EMU CONSTRUCTION AND ITS EFFECTS ON THE CONSOLIDATION PROCESS BETWEEN THE EU AND THE REST OF EUROPE

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Introduction

The European Monetary Union is causing dramatic shifts in the global economy and finance. Without doubt, it can be regarded as one of the main economic events in the post-war history of Europe. Therefore, we must ask ourselves how likely the EMU is to influence not only the EU member-states (both: the “ins” and the “pre-ins”), but also the neighbouring countries and, thus, the overall economic environment in Europe. Will it lead to a closer consolidation of both parts of the region, or will deeper EU integration (in the political *and* monetary sphere) lead to a "fortress Europe” and widen the gap between Euroland and its neighbours?

This paper analyses the prospects of the EU's relationship with Central and Eastern European countries (including Russia, Ukraine, Belarus and Moldova) and leaves aside issues concerning non-EU Western European states - Switzerland, Norway, Iceland and others. This restriction has been made consciously and is warranted by three factors: 1) the CEE countries are the most numerous group in non-EU Europe; 2) the countries have much in common (including their socialist past); 3) many problems they face with regard to the EMU are, to a large extent, similar and differ from specific issues arising in countries like Switzerland or Norway. (The latter point, however, should not be regarded as absolute, because many of the EMU's external effects are alike in most third countries).

Some Central and Eastern European countries are likely to join the EMU in the medium run, some in the long run, while others will remain outside the structure for the foreseeable future. According to experts, there is little probability that even those first in line will enter the EMU earlier than 2006-2008 (Gronkiewicz-Waltz, 1999; Palankai, 1998;

Toth, 1999). Even if some of them do the majority of the CEE countries obviously will stay outside the EMU for at least the next 10 years and the euro will remain a foreign currency for them. According to the President of the Austrian Central Bank, Klaus Leibscher, the progress of fully integrating the candidate countries into the euro area may take “more or less twenty years” (European Parliament, 1998c). This paper deals with this particular situation and ignores any questions concerning the future participation of candidate members in the EMU.

I have looked at the following issues:

1. The reasons that make Central and Eastern Europe and the European Union interested in seeing that the euro becomes an all-European currency.
2. The extent to which different Central and Eastern European countries are likely to welcome the euro and to rely on the euro in their external economic relations.
3. The problems that Central and Eastern European countries face from the EMU whilst remaining outside the EU, their scope, their impact on the pan-European dialogue and instruments that need to be settled.
4. The issues that arise in candidate countries on their way to the EMU and probable gains and losses of the convergence process.

1. The euro as an international currency in Europe

The Central European states, as most of the third countries, will be influenced by the introduction of the euro and a shift in the world financial environment from a dollar-dominated to a bi-polar system. The start of the EMU takes place at a time when the grade of interdependence of all more or less industrialised regions of the world has come to a level, beyond which, prosperity can no longer be reached on an individual basis. The recent Asian and Russian crises serve as testimony to this idea. Evidently, in the XXI century, economic and financial hazards will spread all over the world with lightning speed.

In the middle of the 90s, existing globalization was supplemented by new factors. The movement of capital has become even freer, information technologies and new financial instruments have been widely introduced in the financial business, and electronic trade has taken root. Above all, Central and Eastern Europe have witnessed the final crystallisation of financial markets operating according to the same rules as in the West. The world situation has experienced a qualitative change: if previously, the Berlin Wall was a barrier to the flow of economic difficulties (also weapons, drugs and illegal capital), then, now, nothing can stop the virus of a crisis.

The advent of the euro is very likely to play a significant role in the process, because financial operators will now be able to choose between the two reserve currencies. Indeed, there was a choice before, but not between currencies of equal might (even the German mark played a much less important role in international finance than the dollar. For instance, it accounted for 15% of official world reserves, while the dollar's share was around 60-65%). Thanks to the EMU, there will be two big players in international finance, and, thus, it will be vital for them to reach a consensus. Otherwise, chaotic shifts of capital from the euro to the dollar and *vice versa*, coupled with great X-rate fluctuations, will easily destroy the whole world's monetary order, causing depression in both the United States and the European Union.

Obviously, the USA and the EU will be much more interested in maintaining a dialogue with the third countries than the United States are at present. Up to now, there was no genuine competition between currencies, and the international monetary system was, to a large extent, excluded from the "jurisdiction" of market rules. The advent of the euro brings the code of the market economy into the world monetary framework. Not surprisingly, the European Central Bank, has been open to external contacts from the very start and welcomes visitors from all over the world. Naturally, the euro's fate in international markets will depend greatly on the EU's ability to deal with its partners in monetary matters. A similar philosophy is likely to penetrate US monetary policy little by little. Possible reform of the IMF should reflect the new situation.

In the presence of two reserve currencies, the rest of the countries (including Central and Eastern Europe) will need to be more alert and more active in their monetary policy. They will now have much greater room for manoeuvring while taking decisions on the X-rate regime, currency structure of official reserves, lodging or granting external loans and invoicing their foreign trade. Since the volatility between the dollar and the euro is absolutely natural (due to different economic cycles and different models of the market economy), the third countries will have to monitor the events, forecast possible future performance and alter their monetary policy in accordance with these trends. In other words, from now on, they will become more independent from external influence, but more dependent on their own ability to assess external developments and to adjust to them. (The last point is also true for the ECB).

Thus, Central and Eastern European countries will gain at least two strategic advantages thanks to EMU: 1) wider room for manoeuvre in monetary affairs and better possibilities for conducting self-sustained, independent policy; 2) higher chances that their interests will be taken into account by the monetary authorities of the Euro zone and (to a lesser extent) of the USA.

We also need to consider the attitude of the European Union to the fate of the euro in the rest of Europe, i.e. whether it will affect the future of the EMU and be relevant for the EU.

In fact, it is common knowledge that the main aim of the ECB is to maintain price stability. Normally ECB officials emphasise that budget discipline coupled with low inflation constitute the main preconditions for a stable and viable euro. This is fairly true, nevertheless no one can deny that the fate of a currency usually depends as well on private investors (European Commission, 1997) and, consequently, on numerous market powers often having little to do with economic fundamentals. Thus, if the euro is designed to become an international currency, the attitude of Central and Eastern Europe is extremely essential for the EU.

There are at least two reasons for this to be true. 1) It is natural for the new currency to embark on its way in its home region. One can hardly expect the euro to edge the dollar immediately out of America, Asia, or even Africa. Issuing a world-wide reserve currency will mean a completely new experience and new international obligations for the ECB. It would probably be better to test them with its European partners, some of which will soon join the EU. 2) The fact that financial markets in the former socialist countries are not yet as developed as in the West could be an advantage for the European Union. The euro may expand its circulation area there by occupying new market sectors: by this means, it will avoid conflict with the dollar.

The last thesis needs additional explanation. One might argue that financial markets of Central and Eastern Europe are not crucial to the fate of the euro due to their small volume of activity (in 1995 the size of financial markets in Slovenia, Slovakia, Hungary, Poland and the Czech Republic altogether amounted to $140 billion - a mere 3.6% of that in Germany) (Haiss, P. Fink, G). However, these markets are rapidly growing and have much room for expansion, as the proportion of domestic credit and securities in the GDP is lower than in Western Europe. Moreover, the financial sector is not the whole economy and EU relations with Central and Eastern Europe have a solid economic backing (Table 1).

In 1997, EU exports to the CEE countries (also including Albania, Bosnia-Herzegovina, Croatia, FYROM, Serbia and Montenegro) accounted for $87 billion; together with the European CIS countries, this figure grows to $114 billion or 15.8% of the extra-EU exports. This is 80% of the EU exports to the United States and more than to any other region (the share of Japan is 5.0%, Mediterranean Basin - 11.6%, OPEC - 7.3 %, Latin America - 6.3%).

Table 1 The EU trade with Central and Eastern Europe in 1997

Country	EU-exports fob, MIO ECU	Share in the extra EU exports, %	EU-imports c.i.f., MIO ECU	Share in the extra EU imports, %
Bulgaria	1834	0,3	2082	0,3
Czech Rep.	15816	2,2	11733	1,7
Estonia	2347	0,3	1409	0,2
Hungary	13539	1,9	11548	1,7
Latvia	1525	0,2	1288	0,2
Lithuania	2138	0,3	1311	0,2
Poland	24986	3,5	14155	2,1
Romania	5005	0,7	4405	0,6
Slovakia	4788	0,7	3978	0,6
Slovenia	6289	0,9	4659	0,7
Total 10 CEEC	78267	10,9	56568	8,5
Belarus	*400*	*0,1*	*900*	*0,2*
Moldova	*100*	*0,0*	*200*	*0,0*
Russia	25124	3,5	26588	4,0
Ukraine	*1500*	*0,2*	*2600*	*0,4*
15 CEEC+Russia	112270	15.6	86926	13.0
USA	140698	19.6	136480	20.4

Sources: Statistical Service of the European Parliament *Statistical Annex on Enlargement Briefing No 22,* Luxembourg, 30 June 1998; Europe (Agence internationale d'information pour la presse) Weekly Selected Statistics, No 1059, 15 June 1998; Eurostatistics 1B, July 1998.

Note: Italic figures refer to 1996

Besides, the EMU is not a purely economic project: it has wide political and international aims. If it had been only a question of creating a financial market comparable with the American one, it would have been enough to unite the German and French financial markets, the idea of a French-German monetary alliance was vigorously rejected by the Commission. If the euro fails to take root in Central and Eastern Europe, it will be harmful for the strategic prospects of the EU and will provoke a negative response from other foreign money markets.

There is one more important aspect of the EMU's impact on the EU neighbourhood. Both the European Union and the CEE countries need stability (economic and political) in Central and Eastern Europe. Nowadays, markets prize stability much more than high growth rates and stability becomes the main requirement for a favourable investment environment. The EU needs economic stability in Central and Eastern Europe, because: 1) it is good for EU companies conducting business in the region; and 2) any significant disturbance in Central and Eastern Europe is very likely to be instantly transmitted to EU members that may cause not only losses but also an asymmetric shock.

After the Russian crisis, the European Union undertook a number of steps to cope with the increased international instability. In September 1998, France presented to the informal Euro Council (Group of Eleven) in Vienna a plan entitled: “Facing International Instability: Twelve French Proposals for a European Initiative”. Its main message is that the European Union (also due to the introduction of the euro) should take more responsibility for safeguarding economic stability in the world and in Europe. The document states that it should be important to “extend the European area of stability beyond the euro area” and that “financial and economic stability is also of major importance for the countries applying to join the Union”.

The G-7 Finance Ministers and Central Bank Governors meeting held on 20 February 1999 in Bonn unanimously endorsed Hans Tietmeyer's report entitled “International Co-operation and Co-ordination in the Area of Financial Market Supervision and Surveillance”. The document says that the speedy process of global integration is increasingly exposing the limitations of present standards of soundness and risk-awareness in financial systems. One of the main elements of a new approach towards this problem is “integrating emerging markets more closely in this process” (Tietmeyer, Hans, 1999).

The EMU is very likely to make Central and Eastern markets more stable. 1) Using both the dollar and the euro in foreign trade and official monetary policy, Central and Eastern European countries will minimise losses induced by exchange rate fluctuations. It may also help to cut down “imports” of exchange rate discrepancies that emerge due to unfavourable developments in other parts of the world (like it happened, to a certain extent, in Russia after the dollar appreciated drastically against “soft” South Asian currencies). 2) Candidate countries will have to comply first with the Copenhagen criteria and then with the Maastricht criteria, especially since they are not likely to be granted an opt-out clause as the UK and Denmark were (Cas Granje, 1999). This will improve the state of financial markets, depress inflation and tighten budget discipline. 3) The EMU will increase the need for co-operation between both parts of Europe. If such a dialogue lies on an appropriate institutional base and is regular, it will improve understanding and may constitute a leverage for crisis prevention.

From its advent, the euro differs from the dollar by its nature - by its origins the euro is a collective currency, therefore it is likely to be more suitable to serve as an international currency. The ECB's monetary policy is to take into account economic developments and interests of many countries that will make it more balanced and predictable. In certain aspects, the euro may be more suitable for CEE countries, as many of their fundamental interests are consonant with those of the EU (if only because of their geographical location, alone).

At the end of 1998, eight out of ten candidate countries had currency regimes based on the German mark and other Euroland currencies (Table 2). Nine countries have already (or plan in the nearest future) increased the role of the euro in their exchange rate regimes and this trend is likely to develop in the coming years.

Table 2 Exchange rate regimes in the CEEC and CIS

Country	mid-1998	April 1999	Likely future arrangements
Bulgaria	currency board DEM	no change	peg to EUR
Czech Rep.	managed float DEM	managed float to EUR	
Estonia	currency board DEM	currency board to both: EUR and DM	
Hungary	crawling peg to basket: 70% DEM, 30% USD	crawling peg to basket: 70% EUR, 30% USD	peg to EUR only from 2000
Latvia	fixed exchange rate SDR	no change	peg to EUR not before 2000
Lithuania	currency board USD	no change	peg to basket: 50% USD, 50% EUR in 2000
Poland	crawling peg to basket: 35% DEM, 45% USD, 10% GBR, 5% FRF, 5% CHF	crawling peg to basket: 55% EUR, 45% USD	EUR only basket or free float
Romania	free float	no change	managed float
Slovakia	fixed X-rate to a basket 60% DEM, 40% USD	managed float EUR	
Slovenia	managed float DEM	managed float EUR	
Belarus	managed float USD	no change	
Moldova	free float	no change	
Russia	free float (managed float USD before Sept. 1998)	no change	
Ukraine	managed float USD	no change	

Sources: European Economy, Supplement A, Economic Trends No 5- May 1998 p. 4; Financial Times Tuesday December 8 1998; EURO No 47 - 1999/II, Brussels; National Central Banks.

After the fall of the Berlin wall most CEE countries substantially increased their trade with the European Union and partly shifted their economic links from former Comecon partners towards Western Europe. For many of them, the EU is the main trading partner, and its share in trade has increased over the 90s. (Table 3).

Thus, Central and Eastern European states are likely to benefit from changes in the internal EU market induced by the EMU (that is to become deeper, more homogeneous, liquid and stable). The fact that no member of the Euro zone may use competitive devaluation also strengthens the confidence of Central and Eastern European exporters. It is believed that the transparency of prices and increased competition inside the euro zone will be helpful for third countries. Fixed exchange rates coupled with a rigid fiscal discipline encourage low interest rates inside the EMU that makes Western credits cheaper for CEE countries.

Table 3 The EU's share in total exports percent

Country	1992	1993	1994	1995	1996	1997
Bulgaria	32.2	30.4	39.1	37.6	37.9	n.a.
Czech Rep.	n.a.	43.9	46.2	42.8	58.2	59.9
Estonia	n.a.	48.3	47.9	54.3	51.0	48.7
Hungary	62.1	55.9	63.7	62.8	69.7	71.2
Latvia	40.1	33.4	39.4	43.6	43.5	48.8
Lithuania	n.a.	38.7	30.0	36.4	32.7	36.9
Poland	61.7	69.2	69.2	70.1	66.3	64.2
Romania	35.2	40.8	47.8	55.0	56.5	56.6
Slovakia	n.a.	29.6	35.0	37.4	41.3	45.0
Slovenia	n.a.	63.4	65.5	67.0	64.6	63.6
Russia	48.1	44.4	33.1	32.1	30.4	32.9

Source: European Parliament *“Statistical Annex on Enlargement”, Briefing No 22*, Luxembourg, 22 April 1999.

Usually it is considered that the euro is beneficial for Central and Eastern Europe since it decreases exchange expenses (especially inasmuch as the EU is the main trading partner for all candidate countries and Russia) and minimises losses induced by exchange rate volatility. Obviously, this advantage is crucial for a limited type of business, for instance tourist firms, transport and trading companies. It is worth noting that the Ministry of Transport was one of the first Russian government bodies to start studying the EMU project and to develop internal preparatory regulations.

However, this advantage should not be overestimated. The rationale is that a country can benefit from a decrease in conversion costs and termination of exchange rate volatility if it has vast trade with many EU members. For most of the Central and Eastern European countries, Germany is the main exporter and importer. The second and the third places are usually occupied by Italy, Netherlands, France or Austria. The first three partners commonly account for 3/4 - 5/6 of the total commerce with Euroland (Table 4). Hence, the average share of each of the other 8 EMU members account for 2 to 3 %.

Table 4 Exports to 3 main trading partners inside the euro zone in 1997

Country	percent of total exports to the EU-11
Bulgaria	73
Czech Rep.	85
Estonia	86
Hungary	80
Latvia	85
Lithuania	73
Poland	80
Romania	84
Slovakia	86
Slovenia	84
Russia	66
Belarus	*77*
Ukraine	82
Moldova	*92*

Sources: see Table 2
Note: italic figures refer to 1995; Ukraine - 1994.

If the three leaders include Germany and the Netherlands (in Latvia they account for 77% of exports to the EU-11), or Germany and Austria, one can easily figure out that the aforementioned advantages of the EMU are very far from fundamental for the Central and Eastern European states. Naturally, the German mark is much wider spread there than any other West European currency. Moreover, many CEE countries (like Poland, the Baltic states and especially Russia, Ukraine, Belarus) still have high shares of US dollars in their external trade.

In Russia, many big exporters, like mining plants, have only one or two so-called strategic suppliers in the EU. This means that for many years they import goods (for instance, machinery) from the same foreign company. In such cases, the benefit of using the euro as a currency for transactions with many different European countries is virtually negligible.

2. The prospects of the euro in different parts of Central and Eastern Europe

An interest in the single European currency may vary from one CEE country to another. The overall national outlook, naturally, will depend on the importance of the above-mentioned advantages of the euro for a particular country, and their ability to outweigh the advantages of the dollar. This will be linked to: the way the exchange rate regime operates; the overall trade linkage with the EU and the euro zone; the general level of economic development; and the commodity and geographical structure of external trade.

As mentioned above, 8 out of ten candidate CEE countries peg their national currencies, in one way or another, to the euro or national euro zone currencies (mainly DM) (Table 2). Only Romania and Lithuania do not, though the latter plans to switch to a 50% USD, 50% EUR basket in 2000.

In all the European CIS countries, national currencies are linked to the dollar. Formally, the exchange rate regimes do not involve any kind of peg but, *de facto*, the main concern of each National Central Bank is the rate against the dollar. It is widely used by government bodies, commercial enterprises and citizens. In Ukraine, a so-called “inclined corridor” is used - the government declares that during a certain period of time it will sustain the rate within specific margins. A very similar mechanism was used in Russia before the recent crisis. In Belarus, three main (and a number of secondary) rates exist, namely: an official rate (the rate at which exporters sell hard currency to the National Central Bank); a commercial rate used as a reference for commercial deals inside the country; and a market rate derived from supply and demand equilibrium at the Forex stock exchange. Though these countries are not likely to change their exchange rate regimes dramatically in the nearest future, national authorities are going to monitor the euro and to evaluate a possibility of a shift from a 100% dollar-linked rate to a basket of euros and dollars.

Among the five first-wave candidates (Estonia, the Czech Republic, Hungary, Poland, Slovenia) plus Rumania, more than 50% of exports go to the EU. In Latvia, Lithuania, Slovakia, Bulgaria and Russia this varies from 30 to 44%. (Table 5). In Belarus, Moldova and Ukraine it is approximately 10%.

Table 5 EU links and economic development

Country	Exports (fob) to the EU as % of total exports,1996	Exports (c.i.f.) to the EU as % of the GDP, 1996	GNP per capita PPP, EU=100 1996, %	Share of agriculture in the labour force, %
Slovenia	64.6	29.7	65.2	6.0
Czech Rep.	58.2	22.9	58.5	11.2
Hungary	65.0	19.7	36.2	15.2
Slovakia	41.3	19.8	40.1	12.1
Poland	66.5	12.1	32.3	27.5
Estonia	51.9	25.1	25.1	14.4
Latvia	44.1	12.6	19.6	15.8
Lithuania	33.4	17.5	23.6	18.5
Bulgaria	37.9	19.0	23.0	13.4
Romania	55.9	14.6	24.4	24.0
Russia	30.4	6.2	22.6	14.4
Belarus	*12.2*	3.6	23.6	17.6
Ukraine	*8.0*	4.3	12.0	21.8
Moldova	*11.6*	5.1	7.7	43.0

Sources: Statistical Service of the European Parliament *Statistical Annex on Enlargement Briefing No 22,* Luxembourg, 30 June 1998; European Economy Supplement A No 5 - May 1998; Europe Weekly No 1059, 15 June 1998; Interstate Statistical Committee of the Commonwealth of Independent States *External Economic Activities of the Countries in 1995*, Moscow, 1996; *Commonwealth of Independent States in 1997,* Moscow, 1998.
Note: italic figures refer to 1995

The external trade pattern, however, does not account for the grade of openness of an economy and, thus, may give rise to a certain misunderstanding. The share of exports to the EU in a country's GDP (Table 5) reveals that Slovenia, Estonia and the

Czech Republic are the most dependent on the EU. The proportion of their GDP exported to the EU (23-30%) is double that in Poland, Romania and Latvia (12-15%).

For all the CIS members, trade with the EU accounts for about 4-6% of GDP. Nevertheless, the EU is very important to them, because they buy modern machinery, many manufactured goods and foodstuffs essential for meeting internal demand. For Russia, exports to the EU present a significant source of hard currency for sustaining the official reserves.

The degree of dependence on the EU is also influenced by the overall level of economic development often measured by the GDP per capita. Normally, the more prosperous a country is, the more open its economy is (with the exemption of a very big countries) and, therefore, the greater is its dependence on a strong partner like the EU in terms of intra-industry trade and division of labour. The GDP per capita and the share of agriculture in the labour force (Table 5) are normally linked with such variables as the degree of industrialisation and urbanisation, the overall level of education and the intensity of foreign contacts per inhabitant. These factors are very influential on the attitude of a country towards the euro. Opinion polls in the EU member countries suggest that people living in big cities and having a high standard of education are more internationally-minded and generally demonstrate greater support for the euro.

From this point of view, Slovenia and the Czech Republic have the most suitable general economic background for switching foreign currency operations to the euro. Their GDP per capita is very close to that of the EU Mediterranean members, whilst agriculture accounts for only 6-11% of total employment. Slovakia, Hungary, Estonia, Lithuania, Bulgaria, Russia, Belarus and Latvia form the second most suitable group, as their GDP per capita varies from 20 to 40% of the EU level, whereas the share of agriculture in the labour force ranges from 12 to 18.5%.

Bulgaria, Romania, Ukraine and, particularly, Moldova may face public opposition to the euro beyond their capital and main cities. In the candidate countries of Bulgaria and Rumania, agriculture accounts for a large part of the labour force and GDP, and this is likely to hinder the process of adjusting to the EU economic environment. After 2001, special attention should be paid in these countries to the problem of “the old lady” who may keep German marks or other Euroland banknotes and ignore the euro.

There are also specific features of the area's trade pattern which could foster or hinder the enthusiasm for switching foreign transactions to the euro. Table 6 shows the share of the four “out” countries (Greece, Denmark, the UK and Sweden) in the area's exports. The Baltic states are heavily involved in trade with the UK, Sweden and Denmark and are less dependent on the euro zone than most the rest of candidate countries. To a certain extent, this is true for Bulgaria, which is extensively linked with Greece.

Estonia, Latvia and Lithuania also export extensively to Russia and Ukraine (Table 6). Thus, if the euro is increasingly used in Russia and Ukraine (that is not likely to happen very soon), this will promote a chain reaction in the Baltic states and other CIS European countries such as Belarus, Moldova and Ukraine, all of which are closely linked with each other.

Initially, the euro will become an alternative reserve and invoice currency in Europe and only later will this happen in other parts of the world. For most CEE countries, the share of exports outside Europe oscillates between 10 and 25%. Only Bulgaria, Romania and Russia have strong interests in Asia and other overseas regions (which often account for around 40% of their exports). This naturally reduces the incentive to switch to the euro.

Most raw materials are traditionally traded in dollars. Countries exporting fuels, metal ores, timber, etc. are closely attached to non-European currencies, particularly in the case of Estonia, Lithuania, Ukraine and, especially, Russia and Latvia. (Table 6) This is also true for trade in iron, steel and non-ferrous metals that account for 21% of EU imports from Bulgaria, 16% from Russia, 14 % from Romania, 13% from Slovakia and 9% from Poland.

In Russia, about 2/3 of its foreign trade is with Europe and 80% of its export and import contracts are denominated in US dollars. In banks, only 5-10% of foreign currency operations are carried out in other foreign currencies, mainly German marks and Dutch guilders. To reduce conversion costs, Russian companies exporting oil persuade their foreign suppliers to accept dollars and, therefore, imported goods from Western Europe are often denominated in US dollars.

Table 6 Trade pattern

Country	Exports (c.i.f.) to the four "out" countries as % of total exports to the EU, 1997	Exports to Russia and Ukraine as % of the total exports (average 1995-1997)	Exports outside Europe as % of the total exports (average 1995 - 1997)	Raw materials (SITC 2+3+4) as % of exports to the EU, 1997
Slovenia	5.6	4.0	25.0	2.8
Czech Rep.	9.3	4.0	14.0	9.4
Hungary	8.8	7.0	18.0	5.6
Slovakia	5.5	6.0	10.0	6.8
Poland	15.2	10.0	15.0	10.5
Estonia	37.8	19.0	13.0	39.4
Latvia	40.2	26.0	16.0	64.0
Lithuania	28.3	27.0	21.0	29.0
Bulgaria	26.1	13.0	42.0	9.1
Romania	12.1	3.0	36.0	3.6
Russia	14.6	12.7	39.7	51.8
Belarus	*11.1*	*58.7*	*12.5*	*18.5*
Ukraine	16.2	49.6	n.a.	29.6
Moldova	*10.4*	*59.7*	*7.8*	*5.4*

Sources: see Table 5
Note: italic figures refer to 1995; Ukraine - 1994; columns 2 and 3 for Russia refer to 1996, column 2 for CIS countries refer to Belarus, Moldova, Russia and Ukraine, underlined figures show the shares of mineral products and non-precious metals (data not comparable with the SITC).

On the basis of the above analysis, it is possible to carry out a classification of the euro-orientation and euro-dependence of CEE countries. Three main groups may be singled out, although the boundaries between them are not absolutely distinct.

The first group includes Slovenia, the Czech Republic, Hungary and Slovakia. All are first-rank candidates that enjoy comparatively high living standards (GDP per capita 36-65% of the EU average). Their economies are highly dependent on the EU (19-29% of GDP is exported to the EU). Their trade is directed mostly to Euroland and they have low trade volumes outside the euro zone and Europe. Moreover, manufactured goods dominate their exports. All peg their national currencies to the euro (or a euro dominated basket in case of Hungary). The likelihood of intensifying their economic integration with the EU is high.

Hence, Slovenia, the Czech Republic, Hungary and Slovakia will probably become the pioneers of euro payments in Central and Eastern Europe. They, more than other CEE countries, should pay attention to adequate preparation by embracing different spheres of economy. These four may act as a testing ground for using the single currency with all the consequent benefits and losses, and they should adjust their economic and monetary policies to the euro.

Poland occupies an intermediate position between the core group and the second. Being a first-wave candidate, it has a lower living standard and a less modernised economic structure, including a large number of workers in agriculture. Its economy is less open; the country has extensive trade outside Euroland and a higher share of raw materials (especially coal) in its exports to the EU. 60% of Polish commerce within Euroland is conducted with Germany hence the country will hardly gain from avoiding exchange costs.

The second group comprises the Baltic states, Bulgaria and Romania. Despite the fact that Estonia is a first wave candidate and the rest are not, all have much in common. Their GDP per capita is about 20-25% of the EU average. Their euro-zone orientation is notably weaker: the Baltic states are heavily involved in trade with the UK, Sweden and Denmark and the former USSR republics account for 19-27% of total exports. Around 40% of Bulgaria and Romania's exports go to Asia and Bulgaria has vast trade with Greece.

The North and South edges of the candidate countries area are less exposed to the euro than the centre. Probably, their governments will be able to use the experience of the first-rank group to specify priority spheres, where the switch to the euro might be inevitable and efficient. But they are likely to be somewhat slower in introducing the euro than the core countries.

Eventual development will depend on many special issues, like: the willingness of British, Swedish and Greek firms to use the euro in cross-border payments the fate of the euro in Russia; and, in the medium term, the possibility of using the euro for trade in raw materials, particularly cork and wood that represent 31 % of EU imports from Latvia, 15% from Estonia and 10% from Lithuania.

CIS countries form the third group. In Russia and Belarus, the GDP per capita is similar to that of the Baltic states, Bulgaria and Romania, but in Ukraine it is twice and in Moldova it is four times lower. Being a large country, Russia is, therefore, less integrated in international markets, while the rest of the CIS European countries traditionally have extensive trade with each other, especially Russia. As a result, exports to the EU account for only 4-6% of their GDP. All CIS countries, besides Moldova, have a large share of raw material exports; thus, the currency structure of company liabilities in these countries is dollar-dominated.

In the CIS, citizens are very attached to the dollar. After periods of galloping inflation, the dollar has become a symbol of stability and the only secure currency, so it will not be easy to alter that perception. Moreover, during the first three years, the euro exists in a non-cash form, hence, not suitable for retail payments or putting under a mattress. Currently, citizens in Russia have some $ 40 billion in cash, whilst electronic money and credit cards are unpopular, because even cards like VISA or Mastercard became invalid abroad in September 1998.

All this implies that the CIS's dependence on the euro is low. Besides some special areas, there is little motive to switch to the euro immediately and withdraw dollars from circulation. Thus, they will have time to monitor events in the EMU and candidate countries, and make use of the experience of neighbours. In an emergency, they would be able to manage without the euro.

3. The Euro in Central and Eastern Europe: practical issues

Since 1 January 1999, the euro has become a reserve currency, an invoice currency and a unit of account in Central and Eastern Europe. National central banks issued special letters or instructions for financial institutions and business. For instance, in Russia the Central Bank sent out a letter explaining the main features of transfer to the euro. The letter is based on the European Council's Regulation No 1103/97 "on certain provisions relating to the introduction of the euro"; it also repeats the "no-compulsion, no-prohibition" clause of the Council's Regulation "on the introduction of the euro". The message treats the euro as a reserve currency. The Central Bank recommends Russian banks to convert national currencies of the EU-11 into euros free of charge. Individuals are allowed to open accounts in euros for keeping personal savings and for non-cash operations, including by means of payment cards and letters of credit.

In January, former Russian Deputy Prime Minister Vladimir Bulgak set up an expert group on the euro. The group is headed by Deputy Chairman of the Central Bank, Oleg Mozhaiskov, and includes specialists from the Academy of Sciences, the Ministry of Finance and the banking sector. A recently presented report highlights the most important questions concerned with the introduction of the euro, placing special emphasis on both practical and applied aspects of the coming year. During July it will be discussed by the relevant ministries and, afterwards, the final version should be placed on the Internet and translated into English. In Belarus, there is an expert council that advises the government on topics related to the euro.

National central banks of CEE countries also started to convert their official reserves held in national euro zone currencies into euros. For example, in the Czech Republic and Russia, all the German mark-denominated reserves were from the outset shifted into euro reserves.

From January 1999, central banks started to determine the official rate of a national currency against the euro. In Russia, it is based on the price of rouble with regard to the dollar. The exchange rate of the euro is published in the usual manner in newspapers, it is also announced by TV and radio. The Central Bank has established special procedures with a number of interbank currency exchanges for carrying out operations with the euro. The Moscow Interbank Currency Exchange has elaborated the necessary legal and technical terms and started operations with the euro on 19 January 1999.

Though the issue looks technical, it is, in fact, a political one, particularly in Central and Eastern Europe. Here, national authorities face a choice: to determine an exchange rate against the euro via the dollar or to let national markets decide on an independent rate against the euro. The first alternative is suitable for 1999, because the markets have not yet become accustomed to operations with the euro and, in many Central and Eastern European countries, especially in CIS, the volumes of traded euros are too small to form the true price of the new currency. There are two facts that may considerably hinder the process of developing national euro markets. First, financial markets in Central and Western Europe are far less deep and liquid than in the West. Second, certain areas of Central and Eastern Europe (e.g. Russia, Poland, Lithuania) still are dollar-dominated. However, if a national government continues to determine the exchange rate against the euro via the dollar, this will just make the euro a non-decimal denomination of the dollar and, thus, national operators will have little interest in the euro.

An independent exchange rate would make them alert and help to form a true Forex market with all the necessary attributes, including currency arbitration. National markets will get an opportunity to make a conscious choice between the dollar and the euro, taking into account their economic background and an international role. The latter may be of special importance for Central and Eastern Europe, since the dollar has been used extensively by many regions affected by financial crises. Consequently, its value may deviate considerably from underlying fundamentals of the American economy and bear significant discrepancies of a psychological nature.

Special attention should be paid to government external debt. In Russia, about 35-40% of the external obligations are denominated in German marks and other national currencies of the euro area. During 1997 and 1998, Russia issued two tranches of eurobonds for seven years each, amounting to DEM 3.25 billion. The sum will be paid back when German marks no longer exist. Russia, like other Central and Eastern European countries, would prefer that the switch to the euro will not deteriorate the terms of returning money.

Even up until now, it is still not clear whether the individual EU members or the EU will be in charge of the re-denomination. According to the *lex monetae*, this is the prerogative of a country whose currency was used to create the liability. It would be useful to have consultations between the EU and Central and Eastern European states on this topic. If the EU declares its position, the non-EU European countries will feel more secure and the problem will be more transparent. A co-ordinated approach could be used with regard to all of the Central and Eastern European countries (partly based on harmonised rules elaborated for re-denomination of the EU bonds).

Some peculiar questions may arise. One of the most tricky is a shift from national-based reference interest rates to Euroland-based rates. It is not yet clear whether a transfer from, for instance, DM-LIBOR to EURIBOR may alter the agreed terms. The problem may be caused by the fact that, relying on DM-LIBOR, parties aimed to use interest rates derived from the future economic performance of Germany. In the case of EURIBOR, they, *de facto*, use interest rates proceeding from the whole Euroland economic performance, which is far from being the same as in Germany.

As EU legislation does not have extraterritorial scope, the Council regulations on the legal status of the euro cannot be taken for granted in third countries including Central and Eastern Europe. Consequently, legislative loopholes are likely to appear. It is not yet clear whether and how the "no-compulsion, no-prohibition" rule will be applied to entities outside the EU. Do debtors outside the EU have the privilege of opting for a currency of payment if their contract with an EU company is signed in German marks or French francs? Some lawyers say "yes", because the "no-compulsion, no-prohibition" rule creates an obligation for an EU creditor to accept a payment in euros; but, having no extraterritorial scope, it does not create a similar obligation for a creditor that is located outside the EU.

If the EU banks do not charge for conversion of the euro to national currencies and *vice versa*, the problem will not arise. But if some banks do, will companies outside the EU have the same rights as their EU partners? Will, for instance Central and Eastern European financial institutions feel free about using euros in their liabilities? At present one cannot exclude that firms or banks in CEE countries may find themselves in an ambiguous situation, whereby no legislation will protect their interests. It seems more rational to fill the legislative gap now, than to appeal to courts in the future.

Difficult situations may emerge in relations between two non-EU countries with regard to liabilities denominated in a euro zone currency. For instance, Russia traditionally uses French francs in contracts with Morocco and other francophone African countries. One may not be sure that the *lex monetae* will allow all controversial points to be resolved, especially if the law of the EU contradicts the local legislation of a defendant. Obviously, there is a need to carry out a wide study of the legal issues related to the external use of the euro. It would be very useful, because many regions are going to face similar problems (for example French-speaking Africa, or, in the near future, many countries using the pound sterling - in the event that the UK joins the EMU). It would also encourage third countries to develop a favourable attitude towards the euro.

The EU and Central and Eastern European lawyers' associations may elaborate a standard set of clauses that may be used by partners willing to adjust valid contracts to the euro. Perhaps, a code of good conduct might be designed for EU companies doing business with non-EU European partners.

In the banking sector, the euro is expected to pave its way in two directions. First, many people may be interested in having credit cards in euros, particularly those who travel throughout Europe. Second, it is very likely that government and commercial credits from the EU-11 will be granted in the single currency, especially with regard to long-term loans and loans with a complicated mechanism, like syndicated credits and credits with a floating interest rate. Logically, in future tranches of eurobonds issued by Central and Eastern European countries, the share of euro-denominated obligations will increase, also because the present interest rates in the EU are significantly lower than, for instance, in the United States.

Nevertheless, there are fears that the 'securitisation' process in the EU induced by the advent of the euro may damage the CEE countries' access to EU financial resources. The rationale behind this thesis is that markets are currently witnessing a shift in the “ideology” of operators - if, until recently, they concentrated their attention on exchange rate risks, they now focus on credit risks. Hence, the latter are very likely to fall. In this respect, less developed countries will find themselves in a more difficult position, since their credit ratings are far from high.

Companies and banks in Central and Eastern Europe that will receive loans in euros will have to learn how to operate with them. They will also have to adjust their relations with domestic recipients of the loans. In countries like Russia, where the dollar is the measure of value, this process might take time and cause problems. The growing euro will speed up these events because, if a national bank receives credits in appreciating euros, it would be absurd to grant loans to clients in depreciating dollars.

Investments proceeding from the EU-11 (and probably from the rest of the European Union) are also very likely to be denominated in euros and, together with credits, may become an important channel by which the euro can penetrate CEE markets.

As previously mentioned, difficulties may arise in a number of countries (e.g. Russia, Ukraine, Poland, the Baltic states) over internal settlements involving importers who buy goods in the EU for euros. For example, in Russia many enterprises (in industry, trade or services) quote prices in so-called “conventional units”, that, in fact, mean a rouble equivalent of the dollar on the day of payment. Since it has been prohibited to conduct domestic (national) settlements in dollars, companies use the above-mentioned mechanism to avoid exchange rate losses. As inflation has bounced because of the crisis, these habits (that had been steadily disappearing before) are now gaining ground again.

If the dollar is appreciating, a Russian foreign trade company makes a profit when it has a contract with an EU supplier in depreciating francs or euros, but settles payments with a Russian wholesale company in the dollar equivalent. However, if the euro starts to appreciate, the intermediary will suffer losses and will be forced to talk his Russian partner into arranging settlements in a euro equivalent. The latter will not be an easy thing to achieve, as domestic companies are attached to the dollar, have little faith in the euro and no practice in using it. If a CEE importer is a big firm in an industrial centre, it will be more willing to accept the new currency than a small or medium size enterprise in a remote place. This is not unusual - similar differences in attitude can be traced almost everywhere, including the EU.

EU-11 subsidiaries and joint ventures located in Central and Eastern Europe will have to train personnel, modernise software and adjust accounting to the single currency. As a rule, they currently have two types of accounting reports - in the local currency and according to local prescriptions, and in the currency of the main office. Soon, they may switch the latter to the euro or have to prepare a third euro-version of a balance sheet.

The Central and Eastern European countries do have leverage to facilitate or hinder the spread of the euro in their territory. In order to create a favourable attitude to the single currency, the national central bank may issue explicit instructions to commercial banks on the rules for switching over to the euro. In countries where dollars are widely used, the introduction of a direct conversion rate from the dollar to the euro should make the latter much more attractive (in order to change dollars for German marks at present in Russia, a person must first sell dollars for roubles and then sell roubles for marks, losing up to 20% of the original sum altogether). Moreover, national governments have a wide scope of administrative instruments for regulating the process. The position of the mass media could also be vital.

There are questions that can be tackled only with the efforts of both sides. In three years, Central and Eastern Europe (as all other third countries) will have to cope with a change of national banknotes to euros. The terms of this change should be defined beforehand. Citizens in CEE countries, especially in remote and rural areas, should at least know how they can convert banknotes and what kind of risks they run by keeping them after June 2002.

When Germany introduced new banknotes in 1994, many Russian banks, especially in the provinces, refused to accept valid banknotes six months before they ceased to be legal tender. The unfortunate owners of the “old” marks took them to Moscow as a last resort. Large banks in the capital accepted the notes without any limits. Meanwhile, some financial institutions in the provinces made profit by buying banknotes at a discount rate. In 1996, there were no problems caused by a change of dollar notes. Everybody was well informed about the conditions and procedures. In Moscow, they were repeated on TV every half an hour.

Measures against forgery and counterfeiting should be taken in both parts of Europe, because populations will not be familiar with the euro banknotes and coins, and forged banknotes may easily undermine the reputation of the new currency. The EU-Russian Partnership and Co-operation Agreement contains a special clause on common measures against money laundering and, in practice, parties do exchange information and take joint measures. Similar steps will be needed against forgery and counterfeiting. The EU’s help to the CEE countries and, especially, the Russian police will be essential also from the point of view that Russia lies between Asia and Europe.

In the medium run, Central and Eastern European raw material exporters (like Russia, Poland and Baltic states) and the European Union may have to decide (probably at state level) whether the euro may be used as an invoice currency in contracts for the sale of oil, gas, coal, timber, ores and metals. Evidently, such a practice could be profitable for both sides. At present, Russia's biggest gas exporter, *Gazprom*, uses the principle of a balanced currency basket in its long-term contracts. In 1998, 53% of its export revenues from non-CIS countries were in dollars, 33% in German marks and the remaining 14% were in French francs and Austrian shillings. This approach may be part of a general shift in world trade in regard to invoicing traditions. In this respect, the European Union will have few instruments to influence Russia’s or Poland’s decision, and only goodwill on the part of both sides may lead to a positive outcome.

Naturally, banks and companies in the Central and Eastern European countries will have numerous questions related to the euro. Small and medium enterprises may suffer from a lack of information. It would be very useful if CEE authorities and major banks were to launch a euro information campaign. Though it should not be as wide as in the EU, the demand for detailed and reliable data must not be neglected. Timely and proper information will help the euro find its feet in the region, and, moreover, will reduce risks of committing mistakes and infringing the law while switching to the single currency. Perhaps, the European Union should provide technical and financial support for these activities. EU experience would be of great use. EU banks dealing with Central and Eastern Europe could probably contribute to the dissemination of knowledge; above all, it would help them to acquire new clients and gather valuable data about the needs of the CEE market.

A conference or a meeting between the ECB and national central banks of the Central and Eastern European countries would be helpful. It could pinpoint the most acute problems and form a draft strategy for the future. The rationale behind this is that many of the difficulties experienced by the Central and Eastern European countries may be very similar; hence, it may be easier to have a common approach towards them. European experience might also be useful in settling problems related to the euro with other regions of the world.

It is worth thinking about introducing similar supplementary clauses in EU Association Agreements with the candidate countries and in Partnership and Co-operation Agreements with the CIS members. These clauses may tackle the most important issues connected with the introduction of the euro and should foresee co-operation in financial matters.

It would be useful to have bilateral *ad hoc* bodies (probably within the Association or Partnership and Co-operation Agreements) dealing with routine questions related to the euro. A special telephone line or an Internet page, and/or an information committee, could be extremely useful, especially during 1999 and 2002.

4. Candidate countries: a long way to the EMU

To become a member of the euro zone, a candidate country must fulfil two types of criteria. First, those needed to join the European Union and, second, those needed to join the EMU itself. The European Council in Copenhagen in June 1993 identified the economic and political requirements for accession to the EU. They are:

- Political: to achieve "stability of institutions guaranteeing democracy, the rule of law, human rights, and respect and protection of minorities".
- Economic: to have a "functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union".
- Institutional: to be able "to take on obligations of membership, including adherence to the aims of political, economic and monetary union".

The economic criterion, therefore, consists of two parts: 1) to create a functioning market economy; and 2) to be able to counter competitive pressure within the Union. Both of the parts entail a number of preconditions that require great effort and time to be met (Cas Granje, A. 1999). A functioning market economy means:

- equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;
- significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent:
- the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
- macroeconomic stability has been achieved including adequate price stability and sustainable finances and external accounts;
- broad consensus about the essentials of economic policy;
- the financial sector is sufficiently well-developed to channel savings towards productive investment.

In order to be able to face competition inside the EU, a country's economy should reach a minimum level of competitiveness. The elements to be taken into account include:

- the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;
- a sufficient amount of human and physical capital, including infrastructure, education and research;
- the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SME, etc.;
- the degree and the place of trade integration a country achieves with the Union before enlargement (the volume and commodity structure of trade);
- the proportion of small firms in a county's economy.

The fact that the European Union switched to a single currency from 1 January 1999 implies that any future candidate country will have to conform with the already existing "stock" of the community *acquis*, including monetary integration. Three distinct phases regarding the adoption of EMU *acquis* can be identified, namely:

1. the pre-accession phase, covering the period up to accession;
2. the accession phase, covering the period from accession to adoption of the single currency;
3. the final phase, with the adoption of the euro.

During the pre-accession phase the candidate countries have to implement steps taken by the present EMU members during the first stage of the EMU, namely: to liberalise capital movements; to prohibit any direct public financing by the central bank and to eliminate any privileged access of the public sector to financial institutions; to make its central bank fully independent and devoted to the price stability goal.

Upon accession, CEE countries will be members of the Union and, hence, will be part of the single market, but will not adopt the single currency. Their status will be similar to that of countries with derogation (like the UK or Denmark). They will have to comply with the following requirements (Cas Granje, A. 1999): adherence to the aims of the EMU; treatment of exchange rate policy as a matter of common interest and, probably, participation in ERM-2; co-ordination of economic policies within the EU; avoidance of excessive government deficits in accordance with the Stability and Growth Pact; further adoption of the status of the central bank with a view to participation in the European System of Central Banks (ESCB); progress towards the fulfilment of the Maastricht criteria.

Their participation in the euro area will be decided on compliance with the Maastricht criteria and the achievement of a high degree of sustainable convergence. However, prior to accession, there is no need to assess progress made on convergence criteria - these figures may be used only as an additional reference (Cas Cranje, A. 1999, Ionita, L. 1999).

Table 7 Inflation, interest rates and budget balance in candidate countries in 1997

Country	Inflation rates		Long term interest rate	Budget balance (% of GDP)
	1997	1998*		
Bulgaria	1,089	35	12.0	-2.6
Czech Rep.	10.0	12	13.2	-2.2
Estonia	11.1	10	19.8	2.4
Hungary	18.1	15	32.6	-4.5
Latvia	8.5	5	15.3	-1.4
Lithuania	8.9	7	14.4	-1.9
Poland	13.0	10	25.5	-3.5
Romania	154.8	54	35-40**	-4.5
Slovakia	6.4	10.4	18.7	-4.9
Slovenia	9.1	8	21.3	-1.2

* forecast
** estimates
Source: European Parliament “The Economic and Monetary Union (EMU) and the Enlargement of the European Union” Briefing No 34, Luxembourg, 4 December 1998.

High inflation has been one of the less desirable consequences of transition to a market economy in former socialist states. After 1990, inflation rapidly reached very high levels in all applicant countries.

The inflation targets proposed for these countries illustrate the distance to be travelled before convergence with the EU average (1.3% at the beginning of 1998 [European Parliament, 1998c]). Interest rates in the candidate countries, naturally, shadow inflation rates and, hence, are also much higher than in the European Union.

As for the exchange rates, the most stable currencies during 1991-1997 were the currencies of the Czech Republic, Estonia, Lithuania, Slovakia and Latvia. At the end of the aforementioned period, their exchange rates had declined from the 1991 rates within limits of ± 25%. In Poland, Hungary, Slovenia and Lithuania national currencies devalued 2-2,5 times. The Romanian *leu* experienced a 30-fold depreciation, and the Bulgarian *leva* rapidly devalued until June 1997, when a currency board was introduced.

The deficit and debt positions may be regarded as satisfactory in most applicant countries. Many of them achieved considerable improvements in their budgetary positions in the early 1990s, largely through drastic cuts in public spending. After the first few years, however, economic recession caused a fall in tax revenues and, thus, budget deficits bounced in some countries (Hungary, Czech Republic, Slovenia, Estonia, Romania and Lithuania). As for overall debt, all candidate countries with the exemption of Bulgaria (80% of GDP) and Hungary (73% of GDP) comply with the Maastricht criterion. In certain countries, the ratio is significantly below the benchmark: 10-20% in the Czech Republic, Romania, Latvia and Lithuania; less than 40% in Slovenia and Slovakia (European Parliament, 1998c).

Most applicant countries have set in train policies which lead to fulfilment of the criteria. However, unforeseen economic or political developments could derail the process. The economies of these countries are fragile with much of the financial infrastructure still new and untested (European Parliament, 1998c).

Nevertheless, the candidate countries will have to meet the convergence criteria in an extended and deepened formula, because of the requirements contained in the Stability and Growth Pact. It would be much more difficult for them to take the EU train than it was for the newcomers of previous enlargements. Applicant countries will face towering challenges on their way to the EMU, namely, they will have to (Stepniak, A., 1999; Klein, M., 1998):

- enter ERM-2 on a "voluntary" basis and stay within its bands, to be ready to defend their currencies unilaterally without simultaneous interventions from the side of the ECB;
- to adjust their monetary policy to the strategy undertaken by the ECB, the Commission and the Council having little power to influence the decision-making of the latter;
- to maintain long-term low inflation and interest rates, to keep their budget deficits below 3% of GDP;
- to conduct tax policies compatible with the present Community strategy in this area.

Applicant countries will, naturally, have to co-ordinate their economic policies with the Union's objectives and to submit stabilisation programmes. Future membership in the euro zone may be achieved only along with crucial sacrifices. The most important of these are: deprivation of sovereign rights in the monetary sphere and long-lasting constraint in public spending. For countries in transition this could constitute a real threat to the policy of structural modernisation. The effects of the Russian crisis on certain parts of Central and Eastern Europe are testimony to the fact that they still have a high degree of dependence on the CIS. Consequently, a universal ECB monetary policy may be not suitable for CEE countries and, hence, trigger unfavourable economic performance. A possible slow-down in the Union's growth may also seriously damage CEE macroeconomic variables, since the latter highly depend on EU investment, credits and imports.

Small and very open CEE economies are more exposed to external shocks than many EU countries. Some of them are excessively dependent on energy imports and/or on agricultural exports. If world prices for oil or gas go up sharply, or prices for alimentary products go down, the probability of an asymmetric shock will be much higher in candidate countries than in the Union. (Palankai, T., 1998).

Indeed, candidate countries currently demonstrate, more or less, satisfactory fiscal development. One should bear in mind that the underlying economic fundamentals give little ground for cheerful forecasts. Governments in some CEE countries have been carrying out massive privatisation of the former state sector and this has alleviated central budgets considerably. However, this source of revenue cannot last long. Several governments still hide debts in bad loans consolidated in state-owned financial institutions.

Meanwhile the accession process will entail significant spending and, thus, pressure on budgets. According to World Bank estimates, Poland alone will have to spend $6.6 billion in the next few years to take on EU directives on regulatory and administrative structures. Slovakia will have to invest $300 million annually over the next twenty years to comply with EU environmental legislation. There is little likelihood that the European Union will be able (and willing) to cover all these expenses. Current negotiations on the reform of the Common Agricultural Policy (CAP) and ardent disputes on the fate of structural funds leave little room for such hope.

If the candidate countries just cut spending on public and social needs, it will hinder structural reforms, particularly infrastructural adjustment, and may cause a drop in standards of living, thus, increasing the gap between CEE and the Union. The latter consequence is dangerous for both parties. In the event that CEE governments increase taxes, they may repress investment activity without receiving appropriate revenues, simply due to the fact that the average *per capita* income in these regions is low.

Thus, a hypothetical, premature adherence to the EMU could have a damaging impact on a national economy (as well as negative effects on the rest of the euro zone). If a country is not able to maintain long-lasting, low inflation rates and to follow severe budget discipline, it had better stay outside the EMU in order not to run the risk of suffering financial and moral punishment in line with the Stability Pact. Extraordinary measures to counter inflation and a budget deficit are very likely to bring only temporary and nominal results, while causing serious in-depth macroeconomic discrepancies.

Despite numerous difficulties, candidate countries are sticking to the goal of entering the EU and the euro zone. There are several reasons for this. First, for countries whose currencies were not convertible for decades and then experienced rapid devaluation throughout the transition years, joining the EMU is a benefit of unique significance. The promise of a stable single currency has great influence on public opinion. Second, belonging to a stable monetary zone improves the allocation of sources of capital, makes national capital markets deeper and more liquid. It may also improve the overall national business environment and make the country more attractive from the point of view of foreign investment. (Palankai, T., 1998).

The most ambitious aim is to become a part of an economic, political and, in future, monetary superpower. If the euro is a success (and its share in world trade and finance is equal or close to that of the dollar), CEE countries in the foreseeable future may invoice their foreign contracts in the national currency, including purchases of oil and gas (Palankai, T., 1998). The EU newcomers will enjoy the possibility of being treated as equals by the IMF, World Bank, other international organisations and powerful countries. Evidently, it would be of enormous strategic benefit - something which CEE states could not think of in the past.

Conclusions

1. The EMU (barring failure, which is unlikely), which added to the increasing globalization of the 90s, will lead to even **greater interdependence** of both parts of Europe. Prosperity can no longer be achieved in Europe on an individual basis.

2. It is essential for both the EU and Central and Eastern Europe that the euro takes root in non-EU Europe. This is a question of a **strategic importance** for them rather than a question of commercial benefits (e.g. with the cessation of exchange rate volatility, savings will be much less in CEE countries than they are considered to be). In the presence of an alternative international currency, CEE countries are to formulate a **more active** monetary policy.
3. The advent of the euro may be used by the two parts of Europe as an additional powerful lever to achieve lasting stability, to create a more favourable business environment and wider markets, and to facilitate access to resources. It also raises numerous practical issues, many of which require bilateral efforts. In order to solve them and reap possible benefits, the EU and Central and Eastern Europe need **more intensive co-operation** and co-ordination in many spheres (monetary, economic, political, etc.). This dialogue requires the appropriate institutional bodies.
4. In Central and Eastern Europe there are **three main groups** of countries with regard to the euro. Staying outside the EMU, they will demonstrate different speeds at switching foreign transactions to the euro, and, consequently, they need different preparation strategies. This means that the impact of the euro on pan-European consolidation will have a different intensity and character according to the region.
5. Candidate countries have a **long way to go to EMU** membership. In order to achieve real convergence, it is not sufficient to fulfil the nominal Maastricht criteria - greater efforts are needed. Those countries which succeed will gain a strategic advantage of unique significance. Premature entry into the euro zone is fraught with harmful effects on growth and social development.
6. The EMU will intensify pan-European economic consolidation **before** certain applicant countries **join the euro zone**. For most CEE countries, the euro will remain a foreign

currency for a long time, and its consequent influence on EU-rest of Europe' relations will dominate the next 10-15 years, at least.

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