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Correction 1

Subject: **Monetary and Exchange Rate Policy of Transition Economies of Central and Eastern Europe after the Launch of EMU**

CORRIGENDUM

Page 1 was inadvertently omitted in PDP/99/5 (July 1999). The cover and pages 1 and 2 of that document are attached.

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Monetary and Exchange Rate Policy of Transition Economies of Central and Eastern Europe after the Launch of EMU[1]

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Abstract

The more advanced Central and Eastern European Countries (CEECs) face an evolving set of considerations in choosing their exchange rate policies. On the one hand, capital mobility is increasing, and this imposes additional constraints on fixed exchange rate regimes, while trend real appreciation makes the combination of low inflation and exchange rate stability problematic. On the other hand, the objectives of EU and eventual EMU membership make attractive a peg to the euro at some stage in the transition. The paper discusses these conflicting considerations, and considers the feasibility of an alternative monetary framework, inflation targeting.

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I. Introduction

For several years now, the more advanced transition economies of Central and Eastern Europe (CEECs)[2] have reached a new stage in their adaptation to market forces and convergence toward the structures and economic outcomes exhibited in Western Europe. Growth has strengthened, inflation has been reduced markedly, and public and private institutions have been developed to provide the infrastructure for liberal, competitive, and efficient economies. Moreover, the EU accession process was launched in March 1998 for five of these economies—Czech Republic, Estonia, Hungary, Poland, and Slovenia—presaging membership in the next few years and further progress toward convergence with the West.

It therefore makes sense to consider whether to evaluate economic policy options and regimes for some of them on a similar basis as for advanced market economies—especially the five countries mentioned above. In the early years of transition, exchange rate and monetary policies were constrained by thin financial markets, the absence of indirect monetary policy instruments, weak and dependent central banks, large budget deficits, and the special needs of these economies for rapid adjustment of relative prices. Pegged exchange rates served a special, and in several economies, a temporary, role in anchoring price levels and relative prices to those in market economies and in disciplining monetary and fiscal policies. As the transition process progressed, several CEEC economies moved to greater exchange rate flexibility, though a number of them continued to operate de facto or de jure fixed pegs and currency boards.

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[2]In this paper, CEECs are taken to include Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, Slovak Republic, and Slovenia.

As the prospects for accession to the EU increase, and with the launching of the euro on January 1, 1999, monetary and exchange rate policies are likely to face new pressures for further mutation. New members of the EU will be expected to adopt the *acquis communautaire*, and this will include EMU. While no country from the current members of the EU can be forced to join EMU (and countries can deliberately avoid a formal obligation by not meeting all the criteria), it may well be expected that countries negotiating to join would make some commitment to try to become part of the euro-bloc on some mutually agreed time-table. Furthermore, they will be expected in the meantime, between joining the EU and adopting the euro, to participate in the so-called ERM2 arrangement which will limit fluctuations of non-EMU EU countries' currencies relative to the euro. Even before joining the EU, countries negotiating accession may feel that they can improve their chances of a successful outcome through showing that they are good Europeans by pegging to the euro, or in any case orienting their monetary policies around a euro-based exchange rate target.

This paper explores the implications of that choice, and discusses whether alternative monetary policy strategies—and, in particular, inflation targeting—may be more appropriate for some CEECs at this stage in their transition process. Two hazards are identified with a premature euro peg: first, that capital flows to CEECs, like those to many emerging markets, may be strong and volatile, making the defense of pegged rates difficult; and second, that faster productivity growth or a trend increase in non-traded goods prices may produce a trend real exchange rate appreciation, which would be inconsistent with a combination of nominal exchange rate stability and low inflation. It is recognized, however, that EU membership seems a likely and desirable goal for most CEECs, both because of political reasons and