice-President of the ECB and the governors of all EU central banks (Art. 45 of the Protocol).[70] The General Council will be informed of

[70]The ESCB is made up of the ECB and the national banks of all EU countries. The main governing bodies of the ECB are the Executive Board, comprising the President, the Vice-President and four other members, all appointed from among persons of recognized standing and professional experience in monetary and banking matters, and the Governing Council, comprising the members of the Executive Board and the governors of the central banks of euro-area countries. As the highest decision-making body, the Governing Council will be in charge of the broad design of monetary policy in the euro area, while the Executive Board will be in charge of the daily implementation of this policy in accordance with the Governing
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the decisions of the ECB's Governing Council, thus giving countries with a derogation the opportunity to follow closely and, to a limited extent, influence monetary developments in the euro area. The General Council will also be in charge of monetary cooperation between euro-area countries and other EU countries within ERM II, including the operational aspects of this exchange rate arrangement, and of the necessary preparations for participation of members with a derogation in the euro area (Art. 47 of Protocol No.3). Countries with a derogation will, however, be excluded from the appointment of the members of the ECB's Executive Board and will have no representation in the ECB's Governing Council other than via the President of EU Council and a member of the Commission, who can attend (without voting rights) the meetings of the Governing Council (Art. 109b and 43 of Protocol No.3).

EU member states with a derogation will of course be allowed to continue to conduct an autonomous monetary policy and will keep official foreign exchange reserves under national control (they will not participate in the pooling of reserves at the ECB). They will also be excluded from the provisions regulating the transfer of ECB's net profits and the allocation of the seignorage income accruing from the common monetary policy (Art. 33 and 32 of Protocol No. 3). They will, however, be obliged to consult the ECB on any draft legislative proposal in its field of competence (Art. 105, 4), and their financial institutions could be subject to prudential supervision by the ECB, should the latter be assigned this task in the future (Art. 105, 6).

Liberalization of capital flows

Free capital movements are an essential component of monetary union. The obligation of EU countries to liberalize capital movements among themselves stems, however, not from the Maastricht Treaty or subsequent secondary legislation but from the Treaty of Rome (Title III, Chapter 4) and a number of Council Directives (in particular, the Directive 88/361/EEC of June 24, 1988 requiring the full liberalization of intra-EU capital flows). Countries joining the EU will have to comply with this part of the *acquis communautaire* upon accession, although some of them may obtain transitory periods for certain types of flows (in particular short-term flows), just as the Directive of 1988 granted transition periods to Spain, Greece, Portugal and Ireland. As noted in Section II.B, the EAs also contain certain obligations (largely limited to FDI) with regards to the mutual opening of the capital accounts. What the Maastricht Treaty added (Art. 73 b) is the obligation to liberalize capital flows also vis-à-vis third countries (something most EU countries had already done when the Treaty was signed). This obligation became effective for all EU countries on January 1, 1994.

Most CEECs lifted restrictions on FDI inflows (except in a few sensitive or defense-related sectors) at the beginning of the transition. They also guaranteed in most cases the free repatriation of both profits (current account convertibility) and FDI capital. FDI inflows were

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[70](...continued)
Council's guidelines (Art. 109a, and 1 and 9-12 of Protocol No.3).

welcomed as a non-easily-reversible source of foreign exchange and because of the usual externalities associated with FDI (introduction of new technologies and managerial skills, access to export networks, etc.). In addition, FDI was to play a key role in these countries' privatization and enterprise restructuring processes, and as a source of government revenues. Most CEECs initially required authorization for FDI outflows, but the authorization was normally granted liberally when the investment was thought to help exports. Since early in the reform process, most CEECs have also applied a quite liberal treatment to trade credits (in the case of outward trade credits because of their positive effect on exports), and allowed individuals to hold and operate foreign exchange accounts at local banks, a privilege that most OECD countries accorded only at the latest stage of liberalization of their capital accounts.

With the exception of FDI-related transactions, however, most other capital movements remained very restricted in CEECs, as these countries feared the potentially destabilizing effects of an open capital account at a time when they were still trying to put their macroeconomic houses in order. In particular, financial credits, portfolio flows, and real estate operations remained severely restricted for years in practically all countries. A general pattern, and one that has endured until today, was the existence (legally and de facto) of much tighter controls on outflows than on inflows and more serious restrictions on short-term than on long-term transactions. Only the Baltic countries (and in particular Estonia), which opted for a very high degree of capital account openness from the start of the transition process, have escaped this general trend.[71]

Since 1995, a number of CEECs have been gradually easing restrictions on capital movements. This process has been led by the Czech Republic, Hungary, and Poland. These three countries have undertaken substantial liberalization commitments as part of their accession to the Organization for Economic Cooperation and Development (OECD) in December 1995, May 1996 and November 1996, respectively.[72] In this context, the Czech Republic, Hungary and Poland have liberalized FDI outflows (vis-à-vis OECD countries and countries having signed bilateral investment protection agreements in the case of Hungary and Poland), outward trade credits, and personal capital movements. They have also liberalized other outflows (particularly long-term outflows) to varying degrees.[73] Furthermore, within the OECD, the Czech Republic and Hungary have committed themselves to abolishing all remaining capital controls within three to four years of their dates of OECD membership, if

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[71]See OECD (1993) for a description of exchange control policies in CEECs in the first years of transition.

[72]OECD membership requires the acceptance of the obligations under the OECD Code of Liberalization of Capital Movements.

[73]The acceptance of the OECD capital movements code also implies for these countries the need to comply with its standstill, nondiscrimination, and transparency clauses. See Ley and Poret (1997).

the macroeconomic situation permits, while Poland has committed itself to removing all remaining restrictions by end-1999.

Regarding the selected Mediterranean countries, Turkey undertook a substantial liberalization of its capital account during the 1980s and first half of the 1990s, partly reflecting its obligations as a member of the OECD. In Cyprus and Malta, progress in liberalizing capital movements has been slower, although the former country has recently taken a number of steps in this field, and plans to take further measures in the coming years, in preparation for its integration into the EU.[74]

Table 11 provides indices of liberalization for selected categories of capital flows in the countries under analysis. It focuses on FDI, real estate, and portfolio and credit flows not involving the domestic banking system, thus leaving aside the specific provisions affecting banks and other financial institutions, the investment restrictions affecting institutional investors, and the regulations determining the capacity of residents and nonresidents to hold and operate foreign- and domestic-currency-denominated accounts. An overall index of liberalization of the capital account, based on the selected flows, was also calculated as a proxy for the overall degree of capital account openness (see Table 11).[75] It can take values between 0 and 100, with 100 representing the maximum degree of liberalization.

Table 11 shows that Estonia and Latvia (which have removed practically all capital controls), Lithuania, and the Czech Republic are, by a substantial margin, the countries that have made more progress in opening their capital accounts. They all show overall liberalization indices of between 74 and 98 percent. They are followed by Hungary, Poland, and Turkey, with indices in the 50-60 percent range. A third group with an intermediate degree of liberalization comprises Bulgaria, Croatia, Cyprus, Malta, and Slovenia. All other countries show indices below 25 percent, although in some of these countries (in particular, Albania and Bosnia-Herzegovina) the actual enforcement of capital controls would seem to be so weak that the index is likely to significantly underestimate the actual openness of their capital accounts.

The almost complete openness of the capital account in the Baltic countries, and the high degree of openness and commitments (within the OECD) for further liberalization in the Czech Republic, Hungary, and Poland, imply that these countries will be in a favorable

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[74]In 1996, Cyprus eased the rules on portfolio flows. In 1997, it simplified the administrative procedures for inward FDI and allowed foreign participation of up to 100 percent in most industrial and services sectors. The criteria applied by the central bank to authorize outward FDI were also eased.

[75]While some of the regulations excluded from the analysis are admittedly important, they are often too complex to be characterized in a simple way, and the overall degree of liberalization of the capital account might reasonably be expected to show a high degree of correlation with the overall degree of liberalization of the capital flows included in Table 11.

Table 11. Indices of Capital Account Liberalization
(Position as of December 31, 1997, unless otherwise indicated)

	Albania	Bosnia-Herzegovina	Bulgaria	Croatia	Czech Republic	Estonia	Hungary	Latvia	Lithuania
Controls on direct investment 1/ 2/	66.7	33.3	66.7	83.3	100	100	100	100	83.3
Controls on real estate investment 2/	75.0	0.0	50.0	0.0	50.0	75.0	75.0	75.0	50.0
Controls on credit operations 2/ 3/	0.0	50.0	37.5	83.3	62.5	100	75.0	100	62.5
Controls on portfolio flows 2/	0.0	0.0	25.0	35.0	70.0	100	33.3	100	100
Overall index of liberalization of the capital account 2/	16.7	17.6	35.3	44.4	73.7	97.6	59.5	97.6	85.7
Memorandum item:									
Current account convertibility (date of acceptance)	Article XIV	Article XIV	Article XIV	Article VIII (May 29, 1995)	Article VIII (Oct. 1, 1995)	Article VIII (Aug. 15, 1994)	Article VIII (Jan. 1, 1996)	Article VIII (June 10, 1994)	Article VIII (May 3, 1994)

Table 11 (concluded). Indices of Capital Account Liberalization
(Position as of December 31, 1997, unless otherwise indicated)

	FYR of Macedonia	Poland	Romania	Slovak Republic	Slovenia	Cyprus	Malta	Turkey
Controls on direct investment 1/ 2/	66.7	100	83.3	83.3	83.3	66.7	50.0	83.3
Controls on real estate investment 2/	0.0	50.0	0.0	50.0	50.0	0.0	0.0	50.0
Controls on credit operations 2/ 3/	37.5	75.0	0.0	50.0	37.5	37.5	50.0	50.0
Controls on portfolio flows 2/	0.0	35.0	0.0	0.0	25.0	20.8	36.4	38.9
Overall index of liberalization of the capital account 2/	23.3	55.3	12.5	23.7	40.5	28.6	37.5	53.3
Memorandum item:								
Current account convertibility (date of acceptance)	Article XIV	Article VIII (June 1, 1995)	Article VIII (Mar. 25, 1998)	Article VIII (Oct. 1, 1995)	Article VIII (Sep. 1, 1995)	Article VIII (Jan. 9, 1991)	Article VIII (Nov. 30, 1994)	Article VIII (Mar. 22, 1990)

Sources: *Annual Report on Exchange Arrangements and Restrictions, 1997,* IMF; and OECD.

1/ With the exception of investments in sectors normally considered sensitive or of strategic national interest.

2/ The index can take values between 0 and 100, with 100 representing the maximum degree of liberalization of the capital flows under consideration. The index for a given country is constructed by adding up the values obtained in each category of capital flows and dividing the total by the maximum possible score. Flows not subject to controls are assigned a value of 2; flows classified as being subject to partial controls are assigned a value of 1; flows subject to serious controls are given a value of zero. When information on a given capital transaction was not available, a value of zero was assigned in both the numerator and the denominator.

3/ Borrowed or extended by residents other than banks.

position regarding compliance with the Maastricht requirements in this area once they join the EU. For the rest of the countries under review, however, EU membership would require a substantial effort of liberalization of the capital account.

Policy coordination and surveillance

From the date of accession, new EU member countries will fully participate in "economic union" (the "E" in EMU), being obliged to regard their economic policies as a matter of common concern (Art. 103) and be part of a number of EU mechanisms for the multilateral coordination and surveillance of the macroeconomic policies of the member states. These mechanisms have been strengthened by the Maastricht Treaty and subsequent decisions. The most important (apart from the already discussed ERM II) are the broad economic policy guidelines, the convergence programs, and the excessive deficit procedure (reinforced by the recently adopted Stability and Growth Pact). The main channels of EU-wide policy coordination and surveillance in Stage II of EMU are the Council, the EMI, and the Monetary Committee, the latter two to be replaced in those functions at the start of Stage III by the General Council of the ECB and the Economic and Financial Committee, respectively. Countries with a derogation will be represented in all these institutions.

The *broad economic policy guidelines* report has been issued on an annual basis by the Council since 1993. A synthesis of the EU's consensus on economic policy, they are meant to provide the key overall medium-term framework for the conduct of both macroeconomic and structural (particularly labor market) policies in the EU. The implementation of the guidelines is reviewed every winter. It is complemented by the *Annual Economic Report* of the European Commission to the Council.

The Maastricht Treaty required EU member states to submit, where necessary, multi-annual *convergence programs* before the start of Stage II of EMU. Austria, Finland, and Sweden also presented convergence programs after their accession to the EU. These programs, which are reviewed by the Council, should indicate the strategy a country intends to pursue, and the concrete measures it plans to take, to ensure future compliance with the convergence criteria. Although there was no provision in the Treaty for updating these programs, many countries have subsequently done so and, as part of the Stability and Growth Pact, it has been agreed to make the annual presentation of convergence programs compulsory for all member states with a derogation, which would include the countries under analysis once they join the EU. In addition, and in accordance with Article 109e(2)b of the Treaty, the Council reviews every year, on the basis of a report prepared by the Commission (the *Report on Convergence in the EU*), progress being made in the EU with regards to economic and monetary convergence.

Under the *excessive deficit procedure*, governed by Article 104c, all EU countries must *endeavor* to avoid "excessive deficits" under Stage II of EMU and are *obliged* to do so under

Stage III of EMU.[76] The Council, on a recommendation by the Commission, issues a confidential finding to any country designated to have an "excessive deficit."[77] In this finding, the Council outlines its views on the fiscal policy needs of the country and recommends concrete corrective measures. In the past, these recommendations have normally been based on the budgetary objectives contained in the convergence programs. If the country fails to take appropriate measures within a specified time limit, the Council can make its recommendations public. Also, countries benefiting from the Cohesion Fund may find their financing from this source in jeopardy if they fail to take corrective action, a particularly relevant consideration for the non-EU countries with accession prospects considered in this paper, since most of them are likely to be eligible for this potentially important source of financial support. In addition, for euro-area countries, the Council may impose sanctions such as the interruption of European Investment Bank lending, non-interest-bearing deposits, and fines.

The excessive deficit procedure has been strengthened by the *1997 Stability and Growth Pact* adopted by the European Council of Amsterdam.[78] Under the Pact, all EU countries commit themselves to aiming for a medium-term budgetary position close to balance or in surplus. This is expected to allow the automatic fiscal stabilizers to work over the whole business cycle without breaching the Maastricht limit of a deficit of 3 percent of GDP. The Pact defines the circumstances under which a deficit exceeding the 3 percent reference value may be considered exceptional and temporary. It also clarifies other aspects of the excessive deficit procedure, including the imposition of sanctions, and strengthens the surveillance over medium-term fiscal policies to provide an early warning system. Euro-area countries will be obliged to present on an annual basis "*stability programs*" specifying their medium-term budgetary objectives and an adjustment path for the government deficit- and debt-to-GDP

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[76]Only the United Kingdom, if it chooses not to participate in Stage III of EMU, would not have the legally binding obligation to avoid excessive deficits in Stage III (Art. 5 of Protocol No. 11).

[77]The avoidance of "excessive deficits" is one of the convergence criteria required by the Treaty to qualify for EMU, which embodies in fact the criterion on the government deficit and the criterion on debt. For the definition of what constitutes an excessive deficit according to the Treaty, see the initial footnote to Table 5.

[78]The Pact consists of the Resolution of the European Council of June 17, 1997 on the Stability and Growth Pact, Council Regulation EC/1466/97 of July 7, 1997 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies, and Council Regulation EC/1467/97 of July 7, 1997 on Speeding Up and Clarifying the Implementation of the Excessive Deficit Procedure.

ratios. Countries with a derogation, as noted, will have to update their convergence programs on an annual basis.[79]

The need for an efficient, market-oriented financial sector

The prospect of EU membership increases pressure on non-EU candidate countries to continue to make progress towards developing a healthy, efficient, and market-oriented financial sector. Barring the possibility of transitory periods, these countries will have to comply with the entire *acquis communautaire* in the area of financial services (banking, insurance, investment firms, etc.). The EMU process further increases this pressure. Without additional development of their capital markets, it will be difficult for most CEECs to comply with the strict Maastricht rules on central bank and privileged financing of the government (rules that, as noted, will apply to them upon accession). Deeper and more liquid capital markets are also essential for moving toward the complete reliance (other than for occasional changes in reserve requirements) on indirect, market-based instruments of monetary control required by participation in the euro area.[80] For a number of countries, this implies a rigorous agenda of structural reform.

Despite substantial progress in recent years, the financial sectors of many of the countries under review still suffer from a number of problems.[81] In many CEECs, banking systems are still burdened with bad loans and undercapitalized. They also tend to exhibit an excessive degree of concentration and state ownership, and are insufficiently exposed to foreign and domestic competition. In a majority of countries, capital markets are at an infant stage of development and payment systems remain rudimentary. Financial regulation and supervision, for their part, are in need of improvement, although some of the current shortcomings in this area will automatically be addressed as part of the effort of harmonization with EU regulations. Also, in some CEECs the financial and enterprise sectors continue to be subject to "soft budget constraints."

Structural weaknesses of this kind can complicate a country's participation in the euro area. Insufficient competition among banks can, for example, reduce the responsiveness of bank lending rates to monetary policy changes, while soft budget constraints can reduce the

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[79]For a more detailed description of the Stability and Growth Pact, see the resolution and regulations mentioned in the previous footnote, and IMF (1997a and 1997b).

[80]Recent progress made by CEECs toward adopting indirect instruments of monetary policy is documented in de Melo and Denizer (1997).

[81]See, for example, EBRD (1995), Classens (1996), and IMF (1997b, Chapter V).

sensitivity of expenditure to interest rate changes.[82] The transmission mechanism of monetary policy in countries with such structural difficulties could therefore differ significantly from that prevailing in the average core euro-area country, implying that changes in the policy stance decided by the ECB could have undesired implications for the former.[83] This could be particularly the case since, as noted above, newcomers are more likely to experience asymmetric shocks and a smaller degree of cyclical synchronization with respect to the core euro-area countries.[84]

The payments system

An essential component of EMU will be the creation of an EU-wide payments system, named TARGET, that will handle large-value euro payments and will be composed of the national real-time gross settlement (RTGS) systems connected through an interlink network. Commercial banks from EU countries with a derogation will also have access to TARGET provided they are capable of dealing in the euro, although it would appear (even though the issue has not been resolved yet) that they will not have access to intraday liquidity from the ECB. A decision has not been taken either as yet on whether commercial banks from non-EU countries will be able to access TARGET (on a restricted basis), but there do not seem to be strong reasons against it.[85]

Technically, the CEECs and selected Mediterranean countries would basically need to meet two requirements, namely, to have a RTGS system and to be able to conduct payments in euros. As noted above, many of the countries under analysis are still in the early stages of developing a modern national payments system. The establishment of TARGET in the context of EMU (whether they will be able to connect to it since its creation or only if and when they join the EU) "provides an opportunity [for CEECs] to leapfrog, introducing right at the outset

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[82]See Cottarelli and Kourelis (1994).

[83]On this point, see McCauley and White (1997), and Bank for International Settlements (1995).

[84]Countries that are undergoing rapid structural changes (particularly within their financial sectors) are also likely to show less stable money demands. However, with capital flowing freely within the monetary union, this should not create serious difficulties for a country subject to the ECB money supply rule. Any excess money demand or supply in that country caused by the divergence between money demand trends within it, on one hand, and the money supply stance of the ECB, on the other, should be met smoothly through the (invisible) balance of payments of that country with the rest of the euro area.

[85]The issue of access to TARGET is also relevant for developed non-EU countries. Thus, for example, Switzerland is considering making small technical adjustments to its payments system to be able to eventually connect it (if allowed to do so) to TARGET.

the systems that are compatible with and best suited for TARGET" (Szapary, 1997). The importance for the countries under review of adapting the national payments systems as required by a future connection to TARGET is likely to be reinforced by the increase in cross-border transactions between them and the EU that the introduction of the euro is expected to bring about.[86]

V. Concluding Remarks

This paper has focused on relations with the EU and the institutional implications of EMU for the CEECs and a selected group of Mediterranean countries. Most of these countries are developing an increasingly close economic and political relationship with the EU, built upon the conclusion of trade and association agreements; they all may want to become members of the EU one day.

Since the fall of the Berlin Wall, the EU has concluded TCAs and AAs with most CEECs. The EAs have as a fundamental objective the establishment of a free trade area in industrial products between the EU and the associated CEECs, but they are much more than trade agreements. They are seen as a stepping stone towards future EU membership of the associated CEECs and cover a number of areas (such as political dialogue or harmonization of legislation) that cannot be properly understood without taking into account that perspective of membership. In 1993, the EU accepted the idea of an enlargement to the associated CEECs and developed subsequently a "pre-accession strategy" aimed at intensifying economic and political dialogue with these countries and helping them adapt to the requirements of membership. Meanwhile, all the associated CEECs have formally applied for EU membership. This evolutionary process culminated with the beginning of accession negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia in March 1998.

The EU has also reinforced in recent years its institutional relations with the selected Mediterranean countries. Cyprus, Malta, and Turkey can all participate in the new Mediterranean policy of the EU but their relations with the EU are following a different path. Notwithstanding the political difficulties related to the division of the island, Cyprus started accession negotiations with the EU in March 1998, together with the five CEECs mentioned above. Turkey has established a CU with the EU and is harmonizing its legislation with that of the EU in a number of domains, as part of a process that could lead one day to its full integration into the EU. Malta is currently reconsidering its relations with the EU following the recent decision by its government to freeze its membership application, but, whether it chooses to develop the customs unions project envisaged in its AA or eventually decides to reactivate its membership application, it is likely go beyond the level of integration with the EU offered by the EU's new Mediterranean policy.

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[86]See Prati and Schinasi (1997).

Against this background of growing institutional links between the EU and these two groups of countries, and of accession negotiations with a few of them, the European single currency is expected to be launched. The European Council of Copenhagen indicated that countries wishing to join the EU must first demonstrate their capacity to adhere to the aims of EMU. As stressed by the European Commission and the Council, this does not imply that these countries will need to satisfy the macroeconomic convergence criteria laid down in the Maastricht Treaty to become members of the EU. It does mean, however, that they will have to eventually join the euro area. With transitory periods being unlikely, they will also have to comply from their dates of membership with all the body of EU legislation in the area of EMU.

Although none of the countries examined currently meets all the Maastricht convergence criteria, a majority of them appear to satisfy the fiscal criteria and a few are also reasonably close to meeting the inflation and interest rate criteria. Further progress toward inflation (and interest rate) convergence, however, is likely to be slow and difficult and no country is expected to meet all the criteria before 1999 at the earliest. These convergence criteria are regarded in many of the countries reviewed as relevant references that are already influencing to some extent economic policymaking in them.

The new exchange rate mechanism that will link the euro with other EU currencies (ERM II) will be a voluntary and flexible system that should accommodate the varying circumstances of the CEECs and Mediterranean countries joining the EU. The introduction of the euro, however, may require an immediate redefinition of the baskets or currencies of peg in some of these countries. As countries join the EU, they may need to further modify their exchange rate regime if they wish to participate in ERM II, or simply to respect the need to treat their exchange rate policies as a "matter of common interest" within the EU.

Countries with EU membership prospects will need to adapt their central bank legislation in order to eventually participate in the ESCB, even if they remain outside the euro area for some time. This implies in particular the need to comply with provisions aimed at guaranteeing the independence of the national central banks and limiting central bank and other privileged financing of the government. Some CEECs have recently amended their laws with that objective in mind, and central banks in most CEECs enjoy a relatively high degree of statutory independence (although they seem to have less de facto independence), with a few of them fully complying already with the Maastricht rules. The situation in Cyprus, Malta, and Turkey is rather different: these countries will have to reform substantially their legislative frameworks to meet EU standards on the matter.

Other implications of EMU for countries planning to join the EU stem from the obligation, reinforced by the provisions contained in the AAs and the liberalization commitments undertaken by some countries vis-à-vis the OECD, to fully liberalize their capital flows (including vis-à-vis third countries) as of their dates of membership. For those countries that hope to be part of the EU as early as in 2002, the strategy in the area of capital account

convertibility is thus likely to be driven by institutional forces. Finally, EMU will reinforce these countries' need to develop sound and market-oriented financial systems, rely increasingly on indirect instruments of monetary policy, and get ready for their eventual participation in the EU's system of coordination and surveillance of macroeconomic policies.

In short, EMU is not without institutional implications for the two groups of countries considered in this paper. For those countries that expect to join the EU in the year 2002, integration into the EU and eventually into the euro area is not a distant undertaking anymore. Four years is not a long period of time to get their economies and legal frameworks ready to participate in a EU with a monetary union at its center. In these countries in particular, but also to a lesser and varying degree in most of the other countries examined here, EMU is likely to act as a catalyst for macroeconomic convergence with Western Europe and as an engine of institutional change.

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