Studien

des Instituts für den Donauraum und Mitteleuropa

Nr. 1 | Jänner 2003

Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU

IMPRESSUM

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Vervielfältigung
Raiffeisen Zentralbank AG
Am Stadtpark 9
A-1030 Wien

Das Institut dankt der Raiffeisen Zentralbank für die gewährte Unterstützung.

Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU

Papers of Participants of the Summer School "Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU"

Eisenstadt, April 27 – May 11, 2002

Institut für den Donauraum und Mitteleuropa
Institute for the Danube Region and Central Europe

Fachhochschule Eisenstadt
University of Applied Science for International Business Relations

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Dr. Michael Jandl

In the spring of 2002 the negotiations for the 5th Enlargement of the European Union had entered a difficult phase. After successfully closing about two-thirds of all chapters in the negotiation process, the most difficult chapters (agriculture, competition policy, structural funds and the budget) were now up for negotiation and led to substantial haggling between the negotiation partners. However, it was clear to everyone that even the most controversial issues defining the terms of the accession process would eventually be resolved and would give way to the start of the most significant political development in Europe since the end of the Cold War: the full integration of the former communist countries of Central and Eastern Europe (CEE) into the structures of the European Union. With that goal in mind, policy-makers in the European Union and the Candidate Countries concentrated their efforts on successfully closing the negotiations for enlargement by the end of 2002 so that – leaving enough time for the lengthy ratification process of the accession treaties – the new members could then join the EU in 2004 and participate in the elections to the European Parliament in that same year.

While the precise terms and conditions of the accession process were already taking shape, the more difficult question had become: What comes after that? In particular, for policy-makers in the CEEC preparing for their integration into the EU, the question now is: what policies are called for to best prepare our economies for the new challenges the Common Market will pose? Obtaining clear answers to this question will determine whether or not the enlargement of the EU to Central and Eastern Europe will be judged a success or a failure.

To contribute to this debate, and to provide young academics from the region the opportunity to learn from eminent economic experts in a relaxed atmosphere, the Institute for the Danube Region and Central Europe (IDM) in cooperation with the Fachhochschule Eisenstadt for International Business Relations organised a special summer school on the topic "Long-term strategies for the Central and Eastern European Candidate countries after their entry to the EU". This special summer school for postgraduate students specialising in the economics of EU-enlargement took place from 27th April to 11th May 2002 in Eisenstadt, Austria. A total of 18 participants from 9 European countries took part in the program. The seminars were all held in English and were taught by 15 internationally renowned experts from the fields of academia, politics and business. Five subject areas were covered: Structural Policy, Monetary Policy, Agricultural Policy, Trade Policy and Foreign Direct Investments. All participants had to present their own research papers on a selected topic in one of the five subject areas. Following the presentation, there was room for critical discussions and suggestions for improving the research papers. In the follow-up to the summer school the revised papers were then collected and edited. From all the submitted papers an expert panel selected 14 research papers to be of sufficiently high quality to merit publication.

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3. MONETARY POLICY

Monetary Policy - The Cases of Poland, Hungary and the Czech Republic

Krystyna Mitręga-Niestrój, Peter Halmosi, Přemysl Rosulek

The transition from centrally planned to free market economies and future entry to the EU and EMU, pose serious challenges for monetary policy in Central and Eastern European countries. Among many of the important problems in the area of monetary policy is the question of an adequate exchange rate system. The choice of an exchange rate mechanism is important, since the resultant exchange rate will, naturally, affect a number of crucial macroeconomic and microeconomic variables. Exchange rate policies vary widely across the CEEC and the transition countries have adopted different exchange rate systems and followed contrasting exchange rate policy courses.

In our presentations we focused on different areas of monetary policy – exchange rate policies, interest rate policies and problems concerning foreign investments. One of the many common problems in our countries was inflation.

Poland

At the beginning of the nineties, the choice of the exchange rate mechanism in Poland was determined by high inflation. The adoption of a fixed rate pegged to the US dollar in January 1990, and the rapid devaluation of the polish *zloty*, were instrumental in halting inflation and restoring confidence in the national currency. Then, an accumulation of negative effects (especially a rapidly growing current account deficit) called for a change of the underlying exchange rate policy towards greater flexibility, so in May 1991 – the crawling peg was introduced. As for the exchange rate policies in the years 1990–1995, one cannot but admit that the reforms instituted by the Central Bank in that period were beneficial to the economy, and that all the Central Bank's principal objectives were successfully accomplished. But at the beginning of 1995, the crawling peg was increasingly seen as too heavy a burden for the monetary policy, as evidenced by the rapidly growing foreign exchange reserves. As a consequence, negative macroeconomic effects (in particular, the excessive growth of official foreign currency reserves, the new forceful inflationary trends and the foreign exchange market disequilibria) led the Central Bank, in May 1995, to significantly alter its exchange rate policy. The crawling peg was replaced with the crawling band, which had a pre-announced and gradually diminishing rate of monthly devaluation (initially at ±7%). The new exchange rate control mechanism that was put in place in 1995, represented a vital step towards increasing the role of the market in determining the *zloty* exchange rate and towards a greater flexibility of the rate. In the middle of the nineties, Poland started to be a very attractive place for foreign investors; the Polish currency appreciated in value, which then led to a deterioration in the balance of trade. Poland also experienced an influx of speculative foreign capital, further increasing foreign currency reserves. The financial crisis in 1997 caused a drop in the value of capital inflows to Poland but, already in 1998, substantial interest rate differentials and good economic prospects brought back foreign portfolio inflows

and this again undermined the stability of the exchange rate regime. Inflation at that time was definitely too high to justify getting rid of the existing exchange rate mechanism. But in September 1998, the monetary authorities published the "*Medium-term Strategy of Monetary Policy, 1999-2000*" and, according to this document, there were important grounds for the adoption of direct inflation targeting. The maintenance of an exchange rate band, however wide, was not possible in this new inflation strategy, which required the liberalization of the exchange rate mechanism. What is more – the maintenance of the existing exchange rate was also dangerous in conditions of the liberalization of capital movements. The change of the exchange rate system could not be carried out immediately and the introduction of a floating exchange rate was only possible in April 2000.

Hungary

After transition (in 1992-1993), inflation was the biggest problem for Hungary. To deal with this, the Hungarian National Bank relied on increasing future productivity and, therefore, applied foreign deficit financing, which:

- invigorated domestic demand through real appreciation,
- decreased exportability.

The outcome was a growing cumulated deficit and increasing inflationary pressures. The general development of the economy became somewhat unpredictable and the economic recession continued, making an anti-inflation policy unfeasible. This was the consequence of a structural change in the economy and not of a wrong policy choice. The National Bank and the government drew the conclusion that making growth dependent on an increase of the current account deficit could not be pursued.

In 1994, the decrease of confidence continued and, after the Mexican crisis, FDI began to flow out of the country. In 1995, the "Bokros-packet" was launched to repair the damage caused by the distortion of prices. After making the necessary macro-structural changes, the current account then started to improve. This was achieved by reducing real wages and government expenditures. This stabilisation process did not decrease aggregated demand but changed its structure in favour of a reduction in export consumption on the one hand, and government expenditures on the other. Also in 1995, the crawling peg system was instituted and attention was drawn towards prudent budgetary policy. After 1998, the current account deteriorated, from –848 million EURO in 1998 to –2020 million EURO in 1999.

Inflation: in December, 2001 inflation reached 6,8% but this was largely due to isolated factors (the decrease in prices of raw foods and fossil fuels). In 2002, Hungary is confronting stagnating inflation (in 2003 inflation is predicted to be 3,9%).

Trust: after September 11th there was an initial shock which disappeared quickly after U.S. military action, but the crisis in Argentina caused additional problems, as can be seen from Hungary's regional risk (the real interest rate of the Deutsche mark bonds issued by the MNB has increased).

The Czech Republic

Since 1997, when there was a currency crisis in the Czech Republic, the exchange rate has been floating. This crisis has caused a growing deficit in foreign trade. Another concern was the growth of salaries, which was not accompanied by increasing productivity. Before the crisis inflation was about 6%, but afterwards it went up to 10.7 % (in 1998). The monetary authorities raised interest rates, but the restrictive policy threatened an economic slowdown.

Within a short period of time inflation remained at a lower rate than that which had been expected by the Central Bank, leading to criticism of the Czech government. In 2000, the inflation target was between 3,5% and 5,5%; for 2001 between 2% and 4%, and for 2005 expectations are for it to be between 1% and 3%.

Since 2001, there has been a new system for targeting inflation: the Central Bank does not take account only of "pure inflation" but of inflation with regard to deregulation and taxation. The year 2001 was the first year since the currency crisis when the inflation expectations of the Central Bank were proved correct.

At the end of 2001, the Czech crown (CZK) was getting much stronger and the Central Bank admitted that it did not have the power to control the currency, and initiated the privatization of its own reserves. Another option was that investors would pay partly in CZK. In 2001 and at the beginning of 2002, the Czech National Bank (CNB) and the government came to the following agreement: the CNB would buy incomes from the government and spend part of the income devise reserves.

Despite several CNB interventions until the end of April 2002, and repeated steps towards decreasing interest rates, the CZK continued to strengthen against the EURO. The CNB started to be criticized for losing money. Today, the Czech currency is still too strong and exporters would like to see an exchange rate of between 33-34 CZK per EURO. However, the CNB has no realistic means of achieving this target and all the measures that have so far been taken to remedy the situation have proved to be fruitless.

Conclusions

From the above we can see that no one single exchange rate mechanism (and, of course, no single monetary policy in general) could be applied to all countries. What is more, the exchange rate mechanisms have evolved over time in response to changes in the internal and external economic environment. Among the factors that influenced changes in the exchange rate mechanisms were: the speed of reform implementation, the degree of openness of the economy and the magnitude and composition of capital movements.

Future membership of our countries in the European Exchange Rate Mechanism (in 2004) and Economic and Monetary Union – i.e. replacing our currencies with the euro (in 2006) - will change the existing exchange rate mechanisms.

The introduction of the euro and entry into EMU will have important benefits but also some costs. The most important benefits will be: a reduction in the exchange rate risk and a decrease in transaction costs. The most significant cost will be the loss of national sovereignty in monetary policy. Nevertheless, the euro and EMU remain the future for Poland, Hungary and the Czech Republic because we still have difficulties in the micro- and macro-spheres of our economies.

Exchange Rate Policy in Hungary

Peter Halmosi

After the change in 1989, political and regulatory changes were the main targets of the government's economic policy and, within monetary policy, exchange rate policy was the only area whose tangential role was not argued with. The main aim of exchange rate policy in the 1990's was to hinder the acceleration of inflation and maintain the competitiveness of exports. The question of whether these goals are reconcilable was justified at the beginning. There was a great danger that accelerating inflation would lead to growing pressure for devaluation of the currency through increasing costs, then after the devaluation it could stimulate inflation by increasing import prices and start a so-called price-devaluation-price spiral. The economic transition was not going without a hitch.

An important milestone in Hungarian monetary policy was the LX regulation of 1991 by the Hungarian National Bank (MNB) which defined the tasks of monetary policy:

a) Stabilising the purchasing power of the national currency;
b) Operating the domestic payment system;
c) Striving for internal and external financial balance, stable development and international integration of the national economy.

To achieve this, the MNB was able to influence the supply and demand of money and credit through instructing monetary institutions. At the same time, foreign credit withdrawals were no longer made through MNB as before, but through companies as well as through local and central government and, since 2002, households which have also been able to apply for foreign exchange credit. However, their obligation of informing the MNB remained in some cases. Since then, the MBN is no longer responsible for any positive or negative changes in the cumulated national deficit.

Through the law, the MNB was given regulatory means to defend the exchange rate. It really needed this because there was great pressure on the Hungarian current account in the early 90's: a huge import surplus originated from the so-called „lacking economy" which was a feature of Hungary in the 80's and which caused serious displacement in the structure of trade and was also accompanied by high inflation. These inflationary pressures led to the devaluation of the national currency. At the beginning, this was carried out in big steps without warning and so was unpredictable. Later, any correction of the exchange rate was made at certain periods: through bigger devaluations at the beginning of the year and then smaller corrections at other times of the year, the MNB tried to increase the degree of estimation. The first step in breaking inflationary expectations was the opening of the foreign exchange rate market in 1992, where market effects played a role in determining the exchange rate. In 1990, a new currency basket was introduced based on the foreign exchange system of exports and imports. Since December 1991, this basket has consisted of the US dollar and the