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Monetary Policy Strategies after EU Enlargement

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I. Introduction.

The title of this conference is 'Challenges for Central Banks in an Enlarged EMU', and the remit for my contribution is to examine what could be learned from other central bans in this respect. With this in mind I start in the next section by identifying what I perceive to be the main challenges resulting from the enlargement. In view of the small size of the accession countries I argue that there are only two real issues that need to be discussed; the question of the size and composition of the decision making body of the ECB and their impact on monetary policy decisions on the one hand, and the choice of monetary/exchange-rate policy in the accession countries themselves during the transition to EMU membership on the other. These two issues will be taken up respectively in Sections III and IV.

The main conclusion from Section III is that in the absence of the first-best solution consisting of delegating monetary policy to a monetary policy committee made up of recognized experts, the ECB should address the problem of decision making in an enlarged Governing Council by explicitly adopting a strategy based on inflation forecast targeting and by changing its communication strategy accordingly.

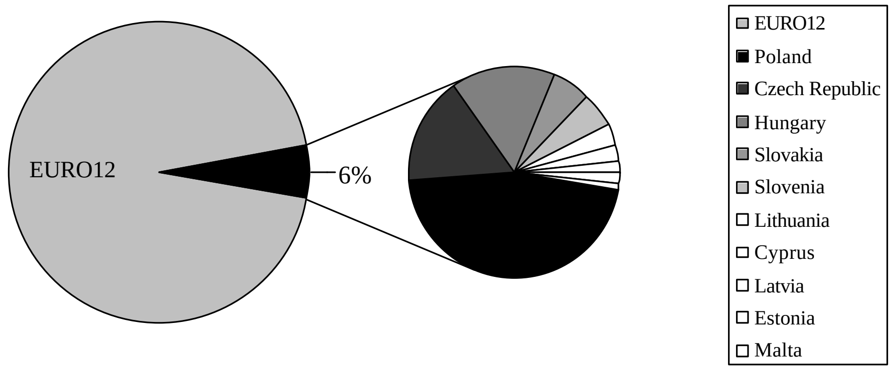
In Section IV I draw on the experience of Finland's transition to EMU membership to argue that those accession countries that are currently pursuing inflation targeting as a monetary policy should continue to do so during the two-year period they are likely to have to spend in an ERM2 arrangement. There is little to gain, and potentially a lot to lose, from switching to an exchange rate based monetary policy even though the ERM2 membership implies announcing a central rate between the local currency and the Euro during the transition period.

These conclusions are briefly summarized in Section V of the paper.

II. A Taxonomy of Challenges facing Central Banks.

What are the monetary policy challenges of the EU enlargement? In this section I will examine this question from two perspectives. I will identify the issues facing different central banks (the ECB, those in accession countries, non-member countries) on the one hand, and I will look separately at the period of transition to EMU membership and the period after enlargement has been completed on the other. First, however, a word of caution is in order. When we discuss the challenges for monetary policy posed by the accession of ten more countries to the Euro area, it is important to keep in mind that the countries in question are economically speaking very small. Figure 1 illustrates this by showing the size of the accession countries GDP relative to that of the EURO12 countries as a group.[1] The total size of the ten newcomers is less that six percent of the combined GDP of the current Euroland countries. To make the point differently, adding the ten new countries to the EURO12 group is similar to adding another Netherlands!

Figure 1: The relative size (by GDP in 2002) of the EURO12 region and the accession countries



To appreciate the implication of this small size, consider how the problem for the ECB of keeping inflation within its acceptable range might change as a result of the inclusion of the ten accession countries. We know that the Balassa-Samuelson effect is likely to imply a higher inflation rate in the faster-growing new EU members than in the EURO12 group. In order to have an inflation rate that is two percent on average for the entire region, this implies that the average inflation rate in the EURO12 countries must be

[1] An appendix contains a more detailed figure on the relative size of the accession countries themselves. It reveals that three countries – Poland, the Czech Republic, and Hungary – together make up almost eighty percent of the combined GDP of the ten accession countries.

somewhat less. How much less is illustrated in Table 1.[2] Buiter and Grafe (2002) estimate the size of the Balassa-Samuelson effect to be such as to make the inflation rate in the accession countries about 1.5-2.5 percent higher than in the current Euroland members.[3] This implies that the inflation rate in the latter countries will have to be in the range 1.91-1.85 percent if the ECB aims for and succeeds in delivering two percent on average. Even if the Balassa-Samuelson effect should turn out to be an implausibly large 4 percent, the inflation rate in the EURO12 countries would only have to fall to 1.76 percent.

Table 1: The (un)importance of the Balassa-Samuelson effect for aggregate inflation in the EURO12 countries

Size of the Balassa-Samuelson effect	Maximum inflation rate in the EURO12 countries required to keep the aggregate EURO22 inflation rate at 2%	Inflation rates in the accession countries
0	2	2
0.5	1.97	2.47
1	1.94	2.94
1.5	1.91	3.41
2	1.88	3.88
2.5	1.85	4.35
3	1.82	4.82
3.5	1.79	5.29
4	1.76	5.76

With these statistics in mind, let us examine the main issues introduced by the enlargement for, respectively, the ECB, individual current EMU members, new EU countries, EU countries which are not part of the EMU, and finally the rest of the world.

II.1. The ECB.

From a strictly technical point of view the problem for the European Central Bank of conducting monetary policy will not change appreciably in an enlarged EMU. The small size of the accession countries means that neither the information content of

[2] The table assumes a weight of 0.06 for the accession countries in the aggregate EURO22 price index. The Balassa-Samuelson effect refers to the inflation differential between the EURO12 countries and the accession countries.
[3] See also the recent study by Mihaljek and Klau (2003) which puts the central estimate of the effect at 2%.

relevant economic statistics nor the transmission mechanism of policy changes to inflation and output will be appreciably modified. One could argue that the inflation objective should be revised upward marginally. If 2% (or just below) is optimal for EURO12, and if there is a Balassa-Samuelson effect in the accession countries, a case can be made that the objective for the aggregate EURO22 inflation rate should be adjusted upward by ten or twenty basis points.

A more important impact will be the effect on the decision-making process and/or the perception of this process in financial markets. The current decision-making body, the Governing Council, has eighteen members of which the Executive Board constitutes one third and the Governors of the central banks of the member countries the remainder. With the enlargement the Governing Council will have twenty-eight members, and the proportion of the Executive Council would be reduced to just over one fifth. As a consequence there is a risk that decision-making will suffer gridlock, that it may be captured by coalitions of national interests, and that it will be misunderstood by financial markets and economic agents in general. How to deal with this aspect of the enlargement has of course been debated both inside and outside the ECB, and I will add some elements to the debate in Section III below. Essentially I will argue that the enlargement may constitute an opportunity of the ECB to adopt a more focused strategy both in terms of substance and in terms of communication.

During the transition process the policy of the ECB will remain concentrated on the current members, and the accession countries will attempt as best they can to fulfill the convergence criteria imposed on them as a condition for EMU membership. Their small size, however, implies that the monetary policy questions facing the ECB will normally be unaffected. Problems will only arise if the convergence process becomes messy in the sense that it will be associated with exchange-rate and financial crises in a number of the accession crises.[4] Such crises might have an impact on the euro region to the extent that commercial banks there are suffer significant losses or to the extent that financial markets are subject to contagion. The obvious insurance against this problem arising lies in the design of the transition process, a topic I will touch on in Section IV.

[4] See, for example, Begg, et. al. (2003).

II.2. Individual central banks in current and future Euroland countries.

These central banks have no individual monetary policy autonomy, so the only monetary policy issues of concern after the enlargement of Euroland relate to their role in the decision-making process of the ECB. As already mentioned, this will be discussed further below.

During the transition, the accession countries obviously have a lot at stake. They basically face three types of decisions: when to seek entry into the ERMII, how to conduct policy in the meantime, and how to ensure that the purgatory[5] within the ERM2 goes smoothly. Some lessons from central banks that have gone through a similar process will be brought up in Section IV.

II.3. Non-member EU countries and non-EU countries.

This group of countries will only be influenced significantly to the extent that the Euro area as a whole, and therefore the policy of the ECB, is affected. As discussed above, the likelihood of this happening is essentially limited to the implications for the decision-making structure of the ECB. If the transition process leads to financial instability in the accession countries, there may be some additional effects on countries outside the Euro area, but these effects are likely to be quantitatively small due to the limited size of the financial markets of the accession countries. In any event, there is not much central banks outside the Euro area can do about this problem

What do we retain from this taxonomic listing of the potential effects of EU enlargement on central bank policy? Only two issues are really important: 'How will the enlargement influence the decision making process within the ECB and therefore its policy and the perception of its policy?' and 'How should the transition period be designed and managed?'. Following my remit for this paper, I will discuss what the experience of other central banks can teach us about these issues.

[5] According to the online Mirriam Webster dictionary purgatory means "a place or state of temporary suffering or misery" which seems quite an appropriate description.

III. The ECB in a Euro Zone of 22 countries: problems and opportunities.

I have argued that the main problem facing the ECB in the enlarged Euro Zone will be to manage a decision making body that could contain up to twenty-eight members. In increasing order of importance the challenges relate to:[6]

- the efficiency of monetary policy meetings in a context where each of the 22 central bank governors may find it necessary to intervene to make general statements describing the economic situation in her/his country. The focus on substantial Euro-wide issues may be lost and with it the information for a sound interest rate decision.
- the potential conflict between the Executive Board, which is supposed to take a comprehensive Euro-area view of policy objectives, and the Governors, who are typically suspected of having more narrow national interests in mind.
- the possibility that coalitions formed between small countries lead to voting on interest rate changes that serve the interest of only a tiny minority of the population in the Euro Area.

Unless these issues are dealt with carefully there is a risk not only that the actual monetary policy will be suboptimal, but also that the ECB's policy will be misperceived by financial markets thereby potentially causing increased volatility in asset prices and, by extension, in economic activity.

The solutions have mostly been discussed in term of changes in the representation and/or voting rights of each NCB Governor at the Governing Council. The alternatives mentioned most frequently are:[7]

- Delegation of interest rate decisions to a small group of experts, as is done for example in the United Kingdom and Sweden.
- Creation of constituencies among member countries along the line of the practice at the IMF.

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[6] The issues that follow have of course been identified in the literature. See for example Buiter and Grafe (2002) , Baldwin, et.al. (2001), and Gros (2003).
[7] See, for example, Eichengreen and Ghironi (2001).

– Rotating membership among the NCB Governors.

The first of the three addresses all the identified difficulties associated with the increased number of Euro countries. Efficiency in decision making is ensured by the small size of the group and the risk of national bias can be reduced by establishing a mandate which explicitly states that the monetary policy should be conducted exclusively with the Euro area as a whole in mind. In my opinion, this would be the most desirable decision-making structure. The drawback of the solution is political in that it reduces the role of national representatives, and may therefore meet with resistance from member governments.

The second and third alternatives are intended to reduce the number of votes of national representatives at the expense of the Executive Board. If pushed far enough it may lead also to a more efficient size of the decision-making group, but it is not clear that it will solve the problem of national bias in the decisions. In fact, it may be argued that these solutions make this problem worse, because they make it explicit that the governors who do vote are representatives of a specific country or group of countries. As such they may feel the need to represent their constituency rather than take a Euro-wide view of monetary policy.

The proposal that the ECB put forward in December 2002 and endorsed by the European Council in March 2003 appears to be a combination of the second and third alternatives. It envisages that for the purpose of voting in the ECB Governing Council the NCB Governors will be assigned to groups each of which will be given a certain number of votes. Each group will have a fewer number of votes than the number of Governors represented therein. Hence there will be a rotation among the Governors of voting rights within each group.[8]

A serious problem with the ECB's proposal is that it appears to endorse the notion that the Governor's represent their country. This is implicit in the principle of weighted voting, where the weights are determined by some measure of the size of the country/region where the voter comes from. The Governors may therefore be judged by

[8] See European Union (2003).

how well they represent their group's interests rather than how well they represent the interests of the Euro zone as a whole.[9]

The Council decision which endorses the ECB's proposal will have to be ratified by the Member States. It is therefore not certain that it will take effect. In event that it will, however, there is a need to find other ways to make sure that the decision-making process in the enlarged Governing Council will produce the desired monetary policy.

We can frame the problem as one of trying to align the interests of the national representatives on the Council with the principle that ECB policies should be focused on the Euro-zone as a whole. If we think of the national representatives as having an objective function that contains both national and Euro-zone variables, the solutions we are searching for are those that will increase the weight on Euro-zone variables in this objective function on the one hand, and that will penalize decisions that are based on purely national concerns on the other.[10]

III.1. Focus policy analysis, decisions, and communication on an inflation forecast.

The emphasis on the Euro-zone as a whole in the interest rate decisions of each NCB Governor on the Governing Council could be enhanced if the preparatory analysis and the internal policy discussion were focused on an inflation forecast for the region as a whole.[11] Before each monetary policy meeting the staff of the ECB would prepare forecasts for the Euro-zone inflation rate based on assumptions and scenarios supplied by the Council members. The forecasts would be communicated to the NCB Governors for comments, and if need be they would be recalculated based on revised assumptions and scenarios.[12]

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[9] For an extensive criticism of the ECB proposal, see Gros (2003). Gros also emphasizes that the proposal also does not call a large enough reduction in the number representatives on the ECB Governing Council thereby failing to address the question of the effectiveness of the decision-making process.

[10] These are analogous to appointing a 'conservative central banker' and designing 'performance contracts' in the conventional inflation-bias literature.

[11] As minutes of the discussions of the Governing Council are not available, it is not possible to know for sure to what extent this is done at present. What is clear, however, is that the Monthly Bulletin of the ECB does not contain the same emphasis on inflation forecasts as most inflation-targeting Central Banks. I will comment further on this below.

[12] This way of proceeding is basically what is done in countries like Norway, Sweden, Switzerland and the UK at the present.

Focusing on an inflation forecast for the region as a whole would have several advantages in the context we are concerned with. NCB Governors would be compelled to couch their arguments for interest rate changes in terms of their effect on the inflation forecast, which would almost automatically give the appropriate weight to conditions in each individual country. In order to have an influence on the final decision, Governors of small countries would have as much incentives to understand and comment on conditions in larger countries as the Governors from the latter. This is likely to increase the quality of the policy analysis and lead to interest rate decisions which are based on improved background analysis. To the extent that coalitions among Governors would form, their impact on the overall interest rate decision would get the 'right' weight because their joint arguments would have to be made with reference to the Euro-zone inflation rate.

III.2 Publish minutes and voting records of the Executive Council meetings.[13]

Focusing the internal analysis and the Council discussion on an inflation forecast would help tilt the incentives of the individual members in the right direction, but it can not guarantee that when it comes to voting on interest rate changes, a member of the Council will not take a resolutely nationalistic perspective. Some form of penalty would be useful to guard against this eventuality.

Publishing the ECB staff inflation forecast and underlying analysis together with the minutes of the Council discussions as well as the voting records would go some distance towards providing such a penalty. The staff forecast would provide the benchmark against which the analysis and voting of the individual members could be judged, and publishing the minutes and voting records would lead to some external pressure to take decision on the basis of comprehensive rather than parochial economic conditions.

Publishing inflation forecasts is a common feature of the communication strategy of inflation-targeting central banks. Fracasso, Genberg, and Wyplosz (2003) document that 19 out of 20 central banks which pursue inflation targeting publish inflation forecasts in what is typically called an Inflation Report. The Inflation Reports furthermore devote

[13] The suggestion that the ECB should publish inflation forecasts, minutes of Executive Council Meetings and voting records is not new of course. For an early debate see Buiter (1999) and Issing (1999). Linking these issues to the enlargement of the Euro region may be somewhat novel, however.

significant space to explaining the construction of the inflation forecast and its significance for monetary policy. Fracasso, Genberg, and Wyplosz argue that the overall quality of an Inflation Report depends in part on the quality of the analysis underlying the inflation forecast and on how well it is conveyed. In addition they claim, and present some supporting evidence, that a more informative Inflation Report leads to more predictability of monetary policy.

The alignment of the individual NCB Governors' interests with those of the Euro-zone as a whole can never be perfect since it is the governments of the Member States who appoint their local Central Bank Governor, and since the Governor is guaranteed a seat on the ECB Governing Council. However, if both the minutes of the discussions and the voting records are made public, then external scrutiny from the European Parliament, the specialized press, or other monetary policy watchdogs will provide an important offset to the temptation to pander to national interests.

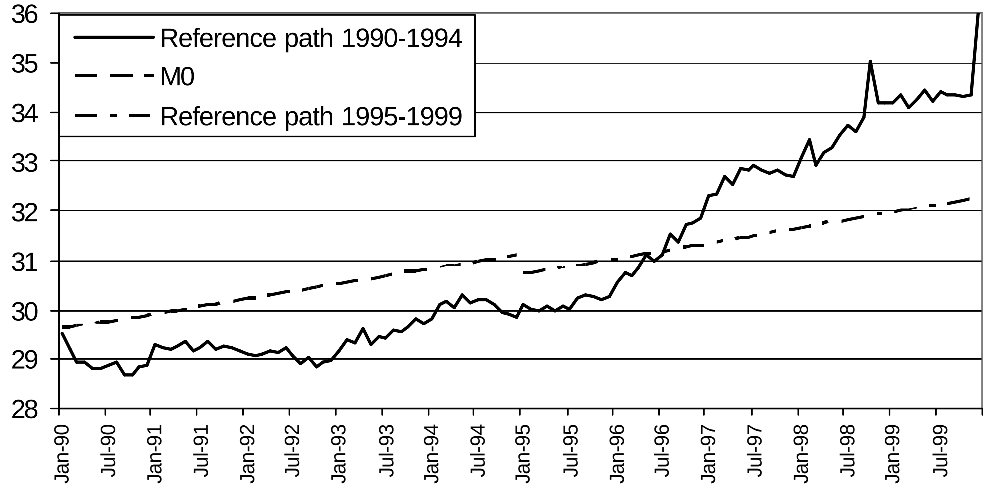
III.3. Changing Strategy to Increase Transparency: Lessons from Switzerland.

Would dropping the current two-pillar strategy in favor of an approach which focused more squarely on an inflation forecast be well understood by financial markets, or would it on the contrary be interpreted as an admission that the current system is flawed and thereby lead to a loss of credibility of the ECB? A review of the experience of the Swiss National Bank (SNB) may be of interest since it has recently introduced a similar change in its policy strategy. Although many other countries are now basing their monetary policy decisions on inflation forecasts, the Swiss case is of particular relevance because the evolution of the SNB's strategy is quite similar to that of the Bundesbank/ECB except it has been carried farther, some would say to its logical conclusion.

Excellent descriptions of Swiss monetary policy since the early seventies are available in Rich (2000) and Rich (2003), and only the highlights will be presented here. After abandoning the fixed exchange rate in the early seventies, the SNB pursued conventional monetary targeting until the early 1990ies as a way to achieve price stability.[14] By conventional monetary targeting I mean setting annual targets for some monetary aggregate. Even if details of the implementation differed, the approach was not unlike that of the Bundesbank at the time. The policy strategy was quite successful judged by the evolution of the average rate of inflation during this period.

Due in part to changes in the domestic payments system in the latter part of the 1980ies, the usefulness of monetary targeting started to be questioned both inside and outside the SNB. The central tenet of monetarism, that inflation is a monetary (aggregate) phenomenon, was not questioned but the focus of monetary policy changed from year-on-year growth rates to a medium term path of the money supply. Hence, starting in 1990 the SNB couched its policy strategy in terms of a five year reference path for the monetary base. This path was defined as the value of the money supply that would be consistent with price stability provided the economy were operating at its capacity level. The last proviso made clear - in principle but as it turned out not in practice - that the SNB did not intend to make the actual level of the monetary base follow the reference path at all times. If the economy was not operating at capacity, and if other conditions so dictated, the SNB would allow the money supply to wander away from the reference path for extended periods of time, and it did (see Figure 2).

Figure 2: Switzerland, deseasonalized central bank money and reference paths. (Source: SNB)



[14] The only exception was a brief interlude of exchange-rate based policy in 1978/79 to counter what was then perceived as a clear misalignment of the Swiss Franc/US Dollar exchange rate.

While the new approach had the merit of focusing on longer-term money growth rather than on year-to-year changes, the fact that the actual value of the money supply had no apparent link with the reference path created confusion.[15] Although the SNB took great pains to explain the strategy, it was never well understood in the markets, and in 2000 the SNB gave it up in favor of an approach based on an inflation forecast.

In several respects the reference value for the money supply relied on by the SNB in the nineties resembles the first pillar of the ECB's current strategy: (i) they were/are both intended to give a medium term orientation to monetary policy, (ii) when the money supply deviated/deviates from the reference value there is no presumption that it will be brought back to it in the near term, and (iii) neither was/is well understood by the public and by financial markets. For this reason it is of interest to ask whether the switch to an inflation-forecast targeting regime in Switzerland had any noticeable effects on the economy.[16] Clearly it is too early to tell whether the properties of the inflation and output paths have changed, so I will limit the comparison to the predictability of monetary conditions as measured by interest rates. Specifically I calculated the difference between the realized 3-month Swiss Franc Libor rate in London and the predicted rate based on the 3- and 6-month rates three months earlier.[17] I then compared the mean absolute value of these differences in the period 1990-99 with the mean absolute differences thereafter. The result is that average forecast errors are smaller in the period of inflation targeting since 2000 and the difference is significant at the 5.2 percent level. This suggests that the policy based on and explained in terms of an explicit inflation forecast is more predictable that one based on a monetary aggregate. Although this by itself is not conclusive evidence that the switch to the inflation-forecast regime has been a success, it does suggest that it was well received by financial markets.

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[15] See Genberg and Kohli (1997) for a critique of the approach and Rich (1997) for a rebuttal.

[16] The SNB does not refer to its strategy as being one of inflation targeting, but in my view this is a matter of semantics rather than substance.

[17] Specifically, let i_{t+i}^{j} stand for the *j*-month interest rate at time $t+i$. Then the expectations theory of the terms structure implies that $1+i_t^6=(1+i_t^3)(1+E_t i_{t+3}^3)$ from which we can derive the forecast error for the 3-month interest rate as $i_{t+3}^3 - E_t i_{t+3}^3 = i_{t+3}^3 - \dfrac{i_t^6 - i_t^3}{1+i_t^3}$.

What lessons if any can we draw for the ECB from this episode in Swiss monetary history? The first pillar of the ECB's monetary policy strategy is as misunderstood as the reference paths for money used by the SBN. Whether or not it is theoretically flawed is not the real issue. What matters principally is whether the approach delivers the desired outcomes, and in this respect predictability of the strategy is generally considered an advantage. The evidence from Switzerland suggests that abandoning a misunderstood policy approach may have positive consequences.

IV. Monetary and Exchange Rate Policy in the Transition to EMU Membership. [18]

Buiter and Grafe make a strong case that the ten accession countries should be allowed to enter the EMU without having to go through a two-year waiting period within an ERM2. They argue in particular that it makes little sense for the EURO12 countries to impose such a waiting period, because the small size of the accession countries means that whatever adjustment difficulties they would have in a rapid accession scenario would have trivial effects on the current EMU members. They also suggest that a rapid entrance into the Euro area will not necessarily involve greater adjustment pains than a drawn out one. While I fundamentally agree with this position, it appears that there will be no concession from the EU with respect to the entrance requirements of new members. Hence they will be expected to enter into an ERM2 by declaring a central rate for their currency with respect to the Euro. They must then gear economic policies towards maintaining the spot market exchange rate within ± 15 percent around that central rate. They will also need to fulfill the other Maastricht convergence criteria. In this section I will look at some options and implications that follow from the ERM2 requirement, and in so doing I will draw some lessons from two current EMU member that come closest to providing relevant points of comparison, namely Austria and Finland. These two countries only joined the EU in 1995 and entered into the ERM shortly thereafter with the hope of qualification for EMU membership when this was decided in May 1998. In other words, they did not have a long history of EMS membership behind them when the two-year test period started.

[18] This section draws heavily on Genberg (2000).

Austria had followed a 'hard-currency' policy since the early eighties by which the Shilling had stayed within very narrow margins of fluctuations relative to the German Mark.[19] Credibility for the policy had been built up by the pursuit of consistent fiscal policies and by managing to form a broad consensus that it was in Austria's best interest to maintain the hard currency strategy. It was therefore obvious that upon entry into the EU and the EMS, the only reasonable strategy was to continue this strategy within the ERM and not to contemplate making use of the larger margins of exchange-rate fluctuations allowed in this arrangement. For Finland the choice was less obvious.

IV.1. Finland's transition to EMU.

IV.1.1 From an adjustable peg to floating with inflation targeting.

Until the early 1990s, the cornerstone of monetary policy in Finland was a pegged exchange rate. During the Bretton-Woods period, the value of the Finnish markka was pegged to the US dollar, first at about 3.20 to the dollar and then, after a devaluation in 1967, at 4.20.

After the breakdown of the Bretton-Woods system in the early 1970s, the Finnish authorities continued with a unilateral fixed exchange rate regime, but switched to a basket of currencies as the anchor. Macroeconomic policies were however often too permissive leading to cost crises and balance of payments difficulties requiring occasional devaluations. Thus, the markka lost about sixty percent of its value relative to the German mark from the mid-1970s to the end of the 1980s.

When the strains on the European Monetary System emerged in the early 1990s, the currency pegs of non-members were not spared. Having been affected strongly by the break-up of the Soviet Union, Finland became one of the earliest countries to be attacked by currency speculators. Doubts about the ability of the authorities to maintain the fixed exchange rate in the face of the loss of a major export market lead to pressures on the markka and eventually a currency crisis triggering a devaluation in the fall of 1992.

Rather than attempting to continue the pegged exchange rate policy of the past, the Finnish authorities took the opportunity of the 1992 crisis to change strategy. They

[19] See Hochreiter and Winckler (1995).

opted for a floating exchange rate and a monetary policy based on inflation targeting. The new policy regime delivered the desired reduction in inflation and a partial convergence of interest rates towards the German levels.[20] The preparation for the entry into EMU was thereby laid.

IV.1.2. EU membership and the decision on EMU.

Finland joined the EU in 1995 after the Maastricht Treaty had been elaborated. By signing this treaty without any special ‘opt out’ clauses that Denmark and the United Kingdom had negotiated, Finland was committed to join the monetary union. Although the Parliament would be asked to decide on the matter of EMU membership, it was generally felt that the real question was not whether Finland would join, but when it would do so.

It was clear to the Finnish authorities that membership in ERM would be a very useful, if not completely necessary, prerequisite for EMU membership. Finland therefore joined the ERM in October 1996, not quite two years before decision of the EU Heads of State on which countries would qualify for membership.

IV.1.3 Monetary and exchange rate policy leading up to EMU membership.

Even after joining the ERM and declaring a central rate of the markka relative to the ECU and therefore to the other member currencies, the Bank of Finland continued to conduct monetary policy as it had since the adoption of the inflation targeting strategy in 1992. Exchange rate stability did not replace inflation as the objective of monetary policy neither in public pronouncements nor in its day to day actions. How was this possible in view of ERM membership, and what role did this policy strategy play in rendering the transition period relatively smooth? Several factors seem to have been important.

- The 15 percent wide bands within the ERM allowed considerable movements away from the central rate before any speculative capital flows would threaten the parity.

[20] The inflation rate fell from about six percent at the end of the 1980s to just slightly over one percent in 1995.

- Markets seemed to believe that the chosen central rate was appropriate, so they had no reasons to speculate against it. In addition, the fact that the authorities never stated that they would defend any particular value of the markka implied that there was no specific target rate speculators could focus on.
- Sound fiscal and monetary policies. The government's budget balance improved from a deficit of about 3 percent of GDP in 1996 to a deficit of 1 percent in 1997 and a surplus of 1 percent of GDP in 1998. Inflation also declined from about 2 percent in 1997 to slightly under 1 percent at the end of 1998.
- Luck.
  - The decision to join the ERM coincided with the start of a cyclical upswing in the Finish economy. The strength of the economy meant that the pressures on the currency were towards strengthening rather than weakening, and it is easier to maintain credibility for the central rate in this case compared to a situation where there are pressures in the opposite direction. This is particularly the case for a country that has had a history of currency devaluations.
  - There were no particular events – internal or external, of a political nature or otherwise – that lead to pressures on the ERM or to serious doubts about the EMU project.

IV.1.4. Are there lessons to be drawn from the experience of Finland?

Finland spent its time in the ERM pursuing inflation targeting. Although it had a history of currency devaluations, the new monetary policy strategy did not only bring about and maintain low inflation, it was also conducive to exchange rate stability. In fact, comparing the two ERM years with the two years immediate prior, the volatility of the FIM/DEM rate fell by a factor of three. Even without an explicit exchange rate anchor for monetary policy, the market exchange rate converged smoothly towards the conversion rate during the last months prior to the introduction of the Euro in 1999.

IV.2. Implications for monetary policy in the accession countries?

It is useful to make a distinction between those accession countries that are already following policies based on a hard exchange rate peg, e.g. Estonia and Lithuania, and those that have adopted inflation targeting as their monetary policy strategy, notably the Czech Republic, Hungary and Poland. The former group of countries is essentially in the position that Austria was prior to joining the ERM, and there is no reason to suggest that they should change their policy.

For countries that are currently pursuing monetary policies based on inflation targeting the situation is different. They essentially face three choices. One is to opt explicitly for a narrow band within the ERM and to copy completely the monetary policy of the European Central Bank. This is the policy adopted by Austria, and it could be defended on the grounds that it would signal clearly intentions to adopt the monetary policy of Euroland, and would speed up de facto monetary integration with the rest of the members. The drawback of this strategy is that it the one most disposed to being ‘tested’ by the markets, and could therefore be subject to speculative attacks.

A second strategy would be to choose a wider band, and to adopt an exchange-rate based monetary policy. By this is meant a strategy where the policy instrument is adjusted primarily in response to deviations of the exchange rate from the central rate, and where interventions in the foreign exchange market are used for the same purpose. This strategy would be less constraining than the first, in that it would permit some macroeconomic adjustments by means of temporary exchange rate movements. It would however represent a break with current practice and may for this reason not be well understood. In particular, inflation convergence may not be as complete with an exchange rate based policy as with explicit inflation targeting.[21]

The third strategy is to continue the current inflation-targeting approach, while at the same time being part of the exchange rate mechanism. An objection that has been made to this strategy is that it could lead to ‘too much’ exchange rate volatility compared to what is compatible with the Maastricht criteria for being admitted to the EMU. The objection might be well taken in a context of a freely floating exchange rate, but during a transition period within the ERM2 a central parity will have been established, and it will be known that this exchange rate will become the conversion rate upon entry to the EMU. Under these circumstances, speculation in the foreign exchange market is likely to be stabilizing, and actual volatility relatively limited. The experience of Finland is consistent

[21] Svensson (1995).

with this view. Recall that before joining the ERM, the markka was floating and the Bank of Finland was pursuing an inflation targeting strategy. There was no fundamental change in policy after the entry into the ERM, but the volatility of the exchange rate vis-à-vis the German mark was reduced substantially.

The third strategy of continuing the status quo is the one to be preferred for those accession countries that are currently pursuing inflation targeting. Provided that other macroeconomic policies are consistent with the announced conversion rate, this strategy will contribute to a smooth transition to EMU membership. It also has the advantage of not requiring any change in the explanation of monetary policy by the respective central banks.

Of course, the inflation targeting strategy will have to take into account the constraint of the exchange rate commitment implicit in ERM2 membership. In particular, the target rate must exceed that of Euroland by an amount roughly equal to the expected Balassa-Samuelson effect in order to permit the required real appreciation with a stable nominal exchange rate.

V. Summary and Concluding Remarks.

The enlargement of the EU by ten countries will eventually also lead to an enlargement of the Euro area. The accession countries are economically very small, however, as they represent only about 6% of the combined GDP of the current Euro-zone countries. This means that the monetary policy implications for the ECB will be limited essentially to the question of its decision-making structure. In the absence of a fundamental reform in which the monetary policy decisions are delegated to a small monetary policy committee made up of independent experts, I argue that the enlargement represents an opportunity to for the ECB to adjust its policy approach and communication strategy. I believe that focusing monetary policy decisions explicitly on Euro-zone inflation forecasts will go some way towards diminishing potential problems associated with the large number of country representatives relative to Executive Council members on the ECB's Governing Council. To increase the incentives for country representatives to focus on conditions in the Euro-zone as a whole, the ECB should also publish minutes of monetary policy discussions as well as voting records. Evidence from Switzerland suggests that abandoning a monetary policy strategy which, like the current two-pillar strategy of the ECB, is not well understood in favor of explicit inflation-forecast targeting can have beneficial effects on the predictability of monetary policy.

The other significant monetary policy issue associated with the enlargement of the EMU concerns the monetary policy strategy the accession countries should follow during the time they have to spend in the ERM2. I focus on whether those countries that currently target inflation should change and adopt a strategy more geared towards an exchange rate target. The experience of Finland is instructive this respect. When Finland entered the ERM in 1996 it continued to conduct monetary policy based on the inflation-targeting strategy it had adopted after the exchange-rate crisis in 1992. The result was an uneventful transition period within the ERM as exchange rate volatility decreased substantially and the market rate converged smoothly towards the Euro conversion rate. I conclude that the inflation-targeting central banks in the accession group - essentially the Czech Republic, Hungary, and Poland - should maintain their current monetary policy strategy. There is little to gain, and potentially a lot to lose, from switching to an exchange rate based monetary policy even though the ERM2 membership implies announcing a central rate between the local currency and the Euro during the transition period.

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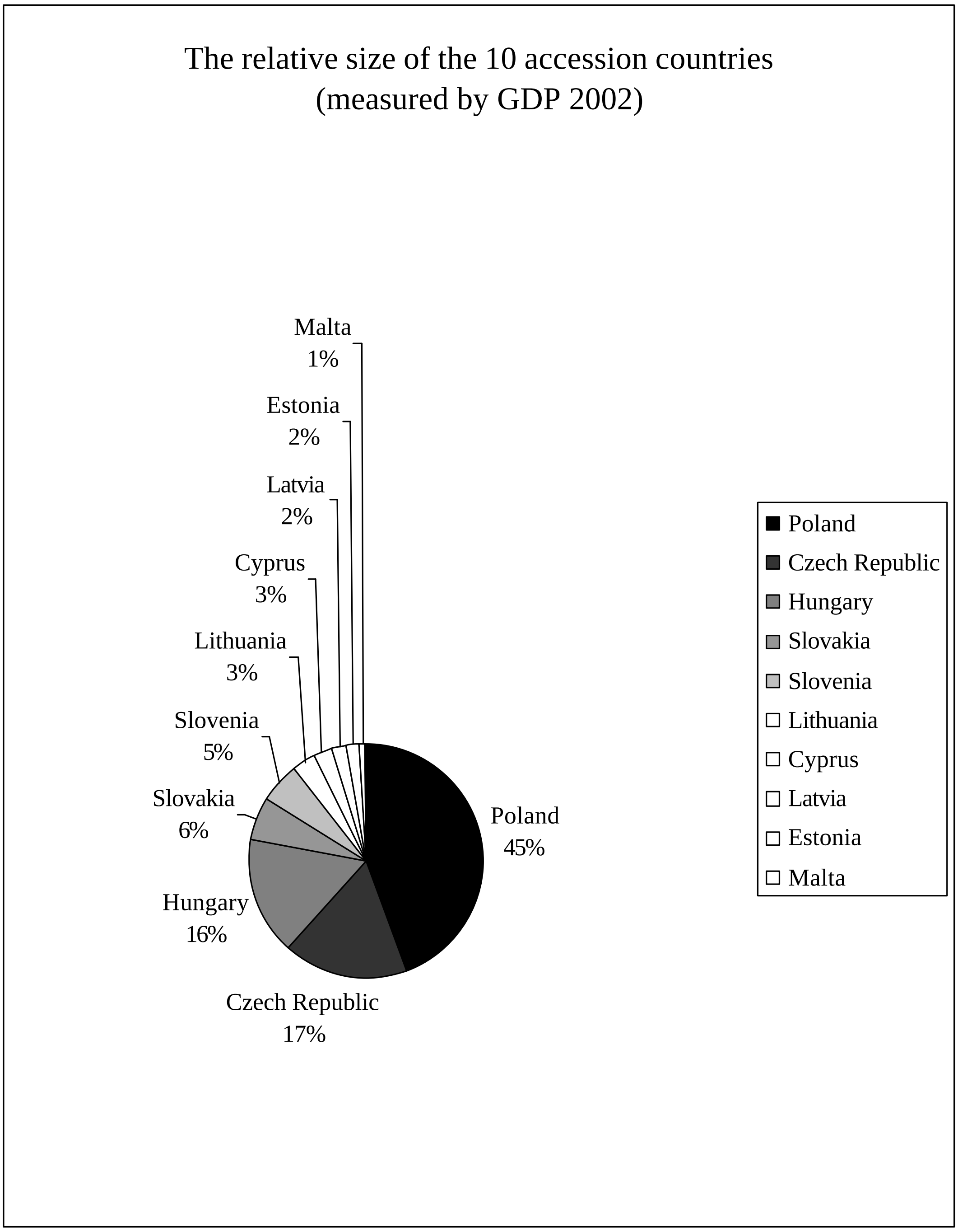
Appendix


The relative size of the 10 accession countries
(measured by GDP 2002)
Malta
1%
Estonia
2%
Latvia
2%
Cyprus
3%
Lithuania
3%
Slovenia
5%
Slovakia
6%
Hungary
16%
Czech Republic
17%
Poland
45%
Poland
Czech Republic
Hungary
Slovakia
Slovenia
Lithuania
Cyprus
Latvia
Estonia
Malta