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Anchor, Float or Abandon Ship: Exchange Rate Regimes for Accession Countries

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Abstract

The Paper considers alternative exchange rate regimes for the 10 East European accession candidates, both prior to EU accession and during the period following EU accession but prior to EMU membership. We conclude that from an economic point of view, EMU membership should be as early as possible, preferably at the same time as EU membership. The prevailing interpretation of the exchange rate criterion for EMU membership is that it requires two years of successful membership in the Exchange Rate Mechanism (ERM). If ERM membership presupposes EU membership, this would postpone the earliest possible date for EMU membership till two years after EU membership. Unrestricted financial capital mobility would be required during this period. We argue that a stay of two years or more in this 'ERM purgatory' would be pointless and costly. A derogation or waiver of the exchange rate requirement would therefore be desirable. Any credible fixed exchange rate regime prior to EMU membership would risk running afoul of the inflation criterion for EMU membership because of the Balassa-Samuelson effect. A temporary recession might be required to crawl under the inflation hurdle. To avoid this, a derogation from the inflation criterion for EMU membership, or a re-interpretation in terms of the inflation rate for traded goods prices only, is recommended. The use of the euro as a formal parallel currency in accession countries prior to EMU membership (or even prior to EU membership) deserves serious consideration. This would not require a derogation from any of the Treaty requirements.

Keywords: EMU, enlargement, euroisation, Balassa-Samuelson effect

JEL Classification: E42, E44, F15, F31, F33, F41

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